Firstlinks
Connecting investors with ideas

Edition 330, 1 November 2019

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MFS's Carol Geremia on short-termism and time tolerance

Graham Hand

Carol Geremia is President of MFS Investment Management, which manages about US$450 billion with headquarters in Boston, USA. She has worked at MFS for 35 years and has seen many investment cycles play out.

GH: You have written about misalignments in the asset management industry. What is the most important the industry is now facing?

CG: The most obvious one is what active managers say is their main goal - to outperform over a full market cycle – and what the industry has actually anchored around.

The industry focusses around three to five years, more towards three and arguably even one year. We've confirmed this with global studies to check perceptions. But against this, a full market cycle is much closer to seven to 10 years, and now we're in this extended bull market that's going even longer.

GH: It's already over 10 years since the 2009 bottom.

CG: Yes. If you're a long-term active manager, and your purpose, first and foremost, is to put money to work responsibly, to allocate capital responsibly, that is what will create value over time on a long-term asset. But people don't understand the full market cycle of peak to peak or trough to trough. It must include the bull and the bear, it's not just one side. So we've already started off from a place of misalignment.

Active managers have thrown this out the window and said, "Nobody's giving me the time, so let's not even talk about it." That's the most acute misalignment.

GH: And you put the blame on the industry rather than investors?

CG: We try to micromanage the debate but I worry that it translates into a blame game. We haven't had enough aligned conversations on the subject of time. Fund managers are under so much pressure to deliver alpha (*Ed, returns above the index*), that even when everybody's making money, if managers don't generate alpha, it almost feels like they've lost somebody's money. But most haven't even come close.

GH: Yes, with the market up strongly over the last decade, investors have had a good time.

CG: We need some different performance metrics, because outperforming a price momentum biased benchmark all the time is not what investors should pay for.

GH: And focussing only on performance and not on risk.

CG: That's the whole point. At some point, if an investor picks an active manager, they really should watch if they have counter-cyclical skills. Can they go against the grain at the right time? There's a lot of concern now that pro-cyclicality is happening. It's chasing past performance and shorter and shorter periods of time, and that will cost end investors.

GH: And some value managers feel they must chase growth stocks at what is probably the wrong time.

CG: And it becomes this style game, active versus passive and hiring and firing active managers, all at the wrong time. The industry can do better than that.

GH: One of the changes you are making which I like is in the way you set out your performance tables, putting the long-term numbers first. The first column is the 10-year number. In fact, today I saw a presentation where the manager showed their one-month number first.

CG: Putting long term first is not a unique idea, but the beauty of it is not only the measurement itself, it's the opportunity for a dialogue with the client. It leads to a discussion on greater trust, clarity, transparency and understanding. They might ask, "Why are you talking to me about the 10-year number?" And we can say, "Well, even though my one-year number is good, I want us to manage the expectation that the 10-year number is more realistic."

In my career, I came out from the fiduciary world of the 401k business (*Ed, retirement plans in the US*). I ran that for about 20 years at MFS, and we changed our statements to start with the 10-year number in the retirement plans. It helped with client conversations. We realised when we did education sitting with company employees, and said, "Here's a stock, here's a bond, here are your 30 options," it was just confusing for them. So we realised, okay, what can we tell them that really helps? And the most common question was, "How much risk should I take?"

GH: What's the response to that question, whether to a retail investor or institution?

CG: My only answer is, "Tell me how much time you have." We used to call it risk tolerance but it's really time tolerance.

Finishing that point on the statements, we did that in the late 1990s when the market was rocketing up, and we were worried that people were taking too much risk to chase the returns versus realistic long-term expectations.

GH: Within your own company, how do you create the right long-term thinking when people are paid bonuses each year and in all personal lives, everyone has both short-term and long-term needs and goals?

CG: You absolutely must, and it starts with a culture that values a long-term view. And I don't say that lightly and we even say loyalty is important. And when people say, well, in today's world, loyalty might mean complacency, my response is that loyalty at the best firms in the world is probably the number one attribute. It's not complacency. It's the values that having a long-term view is the right thing to do if you're caring for something that's not yours.

So that must be real. You can change remuneration, for example, we don't pay bonuses on one-year numbers. In fact, we pay on the longest track record that somebody has. You must watch the incentive misalignment. You can't expect people to run money with a long view if you drive short-term incentives. And you must run the business that way too, which sometimes means short-term pain. But I do think the culture piece is the hardest. You must believe it.

GH: MFS is an active manager, and in Australia at the moment, including in the media and by the regulators, there's a strong focus on fees rather than net performance or risk. And it's fair to say that the active managers are losing the passive versus active argument in the public domain. How can the active managers fight back?

CG: We have to, but do it in a way that is not self serving. I'm cautious about conversations that involve self reflection. Here's the thing. Over what period of time are you measuring active manager performance? That’s my first question. The good managers deliver over the long term, and we have the data to show it.

But I actually think the comparison is a good thing. The investment industry is managing US$100 trillion globally. That's a lot of money to oversee and a lot of people to serve. I think that the growth of passive is to the benefit to active management, as it will weed out the mediocrity that is in the system right now.

GH: We’re certainly seeing plenty of fund managers leaving the industry.

CG: But the second piece is it will define more clearly why investors pay an active manager and what they are paying for. People pay for quality, but what is quality in the investment business? I know when I buy a quality jacket, I can tell it's been well made. What is it in investing? I say it's responsibility, putting money to work responsibly in this system?

By the way, the public markets are under massive threat. If we don't take care of public markets, the whole system, we've got much bigger problems than passive versus active. We as an industry in active management, if we say we're long term, we must prove it. Conviction is not position, size or concentration. Conviction should be capital commitment to great underlying businesses that will create value for shareholders, and the whole system, communities, employees. The debate is more about shareholder versus stakeholder and the efficiency of capital allocation.

There's a lot of capacity chasing risk right now and active and passive can work together. Investors pay active management a premium to hold corporations accountable with true engagement, way beyond proxy voting.

GH: What types of engagement, other than proxy voting?

CG: There’s tons of it. You embrace understanding the business and its competitive dynamics. You talk to management about what you think they do well or don't do well. You ask them about their long-term strategy. Proxy voting is important but it’s only one piece of the pie.

GH: You've had various roles in MFS over 34 years. Can you identify one good change about the the asset management industry, and one unwelcome change?

CG: The best thing that has happened is the democratisation of investing. As much as we beat each other up, the amount of long-term savings and wealth that has been created is considerable. Now, I'm very sensitive that the distribution of that wealth is quite warped, but investors who did not even know what a stock was in the past now have easy access to invest.

GH: That's the plus, what’s the minus?

CG: The exact flip side of that is the amount of communication, education, responsibility and obligation we need to get this right. To fight against the misalignments that have crept into the system. About 80% of public markets is now owned by institutions, the mutual funds, superannuation funds, pension plans. But 25 years ago, that was 30%. We have this long chain of intermediation which creates agency issues amongst ourselves.

But we're trying to micromanage each other and hold each other accountable so much that we can forget about what it means to the end investor. We have to improve communication because investors are now taking five times the amount of risk to get the same return than they did 15 years ago. We must talk to them about extending the investment horizon and it's not because we want to get paid longer. We are taking risks with their money and they must understand.

GH: Here’s my one macro question. Do you think the massive expansion of central bank balance sheets and injection of trillions of dollars of liquidity will end badly at some stage?

CG: Well, I like to be an optimist, but the market is very distorted. I understand the importance of keeping the economy growing, but at some point, we must come up with a better strategy. I think we can because it's amazing the things that we can do.

GH: If you think about all the trends in the world, such as demographics, climate change, the aging population, technology. Do you think the market is missing a global trend?

CG: There are so many huge disruptions that are impacting everything, ranging from absolutely terrifying to cool and exciting. Technology, innovation, it's endless, we could go on and on. Yet we are missing the biggest thing in our industry, and that's alignment. We need better ways to manage risk and extend our time frames.

Graham Hand is Managing Editor of Firstlinks. [MFS International Australia] is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

MFS has undertaken a two-year exercise internally, instigated by the MFS Board, to identify its own misalignments, including internal and with investors. The Board wanted to see options that ensure fund performance is consistent with how MFS views performance. The case study of its findings is [attached here].

Two big reasons to go global

Joe Magyer

Australian equities have been a star long-term performer -- 27 years without a recession has that effect -- and our local market is ripe with success stories. Australian investors aren't blind to that success either as the latest ASX Investor Study shows a stout 31% of Australian adults hold listed shares.

As great a ride as it has been, though, Australia is far from the only long-term winner for equity investors. In fact, even though the Australian economy punches above its weight, the whole of the Australian equity market only comprises about 2% of the world's list equities.

Australian equity market is sector-specific

You might think that a majority of Australian investors who hold listed shares would be invested overseas as well, given Aussies own exchange-listed investments at a much higher rate than peers like the US (14%), UK (18%), and New Zealand (23%). However, less than 8% of Australian adults (up from 5% in 2014) hold listed overseas shares even though overseas equities make up 98% of the global market.

