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Editorial

Unless there a remarkable economic recovery or a rapid burst of inflation, both unlikely, we have low interest rates for a very long time. In fact, it's doubtful we will see short-term rates above 5% for at least a generation, maybe a lifetime. It's a weird thing so say for someone who spent his first decade in money markets with double-digit rates and a bank bill rate of 17.5% in 1990.

The Reserve Bank (RBA) has already promised the 3-year bond rate will remain at 0.1% until at least 2024, but there is limited scope to increase rates after that. Home buyers are not worrying as much about the prices they pay as the amount they can afford in repayments. What looks fine in the household budget at 1.75% is a severe strain at 3.75%. For our older readers who endured borrowing rates of 15% and more, anything below 5% would look like a dream, but the amounts borrowed these days supercharge the debts of 1990. (Source: RBA Chart Pack, March 2021).

Putting further doubt into any potential for rate rises was RBA **Deputy Governor Debelle**, who told a Senate Committee last week that there will be no rate increases until the unemployment rate falls "*to a number in the low 4s or even in the high 3s*". It is currently 5.8% but with an estimated 150,000 likely to lose their jobs with an end to JobKeeper last weekend. The RBA's rationale is that it wants more wages growth to achieve their inflation target of 2% to 3%.

As **David Harrison**, CEO of the **Charter Hall** Group, said last week:

"I cannot see a long-term rise in inflation. I talk to chief executives who occupy Charter Halls' $50 billion portfolio. No one I talk to predicts a wage breakout and technology will continue to be a wage deflator."

High-profile experts on superannuation...

We had some great reactions (see below) to **Bernard Salt**'s article last week, and we keep the big names coming.

One of the features at the COTA Policy Forum we previously reported on was the appearance of the three members of the Retirement Income Review together for the first time. Discussion clarified some of their thinking which is upending super policy. **Dr Deborah Ralston** said many retirees do not know how to manage their super:

"So what are people doing with their money? There are quite a number of people who get to retirement and, in the absence of any guidance or advice, they simply take the money out, pay a few bills and put it in a term deposit. Other people get to retirement and they think, 'wow, I've got a little nest egg for emergencies' so keep it in accumulation and they don't even transfer it into an account-based pension. Others do transfer it, but almost invariably draw it down at the minimum rate because – and this is the thinking – we need to make it last."

Dr Ralston is increasingly influential in the retirement income debate, so we are delighted that she is writing exclusively for Firstlinks in developing her thoughts on access to the equity in housing.

Similarly, **Dr David Knox** is highly respected in superannuation circles, and he presents a radical new idea to solve the intractable arguments about whether the Super Guarantee should increase from 9.5% to 12%. It balances current needs with future living standards.

Still on super, **Julie Steed** provides an excellent summary of the threshold changes coming on 1 July 2021. I must admit I did not realise the changes, and therefore the opportunities, were so extensive.

And please forgive us if we use the shorthand to refer to **Senator Jane Hume** as the Minister for Superannuation when, in his scramble to address women's issues, **Scott Morrison** has now given her the title of **Minister for Financial Services, Superannuation, the Digital Economy and Women's Economic Security**.

An Easter look at buns and funds

When companies don't make profits, sometimes earnings, the stock market turns to other ratios because the Price to Earnings ratio (P/E) is infinite. Popular for growth stocks is Price-to-Sales. Think about that. No profit but selling on a high multiple of the revenue from the stuff it sells, ignoring what it costs to make the stuff. It is estimated that as recently as 2017, there were only 25 listed tech stocks in the US with a Price-to-Sales ratio about 15. Today there are 366. **Tony Sacconaghi** in Barron's reports that stocks with a Price-to-Sales ratio of 15 or higher have not usually done well over time. Of course, there are exceptions, such as Amazon, which keeps investors hopeful.

This week, we look at the dichotomy between the fund managers who look for companies with consistent earnings in predictable ways, and the growth managers who back the disrupters. Like selecting your hot cross buns, there is no right answer to what suits your taste and appetite, but the results of your decision will drive vastly different results.

We highlight not only some respected fund managers with recent underperformance, but also **Cathie Wood**'s NYSE-listed Ark Innovation ETF, where the median Price-to-Sales ratio for portfolio companies is 22 versus 2.5 for the overall stock market.

Then **Edward Glyn** delves into fund flow data to show that active funds are attracting far more support versus passive than might be popularly believed, especially in Australia. We are either leading or lagging global trends.

Richard Dinham concludes his series on retirement with a look at five strategies which can be personalised based on risk appetite, capacity and needs.

If articles on sustainability have started to sound repetitive to you, as we must all by now accept the implications of ESG on companies and it's nothing new, then **Robert Almeida and Robert Wilson** bring a fresh perspective. It's not all a bed of roses in which all companies happily flourish.

This week's White Paper from **Western Asset Management** focusses on the threat of inflation, which will not only have a significant impact on long bonds, but valuations in the stockmarket.

And finally, heading into Easter, because most readers do not return to check the comments, we share feedback from one of our readers, **Roy Taylor,** on a life well lived.

"I'm 77 and worked 3 hours before school and after school from the age of 10, left school at 15 and never ever worried about getting a job worked full time 60 plus hours a week until 70 and I still do relief work in my

industry. Unfortunately there are too many whiners in our country, get off your arse and get out there and into it. I have owned a number of houses during my time, never got interest rates as cheap as now, in the 60s rates were at 6%, I paid 17% in the 80s for home, paid 23% for bank bills for business at that time and I got through ok, bit of hard work never killed anyone. Too many people worry about things that they have no control over, the weather, the planet will give you what it wants to give, not what you want it to do. Just get out there and give life a go, it's the only one you ever get, be happy mind your own business, get married have kids, get divorced get married again buy cars, boats, aeroplanes, drink eat laugh with your friends, just enjoy life, and all of the ups and downs because you will get plenty and you will be dead before you know it."

Ralston on accessing equity in the family home

Deborah Ralston

Dr Deborah Ralston is currently a Professorial Fellow at Monash University and in 2019 she was appointed by Treasurer Josh Frydenberg to the three-member panel for the ***Retirement Income Review****. Exclusively for Firstlinks, she elaborates on the Review's findings on the family home.*

As Bernard Salt's article in Firstlinks on '*the 2020s baby boom retirement surge*' pointed out, Australians retiring today have never been healthier, better educated or longer living. There is an increasing emphasis amongst retirees on quality of life in retirement and maintaining a standard of living commensurate with their pre-retirement lifestyle.

This generation has also had the benefit of rising property values over recent decades, with the consequence that a large proportion of their wealth resides in the family home.

What the Review uncovered about the importance of the family home

This subject was covered in some depth in the recently-released *Retirement Income Review* (the Review) (All data in this article unless specified otherwise are drawn from this Review).

In examining the three pillars of the Australian retirement system - the age pension, compulsory superannuation and private savings - the Review pointed out that:

The home is the most important component of voluntary savings *and is an important factor influencing retirement outcomes and how people feel about retirement. Homeowners have lower housing costs and an asset that can be drawn on in retirement.* (p18)

At present, about 80% of retirees are homeowners. This is a high rate of homeownership by international standards that not only benefits individuals but the wider economy. Home ownership lowers age pensioners' living expenses and means that the system is very cost effective for Australian taxpayers. At 2.4% of GDP, Australia has one of the lowest cost public pensions systems in the OECD.

Patterns of home ownership are changing, however. Housing costs have increased, and people are entering the workforce, marrying, forming households and buying their first home later in life. Between 1981 and 2016 the average age at which people purchased a home increased from 24 to 33, and, as a natural consequence, the average age at which mortgages were paid out increased from 52 to 62 (Review, p122). In 2017-18 around 10% of people entered retirement with a mortgage, a proportion which is increasing each year. Estimates now suggest that may be closer to 20%.

For most Australians, the family home is not only of huge personal and psychological importance, but it is also a major store of wealth. As housing is exempt from the age pension assets test and capital gains tax, for many it is a preferred form of retirement savings. At present, around 15% of age pensioners live in homes valued at more than $1 million, although the vast majority of these are in Sydney or Melbourne where property prices have escalated over recent years.

Many retirees in this situation did not have the opportunity to accumulate much superannuation during their working lives and may be termed 'asset rich and income poor'.

The family home is a store of wealth which can be used

For median homeowners at retirement, home equity represents around three to four times as much wealth as superannuation (median superannuation balances at retirement are around $200,000, while median home equity of retirees is $750,000). With the family home constituting such a large component of private saving, accessing equity in the family home is an attractive means of increasing retirement income and continuing to age at home.

There are two Government measures to encourage retirees to access the value of their home:

The Pension Loans Scheme (PLS) is effectively a reverse mortgage for age pensioners and self-funded retirees, designed to supplement retirement income up to 1.5 times the maximum age pension per fortnight. There are no regular repayments through the life of the loan, and income from the scheme is not assessable in the age pension means test. It is not possible, however, to borrow a lump sum under PLS.

