Inside the minds of Australia's most successful global investors – Part.2

James: So I asked each of you to bring along a question, take me out of the frame and to pitch a question to each other. So Andrew, you've got a chance to ask Hamish a question that you want to put to him.

Hamish: Go easy, Andrew.

Andrew: I think I'm always interested when people come into investment management from another area. I think it's a sort of a funny industry, and there's a lot of things about it that are unusual. I was just interested in your ... You've had enormous success with Magellan, but I'm just interested in what are the perspectives you think your former work brought or gave you coming into this industry?

Hamish: Well, it's a really interesting question. I think it gave us two real things. How we organised our research was very much an investment banking sort of model. Where we set it up in global sort of sector basis. You've set up in sector, but a lot of global managers do not set themselves up on a sector. They set it up in a very generalist or a country view of the world. We came in with a view that it had to be a sector basis.

Really, we wanted very smart, very analytical people in that sort of research area. We kind of built it pretty large from the start. That was probably a lesson I took out of it. We did a lot of valuations in terms of when we're investment banks on the advisory side.

We spent a lot of time interacting with management around strategy. When we came in, we really thought about the strategy of the companies. We got our analysts thinking about the strategies of the company.

That was pretty positive from investment banking, but there's not all positives in investment banking. Here, what we kind of didn't want to do is create an investment banking culture. Partnership is not a concept that really exists inside an investment bank.

All the incentives are completely skewed for bad outcomes for other stakeholders. We actually employed very, very few people from the investment banking industry. What we said is, look, we've seen the good and we've seen the bad, on investment banking.

We really tried to extract the good. I would actually say our focus on risk, as well, was probably the other thing. The focus on risk is important, and how we arranged our research efforts, but what we really said is we don't want an incentive system that would cause certain types of behaviours.

We are very, very focused on how we create the right incentives inside, and the culture within Magellan. We almost wanted to be the polar opposite of what we saw on investment banking.

Andrew: Yeah. No. It's a really interesting point, because we've always seen that what's important for us in coming to a decision is this internal debate about the idea. To have an open and honest debate about ideas, you got to know that your team members are all coming at it with a genuine interest in getting the answer, not proving their point or knocking your stock out of the portfolio.

If you get internal competition, we compete with the world and we all at Platinum we all, I think, like competing and winning, but internally we're on the same team. I think getting those incentives right and getting that culture right's really very, very important.

Hamish: Andrew, I would be very interested maybe to reflect on an investment mistake in your career that you've done, and really what sort of lessons you took out of it. I think learning from our own mistakes is, we all make them-

Andrew: Yep.

Hamish: What something that has stood out in your career of a mistake, and what's the lesson you or you think investors should take out from that?

Andrew: Yeah. It's a great question. The way I like to think about this is the biases that we have that lead to these mistakes. One of the classic problems that all humans have is confirmation basis.

We see in every bit of information that comes along, the right outcome for what we're doing. It's sometimes very easy to see in others, when they're doing it. Very hard to see it in yourself. Along the way, people are always like, individual stories about this, and I can think about many, many years ago we had a significant investment in Indonesia, in residential property development.

This thing was beautiful, had this great land. Bank was trading well below NAV. What came along was the Asian crisis, the currency fell 90%, and this company had a small loan in US dollars that became a very massive one.

You sort of look at the behaviour. It's a very simple example from long ago, but I get worried when I see companies doing the things that just, why are you buying that? Or, why are you doing ... That doesn't make sense. It might only be small, and you can ignore it, but it's often a symptom of something else that's going on in their world.

I think you particularly see it in M&A where they go into something that sort of half makes sense, but is it really? Is there really a coherent thought there? I think it often indicates that a company, you can sort of see the writing on the wall with their ongoing business.

Even if it's four, five years out. That confirmation bias is just something that we're all fighting all the time, I think.

Hamish: I completely agree with you.

James: What techniques do you use, and for you as well, Hamish, what sort of techniques do you use to manage your biases? It's probably one of the things that comes up most consistently within our readership as something that they feel like they're susceptible to. Do you use specific techniques or are you just aware of it?

Andrew: I think there are some tools that you can use, but really for us, it's about having this very robust internal debate, and an insistence that you write the case down for why you're doing what you're doing.

The reason I find that very powerful, and it's probably more powerful for the introverts amongst us, is that you can talk in great terms about this company and why it's extraordinary, and it's going to be a great opportunity, but the moment you start writing it down you start going, oh, can I actually say that?

