Firstlinks
a Morningstar company

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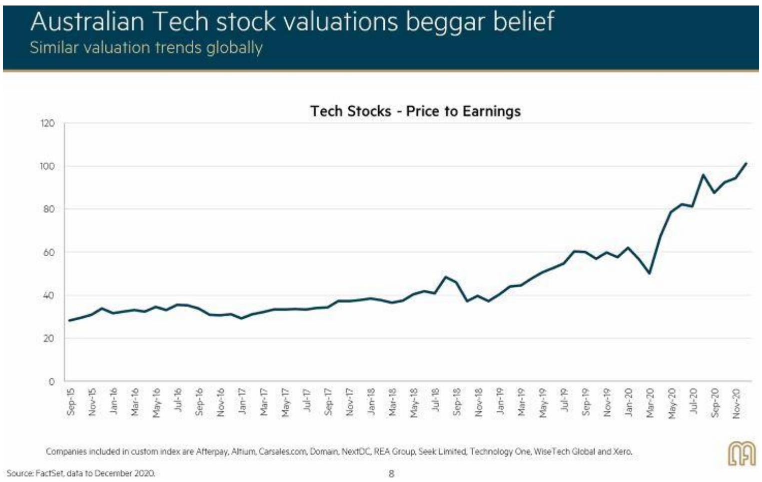
Editorial

When we wrote about Robinhood and Reddit investors in June last year, it was not expected that their activities would ramp up to another extreme level. Fuelled by stimulus cheques and social media stories of instant wealth, thousands of new participants in the US are speculating in a way the market rarely sees. Think Dutch tulips in 1637, South Sea Bubble in 1711, the Japanese stock market in the 1980s, Alan Greenspan's 'irrational exuberance' of 1996, the dot coms of 2000 and US housing before the GFC.

When a stock like **Gamespot** rises 125% in five days, 300% in a month and 1,900% in six months, and it's a video game retailer with declining sales, speculators have no regard for the underlying business. It is already a case study in the power of unified individual investors. Thousands of people are joining **Reddit** groups, deciding to buy a stock and take on the professional hedge fund shorts, who are then forced to buy to cover their positions. There are also losers as Gamespot fell 60% in an hour before resuming its rise. The US market has never seen options and retail activity at this level before.

Obviously, this is not on the same scale as Australian tech winners such as **Afterpay, Xero, WiseTech and Altium**, which are real businesses with share prices riding a wave of optimism. But they are causing a performance problem for some of our more respected fund managers who use fundamental analysis. They can't match the growth market rise and are forced to explain their 'underperformance' to their clients. A fund manager with a long history such as **Maple-Brown Abbott** is using the this chart, among others, to show how a custom index of Australian tech stocks has reached a Price/Earnings ratio over 100 which 'beggars belief'. These managers will benefit when the market finally rotates from growth to value.



This week, we look at the difficulty facing investors who attend fund manager presentations for insights into the quality of the manager. Performance is in the past and there is no way of knowing whether the manager will deliver in future. In addition, every presentation makes a good case for support leaving investors with unlimited choices.

Kate Howitt describes the investor dilemma of deciding whether to participate at elevated prices in the risky game of speculation as a '**Breaking Bad**' moment. Spoiler alert, that does not end well for the main character but financial markets are not at that point.

Nobody could accuse **Warren Buffett** of taking a short-term, speculative view on the market, but even he and **Charlie Munger** went into their first IPO for years by investing in **Snowflake**. And they have a big position in **Apple**. **James Gard** look at Buffett's portfolio in 2020, where not everything went as well as the tech exposures.

Olivia Engel sees a return to some normality in 2021, where a company's share price better reflects its business fortunes, and she identifies the sectors and themes she expects to pay off. Likewise, the renewed optimism that our major banks have withstood the worst of the pandemic is reflected in recent price rises, and **KPMG** runs its ruler over the resilience of bank balance sheets.

During the pandemic, while some people enjoyed business and market success, many others have struggled. One way to stimulate the economy is through more social housing, and **Matthew Tominc** suggests ways this can be done while still meeting the reasonable investment return needs of savers.

The Minister for Superannuation, Financial Services and the Digital Economy, **Senator Jane Hume**, turned up the temperature in the super debate with a piece in **The Australian Financial Review** on 22 January 2021. It started with a strange comparison between retirement savings and a bikini:

"We all tend to make the most of our best assets ... If you have a fabulous bikini body, surprise, surprise, you tend to wear bikinis. It’s human nature to make the most of what we’ve got. Except, strangely, when it comes to our retirement savings."

Anyway, she highlighted that many retirees live unnecessarily frugal lives and die with most of their savings intact. The challenge for policymakers is:

" ... how to improve the confidence of retirees to use their savings more efficiently to enjoy a better standard of living."

It's a debateable definition of efficiency, with Senator Hume promoting the availability of reverse mortgages and the age pension to cover a loss in savings.

"For example, as superannuation balances decline over time the social security safety net available to all Australians will kick in, providing a part pension that scales up as superannuation balances are drawn down."

I'm guessing most readers of Firstlinks do not plan to draw on an age pension, but future increases in Superannuation Guarantee are clearly in jeopardy. **Roger Cohen** offers his view on whether this is the correct policy.

With the recent rise in the CPI, the ATO has announced the first increase in the Transfer Balance Cap (TBC) from $1.6 million to $1.7 million from 1 July 2021. Only people who start a pension after that date will be eligible for the higher cap. Super is already complicated enough and soon we will have TBC amounts specific to particular people.

This week's White Paper from **Franklin Templeton** looks at a product that is at the centre of a battle between improving standards of living and decarbonising national economies.

Unfortunately, all fund manager presentations are good

Graham Hand

Part of a portfolio manager’s role is generating inflows to their fund, raising new money and retaining clients by telling a captivating story. Month after month, year after year, the presentation skills are refined. For the most part, the managers enjoy the work, the enthusiasm is genuine and there’s always a story to tell. They are smart people, as becoming a portfolio manager requires a lot of study, time in the job, market analysis and experience, and beating others for the top gig.

They routinely update their professionally-designed Powerpoint presentations with charts that support a compelling narrative, and after adding a table showing a successful overweight stock position or two, they're off to the races. And don't forget to smile confidently and thank everyone for their attendance.

Investors love stock stories

Most fund managers have talked the talk and walked the walk hundreds of times. They have the advantage of an interesting subject matter, especially stock stories. Even a fund manager who is underperforming across a portfolio of say 30 stocks will own a few big winners. Attend any conference where a fund manager is speaking about stocks and watch the audience members taking copious notes. People love stories about stocks, and fund managers feed the need by explaining how they are overweight a company which has doubled in price. It shows their skill in selecting companies, and retail investors hope the magic dust will sprinkle on them.

What is not said is that there are at least as many dogs in the portfolio, but let's ignore them and focus on the good bits.

Combine long-term experience delivering a similar message, a subject matter that attracts a cashed-up audience and a public profile, and it's a recipe for universally-strong presentations.

I attend a hundred of these events a year and I have probably heard a thousand in my life. I listened to three last week and they were all interesting. Based on what was said and no further research, I would be happy for any of the presenters to manage my own money.

And that's the problem. There's no such thing as a bad presentation and investors are left with unlimited choices. All Chief Investment Officers can make a convincing case that their fund is about to deliver strong results. Investors should not simply hand over their hard-earned on basis of a presentation.

