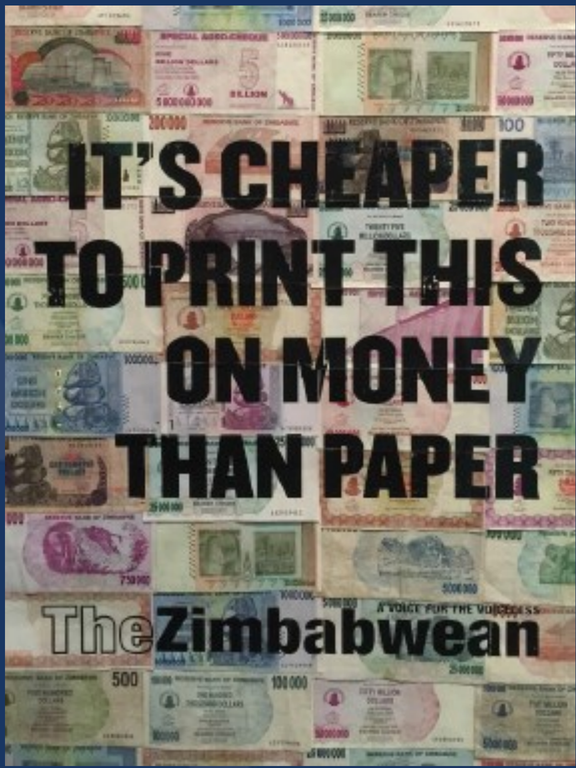
SENTINEL WEALTH



Investing Sanely in an Insane World

A summary of a presentation delivered by Justin Hooper

AUSTRALIA is the tenth richest country in the world, Zimbabwe is the second poorest.

Yet I think there are lessons we can learn from them.

For 50 years Australia has enjoyed unprecedented prosperity; for many Australians who look back over the last 20 or 30 years they would believe this is "normal". We have enjoyed peace, prosperity, less violence, more growth and greater wealth creation than at any other time in our history. Just the other day a colleague felt compassion for a beggar and bought him a coffee. As she bent down to hand it to him he said, "No thanks, already had one". It has been a golden period and let's hope it continues.

Yet we seem to be hearing many more opinions that things might change. Whilst opinions and predictions are nearly always wrong, that isn't really the point.

The point is that we want to be comfortable and enjoy our lives **no matter what happens**.

Australia is never going to be another Zimbabwe – that's one prediction I am very happy to make. But it's all relative. Money is such a vital part of our lives and money issues are the biggest cause of depression and divorce that we should always be planning for any eventuality.

Bearing that in mind – and starting from a position of gratitude for the life we have in Australia – here are five lessons I think the Zimbabwe experience can teach us.

Lesson One: Things can change!

It's hard to imagine Australia being any different to the way it is now. But that's because of the natural bias to recent experience we all have. Yet in 1980 the Zimbabwe dollar was worth US$1.41. What happened? Things changed.

Can things change here in Australia? Some astute commentators are concerned:

> "Australia is headed for an Economic Armageddon"
>
> Previously Economics and Policy Advisor to Senator Arthur Sinodinos

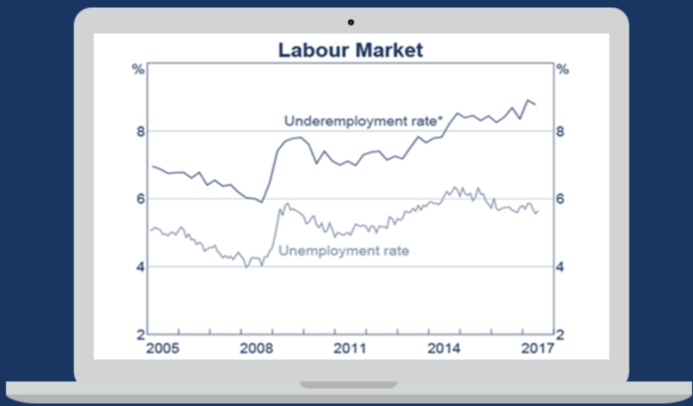
> "I do think people under-estimate that Australia may have gone a quarter of a century without a recession, but that's involved a lot of luck and a lot of China. Chances are our luck is turning."
>
> Chris Richardson – Deloitte Access Economics

