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Editorial

At any time in the investing cycle, a strong case can be made for both buying and selling equities. There are no absolutes. Even as markets look overvalued at the end of a bull run, the optimism could play out for years to come. Investors hate to sell and then watch their shares continue running, and the FOMO of daily headlines about record highs become increasingly irritating.

The added complication for investors at the moment is the unlimited liquidity the central banks are pumping into the system. The TINA trade is real. In the past, switching to term deposits at 5% was a reasonable choice, but many feel There Is No Alternative to holding equities when bonds and deposits do not even cover the inflation rate.

This is the biggest dilemma facing investors. **Christine Benz** analyses the tension and says retirees should watch their portfolios have not become too aggressive, especially those who have not rebalanced and equities are now overweight.

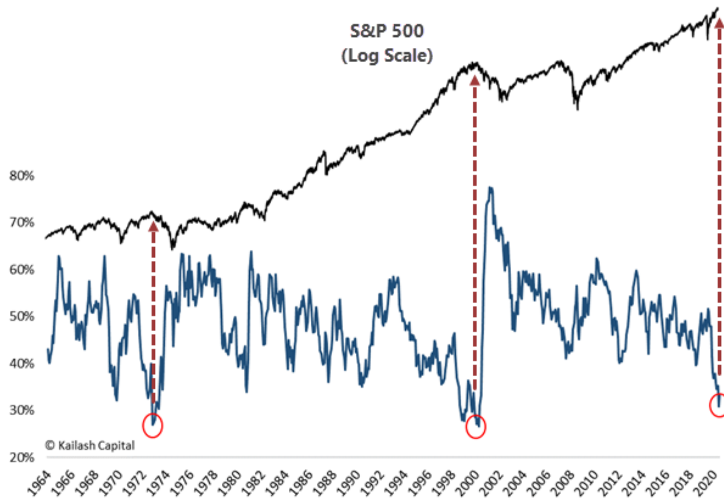
The biggest names in global investing continue to issue warnings. As **Howard Marks** noted in a recent *Bloomberg interview:*

"Fear of missing out has taken over from the fear of losing money. If people are risk-tolerant and afraid of being out of the market, they buy aggressively, in which case you can't find any bargains. That's where we are now. That's what the Fed engineered by putting rates at zero.

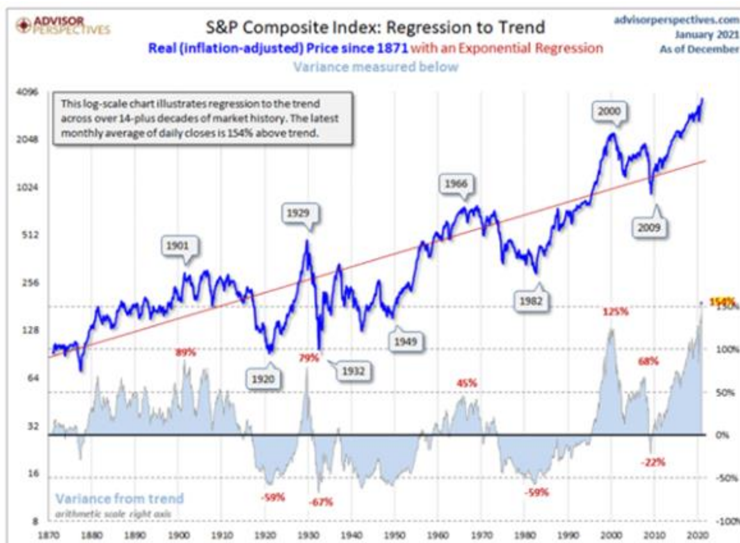
"We are back to where we were a year ago - uncertainty, prospective returns that are even lower than they were a year ago, and higher asset prices than a year ago. People are back to having to take on more risk to get return. At Oaktree, we are back to a cautious approach. This is not the kind of environment in which you would be buying with both hands. The prospective returns are low on everything."

Regardless of the expertise brought to the discussion, it's a personal decision. Nobody knows the future, but we do know that central banks and governments have discovered a stimulus nirvana and the market is ignoring the inflationary consequences. Who does not want to enjoy the equity party?

Adding to the difficulty of selecting shares, as the following chart shows, only about 30% of companies in the S&P500 beat the index over the last 12 months, close to a record low. It's no surprise that investors are flocking to index ETFs, as our first article explains, when the prices of most shares cannot match the index. Stock picking is not as easy as it looks.



Source: Sentimentrader



And, yes it's true that we often publish charts showing equity markets are expensive, and then they rise again next month. In the US, this second chart from **Advisor Perspectives** showing the S&P Composite Index is further above (at 154%) its long-term trend line than at any other time in history. As we said above, these trends can persist for years, but they do point to lower long-term returns from equities with this expensive entry point.

Plenty of people think these levels are justified by record low interest rates and central bank spending, and **Andrew Mitchell** asks what would happen to equity prices if bond yields rise. As my old colleague **Satyajit Das** writes in the AFR this week, low rates feed asset price inflation, encourage mispricing of risk and distort financial activity. Why do we assume this can go on forever?

There are few places to hide that produce decent returns, and one alternative is private debt as explained by my co-founder, **Chris Cuffe**, last year. **Simon Petris** has a good sporting analogy and provides charts showing how an allocation to private debt can improve a portfolio. It's a sector increasingly in the spotlight, and **Metrics Credit Partners** is a manager of $6 billion in this sector and they join Firstlinks as a sponsor this week.

One consequence of asset price inflation is that those with the assets - especially shares and property - are doing well while inequity rises. **Dr Rodney Brown** explains the downside of low rates and says investors should prepare for the day when governments need to address the fiscal and monetary imbalances.

Finally, two thought-provoking articles. **Andrew Podger AO** doubts superannuation funds can provide the 'optimal' drawdown arrangements proposed by the Retirement Income Review and he suggests another way forward. Then **Michael Collins** looks at Germany's attitude to Europe and the euro, and for those hoping the continent's problems will be fixed by a fiscal and political union, he gives five reasons this is unlikely to occur.

For anyone who missed my editorial on **GameStop** last week, we now include it as an article with some new paragraphs. There is also an interesting comment which supports my view that those who claim the **Reddits** beat **Wall Street** do no know who was on the other side of the trade. To quote from the comment:

"I'm aware from my industry contacts of some very large hedge fund (or private office) investors who believed that the short side guys simply had it wrong and they were long. They loved it!"

For the record, at time of writing, GameStop shares are down to US$50 from US$500. How many young Reddits suffered from a lack of 'diamond hands'?

This week's White Paper from **Neuberger Berman** continues the theme of taking a steady rather than aggressive approach to investing in a report from its most recent Asset Allocation Committee. What does the global team think?

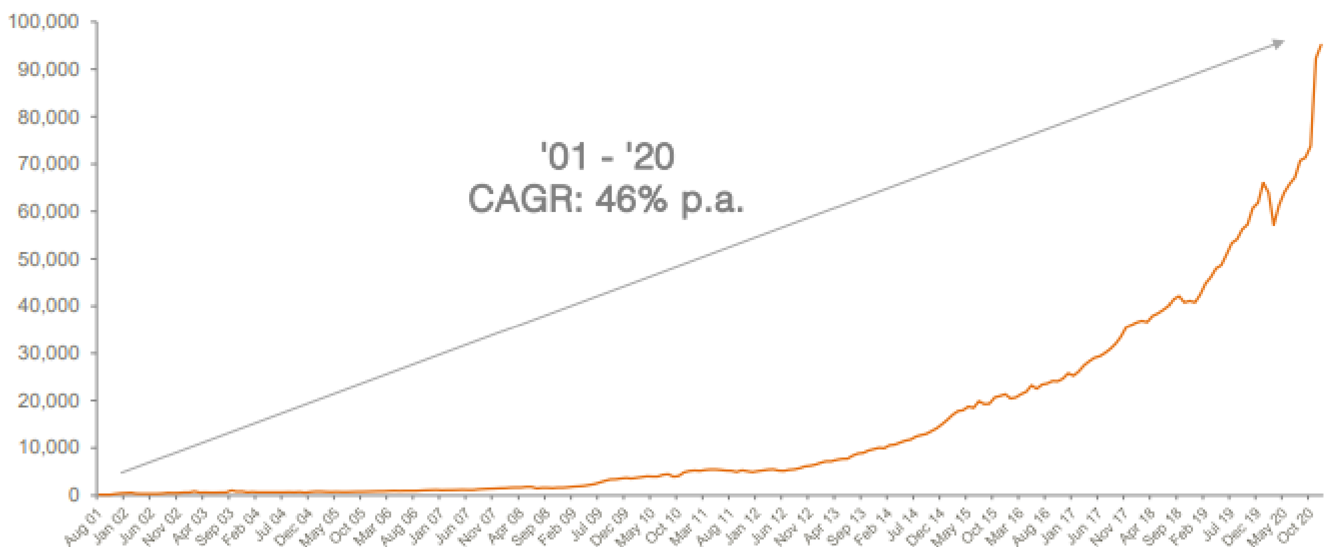
$100 billion! Five reasons investors are flocking to ETFs

Graham Hand

Any day soon, perhaps now, the Australian Exchange Traded Fund (ETF) sector will exceed $100 billion. It's a remarkable rise. It started 2020 at $62 billion, giving an increase of over 50% in a year. In the last decade, ETFs have moved from marginal usage by specialist advisers into mainstream investments, with 215 products listed on the ASX and another 11 ETFs and QMFs on Chi-X.

