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### Editorial

It is trite and obvious to say the future is uncertain, and while COVID-19 brings extra risks, markets are always unpredictable. However, it's fair to argue that investing conditions are more difficult than ever, mainly because the defensive options for portfolios produce little income. Moving beyond cash, term deposits and investment-grade bonds introduces risk. In his [latest memo to his clients](#), Oaktree's Howard Marks says:

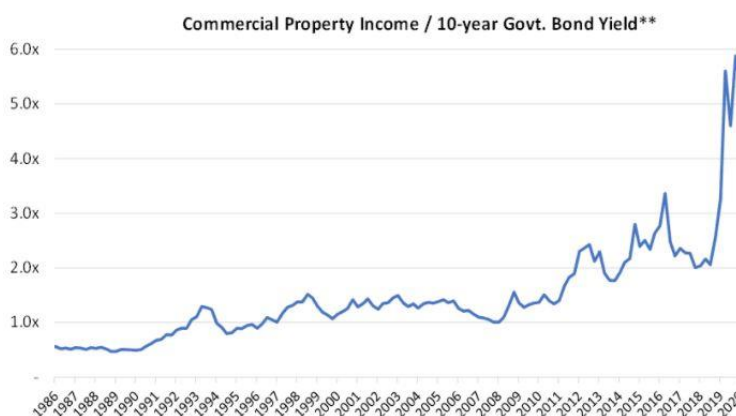
*"In my view, the low interest rates represent the dominant characteristic of the current financial environment, creating the dominant consideration for investors: **the lowest prospective returns in history** ... when uncertainty is high, asset prices should be low, creating prospective returns that are compensatory. But because the Fed has set the rates so low, returns are just the opposite. **Thus the odds aren't on the investor's side, and the market is vulnerable to negative surprises.**"*

Overwhelmingly, low interest rates and ready liquidity are driving demand for other assets, and reconciling these values is our major focus this week. For example, at a time when office rents are facing downward forces and some sections of retail are facing online disruption, cap rates (that is, income divided by purchase price) on commercial property remain robust. The chart below shows that in the past, say from 1995 to 2010, cap rates were far less than double 10-year bonds. Now, with earning yields on commercial property at about 5.8% and bonds at 0.8%, the multiple is around seven times. Such returns sustain demand for property notwithstanding COVID.

Our articles start with veteran consultant to the superannuation industry, **Don Ezra**, who asks whether the rules of investing have changed. He takes us through [seven logical steps](#) to show where he has settled with his own retirement thinking.

Complementing this approach, in the White Paper section, **Vanguard** explains its ['Total Return Investing' concept](#). It ensures alignment with risk tolerances instead of taking unwanted market and credit exposure in the search for income.

(See also the exchanges on growth/defensive in [my article on YourSuper](#) last week which drew a strong response from **Hostplus' CIO Sam Sicilia**).



Past performance is not a reliable indicator of future performance  
 \* Source: AMP Capital as at 30 September 2020; RBA as at 13 October 2020  
 \*\* Source: AMP Capital, RBA, MSCI as at 30 June 2020

Then we have different perspectives on the major company successes of COVID-19, the tech stocks. There is no hint of a recession for the **Amazons, Afterpays, Googles and Kogans** of the world when they are enjoying such strong growth. **Ashley Owen's** charts to show how [local and overseas tech stocks](#) have performed in 2020. Then **Benjamin Chong** makes the case that, contrary to popular categorisation, many of the best tech stocks now have the [defensive characteristics investors crave](#). Even if Chong is correct, stock selection remains important. For example, **Tesla** is up 425% in 2020 versus the S&P500's 9%, with little in earnings updates but plenty of retail investors living the dream on the back of Elon Musk's hero status.

Returning to Howard Marks for a comment on this, surprisingly for someone who says investing opportunities are scarce, he says:

*"Current profits severely understate the tech leaders' potential. They currently choose to spend aggressively on new product development to expand (market) share and head off competition, voluntarily suppressing margins. This enormous potential exists for tech companies to increase profit margins in the future ... For these reasons, a large differential in terms of P/E ratios is warranted."*

But it's never obvious when valuations are too high. **Trent Masters** says it is incompatible to assume strong growth at the same time as low interest rates, and he provides worked examples of how this is [inflating stock prices](#). And **Michael Collins** provides 10 reasons why low rates can actually be [counterproductive for economic growth](#), including the 'liquidity trap'.

It's useful to remind ourselves when markets are at highs, there are plenty of stocks investors are wary about. ASIC produces data each week on the extent to which stocks are shorted, and **Leisa Bell** has extracted the Top 10 in Australia. There's a lot of hoping that prices of these stocks will fall.

Listed entity and share type	Stock code	Reported short positions (\$M)	Value of shares on issue (\$M)	Short positions as a % of value of shares on issue
Webjet Limited Ordinary	WEB	50.8	339.0	14.97
Speedcast Int Ltd Ordinary	SDA	25.4	239.7	10.59
Myer Holdings Ltd Ordinary	MYR	83.6	821.3	10.18
Invocare Limited Ordinary	IVC	14.5	143.5	10.10
Galaxy Resources Ordinary	GXY	37.3	409.5	9.12
Inghams Group Ordinary	ING	32.2	371.7	8.67
Mesoblast Limited Ordinary	MSB	48.1	586.6	8.21
Bank of Queensland Ordinary	BOQ	36.7	454.3	8.07
Clinuvel Pharmaceut Ordinary	CUV	3.7	49.4	7.50
Freedom Food Ltd Ordinary	FNP	19.3	277.1	6.95

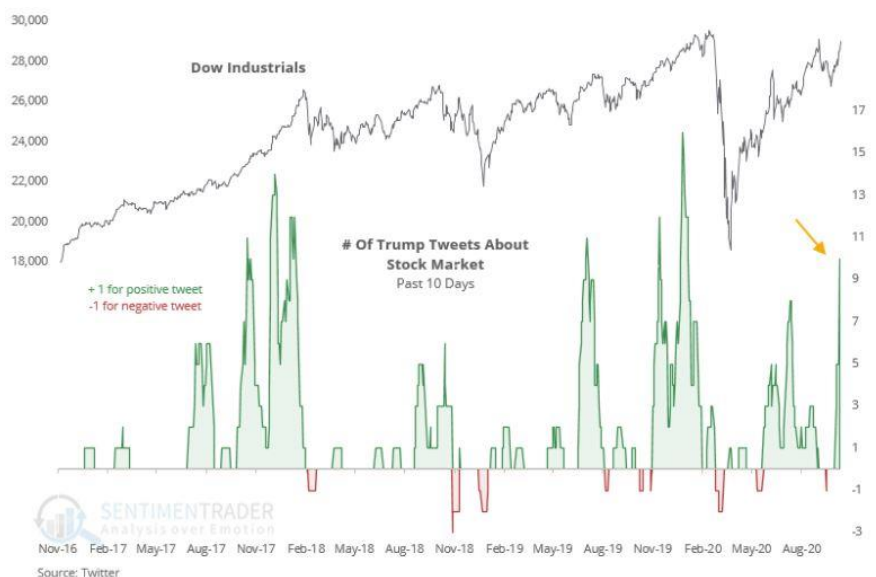
As more Australian investors acquire global assets, **Raewyn Williams** detects a move from hedging currency exposure or taking a default 50/50 approach to using the [risk as a source of added return](#).