> "Australian economy is vulnerable because there is a bubble in the housing market"
>
> David Murray

> "We think it highly likely that at some point the Australian property market will have some sort of setback, and that potentially along with it we will see significant distress in household finances and a significant jump in the credit costs of the banking system."
>
> Platinum Asset MGMT

These commentators are not prone to exaggeration. So what is causing them to have these opinions? Here is some of the evidence:

- The Australian consumer is coming under severe pressure.
- There has been a rise in Unemployment and Underemployment and the forecast is for this to continue. For example, the car industry shut down - including Ford last year and Holden and Toyota this year. This will affect another 40,000 people directly or in related industries.

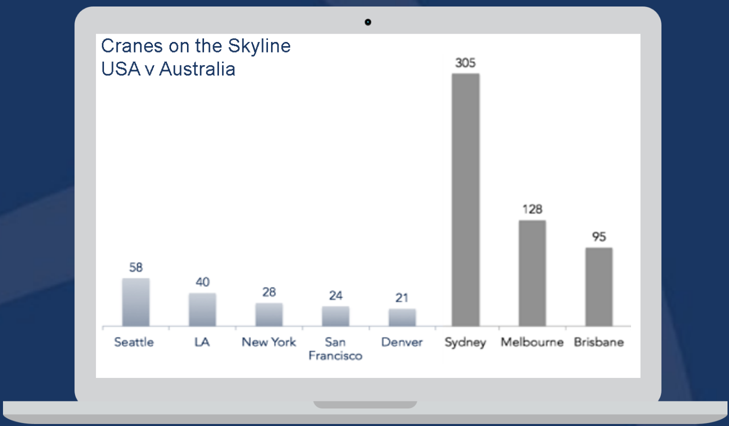


Personal debt has risen significantly and even though interest rates are at record low levels, over 820,000 households are under mortgage stress. The residential property market has gone through a significant growth phase over the last few years and a massive increase in apartment construction is still under way.

Personal Debt/Income

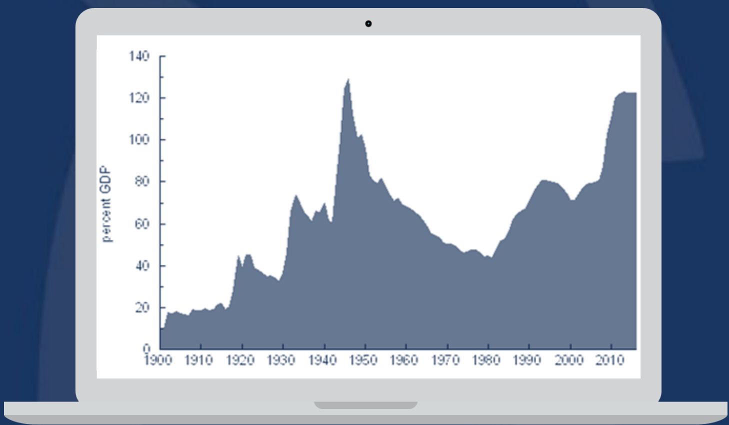
End of Construction Boom...

The residential property market has gone through a significant growth phase over the last few years and a massive increase in apartment construction is still under way. However, as can be seen from the chart showing the difference in cranes in Australia vs the USA, this construction boom is likely to come to an end and impact GDP.



USA

The US stock market is also at record levels with the key ratio of price/book at it's second highest level ever and federal debt to GDP at almost the same level as after WWII.



The Alternative View

Australia is in the fortunate position to have a number of industries that are likely to provide a buffer to any economic woes. First there are 100 million tourists worldwide each year and although Australia is regarded as a particularly favourable destination, we only have a 1% share of this market. Forecasts are that this industry will experience a 50% growth over the next ten years.

Second, commodity volumes will grow until well into the second half of the 2020s. We also have service exports, education and a resurgent agricultural sector to take up any eventual slack.

But of course, nobody knows what will happen. And that's why it's wise to **be prepared for anything**. There's a lot of value in just accepting that the future won't necessarily be the same as the past. That reminds me of an interview I saw on television with Sebastian Coe the famous middle distance athlete who was the Chair of the London Olympics Organising Committee. When asked if he was worried about anything, he said, "I'm not worried about anything we have thought of".