Magellan's success after six years of presentations

Who is the highest profile and arguably most-successful portfolio manager in Australia? I nominate Hamish Douglass, who has built Magellan into a $100 billion investment powerhouse and introduced many market innovations. Hamish came from an investment banking background and was always a polished and persuasive performer. You would think a fund manager like Hamish would experience instant success and a big following from Day 1.

Magellan was established in September 2006, but it did not establish a meaningful reputation among advisers and retail investors for many years. I recall an early presentation in the Magellan office where Head of Distribution, Frank Casarotti, struggled to attract more than 20 people. It was social distancing before we knew the meaning of the words. As Casarotti describes in this article from 2016, Magellan did not have a month of retail flows over $50 million until 2012. That's six years of excellent presentations and strong results before significant retail inflows were generated.

One reason for the slow inflows (and a little matter called the GFC) is that despite the quality of Douglass's presentations, they were not materially superior to many others. It's difficult to really stand out in an impressive group. It was the combination of results and marketing over a long time which created the Magellan success story and the Douglass reputation.

Practice makes … pretty good

In the mid-1980s, when I was Head of New Issues at the Commonwealth Bank, I undertook a fund-raising roadshow in Hong Kong and Singapore with Deputy Treasurer, Paul Skerman. We booked over 30 meetings in a hectic week, including breakfasts and dinners. Prior to the trip, we practiced our presentation several times, including where to pause, when to smile or nod, who would say what. Paul focussed on the big picture while I talked about the balance sheet and the transaction.

By the middle of the week on the road, I could have done the presentation in my sleep. Maybe I did, because after a couple of days, Paul asked me to smile more and look enthusiastic when he was talking. It was a good lesson. Approach every meeting as if it were the most important, as if the subject were fresh. We might hear the patter dozens of times but everyone else would only hear it once.

By the time we left Asia, we knew all the questions, all the answers, and it went like clockwork. It's not that we were especially good presenters, but there was a lot of interesting material backed by plenty of practice. I'm sure it was a good presentation and the transaction went well.

What if a fund is underperforming?

Surely it's not possible for a fund manager to make an impressive presentation if their fund does not have a good recent track record.

Paul Fiani founded Integrity Investment Management in 2007. He had previously shot to prominence while at UBS Asset Management when he took a strong stance against a private equity bid for Qantas. In the early years, Integrity won a number of awards and at its peak was managing over $5 billion.

I was at Colonial First State when we took Fiani on a national adviser roadshow, a prized role for any fund manager as the adviser exposure was unequalled at the time. However, Fiani had experienced a run of underperformance, as happens with all managers, and I was intrigued by how he would explain the poor numbers.

Fiani was a good presenter, and watching the advisers in the room, he held their attention as he talked the stock stories they all love. Then came the crunch slide on Integrity's performance, but Fiani did not miss a beat. He explained that the best time to invest with a fund manager was not when they had just done well, as all their bets had already paid off. It's when they have done badly, because investors gain exposure to companies before the share prices improve.

It was brilliant. He made the poor performance into a big plus, and the advisers around my table nodded their agreement. (Footnote: for various reasons, Integrity closed in 2017 and returned all money to its investors).

Value versus growth presentations in the current day

The last few years have challenged traditional 'value' managers who select companies based on fundamental assessments of intrinsic company value versus current market price. In contrast, 'growth' managers buy expensive stocks when they can see the future potential with profits in the distance. The best examples are tech stocks trading on extreme price multiples but with exciting prospects. Value managers argue they are priced for execution perfection and it's better to stick to proven companies making real profits. Growth managers believe the dream.

Within the space of two days recently, I listened to a value and a growth manager and both were persuasive.

The growth manager was Munro Partners' Chief Investment Officer, Nick Griffin. In this climate, growth managers are delivering impressive results and loving that their investment approach is vindicated. Munro's Top 5 investments are Amazon, Microsoft, HelloFresh (food delivery), ServiceNow (digital workflows) and Taiwan Semiconductors. Strong results were also delivered for the portfolio by chipmaker ASML and Vestas Wind Systems. Munro's investments are dominated by tech, climate change and e-commerce, and here are the strong results.

PERFORMANCE	3 MTHS	6 MTHS	12 MTHS	INCEPTION P.A.	INCEPTION CUMULATIVE
MUNRO CONCENTRATED GLOBAL GROWTH FUND (AUD)	**5.7%**	**16.4%**	**33.7%**	**32.2%**	**38.6%**
MSCI WORLD (EX-AUS) TR INDEX (AUD)	5.7%	9.7%	5.7%	8.3%	9.8%
EXCESS RETURN	0.0%	6.7%	27.9%	23.9%	28.8%

Griffin's Global Growth Fund picks from the best companies in the world according to themes which he believes are changing the ways we live and delivering outstanding company opportunities.

It is a classic growth story, believing in the promise of the future, and Munro has enjoyed the market run with a handsome 34% return over the last year, a long way above its benchmark. Griffin has great optimism in market conditions over 2021 and his ability to select the winners.

The second presentation was by Schroders' Martin Conlon who has been Head of Australian Equities there since 2003. A focus on the Australian market is a headwind in the current conditions, as the local market does not have the tech and health sector titans which have driven US markets. The broad Australian index was flat for 2020. Schroders is more of a traditional manager, which:

"… seeks to focus on the fundamental risk inherent in a business and the way it is financed rather than focusing unduly on the range of emotional and non-fundamental factors which drive day to day share prices." (Source, Schroders Wholesale Australian Equity PDS, 1 October 2020).

On 10 January 2021, Conlon wrote:

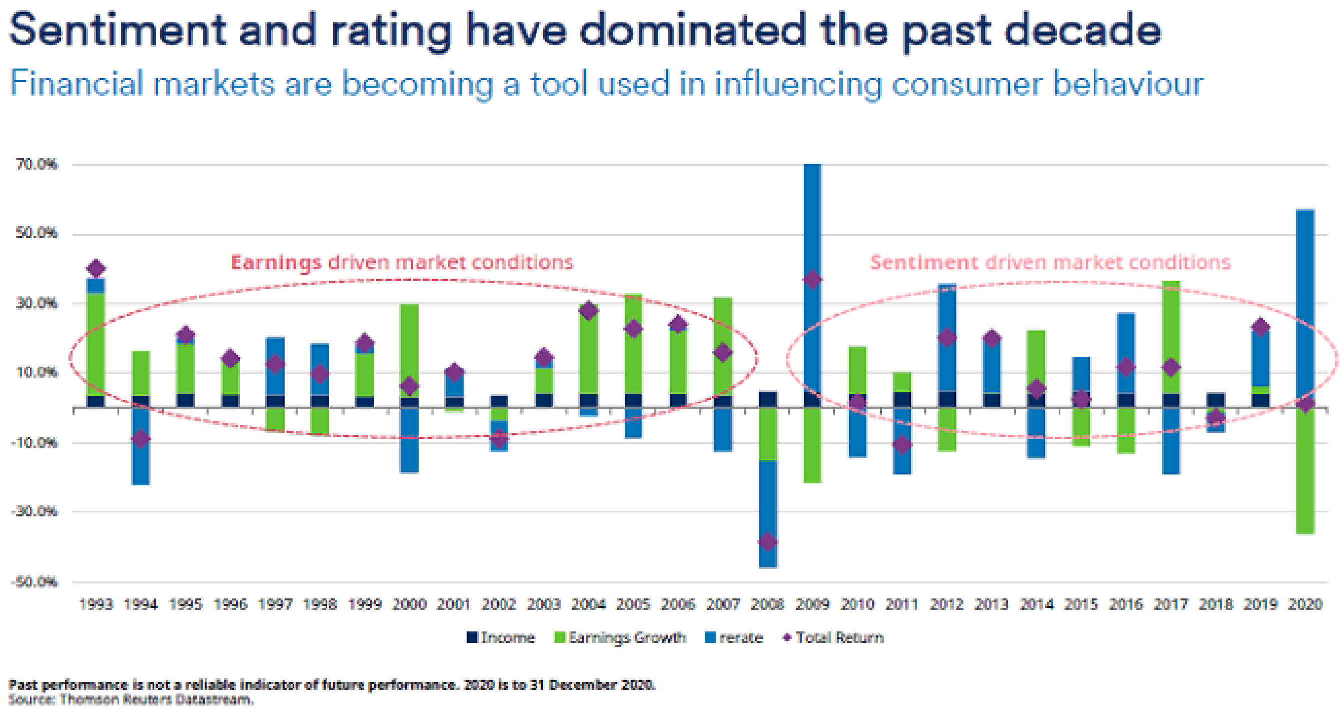
"There is some bitter irony in large pension funds observing the crazy punting of Tesla in the US by the Robinhood Army, only to buy it themselves at much higher prices when S&P tells them. Domestic poster children remained the usual suspects; Afterpay (+47.5%) and Xero (+45.7%) in tech, Polynovo (+75.6%) and