I think we then will get that case on paper, we will debate it, and try and get many different points of view there. Then because we have a number of portfolios who can all own the same stock, one of the most interesting things that we have is that if I'm buying Micron but Clay Smolinski is not, or Alex Barbi who runs our tech fund is not, we're all experienced investors.

We've all got access to exactly the same information and debate and discussion, but we come up with different points of view. That's worthy of a very significant effort to try and pull that apart.

Now, we don't go to consensus. Sometimes we will have those differences, and we let them stay, but you certainly don't want ... There's a lot of unstated experience investors will look at a situation, go I don't really like that. That's not very helpful. You need to get out of them why they don't like it.

What is it in their experiences that's leading them to that conclusion. That's essentially the process that we use internally to try and come to remove those problems, but they still remain.

James: Hamish, do you suffer any biases as an investor or are there some that you find yourself repeat patterns of behaviour that you have, when it comes to putting stocks in the portfolio, managing the fund?

Hamish: Look, in terms of heuristic biases, it's something that I've always been incredibly focused on. It's very hard, because we're hardwired naturally to have these biases, to take shortcuts and do certain things.

If people went to the front page of our website, one of the things I wrote a long time ago was a whole series of investing biases that I think are very important. I often reread them, and I often resend them to the team.

There's a series of probably the more important ones: confirmation bias, and I’d put group think very much in the confirmation bias. What worries me more is when we get everyone on the same page on a topic.

I'm very sensitive to when we starting to get group think, but that's probably one of the most dangerous ones, when you start getting a whole lot of people who have a conviction that we're right, and there's not a voice saying, "Hey, hang on." That can be dangerous.

Another one I would say is oversimplification is a problem. Therefore, things that are incredibly complex and a lot of banks are incredibly complex, and sometimes I would sit down and I will read a 400-page 10K annual report on a bank, just as a reminder about how little you actually understand about them.

Which is a thing, even we simplify the investment case, and we got a price to book multiple and everything else, but sometimes you need a reminding of just how much you really understand. There are other biases. Anchoring biases, here. I think we're fairly good at not being anchored.

I have a team around me to try and overcome some biases. I've chosen their personalities. Some of them will deliberately take contrary views, nearly all the time, to mind. With analytics. I think that's very important, that you're testing the other cases. Something I've learned a lot about is another bias is neglect of probability.

I've made mistakes. I think the biggest mistake I made around Brexit, on neglect of probability. We held some investments in the UK, all the opinion polls were telling us that the remain vote would get through. We had some investments there, and because of all that information was coming in that looked very likely it was in, the problem with the polls were very close, that everyone thought it would be slightly over 50%.

Which means it was almost a 50% probability that something else was going to happen. The something else was going to happen was potentially very ugly, in terms of what would happen to the pound. We owned Lloyds Bank at the time, in that.

That was an experience about assessing the probabilities, and actually really looking at the alternative cases when the probabilities are anywhere material. That was a bias, and I always talk about probabilities and scenarios. One that was staring at me in the face, it was so obvious, lo and behold your biases came in, and we got it wrong. I wouldn't use ‘we’. I put ‘I’ got it wrong.

Andrew: I really like your comment, Hamish, about when everyone's convinced that this is a great idea, and so we have our stock meetings and as I say, the best ones are when there will be five, six, seven people there, and if seven people walk out of the room going, this is great, it's invariably terrible.

They haven't seen the weak side of the case. The best ones are where genuinely the analyst is firm in their view. They've done the work. They've spent weeks, months potentially, going through the case and the best they just manage to drag the PM's over the line to do something.

They're invariably the good ones, because if you don't have some of that uncertainty around why this is good, it's obvious-

Hamish: The uncertainty that creates the opportunity-

Andrew: Absolutely. Yeah.

James: Listen, we're going to wrap up because we've got a few of the audience questions, which we're going to run through. The rules are we need to keep it pretty short and sharp.

Hamish: Problem with both of us. Guilty as charged.

James: Well, we're talking about global investing. Currency movements. How do you manage the risk or the opportunity with regards to currency? Andrew?

Andrew: We, I guess I'll say our mutual position is having no hedges on. If we're in Japanese stocks, we'll be exposed to the Yen. There will be occasions where we really think currencies are at an extreme, and they actually may be giving opportunities. For example, the Yen's been very strong in the past, there's a great opportunity to buy exporters, but you obviously want to take the view that the Yen will weaken out of the equation.

