Future Focussed

Why Australian investors need to switch to a "Future Focussed Portfolio"

Capitalising on global disruption. A five part series, by Holon

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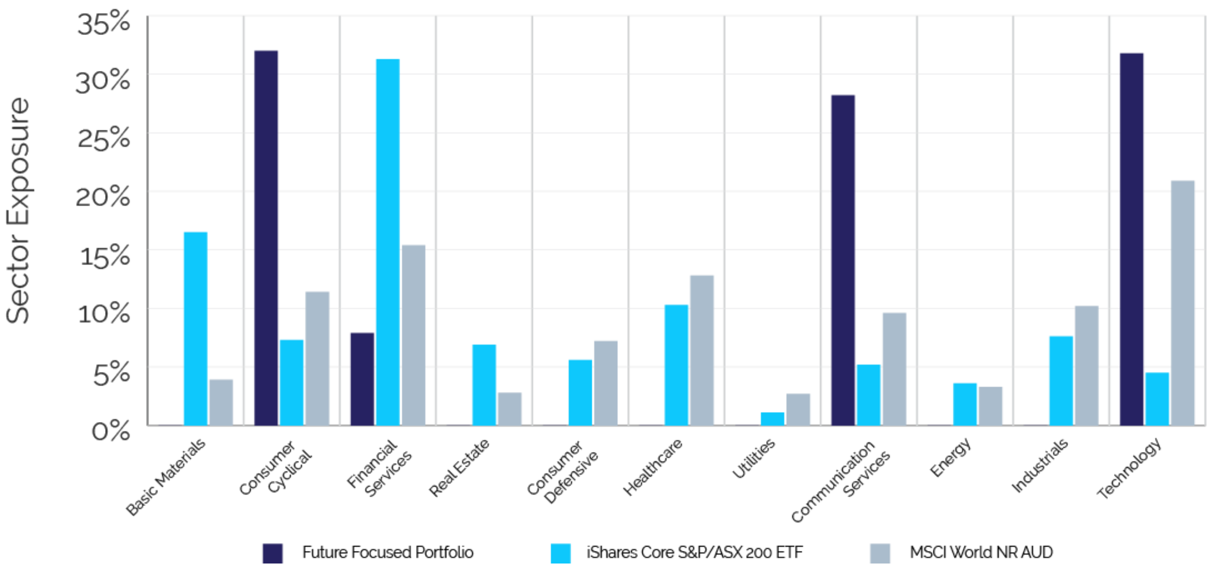
Why Australian investors need to switch to a "Future Focused Portfolio"

The Australian sharemarket represents just 3% of global market capitalization, yet many Australian investors have a domestic market bias in their portfolios. This misses 97% of global opportunities and creates a bias that is a serious potential growth impediment for both Australian index and active investors.

Australian investors have overweight positions in resources and local financial services and are underweight in innovation and technology enabled businesses. As shown in the Sector Exposure graph below, the IShares Core S&P ASX 200 ETF (which is a proxy for the Australian market) has large weightings to the basic materials and financial services sectors. A traditional diversification strategy to include exposure to a broad-based global index, such as the MSCI World, doesn't solve for the underweight exposure to innovation and technology enabled businesses. An allocation to a future focused portfolio is required to appropriately reweight the typical Australian investor's portfolio.

Portfolio Sector exposure



The future-focused portfolio should have exposure to:

- **The Mega Caps, the largest companies in the world with billions of customers, entrenched network effects, incredible balance sheets and the world's best talent;**

- **Companies that have the ability to grow exponentially through the application of technology; and**
- **Web 3.0, leveraging the latest Web 3.0 technology to disrupt and challenge existing business models including the Mega Caps (Web 2.0 companies) of today.**

Local and linear to global and exponential

The world is now divided into two types of businesses: 'old world' and 'new world'. Last century's old-world organisations needed to be big to be global, with large teams of people in international office networks. They took years in waterfall style, steady and sequential development to bring products to market.

The local and linear old-world businesses, that often form the bulk of many Australians' investment portfolios, face serious disruption if they are incapable or unwilling to transform. Kodak is an infamous example. Kodak invented the digital camera, but the leadership team did not have the risk appetite to take the digital camera to market and disrupt their existing, profitable product lines. The rest, as they say, is history.

Australia's local banks are particularly ripe for this disruption. They were designed last century with bricks and mortar presence and are now crippled by ever increasing risk and compliance overheads. The banks tell us they are modern, but other than online banking, what product or service innovation has any incumbent bank delivered this century?

By contrast, with the power of computing, the cloud and mobile technology, 'new world' businesses can expand at near zero marginal cost, virtually overnight, and capture a global market.

> ***"Instead of thousands of employees and large physical plants, modern start-ups are small organizations focused on information technologies. They dematerialize what was once physical and create new products and revenue streams in months, sometimes weeks. It no longer takes a huge corporation to have a huge impact."***
>
> **- Peter Diamandis, futurist and founder of Singularity University.**

COVID has accelerated the transformation to new world businesses, which are digitally enabled and global. They are the 'global and exponential' platforms we live and work on today (e.g. Zoom, Amazon, Netflix) that continue to deliver huge profits and returns.

Australian investors need to significantly ramp up their exposure to 'new world' companies to broaden their opportunity set, ensure participation in new "game-changing" economic propositions and lift potential returns.

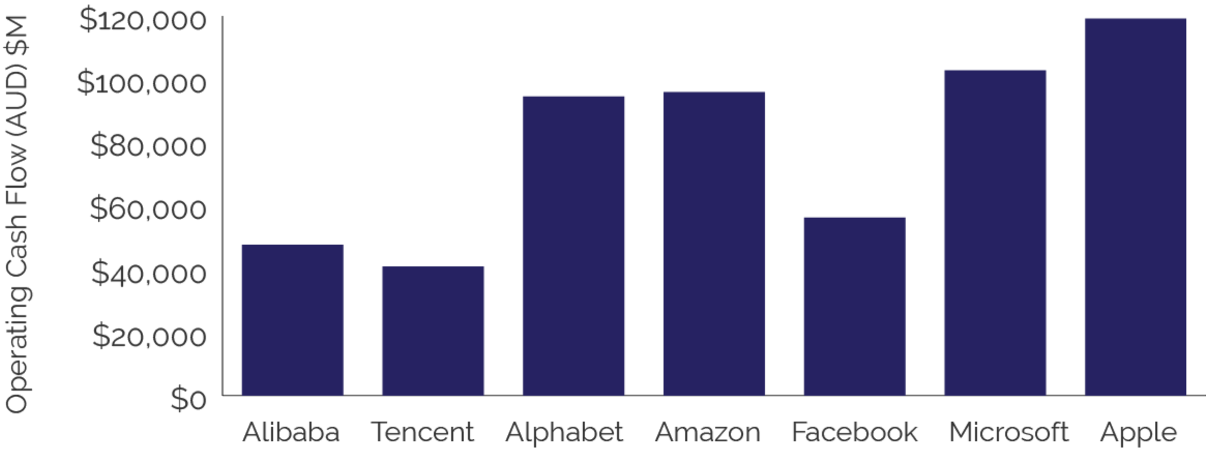
The future focused portfolio solves this underweight with three key building blocks:

1. **The Mega Caps – the infrastructure of the digital world**

The future focused portfolio must have a core exposure to the infrastructure providers of the digital world. These are the companies that enable the development of e-commerce, and distribution of digital entertainment and gaming, the infrastructure on which much of our digital lives are based. These massive companies such as Amazon, Tencent, Alibaba, Alphabet, Facebook, Microsoft and Apple are dubbed 'Mega Caps' and technologists refer to these companies and their networked platforms as Web 2.0 based entities.

Many investors believe technology enabled businesses are risky. That view assumes that many of these companies are unprofitable. But that view ignores the value propositions, the balance sheets, and in the case of the Mega Caps, the network advantage of billions of growing customers. The chart below shows the exceptional levels of operating cash flows that are generated by the Mega Caps. For example, in FY 2020 Amazon generated an operating cash flow of approximately AUD $100 billion.

The Mega Caps operating cashflow (AUD) $M



The truth is that most of the companies that would be considered for a future focussed portfolio are highly profitable. And if they are not, they are deliberately so as they expand rapidly to exploit the opportunity to capture their global market share.

The Mega Caps are benefiting markedly from the centralisation and scaling of data globally, creating near unassailable network economics and competitive advantages. The strength of the Mega Cap business models was clearly recognised in Q1 2020 when they fell substantially less under the quickest sell off in equity market history.

Post pandemic, the digital infrastructure provided by the Mega Caps is looking more essential than ever. We believe that the structural digital transformation already underway has accelerated.

2. **Global and exponential opportunities**

The future focussed portfolio should also have core holdings in companies that use the technology provided by the Mega Caps to scale globally and generate exponential growth.

Typically, these companies will be in sectors such as e-commerce, entertainment, technology hardware, internet of things, gaming and the shift to renewable energy. Companies such as Tesla, Xero, Megaport, Meituan and Xiomai are good examples.

The Mega Cap stocks, and those that can be global and exponential, are fantastic businesses leveraging technology at scale, with incredible margins and global customer bases. It is difficult to contemplate where the competition might come from.

