The Australian Finance Podcast Episode Transcript

Episode: The case for defensive assets: cash, bonds & gold
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Speakers: Kate Campbell,Owen Rask $ Chrick Brycki
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Episode transcript:

Owen:
Kate, welcome to this episode of the Australian Finance Podcast.

Kate:
It is good to be back, Owen.

Owen:
It is indeed. Today, we're talking about the one half of the portfolio, which is often neglected on our show and it shouldn't have taken this long for us to get an expert on to talk about this side of the portfolio, which is so essential to long term wealth creation. Do you invest in bonds?

Kate:
I do. Through ETFs and in my super fund.

Owen:
Okay. And how about gold?

Kate:
Possibly in my super fund, but not directly through ETFs, though I do have some gold jewellery.

Owen:
Okay, cool. Well, today we're going to be talking about some of these asset classes and we're joined by Chris Brycki, founder of Stockspot. How you doing, mate?

Chris:
Very well. Thanks for having me on guys.

Owen:
Yeah. We actually had a video of yours shared in our Facebook Community before Christmas and everyone was talking about it and saying how good it was. So we thought, well, why not get you on the show to take us through it and talk a bit more about these defensive asset classes, obviously as the founder of Stockspot, I'm going to say, I don't know if it is the right characterization, but the way I think about what you guys do is, that what we were talking about is Robovise, but it's actually structured portfolios, it's to help people get started and stay invested throughout different market environments for the long term. Have I got that correct?

Chris:
Yeah, it's a pretty good characterization. We just try and simplify the process for people that don't want to be actively managing their portfolio. There's plenty of people out there that want to take it... A lot of involvement in the process. There's also people that just want to make sure their money's invested sensibly and they don't have to pay attention. So that's really the group that we see using Stockspot, then they don't have to worry about picking the right assets, the right ETFs, rebalancing, managing tax and all these sorts of things and hopefully they can get a great return over the long run. I personally believe doing it this way can give them a better return than most of the professionals out there and I think that's really the secret source of automated investing.

Kate:
It's interesting. We actually, Owen and I did a episode about the pros and cons of robo-investing last year, which sparked a lot of discussion because a lot of people hadn't considered particular elements and so that's... I'll include that in the show notes, if people want to learn a bit more about robo-investing, but today we're really wanting to talk about defensive asset classes. That's a part of your portfolio, you might not have looked at too much, even high growth super funds usually have some allocation to defensive asset classes. So Chris, to start us off before we get in too much to the weeds, are you able to outline some of the main types of defensive asset investments that people should know about?

Chris:
Sure. I think it's pretty important for people to, first of all, work out what a defensive asset is and I think definitions definitely vary in the industry quite widely. In my mind, and we put in sort of submissions to various government and other processes around this because there's a lot of debate in the super industry, but I agree with ASICs' definition of a defensive asset. So if you

look on the ASICs' Moneysmart website or on ASICs' website, they say a defensive asset is cash or government bonds and actually, I think that's pretty close to the truth.

Chris:
Cash is defensive because when the market falls, it holds its value and then bonds generally do one better and actually rise in a falling market. That's what makes these assets defensive. Gold, I put in the same bucket as cash, gold is the ultimate sort of original form of cash.

Chris:
I think these days, there's a lot of other assets that some people consider as defensive, often they're assets that have a high income stream and low growth. So it might be hybrids, emerging markets, debt, other yield type assets. In my mind then, they're not really defensive assets, although they may not give a as higher capital growth as shares or typical growth investments.

Chris:
The reason in my mind, why they're not defensive assets is that when markets fall and particularly during very bad market episodes, like we saw in March, 2020 or in the financial crisis, these high yield type assets, very much move in the same direction as shares, they don't provide any level of protection or very little levels of protection. So while they may not have a high correlation or they may not move in the same direction as shares when markets are doing well, they do move in the same directions when markets are performing poorly and that's exactly when you need defensive assets in your portfolio and so in my mind, these aren't defensive assets, and I think there is a lot of confusion out there because people wrongly think something with a high yield that doesn't have a lot of growth is defensive.

