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Editorial

The US tech index, the NASDAQ, peaked on 2 September 2020 at 12,058 and closed three weeks later at 10,632. On the same days, Apple hit US$137.98 and then fell to US$107.12. These falls of over 10% and 20% seem high but both were simply returning to their early August levels. It's hardly a rout when a month's gains are given back, although **Morgan Stanley** analysts warned the sell off was only half way done.

The bigger question is whether such a stock correction will scare off the '**Robinhood**' traders. Much of the demand for tech has come from new retail investors living the 'markets only rise' dream, buying US$500 billion notional value of stock options in August alone, or five times the previous monthly high. The options sellers who take the other side of the trade cover their exposures by buying the same shares, adding to demand. For the first time ever, options trades exceeded normal share trades on US stock markets in August.

What happens when these new players realise markets do indeed fall and their options are well out-of-the-money and likely to expire worthless? Perhaps they hang on for a rise. As we discussed in [this article on retail investors](), it is their impact on the actions of professionals that has the most impact on the stock market. The chart below shows the incredible growth (blue line, almost vertical) in 'small trader call buys', that is, stock options bought by retail punters hoping the market will rise. Apple's 20% fall will test the mettle of many of them.

"Retail doesn't have the ability to move the market by themselves, but by buying calls they force dealers to hedge themselves, and triggered this parabolic move in tech stocks." ft.com/content/b330e0...

And yet amid the tech 'correction', an eight-year-old cloud-data software company floated with a value of US$70 billion. **Snowflake**'s shares rose from its issue price of US$120 to reach a high on the first day of US$319. At its closing price, it was worth six times more than its last funding round as a private company as recently as February 2020.

In case you are wondering who gets a piece of the action when first day trading leaves US$4.3 billion on the table, the answer is, those closest to the investment banks handling the deal. It's impossible to receive an allocation unless you know someone or are a big client, with **Warren Buffett** making a billion on the day. As **David Dechman**, once Head of Private Wealth Management at **Goldman Sachs**, confirmed in an internal memo written many years ago, the system allows the rich and connected to become even wealthier (sourced from Bill Gurley's Twitter feed via AFR):

"The hot deals are obviously a currency, which can be used to please institutions, please high net worth individuals, acquire new customers ..."

1. The hot deals are obviously a currency, which can be used to please institutions, please high net worth individuals, acquire new customers (perhaps for GS.com), help ECM as per the memo, etc. How should we allocate between the various Firm businesses to maximize value to GS?

2. How much "say" do the issuers have? They have an obvious trade-off between a big "pop" (great media coverage and morale boost) versus more cash proceeds. Could we offer a "dial" to issuers and let them (and perhaps their Ad agencies) decide?

3. For GS.com, EXCLUSIVE access to GS hot deals might be a critical competitive tool to keep customer acquisition costs low and encourage larger clients to move to our site from a competitor's.

Hope this is helpful. Please keep me informed as the work progresses.

David A Dechman

Does the same thing happen in Australia now? Of course it does. Winning the hot deals is not just about the fees the investment bankers earn.

This week, a focus on tech and innovation

We continue our Interview Series with **Thomas Rice**, who manages the innovation fund that delivered 43% in the last year by finding the best new ideas around the world. He describes his biggest positions and what he likes and does not like in global tech. How could you not love a job like that?

Then in the high-profile **Battery Week**, a comprehensive review of **Tesla** looks at whether the current price can be justified. The market did not like **Elon Musk** saying major cost improvements could take three years, and **Vikram Mansharamani** takes a deep dive into the bubble of Tesla's share price.

Then **Adrian Fyffe** describes the impact of currency movements on a global portfolio, and ways that Australian investors can access the big US names like **Facebook, Apple and Google** while minimising costs and FX transactions.

Moving on from tech, **Christine Benz** takes an unusual look at retirees who have enough money and would rather protect what they have than push for more, while **Wade Matterson** shows how, even for relatively wealthy retirees, the current age pension provides a safety net if the market falls. It's a reassurance but financial independence is still the best outcome.

Are we facing a W-, V- or U-shaped recovery? **Kristiaan Rehder** thinks it's more likely a K, with some companies doing very well as the expense of others.

In the final three articles by Leisa on our Survey, she covers your views on the increase in Super Guarantee and fall in JobKeeper, how you have changed your investment portfolio and your economic outlook, and how

COVID-19 has affected you including long-term consequences. There's a fascinating collection of hundreds of comments on how you think the world will change ... or not.

In a footnote to last week's article on how LICs and LITs are facing challenges, another conflict appeared in the media this week with high-profile bankers **Rob Ferguson and Malcolm McComas** running the following advertisement in *The Australian Financial Review*.

Interview Series: What's new in a global innovation fund?

Graham Hand

Thomas Rice is Portfolio Manager for the Perpetual Global Innovation Share Fund, a long-only global fund focused on investing in new trends in innovation and technology.

GH: Managing a global innovation fund must be the best job in funds management. What have been your big winners in the last year and why did you buy them?

TR: Yes, the Perpetual Global Innovation Share Fund returned 43% net in the year to end August so there have been many winners. We've held 31 different stocks that each added 0.5% or more. Three of the biggest were Zoom, Axon Enterprise and Vestas Wind Systems.

I'll start with Zoom, which the Fund first bought in April 2019, the day it listed. What struck me about the company was it was one of the fastest growing SaaS (Software as a Service) companies in the world while having positive margins which is incredibly rare. Most SaaS companies have negative margins because they spend so much on customer acquisition. Videoconferencing seemed like a mature market, but Zoom was winning significant market share for two reasons. First, an incredible focus on the customer experience made it easy to use, which was new at the time. And second, Zoom was built for the cloud, and technically, it was far more reliable than competitors with efficient switching and routing. Then in March 2020 as video conferencing grew during COVID-19, I invested further in Zoom, and it became the biggest position of the Fund at 6.5% at the time.

GH: What about the impact of COVID on other parts of your portfolio?

TR: In February, my focus honed in on the potential impacts of COVID on the portfolio when the virus moved beyond China. I sold out of travel company Expedia and Disney. But I also went on the offensive and Zoom

looked like a major beneficiary. I increased it to 10% of the Fund as I gained more confidence in the stock. Zoom went from 10 million daily meeting participants in December to 200 million a month then 300 million.

GH: But didn't you then have a problem about the maximum proportion of the Fund which can be held in one stock?

TR: The Fund can hold up to 12% of one stock at the time of purchase or up to 15% with a market movement. We only hold that when I have a lot of confidence in the position. With Zoom, I talked to their existing customers and estimated how many the S&P500 companies had signed up by tracking subdomains. For example, a large customer like Nike will have a subdomain like nike.zoom.us. This allows you to check if those domain names exist and therefore, if they are Zoom customers.

GH: And you had strong confidence in another name?

TR: Yes, Axon Enterprise was the biggest contributor to the Fund in its first year in 2018. When I found this company in 2017, their main focus was Tasers, but they were also investing heavily in body cameras. I had previously done a lot of work on AI and machine learning, and I knew technology was improving and that they could interpret videos and images better than ever before. I also knew that transparency in policing was becoming important and I thought police body cameras would become the norm.

These body cameras are not like a GoPro camera, as some people assume. It's more of a data management business. It's not about selling devices, it's selling a monthly plan where a police officer puts the camera on a dock which uploads the evidence into a cloud platform on evidence.com. It's a subscription software business managed where they can tack on AI processing to add value. Axon's service allows tracking of police officers in the field and livestreaming of videos in real time, at say, high-profile events.

Body cameras are already used in Queensland and Victoria, and internationally they recently won their first contract in India. Axon cameras are also expanding into new areas, such as forestry services, border patrols and prisons. In fact, Corrective Services NSW deployed 336 body cameras in December. I view Axon as a perfect blend of understanding the technology plus knowing the space they operate in. The Founder and CEO is doing his life's work running this business. He wrote a book called 'The End of Killing' where he talks about his mission to make the bullet obsolete.

