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Editorial

The impact of central bank activity on stock and bond markets is so pervasive that '**don't fight the Fed**' has become a cliché. In fact, clichés are thriving in the coronavirus pandemic. We hear 'the cure is worse than the disease', events are 'unprecedented' and 'black swans', hotels and ships are 'Petri dishes', while 'we're all in this together' but it's 'the worst since the Great Depression' before we 'come out on the other side'. And yes, yes, yes, we know 'when the tide goes out, we can see who's been swimming naked', although 'it's the end of the beginning'.

'Don't fight the Fed' is advice to invest in alignment with the actions of the US Federal Reserve, which is doing 'whatever it takes'. It's a risky strategy. It's apparently safe to invest in equities when the Fed is lowering rates and pumping money into the economy. Confidence has even returned to high-yield (which we used to call junk) bond markets because the Fed is buying, despite the fact that many companies will not survive the downturn. Poorly-run companies which have leveraged their balance sheets by borrowing for share buybacks (and thereby enhancing executive bonuses) instead of building reserves should be allowed to fail. Risk should have a price.

For many years, since it ran out of monetary policy ammunition, the Bank of Japan has been buying trillions of yen of equities a year to stablilise the market, and the Fed is not far behind.

But while the Fed can print an apparently unlimited amount of money, 22 million Americans who have lost their jobs in the last month will not spend it. Millions of companies facing lockdown will not invest it in new equipment. Most people are home-bound, hunkering down and protecting cash. And as restrictions are lifted, will people resume their pre-coronavirus lives? Bonuses and incomes are falling, rents are not paid, and for a long time, we will be wary at sporting events, in restaurants, at shopping centres. Then what happens when governments shut off the life supports?

In Australia, 800,000 jobs have gone in three weeks. The **Grattan Institute** estimates that up to 26% of Australian workers could be out of work as a direct result of the shutdown, with "*an enduring impact on jobs and the economy for years to come."*

Nassim Taleb (he of 'black swan' fame) in his book *Antifragile: Things That Gain from Disorder, says*:

"Indeed, our bodies discover probabilities in a very sophisticated manner and assess risks much better than our intellects do. To take one example, risk management professionals look in the past for information on the so-called worst-case scenario and use it to estimate future risks - this method is called 'stress testing'. They take the worst historical recession, the worst war, the worst historical move in interest rates, or the worst point in unemployment as an exact estimate for the worst future outcome. But they never notice the following inconsistency: this so-called worst-case event, when it happened, exceeded the worst case at the time."

If the crisis is indeed 'unprecedented', we are not overly worried when, since the heavy falls to 23 March, stock markets have rallied strongly. That's 'don't fight the Fed'. We are now back above the average price/earnings ratio for the S&P/ASX200 since 1999 despite the prospect of massive corporate earnings collapses. The chart below is to 31 March 2020 and the market is up since then. Look what happened in 2008 during the GFC.

Valuation measure	Description	31 Mar 2020	Avg*
P/E	Forward P/E	14.4x	14.3x
Div. Yield	Dividend yield	4.9%	4.6%
P/B	Price-to-book	1.9x	2.0x
P/CF	Price-to-cash flow	9.2x	9.7x
EY Spread	EY minus corp bond yield	1.8%	1.8%

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus corporate bond yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) less the yield on the AusBond Credit (5-10y) Index. *Average dates vary due to data availability, start date is 31 December 1999 except for P/B, which is January 2001, and EY spread, which is October 2003.
Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Australia. Data as of 31 March 2020.

And while Australia can take comfort from its impressive control of coronavirus, in the 'Land of the Free', armed protesters are taking to the streets to campaign against the lockdowns, actively encouraged by their President.

This week, we continue to seek expert input to guide our readers: not to pick a turning point or a guess at a market top or bottom, but to plan a long-term strategy that looks through short-term volatility.

We lead with a comprehensive review by three authors from consulting and actuarial firm **Rice Warner**, contrasting decisions taken by different countries. They plot an exit strategy, comparing the 'go too early' versus 'stay out longer'.

Duncan Lamont checks 11 bear markets since 1871 for investing lessons, notably warning that hiding in cash and not reinvesting misses the inevitable market recoveries. **Paul Taylor** identifies a rule-of-thumb the market is using, and looks at business activities which will survive the downturn.

Chris Manuell warns of further falls as economic conditions deteriorate, and the oil price crash shows widespread problems caused by lack of demand.

While it's accepted that there is little potential for inflation while output is so weak, we complete the third part in our series asking experts to opine on the consequences of massive borrowing programmes. A trillion here, a trillion there, and soon we're talking serious money. **Chris Brightman** worries that governments have lost all semblance of fiscal restraint when money printing seems so easy.

Raewyn Williams sees an opportunity due to the market fall not only to seek stock bargains, but to do a portfolio makeover without a capital gains tax bill, while **Aidan Geysen** says loss of dividends can be managed by taking a 'total return' approach to spending needs.

In this week's White Paper, **Shane Oliver** lists the good news and the bad news to see if there is a light at the end of the tunnel.

Finally, **David Knox** addresses whether superannuation taxes unfairly benefit wealthy people, and **Morningstar's Adam Fleck** runs his ruler over **Magellan** and **Platinum** as investment opportunities.

Graham Hand, Managing Editor

What are the options for a pandemic exit strategy?

Michael Rice, Alun Stevens and Michael Berg

Most Australians are now paying close attention to the pandemic sweeping the world. As it is affecting every one of us, there is much discussion on death rates, *flattening the curve*, and the source and spread of new cases of COVID-19. Actuaries are among those using existing skills and training to interpret the data and its implications for decision making. Both erudite technical and forthright public discussions (now mainly on social media or Zoom) show frustration with the apparent lack of any cohesive plan to exit the population's imprisonment – and the confusing and often contradictory messages being sent out by our governments. This is to be expected though, give the range of different expert opinions being espoused and with governments having to deal with today's issues while trying at the same time to make policies for the future *on the run*, with very little data or historical evidence to support it.

Governments everywhere have embraced a variety of strategies to eliminate this scourge. The tactics can broadly be grouped as:

Do nothing much – the USA and UK did this initially, and it continues to be the stance of Brazil and Iran – and the virus has spread much further into their populations as a result. This could be the least bad option for countries with young (less vulnerable) populations that lack the economic resources to sustain protracted lockdowns.

Herd immunity while flattening the curve – Sweden is systematically allowing some spreading of the virus while encouraging older and other high-risk people to self-isolate, but this is now under stress as the older groups have not been protected and death rates are rising. The UK's herd immunity strategy had to be abandoned when it became clear that it would not achieve sufficient reduction in caseloads for the National Health Service to provide proper treatment.

Hard and late – Italy, Spain and France were quickly overwhelmed. They ran out of medical resources and many people have died through lack of treatment or survived with serious long-term health damage. The UK is now at risk of joining this group. In hindsight, adequate medical resources seems to be one of the most critical items to reducing the death rate – having enough respirators and intensive care units to cope.

Whack-a-mole – the current situation in the US, with different states taking different steps at different times. Bill Gates describes this as "*a recipe for disaster*". He views the top priority as having a consistent approach in strategy across different states, otherwise the infection will keep travelling backwards and forwards. He argues the position should be that "*Shutdown anywhere means shutdown everywhere. Until the case numbers start to go down across America—which could take 10 weeks or more—no one can continue business as usual or relax*

the shutdown. Any confusion about this point will only extend the economic pain, raise the odds that the virus will return, and cause more deaths."

Hard and early – South Korea, Taiwan, Singapore (noting that Singapore has had a relapse from the virus breaking out amongst its migrant workers), NZ and Ireland have tried to quarantine those carrying the virus hoping to eliminate it while enforcing significant social distancing. The more successful strategies have been characterised by extensive testing - and use of test results to implement targeted quarantines and inform policy decisions. Australia actually went Hard and Late – we were not testing sufficiently and were poor on quarantining; however, our isolation and subsequent actions have protected us from similar fates to other countries.

