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Risk and diversification

PART 2 WRITTEN BY CHRISTOPHER WONG

DIVERSIFICATION IS SIMPLY THE OPPOSITE OF CONCENTRATION. IF YOU OWN JUST ONE ASSET, YOU OWN BUSINESS SHARES IN A SINGLE COMPANY OR A SINGLE PROPERTY, YOUR OUTCOME IS CONCENTRATED ON THE OUTCOME OF THAT SINGLE INVESTMENT. DIVERSIFIED BY CONTRAST IS BEING IN MANY THINGS AND THEREFORE SPREADING THE RISK. GOOD DIVERSIFICATION SPREADS THE RISK IN LESS CORRELATED WAYS.

THEREFORE, THE FUNDAMENTAL OBJECTIVE OF DIVERSIFYING A PORTFOLIO IS TO NEUTRALIZE UNSYSTEMATIC RISK.

There are three basic levels of diversification: asset class, geography, and industry. Asset classes (shares, property, term deposits, etc.) carry different risks and rewards, and getting the balance right is a critical decision, based on your horizon, simply when you need the money back.

Geographic diversification is reducing the concentration of investments in a country or a region so that regional or national politics, economics, or events do not affect the whole portfolio. It also refers conceptually to not buying two houses in the same street, suburb, or city as the price movements are likely to be more highly correlated, for better or worse.

Finally, industry diversification refers to the likely movement of competing companies together, other than market share changes, as they are likely affected by economic events and the business cycle in similar ways. Noting that by owning the whole investable sector, such as through Kernel's NZ Commercial Property Fund, you benefit from the collective profitability rather than working out whether Goodman Property Trust or Property for Industry are more likely than their competitor to succeed.

MODERN PORTFOLIO THEORY

Modern Portfolio Theory is a Nobel-Prize winning theory on how investors can construct portfolios to optimise or maximise expected return based on a given level of market risk, emphasising that risk is an inherent part of higher reward. According to the theory, through lowly correlated diversification, it is possible to construct an "efficient frontier" offering the maximum possible expected return for a given level of risk.

In the book 'Modern Portfolio Theory and Investment Analysis'

(1980), it was concluded that the average standard deviation (risk) of a single stock portfolio was 49.2% while increasing the number of stocks in the average well-balanced portfolio could reduce the portfolio's standard deviation to a maximum of 19.2% (this number representing market risk). By having 20 stocks in a portfolio, the risk was reduced to 20%. Notwithstanding, the additional stocks from 20 to 1000 only reduced the portfolio's risk by about 0.8%, while the first 20 stocks reduced the portfolio's risk by about 29.2%. However, it is not suggested that the number of stock holdings within a portfolio was the only important factor. Rather what mattered equally, or even more, was having uncorrelated holdings.

For example, holding two New Zealand electricity companies are likely to be more correlated than an electricity company in New Zealand, and a software company in the US. Of course, if the software company does well and the electricity company badly, you will wonder 'why not concentrate'? The answer being to allow for the opposite. As demonstrated below in Figure 1, there is a low correlation (0.16) between the returns of the utilities and information technology industries. Thus, this exhibits good diversification.

SECTOR CORRELATIONS Source: Bloomberg, as of 10/19/17

	Consumer Discretionary	Consumer Staples	Energy	Financials	Healthcare	Industrials	Information Technology	Materials	Telecom	Utilities	Real Estate
Consumer Discretionary	1.00	0.52	0.45	0.78	0.51	0.85	0.72	0.74	0.54	0.26	0.70
Consumer Staples	0.52	1.00	0.34	0.58	0.65	0.57	0.27	0.47	0.39	0.43	0.55
Energy	0.45	0.34	1.00	0.49	0.35	0.60	0.37	0.67	0.31	0.43	0.37
Financials	0.78	0.58	0.49	1.00	0.60	0.81	0.51	0.69	0.42	0.33	0.72
Healthcare	0.51	0.65	0.35	0.60	1.00	0.56	0.39	0.43	0.41	0.37	0.51
Industrials	0.85	0.57	0.60	0.81	0.56	1.00	0.66	0.83	0.49	0.37	0.69
Information Technology	0.72	0.27	0.37	0.51	0.39	0.66	1.00	0.54	0.51	0.16	0.53
Materials	0.74	0.47	0.67	0.69	0.43	0.83	0.54	1.00	0.39	0.30	0.62
Telecom	0.54	0.39	0.31	0.42	0.41	0.49	0.51	0.39	1.00	0.30	0.34
Utilities	0.26	0.43	0.43	0.33	0.37	0.37	0.16	0.30	0.30	1.00	0.44
Real Estate	0.74	0.55	0.37	0.72	0.51	0.69	0.53	0.62	0.34	0.44	1.00