You'll hedge it. Other examples would be in China at the moment, where we have a significant exposure. One of the release valves for that economy if really things do not unfold well, will be to let their currency weaken.

If that doesn't happen and the currency's a bit stronger, that's' fine, but we've hedged some of that out. I think our stocks will be doing very well, but on the other side, if the currency does weaken, we're protected from that.

By and large, you want to have a very strong view for doing anything in currencies. I think if you're playing around here and there, based on your view on rates or growth, or whatever, I just don't ... I think that's a zero-sum game for the market, and for those who participate in that I think you're more likely to give away.

Hamish: Well, first of all I would say any long-term investor shouldn't get too concerned about the currency. The reason I say that is because currencies don't compound at the end of the day. They have one off sort of adjustments around their mean.

If you're looking over to get a 10% return per annum and you achieve that over time, that means every seven years your portfolio is doubling, but a 20% currency movement is going to take 20% off of doubling, assuming you've at the starting point to the end point, you've had that adjustment.

Taken in the context on a per annum basis, that currency shift in the long-term portfolio just isn't that material. I think there is a genuine diversification benefit to having some unhedged currency exposure, because we live in a country with a commodity related currency.

When the world has a real problem, the A$ tends to fall. When the A$ is falling, your offshore investments back in A$ are worth more. You tend to get a bit of a protection around that. I completely agree with Andrew, at the extremes when the dollar was a parity, it would have been mad to have had any sort of currency hedges on.

If the dollar is at 60 cents, we don't actively manage that outside our high conviction strategy around those extremes, but they can be quite obvious. We offer both currency hedge, and non-hedge product. You could actually switch between it at those extremes.

I think you can get overly caught up. There is a genuine diversification benefit, and overly caught up the difference between the compounding effect of the earnings growth of the companies, verse a one-off adjustment of the currency. It's over a long period of time. It's actually not that material.

Andrew: No. That's absolutely right.

James: Next question. ETF flows and the growth of them. Have they created more opportunities for active management?

Hamish: Look, I wouldn't say it's just ETFs. I think by definition the more and more of the market that goes to ETF, there's fewer and fewer active managers that are going to be there. I think for active management that's actually a good thing, for people who are skilled in running portfolios.

By definition, it's going to have to make the markets more efficient. If everything went to passive, even the bad companies, nothing would be reflected in price. The markets would be completely inefficient if everything was 100% passive. Just by definition, more of the markets has been taken out of passive.

There's less room for as many active firms. I would also argue what's happening with MIFID 2 effectively putting a cost on research and making research effectively a barrier to entry for smaller bright teams who spin out, who are going to have to pay for their own research.

That is also potentially going to make the markets more inefficient. It's probably very good for a Platinum or Magellan, who's got the capability to hire people. We pay for our own research. It doesn't worry us at all, MIFID 2, but there's a number of things that ultimately are probably leading to some skilled active managers, creating that this industry's always going to exist in the future.

Andrew: I think the move, if we think of ETF's as passive, that's our opportunity that there's less and less people looking for these opportunities. I would actually say that one of the interesting things about passive, and you sort of can't deny the logic of the average active manager doesn't outperform over time.

But it doesn't answer the question of whether I should be in the market or not. I think at the core of probably both our investment approaches is not ... We're not there saying ... We're expected to do better than the market, but that's not what we're trying to do.

I'm saying to you that Micron today, I think, has an implied return of the order of 20-30% per annum over the next five years. You would have a sense of what you're expecting from Facebook or whatever. But we're making that judgement on that stock against if you like, US 10 year, or the Australian 10 year. Whatever it is.

I think it will do better than the market, through time. If you're going to go passive, you're assuming that you're going to make money from the market. Well, ask a Japanese investor who went passive in 1989 how that went for them. You know?

It's not surprising that passive is not very popular in that part of the world.

James: All righty.

Andrew: These aren't the short answers.

James: We're going to go, geographically, Asia or America? Which area has the brightest future?

Andrew: I think both the US and China have extraordinary potential. They are the two dynamic economies in the world. That's where opportunities come from. There's a reason for Silicon Valley's existence, there's a reason why China is doing so well in many of the same areas.

I think they're the two great opportunities. Then you'll see other parts of Asia. Japan, the economy's doing better but it doesn't have that dynamism that those two places have.

Nor does Italy. Then somewhere like Germany is pretty good. I think it's all about the world we're in, that entrepreneurial zeal and the desire to find the new thing.

