Webinar and Live Q&A: Australian and Global Equities Outlook – Webinar transcript

Ed Reekie (Pinnacle Director) with Mark Arnold (Managing Director and CIO) and Jason Orthman (Deputy CIO)

This transcript is intended be read in conjunction with viewing the webinar via the Hyperion Adviser webinar portal.

Ed Reekie:

Excellent. In fact I should be saying good afternoon – great, well let's get things up and running. Welcome everyone thank you for joining us this afternoon it's great to have you here for this webinar. We're going to focus today on the global and Australian equities outlook. My name is Ed Reekie I'm one of the directors here at Pinnacle investment and more importantly I'm delighted to be joined by Hyperion's CIO Mark Arnold and Hyperion's Deputy CIO Jason Othman.

In terms of background a lot of you know but just to bring everyone up to speed Hyperion is an independent fund management group, they've delivered substantial outperformance in equities for more than 20 years - started in '96 so 24 years and counting. What makes them different? Well they run a very concentrated, benchmark unaware set of portfolios. They only invest in the highest quality businesses and a lot of managers say that they invest in high-quality businesses, but do they really have a definition or are they just investing around the benchmark? By contrast Hyperion has a very clear definition.

These are sustainable competitive advantage of businesses with a high return on capital they've got low or no debt, and what it means is they've got a very stringent investment process and that ends up with three portfolios that are very concentrated and importantly very different to the index. and what does that all mean in terms of outcome? Because at the end of the day that's what we're all interested in.

The track record about performance over 20 years speaks for itself - I have put a slide in this pack to do on that so we might touch on that - but it's also particularly worth thinking about performance around the GFC here which I guess was the ultimate stress test for many portfolios during that time the Hyperion Australian growth companies fund returned a flat zero percent for the ended in June 2009 so they were flat for that year by contrast there All Ordinaries were down for that same year by minus 20% so their capital preservation just speaks for itself and we're beginning to see that same capital preservation coming through right now over the last couple of months.

It's also worth drawing your attention to a quote that's in the AFR from late January no the team don't have a crystal ball they didn't foresee COVID but what they do foresee is at least six or more big headwinds that are facing the market of which the natural resource constraint and disruption that COVID is a part of is really just one of those but there's plenty more and that's really what we'll be talking about a lot today in this portfolio and this is our presentation and we plan to keep it fairly short and sweet so you know no more than twenty minutes but we have got time for questions and so please feel free to put your questions online using the Q&A button on your screen it should be at the bottom.

Beware there's also a chat button and try not to use that because if you want the Q&A to come through please just use that Q&A button I'm also I'm aware that you'll be aware we're also working from home in the working home environment so please excuse any noise from kids or dogs or lawnmowers or whatever um my house for example we've got a five year old and a two year old. The five year old kind of knows what the office door being closed mean but their two-year-old less so, so please accept my apologies in advance for that now you didn't tune in to hear from me so let's get things started away Mark and Jason.

Jason Orthman:

Thank you

Mark Arnold:

Thanks Ed. Good afternoon everyone. Since the GFC the world has permanently changed we don't believe there's any going back to the high growth world that existed prior to the GFC. We are facing a structurally low growth world, a low inflation world, a low interest rate world, and a low equity market return. Well prior to the GFC there was a six decade period of very high economic growth where corporate profits were also growing at very high rates. Most people thought that this period was permanent and that the tail winds had drove that strong economic growth were permanent also, but it turns out that they were temporary for this period from the 1950s to 2007.

These tailwinds included young and growing populations, the commercialization of cheap fossil fuels for energy, the development of powerful engines, the gearing up of society, women entering the workforce we had a robust middle class particularly for the first 30 years of that period and there were no obvious natural resource constraints and disruptions during that period but as I said before these tailwinds were actually temporary and in this high-growth world that existed prior to the GFC with low levels of disruptions average businesses did well because they shared in the growth of the economic pie.

Since the GFC the headwinds have appeared ageing population is a key one and also declining population growth, globally population growth peaked in the late 1960s and has been declining ever since.

The high debt levels that we enjoyed in terms of the gearing up period where people could spend more than they earn and they could invest more that, that high debt level has now become a burden and has become created a growth hole effectively for future growth rates.

There's been rising wealth inequality since the 1970s in most countries around the world and this has resulted in a hollowing out of the middle class. We believe you need a robust middle class to sustain high levels of economic growth it's worth I'm highlighting with that rising wealth inequality what it means and effectively the world has just become a lot more competitive, rewards are not shared evenly so it doesn't matter whether you're in at school, in business, in funds management there are fewer and fewer winners and a lot more losers and as we go through this pack I hope to show you why you want to be on the right side of that ledger and be with the winners and that rising inequality is absolutely real. The world's more competitive and we all need to shift in that direction to sort of a modern view of the world.

