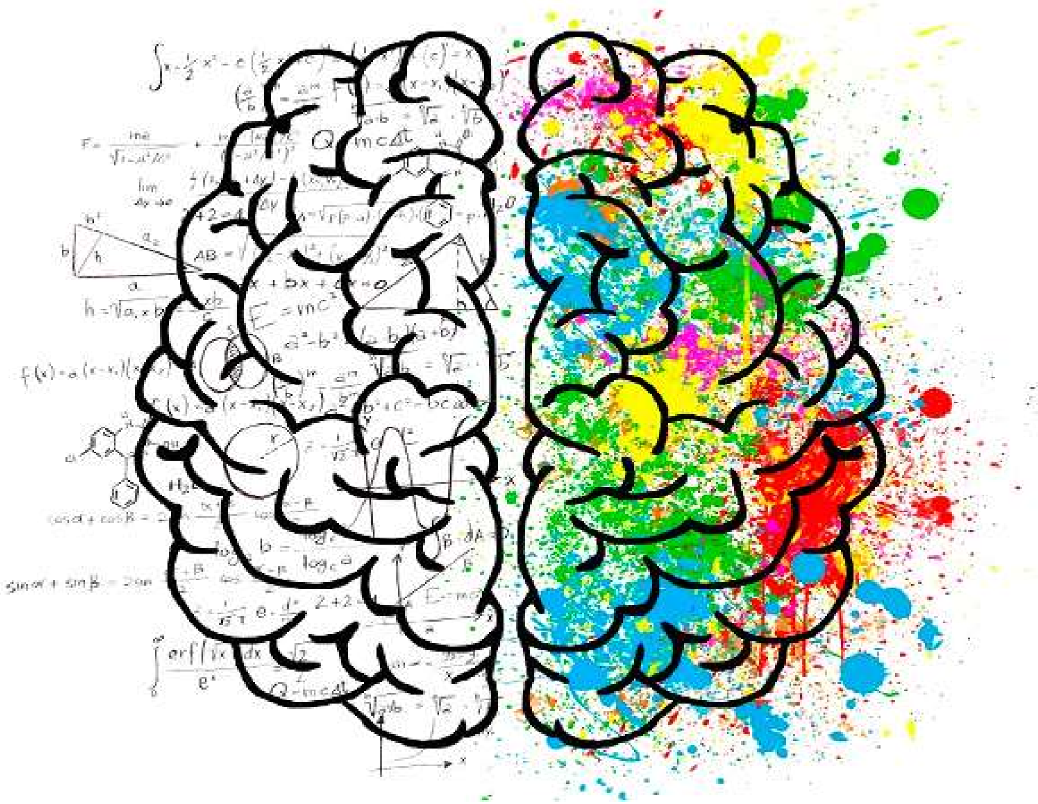
Wealth Adviser

ISSUE 72 AUGUST 2023



Howards Marks rejects forecasts in favour of psychology

INSIDE

BY GRAHAM HAND

Republished from firstlinks.com.au

On 24 May 2023, Howard Marks spoke by video to a room of MBA students at INSEAD's Fontainebleau campus outside Paris. Marks is a pioneer of distressed debt investing as an asset class and in 1995, he founded Oaktree Capital Management, where he is now Co-Chairman of a firm with over 1,000 employees globally and more than US$170 billion assets under management. Marks has written two books and is best known for his client memos published since 1990 (free to subscribe). He was interviewed by Roi Lipovetzky and Andras Galambos, students at INSEAD. This is part 1, of a 2-part series.

Marks starts with two lessons from his investing career that started in 1969, over 50 years ago. "Number one, we pretty much only learn from our failures, we don't learn much from our successes. And number two, it's very desirable to learn the lessons early in your career when you have time to correct your mistakes and when you don't have too much money to lose.

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Price is more important than quality

He gives the example from his early days when all the big banks and investment banks believed the so-called Nifty 50 companies in America were the best and the fastest-growing, and so good that nothing could ever go wrong and there was no price for their stocks that was too high. But he saw massive losses by investors after 1969, so what went wrong?

"Well, guess what, the prices were too high, and these stocks sold between 60 and 90 times earnings and five years later they sold between 6 and 9 times earnings, which is an easy way to lose 90% of your money. So, this came as quite a shock to everybody who had thought that these things were bulletproof."

He switched from equities to start a convertible bond fund, also investing in high-yield bonds. And here is the first lesson which challenges some standard investing conventions. He moved away from investing in what were supposed to be the best companies:

"Now, I'm investing in the worst public companies in America, and I'm making money steadily and safely. So, this was really formative for me. What does it teach you? It's not what you buy, it's what you pay, that investing success doesn't consist of buying good things, but buying things well … But if you buy things for less than their intrinsic value, you're probably on your way to a good outcome."