Figure 1: S&P 500 Sector Correlation Matrix, source: https://www.globalxetfs.com/cio-insights-sector-investing-and-correlations/

What is sustainable investing and does it even work?

WRITTEN BY NEHA KUMAR

WHAT IS SUSTAINABLE INVESTING?

SUSTAINABLE INVESTING IS WHEN PEOPLE INVEST IN COMPANIES THAT ACTIVELY WORK TO PROGRESS AND BETTER THE WORLD. INVESTMENT INTO THESE TYPES OF COMPANIES POSITIONS THEM FOR GROWTH THAT ALLOWS FOR IMPACTFUL CHANGE AS WELL AS RETURNS. ETHICS IS AS IMPORTANT A FACTOR AS RETURNS - AN ELEMENT OF PERSONAL DUTY AND SATISFACTION IS CONSIDERED WHEN INVESTING THIS WAY. TODAY, SUSTAINABLE INVESTING CONSISTS OF INVESTING IN COMPANIES THAT MAKE AN EFFORT TO TACKLE CLIMATE CHANGE ISSUES, SOCIAL ISSUES AND PURSUE TECHNOLOGICAL ADVANCES, BOTH OF WHICH AIM TO HOLISTICALLY BETTER OUR QUALITY OF LIFE.

For example, we move away from investments like nuclear power, which give decent returns but are unethical, and towards companies like Meridian Energy (NZE: MEL) which produces 100% of its energy from wind farms.

Now, how would your average investor know which companies are relatively more sustainable? ESG's, similar to corporate social responsibility, help to hold companies accountable for their actions and materially affect the performance of the company. The score is essentially a reflection of the company's sustainable practices. As a general rule of thumb, the more transparent the company is willing to be, the higher their ESG score will be. The rating scale is between 0-1 with a grade scale given. Those with higher grades would be ESG Leaders and lower grades, ESG laggards; 0.3 would be a C- and would mean that the company is rated less than the average expected in their field, 0.5-1 (B- to A+) would be considered reasonable placements for companies.

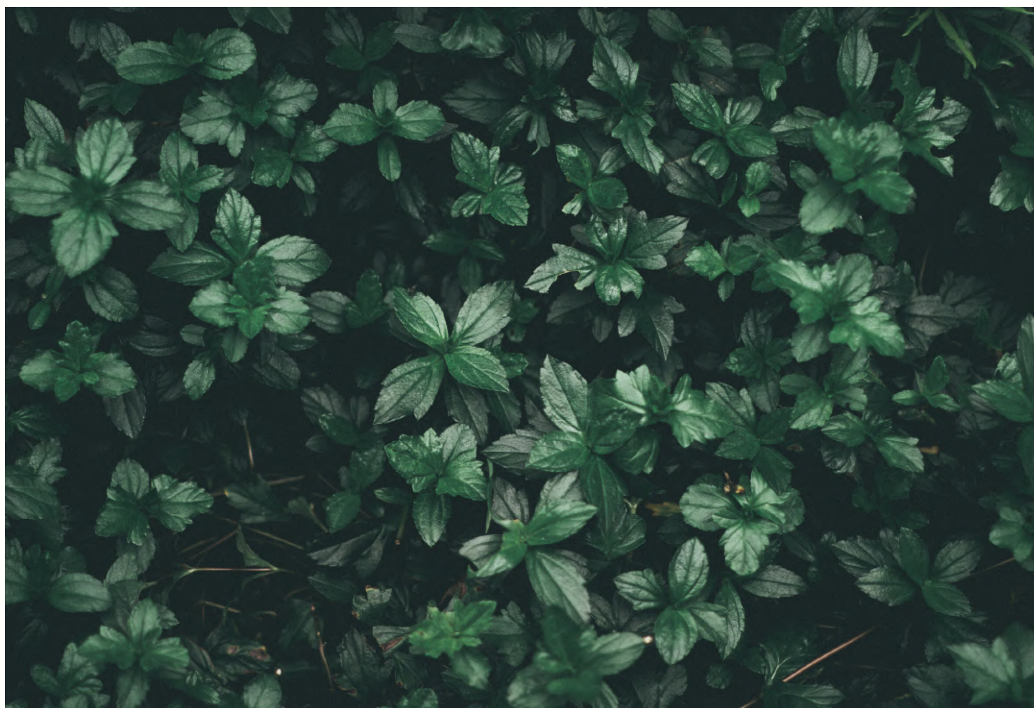
THE POSITIVE EFFECTS OF SUSTAINABLE INVESTING

