HYPERION
ASSET MANAGEMENT

Hyperion Webinar: Alpha, Inflation and Passive Investing in a New World

Jolon Knight (Hyperion Investment Specialist) with Mark Arnold (Managing Director and CIO) and Jason Orthman (Executive Director and Deputy CIO)

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

Jolon Knight:

Welcome to the Hyperion webinar, "Alpha, Inflation and Passive Investing in a New World". My name is Jolon Knight, and I am an investment specialist with Hyperion Asset Management. Today, I am joined by both, Mark Arnold, the Hyperion CIO, and Deputy CIO, Jason Orthman.

For those of you who are new to Hyperion, Hyperion is a client centric, alpha seeking business. Our primary focus is to protect and grow clients' capital sustainably over the long-term by investing in what we believe to be the only highest quality businesses. Our approach is structural growth, we're leaders in structural growth and sustainability, and as a result have produced above benchmark returns for our clients over the long-term. Hyperion has been successfully investing clients' funds since 1996, and currently manages approximately $13.4 billion on behalf of our clients.

In the webinar today, we'll cover the importance of long-term alpha after fees; how rare our performance is, both domestically and globally; why most active managers fail to outperform; the rise of passive investment and if that's changed the way that we now invest; the importance of stock selection, portfolio management and portfolio turnover; we'll also touch on the recent reporting seasons, both domestically and globally; and also revisiting why we don't believe Tesla is a "meme" or a concept stock; we'll turn our attention to inflation and our belief that it is indeed still transitory; and we'll also look at some of the factors as an active manager Hyperion exploits to generate alpha.

Thank you for all the questions that have been sent through prior to today, we will cover the majority of them in today's presentation. As we go along, there is a Q&A box at the bottom of your screen, so please do send questions through, we'll attempt to answer them today or get back to you after today's presentation.

With that I'll throw to Mark on a question, which I don't really think is being asked enough of fund managers in the industry. Why does Hyperion exist?

Mark Arnold:

Thanks, Jolon. Good morning, everyone. We exist to protect and grow clients' capital. Our values, we believe, are key competitive advantages. Being research driven and employing evidence-based decision making are key values that we have. Generating long term alpha is very valuable to clients. Without alpha generation, Hyperion would not exist. We focus our resources on areas that help generate alpha. Long-termism is fundamental to our ability to produce alpha. The results of these values can be seen in the $6

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billion in funds under management that is from pure alpha after fees. Our values and the dollar alpha that we've produced over the last 25 years makes us substantially different to many of our competitors.

Jolon Knight:

Now, we mentioned alpha, and alpha being returns generated above benchmarks or excess returns. It probably is stating the obvious, but Jason, how important is alpha in portfolio management?

Jason Orthman:

It's obviously incredibly important and that's the reason Hyperion exists. We want to co-invest alongside our clients and deliver excess returns over long periods of time. We're not in the business of being a business, we're not a marketing organization, we're not a product led organization. We actually want to grow our wealth and our clients' wealth through achieving a long-term alpha. So, you can see here on the screen a track record of the global fund[1] over the last seven and a half years. Already the positive jaws are starting to open up between the red line, or the global fund[1], and the blue line, our benchmark. That has largely been driven by compounding earnings per share of the Hyperion portfolios at higher rates. That is high tens close to 20%, versus the benchmark that has done high single digit or close to 10%. The reason we exist is absolutely long-term alpha, and we're focused on the fundamentals to get there.

Jolon Knight:

How rare is this long-term alpha in the industry?

Jason Orthman:

Well, it's actually incredibly rare. We've put some White Papers out on this. On our estimates, all of the alpha that is accrued is by 2% to 7% of active fund managers. There's actually a narrow group of winners. They're the funds that understand the inefficiencies in the market, how to exploit those anomalies and have a structured and disciplined process to repeat that. On the screen here we've taken a snapshot out of the Morningstar database, and this is all the funds competing in the Australian market across those various categories. You can see on the top left in international equities, that actually 93% of funds have been beaten by the benchmark, or reversing that, only 7% of those funds that are managing international equities have outperformed the benchmark. Again, it's pretty hard to do and Hyperion has been on the right side of that, and we'll continue to fight for that day to day.

