THE PARADOX OF INVESTING?

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BY PAUL MIRON

In our July board meeting with our Chairman, we discussed a recent article, titled "Super Shake Up", featured in the Australian Financial Review. It ranked the performance of the 50 largest 'balanced' (or 'growth')[1] Superannuation Funds in Australia, with only 3 reporting an absolute profit (of 1.6%, 0.6% and 0.5%) for the 12 months to June 30, with the remaining 47 recording losses for their investors.

I am sure Super Funds and Investors will be closely examining the results to identify the ideal composition of a portfolio to outperform competitors and the index.

Growth Funds' Performance to June 30, 2022

	Fund	1 year (%)	5 years (% pa)	10 years (% pa)
1	Hostplus Balanced	1.6	7.8	9.7
2	Qantas Super Growth	0.6	7.5	8.1
3	Christian Super My Ethical Super	0.5	6.3	7.9
4	Legal Super MySuper Balanced	−0.7	6.5	8.6
5	Australian Retirement Fund - Super Savings Balanced	−1.0	7.2	9.0
6	Energy Super Balanced	−1.0	5.6	8.2
7	Australian Catholic Super & Retirement Balanced	−1.2	6.1	7.8
8	Rest Diversified	−1.6	6.0	8.6
9	CareSuper Balanced	−1.7	6.4	8.7
10	Australian Retirement Fund - QSuper Balanced	−1.7	5.6	7.9

[1] These "balanced" or "growth" funds were labels used by Chant West (a leading superannuation research and consultancy firm) for those firms with an allocation to growth assets of 61-80% – [Duncan Hughes - 'Super Shake-up as Soaring Inflation and Rate Rises Bite' (2022)]

Australia's Superannuation Sector

Australia's superannuation sector manages roughly $3.4 trillion, impacting the majority of Australians' financial future.

One of the biggest controversies is not that this is a terrible outcome for investors. Rather, it is about the so-called 'unfair advantage' some firms are enjoying regarding the accounting treatment of unlisted assets.[2] By investing into unlisted assets, valuations are not reflected as frequently as they are for listed assets, which undergo a near-constant process of price discovery.

Fund managers in this sector have faced a plethora of economic challenges, including rampant inflation, rapidly rising interest rates, declining asset values, geopolitical uncertainty, cost pressures, additional costs as we transition into green energy, a war in Europe, supply chain issues…and the list goes on. Most fund managers make clear that conditions will worsen before getting better due to these challenges not abating any time soon.

In essence, investors should not expect any pleasant surprises in the next 12 months, with many ASX companies downgrading their profit forecasts due to the challenging economic environment. Perhaps now it is a matter of selecting the fund managers who will be less likely to lose more of your money relative to their peers. This is a bleak and dismal outlook considering a superfund that outperforms its peers may still be losing your money on an absolute basis.

The consensus between super fund managers referred to within the article indicates a desire to transition away from traditional asset classes and allocation styles, and instead seek greater exposure to alternative asset classes with a more defensive position.

The time for fund managers and investors has never been more appealing for considering the benefits that Private Credit can offer to a diversified portfolio given its asset preservation qualities and consistency of income. The importance of this can hardly be understated in our highly uncertain economic environment.

Confusions in Risk-assessment

Now, here is the paradox: consider Msquared Capital – a fixed-income fund manager (Private Credit Provider) that manages direct mortgages. Investors would not react with the same silent acceptance if we produced the same financial outcomes as the superannuation funds in the past 12 months.

If we provide investors with the bad news of negative returns, it would be catastrophic for our business.

On the contrary, the average performance of all the direct mortgages we have written for the past five years is 8.00% p.a., with the benefit of consistent monthly income, no volatility and no losses. Over the past 5 years, we have done significantly better than all the super funds mentioned in the AFR article. Being nimble, we are able to tailor our debt investment opportunity in a way that will complement your risk appetite and overall portfolio.

Perhaps this can be better illustrated with the following insights from American economist, Steven Levitt, known as 'the economist exploring economic riddles':

"Why do people fear flying as opposed to driving?" Research shows that 30% of us are petrified of flying despite it being considered one of the safest modes of travel from a statistical perspective.[3] You are 2000x more likely to die in a car accident than taking a flight.

Why would this be the case?

"I don't think he is a confident flyer."

[2] Aleks Vickovich and Lucy Dean - 'Financial Advisers Question Hostplus Returns' (2022).

[3] Alex Preston - 'Fear of Flying: The Spectre that Haunts Modern Life' (2014).

It comes down to our biology and psychology. As humans, we are TERRIBLE assessors of risk.

When we enter a car, we are more accepting of risk than when we enter a plane due to *perceived control*. Additionally, a plane crash is more likely to be instant and fatal, which is the logic behind people's fear of flying compared to getting into a car.

The same paradox exists when you entrust your money with a fund manager who invests in shares and bonds. In the event of an absolute negative return, they do not have control over changes in the market, which no one can control. Yet, we accept the volatility and shaky performance, while remaining committed to the investment in the long-term. We ride the wave of random yearly returns and accept the risks, even as poor performance is clear, as was the case in the 12 months to June 30.

Investing solely in bonds and shares is the equivalent to driving in the car; investing in alternative asset classes, such as mortgages, is like flying in a plane – less objectively risky, yet many have an irrational fear towards it. This highlights the importance of assessing risk objectively.

Private Credit – Lower Risk, Higher Return

Now, let us look at Msquared Capital – a private lender who secures loans via first registered mortgages. Perhaps, similar to a plane crash, people fear the immediate and uncomfortable fear of an absolute loss of capital when the borrower cannot repay their debt and return money to you, the investor. However, not all types of debt are the same, and neither are the managers.