As mentioned before, sustainable companies attempt to take the ethical route when it comes to their business model. Often this gives the impression that returns will also be lower. However, environmental, social and governance premises often tangibly affect the performance and market value of a company. Put simply, having a decent ESG score and ethical business model can improve a company's reputability and social acceptance- which, in turn, can increase their market value and overall interest from investors.

Benefits are often given to sustainable companies through tax credits, subsidies and tax deductions. Investors have incentives to continue to practice sustainable investing due to the low-risk and high growth prospects. The risk level for most ESG funds is usually lower making it a better long term investment prospect while ethically diversifying a portfolio. This lower risk factor also speaks to the unlikelihood of getting caught up in ethical scandals that could tarnish the reputation of the company and in turn cause a dip in stock price. All considered, investing in sustainable companies can be seen as a safe bet due to its risk-averse nature, its long term growth prospects, reputability within the community and the satisfaction of making an active impact in bettering the world.

An example of a company that is making an effort to be more sustainable, and considering their ESG mark is Z Energy (NZE: ZEL). In 2016, Z Energy built New Zealand's first biodiesel plant that uses renewable resources to produce biodiesel, a more sustainable and cleaner burning compared to regular diesel. Z Energy distributes directly to companies such as Fonterra and Transport Investments Ltd as well as commercially. 2016 was also when the share price of NZE: ZEL peaked, shortly after ads were run about the new biodiesel plant. Another example is Meridian Energy (NZE:MEL), New Zealand's largest renewable energy power company. Their dedication to being environmentally friendly goes beyond their power generation; Meridian's Wellington office has won awards for its construction, design and operations. They also scored a 5.5/6 for its energy efficiency by NABERNZ, a system for assessing the energy efficiency of office buildings.

The long term effect of putting an emphasis on ESG scores and investing in companies that actively attempt to be sustainable



is that more companies will strive to be desirable in this light and therefore make an effort to be more sustainable. The flow-on effect is that companies will increase their sustainable practices once they realise that investors are actively seeking out sustainable companies. This would increase the accessibility for investors to find sustainable companies, and would increase access for sustainable companies while phasing out inflexible, non-sustainable companies as long term investments. Overall this would create a shift towards sustainable investing as being the norm and fewer non-sustainable companies being funded, merging the worlds of investing and sustainability.

THE NEGATIVE EFFECTS OF SUSTAINABLE INVESTING

Although it can have its perks, there are a few downsides to sustainable investing. Firstly, sustainable investing could be progressing companies that aren't making a lasting positive impact. Net positive sustainable investing is investing where the consequences are mostly positive and limited negative. Essentially, a company has a 'net positive impact' when all three areas of ESG are balanced but this is rarely found; coal-mining company Bathurst Resources is attempting to expand their already 38-hectare mine in Canterbury by another 18 hectare which covers forests and wetlands. This has a positive social impact as it increases labour use but has negative environmental impacts as it further strains the already fragile ecosystems. Earlier, Z Energy was mentioned for their efforts towards producing biodiesel, this reduces their negative environmental impact. As of 2018 Z Energy also has a 55% market share in New Zealand's downstream fuel market. Their social impact is positive as their continuous growth means continuous demand for labour (currently they employ around 2600 people). However, they are a company that profits off of crude oil and leaves a high carbon footprint, even with biodiesel, leaving a lasting negative environmental impact and indirectly having a negative social impact. Despite their efforts, Z Energy still has a net negative impact.

