Webinar and Live Q&A: Revisiting a low growth, low interest rate and low inflation world through COVID-19

Jolon Knight (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.

Jolon Knight:

Good morning all. Welcome and thanks for joining us today for Hyperion's webinar: Revisiting a low growth, low interest rate and low inflation world through COVID-19. My name is Jolon Knight and I'm a BDM for Pinnacle Investments. Pinnacle are equity partners, and work alongside Hyperion to distribute their award-winning suite of investment strategies. Today I'm joined by Hyperion CIO, Mark Arnold, and Deputy CIO, Jason Orthman. For those of you who are new to Hyperion, Hyperion is a client-centric alpha-seeking business with the primary focus of protecting and growing client's capital sustainably over the long-term, through their philosophy of investing in only the highest quality businesses. Their approach has resulted in above benchmark returns for their clients over the long-term. Hyperion has been successfully managing listed equity portfolios for clients since 1996, and currently manages approximately $10 billion on behalf of their clients, including around $2.4 billion in the Global Growth Fund[1], which has been up and running for a little over seven years now.

The Global Growth Fund, as you may know, is accessible on the ASX, as an active ETF under the code HYGG. It's important to note that this is exactly the same fund that you may access directly via a platform such as Netwealth, HUB, BT, or through their online or paper-based application that you can see through their website. I'll try to keep today's discussion to around 45 to 50 minutes. Thank you to all that the pre-submitted questions, as they will be making up the bulk of our discussion today. Apologies if we don't get to all your questions. We will endeavour to send a response through to you after today's presentation. You may also send questions through as we go, through the little chat tab down the bottom there.

Today, we will be revisiting the thesis that we are in fact, in a low growth, low interest rate and low inflation world. We will look at:

- Short- and long-term outlooks for inflation and interest rates;
- Why changes in bond yields and discount rates have a one-off impact on valuations, and whether growth stocks are looking overvalued from the recent surge in inflation and long-term rates;
- The additional structural headwinds that may impact companies globally;
- How Hyperion identifies these modern businesses, that may have strong value propositions and may grow their revenues and profits organically, regardless of these changes in inflation; and

[1] The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

- Examples of companies that have strong pricing power, even in this inflationary environment.

With that, I think I'll jump off to the first question. Just let me share our screen with a few slides, to Mark Arnold. The first question we've got here is, *"The market has begun to worry about higher interest rates. Can you talk through the levels of debt in the world and whether the world can actually handle them?"*

Mark Arnold:

Thanks, Jolon. Good morning, everyone. Debt levels are at historical highs in most economies currently. The world has been increasing financial leverage dramatically since the 1960s and it's been building at a faster rate than the overall economy. Government debt, corporate debt, and household debt, have all increased at rates faster than the overall economy. Increased financial gearing has boosted historical growth rates because people could spend more than they earn. Much of this debt has been used in unproductive assets. Lower interest rates have hidden the impact of higher financial leverage. Significantly higher interest rates would cause substantial financial stress in most economies around the world. This would lead to negative economic growth and high unemployment levels, and governments around the world would lose elections if interest rates went up significantly. Our view is that the global economy can no longer afford high interest rates, because of the high debt and the high asset prices in most major economies. Thanks, Jolon.

Jolon Knight:

Thanks, Mark. Jason, we might move on to a question for you, *"We've seen U.S. bond yields moved in the past six months. How do interest rates impact your evaluations?"*

Jason Orthman:

Interest rates are directly and inversely correlated with valuation. Put simply, if interest rates are going up, terminal values and short-term metrics, such as price to earnings ratio that the markets focus on, is going down. Of course, if you've got lower interest rates, all things being equal, you've got higher terminal values and higher short-term earnings, P/E ratios. Hyperion looks out and sets intrinsic value in 10 years time. To do that, we forecast out sales, earnings, cash flows, over 25 years, but we also need to put a factor model on that 10-year terminal value. Lower interest rates are supportive of that factor model in those 10-year valuations. What Jolon has put up here on the slide is really what interest rates have done over a long period of time.

I think there's two key points here. One is interest rates have been in decline and this is 10-year U.S. bonds from the '80s. That is really with the financialization of society. The second point is, if you look at the 10 years prior to COVID-19, these 10-year U.S. bond yields have averaged around 230 basis points and that's what we consider the new normal, and that's how we set our framework. As we push through COVID-19 and think about the next 10 years, we're setting our long-term valuations at 250 basis points. To put that into perspective, today 10-year U.S. bonds yields are around 120 basis points. If anything, we actually think our forecasts are pretty conservative. The recent moves in bond yields, hasn't had any impact on our long-term valuations or intrinsic values.

