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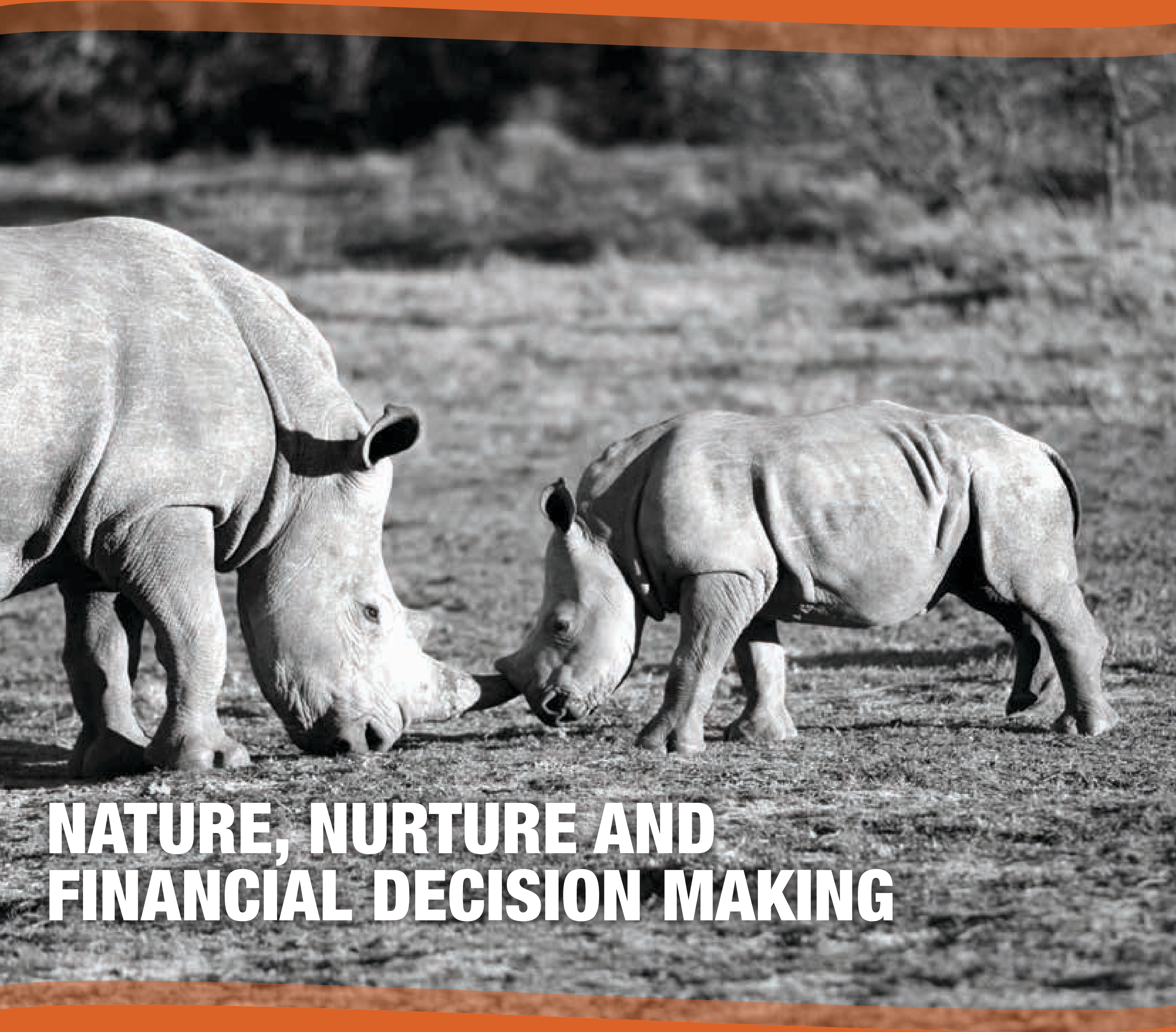

