Firstlinks
a Morningstar company

Edition 385, 27 November 2020

Contents

Editorial

The Retirement Income Review was a welcome surprise packet. Superannuation as we know it is under attack on several fronts. Far from being simply a 'fact based' set of statistics or rules, the Review takes a firm stance on many controversial subjects. While not formally making recommendations, its findings are no less powerful. We explore five ways the Review will guide future policies, setting up retirement planning for significant changes.

It will stand as a turning point in the way we think about superannuation and retirement incomes, although as far back as 12 April 2018, I wrote an article pre-empting a major finding of the Review, saying:

"Superannuation involves a calculated drawdown of capital for most people. This is not only about 'income' but access to money and cash flow."

Two other pieces on this important document. **David Bell** highlights how the Review focusses on this need to draw money from assets (including super and the home) and not only live on income. Then we provide an edited transcript of **Paul Keating**'s discussion with **Leigh Sales** on the **ABC's 7.30**, plus links to the full video. Keating was critical of major findings and not surprisingly, took the opportunity to make a passionate defense of the existing superannuation system.

My interview this week is with **Steve Bennett** of **Charter Hall**, who is also Chairman of the **Property Funds Association**. Many property sectors have been resilient during the pandemic, and he explains how funds with long-term leases to prestige clients provide an income alternative for investors, as well as exploring various property trends.

The rapid rise in share prices of tech stocks (and Tesla's market cap is now an extraordinary USD520 billion) is leading to portfolio concentrations that many investors may not have expected. In the US, the broad S&P500 is now one quarter tech. **Amy Arnott** asks whether it is time for some diversification into other sectors.

On a similar theme, for those looking for diversification opportunities in Emerging Markets, there is an even stronger index dominance of 'China tech', with the top 5 companies making up 40% of the index. The White Paper from **Realindex** is a warning to everyone to check what's in an index before assuming it delivers broad-based exposures.

For the moment, all governments are providing fiscal stimulus with a bottomless pit of debt, but at some point, it will need to be repaid. **Kate Howitt** looks at how the problem was faced in the past, Australia's adoption of similar policies and the likely future drag on share prices.

Amid all this market and political action, we can't avoid the need to manage our SMSFs. **Graeme Colley** warns of a little-discussed consequence of the new bankruptcy rules, that there is no forgiveness of the need to meet pension payments simply because an asset is no longer throwing off the required income.

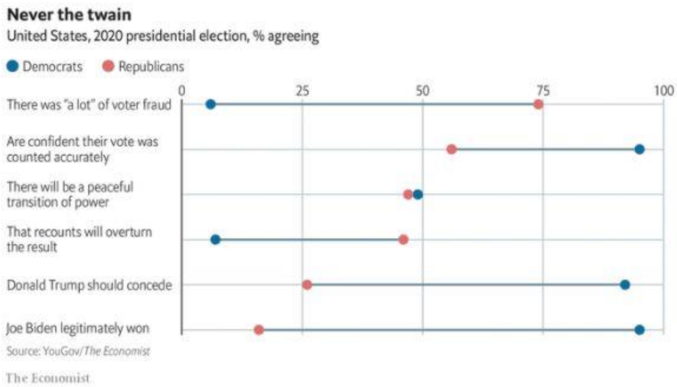
What else is happening?

The one market most analysts expected to fall during the pandemic was residential property prices. How could they withstand the loss of migrants, rise in unemployment and businesses closing? Enter 2% borrowing rates, an easing of lending restrictions, fiscal spending and ex-pats returning. Among many who have changed their forecasts, **ANZ Bank** now expects a combined capitals small price rise in 2020 and up 9% in 2021. Loan servicing is easier than ever for most people, as a 2% fixed rate on $1 million in only $20,000 a year (assuming no repayment of principal).

Matt Comyn, CEO of **CBA**, said last week:

"I don't think the housing market is a risk anymore. I mean we've substantially upgraded our forecast in and around housing versus where we were in May and even in August."

Finally, there were many media reports during the week that **Donald Trump** had conceded to **Joe Biden**, but a quick check on his Twitter feed shows he continues to stoke the flames with lawsuits and fraud claims. He also takes credit for the strong US stock market.



Despite his failure to prove anything in courts, his stance on election legitimacy is widely supported by Americans. As a poll last week in *The Economist* shows, three-quarters of **Republican** voters believe there was 'a lot' of fraud in the election, although only 6% of **Democrats** held the same view. This chart shows how stark the blue/red divide has become.

Five ways the Retirement Review points to new policies

Graham Hand

The Retirement Income Review has delivered far more than expected when it was commissioned. The fact that it does not include any firm recommendations is almost irrelevant. The Henry Tax Review contained 138 recommendations and most of them are still gathering dust. This time, former Treasury official Michael Callaghan's group can expect more policy consequences despite originally being asked only to:

"establish a fact base of the current retirement income system that will improve understanding of its operation and the outcomes"

That sounded like collecting statistics with a rather dry outcome, but the end result includes strong indications of future policy directions. It commendably confronts many of the arguments taking place in the superannuation industry. In fact, there's a fine line between some of its statements and a policy recommendation.

For example, it makes arguments such as:

"Changes to superannuation earnings tax concessions would improve equity."

"Extending earnings tax to the retirement phase could also simplify the system by enabling people to have a single superannuation account for life and would improve the sustainability of the system."

"The weight of evidence suggests the majority of increases in the SG come at the expense of growth in take-home wages."

"Replacement rates are the most appropriate metric for assessing whether the retirement income system maintains living standards in retirement."

"Using superannuation assets more efficiently and accessing equity in the home can significantly boost retirement incomes without the need for additional contributions."

It provides the Government with a blueprint for policies previously hinted at and subject to strong opposition, placing firmly on the agenda that:

- Retirees must learn to live off their savings and the equity in their home, not only the earnings on their investments, and
- Too much of the benefits of superannuation go to wealthier people.

Five highlights from the Review

1. Increases in super result in lower wages growth

Treasurer Josh Frydenberg would have enjoyed the line in the Review saying: *"increases in the SG rate result in lower wages growth, and would affect living standards in working life."*

In the Media Conference releasing the Review, Frydenberg looked mightily pleased with the results, saying:

"It points out that people's early access to superannuation during the COVID crisis has been justified in that it sometimes is appropriate for people to access superannuation early and that this hasn't had a significant impact on people's retirement incomes ... I'll quote it (the Report), 'Maintaining the superannuation guarantee rate at 9.5% would allow for higher living standards in working life. Working life income for most people would be around 2% higher in the long run.' So the Report goes into some detail about the trade off between a working life income and people's wages and that with an increase in the superannuation guarantee, it points out that the most effective way for people to secure themselves in retirement is not necessarily an increase in the superannuation guarantee, but by more efficiently using the savings that they do have."

This is a major point of difference between the Liberals and the unions and industry funds, most vocally represented by Greg Combet, Chairman of Industry Super Australia and a former federal Labor minister. The Government now has the ammunition to ditch the legislated increase in the SG from 9.5% to 10% on 1 July 2021, and subsequent increases to 12%, claiming the money is better in workers' hands now. Combet argues that real wages have stagnated at a time when super has not increased. It is highly unlikely that if the SG is not increased by 0.5%, there will be a 0.5% increase in wages instead. Combet wrote in *The Sydney Morning Herald* of 26 November 2020:

"Analysis of more than 8,000 workplace agreements made following the last freeze in the super guarantee in 2013 found no evidence of compensating wage rises."

