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Peter Meany on global trends in infrastructure assets

Graham Hand

Our Interview Series continues with Peter Meany, Head of Global Listed Infrastructure at First Sentier Investments (formerly Colonial First State Global Asset Management). Peter established the strategy in 2007.

GH: Infrastructure has many attractive features such as high barriers to entry, predictable cash flows and pricing power. What is the most powerful business attribute for your investing?

PM: They're all important and they interrelate. High barriers to entry often bring predictable cash flows. If I had to pick one, it would be pricing power. An ability to charge prices at or above inflation separates the good companies from the great companies. Combined with an essential service, something that people need or want, the ability to price that is incredibly attractive.

If we are heading into lower growth in the long term because of demographics, or over the medium term because of economic conditions, that pricing power becomes even more valuable.

GH: Yes, I always think of Sydney's Eastern Distributor opening with a toll of $3.50, and now it's $7.76. And with automatic tolling and tags, drivers don't even hand over the cash so they feel the cost less.

PM: It's a classic example. The price started at a reasonable level but we've had increases over time at the higher of 4% or inflation. WestConnex will have the same pricing structure for 15 years so it's a valuable franchise.

GH: What global trends are the most powerful for supporting infrastructure at the moment?

PM: There are a few. The longer-term structural drivers such as decarbonisation of the electricity grid are important. The world is moving more to renewables and less carbon intensity and the infrastructure needed is significant. On the one hand, it has negative implications for old fossil fuel power stations and the like but there's a whole new need for investment in wind farms, solar panels and increasingly, battery power storage. We'll have new transmission lines, distribution networks, smart meters.

Elsewhere, the move towards electric vehicles means charging stations will need significant investments. A well-positioned utility company can more than offset the negatives.

GH: Will the market address these trends or should the government be doing more to encourage the changes, particularly in Australia?

PM: We need both. Governments can create certainty of policy and I think that's probably been lacking in Australia, such as what the country wants to achieve with a renewable energy target. Some incentives and penalties might help, then businesses can work with that if given enough time to adjust their capital expenditure and business models accordingly.

In the US, Federal politics has probably played less of a role. Their shift to renewable energy has been more due to state-based targets, such as in Florida, California and Texas.

But economics always beats politics. The reality is, with the investment that's taking place in renewables, we've moved a long way down the cost curve towards cheaper cost than fossil fuels.

GH: Which renewables are cheaper now and which have yet to catch fossil fuels?

PM: Onshore wind in the US is already there. Solar is probably a few years away, and it needs battery storage to extend the utilisation. Renewables are cost competitive with gas-fired power plants, and they've already surpassed coal and nuclear.

My favourite company example is NextEra, the world's largest renewable company and a big part of our portfolio. They've got some projects now where they combine wind and solar at the same facility with battery storage, and that increases the hours of the day that the facility is utilised.

GH: In Australia, most of our power still comes from coal, and yet we have an investor and public movement against coal. How do you see the timing of that transition, especially since your business is positioned as a responsible investor? Isn’t it a difficult call to decide we’re ready to move on from coal?

PM: Being a responsible investor also requires thinking about the sustainability of an energy market. While it would be good to go 100% renewable in a year, the practical reality is that we cannot achieve that, given the scale of the problem. It would help if we had some clear policies on when we want to achieve it.

The economics are moving so quickly that we will probably bring forward some of those longer-term decarbonisation dates. It’s a 10 to 15 year story rather than 25 to 30 years. I'm in the school that accepts for the next 10 or 15 years, a balanced generation mix make sense. We should be working with our companies to drive earlier changes and accept that gas will act as a transition fuel, while the future will be a lot more renewables.

GH: For the last 10 years or so, falling interest rates have provided a tailwind for your investments. While it doesn't look like rates will rise soon, at some point, we will have another cycle. What are the most resilient parts of an infrastructure portfolio against rate rises?

PM: Firstly, it depends how sharply rates rise, because businesses can adjust better to a gradual increase. If rates rise because of improvements in real economic growth, then there will be more traffic on roads and passengers through airports.

If rate rises are driven more by a pickup in inflation, most infrastructure companies that we invest in have the ability to pass on increases. It might not be as direct as a Transurban where it is quarterly, but it's at least annually in most parts of the world. So in the medium term, whether rates are going up or down, doesn't really concern me.

It's the short-term, sharp movements in rates of 100 or 150 points (1% to 1.5%) in a three or six month time frame that you see big sector rotations as people shift from defensives to growth sectors, and there's not a lot we can do in that short period of time.

GH: What types of infrastructure assets do you think will do best in the next five years?

PM: It depends somewhat on the economic and bond yield environment. If we're in a steady state, we prefer companies with good organic growth, prices linked to inflation and room for additional investment to expand a network. Toll roads are a good example. We also think mobile towers will continue to do well. There is massive demand for mobility of data, such as downloading Netflix on the phone and video games in high definition as we move from 4G to 5G. We are simply going to need more towers, more small cells and more infrastructure to support that demand.

GH: Is there a listed player in Australia in that space?

PM: Unfortunately not. Many of the towers here are owned by Telstra. The Vodafone Optus towers were sold by a US company, Crown Castle, to an unlisted Macquarie consortium.

This portfolio diversification is an advantage of being a global investor. While I love the thematic of mobile towers, I can't play it on the ASX, while there are three big tower companies in the US that apply the theme exceptionally well (American Tower, Crown Castle and SBA). We also owned some European companies and just last year, the big Chinese telecom operators separated out their towers into one vehicle.

GH: Do you see any threats or worries to a particular sector, such as global epidemics for airports and ports?

PM: We saw September 11 and SARS affect airports, which was dramatic but in fact, short lived. Infrastructure is usually an essential service driven by long-term structural factors. We've seen earthquakes, terrorism, epidemics, bridges collapse. They make the news but in a diversified portfolio, they tend to come and go quickly.

Longer-term disruption events are more significant. Think about the potential impact of 3D printing on the world's chain of infrastructure. There's the manufacturing of a $5 toy in a western province of China, and all the roads and ports on both sides of the world until it reaches New York. There's a massive amount of infrastructure moving low-value goods around the world. If 3D printing develops over the next 10 to 15 years, it might lead to more deglobalisation.

GH: Do you have a view on whether autonomous vehicles will be a plus or minus for a toll road business like Transurban?

PM: I'm definitely in the plus camp. Over the next 10 to 15 years, autonomous vehicles will create more trips. There might be less cars registered, but there will be more ride-sharing and third parties owning vehicles.

GH: They become more part of the 'public transport' system.

PM: Yes, and what about a future business model where the car manufacturers own the vehicles? You have a contract with say BMW, and a car that you select turns up at the door and takes you anywhere. Business models will evolve making it easy to do more trips. At the moment, people drive their car into work, pay a $4 toll and then $50 to park. Why pay for car parking when an autonomous vehicle could be sent back home? Or it could be used as an Uber during the day.

In the long term, when the whole fleet of vehicles is autonomous, perhaps the road network works more efficiently with less congestion.

GH: Your fund is up 13.5% per annum over seven years, and I'm sure you would bank that result again if you could. What is more realistic for the next five years?

PM: We've always said 8 to 10% total return through the cycle. The seven-year number is picking up from some low points and I would stick to 8 to 10% over the long term: say 3 to 4% yield, plus 5 to 6% growth. Over the next five years, perhaps we could see a 5% return if there's a bit of mean reversion on growth and yield.

