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Contents

OK Boomer: fessing up that we've had it good

Graham Hand

The newly-minted 'OK Boomer' movement is increasing attention on generational inequity. *The New York Times* of 29 October 2019 carried this heading (right).


'OK Boomer' Marks the End of Friendly Generational Relations

Now it's war: Gen Z has finally snapped over climate change and financial inequality.

'OK Boomer' is used by Gen X, Gen Y (Millennials) and now Gen Z (the newest generation) when a Baby Boomer says something dismissive, especially referencing the good old days. The younger person cannot be bothered explaining the ignorance of the older generation, and simply responds with 'OK Boomer'. It's pejorative, a put down. It has already been used in the New Zealand Parliament by a 25-year-old politician to stop heckling during a climate change debate.

Financial equality between generations is an emotive issue with legitimate arguments on both sides. Older Australians want to hang on to the outcome of their hard work, as they have legitimately planned for retirement based on a set of prevailing rules. Younger people see the Boomers enjoying property market, superannuation and investment conditions unlikely to be repeated. Already, the 27% of Australians who are over 50 hold half the wealth, and ASIC estimates 65% of the almost $3 trillion in super is held by fund members over 50.

Confining this article to financial matters, we will focus on:

1. Superannuation contributions
2. Residential property prices and the family home
3. Equity and bond markets
4. Cost of education
5. Death duties
6. Demographic change

It avoids the big social issues such as climate change, global political unrest, #metoo, over population or trade wars. Rather, let's see how Boomers' conditions have allowed them to build financial independence in retirement.

Now it's 'When I'm 84'

In 2014, Alex Denham, then a financial adviser, wrote an excellent article called '*Hey, what have you got against late 60s babies?*' Born in 1969, she feels her generation missed out on many of the advantages that set up older (and in some cases, younger) generations:

"I'm getting a niggling feeling that someone out there has it in for us late 60s babies. We just seem to keep getting hit by changing government policy, and not in a good way. Too old for this, too young for that."

At the time of publication, I recognised that many of the benefits had gone to Boomers. Born between 1946 and 1964, Boomers are now aged 55 to 73. I was born in 1957, the same year two lads named Paul McCartney and John Lennon first met, down the road from my birthplace. 'When I'm 64' is suddenly only two years away for me. I recently attended an amazing McCartney concert where he performed without a break for three hours in a spectacular collection of classics. He was born in 1942 and is now 77 years-of-age. Next time … 'When I'm 84'.

1. Superannuation contributions

Super schemes existed for many employees before the introduction of the Superannuation Guarantee (SG) in 1992. By 1974, an estimated 58% of the public sector and 24% of the private sector had some form of super. However, SG was a massive step forward for widespread inclusiveness when it started at 3% in 1992 under the Keating Labor Government. The compulsory contributions gradually reached 9% by 2002/2003, and the current level of 9.5% was set in 2014/2015.

A Boomer born in 1964 may not have received compulsory super until the age of 28, and would have been 38 by the time the 9% level was reached. It could be argued they have not received the full impact of the super system.

This disguises the limits and the generous ability to put more into super which operated for much of their working life. The limits have been reduced significantly for the following generations. The current maximum annual concessional contribution, the most tax-advantaged way to put money into super, is only $25,000. At various times in the past, this has been as high as $100,000 a year, and was $35,000 for people 49+ as recently as 2017.

The biggest opportunity to put large amounts into super come from non-concessional limits, the amount from after-tax savings. The current non-concessional cap is $100,000 a year, but for three years until FY2017, it was $180,000 a year, and $150,000 a year for many years before that.

One reason many wealthy people have so much in super is Treasurer Peter Costello allowed $1 million in non-concessional contributions for a period of 14 months until 30 June 2007. Although before 2007, there was no limit on after-tax contributions, pensions were taxed so the environment was not so attractive.

What made money in super so appealing was that in December 2006, Costello introduced a Bill to allow people aged over 60 to access their super tax-free. Not only are the earnings on assets in pension phase free of tax, but withdrawals (following a 'Condition of Release' until the age of 65) are also tax free, whether as a lump sum or pension.

This explains why the then Treasurer, Scott Morrison, in the 2016 Federal Budget capped the amount that can be transferred to the pension phase to $1.6 million. Anyone with a total superannuation balance greater than or equal to the transfer balance cap now has a non-concessional limit of zero. Super above $1.6 million must be held in accumulation with a tax rate of 15% on income earned (or 10% for capital gains), still highly advantaged versus the personal tax system.

The tighter caps make it far more difficult to establish large superannuation balances, especially via the concessional limits. The $100,000 years were massively advantageous for high-income earners. In 2016, when the Commissioner of Taxation, Chris Jordan, explained why 2,184 people had over $10 million in super (and six with over $100 million), he said the balances had been accumulated over 30 years or more. That's what high limits, good investing and compounding can achieve.

The rules around a 'Condition of Release' are surprisingly flexible. A person over the age of 60 does not even need to retire, they simply need to resign from a company. They can start work again the next day while also setting up a pension. Although the limits were tightened, a couple can still move $3.2 million into the tax-free phase.

While there is a requirement to take out the legislated minimum of 4%, anyone with other resources will leave the rest untouched because saving in super is subject to such low tax rates.

Let's face it, if a couple with a large super balance pays no tax on $3.2 million of assets and only 10% to 15% tax on the rest, then Australia is not collecting taxes from many people who can afford them (acknowledging that tax was paid before the money went into super). Even if they earn only 5% on $3.2 million, that's $160,000 of tax-free income which might otherwise incur personal tax at 45% plus a Medicare Levy of 2%. That's over $75,000 a year which can finance a decent Mercedes or a couple of amazing trips to Europe a year. One hundred Australians retire every day.

