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Editorial

It was not long ago that 'allfinanz' was the dream of every bank chief executive. It combined banking, wealth management and insurance into one organisational structure to cross-sell as many products as possible. Go into a bank for a home loan, and the best banks would combine it with home and contents insurance, life insurance, and *"Have you met our financial adviser? Let's discuss your superannuation."* But 'allfinanz' has gone the way of 'bancassurance', and no senior banker in Australia dare whisper either word again.

CBA played the cross-sell game hard. **David Murray** drove the bank out of public hands and cemented its leading wealth management position with the acquisition of **Colonial First State**. His successor, **Ralph Norris**, pushed the 'Sales & Service' mantra right through the structure including growing the insurance arm **CommInsure**, demanding product cross-sell as he improved customer service.

But over the years, CBA fell foul with regulators. By the time the next CEO, **Ian Narev**, 'retired' in 2017, CBA was facing massive strain from 'allfinanz'. ASIC demanded compensation to 65,000 customers for mis-selling of consumer credit insurance, there were refunds on home loan protection insurance, plus scandals in financial advice and life insurance.

The next CEO, **Matt Comyn**, couldn't get out of these 'non-core' activities quickly enough. Too many conflicts of interest and stuffing products into unsuspecting customers. And so the corporate structure that Murray started was dismantled as CBA exited wealth management and insurance. As Comyn said in June 2018 when announcing the sale of Colonial First State and advice businesses:

"Today's announcement is another step in our stated priority to become a simpler, better bank and has followed a thorough review of the group's businesses and its optimal organisational structure to drive growth and shareholder value for all businesses. It also responds to continuing shifts in the external environment and community expectations, and addresses the concerns regarding banks owning wealth management businesses."

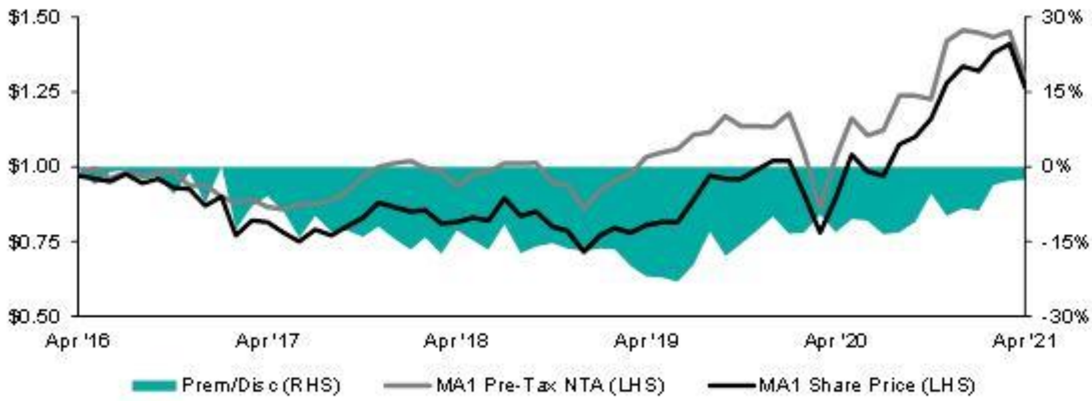
It's a staggering change for anyone who worked in the bank in the 1990s and 2000s when cross-sell was a way of life. Last week, the final nail in the allfinanz coffin was hammered in with the sale of the general insurance business. There is so much cash from numerous asset sales that **Morgan Stanley** estimates CBA's surplus capital has risen from $6 billion in 2019 to as much as $10 billion.

So what will CBA become? One sign comes from the announcement that the bank is hiring hundreds of additional software engineers to become more like a leading tech company with massive digital transformations. Watch for financial innovations by the bus load in coming years, although three systems outages in the last week shows how complex core banking systems are.

What else will the focus on 'retail banking' bring? CBA is Australia's biggest mortgage lender, and despite much competition, it will stay at the leading edge. With all the focus on superannuation, we sometimes overlook the fact that Australians hold the majority of their wealth in residential real estate, and that will not change.

We wrote about the [dominance of ETFs over LICs]() a couple of weeks ago, and if the scrip merger of **Washington H Soul Pattinson** (SOL) for **Milton Corporation** (MLT) is successful, LIC balances will fall a further $4 billion or so. MLT will delist and staff will move to SOL.

An illustration of the other incentive to move away from LICs is shown in the **Bell Potter** graph below. The old **Monash Investors** LIC, MA1, was trading at one stage at a discount to Net Tangible Assets of over 20% (see the green section), and the discount evaporated as MA1 switched to an open-ended fund. Monash has experienced redemptions of one-third of its funds from investors who arbitraged the discount which may make other fund managers reluctant to follow a similar path.



SOURCE: IRESS, MONASH INVESTORS.

As we head into the superannuation changes on 1 July, the super guarantee will rise to 10%. However, research by **Mercer** shows the debate about whether workers pay for super through lower take-home pay is valid. Where an employee's remuneration is structured as 'base plus super', most businesses report additional super will be paid with no impact on take-home pay.

