Sterling Times

November 2020 Edition

In this edition

MERCHANT WEST

STERLING PRIVATE WEALTH

Introductory message from our managing director

By Graydon Morris, Managing Director, Sterling Private Wealth

Dear valued clients and friends.

I am sure you have all heard it before, many times, but what a year, truly!

We hope that you all remain safe and sound and are looking forward to whatever the festive season brings for you, with much anticipation. We hope it gives you the opportunity to relax, spend time with loved ones and forget for a while all that has been thrown at us this year.

In doing so, we all recognise that there are many around the world who have been affected by the year's events in ways that we cannot imagine.

The good news is that all Sterling staff, who have worked so tirelessly this year in trying circumstances, remain fit and healthy and will be energised for 2021 come January. We thank each one of them for their tremendous commitment and efforts.

Our team has grown this year, in a way that significantly enhances our depth, quality and skillset. We were joined in the past few months by **Fritz Lippert** in Gauteng and **Joanne Baynham** in Cape Town. Both are CA's (SA), passionate about markets and wealth management. Joanne is a CFA Charter holder with over 20 years' experience in local and global investing. We are certain they will enjoy a fulfilling and successful career with us and will serve our clients with dedication and passion.

On 1 November 2020, we also took over the **Bridge Wealth** business in Cape Town, centred primarily in the Cape Town Northern Suburbs. We welcome Teresa Heydenrych and Sonja Fagrew as part of this team, as well as their loyal clients who now form part of the Sterling family.

Our business turned **18 years old this year**, in July. We are very proud of what has been achieved but acknowledge that it is only possible with the loyal support and trust we have created with our valued clients. Thank you to you all. We never take your support for granted and It is a privilege to serve you.

This year, on your behalf, we have made in total 3 material donations to Food Forward to support those so in need during these trying times.

We have included a few pieces for your reading pleasure in this Sterling Times edition.

Firstly, our own Joanne Baynham has penned a piece on global property that we thought you may find of interest. We have also included a few Fiduciary Notes from our JV partners Fidelis Vox, one on the Accrual System, and a second on Offshore Wills.

A client recently shared with us a true-life story of risk that has some investing consequences. We thought to share this with you.

Finally, Fund Manager Piet Viljoen espouses his views on the global technology share valuations and ponders the questions everyone is asking.

We wish you all safe travels, much health, and look forward to seeing you all in 2021.

Graydon Morris

Managing Director

Specialised Global property stocks- piggybacking on the growth of the FAANGs

By Joanne Baynham, Wealth Manager, Sterling Private Wealth

Much has been written about global property in the last few months, most of it negative, but as I will argue in this article, not all property stocks are created equal. I am of the view that there are still lots of opportunities within the global property universe, however one needs to take active sector bets and purely choosing a passive strategy via a global property ETF would not be my recommended investment strategy.

Akin to how global equities have had very clear winners and losers in the last few years, global property has had a similar experience, with huge winners in certain sectors and major losers in others.

Looking at the winners of property, I was amazed to see that those who are thriving are the companies that are the landlords and beneficiaries of the digital disruptors, often identified by the anacronym **FAANG** (Facebook, Apple, Amazon, Netflix and Google).

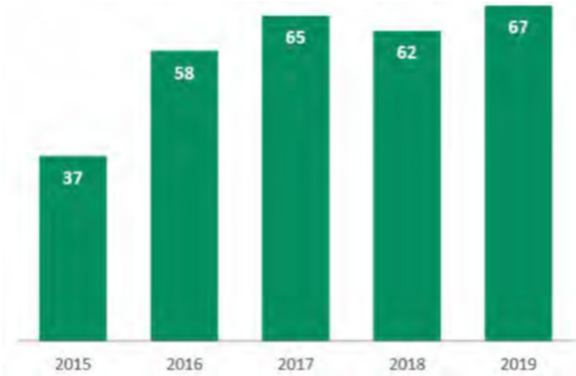
I came to this realisation after interviewing some very smart global property fund managers, who run funds on behalf of Reitway Global, Schroders and Catalyst fund management. To a man, they identified the following real estate sectors as the potential winners of the future: Mobile Towers, Last mile logistics, Data warehouses, Storage, Healthcare and certain residential properties. The majority of these rental opportunities are essentially predicated around the growth in technology.

As the bar charts below show, the sectors that are leveraged to the digital economy have enjoyed strong returns in 2020, whilst those that have seen their businesses disrupted by technology have suffered.

Source: Catalyst Fund Managers & Bloomberg. Returns are total returns in USD

Looking at some of these sectors in more detail, their correlation to the technology disruptors becomes more obvious starting with Mobile tower real estate investment trusts (REITS) - they have become more valuable as individuals remain glued to their screens, but also want faster connectivity (think 5G) and reliability. They have also done well in a world where working from home has become common place and, in some form, or another will be part of our future landscape (especially for those of us who are fortunate enough to work online). SBA communications is one such example and they are up over 20% for the year, not as much as Apple, but comfortably outperforming the S&P 500.

