Firstlinks
a Morningstar company

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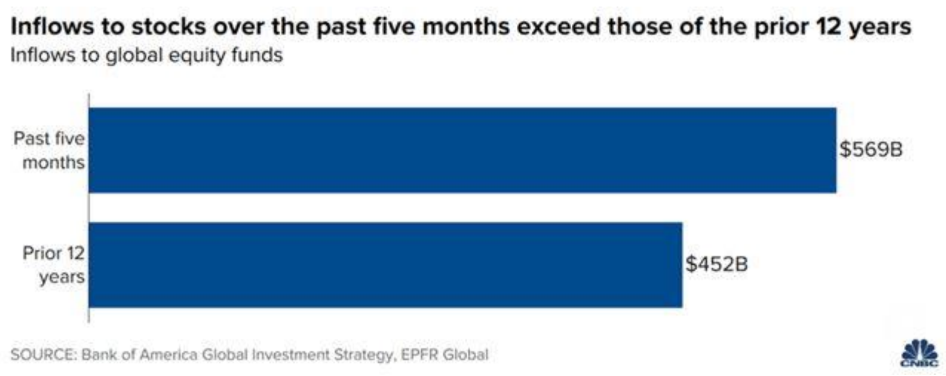
Contents

Editorial

In a market where the valuation superlatives and 'meme investing' gains become more ridiculous by the day - a joke cryptocurrency like **Dogecoin** is now valued higher than **Ford** or **Wesfarmers, Tesla** trades on a P/E of 1,200, a digital nonfungible token (NFT) sells for USD69 million - it's welcome when a chart is the surprise of the week. While we have written about the rapid increase in new participants who consider the stock exchange like a video game, this chart from CNBC shows inflows into global stock funds in the **five months** since November 2020 were greater than in the previous **12 years**.



Morningstar data shows US mutual fund and ETF flows for March 2021 were a record, exceeding the record set the previous month.

During the period when new investors received stimulus cheques while locked up at home in front of their computers, these are the spectacular returns delivered as social media reported how rich their mates had become:

Global stock market moves since low on 23 March 2020

Market Index	23/03/2020	14/04/2021	% Gain
US: Dow Jones	18,592	33,731	+81.4
S&P 500	2,237	4,125	+84.4
Nasdaq Composite	6,861	13,858	+102.0
Germany: DAX	8,741	15,209	+74.0
Japan: Nikkei 225	16,888	29,621	+75.4
Australia: S&P/ASX 200	4,546	7,023	+54.5
China: Shanghai Comp	2,660	3,417	+28.5
CSI 300	3,530	4,981	+41.1

With returns are like this, Australia's 55% looks like an underachievement, and even conservative investors feel a FOMO when their term deposits are earning a miserable 1%.

If it's any consolation, however, this chart from **NAOS Asset Management** shows the three-month relative price performance for the first quarter 2021 for four Australian tech stocks which were darlings in 2020. Phew, thank goodness they have finally fallen, I hear many of you think.

Source: IRESS

Where to from here? We check the 'all-in equities' thesis recommended over many years here in Firstlinks by **Peter Thornhill**, who feels vindicated in the middle of a pandemic, versus the famous '**Warren Buffett indicator**'. Buffett is the ultimate long-term stock market bull but even he believes returns depend on the entry price, and by most measures, the market is very expensive. At some point buyers will be scared away by rising inflation, a pullback in stimulus or a black swan. What does Buffett say about buying at market extremes?

Continuing this theme, **Robert Almeida** checks this last year like no other and forecasts the types of stocks likely to do best as markets return to what might be considered more normal.

The critical component driving markets is the stimulus packages from governments around the world, and **Michael Collins** analyses the consequences of **President Joe Biden**'s massive spending, where a vast range of social programmes are putting money into the pockets of millions of Americans.

At the more conservative end of the investing spectrum, for those looking for more predictable and steady income, **Andrew Lockhart** reports on what to look for in a corporate bond fund and why they are worth a defensive allocation. In this sector, it's better to spread the investments rather than go into individual bonds.

Super update ... but industry needs to step up

The big news keeps coming in superannuation with *The Australian Financial Review* reporting that the Government has decided not to change the legislation increasing the mandatory super rate to 10% on 1 July 2021 on its way to 12%.

The Minister for Superannuation, **Jane Hume**, was using the Retirement Income Review to argue that 9.5% was sufficient if super was used more efficiently. Why the change? The reason seems to be that lower super would further disadvantage women who are already well behind men in retirement savings, and the political mood for a policy not attractive to women is zero after recent events. **Paul Keating** told the AFR:

"Such a decision would amount to a consensus between the parties on the superannuation aggregates, underwriting a generational opportunity for superior income adequacy in retirement. Such an outcome would allow people to plan for retirement knowing they are able to rely on a much larger accumulation, while allowing funds to create longer-term instruments. This would lead to more innovation and efficiency in the deployment of funds across the economy ... More than that, such a change would lead to a much fairer and more equal economic society."

Professor **Deborah Ralston** responds to last week's article from **Ross Clare** as she defends the Retirement Income Review's position on spending money in retirement.

And amid all this argument within the industry and politics about how superannuation should work, two senior finance executives take aim at the failings in the industry. **Amara Haqqani** has stepped away after six years in retirement income product and policy, disappointed with the focus on products and not people. In any case, says **Donald Hellyer**, super funds have not earned the right to more of his money, and cooperative structures do not allow super funds to offer the risk-based products needed to protect from longevity risk.

The **Comment of the Week** comes from Mart in response to Ross Clare's article on superannuation balances at death:

"There will always be hacks or smart strategies (take your pick on which is the best description) to better protect your capital from certain 'imposts' (including the 17.5% 'death tax' in the situation you reference)! I think the real points are (a) careful about the law of unintended consequences and (b) there are often options to those impacted to restructure if they wish to (and are clued up enough to)."

This week's White Paper from **Shane Oliver at AMP Capital** gives three reasons why the long-term bull market in Australian home prices may be close to the end.

Buffett's favourite indicator versus all-in equities

Graham Hand

"If you had read that article in 1979, you would have suffered - oh, how you would have suffered! - for about three years. I was no good then at forecasting the near-term movements of stock prices, and I'm no good now. I never have the faintest idea what the stock market is going to do in the next six months, or the next year, or the next two." - Warren Buffett, Fortune Magazine, December 2001

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You're in good company if you don't have a clue what the stock market will do in the next year or two. The queue starts here.

