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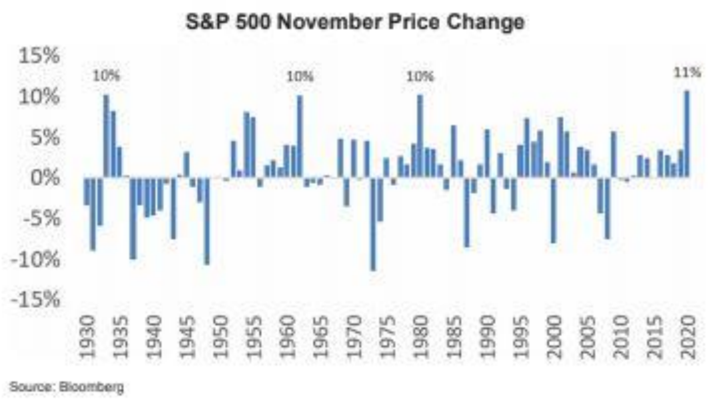
Editorial

It's already become a cliché to say 2020 was a terrible year to be consigned to the rubbish bins of history and the 2021 return-to-normal will be welcome by all. And indeed, the pandemic turned lives upside down and millions suffered. But it also proved again that for financial markets and capitalism, far from being a free enterprise system where government interference is despised, when the going gets tough, bankers and companies run to the authorities for support. Central bankers become the heroes who save the system with a bottomless bucket of cash.

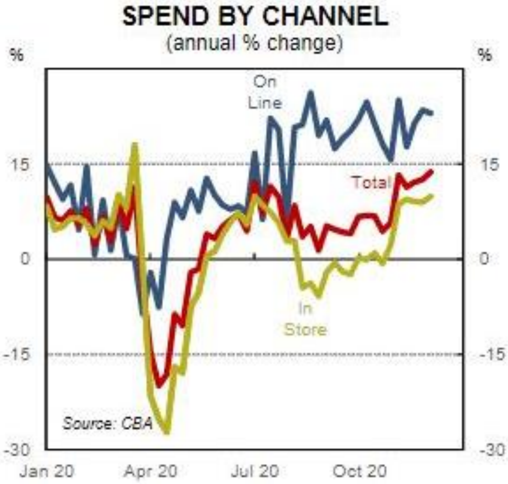
And so 2020 became the punch bowl full to the brim with liquidity spiked with 'whatever it takes' to have a recovery party. Iron ore prices are at a seven-year high, NASDAQ hits records daily and there is a flood of IPOs making people wealthier. Far from the predicted collapse in residential property prices, new mortgage commitments rose 23% in the year to October 2020 driven by owner occupied loans and rising prices. A friend told me this week he has borrowed at 1.79% fixed for four years ... champagne pricing. The S&P500 has hit frequent highs, and just experienced its best November on record, up 11% as shown.

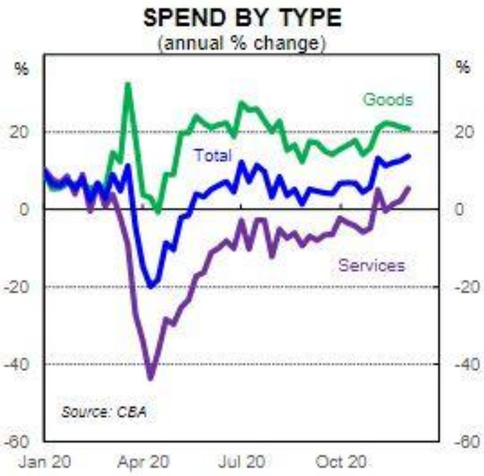


CBA reports that annual growth in wages and salaries paid into its bank accounts has accelerated rapidly in recent months as employment recovers. **Gerry Harvey** of **Harvey Norman** calls it the best trading conditions he has ever seen (and he's 81-years-old) and Metcash shares jumped when CEO, **Jeff Adams** said:

"It has been a standout first half for Metcash, with unprecedented sales growth underpinning a significant lift in earnings and cash generation. I am pleased to report that the Group has had a good start to the second half, with strong sales momentum continuing in all pillars in the first five weeks of trading. We are also expecting strong trading over the Christmas and New Year period."

CBA credit card statistics are published quickly as a leading indicator, and this week they showed in-store and online doing well for both goods and services.





The **ANZ-Roy Morgan** Consumer Confidence index increased 1.8 points to 109.3 on 5 December 2020 and is now 13.8 points above the 2020 weekly average of 95.5. Consumer confidence is at its highest since November 2019 with more Australians saying now is a 'good time to buy major household items'. The **Westpac-Melbourne Institute** Index of Consumer Sentiment rose by 4.1% to 112 in December and is now 48% above the low in April. It has reached its highest level since October 2010.

When the drinks are spiked, the headaches come later. While it looks like the party will continue well into 2021, at some time, the drinks must be paid for and someone will have to clean up the mess. If this is what a recession looks like, funded by governments, who needs capitalism?

With markets so strong, where is value left in global equities? Most Australian investors do not have much exposure to emerging markets, and in this interview with **John Malloy,** he explains the case for the next cyclical upswing in these developing nations and shows how they are changing.

Two of this week's articles look at what to expect in 2021.

Neuberger Berman's Joseph Amato and team have distilled their views into 10 key themes for next year in this summary to help position equity, fixed income and alternatives for the year ahead.

Economists at **Vanguard**, **Qian Wang and Beatrice Yeo**, have run their models on expectations for 2021, including what a balanced portfolio might look like under three scenarios. A diversified portfolio might not shoot the lights out but it will deliver over time.

Then three hard-hitting opinion pieces from experts in their fields.

Superannuation policy expert **David Bell** describes the shortcomings of the Government's proposed performance test for super funds. This is a major issue for the industry when the proposal imposes severe punishments on a fund underperforming by only 0.5%. Implementation is due by 1 July 2021 but it cannot continue in this format.

Actuary and demographer **Bruce Gregor** has pored over the Retirement Income Review and thinks a courageous government has an opportunity to make a couple of changes without drawing the ire of increasing the 9.5%.

On the subject of how capitalism does and does not work, activist investor **Miles Staude** says problems arise for investors when management controls the messages reaching the board. On behalf of his Global Value Fund (ASX:GVF), which is the largest shareholder, Miles is currently engaged with Contrarian Value Fund (ASX:CVF) on solutions for the LIC's weak performance and poor share price rating.

And **Ashley Owen** calls on Australian companies to diversify their revenue sources to counter the increasing trade tensions with China, the recipient of 40% of our current exports.

This week's White Paper from **Neuberger Berman** expands on their article above to explore the evolution of the investment environment over the past 12 months and the themes they anticipate for 2021.

John Malloy: why time is now for emerging markets

Graham Hand

John M Malloy, Jr is Co-Head of Emerging & Frontier Markets at [RWC Partners](). He joined RWC in 2015 from Everest Capital and has focused on emerging markets investing for 23 years.

GH: We have not published much on emerging and frontier markets this year. Can we start with definitions of what countries are included?

JM: Emerging markets are defined as developing countries in terms of their GDP per capita, their stage of economic development, their banking systems, their foreign exchange and interest rate markets. The previous expression 'less developed nations' has become emerging markets. For example, the Morgan Stanley (MSCI) Emerging Markets Index includes 33 countries, the largest being China through to smaller ones such as Egypt and Pakistan. It covers a broad range. We have China, Korea and Taiwan developing at a fast pace, and Taiwan has a GDP per capita that's on par with some developed countries but it is considered emerging because it doesn't have an open capital market.

At the other extreme, we also invest in frontier markets (up to a maximum of 20% of our strategy) which are less liquid and less developed than emerging markets. In the MSCI Frontier Markets Index, the largest country is the Philippines. It also includes Vietnam, Peru, Colombia, the Ivory Coast. We own a company that we categorise as Zambian called First Quantum. It's listed in Canada but close to 100% of its assets are in Zambia and Panama.

GH: If you invest in a country like Zambia, how do you follow events there?

