Perpetual Equity Investment Company Limited

Higher for longer: why inflation doesn't have to compromise returns

By Perpetual Asset Management
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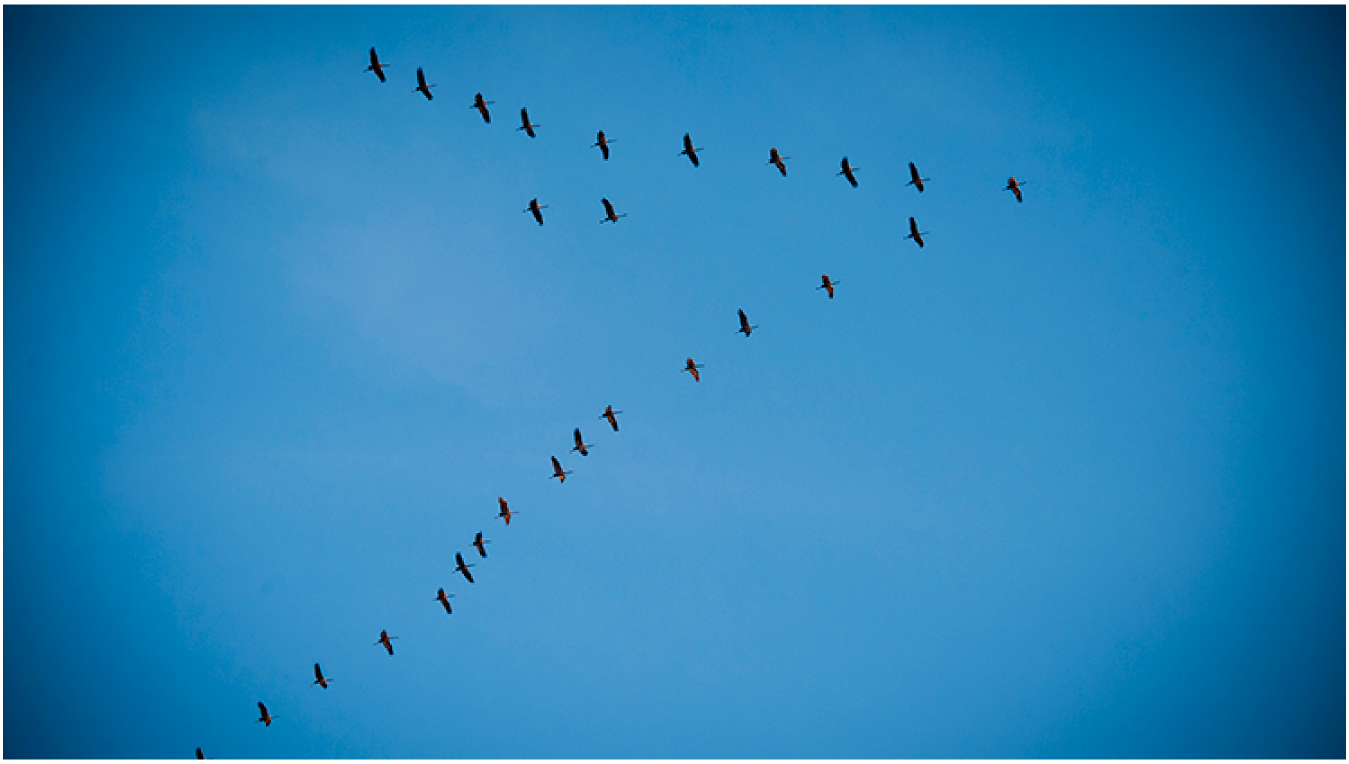

Inflation pressures, high interest rates and market volatility have reshaped the investment landscape, requiring a changed approach to generating returns, says Perpetual's head of

Australian equities Vince Pezzullo.

Early signs of a wage-price spiral, high government spending and rising energy costs are all fuelling higher prices — and despite a concerted campaign from global central banks, there is little sign of inflation heading back to the levels of the previous decade, he says.

That means investors need to adjust expectations away from hoping for a return to the low-rate world of the past decade and instead shift back to the proven approach of buying quality assets at reasonable prices.

“It’s time to admit that inflation is simply a reality — there are real hints of the 1970s around this,” says Pezzullo.

