Advisor Webinar: What Mega Trends Will Drive a Post-COVID-19 World? – Webinar transcript

Mark Cormack (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.

Mark Cormack:

Good morning and welcome to our Hyperion webinar on, The Time for Quality Growth is Now. My name is Mark Cormack. I'm a director of Pinnacle Investment. Pinnacle are equity partners, and work alongside Hyperion to distribute their suite of Australian and global equity funds to the financial advisory marketplace. And today, I'm delighted to be joined by Hyperion CIO, Mark Arnold, and Hyperion's deputy CIO, Jason Orthman.

In terms of background, Hyperion are an independent fund management group that has delivered substantial out performance in equities for more than 20 years. But what makes Hyperion different? Hyperion is a concentrated benchmark-unaware fund manager that only invests in the highest quality businesses. It's interesting, many fund managers say they invest in high-quality stocks, but do they have a definition, or are they really just investing around a benchmark? Hyperion defines quality stocks as those that have a high return on capital, low or no debt, and businesses that can deliver highly predictable earning streams through very strong competitive advantages. This stringent investment process results in the Hyperion portfolio being concentrated and completely different to the benchmark.

So, what's the outcome? Well, firstly, the track record of out-performance over 20 years does speak for itself, but I think we all recognize the GFC is one of the ultimate stress tests for any portfolio. Hyperion's approach to quality investing really came to the fore during the GFC, and the Hyperion Australian growth companies fund returned a flat 0% for the 12 months to the 30th of June 2009, when the all ordinaries one year return was still minus 20. And it's interesting, over the last month, we're seeing Hyperion's capital preservation characteristics really kick in again, with substantial out performance versus the index across all their funds.

So, turning to today's webinar, it'll last around 20 minutes and all attendees have the opportunity to ask questions via the questions tab on your screen. So, without further ado, I'll hand you over to the Hyperion team of Mark Arnold and Jason Orthman, to take you through today's presentation. Thanks, guys.

Mark Arnold:

Thanks, Mark. Good morning, everyone. Hyperion exists to protect and grow client capital over the longer term. We're not just a typical growth manager. We're not a momentum manager. When we invest, we invest for the long term. We see ourselves as business owners. And, as Mark mentioned, we've been successfully investing and compounding capital for clients over the last 24 years.

We don't hide behind complexity, like a lot of other fund managers do. We keep it simple. We're long only. And we invest in businesses that have got robust intrinsic values, and this protects during difficult economic times. We don't short. There's several reasons for this. We just think that shorting is basically a marketing gimmick for most hedge funds. Most hedge funds don't add value on industry shorting and it effectively reduces the compounding effect that our fund managers can achieve over the longer term. So we protect capital during difficult markets by focusing on the long-term intrinsic value of every business that we have in the portfolio, and using that intrinsic value and comparing it to the share prices. And that's how we protect value.

For the last decade or so, we've been saying that the world is low growth, it's low inflation, it's a low interest rate world, and there's series of structural headwinds that are ensuring that. And it's also a low equity return world as well, the equity risk premium, we believe, is substantially reduced from the period before the GFC to now. The structural headwinds that the world faces include declining population growth, aging populations, high debt levels, there has been a massive gearing up of society over the last 50 or 60 years. That brings forward GDP growth, it brings forward income and expenditure, but it also means that that growth that's been brought forward creates a hole in the future and we think that that's what the world's facing at the moment.

There has been rising wealth inequality and income inequality over the last four decades. We think that that will impede growth as well, going forward, because we believe you need a robust middle-class to sustain high levels of economic growth. We think there's massive natural resource constraints, and we think that climate change is one of them. Obviously, things like viruses are also a disruptive force to economies.

We have had, for 40 years, a tail wind of declining interest rates, we're at the end game now, interest rates are effectively as low as they can go on. So that tail wind has disappeared, and then you've had massive disruption particularly since the internet came into being, and that's really been disrupting old world businesses. Their margins have been under pressure, their return on capital has been under pressure and that's an ongoing force, we think, disruption's not going to end in terms of tech innovation, and that will make life difficult for most businesses listed.