Investor psychology drives market prices

He then talks about the importance of understanding investor psychology.

"The economy goes along. In a good year, it's up 3%, in a bad year, it's up 1%. Corporate profits increase. Sometimes they're up 10%, sometimes they're up 5%. The stock market fluctuates wildly. The element behind the fluctuations is not changes in the fundamentals, but changes in investor psychology, which are just wild. So, you better understand what psychology is embedded in the price of the asset you're thinking about buying. If you buy something that's the subject of great optimism, and if that optimism is embedded in the price, which it invariably will be since the optimism is widespread, then it's going to be hard to get a bargain … the most important stuff is about psychology and understanding where you are in the cycle."

Winning by not losing

Marks describes a surprising discussion with a pension fund client with another important lesson about thriving by surviving, not aiming for the top:

"And in the 14 years, he was never above the 27th percentile or below the 47th percentile. Where do you think you are for the whole period? Well, you might say 37th percentile on average. The answer is, for this particular fund, 4th percentile. How can that be? The answer is that in investing, most people eventually shoot themselves in the foot … you can succeed by being a little bit above average consistently and by avoiding disasters."

Marks says that anyone who argues you need to take risks to be in the top 5% of fund managers, and that means sometimes being in the bottom 5%, is taking the wrong approach. Clients don't want the bad results and don't demand the top results.

Superior investors need to think differently

Marks does not support contrarian investing for the sake of it, because sometimes, the consensus is right. But at some point over time, to be above average, an investor must think differently. Average active investors can be replaced by an index. Readily-available information about the present cannot hold the secret to superior results because everybody has it. A good investor needs to know something that others don't, or have a variant in perception or interpreting or understanding information.

He gives the example of General Motors bringing out a new Mustang, and investors buying the stock because it will be popular. But everyone knows the car is coming, so what is the superior information? Is there too much optimism in the share price? Thinking must be more nuanced but not simply for the sake of being different.

The incredible 40-year tailwind

Most investors did not realise how wonderful the period of 1980 to 2020 was for investing with decades of falling (and then ultra low) rates boosting asset prices. Marks gives a fascinating example of his own borrowing:

"I had a loan outstanding from the bank in 1980 and they sent me a slip of paper saying the interest rate is 22.25%. 40 years later in 2020, I was able to borrow at 2.25%. This 2,000 basis point (20%) decline of interest rates over those 40 years had a profound effect on investors and investing. When interest rates come down, the discounted present value of future cash flows goes up, that is to say assets become more valuable. Business is strong. Relatively few people default or go bankrupt. Borrowing becomes cheaper so that leverage strategies become more profitable than one expected. All these good things happen in a declining interest rate environment."

He concedes the low rates were bad for savers but the US Federal Reserve had a long history of bailing out the markets when required, and lower rates made it easier for company management and asset holders. It was a wonderful environment for buyouts and private equity because lower borrowing costs would often rescue bad transactions (in otherwise zombie companies). Never confuse brains with a bull market.

Equity returns from fixed interest

Times have changed since 2021. We now know that easy monetary policy from central banks produces inflation and central banks realise they can't be accommodative all the time and they can't engage in continuous stimulus.

Rates are not going back to where they were. Marks believes the Fed Funds rate is more likely to be between 2% and 4% in future, rather than zero and 2%, making it a better time to invest in credit for yield. For example, the S&P return over the last 100 years has averaged a little over 10%, but today, his funds achieve 8.5% from high-yield bonds, 9.5% from levered loans, and 11% to 13% for senior loans to the biggest buyouts. It is equity returns from fixed income, which are much more dependable than equity returns. It is a massive change in two years.

Macro forecasting and economists are a waste of time

Marks says he does not rely on forecasting because it is unknowable.

"In January of 2016, I was having dinner with Warren Buffett. And he says to me, for a piece of information to be desirable, it has to satisfy two criteria. It has to be important. It has to be knowable. The macro is very important. Seems to be the thing that moves the market most, but it's not knowable ... You've got Buffett, you have Munger, you have Peter Lynch, you have Bill Miller, and you can go on down the list of successful investors. Now, give me a list of the macro investors who have been successful."

"Where are the rich macro investors? And there are so few (under questioning, he conceded on Soros and Druckenmiller). And if you look at the performance of hedge funds, for example, which has been terrible in the last 20 years, there's a subsector called macro. And their results are even worse. Who knows more than others about the macro future? Virtually nobody."