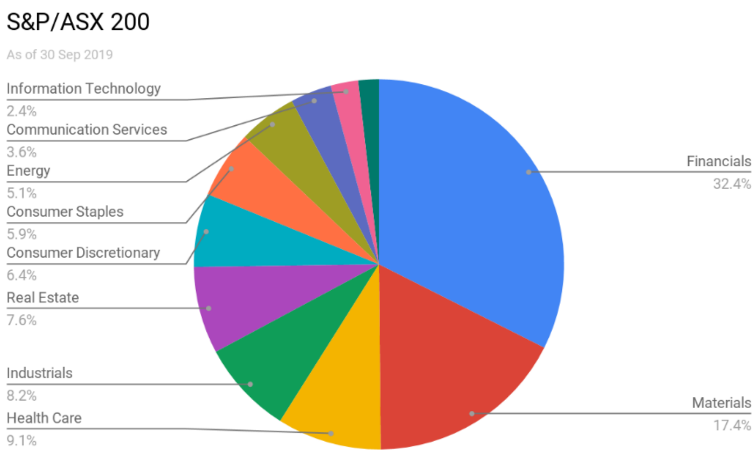
The international investing blindspot costs Australian investors in two big ways.

The **first** is an opportunity cost around world-leading companies. Yes, Australia is home to some global champions, but the vast majority of iconic global companies are not listed here. Visa, Amazon, and Booking, for example, all have big footprints in Australia but are not locally listed. Just the state of California alone has more companies with market capitalisations above US$100 billion (19) than the whole of Australia (5).

The simple reality is that when a market makes up only 1/50th of the world's equity market, the odds of backing a breakout winner in that market get very long (more on that later). The odds get longer still for investors only focused on the big end of town.

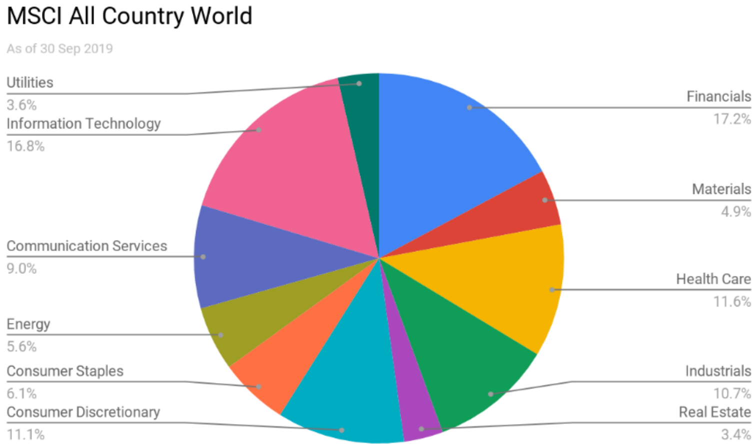
Massive differences in Australia and Global

Consider the sector makeup of Australia's S&P/ASX 200:



A stout 32.4% of the benchmark is in financials, which is mostly comprised of a handful of mature, slow-growing banks. The next largest bucket, materials, does have some winners to point to, namely **Fortescue**, but for the most part materials is a capital-hungry sector known for historically-poor returns on capital.

Now contrast that with the makeup of the MSCI All Country World Index:



Note the huge differences. Materials is more than three times as heavy on the ASX. Information technology (IT) is seven times as large for the MSCI All Country World. We could point to plenty of fabulous IT flops, however, it's also the sector that is home to the world's most disruptive companies and where value can accrue the fastest.

For example, a recent study by Kantar of the world's most valuable brands found that three of the top 10 were IT companies and another four *were* classified as IT until they were reclassified last year as part of a broader reclassification.

The massive gap between the sectors and styles of companies in Australia and offshore leads to a **second** key appeal of investing offshore: diversification.

Unfortunately, far few too many investors are genuinely diversified. The aforementioned ASX Investor Survey notes that 40% of investors say they do not have diversified portfolios while another 46% say they do but only hold an average of 2.7 investment products.

Investing offshore is a direct way to improve a portfolio's diversification. A recent study by Vanguard found that the Australian equity market only has a 0.58 correlation to international equity markets, which provides a lot of diversification bang for the buck. Indeed, the same study found that increasing an international equity allocation to around 60% could reduce average annualised portfolio volatility by around 20%.

A handful of global stock ideas

And so the appeal of global investing is quite clear. What's less clear is how to tackle global investing. The MSCI All Country World Index has more than 2,800 constituents, for example, spanning 23 developed markets and 26 emerging markets. It's a lot of ground to cover for, say, a punter with a day job.

Fortunately, my day job is to sift through those very markets, so in the spirit of helping investors here are a couple of examples of the opportunities available overseas. These aren't recommendations -- do your own due diligence -- but we think they're worth studying.

Let's start with Facebook. What most readers may not realise is that for all the bad press the company has received it is still highly profitable and growing at healthy rates. The number of daily active users on the core Facebook platform grew 8% year on year to 1.6 billion through the second quarter of 2019 with revenue growing 32% in constant currency terms.

The business is also growing strongly outside of the flagship platform -- each of Instagram, WhatsApp, and Messenger has more than 1 billion monthly active users -- and is cashed up with more than 7% of the company's market capitalisation held in net cash. The long spate of fines and bad press aren't behind the company yet and there remains an outside risk the US government might disentangle Facebook's platforms.

However, we think there is a lot to like and the regulatory risk is accounted for given the shares are only selling for around 22 times consensus forward earnings estimates.

An interesting company that would not be on the radar of many Australians is MercadoLibre. The business is listed in the United States, however, it is present in 18 countries and hosts the largest online commerce and payments ecosystem in Latin America. The company has more than 292 million registered users and close to 2 million items are sold on its website each day. The company's eBay-like marketplace has a classic network effect, bringing buyers and sellers together, and is growing at strong rates. We think the payments business is the crown jewel, with the year-on-year growth in total payment transactions accelerating from 64% to 112% in the past year.

The shares are spicy. The valuation is not conventionally cheap, the business is underearning today because it is investing heavily in strengthening its logistics network and broadening the reach of its marketplace and payments networks. Its home country of Argentina is not exactly the classic picture of political stability. Nonetheless, we admire management's willingness to reinvest in the business with a long-term view and think the company, and particularly its payments business, could grow at high rates for a long time to come.

Joe Magyer is the Chief Investment Officer of Lakehouse Capital, a sponsor of Firstlinks. Joe owns shares of Visa, Amazon, Booking, and Facebook, each of which is a holding of the Lakehouse Global Growth Fund. The Lakehouse Global Growth Fund also owns shares of MercadoLibre. This article contains general investment advice only (under AFSL 400691) and has been prepared without taking account of the reader's financial situation.

Lakehouse Capital is a growth-focused, high-conviction boutique seeking long-term, asymmetric opportunities. Lakehouse is the investment manager of the Lakehouse Small Companies Fund and the Lakehouse Global Growth Fund.

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How much super is enough?

Graeme Colley

Okay, so you want a comfortable retirement, which is totally understandable. But do you have any idea of the savings required?

Here's some research from the University of New South Wales: to receive the equivalent of an average wage in retirement, approx. $85,000 p.a. before tax, you'll need to save about 15 to 20 times that amount – $1.3 million to $1.7 million at today's prices.

The Association of Superannuation Funds of Australia has also looked at this question. As opposed to total savings, they focus on income requirements for a 'comfortable' lifestyle, with their current estimates (June quarter 2019) being $43,601 p.a. for a single person and $61,522 for a couple. And if you accept their estimates, then you'd want to avoid relying on social security alone, with the Age Pension currently paying $24,081 p.a. for singles and $36,301 for couples.

What amount do I need to save?

Let's say you are 59 and your partner is 57, and you both intend to receive a 'comfortable' amount in retirement, which is about $61,500 p.a. after tax. At those ages it could be expected that on average you will both live into your mid 80s or later. In addition, it is reasonable to assume that:

- The income you and your partner receive will be indexed in line with the Consumer Price Index (CPI), say 3% per annum. This will be in line with inflation.
- Any pension paid from your super fund is expected to last for your life expectancy and then paid to your partner for their life expectancy. This is increased by five years to consider the likelihood of you living longer.

- The estimated level of income earned on your retirement savings is estimated as 7% per annum which is a long-term rate, net of tax.

While these assumptions may be considered unusual in the current economic environment of low inflation and low interest rates, we are considering a long-term horizon of 40 years or even longer.

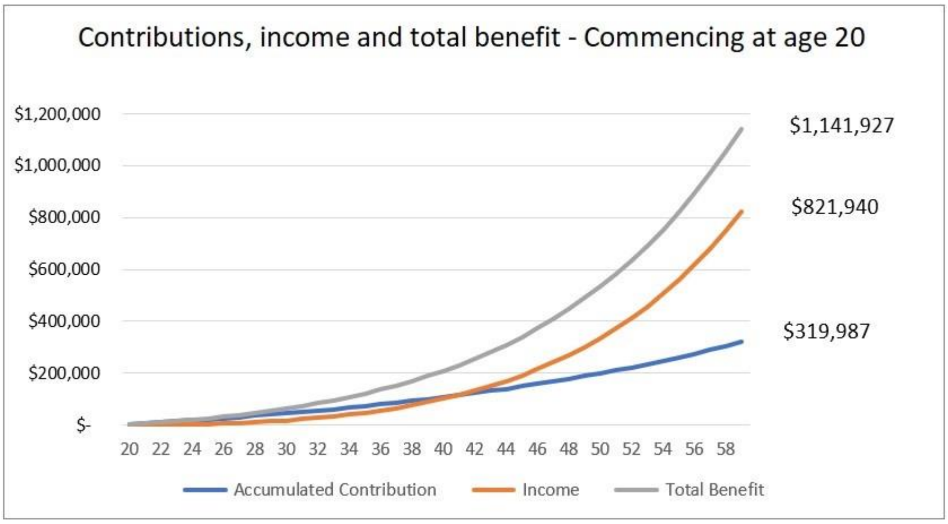
If we use these assumptions, it is estimated that the total amount required in today's money is slightly over $1.141 million.