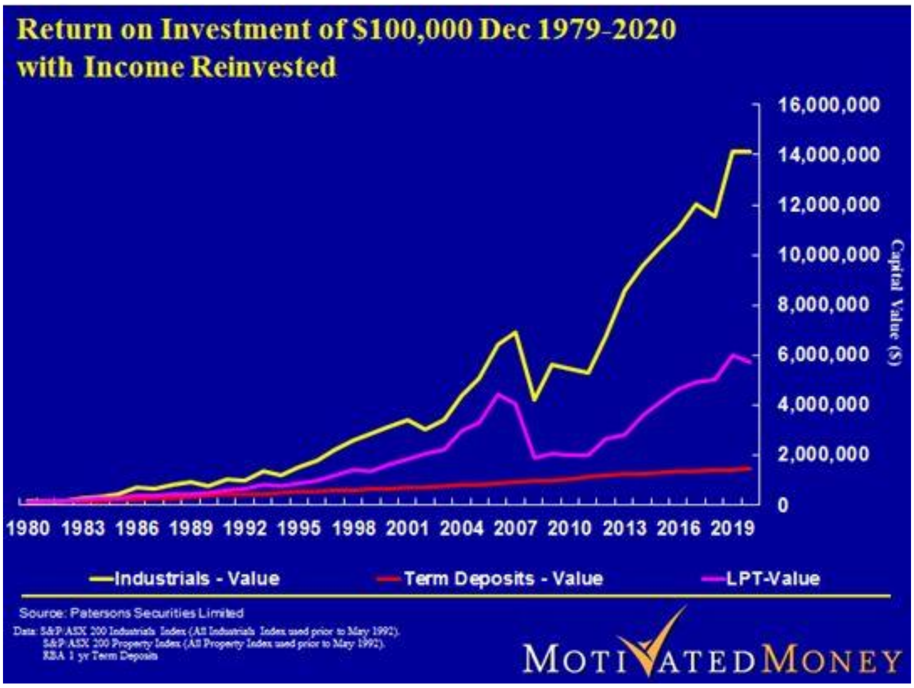
In a recent Firstlinks editorial on asset allocation, we highlighted the risks in a traditional 60% growth/40% defensive portfolio, especially when most of the 40% is earning negligible returns in bonds. Several comments criticised the defensive allocation in a super portfolio required to build wealth for the long term.

Notably, we were contacted by well-known author and lecturer, Peter Thornhill of Motivated Money, who has consistently argued that investors should hold most of their retirement assets in industrial shares paying steady dividends, avoiding cash and term deposits (other than a three-year reserve to reduce the risk of selling shares in a down market). Peter wrote:

"*Your article today is very timely. The super industry serves the public badly. Trying to protect them from short term volatility because of ignorance is an abrogation of their responsibility.*

They should be educating the public to understand the monumental price they pay for this stupidity. Adding rubbish like cash, bonds and property is like adding lead to the saddlebags of a racehorse.

(Peter updated his chart showing 40 years of returns on industrial shares, listed property trusts and term deposits).



I left the industry in 2000 for this very reason. I have no qualifications and my role in the funds management industry was purely marketing.

At that time, I started our self-managed super fund. Below is the result over the last 20 years. A combination of minimum cash, no resources, bonds or property, combined with my dumb luck, has served us well.

(Editor's note: Peter gave approval to share his personal spreadsheet. He says his calculation takes into account all contributions made and the performance of each addition from the entry date. TWR is Time Weighted Return. This article shows some of the stocks he owns).

Update

01 Jul 2000 to 15 Apr 2021

Movement in value

Starting market value	**$260,927.75**
Net withdrawal	-$843,452.64
Realised and unrealised gains/losses	$5,554,769.20
Total income net of foreign tax paid	$3,252,747.95
Total expenses	-
Ending market value	**$8,222,936.68**
Movement in value	$7,962,008.93
Unallocated amount	-$2,055.58

Portfolio returns

Realised and unrealised gains/losses	$5,554,769.20
Total income	$3,253,198.96
Franking credits	$1,130,043.02
Total dollar return before expenses	**$9,938,011.18**
Total expenses	-
Total dollar return after expenses	**$9,938,011.18**

Percentage returns

Periods to 15 April 2021	Since 01/07/2000 p.a.
Portfolio return before expenses (TWR)	**12.66%**
S&P/ASX 300 Industrials Accumulation Index	8.05%

Volatility is not a measure of risk; it is a measure of liquidity. In a super fund, time is on your side and short-term volatility is your friend. Buying CBA at $26 and Wesfarmers at $13, amongst many others, during the GFC was a godsend.

My other major concern is the brouhaha over fee levels. They pale into insignificance compared to the asset mix. The shortfall with the wrong assets over the lifespan of a super holding is monumental."

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The obvious difficulty with Peter's 'all-in equities' strategy for most retirees is that they cannot tolerate the risk. Watching 90% of your portfolio fall 50% in a market crash when you plan to spend 20 years living on the capital and its income is too much for many to stomach. For peace of mind and a decent night's sleep, retirees accept low returns for low risk and capital protection.

But the cost of this conservatism has never been greater. When term deposits were paying 8%, it was an easier decision to protect capital, but now more investors are heading into riskier assets to generate decent returns.

So far it has paid off.

Unfortunately, nobody runs down the middle of the road waving a red flag the day before a market crash. Those who say they will simply sell before the fall are dreaming. What could trigger this amazing foresight? Anyone who sells after, say, a 5% fall based on the belief that 5% will turn into 50% is just as likely to miss the rebound and sit in cash while the market continues its run.

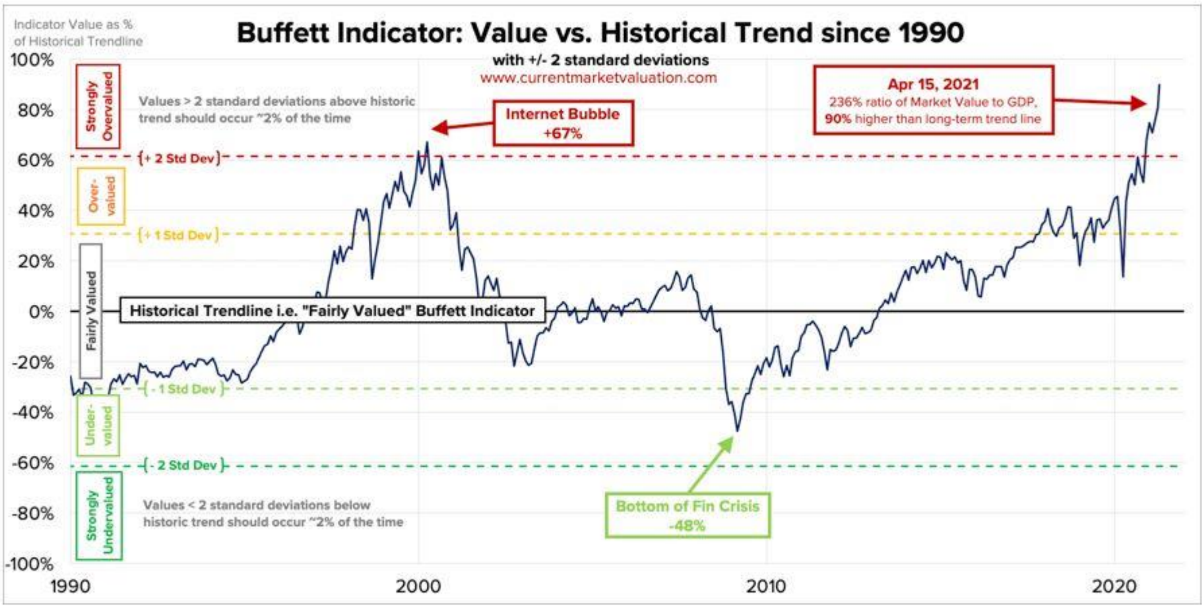
In the absence of a red flag, all we can do is look to history for a poor guide, recognising the current set of circumstances is unique. But apparently, if we don't learn from history, we are condemned to repeat it, so where better to start than with Warren Buffett.

