Top 10 stories of 2018

A selection of this year's most read stories from The Constant Investor

Alan Kohler's

The Constant Investor

Foreword

As we come to the latter part of the year I have been reflecting on the way the financial and political markets have changed over the course of the year. And what a year it's been! Trump tweets have had us on the brink of a potential nuclear and/or trade war. And the political dramas didn't stop there. At home, Scott Morrison became the 5th Prime Minister in as many years, all of which impacted the business and financial markets.

The TCI team and I have posted 100s of stock and market insights and CEO and Fund Manager interviews to The Constant Investor. These Top Stories of 2018 from The Constant Investor were the one that our members were most interested in during the year.

They cover a broad cross-section of the content we offer, including several of my Weekly Overview columns, in which I give my thoughts on the week's events.

We've interviewed many of the ASX's CEOs and some particularly noteworthy one made the Top 10, including the CEO of Macquarie and the CEO of Blue Sky Alternative Investments, who was under siege at the time and eventually bit the dust!

James Kirby and I always have a great time debating the key topics of the week in Money Cafe and one of these is included where I also highlight 5 of my top funds.

Percy Allan is a regular contributor to The Constant Investor with his Market Timing editorial. An article he wrote was of particular interest - how to be a lazy investor while still being a constant one.

The Constant Investor aims to give you access to CEO and Fund Manager insights that can provide interesting investment ideas.

I also try to provide some analysis and interpretation of all that is going on in the markets and the business and finance world so members can keep up to date and informed.

It's an interesting read to see where the year has taken us so far and shows that the world is never constant which is why it is so important to be a constant investor!

I hope this publication gives you a good idea of the type of content we offer to our members and that you enjoy the Top 10 stories of 2018.

Alan Kohler

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Contents

A Shocker, Trump and Trump again, Wesfarmers Spits Out Coles, Ragdoll Kittens, Stephen Hawkins, and more…

March 17, 2018 Alan Kohler's Overview

Quite Frankly, It's A Shocker

Bill Shorten threw another rock into the superannuation pool this week, promising to stop the paying of cash refunds of franking credits to low taxpayers.

He calls it a loophole and so do a lot of other people, mainly economists and other people who are not retired, and are therefore not living on dividends.

I think the idea is a shocker: cash refunds from the ATO are not a loophole, but an equalisation.

Here's how dividend imputation works:
Say you own shares in a company that pays a fully franked dividend of $700, which means the dividend is carrying a franking credit of $300. Another way of putting that is that the pre-tax dividend would have been $1000.

As a result, you have to declare that $1000 on your tax return and pay your normal tax on that amount. But Australia's unique and excellent system means that you get a credit for the tax paid by the company, which is $300 on that $700 dividend.

So if your tax rate is 47% (the top marginal rate), your tax payable on the $1000 dividend (cash plus franking credit) is $470, except it's reduced to $170 by the franking credit.

If the investment is in a company structure, so the tax payable on the $1000 is 30%, then the $300 credit reduces the tax debt to zero, and if it's an SMSF and the tax rate is 15%, the $300 credit cancels the $150 payable and produces a credit balance of $150 which the ATO pays you.

And if you're a charity or a low-income pensioner with a zero tax rate, then you get the whole $300 in cash.

The point is that the 47% taxpayer has effectively been given a cash cheque from the ATO, it's just that it's in the form of the cancellation of a debt.

I'm just a boy from South Oakleigh, but I reckon cancelling a debt is the same as paying cash: money changes hands either way. That's certainly the way it worked when I was at school.

The system that Peter Costello introduced in July 2000, ending the Keating dictum that dividend imputation should not result in cash refunds, means that all taxpayers benefit equally from franking credits.
And to be honest I can't actually see why there is any argument about this at all: why on earth should someone on the top marginal tax rate, and therefore earning quite a lot of money, get more of a benefit from the dividend imputation system than someone who is paying less tax because they're poor?

To put it another way: why should someone on lower incomes, whether it's because they're a charity or an SMSF or simply someone who is poor, have some or all of their dividends double-taxed, so that the principle of no double taxation of company profits only applies to rich shareholders?

I think Bill Shorten and Chris Bowen are on a big loser here, and compensating the poorest shareholders with extra pension won't cut it, for two reasons.

First, you don't have to be dirt poor to deserve equal treatment – what Shorten is proposing is a discriminatory pay cut for most, if not all, retirees through double taxation of some of their dividends, and second, welfare is what the

superannuation system is trying to avoid, and using welfare payments to compensate for an unfair distortion of it is counter to everything it is about.

This could end up being Bill Shorten's WorkChoices, except unlike John Howard, he's doing it in Opposition. So that's where he'll stay.

Trumpski

I used to think Donald Trump would probably get tired of being President and just leave it to others while he plays golf. I wasn't the only one interested in this: there's even a website dedicated to 'Trump Golf Count'; the latest count is 79 (games since inauguration).

Turns out I was wrong about him losing interest in the job though: firing the Secretary of State, only done once before, is a sign of someone who is fully engaged, especially since he did it on Twitter, himself. He's also running the upcoming discussions with Kim Jong Un, although, of course, the jury is out about how successful that's going to be.

So now I think he might be the Manchurian Candidate. He has joined in the general outrage and sanctioning of Russia over that poisoning in Salisbury, UK, but I suppose it would have been a bit obvious if he had seen to approve of that atrocity.

I'm talking about the 1962 Manchurian Candidate film and book, not the 2004 remake; not the one that has Denzel Washington with a nanotechnology implant in his back from the evil private equity firm, Manchurian Global, but the one with Laurence is brainwashed by the commies – Russia and China.

In the 2018 remake, starring Donald J Trump, China is the commie enemy, and Russia? It's just a kleptocracy run by a gangster, not communist.

Putin obviously helped Trump win the election and may have something on him and they may be in league for some nefarious purpose, or they might just be trying to get richer than they. Robert Mueller, you'd think, will find out … if Trump doesn't sack him.

The latest from the Robert Mueller front is that the special investigator has subpoenaed material from Trump's companies, so the posse continues to close in.

I discussed the coming trade war with China last week, and this week's development was a story in Reuters that Trump is set to impose tariffs on US$60 billions of Chinese goods in retaliation for China's IP theft.

That's always been the main game with the coming trade war: US Trade Representative Robert Lighthizer was commissioned by Trump last year to conduct an investigation into China's intellectual property behaviour and whether it constitutes a breach of Section 301 of the 1974 Trade Act sufficient to justify unilateral action against China.

It's pretty clear that it does, and that the Trump Administration is keen to do something about it. The perennial mega-bear, Albert Edwards of Societe Generale, put out a note this week to the effect that protectionism and competitive currency devaluation will now bring about the global deflationary bust that he has been (wrongly) predicting for years. Finally!

Trump and his cohorts are clearly preparing for a technology and trade war with China, which is unlikely to end well for anybody. Will it result in a deflationary bust and new financial crisis?

Well, if you already thought there was going to be one of those, then you are definitely more convinced now. For the rest of us, I guess it depends how far it goes.

A Shocker, Trump and Trump again, Wesfarmers Spits Out Coles, Ragdoll Kittens, Stephen Hawkins, and more…

Albert Edwards says it's China first, then Europe. "Boiling away in the background are Germany's, and now too the eurozone's, outsized trade surpluses" with the US, he wrote, adding: "expect President Trump to soon turn his protectionist fire on both Germany and the EU. That will be messy."

Next question: is Trump a Putin plant, about to get impeached for colluding with the enemy so the whole thing gets reversed? I don't know. It's clearly possible, and to be honest I don't know whether that would be a buy or sell signal.

But here is what I think is the most comforting chart amid all this discomfort:

Global growth is not 6%, or zero, it's 3-4%. That's great in my book: steady, unspectacular economic growth is what we want – enough to generate natural increases in revenue for the companies we invest it but not too much that interest rates have to be shoved up fast to prevent inflation.

Trump's Push and Pull

The problem for the United States and the Trump Administration, newly freed from the chafing constraints of economic reality, is that at the same time as the President is using tariffs to get nation's trade deficit down, his fiscal policies will make it go up.

It's generally agreed (by everyone except the President of course) that his fiscal stimulus is coming at precisely the wrong time – the government is increasing spending and borrowing when the economy is close to full employment.

That means the stimulus can't do much to boost GDP since the economy is already operating at close to full capacity.

It means the stimulus will show up in imports and/or inflation. The market is worried about inflation, but as I have written before, technology is holding prices down and will keep doing so for a while yet. Inflation is structurally low.

The extra demand that President Trump and his loyal band of ignoramuses are now injecting into the US economy can only be satisfied with imports – in other words, he is sucking in imports and driving the US trade deficit higher, while at the same time taxing imports to try to stop them.

I dunno, maybe he is genius after all and the tariffs are designed to raise revenue and reduce the deficit, which will be helped by the fact that he's helping to increase imports at the same time. But somehow I doubt it.

Wesfarmers Spits Out Coles

Wesfarmers bought Coles for $19.3 billion at the end of 2007; when Coles is spat out this year or next, having been chewed on for a decade, it will apparently be worth $19.4 billion.

That's a total gain of 0.52% over 10 years, or a compound annual growth rate on the investment of 0.05%.

I reckon that money might have been better spent, and I told Richard Goyder that every time I interviewed him over those ten years, which was quite a few times, and it included immediately after the takeover in 2007.

He got sick of hearing it. The first few times he patiently explained, to a well-meaning but stupid journalist (me), that return on equity isn't everything, even though Wesfarmers had always believed it was.

After a few more times of me insisting that he shouldn't have bought Coles because return on capital might not be everything, but it's almost everything, he just laughed a jolly laugh and we moved on.

Coles defined Richard Goyder's tenure at Wesfarmers: it was the first thing he did, and getting rid of it is the first thing his successor is doing. I think it makes him a failure.

I'm not saying buying Coles was a disaster for Wesfarmers – after all, since the acquisition Wesfarmers' share price has outperformed the ASX 200 index by 25%. It just wasn't that good. Over the same period CSL has outperformed the index by 470%, having made a company transforming acquisition as well (Aventis Behring); it was just a better one.

Apart from the fact Coles destroyed Wesfarmers' previously wonderfully consistent record of 25% ROE, the other reason I thought it wasn't a good idea to buy it was that it changed Wesfarmers from being a conglomerate into being a retailer.

Richard always insisted I was wrong about that as well, although he acknowledged that there was a danger that the company would lose its "conglomerate licence", by which he meant that very few companies were allowed by investors to be conglomerates – most were forced to demerge eventually.

Wesfarmers under Goyder's predecessor Michael Chaney had been given a "conglomerate licence" because it always earned more than 20% on equity and shareholders were duly rewarded with share price growth and decent yields. Not only did the ROE and share price growth slow down after Coles, but the company became predominantly a retailer.

And those are the two reasons Goyder's successor, Rob Scott wants to get rid of it:
1. In FY 2017 Coles' return on capital was 9.7% against 26.5% for the rest of the group. Coles dragged group ROC down to 12.4% because it employs two-thirds of the company's capital and makes one-third of the profit. What's more that's not going to change, only get worse, with Aldi and Kaufland, and Amazon – Germany and America – coming at it.

2. Rob Scott will be desperate to hang on to the "conglomerate licence", and get the company back to being known for great use of capital by applying the "Wesfarmers System" to a wide range of businesses. To do that he must jettison Coles.

Should Coles be part of your portfolio? Superficially the answer is a loud and emphatic NO, given all the challenges facing retailers generally and Coles and Woolworths specifically – Aldi and Amazon, and Kaufland soon.

But it will depend on price and yield. Coles will definitely not be a growth business, but it could throw off a lot of free cash as it shrinks. It might be a very good income stock with a stable share price because it will be a top 30 stock that institutions have to own.
I'm just saying that's possible – don't prejudge.

By the way, I'm not sure why Wesfarmers is going to keep owning 20% of it – that strikes me as fairly silly and unnecessary. I'd say that idea will be quietly forgotten and Coles will be fully jettisoned.

Dr Gerraty's Cat

I've been spending a lot of time lately with a neurologist named Richard Gerraty, a delightful chap who diagnosed Deb's PRES (posterior reversible encephalopathy syndrome) and treated it more or less successfully.
I say "more or less" because he didn't have to

A Shocker, Tump and Trump again, Wesfarmers Spits Out Coles, Ragdoll Kittens, Stephen Hawkins, and more…

do much, since, as the name implies, the thing reverses itself and also, even though she's well on the road to recovery, she's still pretty crook. It's a weird condition, and perhaps belongs in that book by another neurologist, Oliver Sacks: "The Man Who Mistook His Wife For A Hat". Deb didn't mistake me for a hat, but you get the picture, and the R part of the name appears to be a slow process.

Anyway, Dr Gerraty has a cat named Felix, a silly name, which he blames on his daughter, but he dotes on it and talks about it all the time. Without fail, at every consultation the discussion quickly moved on to Felix the cat and his latest cute adventures, or not so cute, as the case may be.

In fact it sounds rather like Felix rules the roost at chez Gerraty and the doctor doesn't mind one bit.

For Deb and me it all brought back wistful memories of Steve, our beloved tabby who died of cancer, aged 8, about a year ago. It's no good getting too miserable about the passing of pets, I've decided, since you're going to outlive all but one of them (or two I suppose, if you have two at once), but we can't help it can we?

I certainly fear for Dr Gerraty's state of mind when Felix goes to meet his maker – wonky brains across Melbourne will have to look after themselves while he goes into an extended period of mourning.

So convincingly enthusiastic about Felix was he that we started researching cat for sale ourselves, toying with the idea of getting another one, even though we had vowed in our grief that Steve would be our last puss.

Dr Gerraty's Felix is a pretty nice looking ragdoll cat (he had an album of pictures on his desk), which to be honest we'd never heard of, so we thought maybe we'll look at one of those. We found a breeder on Gumtree who had a new litter of them, and by coincidence, the address was in South Oakleigh, just around the corner from where I used to live – in fact I delivered newspapers to that very house throughout my teens, I realised.

So last Saturday we drove out to South Oakleigh for the first time in, oh a decade or so, and drove up the driveway of your standard cream brick veneer (it was on a main road, so we couldn't park in the street).
Except the yard was a very substandard, appalling mess: totally overgrown, with junk everywhere. Hmmm, we thought.

Knocked on the door and a charming Chinese lady answered and invited us in, with – can I say this? – less than perfect English. It was like a hoarder's place. There was stuff everywhere, with narrow pathways between the rubbish, and it stank of cats. Oh did it stink.

This is not good, I thought. The kittens, plus the mum and dad and a few other older cats, were lolling about peacefully everywhere, and of course as soon as we tried to pick one of them up to inspect the merchandise, it took off and hid under a piece of junk.

The nice lady would scoot around and catch the creature we wanted to look at and I must admit they were pretty cute. Very soft and fluffy.
But nah. It was all too dodgy: we could barely understand a word the woman said and goodness knows what the cats have got wrong with them, and anyway, they were all white! With long hair to be left on clothing and furniture! No thanks. We drove away from South Oakleigh shaking our heads.

We've gone off getting a cat now.

10 years at the helm of Macquarie Group

May 4, 2018 CEO Interviews

Nicholas Moore is the CEO of Macquarie Group, and he's been CEO, this month, for 10 years exactly. I've been trying to interview him for about 10 years as well and usually without success, certainly when I was running the TV show Inside Business he wouldn't come on because he didn't do TV. But he's been a reluctant interviewee over the years and it's very good to get him on board today just as he becomes the top paid CEO on the ASX, which possibly at the time may not be the greatest given what's been going on with the Royal Commission. Anyway, I asked him about that and many other things.

ASX code: MQG
Share price: $108.01
Market cap: $34.771 billion
PE ratio: 15.43
Yield: 4.64%

AK: Nicholas, this month of course is your 10th anniversary in the job and I get the sense that business has changed quite a lot obviously in those 10 years and you're now I think about 70% annuity style income, 30% markets, but I get the feeling that it was the other way around 10 years ago, would that be right?

That's right, Alan. There has been a change in the mix. This is Macquarie responding to market conditions as we do. A change in mix annuity versus capital markets, as you say, are largely changing around. As well as that we've continued to grow our international footprint. We've been growing that for some years obviously, but we've continued to grow it this year. In terms of top line revenue, we have about 67% outside Australia. After expenses that's about 70% of our income outside Australia. Australia's still our most important place of business but unusually for a financial services group we have more activity outside our home market than we do have inside our home market, so quite an unusual feature of the group.

AK: But did you have that change of business both geographical and in the style of business in mind when you took over? Was that a plan or were you just sort of making it up as you went along as it were?

Well, the strength of Macquarie is the culture that we've had for 49 years. That's very much a – we call it a bottom-up driven culture. The people who are actually on the ground working in the markets, working with the clients and the customers, are the ones that see the new opportunities and actually respond to them. It's the individual businesses who choose to be growing their businesses outside Australia, it's individuals in those businesses who see opportunities and step up and take them.

As well as that, in terms of new business lines again it's people in the business who see opportunities. Fortunately, Macquarie has always been well capitalised, so we've been able to support people in terms of their endeavours. Also, we have a culture that not only allows people to see what the new opportunities will be, but also we do change – we have a constant feedback where we're looking at how the idea is developing, how the business is developing, how the opportunity is developing and we are changing always slightly at the margin what we're doing.

Over the 10-year period obviously a lot of activities. We stopped doing new activities we took on, we might have taken on a new activity with an objective in one direction but when we started developing it actually moved and transformed in terms of the development. I think having that bottom-up driven culture has been a real strength to Macquarie. We don't sit in the centre and direct activity. We think there's great opportunities in renewables globally. What happens more is all our different businesses will be out there, they'll be dealing with opportunities and they will see what the renewable opportunity may be. They might start investing their time, might start investing their capital and so the business grows up incrementally step by step.

A very granular process, very step by step process. Always been very careful of course in terms of stepping forward. When you're stepping forward you're stepping into the unknown, so things will never be as you expect. What's as important as pursuing the opportunity is actually checking your progress and changing your direction on a constant basis.

AK: A lot of the coverage today has been around your remuneration and the fact that you appear to have become the best paid ASX CEO. Do you think that given what's going on with the Royal Commission and everything, it's a bad thing or is it a good thing because it means that the business is successful?

The success of Macquarie, coming back to the point you raised before, has...

AK: Can we talk about your salary?

Yeah, we are, but I think we have to say how it fits into Macquarie. When we look at Macquarie in terms of the driver, remuneration obviously has always been a feature. David Clarke, our first Chairman, used to make sure that when people were talking about this he would use the word 'profit share'. So when we look at performance based pay at Macquarie it's always a profit share. The Macquarie view of the world is it's always been a partnership between the shareholders and the staff. That was back in 1969 when it started as Hill Samuel Australia. Certainly in 1984 when we became Macquarie that partnership was again emphasised and it continues to be the case.

Peter Warne, our Chairmen, described this in the press conference that we had recently. I think when you talk about remuneration at Macquarie it always has to be on this idea of a sharing of the profits between the staff and the shareholders that both parties are entering into. As well as that, of course Peter emphasised the long-dated nature of that in terms of the amount of pay that's deferred and indeed the pay that's actually invested in Macquarie equity on an ongoing basis. When you think about Macquarie our senior people have been here for a long period of time, as you can see in terms of our remuneration report. It's that real sense of partnership and that's reflected in the pay as being a share of the profits from the business, coming back to the people who led and developed those businesses.

AK: I was also just wondering how you reflect on the publicity of being the highest paid ASX CEO. I get all that and obviously I think about two-thirds of your remuneration was, as you say, share based payments, and long term is probably escrowed to some extent as well. But I'm just wondering how you reflect on that given what's been going on lately with the Royal Commission. Do you think it's possibly a problem or not?

Macquarie's remuneration, as you know, has been a long term story. As long as I've worked at Macquarie, our remuneration, our profit share has been the subject of discussion. It's an issue, it's always been an issue as I recall.

AK: One of the interesting things is that you've been in the job 10 years but you still haven't got back to what you were paid before you became CEO. The year before you became CEO it was $26 million or something and now it's less than $20m.

Well, the board determines the pay I receive and everybody else and they go through a full process, coming back to this idea of partnership we talked about before, they have regard to a whole range of factors and they determine the amount that they think is appropriate.

AK: I calculated the total return on Macquarie, this is capital and dividends, since May 2008, has been something like 8.5-9% per annum compound over that period. Does that sound right to you and if so, what do you think of that? Are you proud of that?

I don't know if you've got the remuneration report, do you have the remuneration report there, Alan?

AK: Yeah, I have.

Okay, so in the remuneration report we have on pages 65 and 66, you can see the Macquarie performance versus a number of indexes. You see it against the MSCI world capital markets index and you can see it against the all-ords. This has been put together by the board of course and it illustrates our relative performance. We've also broken out there – I think you can see the return on equity over the period as well.

AK: And you've also, as it happens, outperformed Goldman Sachs over that period.

Yeah, in terms of our return on equity, again it's public in terms of our return on equity, our share price compared with other companies globally in the space. We can send you that detail if you like?

AK: What do you think the risks are as you think about the next few years facing Macquarie and I suppose, the rest of your industry, what do you think the risks are? Do you think, for example, that you're likely to face some fee compression?

Well, there's no shortage of risks in financial services always of course, Alan, as you know, in terms of the whole range of our different activities. You'd really need to go to the five different businesses we have within Macquarie to drill down in terms of the relative risks. We've got the asset management business and obviously the risk there is the performance of our asset managers. They've performed well obviously to date, particularly in the MIRA business. We sincerely believe they're making good investments and managing them well at the moment.

In terms of our CAF business, it's a leasing and it's a credit business and again we need good judgements in terms of the services that we're providing to the clients there, making sure they are high quality services and that the risk we're taking there are good and effective risks. In terms of our banking and financial services risk, again it's very much making sure we're providing good services to the clients and making sure that the credit risks we're taking there are appropriate for the returns we're getting.

From the commodities viewpoint obviously, there's a whole range of commodity products that we're offering around the world. We have credit risk associated with those. We have market risk associated with those. We have regulatory and compliance risk of course associated with those as all the others. Macquarie Capital, obviously it is capital market activity taking place there. There's a whole range of risks in terms of market risk, but again there's the compliance risks, and the other regulatory risks that we're dealing with. There's a lot of risks in all our businesses.