There's natural resource constraints and disruptions as well climate change has become a bigger issue, COVID-19 is obviously, natural resource disruption as well.

The tailwind that we enjoyed for 38 years has come to an end and that tailwind was the trend from double-digit interest rates down to very low interest rates so we think that that tailwind no longer

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exists,

Then finally there's been a lot of disruption particularly since the internet came into being and also smartphones that has really been quite disruptive and then you've got AI, computers getting better and better all the time, machine learning and robots that will cause further disruption particularly to human capital markets over the next decade and beyond.

Jason Orthman:

It's really important to highlight that what Mark is talking about there so basically in 2007 there was a couple of key events that occurred one was obviously the global financial crisis and that shifted the world from that you know high growth to a low growth world and allowed it to become more competitive and then clearly there was the release of smartphones or effectively the iPhone which again gave consumers a nice experience and now the standards that and expectations are a lot higher so again businesses are in this low growth world and they actually need to offer a good product and a good and a good function.

Mark Arnold:

This chart shows most major economies around the world and the percentage of the population sits greater than 65 years or older and you can see that most of these lines are going up all of these lines are going up and Japan's a leader here that's a red line so over 1/4 of Japan's population is older than 65 years so we often say that we think the world is turning Japanese and that's certainly the case in terms of lower growth rates for population and also aging populations.

As I mentioned before there's been a gearing up of society the financialization of society and that's occurred with households with business and also with governments you can see the US economy debt to GDP has moved up steadily over the last 70 years and then on the right you can see China's total debt to GDP which is moved up more rapidly and the gradient particularly over the last 10 years and as I said before once you get to a certain level of debt people become more risk-averse they're like less likely to spend money and they're less likely to invest.

There's been growing wealth inequality in most countries around the world this chart shows the wealth inequality in the US. Now the top point one percent of the most wealthy people hold the same amount of wealth as the bottom 90% and as I mentioned before we think wealth inequality leads to a hollowing out of the middle class and growing social unrest.

This slide shows the close association between carbon production or CO_2 production and economic growth rates over time that's the chart on the left and then the chart on the right shows as co_2 in the atmosphere has increased global temperatures have also gone up. So we think that climate change as a result of rising temperatures is going to be quite disruptive to economies over the next 10 years and beyond we think flooding of populations will be disruptive biodiversity is going to reduce food production is going to be disrupted as well ocean acidification is going to destroy coral reefs and fisheries so we think that the global economy because it's so reliant on burning fossil fuels is faces a lot of disruption and headwinds as a result of burning those fossil fuels.

Jason Orthman:

And that's why when you look at our modern portfolios that and then their carbon dioxide outport we're actually a fraction of the benchmark or the world indices so that the carbon footprint of the Hyperion for portfolios is less than 10% of the comparable benchmark so you know we're well positioned and acting on that to make sure we've got carbon light portfolios and any of these costs that could be potentially internalized over time don’t impact on our portfolios.

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Mark Arnold:

This chart shows the profitability or the return on equity for businesses in the MSCI world over time you can see that the trend is generally down and average businesses have been finding it more difficult to maintain their current return on equity because the world is globalized particularly since the internet came into being and also smartphones have helped to globalize the world and make competition rather than being regional it's moved to a globalized competitive landscape and that's put downward pressure on margins

Jason Orthman:

And what that slide effectively means that return on equity is declining over time for your each business effectively your intrinsic value of your average business is declining and that and that's an important statement because despite interest rates going lower PEs going higher and stock markets being driven higher the reality is the actual fundamental worth and most businesses are declining and that's really yet to play out in in your average stock price an average business over the next decade

Mark Arnold:

This chart shows the growth versus value anomaly. When this line is rising it means that the value style of investing is outperforming the growth style and you can see over the last almost hundred years value styles of investing have outperformed growth styles of investing overall but the red sections of this chart show periods of economic stress starting with the Great Depression - you can see that the dots move down when they're red, during these difficult economic circumstances, and if you actually look at every recession that has occurred over these this almost hundred years value as a style has consistently underperformed and that's one of the reasons why value has underperformed since the GFC because initially you had the GFC so that was obviously a recessionary environment and then since then you've had very low growth rates for most economies around the world and you've had increasing disruption for those from the internet and also from smartphones and the general globalization that's occurred as a result of those two things so our conclusion is value style of investing is a fair-weather typing of investment style it works very well in high growth rates or got high economic growth conditions and over that that period particularly from 1950s the average nominal GDP growth was around 8% globally and about 7% in the US and in that sort of environment average businesses do really well but in a low growth world that we're facing now average businesses that value investors tend to buy they don't do very well at all and they're suffering and being disrupted at the moment.