Another negative effect of sustainable investing could be many companies that aren't considered sustainable and aren't able to change their business model to be more sustainable will lose investors and public backing. While this may be a win for environmentally conscious businesses and investors, it pushes otherwise successful companies and their subsequent economic benefits to the side. An example of a company facing repercussions of sustainable and ethical neglect would be H&M. From 2016- 2019, many articles have been written on the company's poor ethical practices. Sites such The Sun, The Guardian and Global Citizen have spoken out against H&M and their use of sweatshop labour. This, mixed with consumers decreasing their interest in fast fashion has created a drop in share prices and profits for H&M which has not recovered to before the articles. In 2015, H&M made just under $21,000USD profit for the fiscal year. In 2018 their profit dropped to just over $12,500USD.

Companies may also attempt to greenwash their brands. Using H&M as an example once again, the brand attempted to greenwash by releasing their eco-friendly line 'Conscious'. H&M is unwilling to reveal how the 'Conscious' line is manufactured more sustainably to their other clothes, and while they claim that each piece of clothing contains at least 50% recycled or organic materials, their regular manufactured clothes are mostly synthetic fabrics that take incredible amounts of water to recycle if they can be recycled; to make one piece of 'Conscious' clothing, several more are discarded.

In 2019 Meridian Energy (NZE: MEL) was accused of greenwashing themselves. The claim was made because Meridian has an agreement with Genesis Energy (NZE: GNE) to use power from their Huntly power plant if need be. The Huntly power plant uses coal and natural gas to create energy. While Meridian itself produces 100% renewable energy their dependence on Genesis Energy's power speaks to the unreliability of sustainable energy, which could deter investors. Investors would likely look at other companies to invest in that are sustainable, reliable, and can give returns.

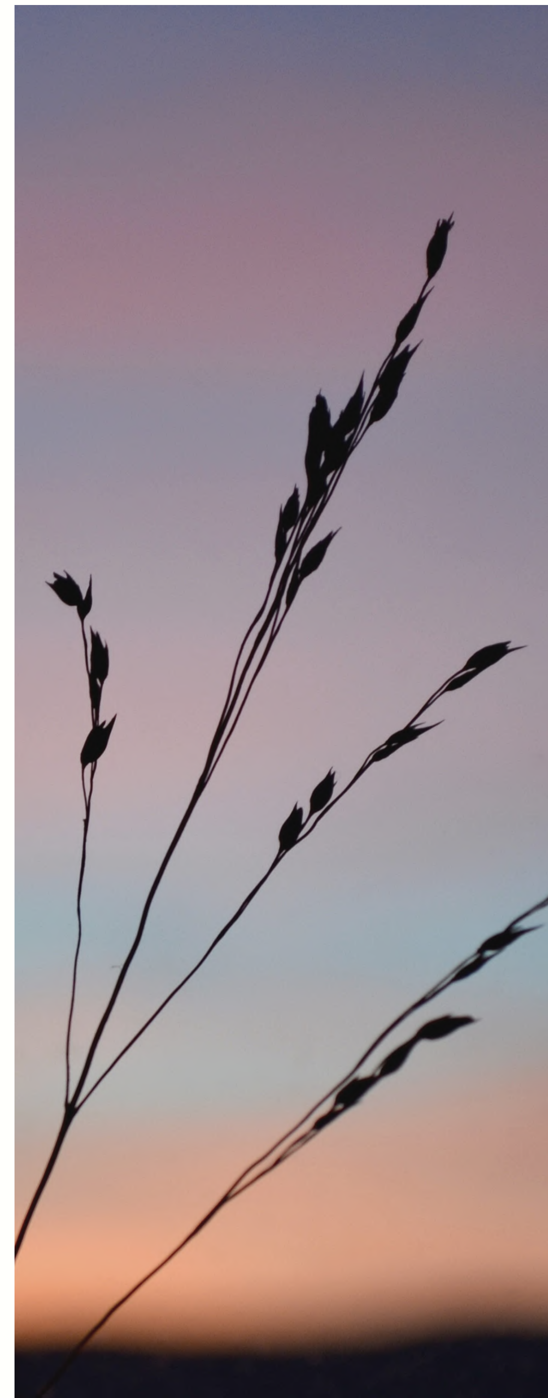
WHY THIS MATTERS IN NEW ZEALAND (AND GLOBALLY)