Axon's focus on AI includes an AI Ethics Committee with independent third parties. They've committed to not using face recognition in any of their cameras because they don't believe the technology provides a fair outcome.

GH: How has the share price performed?

TR: The Fund first invested in Axon in June 2017 at $24 and it's now $84 and a large part of the portfolio. Just think how often you now see body camera footage in the news.

GH: And your third best stock?

TR: That's Vestas Wind Systems, a renewables company. I became interested in wind power when the cost of energy for onshore wind power dropped below fossil fuels in many parts of the world. Vestas Wind Systems is the largest onshore wind turbine manufacturer in a business where scale matters. I think that wind will become an increasingly important part of the energy mix.

GH: We know that many tech and innovation companies trade on extremely high PEs or make a loss. How do you value a company that makes a loss?

TR: In my career, I've bought value stocks and yield stocks and growth stocks and bonds, and I personally invest in startups. And I don't think about them very differently. I go back to first principles, the present value and future cash flows. As long as you understand the underlying assumptions, it's about what the business will earn over time. For a mature company, the near-term earnings are a better proxy for earnings, but for a growing company, you might need to decide how the business will generate a profit in 10 years' time.

For example, what is the value of a company adding customers and how are they monetising it? Take the example of Facebook, where early on, they weren't showing many ads, but they have increased that overtime and monetised their asset. You need a good understanding of costs. How do the costs change over time, are there scale benefits? Put all those pieces together into how you believe the economics will transform in the next five to 10 years. Then you can get a sense of valuation.

I also like to invert the question. Based on where the stock is trading today, what would have to happen to justify the price here? That's often better than a point estimate of valuation which can give you a false sense of security.

GH: Is there an example of a company that the market loves, and you don't.

TR: It's hard to say the market is clearly wrong at any time, but I feel with companies like Uber or Tesla, much of the valuation is based on something that may or may not happen, such as the rolling out of an autonomous car network. I can imagine scenarios where that will happen, but I wouldn't want to bet on that outcome. I want more confidence that something beneficial will happen.

GH: So, the good outcome is already in the price. How do you feel about the big techs, the Facebooks, Apples and Googles?

TR: Apple has clearly gone from being seen as a hardware company to a services company. It's rerated from 15 times to 33 times earnings, but I think it's fully priced now. Facebook still offers reasonable value. I don't think Google, Amazon or Microsoft are too expensive.

GH: Among these many successes, what has been a poor stock for the fund?

TR: Vivendi. It's a conglomerate and their biggest asset is the Universal Music Group. I like this due to the rapid growth of music streaming where content is dominated by only three players: Universal, Sony Music and Warner Music. But other assets in the conglomerate aren't as attractive and the share price has not done so well.

GH: To manage an innovation fund, do you need to be an optimist, even a dreamer, with a lot of faith in the future?

TR: No, not an optimist, more a realist. You need to see the truth in how the world is changing and invest according to that, rather than hoping for the best.

GH: Is there an innovation the market has not recognised enough?

TR: I still think the market is underestimating the shift to renewables. We have reached a tipping point on cost comparisons versus conventional energy. Every year that passes, renewable costs will decline, especially with improvements in batteries and solar.

GH: What has been the biggest miss or act of omission in your portfolio?

TR: My biggest miss has been Apple and the way they have built a services business. Also, Shopify has done incredibly well as an alternative infrastructure provider in the way it competes with Amazon. COVID has been a real accelerant for e-commerce generally. It's a company that I've watched closely but always wanted it a bit cheaper.

GH: Do you own any Australian stocks?

TR: We own Nitro Software, a PDF software company that's also into e-signatures, which I think the market has undervalued. With COVID, you need to understand how behaviours are changing, including the digitisation of office documents. But I tend to focus outside Australia while staying close to the Perpetual Australian Equities team here.

GH: Would you like to see a market pullback to buy into some stocks at better levels?

TR: Not really, I love how the portfolio is positioned, we own a lot of great stocks where we have bought in at cheap prices. The Fund is underweight in the US and I'd like to own some big tech stocks at cheaper prices, say down 10% to 20% from here. But for me, it's more about what are the best companies in the world today based on where prices are now.

This is the way I frame it - there are 10,000 stocks in the world that are liquid with a market cap of over $1 billion. You should always be able to find something that's good value for a portfolio of around 40 stocks. You will never hear me say I can't find anything worth buying.

GH: What about e-sports and the gaming industries?

TR: Gaming has always been a part of the portfolio and the quality of games is now amazing. It's a growing segment of the entertainment industry with excellent ongoing demographic shifts. And it's also an area that a

lot of fund managers tend to ignore which I find very surprising. I've always had 10% or so of the portfolio in video games. The ubiquity of mobile devices that can be used for gaming has been a huge driver as well. One way to get exposure to that is Unity Software, which is a game engine company that powers 53% of the top 1,000 mobile games. They just listed last Friday.

GH: Before we close, we should address the shadow that hangs over companies such as Facebook and Google, and that's the threat of regulation. This extends to AI where people are concerned about privacy. How do you factor that in?

TR: Yes, it's an important question and one that has a way to play out. There have been a number of instances where companies like Facebook have been too slow to understand their social license to operate. Data is a good example of that. There are huge benefits in using data to better understand your clients' needs but at what point does that use of data actually become unethical or a breach of privacy? In the absence of self-regulation, there will ultimately be a regulatory response. The more recent issue of spreading misinformation is complex and addressing it will be difficult and costly as companies build the systems to better manage it.

Graham Hand is Managing Editor of Firstlinks. Perpetual is a sponsor of Firstlinks and more details on the Global Innovation Share Fund can be found here. This article is general information and does not consider the circumstances of any investor.

For more articles and papers from Perpetual, please click here.

Five reasons why Tesla is the everything bubble embodied

Vikram Mansharamani

When financial historians reflect on 2020, they will probably focus on a few stock stories that capture the zeitgeist of our age. Tesla is sure to be on the list. It is the embodiment of several unsustainable dynamics that characterise today's markets.

In some ways, the Tesla bubble is more about investors and our economic environment than it is about the company. The faith in market efficiency, the focus on being 'green', the fear of missing out, and the increasing power of storytelling by celebrity leaders have created fertile ground in which the Tesla bubble took root and grew. I believe it is about to burst.

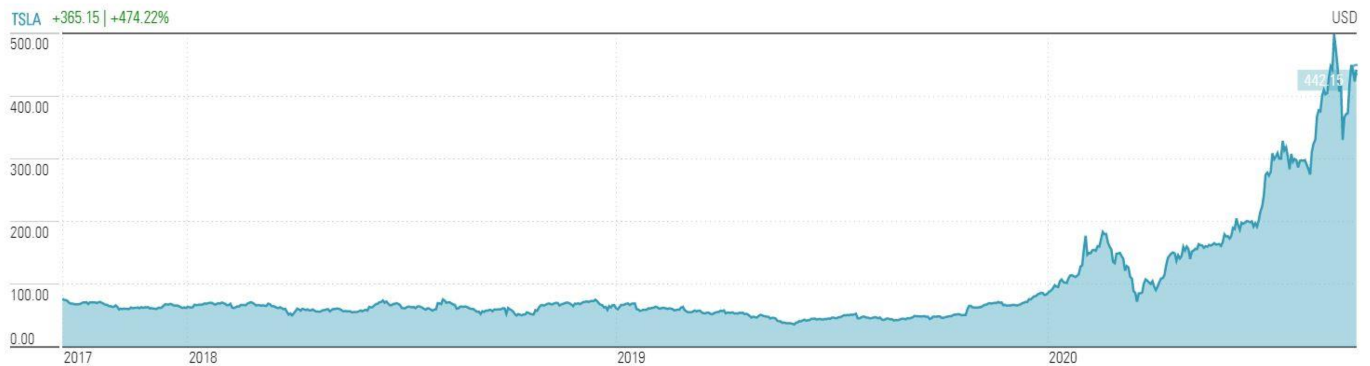
How did we reach this point?

But before articulating why I think so, let's understand how we got here. When it comes to bubble-spotting, context matters.