10 years at the helm of Macquarie Group

Risk is obviously, and we've always made clear, is a key part of who we are as an organisation. Every person within Macquarie focuses on risk, that said we have a separate risk management area that reports into the board which focuses on having a second view on risk within the organisation overall.

AK: Do you have a comment on what's being discovered in the Royal Commission and what's been coming out lately and also the APRA report on the Commonwealth Bank and so on and what's been going on at AMP?

Yes, well we're looking at certainly the Royal Commission on a daily basis and then we've done an initial review and we're doing further work on the APRA report into the Commonwealth Bank. We're looking at it, we're learning the lessons in terms of what that's telling us. We're obviously comparing it with what's happening in our business, we're paying a lot of attention on an individual item by item viewpoint. In terms of the overall viewpoint for the Royal Commission, it's still early days yet in terms of the Royal Commission, so we'll wait to see how it develops. But certainly, every day in terms of what we see, it's the cause for work internally thinking about what the implications may be for Macquarie.

AK: Do you expect to appear?

Well, we don't know plainly in terms of whether we'll appear or not. Plainly, when you think about Macquarie we're a global financial services group. As I mentioned before, we have 70% of our activities outside Australia. We do have retail businesses here in Australia of course, we've got our mortgage business. We've got our Wrap platform amongst other platforms we provide and we have our business banking areas as well. So we do have Australian financial services business outside that retail space, we also have wholesale services we provide in terms of our securities businesses, our advisory businesses and our asset management business.

So we do in terms of the activities here, we have quite a footprint and we have been providing information to the Royal Commission to date and we could be providing more information I suspect going forward.

AK: Do you have a time in mind when you might retire as CEO? I mean, it's been 10 years, it's longer than usual for a CEO. Is there kind of a term in your contract that you could share with us?

No, there's no term in our contracts as such. I've been at Macquarie 32 years. As you know, I've been CEO for 10 years, but I've been here 32 years. I feel very fortunate that I joined Macquarie 32 years ago. It's been a really great privilege to work with the people I've worked with over the last 32 years and I continue to be enthusiastic for the challenges of the role. That position hasn't changed for some time.

AK: So, no thought of when you might step down?

Not at this stage, no.

AK: Well, it's great talking to you, Nicholas, thank you.

That was Nicholas Moore, the CEO of Macquarie Group.

Blue Sky: Under Siege

April 10, 2018 CEO Interviews

Today's CEO is Rob Shand of Blue Sky Alternative Investments, the company that's been under siege from the US short selling outfit called Glaucus Research, the one that sent Quintis broke last year and has now turned its attention to Blue Sky, and a week and a half ago published a sixty seven page report on Blue Sky which tore strips off it and says, primarily, that its assets under management are a fraction of what the company says they are, that it gauges investors with extortionate fees, overvalues assets, and is general overpriced and worth only a fraction of what it was. In fact, the share price has now fallen by a bit less than half to about $5.70 down from over $11.

Obviously a lot of people have decided to sell and ask questions later, and that's fair enough – that's what happens. I've been a supporter of Blue Sky over the years going back quite a long way. I thought it was a great vehicle for small investors to gain exposure to alternative assets that are usually the domain of large super funds. One of the points that Glaucus makes is that half of what Blue Sky invests in is property, and property is just that – not alternative at all. Anyway, Rob Shand is under the pump at the moment as CEO – he's a young man, this is his first big crisis, and he is having to deal with it. He's going around the country talking to investors. Seems to be holding the line at this point. They've put out a statement saying Glaucus' effort is all completely wrong, but in our interview admits that they could do better with transparency and disclosure and they're going to do better in the future. So that's something. He thinks, to that extent at least, Glaucus has a point in that regard and they are going to disclose more. But as for the rest of it, it's all wrong.

I put all the questions to Rob Shand, put him under the griller for 45 minutes; the longest interview I've done for The Constant Investor. He answered the questions clearly and did his best, so I think the best thing to do is listen to read the transcript and make up your own mind.

Here's Rob Shand, Managing Director of Blue Sky Alternative Investments.
ASX code: BLA
Share price: $5.68
Market cap: 441.62 million

AK: Rob, perhaps we can just start with a sort of a general question. Do you acknowledge that you could have been more transparent so that somebody couldn't come along and just make what appeared to be valid assertions about things that really should just be on the record and that there should be no argument about?

Yeah, I'll start by saying it's clearly been very disappointing what has happened. It's disappointing that a group like this can come into Australia – and you mentioned the allegations – with allegations frankly, that had no basis in facts whatsoever and followed a typical play creating fear and confusion across the market.

Absolutely, as a business I think we have done a good job historically of communicating with our fund investors and doing that very, very well. But clearly we will go back and look at how we communicate more broadly and how we disclose more broadly to the market. That's something that as a business we'll be going back and having a good hard look at and we'll do that in a very methodical and very measured way. It's something that we've been improving over the years, it's something that we will have to obviously continue to do much more in that area.

In your response the other day that you put out to the shareholders and to the stock exchange you talked about how you needed to maintain a certain level of confidentiality for fiduciary obligations, is that really necessary? Do you now look back on that, look at that and think, well maybe that wasn't such a good idea after all?

All I'd say there is, as I said before, we are committed to the business to make sure that we provide the appropriate level of disclosure to the market. We are, as I said before, going back and having a good hard look at exactly what we've done in the past and what we can do going forward. For any listed business there is a limit to all of the information that you can possibly disclose, but as I said we're committed to doing more in that regard.

AK: So you will be disclosing more but you can't tell us exactly how much more?

As I said, we want to make sure that we are frankly world-class in terms of the disclosure, as we are in terms of the other aspects of our business. Our returns are very good as a business, the investments we've made have been very good. They're not perfect, clearly, but our track record over 12 years now has been very, very strong. We want to make sure that in the same way that we've done a good job on the investing side of our business, done a good job of communicating to our fund investors, what we do as a business. I think it's also important that we have similar standards in the way that we disclose and talk about our business in property markets, that's obviously I think.

AK: One of the confusions that seems to have arisen out of this process has been around how you should be compared. One of the accusations from Glaucus Research is that you compare yourself to other alternative asset managers like Blackstone and KKR and so on when it suits you, and then when it suits you alternatively you compare yourself to property managers. I mean, how do you compare yourself? Exactly what are you and how should we compare you?

I suppose to start with, this comparison with property fund managers in this country, the simple thing that we were demonstrating in our response is Glaucus tried to allege that it is not market practice in Australia for a property business to measure assets under management in the way that we do. And indeed, there are very many ASX listed businesses that disclose assets under management in the property space in exactly the same way that we do. It's groups like Macquarie Bank, for example, like Goodman, like Mirvac... There are eight or nine that we listed in our response and it was just disingenuous for an allegation such as that to be made.

Your point though around how do you compare Blue Sky, that's a valid one and it's for our business – it's a bit of a double edged sword. The positive for us is we are unique in the Australian context, we are Australia's only listed diversified alternative asset manager and we have as a result, benefitted from the enormous wave of growth towards the alternatives segment both in Australia and overseas. So that's been a very powerful thing for our business and has positioned us very well.

The difficulty and the doubled edged nature of the sword is in the Australian context because there is no other business like us at the moment it's very hard for local shareholders and investors to compare us to another group.

Our business model, it is true to say it's the same sort of business model as some of the larger alternative asset managers overseas, but they are materially larger businesses than our own and so you do have to be a little bit careful with the comparisons.

AK: But I suppose the point being – and I've checked as well with other property managers in Australia and it is the case of course that everyone does report assets under management as the gross figure including debt, and that's what you do. But the thing is that their valuation on the share market, their market capitalisation is generally around about the same as their NTA, a little bit more sometimes, 1.2 times, possibly up to 1.5 times. But even after your share price fall of 45% in the last week, you're still 3 times NTA. And so you're priced as something other than those property companies that you kind of compare yourself with in terms of the assets under management. Do you acknowledge that?

Well, two things I'd say: one is, it is fundamentally important for us as a business that when we measure our AUM whether it's in property or whether it's in private equity or whether it's in any other asset class that we do so in a way that is consistent with market practice in Australia. That's fundamental to the way we report. In terms of our share price it's obviously not something that I can expand on in great detail, but what I would say is given that growth in the alternatives market and given our positioning in that market, you have seen our business on a very, very strong growth trajectory over the last couple of years.

We've increased from inception back in 2006 to having over $4 billion dollars in assets under management today and I think that strong growth profile of our own business coupled with the very, very strong growth of our industry, I think that is perhaps what's being reflected in our price.

AK: No, but isn't it the point that you're only half an alternative assets manager, you're half a property manager and you're saying because we're a property manager we should report assets under management on a gross level like other property managers, except that you are saying you're an alternative asset manager and that the alternative asset managers elsewhere in the world don't do that. I mean, as you say it's a double-edged sword but it's also a benefit that you're kind of getting by being a bit of both?

Yeah, well I'm sure if we were to report our assets under management in any asset class whether it's property or another in a way that was not consistent with market practice in Australia, I'm sure the criticisms would be far louder. At the end of the day we are a diversified alternative asset manager. Other groups overseas that have the same business model, property and private real estate, as we call it, is a core part of what they all do.

AK: The other thing about this particular point is that it depends a bit on what the gearing is and also what the fee is. I think your average management fee is 1%, right? Which I think is a fair bit more than the property managers that you talk about in your response, they're all charging 0.7 and 0.8%, but you're more than that at 1%, is that correct?

Once again, our fee structures are absolutely market standard in each of the asset classes that we operate in. And in the property space you are remunerated as an asset manager based on the size of the building. It doesn't matter in which way it is financed, it is the size of the building that you're constructing or the size of the asset that you're managing that is relevant to that. Our fees are absolutely in line with the market standards here and indeed, we have, as you would have seen in our disclosures, attracted capital from institutional investors both in Australia and offshore. There are 20 institutional investors that invest with Blue

Sky, that's obviously grown over the last three or four years and helped our business grow. These institutional investors spend a long, long, long time on due diligence. They look at both the investment that they're making, the fund manager itself and of course, they look at fees. You wouldn't have groups like these choosing to invest with a fund manager like us if the fees were anything other than the market standard.

AK: And what about your gearing, what's the average gearing level in your property assets?

It depends on exactly which property assets you're talking about, but typically it's in the range of 50%.

AK: You mean that's an average, would you say?

Yeah, that's fair.

AK: From my kind of investigations around the market place, that's a bit high. Maybe you can put me right, but from what I can tell most people are talking about gearing of 30-40%, I mean 50% is not way out of line but it's a bit higher than perhaps others who are claiming gross assets under management.

The asset classes that we're investing in, that's in line with the market standard. The property assets that we manage in Australia, where there is gearing they are banked by some of Australia's four major banks and they are in line with the market standard.

AK: Just on the matter of fees, I mean obviously the Glaucus Research stuff is pretty florid, they're accusing you of gouging Australian investors with extortionate fees and so on, and the figure that they kind of mention which is getting a bit of currency is 17%, that your fees are up to 17%.

AK: What that comes from is a business called Flora, where what they say is the management fee upfront was $0.3 million, so, $300,000. Transaction fees, $1.1 million. Total fees to Blue Sky, $1.4 million. Out of capital raised $8 million, which is 17.3%, which is the largest – I mean, they've got a whole list of different fees of that sort. Talk to us about that, because the $1.4 million is 17% of $8m, right? Why is that not valid?

It's another example and as we said in our response to the ASX last week, this entire opinion piece is riddled with either errors, factual misunderstandings and allegations that bear no resemblance whatsoever to reality. The assets under management allegation was absolutely one of those. They claimed that we only have $1.5 billion in assets under management when categorically we have greater than $4b. In the same way, these assertions on our fees are also categorically not true. They take a piece of information and extrapolate it into something that is just a gross misrepresentation of the reality.

The fees that they represent in Flora Street are, as I said before, absolutely in line with market standard. Some of the fees in there are fees at the outset of a deal that compensate and basically recover costs of doing a deal, whether those are external advisers, lawyers, the accountants required to put the deals together. They are ongoing management fees, once again, in line with market standard and they're performance fees. We charge a mix of those fees in line with every other fund manager in the country and Glaucus' representation and grouping of those all into one lump and saying that that's 17% is, as I said, a gross misrepresentation.

AK: But are those numbers wrong? Is the transaction fee of $1.1 million incorrect? Are you saying that that's not a correct figure?

I don't have that particular fund in front of me, Alan, but as we said in our ASX release, the allegations that they make on that particular fee structure is absolutely misleading.

AK: Well, either the number is $1.1 million or it's not. I'm just looking at their report and they said they seem to be getting that number from disclosure documents, so either you raised $8 million dollars and got $1.1 million in transactions fees for that or not?

I don't have it in front of me, Alan. We do manage approximately 80 funds, but I can assure you that the fees that we charge on each of our funds, Flora included, are absolutely in line with market standard and we clarified that when we responded to the ASX early last week. Our investor base, as I said before, it's made up of a whole range of institutional investors, it's made up of a whole range of scattered investors, high net worth and family offices, people that are well advised. It's not something that these groups would miss.

AK: There was also a discussion about the Burrito business, what was it called? I can't remember what it's called now, Beach Burrito?

Beach Burrito Company, yes.

AK: They said that they've probably skewed your – because that was your first investment and it was a $200,000 cheque written to fund that. I think the point they're making about that is it possibly skews your return since inception of 15% because there were only six or there weren't many in those early days so it kind of distorts the picture. And you've kind of said, well actually it's all weighted, it isn't equally weighted, they're all kind of weighted investments.

They're weighted based on the size of the investment. $150,000 investment 12 years ago has no material impact on our returns whatsoever. It's another example of this complete misunderstanding of our business, intentional or otherwise and therefore complete misrepresentation of the truth.

AK: It just seemed to me you may have been talking at cross-purposes because I think the implication that I got out of it was that it obviously was material back then, 12 years ago it was a material investment. Obviously, it's not now but it would have had a material impact on your percentage performance back then is I think what the point was.

I don't think that was the point. Back when it was our first investment and it was our only investment 12 years ago, your assertion is true if you only have one investment that is material, but now with...

AK: And if the value doubled in that first year then you got 100% return in that year which goes into your return since inception, is all I'm saying. I mean, I don't know exactly how it might have unfolded.

Yeah, and because we equity weight each of the investments in our portfolio, a $150,000 investment, which is, a) tiny, clearly; and b) a long time ago. As I said, it has no material impact on our investment track record whatsoever.

AK: Right. They're pretty comprehensive, the report's 67 pages as you know, I mean you probably read it top to bottom...

Yeah, this is part of the playbook to, as I said before, to create fear and confusion, to throw out 100 allegations knowing full well that probably all 100 are incorrect. And indeed, in our case in this particular report that is the case. The allegations are totally incorrect and we went back to the ASX confirming as such. This is part of the playbook to create that fear and doubt across the market and to have people reading the headlines and therefore sell the shares, drive the share price down such that an overseas group like this profits. That's part of the playbook irrespective of the facts. What I'm keen to make sure the market is aware of is the facts of the situation and the facts of the situation are that we do have more than $4 billion under management, that our investment track record is 15% per annum net of fees. That investment track record was reviewed externally by Ernst & Young in February of this year and that that track record has been one that has stood us in very good light against our global peers and therefore attracted a whole range of institutional investors into our funds.

The final point I would say there is simply that our balance sheet as a business is in a very, very strong position and that is, that's a great platform for our future growth.

AK: Just talking about your performance, they do accuse you of aggressively and unjustifiably marking up the value of unrealised assets and therefore overstating your performance.

Which is once again a complete fabrication.

AK: Well, tell us about how you do value your unrealised assets?

Every asset in our portfolio has had a minimum three levels of external review. So, at a minimum we have an independent valuer come in and effectively sign off on the valuations, at least every 12 months for our liquid asset classes such as private equity. In addition to that we have our audit firm, which is Ernst & Young, sign off those valuations, they're included in the audit work they do each year which is signed off. Our audit committee which is made up entirely of independent directors also signs off on those valuations. It is a very rigorous approach, it's in line with market standards.

As I said, at a minimum there are those three levels and for certain asset classes where there are auditors at the fund level, there was institutional investors involved, there are other independent checks and balances in there. But as I said, at a minimum there are those three independent checks through the process.
And associated with the valuation accusation is also one concerning receivables. Now, just to explain, I think the question of receivables is that if an asset is over-valued, then the management fee that's associated with it turns into a receivable because the asset can't pay the cash as the management fee.

AK: They're saying that your receivables are ballooning which is evidence of the over-valuation of assets. What's your response to that?

Just before I move onto that, the true test of your valuation, you do need to have absolutely a rigorous process which we have and as I said, that's in line with market standards. But the true test is when you go to sell an asset. We have realised 39 assets since our inception and on 34 out of those 39 occasions, we've had to mark those assets up on the way out. In other words, they've been carried at a value that is less than what the actual value is and I think that is very, very strong evidence of the conservative nature of the valuations process.

In terms of the impact of the valuations on management fees, once again, as with virtually everything in this opinion piece, it is a gross misrepresentation.

For the vast majority of our funds, valuations and how those valuations move over the course of an investment period have no impact on the management fees whatsoever. That is relevant for open ended funds. If you're a traditional equities manager, if you're managing a fund that invests in large cap Aussie stocks, yes, your

management fees do move in line with the net asset value, the NAV of your fund each month. That is true in the world of traditional funds management in open ended funds. But you know, 76 of the 80 funds that we manage are closed ended and the management fees are set at the outset. How the valuations move, whether they move up or down, has no impact whatsoever on the level of management fees charged. It's just, as I said, another demonstration of the misrepresentations and the inaccuracies in the report that you've got before you, Alan.

AK: So is it the case that your receivables in FY17 were $86.9 million, which was 126% of revenue, up from 34% back in 2012? Is that figure wrong or right?

I don't have it in front of me, Alan, but I assume that will be right and the growth in our receivables balance simply reflects the growth in our assets under management. As I said, since about three or four years ago we had $1 billion in assets under management. We're now over $4 billion, of course your receivables are going to grow as your business grows, that's not unusual in the slightest.

AK: But they've grown as a percentage of revenue, that's the point they're making is it's gone from 34% in 2012 to 126% last year as a percentage of revenue, so it's relative rather than in absolute terms.

What we provided to the ASX when we responded to this was a comparison of our percentage of receivables as a percentage of revenue or as a percentage of fee earning assets under management and they are absolutely in line with other listed alternative asset managers around the world the world that have the same business model as us.

AK: Right. I interrupted you, you were going to say something else, I'm sorry.
I was just going to say, the percentage for us is about 104%. The range for other groups in other markets is between 80% up to 115%, we're sort of 104%. Our receivables balance is not unusual whatsoever and simply just reflects the growth that we've experienced as a business.

AK: One of the things they say is that from their point of view they're like detectives. "We're playing the role of financial detectives..." they say, "trying to reconstruct Blue Sky's fee earning assets under management from the limited publicly available evidence. So we call on Blue Sky to match the level of disclosure of other alternative asset managers like KKR and Blackstone. Are you going to do that?

We're absolutely committed to make sure that we're doing the best possible job on that side. What I would note is they call themselves detectives, but at the same time as calling themselves detectives, they have had no dialogue with us, with our business at all or senior management. We have invited them to meet with us so they can ask us their questions and that we can take the opportunity to correct any misunderstandings that they had. They have not taken us up on that opportunity. It shines through in the works. They try and build up a picture of our assets under management and miss, just as one example, miss virtually all of the institutional capital that we manage.

The institutional capital that we manage makes up 40% of that $4 billion that we've got in assets under management and it's simply missed from their report. So I'd argue that the detective work hasn't been that well done.

AK: Where do you go from here? What's the plan?

At the end of the day, what we've got to do is we've got a fundamentally good business. As I said before, we've got a very strong balance sheet. Our funds are closed ended, so they don't come with redemption rights and having this sort of opinion piece land has really galvanised our team. What we need to do as a business is make sure that we continue to do what we do best, continue to deliver on outcomes for our investors. Delivery of exits from some of the investments that we've made, and we'll obviously be announcing those as we make them. The delivery and announcement of new institutional mandates in particular that we are awarded, but we've got to continue to focus on building our business in the way that we've done for the last 12 years and those tangible outcomes of those exits or realisations as well as new mandates, I think we'll give the public a very good insight into where the facts lie.

For a research group like this facts aren't really their interest. At the end of the day, they want to profit from the misinformation that they feed and the fear and doubt that that causes. That's fair game and our game is simply to stick to the delivery of outcomes based on the facts.

Well they certainly acknowledge that, I mean they openly admit that they're biased and that they're out to make a profit, that's what they're doing.

And they admit that their report is – you have to look in the fine print for it – but are not statements of fact. As an ASX listed business that's obviously licensed in Australia, we're bound to stick to the facts and that's absolutely what we intend to do and they're bound by no such obligation.

AK: For investors and our subscribers the key issue comes down to, you might have a good business and I've always thought you have, I've always thought that the Blue Sky business was terrific and you guys had integrity and all that stuff, but the question I guess is what's the correct price of the business? Because, as I said before, it's currently three times net assets. Is that the right price? It's roughly 10% of assets under management, as described or disclosed by you? Is that the right price? Because $11 dollars appears not to have been the right price and now it's $5.69 today. Is that the right price or is the Glaucus effort of $2.69 or something the right price? That's the issue, isn't it?

Yeah, and it's not for me as the Managing Director of a publicly listed company to comment on the price. But as I said before, some of the stuff that's been missed are some simple facts around the growth in the business that we've experienced. I've mentioned the AUM previously on this call, but even if you just look at our profitability, that grew by 60% last year. The revenue of the business was up 40%, margins increased from 41.2% to just under 45%.

That growth that we've seen both in terms of the assets under management and the profitability of the business, the team that you mentioned which is a team of integrity, the closed-ended nature of our funds which means we aren't at risk of redemptions in the same way that traditional funds management businesses are. I think these are all the sorts of themes that investors look at when evaluating the price of our shares.

AK: You must be wishing your main company was closed in in the sense you weren't listed...?

Not at all.

AK: Because obviously a listed company is subject to redemptions and that's what you've been getting in the past week.

Being a listed business has been a fabulous platform for our business and if we had our time over again would I have listed the business again back in 2012? Absolutely, we would have. This is a process, Alan, and I think one of the public commentators described it as a baptism of fire. But we'll emerge from this a far stronger business and a far bigger business, frankly. So I don't have any worries about that whatsoever. How will you emerge from it a bigger business? I can see how you think you'll emerge stronger because it is definitely being forged in the fire, but how would you emerge bigger?