As well as strong inflows into ETFs, the rapid rise was boosted in December 2020 by the conversion of Magellan's Global Fund to an 'open class' which allows applications and redemptions on and off market, and this change contributed $13.5 billion. Without this injection, the increase was still an impressive 32% over the calendar year, taking the compound annual growth since 2001 to 46%, as shown in the chart below.

Total funds under management in Australian ETFs, April 2001 to December 2020



CAGR: Compound Annual Growth Rate
Source: ASX, BetaShares

Equally impressive is the fact that the increase did not rely on market movements, as the S&P/ASX200 was flat over 2020. About $20 billion of new money was invested in ETFs over the 12 months, driven by thousands of individual investors including younger people using the stockmarket for the first time. Among the ETF issuers, both Vanguard and BetaShares reported records of over $5 billion in annual net flows each.

Five reasons for the success of ETFs

1. Popularity of index funds to reduce costs

Notwithstanding the ability of active fund managers to attract investors and in some cases outperform the market, about 90% of ETF flows go into passive or index funds. There are two main reasons: first, they are cheaper, such as the BetaShares Australia 200 ETF (ASX:A200) which is the cheapest Australian equity fund with a management fee of 0.07% a year, or Vanguard's US Total Market Shares ETF (ASX:VTS) at 0.03% which tracks an index of about 3,500 US companies.

In addition, there is strong evidence that most active managers fail to outperform the index after fees over time. S&P's SPIVA Australia Scorecard reports on the performance of active funds against their respective benchmarks over different time periods, evaluating over 900 equity funds in large, mid, and small cap categories as well as 463 international equity funds. Although some dispute the analysis, the latest report shows 92% of global equity managers are outperformed by the index over 10 years, and 82% of Australian equity funds.

Investors are increasingly asking if it is worth paying for active management, and these index-tracking funds continue to hold their market share of ETFs, as shown below (source: BetaShares).

	Inflow Value	2020 (%)	2019 (%)	2018 (%)	2017 (%)
Passive	$18,445,847,075	90%	89%	88%	92%
Active	$2,082,736,787	10%	11%	12%	8%

While the broad index ETFs attract the largest flows, some sectors such as gold and tech also did well in 2020, as this table shows.

	Estimated Net Flow (Mil) 1-Yr
Vanguard Australian Shares ETF	2,192
iShares Core S&P/ASX 200 ETF	1,597
ETFS Physical Gold ETC	824
Perth Mint Gold	628
BetaShares NASDAQ 100 ETF	578
VanEck Vectors MSCI Wld ex Aus Qlty ETF	572
BetaShares Global Sstnbty Ldrs ETF	535
iShares Core Composite Bond ETF	509
SPDR® S&P/ASX 200 Fund	445
Vanguard MSCI Index Intl Shrs (H) ETF	424
VanEck Vectors Australian Fltng Rt ETF	-30
UBS IQ MSCI World ex Australia Ethcl ETF	-41
iShares Global High Yield Bond AUDH ETF	-47
Platinum Intl Fd (Qutd Mgd Hdg Fd)	-47
iShares Europe ETF (AU)	-49
iShares Core Cash ETF	-63
iShares Global Consumer Staples ETF (AU)	-64
iShares Edge MSCI World Multifactor ETF	-73
BetaShares US Dollar ETF	-75
iShares JP Morgan USD EmMkts Bd AUDH ETF	-106

Source: Morningstar Direct.

2. Desire for international investments

Like most investors around the world, Australians traditionally invested with a heavy domestic bias. This was encouraged by the franking credits generated by Australian companies, and the popularity of Australian businesses such as the big banks, Telstra, Woolworths, BHP and Wesfarmers.

However, Australians have realised that with 98% of companies by market value listed outside the country, including global tech leaders such as the FAANGs (Facebook, Apple, Amazon, Netflix, Google), a greater diversity of sectors and better exposure to the world's leading companies is needed.

Although global investments also occur directly into companies listed on foreign exchanges and through unlisted funds, global ETFs are major beneficiaries of this broader appetite. In 2020, international equities received the highest level of inflows of any asset category, at about $7.6 billion, ahead of Australian equities at $6.8 billion, as shown below (source: BetaShares).

Category	Inflow Value	Rank Movement
International Equities	$7,556,516,555	-
Australian Equities	$6,766,821,310	+1
Fixed Income	$2,432,444,758	-1
Commodities	$1,538,831,807	+3
Short	$798,757,014	+4

3. Rise of thematic funds

While major indexes attract the bulk of flows, sector-specific funds allow investors to back themes which are benefitting from changes in global trends. There is a wide range of ETFs which gives exposure to sectors such as gold, tech, robotics, commodities, agriculture, currencies, property, infrastructure and cybersecurities.

In 2020, 38 new products were launched across all categories. The year also delivered some big sector and theme winners and losers. Inevitably, the extreme ups and downs are among the special themes rather than the broad indexes.

	Ticker	Global Category	Total Ret 1 Yr
ETFS Battery Tech and Lithium ETF	ACDC	Global Equity Large Cap	62.24
BetaShares Asia Technology Tigers ETF	ASIA	Global Equity Large Cap	62.00
BetaShares Glb Rbtc & Artfcl Intlgc ETF	RBTZ	Global Equity Large Cap	37.65
Betashares Global Cybersecurity ETF	HACK	Technology Sector Equity	36.64
BetaShares NASDAQ 100 ETF	NDQ	US Equity Large Cap Blend	34.78
ETFS Morningstar Global Technology ETF	TECH	Technology Sector Equity	34.04
ETFS S&P Biotech ETF	CURE	Healthcare Sector Equity	33.61
ETFS Physical Silver ETC	ETPMAG	Commodities Specified	33.05
ETFS ROBO Glbl Robotics and Atmtn ETF	ROBO	Equity Miscellaneous	31.50
Platinum Asia ETF	PAXX	Asia ex-Japan Equity	28.36
SPDR S&P Global Dividend ETF	WDIV	Global Equity Large Cap	-19.33
SPDR Dow Jones Global Real Estate ETF	DJRE	Real Estate Sector Equity	-19.93
BetaShares Glb Banks ETF-Ccy Hdg	BNKS	Global Equity Large Cap	-20.07
BetaShares Global Income Leaders ETF	INCM	Global Equity Large Cap	-23.49
ETFS Global Core Infrastructure ETF	CORE	Global Equity Large Cap	-25.97
BetaShares Strong US Dollar Hedge ETF	YANK	Alternative Miscellaneous	-27.93
BetaShares Glb Energy Coms ETF-Ccy Hdg	FUEL	Natural Resources Equity	-33.33
BetaShares Australian Eqs Strong BrH ETF	BBOZ	Alternative Miscellaneous	-35.93
BetaShares US Eqs Strong Bear H CcyH ETF	BBUS	Alternative Miscellaneous	-48.55
BetaShares Crude Oil ETF Ccy Hgd (Synth)	OOO	Commodities Specified	-69.64

Source: Morningstar Direct.

4. Development of Active ETFs

ETFs have become a viable alternative to unlisted managed funds and Listed Investment Companies for many fund managers. It is likely that leading managers will increasingly use these vehicles and they will gradually build market share, with the likes of Munro Partners and Hyperion following up their good 2020 results with new Active ETFs.

Existing issuers include Fidelity, Schroders, Vanguard and Legg Mason. Volumes will be boosted by existing unlisted managed funds converting to listed, open-ended structures, and Chi-X recently launched a range of lower cost Magellan funds in a 'core' series.

5. Preference for listed vehicles

The unlisted managed fund industry has never succeeded into streamlining its direct investing application processes. While it is possible to access unlisted funds via a platform, and these are popular especially for consolidating investments and reporting, platforms come with additional fees at a time when informed investors are looking to minimise costs. Additionally, improved portfolio management software gives HIN-based listed investments much of the functionality of platforms without the cost.