The Review finds many people are forced to reduce consumption in their working years, and often end up with more in retirement than they need. There should be a better balance between pre- and post-retirement needs:

"Saving for retirement involves forgoing consumption in working years. With voluntary saving, people decide on this trade-off. When there is compulsory superannuation, the rate should be set at a level that balances pre- and post-retirement living standards for middle-income earners. It is challenging to set a single SG rate that suits all Australians given the variety of people's circumstances and experiences.

A rate of compulsory superannuation that would result in people having an increase in their living standards in retirement may involve an unacceptable reduction in living standards prior to retirement, particularly for lower-income earners."

2. Retirees must learn to spend their capital not only live on their income

The Review makes many references to the capital in a superannuation fund financing retirement, not only the income. Superannuation should smooth income over work and retirement, not build a nest egg to leave to the next generation. It says:

"A major misunderstanding is the view that 'retirement income' involves the return from investing superannuation balances rather than drawing down those balances to fund living standards in retirement."

The vital piece of research supporting this opinion is this:

"Data provided by a large superannuation fund found members who died left 90% of the balance they had at retirement. When retirees die, most leave the majority of the wealth they had at retirement as a bequest."

In fact, so strong is the view that super should be run down, it is also used to justify leaving SG at 9.5%. Here, the Review argues if savings were more efficiently used (that is, run down), the 9.5% is sufficient to deliver a 65% to 75% replacement rate (of income prior to retiring) which is entirely adequate.

"More efficient use of savings in retirement can have a bigger impact on improving retirement income than increasing the SG. If the SG remained at 9.5 per cent, and retirement savings were used more efficiently, most people would achieve 65-75 per cent replacement rates. Most would also achieve higher replacement rates than with the SG at 12 per cent and drawing down balances at the legislated minimum rate."

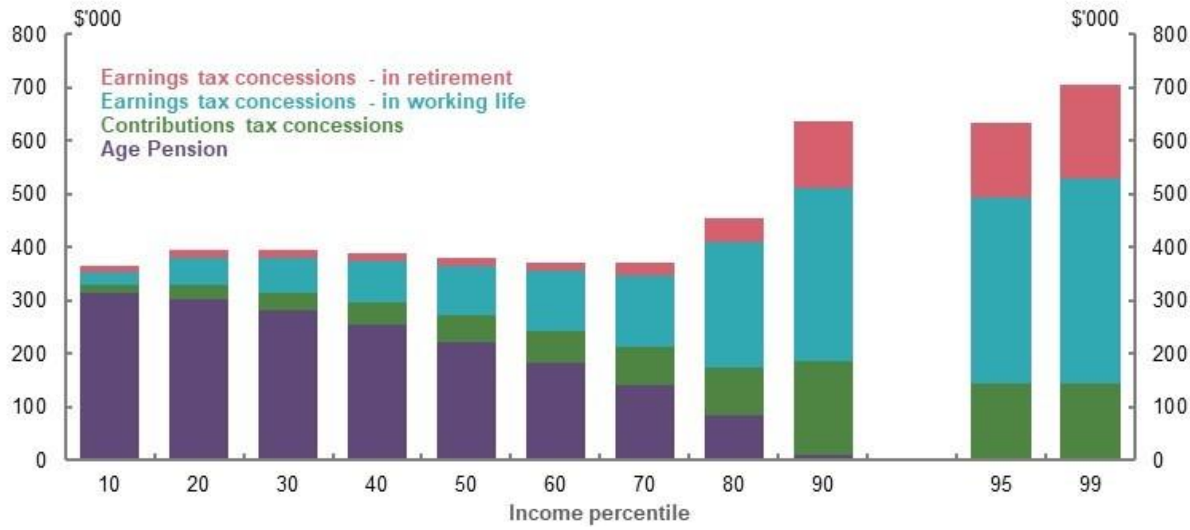
3. People with large super balances receive too much in tax concessions

In noting 11,000 people have over $5 million in superannuation, the Review states:

"While the age pension helps offset inequities in retirement outcomes, the design of superannuation tax concessions increases inequality in the system. Tax concessions provide greater benefit to people on higher incomes."

The Review includes this chart which shows people with incomes in the 99th percentile receive more tax concessions both during their working lives and in retirement than any other grouping. The age pension makes up most of the government support for all groups up to the 50th income percentile, and it's a material contribution even up to the 80th percentile.

Figure 1: Projected lifetime Government support from the retirement income system



Note: Values are in 2019-20 dollars, deflated using the review's GDP deflator and uses review assumptions (see Appendix 6A. Detailed modelling methods and assumptions). Income percentiles are based on the incomes of individuals (whether they are single or in a couple). Source: Cameo modelling undertaken for the review.

Showing the ongoing role played by the age pension, as at June 2019, 71% of people aged 65 and over received some form of pension payment, and over 60% of these were on the maximum age pension rate.

4. The family home is a vital part of retirement planning

The Review makes the case for accessing home equity:

"One of this report's themes is that a more optimal retirement income system would involve retirees more effectively drawing on all their assets, including the equity in their home, to fund their standard of living in retirement."

It has little sympathy for the view that retirees need to preserve the equity in their home to pay for aged care. It describes the following statement as a common misunderstanding: *"I need to preserve my assets in case I get sick or need aged care."*

Josh Frydenberg also embraced the finding that home ownership is key to an adequate retirement income. He said:

"Importantly, the Review provides confirmation of the policy direction being pursued by the Morrison Government with respect to the importance of increasing the efficiency of the superannuation system and lifting home ownership rates – both identified as key drivers of an adequate retirement income ... Additionally, given the importance of home ownership to the financial security and wellbeing of Australians in retirement, the Government will continue to support measures to allow more Australians to buy their first home sooner, including through our First Home Loan Deposit Scheme, First Home Super Saver Scheme and HomeBuilder."

The Review clearly sees people who rent in retirement as vulnerable and the ones the social security system needs to protect. It says:

"The retirement income system does not appear to be delivering an appropriate standard of living for many retiree renters. Owning a home has a positive influence on a person's standard of living in retirement. Whereas, in retirement, renters have higher levels of financial stress. A significant proportion of retiree households that rent are in income poverty, which is even higher for single retiree renters."

The consequence of this retirement funding via home equity is profound. Instead of the heavy focus on superannuation in retirement, the family home will increasingly come into play, including how super money can be used to buy a home. As the chart below shows, the poverty rates in retirement are highest for single renters, couple renters and people forced into retirement early who have been unable to build their wealth. Home owners are least likely to live in poverty.

Figure 2: Income poverty rates of retirees

Note: Data relates to 2017-18 financial year. Elevated poverty rate defined as 5 percentage points above retiree average. Retirees are where household reference person is aged 65 and over. There is overlap between some categories, for example, early retired and renter categories. Early retired means aged 55-64 and not in the labour force. Housing costs includes the value of both principal and interest components of mortgage repayments. Source: Analysis of ABS Survey of Income and Housing Confidentialised Unit Record File, 2017-18.