Marks calls it the 'Illusion of Knowledge' in one of his memos, placing little value on predictions.

"I've been talking about the uselessness of forecasting for a long time ... And the belief that you know is dangerous if the truth is that you don't know. And that's how you get into big trouble. So, I'm firmly against it. Oaktree, I hope I don't insult anybody in the audience, but Oaktree doesn't have an economist. We don't invite economists in to give their talk. And one of the tenets of our investment philosophy is that our investments are not based on macro forecasts."

He prefers to focus on micro analysis to gain an advantage investing in companies, industries and securities and not trying to guess at what GDP will be next year. He references the US Fed and its hundreds of PhD economists, and the Fed can't even predict what the Fed is going to do.

"Now, if it's your behavior and you publish a prediction, obviously you have it within your power to make it come true. And the Fed's predictions of its own behavior don't come true. So, I would say, if they don't know what they're going to do, how the hell can any of you figure out what they're going to do?"

Which is why Firstlinks infrequently covers macro predictions and market forecasts. Not only do most other financial newsletters cover these macro guesses in detail, regularly correcting themselves with forecast updates, but the predictions are of little merit for long-term investing and portfolio construction. It's good to hear Howard Marks confirm our content preferences.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information only.

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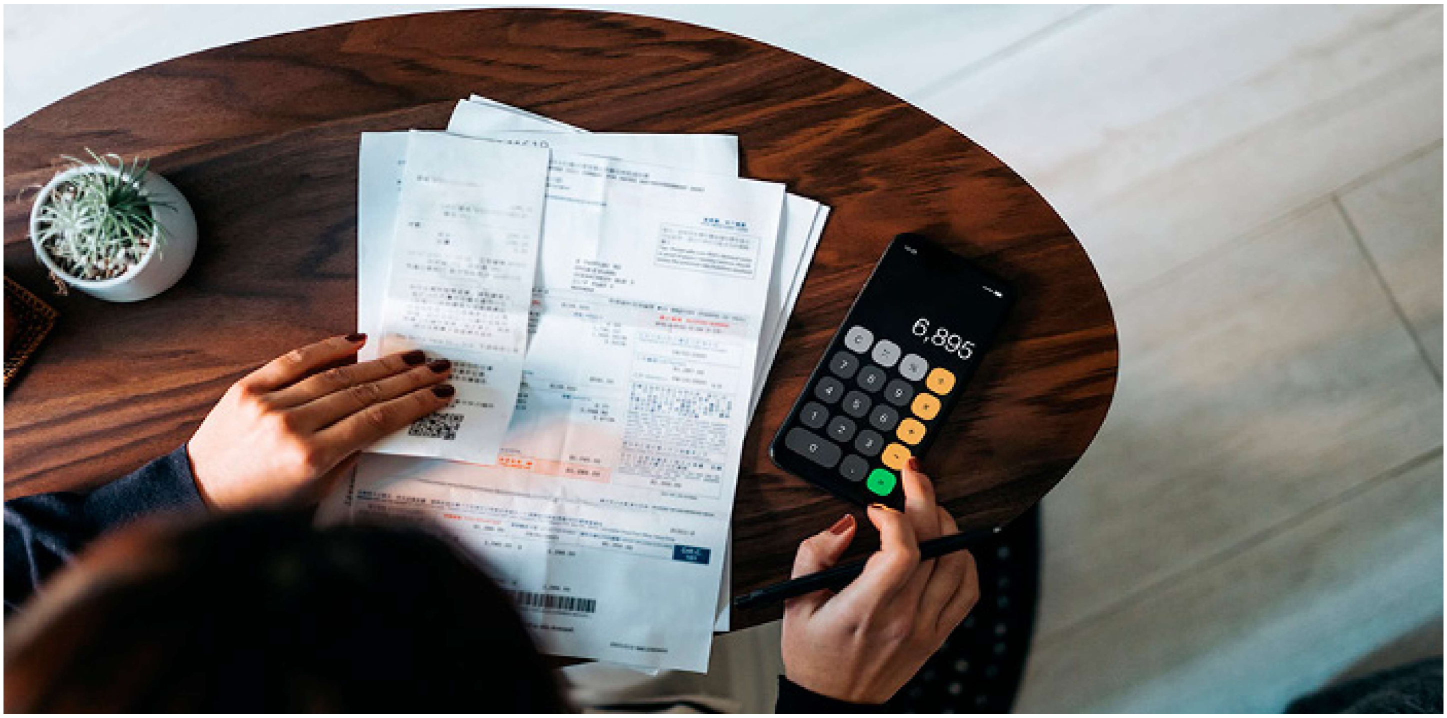


Oliver's Insights – the confusing economic picture

KEY POINTS

- For nearly 30 years Australia had benign economic cycles so the current environment may be a bit of a shock for many.
- Still low unemployment and still high inflation despite slowing economic growth are not that unusual because they both normally lag big swings in the economic cycle.
- The RBA and other central banks need to tread carefully and allow for the lags from the rapid rise in interest rates to work through - lest they end up pushing unemployment far higher than they need to in order to return inflation to target.