GH: Your fund is listed assets only. What do you see as the different opportunities between listed and unlisted?

PM: Both are buying the same underlying infrastructure assets generating the same cash flows. They're just held in different vehicles, which have pros and cons. Unlisted infrastructure has the advantage that revaluations are done infrequently, say every 6 to 12 months, which make them appear to be less volatile.

GH: And that has value from a reporting point of view.

PM: Yes. And there's an argument that a controlling investor has more influence over the investment. In the listed space, we offer liquidity and the ability to strategically and tactically reset our portfolio. When we see trends evolving, we can move in and out of sectors and countries and evolve the portfolio. We give investors instant diversification which would take a decade to build in a new fund in the unlisted market.

Talking my book, I believe listed infrastructure companies have become higher quality because they work to achieve a rerating as investors like us give them feedback. We might suggest that if they sell some non-core assets, or reduce their commodity exposure or economic risk through contracts, they can have a better, lower risk business. Then the market will reward them.

In the unlisted market, there is so much capital chasing so few assets, many infrastructure managers are broadening their definitions, from 'core' to 'core-plus', into areas such as car parking and merchant power generation, and shifts into less-developed countries which do not have strong political and legal systems. They are going up the risk curve.

GH: Do you have a favourite Australian and a favourite global stock at the moment?

PM: In Australia, I can't go past Transurban. It's the only Australian stock we own at the moment. The value of its networks is unique. Governments around the world need to think about congestion pricing in large cities, and Transurban owns and controls the network to do that.

Globally, we like NextEra, with half the business as a regulated utility in the high growth state of Florida, and the other half a renewable energy developer and owner. Over the next 10 to 15 years, it will be the scale operators that are best positioned, the ones that have moved further down the cost curve.

GH: Final question: has your business recognised a trend that the market is underappreciating?

PM: What we do well by being global is recognising trends that are happening in one part of the world, and seeing that as an opportunity in another part. Examples include in the satellite and mobile data space. Back in 2015, there was a clear trend in UK and Europe away from the set top box. It meant getting out of the satellite sector and moving the portfolio heavily into mobile towers.

But it's also learning from mistakes. Germany 10 years ago moved into renewables early, and that had a significant negative impact on coal-fired generation in that country. Having made a mistake there, we moved our portfolio in the US away from utilities that had exposure to coal and more towards renewables.

Infrastructure seems like one sector but we think of it as many sectors, with specialisations within. Take mobile towers out of telecom, take airports and toll roads out of industrials, and then we see the interesting parts of each. Autonomy, 5G, 3D, globalisation, Brexit ... there are so many interesting things for an active manager.

Graham Hand is Managing Editor of Firstlinks. Peter Meany is Head of Listed Infrastructure at First Sentier Investors (Australia) Ltd, a sponsor of Firstlinks. This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs.

How to make money at the end of a bull market

Peter Moussa

In the final stage of a bull market, equities shift up the risk scale as the emergence of a bear market starts to send alarms bells ringing. The problem is not everyone is listening.

In fact, typically there is a burst of euphoria from investors before the bull market ends. Holding a large and perhaps poorly-constructed share portfolio when the music stops can be costly.

The previous bull market ended in October 2007 with the onset of the global financial crisis. Over the next 16 months the US market barometer, the S&P/ASX200 index, fell 54%.

So where are we now? There is widespread agreement we are currently in the final stage of a bull market. At Citi we believe the current cycle will continue through 2020 but come to a close in 2021, although there are certain risks that, if inflamed, could bring about a bear market sooner. A good example of these risks is an escalation of 'trade wars'.

What does the end of a bull market look like?

The shift to a bear market is precipitated by a plunge in market indices. By definition a bear market requires a minimum 20% fall in key indices over a two month period.

As we approach a bear market, but before the downward slide commences, markets tend to act in defined ways. We generally see a large flow of capital into equities, brisk merger and acquisition activity and heightened Initial Public Offering (IPO) activity. None of those measures are currently present and net new money into shares has been absent for the past two years.

The reason we haven't seen these steps this time is likely the high level of volatility that has accompanied the bull market. With a heightened sense of risk in the broader market, a lot of the money that would typically flow into equities has gone into fixed Interest. Citi's Global Head of Equities, Rob Buckland, recently described current market conditions as "a miserable bull market".

What are the signals?

But that does not mean the euphoric burst is not coming, and the sharemarket is currently back around historic highs.

On the positive side of the ledger we have the major central banks doing what is necessary to stabilise economic growth and employment. Interest rates in most key markets have been falling and central bank chiefs have talked about alternative methods of support should it be required.

That could include things like quantitative easing and actions to reduce the cost of funding for banks so they in turn can provide loans to boost business and consumer activity.

Another positive is that the yield curve has also reverted to normal. In normal conditions you expect to receive a higher return the longer the duration of the bond, because you are taking on more risk from events that could occur in the future and impact your investment. The inversion meant investors were concerned about near term issues, principally trade wars.

Due to a yet-to-be-ratified agreement between the US and China on how to move forward on trade issues, there is improved sentiment that a solution will be found. There is also less concern over how Brexit will be resolved.

If the lowering of risk continues, it will likely see more funds flow into equites. We are already seeing a shift from defensive stocks into cyclical companies, and that's an important signal.

Defensive stocks offer a buffer against an economic downturn, perhaps because its product is essential, like healthcare, or constantly in demand, like groceries. They also tend to have stable dividend payouts and examples of defensive stocks include Woolworths, Telstra, Wesfarmers, Coca-Cola Amatil and Cochlear.

Cyclical stocks are more attuned to cyclical spending and perform better in times of economic growth. Examples include Crown Resorts, Amcor, Harvey Norman and BHP.

If money continues to flow into cyclical stocks, it's like a clarion call to beware. The shift to cyclicals should be based on improved economic conditions but it is coming from a perceived lowering of impediments to growth, like trade wars.

In fact, economic conditions are worsening, with recent US retail data casting doubt on the strength of household consumption. China and Europe have also reported disappointing growth and in October the International Monetary Fund lowered global growth forecasts.

Locally the S&P/ASX200 is up 24% since the start of the year and as risk lowers it means fund managers will have to follow the market higher as their investors will expect to see the benefit of those rises. It means prices can go higher but not for the right reasons - it's like a dog chasing its tail.

How do I resist rising share prices?

As the scenario above plays out we can expect to see equity markets climb to a strong finish this year and a positive start to next year.

The tremor will begin if corporate profits fail to show improvement despite rising share prices. It will start a slide that signals the onset of a bear market and it is the point where many people become trapped and have to ride out the bear market to avoid crystallising losses. At Citi we expect it to occur in 2021.

Citi's house view is for a further 9% gain in global equities to the end of 2020. For the S&P/ASX200 we expect a further gain of 6% over the same period. The table below gives a broader outline of our market forecasts.

Citi Strategists' Index Targets

Region	Index	Current Level	End-20 Target	Expected Gain (local)	Expected Gain (US$)
US	S&P 500	2977	3300	11%	11%
Pan Euro	DJ Stoxx600	393	420	7%	11%
UK	FTSE 100	7408	8100	9%	16%
Japan	Topix	1588	1690	6%	16%
Australia	S&P/ASX 200	6688	7000	5%	10%
GEMs	MSCI EM*	1001	1080	7%	8%
Global	**MSCI ACWI Local**	**613**	**670**	**9%**	**11%**

Source: Citi Research.* MSCI EM target is in US$. Price as of 30 the September 2019.