But for the increasingly common arrangements of 'total package', over half of businesses surveyed will either reduce take-home pay (30%) or they have not yet decided (26%). Many workers are swapping current needs for future retirement savings.

	Base plus approach to communicating super		Total package approach to communicating super	
	Number of organisations	%	Number of organisations	%
Company will pay additional super, current take home pay will not be affected.	46	85%	28	42%
Additional super split between company and employee, current take home pay will be reduced.	1	2%	1	2%
Employee will pay the full additional super, current take home pay will be reduced.	3	6%	20	30%
Unsure about treatment of additional super from July 2021	4	7%	17	26%

We start this week with a comprehensive review of the **Your Future, Your Super** reforms, claimed as the most significant since the introduction of compulsory super. We transcribe an interview with the superannuation minister, **Senator Jane Hume**, and then analyse how the changes may affect the industry and its members. It's a controversial debate and contrary views are welcome in the comments.

We announce the launch of a new podcast series, **Wealth of Experience**, with myself and **Peter Warnes**, known to many of you as **Morningstar**'s long-time Head of Equities Research. With a combined 99 years in the market, we bring this experience to help build your wealth. The first edition discusses markets, stocks, superannuation changes and Pension Loan Scheme and it lasts about 30 minutes.

Then a remarkable study by **Ashley Owen** who charts the impact of inflation on 120 years of Australian asset performance, including shares, property, bonds and precious metals. Few people in Australia have Ashley's data base and historical recall to prepare such a study, and with inflation surfacing, it's essential reading.

Andrew Mitchell looks at the three sources of returns from companies - dividends, earnings and revaluations - and asks where performance will come from in the next year.

Richard Jones warns that general classifications of many companies do not stand up to deeper scrutiny, such as where a consumer company is more like a tech innovator, and it's important to understand what really drives profits.

The investing environment for coming years will differ markedly from what worked well over recent decades, and **Simon Petris** explains how the duration of fixed income assets requires new players in many investment portfolios.

Then **Gofran Chowdhury** reports on research among high net worths showing how they are investing and reacting to current market conditions. Do you feel the same way about current opportunities?

As we are at the end of another financial year, a reminder to anyone looking for a tax deduction about Public Ancillary Funds (PAFs). A recent benchmarking report on investment returns of Australia's major PAFs shows the APS Foundation (founded by Chris Cuffe) comes out on top.

Morningstar Premium deal: a one-off repeat for EOFY

A few months ago, to mark our 400th edition, I asked Morningstar for their best price to combine full access to Morningstar Premium with the portfolio management software of Sharesight, and now with EOFY, we are bringing it back for a few days.

If you derive income from the share market, your subscription may be tax deductible, and the Sharesight reporting is sure to make tax time a little easier next year.

Experience Morningstar Premium's independent research, data and tools for $365 for your first year. To access this offer for Firstlinks readers, please email mark.lamonica1@morningstar.com with the promo code DOLLARADAY and your full name. You will then be given instructions on a secure subscription. This offer ***ends 30 June 2021****.*

Jane Hume shakes up super, but what will it achieve?

Graham Hand

The Government claims the 'Your Future, Your Super' (YFYS) reforms that passed the Senate last week are *"the most significant reforms to superannuation since the introduction of compulsory superannuation in 1992."* Considering how often superannuation rules change, that's quite a claim. The legislation seeks to reduce the number of multiple accounts and hold super funds accountable for their performance. Both moves have supporters and critics, but how do they stack up?

This review of the legislation is in three parts:

1. Industry structure and summary of changes.
2. A transcript of the Minister responsible for superannuation, Senator Jane Hume, speaking on ABC Radio the morning after the legislation passed.
3. An analysis of the likely impacts.

1. Industry structure and summary of changes

The $3.2 trillion in super is greater than Australia's GDP of about $2 trillion and the market value of all Australian listed companies of about $2.6 trillion. As shown below, industry funds are the largest segment at $858 billion, followed by SMSFs at $789 billion, public sector at $719 billion and retail funds at $651 billion. The total in MySuper products, the initial target of YFYS, is $846 billion. Treasury estimates there are 6 million multiple accounts.

The stakes are high and the reforms affect the future retirement of millions of Australians.

MySuper products are 27% of superannuation funds but they are the only funds employers can nominate as defaults. At the moment, the performance tests exclude retirement funds where arguably the most protection of large balances is required.