And amid all this investing, we still have the rest of our lives to manage, including aged care for ourselves, parents or grandparents. **Rachel Lane** explains the latest developments from [the Budget and Aged Care Royal Commission](#). We would all like to live happily and healthily in our own homes until we are tapped on the shoulder, but a more likely reality is declining health and later-life challenges.

It's also worth checking **BetaShares** ETF Report for September 2020 (in our [Education Centre](#)) with net flows exceeding \$2 billion in a month for the first time, with the strongest demand for Australian equities. ETFs are at a record high of over \$71 billion.

Finally, as the US Presidential election edges ever closer, expect **Donald Trump** to renew his rampant Twitter activity after a lull during his COVID treatment, sending those who watch them into a lather for the impact on the market. Here's his favourable and unfavourable stock market mentions plotted against the **Dow Jones**.

The Trump Stock Market Tweet-O-Meter



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## Have the rules of retirement investing changed?

Don Ezra

This article is addressed to individuals in the decumulation or drawdown phase, not to pension fund managers. But most investment principles for individuals were developed by applying pension fund principles to the limited case of individuals: for example, what would a fund do if it were down to its final member?

So I will trace the history of asset allocation as it relates to pension funds, and then extrapolate to individuals.

### **Where the history of asset allocation takes us**

My logic here is as complete as possible but some points are in the footnotes to keep the flow of the article as smooth as possible.

#### *1. We need growth assets*

At the two extremes, if you have so much money that you don't need growth, or so little that even a lot of growth won't get you to your target, then none of this applies to you. So I'm only addressing those who absolutely need future asset growth (1). They either don't have quite enough to lock in their desired spending for their longevity horizon, or they're only slightly above the necessary amount.

So we start with growth-seeking assets as the base of the portfolio. The simplest approach is to buy a stock index fund, in the form of a managed fund or an ETF. This was traditionally a local-country index fund, but these days it's more likely to be a global one (2). In the old days this needed to be a simple index fund, but these days it's also possible to get an index fund devoted to ESG characteristics or other factors.

#### *2. Growth assets bring problems*

We know, however, that while growth is highly likely over the long term, it is not guaranteed – that's what William Bernstein calls 'deep risk'. And this uncertainty leads to short-term price volatility, which is bad when we're forced to interact with the market at an adverse time – what Bernstein calls 'shallow risk' (3). Deep risk is unavoidable. Shallow risk is either avoidable or capable of being acceptably mitigated, and that's where fixed income comes in.

#### *3. Pension funds and volatility*

Once upon a time, there used to be defined benefit (DB) pension plans flourishing on this earth. (Yes, I know this rare creature is not yet extinct). The contributions required to finance the promised benefits are necessarily unknown, because they depend heavily on future investment returns. The practice used to be to update the estimated required contributions every three years. This meant that three-year market volatility was reflected in contribution volatility.

To reduce the contribution volatility to what was considered acceptable by the plan's guarantor, the practice arose of diluting the growth exposure with 40% of fixed income assets, like bonds and mortgages. These had the effect of providing some investment return, though less than that expected from the stocks, while reducing the portfolio's overall volatility and therefore the contribution volatility.

That 60/40 allocation became the default approach for many, many years (4). In fact it got to be a joke: "*No matter what the investment question is, the answer is always 60/40.*"

#### *4. Pension funds discovered a new need*

This 60/40 policy worked fine when new contributions exceeded benefit payments, because there was no forced need to sell assets: the benefits could be paid from the new contributions. But if a DB plan closed to new entrants, regular contributions in the current year became smaller and then vanished, and asset sales became necessary to pay benefits. And any forced asset sale right after a market decline locked in a permanent loss.

So funds now had a new need: make sure there's enough cash to pay the benefits, at least for a few years. And that led in turn to a realignment of the fixed income assets, to structure them in such a way that their combined interest and maturity payments matched the benefit cash flows required. This became known as 'liability-driven investing' (LDI for short), and fixed income now took on a maturity structure matched to the liability cash flow, rather than just accommodating the idea that a fixed income index fund would do the volatility-reducing job.

### 5. *What is different today?*

In my early days, fixed income at least promised a relatively high stream of interest payments. Today those interest payments are very low, in fact edging closer and closer to zero, sometimes even negative when considered in real (after-inflation) terms. What difference does that make?

My answer: None. That's just tough.

You still need to reduce stock volatility, you still need to match benefit cash flows. The two needs haven't changed. All that has happened is that the reward expected in the old days from interest payments has essentially gone (5). Too bad, but life has simply become more expensive.

And there isn't an adequate substitute for fixed income. You can consider high-dividend stocks, but (a) they don't reduce the volatility problem and (b) the dividends make only a small dent in the cash flow needed to pay benefits. So they don't solve either of the two essential problems.

This is why so-called alternative assets, such as real estate and private equity, have become so popular. Not being traded daily, they aren't subject to the volatility of traded stocks, so they help with the volatility problem (although low volatility is an artificial characteristic here but I won't pursue that angle). But they definitely don't solve the LDI problem.

So the two problems that fixed income used to happily solve still exist. That's why I say that the role of fixed income is the same as before. What's changed is the degree of comfort with the solution. Too bad. It's like living in the same world as before, but with higher taxes. Your problems are the same, the solutions are largely the same, you're just worse off than before.

(However, see 7. below for another way to deal with the new conditions).

### 6. *What about individuals?*

I'll apply all of this to individuals in the drawdown or decumulation stage of their financial lives. They have accumulated assets. Individuals need growth, and they also need predictable cash flow for a few years, because they want to avoid the need to sell stocks right after a market decline.

The ratio of the two parts (growth and income) may or may not be 60/40, but they will certainly reflect the lifestyle risk tolerance of the couple or person involved.

That risk, of having to sell into a market decline, is now well known. It means that, when you think of the sequence of the volatile stock returns over time, you'd rather have high returns in the early years, when your assets are at their peak, than in the later years, when your assets have been mostly spent.

When Bob Collie, Matt Smith and I wrote our book (6) in 2008, we couldn't find a recognised name for this risk. I think it was Matt who came up with 'sequential risk'. Today there's a standard term: 'sequence-of-returns risk'.

The notion is that a drawdown portfolio should consist of a base of growth-seeking assets, on top of which you place fixed income (typically bank securities) that generates the cash you need for a few years. If the stock market falls, you have mitigated the 'shallow risk', giving time until the market recovers.

How many years? As I said, that depends on your risk tolerance. My wife and I use five years. Why? Because historically, stock markets have recovered enough to provide at least a 0% real (after inflation) annualised return over five-year periods – three-quarters of the time. The remaining 25% of the time is our acceptable shallow risk. Others I know use three years or even one year. In the opposite direction, one particularly risk-averse friend prefers 10 years.

Whatever the time period chosen, that shallow risk is mitigated but not eliminated. The dividends on the stock portion of our portfolio don't come close to meeting our annual cash needs, though they help.

And now that our bank securities provide hardly more than zero interest (actually negative, in real terms), well, that's just too bad for us. It doesn't change the nature of our problem, it doesn't change our solution, it just means we're worse off than when interest rates were higher.