*Nanosonics (+41.4%) in healthcare, not to mention a healthy dose of lithium and rare earths. The durability and quantum of gains from some of these thematics continues to embolden investors. Our assessment of the odds remains one in which **luck and a few hot hands are being confused with mastery of the game**. It is behaviour creating the apparent value, not fundamentals." (my bolding).*

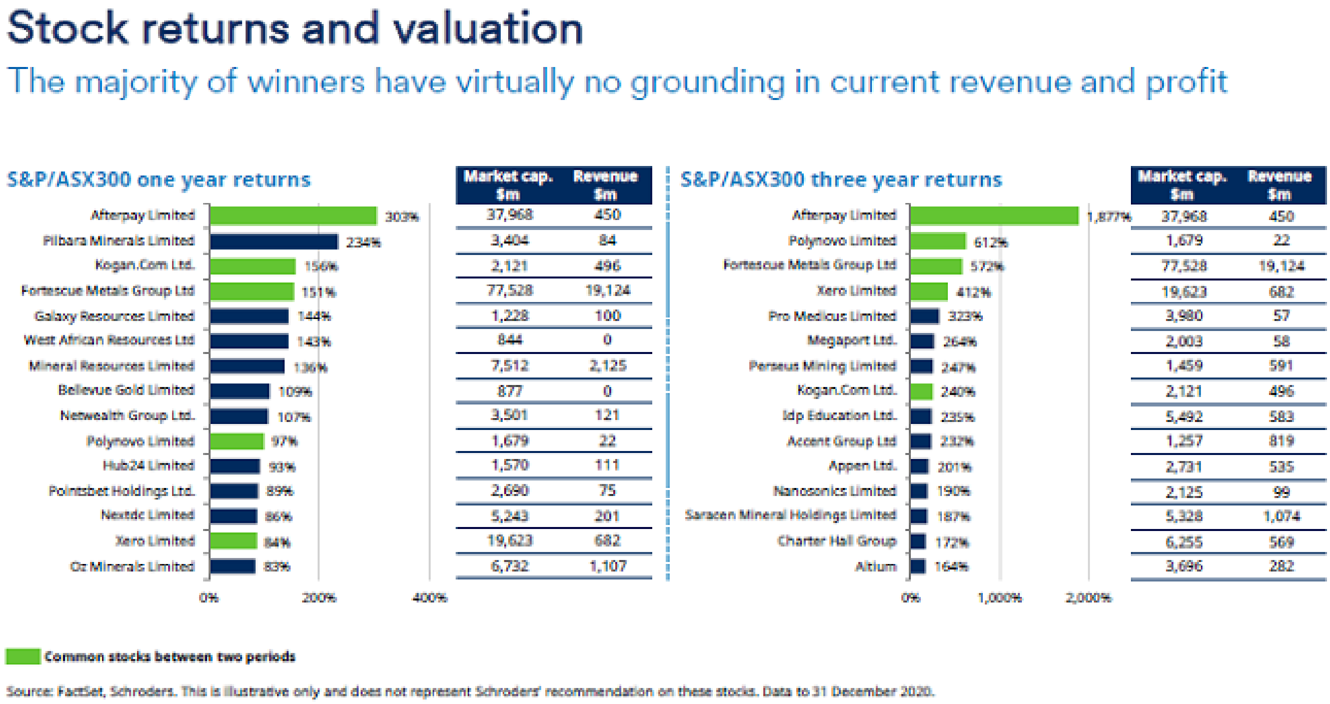
Last week, he presented two charts which show how current prices are frustrating his process. He said:

*"Equity market returns in the past decade have transitioned from being earnings driven to ratings driven. Expansion in the rating attributed to earnings, or in some case revenues given the absence of profit and cashflow, has become the dominant driver of share prices. This is most evident in technology where multiples and valuations are almost certainly in bubble territory, however, most stocks with perceived growth in revenue and expectations of future profit growth remain **priced at levels vastly above historic norms**." (my bolding).*

This chart of market performance shows how earnings growth (the green bars) dominated returns from 1993 until the GFC in 2008, and how rerating (the blue bars, where the market is paying more for the same earnings) have generated returns more recently.

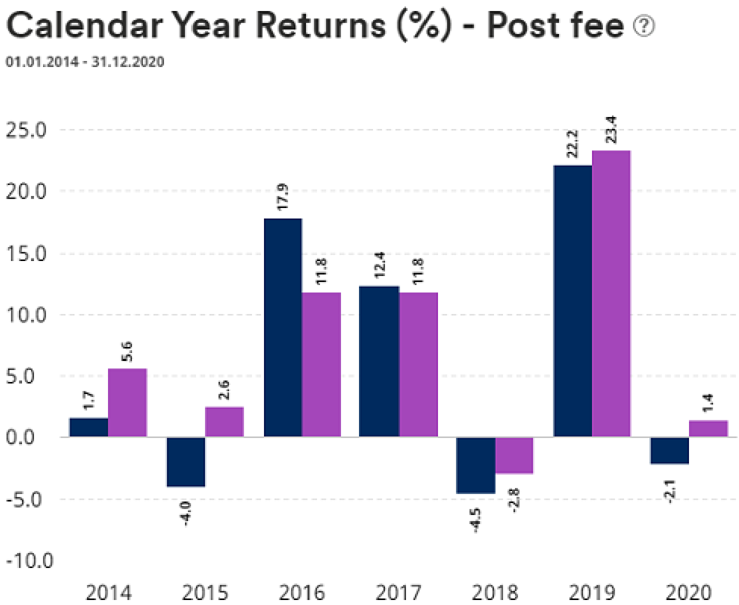


Schroders also provided the following chart which shows: "*The majority of winners have virtually no grounding in current revenue and profit.*"



And fair enough. It was a good presentation showing the market is overvalued and stocks have insufficient revenues to justify their prices. Conlon is in solid company with many prominent investors, such as Investors Mutual, Lazard and Maple-Brown Abbott, arguing the same point. At some point, there will be a convincing rotation from growth to value and these managers will look vindicated.

How has Conlon's fund (the dark blue bars below) performed versus its benchmark (the purple bars)? After fees, it is under its benchmark in each of the last three years, cumulatively by 6.4%. Market conditions have not suited this type of manager, and he has explained why. Job done and everybody is happy because he has stayed true to his style.



