Transcript

The Ideas Exchange

Episode 19: How to invest in volatile markets

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[00:00:02] **Rory Cunningham** Welcome to the Ideas Exchange by ASX connecting you with investment experts, market updates and ideas. I'm Rory Cunningham, Senior Manager of Investment Products at ASX and this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

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[00:00:48] **Rory Cunningham** Hi everyone, welcome to this month's episode of The Ideas Exchange. We're joined here today by James Holt, Director of Investment Solutions at Perpetual. James, welcome.

[00:00:56] **James Holt** Good to be here.

[00:00:58] **Rory Cunningham** So I'm very excited for today's podcast, James. Today we're going to be talking about the current market volatility. And after the downturn that we've had in the markets over the last while, we're also going to be discussing where James and the team at Perpetual are finding investment opportunities in the current environments. But James, before we get into that, maybe do want to give our listeners an introduction to yourself and also to Perpetual?

[00:01:22] **James Holt** Certainly, yes. I work as Director of Investment Solutions at Perpetual. And Perpetual itself is, you know, it's been around a long time since the mid 1880s, started as a trustee business, has private clients wealth, has asset management, has a trust, has a corporate trustee business as well. And really its origins are very much in sort of holding money in trust for people when they accumulated wealth. Early in Australia, trustee companies were formed to sort of hold that in trust for people so they could go overseas and do other things. And that's evolved into the business we have today. And today, look, our core businesses is asset management and we manage about $100 billion in total. And we manage for everyone really, for institutions, for financial advisors, for their clients, for clients directly as well. And we have, of course, also products listed on the Australian Stock Exchange as well.

[00:02:09] **Rory Cunningham** Yeah, recently you've been quite active in listing products on the ASX and just from a personal note, Perpetual was actually my first employer out of university, so I've got a long history dating back with Perpetual as well. So James, really interesting current market environment, lots of volatility, it seems we can't read the papers without there being a discussion on floods, the pandemic, inflation, war, geopolitics, rising interest rates. And of course, that's all leading to market volatility. All of these things are dominating headlines. If we look at performance in Markets year to date, the S&P ASX 200 index is down 13%, the S&P 500 index is down 20% and the Nasdaq 100 is down 28%. So what's Perpetual's view on the current market environment?

[00:02:56] **James Holt** Yeah, look, it's interesting. You know, clearly we've been through this strong recovery from COVID itself, driven by stimulus that's resulted in the last year or two now with concerns around inflation. And of course, we've seen this big swing to value, you know, which favours us because we tend to have a value style in the way that we're investing. And look, I must admit, a year or two ago, central banks were quite sanguine about inflation. We were concerned about it. And the reason for that simply is that we're fortunate we get access to, you know, CEOs, management teams. We analyse companies from the bottom up. And they were telling us very early on that there was an inflation problem coming. So we kind of got set for our clients for that event. And so we've been investing accordingly. What we have seen in the last few weeks is a little bit of a rotation because at some point once the central bank's got serious about inflation, and they started tightening policy very quickly we saw, you know, the Reserve Bank wasn't going to tighten rates until 2024. Suddenly it's on, you know, they're tightening very quickly. The Fed's tightening very quickly as well. And of course, the market now is always looking forward and trying to work out what's going on. And the market's suddenly saying, hang on, we have an inflation problem. We've now got the central banks tightening. Maybe they'll tighten too much. There's a high risk of a policy error here, and maybe we've got to start pricing in for recession potentially as well. So the market is rotating all the time. It did rotate to value. We are though seeing a bit of a revival in some growth stocks and quality names in recent times as the market looks forward and tries to work out where's the market going to land in about 6, 12, 18 months' time?

[00:04:23] **Rory Cunningham** Yeah, I think there was also an example in the US where the Fed increased rates, but the market also went up because they didn't increase as high as what the market was pricing in. So these types of things can have an impact in the short term markets.

[00:04:36] **James Holt** It's always expectations and reality.

[00:04:38] **Rory Cunningham** So what's your views then on inflation and also interest rates in that kind of medium to long term?

