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a Morningstar company

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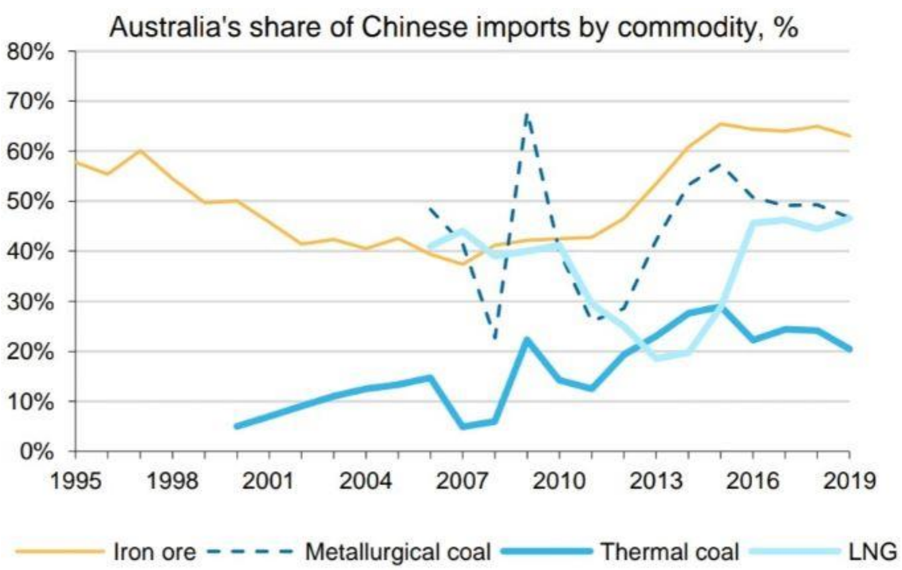
Editorial

We recently sold the family home we have lived in since 1989 for a high multiple of the original purchase price. Does that make us good investors? No. Did we pick a particularly fine house? No. The prices say more about our age than our skill. It simply means we live in Sydney and we allowed the investment to grow over a long time without selling any part of it, like millions of other Australian homeowners.

Investors who treat equities the same way will be better off than those who try to time the market. What if we had sold our house in 1992 when it had fallen in value during the last recession? It's the day-to-day revaluing, worrying about markets and moments of panic which compromise the compounding potential of simply holding an equity portfolio for decades. Our lead story this week looks at the amazing numbers.

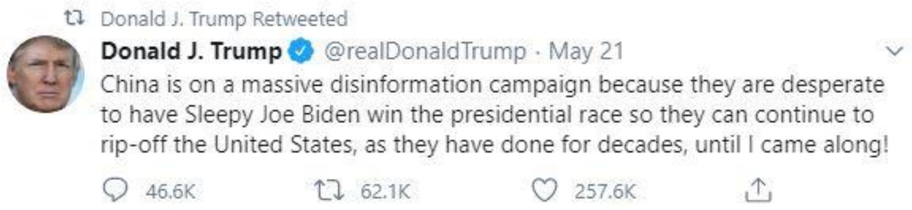
At the moment, the stock market is reacting to each piece of news on COVID-19 while other long-term problems are pushed into the background. The most serious risk is the heightened trade tensions with China, which buys one-third of all Australia's exports. This is more important than whether another person dies in a nursing home or the US hits 100,000 deaths.

On first look, our dependence on China looks like a threat and a need to diversify. However, the issue is far more complex, as China also needs Australia, as shown below.

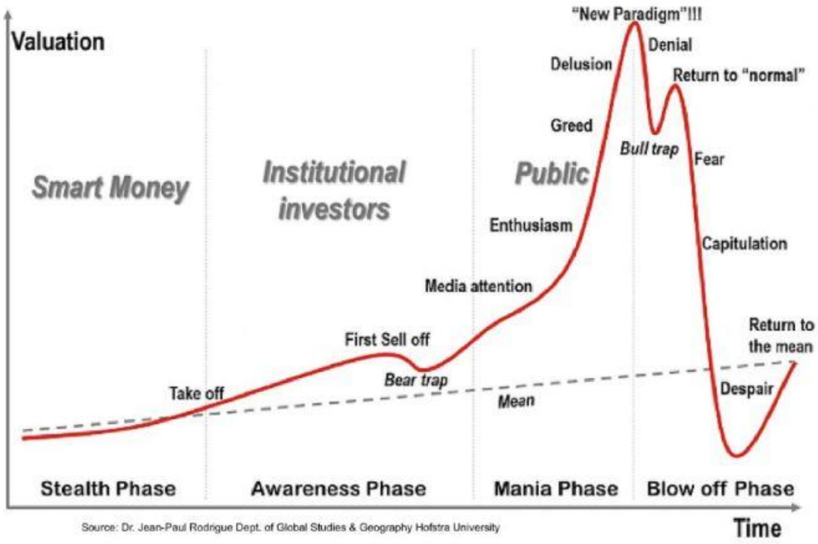


Source: IHS, Macquarie Commodities Strategy, May 2020

China buys two-thirds of its iron ore and almost half its metallurgical coal and LNG from Australia. With Brazil hard hit by COVID-19, facing more daily deaths than any other country, where else will iron ore come from for a long time? A bigger threat comes from the tension with the US and its impact on global growth, especially when one person will do all he can to use China as a political weapon until the November election.



So where are we on the investment cycle chart? Here's one version by Canadian scholar, [Jean-Paul Rodrigue](#), who shot to fame in the GFC with his 'four phases of a bubble' model, as shown below. He argues the stock market works by some smart investors picking the initial 'stealth phase' (is that happening now?), and then institutions join the buying. The media write articles about how much money others are making, FOMO kicks in and the general public drive a 'mania phase'. At some point of greed and delusion, there is a 'blow off'.



Put your own arrow on where you think we are at the moment, it's as valid an opinion as anyone's. Are we near the point labelled 'return to normal'?

That's the problem with investing, there are few absolutes. Outcomes depend on human behaviour, it's not physics or chemistry. Our first article goes back to basics with a mathematical certainty everyone can play with. There's more investing learning in a simple formula than any other lesson.

Also in this week's edition ...

Two high-profile fund managers who have run portfolios for many decades update their latest views. **Paul Moore** is a value investor who saw his style returning to popularity before COVID-19 blasted the focus back to growth companies. Then **Roger Montgomery** explains why the market has run so strongly in the face of economic headwinds, but there are limits to whether it can test the previous highs.

Many investors feel they have missed the rally, so **Emma Rapaport** delves into the Morningstar database to find 10 companies rated 4 or 5 stars but with a more predictable earnings outlook than most.

As investors look to alternatives, **Jordan Eliseo** fielded questions from SMSF trustees on gold and where it might sit in a portfolio, while **Leonie di Lorenzo** says HNW investors are moving from cash to fixed interest, tailored investments and foreign currencies.

On COVID-19, **Francis Scotland** argues time in lockdown is a major risk, and lessons from the past argue for a return to business activity, while **David Bell** describes intriguing work by two young actuaries, **Calise Liu** and **Alan Xian**, who have mapped Australia for regions vulnerable to a virus outbreak.

Finally, the long-running saga on conflicted remuneration for LICs and LITs has been addressed, but commissions can still be paid on other listed issues, which is a disappointing outcome for **Jonathan Rochford**.

This week's White Paper from **AMP Capital** switches focus from the short-term impact of COVID-19 to examine 10 longer-term implications.

The most amazing investing lesson of all

Graham Hand

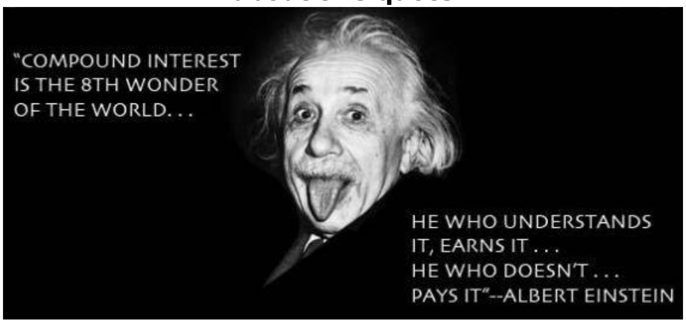
Compounding can produce astounding results. Take the Berkshire Hathaway Annual Letter that Warren Buffett writes. His latest shows a 20.3% annual compound return between 1965 and 2019. Impressive, especially versus the S&P500 return of 10%.

But here's the punchline. That 20.3% is a **2,744,062%** overall gain. Or put another way, $100 invested with Buffett for 55 years would now be worth $2.75 million.

An unwritten rule for every article about compounding is that the author must state that Albert Einstein described compound interest as "*the eighth wonder of the world*".

Trouble is, despite the internet carrying thousands of memes on the phrase, there is no evidence he ever said it. Economist Don Stammer once told me he had spent days trying to find an original and accurate source of the quote without success. Never mind, fake news, but it sounds good.

Einstein's reaction when asked for the 800th time about this quote



Although he never said it, it's true

You can see why the quote is so popular. It's the single most powerful concept to understand and experiment with to appreciate investing and long-term financial planning.

Now, I realise if I start quoting mathematical formulas, many readers will fall into two camps:

1. The 'smarties' (actuaries, I'm looking at you) who will wonder if there is any person on the planet who does not already know this. Let me remind them that 50% of people don't know what 50% means.
2. The 'impatients' who have far too much to do than think about a mathematical formula and are more interested in watching the next episode of *The Last Dance*.