Jolon Knight:

Well, Jason, you've raised a good point. How does Hyperion stack up, I guess, to the average manager, Mark?

Mark Arnold:

[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.

We stack up pretty well. Our products have a long history of producing investment returns well above the relevant benchmarks and also well above most of our competitors. This out-performance is due to many factors. The key ones are the belief in our values and mission, we think that that's really important; only investing in the highest quality structural growth businesses, so we're quite discerning; our structured approach to research and portfolio and management is really important, we'll go into more detail in terms of particularly portfolio management later in the presentation; and finally our culture of hard work. This is not an easy job, everyone is expected to work hard. We think that that's a key competitive advantage. Also, we're never satisfied with the system that we have, so we're try and improve the system over time.

Jolon Knight:

Just give you an idea how to read this chart, up the top there is the global fund[2], on that five-year return, remember it's only been around for about seven years. It has almost double the returns of the average and those funds in the first quarter. The Australian Growth Companies Fund is in middle there, again, almost double the returns of the average fund on five, 10 and 15 years, and the same with those first quartiles as well. That really brings me to our next slide.

We've got a lot of our competitors in the marketplace here, and we've got those three-, five- and seven-year return numbers for our global fund[2] and the global competitors, and those who have achieved that performance over those timeframes. Gross returns and net returns, net returns after fees are very important. How do you think about the correct pricing of after fee returns and how do you think pricing comes into the framework of producing a product?

Mark Arnold:

We think pricing is obviously important. Clients are really after returns after fees, not before fees. We really believe in being aligned with client outcomes. We think that that helps with performance over time and motivation. This is why Hyperion staff have large investments in our products together with our clients. It's also why in pricing the fees for the global fund[2] we've decided to charge a low recurring fee. We have a performance fee as well, but that's only paid if the fund actually outperforms the MSCI World Index.

Our recurring fee for the global fund[2] is well below our major competitors. You can see that on this slide. As we said before, we think that it's really after fees alpha over the long run, that's really the important criteria. Some of our competitors charge much higher base fees than Hyperion. Some of those have not produced alpha over periods stretching out more than seven years and you can see that again in this chart.

Jolon Knight:

I guess as an investor, you might want to ask yourself why you are happy to continue to pay some of these investment managers that don't have positive alpha over that long term period. Why do you think most active managers do fail or fail to outperform?

Jason Orthman:

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We've identified a number of reasons, but maybe we focus on two key reasons. The first one is a lot of professional and retail investors succumb to a number of biases. These include a recency bias, that is a large aspect that drives markets. It is effectively over weighting recent news flow or extrapolating current data points into perpetuity. In life, business and investing doesn't work like that. And it's hard to resist. Then there's the institutional imperative to short-termism as well. Rather taking a long-term view, actually estimating the intrinsic value. There are a number of biases that are really quite difficult to resist.

The other issue that we've noticed is a lot of funds have failed to adapt to a changing economic landscape. We've seen that with the GFC occurring in 2007, 2008. If you think about a lot of the lead portfolio managers now, they really grew up as analysts in the late 90s or early 2000s.

Again, that was a very different economic environment. You really had a growth bubble, average companies did well, you had a tailwind of growth, the world wasn't digitized. Moving forward to the last 13 years, and it is really competitive, it has really digitized, and it has been this slow grind. We believe it has been hard for a lot of players to adjust to that. That's the future we see when we go through COVID-19.

The good thing about Hyperion is, Hyperion was able to outperform prior to the GFC as well because our companies grew earnings at higher rates. It was a tougher environment, but we still accrued alpha. As we've rolled through the GFC, the alpha accruals have increased, because if you have these market leading companies that can take market share, have strong organic growth, that's really valuable and scarce in a world that's not growing.

Jolon Knight:

What investment styles do you think will work versus those that would fail, Mark?

Mark Arnold:

Well, we think that value style investing, and passive investing are not going to produce the returns that they produce in a higher growth environment. We think the world has structurally changed over the past decade. Today, we are facing an economic environment that is radically different to that of the second half of the 20th century when growth rates were high and disruption levels were quite low. We think the period of high economic growth for the global economy and low levels of disruption is dead. We think economic and stock market tailwinds have disappeared, and they've not only disappeared, but they've been replaced by economic headwinds combined with higher levels of disruption. Also, the tailwind of moving from high interest rates to low interest rates has come to an end as well.