Jason Orthman:

All right thanks Mark if we just bring it back to today I guess with the with the coronavirus which is clearly having a large impact on everyone and the severity and speed of this contraction is you know actually worse than the global financial crisis that that we referenced and the reason for that is simply through this containment crisis so if you look at most businesses they rely on some physical distribution getting to consumers physically and if that's the case as you're contained clearly your revenue goes to zero for a zero for at least a short period of time and a lot of these businesses are only average old-world businesses which to put debt on their balance sheet to try and increase those returns on equity we talked about and again as your revenue comes off then you're starting to get pressure on your balance sheet so there is a lot of pain going around for you for your average business and you really need to think how to position your portfolio in a better way.

And most of these businesses are pre-internet type businesses they don't have the ability to

distribute their products digitally and in a crisis like we're experiencing at the moment that makes it very difficult for them to sell their products.

Mark Arnold:

Yeah so basically what you need to do we believe is create a portfolio of modern businesses and we framed that through a number of structural themes so you know we look out over the next 10 or 20 years and try and forecast you know where the world's going and clearly it was always being able to operate remotely moving online using your software digitally you know paying 3 cards again online and so all those structural themes are expected to play out over the next decade or two and what this containment crisis has done is effectively brilliant brought all those long data themes forward to today and you should see an acceleration as we come through this crisis to the these modern businesses these next blue chips will continue to take share and it will actually accelerate as we um come out of that.

And what we found is that these structural themes they were going to occur anyway we think that they were inevitable but during a crisis people are forced to focus more on value propositions or strengths to the value proposition there's less inertia and so the crisis has really accelerated that structural switch that we're talking about and we can take advantage of that in our portfolio.

Jason Orthman:

So if we just move forward to it a couple of examples we've got in the global space a portfolio of anyone's talks but we've also go got that across Australia growth and a small cap fund but if we highlight a couple of names here PayPal is obviously a business that's been going viral over them over the last decade or so and you if you look at the history of payments caches and checkers clearly dominated and these are and MasterCard spent over 50 years going around 200 plus countries and signing merchants up physically but what PayPal has done is brought the consumer online and really quickly signed up 25 million merchants online or on the internet which is a very powerful thing to do a lot of other mega caps have tried and failed at doing that so PayPal is a good example of a business that we want to get behind and own for a long period of time and if you look at where they are in their in their journey so even though they've had that success to sign up those merchants and really enable people to pay on online there are only 2 to 3% through that journey so there's plenty of dollars to actually shift on to PayPal's platform.

Another example is salesforce and obviously we mentioned in this containment crisis that you know revenue is the lifeblood of any business and without revenue you do it you do it extremely tough and salesforce offers a CRM or a customer relationship management tool which again is online and has a large degree of funk of functionality so salesforce is effectively allowing you to serve your potential and new customers sell to them service them and market to them and what it's doing is replacing legacy software like your typical SOP or your Oracle that's the top that's on on-premise and that's the only early days like the shift from your legacy Hardware on site to something more functional born in the cloud is only ten in ten to twenty percent of the way through the journey and as we highlighted earlier as we look through this the actual value proposition becomes more and more obvious and some of the revenues actually got the potential to accelerate as we go to go through this.

Ed Reekie:

I might just jump in here on the performance side I guess this slide really speaks for itself it's quite busy to navigate you around some of the numbers but it's worth just noting before we start that none of these three portfolios have any derivatives in them no one have any shorts in them this is

just old-fashioned vanilla long only investment and it's a longer investment in quality and this shows you if your brutal enough with your selection process and your portfolio construction the results you can get by a long only investment in quality it's probably worth focusing on the total returns since inception which are kind of the left-hand columns the two left-hand columns because this really demonstrates the enormous power of compounding and adding alpha over you know long periods of time if I help me navigate the second blue block down is the Hyperion Australian growth companies fund have a quick look at the second column and the funds done ten point nine percent annualized since inception the benchmark is seven point six percent so that gives out for a three point three annually which is a great result but it's not really until you look at the real left-hand column there and put it in real terms over time that's the difference between two hundred and sixty two percent returns and five hundred and eight percent returns now that is the compounding effect over eighteen years and if I talk take you navigate you down to the net the third blue block which is the pipe own small growth companies fund again have a look at the annualized numbers you know thirteen point nine and five point four but when you start putting that in total returns it's the difference between one hundred and fifty one percent and eight hundred and seventy four percent you know it is just so stark the benefits of compounding and quality companies and remember the turnover in these portfolios is quite small so it's not jumping from idea to idea it's just backing real winners a long period of time and if I take you to the top there that's the global growth companies numbers now this is coming up to six years next month but already just over that six year number you see the total return since inception is basically double what you'd get from the index and that is just in a nutshell the power of compounding quality growth over long periods of time.