Jolon Knight:

Thanks, and what causes inflation and why has there been a massive amount of money printing by the central bank since the GFC? Has this really had an impact on inflation?

Mark Arnold:

Thanks, Jolon. This is a pretty complicated question, but I'll do my best here. Inflation represents a decline in the purchasing power of a currency. If we talk about consumer-based inflation, it can be sourced from several different areas.

Firstly, you can have an exercise of market power. An example of this would be the OPEC cartel. This is normally called “cost-push inflation”. You can also get inflation from governments printing money and injecting that money into the real economy. Note that this is different to “QE” or quantitative easing, and I'll explain that in a minute. Thirdly, banks can create credit and that can be used to fund excessive consumption growth. This is normally referred to as “demand-pull inflation”. Governments, via central banks, printing money and injecting it into the economy, into the real economy, is not quantitative easing. Normally the central bank is separate from the treasury. Governments normally fund deficits by borrowing. They don't normally fund deficits by printing money. QE does not actually cause consumer-based inflation, but it does create a type of money. QE really involves central banks creating reserves out of thin air. The transaction normally, that creates money, is at the central bank or buyer security. So it's effectively an “I owe you” from a third party. Then the central bank creates an “I owe you”, so a liability to that party, to fund the purchase of that security. This “I owe you” is defined as money. It turns into basically a bank deposit or a central bank reserve. As I said before, this does not actually create consumer inflation, because all you're doing is swapping an “I owe you” between financial institutions, including the central bank. Most of the money that quantitative easing creates, doesn't actually enter the real economy. It just stays in the financial sector. On the other hand, commercial banks do have the potential to create money that is actually used in the real economy, and they effectively create money every time they write a loan. So normally commercial banks create most of the money in the economy, not the central bank. Even though QE does not cause consumer-based inflation, it does cause asset-based inflation, and that's because it results in lower interest rates. Lower interest rates mean that asset prices go up.

In terms of M2 money stock, just to define that, that's basically cash, bank deposits, it's highly liquid. That's been growing very fast in the U.S., as a result of increased government transfer payments which is really welfare payments and also QE, which has been creating increased bank deposits. In the U.S., M2 money growth has been running above 20% per annum. It started to slow recently, but it has been running at very high rates. However, the productivity of this money is really low because the deposits created by QE are not entering the real economy. The productivity that I've referred to, which is quite poor, can be seen in the trend to a lower velocity of money. So Jolon has got the slide up there. The velocity of money is really GDP, or the size of the economy divided by the M2 money supply. You can see it's been trending down for a long period of time. Basically, velocity relates to the effectiveness of money, in terms of boosting economic growth. If the velocity is high, it means that money is being actively used in the economy, and basically the effectiveness of money and the velocity of money, has been declining, particularly since the GFC. The velocity of money was approximately 200%, prior to the GFC. Today it's half that rate. So just increasing money supply doesn't necessarily increase inflation and it doesn't necessarily increase growth. What you're seeing is that money supply is going up, but the velocity of that money is reducing. It's netting out to zero. Thanks, Jolon.

Jolon Knight:

So the turnover, the money, actually in the economy, it's not as what it used to be.

Mark Arnold:

Yeah, that's right. It's just, the money is being supplied, but it's not effectively being converted into transactions in the real economy.

Jolon Knight:

Awesome. Thanks, Mark. Jason, I'll throw to you on this. You often mentioned technology a lot when we speak with you. Why is technology-based innovation deflationary?

Jason Orthman:

If you think about what's happening to products from companies that are technology led or innovation led, by their very nature they have to be deflationary because you're effectively offering better products or services at lower prices. Those in the industry aim to 10 times – where you want a product that's 10 times better than the incumbent product, at a 10th of the price. Clearly that's really disruptive. If there are these pretty average goods or services at high prices, and you have something coming along that's a lot better at lower prices, clearly, that's deflationary.

When we think about what's happening with this technology and innovation, it’s becoming more and more central to our lives, and the cadence of that is increasing. So those deflationary headwinds, or disruptions are going to become more and more prevalent. The point of this slide is, if you started in the 1980s like Microsoft did, it did a few good things with its operating systems. You had the Worldwide Web coming along in the ‘90s and Google tried to sort that information effectively in the late '90s. As you push over to the next slide, a lot of those products that we use day-to-day occurred in the last five to ten years. I’ve tried to pull out some highlights there: Uber, with ride sharing and disrupting taxis, Tesla bringing out electric vehicles in 2012, and we're obviously using Zoom today, and COVID-19 has just accelerated that use. Those deflationary headwinds will become greater, not less. It is a good form of deflation, because it's good for consumers and it's good for society to have better products at better prices.

