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Editorial

The ways we think about investing are guided by several foundational texts published decades ago. One classic still read by students of markets is *Security Analysis*, continuously published for almost 90 years with the latest edition carrying a foreword by **Warren Buffett**. Although written by **Benjamin Graham and David Dodd** in 1934, much of it rings true now as markets remain subject to human behaviours that change little over time. Consider how this reflects the current stock market:

"Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence, all upper limits disappeared, not only upon the price at which a stock could sell, but even upon the price at which it would deserve to sell."

With COVID-19 driving big winners and losers, the US market has taken on unusual characteristics. The S&P500 is now at its most concentrated for 50 years, with the Top 5 companies at 25% of the index and the Top 20 at 40%. Yet the 10th largest company in the US, as shown below, is **Tesla**, which is not even in the S&P500 because it is not profitable enough to qualify. It's not considered a blue-chip despite its US$300+ billion market value, exceeding **Proctor & Gamble**, **Mastercard**, **JP Morgan** and **Home Depot**. **Elon Musk** doesn't care as his wealth has overtaken Warren Buffett.

As significant is the lack of any bank in the US Top 10, showing how successful the big tech stocks have been. Australia is not quite the same, although **CSL** is now our largest company and **BHP** is third as our banks have also struggled.

Rank	INDX_MEMBERS	Name	Industry_Sector	Sector	CUR_MKT_CAP	% of Index
1	**AAPL UW Equity**	**APPLE INC**	**Technology**	**Industrial**	**$1,706.948**	**6.198%**
3	**AMZN UW Equity**	**AMAZON.COM INC**	**Communications**	**Industrial**	**$1,639.976**	**5.955%**
2	**MSFT UW Equity**	**MICROSOFT CORP**	**Technology**	**Industrial**	**$1,629.681**	**5.918%**
4	**GOOG UW Equity**	**ALPHABET INC-CL C**	**Communications**	**Industrial**	**$1,066.509**	**3.873%**
5	**FB UW Equity**	**FACEBOOK INC-CLASS A**	**Communications**	**Industrial**	**$711.979**	**2.585%**
6	BRK/B UN Equity	BERKSHIRE HATHAWAY INC-CL B	Financial	Industrial	$446.276	1.620%
7	JNJ UN Equity	JOHNSON & JOHNSON	Consumer, Non-cyclical	Industrial	$379.645	1.379%
8	V UN Equity	VISA INC-CLASS A SHARES	Financial	Industrial	$375.834	1.365%
9	WMT UN Equity	WALMART INC	Consumer, Cyclical	Industrial	$369.287	1.341%
10	**TSLA Equity**	**TESLA INC**	**Consumer, Cyclical**	**Industrial**	**$323.963**	**na**

On the theme of markets at extreme levels, this week we check six popular charts often used by analysts to monitor financial conditions, and it's clear that the elastic is stretched. In Australia, the disconnect between stocks and the real economy shows in the high Price/Earnings ratio in the middle of a recession and a pandemic, a long way above the long-term average of about 15. **Hamish Douglass** of **Magellan** said this week:

"It isn't unusual during an extended crisis for markets to bounce strongly followed by a second sharp sell off. While we do not know how things will play out, investors should be prepared for a wide range of potential outcomes in the next 12 months. There is a real possibility of a collapse in equity markets, just as there is for a continued grind higher in equities supported by low interest rates."

Nobody knows how much of the early release of superannuation is finding its way into the stock market, but requests have reached $23 billion from 2.5 million applications. No doubt many people need the money but that's a lot of people with compromised retirement savings. Hopefully, they have their paperwork sorted as some people who qualified in April or May may no longer be eligible for the second round if they have returned to work.

Also this week, **Hamish Tadgell** describes how his investing has changed during the pandemic, and he reveals the companies best able to withstand the current storm. Then **Will Baylis** looks at income investing under these new circumstances, and explains a 'dual technique' in analysing stocks.

Kevin Davies was a member of **David Murray**'s Financial System Inquiry, and he has identified a product which is not suitable for retail investors but **ASIC** seems unable to regulate.

Many people do not recognise that Australia has two main exchanges, not only the **ASX** but also **Chi-X**, a new sponsor of Firstlinks. As an introduction, **Shane Miller** describes how they selected the most recent additions to their TraCR range, which facilitates purchases of leading US companies on local exchanges.

Gold ETFs are experiencing record inflows (see the **BetaShares** ETF Report below) as investors focus on possible currency debasement due to limitless money printing. **Michael Armitage** says another benefit of investing in unhedged gold is its uncorrelated returns versus stock markets in times of stress.

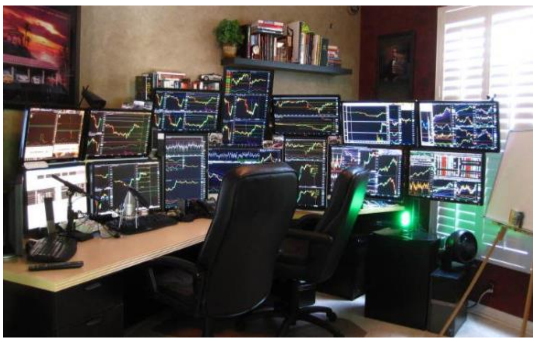
As many of our readers manage their own SMSF, it's always good to read an update on rule changes, and **Graeme Colley** summarises some old and new rules in operation from 1 July 2020.

This week's White Paper is the **BetaShares** ETF Half Year 2020 Review of a sector which continues to prosper regardless of market conditions.

Six ratios show the market is off the charts

Graham Hand

"As in all periods of speculation, men sought not to be persuaded by the reality of things but to find excuses for escaping into the new world of fantasy." – John Kenneth Galbraith, The Great Crash 1929, published 1954



There is no limit to the number of financial charts an investor can follow. Data can be made to fit almost any hypothesis as analysts mine numbers to find unique insights. US academic, Campbell Harvey, has identified over 400 'factors' that supposedly drive markets. His source is not an unknown trader with 20 screens in his garage. Harvey finds these well-researched factors in peer-reviewed papers appearing in leading financial journals, as described in 'A Census of the Factor Zoo'. He says:

"Surely, many of them are false. We explore the incentives that lead to factor mining and explore reasons why many of the factors are simply lucky findings. The backtested results published in academic outlets are routinely cited to support commercial products. As a consequence, investors develop exaggerated expectations based on inflated backtested results and are then disappointed by the live trading experience."

Recognised market measures are at extremes

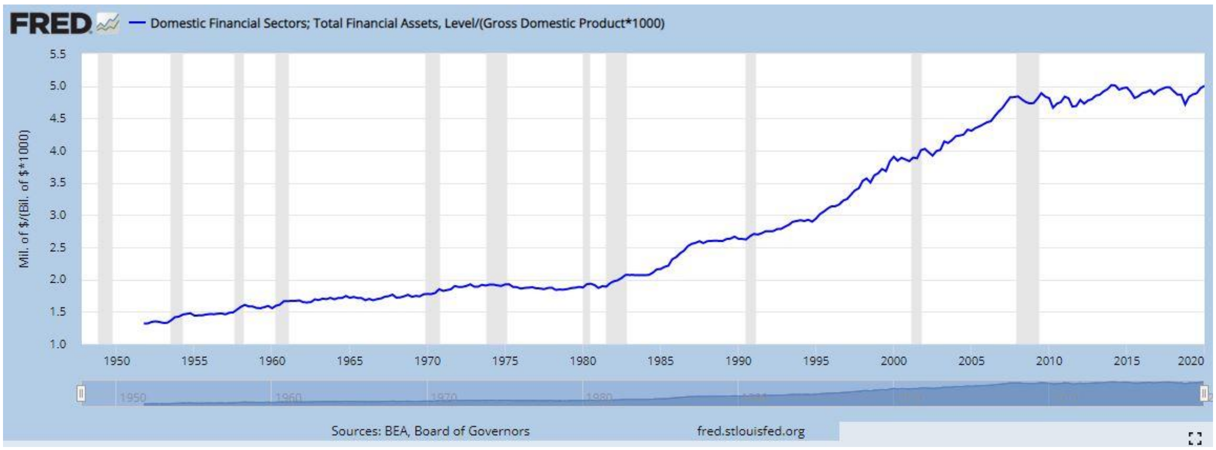
With the qualification that charts can prove almost anything, the following selection is not drawn from obscure ratios and calculations, but the more accepted ways experts watch markets. At a time when stock markets are almost ignoring the economic slowdown caused by a global pandemic, even as bond markets throw out the warning signs, these ratios are at historical extremes.