Owen:
I think that's a good point because we kind of think of it like, if it looks like a duck and it quacks like a duck, then it is a defensive asset, but sometimes it's not, right. Sometimes even though the returns might be low, it doesn't necessarily mean it's a safe investment and so that's a really good point you draw there, mate.

Owen:
I guess the number one thing on the minds of a lot of our listeners and our investors that follow us is that sometimes they think, "Well, because I'm young, I'm going to invest for the next 60 years. I'm a high growth investor." All these things. They think, "Oh well, I don't need to really worry about the portfolio construction. I don't really need to worry about defensive assets." Even Warren Buffett, often says that even though he's a big fan of index funds, and he said that quite a few times, he has said for himself that he would be a 100% invested in shares if he could. What do you say to younger people that in particular... Or people that think that they're high growth investors, should they have defensive assets in their portfolio?

Chris:
That's a good point and I think it's a question we often get from our younger clients as well is, "Why can't I just be entirely in growth assets?" Certainly over a hundred years, growth assets

have done better than defensive assets. So naturally, anyone that wants to maximise their returns will want more of that in their portfolio rather than the thing that hasn't done well.

Chris:
Going back to your point about Buffett, although he sort of may think that equities is great and certainly in his Berkshire Hathaway portfolio, it's an equity, his portfolio. I think he's also said of his estate that he put 90% in an S&P 500 Index Fund and 10% in a Bond Index Fund, Government Bond Index Fund. That estate of his basically has a indefinite timeline, it's a perpetual sort of investment, which I think is probably the right sort of thinking if you had an unlimited time horizon, probably a 90, 10 sort of split between growth and defensive assets makes sense.

Chris:
But then it goes to why would you have any defensive assets if your timeframe is a hundred years or most listeners is probably less than that, it might be 10, 20, 30, 50 years. There's really three reasons that I think the defensive assets still have a place in a portfolio.

Chris:
First, although you might have an intention of investing for a certain amount of time, people's circumstances do change. We saw this in March, 2020 when markets collapse. There was a global pandemic. People lost their jobs, people had the opportunity to release their super early. Without any defensive assets in your portfolio, you're basically forced to sell growth assets at very distressed values in a scenario where you need money unexpectedly and whether it's with your discretionary savings or super or any other sort of long term investment, although it's unlikely to happen, it does happen and March, 2020 was a perfect example. Those with defensive assets were in a better position because they could be selling more of the defensive assets than the growth assets when they needed that capital, so that would be one.

Chris:
Two, I think, just from a psychological perspective and we see it with our clients, absolutely these defensive assets just keep you confidently invested when markets are volatile. As much as I think when clients of ours say when they sign up, that they are very comfortable with risk, what we notice is particularly with people that don't have generations or decades worth of experience is that the first one or two market corrections that they have to weather, it's pretty nerve-racking experience.

Chris:
I see it at the moment, our market's only down 5% or so, or five or 7% from its highs. The U.S. market's down 12%. There's a lot of nervous people out there at the moment. What I think keeps a lot of those people more confident and particularly on our clients, is that there are assets in their portfolio that have risen over that time period. Gold at the moment's up 7% in 2022, whereas these other asset classes are down. And so it provides a level of cushioning people's portfolios, it means they're not suffering from the full losses of the market. I don't think...

It's not as obvious now, it was really obvious in March, 2020 when share markets had fallen something like 35 or 38% from their highs.

Chris:
If you were entirely in shares, that was a pretty heart-wrenching experience and a lot of people that were in risky shares were down 50%+ simply by having some defensive assets in your portfolio, you could really curtail those losses. So as an example, our most risky portfolio fell by about 50% of the markets' falls and a more conservative portfolio might only fall by 20% of the market falls.

Chris:
Now, it's easy to sort of think that when the market's down 50%, you'll be fine, but it's difficult. It's really hard to have that conversation with your partner. It's hard to think about it yourself. It's difficult for people to do and I think defensive assets provide that sort of ballast in your portfolio to keep you invested.