Jason Orthman:

It's worth highlighting, before Mark talks about the current disruption in the market, so over the last month that, so effectively we've been preparing for this slow down or asymmetric risk on the downside for the last 24 months. So, we've entered this crisis a lot better than we entered the GFC and the European debt crisis and, as Mark C mentioned earlier, likely significantly outperformed through those. But as we go through the presentation, you'll see the alpha we have accrued has been enormous over the last month. And that's because we've done a few things right over the last 24 months. And so we've taken cyclicality out of the portfolio. So our portfolio, 20 names across the three fronts, are all elite businesses with structural growth. And so they have the ability to grow in good and bad markets.

We've also made sure that balance sheets are pristine, so already 70% of our company's net cash in each of the funds, but we actually made sure that those balance sheets are rock solid, which is obviously important now. And the returns with the alpha we've been accruing over the last number of years ahead of this crisis has also been occurring while we've been carrying high cash levels. So it's important to note that, before Mark talks about what's happened in the last month, that we've come into this really strong, and got these high class, world-class businesses, which is why we were accruing alpha in these pretty tough times.

Mark Arnold:

The coronavirus is likely to cause significant economic disruption in the short term. Many people are going to lose their jobs. Many businesses are going to go bankrupt, some of the industries too. Those obviously affected are, travel, the travel related industries, traditional entertainment businesses, traditional retail, highly discretionary products and services, particularly those ones that don't have a strong and sustainable value proposition. Commodity-based businesses, banks and other highly leveraged lending businesses will find it very difficult, and REITs will find it difficult, particularly those ones that are carrying a lot of debt.

As we have been saying for many years now, we believe the world is turning Japanese, and what we mean by that is that most governments and central banks have been adopting the Japanese blueprint. So basically, dropping official interest rates to very low levels, quantitative easing (buying assets and printing money to fund that spending). And also, governments borrowing aggressively, largely for infrastructure projects and now more helicopter money, where they're just spreading money out to households and businesses.

The thing to remember here is all of this debt needs to be repaid. So we think it just moves the whole low growth environment and extends it out over long periods of time. So as I said before, debt effectively brings forward economic growth, income and expenditure. But then that debt has to be repaid with interest, and that creates a risk aversion and it creates lower growth in the future.

There's two sources of revenue growth, there's revenue growth that a business gets from the overall economic pie growing. And then there's market share growth. All companies can effectively access their share of growth in the overall economic pie, but very few companies can grow their market share consistently over long periods of time. And we focus only on those elite businesses that can access that second channel.

In the good times, investors and fund managers get away with taking extra risk, and it doesn't become apparent until there's a downturn. And the investors and fund managers invest in businesses that are weaker, the average type businesses or below average type businesses that are highly reliant on the overall economic pie growing.

But in bad times, there's nowhere to hide. And you get the situation where the tide goes out and you get to find out who's been swimming naked, and there's going to be a lot of investors that are going to find that the businesses that their fund managers have invested in are pretty low quality, and a lot of those businesses will suffer a permanent loss of capital, whether that's really through massive dilution, through equity raisings at low prices, or bankruptcy.

Jason Orthman:

Yeah. So your typical business, or average business, often relies on physical locations and serving customers face to face. And clearly in an environment of containment, that revenue goes to zero. So if you've built a modern portfolio that can track digitally and online, you're extremely well-placed to actually still produce revenue. And that scarcity factor is why some funds can do well in pretty tough times, but again, you have to shift to the quality, and actually have business models that are actually modern, on online, or otherwise the companies, they're in extreme danger of actually going out of business, depending on how long the containment crisis goes for.