Buffett's favourite market indicator

The ratio of the market value of the stock market to GDP has become known as the 'Buffett Indicator' after Buffett told Fortune Magazine that it is: *"probably the best single measure of where valuations stand at any given moment."*

It has intuitive appeal, comparing the value of all companies in the Wilshire 5000 Total Market Index (the value of all stocks traded in the United States) with US quarterly GDP. Although it has been trending higher, the theory is that the value of companies should not grow at a faster pace than economic growth for a long time period.

On 15 April 2021, the ratio was an extraordinary 236%, which is not only higher than in the dot-com bubble, it's the highest it has ever been above its long-term trend. It is almost three standard deviations above 'fairly valued'.



Source: [Current Market Valuation](#) (CMV)

Should we be worried?

According to [Warren Buffett](#): *"For investors to gain wealth at a rate that exceeds the growth of US business, the percentage relationship line on the chart must keep going up and up. If GNP is going to grow 5% a year and you want market values to go up 10%, then you need to have the line go straight off the top of the chart. That won't happen.*

For me, the message of that chart is this: If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% - as it did in 1999 and a part of 2000 - you are playing with fire."

Sounds like he never expected to see 236%!

The Buffett Indicator has predicted several historical moments in the US stock market, such as the dotcom bubble (index was 'strongly overvalued'), the bottom of the GFC (index was 'undervalued) and even COVID-19 in February 2020 (index was overvalued).

The big differences in 2021 are the historic low levels of interest rates and central bank willingness to do whatever is necessary to support recovery. Even Buffett concedes that stocks are not always better than bonds: *"But as Keynes would remind us, the superiority of stocks isn't inevitable. They own the advantage only when certain conditions prevail."*

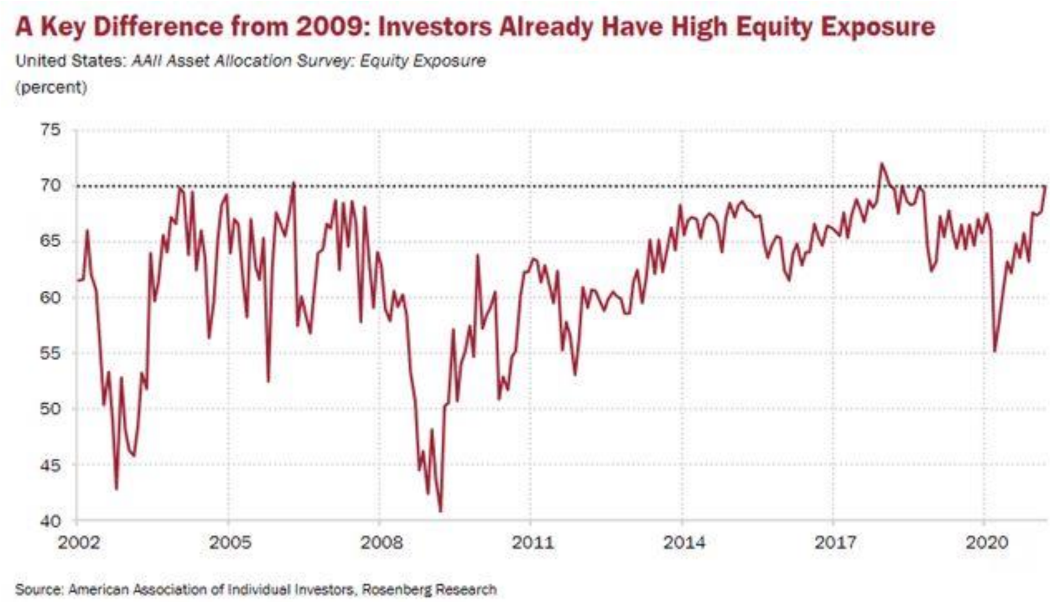
And one of those conditions is the entry point, which should not be at an expensive market extreme.

How much buying support remains?

There is an infinite array of charts that can prove anything, but let's take one from John Mauldin's newsletter, [Thoughts from the Frontline](#), where he states:

"Right now, the stock market is in the land-where-there-should-be-sea phase. What we don't know is when the wave is coming. Maybe there's time to venture out and see what treasure was hidden beneath the waves ... or maybe not. Prudence would suggest that we go searching for treasure on higher ground."

The chart from Rosenberg Research shows the significant amount that US investors have poured into the stock market since the bottom of the pandemic cycle. Mauldin says the investments in equities have already added fuel to the fire and he questions where future buyers will come from.



This fuel has driven the rapid recovery in share prices, far greater than the rise from the lows in recessions such as 1990, 2002 and 2009. The implication is the gains have already been made.

Australian confidence

The latest Westpac-Melbourne Institute Consumer Confidence Index in April 2021 shows a rise from March's 111.8 to 118.8. Said Westpac Chief Economist Bill Evans:

"This is an extraordinary result. The Index is now at its highest level since August 2010 when Australia's post-GFC rebound and mining boom were in full swing."

An Index above 100 indicates the number of consumers who are optimistic is greater than the number of pessimistic consumers, with the long-term average of 101.

Also, NAB's latest monthly business survey index of over 400 firms registered 25, a record high, and a significant improvement on February's 17. ANZ Senior Economist Catherine Birch said:

"The March NAB business survey confirms our expectations that the impact of the end of JobKeeper on the economic recovery will be short and limited and gives us more confidence in a strengthening business investment outlook."

Both of which lay the groundwork for economic growth and business profits. However, the one-year forward price/earnings ratio of the Australian market is 19 times, or about 30% over the long-term trend, leaving little margin of safety.

The final words

While share prices are high based on historical metrics, lenders and central banks are delivering plenty of liquidity and stimulus. The pandemic has loosened the purse strings like never before in history, and banks are not inclined to seize assets as they have in previous cycles.