Overview

Type of fund	Total assets ($billion)	No. of funds	No. of accts (June 20)
Corporate	59	15	0.3 million
Industry	858	34	11.3 million
Public sector	719	35	3.5 million
Retail	651	95	8.1 million
Funds with less than 5 members	789	598,995	1.1 million
Balance of statutory funds	51		
Total	**3,127**		**24.4 million**

Source: APRA Statistics – March quarter 2021 and APRA annual statistics for no. of accounts

Here are some extracts from the Government's media announcement:

- The passage of the Treasury Laws Amendment (Your Future, Your Super) Bill 2021 will save Australians $17.9 billion over 10 years.
- Having your superannuation follow you, preventing the creation of unintended multiple superannuation accounts when employees change jobs. This will commence from 1 November 2021.
- Making it easier to choose a better fund, with access to a new interactive online YourSuper comparison tool. This will commence from 1 July 2021.
- The Government will require superannuation products to meet an annual objective performance test. Those that fail will be required to inform members and persistently underperforming products will be prevented from taking on new members. Members will be notified by 1 October 2021 if their fund fails this test.
- Increasing transparency and accountability, with the Government strengthening obligations to ensure trustees only act in the best financial interests of members and provide better information regarding how they manage and spend members' money.

2. Jane Hume interviewed the morning after the legislation passed

Senator Jane Hume was interviewed by Sally Sara on ABC's Radio National on 18 June 2021 for 10 minutes from the 54.40 mark here. This is an edited transcript.

JH*: We think that a huge number of Australians are going to take the opportunity to switch because now they've got an online performance tool comparison tool, so they can see their funds, compared to other ones. One of the great inefficiencies in the system is the fact that people are disengaged, that it's a compulsory system where essentially they give up $1 in every $10 of everything that they earn, and potentially quarantine it for 40 years. Our objective is to make sure that the super system works much harder for Australians.*

SS*: There are concerns that some people may run into difficulty with the life insurance that's attached to the super. What guarantees are there if people are changing jobs and changing industries, for example, going from a relatively safe industry to one that's more hazardous?*

JH*: We've tried to find some details on this and in fact it's been difficult because by far and away, the vast majority of superannuation funds have insurance policies attached to them that don't have any occupational exclusions at all. So it doesn't matter when you started life as a barista and ended up a crane driver. If you* *stay with the one fund you will still be covered with the life insurance and total permanent disablement. Now that said, we have charged Treasury with doing a review of all insurances within superannuation.*

***SS**: But there are no safeguards in this legislation. Is that right?*

***JH**: Well, there is no reason why anyone should feel that if they had life insurance within their superannuation, and they switch jobs, that they wouldn't be covered. They should be covered, there are no occupational exclusions.*

***SS**: How many funds won't be covered by the performance benchmarking?*

***JH**: The first challenge will be all the default MySuper products. Now, that is the vast bulk of products that are out there, certainly the vast majority of new inflows each year, because those are the default products. In tranche two in one year, we will be dealing with products that aren't default, but are trustee-directed. And that will cover 90% of superannuation money out there and certainly the vast majority of the flow.*

There is one cohort of products that are harder to measure, and we have committed Treasury to working out a way to do that. They will be the final tranche. We want to make sure that every fund is serving (members), but these are non-MySuper products that came in for a lot of criticism under the Banking Royal Commission.

***SS**: Why delay?*

***JH**: Because it's such a small amount of money in them. In fact, the vast majority of money is in the default of MySuper products. They're the ones where the data exists and APRA is already monitoring those.*

***SS**: The Shadow Minister Stephen Jones has described these changes as a dog's breakfast. How can you guarantee that workers will be better off?*

***JH**: We can guarantee that workers will be better off if their funds are better performing. We can guarantee that if your superannuation follows you and you don't get two sets of insurance premiums and two sets of fees, that you'll save around $2.8 billion over the next 10 years. And we can guarantee that without waste in the system through more transparency and accountability, we can save over a billion dollars, and by empowering members to engage better, this saves around $3 billion a year on Treasury estimates. Getting rid of the underperforming tail of funds that have been hiding behind the skirts of the good performing funds for so many years.*

3. Likely impacts of YFYS

a) Insurance and member turnover

The basic principle of 'stapling' a fund to a person for life has appeal, to avoid multiple small accounts and fees for people who change jobs. Most young people are disengaged from super and did not know that they always had the ability to take their super to another fund.

In the interview, Jane Hume is underplaying the life and disability insurance problems. Some retail funds have occupational exclusions. A fund such as Mine Super, which draws members from the mining industry, has special insurance to recognise the dangerous work conditions. It might be better for someone starting in mining to transfer to a new fund for the improved insurance arrangements. Similarly, Cbus Super members mainly come from the construction industry, and CEO Justin Arter said:

"A Treasury review of unspecified outcome or timing will do nothing to mitigate the immediate impacts for workers in hazardous sectors. Within months workers in hazardous occupations are at risk of being stapled to a fund containing exclusions or unfavourable terms and conditions because their existing insurance cover has not been tailored to their new job. Despite paying insurance premiums, stapled members in heavy blue-collar occupations or people working at heights may not be covered. Members and their families will likely only discover these exclusions when tragedy has struck and they try and fail to make a claim against cover they believed they had."

There is also no guarantee that the old fund to which the member is stapled will perform as well as another fund. Superannuation defaults are selected by the employer not the employee. It is common for super funds to market and nurture relationships with employers, and there are many reasons why a fund is chosen.