## 7. But wait – there’s more

Clearly, the world has changed, or the parameters that define the problem have changed. My own reaction has been to accept the reduction in return. But there’s another valid way to react, and that’s to decide that you’re willing to accept more risk than before, in order to get your expected return back to where it used to be.

In other words, you’re thinking: it’s a new world, and a new me, willing to take more risk than before. Then you’ll reduce the amount of fixed income relative to what you used to be comfortable with. At the extreme, you’d reduce it to zero; in which case, something like high-dividend stocks would be your preferred route. Expected return goes up again, risk (both deep risk and shallow risk) go up too, but you’re willing to bear it. That’s a valid reaction too.

### **No magic solutions even for a new you**

I think of low-to-zero interest rates as a world of higher taxation. There are no magic new solutions to the problems. We’re just worse off than before. Or, in search of a higher return, the new you can also accept higher risk, with the inevitable consequences.

### **Footnotes**

1. *Strictly we need a return rather than growth. But I’ve used the word 'growth' extensively in the past that I’ll stick with it. Fixed income gives you a return too, of course. Typically stocks give you a higher return over the long term, with higher volatility and uncertainty.*
2. *I’ll skip the stuff on currency risk, as it’s not relevant here. The same goes for active management – a separate issue.*
3. <https://www.amazon.ca/Deep-Risk-History-Portfolio-Investing-ebook/dp/B00EV25GAM>
4. *I noticed, practising in three countries, that while the US default was 60/40, it tended to be 70/30 in the UK and 50/50 in Canada. To some extent this may have reflected different fixed income yields. But the same principle applied everywhere: how much contribution volatility was acceptable?*
5. *I’m assuming that, with the decline in fixed income yields, the expected return from stocks has declined by the same amount: in other words, that the equity risk premium has not changed. This is consistent with the rise in the stock index that was triggered by the decline in yields and becomes the new base for future projections. With the same equity risk premium, if your risk tolerance doesn’t change, your asset allocation should also not change. Only your expected return changes – downwards.*
6. <https://www.amazon.ca/Retirement-Plan-Solution-Reinvention-Contribution/dp/047039885X>

*Don Ezra has an extensive background in investing and consulting and is also a widely-published author. His current writing project, blog posts at [www.donezra.com](http://www.donezra.com), is focused on helping people prepare for a happy, financially secure life after they finish full-time work. This article is general information and does not consider the circumstances of any investor.*

## **Tech continues to run on rising prices not profits**

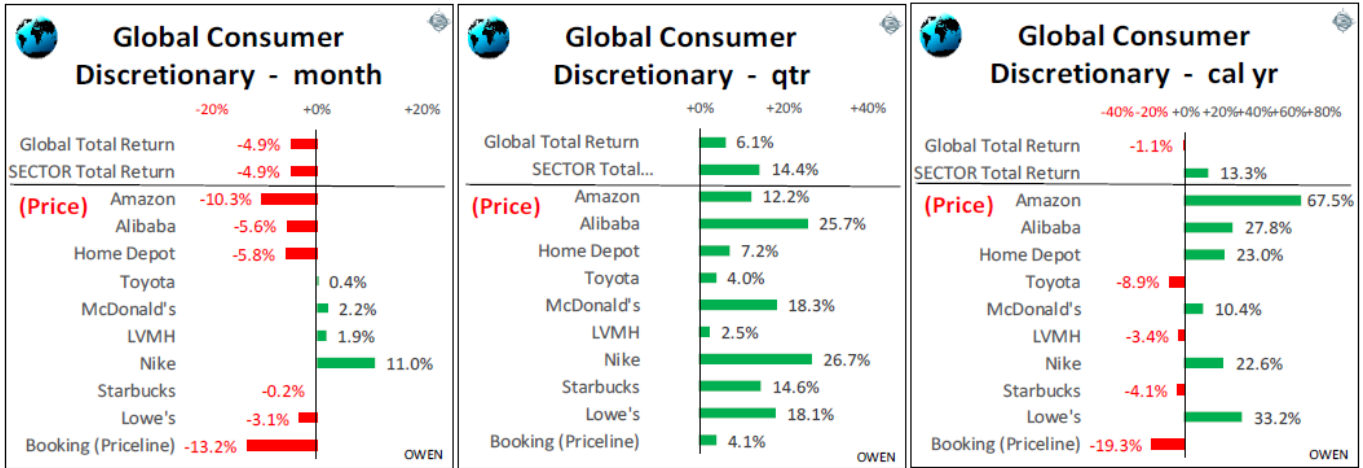
### **Ashley Owen**

Much was made of the fall in the prices of well-known tech stocks in September 2020, but they are well ahead this year, outperforming the overall market, and they have recovered ground in October to date. Many have benefited from changes in consumer spending patterns brought about (or accelerated) by the virus lockdowns.

In addition, share prices of tech stocks across the board have benefited from new first-time speculative traders – in Australia and around the world – buying shares simply because stocks have gone up in price.

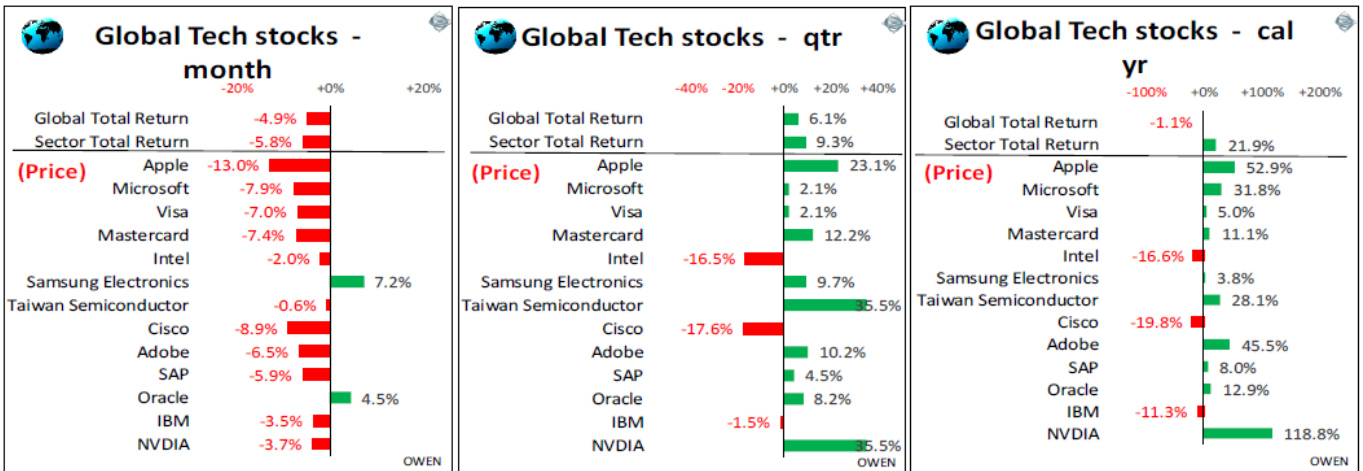
### **Performance of tech over 2020**

Globally, the big tech stocks are classified in different sectors. For example, Amazon (US) and Alibaba (China) are ‘Consumer Discretionary’ (data to end September 2020).



