# Firstlinks
a Morningstar company

## Edition 356, 8 May 2020

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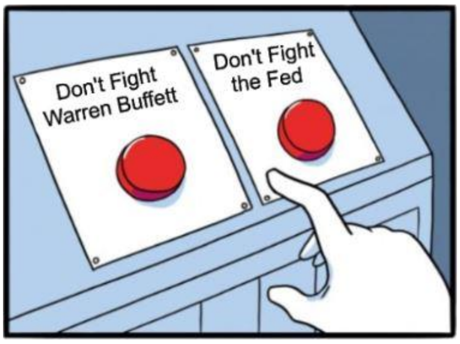



Few investors are as influential as **Warren Buffett**, although for the moment, the stock market is ignoring his caution. The annual meeting of **Berkshire Hathaway** was held last weekend in a virtual format without his offsider, **Charlie Munger**, and it contained the usual insights. Most significant, Buffett did not use the heavy market falls in February to buy shares. In fact, rather than 'buy when others are fearful', he was a net seller of US$6 billion for the quarter, including disposing of all his airline shares. Berkshire is sitting on US$137 billion in cash, suggesting he expects better buying opportunities to come. For the moment, though, the pump-priming by the US Fed seems to be winning.

Although Berkshire lost US$50 billion in the March quarter based on revaluations, Buffett was sanguine and spent a great deal of time describing the historical context of previous crises. He said:

*"I would like to take you through a little history. If you were to pick one time to be born and one place to be born, and you didn't know what your sex was going to be, you didn't know what your intelligence would be, you didn't know what your special talents or special deficiencies would be. That if you could do that one time, you would not pick 1720, you would not pick 1820, you would not pick 1920. You'd pick today, and you would pick America ...*

*I'm not saying that this is the right time to buy stocks if you mean by 'right' that they're going to go up instead of down. I don't know where they're going to go in the next day, or week, or month, or year. But I hope I know enough to know, well, I think I can buy a cross section and do fine over 20 or 30 years. And you may think that's kind of, for a guy, 89, that that's kind of an optimistic viewpoint. But I hope that really everybody would buy stocks with the idea that they're buying partnerships in businesses and they wouldn't look at them as chips to move around, up or down."*

Perhaps one reason he is not buying is the level of the 'Buffett Indicator', the ratio of the market value of all listed equities to US GDP. He said back in 2001 that *"it is probably the best single measure of where valuations stand at any given moment."*

Using the broad-based index of the Wilshire 5000 shows the market is at its highest level since 1970, and that's before GDP falls as expected in the June quarter. Buffett's view is that investors cannot gain wealth at a rate that exceeds the growth in US business. He said in 2001:

*"For me, the message of that chart is this: If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you."*

**Buffett Indicator Variant, Wilshire 5000 to GDP as at May 2020**


*Source: Advisor Perspectives*

Morningstar's Berkshire Hathaway specialist, **Greggory Warren**, summarises his major takeaways from the meeting, as well as presenting a short video.

Moving to retirement planning, when aiming for a desired level of spending in the future, a rate must be assumed for earnings on investments. Many super funds default to 7.5%, despite bonds currently offering only 0.25% and equities being fully valued. We delve into models of **Robert Shiller, London Business School, Research Affiliates and Schroders** to estimate a sustainable future performance assumption.

Complementing this**, Stephen Miller** takes a look at the perils of forecasting in the current market, but despite the unknowns, he sees more risks to the downside.

Still on long-term planning, **Wade Matterson** provides updated data on the spending of older retirees, who might not need as much money as they expect. One financial adviser says much of his job involves convincing retirees to spend more.

Over the years, we have received many questions on how Net Tangible Assets for Listed Investment Companies (LICs) are calculated. It seems such a simple concept, but as **Scott Whiddett** and colleagues show, there is a lot of discretion you should know about.

**Nathan Zaia** checks the value in Australian banks after their heavy price falls and dividend suspensions, to see whether they should continue to play a role in so many portfolios.

As Australia starts to relax coronavirus-inspired restrictions, **Michael Collins** says policymakers are faced with major ethical issues. Then **Tony Dillon** questions whether borrowers reducing repayments really realise how much more a loan will cost them, and some of the bank benevolence is not what it seems.

Finally, on his 68th birthday, **Kevin Kelly,** Co-Founder of Wired magazine has posted 68 little gems of wisdom with something for everyone.

This week's White Paper from **Perpetual Investments** explains how 'real return' funds work, and whether they have a place in the new investing environment.

## The vibe of future returns: tell 'em they're dreamin'

Graham Hand

In the iconic Australian film, *The Castle*, during the classic court scene, the family lawyer, Dennis Denuto, is struggling to make his case, bumbling around with a copy of the Australian Constitution. Finally, he sums up in a scene that has both entered Australian folklore and become required viewing for law students:

*"It's the vibe of it ... It's the Constitution. It's Mabo. It's justice. It's law. It's the vibe and … ah, no, that's it. It's the vibe. I rest my case."*

His case had little relevance to the Constitution. It was simply the vibe of the thing.

There's a similarity now with the assumptions used in calculating future superannuation balances. There's a general vibe drawn from prior performance that is now more like wishful thinking. Let's consider what a realistic long-term return on superannuation should be, and not just a vibe from the past.

**Why bother making forecasts?**

Retirement planning should start decades before the end of full-time work, to gain an understanding of how much should be saved to achieve a desired living standard. An assumption about nominal and real rates of return will show how much the market will provide in addition to capital invested.

In a wonderful world of returns well in excess of inflation rates, driven by compounding over long periods, bond and equity markets will deliver the financial resources for a comfortable retirement far quicker than if returns struggle to beat inflation.

This article will focus more on the next 10-year horizon than the truly long term, where it may be possible to generate the strong market performance of the past. But that belongs in the category of a 'nice problem to have' given the impact of climate change, technology replacing jobs and a rapidly-ageing workforce over a longer-time period.

Superannuation balance calculators usually assume a nominal rate, then discount the future amount by an inflation factor, currently about 2.5%. In this discussion, 7.5% nominal and 5% real are approximately the same.

**'Two cents' worth' on super projections**

The most popular website for starting to understand investing, including superannuation, for many Australians is Moneysmart, administered by the Australian Securities and Investments Commission (ASIC). It is an excellent resource for all aspects of money management, especially for beginners.

It includes a superannuation calculator designed to determine how much super a member will have when they retire. The inputs include age, income, desired retirement age, super balance, employer contributions, personal contributions and fund fees.

The default investment return is set at **7.5%** (before taxes, fees and inflation), updated as at 17 April 2020. It uses Treasury's long-term retirement income models based on 2019 modelling assumptions from this paper. Curiously, as if they realise the number is a stab in the dark, the link is called 'Treasury's Two Cents'.

Similarly, every major superannuation fund provides its members with some type of online calculator, such as AustralianSuper, Australia's largest super fund, updated in April 2020 based on the following assumptions:

**Investment returns**

Assumed investment returns are used in the calculator, which can be varied. Investment returns are shown after investment fees and taxes. The Cash, Low, Moderate and High options represent investment strategies with different assumed return profiles.

| | Accumulation return (pa) | Retirement return (pa) |
|---|---|---|
| Cash | 2.125% | 2.50% |
| Low | 4.50% | 4.00% |
| Moderate | 6.50% | 6.00% |
| High | 7.00% | 6.50% |

Over 90% of AustralianSuper's members choose the 'Balanced' option, with an objective of CPI plus 4% and an investment timeframe of 10 years. This is currently positioned towards 'high' in the table above, so let's call the return assumption 7%. The option's permitted asset allocation is wide, allowing a defensive stance of up to 45% in cash and fixed interest or an all-out aggressive stance of 90% to 100% in equities. At the moment, cash and fixed interest is only 15%.

With Moneysmart at 7.5% and a leading industry fund at around 7% for their default option, the question must be asked: **Are they dreaming?**