So for the record, I'll squeeze a simple compounding formula here which assumes one interest payment a year. FV = P(1 + r)^n where FV is the future value, P is the current principal, r is the interest rate (expressed as a decimal such that 5% is 0.05) and n is the number of periods.

It's an elegantly simple concept. Choose any interest rate to compound any amount over any number of future periods to see how much it will be worth. An easy way to do this is to use the function on Excel to play around, as described in four minutes in this video. I promise this is an easy skill you will treasure for the rest of your life.

Let's check some results

Firstlinks recently published an article on why future returns are likely to be worse than in the past. While many superannuation fund calculators still assume a 7.5% (or 5% real) return, leading researchers now argue real returns of around 2% are more likely.

This change has profound implications for investor outcomes and behaviour.

Obviously, the higher the rate of return, the more spectacular the compounding. According to data from Shane Oliver at AMP Capital (see chart below) the return since 1926 for Australian equities is 10.9% and residential real estate 10.7%.

Table 1 below compounds returns over various periods using four real return assumptions:

- 7.5% real (or 10% nominal), an extremely optimistic outlook similar to past returns
- 5% real, which is still optimistic with rates so low
- 2.5% real, perhaps from a balanced portfolio with good exposure to growth assets
- 0% real or about 2.5% nominal, which is an optimistic assumption for anyone stuck in term deposits or cash.

The results from investing $100,000 at the start are as follows:

Table 1: Compounding at varying rates and periods, no additional investment

Real return	5 years	10 years	15 years	20 years	30 years	40 years
7.5%	$143,562.93	$206,103.16	$295,887.74	$424,785.11	$875,495.52	$1,804,423.90
5.0%	$127,628.16	$162,889.46	$207,892.82	$265,329.77	$432,194.24	$703,998.87
2.5%	$113,140.82	$128,008.45	$144,829.82	$163,861.64	$209,756.76	$268,506.38
0.0%	$100,000.00	$100,000.00	$100,000.00	$100,000.00	$100,000.00	$100,000.00

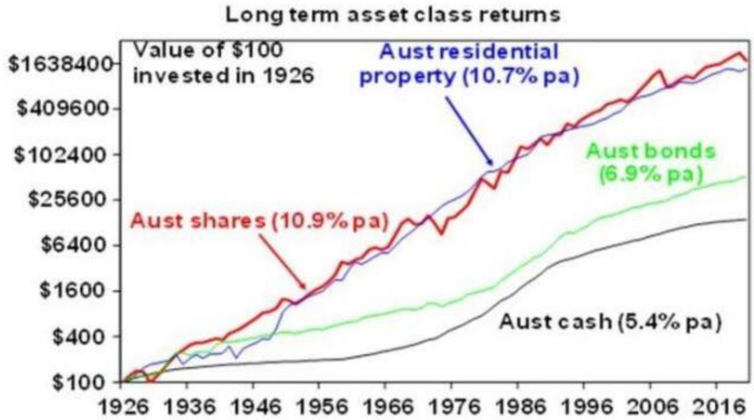
Let's focus for a moment on the shaded 5% results (assumes interest compounded at 5%):

1. At the end of five years, the principal has grown to $127,628. The extra $2,628 over the simple interest of $25,000 is interest on interest. Doesn't sound like much.
2. At the end of 10 years, principal has reached $162,889. Now there is $12,889 added to the simple interest of $50,000. Both are periods of five years, one with an extra **$2,628**, the other with **$12,889.** This is compounding, interest on interest, kicking in.
3. After 20 years, the principal reaches **$265,330**, an increase of $165,330 over the initial principal of $100,000. The increase in years 10 to 20 was $102,440, even more than the initial principal, and a big increase on the rise in the first 10 years of $62,889.
4. After 30 years, the balance has reached **$432,194** and after 40 years, the original $100,000 has reached **$704,000**, or seven times the original principal.

Even Einstein, if he had ever thought about it, would consider this a miracle.

If we use 7.5% real for 40 years, which investors from previous generations could have achieved just by buying residential property or an index fund, **$100,000** would be worth **$1.8 million**.

And for, say, a family endowment fund which is run over many generations, investing **$100** in 1926 at 10.9% grows to over **$1.6 million** over 94 years. All you need to do is live long enough and stay invested.



Sources: ABS, ASX, Bloomberg, REIA, AMP Capital

Table 2 shows how quickly the interest on interest dominates the interest on the original principal. Consider how much the value of the investments increases in each decade over a 40-year period.

Table 2: Increase in value over 10 year periods

Real return	Years 0-10	Years 10-20	Years 20-30	Years 30-40
7.5%	$106,103.16	$218,681.95	$450,710.41	$928,928.38
5.0%	$62,889.46	$102,440.31	$166,864.47	$271,804.63
2.5%	$28,008.45	$35,853.19	$45,895.11	$58,749.63
0.0%	0	0	0	0

At the heady rate of 7.5%, the final decade alone grows by nearly a million dollars.

What investing lessons do these numbers teach us?

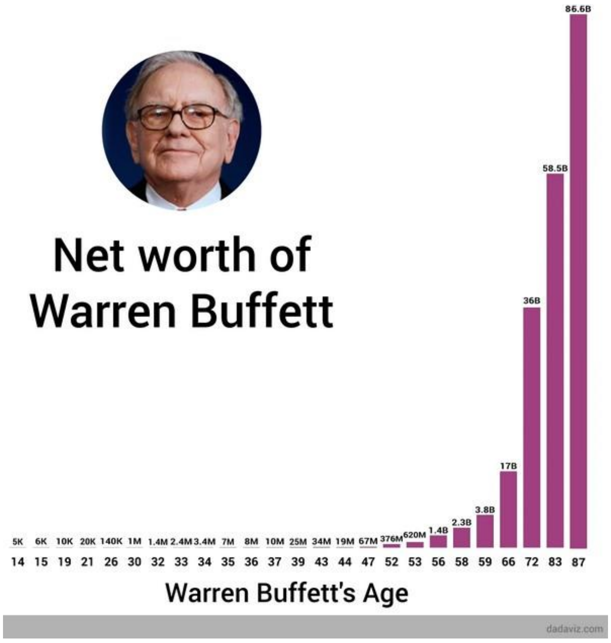
Every person is different and will aspire to varying standards of living and spending ability in retirement. Based on the ASFA Retirement Standards, a couple will need $62,435 a year for a comfortable retirement (and this assumes they also own their home and pay no rent).

For the sake of this analysis, let's say someone inherits $100,000 at the age of 25 and wants $1 million by the time they reach 65.

Now we can see the powerful lessons behind these numbers:

1. If they can achieve a 7.5% real return, they will have **$1.8 million** without saving anything else (except paying off their home and covering any tax). If $1 million is sufficient, they might retire early, reaching this amount after 32 years. As this amount is below the $1.6 million pension cap, all earnings will be tax free after age of 60 or 65. In fact, a couple can have up to $3.2 million in a tax-free pension.
2. If they earn 5% real, after 40 years they would have **$700,000**. This is still an outstanding result but to reach the $1 million, they will need to sit down with a financial adviser and decide an extra savings plan.
3. If they earn 2.5% real, at the end of 40 years, they will have only **$268,000**. The amount is falling dramatically, reaching only one-quarter of their goal. Now the couple needs a significant extra savings plan which may involve working longer.
4. If they leave their money in cash or term deposits earning the inflation rate (a circumstance facing a vast number of retirees now), then at best the purchasing power of their **$100,000** is retained. It will do little to finance a comfortable retirement.

This is a massive issue for today's investors. In the past, wealth could be accumulated over time by relying on high compounding returns. That's why many older 'average' income earners live in multi-million-dollar homes. Back on the example of Warren Buffett, the following chart estimates how much his wealth has compounded in later decades. It shows that 99% of his wealth came after the age of 50. It's not that the percentage return was better, or that Berkshire Hathaway pays him dividends, which it doesn't. It's the compounding impact. In fact, he has donated a lot of money to charities in his later years.



You don't need to be wealthy to become a millionaire. You need time and good investment performance. For example, start with nothing and invest $5,000 a year at 10% for 32 years and the amount will reach $1 million.

Low returns require a fundamental rethink. Far more of the retirement nest egg will need to come from savings over a longer period to avoid missing a lifestyle goal.

Old people with a lot of wealth are not usually brilliant investors. They are just old, and they have allowed their assets to compound over long periods in a favourable environment. On average in Australia at the moment, 60-year-old men have $270,000 in superannuation. At 5% real, assuming no tax and no money drawn out (yes, I know there are minimum drawdowns on a pension account, but it doesn't need to be spent), it will grow to $1.2 million by the age of 90. If a man dies a millionaire, don't begrudge the wealth.

The Rules of 72, 114 and 144

Of course, all this is linked to the Rule of 72. Dividing 72 by the annual rate of interest gives an estimate of how long it takes to double an investment. Put 7.2% into your Excel calculator for 10 years with $100,000 and the result is $200,400. Near enough double.

But what about the Rule of 114, which tells how long it takes for an investment to triple (at 10%, about 11 years) and the Rule of 144, when an investment quadruples (at 10%, about 14.5 years). Crucially, going from 72 to 144 does not go from double to triple: it quadruples! That's compounding.

Other implications: fees and borrowings

The impact of fees on investing is reinforced by studying compounding. An active manager must really justify their fees, not deliver index-like performance for active fees. In itself, 1% does not sound like much, but compounded over an investing lifetime the result is dramatic.