Most governments have a policy of containing the disease, but all are grappling with an exit strategy. No one will be entirely safe until there is a vaccine, but this could be 12 to 18 months away – and no coronavirus has had a successful vaccine developed before.

Clearly, governments need to restart their economies as soon as possible, but all want to make sure they don't then create a further outbreak that exceed their medical resources. However, an early start is essential to reboot the economy. We all know about the huge debt burden of the Commonwealth, but the States will also have huge deficits – they are maintaining most services including retaining all public servants, so their costs remain largely unchanged.

However, they have lost much of their revenue – property stamp duties, gambling taxes, and significant reductions in payroll taxes, public transport fares and GST (noting that the items people are buying now, food and health goods, are exempt from this tax).

Mortality rate

Plagues all have their own characteristics. The Black Death of the fourteenth century was particularly virulent and devastated Asia, the Middle East and Europe. It killed about 20 million Europeans in five years, which was nearly one-third of the total population at that time. In the days before modern science and medicine, such outbreaks were common and the so-called Spanish Flu of 1918-20 killed an estimated 50-100 million people. Thanks to strong quarantining and social distancing, a relatively small number of Australians (about 10,000) were killed.

More recent cases of Ebola, MERS, Zika and SARS have been deadly, but they were quickly contained, partly because these viruses often kill their hosts quicker than the hosts can spread the virus. None of these broke out globally.

Conversely, COVID-19 is fast spreading. Fortunately, it is not as lethal as the other viruses just mentioned, but it is dangerous for four key groups:

The elderly – statistics show that the death rate is much higher for those over age 70, and particularly those over age 85.

Those in confined places – the epidemic has spread in cruise ships, aged care facilities and now in US and French aircraft carriers.

Health workers – fit and healthy people have died, suggesting that extensive exposure to the virus has a cumulative adverse effect. More than 100 doctors have died in Italy and several NHS medical staff have died in the UK.

Those with existing respiratory ailments or other severe co-morbidities such as diabetes, cancer or heart problems.

It also appears that young healthy people are generally not severely affected. The incidence of death under age 20 is very low, and children appear largely unaffected – which is why many are asking for schools to be re-opened.

The actual death rate is difficult to calculate. While there is a league table of cases and deaths produced by Worldometers, both the exposed-to-risk and death statistics are understated.

The level of exposed-to-risk relies both on testing - which is sporadic everywhere - and the rate of community infection. The latter is estimated by epidemiologists but the rapid spread of the virus in the community and the

large number of carriers who are asymptomatic or have mild symptoms means the estimates have statistically significant, but unknown errors.

Results just released regarding the incidence of corona virus amongst the crew of the US aircraft carrier, Theodore Roosevelt, show the extent of the problem. The entire crew of 4,800 was tested and revealed 600 cases with 60% of these entirely asymptomatic. If testing had been confined to symptomatic cases, 360 infected sailors would have been free to infect others. If this level of asymptomatic infectiveness is applied to Australia, the actual number of infected people would be at least 2.5 times the reported number. The difficulty in pinning down these numbers is one reason for the lockdown – to prevent the unknown carriers spreading it further.

The level of deaths is distorted by under-reporting. It appears that Chinese and Iranian deaths are much higher than the reported figures (deliberate misrepresentation by their governments, not scientists), much of the third world does not have the skills or equipment to measure it properly, and even in Europe and the UK where they try to give accurate data, deaths outside hospitals have not been captured well. Australia is also only reporting deaths of previously diagnosed patients.

From the Worldometers site, there are crude death rates related to age and gender. First, about two-thirds of deaths are of males. Then, the virus is virulent at advanced ages as shown in the table below.

Death rate

Age group	**Death rate (%)**
Above age 80	14.80
70-79	8.00
60-69	3.60
50-59	1.30
40-49	0.40
20-39	0.20
Under 20	Minimal

The low death rate under age 40 is one reason why many people are confident we can get parts of the economy back to work without any major health risks. However, as the young meet with vulnerable people, they will continue to spread it. Therefore, we would need to devise a strict quarantine structure for those at risk – and recognise there would be lapses due to some failures by people to adhere to strict standards.

Sweden is trying this strategy, but their curve is still rising, so the quarantining of the vulnerable has not been effective.

Co-morbidities

Most analysis to date has been based on age and gender, but there are some signs that having a serious ailment, a co-morbidity, might be the most important risk factor:

- Significantly more males than females have died in Italy and China, both countries where male smoking has been and is high, suggesting more males than females have weakened respiratory systems.
- Healthy older people often survive. This week, a 105-year-old female and males of 99 and 101 fully recovered in England.
- African-Americans in NYC have higher levels of mortality from the virus. This could be related to high levels of diabetes and obesity amongst this ethnic group and generally poor standards of health due to poverty. Note the large number of people being buried in mass graves in NYC includes many lacking family contacts indicating they are likely to be poor, perhaps homeless (and therefore were in poor health).
- The death rate appears to vary by country, suggesting there are factors other than age and gender - although a lot of this difference could be due to differences in testing and reporting.

There are two sets of statistics published specifically relating to co-morbidities.

First, the Italians released some data on the first 6,800 deaths (as at 27 March). Although most were elderly, it showed that only 2% had no co-morbidity (cancer in last 5 years, hypertension, diabetes, etc). 21% had one illness, 26% had two and 51% had 3 or more.

Second, in New York State, some 10,277 of the first 11,586 deaths (88.7%) had one or more comorbidities.

If these figures were representative of the whole population, it might be possible to isolate a relatively small number of people and let everyone else go back to work! Hence, if we could show that those without a significant co-morbidity are at little risk of serious illness or death, we could start the economy moving quickly.

We could potentially isolate those at risk which might be 15% of those over age 60, all of those over 70, and younger people with a history of major illness (diabetes, heart disease, respiratory problems and cancers). We would also isolate people living with these high-risk people. The problem is ensuring the isolation is enforced and sustaining the people so isolated for the six to twelve months of isolation that would be required.

Exit strategy

What is the path for an exit strategy from lockdowns given the likely timeframe (12-18 months) for a vaccine? There may be early results with research looking at proxies including previous BCG vaccinations. However, we need to assume that we will have to come out of the lockdown long before a vaccine is available.

Australia has an advantage being an island in that it can test anyone arriving into the country and keep out any future transmissions. We are in a position that the number of infected people is at a relatively low number. From this, we should be able to triage the population and get back to normal.

We need to trust the hypothesis that healthy lives will recover without hospital treatment. Therefore, we must try to isolate riskier lives (and those living with them). We allow the safer lives to return to the economy but, accepting the risk of a major outbreak, we need:

- Recognition that there are no risk-free options, and that one-dimensional strategies which fight the virus without reference to the economic implications will kill more people from poverty and mental health issues than they save from the virus. The approach needs a careful balance between expanding economic activity and preventing the virus spreading exponentially.
- Phased introduction, perhaps by geographical region, starting with schools due to the low levels of health risk to younger people and the double-whammy of disrupted education for children and disrupted work for parents if schools are closed or only notionally open.
- A plan to deal rapidly with localised outbreaks by identifying, quarantining and testing people who may have been exposed to infection.
- A plan to lockdown again (perhaps by region) if the strategy does not work. Acknowledgement that some people will not follow the rules – so some high-risk people will be exposed by having contact with (say) family members.
- Acknowledgement that mild or asymptomatic cases could lead to further breakouts.
- Full testing within regions to ensure local elimination – as done in the North Italian town of Vo. While this could be viewed as intrusive, it is far less intrusive than requiring people to give up their livelihoods.
- Recognition that frequent heavy exposure kills healthy people – so we need to minimise people needing hospital care.

We will maintain:

Closed borders – we could have travel between cleared countries in time, perhaps starting with NZ.

Limited travel between regions - until they are all clear or reliable tests can be carried out before travel and at points of entry.

The risk of going early is still large. It could be managed progressively but the risk of staying out longer will be crippling for the economy. The further risk of staying out longer once community transmitted cases have reduced to very low levels is that the community will simply stop complying.