Understanding the impacts of sustainable investing allows us to be informed when looking for avenues to invest ourselves; Harbour Asset Management is a New Zealand based asset management company that integrates environmental, social and governance (ESG) research into their investment process. Quay Street Asset Management includes a positive and negative screening in its investment process to ensure socially responsible investing. Incorporating the ESG structure into research shows that the ethical connotations are part of the rewards that come from investing and speaks to the importance given to responsible investing. From 2015-2019 ESG funds had a cumulative return contribution of 1.55%, with many European ESG funds outperforming.

In 2019 it was reported that S&P Dow Jones Indices launched the 'S&P 500 ESG Index'. This new index still uses the benchmark 500 Index, but also considers ESG criteria, excluding those companies that don't hold up. Aside from making ESG funding more mainstream, the new index ambitiously attempts to change the way investors analyse the reputability of a company and whether the sustainability implications make them worth investing in.

Some of the well-known and large companies that didn't pass the S&P ESG criteria are Boeing (NYSE: BA) as they are involved with nuclear weapons, Alphabet (NASDAQ: GOOGL, the parent company of Google) for having an S&P ESG score that was too low. Both Berkshire Hathaway (NYSE: BRK.A) and Netflix (NASDAQ: NFLX) scored too low on the UN Global Compact which means they weren't even eligible for consideration. An entire report was created explaining the criteria of judgement and those companies excluded. The performance of the index can be viewed from the S&P Dow Jones Indices website. The S&P 500 ESG Index is recognition towards the shifting trend in investing in sustainable pursuits. Reid Steadman, the head of ESG Indices at S&P Global, believes there could be a convergence between ESG indexes and benchmark indexes. Companies that adhere to ESG values should continue to grow, and push out companies that don't adhere, ultimately making ESG investing mainstream.

At its core, sustainable investing speaks to the idea that it is possible to make a change in the world for the better through investing in companies that are forward-thinking and focus on societal progress as much as they do company growth. Given the current economic, social and environmental issues the world is facing, there is no doubt sustainable investing is a necessity. But, similar to other investments, it's important to consider the pros and cons of investing sustainably and the effects it can have on the wider community and the investor.



The three most important words in investing

WRITTEN BY SEAN SPIRES

WARREN BUFFET WAS ONCE ASKED, "IF YOU WERE TO CAPSULISE INVESTING INTO THREE WORDS, WHAT WOULD THOSE BE?". HIS RESPONSE?

"MARGIN OF SAFETY".

During my first year of university, I took a paper called "Principles of Engineering Design". The largest component of this paper was where we, in groups, would design and build a truss made of popsicle sticks to support an intended load. My group did everything you would imagine to ensure that our truss would support the load. We figured out how much an individual popsicle stick could support, experimented with different designs, and conducted all manner of mathematical jiggery-pokery. Within all the mathematics we used for the construction of the truss, there is one concept which was arguably the most important. This was the engineering concept known as a factor of safety. For our group, this meant that if we intended for our truss to hold 40 kilograms, we would design the truss to hold 60 kilograms. Now you might be asking, why do you need to bother with a factor of safety if math is so reliable? Well for starters, comprehensive testing for our project was impractical, it was not easy to capture all the possible factors needed for our mathematical equations, and most importantly, there might be emergencies in which the mathematics didn't account for. A factor of safety is needed so that engineers can be approximately right instead of precisely wrong. Anyways, why did I bore you with all this? Well, the concept of a factor of safety, is just as important in investing as it is in engineering.