[00:04:44] **James Holt** We've had still a view that inflation will be a problem for some time. Now, that's not to say that inflation's going to rise to 7% and stay there forever or for ten years, or exactly 5.5 years, or whatever. I think people when they, when you think about inflation, you've got to realise that it has, even historically, and you got to go back in history and find... History rhymes a lot, it doesn't repeat, but it rhymes a lot. And we had it appear before in the seventies where inflation did rise. But even when you look back then, it was up, it was down, it was up, it was down. It was a bit of a stop start economy. And so, you know, if you take into account what's going on and the dramatic stimulus by the central banks, now they're slamming on the brakes. And what happens if we do go into recession? Clearly, inflation would fall in the short term. But the other thing the central banks are now talking about is what happens if they ease too quickly in 6, 12, 18 months after tightening and in fact, they revive the economy, they also revive inflation and suddenly they find themselves back in this kind of 1970s stop start sort of economy. So we certainly think that central banks keep tightening. The rhetoric's out there to tighten. They're backing it up with action, you know, maybe a little bit belatedly, but they're finally tightening and getting that process underway. But don't be surprised if things turn quite quickly towards the end of this year, early next year, they start to loosen again. Certainly the Federal Reserve might. And our central bank, which is a little bit further behind the curve, might continue to tighten a bit further.

[00:06:08] **Rory Cunningham** Yeah, great. You were talking about history there and the lessons that we can learn from the past. So for some of our younger listeners out there, do you want to touch on what we have seen in the past in respect of inflation, the impact that that has had on markets, market downturns in history? Like where do you look to in the past to get guidance for what we might see in the future?

[00:06:29] **James Holt** Yeah, and look, you know, there's hints of maybe the seventies here as well, it's worthwhile noting as well if you look back in the seventies that everyone, in hindsight people forget. People move on and forget and rewrite history and people go back and say, oh, that was all about oil. And to a degree it was. But before oil even came along, we did have some policy errors, which is interesting because again, you can make the correlation today as well. So in the late 1960s, LBJ, who was the president at the time, put in place an anti-poverty programme that, you know, had elements of COVID, the COVID packages to it, you know, it kind of was a big stimulus. It was, you know, the right sort of thing to do, according to his view of history, was, you know, you had to equalise the economy and so forth. But that stimulus resulted in some inflation that eventually got a bit under control again in the late sixties, then Richard Nixon came in, he put together a massive family package in 1972 which pushed inflation through the roof again to high single digits. And then oil price crisis hit in 1973, October '73, and that sent prices up again. So you look back through that period, and you think, oh, well, there's two policy, there's two stimuluses that occurred, two stimuli that occurred, and really sent inflation through the roof in two spikes. Then oil contributed to the middle spike. And then there was a third spike in 1978, and they were called sort of oil supply disruption stories. So we've got kind of the same thing here. We've had COVID, we shut down the economy, we stimulated, we overstimulated, that resulted in inflation. Now there's supply side issues, a bit like the oil price stuff in the seventies. So it's different, but it's similar. You know, it rhymes a bit and therefore it might provide us with, and the big lesson, the other lesson from there, as I said, is not that inflation stays high and goes to 7% and stays there or exactly 8% or whatever. It did average that in the seventies, and it may not get that high on average, but inflation went up. Then it went down. We thought we'd fixed it, then it went up again and then it went down again. We thought we'd fixed it and then it went up again. And through that whole period there was a rising trend. So the thing you're hearing from central banks, too, is expectations and anchoring. And what they want to make sure is that people don't start to expect inflation to be high because once inflation is in the system, once you have 5, 6, 7% inflation for, say, two years, three years, four years, certainly five years, that becomes the new normal. And people say, hang on, this is you know, I'm no longer satisfied with 2, 3% wage claims. I want 5, 6% every year because that's what inflation is. So, everyone starts to anchor themselves with this new higher inflation and it becomes self-fulfilling and gathers speed. That's the real problem that eventually emerged in the seventies and the Fed never got on top of it and eventually had to really hike rates very dramatically in the late seventies, early eighties, to finally bring it under control, which is what they finally did. But it took a decade to get there.

[00:09:11] **Rory Cunningham** So looking forward a bit then, is this time different? And then what challenges do you foresee going forward?