Over the period of time I think what you'll see is, as I said, in a market, the alternative market that is growing as strongly as it is and with the investment track record and the institutional support and the team that we've got, I think at the end of the day once the dust settles on this, people will focus on those facts and we will continue to grow as a business and grow very strongly.

AK: That was Rob Shand, the CEO of Blue Sky Alternative Investments.

Tawana's lithium play

January 29, 2018 CEO Interviews

Mark Calderwood is the Managing Director of Tawana Resources NL, which is one of the more interesting lithium players going on in WA. They've got a mine just near Kambalda in Western Australia and they are about to start production in March of both lithium and tantalum. This mine used to be a tantalum mine going way back. Although he's had a long time in the gold industry, Mark Calderwood is a bit of a pegmatite expert, which is the type of rock that lithium's found in. He wrote the book about it, he says, and he realised that there'd be a fair bit of lithium in the Bald Hill Mine, as it's called, as well as tantalum, and so he bought in.

It's a 50% stake that they've got with another Australian listed company called Alliance, and they're starting to produce lithium, as I say, and tantalum again this month with offtake agreements with Chinese producers and battery makers, but also of the tantalum sold. They executed the offtake agreement for the tantalum with a global trader of that stuff today. The interesting thing about the company perhaps is that although the shares have gone up quite a lot in the last little while – the last few months they've actually taken off, I think it's a 10-bager in the last two years. They've gone from 4 cents to 49 cents over a couple of years.
Mark reckons that there's a fair bit to go because they're about to upgrade the resource, the amount of lithium in the mine, which he says there's a whole lot more than they've currently found, they just need to do more drilling and they're about to upgrade it. So, there's a tip for you, Tawana Resources NL will be announcing resource upgrades in the next couple of months which should result in an increase in the share price. But probably worth having a good long listen to the interview so that you understand the business a bit better and what's going on there.

Also, the other thing worth listening to Mark about is just the lithium market and how he sees it unfolding. Obviously, guys like Mark are all over it and understanding what's going on, so he's worth listening to on that subject as well.

Here's Mark Calderwood, the Managing Director of Tawana Resources.

AK: Mark, obviously your main asset is Bald Hill lithium and tantalum mine, tell us about the mine, where is it and is it a mine already?

Yes, Alan, it's had a historic tantalum production from about 2002 up to 2005 and more recently in 2015, 2016. The mine is located about 50 kilometres southeast of Kambalda in the Western Australian Eastern Goldfields.

AK: How long has Tawana Resources owned it?

Well, we own half of it, it's a joint venture between us and Alliance Mineral Assets, which is an Australian incorporated but Singapore listed. We've been involved since about October 2016 and finished our due diligence at the end of 2016.

AK: It was owned by Alliance and you bought in, is that what happened?

Yes, correct. They were focusing on tantalum and we took on drilling the project out for lithium and subsequently in that period we'd finished a feasibility study, built the plant, almost finished the plant now, so it's been a fairly fast route to production.

What's the background of Tawana Resources? I can't find any history of it on the website. What has it done in the past?

It actually originally had assets in South Africa. Then it had iron ore assets in West Africa. Subsequent to that and basically mid-2016 it parked those assets, the ones in Liberia. It's still got them but they're iron ore and iron ore obviously fell out of favour for juniors. But it started focusing on lithium in mid-2016.

AK: But that's why it's listed on the Johannesburg Stock Exchange as well as the ASX?

Correct. It's for historic reasons.

AK: Is that worth keeping?

We'd suggest probably not, but then the South Africans have suggested, well there is no lithium players on their market and given where things are headed in the future maybe the funds over there in South Africa would like some exposure to lithium on their stock exchange.

AK: You're an old gold man, how did you get involved with Tawana?

Well, before gold I was actually involved with pegmatites, and pegmatites are the source of lithium and I co-authored the book on WA Pegmatites. So, when gold was in the doldrums in '15, various investors were pushing me to look at lithium and I said, well I know one very good lithium deposit that everyone's forgotten about and that was Bald Hill.

AK: How did you know about...?

I'd been there in the 80s, before they even mined for tantalum. I'd seen rich lithium at surface. Those pegmatites have never been drilled, in fact. They're still there waiting to be drilled. But I knew that from the 80s, I'd done a lot of work in the 80s on pegmatites thanks to tantalum.

AK: Do you think there's a lot more lithium at Bald Hill than has been found?

Oh, god yes. We've only really been drilling a year, we know there's many years of drilling ahead of us but it was about speed to production. So we said, rather than finish drilling the project, we'll drill out the initial reserve and then we'll get on and build it and then we'll keep growing the project over the coming years ahead.

AK: What's the grade and how does that compare with other hard rock lithium?

It's pretty similar. Ours is sitting around the 1.2%. If you compare that to say, a gold mine, 1.2 per cent – that's equivalent to about 5 grams of gold, so quite high grade in terms of in-ground value. But typical for the West Australian deposits. The big one at Greenbushes is higher grade than that, the one that's being mined at the moment. But the other guys, the Pilbara guys and the Galaxy's and the Mt Marion's, all around that 1.1 to 1.4 per cent range, that's typical for hard rock lithium.

AK: I note that today you announced that your offtake agreement for Bald Hill had been executed now. These agreements, there was an offtake agreement and a fully funding agreement done last October. Perhaps you can just fill us in on how that works. Because you raised $25 million dollars, you're fully funded to build the mine and now you've executed at least part of the offtake. So, just give us a sense of where you stand and how it all comes to...?

Okay. Last April we actually signed up the lithium offtake, that was 100 per cent lithium offtake for two years, with good faith negotiation on pricing for the next following three years, so it's effectively a five year contract.

AK: Who with?

That's with Burwill, the Hong Kong listed trader who is in joint venture with a Chinese car maker. Basically, it all goes to the one Chinese car maker who makes its own batteries as well, the whole lot. So, they take 100 per cent of our supply, they want more than we can supply but they'll take 100 per cent of what we can on the lithium side.

Tawana's lithium play

They funded that through some prepayments and then they also took a little bit of equity and gave us some low cost loans as well. Then the tantalum one is the one we announced today. We've signed an offtake for the tantalum with a European buyer, one of the main names in the industry. A very good price, confidential – they want to keep that confidential but Bald Hill is a premium product, it'll be the best tantalum concentrate from WA.

AK: What is the price of tantalum at the moment?

The market's gone up a little bit, it's sitting in around that $60 to $70 range per pound US. So it's worth about $190,000 dollars a tonne. Unlike the lithium which was a bit of a semi-bulk, the tantalum's a higher value...

AK: And what's it used for?

Lots of stuff like capacitors in your mobile phones. Without tantalum your mobile phone would probably be 20% bigger than it is. It's used in high strength seals in aeronautics, medical – it's a very wide use. The prices have come off really when it is low, so at the moment the prices have come off a low base, it's been in the doldrums for a number of years and it's come off a very, very low base in real terms. But it would never race away like it did historically, tantalum, because of the supply from Africa. But we expect it to be pretty steady. We get a premium for the market...

I note that you've agreed to sell 600,000 pounds of tantalum until 2020. Is that firm? I note that the deal is still non-binding, what does that mean?

It's firm. We don't have to supply it. If we don't produce it we don't have to supply it. But they want it, they want the certainty of supply. Same as the lithium industry, basically the guys are not too worried about pricing so much, it's more about certainty of supply. That's why they come to WA to lock down – most of their supply comes from Africa and it's quite unreliable. They want to get away from this month by month or quarter by quarter supply uncertainty, they want long term certainty.

AK: Tantalum's hard to extract isn't it? Are you selling concentrate? Do you have to process it on site before you sell it?

Yes. The tantalum plant is there on site already, it's been there for a number of years. We'll treat the ore tantalum more – some of it we get from the lithium ore, we get for a very low cost, some of it we're in the process through the tantalum plant. It won't cost us much. It's really a by-product for us in terms of value, but it's actually a nice little sweetener to the project in dropping the costs, I guess.

AK: When you add together the two offtake agreements that you've now got, what sort of cash flow are you looking at over the next five years?

It comes down to the ramp up of the lithium production. If we bring the fines circuit on, stage 2 on by the end of this year, we'll see net cash flows jump quite dramatically. 2018, not a lot of net cash flow, but next year we were looking at, on a project scale, well over $100 million, and then once we upsize the production on the lithium side we can get that right up to, we expect, over $200 million I'd say in 2020 with increased production.

Is that net cash per annum?

On site, yes, pre-tax obviously.

And is that the whole project?

That's the total project, yeah.

So you've got half of that?

Yes, correct. And that will come through in time.

We share the capital costs as well as we go along. But the project's actually quite a low capital, so it's a very high pay back. At the start I think it had 150 per cent IRR project, so the capital costs are not the issue, it's timing of ramping up of production basically.

AK: Did the study come up with an NPV?

It did, only for the three and a half years. The NPV was about $250 million I think it was, but that's for the first three and a half years without the second stage through fines circuit. So, based on the study we only get about 65 per cent recovery but we'll increase that to about 83 per cent recovery with the second stage that comes on at the end of this year.

AK: Your market cap at $250 million market cap, I mean there's a bit of blue sky built into that isn't there?

Correct. We've increased the resources since the study and we haven't released the new reserve yet, so that's going to come out soon.

AK: Okay, when are you going to release that?

This quarter. Quite a big reserve upgrade and then when we bring out the fine study information, the NPV will jump quite dramatically.

AK: Oh, I see, okay.

Some of the market players are already doing back of the envelopes on some of that I guess.

AK: And you reckon there's probably more upgrades after this one?

Yes, definitely. Like all the WA lithium mines, they will increase their production. It's fairly simple once you're in to actually increase. Because with lithium the actual unit costs are quite low, a lot of it's fixed costs. So, if we can increase that production our cost per tonne concentrate drops off quite a bit.

AK: How do you think the lithium market compares to the gold market? I'm just thinking about the supply and demand balance, because obviously the demand is starting to ramp up now but supply is coming on too and we've had this big thing in Chile where the Chilean producer – I can't remember the name of it now... SQM?

SQM has now got an agreement to dramatically increase its production which has driven the price down somewhat.

AK: How do you see the demand/supply balance for lithium over the next five years?

All the new production coming on, all the Western Australian production is all pre-committed and I would believe SQM, by the time it does ramp up to the numbers it's talking about, it's probably just servicing existing customers I expect. Unlike gold where you forward sell it, everyone's happy, the banks give you the money, or the moneys are coming from the end users and most of the investment's coming from the end users and before each level of production comes on it's already pre-committed.

So, I don't see a huge volatility in the pricing, going forward I don't see it racing up. It might in the spot market but in the real contractual market it won't race up and it won't race down because the amount of inbound enquiries that we have is quite eye watering from different battery makers and want to be battery makers. Obviously, the car makers are getting into it now with Toyota and the Chinese car makers all trying to get their foot on production. They're still all concerned about long term supply going forward.

Tawana’s lithium play

AK: I suppose a better analogy would be iron ore with where the steel mills are trying to lock in supply all the time or have been and so you’re on long term contracts and offtake agreements and so on, that’s probably a better analogy with lithium.

Correct. And it’s quite different to gold where you can sell it straight into the market, you don’t have to worry about who’s taking it. The other thing is, the mines that come on this year, there’s three in WA, there’s us first, then Altura and then Pilbara. Then the existing mines and existing brine operations, they’ll count for most of the new growth. It’ll be a little bit tougher for new players coming on, but existing guys that are in production, there’s probably 10 all up, they’ll count for most of the growth, the near term as the current producers.

AK: But you’re a new player or are you counting yourself an existing...?

No, no, well, near term producers. We’re nearly fully constructed, so we don’t have to worry about financing or that sort of stuff. It’s already there, we’ll be producing this quarter, in fact. If you count the Pilbara, which is a near term, Altura and ourselves as that existing group, that group of horses are well ahead of the next group, so to speak.

AK: Speaking of funding, tell us about the funding deal you did with the German company that’s owned by the Chinese company?

Basically, they took an 11 per cent equity position at above market and then they are giving us $5 million cheap loan as well, but the offtake consortium also put $25 million in on prepayments which they get paid back in two years but it’s interest free. It comes off at 15% of each shipment. They get paid back the $25 million Aussie.

Well, it’s not the discount to market now, it’s 35 cents a share and the shares are 49 cents now. I know, but at the time we were trading at quite a bit lower than that. At the time we were trading a lot lower than that. When we started negotiating with them we were trading on about 22 cents at the time actually.

AK: Also, the loan’s 11 per cent interest, that’s not cheap?

Well, it is for this industry. There’s no warrants and all those extras attached to it. For the mining industry a lot of the guys are putting out warrants as well as high interest rates etcetera. It’s only a small loan anyway, at $5 million. But the other $25 million was completely interest free over two years, prepayments.

AK: Say the name of the company, I can’t pronounce it, you can pronounce it.

It’s Weier. Weier is the German company and that’s owned by a Chinese company called Jiangte, and it’s a car maker. Weier has been in the electric motor business for a long, long time, since the war actually. It’s a specialist, it’s been building windfarms since the 1980s, so obviously the Chinese were chasing them for technology, I suspect, and they were dealing through the German subsidiary.

AK: And obviously they’re making batteries now are they?

Not in Germany yet, but in China they do. They’ve been making batteries for some time and they’ve been taking raw product all the way through to the car. So, that is one of those companies that does from start to finish almost and not yet building batteries in Europe but maybe they want to supply Europe going forward.

AK: Are they going to sit on 11 per cent or are they going to creep up do you think?

Percentage terms? Unless they go on the market it’s going to be difficult for them but I think they’re fairly happy there at that sort of level. I note that they’ve put someone on the board which has also had the side benefit of providing you with some gender diversity.
Yes, they have. The nominee was a Sydney based lady with accounting experience. She’s really good, Vicky’s really good to have on the board and it gives us a direct line back to them I guess in discussions going forward.

AK: Your company’s pretty straightforward in some ways. You’re about to start production, you’re drilling for more. You’ve sold your first lot of production of both lithium and tantalum, pre-sold it, so it’s all reasonably straightforward.

It should be quite an exciting year for us this year.

The shares have already gone up a bit to 250, you’re saying that there’s still more room for rising because of the upgraded resources?
Yes, as we come out with the news flow this quarter and as we start to bring on production and de-risk it for the few people sitting on the fence probably waiting for the de-risking stage, I think there should be a fairly healthy growth for us when you compare us against the other near term producers and producers on a comparison basis.

And you’ve got the side benefit of the tantalum as well?

Correct. And some of the other guys do too but we actually have a premium tantalum product. It makes quite a bit of difference actually to the costs.

AK: Great to talk to you, Mark, thank you.

Thanks, Alan.

AK: That was Mark Calderwood, the Managing Director of Tawana Resources.

Things to worry about, Jim Grant, Australian Economy, The Internet Research Agency,& more

Alan Kohler February 24, 2018 Alan Kohler's Overview

Last Night's Markets

Dow Jones	25,309.99	up 1.39%
S&P 500	2,747.42	up 1.60%
Nasdaq	7,337.39	up 1.77%
Global Dow	3,151.76	up 1.04%
Gold	US$1,331.40	down 0.10%
Oil	US$63.56	up 1.26%
AUD/USD	.78	down 0.19%
Bitcoin	US$10,004.20	up 1.06%
US 10-year yield	2.875%	down 1.45%

Jim Grant

As you might know, I've been a long-time subscriber to Grant's Interest Rate Observer, edited by 71-year-old Jim Grant. I suppose I identify with him to some extent: he started as a journalist on the Baltimore Sun about the same time as I started on The Australian, joined Barron's in 1975 before starting his own newsletter in 1983.

He said of the 1980s: "Where most observers of the 1980s emphasized the rewards, we dwelled mainly on the risks. In the junk bond, in the reckless patterns of bank lending, in the dementia of Japanese finance, in the riot of the Treasury's borrowing, we saw not the bull markets of today but the comeuppance of tomorrow."

He hasn't changed over the years, which means he has foreseen more comeuppances than have actually occurred. Nevertheless he is always worth reading.

A couple of weeks ago he sent this email to subscribers in Australia, including me:

"I make it a point of returning to Sydney every 50 years or so – I last visited in 1966. Would you be my guest at a luncheon on Thursday, February 22 to celebrate the occasion?"

"The purpose is to bring together Grant's subscribers for a free-wheeling discussion of the state of the world. Joining me will be Paul Isaac, a director of Grant's and the founder of Arbiter Partners, a New York-based hedge fund."

Turns out he and his wife, and Paul, have been on a world cruise.

How could I resist? I left my convalescing wife briefly in the safe hands of daughter Phoebe, and went to Sydney for lunch.

He opened his talk over main course: "35 years ago I started a publication devoted to observing interest rates, but the business model has failed. We seem to no longer have interest rates."
Here are a few other quotes as best as I can remember (my shorthand is not what it once was):

"Fixed income securities are inherently less volatile than equities, therefore to equilibrate the risk in a portfolio of stocks and bonds you can prudently lever off the debt portion of that portfolio.

"There have been some very very smart and successful people implementing this strategy – they have done very well by it – and I think that their historical grounding is the observation that rarely do stock prices and bond prices fall in tandem.

"But that has happened, and if it were to happen again there would be a very dramatic shake-out in the bond market as levered bond positions become unwound.

"And I think also by way of umm, just suspicion, I think there is fair reason to assume that with rates so low and with the need for income so high that a lot of people are taking up a lot of leverage and applying it to a lot of low-yielding positions. That's just an assumption or a suspicion.

"So I think, yes, there is a lot of leverage in the fixed income markets and this will be susceptible to a great deal of distress if there is an uncontrolled rise in rates as opposed to a very deliberate one."

On crypto currencies:

"For me, crypto currencies are a little bit like rugby – it's for other people. I see crypto currencies as finally something that makes fiat currencies look really good".

On bonds and money:

"Bonds are a promise to pay money, but what is money? Central banks have materialised $14-15 trillion since 2007. The cost of production was nothing, the effort is nil. This money, this credit, much of it is digital representations of credit that lies in central bank deposit accounts. It has not ventured out of finance into high street economies.

"So you lend money to almost definitionally improvident governments over the course of decades at a nominal interest rate lower than the … or not much higher than the rate of inflation that the central bankers are straining to attain through the production of this digital scrip.

On real estate:

"Those who are bearish on real estate finance and structuring of real estate credit are wont to ask: 'can you afford your own house?' Can a person living in a house afford to buy that now? Increasingly people cannot afford to buy their own houses.

"How does this work in Australia? What is the typically ratio, for example, of loan to value in a mortgage transaction?"

(There were a few attempts to answer this, without much lot of success).

Things to worry about

Mostly I'm an optimistic creature, incurably so says my more sensible wife. Perhaps it has to do with all the relentlessly cheerful CEOs I speak to (I should probably talk more to glum, cynical fund managers for balance) or maybe, as my beloved sometimes says, there's just something wrong with me.

In any case, I do think that, on balance, we are better off in the sharemarket at the moment than out of it. Returns from real estate investing will be sub-standard for a few years, especially in Melbourne and Sydney, (see this interview I did the other day with Tim Lawless of CoreLogic) and I think investors should steer well clear of fixed interest securities for a while.

So equities it is for decent investment returns, but don't think for a minute that I therefore think there's nothing to worry about. There are. Here's what I think are the key things to worry about, and if possible, to insure against:

Inflation

I'm talking mainly about the United States here; we're a little running behind (see below).
The three fundamental factors that have led to low inflation – technology, ageing demographics and excessive debt – are still with us, but we now have a wildcard: massive fiscal stimulus with 4% unemployment.

Much the same thing happened in the early to mid-80s, and the result was a rapid tightening of monetary policy in response to the Reagan tax cuts, leading to the October 1987 correction/crash.

The market currently expects three, maybe four, US rate hikes this year. If it turns out to be more, a lot more, or more likely the Fed really ratchets up its rhetoric dramatically, the market will react – perhaps not this year, but it will.

Things to worry about, Jim Grant, Australian Economy, The Internet Research Agency, & more

Against that, those three big fundamentals reasons for low inflation, the ones that are still with us, and they weren't there in the 1980s, at least not to the same extent.

Complacency

That's the other that happened in 1987 – everybody got on board the bull market, the bears capitulated. Mind you, the market doubled between mid 86 and October 87, so the bears were broke. If this is 1986 again, there's a melt-up still to come.

As 2018 begins, investor sentiment is massively bullish and everyone is confident that there can't be a recession unless the yield curve inverts (that is, long term rates go below short term rates, suggesting a big fall in growth and inflation). One of the rules of investing is that if everybody expects something, then something else will happen.

As with Australia, the US is the most leveraged it has been in history and 20% of the debt rolls over each year. It means every 25-50 basis point increase in interest rates is a big deal.

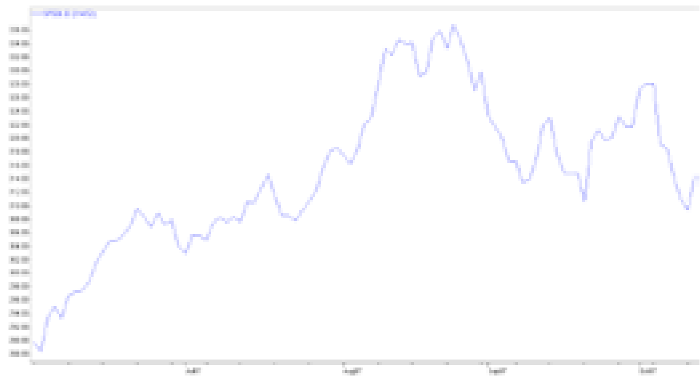
Dave Rosenberg of Gluskin Sheff says the best thing to keep an eye on is the US 2-year Treasury bond yield, which he calls the canary in the coal mine. "It has suffered a massive coronary in the past several months, having nearly from where it was last Labor Day, up around 100 basis points. "There is not a snowball's chance in hell that we can see a massive surge in front-end yields without there being a lagged repercussion for other asset classes – in fact at every turning point in the equity market and the economy, it was the two-year note that played the proverbial role as the canary in the coal mine".

Here is what he's talking about, the 2-year US bond, past 12 months:

Double top

It's too early to be sure, but the US sharemarket may be in the process of forming a fabled "double-top".