Jason Orthman:

Okay thanks Ed and so obviously that performance we were very proud of that I mean that's backward-looking in we need to look forward and that's what investing is all about trying to compound returns over a long period of time and because of Hyperion's proprietary process we've got a unique ability to actually forecast our projected return so for every single stock we come up with an intrinsic value and compare that to a share price so the difference between the share price today and our intrinsic value is an internal rate of return and if you look at this bottom of the slide we've actually built that up on a portfolio basis so if you know the internal rate of return for each stock you can weight each of those internal rate of returns by the weight of the stock and you get a portfolio in forecasts internal rate of return so the bottom rows the most important one there and you can see for the Hyperion global growth companies fine on the on the bottom right of the table that we're at forecasting a 22 percent per annum annual return so we've sort of done around 20 percent after fees and looking forward we still think we can do something similar in the two Australian funds to the left there are forecasts to do 17 to 18 percent per annum now to put this in context before the coronavirus crisis here the Australian products were forecast to do 12 to 13 percent annual returns and the Hyperion global growth companies fund was forecast to do around 15 to 16 percent so you can see by that through this crisis that developed through February March and into April it's actually increased the attractiveness of the outlook and improve the margin of safety in our view and so if we just quickly post it to how we get those forecast returns the top-line really drives it so again for each stock and portfolio we've forecast out its earnings per share outlook over the next five years and that moves into a portfolio and we take off the p/e contraction we expect and part of that's to be conservative part of that support folio maturing and add the dividend yield so for example in the Hyperion Australian growth companies fund twenty one percent forecast less six percent gives you or fifteen percent return and are the dividend giving you 17 so I hope that charts relatively instructive and gives a sense of you know how we're looking forward.

Mark Arnold:

I think that an important thing to note with these returns is that as I said before it's a low a low

return a world that we're looking at a low economic growth world and in our projections for passive investing we think that you're likely to get low single digit returns over the next five to ten years so substantially lower than what indexers have done historically because of that more competitive and more low growth world that we face.

I think we're handing over to you from any questions I guess Ed.

Ed Reekie:

Yeah let's take some questions. Also just worth noting on that last slide you know from I go rarely see managers that put have confidence you know to talk about forward projection so it's great to see and great to hear your views generally over you know the next five to ten years or more and right let's hit the QA please use that QA button we've got some coming already and while we just work for a couple more just quick summary of what we talked about. You know we talked about high quality threshold for stocks to get into the portfolio ROEs, low ideally no debt, very strong competitive advantages that could be held for long periods of time, we talked my conviction in allocation not investing around the index not equally weighting a portfolio and what team really have touched on but again worth reminding you know they've been investing since 96 they've excelled during the last crisis and significant and that alpha has come the we talked about in that slide is coming both up and down markets.

Let's jump to some questions. One here on the shape of the recovery will we see a V U or L shape recovery and what is the expected timing please?

Mark Arnold:

It's a very dynamic situation you're facing so it's quite difficult to know in the short term how things are going to play out but as we said before we're really facing a low growth world regardless so there will be some recovery it may be an initial recovery and then a relapse if the COVID-19 cases start to accelerate again as the lock downs pulled back. So difficult to know over the short term but we think regardless you're really facing a growth constrained world.

Ed Reekie:

Thank you and one here: given the unforecastable and wide range of potential economic scenarios and the length of economic downturn recovery how do you make revenue estimates for these companies that you're modelling?

Jason Orthman:

Yeah well we really need to look out as business owners over the next five to ten years we talked about setting that internal rate of return over five years so of course we make a good effort to actually forecast where the revenues and earnings will be over twelve months but really to set your intrinsic value you need to actually have a look at what the underlying economics are and so and most businesses it's difficult to actually forecast out that long but if you get a rare collection of elite businesses that are market leaders have predictable earning streams you know really strong business moats you've got a better chance than most to be able to do that so most of our peers can't follow that process through but it really comes down to the quality of the companies you invest and really taking a long-term view which is which is really important of course you need to survive any containment crisis so you need to make sure the balance sheets strong but when you look at out at our balance sheets in our portfolios often the companies have net cash and certainly that's up you know between 50 to 75 percent of the portfolios have net cash depending on with which one you which one you look at so really taking that long-term view and making sure you don't get wiped out

on the journey is really important.

Ed Reekie:

Thank you for your questions I'm sort of noticing they're falling into kind of macro and stock specific so what I might do is sort of still talk about sort of focus on more the macro level and then the sector level and then we also jump into the stock specific ones. Does the panel foresee an increase in corporate defaults occurring in the near future if so what are your views are the impact on global equity market valuations?