The first dynamic that enabled the Tesla bubble to blow is the widely accepted faith in market efficiency and passive investing. As fewer and fewer professionals actively consider the merits of a company's prospects, stocks become disproportionately driven by capital flows. Stocks disconnect from fundamentals as pricing distortions are compounded by momentum-driven algorithms and traders. Further, as hedge funds have been vilified and have shrunk as a percentage of the market, the useful price-discovery role played by short-selling has been diminished.

This is a dynamic likely to get worse as the passive investing bubble continues to inflate. Relatedly, interest in environmental, sustainability, and governance (ESG) matters has grown rapidly. Yet the availability of ESG investment opportunities has not grown as quickly, leading those with ESG mandates to focus on fewer and fewer investments. In the quest to invest in 'sustainable' companies, many investors have stopped thinking about prices, creating unsustainable investments.

Second, the rise of social media has exacerbated the dreaded 'fear of missing out' (FOMO). Individuals and portfolio managers alike are uncomfortable with contrarian and independent thinking. Greed has come to trump fear. Everyone wants to keep up with the Joneses, either personally or professionally. Such a dynamic is easily spotted when higher prices incentivize, rather than reduce, the number of new buyers. Consider the fact that Tesla is worth 10x what it was around one year ago. Fewer and fewer investors are worried about downside risks.



Source: Morningstar, as at 18 September 2020

Lastly, stories have come to trump reality in many walks of life. Like the movie *Wag the Dog*, sentiment can and is manipulated to create perceptions that often differ radically from underlying reality. Celebrity story tellers in business and government come to wield enormous power over cult-like followers. This tends to generate highly polarized groups that blindly follow or routinely criticize. Facts matter less in our post-truth society. Nuanced and critical thinking have been replaced by unquestioned faith.

As fewer investors think for themselves, the bubble has grown to concerning levels and a five-lens framework I've developed to spot bubbles before they burst points to imminent risk.

1. Price action

My first lens is price action. The stock's parabolic rise to $500 per share ($2500 pre-split) is the result of individuals buying without regard to price. This may be hedge fund managers covering shorts or individual traders planning to buy high and sell higher. As the FOMO music plays, investors continue to dance. The music appears to be slowing, if not stopping.

2. Mispriced or misallocated capital

Evidence of mispriced or misallocated capital is my second indicator. And here, global central banks have penalised savers and rewarded those with ongoing capital needs. Tesla has tapped capital markets numerous times (including a recent offering) over the past year and achieved a $400+ billion valuation, making it worth more than Walmart, Procter & Gamble and JP Morgan. When money is mispriced, it tends to be misused and enables unsustainable business models to thrive. Further, as the share price rises, the company's cost of capital falls, enabling investors to justify higher prices.

3. Misplaced vision

Almost every bubble has a sexy new story associated with it that allows investors to envision a fantastic new world that lies ahead. Tesla's 'new new thing' is autonomous driving and the vision that CEO Elon Musk paints of robotaxis taking over transportation is one that captures the imagination. Add on top of this the allure of the recently announced US$25,000 electric (autonomous) vehicle, and you've got a strong cocktail. Investors are giddy with optimism.

The vision is so seductive that analysts reach inordinately far into the future to justify today's prices. Several analysts now have valuation-based models using operating assumptions in 2030 (or beyond) to justify today's prices. Between now and then, rapid growth is assumed to be certain. Hope turned to expectations which in turn are now assumed to be virtually certain. Competition (and lots of it) appears on the horizon. Yet headlines like 'Why Tesla could become the world's first US$10 trillion company' capture the spirit of the times. There is widespread belief that 'it's different this time'. It rarely is.

4. Government policies

The fourth sign of a bubble about to burst is political manipulation of underlying demand. And in this regard, the impact of subsidies has proven that Tesla demand has been impacted by government policies. A quick glance at California and the Netherlands demonstrates that demand can and does plunge after subsidies end. Demand has been artificially elevated by political actions. Further, because owners of electric vehicles don't contribute to the Highway Trust Fund but use the same highways as the contributing gasoline car drivers, the cost of operating a Tesla is being indirectly subsidised. Lower subsidies will reduce demand, particularly if the economy slows further.

5. Popular sentiment

My final indicator is one about popular sentiment. Think of a financial bubble like an epidemic, one spreading through a population. One key variable to watch in gauging the maturity of a bubble is the population of still 'infectable' individuals. And with respect to Tesla, the question is about popular sentiment. When cocktail party banter and dinner conversations turn to a topic, the universe of new buyers is likely dwindling. The fuel to pour on the fire is running low. Everyone is talking about Tesla.

The recent surge in advance of the stock split suggests amateur investors are a driving force. Others, eager to join the party, justified purchases as a trade to profit from the company's inclusion into the S&P 500 index, a hope that failed to materialise. While games can and do go into extra innings, Tesla appears to be a ninth-inning bubble.

Some have suggested Tesla should be thought of as similar to Amazon during the internet bubble. But let's not forget that Amazon stock fell from over $105/share to under $6/share as the internet bubble burst. It took almost a decade for the company's share price to again cross the $105/share value. Even if Tesla does achieve its grandiose ambitions, its stock appears to be way ahead of itself. Musk himself seemed to suggest this very fact, highlighting during Battery Day this week that the company is not as profitable as its valuation may suggest. Like Amazon, Tesla may prove to be a wildly disruptive and successful company that changes the world, but that does not make it a promising investment today.

Distancing from popular sentiment

Investors need to step back and think for themselves, free and clear of the popular sentiment that surrounds them. When I did so, it led me to short Tesla's stock and buy put options. Some may argue I've written this piece because of this economic exposure, but such logic is flawed. I'm betting against the company's equity because of my arguments in this article, not the other way around.

Vikram Mansharamani is a Lecturer at Harvard University and the author of "Think for Yourself: Restoring Common Sense in an Age of Experts and Artificial Intelligence" (HBR Press, 2020). He is also the author of "Boombustology: Spotting Financial Bubbles Before They Burst" (Wiley, 2019) and previously taught a course on Financial Booms & Busts at Yale University. This article is general information and does not consider the circumstances of any investor. A version of this article previously appeared in Newsweek.

Three retirement checks for when you have enough

Christine Benz

One of the most illuminating portfolio makeovers that I've had the chance to work on over the past few years featured Ted, a retiree employing a conservative strategy.

At age 70 and divorced, Ted was savouring life in a warm climate, spending time with his significant other, enjoying his photography (and making a little bit of money on it, too) and relishing his close bond with his adult daughter. He was extremely frugal - purchasing a small SUV that he expected to keep for many years was a rare splurge. Ted told me that he was content to make do on social security and extremely modest portfolio withdrawals of less than 2%. And his portfolio wasn't huge at about $450,000. That translated into a $9,000 annual cash flow from his portfolio.

Ted's portfolio was so conservatively positioned, with about 70% of assets in cash and bonds, that I had some concerns about the effect of inflation on his purchasing power, especially because he noted that his healthcare expenses were beginning to flare up. Thus, my 'After' portfolio nudged up his equity weighting to 50% of assets from 30% previously. With a spending rate as low as Ted's, I argued, he absolutely could afford to take more equity risk. Even if his equity holdings encountered a sustained bear market, there was little to no chance he'd need to sell them in a trough. And switching into a more aggressive portfolio mix would probably enlarge his eventual balance, which he could use for travel or pass on to his daughter.

But in hindsight, I wondered if my increase of stocks in the 'After' portfolio was more reflexive than it was necessary. Yes, his bond-heavy starting portfolio had low return potential, and yes, a heavier equity allocation would likely bump up returns, albeit with extra volatility. But given Ted's modest spending, he could afford to maintain a more conservative asset mix that provided him with more peace of mind than he'd be able to have with a more stock-heavy portfolio. His portfolio was enough.

'If you've won the game...'

Ted's approach reminds me of the saying I most closely associate with asset-allocation guru Bill Bernstein:

"If you've won the game, quit playing."