3. **Web 3.0 – blockchain enabled innovation**

The future focussed Australian investor should have a third kind of 'new world' investment: Web 3.0.

The decentralisation movement (AI, Blockchain, Distributed Ledger and related technologies) of Web 3.0 is ushering in a new era of core technology infrastructure and innovation enabling a shift from the 'internet of communication' to the 'internet of value'. This new Web 3.0 technology platform is reflected in digital asset markets.

The picture below depicts the shift that is underway. Many readers will remember the companies that dominated the Web 1.0 landscape, the original search engines and email that allowed us to find information and communicate, a very static environment.

The arrival of Web 2.0 allowed the growth of transactions, e-commerce, data storage and networking. Many of the brands depicted in Web 2.0 below have become some of the largest companies in the world and were, and still are, at the forefront of disruption and innovation. Web 3.0 decentralised digital protocols now threaten the Web 2.0 businesses.

A prime example is Bitcoin which provides a solution to governance over our money. Further examples are Filecoin, which is providing a decentralised cloud solution for privacy and security over data and Ethereum, which provides a technology layer for verifying and recording transactions.

Web 3.0 will enable the global digitalisation of financial services. Australia is particularly exposed to disruption from Web 3.0 as the local equity markets are substantially overweight financial services.

In addition, the decentralised platforms and public networks of Web 3.0 solve the privacy and security issues currently facing Web 2.0 companies today. We therefore believe the key threats to Web 2.0 companies and many traditional 'old world' companies are likely to come from Web 3.0 solutions in the future. Furthermore, many of the public open network solutions of Web 3.0 are likely to be many times larger than platforms solutions of Web 2.0.

The future focussed portfolio should have an allocation to Web 3.0 because this new technology is likely to be the potential disruptor of today's Mega Caps. Investors need to look beyond the volatility of a digital asset and understand the use cases and what the blockchain technology that underpins the digital asset enables. Without understanding the technology, it is easy for an investor to dismiss digital assets as "vapor ware" or to suggest that they have no value.

An understanding of Web 3.0 and the potential threat it poses to existing businesses is a key tenant of the future focussed portfolio. There is increasing adoption of digital assets and the infrastructure underpinning them by many large global companies that have identified the threat to their business models and are looking to implement strategies that incorporate the infrastructure in order to future proof their businesses.

Well known examples include Visa and Mastercard, enabling payments via digital assets and incorporating blockchain technology in their businesses. Web 3.0 is likely to spawn a whole new breed of innovative organisations that will have significantly lower cost bases with no legacy systems or business models. Investors need to be aware of these competitors enabled by blockchains and what they could do to incumbent businesses.

The remarkable power of exponential

If you walked out your front door and took 30 'exponential' steps (let's say west), where would you land? Would you be in NSW? In Perth? South America? You would, in fact, travel 26 times around the planet. Hard to believe.

Exponential growth may sound scientific, but it is a simple doubling, that is, 1, 2, 4, 8, 16, 32 and so on. This simple anecdote illustrates the power of 'exponential' to drive explosive growth, and which is at the heart of 'new world' companies.

To grow and protect their wealth in years to come, Australian investors should be building a future-focussed portfolio. That means shifting from disruption-prone 'local and linear' investments to the exciting world of 'global and exponential'.

Components of a "Future Focussed Portfolio" Part II: Todays Mega Caps

In our previous piece for XY, we made a case for the advantages (for Financial Planners and investors alike) of what we call a future focussed portfolio, that is a portfolio that addresses the domestic market bias – to be underweight in innovation and technology enabled businesses – in too many Australian portfolios. Local investors potentially miss an estimated 97% of global opportunities – a serious potential growth impediment for both Australian index and active investors.

A deeper dive into this line of thinking will look at what many feel are the compelling features, benefits and the investment case for a global Mega Cap investment component. For the purposes of this analysis we will define Mega Cap as referring to companies with a market capitalization above USD$200 billion.

Mega caps and the perception of risk

International growth investors often mistakenly view a future focused portfolio as a technology fund and therefore, risky. The reality is quite the opposite.

These Mega Caps are the largest companies in the world with billions of customers, entrenched network effects, incredible balance sheets and the world's best talent – and yet are still saddled with the risk label. Why?

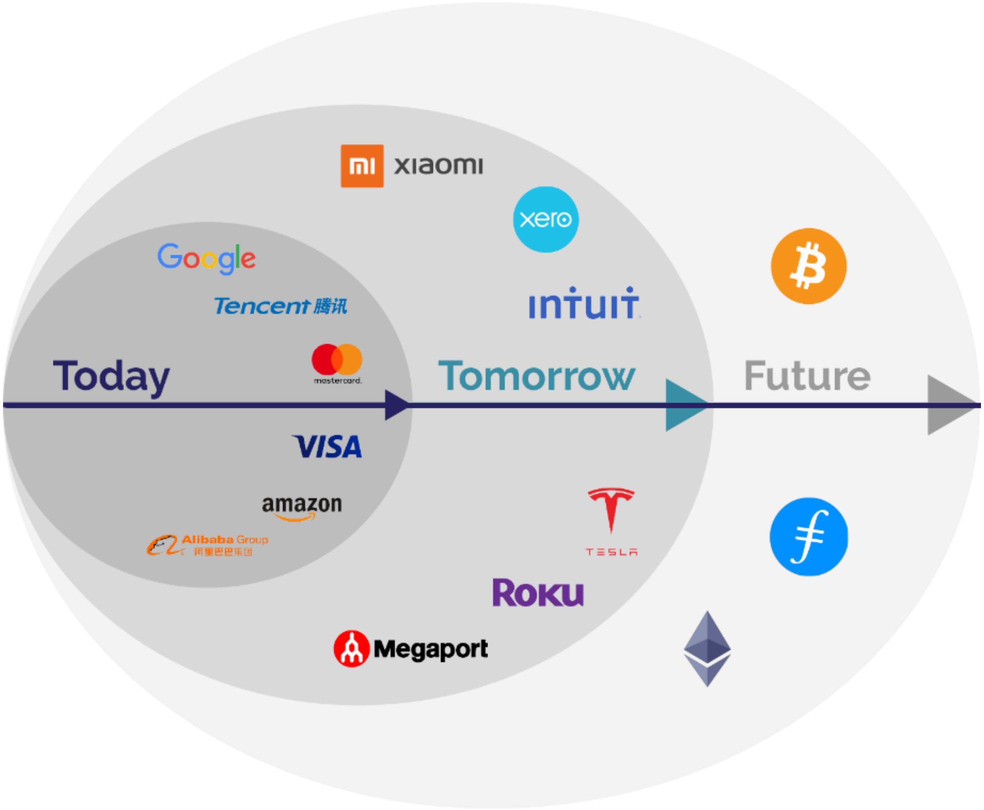
As a first step, let's define risk.

Volatility is not necessarily risk. It can even be said that volatility is good, so long as it's in the right direction over time. We need volatility.

Instead, risk is better defined as:

"The probability of the expected cash flows not being realized."

When investing in a company you are taking ownership of a real business. As a business owner, you care about the quality and reliability of the free cash generated by that business, not the share price fluctuations. The share price merely presents an opportunity for us to value and benchmark these cash flow streams and ensure that a portfolio is invested in quality growth businesses at reasonable valuations.



A future focused portfolio invests across the innovation of today, tomorrow and the future, as illustrated above. The risk, as we defined, changes across these three components.

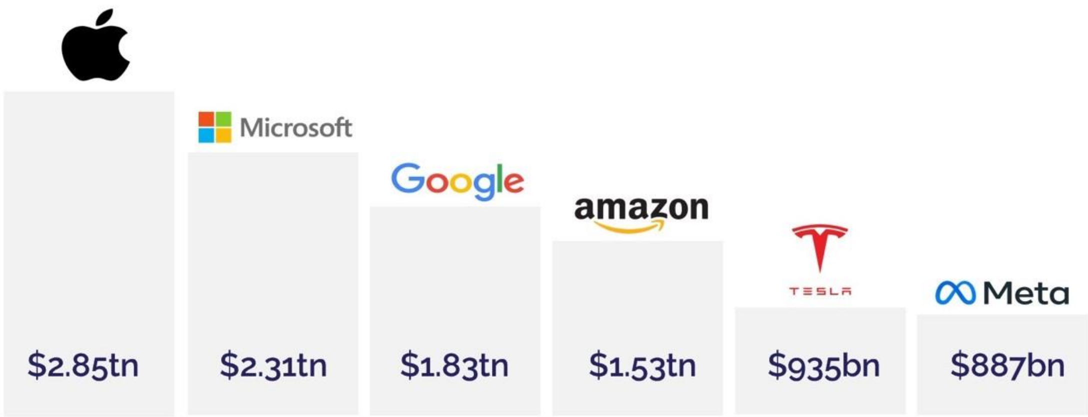
The largest proportion of a future focused portfolio is the 'today' bucket. It is the core of the portfolio. Based on the definition of risk — *the probability of the expected cash flows not being realised* – the 'today' companies are far less risky than most investors realise. These Mega Cap companies are in such dominant competitive positions (think Amazon, Tencent, Alibaba, Alphabet, Facebook, Microsoft and Apple) that they are almost guaranteed to generate massive cash flows into the future. And despite perceptions, they are also good value… particularly after the recent market pull-back.