Chris:
Then the last reason I'd say is that even though over very, very long periods of time, like a hundred years defensive assets, like bonds and cash have done worse, it's not always the case over shorter timeframes, and I'm not talking a one year timeframe. Over 20 years in Japan, for instance, Government Bonds did much better than shares. And so there are certainly periods in history, quite long periods in history where defensive assets can actually do better and be a stabiliser in your portfolio. So unless your timeframe is a hundred years, it's certainly possible that over your investment time horizon of five, 10, 15 years. Something like gold or Government Bonds might do better than shares. I think a lot of people aren't aware of that, they think that as long as you're investing for at least 12 months or two years, shares will definitely do better, it's simply not the case.

Kate:
I think that's really interesting because we often set out to be long term investors, but so many things just pop up in life. You might have to care for someone even in March, 2020, that market fall was also accompanied by a lot of redundancies and job loss. So these things often go hand in hand. It's not like you've got everything else going for you, plus there's a market crash at the same time, often multiple events are happening at the same time, and I guess just from personal experience, when I... In March, 2020, I did have an ETF portfolio with defensive assets and a high growth super fund, but that did have some exposure to defensive assets, but then I also had a shares only portfolio and it did smooth out the ride a lot more having defensive asset classes. It wasn't as dramatic of a swing and I think just psychologically, it does help not seeing your super fund go down 50% because looking at the share portfolio, it was a lot more dramatic, that fall in March, 2020.

Owen:
And I think Kate there, your point is around the diversification. I think the line is that you can't... If you're well diversified, you won't do... Your portfolio won't do better than your best investment

and it won't do as bad as your worst investment, it'll be somewhere in between that. And so we're talking about spreading the risk here, over investment classes.

Owen:
Chris, one of the questions we get asked a lot when we start talking defensive assets is, everyone's like, "Okay, I've got... I know bonds and gold, defensive, sure. But how much should I have? Is there any rule of thumb or the... How do you go about thinking about that for each individual investor?

Chris:
That's really a question for... That is driven by a few main factors, I'd say Owen. So first of all, your investment time horizon, so we've already sort of talked about that. The longer you are planning to invest, even though we know that it doesn't always end up that way, the more capacity you have to have more growth assets in your portfolio, it's as simple as that. Our advice to clients is if you're planning to invest, let's say for six months or a year, there's really no place for growth investments in your portfolio because your chance of making a positive return over that time period is barely over 50, 50. It might be 60, 40. So it's no better really than flipping a coin and in my mind that's speculation, it's not investing.

Chris:
So the way we think about it from a timeframe perspective is, what is the asset allocation that's based on some level of assumptions is going to give you a very high probability of a positive return over that period and that really drives what percentage should be in those different asset classes.

Chris:
Then there's obviously the overlay of, "Oh, what's your risk capacity?" Because in addition to knowing what should be in there theoretically, you want to be confident that in a draw down scenario, you'll still stay invested to be able to enjoy the positive returns after that time horizon, and that's a conversation I see our client care team have with our clients whenever markets fall.

Chris:
Clients sometimes get nervous and say, "Look, my markets... sit down. I've lost two or 3%, let's say in the last six months and we always bring it back to what's your time horizon and they will say, "Look, I'm investing for seven years to buy a house or I'm investing for 20 years for my super, so we iterate that based on that time horizon, your strategy is correct, and no one can accurately and consistently pick when markets are going to be going down 2% or up 3%, that's just kind of the noise around the long term trend and no one can pick the noise and so you might as well just focus on the long term trend and make sure you've got the right mix for your time horizon.

Chris:
So time horizon and risk capacity are really the two that are most important. And then rule of thumb, I would say is, if you've got any infinite time horizon like Warren Buffett does for his

estate, I think his estimate of 90, 10 makes a lot of sense. For anything less than that and most peoples' are a lot less than that.

Chris:
I actually think people don't have enough defensive assets generally in their portfolios. Super funds are a little bit of an anomaly because the time horizon for someone in their 20s or 30s is quite long, it might be 40 years or so, but a lot of people investing their discretionary savings for some sort of coal, saving up for a wedding or a holiday or just saving up to buy a house one day, your time horizon might be five years or seven years or so, and for that sort of time horizon, for our clients, at least, we recommend at least a 20% allocation to defensive assets and our view is, it doesn't really harm your returns too much, but it adds a huge improvement in the quality of your returns and by quality of returns, I mean, how much downside you have to experience.