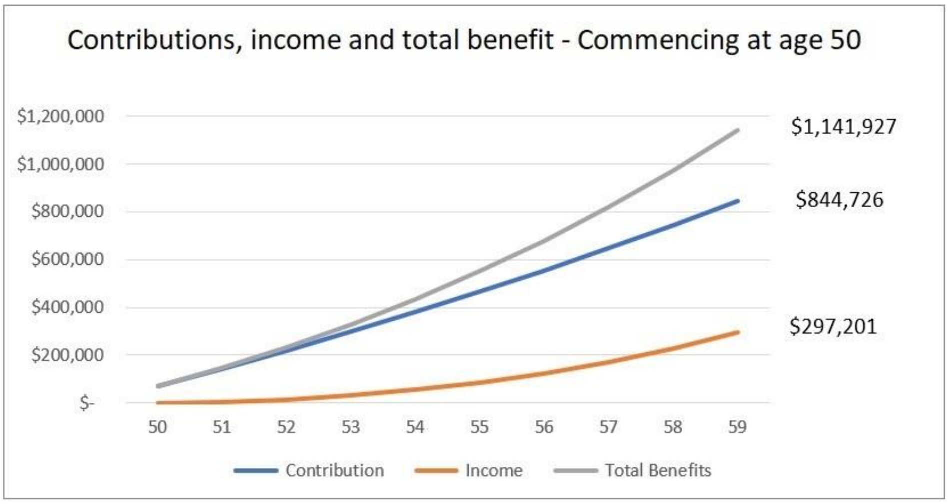
How much do I need to contribute to meet that target?

Having estimated the amount required, we need to work out how it can be accumulated. Important considerations include: how determined you are to save for retirement; the benefit of compound interest and; the age you start saving. Let's look at the difference if you started saving for retirement at 20 compared to 50.

By beginning at age 20 – and to accumulate about $1.141 million – the amount you need to contribute each year starts at about $3,367 p.a. If you begin saving at 50, the equivalent figure is $70,358 p.a.

The advantage of starting at age 20 compared to 50 can be illustrated in the two following tables. These show how much of the final amount accumulated in super will be made up of the contributions themselves and corresponding investment income. Starting at age 20 means a greater proportion of the final benefit will be investment income.





When will the money run out?

The hardest question to answer is 'how long will your super last', which can be influenced by many factors including unforeseen drawdowns, emergencies and market forces. For instance, you may need to withdraw an unexpected lump sum soon after retiring to pay for age care accommodation or other health needs. Or there be significant long-term changes to rates of return on investments, or inflation may nibble away on the value of your super.

It is possible that you or your partner may die earlier than expected, leaving your remaining super to your surviving spouse or other beneficiaries. The amount required to live on and the timing of the payments are not easy to predict.

Assuming a target savings amount of $1.141 million, let's see how long the money would last for based on an expected drawdown of $61,500 p.a. indexed to CPI plus three additional variants:

1. Long-term interest rate drops to 5% p.a., instead of an expected 7% p.a.
2. A lump sum withdrawal of $550,000 is made in the 30th year after retiring
3. A $120,000 lump sum is required in the 10th year after retiring

From this chart we can see that the quickest depletion is caused by a lower-than-expected earnings rate (5% p.a. instead of 7% p.a.), with a nil balance being reached by the 25th year post-retirement.

If $550,000 is drawn down in the 30th year, the amount in superannuation would run out in year 34.

And if $120,000 is withdrawn in year 10, the amount accumulated would last to the 35th year.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at [SuperConcepts](), a sponsor of Firstlinks. This article is for general information purposes only and does not consider any individual's investment objectives. For more articles and papers from SuperConcepts, please click here.

How to include homes in the age pension assets test

Anthony Asher

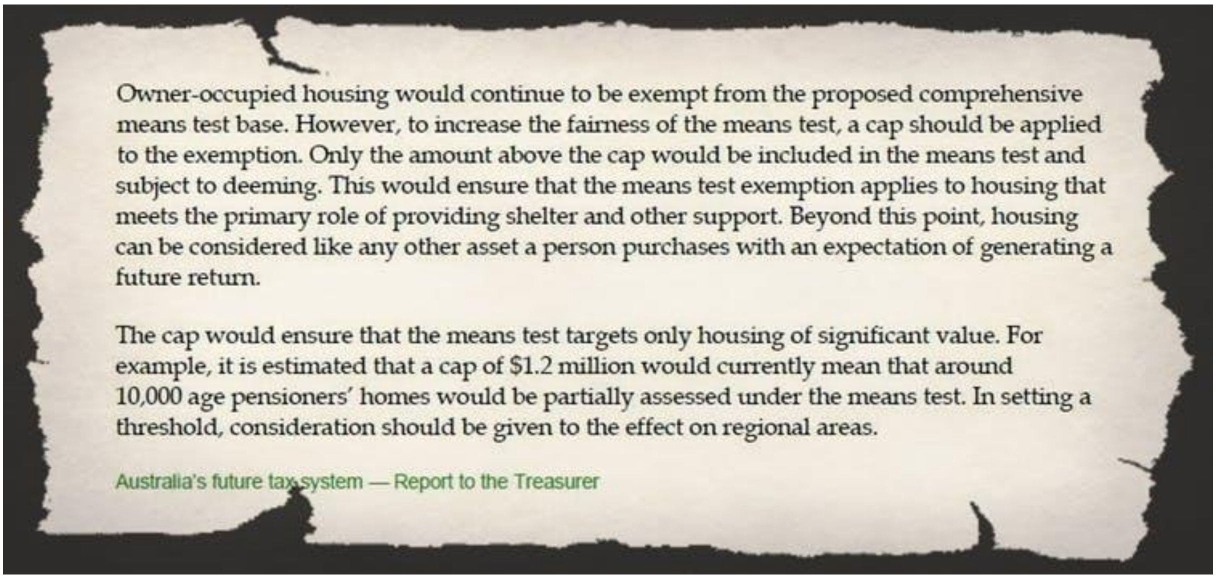
(Following the article by Anthony Asher on possible inclusion of the family home in the pension assets test, a reader who is required to remain anonymous by his employer demonstrates the inequity he feels).

Here's the boldest idea the government's inquiry into retirement incomes should consider but might not: no longer exempting all of the value of each retiree's home from the pension assets test.

The test would merely exempt part of the value of retirees' homes. The change would free-up funds to support other retirees who are struggling because they have to pay rent.

It's an idea with an impressive lineage.

The Henry Tax Review suggested exempting only the first A$1.2 million. The bit above $1.2 million would be regarded as an asset and subject to the test.



Owner-occupied housing would continue to be exempt from the proposed comprehensive means test base. However, to increase the fairness of the means test, a cap should be applied to the exemption. Only the amount above the cap would be included in the means test and subject to deeming. This would ensure that the means test exemption applies to housing that meets the primary role of providing shelter and other support. Beyond this point, housing can be considered like any other asset a person purchases with an expectation of generating a future return.

The cap would ensure that the means test targets only housing of significant value. For example, it is estimated that a cap of $1.2 million would currently mean that around 10,000 age pensioners' homes would be partially assessed under the means test. In setting a threshold, consideration should be given to the effect on regional areas.

Australia's future tax system — Report to the Treasurer

Henry Tax Review

The review said it would hit only 10,000 retirees. The $1.2 million figure was in 2009 dollars, meaning that if the change came in today the review would want it to cut in at a higher dollar figure.

The Grattan Institute suggests a lower cut in at $500,000. The first $500,000 of each mortgaged home would remain exempt from the pension assets test, the part above $500,000 would be regarded as an asset. Grattan says it would save the budget $1 to $2 billion a year.

The Australian Chamber of Commerce and Industry agrees, as does the Actuaries Institute.

The idea scares homeowners

Who could object?

The Combined Pensioners and Superannuants Association says asset testing the family home would be "massively unfair", targeting the vulnerable. But people with high-value mortgage-free homes aren't normally thought of as vulnerable.

Labor's treasury spokesman Jim Chalmers says it would push more retirees "off the pension, out of their homes, or both". He is right about the former, but wrong to think the retirees who suffered a cut in their pension or lost their pension would be badly off.

The worst off retirees, as recognised by a Senate Committee, are those without homes making do with grossly inadequate rental assistance.

Right now it is possible for a single person owning a $1.3 million mortgage-free home and $260,000 of other assets to get the full age pension.

Assuming that person draws down on those other assets at the rate of 5% per year, he or she can spend $37,000 per year and pay no rent.