The impact on capital value of the property is less than you might think. While interest rates are higher for reverse mortgages because there are no regular repayments, the net interest cost after allowing for some increase in property value is quite modest. The RIR gives an example of a retiree who draws $5,000 each year throughout retirement against equity in a home worth $500,000. By the age of 92 the property has an accumulated debt of only around a quarter of its value (Review, p183).

The **Downsizer Contribution** allows people aged over 65 to enhance retirement incomes by increasing super balances on selling the family home. Provided the home was held for at least 10 years prior to sale, and the $1.6 million transfer balance cap has not been reached, a person can contribute up to $300,000 to superannuation from the proceeds. This could mean a combined $600,000 boost to superannuation balances for a couple.

In the current economic environment, a variety of new forms of private sector home equity access products are attracting more interest from both age pensioners and self-funded retirees. These include reverse mortgages, home reversion or equity release products. Each of these is slightly different, as discussed on ASIC's Moneysmart website.

Private sector **reverse mortgages** offer the choice of income stream, line of credit, lump sum, or a combination of these. A lump sum could be used for purposes such as paying out a mortgage at retirement, covering the cost of large expenses such as home renovations, assisting younger members of the family with a home deposit or education expenses, or providing additional resources for in-home or residential aged care.

For an increasing proportion of older Australians with mortgage debt at retirement, refinancing with a specialist reverse mortgage provider is an attractive option. Loan repayments can be drawn against equity in the home instead of being repaid in cash, thereby preserving superannuation balances for retirement income. Importantly, unlike a regular home loan, a reverse mortgage does not require regular repayments and a borrower cannot default for missing payments.

Since 2012, federal reverse mortgage legislation has provided significant consumer protections, limiting loan to value ratios, guaranteeing occupancy, and ensuring people cannot have negative equity in their homes[1]. There are fairly strict limits on what you can borrow against the home, starting at 20% of equity at age 60 and increasing by 1% with each year of age. These measures ensure in all but the most extreme economic scenarios, homeowners can expect to own a majority of their home equity by the time they reach 90 years of age.

Home reversion is a property transaction rather than a loan, where you agree to sell a portion of your property to a provider or investor in return for a lump sum payment. Any future growth in property value is shared, based on the percentages of ownership. The home reversion provider pays a 'discounted' amount for the share of equity, which can be much lower than the current market value. For example, you could sell 50% of the future value your home, but only receive somewhere between 25% and 40% of the value up front, depending on your age.

Home reversion is not subject to the same protections as a reverse mortgage under the National Credit Consumer Protection Acts (NCCP). There may also be limited availability based on location for this product compared to a reverse mortgage.

Not so well known are **equity release** contracts, where you can sell a portion of your home to one or more investors, in return for a lump sum or a regular income stream. All maintenance, repairs and insurance costs are shared between the owner and the investors. Each five years, an additional small part of equity is used to pay a notional rent to the investor as return on their investment. While the owner retains the title of the property and the right to continue living there, they may also choose to rent the property out and retain all the rental income.

Equity release products do not have a "no negative equity" restriction however, so you need to keep track of your borrowed portion. Geographic restrictions do not apply so equity release can occur anywhere provided property investors can be found. These may be family or friends, self-managed superannuation funds or unrelated parties.

A little known but valuable feature of an equity release product is that they also qualify for the tax-free Downsizer Contribution allowance, allowing retirees to stay in their home but contribute funds from the sale of a portion of their equity into their superannuation accounts.

Each equity access product has different features which may or may not suit an individual retiree's needs. As the Moneysmart website points out, it is essential to get some independent advice regarding how such a transaction might impact on your age pension entitlements, bequests etc. There is also a fact sheet from Service Australia to assist.

What is the efficient use of retirement savings?

Throughout the Review there are ongoing references to the **efficient** use of retirement savings. That is, using retirement savings to provide needed funding in the form of both income and capital. This statement has often been misinterpreted to mean that retirees should reach the end of their lives with all retirements savings exhausted, but this is not the case.

It is pointing to the fact that once people reach retirement, they often become very cautious about spending down their retirement savings. Many live frugally in the belief that they should preserve the capital they have saved, only spending returns and dividends, and with a concern that they will 'run out of money' before they die. This approach is well motivated in that people feel they are being financially responsible and do not want to be a financial burden on others. But more often than not, this approach means that savings intended for retirement funding, including capital, go unspent and create an unintended bequest for future generations.

As the Review points out, in each decade of retirement we spend less. Concerns of providing for future costs are largely unfounded, as in this country we enjoy a generous system of 'social transfers in kind'. These are benefits in terms of the health and aged care systems, tax concessions such as SAPTO, social security benefits such as the carer's pension, and discounted state and local government services such as concessional pricing for public transport, discounted utilities, car registration and council rates. In many ways these transfers represent a fourth pillar of the retirement system and they are not insignificant. Indeed, the Review found that the average value of such benefits is greater than the full age pension for people over 65 (Review, p.134).

The purpose of the government encouraging and supporting retirement saving is to ensure that people can live well in retirement, not save for the next generation. By all means leave a bequest but ensure that this is not at the expense of living well yourself. Drawing equity in the home to ensure you can enjoy your retirement with both adequate housing and funding is another example of using retirement savings well.

Conclusion

For the current generation of retirees, housing represents a significant proportion of wealth. It is likely that an increasing number of retirees will draw on this precious asset to improve standards of living, to pay out a mortgage, or to provide additional resources for those wishing to age at home.

For most people staying in their own home and community is an important priority in later life. The additional income which can be generated from the wealth stored in the family home can ensure a higher standard of living in retirement and is especially important for those who have not had the benefit of higher superannuation contribution levels for much of their working lives.

Dr Deborah Ralston is currently a Professorial Fellow at Monash University, where she is a member of the Steering Committee for the Mercer CPA Global Pension Index. She is currently a member of the Reserve Bank of Australia Payments System Board and holds several non-executive director roles. In 2019 Deborah was appointed by the Treasurer Josh Frydenberg to the three-member panel for the Retirement Income Review.

[1] Prior to 2012 reverse mortgages were not subject to product specific legislation and were regulated at the state level resulting in highly variable customer experiences and product designs that generated unexpected outcomes for customers and misaligned selling practices.

To your taste: hot cross buns and hot, cross funds

Graham Hand

"I've been doing this as some kind of Chief Investment Officer since 1978. And this is about the wildest cocktail I've ever seen in terms of trying to figure out a roadmap."
Stanley Druckenmiller, Duquesne Family Office, speaking on Goldman Sachs' *Talks at GS*, 4 February 2021.

Any investor hoping to find a fund manager who outperforms in all market conditions will be sorely disappointed. It's an elusive goal. At the moment, there's a great divide between those who believe investing conditions are excellent and those who see risks everywhere. Time will tell whether funds which outperformed in recent years continue to do so, but signs are the tide is turning.

Fund managers have different perspectives

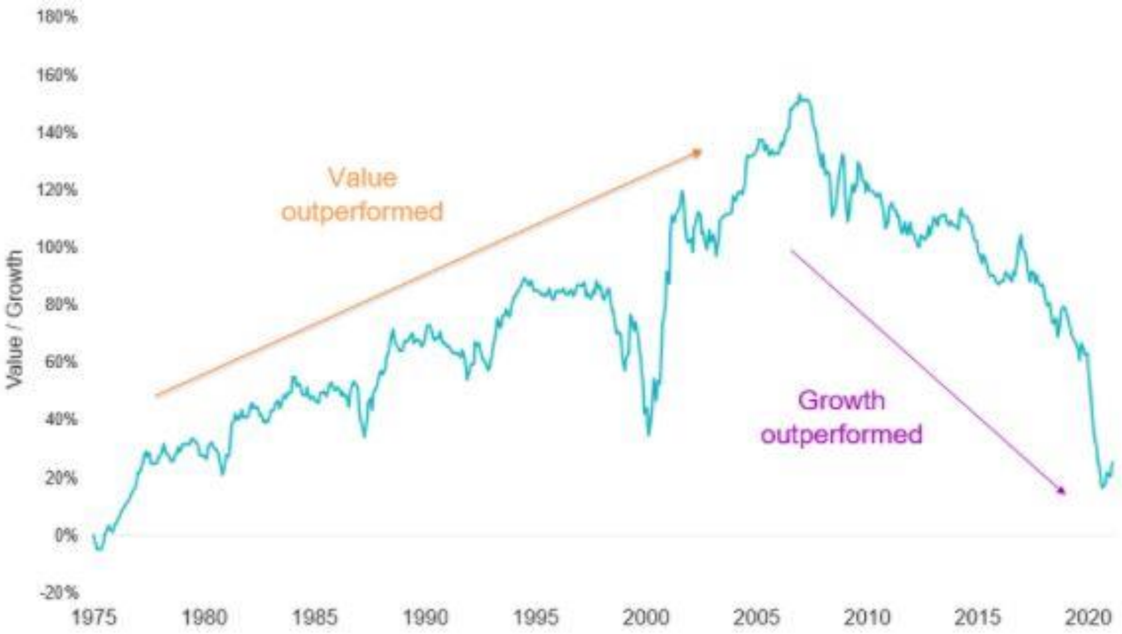
Experienced investors with decades in the market are currently the most cautious. World-famous names such as Howard Marks, Charlie Munger, Jeremy Grantham and Stanley Druckenmiller see bubbles everywhere. Locally, luminaries such as Hamish Douglass, Anton Tagliaferro and Andrew Clifford issue warnings. On the other hand, some lesser-known fund managers such as Thomas Rice of Perpetual, Alex Pollak of Loftus Peak and Joe Magyer of Lakehouse see disruption and tech as great opportunities, and their funds performed well in 2020.