1. The ratio of financial assets to GDP

Warren Buffett told *Fortune Magazine* in 2001 that if the ratio of the market value of financial assets to GDP (or GNP) rises rapidly, "*you are playing with fire*". Buffett believed that over time, it should not be possible to build wealth faster than the growth of business or the economy. He said:

"The chart shows the market value of all publicly traded securities as a percentage of the country's business - that is, as a percentage of GNP ... it is probably the best single measure of where valuations stand at any given moment ... For investors to gain wealth at a rate that exceeds the growth of U.S. business, the percentage relationship line on the chart must keep going up and up ... That won't happen."

Sorry, Warren, yes it will.



Policymakers have driven down interest rates, inflating the value of most investments. This is seen as a precursor to economic recovery as activity is stimulated, with Wall Street leading Main Street. But financial assets are now 5.6X US GDP when Buffett thought 2X was extreme. For a breakdown of inclusions in financial assets, see FRED Economic Data.

2. The dispersion of profit forecasts

From the thousands of stock analysts who dissect the results of companies and create complex spreadsheets of forecasts, there is usually a reasonable consensus. However, such is the uncertainty as companies withdraw guidance and analysts struggle to build in the impact of COVID-19 that the earnings per share estimates are at record high dispersion.

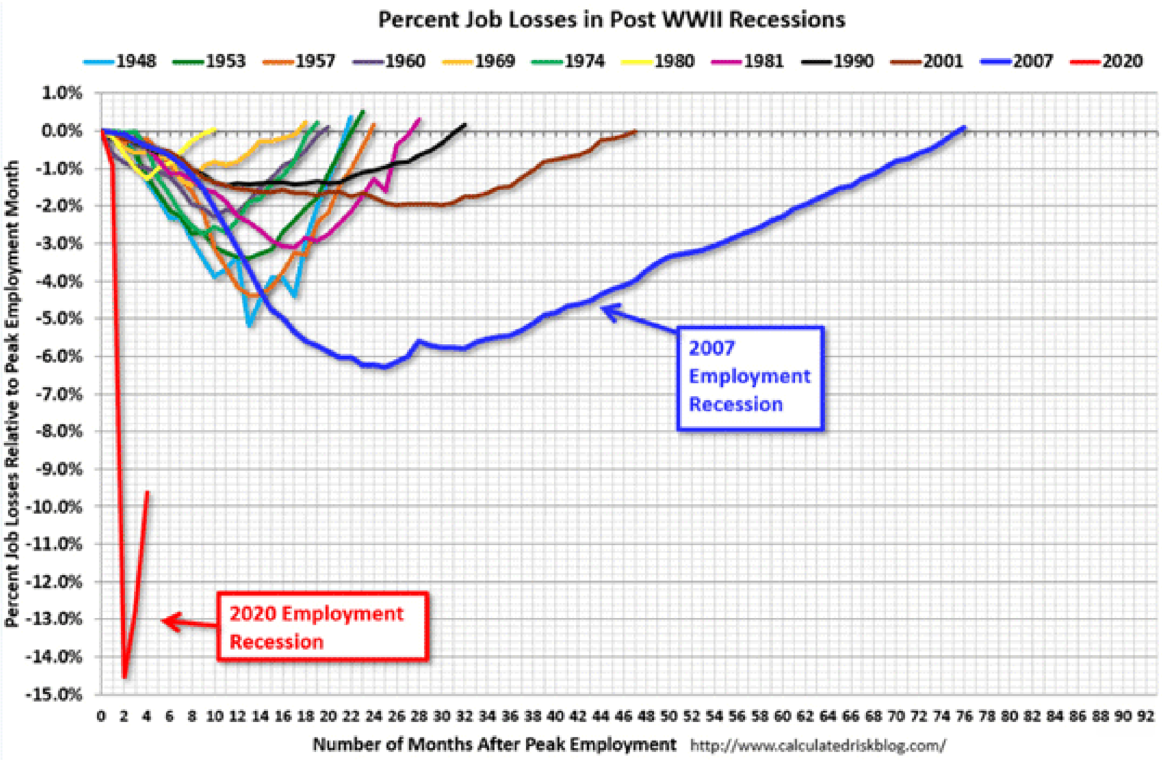
Top 200 listed companies in Australia, Earnings Per Share (EPS) Dispersion

Source: IBES, Factset, Morgan Stanley Research. Data as at May 29, 2020.

3. The size of jobs fall and time to recovery

In the 12 recessions in the US since the Second World War, the shape of the U- or V-shaped recovery has varied significantly. The following chart shows the percentage job losses relative to the prior peak in employment in the US. Jobs returning to previous levels has taken from only a few months to many years in the case of the 2007 employment recession.

The red line below shows the current pandemic. While it seems to have hit the bottom, it is a long way back when the virus continues to threaten (California represents 15% of US GDP and has gone back into lockdown this week). Many companies will never return. If the experience of 2007 is repeated where job creation took 76 months to recover, the US is looking to 2026 or 2027 to return to normal. That does not sound like much of a V, especially when about 33 million Americans are receiving unemployment payments, or 24% of workers, but the official unemployment rate is only 11%.



Source: Calculated Risk

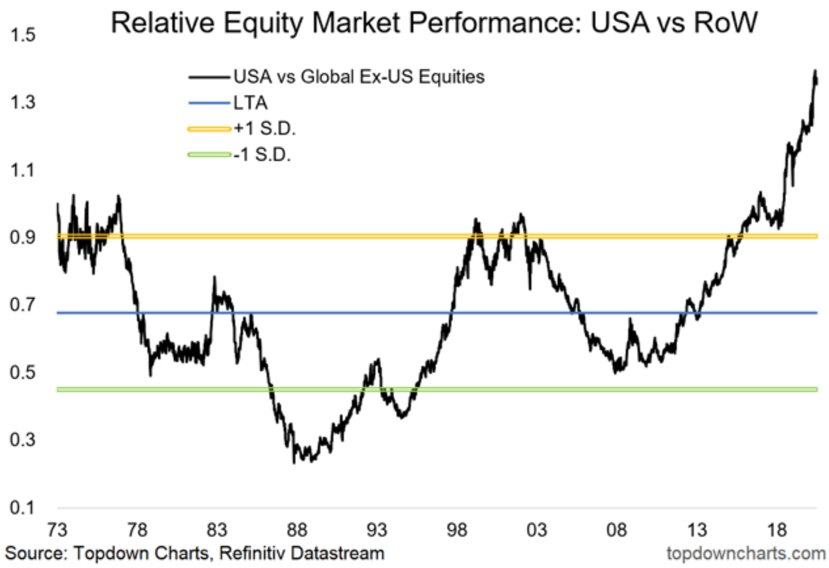
4. The value of US equities versus the rest of the world

We all know the incredible success of the large US technology companies such as Facebook, Apple, Amazon, Netflix and Microsoft. The top 5 companies now represent 25% of the market cap of the S&P500 (the largest concentration in 50 years) with the NASDAQ P/E ratio hitting 30 for the first time since 2004.

