INSIGHT

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Dog Days

A Letter to Investors

Morningstar Investment Management Australia

Peter Bull
Head of Equities

Nimalan Govender
Portfolio Manager

"I think that the single best piece of advice: constantly think about how you could be doing things better and questioning yourself." – Tesla Motors CEO, Elon Musk

In May of 1967, psychologists Martin Seligman and Stephen Maier conducted a series of experiments on dogs. They subjected the dogs to painful electrical shocks and, disturbingly, gave them no way to control or anticipate the shocks that they received. One of the researchers' more sad findings was that when these dogs were finally granted the opportunity to escape, they were "psychologically" unable to do so. They had learned to be helpless and not to entertain any possibility of improvement.

Many investors may have succumbed to a similar condition. They are subject to the whims and jolts of the market, yet stay put in the belief that any attempt to exercise control is futile. They have convinced themselves that there is no better alternative, despite the freedom of choice and opportunity that investment markets provide. In this regard, they may not be too dissimilar to the subjects of the Seligman and Maier study.

Since we last wrote to you, a perfect storm of geopolitical events has meant that global equity markets have experienced a tumultuous period. In contrast, our international equity portfolios have performed well, generating positive returns and outperforming the vast majority of competitors. In fact, over all time periods since inception of the fund (see the table on the back page).

Investments that "kick"

To successfully invest in these markets, we seek to emulate the tenacity of Steven Callahan (an American author, naval architect, inventor and sailor) when he survived a 76-day ordeal lost at sea. Following the capsize of his boat in a violent storm, he had only a life raft and limited supplies adrift in the Atlantic Ocean. To Callahan's benefit, he made maximum use his experience as a naval architect and sailor in his perilous journey back to land.

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“I now have a choice: to pilot myself to a new life or to give up and watch myself die. I choose to kick as long as I can.” – Steven Callahan

We too use our experience and knowledge to navigate markets and build strategies that better protect against the painful episodes that the market inflicts upon those who subject themselves to its whims.

While we avoid focusing on short-term results, we do try to ascertain cause-and-effect relationships in periods of market turbulence. We attribute our portfolios’ robustness to their design: they have been designed to “kick” as long as they can.

Think and question constantly

Our flexible investment process enables us to incorporate new measures when necessary to counter the latest gimmicks in the market. At this point, we are increasingly concerned with the distortions created in equity markets by the prolonged impact of incredibly low and (in some cases) negative interest rates.

“We are in a world where we don’t know the fundamental value of any asset.” – Governor of the Reserve Bank of India, Raghuram Rajan

Each year, central bankers eagerly find new reasons to cook the books with very accommodative monetary policy. As time passes, we are sceptical of the broadly anticipated interest rate normalisation process. We also have a number of concerns relating to the impact of cheap debt on company management and ultimately on the difficulty in calculating companies’ intrinsic (or ‘true’) value.

A primary concern is the tendency of company managements’ to be seduced by leverage, such that they increase borrowing to unsustainable levels. Theory would have us believe that as levels of debt increase, equity becomes riskier and its attendant “cost of equity” increases. Cost of debt also increases as the levels of debt increase. These higher costs relate to increasing financial distress risk. To some extent, these costs are offset with falling interest rates and the benefits generated from the reduction in income taxes resulting from the interest ‘tax shield’. We understand that any management team worth their salt would seek to lower the company’s cost of capital.

If management were to raise debt levels to unsustainable levels, we would expect the cost of financial distress to weigh upon the cost of equity, so that market values reflect this increased risk. To us, however, it appears that the market has forgotten about this component. It seems that the persistence of low interest rates has provided a false sense of security to the market.

The next area of concern is on the deployment of this cheap source of capital. Companies with sharply reduced costs of capital are able to justify increasing numbers of previously infeasible projects. Under normal lending conditions, these projects would ideally be abandoned to the scrap heap of poor ideas. This is no longer the case and such investments are likely to lead to less productive, overvalued asset bases. This view was supported in a recent Bank of International Settlement's working paper, in which the authors find that credit booms undermine productivity growth.

"Proper allocation of capital is an investor's number one job" – Charlie Munger

Some industries have already fallen prey to this. Look no further than large construction, materials and US shale energy companies, which have limited pricing power and yet have embarked on ambitious capital expenditure projects. These companies now find themselves operating in oversupplied markets.

As low interest rates persist, we are increasingly concerned about where the next set of excesses materialises. As conservative investors, we seek to understand the true risks and costs to an equity investor. The remaining benefits of cheaper capital are also eroded by low levels of long-term growth. As a result, we are convinced that our conservative assumptions we apply are appropriate.

Our process also weeds out companies that raise debt unnecessarily and have displayed poor ability at employing capital efficiently. This is achieved through a number of different methods.

Companies that are able to generate generous free cash flow generally have little need for debt. Often these companies are loath to raise debt, as their cash flow generation fulfils their requirements. When these companies purposely raise debt, our process is generally more forgiving. We feel that this is correct in light of these companies' assets being of greater quality, with management having displayed suitable restraint in raising debt and most importantly in employing capital efficiently. Accordingly, we find that these companies are well suited to continue generating sizeable free cash flow.

If, in the process of raising debt, the company allocates capital poorly and thereby impairs cash flow generation, we are less forgiving and will have no hesitation in penalising the company's valuation.

Our investment process is less forgiving to companies with poorly operated assets that choose to raise debt. When these companies increase debt, the marginal benefit of debt declines faster and risks to equity holders rises faster. Again, we are quick to penalise and reflect this in our valuation. We believe that our interest as investors are best served, with the company generating suitably high returns on assets, than moving to a higher 'debt to business value' ratio.

"Good business or investment decisions will eventually produce quite satisfactory economic results, with no aid from leverage." – Warren Buffet

As a result, when rates do eventually normalise, our portfolios will not be caught up in low return generating assets that face the crippling debt related costs.

Furthermore, we do not overly rely on companies' forecast growth but rather the sustainability of earnings through the business cycle. While conservative in many ways, this process has successfully prevented us from purchasing stocks that were over-levered and briefly "over-earning". When investors are fickle and continually attribute value to unsustainable earnings growth, we expect our portfolios to underperform. Over the longer-term, however, we expect this ebullience to unwind and our portfolio to generate better outcomes – on a risk to reward basis.

For further information on investment management products and services, please contact our Investor Services Team on +61 2 9276 4550 or email AUDistribution@morningstar.com

MORNINGSTAR®

Level 36, Australia Square
264 George Street
Sydney NSW 2000

Tel: +61 2 9276 4550
Fax: +61 2 9276 4545
AUDistribution@morningstar.com

www.morningstarinvestments.com.au