An alternative path

Predictions are all well and good but events happen that can change them. Here and now, direct share ownership is getting risker and as time progresses it will increase.

When the downturn comes, we expect growth to slow to about 1% and it will feel like a recession, even if it doesn't hit the technical definition of two quarters of negative growth.

The message is to balance your portfolio with high quality corporate bonds and equities. You may also consider structured investments that allow investors to profit in a rising, flat or moderately declining market.

It's also good to consider offshore diversification to give exposure to areas like pharmaceuticals, technology and digital. It may also open a pathway into foreign exchange opportunities to further enhance your portfolio, though of course FX implications should be considered.

Peter Moussa is an Investment Specialist - High Net Worth at [Citi Wealth Management](). This article is general information and does not consider the circumstances of any investor.

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Uncharted waters, 2020 and beyond

Phil Ruthven

We live in tumultuous times. Economic dominance has moved from West to East, with the West in some ways still recovering from the GFC over a decade ago. We're experiencing record low interest rates, rising world and national debt levels, trade wars, digital disruption, stagnation in wages and household incomes in developed economies, political populism overwhelming rationality and, for some major nations, the return of 1930s-style dictators.

The Ruthven Institute has looked at 10 main issues that are making headlines to find answers to their significance and impact. These are:

- The changing world order
- Debt, deficits, quantitative easing (QE) and living-beyond-our-means
- Record low interest rates, and fiscal vs monetary policy
- Overvalued share markets
- Populist politics and dictators
- Trade wars
- Digital disruption
- Enough future jobs or enough future workers
- Australia's economy: structure and externalities
- Climate change

This article discusses the first three issues, and the full report can be obtained at the address at the end of the article.

A changing world order

For over a century, spanning six or seven generations, the United States was the largest economy worldwide. China had previously held the position for millennia, but as a closed kingdom, few knew it was the largest. In 2016, and much to the West's discomfort, China regained economic dominance.

The British Empire was regarded as the world leader into the 20th Century, and indeed it was if we factor in the GDP of Commonwealth countries such as India (long in the top four largest economies for centuries), Australia and others. With that hegemony came currency dominance, language dominance and a measure of stability.

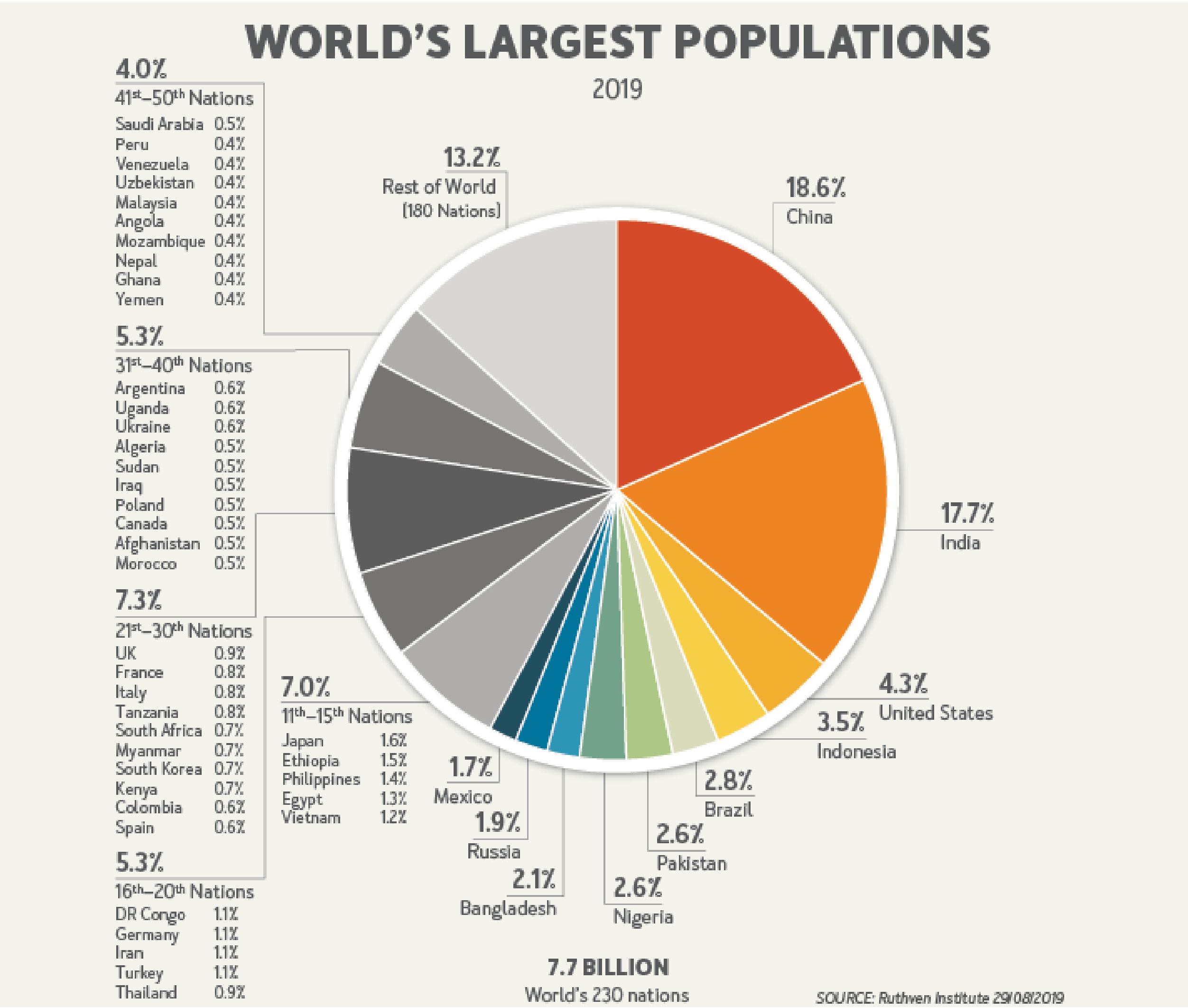
But empires come and go, be they Roman, Ottoman, British or American-cum-the Western bloc. Their economies all slow due to their wealth, high standards of living, complacency and excessive regulation.