What is less well-known is the extent to which the US market has overwhelmingly outperformed the rest of the world. Most global equity managers not invested in the big US companies are having a torrid time against the global index. Those who made a convincing case to invest in the best from Asia or Europe or Less Developed Countries have been overshadowed by five or six excellent US companies.

Investing is about the future not the past, and many fund managers are now saying that the only value left in equities is outside the US. But who is game to bet against the NASDAQ tech story which just keeps running? According to analyst and commentator, John Mauldin:

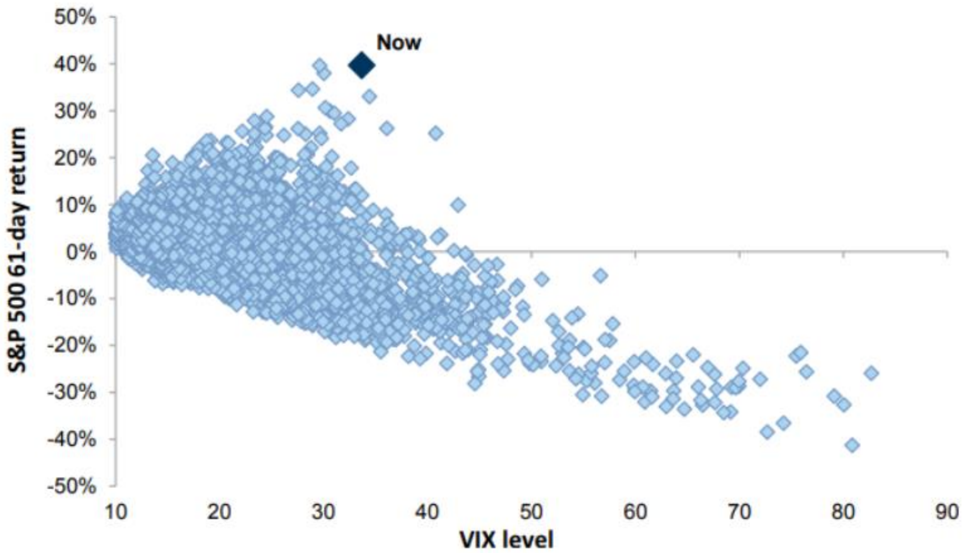
"The last time the rest of the world was this consistently cheap vs US equities coincided with the peak in the previous big cycle of US vs global equities relative outperformance. Turning to valuations, the RoW index is just plain cheap versus USA stocks. It appears it is a matter of when, not if, global equities perk up vs US stocks. A remarkable 90% of countries offer better value than the US—a level bested briefly after the tech bubble in the early 2000s."



5. The volatility of equities after a market rally

The VIX Volatility Index is a measure of the level of risk or fear in equity markets. Traditionally, the 'fear index' moves inversely to the stock market. This has appealing logic: as prices rise, investors become more relaxed and VIX falls.

However, according to a report in Zerohedge, the VIX has never been this high after such a strong rally in the 61-day S&P500, as shown below. The chart indicates how the VIX becomes elevated when markets fall, with a big cluster of low volatility when the market rises. The current combination of high returns and high volatility is rare.



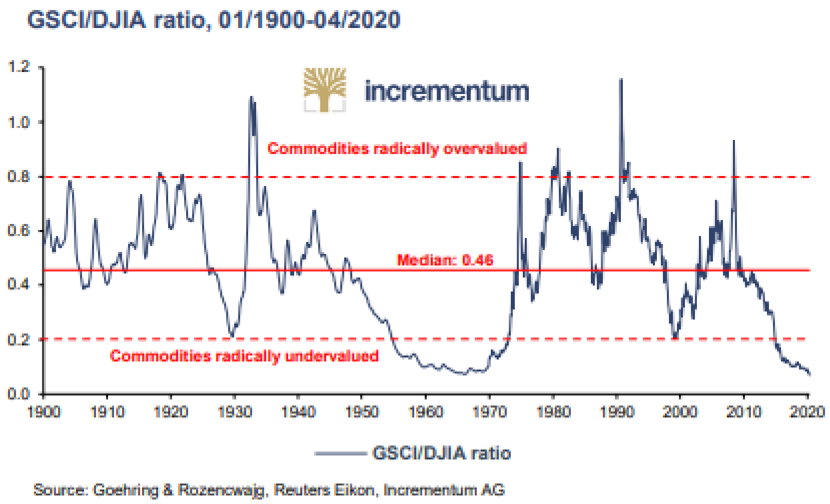
6. The performance of commodities relative to equities

A common measure of the performance of a wide range of commodities is the S&P GSCI (Goldman Sachs Commodities Index). It is a benchmark for investment in commodities and is a tradeable index equivalent to a stock index such as the S&P500 or Dow Jones Industrial Average (DJIA).

The ratio of the GSCI to DJIA is at its lowest level in 50 years and almost touches the 120-year record. According to the chart below, this places the index in the 'commodities radically undervalued' region. Of course, it is a ratio of one number to another, so it also means 'equities radically overvalued' relative to commodities. It's even more surprising when the components of the GSCI are so varied:

"The index currently comprises 24 commodities from all commodity sectors - energy products, industrial metals, agricultural products, livestock products and precious metals. The wide range of constituent

commodities provides the S&P GSCI with a high level of diversification, across subsectors and within each subsector."*



When markets are at extremes, something must give

While reversion to a mean can take many years, decades of well-known financial ratios will not remain at these new extremes forever.

A common theme in five of the charts above is that equities are expensive, which makes the sixth chart of record job losses and a long recovery all the more important.

A foundational text on investing was written by Graham & Dodd in 1934, and it remains relevant today:

"Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence, all upper limits disappeared, not only upon the price at which a stock could sell, but even upon the price at which it would deserve to sell." – Benjamin Graham & David Dodd, Security Analysis, 1934

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

Too much, too fast: four ways we are investing now

Hamish Tadgell

Investors may well be feeling a bit seasick following the swings and roundabouts of the past few months. The market freefall in March was followed by a sharp snap-back in April and May. Growing turbulence from the perceived disconnect between economic and healthcare outcomes and markets, and rising geopolitical tensions, has been tumultuous for even the most seasoned participants.

Much of the rally seems to come from news of a slowdown in the number of covid-19 infections, coupled with the extraordinary speed and scale of the stimulus from central banks and governments around the world.

The burning question is, where to from here?

We have been surprised by how sharp and rapid the rally has been. History shows that it is typical for markets to bounce sharply in 'event'-driven bear markets, but this time has broken all records on the way down and on the way back up.

It appears the rally has been driven more by fading tail risk owing to policy support rather than optimism around a pick-up in growth. We feel that markets have paid too much for the prospect of a return-to-normal in the short term.