For example, $100,000 invested at 5% real for 30 years grows to $432,000. Now impose a 1% fee and earn 4%, and the final amount falls to $324,000, or $108,000 less. That's a drop of 25% for a 1% fee. Impose a 2% fee and earn only 3%, the final amount drops to $243,000, a fall of 44%.

And all this good stuff on investing works in reverse for borrowing. Remember the other side of the phrase that Einstein never said: *"He who understands it, earns it … he who doesn't, pays it."* For most people, repayment of non-tax-deductible borrowings is their best investment.

In this '***save early, save often, save for a long time***' message, the last word goes to Buffett, and it applies for most people, even those of average means.

"I always knew I was going to be rich, so I was never in a hurry."

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

What will stop the market returning to its highs?

Roger Montgomery

The worst seems to be over. Road traffic is returning, retail sales are rising, and house auction clearance rates have improved. In the US, air travel and hotel and restaurant bookings have bounced. Economies around the globe are cautiously and tentatively making the necessary steps towards recovery. Many sectors of the economy are not getting worse and some are growing quickly.

Meanwhile, markets are buoyed by optimism surrounding the reopening of commerce and the growing number of experimental vaccines under development.

Heading for a common destination

The post-pandemic news flow is so good that I am reminded of one of those trains in India, where upon every vacant centimetre there is a human desperate to travel to their intended destination. Crowded trains and crowded trades, it seems, are both part of the human need to go in the same direction.

Even as we talk of post-COVID-19 conditions, we are not yet certain the pandemic is under control. Developing and developed countries weigh the easing of lockdown restrictions even while new coronavirus infections and deaths rise. Meanwhile, the optimism about a still 'hoped-for' vaccine ignores the time it will take to manufacture billions of doses and the logistics required to disseminate it to everyone on Earth.

As borders are opened and restrictions eased, the risk of an explosive acceleration in infections, hospitalisations and deaths remains and so a measured approach to the reopening of businesses and economic activity is certain, as is the breaching of health and social distancing guidelines and requirements to keep populations safe.

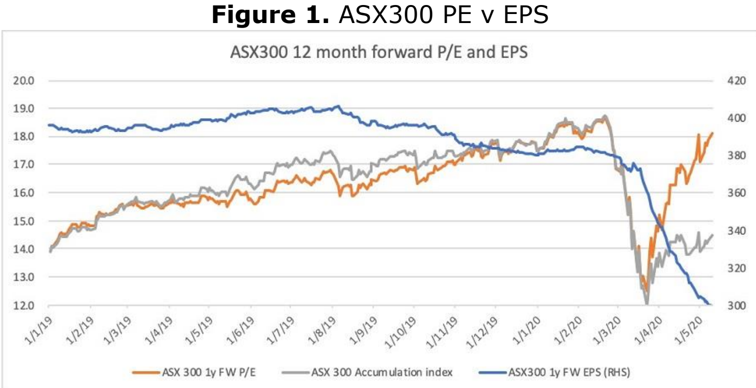
But no matter, it seems. Investment markets don't need the problems to be solved and concluded, they merely need the worst to be behind them. The recent strength in equity markets reflects an optimistic future.

Has it gone too far, too soon?

The recent rally and sustained recovery in share prices have expanded the price to earnings (PE) ratio for the ASX300 to 18 times earnings. While PE ratios aren't always a reliable gauge as to value, in aggregate they can be helpful in establishing whether sentiment is dominated by enthusiasm and optimism, or pessimism and hopelessness.

Figure 1 reveals sentiment in the Australian market is almost as optimistic as it has ever been (recalling PE ratios at the end of calendar 2019 were the highest on record).

Figure 1. ASX300 PE v EPS



Source: Andreas Lundberg at Montgomery Investment Management using Bloomberg.

Notwithstanding the fact that a multitude of companies have pulled their guidance for FY20 and FY21, consensus earnings have plunged and multiples have returned to levels seen at the peak of the prior boom. Obviously, if earnings expectations recover materially in the near future, the forward PE ratio will contract, all else being equal.

At the time of writing, the ASX small companies index is trading at 21.4 times earnings for the next 12 months and 20.9 times FY21 earnings. Consensus earnings estimates suggest aggregate earnings will exceed 2019 levels in FY22.

Signs of better company results

Supporting this view is a litany of positive updates from Australian companies.

In the automotive parts and supplies sector, Eclipx has noted that the volume of end-of-lease car sales is picking up; Bapcor is optimistic; and even Mercedes is reporting a pick-up in sales off depressed levels. Other operators are also recording a recovery in used car prices, a clear sign consumers are spending.

With consumption a significant proportion of economic activity and output, it's worth considering the recent aggregate consumption data.

Even back in March 2020, total retail sales were up 10.1% year-on-year and 8.5% higher month-on-month. The significant year-on-year jump was due to stockpiling and panic-buying of liquor (+33.9%), pharmacy items (+29.4%), and groceries (+26.7%), ahead of expected lockdowns. And anyone lining up at Bunnings for 'essential' items during the lockdown would not be surprised to also learn the Hardware category saw retail sales up nearly 18% year-on-year, while recreational goods were up 16.7%.

Retailers from Baby Bunting and Adairs to Kogan and City Chic are reporting accelerating year-to-date sales, a jump in online business (Kogan reported a more than doubling of April gross sales) and success in renegotiating cheaper leases and therefore a lowering of the cost of doing business.

Another measure of consumer activity is provided by the operators of consumer fintech solutions and platforms. Buy-now, pay-later operator Afterpay reported the online share of total retailing accelerated 10% in April, up sharply from 6% in February, while competitors Zip Pay and Flexigroup reported flat arrears and resilient volumes respectively. The UBS Consumer Survey recently indicated spending intentions are better than previously feared.

Housing, and in particular residential construction, is one area we have held concerns. The residential construction industry employs about 3.5% of the Australian workforce (representing a lot of potential retail consumers). Our channel checks had reported a near one-third drop in forward orders for new builds thanks to pressure on household incomes, contract cancellations, a forecast 30% drop in net overseas migration this financial year and an 85% fall in 2020/21. This would potentially have serious consequences for the likes of Stockland, Mirvac, Adelaide Brighton, Boral and CSR.

Most recently, however, the Prime Minister announced a package that would ensure support for the beleaguered sector.

We need to define 'recovery'

The question of course is whether optimism over a V-shaped recovery is warranted. It is true that we are witnessing a recovery from the impact of lockdowns. But what is the definition of a recovery? If recovery means a bounce from the bottom, then we are in a recovery.

But if the definition of recovery is a return to pre-crisis levels of demand, revenue and profits we are a long way off. Indeed, expectations of a rapid return to pre-crisis levels of activity look like wishful thinking.

Take restaurant bookings for example. According to Steve Hafner, the chief executive of OpenTable in the US, despite a slow and steady rise in seated-dining bookings across the US, as many as a quarter of restaurants in the US will never open their doors again.

In Australia, with unemployment a lot worse than the full-employment levels we enjoyed prior to February, restaurants can expect the same tentative recovery.

Meanwhile, the retail sector in Australia is unlikely to return, in aggregate, to the levels enjoyed previously. Retail is the second largest employer in Australia. With a plethora of household name retailers having collapsed or closing a significant number of stores (McWilliam's Wines, Flight Centre, G-Star, EB Games, Bardot, Curious

Planet, Jeanswest, Bose, Kaufland, Colette, Ishka and kikki.K) it is reasonable to expect that fewer jobs will be available for JobKeeper recipients to return to when their payments cease.

With market valuations at stretched, if not extreme, levels, the question investors must ask is whether the current buoyant recovery is more than a little fuelled by government support.

There is little doubt that it will take very little time for the economy and business activity to show a recovery from the lows, but it will take much longer to fully recover. And the time and sustainability of a recovery is very much dependent on the willingness of government to offer support. By September or October this year we will have a much better idea of the extent to which the recovery is self-sustaining. That is when many of the current support offerings by government, banks and landlords expire.

In the absence of government support, we believe household incomes would come under significant pressure by the end of the year. Combined with still record levels of household debt, it is a recipe suggesting too much optimism is currently reflected in the equity market.

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](). This article is for general information only and does not consider the circumstances of any individual.

Value is under pressure again - but its day will come

Paul Moore

Just as we believe both cyclical and secular inflection points are appearing on the horizon, market commentary is again reaching a climax in its declaration of the death of value investing. Compare the 1999 commentary on Warren Buffett to that of 2020:

"After more than 30 years of unrivalled investment success, Warren Buffett may be losing his magic touch." - Wall St Journal, 27/12/1999

"…the worst results in Berkshire's history underscore just how challenging the environment has been for [Warren Buffet's] approach to picking stocks." - Financial Times, 14/5/2020

Value continues to struggle

'Value investing' (defined as buying stocks that appear to be trading for less than their intrinsic value) has had a difficult run since the GFC. 'Value' stocks outperformed 'growth' stocks for a short time at the beginning of the 2010s, immediately subsequent to the GFC, but since then growth stocks have outperformed significantly.

Particularly from 2016 onwards, valuation has taken a back seat to the search for growth, and this has had a serious effect on what is known as value investing.

The Russell 3000 Value index (a broad measure of US value stocks) at the time of writing is down more than 20% in 2020 and since 2010 has risen 80%. On the other side of the ledger, the Russell 3000 Growth Index is up more than 240% for the decade and has bounced harder than value stocks in the post-March recovery.

Source: FT

In a benchmark like the S&P500, which is more concentrated and has larger stocks, the difference between value and growth has been even more pronounced. In the past decade the [S&P500 Value Index]() has risen

82.0%. The S&P500 Growth Index over same period has risen 223.1%, heavily influenced by investors' preference for the FAANGM tech stock complex (Facebook, Amazon, Apple, Netflix, Google and Microsoft), which accordingly now accounts for 25% of the S&P500 index compared to less than 9% in 2012.

