Exclusive Subscriber Content
16 SEPTEMBER 2015

Protect your Purchasing Power

In the very long run, investing successfully has little to do with picking the tops and bottoms of markets or asset prices. It has instead everything to do with maintaining, preserving or enhancing your purchasing power.

Investing some of your assets in carefully selected international companies may just be the best way of preserving your purchasing power against the multitude forces of inflation, global disruptors and further potential declines in the Australian dollar.

Start by looking at your portfolio, including shares, property, bonds and cash, and ask yourself, how much is exposed to Australia and the Australian dollar?

- By Roger Montgomery

The information provided in this document may contain general financial advice and does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives; financial situation and particular needs before acting upon any information and consider seeking advice from a financial advisor if necessary. This document is based on information obtained from sources believed to be reliable as at the time of compilation. However, no warranty is made as to the accuracy, reliability or completeness of this information. Recipients should not regard this paper as a substitute for the exercise of their own judgement or for seeking specific financial and investment advice. Any opinions expressed in this paper are subject to change without notice and we are not under any obligation to update or keep information current. To the maximum extent permitted by law, neither we nor any of our related bodies corporate nor any of our respective directors, officers and agents accepts any liability or responsibility for any loss or damage of any kind which may be suffered by any recipient through relying on anything contained in or omitted from this paper or otherwise arising out of their use of information contained in this document.

Before embarking on this discussion allow me to take you on a short personal journey. The experience is not unique but it is instructive.

As is often the case in investing, some of the better ideas arrive when you least expect them. The thesis behind a highly profitable investment occurred to me when I purchased, online, a pair of Italian leather shoes.

When the shoes arrived, I was struck not only by their hand-made quality and provenance but also by just how little they had cost compared to local equivalents. And then it dawned on me; Australia cannot compete in terms of quality for the price.

Concluding that the Australian dollar could not justifiably be sustained at US$1.02, and remembering The Reserve Bank of Australia had also stated that they wanted the currency lower, I realised there was an investment I could immediately make that would ensure the then current purchasing power of the Australian dollar could be preserved and I would be able to buy goods, from overseas, equally cheaply, well into the future.

So, some years ago, with the Australian dollar at US$1.02, I opened a US dollar term deposit. I was however a slow learner. The currency had already fallen from US$1.10. Nevertheless, I did the same thing with British Sterling when one Australian dollar bought 65 or 66 Pence.

Those are positions I hold today and have more recently added to. Who would have thought term deposits could be so rewarding?

It's worth keeping in mind that the fall in the Australian dollar from US$1.02 to US$0.70 has already occurred and a further fall of similar magnitude is not expected. In order to be competitive however, some further weakness is required.

An international lens

During the Australian winter of this year I travelled with my family to Britain and Europe and with the Australian dollar buying just 50 pence, the prospect of doubling every price visible on a swing tag, a menu or a hotel bill, to arrive at the Australian dollar equivalent, could have become an annoyance if not an eye-watering exercise.

But the decision made years earlier, to take advantage of an unusually strong Australian dollar, meant that I had preserved the international purchasing power the previously strong Australian dollar had offered.

Living in Australia - with its enviable climate - means that we often fail to consider the international purchasing power of our money. It isn't until we head overseas that we start to think about Australia through the lens of our international friends, business associates and trading partners.

Protecting purchasing power through international equities

The above example, explains how diversification into foreign currencies can help preserve your wealth in international purchasing power terms.

This article seeks to also explain how, through diversification into international equities, you can make important decisions that may ensure not only that the wealth you have accumulated is preserved, but that it actually grows.

When it comes to protecting wealth, there are many things that can go wrong.

Living in Australia - with its vast distance from the global financial and economic centers of Europe, the US and China, and a tax regime that dissuades the realisation of profits – often leads to investors passively and emotionally riding the tides of equity markets not realising there are some actions that can be taken to protecting one's purchasing power over the long-run.

In the first instance, we believe investors should be invested in high quality Australian businesses, those with bright prospects, purchased at a discount to a rational estimate of their instrinsic values. Our Whitepaper entitled *Getting there is half the fun* explains how Montgomery has beaten inflation, the market and many of our peers while also capturing most of the upside but only half of the downside since inception.

It is also true however that many Montgomery investors have large direct equity portfolios with precious little exposure to overseas opportunities.

In the very long run, investing successfully has little to do with picking the tops and bottoms of markets or asset prices. It has instead everything to do with maintaining, preserving or enhancing your purchasing power.

It's not much use perfectly timing the ups and downs of markets, if you find you cannot dine at the same restaurants you once enjoyed, nor travel to the same international destinations as you once did, because your dollar hasn't travelled as far as inflation or as far as other currencies.

