Common sense yields rich returns

By **Stirling Larkin**

MANY people ask why Australian ultra-high net worth investors typically invest more of their wealth in foreign markets compared to others.

The answer may be found in a small Dutch town called Drachten, where a road death happened on average every three years. In 1999, the local municipality decided to remove all traffic lights and signs, hoping people would pay more attention to the road and not fixate on rules and regulations. Since then there has not been a single road death.

This suggests that allowing more room for common sense yields better results. It may also illustrate the perils of too many rules and not enough ingenuity.

Even in light of the recent wave of long overdue reforms, Australia is still the OECD's most over-regulated, red-taped, bureaucratic economy. Bureaucracy of this scale has not only stifled productivity growth — arguably the most important engine of genuine economic growth — but has also subdued common sense.

UHNW investors — unlike many other investment communities in Australia that are prescriptively mandated to invest heavily domestically — have often chosen to seek opportunities abroad where, they believe, rules, ingenuity and opportunities are better matched.

They believe that until Australia is clear about what are the best goods and services it should produce and which trading clients and markets have longevity, the better opportunities are often found abroad. As mentioned in last week's column, this community has recently sought opportunities in North American equity markets, Chinese corporate credit spreads and regional currency pair trades (we'll discuss the yen and Abenomics in columns to come), to name but a few.

The Robert Ringer makeable deal theory posits that it is far more efficient to work hard on finding a few makeable deals than to work hard on an endless number of unmakeable deals which have little possibility of closing or yielding an attractive return. This theory is deeply grounded in common sense. An intelligent person can find any number of unmakeable deals but only those who enjoy good judgment have the common sense to pursue and acquire makeable deals.

Australia has many potential makeable deals but has done a miserable job of connecting resources, ingenuity and capital. It could well be argued that all we need to do is value the importance of rediscovering common sense.

Last year's Nobel economic sciences laureate Robert Shiller says "we seem to be at the mercy of our narratives", and this aptly reflects Australia's position. Our groupthink surrounding the plight of China and our belief that it has an obligation to purchase our iron ore is irrational and lacks all sense, let alone common sense.

Even though we are explicitly told demand for iron ore is waning and our mining capital expenditure is rapidly diminishing, too many Australians remain over-allocated in mining shares and commodity exposures.

We get angry at an economy that has more than a billion people because its headline growth marginally slows, even though it is still four times as high as ours, and because it no longer seems to want to buy as much of a product it no longer requires — at least not in the same quantities as before.

Australian UHNW investors see the lack of common sense in this thinking and have moved on, while many others remained fixated on an old story. These UHNW investors are out there scouting for the makeable deals of 2014, not the redundant and unmakeable ones of 2010.

What’s more concerning is that many still fail to understand the China story, and China’s and Australia’s roles in the triumph of globalisation.

The concept of globalisation is not a new one, although the stars finally aligned for this paradigm only when Ronald Reagan and Margaret Thatcher led the world aggressively down a new path of economic liberalisation, market reforms and genuine reductions in tariffs, oversight and bureaucratic overreach during the 1980s.

Aligned with this renaissance in economic remodelling was an unprecedented push for economic globalisation, especially between the then developing and developed worlds. Whether it was in Latin America, Asia or eastern Europe, the developing nations were strongly sold on the idea of participating in globalisation.

In essence, the pitch was that as they became the developed world’s outsourced manufacturing hubs (as the “invisible hand” deemed them better suited at that point to manufacture due to their then cheaper labour costs), they would export these manufactures back to the developed world.

By doing so, they would slowly but incrementally become richer, and in due course they would become affluent and evolve into a consumer-led economy just like the developed nations.

Countries such as China that, coincidentally at that same time, were looking for a new market-led model, tacitly accepted this accord and championed it with zeal.

Jumping forward 30 years to present-day China, this economy has reached that mature stage of the globalisation paradigm and is ready to progress to the next level of becoming a consumer-driven economy itself. The Chinese kept to their end of the bargain (from 30 years ago) and now understandably want what they were promised: a developed, prosperous consumer economy.

So as investors, when we see Chinese export numbers normalising or even declining, we should not see an economy in decline but more an economy progressing and evolving exactly as scripted a generation ago. As investors, especially here in Australia, we need to change our thinking with the times. No longer should we think of China as solely an exporter but also now more and more as a consumer economy ready to import all the developed goods and services an advanced economy such as Australia could offer.

There are now more than 1.5 billion of our northern neighbours who want all the consumer staples we have been enjoying.

This new reality bodes well for Australian businesses and investment communities.

It is time to take heed of the pioneering efforts of many UHNW investors and to take action on engaging China beyond selling it our resources, wines and ugg boots. Rediscovering the importance of common sense is an intelligent start.

Stirling Larkin is chief investment officer of Australian Standfirst (www.australianstandfirst.com)