The question remains - has there been a structural, permanent, change that will continue to favour large, growth-oriented stocks where raw valuation takes a second position, or can valuation still be a major part of the process and therefore value investing offer the potential for outperformance?

The impact of low rates

The largest factor to favour growth stocks is the historically low level of interest rates, quite possibly the lowest in 5000 years. As the level of rates has fallen, the cost of capital has fallen with it. Unlike previous cycles, the past decade has seen reserve banks around the world embark on yield curve control, otherwise known as quantitative easing, by flooding the market with liquidity and lower short-term rates. This has resulted in a wall of capital chasing the prospect of higher long-term returns offered by any company that investors perceive as having strong and consistent long-term growth potential.

Investor willingness to pay for and believe in strong or defensive long-term growth has been assisted by globalisation and the lack of national 'virtual' barriers (as opposed to physical national borders), benefitting large global-sized entities such as the FAANGM stocks. They, in their turn, have also benefited from technological improvements that have made the ability to order goods and services online seamless, as well as delivering advertising dollars. Their advertising capability is now to the point where the only media that can challenge the behemoths of Google and Facebook is free-to-air television advertising, and even that is now under attack from the likes of Google's 'in-clip' direct response ads on YouTube.

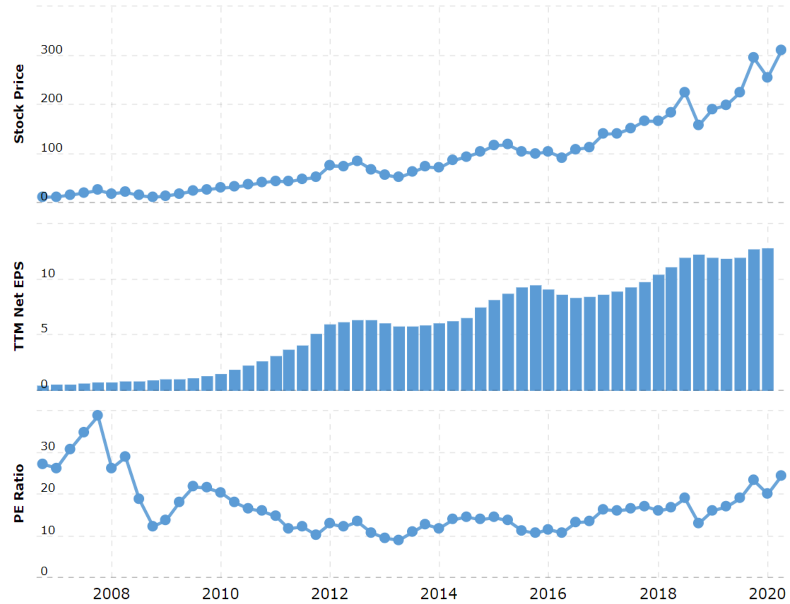
While growth companies like Google and Visa have justifiably higher PE ratios given their growth trajectory, companies like Kimberly Clark that are perceived as defensive growth companies have also been bid up. This kind of stock would have traditionally been seen as more of a value play, but even its share price in the period 2009-18 rose 87%, while its operating income was flat (0% growth per annum).

The popularity of market capital-weighted index funds has also accentuated the growth of these large growth stocks, as seen in the performance of the Russell Value Index versus the S&P500 equivalent. The index funds have accentuated the moves of the big stocks, making them more resilient to what have been, on the surface, significant increases in valuations (noting, however, that active managers have not done themselves any favours in this regard. Scared of being left behind in their peer ranking tables, many have jumped on the bandwagon notwithstanding valuations).

Apple also highlights the expansion in PE ratios. In the post-GFC environment its stock has moved from ~US$10/share (2008) to now be trading at over US$300 at the time of writing. Its earnings per share have risen also in that time, but nowhere near to the same extent. The market has moved to pay over 23 times historical earnings, whereas in 2016 it was closer to 10 times.

However, where can interest rates go from here? Bond yields are already at or below zero in many parts of the world. Implied yields on futures contracts linked to the federal funds rate have gone below zero, suggesting investors are betting that the Fed will cut its key rate below that by mid-2021, but the Fed's chairman, Jerome Powell, has said that negative rates are not an "appropriate policy response".

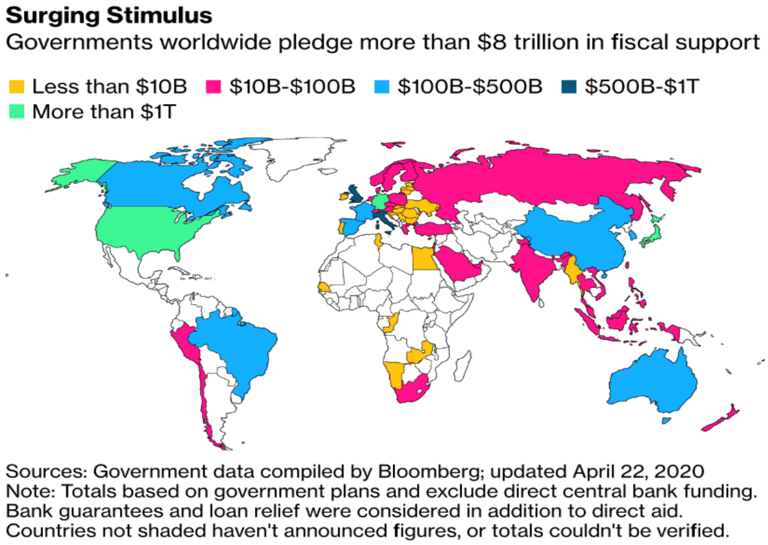
APPLE



Source: macrotrends.net

US$8 trillion of stimulus and counting

Fiscal stimulus to fight coronavirus is also at levels never seen before. Bloomberg estimates that over $8 trillion has and will be spent in a very short space of time globally propping up economies using a range of measures, including direct spending and bank guarantees.



How are we going to pay for all the fiscal stimulus? After the coronavirus has been tamed, taxes are going to go up but I doubt anyone has the stomach for real austerity. The reality is that apart from default, the only palatable option to deal with how we pay for the fiscal stimulus is inflation.

However, once the inflation genie is out of the bottle, if it pushes through reserve bank target levels, interest rates will be forced higher, resulting in at least a partial unwinding of the positive effects that lower interest rates have had on growth stocks over the past five years (in particular).

This is why I have been very strong in arguing that when we look out over the longer term, investors need to be thinking about businesses that will not be hurt by the evolution of inflation. This argument has obviously been affected by coronavirus, but my longer-term belief remains intact.

Everyone is jumping aboard the rally — for now

In December we saw European countries begin to understand that negative rates were not assisting economic growth, the US economy move into a stronger growth phase and signs of a rotation towards value stocks. In our portfolio's case, banks, resources companies and stocks on low valuations such as Siemens moved forward strongly — gains that were carried into January 2020.

Of course, this was pre-coronavirus, which stopped this trend dead and re-ignited the search for any kind of semi-reliable growth by anyone that feels overall expansion will be moribund in the next 12 months.

The market is always 'right' — at that particular point in time. We can only go from where we are now. What is going to be key is the ability to ignore the crowd and the hot stocks because at the moment the market is like a yacht listing to one side. Everyone has clambered on, and, for the moment, it continues to sail, but at some point the yacht will right itself.

It is just a matter of time.

What is clear to me is that when you look at valuation, it would appear to be a once-in-a-lifetime opportunity in quality cyclical and industrial stocks with the upside return possibility equal to or greater than what I saw post-GFC with the market in general.

We feel the pandemic has not simply delayed our thesis, but the fiscal and monetary actions will have the effect of essentially making the thesis inevitable. The unknown factor is the timing. In the short-term, behavioural biases have not declined, and their effects will be exaggerated by the weight of the index funds. This is why it is so important to have a longer time horizon so as to let the thesis play out to its full extent and in doing so profit from it.

What I also see is that when they were last calling the death of Buffett's value-style of investing in 1999, in the 10 years subsequent (starting in the year 2000) Berkshire Hathaway's book value per share rose a cumulative 87.8%, compared to the S&P500's cumulative 12.2%.

While stocks that are called 'value' may have been on the nose for longer than average, the rationale for valuation-based investing is as strong as ever.

Paul Moore is Chairman and Chief Investment Officer of PM Capital. He is the Portfolio Manager of the PM Capital Global Companies Fund and the PM Capital Global Opportunities Fund (ASX:PGF). This article is general information and does not consider the circumstances of any investor.