Lesson two: do something!

In September 2001, Morgan Stanley was the largest tenant at the World Trade Centre with 2700 employees working in the South Tower over 22 floors between the 43rd and 74th. One minute after the first plane hit the North Tower they started evacuating and when the second plane hit the South Tower 15 minutes later, the Morgan Stanley offices were largely empty. Despite an almost direct hit, they lost only seven people.

Of course they were lucky – the firms in the North Tower who received a direct hit had no chance - but it was Morgan Stanley's hard-nosed realism that allowed them to benefit from that luck. Soon after the 1993 attack, senior management realised that the building was susceptible to terrorism. So they implemented strict fire drills. In fact Rick Rescorla, a Briton and Vietnam veteran was head of security and he brought military discipline to the drills. Everyone was fully drilled on what to do in a catastrophe. Morgan Stanley also had not one, but three back up sites. To many on September 10th it seemed like an expensive extravagance, but by September 12th it looked like genius.

The fact is – when we confront all possible realities, we prepare ourselves to act in ways that allow us to endure and survive extraordinary hardship.

So why don't we prepare?

We had a fire drill in our building two weeks ago. It's twenty six levels but for some reason, the tenants on only four levels were affected. The announcement was made numerous times yet when it came to the crunch very few people participated and most who did were pretty disinterested. This shouldn't be surprising. In fact U.S. research shows that very few people are prepared for catastrophe. Only 1 in 10 have taken the appropriate steps to be prepared for something catastrophic.

There has been much research on why we don't prepare but let's just say it is totally normal.
The most common reasons are:

- We think it won't happen to us
- Past disasters are forgotten
- We underestimate the potential losses
- We think the government or someone else will look after us
- We believe it's too expensive in time or money for no guaranteed return

And in most cases the reality is that ***it is too much effort**, **it does require thinking and thinking is hard**, especially if others aren't doing it too.*

82 percent of Americans agreed that, "If someone could make it easy for me to be prepared, I'd do it".

So the majority of people are not going to prepare – the question is, are you in the majority?

Lesson three: Cash flow is like air

In his book "Wellness", Tom Rath explains that the perception of having enough cash flow in the future is more important than the cash flow itself. In other words, having ***a feeling of security** around cash flow is the most important ingredient of financial wellness. This is supported by Maslow's hierarchy of needs where the second level is 'security' and without it human beings are unable to think about relationships, self esteem and self-actualisation.*

At a practical level, being as confident as possible that under any circumstances there will be enough cash flow can only be achieved by evaluating all possible scenarios. During the very difficult times in Zimbabwe the people who had strong cash flow were actually better off than they were before the crisis – they were able to take advantage of the situation.

So you will have to build cash flow models. It's not difficult. Start with the worst case - what if inflation was 20%? What if asset prices fall by 50%.

Model crazy scenarios just for fun. It's a very powerful way to deal with any concerns and more importantly to **create a plan** and be ready for any opportunities. There's something very natural that happens when you think about worst case scenarios. We automatically start finding solutions and that's why any anxiety disappears.

We do this all the time for our clients. For example, some lawyers in some of the big firms have come to us and said that they "feel trapped". They earn good money but they say that having no other skills and big mortgages has effectively stripped them of options and they aren't enjoying life. Cash flow models will resolve that.

Another client came to us in the middle of divorce proceedings after a long marriage. They couldn't agree on the property settlement mainly because of the assumptions being made on a commercial property that the wife wanted to keep. The property was a major asset in the settlement so the assumed return had a big impact and they couldn't agree what return should be assumed. The impasse was eventually broken when I suggested that the husband (who wanted to assume a higher value of the property in the future) give his wife a put option based on his expected growth rate in years 5, 10 and 15. From the modeling we could calculate exactly what the property would be worth on his assumptions. He decided to pay out more on settlement rather than carry the risk.

Another client was very concerned about a possible economic Armageddon back in 2012. He said, "I've been doing some work with my spiritual colleagues and we are convinced that financial Armageddon is going to happen".

I said, "Well, let's model it. What are your specific assumptions?"

"Well", he said, "the markets will crash by 50% at least".