2. Property prices and the family home

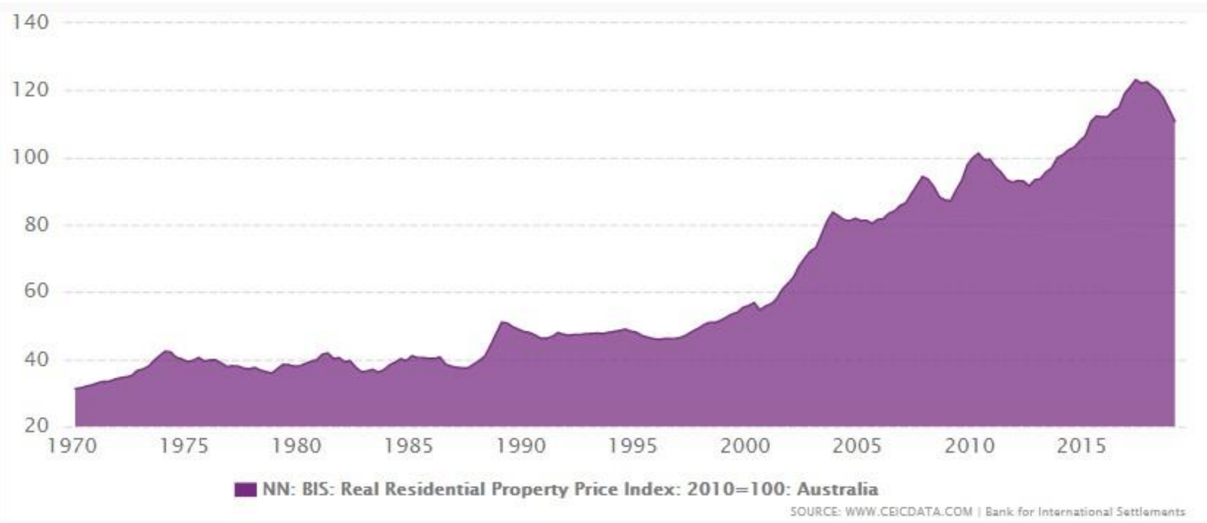
The first property I bought in Sydney in 1980 cost $56,000, for a three-bedroom terrace. It's now near a train station and would be worth maybe $1.5 million. Adjusting $56,000 in 1980 to current day dollars (using the RBA's inflation calculator) gives $241,000. The real cost is up by 330% over 38 years, but that's only 3.9% a year for inflation.

The second house, this time free-standing on the Lower North Shore, cost $104,000 in 1983. Let's guess it is now worth $2.5 million. Current day dollars for the $104,000 is $333,000, a change of 220% at an average inflation of 3.4%.

These examples are typical, give or take, of millions of people who entered the property market 20 to 30 years ago. The following chart shows real property prices for Australia since 1970, adjusted for inflation. The index is set at 100 in 2010, and this is not the most expensive markets of Sydney and Melbourne.

It shows how far ahead of inflation, and similarly wages, house prices have risen, although it's not a straight line. The index rose from 1970 until 1975 and then held its real levels for the next dozen years, with a strong kick up before the 'recession we had to have' in 1991. Many houses purchased in 1990 were worth less five years later. And yes, interest rates in the late 1980s were much higher, with the variable rate at around 13.5% for most borrowers. But anyone owning a house for the last 25 years has materially benefitted.

Australian Real Residential Property Price Index from March 1970 to March 2019



With this increase in wealth, consider what owning a family home gives under our current system:

1. Tax-free capital gains. I asked a fund manager many years ago where he invested his own money. He said that while he held his liquid assets mainly in his own fund, the best investment for tax-free capital growth was Sydney houses on large blocks of land in great suburbs. And in his case, it needed to come with its own tennis court.

2. Exemption from social security assets tests. Even for most people who have not accumulated much wealth outside the family home, but spent their life paying off their mortgage, they are now sitting on a substantial asset in retirement. A couple can receive a full age pension with other benefits such as cheap medical prescriptions if their assets outside the home are less than $394,500, and part pension up to a healthy $863,500. They can top up their cash flow through the Pension Loans Scheme up to 150% of a qualifying pension (the maximum age pension for a couple is $36,582 a year, plus pension and energy supplements). There are many reverse mortgage schemes which also give access to lump sums if needed.

For all the attention we rightly pay to superannuation, it is the ownership of a home, exempt from assets tests but giving access to cash flow through a reverse mortgage, which offers the greatest financial security and independence in retirement. Due to property inflation, newer generations are finding it far more difficult to reach this milestone, increasing the uncertainty of their futures.

3. Equity and bond markets

To avoid doubling the length of this article, let's consider a few data points which show how favourable investment conditions have been over the last 30 years, even including the GFC.

The 2019 Vanguard Index Chart gives financial year returns for major asset classes, with the averages since 1990 of:

- Australian shares, 10.0%
- US shares (unhedged), 11.8%
- Australian bonds, 8.3%
- Australian listed property, 10.6%

Investors should be delighted if these returns are repeated in the next 30 years. Even a balanced portfolio with conservative allocations to bonds and cash has delivered close to 10%. With bond rates now at 1% and markets fully-priced, if anyone offered you these returns, bank them before they blink.

4. Free education

In 1974, Gough Whitlam abolished fees for university and tertiary education became free until the introduction of HECS in 1989. I went to university for four years from 1976 to 1979, with every year free. Now it is common for students to acquire $100,000 or more of HECS debt. I also benefitted from a Commonwealth Bank bursary that paid full salary while studying, but the Bank no longer offers such funding.

5. Death duties and super for estate planning

It is claimed that no other developed nation has policies that both exempt the family home from any form of taxation or social security test, plus imposes no death duties. It's also argued this places the tax burden on income which is unfair to younger generations, encourages a brain drain to lower-taxed countries and reduces the turnover of property.

Australia does have a form of death duty. Non-dependant children who inherit a superannuation lump sum will pay 15% tax plus 2% Medicare Levy on the taxable component of the balance. The best way to avoid this tax is to transfer money out of superannuation the day before death. Get the paperwork ready.

This raises another point on the purpose of superannuation. While it is widely accepted that super is intended to finance retirement, the reality for many wealthy Australians is that super is an estate planning tool. Keep the money in a favourable tax environment for as long as possible before handing it over to the children, and whip it out of super before buying the coffin.

Somewhere along the way, the bank of Mum and Dad might help in the property market.

At the last Federal Election, the Coalition successfully targeted 'death taxes' as a Labor strategy, even thought it was not on the policy agenda. Such tactics ensure unpopular policies are removed from debate, when a death duty potentially lowers inequality and reduces reliance on other taxes. Dead people do not vote, but they enjoyed passing their wealth to their children.