Here's the S&P 500 in the months leading up to the October 1987 crash:



The double top was first August, then early October, leading to 50% drop on the 19th. Something similar happened in 1990, 200 and again in 2007, preceding big falls.

Here it is over the past few months:

There have been plenty of charts over the years that look like that and are not "double-tops" that precede corrections – they're just corrections followed by recoveries, and my "base case" as the economists say, is that the market is likely to break through that January top and keep going, at least for a while.

But it could also be the bad kind of double-top.

Australian economy.

Here is a brief transcript of an informative chat I had this week with Sally Auld, chief economist with JP Morgan Australia:

AK: Sally, there's a bit of news out this week on wages and also some minutes from the RBA. What did you think of the wages report?

The wages number, it came in at .55 of a percent in the quarter to two decimal places. That was a touch above the market consensus which was sitting at .5. I think what's interesting about the number is that we also get a breakdown between public and private sector wages and private sector wages, which is really the part of the economy that's going to be a bit more responsive to what, if anything, is going on in the labour market. They were pretty subdued in the quarter. There was a bit of talk that we were going to see a higher number in the fourth quarter because we were going to get some delayed pass-through of changes related to the minimum wage outcome on the 1st of July and I think relative to those sort of expectations, the number was at the end of the day, pretty reasonable. It just, once again, highlights that wages growth is running at about 2% year on year, inflation is running at about 2% year on year. In a real sense when we look at the purchasing power of wages, that's basically slight. I think this is one of the things that the RBA worries is potentially going to start to drag on the consumption outlook from here.

AK: With some reason, wouldn't you say, Sally?

Yeah, I think so. I mean we're not particularly optimistic on the consumption story in 2018. We've got consumption volumes growing at a little bit over 2% for the year which is pretty sluggish, but I think that's a fair outcome given we know that the savings rate has already been run down and we know that mortgage rates in some parts of the economy are going up and the RBA has been pretty clear about wanting to limit the extent to which house prices and credit growth can run. I think in the face of all those constraints, it's going to be a more difficult year for the consumption story.

AK: Nothing really changes this week on the outlook for interest rates, does it?

No, not at all and we heard from the RBA – we've heard from them a lot really, over the past couple of weeks and the message is pretty clear which is that things are better than they were but we're certainly not anywhere near a point where the RBA would be comfortable in adjusting rates higher. I think the main source of uncertainty for them is really the labour market and how quickly they can expect the unemployment rate to fall and if that happens, how quickly will wages pressures lift. Until they have, I guess, less uncertainty and a bit more clarity about the way the labour market's working, they're not going to do anything on rates any time soon.

Things to worry about, Jim Grant, Australian Economy, The Internet Research Agency, & more

AK: What's your view on the Australian dollar and in particular, what are you getting from your American colleagues about the outlook for the US dollar?

Yeah, that's a good question because I think there's a standard of confusion or uncertainty about what's going on with the US dollar at the moment. You can often find periods where even if the US is doing well, but the rest of the world is doing even better, that tends to be quite a negative environment for the US dollar. I think that's where we've been over the last six months. US growth has been good, but it's been even better in other parts of the world and that's held the dollar back. But we just might be at a turning point now. I think we've had a couple of days where the US dollar has performed better and we're starting to see just a little bit of a moderation in some of the global data. Some European data last night was a little bit softer, albeit off phenomenally high levels and we've had some weaker Japanese data over the last couple of weeks.

This sense that maybe this rest of the world outperformance is starting to cool off a little bit, might give the US dollar a little bit more support in the near term. But I think the other thing that's starting to perplex markets is this idea, which rears its head every now and then, of twin deficits. Where, given the fiscal stimulus and tax cuts that Trump has enacted in the US, on our numbers, next year the US budget deficit is going to be close to 5.5% of GDP and that's a remarkable outcome given how strong that economy is at the moment, so it's pretty close to full employment, if not already there.

The thing that markets are grappling with is, well what happens when the next downturn comes, which it will at some point, that budget deficit could go quite close to 10% of GDP pretty quickly in the next downturn. Typically, if you're running a big budget deficit and also a current account deficit which the US is running, then that's not an overly supportive environment for the US dollar. That might be another reason for why the dollar is weak but I think this persistent dollar weakness in the face of the Central Bank who's lifting rates, and US yields are higher now than they are in Australia across the curve. It doesn't sort of make sense to see the Aussie dollar outperforming against the US dollar in that environment.

Reporting Season

AK: That's all well and good, but how do we reconcile a bumper reporting season with low wages growth?

We don't, I suspect: profits simply don't connect to wages.

Of the companies that have reported so far, more have beaten expectations than missed, most lifted guidance for next year, and three-quarters of them increased the dividend. Telstra aside (the company has halved the interim dividend as it grapples with the NBN), the average dividend increase is about 4 per cent – twice the average wage rise.

It is fair to say that the key contradiction in the Australian economy is on display.

The best thing about the economy is that after years of relying on monetary stimulus and state spending, private sector companies are flying. The worst thing about the economy is that the wages those private sector companies are paying is stuck in the mud: wages growth is 1.9 per cent, according to this week's report from the ABS. So those who invest in companies are doing a lot better than those who work for them.

To drive the point home, as the Australian corporate sector has been, on the whole, basking in its successes over the past two weeks, the Governor of the Reserve Bank, Philip Lowe was wringing his hands about wages growth. "If we're going to deliver average inflation of 2.5 per cent we should probably have average wage increases over long periods of time at 3.5 per cent", said Dr Lowe in Parliamentary testimony. From this week's RBA board minutes: "Growth in the wage price index in the September quarter had been weaker than expected and wage growth outcomes associated with new enterprise agreements had been lower than the percentage increases incorporated in agreements they were replacing".

If the interim reporting season is any guide, the solution to this puzzle is not to be found in the profit and loss accounts of companies, which are fine.

The RBA directors "noted" that low growth in productivity, globally, may have contributed to low growth in wages, although they're not sure, and it might also be that there is more spare capacity in labour markets than implied by "conventional estimates".

To an extent, macroeconomics has stopped working – that is, the normal relationship of unemployment through to wages and then to inflation – and economists and central bankers are basically just waiting for it to start working again.

"Indeed, it was possible," said the minutes, "that ongoing strength in the demand for labour might result in wage growth picking up by more than anticipated, both in Australia and abroad." Might.

The contrast with the confidence of Australia's of corporate leaders that has been shining through the interim profit announcements, couldn't be sharper.

And why not? All they have to do with free cash flow is maintain the assets and pay the rest to shareholders – that is, take few risks.

Their days are no longer spent dealing with troublesome unions threatening to go on strike, and the only complications to watch out for are sexual harassment writs and social media bombs. Apart from that it's just a matter of figuring out which artificial intelligence consultant to use to get costs down further, so that the dividend, and therefore TSR (total shareholder return) can be increased again next year so there can be another solid executive pay rise.

The Internet Research Agency

President Donald Trump isn't the only one paying too little attention to the Mueller indictment against the 13 Russians was are alleged to have swayed the US election in 2016. The coverage of special counsel Robert Mueller, and his investigation into Russian interference in the 2016 US election is naturally focused on whether or not Trump himself was involved or not, which would lead to his impeachment. But there is much more to what is being uncovered. The 37-page indictment of 13 Russians last week should be required reading for every government in the world, in fact every company, and organisation of any sort, for that matter. And it also has huge implications for investors.

The detailed descriptions of how an unknown company in St Petersburg used social media to produce an astonishingly powerful impact in the United States is a guidebook for anyone who wants to use Facebook and Twitter for nefarious purposes, and a wake-up call about how much the world has now changed.

Facebook's vice-president, advertising, Rob Goldman, produced – ironically – a storm of tweets (that is, on Twitter) defending Facebook and arguing that influencing the election was not main goal of the Russians' activity, but that's certainly at odds with the indictment's rather more detailed and believable allegations.

The key focus now is whether the Trump campaign, and Trump himself, colluded with the Russians, and specifically President Putin, in a conspiracy to corrupt the election in his favour, and that's understandable.

Things to worry about, Jim Grant, Australian Economy, The Internet Research Agency, & more

But it seems to me the evidence of what's now possible with the internet is equally significant. The stunning thing is not so much how sophisticated and well-planned the operation was, although it was certainly that. It's that it was not just possible, but fairly easy. It's true that the operation appears to have had the resources of a state behind it, but it doesn't look to have been all that expensive.

Any large company or well-funded NGO could do it. The operation was run out of a company called the Internet Research Agency in St Petersburg and apparently had about 1000 people working there at its peak, which is not that many really. They didn't only use Facebook, but it was the main vehicle. They bought ads to directly influence opinion, set up actual rallies, mostly in favour of Trump and against Hillary Clinton, and set up ginger groups and fake organisations. They disguised their activity in three ways, according to the indictment.

First, it was all done through virtual private networks (VPNs) established on US-based servers.

"To hide their Russian identities and ORGANIZATION affiliation, Defendants and their co-conspirators… purchased space on computer servers located inside the United States in order to set up virtual private networks ("VPNs"). Defendants and their co-conspirators connected from Russia to the U.S.-based infrastructure by way of these VPNs and conducted activity inside the United States—including accessing online social media accounts, opening new accounts, and communicating with real U.S. persons—while masking the Russian origin and control of the activity."

Very easy.

Second, they used stolen identities to buy advertisements.

"In or around 2016, Defendants and their co-conspirators also used, possessed, and transferred, without lawful authority, the social security numbers and dates of birth of real U.S. persons without those persons' knowledge or consent. Using these means of identification, Defendants and their co-conspirators opened accounts at PayPal, a digital payment service provider; created false means of identification, including fake drivers' licenses; and posted on ORGANIZATION-controlled social media accounts using the identities of these U.S. victims."

That's a bit harder.

And third, they set up hundreds of fake email accounts, posing Americans. Not too hard at all. Some of the reaction, especially in the media, to this has focused on Facebook and other social media platforms, suggesting that they should have identified the crooks and shut them down, but that's actually missing what's happening here.

It's not social media that has made this possible, but the internet. Facebook is just a manifestation of the internet, as is Twitter, Instagram and email for that matter.

It's 25 years since this iconic cartoon appeared in New Yorker:

"On the Internet, nobody knows you're a dog."

On the internet nobody knows you're a Russian either, it's just that in 1993 that was a joke. Now it's serious.

Facebook is not named as a defendant in the Mueller indictment, but it doesn't come out of it with completely clean hands.

However the criticism of Facebook and social media generally is pointless. It's inevitable that there are going to be large-scale content aggregators and platforms like Facebook on the internet – if not them, then something else – and they will never be in a position to do more than the most superficial filtering and checking of content.

This is a permanent change. What the Russians did in 2015-16, and the Mueller indictment has now exposed, is a marker of where we are at now; the hackers are probably well past that now. In fact, the potential for "attack by social media", which is the focus of last week's indictment is probably the least of it.

It's clear that we are already in the age of cyber warfare: the next big war is likely to at least start over the internet and probably continue there, with adversaries hacking into, and shutting down, infrastructure and banking, causing chaos and social disorder.

Meanwhile the Australian Government is spending $50 billion on submarines. Enough said.

Desmond: 'Forgive me, Alan, but you're being simplistic'

And along similar lines, here is Desmond's response to my piece last week that I wrote in answer to his question about the Singularity, and the dangers of artificial intelligence.

Dear Alan,
I really appreciate the attention you paid to the comment I sent you last week. I understand that debating such things is not part of the core business of The Constant Investor. Knowing your strong interest in ideas generally, though, I could not stop myself writing what follows.

In my view, whoever thinks seriously about why things are as they are is a philosopher. Hence, I think, you are mistaken when you say that you are not "a philosopher on these matters, or any others". I'm not a philosopher in the professional sense either. Only a (very ordinary) mathematician who has long been doing his best to understand what happens. I've written two ebooks about that which no-one reads.

I agree with much of what you say, but, forgive my saying so, I think your analysis of the Singularity is simplistic, most obviously in your referencing Ray Kurzweil, one of the prophets of AI who look forward to the Singularity as an opportunity to make more money. That all began with Marvin Minsky, and others, in the 1960s, predicting an AI revolution which was always just a decade or two in the future. The problem, still with us in AI talk today, was the failure to see that what we call intelligence is essentially trivial, something that was clearly demonstrated in the toy societies of communicating computer critters that were implemented by myself and colleagues at the University of Tasmania in the nineties. Back then, I predicted in published papers that communities of computer critters like the ones I called The Simpson's and The Royals (featuring Charles and Diana) would soon pass an objective Turing test in which the judge is only a passive observer of the critter conversations.

This does not mean that human intelligence can be ignored. On the contrary we should take very seriously the insights, informed by their humanity, of brilliant men like Stephen Hawking and Elon Musk, who were mentioned, I think, in your Facebook Livestream. They see that the danger to humanity is not AI as it was naively conceived, and still is.

The danger lies in the unbridled communication that the internet allows, not so much because of the loss of privacy that it brings as because of the loss of individual autonomy that is occurring right now *as human weaknesses are so successfully exploited by those with big money and the power that big money gives to them.*

You cite Big Blue's defeat of Gary Kasparov as evidence that machines have become smarter than us. What that showed was only that computation is done better by a brute force algorithm running on a brute computer than by a chess genius like Gary Kasparov. What makes human intelligence human is something very different from computation. It is the communication between people that has produced our civilisations, or, as I prefer to say, that has produced the human Mind.

I think you are spot on when you ask what Kurzweil means by "merging with the intelligence we have created." He means "submerging the human mind we have made in the intelligence Google has created."
As you say "the internet isn't a thing that has a purpose." But that is the problem. The internet is open to exploitation by those with the power to exploit it. And those with the power include more than the "do no evil" guys at Google.
You think that "the internet, and now blockchain, have allowed the creation of new form of capitalism to flourish." Yes, indeed, but much more than that. Including, for example the Russian meddling in US politics, propelled by a form of capitalism very different from the free market that you and I favour.

Let me ask, Alan, whether you read the Washington Post article, published earlier this week, under the headline Why Facebook is afraid of Robert Mueller. It includes the following big claim:

"There is plenty of evidence now that the very nature of the platforms encourages ever more extreme, ever more offensive material. Studies of YouTube have shown how automated video production, governed by algorithms, not humans, leads inexorably to more violent and more disturbing videos. One recent survey suggests that up to 15 percent of Twitter accounts — some 48 million — may not be human at all."
To me it is clear and urgent for all of us to begin to seriously worry about the Singularity which is diminishing humanity right now, as we look on.

Best wishes,
Desmond

Five favourite funds. Why global share markets are moving higher. Stagefright or something worse – online lender Prospa perplexes.

June 7, 2018 The Money Cafe

This week in The Money Cafe, James Kirby and I discuss the following:

Are we are living in an era of regulation on the front page?

- ANZ charges, names named, scared the crap out of the industry.
- The float that sunk 15 mins before launch.
- Fortescue: the resources story to watch right now.
- A sadder, wiser Wesfarmers looks for growth options.
- Ruslan Kogan could be the next Gerry Harvey, if he doesn't blow it.
- James Kirby's favourite listener question in months!
- Alan picks his five favourite funds.

Hi, I'm James Kirby, Wealth Editor at The Australian.

AK: And I'm Alan Kohler, Publisher of The Constant Investor.

And we are The Money Café.

AK: I was going to say Money Café, I was dreaming.

Our producer says keep going, oh lord. Okay, sorry about that, folks, but I'm sure we'll dovetail again.

AK: No, I was just dreaming about the Dreamtime at the G game that I invited you to.

Yes, it was very nice of you.

AK: Which you didn't come to.

I didn't…

AK: Because you were too busy otherwise engaged…

But it was very nice of you.

AK: The seat remained empty. It was good that you didn't go because it was terrible.

Well, you weren't to know that. In fact it has great razzmatazz, that game and that event, but it was a fizzer?

AK: Well, it was for Essendon, it was clearly not a fizzer for the Richmond Tigers.

Okay, but it wasn't even a great match, it wasn't…

AK: Well, they played well and they were just too good.

Gee, I came down yesterday from Sydney on the plane with a lot of rugby league fans going to the State of Origin. It's amazing, they've been doing it for 20 years now, they have this huge game here at the MCG and nobody in Melbourne pays any attention to it whatsoever.

AK: Well, of course.

And all these people fly down and they fly back.

AK: Because it's a dreadful game. Look, it's a terrible game, come on.

Well, I tell you what if they think they've made a dent in the AFL obsessed hoards of Melbourne honestly, I see no evidence.

AK: This week we want to start with the Mega Trend Moment, the BT Financial Group Mega Trend and you have in the notes here, James, written regulators run rampant. Now, I would have thought it was banks run rampant, the regulators are just mopping up and I think that's an extremely colourful biased…

See, you're going on the ethical front foot there, aren't you?
AK: Biased language, regulators run rampant,

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what are you talking about?

You're such a good person, thinking of the good guys all the time. Well, let me rephrase that. It is definitely an era of regulation on the front page, Alan, you'll agree with that, it just keeps coming, doesn't it? I mean on top of everything else, and in the same week, actually, that the Commbank pay out $700 million on the AUSTRAC incident the ANZ, in what does not sound like a spectacular incident but the ANZ have been caught up in a spectacular court case now which is alleging criminal charges against some of the biggest investment bank names in the land.
So, back to your headline which is an interesting one, because essentially the government body, virtually every government body you can think of, is joining in a little queue of people to line up to kick the banks.

AK: Yes, and why didn't they do it before and why are they all doing it at the one time? It seems like that though, looking at it some of these cases are running a long time, like even the ANZ ones three years ago that that share placement, that funny share placement, occurred.

Yeah, so it's all coming out now, right?

AK: Yeah, it's all coming out now, is that a coincidence?

Well, they're kicking them while they're down, are they not?

AK: And they have the public onside. And it's all about the Royal Commission because the Royal Commission has set up this environment in which the banks look terrible, really.

I think it's worth even just – Devil's advocate here, you can't defend yourself in the Royal Commission, you don't get time. You certainly don't get time to prepare a defence like you do in a traditional court case. So, in no way am I excusing any of it or any of them but it's interesting that legal people do say that if you put any profession up, including ours – let's put that on the table straight away, put us up in front of the Royal Commission and grill us for five hours non-stop, you're not going to look quite as good.

AK: I was up late last night composing my Saturday column for The Australian, would you like a preview?

I would.

AK: Because, I'm saying that it all goes back to the Wallace Inquiry in 1997.

Which I attended.

AK: There you are.

There you are, I remember it all quite clearly.

AK: Wallace recommended the removal of the four pillars, it was actually six pillars then, it was the big four banks plus AMP and National Mutual.

That's right.

AK: Wallace recommended the creation of APRA which did happen, which the government followed up on, however it did not remove, as recommended, the four pillars. The four pillars, to remind everybody, was something introduced by Paul Keating in 1990 that would prevent the big four banks and AMP and National Mutual merging with each other.

And it's not a law it's a convention.

AK: No, it's not a law it's a policy.

Yeah.

AK: And also Wallace recommended that consumer protection and competition laws apply to superannuation and wealth

management and that wasn't taken up either. What it seems to me happened out of that, out of Wallace, was that the regulation of banks and financial services was all about APRA's regulation which is designed to ensure the safety of the system.

Prudential stability, yeah.

AK: What happened was that from that moment on the regulation of banking and financial services was all focussed on coddling them and protecting them and preventing them from merging with each other. What the result of that is was a comfortable oligopoly that resulted directly from the Howard Government's decision not to selectively implement Wallace.

Just kicking it around if you scrap the four pillars and if you had open season, and let's say Westpac could take over ANZ tomorrow, is that in any way going to improve the scenario that's unfolding in the inquiry?

AK: No, I'm not saying that and it is true that probably it would have turned from an oligopoly to a duopoly as a result of that.

A reinforced oligopoly, yeah, perhaps.

AK: But I'm just saying that an unintended consequence of that has been to establish this kind of oligopoly of four banks that were able, really – because what the government didn't do at the same time was to take action to increase competition against those four either from – so, they could have done things that would enable other banks.

And they had tried to, 16 foreign banks came into Australia just before Wallace and really none of them got mainstream.

AK: And the government would have had to actually do something to encourage either the foreign banks or the regional banks, the smaller banks or the non-banks, to provide competition against the big four and they didn't.

In fact, Alan, the opposite happened. The four banks withdrew from overseas substantially, ANZ particularly, they all withdrew into the market and they actually reinforced the oligopoly in recent times.

AK: That's right, so their profits, the bank profits in Australia as a percentage of GDP is about twice or three times what it is in most other countries, and I'm saying as a result of what happened with Wallace.

Yeah, the accidental or inadvertent coddling. That's really interesting, actually.

AK: Just looking at the ANZ criminal charges, which has absolutely shocked the crap out of the whole industry.

It has because names were named and they're big names.

AK: Big names, yeah.

Stephen Roberts, absolutely.

AK: Poor old Stephen Roberts, he announced his retirement a month before the ANZ Chair issue in 2015 and he wanted to go immediately but the replacement they hired had to do gardening leave for six months and there he was, so he was stuck there.

He clipped his toe at the last fence at the last jump.

AK: And now he could be off to jail.

He could be, well you wonder.
AK: Because the maximum penalty for these

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offences is ten years jail.

I know, ten years or $420,000 which I reckon someone like Stephen Roberts would pay right now just to stop the entire thing if he could.

AK: He'd barely notice it. But, imagine all these characters with arrows on their suits pointing upwards.

We'll see. Will anyone face criminal charges. Without going too deeply into this at the same time we're talking about the Royal Commission I saw where Sam Henderson, who was also at one stage at risk of facing charges beyond what had happened at the Royal Commission, that it was noted he's resigned entirely, he's gone from financial planning. It's amazing how these people can get shot out of the sky, really. If you think of someone like Alex Malley a year ago where you could get away from Alex Malley, he was everywhere, and an incident occurred and he's gone, he's just disappeared.

AK: He's nowhere.

Sam Henderson has closed down and left the financial planning industry, and four months ago he was everywhere. He was in papers, he was on TV...

AK: And he didn't even get to sell his practice.

Well he had sold it.

AK: Had he?

To an Italian conglomerate a few months earlier.

AK: Do you know what he got?

No, I don't know what he got but I'll tell you one thing, if there was earn out provisions then I don't think he even made them.