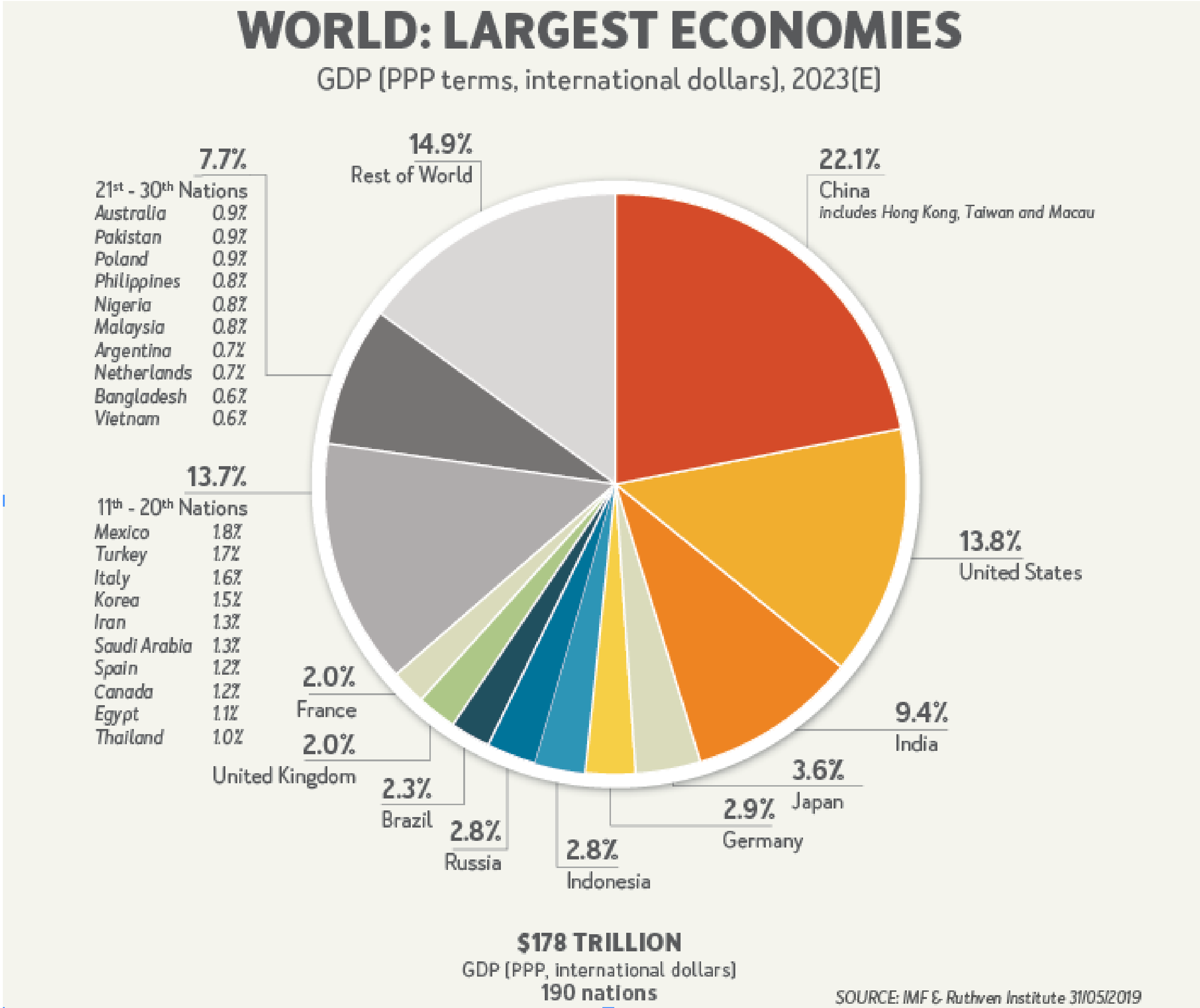
The re-emergence of China, and indeed the East at large, is pointing to a very different world order for the rest of this century and the next.

Eastern economies, especially China and India, have embraced the Industrial Age (with the advantage of advanced equipment and cheaper labour) but have equally embraced the West's Infotronics Age of services and information and communications technology (ICT).

Australia, being a geographic, economic and social (via immigration and tourism) part of the Asian megaregion, has everything to gain from the East's economic dominance. However, diplomacy must be carefully crafted and maintained as we morph into a larger, wealthier Eurasian society and economy. Is it possible to support both the fading West and the dominant East? We have to try.

The two charts below provide perspective on current world populations and economies, as we enter the 2020s.

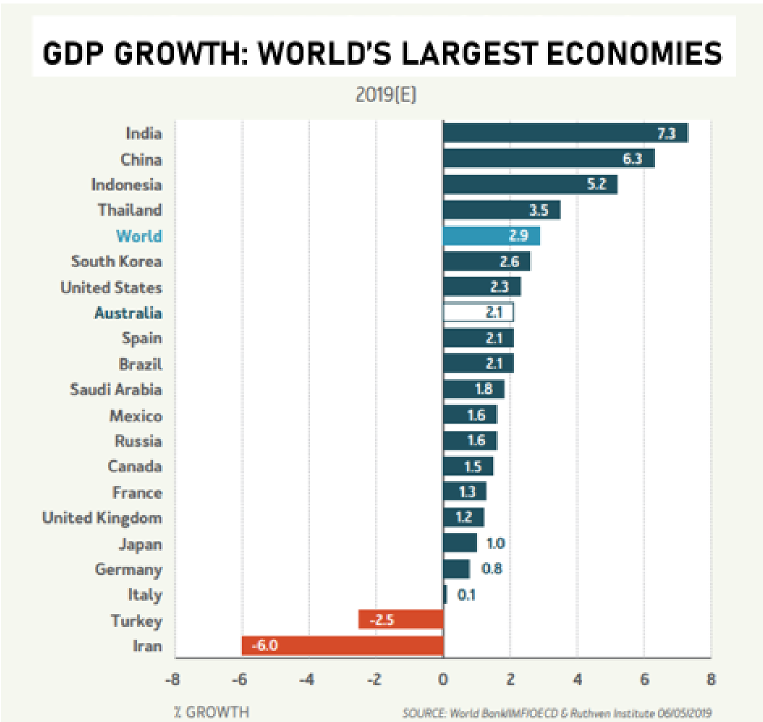




Tectonic changes of power are always unsettling, especially if accompanied by sabre-rattling, chest thumping and hegemony from both the old and new dominant powers – as we see happening today with territory creep in the South Seas and the world's once-largest economy waging a trade war.

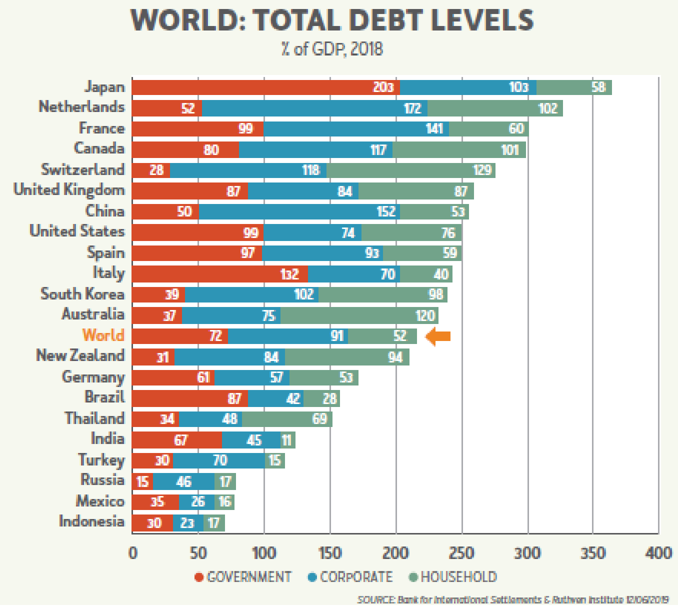
The transfer of power to China and the East at large is being expedited by slow economic growth in the West, as shown (right).

