ZANACORP

Investment Insight

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Like a real world version of the movie Groundhog Day, the post GFC problems of the past remain the problems of today and seem destined to be the problems of tomorrow. Despite the need for structural change, the same failed "soft" remedies are being again employed expecting a different outcome. Enjoying the highest standard of living in human history at a time of the lowest interest rates in history and employment rates close to the highest ever, all absent inflation, it seems inconceivable that the masses are dissatisfied. Yet here we are, both young and old, feeling financially insecure and disenfranchised by governments. The 99% now seek to flex their democratic muscles to restore equity. That pursuit presents itself in the form of ever bigger government promises and the rise of socialism. We rest uneasily with the increasing belief that individual discontent is cured by passing costs onto society. We've seen all this before and it fails.

Nothing To See Here, Look Elsewhere

In recent years, information, the life-blood of coherent thought, has come under attack with engineered reporting of both social and economic events. Government and the media, in all its incarnations can no longer be trusted to present complete and objective reporting of all relevant facts. In a world of too much data, misinformation now reigns. Headlines momentarily capture our attention whilst all important details and follow up are often overlooked or ignored by our time-poor society.

Our professional concern is with the misreporting of the current economic state of affairs and the mind numbing proposals put forward by political interests to extend the current illusionary yellow brick road.

Lessons From Venezuela

Our November 2018 Insight reported that the people of Venezuela were not told by the reigning Maduro regime of their imminent economic risks. They were betrayed by socialists who **promised too much, to too many, for too long,** all funded by the proceeds of the most abundant oil reserves on earth. Successive regimes created a welfare state where people grew to rely on government redistribution of income, rather than individual initiative or efforts. **The state now lies in turmoil** amid nationwide food, health and power shortages. Businesses large and small, the employers, are evacuating to bordering countries, along with their capital. So too are many workers, determined to back themselves in to eke out a new life, hard as that may be, free of government intervention.

Despite this, **state propaganda has deflected responsibility at the feet of those now providing humanitarian aid** and many believe it. So much for the information age.

"It's easier to fool people than convince them they have been fooled" - Mark Twain, 1835-1910.

Risk versus Return

We are occasionally criticised for seeing risk, where none apparently exists. Of jumping off a wave too soon, missing the "rush" of spectacular returns. To that claim we may be guilty as charged, but so too have we **avoided being wiped out** when that wave inevitably crashes, destroying capital. This essentially defines investment risk and always has.

Accessing a comprehensive suite of paywall investment research and opinion, we respect all informed yet contrasting views. However, we must ultimately form our own opinion as to the strategies and asset allocation that will optimise the long term returns on our clients' capital.

As the caretakers of people's lifetime assets and retirement savings, often for decades, we know all too well that **it is far easier to lose money by ignoring risks, than it is to make money, being unaware of risks.**

Recent years have been challenging for value investors with red lights flashing in all directions. Despite this, we are pleased that via Tactical Asset Allocation (TAA) and dollar cost averaging (DCA), Zanacorp clients have enjoyed **above market returns whilst taking below market risks.** As we approach the climax of this unique post GFC cycle, our compass shifts from **return on capital to return of capital**, presently a lonely place to be. Like markets, our gaze is on leading economic indicators of conditions 12 months out, not on what is visible today. The global collapse in new car sales and tepid consumer spending look like canaries in the coal mine.

Asset Prices, Debt and Spending

The conjunction of elevated global asset prices, indebtedness, trade imbalances and excess spending go to the core of the **economic cancer that is not and will not be correctly reported.** Having discussed this repeatedly in recent years, all readers will be well aware of our concerns. Like the Venezuelans, we have been led to believe that the world's "brains trust" has got our backs and our economy is fine. There is nothing to see here, look elsewhere. Yeah right. Australia, look outside right now.