5. The case to means test the family home

While the Review leans heavily towards policy suggestions in many other areas, it dare only hint at that most sacred of cows, the exemption of the family home from social security tests. However, the subject is not ignored:

"A key aspect of the retirement income system favouring home owners is that the principal residence is excluded from the assets test for the age pension. Regardless of the value of the house, a home owner can receive the same age pension as a renter, all other things being equal.

This suggests that wealthier retirees (in terms of the value of their homes), can receive the same Government assistance as those less wealthy (either retirees who rent or home owners with houses of lesser value)."

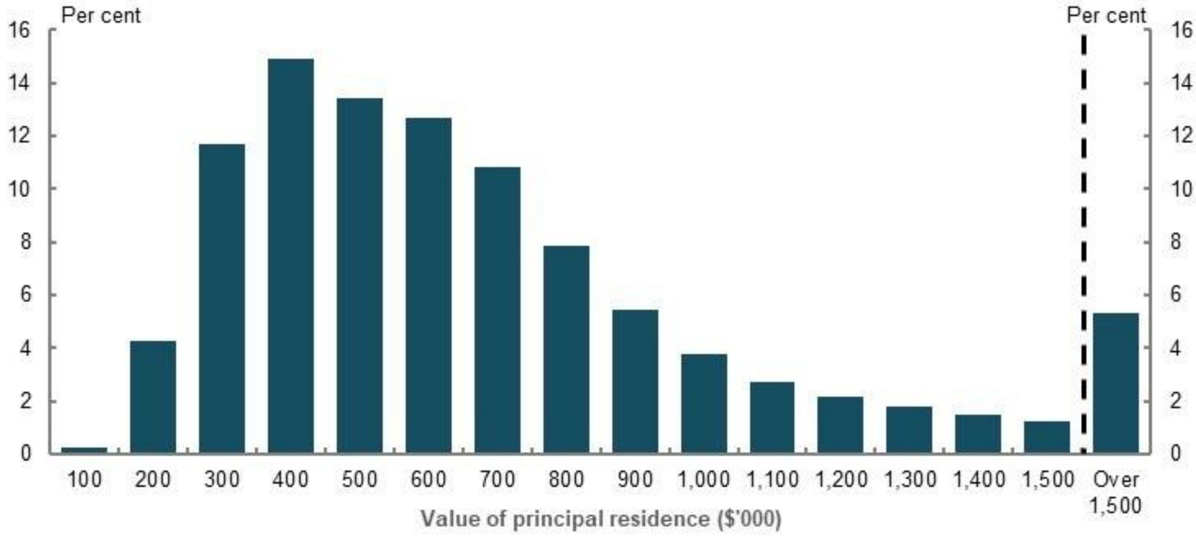
Renters who hold assets in a form other than their house will receive less in an age pension than a home owner with the same level of wealth. The worry is that a declining trend in home ownership will increase the number of retirees renting in future.

On this sensitive subject, the opinions are of 'some stakeholders' rather than the review team, although it's clear that home owners and renters are not treated equally in the retirement income system:

"Some stakeholders suggested that if a retiree's principal residence was part of the age pension assets test, this would help equate the treatment of home owners and renters. If the home were included in the assets test, some home owners would no longer be eligible for the age pension. Others would receive less age pension. In response, home owners may be more inclined to access the equity in their home to fund their retirement."

To illustrate how home owners benefit from this system, this chart shows many age pensioners own homes with a value above the pension cut off level (which for a single home owner is $578,250).

Figure 3: Distribution of home values among age pensioners who own their home

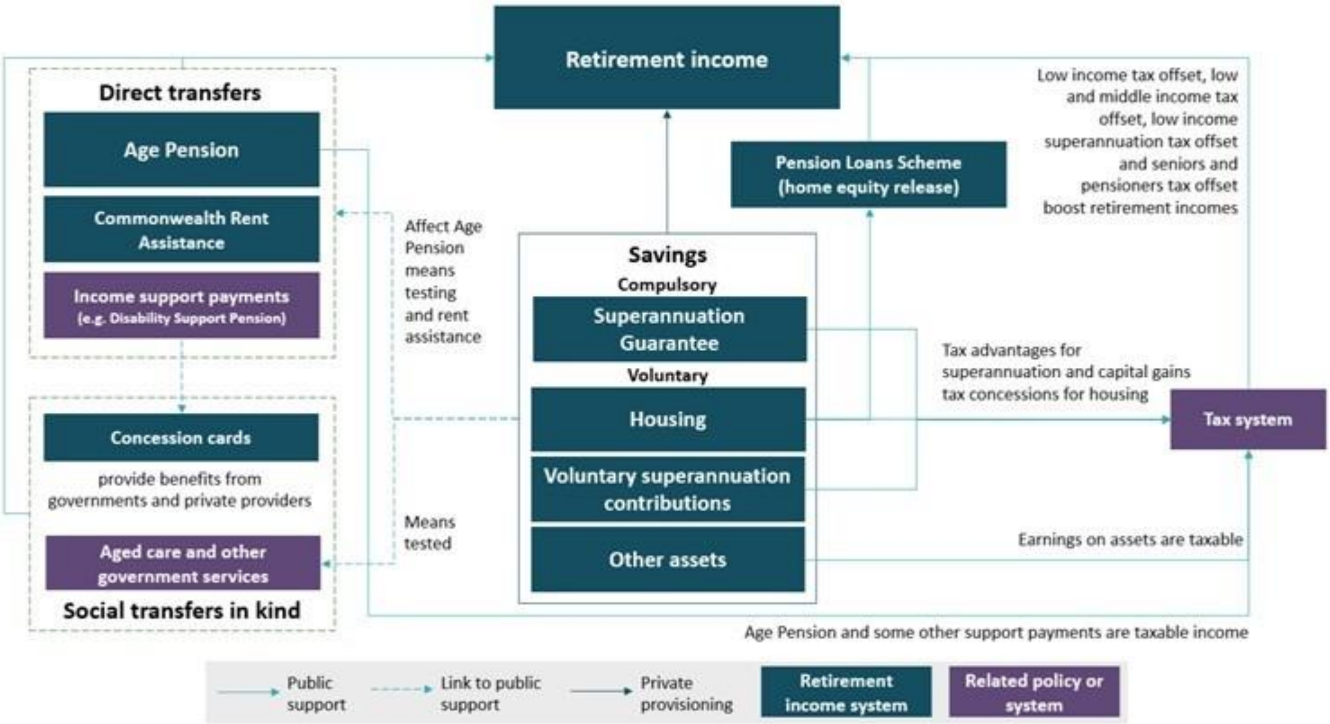


Note: Horizontal axis labels indicate home values up to that amount (e.g. $200,000 includes homes over $100,000 up to $200,000). Source: Department of Social Services analysis of payment data, June 2018.

Bringing it all together in an interactive system

The 650-page final report contains a wealth of information that will inform the superannuation debate for years to come. It highlights the major interactions of the welfare and government concession systems, such that certain people benefit from multiple benefits. The figure below is a useful summary bringing together these interactions.

Figure 4: Key retirement income system interactions



The Retirement Income Review goes much further than an innocent-sounding 'fact base'. If we thought the fight over franking credits at the last election was heated, we are likely to see even fiercer battlelines at the next election between unions (and industry funds) and the Coalition Government.

Graham Hand is Managing Editor of Firstlinks. The full [Retirement Income Review is linked here.]