JM: On-the-ground due diligence is key, although that's compromised during COVID. We continue to have close contact with our target companies. We've traveled to these places for many years. I started in emerging markets in the early 90's and James Johnstone, who co-heads the strategy with me, has almost 25 years of experience. We also have a unique consulting arrangement with Rice, Hadley, Gates & Manuel. Condoleezza Rice, the former Secretary of State under Bush, started a consulting firm, and they speak to world leaders, they have contacts, they have very good access. Bob Gates was a former Secretary of Defence for Bush and Obama, Steve Hadley was a National Security Adviser. These contacts give us good perspectives, and our analysts also travel a lot.

GH: Why are you underweight China and Taiwan?

JM: We have shifted. We were close to a market weight earlier in the year, and both those markets have done well for us in the past. But as stock prices have appreciated, most of them have hit our price targets, and we are very disciplined, and we sell if we don't see additional upside. So, over the past two months, we've rotated capital out of China and Taiwan and into other places such as Zambia, Korea, Brazil and Russia on the expectation of a global recovery.

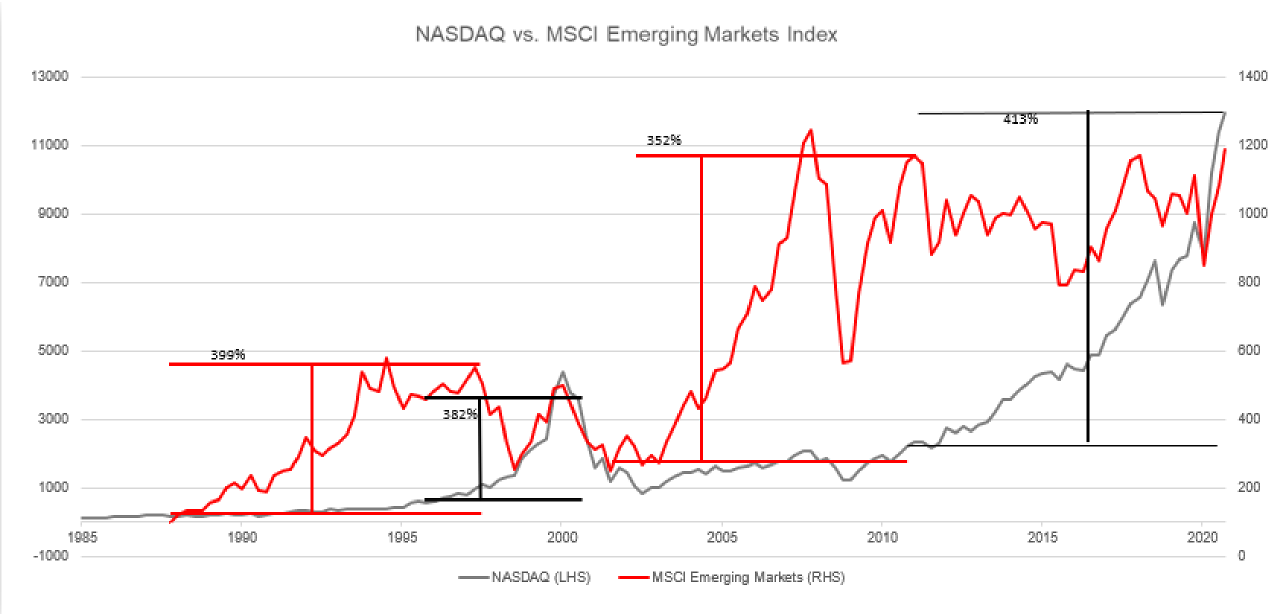
GH: In emerging markets, and maybe even more so for frontier markets, do you feel that you're getting a greater reward for greater risk? Or do you analyse companies in a similar way as developed market stocks?

JM: The fundamental due diligence is similar. We model the income statement, balance sheet, cash flow statement, we have a price target, we have our own internal ESG scoring system. However, where there are differences is in the macro risk. So when investing in, say, a Chinese company, there is Renminbi risk or in Brazil, the Brazilian Real risk, so you need to understand the dynamics around the currency. The other difference is that some of these markets include companies that are run or owned and controlled by the government. Is this company run for the shareholders or for other stakeholders? Additionally, you have to ensure information is good, especially accounting standards. All this requires experience and we have 20 people based in Miami, London and Singapore.

GH: Does a typical emerging markets portfolio have greater volatility for the return than in a developed markets portfolio?

JM: My view is that if you invest in these markets, you should demand higher returns. So for example, it doesn't make sense to invest in a low volatility emerging markets strategy. Investors are not compensated for the risk. We have produced higher returns with higher volatility, compounded strongly over the nine years that we've run the strategy.

Emerging markets are cyclical, as shown in the chart below. From the late 80's to the mid 90's, emerging markets did phenomenally well (up 399%), and then did nothing for about a decade. Then they did well again, from early 2000's to the GFC around 2010 (up 352%). And since then until recently, they've done nothing. So we believe there's an opportunity, especially with the dollar weakening and an enormous amount of quantitative easing, that emerging markets are set to do well.



Sources: RWC Partners, Bloomberg, 1987 – 16 November 2020

GH: What challenges in particular has COVID thrown up in analysing emerging markets companies?

JM: Obviously, it's a global shock, and many of these governments don't have the fiscal strength to put in the types of stimulus offered by countries like Australia, the US or parts of Europe. But what they do have is the ability to put in place stringent measures and for the most part, the populations adhere to them. On the stringency tests conducted by Oxford University, which looks at things like shutting down mass transportation, closing down schools and contact tracing, many emerging markets score better than developed markets. It's why we're not seeing a great second wave of cases in these markets.

Asia is a good example. Taiwan is a phenomenal story, and with 24 million people, they didn't close down the economy and they've had less than a dozen fatalities. How do they do that? They obey government rules on wearing a mask, social distancing, tracing on cell phones, personal quarantining. In contrast, some developed countries have handled COVID incredibly poorly. Some emerging markets had a sharp decline, but they are experiencing a very sharp V-shaped recovery.

The second point is the demographic backdrop, including younger populations who are less obese. In the US, a large proportion of the deaths are older people and people with health problems.

GH: They are interesting points. It would be easy to assume that the countries with the best hospital systems and money to spend would manage the pandemic the best. Let's look at ESG. How do you handle investing in countries with problematic rules of law, a lack of democratic elections, different media freedoms, etc?

JM: We focus on ESG using our internal scoring system to check governance, environment and social issues. Often, third party providers such as Sustainalytics, Morgan Stanley or Bloomberg don't fully cover the full emerging markets universe. ESG compliance is improving, much better than even five years ago. More companies openly engage about doing the right thing, including disclosure, data privacy, diversity and minority issues. Governments are also improving, such as China moving on sharemarket access and inclusion into the Global MSCI Index.

There's more focus on community, on education, on social issues, because companies recognise that there's a real cost to having a strike or a boycott of their products or as in Bangladesh, a factory collapse.

GH: Can you describe the technology in the countries that you deal in? For example, how good is the rollout of the internet and smartphones? And how far behind or maybe ahead of developed countries are they?

JM: There are two buckets. China, Korea and Taiwan are highly advanced and they are rolling out 5G aggressively. In the US, the real 5G is located only in city hotspots but China and Korea are really rolling it out nationwide. Their 5G networks will be 50 to 100 times faster, which allows technology such as autonomous vehicle driving, drone technology, faster communications and remote operation such as a doctor operating by a robot from 1000 miles away.

Then in the second bucket, like India, Brazil and South Africa, they are leapfrogging over countries with basic technology. So they won't even build branch networks for banks because they're going directly to digital banking and digital payments via their smartphone. And these are not Apple smartphones costing $1,000. A company we own called Mediatek is selling semiconductor chipsets into these markets, and the smartphones cost $100 with the same functionality as Apple. In a place like India, if hundreds of millions can suddenly tap into e-commerce or digital payments, it changes the dynamics of the country. They are literally becoming wired overnight. It's incredibly disruptive for some companies but it's very positive for technology leaders.