Jolon Knight:

Thanks. A good question has just come in. I will ask this one now, *"Why are we starting to see inflation increase recently? And is this likely to increase further, or decline in the long run?"* Mark, do you want to have a go at that one?

Mark Arnold:

There's a lot of short-term factors that have been boosting the recent rising inflation in the U.S. If you look at the different causes of it, firstly, you've got a base effect. 12 months ago, commodity prices were quite low, inflation was quite low, and this is resulting in higher reported short-term inflation numbers. We think that this base effect will roll off as you move into 2022. Also, you've had the effect of the lockdown. During the lockdowns, people couldn't spend money on services so they switched some of that spending to the purchase of goods. This has boosted the demand for durable and non-durable goods pretty dramatically.

This has fed through into higher commodity prices because you need those commodities to produce additional goods. You also had the price of gasoline go up. You've seen used car prices go up, airline tickets, accommodation – all of these have increased in price fairly materially since the lockdowns started to wind down. We think these price increases for travel-related and transport-related items are likely to be temporary. Also, you've had increased government transfer payments, such as welfare payments that have boosted short-term consumer demand. The disruption from the COVID-19 lockdowns affected the global supply chain as well, and that has contributed to the shortages of goods, because it has taken a bit of time to ramp the global supply chain back up. It's still not fully ramped. Also, you've had oil prices which moved from really low levels to more normalized levels. Our view is that the oil price is likely to move lower over the coming years. We think that it will be driven mainly by the take-up of electric vehicles increasing, and that's going to displace some internal combustion engine vehicles which will result in lower demand over time.

This will ultimately, result in OPEC falling to bits and that'll be a gradual process, as demand starts to decline. Obviously, lower oil prices are disinflationary. That means the lower price will be putting downward pressure on future inflation levels over the longer term. Better computers and robots, that leads to higher productivity and an abundance of goods, we think in the long term. So higher productivity growth is disinflationary. As Jason mentioned, tech-based innovation resulting in new products, better products, at lower prices – this is disinflationary.

Then on the demand side, we think that the outlook is weak longer-term. Even now you've got strong economic growth at the moment, we think that that's going to fade pretty quickly as you go into next year. The reason for that is the economic headwinds, these are structural economic headwinds of ageing populations, lower population growth, high debt levels, and rising wealth inequality in most countries around the world and that's associated with the hollowing out of the middle class. All of these factors will help ensure economic growth rates remain low, and inflation remains low in the long term. Back to you, Jolon.

Jolon Knight:

You might have answered this question just then, but on transportation and energy costs going forward, future energy concentrated applications, I guess you don't think they're going to increase in the long run now? Jason, you want to have a crack at that?

Jason Orthman:

Mark's already touched it, but really energy transportation is a really important component of the CPI. We do think over the next five to ten years the prices of transportation and energy will come down significantly and we're close to an inflection point. Society has used cheap fossil fuels, oil, and gas over the last 100 years, but the reality is now with renewables, solar, wind, and combined with storage, effectively the incremental cost at scale goes to zero. They're large industries. You've put up there $20 trillion of revenue at risk and potentially disrupted by autonomy and renewables. Again, Tesla driving electric vehicles is pretty important. Service components is a large part of the cost of ownership that goes away or largely goes away with electric vehicles.

If you actually get autonomy going, and we believe that they're close, then you take labour out of the vehicles and Uber gets disrupted as well. The cost of transport should come down significantly. If you effectively have your own power plant in your home or business, through actually having storage, the major costs of energy are transporting it around through poles and wires, you can see on this slide that battery prices have been going down at double digit rates. So, when that inflection point comes, it's going to be really disruptive. That $20 trillion of revenue could shrink on quite a lot and that's in the CPI figures, which puts pressure on inflation again.

Jolon Knight:

We've seen a lot of government spending, not only here in Australia, but globally. Do you think this increase in that government spending is likely to cause the economy to overheat and result in higher inflation, higher interest rates, in the longer term?

Mark Arnold:

No, I don't think so. We think the underlying economic fundamentals are pretty weak, generally across most economies. The increase in government spending is really just debt funded and this adds to the already massive government debt burden that is pre-existing. Basically, the money has to be repaid, so it's not just printed money. We think the government spending, if you look at it, even though the numbers seem really large, they're actually fairly small in terms of the overall global economy. Obviously, they're largely non-recurring as well.