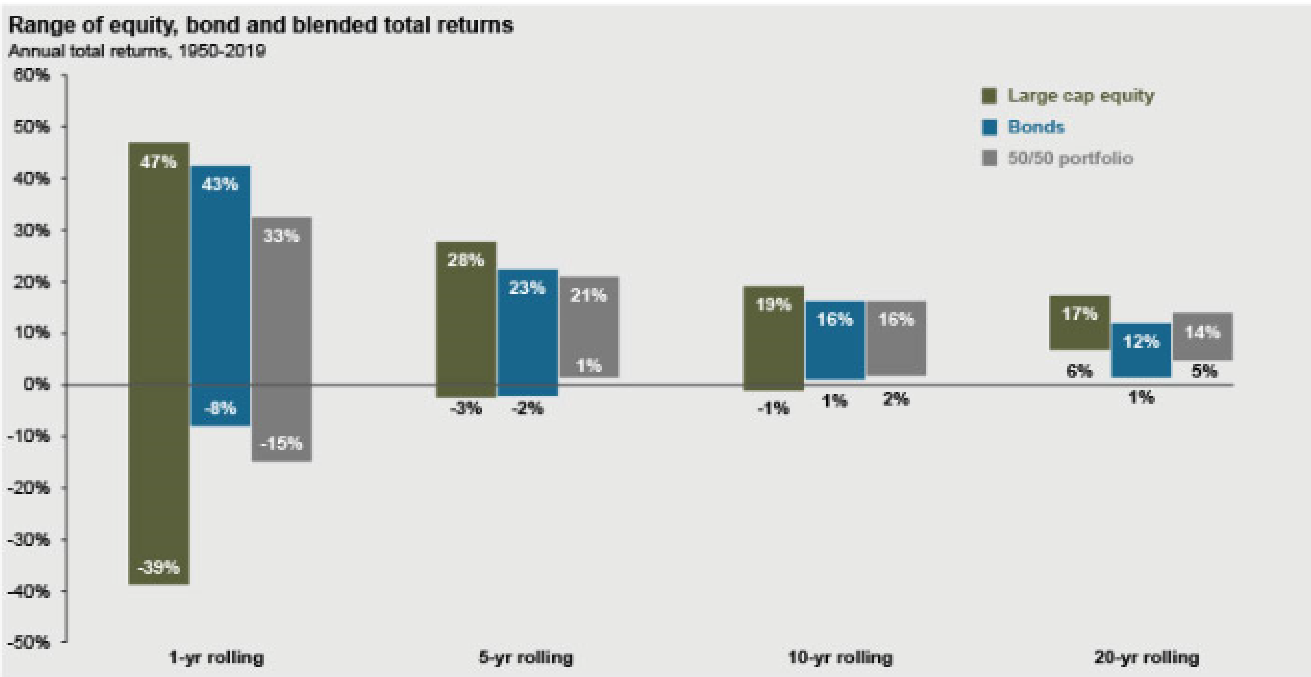
**Sorry, Millennials and Gen-Z, these returns are in the past**

The most obvious factor reducing future returns is the fall in interest rates. Global and Australian markets are at the tail end of a 30-year bull market in bond rates, and in fact, rates peaked at 16.4% for 10-year Australian Treasury rates in 1982. This has not only delivered handsome coupons but strong capital gains on the so-called defensive part of the asset allocation. It has made fixed income and to a lesser extent, cash, an attractive part of the asset allocation.

However, the starting point for future returns is a cash rate and bond rate of 0.25%. The Reserve Bank has signalled ultra-low bond rates for many years to come, driven by the imperative to recover in a post-coronavirus world.

The extraordinary result is that between 1950 and 2019, the 20-year rolling returns (in nominal terms, not adjusted for inflation) for the S&P500 averages 17% per annum, while bonds delivered 12% and a 50/50 blend a wonderful 14% (Australian market returns would be marginally less).

That's a retirement tailwind that should go straight to the pool room.




Source: Barclays, FactSet, Robert Shiller, Strategas/Ibbotson, U.S. Federal Reserve, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2018. Large cap equity represents the S&P 500 Shiller Composite and bonds represents the Strategas/Ibbotson for periods from 1950 to 1980 and the Barclays Aggregate after index inception in 1980. Past performance is not a reliable indicator of current and future results.
*Guide to the Markets – Australia*. Data as of 31 March 2020.

J.P.Morgan Asset Management

In the context of these returns, the assumption of earning 7% looks fine. But these were glorious investment conditions enjoyed by Pre-Boomers, Baby Boomers, and to some extent, Generation-X. Unfortunately Gen-Y (the Millennials) and Gen-Z are unlikely to have it so good.

**All that matters now is the future**

Anyone investing now cannot live on past returns. While there are as many forecasts in the world as there are economists, let's draw on four forecasts to glimpse into the future.

### 1. Elroy Dimson and his London Business School colleagues

The Global Investment Returns Yearbook has been published since 2000 and has become a global authority on long-run asset returns. It provides a 120-year review of the risk and performance of the main asset categories in 23 countries in North America, Asia-Pacific, Europe and Africa. It includes a forecast of future returns as an econometric derivation of the data.

Its current edition quotes the lead author, Professor Elroy Dimson (for my 2014 interview with Elroy, see here) forecasting lower future returns because:

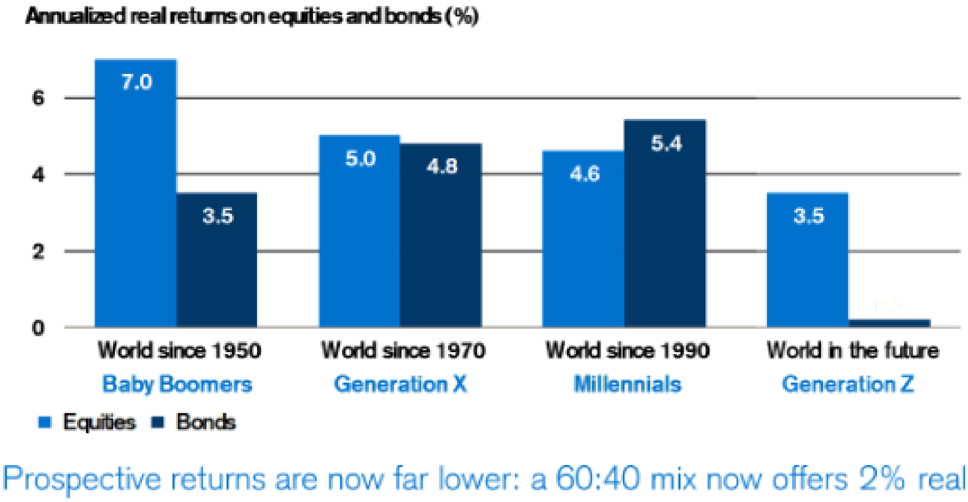
*"It's real interest rates that provide the baseline for all risky assets, and when real interest rates are low, so are expected returns."*

In real terms (adjusted for inflation) interest rates today are effectively negative, other than when credit risk is taken. Professor Dimson, together with his colleagues Professor Marsh and Dr Staunton, expect prospective real returns from equities to be somewhere in the region of 3.5%. However, in a typical 60/40 balanced portfolio used for the default option in most Australian super funds, 40% of the portfolio in fixed interest will probably contribute little.

***This means the future balanced portfolio may deliver a real return of only about 2% a year.***

Dimson argues that in this low-return environment, it is even more important for investors to reduce the amount they pay in fees. The Yearbook provides the following chart to show how the generations have fared. Returns have fallen over time, but the future is the worst.

**Global Investment Returns Yearbook, 2020 edition, likely future returns**




*Reproduced with permission from The Global Investment Returns Yearbook, written by Elroy Dimson, Paul Marsh and Mike Staunton. Copyright © 2020. See acknowledgement at the end.*

### 2. Robert Shiller's implied future market returns

Nobel Laureate, Professor Robert Shiller of Yale University, invented the Shiller Price/Earnings (P/E) Ratio and it has become a standard to measure the market's valuation. This is not the place for a full study of it, but further details are available here and his data base is here.

The Shiller P/E 10 in the table below eliminates some of the fluctuations caused by business cycles (10 refers to the average of 10 years of earnings).

As at 4 May 2020, the current Shiller P/E of 27 was 57% higher (the red line above) than the historical mean of 17 (the black line above). An estimate of the future stock market return then comes from three factors:

1. Contraction or expansion of the Shiller P/E to the historical mean
2. Dividends
3. Business growth

**Based on the current Shiller P/E level, using this method to calculate the future stock market return, gives around 0.2% (real) a year.** (For source and more information see Gurufocus).

The 0.2% is derived from reverting to the mean, and it will take a 'really lucky' result of 150% of the mean to deliver a nominal 5% from today's levels, as shown below. 'Really unlucky' does not bear thinking about.

| Scenario | Shiller P/E after 8 Years | Annual Return from Today (%) |
|---|---|---|
| Really Lucky | Mean x 150% | 5.2% |
| Lucky | Mean x 125% | 2.9% |
| Reverse to the Mean | Mean x 100% | 0.2% |
| Unlucky | Mean x 75% | -3.1% |
| Really Unlucky | Mean x 50% | -7.6% |

The market is expensive and this will reduce future returns. However, Shiller places it in the context of the alternative of the extremely low rates on bonds. He wrote in *The New York Times* on 2 April 2020:

*"On balance, I'd emphasize that the stock market is not as expensive as it was just a month ago. Based on history, we would expect to see it to be a reasonable long-term investment, attractive at a time when interest rates are low."*

**3. Research Affiliates' interactive forecasts**

The work of Research Affiliates and its expected return models is notable for its interactive website, allowing investors to check forecasts across a wide range of asset classes, as well as standard deviations and the probabilities of forecast accuracy.

Here is a sample of its 10-year expected returns, plotted against expected volatility. While there are some assets above the 5% real return line, they are mainly in Emerging Markets (EM) where Australians rarely invest. Most traditional markets offer small real returns.