In the investing world, we don't use the term factor of safety. Instead, we call it a margin of safety (take that, engineers). A margin of safety in investing can be defined as the difference between the intrinsic value of an

asset and its market price. What does this mean in simple terms? Buy dollar bills for less than a dollar. Having a margin of safety between what you pay and what the asset is worth is incredibly important to protect your capital. When you buy any stock, you are predicting the future profitability of the underlying business. Depending on what you estimate the future profits of a business to be, you arrive at an 'appropriate' value for a stock. In a sense, we are more like futurists than investors if you think about it. And the funny thing about futurists is that they are nearly always wrong. So how can we protect ourselves against our poor estimations of the future? By demanding that there is a huge buffer between what we pay for a stock and what we think its worth. Because what you think it is 'worth' does not capture the realities of the future. While this might seem like common sense, this is the most widely ignored piece of common sense. The reason for this, in my opinion, is twofold. First, investors do not take Murphy's law that "Anything that can go wrong will go wrong", into account when making their investment decisions (I mean, who could have predicted a global pandemic). Secondly, the focus of modern finance has, at least in my understanding, sought to place more of an emphasis on mathematical models and metrics. While there is nothing wrong with this per se, there is a problem with relying too much on the output of these models at the expense of the margin of safety you demand from your investment.

Just to conclude, I would like to make a final comparison between the investor and the engineer as they do have much in common. I would suggest that to increase your investment success, you should adhere to the concept of a margin of safety just as vehemently as the engineer adheres to the concept of a factor of safety. Just as the engineer who builds a bridge with the intention for it to support loads in the future, so too does the investor buy a stock with the intention for it produce profits in the future. Both the investor and the engineer make assessments of current conditions and facts to guides their estimations of the future. However, the concept of a factor of safety, while used by the engineer, is largely not used by the modern investor. The engineer realises that he does not have all the information needed and seeks to be approximately right. The modern investor, with all their attention, fixated on price movements and the new wave of arcane valuation formulas, is interested in being precisely wrong.

Uber eating up the industry

WRITTEN BY ANANYA AHLUWALIA

WHETHER YOU'RE HAVING A LAZY NIGHT IN OR RECOVERING FROM A BIG NIGHT OUT, THIRD PARTY DELIVERY SERVICES ARE THE BEST WAY TO SATISFY UNCONTROLLABLE CRAVINGS. FOOD DELIVERY APPS LIKE UBER EATS ELIMINATE THE HASSLE-INDUCING GAP BETWEEN RESTAURANTS AND THE WARMTH OF YOUR HOME, DELIVERING MEALS DIRECTLY TO YOUR DOOR. THE CONVENIENT DINING EXPERIENCE THEY PROVIDE BRINGS TAKE-AWAYS TO A NEW LEVEL, CHANGING THE VERY FOUNDATIONS OF HOW WE EXPERIENCE FOOD.

Unlike New Zealand, where the industry is practically monopolised by Uber's (NYSE:UBER) Uber Eats, the United States' market is a lot more crowded. Additionally, the interchangeability of the competitors' services means the distribution of market share is significantly volatile.

