

### This Week's Top Articles

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### Phil Vernon on rules for managing competing priorities

Graham Hand

*Phil Vernon is Managing Director of ASX-listed wealth manager, Australian Ethical (ASX:AEF), which was founded in 1986. It manages about \$3 billion for over 45,000 clients, with two-thirds in a superannuation fund.*

**GH:** Every person who invests with Australian Ethical has their own set of ethics. How do you reconcile yours with theirs?

**PV:** There are three main elements to that: one is the rigour of our process, two is disclosure, and three, we test our preferences with our clients.

Briefly on each. **First**, as much as ethics might seem like a subjective issue, we try to make it as objective, analytical and rigorous as possible. I equate the hierarchy of our process to the way a country operates. There's a constitution, then legislation – which interprets the constitution in a rigorous framework – and then there's case law.

In a similar way, we have an Ethical Charter that sits in our Constitution, with our high level principles. It includes 12 positives that we look for and 11 negatives we avoid. That's our starting point. Then we develop a set of ethical frameworks that focus on industry sectors and specific issues, with potential crossovers. For example, you might have animal welfare issues that affect different industries.

Many outcomes we look at must balance positives and negatives, so there's a lot of internal discussion which determines where we land on certain things. It's overseen by an ethical Advisory Committee, which is an internal management committee comprised of myself, the Head of Ethics and Chief Investment Officer.

That puts in place an objective standard in the way we view the world. It gives the investment team reasonable certainty on what they can look at. It allows enough flexibility so that if things change over time, and we have to adjust, we can have a robust discussion. That's why I pointed to legislation, which can shift, but we don't change on a whim.

**GH:** And **second**, on disclosure and transparency?

**PV:** Yes, [on our website](#), we explain our position on 42 hot topics, such as on fossil fuels, climate change, animal welfare, human rights. You can see what we believe. We're very active on social media and we encourage people to offer their views. We invest a lot of resources and time in responding. Our ethics team will often give detailed responses and people are surprised by the responses they get.

**GH:** Yes, I've heard you have something like 120,000 social media followers. And the third element?

**PV:** **Third**, we check the mood of our community, including our members. We do an annual survey on ethical preferences to make sure that our judgments are in line with the general mood.

**GH:** Can you give an example of something that has changed over time, a community expectation that you've had to reconsider.

**PV:** The classic example is fossil fuels. One of our key ethical charters is environmental and we've always been strong on climate change. It's the key thing that our members care about. If we go back a few years, we were a supporter of gas as a transitional fuel to help manage the climate crisis. A classic case of balancing positives and negatives, as we have a charter to lower emissions but we also have a positive charter about human happiness and dignity.

**GH:** So we have to transition away from fossil fuels in a just way.

**PV:** Yes, 'transition' has become a common term but we were debating that 10 years ago. We reached the point where, after a rigorous debate with lots of external experts, we decided the urgency to adjust for climate change was greater than we previously thought. And the technology to allow a just transition had improved dramatically. For a host of reasons, there was no remaining justification to support gas as a transitional fuel.

**GH:** If there's an analyst in your investment team who finds a company they like, what's the ethical check on that investment? Do they do the ethical screen before they do the research? Or do they find the company and ask if they can invest in it

**PV:** It's a bit of both. The frameworks are done and we have a reasonable assessment of the investment universe, but there's still a lot of bottom-up identification of companies. We don't do 100% screening of the market up front.

**GH:** Do you think investors give you money for ethical or investment performance reasons?

**PV:** An outcome of our annual survey is that we categorise our investors, and there are four broad categories. First group we call 'Highly Ethical', where ethical decisions are the dominant reason for investing. They're willing to compromise on performance or indeed, whatever market or product they are in, ethics comes first. That's about 10% of people.

Then there's a broader category covering about 40% of people which we call 'Ethical Action Takers' where ethics is a strong driver but they look at quality and performance as well. There are two sub-categories in there: people where ethics is the dominant driver and another where performance dominates.

And then there's a bunch of people where ethics isn't really a driver at all.

Historically, we've come from people whose dominant decision was the ethics, and they were probably willing to compromise. But it's changing, and our members are mainly people who want the ethics but not with a compromise on performance.

**GH:** All fund managers now talk about their ESG (Environmental, Social and Governance) principles. Do you think that the ethical side, which has been part of your DNA since the start, is now less of a competitive advantage than it used to be?

**PV:** No, there's a distinct difference. ESG as a philosophy still puts the financial decision as the primary driver. The ESG issues are relevant only where they can demonstrate improved company performance, They are an input to the investment decision.

Our philosophy is quite different. Our ethical conviction exists in its own right, but our belief is that you can make that decision and not compromise long-term performance. So, yes, there's more competition in that space, but the conscious consumer recognises the distinction.

**GH:** How do you hire staff? When you're interviewing someone, they must try to interview well and tell you about their ethical values.

**PV:** It's a really important point. We want a culture where people actually live and breathe the values that we stand for. It's always a judgment but it is an explicit part of our interview process.

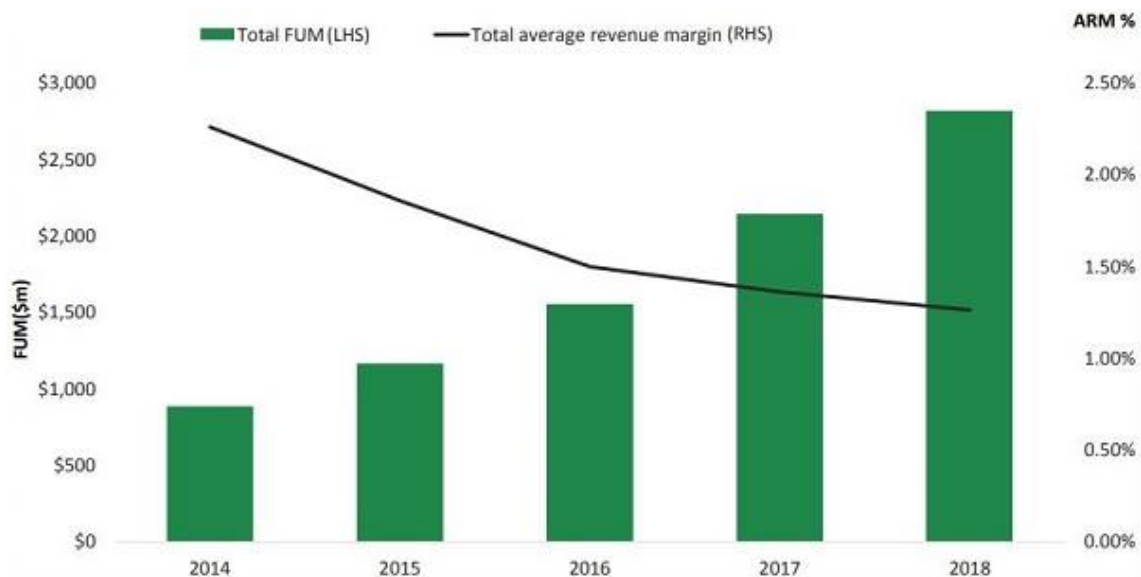
**GH:** What do you ask them?