BY SHANE OLIVER

Republished from amp.com.au

Introduction

I reckon many must be confused about the current economic situation. We hear constant talk about how high interest rates and cost of living pressures are causing economic pain for many households, consumer confidence is at recessionary levels and various companies are expressing concern about the economic outlook. But at the same time the unemployment rate remains very low, lots of Australians seem to be holidaying in Europe and restaurants and cafes are doing well. While perplexing, it's not that unusual at turning points in the economy for various indicators to be conflicting. Much of it comes down to the difference between leading, coincident and lagging economic indicators. This note looks at the differences and why it's important to allow for them.

Leading versus lagging economic indicators

Economic indicators can be divided based on whether they lead, lag or are coincident with the economic cycle measured by GDP growth. It's important to be mindful of this when the economy is turning down. The next table lists examples of the most common indicators in each:

- Leading economic indicators are economic indicators which lead the economic cycle often by 6-18 months. This is because they reflect changes in monetary policy - like the yield curve which is the gap between long term bond yields and short-term interest rates which are a guide to whether monetary policy is tight or loose and money supply growth - or they respond quickly to changes in interest rates - like share markets, confidence and building approvals.
- Coincident indicators move with the economic cycle, so GDP growth by definition is coincident as are retail sales and household income.
- Lagging indicators tend to turn after the economic cycle has turned. Unemployment and inflation are lagging indicators because companies are invariably slow to adjust hiring and pricing decisions. They persist with decisions to hire or raise prices after demand has slowed because it takes a while to recognise that any downturn is permanent and turnaround the mechanisms by which they hire and raise prices.

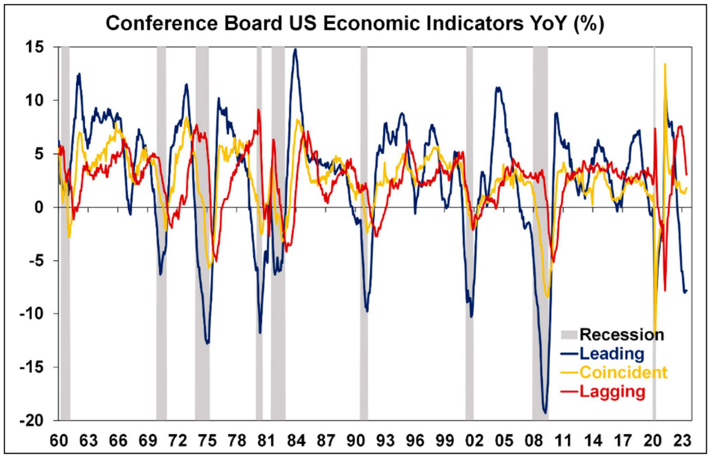
Of course, leads and lags for various indicators may vary for each cycle so it's often best to focus on an average of them.

ECONOMIC INDICATORS

Type	**Economic indicator**
Leading	Yield curves
	Money supply
	Share prices
	Building approvals
	Consumer and business confidence
	New manufacturing orders
	Sales to inventory ratio
Coincident	GDP
	Retail sales
	Home building
	Household income
	Industrial production
	Job vacancies
Lagging	Unemployment
	Business credit
	Debt delinquencies/insolvencies
	Unit labour costs
	Inflation rate

