PPM
PRIVATE PORTFOLIO MANAGERS

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INSIGHTS

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A discussion of PPM's views by Peter Reed, Director/Portfolio Manager at Private Portfolio Managers

Bonfire of the Volatilities

Lessons and Opportunities post-GFC Continue

It's fair to say that the makeup of PPM's holdings of financial stocks has changed significantly over the past decade or so.

Around the time of the GFC exposure was dominated by the major Australian trading banks. Loan growth remained healthy: this was particularly the case with residential mortgage lending where borrower debt levels were not excessive and house prices (at least in hindsight) had not moved into unreasonable territory.

For a long time we had been attracted to the sector partly because of the appealing structure of the industry in Australia. Residential property lending was dominated by the big-4 banks and this position was further strengthened post-GFC as the smaller lenders lost competitiveness against their major rivals.

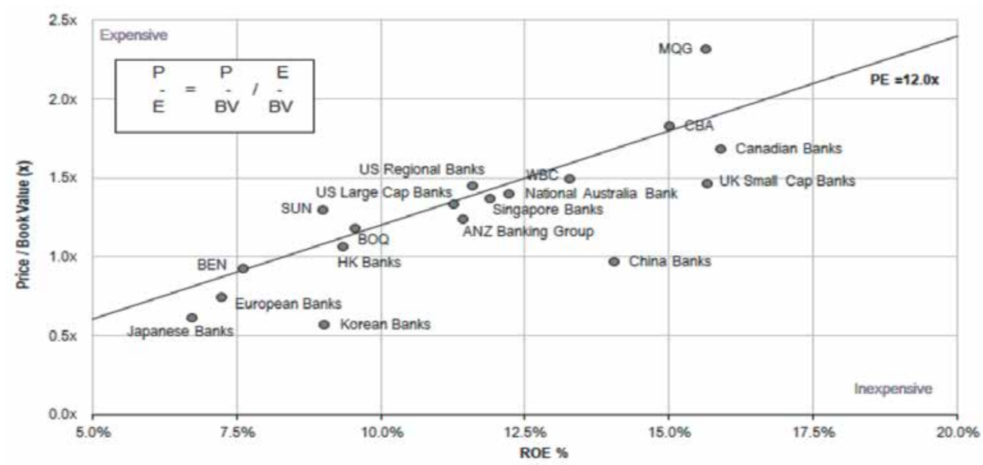
But as these cycles typically work out, asset (house) prices soared, borrower indebtedness continued to rise and the skew of the banks' exposure to this segment continued to rise, all of which gave rise to concerns over risk levels of the banks and the outlook for growth. Although bank lending books remained healthy, at least in terms of bad and doubtful debts, we did not have to think too hard to come up with scenarios where what appeared solid loan books quickly turned mushy.

To reinforce this view, valuations of the banks had been pushed to levels that made them look increasingly unattractive, particularly from a global perspective. In the case of CBA, for example, the price to book ratio had been pushed above 2X (see chart). When the stock was trading on an ROE greater than 16% this could be justified but at the same time we viewed the risk to the sustainability of such high ROEs as significant. A slowdown in lending growth, higher bad debt experience and a higher regulatory burden, a real risk post GFC, were all realistic possibilities which would affect the ROE.

"At PPM we become particularly interested in banking investment opportunities around a financial or economic crisis."

It is at such times that with a bit of fortitude investors can buy banks on price to book ratios closer to 1X and, depending on the severity of the crisis, even less than 1X. Remembering that a value of less than 1 indicates permanent damage to the bank's franchise, if we take a contrary view that there actually remains real value inherent in the franchise then a purchase at such levels, all else being equal, should be attractive.

And so it was from this perspective that with the effects of the GFC rippling around the globe we cast our net further afield for attractive banking franchises which, in our view, appeared attractively valued.



Bank Sector Price / BV (6 month forward rolling) with 12 mth fwd rolling ROE. Source: Company data, IBES, Credit Suisse estimates 21/5/18

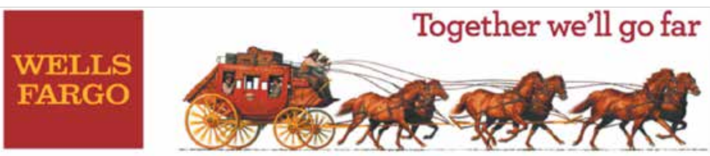
The first port of call in this quest was the US, where unlike Australia, a number of significant financial institutions went to the wall, starting with Lehman Brothers, and many that didn't were put under severe stress. In such circumstances the sector as a whole tends to suffer a significant market downgrade. This was the case for Wells Fargo, a bank we held in high regard prior to the GFC but which could be argued was ultimately a beneficiary of the crisis.

With the US government looking for relatively strong institutions to help bail out weaker competitors, Wells was the prime contender to step up and take over Boston-based Wachovia Corp. Matched with Wells' west coast centred business, the combined banks now offered a true coast to coast banking franchise with 9,000 branches and over 12,000 ATMs.

At the same time most other major competitors of Wells, having been put under severe financial pressure, were now distracted with the prime task of remediating their own business – writing off bad debts, cauterizing parts of the business by creating "good bank"- "bad bank" loan books and generally rationalising the business and slashing costs. The environment was ideal for stronger competitors such as Wells to cement their market position.

Purchased at a price close to book value, our expectation was that over a period as financial markets normalised and assuming the bank is able to further develop its business the price multiple for the franchise will further expand. So not only will the share price likely rise with the natural growth of the business, the valuation multiple applied to the business will also increase as investors become increasingly comfortable with its prospects. This will likely play out over many years and, notwithstanding the occasional difficulty along the way such as the recent issue of regulatory fines against Wells, the investment for our clients is expected to yield attractive returns.