One reason for the divide is the type of investing they believe in. One side would never invest in Tesla or Afterpay or Zoom at high multiples of revenue, often without profits, and the other side who would never invest in traditional industrials such as financials and energy (fossil fuels) because they are old world stories.

It's a variation on 'growth versus value'. It's not a clear distinction, but 'growth' stocks hope to grow faster than the economy due to some special factor, such as tech or healthcare, while 'value' stocks are trading below what they are worth and are expected to grow in line with the economy, such as consumer goods and financials.

It's been a fascinating divide in the last few decades, as shown in the chart below. Between 1975 and 2008, the market in which our most experienced fund managers cut their teeth, value strongly outperformed growth. In the last dozen years, especially driven by the rise in tech stocks, growth has killed value, and with it, the relative performance of many long-term managers. But in the six months to end February 2021, value achieved a strong 8% reversal.

MSCI World Value Index relative to MSCI World Growth Index



Source: Van Eck using Bloomberg data

Where should an investor put their money?

Investing is more art than science, and the answer lies in what an investor wants from their fund manager. Do you jump on the growth bandwagon believing the momentum until the end of 2020 will return, or back the expertise of fund managers with long-term records in more traditional stocks?

Morningstar global research shows that of the hundreds of funds that have outperformed their benchmark by more than 1% annualised over 10 years, 100% of them underperformed the benchmark in a 12-month period. Investors who jump from fund manager to fund manager risk always backing the wrong horse.

It's the same as selecting hot cross buns

Let's step away from the desk and into the kitchen and find some experts to help select hot cross buns.

Heading into Easter and being rather fond of fruit bread and hot cross buns, I checked the Choice website for their favourites. You'd be struggling to find a better panel of judges than the three experts rating a selection of buns. There was Christopher Thé, who after training in fine dining restaurants including Bel Mondo, Claude's and Quay, opened his own boutique patisserie, Black Star Pastry, in Newtown. He's worked on tasting panels for Gourmet Traveller and Good Food. Then there's Brigid Treloar, a food consultant for over 30 years, author of eight cookbooks and a judge in the Sydney Royal Fine Food Show Bakery Competition. Plus Ian Huntley, a pastry chef for 35 years, who after working in Sydney's InterContinental and Regent Hotels started his wholesale patisserie business. He is Chief Assessor for patisserie at Le Cordon Bleu.

Surely, in seeking guidance, this is an incredibly well-credentialed trio. These are not Instagrammers or Facebookers or Influencers who jumped on the web during COVID.

I'll spare you the full details of the Choice review, but here is the winner.

Coles Traditional Fruit Hot Cross Buns

- Choice Expert Rating: 80%
- Price: $0.58 per bun ($3.50 per 6-pack)
- Made from at least 95% Australian ingredients, the highest percentage of local ingredients of all products on test. At 27%, these buns also contain the most fruit.
- Experts say: "Even cross, good colour, shiny! Bouncy texture. Quite a lot of fruit. Great balanced mouth feel and flavour. A nice hot cross bun despite its slightly odd shape."

So I dutifully headed down to Coles and bought the best. At the first bite, I thought 'fake food'. Too sweet, little texture. The judges seem to like a bouncy 'mouth feel', but I want firmness. Give me a bit of substance to the bite, and who cares about 'slightly odd shape'.

One hundred years of combined culinary expertise and that's the best they can do.

A few days later, *The Sydney Morning Herald* of 23 March 2021 posted its own bun review. Rating for the exact same Coles buns? A measly 2/5, as the SMH said, "… *a bland aftertaste. Needs more spice*."

Wait a minute. Aren't they all experts?

It's the same with fund managers. What suits me might not suit you, regardless of the level of expertise.

What do you want in a fund manager?

Let's examine what might appeal in a fund manager by checking the recent results of one of the best-known stock pickers in Australia, Anton Tagliaferro.

Anton has been around for decades. At the risk of torturing the analogy, if you're wondering whether he is capable of 'hot and cross', well, I sat in front of him at the Australia versus Japan game in Kaiserslautern, Germany, at the football World Cup in 2006. In the 26th minute, a Japanese player barged into Australian goalkeeper, Mark Schwarzer, and the ball drifted into the net. It was a clear foul and Anton let the referee know. I learned a few new words that day, especially since Australia did not equalise until the 84th minute (Tim Cahill scored the country's first ever World Cup Final goal). By that time, Anton was well and truly hot and cross.

What do Morningstar's analysts think of Anton's Investors Mutual? Of the 78 Australian equity funds rated by Morningstar, only 14 receive a gold rating, including Investors Mutual, with this comment from analyst, Edward Huynh:

"Investors Mutual Australian Share's shrewd investors and a class-leading process make this strategy one of our favourites in the value space. IML was founded by Anton Tagliaferro in 1998, and IML has maintained the same value quality approach to a fault.

One of the hallmarks of the strategy is strong downside protection. This came to the fore during the recent coronavirus sell-off as IML's strategies achieved the lowest decline amongst the category. However, IML missed out on the violent rebound as low-quality names and high-flying tech stocks outperformed, which IML typically avoids. We're confident that when value returns to favour, IML Australian Share's talented investors and rigorous process are best positioned to capture the value premium, making this one of our favourites."

IML gives downside protection but its process doesn't participate in the expensive growth winners such as in the tech sector.

It's a bit like a firm hot cross bun without the exciting extras, and not a fluffy one that blows with the wind.

A look at its short-term performance is not encouraging. According to Morningstar, as shown below, over one year it is 8% under the index and beaten by 95% of the funds in its category. Even over 10 years, it is flat with the index. Yet Morningstar rates it gold and a top pick.

	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Total Return %	1.45	0.86	1.94	-1.60	2.72	6.30	7.83
+/- Category	-1.27	-3.42	-1.19	-9.07	-1.35	-1.44	0.72
+/- Index	-0.01	-2.14	0.17	-8.08	-4.67	-4.44	0.07
Quartile Rank							
Percentile Rank	79	93	81	95	73	79	26

A breakdown of performance into calendar years shows a strong run from 2011 to 2016, outperforming the index every year and by 8.59% in one year.

Total Return %	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD
Fund	-1.96	23.96	21.14	9.78	4.33	11.87	7.99	-3.77	17.29	-7.31	1.94
+/- Category	5.71	2.98	-1.81	4.12	2.12	1.34	-0.69	3.93	-1.14	-5.83	-1.19
+/- Index	8.59	3.71	0.94	4.17	1.77	0.07	-3.81	-0.93	-6.11	-8.71	0.17
Quartile Rank	—	—	—	—	—	—					
Percentile Rank	—	—	—	—	—	—	89	33	91	85	81
# of Funds in Cat.	110	100	104	100	100	105	103	106	107	108	108

YTD Fund as of Feb 28, 2021 | Category: Equity Australia Large Value as of Feb 28, 2021 | Index: S&P/ASX 200 TR AUD as of Feb 28, 2021

Here is Edward Huynh again:

"The value tilt and mistrust of speculative stocks caused underperformance during the resources-led bull run from 2003-07. IML outperformed substantially in the 2007-08 turbulence. However, the strategy gave back that outperformance during the junk rally in 2009. The strategy performed strongly from 2010 to 2013 as sustainable income producers led the market. In 2014 and 2015, the strategy dodged plummeting mining and energy names ... The year 2016 was solid despite a resources resurgence, finding winners in CSL, Steadfast, AGL, and IAG. In 2017, IML struggled as growth and momentum stocks rallied. Underperformance was attributable to zero or underweight positions - such as ANZ and Rio Tinto - rather than picking losers ... Performance for 2020 has been mixed with class-leading downside protection during the Covid-19 sell-off; however, the lack of tech and resource holdings hurt the strategy on the rebound."

How an investor feels about IML depends if they understood what they were buying and prefer Anton to stick to his process. On one level, he is well under the index for five years, so what is an investor paying for? On the other, he's better at protecting the downside and will probably do well in the 'value rotation'. It's the future that matters in investing, and the market may be moving steadily towards traditional industrial stocks over resources and technology. Since inception in 1998, the Australian Share Fund is well ahead of the index.

IML might not use the words 'hot and cross' to describe the current market, but similar words such as 'outrageous' and 'ridiculous' can be found in its February 2021 report:

"This is why it remains so important to maintain perspective and to not get caught up in hype, and to not subscribe to theories about a so-called 'new era' touted to justify outrageous increases in share prices and the many ridiculous valuations that we are witnessing today."