Source: AMP

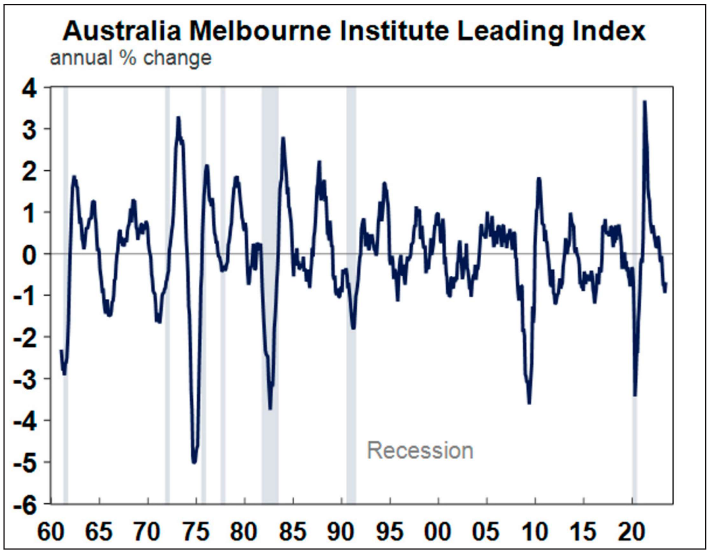
Various organisations publish indexes based on each. For example, the next chart shows indexes of all three produced by the Conference Board. As can be seen the Leading Index (blue line) tends to lead going into downturns/recessions whereas the Lagging Index (red line) follows.



Source: Bloomberg, AMP

Current conditions

And so it is right now in the US with leading indicators depressed, coincident indicators having slowed but still growing and lagging indicators having slowed recently but still around pre-pandemic levels. It's a similar story in Australia with the Westpac/Melbourne Institute leading index having slowed but GDP growth still positive.



Source: Macrobond, AMP

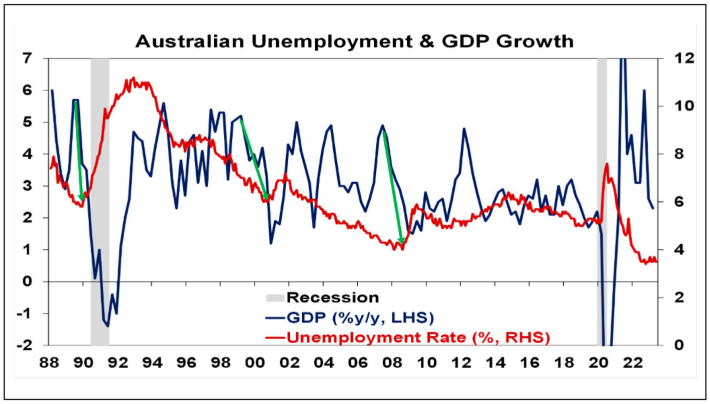
This is particularly relevant now in relation to unemployment & inflation.

Jobs leading indicators are pointing down

Recent Australian jobs data has been strong with employment up 3%yoy, hours worked up 4.7%yoy and unemployment around a near 50 year low of 3.5%. For much of the last thirty years, Australia has not had a lot of clearly defined

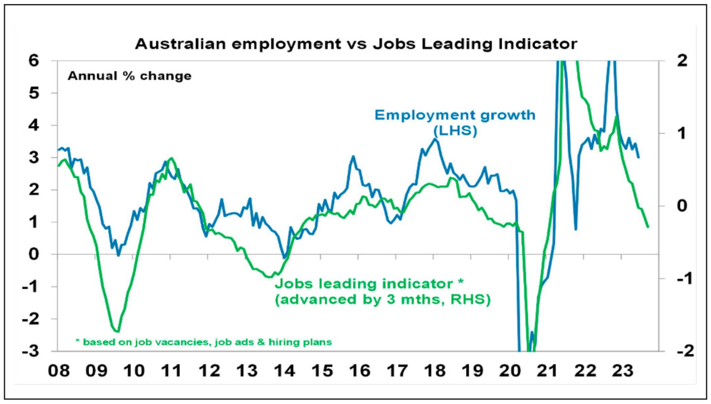
On current trends our Jobs Leading Indicator suggests employment growth is likely to fall below the 1% growth the RBA is forecasting over the next year suggesting upside risks to their forecast for a rise in unemployment to 4.5%.

economic cycles and unemployment was in a downtrend. The pandemic also distorted normal economic relationships. However, as can be seen in the next chart significant swings in unemployment around the early 1990s recession and the early 2000s and 2008 growth slowdowns saw unemployment tend to lag swings in GDP growth (eg, see the green arrows). This was particularly evident around the early 1990s recession with unemployment still going down as GDP slowed in 1989 and only starting to rise in earnest once the economy was in recession. After the recession ended in mid-1991, unemployment did not peak until late 1992.