It is unlikely that any Australian is unaware of the modest house price decline in both Sydney and Melbourne with prices drifting down between 7% and 13% since their 2017 peak. This is not news, as prices still remain extraordinarily high. The real news is radical monetary measures being considered behind closed doors to **keep prices high and avoid meltdown.**

RBA, APRA & Josh Frydenberg – The Official View

Despite every person knowing someone in too much debt, RBA Governor Lowe, following the release of the latest quarter GDP, an anaemic 0.2% proclaimed ***"house prices won't derail growth".*** This is untrue. An internal RBA report by analysts (Saunders and Tulip) suggests that **REDUCING INTEREST RATES** was the primary driver of increased housing prices. **Economic growth, population growth, construction costs, availability of land and rents have a smaller effect.** Ignoring the significant "China impact" on our housing market, it dispels entirely the **urban myth that prices were high because of a shortage of supply.** There are empty houses and apartments everywhere, with plenty more in the pipeline, the concern now is how many new projects are being shelved and jobs to be lost.

As for Dr Lowe's 3% pa GDP growth? ***"Tell him he's dreaming".*** The current per capita GDP recession, means **Australia would already be in recession**, were it not for immigration and massive infrastructure spending.

RBA members have publicly stated they are ready to decrease rates and adopt unconventional policies (i.e. print money), if required to save the economy. Does that sound like we have nothing to worry about? Expect **official interest rates closer to 1%** by Xmas, 2019. APRA too is also panicking having recently **reversed the cap on interest only lending**. Oh dear.

In December 2018 Australia's Treasurer, Josh Frydenberg, explicitly put the blame on banks for the fall in property prices. He said "banks need to keep credit flowing" and "we do not want to see a spill over impact on the real economy", specifically directing them to lend and take more risk.

So as to concentrate on facts rather than perceptions, **Australia's total household debt continues to rise every single month.** The only thing that has changed is its rate of increase, as a result of a more responsible assessment of borrowers' capacity to service debt. This is not a credit crunch. **It is what normal lending looked like before we lost our minds.**

Both the Treasurer and RBA have been reduced to speak economic and banking nonsense to keep the property balloon in the air. Make no mistake **debt has metastasised onto the Australian economy**. Property prices affect everything and everyone, if not economically, then psychologically since it represents over 60% of Australian household net worth. Although it won't be said in these words, the RBA knows **high house prices rely on high debt**. To stop prices falling **we must continually induce more people into borrowing more money then to keep on spending all their income.**

Looking abroad, both the US and now China have reverted to old fiscal tools to support growth. Japanese and European growth has all but stalled and emerging markets are struggling with excess debt. While Deal or No Deal Brexit is on the nose, watch out for **QUITALY**, it's coming soon.

Zanacorp - Fee for Service Changes

Many changes recommended by the Hayne Royal Commission resulted from **unscrupulous fees for no service** charged by many larger institutions, including fees to dead people. To obliterate this practice, changes will be made to many investment funds and the manner in which advisers are remunerated from them. Some Zanacorp clients will be impacted, particularly those with investments held with us prior to 2013, many being the best investments in the market. We will be contacting clients over coming months to inform and advise them of the proposed changes. **For all clients, our absolutely non negotiable undertaking is that no client will be adversely impacted, nor will our client service be compromised.**

For over 30 years, Zanacorp is proud of its record of delivering clients high quality personal investment advice and strong investment returns. This has been achieved by diligently seeking the best fund managers for clients at the most economic cost. Many clients holding assets with Colonial, Perpetual, OnePath (formerly ING) and Macquarie Bank have prospered from the combined ongoing efforts of all Zanacorp staff, the investment managers we have accessed on these investment platforms and by the independent research, paid by us, to meet our clients' goals and needs.

Having adopted industry best practice for over 30 years, Zanacorp has provided written advice of our recommendations, the uncompromised basis of our recommendations and full disclosure of all costs, including any ongoing commissions received as a result of the advice. The ongoing fees we have received from our investment providers has funded our investment in staff and technology to deliver highly skilled personal client service, meet ever increasing costs and provide ongoing services to monitor and implement timely portfolio asset allocation switches, enhancing returns. We believe all stakeholders, most of all our clients, have benefitted from our collaboration together. **Client success has been the core of our success, just as it should.** We would hope that no amount of government regulation will impair our continued relationships or high service standards. Ultimately, most people know you get what you pay for. In our experience, our personalised active asset allocation model generates an additional risk adjusted return of 2% - 4% p.a. by sidestepping disasters. Funds often advertised on TV, rarely match that, despite their claims.