Investing is about the future

In two good presentations, one manager sees a bright future for many high P/E stocks and backs his growth thematics, while another sees investors pumping money into recent winners regardless of price and value, and at some stage, the market will come to its senses.

Who is right? I have no idea. Ask me in five years when we can look back on Munro and Schroders.

The point is that both presentations were impressive. What should an investor do?

- Back the recent winner whose style will continue to pay off, or
- Back the recent loser whose style is about to pay off?

So if you can't tell from the quality of the presentation who to invest with, how do you select a manager? Co-founder of this publication, Chris Cuffe, has spent a career selecting managers, and his coverage of the subject is here and here and here. Chris primarily backs long-term performance and ignores numbers over less than three to five years. His 'for charity' multi-manager Third Link Growth Fund has outperformed its benchmark by 3.5% per annum compound since May 2008.

In the meantime, sit back and enjoy the fund manager presentations from an unlimited range. They are all good although not decisive in the investing decision. Lap up the stock stories (you know you love them, even if you're not sure why or what to do with them), follow the pretty charts, hear the well-practised patter and nod sagely.

And if you do give the fund manager your money, consider it a 10-year commitment because that's how long it will take before you know if they have talent or luck.

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

Win some, lose some: Buffett's 2020 scorecard

James Gard

In a tough year for most investors, even Warren Buffett had a mixed year by his standards. The share price of his Berkshire Hathaway (BRK.B) investment company inched forward by just 2.5%, lagging major US benchmarks like the S&P 500.

Top holding Apple (AAPL) had a stellar year and an investment in data IPO Snowflake (SNOW) proved an immediate hit. But there were a number of misses too, with investments in US banks and financial services proving costly.

Let's take a closer look at his portfolio:

What worked

We covered the Sage of Omaha from a range of angles last year: Morningstar columnist John Rekenthaler analysed Buffett's predictive powers, in December we dug into Berkshire Hathaway's portfolio and in June Susan Dziubinski picked out three potential buys from the portfolio following the spring 2020 crash.

Looking in-depth at the portfolio, there were some strong performances from the likes of **Apple** and **Amazon** (AMZN), whose shares were 70% higher at the end of the year. But the standout performer in 2020 was new holding **Snowflake**, which floated in September at $120 and closed the year 134% higher at $281. The investment was particularly notable as value investor Buffett typically rejects the 'hooplah' associated with IPOs. Indeed, the last time he bought a newly listed company was **Ford** motor company in 1956.

So what were the biggest changes to the Buffett investment portfolio in 2020?

Healthcare was one of the boom areas of 2020 so it was no surprise to see an increased weighting to these stocks last year. In the third quarter of 2020, the portfolio added to positions in **Abbvie** (ABBV), **Merck** (MRK) and **Bristol Myers Squibb** (BMY) - the trio now accounts for 2.4% of the portfolio's assets between them.

Of these, only Abbvie posted a positive return for the year, up 20%. Merck, meanwhile, is one of four companies in the portfolio rated as undervalued by Morningstar analysts with a 4-star rating (the others are food giant **Kraft Heinz** (KHC), bank **Wells Fargo** (WFC), which fell nearly 45% last year, and US car firm **General Motors** (GM)). The position in Wells Fargo was reduced in 2020, as were stakes in **Bank of New York Mellon**, **Visa**, **Mastercard** and **US Bancorp**.

Merck is also one of two companies in the portfolio's top 20 positions to have a wide economic moat, an important concept gauging competitive advantage for Warren Buffett and Morningstar. General Motors and Kraft Heinz are the only stocks in the list with no economic moat, while Snowflake does not yet have a Morningstar rating.

Stock	Ticker	Weighting (%)	Economic Moat	Star Rating	% Gain/Loss (2020)
Apple	AAPL	47.8	Narrow	2	78.44
Bank of America	BAC	10.6	Wide	3	-13.51
Coca-Cola	KO	8.6	Wide	3	-0.22
American Express	AXP	6.6	Wide	2	-2.96
Kraft Heinz	KHC	4.3	None	4	10.95
Moody's	MCO	3.1	Wide	2	20.37
US Bancorp	USB	2.1	Wide	3	20.37
Charter Communications	CHTR	1.4	Narrow	2	33.79
DaVita	DVA	1.4	Narrow	2	56.37
Wells Fargo	WFC	1.3	Wide	4	-43.50
Verisign	VRSN	1.1	Wide	2	7.73
Bank of New York Mellon	BK	1.1	Wide	3	-15.58
General Motors	GM	1.0	None	4	14.65
Visa	V	0.9	Wide	3	15.36
AbbVie	ABBV	0.8	Narrow	3	20.80
Merck	MRK	0.8	Wide	4	-10.36
Bristol Myers-Squibb	BMY	0.8	Wide	3	-1.19
Amazon	AMZN	0.7	Wide	3	73.71
MasterCard	MA	0.7	Wide	2	18.81
Snowflake*	SNOW	0.7	n/a	n/a	134.50
Average return					***19.93***

Source: Morningstar Direct. Performance data to December 31, holdings data to end of September 2020
*Snowflake floated on September 16

The trouble with Berkshire

How do you measure Warren Buffett's performance? A conventional investment portfolio with 50% exposure to Apple would have done very well in 2020. The average share price gain for the biggest holdings in the portfolio is just below 20% (see table), which beats the S&P 500's gain of 15% for last year.

But things aren't that simple: Berkshire Hathaway has many facets and while the investment portfolio gains investor attention because of Buffett's status, it's also part of a much wider empire.

Berkshire Hathaway Energy and its railway subsidiary BNSF, for example, were hit hard in 2020. The manufacturing, services and retail (MSR) arm, with holdings in metalworking companies and aircraft parts suppliers, has also been damaged by the pandemic. And exposure to insurance has weighed on performance, with much higher payouts last year in the industry as a whole.

But Berkshire Hathaway B shares are now undervalued, according to Morningstar analysts, and retains its wide economic moat. The company could come under pressure to return more of its cash mountain to shareholders this year after a lacklustre 2020 in share price terms.

Berkshire is not easily compared with an index or a conventional investment fund. While the Berkshire Hathaway share price barely moved the needle last year, Morningstar analyst Amy Arnott says the Buffett magic keeps retail shareholders loyal:

"The legions of investors who still count on it as a quasi-fund for their life savings likely aren't complaining."

Now 90, Buffett has handed the running of his equity portfolio to former hedge fund managers Todd Combs and Ted Weschler, who run $30 billion between them. After the portfolio's surprise (and highly lucrative) punt on Snowflake towards the end of last year, Berkshire investors could see further unexpected developments this year. And with value investing making a tentative comeback and the real economy recovering, these conditions could be more favourable to Buffett's approach of buying unloved stocks.

James Gard is content editor for Morningstar.co.uk. This article is general information and does not consider the circumstances of any investor. Any Morningstar ratings/recommendations contained in this report are based on the full research report available from Morningstar.

Prefer or defer? Sector and investment themes for 2021

Olivia Engel

The most confounding thing about financial markets in 2020 was that, in totality, the mood of the global equities market seemed completely different than the mood of everything else happening to humanity – i.e., millions of lives lost worldwide, ongoing concerns for health and employment, political instability, racial injustice, and the list goes on ...

Market paying more for less earnings

The MSCI World Index in the calendar year delivered a positive return of almost 16% (trading in a 46% range after a year-to-date low of -30% at the end of March) while the annual earnings of companies within the index are expected to have fallen by 7%.

This represents a price-earnings (P/E) multiple expansion of around 25%.