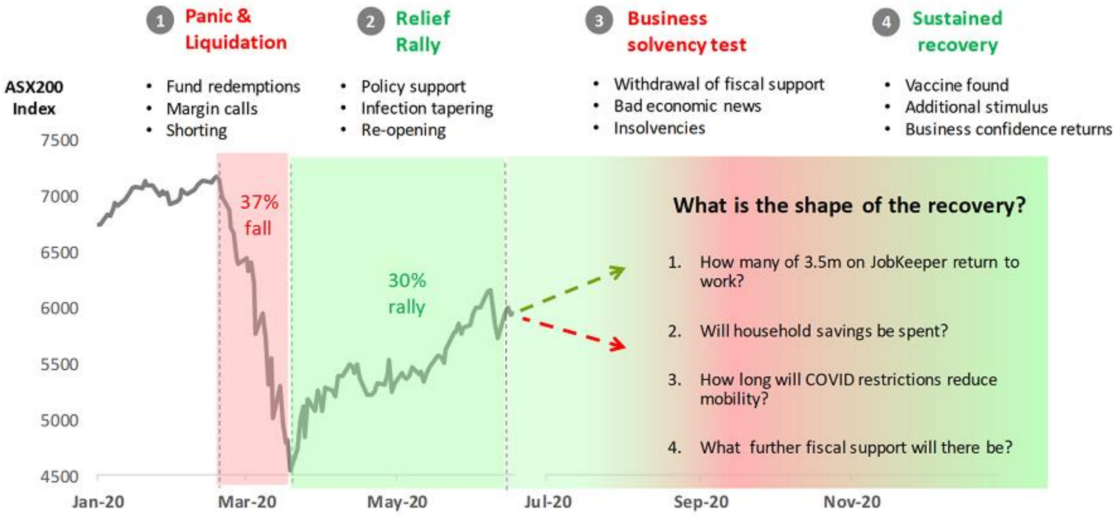
Of course, the unpredictable and unique nature of the shock to the system means there is no data set to draw on. If lockdowns continue to be eased and economies open up over the coming months, the sequential growth will look strong, which seems to be what markets are reflecting.

But it is hard to see the pace of growth being anything but weak given the massive economic dislocation, higher expected unemployment and cautious approach to gradual reopening of economies. This at best seems to point to an intermission and markets trading sideways, but the greater risk seems to be that investors become disappointed relative to current expectations and markets fall back.

Our concern locally is that as the massive support packages start to roll-off around August-September, we will see a fiscal cliff and sharp fall in household income and rise in unemployment.

Even if existing measures are recalibrated and extended to the more vulnerable sectors and weaker areas of the economy, unemployment remains key. The headline unemployment rate remains noisy and an unreliable indicator. It is unclear how many jobs have been temporarily furloughed and will cease to exist post JobKeeper and as businesses recalibrate to the new normal.

Phases of market cycle - Tug of war between stimulus and unemployment



Source: SG Hiscock, IRESS (prices at 30 June 2020)

More risks on the horizon

We are also becoming increasingly concerned with geopolitical risks. The riots in the US and the divisive nature of US politics seems destined to see greater social unrest heading into the US Presidential election in November.

A more optimistic view is that the impact on consumption will be mitigated by households spending savings from enforced hibernation and pent-up demand, along with the possibility of the government extending existing support measures and announcing additional fiscal initiatives.

However, the greater risk is any pick-up in earnings is likely to be short-lived, with the real costs of social distancing under-appreciated. We continue to think a V-shaped recovery underestimates the medium-term risks. We expect until a vaccine is found, social-distancing measures will remain in place and weigh on both consumer activity and workplace productivity, impacting both revenues and margins.

China, the leading template so far for what a re-start might look like, is hardly sending a positive signal for the consumer. Various bottom-up China activity trackers have seen upstream industries (such as basic materials) already recover to 80-90% of 2019 levels, but discretionary spending categories are recovering at a much slower pace.

Although investor panic around the covid-19 crisis might seem over, the effects of the panic are not, and are still to fully play out. This doesn’t mean that good opportunities don’t exist, but it is likely to require a more nuanced and active approach, making stock picking more important.

Beyond the inflection-driven 'hope' phase of the recovery, we see the market is less likely to be driven by valuation expansion as interest rates are already at their lower bound. We expect bond yields to remain low, which favours longer duration growth stocks, including IT and healthcare and selective infrastructure like assets. We also expect nominal GDP growth to remain low, with the risk companies will face rising costs, including wages as the social contract and profit share shifts more to labour, and margins come under pressure. This favours higher quality companies and companies exposed to secular growth over the medium to longer term. In the short run, we also expect there will be the potential for more cyclical businesses to benefit from any inflection in economic activity, particularly where supported by fiscal stimulus and infrastructure building projects.

Four examples of better opportunities

Ultimately stocks with good earnings growth and strong cash generation and balance sheets have the best chance to outperform. We therefore continue to participate with prudence and look to:

1. Build positions in higher growth companies that are structural leaders and typically trade at significant valuation premiums, but currently discounted. For example, SEEK (ASX:SEK), the leading online job placement company in ANZ and Asia, and Aristocrat Leisure (ASX:ALL), a global leader in the design and manufacture of slot machines and online digital game content. While neither company is immune from the impact of covid-19, recent price weakness has provided an opportunity to buy two high quality companies with market leading positions, a strong competitive advantage and pipeline of growth at an attractive margin of safety.

2. Invest in companies which will emerge stronger from the crisis with a better sustainable market position and competitive advantage. Arguably the most profound change as a result of the virus has been the acceleration in digital disruption and technology trends already in place prior to the pandemic. NextDC (ASX:NXT) has been a material beneficiary with a surge in data centre demand and a number of hyper-scale players including Google committing to new space in recent months. The increase in demand for telecommunication and online services is also driving strong secular growth for fibre and telco infrastructure services like Uniti Group (ASX:UWL).

3. Buy deeply oversold, large, liquid quality cyclical stocks that will benefit as the cycle turns. Infrastructure spending and financing has been a secular portfolio investment theme for some time. Federal and state government fiscal stimulus to support the post pandemic economic recovery and stimulate job creation is only expected to enhance the growth opportunity. This is likely to be skewed to 'shovel ready' social infrastructure projects, as well as education and transport, rather than the recent 'mega' projects and should underpin earnings for Seven Group Holding's (ASX:SGH) Coates Hire business (Australia's largest equipment hire company). Gold also remains attractive given the explosion in money supply and growing government debt levels, particularly where augmented by attractive underlying volume growth as in the case of Saracen Minerals (ASX:SAR).

4. Remove companies that will struggle to recover from the covid-19 crisis or are likely to suffer longer term structural issues as a result. We remain wary of more consumer-facing companies, particularly those exposed to discretionary retail, travel and airlines. We are also cautious around commercial real estate developers, and associated lenders to these sectors.

Hamish Tadgell is Australian equities portfolio manager at SG Hiscock & Company. This article contains general information only and does not take into account any person's individual financial circumstances.

Punting with retail financial products beyond ASIC's watch

Professor Kevin Davis

Despite the publicity in recent years about financial institutions selling unsuitable financial products to retail investors, the behaviour has not stopped. ASIC should take action to prevent sales of a number of investment products designated as 'deferred purchase agreements' (DPAs) by 'large, reputable' and other financial firms. Investment banks and financial advisers have offered such products with doubtful understanding by their clients.

Not suitable for retail investors

Notably, there appears to be no public information on the outcomes of past investments in such products. In some cases, they may well have been good. But the inability of a retail investor to assess the expected return and risk makes them unsuitable products.

What are they? To illustrate, imagine investing in a financial product where the final return in two years depends upon both the share prices of some US companies such as Amazon, Twitter, and Facebook (the 'reference' assets) at that time, and the paths the share prices have taken over those two years. The precise relationship between your payoff and the share price behaviour is very complex (as illustrated later), and you could lose a lot or gain a lot.

While explicit formulae are specified to determine the payoff, the likelihood of a retail investor or SMSF trustee (the target market for these products) being able to understand these sufficiently to accurately assess expected return, risk, and value for money is very low.