AK: It was cut short.
Okay, well why don't we move on. That is definitely the Mega Trend of this week, isn't it, the rise of the regulator and the regulators' moment in the sun if you want to put a positive spin on it. One of the things I'm going to look at this weekend, though we did this very ambitious exercise on superannuation last week people are so interested. I don't think most people realised. We're so kind of inside the tent, if you like, in terms of understanding all this I don't think people realised the gap in super, how some were so good, how some were so bad, how industry funds were so much better than retail funds over ten years. This weekend we are looking at it afresh and just looking at some of the options that people want to do.

AK: What are you doing?

We've got a number of people coming in, Peter Switzer is coming in to give us a hand as well, he is appearing for the first time in the wealth section which I'm quite happy to have him. I've been doing a few shows with him of late on Sky, we did four shows actually of late and a lot of them were on the broader issue of super. We're going to look at what do you do, how do you switch, if you're going to switch how do you make the decision, that's what we've got on the agenda. What else has been happening this week?

AK: Well, we had the amazing situation of an IPO, a float, being pulled 15 minutes before they were meant to start trading.

15 minutes.

AK: Heavens.

I know, what on earth? I've seen big floats pulled on the morning of due but I've never seen a company pull a float on the day and fulfil their promise.

AK: I haven't had a chance to see what happened, why did they pull it?

It is unclear why they pulled it. In fact, my colleague, Supratim Adhikari, who is the Technology Editor on The Australian this morning has a story where basically ASIC are saying well it wasn't us.

AK: Because the only thing I did know is that they blamed ASIC.

This is the point I'm making, well ASIC have said this morning quite clearly we just did a routine – they said they did routine checks that they do with every float and they implied very heavily that they didn't call Prospa and say listen, you go ahead and you're in trouble.

AK: But I think they said it was going to be put off for two days and it's now more than two days.

It's not more than two days, it was yesterday midday being Wednesday, so Friday afternoon they should come on but the other thing was it gave everyone a second chance to look at what on earth they were doing and how did they work charging 41% annualised interest rates to small business.

AK: I tell you what, they can't blame a weak share market because the share markets are going bloody beautifully. How's that for a segue?
Magnificent.

It's good.

AK: The share market is going great.

Well, if you stand back from it you've got strong GDP quarterly figures that were better than expected, you've got the American market with big profit upgrades coming through the ranks on all the big US corporates so there is momentum there. You've got globalised synchronised GDP. But, the problem for us is that not all but many of our big favourites, the banks, Wesfarmers, Woolworths, AMP, they're a drag, they're all down.
AK: Yeah, so what's holding our market up are the resources stocks because commodity prices are doing okay and China is fine until Donald Trump blows things up.

Yeah, until he does but for the moment he's doing the opposite, actually, because those tax cuts are kicking into the American market and the commodities are going up. Yeah, that's right, it should be interesting to see. One of the companies I find so interesting is Fortescue. They have reshaped themselves so many times and they've survived just about everything but it's interesting, this time around they're not getting the lift like Rio and BHP because their iron ore is dirtier basically and it's a lower grade. They said for weeks and weeks to all their shareholders this will pass, it'll be fine and now they're saying actually we've got to upgrade our iron ore. Today they bought a stake in Atlas just an hour or so ago.

AK: 15%.

Where it's a big call to try and upgrade your iron ore quality fast and the mines are there working away, but that's what they're going to try and do. I reckon it's one of the great stories locally in the resources market just now, Fortescue. BHP and Rio are tracking away nicely, especially Rio. Woodside also, I think, are going pretty well. The ones we're waiting for is that next phase of the resources boom, the resource services, the mining services stuff, that should be the next wave.

AK: It was last time, that's true.

It tends to be, it was the last time, it was absolutely fantastic as a sector.

AK: Yeah, but then they collapsed.

Yeah, I know. They run and then they blow up tends to be how they do it.

AK: That's because of their operational leverage which is good when things are going great but because of their fixed costs when

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they start losing contracts it's disastrous.

Well, if you're looking for a trade mining services might be somewhere to look at. Why don't we just have a look at Wesfarmers and Kogan, Alan, and there's lots of good questions, we should hop onto those. Tell us about Wesfarmers.

AK: Well, they're going to have a war chest. So, they're spinning off Coles, they've shut down UK Bunnings, I think they've raised a couple of other things and so they're going to have a war chest of about $12 billion to make takeovers. I was just recalling that the Coles takeover in 2007, 11 years ago, which was the biggest takeover in history at the time was $19.3 billion.

And what did you say they have to spend, 12? Now they've got 12 so it's not that much of a war chest, not as compared to what it was in 2007. Of course, and if you index it the point is even stronger.

AK: Actually, no, I did the exercise, if you index it at 2% a year, which is the rate of inflation, it's $30 billion now.

Okay, yeah.

AK: The equivalent of the Coles acquisition now would be $30 billion so they're talking about less than half of that and actually Rob Scott, the CEO, is saying no we're not going to make one big takeover, we're not going to do that. We might take strategic stakes in things. It's a sadder and wiser Wesfarmers now. Really, I think Coles was not a great deal for them.

No, well the issue is that the UK stuff was so appalling. Roger Montgomery, who of course writes for the wealth section every fortnight and a very popular writer in the section, he says that the UK thing alone, the UK exercise Home Base, cost $1.50 per share. That's how much a loser it was, $1.50 per share on Wesfarmers. This new guy, he's doing things.

AK: Sure, and we're all waiting now. He's doing negative things in the sense that he is closing things, he's getting rid of stuff so the question is what's he going to do positively that he's going to set Wesfarmers up for growth. That's what everyone is waiting for.

I wonder what it could be because as you say he's not going to go off and do Coles again or indeed Home Base again, that's for sure. Why don't we look at the questions? Hang on, I'm sorry, we have Kogan.

AK: You were going to say something about Kogan, what's going on?

Yeah, well just like we were talking about Prospa, Kogan – just so everyone is up to speed on it I think Ruslan Kogan is very impressive and boy oh boy, if anyone had that stock a year ago it's up 500%, hear me on that one. But, this week him and his partner went to sell shares in the market and then they withdrew them and it was a bit of an embarrassment really, I don't know what they're up to. It's about 9% of the whole company but the stock fell 10% straight away off the back of it.

AK: I think it had previously gone up 10% because they were going into appliances.

Yes, and I think that sounds really smart that he moves from the consumer electronics to whitegoods and takes on Harvey Norman. In a way Ruslan Kogan has the potential to be the Gerry Harvey of his time.

AK: Yeah, of course.

If he doesn't blow it on something like controversial share sales which is exactly what happened this week.

AK: He does good interviews like Gerry Harvey does.

Yeah, he is a great talker.

AK: Like Gerry Harvey, you love getting him on.

Great retailers are great talkers, I think, they often are. Okay, who has the questions. Why don't we do them alternately. Will we start with this one from...

AK: I need to ask you the one from Charles.

Okay, shoot.

AK: He says I know the table on page 18 of the Weekend Australian showing the increase in value of assets in various super funds in the year to March 2018, for example industry funds increased 16%, SMSFs up 4%. This bloke wants to know how do they know about SMSFs because he says I only show the value of my assets in my SMSF June 30 each year and how the hell do they know?

Charles, it is a superb question. Personally, I would pick it as my favourite question for a long time because it's a point I've been trying to make all week. You cannot measure SMSFs against each other, you can only make the broadest and vaguest of estimates on it. That table you referred to – by the way, Alan, if you didn't see it an entire broadsheet page, one single table last week we ran the APRA numbers of every super fund in the country and how they were going.

AK: I never read print.

Well, I'll tell you it has its advantages. You couldn't do this online, you just couldn't do it online. It was a fabulous use of a broadsheet page if I may say so because you could just see them all, you could just sit down and compare them.

AK: This is apart from fish and chips.

In any event the point I'm making there about the SMSFs, yes everyone is different Charles, you are absolutely correct. But, people are forced to compare them and I think you find the super ratings, for instance, will compare them and the various associations will make these stabs in the dark but that's all they are. How are SMSFs doing, it's like how are individual people doing, each one is different. Okay, question from David for you. I notice that Genworth Australia share price has fallen around 20% since late last year.

Do you think mortgage insurers still have a viable business model? Genworth is a mortgage insurer, of course. That's from David. What do you think, Alan?

AK: Well, I think it's another excellent question because mortgage insurers make money, their business improves, when banks make risky loans, high value to loan to value ratio loans because they all have to be insured. Genworth makes a lot of premiums on that basis and you're absolutely right, David. Now, whether they've got a viable business model going forward I think what we're seeing is a cycle here and I do believe that high loan to value ratios will come back.

But the cycle is against them just now?

AK: Just at the moment the cycle is against them.

Yeah, it is isn't it.

AK: Because they're cutting back their LVRs from 100% back to below 80% in general.

And the volumes are down.

AK: That's right, so fewer of the loans have to be insured and so Genworth is getting less business. I do think it's a cycle and they'll come back at some point but for the meantime whether they've bottomed yet I don't know. It may be a little while before they bottom.

Yeah, and there's no good news for them in their area. Mortgage Choice has been absolutely hit for six in recent times thanks to investigative work.

AK: Here is one for you from Cillian, I think. I've been listening to your podcast since the very beginning and it is one of the highlights of my week. You're a very sad man, Cillian.

You make economics and the financial markets understandable and interesting, thanks for doing what you do. Given the main index, the all ordinaries in this case, has been hovering around the 6,000 level for quite some time where do you believe we are heading looking forward for the remainder of this year and going into 2019?

Well I'll be fascinated to hear this too, Cillian. Where are we heading, James?

Let me think. I don't know, no one knows, Cillian, sorry, I wish we did. I think everyone's a bit disappointed that we are still at 6,000. I mean, honestly, how miserable can this local market be. It's unbelievable it's still at 6,000 but there it is.

AK: Yeah, that's true.

What is it? Is it skewed towards the banks now?

AK: It's the banks.

Yeah, it is the banks, they were like 35% of the market.

AK: And Telstra's gone down. You said it before.
And Telstra, that's about 40%.

AK: And AMP is down 25%. I mean, a lot of our biggest companies have had a shocking time.
Yeah.

AK: That's the problem.

Which is an argument against blindly buying the blue chips and it's also an argument against ETFs.

AK: Exactly. Mind you, it's not an argument against say a resources ETF.

Sure, yeah.

AK: And this is the point, Cillian, there isn't one share market. It is fallacious to talk about the share market as a whole because there's such a difference between the resources sector and the banks and the industrials, also so many of our big companies and small companies are virtually international stocks. CSL is up 50% in the past 12 months but it is not an Australian company, CSL. It's based here but it is a global business.

But that's what you want.

AK: Of course, that's what I'm saying. It is a global biotech business up 50% in the past 12 months, it's now the third or fourth biggest stock on the ASX, it is completely fallacious to just whack it all together.

Yes, but having said that we have to answer the question. Sorry, Cillian, we don't know. I can get you a broker report tomorrow that will tell you it's going to go to 6.2 or 6.3, or whatever, they basically invariably pitch it up about 7%.

AK: You won't be able to give us a broker report saying it's going to go down I don't think.

No, it will be very hard to find one of those. Now, there's actually quite a few good questions, just jump that Twitter one, Alan, and let's go to Scott.

Hi gents, keep up the great work. My questions are after the AUSTRAC $700 million fine, which we mentioned a few minutes ago, again CBA, is the CBA dividend under pressure? The second part of that is would you explain why the DPP lodged criminal charges against ANZ, Citi and Deutsche Bank? Okay, well I might try and take the second one because I have been covering it.

AK I just found all the other questions, goodness gracious there's lots of them.

I told you there was loads.

AK: Heavens, we're going to be here for ages.

No, because we're going to do them very succinctly and efficiently, Alan. The criminal charges against the investment banks was to do with a capital raising by ANZ some years ago, it wasn't actually a gigantic raising but it had key investment banks in there and the questions that have arisen are about there was a shortfall, it wasn't all placed and what happened to the money.

That's about as simple as I think you could put it. As for the CBA dividend well, I haven't seen any report to that effect.

AK: The $700 million fine won't cause the dividend to be under pressure.

It won't.

AK: The dividend might be under pressure anyway.
Yeah, a very poor housing market could hit CBA, they are down, I think they're proportionally down more than any of the other banks but then they ran very high for a long time. I think they're back around $70 now.

AK: Household earnings in Australia is among the highest in the world and a record high for Australia, so these banks, and clearly CBA, have been stuffing loans down everyone's throat and everyone is now choc-a-block, can't eat any more.

Can't eat any more, exactly. Okay, the question from Scott, you can have a go with that one if you like.

AK: What are your thoughts on AMP growth bonds or equivalent products, I have two kids – we don't want to know, Scott, what your personal details are because we can't give you personal advice. James might offer a general opinion about AMP growth bonds.

I will. But I must, Alan, read the last sentence of Scott's question which says the 20,000 is currently invested in Apple and Google shares. Well, good on you, Scott. Can I just say to you don't take your money out of Apple and Google and put it into AMP growth bonds, that much I could say. Growth bonds, for what it's worth, they're an unusual little thing. You put the money in and you must leave it in there for ten years and when it comes out the far end you don't pay tax on it. But, there's a whole pile of strings attached to that, there's a whole pile of fees, the earnings don't tend to be great. Regularly I've asked people to have a look at these, I've commissioned people to study them and it seems to me they're pretty ordinary in their performance and the fees really weigh against it. But, it is tax free and if you wanted an alternative to super they have their uses. But, gee I must say if I was in Apple and Google and I had them for any length of time I'd be very happy with that.
AK: And they're running hard at the moment so you wouldn't sell now.

Yeah, off they go again. Okay, question from Justin.

AK: You forgot about what's Alan's top five

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managed funds.

Sorry, what is Alan's top five managed funds?

AK: Okay, here they go. You ready?

Yes.

AK: Number one, Bennelong Concentrated Australian Equities Fund.

Number two, Loftus Peak, our mate Alex Pollak.

I know both of them, yes.

AK: Number three, Munro Partners, Nick Griffin.

Don' know that one.

AK: Well, it's a global technology kind of fund.

Number four, Wilson Asset Management, WAM Capital, it's a listed equity thing.

Number five, which is actually the best performing fund in the last quarter, is something called Selector but I can't remember the rest of the name of it, Selector something or other.

It's very impressive, Alan has no notes here by the way, folks, just telling you. Can I just ask you on what basis do you pick that five? Pure returns was it?

AK: Yeah, returns.

Yeah, over what period?

AK: Yeah, and it's actually not necessarily in that order. The best performing fund in the last quarter was Selector.

Yeah, but it's just a quarter.

AK: That's one quarter. The number two performer, who's much more consistent over long periods of time, is the Bennelong Concentrated Australian Equities Fund and I've interviewed the Fund Manager, Mark East, he's terrific. I know Alex Pollak very well and Loftus Peak's performance over I think it's five years is 22% per annum compound.

Yeah, interesting list.

AK: Nick Griffin has got a terrific portfolio and he is really investing quite a lot in videogames, e-gaming.

What's the company called again, the fund?

AK: Munro Partners and it's named after Munros which are mountains in Scotland.

There you are, never heard of them.

AK: Are they not? Come on, you should know that.

Very good, and we must say to our listeners past performance is no guarantee of future performance but they are impressive and they're all available…

AK: And we should also say I don't get any commercial benefit by naming them, they're not paying me an absolute cent.

Tell me one thing, they're all available to anyone, are they? There's no minimum?

AK: Well, I can't remember. So, Loftus Peak has a couple of funds, one is a $50,000 minimum, one is a $5,000 minimum. The minimum in the Bennelong Fund is $10,000

minimum. They're okay, they're achievable.

That's not crazy.

AK: And WAM Capital is listed so you can invest $1,000 if you want to.

You can just buy on the market. Okay, that was very interesting.

Now, Justin asks I'm a relatively new listener and I'm a finance broker. I'm interested to know what changes you think the Royal Commission into banking will bring about for my industry and how these changes could create opportunities for people like me. Well, that's a good question and interesting for a finance broker.

AK: I think you're going to end up, Justin, with a requirement in the law for you to behave in the best interest of your clients which is in the rules for financial planners but not so much at this point for finance brokers and mortgage brokers.

I think that will probably come in. I'm sure, Justin, it will make no difference to the way you operate because I'm sure that you operate in the best interest of your clients but it's another piece of compliance that everyone is going to have to watch I believe. Whether commissions are banned for finance broking or not is another question and I think it's an interesting question. I don't know the answer to it, I don't even know whether I think that they should be banned.

I think qualifications and independence will really be rated from hereon in.
AK: Yeah, of course.

Much more than they have been. Okay, maybe final question from Tim. Hi, Alan and James, I read with interest the table in the Weekend Australian. This is the same table I mentioned at the start, that huge table we ran of all the funds. Tim says the Vanguard US total stock market index fund had a 9.24% annualised return and he makes the point that this beats all these high ranked funds. Why shouldn't we all just invest in a US stock market index? Well, Tim, because we shouldn't all do the one thing and you shouldn't put all your eggs in one basket. Having said that nothing wrong with the US stock market index, in fact I have two of them, a big cap one and a small cap one, both ETFs. It makes a lot of sense, a nice way into the US market if you don't want to get specialised but obviously you never put all your money into anything.

Would you think that's a fair answer, Alan?

AK: It's an excellent answer, James.

Thank you very much.

AK: As I would expect.

Alright, I think we'll leave it there, thank you, folks.

AK: Hang on, we've got one from Twitter.

We have one from Twitter.

AK: Tim on Twitter. Can you recommend a data service for current and historic ASX financial disclosures? Morningstar seems expensive for a small time investor and as far as I can tell does not allow me to programmatically screen companies.

Yes, okay, Tim. He has to spend some money, if he wants to get that sort of service he's got to pay.

AK: Yes, but I just think that's outrageous.

What?
AK: Because Morningstar is expensive, it's

like $600 a year and there are three other services that do similar things, there's Lincoln Indicators, there's My Climb and there's Roger Montgomery's Scaffold. Each of them is more than $600, I think, so they're all quite expensive.

$600 isn't expensive if you're a serious investor and you want to get some software.

AK: You're a hard man, James.

Bloomberg – I'll get into trouble here but it's true, a Bloomberg Desk is – well, the last time I paid for one it was something like $25,000 US a year so there you go.

AK: That's what it is, so is Thomson Reuters.

So, I'm afraid you have to spend a bit, Tim, but it'll be worth it. Okay, I think we'd better leave it there for today, Alan, we'll be getting towards a record breaking Money Café. Don't forget you can subscribe to The Money Café, folks, on Apple Podcasts or your app of choice and if you're there it's very helpful to leave a review or rating. Please send in some questions, we really did enjoy the range of questions this week.

AK: Hey, what have you got coming up in the wealth section?

I have a very good exercise on super and how you choose super. Now that we know all about super and who's doing well and who's doing bad, how to make a decision how to choose this weekend.

AK: Very good. Before I come here today I do an hour long Q&A with my subscribers on The Constant Investor. So, tonnes of questions and answers.

Facebook Live?
AK: Facebook Livestream. Lots of people listen to it and any questions are answered, and so if you're interested in questions being answered I do it in the Facebook Livestream on The Constant Investor.

That's the plug, there you go.

That was a big plug. Okay, remember to e-mail this show, folks, it's hello@theconstantinvestor.com. Until next week, I'm James Kirby, Wealth Editor at The Australian.

AK: And I'm Alan Kohler, Publisher of The Constant Investor.

Talk to you soon.

The Unpredictable Bank Scandal

The Unpredictable Bank Scandal Fallout, Yield Cuve, US Employment, 23.9, Thoughts on Franking, Interviews, and more

Alan Kohler May 5, 2018 Alan Kohler's Overview

Fallout

We'd forgotten all about the review of Commonwealth Bank's governance that was commissioned last August after AUSTRAC pinched them for multiple violations of the money laundering laws.

It was conducted by former APRA chief John Laker, with company director and former investment banker, Jillian Broadbent, and former head of the ACCC, Graeme Samuel. It lobbed with a bit of a splash on Tuesday and then quickly got lost among all the other blows raining down upon the heads of the banks and AMP, and put into the background by the sensational defenestration of AMP chairman Catherine Brenner and then the revelation on Thursday that CBA had managed to lose 20 million customer records.

It is a statement of the bleeding obvious that the big banks and AMP are under siege on all sides, although the bank share prices have bounced in the past week or two because of bargain hunting in the light of quite decent half-yearlies – resulting, it should be said, partly from low impairment provisions, which are outside their control.

Broadly, there are two risks for investors out of what's happening, in my view:

1.Macro: that lending standards tighten significantly and turn the property market downturn that started last year into a rout; and

2.Micro: that the banks become so over-regulated and risk-averse that they lose touch with how to be businesses at a time when they will need all their wits about them to deal with fintech disruption.

The extent of Australia's household debt problem is well known, along with the associated housing price boom, although I must say this chart from Gerard Minack that I showed on the ABC news the other night surprised me:

It has become clear from evidence to the Royal Commission (although we kind of knew it already) that contributing to the surge in household leverage and house prices has been a combination of "liar loans", where borrowers write down unrealistically low living expenses on the mortgage application forms, and interest-only loans.

These things are clearly coming in for particular attention from the regulators, and from the suddenly galvanised board risk committees of the banks themselves.

No one will want to be stupid about cracking down on lending standards – everyone understands the dangers – but in the end, it may not be controllable. Simply following their legal obligations might result in a major, effective tightening of credit.

Gerard has done another very interesting

The Unpredictable Bank Scandal Fallout, Yield Cuve, US Employment, 23.9, Thoughts on Franking, Interviews, and more

calculation: he has redone the sums for debt service as a percentage of income assuming the interest only loans turn into 20-year principal and interest loans:

In other words, if borrowers have to actually repay the loans, and not just service the interest, then the household debt service burden is well above average – not just on average as the red line suggests. And if/when interest rates start going up, the picture will look much worse.
What happens out of the Royal Commission and the besieging of the banks is obviously uncertain, but at the very least it adds another risk to the usual one at this point of the cycle, of rising inflation, followed by higher interest rates and higher unemployment leading to a housing bust. This time there is the possibility (no more than that) of a credit squeeze brought on by scandal.
The second issue (above) is related to that, but different: the banks are not just under siege from regulators and angry disillusioned customers, but also from technology disruption.

This is something else that is completely uncertain. After all, there is no shortage of sensible people describing blockchain and cryptocurrencies as over-hyped nonsense.
I happen not to be among them and believe blockchain is a big deal and worthy of hype, but while I think that blockchain is likely to eventually become the way all records will be held, especially of transactions, I don't know what that means for banks.