GH: Can you name three companies that you're most confident about in coming years.

JM: Well, when I look at our portfolio of about 60 names, they are all really interesting. The table below shows our Top 10 holdings, so three I'll highlight are Taiwan Semiconductor, Sberbank and First Quantum Minerals.

Position	Company	Position Size	Index Weight	Country	Industry	Themes
1	First Quantum Minerals	4.9	--	Zambia	Materials	Copper
2	Samsung Electronics	4.6	4.7	South Korea	Information Technology	5G
3	Petrobras	4.2	0.6	Brazil	Energy	--
4	Taiwan Semiconductor	4.1	5.8	Taiwan	Information Technology	5G
5	Sberbank	3.3	0.5	Russia	Financials	Financial Inclusion
6	Focus Media	3.1	0.0	China	Communication Services	New Media &Leisure & Gaming
7	New Oriental Education	2.7	0.4	China	Consumer Discretionary	Education
8	Reliance	2.5	1.0	India	Energy	Technology Disruption
9	Ping An Insurance	2.5	1.1	China	Financials	Financial Inclusion
10	Vale	2.3	0.8	Brazil	Materials	--
Top Ten Total		**34.2**	**14.9**			

Source: RWC, as at 16th November. Figures may not add up to the total figure due to rounding.

First Quantum is a copper producer, and the growth of electric vehicles, clean technology and clean energy will drive copper demand. An electric vehicle uses five to six times more copper than a traditional vehicle and countries and building out their charging networks. We think First Quantum is a phenomenal company with great management, great assets and a reasonable valuation.

Taiwan Semiconductor is the largest manufacturer of semiconductor processors in the world, increasing market share to 60% versus 30% a few years ago. They're doing a great job against Intel, yet Taiwan Semi trades at only about 18 times earnings. It's also focused on ESG and renewable energy.

And Sberbank is owned and controlled by the Russian Central Bank, but it's run like a private company with a close focus on the stock price and return on equity. They paid out a 9-10% dividend yield two months ago, yet Sberbank is trading on a low valuation. They're a leader in technology and they're closing branches to reduce costs.

We think all of those stocks have strong upside supported by good management teams.

GH: The Bank of America Fund Manager Survey for November 2020 shows a rotation into EM investments. Are you seeing that trend?

JM: We're seeing a good uptick but we expect a wall of money to come into emerging markets in 2021. Ironically, most emerging markets really don't need money. Many are running positive current account balances and don't need external sources, so the external money should also be good for their currencies. We've seen it in Korea and Taiwan and China so far, and we're starting to see it in Brazil and Russia.

But let me say that I'm not a big believer in the growth versus value debate. There's no point buying a value company that faces a severe technology disruption as it could end up being worth zero. I remember when people thought paging companies were cheap but like Blockbuster, the movie video retailer, they became worthless. Companies within emerging markets can remain cheap for a long period of time because of regulatory risk, state owned enterprises (SOEs), technology disruption or ESG concerns. We are growth at a reasonable price (GARP) investors but we need to top line and bottom line growth. The starting point isn't valuation.

GH: Many of our readers have traditional portfolios of global and Australian equities, fixed interest and maybe some property. Why should they make an allocation to emerging markets?

JM: If you look at what is happening in countries like India, Brazil, Taiwan, Korea, where they are focussed on infrastructure, opening up their markets and deregulation, it's good timing for someone with zero exposure. We've gone through a massive bull market in the US and you could argue the valuation case from here. The valuation case in emerging markets is more compelling and we have seen the cycle before. Also, in terms of diversification, it's worthwhile thinking long term and the commodity backdrop should be constructive. There's been a lack of investment in commodities such as copper. There is an element of opportunism in emerging markets because it is a volatile sector, so investors should take a global approach with a manager with the resources to monitor all these markets and not simply a focus on say China or Korea.

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

Access to the RWC Emerging and Frontier Markets strategy is available to Australian investors via Channel Capital, a sponsor of Firstlinks. John M Malloy, Jr is Co-Head of Emerging & Frontier Markets, at RWC Partners, a Channel Capital partner.

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10 key themes for 2021

Joseph V. Amato

with Brad Tank, Erik L. Knutzen, and Anthony D. Tutrone.

The heads of Neuberger Berman's investment platforms identify key themes they anticipate will guide investment decisions in 2021. These 10 themes are summarised below and discussed in more detail in the Solving for 2021 White Paper.

Macro: the world after coronavirus

1. A return to early-cycle dynamics but no substantial reflation

The coronavirus pandemic caused a deep recession that has set a low base from which to rebound. We now face early-cycle dynamics not seen for a decade with above trend-line GDP and corporate earnings growth, declining unemployment and rock-bottom interest rates. In addition, we see limited drivers of substantial inflation before 2022, and, without significant continuing fiscal stimulus, no clear change in the underlying causes of secular stagnation.

2. Populism is here to stay

The end of Donald Trump's presidency is not the end of political populism or its causes in the U.S. or more broadly. This likely means continued political and geopolitical volatility, but perhaps more importantly, it also makes additional fiscal stimulus more likely, as governments pursue borrow-and-spend policies seeking to address the causes of populist discontent. The efficiency and effectiveness of these policies will likely be key in assessing the likelihood of avoiding secular stagnation.

3. Accelerated digital transformation puts down roots

During the coronavirus crisis, many consumers and businesses have fully embraced working, shopping and accessing services from home. The case for digitalisation and automation in factories, warehouses, offices, homes and other workplaces has been strengthened. Some of this is likely to spring back once the pandemic eases, but in our view the trends have not only accelerated but permanently transformed many consumer and business practices. During 2021, we will move firmly into the world of 5G connectivity, the Internet of Things and cloud computing.

4. Supply chains become shorter and more diversified

Geopolitical uncertainty, economic populism and simple wage and cost convergence have been shortening global supply chains for more than a decade already. The coronavirus pandemic added further impetus to this trend. The ongoing transformation of supply chains can reduce companies' and industries' exposure to disruption risk, but at some cost to investors and consumers.

Fixed income: static yields, volatile currencies

5. Low yields and flat curves demand opportunism in credit markets

As with every recession, the 2020 coronavirus recession caused credit spreads to widen. Rapid and substantial central bank intervention made this an exceptionally short-lived phenomenon, leaving investors with a highly complex mix of early- and late-cycle characteristics, and default and valuation risks. We think this demands a flexible, 'go-anywhere' approach to credit, backed up by the ability to make relative value assessments across fixed income sectors, broad expertise and nimble decision-making.

6. Macroeconomic dynamics will be expressed through currencies

The major central banks have signaled their intention to maintain low interest rates a long way out on the yield curve. With rate volatility suppressed, worldwide growth and inflation differentials are more likely to be expressed through currency markets. Heightened currency volatility and the end of persistent U.S. dollar strength would strengthen the case for dynamic currency hedging.

Equities: cyclical opportunities, long-term themes

7. Secular growth stocks ultimately prevail over cyclical rallies

Early-cycle dynamics will likely favor cyclical stocks initially as economic growth accelerates, but ultimately, we believe the looming backdrop of secular stagnation - characterized by low rates, low growth and low return outlooks - will lend support to growth stocks and long-duration assets. Nonetheless, if 2020 has taught us anything, it is humility. It remains important to diversify across style factors.

8. A thematic approach can help to uncover long-term growth

In a low-growth world, a thematic approach can help identify genuine long-term growth opportunities. The coronavirus crisis has accelerated some key themes, especially the digital transformation of the economy, while also showing how these themes transcend regions and sectors. We believe thematic investing is about finding quality companies exposed to secular growth themes: it must be driven by in-depth research, especially when large-cap growth stocks are trading at such stretched valuations.

Alternatives: resilience for growth, nimbleness for value

9. Resilient growth will be in favor but it won't come cheap

We have seen the coronavirus crisis accelerate the trend for private equity to favor businesses with resilient growth prospects and executable plans to add value. This translates to favoring sectors such as software, technology and health care. By region, it manifests as a tilt toward growth markets such as China. Valuation is the biggest risk in our view, which will likely need to be mitigated by implementing significant strategic and operational improvements to accelerate potential earnings growth.