It is also likely that not much will happen at the first performance warning date. Disengaged members are not likely to go to the APRA website and work out how to find a better fund. Many members will not be able to make an informed comparison, and different options carry different risks. Even at the second annual performance warning, many existing members are unlikely to act. Employees will remain stapled to underperforming funds.

Which means the heavily disengaged may be left behind as more-engaged members leave, with their redemptions funded by the sale of liquid assets. The remaining portfolio may be less liquid or otherwise impaired.

The YFYS legislation confidently states:

"The YourSuper comparison tool will be available on an interactive website designed to make it easy for beneficiaries to choose a superannuation product based on fees and performance information."

To achieve the desired results, APRA will need to become active to move members from existing underperforming funds.

The inability to accept new members will be a massive problem for some super funds as it will cut off the inflows which usually finance outflows due to withdrawals such as pensions or from redemptions. There are around 25 funds expected to fail the performance test. Will these funds be allowed to explain why they 'underperformed' when they communicate with their members?

b) Measuring underperformance

The most difficult part of the YFYS reforms is determining whether a fund has genuinely underperformed or simply not matched the benchmark measurement. Investment performance relative to an index is affected by many variables such as a market timing or style rather than a fundamental shortcoming in an investment process. Styles come and go and there is a strong possibility that fund members will be encouraged to switch from a fund just as its style comes back into favour.

We only need to look at the style rotation from growth to value that is currently underway (although there are signs it is going back) to see how manager and style selection can have a major impact on performance. Some of Australia's most prominent and experienced fund managers have struggled as their style has been out of favour for long periods, as explored in this article.

APRA explains how the comparison will work this way:

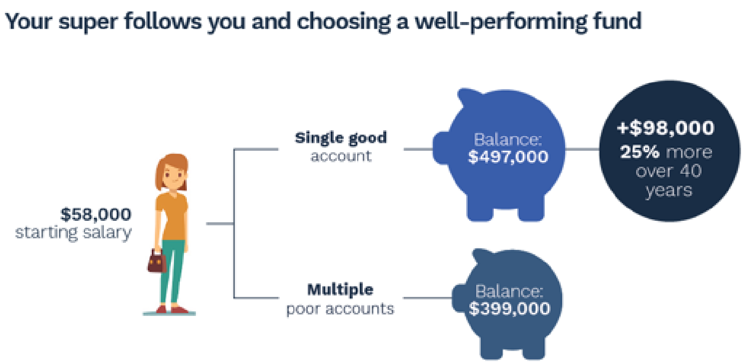
"Each year APRA will construct an individual benchmark for every MySuper product based on an individual product's portfolio asset allocation, taking into account fees, tax and other relevant assumptions. Each product will then be compared annually against their benchmark.

Products that underperform their net investment return benchmark by 0.5 percentage points per year over an eight-year period will be classified as underperforming. For MySuper products that were in place from 1 July 2014, their first performance test will be based on seven years of performance data. On an ongoing basis the test will apply over an eight-year period.

To ensure funds are all held to the same standard, the test will be set in regulations by the Government and administered by APRA. APRA will publish the results of the test.

The new performance framework will now be the primary method for measuring underperformance in the superannuation sector and the APRA Heatmaps and the annual member outcomes self-assessment under existing law will be amended accordingly."

This illustration is wishful thinking. It assumes a person will find a single better fund for 40 years (!) and then be 25% better off. It will be more a matter of timing luck over such a long investing period if the first fund a person joins permanently outperforms through dozens of investment management and market changes. The team managing the money will rotate multiple times and take different views each time.



Let's look deeper into the performance calculation itself, remembering that it only needs a fund to fall a small 0.5% pa under its benchmark to flash a warning and be required to advise members of its terrible efforts.

First, APRA has announced it will compare fund performance with the trustee-approved strategic asset allocation (SAA) of the fund. However, some funds don't have an SAA while those that do are often expressed in general terms, such as equities 50%, bonds 40%, cash 10%. In the comparison, APRA might take the equities weighting of 50% and compare actual returns against the S&P/ASX300 index. But tactical asset allocation (TAA) decisions in the fund might weight conservatively in an expensive market, allocating 40% to equities. The fund may do well in a falling market or poorly in a rising market. And vice versa if weighted at 60%. That does not mean the fund was poorly managed. The trustee might legitimately focus on protecting capital in an overvalued market.

The super industry believes, therefore, that funds are likely to report their actual asset allocation to APRA as the benchmark to judge against, rather than the SAA. But APRA says:

"Actual asset allocation is inherently unstable and is affected by market movements: using actual asset allocation to construct the benchmark portfolios will only measure a product's performance relative to asset class benchmarks i.e. value added or detracted from asset class implementation only."

The selection of the asset allocation used by APRA to benchmark the fund will be critical for the performance review.