10 undervalued stocks if you're worried about volatility

Emma Rapaport

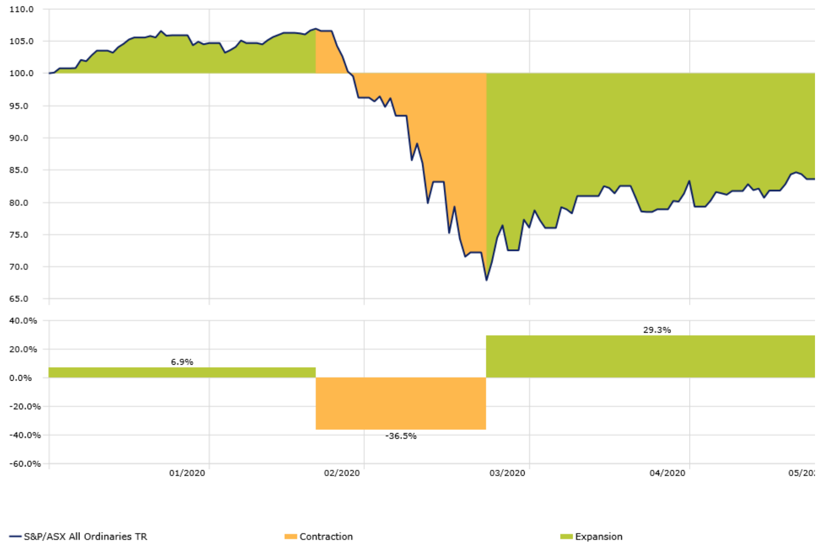
April 2020 was a month of recovery. The All Ordinaries Index enjoyed a strong monthly gain after COVID-19 struck the market in February, rallying 9.5%. This represented the best monthly performance on record since March 1988, and so far, it has continued in May.

The All Ords has now risen almost 30% since its March 23 nadir, leaving it just 16% down from its February 24 peak. The 5% plus rally in two days earlier this week showed a lot of confidence among investors.

However, the economic outlook remains uncertain and analysts are urging caution. April job figures showed the extent of the damage to the economy. The unemployment rate jumped to a seasonally-adjusted 6.2% but it was limited by an 'unprecedented' drop in the participation rate to 63.5%.

This means that of the 594,300 people that left employment, only 18% of these people become unemployed - that is, actively searching for work and applying for jobs - with 80% of people leaving the labour force.

Investment growth | S&P/ASX All Ordinaries TR, YTD



Source: Morningstar Direct. Define drawdown as decline by 10% or more. Time Period: 2/01/2020 to 26/05/2020

In this environment, it's difficult to predict companies' future earnings and cash flows with any kind of certainty. Many are throwing their guidance out the window, slashing dividend payouts, or rushing to secure additional equity or debt to shore up their balance sheets.

Companies offering value and lower uncertainty

Morningstar analysts say there are almost 100 companies currently trading below their intrinsic value. However, only a handful of those have carved out solid (and in some cases growing) competitive advantages that will allow them to thrive for many years with low or medium fair value uncertainty ratings - meaning companies analysts feel they can estimate future cash flows with a higher degree of confidence.

These include stock transfer company Computershare (ASX:CPU), superannuation administration services provider Link Administration Holdings (ASX:LNK) and funeral home operator InvoCare Ltd (ASX:IVC).

To find stocks to fit the bill, we screened for the following:

Economic moat: First, they need to boast wide Morningstar Economic Moat Ratings - and their Morningstar Moat Trend Ratings must be stable or positive. In other words, these companies have competitive positions that are steady or even improving.

Discounted: Second, the stocks of these companies must be trading at a decent discount to our fair value estimates - selling at Morningstar Ratings of 4 or 5 stars.

Fair value certainty: Third, we need to have a high degree of certainty in our fair value estimates for the stocks of these companies, limiting our search to stocks with fair value uncertainties of medium or low. This rating represents the predictability of a company's future cash flows.

Top notch steward: Finally, we tossed out companies with Poor stewardship ratings, preferring to ride along with management teams that have a proven record of being good stewards of investor capital.

Don't think of this as a list of 'buys', though. Instead, think of it as a collection of names to investigate further. Morningstar Premium members can see the individual stock pages for full analysis. Morningstar Director of Equity Research, Johannes Faul, says:

"A 5-star rating does not suggest that the stocks won't drop further. Our aim is not to pick the bottom, but to highlight to investors that they can pick names up at a discount."

Quality stocks trading at a discount

This is a snapshot of how these stocks stand at the time of writing on 26 May 2020. Given the current market volatility, the valuations could jump around.

Name	Ticker	Industry	Economic Moat	Fair Value Uncertainty	Stock Stewardship Rating	Price / Fair Value 26-05-2020
Link Administration Holdings	LNK	Information Technology Services	Narrow	Medium	Standard	0.53
Adbri (formerly Adelaide Brighton)	ABC	Building Materials	Narrow	Medium	Standard	0.65
Telstra Corp	TLS	Telecom Services	Narrow	Medium	Standard	0.73
InvoCare	IVC	Personal Services	Wide	Medium	Standard	0.73
Computershare	CPU	Information Technology Services	Narrow	Medium	Standard	0.79
Bingo Industries	BIN	Waste Management	Narrow	Medium	Standard	0.81
Bapcor	BAP	Specialty Retail	Narrow	Medium	Standard	0.83
AGL Energy	AGL	Utilities - Renewable	Narrow	Medium	Standard	0.84
Tabcorp Holdings	TAH	Gambling	Narrow	Medium	Standard	0.85
Auckland International Airport	AIA	Airports & Air Services	Wide	Medium	Standard	0.91

Source: Morningstar Direct

Morningstar Premium subscribers can access the full list of undervalued Australian stocks here. The latest Australian and New Zealand Best Stock Ideas list can be found here.

A free trial is available on the link below, including access to the portfolio management service, Sharesight, and a series of eight webinars that Morningstar will run during June 2020.

Emma Rapaport is an Editor for Morningstar.com.au

6 questions SMSF trustees are asking about gold

Jordan Eliseo

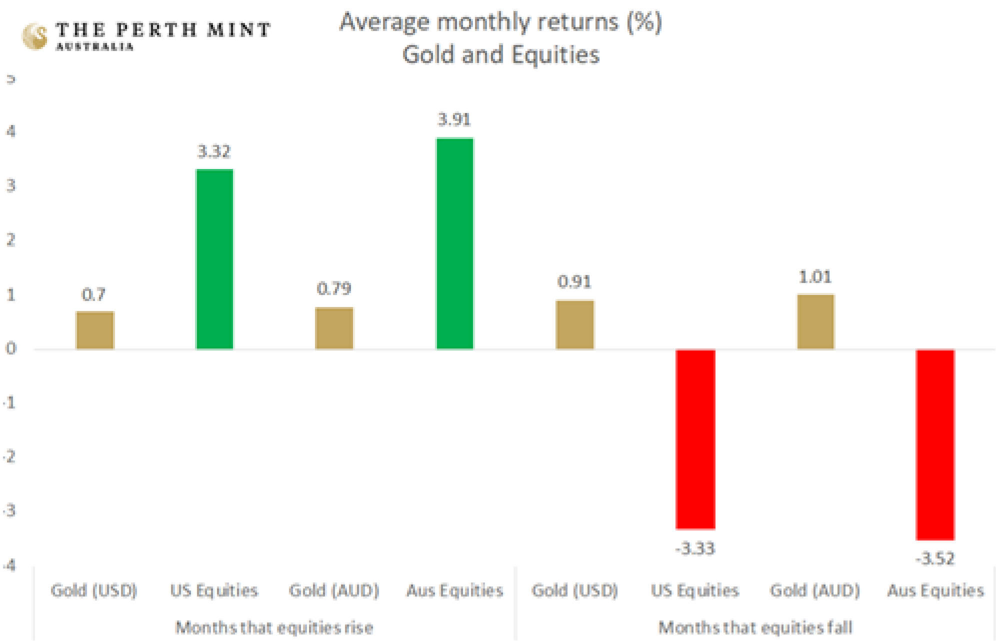
Recently the Australian Shareholders Association (ASA) invited The Perth Mint to host a webinar for ASA members entitled '*Gold - Where to next?'.* The webinar looked at recent performance trends in gold, the outlook for investment demand, the potential short-term headwinds and tailwinds driving the gold price, and the key reasons investors, including SMSF trustees, are including a gold allocation in their portfolios.

During the course of the webinar, we asked trustees two questions relating to the outlook for investment markets.

In the **first** question on the potential for further equity market volatility, more than 90% of respondents stated they were concerned.

This is relevant for future gold demand, as market data from 1971 to 2019 reveals that gold has typically been the highest-performing asset in the months, quarters and years that equities suffered declines in value. It also happens to be positively correlated to rising equity markets.

The chart below shows the average returns for gold and equities in the months where equities rise, and the months where equities fall (1971-2019).



Source: The Perth Mint, Reuters

In the **second** question on the current cash rate of 0.25% and the outlook for rates with Australian 10-year government bond yields below 1%, more than 60% stated that this was a concern.

The anxiety regarding low interest rates will likely help drive gold demand in the future. Market history tells us that gold has been an outperformer in periods of low real interest rates, delivering annual average gains of more than 20% in nominal terms between 1971 and 2019 in the years when real interest rates were 2% or less.

Here are some of the questions from the webinar.

1. Is gold supply growing faster than demand?

Over the 10 years to the end of 2019, gold demand averaged just over 4,400 tonnes. Gold mine production averaged just over 3,200 tonnes over the same period — so gold mine supply is not outstripping demand.

While gold production changes each year (it rose by 24% between 2010 and 2019), this newly-mined gold is only a small fraction of the existing stockpile.

This stockpile has been built over thousands of years as humans have found gold, mined gold, refined gold, and then either worn it as a display of wealth or held it (in the form of bars or coins) as an investment.

The table illustrates the small impact annual mine production has on the total gold stock. It shows the total above-ground gold stock on a yearly basis over the last decade and the percentage increase in the total gold stock on a yearly basis over this time.

The total supply of gold increases at a stable rate over time. Given that the price of any asset is determined by its supply and its demand, this understanding of gold's stable total supply should make it clear to investors that the gold price is almost exclusively demand-driven.