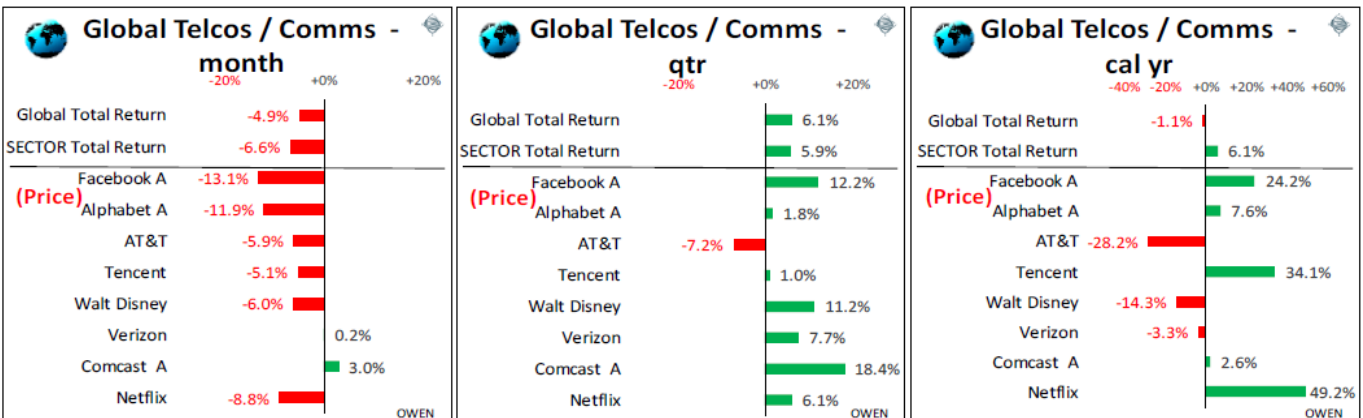
Also in this sector, it is notable that the big US home renovation/hardware chains Home Depot and Lowe's have benefited from changing spending patterns during the lockdowns. Likewise with Bunnings (Wesfarmers) in Australia.

Apple and Microsoft are classified in the 'Tech' sector:



In this sector, we also see Nvidia (gaming software) and Adobe (office software) benefiting greatly from the lockdowns.

Facebook and Google (Alphabet), Netflix and Tencent (China) are in the old 'Telco' sector:



Tesla's share price was also down 14% in September but is up more than 400% in 2020 to the end of September. The share price jumped on its 5:1 share split in August in anticipation of being included in S&P indexes (when a company is added to an index, every index fund in the world that tracks the index must buy

shares in the new company to keep up with the index). But the share price fell back in September when index inclusion did not materialise.

Even though Tesla is profitable (just), it is impossible to value. It is trading on Amazon-like multiples at 1,000 times profits. Amazon's price/earnings multiple is a relatively 'conservative' 115 times earnings!

**Snowflake's chance?**

The rise of tech stocks this year has led to a flood of new tech floats to cash in on the boom. The highlight of the US tech IPO boom has been a company called Snowflake (SNOW). It is yet another cloud-based data storage firm. Unusually, its CEO Frank Sloatman is not the founder, but a hired gun brought in by investors to ramp up the IPO, fresh from rescuing two other similar outfits in recent years (Data Domain and ServiceNow.) Snowflake's accounts show 100%+ revenue growth and big losses to match. The bigger the losses, the better for a tech IPO!

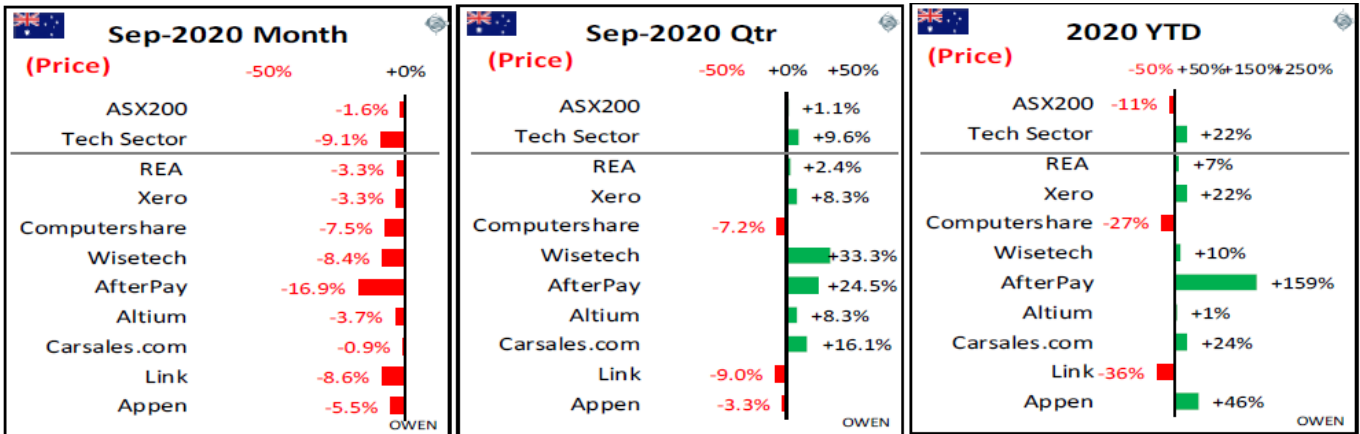
The company raised US\$3.4 billion at \$120 per share, listed on 16 September, more than doubled to \$253 on the first day, but since then it has drifted sideways. Snowflake is the first time Warren Buffett's Berkshire Hathaway has jumped into a tech IPO. Berkshire bought \$250 million of shares at the IPO price and is sitting on a 100% gain in a couple of weeks.

Buffett has made some very expensive mistakes in recent years, and all have been big departures from his long-held investment philosophies. The Kraft-Heinz deal (mistakenly assuming US brand loyalty extended to non-US markets); the Occidental-Anadarko oil take-over, right before oil prices crashed (having promised for decades never to invest in commodities companies); and big losses on four US airlines (having promised for decades never to invest in airlines). He also spent the 1990s vowing never to invest in tech IPOs (he was right at the time), but he's doing it now.

Another tech highlight of the month was video conferencing outfit Zoom. Its share price has zoomed up more than 600% this year.

**Australia's tech sector**

In Australia, the main speculative 'tech' stocks were also down in September in the global mini correction, but all were still ahead for the September quarter and ahead for the year to date. (The exceptions are the two share registries Computershare and Link, which are classified as tech stocks for some reason).



Realestate.com (REA) and Carsales.com are not 'tech' stocks. Both have risen with hopes of a recovery in consumer spending.

This is not to suggest that the local tech stars are good investments (most are speculative bets, not investments) but shareholders have still done well this year, especially if they bought them in the coronavirus sell-off.

**When will it end?**

Hundreds of thousands of mostly young first-time speculative traders opened brokerage accounts since the virus sell-off to buy into the hot tech stocks du jour because most of the sporting events on which they usually gamble have been closed. The mini-correction in tech stocks in September was the first time they experienced

prices actually going down. They bought purely because share prices were rising (“Hey, I doubled my money in a month – I’m a genius! Defs”).

The current boom will end the same way as every other speculative frenzy that was driven by the mass hysteria creating momentum from rising prices rather than actual profits.

When will it end? It will end when global confidence in the prospect of endless monetary and fiscal stimulus runs out of steam, but confidence seems to be holding up thus far.