6. The Intergenerational Report

Somewhere in this divide is the harsh reality of future budget constraints. The 2015 Intergenerational Report assesses the long-term sustainability of government policies looking ahead 40 years, and it includes:

- In today's dollars, health spending per person is projected to more than double from around $2,800 to around $6,500 a year. State government costs will also be significantly higher.
- Aged care expenditure is projected to increase from 0.9% of GDP in 2014-15 to 1.7% in 2054-55, and from $620 to $2,000 in real, per person terms.
- Despite policy changes and greater super balances, payments made through age and service pensions per person are projected to increase from almost $2,000 in 2014-15 to around $3,200 in 2054-55 per person in today's dollars.
- Most significant of all, *"There will be fewer people of traditional working age compared with the very young and the elderly. This trend is already visible, with the number of people aged between 15 and 64 for every person aged 65 and over having fallen from 7.3 people in 1974-75 to an estimated 4.5 people today. By 2054-55, this is projected to nearly halve again to 2.7 people."* That's a lot less workers paying taxes to support the elderly.

They are coming to get us

Boomers are a large voting group. High post-war birth rates and longer life expectancies means it's a cohort few politicians want to offend. We Boomers fight to retain our benefits, as former Shadow Treasurer Chris Bowen discovered when he was completely out-muscled over franking credits.

There's little doubt the Labor Party will abandon the policy. New leader Anthony Albanese recently told the National Press Club following the review of Labor's election defeat:

"When you've got to explain dividend imputation and franking credits from opposition, tough ask. While the call on the budget of franking credit arrangements is large, many small investors felt blindsided and it opened up a scare campaign."

Data from demographer Bernard Salt shows Millennials already significantly outnumber Boomers, and they will increasingly hold the power at the ballot box. By 2040, the first Boomers born in 1946 will be well into their nineties and life expectancy increases will not save all of us.

The great generational divide

Population levels by generation, 2016 & 2019

Age group	Generation	2016 (m)	2019 (m)	Change
18-37	MILLENNIAL	6.9	7.3	405,000
38-57	GEN X	6.3	6.4	123,000
58-77	BABY BOOMERS	4.4	4.8	380,000
78+	PRE-BOOMERS	1.2	1.3	104,000
TOTAL 18+		18.8	19.8	1.012000

Source: ABS, The Demographics Group

Time to fess up

Of course, not every Baby Boomer has enjoyed the good times, and this article makes sweeping generalisations about opportunities. It focusses on the prevailing circumstances millions have faced, not whether they were fortunate enough to grab them. Female Boomers also did not have equality in employment and salaries.

Missing out on the war years and the immediate austerity that followed, Boomers have benefitted from a favourable superannuation system with high limits and then little or no tax in retirement, surging property prices, excellent bond and equity markets, free education and avoidable death duties … we could go on about cheap global air travel, rapid medical advances, low unemployment and a healthy environment.

The next generations worry about the climate change problems we will leave behind, how future education and health and social services will be funded, and how they will ever enter the property market.

Let's cut a little slack and campaign less against every change that might adversely affect us. We've had the politicians in our pockets, next to our bulging wallets, but it will not always be that way. The younger generations include our children and grandchildren.

Truth is, it's been good for us. OK, Boomer?

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any individual.

Young women are investing more in shares

Gemma Dale

While share ownership in Australia (and around the world) is dominated by men, there are encouraging signs that the wealth gap may close over time, as younger women start investing to build wealth. In a recent analysis by nabtrade, Gen Z women (the generation born between 1995 and 2015, following the Millennials) hold 20% larger portfolios than men of the same age.

Women's wealth traditionally held back

Demographic headwinds such as time out of the workforce to have children and lower average salaries have generally prevented women from accruing wealth at the same rate as men, resulting in a substantial wealth gap between the sexes in older generations.

In younger people, however, women are building portfolios through a combination of careful stock selection in large companies and much lower turnover rates than their male peers. This results in larger portfolios and lower transaction costs. In contrast, young men are more likely to hold stocks outside the S&P/ASX200 and to trade more frequently.

While women typically trade far less frequently than men across all age groups, they also trade in larger parcel sizes relative to their overall portfolio holdings. This aligns with global research since the 1990s, which suggests that men may be prone to overconfidence in their trading. Research shows men actively turn over their portfolios, which may reduce returns through excess transaction costs and imperfect market timing, while women place fewer trades and show greater commitment to their long-term investment strategies.

Stock selection

Individual shareholdings also differed between the genders across the generations, with women favouring staples such as Coles and Woolworths, as well as retailers including Harvey Norman. Women were also more likely to hold Bubs Australia and A2 Milk than their male counterparts.

nabtrade data showed women tend to stay with stocks and sectors that are familiar to them, meaning they are more likely to hold bank shares and less likely to invest in direct international shares than men across all age groups. While female investors showed a strong preference for ethical ETFs and were also much less likely to hold gambling and energy stocks than men, they were equally likely to hold one of the big miners.

Stock/Sector/Instrument Type	More likely to hold
Coles and Woolworths	Women
Retail sector	Women
Big Miners	Equal
Big Energy	Men
Gambling	Men
A2 Milk, Bubs Australia	Women
Domestic ETF	Women
International ETF	Men
Ethical ETF	Women

Differences between generations

While Gen Z women hold larger portfolios than their male counterparts, and Gen Y portfolios are of similar size between the sexes, female Baby Boomers hold just 56% of the portfolio size of men in the same age group. Gen X women hold portfolios nearly 78% the size of a man’s in the same age group.

These statistics paint a particularly dark picture of women’s economic wellbeing when couples commonly (and logically) choose to invest in the name of the lower-income earning spouse, typically the woman. Once accounting for this bias, the value of women’s overall holdings is further reduced.

The rise of online share trading and the proliferation of low-cost products such as ETFs has allowed young people of both genders to come to the share market at a younger age than previous generations, giving them a head start in wealth creation. As these investors grow in confidence and experience, it is hoped they will continue to invest for their future.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs. For more nabtrade insights or to open an account, visit the website. You can also access Gemma's weekly Your Wealth podcast on nabtrade, or via Apple podcasts, Spotify or Podbean.

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Why divest from fossil fuels?

David Macri

The 'boycott and divest' campaign aimed at the fossil fuel industry has hit the headlines in recent weeks. Prime Minister Scott Morrison has threatened to ban 'secondary boycotts' aimed at companies that service the fossil fuel sector.