**Research Affiliates' Selected Returns for 10 years, as at 31 March 2020**

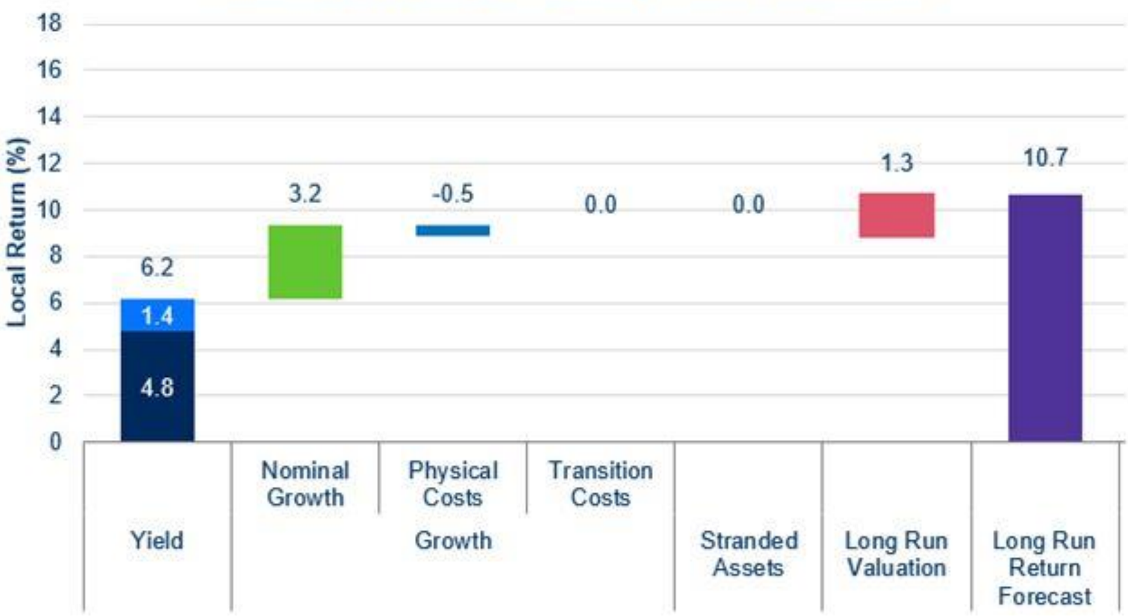
| Asset class | Real Return Forecast | Probability of a 5% Real Return |
|---|---|---|
| 60/40, 60% US large caps, 40% US bonds | 0.7% | <1% |
| US long bonds | -4.7% | <1% |
| Global multi asset based on market value | 2.2% | 2% |
| US large cap (S&P500) | 1.5% | 6% |
| US small cap (Russell2000) | 2.4% | 19% |
| US listed property (US REITs) | 1.4% | 15% |

These real returns offer little prospect of achieving the 4% to 5% assumed in superannuation calculations.

**4. Schroders Australia**

Differences of opinion make a market, and for every buyer, there's a seller. So we reached out to Schroders Australia for a local perspective, and they are more optimistic.

For Australian equities over the next 10 years, updated as at end of April 2020, the forecast is 10.2% (nominal), made up as follows:




In other asset classes, forecasts are 4% for US equities, 6% for global equities, 7.5% for A-REITs and 1% for Australian Government Bonds. This means an allocation of 60/40 (say 30% global equities, 30% local equities and 40% bonds) is forecast to deliver about 5.25% nominal, or 2.75% real.

**What should a superannuation member do?**

The first step when using a calculator to plan for a future retirement is to be realistic. For all the expert opinions, personal judgement is the final arbiter. For extra security in retirement, instead of expecting 5% above inflation (or a vibe of 7% to 7.5% nominal), aim for **closer to 2% to 2.5%**.

Planning should not be based on a short-term buying opportunity in the pandemic, but taking a longer-term view across many investment cycles. Shares are down only about 15% and back to early 2019 levels. Markets are trading above their long-term price-to-earnings ratios, and are likely to produce relatively poor returns for at least a decade.

The outlook affects all generations, but in different ways. Baby Boomers who have already built their retirement savings will need to watch drawdown levels, as spending 5% of a pension fund might erode capital quicker than expected. Millennials and Generation Z who are saving may need to put more into superannuation or work longer than their parents to achieve the same balances.

This comes at a time when the costs of bailing out countries from the coronavirus will need to be repaid. In Australia, the $400 billion of virus deficits will hang over future economic growth as governments look to repay debt. While the spending in 2020 is right to support the economy and people in need, the federal government cannot continue to pay the wages of millions of unemployed. Australia will swing back towards a period of fiscal restraint. It’s also likely that spending on health and aged care will ramp up, at the same time as Australia wants to return to a market economy.

The potential for future tensions is obvious. Many people in older generations have benefitted from negative gearing, tax-free capital gains on their family homes, favourable property prices, strong stock and bond markets and lightly taxed savings in the form of superannuation. The calls for increasing pensions, health and aged care spending also predominantly benefit retirees. The social contract between generations will be challenged.

The reality is that return for risk payoffs are now lower. The average long-term expected outcome is reduced but the range of possible outcomes is just as wide, which means a larger proportion of potential outcomes may be unacceptable. But de-risking involves a greater acceptance of a lower average return.

The best way to minimise the impact is to ensure as much financial self-sufficiency as possible, which begins by not deluding ourselves about future returns.

Here's some final words from Robert Shiller's April article:

*"As a practical matter, my advice is to look at your portfolio to make sure that it is not so heavily weighted to stocks that further losses would be unbearable. Otherwise, I’d try not to worry too much about the stock market. Most likely, it will do moderately well in the coming years, even if there is a risk that you will need to be very patient."*

If someone offers a 7.5% return over decades, while there may be a temptation to say "That’s going straight to the pool room", in reality, it should be "Tell 'em they're dreamin'".

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

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## Buffett's meeting takeaway: extreme caution

### Greggory Warren

*Morningstar's US strategist, Gregg Warren, specialises in researching Warren Buffett's Berkshire Hathaway (BRK). In this two-part article, he provides a brief review of his major highlights from the annual meeting of BRK, followed by a short video summarising Buffett's presentation last weekend.*

While wide-moat-rated Berkshire Hathaway's (BRK.A/BRK.B) annual meeting has always been entertaining, it hasn't generally been a big source of meaningful insights into the firm's operations. This year's event, which was a significantly smaller affair with no shareholders in attendance in Omaha and just CEO Warren Buffett and Greg Abel (vice chairman of Berkshire's noninsurance business operations) taking questions from a remotely located Becky Quick (of CNBC), who was collating all of the questions for the three journalists on the journalist panel, was relatively subdued. The meeting not only started later in the day, but Buffett spent much of the first two hours of the five-hour event speaking about his thoughts about the COVID-19 pandemic and its potential economic impacts, touching on everything from monetary and fiscal policy to consumer and commercial behaviour.

The main thing we took away from Buffett's preamble, as well as the question-and-answer segment, was that Berkshire (much as we heard from Charlie Munger in a *Wall Street Journal* interview in mid-April) is being extremely cautious right now, given all of the uncertainties surrounding the COVID-19 pandemic and subsequent shutdown/recession. Unlike Buffett's famous maxim to "be fearful when others are greedy and greedy when others are fearful", Berkshire actually dumped some stocks, did not pursue any deals, and let its cash balances expand during the first quarter.

While it was no surprise to see Berkshire dump the airlines, we were shocked to see that Buffett stopped buying back Berkshire's shares on March 10 and didn't repurchase any of the company's common stock between then and the end of April. Our general feeling has been that with cash reserves being guarded, distressed opportunities few and far between, and many of Berkshire's stock holdings either struggling with the COVID-19 pandemic or subsequent shutdown/recession, the best option for the company's excess cash may be Berkshire's own common stock.

**Surprises from Berkshire's Annual Meeting**

*Click on the image of Gregg Warren to hear his reactions to Buffett's presentation.*

*Greggory Warren, CFA, is a financial services sector strategist for Morningstar. This article is general information and does not consider the circumstances of any investor.*

## Retiree spending patterns differ from most expectations

### Wade Matterson

The financial services industry may have underestimated the dramatic fall-off in retiree spending as retirees age, according to our analysis of real-world expenditure data. This is potentially a positive message for retirees and their advisers dealing with the Covid-19 crisis.

**How retirement spending falls**

The median retired couple’s expenditure falls by more than one-third (36.7%) as they move from their peak spending years in early retirement (65 to 69 years-of-age) and into older age (85 years and beyond). The decline in expenditure for couples is relatively stable in the early years of retirement at about 6% to 8% across each four-year age band, but then rapidly accelerates once retirees pass 80 years-of-age.

Association of Superannuation Funds of Australia (ASFA) has previously estimated a ‘comfortable’ couple aged 85+ years will spend about 8% less than those aged 65-85 years of age. Another industry study by the Australian Institute of Superannuation Trustees (AIST), based on Household, Income and Labour Dynamics in Australia (HILDA) data, has suggested that spending may not decline materially through retirement.

However, the Milliman Retirement Expectations and Spending Profiles (ESP) analysis is the first based on the actual spending of more than 300,000 Australian retirees.