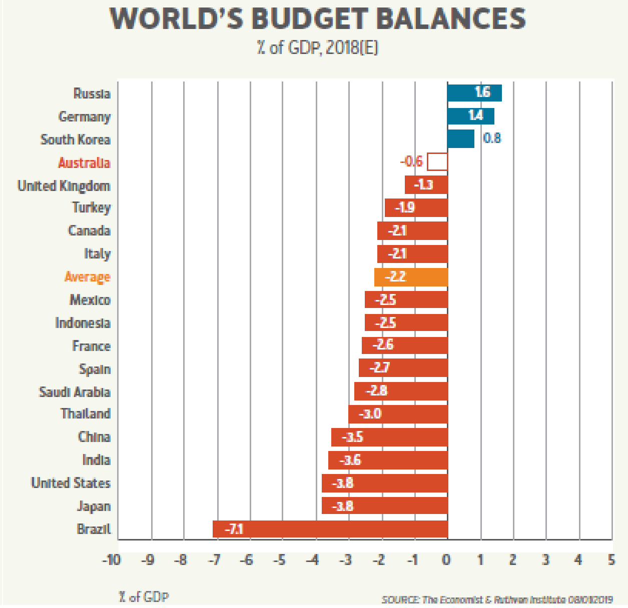
Ironically, this polarisation seems not to be having an adverse effect on world growth so far. However, already the GDP (in ppp terms) of the East has overtaken that of the West in 2017, with the East growing at 5% pa compared with less than 2% for the Western nations.



2. Debt and deficit spending

Debt levels can be worrying, as it is never wise to live beyond one's means. The following two charts outline total debt levels and government budget balances among the world's major economies.





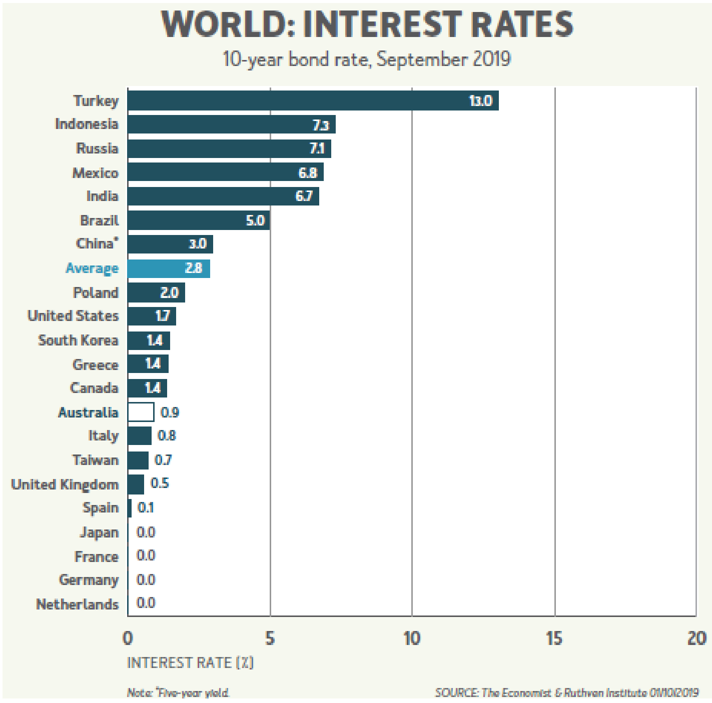
More than a handful of nations have excessive debt or deficit spending risks. Interestingly, China and India are in this cohort, but Western economies are predominantly at risk. Australia is only at risk with its household debt component, but so far this has been manageable via record low interest rates … which brings us to our next topic.

3. Record low interest rates

Using 10-year bond rates as the guide, the picture of interest rates is mixed across the world's 21 largest economies, as we see below. While the average of 3% is low by historical standards, six nations are at or well above the historical average of around 5% to 6%.

The United States and 14 others are well below both the historical and current average. Turkey, Russia and Brazil have ailing economies, leading to high bond rates. However, nations with bond rates below 1% – including Australia, whose growth has dropped to half its long-term average in 2019 – are hardly vibrant, or even well, by contrast.

Continuing to lower or maintain near-zero interest rates and resorting to quantitative easing (sort of pump-priming) is, ultimately, defeatist. It frees up capital for the private sector, which may or may not invest it in growth, and increases the national debt, rather than allowing nation-building projects to proceed with government deficit spending. But again, debt servicing is easy with low interest rates, so there is no Sword of Damocles hanging over heavily indebted nations in the near future.



Australia faces this question and others as we enter the 2020s, having had no wake-up call in the form of a recession for almost three decades. Meanwhile, there have been no meaningful reforms to taxation, the labour market, energy, communications, and other aspects of the nation's affairs since the Hawke-Keating and

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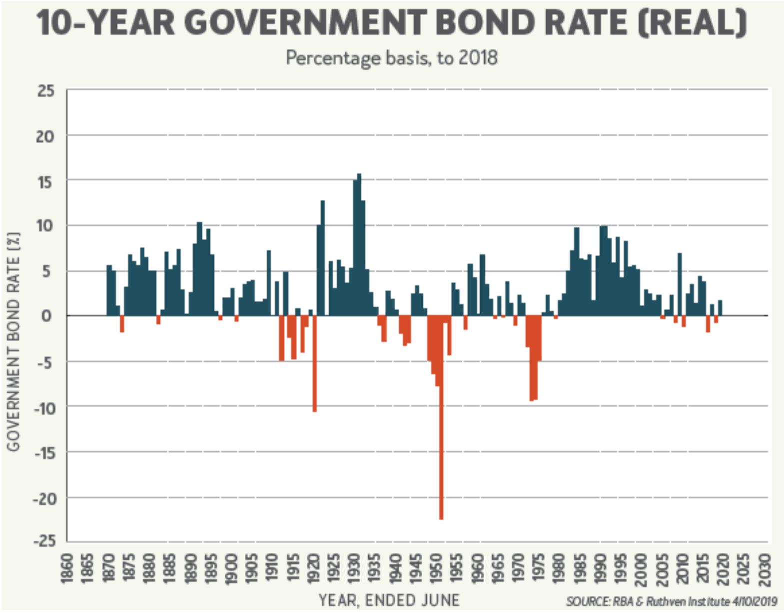
Howard-Costello governments ended in 2007. Monetary policy is being asked to do all the work when fiscal policy and reforms should be taking the wheel, so to speak.

We must also ask: Do we really have record low interest rates in Australia? When we examine real interest rates after deducting inflation, we see that we do not.



It is interesting to note, over the past century and a half, the events that have triggered plunges in real interest rates. The five main periods have been:

- World War I
- The 1930s recovery from the Depression
- World War II and the subsequent years of recovery
- The Oil Crisis (and resultant inflation), and
- Now, in the years leading into the 2020s.

So, yes, low and low real interest rates are sometimes a harbinger of potentially serious problems, but they are not associated with depressions (only recovery from depressions). They seem to be more related to global traumas, such as world wars and world crises. All of which is unsettling, to say the least.

No 2020 vision to certainty

As we approach the 2020s, we are indeed sailing into uncertain waters at best, if not uncharted ones. However, we are fortunate that these times also have some historical precedents.

Australia is not over-exposed to external dangers in the years immediately ahead of us. That is not to suggest that downturns, or even a recession, are not going to happen – they could. While we certainly remain a 'lucky' country at large, we must not rely too heavily on our relatively good fortune to date in an increasingly volatile world. Rather, we have a serious and pressing need to tackle our internal issues, including the political hot potatoes of productivity and overdue reforms. Otherwise, the luck runs out.

Phil Ruthven is Founder of the Ruthven Institute, Founder of IBISWorld and widely-recognised as Australia's leading futurist.

The full 30-page report, Uncharted Waters: 2020 and Beyond, is available by emailing info@ruthven.institute or see www.ruthven.institute.