Unassailable positions

These are the companies that enable the development of e-commerce, the distribution of digital entertainment and gaming, and the infrastructure on which much of our digital lives are currently based. These massive Mega Caps, along with their networked platforms are Web 2.0 based entities.

The value proposition of these companies is so strong and the economies of scale and scope so large that they are in near unassailable positions as shown in the following market capitalisation diagram:

Mega Cap Market Capitalisation



These Mega Caps have diversified across multiple industries and business lines; they reach billions of growing customers; and they have incredibly strong balance sheets, enabling them to easily respond to opportunities, invest and grow. What's more, they can attract the best human talent in the world to execute their strategy. As per the chart below, in many ways these companies are starting to look stronger than some governments (they certainly have more cash and more satisfied customers).

Key characteristics of Mega Caps

Importantly, as the chart below highlights, the Australian share market has significantly lagged the U.S market throughout the internet age and this differential is accelerating. In particular, the technology rich NASDAQ 100 has outperformed the banking and resource dominated ASX 200 by 11% p.a over the past 15 years and an astounding 18% p.a over the past 5 years.

Australia has significantly lagged in the internet age

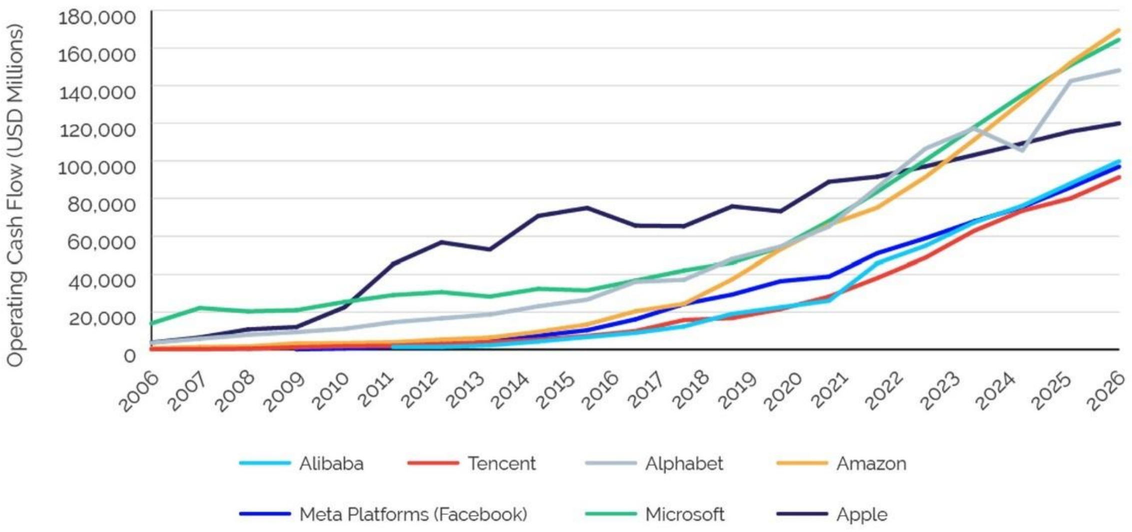
In addition, Covid-19 has proven the safety of the Mega Caps in a market sell-off. When Covid first hit the headlines in 2020, markets posted some of their sharpest falls in history. But Amazon responded by hiring 175,000 employees in one quarter to meet unprecedented demand; Google released crucial Covid statistics on their home page to keep people informed and worked with governments to communicate to a global audience. It was clear a few months later just how reliant we were on these companies and their share prices provided a cushion reflecting it.

Safe *and* cheap

Investors may also have concerns about valuation. That's understandable because investors want to buy undervalued businesses. But, again, looking under the hood shows that even at scale, these companies are delivering significant growth, largely due to their cloud businesses and the continual shift by society to a digital world, a trend that is only accelerating.

The fundamentals of the business (the cashflows) have caught up to the price premiums. So, valuations that previously have looked expensive are now starting to look like good value.

Operating cash flow – Mega Caps (USD Millions)



Based on detailed analysis, the operating cashflow across the Mega Caps will increase at an average of 14% over the next 5 years, making them compelling even at this scale (chart above).

The Mega Caps are also benefiting markedly from the centralisation and scaling of data globally, creating near unassailable network economics and competitive advantages.

Post pandemic, the digital infrastructure provided by the Mega Caps is looking more essential than ever. We believe that the structural digital transformation already underway and that powers their growth has accelerated.

Investors in a future focussed portfolio are in a unique position where they gain access to the defensive nature of these Mega Caps, whilst getting exposure to the growth from the world's accelerating digital expansion.

International investing is changing

Ultimately, when investors perceive that tech is risky, they ignore the value proposition of these companies; they ignore the enormous war chest these companies have built to weather any storm; and they ignore the reality that these businesses were investing heavily in prior years to increase cashflows which are now falling through to the bottom line.

By contrast, if we look at the ASX200, we see a market heavily overweight with old world companies that face disruption and real threats to their cashflows. The world has moved globally, and investors need to think globally.

Australian investors are daily users of the mega techs but don't benefit as owners, and they should. It is time to accept that the world is changing and so too must our investment strategies.

With financial advice, we can't entirely remove risks, but we can reduce them. The Mega Caps of 'Today' represent some of the lowest-risk and highest performing companies in the world. Australian investors not exposed to them might feel like they are avoiding 'risk', but in fact they just can't see the opportunity cost and real risks of narrow local share market investing.

Components of a Future Focussed Portfolio - Part III: Tomorrows global & exponentials

In our previous articles we addressed the investment case and key components of what we call a 'future focussed portfolio', and an unpacking of the opportunity we see in global Mega Caps. This solves for the underweight exposure to innovation and technology enabled businesses typical in many Australian investors' portfolios.

We segue now to a fundamental question that many are asking: why are investors underestimating the opportunities in a global and exponential world?

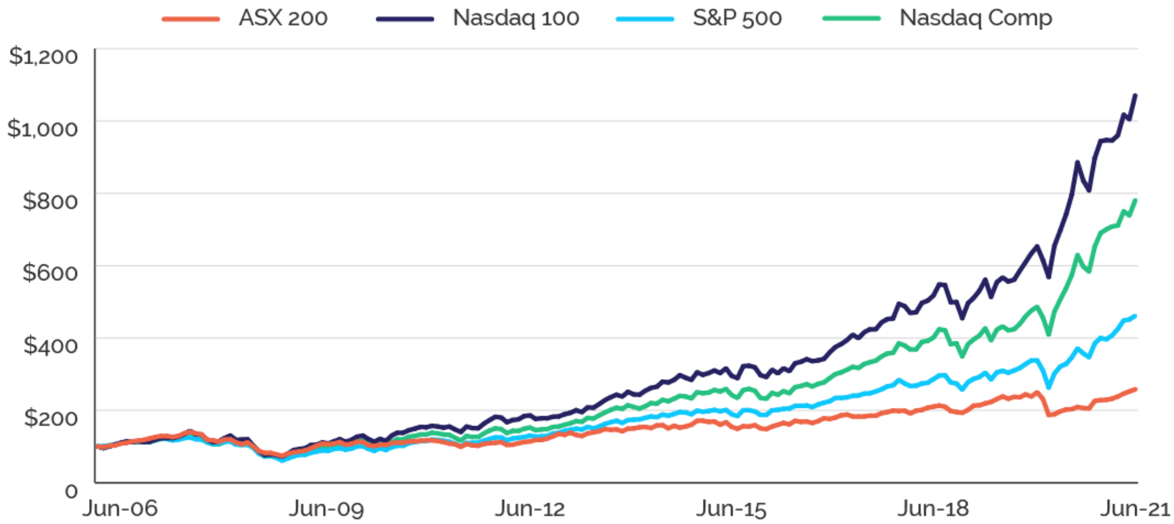
Technological innovation is occurring at an accelerating pace, this we know all too well, and it becomes even more apparent when we try to project forward 10, 20 or 50 years from now. At the heart of this acceleration is one of the most powerful and transformative forces we have ever witnessed: our collective shift online which has transformed businesses from local and linear, to global and exponential.

This change has thrown up a range of Mega Cap winners; Amazon, Apple, Microsoft, Alphabet (Google) and more. But we believe that investors are still underestimating the size of the opportunity created. It has spawned a core group of companies that use the technology provided by the Mega Caps to scale globally and generate exponential growth – the global and exponentials.

A global and exponential mindset

It should be noted that the shift from local and linear to global and exponential is no coincidence. The Mega Caps have laid the foundation of today's digital infrastructure, infrastructure that is the equivalent of the railway and roads of our physical world, with two key technologies forming the basis of this infrastructure and precipitating the Nasdaq acceleration: cloud computing in 2006 and the smartphone in 2007.

