# Leyland Lines

June 2022

MARKET INSIGHTS

Leyland Lines is our monthly newsletter providing investors with our insights on the overall market, individual companies and other relevant issues. All the information contained in this newsletter is for general reading only and should not be taken as a personal recommendation. Companies and ideas discussed in this newsletter are not necessarily buy or sell recommendations. We don't know when the opportunity to purchase or sell at favourable prices may occur, but when it does we act decisively. For that reason we encourage clients to allow us discretion using our Individually Managed Account service.

## Welcome to the June edition of our newsletter for 2022

Rising inflation and interest rates globally have impacted markets, with both equity and bond markets dropping to adjust for the rate rise, increasing the return on cash (risk-free rate of return). The ASX is down about 10% for the month (at time of writing).

Signs of inflation have been clear for some time, and well before the Russian invasion of Ukraine. Energy prices were rising mainly due to political ineptitude resulting in underinvestment in power generation. The global economy was reopening with demand far outpacing supply due to supply chain disruptions. This, along with many other contributing factors, has resulted in a general increase in prices.

Central banks globally appeared slow to act given their mandate to maintain price stability. More recently, central banks have aggressively increased rates to combat very evident inflationary pressures. An effective tool to curtail demand is the 'wealth effect', whereby consumers feel less wealthy as asset prices fall (or visa-versa). Additionally, those heavily indebted households will experience an increase in debt servicing, although this appears manageable as unemployment is at record lows and incomes are rising. Consumer confidence is low notwithstanding technically full employment.

In short, interest rates are normalising from emergency settings impacting markets and the consumer. The US consumer accounts for 14% of global GDP, and a large portion of them are under stress (approximately 50% have zero savings).

Without attempting to forecast future macro movements, it appears that several factors that have contributed to inflation are now reversing. For example, container shipping costs have dropped sharply.

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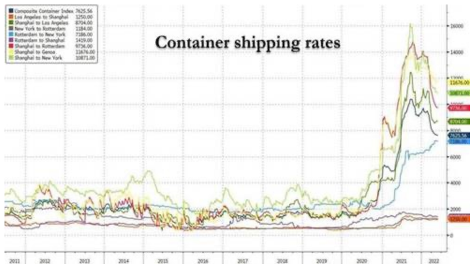
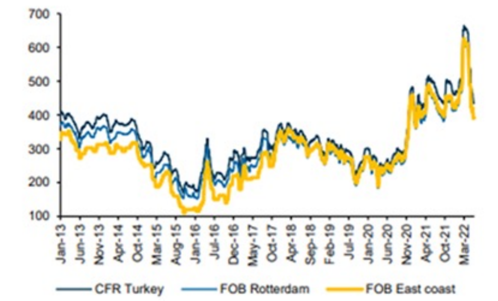
MARKET INSIGHTS

## Welcome to the June 2022 edition cont'd

### Shipping freight costs:

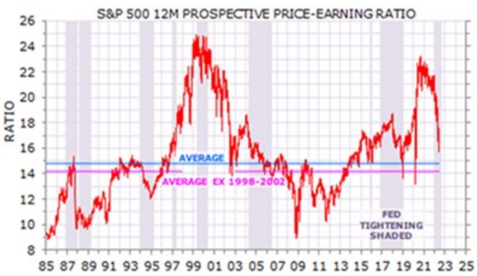



Scrap metal prices have also fallen:




Source: Platts, Macquarie Research, June 2022

Equity valuations have returned to what is considered 'normal'.




If earnings can be maintained, or fall only slightly, valuations appear reasonable. The valuation gap between the return on equities versus that of cash (risk-free) has been maintained. High quality large-cap companies have been sold off in what is a broad market retracement. These companies have weathered numerous cycles and should do so in this instance. When things become clearer, share prices will adjust accordingly.

Finally, China remains a key factor, as it commences an interrupted reopening, freeing up of supply chains (Shanghai is the largest freight terminal globally) and increasing demand for commodities.

The market tends to overshoot in both directions. The pending end-of-financial year results will tell an interesting story.

Throughout the month both Alex and Charles Leyland appeared on Ausbiz discussing high-quality earners in a volatile market.

### Six boring 'buys'


### Are banks good bang for your buck


In this edition of Leyland Lines, we discuss The Lottery Corporation. For the video of the month, we include an insightful discussion our Managing Director, Charles Leyland, had with David Gonski. Finally, in light of the recent volatility, we thought it timely to reflect on the decision-making heuristics and biases that make smart people do dumb things.