10. A continuing role for opportunistic and idiosyncratic strategies

Next year will likely bring an unusual mix of early- and late-cycle dynamics, and ongoing pandemic and policy questions. Any resulting volatility or uncertainty is likely to create windows of opportunity for liquid strategies such as equity long/short, distressed and short-term trading strategies, but also for less liquid strategies such as private equity secondaries, opportunistic credit and structured equity. Idiosyncratic and uncorrelated strategies such as insurance-linked securities and macro trading could help lend stability to portfolios during any periods of increased volatility.

Joseph V. Amato is President and Chief Investment Officer, Equities; Brad Tank is Chief Investment Officer, Fixed Income; Erik L. Knutzen is Chief Investment Officer, Multi-Asset Class; and Anthony D. Tutrone is Global Head of Alternatives at Neuberger Berman, a sponsor of Firstlinks.

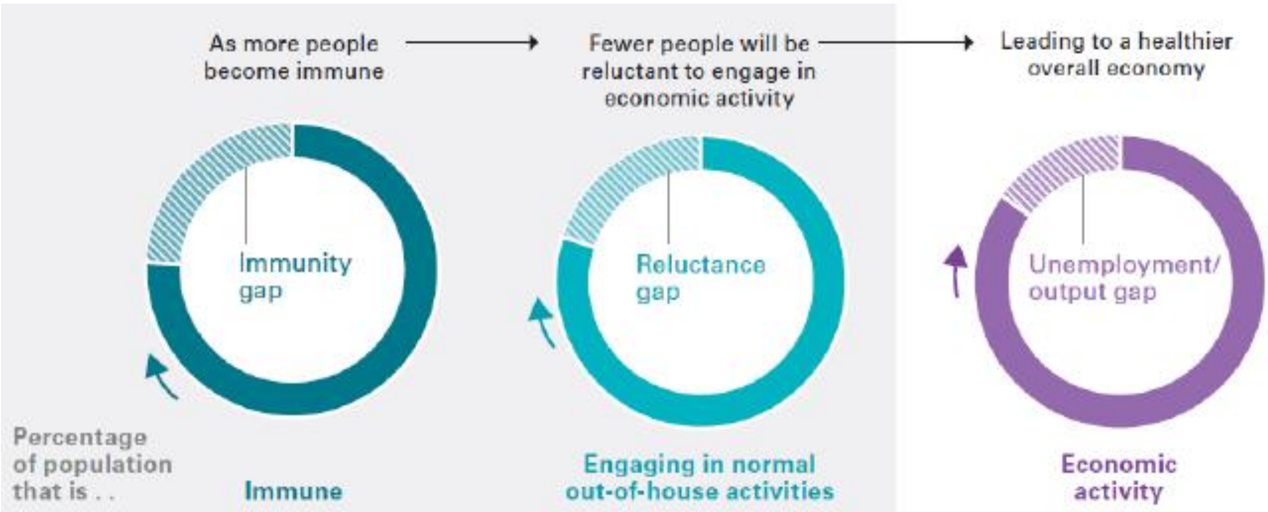
2021 economic and market outlook report

Beatrice Yeo, Qian Wang

The 'Vanguard Economic and Market Outlook 2021: Approaching the Dawn' says the expected path to economic recovery hinges on controlling COVID-19. An improvement in the health of the global population will result in an improvement in the economy. Thanks to swift fiscal and monetary policy responses, many economies are in a better position now than during the second and third quarters of 2020.

The next phase of recovery depends on greater immunity to COVID-19 and reduced consumer reluctance to engage in normal economic activities. Should a vaccine become distributed, administered broadly, and be effective, much of the economic losses from COVID-19 could be recovered in the next year. That said, there is risk that if immunity does not rise, economies may only see marginal progress from current levels.

The way the health recovery will drive economic activity is like this:



Which leads to the base case economic scenario for 2021:

- Major economies will achieve greater immunity to COVID-19
- Face-to-face social and business activity will normalize
- Unemployment rates will fall
- Inflation rates will move higher, and
- Pre-pandemic levels of economic output will be reached

In countries with more effective containment of the virus, such as in Australia and China, the return to normalcy may prove to be slightly faster, with Australia's expected growth of 4% likely to fuel an expected return to pre-pandemic levels by the middle of next year compared to the end of the year for countries such as the Euro Area and the UK.

Three post-pandemic scenarios

Looking beyond the shadow of COVID-19, our outlook details longer-term effects that the pandemic may have on the economy, including: the acceleration of work automation and digitalisation (i.e. working remotely), continued slow-deglobalisation and supply chain recalibration, as well as changes in the expectations and preferences for government policy.

Under the confluence of these forces, Vanguard hypothesises three possible post-COVID scenarios over the medium-term with consequences for growth, inflation, interest rates and productivity. We assign probabilities to each, as follows:

Accelerated

- Productivity
- Winner-take-all
- De-globalization
- Inequality
- Location flexibility
- Role of the state

Temporary

- Health care challenges
- Consumer reluctance
- Labor market scarring
- Accommodative policy

Unaltered

- US/China
- Idea multiplier

	Proximate path (1960s recoveries)	Off-course (Stagnation, post-GFC, Japan)	Path improved (Productivity boost, 1950s & 1990s)
Probabilities	55%	25%	20%
Growth	Moderate and steady	Low, recessionary scares	Strong
Inflation	Moderate	Ultra-low, periodic deflation	Stronger pressures
Rates	Rising from historic lows	Remain at historic lows	Moderate but rising
Productivity	Modest	Minimal	Strong surge

Source: Vanguard.

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Compared with falling into a prolonged stagnation ('off-course') or a rapid reflation and surge in productivity gains ('path improved'), we see a return to steady but still moderate growth, and interest rates normalising gradually from historic lows, though remaining low and supportive for some time.

Based on these scenarios, balanced portfolios with different asset mixes may not always shoot the lights out but they will not produce the worst results either. They are a good solution for most long-term investment portfolios and for investors who do not hold a strong view about the future state of the economy.

Scenario 1
Proximate Path (55%)

Broadly diversified across equity and bonds

23%	Aus equity
39%	Global ex-Aus equity
25%	Global agg ex-Aus hedged
8%	Australian credit
1%	Aus short-term linkers
2%	Aus short-term Govt. bonds
2%	Aus long-term Govt. bonds

Scenario 2
Off-Course (25%)

Small underweight equity and overweight long duration

19%	Aus equity
34%	Global ex-Aus equity
35%	Global agg ex-Aus hedged
2%	Australian credit
2%	Aus short-term linkers
2%	Aus short-term Govt. bonds
6%	Aus long-term Govt. bonds

Scenario 3
Path Improved (20%)

Larger overweight equity and overweight inflation-linked bonds

25%	Aus equity
41%	Global ex-Aus equity
22%	Global agg ex-Aus hedged
1%	Australian credit
8%	Aus short-term linkers
2%	Aus short-term Govt. bonds
1%	Aus long-term Govt. bonds

	Scenario 1	Scenario 2	Scenario 3
Best	Proximate path	Off-course	Path improved
2nd best	Off-course	Proximate path	Proximate path
Worst	Path improved	Path improved	Off-course

Note: Performance is relative to the efficient frontier. Portfolio are selected from the frontier based on a fixed risk aversion level. Forecast displays simulation of 5-year annualised returns of asset classes shown as of September 2020. Scenarios are based on sorting the VCMM simulations based on the rates, growth, volatility and inflation. The three scenarios are a subset of the 10,000 VCMM simulations. The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.
Source: Vanguard, 30 September 2020 VCMM Simulation.