Two influential voices in the investment sector have also spoken out against fossil fuel divestment. Billionaire philanthropist Bill Gates and Hostplus chief investment officer Sam Sicilia have respectively described the international divestment movement as having 'zero' impact and being 'weak'. Neither of them are climate change deniers – in fact, both are keenly aware of the perilous state of the climate emergency.

Their argument about divestment is a trivial one. Small-scale divestment might only result in shares changing hands, but if there are enough sellers there will inevitably be a financial impact in the form of a lower share price and a higher cost of capital.

Why investor divestment will work

That said, the debate about the short-term impact of divestment misses the point. It is hugely important to understand *why* the shares are changing hands.

The current fossil fuel divestment campaign, which has to date secured US$11 trillion worth of divestment commitments including €300 million from the entire Government of Ireland, echoes a similar campaign against the South African apartheid regime in the 1980s. The anti-apartheid movement called upon US colleges and universities to divest from South African companies as well as any company with South African interests. The campaign reached its peak in August 1988 when 155 institutions had agreed to divest. This movement, along with international sanctions and consumer boycotts, is credited with hastening the end of apartheid in 1991. The widespread television coverage generated by the 'divest and boycott' movement played a pivotal role in generating the critical mass needed to abolish the apartheid legislation. The investors who refused to support the apartheid regime with their capital were effectively denying a social licence to companies benefiting from institutionalised racism.

In 2019, the fossil fuel divestment movement is making it clear to companies who extract coal, oil or gas from the ground that they do so without a social licence. The release of harmful greenhouse gases into the atmosphere via the burning of these fossil fuels is threatening to destabilise life on this planet.

Climate change constantly ranks as the number one issue for our members and as such we have a duty to advocate for immediate action to address it. And we will continue to do so despite efforts by the government to discourage the boycott and divest campaign.

In fact, we want the whole investment industry to divest from fossil fuels. If that happened, the effect would be tangible. Share prices of fossil fuel companies would fall, creating a higher cost of capital for expansion projects (ie, new mines or infrastructure) to the point they would become uneconomical. This would naturally reduce future supply and increase prices, which should in turn reduce future demand, especially as alternative fuel sources and energy storage become increasingly cheaper.

Action on multiple fronts

People like Bill and Sam say it’s a waste of time to divest from fossil fuels. Instead, they argue, it makes more sense to invest in technological solutions to combat climate change. We believe it’s possible to do both things at once.

In fact, divesting from fossil fuel companies inevitably frees up capital that can be invested in renewable energy and other technology that can help mitigage climate change. By shifting capital to renewables, investors help to bring down the price of renewable energy, encourage investment in more flexible electricity grids and energy storage, and contribute constructively to a sensible public discussion about energy policy.

If super funds behave like the ‘universal investors’ they are rapidly becoming, they will be acting in the financial interests of their members by helping to generate superior market returns in a lower-warming world (relative to business as usual, which will lead to a higher-warming world in which climate change creates financial and real asset catastrophes). Increased demand for the shares of companies aiming to have a positive impact also means they will be able to raise new capital at a cheaper cost in the future to pursue growth plans. In addition, public debate about the benefits and harms of different industry sectors encourages better policy from governments to promote sustainable businesses.

If we are to avoid the worst effects of climate change, there must come a point when divestment, consumer boycotts and government action ends the widespread use of fossil fuels. We believe that denying a social licence to dangerous fossil duel companies is an important first step towards that goal.

David Macri is the Chief Investment Officer of Australian Ethical Investment, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Shorting deserves more respect

Jun Bei Liu

Long-short equity strategies have been used for a long time, but the current volatility and uncertainty plaguing the market is markedly influencing this investment approach.

While the merits of short selling and its impact on markets have been the source of much debate, the fact remains that short selling plays an important role in ensuring securities are priced correctly relative to fundamentals.

Briefly, the process of selling a share 'short' involves borrowing a stock from a broker and then immediately selling it in the expectation that the price will fall. It can then be bought back at a lower price and returned to the broker it was borrowed from, while profiting from the difference in price.

A long-short strategy buys shares on the long side hoping they rise in price, and sells shares on the short side hoping they fall in price.

The multiple roles of shorting

Shorting is a controversial topic in Australia and has often been unfairly blamed for creating excessive volatility in markets. However, short selling doesn’t change the underlying fundamentals of a business. Shorting creates opportunities for investors with differing views, aids in price discovery and provides greater market depth.

Traditional long-only fund managers are, by definition, skewed towards identifying opportunities to buy, whereas those managers that adopt a long-short approach can take a position in a range of investment opportunities across a much wider spectrum of investment options through both buying and short-selling.

The most obvious benefit of long-short investing, therefore, is that it offers investors the ability to benefit from both rising and falling prices, whatever the market conditions. A long-short equity strategy seeks to profit from share price appreciation above the index in its long positions as well as from price declines below the index in its short positions.

From a pure risk management perspective, long-short investing can substantially lower the risk profile of a portfolio, while at the same time allowing investors to access stocks in high-performing but volatile sectors.

The technology sector is a good example. It is inherently volatile due to sensitivities around growth assumptions and bond yield movements, while simultaneously offering some of the brightest spots and rare growth companies. It would be a shame for investors to shun this sector due to volatility, and while current valuations are stretched, it need not be disregarded entirely.

In managing this risk, an asset manager will short sell companies that are less appealing yet on high valuation to remove some of the volatility. Holistically, from a pure portfolio standpoint, long-short investing should offer better risk-adjusted returns for investors.

Portfolio construction using shorts

The fund manager focusses on both short selling a range of stocks with weak investment characteristics and reinvesting the proceeds in long positions in preferred stocks, giving long-short managers a high degree of flexibility in active decision making. This is particularly relevant in the local context, given that the Australian share market is small by global standards and is dominated by a small number of very large companies.

When using a benchmark for constructing an investment portfolio, such as the S&P/ASX 200 Accumulation Index, the performance of a traditional fund which only takes long positions will be determined by the size of the fund’s shareholding of these large companies relative to that company’s weighting within the benchmark.

In contrast, a fund that is also able to take short positions by borrowing securities from other holders can sell on market then reinvest the proceeds in long positions. It creates a larger set of investment opportunities and potential to outperform the benchmark. That said, a short investment strategy is not for all investors, not least because returns and exposure are amplified on the upside as well as the downside. The most a long position can lose is the amount invested, whereas a short position can in theory lose multiple times the inital short if prices rise rapidly.