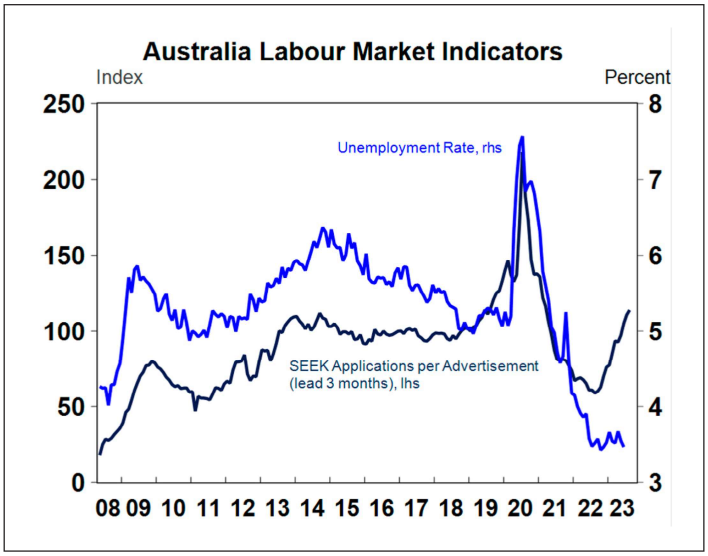
Source: ABS, AMP

Our leading indicator of jobs growth - based on vacancies and hiring plans - points to a sharp slowing in jobs growth ahead.



Source: ABS, NAB, ANZ, AMP

Consistent with this, data from Seek shows a rising trend in applications per job ad and consumer surveys also show a rising trend in unemployment expectations which tends to lead the unemployment rate at turning points.



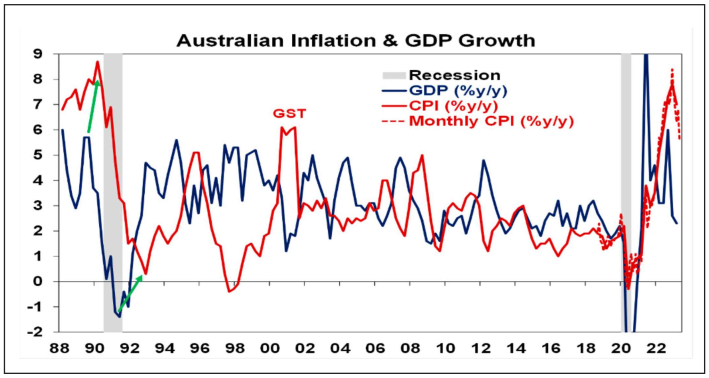
Source: Macrobond, AMP

On current trends our Jobs Leading Indicator suggests employment growth is likely to fall below the 1% growth the RBA is forecasting over the next year suggesting upside risks to their forecast for a rise in unemployment to 4.5%. Roughly 3% jobs growth now is needed to keep unemployment stable given the surge in population growth with high immigration.

Inflation also lags

As with unemployment, major swings in inflation also tend to lag major swings in GDP growth. Of course, as already noted Australia didn't have a lot of clear economic cycles over the last 30 years, but the lag was clearly evident in the early 1990s (see the green arrows below). Of course, the pandemic distorted things pushing inflation down very quickly in 2020 and the combination of pandemic related distortions, floods and the war in Ukraine which depressed supply helped boost inflation since 2021 but the supply side is now normalising.

Still low unemployment and still high inflation are not that unusual despite slowing growth because they both normally lag big swings in the economic cycle – running the economy with too much focus on them is a bit like driving a car with the rear-view mirror.



Source: Macrobond, AMP

While inflation is still too high, the increasing signs of a sharp slowdown in growth and a high risk of recession (which we put at 50% with the biggest risk being RBA overtightening) point to a further sharp fall in inflation as weaker growth means less demand relative to supply in the economy.

Concluding comment

To conclude, the key points are that:

- Still low unemployment and still high inflation are not that unusual despite slowing growth because they both normally lag big swings in the economic cycle – running the economy with too much focus on them is a bit like driving a car with the rear-view mirror.
- As such the RBA and other central banks need to tread carefully from here and allow for the lags from the rapid rise in interest rates to work through lest they end up pushing unemployment far higher than they need to in order to return inflation to target. Fortunately, the minutes from the last RBA board meeting suggests it's aware of the risks.

Shane Oliver is Head of Investment Strategy and the Chief Economist for AMP.

When is the best time to invest your money?

BY LUKE SHEATHER
Republished from betashares.com.au

No matter how experienced an investor you are, the decision of when to invest money can naturally provoke a feeling of uncertainty or apprehension. Are shares too expensive at the moment? Will rising interest rates cause another sharemarket crash soon? Am I better off just leaving my money in the bank until a better buying opportunity arises? These nagging questions can undermine confidence and cause even experienced investors to second guess their investment decisions. But perhaps the better question is, to what benefit?