Most unlisted application processes are stuck in the dark ages, especially for SMSFs. They require certified copies of trust deeds, identification of directors and completion of a long application form. The FATCA identification process adds more compliance, and each unlisted fund is supported by a unique website with logins and passwords.

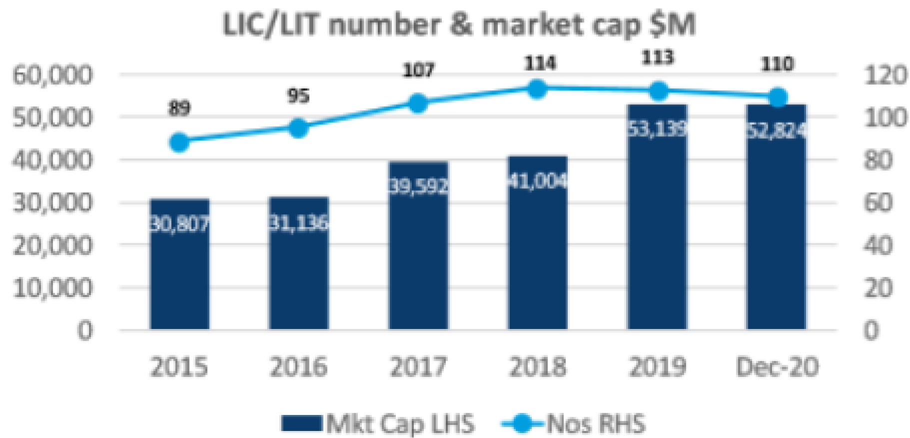
Younger investors find the simplicity of one signup with an online broker appealing, with ready access to hundreds of funds and thousands of companies at their fingertips. The more advanced platforms are now HIN-based pushing more investing online.

The stalling of LICs and LITs

As recently as a couple of years ago, in 2018, the ETF and LIC/LIT sectors were about the same size, around $40 billion. LICs have a history of almost 100 years and previously dominated the listed fund space. However, much of the LIC/LIT demand was driven by commissions paid by issuers to advisers and brokers, under an exemption from the Future of Financial Advice (FoFA) laws introduced in 2012 which prevented advisers from

receiving a commission from product manufacturers. However, this exemption was removed in 2020, and there have been no new transactions for a year. As shown in the chart below, LIC/LIT balances have stagnated.

LIC/LIT market capitalisations and number to December 2020



Source: Listed Investment Companies & Trusts Association (LICAT).

It remains to be seen whether LICs and LITs can come again. Their closed-end structure gives fund managers committed capital and they do not need to sell assets to meet redemptions, especially in times of market disruption. This has advantages for less liquid asset classes such as private debt or non-investment grade bonds.

However, prices can drift into heavy discounts to the value of the underlying assets if demand falls away. Issuers have been unable to attract enough buyers for new transactions without paying commissions to brokers and advisers. For now, most active managers are adopting the ETF structure for new transactions.

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

Guess what? It may actually be different this time

Christine Benz

It was late September 2008. I was in Provence with my husband and some extended family, enjoying my sabbatical in our perfect little rented house. But things weren't all that tranquil. The market was tumbling, and one of the family members who had joined us was in a state of panic. Although she was still years from retirement, she was convinced that she wanted to sell all of her stock holdings. The news about the markets and the state of the global economy seemed to be going from bad to worse by the moment.

Finally my husband broke through. "Are you getting ready to retire? Will you need your money soon?" No and no, she answered. "Then stop worrying and enjoy your vacation!" And amazingly, that seemed to break the spell. We snapped off the TV with its dire news about the market's drop, and our relative ignored the market and stood pat with her portfolio.

That sounds like a success story, and it was. But I wouldn't necessarily give that same family member the same advice today. No, I don't have any insight into whether the next few years will be bad for stocks. But I do know something about my relative: Now she is ready to retire and she will be drawing upon her portfolio for living expenses.

That means that the approach that made sense for her 10 years ago - don't sell any stocks! - may in fact be ill-advised today. If she hasn't taken steps to reduce her equity exposure in the interim, cutting the stake now in favour of safer investments could be the right course of action.

Selling into a downturn isn't always a bad idea

The fact that investors can vary so much in their spending horizons is the key reason why I often cringe when I hear one-size-fits-all recommendations during volatile markets. Even as well-meaning market observers exhort

everyone to “stay the course”, not everyone should. People getting close to retirement or those who are already retired are courting serious risks by standing pat with too-aggressive portfolios.

For one thing, hands-off portfolios have a way of becoming more aggressive over time. Take, for example, a portfolio that was 60% S&P 500/40% Bloomberg Barclays Aggregate Index 10 years ago. Even if an investor hadn’t been shovelling money into strong-performing stocks over the ensuing decade, that portfolio would be about 80% equity today

That ever-more aggressive positioning isn’t a problem for people who still have many years until retirement. In fact, it’s desirable, provided the investor knows not become unduly rattled (and therefore at risk of panic-selling) amid declines. While it’s not a given that stocks will outperform safer asset classes over long time periods of time, market history suggests that’s a reasonable bet. When you’re young (and by that I mean under 50), not taking full advantage of the historical outperformance of riskier asset classes is a bigger risk than being too conservative.

But those risks flip once you get close to and enter drawdown mode. At that life stage, you’re much more vulnerable to 'sequence-of-return' (or sequencing) risk. That means that if you encounter a calamitous equity market early in retirement and need to spend from the declining equity portfolio, that much less of your investments will be left to recover when stocks finally do.

Your only choice to mitigate sequencing risk, assuming your stock portfolio is in the dumps and you don’t have enough safe investments to spend from, will be to dramatically ratchet down your spending. Needless to say, that’s not something most young retirees are in the mood to do.

And here’s another thing. Your past behaviour in market declines isn’t always a great indicator of how you’re apt to behave in the next big downturn. Even if you sailed through the 2007-2009 market meltdown without undue worry or panic selling, the next downturn could prove more visceral if retirement is closer at hand and starting to seem like a realistic possibility.

It’s not fun to see your portfolio drop to $225,000 from $500,000 when you’re 45. But it’s way worse to see your $1 million portfolio drop to $450,000 when you’re 55 and beginning to think serious thoughts about the when and how of your retirement. The losses are the same; the ages and dollar amounts are different. Retirement is no longer an abstraction, so it stands to reason that you could be at greater risk of selling yourself out of stocks at the worst possible time.

How much safety is enough?

Of course, people nearing or in retirement should be sure to hang on to some stocks, too. Returns from cash and bonds are unlikely to keep up with inflation over time given how low cash and bond yields are today. To help preserve a portfolio’s purchasing power, even older retirees need the growth potential that can accompany stocks. People who are sourcing a lot of their retirement income needs from nonportfolio sources like the age pension pensions can arguably maintain portfolios that skew heavily or even mostly toward stocks, because they’re hardly spending from their portfolios.

Risk tolerance is a factor; even if an equity-heavy posture makes sense on paper, it’s a bad idea if it puts the investor at risk of dumping all those stocks at an inopportune time. Investors looking for benchmarks on appropriate asset allocation could look to Morningstar's Lifetime Allocation Indexes. However, those yardsticks don't factor in an investor's own retirement spending rate and need for liquidity.

By using expected cash flow needs to determine a portfolio's allocation, the 'bucket' approach to retirement-portfolio management can help investors determine a stock/bond/cash mix that's appropriate for their time horizons. I've created a number of bucket portfolios for retirement but the starting point when right-sizing those buckets is to figure out how much of your portfolio you'll be spending each year.