Steve Bennett on investing in direct property for the long term

Graham Hand

Steve Bennett is Chief Executive Officer at Charter Hall Direct and was elected President of the Property Funds Association in April 2019. He oversees in excess of $6 billion of direct property investments.

GH: Which property sectors have been most and least adversely impacted by the pandemic?

SB: Most sectors have been impacted in some way by the pandemic if you look at it from a foot traffic or tenant usage view. Most adversely are the large discretionary shopping malls, which were hit by the lockdowns. Plus places like Melbourne office buildings where the State Government mandated people to work from home. And then the least adverse are assets such as Bunnings which in most parts of the country continued trading strongly through the pandemic, and industrial assets have been positively impacted. When people order things online, it doesn't just magically appear with click of a button. It comes out of a warehouse and goes onto a truck, and industrial logistics has been a long-term trend and the pandemic has really speeded it up.

GH: Did Charter Hall make any lease adjustments, especially in the beginning around March and April?

SB: Not really. We've been fortunate in two main ways. The first is that the whole group focusses on long WALE (Weighted Average Lease Expiry) properties as a thematic. So we haven't renegotiated any material leases that were up for expiry because they are pushed well into the future. And secondly, the group focuses heavily on government and highly-rated corporates. These are financially-strong counterparts which don’t need special treatment.

Where we've had to be accommodative is for SMEs who were suffering financial hardship or stress. Under the Government's National Code of Conduct, SMEs were provided some rent relief to help our smaller tenants come through the other side. It's in everyone's interest.

GH: Could you give an example of a type of tenancy and property where you relaxed the lease terms?

SB: If you think of a large premium grade office tower, typically there's a coffee or a sandwich shop in the foyer. And when the foot fall through CBDs plummeted, we needed to help with the rent because everyone wants the amenity to stay there, particularly for the operators who were trading well and had always paid the rent. And in non-discretionary retail, such as in neighbourhood centres anchored by Woolworths or Coles, we've helped some of the smaller specialty stores although most of the food operators have traded well.

GH: Many of our readers will be familiar with residential leases, but can you highlight some ways a commercial lease normally varies from a residential lease?

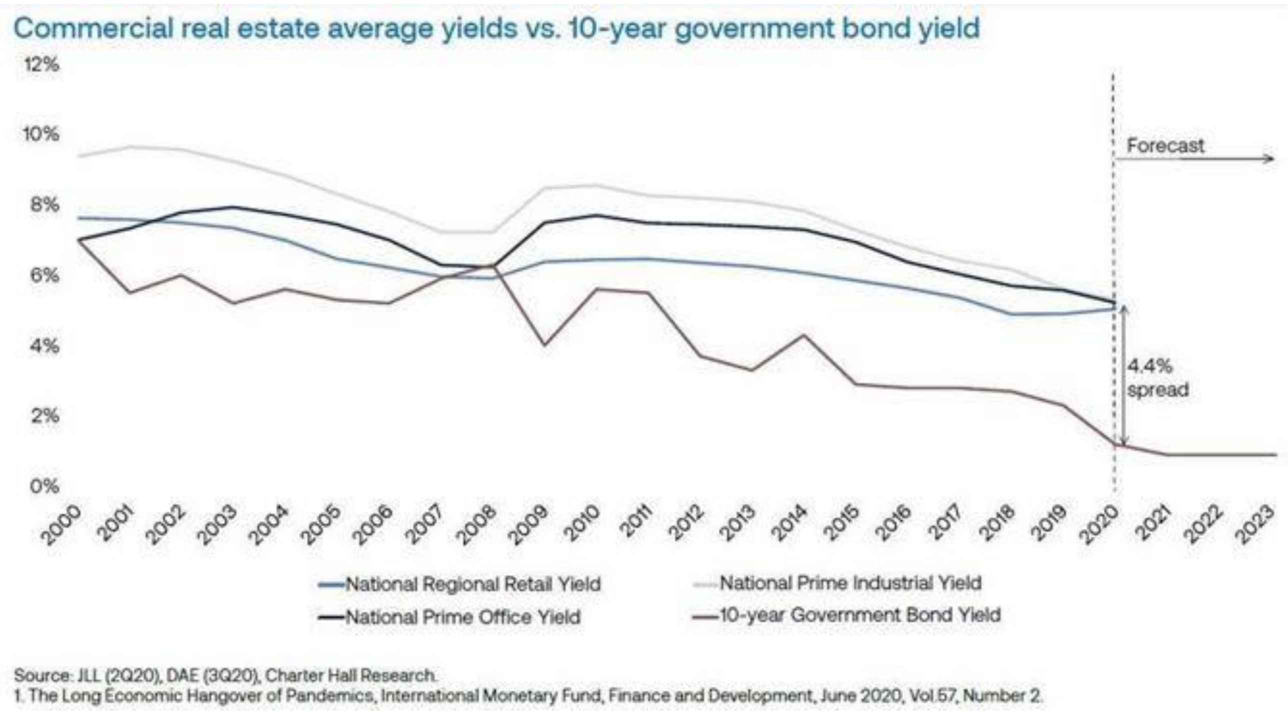
SB: There are three big differences. First, the length of the lease. Most residential leases are six to 12 months, while we have leases to governments and major corporates such as Woolworths and Coles for up to 20 years. Our office fund's average lease term is eight years and industrial fund is over 10 years. The second is the income yield. Most of our funds are paying somewhere between 5.5% to 6.5% per annum income whereas if you're getting 2.5% to 3% in residential, you're doing well. Plus commercial leases are typically net leases where the tenant is responsible for all the costs. So the return is after all those costs are paid whereas residential, the landlord has to cover body corporate fees, sinking funds and agents fees, and that's just the start.

GH: Tell me about it, I should sell my investment apartment this afternoon.

SB: Exactly. There's a place for residential in some portfolios but commercial property stacks up well for investors who want diversification and to avoid the hassle of a single, short-term leased residential asset.

GH: Across the many property sectors you cover, where do you see the best opportunities?

SB: The best opportunities, and we're hearing this from institutional investors globally, are the long lease assets with some type of a monopolistic feature, such as a long lease Bunnings in a great metro location. They are well bid by almost everyone from high net worths to institutional managers. And a long-lease asset regardless of the sector with a very strong tenant will continue to do well. For example, we own a new office building at Macquarie Park with a 10-year lease to the New South Wales Government and it's throwing off 5.5% income. In a world where interest rates are close to zero or negative in real terms, it's easy to see why that style of property is popular. As the chart below shows, the spreads between commercial real estate and government bonds is wider than ever.



GH: Where is that office asset held?

SB: That one is in our Direct PFA Office Fund, open to SMSFs and high net worth investors.

GH: What are your expectations on the medium- to long-term consequences of working from home changing the city office market?

SB: We think there are huge advantages in collaboration, risk management, providing experience and guidance to younger team members, networking, and obviously the amenity that you get in a CBD location. Having said that, the trend to working from home has been bubbling away for a long time. So, it's undoubted that home will form part of the way we work in future. We believe businesses will provide additional flexibility, so staff might work for a day or two a week at home.

The previous process of 'densification', a fancy word of putting more people per square metre into an office, is now reversing, and this move back to lower density will balance working from home. But we are also going through a recession so we shouldn't kid ourselves that in the short term, there will be a reduction in white collar jobs. It shows the value of a long lease strategy.