As debt levels go up, the productivity of debt reduces. Once debt to GDP gets beyond a certain level, the next dollar of debt and the spending of that, is less effective in terms of driving economic growth. We think that most major economies, including the U.S. and China, are beyond that optimal gearing level, and the effectiveness is deteriorating. We say that because of the law of diminishing returns, and this law applies to both QE and also government borrowing. Government-funded spending obviously improves short-run economic growth, but we think it will impede long-term economic growth. QE, as I mentioned before, pushes up asset prices and that enables people to borrow more, but the government spending multipliers are low or negative, because of the previous overuse of debt. Thanks, Jolon.

Jolon Knight:

What sectors might inflation hedge if we do have that inflation?

Jason Orthman:

We've had a number of pre-submitted questions saying what happens if you're wrong about that framework and you get inflation. This question really tries to address that. Traditionally in markets, your typical inflation hedges have been things like non-fiat currencies, such as gold and commodities, maybe you go down to another level and buy utilities with CPI annual pass throughs, maybe you have some ultra-luxury brands – and we do have some ultra-luxury brands in our Global Fund – that have a scarcity factor, an exclusivity factor and have big pricing power that can pass on input costs. How we think about it as well, it has really modernized and really in the last three to five years. If you did get inflation in this modern world, and obviously we don't think you do, but if you did get that, we actually think your modern inflation hedges are software as a service businesses, modern technology businesses, those with network effects, because they're actually quite sticky within your business.

They haven't priced for value yet. Because we're early on in this journey, they're actually expanding their usage, getting in users, but not using the pricing lever. With a lot of these software businesses', the value is ahead of them and they'll be able to offset some of these input costs. On the chart here, most of the benchmarks do not have these modern businesses. If you look at Australia, the ASX 300, it's about 8% effectively that you might call tech. If you go offshore to the developed global markets, it's about 30%. Our portfolios are full of these types of "modern hedges", but that's in stark contrast to the broader market.

Jolon Knight:

Thanks Jason. Someone else has picked up on this in the chat as well. Mark, you mentioned “AI” (artificial intelligence) and robots. What's the long-term impact of AI and better, robots?

Mark Arnold:

We think that better computers and robots will ultimately result in abundance of most goods, because manufacturing will just get better and better. Innovation is going to create more advanced goods, better goods, and better services over time. So lower manufacturing costs, lower energy costs, lower transportation costs, are all ultimately going to result in very inexpensive goods. They will be higher quality compared to the goods that we have today. This innovation will result in disruption. Most industries are quite “old world”, and we think that these new products will be quite disruptive to many businesses. They're also going to be quite disruptive to human capital markets. This is over the longer term, obviously. The cost of manufacturing is going to decline, as robots and AI-driven software control more and more of the manufacturing process.

The advantage of cheap labour is going to become less relevant, as machines take over the manufacturing process. Emerging markets are likely to lose a lot of their competitive advantage that they traditionally have from using cheap labour. We think that manufacturing is going to move closer to the consumer. Transportation should get cheaper, basically from “EVs” (electric vehicles), because there's a lower cost of running an EV compared to a combustion engine car. Also, you're going to get cheaper electricity to run those cars. We think within the next five years or so, you should be moving towards the commercialization of full autonomy. That is going to enable removal of human drivers which is going to reduce the cost of transportation as well.

We think wage growth is going to be low in this sort of environment because better computers and robots are going to reduce the bargaining power of human capital. Many traditional jobs are going to disappear, but we think on the positive side, that the standard of living for most people will probably improve, because these new products and services are going to be of higher quality than the existing products, and they'll also be cheaper as well. This innovation and disruption will result in low real GDP growth in the future, low inflation, and also low interest rates. Thanks, Jolon.

Jolon Knight:

So deflationary. You touched on this, the disruption to human capital markets in a long term. Jason, do you want to dig a little bit deeper into that?

Jason Orthman:

The question is really asking what's going to happen to the labour force and hourly rates. We believe there's going to be a lot of pressure on that. If you go back over the last 100 years, a lot of automation has been really with dumb machines, effectively replacing physical exertion. Whereas moving to today and that AI and machine learning that Mark talked to is actually intelligent automation. It replaces human decision-making, human planning, human storage and a lot of the services that we use to get that targeting and to get that scale, they do use a lot of machine learning and automation. It's really scary for an average executive, office worker, executive assistant and here are some examples.