During 2020, the price appreciation of public equities reflected a high level of optimism about the ability of the global economy to recover from the pandemic and come out stronger than before. In 2021 we believe that the listed price of publicly traded companies will more closely tie to the underlying near-term earnings trajectory and financial strength of those companies.

While valuation is an important theme when we select stocks, we find attractive stocks at both ends of the price-to-book valuation spectrum. There are cheap stocks we like, and there are cheap stocks we don't like; expensive stocks we like, and expensive stocks we don't like.

Among stocks that look expensive as measured by price-to-book ratio, we see a subset as attractive once we conduct a nuanced analysis of where they derive their value.

For example, in developed markets, tech hardware and semiconductors have average or slightly above average value scores according to our measures, despite being extremely expensive on price-to-book alone.

Figures 1 and 2 show that we expect high returns to be found among both cheap and expensive stocks.

Figure 1: Developed market sector return expectations by sector valuation

	High Expected Return	Low Expected Return
Cheap	Traditional Autos Financials	Energy Real Estate
Expensive	Tech Hardware Semiconductors	Consumer Services Retailing Tech Software & Services

Source: State Street Global Advisors, as of January 10, 2021.

Figure 2: Emerging market sector return expectations by sector valuation

	High Expected Return	Low Expected Return
Cheap	Energy Financials utilities	Real Estate
Expensive	Consumer Durables Health Care Equipment Software Semiconductors	Commercial Services Consumer Services Retailing Consumer Staples

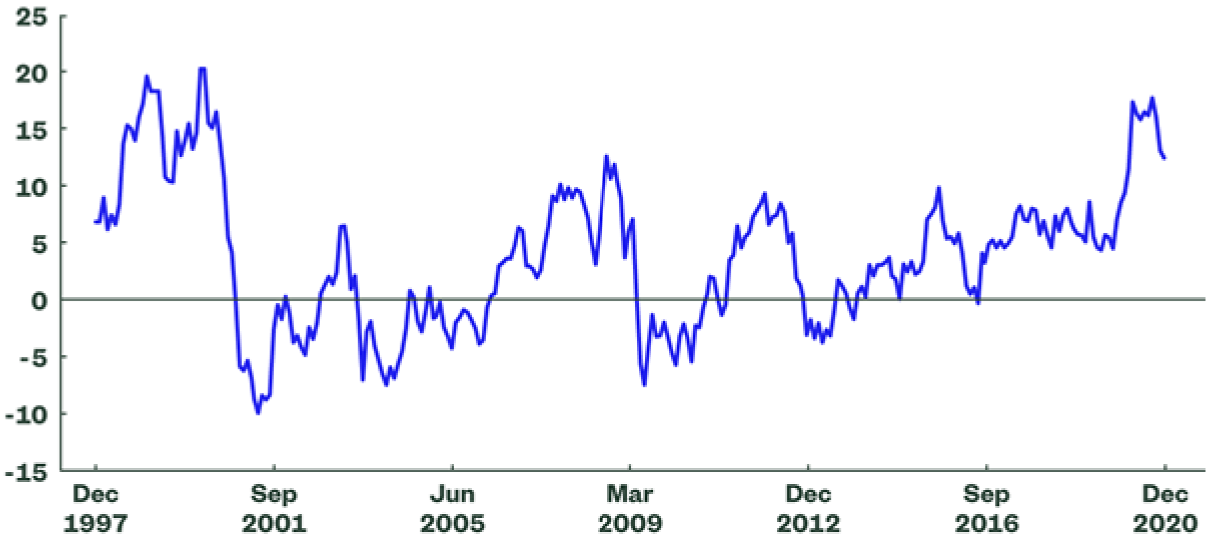
Source: State Street Global Advisors, as of January 10, 2021.

While highly-volatile stocks had a very strong rebound in the fourth quarter of 2020, we do not expect this to continue much into 2021. In both emerging and developed markets this means we will stay away from most stocks in the consumer services segment, where risks are still high.

Price momentum

During 2020, we were concerned regarding market concentration in expensive and high-momentum stocks, and we are still concerned about companies that may, due to their size, impact market indices in aggregate if they pull back. Figure 3 shows that the embedded price momentum built into the S&P 500 over the past few months reached levels not seen since the height of the dot-com bubble.

Figure 3: Embedded price momentum in S&P500 Index (11-month return, lagged one month)



Source: State Street Global Advisors and S&P, as of December 11, 2020.

Opportunities in 2021

Since market concentration in expensive, high-sentiment stocks reached all-time highs last August, some out-of-favor stocks are showing signs of improving sentiment and creating better opportunities for us to find companies that tick all the boxes.

In aggregate, the following segments are where we see the greatest opportunity with a nine- to 12-month horizon.

Figure 4: Most preferred and least preferred segments for 2021 by region

	Most Preferred	Least Preferred
US	Household Personal Products Consumer Durables and Apparel Autos	Real Estate Consumer Services Pharma & Biotech
Europe	Autos Telecom Services Insurance	Software & Services Pharma & Biotech Consumer Services
Japan	Tech Hardware & Equipment Autos Capital Goods	Software & Services Household Personal Products Consumer Services
APAC ex Japan	Banks Health Care Equipment & Services Telecom Services	Transport Software & Services Consumer Services
Emerging	Autos Semiconductors Telecom Services	Transport Household Personal Products Consumer Services

Source: State Street Global Advisors, as of January 10, 2021.

The bottom line

After a year of high optimism in equities markets – an optimism that often seemed disconnected from the year's many challenges – we believe that equity prices will increasingly reflect underlying fundamentals in 2021. Multiple expansion will not be enough. Although market concentration in stocks benefiting from extraordinarily high price momentum remains high, some out-of-favour stocks are displaying improving sentiment, widening the range of stocks that are attractive across multiple themes and dimensions of investment performance.

We stand on the threshold of a new investment reality as COVID vaccines roll out and monetary and fiscal conditions change in response to a global economic recovery.

Olivia Engel, CFA is Global Chief Investment Officer, Active Quantitative Equity at State Street Global Advisers. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Is cancelling the SG increase a retiree version of 'Buy now, pay later'?

Roger Cohen

Following the recently published findings of the Retirement Income Review, questions have been raised about the efficacy of keeping the Superannuation Guarantee (SG) at its current level of 9.5% rather than proceeding with legislated increases to 12.0% by 1 July 2025.

Arguments in favour of maintaining the 9.5% level include:

- the benefits of additional income for workers pre-retirement (effectively an increase in take-home pay)
- greater flexibility about whether to spend or save, and
- savings outside super need not be locked up until retirement.

The contra argument is that increased savings for retirement lead to a better outcome both for the individual retiree (increased retirement income) and for society (decreased reliance on the age pension). The original timeline for the rise in the SG has already been deferred, and now there is talk of deferring it further or even cancelling the increase altogether.

Is this just a form of 'buy now, pay later' for retirees?

Arguments on both sides have merit

More income now provides a direct benefit - today - to the individual. More income leads to increased spending, which will flow through and lift the whole economy. This is substantiated by evidence from the early release of super during the COVID epidemic. The early release scheme saw a massive uptake across a wide spectrum of age and income ranges. Over $35 billion was withdrawn from the superannuation system, with 3.4 million initial and 1.4 million repeat applications.

Clearly, a diverse section of the population wanted access to their super early, some for genuine hardship reasons, while for others it was a spending bonus. Evidence suggests that what was intended as a mechanism to ease financial hardship was embraced by many as a windfall to be spent conspicuously and on discretionary purchases including gambling, restaurants, furniture, alcohol and tobacco.