In these circumstances, we think passive investing and benchmark hugging, which a lot of our competitors employ as part of their investment process, only really work well when economic growth rates are high and disruption levels are low. We think innovation and the ability to take market share are going to be the key attributes of successful companies in a world of low economic growth. We believe that successful equity investing is all about investing in businesses with attractive long-term EPS and free cash flow growth. In a low growth environment, most businesses and stocks will fail to grow, and this will produce disappointing investment returns for many investors.

Jolon Knight:

Now, we do mention "passive" there and "passive" being investing in an index fund or a benchmark. We have seen the industry shift towards passive investment of late, and I guess you can't really blame people when you look at the amount of managers that do actually underperform. Although, that does raise the question, has this style or shift towards passive investment changed the way that most asset managers structure their portfolios?

Jason Orthman:

We believe it has. You're right, it is hard to resist. As interest rates have been moving down to zero, the values of all assets have moved higher regardless of the fundamentals behind that. So, it's easy to crowd into that, have that herd mentality, it seems safer and easier to do that. Particularly as you pointed out, it's so hard to accrue long term alpha. We've seen more and more funds return to that strategy of having a broad selection of stocks and going overweight or underweight in each position versus the index or effectively having a benchmark enhanced or a smart, passive strategy.

As we look forward, we believe there's a lot of fundamental risk in doing that strategy. From here as interest rates bumble around near the bottom, around near zero, you really need the fundamentals or the earnings per share to drive markets higher. We can see here within the ASX 300, on the right, nearly 80% of companies are actually "old world", or they're not growing, they're not relevant in the next generation. We believe these will be disrupted by a better way of doing things.

It is the same on the left there when you go globally, it's nearly 65% of the benchmarks by market cap are these large incumbent businesses that are not that relevant. If value and traditional investing died with the GFC, as we look forward, we believe passive investing could go the same way because it's going to be particularly painful for the new market winners to take over from the incumbents and drive markets higher.

Jolon Knight:

I guess to that end, Mark, do you think it is low or higher risk to have these benchmarks?

Mark Arnold:

We think in the current environment it is actually higher risk. That is different to the world before the GFC where you had high levels of growth. We think that the indices are full of businesses that are "old world", so second industrial revolution type technologies that underpin these businesses. We think these businesses face a world of massive disruption and that the disruption is really going to come from modern technologies. The businesses that have these modern technologies are still a minority of the overall benchmarks. In a world that is facing radical innovation and disruption, we think it's going to be less financially rewarding to track the index over the next 10 years.

If you look at the data on the previous chart, you can see that the IT and the Communication Services sectors of the index, which we think comprise mostly modern businesses, are less than 10% in Australia if you aggregate the two sectors together. We think that low exposure to these modern businesses is going to be a drag on future index returns. On the next chart, you can look at the benchmark in a different way, looking at the overall profitability or return on equity for the MSCI stocks. You can see that in the most profitable decile, the return on equity has been increasing since the 1990s. In the vast majority of the benchmark, so the MSCI world, the profitability of these stocks has been flat to declining.

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We think this is the case in most broad-based indices around the world. It's not just the MSCI world that's suffering from this problem. We think that lower levels of profitability is going to be a drag on the indices. We think a lower return on equity is really telling you that the intrinsic value of those businesses is under downward pressure.

Then on this slide, you can see, this is the biggest companies ranked by revenue, so the Top 20 in the world. We've shown this chart in this table in previous presentations, but we think it's still relevant. The Top 20 are really dominated by “old world” businesses that are likely to face disruption and probably bankruptcy over the next 10 to 20 years. You can see there is a significant number of oil and gas companies, there is a few utilities, and there's quite a few legacy auto companies as well. We think that these businesses face the real prospect of permanent demand destruction as the world switches to modern technologies, including EVs (“electric vehicles”), batteries and renewables over the next 10 years. We think that this switch to EVs and those other technologies is going to occur much faster than what most commentators think at the moment.

Jolon Knight:

Thanks, Mark. Let me move to stock selection now. Obviously selecting the right stocks is very important. How does Hyperion think about the difference between a quality growth company, versus a growth at any price company, just buying anything that looks attractive and has growth?

