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> ROGER MONTGOMERY

Cash's hidden value: it's an option over every asset class

ROGER MONTGOMERY

What's going on ... is there nothing to discuss? We recently held our shortest investment committee meeting. I timed it. It went for 22 minutes. What gives?

The impact of history's greatest monetary experiment is now upon us. Low interest rates, flat yield curves and the pursuit of yield have rendered it difficult for value investors to find interesting new opportunities. Make no mistake we are invested already in a portfolio of extraordinary businesses, generating above average returns on equity, with below average debt and with bright prospects for continued earnings growth. Companies such as Altium, CBL, Challenger Financial, REA (a subsidiary of News Corp, owner of *The Australian*), TradeMe, Vocus, and Vita Group have made the grade but finding reasonably priced new opportunities to invest a growing cash pile is challenging.

Recently released, *The 2016 Long-term Investing Report*, co-authored by the ASX and Russell Investments, has backed up our previously-published concerns that low returns are here to stay.

Citing meagre returns from listed property and cash (1.7 per cent and 3.1 per cent, respectively, for the decade to December 2015), as well as cracks appearing in direct property, and higher expected volatility from shares and bonds, the report suggested investors "seeking to achieve their required rate of return, at a risk level they can tolerate, should consider dynamically managed real return funds to gain exposure to a more diversified investment opportunity and be able to quickly respond to changing market conditions".

I'd go one step further and suggest building up some cash.

Back in 1981, the risk-free rate of return in the US — as represented by five-year treasuries — was 15 per cent. Real rates were close to 5 per cent. To compete with high risk-free rates, assets were priced very cheaply. And the 15 per cent hurdle rate forced companies to invest capital wisely and where necessary restructure. Financial leverage as measured by Total Credit Market Debt to GDP was less than half of what it is today. Back then credit-fuelled growth lay ahead. Today it does not. GFC-response policies have discouraged de-leveraging. In fact leverage has risen.

The period that followed 1981 was one of the greatest bull markets in financial history.

So how can precisely the opposite environment (historically low interest rates, expensive asset prices and historically high levels of debt) to that which existed in 1981, also be a great investment environment?

It simply cannot.

Former Soros Funds Management director Stan Druckenmiller in early May observed, "In 1982 the market sold for seven times on depressed earnings and with dozens of rate cuts and productivity improvements ahead. Today we're at 18 times inflated earnings, with productivity (margins) declining and no further ammo on interest rates. While policy markers have no end game, markets do."

And that brings me back to cash.

We tend to think that cash is safe but it is not. Cash is not a risk-free asset at all. What could be riskier than being guaranteed to lose more purchasing power the longer you hold it? As Warren Buffett explained last year, during the 50 years from 1964 through 2014, the S&P 500 Index returned 11,196 per cent, including reinvested dividends. During those years, the value of a dollar fell by 87 per cent. Investing for long periods in cash is not desirable.

But in the short run cash is like an option over every asset class, with no expiration date and no strike price. Cash provides the option to sweep up a bargain when it becomes available and this must have some value above the fact it earns almost nothing.

If the purpose of an investment portfolio is to grow as well as protect the wealth you've accumulated over the years, doesn't it make sense, if you can afford it, to also hold an option?

At this juncture there is value in holding some cash. Not most of your money, but some.

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Crowdfunders round up Kidman

CHRIS KOHLER

Crowdfunder DomaCom and Lloyds Business Brokers are bidding for the huge S Kidman & Co empire, which includes Helen Springs Station

Crowdfunding started as a novel way to raise money from large amounts of people for any cause. More recently it's emerging as a way to fund investments. Yet, most people are struggling to get their head around it ... and with good reason.

The term "crowdfunding" is fundamentally confusing because it covers too much — fractional property investment, small-scale venture capitalism, debt-based funding, as well as charitable donations, and a significant grey area combining charity and investment.

But then again it's an area brimming with possibilities. Here's an example that outlines the issue:

A beer pipeline is currently being built under the medieval Belgian streets of Bruges and the owners of the De Halve Maan (The Half Moon) brewery have their loyal customers to thank.