Then we have Last mile logistics, which has become incredibly popular thanks to e-commerce and the ever increasing need to get goods to clients, as quickly as possible. The location of these logistics properties is very important as speed is relative to distance and hence the last mile logistic centres have become very valuable, especially near built up and densified urban areas.



The above chart is the percentage of people who think that 3-4 days is too slow for something to be shipped (Source: Reitway Global)

When one thinks of logistics, one thinks of Amazon and Alibaba, as these mega tech giants are huge drivers of e-commerce. If the price of Alibaba and Amazon is too pricey for some, why not invest in the logistics companies that rent out space, to help with their e-commerce activities. Prologis is one such example, with its focus being industrial logistical real estate and has benefitted handsomely from the growth of online commerce. This share is up over 12% for the year, also outperforming the S&P. The COVID-19 pandemic has fast forwarded their expected growth in e-commerce demand, with the demand in the first 5 months of the year surpassing their forecasted 5-year demand numbers.

Data warehousing, another growth driver of real estate and aligned to the digital economy. Interestingly enough, it is the wholesale data warehouses that sell space to the FAANGs stocks that are best avoided as the power these behemoths wield will eventually lead to lower rentals going forward. One needs to rather be invested in retail central centric data centres in which rentals yields have more pricing power, as the land is closer to city centre and is more difficult to replicate further away. But regardless of location, the demand for data warehousing is only going to rise, as cloud-based solutions increase and consumers and companies store their data on the cloud.

In analysing the sectors that will be disrupted by technology there is no denying that working from home (WFH) is and will cause damage to the office rental market, due to the changing dynamics of the office work environment. I would argue that even in world where a vaccine is found and life returns to "normal ", our working life as we know it will not be the same as it was. No-one is saying that none of us will ever work from office again, but flexi time and an aversion to long commutes will mean that offices won't have the occupancy numbers that they have has of the past. This will cause pressure on rental yields, as excess capacity will only be met by reducing rentals.

In the consumer world, retail rental had been declining pre COVID and COVID-19 has just accelerated this trend, as consumers choose to shop online. Admittedly, consumers will still shop in the real world, but akin to the trends we are seeing in offices, it will be less than in the past.

But what about those investors who want to invest in real estate for yield? As a number of these specialised real estate offering trading more like growth stocks, with low yields and a valuation multiple that rewards future earnings. When I asked this question of the managers, there answer was that yield was dangerous, as

To give one example second tier and third tier shopping centres will eventually go out of business and if they don't rental yield growth will be a fraction of what it was in the past. This was happening pre COVID-19, as several countries in the world had a huge oversupply of retail space, it was not just ecommerce that led to this fall.

In the words of one of the mangers I interviewed:

“No price is low enough to invest in retail shopping malls in B grade and C grade retail malls”.

To conclude, the digital future is here now and the property REITS that embrace this new world will have a far better chance of achieving sustainable and growing rentals. Those that invest in the old economy will struggle to raise rentals, unless their properties are in areas that can be easily repurposed for this new environment.

As I mentioned in the beginning not all property is equal, nor is it only retail and office space. The property sector is now offering more choice than it ever has had before, but I would still recommend investing with a specialised property manager, who understands the different sectors and their particular growth drivers.

Lastly, if buying the FAANGS makes you nervous because everyone loves them, then buying property stocks that offer investors a “real asset “exposure to the growth of the FAANGs is potentially another solution.

Estate planning & the accrual system

By Fidelis Vox

When a couple gets married and enters into an ante nuptial contract the accrual system is automatically included in terms of the Matrimonial Property Act No. 88 of 1984. The accrual system should be expressly excluded in the ante nuptial contract, if the intention is that it should not be applicable to the marriage.

At the dissolution of the marriage, by way of divorce or death of one or both the spouses, the spouse or estate which shows the smaller accrual acquires a claim against the other spouse or estate for an amount equal to half the difference between the accrual of the respective estates of the spouses.

This could become problematic in the case of the spouse with the smaller accrual dying first and that estate having an accrual claim against the surviving spouse. One way to overcome this issue is for the spouse with the smaller accrual to bequeath an amount equal to the accrual claim to the surviving spouse in his/her Will.

The application of the accrual system can also mean that bequests to beneficiaries in a Will do not end up in their hands, as the accrual claim has to be settled first. An option is for the bequests to the surviving spouse with the accrual claim, to specifically include the accrual claim, or for bequests to him/her to be subject to him/her renouncing the accrual claim. Careful planning needs to be done in such a case, as donations tax may be levied if the inheritance received by the spouse with the accrual claim is less in value than what the accrual claim would have been.

When an ante nuptial contract is entered into, the spouses may specify in the contract which assets are to be excluded from the accrual system- this has to be done and signed before the date of marriage. There are, however, certain assets which are excluded from the accrual system in terms of the Matrimonial Property Act No. 88 of 1984. These include an inheritance, a legacy or a donation which accrues to a spouse during the subsistence of his/her marriage, as well as any other asset which was acquired by virtue of the possession of or former possession of such inheritance, legacy or donation.