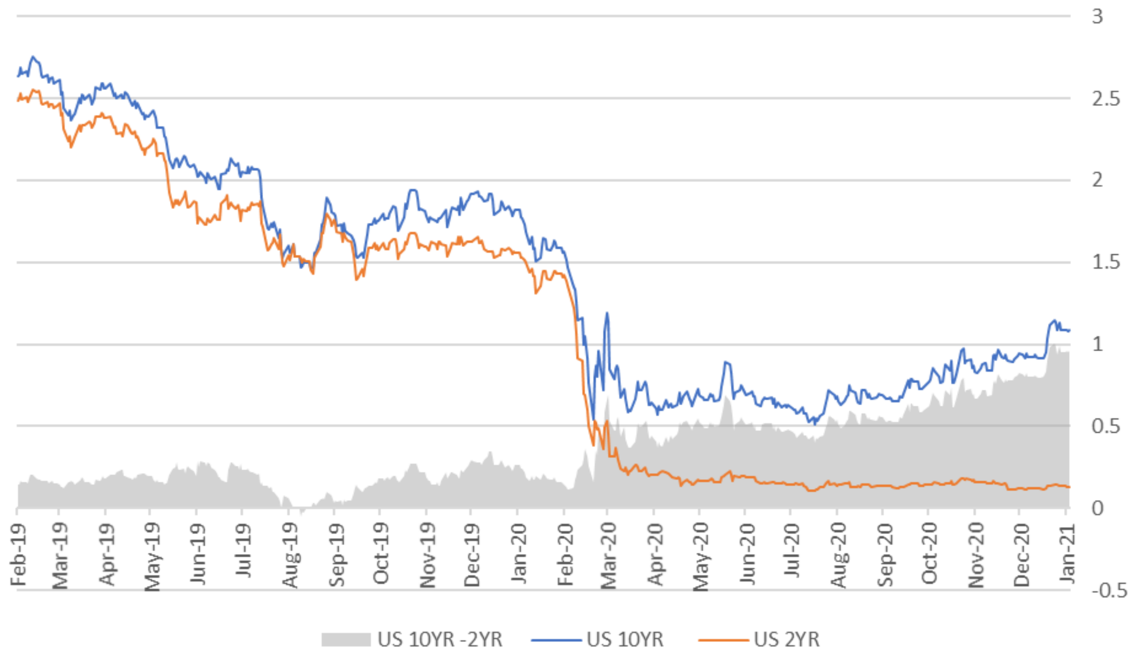
In addition, investors who are lightening up on equity exposure must be sure to watch the tax consequences, as it's possible to rebalance in a tax-efficient way. An additional tool when it comes to correcting overly-risky portfolios is withdrawing from the most appreciated and presumably highest-risk positions.

Christine Benz is Morningstar’s Director of Personal Finance. Any Morningstar ratings/recommendations contained in this report are based on the full research report available from Morningstar. This article does not consider the circumstances of any investor, and minor editing has been made to the original US version for an Australian audience.

Should equity investors fear higher bond yields?

Andrew Mitchell

Investors have focused on the bond market in recent weeks because they have seen something unfamiliar – rising bond yields. In January, the US government 10-year bond yield (the rate of interest the US government borrows at) surpassed the psychological barrier of 1% for the first time since the COVID shock began.



Given lower bond yields have been used to justify higher share market valuations for much of the last decade, rising yields could pose a threat to equities.

Seasoned investors have been arguing for years that equity valuations have become dangerously dependent on the persistence of historically low bond yields.

While we don't believe the rise in bond yields is dangerous yet or reflects the threat of a sharp acceleration in inflation, rising yields will likely be a headwind in gains for equities. And that means that if investors want to generate strong returns from equities in coming years, they will need to focus on stock-picking skills.

Why bond yields have been heading higher

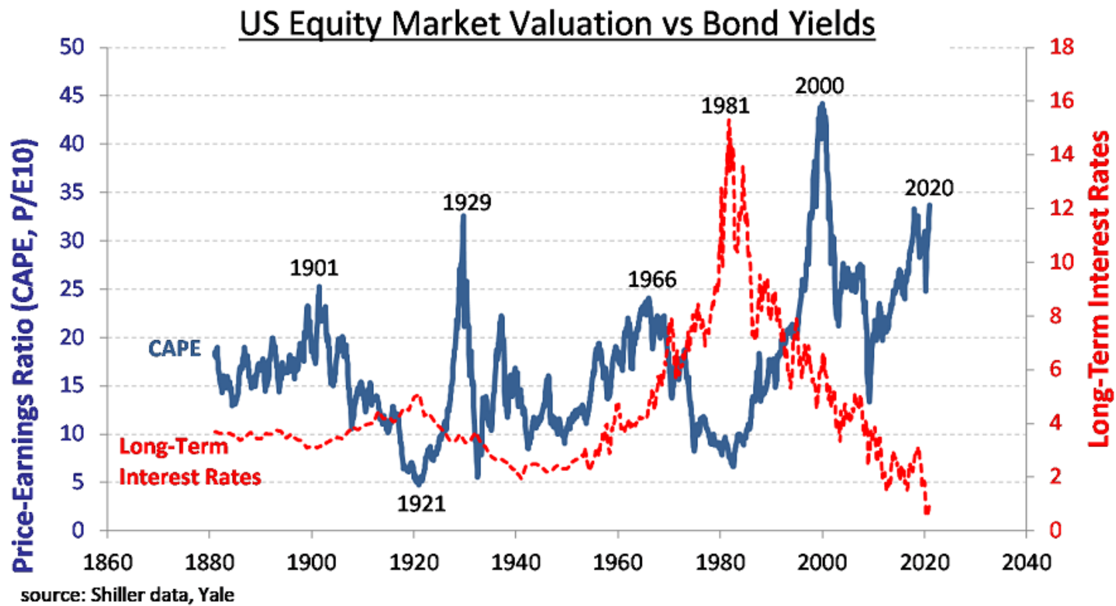
Expectations around economic growth and inflation have driven bond yields higher. The emergence of effective coronavirus vaccines has triggered optimism that the global economy will rebound powerfully in 2021. The Democrat control, of the US Senate has also increased their ability to drive through a reflationary economic agenda.

Yet even as the pandemic recedes, it appears central banks are set to maintain policy rates at or near zero, further allowing inflation pressures to build. This comes as the US Fed, as well as the Australian RBA, want to now wait longer to see actual inflation (rather than expected inflation) heading sustainably higher before they start lifting interest rates.

How bond yields affect equity valuations

Bond yields are an important determinant of equity valuations. When bond yields go down, share market valuations tend to rise … and as bond yields go up, share markets tend to falter.

The relationship may not exactly hold in the very short-run but it becomes more clearly visible over longer time periods as can be seen in the figure below (cyclically-adjusted price-to-earnings ratio used a share market valuation measure).



There are three key and interrelated factors that link bond yields with equity valuations:

- Firstly, bond yields drive the opportunity cost of equities. If, for example, the 10-year bond is yielding 5% per annum, then equities only become attractive if they can earn well above 5%. In fact, because equities are riskier than bonds, investors demand a 'risk premium' to justify owning them. The long-term average risk premium on equities is 5%. So a 10% return - the 5% investors could get from bonds + the 5% risk premium - will act as the opportunity cost for equity. Below a 10% return, it makes less sense for investors to hold equities because they are not being compensated for the additional risk. As bond yields go up, the opportunity cost of investing in equities also goes up, and equities become less attractive.
- Secondly, bond yields also impact the cost of capital in valuing equities. The yield on bonds is typically used as the risk-free rate when calculating this cost of capital. When bond yields go up, the cost of capital goes up. That means that future cash flows get discounted at a higher rate, meaning a $1 of cash flow received in the future from a company is worth less today. This compresses the valuations of these stocks.
- Thirdly, bond yields impact financial costs for companies. When bond yields go up, it is a signal that corporates will have to pay a higher interest cost on debt. As debt servicing costs go higher, the risk of bankruptcy and default also increases, typically making highly leveraged companies vulnerable.

Good and bad market volatility

Although bond yields do impact share valuations, investors should be more worried about losses that result from a downward revision of a company's earnings potential than losses caused by an increase in interest rates (all else equal).

The former suggests a market assessment that there is now a greater chance that the business will fail to deliver its expected earnings growth. While losses from increasing rates indicates the adjustment of the rate of discount, without a revision of market views on the company itself.

Indeed, to achieve long-term success, investors should distinguish between good and bad volatility. Private investors often regard any loss as bad news, but it may be an opportunity to lock in access to higher future income.

For example, a move up in bond yields allows investors to buy and lock in future income at a lower cost. That's good news for anyone saving for a pension or an education endowment. For superannuation savings plans, it means that more future pension income can be bought with each new dollar of saving.

Should investors be worried?

The critical question is whether the current move up in bond yields goes beyond a healthy reflation that reflects the post-pandemic economy, and surges into inflation.

At the moment, markets are positioned for the former: that is, the economy will recover, inflation will stay under control and interest rates will remain low.

Even under this scenario, investors should still factor in that equity valuations are likely to be pressured over coming years as interest rates trend higher. This means that strong equity returns will have to rely more on actively selecting the stocks that can generate sustainable earnings growth, and less on free kicks from falling bond yields and central banks cutting interest rates.

Or in other words, a greater proportion of returns are likely to come from stock picking skill rather than a rising tide lifting all boats (read: companies) in the market.

Andrew Mitchell is Director and Senior Portfolio Manager at Ophir Asset Management. This article is general information and does not consider the circumstances of any investor.

Read more articles and papers from Ophir here.

The attacking defender: position for downturns with private debt

Simon Petris Ph.D.