A finance specialist with the aid of good computing power could probably do it in a couple of days. But, realistically, the internal workings of these products are no clearer for the average investor than the workings of a poker machine!

To make things even more obscure, the contracts involved are classified as DPAs. This occurs because the value of the payoff in two years is settled by the financial product issuer delivering an equal value of shares in some specific company unrelated to the reference assets involved (such as Telstra). The DPA refers to the fact that the issuer has entered a contract for future delivery of some (uncertain) number of Telstra shares, for a payment by the investor at that time which is equal to the value of the investment's payoff.

In most of these products, the issuer will agree to sell those Telstra shares on behalf of the investor, rather than deliver them, and provide the cash proceeds to the investor. Does something smell fishy? Why have this roundabout way of generating a cash outcome for the investor?

Designed like this for tax and ASIC reasons

The answer appears to lie in the bowels of tax legislation. The receipt involved in a DPA (of more than a one-year term) is treated as a capital item for tax purposes, meaning that profits or losses are treated as capital gains (taxed concessionally) or capital losses, rather than as normal income. Thus, if an investor on a 50% tax rate received $12,000 from an initial investment of $10,000, the tax on the $2,000 profit would be $500 (since only half of the capital gain is included in taxable income) rather than $1,000.

For those with suspicious minds, there may be another reason for structuring the investment product as a DPA. For some unknown reason, the product disclosure statement (PDS) of a DPA does not need to be lodged with ASIC!

Why are these products so hard to value? Consider an illustrative (simplified) typical structure.

First, over the two years there will be quarterly 'memory call' dates specified. On any call date, if certain conditions are met, the product may be terminated by the issuer by repaying the investor their principal plus a prespecified dividend amount. The product cannot be terminated at a call date if there is at least one share whose price has never been above its issue date value either at that, or an earlier, call date.

Second, if at any time the price of any single reference asset falls below 65% of its value at the product issue date a 'kick-in' event occurs. This triggers a specific formula being used for the final payoff, which also depends on the values of reference assets at that final date. A likely outcome is that the final return depends on the share price of the worst performing reference asset, such that a large loss could occur if that share price was less than its issue date price.

Third, if no 'kick-in' occurs, the final payoff will be the larger of some specified minimum positive return and the absolute return of the worst performing reference asset. If all reference assets have a positive return, it is likely that a call event will have occurred such that the product has been terminated earlier. But if one has a negative return, the formula is relevant, and the investor's return will reflect the (absolute) return of the reference asset which has deviated most from its initial price (if that deviation is above the specified minimum).

Complicated? Certainly

The issuer can model these possible outcomes and determine how it might hedge its risk by derivative transactions in the reference assets (and the exchange rate if they are overseas stocks), and how setting of the various terms will affect its likely profit. But the chances of the retail investor being able to do likewise and determine whether the product offers fair value seem very unlikely. Nor, for that matter, are the financial/client advisers likely to have the technical skills needed to properly assess expected risk and return and product suitability for their client.

The introduction of Design and Distribution Obligations for financial product manufacturers and distributors to show product suitability for the target market has recently been deferred until 2021. Once they come into operation it seems unlikely that such complex products would meet those requirements and cease being offered. In the interim, there looks to be a good case for ASIC using its recently acquired Product Intervention Powers to stamp out such offerings.

Kevin Davis is Professor of Finance at University of Melbourne. In 2013, Professor Davis was appointed to the Commonwealth Government's Financial System Inquiry panel (The Murray Inquiry) which was "charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth", and which presented its report to the federal Treasurer in November 2014 (www.fsi.gov.au)

This article contains general information only and does not take into account any person's individual financial circumstances.

Income investing during COVID-19 demands a dual technique

Will Baylis

Covid-19 has created one of the biggest market falls (or drawdown) in Australian equity earnings in history, even bigger than during the GFC. Income investors are understandably concerned about the impact the shutdowns and ongoing social distancing will have on the ability of Australian equities to pay dividends.

This article discusses our forecast of the near-term dividend outlook and examines how active managers can help investors navigate this unique moment with the objective of creating a sustainable income stream.

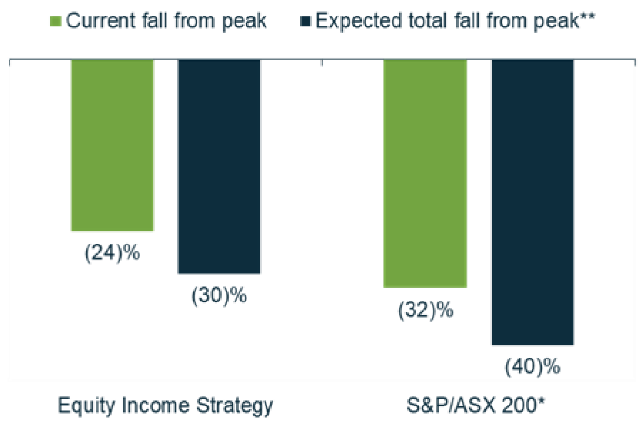
Equity income and Australian dividend outlook

The near-term outlook for dividends remains challenging. At the time of writing, based on broker consensus estimated for next 12 months dividends, the dollar dividend stream from the February (pre-COVID-19) peak for the broad market (S&P/ASX 200) will be down more than 32% (and down 24% for the stocks in our Equity Income strategy).

We expect the income stream to come down further as dividend forecasts published by stockbroking analysts have yet to fully account for the effect that the reduced company earnings will have on dividends.

Our own 2020 COVID-19 dividend profile work suggests that the full extent of downgrades to the income stream for the broader Australian market will be in the order of approximately 40% down on February estimates (and for our Equity Income strategy, down ~30%) as shown below. See notes at end of the article for more details on Next 12 months (NTM) calculations.

Expected fall for NTM dollar dividend stream versus pre-COVID-19 peak



A crisis and an opportunity

We recognise that the fall in income is a critical issue for investors such as retirees who rely on that income for their living expenses. However, without minimising the seriousness of that issue, we believe this crisis is an opportunity for active managers like ourselves to build a diversified portfolio of businesses with the ability to generate sustainable dividends at once-in-a-lifetime valuations.

For an income-oriented strategy, successfully navigating these market conditions requires a balancing act that entails a nuanced approach satisfying both of the following two conditions:

1. Ensure that the long-term income potential of the portfolio remains robust, i.e. focus on the long-term business outlook and dividend potential of the portfolio companies.

2. Deliver the best possible income stream over the course of the near-term business disruptions caused by the pandemic, i.e. ensure that there is a reasonable level of income in the coming 12 to 24 months to support income requirements.

The need to optimise across these two parameters illustrates an important benefit of active management over passive or 'smart beta' strategies at this critical juncture.

For example, a passive manager who indiscriminately sells stocks where the dividend is cut to $0 will likely be selling uniquely profitable and monopolistic businesses at historically low valuations. Similarly, buying stocks in sectors where dividends haven't been reduced to chase higher short-term income will entail paying a significant valuation premium and must be done with a discriminating eye towards long-term dividend sustainability. The combined effect of such a robotic approach to income investing is likely to result in a significant impairment of the long-term income potential for investors in these passive, yield-chasing strategies.

What's called for at this moment of market dislocation is a case-by-case assessment of each company's prospects by a seasoned team of sector specialists to parse the likely winners from losers. We use a dual track framework that examines both the short- and long-term income potential of each portfolio company.

Deep fundamental analysis of short-term impact

Since the start of the covid-19 crisis, each stock in our portfolios and investible universe has undergone a '2020 COVID-19 Dividend Profile' to accompany the 'Sustainable Dividend' analysis. This analysis more precisely calibrates each stock's downside income risk, and understands which stocks should see dividends recover relatively quickly versus those that are likely permanently impaired.