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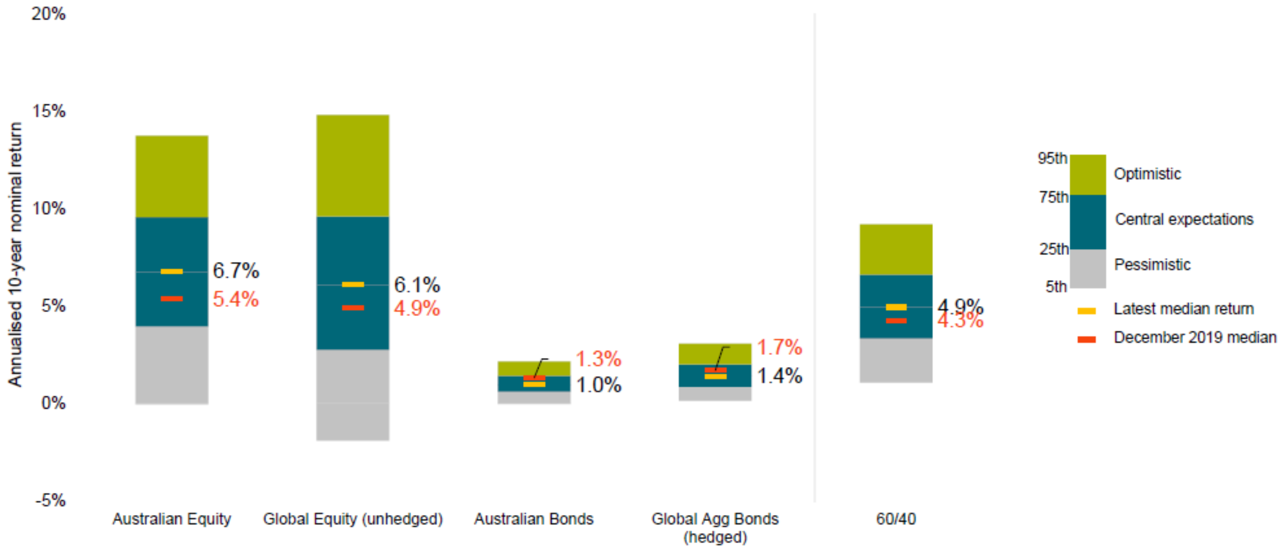
A moderating outlook for global asset returns

Vanguard's Capital Markets Model projections gives an outlook for global and Australian equities in in the 5%-7% and 5.5%-7.5% range respectively for returns over the next decade. While this range is below returns seen over the last few decades, equities are anticipated to continue to outperform most other investments and the rate of inflation.

10-year annualised forecast: setting reasonable expectations



Note: The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class in AUD. Results from the model may vary with each use and over time. The 60/40 portfolio is 60% global equity and 40% global bonds, where the global equity is 40% AUS equity and 60% global ex-AUS equity, and the global bond portfolio is 30% AUS bonds and 70% global ex-AUS bonds.
Source: Vanguard, 31 December 2019 and 30 September 2020 VCMM Simulation.

Interest rates globally are expected to remain low despite a constructive outlook for firming global economic growth and inflation as 2021 progresses. While yield curves may steepen, short-term rates are unlikely to rise in any major developed market as monetary policy remains highly accommodative. Bond portfolios of all types and maturities are expected to earn returns close to their current yield levels.

Risks to the Australian outlook

The risk to the economy and markets should shift as 2021 progresses. Between now and widespread vaccine distribution, health-related risks to economic growth and sentiment should prevail. However, as growth and inflation firm in 2021 and immunity to COVID-19 increases, an 'inflation scare' is possible. Ultimately, inflation could cyclically bounce higher in the middle of 2021 from current lows owing to an ongoing economic recovery, before plateauing back to the mid to low 1% levels, and such a move could introduce market volatility.

Meanwhile, the tapering of relief measures poses a risk to the consumption and financial stability outlook, but Vanguard takes comfort in the resilience and speed of the initial recovery to date, and expect the household savings buffer to be used to smooth spending.

In 2020, disciplined investors were yet again rewarded for remaining invested in the financial markets despite troubling headlines and a challenging environment. For 2021, the wisdom will be to maintain that same level of discipline and long-term focus, while acknowledging returns may moderate from the past.

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Just how reliant on China are we?

Ashley Owen

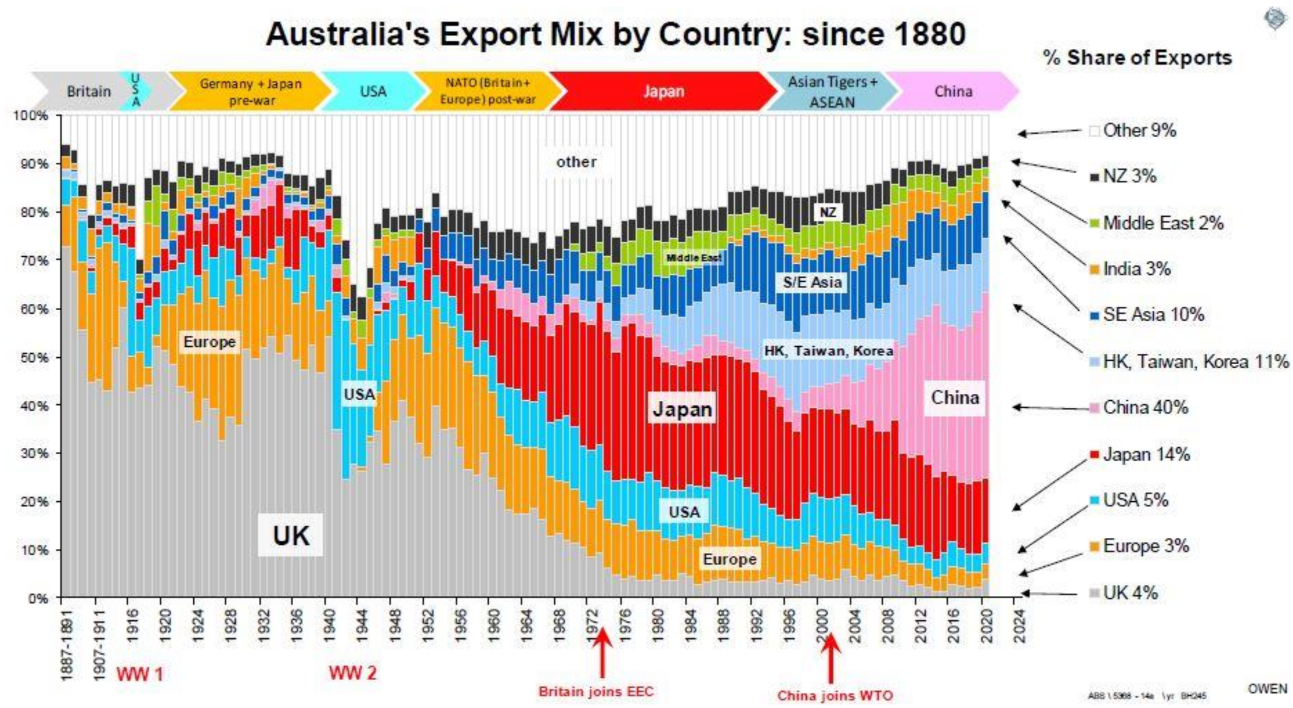
When President Trump started his trade wars with China in 2018, Australia's trade relations also took a series of hits from China, as Australia is essentially America's sheriff in the South Pacific. Relations have worsened dramatically in recent weeks, widening the range of exports under threat, from crops, food, wine, coal, to education and tourism (once borders are open).

Heavy reliance on another country

Australia has not been as reliant on one country for export revenues (and tax receipts) since 1953 when the largest buyer was Mother England. China overtook Japan as our largest buyer in 2010, and now accounts for more than 40% of export revenues.

Hundreds of ASX-listed companies rely on Chinese demand, directly or indirectly, across many industries. Iron ore is our largest export to China, and the three main producers BHP, RIO and FMG together make up more than 11% of the total value of the 2,200 ASX-listed companies. These three companies are worth more than the smallest 2,000 listed companies combined. In the latest reporting season to June 2020, BHP, RIO and FMG contributed 41% of all profits reported ($15.8 billion dollars out of $40 billion in total profits).