We can expect a slow relaxation of restrictions and a slow restarting of the economy with an ultimate return to whatever the new normal is, once a vaccine is freely available, likely to be sometime late in 2021 but possibly earlier given the resources working on it.

Michael Rice AO is Executive Director, Michael Berg is Senior Consultant, and Alun Stevens is Senior Consultant at independent actuarial firm Rice Warner. The Actuaries Institute has set up a COVID-19 Working Group to consider the financial and health impact of the coronavirus on Australia. Michael Rice is a member of that group. This article is general information and does not consider the circumstances of any person.

What do 11 stock market crises over 148 years tell us?

Duncan Lamont

Like many of you reading this, my savings have taken a hit since February. I know we always say that investing in the stock market is for the long term, but that doesn't make holding your nerve through this any easier.

Every time there is a major downturn, it feels like we are drowning. When will the storm end? When will we be able to catch our breath? Where is the dry land? Importantly, how we respond to these downturns can have a big impact on our future wealth.

Risk of loss is the price of the entry ticket for the stock market

The unfortunate truth is that stock market declines of the recent magnitude, and worse, occur from time to time. Volatility and the risk of loss are part of the 'price of the entry ticket' for stock market investments.

There have been 11 occasions in the 148 years between 1871 and 2019 when stocks (as measured by the S&P 500 Index) have destroyed at least 25% of value for investors (see table). In the 2001 and 2008 downturns, losses exceeded 40%.

In the worst case, the Great Depression of the 1930s, investors lost over 80% of their money. It took over 15 years for them to make their money back if they remained invested.

Other stock market falls were not quite so calamitous. In seven of the 11 episodes, investors would have recouped all losses in two years or less if invested in the S&P500 index. In 1893, 2001 and 2008, the period to breakeven was four to five years.

How long did US stocks take to recover losses from a 25% crash?

Market crash	Maximum loss	Years to breakeven from -25% point
1877	-33%	1.8
1893	-25%	4.0
1903	-26%	1.1
1907	-34%	1.2
1917	-28%	1.5
1929	-82%	15.2
1970	-25%	0.8
1974	-39%	2.0
1987	-26%	1.5
2001	-42%	4.1
2008	-49%	4.8
Median	**-33%**	**1.8**

Past Performance is not a guide to future performance and may not be repeated.
Source: Robert Shiller, Schroders. Monthly data 1871-2020. Data is for S&P 500 and assumes investors retained their exposure to the stock market.

These figures are all in nominal terms, so they include any uplift that may have come from inflation. The numbers look worse in inflation-adjusted terms. For example, although the US market had made up its dotcom losses by October 2006 in nominal terms, it was not until April 2013 that it broke even in inflation-adjusted terms.

On the flip side, over the last 148 years and two months, US stocks have returned an amazing 8.9% a year, 6.7% a year ahead of inflation. Over the same period, US cash returned only 4% a year.

Dash for cash, stick with stocks, or double-down?

There are three common investor responses to a market crash:

- Dash-for-cash: abandon the stock market in favour of the perceived safety of cash
- Stick-with-stocks: the 'do nothing' approach

- Double-down: invest additional money in the stock market, either as a lump-sum or by drip-feeding money in.

Lump-sum investing exposes investors to the risk that they make the investment at a bad time, adding the challenge of picking exactly the right time. It also assumes that investors can access a large cash pile to finance that investment.

In contrast, the drip-feeding approach is a bit like 'buying low' but with the humility to accept that we have no idea when the lows will occur. 'Buying lower than before' might be a better description.

In the remainder of this article, we assume this is the approach taken in the double-down response.

Why alternative responses matter

In the 11 previous falls of 25% or more, investors were in the position that many find themselves in today.

For the purpose of this analysis, in the double-down response, we have assumed that an individual invests an annual amount equivalent to 5% of the portfolio's value in the month when the market first declines by at least 25%.

So, for a portfolio worth $10,000 which had fallen in value by exactly 25%, the monthly investment would be 5% x 7,500 / 12 = $31.25 per month. This is equivalent to just over 0.3% of the pre-crash value of the portfolio. This would not be an unrealistic amount for many investors and can easily be scaled up or down for different amounts. These figures are for illustrative purposes only and are not a recommendation.

It follows that investing new money will increase a portfolio's value faster than doing nothing. We then calculate the length of time to get back to the pre-crash level plus the value of additional investments. In the table below, the 'stick-with-stocks' results are the same as those shown earlier.

Number of years before all losses are recouped

			Double-down (drip-feed)	
	Stick-with-stocks	Dash-for-cash	To get back to pre-crash value	To get back to pre-crash value + value of additional investments
1877	1.8	6.9	1.8	1.8
1893	4.0	6.2	1.8	2.0
1903	1.1	6.2	1.0	1.1
1907	1.2	8.8	1.1	1.1
1917	1.5	6.3	1.3	1.4
1929	15.2	34.0	6.3	6.7
1970	0.8	5.0	0.8	0.8
1974	2.0	5.3	1.6	1.7
1987	1.5	4.3	1.4	1.5
2001	4.1	Still underwater	3.3	4.3
2008	4.8	Still underwater	3.3	3.6

Source: Federal Reserve Bank of St. Louis, Robert Shiller, Schroders. Stock market data is for S&P 500. Monthly cash return 1934-2020 based on 3-month Treasury bill, secondary market rate; 1920-1934 based on yields on short-term United States securities; 1871-1920 based on 1-year interest rate. 1871-1920 data only available annually so a constant return on cash has been assumed for all months during this period. Other data is monthly. All analysis is based on nominal amounts.

There is a real risk that individuals are so scarred by recent experience that they are put off from investing in the stock market for a long period of time. They dash for cash. However, our research shows that historically, that would have been the worst financial decision an investor could have made. It pretty much guarantees that it would take a very long time to recoup losses.

For example, investors who shifted to cash in 1929, after the first 25% fall of the Great Depression, would have had to wait until 1963 to get back to breakeven. This compares with breakeven in early 1945 if they had remained invested in the stock market. And remember, the stock market ultimately fell over 80% during this

crash. So, shifting to cash might have avoided the worst of those losses during the crash, but still came out as by far the worst long-term strategy.

The message is overwhelmingly clear: a rejection of the stock market in favour of cash would have been very bad for wealth over the long run.

Should investors buy more?

This is a very personal question. Irrespective of any investment considerations, not everyone will be able to buy more, whether they want to or not. Alongside the significant health consequences of Covid-19, people are suffering job insecurity and cash flow difficulties. The need to pay rent and bills, to buy food, to feel financially secure, trumps any opinions about whether the stock market is good value or not.

All comments which follow must be taken with that caveat in mind. That is in addition to the caveat that it remains very difficult to quantify how bad things will get during the current downturn.

However, at least in regard to that second caveat, that is no different to any previous market crash. Do you think investors knew in 1929, after the first 25% fall, that the stock market was going to fall another 75%? Or that in 1893, 1903, 1917, 1970, or 1987, they knew that -25% was close to the low point?

Our analysis finds that, in most cases, the double-down response would not have made a huge difference to the length of time needed to recover losses compared with doing nothing. It shortens the recovery period in six cases, makes no difference in four and results in a worse outcome in one.

However, the one time that it made a big difference was in the worst downturn of all, the Great Depression. Then, drip-feeding a small amount into the stock market would have cut the length of time to recovery by more than half—6.7 years compared with 15.2 years.

Although it may seem surprising that the double-down strategy does not make a bigger difference, this is partly because the assumed size of the investment is relatively low. Investing an amount equivalent to 20% of the portfolio value, rather than 5%, would have closed the gap quicker in each case.

Actions have consequences

Everyone's circumstances are different, and this is in no way intended as financial advice. Nonetheless, for those who are already invested in the stock market, the steps you take now will have an impact on how your portfolio recovers from the current downturn. Anyone thinking of moving to cash should consider the consequences, with savings rates at close to zero.

In contrast, history shows that investors who hold their nerve are likely to end up with a better long-run outcome. Those who are in a position to be able to add to portfolios could end up even better off and are unlikely to end up worse off.