Jason Orthman:

Hyperion doesn't want to speculate, we're not interested in concept stocks so valuation is fundamental to what we do. It's just that we don't do the traditional way where we look at short term metrics. We're really trying to look out 10 years, estimate the intrinsic value of those businesses and compare the share price to that, and come up with a forecast internal rate of return. If you take a step back, we're really interested in the growth, quality, and valuation triangle. So we want all of those aspects.

If you start with Amazon versus eBay, this is the growth element that we're after. To us a quality business needs to be able to grow at high rates. We're not interested in a McDonald's or an eBay or an established business that is not growing at high rates. Something like Amazon clearly has got a lot of growth ahead of it with the shift to e-commerce and cloud.

If you move to the right of the slide, we want that quality element. That comes back to first principles: why is this the market leader, what's the value proposition, what's the competitive advantage? We own Spotify because we believe they've won the music streaming race, and they're the most relevant to the next generation with nearly 400 million active users. As you go and look at video streaming as a contrast and in our home market, you've clearly got Kayo, Stan, and then the global players like Netflix, Amazon Prime, Disney+, Apple, and other regional players. It's a lot harder to identify who the actual market winner is over the next 10 years.

Finally looping back to the start of the question on valuation, and at the bottom of the box it compares Tesla to something like Rivian. Rivian has obviously been a really hot float and they've come onto the market strongly with the excitement to the transition to electric vehicles, but it's yet to produce any meaningful revenue or produce any cars and scale. Tesla has been through that. We watched Tesla for over five years before we made our purchase in January 2020. We believed that the valuation was really compelling because the share price looks cheap and still looks cheap relatively to the earnings that we

forecast in 10 years' time. We really do hope a company like Rivian does well and scales, but there's years of hard work ahead of them before that happens.

Jolon Knight:

Now you mentioned a term that you use a lot, which is first principles. Mark, why is first principles investing key to achieving these long-term results?

Mark Arnold:

Well, we think breaking investing down into basic fundamentals is really important. And focusing on the long-term economics of a business is key to first principles investing. We're looking for businesses that offer strong value propositions to key stakeholders, those value propositions need to be sustainable, and there needs to be a large addressable market, so these businesses can grow organically at higher rates for long periods of time. When I say long periods of time, it needs to be at least a decade.

We think that focusing on short term metrics in this sort of environment is value destructive. The best performing investments that Hyperion's ever made have involved investing in businesses that have very high short-term P/E ratios when we added them to the portfolios. In some cases, these stocks were loss making when we first purchased them, so they had no P/E. Examples include Amazon, Facebook, REA, Xero, and Tesla as well.

Our view is that it is impossible to predict short term share price movements. This is because most of the factors that drive share prices in the short term are non-fundamental in nature. Our view is that if you identify a very high-quality structural growth business, it's unlikely that it's overvalued. This is because these businesses experience exponential growth over long periods of time. This growth compounds and produces values normally significantly above current share prices even if the short-term P/E is quite high. These high-quality structural growth businesses are normally highly innovative, so that's a key attribute that we're looking for. That innovation is normally quite costly because of R&D spend, so it reduces short term earnings, but we think it enhances long term value.

Jolon Knight:

Thanks. We might move to just briefly touch on the recent quarterly reporting, both here and globally in August and in October. Jason, both the Global fund[3] and the Australian funds did very well through these periods. Do you have any highlights or any overviews that you'd like to share with us on this past reporting season?

Jason Orthman:

Sure. The Australian Growth Fund did really well through August reporting season as you mentioned and produced excess returns of sort of 1,100 basis points or 11%. We typically don't focus on short term performance, but the interesting thing is that reflects how well those companies reported versus the

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broader market and it was based on fundamentals. We saw a number of stocks whether it's WiseTech or James Hardie or Domino's rerate up on the back of stronger than expected growth.

Obviously, that feels like a lifetime ago now, but if you roll into the Global Growth Companies Fund (Managed Fund)[4], we have just been through the October reporting season and seen the third quarter results. Again, the portfolio accrued excess returns of around 400 basis points after fees through October. Again, that was fundamentally driven. The exciting thing for us is that a number of the tier two structural growth companies that we own look to be at inflection points and producing really strong reported profits and growth.