Other exclusions from the accrual calculation are donations between spouses, any amount which accrued to a spouse by way of damages other than for patrimonial loss, the proceeds of -

a ceded policy on the life of a deceased spouse, the proceeds of a policy on the life of a deceased spouse payable to a nominated beneficiary, and lump sum benefits payable to a nominated beneficiary on the death of a member from a pension or retirement fund or group life insurance.

You may need a separate Will dealing with your non-South African assets.

A Will drafted and signed in South Africa may be, but is not always, sufficient to deal with your South African and non – South African assets.

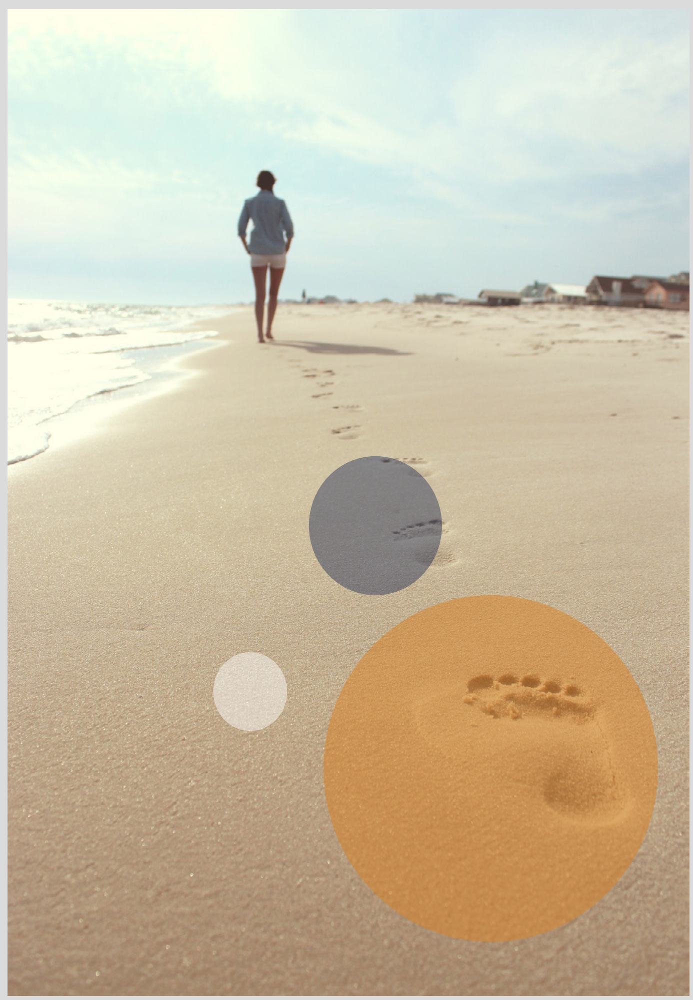
If you have, for example, externalised your discretionary foreign investment allowances and now hold investments in your own name in other countries, you may need to consider a separate Will dealing with your non-South African assets, for the following reasons:

South African law is mostly based on Roman Dutch law principles, with some English law influence. Some legal terms used in SA wills are not known in certain foreign jurisdictions, which may result in delays and costs to obtain legal interpretations. It may also be necessary to have your worldwide will translated and sealed before sending it to the foreign executor or agent. When drafting a separate Will dealing with the assets in a specific jurisdiction, the legal terms as known in the laws of that country can be used in the Will.

In common law jurisdictions, such as the UK or the US, both immovable and movable assets may be subject to inheritance taxes being levied at rates of up to 40% on assets classified as situs assets in those countries. The Chambers Murray Latin-English dictionary translates the Latin word 'situs' as 'lie, position, situation'. In terms of private international law, the situs of assets are generally determined by the location of immovable property, the place where shares are registered or listed, the place where bonds - have been issued, and in the case of intermediated securities in some cases looking at the situs of the security itself and in others at the situs of the underlying assets. It often proves to be extremely difficult for an executor in South Africa dealing with a worldwide estate, to deal with the tax authorities in other jurisdictions in this regard.

Legislation in different foreign jurisdictions may differ substantially regarding validity requirements for the signing of wills. When separate Wills are drafted dealing with assets in certain jurisdictions, the validity requirements can be taken into account and adhered to.

With a separate offshore will in place, there will generally be no need for your executor to obtain sealed copies of your Will and Letters of Executorship from the Master of the High Court in South Africa to provide to the person who will apply for a grant of probate in the foreign country, which process may cause unnecessary delays.