Kate:
And I guess on the topic of downside, it's probably important to differentiate bonds and hybrids and gold are not the same as cash in the bank account and there is risks involved as well. I saw a product recently that was pretty much advertising bonds as a savings account and I thought that was probably quite misleading because people might put their money in there thinking that it was capital guaranteed and it's not. Do you sort of have it... Do you get questions from clients often about whether they should put their short term savings in bonds?

Chris:
Yeah, it's a great point. And I agree with you. Certainly bonds isn't a short term saving instrument either. So I wouldn't recommend if someone has a one year time horizon to put it in bonds rather than cash. I think people do make that mistake as well as their... People are desperate in this day and age to earn a better return than what they get in the bank. You can get your, whatever it is now, 0.1% in the bank, you might get lucky in a high interest account, getting a little bit more than that. You can get a term deposit, maybe get a little bit more than that, but above that, you're always taking kind of risk. It's just the way things work. There's no such thing as a free ride or free lunch.

Chris:
And if anyone's promising you a higher return than a term deposit in a Commonwealth Bank account, then you are taking risk and that risk could be through different sort of factors. It could be counterparty risk, you could be lending your money to a less safe bank. You could be investing it in some sort of security that varies in value, like you say, a bond. It's something I think people always need reminding and I see sort of the same advertisements as you are. I got very scared a few years ago when there was a lot of advertisements out there for some other businesses that have since gone defunct, advertising sort of stable savings-like returns. I think nothing should be able to advertise itself like savings-like unless it's a bank account. Otherwise it's a risky investment.

Chris:

So bonds aren't a savings tool, but what they do provide is, generally through the cycle, a level of stability in a portfolio. Now what's interesting is at the moment, we're not really seeing that counterbalance happening as well as it has in the past, with interest rates basically at zero in most of the developed world. There's little capacity to further reduce interest rates to basically get absorb economic shocks.

Chris:
Also the the emergence of inflation as a risk has actually meant that bonds have actually performed quite poorly as well over the last few months. So since the start of the year where share markets around the world have fallen, in previous crises, you generally see bonds rise in value, but because a large part of this current concern is around inflation, bonds have fallen as well.

Chris:
So I think it's another important point is, that different defensive assets basically defend you against different scenarios. So government bonds perform really well in a period of low or poor growth as well as low inflation. We saw that for a lot of the early 2000s or mid 2010s, but in a period of low growth and high inflation, bonds aren't likely to provide that level of protection and that's where assets like gold historically have done a lot better. The point, I guess I'm making is that not all defensive assets protect against all different scenarios and if you pick a defensive asset that doesn't protect against the current scenario, it may not be as defensive as you expect.

Owen:
Chris, that one which you bring out, which is gold, is quite controversial amongst a lot of investors. Some investors say, "It's great. Historically, has performed really well." Others say, "You're probably just better off having bonds or some other type of instrument in there or cash." But you made a good point there about the certain environments. We spoke to Kanish Chugh of ETF Securities not long ago about the gold ETF as well. So what would be your, I guess pitch for people to have gold in their portfolio and I guess an extension of that is, maybe if you could just take Kate and I, as an example, I'm around 30, Kat's a bit younger, how much gold should we have in a portfolio, ideally?

Chris:
Well, yeah. First of all, on your personal circumstances, I'm not [crosstalk 00:20:28] and I'm sure you've got that [inaudible 00:20:30]-

Kate:
No, no personal advice here.

Owen:
We're just a hypothetical example.

Chris:

... Hypothetically, to give you an example, in our client portfolios, we recommend around 15% and like you've mentioned, for some asset allocators out there or some investors that might seem controversial because gold definitely is something that tends to create a bit of a dichotomy of views out there. I think at the moment, it's quite obvious why gold is a valuable defensive asset, is that we've seen a long period where bonds and shares have moved nicely in opposite directions, and in the last few crises, whether it was the financial crisis or the COVID market crisis, bonds actually insulated portfolios quite well, but now central banks around the world have printed a tonne of money. Interest rates are sitting at zero. There's very little leeway left for them to continue to push rates lower and pushing rates lower is the mechanism that helps to drive bond values up.