Hamish: Yeah. I would very much agree with Andrew. We are very bullish on the long-term outlook for China and the opportunities in China's economy. It's a massive economy with a massive educated population, with a growing and probably will be the world's largest domestic market.

Just the US is currently the world's largest domestic market. I think both of those economies have massive, long term strategic advantages. The end of the day it's not about investing in economies. It's about investing in individual companies.

At present, I would say for various reasons, some of the leading American companies have an edge. From governance reasons, from talent reasons, from incentive systems, from a whole series of things, but there are going to be great Chinese companies that come up through that with the massive domestic market and everything they have, and the technology and the education system in China.

There are going to be some amazing businesses in China, but on a global scale at the moment, many of the very large leading American companies do have an edge. Those edges aren't going to suddenly disappear overnight.

James: Very quickly. You got up to the top of your cash threshold, or what the funds in the mandate, that 20% level. Would you have liked to have been able to go higher?

Hamish: Look, at the end of the day in our core product, which is the Magellan Global Fund, cash is a risk position as well. You know, holding very substantial amounts of cash for extended periods of time is a 20% position, at max, in our portfolio.

People have to understand, cash isn't some sort of riskless asset. It's not going to earn our investment returns through a cycle by taking a very large positions in cash. I wouldn't go anywhere near 20% in a single stock.

I think it's a pretty substantial part of an equity portfolio, 20% I feel very comfortable, on a high conviction front, I can go greater than that, but that's kind of a very, very targeted, very, very ... It's 8-12 stocks.

It's a very different thing, but in a core product I think 20% is a big position to be taking in any single asset in your portfolio. I feel very comfortable about that.

James: Andrew, after a tough 2018, how much capital is going back into Asia now?

Andrew: From our perspective?

James: And outside of your own perspective.

Andrew: Look. We have, as I was saying earlier, we have really been changing the portfolio over. Probably no more capital has gone into Asia then where we were a year ago, but some of the names have most certainly changed.

We are, in terms of the market you are seeing today the early signs of a pickup from investors coming back into Hong Kong and the Chinese A-Share market. That's starting to happen, but you never know whether that goes on.

James: Okay. Final question. For each of you. What's the most significant opportunity in the market that no one is talking about?

Andrew: I would keep coming back to these semi-conductor companies that we've been buying. To be buying these companies that are at the core of everything we do. Yes, they're cyclical to a degree, but okay. Today we're probably paying 30% above book value, but all because we're scared about the year ahead.

Earnings aren't going to be down this year. The valuations I have not seen valuations for companies of this quality, in my 30 years. I just think they're extraordinary, and there's a whole grouping of companies around them that I think are very similarly very, very cheap.

James: Right. Hamish?

Hamish: Well, I really can't answer that question, James. I'm not really aware of big, big opportunity that actually no one's talking about. Whether people have valued it correctly or not. Obviously, there is massive uncertainty about the future regulation of things, that create ... People are all over that debate, in terms of technology and things, of where that is.

I would actually argue in the big Cloud computing side of things, I don't think people understand the duration of it. Everyone's talking about it, but I don't think many people really focus on a decade or 20 years, in terms of really the scale of the investment opportunity.

What people are talking about, that's why I'm saying I can't really answer your question because many people are talking about it. I don't think people get the duration of the investment opportunity and can value that to the scale. But is anyone not talking about it? No.

There are not many things we're looking at. I don't think people sometimes have, what we call duration arbitrage. They don't actually get the value and the duration of it, because markets tend to be much more short term focused. Am I saying we've identified something like this and no one else has worked it out? No.

Because we take a longer-term view, we actually can see value that others aren't prepared to invest in, but it's not like we've got an insight that we're the only people in the world who do this.

Andrew: I think we're in a world now ... Maybe 25 years ago people hadn't talked about a new emerging market or something that was happening in tech, but today, we are saturated in. There's nothing much left.

Hamish: Gene editing is incredible, and gene therapy and things, advances in both these spaces. Incredibly exciting. You can do a lot of research. You probably found great opportunities by doing that. But it is something no one's talked about?

Andrew: It's just a question of whether they actually have the insight as to where the final destination is.

James: A fair answer. Well, gentlemen, thank you both for presenting the opportunity to come and have a chat two great Australian global investment firms. Appreciate your candour and taking on the challenge of putting a few questions to each other, as well. Thank you very much.

Andrew: No. Thank you.

Hamish: Thanks, James.