Risk control is therefore paramount. Managers with inappropriate risk modelling will find it difficult to consistently outperform. One way to approach this is to invest in a manager that uses a combination of quantitative and fundamental investment processes.

Shorting offers diversification opportunities that would not be otherwise available to a long only manager, especially at higher levels of active risk. For instance, shorting offers the opportunity to hedge out a factor such as industry risk while allowing the benefit of stock-specific drivers of returns. Shorting is also used to leverage high-conviction long ideas within a fund.

How shorting works

Short selling opportunities should be approached in the same way as buying opportunities. Extensive research of a company's earnings prospects should be undertaken by analysing the industry structure and business model, as well as the quality of its management team, then overlay this with a top down macro-economic forecast.

The valuation is then typically referenced against peers and the earnings forecast relative to broker consensus expectations.

Once a decision is made to short, stock catalysts are then identified and an assessment of a potential holding period is made. Examples of stock catalysts include an earnings release, industry news flow, industry disruption and the prospect of regulatory changes.

Timing is important for concentrated short positions. For example, the stakes my fund recently took in lithium names such as Pilbara Minerals and Syrah previously, illustrate this. The global shift to increase electric vehicle investment had seen enormous amount of demand for battery materials such as lithium and graphite, and share prices of the sector rallied hard. In the past three years however, we have witnessed vast supply response from the raw materials producers which has meant the bullish assumptions investors initially used were grossly overstated. Those lithium positions were implemented early in the year and have been closed recently.

Increasingly, investors are realising that opting for a completely conservative investment allocation is not a viable solution. They recognise that there should be some allocation towards growth assets, and a long-short

Australian equity fund may meet that criteria. The extra leverage and potential for losses on both the longs and the shorts means these funds are more suited for investors with a long-term perspective.

Ultimately, a long-short approach enables portfolio efficiency to better capture alpha insights. This is particularly relevant with the current uncertain market outlook both globally and domestically.

Jun Bei Liu is Portfolio Manager at Tribeca Investment Partners. The information contained in this article is for informational purposes only and should not be considered investment advice.

Focus on quality yield, not near-term income

Rudi Filapek-Vandyck

It is the subject most share market experts and commentators would rather not talk about: buying cheaply-priced stocks works best when interest rates are higher, economic growth and cycles are relatively robust and there is no mass-disruption eroding barriers of entry and technological innovations.

The current environment is different. Interest rates are exceptionally low, and likely to move lower still. Economic growth the world around post-GFC has never been quite the same, and the overall pace remains low by historical standards. And change caused by innovations.

Cheap companies might stay cheap

The direct result is that corporate throwbacks, missteps and failures are not necessarily temporary in nature, as was mostly the case pre-2012. Cheaply-priced companies might find it hard to sustainably improve their operations and thus catch up with the prolonged bull market in equities.

It is one reason why 80 of small cap and 92% of large cap actively managed funds in Australia, according to a recent sector update by Morgan Stanley, are unable to keep pace with their benchmark, let alone decisively beat it.

There are plenty of examples to choose from. In the health care sector, far and away the best performing in Australia, plenty of funds preferred Healius (ASX:HLS) instead of the much more ‘expensive’ looking Cochlear (ASX:COH), ResMed (ASX:RMD) or CSL (ASX:CSL). Yet it's the ‘cheaper’ one out of these four that has, on balance, hardly performed on a five-year horizon.

Amongst REITs, one of the better-performing segments on the ASX, the likes of Goodman Group (ASX:GMG) have at times become the focus of short-positioning, but the share price consistently moved upwards, at least until the mini-correction in August this year.

Once upon a time, Goodman Group shares were highly sought after by income hungry retirees, but these days the shares only offer circa 2% forward looking. That can serve as an indication of how ‘expensive’ those shares have become.

Income-seeking investors have instead preferenced REITs such as Vicinity Centres (ASX:VCX), which still offers circa 6% yield. On the flip side, Vicinity shares have eroded some -23% since their peak in mid-2016 and have largely trended sideways throughout 2019 when most market indices added near 20%.

Amidst an ongoing tough outlook for industrials in Australia, the increasing number of profit warnings and negative market updates are accompanied by a reduction in the dividend for shareholders. There are predictions of a lower payout by Vicinity Centres in 2020, and, post the recent profit warning, Medibank Private's (ASX:MPL) FY20 dividend might be at risk too.

Cheap stocks might lag for good reason

Probably the most striking examples have come from the banking sector, in particular in Australia, prominently represented in investment portfolios. If it isn't because of the dividend appeal, it's because the sector remains by far the largest on the local stock exchange with all four majors plus Macquarie included in the ASX Top10.

In a recent strategy update on global banks, analysts at Citi offered the following warning for investors: **Don't Buy Cheapest Banks.**

Their motivation: "*Pursuing a Value strategy within the global Bank sector has been an especially disastrous strategy. Cheap banks in Europe and Japan have got even cheaper. More expensive banks in the US have stayed expensive. We don't expect this valuation gap to mean-revert anytime soon.*"

In other words: when growth is elusive, and the pressure is on, investors should adjust their strategy and focus too. Cheap stocks might be lagging for good reasons.

With yield curves inverting for government bonds, economic momentum struggling and credit growth sluggish, banks globally have been lagging the bull market. Hence the recent reset in bond markets, whereby yield curves steepened, and triggered a renewed interest in bank shares around the world. This is part of the rotation into 'value' career professionals like to talk about.

But Citi analysts are not buying it. They argue valuations for bank shares should stay 'cheap' because the global economy remains weak and bond yields will remain low.

In Australia, it can be argued, bank shares are not particularly 'cheap', as they have benefited from the attraction of 5%-6% dividend yield. But they seem 'cheap' in comparison with stocks like Macquarie Group (ASX:MQG), Transurban (ASX:TCL) and Charter Hall (ASX:CHC). These stocks that have fully participated in the share market uptrend and contributed with gusto to pushing major indices to an all-time high this year.

Banking sector not all about yield

Yet, the October-November reporting season has left shareholders with a sour after-taste. All of Bank of Queensland (ASX:BOQ), Westpac (ASX:WBC) and National Australia Bank (ASX:NAB) announced a sizable reduction in their final dividends, while ANZ Bank (ASX:ANZ) kept it stable, but with -30% less franking. In a surprise move, Westpac raised extra capital too.