Let's finish with another Warren Buffett statement from his most recent annual shareholder letter, with a simple focus on long-term investing that support's Peter Thornhill's general strategy:

"All that's required is the passage of time, an inner calm, ample diversification and a minimisation of transactions and fees."

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

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A year like few others, but what's next?

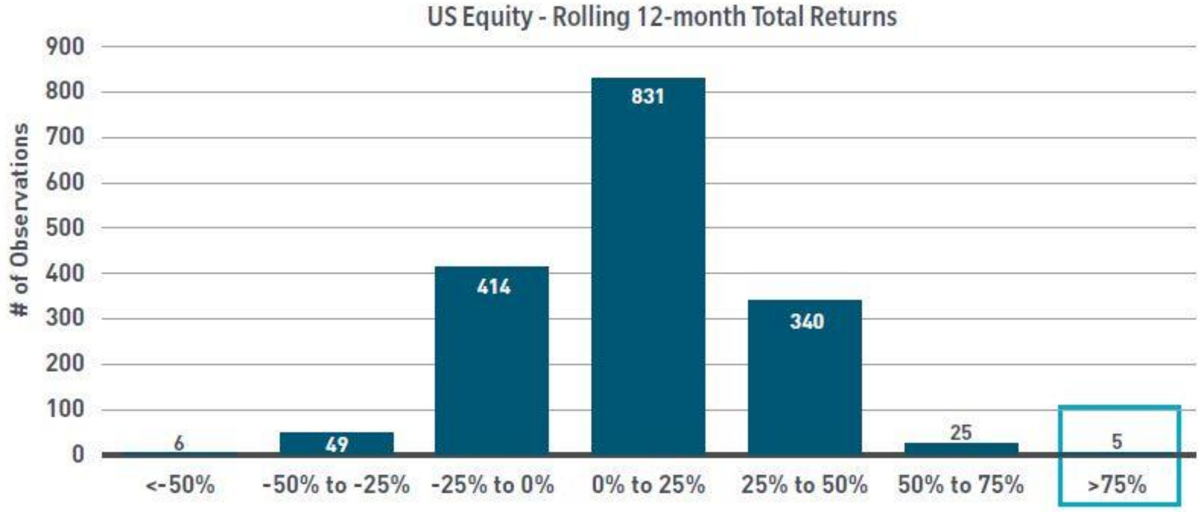
Robert M. Almeida

The one-year anniversary of the low point in the S&P 500 index during the pandemic was 23 March 2021, so we want to put the trailing one-year return of 77% into context as we look ahead.

This was a rare event

With the help of Bernstein Research, we calculated trailing 12-month returns for every month-end beginning in 1882. We then aggregated all the return streams into buckets, as shown below. So, how rare was this past year's return? Extremely.

Exhibit 1: Only a handful like it



Source: Bernstein. Monthly data from 31 January 1881 to 28 February 2021.

All five previous examples of 75% or greater 12-month trailing returns occurred during the Great Depression of the 1930s, another period of extraordinary government economic intervention.

What's unique about the response to the coronavirus pandemic is the speed at which the US economy exited the recession once the US Federal Reserve put a floor under credit risk.

Markets may be short term, but they're not dumb

Financial markets are a discounting machine. They tend to ignore seemingly material factors such as high unemployment while zeroing in on things that really matter, such as free cash flow generation.

For instance, in the quarters preceding Franklin D. Roosevelt's New Deal, investors looked through intense economic pain and suffering in anticipation of an explosion of economic growth in 1934. What followed was a strong, but short-lived, business cycle. After the effects of the early-New Deal stimulus had worn off in 1937, worries about deficits resulted in spending cuts and the economy contracted again. Financial markets anticipated that too, as evidenced by the rollercoaster market returns throughout the 1930s.

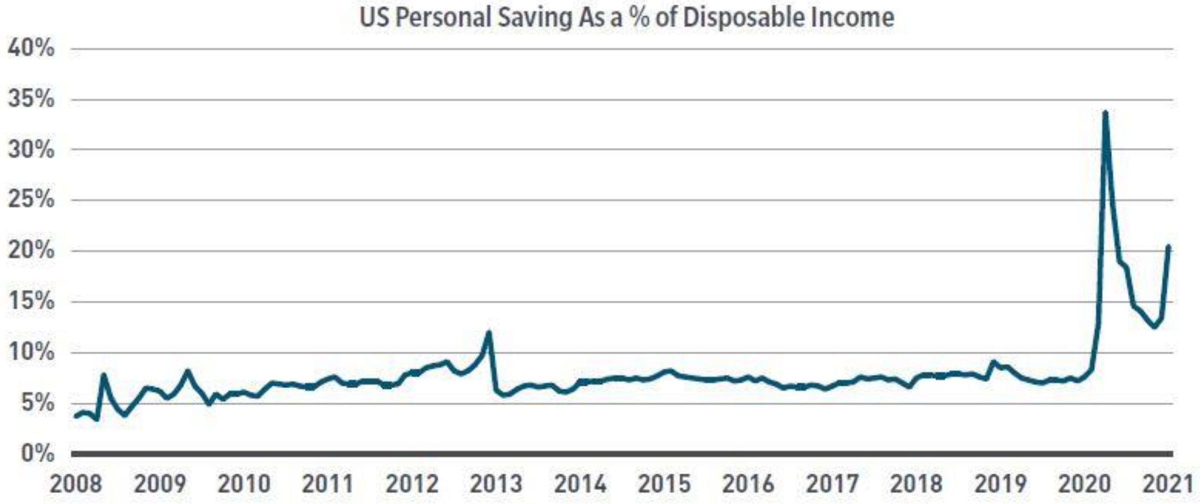
Bringing it back to the present day, following the lows of last March, the beneficiaries of the initial phase of the rally were stay-at-home stocks such as streaming services and video conferencing providers.

However, as the weeks passed, investors began to look though the uncertainty surrounding the virus to what could be a massive snap-back in US economic growth in the second half of 2021. They switched their focus, shifting capital away from free-cash-flow compounders — companies that are typically more in control of their own destinies — and toward the stocks and credits most leveraged to the economic outlook: cyclicals.

The significant outperformance of companies with highly indebted balance sheets or lower-quality income statements is characteristic of the early phase of a market cycle. Regardless of quality, those companies that are most directly leveraged to a rebound in economic growth have historically become market darlings. That pattern played out during the previous two business cycles, after the collapse of the dot-com bubble and again in the wake of the global financial crisis.

I don't discount what the market is signaling. It may be short term, but it's not dumb. The combination of an exceedingly high US savings rate (thanks to pandemic-driven government transfer payments) and pent-up consumer demand (after more than a year of lockdowns) should lead to an enormous pop in economic growth.