This chart of Australia's export buyers since 1788 shows the global power shifts over the period, from the UK, Europe, via the US, to Asia. It also highlights Australia's central role in helping to build industrial and economic capacity in a string of Asian nations as they 'emerged' one by one along the way – first Japan, then the Asian Tigers, then ASEAN, and now China.



Brief history of trade relations

Trade relations have always been closely intertwined with strategic and military relations. From 1788, Australia started out as a string of British prison colonies that turned into suppliers of oil, wool, grains, food, gold and other metals to Britain as part of the British trade bloc, protected by the British Navy.

After Federation, Australia rapidly increased its exports to Germany, helping build its industrial and war machine for WWI. When war broke out, our exports to Germany ceased and the US took over. In the post-war reconstruction, Australia again increased exports to Germany, Italy and Japan, assisting in their industrial and military build-ups to WWII. When war broke out again, exports ceased and America again came to the rescue to win the war, and it again filled the gap in taking Australia's exports. Likewise in the Korean War.

In the 1950s and 1960s, Australian exports boomed in the reconstruction of Western Europe as a US ally against communist USSR. Meanwhile, in the Pacific, Australian coal, iron ore and other metals helped build the rebirth of Japan, as a US ally against rising Communist China following Mao's revolution in 1949.

After Japan's growth ended in the early 1990s, Australia's mineral exports helped to build the next breed of rapidly expanding 'emerging markets' – first the 'Asian tigers' (Hong Kong, Singapore, South Korea, Taiwan), and then the ASEAN countries including Malaysia, Taiwan, Philippines and Indonesia.

China is the latest 'emerging' nation built with the help of Australia's exports. Before China joined the World Trade Organisation in 2001 it bought just 5% of our exports, but the WTO entry kicked off its incredible urbanisation and industrialisation boom. The key ingredient was, and still is, steel made mainly from Australian iron ore and coking coal. Our rocks and dirt are building not only the gleaming new Chinese cities and railways, but also the war machine it may use against us one day, just as we supplied Germany, Italy and Japan in their military build-ups to the two World Wars in the 20th century.

China's extending ambitions

We are not at war yet of course nor are we even close. What we do know is that President Xi Jinping has extended China's national ambitions well beyond Mao and Deng's vision of China to simply regain its pride and standing in the world after two centuries of foreign domination and impoverishment. China has achieved that and is now flexing its economic, political and military muscles to extend its power across the region and also into Central Asia, Africa and Latin America in search of markets for its products, sources of raw materials, and strategic alliances.

What is also evident, is that there is a global military build-up brewing, not only in China and the US, but also involving key allies like Japan, and also other players like Russia and a strategically resurgent Europe. This will be good for Australia's miners.

Hopefully, there will not be a major military conflict for many years or perhaps even decades, but as tensions build, China has slapped tariffs and restrictions on several non-critical imports from Australia. This is partly to punish Australia (for supporting the US on Huawei, etc.) but also partly as a show of power, and partly to genuinely help its local suppliers that have been hurt by the coronavirus restrictions and recession.

The industries affected so far are non-critical to China. However, in the case of economically and strategically critical iron ore and coking coal (for steel), China knows that it is still heavily reliant on Australia. China has been actively trying to develop alternate suppliers for several years, both internal and external, but with little success to date.

Hypothetically, in the event of war (e.g. China-US), if we were still a US ally at the time, our exports to China would cease immediately. In practice, China would probably move to act much earlier and restrict supplies to weaken Australia's resolve and test its alliance with the US.

China has been buying up Australian companies outright for several years, and also buying up stakes in many listed Australian companies. It is already the largest shareholder in RIO, FMG and numerous other miners and exporters. This trend is now being countered by more assertive government restrictions on Chinese investments, on the grounds of 'national interest'.

Would the US fill the resultant export revenue gap if China were to stop buying from Australia? It depends on the importance of the export. It would be an ideal bargaining chip for Australia as a condition of our military support in a conflict (as Menzies was able to achieve in the Korean War).

Trade tensions strike home

All of this is well into the future of course, but we can see the wheels turning. This latest escalation in trade tensions appears to have finally struck home to CEOs and boards of Australian companies that they urgently need to diversify their revenue sources away from the heavy reliance on China. Developing new markets is expensive and time-consuming, especially with the current global travel restrictions.

It will probably mean companies retain more of their earnings for reinvestment in developing new markets. This would require a major reversal of the current shareholder demand for high dividends and minimal reinvestment for the future.

What is the relevance to investors? Aside from the further likely disruptions to hostile trade actions (which are outside the control of companies), we should also expect (and like) to see more companies reinvest more of their profits to develop new markets. This would mean lower dividends in the short term but potentially greater growth in profits and dividends, and diversification of revenue sources, in the medium to long term. It would also probably mean fewer windfall gains to investors from Chinese takeovers of local companies.

It is also a reminder of the importance of investing in international share markets, where the risks and potential rewards are more diversified than on the local Australian market.

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Three reasons why super performance test fails

David Bell

This year's Budget included the Your Future, Your Super (YFYS) reform package, which will have a significant impact on superannuation. One reform, a performance test, has proven highly controversial. A performance test sounds like good policy to protect consumers, so why is it proving so controversial?

This article uses some of the findings from a collaborative research effort between The Conexus Institute and five leading industry consultants: Frontier, JANA, Mercer, Rice Warner and Willis Towers Watson. The detailed research (papers and models) can be accessed here.

The performance test explained

The YFYS performance test works as follows:

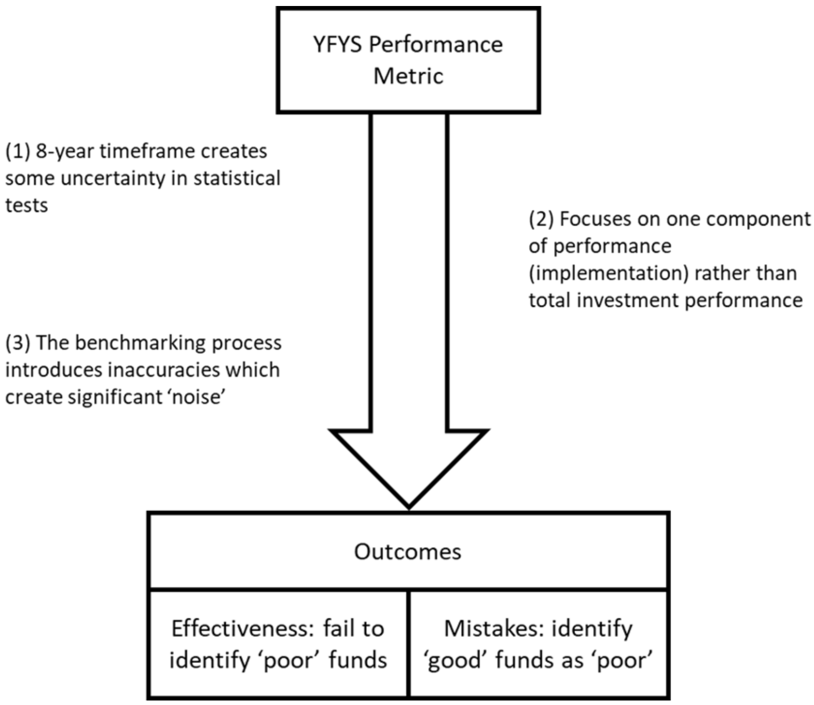
- Over a rolling 8-year period the performance of each fund is compared against the performance of a tailored benchmark based off that fund's strategic (i.e. long-term) asset allocation through time. The benchmarks are all public listed market indices. This could be considered implementation performance, capturing the sum of how well each portfolio position performed against a benchmark as well as the performance of any short-term (tactical) asset allocation calls.
- Initially if a fund fails the test (underperforms by more than 0.5% pa), it needs to write to its members to advise it has been identified as an underperformer, and provide details of a to-be-developed Government website which will detail performance and fees for the universe of super funds.
- If the fund fails for a second consecutive year, it is no longer able to accept new members until the fund passes the performance test. The fund can continue to accept contributions from existing members.