Five innovation traps for super funds to avoid

Raewyn Williams

Large superannuation funds are currently debating the merits of APRA's imminent 'heatmap' system of grading MySuper funds under the colours of red (a flag for members), yellow (a further look required) or white (a relatively clean bill of health), with varying shades. Note there is no green because, to quote APRA Deputy Chair, Helen Rowell,

"This is not a traditional 'traffic light' system with three distinct and simple categories. This is intentional. The heatmap is designed to emphasise underperformance; it's not meant to give a pat on the back to better performing MySuper products, or be seen as a peer ranking mechanism."

This idea emanated from the Productivity Commission's recommendation earlier this year that superannuation fund members be able to rely on a 'best in show' default fund shortlist.

Looking for more innovation from super funds

Behind the Productivity Commission's original recommendation is one aspect that deserves more attention - that APRA-regulated funds be assessed on a "record of innovation, including in the use of member-related data, and in developing products over time (including retirement)". This is a timely reminder that innovation is a thing of value; a cultural attribute that enhances a fund's ability to deliver on its central mission to members.

The Productivity Commission's exhortation sends a message that superannuation funds (and industry segments) who can genuinely innovate will have a competitive advantage over funds that don't. More to the point, members of an innovative fund are more likely to be better off in retirement than members of a fund that does not innovate.

Our published research on 'Status Quo Thinking' notes that genuine innovation is surprisingly hard to master, whether in the corporate, superannuation or other sector, and questions whether superannuation funds could show a good track record on innovation. Scale, career risk management, peer sensitivity and cultural risk aversion are among the headwinds to effective innovation that funds face.

The architects of both the Cooper (2010) and Murray (2014) reports into superannuation have criticised the industry for its lack of innovation.

Regulators want innovation but make it difficult

The CEO of ASFA has pointed to the raft of regulations and reviews as 'crowding out' funds' ability to innovate.

Regulators cannot have it both ways – they cannot both affirm the Productivity Commission's views on innovation and also foster an environment that makes it hard for funds to innovate.

Our own research suggests that while innovation is hard to do, funds can take two immediate steps to seize the innovation mantle. The prize – giving members confidence and dignity in retirement – is large and the risks are potentially existential for funds who attract a 'red light' grading from APRA.

First, initiate an explicit discussion within the fund about what innovation really is.

Does the superannuation fund speak innovation language? Is innovation defined too timidly. For example, is existing thinking 'tweaked' rather than challenging, or even (shock, horror) changing the paradigms themselves? For example, innovative retirement solution design surely needs to go beyond merely tweaking existing pre-retirement accumulation products and begin by redefining aims in terms of yield and longevity risk. What does an 'innovation budget' look like within a large superannuation fund and who sponsors it?

Second, we encourage funds to 'take their innovation temperature' by working through their 'status quo thinking traps'.

We identify **five traps** to avoid to encourage better innovation.

1. *Risk aversion or blame culture* – how powerful is the fund's member-centric culture in driving a good idea forward? Is there individual aversion to change, a lack of reward or a perceived penalty for sponsoring new ideas?

2. *'Status quo' roles, responsibilities and resourcing* – every superannuation fund has built a 'value chain' designed to deliver retirement dollars to members' accounts. Across this value chain, are the fund's roles designed to simply 'keep up with business' or given the bandwidth to generate and test new ideas?

3. *Functional silos* – who in a fund is tasked with identifying opportunities to redesign, unbundle and reconfigure across the value chain? These should be people with industry-wide perspectives, not focused on deliverables within functional silos.

4. *Fund size* – corporate literature on change identifies size as an inhibitor of genuine innovation, not an enabler. Scale entrenches status quo thinking and new ideas are viewed more cautiously as 'risking' the existing business. Large superannuation funds have criticised disruptors like Spaceship and Zuper, but how open are large funds to the lessons these disruptors can teach them?

5. *Industry groupthink* – APRA-regulated funds can point to a healthy level of industry-wide dialogue and information-sharing, but does this really evidence a collegiate, ideas-generating culture and a commitment to continually evolve? One could argue that, instead, it engenders a collective status quo which is a safe space for large funds to occupy.

New ideas acted on can have an 'annuity' value delivering over and over again, and this value compounds over the long-term horizon in which superannuation funds operate. Given the high-stakes, long-term, society-wide mission of superannuation, the 'cost' of new ideas that disappoint must, surely, pale in comparison to the opportunity cost of genuine innovation that never sees the light of day.

The Productivity Commission, in airing (again) the need for the superannuation industry to be genuinely innovative, was onto something important. Funds should take their cue, and demand that regulators offer more than just lip service in helping funds rise to the innovation challenge.

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Equity manager vigilantes exert market power

Kate Howitt

If I say the word 'vigilante', what image springs to mind? For many years, in fact since the first comic in August 1962 and 17 movies later, you may have immediately thought of Peter Parker turning into his Spider-Man alias to use his powers to fight evil.

However, it's fair to say the action superhero industry is evolving, and these days we're increasingly seeing female characters taking on the leading roles in the latest action blockbusters.

Financial market vigilantism is also evolving. From the 'bond market vigilantes' of the early 1990s, we are increasingly seeing the rise of equity market vigilantism, particularly in the Initial Public Offering (IPO) market. This will challenge a range of assumptions that market participants are currently making about how markets play out through time.

The rise and fall of bond vigilantes

The term 'bond market vigilantes' arose in the early 1990s to describe the power that the US bond market exerted on wayward governments and companies. Financial vigilantism is rooted in the role that investors play in setting differentiated costs of capital for individual countries and companies.

Where bond investors perceived that inflation risk (for governments) or credit risk (for governments and companies) were not being managed adequately, issuers would be would 'punished' with low bond pricing, i.e. high bond yields.

Bond investors withheld their buying, thus driving up costs to access capital markets. At extremes, this acted as a constraint on the ability of governments to underwrite big spending by issuing lots of debt. It was a very powerful weapon.

Do bond vigilantes still have the same influence today? I'd argue no. Far from holding governments and management teams to account, bond investors seem more willing to support issuers, even those offering negative interest rates, blowing out their debt levels or having a rap sheet of previous defaults, bond markets these days are behaving more like the sleepy cat than the powerful mastermind.

Why did the bond market have so much power in the 1990s and what has changed to today?

As with most things in financial markets, the most fundamental drivers are supply and demand. By the mid-80s, bonds had been in a multi-decade bear market. The average interest rate paid on government and corporate debt peaked at 10%, which in today's low-return world looks highly attractive but at the time reflected years and years of painful losses on the face value of bonds. Consequently, investors shunned bonds and the overall US bond market was valued at less than 75% of US Gross Domestic Product (GDP).

There were a lot of issuers seeking support for new bonds but very few bond funds were able to invest. Bond funds could be very picky and invest in only the highest-quality issuances with rich coupons. Issuers needed bond investors much more than the bond funds needed issuers.

Fast forward to today and much has changed. Thanks to the Michael Milken-led junk bond revolution and central bank-led Quantitative Easing (QE), the overall US bond market relative to GDP has doubled, swelling to almost 150% of US GDP. Bond investors lost the upper hand in their search for any bonds that might offer a skerrick of yield. The balance of supply and demand has been turned on its head.

The next generation of vigilantes

Who are the vigilantes in today's markets?

