Firstlinks
Connecting investors with ideas

Edition 342, 31 January 2020

Contents

Just for Josh: Survey on attitudes to LIC fees *Graham Hand*

Mr Market isn't so foolish, after all *John Rekenthaler*

Tesla surges, VW doesn't. Here's why *Alex Pollak*

Why this age of artificial returns must falter *Miles Staude*

Who does compulsory superannuation really benefit? *Geoff Warren*

Long-term optimism for margin lending but share outlook subdued *Recep Peker*

Media worth consuming - January 2020 *Jonathan Rochford*

Just for Josh: Survey on attitudes to LIC fees

Graham Hand

The Federal Treasurer, Josh Frydenberg, has announced a brief public consultation into whether financial advisers should receive 'stamping fees' for distributing listed vehicles to their clients. The results of this Firstlinks survey will be provided to Treasury as input to its decision. Please take a moment to share your views and we will publish the results next week.

A changing landscape for listed entities

After $4 billion of issuance in Listed Investment Trusts (LITs) and Listed Investment Companies (LICs) in each of the last two years, the regulatory landscape is about to change. Although two fixed income LITs are currently raising money under the old rules allowing stamping fees to be paid to financial advisers, it is likely that the Federal Treasurer will ban the practice in future and bring listed funds and trusts in line with unlisted vehicles under FoFA.

For those who require more background, we have published several articles on the subject, including:

Advisers and investors in the dark on LITs and LICs, a detailed background paper explaining the current regulations and why they are unsustainable.
Authorities reveal disquiet over LIC fees, following the FOI revelation that ASIC argued the payments should be banned.
1 January is moment of truth for the wealth industry, a financial adviser argues good advice must be free of conflicts.
Three overlooked points on the LIC/LIT fee battle, offers the same conclusions we expect Treasury to reach.

Here is Josh Frydenberg's announcement:

> *"The Morrison Government is today announcing that Treasury will undertake a four week targeted public consultation process on the merits of the current stamping fee exemption in relation to listed investment entities.*

Stamping fees are an upfront one-off commission paid to financial services licensees for their role in capital raisings associated with the initial public offerings of shares.

Public consultation will allow the Government to make an informed decision on whether to retain, remove or modify the stamping fee exemption in order to ensure that the interests of investors are protected and capital markets remain efficient and globally competitive."

In addition, the CEO of the Financial Planning Authority (FPA), Dante De Gori, responded with support to ban payments:

"At this point in Australia, all other forms of product-directed payments that a financial adviser receives from clients have been banned, leaving most financial planners only receiving fee-for-service payments. The FPA supports the government's efforts to improve the quality of financial advice that all Australians receive."

Let us know your opinion including comments and we will ensure the survey is presented to Treasury. The survey is only a few questions and no identities will be revealed.

Mr Market isn't so foolish, after all

John Rekenthaler

You and Mr Market jointly own a private business. Each day Mr Market announces the amount that he believes the business is worth. You may pay him half that figure to become the full owner, cash out of your stake, or do nothing.

This arrangement strongly benefits you, because while Mr Market determines the amount, you alone possess agency. You, not Mr Market, decide if a transaction will occur, and if so, in which direction and at what price. Better yet, Mr Market is an idiot – the proverbial sucker at the table.

When he's giddy, he "*can only see the favourable factors affecting the business*," and thus "*names a very high buy-sell price*." Other times, "*he is depressed and can see nothing but trouble ahead … on those occasions, he will name a very low price.*"

The story of Mr Market originated with Ben Graham and was further popularised by Warren Buffett, whose words I cite. That passage was among my first investment lessons. I was so taken with the Mr Market metaphor that my imagination reworked it. In my adaptation, Mr Market became a dressmaker, who puts his creation on the floor each day, then sets a price that matches his mood. Successful investing meant not paying retail. Wait to buy until Mr Market is glum; the identical dress will be offered at a lower price.

Good versus evil

There's less talk these days about Mr Market. However, the underlying concept remains intact. In a year-end commentary in The Financial Times, former investment manager (and current fellow at the London School of Economics) Paul Woolley depicted the equity markets similarly:

"Active investing comprises two main strategies. One is based on the expectations of the cash flow each asset can generate. The other responds to short-term movements and ignores fundamental value."

To restate, Mr Market's business has an immutable value that can only be known with certainty by The Lord, but which can be estimated by top investors. However, that fixed value is buffeted (so to speak) by the actions of the rabble. The One True Price will bobble, sometimes sharply. This behavior frightens the masses but represents an opportunity for those who resist the popular confusion.

It's a morality play. Good investors are those who hold stocks solely for their future cash flows, regarding them exactly as they would private businesses, except that public stocks may be bought and sold far more conveniently. Every other type of investor is bad. Fortunately, justice is served, as the virtuous profit and the wicked do not.

The messy reality

I no longer believe such a thing to be true. Over the years, I have come to realise that the two-investor scheme is hopelessly oversimplified. The marketplace contains far more participants than merely 1) fundamental buyers

who invest dispassionately, valuing companies based on their expected future cash flows, and 2) nonfundamental investors who are driven by their emotions, or something else silly.

For example, some investors seek earnings surprises - companies that declare higher-than-expected quarterly results. They buy stocks after their companies release unexpectedly good announcements, then exit when the news becomes less positive. Such investors do not belong in the second category, as their decisions clearly rely on business fundamentals. But neither do they place in the first category, because they don't discount expected cash flows. They are something different altogether.