The investor Diego Parrilla is well known for making the analogy between constructing a successful investment portfolio and building a successful soccer team. It's possible to extend this analogy to private debt, which can provide a winning blend of attack and defence in an investment portfolio. Let's look at how this analogy works.

Attacking and defending

In soccer, the aim is to score as many goals as possible to win. In investing, earning income and generating capital gains are akin to scoring goals. But it's not enough just to score goals to win the game. The successful team also needs to stop the other side from scoring by defending their position. We can think of this as the portfolio manager's role of preserving capital and reducing drawdowns.

Let's put the whole team together. The table shows the role of each asset class in a portfolio corresponding to the role in a soccer team.

Role in an investment portfolio	Role in a soccer team
Investor/allocator	Coach/manager
Listed equities Venture capital Private equity	Strikers
Commercial property Infrastructure Hedge funds	Midfielders
Corporate bonds Gold Inflation-linked bonds	Defenders
Private debt	Attacking Defender/Wing Back
Sovereign bonds	Goalkeeper
Cash to buy attackers or defenders as required	Interchange bench
Unlisted assets	Players on long-term contracts who are more difficult to transfer out of the team than their listed counterparts on short-term contracts

A successful team in both soccer and investing has a diversity of players or investments. To succeed, each has different strengths, skills and roles to play. Fielding a team that's full of attacking players is like building an investment portfolio with too much equity beta (share market volatility risk) and is only effective in a raging bull market.

As it’s skewed too much towards attacking and not focused enough on defending, this unbalanced team or portfolio will get caught offside too often and ultimately concede too many goals or drawdowns in most circumstances.

In a well-balanced portfolio, private debt plays the role of the attacking defender or wing back. This is a critical position in every successful investment portfolio and soccer team. Its purpose is to enter the final attacking third and help their team to score, without neglecting the defensive duties at the other end of the field.

In the same way, private debt provides a regular and stable source of income, akin to the soccer team’s attacking qualities, while maintaining a core focus on capital preservation, which is about defence.

Some of the best attacking defenders of all time include Dani Alves, Cafu, Roberto Carlos, Ashley Cole, Bixente Lizarazu, Phil Neal and Javier Zanetti. While they may not be as well-known as famous strikers and attacking midfielders like Messi, Pele, Ronaldo and Zidane, these wing backs have played crucial roles in some of the most successful international and club teams of all time. In a world of zero interest rates where income is hard to source, private debt can also provide that winning blend of attack and defence.

Positioning for downturns with private debt

Investors turn to defensive alternative allocations to diversify risk and supplement income. In a world of market uncertainty and low interest rates, private debt is an increasingly important fixed income option. It can protect capital, provide a reliable income stream and is uncorrelated to traditional bond and equity markets.

As markets work through the impact of the COVID-19 pandemic, accessing stable income is becoming difficult for investors to achieve without climbing too far up the risk curve. Unlike other asset classes, private debt can also give investors more certainty they will get their money back, alongside interest or coupon payments. The regular income can either be spent on living expenses or used to rebalance the portfolio as opportunities arise.

What is private debt?

Private debt or private credit involves lending capital as an investment to an entity in exchange for a defined amount of interest and the return of the original capital at a defined point in the future. The investment manager originates and structures the debt via fully disclosed contracts that typically include security over assets and other structural protections.

Like private equity, private debt involves a private company or entity that needs capital for growth or other business plans. Private debt is patient capital and the investment managers who work in this area appreciate the benefits of investing in illiquid assets that can provide excess return over the long term.

Negative correlation key to downside protection

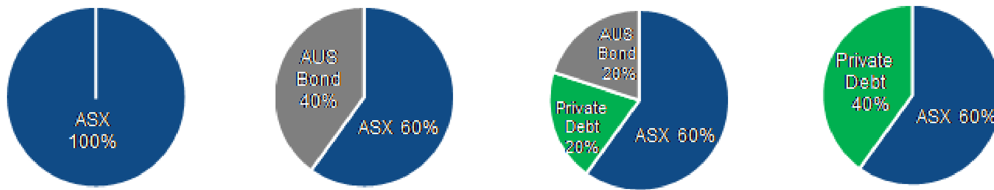
As its performance is largely uncorrelated to equities, returns from private debt help dampen listed market drawdowns in times of market stress.

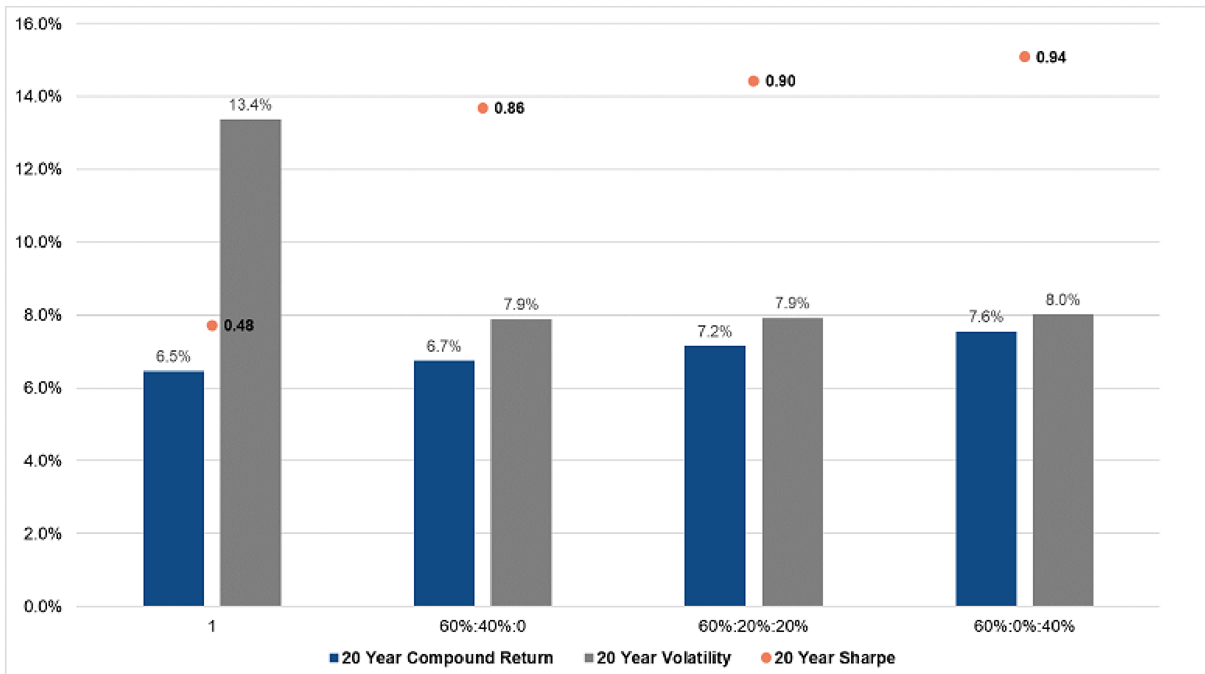
To illustrate this, we provide a study using the last 20 years of data combining a private debt benchmark based on BBSW plus a gross credit spread of 450 basis points (4.5%) less 50 basis points (0.5%) of modelled credit losses, which is consistent with big four bank loan books, and using the actual net returns from the Revolution Private Debt Fund I for the most recent two years.

Let’s compare the correlations, compound returns and volatility outcomes for a range of portfolio constructions shown below:

- 100% exposure to Australian equities based on the ASX 200 Accumulation Index.
- 60% exposure to Australian equities and 40% exposure to traditional fixed income with the Bloomberg AusBond Composite 0+ Yr Index.
- 60% exposure to Australian equities, 20% exposure to fixed income and 20% exposure to private debt.
- 60% exposure to Australian equities and 40% exposure to private debt.

Portfolio inclusion of Australian and New Zealand private debt
Compound returns and volatilities over a 20-year period (2001 to 2020)





Sources: Bloomberg, analysis by Revolution Asset Management. Past performance is not indicative of future performance. Provided for illustrative purposes only. ASX refers to the S&P/ASX200 Accumulation Index and AUS Bond is the Bloomberg AusBond Composite 0+ Yr Index.