If we take a few on that slide, you can see with Tesla, it is really starting to scale. It didn't really have the right to produce the results it did because it produced reported profit of $1.6 billion or non-GAAP earnings of $2.1 billion. That was just despite well published shortages in the supply chain and chips in globally, and Tesla largely avoided that. A lot of its earnings are still ahead of it.

Airbnb did something similar where had record margins. It's really starting to scale as it comes out of COVID-19. The great thing about Airbnb as a platform is that a lot of the hosts, a lot of the guests that book the accommodations through it, all come to it organically. The earnings streams are really lucrative, and again a really strong third quarter result.

Finally on Spotify, the revenue growth is starting to accelerate there and produce 27% revenue growth in the quarter. It's really becoming ubiquitous across the world in terms of streaming. Again, there is a lot to get excited about in the portfolios and we hope some of these names drive the portfolio higher over the next few years.

Jolon Knight:

Thanks. We might turn our attention now to probably the stock in our portfolio that garners the most attention, which is Tesla. There is a lot of commentary in the marketplace that says that Tesla is a concept stock, or it's a “meme” stock. A lot of other analysts in the industry often say that Tesla is not underpinned by any fundamental earnings or it's just speculation, which is kind of hard to believe with $2 billion worth of earnings just in the last quarter alone, or that the Tesla share price is just trading on exuberance or fear of missing out, the old “FOMO”. Mark, how do you address concerns in the marketplace or views in the marketplace to that end on Tesla?

Mark Arnold:

Well, we believe that the market continues to misunderstand and undervalue Tesla. Traditional media, short sellers and some mainstream fund managers are being vocal about Tesla being a concept or a mean stock with no substance. We believe these are false narratives born out of ignorance about the company. Our view is that the recent share price out-performance has not been driven by misinformed retail investors involved in a mean based speculative bubble. Instead, we think the recent share price, out-performance is based on already excellent business economics that continue to improve over time.

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The evidence suggests that Tesla is a rare investment opportunity because of its ability to rapidly innovate, create new products that are highly disruptive across a variety of industries and all of those industries have very large addressable markets. Our belief is that Tesla will radically change the way the world transports people and goods. We think it's also going to change the way we generate, store and consume energy. Ultimately, we think it's likely to change the way businesses manufacture and produce complex goods because of that innovation in manufacturing.

The company has got many competitive advantages and they're listed on the slide that we have up. However, we think that the most important and sustainable competitive advantage is Tesla's culture. The company is organized to encourage innovation and constant improvement in product quality and to avoid bureaucracy. There are no silos. The organization hierarchy is really flat, and the business is structured to actually innovate rapidly, but reduce the cost of innovation through AI ("artificial intelligence") and machine learning-based simulations.

You can see that the innovation on the next slide with Tesla spending far more on R&D ("research and development") than any of the competitors. The point to note here is that Tesla spends nothing on advertising, so the blue bars are the advertising component, and you can see the competitors spend quite a lot of money on advertising. The money that Tesla saves on advertising is spent on research and development, and that spending leads to improvements in product quality and helps create new innovative products for Tesla.

The company believes that creating exceptional products removes the need for advertising because customers sell the products themselves. They sell the products because they love the products to their friends and family and anyone that will listen. Tesla believes that word of mouth is the best advertising. Also, the spending that Tesla does is very efficient. It only hires the best engineers. It believes a small team of highly talented engineers is better than a larger team of average quality engineers. It can afford to be discerning when hiring, because most of the talented engineers want to work at Tesla.

Jolon Knight:

Thanks, Mark. You really are starting to see a lot more of these cars on the street, definitely in Brisbane alone. We did release a revisit of why we think Tesla is a great investment prospect in an email that you may have received on Friday, the week just gone. We will resend that out with the repay link on this slide presentation today also.

We might just turn our attention now to inflation. Now globally we are starting to see inflation start to creep back into the economy. Now CPI numbers, both here and the U.S. and in Europe are starting to look a little bit higher. Hyperion has a really good White Paper on inflation that you can find on an insights tab on the website. In there, we've often stated that we think inflation is transitory. What we mean by that it's here for the short term and will subside. With all the recent I guess data points that are coming out in the global economies, Mark, do you still think inflation is transitory and here for the short term?