So, too, are those buyers who are guided by macroeconomic conditions. Investors who decided early in the 1970s that inflationary pressures had become too high, and that it was best to trade their inflation-sensitive utilities stocks for oil companies, were fundamental investors. Their analysis did not involve specific businesses, but it was nonetheless rational and related to corporate earnings.

"Emotions," would state Graham and Buffett, when confronted by trades that lay outside their two-investor structure. "Trends and momentum," wrote Woolley. However, neither critique consistently holds. Investors frequently trade their equity shares for defensible reasons that don't involve recalculating a company's expected cash flows.

A question: Are those who buy companies that have increased their dividends in each of the past 10 years "fundamental" investors? Probably not by Mr Market's standards, if they discovered the approach by torturing a stock database until it confesses.

On the other hand, only high-quality companies can raise their dividends every year. That attribute *does* inform about their underlying businesses. It seems to me that such quantitative tactics are just another way of getting at what Graham, Buffett, and Woolley advocate: attempting to gauge the accuracy of Mr Market's prices.

Who’s the sucker now?

That's the optimist's view of stock market behaviour. The pessimist would turn this discussion on its head.

True, some investors seek earnings surprises, others make macroeconomic forecasts, and still others buy "investment factors" (such as rising dividends, low price/book value, or relatively small stock market capitalisations).

Yes, those reasons are seemingly rational. Unfortunately, those investment tactics generally don't work, because so many others are already making similar trades.

I think that the pessimist is largely correct. In the 80s and 90s, several prominent funds thrived by investing in earnings surprises. Their performances have since slowed. Mutual funds that invest based on broad macroeconomic themes have fared even worse. As for investment factors, hundreds of strategic-beta funds currently mine those fields. Most of them trail their benchmarks.

But there's the problem: The same argument applies to beating Mr Market by traditional means. Woolley is correct when he writes that "*few professional portfolios are actually invested exclusively for long-term cash flows.*" What he doesn't mention is that the percentage of such portfolios that outperform the indexes isn't any higher than with portfolios that use less-virtuous tactics.

In summary, when Mr Market discounts his dress, he probably realises something that you do not. He may realise that its style is on the wane, and that six months after buying the dress you will realise that you no longer wish to own it. Or he has learned that the fabric frays. The dress looks fine on the rack, but word is spreading that it doesn't wear well.

It's comforting to regard Mr Market as the gullible party, but unrealistic. More often than not, the overconfident investor is the true sucker at the table.

John Rekenthaler is Vice President of Research for Morningstar, a columnist for Morningstar.com and a member of Morningstar's Investment Research Department. This article is general information and does not consider the circumstances of any investor.

Tesla surges, VW doesn't. Here's why

Alex Pollak

Google recently joined the trillion (US) dollar valuation club, of which Apple and Microsoft are already members at around US$1.3 trillion each, with Amazon close behind at over US$900 billion. Apple has more than doubled since 1 January 2019.

Tesla winning over doubters

Tesla, too, has been on a tear, doubling in just three months. In California, and now Shanghai, and shortly Germany where it is building its third factory, Tesla is on track to deliver 500,000 cars this year, and a million a year or two later, as we have noted several times over the past two years. The company has already generated US$3.1 billion of operating cashflow since 1 January 2018. It is now the second most valuable car company in the world, worth more than BMW, Ford, Daimler, and of course VW. Only Toyota is bigger.

Meanwhile, the stock price of VW is trading at 70% of the value it held before what will come to be known as its most critical failure ever, the diesel scandal. It is on a PER of only 6.5x.

Profound disruption across all industries

There is a land grab quality to all this, but frankly, the disruption that is rolling through *all* industries is profound, making obsolete the business models of companies that have been the largest in the world for decades - like the car and oil companies, but also telcos, retailers, tv broadcasters and increasingly banks.

It is difficult to understand the pricing of some of these disruptive companies unless we see the big picture of the changes in direction by government and society to these whole-of-world issues.

For example, London will charge diesel vehicles an extra tax amounting to between £12.50 and £200 per day when they are used on its roads. Paris already bans pre-2005 diesel cars from the city centre on weekdays between 8am and 8pm. And diesel cars are set to be outlawed entirely from the centre of Paris from 2024, followed by petrol in 2030. In total, 24 European cities with 62 million inhabitants are phasing out diesel cars in the long term, 13 of which want to ban petrol vehicles too. Prominent examples include Paris, Madrid, Copenhagen as well as London and Rome, Bloomberg has reported.

Hundreds of British and European towns and cities have already restricted older model diesel vehicles from the city limits.

Avoiding becoming another Nokia

Volkswagen Chief Herbert Diess last week warned senior management that the company needs to overhaul its business to avoid becoming another Nokia - the company which lost its dominance first to Blackberry and then Apple.

VW owns, and provides the manufacturing platforms for Audi, Bentley, Seat and Porsche. Porsche has already discontinued the diesel of its popular SUV models Macan and Cayenne.

The root of the problem for VW can be traced to the culture that thought it was acceptable to cheat on emissions tests for its diesel cars. At the time, many thought the problem would simply go away, with VW paying a fine and moving on. After all, VW was selling over 10 million vehicles per year.

The company did pay a fine (already in the billions, with more expected) and is moving on, but not in the direction hoped. Following the discovery, VW admitted that it did not have the technology to field a new, cleaner diesel motor.

Diess comments should be seen in this context, and are frankly chilling.