**PV:** We ask people to talk about things they've been involved in, what they have an interest in, and we allow them to elaborate. One of our corporate values is authenticity, so we search for the authenticity in the answer and sometimes you don't get it. Often, it's obvious that the person is telling us what they've practiced in their response. You can pick it.

**GH:** There's a lot of debate in the industry about why fees don't fall as funds under management grows, as fund managers achieve scale. How have you coped with that issue in an ethical business with responsibility also to shareholders?

**PV:** We have a distinct philosophy of sharing the benefits of scale with our customers. You can see how our fees have come down in the last five years. We used to be an average fee margin of about 2.2%. We're now down to about 1.2%, so we've given 1% back to our customers as we've grown.

(Ed. Phil showed me this chart where the black line shows the average revenue margin falling since 2014 against FUM).



**PV:** I wanted to mention that I read your book (*Ed. 'Naked Among Cannibals', published in 2001, about failures in the way the banking system operates*) many years ago. It was around the time I was reading a number of seminal works that ultimately led to me being here, challenging what was wrong with the normal corporate model, and your book was a master at calling a lot of that out.

**GH:** Thanks. And 20 years later, we had a Royal Commission.

Graham Hand is Managing Editor of Cuffelinks. [Australian Ethical](#) is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. This article is part of our [Interview Series](#) with fund managers and leading executives.

## Green bonds: greenwash or the real deal?

Tim Kelly

Green bonds, also known as climate bonds, are designed to fund positive environmental or climate projects. They are often issued by major banks which identify qualifying assets (loans) on their books that meet the relevant criteria. The issuer then promises to maintain a pool of assets that exceeds the value of the funds raised through the bond issue.

For investors, buying a green bond helps fund projects focused on issues such as energy efficiency, recycling and waste reduction. For the sustainable sector, green bond issuance helps identify institutions likely to fund new projects.

It's not just banks that issue green bonds. They have also been issued by governments, universities and listed companies that want to fund projects that benefit the environment. Woolworths is the latest company to issue a green bond in Australia.

### **Green bonds in Australian institutional portfolios**

Green bonds are periodically made available to institutional investors in Australia. At the time of writing, approximately \$21 million (5%) of the Australian Ethical Fixed Interest Fund is invested in a dozen international and Australian green bonds, including:

- The World Bank Green Bond which aims to support the transition to low-carbon and climate resilient development and growth in client countries.
- The Australian Catholic University's Sustainability Bond which supports the energy efficient design of new buildings within the university's capital development plan.
- The NAB Climate Bond which is backed by NAB loans to renewable projects such as wind farms.
- The Westpac Climate Bond which finances a number of renewable energy projects as well as low-carbon buildings.
- The NSW Government's Green Bond which is backed by public transport projects including the Newcastle Light Rail project and the Sydney Metro Northwest.

We do not automatically invest in every green bond that comes to market. We have declined to participate in several high-profile Australian-dollar denominated green bonds. For example, we avoided an ANZ green bond because the pool of green assets backing it was dwarfed by the bank's ongoing fossil fuel lending; we avoided a green bond issued by the Victorian State Government because we decided the deal size was too small relative to other Victorian Government issues; and we declined to participate in a CBA green bond because the composition of the asset pool lacked transparency.

### **Woolworths green bond**

In April 2019, we invested \$3 million in [Woolworths green bond](#), which was the first green bond to be issued by a supermarket operator in Australia. To create the bond, Woolworths worked with the UK-based Climate Bonds Institute to establish a benchmark for the carbon intensity of its supermarket sites. This benchmark will provide the bond market with a solid framework to assess Woolworths' progress at lowering the carbon intensity of 32 of its supermarkets.

Under Woolworths Green Bond Framework, the pool of eligible assets encompasses projects covering renewable assets, energy efficiency, pollution prevention and control, clean transportation, sustainable water management and green buildings. Examples include the placement of solar panels on top of car park shade sails, retrofitting energy efficient LED lighting in stores, upgrading stores with hybrid or HFC-free refrigerators and cutting down on plastic wrapping on fruit and vegetables.

Over time, Woolworths will need to return to debt capital markets as other bonds mature. If the company has not successfully brought more stores up to the standard it agreed with the Climate Bonds Institute, or the existing portfolio does not continue to improve its carbon intensity, Woolworths will not be able to issue another green bond. As a result, the company will be likely to experience lower demand for future bond issuance and pricing due to socially-responsible investors sitting out of future non-green transactions.

### **Doesn't Woolworths own pokies?**

Our decision to invest in the Woolworths green bond does not mean we are invested in Woolworths shares. In fact, our Ethical Charter prohibits us from owning Woolworths shares for a number of reasons. A key factor is the revenue the company earns from poker machines as a result of its ownership of hotels across Australia. In our public advocacy, we raise awareness of the harm caused by the gambling industry and the choice people can make not to invest to support this industry. However, at the same time as we exclude investment in companies like Woolworths and Tabcorp, our ethical team has concluded it is acceptable for us to invest in Woolworths' green bond to support its positive impact.

We did ask ourselves whether this green bond was an attempt by Woolworths to greenwash the less sustainable parts of its business. However, after assessing the company's actions on climate change and emissions reduction, we concluded Woolworths was acting in good faith. When we looked at the company's other behaviour, we were satisfied Woolworths was serious about supporting the transition to a low carbon economy. For example, Woolworths is reducing operational emissions, food waste and excess packaging, and also pursuing a science-based target for emissions reduction for its overall business.

We believe the green bond market has great potential to shift capital to climate-friendly technologies and infrastructure. They encourage better measurement and transparency of climate impact and create momentum for continuous improvement. Woolworths have set an expectation that their future supermarkets will meet the green bond supermarket criteria.

*Tim Kelly is the Fixed Income Portfolio Manager at [Australian Ethical](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.*

*For more articles and papers from Australian Ethical, including Graham Hand's interview with AE's Managing Director, Phil Vernon, please [click here](#).*

## Quick checklist for end of financial year

Michelle Bromley

As the end of 2019 financial year is upon us, it's time to maximise contributions, satisfy minimum pension drawings and optimise your tax and superannuation outcome prior to 30 June.

As a quick checklist, here are some items to consider:

- Top up your super contributions
- Bring forward super contributions
- Make a spouse contribution
- Obtain a government co-contribution
- Lodge your deduction notice
- Review salary sacrifice arrangements
- Pre-pay expenses and crystallise losses
- Defer income and gains until July
- Gather your receipts
- Meet minimum pension standards

### Maximising super contributions

If you're under 65 or otherwise eligible to contribute to super, you should think about maximising your contributions. However, there are limits on how much you can contribute.

Generally, up to \$25,000 pa can be contributed from 'before tax' money (e.g. employer and salary sacrifice contributions) and provided you've got enough assessable income to offset, the '**concessional cap**' includes personal contributions that you've claimed a tax deduction for.

Any amount of personal contribution that you don't or can't claim as a tax deduction is counted against the \$100,000 pa '**non-concessional cap**'. If you're under 65 and have less than \$1,600,000 in super, you might be able to bring-forward two future financial years' worth of the non-concessional cap to make a larger contribution of up to \$300,000.