[00:09:18] **James Holt** Looking forward, I think, and you consider what happened in that period and what might we take out of it. Well, first of all, maybe the battle against inflation is not as easy as we think. Getting on top of it early is a good thing. Delaying too long is bad. I think the central banks have got that message and they're thinking about the seventies in that regard. The other thing as well is, there are a few structural inflation issues that I think people aren't fully appreciative of or aware of or haven't really sold themselves this concept yet because we've become so used to low inflation for 30 or 40 years. Until two years ago when thought it was transitory, you know, remember transitory was the word?

[00:09:53] **Rory Cunningham** Yeah.

[00:09:53] **James Holt** And then it became transitory for longer. And then eventually it became, oh, maybe it's not transitory, you know, maybe it's here. So you've got to go through this stage of grief to admit, you know, maybe things have changed. And to be sure, there are elements that are transitory. You know, we're not going to have these disruptions forever on many, many commodities. Some of them will go away again. We're not going to have, you know, transport linkages always broken, they'll eventually be fixed up. So some of them will go away. But if you think about some coming trends, like maybe the geopolitical tensions, they're not going to go away in a year or two. They might go on for some time. Even if we resolve the Ukraine war, there's other problems around the world. There's other sort of sabre rattling going on. If you think about decarbonisation, I think decarbonisation is a laudable goal. You know, I'd love to get rid of carbon pollution, but it will cost money. If we rebuild the entire global energy system, which costs tens of trillions of dollars, that will cost a fortune and will have to be paid for in higher prices, certainly in the medium term. So there's sort of things. Ageing itself, you know, one thing that central bankers don't like to hear is that part of the reason inflation stays so long for thirty years is because effectively there's this great dividend. We had the baby boomers in the workforce, the biggest population cohort, they're about to retire or they're part way through the retirement process and they've got the bulk of the assets. Once they start to drawdown those assets, it means higher interest rates and also they'll probably push up inflation as well. The IMF did some modelling of this years ago that inflation is lower when you have a big population cohort like the boomers come through the workforce and it rises again once they retire. So there's all these sort of extra tailwinds we haven't had to deal with for a few decades that are coming on stream. And I think that'll make just the battle against inflation that bit harder than people, you know, assume it'll be.

[00:11:37] **Rory Cunningham** Yeah. Okay. You talked about anchoring before and with some of those tailwinds that you're talking about there, be that a change to decarbonisation and the costs that that's going to have on producing goods and services or baby boomers wanting to spend their savings instead of pass it along to their kids. Do you think we're going to become anchored to a new higher level of inflation, or how do you think that will play out?

[00:12:02] **James Holt** Yeah, I think that is a risk, you know, and again, it doesn't mean necessarily 6% inflation, but, you know, you could well see instead of the 2% inflation we've been accustomed to, maybe it is more like 3 or 4%. We're not talking about dramatic differences here about what that means for banks, if you think about most central banks, they've got a 2 to 3% target or thereabouts to keep the price level. Now when there's a natural, there's a slight bit of 1% inflation per annum, it's like 1% deflation I should say or 1 or 2%. It makes the job of keeping it 2% easy and in fact they've been able to pump money into the system, they've been able to tolerate fiscally irresponsible governments without worrying that inflation is going to go up to 2, 3, 4%. That's happened for 20, 30 years. But if inflation kind of, because of all those factors you mentioned and we've talked about, because it might rise to say 3 or 4%, that's suddenly 1 or 2% always above their target. Right. And so suddenly instead of being able to always, you know, run pretty loose policy, erred on the side of looseness, so to speak, they're constantly uncomfortable. They might have to be always just trying to err on the side of caution and keep rates a bit higher just to try and, you know, tamp down inflation a bit. And that's the difference, I think, potentially with the last few years. I mean, some would say there are some benefits as well, because if you had 3 or 4%, 5% inflation, debt gets inflated. So, I think there are other issues that come with inflation. People lose faith in the currency and they you know, high inflation is one of the components of the misery index that economists built many years ago unemployment, inflation, both of them kind of eat away at people's confidence. But it could also help erode some of the debt that's built up over many, many years as well.

[00:13:41] **Rory Cunningham** Yeah, there's been certainly a lot of debt taken on by governments post GFC and also in the face of the global pandemic.

[00:13:48] **James Holt** Absolutely.