Second, APRA uses indexes for its Heatmap, as shown below, which might differ from the benchmarks traditionally used by the fund (the actual indexes used for the performance test might be slightly different than the Heatmap).

The indexes used, fee and tax rate assumptions used in the Heatmap for each asset class are as follows:

Asset class	Index	Fee	Tax
Australian Equity	S&P/ASX 300	0.05%	0.00%
International Equity (hedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (100% hedged to AUD)	0.11%	14.00%
International Equity (unhedged)	MSCI All Country World Ex-Australia Equities Index with Special Tax (unhedged in AUD)	0.09%	14.00%
Australian Property	S&P/ASX 300 A-REIT Index	0.12%	14.00%
International Property	FTSE EPRA/NAREIT developed ex Australia rental hedged to AUD	0.22%	14.00%
Australian Infrastructure	FTSE Developed Core Infrastructure Index hedged to AUD	0.26%	14.00%
International Infrastructure	FTSE Developed Core Infrastructure Index hedged to AUD	0.26%	14.00%
Australian Fixed Interest	Bloomberg Ausbond Composite 0+ Index	0.10%	15.00%
International Fixed Interest	Bloomberg Barclays Global Aggregate Index (hedged in AUD)	0.10%	15.00%

There are hundreds of indexes in the market, and choice of index might change the way a fund invests. The only Australian equity index fund is the S&P/ASX300 and for global allocations, there is no emerging market index. If a fund uses different benchmarks, there is a basis risk between the two indexes, such as small caps versus large caps, emerging markets versus developed markets, credit bonds versus sovereign bonds. Should a fund be pushed away from a small cap portfolio because the benchmark is the ASX300, dominated by large caps?

APRA will reduce the benchmark performance by the index fee, such that any super fund paying more than an index fee to an active manager will face a higher hurdle. For example, if the S&P/ASX300 index delivers 10% less 0.05% fee, the benchmark will be 9.95%. But a fund using an active manager charging 0.5% will need the manager to achieve 10.45% to cover the fee plus the index. It might push more trustees to index management.

There will also be an inability to check APRA's calculations, as it cannot provide the index data:

"Index level data are subject to confidentiality under the terms of the licensing agreements with the index providers."

Third, some funds are more focussed on protecting capital with defensive investments or operate a CPI-plus objective, rather than comparing themselves with peers or benchmarks. They may need to change how they invest. For example, Mark Rider was appointed CIO of Christian Super a year ago, and he told Investment Magazine:

"The performance of the fund, probably over the medium term, has been below expectations versus the Heatmap, or the proposed APRA performance test, where we're outside of that 50 basis points of underperformance. One of the things about the fund, and this all predates me coming on board, was that the fund was focused very much on the CPI-plus objective and it had much more of an absolute return focus. One of the key things behind [this] was that the fund was set up … not really with a very close focus on peers and not with the type of reference portfolio which the APRA heat maps and the performance tests are about. That's brought out a very significant change in the way that the fund thinks about portfolio construction, how it thinks about some risk in the portfolio."

The performance test does not address absolute returns to members. A highly defensive fund could deliver a return of, say, 1% and pass the performance test while a growth fund could have a return of high single digits but fail the test.

Fourth, as noted by [the work of The Conexus Institute](), where risk and asset allocation can be separated into longer-term (strategic) and short-term (tactical) decisions, *"Overall, this represents a multidimensional problem which makes performance assessment a complex exercise."* It cites research which finds:

1. Asset allocation explains about 90% of the variability of a pension fund's returns over time.
2. Asset allocation explains about 40% of the variation of returns among funds.

The Institute reports that allocating 10% more to growth assets rather than defensive over the last eight years would have added 57bp pa (0.57%) over that time, while allocating 10% more to global shares rather than Australian shares would have added 43bp pa (0.43%) for the eight years.

APRA also explains its assumptions about some listed and unlisted assets:

"There are multiple ways of investing in infrastructure and property assets, for example through listed vehicles (e.g. REITS) or through unlisted investments (e.g. the direct purchase of property). The method of investing in these assets has an impact on the types of exposure provided. Listed investments typically have a high correlation with equity investments and therefore offer limited protection in the event of an equity market downturn. APRA has accordingly classified these assets as 100% growth.

While unlisted real asset investments are sensitive to economic conditions, they also demonstrate some characteristics associated with defensive assets, such as income generation. To account for the slightly more defensive nature of unlisted assets, APRA has categorised these assets as 75% growth and 25% defensive."

Fifth, the test focusses on performance but some asset allocation decisions are made to reduce risk rather than enhance returns. It also ignores improvements around governance, reducing implementation risk, sustainability and ESG principles.

Even APRA admits:

"The Heatmap does not provide the complete picture of the outcomes that a MySuper product provides to individual members and other aspects should be considered in determining whether a particular MySuper product is appropriate for an individual member."

Final comments

Comparisons between funds and benchmarks rely on assumptions, and 0.5% could be more about noise than a poorly-managed fund. What happens when a fund starts to do well the year after it was prohibited from accepting new members and after existing members have been encouraged to leave? Ranking funds by returns also fails to recognise the risk accepted to make those returns.