Yet homeowners do well

A non home owner with $785,000, or half the assets, would be denied the pension. Like the much-richer homeowner, that person would be able to draw an income of about $37,000 per year, but half it will have to go on rent.

It's hardly fair. It encourages retirees with homes to stash more and more of their assets into them in order to get the pension (and pass something valuable on to their children). Retirees with lesser assets miss out and have to rent.

But fairness is in the eye of the beholder. The problem is that a ceiling on exemption from the assets test that seems fair in one part of Australia might not seem fair in another where home prices and perhaps the cost of living is higher.

Our suggestion could be sold as fair

In order to make more equal treatment seem fair to all retirees with homes I and fellow actuary Colin Grenfell have worked up an option that would use the median (typical) price for each postcode as the cut off point for exemption from the assets test.

It would happen postcode by postcode, updated every year using council valuations and as the median prices changed. Only the owners of homes who values were atypical for the area would be affected, and only that part of the value of their home that was atypical would be included in the assets test.

Its key selling point is that it wouldn't threaten homeowners with values at and below the average for their area.

The funds freed could increase the overall pension, but would probably be better applied to lifting rent assistance.

It's important to treat retirees in the same financial circumstances the same, regardless of whether they own a mortgage-free home, and fewer and fewer retirees are owning mortgage-free homes.

It would have the added benefit of reducing the pressure on our parents and grandparents to own houses with bedrooms on the first floor that are never opened, not until they die and their houses are sold.

Anthony Asher is Associate Professor at University of New South Wales. This article is republished from The Conversation under a Creative Commons license. Here is the original article.

(The following note from a reader is published on condition his identity remains confidential. He has identified himself to us and explained why he must remain anonymous).

Hi Graham

It's frustrating the retirement review can't consider recognising the family home for the age pension.

My friend and I have a retirement plan of living in neighbouring townhouses. With our wives, we'll have a very convenient support and social network, especially as we age further and mobility issues set in or we can no longer drive.

When we get to age 67, we're estimating, in today's dollars, that his townhouse will be worth around $1.2 million in Sydney while our house in Albury will be $400,000. His and his wife's super will be around $700,000 while my wife and I will be around $1.5 million.

So, we'll both be worth the same, but because of the home exemption from the age pension he and his wife will get a part pension and all the benefits that flow from all three levels of government and anywhere that offers pensioner discounts.

But our plan will see me and my wife also using this age pension concession and joining the gravy train as well.

- If the family home was included in the age pension calculation, with an offsetting increase in the assets test, we've discussed the idea of moving to a regional coastal town. That would be a better lifestyle for us, and if enough retirees did the same it would help housing affordability and congestion in Sydney.
- The family home concession favours people in Sydney and Melbourne over other capital cities, who are favoured over large regional centres, who are favoured over people in smaller towns where house prices are generally lowest. It's the reverse of all other tax systems where the wealthiest pay the most.
- Not including the family home also ends up for many as an increased inheritance handout to children of retirees. If my parents downsized, they'd lose their age pension and all the other benefits. Uncles and aunts will either lose or see a reduced age pension if they downsize. So the older generation helping each other and my generation are helping to keep everyone in their home as long as possible as we get more money as a family.

Taking me and my friend, if we both moved up the coast and bought neighbouring townhouses we could end up in a scenario where we have exactly the same wealth in our homes and in super/personal names, but the other couple gets a part age pension and all the handouts and we don't.

I am happy for you to share these ideas.

Three key outcomes needed from the Retirement Income Review

Craig Racine

The recently announced Retirement Income Review terms of reference detail the three pillars on which Australia's retirement income system is based – age pensions, compulsory superannuation and voluntary savings. This paper focuses on the second pillar, superannuation.

There are three key outcomes that can be met by the Retirement Income Review:

1. Further develop the risk adjusted returns disclosure arrangements criteria to assist retirees in understanding the risks inherent in retirement income products.
2. Encourage the development of a variety of risk management approaches with the objective of improving risk adjusted returns for retirees.
3. Develop guidelines for *'alternative – conservative' and 'alternative – growth'* asset classifications, based upon the risk level rating and in particular the product's ability to address sequencing risk.

1. Risk adjusted returns disclosure

The December 2018 Australian Government Actuary Paper 'Retirement Income Risk Measure', discusses a range of standard metrics to help consumers make decisions about the most appropriate retirement income product for their own circumstances.

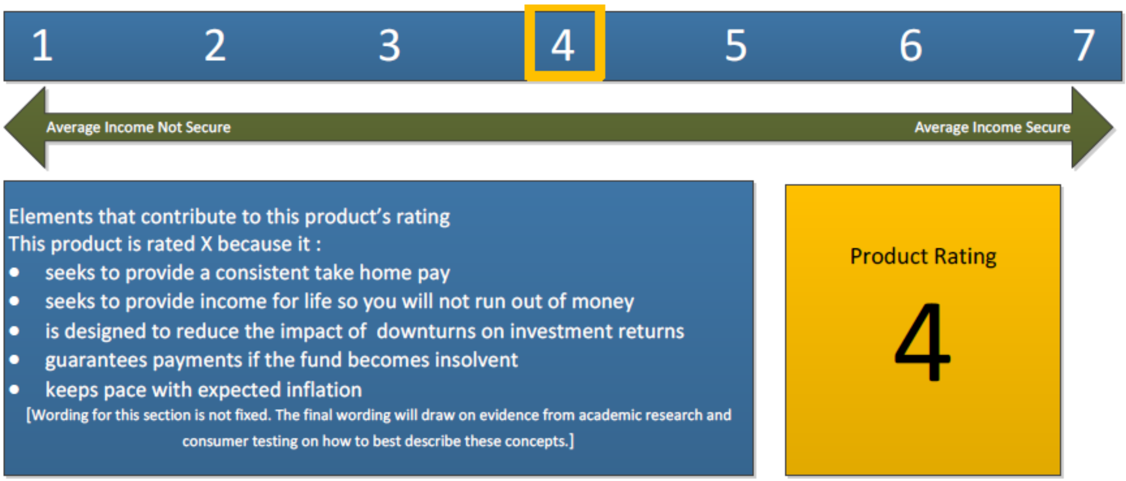
It is noted that:-

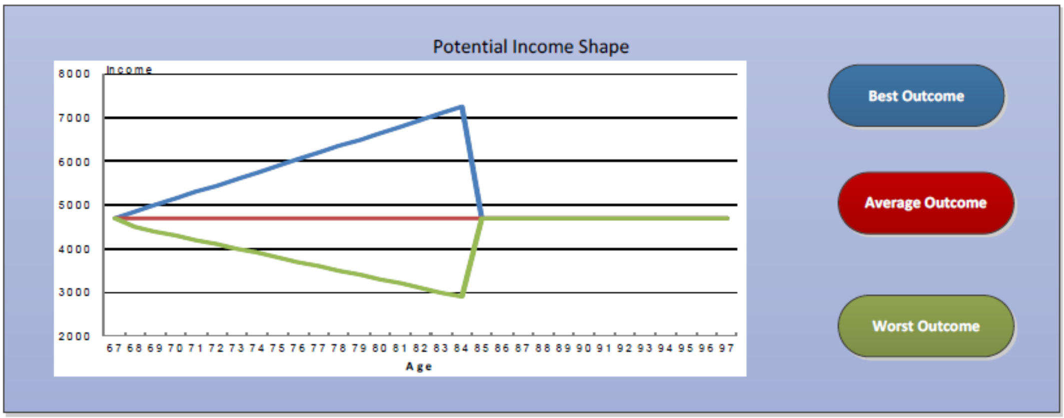
"…behavioural economists commonly point out that individuals are more averse to downside variation than upside variation. Intuitively this would apply to retirement incomes. For this reason, I have chosen to focus on quantifying downside risk and using that to measure the relative 'income risk' of various products."

The Actuary's advice says on page 6:-

"The proposed presentation for the fact sheet is a scale of one to seven referencing 'income security'. A high number on the scale would indicate expected income is stable and reliable, higher risk products would equate to a low level of security, so a lower number on the scale ...

The income security measure takes account of inflation, longevity and market risk. For consumers these risks may be of different values. For example, a consumer who is concerned about whether their income varies due to market forces may want to know whether the product protects them from this particular risk."





The much-discussed 'Comprehensive Iincome Product in Retirement' (CIPR) would provide a complete solution that balances a number of competing objectives. The three key retirement objectives are to maximise income, ensure income is provided for life and provide flexibility to access capital.

The Review provides the opportunity for industry to critically review the Treasury analysis of CIPR and observations on the proposed risk objectives (including any suggestions on how the approach could be improved). This process may enhance the risk metrics ratings products will receive on their ability to address longevity risk, market risk, sequencing risk and inflation risk.

2. Encourage the development of a variety of risk management approaches

There are a variety of investment risk management approaches with the objective to meet the equity income needs of retirees and defend against losses in declining markets.

Typically, the investment generates dividends from a diversified portfolio of Australian shares with an investment risk management overlay that aims to reduce the volatility of returns, in particular defending against losses in declining markets.