[00:13:49] **Rory Cunningham** I want to switch focus just slightly over to asset classes and who's going to benefit from this or who's going to be hardest hit. We might start by who's going to be hardest hit by this kind of change that we're seeing. And I'm going to pick on the FANG stocks for a second. So we've had Facebook obviously now called Meta, down 51% year to date. Apple is down 20% year to date, Amazon down 34%, Netflix down 70%. And Google now called Alphabet down 20%. So I hope this isn't leading, but what asset classes have and are going to be hardest hit in the current market environment?

[00:14:29] **James Holt** I mean, bonds were hit first, right. And they are in many respects a linchpin asset class. Right. We price things off bonds. You know what a bond yields, therefore, what should the equity risk premium be, therefore, that's what equities should be. So they've sort of put a spear into this equity market, particularly the growth bubble in many, many ways. And I think you've got to triage some of these stocks, too. I think some of them will come back. You know, there's no doubt about that. The quality ones will come back. And if you go back far enough, you'll find back in 2000, stocks like Amazon fell 90% or thereabouts, but they came back and they thrived. As long as you don't go broke, that's a critical thing. So companies that, for us you know we use for quality criteria, and they are recurring earnings, conservative debt management and, industry quality business, so to speak as well. So you think about it, companies that fail, one or more of those filters are at high risk. You know, if you don't make money, a lot of these concept stocks, as they're often referred to, you know, they might have a brilliant concept, but if you can't make cash out of it, you're in trouble. Eventually you've got to make money. We did see some companies come to market in the last few years where they listed and amongst their offer documents, it said we may never achieve profitability. Which begs the question why you're in business? That's what business is all about, making money, doing things for people, making money and returning it to the investors who took the risk to get the idea going in the first place. So if you can't make money, or you've got too much debt. You're in deep, deep trouble. Management is critical, that said as well, and being in a quality industry. So some of those stocks, and you think about the buy now pay later space, where it's unsecured debt, you know in a crisis, a tiny percentage of home owners can't repay but unsecured creditors, a large percentage of them can't repay. And suddenly your whole customer base sort of evaporates. I think that's a problem. So I think a few of those companies are potentially very, very challenged. But amongst the high quality companies, they can certainly make a comeback. And of course, they've been hit to varying degrees. And also there's an element of valuations in issue. Some of the FANG stocks now aren't actually necessarily ridiculously expensive, but they've got a huge profit ONPAT each year that they generate. Can they keep growing that without competition? Coming in tech is a very cutthroat space, so you've got to weigh all that up as well. You know, is today's rooster in the tech space, tomorrow's feather duster, when it gets replaced by something else? You know, I think that's, you know, unless you've got a real lock hold in the industry or a monopoly or licence or something that we think makes a big difference as well.

[00:16:49] **Rory Cunningham** Yeah. And I suppose for those earlier stage/concept stocks, if they don't have enough cash flow to fund their operating activities, it means they're going to have to raise capital, either equity capital or debt capital. And in the last couple of years, that's been relatively easy. Right. But going forward, that could be more challenging.

[00:17:06] **James Holt** Exactly. You've got to earn the money or raise the money for the equity market or the bond market, as you say. But if the equity market and the bond market close or the banks close their doors to that organisation the only way out is profitability.

[00:17:16] **Rory Cunningham** Let's talk a little bit about Australia's favourite asset class - housing. Thoughts, views, opinions?

[00:17:24] **James Holt** Yeah. Look, I think it's obviously done very, very well through COVID. That's been a global story as well. Rates went to zero, QE came in, house prices went skyward. The overwhelming, I don't know anyone credible in the market who's not predicting a 10 to 15%, maybe even a 20% drop in house prices. So we haven't seen that for a while. I think the Reserve Bank Governor made a good point when he said, you know, if you raise rates two years early, and the quid pro quo he more or less said, which I think is very true, is that well house prices have gone up 20, 30%, so even if they come down to 5, 10, 15% net, people are still ahead who borrowed maybe on the basis of rates being lower for longer. And also look, the central bankers aren't, you know, they can clearly see what they're doing. They set policy for sort of six, nine months ahead. That's how long it takes for monetary policy to sort of hit the economy. But we'll clearly see, I think, that they're not going to go crazy and take, you know, the cash rate up to 4% or whatever in the short term. They'll keep raising the pressure. A stitch in time saves nine. I think if they raise rates now reasonably aggressively through the end of this year, a couple of, you know, 2 or 3 50 point rises then a couple more, I think that'll sort of reset house prices without causing, you know, a significant downturn. But, you know, I think a 15% correction is sort of appropriate given how far they've gone up in the medium term.