Nor do I know what all the activity in the world of cryptocurrencies will mean for the payments system. Again, while there is clearly some price excesses in the Bitcoin market, and cryptocurrency market generally, I don't think these things will go away.

In essence, a lot of very smart people are working hard to replace the existing bank-controlled systems of payments with a different one that uses blockchain-based transferable tokens called cryptocurrencies.

I think it's clear they will succeed to some extent, although it's not clear how much, or whether it will involve Bitcoins, Ethereum, Litecoin or one of the others, or several of them together, or whether it will involve munching on the banks' lunches.

It is very early days. The analogy is probably the internet ... it's about 1990, when Tim Berners-Lee invented the World Wide Web.
And as subscriber Lou Wilson wrote to me yesterday: "When you think about it, our whole finance system is based on belief and trust. Very little hard currency is used these days. It's probably only a matter of time before we all get comfortable with a new payment system."

Meanwhile the banks are being picked off by a Lilliputian army of non-blockchain competitors – peer-to-peer lenders, cheap foreign exchange operators, non-bank deposit-takers and so.
How it will all play out is anybody's guess, but one thing is clear: the banks will need their wits about them, and will need to not have to be spending time bailing out their sinking sailboats of community satisfaction and corporate governance issues. Compliance is the enemy of good business.
By the way, on the subject of blockchain, you may be interested in a keynote speech I delivered this week to a blockchain conference in Sydney put on by First Digital Capital, a new cryptocurrency fund manager.

Here are the first few lines:
I have three key points to make:

One, blockchain is an evolution of the internet, a renovation if you like – a new kitchen, or perhaps an extra room.

Two, it is in essence, the addition of a trust mechanism,

And three, no one has any idea what will come of it, or even what will happen next.

Also, it's worth reading, or listening to, my interview with the inventor of blockchain, Scott Stornetta, who spoke after me at the conference.

The Yield Curve

That chart is what's known as the yield curve – well, it's not exactly curve, but it shows how it has changed over the years. It's the difference between the US 10-year Treasury bond rate and the 2-year rate.

You can't read the numbers on the side or the bottom (sorry about that) but basically, over the past two years, the difference between them has gone from 2.6% to below 0.50%, or 50 basis points.
That happened because the 10-year bond yield did this:

While the 2-year yield has done this:

So while it's true that the US 10-year bond yield famously went above 3% recently and briefly, for the first time in a while, the 2-year yield has been surging to new highs all the time, as you can see.
The Australian yield curve has also dropped, but not as much. The difference between the 2's and the 10's in Australia is currently 0.75%.

That shrinking of the difference between short term and long term interest rates is called "flattening" of the yield curve and it usually precedes economic slowdown. If it "inverts" – that is, the 10-year rate goes below the 2-year rate, it's always taken as a sure sign that a recession is on the way.

In fact the difference between the U.S. 2's and 10's is now the narrowest since 2007, when the flattening did, indeed, signal a whopping great recession.
This year, however, the sharemarket is taking

The Unpredictable Bank Scandal Fallout, Yield Cuve, US Employment, 23.9, Thoughts on Franking, Interviews, and more

very little notice of the yield curve, if any. The curve has flattened 70 basis points since January 2017 (from 1.2% to 0.5%) but the S&P 500 has gone up by 13.5% over the same period, interrupted only by that bout of volatility in February/March caused by an incorrect reading on US inflation.

Why is it different this time? Why is the yield curve being ignored?

There are three important reasons, in my view, that all investors need to understand: first, central banks are now seen as bond buyers of last resort through quantitative easing, so the market understandably reckons that if things go south again, we'll just get QE again and bond yields will be held down by central buying again; second, the sharemarket is now dominated by passive investors rather than hedge fund traders, and senses have therefore been "dulled"; and third, technology has fundamentally changed the relationship between economic growth and inflation, possibly forever, but definitely for quite a while.

Let's go through these one at a time because they are fundamental to understanding the way markets are operating at the moment.

1. Central banks et al

Since the GFC, long term yields have been held down by "non-commercial" buyers – that is, mainly central banks applying QE and also pension funds whose bond mandates increased after the sharemarket crash.

So powerful were these forces that more than US$8 trillion in bonds were trading at negative yields last year, which means their prices were so high that buyers of them were guaranteed to lose money over their life, unless they could find a greater fool to pass the parcel to. It was clearly a bond bubble.
What's more the impact of this on yields has been magnified by careful central bank forward guidance, ever since the so-called "taper tantrum" of 2013 when there was a bond market rout after Ben Bernanke came out with a surprise statement that he was about to start tapering QE. In the past five years the Fed and other central banks have been aggressively reassuring markets that there will be no surprises, which has also had the effect of increasing market confidence, both in general, and specifically that they won't hesitate to do QE again if needed.

At the same time short-term yields have been pushed higher by five US rate hikes, and guidance about more hikes, as well as the huge increase in sales of US government debt that's about to hit the markets.

2. ETFs

The way markets usually operate is that bonds signalling the macro outlook while the sharemarket is more "bottom up"; the indexes are an average of thousands of individual company outlooks.

When bond investors signal a downturn by flattening the yield curve (that is, by shortening the duration of their portfolios – or reducing their "sail area" – because they can see a storm ahead), hedge funds move quickly to short-sell stocks. They are followed later by slower-moving institutional and retail investors. And to some extent the whole thing becomes self-fulfilling. But last year, according to Morningstar, US$220 billion had been moved into passive ETFs, taking to total passively invested to more than US$7 trillion. About the same amount came out of active funds.

This steady flow of "dumb" money is muffling the usual market signals – hedge funds and active investors don't have anything like the same influence they used to have.

3. Disruption

This is something I bang on about quite a bit, so I won't bore with it some more today. The current disruption wave – the fourth or fifth in human history (or is it the sixth?) – is causing a secular down-shift in inflation, and therefore interest rates.

We discussed this at length in a lively session at our "Investing in Disruption" event in Sydney on Tuesday night, with Alex Pollack of Loftus Peak Investment Management and Jo Masters of ANZ Research, and I think the bottom line of the night was basically that there is a lot of it going on.

And by the way, it was great having more than 60 of you join me on Tuesday night for the event. Alex spoke about the disruptive power of Google and Amazon, and the other big firms like them, and how they'll play a role in our daily lives in the coming years, with Amazon to even be involved with how your groceries get delivered from Woolworths.

Retail is especially being disrupted right now, and especially in Australia, but globally Amazon and Alibaba are powerful forces for deflation. Moderator Emma Alberici (Chief Economics Correspondent at the ABC) and Jo had an interesting discussion about retailing in this country, with Jo pointing out that retail margins are still about twice as large as elsewhere in the world, and Emma highlighting the fact that she can order items from online retailers in the UK, and the items arrive quicker than say ordering something from David Jones.

I spoke about the state of play of boards in this country, and how they aren't really up to scratch, especially when it comes to investing in R&D, which is why we don't often see a lot of disruption coming out of this country. One of the reasons for this is that companies pay dividends instead of re-investing back into their companies like say Google and Amazon.

Alex also made an interesting point about cancer, saying that he and I might live past the "cancer cut-off" as he put it – that it will be cured in our lifetime, so we'll be right. Here's hoping!

Gerard Minack (who wasn't there on Tuesday night) calls it "secular stagnation", which is a more broadly economic term, because he's not just talking about technology.

I just call it disruption. I see it is a positive force, not negative: the fact that prices are being forced lower by competition and cost reduction is good, not "stagnation".

But Gerard correctly (in my view) points to the difference between the secular long-term and the cyclical short term.
He wrote in a recent note: "...while-ever the low through-the-cycle rate view holds, further Fed tightening will continue to flatten the yield curve (2-10 Treasury spread). The fact that the curve is now unusually flat given the level of the (real) Fed funds rate is in my view largely due to the market accepting that the neutral Fed funds rate is lower now than in prior cycles."

None of the three things that I have identified as interfering with the normal functioning of markets – the central bank "put", passive investing and disruption – is going away in a hurry.

The markets are not normal – it IS different this time.

US Employment

The American unemployment rate has fallen below 4% for the first since the end of 2000, when Bill Clinton had just lost the Presidency to George W Bush, the Nasdaq had crashed, and Independent Women Part 1 by Destiny's Child was the No.1 song (what a terrible song).
And back then the dip below 4% was very brief

The Unpredictable Bank Scandal Fallout, Yield Cuve, US Employment, 23.9, Thoughts on Franking, Interviews, and more

as the sharemarket crash and interest rate hikes up to 6.5% in May 2000 caused unemployment to rise back to 6% in quick time.

In April 2018, payrolls increased 164,000, unemployment fell from 4.1% to 3.9% and, most importantly, wages growth fell to 2.6%.
It confirms again, as I wrote in the previous item, that the traditional relationship between growth/employment and wages/inflation has fundamentally broken down.

And this is the 91st consecutive month of jobs growth in the US, so anything but a flash in the pan, yet wages growth remains subdued.

No wonder the sharemarket had a decent rise last night: strong growth with low inflation is the best scenario for equities, and it means the Fed is likely to stick with its plan to gradually increase rates.

Meanwhile, the surging US dollar is putting heaps of pressure on emerging markets.
Last night Argentina stunned the markets by raising its main borrowing rate to 40%, which produced a 5% lurch higher by the peso from its record low earlier in the week.

The 3.4% rally by the S dollar index in the past month might not seem much, but it's putting heaps pressure on EM currencies. The Polish zloty, Mexican peso and Turkish lira are all down plenty and EM countries generally are seeing the beginnings of a capital flight.

Argentina is at the pointy end because of its US$100 billion default in 2003, but it's much broader than that and bears watching.

23.9

So the Government is proposing to put a hard cap on the tax revenue to GDP ratio in Australia of 23.9%, at least while they are in charge.

It's an arbitrary, meaningless number that has nothing to do with what is the right level for the Australian economy. No work that we know of has been done to determine the optimum level of taxation as a percentage of GDP in the Australian context, with comparisons with the rest of the world.

Many happy countries have higher tax to GDP ratios than that and some very unhappy countries have lower ones. The average is higher than 23.9%.

The purpose of the hard cap, it seems to me, is to legitimise the tax cut promises that will be in next week's budget – that is, by pronouncing a tax to GDP limit of 23.9%, and then forecasting that it would otherwise rise above that level in future years, the Government can promise to return any excess to taxpayers and claim that it's sound economic management, not vote-buying.
It's actually a form of tax indexation, which does away with bracket creep by tying the marginal tax scales to the CPI or to wages, so that as peoples' wages rise the higher tax rates also kick in at higher levels so people don't slip into higher brackets.

It was tried once, by Malcolm Fraser in 1976, and then hastily dropped because it meant there couldn't be "tax cuts" that just involved giving back bracket creep, since there wouldn't be any bracket creep, and nor could bracket creep be used to reduce the deficit.

Tying tax revenue to GDP kind of does the same thing, except that GDP growth is not the same as wage growth or the CPI, although let's be honest they're not far apart at the moment. Inflation is 2%, wage growth is 2% and the GDP growth was 2.4% in 2017.

So in essence, Treasurer Scott Morrison and Finance Minister Mathias Cormann have come

up with a brilliant wheeze: have a form of tax indexation that involves giving tax cuts. Cake and eat it!

Is 23.9% enough tax revenue? Almost certainly not, given the pressures of NDIS and ageing population, especially now that the increase in the Medicare levy to pay for the NDIS has been foolishly cancelled.

But then again control a lid on government spending elsewhere is no bad thing.

Some Thoughts on Franking

1.Don't do anything until after the election. Turnbull might win in which case nothing changes. After all, Bill Shorten is an unattractive candidate.

2.If Labor wins and cash refunds go, then if you're a zero tax-paying SMSF, or low taxpayer, then the only change is that the stated dividend yield becomes the yield – there is no "grossing up" of returns to include the tax benefit unless you pay more than 30% tax.

3.If you're paying 15% tax, then the calculation is simply 50% of the gross-up.

4.You can and should still invest in 100% franked dividend payers, as long as the yield and/or capital gain is good enough. For example, Fortescue and Telstra dividends are fully franked, but the yield is above 7% so that's still fine.

5.The best place to look for high yielding, unfranked income stocks is among owners of real assets – that is, buildings and infrastructure. That means REITs (real estate investment trusts) and utilities like Spark Infrastructure.

6.Another to think about is bringing tax-paying children into the SMSF and allocating the dividends to them.

A hardware AI business: BrainChip Holdings

Lou DiNardo is the CEO of BrainChip Holdings (ASX:BRN), an ASX listed company. He's talking to us from Newport Beach, California where BrainChip has one of its offices; its Head Office I guess you'd have to say is in San Francisco and it's got an office in Toulouse, France, and it listed on the ASX through a backdoor listing back in 2015.

I only learnt this at the end of the interview with but Lou, that BrainChip is the only pure play artificial intelligence listed company in the world. All of the AI companies otherwise, of which 140 were sold last year as a matter of fact, are all venture capital based and they're not listed. He says it's the only way to invest in a pure play AI company as a small investor on the stock exchange and it happens to be on the ASX.
It's basically a hardware AI business, no software, which is profoundly important I think because it basically is a chip company. They make a chip that tries to emulate the way the brain works with neurons and synapses. The thing that was invented and patented by Peter Van Der Made, who's an American guy who spent a lot of time in Australia. He came up with this way of copying the way the brain works in a chip, which reduces the amount of energy and reduces the amount of data that the chip needs to get in order to draw conclusions.

Basically it learns on the run, as the brain does, and it's a really interesting business. They're focusing at the moment on surveillance in casinos, railway stations, for police forces and so on, they're starting to make sales that way. But I think there's a lot of potential here. One of the questions I asked him was whether they can mine bitcoins with the thing and do it without using so much energy. He then went off into a long rave about that which was interesting, and also the question of how the BrainChip product works with quantum computing which he says is also quite huge.

I think this is a very, very interesting, possibly exciting business. They've just done a big capital raising last year, about $20 million dollars, and more importantly in some ways, they brought in a whole lot of Australian institutions onto the share registry. Now it's institutionally held and it's fully funded. They've done a series of capital raisings now, raised about $30 million and he says they're now fully funded to break even which is good news. The stock's about 20 cents and a really interesting little business.

Here's Lou DiNardo the CEO of BrainChip Holdings.

Lou, I'm speaking to you from Newport Beach in California. Is that where the company is based or is it based in San Francisco, in Australia, or where is it based?

Yeah, the company is listed on the ASX, so certainly we have a big footprint and presence with the institutional and retail or individual investors in Australia. What we call our Head Office where myself, our CEO/CFO, Ryan Benton, as well as Senior Vice President of Marketing reside in San Francisco. We have two design centres, one is in Aliso Viejo, where you're speaking to me from just outside of Newport Beach. We have about 14 employees here. They fundamentally do hardware design and then our founder, Peter Van Der Made as well as a couple of research scientists are here.

Then we have our Toulouse facility, Toulouse, France, which is Southern France just at the foot of the Pyrenees Mountains. We another 13 or 14 people there that do algorithm development as well as software. We're spread around wherever we can find the talent, but I think those are three primary physical locations. Of course, Australia's always top of mind to us because that's where our investors are.

Why are you listed on the ASX? Is it become the founder, Peter Van Der Made, spent some time in Sydney?

He's frankly spent some time all over Australia. I know he was in Sydney, I think he was in Melbourne, I know he was in Brisbane. But he spent a lot of his time in Perth, out in Western Australia. He was teaching neuroscience at the University of Curtin. The reason for the ASX listing, it's interesting as I'm sure you have kind of followed how technology companies get funded during their formative years. Peter had a prior company, a company called VCIS, which was Venture backed by Silicon Valley venture capitals. Built the company to be a very successful company. It was early stages of what we would call cyber security or malware protection.

When he sold the company the venture capital guys go through subsequently several rounds of funding, they took more and more ownership and at the end of the day they took the very much lion's share of the proceeds from the transaction. Peter has had a passion for BrainChip for the better part of a decade or more. He sees it as a big idea, as do I and that's why I joined the company. There was a reverse takeover of a mining – I guess you would call it resources company Asiana in September of 2015. Peter decided, you know what, I'm going to put this out in the public market and let public market investors enjoy the upside during that RTO in September '15, AUD$4 million was raised, gave Peter enough capital to put a team together. You can rent the offices here in Aliso Viejo and take what was in his head, what he really has a passion for in mimicking how the human brain works in Silicon, take it from his head to paper. It was an innovative and unique idea, at least from the standpoint that those of us who have grown up here in Silicon Valley went back to the market in April of '16, raised another $4 million. That got him from paper to a piece of silicon, in what we call an FPGA, a programmable [6:54.2] silicon yet, but you know, emulate in an FPGA. That worked exceedingly well. Recognised at that point, having a neural network in Silicon, synthetic synapse and synthetic neurons, it's great, it was a great achievement.

But you do need a kind of turnkey or full solution to demonstrate to customers that it actually works. So if you fast-forward from April '16 to September '16, the company acquired a company in Toulouse, France, called Spikenet. Spikenet also uses a spiking neural networks.

They happen to do it in software, so simulated in software, and Peter and Anil, his co-founder, Anil Mankar who's also here in Aliso Viejo. They acquired Spikenet with the intention of integrating the Spikenet simulated algorithms as well as use case where application level into an FPGA that could then be marketed, demonstrate proof of life and get marketed.

It was interesting that what they found in Spikenet was a very similar thinking about how to do neural more for computing with a spiking neural network which is much different than much of what you read about or hear about in the artificial intelligence. But they hard marquee customers. They had them marketing their software simulation to the equivalent of the Department of Homeland Security in France, the Paris Police Force, the Bordeaux Airport. Rockwell Collins, Saffron – really world class companies. The software and algorithms were battle hardened and the effort then from – I joined in late September, September 29th of 2016, and we took the next 6 months and basically integrated the software into a new silicon solution.

A hardware AI business: BrainChip Holdings

So, I suppose the essence of BrainChip in a way is the conversion of that kind of spiking software into hardware. You've got a hardware solution for what's usually a software solution in fact?

That's exactly right and we call it an accelerator. We took when I joined in in late September of '16. Early October, we went out and raised another AUD$5.4 million dollars. It was done through a private placement. I think it was the first week of October in 2016. Then we took that capital and we took the software simulation of the spiking neural network, the algorithms and the application layer which allows people to interface. The guys at the police department, the law enforcement folks, they're no scientists, they want a user interface. They want to be able to highlight a suspect and then, you know, whether it's forensically look back at videos that are stores or sometimes in real time with live feeds.

The real strength in vision systems, the real strength to the spiking neural network, without going into a whole bunch of the technical nuances, is that just like the human eye and your ability to process information in your brain. We can work on very poor images, so low resolution cameras, dark environments. If you think about the Paris subway system as an example, those cameras are 20-25 years old. They're melted in horrible places, it's dimly lit and we can extract a face so we do facial protection. We extract to that image, we turn it into a spike map which is the same electrical impulses that your brain would receive from your ocular nerve. Then we can match that against a known set of terrorists. That's fundamentally what we did...

I have trouble getting my head around how you can have artificial intelligence in hardware rather than software. That is a real jump, it seems to me.

It is a real jump and gosh, I've been doing semiconductor hardware for 35 years. I retired in October at 2015, has no intention of going back to work but when I got called and I met Pete I had the same chasm that I had to get over, but once you have the digital or synthetic synapse architecture thought through. Then the synthetic neuron – basically it's digital logic.

We put down a bunch of registers, they act like synapse, those registers dish data off to what we call neurons and all those synapse are all connected to all the neurons. Everything's parallel processed.

If you run our software, which was the Spikenet software, now we call it BrainChip SAS. If you run that software on a server and let's say you're getting high definition feeds. You're getting a minimum of 1080p and you're getting 30 frames per second. The software on a high end intel processor can do maybe five channels simultaneously. If you run it on our hardware you can get somewhere between 16, maybe even 20 or 24 channels through the same server. We don't do anything different, we put the same architecture that was simulated. We put it down in digital logic but because of the way we can do it in hardware, it's something that's five or six times faster than running the software on a CPU or even an Nvidia GPU and we can reduce the power by a factor of 10.

I was going to say, do you use much less energy as well?

It's enormously less energy. If you run the software on, let's say and Nvidia CPU or even an Intel CPU, you're going to burn somewhere between 200-300 watts of power. To put that in its context, take a 100 watt light bulb, put two or three of them in a briefcase which is the size of a server and you'll just see the thing melt down.

The amount of heat dissipation is enormous. When you get into high-end GPUs they're at least actively cooled with a fan and a heat [sink [13:34.8]. Sometimes they're actually water cooled, where they're putting cold water through the heat sink to keep things cold.

Our chip itself runs at 10 watts. We put it on a board, so it's a plug in card into a server, and the entire card runs 35 watts. So, it's something in the order of 10 times less power, 6 times the speed and frankly delivers on a promise for being able to extract an image that otherwise any traditional vision system or even a deep learning system just simply couldn't do. That's what the folks in Departments of Homeland Security and the police forces love about the product. It's easy to use, able to extract an image from very poorly lit and low resolution environments. It's very fast and it's very low power.

A random thought just popped into my head. Could you mine bitcoins more cost effectively and without using so much energy? Would your chip do that better?

Well, it's a really good question – and I always hate saying it's a good question because I know that's why you asked it. The difference between computing, and even in a GPU or a CPU, because we work like the brain, we're not doing math. Your brain doesn't really do 1 plus 1 equals 2. Your brain has a spike math that recognises I learned this when I was a kid, 1 plus 1 equals 2. We don't do computation. That's why it's extremely low power. What we could do in crypto or just blockchain generally, we will never be the solution to calculate the transaction, 1 plus 1 equals 2. What we can do and what the technology is exceptional at is recognising competing patterns.

So as this crypto environment matures or blockchain more generally, because it's not just with respect to currency, blockchain is being applied to many other avenues as well, is we can recognise repeating patterns. We could do that for Blockchain and we could say, if there was a very high density of transactions with a very similar pattern being executed, we could do it for cyber security where we could recognise patterns for denial of service attacks, malware attacks.

More generally, harkening back to crypto, fintech or financial technology generally. High frequency trading patterns, people want to know what those patterns are so they can forecast what their future transaction should be or they want to intersect somebody else that's trying to do exactly the same thing. So, the technology is not about compute, it's about recognising repeating patterns.