## Video of the month

We were privileged to host a discussion with distinguished Australian, David Gonski.

## The Lottery Corporation Limited (ASX: TLC)

**Share Price:** $4.49
**Market Cap:** $10b

The demerger of Tabcorp has resulted in the spin-off of a powerful lotteries and Keno business into a separately listed vehicle called The Lottery Corporation (TLC). One of the highest performing lotteries businesses in the world, TLC has long duration and exclusive licences to operate lotteries. Lottery ticket sales are resilient to economic cyclicality, cash flows are steady and predictable, and there is a low ongoing need for capex. These characteristics mean we expect TLC to be able to deliver a fully franked dividend at a high payout ratio, while still paying down debt steadily. This may create the opportunity for future capital management.

Future earnings are largely predictable over the long term. The long duration of lottery licences issued to the company remove some key risks to the business. The licences to operate Lotteries have 21 years until expiry while the Keno licences have 29 years average until expiry.

TLC has a strong distribution network. The lottery tickets are sold through 4,000 retail outlets and online through its digital app and resellers. Digital sales are now 40% of revenue. This along with TLC customer database means it can reach a very large audience. The lottery is the most popular form of gambling in Australia. Keno, a game of chance, is distributed in nearly 3500 venues such as hotels and clubs.

Lottery ticket sales have historically been resilient to economic cycles, in fact sales may actually increase in tough times. TLC is, as a result, is a steady cashflow generator and not capital intensive. It is a not dissimilar to an infrastructure asset in this way. Infrastructure and annuity type assets are currently very much in demand from the large super funds, both local and overseas, seeking investment certainty. There is a chance that TLC may be taken over by one of these funds, at the very least, they are likely buying large shareholdings in the company.

| $m | FY21 | FY22e | FY23e | FY24e |
|---|---|---|---|---|
| Revenue | 3,206 | 3,504 | 3,565 | 3,688 |
| growth yoy % | 9.8% | 9.3% | 1.7% | 3.5% |
| EBITDA | 611 | 695 | 724 | 768 |
| EBIT | 591 | 609 | 640 | 685 |

Broker forecasts expect TLC to deliver near 15% growth in EBITDA in FY22. Growth is expected in both the Lotteries and Keno divisions. This may be peak short-term earnings as the large number of jackpots in 2022 are expected to normalise in future years, earnings are still to be healthy but profit growth is to flatten into FY23 and FY24. The forecast price earnings ratio is currently a bit high, at 25 times based upon 2023 earnings but the dividend is expected to be 3.5%, fully franked in this year. Broker valuations have price targets of $5.40.

This stock is not risk free, demergers are complex and costly, smaller jackpots can lead to lower sales and licences might not be renewed on expiry. The question on valuation is how much of a premium should investors pay for certainty of earnings, and dividend, in these uncertain times?

*Jon Stutt*

MARKET INSIGHTS

# Why Smart People Do Dumb Things

*Warren Buffett gave an important lecture at Florida University on 15 October, 1998[1]. An eager MBA student asked him about his involvement in the rescue of one of the most spectacular hedge fund blow-ups in financial history.*

A fund by the name of Long Term Capital Management had great success making money from the arbitrage of bond securities from 1995 to 1998[2]. 'LTCM' was invincible and some of the smartest men in America were in charge.

The fund was a behemoth. $126 billion in assets under management. No less than $10 million to be part of the action. Initial success was attributed to the genius of its founder, John Meriwether—a former high flyer on the Salomon Brothers trading desk.

And he was in good company. The principal shareholders of LTCM were Nobel prize-winning economists Myron Scholes and Robert Merton plus 13 other men.

These men, "if you take the 16 of them, they have about as high an IQ as any 16 people working together in one business in the country, including Microsoft. An incredible amount of intellect in one room," said Buffett.

But they blew up. And they blew up big. By September 1998, the company's risky trades brought it close to bankruptcy.

LTCM's size meant it was 'too big to fail.' The U.S. Federal Reserve had no choice but to step in. The pending collapse was going to spark a global financial crisis. The call to Buffett pleading for help came next.

Buffett found it fascinating, "…they're not bad people at all; but to make money they didn't have and didn't need, they risked what they did have and didn't need. That is just plain foolish; it doesn't matter what your IQ is. If you risk something that is important to you for something that is unimportant to you it just doesn't make sense," said Buffett [3].