Workday, for example, which we do own in the Global Fund, is really disrupting human resources and taking workers out of those departments. ServiceNow is even broader and embedded in an organization. It is automating workflows, how you connect to IT, how you onboard, how you off-board, and how you store and find your information. It is putting pressure on roles that were traditionally done in those that can think and plan and store, and a lot of these software products are doing that. It's going to get pretty tough and we think you want to invest with that disruption and you can't fight it. A hedge against that is to own some of these type of businesses and try to benefit from their growth, where unfortunately, the average employee is probably going to suffer.

Jolon Knight:

You've mentioned a few of these, and this is a pre-submitted question. The ageing population and lower population growth long-term, that you said that was a problem earlier, Mark, do you mind going a little bit of detail there?

Mark Arnold:

This is a common problem that most economies around the world are experiencing and that includes China. They’ve got an ageing population problem. Obviously, Japan's the leader in this area, where they've got negative population growth. This is a problem because older people work less hours, they produce less income, and they make a lower contribution to GDP on average. We think that ageing populations are going to have a negative impact on future economic growth. At the same time, population growth rates have been declining in most major economies since the 1970s. Lower productivity from ageing populations, will be, to some extent, offset from the productivity gains that I mentioned before, from smarter machines. So lower population growth, ageing populations, will be disinflationary. They're going to put downward pressure on not just economic growth rates, but also inflation in the future. Thanks, Jolon.

Jolon Knight:

Thanks. Jason, with everything that's going recently in the macro developments, has any of this changed the economic framework that we're in?

Jason Orthman:

No, we don't think so. We’ve been on record for some time really, saying that the GFC was the line in the sand and that we've moved to a low growth, low interest rate, low inflation, disrupted, competitive, and globalized world. That's the framework that we operate in or that “new normal” that we mentioned. Clearly COVID-19 has shocked the system but as investors we need to look out and have to be careful of one of the main biases of the recency bias. People put too much emphasis on what's happening now, rather than looking out.

In our view, there's no point looking at the last 10 months, you want to look at the last 10 years. That's why we spent so much time on this call today thinking about what are the structural headwinds and what the next 10 years is going to look like. Our view hasn't changed. We've published a paper which is 37 pages discussing these interest rates, inflation, innovation, and what the next 10 years look like. We really try to be evidence-based, but everything we have seen at the moment is transitory and it will pass with time. The framework absolutely remains intact in our view.

Jolon Knight:

If the framework hasn't changed and we are seeing greater debt in the system as well, is the world in a debt trap now?

Mark Arnold:

We think that the world is in a debt trap. Once financial gearing gets beyond a certain level, future growth is impeded, and once you get to that stage using more debt just ends up making the situation worse. Obviously, it would boost short-term growth but that's just like a sugar hit. It doesn't last and long-term growth is impeded. As I mentioned before, the productivity of debt has been declining and that goes back to that law of diminishing returns. Japan has been a leader in the use of extreme debt and aggressive monetary policies, and the rest of the world is now copying the "Japanese blueprint". Thanks, Jolon.

Jolon Knight:

Putting that together, we're seeing these short-term rises in interest rates in short-term inflation, can you give us a bit of an explanation on how that impacts valuation?

Mark Arnold:

Inflation has an influence on both interest rates and discount rates. Inflation, GDP growth, economic stability, all of those factors have an influence on the interest rates that are used to price government bonds. In simple terms, higher inflation results in higher interest rates and higher discount rates. All other things being equal, higher inflation results in lower present values. The way to think about it is a discount rate is really a bridge that connects the current values of assets and businesses to the future cash flows of those assets and businesses. Discount rates comprise both interest rates, government-type interest rates, and also risk premiums, that relate to the particular security. Higher inflation is bad for an economy. It increases uncertainty and that gets built into increased risk premiums and higher discount rates. Higher discount rates normally result in lower P/Es. That is really what you saw in the 1970s, when inflation got out of control, P/Es for the overall market dropped pretty materially.

That does assume that the businesses that are affected by higher inflation and higher discount rates can't pass those higher input costs onto their consumers or their customers. We think that high quality businesses with strong value propositions generally do have the ability to offset the impact of higher inflation on their cost bases. We have lots of examples in our portfolios of businesses that we think have the ability to do that. If a business can do that, so they can pass on higher inflation costs to their customers, that effectively means that the nominal free cash flows increase, and the real forecast future cash flows are stable. So higher inflation doesn't necessarily mean that the P/Es for these businesses come down. Thanks, Jolon.

Jolon Knight:

Thanks. You briefly touched on it before and a question that came in earlier, if we do have these higher interest rates and higher inflation, how are most businesses placed to deal with these external macro pressures?