More recently in the global sphere, another gold-rated fund has experienced a few difficult months. We published the full transcript and webinar explanation from Magellan's Hamish Douglass a few weeks ago. My colleague at Morningstar, Emma Rapaport, wrote an article on 24 February 2021 called '*Will Magellan Global Fund's underperformance persist*?'. Wrote Emma:

"The gold-rated Magellan Global Open Class fund had its worst year in a decade in 2020, delivering investors a negative return (-0.2%) and underperforming both the Morningstar World Large Blend category (5.69%) and the MSCI World Ex Australia NR AUD index (5.73%) ...

Morningstar fund analyst Chris Tate says Magellan's returns were hampered by three key decisions lead portfolio manager and Warren Buffett-disciple Hamish Douglass took during the year: a big bet on Chinese e-commerce giant's Alibaba; energy sector exposure; and a dash for cash in the March-downturn. Tate says uncertainty remains over Magellan's short-term performance. "They'll do well if volatility returns to the market; if it keeps going up in a straight line they could lag." However, he hesitates to describe their position as bearish, pointing out that the strategy continues to hold a host of quality growth names.

(Links including to the full article are available to Morningstar Premium subscribers).

The hot, happy (not cross) funds

Some fund managers have bought into the world of disruption and have delivered excellent results, especially in global markets with better tech opportunities. A check of the Morningstar database of World Large Growth shows the following leading the pack on 12-month performance.

World Large Growth

Fund Name	Morningstar Rating	6m%	1y%	3y%
Hyperion Global Growth Companies B	★★★★★	8.18	40.62	27.63
T. Rowe Price Global Equity I	★★★★★	13.49	28.18	19.73
Franklin Global Growth W	★★★★★	12.89	26.71	18.63
Pan-Tribal Global Equity Fund	★★	19.98	22.11	10.73
Fidelity Global Equities	★★★★	13.47	16.60	14.34
Zurich Investments Unhedged Global Gr	★★★★	8.64	14.36	16.07
Generation Wholesale Global Share	★★★★	14.94	14.07	15.49
Stewart Investors W Wrldwide Sustainabty	★★	10.41	11.52	11.35
Zurich Investments Gbl Thematic Shr	★★★	8.16	10.88	13.65
C WorldWide Global Equity Trust	★★★★	5.42	10.23	13.36

How did Hyperion generate a 41% return in a year? Says Morningstar's Christopher Franz:

"Hyperion's concentrated portfolio hosts some punchy bets. Technology and consumer discretionary names have long been well-represented, and alongside communication services stocks, accounted for around 80% of assets as at 31 March 2020. Hyperion believe they have an edge identifying companies in these sectors, as many stocks maintain strong competitive advantages and high returns on equity. High-conviction holdings here include Amazon.com and Microsoft, both of which eclipsed 10% of assets, slightly below the fund's 13% cap on any single stock. They've also gravitated towards payment companies and nonbank financials, like Visa, Mastercard, and PayPal, companies they believe are taking advantage of the shift from cash to electronic

payments. The portfolio also holds several luxury goods brands like LVMH and Hermes, which they believe to be at the pinnacle of brand equity and pricing power."

Where do we find a high tech hot cross bun and fund?

Maybe Choice magazine and its experts were looking in the wrong place at the traditional high street retailers. Let's turn to the online, trendier publication, [Broadsheet, for its own take on the best hot cross buns (HCB)](). Some of these buns cost $5 each versus 60 cents for Coles Traditional, but do you get what you pay for?

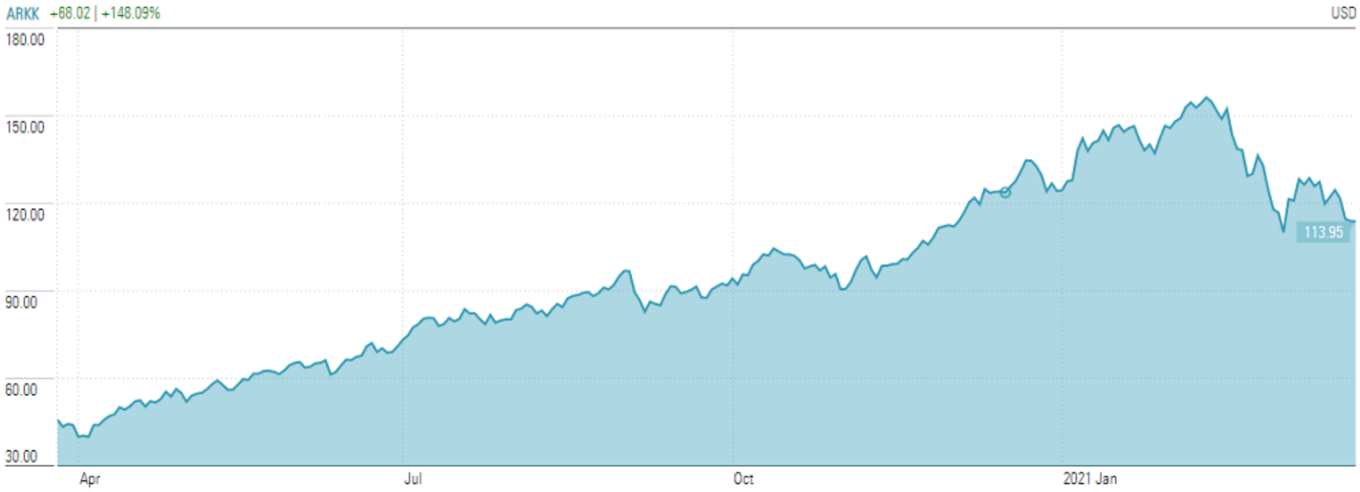
"From a frankincense-glazed beauty by a cult bakery to a gluten-free bun that'll impress those with gluten intolerances and the gluten-loving alike and myriad varieties (including choc-chip, apple-cinnamon crumble and classic fruit), there's loads to love in the HCB realm this year."

Maybe these are the private equity funds of the HCB world. High cost with high returns. For a special treat to give some upside, maybe a couple of buns with *"a special spice blend, Earl Grey-macerated fruit and house-made candied orange"* or *"organic sultanas, candied peel and loaded with spice"* or *"cranberries, raisins and candied orange peel"* will spice up a portfolio.

The ultimate HCB fund of the last year was Cathie Wood's NYSE-listed Ark Innovation ETF (ARKK). Wood and her colleagues look for companies that benefit from disruptive innovation, posting a total return of more than 150% in 2020 and raising about US$10 billion in net inflows for the year (and US$1 billion on each of 9 February and 11 February). It is the fastest-growing fund in the US, holding only US$3 billion a year ago versus over US$20 billion in March 2021.

But then … as shown below, the main fund dropped 30% from almost US$160 to US$111 in February and March 2021, including over 6% on one day. It's a portfolio full of future promise and low current-day earnings, with the median price/sales ratio for ARKK's companies at 22 versus 2.5 for the overall stock market. Only one third of its investee companies are currently profitable (as at early March 2021).

If this is what you want from your '*frankincense-glazed, organic sultana, home-made candied peel*' fund, then there's a place in a portfolio. But there's only room for a small allocation in the retirement portfolio of someone protecting capital.



What other types of funds might be hot and cross?

In a market where a stock can go from $8 to $150 in a year (Afterpay), or the top-performing large cap stock in the world, Sea Limited, which listed in the US in 2018 and rose 395% in 2020, managers who short stocks face risks way beyond their normal models. The most a stock can fall is 100% but it can rise, in theory, to any level. And we all know what happened with GameStop (up from US$40 to US$480), backed by an army of Reddits and Robinhooders who don't care about value. They expect that someone else will pay more next week.

Shorting has not only become more dangerous, but in a world where poor quality companies without earnings can rally strongly, even a 'correct' analysis can blow up a fund. Many hedge funds, or long-short funds, have decided to either close their shorts or manage risk by shorting the index rather than a single stock. Australia's best-known hedge fund, Bronte Capital, is down around 20% this financial year.

Another high-profile long-short manager forced to reassess its process is VGI Capital, which advised investors in a letter of January 2021:

"This environment has conversely driven an acceleration in the creative destruction of business models. Short selling in recent market conditions has been arduous as the market has been both far less discerning of questionable accounting and more willing to look through short-term business performance, even if it may be a strong indicator of long-term issues."

Hedge funds expect there will come a time when market conditions favour shorting, as historically, the most-shorted stocks have performed poorly and the market should punish companies with a weak business. For the moment, the dough is left to prove.

Another manager underperforming in recent years is Platinum Asset Management, which until Magellan came on the scene, dominated retail flows into global equities. It was positioned away from the US where much of the global success due to the FAANGS is located. Writing on 11 March 2021, Morningstar analyst Adam Fleck said:

"While its strategies have outperformed over the long term, in the last five years, they have generally underperformed their benchmarks ... Most of the asset manager's strategies outperformed over the year to January 2021, supported by recent stock price appreciation of cyclical and deep value stocks following promising vaccinations news ... the market is already pricing in the likely benefit of prospective outperformance, that being an immediate resumption of new inflows".

And there we have a prime example of the problems fund managers face. Despite its good long-term results, Platinum has been unable to generate inflows in recent years, as investors wait until after a good run before investing, backing last year's winners.