GH: WFH has its productivity benefits but it's more difficult to have a collaborative discussion about a complex subject between five or six people on Zoom than it is sitting around a table.

SB: I couldn't agree more. We were launching and refining a new product through COVID and what would have taken one maybe two meetings with the right people in a room and a whiteboard required endless Zoom calls. We speak to a lot of CEOs because of the nature of our business, and there's a consensus building that their companies are losing some of the culture that they've built up over many years. How are junior people going to learn if they are not sitting with their team? I think one of the reasons for the claimed success of working from home is that it's self-reported.

For thousands of years, we've had migrations into cities. We've had pandemics before. We're not going to stop the ways we interact and live because there is value in it. I laugh when I read some of these tech companies, the Googles and Facebooks, say they will never have people in the office and then Atlassian announces it will build a billion-dollar property in the Sydney CBD. If it is so unimportant, why do the tech companies group themselves together in Silicon Valley?

GH: Stock market volatility has been extreme in the last six months, and the share price of the Charter Hall company is no exception. January $14, March $5, now back towards $14. Is it possible for an executive to distance from what is happening with the market's assessment of the value of your company and does that lead to caution in your activities?

SB: It's one aspect we love about unlisted properties. We don't get caught up in the sentiment that can infect listed markets. There's a lot to be said for experience as well. I was in London with Macquarie throughout the GFC when the share price went to low single digits. The feeling around the office was that the company was trading through a potential existential threat and the bank guarantee from the government helped pull the banks through.

I never saw anything like that at Charter Hall. We knew the business was extremely sound, we understood how the funds are set up with long lease terms. In fact, some executives picked up more shares in the company as the low price just didn't make sense. It was a classic equity market mispricing, and it can happen on the upside and the down. If I compare the two experiences, this year and during the GFC, everyone just got on with it this time.

GH: Charter Hall has been on an acquisition drive for many years. Has it continued this year?

SB: If anything, COVID gave us more impetus around the long lease, high quality Strategy. We used the opportunity to pick up assets that we probably wouldn't have been able to obtain at such favourable prices, especially in industrial logistics in the September quarter. We also picked up a portfolio of Bunnings. It's the advantage of having capital to deploy and looking through the cycle with people on the ground to do inspections. We're also the biggest player in sale and leaseback, helping companies free up capital from their balance sheets and giving us assets to meet the needs of our investors.

GH: So for a Firstlinks reader, perhaps the trustee of an SMSF, with a traditional portfolio of cash, domestic and global equities and fixed interest, but looking to deploy funds into other asset classes, what are one or two of your funds for that sort of a portfolio?

SB: First, they should recognise that quality sources of income will be even more highly valued in the medium to longer term due to where interest rates are. We've got a diversified fund called the Charter Hall Direct Long WALE Fund paying 6% per annum income, paid to investors on a monthly basis. And we have a highly-rated industrial fund, DIF4, with a similar distribution yield, average lease term of 11 years and occupancy rate of 99%.

GH: They are both unlisted?

SB: Yes, and investors should consider whether every part of their investment portfolio needs to be liquid. These funds give high quality income streams from core real estate, and they have low gearing. We could increase the distribution yields by simply putting more debt in but we believe that a gearing range of 30% to 40% is the right place to play.

GH: Is this an unlisted version of the listed Long WALE REIT (ASX:CLW)?

SB: It's a similar diversified fund but holding different assets and much smaller than CLW at this stage. We mix assets from office or retail or industrial to take advantage of diverse opportunities as they arise. And I'll just add that we have over 15,000 direct investors in our funds and we're supported by over 1,200 financial advisers. We manage more third-party capital in commercial real estate than anyone else in Australia.

Charter Hall's free ebook 'Your Guide to Investing in Australian Commercial Property' is linked here.

Graham Hand is Managing Editor of Firstlinks. Steve Bennett is Chief Executive Officer at Charter Hall Direct and was elected President of the Property Funds Association in April 2019. Charter Hall is a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

For more articles and papers from Charter Hall, please click here.

Retirement Review gives strong views on hoarding of super

David Bell

Fairness of outcomes in retirement income between middle and mid-high wealth cohorts has been a hotly debated topic in the media, including in Firstlinks. Now the Retirement Income Review has had its say.

The fairness argument runs along the following lines (using the case study of a $500,000 retirement balance and a $1,000,000 balance):

- The household with $500,000 may have higher 'retirement income' than the household with $1,000,000 at retirement when 'income' is defined as age pension payments, asset earnings and franking credits.
- This is unfair when the household with the $1,000,000 balance has made more contributions over time.

Income includes drawdown of capital

The Review didn't just explore this issue: it was probably the most significant finding: households not spending down their capital in retirement is one of the greatest sources of inefficiency in Australia's retirement system.

To understand the Review's finding, we need to revisit the definition of 'retirement income'. The Review's interpretation is that retirement income should include not only the age pension payments, asset earnings and franking credits, but also the drawdown of accumulated capital.

Ultimately the term 'retirement income' has been mis-used and is probably not the correct term. It is really 'consumption in retirement', but that is more clunky. Alongside terms such as 'investments', 'savings', and 'nest eggs', we have a framing issue where people experience unnecessarily low living standards due to a restricted definition of retirement income.

A wide range of complex issues

The Review highlights a range of issues which compound this framing issue, including:

- the system is highly complex

- the understanding of how different retirement income sources interact is weak
- little low-cost guidance is available to assist
- consumers may interpret minimum drawdown rules as guidance
- there are concerns about uncertain health, aged care costs and the possibility of outliving savings.

The Review addresses these concerns by identifying that health and aged care costs are heavily government funded and the age pension both provides a baseline and performs a risk management function.

The Review twists the commonly-raised concern about the high age pension taper rate (that the taper rate is too high and provides a disincentive to save for retirement) on its head. It says a high taper rate means that participation in the age pension is available readily to those as they drawdown or experience unexpected losses.

Broadly, it identifies that the retirement system could deliver better retirement outcomes if people spent down their savings more appropriately. System-wide equity issues arise when high balances, which receive significant tax incentives, are bequeathed. In its current state the retirement system is underperforming its potential. Indeed, the Review identifies that a system drawing down effectively at a 9.5% SG will produce better outcomes than one at a 12% SG drawing down as per current practice.

Pointers to solutions

The Review is not pointing the finger at individual households, rather it suggests a range of solutions are necessary:

- Education to dispel some retirement myths, particularly around the definition of 'retirement income', the fear of healthcare and aged care costs, and the role of the age pension in retirement. This responsibility lands on many including Government, industry, consumer groups and media.
- Better access to low-cost, accessible financial advice and guidance.
- Superannuation funds need to improve retirement solutions which better manage the risks of outliving their savings, enabling their members to consume with confidence. I anticipate a Retirement Income Covenant will be introduced by Government to formalise this, but I have some reservations about the broad range of solutions which may result.

For those retirees who are actively engaged and living off a restricted definition of retirement income, the message is that you should most likely be experiencing higher levels of consumption. You can investigate further through talking to an adviser, your super fund or using a financial calculator such as ASIC MoneySmart.

David Bell is Executive Director of The Conexus Institute, a not-for-profit research institution focused on improving retirement outcomes for Australians. This does not constitute financial advice.