Power comes from scarcity, so we need to look to today's scarce pools of capital to find the answer. But thanks to an underlying excess of savings which began in the 2000s, and the layering of QE on top of that, most asset classes in the world are awash with capital. Investors have been crowded out of lower-risk asset classes and shifted into riskier assets to promote real-world investment and economic growth. Waves of liquidity have sloshed from sovereign bonds, into corporate bonds, then high yield bonds / equities / property / venture capital / fine art. Venture capital has especially seen a massive influx of capital.

Overall, stock markets have also seen a major expansion, albeit with significant volatility along the way. In the 1980s, the US stock market was valued at 40% of US GDP. It peaked at approximately 185% in 1999 with the dotcom bubble and then by 2009 it had fallen all the way back to 85% of GDP. The bull market of the past 10 years has seen US stock markets climb back up to approximately 180%.

So, despite significant levels of corporate buybacks which 'de-equitise' the market, the US stock market also seems to enjoy abundant liquidity.

Today, issuers - whether profligate sovereign states, drill-at-all-costs shale-frackers, or vapourware software start-ups - can all obtain funding, and mostly at rates which are unbelievably attractive in the context of history.

Power from scarcity

However, there is still a pocket of the financial economy that is not awash with liquidity. Allocations to active equity managers have been shrinking for a decade. In the midst of an overall equity bull market, it's been a bear market for active allocations. The vast majority of the expansion in US equity holdings has been via passive and other algorithmic strategies.

There are some unintended consequences to this shift - and a potential silver lining.

The **first** impact is to market price efficiency. The shift away from active management has in part meant a shift towards strategies where valuation does not play a role in stock selection.

This is a seismic shift. Previously, the majority of stock market actors, whether institutional or retail, were employing some form of buying stocks perceived to be undervalued and selling stocks thought to be expensive. This meant every trade mobilised the wisdom of crowds to arbitrage stocks towards an underlying 'fair value'. This is the mechanism of market efficiency. It was never perfect, and there have clearly been periods of excess exuberance or pessimism in the past, but it generally worked to obtain a level of price discovery. But with a large and increasing cohort of investors not looking at the underlying fair value, we may have to change the expectation that markets will be efficient over any time horizon.

The **second** impact is the societal aspect of this deterioration of market price efficiency. The inverse of price is cost of capital. Simplistically, 'good' companies should trade at high valuations and enjoy a low cost of capital, while 'bad' companies should trade at low valuations and face a much higher cost to access capital markets. When stocks aren't priced efficiently their cost of capital is also not at an economically efficient level. When prices are out of whack, companies face either a much higher or a much lower cost of capital than they should. Clearly in some sectors of the market, the earnings yield - which approximates the cost of capital - is extremely low and in many cases even negative. This creates distortions in the real economy, since these companies are given an incentive to over-expand. The likely outcome is that returns on that expansion capital will ultimately disappoint. Uber, anyone?

The **third** impact is the risk of a reduction of discipline on management and boards. When equity holders are no longer as likely to 'vote with their feet' if the board adopts poor governance practices, one brake on corporate excesses is absent. Arguably one driver of the increase in Environmental, Social and Corporate Governance (ESG) engagement is a need for 'captive' investors (who are unable to sell down) to have a mechanism with which to push back on corporate boards.

The potential silver lining of the shift away from active to passive and algorithmic strategies is that scarcity creates power. While active managers may have to wait for longer for a return to price discipline in the broader equity markets, there is a place where only active managers play providing the power to enforce the price discipline we need to see in a well-functioning market.

The reality check in the IPO market

Historically, only active managers have participated in IPOs, thereby determining which companies make it onto bourses and at what price. The rejection of WeWork's IPO, even at cut-down valuations, and the local rejection of Latitude and PropertyGuru, demonstrate that where scarcity remains, there is probity within financial markets.

What are the implications of this?

Funding into private equity is swollen and there will be a time when companies held in these funds need to be monetised. Historically this has mostly occurred via IPOs. But if active managers, deploying their scarce capital, create a skinny little bottleneck of sensible pricing between private markets and public markets, how will the highly-valued holdings emerge from their enormous private funds?

Investors within Private Equity (PE) funds can expect to face lower returns as monetisation rates slow and holding periods extend. And as asset allocations inevitably then shift from stock markets to PE, investors will end up paying higher fee levels for access to the same range of businesses they would previously have owned on the stock market.

So, if active managers are the vigilantes using their scarcity to enforce sensible pricing in the IPO markets, where does this story end?

Vigilante storylines follow a familiar arc: a downtrodden minority rises up from their difficulties to take a stand against injustice. In financial markets, the story plays out with an abundance of liquidity morphing Rambo into the fluffy white cat.

But in Hollywood movies the vigilantes prevail, Jedi-style! Let's hope active investors keep wielding the lightsabre and can prevail over undisciplined pricing and shareholder-unfriendly governance - at least in the IPO space - and that the bond market vigilantes of the 1990s are surpassed in their effectiveness by the equity market vigilantes of the 2020s.

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Responses to the 'OK Boomer' poll

Leisa Bell

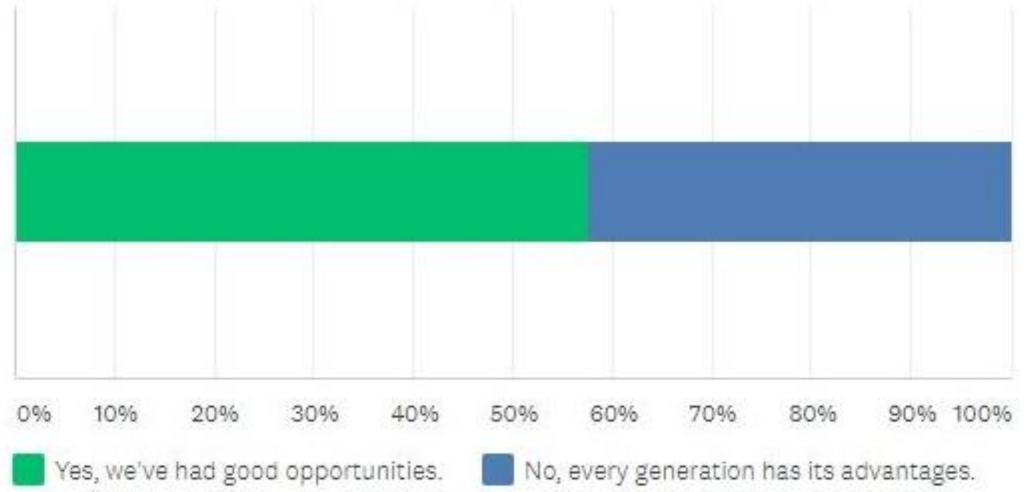
In conjunction with Graham Hand's article, OK Boomer: fessing up that we've had it good, we asked both Boomers or Non-Boomers:

Do you agree the Baby Boomer generation has been favoured?