One of the industry's favourite disclaimers warns about using past returns as an indication of future returns. ASIC has an entire policy on why past performance may be misleading, such as:

"Where past performance information is used to support a claim about an entity's skill or good performance (overall or in a particular sector), it may be misleading to use past performance selectively so as to exaggerate the entity's success or disguise its lack of success."

Yet here we have the future of many funds determined by their recent past performance.

This article is not saying poorly-performing funds should simply be tolerated forever but there is a better way to manage them out of the default superannuation system. APRA has the data and the ability to regulate super funds. It should be within APRA's ability to closely monitor these funds and engage with trustees over a couple of years. This consultation process would give the fund a chance to explain why it 'underperformed', and if dissatisfied, APRA could then require changes or mergers. This process would be better than forcing the decision on to a disengaged and less informed public with unintended adverse consequences.

Graham Hand is Managing Editor of Firstlinks. This article is general information and is based on an interpretation of relevant legislation at the time of writing.

Thanks to David Bell, Executive Director of The Conexus Institute for comments on an earlier draft.

Launch of the 'Wealth of Experience' podcast

Graham Hand and Peter Warnes

Welcome to the first episode of our new fortnightly podcast, *Wealth of Experience*, with Peter Warnes.

Between the two of us, we have spent 99 years in financial markets. Peter started in stockbroking in 1968 and I started in banking in 1976. We considered the name '99 and Counting' for the podcast, but went with 'Wealth of Experience' as we hope to build your wealth through our experience. Our 99 years clearly differentiates us from the 'finfluencers' who have been around for five minutes.

Peter is already well-known to many *Firstlinks* readers, as Head of Equities Research at Morningstar and Editor of *Your Money Weekly*. He originally joined Aspect Huntley as Head of Research in 1992 which was acquired by Morningstar in 2006, giving him 30 years in the Morningstar stable. He is widely quoted in the media for his stock calls and deep market analysis.

Peter and I will analyse, explain and have some fun talking about financial markets, stocks, products, trends and government policies. Each episode will cover highlights in both *Firstlinks* and *Your Money Weekly,* and in future we will invite guests from the market.

The podcast is available via our dedicated website page, Apple Podcasts, Spotify, and BuzzSprout.

Please share with friends and colleagues, and a favourable rating would also help spread the word. We also welcome questions and suggestions for upcoming episodes at firstlinks@morningstar.com.

Grab a cuppa and settle in for our chat.

How inflation impacts different types of investments

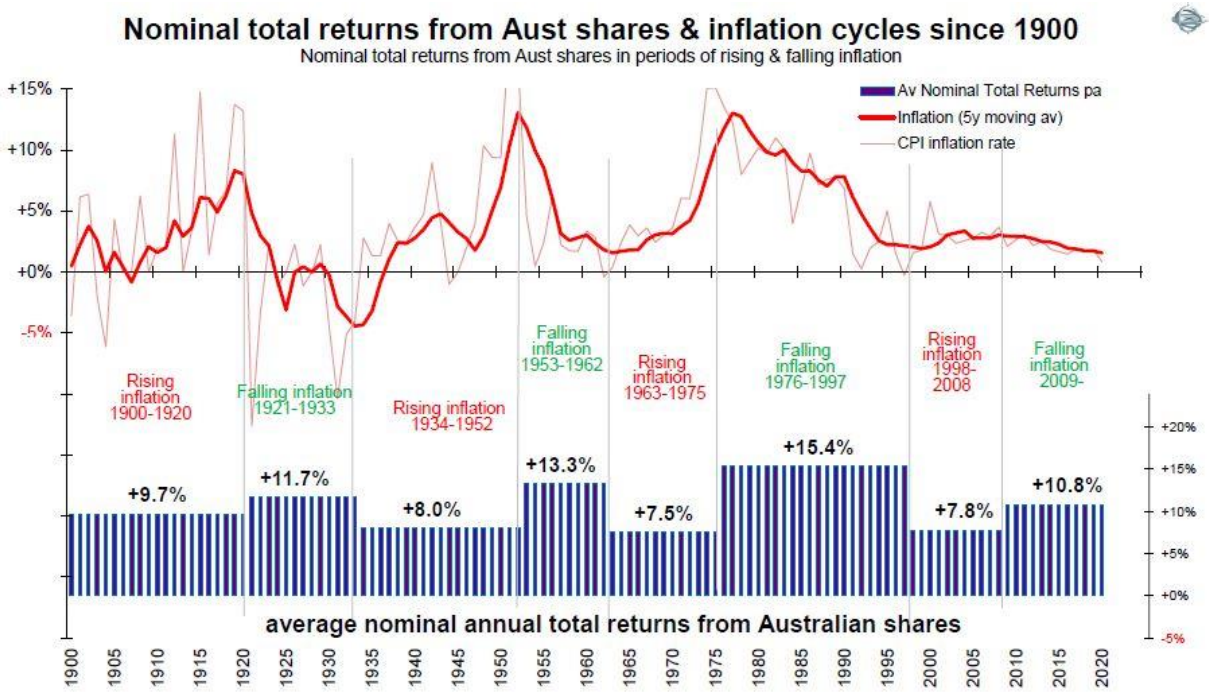
Ashley Owen

Inflation is one of the most critically important issues for long-term investors, as returns can vary considerably in different inflationary conditions.