However, this only holds in the long run. No one has a crystal ball to be able to predict how and when the current downturn will end. Repeating what I wrote earlier, risk of loss is the price of the entry ticket for the stock market. Higher long-term returns are the potential payoff. The mental scars of what we are living through will be with us for a generation, but the financial scars need not be.

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A band-aid on a bullet wound

Chris Manuell

These are extraordinary times and they have elicited extraordinary measures from government and central banking authorities the world over. The invasive and far-reaching effects of COVID-19 were enough to stop the 11-year bull market in risk markets in its tracks. The difficult question for society and financial markets is when can we expect some normalisation to occur in a post-virus world.

We feel this pandemic has changed consumer behavioural habits for the foreseeable future and will have devastating ramifications for the economy. At the same time, the virus has also exposed some pre-existing shortcomings in the structure of the economy and financial markets.

Full marks to the coordinated efforts of our global central bankers and politicians who have all dug deep into their accommodative war chest with eye-watering quantitative easing and fiscal programs. Estimations for balance sheet expansion commitments in recent weeks from the US Federal Reserve (the Fed), the European Central Bank (ECB), the Bank of Japan (BoJ) and Bank of England (BoE) alone amount to more than US$5 trillion, coming off a relatively tiny negative number last year.

For some perspective, that is a multiple of two and a half from prior peak balance sheet expansion periods in late 2009 and 2016. Sprinkle the unprecedented global fiscal measures on top and this has provided the impetus for the recent risk rally from the 35% decline in equities.

We believe this recent rally shows all the signs of historical bear market risk bounces, most recently through the GFC where markets had episodic rallies in the secular downtrend. The bigger picture template is the Japanese model, where equities failed to return highs that were reached more than a decade earlier.

Corporate balance sheets will be severely tested

COVID-19 has accentuated the financial distress on many consumers and corporate balance sheets that fiscal and monetary stress cannot completely alleviate. Unfortunately, a wave of global consumer defaults is just getting started. Even following the 'flattening of the infection curve', travel and education will be altered, and shopping and work patterns will be changed forever. The corporate balance sheet which was already bursting from the seams with debt. US non-financial corporate debt is a record 47% of GDP, and it will become even more bloated as cash-starved corporations pile on the debt as their revenues dry up.

We have warned for years about the systemic risk that corporate debt poses to the financial marketplace and to paraphrase the well-worn market anecdote, 'as this tide goes out, corporate debt will be found to be swimming stark naked.' Unfortunately, as hopes of a V-shaped economic recovery diminish so do the revenue prospects for corporations particularly those smaller companies that need to borrow to survive.

Downgrading these companies will only add fuel to the fire as many performance-chasing fund managers have stuffed their yield-seeking portfolios with sub-standard debt. Both client redemptions and credit downgrades will force selling at discounted and distressed prices.

A tsunami of corporate bonds due to mature

Another crack in the wall of the corporate debt market is the tsunami of bonds rated BBB or below in the US that are set to mature this year – a staggering $840 billion worth of bonds. The Fed announced recently that it will expand its bond-buying programme to include debt that was investment-grade rated as of 22 March. However, this was later downgraded to no lower than BB-, which is three levels into high yield (once called junk bond).

The Fed's intention to purchase ETFs that track speculative grade debt is an indication of how deep it needs to dig into its monetary policy toolkit to rescue these fallen angels. It is important to remember that Fed buying or supporting asset prices fails to replace cash flows or fortify balance sheets.

This is just a band-aid on a bullet wound.

In the good times, it is always easy to turn a blind eye to flawed practices. Aside from the borrowing bonanza over the decade-long rally in risk, another artificial support for risk markets has been the preponderance of equity buybacks. Studies from Goldman Sachs analysts suggest US companies will spend half as much repurchasing their own stock in 2020 compared to last year. With the expected suspension of dividends, this takes away demand from the equity market that fiscal and monetary stimulus cannot provide.

The shape of the economic recovery will provide lots of discussion points over the journey of the pandemic, with many dispersions on the economic forecasts to be expected. One thing that we can say with certainty is that the economic damage will be unprecedented for the modern era, as the below forecasts for the US second quarter GDP illustrate. We maintain that the risks of re-infection or second wave from the virus along with an elongated containment policy from authorities will only serve to deepen the economic recession and the lagged effect will ultimately push the economy towards a global depression.

Looking at previous US equity bear market drawdowns (defined as a 20% loss from the highs) since the Great Depression supports the view that there is still room to run on the downside for risk markets. The average fall from top to bottom of these 10 bear market events was 373 trading days, or over a year before we can expect a trough in equity markets.

At a minimum, we expect there will be a retest of the recent stock market bottom, and investors should brace themselves for risk market declines as we anticipate the worst drop in global GDP since World War 2.

Second quarter 2020 US GDP growth forecasts by global investment firms

Firm	2Q2020 GDP forecast
Bloomberg Economics	-9.00%
UBS	-9.50%
Pantheon	-10.00%
Strategas	-10.00%
Cornerstone Macro	-11.00%
Oxford Economics	-11.90%
Citigroup	-12.00%
Credit Suisse	-12.00%
Bank of America Merrill Lynch	-12.00%
Deutsche Bank	-12.90%
IHS Markit	-13.00%
Wells Fargo	-14.70%
TS Lombard	-17.70%
Evercore ISI	-20.00%
JP Morgan	-25.00%
TD Bank	-27.00%
Morgan Stanley	-30.10%
Goldman Sachs	-34.00%
Capital Economics	-40.00%
ING Group	-40.00%

Source: Bloomberg.

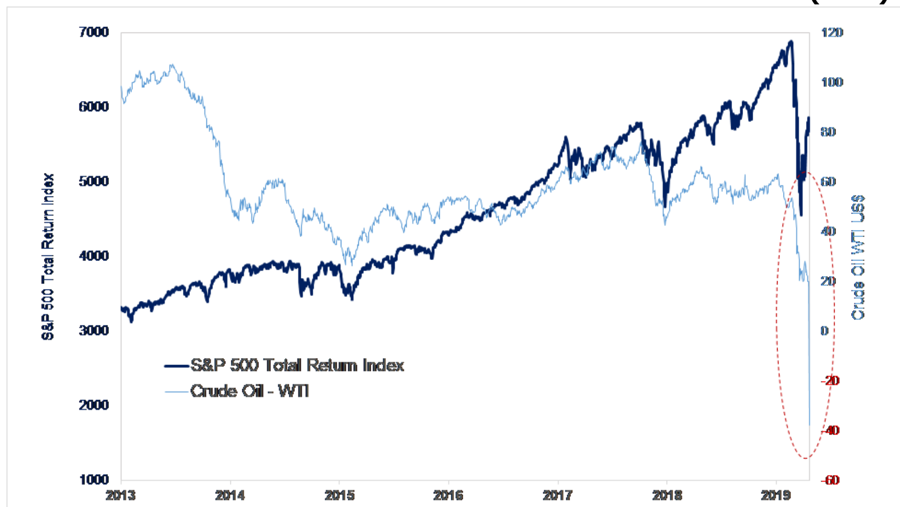
Oil price collapse is a warning

The recent carnage in the crude oil market, where West Texas Intermediate crude futures fell more than USD55 to settle at a negative USD37.63, created history. It was the first time it had traded in negative territory and is a clear example of the structural problems currently facing financial markets. This price action in crude embodies how the virus has exposed the frailties of market ecosystems. The lack of demand for oil occurs as global containment keeps the V-8 in the garage and the Boeing 737 in the hangar while on the supply side, shutting down production is difficult and costly.

Oil is the world's most important commodity and driver of inflation expectations, yet it has fast lost its value. JCB has long warned about the secular disinflationary forces pervading in the economy. It is a salient reminder that an extended period of falling prices is what differentiates a garden variety recession from an impending depression or the lost decades in Japan.

The disequilibrium in the oil market is expected to persist over 2020 and will cause waves throughout the financial system given its high correlation to all asset classes and its importance on Wall St, Main Street and Capitol Hill. The effects should place further pressure on the commodity currencies and high-yield bond market as well as emerging market countries whose fortunes are entwined with crude. It reinforces our belief in a retest of the March equity lows, given the relationship with the S&P500 as shown in the chart below.