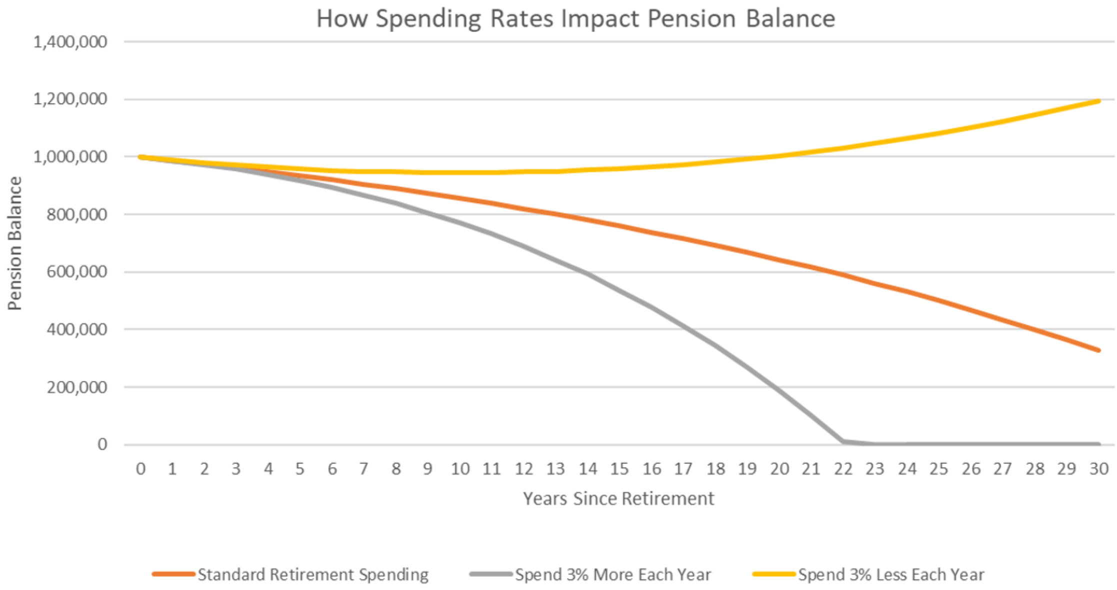
The data shows that retirees’ food expenditure—the largest component of essential spending—declines steeply with age, while health spending increases with age but dips again after age 80. All discretionary expenditure, such as travel and leisure, declines throughout retirement.

The faster-than-expected drop-off in spending casts doubt on some common rules of thumb and suggests that financial plans for retirees that assume a steady or increasing spending over time may be conservative relative to actual behaviour. This is potentially good news for advisers and their clients given recent events.

If we compare a small increase of 3% each year in a $50,000 p.a. retirement spend with an equivalent decrease of 3%, we find that this change has massive implications on retirement account balances (Figure 1). In fact, in the scenario where spending decreases annually, retirees can end up with a higher account balance than when they first retired, due to underlying asset growth outstripping spending.

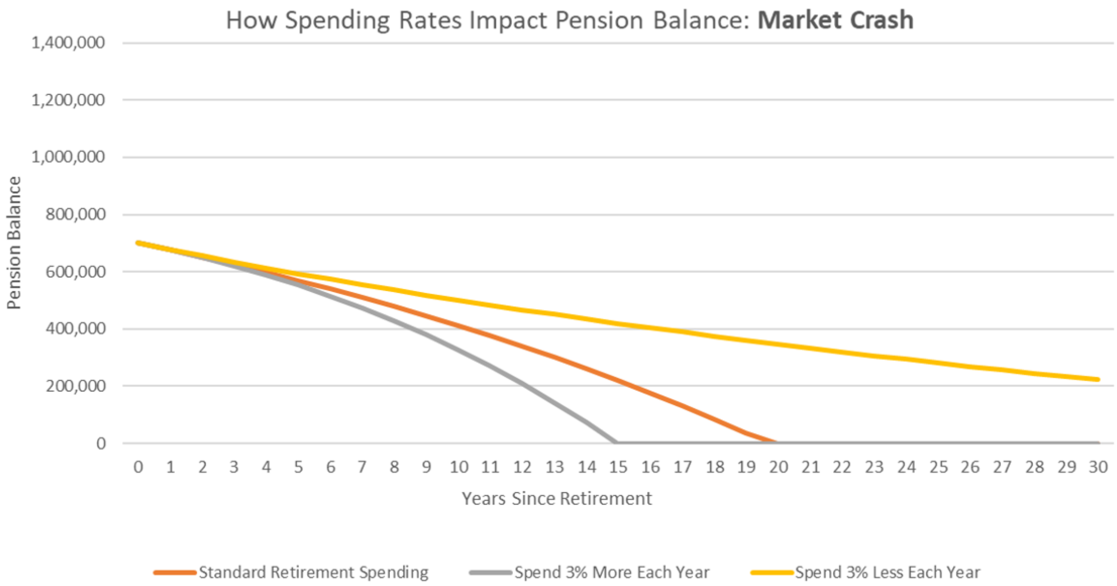
Even assuming no annual increase in spending results in a drastically different picture that can help to offset the concern of seeing a drop in asset values as a result of market volatility.

**Figure 1:** How spending rates impact pension balance




Additionally, this drop off in spending can help soften the impact of a market crash shortly before retirement (Figure 2). If we consider a 30% drop in asset values, but still take the same annual withdrawal amounts as before, decreasing spending throughout retirement mitigates longevity risk and helps reduce the chances of funds running out.

**Figure 2:** How spending rates impact pension balance in a market crash scenario



**Experience navigating retirement**

Financial advisers are well positioned to coach clients that may have recently entered or are considering retirement. Their experiences with other clients who have successfully navigated retirement for many years are real-life examples of the lifestyle changes and reduced spending behaviour that evolves naturally.

In addition, clients of financial advisers will be better placed to amend their short-term behaviour and, combined with changes to minimum withdrawal rates, will be more resilient in the face of ongoing volatility. This may mean dialling back areas of discretionary expenditure in order to focus on the essential costs of daily living.

Incorporation of conservatism within the planning process, whether captured in client goals, the use of bucket strategies or implementation of portfolio risk management approaches can be a boon in times such as these.

**Key assumptions and methodology**

A 30-year timeline has been used, with an initial withdrawal of $50,000 p.a. A flat withdrawal amount is compared with an amount increasing by 3% annually and one decreasing by 3% annually.

A starting account balance of $1,000,000 has been assumed along with a rate of 4% growth p.a. on this balance, post withdrawal each period.

In the market crash scenario, the starting account balance was decreased to $700,000 to simulate an instantaneous 30% drop in asset values.

*Wade Matterson is a Principal, Senior Consultant, and leader of Milliman's Australian Financial Risk Management practice and a fellow of the Institute of Actuaries of Australia. This article is general advice only as it does not take into account the objectives, financial situation or needs of any particular person.*

## Why is tax increasing my LIC's NTA?

### Scott Whiddett

*Co-authored by Allan Mortel and Howard Badger, Partners at Pitcher Partners Sydney.*

*A Firstlinks reader, Robert Baker, asked the following question:*

*"For an increasing number of LICs, post-tax NTA is now larger than pre-tax NTA, a reversal of what many investors experience as the norm. However, chatting to other LIC holders, the potential financial implications of this shift is not understood. For example, what are the franking credit implications of having a high post than pre tax NTA?"*

A listed investment company's (LIC) net tangible asset (NTA) is an important measure of its worth or financial position at a point in time. In theory, the calculation of NTA is simple, but the reality is that there is a great disparity in the way LICs calculate and report their NTAs.

[For more on LIC performance, see Chris Cuffe's article, published in this publication on 14 December 2017.]

Generally, a profit generated usually results in the recognition of an income tax liability. An investor in a LIC can expect the post-tax NTA to be lower than a pre-tax NTA. However, this is not always the reality as some LICs are reporting post-tax NTAs higher that the pre-tax NTAs.

**What is happening with these NTAs?**

In our current climate of share market volatility and the many unknowns surrounding the impact of Covid-19, some LICs may experience significant realised and unrealised losses resulting in large tax benefits being recognised. Ultimately, directors and auditors will need to scrutinise the recoverability of these losses under the accounting standards as to whether they are recognised as assets, written down or written off completely. However, this generally will not take place until the year end (or half year end) reporting cycle.

Monthly NTA announcements by LICs during this crisis may not have the same level of rigour applied to the assessment of tax benefits as during annual and half year reporting.

Investors need to know what to look for to better understand a LICs published NTA. Briefly, for a LIC to report a higher post-tax NTA than its pre-tax NTA, it must have a tax benefit that exceeds its tax liabilities (if any) and include that tax benefit as an asset. Prima facie this would indicate the LIC has experienced losses.

**What is a tax benefit?**

A tax benefit is also known as a deferred tax asset (DTA) or in the old terminology, future income tax benefit (FITB). Simply stated, it's the amount on which a company can pay less income tax in the future.

A tax benefit may include one or a mix of the following:

| | **Type of tax benefit** | **What's the implication?** |
|---|---|---|
| 1. | Tax losses—including carried forward tax losses and current period tax loss either arising from trading losses or expenses exceeding income.<br><br>The nature of a tax loss (revenue or capital) for a LIC on capital account for tax purposes may limit their utilisation. | LIC will not need to pay tax to the extent of tax losses available. Not able to be converted to cash.<br>Investors need to be aware that this asset would not convert to a refund or cash on wind-up or transfer to a Trust in the event of a scheme to convert from a LIC to a managed investment scheme / trust or Listed Investment Trust (LIT). It would instead be written off the balance sheet and expensed.<br>Further, a company can lose tax losses, but that's too technical to go into in this article. |
| 2. | Net unrealised losses on investments | A temporary tax provision, which until the investments are sold, may change in amount or become a liability (i.e. in the event the value of the investments increases above their cost base). |
| 3. | Excess franking credits contribute to carry forward tax losses, which can be recognised as a tax benefit. | As for 1 above. |
| 4. | Capitalised offer costs—a tax deduction deferred (claimed) over 5 years from being incurred. Being the capitalised cost at the relevant company tax rate. | A temporary difference between the accounting and tax treatment. The LIC will benefit from the tax deduction (pay less tax) over a 5-year period. |
| 5. | To the extent a trading stock election is made in respect of investments held as trading stock, a deduction may be available to generate tax losses in the relevant income tax year. | As for 1 and 2 above. |
| 6. | A tax refund due from the ATO (this should be recognised as a current tax asset but may be grouped for NTA purposes together with other tax benefits). | Will be converted to cash. |

**What are the implications of tax benefits on franking credits?**

The recognition and value of tax benefits recorded in a LIC's balance sheet is subject to satisfying the relevant criteria stipulated in the accounting standards. The tax benefit recorded in a LIC's accounts and used in NTA calculations should be that amount the directors reasonably expect to be utilised by the company within a reasonable period. That is, there must be an expectation that the company will derive income or gain in the future that will be taxable and the tax benefits will reduce the amount to be paid to the ATO. Sounds good, but is it that straightforward? Consider:

- For many investors, a LIC's ability to pay franked dividends is attractive. A LIC either receives franking credits with franked dividend income earned on stocks within the portfolio or generates them by making tax payments to the ATO. Where a LIC does not need to pay tax to the extent that tax losses are available, it will not generate further franking credits.