If you earn at least 10% of your income from employment, the Government may give you up to \$500 as a **government co-contribution** if you make a non-concessional contribution. You need to be less than 71-years-old, earn less than \$37,697 and make a \$1,000 contribution to receive the full \$500.

Low income earners also get a break on the 15% tax applied to concessional contributions. The Government will apply a **low income super tax offset** of up to \$500 to your super account if you earn less than \$37,000, so it might be worthwhile contributing extra and claiming a tax deduction.

If your spouse isn't earning much, you might want to give their super a boost. If your spouse earns below \$37,000, you can claim a **spouse contributions tax offset** of up to \$540 when you contribute \$3,000 to their super. They must be under age 65, but if they're 57 or older they can't be retired.

If you've made personal contributions that you intend claiming a tax deduction for, don't forget to lodge your **Notice of Intent to Claim a Deduction form** with your super fund. You must receive an acknowledgement

letter back from your super fund before you lodge your tax return, or before the end of the financial year following the year in which you made the contribution (whichever comes first). Without the acknowledgement letter, you can't claim the deduction.

How to fund contributions? Perhaps you have spare cash, or think about selling or in-specie transferring assets held in your own name (subject to capital gains tax considerations, see below.)

### **Bring forward expenses and defer income**

If you think you might earn less next year, or simply to have a bigger refund, you could bring forward tax deductible expenses and deferring assessable income.

Generally, you can **pre-pay up to 12 months of expenses** such as interest on an investment loan. This applies to deductible work-related expenses like insurance premiums for income protection policies too. If you're planning on buying a new work-related tool (e.g. adding to your professional library or tools of trade), it's immediately deductible if it costs less than \$300.

If you've realised a capital gain during the year, you might want to consider bringing forward the disposal of an asset carrying a **capital loss to offset capital gains**. Just be careful not to get caught out in a 'wash sale' (where you sell shares to crystallise a loss and then buy them back shortly thereafter) as the ATO considers that a tax avoidance scheme and will cancel the benefit. The exception is if you in-specie transfer the shares into your SMSF, as the primary motivation is providing for your retirement.

Deferring income can be problematic, but worth considering if you are certain that you'll earn less next financial year. A standout strategy is where you are retiring, and you ask your employer to **defer your retirement until an agreed date in July**. Your Employment Termination Payment will be subject to tax at the lower marginal rates (provided you won't have any other sources of income next financial year) and if you're 65, you have the opportunity to meet the 40 hours in 30 days 'work test' that ensures you're eligible to contribute to super for the rest of that financial year.

While it's generally too late to enter into a **salary sacrifice arrangement** for employment income earned in the current financial year, you should review your future arrangements for the coming 2019/2020 financial year.

Make sure that any salary sacrifice arrangements for extra concessional contributions to super are not breaching the contribution caps, resulting in paying extra tax. You should also review those arrangements when you have a change in salary.

### **Lastly, get your administration in order!**

SMSF trustees, please ensure that you **meet your minimum pension payment** requirements, and place your paper work in good order.

*Michelle Bromley is Director and Private Client Adviser at [Prime Financial](#). This article is general information and does not consider the circumstances of any individual.*

## **Facebook, Google need smart self-regulation**

Annabelle Miller

*"Don't be evil." Googlers generally apply those words to how we serve our users. But "Don't be Evil" is much more than that. Yes, it's about providing our users unbiased access to information, focusing on their needs and giving them the best products and services that we can. But it's also about doing the right thing more generally – following the law, acting honourably, and treating co-workers with courtesy and respect."*

– [Google Code of Conduct until 2015](#)

*"Move fast and break things. Unless you are breaking stuff, you are not moving fast enough."*

– [Facebook motto until 2014](#)

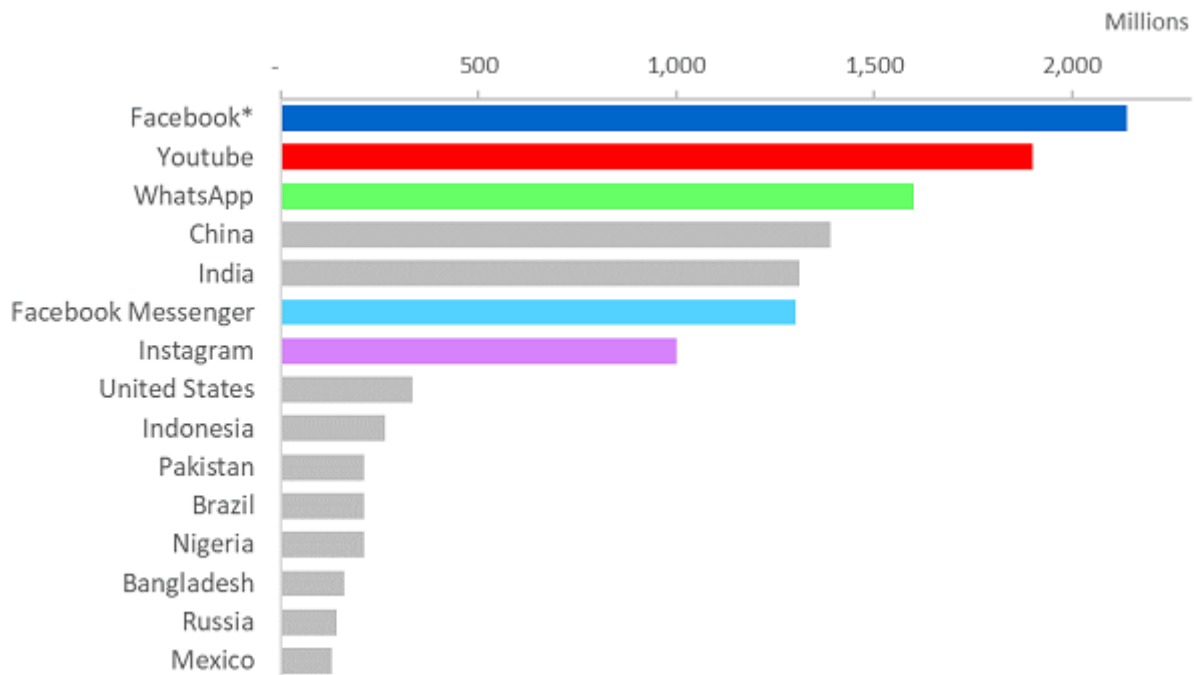
These are the two cultural mottos that underpinned Google’s (Alphabet’s largest subsidiary) and Facebook’s building of giant businesses that, through their global duopoly in digital advertising, have significant impacts on the passage of information globally, producing economic, social and political power.

Google has 92% [market share in search](#) across all platforms. Facebook has about 75% [market share across mobile social media](#). This concentration of market power has meant that these two businesses accounted for close to 90% of the growth in digital advertising in 2018.

**If Facebook were a country ...**

The power of these business models lies in the network effects generated from daily user bases greater than one billion people. In fact, if Facebook users were gathered in a single country it would be the most populous in the world, given its 2.38 billion monthly active users. The more users engaging with the site, the more data they collect, the more value users are to a potential advertiser. Scale begets scale.