First, we consider Australian shares.

The first chart below shows the Australian inflation experience since 1900. In the upper section, the annual inflation rate is shown as a fine red line, and we also show the five-year moving average (heavy red line) to reveal the underlying inflation trend through the short-term volatility. The three main periods of high inflation were the post-WWI spike, the post-WWII/Korean War spike, and in the mid-1970s.

The lower section in the chart shows total returns (capital gains plus dividends) from the broad Australian share market during the difference phases of rising inflation and falling inflation.

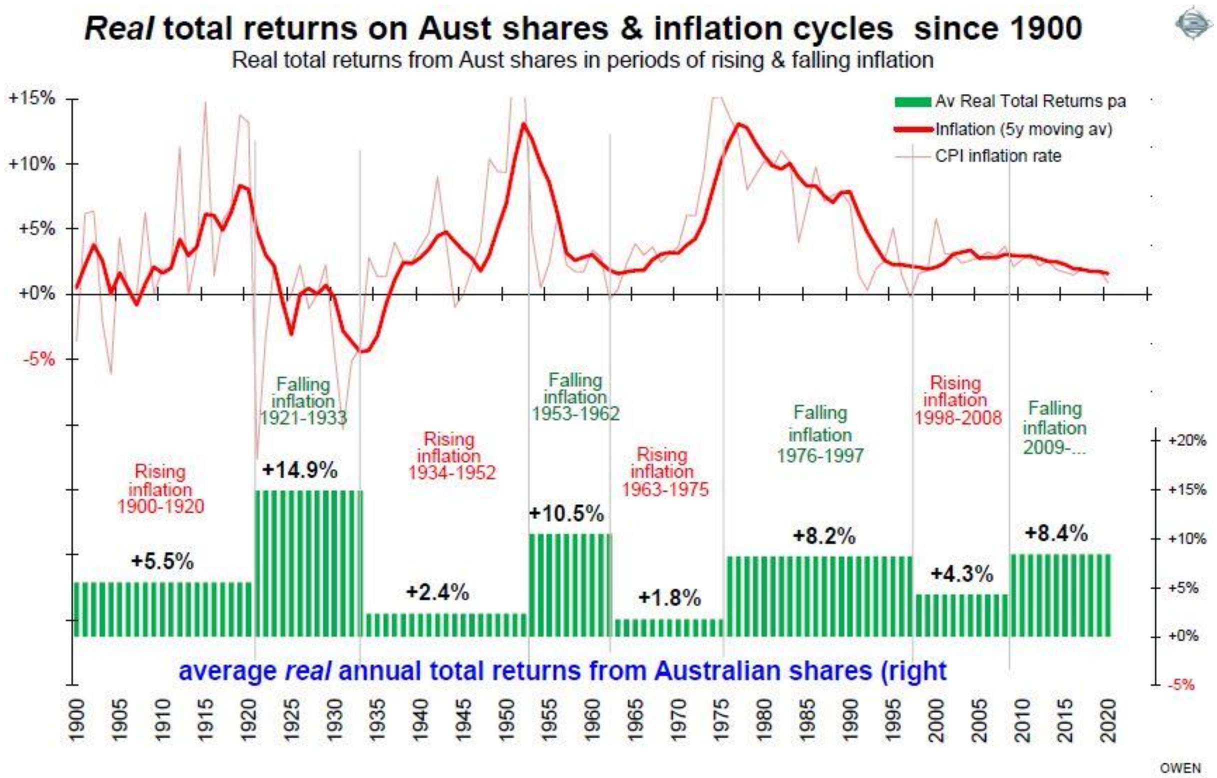


Lower returns when inflation rises

The broad Australian share market generated returns averaging above 10% per year over the whole period, but returns have been very different in different inflationary conditions. Returns during the 'rising inflation' phases have been consistently lower than returns during 'falling inflation' phases.

At first glance, these lower returns in these rising inflation phases still appear not too bad, with an average of 9.7% pa in 1900-1920, 9.0% pa in 1934-1952, 7.5% pa in 1963-1975, 7.8% pa in 1998-2008.

The problem is that these are the returns *before* inflation. As long-term investors we need to focus more on the returns *after* the wealth-destroying effects of inflation, especially since inflation has a compounding destructive effect on wealth over time. The next chart looks at the after inflation ('real') returns for the same periods.



This highlights the fact that the total returns after inflation have been much lower (and barely positive) in some of these relatively long periods in which inflation was rising.