- If the LIC's income predominately consists of franked income, it won't need to pay as much (if any) additional income tax, keeping cash in the company and still having franking credits available to distribute to shareholders. However, unfranked income is required to utilise the tax benefit.
- If the LIC does not receive sufficient franked income to frank a dividend, it could elect to carry forward (some or all of its) income tax losses and elect instead to pay tax which would generate franking credits to enable it to pay franked dividends to shareholders. This would entail the company utilising its cash instead of its tax benefit.
- Carried forward tax losses will only have real value where there is unfranked income to absorb that loss. This arises due to the extent in which any profits in the LIC are taxed, they can be distributed to the shareholders with the accompanying franking credit. Conversely, profits that are distributed without corresponding franking credits will have less value to most shareholders.

**What should investors look for?**

Here are four points for LIC investors to check:

**1. Understand the LIC's predominant investment style**

Whilst some LICs may have a mix of long-term investing portfolios and more actively traded portfolios, there will be a more dominant style. The ASX Listing rule option to either disclose NTA before or after provisions for estimated tax on unrealised income and gains (deferred tax) can be confusing to investors.

For example, for a LIC that:

A. Rarely realises an investment and therefore rarely pays the deferred tax liability provided in its accounts, the NTA backing before the estimated tax on unrealised income and gains is a meaningful proxy for the net assets at work for shareholders. This LIC might be described as having a long-term, or passive investment style, or investing for income growth. OR

B. Actively realises its investments, the estimated tax liability provided in its accounts will quickly become payable and therefore, NTA backing after all tax provisions may be a more meaningful proxy for the net assets at work for shareholders.

Ideally, each LIC would report *both* NTA backing before and after provisions for estimated tax on unrealised income and gains (or net losses) and explain which they consider more meaningful.

**2. Understand the nature of tax balances**

A tax benefit that relates to net unrealised losses may be less of a concern than one that relates to growing tax losses. A LIC may have both tax assets and tax liabilities at a point in time. They may not have been netted off due to the differing nature of the tax item (e.g. capital losses cannot be used to offset income gains for some companies) or perhaps they were disclosed separately because the portfolio swings from unrealised losses to unrealised gains with regularity.

**3. Look at trends in tax balances**

Some LICs continue to pay tax and frank dividends to shareholders, yet tax losses remain on the balance sheet or continue to grow over time. What sort of performance would see the tax losses utilised without impacting franking credits available for distribution? Or will future dividends need to be franked at a reduced rate? Are there calls to wind up the LIC, convert to a trust or return capital to shareholders? If so, will the tax assets be written down or off rather than benefit the company and its shareholders?

**4. Look for disclosures of the LIC's franking balance**

Franking credits that a LIC has available to distribute to shareholders are not recorded on the balance sheet nor in any NTA calculation and are of no value to shareholders until they are distributed (and to varying degrees of value depending on the shareholder's circumstances). Further, a company can only distribute franking credits to the extent that the company has profits available.

A dividend cannot be franked beyond 100%. Accordingly, a LIC with franking credits greater than accounting profits may have franking credits unavailable for distribution.

**Footnote: the variation in NTA calculations**

Bearing in mind all of these factors, a LIC can publish various calculations of its monthly NTA by altering assumptions on the tax benefit and tax provision on unrealised investments. For completeness, we have included some examples to show how the NTA can vary. The calculations in each column A to F are explained briefly as follows:

A. In practice, some LICs include tax benefits as an asset. In the second example, this results in post-tax NTA being higher than the pre-tax NTA.
B. The tax benefit is excluded from the calculation on the basis the tax benefit is intangible.
C. Any provision for tax on unrealised gains is excluded, but tax benefit is included.
D. Any provision for tax on unrealised gains is excluded and the tax benefit is excluded as intangible.
E. All tax balances are excluded, except tax payable arising from an assessed liability to ATO.
F. As for E above, except tax payable has been excluded (in error).

In the first example, Company ABC has a significant provision for tax on unrealised gains suggesting that the portfolio has recorded gains. In this case, the post-tax NTA is lower than the pre-tax NTA.

| | | A | B | C | D | E | F |
|---|---|---|---|---|---|---|---|
| | **ABC** LIC's simple balance sheet | NTA post tax [1] | NTA post tax [2] | NTA after tax and before tax on unrealised gains [1] | NTA after tax and before tax on unrealised gains [2] | NTA pre tax (all taxes) | NTA pre tax (all taxes) |
| **Assets** | | | | | | | |
| Cash | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 |
| Investments | $259,000 | $259,000 | $259,000 | $259,000 | $259,000 | $259,000 | $259,000 |
| Tax benefit | $1,000 | $1,000 | - | $1,000 | - | - | - |
| **Total Assets** | $310,000 | | | | | | |
| **Liabilities** | | | | | | | |
| Tax payable [3] | $3,000 | -$3,000 | -$3,000 | -$3,000 | -$3,000 | -$3,000 | - |
| Tax provision - current | $2,000 | -$2,000 | -$2,000 | -$2,000 | -$2,000 | - | - |
| Tax provision on unrealised gains | $5,000 | -$5,000 | -$5,000 | - | - | - | - |
| **Total Liabilites** | $10,000 | | | | | | |
| Net Assets | $300,000 | $300,000 | $299,000 | $305,000 | $304,000 | $306,000 | $309,000 |
| Number of shares on issue | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 |
| NTA / share calculation | | $1.000 | $0.997 | $1.017 | $1.013 | $1.020 | $1.030 |

In the second example, Company XYZ has a significant tax benefit, suggesting the portfolio has suffered a loss or the LIC has had prior period losses. Note that in some calculations the post-tax NTA is higher than the pre-tax NTA.

| | XYZ LIC's simple balance sheet | A<br>NTA post tax [1] | B<br>NTA post tax [2] | C<br>NTA after tax and before tax on unrealised gains [1] | D<br>NTA after tax and before tax on unrealised gains [2] | E<br>NTA pre tax (all taxes) | F<br>NTA pre tax (all taxes) |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 |
| Investments | $251,000 | $251,000 | $251,000 | $251,000 | $251,000 | $251,000 | $251,000 |
| Tax benefit | $4,000 | $4,000 | - | $4,000 | - | - | - |
| **Total Assets** | $305,000 | | | | | | |
| **Liabilities** | | | | | | | |
| Tax payable [3] | $3,000 | -$3,000 | -$3,000 | -$3,000 | -$3,000 | -$3,000 | - |
| Tax provision - current | $2,000 | -$2,000 | -$2,000 | -$2,000 | -$2,000 | - | - |
| Tax provision on unrealised gains | $ - | $ - | $ - | - | - | - | - |
| **Total Liabilites** | $5,000 | | | | | | |
| Net Assets | $300,000 | $300,000 | $296,000 | $300,000 | $296,000 | $298,000 | $301,000 |
| Number of shares on issue | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 |
| NTA / share calculation | | $1.000 | $0.987 | $1.000 | $0.987 | $0.993 | $1.003 |

*1 Tax benefit included as an asset (in practice some LICs include tax benefits as an asset. See footnote 2 below)*
*2 Tax benefit excluded as an asset (we consider a tax benefit to be an intangible and should be excluded)*
*3 Tax payable arising from lodgement of a tax return converts from a tax provision to a creditor and does not get excluded as other tax provisions are from the pre-tax NTA calculations*

*Scott Whiddett, Allan Mortel and Howard Badger are Partners at [Pitcher Partner](#) Sydney, advisers to fund managers, investment entities and investors. The material contained in this publication has been made available for informational and discussion purposes only, it is not professional advice. Neither Pitcher Partners nor its affiliated entities, nor any of our employees will be liable for any loss, damage, liability or claim whatsoever suffered or incurred arising directly or indirectly out of the use or reliance on the material contained in this publication.*

## Post Covid, the risks are skewed to the downside

### Stephen Miller

When it comes to the Covid-19 crisis, if we have learnt anything amid the plethora of commentary from an army of 'experts' across a plurality of disciplines, it is just how much we don't know.

To paraphrase former US defence secretary, Donald Rumsfeld, not only are there a lot of 'known unknowns' but by definition incalculable 'unknown unknowns'.