Firstly, when investing in a secured mortgage investment, risks can be controlled and measured. For example, at Msquared Capital we choose whom we lend to, how long for, the rates we charge to borrowers, and of course, the return we provide to investors based on their risk-reward preference. Most importantly, we ensure that we are secured by high-quality real estate so that we are protected in the event the borrower defaults. We position ourselves in a way that we can recover both the principal and interest. This is how we have been delivering and will continue to deliver consistent and reliable returns for our investors.

Most Australians fear investing in mortgages where risks are well-defined compared to the risks inherent in shares and bonds. This is despite the statistical performance being exceptional for mortgages, with stable and predictable returns as long as the fund manager is both disciplined and adheres to tried and tested principles.

Perhaps Australia is still in the embryonic stages of the private credit market, with firms like Msquared Capital making up only 8% of the commercial loan market. This is a number dwarfed by the US and Europe, where 70% and 50%, respectively,[5] of commercial loans are written by private credit providers. In the US and Europe, this sector is not defined as an 'alternative asset class' or an 'exotic investment', but is proudly named as 'Private Credit' and is a mainstream investment option.

Banks, Bonds and Msquared Capital

The concept of debt first appeared 3500 years ago in the Sumer Civilization.[6] Private Credit providers today, such as Msquared Capital, are not too dissimilar to a bank's primary operations in collecting deposits (in our case, investor funds) and lending money to borrowers. The significant difference is the ability of banks to borrow money from the Reserve Bank as cheaply as to generate debt from deposits, roughly a 1:5 ratio.[7] Arguably, this cheap "free money" points out sometimes as being unfairly subsidised by taxpayers. Despite the fundamentals of our business model being very similar to banks, we are referred to as an 'alternative asset class' in Australia.

When we look at the misapprehension many people have towards private credit, we realise that it may simply be a case of compounding biases and perceptions built over many decades. On the other hand, by being able to objectively assess risk, go past the market biases, and look at hard facts, we realise that there are many high-return opportunities ripe for investment in private credit.

One of my role models within the industry, Howard Marks of Oaktree Capital, talks in length about how he pioneered one of the world's first distressed debt funds. Earning superior returns and unravelling value in an asset class was frowned upon by his fund manager peers chasing the next big stock pick. This proactivity and boldness enabled Marks to become one of the best know contrarian investors on the planet by building one of the most successful debt funds and accumulating $2.2 billion US dollars in personal wealth.[8]

[5] The Economist - More Borrowers turn to Private Markets for Credit; MV Credit - 'The Growth of European Private Debt' (2019).
[6] Michael Hudson - 'Reconstructing the Origins of Interest-bearing Debt'.
[7] CEICData - 'Australian Capital Adequacy Ratio' (2022).
[8] Forbes - 'Profile: Howard Marks' (2022).

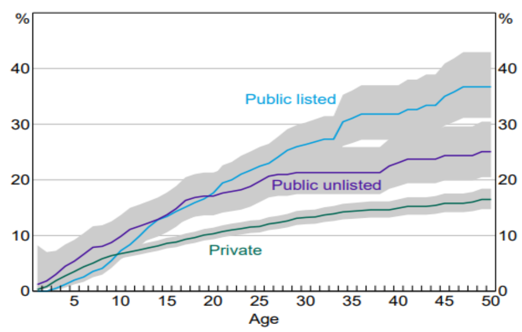
Now, let us take a look at bonds.

Bonds get a lot of attention for being 'safe'; indeed, none is safer than government bonds. However, not all bonds are the same. When it comes to corporate bonds, they can place a significant burden on the corporation. Hence, when a corporate entity or sovereign country defaults on a bond, it typically signals a capital loss for its investors.

It is important to note that the security of corporate bonds can be nothing more than a simple corporate guarantee. The recovery may be based solely on the business's goodwill. This is simply not good enough, considering the many so-called "too big to fail" companies falling into trouble – Virgin, Dick Smith Onetel, Ansett, Enron…and the list goes on…

In research conducted by Reserve Bank economists, Kaplan and Meier, publicly listed companies are twice as likely to go into administration than private businesses.[9] When it comes to a secured private credit provider such as Msquared Capital, we have the added peace of mind that we will take security over high-quality real estate for every single loan so that we can recover in the unlikely event of default.

Figure 3: Kaplan-Meier Failure Curves
Probability of failing by each age



Note: Shaded areas represent 95 per cent confidence intervals
Sources: Australian Securities and Investments Commission; Authors' calculations; Dun & Bradstreet; Morningstar

Perhaps I was destined to be a secured lender due to my non-confrontational disposition. I still recall reading with shock Shakespeare's famous play, "Merchant of Venice", where Shylock takes "a pound of flesh" as security in case Antonio defaults on the repayment of debt.[10]

In the end, despite common misconceptions, borrowers can indeed assess their own risk appetite. As long as you are not the lender of last resort and you ensure that you lend money to people of good character, borrowers who get themselves into trouble will either sell an asset themselves or refinance the debt well before the fund manager need to intervene. It is for this reason that Msquared Capital prides itself on its strong, robust credit process. The result: effective loan solutions for borrowers, and consistent, reliable returns for investors.

If you would like more information, please feel free to contact myself or our dedicated team of professionals at our office with the following details:

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[9] Rose Kenney, Gianni La Cava and David Rodgers - 'Why do Companies Fail?' (2016).
[10] William Shakespeare - 'Merchant of Venice' (1598) - Act 4 Scene 1