1 https://www.youtube.com/watch?v=2MHIcabnjrA

2 https://www.thebalance.com/long-term-capital-crisis-3306240

3 https://www.tilsonfunds.com/BuffettUofFloridaspeech.pdf

Many of LTCM's shortcomings can be attributed to basic human biases common to all of us. The average investor can benefit greatly by being aware of some of these unusual patterns of thinking.

Following is a sample of the common biases and heuristics that get us into trouble when investing. No matter your IQ. We conclude with some advice to help overcome these biases.

It's our job as value investors to be aware of irrational thinking and moments of wonder.

As Buffett warned in his lecture, "the downside, especially if you are managing other people's money, is not only losing all your money, but it is disgrace, humiliation and facing friends whose money you have lost."

## What is a Heuristic?

A heuristic technique, often called simply a 'heuristic', is "an approach to problem solving that employs a practical method not guaranteed to be optimal, perfect or rational, but sufficient for reaching an immediate goal."[4] An activity like investing comes to mind.

Where finding an optimal solution is impossible or impractical, heuristics can be used to speed up the process of finding a satisfactory solution. Think of them as mental shortcuts that ease the cognitive load of making a decision.

Examples include trial and error, a rule of thumb, an educated guess, an intuitive judgment, a guesstimate, profiling, or common sense.

It's basically making decisions when there is uncertainty or unknowable information. The result can sometimes be irrational decision making and unusual thinking patterns.

Prior to the work of some smart Israeli men in the 1960s and 70s called Daniel Kahneman and Amos Tversky, the predominant view in the field of behavioural finance was that humans are 'rational'—not 'irrational.'

Tversky and Kahneman began work on a series of papers examining 'heuristic and biases' used in 'judgment under uncertainty' and began to think otherwise.

4 https://en.wikipedia.org/wiki/Heuristic

## Why Smart People Do Dumb Things cont'd

Following are some examples of different types of heuristics and biases and how they can affect your investing habits.

### The Availability Heuristic

The availability heuristic is a mental shortcut that relies on immediate examples when evaluating a specific topic.

If you see a story about a shark attack on the news then you'll automatically think the chances of dying of a shark attack are greater. But reality says you have more chance of dying from falling airplane parts.[5]

An example in finance is Franklin Templeton's Annual Global Investor Sentiment Survey[6]. In 2012 they asked individuals how they believed the S&P 500 Index had performed in 2009, 2010 and 2011.

66 percent of respondents said they believed the market was either flat or down in 2009, 48 percent said the same about 2010 and 53 percent also said the same about 2011.

In reality, the S&P 500 saw 26.5 percent annual returns in 2009, 15.1 percent annual returns in 2010 and 2.1 percent annual returns in 2011.

This meant lingering perceptions based on dramatic, painful events like the Global Financial Crisis in 2008 were still impacting investors' decision making three years on.

Staying in cash during this period out of fear means investors left a lot of money on the table.

### The Illusion of Understanding

This bias is powerful when it comes to investing.

It's based on the premise that good stories provide a simple and coherent account. But they can lead to a sense of inevitability… 'This or that had to happen exactly as it did, because this and that happened before.' It is coherent. It is a story.

Investors don't seem to care whether the story was correct… 'Just that it was made up by someone sounding authoritarian'—like a stockbroker.

In his book Thinking Fast and Slow, Daniel Kahneman said, "I have heard of too many people who knew well before it happened that the 2008 financial crisis was inevitable.[7]

This sentence contains a highly objectionable word, which should be removed from our vocabulary in discussion of major events. The word is, of course, knew. Some people thought well in advance that there would be a crisis, but they did not know it."

Kahneman says, there is no real understanding in stories—only the illusion of understanding. By focusing solely on the events of a story that make sense we forget about all the random occurrences. And were they any different, the final result may have been completely different too.

Humans need stories to comprehend complex ideas. But stories won't give us the truth, just a coherent made-up selection of events.

The Illusion of Understanding is very similar to one of the principles from Nassim Taleb's book, The Black Swan, called the Hindsight Bias.

Taleb says in hindsight, nobody expects X (the GFC for example). But, "after X has happened lots of experts will show up to tell us it was clear this would have to happen for so and so."

### The Endowment Effect

To demonstrate this unusual bias, participants—in a study conducted by Daniel Kahneman and his peers—who were given a Swiss chocolate bar were generally unwilling to trade it for a coffee mug. In contrast, those first given the coffee mug were generally unwilling to trade it for the chocolate bar.[8]

It was suggested by Kahneman and his colleagues that the endowment effect is, in part, due to the fact that once a person owns an item, forgoing it feels like a loss, and humans are loss-averse.