Year	Total Above Ground Gold Stock (tonnes)	Change in Total Above Ground Gold Stock (%)
2009	165,554.85	
2010	168,348.49	1.69%
2011	171,205.93	1.70%
2012	174,135.02	1.71%
2013	177,245.37	1.79%
2014	180,448.31	1.81%
2015	183,749.01	1.83%
2016	187,147.48	1.85%
2017	190,602.67	1.85%
2018	194,111.99	1.84%
2019	197,575.66	1.78%

Source: The Perth Mint, World Gold Council

2. How much gold should your portfolio hold?

As with all asset classes, the size of any allocation is a personal decision. This is affected by multiple factors including age, employment status, income requirements, existing asset allocation and tolerance for short-term volatility.

Some investors will have zero allocation. Others, including diversified managed funds, will have up to 25% of their portfolio in gold. Investors with allocations of this size view the metal as an essential element of a portfolio, due to the fact gold has delivered strong returns over the long-term, acts as a diversifier in a portfolio, and can hedge inflation risk.

While the Perth Mint can't provide financial advice, many of our SMSF trustee customers allocate between 5% and 10% of their portfolio to precious metals.

3. How should investors buy gold, and what are the storage costs?

Much like equity investors have multiple vehicles through which they can gain their exposure (direct shares, managed funds, ETFs or LICs for example), there is no one-size-fits-all approach to investing in gold.

Physical bars and coins are the traditional method, and remain popular, especially for those who like to feel tangible wealth in their hands. These products typically come with higher trading fees due to the fabrication costs of manufacturing them.

Some SMSF trustees use a Perth Mint depository account, which allows trading any time of the day or night and also includes custody. Trading costs are typically 0.95% for trades between $10,000 and $100,000, and this fee declines for higher value trading.

Storage costs for depository accounts are 1% per annum for allocated bars (those bars you have direct legal title to). Unallocated gold, where you don't own the title to a specific bar but a portion of the physical gold held by The Perth Mint, has no associated storage costs.

The third option is an exchange traded product. There are three ASX-listed gold products, including Perth Mint Gold (ASX:PMGOLD).

4. Why hasn't silver performed as well as gold recently?

While gold is often considered a safe-haven asset and monetary commodity, silver is seen as a quasi-industrial commodity. Almost 60% of the demand for silver comes from industrial use including photography and silverware.

As such, silver often tends to sell off during periods of heightened concern about global growth. The economic fallout from coronavirus saw the Goldman Sachs Commodity Index fall 40% in the first three months of 2020. As part of this, the price of silver dropped 20% over the same period.

5. Should Australian investors invest in gold hedged in US dollars rather than unhedged in local currency?

Investing in gold unhedged in Australian currency gives investors exposure to two factors:

1. the movement in the US-dollar gold price, and
2. the movement in the Australian-to-US dollar foreign exchange rate.

This introduces another risk factor for Australian investors, but also adds a potential source of return. Any fall in the Australia dollar relative to the US dollar will boost the local price of gold.

Many Australian investors are happy to have their exposure to gold unhedged in local currency. This is because they see it as currency diversification for their overall wealth, and typically earn their income in Australian currency and have exposure to Australian real estate, shares and cash in their portfolio.

Ultimately though, this is an individual choice.

6. Are gold miners a better investment than gold?

Just like buying shares in Australia's big banks is not the same as buying an investment property (even though the majority of bank lending is directed toward residential property), gold and gold miners are different investments.

Physical gold is an exceptionally liquid asset (turnover in the gold market is typically more than US$150 billion per day), has zero credit risk, and has a long track record of protecting wealth in periods where equity markets sell off. However, gold does not provide an income stream.

Gold miners on the other hand can pay dividends, and can see their profits grow substantially in periods of rising gold prices, depending on a handful of factors including their ability to:

1. maintain or grow production.
2. maintain or grow the margins they make on their production.

Movements in gold mining company share prices are typically more volatile than movements in the gold price itself.

The market tends to treat gold as a defensive asset, while gold equities are typically considered to be growth assets. Gold companies fit within the equity component of a portfolio, due to the higher risk and higher return characteristics they typically display.

Jordan Eliseo is a Senior Investment Manager at The Perth Mint, a sponsor of Firstlinks. The information in this article is for general information only and should not be taken as constituting professional advice from The Perth Mint. The Perth Mint is not a financial adviser. You should consider seeking independent financial advice to check how the information in this article relates to your unique circumstances.

For more articles and papers from The Perth Mint, click here. The Perth Mint offers a gold Exchange Traded Product (ASX:PMGOLD) which has a management fee of 0.15%.

LIC fees banned but other doors remain open

Graham Hand, Jonathan Rochford

This article includes a summary by Graham Hand, and an opinion piece by Jonathan Rochford. We both made submissions to Treasury's review of the commissions policy which will be publicly released soon.

Treasury and the Coalition Government have finally banned commissions paid to brokers and advisers on Listed Investment Companies (LICs) and Listed Investment Trusts (LITs), bringing an end to a strange exemption granted in 2014.

Firstlinks has published extensively on the issue of conflicted remuneration on LICs and LITs, such as:
Fixed interest LIT carnage makes stamping fees worse and
Regulator reveals disquiet over LIC fees

In brief, the Future of Financial Advice (FoFA) laws introduced in 2012 prevented advisers from receiving a commission from product manufacturers such as fund managers for placing clients into products, particlarly managed funds and ETFs. However, under lobbying pressure, in 2014, the Coalition granted an exemption for LICs and LITs, which allowed fund managers to pay advisers and brokers a 'stamping fee'.

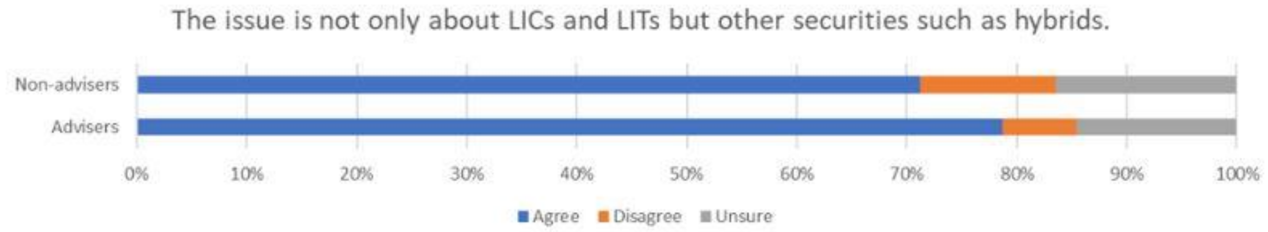
It was a primary driver of success for many fund managers who would otherwise struggle to attract large amounts from retail investors. The poor consequence came to a head in 2019 and 2020 when many transactions performed poorly, most trading at significant discounts to their net tangible asset (NTA) value. At one stage, as calculated in the first article above, losses on eight LITs totalled over $1 billion.

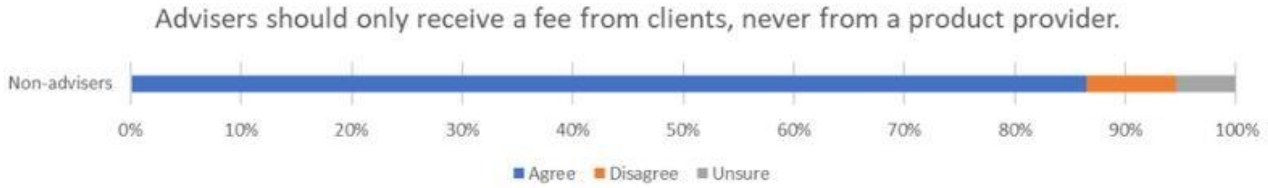
Last week, when Treasurer Josh Frydenberg announced the ban on conflicted remuneration for LICs and LITs, he left the door open on transactions in the 'real' economy. It's a somewhat arbitrary distinction which allows commissions to be paid on transactions such as hybrids and property trusts (A-REITs). The announcement said:

"Extending the ban on conflicted remuneration to LICs will address risks associated with the potential mis-selling of these products to retail consumers, improve competitive neutrality in the funds management industry and provide long term certainty so that this segment of Australia's capital markets can continue to operate effectively and provide investors with opportunities to diversify their investments.

The treatment of equity and debt securities in trading companies (including hybrids), real estate investment trusts (REITs), and listed infrastructure investments will not be impacted by these changes. Maintaining the *existing treatment for these investments is designed to ensure that direct capital raising activities which support the economic activity of companies in the real economy are not impacted by these changes. Persons providing personal advice to a retail client in relation to these products will continue to be legally required to act in that client's best interests."*

Firstlinks conducted a Reader Survey in February 2020 on this issue, which we have been told was influential in Treasury's final decision. However, our readers generally thought the ban should extend beyond the limited carve out announced, and that advisers should not receive any payments from product manufacturers:





Repeating what I wrote in this article:

"With a LIC or LIT, the fund manager can accept every dollar offered and then simply buy more assets. There is an enormous incentive to 'back up the truck', as L1 Capital did with its $1.3 billion raise and KKR did with its $925 million issue. Both then struggled in the secondary market under the weight of supply and traded at discounts to NTA.

Yet financial advisers and brokers put $2.2 billion into these two issues, readily accepting the stamping fees, even after the originally-advised minimum transaction amounts were massively exceeded, with the inevitable oversupply issues.

How can an advice licensee assessing whether an adviser's action was motivated by the selling fee argue that a LIC or LIT that trades at a discount is in the best interests of the client?"

