Borrowing to invest just adds to market volatility

ROGER MONTGOMERY

You should invest for the long term — it's a line you hear all the time. But what they don't tell you is that time is the enemy of the mediocre business. Witness the languishing share prices of Virgin Australia Holdings or Telstra, each below the level they were more than a decade ago.

So, let's just make one thing clear: when I speak of long-term investing I am referring to quality businesses and assets.

With that in mind, my visit to Gulargambone (not far from Tamworth) last month yielded an interesting insight. A farmer told me the story of a man he knew who had bought large tracts of coastal land in NSW for a little less than the equivalent of $60 an acre. That land today trades in excess of $4000 an acre.

Surely the man's heirs are now very grateful for this far sighted purchase? Sadly not.

Warren Buffett once compared a several trillion dollar investment in all the world's gold to investing the same amount of money in all of America's farmland.

He pointed out that over the ensuing 100 years that land would have produced Everest-sized mountains of valuable crops and meat while he noted the investor in gold could merely fondle his investment, which was good for little else.

Buffett recently held forth on one of his favourite subjects — spurious reasons that people offer up not to invest: "I've been hearing it, you know, all my life. And in the spring of 1942 I was 11 years old, and the Dow was at about 100. And we were losing the war in the Pacific at that point … and people said, 'Well, let's wait until things are clear, let's wait until we start winning the war'. There's always a reason to wait and I've listened to that all my life."

He added: " (If you) save money you can buy bonds, you can buy a farm, you can buy an apartment, house, or even buy a part of American business. And if you buy a 10-year bond now you're paying over 40 times earnings for something whose earnings can't grow. And you know, you compare that to buying shares, … good businesses … I don't think there's any comparison. But that doesn't mean the stockmarket can't go down 20 per cent tomorrow.

"I mean, you never know what it's going to do tomorrow, but you do know what it's going to do over 10 or 20 years. And people talk about 20,000 being high. Well, I remember when it hit 200 and that was supposedly high." (The Dow Jones is currently close to 20,600.)

Get to know FOMO

In other words it's easy to look back over history and ponder, 'if only'. Much rarer are we offered a telescope with which to see the future.

Broadly speaking equities appear to be expensive right now and understandably investors are hesitant. But ask a room full of people today, would they be buyers if share prices fell by half, and with immeasurable enthusiasm they'd confirm they would.

Sadly, thanks to human temperament, that will not be the case.

I have one thing in common with Buffett; I don't have the foggiest idea what the stockmarket's going to do next week, next month, next quarter or even next year. I do know however that provided a business can retain a large portion of its profits and reinvest that money at high rates of return it will grow in intrinsic value and that will eventually be reflected in the market price.

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A mere doubling of the population of Australia will ensure the banks will be making mountains more money than they are today. And when the population of the world doubles, CSL should also be making mountains more than it is today.

But what stops investors from benefiting from this almost assured growth?

The fear of loss and the fear of missing out drive all sorts of odd behaviour. Property income yields remain entrenched at low single digits and yet property buyers couldn't be more enthusiastic.

Buying city property on a lousy gross yield of 2.5 per cent, with the expectation of a capital gain, fails to appreciate that a capital gain will only accrue when a greater fool is found willing to accept an even lower yield. But the yield on an oversupplied and vacant apartment is zero; they cannot fall much further.

When an investment, such as an apartment, is offered with unattractive fundamentals, that investment isn't made more attractive with borrowing.

It's the fear of missing out — sometimes tagged with the acronym FOMO — that causes people to borrow. Borrowing is an accelerant for those who aren't patient. And like all accelerants, debt makes investments highly volatile.

Remember that NSW coastal farmer who bought vast tracts of land at less than $60 an acre? He lost the lot when prices fell to $20 an acre. His borrowings brought him down.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

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Spotting alternative opportunities

MY WAY
Rob Shand is managing director of Brisbane-based fund manager Blue Sky, which specialises in offering so-called 'alternative investments' to retail investors

GLENDA KORPORAAL

'We focus on long-term structural trends,' says Blue Sky's managing director Rob Shand

LYNDON MECHIELSEN

What is the point of looking at alternative investments, particularly for the retail investor in Australia?

Global institutional investors allocate 20-25 per cent of their portfolios, on average, to alternatives (or private markets investments). In Australia, the Future Fund allocates approximately 39 per cent of its portfolio to alternatives, and retail investors are recognising the opportunity. Alternatives offer superior returns and they allow investors to diversify away from equities and debt.

Should Australians be investing offshore or is it better to stay at home?