From a report by AlphaBeta:

*"… early superannuation withdrawals have not been used as intended: of the 1.35 million) Australians who applied ((as at May 25, 2020) for early access to their superannuation, **40% actually saw no drop in their income during the COVID-19 crisis**. Only 22% of super withdrawals was used on essentials, while 64% was spent on discretionary purchases including gambling (11%) and clothing (10%)."*

This suggests that without constraints, a large section of the population would access their money now and would use it in a way which would not benefit their retirement.

This early release will have a lasting impact, with the long-term cost to the super system estimated at $100 billion or more[1], as those who took their money out early reach retirement.

Research from Industry Super Australia shows that the early release of super is expected to result in higher future pension costs for the government as well as reduced income in retirement. For a 30-year-old on a median income who takes the full early release entitlement of $20,000, the additional pension burden on the Government would be $50,000, while overall the individual would be $41,000 worse off in retirement.

No doubt, any reduction or deferral in the SG increase would be received favourably by many and it would be a popular move for the political party who instigates it.

The purpose of superannuation

However, this undermines the very foundation of our superannuation system, which institutes a rigid savings regime to ensure that all working Australians contribute towards funding their retirement.

It is easy to ignore the long-term consequences of taking money now rather than saving for later, because they are not immediately obvious. To many, the future value of money locked inside their super is not fully appreciated, whereas the value of money that is immediately accessible is obvious.

This means that the trade-off of 'now' for 'later' is not viewed as detrimental and long-lasting. The ultimate outcome of reduced levels of retirement income and increased reliance on top-ups from the government through the pension is an abstract concept and thus heavily discounted.

Australia has, by world standards, a top-tier retirement system. Reducing the level of future contributions risks diminishing it and diminishing the quality of life of retirees.

Improvements rather should focus on engaging with stakeholders, creating an environment where the value of retirement savings is better understood. This environment should foster the development of improved retirement products and services, provide better access to and delivery of advice, and focus on reducing complexity. This will ensure that Australia maintains or increases its standing as a leader in providing for a great retirement for its population.

Trading the benefit of future income for the ability to spend now is not the way to a better retirement system or a better outcome for retirees.

[1] Source: BetaShares modelling, as at August 2020, of the estimated future shortfall that will need to be funded by Australian governments, as those who have withdrawn super will be less able to fully fund their own retirement needs. Modelling assumes a long-term return profile of CPI+5% p.a.

Dr Roger Cohen is the Senior Investment Specialist at leading ETF provider, BetaShares, a sponsor of Firstlinks. This article is not financial advice. It is for general information only and does not consider the circumstances of any investor.

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Three ways to match housing affordability with good returns

Matthew Tominc

If there is one positive to take away from the past year, it is the importance of what we do together. The adverse impacts of a pandemic fall disproportionately on the most vulnerable: people living in poverty, the working poor, women and children, persons with disabilities, and other marginalised groups around the world. Loneliness and mental health issues spiked amongst our most vulnerable, millions of children experienced a new mode of education and, of course, we were reminded that like a pandemic, climate change can have far reaching consequences for our global economy if left unchecked.

Our Impact Fund focuses on each of these areas through its four key investment sectors including specialist disability accommodation, social housing, community solar and social impact bonds.

Social housing is the focus of this article where we look at the sector and how to address the challenges of social housing investment in Australia.

Why is housing such a challenge?

Few would dispute that housing is a fundamental human need, yet even in a developed economy like Australia the provision of stable housing is not guaranteed.

Housing is also an asset class and sits at the intersection of human needs and financial markets. It is an area where impact investment is uniquely suited to address the challenges society faces in providing shelter to those in need.

Housing affordability is a challenge globally, and is particularly acute in Australia, where demand and supply side factors have combined to increasingly push housing beyond the reach of many families.

In the short term, house prices increase because of demand side factors, including government policies encouraging home ownership designed to create financial security for voters, falling interest rates, and wealth inequality that drives demand for certain types of housing.

Over the longer term, house prices stay high because of supply side factors, including lack of appropriate supply to address demand, NIMBYism stalling development of new housing stock at scale, and in some cases, policies designed to support housing (such as rent controls) that also deter new developments.

How big is the challenge?

On a given night in Australia, one in 20 households need to rent social housing, but that statistic does not account for the large waiting lists of people vying for shelter.

Digging into the state level provides a better understanding of some of the challenges, as all states in Australia are governed by different regimes and dynamics for social housing.

Victoria, where Conscious Investment Management is based, has the lowest level of public and community housing stock in Australia (3.2% of all housing stock). The national average sits at 4.5% of all housing stock as social housing. To simply maintain its social housing stock at 3.2%, Victoria will require 3,500 new social housing beds to be built every year for the next 10 years. Similar calculations can be made for other states.

In NSW, in 2018 there were around 53,000 applicants on the social housing wait list. Of these applicants, 23,000 were households with children. Wait times were beyond 10 years for social housing in many areas.

What are some solutions?

Governments and various community organisations have tried different policies and approaches over the past few decades, with varying degrees of success.

Incentives and concessions for developers, planning restrictions, direct financial support of community housing charities (say through cheap debt), or cash payments directly to social housing tenants all have a role to play. A major boon for the sector was the launch of the Commonwealth’s National Housing Finance and Investment Corporation (NHFIC) in 2018 to provide an increase in low-cost financing for social and affordable housing providers.

Financial markets and institutional investors have also begun focusing on the sector over recent years, attracted by perceived scalability and stability of returns.

A challenge for these investors, however, is that investors typically require ‘market’ rate financial returns. By definition, social housing tenants cannot pay market rent. That disconnect is difficult to solve and remains a key reason why financial investors have not entered the asset class at scale.

Three investment angles address the challenges

We have focused on the sector from a few angles:

1. Build-to-rent investments

- After a positive experience investing in the US ‘multifamily’, or ‘build-to-rent’ sector, which has been responsible for significantly increasing affordable housing supply in the US, we’ve sought analogous investment opportunities in Australia.

- Build-to-rent in Australia is a new industry, and many build-to-rent developments underway are not necessarily 'affordable' (even if marketed as such). We expect to continue assessing the sector.

2. Working with Community Housing Providers, often charities, to understand novel ways that our funding can play a role to support their mission.

- For example, we have explored pairing social housing with specialist disability accommodation or other commercial real estate to obtain a 'blended' market rate return.

3. Direct engagement with governments to seek a concession.

- Analogous to our investment in specialist disability accommodation, Government support can assist in addressing the gap between what a tenant can afford and market returns.
- By plugging the gap between market returns and social housing rents, Government can drive increased private sector engagement and investment in a sector as it matures towards institutional scale investment.
- This is the most attractive way to structure social housing investments, but also the most challenging.

As impact investors, we are dually focused on long-term investments that drive positive change, as well as the generation of stable and strong returns for our investors.

We spend months and even years understanding an area of need and the sector that seeks to address it, to make investments that can combine both impact and financial returns.

Matthew Tominc is Chief Investment Officer at Conscious Investment Management (ACN 630 131 476 AR No. 1275316), a Channel Capital partner. Channel Capital is a sponsor of Firstlinks. This information is not advice or a recommendation in relation to purchasing or selling particular assets. It does not take into account particular investment objectives or needs.

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Investors face their own Breaking Bad moment

Kate Howitt

Market liquidity is typically thin over the annual holiday period as investors and asset allocators seek a change of scenery for a week or two. This year, even that change of scenery will need to be virtual. Investors reduced to taking their mental break via streaming could do worse than (re)watching the AMC series "Breaking Bad". Aside from being rated as one of the top TV series of all time, the series' story arc takes viewers on a journey that could be prophetic for global investors.