Paul Keating on why super relies on "not draining the bath"

Interview by Leigh Sales

Leigh Sales interviewed former Prime Minister, Paul Keating, on ABC television's 7.30 programme on Monday 23 November 2020 following the release of the Retirement Income Review the previous Friday.

LS introduction: Paul Keating has been Australia's leading champion of compulsory superannuation as the central means of funding retirement. When Keating finally claimed the Prime Ministership, he continued to drive home the imperative and eventually took to the 1996 election a promise to increase superannuation contributions to 15%. That increase was never fully realised because John Howard and later Tony Abbott were not keen. Next year, legislated increases to the rate of superannuation contributions are due to start. But the question is whether the Morrison Government may try to undo them.

On Friday, the Government released its Retirement Income Review conducted by the Treasury. It says the weight of evidence suggests the majority of increases come at the expense of growth in take home wages. The Reserve Bank Governor shares that concern. The Government says it won't make a decision about next year's increase until the May Federal Budget.

The Prime Minister Paul Keating is with me in the Sydney studio. What do you think will happen if Australia does not increase the rate of superannuation contributions?

PK: Before we do that, let's go into the main point of the Report, which has had little publicity. The Government released the Report on the day they released the Afghanistan revelations. The point was for the Government not to have people focus on the central finding. They wanted to report to say that super was sort of in trouble. But here's the first line, "The Australian retirement income system is effective, sound, and its costs are broadly sustainable." And the second line says, "Without compulsory superannuation, middle income earners would not save enough for retirement."

The Report has confirmed the universality of superannuation. It's compulsory nature. And of course, the Libs hate that. All those people watching us tonight who have got superannuation are often worried because of all the nonsense that runs in the newspapers but here it is: "The Australian retirement income system is effective, sound and its costs are broadly sustainable."

LS: The rest of that sentence goes on "… but the evidence suggests there are areas where the system can be improved."

PK: Oh, any system can be improved, of course.

LK: What would you say to an Australian who said to you, "I get what you're saying about needing money for my retirement, but I need money right now because I've got rent to pay, I've got kids and it's my money. Why shouldn't I have it now if I want it and let later worry about later?"

PK: The Report gave the answer. It said for every $10,000 allowed out in the early release programme for someone in their 30s, it costs them $100,000 later. It's a tenfold increase leaving it in because of the compounding. So, we're talking about a half a percent, on 1 July it goes from 9.5% to 10%, the half a percent is eight dollars a week, two cups of coffee. For two cups of coffee, people are supposed to walk away from their future.

And of course the other thing the Libs are up to is in the Report. I'll just read this to you. "If the SG rate remained at 9.5% and people made more efficient use of their retirement savings, many would have higher replacement rates than they would have under the SG at 12%." And what they mean by that is accessing home equity. So, the idea is this. You can do better than 9.5 but you got to eat your house by reverse mortgaging your house.

LS: People now tend to live off their investments and when they die they have their house and they have most of their super which they then pass on to their kids. Doesn't it bake in inequality because if you are rich then you've got an asset to pass on your kids but if you're poor and you actually have to run down your savings, then your kids get nothing.

PK: Well, you can't blame the system, poor people have all sorts of choices. But the idea that a Report endorsed by the Government is putting about is that you don't pay more than 9.5% but you should start reverse mortgaging your house. In other words, give the kids nothing, eat the house, and then you don't have to go above 9.5%. Now, just remember this. There's been no increase in real wages for eight years now. There's been a 10% improvement in labor productivity and the legislation for the super is passed. People have earned the superannuation, they've earned that 2.5%, the employers are going to pay it. And today the stock market was 6,500 on the index because the wage share of GDP is falling and the profit share is rocketing. So that's why.

The argument runs that if you get an increase in super, you don't have any wages. And if you don't have it in super, you do have any wages. We've had no increase in superannuation since 2013 yet there's been no wage increases since 2013 ... We're going to have the lowest (pension) call by any country in the world upon the budget, and this is all because of superannuation.

LS: What do you think would happen in Australia if we don't increase the rate of superannuation contribution?

PK: If we don't, the profit share will certainly rise and it will cost people in the long run. You work it. 2.5% is about a quarter of 9.5%. So, if you had 400,000 in super today, you would have 500. If you take a quarter out, you'll end up with a quarter less at the end, and for most people, that's about 150,000 bucks.

LS: Do you think that the pandemic and the drastic change in economic circumstances give any rise to an argument for deferring an increase in the rate of superannuation contribution?

PK: None whatsoever. This is the first year since Governor Phillip came into Sydney Harbour that we hold more assets abroad than foreigners hold on us. We're going to be, with Germany and Japan, a capital exporter for the first time in history. So it's a real measure of national resilience to not have a begging bowl out funding your current account deficit. It's as simple as this. Put more money into savings, into super, you get more investment. If we want more employment, more GDP, more investment, you make the super bowl bigger.

LS: If you want that kind of investment though, the superannuation funds need certainty, which means they presumably need to not have people able to withdraw on their superannuation funds early.

PK: Compulsion and preservation are the two keys, not draining the bath, not taking money out for housing deposits, not taking money out for education or health but leaving it in there to compound for retirement income. That's the whole point of the tax concessions.

This is an edited transcript by Graham Hand, Managing Editor of Firstlinks. Editing is done for briefness and clarity without removing any meaning. The full video is linked here.

Is your portfolio too heavy on technology stocks?

Amy C. Arnott

Even if you don't hold any technology stocks or tech-sector funds, your portfolio might be more tech-heavy than you think. If you invest in a US index fund, the tech sector now accounts for 24.2% of the S&P 500.

Communication services, which is home to tech-oriented leaders such as **Alphabet** (NAS:GOOGL), **Facebook** (NAS:FB), and **Twitter** (NYS:TWTR), made up another 11% of the benchmark as of 31 October 2020.

Tech leaders have dominated returns for the index for seven years running; as a result, the largest companies in the index are all big tech names, including **Apple** (NAS:AAPL), **Microsoft** (NAS:MSFT), **Amazon.com** (NAS:AMZN), and Facebook. (Amazon is officially part of the consumer cyclical sector, but obviously tech related.) Those five companies alone now account for about 23% of the index's value.

Because the S&P 500 is such a widely-used benchmark, thousands of index funds, Exchange Traded Funds, and actively-managed funds also have large amounts of exposure to the tech sector. While there are good reasons behind tech's growing dominance, it also warrants a bit of caution. In this article, I'll delve into what's been driving the surge in tech stocks, why this is potentially problematic for investors, and how to adjust your portfolio to mitigate the risk.

The rising tide

Over the past 31 years, the tech sector's weighting has nearly tripled as a percentage of the S&P 500. Over that period, the weighting has been as low as 6.3% (at the end of 1992) and as high as 33.0% (in August 2000). The high-water mark in 2000, of course, marked the beginning of the end of the tech bubble, when hundreds of Internet startups with inflated valuations quickly dropped down to earth. More established tech names held up better but also experienced significant drops. Between 2000 and the end of 2003, Morningstar's US Technology Index lost more than 70% of its value in cumulative terms.

Exhibit 1: S&P 500 Technology Weighting Over Time (%)

Source: Morningstar Direct. Data as of Oct. 31, 2020.