“But that doesn’t mean there’s not opportunities to be had.

“As an investor, you must tilt your sails to the prevailing wind.”

Pezzullo is the portfolio manager of the Perpetual Equity Investment Company (PIC), an ASX-listed investment company that invests in a diversified portfolio of high-quality Australian and global listed securities.

PIC’s mission is to provide its shareholders with an income stream and long-term capital growth in the simple and convenient vehicle of a listed investment company (LIC).

Understanding the unique advantages of LICs

Listed investment companies are among the oldest forms of investment vehicle, with a 150-plus-year history that pre-dates the invention of the open-ended managed fund.

Today, the LIC structure still offers many attractive features, says Pezzullo.

LICs trade on the ASX just like ordinary shares, so buying and selling takes place through a stockbroker. That means investors can start with any amount then add to investments as they wish.

Because they trade freely on the market, at any given time LICs may be trading above or below their underlying net asset value, offering the opportunity to buy shares at a discount and sell at a premium.

LICs also have the advantage of paying fully franked dividends, because tax is paid before earnings are distributed to shareholders. For many investors, this is an advantage over managed funds which are untaxed and leave investors to pay tax on their distributions, says Pezzullo.

The ability to retain earnings also means LICs can smooth out dividends over multiple years. This is another important difference to managed funds — which under Australian tax law must pay out all realised earnings every year. Smooth dividend payments can be particularly attractive for investors seeking regular, predictable income.

And because shareholders buy and sell shares directly with each other, LICs do not have to keep liquidity aside to cope with redemptions. This allows managers to invest for the long term and invest in illiquid assets like small and micro-cap shares, says Pezzullo.

Quality and value

The changing investment environment requires a shift back to a proven investment approach of focusing on quality and value, says Pezzullo.

Quality means profitable companies with good market positions, great products and low debt. Valuation means the companies are trading at a reasonable price.

“It's a winning combination — quality at a reasonable valuation is the best of both worlds.”

Investment strategies that delivered success when rates were low — like fast-growing but loss-making tech stocks — are unsuitable for a future of rising prices and higher interest rates, he says.

“You want companies that will generate cash flow today – because they can pay you dividends out of cash today, and they don’t have to borrow.”

Look beyond Australia

But quality stocks are not only found in Australia. For this reason, Pezzullo adds that it’s important to have the flexibility to invest anywhere in the world if the right opportunities arise.

"PIC is a concentrated portfolio of 20 to 40 stocks that represent the best ideas of the Perpetual investment team, one of the largest and most experienced equities teams in Australia.

"Importantly, the strategy includes the ability to go up to 35 per cent offshore, which means we can seek value across the spectrum and can be opportunistic domestically and globally when it comes to enhancing the value of the portfolio," he says.

Often, this plays out as the investment team finds global counterparts to Australia's best listed companies.

One holding is France's monopoly lotteries operator, La Francaise Des Jeux SA, which attracted the investment team's attention as it embarked on a digitisation similar to the successful transformation of Australian Tabcorp spin-off The Lottery Corporation. Another is British-based, US-listed plumbing products distributor Ferguson plc, directly inspired by a long-term investment in Australian market leader Reece Ltd.

"We're able to use our experience and knowledge of Australian companies to acquire, often at much lower multiples, equivalent and very successful businesses operating offshore," says Pezzullo.

A track record of performance

Since listing on the ASX in 2014, PIC has established a track record of investment performance and provided its shareholders with a consistent stream of fully franked dividends.

"PIC is focused on identifying high-quality, attractively valued securities using a proven investment process that can navigate tougher operating environments," says Pezzullo.

"As global investment markets get rockier, that quality and value approach is once again coming into vogue.

"It's never a bad idea to have exposure to quality and value in your portfolio.

"But tactically, that type of strategy tends to do better during inflationary periods and during economic recoveries — and that's the environment investors are facing over the coming years."

Find out about Perpetual Equity Investment Company (ASX:PIC)
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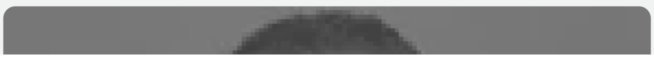

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