The S&P 500 Total Return Index vs the Price of Crude Oil (USD)



The rapid fall in energy prices is also another shot across the bow for bond naysayers clinging on to the inflation argument in their crusade against the allocation to high-grade bonds in a well-constructed portfolio.

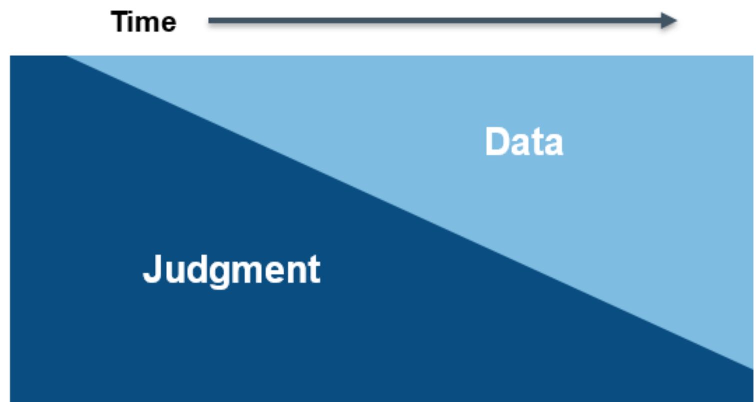
Chris Manuell CMT is a Portfolio Manager at Jamieson Coote Bonds (JCB). This article contains general information only and does not consider the circumstances of any investor. JCB is an investment manager partner of Channel Capital, a sponsor of Firstlinks. For more articles and papers from Channel Capital and partners, click here.

The vital 'rule of thumb' influencing the market

Paul Taylor

Donald Rumsfeld, US Secretary of Defence from 2001-06 during the War on Terror, separated risks into known unknowns and unknown unknowns. He was ridiculed at the time, but we can now see the point he was making. He is suggesting there are regular risks that we can plan and manage for, and there are some risks that are off the charts and difficult to prepare for. Some people also call this second group, 'black swan' events, after the Nassim Taleb book of the same name. The Covid-19 pandemic fits in this second group.

The difficult issue in dealing with black swan events is that you are dealing with little and imperfect data. At the start we have very little data and need to exercise a huge amount of judgement. As time goes by, we get more and more data and analysis and judgement is required less. Andrew Likierman from London Business School (LBS) represented this relationship graphically below:



Source: Andrew Likierman, London Business School

The 'rule of thumb' influencing the market

In periods when data is scarce and huge amounts of judgment are required, people tend to use heuristics, or rules of thumb. These heuristics represent our knowledge of history and what tends to work best in these situations.

A key market heuristic in periods of crisis is to watch the second derivative. The second derivative is simply the rate of change or the acceleration or deceleration of whatever is causing the crisis. I think the market focuses on the point when the second derivative changes from acceleration to flattening or deceleration as it often represents the point of maximum pain and destruction.

In the case of Covid-19, that change in the second derivative may represent a heightened point of community concern and also the point of most aggressive government action. Markets are forward-looking and typically bottom nine months to a year before the economy bottoms. As the second derivative changes and governments increasingly talk about a six-month period, markets can now start to see the light at the end of the tunnel.

The second derivative is now changing in most parts of the world. We are seeing a deceleration of new infections in Australia as well as most of Europe, parts of the US and the majority of Asia. On cue, markets are responding to this change in second derivative and are now starting to improve. This does not mean that market volatility will end but rather we can see the light at the end of the tunnel and some relief is entering markets.

Building bridges in a social experiment

Governments in recent weeks have used analogies of bridge-building and hibernation. They have viewed this crisis as a giant ravine where we need to build a bridge over that ravine, or a sudden frozen snap where we need to go into hibernation to survive to the other side.

I do agree that this crisis is fundamentally one-off in nature and it is all about surviving to the other side. While I believe it is a one-off event and should be viewed as a 1x per event and not a 15x per event, it is important to note that life will be different on the other side of the Covid-19 crisis. There have been major disruptions throughout human history and while things get back on track eventually after that disruption, there can be many business, educational and community practices that change forever after the disruption.

For each major disruption, we effectively go through a huge social experiment. Under this social experiment we try new things, and some work, some don’t. The experiments that work we adopt forever. During WWII, as men went off to war, women entered the workforce to perform their jobs. At the end of the war as life resumed and men returned to their jobs, the workforce and its structure had been changed forever. WWII was the catalyst for women to enter the workforce and this increase in the participation rate has been one of the largest

contributors to GDP growth globally for the past 80 years. A change occurred during this disruption, women never looked back and our economy and community had been changed forever.

There are other examples, like the birth and acceleration of the Indian IT industry post the Y2K bug, which demonstrate that changes that occur during major disruptions can change business, education and community practices forever.

Vijay Govindarajan and Arup Srivastava, writing in the *Harvard Business Review*, have used these historical examples as to why they think higher education will change forever post the Covid-19 crisis.

Focus on changes that survive the crisis

Thinking through these sorts of changes post the Covid-19 crisis is where I am spending most of my time at the moment. These changes may include an acceleration of existing trends like ecommerce, digital delivery of food and beverage, working from home, technology solutions for better communications, smaller office design and deglobalisation. All of these would create winners and losers in markets.

In terms of the Fidelity Australian Equity Fund, I remain very comfortable with the portfolio. The Fund is invested in large, blue-chip companies, which themselves are liquid in nature, and I look to selectively invest in sectors like technology, resources and travel as opportunities arise.

The Fund will remain well positioned through the current Covid-19 crisis. I have 100% of my superannuation allocated to my fund. I believe this is the right approach for alignment and taking the ups and downs with every investor.

Stay safe and invest well!

Paul Taylor is a Portfolio Manager of the Fidelity Australian Equities Fund. Fidelity International is a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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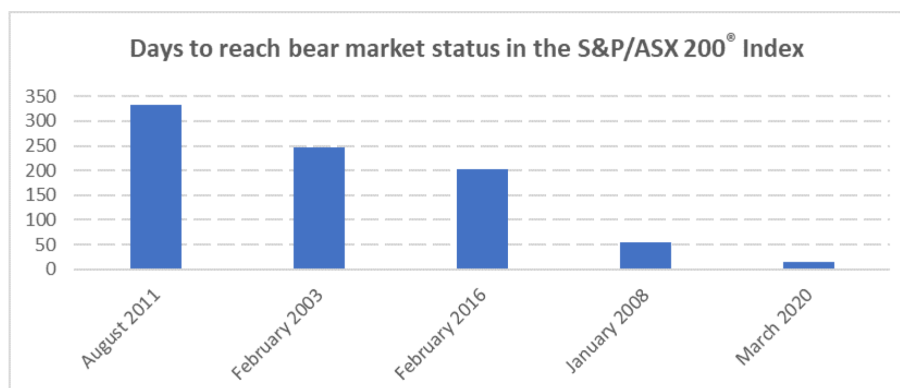
Bear markets are good for portfolio makeovers, not only bargains

Raewyn Williams

Notching up record after record, financial markets are continuing to deliver unpleasant reminders of just how unprecedented the global pandemic crisis is. One recent record is the speed of the S&P/ASX 200 Index's sudden slide to bear market status (defined as a 20% decline in pre-tax value from peak to trough). This slide took a mere 14 days in March, the quickest in the index's history, easily eclipsing the next worst market slide of 55 days which signalled the onset of the GFC.



Source: Bloomberg, Parametric 31 March 2020. For illustrative purposes only. It is not possible to invest directly in an index.

Portfolio management in a crisis

A sophisticated approach to managing equities through this crisis period, as any large super fund will tell you, focuses on two things: **first**, avoid being a forced seller, and **second**, be well-positioned to take advantage of buying opportunities (which have been hard to find in recent years).

Despite fearmongering about the liquidity of large super funds in these extraordinary times, my conversations with super fund clients have been focused on the latter—tactical buying opportunities—not the risk of a debilitating run on funds and becoming a forced seller of equities. This suggests that, at least for these funds, liquidity is being well managed and will not be an issue.