The basic idea is that if you've built your portfolio up to a point that it meets your goals, you don't need to keep gunning for additional returns. Instead, you can switch your focus to extracting your cash flows from a more conservatively positioned portfolio that provides you with peace of mind.

Ted's case is also an illustration that you don't need to have several million dollars to shift into the 'enough/peace of mind' camp. People of more modest means can get there, too. The key is that the portfolio spending rate must be low enough to make it work, and the portfolio should be positioned to support that spending as well as to accommodate inflation and short-term spending shocks.

At the same time, maintaining a very conservative portfolio can introduce risks of its own. The portfolio may not grow enough to support the planned spending rate, or that spending could increase due to inflation or a lifestyle shock, such as long-term care expenses later in life.

If you're inclined to de-risk your portfolio for retirement because your spending rate seems low relative to your portfolio size, be sure to consider the following as part of your calculus.

1. 'Safe assets': low return drives low withdrawals

A key consideration for investors attracted to a less volatile portfolio that features lower equity exposure is that the return potential of fixed income assets has dropped markedly over the past several decades. Current yields are a good predictor of what bonds will return over the next decade, and the 10-year bond yield is just 0.70%. Other high-quality bonds (and in Australia, perhaps term deposits) yield a bit more, but it's hard to push yield much over 2% without taking substantially more risk.

That has implications for safe withdrawal rates. After all, the 4% guideline has only been stress-tested over periods featuring much higher yields, and the back-tests featured a balanced equity-bond portfolio, not one that skews heavily toward bonds. That suggests that retirees who wish to maintain very conservative portfolios also need to be similarly conservative about their withdrawal rates. Ted's 2% withdrawal rate doesn't seem too far off the mark. The trouble is many retirees won't find that to be a liveable income stream.

2. Spending could change

And even as you might have a disciplined spending plan in mind for your retirement, it's also worth bearing in mind that in-retirement spending isn't 100% within your control. While inflation has been fairly benign over the past decade, running well below historical norms for most categories, it could run higher in the future. (High government spending to ward off a recession could stoke inflation, though many experts also predicted inflation following the global financial crisis from 2007-09 and it didn't materialise.) It's also important to consider that your own inflation experience could be different from CPI at large, especially if healthcare-related costs consume a large share of your spending. Higher inflation has the potential to drive your overall spending - and in turn your withdrawal rate - higher than you intended, even if consumption remains the same.

In addition to inflation, it's worth considering that what you spend money on - and in turn your total spending rate - might change over your retirement life cycle, too. Research from Morningstar Investment Management's Head of Retirement Research David Blanchett points to spending tapering down in the middle years of retirement, then flaring up toward the end, largely due to uninsured healthcare costs. If you haven't made a plan for long-term care expenses should they arise, it's particularly important to factor in those potential costs.

3. The value of a second opinion

There are so many moving parts in creating a retirement plan; changes in one part of the plan have repercussions in another. For that reason, it's valuable to get a professional opinion on any asset allocation or withdrawal setup you're contemplating, to understand and troubleshoot any unintended consequences.

It's also worthwhile to consider all of your spending sources together - not just your portfolio, but also any income you'll derive from pensions or any other sources. After all, if your aim is to create a conservative plan, one of the best ways to ensure that is to create a baseline of retirement cash flows through non-portfolio sources to cover very basic living expenses. That takes pressure off the portfolio and portfolio withdrawals, which in turn can contribute to peace of mind.

Christine Benz is Morningstar's director of personal finance and author of 30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances and the Morningstar Guide to Mutual Funds: 5-Star Strategies for Success. This article does not consider the circumstances of any investor, and minor editing has been made to the original US version for an Australian audience.

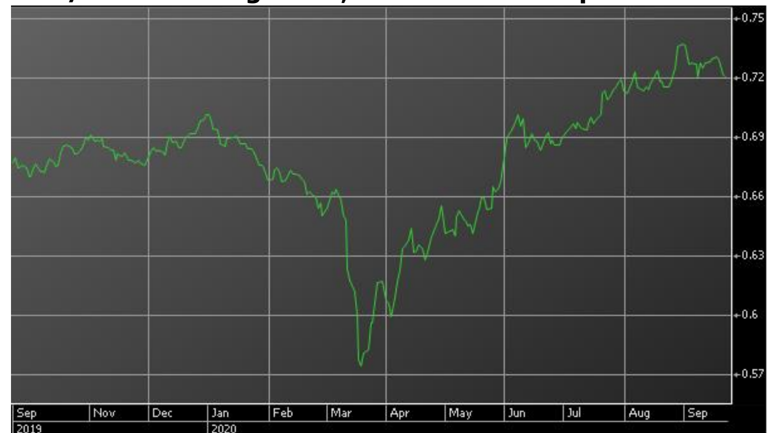
Hide and seek: the FX impact on global equity investments

Adrian Fyffe

While domestic equities remain the main investment of choice for many Australian investors, there has been a shift in recent years towards international stock markets to increase returns and diversify portfolios. In a 2019 Investment Trends survey, a sixth of Australian investors stated that they intend to start trading international shares over the following 12 months. Overwhelmingly, the US market was seen as the starting point.

This article looks at three key areas which explain why equity investors should care about foreign exchange. We examine this issue through the lens of Aussie investors investing in US stocks, though the concepts covered are relevant for investments in other overseas financial markets.

AUD/USD exchange rate, 12 months to September 2020



Source: IRESS

One look at a chart of the AUD/USD exchange rate in the last year shows the range of US57 cents to US73 cents can have a profound impact on returns from overseas investments.

1. Investment returns due to currency risk

When you purchase and sell shares in an Australian company, whether your investment makes a profit will largely depend on the change in the company's share price.

However, investing abroad is similar to going to a foreign country on holiday where the exchange rates can make a huge difference to travel costs. For international investing, the impact of foreign exchange rates can have a material impact on unhedged returns subject to currency movements.

It is commonly believed that Australian retail investors are underweight global shares, but this is due to a misinterpretation of ATO data on SMSFs. A more balanced picture shows global equities are the largest asset class in ETFs in Australia.

ETFs by asset class, as at August 2020

2. Company earnings

"The local bourse was up 0.6% today, with the lower Aussie dollar benefiting offshore earners."

This is a common headline in market wrap-ups but what drives this scenario?

Some of Australia's best-known companies are beneficiaries of a lower Aussie dollar because of their ability to generate or collect revenue in US dollars or other currencies.

Iron ore miners such as BHP Group (ASX:BHP) and Fortescue Metals (ASX:FMG), gold miners such as Newcrest Mining (ASX:NCM) and oil producers like Woodside Petroleum (ASX:WPL) receive a boost to earnings when the Australian dollar falls since the prices of their exports are benchmarked to the US dollar.

Other local companies leveraged to a strong greenback include healthcare giants CSL (ASX:CSL) and Cochlear (ASX:COH) and manufacturing and materials companies like Boral (ASX:BLD) and Amcor (ASX:AMC) who generate a large portion of their sales volumes in North America.

Companies may decide to hedge some or all of their currency exposure to deliver more stable earnings over time or they may be happy to take on the risk of short-term currency fluctuations.