Exhibit 2: US stimulus has ballooned savings



Source: Bloomberg. Monthly data from 31 January 2008 to 31 January 2021.

Cross-cycle compounders will replace cyclicals

Most investors focus on the near term. That will probably never change. Therefore, it comes as no surprise that the market's ability to predict what will happen in the short term is strong but weakens over the medium and long term. That's why our focus is always on the out years.

At some point, as they always do, financial markets will look through the coming eye-popping economic statistics. They will begin to discount what business fundamentals will look like without the tailwind of exceptionally accommodative fiscal and monetary policy.

And if history is any guide, we expect that as policy normalises, investors will pivot back to the type of cross-cycle earnings-compounders that make up many of our core holdings. These 'compounders' grow or 'compound' their earnings better than lesser companies across cycles as their revenues hold up in difficult conditions. They deliver strong cross-cycle earnings growth.

Cyclicals will have had their day, as they often do in the early phases of a market cycle, but we believe secular trends will win out in the long run, rewarding patient investors as the cycle matures.

(Editor's note: A stock is secular when company earnings remain relatively constant regardless of other trends. Examples are consumer staples or products that households consistently use. A cyclical stock's price is more affected by changes in the economy).

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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Biden is stimulating an economy already enjoying a sugar hit

Michael Collins

Detroit's giant carmakers were among the US businesses tottering as the GFC took hold. About 2.6 million Americans lost their jobs over the four months from when the recession erupted in September 2008 until President Barack Obama assumed office at the start of 2009. The modelling of Christina Romer, Obama's Chair of the Council of Economic Advisers, showed the then-US$15 trillion economy needed stimulus of about US$1.8 trillion to close the 'output gap' within two years.

How times change

But the Democrat-controlled Congress was infused with the era's conventional wariness of budget deficits and government debt. Obama sought fiscal stimulus of only US$775 billion, though he expected the usual bartering among lawmakers to bloat the package to US$1 trillion. Republican outcries about government squandering swayed enough moderate Democrats, and the American Recovery and Reinvestment Act of February 2009 contained only US$725 billion in new money.

The jobless rate jumped from 8.3% that February to a then-post-war high of 10% eight months later as the number of unemployed swelled by another 3.5 million people. No surprise, the Obama stimulus of 5% of GDP has gone down in Democrat folklore as a 'measly' response that was partly to blame for the party losing Congress in the 2010 elections.

President Joe Biden appears determined not to repeat the errors made when he was Vice President. Biden is implementing a stimulus package worth 9% of GDP, even though the US economy is well past crisis-mode and the output gap – the difference between the economy's actual and potential performance – is narrowing.

Package upon package

The recovering US$22 trillion economy is enjoying a vaccine-inspired reopening. Congress had already passed four covid-19 fiscal packages worth more than US$4 trillion that are still energising spending. The jobless rate has plunged from 14.8% in April last year to 6%. Housing prices are soaring at a 12% annual clip. The Federal Reserve has pledged to maintain its ultra-loose unconventional monetary policy.

In an era when 'magic money' theories dismiss concerns about government debt, the American Rescue Plan entails US$1.9 trillion of fiscal stimulus that will boost the budget shortfall for fiscal 2021 to 18% of GDP. Washington's debt load will soar from the pre-stimulus forecast of 102% of output, most likely well past the record 107% of GDP it reached around the end of World War II.

To its proponents, the inequality-fighting stimulus gives money to poorer households, extends unemployment relief, adds funds to vaccination programs, helps schools reopen and plugs gaps in the finances of local and state governments. The mostly one-off spending is popular and presaged more durable outlays such as the infrastructure plan Biden announced on March 31 that, if passed by Congress as announced, would over the next eight years entail US$2 trillion of fresh spending. Other Democrats are calling for a US$2 trillion 'Green New Deal' and expanding free healthcare to those aged below 65.

With US growth surging, did it need more stimulus?

As for the macroeconomics, the emergency relief prompted Fed officials to lift their US growth forecasts for 2021 from 4.2% to 6.5%, which would be the fastest pace since 1984's result of 7.2%. Others have raised their US growth forecasts for this year to as much as 8%, a speed last matched in 1951. Unfazed by the faster growth, Fed officials offered the 'forward guidance' that the US cash rate would stay at near-zero in coming years.

To its critics, much of the stimulus is a superfluous 'sugar hit' because the economy's spare capacity is shrinking anyway. They worry that government debt is reaching troublesome levels. This first points to higher taxes and reduced benefits in coming years – thus the package boosts intergenerational inequality while hindering growth from 2022.

The major concern is that the package is bound to lift consumer prices. Inflation, as the Fed concedes, is most likely to accelerate beyond the Fed's 2% target, though the central bank is unruffled by any spike in inflation above target. The critics worry that the expected rise in inflation beyond 2% proves more permanent. Biden's relief thus could backfire if it were to spark sooner- and larger-than-expected increases in official and market interest rates. Biden's first big legislative victory shows the new President is prepared to take risks on fiscal policy that could shape the rest of his presidency.

To settle a quibble, Obama's stimulus should be better remembered because what was one of the largest post-war stimulus programmes set up a record US expansion. More urgently, the pandemic is far from over. Mutations that nullify the vaccine would upend the economy. Yet Biden's stimulus might make it much harder to conjure up more huge sums without political and financial ructions. As to the threat from higher prices, hasn't the neoliberal age of 'independent' central banking killed inflation? The Fed can always do a U-turn and crush inflationary pressures.

Relying on low inflationary expectations

That, however, would thump the economy and upset capital markets. The most likely outcome is less threatening. In an era of low inflationary expectations and relatively weak labour bargaining power, there appears to be enough of an output gap to make it highly likely that the expected acceleration in inflation proves fleeting and Biden's bold approach will reinforce just how cautious Obama was 12 years ago.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.

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Four ways corporate loans can benefit your retirement income

Andrew Lockhart

After the financial market volatility of 2020, many investors are looking for more reliable sources of income and capital stability. However, with official interest rates at record lows, finding defensive investments that also deliver an attractive return is no easy task.

Australian corporate loans are among the few asset classes that offer both capital preservation and attractive risk-adjusted returns. Traditionally the asset class was only available to wholesale investors. However, in recent years, opportunities have become available to SMSFs and other self-directed investors in the Australian market.

Let's take a look at four key benefits of investing in a well-managed portfolio of corporate loans - reliable income, capital stability, diversification and protection against inflation.

1. Attractive, reliable income

Private debt can provide regular income, even during extraordinary times such as we saw in 2020. Interest and fee payments are received from borrowers at specified intervals under the binding terms of their debt contract. A floating base rate, with additional credit margin, ensures total interest income rises in line with upward movements in market interest rates (which may occur as a means of combating inflationary pressure).