A brief summary of the approaches is as follows:

- Vary asset allocation between stocks and bonds (diversification)
- Buy underlying asset, write call options (buy-write income funds)
- Long/short funds (market neutral, 130/30)
- Buy underlying asset with the ability to sell futures contracts
- Buy put options and hold cash
- Buy underlying assets, buy put options (always include a 'hard' risk parameter)

These approaches are adopted by Russell Investments, State Street and Gyrostat (amongst others).

By developing clear evaluation criteria, industry will likely continue to develop innovative risk-managed investment approaches. It is likely that through the combination of these approaches, retiree solutions that maximise risk adjusted returns can be developed, with external providers becoming a component part of the retirement product if these are 'best of class' addressing a particular component of risk.

3. 'Alternative – defensive' and 'alternative – growth' classification criteria

For a product to be classified as 'alternative – defensive' it must address sequencing risk. Sequencing risk is the risk that the order and timing of investment returns in unfavourable, resulting in less money for retirement. If the benchmark used by a fund has experienced significant drawdowns, it does not address sequencing risk, and would be an 'alternative – growth' classification with a lower risk rating.

The marketing literature of many funds attracting retiree investors typically show:

- Income feature
- Return feature over specific time periods
- Relative performance versus selected index over specific time periods

Rarely do they report the maximum capital drawdown since inception. Given that the fund's objective is to outperform a chosen index, the underlying investment may be exposed to large losses in the event of a major market correction. The protection element is reflected in the fund's maximum capital draw-down.

Many doubt the Review will focus on such definitions, as the super industry has struggled to deliver consistent standards to define growth or defensive assets.

Conclusion

The desirable retirement income product features combine **protection**, **returns** and regular **income** through all stages of the investment cycle, including large market falls. The Retirement Income Review can make positive contributions towards this objective and ultimately meet the policy objective to enable retirees to maintain their standards of living when they retire from the paid workforce or reach the retirement age.

Craig Racine is Managing Director of Gyrostat Capital Management. This article is general information and does not consider the circumstances of any investor.

Internet of things and the power of 5G technology

John M Malloy Jr

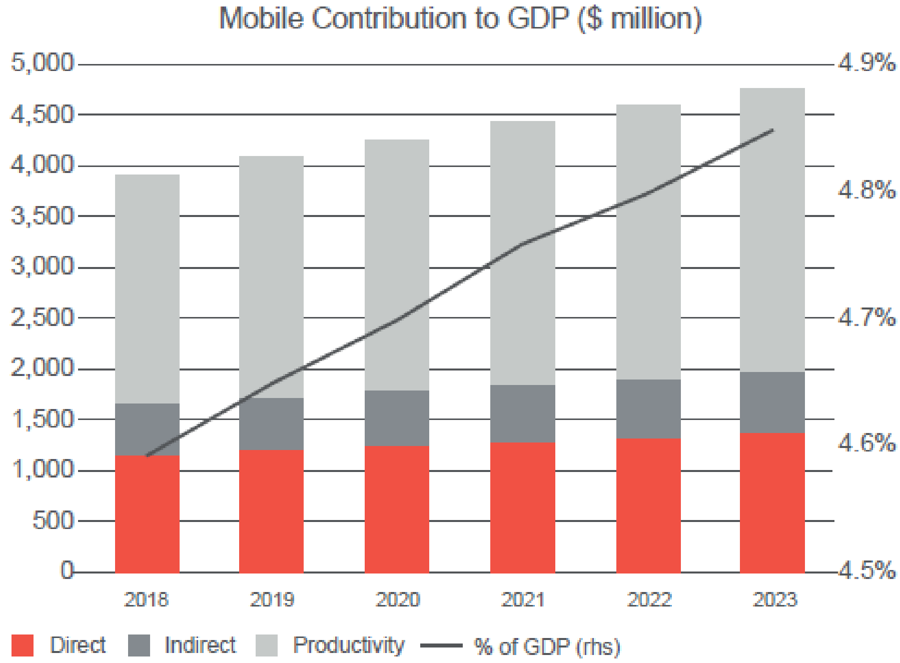
Fifth generation (5G) cellular network technology is the next step in the evolution of digital communications. Faster transfer of data, lower latency, reduced congestion and increased connectivity are just some of the improvements 5G will bring.

5G set to contribute to world GDP growth

According to GSMA, in 2018, mobile technologies and services generated US$3.9 trillion of economic value which equates to around 4.6% of GDP (see Figure 1). GSMA estimates that the economic contribution of mobile technology will increase by almost US$850 billion by 2023 and 5G will contribute US$2.2 trillion to world GDP by 2034.

We believe 5G will not only facilitate the population's voracious appetite for data, but it will also accelerate our consumption and pave the way for seamless connectivity and productivity improvements worldwide.

Figure 1. Economic contribution of mobile services will likely increase $850 billion by 2023



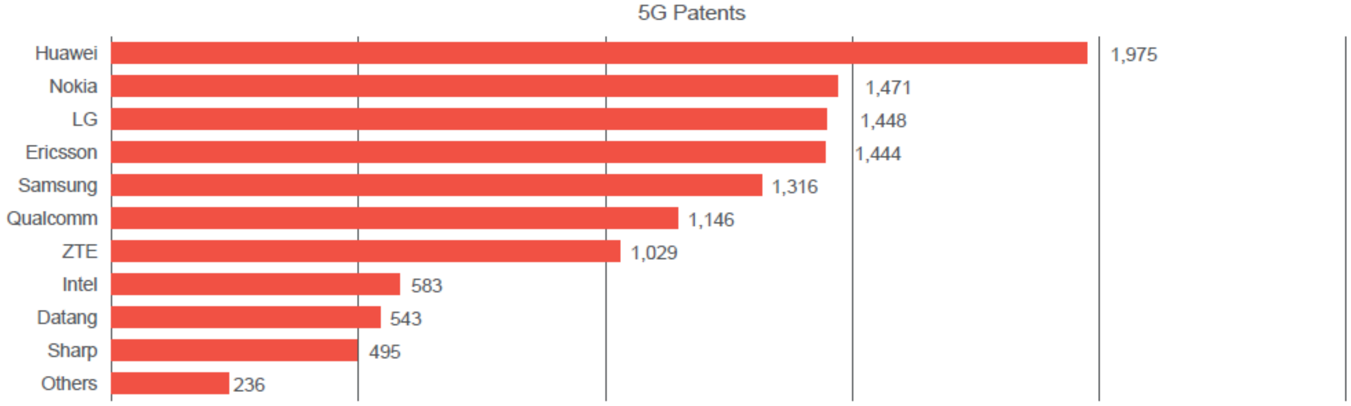
Source: RWC Partners, GSMA Intelligence as of 28 June 2019.

Implementation set for 2020

The United States and South Korea launched 5G commercially at the end of 2018 with 16 more countries launching during 2019. The Chinese government has awarded 5G spectrum licenses to all three telecommunications companies in order for them to conduct trials before commercial roll-out in late 2019.

However, the majority of 5G deployments will happen after 2020 and will be dependent on 3rd Generation Partnership Project (3GPP) standards. Huawei is an essential and integrated part of 5G as the company holds a substantial amount of 5G patents. Equipment vendors generally adopt a cross-licensing model which makes it very difficult to exclude Huawei from 5G network participation. The company has filed 1,975 5G patents, more than Qualcomm and Intel put together (as seen in Figure 2).

Figure 2. Number of 5G Patents Registered by Companies



Source: RWC Partners, European Telecommunications Standards Institute – 2019.

5G technology brings three new technical features

In an industry full of jargon, some of the new technical features include:

1. Enhanced mobile broadband (eMBB), ultra-reliable low latency (uRLL) and massive machine type communications (mMTC) which are to be rolled out in two phases over the next few years

2. Release 15, which focuses on eMBB, and

3. Release 16, which concentrates on Ultra Reliable low-latency communication (uRLLC) and Metals and Minerals Trading Corporation mMTC, including Internet of Things IoT.

Release 15 will concentrate on existing applications whose process can be improved by utilising the higher capacity and cheaper data rates, while Release 16 will focus on enhanced IoT including industrial and automotive connectivity.