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## When defensive assets become indefensible, turn to tech

Benjamin Chong

The appeal of owning traditional defensive assets of any type is currently less than in almost any other period in history. In fact, in this extremely low rate environment, we are seeing just how unattractive traditional defensive assets can become.

But despite the serious headwinds facing defensive assets, investors started moving billions into these safe havens well before COVID-19 struck, as many feared equity markets were topy and it was late in the economic cycle. This may have proven a saviour for some investors in March 2020.

### A redefinition of what is defensive

In the flight to safety, many investors took their medicine even though the cash rate was at an historic low, term deposits above 1% were rare and incomes from investment grade bonds had plummeted. The riskier high yield bonds broadly tracked the share market which calls into question their *raison d'être* as they do not have the desired defensive qualities in a downturn.

With income generation previously a major drawcard for a defensive allocation, many investors have realised they can no longer rely on an income of 5-7% a year and are having to rethink their future. Or at least change their investment strategy.

It is time for investors to broaden their approach to defensive investing and take a closer look at defensive sectors, rather than just the asset class.

To look only at defensive asset classes is a narrow view of the investment universe. This fails to take into consideration one critical factor that impacts the success or failure of the underlying companies, and that is the sector in which they operate.

For those more sophisticated investors who already take a sector approach to portfolio construction, it may also be time to look outside the usual suspects of consumer staples, healthcare and utilities, where demand for these goods and services are relatively inelastic and as a result they perform relatively well in a downturn.

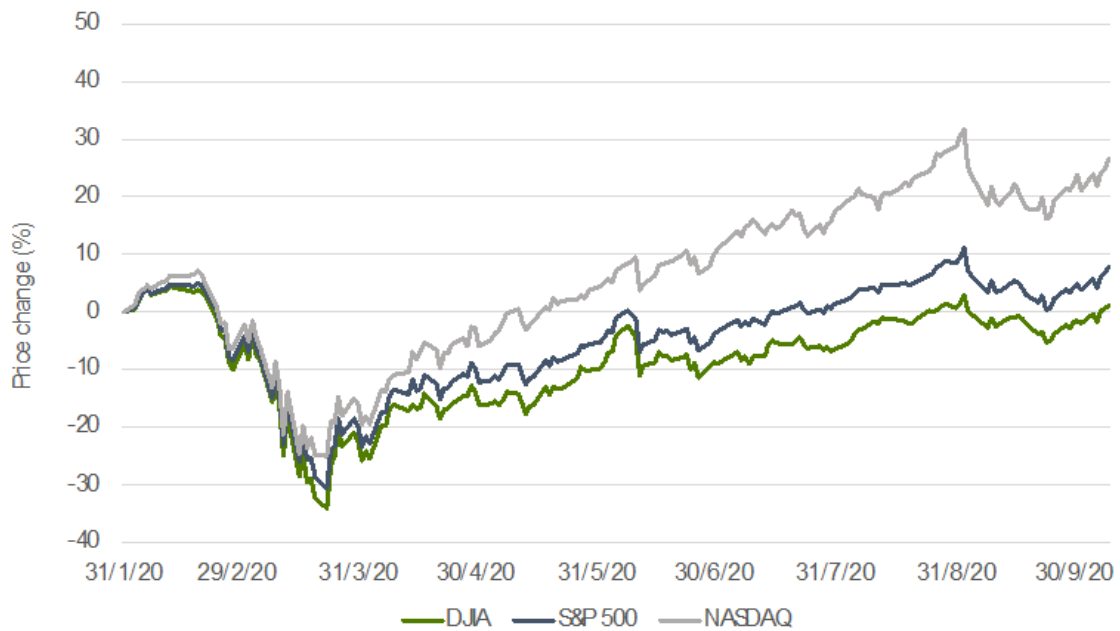
### Technology has joined the defensive club

During this pandemic and early days of the economic recession, we are seeing a surprising new entrant to the defensive sector grouping. Technology shares have been behaving a lot like defensive shares such as food and utilities.

The S&P/ASX 200 is down 12.6% since February 2020, while the S&P ASX All Technology Index, a broad index of technology companies, is up 30%. Over the same period, the S&P500 is up nearly 8%, while the NASDAQ, the home of many technology companies, is up over 25%. This is not a fluke. See the chart below for a comparison between the NASDAQ, S&P 500, and DJIA.



### DJIA v S&P 500 v NASDAQ



Source: S&P Global

Technology is holding its own and providing investors with a defensive position in this time of great uncertainty, with the NASDAQ fuelled by the strong revenues and forecast growth rates of many of its technology companies.

The reasons are plain to see, not least because technology has been the lifeline for individuals and businesses during lockdown. In the US, a recent Fortune 500 CEO poll found that 75% of companies plan to increase spending on technology.

So while the NASDAQ suffered a fall in September due to investors reducing their valuations for companies such as Apple and Tesla, and further exacerbated by the number of equity derivatives involving both retail investors and SoftBank, the index has stabilised (and recovered) recently. Their traditionally higher valuations can be attributed to drivers such as high margins, growth rates and their ability to be agile in adapting to consumer and businesses changes caused by COVID-19.

History has proven that technology thrives on shocks. These are events that are, by and large, unexpected and bring out changes in real economic growth, inflation and unemployment.

There has been no greater shock in a generation than COVID-19. This is a shock that will have lasting effects and technology will exacerbate the impact on certain sectors and force changes that allow businesses to survive. COVID-19 has accelerated innovation in sectors including ecommerce, cloud computing, gaming, streaming and remote communication such as videoconferencing.

#### Technology is a deflationary force

Investments in technology by companies are made to reduce costs, increase profits and improve efficiencies. It is difficult to imagine that any business will reject technology that enables them to produce more product, more quickly and ultimately make larger profits.

Investors are already shifting away from the today's sunset industries and hedging with investments in technology. As a resource economy, it has been difficult to avoid investing in large mining companies but the shape of our economy is changing. Some commentators have suggested that COVID-19 has hastened the slow passing of the oil age and is driving an increasing focus on sustainability generally. Technology drives this sustainability.

#### Investors taking stock of tech opportunities

Investors will undoubtedly be taking stock and assessing their investment portfolio as the world waits and watches to see what happens next in these strange times. With tech shares currently trading at high multiples, we can expect investors will look across the spectrum of tech investment opportunities. Venture capital funds

are sought after as investors seek exposure to early stage tech businesses in what is ultimately a long-term game plan.

Technology has never been more important. This holds true in daily lives, in business and in the global economic recovery. When times are tough, corporates slash procurement costs, automate procedures and optimise back-office efficiencies. Technology delivers on all of these fronts. In better times, we can expect to see high growth tech businesses continuing to innovate and bring new products to consumers and business.

With a greater focus on defensive sectors rather than poor-performing defensive asset classes, investors may just be able to have their cake and eat it. A strategy that is both high growth yet defensive, supporting economic recovery and creating an economy of the future.

*Benjamin Chong is a partner at venture capital firm [Right Click Capital](#), investors in high-growth technology startups. This article is general information and does not consider the circumstances of any investor.*

## 10 reasons low interest rates may limit growth

Michael Collins

Sitting on the desk of Reserve Bank of Australia Governor Philip Lowe most days when he arrives at work are letters from the public. Many are from retirees who have one complaint in this world of low interest rates. Lowe told a parliamentary committee last year.