Beyond the bargain-hunting opportunities for super funds (and other investors), there is a bigger opportunity available when bear markets hit—to give the whole equity portfolio itself a structural 'makeover'.

As funds become larger and more sophisticated, they look to migrate their equity holdings from pooled investment funds housed in a legal trust structure (for example, ETFs and unlisted managed funds) across to separately managed accounts (discrete mandates) which give super funds direct ownership of the equities in their portfolios.

Pooled investment funds have their place as they are easy to use, 'off-the-shelf' ways to invest in equities. They shield the investor from much of the complexity and compliance burden of equity investing, which are instead borne by the product provider or pooled fund manager. But trends in the APRA-regulated super fund sector suggest funds are favouring more transparency, tax efficiency and customisation in equity investing.

The package of benefits that can be delivered in a separate account equity investment structure (with the right managers) but not through pooled funds includes:

- specific ethical screens and values-driven investing
- centralised portfolio management (CPM)
- innovative fee structuring
- tactical portfolio 'tilting'
- efficient transition management
- after-tax investing
- better assessment and management of portfolio risks, and
- custom stakeholder reporting.

The window to restructuring a portfolio

Ironically, the strong returns on equities over the past decade (Australian, developed and emerging markets) have created a problem for super funds wanting to restructure their equity holdings—the capital gains tax liability they would incur in redeeming their investments from a pooled equity fund to seed a new separate account.

This kind of restructure can be done tax-free under US law, but not under Australian law, so beware literature from the US, which misleads Australian investors on this issue.

Consider a super fund wanting to transfer its $500 million equity portfolio from equity unit trust holdings into a separate account. The units have appreciated 25% since their acquisition, and 90% of the units are long-term holdings, with the remainder acquired in the past year. In isolation (and without tax-managing the transition), the fund faces a $10.5 million tax bill to restructure, or over 2% of portfolio value. While the restructure would deliver many benefits, the up-front tax bill is hard to swallow and a reason to delay the move and persist with what the fund believes is a sub-optimal structure.

Which brings us to the bear market conditions suddenly upon us. For super funds and others encumbered with 'legacy' investment structures and their embedded tax, now is an important window of opportunity for much more than just bargain-hunting—to re-cut the numbers to see just *how much lower* the tax cost of a move to their desired 'future state' for equity investing would be.

It is far more likely right now that the tax cost of a 'portfolio makeover' to move equities to a separate account structure would be immaterial or easily outweighed by the benefits. In our example above, the fund might even find that the current market value of its units in the equity trust has dipped below the original $400 million

acquisition cost, which would actually deliver a windfall tax benefit if the fund seized the opportunity to restructure now.

While this 'portfolio makeover' opportunity represents a rare piece of good news for those navigating current market conditions, the cautionary lesson for super funds given the ASX bear market's sudden, dramatic arrival is this: that predicting the market turnaround and speed and shape of the recovery (V-shape; U-shape; Nike 'swoosh'?) will be fraught with difficulty.

The opportunity to not just find equity bargains, but migrate to a best-of-breed equity investment structure, is one to seize now, in case it vanishes just as fast.

Raewyn Williams is Managing Director of Research at Parametric Australia, a US-based investment adviser. This material is for general information only and does not consider the circumstances of any investor. Additional information is available at parametricportfolio.com.au.

Are we again crying wolf on inflation risk in pandemic response?

Chris Brightman

Now is too soon to worry about inflation from a public policy perspective given the immediate humanitarian need for disaster relief. Many millions of newly unemployed people need cash now to pay bills and just to buy food for themselves and their families. Hesitating to provide help now because of worries about inflation later would be beyond the pale.

Now is too soon, also, to expect to see a rising Consumer Price Index (CPI). Rising unemployment and precautionary savings are currently exerting downward pressure on inflation. Longer term, however, exploding deficits, soaring debt levels, and money printing raises the risk of a toxic bout of inflation. Investors should consider the opportunity provided by declining inflation expectations to diversify into newly cheap inflation-hedging assets.

Falling employment is deflationary

A shocking number of people are losing their jobs. Approximately 17 million people across the United States filed for unemployment insurance during the three weeks ended 4 April 2020, representing almost 11% of the 150 million people working in the US in March (FRED, 2020). Add expected new claims for the week of April 11, and the unemployment rate is likely near 15% and climbing fast. Layoffs and furloughs will continue in coming weeks.

In Australia, the Treasurer Josh Frydenberg has conceded that unemployment will rise to 10% in the three months to June 2020, up from 5.1% in February. The sight of long queues of newly unemployed people at Centrelink offices was a major factor in the massive size of Australia's stimulus package.

When people lose their jobs, they must immediately cut back discretionary spending. More important, those who keep their jobs reduce spending to increase precautionary savings. This sudden decline in spending reduces aggregate demand more than aggregate supply and thereby puts downward pressure on the prices of goods and services.

Exploding deficits

We must act. Fiscal stimulus is a necessary humanitarian effort to keep our economy functioning through this COVID crisis. By propping up aggregate demand, we aim to prevent a larger than necessary decline in economic output. Failing to do so would risk a depression and profound human suffering.

When tax receipts tumble and government spending soars, deficits explode. Consider tax collections. Income and employment tax receipts are falling alongside declining employment. Sales tax receipts are falling in line with lower spending. Capital gains tax receipts are falling because stock prices have dropped.

How much new debt will be created in the US? Goldman Sachs estimates that the combination of already enacted fiscal stimulus along with additionally required disaster relief legislation will raise America's deficit to $3.6 trillion this year and $2.4 trillion next year for a total of $6.0 trillion over just these two years (Rosenberg,

2020). Given that the United States was already on track for $1 trillion annual deficit before the COVID crash, that's a tripling of its deficits.

Who will buy all of this new debt? The Fed will.

Printing money is inflationary

The Treasury is now wiring newly created money directly into people's bank accounts. Even if 'helicopter drops' of cash and the Fed's buying of $5 trillion worth of newly issued bonds could maintain the nominal value of output and consumption, it cannot prevent the real value of consumption from declining.

Surely, you might think, we should be able to consume more than we produce during this unprecedented crisis. But how can we do so in aggregate? We are not an agrarian economy; eating our seed corn and pepper rations won't substitute for today's lost production. Nor will we be able to replace the lost output of goods and services by consuming imports from the rest of the world. All other countries' output is falling too.

Real consumption must decline in line with the real value of output lost due to the cessation of productive activity. If today's money printing does succeed in maintaining the *nominal* value of consumption spending, many more dollars will be chasing a smaller amount of goods and services. The result will be inflation.

Crying wolf

The boy who cried wolf is one of Aesop's more famous fables. The moral of that story is those who repeatedly make false warnings will be disbelieved when their warnings are finally true. Are we crying wolf about an imaginary risk of inflation?

I don't think so. I explained in 2015 why quantitative easing (QE) was not then causing inflation and needn't cause inflation in the future. Quantitative easing creates bank reserves, which do not necessarily increase the money supply. Further, by paying interest on bank reserves, a central bank can effectively discourage banks from using those reserves to create money. I also said:

"Money printing is different from QE. Money printing is inflationary by definition. If the central bank rapidly prints a lot more currency and immediately puts it into circulation, then more money is chasing the same amount of goods and services."

To be clear, our worry isn't about monetary policy conducted by the Fed. We worry about fiscal policy conducted by congress. We worry that future congresses may become addicted to imprudent deficit spending. With the economy at full employment, $1 trillion deficits didn't cause inflation in 2019. If $4 trillion deficits don't cause inflation in 2020 and 2021, will congress choose to raise taxes and/or reduce spending in 2022? After the economy recovers to full employment, some level of government spending in excess of tax collections will be inflationary. Inflation is ultimately a political choice.

Is this time different?

On the one hand, lessons learned from austerity in Europe following the GFC warn against failing to provide necessary emergency fiscal stimulus (Fatás, 2018). On the other hand, history also teaches us that if government sends large quantities of cash directly to people for too long, financial crisis and inflation result (Reinhart and Rogoff, 2011).