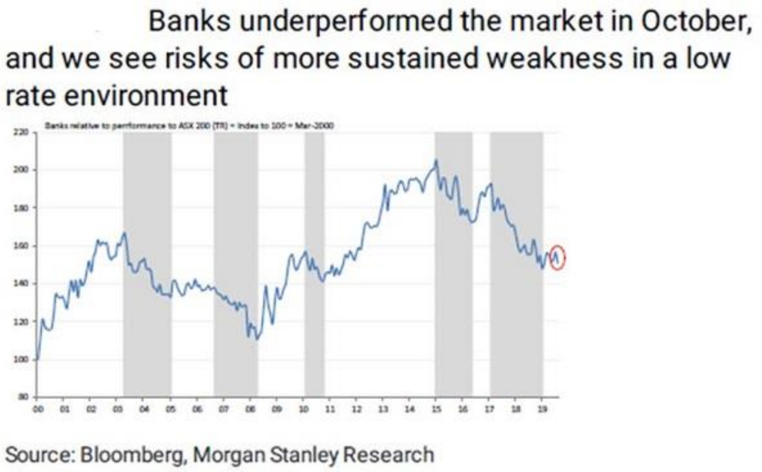
Little surprise, the local bank sector has been the worst performer of late. October delivered a general decline of -4.4% for the sector to keep the overall performance for the Australian market slightly in the negative for the month. In the words of UBS: "*it appears the market is coming to terms with the outlook of decreased profitability from lower rates and increased capital requirements*".

The higher yield (as implied by a 'cheaper' share price) does not make the better investment. It's usually the **exact opposite**.

Commbank (ASX:CBA) shares trade at a noticeable premium and its premium valuation is backed up by superior returns versus 'The Rest' over five, 10, 15 and 20 years. Occasionally, one of the laggards in the sector might experience a catch-up rally that temporarily pushes CBA into the shadows, but the two prize for consistency and performance in Australian banking are CBA and Macquarie.

This by no means implies there cannot be more negative news from CBA or the other banks. If investors want more evidence the 'Golden Years' for banking in Australia are now well and truly in the past, Morgan Stanley's research shows banks have noticeably underperformed five prolonged times since 2000, with two of the five periods occurring since April 2015.

Below is the graphic depiction of the five periods since 2000 that accompanied the Morgan Stanley research report:



What the banks have once again shown to investors is that higher yield tends to correlate with higher risk. And that risk should not be solely measured in loss of capital. CBA shares have trended sideways since September 2015. Over that same period, shares in Macquarie have appreciated by some 75%.

For a slightly lower dividend yield on offer, backed by a superior growth profile, Australian income investors could have accumulated significantly better returns if only they weren't so afraid of paying a little more for it.

Where can cash be deployed in the share market?

So what is an investor to do who today is sitting on some cash, looking to be deployed in the share market?

My advice is to look for **quality yield**. What exactly defines quality yield? It's a dividend that is most likely to rise over multiple years ahead. Admittedly, such a proposition is probably not available at 5.5% or 6%, but then again, investors are less likely to find themselves confronted with capital erosion or a dividend cut further down the track.

Look for research that is not solely based upon 'valuation', relative or otherwise. Foe example, Morgan Stanley prefers 'manufacturers' over 'collectors' and 'creators' over 'owners', with the team labelling itself 'selective with value'. Identified property sector favourites are Stockland (ASX:SGP), Goodman Group and Mirvac (ASX:MGR). Sector exposures to stay away from, even though they might look 'cheap', according to the team, include Scentre Group (ASX:SCG), Vicinity Centres and GPT (ASX:GPT).

Investors should note Morgan Stanley analysts agree with the view that owners of retail assets look 'cheap', but they still see shopping malls coming under pressure from both tenants and consumers.

Macquarie analysts have compared infrastructure stocks with utilities and AREITs and concluded utilities currently offer the superior total income profile, with infrastructure and AREITs both equal second. Risk-adjusted, Macquarie believes, infrastructure offers the highest potential return. AREITs are seen offering 'a balanced yield exposure'.

On Macquarie's projections, utilities such as AusNet Services (ASX:AST) and Spark Infrastructure (ASX:SKI) carry the highest income potential over the next three years, but they also come with the highest correlation with the broader share market (meaning: above average volatility in share prices). This is most likely because they offer little in terms of growth. It's all high yield.

Rudi Filapek-Vandyck is an Editor at the FNArena newsletter. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

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Policymakers fear cutting stimulus can lead to recession

Michael Collins

At a 'Fed Listens' event held where the US central bank's policy-setting board meets, Federal Reserve Chair Jerome Powell in October 2019 described how the room with *"26-foot ceilings, a monumental marble fireplace and a 1,000-pound brass and glass chandelier"* had "*seen a lot of history since Franklin Roosevelt dedicated this building in 1937*".

That's probably the most innocuous economic event linking 1937 and the 32nd President. The pairing is more renowned for the 'depression within a depression' Roosevelt triggered in his second term when he tightened monetary and fiscal policies after US production surpassed pre-Depression levels.

The controversial and damaging action

Under Roosevelt's direction, the Fed boosted bank reserve requirements by 50% and the Treasury withheld gold inflows from the monetary base, to guard against inflation. Government spending was cut in a quest to eliminate the federal deficit within two years. The result was the third-worst recession of the 20th century. Real

GDP dived 10% and industrial production plunged 32% while the jobless rate jumped to 20% as four million people lost their jobs.

Roosevelt's premature tightening still haunts US policymakers. Avoiding 1937-style missteps was pertinent in 2016 when the economy was healthy enough for the Fed to tighten monetary policy and for the administration of Barack Obama to reduce budget deficits towards 2% of output from a post-crisis peak of 10% of GDP in 2009.

That the US expansion that began in 2009 has entered a record 11th year shows officials have avoided a 1937 rehash. To help ensure no repeat, the Fed this year resumed loosening monetary policy, while Washington's budget deficit is widening. President Donald Trump's tax cuts of 2017 have stretched the shortfall beyond 4% of output.

Stimulus comes with risks

Prolonging an upturn with stimulus is an achievement but it comes with risks. Three leap out.