Quality, Value and Prospects

There is, in our view, two broad approaches taken towards the stock market. The first and surely the most popular, is to treat 'stocks' like instruments upon which the rises and falls and can be 'bet' against.

Betting on the 'ups' and avoiding the 'downs' however is tantamount to betting on black or red at the roulette wheel, and with so many investors doing this without fully researching the quality, value and prospects of the underlying business, they aren't in fact investing at all, they are speculating.

Rather than approach the stock market as one might a casino, genuine investors focus on the underlying business. The stock market's only two purposes is to provide the platform through which pieces of extraordinary businesses can be purchased and to aggregate participants in such circumstances that their activity, or lack thereof, might infrequently offer opportunities that can be taken advantage of. In this way investing is most successful, when it is most business-like.

Assuming one's understanding of business quality and valuation is sufficient, the remaining question for an investor to answer is about a business's prospects.

Start with reviewing your current portfolio's prospects – a warning

If you are like many Australian investors the local banks, BHP and RIO, dominate your equity portfolio. Indeed according to combined data from the ATO and the Australian Bureau of Statistics – the Australian banks alone amount to as much as 40 per cent of the average self managed superannuate's portfolio. As an aside The Montgomery Fund and the Montgomery [Private] Fund are not. You may also have some exposure to the major domestic supermarkets and the nations largest telecommunications carrier.

You may also have a little Wesfarmers and Woolworths and some Telstra shares but anything else is a distant second, third or tenth.

The once bright prospects for these businesses however are dimming and risks are rising.

- For Australian banks one risk stems from the dominant position they hold in portfolios.
- Another risk is that they cannot continue to grow at the rates they have enjoyed in the recent past thanks in part to the Australian Prudential Regulatory Authority's (APRA) moves to slow bank lending to property investors.

- Bank returns on equity are under pressure – and therefore their intrinsic values – as the recommendations from David Murray's Financial System Enquiry seek to bolster their capital adequacy such that they are unquestionably strong.

- ASIC has also uncovered irresponsible lending practices at a time when both, mortgagees have overextended themselves financially to chase ever increasing house prices, and banks have reduced their provisions for bad and doubtful debts to record lows.

- Finally Australian banks earn the vast bulk, if not all, of their profits in Australian dollars.

Banks not alone

Turning to the major materials producers, BHP and Rio Tinto, you will recall that we have presciently warned investors, since 2010, about impending declines in steel and iron ore demand from China, and the impact on commodity prices from an entirely predictable global supply response - as companies sought to recoup, through volume, the costs of developments commenced when commodity prices were at record highs.

China's economy continues to slow, and the recent coincidental property and stock market corrections there make China's attempt to move rebalance economy from dependency on centrally-planned fixed-asset investment, to a consumer-lead economy, much more difficult to orchestrate, let alone succeed.

Gross fixed capital formation is already slumping, from 25 per cent annual growth rates in 2009 to circa five percent today. The adverse impact on steel manufacturers like Arcelor Mittal, whose revenues declined 18 per cent year-on-year in the latest quarter, while EBIT fell 30 per cent is symptomatic. It's all a telling indictment about the rate of slowdown - nay, a precipitous decline - in property, infrastructure and manufacturing in China.

The 'crackdown' on corruption, which can be seen in revenue and visitor numbers at venues like Macau and in the same-store-sales numbers for luxury fashion brands, is also having a negative impact on the prospects for China's economic growth.

And the repercussions for countries like Australia, who depend on China for trade and tax revenue, investment and growth itself, are far-reaching. Of course the adverse impact on government revenues and the terms of trade dominate the headlines, but it is the adverse impact on personal purchasing power that will be felt more acutely.

A silver lining

Disruption is turning what were once cyclical slowdowns into more permanent structural deteriorations. Of course, like me, you will be aware of the adverse impacts international online shopping is having on domestic retailers, like the larger department stores and electronics chains, but perhaps less well-documented are the changes being felt in free-to-air television, by Australia post, taxi companies and by supermarkets.

Quite simply, if Australia's products and labour are too expensive to compete on a world stage, the world will make them cheaper for us by reducing the value of the currency. For that reason Australian investors should consider the benefits of diversification that gains both foreign currency exposure and exposure to the winning disrupters.

In every case however there is disruption. Whether cyclical, as is the case for banks, or structural, in the case of resource businesses, supermarkets and incumbent telecommunications carriers, the outlook for the prospects of these businesses has dimmed. Offshore disrupters you are not invested in are disrupting the companies locally that you are likely to be invested in.