**Number of ‘monthly active users’ and size of countries by population**



Source: User data from [statista.com](#). Country data from [census.gov](#). Adjusted for ~10% of users that have multiple accounts.

They have become necessary social utilities. Some users called emergency services when [Facebook recently went down](#).

As investors we have cheered. We have been beneficiaries of the tremendous earnings power in these businesses by nature of the concentrated industry structure, enabling them to earn monopoly-type rents. Operating margins are in excess of 25% for the core Google business and 40% for Facebook.

**Finding an economic and societal balance**

As stewards of client capital, we view Google and Facebook as excellent franchises that have the ability to earn an above average return on capital over the long term. However, we must balance that with the economic and societal sustainability of how they earn their returns. From a market perspective, for example, there is some history of using antitrust laws in the US of breaking up powerful corporates – see AT&T and the Baby Bells in telecommunications and Standard Oil in the early 20<sup>th</sup> century.

These do not just include direct financial and valuation risks, but societal and industry-related trends and associated risks. We have to be wary of any future limitations that may be placed on these companies’ social licenses to operate, and therefore commensurate effects on valuations. In the trading session after the announcement that the Cambridge Analytica scandal had prompted slowing user growth (along with

introduction of new European Union data protection legislation) [FB's share price fell 19%](#). Notwithstanding this, in CY2018 total revenue rose 37% versus 2017.

Some issues relating to possible market failures are covered in an excellent book, [The Myth of Capitalism](#) by Jonathan Tepper and Denise Hearn. In it we learn about US Senator John Sherman, who in 1890 had a simple approach to market power:

*"If we will not endure a king as a political power, we should not endure a king over the production, transportation, and sale of any of the necessities of life."*  
– Senator John Sherman

His approach led to the subsequent creation of the Sherman Act in the 1890s and sowed the seeds for the creation of the Clayton Antitrust Act and the Federal Trade Commission. These acts were described by Justice Thurgood Marshall, in a landmark judgement, as a form of Magna Carta for free enterprise:

*"They are as important to the preservation of economic freedom and our free-enterprise system as the Bill of Rights is to the protection of our fundamental personal freedoms. And the freedom guaranteed each and every business, no matter how small, is the freedom to compete – to assert with vigor, imagination, devotion, and ingenuity whatever economic muscle it can muster."*

Google has been [fined twice](#) by the European Commission for anti-competitive practices. Similarly, Facebook expects to be fined up to \$US5 billion by the US Federal Trade Commission for [breaching privacy violations](#).

### **Protection versus innovation**

There remains considerable debate about how to best protect the consumer, promote competition but also enable these businesses to continue to innovate longer-term. The chorus of critics across regulatory and political (rather than economic) spheres argue for the need to break up the tech giants in order to reduce their market power. But they miss the bigger issues.

Yes, it would reduce the *market* power of Google and Facebook, but it would not solve other issues confronted by Google and Facebook like the spread of abusive content on YouTube or the use of WhatsApp to propagate radicalism.

As shareholders we prefer management and regulatory bodies to work together, producing a solution that preserves companies like Google's and Facebook's innovative engine, underpinned, as Justice Marshall put it, by vigour, imagination, devotion, and ingenuity. This will produce better products and services and also protect their social license to operate without significant and financially painful government intervention.

Following the terrorist attacks in Christchurch Microsoft, Twitter, Facebook, Google and Amazon released a [joint statement](#) affirming their commitment to screening content that fuels hatred and extremism on their platforms. This agreement states five individual actions around terms of use, user reporting, technology, livestreaming and transparency reports. This is an encouraging step in forging a path of self-regulation by these companies, likely producing better long-term outcomes for users, society and shareholders and helping head off government fixes.

While Facebook's and Google's current outlook remains strong and we are happy to hold them, we remain vigilant about the economic, social and political implications of their market positions.

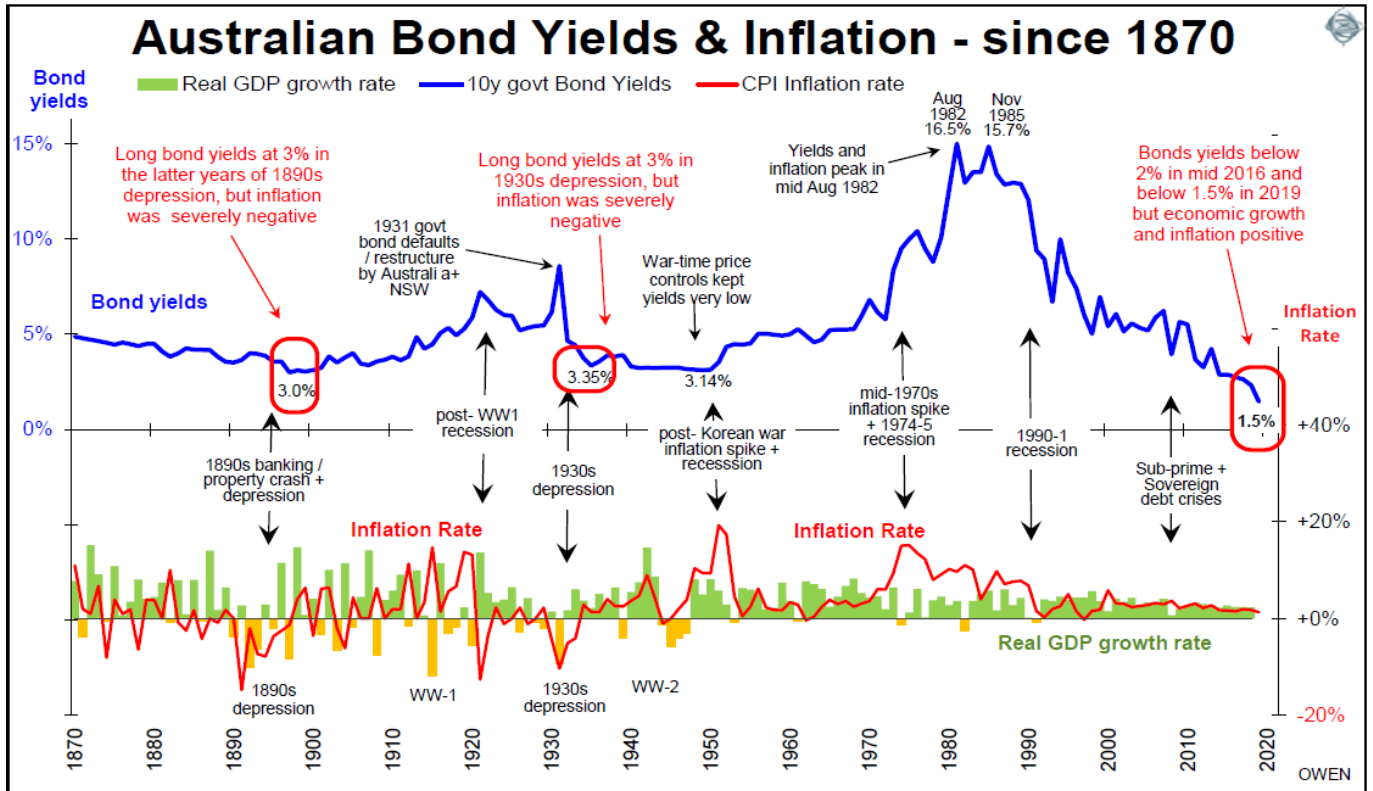
*Annabelle Miller is an Investment Analyst with [PM Capital](#). This article is general information and does not consider the circumstances of any individual.*

## **Why are Aussie bond yields at lowest ever?**

Ashley Owen

Yields on Australian government bonds have continued falling this year. At the end of May 2019, the 10-year bond dipped below 1.5%, the lowest in history. Yields on 10-year government bonds peaked at an incredible 16.5% in mid-August 1982 and have been declining (along with inflation rates) ever since.