Mark Arnold:

We still think it's just going to be temporary. We think that the bond market is correctly assessing the long-term outlook for both inflation and economic growth through the level of interest rates that are currently in the market. Inflation peaked at really high levels in the 1970s and trended down during the early 1990s. Then it has stayed at quite low levels for a long period of time. You can see on the slide that's

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up at the moment that basically interest rates have been declining for four decades, and that's on the back of what I've said: lower inflationary expectations and also lower real expectations for economic growth.

On this slide, you can see there has been a big increase in oil-based products in terms of the pricing, but we think that that's largely base effect. This is in the U.S. economy. When I say a base effect, oil prices were very low when the crisis hit in early 2020, and then they have normalized and that is reflected in higher inflation or CPI numbers in the U.S. and in other markets. Also driving inflation has been the global supply chain. You've had a situation where the world basically, or the global economy, stopped early in 2020, which is very unusual and then accelerated out of that closed period very rapidly. The global supply chain isn't designed for those sorts of events that are extreme in nature.

Our view is that the bottlenecks that are in the global supply chain are slowly being removed. We think that the shortages are likely to be resolved over the next 12 months. Fixing up the global supply chain and removing those bottlenecks is disinflationary. Also, the demand side of the global economy is looking weak, particularly in China. We think China has got massive structural problems, there has been a massive overdevelopment in residential property in China, and that has been combined with high debt levels. This lower growth out of China is going to be disinflationary.

If we're wrong, we think that the portfolios are in a pretty good position to handle higher levels of inflation, if inflation did take off and stayed at high levels for a long period of time. This is because most of the stocks in the portfolios have substantial pricing power. That pricing power really comes from the strong value propositions that they offer customers. They can increase prices if they need to if the prices in their cost bases increase.

Having said that, if we did get a sudden unexpected increase in inflation that was deemed to be permanent, then bond yields would go up. Our calculation suggests that if there is a hundred basis point increase in the 10-year U.S. treasury yield, that would result in about a 9% reduction in the market value of the global portfolio. Having said that, once the market realized the pricing power that the businesses that are in the portfolio have, and that they can pass on effectively any increase in interest rates through increasing their future nominal revenues and profits through price adjustments, then we think that that gap would close. The other thing to note is that the global portfolio is forecasted to grow its EPS at approximately 24% per annum over the next 10 years. There's a lot of growth underlying the businesses in the portfolio. That would over time recoup any negative impact from a one-off increase in interest rates.

On this slide, you can just see how extreme the COVID-19 crisis has been, in terms of negative growth when the crisis first occurred, and then the rebound that has been extraordinary. Our view is that during this rebound period, you've got an abundance of growth. However, we think as we've said before, that growth is likely to be very temporary. We think we'll move back into an environment where there's a scarcity of growth in 2022 and 2023.

Jolon Knight:

Thanks, Mark. You did mention that abundance of growth, so it is obviously should be very easy for companies currently. Here we've got a slide that we show often, which is some of the headwinds and

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tailwinds in the marketplace. You mentioned strong GDP growth there is unlikely to persist in the future. Do you want to touch on some of these tailwinds and now headwinds in the economy?

Mark Arnold:

Prior to the GFC, there were a lot of tailwinds that really supercharged the economy. The main ones are young and growing populations, you had that for many decades; you had a gearing up of society that brought forward growth; and then you had a growing and robust middle class as well. Those tailwinds have been replaced by headwinds. The key headwinds we think are high debt levels, that is going to impede future growth; over the longer term ageing population is going to be a problem and lower population growth; and then climate disruption we think is going to impede economic growth as well over the longer term.

Jolon Knight:

Thanks. We might move on to a subject that probably doesn't get enough attention which is portfolio management and portfolio structure. Jason, does the structure of your portfolios weigh heavily on you? When I say that, the stock weights within the portfolio and how you build that portfolio, does that make a big difference to the overall performance?

Jason Orthman:

It absolutely does. We'd agree with the premise that portfolio management is just as important as stock selection and the industry doesn't give it the focus it deserves. If you actually think out long term and want to hold some of these elite businesses for 10 to 20 years and if you own 25 of them, it doesn't make sense, to us anyway, to own 25 stocks at 4% weight each because clearly you get random walks and share prices perform differently. There might be a point in time where that 4% weight makes sense to be 12.5% or equally it could be 0.5%.

