Future Generation: Investment Insights

Caroline Gurney and Sean Farrington – Holowesko Partners

CAROLINE GURNEY: Hello and welcome to Future Generation Investment Insights. My name is Caroline Gurney and I'm the CEO of the Future Generation Companies, which are Australia's first listed companies to deliver both investment and social returns. Today I'm thrilled to be joined by Sean Farrington, who's a Director and Portfolio Manager of Holowesko Partners. Holowesko Partners is a leading global investment firm based in the Bahamas, and last year they agreed to manage 8.1% of Future Generations Global Funds. Like all of our fund managers they do that on a pro bono basis, which means they don't charge any management or performance fees to our shareholders. This, in turn, allows us to donate 1.0% of our assets to not-for-profit organisations that prevent mental ill-health in young Australians. Today Future Generation Global (ASX: FGG) has donated up to $32.6 million and that's thanks very much to fund managers like Sean. Sean welcome.

SEAN FARRINGTON: Thank you Caroline. It's a pleasure to be with you.

CAROLINE GURNEY: One of the reasons I'm really excited to have you here is because you are one of the original partners of Holowesko and you're the Portfolio Manager of Holowesko Investment Strategies. You learnt your trade at the feet of global investment legend Sir John Templeton which everybody would have heard of. He was definitely one of the world's best known value investors. I've got to ask you in the current environment of rising interest rates, bond yields, is the scene finally set finally for a resurgence in value investing?

SEAN FARRINGTON: Maybe not surprisingly, I definitely do think so. I think we've been through an extraordinary period over the last 15 years coming out of the Global Financial Crisis (GFC), and I think people may have lost perspective on just how strange and unique that period was. I mean nine of the 14 years following the GFC we had the Fed keep interest rates at zero. They went from owning 5.0% of assets relative to GDP up to 35.0% of assets relative to GDP. They bought back a third of all mortgage backed securities and they bought a quarter of all Treasury securities. That's a very unique environment and the consequence of that was to keep the cost of capital for companies virtually non-existent. If we think about what that meant, it meant if you were a company that was going to grow and grow your revenues, you could do it regardless of cost because you could finance the loss with a cheap loan that cost you nothing, or even better you could get cheap financing in the form of equity because the market was willing to give you the big valuation with the promise of these future cash flows discounted back at a very low rate. And that I think contributed to this just incredible disparity in performance you had between growth companies, what were considered growth companies, and value. Now that's changing. We have the Fed obviously increasing rates in the US pretty dramatically. There's talk of now winding down the balance sheet buying that they've done. And what's changing is really that the inflation genie has come out of the bottle. You know when you have 6.5% inflation like you do in the US today rates can't stay at 4.5%. So we really think that the kind of malaise that you had over the last 15 years coming out of the Global Financial Crisis is really changing and cost of capital matters more, and when cost of capital matters cash flow, earnings, dividends, fundamentals, balance sheet strength, all of that matters. The here and now matters rather than the hope and promise in the future.

CAROLINE GURNEY: Earlier this month the IMF basically came out saying they thought everybody had been a bit pessimistic in terms of their predictions of 'market doom and gloom'. The US, to me, seems to have actually dodged a recession. The US, EU labour markets they've proved quite resilient. And China now is finally reopening. So what do you see in terms of the global markets? What's your outlook?

SEAN FARRINGTON: In terms of the economies you know I think you're right. I think we've all been surprised by the strength in the US recently. That said you know if you look at a lot of indicators, you look at leading economic indicators, you look at the Fed has their own recession probability measure that you can look at, you can look at CEO confidence, they're all consistent with levels where you would expect to be if you were about to see a recession. What's held the

US up has really been the strength of the consumer. And the consumer's been buoyed in the US by all of the savings that they effectively accumulated coming out of the pandemic thanks to a lot of the programmes that were put in place. So that was as much as $2 trillion, a huge amount of stimulus. And about half of that's been wound down. I think what's sustained the economic picture in the US here in the near term has just been the strength of the consumer but we worry a bit more about that going into the second half of the year as those savings are worked down and I think that the probabilities of a recession are better than 50/50 as we sort of get in the second half and that would be kind of consistent with you know the way economies have evolved over time. We do still have some economic concerns in the US. I think your point about China is correct you know and I think if you look at excess savings in China they had a similar phenomenon, increased by almost 50.0% from where they were pre-pandemic. That's $5.5 trillion. That's bigger than the GDP of the UK. And like the rest of us you know they want to spend and they want to get out their apartments and homes and go and travel. I think that you know that spending will help places and where it's traditionally helped has been markets like Europe and also obviously some of the surrounding Asian market. So I think that helps those regions but I think the US has its own particular issues that they face with the consumer that's such a big part of the domestic US economy facing challenges in the second half.

CAROLINE GURNEY: At Holowesko, you invest globally. What do you see in terms of Australia? Our shareholders love hearing about Australia in terms of you know what is worth investing in. Are you looking at Australia and thinking these are some areas we should be investing in or are there some themes here that you can see globally?