Jason Orthman:

Well, most of the businesses that are on these listed exchanges are probably poorly placed because they do tend to be average large businesses that are maturing. It really means they're relying on the broader economy for growth and their future revenue and earnings. If you've got input costs pushing up your funding costs, higher interest rates, and higher input costs, it is actually hard to pass that onto the consumer because the consumer has many alternative choices. They've been trained, particularly in a modern transparent world, to look around on prices. The vast majority of companies are really going to struggle to adapt. We've revisited with this slide what percent of the benchmarks are “old world” and “new world”. As a reminder, when we talk about “old world”, these are businesses that are not growing or only growing slightly, are being disrupted by a more modern product, and are probably not relevant to the next generation.

The ASX 300, in our backyard, we believe 79% by weighting old world. There is a lot of fundamental risk in these businesses. When you go to the global developed markets on the left, the MSCI world, it's not that much better. Our estimate is that 63% is old world. They are really relying on what happens, and they can't control their own destiny. If you push forward to the next slide, we've tried to refresh some of the data. This is the top 20 companies by forecast revenue and we can see here that out of that top 20, there's only three that are actually “new world”, modern, growing, and relevant to the next generation. That's Amazon in spot number one, and you could argue Apple in number five, and then Alphabet in 15, which owns Google, YouTube and Other Assets.

There is around five and a half trillion dollars of revenue that potentially will be disrupted. When you run down that list, interestingly a lot of it is traditional oil and gas, and traditional auto companies. We highlighted through this talk, we believe we're at an inflection point where there's more modern product that will disrupt that. To loop back to the question we think it's pretty difficult for your average company to deal with some of these issues.

Jolon Knight:

We have the short-term valuation metrics and the question is, how relevant are short-term valuation metrics to you as long-term investors?

Mark Arnold:

We believe that long-term investors should focus on long-term metrics. Assessing a long-term return profile of a high quality structural growth business by using short-term metrics is not the way to approach the problem and to get good results over time. Exceptional businesses are extremely valuable because of their long-term growth potential. Short-term P/Es become less relevant, the higher the sustainable growth rate for a business is over the longer term. Long-term metrics and long-term growth and the fundamental risk of a business are the important criteria to assess. Short-term metrics are less relevant or not relevant for that process. We think that focusing on short-term metrics is likely to result in poor investment returns over the longer term. We think that buying and holding structural growth businesses is an important way to grow wealth over the long-term. We've got the example of Amazon that we have used before, but we think it carries a really powerful message.

If you're just focusing on short-term P/E ratios, you'd never have bought Amazon. The average P/E for Amazon since it listed in 1997 has been about 94x which compares to the average P/E for the MSCI World Index at 16x over that period. For many years, Amazon was actually loss-making, but it always produced positive free cash flows and we think that that's much more important. The sales growth per share since IPO has been 143,000% - that is quite powerful in itself and has resulted in the share price which has compounded at close to 38% per annum, compared to the MSCI World growth of about 5% per annum, over that same period of time. There are other examples as well. We've used Microsoft before as an example, but Amazon really emphasizes that message that looking at short-term metrics is probably going to be wealth destructive if you're missing out on the best businesses in the market.

We think investing in structural growth businesses at an early stage is really an important determinant of long-term returns that you achieve. Waiting until a business has penetrated most of its addressable market is likely to result in lower returns in the long term. We think that many of the most alpha enhancing investments that Hyperion has made was where a business, in a qualitative sense, has proven that it has a superior value proposition and that that value proposition is sustainable over the longer term, but it was still loss-making at that stage. It hadn't reached scale at that stage, and it was still investing heavily to exploit that really large addressable market. We think investing involves looking forward, not looking backwards, not focusing on short-term metrics, and instead focusing on long-term fundamentals. We think if you can do that, then you're going to be very successful as an investor over the long term. Thanks, Jolon.

Jolon Knight:

This next one's a bit of a crystal ball, and by far it's the question we've been asked the most prior, and even today. Jason, *"Are major stock markets overvalued currently?"*

Jason Orthman:

We don't think they are if you look at the current economic framework, which means interest rates stay really low and the actual earning streams currently are maintained and not disrupted. In that framework, markets are not ridiculous. The thing that concerns us is there is levels of optimism that those scenarios will be retained, and investing is all about looking forward. We think that an average business, or effectively a benchmark, will struggle to grow its earnings at low single digit returns over the next 10 years. The concern is of all this disruption that we're talking about continues to come down the pipe and continues to increase. There is potential downside to that forecast of effectively low single digit earnings, or low single digit returns. Our portfolio, we believe is a lot better placed, because it does have that structural growth.