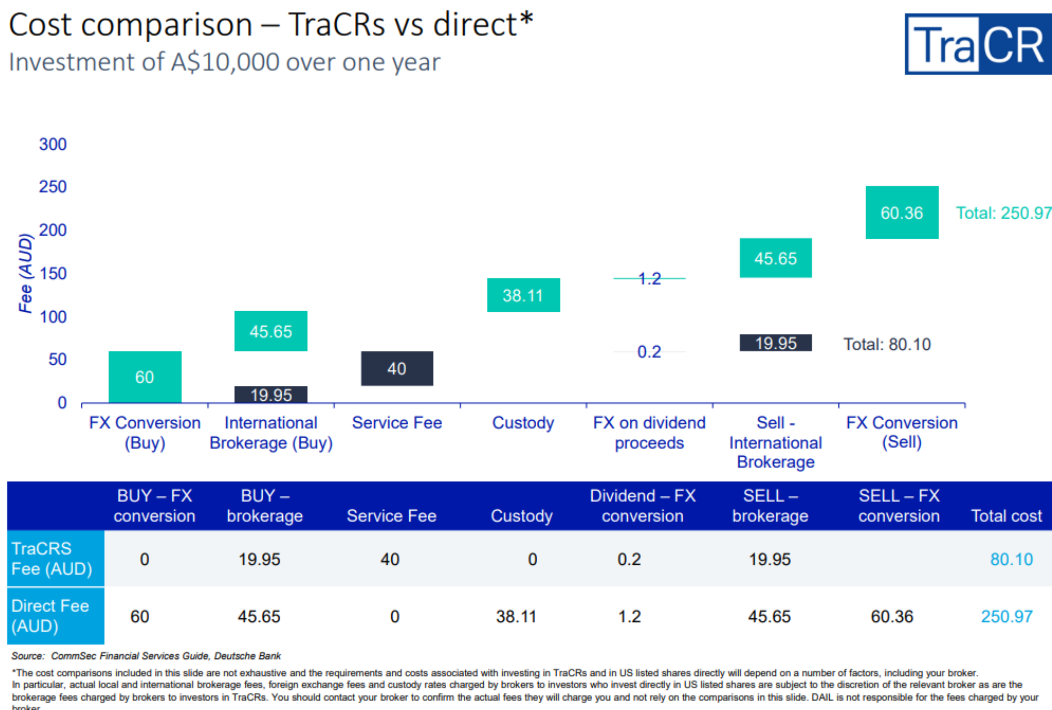
3. Fees

While the fundamental rules of share investing are the same regardless of the market (buy quality companies with strong fundamentals and a resilient business), fees are more complicated and investors need to know how to minimise any erosion in investment returns. Brokerage fees, service fees, management fees, foreign exchange conversion fees and custody fees are some of the more common charges associated with international investing which require a closer inspection.

For Australian investors looking for single stock exposure, there are two common ways of investing;

- Open an international broking account and trade direct shares on the relevant exchange (Direct).
- Trade depositary receipts listed on Chi-X Australia in AUD and locally through your domestic broker (TraCRs).

A recent report published by Deutsche Bank (the issuer of TraCRs) looks at these two options by comparing the fees charged by a large online broker which offers exposure to the US equity market via direct share investment and TraCRs. A summary of their findings can be seen below.



	BUY – FX conversion	BUY – brokerage	Service Fee	Custody	Dividend – FX conversion	SELL – brokerage	SELL – FX conversion	Total cost
TraCRS Fee (AUD)	0	19.95	40	0	0.2	19.95		80.10
Direct Fee (AUD)	60	45.65	0	38.11	1.2	45.65	60.36	250.97

Source: CommSec Financial Services Guide, Deutsche Bank

*The cost comparisons included in this slide are not exhaustive and the requirements and costs associated with investing in TraCRs and in US listed shares directly will depend on a number of factors, including your broker. In particular, actual local and international brokerage fees, foreign exchange fees and custody rates charged by brokers to investors who invest directly in US listed shares are subject to the discretion of the relevant broker as are the brokerage fees charged by brokers to investors in TraCRs. You should contact your broker to confirm the actual fees they will charge you and not rely on the comparisons in this slide. DAIL is not responsible for the fees charged by your broker.

The cost of direct share investment is significantly higher than via a TraCR, and this is largely attributable to the foreign exchange conversion costs. Most investors may not realise that $170 in FX fees is equivalent to an additional 1.7% lost return on an investment of $10,000.

Ever wondered how the ever-expanding number of zero commission brokers earn a profit? This might explain it. In the case of TraCRs, the service fee is only applied to dividends, so if a stock does not pay a dividend, there is no service fee. And there's a surprising range of companies which do not pay dividends that are available as TraCRs, meaning no services fees for holdings in Berkshire Hathaway (CXA:TCXBRK), Facebook (CXA:TCXFBK), Amazon (CXA:TCXAMZ), Netflix (CXA:TCXNFL), Google (CXA:TCXGOG) or even Zoom (CXA:TCXZOM).

Let’s look at an example

An investor sees many more people streaming television programmes and decides to invest in Netflix which trades on the NASDAQ exchange. She buys 100 shares in the company at USD500 per share when the exchange rate is AUD/USD 0.7000. So at the time of investment, the market value of these shares was USD50,000 or AUD71,428 (i.e. 100 shares x USD 500 / 0.70).

Fast-forward 12 months and let’s assume the price of Netflix has increased 20% to USD600 per share. The US dollar value of the 100 shares is now USD60,000, generating a tidy profit of USD10,000. However, over the same 12-month period, the value of the Aussie dollar appreciated 20% against the US dollar meaning the rate is now AUD/USD 0.8400. Converting USD60,000 to Australian dollars gives Australian dollar proceeds of AUD 71,428, the original investment!

Not a great result given the investment idea was correct and Netflix increased 20% over the year. It would equate to a small loss once the fees outlined in the previous section are taken into account.

Of course, the opposite is also possible. The currency headwind can turn into a tailwind when exchange rates move in the opposite direction. Purchasing unhedged shares, TraCRs and ETFs can be a positive if the Australian dollar depreciates. Staying with the example above, if the Australian dollar depreciates by 20% down to AUD/USD 0.56, close to the level in March this year, the Australian dollar value would be an impressive AUD107,143 (i.e. 100 shares x USD 600 / 0.56).

In this example, if the investor expects the Australian dollar to fall, they might be happy to take an unhedged position. However, for those who want to take the currency risk out of the equation, there are a number of products (including ETFs) which can assist in hedging some or all of the currency exposure.

More investing overseas means more FX risk

As companies and investors continue to explore growth opportunities outside Australia, foreign exchange movements are becoming more intertwined with equity investor returns. The range of investment products is increasing which brings choice but it’s important to consider the additional fees and charges associated with dealing in international markets.

No matter whether you are investing in local or offshore companies, or on an Australian or international exchange, it pays to take a closer look at the impact of foreign exchange on your equity investments.

Adrian Fyffe is a Product Manager at 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.

When America sneezes, the world catches a ...

Kristiaan Rehder

After looking dubious for some months, President Trump's chances of winning the next election are roaring back, with his campaign focusing on law and order and re-opening the US economy.

With riots continuing to spring up across the US, law and order has become a powerful platform, particularly among female voters. Added to this, elections are often won or lost on the economy, and there is a growing desire in the US for the economy to open and for workers to return to their jobs. This becomes a stark choice for those idle workers voting to reopen versus remaining in lockdown.

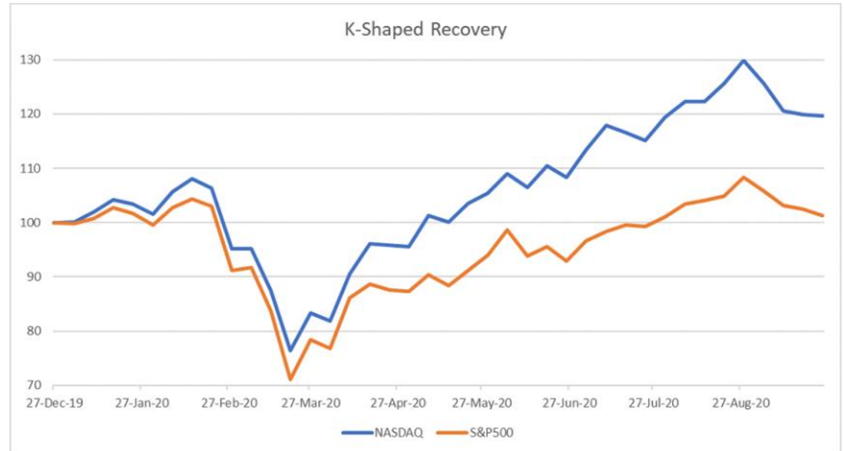
We believe the mainstream polls underestimate Trump's support. The bipartisan divide in the US is strong, and many voters are unwilling to publicly admit their support for the President.

A K-shaped recovery?