Chris:
We're in also a world where real interest rates after a fuckin' inflation's accounted for, a very negative in most developed markets, which isn't a good world for bonds. So my pitch for you guys, why I think gold is something you should have in your portfolio is that, one, it's a great diversifier, it has, of all assets, particularly in very negative market scenarios, it has a very low correlation or negative correlation with a lot of the growth assets you probably have in your portfolios.

Chris:
It's definitely more evident during what's known as left tail market events, so big unexpected events that lead to big market crashes. In those events, often assets like, even bonds and certainly hybrids and other high yield investments aren't going to perform very well, so they're not going to provide much protection.

Chris:
Two, is as an insurance policy. Most of your assets are going to be domicile probably in Aussie dollars or I'm sure you've got some other global ETFs and investments as well, but something that is always a risk when you've got assets domiciled in a currency is currency devaluation, and it happens when whatever currency your assets are domiciled in lose their purchasing power over time because of government or monetary policy. Gold historically, is a good way of preserving the real value of your wealth over time.

Chris:
Then third, and this is the one that's probably most obvious is at the moment is, gold has shown to be a very good geopolitical, safe haven. So during times of political uncertainty, gold doesn't have a yield. It's not going to give you a dividend or some sort of return, but it's likely to give you a good capital return during those sorts of periods. And there are periods in time, I sort of would go back to you mid 1970s to early 1980s, as an example of periods in time where gold does very, very well. It returned thousands of percent over that period in time while bonds and shares both did poorly, and I'm not saying that's definitely going to happen in the future but-

Owen:
For sure.

Chris:
... I think anyone investing should be humble enough to recognise that there are all sorts of different scenarios out there that can happen and you want to be comfortable that your portfolio can withstand those different scenarios. Gold in my mind is an insurance policy. It's ensuring against all those scenario, you've got your fingers crossed hoping they don't happen and maybe you're even predicting they won't happen, but just accepting that it's a possibility is the reason why gold is something that you should have in there.

Kate:
And you mentioned gold allocation around 15%. Is that in your high growth portfolio?

Chris:
High growth portfolio as well. So yeah, our allocation is consistent across the different asset classes. And actually the modelling we use suggests that it could even be higher than that. Gold provides such a good improvement in the quality of returns in a portfolio that I think it's easily justifiable. To me, it's actually good to see that very few asset allocators have actually made this decision because something that always worries me in markets is when everyone's done the same thing, that always makes me think, "Shit, maybe I've got it wrong. Maybe everyone already thinks this." But in the world, there's hundreds of trillions of dollars in basically government debt and only about, I think it's eight or 10 trillion dollars in gold, so gold relative to everything else out there is still quite small.

Chris:
Most asset allocators and investors don't have much of an allocation. Kate, you mentioned your super fund. There are some super funds in Australia that have a very tiny allocation to gold, but generally it's one or 2%. I could certainly see a world over a period of time and I'm not sure when it will happen, but where asset allocators are basically forced to increase that allocation, and it wouldn't surprise me if that followed a period of inflation where bonds didn't provide the returns or the protection that people expected.

Owen:
That's really interesting.

Kate:
Given it used to be a lot more difficult, well pre ETFs and everything to add things like bonds and gold to your portfolio. If people want to do allocation to these defensive asset classes in their portfolio, whether that's ETFs or just direct investing, how do they do that?

Chris:
Well, there's lots of different options. So one is, take buying lots more necklaces. You can go to the jewellery store and continue to ramp up for your supplies.

Kate:

Yeah. It's got to have a good [crosstalk 00:26:14].

Chris:
Not sure how that one would suit the family budget, but you can buy a physical gold, and I think in some countries like India and China, it's quite popular to buy gold through jewellery, less popular in Australia. You can also buy it through coins and there's a few coin stores. There's one across from the road from us in Sydney, that sells beautiful coins from the Mint or from other Mints around the world. That's not a bad way, in small quantities and there's actually... You don't have to pay GST for instance, if you buy gold in that format.