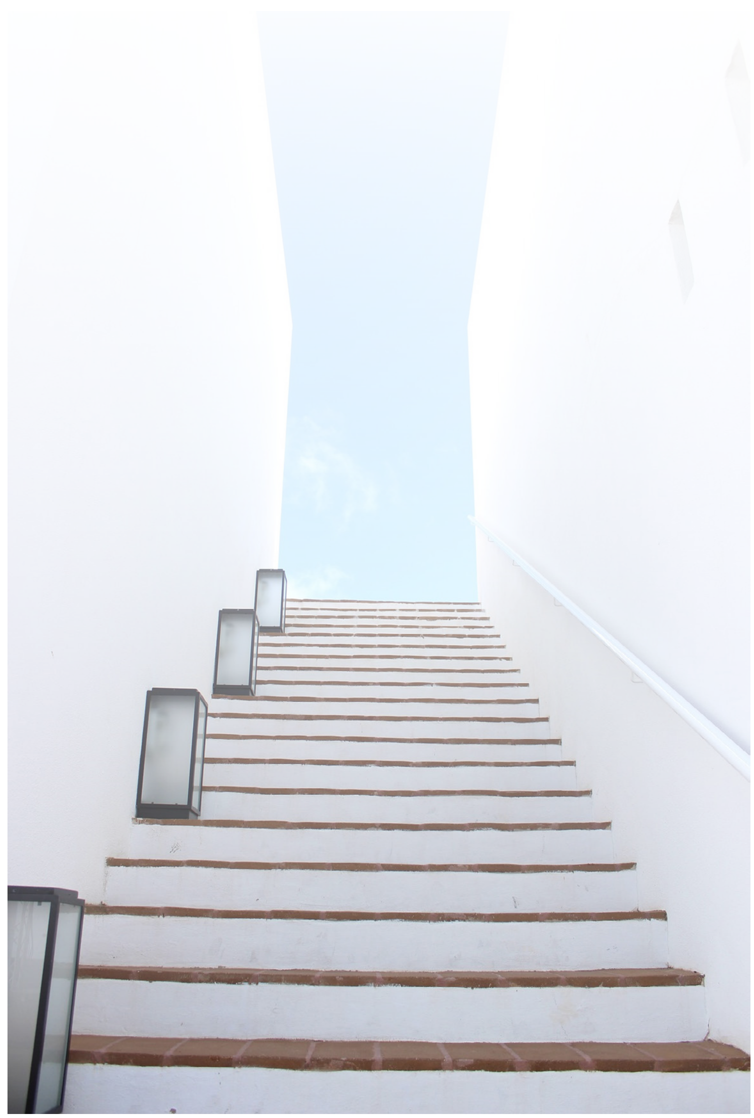
The separate Will allows an offshore solicitor to be appointed to obtain a grant of probate abroad where necessary.

Succession laws and validity requirements in other jurisdictions can be taken into account when drafting the separate Will.

Bequests are often made to SA trusts in wills dealing with worldwide assets, for instance when the balance of an estate after specific bequests is dealt with which may include assets outside SA, with the unintended consequence that the SA trustees are not allowed to hold the non SA assets outside SA in the name of the Trust, in terms of exchange control regulations, and have to then sell them and repatriate the funds to South Africa.

When drafting Wills dealing with non -South African assets one has to take care that the separate Wills do not revoke each other and that the Wills do not deal with the same assets.

Forced heirship rules in some jurisdictions should be considered in drafting offshore Wills, as immovable property situated in jurisdictions such as Portugal may be subject to these rules irrespective of the bequests relating thereto in a Will, which may cause the ownership of these properties to be transferred to persons other than intended by you.



The Three Sides of Risk

By Morgan Housel

I grew up ski racing in Lake Tahoe. I was on the Squaw Valley Ski Team, and it was the centre of my life for over a decade.

At a conference a few months ago, I was asked what skiing taught me about investing. This was on stage, where you cannot ponder your answer – you must blurt out whatever you can think of.

I did not think skiing taught me anything about investing. But one incident came to mind.

"Well, let me take this to a dark and tragic place," I said before telling a group of 500 strangers a story I had not talked about much in almost 20 years.

A dozen of us had grown up skiing together. Most had known each other since we were young children.

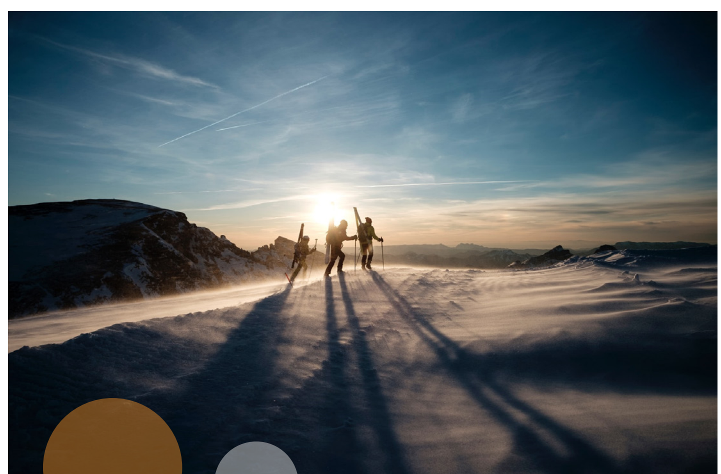
By 2001 we were in our late teens, having spent most of our waking hours over the previous decade never far from each other. We skied six days a week, 10 months a year, spending summers on the glacier of Mt. Hood, Oregon and in New Zealand, where the seasons mirror our own. Skiing took precedence to everything. Most of us were in an independent study program that let us bypass traditional high school. After skiing all day, we read a few books and filled out a few forms in the evening in what – to our amazement – led to a diploma.