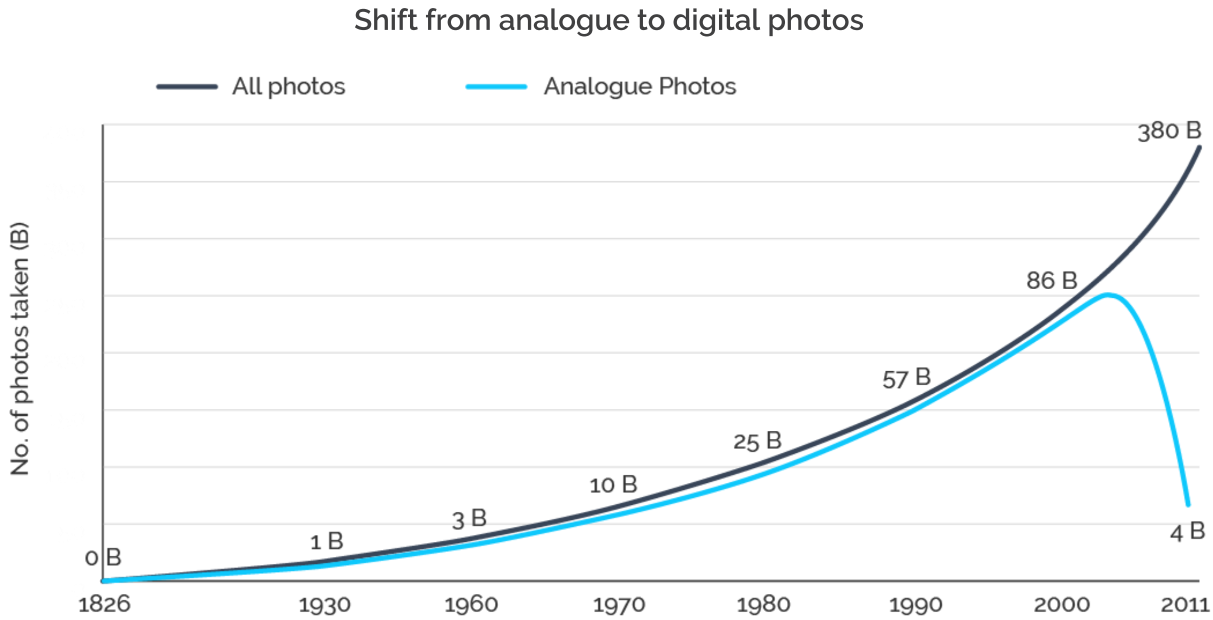
Everything changed post cloud (2006) and smart phone (2007)



Cloud computing, pioneered by Amazon, enables businesses to leverage their physical infrastructure to scale their own businesses internationally. The smartphone, led by Apple, allows businesses to reach large cohorts of users at incredibly low costs.

In many ways small businesses can compete with larger players like never before. Organizations are using innovative digital infrastructure to deliver products and services at demonstrably lower costs, disrupting the economics of prevailing business models.

This rapid transformation is comparable to the shift from analogue to digital photos which took place in the first decade of the 21st century, where digitization left analogue in the dust. Even Kodak, the inventor of the technology was caught off guard.



Global digital technology platform models like Netflix, Airbnb and Uber are transforming industries at an accelerated pace, and an all-too-common investor mistake is to underestimate the Total Addressable Market (TAM). Amazon comes to mind as 'just a bookstore' but there are examples closer to home as well, such as Xero, the first cloud-based accounting software, now moving global and growing exponentially.

Xero's still just a start-up

Xero's founder Rod Drury understood that moving to cloud accounting would change the economics of the SME accounting industry. Xero has been successful, but many investors still underestimate the sheer size of Xero's global opportunity.

Xero's platform is currently used in 180 (out of 195) countries globally. They have a direct presence (website, pricing, and people) in 12 countries today that have a combined population of 936 million and nearly 100 million SMEs.

In New Zealand, according to Stats NZ (the national statistical authority), the ratio of SMEs per capita is 1 in 9. Xero however, due to its ubiquitous coverage in New Zealand, and because it has data to verify this through its interactions with nearly all the SMEs in the country, understands that the ratio is closer to 1 in 7.

So, what explains this mismatch in addressable markets for NZ accounting software?

It is a combination of conservative statistical estimates of the TAM and the transformative innovation of cloud accounting that is driving SME adoption. That is: Xero's value proposition is pushing SMEs to adopt the software at an earlier stage of their business.

By March 31, 2024 we estimate Xero will have nearly 5 million customers and approximately NZ$1.5bn in revenue. But those 5 million customers would still be less than 5% of the global market it currently operates in today.

If we consider the 180 countries where Xero's product is currently used, but where it does not have a physical presence (i.e., people, offices, etc.), the number of SMEs exceeds 400 million.

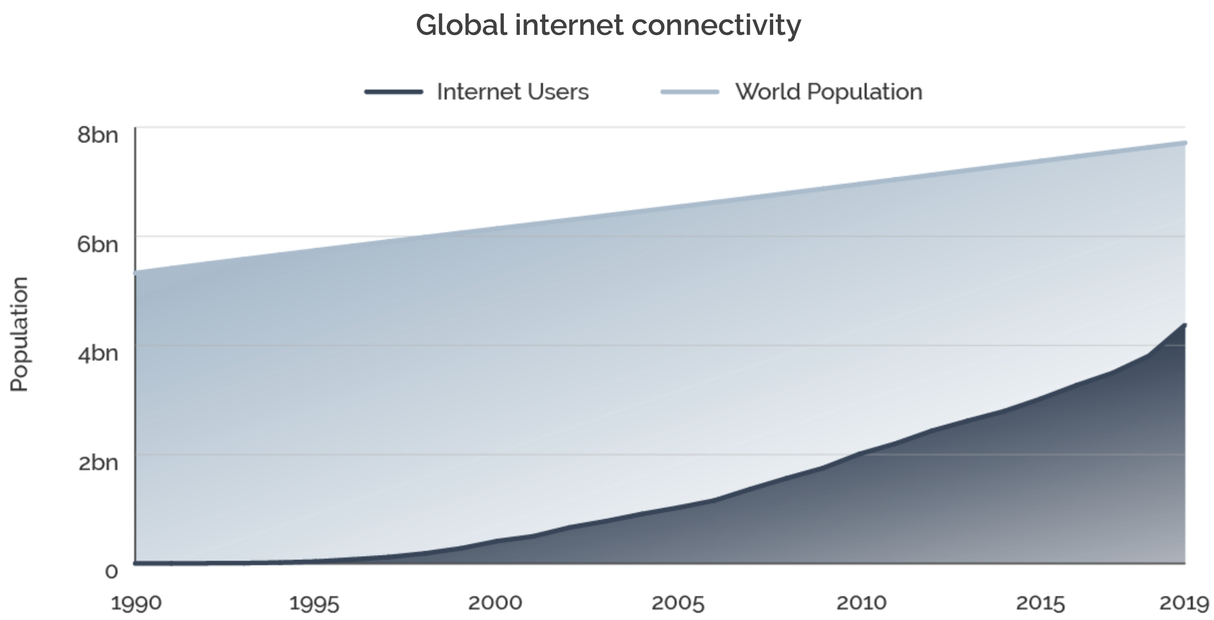
With less than 2% global market share at this point, it would continue to make sense for Xero to reinvest just about all its NZ$1.5bn revenue to capture the global network effect of a platform ecosystem.

In doing so, metrics like P/E ratios are elevated as Xero suppresses earnings to address the opportunity. At a market capitalization of AU$15bn, Xero is still just a start-up on a global stage. This is a common trait for the global and exponential opportunities. A long-term horizon is not just helpful here, it is a prerequisite.

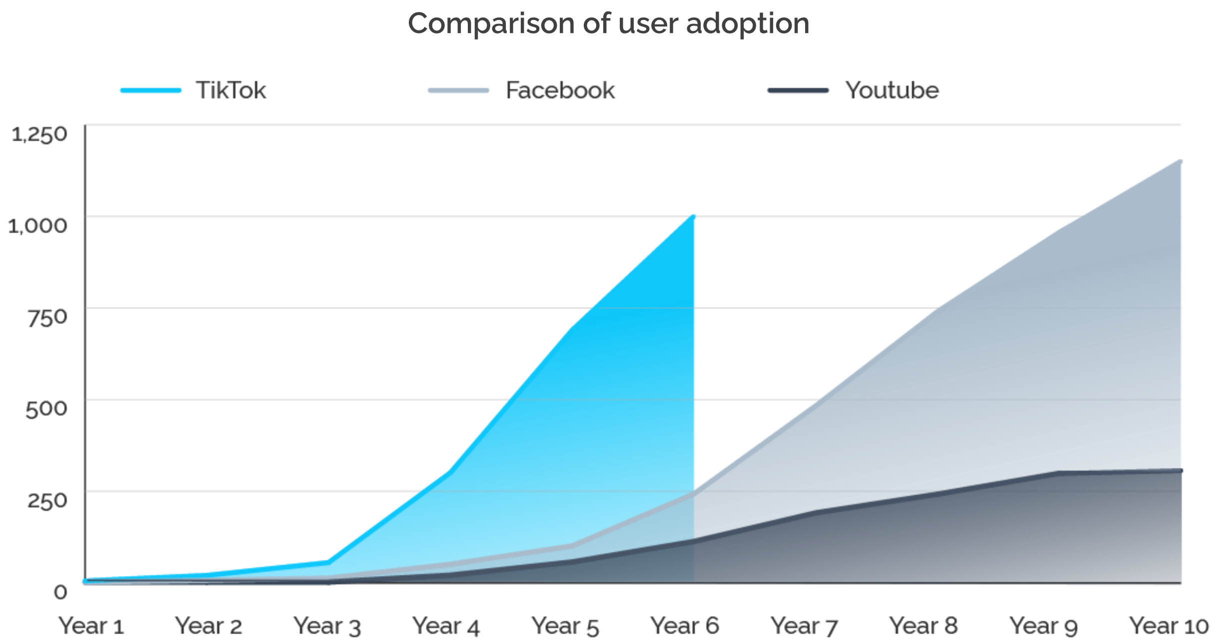
While the adoption of accounting software can take some time for businesses to migrate, digital products have the ability to scale frighteningly fast.