Mark Arnold:

Yes, we think that it's pretty likely that debt defaults are going to go up pretty dramatically and there's going to be lots of implications as a result of that but one of the main ones will be that there will be a lot of emergency capital raisings at really low prices so there'll be a lot of additional chairs on issue and that's that will give us the potential to further outperform because our businesses generally won't be raising capital at really low prices and so the dilution in our portfolio won't be as high as what the overall markets going to suffer.

So during the GFC or just after the GFC there was around a 25% increase in the number of shares on issue in the Australian market and you had similar situations globally as well and so that's a key reason why the EPS of the benchmarks in Australia is still below the peaks that were achieved prior to the GFC so even though the profit growth is exceeded generally the pre GFC profits the EPS is still below because of their 25% increase in the number of shares.

Ed Reekie:

Thanks Mark there's another one in here also in this other equity raising space can you sort of give us some feel for what you think is happening in terms of both globally in Australia the kind of the quantum I guess of these raisings and I guess implicit in that is there any environment which you might participate in one of those raisings?

Jason Orthman:

Yeah it's a really good question because some of those capital ratings can be attractive if it's not so dilutive and if you're actually fortifying your balance sheet and you can come out quite strong. So if you're doing raisings of say ten percent of your enterprise value and you can fortify that fortify that balance sheet against your competitors that can be quite attractive so you know we participated in in cochlear and Ramsey for example.

The real issue is when you get that huge dilution in emergency capital raisings and we've seen that through things like WebJet and Flight Center and to Mark's point earlier it's really that that dilution is permanent and it's really hard to earn that back because the more shares on issue you need the profits to actually exceed that over time so I think when you're looking at your capital raisings and it is quite attractive now with share purchase plans of up to 30,000 across each of your accounts really try and distinguish between whether it's you know a small capital raising to ensure this business comes out stronger and can invest and they often can be good capital raisings for quality businesses, but it's certainly those emergency raisings where you have significant dilution it's probably best to um avoid them because you'll pay for those sins for a number of years.

Ed Reekie:

Thank you. Lots of questions coming in so apologies in advance I'll try and sort of bucket them

together I guess so that we can try and address as many as possible. A lot of questions here about you know which sectors, I guess industries, market sectors are going to suffer from permanent dislocation? So office, business that kind of area.

Mark Arnold:

Yeah there's lots of sectors that'll suffer. Capital intensive, highly geared sectors so like oil the oil sector's an obvious one that's because the oil crisis is created that's going to cause a lot of stress in in in that sector. Physical retail that was suffering anyway and now with the COVID-19 crisis and the lock downs and that's you know really suffering badly so there's those sorts of sectors. As well as anything that's exposed in terms of business models to basically they need physical contact between the business and clients that's those businesses are under stress and particularly those businesses that are capital intensive and as a result of that being capital intensive got a lot of debt those two things in combination mean that those businesses are they're really under threat in terms of survival.

Ed Reekie:

We will come back to sectors, we're getting a fair bit of currency type questions in here with countries responding differently to COVID, some currency volatility might be expected, how do you handle this? What's your view on the AUD? Do you hedge the fund? Can we have some sort of currency or sort of currency thoughts please?

Mark Arnold:

We think that the US dollar is probably going to be remain the reserve currency of the world we can't really see that changing anytime soon so we think the US currency over time should remain fairly strong. Obviously, they'll be periods of weakness but generally there's no real alternative we don't think to the US dollar so we think the US dollar will stay strong. In terms of the Australian dollar outlook it's difficult to say but we you know we think that commodity prices generally will be under pressure over the next five to ten years because we think that China is geared up there's a lot of debt in China now we think that the big spending programs that they had undertaken since the GFC have in a way artificially or temporarily pushed commodity prices up and margins up for those commodity producers, we think that there's downside risk there over the next five to ten years as the as the Chinese economy continues to slow so that would put downward pressure on the Australian dollar.

The problem that the Australia has as well is we've got a lot of household debt and that debt is held predominantly in US dollars so it just means that if the dollar goes down that means that that debt has to be repaid in US dollars so that's another sort of pressure point for the Australian dollar. So the product isn't hedged and the reason for that is well number one currencies are difficult to forecast but most importantly we think because of that compounding that we spoke about of the EPS so running at twenty percent per annum of thereabouts for most of our products that compounding effect of that EPS is going to swamp any currency moves over long periods of time so we're quite comfortable having an unhatched product because we think that the even if for the Global Fund even if the Australian dollar does go up that twenty percent are compounding over longer periods of time is going to dominate the return program.