Neither L1 Capital nor KKR was a retail name, and there are plenty of unlisted bond funds which are far better known and longer established in Australia that do not receive much adviser or broker support. While most advisers did the right thing, some issuers, brokers and advisers only have themselves to blame for losing the commissions as they over-egged the pudding.

Graham Hand is Managing Editor of Firstlinks.

The Federal Government tacitly approves conflicted financial advice

Jonathan Rochford

The announcement by Josh Frydenberg that commissions for selling listed investment funds (commonly LICs or LITs) will be banned is being spun as a win for consumers seeking independent financial advice. Whilst that is superficially true, this is yet another case of vested interests in the financial industry being prioritised over consumers. The Federal Government has deliberately chosen to ignore the obvious conflict created by commissions being paid to advisers who sell debt, hybrid and equity securities to their clients. Despite these commissions being known to distort investments decisions, the Federal Government has given clear approval for these commissions to continue.

ASIC advised a broader ban

The debate over commissions has raged for many years, with the Federal Government previously ignoring department advice to ban all conflicted remuneration. The flurry of new debt- and equity-focussed listed vehicles in recent years has antagonised many, who rightly pointed out that without commissions these vehicles either wouldn't have existed or would have raised far less. This created an imbalance where some listed funds paid commissions to raise capital, whilst unlisted funds didn't. Clearly something had to be done.

In January, the Federal Government called for a rapid consultation with submissions requested. I made a submission and all submissions should be available for review soon. It is unclear what happened after this, as I and those I know did not receive any meaningful correspondence seeking further information. The unwillingness to talk through the issues with those holding different opinions and making different suggestions was not a good sign.

A wide consultation on confliction remuneration was necessary as the rorts had taken hold long before the wave of listed funds started. A small minority of advisers has long implemented a portfolio churning strategy with hybrids, always buying the new securities to replace existing holdings. This earns the adviser a regular stream of additional income, but the new hybrid often isn't the best investment available. Older hybrids sometimes offer a better margin or shorter term, which an unconflicted adviser would choose.

Similar experiences with corporate bonds

Similarly, advisers who purchased Axsesstoday or Virgin Australia debt securities for their clients have almost certainly caused their clients to suffer substantial losses. If bought at issue and held to default, the losses are expected to be more than 50 times the usual commission paid to advisors. It would be naive to think the same behaviours seen with debt and hybrid securities aren't occurring with equity securities.

The Treasurer's announcement leaves unanswered many questions those focussed on the best interests of consumers are still asking including;

- Why are conflicted commissions still allowed on debt, hybrid, REIT and equity raisings?
- Does the Federal Government think that the minority of advisers that were improperly influenced to sell listed funds won't switch to selling other commission-linked products?
- What clear warnings will be required when brokers or advisers are spruiking commission-linked securities to their clients?
- Why are commissions required to sell listed securities when the unlisted bond market doesn't require these?
- Doesn't the fact that a commission is required to sell a product indicate that it is lacking sufficient features to be attractive on a standalone basis?

Footnote: in giving a brickbat to the Federal Government for poor consultation processes it would be unfair to not give a bouquet to a recent example of excellent process. In developing initiatives to support competition in lending from the securitisation sector, the politicians and public servants involved have conducted open consultations that deliberately sought out a broad spectrum of industry feedback. This is to be commended, particularly the work of the AOFM in very trying times.

Jonathan Rochford, CFA, is Portfolio Manager for Narrow Road Capital. This article is for educational purposes and is not a substitute for professional and tailored financial advice. This article expresses the views of the author at a point in time, which may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views.

Is it the end of cash for SMSFs?

Leonie di Lorenzo

Falling SMSF cash balances over the past five years are tipped to accelerate on the back of new COVID-19 challenges, as interest rates look set to stay lower for longer. These interest rate declines dominated the headlines for SMSFs during 2018 and 2019, as many trustees reconsidered their investment strategies. The average SMSF reduced its cash balance by 6% in the five years prior, according to the September 2019 data from the Australian Tax office. SMSFs are certainly looking for alternatives.

Challenges for SMSF portfolios

Then came COVID-19 and its associated challenges, including falling share dividends and uncertain property and rental markets. This has placed further strain on SMSF cash flows and is expected to lead to a wave of diversification as trustees seek to prop up reduced cash flows.

In the recent company reporting season, SMSFs were hard hit by announcements from Australia's big four banks that dividends were being reduced or suspended – a move that is expected to be mirrored in other key industries including airlines, hospitality and tourism.

Historically, the strong dividend programs of Australia's blue-chip companies have proved lucrative for SMSFs, reducing the incentive to consider other investment avenues. Unfortunately, it has also led to portfolios being too concentrated and subject to shock from unforeseen events.

Continued market volatility coupled with the flow-on effects of COVID-19 and rock bottom interest rates has Australia's wealthiest SMSF investors actively seeking opportunities outside of the traditional asset classes.

When savvy SMSF investors consider how they want their portfolio to perform, they don't just think about returns. A key consideration is the ability to be able to withstand unexpected market events.

Why are SMSF investors turning to fixed income?

We have noticed an increase in SMSFs wanting to lock in returns and reduce risk. These factors are driving a renewed focus on income options like corporate bonds and tailored investments, which offer investors access to equities in a structure that can reduce risk, and which provide an agreed rate of income upfront.

During the first quarter of 2020, we saw a 44% year-on-year increase in bond transactions and a 73% increase in tailored investment transactions.

(Tailored investments are also known as structured products, as they typically pair a bond and a share or basket of shares to form an income-bearing product with exposure to equity markets).

SMSFs have traditionally been underweight in fixed income, although it tends to be more resilient during times of market volatility. Adding fixed income to an equity portfolio can reduce the unpredictability in portfolio returns without overly hindering performance.

It is also a source of reliable income, because interest payments are guaranteed by the issuer and paid regularly – assuming the company doesn't default. Our clients focus on investment grade local and global companies, with strong balance sheets and a track record of performance and risk management.

Foreign currency and risk management

Another key trend we have observed is a significant increase in foreign exchange transactions, up 77% in the first-quarter 2020 versus the same period last year.

This foreign exchange movement has primarily been into US dollars, for the following reasons:

- to take advantage of the currency's safe haven status,
- a belief that the recent Australian dollar rally may not be sustained as long as uncertainty remains the norm.

For SMSFs, investing outside of Australian-denominated assets has not been a widely-utilised strategy. However, investors who hold positions in foreign currency are able to access a wider range of hedging and diversification opportunities.

The simple message to diversify is not a new one, but it is one that has not sunk in for thousands of trustees within the SMSF space due to the appealing lure of equities and dividends.

While COVID-19 presents many challenges, one positive may be that it encourages SMSF investors to look to new investment strategies and investigate the benefits of diversification across asset classes.

Leonie di Lorenzo is an SMSF specialist at Citi Australia, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual.

For other articles by Citi, see here.

Depression or recovery? The risk of time

Francis A. Scotland

Policymakers are beginning to worry about a depression. In a recent CNBC interview, St. Louis Federal Reserve President James Bullard put it bluntly:

"The shutdown can't go on forever because if it does … you risk getting into a financial crisis or even a depression … and if you get into that I think even health outcomes would be way worse."

There are no easy decisions for policymakers and politicians, particularly with public opinion so polarised on the policy choices.

Time is the biggest economic risk

Bullard's comment clarifies that the biggest *economic* risk is time. The economy will not breathe again before the lockdowns are phased out. What mattered most during the Great Depression and does again today is the *duration* of the contraction in incomes and spending. The hit to current economic activity has been so fast and deep that the longer it stays below normal, the greater the potential for irreversible deflationary feedback effects.

Personally, I agree with Bullard and think that a calculated unwind of the lockdowns is the right thing to do.

From 1929 to 1933, the unemployment rate surged to 25% while real gross domestic product (GDP) fell 26%, based on annual data, or roughly 10% on average a year. The Congressional Budget Office expects real GDP to drop by as much as 10% in the current quarter alone. Bullard's staff projected in March that the pandemic's unemployment rate might rise above levels of the 1930s. However, the data are biased by the sharp drop in the participation rate and by government programmes aimed at encouraging businesses to sustain employment.

What many omit in their comparisons of current events with the 1930s is the behaviour of prices. Deflation was systemic in the 1930s; most assume that will not be the case currently. That is also what most thought about real estate in 2007 just before the biggest bust in 80 years.

It's worth noting that:

- In the early years of the Great Depression, the GDP deflator fell roughly 20%, contributing nearly half of the 45% contraction in nominal GDP that took place. There are plenty of theories about why this drop in price levels happened, but macro policy did not help. The dollar was handcuffed to the gold standard, and Treasury Secretary Andrew Mellon famously advised President Hoover to allow the liquidation to run.
- The deflation stopped in 1933-1934 after FDR revalued the dollar against the gold standard, the 1930s version of quantitative easing. By then, it was too late. A massive hole in nominal incomes and spending had been created relative to the economy's nominal potential.
- The level of real GDP rebounded briskly at a 10% annualised growth pace and returned to 1929 levels by 1936. But *nominal* GDP took seven years, close to a 9% annualised growth rate, and the start of a war before it returned to 1929 levels. It took even longer, until the end of the war, for both the GDP price deflator and the unemployment rate to fully renormalise.

The destruction of wealth and the toll on human suffering from the Great Depression is well documented. What is not as widely discussed or agreed upon is the lingering influence of falling price levels. Deflation inflicts irreversible economic damage by depressing nominal incomes and spending, which in turn triggers systemic liquidation. Sustained illiquidity turns into insolvency: unemployment surges, wages retreat, and nominal spending stays below its high-water mark for years.