Our recent focus has been on the following market segments:

- Companies that 'make money while you sleep' rather than those that have a more 'transactional' nature
- Exiting positions that are most vulnerable to the adverse outcomes from social restrictions, and
- Purchasing undervalued companies that have not acted as defensive as they genuinely are.

Quantifying dividend sustainability and long-term income potential

Portfolios are constructed from stocks based on their ability to pay a forward looking 'Sustainable Dividend' rather than a current or consensus dividend. We judge each company's dividend paying power by assessing their free cash flow generation through different stages of the economic cycle. The analysts then model a two-year bear-case scenario, i.e. can a dividend be paid in eight out of the next 10 years? The 8/10 approach considers a significant downside scenario for each company and what level of dividend they can pay post a crisis.

The unprecedented impacts from covid-19 mean that for a number of companies, short-term expectations for dividends have fallen below the sustainable dividend forecast. Critically, though, where the long-term sustainable dividend potential remains robust, we continue to hold them.

"We continue to think that it is usually foolish to part with an interest in a business that is both understandable and durably wonderful. Business interests of that kind are simply too hard to replace." - Warren Buffett

Using this dual track analytical framework balances long-term dividend potential and short-term income protection. The aim is to re-position income strategies to remain well positioned to provide investors with portfolios built on a foundation of sustainable dividends for the long-term.

Will Baylis is a Portfolio Manager for the Legg Mason Martin Currie Equity Income Fund. Legg Mason is a sponsor of Firstlinks. The information provided should not be considered a recommendation to purchase or sell any particular security. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.

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Source: Martin Currie as of 29/05/2020, Next 12 Months (NTM) Income yield is calculated using the weighted average of broker consensus forecasts of each portfolio holding –because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return for Martin Currie Equity Income.

Finding companies in four themes COVID-19 has accelerated

Shane Miller

The financial impact of COVID-19 has been swift, triggering the worst economic contraction since the Great Depression. Global stock market moves have been equally dramatic, with the quickest bear market collapse in history followed by an equally sharp retracement. The losers have been energy, travel, tourism and real estate, while the winners are healthcare and technology.

Looking beyond the short term, we are interested in identifying long-term trends that the COVID-19 crisis has reinforced and accelerated. There are four such trends that are now commonly discussed in the financial press: e-commerce, cashless payments, working from home and healthcare.

These trends are all global in nature. Through depositary receipts listed on Chi-X Australia, known as TraCRs (Transferable Custody Receipts), these trends and US stocks are available to Australian investors. Trading is in Australian dollars, during Australian trading hours, cleared and settled in the usual CHESS system, just like any other Australian share.

It is through the lens of TraCRs that we have been thinking about COVID-19 and its effect on the stock market. There are now 35 TraCRs ranging from A (Apple, Amazon) to Z (Zoom Communications). Together, these 35 depositary receipts represent about 42% of the market capitalisation of the S&P500 Index or 58% of the Nasdaq 100 Index.

1. E-commerce

COVID-19 has delivered a very public effect on shopping. It was evident early with 'runs' on toilet paper, the closure of non-essential shops and a dramatic shift to online retail. Amazon (CXA:TCXAMZ) reach its highest ever stock price in both USD and AUD terms. In our view, Amazon's e-commerce business has material upside, though not without competition or challenges.

There are two facts that summarise the long-term opportunity.

First, e-commerce only represents about 15% of adjusted retail sales in the US. COVID-19 has accelerated the take-up of online retail with experts now predicting e-commerce will be a significantly higher percentage of retail sales in five to ten years' time.

Second, North America accounts for over 70% of Amazon sales, excluding Amazon Web Services (AWS). Hence Amazon's global expansion to India, Brazil, and even Australia will add further earnings upside.

Amazon is not the only e-commerce giant. Traditional bricks and mortar retailers are moving into the e-commerce space, including Costco (CXA:TCXCOS) and Walmart (CXA:TCXWMT). Walmart's expansion into online shopping started in 2016 with the acquisition of Jet.com, and it has since acquired at least seven other e-commerce sites. COVID-19 has driven e-commerce sales for Walmart up 74% during the past quarter. This will be consolidated with the recent announcement that Walmart Marketplace will partner with Shopify (a platform that is used by more than one million businesses) to target third-party sales.

We have also rapid growth in many direct-to-consumer websites, including those launched by food and beverage heavyweight PepsiCo (CXA:TCXPEP) with snacks.com and pantryshop.com.

2. Cashless payments

Of the four long-term global trends discussed here, it is perhaps easiest to identify with cashless payments. I am reminded of a three-day trip to Denmark in 2005 where I did not use cash once. That meant payment for food, drink, travel, accommodation and cheap souvenirs all using either Visa (CXA:TCXVIS) or MasterCard (CXA:TCXMAC). Of course, since 2005 the 'war on cash' hasn't just continued, it has accelerated. During Covid-19 many retail shops and cafes are only accepting card payments, something we expect to continue well into the future.

We only need look to China where this has already occurred. However, if you take a global view, the cashless payments trend still has a lot of room left to run. The best way to take advantage of a global trend is with global payment providers such as Visa, MasterCard, Paypal and American Express, more so than a local Australian stock such as Afterpay (ASX:APT).

3. Working from home

Overall, working from home has been remarkably successful with little or no reduction in productivity. A major reason has to be the widespread adoption of video-conferencing technology, epitomised by Zoom Communications (CXA:TCXZOM). The company name has now become a verb, which is promising when you think of previous examples like Google (CXA:TCXGOG), Uber, Xerox or Hoover. Many of us now have accounts with Zoom, Microsoft Teams (CXA:TCXMSF) and Webex, despite never having used any of these services prior to March this year. As a business, the results for Zoom have been spectacular, with a number of industry analysts claiming the last quarter results to be the largest 'beat' versus expectations in over 20 years. Will video-conferencing and working from home prove to be fleeting trends? It's difficult to say, but more flexible work arrangements, reduced office space and significantly less business travel provide the ideal environment for businesses to continue to host Zoom meetings.

Have you ever wondered which company powers Zoom? As well as Netflix (CXA:TCXNFL), Fortnite, Slack and many other work-from-home or stay-at-home applications? It is the aforementioned AWS. The cloud computing businesses of Amazon, Microsoft and Google have seen tremendous growth since the start of this year. But they don't just provide the infrastructure for video streaming, video conferencing, gaming and work productivity tools, they also power the first two trends of e-commerce and cashless payments.

4. Healthcare

Healthcare is a multi-faceted multi-decade global trend that has propelled CSL (ASX:CSL) to become the largest listed company in Australia.

The Australian Institute of Health and Welfare published a report in June 2019 "*Australia's health expenditure: an international comparison*" which showed that the percentage of GDP spent on health care in Australia was 7.4% in 2000 but climbed to 9.2% in 2016 and has subsequently increased further. In the US, healthcare expenditure increased from 11.7% in 2000 up to 17.1% in 2016. The scale of the US economy combined with the disproportionate size of healthcare spending explains why the four TraCRs companies from the healthcare sector are all larger than CSL.

Johnson & Johnson (CXA:TCXJNJ) is four times larger than CSL while both Merck (CXA:TCXMRK) and Pfizer (CXA:TCXPFE) are approximately twice as large. The most recent healthcare TraCR added is Gilead Sciences (CXA:TCXGIL), which has a market capitalisation marginally higher than CSL. Gilead is the world's leading producer of anti-viral drugs providing treatment for HIV, hepatitis B and C as well as influenza. It is for this reason that Gilead has been in the news, with their anti-viral drug remdesivir. While the use of remdesivir to treat the COVID-19 disease has had a degree of controversy, but Gilead has already licensed it to generic drug companies for distribution to over 127 countries.