Another factor likely to have an impact on the election outcome is, of course, COVID-19. Despite crossing the 200,000 milestone this week, US deaths relating to the virus have dropped materially from a peak weekly count of 17,000 (according to the CDC data) to around 5,000. It is a little surprising that the media has not focused on this statistic, instead preferring to focus on the infection rate. This too has been falling, with average new cases per day falling from above 60,000 in July to around 35,000 in mid-September.

We are not sure COVID-19 infection rates will ever hit zero, but maybe they don't need to. If we can learn to live with COVID-19 while opening up business, we believe the economy – including ours in Australia – has a good chance of continuing its recovery.

The discussion about the 'shape' of this continues. Will it be a V, W, or U? Perhaps it will be a K – that is, good for some and bad for others. It is difficult to imagine a more conducive environment for e-commerce businesses, with large numbers of people confined to their homes for business, consumption and leisure. This has, therefore, created an enormous inequality between those businesses that are leveraged to e-commerce and those that are not.



Changes afoot at the Fed

The other key support for markets is US monetary policy, with the US Federal Reserve recently announcing a new framework. It's yet another evolution in thinking for the Fed, which has proven increasingly willing to use the tools at its disposal to engineer a recovery in the economy.

The framework suggests that monetary policy during economic expansions should aim for inflation moderately above 2% for some time, providing a boost to employment and economic growth. This contrasts to the Fed under Paul Volcker in the early 1980s, when interest rates were quickly raised to record highs to crush runaway inflation (which was running above 12%) and euphoric commodity, housing and bond markets. This current shift in policy towards a greater tolerance of inflation suggests lower rates will persist for some time, with no pre-emptive tightening; which should support gold, commodities and other inflation-benefiting stocks, as well as equity markets in general.

If history is any guide, when the Fed makes a change of this magnitude, it's worth paying attention. We have long believed that during periods of market dislocation, the actions of central banks are the key drivers of market returns. If a deal on a fiscal stimulus plan cannot be agreed between the Republicans and Democrats, it is likely that the Fed will continue to do the heavy lifting.

'Unprecedented' indeed

In February and March, COVID-19 and the subsequent economic shutdown spooked investors so much that they sent the market vertically down for a total drawdown of 36%. To be fair, no-one living today has experienced a pandemic on this scale.

As time has marched on, however, it is looking increasingly likely that the pandemic was more akin to an exogenous shock than a structural downturn – a black swan event which may see the economy recover faster than most expect.

Kristiaan Rehder is a Founder and Portfolio Manager at Kardinia Capital. This is general information only, and has been prepared without taking account of your objectives, financial situation or needs.

How the age pension helps retirees cope with losses

Wade Matterson

The immense value of the age pension is often underappreciated when markets are strong, but its worth is never greater than in a crisis.

The government age pension can potentially offset a one-third decline in the value of a wealthy retired couple's investment portfolio, according to our analysis. This revelation will provide some much-needed comfort to investors as the COVID-19 pandemic creates widespread job losses and wipes billions of dollars from retirement balances.

How the age pension makes a difference: a practical example

Theo and Sue are a hypothetical 65-year-old couple who own their home and have $1 million in pension assets.

Their comfortable position means they initially aren't eligible for the age pension. However, they may well become eligible in future as they draw income from their investments. This can provide them with enormous additional value.

Milliman has modelled thousands of future scenarios for the couple, which demonstrates that the potential future age pension payments they might receive over the next 25 years have a median value of about $180,000 over the course of their retirement.

If Theo and Sue's assets fall by 30% in a major shock to the market, the value of the age pension increases even more. This is because they are more likely to receive larger age pension payments, as well as benefiting from receiving them earlier into their retirement.

In fact, the median value of their age pension more than doubles, rising to approximately $500,000, essentially offsetting the entire fall in their retirement savings.

(The current level of a full age pension is $37,000 a year or $1,423 a fortnight including supplements for a couple).

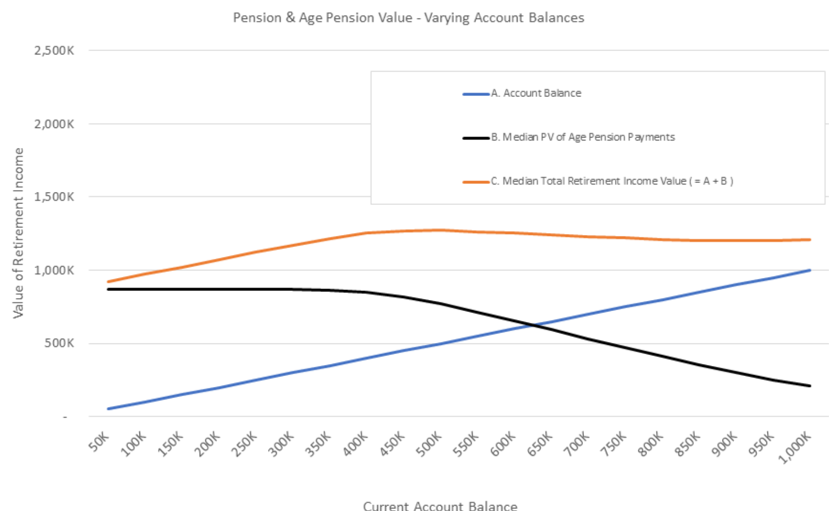
What it means for different people

Wealthier retirees often receive the largest financial buffer from the age pension as their private savings decrease, even where they consider themselves to be self-funded retirees.

That's because retirees with lower retirement savings already receive a full age pension. Those people, most of whom don't receive financial advice, benefit far less as there is no more age pension to receive either now or in the future.

This is demonstrated in the following graph, which shows how the median value of future age pension amounts (the black line) can combine with the value of their private superannuation savings (blue line) to protect the value of their total retirement income (orange line) as retirement savings fall.

As eligibility for the full age pension becomes more likely at around a $400,000 pension balance, the value of future age pension payments levels off, leaving these individuals' retirement incomes more exposed to further market falls.



Source: Milliman analysis

Financial advice in turbulent times

The emotional impact on retirees of seeing huge falls in the value of their retirement savings needs to be appreciated, along with the behavioural biases that come to the fore at times like these. The pain felt by many retirees has been proven to be much greater than that experienced by younger people.

In the current environment of falling investment values, understanding the role of the age pension as part of their retirement plan can provide welcome reassurance.

These complexities underline the value of ongoing advice and analysis to assist retirees in navigating turbulent and volatile environments. Advisers can help retirees better manage this issue in the current climate, by implementing portfolios that provide explicit protection against current and future market falls.

Key assumptions and methodology

Analysis is modelled using the Milliman GBA Platform to model 1,000 random future scenarios. Analysis assumes a couple, both aged 65-years-old who own their own home. The couple's assets are all invested in a 70/30 Growth/Defensive asset mix within an account-based pension, with no further sources of income or assets (for age pension means-test purposes).

The couple draw down the usual minimum required income each year from their pension account (not the temporary COVID levels). All income (including age pension) is assumed to be spent, with no reinvestment of future income.

Future age pension payments are valued by means testing to determine payment amounts in each modelled scenario, then discounting those payments to today's dollars using modelled wage inflation in each scenario. Future age pension amounts assume payment rates and thresholds (indexed in line with AWOTE) as at 20 March 2020 with deeming rates based on the announced deeming rates effective from 1 May 2020.

The analysis runs 1,000 stochastic simulations through to age 90 (i.e. over 25 years), assuming both of the couple survive to this time.

Economic models use Milliman's standard Australian Stochastic ESG calibration and setup as at 31 December 2019. This setup is intended to be used to model the long-term dynamics of a wide range of economic variables, including asset returns, income, inflation and interest rates, and is updated quarterly as part of Milliman's GBA Platform modelling services.