*"It's not uncommon for people to say to me they've worked hard all their lives, they've saved, they're frugal, they don't spend very much, they rely on interest income and they're having to cut back their spending."*

### The limits of low interest rates

The RBA Governor earlier that session said that for every dollar the household sector received in interest income, it paid more than two dollars in interest payments. So overall, lower interest rates help the economy because they enable more consumer spending. To extend such conventional analysis, lower interest rates promote business investment, reduce borrowing costs for governments, which frees up more spending, help exports by lowering a currency and create a 'wealth effect' that encourages household spending by boosting asset prices.

Such thinking has motivated central banks to reduce interest rates to rev economies such that low rates have been a mainstay since the global financial crisis of 2008. An obvious problem with interest rates as a macro tool is they lose their stimulus fizz when they are close to zero or even mildly negative.

UK economist John Maynard Keynes in 1936 spoke of the 'liquidity trap' when describing the limits of low interest rates as an effective policy tool. When uncertainty is so great, even low interest rates fail to generate enough demand to ensure full employment.

But Keynes was indicating that low interest rates could be ineffective as a macro tool.

### 10 side effects stand out

The worry after 12 years of low and negative rates is that these settings produce side effects that make them counterproductive.

**First**, a core concern is that Keynes's liquidity-trap concept seems to underestimate the dampening effect of emergency measures. Low rates seem to dent consumer spending and business investment because they signal that authorities are gloomy, even panicked.

A **second** side effect is that low interest rates have encouraged so much borrowing that consumer, corporate and government debt have reached an unprecedented level of GDP in many countries. This could prove a systemic risk. Even without such mishaps, future repayments are likely to reduce consumption and investment.

A **third** effect is that low and negative rates can lift asset prices. Lower interest rates push investors into riskier assets and argue for higher prices on property and shares, asset gains that tend to boost inequality. More tellingly, negative policy rates helped push bond prices so high that yields went negative – and widely so. The

concern is that, if low and negative rates help the economy as intended, interest rates will move higher and puncture asset prices.

A **fourth** problem is that low and negative rates trouble the business models of insurers and pension funds that typically use the safety and positive returns of government bonds to help meet long-term liabilities.

A **fifth** spillover is the squeeze on bank margins, perhaps to the point of threatening financial stability.

Any crimping in bank margins brings a **sixth** problem: that at some level, low rates could backfire by forcing banks to restrict lending – a level known as the ‘reversal rate’.

A **seventh** handicap is that central banks have faced political pressure for hurting savers and rescuing reckless borrowers.

An **eighth** side effect is low and (especially) negative rates can, perversely again, force people to save more to attain a targeted level of savings.

A **ninth** drawback is that low rates can encourage unproductive investment.

A **tenth** criticism is that low rates help embed economies in the ‘debt trap’. This term describes how indebted economies need more debt to overcome the problems left by past debt. But at some indeterminant point this strategy must miscarry.

### **Failure to generate economic growth**

These risks might explain why low rates have often failed to spark sustainable economic growth. The question arises as to whether such risks are worth taking to fight mild deflation which, in economic effects, is not much different from negligible, or zero, inflation.

No matter these doubts, low and negative interest rates appear entrenched for the foreseeable future. In such a world, policymakers will need to rely less on monetary stimulus and be mindful of, and perhaps take steps to mitigate, the side effects they are creating.

It must be noted that real interest rates are more critical economically than nominal ones. Low nominal rates have essentially failed to charge economies because they haven’t approached the negative real rates that stimulated economies over much of the 1940s to the 1970s. That said, low nominal rates have helped stoke some economic growth.

For all their side effects, low interest rates are yet to trigger an upheaval – a jump in inflation that would undermine bond prices whatever level they were at. But even with these qualifications, central bankers appear concerned about the side effects that low and negative rates are provoking. They are among the most vocal in calling for instruments other than monetary policy to lead the world back to prosperity.

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## **What the RC, Budget and Keating mean for aged care**

Rachel Lane

Between the Aged Care Royal Commission’s special report on COVID-19 and the Federal Budget, there have been a lot of announcements in relation to aged care recently.

### **Keating steps into aged care**

Last month the Royal Commission turned its attention to financing and funding arrangements. The most-anticipated witness was former Prime Minister Paul Keating. He suggested that aged care could be funded through a similar mechanism to the Higher Education Contribution Scheme (HECS), that is, the government could claim any aged care costs owed against the assets of the estate.

This is a dangerous idea for at least two reasons.

The **first** is that such a system could be exposed to rorting with people deliberately changing the ownership of assets to avoid paying. After all, not every asset is dealt with by a person's estate – binding nominations, joint ownership, trusts and companies can all deal with assets outside of an estate.

The **second**, and in my opinion potentially the greater risk, is that this solution offers an 'easy win' for government. It could be adopted without fixing the fundamental issues of the funding and means testing arrangements which are complex and can be grossly unfair.

### **COVID-19 recommendations and the Budget**

At the end of September, the Aged Care Royal Commission released a special report into COVID-19 providing six recommendations, including:

1. funding to ensure that people living in aged care can receive visits from family and friends
2. the provision of allied health including mental health services to people living in residential aged care
3. establishment of a national aged care plan
4. all aged care homes to have at least one trained infection officer and the provision of infection control experts to assist homes with training
5. developing an outbreak management plan to assist with outbreaks
6. that the Government should report to Parliament no later than 1 December on the implementation of the recommendations.

The Morrison Government accepted all six recommendations the next day, announcing an initial \$40.6 million of funding. This was followed in the Budget with \$746.3 million to further support the industry's response to COVID-19 and \$408.5 million to improve aged care quality (some of which was announced earlier in the year).

Other Budget measures include:

- \$245 million to continue the COVID-19 supplement and a 30% increase in the viability supplement and homeless supplement for a further six months.
- \$92.4 million to cover the costs of single site workforce arrangements in COVID-19 hotspots.
- \$91.6 million to fund the second stage in the implementation of a new funding model for residential aged care which is aimed at delivering more accurate funding to meet the resident's care needs.
- \$71.4 million to support people who temporarily relocate from residential aged care to live with family due to the pandemic.
- \$35.6 million to provide grants to eligible residential aged care facilities that are experiencing financial difficulty.
- \$29.8 million to have almost 70 people staff a Serious Incident Response Scheme to ensure people in residential aged care will be better protected from abuse and serious incidents are better responded to.
- \$11.3 million for specialist counselling teams will be available to provide expert psychosocial services to address issues raised by the Royal Commission around the use of chemical and physical restraints for people living with dementia.
- \$10.6 million for up to 40 co-ordinators to stop young people going into residential aged care by connecting them with more age appropriate facilities.

### **Budget provisions for Home Care Packages**

The Budget provided \$1.6 billion for an additional 23,000 Home Care Packages, the additional packages will comprise:

- 5,000 Level 1 Home Care Packages
- 8,000 Level 2 Home Care Packages
- 8,000 Level 3 Home Care Packages
- 2,000 Level 4 Home Care Packages

The Government's most recent Home Care Package data (as of 31 March 2020) shows the number of people waiting for a Home Care Package at their approved level as:

- 3,363 at Level 1
- 40,350 at Level 2
- 41,500 at Level 3
- 18,386 at Level 4

Home Care Package funding provides a Basic Subsidy based on the level of the package. At Level 1 the Basic Subsidy is \$24.46 per day while at Level 4 the Basic Subsidy is \$141.94 per day. There are additional supplements for people with special care needs of dementia, oxygen and enteral feeding.