Breaking Bad's narrative innovation was to take the protagonist on a journey. The show's creator, Vince Gilligan, told Newsweek: "Television is historically good at keeping its characters in a self-imposed stasis so that shows can go on for years or even decades. When I realised this, the logical next step was to think, how can I do a show in which the fundamental drive is toward change?" The five seasons of the show tell the story of high school chemistry teacher Walter White responding to hardship by "breaking bad" and ultimately transforming from downtrodden hero into violent, hard-boiled villain.

Savers are also on a journey as they undergo a transformation from sober, cashflow- and value-focused investors towards more flamboyant, risk-taking speculators. What has prompted this change and how far along are we?

In Breaking Bad, the transformation starts when Walter White discovers he has advanced cancer and starts taking more risks to provide for his family. The health scare for savers was the Global Financial Crisis, when market falls gave investors a shock to their net worth. Their efforts to rebuild their wealth by investing in assets that had traditionally provided solid returns were hampered by the arrival of the policy-led era of low interest rates, which came to be known as "lower for longer". Yield compression across all asset classes began to rapidly boost asset values and diminish income. This meant that by late 2019, the only remaining lens through which equities looked like attractive value was "relative to bonds".

Then in early 2020, just as investors might have begun to hope that policy rates would start to rise, allowing yields to rebuild and equities to offer a better entry point, the pandemic struck. Counterintuitively, asset values - across stocks, bonds, property and bitcoin - have taken another leg up. Why? Because of the most significant behavioural impact of the pandemic on financial markets: savers have gone from reluctantly edging out the risk curve, to beginning the capitulation into outright speculation.

So where does this end? By the end of Season three, Walt is faced with the choice of bowing out of the drug trade on which he is now reliant, or murdering his erstwhile apprentice Gale. While much less extreme, investors have also been wedged into a corner. So long as interest rates were expected to "eventually" go up, then investors needed to be careful to not fully price low interest rates into asset valuations. But 2020's shift of mindset from "lower for longer" to "lower for forever" - the belief that policy rates can "never" go up - means that risk discount rates will keep coming down towards zero. Mathematically, this means that asset values must keep going up.

The combination of a dearth of assets offering anything above a peppercorn yield, and the prospect of asset values disconnecting from traditional cashflow-focused metrics, means that assets will now be priced on what tomorrow's greater fool might pay for them. Savers increasingly face Walt's choice: do they bow out, leaving behind the life of riches they have become accustomed to? Or do they take the next incremental step in jettisoning their previous standards?

Obviously the analogy falls down in that (*spoiler alert*) Walt chooses the illegal and immoral course of action, whereas there is nothing illegal or immoral about the way investors are behaving. That difference aside, anecdotes of profligacy abound, from the customer who told a bank CEO that he was "saving" for a mortgage deposit by day trading tech stocks… to the wealthy Australians who have concluded that buying luxury property is the only way to earn a return on their capital… to index investors buying Tesla at a valuation greater than that of the entire Japanese auto industry...

We look back on the 1920s and marvel at their folly to believe that "stocks had reached a permanently higher plateau". As my colleague Anthony Bolton says, there's always a story that drags markets to an extreme - and these days "lower for forever" is it. However, Anthony also cautions that once the narrative is fully priced in it loses its power. There comes a point where everyone who can or will buy stocks to chase the narrative has done so. At that point, markets peak and then fall.

Currently, savers are making small decision after small decision that leads them further away from investing and closer to outright speculating. We're somewhere around the end of Season 3. Time will tell if we will head towards the bloody climax seen in Season 5 or follow a new narrative.

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

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Australian banks prove resilient but risks remain

KPMG

During the COVID-19 pandemic, the Australian major banks (the Majors) significantly increased their loan loss provisions and allowed customers to defer loan repayments, but to date their actual loss experience has been minimal.

The open question is to what extent loan losses will materialise in 2021, as the Government unwinds its economic support measures.

Key highlights

The Majors reported a **cash profit after tax** from continuing operations of $17.4 billion in FY20, down 36.6% on FY19. The profit fall was a function of a number of factors, including some large, notable items like restructuring costs associated with divestments as well as ongoing regulatory and remediation costs. It was also negatively impacted by rising loan impairment charges and credit provisions, in advance of an expected deterioration in the economy as Government support comes to an end.

The average **net interest margin** (cash basis) saw continued compression, decreasing 5 basis points compared to FY19. Declining net interest margin (NIM) was driven by repricing of deposits, mortgages and business lending assets amidst RBA rate cuts and increased competition in the market. Excess liquidity from an inflow of deposits also hurt margins. However, the Majors benefited from favourable wholesale funding pricing in the second half of the year.

Cost-to-income ratios have increased from an average 47.2% to 53.2%, in large part driven by rising IT related expenses which included higher costs associated with mobilising their workforces for remote working conditions and higher software amortisation charges. In addition, one of the Majors reported significant items relating to regulatory matters.

Excluding these, average cost to income ratio increased by 177 basis points to 45.2%, with increases reported for each Major.

Aggregated **loan impairment expenses** increased by 201% to $11.2 billion, coming off a historically low provision base at the end of FY19. This increase reflects the Majors expecting higher loan losses and customer defaults as a result of the pandemic, and continued uncertainty in the economic outlook. As a result, total provisions increased to $24.8 billion, providing a significant buffer for potential future losses.

While the actual loss experience has been modest to date, a big question for FY21 is to what extent loan losses will materialise as the Commonwealth government unwinds its economic support measures.

Financial performance and Tier 1 capital

The Majors have maintained a strong **Common Equity Tier 1 (CET1) ratio** capital position of 11.4%, increasing 59 basis points from FY19. This result has been driven by prudent capital management, and decisions to reduce dividends in line with current APRA guidance, which saw the **dividend payout ratio** reducing to 52.7% from 81.3%. Westpac and NAB additionally reported a $2.8 billion and $3.5 billion capital raising respectively earlier in the year. While regulators have provided guidance to the banks that in current conditions it would be acceptable to temporarily reduce their capital ratios, it appears that the Majors have preferred the safety of strong balance sheets heading into an uncertain FY21.

The focus on balance sheet strength and reduced profitability has continued to impact **returns on equity (ROE)**, which decreased 458 basis points on the prior comparative period to an average of 6.7%. As the Majors continue to focus on supporting customers, investing in the necessary transformation and maintaining strong balance sheets, shareholder value creation will be an important challenge in upcoming years.