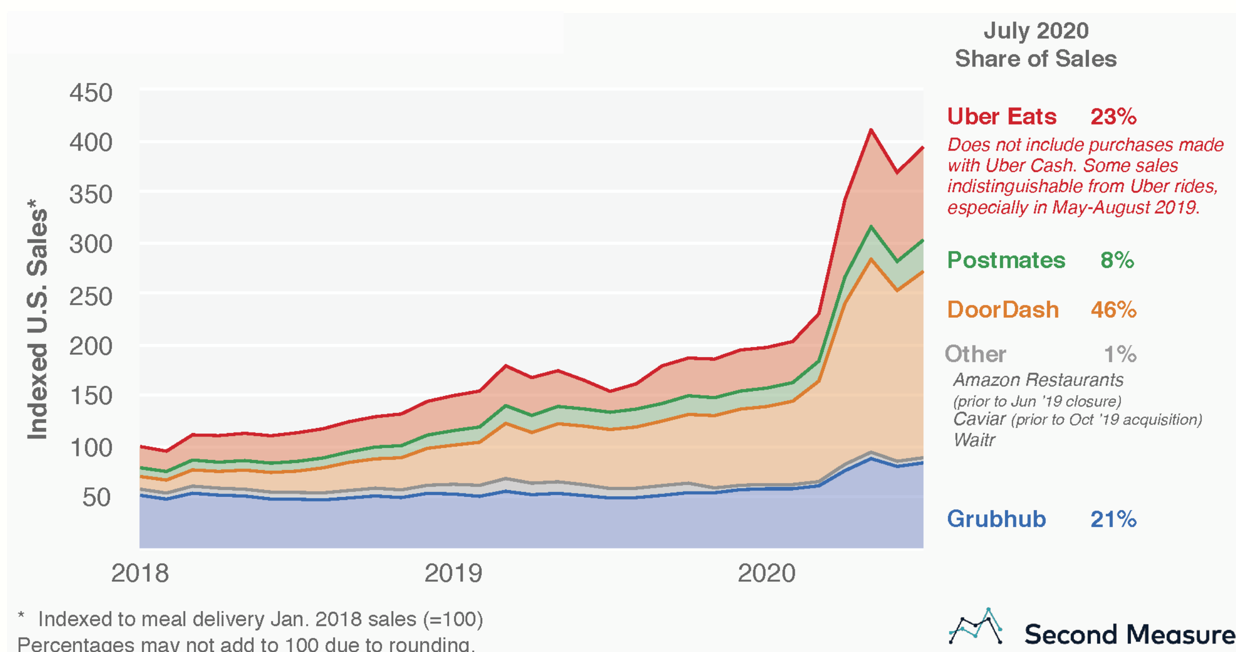
DoorDash is currently leading the industry in the United States, earning 45% of all food delivery sales made in April 2020. The company was in the process of going public before Covid-19, having submitted files to the US Securities and Exchange Commission confidentially.

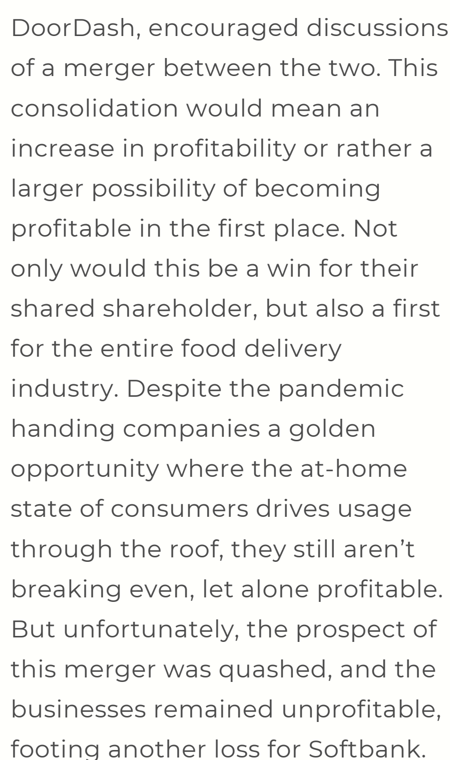
However, considering the volatile state of the current market, it is unlikely that further actions will be taken towards the venture right now.

While it holds a dominating position in New Zealand, UberEats looks like it's losing the digital delivery battle in the United States, earning 24% of April 2020's sales (excluding Uber Cash sales). Since its launch in 2014 as "UberFRESH", UberEats has blown up globally, with revenue hitting $1.211 billion in the second quarter of 2020. However, like its parent company, Uber Eats is not profitable and isn't estimated to be until at least 2024.

According to investment firm Cowen, even while taking a 30% cut and delivery fees from sales, the company was still losing USD$3.36 on every order. Despite its subpar performance, Uber publicly-listed mid-2019 with starry eyes and the optimistic private valuation of $76 billion and famously crashed and burned. Its IPO price fell 17.6% from the initial $45 per share by the second day of release, declaring the highly anticipated IPO the "5th worst over the past quarter-century".