There's a lot of randomness that occurs in markets and we've listed some of it there: you have momentum, you have feedback loops, you have short term news flow, you've got the normal P/E and earnings arbitrage play, and then you got noise with shorting and some of the macro that we have just discussed. We really want to be in a position to take advantage of that noise. If share prices are moving in significant non-fundamental reasons, you need a system to capture that and move the weights around.

We can see here for the Australian product, where we've got the data from January 2005, that stock selection contributes to 61% of the alpha or excess returns and 39% has been due to portfolio management. As we look forward, we expect it to broadly be 50% portfolio management, 50% stock selection. It moves around from time to time. Through COVID-19 it has been quite unusual because the stock selection has been so good for the Hyperion portfolios, and we've made few mistakes. But if you think about it as fifty-fifty, I think that's a fair assumption.

Jolon Knight:

Great. We often hear that the market is very narrow at this stage. Having a concentrated portfolio, having a very narrow range of winners, some people say, "But we only just own the fans and they're responsible for the growth that we've seen." Now does the concentrated nature of our portfolio and the idea that the market is only very concentrated, how does that play into your thinking?

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Jason Orthman:

We're very targeted around the stock selection and the portfolio management. We're quite bemused. We have professional investors come out and say the market is only being driven high by the few. That gets amplified in the media. The reality is it has never been broad based. Excess returns and markets are driven higher by the few, it is in the tails. When we look at it today, the market leaders and some of those mega tech names have never been more profitable and never been more important to driving the earnings per share growth of the broader benchmark.

That is another false narrative that markets are broad based. We want to play the tails. If you move forward to on the next slide and think about first principles, again, whether you're at school or whether at university, you're taught that things behave in terms of normal distributions and averages. If you take some risk and you get some return. But that absolutely doesn't occur in markets and the evidence is there.

What happens instead is it’s in the tails, it's the power laws, it's the 100 baggers, the multi baggers, the Amazon’s or the Apple’s that drive markets higher. Most businesses actually fail to accrue returns above cash. Whether it's the broader market or whether it's the Hyperion portfolio, there is absolutely power laws there. We're very deliberate in attacking those structural growth winners.

Jolon Knight:

It really does pay to get your weights right and really select the right stocks within that portfolio set. A lot of managers do have a lot of a high turnover in their portfolio. By high turnover, I mean they buy and sell a lot, or they change stocks in their portfolio often. Do you think this is because they're trying to time their investments for instant success?

Jason Orthman:

We believe so. There is a lot of short-termism in markets and a lot of trading. If you're turning over your portfolio once per annum, you're a renter of a stock. You're not a business analyst. You're not a long-term holder. It's very difficult to see how you can accrue long term alpha and returns. You can see here on this slide and the Hyperion three products over the last five years, our turnover is between sort of 25% to 30%. That includes both that name or stock selection and portfolio management.

We don't overtrade and we hold these businesses on average for 10 years and enhance the weights and alpha by taking advantage of any non-fundamental moves. If you roll over to the next slide, in contrast like the broader market, and you can see the bottom left box there, the average turnover rate of the ASX 300 is 93%, the Small Ords is 142%, and the Global benchmark (MSCI World Index) is 150%. What that is saying is that the portfolio that you start the year with will be completely different to the portfolio you end the year with. That's crazy behaviour. Clearly people are trying to string short term alpha together and do something like that. But it's actually really competitive and difficult to do.

Jolon Knight:

Now, obviously share markets can be volatile at time and are very fluid. How does Hyperion think about share price volatility, and how do you deal with the volatility in even the stocks that we do hold, Mark?

Mark Arnold:

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We look at long term forecast risk adjusted returns in our portfolio management system. We use that to help protect capital for clients and also to boost investment outcomes. This system effectively moves portfolio capital to the highest risk adjusted return opportunities at any given time. We don't try and predict short term share price movements, because as we've said previously, we think short term volatility is largely driven by non-fundamental factors that are unpredictable in nature.