Business models are changing rapidly

Natively digital products have an unfair advantage in their ability to transverse across the globe. The global digital opportunity is only set to accelerate as 40% of the world's population remain disconnected. China, for example, had more than 85 million people move online for the first time in 2021, four times Australia's total population. With penetration in China at just 68% there is still significant growth to come.



While the spread of Covid-19 has given many of us an introductory lesson on exponential movements, the speed of adoption in business can be both exciting and daunting for investors. In less than six years Tik Tok has accumulated a billion users, dramatically outpacing the adoption of any social media application in history.



For investors, disruption at this pace can mean that the fundamentals of a business can change very quickly. But what is the best approach? There has to be a focus on the value proposition – the underlying driver of sales — to understand these changes.

Value proposition trumps all

With the digital infrastructure largely laid by the Mega Caps, the ability for businesses to move globally is substantially simplified. Thus, a focus on the value proposition is a key leading indicator to business growth.

Afterpay, another homegrown example, typifies this.

Many Australian investors were puzzled by the growth of 'just a credit card for millennials', but they missed the real value proposition, which was driving incremental sales to small businesses, increasing the businesses' conversion rates. When businesses implemented Afterpay they saw a significant uptick in sales, and in a few short years, retailers were pulling Afterpay across the globe to drive growth for their international stores.

Filling the gap in Australian portfolios

Fundamental value driven investors and conventional funds typically do not invest in global and exponential businesses because these stocks fall outside traditional evaluation parameters, such as price/earnings ratio and dividend yield.

However, for global and exponential models, as the likes of Xero and Afterpay (now Block) illustrate, the scale of their global opportunity may not be captured through a conventional lens.

The speed and size of these markets can be perplexing for investors. Many ignore these models altogether. But that causes real issues for locally focused portfolios that have a lack of exposure to innovation in the first instance.

By blending a component of Mega Caps with a component of global and exponential opportunities in the one portfolio, we believe a future focused portfolio can give investors unique exposure to the certainty and defensiveness of the Mega Caps, coupled with significant growth opportunities that are present in tomorrow's emerging global leaders.

Components of a Future Focussed Portfolio – Part IV: web 3.0 & blockchain

One of the biggest risks to an equity portfolio is structural change, and investors know it is incredibly important to be positioned ahead of it. What we call a future focussed portfolio must be built to benefit from these changes. In response to that, we recommend that investors invest across the innovation of today, tomorrow and the future.

In our previous articles, we showed the strength and opportunity of the first two components of a future focussed portfolio, which incorporate companies such as Google, Amazon, Xero, and Intuit. These are what we call Web 2.0 companies, and they are so strong that it seems unlikely that a single company can disrupt them.

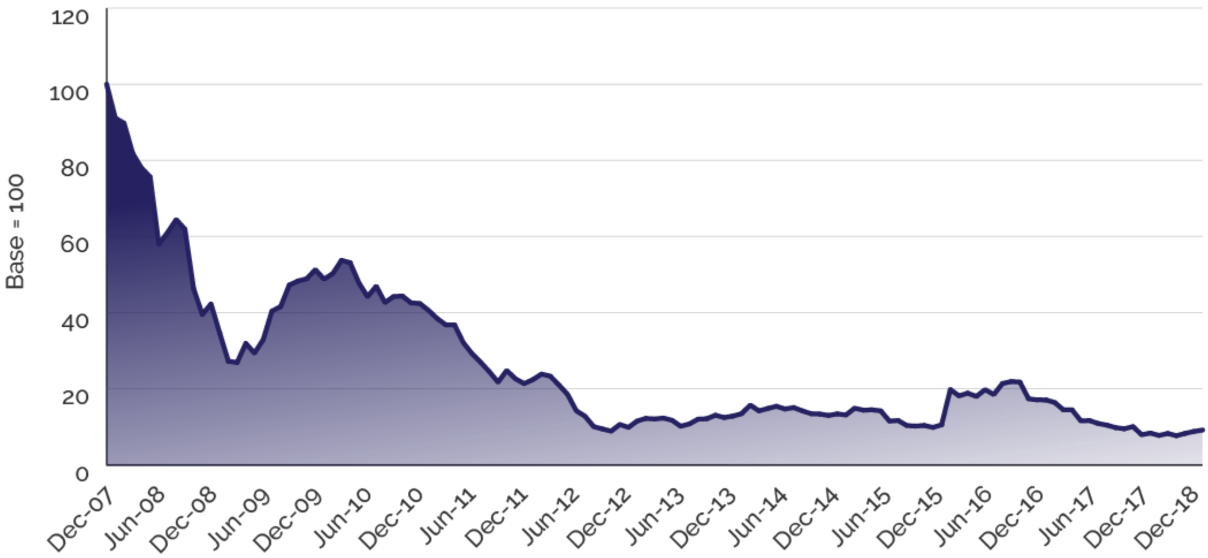
However, there is another threat: Web 3.0 or the next generation internet enabled by blockchain technology. The future component of a future focussed portfolio must address this. This represents the next major structural technological change sweeping the world's businesses, and all investors need to be made aware.

There is a mantra currently doing the rounds in Web 3.0 circles: if you don't understand Web 3.0 you don't understand the risk associated with your current portfolio. But fear not, help is here.

Revolutionising the internet

Australians may have forgotten the power of technological changes that disrupted entire industries. Only a decade ago, online media effectively swept away the long-established media industry. Australian investors were lucky, however, as this represented just 5% of the ASX.

Share price performance of Australian domestic media stocks



But they may not be as lucky next time. The next iteration of digitalisation – Web 3.0 and blockchain – is aimed squarely at financial services, which makes up 30% of the ASX. Blockchains are transitioning us into a new era of the internet by digitising value, a concept that will play out over many decades, just as Web 2.0 has.

What many are calling the internet of value will change the way that we move value across the internet, which spells trouble for our locally focused financial services industry.

Why? Financial services are not natively digital these days. Blockchains on the other hand, are – and that means that services can be offered globally without a presence in the economy. Digital asset businesses could offer financial services at a significant discount in comparison to local operators. Likely this comes with a stronger value proposition too; we're seeing stable coin yields in the double digits, a far stretch from the 0.5% many of us have grown accustomed to.

And it's not just financial services that will be affected. In fact, blockchains are much broader, providing a coordination mechanism – or incentives – that drive new business models and value propositions. We know this intimately well through our Filecoin data storage operation.

Daily Mail, Tuesday, December 5, 2000

Internet 'may be just a passing fad as millions give up on it'

By James Chapman
Science Correspondent

THE Internet may be only a passing fad for many users, according to a report.

Researchers found that millions were turning their back on the world wide web, frustrated by its limitations and unwilling to pay high access charges.

They say that e-mail, far from replacing other forms of communication, is adding to an overload of information.

Experts from the Virtual Society project, which published the report, say predictions that the Internet would revolutionise the way society works have proved wildly [illegible].

Many teenagers are using the Internet less now than previously, they conclude, and the future of online shopping is limited. Steve Woolgar, director of the society, said: 'We are often presented with a picture of burgeoning Internet use, but there is evidence already of drop-off and saturation among users.

'Teenagers' use of the Internet has declined. They were energised by what you can do on the Net but they have been through all that and then realised there is more to life in the real world and gone back to it.'

The project, sponsored by the Economic and Social Research Council, gathered together research by [illegible] universities across Europe and the U.S.

It estimated that in Britain alone there could be more than two million people who regularly used the Internet but had now given up.

Analysts say some simply became bored, while others were frus- [illegible]

Net loss: Two million Britons have logged off the Internet

EXCLUSIVE!

NOW THERE'S ANO
INTELLIGENT FI
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Filecoin can be likened to the Airbnb of cloud. At scale, it leverages blockchain technology to offer users cheaper, faster and a more secure means of storing data and distributing it globally.

One of the big keys for those new to Web 3.0 (and aren't we all?) is that Filecoin isn't competing with Amazon or Google, it is competing with the underlying protocol HTTP.

Filecoin is changing the way that data moves around on the internet, and it's changing the World Wide Web.

The opportunity is enormous, and the structural change here is tectonic in nature – think film to digital photos. With a future focussed portfolio having a significant investment in cloud services via Web 2.0 companies, its essential we understand this change.

Like the pioneering days of the internet

Critics of the digital asset space, and indeed some investors, might be quick to dismiss the industry as a fad. But the environment today reminds us of the early stages of the internet.

But you've no doubt heard this all before – this is how disruptive technology evolves, it iterates, and it appeals to a sub sector before moving mainstream. New value propositions come to life, drawing in new users. The global platforms we see today would have been impossible to predict in the 1990s.