Those who inherit share portfolios from deceased relatives exhibit the endowment effect by refusing to divest those shares, even if they do not fit with that individual's risk tolerance or investment goals.

5 https://web.archive.org/web/20190325193349/http://legacy.sandiegouniontribune.com/uniontrib/20040222/news_mz1c22odds.html

6 https://www.businessinsider.com.au/the-availability-bias-is-driving-investor-decisions-2012-10?r=US&IR=T

7 https://en.wikipedia.org/wiki/Endowment_effect

8 https://en.wikipedia.org/wiki/Prospect_theory

## Why Smart People Do Dumb Things cont'd

Another example outsideof finance is an individual who may have obtained a case of wine at a decent price.

If an offer were made at a later date to acquire that wine at a marginally higher price, the endowment effect might compel the owner to refuse this offer, despite the monetary gains that would be realised by accepting the offer.

### Rare Events

This bias suggests we often overestimate the probabilities of unlikely events. We give them too much clout in our decisions.

We are more afraid of dying in a terrorist attack than from a heart attack, or being in a plane crash than a car crash for example.

In other words, we both overestimate and overweight small probabilities. This was uncovered by Tversky and Kahneman's in their work on Prospect Theory. [9]

If you didn't add any companies to your portfolio after the GFC then this bias might explain why. You may have been reeling from the psychological impact or plain scared of entering the market again.

Truth is the odds of another GFC type event had never been lower post-GFC.

History now tells us this period was a good time to be buying quality businesses.

### Framing

Framing bias occurs when people make a decision based on the way information is presented, as opposed to making decisions based on the facts themselves.[10]

In finance, investors may react to a particular opportunity differently, depending how it is presented to them. Consider the following example. Which scenario frames the earnings of a company better?

'Earnings per Share (EPS) were a $1.25, compared to expectations of $1.27.'

Versus

'Earnings per Share (EPS) were a $1.25, compared to last quarter, where they were $1.21.'

### Same information. Different frame.

Clearly, option two does a better job of framing the earnings report. The way it's presented—as an improvement over the previous quarter—puts a more positive spin on the EPS number.

You need to be aware of some of this trickery as a long-term value investor. It's especially prevalent in the language of annual reports and analyst reports.

### Confirmation Bias

We're all guilty of this one. Once we have a theory, we seek confirming evidence. This is called 'confirmation bias.'

"We fall victim to epistemic arrogance, becoming overconfident about our ideas and failing to account for randomness," according to author Nasem Taleb.

To make theories work, we "smooth out the jumps in a time series or historical sequence, looking for and finding patterns that don't exist."[11]

It is also known as 'tunneling.'

In other words, you may start looking at all the reasons for buying a company and ignore all the reasons why you shouldn't. It's like wanting to buy shares in a favoured company and looking for all the positive 'Buy' recommendations and ignoring the 'Sell' reports.

Just remember, it's prudent to look at the reasons why you shouldn't buy shares in a company too.

### Self-Serving Bias

This bias drives fund managers and CEOS up the wall.

9 https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/framing-bias/

10 https://en.wikipedia.org/wiki/Self-serving_bias

11 https://www.washingtonpost.com/national/health-science/optimism-bias-why-the-young-and-the-old-tend-to-look-on-the-bright-side/2012/12/28/ac4147de-37f8-11e2-a263-f0ebffed2f15_story.html

## Why Smart People Do Dumb Things cont'd

It is the tendency to blame external forces—like a fund manager—when bad things happen and give yourself credit when good things happen.

When you beat the benchmark for any given year it is due to your skill at selecting the top fund managers or supreme companies.

When you lose it's due to the incompetent fund manager or stockbroker and their flawed investment philosophy. Fund managers aren't off the hook though. They are guilty of blaming the macro economy and movements in interest rates, currencies, droughts, Brexit, housing prices, the Euro crisis, Asian crisis, Trump tweets or any other causes, no matter how esoteric.

Whatever the reason, they all have in one thing in common: they are impossible to disprove as a factor. [12]

Be sure to take responsibility of your investment decisions if you plan to be in this game for the long-term.