This contrasts with dividends that are paid to equity holders at a company's discretion. Even when equity markets were at their most turbulent in early 2020, and many companies were suspending or reducing dividends, well managed private debt funds continued to deliver consistent monthly income for investors.

The asset class can provide attractive risk-adjusted returns even in a low interest rate environment. More conservative funds can deliver a return around 3% to 4%, an attractive alternative to low-yielding corporate bonds, hybrids, government bonds or even cash deposits. A higher yield fund can deliver a cash distribution around 6% to 8%.

When accessing corporate loan investments through an ASX-listed structure (Listed Investment Trust or LIT), investors benefit from liquidity available via secondary market trading. Investors enjoy the premium income distributions associated with this asset class without having to lock up capital for 3 – 5 years, which is the typical term of the underlying loans. Investors may be able to buy or sell units in the LIT on the ASX daily.

A skilled lender or private debt manager will seek to negotiate appropriate fees and credit margins to ensure investors are generating an appropriate return for risk and for the provision of non-bank debt finance to the borrower.

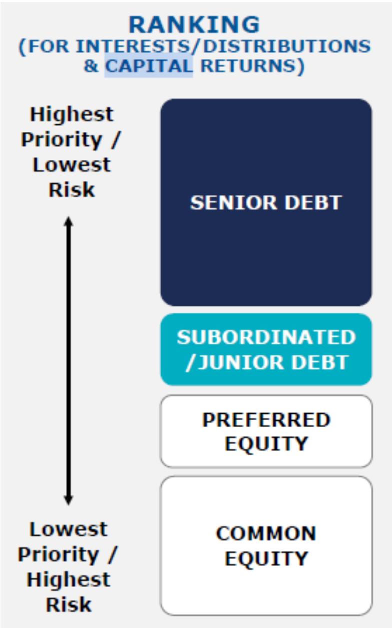
2. Capital stability

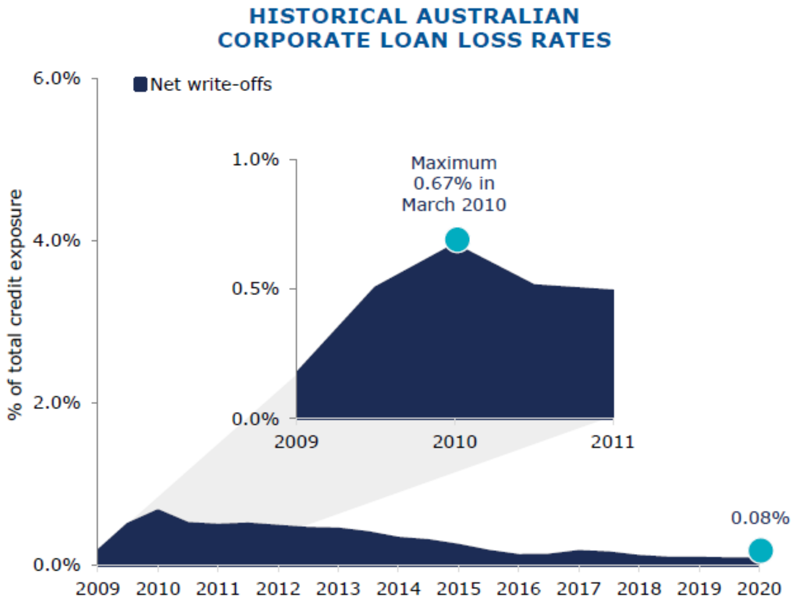
Another key attraction of the asset class is that it can provide capital stability through the economic cycle.

Corporate debt is a lower risk investment than equity because Australian corporate insolvency laws give priority to the interests of creditors in claims over the assets of a business.

In a private market, lenders negotiate directly with borrowers. A skilled lender or private debt manager will seek to negotiate with the borrower appropriate terms and conditions, controls, reporting obligations, covenants, and security to ensure the lender has greater influence on loan terms seeking to mitigate potential risk of loss. Covenants and ongoing borrower reporting obligations are negotiated and provide protection and early warning of changing risks. Security held over the borrower ensures the rights and protection of capital ranks in priority to shareholder equity and any unsecured creditors.

As a result of the protections in place, the corporate loan loss rates for Australian companies have been very low for many years.





Past performance is not a reliable indicator of future performance. Source: Bloomberg.

However, all borrowers and loans are not created equal. When it comes to investing in corporate loans, it is important to invest with a manager who has the necessary skills and experience to preserve investor capital and negotiate appropriate pricing with the borrower. Here's what to look for:

- **Size and scale**: Managers need a sizeable team and breadth of market coverage and borrower relationships to be meaningful to borrowers and better able to negotiate loan terms, recognising the value of the capital available to invest in the borrower.
- **Origination capability:** Check the manager has direct relationships with borrowers and other market participants to directly negotiate loan terms.
- **Risk management capability:** A strong focus on risk management and experience in loan restructuring in the event of a default is essential to preserve investor capital.
- **Track record of performance:** Seek evidence from the manager of capital stability and delivery of regular income payments to investors and that they have been meeting their stated investment targets over time.
- **Diversified portfolios:** A diversified portfolio helps to spread risk across sectors. Investors should look for portfolios that are diversified across borrowers and ensure the exposure to any one individual borrower doesn't expose investors capital to inappropriate concentration of credit risk.
- **Appropriate terms:** When negotiating a transaction with a borrower, the lender must ensure they achieve appropriate terms and conditions and put in place controls to protect investor capital. These controls are designed to put constraints on the borrower to manage risk and therefore protect and preserve investor capital.

Other factors that underpin capital stability include, imposing appropriate reporting obligations and taking security over the company or assets, combined with regular ongoing monitoring of the performance of the borrower.

3. Diversification

During 2020, many fixed income investments failed to deliver the safe haven and downside protection expected. Bonds no longer rise as equities fall, making 'balanced portfolios' a lot less stable in times of turmoil.

Corporate loans have a low correlation with other major asset classes, including growth assets such as equities and property, as well as other fixed income products such as bonds, providing excellent diversification opportunities.

Because they deliver reliable income and capital stability throughout the economic cycle, they can be an asset to your portfolio when other markets are volatile.

We believe the best way for investors to access corporate loans is through a low cost and well diversified managed fund, which helps to spread risk by investing in a varied range of sectors, loan types, and borrowers with differing credit quality and maturity profiles.

4. Protection from inflation

The recent spike in US Treasury bond yields is a clear warning that investors globally are again starting to worry about inflation, and the potential impact it could have on monetary policy and financial markets.

Markets are increasingly pricing in a possibility that rising inflation in the US could lead the US Federal Reserve to ease off on its bond buying or even raise official interest rates sooner than expected. Many other countries around the world will face similar risks of rising inflation as their economies recover at varying paces from the COVID-19 recession.