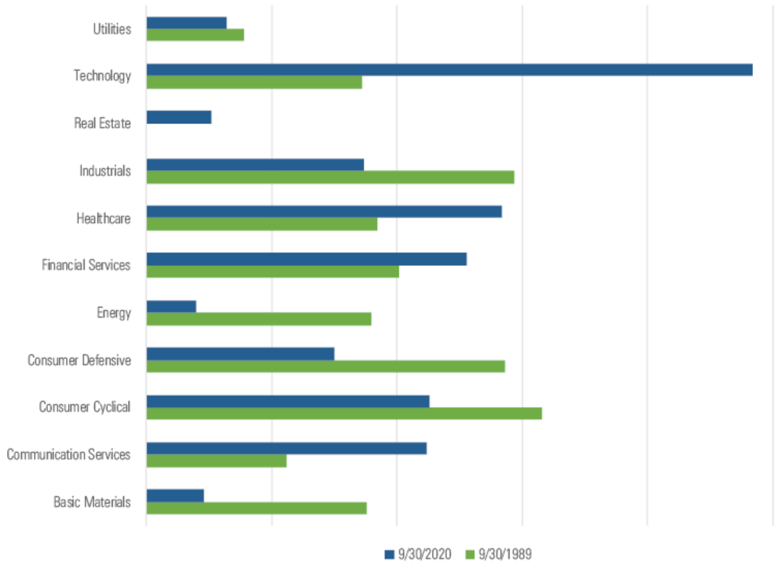
Since then, the sector has steadily climbed, suffering only a temporary drop during the fourth quarter of 2018's market jitters. Tech stocks even held up better than average when the novel coronavirus roiled the market in March 2020. More recently, some market pundits have even gone so far as to describe technology as a safe haven.

No worries?

The size of any sector's weighting in itself doesn't necessarily mean a correction is imminent. Market valuations represent the collective wisdom of market participants about the underlying value of each company.

Many of the more recent shifts in sector weightings reflect changes in the nature of the economy. We can look at sector weightings going back to September 1989 (the earliest date for Morningstar's sector data) to see how the overall makeup of 'the market' has shifted over time. Over the past 31 years, old-economy sectors, such as basic materials, energy, consumer goods, and industrials, have all declined, while technology, healthcare, communication services, and financial services have increased in percentage terms.

Exhibit 2: S&P 500 Sector Weightings: Now Versus Then



Source: Morningstar Direct. Data as of Oct. 31, 2020.

To a large extent, these changes reflect the underlying economic contributions of each company. If we aggregate all of the financial statements for the companies included in the S&P 500, for example, the tech sector accounts for a large percentage of the total revenue, operating income, and free cash flow generated over the past 12 months. Those are all key inputs that help drive the underlying value of a company.

What's more, equity values are forward-looking, so the large tech weighting also reflects the expectation that companies in the sector will continue generating above-average growth. Indeed, the median five-year earnings growth estimates from Wall Street analysts are higher for companies in the tech sector than nearly any other sector.

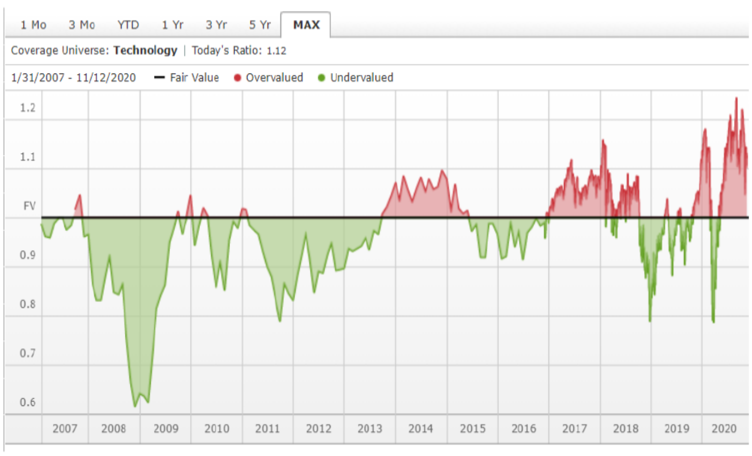
The positive trends driving technological growth show no signs of stopping. Some of these include the acceleration of digital tools in all aspects of life, 5G mobile network standards, and productivity-enhancing technologies like artificial intelligence and robotic automation.

Potential danger signs

But even if tech lives up to its high growth expectations, are the assumptions baked into current stock prices too high?

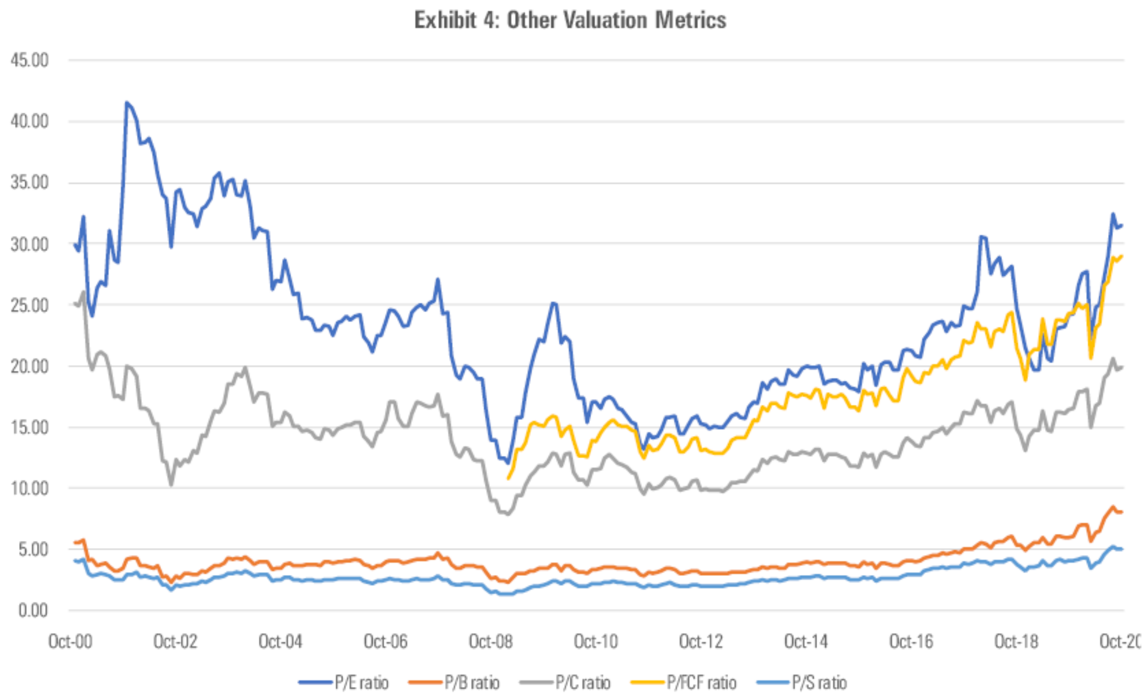
Morningstar's equity analysts calculate fair value estimates for individual stocks under analyst coverage, with the values based on detailed models of projected future cash flows (discounted to present value). On that basis, tech-stock valuations look a bit steep. As of 12 November 2020, the median tech stock in our coverage universe was trading at a price/fair value ratio of 1.12. That's down a bit from a recent peak in October 2020, but still relatively rich.

Exhibit 3: Median Price/Fair Value for Technology Sector



Source: Morningstar analysts. Data as of Nov. 12, 2020.