Mark Arnold:

Our portfolios are focused on modern businesses, because we think investors have a choice. They can invest in modern businesses, or they can invest in old world businesses. Most businesses that are listed are old world businesses, and they're in the process of being disrupted. We think in tough times, buyers of products and services really focus hard on value propositions. In good times, there's less of a focus by customers and buyers of products on value propositions, there's a lot of inertia naturally. But in tough times, a lot of that inertia disappears because people become more discerning and more focused on every dollar. And we think that that's what's going to happen now.

So we think there will be an acceleration of market share gains by the companies that we have in our portfolios during this disrupted period, and there's a series of themes and structural shifts that will accelerate as a result of the Coronavirus, and we've listed them there. I won't read them all out, but there's always an underlying structural theme behind the companies that we invest in, because there's no point in investing in a high quality business if it can't grow at double digit rates over a long period of time organically. And so you really need each of these businesses to have a structural tail wind. And we've listed structural tail winds there.

Jason Orthman:

The great thing with our businesses, if the structural theme was going to take 10 years, and most of our businesses are market leaders, so they tend to be online, they tend to be digital, they tend to be mobile. But the added advantage that we've got through this crisis is that the earnings stream isn't illusionary, like your average business. Because the advantage is if you can actually serve and operate remotely, you can actually still incur revenue and earnings, and that is ridiculously valuable in an environment like this, where most companies are actually trying to find a way to survive.

Mark Arnold:

We don't think value style investing is the right style for the world that we face over the next 10 years. On this chart you can see, this is the Fama-French index. When that line is going up, that means value is outperforming growth, in terms of style. The red periods are periods of recession that have occurred historically. You can see during the Great Depression there was massive under performance by the value style, and also during the GFC and post-GFC, there's been under performance of value as well.

Value will not protect you as a style in difficult economic conditions. It's a fair-weather investment style. It got its reputation because we had an economic boom from basically the 1950s to the GFC. You had that massive tail wind, where the average businesses could do well because they just grabbed their share of the growth, the high rate of growth in the economic pie, and that's how value got its reputation for being able to produce alpha. But in a more competitive environment, a lower growth world or a negative growth world, average businesses, if you buy those, they just go down, the intrinsic values go down over time and you end up with permanent loss of capital. So we think that sticking with value investors is the wrong decision. Over the next 10 years, things are going to remain tough and they're going to remain low growth. So we think it's a very good time to reassess your exposure to value investors, because we don't think their performance is going to improve.

This chart shows the relationship between share prices and EPS over long periods of time. This is our large cap composite, over 24 years. The green line is the EPS of the composite. There is a very tight relationship with composite and EPS over a long period of time. Basically, if you can buy businesses that can compound EPS over long periods of time, that means that you're in a good position to outperform. You can see the index, which is the EPS of the index, which is the blue dash line, hasn't really performed that well. If you look at the total period, our portfolio has compounded EPS at 10% per annum. The index has compounded EPS at about 5% per annum, and that really is the alpha difference, that's why we have outperformed over the last 24 years.

You've got a similar situation with the small cap fund, you've got higher EPS growth of around 13 or 14% over that period of time, and that again has led to a compounding effect over long periods of time, and attractive absolute returns over long periods of time, and also out performance of the benchmark.

And finally, the global growth fund. Again, it's being compounding over the last almost six years now at around 20% per annum for EPS growth. And that really has been the thing that's driven the out performance compared to the benchmark.

Over long periods of time, we've added a lot of alpha, we've been able to produce double digit returns and we're quite confident that we can continue to do that in the future. The disruption that's occurred as a result of the Coronavirus over the last month or so, we don't like to focus on short-term performance, but it does illustrate the out performance is there, not necessarily because in the short-term the share prices have not fallen as far, but that is the case this time. It's really because the businesses that we invest in have got really robust intrinsic values, the intrinsic values are way above the current share prices, and the market is assessing those longer term intrinsic values and it effectively means that in the short term, the share prices haven't fallen as much.