The amount of time we spent together created a relationship closer to siblings than friends. Ski racing is an odd hybrid between a team and individual sport. You train and travel and eat as a team, but the sport itself is individual. Our race results did not rely on each other; our daily sanity did.

Any group of a dozen teenagers will find a way to butt heads. Half the time I think we hated each other. Twenty years later, few of us keep in touch.

But of the dozen teenagers who, by 2001, I had spent the majority of my life with, four of us had become inseparable best friends.

This is the story of two of them – Brendan Allan and Bryan Richmond.



You take amazing things for granted when they become routine. Squaw Valley is one of the largest ski resorts in North America, was home to the 1960 Olympics, and attracts a million visitors a year. It's staggeringly beautiful. To us, it was just an extension of home.

Ski racing required four hours a day of training, which felt like work to us. The rest of the time – another four hours a day, six days a week – we just skied around, unstructured, having a good time. We called it "free skiing." Everyone else just calls it skiing.

On February 15th, 2001, we had just returned from a race in Colorado. Our flight home was delayed because Lake Tahoe was blasted with a blizzard vicious even by its own standards. You can't race or train when there's a blanket of new snow – racing requires hard-packed ice. So, it was time for a week of free skiing.

Earlier that month Tahoe received several feet of light, fluffy snow that comes from Arctic temperatures. The storm that hit in mid-February was different. It was warm – barely at the freezing point – and powerful, leaving three feet of heavy, wet snow on top of the light powder that came before it.

We did not think about it at the time – we didn't think about much at age 17 – but the combination of heavy snow on top of fluffy snow creates textbook perfect avalanche conditions

Imagine a thick layer of sand with a layer of heavy cement on top. Now imagine putting those layers on a steep hill. It's fragile, prone to sliding down. That's what Squaw Valley was like

Ski resorts are good at managing these kinds of conditions to keep people safe. Few tourists realize it, but if you visit a ski resort in the early morning hours after a blizzard you will hear what sounds like bombs going off. The sound isn't deceiving. With a combination of mortars, grenades, and charges dropped from helicopters, ski patrol do controlled blasts of at-risk pitches to intentionally trigger avalanches when the resort is empty, pre-empting slides before guests arrive.

It is an effective system, keeping avalanche accidents at major resorts rare.

But if you are skiing out of bounds – ducking under the **DO NOT CROSS** ropes to ski the forbid.

Skiing out of bounds is illegal, a form of trespassing. The main reason resorts don't want you doing it is because it's dangerous.

Out-of-bounds areas are not patrolled, so you're on your own if you get injured. They usually do not lead down to a chairlift, so you have to find your own way back up.

And they're not bombed for avalanche control. So, it's here – out of bounds – that a skier is most likely to discover Mother Nature's sliding wrath.

On the morning of February 21st, 2001, Brendan, Bryan, and I met in the Squaw Valley Ski Team locker room, like we had hundreds of times before. Bryan's mom told me years later that his last words when he left his house that morning were, **"Don't worry, Mom, I won't ski out of bounds."** But as soon as we clicked into our skis, that is what the three of us did.

The backside of Squaw Valley, behind the KT-22 chairlift, is a stretch of mountain about a mile long that separates Squaw from Alpine Meadows ski resort.

It's good skiing – steep, wide open, with rolling terrain. And since it's out of bounds, it was completely untouched. Our private playground.

Before February 21st I had skied it maybe a dozen times. It wasn't one of our frequent spots, because it's a pain in the ass. The end of Squaw's backside spits you out on a back-country road, where we would hitchhike back to our locker room.

Brendan, Bryan, and I decided to ski it that morning.

When an event becomes life-changing, all kinds of mundane details sear into your memory. Almost 20 years later I remember Brendan duct-taping his ski pants shut on the chairlift because I had broken the side zipper while wearing them the week before. I remember Bryan cackling with joy as the three of us entered barren wilderness while the rest of the resort was packed with crowds.

And I vividly remember getting hit by one of the only avalanches I've ever experienced.

It was tiny, not going over my knees. It wasn't scary. I remember laughing. But the feeling is unforgettable. I didn't hear or see the slide. I just suddenly realized my skis weren't on the ground anymore – I was literally floating in a cloud of snow. You have no control in these situations, because rather than pushing back on the snow to gain traction with your skis, the snow is pushing you. The best you can do is keep your balance to remain upright. I remember putting my hands up and shouting, **"Wahoo"** like I was on a roller coaster. I essentially was.

The avalanche ended quickly. Brendan was to my left and Bryan was below us. No one stopped. We just charged to the bottom.

"Holy shit, did you see that avalanche?" I remember saying when we got to the road.