Inflation poses a threat to investors because it chips away at the purchasing power of savings and investment returns. It can be particularly damaging to returns on fixed income investments. Because the interest rate on most bonds and other fixed income investments remains steady until maturity, investors risk missing out on the income boost from higher interest rates as the global economy recovers.

Corporate loans offer protection against inflation because they earn their returns from fees charged to borrowers and interest that is generally charged at a floating rate. The interest on Australian corporate loans is usually structured as an additional margin over the benchmark Bank Bill Swap Rate (BBSW).

The BBSW is essentially the rate at which Australia's major banks are willing to lend short term money to other banks. It reflects not only the current level of the RBA cash rate but also the expectations the banks have of future cash rate settings.

So if interest rates rise, your income will also rise, which acts to protect the capital of your investment.

Andrew Lockhart is Managing Partner and cofounder of [Metrics Credit Partners](#) (MCP), an Australian debt-specialist fund manager, and sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Metrics Credit Partners was the first fund manager in Australia to launch an ASX-listed corporate loan fund, the MCP Master Income Trust (ASX:MXT), to give investors a way of accessing this opportunity in a simple listed format that provides liquidity not previously available in the asset class.

Ralston responds on super balances of older Australians

Deborah Ralston

The ASFA Report on *Superannuation balances prior to death: superannuation balances of older Australians* released in March 2021 points out that many older Australian have very little, if any superannuation. ASFA concludes that this supports a case for "increasing the Superannuation Guarantee (SG) to 12% (as currently legislated) so that retirees can live in retirement with dignity."

The fact that many older retirees have very low superannuation balances is hardly surprising. While the SG was introduced at 3% in 1992, it did not reach 9% until 2012. As the [Retirement Income Review]* says:

"*The maturity of the superannuation system influences the level of assets people hold when they reach retirement and how much they rely on the age pension. Australia's superannuation system will have matured by the 2040s, when the SG will have been at least 9% for 40 years (the average length of a working life). Most people entering retirement over the past five years have only had around 20 years of superannuation accumulating at relatively low rates." (RIR p.116)*

There are also a significant number of Australians who retire without superannuation. According to a [2015 Productivity Commission (PC) report], around 20% had no superannuation at preservation age, which would include those not in paid employment, the self-employed or those under the $450 per month SG threshold.

The fear of running out of money

By retirement, this grew to around 40%, and by the age of 70, 60% of Australians had no superannuation. Many of these people are not exhausting their savings, but rather they are making lump sum withdrawals around preservation and retirement ages. In 2011-12 around 30% of superannuation assets were taken as lump sums by the current cohort of retirees (PC, p.81). For those with small balances it may make sense to pay down debts, purchase white goods or a car, and otherwise prepare for retirement. Residual funds are often held as term deposits.

Increasingly, as balances grow more retirees elect to establish an account-based pension at retirement and take their superannuation as an income stream.

People are cautious about spending down their retirement savings and many fear 'running out of money'. They often live frugally in the belief that they should be financially responsible, preserving their capital and only spending returns and dividends.

There is also a lack of understanding about access to 'social transfers in kind', that is, health, aged care, tax benefits, concessions etc, which constitute what is essentially a fourth pillar of the retirement system. The average value of such benefits is greater than the full age pension for people over 65 (RIR, p.134).

Despite ASFA's claim that "*there is little or no evidence that the typical Australian dies with around the same amount of financial wealth as when they retired*", multiple sources provide substantial evidence that retirees die with the majority of their retirement savings unspent.

Sources include independent research institutes, government departments, and a large superannuation fund, as outlined in the RIR. Many of the studies in this robust evidence base rely on longitudinal analysis, following people and cohorts over time and observing their spending patterns.

These sources consistently find that current superannuation drawdown patterns are conservative with at least half of all retirees drawing at the minimum rate. Data from one large superannuation fund shows that members with income streams die with around 90% of their starting balance. This was the case even for members who live to life expectancy. Fund members aged 80-90 who died in 2020, when balances were subdued due to the pandemic, died with 82% of the balance they had when entering retirement.

The real challenge

It is clear that in the absence of any guidance or advice many retirees lack the knowledge, confidence and support to spend their savings, resulting in a poorer quality of life in retirement.

This is the real retirement income challenge. The superannuation system to date has focussed strongly on accumulation, rather than retirement income. A sound retirement income system will see well-informed older Australians use retirement savings in an efficient manner to maximise their wellbeing.

*Retirement Income Review, The Commonwealth of Australia The Treasury, July 2020. (All data in this article unless specified otherwise are drawn from the Review)

Dr Deborah Ralston is a Professorial Fellow at [Monash University], where she is a member of the Steering Committee for the Mercer CPA Global Pension Index. She is 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.

It's time to do things differently in retirement policy

Amara Haqqani

Amara Haqqani worked with Jeremy Cooper at Challenger for three years before becoming a consultant and policy specialist for Milliman, a leading actuarial firm. She has seen how the retirement income sector works at a policy and theoretical angle, as well as focussing on product creation and distribution. She has moved on from retirement income policy to become Chief Client Strategy Officer with Bennelong Funds Management.

In the course of a casual conversation with my husband recently, I had to explain to him what mortality credits were. He giggled like a pre-teenager. Suddenly ashamed at its absurdity in everyday language and the culture behind it all, so did I.

I've spent an amazing six years in retirement income helping super funds and policymakers with their positioning, strategy and product in all things decumulation. In that small amount of time there have been several policy interventions and most recently, the Retirement Income Review.

While my six years is nothing compared with the time spent on this area of finance by others of my industry peers and elders, it's still been a great snapshot in time of the types of conversations we have, the types of decisions that get made by various players in the ecosystem and, in the end, the sorts of things we need to wake up to.

People first, product second

A colleague told me at the beginning of my retirement journey that this is an industry where we like to make products that we want to sell, not that people want to buy.

His throwaway line has proven true, and the evidence of it is everywhere. We remain one of the few industries left on the planet that isn't client centric, most likely because we haven't had to be. We've had compulsion and information asymmetry and general all-round apathy working in our favour. The groundswell against this movement is already everywhere you look - from the surge in ETFs to the recent GameStop trading event.

The issue is much more acute in retirement strategy. The answer to retirement working in Australia is not the creation of more product 'innovation'. It is not making them mandatory in regulation, it's not forcing funds to create products today that will become tomorrow's legacy product. It is not attacking account-based pensions when they've done nothing wrong in isolation.

The superannuation industry and its policymakers need to turn product thinking on its head. Retirement will only succeed in this country when we genuinely put the retirees ahead of the products we're trying to build for them. Retirees need very basic help that we neglect to provide - help on budgeting, on the age pension, on building their retirement context. Products come after we help them and give them comfort and guidance. Products only help answer aspects of retirement problems, they don't replace them entirely.