Co-Chief Investment Officer at Platinum, Andrew Clifford, spoke at an investor presentation on 30 March 2021, saying:

"The speculative mania in growth stocks will end badly for those who stay too long, just as it did in the tech bubble and countless other speculative manias. When you hear people say, 'It's not like the 2000 tech bubble', I must say, I agree. This is a much bigger bubble."

Should you invest in hot, cross funds?

Over time, active fund managers need to justify their fees, but cycles will work both for and against them. Any investor deciding on active over passive should consider it a 10-year decision. Otherwise, they are likely to redeem just before the fund manager becomes hot and happy.

However, fund managers also need to consider that disruption is permanent, and some companies are expensive for a reason – they have outstanding long-term prospects. Disruption is accelerating, and trends in biotech, AI, automation, robotics, cyber and a massive range of new technologies will continue to flourish. There is a place in every portfolio for added spice.

Similarly, hot tech funds need to recognise when the market reaches ridiculous levels, pricing to the moon stocks with little permanent competitive advantage and ongoing losses, such as Uber. There is a time for a reality check.

Either way, enjoy Easter

Whether buns or funds, the most expensive are not necessarily better. It's subjective and personal, but I reckon it's worth including a couple of the $5 HCBs from a boutique bakery, even if you also like the 60 cent basic from Coles. You can fill the rest of your supermarket trolley (and your portfolio) with home brands (index funds) to save money, or if there is a name brand (an active fund) worth paying for, back the one you have always relied on.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances or dietary requirements of any investor or HCB-lover.

How a sidecar can keep super motoring along

David Knox

The COVID-19 pandemic highlighted that we live in an uncertain world where our financial position and lifestyle can change quickly. Of course, these changes can be caused by many events including unemployment, sickness or an unexpected financial shock, such as a medical bill or home repairs.

Many Australian households live from one pay packet to the next, with no savings that are easily accessible for emergencies. In such circumstances, it is not surprising they need to borrow funds, often through their credit card, and so can begin a debt spiral with significant long-term consequences.

Is there a better way?

Trials in the UK and the US are developing an emergency savings account linked to the individual's superannuation or pension account. The idea is simple.

Behavioural economists discuss the concept of mental accounting. That is, we have different buckets of money for different purposes. Unfortunately, many households have only two buckets – the immediate bucket for today's needs and the longer-term bucket for their retirement through superannuation.

What's missing is the emergency savings account representing a third bucket, which has funds available to respond to those unexpected costs.

An important feature of these 'rainy day' accounts is that they are not as easily available as cash in the bank. They are slightly different and so there needs to be another step in the process. For example, millions of Australians accessed some of their superannuation in 2020 by applying through the Tax Office. A similar process could work with these accounts.

This emergency financial buffer is likely to provide many households with improved wellbeing as they know that some funds are available, if and when the money is needed. Without access to such funds, these unexpected and costly events can lead to additional adverse outcomes such as mental stress, relationship issues or reduced productivity at work due to the individual's financial concerns.

An important question related to savings, highlighted by the pandemic, is what is the best balance between short term and longer term savings? This is a current policy debate around the world and there is no 'correct' answer. However, a binary answer of either the 'now' or the "longer term" is not the best solution for many households. There is need for some middle ground.

Further, behavioural science has repeatedly demonstrated the power of defaults. That is, a good outcome happens without the need for a personal decision.

As noted above, these emergency saving accounts are now being developed overseas. So, how might Australia do it?

Another use of the SG increase

One approach would be to direct some of the increase in the Superannuation Guarantee (SG) planned for 2021-2025 into an individual's emergency savings account. Call it a sidecar, if you like, operated by the individual's super fund.

The emergency savings account would be invested for the shorter term, say in a typical conservative fund, whereas the existing retirement account would continue to be invested for the longer term, say in a balance fund. Individuals would be able to access their savings account at any time, subject to a minimum withdrawal of $1,000, and no questions would be asked about reasons for the withdrawal, which could also include housing costs.

For example, let's assume an individual is earning $80,000 pa and the increase in the SG from 10% to 12% (i.e. 2% of their income) is saved through the sidecar account. At the end of the year, this would represent at least $1,600 ignoring earnings. Even allowing for a 15% tax on withdrawal, this would provide them with available funds of $1,360.

Individuals, who wish to save these additional contributions for the longer term could transfer funds from their savings account to their retirement account at any time. However it would then be subject to the standard rules and preservation that apply to superannuation. A cap could also be applied to the savings account to ensure that significant investment income was not lost.

Of course, the tax treatment of the withdrawals would need to be considered to make sure there is no tax avoidance. However an application through the ATO using existing technology would make this feasible with a tax rate on withdrawal linked to the individual's marginal tax rate (which is known by the ATO) less the 15% tax already paid on concessional contributions.

The concept of a second account in the pension system is not new and would not be unique to Australia. Singapore's Central Provident Fund has three accounts (or buckets) for different purposes. Its experience is that the savings account is often left unused during the working years and is subsequently available to increase the retirement benefit. It's a win-win; some cash is available during the working years, but otherwise, the savings are invested for retirement.

The introduction of this 'superannuation sidecar account' will require imagination, political will, industry commitment and clear communication. But it's worth it for the benefit of our community.

We'll achieve greater flexibility for individuals and households and ensure more Australians can save for their future.

Dr David Knox is a Senior Partner at Mercer. See www.mercer.com.au. This article is general information and not investment advice, and does not consider the circumstances of any person.

Active funds in Australia land some punches

Edward Glyn

Like their peers around the world, Australians have enthusiastically embraced passively managed index tracking funds in recent years. Active funds are of course still significantly larger than their passive counterparts making up roughly $2 in every $3 of equity assets under management in this country, about the same as in the UK.

Change happens more slowly than we think

This is simply because net flows of new cash into funds are orders of magnitude smaller than the hundreds of billions of dollars already under management, so change tends to happen rather slowly. What's more, having steadily lost market share in the past, active funds have recently fought for new investment dollars more successfully here in Australia than they have in in comparable countries.

The Calastone network handles hundreds of millions of fund transactions around the world each year. We have good coverage in Australia, so we get a great overview. It is not our role to say one kind of fund is better than another. This is a job for financial advisers and investors themselves. But we are well positioned to observe the behavioural trends and pick up turning points long before anyone else can, and in real time.

What's happening with fund flows?

First a bit of context. 2020 saw a huge increase in overall transaction volumes across our network globally (+45% compared to 2019). The year started with net outflows from equity funds as the coronavirus infection took hold in China. Investors in Asia were first out of the blocks. Australians and Europeans jumped ship next, selling down heavily in February, while those in the UK took longer to respond.

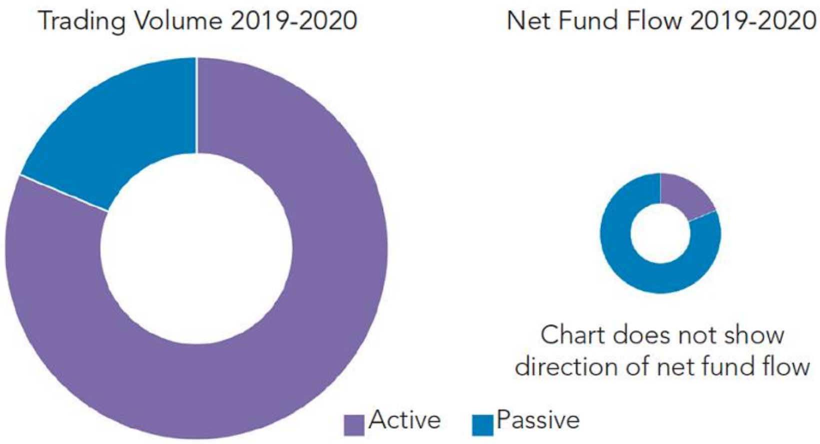
From April onwards, however, the global policy response to the pandemic prompted investors everywhere to pump cash into equity funds. Australian investors were among the most bullish, adding $6.8 billion to their holdings by the end of the year. Three fifths of this was in November and December alone as vaccine approvals raised hopes for an end to the pandemic. Our index of funds flows for the year scored a very positive 54.9 in Australia compared to those outside Australia of 51.3 (a reading of 50 means inflows equal outflows).

More than a third of the money Australians added to equity funds in 2020 went into funds that only invest in Australian equities. In Europe, the UK, and most of Asia, investors preferred to take a more global approach. While there are good reasons to have a portion of savings in domestic assets, it is surprising to see Australia-only funds take such a big slice of the inflows. Perhaps the successful suppression of the pandemic here in Australia encouraged investors to stay local.

When it comes to active and index funds, investors behave rather like fund managers. Flows into index funds are relatively stable, reflecting a simple 'buy and hold' strategy that accumulates savings over time. Net inflows are large by comparison due to total trading volumes – steady buying, not much turnover.

By contrast, investors trade their active funds much more often, picking favoured funds, adding money more opportunistically in response to news flow on economic, political or world events. Investors re-allocate around the world by switching between funds with a particular regional focus or favoured strategy. For active funds, total trading activity is very large, and the resulting net inflow or outflow is extremely small by comparison to overall volumes.