Jason Orthman:

It's a busy slide but it's important to highlight that, as Mark mentioned earlier in the presentation, that we've got a strategy and process that can produce alpha in both up markets and down markets and we believe that's pretty unusual, and actually pretty unique because a lot of funds, when markets are going well and there's growth and momentum, can do okay, but we believe most investors can't distinguish between super high quality businesses and just average businesses. So you end up having some draw down or some permanent loss of capital, which isn't ideal, through the cycle. And then there's other funds that are focused on protecting that downside, which we think we can do just as good a job, if not better. But then they actually miss the upside in normal conditions ahead and post-crisis.

And as I mentioned, it's a busy slide, but that calendar year to date's actually relatively meaningful because through January, February, March, we've had different cycles and effectively had a little mini crisis. And I think it surprises people that if you do have a portfolio that can compound at a high rate, you can actually still protect capital and stock draw downs, if you know what an elite business is, and if you pay the appropriate price. And this is just another data point that we've had over the last 10 to 20 years.

Mark Arnold:

The outlook for the products is very attractive. We think all of the three products are projected to produce double digit returns, over the next five years and beyond. And that again is really driven by superior EPS growth. We think that most indices around the world, over the next 10 years, will struggle to grow EPS much at all.

We're projecting most benchmarks, the likely nominal return per annum is around 4%, so that compares to the historical return of around eight or 9%, so we think there'll be a halving in return. So we don't think passive investing is going to be that attractive because the alpha generation that we believe that we be able to achieve, will be larger in this sort of environment, and the absolute returns, we think, will be very attractive.

Jason Orthman:

And, Mark, those IRRs are as at end of February, so I assume they would have moved a bit.

Mark Arnold:

Yeah, so they've moved higher. The thing to note about the global fund is that it's a higher rate of return. So at the moment it's sitting at about a 22% projected return over the next five years. So it offers a premium return compared to the small cap fund and the Australian large cap fund. And also, we believe it has less risk in that fund as well, because the quality of the businesses within that fund are higher, generally. That's not to say that the quality of the other funds is low, it's not. It's very high within the context of the Australian market, but globally there's more companies, more high quality businesses, and so we can lift the quality bar when we go global. So you're getting a higher return with global, and you're getting lower risk and higher quality businesses within that portfolio.

Jason Orthman:

So the IRR is now actually pretty attractive. So if we, late last year, if we look at that slide, the domestic funds were forecasting 12 to 13% annual returns over the next five years. And obviously with the crisis they're up to 17 to 18, and the global fund was sitting at a forecast 15 to 16 per annum return, and as Mark highlighted, now it's sitting at a forecast at 22% per annum over the next five years. And if history is any guide, those 20% returns tend to be pretty good entry points, and provide a really large margin of safety.

Mark Arnold:

And finally, we think we've priced the global fund at an attractive level. So the management fee's 70 basis points compared to, we've got some competitors listed there that have got higher fees. So we think that that's a win- win. We really believe in alignment with clients, and so that's why we've gone with a low management fee and alignment through a performance fee.

Mark Cormack:

Excellent, guys, look, thanks and great to get your views on investing, I suppose not just in today's COVID environment, but why now is the time for quality growth investing, especially considering the points you made on being in a low growth world post-COVID, or Coronavirus, and looking at least five to 10 years.

A couple of take-outs from today, I think. Hyperion are a fund manager that have the strictest thresholds for stocks to actually get into their portfolios. They must have that high ROE, low or no debt, and the strongest competitive advantages to deliver what Mark and Jason were talking about there, that strong EPS growth, which is the ultimate metric that drives share prices in terms of their approach.

Secondly, Hyperion have conviction in their allocation. They're not just investing around an index or equally weighting a portfolio for risk management purposes. The outcome has been genuinely an active portfolio that considers a core equity holding, or as a satellite. And finally, you're investing with a team that is highly experienced in that business and the team have been managing portfolios since the nineties and delivering significant alpha in both up and down markets.