The chart shows bond yields, inflation and economic growth rates in Australia since 1870.



**What do low bond yields tell us?**

As bond yields represent the market’s collective view on the outlook for economic growth and inflation, the current ultra-low yields are extremely pessimistic. Yields are now lower than in the depths of the 1890s depression and the 1930s depression, when economic growth and inflation rates were deeply negative.

But since economic growth and inflation are positive now, why are yields so low?

At first sight, it appears that the current all-time low yields are a sign that ‘the market’ is expecting worse outlooks for growth and inflation than in the 1890s depression and the 1930s depression. However this is misleading. Prior to the 1990s Australia was regarded as a high risk ‘emerging market’ and so yields on bonds were higher to reflect a higher risk of default. Indeed the Commonwealth government defaulted on its entire stock of domestic bonds in 1931 (having taken over responsibility for the State debts, and in particular the defaulting NSW). Australia only regained respectability in international credit markets after the long post-WW2 boom which allowed the debt to be repaid, and after the reforms in the 1980s including dismantling tariff barriers, privatisation, deregulation, and floating the dollar.

Australia’s good standing in credit markets now partially explains the lower overall level of yields in the past few years compared to the prior 100 years.

**But yields are too low**

Even allowing for this change in status of Australia as a credit-worthy borrower, the current yields are still far too low. Australia may be heading for a local slowdown and possibly recession in the coming year or so, but the current yields are suggesting we should expect virtually zero growth and inflation for the next decade. This is far too pessimistic for a country with the fastest growing population, the most favourable demographics, the lowest government debt levels in the developed world, strong public institutions and a stable government.

The main reason for the low yields is that most Australian government bonds are owned by foreigners scouring the world for yield, and Australia is one of the very few countries left with a ‘AAA’ credit rating. Australian yields may be low relative to our history, but they are still higher than many other countries.

Japanese and German yields are still negative thanks to years of massive central bank ‘quantitative easing’ bond-buying programmes. UK yields are not far above zero, and French and Spanish bonds are below 1%. Australian yields are now even lower than in Canada. Canadian yields are being kept relatively high by the close

links to the US, where the economic recovery boosted by the Trump tax cuts has kept US yields above 2% since their post-Brexit lows in 2016.

What does this mean for investors? Although we believe Australian yields will rise in the medium term, we have significant allocations to Australian bonds in portfolios as we had been expecting yields to fall in the short term. The declining yields generated above-average returns of around 6% for 2019 to date (and they beat shares by 8% in 2018). Not bad for boring old bonds in a so-called 'low return world'.

*Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown](#) and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.*

## Turning up the heat on our energy problems

Michel Debs

Energy prices. The environment. Climate change. Saving the planet. These issues seem to be increasingly topical, but many of the discussions are not grounded in fact. Let's look at the current state of play in energy usage in Australia and consider the path forward.

### Australians do not use energy sustainably

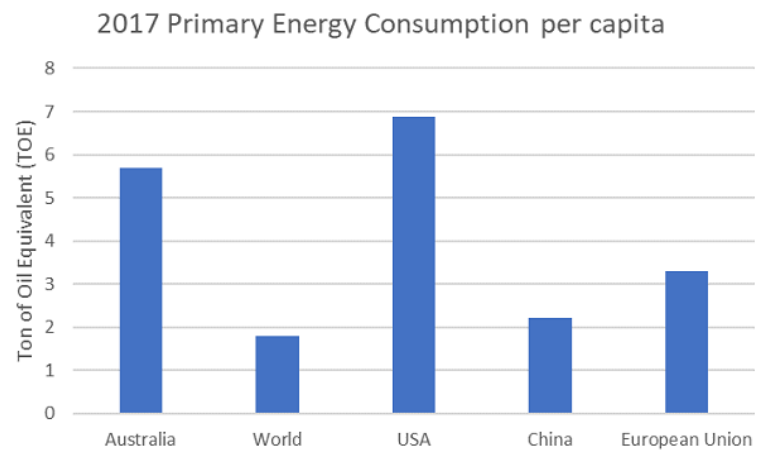
Each Australian annually uses energy corresponding to 5.7 tonnes of oil. This is in the same range as the US (6.9 tonnes) but much more than the rest of the world including China and Europe. There is a lot of room for Australians to use less energy with more efficient materials and machines or making lifestyle changes.

Australians rely on fossil fuel for about 94% of their total energy needs. The only countries that rely more on fossil fuel are either oil producers (such as countries in the Middle East, North Africa, or the former Soviet Bloc), coal producers (such as Poland) or countries with limited resources (such as Trinidad).

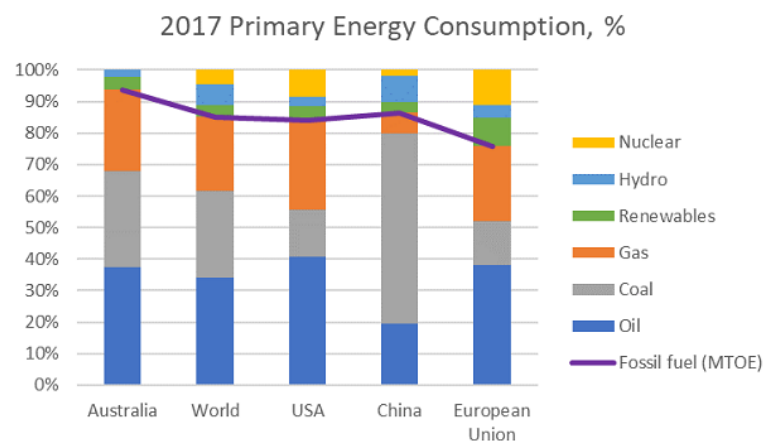
Comparing Australia to other large economies, we rely more on fossil fuel than oil, gas and coal producers (such as the US, China) and materially more than countries that have made fighting climate change a priority (such as those in the EU).

The consequence of this intensive use of fossil fuel is that Australia, with less than 25 million inhabitants, emits about 400 million tonnes of CO2 annually.

This is comparable to what is emitted by the 66 million residents of the United Kingdom (410 million tonnes) or the 80 million residents of Turkey (398 million tonnes).



Source: BP and the UN



Source: BP

Looking at per capita emissions, each Australian emits about 16 tonnes of CO<sub>2</sub> every year. That is about four times as much as the world average and two and a half times as much as developed economies in Europe.