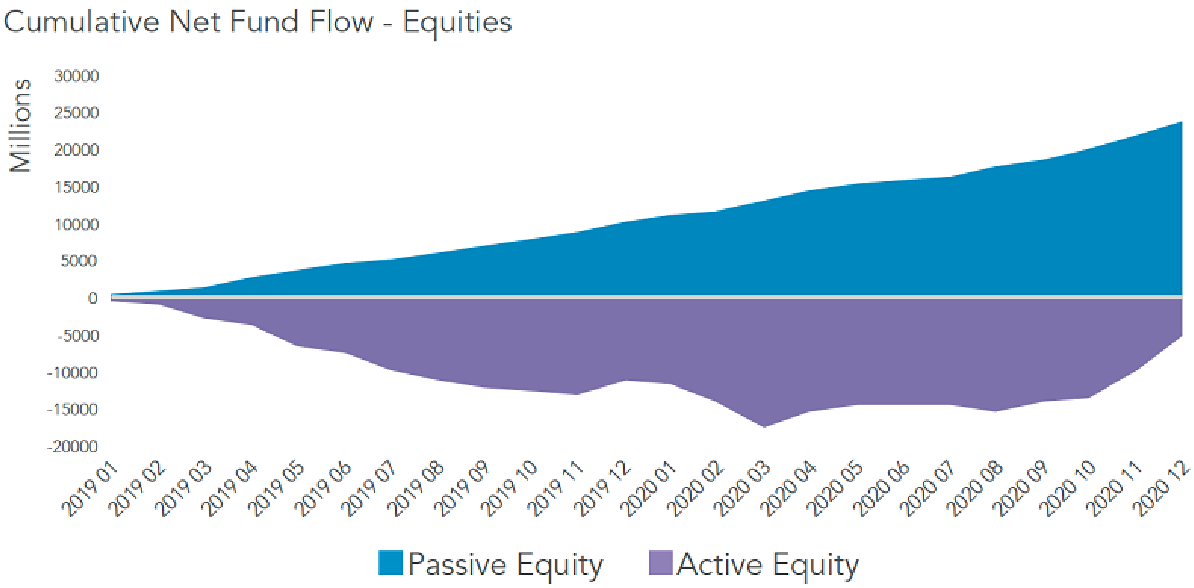
Net fund flows are small relative to huge trading volumes



Overseas, index funds are comfortable winners

Outside Australia, index trackers comfortably beat active funds in the race to attract new capital in the last two years. Across Calastone's global network, index funds garnered inflows of $12.2 billion in 2019 and a further $18.2 billion in 2020. By contrast, active funds saw net *outflows* of $16.7 billion in 2019 and would have shed cash again in 2020 were it not for a dramatic turnaround in the final quarter. By the end of the year, investors added a net $3.3 billion to their holdings (not enough to make up for 2019 outflows).

Net inflows for index tracking equity funds were US$23.5 billion (A$31 billion) in 2019 and 2020.



Australians still focus on active funds

In Australia, the preference for passive funds has been less clear in the last couple of years. Australians actually *added* modestly to their active fund holdings in 2019 and significantly in 2020, in contrast to investors in the rest of the world. Over the two-year period, these inflows totalled A$5.7 billion.

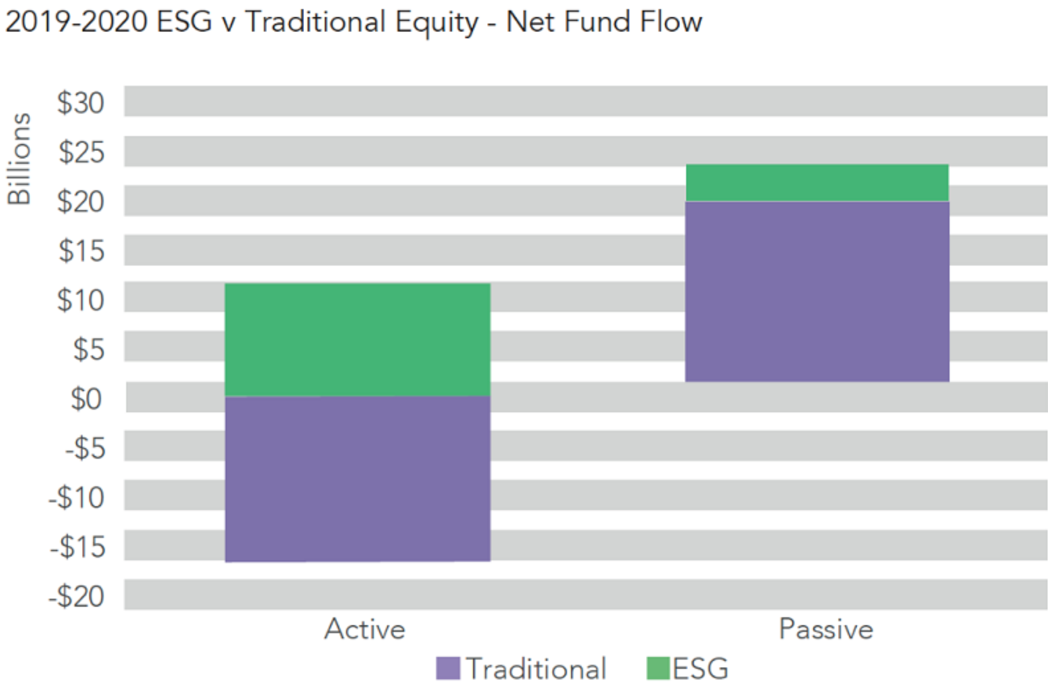
Unlike investors elsewhere, Australians added ***less*** to index funds - A$3.6 billion. However, there was relatively little two-way trading associated with the index-fund flows. Activity was characterised by steadier buying while active fund inflows were on the back of volumes four times greater.

The long bull market has favoured passive funds. Savers are happy to ride a rising index and take the simple market return. But passive investors are all-in on market bubbles and market crashes alike. Moreover, the rise of mega-caps like Apple and Amazon has increased absolute risk for passive investors, even if a fund continues to mirror the market perfectly. This is a sort of hidden risk.

Active funds winning in ESG globally

There is one area where the active fund management industry outside Australia is mounting a hugely successful defence against the rise of index trackers – ESG funds. They are the undisputed success story of the last two years. From a near standing start, they have captured investor imagination to such an extent that in 2019 and 2020 they took an astonishing $84 in every net $100 flowing over our network into equity funds of *any* kind. Net inflows rose seven-fold between 2019 and 2020, even though overall turnover in ESG funds only doubled. Three quarters of this new ESG capital ($16.3 billion) flowed into active funds.

Globally, three quarters of new ESG capital (US$11.3 billion) flowed into active funds. If we strip out ESG funds altogether then traditional active funds have shed US$16.8 billion over last two years.



UK and European investors have been the keenest buyers. Based on fund flows, Australian and Asian investors appear to be about two and three years behind the curve respectively. In 2019 and 2020, Australian investors added just $1.2 billion to ESG equity funds, only $1 for every $13 that flowed into equity funds of any kind – a fraction of the global average.

Appetite is growing, however. November and December saw larger inflows to ESG funds in Australia than in the previous two years combined. Active managers like them because it's much easier to differentiate their funds from vanilla index trackers. In Australia they are pushing at an open door.

Investors have shown they are still open to buying active funds. Structurally, index funds are likely to take more market share over time, but ESG has given active managers a new string to their bow and a good reason to fight back.

Edward Glyn is Head of Global Markets at [Calastone](). The full report, "Tidal Forces – Can Active Funds Fight the Passive Flows?" can be [downloaded here]().

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Risk in retirement: five strategies for finding the right balance

Richard Dinham

For many, retirement means dream holidays, reading books and spending time with grandchildren.

However, for some Australians, the notion of enjoying their golden years after a lifetime of hard work hit a roadblock last year when COVID-19 struck and hit economies and markets hard. Many businesses were affected and the associated restrictions impacted employers, employees, profit margins and, ultimately, dividends. Retirees have been feeling the pinch, particularly self-funded retirees, and those that utilise investment properties as a source of retirement funding may also feel the effects with rental reductions and an influx of properties on the market.

Against this background, retirees still need to take measured risk to meet their goals, but they may need to plan differently than they would have in the past.

Why do investors need investment risk?

Regardless of retirement status, all investors face investment risk of some kind. Risk refers to the degree of uncertainty or potential financial loss that is inevitable in any investment decision. Typically, as investment risks rise, investors seek higher returns to counteract their own anxieties for taking such risks.

However, retirees usually view the world differently from when they were working, and perhaps the single largest change they experience is how they respond to risk. Typically investors are much more 'loss averse' in retirement, that is they fear losses much more than gains feel good.

Nevertheless, it is still necessary to take some degree of investment risk with their superannuation assets. If retirees opt to take little or no investment risk, then their investment outcomes will probably be less than needed to achieve their lifestyle goals.

Investment strategies need to take into account each unique risk profile. This profile includes risk tolerance, risk capacity and risk requirement.

Risk tolerance refers to an investor's subjective attitude towards taking risk. It's a measure of how they feel when markets become volatile and uncertain.

However even if people are willing to take the risk, they may in fact not be able to afford it - what they can actually afford is referred to as ***risk capacity***.