The problem was that the skinny, cobbled streets were frothing up the beer and making for a logistic nightmare, so lovers of the beer opened their wallets to the tune of $US4.5 million ($6.2m) to fund an underground pipeline to the bottling plant.

This is not investing, but it does fall under the banner of crowd funding.

The brewery pipeline is the sort of scheme that gets a lot of attention, but does little to promote the possibility of crowdfunding as an investment alternative.

"They all look at us as a joke," said Arthur Naoumidis, founder and CEO of DomaCom, one of the key Australian players operating in this space.

But DomaCom is emerging from the sidelines with an audacious bid for Australia's largest agribusiness, and if they pull it off you can guarantee there will be no laughing.

The sale process of Kidman & Co, the family-owned pastoral business with lands roughly the size of Bulgaria, made headlines when Treasurer Scott Morrison blocked a $371 million bid from a Chinese consortium last month, saying it wouldn't be in the nation's best interest. The sale has been reopened and crowdfunder DomaCom is now the one making headlines as it joins forces with Melbourne-based Lloyds Business Brokers to launch its own $371m bid.

The plan is to split the land and the operating business using funds from thousands of investors.

Arthur Naoumidis has linked 5500 investors to buy the land holdings.

They've raised $70 million and are targeting $210 million. Lloyds Business Brokers will lease the land from DomaCom and invest about $160 million in the operating business.

"We reckon we can stream a 10-12 per cent yield for the operating business, if you take the land away. That's roughly 8 times price to earnings — that's the goldilocks zone."

But how does Domacom actually work?

- It's a unit trust structure, which means each asset is treated as its own managed sub-fund. Investors get units in the sub-fund that owns each asset.
- No other crowdfunders in Australia operate with this legal structure and it means DomaCom is open to anyone — there is no minimum required annual income as with other crowdfunding investment brokers operating in Australia.
- The process is called "fractional property investing" and involves bringing together "like-minded investors" to fund property purchases.
- DomaCom supports residential, commercial, industrial or agribusinesses and does the due diligence of conveyancing, valuation and property inspection.
- Investors can invest as little as $2000 per property and receive returns — rental and capital gains — in line with their investment.

> 'They all look at us as a joke'
> ARTHUR NAOUMIDIS
> DOMACOM FOUNDER AND CEO

- A secondary market is emerging for buying and selling shares.
- DomaCom makes its money by taking 0.88 per cent of the assets invested.

So what can go wrong?

It all hinges on the earning power of the property. If a drought struck the Kidman properties it could impact the rental yield over time, and like any other business, there are a range of risks to be managed.

Another central player in this space is OurCrowd, an Israel-based crowdfunder with 12,000 global members — around 1800 of them Australian — and almost $US350m ($485m) invested.

Unlike DomaCom, it's only available to what the law defines as "sophisticated" investors, which means to be involved you need to have a minimum annual income of $250,000 or investable assets of $2.5m.

So, how does this crowdfunding model work?

- OurCrowd researches thousands of start-ups each year and presents to its members the ones it sees as having the most potential (about 1 per cent make it through this process). It invests its own funds alongside members.
- The member chooses a start-up, or a few, and invests a minimum of $US10,000 per company.
- Documents are automatically generated and sent to the investor. The stakeholders in the business are represented by OurCrowd.
- OurCrowd takes board seats in the start-up, and speaks on behalf of members.
- Investments are expected to last at least four years and there is no secondary market for trading between members.
- OurCrowd takes a 2 per cent management fee for four years and takes 20 per cent of the capital gain.

"What's really important here is that once they're an investor, we don't disappear. We mentor the company and stay involved. This is the big difference with most other crowdfunders," Dan Bennett, managing director and partner of OurCrowd Australia, told *The Australian*.

"This is venture capital," Bennett stresses. "And if you're targeting 10 times or 20 times your money, or in the case of Uber, thousands of times return, there's a risk that some of them may not work and that's something people have to be comfortable with."

Disclosure: The Kohler family has interests in the Domacom group.