"Haha, that was awesome." Brendan said.

No one thought much more of it.

We hitchhiked back. At first, we had trouble getting a car to pick us up, so I decided if we took our shirts off in the 20-degree weather people would have sympathy for us and stop. It worked. Seventeen-year-old boys are resourceful.

When we got back to Squaw Brendan and Bryan said they wanted to ski the backside again.

I have no recollection of why, or how this came about, but I did not want to go.

It may have been the hitchhiking, which I always hated. That, more than the out-of-bounds skiing, felt reckless to me.

But I had an idea. Brendan and Bryan could ski the backside themselves. Rather than hitchhiking back, I would pick them up in my truck.

Everyone agreed on the plan, which we made in the Wildflour Baking Company cookie shop in the Squaw Valley lodge after lunch. This was before we had cell phones, so syncing on concrete plans ahead of time was important.

Brendan and Bryan walked out and skied off.

Thirty minutes after Brendan and Bryan took the chair up to ski the backside, I drove to the back-country road where I was scheduled to pick them up.

They were not there.

I waited another 30 minutes before giving up. It took maybe five minutes to ski the pitch, so I knew they were not coming. It did not occur to me that they were in danger. I figured they beat me to the bottom and hitchhiked back.

I drove back to our locker room, expecting to find them. They weren't there, either. I asked around. No one had seen them.

I drove to Brendan's house, which wasn't far from the pick-up point. No one was home. I drove back to the locker room and called his house. It went to voicemail. I remember ending the message with,

"I hope you're OK man."

I was starting to get nervous, but not enough to make a big deal. People were more comfortable being out of touch before the texting era.

Later that day, around 4 pm, Bryan's mom called me at home. I remember every word.

"Hi Morgan, Bryan didn't show up for work. Do you know where he is?" she asked.

I told her the truth.

"We skied the backside of KT-22 this morning. He and Brendan did it again, I was going to pick them up on the road. But they weren't there, and

"Oh my God," she said.

Click.

I think in that moment she pieced together what may have happened to her son. I did, too.

Later that evening, after sunset, my friend Ahren and I bought heavy duty flashlights at a drug store and drove to the pick-up spot. We shined the lights up the mountain shouting, "Brennndan .... Bryyyyyan." I remember Ahren and I thinking they had likely broken their legs and were stuck on the hill. In the back of my mind I knew it was more serious, but it was comforting to think we could find them.

We gave up quickly and drove to the locker room.

I forget who made the call, but the police were suddenly taking our information in what had become a missing-person report.

I don't fault the police for this, but they didn't take it seriously. I remember one saying, "99% of the time in cases like these the person is out drunk at a party or ran off with a girl for the night." I'm sure he was right – that was usually the case. But I knew he was wrong.

"Their shoes are right there," I said, pointing to Brendan and Bryan's sneakers on the locker room floor. "That means their ski boots are on their feet. And it's now 9 pm. Think about that. It is 9 pm and they have their ski boots on their feet. They are not at a party."

Around 10 pm I was told to go to the Squaw Valley Fire Department where I met the local search and rescue team. They took it much more seriously.

I explained everything Brendan, Bryan, and I did that day. The search team pulled out maps, and I showed them exactly where we entered the out-of-bounds area, where we exited, and the path we took. I told them about the small avalanche we were caught in that morning. As soon as I mentioned it, I could see the dots connecting in the rescuers' heads. These were seasoned professionals who understood the danger of mountains. When I finished talking, I remember two of the rescuers looked at each other and sighed. They knew.

I drove back to the locker room around midnight. The Squaw Valley parking lot can hold several thousand cars. By this time, it was almost empty. Everyone had gone home, except two cars parked next to each other: Brendan's Jeep, and Bryan's Chevy pickup.

Search and rescue teams were on the backside of Squaw a little after midnight. It was still a blizzard, with gusty winds and low visibility even during daylight. I remember watching them ski off in the pitch-black night.

With giant floodlights and a team of search dogs, they went looking for Brendan and Bryan.

I later learned that as soon as the rescue team entered the out-of-bounds point where I told them we skied; they found the fresh scars of a massive avalanche field.

I tried to sleep on a bench in the locker room but couldn't shut my eyes. I remember hoping Brendan and Bryan would come bounding through the door. The hours dragged on and felt like days.

By 9 am the locker room was packed with other ski racers, parents, friends, and family, all eager to help. It became a staging area for the search. I laid back down on the bench and finally fell asleep. A few minutes later I awoke to the sound of a scream, followed by yelling and commotion.

I knew what happened. No one needed to say it. I walked to the second floor of the locker room where I saw Bryan's mom on a couch. The scream was hers. "I'm so sorry," I told her, bawling. It's hard to describe a moment like that. I didn't know what else to say then. I don't know what else to say now.

Search dogs had homed in on a spot in the avalanche field where rescuers with probe poles found Brendan and Bryan buried under six feet of snow.

They were born one day apart and died 10 feet from each other.