**The reality of making Covid-19 forecasts**

Economic and financial developments, and more importantly economic and financial *forecasts,* should be understood in that context. Put simply, the current circumstance is one for which there is little precedent and forecasting, which is fraught at the best of times, and especially so now.

On the economic consequences, it is safe to say that the 'base case' is probably the worst we have confronted since the Great Depression. But the distribution of possible outcomes is immensely large, and, in my view, skewed to the downside.

In the Australian context, that much has been asserted by our most senior econocrats, including RBA Governor Philip Lowe and Treasury Secretary Steven Kennedy. They have both articulated scenarios encompassing falls in GDP of greater than 10% and an unemployment rate running well into double digits.

In fact, the impact may be bigger on Australia than other developed economies.

Australia is a medium-sized open economy dependent on a smoothly functioning international trading environment and was already under some stress before the onset of the crisis. To date, population growth (aided by an influx of overseas students and tourists) has underpinned Australia's enviable growth record, but population growth is set take a considerable hit and recovery from this is likely to be slow. Offsetting this may be the recent realisation of Australia's relative success in preventing the spread of Covid-19.)

Globally, however, financial asset prices seem to imply that investors are quite sanguine about the outlook. Markets are implying that the bounce back will be well under way by the fourth quarter of 2020 and will be 'V' shaped rather than a 'bath-tub U' or, worse still, an 'L' shape.

In the US, the S&P500 is some 28% off its lows of 23 March and 'only' 15% shy of its peak in February. It is currently trading at around levels seen in early June 2019, a time when some analysts were questioning whether the market then was 'stretched'.

In Australia the S&P/ASX200 is about 20% off its lows and still some 25% from its February peak, reflecting, inter alia, the high weighting of bank stocks in the Australian market.

**Why are markets so sanguine?**

Financial markets are drawing an extraordinary degree of comfort from the stimulus packages from governments and central banks. These packages go well beyond anything contemplated during the GFC. Both the Fed and the ECB are buying private sector debt (including 'junk' bonds) to support those markets, while locally the RBA has undertaken quantitative easing (QE) measures.

On the fiscal side, there have been extraordinarily large packages put together, including Australia's at a little over 10% of GDP.

But are markets drawing too much comfort?

Arguably risks were weighted to the downside before the Covid-19 crisis. Not only were trade tensions already elevated, but global politics were dysfunctional. The US was characterised by 'gridlock' and a polarising presidential campaign. In Germany, Angela Merkel was in government but not power, and China had a Hong Kong problem.

Geopolitical tensions were rising (witness US/China tensions, a cyber 'Cold War' and ongoing turmoil in the Middle East). Governments were wrestling with deep-seated structural issues such as climate change, inequality and 'oligopolisation'.

And this at a time when monetary policy, as we conventionally understood it, was exhausted, and the efficacy of any future stimulus was doubtful. Similar doubts attach to the monetary policy innovations instituted since the onset of the crisis.

Investors must also contemplate potential longer-term pitfalls relating to exit strategies from extraordinary stimulus. What, for instance, are the consequences of Fed and ECB purchases of private sector debt?

It was a build-up in non-financial leverage (i.e. debt) that tipped the world into the GFC. In the period since, not only has corporate debt increased but its quality has deteriorated, and the stakes just got higher with Fed and ECB purchases of private debt. The 'moral hazard' issues attaching to those measures loom large.

There are misgivings too about the potential for monetary financing of budget deficits—a type of 'modern monetary theory' in its most extreme form—and the potential longer-term inflationary, or perhaps stagflationary, consequences of such measures.

Caution is warranted and will be for some time. Despite the signs that authorities are on top of the spread of Covid-19, the 'unknowns' loom large, particularly in the post-lockdown period and with the negative economic consequences potentially underrated.

The first principle of investing is diversification, and now is a good time to remind ourselves of the virtues of that principle.

*Stephen Miller is an Investment Adviser with GSFM. This article is general information and does not consider the circumstances of any investor.*

## Australian banks undervalued amid economic turmoil

### Nathan Zaia

[*Editor's introduction: Nathan Zaia is an equity analyst, covering the banking and insurance sectors at Morningstar Australasia. Given the importance of bank stocks in many portfolios, this article reproduces Nathan's latest research on Australian banks. With bank share prices moving around rapidly, these opinions are based on circumstances last week and may change at any time.*]

Uncertainty is elevated and unprecedented events are unfolding. But with Australian bank share prices down about 40% since late February, those risks are in the price and bank shares are cheap in our view. The Reserve Bank of Australia says the pending economic contraction is a once-in-a-century event, and with earnings tied to the health of the economy, investors worry how the banks will fare. Our confidence in estimating loan losses and asset growth in the short term has reduced, which has major implications for earnings, dividends, and capital adequacy. However, after revisiting our forecasts to incorporate a wider range of outcomes, and more near-term downside, we maintain our positive view.

**Key takeaways**

- We reduce our major bank valuations by up to 7% after factoring in higher loan losses and small equity raisings via dividend reinvestment plans. On price/book values of 0.7-0.8 times, the banks trade at substantial discounts to the five-year historical averages of about 1.5 times, and to our fair value estimates. We believe the market is overly focused on near-term earnings. We expect major bank loan losses to normalise and for return on equity to average 10.5% by fiscal 2023.
- After enjoying impairment charges as low as 0.1% of loans over the last three years, we expect a meaningful increase to 0.50% over fiscal 2020 and fiscal 2021, before returning to midcycle levels around 0.20% by fiscal 2023. On average, our short-term earnings forecasts fall around 20%.
- We expect all banks need to materially reduce dividends with payout ratios expected to average 50%–65% over the next three years. Our base case assumes ANZ, National Australia Bank, and Westpac each raise AUD 3.5 to AUD 4.0 billion of new equity in the next two years. We expect partially underwritten dividend reinvestment plans, but a traditional placement and share purchase plan is possible.
- In our bear-case scenario, loan impairment expenses peak at 1% of loans in fiscal 2021 with cumulative impairments of 2.2% over fiscal 2020-2023. While the banks remain profitable in this scenario, we estimate three of the majors would need an additional AUD 5.5 billion in capital to offset likely growth in risk-weighted assets. Payout ratios will also contribute to the actual amount banks could end up raising.
- Given the increasing uncertainty around the economic outlook, and the broader range of potential outcomes, our uncertainty ratings increase to high from medium for all four traditional Australian banks.

**Australian bank shares cheap, pricing for more pain than our bear-case scenario**

We expect earnings and dividends to be under pressure in the near term with compressed net interest margins and rising loan losses, a view shared by the market. Our long-term view differs though. Based on grossed-up share prices, the Australian major banks trade on P/E multiples of around 7.5 times our fiscal 2024 forecasts, with the exception of **Commonwealth Bank** (ASX:CBA), which is at about 11 times. Seeing through the current high forward P/E ratios and low dividend yields, due to the trough in earnings, should reward long-term shareholders if the economic recovery plays out as we expect.

**Exhibit 1: Share prices imply long-term pain for the banks**

| | | | | Forward Yield % at FV | | Forward PE at FV | |
|---|---|---|---|---|---|---|---|
| | Fair Value $ | Price/Fair Value | Fair Value/Book | FY20e | FY24e | FY20e | FY24e |
| ANZ | 25.00 | 0.64 | 1.20 | 2.7 | 5.2 | 18.3 | 13.5 |
| CBA | 71.00 | 0.83 | 1.80 | 4.5 | 4.8 | 18.6 | 14.4 |
| NAB | 25.00 | 0.63 | 1.30 | 1.8 | 5.0 | 27.6 | 13.1 |
| WBC | 25.00 | 0.61 | 1.30 | 2.0 | 4.9 | 24.4 | 14.2 |

*Source: Morningstar Estimates/Morningstar Direct: Prices as at 23 April 2020*

Our overarching thesis for the banks is earnings by fiscal 2024 will be around 24% higher than fiscal 2019 levels, with earnings bottoming over fiscal 2020 and 2021. We assume low-single-digit loan growth of 3.5% over the next five years, with NIMs falling on average by 15 basis points from fiscal 2019 to fiscal 2021. After reaching a low of 1.83% we expect a modest recovery to 1.95% by 2024 as cash rates begin to lift. The current environment has the potential to prolong ultra-low cash rates, however, such an environment could see loan losses fall back to levels banks recorded pre-coronavirus.

We also expect customer remediation and regulatory penalties to be materially lower in the future. Coupled with lower loan losses and additional operating cost savings, we project cost/income ratios for the majors will trend towards 40% to 45% versus a peak of 50% in fiscal 2020. This is a return to fiscal 2019 ranges when accounting for the significant one-off items which have been incurred. Our loan impairment expense assumptions of 0.5% of loans in the short term fall back to midcycle levels of 0.2% by fiscal 2023.

While the pandemic means our confidence in projecting earnings and dividends in the short term is low, we remain comfortable with midcycle earnings forecasts. If our bear case for loan losses was to play out in the short term (cumulative loan impairments of 2.2% of loans over three years), but loan losses normalise back to our forecast midcycle levels, with all other base case assumptions held, we estimate our fair value estimates for the Australian major banks would fall around 5%. In this scenario, our fair value estimates would still be around 30% above current share prices.

Higher near-term economic uncertainty, especially with regard to the potential downside risk captured in our bear cases, means we increase our uncertainty ratings to high from medium for all of the Australian banks. Our bear case fair value estimates are around 0.65 times our base case, versus 0.75 times previously.