> *"The era of the classic car makers is over. Volkswagen needs to get a grip on software and electronics as well as producing a raft of electric vehicles and batteries so it can comply with stringent anti-pollution rules. In summary this is probably the most difficult challenge Volkswagen has ever faced."*

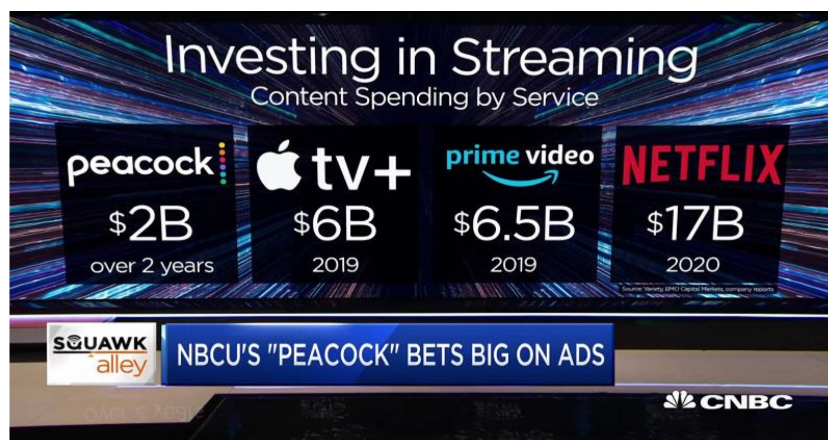
The world has seen the problems of fossil fuels, and at the same time been presented with an alternative which isn't just equal to, but better than those with combustion engines. Meaning faster, of course, but also cheaper to build and cleaner. Battery technology is sufficiently well advanced that energy density is all but irrelevant.

All TV will be streamed?

Another example: consumers are living the changes that are taking place in television viewing – streaming on demand (essentially time shifted viewing), ad-free or ad-supported, etc. Netflix already has more subscribers in the UK after 10 years than Sky UK had after 30, and it continues to grow more quickly.

One of the streaming players has already noted that in the future all television will be streamed, including the plain old TV of today, which is now known as linear tv. They may be exaggerating, but not much.

Netflix is not some chancer in the field. Its quarterly numbers, released last week, were positive at the Earnings Per Share line, as they consistently have been. The fact that the company borrows to invest in content, which it then amortises through its income statement, is no more remarkable than the business model of a railroad laying track or buying bogies. Yet there is still criticism that the company makes no money!



The largest media companies in the world have all announced significant changes to their business models (ie they will stream tv like Netflix), including Time Warner/HBO, Disney, Comcast (owner of NBC Universal Studios). Disney especially should be taken seriously, however a cursory look at its inventory reveals a lot of Marvel and Star Wars content that's newish (rather than new) and a back catalogue of admittedly excellent animation, but with nothing like the depth of programming of Netflix.

HBO is also a strong contender, but following the acquisition by AT&T, the company has significant balance sheet issues, which will limit its chances of rolling out the quantity of programming required to beat Netflix. The difference here isn't about production, but the sales channels which will be dismantled, meaning the cable tv bundle, with the significant loss in profitability that this entails.

No such issues exist with Apple and Amazon (or Netflix) which are already adding significant subscribers.

Other examples are everywhere

Look at connectivity and tools to assist agricultural crop yields, virtual banking, transport and the like.

Many investors talk about machine learning, or cloud-based infrastructure, but we have investments in this area that have already generated a quantifiable level of return, measure-able from the group of companies within the portfolio which are a part of these thematics.

Meanwhile, the value players (who most likely have been buying VW) have been badly damaged. Advertising, media, banking, retailing, energy, carmaking – all are in the firing line, and it isn't a cyclical downswing which is hurting, but rather profound structural change.

There is nothing wrong with value investing – there is a time and place for it – but not now, at a point in time when the pace of technology is remaking entire industries (which have taken decades to evolve) in just a few short years.

Alex Pollak is Chief Executive, CIO and Founder of Loftus Peak. This article is for general information only and does not consider the circumstances of any individual.

Why this age of artificial returns must falter

Miles Staude

January 2020 marks 12 years after the start of the financial crisis and it's an important milestone for Australian investors. The S&P/ASX200 index finally crossed 6749, the previous peak set in October 2007. It may have taken more than a decade, but Australia's largest listed companies had finally recovered all of their lost market value. Time to break out the bunting.

Profits down in a decade

In fact, the headline strength of the Australian share market hides a deeper malaise. Consider this: 2019 company earnings for the S&P/ASX200 were 20% lower than in 2007. Or, said another way, the market today places the same value on the companies within the index as it did in 2007, despite the fact that these businesses are only 80% as profitable as they used to be.

Indeed, once we account for more than a decade of inflation, company earnings today remain woefully below their pre-crisis levels. Instead of earnings growth, the bull market, both in Australia and the rest of the developed world, has been underpinned by investors willing to pay substantially more for company earnings than they did before.

The driver for this investor largess has been a dramatic fall in interest rates. In Australia, base interest rates have fallen from 7.25% in 2008 to an all-time low of 0.75% in 2019. Falling interest rates increase the relative value of other future income streams, like company profits. Thus, even though company profits have fallen, the value of these earnings have become worth much more over the years.

Calendar 2019 exemplified this trend neatly. Basic earnings per share for the S&P/ASX200 index fell by 4% over the year, yet the index delivered a total price return of 23%, one of its best calendar years on record. The main driver was three interest rate cuts throughout the year. Similarly, earnings per share for the European and Japanese share markets also fell over calendar 2019, by 5% and 8% respectively, but these equity markets rallied by 26% and 21%.