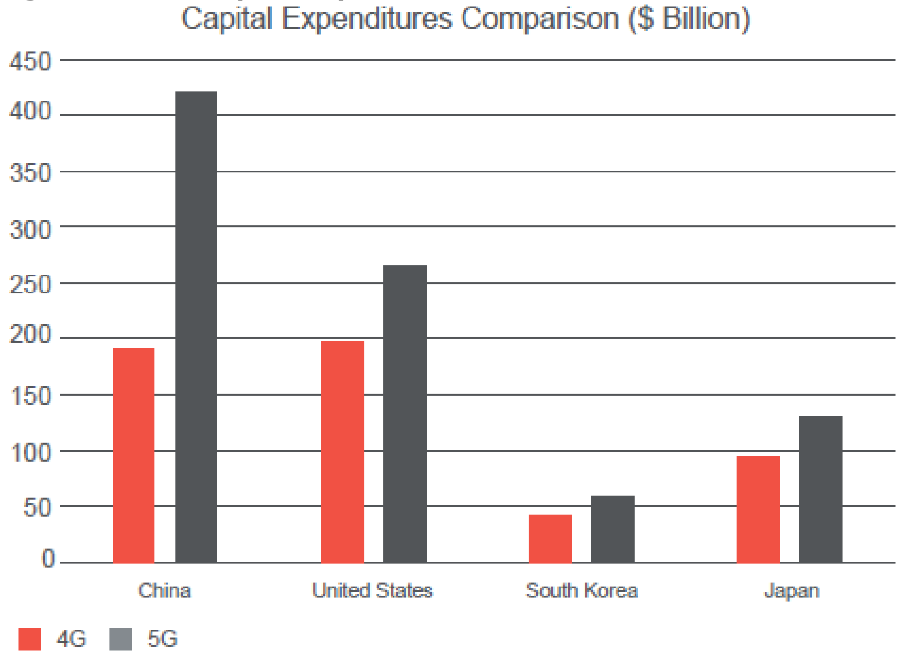
As the technology rolls out, it will enable applications such as:

- Virtual and augmented reality
- Ultra-high speed video
- High density internet of things
- Autonomous driving, and
- Smart cities

China showing the greatest level of investment

According to Credit Suisse estimates, global wireless capital expenditures are expected to be around US$500 billion between 2018 and 2020. However, this is dependent on the level of coverage that operators choose. Most mobile networks were built starting from places of affluence before expanding regionally. Many 5G applications will have significantly different requirements and coverage will likely be a function of monetisation opportunities in specific countries and regions as seen in Figure 3, with China showing the greatest level of investment.

Figure 3. Total Capital Expenditures for 4G and 5G



Source: RWC Partners, Morgan Stanley Estimates – 4G up to 2018, 5G 2018 and Beyond (estimates).

Furthermore, additional and higher frequency spectrum requires more sophisticated designs in radio frequency components, including antennae, amplifiers, filters, switches and basebands. 5G base stations are far more efficient than 4G. While 4G base stations just use antennae, 5G base stations combine a remote radio unit (RRU) with an antenna to form an active antenna unit (AAU). 5G network architecture also requires middlehaul in addition fronthaul and backhaul which results in more demand for optical modules.

Internet of things will grow rapidly

With the power of 5G technology, the IoT phenomenon will grow exponentially. GSMA estimates that most of the value of IoT from now through to 2025 will come from applications, platforms and services which will increase by roughly US$600 billion.

5G is the first wireless technology with high throughput, low latency and high reliability to replace wireline connectivity in factories. Consequently, industrial IoT will also likely see robust growth as manufacturers move towards a leaner cost structure, digitalisation and flexibility in processes and production through methods such as condition-based monitoring.

Figure 4. Smart City

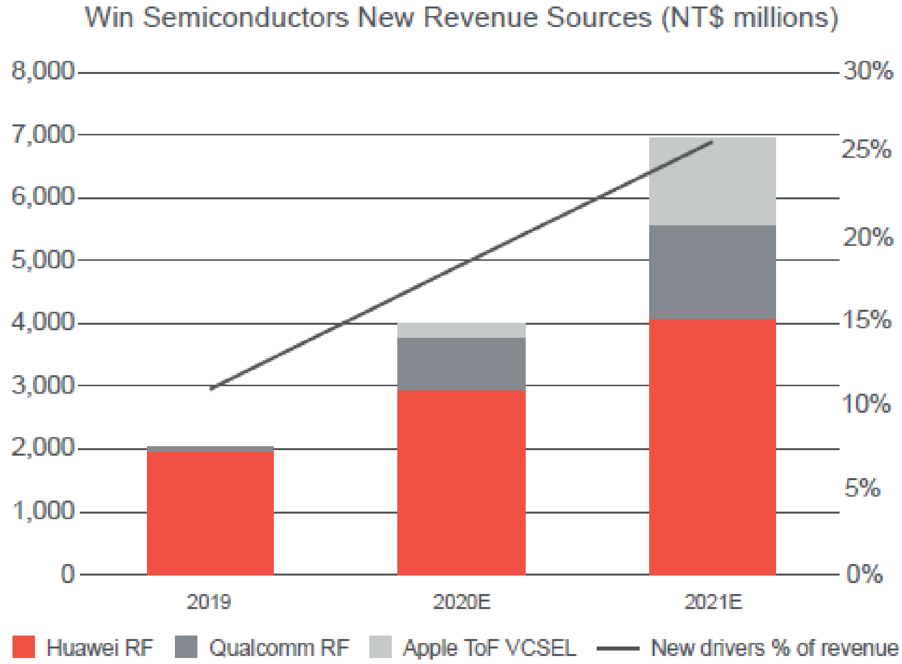
Source: RWC Partners, Industrial Safety Review 2018.

ABI Research estimates that by 2025 there will be around 90 million condition-based monitoring connections. Over time, enhanced IoT will lead to the evolution of smart cities which we believe will likely enhance productivity (as shown in Figure 4).

Case study of a 5G investment opportunity: Win Semiconductors

Win Semiconductors is the largest gallium arsenide (GaAs) foundry with 60% global market share. GaAs has superior electronic properties over silicon which makes it the best power amplifier for use in radio frequency devices such as smartphones, WiFi routers and industrial IoT components. Risks to the thesis include a continuation of trade tensions between the United States and China.

Figure 5. Estimated New Sources of Revenue for Win Semiconductors



Source: RWC Partners, Morgan Stanley – 2019E-2021E.

The investment cycle for 5G base stations has already started with sub-6 GHz applications, while mmWave (28 GHz) will be more from 2022 and beyond. The company's infrastructure business may profit from mmWave implementation as the company offers GaN technology for high power amplifiers which is more efficient and provides better performance.

Additionally, radio frequency content could rise up to 50% from the 5G smartphone in addition to double the amount of filters and switches. The stock trades at 21.4x 2020 earnings on our estimates and has a 5-year earnings per share CAGR of 17% on our estimates.

Opportunities include emerging markets

Emerging markets are inherently dynamic and there is an ongoing developmental shift which we are constantly looking to exploit. We firmly believe that much of the opportunity in emerging markets is underappreciated or is overlooked by other managers due to their index orientation and capacity. Our index agnostic mindset and deep experience investing across all levels of emerging and frontier markets stands us in good stead to extract value and generate meaningful alpha from the entire opportunity set.

Access to the RWC emerging and frontier markets strategy is available to Australian investors via Channel Capital, a sponsor of Firstlinks.

John M Malloy, Jr is Co-Head of Emerging & Frontier Markets, at [RWC Partners](), a Channel Capital partner.

For more articles and papers from Channel Capital and partners, [click here]().

Should you buy CBA PERLS XII Capital Notes?

Adam Fleck, Shaun Ler

Commonwealth Bank of Australia (CBA) will raise $1.25bn via a Tier 1 hybrid issue, to be listed on the ASX, called CommBank PERLS XII Capital Notes. This issue will provide Additional Tier 1 (AT1) regulatory capital. The offer comprises a broker firm offer and an eligible securityholder offer. Unlike recent PERLS issues, this note is not a replacement of an existing issuance, hence there is no reinvestment offer.

CBAPI is a fully paid, convertible, transferrable, redeemable, subordinated, perpetual, unsecured note with a $100 face value and mandatory exchange date of 20 April 2029. Mandatory exchange is subject to several exchange conditions. CBAPI may be exchanged earlier as a result of a trigger event or CBA exercising an option to call the security two years early on 20 April 2027. Distributions are discretionary, noncumulative and fully franked with a dividend stopper. Distributions will be paid quarterly in arrears, based on the 90-day Bank Bill Swap (BBSW) rate plus a margin of 3.00% per year. For example, using the current 90-day BBSW rate of 0.85%, this equates to a gross running yield of 3.85% per year.

Key takeaways

- We recommend investors subscribe to the offer for CBAPI. CBAPI's issue margin of 3.00% provides a relatively attractive premium to our current fair value curve of major bank AT1 securities in the 7.5-year term to call range.
- Following completion of the bookbuild, CBA has finalised the issue size at $1.25bn and a margin of 3.00%. Initially only seeking $750m and an indicative margin range of 3.00% to 3.20%, investor demand was clearly strong. The hunt for yield continues, triggered by low cash rates and growing expectations the RBA will cut further and even implement some form of quantitative easing in Australia.
- Our near-term outlook for hybrid pricing remains constructive. The major banks are profitable, have strong AT1 capital positions and need to raise more Tier 2 Capital. Supply should remain tight in the near term, as corporate issuances have dried up with little signs of revival and major banks face a near-term shortage of AT1 reinvestment opportunities. Risks include a global backdrop of increased market volatility, or a major bank AT1 supply spike in the next six months should the banks take advantage of the prevailing low rate environment to execute large, long-dated deals.
- It is important to reiterate hybrid securities should not be viewed as traditional fixed-income products, nor should they be considered a substitute for low-risk investments such as term deposits. We consider hybrid securities suitable only for investors with a medium to high risk tolerance due to their subordination on the capital structure.

Recommendation

We assign CBAPI a medium investment risk rating, the same as other Basel III-compliant Tier 1 major bank hybrids. The terms and conditions, such as nonviability and capital conversion triggers, in this new breed of hybrid securities make them more equity-like and, consequently, riskier than the "old-style" issues. Investors should understand these risks and be incrementally compensated in return. Nevertheless, for investors willing to take a position on the lower end of a company's capital structure, hybrid securities can represent an attractive yield investment.