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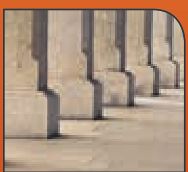

UNDERSTANDING THE MANTRA: LOOK FOR SUSTAINABLE RETURNS

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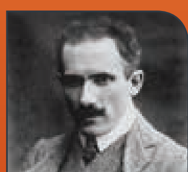

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Understanding the mantra: look for sustainable returns

By Andrew Macken, Portfolio Manager, Montgomery Global Fund

In May this year I addressed ASA members at the annual conference in Melbourne. I was tasked with discussing the Australian banking sector – a subject that is both complicated and wholly unsexy. With the help of a very patient audience, we had a great discussion on whether or not Australian banks are "bullet proof" and also explored some of the topical issues in the space right now; such as capital requirements, dividend yields and generally where to invest your money today.

To briefly recap on the Australian banking sector, some of the high level numbers never cease to amaze me – no matter how many times I look at them. We highlighted the unique structure of the Australian banking system in that the big four banks are over eight times larger than the second four banks, with aggregate tangible assets of around $3.3 trillion. For context, the federal government receives annual tax receipts of around one tenth of this size.

We aggregated the big four banks into one large hypothetical bank to gain a sense of the relativities between mortgage assets and bank equity. After all, many ASA members are owners of Australian bank equity (via their ASX-listed shares). So out of $3.3 trillion in total big four banking assets, around half relates to mortgage assets. For context, these mortgage assets are roughly the same size as Australia's annual gross domestic product. This is why the housing sector is so critical to the Australian economy – it's just so big.

Finally, we noted that the equity cushion of our hypothetical big four banks aggregate was just $200 million. The big four banks hold $15 of assets (half of which are mortgages) for every $1 of equity. This represents the significant "asset leverage" in the banking system.

The key question that arose during the Q&A session was around the prospective investment merits of Australian bank shares today. Naturally, such a topic is of critical importance to ASA members – many of whom are in the retirement stage of their life and rely on their accumulated savings to provide an income stream for living.

The argument put forward in favour of owning Australian bank shares is that: (i) they provide an attractive dividend yield, of around 5% on average; (ii) the dividends typically come with franking credits that are the most valuable to retirees; and (iii) at the end of the day, the major banks are generally high quality businesses in an industry somewhat protected from major competition. Oh, and there is an implicit government guarantee on the major banks – they will surely never be allowed to fail. So what's not to like?

It's difficult to argue with any of the above – except for one subtle point. The total return provided by any share investment is a function of the dividend yield, franking credits and the capital gain or loss of the share price. This latter point is key and was a topic of considerable discussion in Melbourne. Even if a bank delivers you 5% in dividends, and let's say you can gain another 2% from franking, it takes only a 7% decline in the share price to completely wipe out your return. Consider that CBA shares declined 17% between March and June this year alone. All else being equal, it would take nearly two and a half years to make this loss back up through franked dividends.

If we ask what we are really looking for in an investment, it really comes down to two things: (i) a sustainable return over the medium term; and (ii) some level of downside protection. With these two attributes, the goal of maximising the useful life of your accumulated savings over retirement can be attained. Note dividends or income is not referred to specifically.

Many believe that retirees need high dividend paying stocks as a form of "income" but this I have never understood. I would much rather own a share that pays no dividend and appreciates by 15% in a year than a stock that pays a 5% dividend and remains flat. After all, in the former case, I could simply sell around 5% of my shares at the end of the year to create an "income" roughly equivalent to the 5% dividend, and I would still be left with a capital base roughly 10% higher than it was at the beginning of the year.

Even if we accept that we should only be focused on sustainable returns and downside protection, the question of where to invest your money does not necessarily become any clearer. The Australian share market is a challenging place to find value opportunities at present; and leaving your money in Australian term deposits yields very little these days (though it does fully protect your downside).