In the US, earnings per share for the S&P500 index was unchanged over the year. The index however, delivered a staggering total price return of 31%, with three interest rate cuts by the US Fed drowning out any need for the traditional focus on business fundamentals or earnings growth.

In fact, shockingly, the US market today has reached a point where actual earnings are almost irrelevant. Close to 40% of all US listed companies lost money during 2019. Further, 74% of the IPOs that came to market during the year were for loss-making businesses.

To infinity and beyond

The logic of falling interest rates driving asset prices higher is clear. In a world where there is US$11 trillion of negative-yielding bonds on issue, asset classes that generate positive cashflows have become increasingly scarce. An even greater premium is put on companies that hold out the prospect of significant future earnings growth, even if they are loss making now, given today's low-growth background.

Should we care? If the last 12 years have taught us anything, it is that ultra-low interest rates have re-written the rules of investing. Much of the world of fundamental analysis has been rendered redundant in the face of unprecedented stimulus by central banks around the world. In the process, the traditional role that the markets play in enforcing discipline, weeding out underperformers and rewarding innovation, has been greatly reduced.

Instead, perversely, financial markets have been carried higher on deteriorating economic fundamentals, characterised by low growth and stubbornly low inflation. Looking ahead, there seems few reasons to believe this paradigm is about to change. In Australia, where over 13% of the working population is either unemployed or underemployed, markets currently fully price in at least one further interest rate cut before August. Many anticipate further cuts after this, followed by quantitative easing. Through the current lens, the worse things get, the better the outcome for investors. If sluggish economies and low inflation drags down interest rates - and lifts asset prices in the process - should investors not just be cheering the process on?

Dancing the limbo: 'how low can you go'?

There are three reasons why the current paradigm cannot continue indefinitely, even if it can persevere for several more years yet.

1. Interest rates have a lower bound, effectively zero. A few countries have experimented with negative interest rates but even these have a finite lower level. If you start charging people too much money to lend their savings to the bank, they start putting their money inside a bank vault instead. That is a disastrous economic outcome, as capital is no longer put to productive use. While central bankers still retain some ammunition, mainly through quantitative easing, there certainly isn't another 12 years of continual easing ahead of us.

2. The current paradigm is predicated on interest rate moves being a continual one-way bet … lower. Central banks are not tasked with pushing up asset prices. Rather, their job is to support the economy and maintain price stability. The greatest challenge policy makers face today is how to deal with the next downturn when it comes. Historically, developed economies have had to cut interest rates by 5% to 6% to counter a recession and return an economy to growth. The fear is that having already cut rates so much, either through traditional interest rate cuts or quantitative easing, there will not be enough firepower left when it's really needed. Regardless of how one-way the bet has seemed for so long, central bankers are desperate to raise interest rates as soon as the economy can support it, and they need to.

   We have one real-time example of this occurring since the GFC. With the US economy regaining some of its footing between 2016 and 2018, the US Fed began a modest tightening cycle. Markets took this in their stride until late 2018, when the fear of moderately higher rates finally set in. From peak to trough the S&P500 fell by 19%, while high growth sectors fared much worse, notably the FANG (a share market index comprising the highly traded technology companies like Facebook, Amazon and Google) index fell by 27%. The only development that halted these falls was the US Fed switching back to easing mode, cutting interest rates three times throughout 2019 and sparking another large rally in the process.

3. Finally, while 12 years of falling interest rates have propelled just about every asset class higher, fundamentally the drivers behind this are hardly developments investors should cheer on. In Australia, where share markets have just reached an all-time high, annual GDP growth currently sits near a 20-year low. Over two million Australians either can't find work or can't find enough work. Wage growth remains anaemic.

   Against this backdrop the RBA has been using the tools it has, cutting interest rates to support the economy, and in the process trying to return it to a more even footing. One day these actions might even work. When that day comes, we should expect falling asset prices and a healthier underlying real economy. Perhaps that is not a desirable outcome for investors, particularly those holding higher-risk assets. Far better than the alternative though. A central bank that has fired all of its bullets when facing up to a real recession.

Miles Staude of Staude Capital Limited in London is the Portfolio Manager at the Global Value Fund (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

Who does compulsory superannuation really benefit?

Geoff Warren

Whether the Government should be increasing the superannuation guarantee (SG) from 9.5% to 12% has become a topic of hot debate. Our research finds that whether a higher SG would benefit most people is far from straightforward for two reasons.

First, the appropriate SG varies greatly across individuals. We think this supports an argument for more flexibility rather than imposing a higher SG on everyone.

Second, the case for increasing the SG depends on what superannuation policy is trying to achieve. A clear case emerges if the aim is to replace the age pension, but not necessarily otherwise.

Super pushes money from pre-retirement to post-retirement

In a recent study (link below), we identify what might determine the 'right' level for the SG, and how it varies depending on the individual and assumptions. The analysis is conducted across nine income levels ranging from $30,000 to $150,000 and differing target spending levels. We apply existing rules that govern tax,

superannuation and the pension. The table below presents selected estimates for the 'optimal' SG, although this is only a subset.

Our model focuses on the trade-off involved in saving via superannuation, which reduces money available pre-retirement but creates a benefit in terms of post-retirement income. Evaluating super as a trade-off is important. Focusing only on 'how much super is needed' to generate adequate income in retirement overlooks the possibility that some people might have better uses for the money.

For example, forcing lower income earners or women to place money in super need not make them better off if they are struggling to make ends meet or could use the funds to help buy a house during their working life.