Okay. So enough from me. Attendees do have that opportunity to ask questions and we will go to Q and A, because we've had a number come in. Mark, a kick-off with a question in relation to more the global fund, "You don't have any emerging markets growth companies in your global portfolio? I would have thought a stock like Alibaba would fit into Hyperion's investment metrics with the digital move online and Chinese growth?"

Mark Arnold:

Yeah, we've traditionally had zero weight in emerging markets, in terms of direct investments in emerging markets, and the reason for that is that we think you're going up the risk curve when you go directly into emerging markets, and this, with the Coronavirus occurring, we think it's becoming obvious that many emerging markets are going to find it very difficult to deal with the Coronavirus. It's going to be incredibly destabilizing to their economies. Places like India, Indonesia, places like that will, we think, suffer pretty badly for a long period of time. So, and it's been our view that most emerging markets will never emerge.

The highest quality emerging market is China, and we have actually added Alibaba into the portfolio just recently with the sell off. We see that as, and it's only a low weight, we see that as the highest quality business we've identified within the Chinese context and it's never going to be a large weight because of the risk profile of emerging markets in China, we think is higher than investing in developed markets because you don't really have the rule of law and it's a one party state and there's a whole lot of other additional risks there, but we have taken a modest position in Alibaba, because we do think it's an exceptional business and it does have the structural growth we're really looking for, and we think that over the next 10 years it should be able to grow its revenues organically at very high rates, so that makes it fairly attractive.

Mark Cormack:

Okay. Another question, more on global. "Mark, I know Hyperion likes Tesla. Might other large car manufacturers with lower cost spaces erode Tesla's first mover advantage in the electric vehicle market?"

Mark Arnold:

No, we don't think so. We think that the Tesla killers, well, they haven't arrived yet and we think it's pretty unlikely that they're going to arrive. The traditional legacy car manufacturers are very good at producing combustion engine cars. The problem that they have is that combustion engines are old technology, and in order to change their business models to electric is going to be very difficult. There's a whole lot of cultural reasons, there's just a whole lot of technical reasons why, they're not good at software either, and software is really going to drive EVs, we think.

So Tesla's in a very good position. They've got superior battery technology, they've got over-the-air updates, they've just got a better product, a much better product than what the traditional car manufacturers have in the EV space, and we think that Tesla will really dominate that area. The other thing about Tesla is that they've got a massive addressable market, in terms of energy generation and energy storage. So that's a market that is about to be disrupted in a major way, and we think that Tesla will take advantage of that, and they'll be able to grow the energy business substantially over the next 10 years.

Mark Cormack:

Okay. I might give this one to you, Jace. "I see you have Costco in the portfolio. Can it survive with Amazon?"

Jason Orthman:

We believe so. We think Costco is one of the best long duration growth companies, and it's got one of the strongest moats we've seen globally. Of course Amazon's a very formidable company, but what Costco does, it does very well. So it only has a small number of skews, and it buys them at scale, and has a large cost advantage. So it's relentless on cost. So even when we look at a basket of grocery goods, Costco is still, on our estimates, 30 to 40% cheaper than Amazon. So there's not too many companies that can compete with Amazon. We absolutely believe Costco can because of their focus, their scale, and their cost advantage. And we don't believe that moat will break down over the next 10 years.

Mark Cormack:

Okay. One more for the Aussie portfolio. "Your Australian portfolio is overweight healthcare with CSL and Cochlear. How come there're not as many high quality healthcare stocks that make it into the global portfolio?" Jason Orthman:

Well, we just think there's been this perception that domestically listed or Australian listed healthcare companies are expensive, but we actually believe they're actually world-class. So if you go through and have a look at Cochlear, with a 60% market share, ResMed with a 40% market share, CSL with a 30% market share, they're all global players and they're all market leaders.