SEAN FARRINGTON: I think the area that interests us is in the resource side. We are particularly interested in having exposure to copper as we think that copper is going to be a huge beneficiary of the electrification of economies. You know very simple numbers if you look at the IEA's own estimates for how much electric vehicles could be a share of total cars you get it's about a third of cars by 2030. If that comes to fruition you need to double the amount of copper production from where it is today. And that doesn't include of course the build out of the grid to support that and a lot of other ancillary supporting investment. So that could be as much as six times in the next 10 years. We just don't see the capital expenditure happening to support that kind of production growth. So that's an area that intrigues us and the exposure we do have in Australia is sort of geared to that the resource sector and particularly towards copper.

CAROLINE GURNEY: What else you do see as a good sector to look at?

SEAN FARRINGTON: Well one of the sectors we like quite a bit is the forest product sector. You know we have a couple of holdings particularly in Europe in there and they're benefiting from the whole move away from plastics towards more sustainable products. In many cases we can buy those companies, well we like they have large forest timberland holdings, and the price we're paying for businesses really don't reflect the value of those timberland holdings so that's a sector we like.

CAROLINE GURNEY: From where you live in the Bahamas you had this sort of amazing ringside seat in terms of what was happening with the great crypto crash. You could see offices of one of the bigger players from your building. Do you think that this has actually damaged market sentiment? Do you think that investors you know are now nervous and are they nervous of crypto?

SEAN FARRINGTON: I think it has had an impact. I think every generation sort of needs to see or experience these phenomenon that we get, these bubbles that occur in our opinion, and you know I think of crypto very much along the lines of what I experienced back in the Dot.com boom when you had companies like Pets.com and E-stamps.com you know the big advertising on the big US Super bowl. We had the same thing with the crypto companies last year. And now those companies the Pets.com and the E-stamps they all went bankrupt eventually and disappeared. But they left behind an incredibly infrastructure that was the internet you know which changed all of our lives. I think crypto may do a bit of the same sort of thing. I think the crypto side may disappear but we'll be left with the infrastructure of block chain and decentralised finance which will have a big impact in the future for a lot of industries.

CAROLINE GURNEY: Do you actually think that the younger investors that were getting into crypto probably are going to continue to invest once they got a taste of it?

SEAN FARRINGTON: I don't think of crypto as investing myself. I think of it as purely speculating and it's certainly nothing I probably have any great insight into. As I said I think that the infrastructure that surrounds it, block chain, decentralised finance, that's very interesting and that to us holds a lot of promise. We don't think crypto currency does.

CAROLINE GURNEY: A lot of our shareholders they love stocks. I was wondering whether you could give us two stocks that you actually like on a risk and reward basis and why?

SEAN FARRINGTON: Well I'll give you one in the forest products area since I mentioned that. We own a company called Stora Enso (HEL: STERV). Stora Enso is the second largest private owner of forestland in the world. We think those forest assets are worth about 75% of the share price. So the remainder of the business is on the industrial side in some of the pulp and papermills. They have a huge cost advantage there. Two-thirds of their energy production is actually done in-house so that's a very big competitive advantage in Europe these days. But if you value those industrial assets and add it to the value of the farmland you get a valuation in our estimate about 25.0% above where the share price trades today. Sells at about 12 times earnings with about a 4.0% dividend yield which is very attractive. And they have this sort of interesting other side which is they have invested in a technology called Lignode which is potentially using wood products to replace graphite in a lot of the batteries. They're moving away from a coal based product to again a sustainable product. We think that's a really interesting business.

CAROLINE GURNEY: And it ticks the environmental box as well.

SEAN FARRINGTON: It benefits from the environmental trends for sure. The other one I would mention would be Amadeus (BME: AMS) which is one of the world's largest reservation systems for airlines and also does passenger service systems which are basically the booking systems for airlines. One in every two travellers either book their ticket with an Amadeus system or they have been processed by an Amadeus system. Phenomenal business franchise. We were able to buy the stock coming out of COVID when there was a lot of pessimism obviously around travel. What they were able to do during that period was to consolidate a lot of their IT platforms, because people weren't travelling they didn't need to run these systems, and that's reduced their cost base. At the same time because their balance sheets been so strong they've gained market share. So they have today about 8% more passengers just by market share in terms of growth. So the combined impact of those two things we think and the recovery in travel they can easily earn 10-15% more than they do today but the share price is 20.0% below where it was going into COVID. It's a company that's had phenomenal returns over time and just a wonderful moat around its business and the valuations look attractive. Now I would say, we own stocks in a diversified portfolio and you know we get one third of our ideas wrong, but those are two that we like.

CAROLINE GURNEY: Excellent. They sound really interesting actually. One of the things that I really wanted to ask you and when Mark was here he actually talked about why he thought Future Generation was really important in terms of giving back as he'd been very supported by Australia when he was setting up his business. Do you have a reason for wanting to be part of this?

SEAN FARRINGTON: I would echo what he said. But particularly to me in many ways my career really began in Australia because the first portfolios I was given to manage at Templeton at the time were in Australia. I started coming here in the mid-90's and have been here I think almost every year since, other than during COVID when we couldn't come. Australia's been a place I have a lot of affection for and we've had a lot of support in this market and we've been very grateful for that and to be able to give back a bit is really gratifying and we appreciate you giving us the opportunity to do that.

CAROLINE GURNEY: I'm really grateful to you today for giving us your time and your insights, but also for managing the Future Generation money for us on a pro bono basis. As you know Future Generation has a really diversified portfolio, because we have different managers for different investment styles, and it really is because of all your expertise that Future Generation can continue to deliver long term performance for our shareholders. Thank you very much Sean.