Domestic major bank AT1 hybrids have performed well since 2016, thanks to the search for yield amidst geopolitical/economic uncertainties, as well as record low interest rates globally. While the hybrid market has had a challenging close to 2018, 2019 has been very strong as markets embraced more risk following the Coalition's victory in May. While average major bank trading margins moved out to 4.00% towards the end of 2018, they have just as rapidly recovered those price falls and at the time of writing sit around the 2.40% mark.

We believe a key reason for the CBAPI issue is to space out the maturity profile of the bank's hybrids and avoid having clustered, mega deals as it did previously. With more than $14.5bn of major bank hybrids, of which around $6.1bn are CBA's, due to be called in 2021–2022, future issues could: i) involve having to "outbid" issuers via higher margins; or ii) risk not being fully absorbed by the market. The more clustered the terms to call, the higher the refinancing risk.

Of the four major banks, National Australia Bank (NAB) has the biggest near-term refinancing needs, with both NABPB and NABPC due to be called in 2020. We expect NBA to refinance both hybrids in new issues in 2020, though it (or any other bank) could follow CBA's lead and launch long-dated, "new money" issues early in order to pre-emptively meet APRA's requirement for the major banks to have AT1 ratios of at least 1.5% by 2024.

The timing of the CBAPI issue is practical, particularly given favourable funding conditions which are expected to persist. The distribution rate for hybrids are linked to the BBSW has plummeted over the course of 2019 following the repricing of cash rate expectations. The 90-day BBSW has more than halved from 2.08% at the start of January to around 0.85% currently.

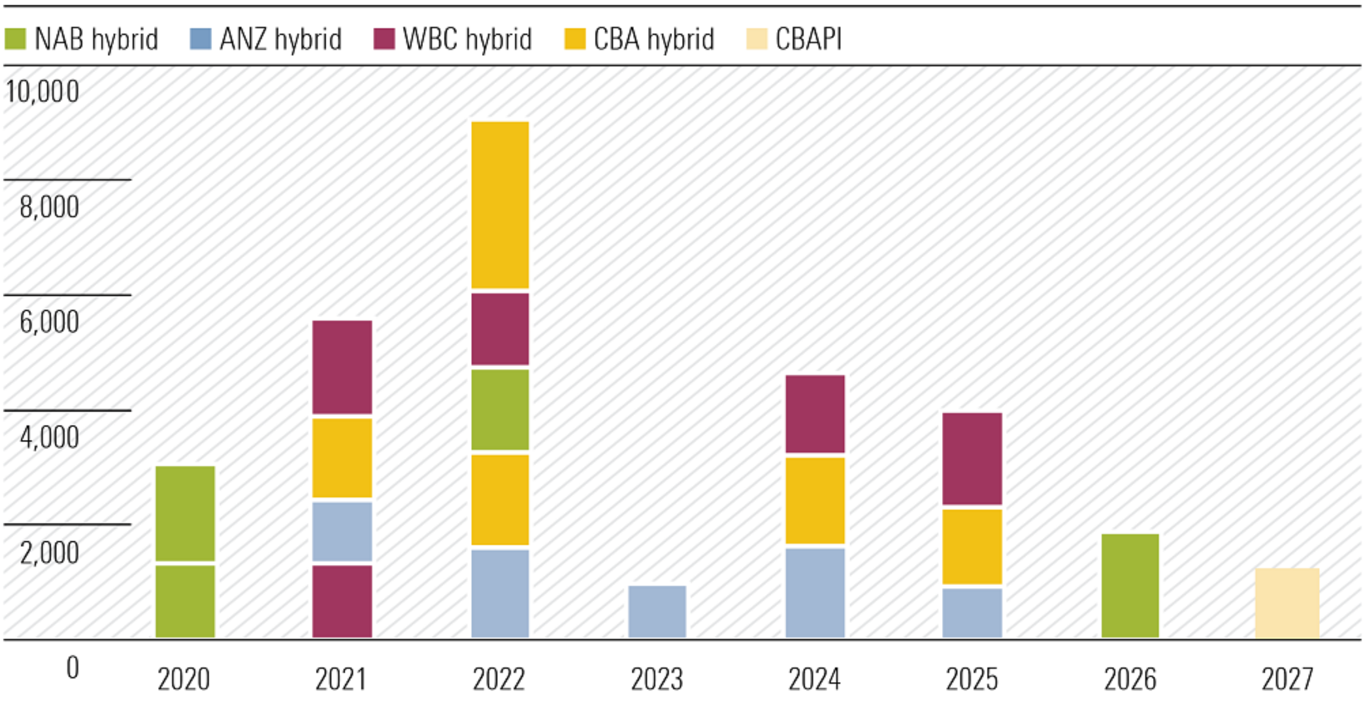
Barring an unexpected bout of inflation, we do not envisage a spike in the BBSW in the near term given the RBA's apparent intentions to ease monetary policy further.

From a capital ratio standpoint, we do not believe any of the major banks are in urgent need of additional AT1 capital, bearing in mind there are limited scheduled redemptions in 2020 (apart from NABPB and NABPC). All four major banks currently have enough AT1 capital, need to raise more Tier 2 capital (which are cheaper than AT1 hybrids) and meet common equity Tier 1 requirements in the near term. So, while near-term supply levels should remain tight, the prevailing low rate environment and strong investor appetite for yield could entice issuers to tap the market anyway.

Despite the relative attractiveness of CBA's equity dividend yield premium to CBAPI's yield to call, we still see value in CBAPI due to its lower expected volatility. As we have seen in recent years, hybrid volatility has been significantly lower than that of the equity of the same issuer. The latter bearing the brunt of the headline risks the major banks continue to face.

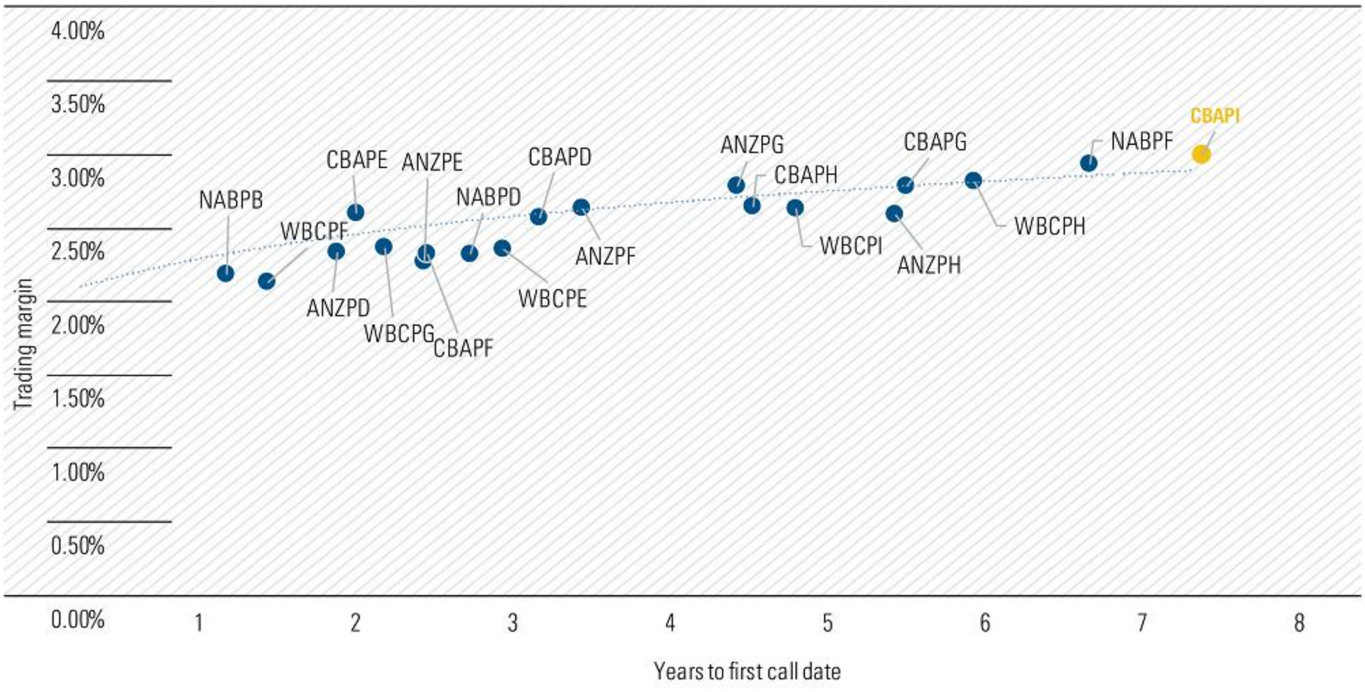
Adam Fleck is Regional Director of Equity Research, Australia and NZ, and Shaun Ler is Associate, Equity & Credit Analyst, both at Morningstar Australasia. This article is general information and does not consider the circumstances of any investor. Please consultant a financial adviser before taking investment decisions.

Exhibit 1: Major Banks AT1 hybrid call dates



Source: Morningstar

Exhibit 2: Major banks AT1 hybrid trading margins vs term to first call date



Source: Morningstar

Media worth consuming - October 2019

Jonathan Rochford

A monthly look at dozens of global media articles that often do not receive mainstream coverage in Australia.