First is that stimulus can delay adjustments an economy might need to thrive over the long term. Today's US recovery is sluggish and it is at risk if imbalances metastasise. These distortions include record asset prices and government, household and business debt at worrying levels.

Second, the Fed is unable to respond in a meaningful, conventional way to threats. The central bank has cut the cash rate to between 1.5% and 1.75% and its balance sheet is still distended from three bursts of asset buying (or quantitative easing).

Third, policymakers might need to double down on fiscal solutions to extend the expansion. Washington's projected deficits, on top of almost continual shortfalls since 1970, are forecast to boost its debt to 95% of GDP by 2029, the highest ratio since just after World War II. At some point, the public and investors could lose confidence in Washington's budgeting abilities.

US policymakers should ask themselves whether extending the expansion might lead to an uglier downturn than what they might have evaded so far.

To be sure, any slump comes with social costs best avoided; policymakers had little choice politically but to stimulate the economy when they could. The US's imbalances aren't as large as those of the Eurozone and Japan, where radical stimulus has largely failed to stir robust growth.

Stimulant side effects

Herbert Hoover was President when the Great Depression struck in 1929. In his memoirs, Roosevelt's predecessor told of the advice of his Treasury Secretary, Andrew Mellon.

"Liquidate labour, liquidate stocks, liquidate farmers, liquidate real estate. It will purge the rottenness out of the system."

The quote summed up the tightening of fiscal and monetary policies that officials followed in the 1930s, the same type of voluntary deflation known as austerity that Europe pursued during the eurozone debt crisis.

Repeated spectacles where austerity misfired by hurting the economy gave credence to the remedies of John Maynard Keynes. The UK economist argued that easing monetary and fiscal policies in tough times and doing the reverse in good times prolongs growth and softens recessions. Such policy activism explains why five of the six longest US expansions of the 34 upturns recorded from the 1850s have occurred since the 1960s.

While advocating macro management, Keynes was aware of its limits, especially with monetary policy. Keynes warned of the 'liquidity trap', a concept that describes situations when uncertainty is so great, low interest rates would fail to generate enough demand to ensure full employment.

One question is whether emergency steps could be ineffective or even prompt perverse behaviour. On the fiscal side, policymakers are assessing whether prolonged activism might only lead to torpor and damaged public finances. Italy's budget deficit, for instance, averaged 3.4% of output from 1995 to 2018, which boosted government net debt from 101% to 120% of output. Yet the economy struggled most years.

Central bankers are also questioning whether loose monetary policy could reduce the pressure on politicians to take the steps economies need to thrive over the long term. They are aware that the European Central Bank calmed the eurozone debt by 2014 and saved the Euro. But that allowed politicians to duck devising the fiscal, political and banking unions the currency needs to endure.

Avoiding further asset price inflation

Another side effect policymakers are wary of is that stimulus can inflate asset prices and foster risk-taking. The 'Greenspan put' described how Fed chief Alan Greenspan repeatedly cut interest rates to insulate the economy from falling stock prices. These cuts rewarded excessive risk-taking, which is often cited as causing the GFC. Does policy activism make people too dependent on stimulus? Household budgets, for instance, appear unprepared for any meaningful rise in interest rates, however unlikely that might appear.

Prolonging stimulus could feed imbalances that recessions usually correct. The 'Austrian School' of economics opposes stimulus because slumps rid economies of 'malinvestment'. While that's considered extreme, low rates have led to record household, corporate and government debt in many countries. Imbalances typically get corrected one day.

The complications of stimulus don't argue against heeding the lessons of 1937. They just mean that when policymakers gather in their splendid rooms to ponder options, they must ask themselves if they risk creating a world of rarer but perhaps harsher downturns.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.

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Bank reporting season scorecard for FY19

Hugh Dive

For much of the last decade, the profit results for the banks were rather simple to analyse. Coming out of the GFC, the major trading banks steadily grew profitability on the back of solid credit growth, declining bad debt charges and reduced competition as foreign competitors either exited the Australian market or were taken over.

Reporting season scorecard November 2019

Company	Share Price		Market Cap $B	Cash earnings per share growth	Dividend growth	Net interest margin	Impairment charge as % of loans	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2019 total return
Westpac	$	26.80	$ 95.6	-16.0%	-15.0%	2.1%	0.13%	11.3%	10.5%	13.7	6.0%	14.0%
ANZ	$	25.34	$ 71.8	2.0%	0.0%	1.76%	0.13%	11.4%	10.90%	12.9	6.3%	10.1%
NAB	$	29.08	$ 83.8	-12.5%	-16.2%	1.78%	0.15%	10.4%	9.90%	14.9	5.7%	24.3%
Commonwealth (Aug 2019)	$	80.83	$ 143.1	-5.5%	0.0%	2.10%	0.16%	11.8%	12.50%	17.0	5.3%	17.6%
Macquarie (1H20)	$	136.72	$ 48.5	11.0%	16.0%	n/a	n/a	11.4%	16.40%	15.9	4.3%	31.4%

Source: Company reports, IRESS, Atlas Funds Management

However, over the past two years, the profit results of the banks have become increasingly complicated to analyse. The Financial Services Royal Commission resulted in extensive remediation provisions, increased compliance costs and a spike in legal fees, at a time where credit growth has slowed dramatically and interest rates have moved towards zero.

Additionally, Commonwealth, ANZ and Westpac all divested divisions, primarily in wealth and insurance, the areas of their businesses that were the source of the majority of their remediation charges.

This update looks at the themes in the approximately 800 pages of financial results released over the past 10 days by the financial institutions that grease the wheels of the Australian capitalism. We award gold stars based on performance over the past year.

Remediation

Customer remediation was a key theme for the results in 2019, with banks compensating customers or taking provisions related to financial advice, banking, insurance and consumer credit.

Australia's banks have taken remediation provisions over the past 12 months of between $826 million (ANZ) and $1.1 billion (Westpac and CBA), with NAB around the $1.4 billion mark. ANZ's lower level of provisioning does not reflect any lack of prudence, but rather their historically lower level of exposure to financial advice and funds management. NAB's higher level reflects their desire to put MLC on solid footing before either selling or listing it in 2020.

No star is given. The fact that the banks have made these provisions is bad for both their customers and shareholders.