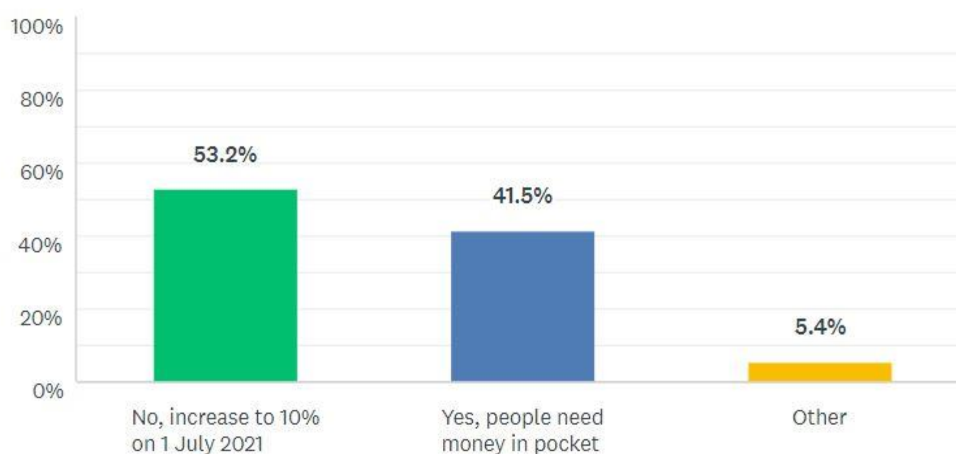
Wade Matterson is a Principal, Senior Consultant, and leader of Milliman's Australian Financial Risk Management practice and a fellow of the Institute of Actuaries of Australia. This article is general advice only as it does not take into account the objectives, financial situation or needs of any particular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

Your views on the Superannuation Guarantee and JobKeeper

Leisa Bell

Our September survey sought readers' views on how the Australian Government has handled the COVID situation. The question on increasing the superannuation guarantee was:

Should the Government delay the legislated increase in Superannuation Guarantee?



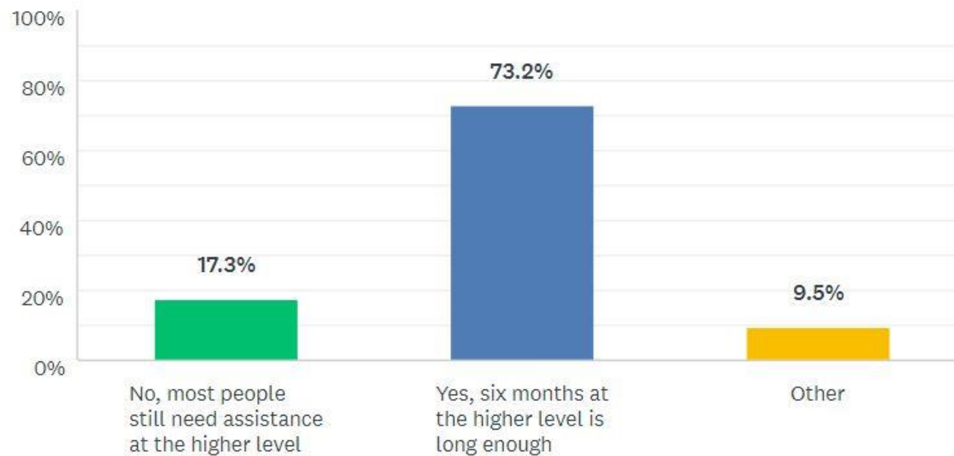
Opinion was evenly divided. A little over 53% say the increase should go ahead, citing reasons such as it having been already delayed for too long; that 0.5% is only a small difference; and a belief that governments may never increase the SG if it delays it this time around.

Conversely, 41.5% think delaying the increase would be better given the financial impact of COVID may continue for a long time and to give business extra time to recover.

The remaining 5.4% who answered 'other' tended towards a wait-and-see approach, suggesting upcoming economic data should be taken into consideration; wanting a guarantee that if not now, it will be increased soon; or said that it won't make a difference either way.

The next question was about JobKeeper:

Is the Government correct to wind back JobKeeper from 28 September 2020?



JobKeeper was a vital measure for many during the height of the COVID pandemic, but it was always intended to be temporary. It will fall to lower levels (depending on hours worked) next week.

A clear majority of readers (73%) thought that six months was enough for JobKeeper to remain at the highest level of $1,500 a fortnight. Just 17% wanted it to continue as is, while 9.5% had a different view.

To get a feel for the sentiments around both these issues, see website for comments.

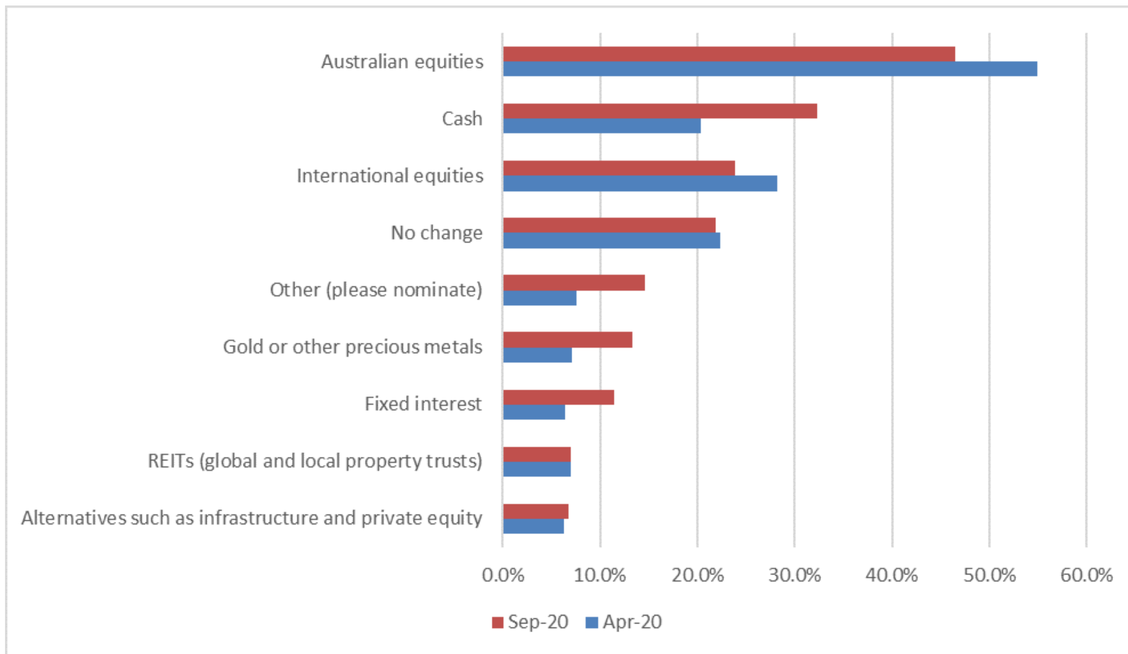
Your portfolio changes and post-Covid outlook

Leisa Bell

Our September survey sought readers' views on how their own portfolios, investment decisions and outlook had changed from our earlier COVID survey in April. We compare the results from both surveys.

Into which asset class(es) have you invested more since COVID-19 started? (multiple responses allowed)