Finance

S&P 500 companies are paying out over 100% of their free cashflow as dividends and buybacks, even though earnings growth has been flat for the last two quarters and is likely to be negative for the quarter just ended. On some measures, the US stock market isn't bubbly at all. Insiders are selling their stock at the highest pace in 20 years. US rail freight levels are down 5% year on year and container shipping rates are down 43% year on year. Inflation, exports and imports are all negative in South Korea.

29% of US leveraged loans are rated B- and another 11% are rated CCC or below, which creates price jump risk for CLOs facing rating constraints. Standard and Poor's sees a growing pile of "weakest link" corporates that will form a default wave in the next downturn. LBO companies rarely hit their EBITDA growth and debt reduction targets put forward at the time of borrowing. EBITDA adjustments in private equity transactions are at a record high, with adjustments nearly half of EBITDA for B rated companies.

Some "investment grade" bond funds are loading up on debt with split BBB/BB ratings to boost returns. Moody's sub-investment grade downgrade to upgrade ratio has substantially deteriorated this year. Rating agencies are giving some big corporates several years of leeway to earn the rating they currently have. Defaults are jumping in the municipal bond market. The US Treasury Department is regularly approving reductions in pension benefits for defined benefit funds heading towards insolvency.

The Bank for International Settlements studied the impact of low interest rates and found that banks reduced lending and increased risk taking as a result. Smaller German banks are increasingly passing on negative interest rates to their retail clients with larger banks considering doing the same. Greece is selling short term debt at negative interest rates.

WeWork's downfall is reminding investors to value the math rather than the magic. Softbank is going to spend $10 billion bailing out WeWork and its CEO. Tesla recorded a profitable quarter by cutting costs faster than revenues fell and has built a Chinese car factory in 168 days. Tesla owners are posting videos of their cars going wild after using the "smart summon" feature. This cycle's tech bubble is running out of helium. Silicon Valley held a conference to express their hatred for IPOs, right after several large tech company founders enriched themselves by listing shares that subsequently crashed.

Indian lenders are caught in a liquidity crunch with property developers the worst impacted. Rating agencies in India are doing a poor job of predicting defaults. Residential property sales have fallen hard in Beijing and Shanghai with commercial office vacancy rates well above international peers and rising. China has stopped publishing industrial employment data with alternative sources pointing to employers heavily cutting back on hiring.

Asset allocators get fee cuts by threating to go passive, but they'd be better off switching to managers that deliver decent outperformance rather than sticking with mediocre managers. A review of academic studies over the last 20 years finds that active management has been judged too harshly. New research points to US equities outperforming bonds by only 1.7% over the last 220 years. Ken Fisher made another batch of offensive comments at a financial conference, leading to his firm losing $3 billion in assets in two weeks. South Korea's largest hedge fund has frozen investors after a redemption run. Investors wanting ESG bond portfolios need to accept lower returns and concentrated holdings. A Reddit user bragged about turning $766 in $107,758 in a week by options trading. Virtue signalling CEOs are being cut down by their shareholders for underperformance.

Politics & Culture

Google is meddling in the US presidential election by supressing information about Tulsi Gabbard. Mitt Romney used a fake twitter account to say nice things about himself and lob criticisms at Donald Trump. The 10 most toxic donors, whose money has brought trouble onto those who received it. Trump's properties gave different financial information to the government and their lenders. The allegations that groups are booking rooms at Trump's hotels and never staying in order to curry favour.

Where women see gender bias, men see a lack of women making the choices and sacrifices needed to get to the top. Voters in the all American stock research rankings are more likely to vote for women, even after adjusting for experience and performance. There are more men in STEM partly because men are so much worse at humanities than women. Several countries are allowing men to serve time in women's prisons if they self-identify as female.

A US federal court judge has deemed legal Harvard's blatantly racist admissions policies which include giving preference to kids that play expensive sports, dominated by wealthy white kids. Giving parents a choice of schools increases the quality of public and private schools. Technical/trade orientated high schools substantially increase the employment prospects and earnings of their students.

The NBA rejected Chinese bullying to fire a Houston Rockets employee for a pro-Hong Kong tweet. NBA fans mocked LeBron James for choosing Chinese money over free speech. China is spying on its citizens and feeding them propaganda through an app that is mandatory for government workers. A Chinese mayor was arrested after his home was raided and $660 million of gold was found. Chinese courts are denying divorce applications from women who are victims of domestic violence. Singapore has passed a law banning news the government doesn't like with punishment of up to 10 years imprisonment and a $1 million fine.

An Ontario dental assistant lost his licence to practice after treating his wife. An Atlanta City Manager has shut down a preschool stall selling cheap vegetables in a poor neighbourhood for "zoning violations". Swedish towns are requiring beggars to get a permit before hassling people for money. The German Parliament is considering jail sentences of up to 3 years for insulting the European Union anthem or flag. You can be fined up to $250,000 for using the term "illegal alien" in New York. US Police accused of stealing over $225,000 can't be sued after a bizarre court ruling.

A Spanish court has handed down long jail sentences to nine Catalan leaders for pursuing independence. Canada's government tried to block independent journalists from reporting on the election. The Australian government completely bungled an Interpol notice resulting in a refugee being jailed for 77 days. An Australian University is suing a senior academic for damages after he reported its alleged misconduct. Britain should leave the EU and join NAFTA.

Dave Chappelle's comedy special shows that ordinary people prioritise laughing whilst critics prioritise political correctness. An initial review of Stockton's UBI experiment shows recipients could use financial counselling at least as much as the money. It's odd that people like to wear t-shirts of the mass murderer Che Guevara.

Behind San Francisco's homelessness epidemic lies drug abuse, mental illness and a lack of enforcement of basic standards.

Economics & Work

The winners of the Nobel Prize for Economics this year broke new ground in designing and testing programs to alleviate poverty. One of the Nobel Prize winner's idea to pay poorer countries to take refugees could ease the global refugee problem. 5 economists who were in contention for the Nobel Prize.

12 cutting quotes from Milton Friedman on government and freedom. Libertarians have gone on a cruise to share their disdain of Paul Krugman. Hungary, Poland and Serbia have railed against migrants but now need to import more to combat labour shortages. Americans with the lowest wages are seeing the biggest percentage wage gains.

Swiss Cantons are taking drastic action to avoid the sting of negative interest rates. Central bankers have self-assessed their use of unconventional monetary policy tools as a great success with minimal negative effects. The IMF has quietly admitted that easy monetary policy has provided the fuel for the next crisis. The increasing amount of debt creates a "bubble or nothing" economy, vulnerable to a long and deep recession. The argument over whether the latest batch of Federal Reserve bond buying counts as quantitative easing. Governments default regularly and we shouldn't be surprised when they do.

Miscellaneous

US hospitals are detaining patients against their will and sticking them with the bill. US family healthcare premiums have surpassed $20,000 per year. When healthcare costs are included in the calculations, America looks like a European welfare state. Walmart is revolutionising healthcare by offering basic medical services at a 30-50% discount. An American private equity firm auctioned off its graduate doctor slots at a distressed hospital. Sheriffs in Alabama frequently release sick inmates so they don't stuck with the cost of medical care.

Ultra-processed foods trick our brains into thinking we need more food. The average human skull is shrinking, which negatively impacts sleep, weight and development. 30% of men and 86% of women in the US Army are failing the combat fitness test. Sleep deprivation is the biggest issue for NBA players. 5.7 million children in the US have a parent with addiction issues, so Sesame Street is introducing a character to help children deal with it.

A Chinese family went through 23 weddings and divorces in a month to get a bigger share of a property development. Five Chinese men are going to jail after four of them each subcontracted a contract to kill and the fifth contacted the target and asked him to fake his death. China purged its internet of South Park content after an episode that mocks government censorship.

Celebrities that support action against climate change should jump on board the campaign to ban private jets. Climate activists gained infamy by botching their attempt to spray a government building red. London residents are fighting back against Extinction Rebellion protestors and the city has banned one of their protests.

Hydrogen has the potential to be the clean energy fuel of the future, with scientists becoming more efficient in using electricity to create hydrogen from water. Molten salt towers could be the cheap storage option that renewables are currently missing. Regenerating degraded soil could be a relatively cheap way to buy 20 years to address climate change. Wind and solar power are subject to very large swings in production on a daily and seasonal basis. The Sicilian Mafia is a big investor in wind farms.

Celebrating late bloomers; those who make a great impact in life after mediocrity early on. France offers its elderly citizens a low cost service for their postman to drop in and check on them. Granny flats are becoming the affordable housing solution. There are so many magazines about food, why not one about toilets? The ten deadliest foods in the world. Forbes is encouraging single women to travel to Taliban dominated parts of Pakistan. Qatar is working on outdoor air-conditioning in advance of hosting the Soccer World Cup. A New Zealand café is charging a $5 surcharge for "hipster allergies". The man who makes public monuments dedicated to urban legends.

Written by Jonathan Rochford of Narrow Road Capital. Comments and criticisms are welcome below or can be sent to info@narrowroadcapital.com

Disclosure

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