In this article, we analyse the experience and fortunes of five hypothetical investors who employ five very simplistic investment strategies over the course of 22 years (Jan 2001 - Dec 2022). The analysis replicates a study performed by Charles Schwab on the US sharemarket, however in this example we focus on how these strategies play out in the Australian market.1 Each investor received $2,000 at the beginning of every year and invested it as follows:

1. **Lucky Leo** had a knack for timing the market perfectly. Whether through incredible skill or plain luck, he was able to invest his $2,000 at the sharemarket's lowest level every single year (a feat that even professional or most experienced investors fail to achieve). For example, in 2001, instead of investing his money immediately in January, he waited and invested it on 24 September, which was the Australian sharemarket's lowest closing level for that year.
2. **Rapid Riley** was far too busy to pay attention to sharemarket news or worry about market timing strategies. She invested her $2,000 on the very first day she could, being the first trading day of the year.
3. **Steady Eddy** appreciated the benefit of long-term sharemarket returns but was also concerned about investing all his money at once, in case of a subsequent market collapse. He employed a dollar cost averaging (DCA) strategy and divided his annual $2,000 into 12 equal investments, which he made at the start of every month.
4. **Hopeless Harry** (like Lucky Leo) attempted to time his investment into the sharemarket at its lowest level each year. However, unlike Leo, Harry had incredibly bad timing and instead managed to time his investment at

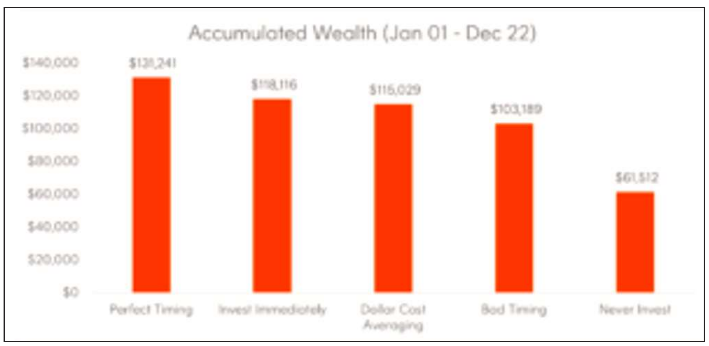
> **While some investors may strive to be the next Lucky Leo of this world, a strategy of perfectly timing the market is completely unrealistic. In fact, Dow Jones 2022 SPIVA data, shows that half of all professional stockpickers underperformed the S&P/ASX 200 benchmark over one year, let alone have a perfect run with their investments.**

each year's market's peak. For example, in 2001, Harry invested his $2,000 on 29 June, which coincided with the Australian sharemarket's highest level for that year. He continued to invest at market peaks each year through to 2022.

5. **Hesitant Hayley** was always too nervous to invest her money and would typically have an excuse for "why today was not an opportune time to invest". Hayley, therefore, left her money sitting in her bank account, which would only earn the interest rate that her bank was offering.2

And the winner is ...

The chart below displays the accumulated value of each investment strategy as at the end of 2022.



For illustrative purposes only. Individuals invested $2,000 each year into a hypothetical portfolio that tracks the ASX All Ordinaries Accumulation Index. The individual who never invested received a return in line with Bloomberg Ausbond Bank Bill Index

Unsurprisingly, Leo's strategy of timing the market perfectly every year allowed him to earn first place, as unrealistic as it may be. However, what was surprising was his somewhat slender winning margin of just $13,125 ahead of Riley, who had simply invested as soon as she could, without any consideration of market timing.

The dollar cost averaging (DCA) strategy employed by Eddy gave him third place and $3,087 less than Riley. A result that can partly be explained by the tendency for sharemarkets to trend upwards over the long-term. This means Eddy, who opted not to invest all his money at the start of the period, would more likely be hurt by 'up periods' in the sharemarket, than benefit from 'down periods' as he carried out his strategy.

Although Harry's poor market timing strategy left him $14,927 short of Riley, who had no interest in timing markets, he still accumulated significantly more wealth than had he not invested at all. Unfortunately for Hayley, she would have been far better off investing at sharemarket peaks - which ironically, was what she was afraid of.

Results stand the test of time

To ensure our findings were no fluke, we examined 24 separate 20-year periods dating back to 1980 (such as 1980-1999, 1981-2000, and so on). Remarkably, throughout all 24 periods the rankings remained unchanged. The perfect timing strategy provided the highest returns, investing immediately always produced better returns than dollar cost averaging, and bad timing always produced better returns than not investing at all. Even expanding our analysis to include all possible 30 and 40-year time periods since 1980, we observed the same pattern persisting across all time frames.