Australia is a fantastic economy in which to invest: our forecast population growth over the next decade is the highest of more developed countries at around 1.2 per cent per annum (compared with the US at 0.7 per cent and the UK at 0.6 per cent per annum); our GDP growth rates over the past decade have been some of the highest of all advanced economies; and, compared to many faster growing economies, Australia has relatively higher levels of geopolitical stability. Having these macro settings in our economy is the envy of most countries.

Having said that, I fundamentally believe investors should have diversity within their investment portfolio and that includes having geographic diversity.

The outlook for investing in water rights and agribusiness in Australia has strengthened since Blue Sky began investing in them. Why is Blue Sky in these areas and what is the outlook?

The outlook for water rights and agribusiness is very strong, and simply driven by long-term demand and supply factors.

Take water rights, for example: in Australia, water is the key limiting factor in our agricultural production (we certainly have no shortage of land or sunshine) and the simple reality is that there isn't an endless supply of water.

On the demand side, there is a population of 4.5 billion across Asia with a rapidly growing middle class demanding more food from places like Australia.

For an asset class like water that has capped supply and ever increasing demand, over the long term this situation will lead to appreciation in the value of water.

Blue Sky has funds in several different areas. Which are the most popular?

We invest across the four major alternative asset classes: private equity and venture capital, private real estate, real assets (focused on water and agriculture) and hedge funds.

These asset classes are popular with investors who are looking for greater diversification and lower correlations (links) with their other asset allocations.

Recently we have seen strong interest in our private equity and venture capital investments, as investors search for growth outside of public or listed markets and in investments exposed to long-term growth in Asia such as student accommodation along with food and water. There is also interest in assets exposed to favourable long-term demographic trends such as retirement villages.

How is the market for the different Blue Sky funds?

The market in Australia is enormous: a $1.8 trillion funds management industry and growing.

Today, alternatives represent 20 per cent of market, compared with only 5 per cent 20 years ago. And they are set to represent a greater proportion of the overall market than Australian listed equities within a decade.

Are there any world trends at the moment Australian retail investors should be wary of?

We don't focus on short-term global trends. By definition, investing in alternative assets is a long-term game, so we focus on long-term structural trends and how they might influence asset prices over the coming five, 10 and 20 years.

What were your first significant investments? Any lessons learned along the way?

I made some investments in Australian shares at university. I had some wins and losses but, overall, I did reasonably well.

My first significant investment was buying our house and investing in Blue Sky. Both long-term investments: we love where we live, so the investment in our house might not be one we ever realise, and given Blue Sky's strong growth outlook that isn't an investment that we'll be realising for a while either!

From July 1 Australians won't be able to put as much as they want into their superannuation, or may be considering some alternatives outside super. Should they look at, say, investment properties?

Property is almost always included in a well-diversified portfolio, and Blue Sky's property investments have performed very well. Even recently — despite negative sentiment about Brisbane's property market — we realised investments for investors with returns in excess of 50 per cent.

It's important not to generalise, however, as dynamics of each market are different.

How did you get into your current job?

I joined Blue Sky in 2010 as part of our private equity and venture capital team. Prior to that I had worked at Bain and Company.

I was appointed as chief operating officer of Blue Sky in 2013, a 21C role, and then managing director in September 2016.

Why company bonds beat shares for value

ELIZABETH MORAN

Telstra is one of Australia's top 10 companies by market capitalisation. Love or hate it, most people will have a connection.

Even if you don't have a Telstra mobile or internet association it's likely your superannuation fund will own shares or bonds, or both.

This week Telstra made headlines again with a severe 7 per cent one-day drop when it was announced TPG would become a fourth mobile provider to rival the incumbents Optus, Telstra and Vodafone.

But there is more for the investor to consider than Telstra's high yields but struggling shares: you might find it interesting to learn that Telstra raised $1 billion in the bond market earlier this month. That's a large sum, and even more impressive was the fact that $2bn in bids were received for the bonds.

The deal was broken down into three tranches (or parcels): a $300 million four-year fixed rate bond paying an annual 2.95 per cent, equivalent to 82 basis points over the benchmark swap rate, a $150m floating rate bond with the same term and same margin, and a $550m 10-year fixed rate bond with an issue yield of 4.06 per cent a year.

The returns don't look very appealing especially when you consider the dividend yield on the company's shares is approaching 9 per cent a year following those recent falls.

While any serious investor naturally compares the two asset classes, in reality they are complementary as opposed to mutually exclusive. They have different features and purposes but both should have an allocation in your portfolio.