Jason Orthman:

And so they're indexed pretty average in the Australian market, but what the Australian index does well is have some world-class health care names. And when we look out globally, a lot of those healthcare names are large conglomerates, and they tend to be pretty mature. Or, then you've got single-product companies, which are at the risk of disruption. So our exposure has changed a little bit to healthcare globally, but CSL is one of those that we added in this crisis in March, to take advantage of the share price weakness because the plasma centres will remain open, and we're also using the crisis to acquire another business, which has effectively had a monopoly for 25 years. So there is some businesses globally in healthcare, but you have to look pretty hard, and some of the best placed are actually in our own back yard.

Mark Cormack:

Excellent. Okay, one on the small cap fund here, "Is Xero a genuine global player? Take me through the thesis there?"

Jason Orthman:

We believe so. And our thesis was that it's the market leader in New Zealand, Australia and UK, certainly online, and certainly in its SAAS offering. And one of the advantages of running a global and domestic fund is the synergy. So we've been tracking it for over 10 years and it's been one of our core holdings in the global fund. So it's coming up to six years. So our view is, Xero will struggle to unseat Intuit in the US, but it doesn't need to because, as I mentioned, it's got market leadership in a few other markets. Some of its competitors, legacy competitors such as MYOB and Sage in the UK are pretty poor operators. So we believe, outside the US, Xero can win, and is winning. So it's a genuine global business. But in the US it's going to be a lot harder, but as we mentioned, it doesn't actually need to win.

Mark Cormack:

Okay. Another question, a couple of questions here, on what portfolio turnover you guys have, and maybe, Mark, I know you talk often about name turnover and actual portfolio turnover. So?

Mark Arnold:

Yeah, the name turnover's around 10% so on average we hold a business for 10 years, and that really comes back to our philosophy that we're long-term investors and that we're business owners. The actual total turnover is higher than that, but it's still fairly low in the overall context of the market and competitors. So tends to run at around 20 to 30% through the cycle, and that is actually an important component of how we create alpha. The topping and tailing, using our proprietary portfolio construction, portfolio management system enables us to effectively double the alpha that we've achieved over time through basically right sizing the weights we have and the exposures that we have to the stocks through different periods of the cycle.

Mark Cormack:

Excellent. And I've just got one more question, and I know we've been actually been bombarded with questions, "How do you approach cash in your funds?"

Mark Arnold:

At the moment, the cash is reasonably elevated, so it's sitting at a low double-digit levels. The reason for that, and we've been running high cash for 18 months or so, we believed that there would be opportunities to deploy that capital. We're very good at allocating capital, and when you get a crisis like that, it does provide opportunities. So we wanted the flexibility. We did not obviously predict the Coronavirus, but we thought that at some stage there would be a correction. And so we're well positioned to take advantage and the optionality that cash provides is pretty valuable at this stage.

Mark Cormack:

Look, that's all we do have time for today. Many thanks for the questions that have come in. As I mentioned, we have been overloaded, and we will get back to you with any unanswered questions via the Pinnacle distribution team. Look, in closing we often get asked the status with Hyperion and the research houses, or both Hyperion's Australian and global funds are favourably, or at least recommended rated, by Lonsec and Zenith, and over the years Hyperion has either been nominated or named as Fund Manager of the Year with Lonsec, Zenith, and Morningstar, and with a current Fund Manager of the Year in Australian Equities with Morningstar.

Look, just on access, Hyperion's Australian funds are available widely throughout the market. The Hyperion global growth fund does have more limited access on APLs and platforms, so if you do want to have the Hyperion global fund available, we look forward to hearing from you, let us know so that we can ensure that we work with the platforms and the advice research dealer group teams and make the fund available.

But hopefully you've enjoyed our session, it's provided you with not only an update on Hyperion's approach, but why now is the time for quality growth. We will be making the webinar available on the Hyperion website today, which is www.hyperion.com.au. If you have any further inquiries, please refer to that Hyperion website, or contact your local Pinnacle BDM representative. We certainly like to thank you for your attendance today. Thank you for your questions, your engagement, and wishing you and your families a healthy and safe couple of weeks. Take care and goodbye.

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