Finally, the 3M company (CXA:TCXMMM), previously known around the world for Post-it Notes, is now in the news for N95 masks, an essential component of the personal protective equipment (PPE) needed by health care workers. 3M is an industrial conglomerate that operates in over 70 countries, it makes over 60,000 different products across its four business segments of: safety & industrial; transportation and electronics; healthcare and consumer. 3M's defensive attributes, steady dividend and leverage to the ongoing demand for their healthcare products combined with a need to replenish national stockpiles make it a compelling COVID-19 investment in both the short and long term.

Valuation and concentration

The impact of COVID-19 is likely to be long lasting as economies around the world emerge from a global recession. These long-term trends have further to run. So, what are the risks to investing in stocks that are leveraged to these themes? Valuation and concentration.

With respect to valuation, almost all of the stocks mentioned here have had significant price appreciation since February this year. Only time will tell if all future upside from these trends has been accurately factored into current prices. Don't put all your eggs in one basket or even in one well-documented trend but better to construction a well-diversified portfolio. No matter how convinced you are of the thesis for any stock or macro trend, it pays to mitigate your risks.

Shane Miller is the Chief Commercial Officer of Chi-X Australia, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any person. For more articles and papers from Chi-X, click here.

What super changes should you know from 1 July?

Graeme Colley

The start of a financial year always brings new rules for super funds. For the 2020/21 financial year, two changes are the abolition of the work test for anyone aged 66 and 67 wishing to make personal non-concessional contributions (NCCs), and an extension of spouse contributions from age 70 to 75.

The continuation of the 50% reduction in the minimum pension rate for account-based pensions due to the COVID–19 pandemic will apply for the whole year. We are still waiting for the change that will allow access to the bring forward rule.

Let's look at some rules, new and not-so-new, in more detail.

Abolition of the work test to age 67

Until 30 June 2020 there was no need for a member to satisfy a work test for personal concessional and NCCs before reaching age 65. However, once they reached 65 in the financial year a work test of 40 hours in 30 consecutive days was required to be met at some time during that year and prior to the contribution being accepted. Providing the work test is met in a financial year, personal concessional or NCCs can be accepted up to 28 days after the month in which the person reaches age 75. But there are exceptions to the work test where personal contributions are made in the year after ceasing work or for purposes of downsizer contributions.

From 1 July 2020 it is now possible to make personal contributions without needing to satisfy a work test until age 67. In the financial year the member reaches age 67, personal contributions can be made prior to reaching that age but a work test must be met at any time during the financial year prior to the contribution being made.

Ceasing work contributions

Ceasing work contributions are permitted on a once-only basis after the member has reached 67, previously age 65. Personal contributions can be made on a once-off basis in the financial year after work has ceased and the person has a total super balance of less than $300,000 on 30 June in the previous financial year. These contributions can be accepted by the fund up to 28 days after the month in which the person reaches 75.

Downsizer contributions

Downsizer contributions can made after the sale of a person's main residence, as described for capital gains tax (CGT) purposes, which they have owned for at least 10 years. To be eligible the person must be 65 or older and a contribution of up to $300,000 must be made within 90 days of the sale. The person's spouse may also be eligible to contribute up to $300,000 if they are 65 or older. There is no upper age limit applying to downsizer contributions or any work test that applies.

Employer contributions

When it comes to employer contributions for anyone 65 or older, there are no work tests or age limits for compulsory employer contributions such as superannuation guarantee contributions or those made under an industrial award. But a work test must be met if the employee wishes to salary sacrifice to super and they are unable to be made 28 days after the month in which the employee reached age 75.

Access to the bring-forward rules from 1 July 2020

It is possible for anyone who is under 65 to trigger the bring-forward rule which allows up to two years of NCCs to be made over a fixed period. The period commences from the year in which the person makes an NCC that is greater than the standard annual amount of $100,000.

Whether a person has access to triggering the bring-forward rule depends on their total superannuation balance on 30 June in the previous financial year. For anyone with a total super balance of less than $1.4 million they are able to bring forward up to two years' standard NCC and anyone with a total super balance of between $1.4 and $1.5 million is able to bring forward up to one year's standard NCC. Once a person has a total super balance of between $1.5 and $1.6 million only the standard NCC is available and there is no bring forward amount. With a total super balance of $1.6 million or more, it is not possible to make a NCC without incurring a tax and interest rate penalty.

It was announced in the 2018 Federal Budget that the bring-forward rules would be amended to apply to anyone who was under 67 on 1 July in a financial year. However, the bill has a way to go prior to becoming law.

Those fund members in the 65-66 age bracket are in a bit of a dilemma until the time the passage of the legislation is clear. From a practical point of view, it is only those members with a total superannuation balance of less than $1.5 million as at 30 June 2019 or 30 June 2020 who will be impacted if they wish to maximise NCCs by using the bring-forward rule.

Spouse contributions and the tax offset

It is possible to make contributions for an eligible spouse which are treated as NCCs and counted against the spouse's NCC cap. If the spouse has an adjusted income of less than $37,000 it is possible for the contributor spouse to receive a tax offset of up to 18% on the first $3,000 of any non-concessional spouse contribution. The tax offset amount phases out between $37,000 and $40,000 on a dollar for dollar basis.

Until 30 June 2020, it was only possible to make spouse contributions up until age 70. Between age 65 and 70 the spouse was required to meet the work test of 40 hours in 30 consecutive days for the year in which the contribution was made. However, from 1 July 2020 this has now been extended to apply for spouse contributions made between 67, and 28 days in the month after the spouse reaches 75, which puts it in line with other personal superannuation contributions. The work test must be met prior to spouse contributions being made to the fund.

Reduction in minimum pensions for account-based pensions

In March 2020, the government amended the minimum percentage required to be paid for account-based pensions by 50%. This meant that account-based pensions, transition to retirement pensions and market-linked income streams would have their minimum pension percentage reduced by 50% for the 2019/20 and 2020/21 financial years.

Here are the reduced percentages that apply:

Age	Minimum pension percentage for account-based and transition to retirement income streams for the 2019/20 and 2020/21 financial years
Under 65	2.0%
65 - 74	2.5%
75 - 79	3.0%
80 - 84	3.5%
85 - 89	4.5%
90 - 94	5.5%
95 or older	7.0%

What next?

The extension of the work test exemptions to age 67 for personal superannuation contributions has been a bonus in these difficult times as well as the extension of the age at which spouse contributions can be made. However, we wait with anticipation for the extension of the bring forward rule to age 67 to become law when parliament resumes in the next few months.

Case study examples of each of these super regulations are contained in this attached longer version.

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The asymmetric value of gold for Australian investors

Michael Armitage

Australia is known as the 'lucky' country. Our attractive weather and natural resources are some of the many positive attributes of the nation. Currently, global positioning away from the rest of the world's problems, especially in the age of COVID-19, could be viewed as the most important health risk mitigant for the near future.

There's another benefit in investing. Unhedged exposure to gold, that is, an Australian investing in gold without hedging its USD price (Gold/AUD), provides attractive properties for portfolio risk management including equity market and inflation hedges. Further, for portfolios that have a focus on re-balancing as an added source of return, equities versus gold provides an attractive pair to harness volatility. For lucky Australian investors, gold relative to the Australian dollar can be a powerful addition for equity-heavy portfolios.