Australian private debt is negatively correlated with the ASX200 Index

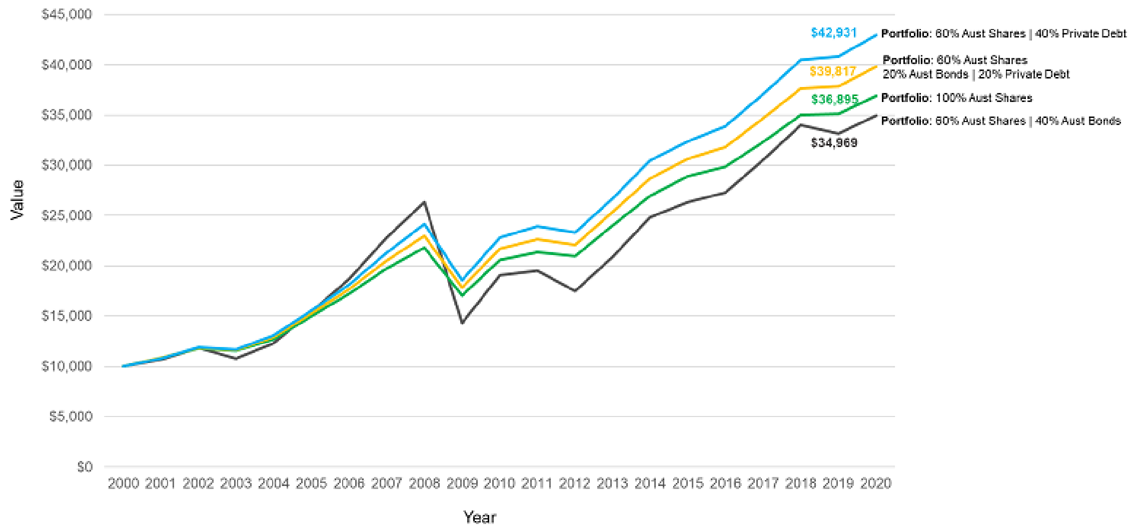
	S&P/ASX Total Return 200 Index	Bloomberg AusBond Composite 0+Yr Index	Revolution AUS Private Debt Index
S&P/ASX Total Return 200 Index	100%		
Bloomberg AusBond Composite 0+Yr Index	-21%	100%	
Revolution AUS Private Debt Index	-8%	13%	100%

Let’s examine the potential growth of an initial $10,000 investment over this 20-year period. This analysis demonstrates how an allocation to private debt can help to achieve better return outcomes and smooth out returns in a balanced portfolio.

This portfolio delivers superior returns and lower volatility or capital stability when an exposure to Australian and New Zealand private debt is included in the portfolio, which translates to a higher portfolio Sharpe ratio. This ratio helps investors understand an investment’s return versus its risk.

These results are impressive given 20 years ago the 10-year government bond yield and the RBA cash rate were both above 5%. These starting points are far more favourable to traditional fixed income versus the current 10-year government bond yield of 1.1% and RBA cash rate of just 0.10%.

Growth of $10,000 over a 20-year time horizon



Sources: Bloomberg, analysis by Revolution Asset Management. Past performance is not indicative of future performance. Provided for illustrative purposes only.

Private debt complements other exposures

Much like private equity is often considered a core allocation alongside listed equity, private debt is an increasingly popular allocation to complement existing traditional fixed income allocations. The illiquidity premium is one of private debt's key attributes. Private debt, just like private equity, doesn't have a liquid secondary market. Liquidity risk needs to be carefully and individually assessed by each investor. Investors suited to this type of investment tend to have a long-term investment horizon and a buy-and-hold approach to this part of their portfolio.

One criticism of this study may be the modelled level of losses is too low. The manager's ability to add returns is critical, assuming the big four banks' loan books are a proxy for the market exposure to private debt.

As a soccer team prepares for an unfamiliar opposition each week, it makes sense to include an attacking defender in the line-up. As markets evolve, investors will continue to seek returns that provide genuine diversification in their portfolios. Protecting against downside risk, generating uncorrelated and reliable income, and being prepared to protect against either inflation are also key concerns.

Revolution's goal is to be the attacking defender in investor portfolios and deliver private debt strategies that solve the need for income with capital protection.

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Taxing the 'rich': the potential tax consequences of inequality

Dr Rodney Brown

Writing recently in Firstlinks, Andrew Macken enlightened us on the drivers and consequences of inequality and how investors can prepare their portfolios accordingly. He pointed out that inequality reduced dramatically after World War II due in part to higher taxes. The potential for new taxes specifically targeted at the 'rich' is explored in this article.

The gap between rich and poor is widening

The widening gap between the 'haves' and the 'have nots' is indisputable and an unfortunate outcome of our economic system. The COVID-19 pandemic has illuminated the problem with the combined wealth of Australian billionaires rising by more than 52% from December 2019 to December 2020. House prices have reached record levels and stock markets have been catapulted to new heights, bringing good fortune to those holding such assets.

By comparison, regular families have experienced stagnant wages, unemployment, continued low levels of home ownership and increasing debt and in many cases have tapped their superannuation early just to survive. Internationally, a recent Oxfam report claims the combined wealth of the world's 10 richest individuals rose by US$540 billion during the pandemic and concludes that current policy settings have allowed:

"a super-rich elite to amass wealth in the middle of the worst recession since the Great Depression, while billions of people are struggling to make ends meet".

Such statistics have led many to question the capitalist system and demand the rich contribute more.

Unlikely warning voices

Calls for action have come from some unlikely places. As recently as this week, a London-based asset manager opined in the Financial Times that a wealth tax would support the pandemic recovery and reverse part of the long-term increase in wealth inequality. Two weeks ago at a recent Davos World Economic Forum, Russian President Vladimir Putin cautioned that the pandemic and rising inequality has created alarming parallels to the 1930s and warned that a failure to address these tensions helped trigger Word War II.

In December, hedge fund billionaire Ray Dalio warned that political and wealth gaps in the US could lead to conflict and even civil war.

Based on the mind-boggling statistics above, it is easy to mount an argument for taxing the rich more based on fairness grounds. However, notions of 'fairness', 'rich' or 'wealthy' are challenging because of their subjectivity and there is no widely accepted view on what is fair or who is rich or wealthy.

Recent house price data from Domain for the December quarter reveals that the median house price in Sydney reached a record high of more than $1.2 million. But anyone living in Sydney knows that if you own a house of median value, you are by no means 'rich' or 'wealthy' lending support to Warren Bird's argument in Firstlinks that millionaires are not wealthy.

Furthermore, the latest official data reveals the average Australian household has a net worth of $1,022,200 with half of Australia's households having a net worth of $558,900 or more, further clouding the distinction between 'rich' and 'poor'.

Recent international developments

Globally, government responses in the form of direct income support and other fiscal measures have been extraordinary and necessary but the fiscal consequences could last a generation. To help address the burden, some countries have introduced controversial measures. For example, in early December, Argentina passed a new one-off tax on its 12,000 wealthiest citizens - those with assets worth more than 200 million pesos (US$2.5 million). The so-called 'millionaires' tax' is a progressive rate of up to 3.5% on wealth in Argentina and up to 5.25% on wealth held outside the country and is expected to raise around 300 billion pesos to purchase medical supplies, provide relief to small and medium-sized businesses, and help poor neighbours.

It has led to similar calls in the UK for the imposition of a one-off wealth tax on the super-rich. The Wealth Tax Commission, a group of leading tax experts, academics and policymakers, issued a report in December stating that targeting the richest households would be the fairest and most efficient way to raise taxes in response to the pandemic. Their modelling claims that a levy of 1% on the value of household assets over a £1 million threshold could raise £260 billion over five years.

Theoretical options for new taxes on the 'rich'

The effectiveness of wealth taxes rests heavily on the thresholds set, which assets and liabilities are in-scope and the rates that apply. Prior to the pandemic, wealth taxes were not particularly popular amongst OECD nations. According to the latest statistics (up to 2018), only five OECD countries (Colombia, France, Norway,

Spain and Switzerland) levy a recurrent tax on individual net wealth. However, the revenue raised from these taxes is relatively small at an average of approximately 0.2% of GDP.

An OECD report in 2018 on the role and design of net wealth taxes concludes that:

"from both an efficiency and equity perspective, there are limited arguments for having a net wealth tax in addition to broad-based personal capital income taxes and well-designed inheritance and gift taxes".

However, the report also argues that:

"capital income taxes alone will most likely not be enough to address wealth inequality and suggests the need to complement capital income taxes with a form of wealth taxation".

Australia has a progressive income tax system and taxes capital gains, although the latter are taxed concessionally in many instances. Arguably, Australia relies too heavily on direct income taxation and should tax unearned income or idle wealth more heavily.

Inheritance taxes (otherwise known as 'death duties' or 'bequests taxes') existed in Australia until the late 1970s. Today, Australia is one of only a handful of OECD countries not to tax inheritances. While inheritance taxes are relatively efficient (they have little impact on incentives to work and save), they raise little revenue compared to income or consumption taxes.

In the UK, the standard inheritance tax rate is 40% and is charged on that part of the deceased's estate above a £325,000 threshold. In recent years there have been calls for the introduction of inheritance taxes in Australia, New Zealand and Canada to address housing affordability, aging populations and growing inequality.