Just before we get onto some other matters, another thought that occurs to me is, what if we could combine your technology and Peter's ideas with quantum computing?

That could be huge. There's always going to be kind of a side by side environment. Even if we look at today, some of our engagements because of this ability to do vision exceptionally well – we're being approached by major automobile manufacturers around the world. Detroit, Germany... Again, we're never going to do the compute, we're going to recognise very quickly and very efficiently a pattern. So, we likely will sit side by side during the short to mid term, we'll sit side by side with a CPU or a GPU, they'll be crunching numbers and we'll be functioning like a brain doing the thinking...

A hardware AI business: BrainChip Holdings

AK: But Lou, it just seems to me, just thinking about it, I mean the computing thing that CPUs do and have always done, and in fact the whole history of computing up to now has been an attempt to in a sense, replicate what the brain does, but to do it through computing. As you point out, that process of computing in order to replicate thinking is not really a good way to go about it. It just seems to me, studying your business and studying what Peter has thought of, what you do is much closer to how the brain operates, right?

What you have – and I guess a good slide in our investor deck – to date, for the last 50 years, everything we've done in digital electronics is based on what we call the von Neumann Architecture. A guy named von Neumann, I believe it was in the late 40s – I'd have to be corrected on that – it's all serial processing. It's instruction, fetch data from memory, process instruction, fetch data, process instruction, fetch data, process... And we've gotten away with that for 50 years because we've been able to follow Moore's Law – logic gets smaller and smaller faster and faster... Intel CPUs, even in a laptop, are now running at 4 GHz clock speeds. That's 4 billion cycles per second. So we've gotten away with kind of not mirroring what the brain does but trying to reinvent how we could process and come up with some other conclusions.

Peter's view of it is that in order to advance our true artificial intelligence you need to process in parallel, just like the brain does, all of your synapse, all of the same electrical charges at all times. They get excited and the ones that get excited first and what we call intensity and temporal integrity, so they're excited to a large extent and it lasts for a long period of time – long being fractions and fractions of a second. It fires off, it goes to a neuron and if enough of the same synapse are seeing the same event, that neuron gets excited and you go through – when we talk about layers, that's when you go through layers of the neural network. Is it three layers, is it five layers? The human brain probably operates on seven layers.

The challenge with what's gone on to date – and there's been great use cases where it's absolutely appropriate, but as people jump out of von Neumann serial processing and they've moved into convolutional neural networks, CNNs, or DNNs, there's a whole variety of things. They still let themselves processing in a computing fashion, everything's done mathematically. The spiking neural network doesn't do that, the first thing we do is we convert every input that we see and it could be data from a stock transaction, it could be a visual input from a standard pixel based camera. First thing we do is we turn it into spikes. When you go to spikes you need a small fraction of the information.

We have a really cool demo where we fire up a video and it looks like a noisy screen, just looks like a bit of white noise. Then we start to pixelate and fill it in. The average human being – and I've done this for hundreds of people now, within 5 or 10% of the data your brain recognises what the image is. You'll know it's an eagle or it's a fox or it's a train. If you're doing that in a computing architecture, before you could make your decision and move on, you'd have to get 100% of the data. When people ask, how can you be faster than an Nvidia CPU? It's because we only need 5% of the data. At 5% of the data the synapse triggers or fires and it sends the information off to the neuron.

So you're right, we're moving into an entire – this is probably the most disruptive technology I've seen in 35 years and I've worked for some of the best semiconductor companies in the world. They started in devices, went to linear technology... I came back to work because this is just darn exciting.

AK: Tell us about sales you've made.

We introduced our first commercial product on – let me get my dates right – July 17th. That was the software. When I joined in September of '16 it was clear that the Software that had been developed by the Spikenet team was really kind of customised, it had a little bit here for this customer and a little bit there. We decided to retrench and what we call refactor the software, bring it all up to kind of current code, make it very user friendly. We introduced on July 17th, the software and then on September 10th we introduced the software accelerator where we ported the software to the hardware. Historic sales, call it $1 million bucks or less US. We don't publish or forecast...

But have you made any sales at all?

Oh yeah, we have. We've had recurring revenue with the Paris Police Force. I'll use US language because I can't speak French, their Department of Homeland Security. We've got installations at the Paris Police Force, the Paris department of homeland security. They continue to buy products. We're installed at the Bordeaux airport. We do perimeter intrusion. If people hop over a fence or go near an airplane when they're not supposed to, we do that pattern recognition. We're live in one casino. It's interesting that when the casinos figured out that we can recognise a pattern off of a junk old camera 3 metres up or 5 metres up, they engaged us to basically count cards in casinos, who won, who lost, did the deal get paid off properly or not?

AK: So your processes can count cards?

Yeah, we can count cards and chips, from the eye in the sky. 5 metres up we can recognise an ace, a king, a queen... There's an application. We collaborate with someone that knows the casino industry because we don't want to have to be calling on casinos. But yes, we have a product called Game Outcome – ace, king, queen, 2, 3, 4, she won, he lost, did the dealer moved the chips in the right direction so that it got paid off properly or not? That's called Game Outcome. Game Statistics takes the same data and said, 'John sat at the table for four hours, he played 72 hands, he won 30 and he lost 40 – maybe we should comp him dinner and try and keep him in the casino.'

The casino operators give away a whole lot of money and one large casino engagement we have in Las Vegas said directly to me that they give away $30 million dollars a year US in complementary services, show tickets, rooms and dinners.

But only to losers, right?

Well, their own estimate was 50% goes to the wrong people because they don't know. They don't have any analytics. They got a pit boss with a scratch pad trying to walk around and keep up with it and people have player cards but they're all swapping player cards. Now we give them real time analytics and eventually that will be attached to facial recognition which is one of the strong suits, so not only do we know it was a player at spot number one, we'll actually know which player it was and when he gets up and he goes to another table, we'll figure that out as well.

At this point it's about vision. I don't want to miss one major point, and that's about vision, because it's one of the most straight forward applications and areas to apply to technology. We've got great traction, got a great customer base. The products really only came out in the 3Q17. The development that we're working on now, we came back to the market again in November and we raised AUD$19.5 million. Frankly, it was well over-subscribed. We have capacity limitations as to how many shares we can issue, but we raised $19.5m which is all still sitting on the balance sheet.

But we have launched a product development we call Akida. Akida happens to mean spike in Japanese. It is a next generation standalone neural processor, we call it an NSOC, which is a neuromorphic system on a chip. This will really be I think the world's first truly and fully integrated neuromorphic processor. It might sound audacious, but yes, it's going to compete with Intel, it's going to compete with IBM, it's going to compete with Nvidia. We have the neural networking core which is our next

A hardware AI business: BrainChip Holdings

generation architecture and learning rules. We have that up and running coming out of research going into development.

We expect to have it emulated in an FPGA sometime around mid-year and we're going to go into building our own integrated circuit some time late in F18. So, we're moving from an FPGA which it works and it's a great way to get to market. It's not the most cost effective way to get to market. It certainly doesn't give you the lowest power or the highest speed or the greatest density. It's great for what we have in vision systems. But he Akida development is really the future of the company.

Can we just talk about cash now...?

Sure.

As you say, you raised some cash last year and it seems to me what you did then was relatively transformative, not just in the cash you raised, but also the institutional shareholders that you brought onto a register. But it does seem to me that before that you were about to run out of money. According to the September Q you were burning about $2 million a quarter and you had less than $5 million in the banks. So, as we say in Australia, you were on the bones of your arse at that point.

[Laughs] Yes, it's a fine line as to when you go out and raise the cash. I wanted to get the commercial product up into the marketplace. I wanted to be able to speak to them, I wanted to be able to speak with the opportunity and the customers that we were engaged with. The Australian market is extremely receptive to this story. When you think about real technology companies that have – I mean this in a good way – that also have a centre of gravity that's in Silicon Valley with very seasoned Silicon Valley executives running the company. We have half of our board in Australia, we have half of our board in the US with independent directors. Yeah, we take it up to the wire. We were close, we were close...

Yeah, you were close.

We knew there was demand and you're right, I think two important things which you just touched on, we are fully funded now. We have enough capital to build our revision system with our BrainChip studio product and the accelerator hardware. It's also enough capital to get us through the development of the IC. It puts shareholders' mind at ease with respect to when's the next capital raise? Well, you know what, we have enough capital. And as you said, maybe as important or maybe more importantly, we have changed the composition of the shareholder register. I think we brought in 21 new institutional investors. I'm not allowed to name names...

Are they Australian institutions or American?

No, at this point they're all Australian. I decided not to bring it to the US market yet. There's such an appetite in Australia. And again, we were way, way over-subscribed and the institutions that came in, you know, they're dominant names. Names that everybody knows, loves and trusts. There's long term holders, you know, you're not flipping in and out of the stock. I mean, there's always some that do. But between us I've done three raises since I joined in September. I did one in October of '16, I did one in May of '17 and one in November of '17. Got us fully funded and I think we've probably added 30 institutions.

The capital structure remains interesting, and again this harkens back to one of your first questions about why do a back door listing? Peter Van Der Made and Anil and at the time the CEO, he had to leave for personal health reasons. There were meaningful investors in Asiana which was the target of the RTO. Primarily Metals X and then some syndicate around Metals X. Between those five or six shareholders, they're something around about 65% of the stock. It's highly concentrated in long term investment. Metals X has been very, very loyal. Of course Peter, Anil and Robert Mitro, the former CEO, if you looked at some of our press releases, when

you do a reverse takeover there's a mandatory – I think it's an ASX listing requirement – there's a mandatory two year escrow period on any of the shares that are part of the RTO.

On September 22nd I think it was 361 million, it was well over 350 million – I think it was 361 million shares came out of escrow. I happened to be in Australia at the time, not raising money but just talking to institutional investors and everybody was a little skittish. All of a sudden there's 360 plus million shares that hit the marketplace that previously couldn't be traded. So I made five phone calls and I forget what the date was – you could check the ASX press releases. It was just before we raised the money. I think it was probably October 17 – October/early November – made five phone calls to those major shareholders and I put back into escrow I think it was 403 million shares. We actually put back into escrow more shares that came out of escrow.

I saw that in your announcement too, I thought that was amazing! That was really something, that was.

Yeah, it calmed people's nerves...

You kind of had to do though didn't you, because you were about to raise $20-30 million bucks? Yeah, you had to. How can you raise money when you've got all this float out there? And none of these people were sellers. I mean I thought I was going to have to put on my salesman shoes and they were literally very, very easy phone calls.

I'm going to have to end soon, but what is the exit strategy? I mean, is the plan to setup an auction between Intel, Nvidia and Qualcomm and see what price you can get or do you think you can eventually become one of them?

I get asked that question a lot and this is my fourth time as a public company CEO, a couple of Nasdaq and one New York Stock Exchange. Frankly, all three of those companies ended up being acquired, but my philosophy is build the best company you can. Build the best products, address the growth markets, drive consistent profitability and let the chips fall where they go. I think, you know, to try to architect a company for an exit in the way of M&A, it's kind of a fool's errand. Companies don't get sold, companies get bought. Those that get sold, they get sold at sub-optimal exits because that's all they're saying, all that matters is getting sold.

Our goal is to build a company with an enduring brand, the leader in neuromorphic computing, and is somebody going to come in and put us in play? There was 140 acquisitions of AI companies in 2016. I think the value our share [34:50.8] have is of those 140 which was billions and billions of dollars in consideration, not a single public market investor made a dollar because all of those companies were backed by venture capitalists in the US and they've harvested great upside. What I tell our investors is this is your only pure play AI company that's publicly listed.

Oh is that right? I didn't realise that. Is that so?

Yeah. You could buy Google, you could buy Tesla, you could buy a whole bunch of AI players, but if you look for a publicly listed pure play AI company, whether it's ASX, Toronto Exchange, Nasdaq, New York Stock Exchange, there is no pure play AI company for public market investors to put their money into.

And it's on the ASX, there you go.

Exactly.

Well, it's been great talking to you, Lou.

Thank you very much, any time.
That was Lou DiNardo, the CEO of BrainChip Holdings.

How to be a lazy investor yet still be a constant one

16 August 2018, Percy Allan Market Timing

This editorial is heresy. After all we are meant to be constant investors, not lazy ones. But how much of our portfolios do we want to actively manage? And how much time and effort do we want to put into investing?

For some people investing is a hobby, something to do in retirement. But for others it's a distraction from work commitments or leisure pursuits.

The main reason for having a self-managed super fund is to control one's investments. And outside super there is no choice, but to take such control.

But say you want to do a bit of both – be a lazy investor most of the time, but a constant one for some financial assets.

The first step is to decide how lazy you want to be. In other words what proportion of your financial assets (such as cash accounts, term deposits, bonds, debentures, property trusts and shares) do you want to leave alone as opposed to actively monitoring and managing?

For instance you might decide that you want to be passive with one third or one half or two thirds of your portfolio and concentrate your investment skills on the rest. But before doing so, decide your preferred asset mix because the split between defensive assets (e.g. lower risk/lower return cash and bonds) and aggressive ones (e.g. higher return/higher risk commercial property and shares) will decide the likely gain and fluctuation in portfolio value you will experience.

The typical risk/return portfolio choices advanced by investment advisers are "Income", "Balanced" or "Growth". See examples below published by The Vanguard Group for USA securities. Note how average historical returns rose the more downside risk was endured.

Income Portfolio:

Balanced Portfolio:

Growth Portfolio:

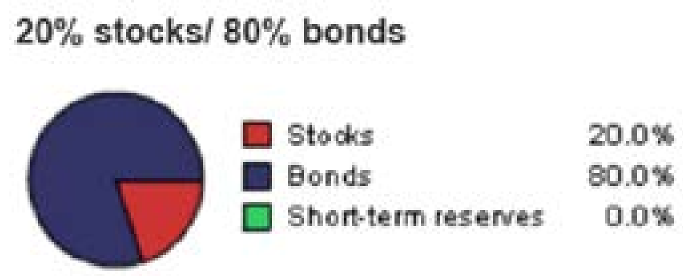
Source: https://personal.vanguard.com/us/insights/saving-investing/model-portfolio-allocations?lang=en

Younger people usually favour "Growth" because they are less reliant on investment income and their time horizon is sufficiently long for their portfolio to recoup any losses. Older people generally prefer "Income" because they have left the workforce and can't afford major setbacks to their wealth. The middle aged normally plump for "Balanced". Of course rich investors have greater capacity to withstand losses, but even they are often risk averse because of past misfortunes with bad investments or market cycles.

For illustrative purposes let's assume you want to be lazy with half your investment portfolio and proactive with the other half. Now the question is do you want the same asset allocation in both your passive portfolio and your active one?

Or would you prefer to tilt your lazy portfolio towards defensive investments and your active one towards aggressive investments since the latter need more attention than the former? If so a Balanced portfolio split between lazy and active might look as follows:

Lazy Passive Portfolio:



Note that the overall portfolio would still be 50% bonds and 50% stocks to satisfy the Balanced portfolio's allocation requirement. But most of your attention could now go on stocks, not bonds.

Many permutations of the above example are possible depending on what asset mix you choose overall and the lazy/active split you apply to the pie.

But to keep things simple let's stick with our case study above.

When it comes to the lazy portion, what's the best way to implement it? There are basically two alternatives; listed funds or unlisted ones.

Listed funds can be bought on the stock exchange (ASX) as easily as shares so involve no complicated paperwork. They take various forms such as exchange traded funds (ETFs), listed managed funds (LMFs), listed investment companies (LICs) and Australian Real Estate Investment Trusts (AREITs). The full array of those available can be seen at: https://www.asx.com.au/documents/products/ASX_Investment_Products_June_2018.pdf

Unlisted funds are bought directly from a fund's manager and involve completing an application form. But 170 unlisted managed funds (called mFunds) are now available online through stock broker platforms using the automated ASX CHESS settlement system. Units owned in mFunds get recorded on your CHESS sponsored HIN Holding statement. For an explanation of how mFunds work visit https://www.canstar.com.au/online-trading/what-is-an-mfund/

For a full list of mFunds visit pages 4 and 5 of https://www.asx.com.au/documents/products/ASX_Investment_Products_June_2018.pdf

For a wider range of unlisted managed funds (many of which are outside the mFunds stable) revisit https://www.canstar.com.au/managed-funds/

Here you can find multi-sector Moderate (meaning conservative), Balanced, Growth and Aggressive (meaning high-growth) funds as well as purely single sector funds covering cash and bonds, property or shares.

A typical choice for the lazy portion of a portfolio could be one of the Vanguard Australia funds found at https://www.vanguardinvestments.com.au/retail/ret/investments/product.html

Vanguard's funds come as either unlisted retail or wholesale funds (depending on whether you have a minimum of $5,000 or $500,000 to invest) or listed ETFs (which have no floor amount). They cover a wide range of asset classes, but if you want a one stop solution choose a Diversified Index Fund covering multiple asset sectors. They go by the labels Conservative, Balanced, Growth and High Growth. Their annual management fees are 0.27% (ETFs), 0.29% (Wholesale) and

How to be a lazy investor yet still be a constant one

0.90% (Retail) which is low compared to actively managed funds.

In our case study above the lazy portfolio using the Vanguard Conservative Fund would provide a strong exposure to income securities (70%) and a low one to growth securities (30%). See table below. It would not be quite 80% bonds and 20% stocks as depicted earlier, but it would provide adequate ballast to a proactive portfolio containing 70% growth and 30% income assets.

Vanguard's Diversified Conservative Index Fund 31 July 2018 (ASX Code: VDCO)

Asset allocation (%)

	Fund	Target	Range
Growth assets			
Vanguard Australian Shares Index Fund (Wholesale)	12.1	12.0	10.0 - 14.0
Vanguard International Shares Index Fund (Wholesale)	8.4	8.5	6.5 - 10.5
Vanguard International Shares Index Fund (Hedged) - AUD Class (Wholesale)	5.6	5.5	3.5 - 7.5
Vanguard Emerging Markets Shares Index Fund (Wholesale)	2.0	2.0	0.0 - 4.0
Vanguard International Small Companies Index Fund (Wholesale)	1.9	2.0	0.0 - 4.0
Total	**30.0**	**30.0**	**28 - 32**
Income assets			
Vanguard Global Aggregate Bond Index Fund (Hedged)	42.0	42.0	40.0 - 44.0
Vanguard Australian Fixed Interest Index Fund (Wholesale)	18.0	18.0	16.0 - 20.0
Vanguard Cash Plus Fund (Wholesale)	10.0	10.0	8.0 - 12.0
Total income	**70.0**	**70.0**	**68 - 72**
Total	**100.0**	**100.0**	

Source: https://www.vanguardinvestments.com.au/retail/ret/investments/product.html#/fundDetail/etf/portId=8219/assetCode=balanced/?overview

The lazy/active portfolio split would now look as follows:

Lazy Passive Portfolio:

70% Income Assets/30% Growth Assets through Vanguard's Diversified Conservative Index ETF (ASX Code: VDCO)

Pro-Active Portfolio:

30% Income/70% Growth Assets through self-selected financial securities and/or funds.

In the pro-active self-managed portfolio (whether its 50% of your total assets as illustrated above or a lower or higher proportion) you can either follow the individual security route (buying individual shares through a stock broker such as CMC Markets, CommSec, Amscot, Belldirect, Nabtrade or Westpac and discrete bonds through a bond broker such as FIIG Securities, MINT Partners or Australian Bond Exchange-ABX) or take the investment funds route (ETFs, LICs, AREITs, mFunds or other managed funds). You could also hedge your equity market risks by applying MarketTiming strategies to certain ETFs and buying market neutral funds (see https://theconstantinvestor.com/hedge-market-crash/)

The Lazy portfolio would receive just single quarterly distribution statements and an annual tax statement from Vanguard leaving you lots of time to focus on managing your proactive portfolio, which would receive multiple distribution and tax statements depending on how many different securities and/or funds you held.

The lazy/proactive portfolio split would offer these advantages:

- It would reduce the time you spent on investments to those that really interest you.
- It would provide ballast to any high risk decisions you make in your proactive portfolio.
- It would test whether your own security selection could beat the lazy portfolio.
- It could reduce the management and transaction costs of your overall portfolio.
- It would provide a causeway to simplify portfolio management as you aged.

The last point means you could transfer more assets into the lazy portfolio if your health or mental acuity faltered. And if you wanted your lazy portfolio to be more growth oriented as you ran down your proactive portfolio that could easily be done by switching your default multisector fund from say Conservative to Balanced (in the example used above).

Those sceptical of a lazy fund sitting alongside active investing have two concerns:

1. Active investors supposedly do better than lazy investors; and
2. Actively managed funds surely outperform passive indexed funds.

Let me assuage you of these fears.

According to the 2018 Dalbar Quantitative Analysis of Investor Behaviour, for the past 20 years the average American investor's performance in both equity and fixed income funds has significantly trailed those funds' respective market indices, the S&P500 share index and the Bloomberg-Barclays aggregate bond index. See table below. That would suggest a lazy investor in an indexed fund has not been at a disadvantage.

	Average Equity Fund Investor (%)	Average Fixed Income Fund Investor (%)	Average Asset Allocation Fund Investor (%)	Inflation (%)	S&P 500 (%)	Bloomberg-Barclays Aggregate Bond Index (%)
20 Year	5.29	0.44	2.58	2.15	7.20	4.60
10 Year	4.38	0.48	2.52	1.64	8.50	3.31
5 Year	10.93	-0.40	5.41	1.48	15.79	1.27
3 Year	8.12	-0.05	3.85	1.71	11.41	1.40
12 Month	20.64	1.52	10.08	2.11	21.83	2.31

Source: https://[illegible]-wpengine.netdna-ssl.com/wp-content/uploads/2018/04/2018-QAIB-Report_FINAL.pdf

And according to the 2018 S&P Dow Jones SPIVA Australia Scorecard, over the past 15 years over three in four Australian active managers of equities and bonds (after deducting their high fees) have lagged their benchmark indices. The exception was Australian equity mid-and small-cap fund managers where only 55% underperformed the market index possibly because smaller companies are under-researched. Hence a lazy investment in a passive indexed fund (after allowing for low admin fees) might not have lagged an actively managed investment.