Capital

While all banks have core Tier 1 capital ratios above the Australian Prudential Regulation Authority (APRA) 'unquestionably strong' benchmark of 10.5%, boosting capital was a feature of bank results in 2019.

Gold Star

Westpac increased its capital via both a $2.5 billion equity raising and cutting the dividend, ANZ and CBA saw capital increase after selling wealth and insurance divisions and not buying back shares to neutralise the earnings per share impact and NAB's final dividend was partially underwritten.

Normally, increases in capital are only required when a bank is either substantially increasing its loan book or writing off the value of assets in a recession, neither of which is facing the banks in 2019. It is an environment of anaemic credit growth and low bad debts. These moves are in response to potential changes to capital requirements across the Tasman discussed below and APRA's moves to retain capital in the Australian banking system.

New Zealand

New Zealand's banking market is unusual in the developed world in that around 90% of lending is done by foreign banks. The subsidiaries of Australia's major four banks and the country are a major capital importers. While this market dominance is often portrayed as a takeover of the New Zealand banking system by sinister Australian institutions, the concentration of market power is primarily due to the collapse of New Zealand owned banks in the 1980s, with these banks being taken over and recapitalised by Australian banks.

Late in 2018, the RBNZ released a consultation paper on bank capital requirements, essentially saying that they would like the banks operating in New Zealand to lift their Tier 1 Capital from 8.5% to 16%, well above APRA's Australian standard of 10.5%. The impact of this decision (if implemented) would be for the Australian banks to inject around to A$12 billion into their NZ-based subsidiaries.

The RBNZ consultation paper is based on the naïve assumption that Australian shareholders would blithely fund New Zealand's aspirations to be the best-capitalised banking system in the world, without any impact on pricing of mortgages in New Zealand or overall credit availability in the shaky isles. In December 2019, the banks will gain clarity as to how the RBNZ intends to implement its plans and in response, all of the banks other than NAB are carrying high levels of capital.

In its results, NAB took the most aggressive tone, suggesting that they will reduce lending in New Zealand and reprice loans, an interesting move given that in 2019 New Zealand was NAB's most profitable market and the only division in NAB that saw higher cash profits. If New Zealand's capital requirements turn to be less onerous than expected, investors may expect share buybacks from ANZ and CBA.

Profit growth

Bank profit growth reflected anaemic credit growth, falling interest rates and significant remediation charges, with earnings per share across the major banks declining by -8%. While some analysts and the banks themselves ignore these charges and talk about 'normalised earnings', we see this as specious logic. These remediation charges are not non-cash accounting charges, but actual cash outflows that impact shareholder dividends.

ANZ Bank grew cash profits per share by 2% courtesy of a strong performance by its institutional bank and taking most of their remediation medicine in 2018. However, the gold star goes to Australia's global investment bank, Macquarie, which stands out with an 11% growth in earnings per share. Macquarie's rising earnings per share is due to both successful expansions offshore and sidestepping most of the issues revealed by the Royal Commission.

Dividends

In 2019, NAB and Westpac cut their dividends to more sustainable levels, while ANZ and CBA kept its dividends steady. Macquarie sharply increased its dividend ahead of profit growth, a luxury afforded to Macquarie by its low dividend payout ratio. Across the major banks, ANZ has the highest dividend yield at 6.3%, though this may be at risk in 2020 if the bank does not buy back stock to neutralise the impact of lost earnings from the sale of its insurance and wealth management divisions.

Bad debts

One of the biggest drivers of earnings growth over the last few years has been the ongoing decline in bad debts. Falling bad debts boost bank profitability, as loans are priced assuming that a certain percentage of borrowers will be unable to repay, and that the bank will incur a loss on the loan. Over the past few years, when analysts look through a bank's financial statements one of the first numbers checked is the bad debt charge. Even a small rise may be interpreted as the start of a trend back to a normalised long-term level of bad debts around 0.3% of total loans.

Bad debts remained low in 2019, with Westpac and ANZ reporting the lowest level of bad debts of a mere 0.13% of the loan book, aided by a stabilisation in the East Coast property market and improving affordability stemming from several interest rate cuts. On the business side there were no major corporate collapses over 2019.

Very low interest rates

Over the past 12 months the RBA has cut the cash rate from 1.5% to a historic low of 0.75% and the standard variable rate for an owner-occupier mortgage has fallen from 4.7% to 4.1%.

While lower rates are positive for borrowers, low rates impact bank profitability and in particular their net interest margin. In 2019 the banks' net interest margins [(Interest Received - Interest Paid) divided by Average Invested Assets] decreased across all banks. The fall was attributed to increased competition, customer remediation charges and the reduced funding benefit from the bank's pools of deposits.

For example, NAB has $88 billion in deposits that are currently earning interest rates close to zero, as lending rates fall and the bank (unlike the Swiss banks) cannot charge negative interest rates. The profit margin gets squeezed.

In his presentation to the market, NAB's CEO made an interesting point that the RBA's rate cuts were not achieving their goal of stimulating the Australian economy. He saw that borrowers were not reducing their monthly payments to spend on consumer goods and savers such as retirees who are likely to spend all of their interest income are getting a much lower rate on their term deposits. Thus, very low interest rates result in a wealth transfer between savers who would otherwise be spending their interest income to reducing the debts outstanding for borrowers, with a minimal positive impact on the economy.

Westpac and Commonwealth reported the highest net interest rate margin in 2019 which reflects both their greater focus on mortgages (which attract a higher margin than business loans) and the lower loan losses on mortgages compared with business loans.

Our take

We expect the banks to deliver around 3-5% earnings growth as they face low credit growth and increased regulatory scrutiny. There remain significant cost saving opportunities from rationalising their 1,000 branch networks around Australia as the nature of banking changes to digital interactions.

However, if investors examine the wider Australian market, the banks look relatively cheap, are well capitalised, and should have little difficulty in maintaining their high fully franked dividends. Additionally, their share prices are likely to see support over the next 12 months as the remediation and compliance charges stemming from the Royal Commission begin to abate. Commonwealth Bank and ANZ may conduct share buy-backs over the next year if the RBNZ adopts a more conciliatory capital strategy.

Hugh Dive is Chief Investment Officer of [Atlas Funds Management](). This article is for general information only and does not consider the circumstances of any investor.

Additional Infographic, courtesy of KPMG