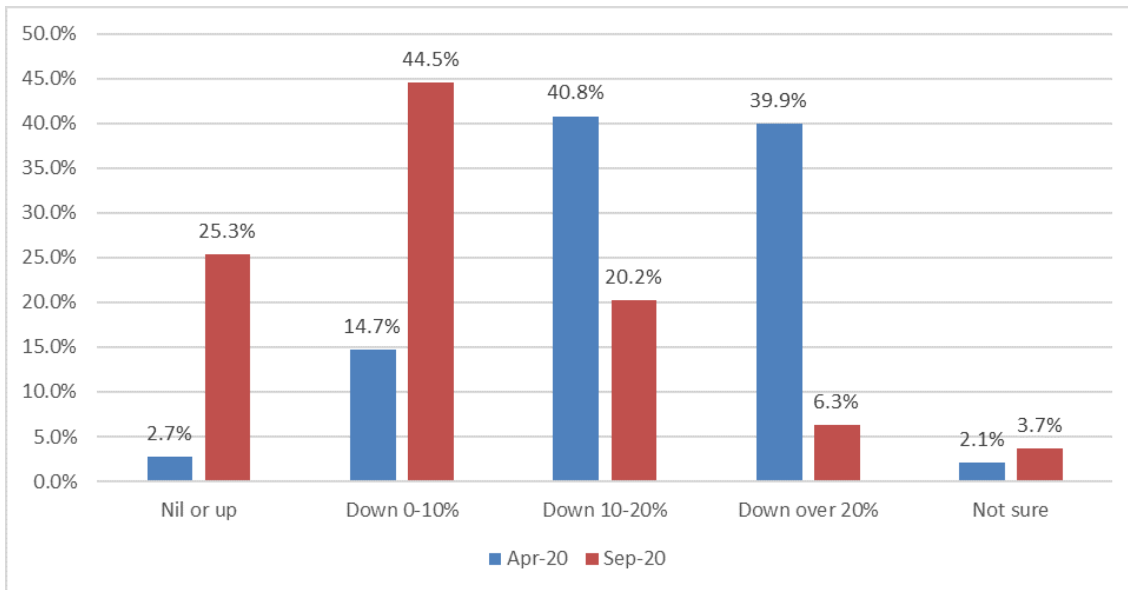
	Apr-20	Sep-20
Australian equities	54.9%	46.5%
International equities	28.3%	23.8%
REITs (global and local property trusts)	7.0%	7.1%
Fixed interest	6.4%	11.4%
Alternatives such as infrastructure and private equity	6.3%	6.8%
Gold or other precious metals	7.1%	13.4%
Cash	20.4%	32.4%
No change	22.4%	21.9%
Other (please nominate)	7.6%	14.6%



While Australian equities was still the top asset class being invested into in this latest survey, there has been some shift towards cash, fixed interest and gold since the April survey. The number of people making no change to their asset allocation remained fairly steady at 22%.

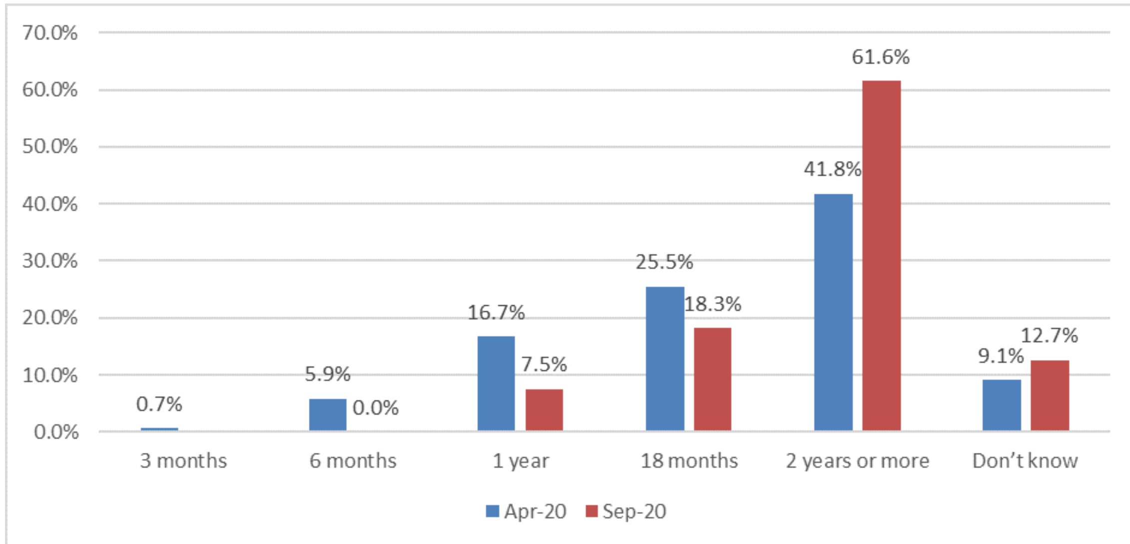
Additional comments, including details on 'other' responses, are included below.

How much has the value of your investment portfolio changed since the end of January 2020? (approximately)



This comparison between April 2020 and September 2020 shows that investment portfolios are recovering from their initial Covid-19 shock. The earlier survey revealed over 80% of people reported portfolio values down more than 10% from the beginning of 2020 (40% saying values were down more than 20%). Now, most are seeing a depletion of less than 10%, with a quarter of people saying the value is flat or higher.

How long will it take for economic activity to restore to pre-COVID-19 levels?



The clear change from April to September is that economic recovery will take longer than first thought. Those saying '2 years or more' increased from 42% to 62%. The 'don't know' camp also increased.

See website for comments on asset allocation and economic recovery.

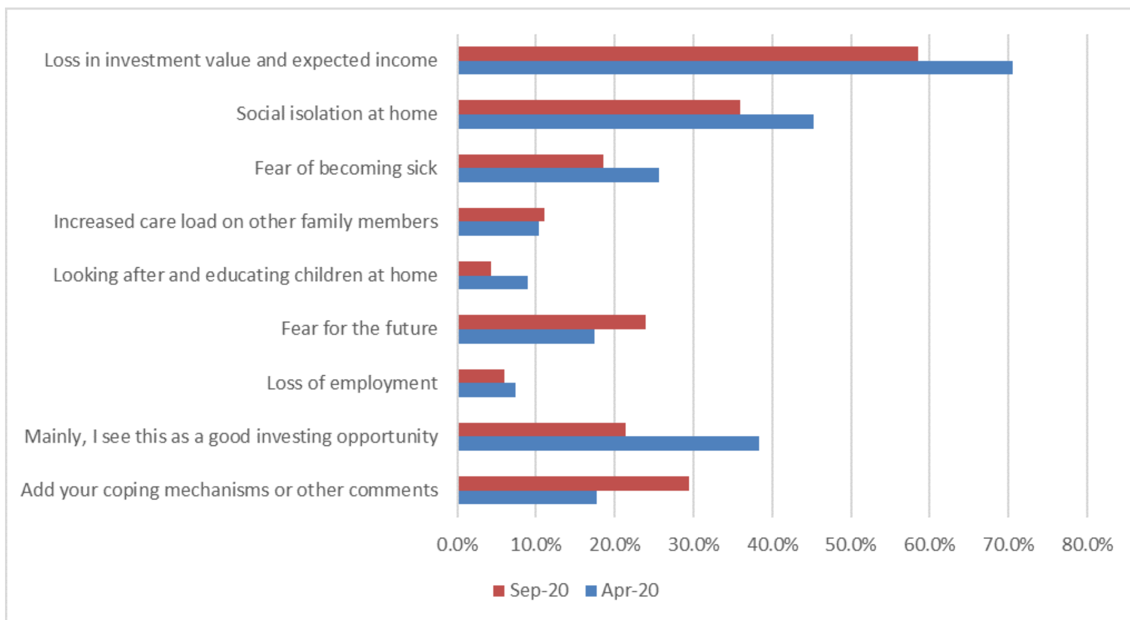
Your adverse Covid effects and post-pandemic consequences

Leisa Bell

Our September COVID survey asked readers about what has been personally affecting them during the pandemic and what they think would be the long-lasting effects. We have compared their responses to our COVID survey in April.

What changes are personally affecting you adversely? (multiple responses allowed)

	Apr-20	**Sep-20**
Loss in investment value and expected income	70.6%	58.5%
Social isolation at home	45.3%	35.9%
Fear of becoming sick	25.6%	18.6%
Increased care load on other family members	10.4%	11.1%
Looking after and educating children at home	9.0%	4.3%
Fear for the future	17.4%	23.9%
Loss of employment	7.5%	6.0%
Mainly, I see this as a good investing opportunity	38.3%	21.4%
Add your coping mechanisms or other comments	17.7%	29.4%



Over half of our September respondents are still reporting declines in investment values and expected income, but this has improved since April when 70% chose this response. However, fewer (21%) are seeing this time as a good investment opportunity than in April (38%).

The fear of becoming sick and feelings of social isolation have diminished in line with Australian case numbers declining as a whole.

See website for comments on coping mechanisms or other experiences.

What will be some sustained consequences of COVID-19 when the crisis is over? Other general comments

See website for comments.

Disclaimer

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