This slide tries to put in context of what is going on in Hyperion's portfolio. Again, this is backward looking, but that dotted green line is the earnings per share of the Hyperion Global Growth Companies Fund[2] over the last seven years. It has been compounding at about 19% per annum. The black line, effectively the portfolio, has followed that. The dotted blue line is what's going on in the MSCI World, in terms of earnings, and again, the Index has broadly followed that. The thing to worry about is, as the leadership of the market changes and gets disrupted, you could have some really big swings and roundabouts, as the next market leaders come into those top 20 revenue earners and become large components of the benchmark. We believe gone are the days of relying on what the benchmarks and the broader markets are going to do, and you need to be really, really selective. We own 24 stocks, we don't own 20,000, and we think that's a more intelligent way to hedge against some of that risk that we see coming down the trail.

Jolon Knight:

[2] The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

Okay. This one's a bit of a devil's advocate – what if you're wrong, what if inflation does move higher over the term. How do you think the Hyperion Global Fund is positioned going forward?

Mark Arnold:

We think the stocks in the global portfolio have significant pricing power, and that pricing power enables the management teams in those businesses, to drive organic growth. The businesses have innovative cultures generally, and that enables them to produce additional features to their existing product set and to also produce better products over the long term. So that puts the stocks that we have in the Global Fund[3], in a really good position to be able to offset any material increase in inflation in their cost bases. As I said before, if a business can increase its revenues to offset the increase in costs, it means that their nominal earnings and free cash flows go up, but more importantly, they maintain their real free cash flows and earnings, and that effectively helps retain the present value of those businesses.

The other advantage that these businesses have is they're growing at very high rates. We think over the next 10 years, stocks in the Global Fund[3] should be able to grow their revenues organically, at something like 23% per annum. Even if you get a one-off impact of higher interest rates and higher discount rates, the businesses have the ability to recapture any lost value as they compound up and their intrinsic values are driven higher by their future earnings.

Jolon Knight:

Thanks. Jason, do you have any examples of these companies that have the ability to handle any inflation, their pricing power in the products that they offer?

Jason Orthman:

When we think about it as broadly, a couple of buckets it's obviously those modern software businesses, and then there's the ultra-luxury businesses, which have strong pricing power. Some of the examples that we use are Tesla on the left. In a way that is a modern ultra-luxury company where a lot of the products in its suite have a lot of demand, and Tesla can't meet that. If you even look at the Model S and Model X at the moment, and try and order one of those from Australia, they're expected to be delivered in late calendar 2022. There's certainly not a demand issue there for Tesla and they could pass on any input cost pretty simply.

Then there is Salesforce, which really do win business or retain business. You need a modern storage mechanism, and Salesforce starts you off on a really low monthly fee. Increasing that a few dollars or even tens of dollars a month, we don't think businesses would blink at something like that. When you move to Tencent, some of these businesses haven't priced for value and have really under monetized it. If you look at all its apps and its userbase, there are a billion people in China sometimes using its services for hours a day. Looking at Tencent's take rates and comparing them to Western business models, they haven't actually closed that value gap. So again, this just means you can put prices up.

Finally, Hermès, which is really its flagship in the Birkin handbag. If we go back on our estimates, look at the last 30 or 40 years, and look at a second-hand market of Birkin handbags, it looks to us that they have increased year-on-year at double digit rates. It is nearly impossible to purchase one of those. Hermès has

[3] The name of the fund was changed from Hyperion Global Growth Companies Fund – Class B to Hyperion Global Growth Companies Fund (Managed Fund) on 5 February 2021 to facilitate quotation of the fund on the ASX.

that supported second-hand market, and the scarcity and exclusivity factor. There are not too many businesses that can have higher prices on the second-hand market, and it can push up at those levels with consistency in those levels. The pricing power in the Global Fund[4] is really, really high. There is a cross section of some of the stocks.

Jolon Knight:

Thanks. I'll have to keep an eye on that second-hand handbag market, Jason. Next question, I'll throw to you, Mark, *"Are you concerned about the recent rotation to value stocks, and I guess how the Global Fund has compared maybe even to its benchmark over the year?"*

Mark Arnold:

No. We haven't been concerned by the rotation to lower quality stocks. We take a long-term view, and we think it's a good opportunity to increase exposure at better prices on any weakness in the stocks. We're not concerned because we think the intrinsic values of the stocks, we have in the portfolio have been increasing over that period of time, the last eight months, with the rotation. Any decline in the average value of the portfolio enhances the future likely returns. The fundamentals haven't been changing or going in a negative fashion, they haven't been declining, and as I said before, they've been improving. We think that it's just a temporary transition.