Realistic options for Australia

Last year, I outlined some general options the government could use to start repairing the fiscal hole caused by the pandemic including the unwinding of the legislated personal income tax cuts (in fact, these were brought forward!).

However, options such as the resurrection of a 'Temporary Budget Repair Levy' remain and could easily be modified to ensure a greater contribution from those deemed 'wealthy' or 'rich'. Other options touted for some time include the reduction of the CGT discount (to 40% or 25%) and limits to negative gearing. These tax concessions are enjoyed primarily by the 'haves' as opposed to the 'have nots' so a reasonably arguable case for reducing them could be made on equity grounds.

The findings of the Retirement Income Review delivered in November raised intergenerational equity issues. For example, it found that most retirees leave the bulk of their retirement savings as a bequest instead of drawing down on it to fund their retirement. This raises the question of the purpose of the superannuation tax concessions which are meant to assist with the building of future retirement income and not purely for wealth accumulation. This could impact many investors if a higher tax rate is applied to superannuation bequests paid to non-dependants (currently 15%) to recoup the tax breaks not utilised in retirement.

The Review also suggests there has been insufficient attention given to assisting people to optimise their retirement income through the efficient use of their home equity and concludes that the pension system favours homeowners through the exemption of the principal residence from the age pension assets test. Accordingly, the age pension means test could be adjusted to include part of the value of the family home over a certain threshold, say $1 million, to address taxpayer subsidisation of property inheritances and to ease the pressure on the pension system.

What can investors do?

Investors should think more proactively and strategically about the tax positions of their investment portfolios, including liaising with financial advisers and tax specialists (e.g., timing of asset sales, the entity within which assets are held, general estate planning) based on their circumstances and the current rules. However, they should keep an eye out for any significant trends emerging in the tax landscape.

One thing is certain, the debt repair challenge thrust upon the government is too large to be addressed through normal means once the economy recovers. At some point, the politicians will start debating how to reduce the national debt but this time they may bow to societal pressures arising from rising inequality and implement measures aimed at simultaneously easing budget pressures while reducing the gap between rich and poor.

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Germany will do the minimum to support the euro … and Europe

Michael Collins

Remember the GFC?

In September 2008, UK authorities realised troubled mortgage lender Bradford & Bingley could topple the country's financial system. Belgium-based giant Fortis faced closure. The French administration of President Nicolas Sarkozy was battling to save Franco-Belgian lender Dexia. The German government of Angela Merkel was preoccupied with rescuing Hypo Real Estate. Then the three biggest Irish banks, whose balance sheets amounted to 700% of Ireland's GDP, tottered. A panic-stricken Dublin effectively bankrupted the country by guaranteeing the deposits and liabilities of the country's six largest banks.

Little love lost between leaders

To save Europe's financial system, the Dutch government proposed each country should establish bank-rescue funds on a common basis by contributing 3% of GDP, which would amount to 300 billion euros. Sarkozy supported the joint measures and invited the leaders of Germany, Italy and the UK to Paris to discuss the idea, which Italy quickly backed.

But Merkel denounced the proposal and threatened to boycott the Paris gathering if it was called a "crisis" meeting. The summit went ahead but failed to agree on joint solutions. Sarkozy blamed Merkel. "You know what she said to me? Chacun sa merde. (To each his own shit)."

Now, German officials denied Merkel used such French. They said Merkel quoted Goethe in German that 'everyone should sweep in front of his door and every city quarter will be clean'. Whatever Merkel said, both responses describe Germany's ambivalent attitude towards securing the future of the euro during the GFC and the eurozone debt crisis of 2010 to 2015.

Germany has just done enough in the past

Many times when the euro's future needed cementing, Germany watered down or refused joint solutions if they imperilled German taxpayers. Berlin vetoed fiscal-transfer solutions, ruled out sovereign debt pooling (eurobonds) and thwarted the proper banking union needed to snap the 'doom loop' between banks and governments. Berlin delayed, then constrained, European Central Bank remedies such as quantitative easing. It placed an inadequate cap on the European rescue fund.

From 2010, to deal with Greece's insolvency, Berlin opposed the default the country needed, inflicted measures that impoverished Greek society and sanctioned bailouts that only rescued foreign banks. In 2011, Berlin imposed austerity across Europe despite the huge social costs inflicted. In 2012, Germany initially disowned ECB president Mario Draghi's 'whatever it takes' comment that saved the euro.

Yet, over these years, Germany always did enough to preserve the eurozone, even at some risk and cost to German treasure. Berlin sanctioned the small rescue fund and authorised baby steps towards a partial banking union. Merkel permitted ECB asset-buying and swung behind Draghi's whatever-it-takes bluff. In 2020, Merkel probably performed the biggest U-turn of her career when she approved a 750-billion-euro recovery package funded by eurobonds. But the stimulus was a one-off, paltry and delayed.

Confusion about Germany's intentions for the euro has given birth to the German verb 'merkeln', meaning to dither. Germany's ambivalent attitude and minimalist approach to the euro could be tested again soon enough and possibly before Merkel retires as leader in September after 16 years as chancellor. The covid-19 pandemic has ravaged Europe's economy, jolted anew by a winter-wave of infections.

Ultimately, the best solution for the currency union in its current state is for it to be enmeshed in a political and fiscal union that would allow German wealth to flow to weaker parts of the eurozone.

But German leaders are unlikely any time soon to take such breakthrough steps for five reasons.

The **first** is the natural selfishness of sovereign bodies as shown by how parochial Australian states turned during the pandemic.

The **second** is that Germany's recent history makes it reluctant to lead.

A **third** reason is the German view that its neighbours have heaped misfortune on themselves.

A **fourth** is disquiet that the lax monetary policy of the ECB penalises German savers and subsidises undeserving southerners.

The **fifth** reason, perhaps the most obscure, is that rising inequality in Germany acts against a consensus that Germany should dispense its resources to save Europe – after all, many Germans think it is they who need help. So expect Berlin to do only the minimum required to hold together the currency union in its present form.

Germany reluctant to drive complete union

To be sure, a big-enough emergency coupled with 'enlightened self-interest' could prompt Berlin to take grand steps towards the political and fiscal union the euro demands because if the eurozone fails Germany will suffer too. Debtor countries and other creditor countries, not just Germany, could determine the destiny of the eurozone.

But no euro user approaches Germany's pivotal position to determine the currency's fate. Even amid sporadic crises, the eurozone could stumble along as an incomplete currency union for decades yet. Germany has no intention of pulling out – the euro keeps German exports more competitive than would a return to the Deutsche mark.

It's just that, if need be, German policymakers will find it hard to win their population's assent to take watershed steps to secure the euro. Thus, keep in mind either of the comments attributed to Merkel in that 2008 emergency meeting next time the eurozone is engulfed in crisis and that while Berlin can take only a minimalist approach towards the euro, the currency's future will never be guaranteed.

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The challenge of completing Australia's retirement income system

Andrew Podger AO

The Retirement Income Review (Callaghan) Report concluded that the Australian retirement income system is effective, sound and its costs are broadly sustainable.

While the Review's terms of reference were 'to establish a fact base' rather than make recommendations, the Report has a very clear overall message: that we should now focus on settling the pensions phase of the system, moving on from the focus up until now on the accumulation phase. That is a message many of us have been pressing for several years now.

9.5% not enough for vulnerable groups

Should the Government decide not to proceed with the legislated increase in the superannuation guarantee (or at least not the full increase to 12%), citing the Report's evidence that optimal use of savings accumulated at the current 9.5% can deliver adequate retirement incomes for those on median incomes or below, there must be a *quid pro quo.* The Government should fix the outstanding problems in the pensions phase that are causing sub-optimal use of savings and leaving gaps for particular vulnerable groups. Unless these problems are resolved and retirees fully utlilise their savings, then as the Report finds, an accumulation rate of 9.5% will not deliver adequate retirement incomes.

Unfortunately, Callaghan is not very helpful about the solutions to these problems. The Report highlights the underlying problem of complexity and suggests the need for much greater cohesion particularly between

superannuation and the age pension, but it offers no support for any of the practical solutions it canvasses. Strangely, it also questions the value of the measures available to directly increase support for those facing the greatest financial stress without offering alternatives.

Difficult optimal drawdown solutions

The Report's 'optimal' use of superannuation is questionable. It is doubtful that funds could offer the drawdown arrangements it involves: these are highly complex as they are designed to reduce real superannuation incomes as people get older to offset exactly real increases in the age pension, with superannuation balances dropping to zero at age 92.