Start by looking at your portfolio, including shares, property, bonds and cash, and ask yourself, how much is exposed to Australia and the Australian dollar? A ten percent allocation to international businesses through an unhedged global fund could be a rational first step in a transition towards a portfolio that more sensibly reflects the bright opportunities and prospects available across the world.

Exposure to bright prospects is essential, but remember, no matter where you invest, be sure to weight your equity investments towards the highest quality companies, and purchased at rational prices with respect to their intrinsic value.

Further protection

Conventionally-managed equity funds - those managed by many of our much larger peers - buy shares in the expectation of both capital gains, from rising share prices, and income from dividends. If one hundred thousand dollars is invested in such a strategy, exposure to the market usually amounts to 100 per cent. These funds are typically 95 to 100 per cent invested at all times.

At Montgomery we believe our team is best positioned to assess the presence or absence of both quality and value in the market place, at any time, and so we retain the flexibility, to preserve the wealth of our investors, by holding funds in the safety of cash. This flexibility is retained in all of our funds.

The Montaka Global Fund (and the forthcoming Montaka Global Access Fund) offers investors an additional path that seeks to protect capital by also profiting in declining markets and from deteriorating businesses.

Completing an application form for The Montgomery Global Fund or the Montaka Global Fund might be all that is separating you from a sensible weighting to international opportunities with indisputably bright prospects.

Additional protection with Montaka

Disruption is impacting many business models from the retailing of groceries to the delivery of stamped envelopes. New technologies are replacing the way we find everything from a job to a partner, and start-up companies are destroying the revenues, profits and margins of large, entrenched companies that were once considered blue-chip.

History however shows us that even when new technology changes the world, not all participants are profitable. Witness, for example, the advent of television. More than 450 companies have manufactured televisions since 1949 and yet only a handful exist today.

Disruption is the current buzzword given to what might otherwise be known as 'transition' and we believe it is easier to find those businesses that are in terminal decline as a result of disruption than it is to find those winners that will be sustainably profitable.

Through the Montaka Global Fund investors can profit from businesses whose share prices decline as a result of disruption, supply-and-demand dynamics or even corporate fraud.

By borrowing, and then selling, the shares of businesses whose prospects are clearly deteriorating – perhaps terminally – Montaka investors can profit.

Less exposure too

Hypothetically, a $100 investment in the Montaka Global Fund might only have a 40 per cent exposure to the market. If $100 is invested in extraordinary business with bright prospects, and an additional $60 worth of shares are borrowed and sold, with the expectation those shares will decline in price, the investor's exposure to the market is only 40 per cent.

If, for example, stock markets declined, amid heightened volatility and uncertainty, by 10 per cent, investors in Montaka might expect to see all things being equal, only a four per cent decline in the unit price.

Through a fund like the Montaka Global Fund (and the forthcoming Montaka Global Access Fund) investors gain the benefits of 1) extraordinary global businesses, 2) the ability to profit from deteriorating businesses, 3) reduced net exposure to the stock market overall and 4) currency diversification.

Is now the time to invest?

Investing in equities is known to preserve purchasing power.

The last time US cash interest rates were as low as they are today was in the 1930's, and it is informative to examine what transpired in the years that followed.

After peaking in September 1929 at 4.80 per cent, the US Fed Funds rate hit a low of zero percent in September 1932. Rates then began to climb again until 1953 when rates reached 2.10 per cent.

As an aside, those experts who currently promote the idea of a 'new normal' environment of lower returns might be looking to the returns after 1932 as a road map for 2015 onwards. It is not without precedent then that we collectively dodged the depression but not the long and fitful recovery afterwards.

As Table 1. reveals had you invested US$100 in bank deposits in 1934 for twenty years, your cash would have grown to just US$115. Had you invested in US 10yr bonds through this period your investment would have grown a little more to US$162.

The problem with these returns is not only were they low in absolute terms, but the investor was indeed poorer in 1954 than they were in 1934. You see, inflation has meant that US$204 was required in 1954 to purchase the same basket of goods as US$100 had purchased in 1934.

Shares on the other hand, and despite all of the market's vicissitudes between 1934 and 1954, saw US$100 grow to over $250, not only preserving purchasing power but enhancing it.

Table 1. $100 invested in 1934

$100 Invested in 1934		
	1934	**1954**
Deposit	100	115
10 Year Bonds	100	162
Inflation	100	204
Stocks	**100**	**252**

Investing overseas is something Australian investors are, in the majority, underexposed to. The Australian currency appears to be under pressure as do many of the sectors that dominate the Australian stock market and dominate most investors portfolios.

Provided you are investing for the long run, today may be as good a time as any to consider the merits of investing globally.

To discuss any of the Montgomery funds, or the information in this paper, please click here to request a phone call with David Buckland. We will be in touch promptly.