### Anchoring Bias

Anchoring relates to the use of irrelevant information on which to make a decision—investments or otherwise. One excellent example is that of two similar products, both priced at $99.00. Item one, however, is 'on sale' and has been 'reduced' from $150.00. Consumers will generally purchase item one as they are anchored by the original price.

The historic value of securities also misguides investors who focus on their 'anchor point' (e.g. lowest recent price, price at which they 'meant to purchase' etc.), notwithstanding that the anchor point has no correlation with the current valuation or target return.

Warren Buffett admits anchoring is one of the biggest mistakes he has made. He has been caught many times sitting back "sucking his thumb when he should have been buying stock in a great company."

In other words, Buffett waited to infinity for the stock to move down to his 'anchored' level, or an earlier price at which he had considered purchasing.

12 https://www.economist.com/babbage/2014/03/11/anything-you-can-do

### Optimism Bias

This bias leads you to believe that you are less likely to suffer from misfortune and more likely to attain success than your peers. In short, we are often more optimistic than realistic. [13]

Take marriage, for example. In the Western world, divorce rates are higher than 40 percent. Two out of five marriages end in divorce. But newlyweds estimate their own likelihood of divorce at zero.

Even divorce lawyers hugely underestimate their own likelihood of divorce. Although the sunniest optimists are just as likely to divorce as the next person, they are also more likely to re-marry.

This bias has brought many intelligent hedge fund managers unstuck when it comes to leveraging a portfolio. Not to mention DIY investors who leveraged-up during the bull market from 2002 to 2007.

If you take account of your natural tendency to think you are untouchable when it comes to investment failure then you're more likely to stick to fundamentals. And less likely to think you, or your tipster friend, are infallible.

### The Better than Average Affect

This bias suggests we consider that we are smarter and more capable than we really are. We are blinded by our own incompetence it seems.

This idea was put forward by Eilath Giladi and Yechiel Klar at Tel-Aviv University in the late 1990s. They found a person will tend to rank themselves above a group's average performance level. This explains why 90% of drivers think they're above average drivers.

If an individual is asked to assess their own skill at driving compared to the rest of the group, they are likely to rate themselves as an above-average driver.

Furthermore, the majority of the group is likely to rate themselves as above average. Research has found this effect in many different areas of human performance, including investment. The principals

13 https://www.youtube.com/watch?v=2MHIcabnjrA

## Why Smart People Do Dumb Things cont'd

of a fund from the 1990s called Long Term Capital Management come to mind.

It pays to focus on capital preservation before thinking about how much more money you're going to make in comparison to your peers.

As Warren Buffett likes to say when managing a portfolio, "rule no.1 is don't lose money, rule no.2 is don't forget rule no.1."

### Are We Doomed When it comes to Investing?

If you think an intruder is in your house at night and you need to do something based on intuition then good. Intuition is heuristic in nature and in most day-to-day situations heuristics serve us admirably.

And it's a great we can look at grey areas in everyday life and develop theories when information is missing. This type of thinking requires a heuristic approach.

But investing can sometimes be counter intuitive ("be greedy when others are fearful, and fearful when others are greedy," says Buffett) and biases and heuristics can be a thorn in your side when this counter-intuitive thinking is required.

Buying companies you understand goes some way to overcoming the knowledge gap, or grey area. Stick with your circle of competence and reduce your natural bias to make up stories about companies you know nothing about.

Doing so "narrows it down by 90%" said Buffett during his speech at the University of Florida.

Buying for the long-term also helps overcome things like the attention bias. If you believe a company can stand on its own two feet for the next 10 years then you're not going to give much weight to a company's recent third quarter earnings report, or be misled by some clever framing techniques.

Doing your research and ignoring the hype on Wall St helps alleviate the effects of the self-serving bias. If your investment turns bad after doing your own research then you're more likely to take responsibility for your investment choices. Plus, you'll stop taking every share tip flooding your inbox.

And start looking at your investments through the eyes of a business owner. This helps dismiss the short-term exuberance or excessive fear engulfing us each day in the financial media. This helps alleviate the attention bias.

Getting caught up in the media hype means we end up buying overpriced companies or selling great businesses when we should be doing the opposite.

### Strength in Humility

Perhaps the best lesson from value investing is remaining humble. This will ensure you don't fall into the trap of becoming overly optimistic about a company's future or your own personal wealth.

Stay humble and you can ride the down periods and buy good companies at a discount to their intrinsic value when share prices fall. Don't be the one selling when you get spooked by another financial commentator predicting the next market calamity. It might be the biggest mistake you make.