One avenue that investors might consider for a portion of their portfolio is that of global equities – particularly if it's combined with global cash that can provide some downside protection and diversification against a potentially depreciating Australian dollar. The world of global equities offers investors a much wider range of potential opportunities as well as the ability to gain exposure to a number of structural trends that may elude domestically-focused investors. Structural trends can provide a sustained tailwind to the growth of businesses that are strategically well-positioned. Investing with tailwinds is often advantageous: businesses in industries that are

growing naturally typically find it much easier to earn higher returns on investment.

One such trend relates to the emergence of the Asian middle-class that will continue to generate larger than average rates of consumption growth. In China alone, there is around $4 trillion of annual consumption that is growing rapidly; and another $2 trillion in India and Indonesia that is growing just as rapidly. As the nearly 3 billion citizens of these three countries alone grow their wealth, their consumption - both discretionary and non-discretionary - will naturally increase. And to put the size of this population in some context, it is more than 120 times the entire population of Australia.

At the other end of the spectrum are the aging populations of many of the world's developed countries. We know the dynamics of an aging population pretty well here in Australia. Yet many are often surprised to learn that the same dynamics we are experiencing exist in the United States, most Western European countries, and the United Kingdom. Even Brazil and Mexico fall into the same category. With sustained structural changes of this nature comes opportunity. In the United States 10,000 citizens turn 65 every day. Not surprisingly, the medical requirements of this age group look very different to those of their younger counterparts. Senior Americans utilise nearly three times as many prescriptions as the younger population. While the percentage of individuals requiring vision correction is over 70% for persons at the age of 45, it is approximately 95% for persons at the age of 70. Businesses such as CVS Health in the US or Essilor International in France will likely do well from these trends.

Trends in technology can also be sustained and are structural in nature. Consider the smartphone: this pocket-sized computer and wireless communication device has become the largest technology platform the world has ever seen. The installed base of smartphones today is around 2.6 billion; and this will more than double by 2020 – most of the growth occurring in developing countries. The opportunities this will create for e-commerce, communication, social networking, healthcare and many other industries are endless. Even installed machine-to-machine connected devices, otherwise known as the "internet of things", will grow from around 250 million today to over one billion by 2020. A company like Qualcomm in the United States, which owns many of the patents to 3G and 4G mobile telecommunications technology, will surely do well from these structural trends.

For Australian investors, including many self-managed super funds, gaining exposure to some of these mega trends is not particularly straight forward. It is an enormous amount of work for an individual to identify and monitor these global themes; followed by the identification of the right individual stocks to buy that are well-positioned to benefit from these themes. And that assumes the individual has at least some background in global businesses and industries. This perhaps explains why Australian self-managed super funds are significantly underweight global equities en masse.

Many investors use a small number of trusted fund managers to identify and monitor global themes and subsequent investing opportunities. This is sensible as it effectively leverages the experience, skill and manpower of the fund manager's team. To the extent the fund manager has the ability to hold global cash in addition to global shares, this helps enhance the downside protection in the portfolio. (Some investors take it one step further and engage a manager that can also hold a "short" portfolio of deteriorating businesses in parallel. This enhances downside protection even further – though this is a topic for another day, perhaps next year's ASA conference).

Talented global fund managers based in Australia have been relatively few and far between, though this is changing. As technology has flattened the world and talented Australians relocate home from abroad, we are now seeing some high-quality Australian-based, global offerings become available for Australian investors.

This does not make the task of selecting an appropriate fund manager any less challenging for investors. It is, however, probably a better use of investor time. Instead of trying to pick individual global stocks – a task that only a highly-skilled and experienced team can do consistently well – Australian investors would perhaps be better served spending that time working to identify a portfolio manager they can trust, they understand and in whom they believe.

Remember, sustainable returns in any form (not just dividends) and downside protection. Sometimes you will find this combination in Australian banks, sometimes you find this combination elsewhere. But what you are looking for always remains the same.

At the ASA National Conference held in Melbourne from 4-6 May 2015, Andy Maken's presentation titled 'Are Australian banks bullet proof?' was rated equal third of all presentations. To find out more about Montgomery Global Fund please visit www.montinvest.com/mgf.