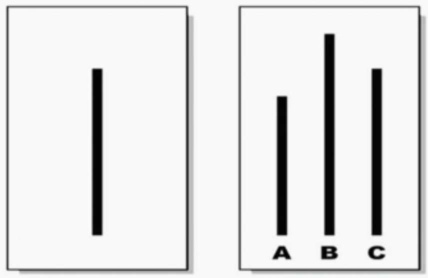
Social Conformity - Have We Really Changed?

Most people today believe that through education and information they are somewhat **smarter than all previous generations**. Faith in science (and Google) has apparently created a new universal knowledge and objective thought, crushing the "old world" pillars built on the trust in institutions, government and religiosity. Many may wonder how the Venezuelans could have been so easily deceived by state propaganda, dismissing the people as uneducated. Paradoxically, possibly naively, many first world citizens today do not believe another tulip bubble, social uprising or even economic depression is possible. We wish we could share that view.

Economics and society, are grounded in predicting both individual and collective behaviours into cohesive structures. Yet no matter how smart we may believe ourselves to be, we remain as susceptible as ever to the actions of others as well as to the mind bending influence of groups.

In a series of perceptual experiments, first completed by Solomon Asch in 1951 and replicated under various conditions to this day, **most of us are not free thinkers at all**. This is so, even though we individually believe we are.

Using the illustration below, test subjects (amongst a control group of non subjects) were asked to match the length of the first line with either A,B or C. Simple enough, and no prize or punishment was involved or pressure to conform. After a series of correct answers on other slides, the control group all chose "A" in this example and **75% of test subjects agreed**, many knowing it to be clearly wrong. Why would they do that, one may ask?



The **Asch conformity experiments**, published in 1951, were a series of social psychology studies that demonstrated the power of **conformity** in groups.

These results demonstrate that people generally seek the self assurance of being in a group and not standing out or made to look foolish. 75% of the time, we conform to group think, behaviours known as normative social influence (fitting in) and informative social influence (believing the group knows something we don't). These tendencies are timeless, powerful behavioural influences, partly explaining why and how seemingly inexplicable things happen over and over again, including booms that bust. (Bitcoin?)

What we draw from social conformity studies, is that individual and social behaviours must be understood in their context and setting. Hindsight has us all appear smarter than we really are. Presently, the we have been lulled into a false sense security by the cloak of soothing talk from all knowing bankers and politicians. We believe that in the long run, mean reversion dictates all asset prices. So, **we worry about flat household income, high household debt, elevated asset prices, slowing growth and the propensity of people to rush to the exit door at the same time.** Amongst many other things, history teaches that us **panic takes hold swiftly and knows no date.**

2019 Australian Federal Election

Misinformation is a pervasive tool friendly to all. It does not align itself to the left or right, to those in power or those seeking it. Typical of the climax of all booms, surpluses seem to arrive right on cue to perpetuate the belief that good times will last. We expect both the coming budget and election to be full of "freebies" and false hope, just like the 2007 Federal budget and election. Then as now, the resource boom and peaking economy topped up government coffers. To be followed by the **GFC that no one saw coming**.

We understand and respect ideology will play a big role in the election and revenue measures are needed to fund ALP promises, like CGT changes and Trust taxes. However, we must say poor policy is being considered, causing much angst to self funded retirees both current and future. If franking credits are so costly to the country, why not ration them to target the benefit to those who most need it? **Here's a crazy idea – restrict refunds of franking credits only to people over 65, up to a maximum of $5,000?** It seems inequitable to punish and estrange our oldest and usually highest taxpayers.

Similarly, whilst we hate debt, it seems a most irrational time to propose to eliminate negative gearing. With both Sydney and Melbourne house prices already soft, we believe this measure could (or should) be kept on ice. We fear both the economy and all home owners may unintentionally suffer, should the timing of this measure be inconsistent with the state of the economy. Whichever party assumes office, we can only hope any policy change measures will be carefully considered for the greater good.