Later that day I drove to see my dad at work. I wanted to be around family. He met me in the parking lot and said, "I've never been so happy to see you." It was the only time I've seen him cry.

It did not occur to me until that moment how close I was to going with Brendan and Bryan.

Why did I ski the backside with them once that morning, but then decline a second run?

I have thought about it a million times. I have no idea.

Why was the avalanche on our first run a tiny little thrill, but the second run triggered a massive slide that killed two 17-year-olds?

We'll never know.

The next evening, Tom Brokaw told Brendan and Bryan's story on the NBC Nightly News. It was surreal to watch. We were laughing together 36 hours before. Now their death was national news. And the only thing that kept me from being a third name in the newscast I had watched religiously was a fluke decision I put no thought into.

It's been almost 20 years since this happened. Sometimes I think about everything that's occurred since – college, marriage, career, kids – and remind myself that I've only experienced it because of a blind, thoughtless decision to decline another ski run.

This story isn't unique. Many people reading this have had near-death experiences. Most have lost someone dear to them. And everyone reading this has made what seemed like know-nothing, inconsequential decisions that fundamentally reshaped their lives. Sometimes those fluke decisions are positive. Sometimes they're negative. But they're always out of the

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After I told this story at the conference, I had to tie it back to an investing lesson. It was easier than I thought.

My risk tolerance plunged after Brendan and Bryan died. I broke my back skiing (no nerve damage) a few months later, which crushed it even more. I haven't skied much since. Maybe ten times in the last 15 years. If I'm honest, it scares me.

I've been risk-averse in other areas of life ever since, too. I drive the speed limit. I obey the seatbelt sign on airplanes. I invest in index funds.
I don't know if Brendan and Bryan's death actually affected how I invest. But it opened my eyes to the idea that there are three distinct sides of risk:

- The odds you will get hit.
- The average consequences of getting hit.
- The tail-end consequences of getting hit.

The first two are easy to grasp. It's the third that's hardest to learn, and can often only be learned through experience.

We knew we were taking risks when we skied. We knew that going out of bounds was wrong, and that we might get caught. But at 17 years old we figured the consequences of risk meant our coaches might yell at us. Maybe we'd get our season pass revoked for the year.

Never, not once, did we think we'd pay the ultimate price.

But once you go through something like that, you realize that the tail-end consequences – the low-probability, high-impact events – are all that matter.

In investing, the average consequences of risk make up most of the daily news headlines. But the tail-end consequences of risk – like pandemics, and depressions – are what make the pages of history books. They're all that matter. They're all you should focus on. We spent the last decade debating whether economic risk meant the Federal Reserve set interest rates at 0.25% or 0.5%. Then 36 million people lost their jobs in two months because of a virus. It's absurd.

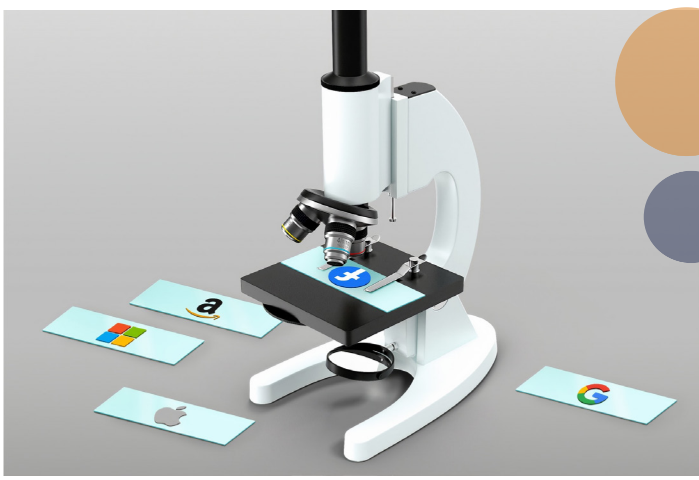
Tail-end events are all that matter.

Once you experience it, you'll never think otherwise.

Portfolio Manager Piet Viljoen reflects on how most investing concepts expressed in terms of acronyms have historically had poor track records.

By Piet Viljoen, 19 August 2020

Investing concepts expressed in terms of an acronym have a poor track record. Over the past 40 years, quite a few have come and gone. None of them met with any long-term success. The emerging markets crisis of 1996 savaged the Asian Tigers, the NASDAQ collapse in 2001 pricked the TMT bubble and the global financial crisis in 2008 ended in a BRIC's bust. Today, investors have found a new concept – the FAANGs **(Facebook, Amazon, Apple, Netflix and Google).** In preview, at Counterpoint the view is that stocks represented by an acronym are not a safe space today.



First – a mea culpa. With perfect foresight, both Amazon and Apple were priced like classic value stocks a few times during the past 20 years. And many value investors did indeed have sufficient foresight to take advantage. Microsoft was once a sizeable position in our funds – criticised at the time – but that was it. Nothing else.

Not owning Big Tech has been a huge sin of omission.

But investing is all about managing your exposure to uncertain events in the future, not perpetually kicking yourself for sins committed in the past. The past is prologue, but not a predictor.