Key lessons

1. The cost of waiting to invest is high - make a plan and be decisive. While it's nearly impossible to identify market bottoms accurately and consistently over time, the findings in this study suggest that the benefits of market timing may not be worth the effort or attention in any case. Investors can, in fact, be better served with a considered and structured investment plan that they stick to, regardless of whether the sharemarket is high or low.
2. Dollar cost averaging (DCA) overcomes a psychological hurdle - but it also gives up returns. While investing immediately has proven a superior strategy financially, DCA

may still be an appropriate strategy for an investor who is anxious about investing all their cash in one go, or who is prone to regret when the market falls suddenly following an investment. DCA, like the 'invest immediately' strategy, also eliminates the temptation of market timing and discourages procrastination.

3. Over a long time-period, bad market timing still beats not investing at all. Hayley demonstrates the pitfalls from sitting on the sidelines and waiting for the perfect time to invest. From Jan 2001 - Dec 2022 she sacrificed a staggering $41,676 relative to Harry, who continually invested in the sharemarket at the worst possible time. If nothing else, this study has illustrated and reinforced that it's time in the market, not timing the market, that is key to a successful investment strategy.

While some investors may strive to be the next Lucky Leo of this world, a strategy of perfectly timing the market is completely unrealistic. In fact, Dow Jones 2022 SPIVA data, shows that half of all professional stockpickers underperformed the S&P/ASX 200 benchmark over one year, let alone have a perfect run with their investments. However, as we've learned, with a disciplined investment strategy and adequate investment horizon, positive investment outcomes can still be achieved without the stress of attempting to time markets.

Luke Sheater is an assistant portfolio manager for Betashares, responsible for managing several equity strategies and portfolios.

BetaShares is a leading Australian fund manager specialising in exchange traded funds (ETFs) and other Funds traded on the Australian Securities Exchange (ASX). Since launching their first ETF more than a decade ago, BetaShares has grown to become one of Australia's largest managers of ETFs.

Q&A: Ask a Question

Question 1

How does gifting work with Centrelink?

Gifting in the context of Centrelink in Australia refers to giving away money or assets without receiving adequate financial consideration. The gifting rules are in place to prevent individuals from reducing their assets to qualify for higher pension payments. The gifting threshold is $10,000 per financial year or $30,000 over five years for singles or couples combined. Gifts beyond this limit may be considered as a “deprivation of assets” and counted as part of the assessable assets for up to five years. Exempted gifts include gifts to a special disability trust, and certain gifts to cover medical, education, or accommodation expenses for immediate family members. If receiving Centrelink payments, individuals must report gifts made within 14 days. It’s advisable to seek advice from a financial adviser for your specific circumstances and up-to-date information.

Question 2

How can I reduce my Capital Gains Tax (CGT)?

Some examples of strategies that can be used to lower your CGT liability are as follows:

1. Hold assets for over 12 months: If you hold an asset for more than a year before selling, you may qualify for a discounted CGT rate (e.g., 50% discount for personal investments).
2. Offset gains with losses: If you have capital losses, they can be used to offset capital gains in the same financial year or carried forward to offset future gains.
3. Use tax concessions and exemptions: Explore tax benefits available for specific assets or circumstances, such as small business concessions.
4. Time asset sales strategically: Be mindful of tax bracket changes and other regulations to optimise your CGT position.

Remember that tax planning should always be done within the boundaries of the law. Always seek advice from a financial adviser before selling assets with large CGT as there may be strategies that can minto ensure you are compliant with tax regulations while optimizing your tax position.

Question 3

What are the key characteristics of ETFs?

Exchange-Traded Funds (ETFs) have several key characteristics that distinguish them from other investment vehicles. Here are the main features of ETFs:

1. Traded on Exchanges: ETFs are bought and sold on stock exchanges, like individual stocks.
2. Diversification: ETFs hold a variety of assets, spreading risk across multiple investments.
3. Passive and Active Management: Most ETFs track an index passively, while some are actively managed by fund managers.
4. Transparency: ETFs disclose their holdings regularly, allowing investors to see what assets they contain.
5. Liquidity: ETFs offer high liquidity, allowing investors to buy and sell shares at market prices throughout the trading day.

Overall, ETFs provide benefits such as diversification, transparency, liquidity, and cost-effectiveness, making them popular investment options for a wide range of investors. However, it’s essential to consider personal investment goals and conduct thorough research before investing. Seeking advice from a financial adviser is recommended to learn more about ETF suitability for one’s portfolio.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wtfglimited.com**.

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