Ed Reekie:

Thank you lots of questions on whether that fund performance on slide 13 was net or gross I can tell you that's all net, so thanks for your question on that. Let's talk about luxury, you know obviously

luxury so one question here are you still positive on luxury stocks like Ferrari, Hermes, LBMH that probably captures most of the questions on that

Jason Orthman:

Yeah absolutely, when you take a long long-term view and again we want to hold these businesses for them for the next decade plus if we can and clearly when you know fifty to sixty percent of you your store networks being shut down in this containment that puts pressure on your on your short term revenue stream but the positive structural themes and earnings outlook over the next five ten years remain unchanged and sometimes when you're a long-term investor you do need to adjust your expectations like as we mentioned earlier this containment crisis has been a lot more vicious in the short term than the GFC so when you look at some of the businesses that we own in the luxury space and the brands that they have like the Louis Vuittons the Guccis the Ferraris the Hermes with the Birkin you know they all grew their revenue slightly you know through the GFC at sort of one to two percent levels which was a great outcome as many of their peers revenue fell sort of twenty five to fifty percent but as we roll through this time in the short term you'd expect that their revenue actually declines but you know simply as we mentioned that the store the stores have been shut but we still really like those businesses they've built a brand heritage over hundreds of years they've got an exclusivity and a scarcity factor and we think they'll continue to take share out of the other side and of course, we're not sitting still, like things like Moncler which sells luxury snow jackets they'd been a large winner for us over a number of years we actually did exit that through this crisis as it starts to mature and as it's a single product but our learnings over time has been you always want to be at the top of the pyramid in terms of quality be with those elite businesses and that's certainly the case with the ultra-luxury and those brands again such as Louis Vuitton, Gucci, Birkin they'll probably still be around in another 100 years and they will take share from you know the Pradas and the Burberry's and so we're very comfortable with where we sit.

Ed Reekie:

Lots of questions I think drilling the same kind of thing which is portfolio turnover over the last two to three months. I guess to summarize these questions is you know how much turnover has there been, has it been driven by great once-in-a-decade opportunities coming in or has it been driven by the need to trim some of the names that have proven to be less quality or that kind of thing I guess in summary.

Mark Arnold:

It's been a combination we do have a very disciplined framework for portfolio construction so we're calculating those five-year IRRs and we're using that to set target stock weights within the portfolio so when you get lots of share price volatility it does enable us to trim some positions where the IRR is declined where the stock price has held up better than the portfolio overall, and then invest more in some stocks that have fallen more than the average stock and the portfolio because the IRR has gone up so we've been doing a lot of that topping and tailing in the portfolios as a result of the volatility and we think that that should convert into higher alpha over the next five years. That’s what we've found using that topping and tailing process, that’s effectively doubled our alpha over the last couple of decades so having that volatility is actually pretty good for the process. We have added some stocks into the portfolio that were sitting on the bench but we've done all the work, were comfortable with the quality of the businesses but the prices were too expensive or the IRRs were too low prior to the crisis and with their share prices falling the IRR s have gone up so we've added a couple of stocks particularly in the Global Fund so that's been a good opportunity. And there has been, as Jason mentioned Moncler we sold that out of the Global Fund also Rightmove we sold that out - Rightmove is a great business but it is cyclical and it is growing at a lower rate than

the average.

Ed Reekie:

Mark just to interrupt we've had a couple of questions specifically on Rightmove so do spend just a few seconds just on that – the exit of Rightmove.

Mark Arnold:

Yeah so that that's been that was at the lower end of the spectrum in terms of sustainable growth so we thought that that was sort of a 10% top-line organic story over the next five to ten years with some cyclicality in the business as well, but just because of its exposure to the UK property market even though most of its revenue is subscription but it's still underlying the real estate agents if they're really suffering then there is some cyclicality there. So we sold that because we think that the average revenue growth over the next five years for the Global Fund for the other stocks in the portfolio sits at about seventeen eighteen percent per annum and so right Rightmove sitting down at sort of ten percent per annum was at the lower end of the spectrum so we've just taken the opportunity to sell that one and add some other stocks that are growing at higher rates.

Jason Orthman:

It's important to highlight, like it's a good point because when you look at the domestic Australian markets it is it is a shallow universe so we have the 20 best businesses we believe listed on the ASX boards and so we've only added one name into the small cap fund and one into the Australian growth companies fund. The benchmark is full of average businesses that we believe all will slowly die and over the next decade plus so the opportunity is pretty shallow but when you go globally you know there's 20,000 companies you can look at and we move that 20,000 down to a hundred. So in our view there's only a hundred names that could be potentially come the next blue chips or the next winners and if as you move that down further there's only really 35 stocks outside our portfolio of 21 names that we think could make it in but you've seen we spent a long time on that internal rate of return chart we actually try and value structural growth and so a lot of these businesses on the bench globally have just simply been too expensive because they're fantastic businesses and they don't come cheap that often and often you need some event whether it's a short report or whether it's a crisis like we have so I think we've added around four names through this crisis into February and March and some of these names we've been following for three four five years but the internal rate of return for was simply so low so to Mark's point we've been able to upgrade the quality even further through this period and we're pretty excited, what that means for the portfolio is we look out over that over the long term.