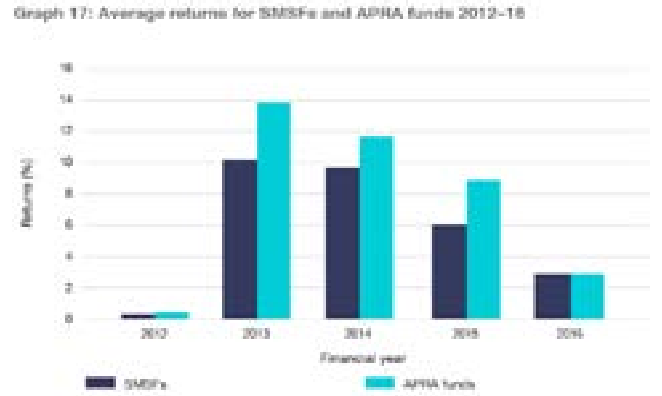
Report 1a: Percentage of Funds Outperformed by the Index (Based on Absolute Return)

FUND CATEGORY	COMPARISON INDEX	ONE-YEAR (%)	THREE-YEAR (%)	FIVE-YEAR (%)	TEN-YEAR (%)	15-YEAR (%)
Australian Equity General	S&P/ASX 200	59.20	86.77	83.00	73.94	77.90
Australian Equity Mid- and Small-Cap	S&P/ASX Mid-Small	74.04	75.00	55.67	40.00	54.72
International Equity General	S&P Developed Ex-Australia LargeMidCap	82.51	80.93	90.86	88.29	87.10
Australian Bonds	S&P/ASX Australian Fixed Interest 0+ Index	66.83	77.36	85.42	86.00	N/A
Australian Equity A-REIT	S&P/ASX 200 A-REIT	43.94	96.15	83.58	71.59	78.90

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 29, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

Source: https://www.spindices.com/documents/spiva/spiva-australia-year-end-2017.pdf

Nevertheless, according to the Australian Tax Office's latest annual statistics, self-managed super funds (SMFSs) "experienced annual positive growth for the five years to 2016 and are in line with the return on investment achieved by APRA funds of more than four members." See chart below. APRA funds include institutional super funds, retirement savings accounts and approved deposit funds.



Source: https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds–A-statistical-overview-2015-2016/?page=6#Investment_performance

I would like to think that the positive performance of SMSFs may perhaps be attributed to some of their trustees reading The Constant Investor.

About The Author

Percy Allan joined the NSW Treasury in 1976 and after a stint as senior policy adviser to both the state Treasurer and Premier, went on to become Secretary of the Treasury and Chairman of NSW TCorp between 1985 and 1994. He then joined Boral as finance director and from 1997 has chaired boards and operated a public finance consulting practice. He co-founded MarketTiming in 2009 and has been editor of its MarketTiming newsletter, having taught himself the methodology and pioneered the trend-trading form of market timing in Australia.

House prices under the microscope

6 July 2018, Alan Kohler, Talking Finance

Hello and welcome to Talking Finance, I'm Alan Kohler.

This week I'm focusing on house prices which are now down 5-6% in Sydney depending on who you talk to. The question before the house, so to speak, is how much will house prices fall in total and how dangerous is this for the economy and for investors generally. For some answers on that I turn to Tim Lawless of CoreLogic who compiles the house price data, Alan Oster, the Chief Economist of NAB and Shane Oliver, Chief Economist at AMP Capital.

Speaking of questions before the house, how about politics this week? What, with David Leyonhjelm and Tony Abbott both going troppo, to discuss the issues behind the theatrics as well as the theatrics themselves of course, I turn to Lyndal Curtis, former Parliament House Bureau Chief for Sky News Australia and ABC News 24 Political Editor.

House prices - CoreLogic

Now, for our monthly house price discussion with Tim Lawless, the Head of Research at CoreLogic, talking about the June house price results.

AK: Tim, I feel like it's once a month we catch up with the latest fall and what are we up to? That's the question, what are we up to now in terms of the fall of the Australian median house price?

TL: It is a bit like that, isn't it? We're seeing month on month falls, in fact this is the 9th consistent month where we've seen national values fall and over GN they were down 0.2% which means we've seen dwelling values fall by a little bit more than 1.5% since they peaked out late last year. But of course Sydney is really where the largest falls have been from since when they peaked in July last year. Sydney values are down by 4.8%, but it's looking like Melbourne is just starting to catch up a little bit now.

We saw Melbourne peak a little bit later than what Sydney did, it was actually November last year, but Melbourne was the worst performing capital city over the June quarter. We saw Melbourne values fall by 1.4% and they're now down 2% from when they peaked.

AK: Sydney and Melbourne went up the most, so it's off a high base of course.

TL: Yeah, absolutely. Keeping this in context is really important. Prior to say, Sydney moving into a decline we saw values rise by about 70%. Melbourne, not quite as much, up by about 62% during the growth phase. So it's really only those buyers that have bought in over say the past year or so that may be seeing some slippage in their overall property value.

AK: Do you have a view of what sort of total fall we're likely to see both nationally and in Sydney and Melbourne?

TL: Well, there's a couple of different views and we do have a formal forecast which is based on the Moody's analytics macroeconomic model that we overlay against [2:59.7] Index, and that shows that Sydney and Melbourne are likely to bottom out early into next year at least on an annualised basis. In that sense, the market downturn looks quite shallow but when you start looking at the credit environment and the fact that we probably aren't going to be seeing any loosening in credit even though we're seeing the 10% investment speed limit being lifted this far. We're not really expecting the credit environment to loosen up and that's really the main driver of what's keeping a lid on housing prices at the moment is the fact that credit availability is much tighter and that of course is affecting investors more than owner-occupiers. With that in mind, I think we probably will see a more sustained downturn than what those formal forecasts are showing.

AK: What amount? What do you think is the percentage we're going to end up with?

TL: We've already seen Sydney values fall by nearly 5% and I think another 5% fall on top of that probably wouldn't be too surprising, so a peak to trough decline of around 10% in Sydney once again and the context of values rising 70% or so prior to that. Melbourne looks a little bit more resilient, we may not see values fall by quite that much, but of course, outside of those two large cities we are seeing much more stable conditions. In fact, markets like Perth are starting to show signs of bottoming out. Even though we did see another month of decline in June the trend rate of decline is much less now than what it has been over the previous years.

AK: Would you say that Perth is the best environment for investors at the moment?

TL: No, I wouldn't say that. I think Perth, even though the market is levelling, it's not really showing a lot of growth prospects simply because we're still seeing migration rates very much in the negatives, particularly interstate migration. The economy is starting to improve and jobs growth is improving but I think it's going to take some time before the market really starts to accelerate. I think better investment opportunities will be found around Southeast Queensland where we're seeing really strong migration trends, the labour market's improved substantially and we're also seeing rising demand coming from New South Welshmen crossing the border, as well as sea changers who are very much attracted to the Southeast Queensland pocket for the lifestyle and the weather and so forth, particularly the Gold Coast and Sunshine Coast markets.

AK: In fact, a lot of the momentum at the moment is in Hobart, are you surprised at the extent of the boom there?

TL: Yeah, a little bit. I'm probably surprised by the sustained level of growth in Hobart. Values over the past 12 months were up 12.7% across Hobart, roughly the same as what it was a year ago. The previous FY values were up 12.8% so about the same. I would have thought that Hobart would be slowing down in that rate of growth by now. Maybe we are seeing the first signs of that, that the month on month figures for Hobart was up 0.3% which is still quite robust, but certainly much weaker than what we've been seeing over previous months.

But if you've got to look at Hobart in the sense of demand has been very strong so migration rates have really picked up but there's been no real supply response, so we are still seeing housing dramatically undersupplied. In fact, listing numbers in Hobart are down about 30% from a year ago which means buyers don't have a lot of choice, there's a lot of urgency in this market and homes are selling very rapidly, in less than 30 days.

Economic update - NAB

Well a fair bit went on in the economy this week and to go through it all, here's Alan Oster, Chief Economist at NAB.

AK: Alan, there's a bit of ABS data out this week, retail sales and trade and also the RBA of course, but I think most people are looking

at house prices at the moment and that was also out this week. I just wonder, how dangerous do you think the decline in house prices is getting?

AO: I don't think it's that dangerous at all. Let me put it a different way, if you're looking at Sydney down about 6% from the recent peak and Melbourne's more like 2 or 3% down, but if you go back to the previous trough, i.e. two to three years ago, they're up about 40%. So, yes, house prices are softening, but there's still significant buffers, if you like, that we've seen over the last two to three years. Then probably more fundamentally, I look at supply and demand, particularly Melbourne and Sydney in terms of the housing market and what I see is an undersupplied market. I don't see interest rates going up any time soon and I also don't see high levels of unemployment, so overall a softening but not a crash.

AK: I think the standard decline in house prices in Australia after a boom is somewhere between 10-15%...

AO: Yeah.

AK: Do you think there's any reason to think this time is likely to be more than that?

AO: No and I think if you look back and you'd say, as I was just saying, if you're 5-6% down, if you take another 5% down from where we are now, you end up with falls in house prices across Australia of 2-3% and maybe flat the year after, which after a pretty strong period I think is healthy to be brutally honest.

AK: I suppose the difference between this time and previous periods was household debt is much higher, so do you think that raises risks in the economy that weren't previously there?

AO: I think what it does is it means the consumer is more cautious. If you're looking at GDP, we know LNG exports are going to go up, we know that infrastructure spending is jumping up a lot, but we also know that retail doesn't look like it's doing that well. The consumer will buy things they think they have to have like their iPhones and whatever or with the doctors and that sort of stuff, but they won't go to the discretionary retail shops and that I think is an important problem because until you get wages growth, consumers are going to stay cautious.

Once you get through some of these lumps and bumps with infrastructure and LNG exports, you end up with growth momentum to 2.5% and that makes life a little bit more tricky.

AK: Speaking of consumers, we saw retail trade on Wednesday, but pretty anaemic annual growth rate at 2.5%. What you seem to be saying is we're not going to see that increase much if at all?

AO: That's basically where we're at. We've got total consumption which includes retail sales as well as the services sector of something like 2.5% going forward. Once you get the special falling out you don't really have much left. I think you're in a situation where the economy will be okay, but most people will think, gee this is tougher than what the GDP numbers are saying and I think they're going to be right.

AK: And the trade data basically confirmed that we're back to being a quarry! [Laughs]

AO: [Laughs] Well, yeah, an LNG exporter obviously, but it's going to add to GDP, we think, 0.2% which is pretty similar to what it did in the first quarter. The domestic economy might travel at about 0.5% or thereabouts and you add a bit more so you get a 0.6-0.7% maybe for total GDP in the second quarter.

AK: Obviously the rates on hold decision on Tuesday wasn't a surprise at all but was there anything at all in the statement that surprised you?

AO: They changed the wording a bit but I think broadly, the short answer is, no. Everybody focuses on the last paragraph which is where they talk about what they think needs to happen and the wording did not change. So, I think they're feeling relaxed about the idea that house prices are coming off a bit. They're sort of saying that APRA has helped in that context and generally they're fairly confident about their forecast which is for growth of around 3% and I think that's roughly right. But as I was saying before there's some specials here that are basically not going to last long and you and me, unless we own LNG platforms, etcetera or own infrastructure aren't really going to feel it.

AK: Do you think that the tax cuts that have just come in will make any difference to the economy?

AO: Short answer is not a lot because if you're looking at the personal tax cuts they don't actually apply until the end of this financial year, so you can't get your tax refund back before the end of the financial year. Sure, they'll spend it, but I think they're reasonably small. On the business side, at this stage anyway, we're not getting the main players, if you like, involved for a while and business, I think is essentially paying down debt rather than investing. I think government cuts to corporate tax will cause more investment and ultimately then cause tightness in the labour market but I think that's a fair way down the track.

House prices and markets - AMP

And here's Shane Oliver, Chief Economist at AMP Capital, to talk about house prices and the markets.

AK:Shane, house prices out this week, you said in your note on the subject that we're likely to see a top to bottom fall of around 15%, which I suppose is kind of normal for this, national average of 5%, and you reckon that a crash landing is unlikely although it's a risk because of the royal commission, tell us what you mean?

SO: Well, I guess for some time I've been thinking, well we're due a bit of a pullback in house prices, we're now starting to see that particularly in Sydney and Melbourne and as you say, I'm looking for a 15% top to bottom fall in those cities. Other cities probably not a reasonable shape, they haven't had the boom so you'll probably see modest growth in those other cities so that's why you get that 5% top to bottom for the national average. I think that weakness will be spread out over a couple of years.

For a while I've been thinking, well we're unlikely to have a crash landing and of course a lot of people do fear that given the extent of the gains, but I felt we were unlikely to have a crash landing unless we get much higher interest rates, much higher unemployment or this supply boom goes on for several years and I still don't see those things as likely. But obviously we've got the Royal Commission going on and I think the Royal Commission is doing a lot of good work. One risk though is that it has the effect of making banks overly cautious.

They go from being too easy and friendly and making their loans, if you want to call it friendly, but two are lax with their lending standards to being overly tight with their lending standards and consequently that tightening leads to a situation where there's a big constraint on buyers coming into the market and that sees the falls in prices turn into a much sharper decline. That's the risk I'm keeping an eye on at the moment. At the moment I'm sticking with the base case, 15% top to bottom in Sydney and Melbourne but that risk is certainly there.

AK: I think we've seen a pretty big decline

House prices under the microscope

in interest only loans and high loan to value ratio loans, but I think overall there hasn't been a credit squeeze has there yet?

SO: No, I think it would wrong to say there's a credit squeeze at the moment. We are seeing a slowdown in lending growth, housing related credit has been growing around 6% but we've seen a stalling in investor loans and of course, as you say, we've seen a sharp decline in interest only lending as well. Some of the breaks might come off interest only lending because the financial regulator, APRA has sort of shifted focus away from that, but there's now a more significant focus on making sure that borrowers do have the income they say they have, that their expenses estimates are accurate and more importantly that banks limit their lending to households with high debt to income ratios and the common thought there is that total debt to income ratio is around 6 times annual average household income.

That sort of restriction, if anything, is going to impact cities like Sydney and Melbourne where the price to income ratios are typically around 10 times, so it's going to be very hard, I think, for borrowers to sort of get the size of the financing they used to get in the past and also for investors to get multiple to fund multiple properties like they did in the past. All those things will start to impact. Right here, right now, have we got a credit crunch? No, but we're yet to see the full impact of the credit tightening which is currently underway flowing through. My feeling is it won't turn into a credit crunch, I don't think the banks will go that far but obviously I do think we're going to see a further slowing in credit growth to come.

AK: You put out a second note this week just looking at the investment outlook, what do you think the outlook is for markets?

SO: I think it's okay. I must admit, I was surprised by the last 12 months when you look back at the numbers. Particularly after the experience of the last 6 months you think well that's been kind of volatile, the worries about the Fed, inflation in the US, the worries about trump and tariffs and trade and all those sorts of things that cause a lot of volatility, but we did see pretty good gains in the latter half of last year, last calendar year, so that sort of set us up for a good financial year to start with. Then of course our share market really got a spurt on in the last month. The Aussie share market returned 13%, global shares was around 11%, but if you allow for the fall in the Aussie Dollar, that pushed that up to 15% out of global shares. Pretty good gains out of share market there even though bond returns were a lot more constrained.

Overall, pretty good financial year that we've just seen but I do think it's going to slow down in the next 12 months. We do have these issues about trade still impacting, obviously concerns about inflation, interest rates in the US, all those sorts of issues are still swelling around. And of course share markets are no longer as cheap as they used to be, that's also a bit of a constraint. I think we'll probably get okay returns but I think it's going to be a lot more constrained once it's certainly this thinking single digits for Aussie shares, more like 7-8% number rather than the 13% we saw in the last financial year.

AK: I was interested you listed the storm clouds as you saw them and you put trade war as third and the US economy at risk of overheating as first, is that the order you see the problems? I mean, do you reckon the US economy overheating is the biggest risk?

SO: I think the US economy probably is the biggest risk and maybe that's the economist in me putting the economics ahead of the politics. I think at the end of the day if the US economy remains strong, even if the trade war goes on for a little bit longer then that's probably something the markets might be able to bear. But if the US economy overheats and then sees a sharp breaking by the Fed, the Fed gets a lot more aggressive than that would be a bigger problem for financial markets than the ongoing trade war. But you could debate these things back and forth. Obviously the trade war impact is significant as well, it's just that I tend to think that the main driver, the main thing to keep an eye on is the state of the US economy. Historically, if you look back through time, whenever we've had significant bear markets, and I mean where your market comes down 20% and keeps going, it's 9 times out of 10 that occurs when the US economy has gone into recession. Think the GFC, think the tech wreck and so on.

Whereas, most other setbacks we've seen in markets due to all sorts of things tend not to be quite as bad if the US economy avoids a recession. For me that's the main issue, the extent to which the US economy overheats, how much the Fed tightens, how much inflation goes up in the US.

Week in politics

I'm joined now by long term political journalist and now freelance, Lyndal Curtis, to talk about the week in politics, and what a week it's been!

AK: Lyndal, I think it's been a fascinating week because a couple of really important issues have been dealt with through personal conflict. Obviously Sarah Hanson-Young versus David Leyonhjelm and energy policy has been kind of expressed through Tony Abbott versus Malcolm Turnbull but can we just talk about for a moment, Sarah Hanson-Young and David Leyonhjelm, how do you reflect on what's been going on there and how we end up?

LC: Look, there are times in politics, Alan, where you really feel the need to bring out your mother voice and just tell everyone to calm down and go to their rooms for a bit. I think Sarah Hanson-Young has a point that whatever she said was not a personal attack on David Leyonhjelm in the Senate but he responded with a personal attack. As ever these days, there's a very heavy overlay of politics to everything that happens. It's kind of politics before policy and he is enjoying his time in the sunshine, his time in the spotlight. He needs name recognition being a minor party senator to get re-elected, whenever the election happens and he's sticking to his guns.

But it doesn't help the body politic to have people throwing personal insults and it certainly doesn't help to have insults that are very heavily gender based like these ones are. It damages the whole body politic. I think people do expect a higher level of behaviour from their elected representatives who of course are being paid by the tax payer.

AK: Of course, those sort of personal attacks have been going on for years, but have you seen anything like that in your years reporting politics?

LC: Occasionally attacks do get very, very personal but that is the exception rather than the norm. People tend to know, politicians, tend to know where to draw the line and they also tend to confine those sort of attacks generally to the floor of the parliament where they get usually stomped on pretty quickly either by the speaker in the house of representatives or the president in the senate. But it is the exception, it's not the norm. They're not edifying when they happen and politicians should know by now not to do it.

AK: Just moving onto Tony Abbott and energy policy, obviously there's two levels to what he's been up to. One is his kind of very interesting attacks on Turnbull but also his attempt to overturn the national energy guarantee. The stuff he's been saying to Turnbull, he says, 'I don't want to knock off the sitting Prime Minister. Turnbull does that, I don't.' Which I thought was amazing. How do you think both Abbott and Turnbull come out of that?

House prices under the microscope

LC: Well, it's hard to get a more pointed remark isn't it? I think part of the problem for Tony Abbott is he's been waging this campaign against any form of what he says is a price on carbon against any reform to the energy market which seems to promote or favour the proponents of the national energy guarantee, so it doesn't favour renewable energy but his attacks are being seen by his colleagues as an attempt to at some stage regain the leadership. He made this as part of his – I can't remember, I don't think it was a 10 point plan, but a multi-point plan for what he wanted that included things like reform of the senate quite some time ago now.

But I think now he has to paint himself as not being after the leadership in order to get some more support from his colleagues because interestingly he doesn't have a kind of wave of support from these colleagues, certainly not publicly and behind the scenes that isn't there. I don't think there's the will for another fight over energy policy to repeat what they've been doing for more than a decade with very little success. He's right, he hasn't overturned a sitting Prime Minister, but he has overturned a sitting leader on the question of policy and it was very similar on the question of Malcolm Turnbull's talking to Kevin Rudd's government over the CPRS.

I think Malcolm Turnbull probably comes out of this fight better than Tony Abbott because whenever the government's doing well it has a tendency to shoot itself in the foot and people who cause problems when the government's doing well for themselves aren't looked on very kindly. At the core of this though is the politics over the National Energy Guarantee. The nationals are making some noises about wanting funds for coal fired energy, so it shows there's a massive political internal fight for the government to have and also they have to keep an eye on the numbers on the floor of the parliament. If it can't get Labor to support it then it really has to keep all of its own troops in line.

AK: Do you have any kind of betting on whether the NEG guarantee will get up or not?

LC: Well, there are quite a few hurdles for it to jump, one of those is the states, that's clearly the first hurdle for it to jump. Then is whether Labor wants to support it in the form the government proposes or in some sort of negotiated form. You would think although if Labor supports it it's handing something of a win to a government. For Labor, the benefits of supporting whatever form it ends up in is that it puts a kind of a floor under the debate on energy and means it can build on that if it wants to in the future.

You would think after many, many years of fighting over this, some resolution is good that allows you to move forward with what you want, but that's a decision for the future. At the moment, Alan, I really stopped predicting things in 2009 when politics went a bit weird, so actually trying to figure out what will happen with yet another energy debate I think is probably above everybody's pay grade.

AK: Just finally, do you think there's any chance of a change of leader in either of the two main parties?

LC: Again, with my no prediction since 2009 hat on, you never say never because the thing that's been happening in politics for the last decade is often the thing you think is least likely to happen. It's difficult and both sides know the damage a leadership change causes. Now, we are within spitting distance of an election, a House of Representatives and half Senate election can be called any time from now. It's due by the end of May next year, so we're within a year of an election. It does tend to focus the minds of the parties on what their electoral fortunes are. Both sides have had people nibbling at leadership questions, Anthony Albanese making his pitch for Labor to be nicer to business on the Labor side and of course, Tony Abbott making his pitch to go back on the Paris Accord which he himself signed up to when he was Prime Minister.

But like I said, both sides know the damage a leadership change causes, there's a very high bar in the Labor Party because of the rules that were implemented to have a change and for the government I think they've had enough kind of little rays of sunlight in the last few weeks to think that they may be okay. But these are decisions for politicians to make and they are less predictable than toddlers.

[Music]

Happy Birthday, Sir Richard Starkey, AKA Ringo Star, who turns 78 tomorrow. He was the drummer for the Beatles of course but as Paul McCartney said, I think, he wasn't even the best drummer in the Beatles and he can't sing for nuts either but that didn't stop him and he made the others let him sing a few tracks including this one.

[Music]

That's all from me this week, enjoy your weekend!

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