**Exhibit 2: Price/book value of major banks**


*Source: Reuters/Morningstar Estimates*

**Prepare for large loan losses, but don't rule out a recovery**

Heading into this recession, fiscal and monetary stimulus, including specific industry measures to help ease the pain, is unprecedented. We expect it will ease the economic pain somewhat. While pain is likely across business and consumer lending, we expect availability of credit, low-cash rates, and stimulus to prevent GFC (0.75% of gross loans) or early 1990s loan loss levels (2%) from reoccurring. The ability to defer payments such as mortgages, rent, insurance, electricity, private health, switch to interest only, and draw on emergency superannuation funds buys all those affected by the lockdown some time. Measures rolled out by the Australian Prudential Regulation Authority, or APRA, to curb high loan/value ratio loans and interest-only loans, which have slowed loan growth among the majors in recent years, should also reduce the pain experienced in this downturn. We do not believe the government will pull the economic lifelines immediately as social distancing restrictions are eased, with government recognising it will not be a return to normal policy settings once economies reopen.

Our bear-case fair value estimate for the majors are AUD 17.00 for **ANZ Banking Group** (ASX:ANZ), **National Australia Bank** (ASX:NAB), and **Westpac** (ASX:WBC) and AUD 46 per share for Commonwealth Bank. While Commonwealth Bank trades at 1.25 times our bear-case fair value, the remaining banks trade at 0.9 to 0.95 times. Given heightened uncertainty around loan losses, and potential growth in risk weighted assets (via growth in loan balances and potential changes to risk loss assumptions), the downside now appears worse than we previously imagined.

In our bear case, we assume loan impairment expenses of 0.75% of loans in fiscal 2020, rising to 1% in fiscal 2021 as stimulatory measures only soften but not stop rising unemployment and business closures. Due to the severe contraction we expect, loan impairment expenses now remain above 0.3% of loans for the forecast period in our bear case. In this scenario, we also assume additional pressure on interest margins. We expect banks to refrain from repricing loans, despite higher near-term credit risk, as it would push more businesses and consumers into default, creating a vicious cycle. Government pressure on the banks not to reprice could also see the banks refrain from exercising pricing power. Nonbank lenders also remain a hinderance to bank earnings. They continue to access cheap funding and keep competitive pressure on rates, and ultimately margins. The Australian government announced in March 2020 it would make available AUD 15 billion for small bank and non-bank lenders, helping negate short-term risks they have no access to competitively priced funding.

Despite revenue being under attack on all fronts in our bear case, we assume cost-saving initiatives are fruitless with increased risk and compliance spend on tougher regulatory scrutiny and investment to maintain and upgrade technology leading to higher operating costs.

**Video: Banks will see out corona crisis**
Nathan Zaia and Glenn Freeman

*Nathan Zaia is an equity analyst, covering the banking and insurance sectors at Morningstar Australasia. This article is general information and does not consider the circumstances of any investor. Please consult a financial adviser before taking investment decisions. To continue reading Nathan's views on this topic, premium members can access the full article here.*

## Payment deferrals more expensive than borrowers expect

Tony Dillon

It has been reported that more than 320,000 homeowners and 170,000 businesses have put loan repayments totalling $6.8 bn on hold since banks first announced support for borrowers as the Covid-19 pandemic unfolded.

Most banks introduced a loan deferral arrangement where loan repayments could be suspended for up to six months. But it's important to note that this is a payment holiday, not debt forgiveness. Interest will continue to accrue on outstanding loan balances and will be capitalised.

The financial implications of taking up such offers is therefore worth considering.

**How much extra will be repaid?**

Assume a 25-year principal and interest loan, established five years ago. The current variable interest rate is 3.5%, and the current minimum monthly loan repayment of $2,030 has just been locked in. The outstanding loan balance is $350,000 and loan repayments will be postponed for the next six months.

If at the end of the deferral period, the borrower resumed paying down the loan at the minimum amount of $2,030 per month, then the term of the loan would be extended by a little more than 12 months, and an **additional $12,544** would be paid over the term of the loan.

Alternatively, in order to repay the loan in full by the end of the original 25-year term, some $72 per month extra would be required, being an additional $4,765 paid over the loan's term.

**Loan payment deferral is expensive**

Deferring loan repayments therefore comes at a significant cost, and the full implications need to be understood prior to undertaking such an approach. Perhaps reduced payments instead of no payments could be discussed with banks, to lessen the blow on the other side. For example, an arrangement whereby interest only is payable for the six months, and no principal.

Then CBA Chief Executive, Matt Comyn, said the following after the Reserve Bank cut interest rates by 0.25%:

*"We will also help up to 730,000 customers by reducing repayments to the minimum required under their loan contract from 1 May. On average, this will release up to $400 per month for customers and create up to $3.6 billion in additional cash support for our economy. Customers will be able to opt out after the change is effective should they wish to keep their current repayment".*

When the interest rate on a variable rate property loan reduces, the amount required to pay the loan out over the original term will also reduce. But many CBA customers choose to continue to pay the higher amount, thus reducing the loan term. And if they do want to pay the minimum, they must contact the bank to ask for payments to be reduced. That is, it is an 'opt in' arrangement.

But what CBA proposed is the reverse. An 'opt out' arrangement whereby the loan will automatically revert to the minimum required payment on 1 May, unless the customer actively vetoes the procedure.

This will also have consequences for borrowers. Five years ago, the official cash rate was 2.25%. So let's assume our 25-year principal and interest example loan established five years ago, commenced at a variable interest rate of 5.5%. The original loan amount was $392,000 with a monthly loan repayment of $2,408. Assume the monthly repayment was left unchanged over the five years. So that now, with the loan balance at $350,000 and the variable interest rate at 3.5%, the minimum monthly payment required to pay the loan out in 20 years as already noted, is $2,030. That is, $378 less per month.

But if the customer opts out of the proposed CBA arrangement, maintaining repayments at $2,408, the loan will be paid out in 15.8 years, cutting 4.2 years off the loan term, and saving about $31,000 in interest.

Most people do not respond to 'opt out' requests. There is little doubt that customers will unwittingly or otherwise not 'opt out'. And if that happens, the financial consequences for the borrower are significant. While the CBA says this approach will 'help up to 730,000 customers' in terms of cash flow, one wonders if it really does help overall.

*Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.*

## Four ethical challenges in exiting Covid-19 rules

Michael Collins

In France, to leave their houses, people must fill in a form that allows them to perform essential jobs, attend medical appointments or go shopping for daily needs, an errand for which people have one hour only and must stay within one kilometre of their homes. The certificates must be shown on demand. Breaching 'confinement' rules risks fines and jail. A relaxation on some of these rules is currently underway.

Such is life in France under the 'lockdown' imposed to stop new infections from the coronavirus. This 'suppression' strategy is one of two broad options leaders in charge of democracies have adopted to fight the disease.

**Liberty suppressed at the expense of the economy**

These lockdowns dispense with liberty to halt the transmission of the virus. The suppression option comes with about as brutal an economic shock as can be self-inflicted because all physical businesses but essential services are shut down. But if the medical emergency were beaten and the public were confident about resuming normal life, the economy would be poised to recover. Risks of this approach include that lockdowns are never all encompassing so there is no guarantee the disease can be eradicated.

Most problematic of all is that the disease could resume its menace when the population is 'unlocked'.

These countries, after isolating the vulnerable, try and slow the spread of the virus through their populations in the hope to suppress it enough for medical authorities to cope and a vaccine might be developed (though none appears likely soon). Within this strategy, at the relaxed end of restrictions, sits the aim of allowing a population to develop a community, or 'herd', immunity or resistance to the disease via a manageable level of infections and possibly a vaccine, a common way for most viruses to be contained.

When pursing mitigation, officials shut as little of society as possible until the spread of the virus is contained. (The northern hemisphere hopes warmer weather will slow the pandemic.) How much of the economy is closed varies across countries. The risks with the mitigation approach are that more lives might be lost, infections might spiral beyond the ability of medical facilities to cope and the economic shock, though initially milder than compared with the lockdown blow, persists longer and proves larger, especially if a spooked public voluntarily locks itself down.

**Lives versus livelihood**

How then to judge the ethics behind choosing suppression or mitigation? At a surface level, the decision appears an ethical choice between lives and livelihood, though, at a deeper level, the choice is between the lives taken by Covid-19 versus the lives lost and ruined over the longer term by the steps taken to contain the pandemic.

Given such unenviable choices and with no clear 'right' answer, one approach to answering this question might be to draw upon different forms of ethical traditions to install guidelines for policymakers.

**First**, the cost of the decision must be spread fairly across society, and the disadvantaged, vulnerable and ill must be protected.

**Second**, measures should be reasonable both in their intent and their consequences even amid extreme circumstances.

**Third**, to do the least harm, policymakers should evaluate the unintended effects of their decisions and take steps to mitigate the damage.

**Fourth**, extreme steps, such as army patrols and curtailments on freedom, should be relaxed as soon as possible.

Even within this framework, policymakers are in an unenviable situation because the scientific characteristics of COVID-19 are unclear. Policymakers had to judge what the death toll might be from either approach and think through the unintended consequences of each option. Flow-on effects of lockdowns might be a jump in family violence and mental health issues. Officials needed to estimate the economic damage of each approach with no precedents to guide them. They needed to ask themselves which option might be less likely to ruin a generation's job prospects and impoverish society for decades, which can lead over time to an increase in deaths of stress, despair, substance abuse, etc.