Will policy nimbly pivot to prevent inflation? The Fed can't do it alone. Some combination of tax increases and spending cuts following the coming recovery will become necessary to prevent a spike of inflation. Will congress understand precisely when to execute this fiscal U-turn? Will our politicians display the required foresight and courage? I worry.

A future bout of high and volatile inflation may prove to be a toxic side effect of today's experimental economic medicine. As we approach the coming recovery, investors should be on the lookout for cheaply priced inflation hedges. REITs, small-cap stocks, and commodities have become interesting, and emerging market value stocks look cheap.

Chris Brightman is Chief Investment Officer at Research Affiliates. Their long-term forecasts for over 100+ assets across global markets are available on the Asset Allocation Interactive (AAI) tool on the Research Affiliates homepage.

Take a total return focus during COVID-19

Aidan Geysen

The recent bear market for Australian shares, triggered by the coronavirus pandemic, is the first since Australia emerged from the GFC a decade ago. The uncertainty created was compounded by the swift nature of the sell-down, reaching 'bear' territory (defined as a 20% fall in share prices) in less than one month. The GFC took nine months to reach the same unwelcome milestone.

The Australian Prudential Regulation Authority (APRA) announcement—asking banks to defer decisions on dividend payments and suggesting that payouts be at 'materially' reduced levels—has further compounded investor uncertainty. However, it need not be the case.

Need to modify income-oriented focus

The banks are likely to experience materially lower appetite for consumers to borrow and rising bad and doubtful debts in both the residential and commercial sectors. A reduction in bank dividend payments could shore up their capital position and strengthen their ability to weather the economic impact of this pandemic. Such an action may even be in the long-term interests of not just the financial system, but shareholders as well. A company's financial health is critical to future share price performance.

However, the prevalence of 'income-oriented' investing to support the spending needs of retirees means a dividend reduction will leave many in limbo about what to do with their portfolios.

An income-oriented approach involves constructing portfolios of investments that have high income returns that either meet or exceed one's spending needs. These include shares that pay healthy dividends, especially with franking credits attached, and high-interest bond and cash products.

Targeting income can also have intuitive appeal because it suggests that, by only spending the income generated, the underlying assets are not touched. In theory, the strategy should last forever, or at least outlast a retirement.

Yet, a high-income return is not the only, or even the most effective, strategy to follow. The changes to dividend imputation rules proposed by the Australian Labor Party in 2018 highlighted a potential risk in a concentrated, high-income portfolio. The current market conditions underscores another.

Using capital when necessary

Keeping these risks in mind, an investor might ask: How do I choose a retirement income strategy that will support my lifestyle but not create an over-reliance on income such as dividends?

The answer lies in looking at all sources of return from a portfolio, both income and capital, commonly termed a 'total-return' approach.

So what exactly is a total-return approach?

Rather than tying a spending goal only to the income generated on a portfolio, a total-return approach first assesses an individual's or household's goals and risk tolerance. It then sets the asset allocation at a level that can sustainably support the spending required to meet those goals.

Where an income-oriented strategy utilises returns as income and preserves capital, the total-return approach encourages the use of capital when necessary.

During periods where the income yield of a portfolio falls below an investor's spending needs, the capital value of the portfolio can be spent to make up the shortfall. As long as the total return drawn from the portfolio doesn't exceed the sustainable spending rate over the long term, this approach can smooth out spending during the volatile periods for markets. Of course, it may also require the discipline to reinvest a portion of the income during periods where the income generated by the portfolio is higher than the sustainable spending rate.

While capital returns—best represented by the price movement of shares—can be a volatile component of this strategy, taking a long-term view is paramount.

This approach allows investors to separate the spending strategy that best suits their goals in retirement from their portfolio strategy and smooth spending throughout retirement. It allows investors to better diversify risk

across countries, sectors and securities rather than skewing the portfolio to a segment of the market with higher-income yields, or worse, taking excessive risk by reaching for the desired yield.

The riskier approach is often a far less reliable response to achieving retirement goals compared to other levers such as saving more or adjusting discretionary spending.

In retirement, the investment horizon can still be long term

By taking a long-term view, investors can also ride out periods like the current crisis with more confidence. Even in retirement, an investor’s time horizon can still be several decades. History has shown this has been sufficient time for the equity risk premium to win through. While dividend yields may reduce, market falls may increase the long-term return prospects for capital values. And this is the crucial reason why APRA’s advice to banks need not be the cause of more uncertainty during an already-challenging time, even for income-oriented investors.

Finally, as this can be an uncomfortable position for many, a further action to improve long-term portfolio prospects is to be aware of the inherent uncertainty in trying to time markets, and the potential improvement in returns that comes from a market sell-off.

In combination, these factors support the merits of rebalancing portfolios during periods of volatility, to ensure they remain well positioned for the eventual turn in the fortunes of the market.

Aidan Geysen is the Senior Investment Strategist at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any individual.

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Is it fair that the wealthier get the most super benefits?

David Knox

Introduction. A Firstlinks reader, Derek O’Hare, asks whether superannuation unfairly advantages wealthier people, and he suggests an alternative taxation structure. We asked David Knox of Mercer to respond.

Hi Firstlinks

I’ve been following your content for a couple years now and have found it informative and helpful in many ways. I wondered if I could suggest a further avenue for discussion?

I’ve read articles elsewhere that point out the inequitable distribution of the tax advantages of super. The vast majority of taxation benefit goes to those with the highest incomes and those least likely to ever need the age pension in the first place. Some articles suggest that instead of 15% flat tax rate on super contributions and earnings, a 15% discount off the individual's marginal rate would be a more sensible option and more in line with the idea of propping up retirement incomes and reducing age pension reliance from the less wealthy. They argue that the tax breaks given to those people who don’t need them is better off (and will far outweigh) spent on the age pension down the line.

I find their arguments to be compelling and apparently sound. I think I would find it helpful if Firstlinks – which has no particular bias as far as I can tell – could provide some opinion and discussion on these matters.

Kind regards,
Derek O’Hare

Hi Derek

Good question. Let’s go back a step or two.

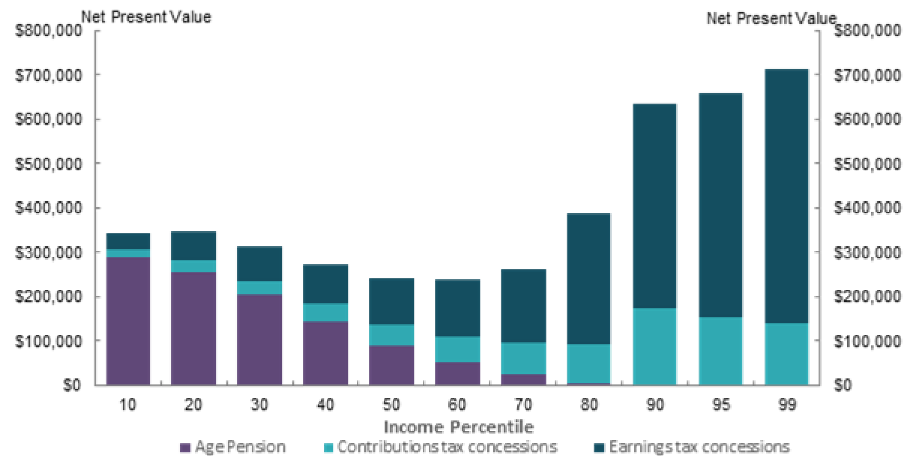
The Government supports the provision of retirement income over an individual’s lifetime in two ways:

- The means tested age pension
- Taxation concessions to superannuation

Not surprisingly, lower income earners receive more age pension and higher income earners receive more superannuation. This is confirmed in the following graph from the consultation paper issued by the Retirement Income Review.

However this graph is misleading as the present values of future payments and support are calculated at a high 5% pa.

In our submission to the Review we made the following comments.