Other valuation metrics also look relatively lofty compared with historical levels, as shown in the chart below. Average ratios for price/earnings, price/book, price/cash flow, and price/sales have all been on an upward trend over the past several years. Three of these four metrics now stand higher than they did at the end of 2000. Morningstar's historical data for price/free cash flow doesn't start until 2009, but that metric is also well above past levels.



Source: Morningstar Direct. Data as of Oct. 31, 2020. Valuation metrics are for stocks included in Morningstar's U.S. Technology Index.

Portfolio tweaks for tech-wary investors

None of this data is a flashing red light suggesting that investors should bail out on tech stocks. But I think there's enough evidence to warrant some caution.

A logical first step is to figure out exactly how exposed you are to the sector. In addition to hefty weightings in most market indexes, any individual stock holdings you own may have ballooned to surprising levels. Making matters worse, many of these holdings have large unrealised gains, making the prospect of selling pretty unappetising.

One way to dial back tech exposure is to consider adding positions in other areas as a counterweight. Adding assets to a value-oriented fund is one way to counterbalance the tech-oriented growth stocks that have dominated the market in recent years. Finally, consider adding a small stake in sectors that have historically had lower correlations with the tech sector, such as energy, utilities, and real estate.

Amy C. Arnott, CFA, is Director of Securities Analysis for [Morningstar](). This article is general information and does not consider the circumstances of any investor. It has been modified somewhat from the original US version for an Australian audience.

Register for a free trial of Morningstar Premium on the link below, including the portfolio management service, Sharesight.

Beware of burning down the barn to bury the debt

Kate Howitt

As this country knows all too well, fires usually end up being much harder to put out than they are to start.

In the decade since the global financial crisis, there’s been a large build-up in sovereign debt by almost all Western nations. As with so many things this year, the COVID-19 pandemic has accelerated the trend. At some point, policymakers will have to turn their attention to the task of deleveraging, to somehow work off these large debt burdens.

Fire versus ice policy moves

They face a difficult set of choices. Do they go down the path of deleveraging via fire (inflation) or ice (deflation)?

If we take history as our starting point, there are four pertinent examples.

1. Japan has been attempting to deleverage through deflation since the late 1980s. The good news is that economic conditions have muddled through; the bad news is that Japan’s sovereign debt position is now well more than 200% of GDP. The result is a chilled-down economy, but with little success at debt reduction.

2. Another example of deleveraging with deflation is the 1930s Great Depression in the US. Here, the reduction in debt was very successful – but this came with an enormous hit to the economy and widespread destruction of wealth. So, deleveraging was achieved by freezing the economy almost to death.

3. During the same period, Germany also underwent a debt reduction. The Weimar Republic reduced its ruinous load of reparations debt, although the vast monetary expansion that enabled this led to hyperinflation and widespread destruction of wealth. So this was deleveraging by raging conflagration, at the cost of burning the whole economy to the ground.

4. However, there is one historical example of a successful deleveraging process that did not entail widespread wealth destruction. In fact, it occurred during a period of prosperity and it was brought about with the nice warm glow of moderate inflation. How was this happy outcome achieved?

After peaking at 116% in 1945, US sovereign debt-to-GDP more than halved over the next 15 years. This was achieved by limiting the interest rate payable on US Treasury bonds, limiting the ability to sell these bonds, and a demand set-up to fuel a decent level of inflation.

Financial repression

This resulted in low nominal returns to bonds, and negative real returns. In other words, holders of US debt lost their purchasing power year after year for 15 years, but with no damage to the broader economy.

They effectively locked bondholders in the barn and then burnt down the barn.

This policy manoeuvre has become known as 'financial repression'. As Carmen Reinhart observed in an IMF working paper in 2015, this 'financial repression tax' is a transfer from creditors to borrowers.

Three ticks in the policy boxes

So could we see policymakers following the same playbook today? We are already seeing evidence of this around the world, and even here in Australia.

1. Limits on the rates payable on government bonds? Tick. In March, the RBA announced a target for Australian three-year debt of 0.25%, with the potential to extend this into longer durations. This is also known as yield curve control (it's now 0.1%).

2. Limits on the ability to sell bonds? Tick. Prudential regulations imposed on banks have gradually increased their requirement to own government debt. The budget’s recent measure to scrutinise superannuation funds’ performance could also result in funds owning more government debt to be more in line with bond indices.

3. Set up for inflation? Tick. The RBA’s stance is to "maintain highly accommodative policy settings" until inflation is within the 2-3% target band.

This playbook is unlikely to play out in the next year or so, since – hand sanitiser and face masks aside – the effects of the pandemic are broadly deflationary. But, in time, the extreme fiscal stimulus being deployed in Australia and elsewhere is likely to have a tightening effect on prices.

Kate Howitt is a Portfolio Manager for the Fidelity Australian Opportunities Fund. Fidelity International is a sponsor of Firstlinks.

This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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

New bankruptcy rules may have a domino impact on SMSF pensions

Graeme Colley

Prior to 2020, the bankruptcy rules were fairly straightforward. If you were declared bankrupt, you could no longer trade in your industry.

But that changed during COVID-19 with the Federal Government adopting US-style bankruptcy legislation that allows small businesses to trade while insolvent.

While there may not be direct changes to the way an SMSF is impacted by the collapse of a business, there could be indirect ways that could have major ramifications on SMSFs.

What happens when a member of an SMSF is faced with bankruptcy?

This part of the legislation has not changed. If an SMSF member is declared bankrupt, they need to move their superannuation benefit to another fund or sell their assets within six months of being declared bankrupt as they are a disqualified person under the SIS legislation.

Bankrupts are not allowed to appoint a legal representative to act in their place while they are disqualified. They need to remain out of the SMSF until they have been fully discharged, a process which usually takes about three years.

These members also need to resign as a trustee or as director of the trustee company, which is covered under the Superannuation Industry Supervision Act 1993 SIS Act. A new director will need to be appointed if the bankrupt person is the sole member of the SMSF and the sole director of the corporate trustee.

How do changes in bankruptcy legislation affect SMSFs?

COVID-19 hit many individuals and business owners hard in 2020 due to forced closures and lost earnings. The Federal Government threw a lifeline to small businesses at risk of collapse by allowing business owners to continue to trade while insolvent, which borrows heavily from the United States Chapter 11 bankruptcy provisions.

On the surface, it would appear this legislation does not impact SMSFs because any member who is bankrupt has to leave the fund anyway, even if they can continue to trade while insolvent.

Instead, the impact is more likely on the fund's investments. For example, according to the Australian Financial Security Authority, the most common industries to report personal insolvencies were construction, retail trade and accommodation and food services.

An SMSF could own a property that is currently rented by someone in those industries who are allowed to continue trading but may be struggling to pay the rent. This could cause a domino effect where there are cash flow delays which could in turn impact the ability of the fund to pay pensions.

This could lead to breaches of the pension standards or a fire sale of assets just to pay pensions as legally required. It shows the risk of using an SMSF to hold a single asset, especially when the SMSF is in pension phase. Trustees need to ensure their fund holds sufficient cash to meet its obligations.

It will require a watchful eye on property assets to ensure those rental payments do continue to roll in and the dominoes are not allowed to fall.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at SuperConcepts, a sponsor of Firstlinks. This article is for general information purposes only and does not consider any individual's investment objectives.

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