There are some fundamental things that need to change before mandated retirement products will work. Trustees may be required to have a product on the shelf for members, however the take-up may be low at best, or members will mutiny at worst, until some key issues are fixed.

Siloed thinking leads to siloed answers

Retirement isn't a product problem, it's also not just an advice problem, nor is it just an investment problem and it's definitely not just an engagement problem either. In my experience it's all of them at the same time.

We have a long way to go to overcome this issue. Retirement cannot be solved in silos.

Funds particularly need to bridge internal function lines in order to deliver retiree-centric solutions that work and are taken up over the long term. Until retirement is treated as seamlessly across a super fund as accumulation is, we cannot say that retirement is done well for the members.

Innovation comes at the expense of simplicity

It's clear we live in an era where the member-investor craves transparency and simplicity. They don't value things they don't understand, and there is the meta-trend of the reduction in value placed on experts.

Products that present as 'black boxes' are now largely mistrusted, and the 'smartest people in the room' affliction we have in the finance industry as economists, actuaries and investment professionals, must give way to understanding that no one out there cares how smart you are if you can't help them in a clear and efficient way.

The problem with most retirement product innovation is that it's hard to do while still being simple or transparent. Any further pushes for the industry to innovate will drive corresponding legacy product proliferation as products become harder to sell, regardless of how perfect they are on paper.

We really shouldn't find hard-to-explain products like annuities all that much of a 'puzzle' in this day and age. Spoiler alert: much like we've discovered that markets aren't actually all that efficient, just because a product is intellectually perfect for someone, doesn't mean they actually understand it enough to want it.

Talking about longevity risk means getting comfortable with death

This is not the place to discuss death, or taxes, or death taxes, however until we are comfortable as a society talking about death, we will never understand how to communicate longevity risk, its insurance, or mortality credits.

The actuaries and policy makers of this industry need to find a way to never say these things in public beyond their own modelling. Until society finds a way to talk about death more openly, we will subsequently recoil at longevity risk conversations. Our best-case scenario for engagement on these topics is people devolving to giggles like my husband did.

Capital consumption is a paradigm shift

And finally, the Australian public is not interested in consuming their hard-earned capital. After all, they've had generations before them demonstrate that they can preserve their capital and live off the income.

If policy makers want a shift in behaviour in line with changing economic conditions, there needs to be a mass-scale level of education done and awareness raised on this topic, else all policies and products that attempt to tackle it will be rejected.

None of these themes are new of course, and others have raised them before me.

In stepping away from the super and retirement income world in favour of working on some other exciting things, I'm hoping that the industry uses the Review, and the upcoming Covenant, to try to do things a little differently. Let's not build retirement products because we have to. Let's put the member at the centre of our systems, our thinking, our regulation and our offerings. Put product last. If we do, this time it could actually stick.

Amara Haqqani is Chief Client Strategy Officer at Bennelong Funds Management.

Super funds must earn the right to higher contributions

Donald Hellyer

I doubt our super will last long enough to outlive my wife, so I am changing the fields in a life expectancy calculator that has her surviving until 92. I now have her smoking two packs a day with a severe drinking problem. Unfortunately, there were no fields to have her addicted to Class A drugs or take up sky diving.

The good news for our superannuation is that my wife's parents died in their sixties. While I am expected to live to 87 according to this calculator, my father died at 70 when he was my oldest living male relative.

Now that is one hell of an error margin when it comes to budgeting for our old age.

The superannuation industry wants me to contribute even more to my super, but the funds haven't earned the right to more of my money. The industry has had many years to think about this longevity problem but it has produced nothing of note.

The way things are going, we will either leave a sizeable inheritance for the kiddies or be living in their spare room.

Firstlinks
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Risk capital is needed for risk products

A key reason why super funds fail to create longevity products is that every growing PFM (profit-for-member) fund has the wrong capital structure. They are 'cooperatives'. A cooperative operates for the good of the members but has no defined equity base or shareholders. No one owns them, and as such, cooperatives cannot raise capital for new ventures or fresh capital in times of economic stress.

They are not just ill-suited for risk-based products (that is, products where capital is needed to manage balance sheet risk such as in a bank or life insurance company). They just plainly cannot develop them. The best they can do is form a joint venture with a 'capital-based' financial organisation. Regretfully, rule number one in life is never to share your client base with another company, especially a profit-seeking one.

Governance and disclosure standards

In addition, cooperatives frequently lead to poor governance as well as poor financial flexibility. Super fund boards of trustees may violently object to this comment, but there are areas where they fall behind minimum disclosure requirements expected from listed companies.

Listed companies are required to produce informative annual reports, which is backed up by an annual meeting of shareholders. At the annual meeting, shareholders vote on essential issues like executive and board remuneration and director representation. Superannuation funds' annual reports resemble advertising brochures and fail to provide a solid disclosure on how the board sets remuneration for executives and directors. Since COVID, some super funds like AustralianSuper and UniSuper have had 'inaugural' annual member meetings. A good start, but currently, the meetings are more Q&A sessions. No resolutions are put to a member vote.

The number of times the word 'remuneration' is sighted in the most recent annual reports of Australia's top 10 listed companies is on average 317 times. The number for Australia's top 10 PFM super funds is 22. Six of the top 10 PFM super funds do not disclose remuneration for executives or directors in their annual report. While this information is legally disclosed elsewhere, it is no easy task for a member to find and interpret the data.

The industry needs to earn a rise in contributions

Before we automatically sign up to make more super contributions, here are some points:

- Super funds complain about APRA's moves to benchmark performance and provide heat maps, but they fail to produce solid performance criteria themselves. Where we can make objective performance analysis, the super industry is at best an average investor. Click here for the previous Firstlinks article on this point.

- Members are entitled to more robust governance and disclosure, along with solving voting for directors and remuneration. There is no easy solution here. Perhaps APRA will need more authority to prescribe minimum requirements and have a remuneration veto. That being said, superannuation executives and directors are not, in my view, overpaid.

- The longevity issue needs to be solved. I would happily contribute a further 2.5% if super funds could use that money to help me manage my super fund drawdowns. The government is on record as saying they want retirees to spend their super, but we need to know more about when we are going to die.

I am not suggesting we throw the baby out with the bathwater. I am not even saying the industry is doing a poor job overall. But we need to back the Government and APRA when they challenge the superannuation industry. No one else will. The industry must do more to earn the right to our extra dollars.

After a long career in banking including 10 years at National Australia Bank as Global Head of Financial Institutions, Funds and Insurance, Donald Hellyer is now CEO of BigFuture and Open Director. BigFuture is a tech development company specialising in building financial applications. OpenDirector is a database for the details of Australia's directors and executives. This article is general information based on public data and does not consider the circumstances of any investor.

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