As you can see, while \$1.6 billion is a significant investment, with around 100,000 people waiting for a Home Care Package at their approved level it is a long way short of what is needed.

### **Granny flat arrangements**

For people looking after an ageing relative, the Budget delivered some good news - a Capital Gains Tax (CGT) exemption for granny flat arrangements when a formal written agreement is in place. The potential CGT consequences of granny flats can be significant and sadly the desire to have children avoid the tax liability leads families to have no formal agreement. This can leave granny and the children exposed when circumstances change in the future.

The CGT exemption announced in the Budget would be limited to family arrangements with a formal agreement where the granny flat arrangement is supporting an ageing or disabled relative. The measure is expected to commence from 1 July 2021 (subject to the passing of legislation).

While the CGT exemption for granny flats is welcome, sadly the additional Home Care Packages (often needed to enable someone to stay in a granny flat) don't go far enough. The Royal Commission heard that more than 16,000 people died waiting for a Home Care Package in 2017-18, undoubtedly many others were forced to move into residential aged care to get access to the care they needed.

The Government seems to be delaying necessary funding pending the Royal Commission's final report, which is due no later than 26 February 2021. Maybe the next Budget will provide the funding needed to ensure that older Australian's receive the aged care they deserve?

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## **Is currency exposure an unwanted risk or source of returns?**

Raewyn Williams

Australia is a small, open economy which compels superannuation funds, fund managers and other large investors to look offshore for investment opportunities. In round terms, the market cap of the Australian Securities Exchange is \$2 trillion and superannuation assets alone are almost \$3 trillion.

### **Australians investing overseas**

There are three main rationales for expanding investment horizons beyond domestic markets:

- To uncover and exploit a much larger opportunity set to add to returns
- To add diversification to the portfolio as a way of reducing risk
- To move more 'invisibly' in offshore listed markets compared to the relatively small Australian market where large investors are liable to leave a 'footprint' and push market prices unfavourably as they place large trades into the market (the technical concept of investment strategy 'capacity').

Investing offshore, of course, brings a new portfolio dimension into play: currency risk. Generally, any offshore asset in which an Australian investor invests is actually a bundle of two exposures – the risk/return of the asset itself, measured in the currency in which the asset is denominated ('local currency'), and the value by which the investor's 'base currency' (AUD) moves in relation to this local currency over the holding period – the currency exchange rate movement.

Here's how this breaks down over the past decade for an investment in index-tracking (passive) international equities:

	<b>Developed &amp; Emerging Markets (MSCI All Countries World Index)</b>		
	1 yr	5 yrs	10 yrs
Local currency	14.63%	10.11%	10.67%
Currency movement	(8.47%)	(0.83%)	1.29%
Base currency (AUD)	6.16%	9.28%	11.96%

Source: MSCI, Parametric. Reflects Accumulation Index returns (net), pre-tax, annualised over performance periods ended 31 August 2020. It is not possible to invest directly in an index.

### **Major impact of currency return**

The 'currency movement' contribution to returns (capturing the difference between the portfolio's local currency and actual AUD experience) are meaningful, especially over shorter time periods. Data informing investment decisions should always reflect the investor's base currency – what is actually relevant to the investor.

To illustrate this, the comparable 1-year return for Developed Markets (only) equities was 14.39% in local currency terms, which lags the 14.63% All Countries return noted above, making it look like adding Emerging Markets was a good tactic. However, the AUD Developed Markets return was 6.39%, outperforming the AUD All Countries return of 6.16%

It shows in fact that expanding to Emerging Markets was a losing bet from an Australian perspective.

Of course, a sophisticated investor can currency-hedge the portfolio to reduce or remove the currency risk and isolate the particular exposure offered by the underlying assets (the 'local currency' performance). To currency-hedge, large superannuation funds typically use a series of ongoing trades in currency forwards (derivative contracts) whose pay-offs move in the opposite direction to the exchange rate movement of the underlying asset.

This does not quite mean that a fund fully currency-hedging its international equities over the last decade would have received 10.67%, though the fund's AUD return should have been similar. Why? Because few currency hedges perfectly offset the underlying exposure and, even if they do, currency hedging comes at a cost.

For example, the Emerging Markets component of the above All Countries equities portfolio would have been difficult to currency-hedge in practice due to the limited liquidity in hedging instruments and regulatory restrictions on trading the currencies of some countries.

Particular attention needs to be paid to how to fund the ongoing rolling of the currency forwards (because these cashflows do not match the cashflows of the underlying hedged physical asset), and also to the tax implications of the hedge.

In other words, the currency hedge is of the *pre-tax financial performance* of the investment, not post-tax, nor does it hedge (offset) the actual cashflows required or generated under the hedging arrangement.

### **Currency as a source of return**

Currency management is changing from 'risk mitigation' to currency as a potential return source. This promising new chapter in currency thinking marks an evolution which began in the early days of compulsory superannuation in Australia (the 1990s), when a typical balanced equities/fixed income global investment portfolio would have the growth assets (equities) unhedged and the defensive assets (fixed income) fully hedged. Effectively, currency exposure was treated like a growth asset, appropriate for fund members with a reasonable time horizon and risk appetite.

In the 2000s, the idea of a setting a static 'hedging ratio' for offshore equities came to the fore, like a targeted 50% hedged, 50% unhedged exposure. This 'least regret' approach meant that, given the volatility inherent in currency, a hedged/unhedged combination would not overwhelm the underlying equity performance (if the AUD rallied) nor overly damage the results (if the AUD deteriorated) over successive performance periods.

Today, this classic balanced portfolio is more likely to have about 28% of the equities and 61% of the fixed income currency-hedged (APRA quarterly superannuation statistics – June 2020).

The thesis that currency can be a return source is being pursued in programmes to dynamically adjust currency hedging ratios and 'tilt' to or from currency positions based on shorter-term views around whether the AUD (or any other currency) is over- or under-valued and how global macro-economic themes will impact the currency's supply and demand.

Few of these sophisticated, dynamic currency management programmes have been around for long enough to build up a long-term track record. As they do, it will be fascinating to see whether currency, long seen as an unwelcome risk in global portfolios, can make a successful, remarkable transition to becoming a valued source of returns.

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## High growth and low rates incompatible with current share prices

### Trent Masters

Share prices around the world have divided sharply since the advent of COVID-19, with some on-line businesses rocketing in value while more traditional businesses are struggling to regain earlier lustre. Are the on-line darlings massively over-priced or are some of those currently in the doldrums significantly under-valued?

#### The impact of low rates on share values

Adding to the debate are arguments that the elevated valuations are justified because the cost of capital is at historically low levels. In share valuing terminology, as discount rates are lower, 'terminal value' multiples should be much higher.

The following is a brief explanation of a standard discounted cash flow model and why the assumptions used can generate massive variability in share value outcomes.