	ANZ		CBA[1]		NAB		WBC	
	FY20	FY19	FY20	FY19	FY20	FY19	FY20	FY19
Ranking								
By profit before tax	2	3	1	1	3	4	4	2
By total assets	1	1	2	2	4	4	3	3
By total equity	3	3	1	1	4	4	2	2
By market capitalisation	4	4	1	1	3	3	2	2
By CET1 capital ratio	3	1	1	2	2	4	4	3
Financial performance (continuing operations)								
Operating income ($ million) – cash	17,752	19,029	23,758	23,577	17,190	17,434	20,626	20,655
Profit before tax ($ million) – statutory	5,516	8,920	10,479	11,376	5,163	8,345	4,266	9,749
Profit after tax ($ million) – statutory	3,676	6,311	7,459	8,101	3,498	5,905	2,292	6,790
Cash profit after tax ($ million)	3,758	6,470	7,296	8,221	3,710	5,853	2,608	6,849
Performance measures (continuing operations)								
Net interest margin – cash (basis points)	163	176	207	209	177	178	208	212
Cost to income ratio – cash (%)	52.9	47.7	45.9	45.9	52.4	46.7	61.6	48.6
Basic earnings per share – statutory (cents)	129.8	222.1	421.8	458.3	112.7	208.2	63.7	196.5
Basic earnings per share – cash (cents)	132.7	227.6	412.5	465.5	120.9	209.3	72.5	198.2
Return on average equity (%) – cash	6.2	10.9	10.3	12.1	6.5	11.4	3.8	10.8
Credit quality measures								
Loan impairment expense ($ million) – statutory	2,738	794	2,518	1,201	2,752	927	3,178	794
Impaired loans to loans and advances (%)	0.40	0.33	0.46	0.48	0.31	0.33	0.40	0.25
Collective provision to credit RWA (%)	1.39	0.94	1.44	1.05	1.56	0.96	1.54	0.95
Financial position								
Total assets ($ million)	1,042,286	981,137	1,014,060	976,502	866,565	847,124	911,946	906,626
Total equity ($ million)	61,297	60,794	72,013	69,649	61,293	55,604	68,074	65,507
Capital measures								
Capital adequacy ratios (%)								
- Total	16.4	15.3	17.5	15.5	16.6	14.7	16.4	15.6
- Tier 1	13.2	13.2	13.9	12.7	13.2	12.4	13.2	12.8
- Common Equity Tier 1	11.3	11.4	11.6	10.7	11.5	10.4	11.1	10.7
Market capitalisation ($ billion)[2]	48.8	80.7	122.7	146.3	58.3	85.4	60.8	103.4

The 'resilience' in bank balance sheets

Whilst Australia has fared favourably compared to other developed economies, the impacts are still pronounced and are reflected in the Majors' FY20 results.

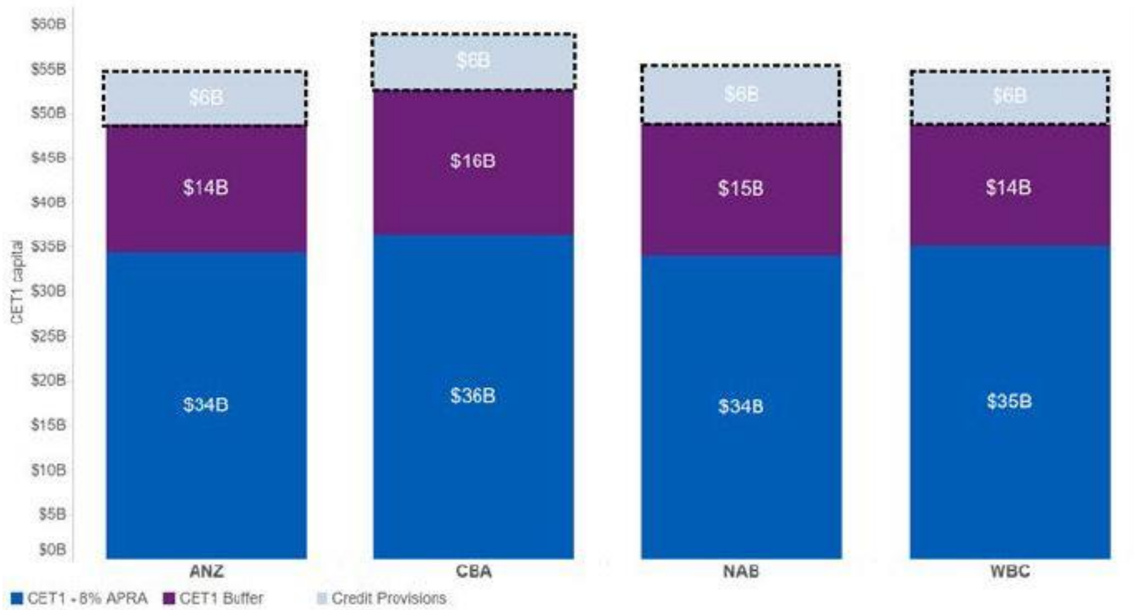
The Majors offered temporary loan repayment deferrals to mortgage and SME lending customers, since the onset of COVID-19 in Australia. Large numbers of borrowers, representing significant loan volumes, have taken up these offers. Due to government support measures (especially the JobKeeper and JobSeeker payments), the Majors have seen the number of borrowers on deferral arrangements come down from their initial levels.

Against this trend, provisioning levels have continued to increase as the economic outlook becomes clearer. Loan loss models built upon historical loss experiences have proven inadequate in the face of current levels of uncertainty, resulting in the Majors applying increased judgement in estimating their credit loss provisions (including significant management overlays).

It should be noted the Majors' loan provisions are still well below those seen in many other countries. There is an expectation that Australia may avoid a loan loss fallout compared to what could be experienced in other countries, given our economic outlook, greater success in managing the spread of the virus and lower risk portfolios which have favoured secured residential lending.

Despite the sharp decline in profitability, the Majors have continued to strengthen their balance sheets and maintain substantial capital buffers to position themselves for any potential future shocks. Capital levels are at record levels and their capital ratios continue to be in excess of APRA's requirements despite regulatory guidance to temporarily relax 'unquestionably strong' targets where needed to continue lending to customers.

Diagram 2: CET1 buffer



Source: KPMG analysis from ANZ, CBA, NAB, WBC annual reports.

Investors have borne the brunt of lower ROEs and the Majors' decisions to reduce payout ratios to below their pre-COVID levels in line with current APRA guidance. It remains to be seen when higher payouts will be restored, as the Majors continue to focus on maintaining financial and operational resilience.

The search for new efficiencies

Aggregated operating income declined 1.7% in FY20 to $79.3 billion, reflecting the slowdown in lending and continued downward pressure on interest margins. At the same time, costs have continued to increase as a result of operational resilience measures, customer remediation expenses and regulatory costs. The outcome is that cost-to-income ratios inclusive of significant items for most Majors have now climbed above 50%.

The Majors are challenged to find earnings growth to aid their recovery. One area where increasing activity has been observed is in partnering with and acquisitions of Fintechs to help them more quickly digitise processes, launch new products and services and build new business models. Recent examples have included the CBA-Klarna and Westpac-Afterpay tie-ups.

Outlook

On a global level, whilst significant uncertainty still exists with key economies where cases of the virus are still prevalent or increasing, financial markets have been able to withstand the initial liquidity challenges of the crisis. In Australia, the Majors have held substantially higher levels of capital and liquid assets compared to prior crises which has positioned them well to absorb significant shocks.

The cash rate and interest rate charged under the Term Funding Facility (TFF) programme is now only 10 basis points (0.10%). This, coupled with the estimated $100 billion quantitative easing programme announced, eases the pathway to recovery with the Majors benefiting from cheap funding sources.

Much of the initial government's and banks' response to the crisis has focused on preserving liquidity and their attention is now shifting to the solvency of borrowers as support measures (such as JobKeeper and JobSeeker) and loan repayment deferrals (in some cases extending out to March 2021) come to an end.

It will be important for the Majors to continue monitoring the loan deferral situation and in particular providing support for customers in hardship situations. Whilst a number of these customers may become delinquent at the end of the relief period, the Majors have significant buffers to absorb potential losses.

The following KPMG staff have made a significant contribution to the development of the full report: Danny Pang, Matthew Newell, Jonathan Tan, Hugh McMicking, Sharmani Krishnan, Nadira Dantan, Eileen Li, Shruti Hegde, Tony Kong. A copy of the full report is available here. See the report for full disclaimers. This summary is general information and does not consider the circumstances of any person.