**Political intervention triggered by higher bills**

Coal is the king of Australian power production with a 61% share of the mix. The only countries that rely more on coal are South Africa, Poland, China, India and Kazakhstan. Australia’s use of wind and solar is comparable to the rest of the world but it has very limited hydropower. As a result, Australia relies on fossil fuels produced locally for about 85% of its power production.

Australia is the world’s top liquified natural gas (LNG) exporter and the world’s top coal exporter. It exports more than two-thirds of its gas and about 85 per cent of its coal.

There is limited appetite for additional coal-fired power plants due to the amount of pollution they produce and gas plants are hurt by the cost of gas.

Australian gas is becoming more expensive as recently-built assets are geared to export, and Australians have the unpalatable choice to either compete with Asian buyers or source gas from ageing fields whose operating costs increases year after year.

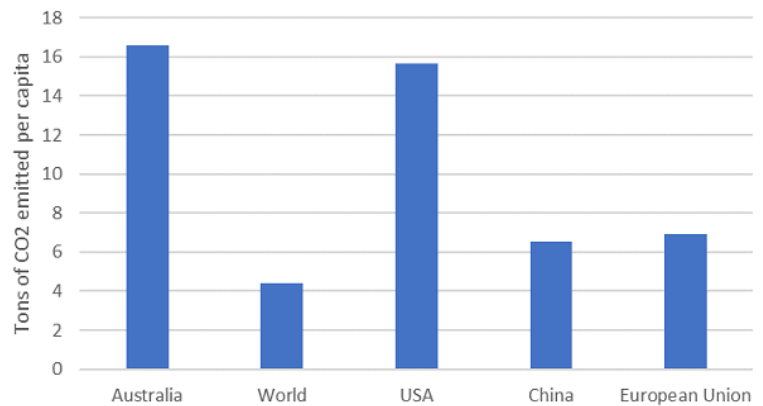
Renewable energy has helped reduce the dependency on coal and gas in other countries. Investment in wind and solar is supported across Australia by subsidies, at both the federal and state level. Most of those subsidies are funded by customers, rather than general taxation.

Today, renewable subsidies represent 4% to 8% of the typical consumer bill. This varies by state depending on the growth of renewables and the layer of support given besides federal programs.

The rise in coal and gas prices, and to a lesser extent the bill surcharges to fund renewables, have added to the combined power and gas bills. In aggregate, Australians of median income now pay about 4.8% of disposable income for power and gas, whereas they only paid 4.4% in 2016.

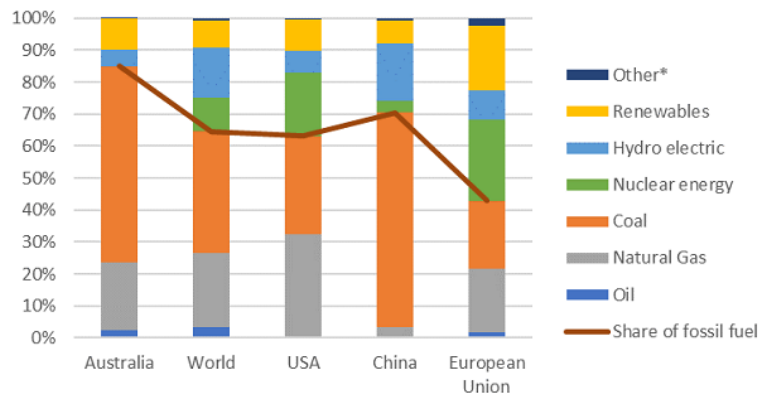
As for lower income households, they now pay about 10.6% of their disposable income for power and gas, whereas two years ago they paid 9.6%. These increases would have been higher if the allowed return for power and gas networks had not been cut by the regulator.

2017 CO<sub>2</sub> emissions per capita



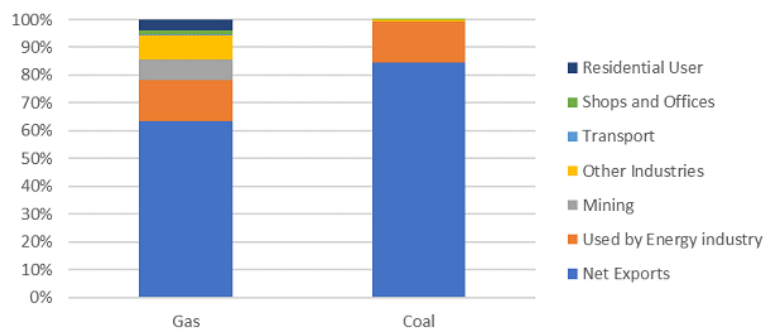
Source: BP and The UN

2017 Power production, %



Source: BP

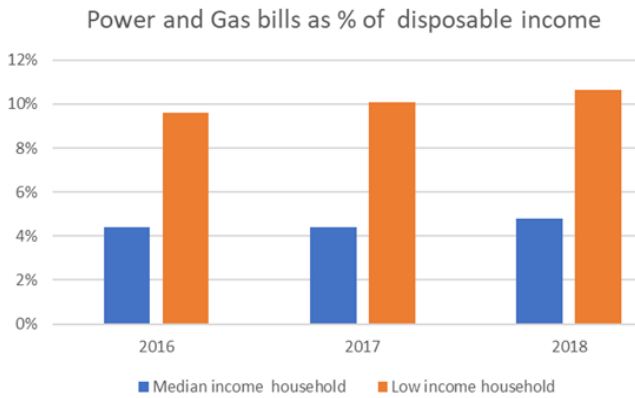
Where Australian production goes



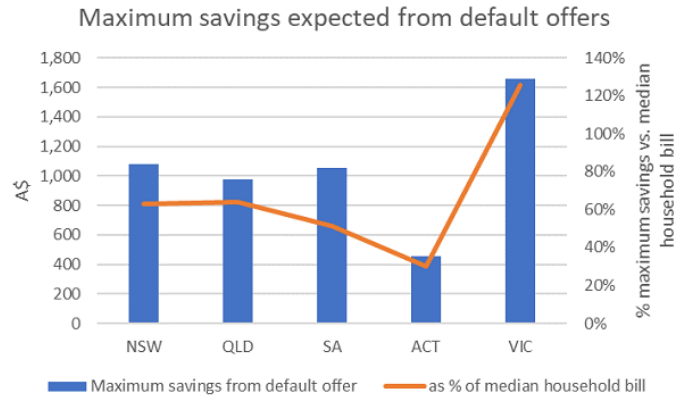
Source: ABS

The pressure on disposable income is also faced by industrial companies, triggering the following political and regulatory interventions:

- Regulators are forcing greater transparency on networks, and besides cutting allowed returns have generally toughened regulation, and
- From July 2019, Australians will benefit from automatic switching to a 'default offer' regulated by the Australian Energy Regulator. Customers on expensive tariffs will automatically be switched to this lower offer. For people on the higher tariffs, this could save hundreds of dollars.