In ensuing editions we plan to look at our experience with bank investments in the UK, again at around the time of great market dislocation following the GFC.



Q&A session by PPM with John Maroney, CEO SMSF Association

What you need is Individual

What you should be thinking about with your SMSF

For SMSF Trustees

1. **What attracted you to the SMSF Association, why did you join?**

I have always been involved and passionate about the Australian retirement system, where I spent most of my career before going to Switzerland. I was part of it when there were major changes happening in the '80s and now, 30 years later, we've got a lot of money and a lot of people in the system and it's starting to get to that very interesting stage of what it's all about, that is, helping Australians retire in a secure and dignified way. It's an area of great interest and passion to me.

2. In the current volatile market what should trustees be focusing on in 2018?

Not only in 2018, but I recommend trustees gain Specialist SMSF advice in conjunction with their own education and research. In a volatile market it is recommended to diversify investments to help ensure a sound investment strategy.

"Trustees' investment strategy should be tailored to their specific circumstances to suit their financial and retirement goals and SMSF Specialist advice is important in helping achieve that goal."

3. What are the key trends impacting SMSF trustees? And how should they respond?

The main trend still impacting SMSF trustees is the implementation of legislative changes effective last year as at 1 July 2017. This has far reaching effects, not only on the day to day administration of their fund but also estate and succession planning. There are many moving parts that trustees need to consider and for that reason it is vital that they seek SMSF Specialist advice to assist them. We see wonderful results when trustees are working in sync with their trusted, professional advisors. Another trend, I have already touched on is the importance of diversification to ensure not all your eggs are in one basket, so to speak.

4. Many issues came out of the 2018 budget, out of these what will benefit the SMSF sector?

The fact that SMSFs were largely untouched in the Federal Budget goes a long way to further instil confidence in the SMSF and superannuation sectors. It is something we, as an Association, have advocated all political parties to carefully consider when contemplating superannuation taxation and retirement design. We want to ensure policy development is done on a holistic basis, not ad hoc with a short-term view or where other political motivations could further undermine confidence in the retirement system. However, increasing the maximum number from 4 to 6 members in a fund enables greater flexibility in estate planning and is a positive change to come out of the budget.

Your advisers (Financial Advisors and Accountants)

5. What is your view on complying with the new education and ethical requirements and the expanding Best Interest Duty?

We are supportive of the Government's decision to establish FASEA, recognising its important role in overseeing the educational and training standards of financial advisors, as well as establishing a solid Code of Ethics. Our Association believes it is another positive step to improve the training and educational standards of advisors, and it is an issue we have long advocated for.

6. What challenges do you see facing SMSF trustee advisers in the next 5 years?

Over the next 5 years we see a few challenges that both trustees and advisors will be facing. One of these challenges includes the implementation and management of transfer balance account reporting. This is an issue that will have a substantial impact on SMSF administration and will need to be closely monitored as part of day to day fund responsibilities.

Another challenge is the diversification of investment portfolios to ensure robust investment strategy and the ability to minimise unnecessary risk to achieve long-term goals.

The potential uncertainty in superannuation, including the recent franking credit policy debate and the integration of retirement policy, is also a constant challenge that the sector faces.

7. Obviously you cannot recommend a fund manager but what are SMSF trustees looking for in investment management?

I cannot recommend a fund manager, but some guiding principles I would offer to SMSF trustees include:

- **Strong relationship and understanding** between advisor and trustee is paramount.
- **Ensure adequate diversification** of your portfolio to satisfy a sound investment strategy.
- **Increased transparency in investment management** is important.
- Look for a **fund manager with a strong history of solid returns and competitive fees**.
- Fund managers with a high level of relevant and specialist knowledge and up to date skills are best placed to guide your investment strategy.

The Future of the SMSF Association

8. What direction do you see the SMSF Association heading in over the next 12-18 months?

The federal election, which will inevitably happen in the next 12 months is a big focus for the SMSF Association. We'll be looking at the general issues but also focussing on the budget and of course the threat from Labor's franking credits proposal which very much targets SMSF trustees. We will be informing trustees and our clients we strongly oppose this proposal and running up to the election this will be a much bigger issue.

We will also be focussing on education in the next 12-18 months and will look at how we can work with higher education providers a lot more closely. We are all waiting to see what FASEA finalise in terms of guidance in the next few months and we will look at revising what we do in the higher education space.

Of course what will happen post Royal Commission findings will determine how we go about doing this. Trustees and investors need to be informed about best practice.

9. We see the SMSF Association more active in the conference space. Can you please discuss the associations direction and perspective on this?

The SMSF Association has been active in holding conferences and face to face events for SMSF professionals across the country for many years to resounding and continued success. We are wanting to provide SMSF trustees with flexible learning opportunities including online education via our Trustee Knowledge Centre and face to face events such as the SMSF Trustee Day “Your SMSF in Focus” Event held in Sydney (on May 14th) where they can connect with like-minded individuals, ask questions of SMSF experts and discuss the latest issues in the sector.

SMSF Association Trustee Day “Your SMSF in Focus”

On Monday 14th May, the Self-Managed Super Fund Association (SMSF Association) held a one day conference in Sydney, entitled “Your SMSF in Focus” providing informative economic (post budget), regulatory and product relevant updates for SMSF Trustees. The conference was well received by all 190 attendees. Hugh MacNally, PPM Chairman and Portfolio Manager, gave an insightful presentation on the importance of understanding and mitigating investment risk, especially in the current volatile and turbulent markets.

For more information on PPM’s participation, the SMSF Association or to access the portal please contact India Hopper at ilh@ppmfunds.com or contact her directly on +61 2 8256 3777 .

For further information about PPM’s services, please contact either Sally Humphris or Adam Griffiths on 1800 463 359 or email ppm@ppmfunds.com.

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