Why Brexit vote rattles international investors

STIRLING LARKIN

If we are to believe the hoopla surrounding "Brexit" or British exit from the European experiment, we could be mistaken for thinking a major divide between Britain, Europe and the rest of the world is imminent.

The June 23 Brexit referendum, like many before it, has more fearmongering and hype surrounding it than it deserves, and for Australian ultra high net worth investors who bank, trade and regularly visit the City of London, this drama brings fresh opportunity to assess their financial relationships with Britain, Europe and the global marketplace at large.

These investors still vividly recall what they were told would happen after the last significant British referendum in June 1975 — gauging support for the country's continued membership of the European Economic Community, which lead to the European Union after the Maastricht Treaty in 1993 — and they recall that most of what they were told would happen never did. In fact, the opposite came to pass.

London flourished, the pound strengthened and the City became the financial services hub for the global economy.

This is not to say resetting a 28-member supranational accord does not have consequences — it does.

But a month out from the referendum, it is timely for global investors to assess the pros and cons for Britain, and possibly Australia as well.

On this, US author James C. Bennett believes: "Trade deals once primarily involved a simple tariff-reduction agreement between a few neighbouring nations, but as trade structures grew larger, broader, and more complex, they grew more opaque and effectively impossible for citizens to control through national representative government."

Bennett argues the EU is now under fire in Britain.

Next it will be the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership.

Attention will then return to smaller, friendlier agreements between similar cultures.

Bennett suggests: "A post-Brexit Britain might find Australia and New Zealand, and perhaps Canada, early candidates for a friendlier, more tractable trade and free movement agreement."

While bearing in mind that the implications of Brexit for the economies of Britain and the EU are difficult to assess — beyond the heightened uncertainty during the negotiation period that weigh on growth in both regions — Australia investors should remember the following.

- In a landmark speech in January 2013, British Prime Minister David Cameron outlined the key principles for the country's EU membership.
- He vowed to renegotiate the terms of EU membership for Britain, arguing the government should negotiate a "better deal for Britain" and that failure to do so could risk a "drift towards (EU) exit".
- The speech and commitment to the renegotiation and referendum were not a call for Brexit, as Cameron strongly favours Britain staying in the EU under improved terms, committing to campaign strongly for this.
- At the start of the year, Britain and the EU negotiated a deal that paved the way for next month's referendum
- Negotiating time was kept short, a likely result of a conscious trade-off decision by the government, limiting the period of uncertainty.

For those leading the "Remain" campaign, their strongest arguments rest on the following.

- The British economy is stronger in the EU given it has access to the single market and jobs linked to the union.
- Membership makes Britain safer, as there is strength in numbers.
- It is easier for Britain to exert influence and leadership from within the EU.
- Alternative models, such as Norway's or Switzerland's, are not as good as EU membership, at least economically.

And for the vocal "Leave" campaigners, the following arguments are key.

> As it now stands, the European experiment is not working particularly well economically

- Britain contributes £18 billion ($36.6bn) a year to the EU and this could be better spent at home rather than on EU priorities.
- Brexit allows Britain to control borders and the flow of immigrants.
- Britain, the world's fifth-largest economy, can negotiate more advantageous trade deals, including those with ANZCERTA (Australia New Zealand Closer Economic Relations Trade Agreement.
- The eurozone is permanently on the brink of crisis.
- Britain can't control the EU's expansion to the east.

As it now stands, the European experiment is not working particularly well economically. Wherever we sit personally in this debate, what is unequivocal is that the macroeconomic impact of Brexit is difficult to estimate and highly dependent on the nature of the post-Brexit deal, if the Leave campaign succeeds.

Combined with hawkish US Federal Reserve comments regarding expected interest rate hikes, an Australian election on July 2, US Democrat and Republican conventions, and all the continuing geopolitical worries, Brexit — like Grexit and the Scottish vote before it — only serves to add additional uncertainty to a year when an ageing global bull cycle is churning downwards.

Brexit is more than just a referendum regarding economics and markets, but for Australian global investors, the best way to assess it is to employ the most powerful economic tool on hand: rational common sense.

Larkin Group is an Ultra High Net Worth Wealth team focusing on high-yielding global investments.

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