Although this rate (5%) represents a reasonable estimate of the average increase of nominal GDP in recent years and hence the likely growth in future tax receipts, it is not a measure that reflects inflation, wage growth or even the government's borrowing rate. All these rates are much lower and better understood by the community and are often used to calculate net present values. The use of a lower discount rate would increase the relative value of future age pension payments due to the fact that they are assumed to be paid in 40-65 years' time and so change the shape of the graph.

It is also worth noting that the graph is in respect of individuals and therefore could be considered from a per capita perspective. Hence the nominal GDP increase may not be appropriate. In short, it must be recognised that the selection of the discount rate, in particular, is critical as it inevitably influences the outcome.

If one allows for a lower discount rate, the value of the age pension increases, thereby benefitting lower income earners. In fact, it becomes a U-shape.

I would also note that the value of the earnings tax concessions for higher income earners shown in the graph assumes that if these individuals did not have their money in super, they would be paying the top marginal tax rate on their investment income. This is clearly not the case, as there are many opportunities for them to reduce the tax on investment eg negative gearing, low income partners, trusts etc.

In fact, when you consider the full picture of retirement income and allow for realistic assumptions, the level of Government support over a lifetime is remarkably level across different incomes.

I might add that when you consider the 30% tax rate on contributions for high income earners and 15% tax for average income earners, together with the LISTO, we are not far away from a 15% rebate on super contributions for everyone.

Hope that helps and happy to discuss.

Dr David Knox is a Senior Partner at Mercer. See www.mercer.com.au. This article is general information and not investment advice.

Magellan versus Platinum: which offers a less bumpy ride?

Adam Fleck

Following the COVID-19 outbreak, equity markets are likely to remain volatile over the near term unless there are clear signs that the virus is successfully contained on a global scale and economic stimuluses are effective in limiting the severity of a global downturn.

Morningstar's assessment of two leading Aussie global managers

Revenue will be under pressure for asset managers **Magellan Financial Group** (ASX:MFG) and **Platinum Asset Management** (ASX:PTM), which derive fee revenue from managing global equity portfolios. This includes base management fees that should reduce on the lower value of assets under management and performance fees that are likely to fall sharply.

Our 'narrow moat', 'medium fair value' uncertainty, and 'Standard stewardship' ratings are unchanged as we transition coverage of both Magellan and Platinum to a new analyst.

Factoring in volatile markets and an economic downturn, we have lowered our near-term funds under management, or FUM, and earnings forecasts for both firms. However, we've increased our outer-year projections on returns and inflows, corresponding with an expected recovery in equity markets and renewed confidence in established active managers like Magellan and Platinum, which should remain resilient in the aftermath of the pandemic.

Following our earnings revisions, our fair value estimate for Magellan remains at $52.00 per share, while our valuation for Platinum is reduced to $3.60 per share from $4.35 previously.

Magellan's unmatched inflows in recent years

In our view, Magellan's solid track record should allow it to attract and retain FUM through the bear market, while it's well placed to recover with equity markets. Conversely, Platinum is likely to see further net outflows from a combination of its historical underperformance and potential risk-aversion toward emerging market stocks (to which it has a sizable exposure).

Both firms possess the necessary brand strength, investment strategy, and distribution reach to navigate through the current downturn and to continue to attract inflows longer term.

However, we think Magellan has a competitive edge over Platinum and should recover faster, in particular given Magellan's strong track record of outperformance. Together with its strong distribution reach and active client engagements, we expect it to be successful in generating inflows over time. Platinum is likely to suffer near-term outflows due to its prolonged underperformance, but inflows should resume over the longer term as investors see the merits of its absolute-return focused strategy and downside protection capabilities, which should outperform amid current volatile markets.

We forecast Magellan to grow earnings per share, or EPS, at about 11.5% per year through to fiscal 2024, and a slower 2.5% per year over the same period for Platinum. Volatile equity markets should weigh on near-term market returns, and we forecast low-single-digit returns for Magellan and a slight loss for Platinum's for fiscal 2020. However, markets should recover over time and support higher investment returns in future. Accordingly, we see market returns growing at about 11% per year for Magellan and 8% per year for Platinum, from fiscal 2021 to fiscal 2024. We expect Magellan to continue attracting net inflows despite near-term volatility, while Platinum should experience further net outflows through to fiscal 2021, before seeing net inflows thereafter. We also forecast management fee margins for both to further compress by about 2 basis points by fiscal 2024.

Accordingly, we project Magellan to grow average FUM at a rate of 14% per year (from fiscal 2019) to about $147 billion by fiscal 2024, while Platinum should grow FUM at a more modest rate of around 2.5% per year to about $28 billion over the same period. In deriving our view, we have compared both firms based on their respective performances, investment styles, and distribution reach.

Magellan's superior history of outperformance stands out. Its core Global Equities and Infrastructure strategies have materially outperformed their benchmarks since inception as well as over a 1-, 3-, 5-, 7-, and 10-year time frame. As a result, Magellan's record of inflows is unmatched in the Australian market. In the five-and-a-half years to 30 December 2019, FUM grew at nearly 30% compound a year to more than quadruple. There have only been three months with a net client outflows.

On the flip side, Platinum's earnings have been hamstrung by the prolonged underperformance of its core International and Asian strategies. As a result, both FUM ($24.8 billion) and management fees ($295.2 million) in fiscal 2019 remain below their fiscal 2015 levels ($26.9 billion and $338.6 million, respectively).

Two leading names with different investment techniques

The disparity in both firms' track records can be explained by their varying investment approaches. Magellan has a sizable exposure to developed markets with a tilt toward large caps, while also exposed to growth-orientated technology stocks such as Facebook, Alphabet, and Alibaba. Magellan's performance has been strengthened by exposure to high-quality growth thematics. We also think large, developed-market stocks are better placed to recover from the current downturn, relative to small-cap or emerging market securities. Accordingly, while we have lowered our market return forecasts to around 3.5% (from 12.5% previously) for fiscal 2020, our return forecasts for the subsequent four years to fiscal 2024 are increased to around 11% per

year (previously 8%). We do not expect Magellan to experience any net outflows throughout our forecast period, but inflows should grow slower than historically at about 5% per year over the next five years given its larger starting size.

On the flip side, Platinum's benchmark-agnostic approach has led to a much higher exposure to developing markets, relative to the MSCI World Index. Both low interest rates and trade tensions were unsupportive of its investment style. However, we believe its focus on absolute returns and strong downside protection capabilities should allow it to perform well amid current volatile markets. We've revised our market return forecasts to average 6.5% per year over the next five years, from 9.5% previously. We project net outflows of about 11% per year through to fiscal 2021 but expect net inflows of about 8% annually from fiscal 2022 onward, as investors gradually gain confidence in Platinum's distinct approach.

Compared with Platinum, we think that Magellan possesses a stronger distribution reach and greater client engagement, which helps with driving growth and building a stickier FUM base. While domiciled in Australia, it derives the majority of its FUM from a diverse range of internationally based institutional clients. Magellan's client-centric image has also assisted with generating new FUM, as evidenced by the successful raising of an additional $862 million (around 3% of its total retail FUM) for the newly listed Magellan High Conviction Trust.

Conversely, Platinum continues to source FUM mainly from domestic retail investors. It has, however, recently made moves to promote its products to U.S. and Canadian institutional investors. Given the small proportion of institutional money at present, we do not forecast foreign or institutional investors to account for a large percentage of total FUM throughout our forecast period.

There is much uncertainty over the immediate future, but the longer-term dynamics are favourable for both firms. Volatility is likely to remain elevated in the near term as it's difficult to deduce the exact repercussions from the pandemic; with poor business conditions and increasing unemployment being counteracted by tranches of fiscal stimulus and monetary easing designed to prevent a financial crisis. But recent market declines should mean future investment returns improve.

We look to news of (1) a globally scalable vaccine and (2) a successful containment of the virus to improve investor confidence and underpin an improvement in equity markets. Interest rates are likely to remain lower for longer, helping to buoy stock valuations and cushion the impact from the economic and consumer downturn. Australia's ageing demographics, the traditional underweight of Australian investors to international stocks, and the growing superannuation system should also expand demand for global equities products offered by both Magellan and Platinum.

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