Inflation and currency debasement

Over the past several months as central bankers have rushed to provide unprecedented liquidity and balance sheet expansion, a growing consensus is emerging around gold for its ability to protect portfolios from currency devaluations and to provide a stable store of value. Gold continues to make new all-time highs against many global currencies, including the Australian dollar.

An expanding list of recognised names including Paul Singer, Ray Dalio, Stanley Drunkenmiller, Crispin Odey, and Paul Tudor Jones have pointed to their increased gold positioning as a way to protect wealth from potential consequences of global government monetary and fiscal actions.

While inflation has so far only shown up within financial asset prices, the level of unprecedented intervention from monetary and fiscal policy may spill into the real economy. Central banks have showcased their game-plan with seemingly limitless appetite for expansion as the potential solution to a massive global debt overhang and global economic weakness.

Gold and other 'real assets' with scarcity value tend to perform well in inflationary periods and diversified exposure to inflation hedging may prove to be prudent if investors lose confidence in the global central bank playbook and their ability to control the inflation genie once out of the bottle. Protecting future purchasing power and real returns should be in focus.

Gold/AUD as equity market protection

While physical gold is a non-yielding asset, many still view gold as a currency, albeit one with limited ability to print like fiat currencies.

The gold price is often quoted against the US dollar. However, for Australian investors utilising Australian dollars for their holdings in gold, the Gold/AUD (i.e. gold in AUD terms) has held an asymmetric relationship with equities, providing attractive protection qualities for an equity portfolio in severe market stress events.

Figure 1 displays calendar year performance of All Ords Index and corresponding Gold/AUD ranked in descending order of equity market performance.

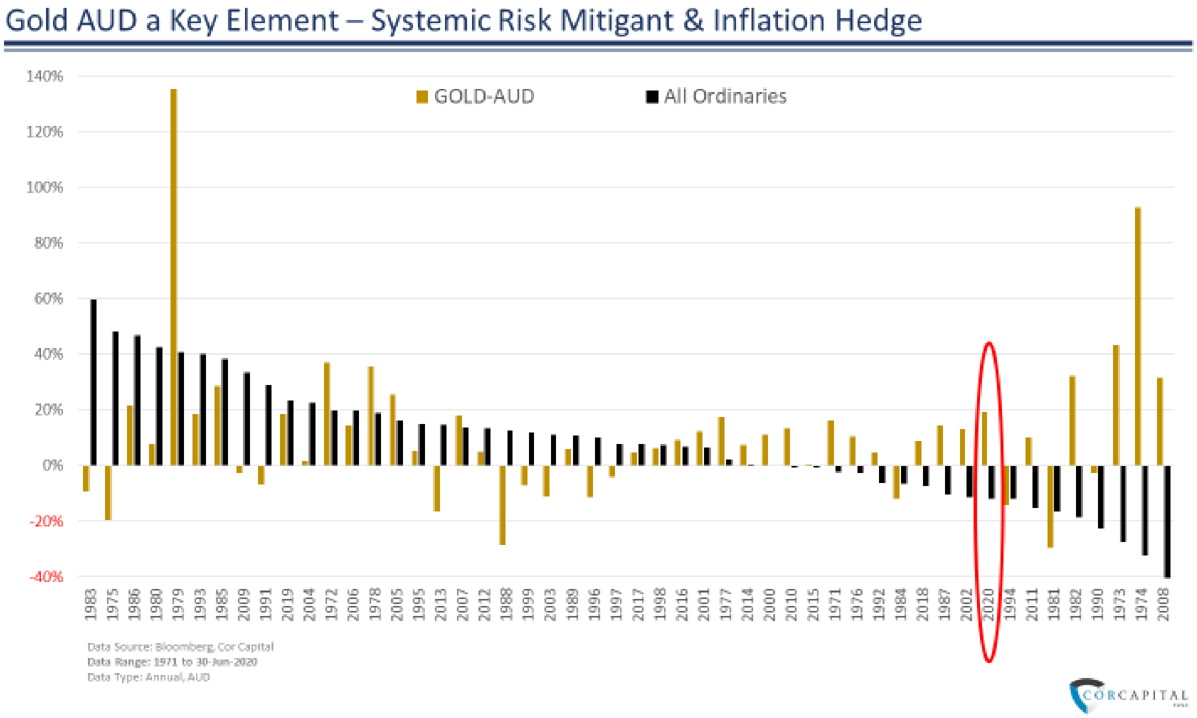
For six months ending 30 June 2020, the All Ordinaries Index fell by -11.8% whilst Gold/AUD gained +19.4% over the same period.

Similarly, during most of the major equity market selloffs, Gold/AUD typically provides relief and negative correlation. Notably, in periods of both equity falls and high inflation, Gold/AUD has provided protection for an equity portfolio, such as during the 1973-1974 equity market crash driven by Bretton Woods and the oil crisis.

Gold typically provides 'safe haven' resilience while the Australian dollar tends to weaken with risk assets. In severe market selloffs, Gold/AUD has often provided a boost when needed.

Importantly, in periods of rising equity markets, Gold/AUD has not held this negative correlated relationship, granting Australians an attractive put against equities with a limited drag in an upward moving equity market. In fact, over many periods both gold and equities rise together.

Figure 1



Source: Cor Capital P/L

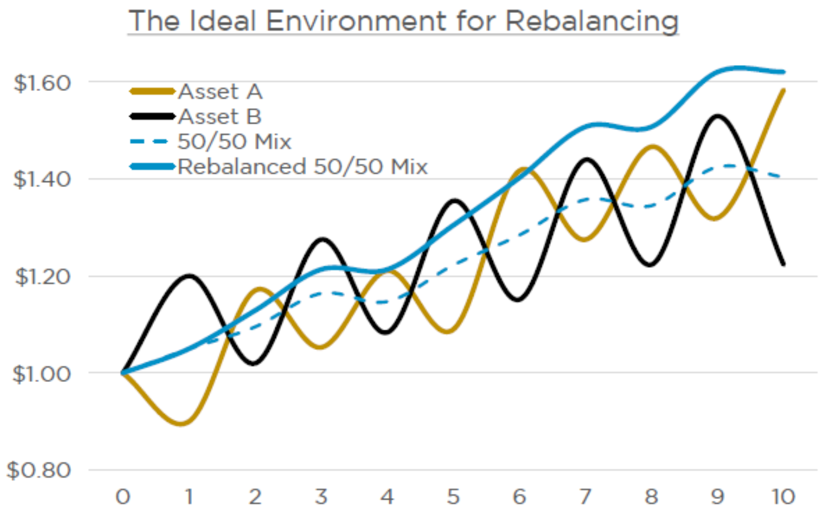
Harnessing volatility through portfolio re-balancing

Within portfolios that regularly re-balance for added return, the ability to combine volatile but uncorrelated assets in constantly re-balanced proportions can add substantially to overall portfolio growth. This is well researched in academia and employed by Melbourne based multi-asset manager Cor Capital.

Normal volatility is harnessed through the trimming of winners and topping up of relatively poor performing assets (buy low/sell high) for added return relative to passive asset allocation. Further, as volatility increases the opportunity set increases.

Figure 2 depicts the stylised scenarios where re-balancing can add to static asset class return.

Figure 2



Source: Cor Capital P/L

Historically, equities and Gold/AUD have held a negative relationship in falling equity market periods with low correlation in all periods. Both assets have recorded roughly mid-teen (15% annually) long term volatility, creating an attractive pair of assets to harness normal volatility between the pairs.

Equity-centric portfolios have the potential to hedge for extreme events, protect future purchasing power and earn a unique source of return without taking on more equity or credit risks. Exposure to unhedged gold in Australia is readily available, for example, through unhedged gold ETFs listed on local exchanges.

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