Telstra is a big player in the bond market

AAP

Lower-risk bonds provide the consistency many investors crave while the shares provide the growth needed. Older investors, or those responsible for preserving capital, should have greater allocations to bonds while younger investors primarily driven by growth would have greater allocations to shares. Here's the case for Telstra bonds:

1. Bonds are safer investments than shares in the same company. They are a legal obligation. Remember bonds are loans, you lend your money to a company or government and they promise to pay you interest in return and repay capital at maturity, so there is a lot of certainty with a bond that you don't have with a share. In the event of a wind-up, Telstra bondholders are repaid before shareholders.

Telstra's share price fell sharply this week — but the price of its existing July 2020 maturing bond was unmoved.

2. Income is paid on set dates and cannot be forgone.

Telstra must pay interest quarterly for the floating rate bond and half yearly for the two fixed-rate options, but it never has to pay a dividend. Shareholders invest expecting the company to grow and hope to see an increasing dividend. However, there is no legal obligation, unlike a bond.

3. Capital is repaid at a known future date.

Bonds have a maturity date, when the face value of the bond must be repaid. So no matter what happens to the price of a bond over its life — as they are tradeable investments and prices can move up and down — investors have the certainty of knowing they will be repaid as long as the company continues to survive.

4. There is less volatility in the price of the bonds compared to the shares.

Bond prices are more stable than share prices, particularly in stressed markets. Because bonds will pay back 100 per cent face value at maturity, investors have that capital certainty no matter what happens to the price in the meantime.

A poor annual result will send the share price plummeting, but bond holders care less, as long as the company can make interest and principal payments as they come due.

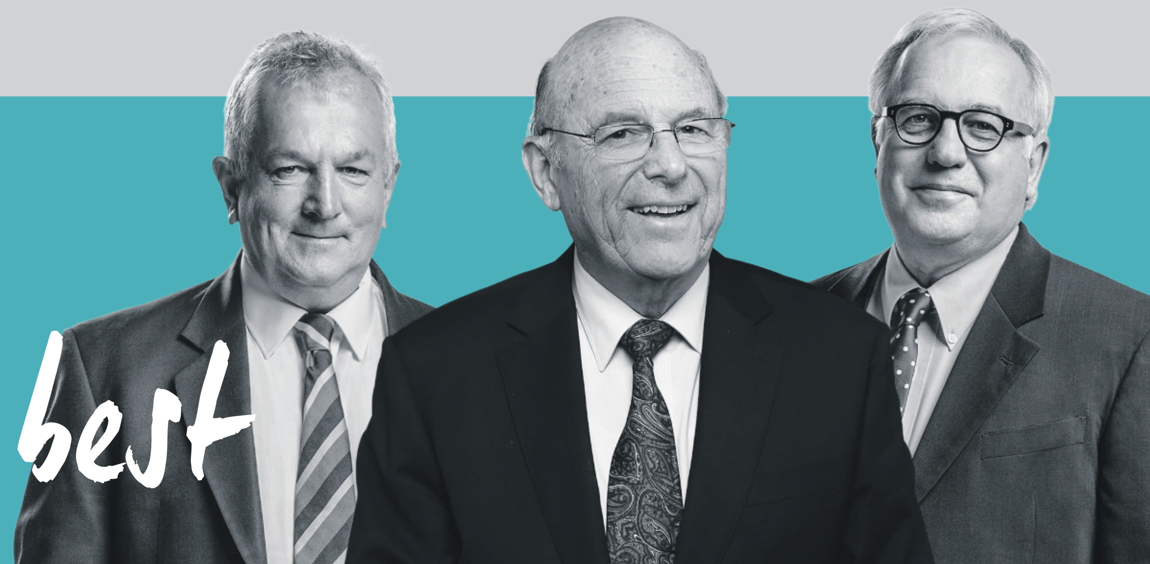
A major difference between the two assets is franking. It increases returns and promotes investment in shares over bonds. But as a share investor, franking isn't the primary driver, expected growth is typically the main goal.

Picking a high achieving growth stock could see you make very high returns, which bonds can't replicate. However, buying bonds when they are deeply discounted from their face value can provide very high returns. I've seen some bonds return about 40 per cent over short terms and double-digit returns are not unusual.

Of course bonds in single companies can often require a relatively big investment for a single investor but then again I would feel confident in predicting the survivability of Telstra for the terms of issue of the bonds. I think it's much more difficult to anticipate growth, along with an improving share price and dividend.

Elizabeth Moran is a director of education and research at FIIG Fixed Income Specialists.

www.fiig.com.au



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