And ***risk requirement*** is the amount of risk people need to take in order to achieve their desired returns.

A solid retirement strategy balances all three of these risk components.

Strategies designed for retirement

Of course, there is no single investment strategy likely to suit all Australians. Retirees need to take into account of their risk profile, their financial circumstances and objectives, the taxation system and Centrelink benefits.

The spectrum of retirement investment strategies ranges from a 'business as usual' approach to a significantly more complex 'income layering'. The spectrum allows for varying degrees of personalisation, and not all of them address all of the risks investors face in retirement.

The table below compares features of each of the most common approaches used by advisers for retirement strategies and how well each approach deals with the primary risks.

Strategy	Primary benefit	Personalisation	Sequence of return risk	Longevity risk	Inflation risk	Market risk	Frequency of review	Complexity
Same as accumulation	Simplicity and consistency	Low	🔴	🔴	🔴	🔴	Low	Simple
Conservative asset allocation	Accounts for retiree's reduced risk tolerance	Low	🟢	🔴	🔴	🟡	Low	
Simple bucketing	Cash bucket provides peace of mind	Medium	🟡	🟡	🟡	🟡	Medium	
Complex bucketing	Extra buffer provides additional layer of security	High	🟢	🟡	🟢	🟢	High	
Income layering	Dynamic allocation and withdraw approach tailored to retiree's needs and wants	High	🟢	🟢	🟢	🟢	High	Complex

*Traffic lights – how well are risks addressed by each advice approach.
Source: Fidelity, CoreData.

Strategy 1: Same as accumulation phase

This is a 'business as usual' approach and involves retirees simply extending the same investment strategy from the accumulation phase into the retirement phase. As the goal in the accumulation phase will usually be to maximise total return on investment, retirees opting for this approach implicitly remain long-term investors with the ability to continue to tolerate market risk.

This strategy potentially overlooks the sequence of return risk and fails to consider most retirees' reducing risk capacity as they age.

Strategy 2: Transition to a more conservative asset allocation

Many Australians opt to move to a more conservative asset allocation strategy in retirement. Generally, retirees' portfolios have a large percentage of the total portfolio allocated to low-risk and low-volatility assets such as conservative equities, fixed income and money market securities.

This strategy ultimately helps to manage the sequence of return risk, potentially making it suitable for retirees who value downside protection more than the upside growth. However, if the strategy is overly conservative, the relatively constrained upside potential of the strategy may expose investors to greater inflation risk.

Strategy 3: Simple bucketing

This strategy divides investors' portfolios into separate components (or buckets) with each bucket serving different objectives.

A simple bucketing approach has only two buckets: a cash bucket and a diversified investment bucket. This approach provides retirees with a short-term cash buffer against market shocks. When combined with a rebalancing discipline this approach can be effective in providing the right amount of risk exposure whilst providing the investor with sufficient liquidity for their short-term needs during periods of market volatility. Investors can better manage both sequencing risk and market risk.

Strategy 4: Complex bucketing

Retirees seeking a more bespoke approach which divides accumulated savings into discrete pools with different objectives. The complex bucketing strategy also helps to manage retirees' sequencing and inflation risks by segmenting the retirement savings pool into different time horizons.

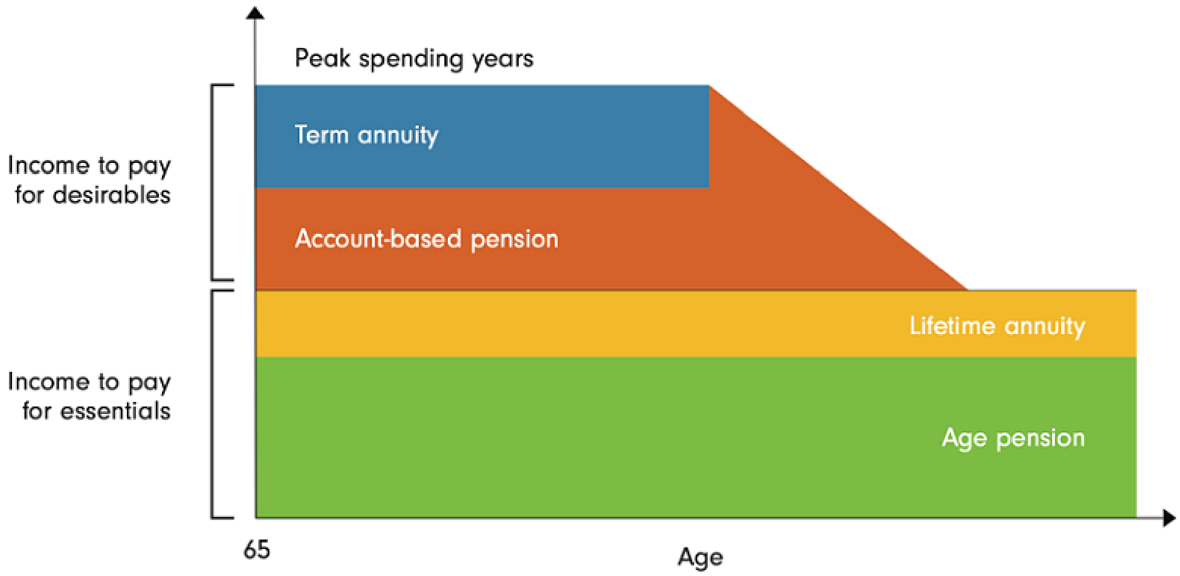
This approach can be viewed as an asset-liability matching strategy as it seeks to match short-term liabilities (or spending requirements) with cash and short-term bonds, providing investors with confidence that money will be available when needed, even in declining markets.

It also seeks to match investors long-term liabilities (or expected expenses) with relatively long-term assets such as equities, with the aim of providing greater return and ultimately, the resources to meet their expected future spending needs. By not needing to draw on the long-term assets when markets are volatile, the benefits of compounding are able to come through with this type of strategy.

Strategy 5: Income layering

This strategy divides retirees' portfolios into separate components, based on their spending needs for life. Spending needs can be grouped into four distinct categories: basic living expenses, contingency expenditures, discretionary expenses and legacy (children's inheritance), as shown below.

Layer	Example objective	Income sourced from
Legacy	Leave funds for family or philanthropy	Account-based pension, term annuity
Discretionary	Fund nice-to-have assets and activities	Account-based pension, lifetime annuity
Contingency	Meet unexpected healthcare expenses, home repairs	Account-based pension
Basic	Food, housing, utilities, clothing, transport	Age pension (if eligible), lifetime annuity



Source: Challenger

This type of strategy matches investors' income priorities with their spending priorities and separates their needs from their wants, while prioritising income accordingly. Term annuities or bond ladders can be used to provide the shorter-term income needs.

Conclusion

To summarise, a certain level of risk-taking is necessary for retirees to achieve their investment objectives and a solid retirement strategy balances all three components of a retirees' risk profile, allowing them to sleep soundly at night without needing to worry about their investments.

Richard Dinham is Head of Client Solutions and Retirement at Fidelity International, a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au. For more articles and papers from Fidelity, please click here.

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Let's be clear: sustainability isn't free

Robert M. Almeida, Robert Wilson

There's a school of thought in parts of the investment community that the increasing focus on corporate sustainability is the ultimate win-win. This group contends that if employers pay their people more, it will result in higher sales and productivity and will ultimately reduce costs. They reason that cutting emissions will not only help the planet, but also bolster companies' bottom lines.

Unfortunately, the reality couldn't be further from the truth. Sustainability isn't free, and in our view, efforts to become more sustainable will challenge many companies and perhaps even bankrupt some of them.

Accelerating trends

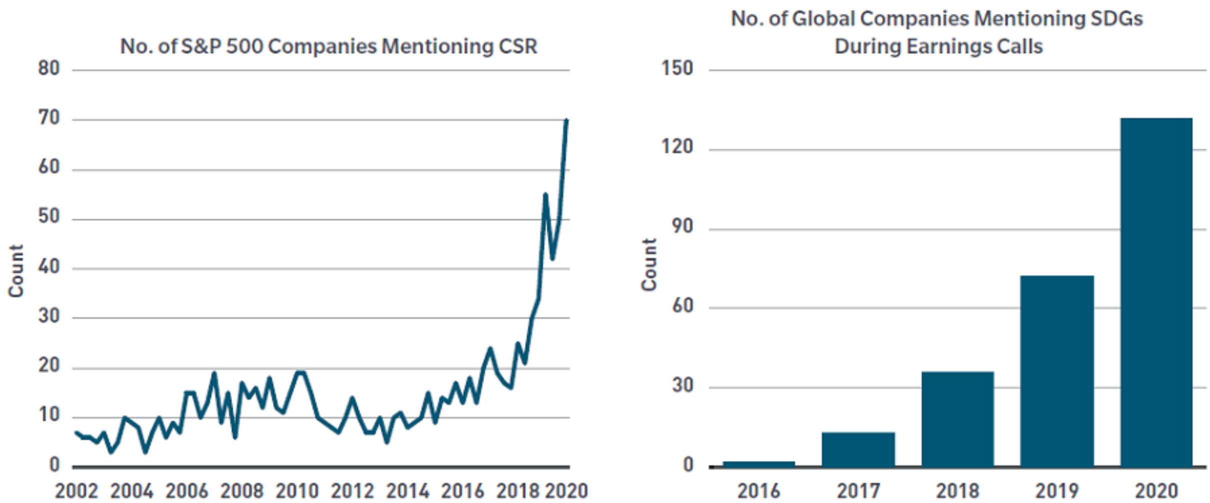
The pandemic accelerated many well-documented secular trends such as digital media, cloud computing and work-from-home. But it also hastened less obvious ones, such as loneliness, wealth inequality and interestingly, investor demand for changes in corporate behaviour.