This sounds reasonable, so what is the problem?

The concept of a performance test is good policy. Done well, it helps protect disengaged members from sub-standard outcomes from super. Government and Treasury are simply following a recommendation made by the Productivity Commission.

But the devil is in the detail: the performance test has important shortcomings. Additionally, there are concerns that the way the test is applied will likely leave some consumers worse off.

We found three main issues with the test, summarised in this diagram.



(1), (2), and (3) combine to make for an ineffective performance test.

Here's how to understand (2) better: implementation is an important part of total performance but the asset allocation decisions made by funds are just as, if not more, important. Yet the test ignores the performance of asset allocation decisions. To illustrate, if your fund had made the decision to have 10% more allocated to global shares than to Australian shares over the last 10 years, this would have added more than 0.4% pa to performance. A performance test should capture this component of performance.

The benchmarking challenges noted in (3) impact the assessment of many asset classes including private equity, unlisted property and infrastructure, credit, inflation-linked bonds, and the entire universe of alternative investments.

For example, unlisted property is benchmarked against listed property and there can be huge dispersion in performance between the two sectors which may unduly impact the performance test result at a particular point of time.

In some cases, we calculated that the test would have a very low likelihood of correctly identifying poor performers (likelihood levels akin to a coin toss) while having a reasonable probability of mistakenly identifying good performers as poor.

Finally, none of this acknowledges changes that funds have made to improve themselves, sometimes in response to issues raised by APRA.

Ineffective plus undesirable outcomes

Not only is the test likely to prove ineffective, but we anticipate a range of undesirable outcomes. We summarise these into three categories:

1. We believe the test will distort the way that funds will manage their investment portfolios. This test will likely be binding compared to other policy and regulatory tools such as APRA's Heatmaps, the Outcomes Assessment Test and the sole purpose test. The flaws in the test mean it does not align well with the broad investment management principles of focusing on total returns and diversification.
2. We believe consumers will be confronted with a range of complex and potentially conflicting information. Many will find making a choice difficult and the heavily disengaged may be left in impaired super funds and experience worse performance (because the fund is further impaired).
3. The focus by industry on the performance test may deter fund mergers. The 'senior' fund may not want some of the assets, a membership profile in outflow, nor the distraction that comes with merging with another fund.

Agents, politics, and policy

Unfortunately, superannuation has become highly politicised and some observers view the industry as self-interested agents. Yet strong engagement can contribute to better policy, while poor engagement increases the risk of policy mistakes. Effective engagement requires the trust between policymakers and industry to be strong. Undoubtedly there is room for improvement, but I see both policymakers and industry aligned in their focus on improving member outcomes.

It is good to see that there will be consultation on the performance test and hopefully it is constructive and positive.

Developing an effective performance test is a great opportunity to improve superannuation outcomes for consumers.

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

Investor downside when management controls access to the board

Miles Staude

"A lot of people die fighting tyranny. The least I can do is vote against it."

- Carl Icahn

Capital markets have been wonderful inventions. Freed from self-interest and patronage, they allow Adam Smith's 'invisible hand' to unemotionally allocate scarce capital around the economy, investing where it will be most productively used. Society as a whole reaps the benefits. Greater economic output raises living standards for all. Better investment returns benefit retirees and those planning for retirement.

These days capital markets are heavily regulated structures. They should be. Despite their capacity to turbo charge economic growth, capital markets have significant flaws. Some of these shortcomings are plain to see. Wealthy and compassionate societies don't let market forces decide whether an ambulance arrives.

We set the boundaries that markets operate within because we know there are many problems that markets can't solve. For the problems we do want them to solve, however, capital markets can still fall well short, often at the great expense of investors.

The agency problem

The original sin within our model of capitalism is that it separates the ownership of companies from their management. Few family-owned businesses can attract the capital or talent necessary to build a BHP. Thus, by separating the ownership of a company from its management, businesses are able to grow - and create wealth and jobs - in ways private firms struggle to replicate.

In doing so, we create what economists call an 'agency problem'. Investors, who put up their hard-earned savings and own the company, must rely on their agents - management - to run the business with the owners' best interests in mind.

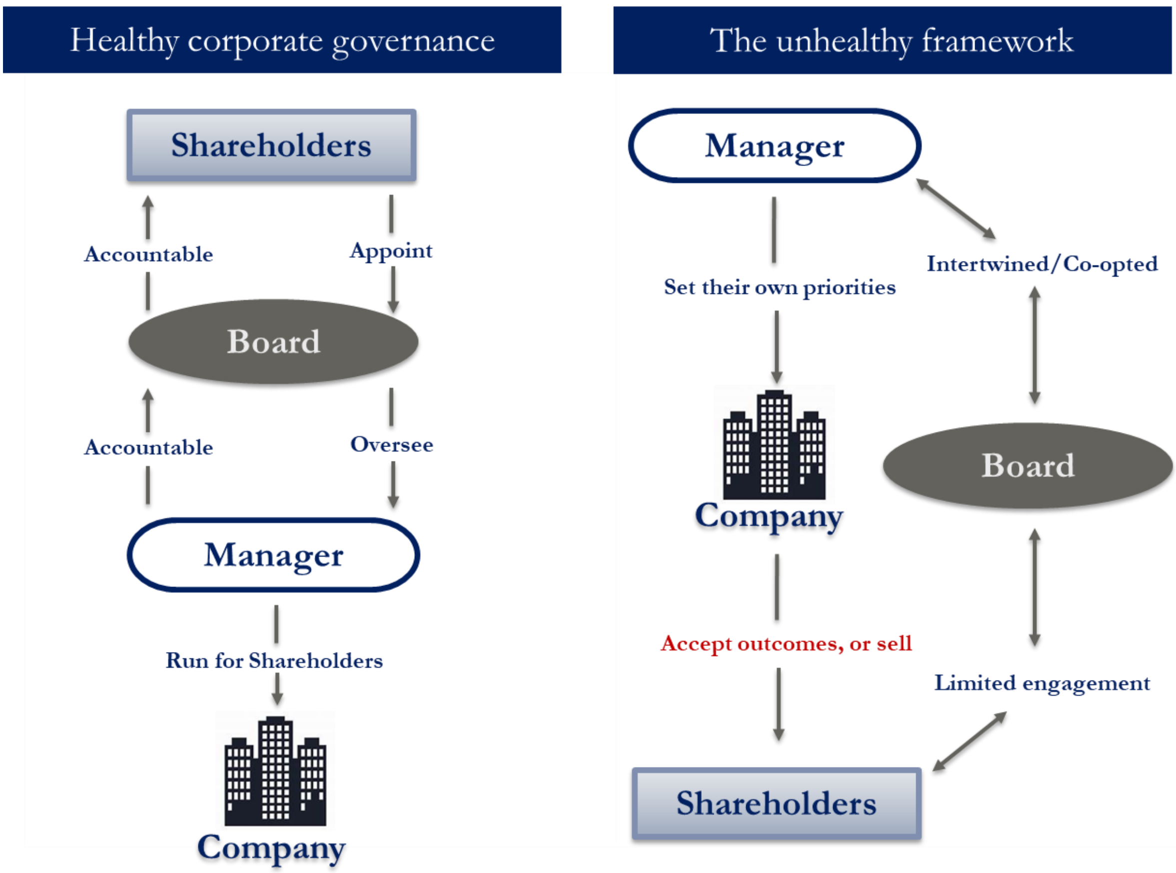
Managers on the whole are an honourable breed. But, as Paul Keating liked to say, quoting Jack Lang: *'In the race of life, always back self-interest - at least you know it's trying.'* Time and again, left unsupervised, managers have demonstrated a terrible tendency to run companies in ways that suit them, not their shareholders.

Our solution to this agency problem is supposed to be robust and independent company boards. Shareholders appoint directors and pay their salaries. They are there to act as the guardians of our capital and to stand up to managers on our behalf.