However, we do use our portfolio management system to take advantage of short-term share price volatility. As an example, if a share price declines our portfolio management system will indicate buying if there has been no change to our long-term valuation or no change to the confidence that we have that the long-term valuation is going to be achieved. As Jason mentioned, this portfolio management system of topping and tailing and using long term risk adjusted returns as the basis for the core weights significantly increases alpha generation for clients over the long term.

Jolon Knight:

Thanks, Mark. Back to our original question, alpha is obviously very, very valuable and clearly very hard to obtain, how is Hyperion different, what are you doing exploit the market, what's your secret source?

Jason Orthman:

I think you need to step back and firstly identify and understand the inefficiencies and anomalies you're exploiting. If you can't get through that gate, it's extremely difficult to do anything meaningful. Clearly then you need a structured process to capture that consistently. Part of that is actually taking a 10 year plus view and being very differentiated from the market. It is understanding again that things in life and things in investing are not linear, and that you really need to take advantage of that exponential growth in the few.

Those inefficiencies need to be understood. You want to be really targeted as well. When it comes back to that stock selection to get those high forecast earnings attractive and high rate returns, often these businesses are completely misunderstood and they're extremely controversial until they're actually proven. We've seen that with Tesla, we've seen that with Square, and you saw that with Facebook and Amazon, if you go back to the days that we launched the fund.

With the portfolio management, you don't want to overtrade, and you only want to change your position if you're taking advantage of something that's non-fundamental. If we look forward onto the final slide, there's a lot of reasons to be optimistic as we look forward. Part of that is the rise of dumb money and passive investing, and the lack of conviction of business analysts in the market. That makes us really optimistic. What we've seen here, and this is a quite complicated chart, but if you look at the bottom right over the last five years in global[5], idiosyncratic alpha has been about half of our overall alpha or excess returns.

That's really important because idiosyncratic alpha is your skill. Effectively the academics can't explain why you are accruing that excess return. They can't use a momentum factor or a skew or a quality bias, all of the traditional factors that you would think explain excess returns. To us that is really quite exciting

[5] 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.

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because that's our portfolio management, that's the inefficiencies we exploit, that's our process and structure and valuation that is proprietary to Hyperion. We believe that gives us a large edge. That's what is repeatable, the idiosyncratic alpha.

Jolon Knight:

Thanks, Jason. A question we often get is, what do you say to people who think that markets are currently overpriced?

Jason Orthman:

It really comes back to your view on 10-year U.S. bond yields. If they stay below 250 basis points, the markets are not overpriced. Where they sit at the moment, they're between 160 to 165 basis points, so your view on interest rates is important. If you take a best-case scenario from here, it doesn't mean that you will do super well backing just your benchmark. From here, we believe earnings will be really low single digit for markets. That is your best-case return.

Unfortunately, the worst case scenario is that you get significant disruption in the benchmarks where the incumbent, large, average, old, and slow market leaders get replaced by those new structural growth winners. Then it becomes extremely, extremely painful. The low single digit earnings or low single digit returns, which is your best case, investing in averages, becomes significantly negative. What we are trying to do is have a basket of 20 to 25 stocks that we think will become the next market leaders and are a really high-quality business that are growing at rapid rates and can control their own destiny. We wouldn't want to be beholden to the broader markets from here.

Jolon Knight:

That's great. Thanks a lot, guys. Some really good insights there from both Mark and Jason.

There is no doubt that alpha and especially after fee alpha is very hard to obtain, especially over the long-term. You can see on this slide here that Hyperion has been able to produce excellent returns for investors over the time in both our Global and Australian strategies.

You can access the Global fund on the ASX under the code, HYGG, as an active ETF[6]. You can also access the Global and the Australian funds, which is available on most platforms, Netwealth, HUB, BT, et cetera, or through the online application on our website.

A link to the Tesla piece that we spoke of today will be sent around with the follow up email with recording of today's presentation. On the Insights tab of our website, there is also a lot of great content from White Papers to Company Profiles, which I'd encourage you to read up on also.

If you do have any questions on the content that we covered today, or on any of our products, please contact myself or our investors services team. We're always very happy to help. Thank you again for your

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time today and sticking with us. I know we did cover a lot of good content today. We do really hope that you enjoy the upcoming holiday season, hopefully lockdown free. Thanks again all. It's been a pleasure.

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