Similarly, with much of Web 3.0, we are still yet to see the long-term implications. Much of the value of the internet comes from the network effect, as more people moved online it became more useful. The same is occurring here with Web 3.0.

However, there is one key difference, as this network effect is being bootstrapped. What do we mean by that?

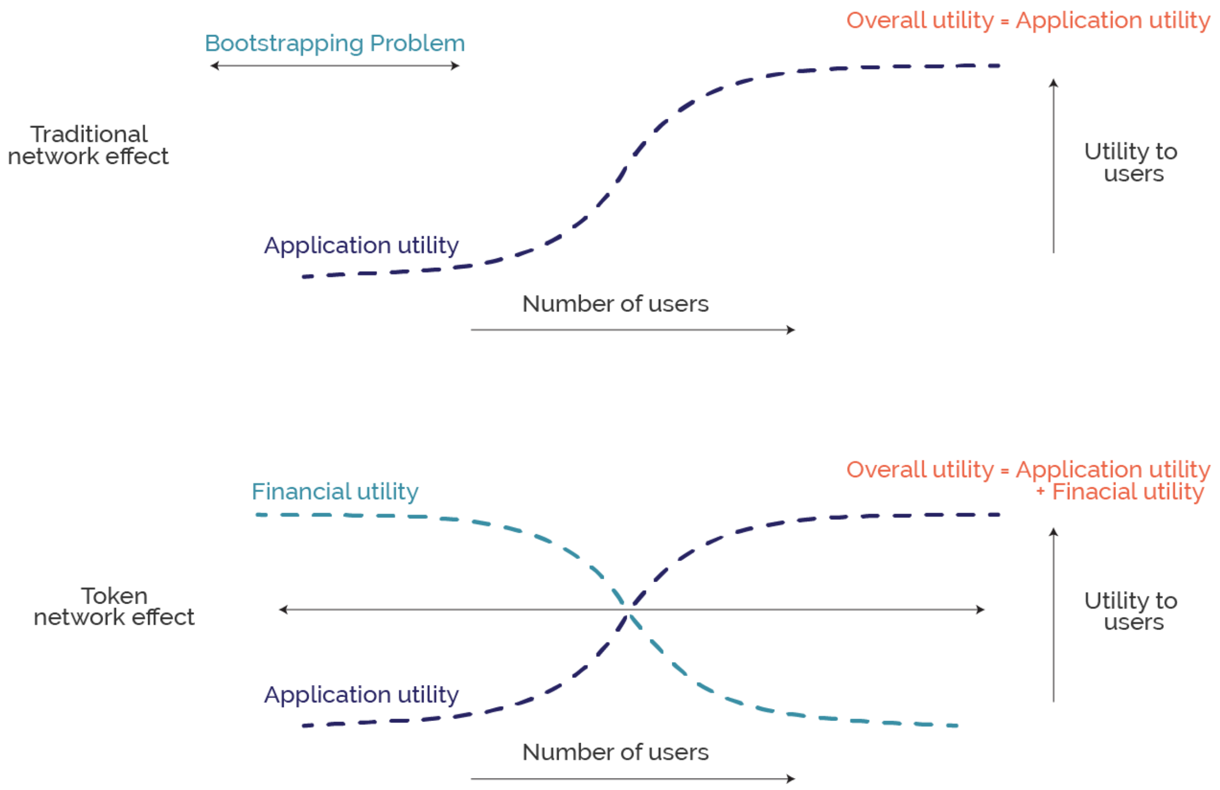
Bootstrapping network effects – the incentives of web 3.0

One of the many things that makes Web 3.0 different from Web 2.0 is the blurring of users and shareholders. This is critical to understand.

In Web 3.0, users own part of the network and receive the financial benefit of that network. This is starkly different to Web 2.0. The users of Facebook, for example, provide tremendous value to the Facebook platform, but those users do not own it or share in the profits.

Web 3.0 is creating a much more aligned model for users, and it is this alignment that is helping bootstrap or incentivise adoption of these networks.

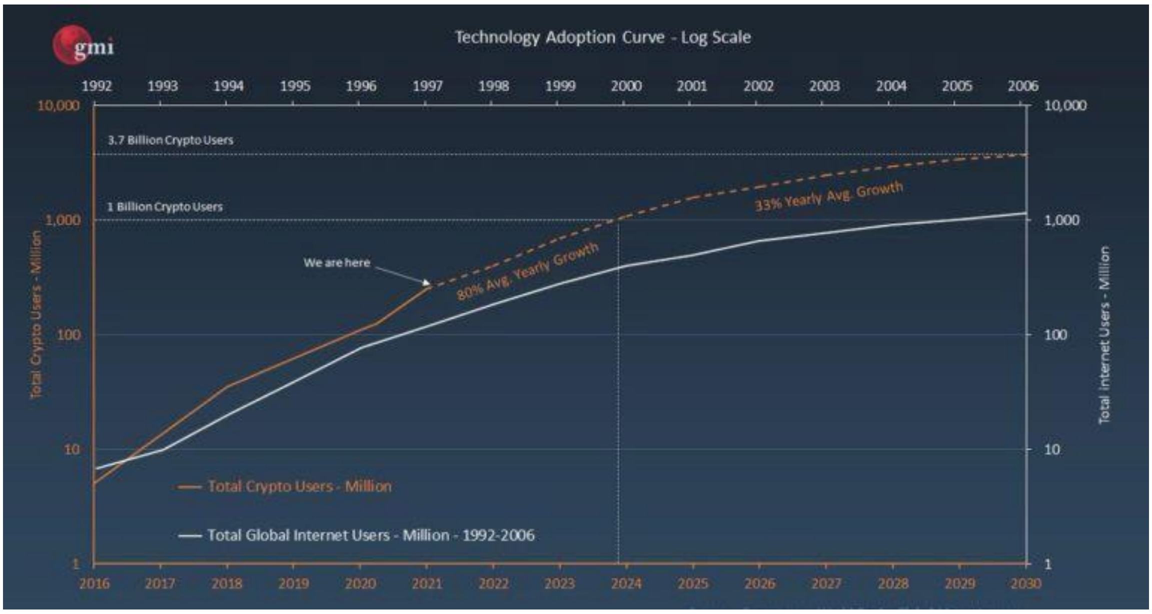
Using token incentives to solve the bootstrapping problem



This is why you may see people getting excited about these businesses, even before it becomes clear their utility is superior to today's alternatives. But make no mistake, the financial utility – the big upside – will accrue to the early adopters, and it is why we are seeing such rapid adoption of Web 3.0. Because we have learnt to incentivise people to join, the digital asset space is outpacing the internet with 4 billion users predicted to be involved in the space within ten years.

This isn't a fad, this is adoption – and structural change.

Technology Adoption Curve – Crypto vs. Internet Users, 2016 – 2030



Crypto has no fundamentals though, does it?

Another misconception critics and some investors have of the digital asset space is that there are no fundamentals. Like gold, Bitcoin is difficult to value. But the fundamental reason we would want a hard money (preferably digital) does not change.

Outside of Bitcoin, we are seeing very similar metrics to what you would see in traditional financial markets. Ethereum, for example, has generated $US350 million of revenue in just the last 30 days (as per end of March 2022), much of which is being paid to miners (those helping operate the network) or redistributed back to holders via a burn mechanism (share buyback). Token Terminal is one of many sites that help highlight the fundamentals associated with this new industry. The value being driven into these assets is no different to how Amazon share buybacks create value for existing shareholders. Thus, the focus for investors like ourselves falls back to the value proposition.

Understanding the value propositions is critical because in many cases, these value propositions cannot be replicated using legacy technology. This is a structural change. A fast moving, sometimes confusing infrastructure change that will have long-lasting ramifications for all investors.

Protecting your portfolio

Now for the most important part – how does this affect you? As outlined, we cannot downplay the profound, structural changes that Web 3.0 and blockchain represent in the world today. Web 3.0 will disrupt many industries – particularly financial services – that make up a huge proportion of the ASX and Australian domestic portfolios. However, understanding – and investing – in Web 3.0 isn't just about capturing the upside of this revolution, it is also about protecting the value in your existing investments.

So, if you don't understand Web 3.0 you don't understand the risk associated with your current portfolio. Whether that's payments, cloud, financial services…Web 3.0 is coming, and investors need to understand it, soon.

The Future Focussed Portfolio – Part V: Investing in Bitcoin – The adviser's guide to client conversations

Maybe you're curious about Bitcoin, maybe you are grossly opposed to it.

Either way, your clients are likely asking about it.

As someone who has spent many years learning about Bitcoin and Web 3.0, I can confidently say, we are entering a stage where it is a necessity for investors to have exposure to Bitcoin.

The size of the allocation is debatable, but keep in mind: not taking a position in Bitcoin, is in fact taking a position - a strong one. I liken this to insurance; a concept advisers know all too well. Bitcoin is no longer just a speculative edge case asset with 'no fundamentals', it is coming of age and as a trusted adviser it's imperative that when your clients ask (and they will ask) that you understand how to navigate their questions.