After Uber's failed IPO, Softbank, a company which has invested heavily in both Uber and





DoorDash, encouraged discussions of a merger between the two. This consolidation would mean an increase in profitability or rather a larger possibility of becoming profitable in the first place. Not only would this be a win for their shared shareholder, but also a first for the entire food delivery industry. Despite the pandemic handing companies a golden opportunity where the at-home state of consumers drives usage through the roof, they still aren't breaking even, let alone profitable. But unfortunately, the prospect of this merger was quashed, and the businesses remained unprofitable, footing another loss for Softbank.

However, recent news celebrates Uber's successful acquisition of Postmates for $2.65 billion. Postmates, was the fourth largest food delivery company in the US, holding 8% of the market's sales in April. Combined with Uber Eats' 24% and predicted growth, analysts estimate the merger will result in Uber controlling a third of the US market. Postmates' services are similar to other services, but the app does not include a star rating system for drivers, but a holistic thumbs up or thumbs down option to rate the experience. Uber plans to keep the two apps operating separately front end but plans to have drivers delivering orders for both services. While the acquisition doesn't drastically change the competitive landscape, it does introduce a glimmer of hope for increased profit margins, resulting in Uber's stock rising 7.3% after the merger was announced.

Founded in 2004 and publicly-listed a decade later, Grubhub (NYSE:GRUB) was one of the first food delivery services in the United States. However, its legacy is not enough to keep the once leader ahead of the rest. Consistently earning around 22% of the industry's sales of the past few years, the lack of growth has left the business struggling to remain competitive in the crowded market. Its $4.5 billion valuation at the start of 2020 is a jarring tumble from the $13 billion it was estimated to be worth around the same time 2019. Its poor performance has led the company to selling, resulting in the consolidation in the industry experts have been eagerly waiting for.

While Uber did make an acquisition bid for Grubhub, a merger which would have resulted in an effective duopoly in the US industry, they were outbid by Just Eat Takeaway (AMS:TKWY). The European company bought Grubhub for $7.3 billion, around $1 billion more than Uber's valuation. Though this isn't the first pivotal merger in the company's history. Less than six months ago, Dutch Takeaway.com bought London-based rival Just Eat for a massive $7.8 billion, despite the UK Competition and Markets Authority's initial concerns. The Grubhub acquisition secured its position as the largest online food delivery company outside of China and marked its entry into the US market.

The news of the sale of Grubhub has investors excited, resulting in Grubhub's stock price jumping by 36% when the Uber-Grubhub merger was theorised, and now once again with Just Eat. This reaction by the stock market shows the positive impact consolidation will have on such a flooded market. While this merger didn't result in fewer competitors in the US market, future ones inevitably will. A thinned out market threatens the decline in popularity of competitive pricing, raising several questions about how price elastic the demand created by laziness is. Currently, consumers are thriving in the competitive environment and the lack of brand loyalty associated with the food delivery industry. Unfortunately, none of the companies are profitable and won't be in the foreseeable future, meaning higher prices are necessary for the industry's survival long term. The challenge they pose to the value of convenience, however, is likely to drive the businesses' majority low-income consumer-base away from delivery all together.

Ultimately, while mergers are a big step in the direction of profitability, the food delivery industry has a long way to go before they can fulfil the bottom line, if ever. Without extensive changes, like increased prices, consolidated businesses and cost cutting, all which would result in unhappy customers, the food delivery industry won't be sustainable.

MYOB's column

MYOB GENERAL ELECTION SNAPSHOT REPORT

In a major turnaround following nearly a decade of MYOB election polls, Labour is currently the preferred political party of New Zealand's SMEs, with 38% of SME owners and decision makers intending to vote red in the upcoming General Election, while 35% will vote for National.

The MYOB General Snapshot report surveys the voting preferences of New Zealand SME owners and decision makers. It delves into the key areas that SME voters would like to see the next Government prioritise.

To find out more about the sentiment of Kiwi businesses ahead of the upcoming election, click here

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