The underlying principle is that the current price of a share is the sum of all future net profits of the business, divided by the number of shares on issue, discounted by the estimated cost of capital of that business. Valuation models are constructed on forecasts of the estimated profits of the business for the next 5-10 years, followed by an estimate of the so-called terminal value of the business (ie summing the balance of sustainable growth in profits to eternity discounted back to that date). Usually, this terminal value represents at least 60% of the estimated value of the business and is much higher for high growth start-ups.

Estimating what discount rate should apply starts with the assumption that the current long term government bond yield is the so-called risk-free rate and margins are added for:

- the estimated relative riskiness of the industry in which the company is operating
- the expected volatility of company performance through economic cycles (beta), and
- the likely debt gearing the company will aim to operate with

In the tables below, we have used a risk premium of 5.5%, a beta of 1 and 20% as a 'standard' industrial company gearing ratio, producing a weighted average cost of capital of 9.5%.

#### High growth rates and low interest rates are incompatible

It is our contention that many current valuations are assuming that real economic growth rates will resume back to what they were when interest rates were significantly higher. The fact that interest rates are close to zero right along the bond curve indicates that neither the market or central banks believe this to be the case. As such, these lower growth rates also need to be reflected in valuations to ensure a sensible outcome.

Working through the mechanics of a simple DCF we can see how these distortions play out.

We start with an 'old' set of assumptions whereby the risk-free rate is set at 5% and the terminal growth in net profits rate at 3% pa. This leads to a terminal value multiple of 15.5x and a notional valuation of **\$13.55** for our theoretical company.

Risk Free Rate	5.0%
Beta	1.00
Risk Premium	5.5%
<b>Cost of Equity (Ke)</b>	<b>10.5%</b>
90 day bank bill	4.5%
Margin	2.5%
<b>Cost of Debt (Kd)</b>	<b>7.0%</b>
Gearing	20%
Tax Rate	25%
<b>WACC</b>	<b>9.5%</b>
Terminal Growth Rate	3.0%
Terminal Exit Multiple	15.5

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Terminal Value
Net FCF	100	103	106	109	113	
Terminal Value						1,745
Discount Rate	1	0.91	0.83	0.76	0.70	0.64
<b>Discounted Cash Flow</b>	<b>100</b>	<b>94</b>	<b>89</b>	<b>83</b>	<b>78</b>	<b>1,111</b>

	Valuation
Defined Cash Flow	444
Terminal Value	1,111
DCF	1,555
Less: Net Debt	-200
Equity	1,355
Shares on Issue	100
<b>Valuation</b>	<b>\$13.55</b>



What happens when we collapse the discount rate and keep all else equal?

Taking the risk-free rate down to 2% leads to the terminal value multiple increasing to 27.8x and the valuation for our theoretical company rising 87% to **\$25.39**. Financial alchemy at its finest!

Risk Free Rate	2.0%
Beta	1.00
Risk Premium	5.5%
Cost of Equity (Ke)	7.5%
90 day bank bill	1.5%
Margin	2.5%
Cost of Debt (Kd)	4.0%
Gearing	20%
Tax Rate	25%
WACC	6.6%
Terminal Growth Rate	3.0%
Terminal Exit Multiple	27.8

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Terminal Value
Net FCF	100	103	106	109	113	
Terminal Value						3,126
Discount Rate	1	0.94	0.88	0.83	0.77	0.73
Discounted Cash Flow	100	97	93	90	87	2,271

	Valuation
Defined Cash Flow	467
Terminal Value	2,271
DCF	2,739
Less: Net Debt	-200
Equity	2,539
Shares on Issue	100
Valuation	\$25.39

But now let's reflect the lower growth rate implied by the lower risk-free rate. Central banks around the world aren't setting short-term funding costs at 0% and below because the outlook is rosy. Taking the growth rate down to reflect an environment that justifies a lower risk-free rate lands us approximately back where we started in valuation terms.

Risk Free Rate	2.0%
Beta	1.00
Risk Premium	5.5%
Cost of Equity (Ke)	7.5%
90 day bank bill	1.5%
Margin	2.5%
Cost of Debt (Kd)	4.0%
Gearing	20%
Tax Rate	25%
<b>WACC</b>	<b>6.6%</b>
Terminal Growth Rate	0.0%
Terminal Exit Multiple	15.2

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Terminal Value
Net FCF	100	100	100	100	100	
Terminal Value						1,515
Discount Rate	1	0.94	0.88	0.83	0.77	0.73
<b>Discounted Cash Flow</b>	<b>100</b>	<b>94</b>	<b>88</b>	<b>83</b>	<b>77</b>	<b>1,101</b>

	Valuation
Defined Cash Flow	442
Terminal Value	1,101
DCF	1,543
Less: Net Debt	-200
Equity	1,343
Shares on Issue	100
<b>Valuation</b>	<b>\$13.43</b>

### Need a meaningful link between rates and growth

These workings highlight how critical not only the setting of the risk-free rate and the terminal growth assumption are in deriving the DCF, but in ensuring that there is a sensible linkage between them.

For our theoretical company, the table below demonstrates how a valuation can be completely overpowered by these two key assumptions; assumptions that tend to get far less attention than the detailed work that goes into deriving the cash flows of the business.

		Risk Free Rate				
		2.0%	3.0%	4.0%	5.0%	6.0%
Terminal Growth Rate	0.0%	\$13.43	\$11.55	\$10.10	\$8.95	\$8.01
	0.5%	\$14.61	\$12.44	\$10.80	\$9.50	\$8.46
	1.0%	\$16.00	\$13.47	\$11.58	\$10.13	\$8.97
	1.5%	\$17.66	\$14.66	\$12.48	\$10.82	\$9.53
	2.0%	\$19.68	\$16.06	\$13.51	\$11.61	\$10.15
	2.5%	\$22.19	\$17.74	\$14.71	\$12.52	\$10.85
	3.0%	\$25.39	\$19.78	\$16.13	\$13.55	\$11.65
	3.5%	\$29.61	\$22.33	\$17.82	\$14.76	\$12.55
	4.0%	\$35.45	\$25.58	\$19.89	\$16.19	\$13.60

Even in secular growth companies, a recognition of the lower growth outcomes associated with a lower discount rate is essential. Apple will still sell lots of phones, Amazon lots of products and Google lots of advertising but not as much as they would have in a world that justified a higher risk-free rate.

And it is in high growth companies that the impact becomes even more pronounced. Given the lack of profits in the short term for some high growth companies (think Tesla, Netflix or even our own Afterpay) a lower discount rate provides greater weight to the distant future cash flows while also pushing an even greater proportion of the valuation into the terminal value. In these high growth companies, upwards of 90% of the valuation can sit within this terminal value.

#### Valuations must focus on more than cash flows

There have been many instances throughout my investment career where cash flows have broadly aligned with sell-side assumptions but the resultant company valuations have differed wildly. The explanation invariably comes down to the set of assumptions and linkages (or lack therefore) between the risk-free rate and the terminal growth rate.

My first question when comparing company valuations moved from "what are your assumed through cycle cash flows" to "what discount rate and terminal growth rate are you using" because that was where the bulk of the valuation dispersion was hidden. But in finance, as in life, if things appear too good to be true they invariably are.

The magical value creation through lowering discount rates while assuming growth is untouched is one such example that falls into this category.

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