Source: Australian Energy Regulator



Source: Australian Energy Regulator and Canstar Blue

### The way forward: the cheapest and cleanest energy is that which you do not use

AMP Capital has decades of experience investing globally in power and gas assets. As long-term investors, we are called upon to fund new investments or support companies during times of transition. In our experience, energy policy has the following pillars:

- **Safety of supply:** the nation has access to energy, and if possible is domestic or from friendly countries;
- **Affordability:** residents and business only need a modest share of their income to pay their bills; and
- **Environment:** environmental damage is avoided or remediated.

These three objectives each cost money and are often divergent (for instance, coal is great for safety of supply and affordability, but is a high pollutant). This means that energy policy is about priorities and investment.

In Australia, the introduction of renewables can help in two ways:

1. If the renewables are commercially contracted over the long term, it will reduce Australia's dependency on coal and gas, and thus reduce the exposure of ordinary Australians to fluctuations in international energy markets.
2. As renewables are intermittent (the strength of the wind and sunshine changes during the day), they need to be backed up by power plants that can react quickly. These so-called peak plants do not need to be built – Australia can, for a limited amount, convert and subsidise existing assets that are largely amortised. This would help ensure safety of supply and protect jobs in those plants.

However we believe the real way forward is for Australia to commit to the cheapest, safest and cleanest form of energy: the energy that is not used. Australia should invest much more in energy efficiency and thus cut bills and pollution materially.

While there are upfront costs (upgrading buildings, replacing vehicles, changing machinery) the long-term savings offer a return and the short-term effort creates and supports many jobs and can dramatically improve the living conditions of the less fortunate Australians.

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## 4 reasons why cash is a core portfolio allocation

Matthew Lemke

Cash has often been a source of confusion for investors. Some people do not consider it an investment class in its own right but more as a 'balancing' or 'residual' item after all other investments have been made. However, there are compelling reasons why cash should be considered a *core* portfolio allocation item.

Investors who see holding cash as a missed opportunity in other investments may deliberately minimise the allocation. In poor markets, this mentality creates problems, because cash cannot fulfill its role to support the portfolio and act as a bastion of certainty.

To understand cash's true value, investments should be measured on a risk-adjusted basis, which puts the cash return in a much more favourable light.

There are four interconnected reasons why all investors should consider cash as core.

### 1. A new dimension of uncertainty and volatility has entered markets

Markets are now more prone to moves that are extremely difficult to anticipate or forecast. Price discontinuity and volatility is partly due to four dynamics at play in markets:

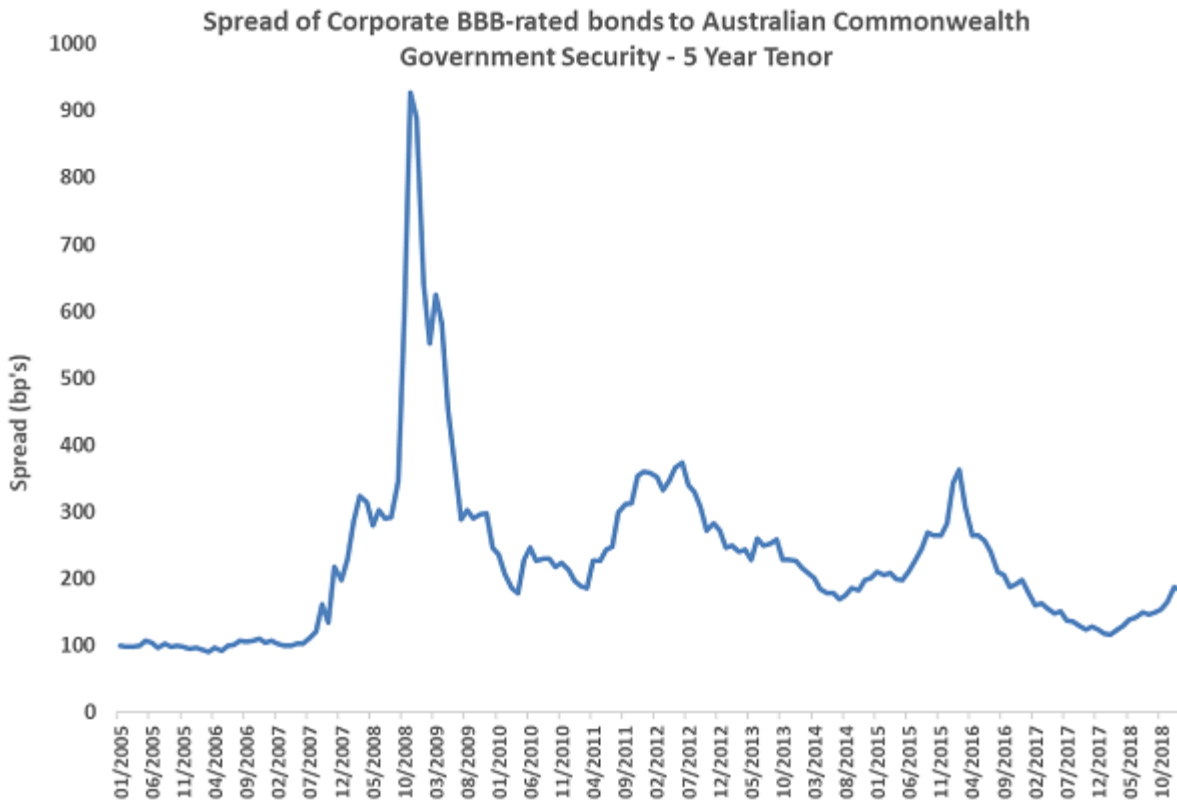
- **Globalisation:** Financial markets are now more influenced by the financial and trade interconnections. These markets are continuously being affected by factors operating in other parts of the world. For example, China has evolved quickly in recent years as the number two economy in the world with a profound economic influence in our region. Our economic and financial models need recalibration but we simply have not had enough time to understand China's influence on global trends or Australian financial markets with much precision.
- **Changes in the political and geopolitical spheres:** New forces and trends are emerging with direct flow-through effects to the way markets behave, including the way government finances and central bank monetary settings are managed. Two examples are: first, the emergence of 'populism' with new reactive politics from both the left and the right sides; and secondly, demographic and cross-generational trends where baby boomers vie with the millennials in an economic and wealth battle. This will accelerate as the baby boomers move into retirement and the sheer number of millennials and the older Gen X out-vote the baby boomers.
- **Growth of large institutions and their use of algorithms:** The use of complex, 'opaque', mathematics-based algorithms by large funds means markets can move indiscriminately, quickly, and even violently if certain market price levels are reached. Algorithms can be 'correlation-based' whereby price levels in several markets need to be simultaneously breached before trading action is invoked. Price movement may trigger further algorithm-based trading. The volume of trading potentially released can overwhelm markets and cause significant dislocation.
- **Uncertainty and illiquidity:** Price volatility increasingly occurs in unpredicted 'jumps' and is a major source of illiquidity and even severe dysfunctionality in markets. Illiquidity exacerbates problems for investors looking to exit securities and needs to be assessed in any investment model.

Potential illiquidity and uncertainty can be risk-managed via a designated percentage of portfolio assets in cash, with the percentage in cash increasing if there is a perceived risk to these price jumps. This cash component needs to be considered a core volatility and uncertainty management tool.