'Optimal' SG estimates per income level and objectives

Income	$30,000	$45,000	$60,000	$75,000	$90,000	$105,000	$120,000	$135,000	$150,000
Baseline Estimates									
Replacement Rate			3.5%	5.0%	6.0%	6.5%	7.5%	8.0%	8.5%
ASFA Comfortable			9.0%	7.0%	6.0%	5.0%	4.5%	4.0%	3.5%
ASFA Modest	3.0%	2.5%							
Excluding Age Pension									
Replacement Rate			15.0%	14.5%	14.0%	14.0%	14.0%	13.5%	13.5%
ASFA Comfortable			20.0%	17.5%	14.0%	12.5%	10.5%	9.5%	8.5%
ASFA Modest	20.0%	18.0%							
Retires Age 62									
Replacement Rate			8.5%	9.5%	10.5%	12.0%	13.0%	13.5%	14.0%
ASFA Comfortable			17.0%	13.5%	11.0%	9.5%	8.0%	7.0%	6.5%
ASFA Modest	10.5%	8.0%							
Lives to Age 102									
Replacement Rate			4.5%	6.5%	8.5%	10.5%	12.0%	13.5%	14.5%
ASFA Comfortable			13.5%	10.5%	8.5%	7.5%	6.5%	6.0%	5.0%
ASFA Modest	5.0%	3.5%							
Lower Returns by 1%									
Replacement Rate			3.5%	5.5%	6.5%	7.5%	8.5%	9.0%	9.5%
ASFA Comfortable			10.5%	8.0%	7.0%	6.0%	5.0%	4.5%	4.0%
ASFA Modest	2.0%	1.5%							
Employer Bears 50%									
Replacement Rate			4.5%	6.5%	8.0%	10.0%	11.0%	12.0%	13.0%
ASFA Comfortable			13.0%	10.0%	8.5%	7.0%	6.5%	5.5%	5.0%
ASFA Modest	5.0%	4.0%							

No single SG suits all

The table illustrates the wide range of SG estimates that emerges depending on income and other assumptions – anywhere between about 2% up to 20%. The lower SGs are associated with the ASFA modest income target which is 85%-90% covered by the pension plus supplements. The higher SGs exclude the pension.

Further, there are dimensions we don't investigate that add to the potential differences across individuals, including household status, gender, assets outside of superannuation and homeownership. In particular, those who own a home obviously need a lot less income during retirement than those who have to pay rent.

The key point is that there is no 'one-size-fits-all' SG. Further, there is an asymmetry around the SG itself. Individuals can currently do nothing about an SG that is set too high but can contribute more if it is set too low. We think this adds up to a case for not forcing everyone to save more regardless but rather adding in some flexibility.

The SG might be better positioned as a default rather than a hard compulsion, while enhancing scope to vary contributions subject to limits that guard against people opting out too far.

Two conditions justify a higher SG for all

Our modelling also identifies two conditions under which increasing the SG would benefit the vast majority of Australians. Both relate to what the SG is trying to achieve, suggesting that the Government should settle the policy objectives before deciding whether to increase the SG to 12%.

The **first** condition would be using superannuation to replace the age pension. This implies getting as many people as possible to become self-funded retirees, with the pension acting purely as a safety net. Excluding the pension from our analysis indicates what savings are required without the pension, in which case an SG of 12% may not even be enough. The alternative is counting the pension as an income stream that is broadly available to all. In this event, the need to save for retirement is much lower because the pension supplies substantial income support, especially for lower income earners. Policy makers might be clear on whether the purpose of superannuation is *either* to substitute *or* to supplement the pension.

The **second** condition would be to ensure that people save enough to support themselves through retirement if things don't pan out as expected, i.e. using superannuation as a self-insurance mechanism. There are three key risks that may lead to savings turning out to be insufficient:

1. Living to a very old age so that the money runs out, also known as longevity risk.
2. Retiring earlier than expected, such that contributions stop before the pension becomes available, thus creating a need to fund spending by running down savings. (Career breaks have similar effects, but there is the chance to catch up on super contributions later, and other income sources may be available such as unemployment benefits or paid maternity leave.)
3. Low investment returns that impair the funds accumulated. The table reports results where we assume living to age 102, retiring at age 62 and lower returns by -1%.

We are not convinced that imposing a higher SG is the best way of addressing these risks. The problem is that requiring everyone to save more 'just in case' can result in over-saving if the feared risks do not eventuate. If the additional savings are not needed, then an individual's pre-retirement standard of living would have been sacrificed without getting commensurate benefit, along with larger bequests for the children.

Other mechanisms to deal with these risks include social security and risk sharing amongst individuals. The latter are known as 'pooling' solutions and include annuities and various forms of member collectives. We would prefer to see policy makers explore these mechanisms.

The 'who pays' issue

A higher SG could be beneficial for some individuals if is paid for by employers rather than coming out of their take-home pay via some form of wage offset. However, this issue is far from straightforward. Evidence is mixed on whether the SG has been offset by lower wages in the past. And even if the employer pays in the first instance, where the burden ultimately falls is unclear. Profits taking a hit is one possibility, but others include the cost getting slated back to individuals if businesses increase prices or cut employment.

Conclusion

It makes more sense to add more flexibility to vary contributions rather than increase the SG. Further, the case for an across the board increase in the SG depends on what superannuation policy is trying to achieve. We see a clear argument if the aim is to replace the age pension, but otherwise the value of an increase is debatable.

Geoff Warren is Associate Professor at The Australian National University. This article draws on research undertaken in conjunction with Dr Gaurav Khemka and Yifu Tang. The full paper can be found here.