Ed Reekie:

I'm just in terms of quality, you know you've been following a stock for five years and what work have you done five years ago? You know what does that involve to get onto your radar as a serious candidate?

Jason Orthman:

Well we've got a structured process and we've been trying to execute on that over you know the last 20 plus years so before even we get to that valuation stage, we do a business quality score on every business. So if you look outside of Australia there's a business quality score produced on a hundred names globally and that's produced through a research - we call it a research template - which is detailed, it's uniform, there's a hundred twenty-five pages you get through within that business quality score. There's two elements there's the quantitative and the qualitative and broadly speaking

if you look at the accounts of a company there's financial indicators or imprints effectively, demonstrating it's a quality business. Things like high return on equity strong balance sheets a track record of double-digit organic sales growth they form part of our assessment of quality but the other 70% is really the qualitative elements and that's the soft stuff and that's where you need to be good business analysts and think like business owners they're things like your value proposition why do customers go to this product or this service rather than others why do they come back when it's tough, you know what is the sustainable competitive advantage? You've got these really lucrative earning streams high margin businesses people are going to compete what is the moat that stops those lucrative returns being eroded? So before we do anything we look at we develop a business quality score and really try and protect ourselves and investors and make sure we're in these elite businesses but then clearly the valuation comes into play and as we mentioned earlier we can wait five years to get a chance where we think the risk-return scenario is right for us to make a significant investment.

Ed Reekie:

Thank you, just a couple of other things a few questions on can we have a copy of the presentation afterwards, yes absolutely we'll make sure that's mailed to you. A few questions on stock numbers across each of the portfolio's pretty much it's 20, 20, 21 something like that. As Jason mentioned it's kind of one in one out you know, the intention is to not let that become 23, 25 or whatever and that's why the turnover when these once-in-a-decade opportunities come from new stocks to come in then you know really that's kind of one in one out so the one with the lowest or lower IRR gets pulled, dropped out the bottom of that quality filter so that's I guess that a couple of questions on turnover which we kind of covered it runs it name turnover across the portfolio it runs at about ten percent only per year i.e. these companies are typically in the portfolio for ten years. That's what quality brings. Great quality companies with strong sustainable ROE deliver year after year after year after year.

Let's talk quickly about healthcare lots of questions on healthcare let me try and get a specific question about it, basically you know what's your view on healthcare, what are you playing it both globally and domestically what are the opportunities?

Jason Orthman:

Yeah well when you're looking for a modern portfolio and you're looking that for those next blue chips obviously healthcare is a place to be because typically those companies have large cap free cash flows and they can innovate and invest in the next products and you know we're obviously critical of the quality of the Australian benchmark but you know one bright spot within the ASX is healthcare.

I mean there are some global leading names and they're in some of our top five positions in our domestic portfolio so CSL for example has got a 30% market share with relatively weak competitors globally and we believe that 30% market share will shift up dramatically over the next five to ten years. ResMed it as well and it was quite topical at the moment through its CPAP again it's a global market leader with a 40% market share. Fisher & Paykel when you move into hospitals and have the need to provide humidified air it's got a market share of around 80% through that acute respiratory care.

These are world-class businesses and they happen to be listed on that on the ASX and optically they look expensive with short term high PEs but when you actually compare their share prices to their long term to intrinsic values they actually look a really good value.

And then when then when you go globally it's a bit a bit of a different environment there's a lot of large conglomerates like you Johnson and Johnson's and your Medtronic's which are typically pretty low growth and you can see by a presentation really the returns that we've made have been through compounding at high double digit rates so we're not interested in them. And then and then there you've got your big farmer or your biotechs which again Hyperion is evidence-based so we will not take any speculative risk, we will protect and grow your capital.

So counterintuitively when we look globally it's actually relatively difficult but one thing the crisis did do is the handful of healthcare names that are on our on our global bench we were able to start purchasing some of them and Intuitive Surgical is one of those examples and that's a business we've watched for a number of years which was very very expensive and has de-rated over time and we took the opportunity to purchase that over the last couple of months. What Intuitive Surgical does, it's effectively got a monopoly in robotic surgeries in hospitals, so when you look around the world only 2% of surgeries are done robotically and they're effectively the da Vinci system or Intuitive Surgical System so it's got a fantastic product, it's got an effective monopoly and that didn't come cheap and when we look at it because the value proposition is so strong: it's minimally invasive, it steadies the hands of the surgeries, really most surgeries should be done through robotics and we expect that that will happen over the next 20 years. and we're delighted that we've been given the opportunity to add that into the global portfolio recently.