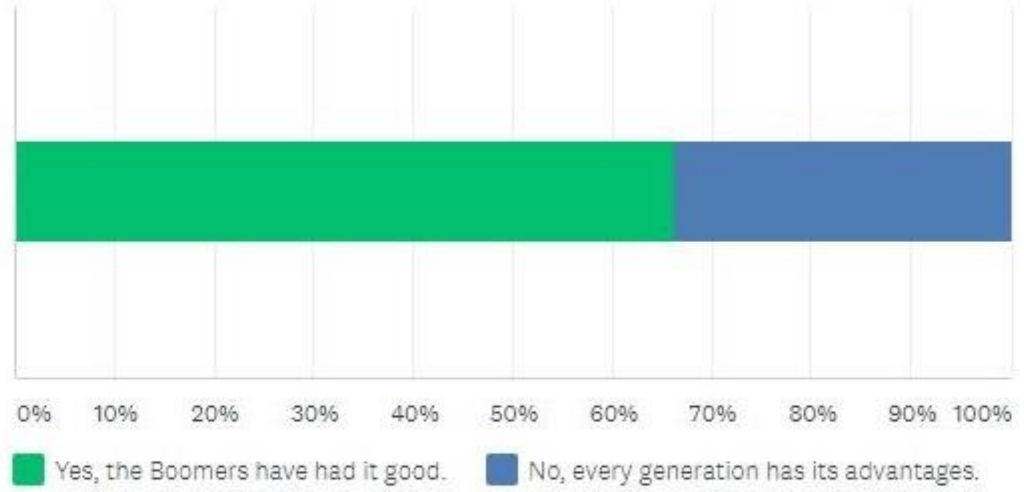
An impressive 1,800 people shared their opinions and circumstances, and while Boomers clearly outweighed Non-Boomers among respondents (68% to 32%), the yes/no responses were a little more balanced.

	Boomers	Non-Boomers
Percentage of total respondents	68%	32%
Yes, the Boomers have had good opportunities	58%	66%
No, every generation has its advantages	42%	34%

For the Baby Boomers (born 1946 to 1964), do you agree your generation has been favoured?



For the Non-Baby Boomers, do you agree they have been favoured?



Republishing comments in full

Many of the 600+ additional comments were heartfelt and passionate, including examples of personal struggles, as well as responses taking one side of the debate versus the other.

We have produced this report from the survey containing results and all the comments.

Leisa Bell is Assistant Editor at Firstlinks.

Robert Merton on retirement incomes and Jane Austen

Graham Hand

Given the recent discussion in Firstlinks on the home in the pension assets test and use of reverse mortgages, we republish the views of Robert Merton when we met him in 2014.

Nobel laureate Robert Merton is on a global crusade. At the moment, he's travelling in Asia and Australia for the best part of a month, and after returning briefly to the United States, he'll make his fifth trip for the year to Beijing. Around the world, governments and businesses are talking about pensions and retirement income.

In Australia, he's arguing for a change in our superannuation thinking and culture. Although he recently turned 70 and was awarded the Nobel Prize for Economic Sciences in 1997, he still has boundless enthusiasm to make his case forcefully.

Even Jane Austen focussed on income

He's almost indignant when he describes our fixation with accumulating a pot of money for retirement, rather than focussing on the income outcome. He likes nothing better than a platform to launch a tirade against the preoccupation with member fund balances, and to quote Elwood from The Blues Brothers movie, it's like he's on a 'mission from God'. He says:

"The pile of money is the wrong measure. When someone wants to know how much a government pension is worth, they don't ask for the present value. They want to know the cash flow, the regular income. ExxonMobil tells you how much your pension is for life, not a lump sum. Even Jane Austen understood this. To show how wealthy Mr Darcy was (in Pride and Prejudice), she writes that he has an income of 10,000 pounds a year. She does not refer to his assets. Standard of living is a cash flow issue. Talking about the pot is the abnormal thing."

Merton believes this is far more than semantics. If you measure the wrong number, then you manage the wrong number. If a good standard of living in retirement is defined by a stream of income, it is unacceptable to expose a portfolio to market volatility that can upset that expected income.

Ideally, a good retirement amount should sustain the lifestyle enjoyed during the working life. It might have been acceptable to have $1 million invested in a term deposit at 5%, earning $50,000, but now in the United States, such deposits earn maybe 0.1%. The same client cannot live on only $1,000 a year. So having the $1 million pot was the wrong goal. And he adds, "If you think you don't need as much in retirement as when you're working, you're wrong."

An engineering problem with a solution

Merton is in Australia seeing institutional clients of Dimensional Fund Advisors, focussing on changing the conversation about retirement incomes. He's confident better solutions can be found.

"Retirement is a global challenge, but it's an engineering problem not a science problem. It's not like coal fusion, where we don't know whether the science can solve our energy needs. The good news is it's addressable. The retirement challenge is due to demographics, the ageing of the population, plus people are living longer. That's not a problem, it's a good thing. It's wonderful, but you have to do something about it."

He gives a simple example. In the past, you worked for 40 years and lived for a further 10 years after retirement. So you needed to pay for 50 years of consumption with 40 years of work. If you want the same standard of living throughout, then you must save 20% each year and consume 80%. It's simple mathematics (40 years at 20% gives 80% for the last 10 years).

What happens if you live another 10 years? You now have 40 years to save for 60 years of living, so you need to save 33% of your income and consume only 67% in your working years (40 years at 33% gives 67% for 20 years). Which means living longer requires a drop in your lifestyle from 80% of income to 67%.

This creates a problem:

"Most people are not interested in reducing their standard of living simply because they are living longer. Somehow, they want to maintain their standard of living by consuming more and then live longer, so what's the

magic answer? Earn a higher rate of interest. That is easy because it means you do not need to do anything. But this is misleading and not feasible. What about the extra risk?"

He says that at this stage in the discussion, people often tell him that over the long term, the sharemarket will deliver the required returns to solve the dilemma. He points out that the market often goes a long time producing poor returns, citing a wealthy, politically-stable country like Japan where the Nikkei index peaked at 39,000 some 25 years ago, and is now at 17,000. Any solution needs to take responsibility for the advice if it does not work, and he adds:

"Embedded in most solutions to the longevity problem is additional risk, as if that solves the problem."

How do we 'move the needle' on the problem, other than working longer? There are only three possible sources of income for retirement:

1. Government, but funding problems make this an unlikely source

2. Employer savings plans, but 'defined benefit' schemes are no longer available

3. Personal savings. Where is the vast amount of wealth tied up for the majority of people, the millions of Australians heading for retirement without enough money? The only place is the family home.

The case for reverse mortgages

So Merton offers a surprising retirement income solution: reverse mortgages. He argues it can make a major contribution in most countries. The world has changed from where the family lived on a farm and the house needed to pass to the next generation to maintain the business. It is rare that a family home is a treasure that must be preserved for future generations. Children are unlikely to move back to the family home. In retirement, it's a financial asset.

Merton believes showing people how to use the family home to supplement income is an important part of a retirement plan. This may come as a surprise to an Australian audience, as reverse mortgages are not popular, with only about 40,000 in existence and many former providers stepping back from the market (both ANZ Bank and Bank of Queensland recently cancelled their products).

Perhaps it's a cultural issue, where we like to pass the full estate to our children, or the risk that comes from variable rate mortgages, where the debt can build quickly if rates rise.

To which Merton simply waves away the criticism. He said it's like listening to a song and not understanding the lyrics at first. After you listen carefully, at the twentieth time of hearing, you're singing along.

At the moment, in Australia on reverse mortgages, we're just hearing the melody, but eventually, we'll also understand the lyrics. Like in The Blues Brothers movie.

Graham Hand met Robert Merton at a lunch organised by the Australian School of Business's Institute of Global Finance, based at the University of NSW, and supported by PwC and Finsia.

Video

Morningstar's Glenn Freeman and Graham Hand discuss the home in the assets pension test plus reverse mortgages in this short video.

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