The optimal use also assumes that 5% of the savings will be directed into a deferred lifetime annuity from age 92. But the market for life annuities is already struggling and the likelihood of funds being able to offer an annuity that does not start to be paid until 25 or more years into the future seems extremely unlikely. This 'optimal' arrangement would also still leave unused some of the accumulated savings whenever the person died before age 92.

Much more likely models for sensible use of superannuation, consistent with the objectives of the system, would include life annuities from retirement (requiring most of the savings) with the remainder available for spending in the first decade or so for holidays and other active retirement living consumption; a small amount might be retained as insurance against unforeseen events but, as Callaghan rightly says, there is significant public insurance for health and aged care.

Such models would of course need to vary depending on the person's accumulated savings and the extent to which they should sensibly rely on the age pension, including for managing longevity risk. But for most people, the simplicity and security involved in having some form of life annuity starting at retirement should be most attractive. And if the funds claim they cannot offer life annuities, the Government should step in and sell them.

The Report's emphasis on avoiding any real increase in total retirement income (super plus age pension) while acknowledging that the pension itself should increase in line with community incomes, would also cause some anomalies. As people age, retirement incomes at lower income deciles would become increasingly compressed. The more likely models involving CPI-indexed life annuities would, setting aside the funds kept for early consumption, lead to a pattern of regular income growth somewhere between wage indexation (for those reliant solely on the pension) and CPI indexation for those not reliant on the pension at all. Such a gradation would avoid the anomaly the Report's 'optimal' model would cause.

Struggling to define income in retirement

While following the [2014 Financial System Inquiry] the Government has lent support to requiring funds to offer 'Comprehensive Income Products for Retirement' (CIPRs), it is now high time to advance that agenda and to clarify what the CIPRs should look like. It is disappointing, however, that the Callaghan Report fails to provide useful guidance in this regard, especially as the progress in introducing CIPRs has been very slow and without them the Report's key conclusion does not stand up.

Further work is also still needed to confirm or otherwise that key conclusion that appropriate use of superannuation savings would lead to adequate retirement incomes for those on median income at the current 9.5% superannuation guarantee.

Despite my previous advocacy for the SG to increase to 12%, my suspicion now is that Callaghan's conclusion will not be far out. Of course, those on higher incomes need to supplement the SG with voluntary savings. The Report mentions the [FitzGerald finding] in 1993 that, in the absence of the age pension, people would need to save around 18% for an adequate retirement income, a rate not dissimilar to the 20% OECD average contribution rate (or the rates applying in most existing Commonwealth Government schemes (including employee contributions)).

Even with the high drawdowns the Report uses, the marginal increase in net retirement incomes from marginal additions in savings are very low. This suggests that, at the margin, the trade-off between incomes during working life (reduced by such extra savings) and incomes in retirement (very slightly increased at best) is extremely poor, and certainly not justified when the extra savings are compulsory. It is concern about just such trade-offs that the Report elsewhere emphasises when questioning the need to increase the SG.

While concluding that the level of the pension is sufficient to protect people from poverty if they own their own homes, the Report highlights the extent of financial stress faced by retirees in private rental accommodation

and those involuntarily retired before age pension age. But the Report does not lend support to the most obvious measures to reduce this stress.

Housing inequity

The Report rightly draws attention to the inequities involved in treating assets held in the home differently to other assets. There is little doubt that, in principle, the value of the home should be taken into account in the means test (and also treated more equally with other savings in the tax system). But home ownership is rightly seen as one of the pillars of the retirement incomes system, providing both security and income-in-kind. With home ownership, the age pension ensures adequate protection from poverty.

The difficulties with including the home in the means test go well beyond the obvious political ones given over 100 years of exemption. Apart from identifying an appropriate threshold (or thresholds based on location), it would be essential to ensure easy access to an income stream funded by the home assets for those left with insufficient age pension support.

The current Pension Loans Scheme goes a little way towards helping people draw on their home assets to supplement their age pension, but there would be considerable advantage if many more home-owners had access to income streams financed from their home assets, particularly amongst the current cohorts of retirees who do not have substantial superannuation savings. This would enhance the retirement incomes system whether or not action was taken to include the home in the means test. It should not be difficult to design market-based schemes with appropriate consumer protection to guarantee occupancy and to limit the net reduction in the person's home equity. If the market has difficulty offering such products, however, there is a strong case for the Government to extend the existing scheme, based on repayment from the eventual estate.

A step towards more equitable treatment of renters *vis-à-vis* home-owners would be to increase the gap between the assets test threshold for renters above that for home-owners.

Taxation of Superannuation

The Report highlights its assessment of the cost of tax concessions for superannuation and that they are concentrated on those with higher incomes. But this analysis is premised on how tax concessions are defined and the benchmark against which they are compared. The Annex at pages 407-409 briefly canvasses the issues involved but the approach taken remains questionable.

The Report argues that the concessions should be benchmarked against 'what is' rather than 'what should be', where 'what is' refers to the existing 'comprehensive income' tax treatment of other savings i.e. taxing both contributions and earnings at the individual's marginal rate of tax but exempting any tax on final spending (or TTE). Some account is taken of the likelihood of changed savings behaviour under such a tax regime, but this is assumed to be small as the superannuation savings are mostly compulsory.

For good reason, however, superannuation could never be taxed this way. The Henry Report, like previous studies, argued that the TTE approach taxes savings excessively discouraging savings. Just because super is largely compulsory is surely no justification for over-taxing it. The degree to which TTE is excessive increases with the length of time the savings are held, as a recent report by TTPI demonstrates, because the tax on earnings is effectively a wedge that compounds. The research mentioned in the Report clearly favours TEE or EET regimes (particularly for longer-term savings) or regimes that also have a modest tax on earnings (TtE or EtT).

Yet the Report's figures highlight the 'concession' on how earnings are taxed in particular, revealing that those on the highest incomes and who are the oldest (and hence have held their superannuation savings the longest) are gaining the most 'concessions'. In terms of any reasonable counterfactual, that is misleading.

Moreover, it plays into the hands of those interest groups who believe there is a magic pudding of tax revenues available for redirection from the wealthy to their particular priorities.

The case for an EET regime for superannuation is actually very strong. Pension schemes overseas generally take this approach as we still do in Australia in the case of the old public sector benefits promise schemes. This is not just because most overseas schemes have no identifiable contributions (or earnings) that could be taxed but also because they are generally compulsory and cannot be accessed before retirement: they do not provide any taxable capacity when they are accumulating. Moreover, the savings are very long-term, generally around 40 years.

Research a few years ago commissioned by the Committee for Sustainable Retirement Incomes suggested that the post-Turnbull reformed ttE tax arrangements were broadly equivalent to an EET regime and hence about right (the CSRI accepted that shifting directly to the preferred EET regime is too hard now). The progressive tax on contributions flows through to the pensions phase, and hence the conclusion about being broadly equivalent to EET applies at all income levels.

Perhaps, as Callaghan seems to be pushing, the tax on earnings could be extended to superannuation held in the pensions phase without upsetting the CSRI research conclusion or causing excessive tax overall, but the Report's view that 15% represents a 'concession' (and really should be increased) is inappropriate. If anything, I suspect the tax on earnings should be lower – perhaps a revenue neutral move to around 10% should be phased in for both the accumulation and pension phases. (A recent report by the Tax and Transfer Policy Institute suggests that, if all forms of savings were from after-tax income, a flat tax of under 10% on the earnings would be revenue-neutral, progressive and efficiency-enhancing.)

An agenda to complete the Retirement Income System

Most likely, the Callaghan Report is correct that the SG does not need to increase to 12%. Further work might confirm this (and whether 9.5% is sufficient or moving to 10% is still advisable).

But the Report also demonstrates the need now to settle the pensions phase of our retirement income system. Foregoing the full increase in the SG to 12% (and the costs to revenue involved) requires a *quid pro quo* that does precisely this if we are to ensure an adequate retirement income for most retirees. This *quid pro quo* should include:

- Funds to report regularly to members on the income streams in retirement their superannuation savings are likely to lead to;
- Accelerating the move to require funds to offer CIPRs that guide people to optimal use of superannuation which, with any age pension entitlement, delivers adequate and secure retirement incomes (if necessary, involving the Government selling indexed annuities);
- A simplified age pension means test that ensures higher savings do in fact lead to improved net retirement incomes while still concentrating assistance on those most in need;
- A sizeable increase in rental assistance, towards that available to public housing tenants, and a sizeable increase in Jobseeker, particularly for the over 60s;
- The introduction of a broader home equity release program with repayment from estates, if necessary managed by the Government.

Some of these measures need further development but the work required is not particularly complex nor are the financial and political hurdles involved excessive. Indeed, the final outcome would confirm the quality and effectiveness of the emerging Australian retirement income system and its deservedly high international standing.

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