Long-term optimism for margin lending but share outlook subdued

Recep Peker

(*Editor's introduction: League tables of the best-performing managed funds of 2019 featured geared funds prominently, but it was primarily driven by leverage into a booming market. We explained what happened in*

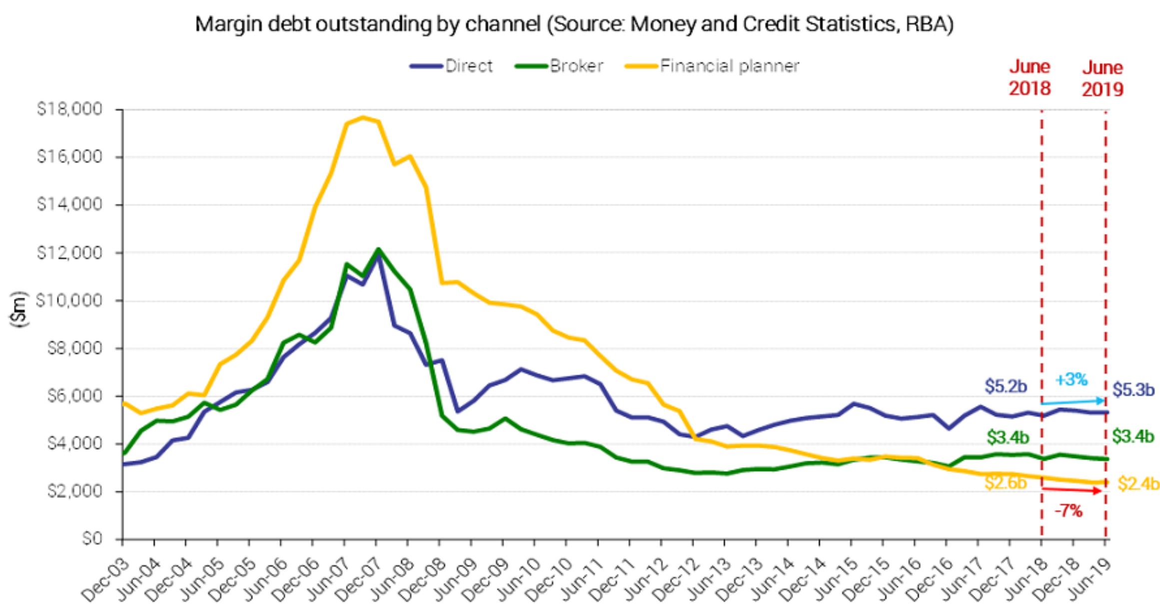
this article. At the same time, Investment Trends has surveyed another form of gearing, margin lending, and here is a summary of their findings).

Key highlights from the *Investment Trends Margin Lending Adviser Report are:*

- Advisers' views on gearing to invest are improving despite their subdued market outlook
- Innovative products are key to rejuvenating the margin lending space.

Investment Trends has kept a close eye on the use and appetite for geared investment products in Australia for over a decade, tracking the rise in the popularity of margin lending products in the build up to the GFC and their subsequent fall. Total outstanding margin debt has remained largely steady since 2012, at around $10 billion, which is well below the $40 billion peak in 2007.

Chart 1: Margin debt outstanding in the direct, stockbroker and financial planner channel



Borrowers taking on much larger loans

Our research shows the profile of margin lending users evolving markedly over the past decade. While overall user numbers have fallen, a wealthier group of individuals has remained, with the level of outstanding margin debt per investor more than doubling between 2012 and 2019 (from $111,000 to $235,000). This group is also increasingly non-advised, with the share of outstanding margin debt held by direct investors increasing from 36% in 2012 to 48% in 2019 (outstanding margin debt among non-intermediated investors increased 3% to $5.3 billion in the 12 months to June 2019).

This smaller pool of wealthier investors appear less interested in short-term speculation and more inclined to use geared investments to build long-term wealth. Compared to a decade ago, these margin lending investors are also more conservative in their gearing levels, making them less likely to trigger margin calls (also check out Graham Hand's excellent primer on the impact of geared investments here).

In 2019, the LVR for the average margin lending investor stands at 42%, significantly lower than levels seen prior to the GFC or the maximum level offered by lenders.

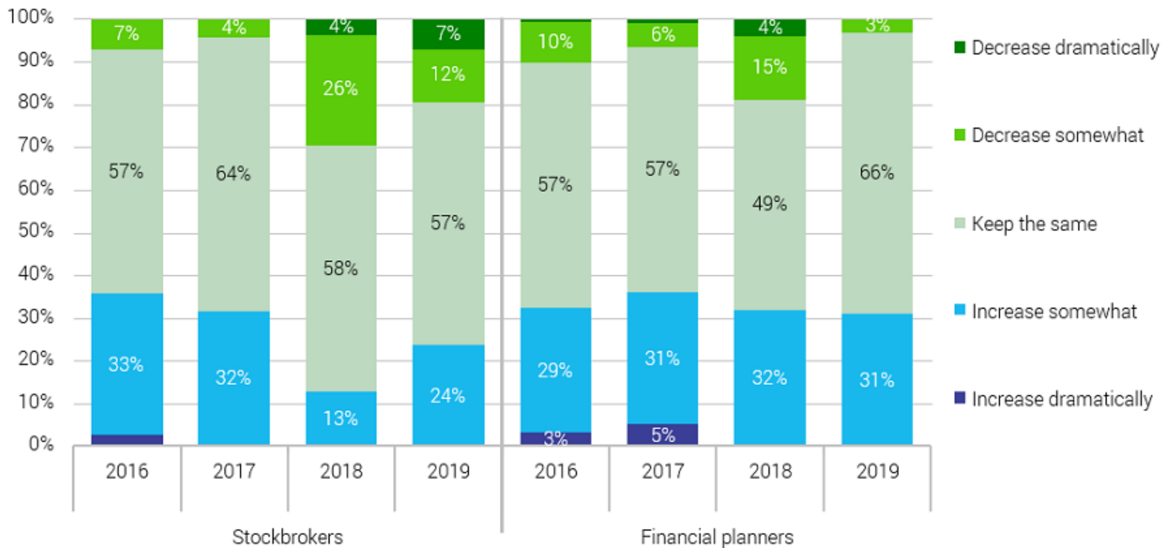
Advisers use for a select group of clients