The 'Wall Street walk'

The entire premise of shareholder capitalism rests on the notion that a board is there to represent shareholders. When the relationship is working well, a company's corporate governance framework should look like the healthy model below.

Shareholders appoint directors who, in turn, oversee management. Boards are there to offer advice to management when it is needed, and to hold them to account when it is necessary. Management then have a clear guiding principle to work towards - prioritise shareholders and shareholder returns.



Well-functioning corporate governance models look great in textbooks. In the real world, modern capital markets have left shareholders increasingly separated from the boards that are supposed to represent them.

Shareholders come and go today with incredible speed. In the 1960s, the average share holding period for a US investor was six years. By the 1990s, this had fallen to just two years. Today it sits at six months. While a company's owners come and go every few months now, boards and managers work together hand-in-hand for years, sometime decades.

It is easy to see how boards can become co-opted by their management teams. Almost all 'shareholder feedback' today comes to boards through the manager and the manager's investor relations team.

When was the last time you directly spoke to the board of a company you owned?

Even with the best of intentions, boards are at risk of receiving curated shareholder feedback that fits with managements' own agenda.

In the real world, the most common corporate governance failing at a company is that its board slowly becomes entwined with its management team. Managers then begin to set their own priorities for the company and their own vision for the future. Sometimes these overlap with what is best for shareholders. Too often they do not.

When this occurs, shareholders - who are the *owners* of the company - are left with two options. Accept the outcomes that management deliver or sell your shares and move on. In market parlance this second option is referred to as the 'Wall Street walk'.

The passive problem

Exacerbating the agency problem in recent years has been the explosive growth of passive investing and the Exchange-Traded Fund (ETF) industry. The premise behind passive investing is hard to fault. 'Efficient market theory' argues that everything you could ever know about a stock is already in its price. Given that, don't bother trying to analyse companies.

Instead, let others do the hard work of figuring out what a company is worth and passively invest into the markets as a whole. This logic is certainly boosted by the fact that, after fees, the average fund manager underperforms the market over time.

While ETFs have provided many investors with a great low-cost way to invest in the market, they have amplified the agency problem that already existed in the stock market. As the share of companies owned by passive investors has increased exponentially, fewer shareholders today are actually involved in the process of holding managers and boards to account.

Vote with your hands, not your feet!

When shareholders feel that the Wall Street walk is the only way to escape an underperforming company, the entire premise of how capital markets are supposed to work has broken down. The point of public companies is that public scrutiny and shareholder democracy is there to shine a light, to hold the people working for us to account.

If shareholders do not exercise those rights, self-interest and cronyism very quickly sets in. Worse, the cycle becomes self-fulfilling. When shareholders vote with their feet and not their hands, vested interests learn a very dangerous lesson. Once learnt, the problems tend to get worse over time, not better.

All of this means that it is more important than ever that shareholders pay attention to what is going on at their companies. If you are a shareholder in a company, you are the owner of the business. Make a point of engaging with your board - they are there to represent you. Most importantly, take the time to vote at shareholder meetings, and if you're unhappy, vote with your hands, not your feet! You own the companies that you invest into. The people running them are supposed to be working for you.

Miles Staude of Staude Capital Limited in London is the Portfolio Manager at the Global Value Fund (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

Two courageous responses to the Retirement Income Review

Bruce Gregor

Whilst media commentary is mainly looking at the Retirement Income Review through the Superannuation Guarantee (SG) rate prism, there are some strategic observations in the Final Report which suggest other more courageous alternatives are needed.

The Report finds reduced complexity and increased efficiency could improve retirement income outcomes without increasing the SG. Two suggestions I have in this area relate to Death and Disability Insurance and Contributions Tax.

1. Separate insurance cover from superannuation

The original policy development of SG focused on retirement income supplementing age pension as well as allowing portability of super as people changed jobs. Whilst existing company employee benefit schemes had death and disability benefits (sometimes outside super as well as inside) the administration of SG contributions has morphed into it also funding these insurances.

This evolution was partly due to competing industry funds promoting additional bells and whistles and partly from insurance companies pushing (unsustainably 'cheap') group-insured products to fund trustees.

Such insurance cover is a deduction from a member's total superannuation balance. Members find out at the end of the year what it cost. If the member's balance is only derived from 9.5% SG accumulation, then insurance is effectively financed by the SG contribution.

It was a magic pudding for insurance companies and as revealed in the Financial Services Royal Commission, open to abuse as 'junk insurance' was often provided on an opt-out basis and without analysis of the level of cover that people really needed. The Government's response (the 'Protecting Your Super and Putting Members' Interests First' reforms) aims to prevent the erosion of small balances by requiring at least $6,000 and age 25 before starting insurance and some as-yet-unregulated prudential changes regarding consideration of needs. In the meantime, insurance premiums have steadily increased.

If we are focused on maximising the retirement income produced from SG, then the accumulation from SG contributions should in future be quarantined from insurance. Employees and employers should finance this separately if employees really need it. In fact, it is more tax effective to provide temporary disability insurance (a major proportion of the cost) outside super where the premiums are tax deductible to employees.

In summary, there remain adequate and flexible voluntary contribution options in funds for employees (and employers) to voluntarily fund death and disability benefits and for members to match them better to their family circumstances, without using SG contributions for this.

I estimate this would allow on average an additional 0.5% of pay to accumulate towards retirement from SG.

2. Eliminate Contributions Tax

My second suggestion is to eliminate the 15% Contributions Tax on SG contributions to produce a more equitable and efficient taxing regime and a better retirement policy outcome. It would reduce the complexity of the compulsory super system and allow about an extra 1.5% of pay from existing SG contributions to be accumulated towards retirement.

There would need to be consequential changes to how retirement benefits are taxed due to the removal of Contributions Tax. I will not address this in detail here but I believe a progressive end-benefit tax focused on income wealth in retirement would produce a better policy outcome.

Firstly, a bit of background on the 15% Contributions Tax. This is a legacy from the Hawke Government's introduction of imputation of company tax and is unrelated to superannuation. The imputation policy curried favour with the business community (when company tax rates were higher than now) in the 1980s and was very costly to revenue.

The compensation for revenue loss from introducing imputation came from the so-called 'bring forward' of superannuation benefit tax in the form of the 15% Contributions Tax. This 35-year-old gimmick has been the main cause of the complexity in people's attempt to reconcile 9.5% pay with how their SG-related retirement savings accumulate. It is a historical anomaly just waiting for a good opportunity to get rid of it and now is as good a time as any.

The 15% Contribution Tax (just from SG contributions) currently provides about $10 billion to the Federal Budget. This could be replaced by an indirect consumption tax. The current GST rate of 10% is well behind New Zealand's 15% and below rates of consumption tax in many comparable countries.

Some additional indirect tax should be raised now to cover the unfunded portion of the NDIS and to provide extra funding for post-COVID health system needs. The recent Medicare levy increase to cover NDIS still leaves about $5 billion per annum of future fully implemented NDIS cost unfunded.

Peter Costello's legislative handcuffing of any change to the GST is a practical roadblock to increasing the GST rate. I suggest a courageous government could now define a new additional consumption tax to be collected alongside the existing mechanism of the GST.

I would suggest that this new consumption tax – call it a Health System Tax or HST) - could be set at 5% with half to be distributed to states on a pure per capita ratio without the much-maligned Horizontal Fiscal Equalisation adjustment. Latest annual GST collections were $65 billion. Based on this figure, a HST of 5% would raise about $32 billion with $16 billion for the states for their health systems and $16 billion for Federal revenue. The Federal revenue share would balance the $10 billion loss of Contributions Tax plus the unfunded $5 billion for NDIS with some left over to stabilise ongoing debt interest funding from COVID programmes.

Two changes to build super

The two changes above would add about 2% of pay to accumulate towards retirement without changing the current 9.5% SG rate.

Bruce Gregor is a demographer and actuary, and Founder of Financial Demographics and OzDemographics. This article is general information only and does not consider the circumstances of any investor.