### 2. Cash is both certain and available

Being certain and available provides real value to a portfolio, yet these attributes are often not measured or given their true importance in risk-adjusted returns. All markets trade essentially as a premium to the risk-free government rate. The premium reflects the extra return required to hold an investment, to compensate for the additional risk. This extra return or premium is seen in capital asset pricing models, which calculate the cost or return on capital deployed, by reference to a premium to the risk-free government rate.

The chart below shows one measure of risk premium, being the premium of five-year bonds issued by BBB-rated companies over the Australian Government bond yield, as compiled by the Reserve Bank of Australia. It shows how the spread was bid very low pre-GFC, spiked violently during GFC, and now has settled back to again to a low level.



Premia are low currently because of the long rally in equities and bonds. While still low in property markets, premia are higher now than in 2018. Premia are also low due to structurally-low inflation and interest rates, which means investors have been prepared to bid up the prices of risk-assets to abnormally high levels.

### 3. Equity markets can turn quickly

Equity markets are reasonably buoyant at the moment, but can turn quickly, making cash (and liquidity) important. Cash returning only 2.0-2.5% may be considered a lame or even unworthy investment, however if the equity market falls 10%, this cash return will look stupendous. Diversification across different markets may not help a portfolio during a significant market fall, as markets often become more correlated during extreme events.

### 4. The emergence of cash-plus and cash-enhanced funds

Cash-plus and cash-enhanced funds allow investors to earn a higher return on a risk-adjusted basis compared to traditional cash investments. This means cash holdings can be 'put to work' more effectively and earn a decent return. Again, applying the risk-adjusted return methodology, these funds generally contain more risk than traditional cash at bank, hence they may allocate only a portion of their 'cash' to the cash-plus fund sector.

#### Cash can be king

'Cash is king' is often the plaintive cry when markets have already moved. While cash may not always be king, it should not be relegated in status to the 'poor cousin' especially in today's markets with new dimensions and sources of price volatility. Cash holdings should be held as a legitimate, wise and prudent form of ballast in a diversified investment portfolio. Cash-plus and cash-enhanced funds provide a ready way for funds to enhance other traditional forms of cash investments.

*Matthew Lemke is the Fund Manager of the [Prime Value Cash Plus Fund](#). Matthew has worked in the securities market for over 35 years. This article is for educational purposes and is not a substitute for tailored financial advice.*

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## Where to now for adequate investment returns?

Philipp Hofflin

US economist Frank Knight was the first to draw a distinction between 'risk' and 'uncertainty' in his 1921 book, *'Risk, Uncertainty, and Profit'*.

Risk is what many investors in portfolio construction address, using statistics like expected mean returns, standard deviations and cross-asset correlations.

Uncertainty, according to Knight, is when you simply do not know what could happen, when even the basic parameters are unknown.

The impact of new technology in retailing, for example, is not just a risk for the retail property industry, but fundamental uncertainty. In the same way, the fact that global monetary policy is in uncharted waters means that the problem investors face is not just risk, but uncertainty.

Furthermore, risk models may not work if the environment in the future is fundamentally different to the recent past. Therefore, uncertainty and backward-looking risk models in a changing environment are both critical today.

### **Today's main 'uncertainty' problem is extreme low rates**

Our starting position is unusual and extreme. Balance sheet recessions in the Northern Hemisphere have resulted in the lowest rates in recorded history in the United States, Japan, the Euro zone, and the United Kingdom in this cycle. These extraordinary rates are the result of balance sheet recessions that followed debt-fuelled property booms.

Given that Australia's residential prices peaked higher than those in the United States, Euro zone and United Kingdom and that Australia's household debt is higher than household debt in those countries, Australia may also experience a balance sheet recession. Under that scenario, rates will move even lower than they are now, despite the cash rate reduction to 1.25% this week.

There is also the opposite (and recently forgotten) risk of inflation. All of these northern countries have engaged in non-standard monetary theory, such as quantitative easing. In the United States, there is also late-cycle fiscal stimulus and speculation about Modern Monetary Theory (MMT), a new acronym for an old idea: the government printing money to spend it.

The established theory in the 1970s, 1980s, and 1990s was that a combination of large government deficits and money printing was the best way to generate high inflation. Yet the example of Japan, where despite extraordinary fiscal and monetary stimulus, inflation has still not emerged, means that MMT is no longer viewed as the best theory of inflation.

In fact, today, we do not have one agreed theory of inflation, which is why some government officials advocate experiments like MMT. The risk is, of course, that there is no such thing as a free lunch, and that if you print money to spend it, inflation eventually arrives and presents the bill.

### **Portfolio implications and will bonds defend?**

In a world of risk and uncertainty, where can investors go to generate adequate returns?

In recent years, bonds have proved to be a successful hedge to falling equity markets, but this is not always the case.

During the GFC, the 1990 recession and the 1987 stock market crash, bonds provided decent off-setting diversification. When the equity market lost a third its value, the bond market, as represented by the 10-year Australian bond delivered about 19%.

But before the great bond bull market that started in 1983, things were different. In the late 1960s, in 1974 and in the 1980 market downturns, equity markets lost about a third of their value, but bonds lost around 14% of capital value and also recorded a negative total return (see table). Given the starting point, the last 35 years may not be the best guide to the future.

The second concern is that from the current starting point of the Australian 10-year bond yield of 1.53%, (as at 29 May 2019), the gains from bonds will be mathematically limited, considering the yield is already near historic lows.

**Today’s problem: bonds do not always play defense**

Period	All Ords Total Return	10Y Bond Capital Change	10Y Bond Total Return
<b>Equity Bear Markets</b>			
GFC, 1990 Recession, 1987 Crash - Average	-36.9%	8.5%	18.6%
1980/82, 1974, Poseidon Bear - Average	-36.0%	-14.2%	-1.5%
<b>Bond Bear Markets</b>			
1994, 1973, 1978/81 - Average	19.1%	-24.6%	-13.7%

Source: FactSet, MSCI, Standard & Poors.

Today, the experiences of the last 35 years may not be relevant, with economic models calibrated with decades of past experience perhaps falling into the same trap that caught those valuing mortgage backed securities in 2007.

**Think outside the box**

If the outlook for bonds is uncertain, asset allocators may have a major problem. Modern asset allocation frameworks are often built on the premise that bonds will act as the defensive part of the portfolio.

Indeed, certain asset allocators may need to re-think their entire portfolio. Equities will have to play a role for the equity yield and the long-term growth. They offer income and inflation protection. However, the benefits come with risks, and some investors may need to think more about their equity exposure and their defensive properties if trouble strikes.

The lesson is that even the growth portion of a portfolio may need to offer defensive properties.

**Uncertainty not risk**

Risk is often measured on backward looking statistical measures, but this may not offer a guide to the future. The behavior of an asset class at some time in the past, does not mean that it will always behave that way.

In our view, equities are needed for inflation protection and income, and the risk of capital loss from owning equities can be limited by focusing on valuation and more defensive (sustainable yield) equities, given that cash (and not bonds) is the only perfect defensive asset.

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