In the intermediary channel, advisers are no less prudent and selective in recommending margin lending products. While 60% of full-service stockbrokers and 21% of financial planners provide advice on margin lending products, these advisers only do so for select clients (typically using these products for only one in ten clients).

However, both stockbrokers and financial planners are increasingly consider gearing to invest to be an appropriate strategy for their clients. The vast majority of stockbrokers believe their clients can benefit from the use of borrowings to boost investment returns (87%, up significantly from 72% in 2018), and this outlook

is even stronger among financial planners (89%, up from 82%). Looking forward, advisers' intentions to use margin lending have also recovered from 2018 lows (see Chart 2).

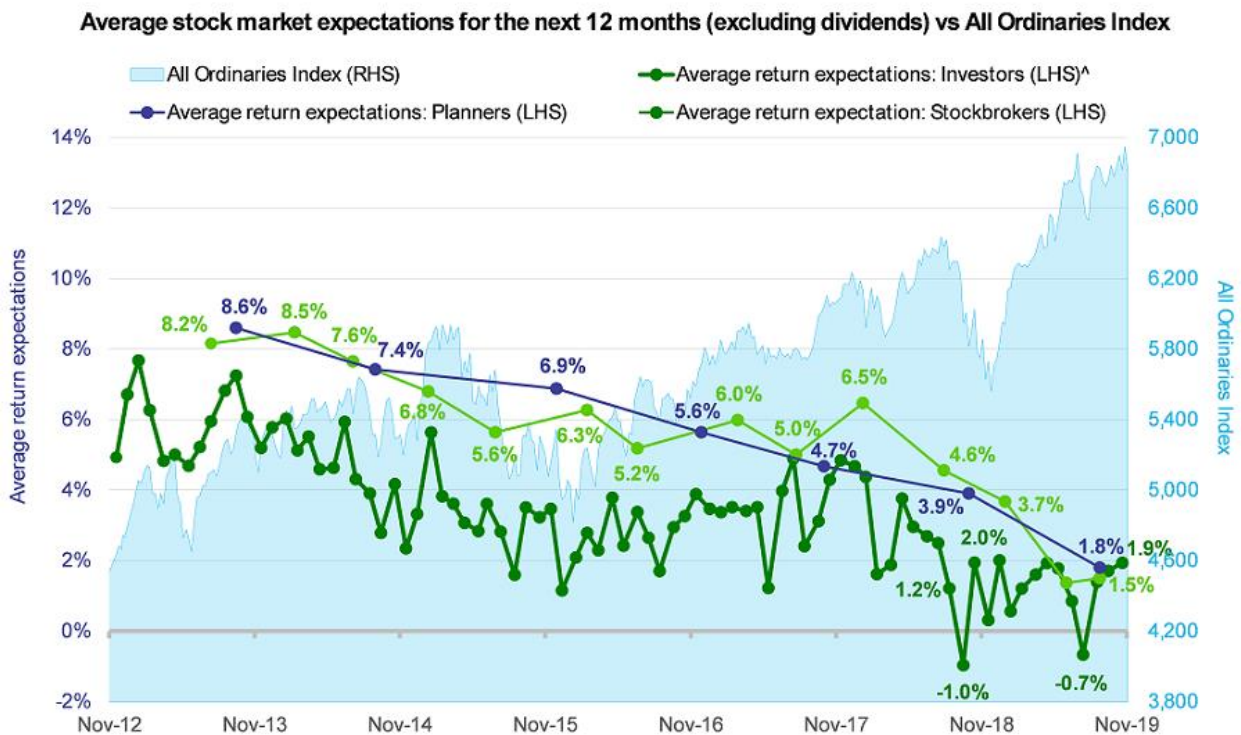
Chart 2: Intentions to increase/decrease use of margin lending among stockbrokers and financial planners



Outlook for shares not strong

While their views on gearing to invest are improving, advisers' outlook for domestic equities remains subdued. The average adviser expects the All Ordinaries Index to rise by less than 2% over the coming 12 months, or vastly lower than the levels observed prior to 2019 (see Chart 3). The fact remains, many advisers consider gearing products in their advice process – as part of their best interest duty to their clients – irrespective of their views on geared investments.

Chart 3: Stock market return expectations among investors, stockbrokers and financial planners



Dormant users may reactivate

Activating or reactivating the advice channel is a growing issue for the margin lending industry. A quarter of stockbrokers and nearly half of planners (43%) have used margin lending in the past with clients but no longer do so. Still, these dormant users are open to resume their usage, with 71% of stockbrokers and 78% of planners saying they can be encouraged to start using the credit product again.

A key catalyst to convert interest into action is improved product features. Compared to last year, significantly more stockbrokers tell us they would be encouraged to use these products if they could structure loans that avoided margin calls (23%, up from 9%) and were given more choices to protect their clients' initial capital (12%, up from 5%).