There was a whiff of liquidation during March 2020. But Treasury Secretary Mnuchin is no Mellon and President Trump is no Hoover. The Federal Reserve fully comprehends the policy blunders of the Great Depression and has intervened aggressively, so far. Policymakers in many countries around the world have adopted similar measures.

For the time being, the macro policy measures have been enough to fend off the signs of systemic deflation, but barely. Breakeven inflation rates are off their bottoms but below levels that prevailed before investment sentiment cratered in February. The dollar has retreated from its March surge but is still firm. Corporate bond spreads have retreated to levels more normally associated with recession. US stocks have rallied but on narrow breadth. The macro policy measures have been epic, but defensive.

Bankruptcies and disappearing jobs

Bullard's comments coincide with a more general shift in policy sentiment toward reopening. The catalyst for the shift is the wreckage unfolding in the economy. Get ready. The free fall in employment offers a glimpse of what is coming: a gusher of bankruptcies and potentially permanent job losses. These data are no surprise but still shocking, which explains why various states are relaxing restrictions.

What will determine the beginning of the coming recovery is timing the end of the lockdowns and gauging when people feel safe. That is partly a bet on winning the war against this disease, which seems inevitable. The entire world is in this fight and the firepower is incredible. It is only a question of time.

But time is the crucial factor that the economy does not have. Waiting for a vaccine therapy with all its attendant uncertainties is not a practical course of action, at least for the next year or so.

How does it all play out?

Abraham Lincoln reportedly once said, *"I am an optimist because I don't see the point in being anything else."* That is probably my perspective at the moment as well.

The depression tail risk grows bigger the longer the economy is kept in its public health-induced coma. Policymakers seem to be realising this trade-off quickly. What is the point of erring on the side of too long a lockdown if the risks attached to that strategy are the same or worse than a pivot back to reopening?

Time is of the essence. The restrictions need to end in days and weeks, not months, for the chance of a meaningful rebound in the second half of this year.

I think there is a good case for a faster-than-expected recovery in the latter half of the year - *if the lockdowns phase out rapidly* and even if scientists do not immediately find a silver bullet for the disease.

That may seem like woolly-headed optimism given the high risk of a resurgence in the disease, which seems the norm for pandemics.

But cabin fever is beginning to overwhelm virus fear. People want out. They want to reconnect with family and friends. Fear is starting to shift to a more practical focus on figuring out how to live with this disease and minimise the personal risks of infection as we strive for a return to some semblance of normalcy.

I do not know what the specific solutions will be. But a sustainable policy for coexisting with this disease, in addition to the obvious response of disciplined hygiene, probably includes:

- widespread testing and monitoring
- follow-up tracing
- technology
- better data and understanding.

It is always easier to see the challenges and risks while underestimating ingenuity and positive possibilities. I suspect that will be the case this time, too.

Francis A. Scotland is a Director of Global Macro Research at Brandywine Global, an independent affiliate of Legg Mason. This document is issued by Legg Mason Asset Management Australia Limited (ABN 76 004 835 839, AFSL 204827), a sponsor of Firstlinks. The information in this article is of a general nature only. It has not been prepared to take into account the investment objectives, financial objectives or particular needs of any particular person. Forecasts are inherently limited and should not be relied upon as indicators of actual or future performance.

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COVID Susceptibility Index can help to manage outbreaks

David Bell

Background: At a recent UNSW virtual research seminar, Calise Liu and Alan Xian presented their research on developing a COVID-19 Susceptibility Index. This interview explores the research and its potential applications. Calise works at Finity Consulting, which specialises in actuarial and strategic analytics consulting. Alan has nearly finished his PhD at UNSW and will start a role at Macquarie University later this year.

David: With your actuarial backgrounds, what motivated you to get involved in COVID-19 research, which to many is the domain of medical researchers?

Calise: Once you have data (and there is a lot of data available), many of the skills required to analyse that data are universal. We had read a lot of medical literature but hadn’t seen the translation of those results to the Australian population. Actuaries are particularly well-placed because we have expertise in modelling large demographic data sets. Of course, we are not medical experts and so we made sure to get specialist medical input. We held discussions with six medical experts on the design aspects of our research.

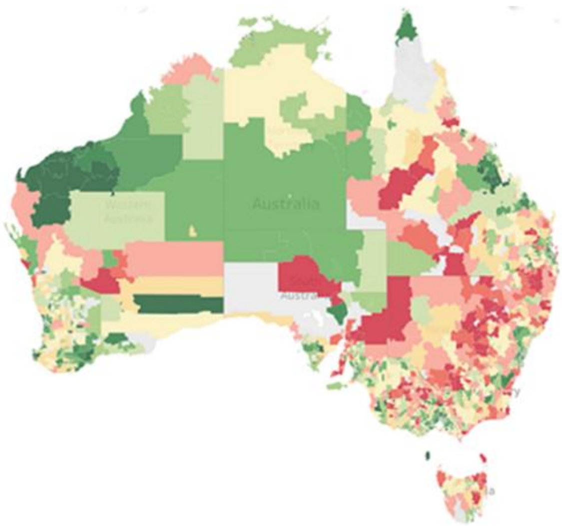
David: Why the focus on susceptibility?

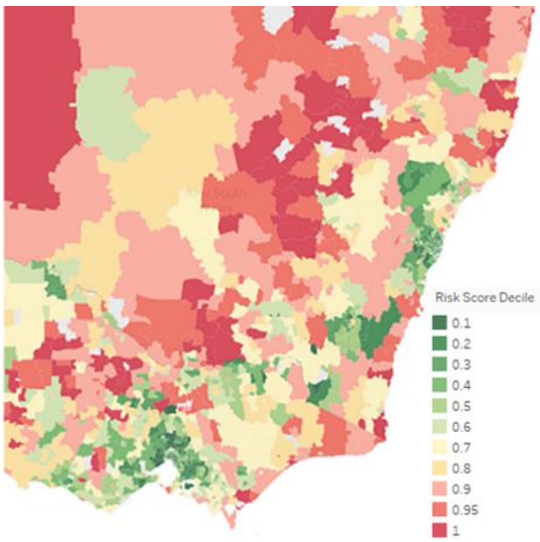
Alan: There was already a lot of research modelling transmission of the virus. We noticed a research gap in terms of investigating susceptibility at a demographic level. Susceptibility, the risk of severe illness or death if an individual were to contract the virus, is important in many ways. At a government level, susceptibility tells you how bad it could be in each region if an outbreak were to occur. This then informs decisions around resource allocation and how quickly you want to be able to identify and treat known cases.

David: Explain how you have developed the Susceptibility Index.

Alan: We combined age characteristics (60-69, 70-79, and 80+) with five health aspects (known as co-morbidities): cardiovascular disease, respiratory disease, cancer, diabetes and obesity. Unfortunately, the data shows that certain groups – notably the elderly with multiple health issues – are many times more likely to have severe reactions if infected with COVID-19, compared with young healthy people.

Calise: By combining our susceptibility score with Finity’s Defin’d dataset of socio-demographic and geographic attributes, we can explore COVID-19 impacts by area, household composition, income band, industry and more. We found some evidence of vulnerable populations away from capital cities, where multiple risk factors are more concentrated. We used heatmaps to visualise the susceptibility risk (red indicates areas with, on average, highest susceptibility).





The news is both good and bad. So far, most of the cases have occurred in areas with relatively-lower susceptibility. However, this is something to consider when looking at when, where and how to relax restrictions.

David: When you combine the demographic data with age and health factors, do any socio-economic effects emerge?

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Alan: Unfortunately, we find that at-risk communities commonly have low socio-economic characteristics (i.e. low income). This isn't surprising – when we spoke to our medical experts, they were aware that health issues and co-morbidities tend to present more strongly in poorer socio-economic groups. As a result, the disadvantaged segments of Australia may require additional resources as we start relaxing isolation measures.

David: What are the implications for government policy?

Calise: We think our work can inform policy in a number of ways. Our model provides an exposure measure for the Australian population that can serve as a foundation for various extensions. Transmission information can be overlaid to assess the impact of various policies. Our analysis can also highlight areas where outbreaks of COVID-19 may be particularly devastating, guiding decisions around allocation of financial and medical resources. Conversely, the additional economic information could be incorporated to examine trade-offs between simulating economic recovery and minimising risk to public safety.

David: I know this is early days, but have you been able to share this research with authorities?

Alan: We have had some interest from the Department of Health. We are happy to work with any interested parties to see how our work could be of assistance.

David: Finally, Alan, you've effectively put your PhD on hold, and Calise, you've been supported by Finity, but most of this research is outside of work hours. Do you think that this may be a feature of your future careers, jumping into projects outside your core line of research where you see the opportunity to contribute?

Calise: I think many young people view contribution as an important part of their career. I'm fortunate to have an analytical skillset which can be applied to different problems.

Alan: I do have to finish my PhD soon and am looking forward to that light at the end of the tunnel. Luckily, I have supportive supervisors who share my view that these contributions are worthwhile pursuits. At the start of my PhD, what I really wanted was to produce societally beneficial research and so these projects are very exciting.

Individuals with co-morbidities or symptoms associated with COVID-19 should follow the government advice and take extra precautions which can be found here.

If you would like to know more about the Susceptibility Index you can read more here.

David Bell is Executive Director of The Conexus Institute, a not-for-profit research institution focused on improving retirement outcomes for Australians. Calise Liu is a Fellow of the Institute of Actuaries of Australia and an intern at Finity Consulting. Alan Xian is a PhD candidate at UNSW.