I said, "Ok, and then?"

"What do you mean?" he said.

"Well", I said, "what happens *after the fall?*"

We eventually finalised the assumptions and as we started creating the model, I said to him, "You know of course that you can make a lot of money if you are sure this will happen. We could create an investment strategy that would involve shorting the market, buying gold call options and bullion... and you'll make a fortune, providing it happens, If it doesn't you will lose money".

The point is that even in such a dire scenario, it's natural to start solving the issue even before it is fully mapped out.

(For more cases, please see our website).

Lesson four: own quality assets

About 4 years ago, I did an exercise on the return on equities in the riskiest countries I could think of. I came up with countries with a variety of risks – Columbia, Eqypt, Israel, Argentina, and a number of others and of course Zimbabwe. And that's where this idea began.

In Zimbabwe, even through the most adverse economic conditions, eventually property and shares retained their value and were able to produce income.

"Quality" assets in my view are assets that will produce income at a reasonable rate regardless of the economic circumstances. Since 1945, total dividends paid in the USA are up sixty-six fold with the average growth rates for one, three and five years being 5.8%, 19.8% and 33.9%, respectively. By investing in shares you not only get fairly stable cash flows, but you also get an income stream that tends to grow faster than the rate of inflation.

Dividends are also generally very stable. Over all one year periods since 1945 the worst drop in dividends was a -19% fall. Over three year periods the worst drop was -18%. And dividends have never fallen over a five year period in that time.

There's another lesson here – buy productive or 'risky' assets when everyone else has been hurt.

The same conclusion could be drawn from other very harsh times. When most people are becoming more conservative, do the opposite and buy productive assets as long as they are fairly priced.

After the Great Depression people were so anti shares that it even became legislated: No more than 35% in stocks for personal trusts! Pensions weren't allowed to have any!

S&P 500: Dividend Growth Rate By Decade

Decade	Total Growth	Annual Growth	Inflation Rate
1950s	60.5%	4.8%	2.0%
1960s	72.7%	5.6%	2.3%
1970s	78.8%	6.0%	7.1%
1980s	95.6%	6.9%	5.5%
1990s	49.1%	4.1%	3.0%
2000s	36.0%	3.1%	2.6%
2010s	93.6%	6.8%	1.7%

Source: Robert Shiller Data

Lesson five: Keep it centred

Whenever I get in a taxi and the driver is from Africa, I always ask them the same question. "Where will you retire?"

Many have lived in Australia for a number of years, but I have yet to find one (and there have been many) who said he would retire in Australia. They all want to go "back home".

When I was in Amsterdam two years ago, I asked one man from Ghana the same question and he gave me the same answer. When I asked him why he said, "old people are lonely in the west".

The final lesson is that **if you are clear about what's most important in your life, you will have far less stress around money**. Nobody said this better than Viktor Frankl the famous Jewish psychologist who survived the concentration camps. He said, "Those who have a 'why' to live, can bear with almost any 'how'." As he explained, DESPAIR is SUFFERING without MEANING. So that's how important it is. As the Buddhists say, No Joy without Suffering. There will always be suffering but if you know what meaning is to you, there will not be despair.

It's not easy under pressure though. Growing up in a capitalist world, it's natural to focus on the money especially under pressure. Although most people would say that they know money doesn't create happiness, most seem to behave as if it does. It is often very difficult to separate money from happiness.

The reality of this approach is that financial stress - or even a relatively small change - results in anxiety.

'Meaning' is simply being clear about our roles or purpose. 'Being a role model to my children' or ' being the best I can be' are two examples of what we call Deep Motivators. Understanding our meaning and purpose can give us a very clear guide in times of financial stress.

There is no doubt that Australia has enjoyed a golden period and it is possible that external factors may change and the environment may be more difficult. But by applying these Five Lessons from Zimbabwe, the future is assured no matter what happens.

ABOUT SENTINELWEALTH

SentinelWealth has taken a leadership role among financial services practices in terms of reducing conflict – by having its own license, not accepting commissions or buyer of last resort opportunities, not accepting subsidies and returning all gifts.
Adviser remuneration is derived from salaries and bonuses, with almost all dependent on client retention.
For details, please ask your SentinelWealth adviser.

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