While innovative products are key to rejuvenating the margin lending space, lenders must continue maintaining their high levels of service and support, particularly their Business Development Manager support. A good BDM relationship is among the top three reasons why advisers favour their main lender aside from its good reputation and range of approved shares and funds.

The greater the support and education they receive from lenders, the better that advisers will be equipped to evaluate and utilise these geared investments for their clients.

About the report

The *Investment Trends 2019 Margin Lending Adviser Report* examines the use of gearing to invest among Australian stockbrokers and financial planners. The study is based on a survey of 182 financial planners and 200 stockbrokers who provide financial advice, concluded in November 2019.

Recep Peker is Research Director at Investment Trends. This article is general information and does not consider the circumstances of any person.

Media worth consuming - January 2020

Jonathan Rochford

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

Finance

The beige book survey finds that the US economy is doing fine. US rail traffic points to sub-par economic growth in 2020. On several measures, US stocks are as overvalued as they were in March 2000. Americans are using their homes as ATMs again.

A former proprietary trader started a hedge that charges no management fee but takes one-third of S&P 500 outperformance. Hedge funds run by white men are being beaten by their peers, though the result could be just a size effect. Expect more asset allocators to buy stakes in fund managers. Managed fund fees are falling, but investors are switching to higher fee funds. Bridgewater's flagship Pure Alpha fund delivered a 0.5% return in 2019, with the all-weather strategy up 16%.

Fitch upgraded Greece to BB; a 15 year bond issue could follow. The IMF is almost out of its self-created Greek mess. Lebanon's citizens are rioting as they are limited to withdrawing $200 per week from their bank accounts. Tesla has the highest market capitalisation any US auto maker has ever reached but one company's detailed analysis argues that Tesla is built on fraud.

American banks are regularly increasing credit card limits without being requested, with subprime borrowers more likely to be targeted. A decade after the financial crisis, American jumbo mortgages are still defaulting with a backlog of arrears waiting to be cleared. Investor protections are being stripped from CLOs. Bad arguments for why leveraged loans aren't a problem. 32 dumb things people say about investment markets.

Politics and culture

Trump is sick of losing wars and paying the bills for other countries, but the military just doesn't get it. Elizabeth Warren's bankruptcy proposals would see some in the middle class relieved of responsibility for their poor decisions.

She was also confronted with the lack of fairness in her policy for cancelling student loans. Trump voters are slightly more likely than Democrat voters to spot fake news. A pro-Clinton Facebook executive credits Trump's victory to his team's far better online campaigning. American sanctions have wedged Iran.

A Chinese man has been jailed for six months for posting tweets that mocked President Xi. The Brazilian Culture Minister was sacked for making a speech remarkably like one given by Joseph Goebbels. Chile's left-wing grievance culture is ruining a prosperous economy. The Austrian Conservative/Greens coalition government is finding ways to work out policy disagreements. German grandmas held a protest after a government owned TV station played a song with children calling them environmental pigs for eating meat and driving fossil fuel powered cars.

CNN is upset that a satirical news website is getting more clicks than it does, with this hilarious article a particularly sharp joke on the network. Rocky Gervais used the Golden Globes to mock the hypocrisy of Hollywood. An American bankruptcy judge has wiped out a $220,000 student loan debt in a case that could signal a turnaround from long standing precedents. A city in Washington state has demanded a widow pay $60,000 for approval to renovate her house. Letting homeless people live with "no rules" is a danger to themselves and others.

Economics and work

Inflation and growth are low due to excessive debt, not a glut of savings. The negative externalities of government deficit financing are like a factory polluting the water for downstream users. A skeptic's guide to MMT. The basics of rent seeking and how it diminishes an economy. The short, illustrated version of Hayek's "The Road to Serfdom". If you like coffee remember that many steps of capitalism were required to bring it to you.

Governments would be much more effective in helping low income people if they focused on the cost of living rather than minimum wages. The reasons that welfare reduces work and the incentives to be independent. Henry Ford voluntarily improved conditions for his workers far more than unions did. The Roman Empire failed in part due to ongoing bailouts and the excessive welfare system. DoorDash pays its American delivery personnel an average of $1.45 per hour, but strangely seems to keep finding people willing to work for it.

Pittsburgh's insurance-free doctor charges $35 per visit. The economics of gift cards. How bulk buying is sometimes more expensive. 5 economic myths that people believe despite overwhelming evidence.

Miscellaneous

How Western society increasingly doesn't ask questions when they might get in the way of getting paid. Microsoft went to war against the IRS when the agency tried to stop its shady tax ploys. The 30 most evil tech companies. The software service Slack is reducing productivity, the exact opposite of its sales pitch. A Chinese bank manager took $40 million in bribes and kept it in cash in his apartment. How a Missouri farmer defrauded buyers out of $70 million selling fake organic grain.

2019 was the second hottest year on record, with the last decade the hottest ever, but there are still a few who argue that global warming doesn't matter. Despite trying to make its grid greener, Germany is closing down nuclear power generation and relying more on coal. US electricity demand is falling, but a wave of wind and solar generation is coming online. A remote West Australian township is testing a 100% renewable, hydrogen/solar/wind power system. 7 personal factors that lead to wealth creation. 15 tasty facts about bacon.

Written by Jonathan Rochford of Narrow Road Capital. Comments and criticisms are welcome.

This article has been prepared for educational purposes and is not a substitute for professional and tailored financial advice. The accuracy of the material cannot be verified in all cases. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.

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