Ed Reekie:

Thank you. Cash levels and you know, across the three portfolios where does it sit relative to history? When you're getting large inflows what sort of considerations about whether to leave that in cash for a period or whether to put it straight in the market?

Mark Arnold:

The cash levels have been elevated for over a year so we're running double digit cash weights across the three products generally over the last that's probably eighteen months and then since the crisis hit we have deployed some of that cash. So the targeted cash weightings have come down from sort of low double-digit levels down to high single digit levels and depending on the opportunities that those cash weights could come down if there's if some of the stocks we're interested in do sell-off off over the coming months.

So it's a really quite a structured process again so as the IRR after the portfolio moves up we tend to move our cash weights down to take advantage of those higher future returns.

Ed Reekie:

Drawdowns, couple of questions on drawdowns. You know where does relative drawdowns look during this periods during the GFC things like that?

Mark Arnold:

Yeah well because we focus so much time on getting that long term, you know, structural growth there is a perception that it becomes harder for us in tough conditions where the contrary is actually correct. So Hyperion's actually a very defensive manager and it comes back to that thing we talk about protect and grow.

The first thing we always do is make sure that we own these great businesses and pay a fair price so we don't suffer any permanent loss of capital. So and if you've got these businesses that are quite rare, that can grow at these levels and can do so defendably and predictably that's actually quite

valuable, so the share prices tend to stay up so in tough or slowing conditions Hyperion tends to tends to outperform and in fact when conditions are quite soft and quite easy, often junk will rally, commodities will rally, speculation begins and Hyperion might may struggle to keep up over short periods of time.

If you look at since the GFC - now like in fiscal year '09 Hyperion performed really well in our Australian growth companies product in fiscal year '09 we were flat and the market was down 20 percent so there was 20 percent alpha or 20 percent outperformance and you roll forward to today, funnily enough in the Australian growth companies fund we've produced 20 percent alpha or outperformance again over the 12 months to the to the 31st of March.

So broadly the Australian growth portfolio is up 5% and the market was down 15% so Hyperion is actually very defensive, can capture our performance in up and down markets, and it's something we you know we probably should do a better job of explaining going forward.

Ed Reekie:

We've had come the questions actually just in terms of you know the performance of the Australian Growth Fund you know over ten years five years three years and one year I think the questions are implying you know why is ten year numbers 8% and then it declines down to six to five you know over one year but my response to that is look at what the index did you know the index over that time period has gone from plus 5 to minus 15 so you know index performance has absolutely cratered and the Hyperion Australian growth companies has been able to retain you know a high single digit return through that period which you know I think speaks for itself with the whole protect and grow philosophy we've got.

I mean I've just noticed it's one o'clock thank you everyone for staying on and being very loyal. One last question and then we'll wrap it up, which is localization lots of questions about you know does this change localization is there an opportunity for people to extract manufacturing out of China should they be doing it what's your thoughts?

Mark Arnold:

Absolutely yeah, I think the problem has been that everyone's been super focused on efficiency and they have just ignored redundancy and they've just gone up the risk curve by concentrating all of their supplies in one geographical location. So if you're a global business it doesn't make sense like even if you're saving a little bit of money having it all in, you your whole business is reliant on one geographical location, we think that that's pretty risky, and the world's been doing that for a long time. We just think that over the next ten years and beyond that there will be more thought about redundancy, about risk mitigation, those sorts of things having situations where there's effectively one country that controls a lot of you know critical medical production related equipment isn't smart so we think that that will change. It's not going to change overnight but I'm pretty sure people be thinking about reducing reliance – sole reliance on one supplier in one geographical region - and trying to spread that risk and making their supply chains more robust and building in redundancy.

Ed Reekie:

Great well 1:02 I think we could carry on. It's interesting about 20 minutes of conversation and 40 minutes of Q&A. Thank you everyone for being on the call, for your participation, for your questions and massive apology I think I managed to probably indirectly answer about a third of what we had and I'm aware there's a lot of big questions there that we haven't been able to answer. So I guess what we're trying to is weave the responses in as much as we can into the next webinar that we do

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which we'll do very soon and try and make sure that we circle back and get those responses to you.

All the funds are open so you can apply for all three funds the Global Fund can actually be done online but all the others can be done just by getting on the Hyperion website and getting in touch with the Pinnacle team who will happily help you fill in paperwork etc as you need.

I hope you got value today from this I could say we're doing it again soon so please feel free to forward the invite that you get to your colleagues and friends, or those who you feel would have interested in one of these three funds, and we look forward to picking up the dialogue with you again and continuing that dialogue.

Thank you Mark, thank you Jason and thank you all for attending goodbye and look forward to speaking again soon.

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