While we can point to numerous data points to illustrate mounting investor interest in ESG (Environment, Social and Governance) through fund flows, to us, what's more noteworthy is the growing recognition by management teams of the need for more sustainable business practices.

For instance, as shown on the left-hand side of Exhibit 1, there was a jump in the number of S&P 500 companies that referenced corporate social responsibility (CSR) in quarterly earnings calls during 2020. The right-hand side of the exhibit looks at the number of global companies that referenced, during earnings calls, any of the 17 Sustainable Development Goals (SDGs), a set of global objectives agreed to by the UN General Assembly in 2015 to improve the quality of life worldwide. It shows a similarly large year-on-year increase.

Exhibit 1: A Different Normal

Growing ESG pressures are driving behavioral changes



Source: LHS - Evercore ISI. Quarterly data from 31 December 2002 to 30 September 2020. CSR = Corporate Social Responsibility. RHS - Goldman Sachs, GS Sustain, "Investing in the Sustainable Development Goals". 12 February 2021. SDG = Sustainable Development Goal.

Why sustainability matters

There is a long list of reasons why civil society, governments and special interest groups are concerned with ESG issues. The most notable one, of course, is that addressing them is critical to the long-term success of our global community. The ramifications, for example, of issues such as runaway climate change or rising income inequality, if left unresolved, are likely to be profoundly negative.

Our point of emphasis, however, is the changing reaction function of companies. Now that investors are focusing on sustainable business practices, management teams have begun to pay attention. And that matters. A lot.

Materiality is key

Sustainability will drive new business opportunities for some while exacerbating risks for others, leading to substantial divergences in the long-term enterprise value of many companies. But what is largely lost in the current ESG narrative is financial materiality. Which of course affects financial asset prices.

A sharp rise in the US minimum wage, for instance, would no doubt challenge a number of business models. Certain retailers would face particular challenges. If companies in this sector are going out of business at an alarming rate while paying the US federal minimum wage of $7.25 an hour, how can they possibly hope to survive if the wage increases to $15?

Some retailers will be able to adapt due to their competitive positioning or other strengths, and in fact some already have, with bonuses and salary increases since the pandemic began, but many will find that sustainability concerns pose major challenges to their profitability.

Producers of fossil fuels and companies reliant on their use will also face high hurdles. Many in the oil industry are banking on a growing middle class in emerging markets to underpin demand and help maintain the status quo. However, over two-thirds of oil demand is tied to automobiles powered by internal combustion engines, and we believe that mode of propulsion will become antique in the not-too-distant future. Cumbersome organisations that are slow to recognise and adapt to this change are unlikely to survive.

Many incumbents will struggle

Looking back over the past 100 years, one thing is clear: Industry incumbents don't fare well in the face of disruptive technologies. And the move toward sustainability is a disruptive force akin to the industrial revolution or the advent of the internet. It will define society and the investment landscape for decades.

But it won't be free. There will be winners and some very big losers. This new paradigm is unfolding during a period in which risk premia are at all-time lows, underlining the importance of allocating capital responsibly.

Robert Wilson is a Research Analyst, and Robert M. Almeida is a Global Investment Strategist and Portfolio Manager at MFS Investment Management. This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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Indexation complication! Four changes you need to know

Julie Steed

Several superannuation thresholds will be indexed from 1 July 2021. In this article we will review the thresholds that impact retirement pensions and contributions.

1. The transfer balance cap

The transfer balance cap limits the amount of superannuation that an individual can use to commence a pension, where the investment returns are generally tax free. It was introduced from 1 July 2017 at $1.6 million and from 1 July 2021 it will increase to $1.7 million.

The transfer balance cap is indexed to the consumer price index in $100,000 increments. However, unlike many other thresholds, not everyone will be able to transfer an additional $100,000 into retirement pension phase. Rather, there is a complex formula used to determine if an individual has any 'cap space' and can therefore move additional benefits to retirement phase pensions.

The transfer balance account is a series of debits and credits that track changes in pensions, most commonly a credit for the commencement of a pension and a debit for the commutation of a pension. The transfer balance account can be negative.

Since 1 July 2017, all individuals have had a personal transfer balance cap of $1.6 million, which equals the general transfer balance cap. From 1 July 2021, anyone who has commenced a retirement pension of less than $1.6 million will have a personal transfer balance cap that is different to the general transfer balance cap. This will make it more confusing for individuals to understand how much they can use to start additional pensions.

Firstly, if a person had a retirement pension at 1 July 2017 or has subsequently commenced a pension for $1.6 million then they have no cap space and cannot use any additional funds to commence a retirement pension. At least that part is relatively straightforward.

For individuals who have commenced a retirement pension of less than $1.6 million, there is a five step process to calculate their personal transfer balance cap:

1. Identify the highest balance of the transfer balance account
2. Identify the general transfer balance cap at the time of the highest balance of the transfer balance account
3. Calculate the proportion of the cap that was unused at that time
4. Multiply the indexation of the general cap by the percentage from 3 above
5. Add to the personal transfer balance cap

The Australian Taxation Office will calculate everyone's personal transfer balance cap which can be accessed via an individual's myGov account.

Case study - Martin

Martin started a pension with $1 million on 1 July 2018. By July 2021 his pension has increased in value to $1,100,000. Martin received an inheritance and has made non-concessional contributions and a downsizer contribution. He wants to know how much he can use to start a second pension.

Martin's personal transfer balance cap is calculated as:

Calculation steps	Calculation	Value
Highest TBA balance		$1,000,000
TBC at highest TBA balance		$1,600,000
Highest cap proportion	$1,000,000 / $1,600,000 rounded down to whole number	62%
Unused cap proportion	100% - 62%	38%
Proportion of indexed amount	37.50% x $100,000	$38,000
Total TBC	$1,600,000 + $38,000	$1,638,000
Remaining TBC amount	$1,638,000 - $1,000,000	$638,000

Martin can start a second pension for up to $638,000.

Contributions

There are several thresholds that will be indexed from 1 July 2021 that impact an individual's contribution planning.

2. Total super balance

From 1 July 2021 the total super balance threshold at which eligibility for making non-concessional contributions and receiving Government co-contributions and spouse contributions increases from $1.6 million to $1.7 million.

The increased total super balance applies to all individuals, there is no personal calculation. The total super balance continues to be measured at the previous 30 June.

3. Concessional contributions

The concessional contributions cap will be indexed to $27,500 from 1 July 2021.

This also impacts the concessional contributions five year carry forward contributions for clients who have a total super balance at the previous 30 June of less than $500,000. This threshold is not indexed.

In 2021/22, clients who have a total super balance at 30 June 2021 below $500,000 will have a concessional contribution cap of up to $102,500. This is calculated as a maximum of $25,000 for 2018/19, $25,000 for 2019/20, $25,000 for 2020/21 and $27,500 for 2021/22.

4. Non-concessional contributions

The non-concessional contributions cap is calculated as four times the concessional contributions cap so from 1 July 2021 the non-concessional contributions cap will be $110,000.

The two and three year bring forward will also increase to $220,000 and $330,000 respectively from 1 July 2021.

The total super balance thresholds for determining eligibility to make non-concessional contributions also changes, as outlined in the table below:

Item	Calculated as	TSB range since 1 July 2017	TSB range from 1 July 2021
Three year bring forward	TSB – (3 x NCC cap)	< $1,400,000	< $1,480,000
Two year bring forward	TSB – (2 x NCC cap)	$1,400,000 - <$1,500,000	$1,480,000 - <$1,590,000
Annual NCC cap	TSB	$1,500,000 - < $1,600,000	$1,590,000 - < $1,700,000

Importantly the three year bring forward maximum contribution is based on the non-concessional contributions cap at the time the three year bring forward is triggered.

Case study

Shamal triggered the three year bring forward in 2020/21 by making a $120,000 contribution. He can contribute a further $180,000 prior to 30 June 2023. He does not benefit form indexation of the non-concessional contributions cap during this time.

Thresholds not indexed

In addition to the threshold for accessing the five-year concessional contributions carry forward, the $300,000 total super balance threshold for determining eligibility for the work test exemption is not indexed.

Summary

The superannuation rules changed dramatically in 2017 and introduced a variety of thresholds that determine eligibility for certain tax concessions. The indexation of the thresholds adds an additional layer of complexity from 1 July 2021. Understanding the additional complexities will assist individuals to maximise the tax concessions available in super.

Julie Steed is Senior Technical Services Manager a Australian Executor Trustees. This article is in the nature of general information and does not consider the circumstances of any individual.

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