[00:18:46] **Rory Cunningham** Let's change focus to where to find investment gems. I was reading the paper this morning and saw that Berkshire Hathaway have just gone on a $50 billion buying spree, which is about one third of its $150 billion cash pile. They've bought stakes or increased their stakes in Citigroup, Paramount, as well as energy companies Chevron and Occidental Petroleum. If they're buying, I suppose we should all be buying. So what are you buying?

[00:19:11] **James Holt** Yeah, it's a really good point. Amongst the investment ideas we've got, we've got certainly energy. Santos is a big position of ours and we've upped our position in that. Really good business, you know, it's a merger of Santos and oil search more recently. Big gas assets. Gas is a transitional energy, you know, away from sort of oil towards gas over time. A lot of, you know, asset rich effectively that company in many respects has options as to whether or not they reduce their stakes in a couple of businesses or sell assets to others, generate some cash and pay shareholders. So we think that's a very, very good business. We also are very big in IAG, the insurance business. So again, if you look at IAG over time, you know, at the top has traded at sort of 6, 7, $8 a share. At the bottom is more like $4 a share. It's currently in the $4 range. With the weather outside, when it's raining, people's claims, motor insurance, those sort of things go up. But you know what? It won't rain forever. And you never have droughts that last forever. And you never have rain that lasts forever. But the market sometimes prices companies as though they do, as though it'll never stop raining or the drought will never stop. And so we think it's a high quality business. It's a small market for those insurers. It's got a good balance sheet, it's well positioned. And we think eventually it'll turn the corner. So again, you want to buy when people are selling and not wanting to put their capital there, that's usually the way again, a bit like Warren Buffett. We also do like businesses that, you know, green metals, for example. So, you know, think about companies, Iluka, Chevros Global, that have got nickel, cobalt, rare earths, those sort of assets which will be in very high demand as we decarbonise the economy and we move to electric vehicles and things like that, all those green metals will be in hot demand. And we think there's structural demand for those for many, many years to come. I would also say as well, in terms of those other more expensive assets coming down, you know, people often are always trying to think about when CSL is a good time to buy. And we love CSL as a company. We think it's a very, very high quality company, but it's gone down from our 40 times earnings or 45 times to about 37 times earnings. So it's still not exactly cheap, if you know what I mean. Whereas we can find global companies as well. If you think about a company like Flutter, which is a gaming business in the UK or La Francaise de Jeux, which is a lottery business in Paris, they're both, you know, of similar quality, we think they're very high quality businesses. In different industries, to be sure, different sectors. But their PE ratio is, is sort of, you know, around 18 to 20 times, not 38 times. So the distinctive thing and I think, again, we're active managers, but a reason we think people have got to think about these things is that, you know, just because the growth sector is derided, it could have more to go potentially. And you can always find some quality somewhere, a gem in that market, which is almost like growth characteristics, but trading at value prices. And we think those sort of stocks are in that position.

[00:22:04] **Rory Cunningham** Okay, great. Thanks for sharing those insights for us. So James, any final thoughts that you would like to leave our listeners with? And also, where can they go to find out more information?

[00:22:13] **James Holt** We have websites available. People can look at Perpetual.com.au for any of our products. We do have, as I mentioned before, they're on the stock exchange as well. So ASX PIC, ASX PCI, ASX GIVE, ASX GLOB. They're all in the last eight years, but especially the last couple of years, we've been listing more ETFs. We've got a couple of listed companies we've had there for a while as well, ASX IDEA. So, they're all out there for people to buy. They can go to the ASX or through their broker to acquire those. They can go to our website. We've got another 20,30 funds as well that are available there through PDS's. And you know, again, we're always here to offer people a better future.

[00:22:52] **Rory Cunningham** Great. James, thanks very much for your time and your insights. I'm sure our listeners enjoyed your perspectives on the current market environment.

[00:22:58] **James Holt** Perfect. Thanks. Good to be here.

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