So why should one avoid Big Tech today?

Unsurprisingly, valuation is the primary reason. The market appreciates the stable, growing cash flows these high-quality businesses generate, especially in turbulent times like the present. Moreover, during the course of the pandemic, these businesses have gained market share and become even stronger.

Interest rates are the price of money. Today, interest rates have become politicised, administered by governments – not set by demand and supply at a market-clearing level.

Market-determined interest rates make sure investors get the right signals to help them allocate capital efficiently. Administered prices do the opposite. Everyone knows the stories about shortages and surpluses in the old Soviet Union, where bureaucrats set prices at levels which had nothing to do with supply and demand.

Interest rates at zero mean a dollar earned in ten years has the same value of a dollar earned today. It's as if governments have created a wormhole in the fabric of time. Each dollar earned, no matter when, is of equal value. It's no wonder high quality businesses, that dependably compound their earnings over time, attract high valuations. All their future earnings are simply summed to derive today's value. It's a lollapalooza effect[1].

However, is the value of a business correctly calculated using an administered price? What happens if the bureaucrats change their minds? What happens if/when governments lose control of their interest rate manipulating levers?

Markets have become political utilities, their main function being to keep the masses happy. But, under lockdown, they've also become gambling and entertainment utilities, evidenced by the popularity of trading apps such as Robinhood. This is a commission-free trading website, mainly used by novice investors, which has become a veritable thermostat of speculative activity. The Big Tech stocks are invariably amongst the top 50 most popular stocks on the site. By way of contrast, there is not one gold stock in the top 100.

Even if one assumes that the bureaucrats know best, and their indicated interest rate is the correct, market-clearing price for money, and that speculators are keeping the market efficient, there is another problem: The earnings of Big Tech overstates their actual earnings power. Due to the widespread use of stock option schemes, they do not convert all their accounting earnings into actual cash flow that accrues to shareholders.

Work done by Sean Peche at Ranmore funds (ranmorefunds.com) shows that the free cash flow yields of the big 5 (Facebook, Apple, Amazon, Alphabet and Microsoft) are a miniscule 3.1%. If one is happy to accept this as an acceptable return for the risk of investing in these companies then all is good. But Sean goes on to show that if one accounts properly for the cost of stock-based compensation, the yield drops by a fifth to 2.5%.

A 2.5% free cash flow yield does not leave much margin for safety if things go wrong. And there are a few things that can go wrong:

1 The risk of the law of large numbers catching up with the giants

The top 5 companies in the S&P 500 make up over 25% of the index. Historically, large index components have struggled to maintain their position over long periods. They end up running out of growth opportunities. Large companies enjoy economies of scale, but at a certain point, diseconomies start to develop. Additionally, as these gargantuan companies grow, they increasingly start to compete with each other. It is difficult to achieve high rates of growth, over a long period, starting at an already very high level. The base rate of success is vanishingly small.

2 Market concentration risk

As indices become more concentrated, they increasingly do not represent a diversified basket of stocks. As more funds flow towards indices, they end up owning an increasing percentage of the companies. And indices, by definition, are holders, not traders. Combined with large insider ownership, there is not much stock left for active managers to buy. So even a small portfolio reallocation by active managers can move prices dramatically. In both directions. Stenotic markets tend not to price assets efficiently.

3 Existential risk

Technology is becoming the battlefield in a new cold war that seems to be intensifying between the USA and China. From ZTE and Huawei through to TikTok and WeChat, the USA is increasingly excluding Chinese tech from operating in their country. And Europe is generally following in their footsteps. But before one jumps to the conclusion that there will be positive spin-offs for the big listed US-centric tech companies, think about this: What if President Xi Jinpeng says that IPhone sales in China are to be banned, due to the IPhone representing a security risk to China? China represents 17% of IPhone sales, and a huge proportion of Apples' supply chain.

Additionally, governments are not only becoming more interventionist externally, but they are also increasingly guiding Adam Smith's invisible hand firmly in the desired direction of the administration in power. Potential antitrust actions in the USA and Europe could have a detrimental effect on the growth rates of the tech behemoths.

In summary – the tech giants are widely held assets with an elevated level of expectation around future performance. And they are quite possibly being valued incorrectly. Combining this with some major emerging risk factors, the prudent investor would expect disappointing outcomes. At the same time, the historical performance of this group of stocks has been so good, and the naysayers have been proven wrong so conclusively, that very few are willing to publicly evaluate the objective prospects of the group.

It is better to step over the easy hurdle of low expectations, than trying to pole-vault over the high hurdle of market fascination. Today, low expectations are not present in the world of Big Tech. The good news is widely known. The bad news is ignored. This is not a good set up, and one which has hurt the performance of most previous acronyms. Will FAANG prove to be the exception to the rule?

[1] *Coined by Charlie Munger, a "lollapalooza effect" is a when several smaller scale factors of human biases, tendencies and/or actions, when acting together, lead towards a certain (and often very significant) outcome.*