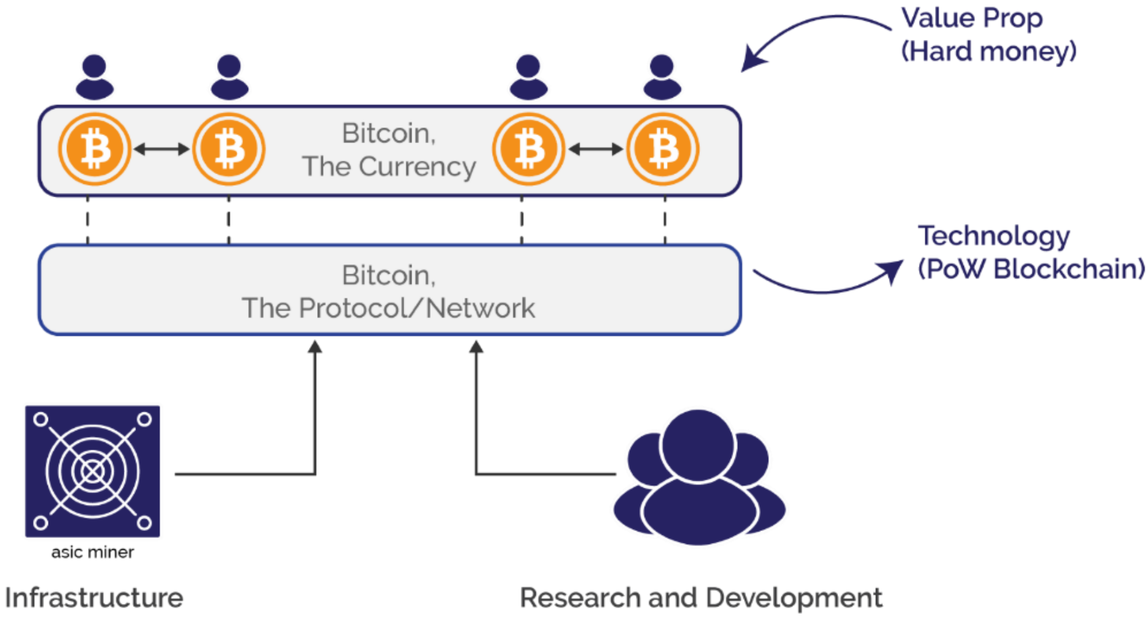
So as a guide, here is your five-minute introduction, to put you in a position to comfortably talk about Bitcoin.

Ignore the technology

The first point is to ignore the tech. Yes, while the technology is important in enabling the Bitcoin network, it is only that, an enabler, and it muddies the waters. The value proposition is what makes Bitcoin valuable. Too many people focus on the Blockchain and write Bitcoin off as generation 1 tech that will be superseded by more efficient technology, missing completely the sustainable value proposition that makes it what it is.

Bitcoin's true value lies in the asset.

The Bitcoin Map



Money is hard

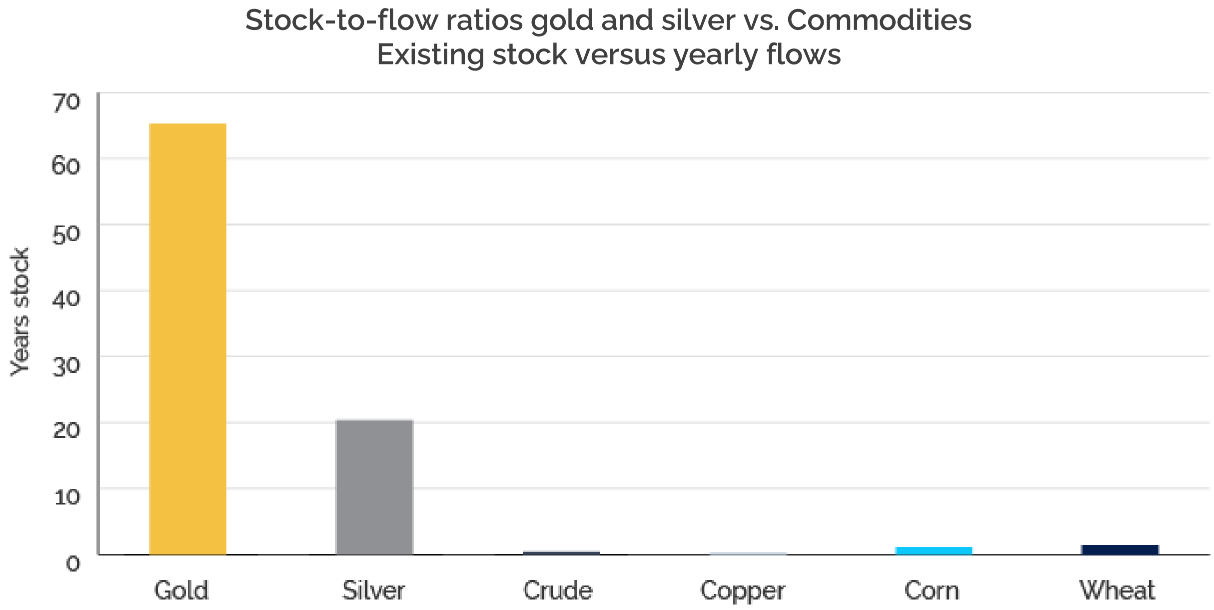
Money is an invention. Created by humans to solve the 'Double coincidence of wants' (an economic phenomenon where two parties each hold an item that the other wants). Money has been and can be anything, there are just consequences of using certain forms of money over others. History is littered with examples of money that in hindsight have been devastating to a society to use, Aggry beads in Africa in the 16th century for one.

So, what makes good money?

Humans have over the last 5,000 years used gold as a reliable form of money. The reason? Gold solves three key necessities of money:

1. **It is divisible (solving a problem of scale)**
2. **It is portable (solving a problem of location)**
3. **It is durable (solving a problem of time)**

The last point is arguably the most important. And while many of you will think of perishable goods here, what it means is that gold has the ability to carry value over time, to store wealth over time. Because creating new units of gold is hard. We measure this hardness, by a metric known as the stock-to-flow ratio. It is clear why gold has become the monetary standard over history, followed by silver.

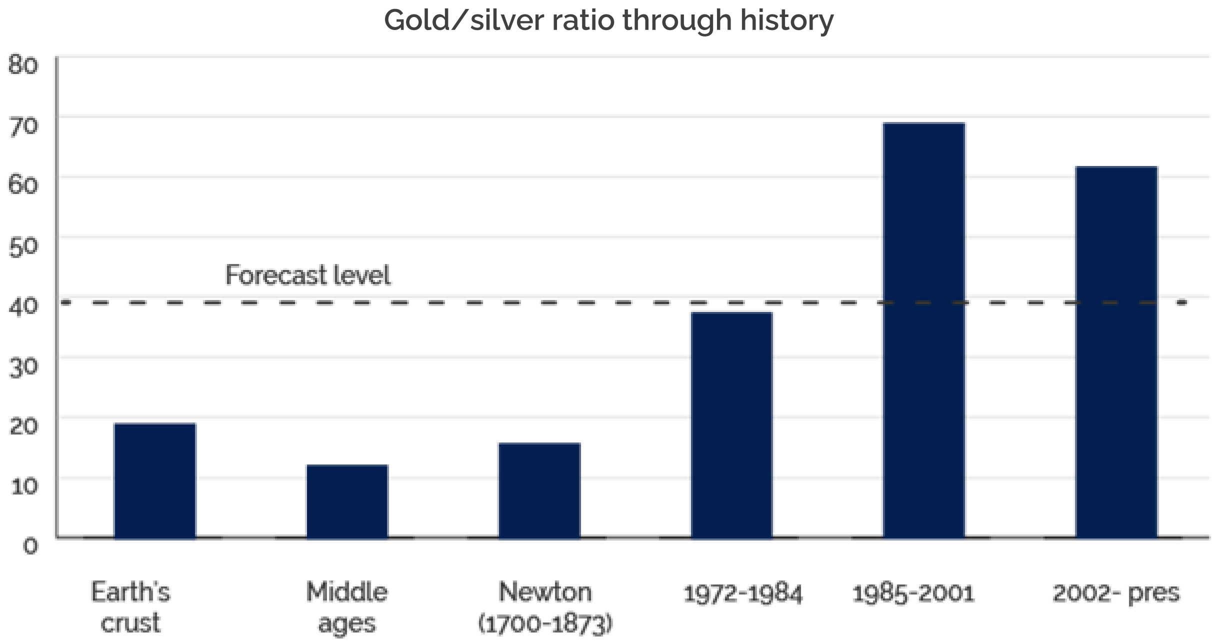


Money serves the people

Gold however has become increasingly impractical as money, as society has become more mobile and technological advancements have occurred. Moving gold from one destination to another became risky and burdensome, and the simple solution was to create paper certificates that were more portable and divisible, and still linked to the monetary value that underpinned it.

While attractive this came to have two unintended consequences. Firstly, the role of silver as a more divisible currency severely diminished, causing an extreme devaluation of silver that has not since recovered from the late 1800's.

The silver to gold ratio has remained relatively low throughout history. The Roman Empire pegged the ratio at 12:1, and this ratio remained relatively stable until paper currency became more widely adopted. The lesson? Money serves the people, and if money stops playing its role the monetary premium dissolves.