We think that the growth is abundant at the moment. It makes it quite easy for short-term traders just to sell our sorts of stocks and buy lower quality stocks, but that's going to be very temporary. We think, as you roll through into 2022, the growth rates in terms of profits and sales growth for low quality stocks, is going to decline pretty materially, and the contrast and the dispersion in growth will expand significantly when that happens.

Jolon Knight:

Thanks. Have there been declines in the intrinsic value in stocks in your portfolio, driven by this value rotation, or is it just purely a short-term rotation?

Jason Orthman:

The intrinsic values have been pushing higher, and particularly after COVID-19 for the companies that we own. Because again, capturing the earnings streams in a 10-year period is the fact that, more and more customers are using these products and you need to act remotely, pay remotely and in a digital into digital fashion. Our intrinsic values have been pushing meaningfully higher, and you can see that in the quarterly results. Even though it's getting lost as Mark mentioned, because there is an abundance of growth with this reopening of the economy and the second quarter is potentially going to be peak growth, you're cycling when really COVID hit 12 months ago.

If you look at the evidence and look at some of our companies, again like Tesla and their first quarter grew revenue 74%, Facebook was something like 48% and Square, when you strip out some of the anomalies and movements around Bitcoin, gross revenue at 44%. We're about to go into the second quarterly results, and they basically start on the 27th, 28th, and 29th of July. Certainly, the intrinsic values have been

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pushing higher on our modelling, and the sales, earnings, and cash flows, have been really, really strong. I'm really happy with the fundamentals of the portfolios.

Jolon Knight:

A follow up question to that is, why do you think there's been a rotation to these traditional value stocks in recent times?

Mark Arnold:

It's really just short-termism. It's where the market is focusing on short-term growth. As I said before, there's an abundance of short-term growth at the moment. So it's an easy decision for a speculator, or a short-term momentum player in the market, to basically sell growth stocks, because the dispersion between the growth, the underlying growth rate of these growth companies and an average business, has reduced or disappeared in some cases in the short-term, but we don't think that that is really relevant. As I said before, it's actually a buying opportunity if there is any weakness in the share prices of our stocks, because the fundamentals are still good and they haven't deteriorated. Time is our friend, because as you go through time, the cash flows are going up at double digit rates, and that really just provides a buying opportunity. Thanks, Jolon.

Jolon Knight:

Thanks. Do you think this rotation to value will be maintained as we go through this cycle?

Jason Orthman:

I think with its very nature, it can't be. This is because of the role of what markets are supposed to do, which is to allocate capital effectively by looking forward and allocating to higher returning businesses away from lower returning businesses. It doesn't make sense, long-term, to sell your structural growth winners and the next world's best businesses to speculate on commodities, or lower quality businesses. Over long periods of time, equity markets are really good at allocating capital because capitalism is really disruptive. It's very difficult to see how it can go for long periods of time. In short periods the market gets lost and that’s the inefficiencies we exploit, but as I said, at it's very core, it's hard to see how you can compound and grow wealth by selling your winners to buy losers.

Jolon Knight:

Awesome. Well, thanks a lot for that guys. Unfortunately, that's all we've got time for today and that is on the hour. Some really good insights there from both Mark and Jason on inflation and interest rates, and the view of how they're thinking about companies as they move through that business cycle. As long-term business owners it really is encouraging to see that the companies that they search for are these modern businesses with strong value propositions, with a few examples we got given there, that may grow their revenues and profits organically, regardless of the changes in inflation.

As I mentioned earlier today, the Global Fund[5] is accessible on the ASX, as an active ETF under the code, HYGG. It's very important to note that this is the exact same fund that you may have accessed previously

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on a platform such as HUB, or Netwealth, or BT, all exactly the same as through the online platform on their website or the paper-based application.

Hyperion have been winners of numerous awards over the years. Most recently, they did win Fund Manager of the Year Award for 2021 from Morningstar. As I said earlier we will be sending you all an email with a follow-up to a replay of this webinar today plus the slides. If you want to dig a little bit deeper into inflation, there's a really good research piece that Mark and Jason have written on their website under the Insights tab under the Research Papers link. It'll give you a bit more of a deeper dive into how they're thinking about inflation going forward.

Thanks again, guys. It's been really good. We've been overwhelmed by the responses. I'll try to get back to you on email with all the questions that we've had through. Thanks again, and thanks to Mark and Jason. Have a great day.

Jason Orthman:

All right. Thanks everyone.

Mark Arnold:

Cheers. Bye.

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