Even though the battle against COVID-19 is far from won, we can say that both approaches can be supported by sound ethical arguments even if the logic behind each judgement call is different. While only hindsight will prove which approach was the most effective, it would be hard to say any democratic government has acted unethically in its fight against the coronavirus, even allowing for mistakes.

It can be said too that, given the economic and social damage Covid-19 will inflict, policymakers are bound to confront even harder ethical choices in coming years than those they faced during the emergency phase of the crisis.

To be sure, it won't be much consolation to think that policymakers acted ethically if the social and economic consequences of their decisions prove immense. In some ways, the ethical choices surrounding covid-19 are no different from other weighty decisions governments make all the time when they implicitly put a price on life.

Perhaps, in time, COVID-19's greatest ethical lesson might be how it exposed the ethics of societies before the pandemic hit. The countries that might be judged to have failed the common good would be those with poor healthcare systems, no pandemic contingency plans, few locally produced essential medical supplies, limited manufacturing to convert and, having stretched government finances, had scant ability to protect their populations without risking their prosperity. That would be many of them.

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## 68 bits of unsolicited advice

### Kevin Kelly

*Editor's introduction. Wired magazine co-founder, Kevin Kelly, posted a link on his Twitter feed to his '68 bits of unsolicited advice'. There is a lot to learn from his brief observations, especially the power of optimism and enthusiasm.*

It's my birthday. I'm 68. I feel like pulling up a rocking chair and dispensing advice to the young 'uns. Here are 68 pithy bits of unsolicited advice which I offer as my birthday present to all of you.

- Learn how to learn from those you disagree with, or even offend you. See if you can find the truth in what they believe.
- Being enthusiastic is worth 25 IQ points.
- Always demand a deadline. A deadline weeds out the extraneous and the ordinary. It prevents you from trying to make it perfect, so you have to make it different. Different is better.
- Don't be afraid to ask a question that may sound stupid because 99% of the time everyone else is thinking of the same question and is too embarrassed to ask it.
- Being able to listen well is a superpower. While listening to someone you love to keep asking them "Is there more?", until there is no more.
- A worthy goal for a year is to learn enough about a subject so that you can't believe how ignorant you were a year earlier.
- Gratitude will unlock all other virtues and is something you can get better at.
- Treating a person to a meal never fails and is so easy to do. It's powerful with old friends and a great way to make new friends.
- Don't trust all-purpose glue.
- Reading to your children regularly will bond you together and kickstart their imaginations.
- Never use a credit card for credit. The only kind of credit, or debt, that is acceptable is debt to acquire something whose exchange value is extremely likely to increase, like in a home. The exchange value of most things diminishes or vanishes the moment you purchase them. Don't be in debt to losers.
- Pros are just amateurs who know how to gracefully recover from their mistakes.

- Extraordinary claims should require extraordinary evidence to be believed.
- Don't be the smartest person in the room. Hang out with, and learn from, people smarter than yourself. Even better, find smart people who will disagree with you.
- Rule of 3 in conversation. To get to the real reason, ask a person to go deeper than what they just said. Then again, and once more. The third time's answer is close to the truth.
- Don't be the best. Be the only.
- Everyone is shy. Other people are waiting for you to introduce yourself to them, they are waiting for you to send them an email, they are waiting for you to ask them on a date. Go ahead.
- Don't take it personally when someone turns you down. Assume they are like you: busy, occupied, distracted. Try again later. It's amazing how often a second try works.
- The purpose of a habit is to remove that action from self-negotiation. You no longer expend energy deciding whether to do it. You just do it. Good habits can range from telling the truth, to flossing.
- Promptness is a sign of respect.
- When you are young spend at least six months to one year living as poor as you can, owning as little as you possibly can, eating beans and rice in a tiny room or tent, to experience what your 'worst' lifestyle might be. That way any time you have to risk something in the future you won't be afraid of the worst-case scenario.
- Trust me: There is no 'them'.
- The more you are interested in others, the more interesting they find you. To be interesting, be interested.
- Optimise your generosity. No one on their deathbed has ever regretted giving too much away.
- To make something good, just do it. To make something great, just re-do it, re-do it, re-do it. The secret to making fine things is in remaking them.
- The Golden Rule will never fail you. It is the foundation of all other virtues.
- If you are looking for something in your house, and you finally find it, when you're done with it, don't put it back where you found it. Put it back where you first looked for it.
- Saving money and investing money are both good habits. Small amounts of money invested regularly for many decades without deliberation is one path to wealth.
- To make mistakes is human. To own your mistakes is divine. Nothing elevates a person higher than quickly admitting and taking personal responsibility for the mistakes you make and then fixing them fairly. If you mess up, fess up. It's astounding how powerful this ownership is.
- Never get involved in a land war in Asia.
- You can obsess about serving your customers/audience/clients, or you can obsess about beating the competition. Both work, but of the two, obsessing about your customers will take you further.
- Show up. Keep showing up. Somebody successful said: 99% of success is just showing up.
- Separate the processes of creation from improving. You can't write and edit, or sculpt and polish, or make and analyse at the same time. If you do, the editor stops the creator. While you invent, don't select. While you sketch, don't inspect. While you write the first draft, don't reflect. At the start, the creator mind must be unleashed from judgement.
- If you are not falling down occasionally, you are just coasting.
- Perhaps the most counter-intuitive truth of the universe is that the more you give to others, the more you'll get. Understanding this is the beginning of wisdom.
- Friends are better than money. Almost anything money can do, friends can do better. In so many ways a friend with a boat is better than owning a boat.
- This is true: It's hard to cheat an honest man.
- When an object is lost, 95% of the time it is hiding within arm's reach of where it was last seen. Search in all possible locations in that radius and you'll find it.
- You are what you do. Not what you say, not what you believe, not how you vote, but what you spend your time on.
- If you lose or forget to bring a cable, adapter or charger, check with your hotel. Most hotels now have a drawer full of cables, adapters and chargers others have left behind, and probably have the one you are missing. You can often claim it after borrowing it.

- Hatred is a curse that does not affect the hated. It only poisons the hater. Release a grudge as if it was a poison.
- There is no limit on better. Talent is distributed unfairly, but there is no limit on how much we can improve what we start with.
- Be prepared: When you are 90% done on any large project (a house, a film, an event, an app) the rest of the myriad details will take a second 90% to complete.
- When you die you take absolutely nothing with you except your reputation.
- Before you are old, attend as many funerals as you can bear, and listen. Nobody talks about the departed's achievements. The only thing people will remember is what kind of person you were while you were achieving.
- For every dollar you spend purchasing something substantial, expect to pay a dollar in repairs, maintenance, or disposal by the end of its life.
- Anything real begins with the fiction of what could be. Imagination is therefore the most potent force in the universe, and a skill you can get better at. It's the one skill in life that benefits from ignoring what everyone else knows.
- When crisis and disaster strike, don't waste them. No problems, no progress.
- On vacation go to the most remote place on your itinerary first, bypassing the cities. You'll maximise the shock of otherness in the remote, and then later you'll welcome the familiar comforts of a city on the way back.
- When you get an invitation to do something in the future, ask yourself: would you accept this if it was scheduled for tomorrow? Not too many promises will pass that immediacy filter.
- Don't say anything about someone in email you would not be comfortable saying to them directly, because eventually they *will* read it.
- If you desperately need a job, you are just another problem for a boss; if you can solve many of the problems the boss has right now, you are hired. To be hired, think like your boss.
- Art is in what you leave out.
- Acquiring things will rarely bring you deep satisfaction. But acquiring experiences will.
- Rule of 7 in research. You can find out anything if you are willing to go seven levels. If the first source you ask doesn't know, ask them who you should ask next, and so on down the line. If you are willing to go to the 7th source, you'll almost always get your answer.
- How to apologise: Quickly, specifically, sincerely.
- Don't ever respond to a solicitation or a proposal on the phone. The urgency is a disguise.
- When someone is nasty, rude, hateful, or mean with you, pretend they have a disease. That makes it easier to have empathy toward them which can soften the conflict.
- Eliminating clutter makes room for your true treasures.
- You really don't want to be famous. Read the biography of any famous person.
- Experience is overrated. When hiring, hire for aptitude, train for skills. Most really amazing or great things are done by people doing them for the first time.
- A vacation + a disaster = an adventure.
- Buying tools: Start by buying the absolute cheapest tools you can find. Upgrade the ones you use a lot. If you wind up using some tool for a job, buy the very best you can afford.
- Learn how to take a 20-minute power nap without embarrassment.
- Following your bliss is a recipe for paralysis if you don't know what you are passionate about. A better motto for most youth is "master something, anything". Through mastery of one thing, you can drift towards extensions of that mastery that bring you more joy, and eventually discover where your bliss is.
- I'm positive that in 100 years much of what I take to be true today will be proved to be wrong, maybe even embarrassingly wrong, and I try really hard to identify what it is that I am wrong about today.
- Over the long term, the future is decided by optimists. To be an optimist you don't have to ignore all the many problems we create; you just have to imagine improving our capacity to solve problems.
- The universe is conspiring behind your back to make you a success. This will be much easier to do if you embrace this pronoia.

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