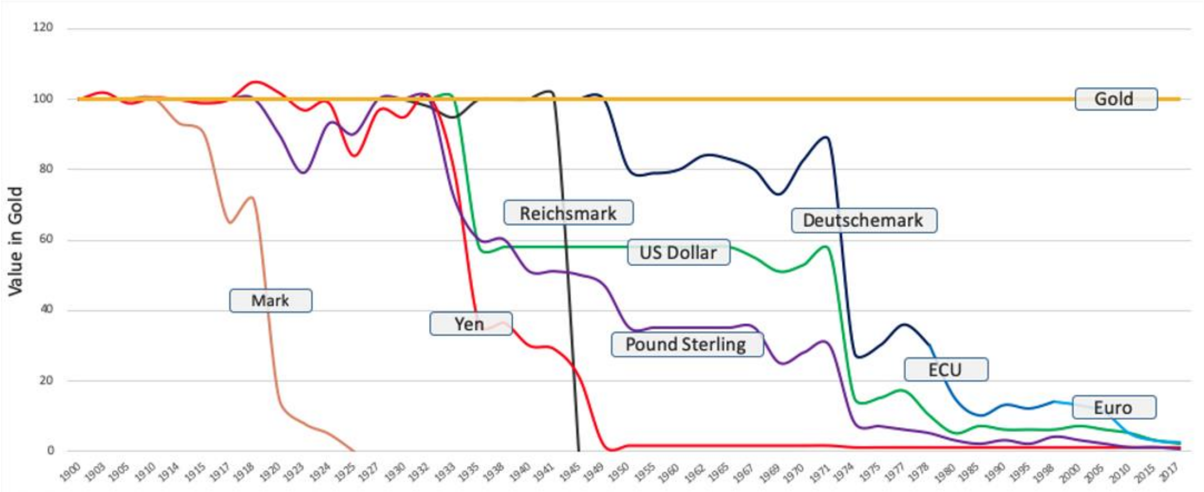


The second unintended consequence was the eventual shift away from the monetary asset itself. The banks that were storing gold eventually began issuing more paper certificates then they had gold, underpinning it (why not create money if you can?).

At the risk of oversimplifying, over time these banks turned into central banks, and we eventually created state issued certificates that had some backing to gold but were not redeemable for gold. This is fiat currency.

Fiat currencies have lost more than 95% of their purchasing power in comparison to hard money (gold) since the 1930s. The incentive for governments to print money in times of crisis is too strong, and the increase of money into the global economy eventually forces hard assets to reprice to a devalued fiat currency.

All Major Currencies Have Depreciated Relative to Gold



The ability to create (print) money for state funded projects is not necessarily bad, there have been many government funded projects throughout history that have helped increase the quality of living for a society. The problem is when the money being created is not well allocated, and inflation starts impacting lives in a negative way - when the money stops serving the people.

A shift to Austrian economics

Moving back to gold is certainly a solution, and maybe it is part of the solution, but gold in today's digital economy will face an even tougher challenge than it did in the early 19th Century.

Enter Bitcoin.

Bitcoin takes the hard monetary properties of gold and improves on them in a digital format.

Bitcoin provides a potential pathway for society to move away from the risks in fiat-based money without compromising on the digital nature of today's financial system. As with Aggry beads and silver, the importance of a new form of money cannot be understated. If society was to shift away from Keynesian economics to Austrian economics (Hard money) the impact on the global financial system would be severe.

Imagine a market based, deflationary system for money, where our key store of value or cash does not devalue, it is completely at odds with the current financial system.

Read that again. It is important.

Most of the global financial system today is built around the idea that money inflates, and that investors must allocate capital to outpace inflation. (I'm sure many of you would understand this from adjusting your Xtools+ assumptions up for increased inflation. You've adjusted them up, right?)

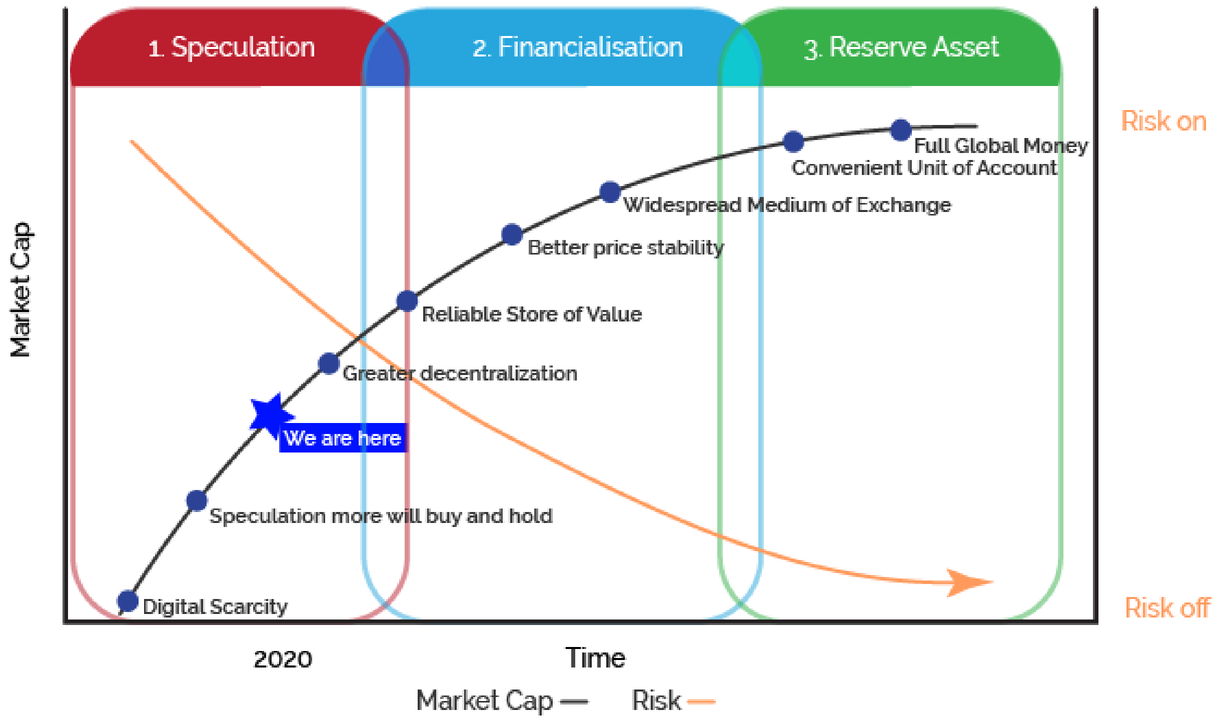
But if investors didn't have to step outside cash to maintain their purchasing power the ramifications would be extraordinary, as the need for financial services would simply diminish. Australian investors in particular would be greatly exposed with 25% of the ASX comprising financial services.

Bitcoin: not allocating is not insuring

In investing we work on probabilities. No one can be certain, it is why we diversify our portfolios across assets, it is why we take out insurance. Bitcoin is very much in the same camp. Bitcoin has proven to be resilient in its early years, and today, every metric of Bitcoin speaks to a story of growing adoption. We're seeing uptake across developing countries; companies are storing Bitcoin on their balance sheets; governments are introducing it as legal tender, and asset management firms are starting to allocate to Bitcoin.

Of course, allocating to Bitcoin isn't just about exposure to the upside, it is about protecting from the downside in the existing portfolio. It is about protecting from a transition in monetary policy, that could be severe to many investors heavily exposed to the current monetary system. Bitcoin is not a perfect store of value today. But as Bitcoin matures it will move from a risk on asset to a risk off asset, the volatility will lower and the confusion about it acting like a store of value will fall away.

The monetary policy journey



Allocating to Bitcoin is about recognising the path that Bitcoin is on and the probability of failure or success. We believe that the case for failure in many advisers' minds is heavily overstated, meaning their clients are currently uninsured.

Beyond hard money

While this is only an introduction to Bitcoin, it would be incomplete without touching on some of the innovation that is occurring on the Bitcoin protocol, that is adding value to Bitcoin beyond the monetary asset.

The Lightning Network is a key development that is enabling Bitcoin to scale to billions of users. The idea of buying coffee with Bitcoin was laughable just a few years ago but the Lightning Network is enabling just that with effectively free transactions. This same innovation is being utilised by Strike to send money internationally, for close to free as well. Strike enables these free USD transfers by using the lightning network in the background. This means the payment rail for international money transfers could be changing too.

Taproot is another recent innovation that is also helping to solve scalability but in a different way. Taproot has the potential to open up much more complex transactions on Bitcoin as well and allow the network to more easily upgrade in the future.

Both these innovations are still relatively early, and it would be hard to put too much weight on their value - but the point is that Bitcoin is continuously developing and the utility of the Bitcoin network will only increase.

Bitcoin and clients

Talking to clients about Bitcoin can be daunting, some know it all and for others it's just 'all over their head'. It is polarizing to say the least.

But, it doesn't have to be.

Bitcoin is less about the technology and more about money, how money should be governed and the cost of inflation over time. Like politics, there will be very strong opposing views.

As an adviser, protecting your client's portfolio for future outcomes is what is important here, it is not what you believe 'should happen' it is what is 'likely to happen'. As usual, education is the key. Put aside the hype, so that you can have these important conversations and not be caught out.