Chris:
The problem with buying physical is obviously storage and safety, unless you're really confident that you've got a safe place to keep this stuff, there's always a risk that it disappears, gets stolen, you lose it and that's why buying something through stock exchange it seems these days to be more popular and it's a safe way to do it.

Chris:
So then you've got a decision, should I buy gold mining companies and I know you mentioned Buffett before, it's something I know Buffett did a couple of years ago, he made his first investment into a gold mining company. He liked that because it's a company that generates cash flows, he could measure the dividends. He could actually kind of feel comfortable that there was a business that was valuable.

Chris:
One of the challenges with miners is that miners are exposed to a lot of other factors other than the price, margins, hedging, their own costs. There's all sorts of things that are out of your control that actually may lead to a particular miner performing quite differently to the underlying metal, generally over the long run, the miners will do better than gold in theory, if they're running their business as well and they're managing things well, but it's actually not what we've seen over the last 10 years. The miners have drastically underperformed, the physical, which is not the reason why I think physical is more valuable, certainly from a portfolio diversification perspective is why we prefer just buying physical gold in an ETF format.

Chris:
So the benefits of that structure is, although you don't physically take possession of the gold, the gold is there, it's sitting in a vault, in the example of the one that we use, the ETF securities, gold ETF, G-O-L-D, it sits in a vault in London and so it's physically backed. You don't have counterparty risk with a bank where they might default, or they might not pay out, but it's stored in a efficient way and you are very closely getting a return that reflects the change in gold price over time.

Chris:
So there's all different options. I think the purest option, if you're wanting a defensive asset is gold physical through an ETF. Gold miners, I think in some worlds acts more like a growth asset.

Over the last 10 years, it definitely hasn't been a defensive asset, but there will be probably a time in the cycle where gold shares do very well as well, because they'll benefit from... Over the last 10 years, a lot of restructuring of their businesses and rationalising costs, as well as benefiting at some point from a rising price.

Kate:
Absolutely. Now, Chris, if someone ask you in the elevator, if your are 60 second pitch on defensive assets, just to summarise everything we've covered today-

Owen:
If you can.

Kate:
... This has been a lot, what would it be?

Chris:
I'd go back to one of my favourite quotes from the behavioural psychologist, Daniel Kahneman who said, "What you see, is all there is." And I think with investors, there's a temptation to think they know everything and that they can predict the future and they have all the information that everyone else has. Something I've learned investing is that really what you know is a drop in the ocean compared to all the information out there that's leading prices to go up and down. So even if your thesis is absolutely right on a stock that you love, or a sector that you like, you could get your timing wrong, or it could already be at the top of everyone else's love list. And sadly, there are so many examples of shares or sectors that fall a long way.

Chris:
So even over of last year, all these meme stocks and a lot of these work from home stocks and cryptocurrencies, they've all fallen 80 or so percent from their highs. So defensive assets are a great way of investing in a humble way. Investing in a way that you're basically admitting, "Look, I don't know what the future's going to hold precisely. I think I'll be right, but if I'm not, at least I'm going to survive." And so I think that's why defensive assets is so appealing to me because I think it pays over the long run to be humble with your investing and defensive assets are a great way of being that.

Owen:
That's a wonderful summary, mate. I like the Kahneman quote as well. Fantastic. So, Chris, I know our listeners can get in contact with you and the team by the Stockspot website. They can see the portfolios there, the different strategies on offer. Is that the best place for them to go?

Chris:
Yeah, sure. You mentioned our YouTube's doing some short videos as well-

Owen:
Yes. You are.

Chris:
... Interested in different investing topics that's also a place where you can go to, to see some different views, but otherwise the Stockspot website is probably the right spot.

Owen:
Cool. And we'll include links in the show notes. So they'll have all that there handy. Kate, this is a bit of fun talking defensive assets. Chris actually made it lively and used some really good examples. So mate, thanks for taking the time to join us today. We really appreciate it.

Chris:
Yeah. My pleasure. Hopefully the listeners won't need to rely on these defensive assets over and well, but we'll see how it goes.

Owen:
Yeah. Wonderful. And Kate, as always, thanks for joining me.

Kate:
Thanks for listening.