Impacts on other types of investments

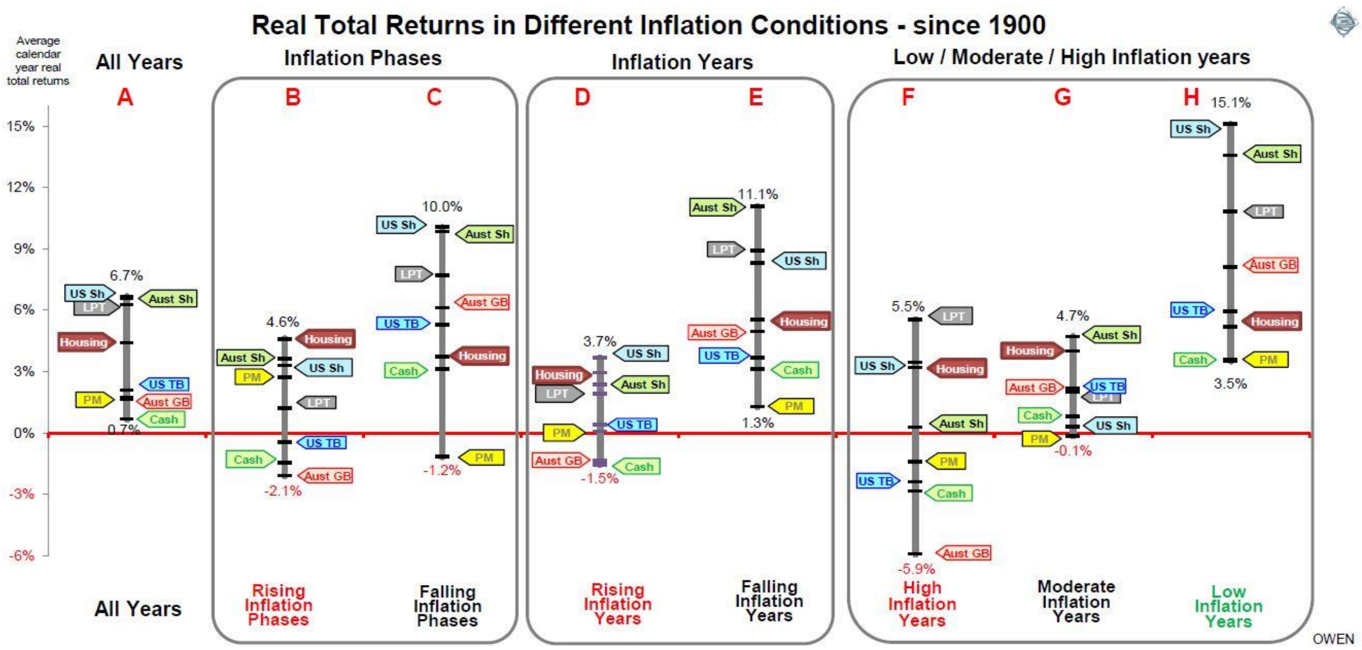
Unfortunately, inflation has similar effects on the other main types of investment assets as well, even so-called 'inflation hedges' like gold. We consider the following types of investment assets:

The next chart below shows total real returns from each of these asset classes in different inflationary conditions since 1900.

Column A shows overall average total returns (ie capital growth plus income) from each asset class since 1900 overall, expressed in Australian dollar terms, and after Australian CPI inflation. (We use returns in Australian dollars after Australian inflation because we are looking at returns in the hands of Australian investors who will live off their wealth in Australia).

The broad share markets in the US and Australia have generated similar total 'real' returns to Australian investors (averaging 6.7% and 6.6% per year respectively since 1900). Returns from Australian listed commercial property trusts (since 1974 when data is available) is not far behind at 6.2% pa.

Next in line comes Australian housing. For this, we use the weighted average of the 8-capital city median house prices, plus net rental returns (so it more or less replicates the returns from a 'median' house rented out at a 'median' rent, after average rental expenses).



The relativities between returns from the different types of assets overall (column A) are as expected – ie higher returns from shares (and listed property), reasonable returns from housing, then lower returns from government bonds (Australian and US), and then the lowest returns from Australian cash. Precious metals also generated very low real returns on average (we use a mix of gold, platinum and silver to account for periods when the private holding of gold was illegal).

How did inflation affect the returns?

While the overall average returns in column A are reasonably straightforward, the picture becomes much more interesting when we look at returns in different inflationary conditions.

Columns B and C show average returns in rising inflation (B) and falling inflation (C) 'phases' (these are the same phases as in the charts on Australian shares in the previous section above). Columns D and E show returns in rising inflation years (D) and falling inflation years (E).

Finally, columns F, G and H show average returns for each type of asset in periods of 'high' inflation (F), 'moderate inflation (G) and 'low' inflation (H). For this purpose, we define 'high' inflation as above 5.4% (which is the highest one-third of years since 1900 in Australia), 'low' inflation as below 2% (the lowest one-third of years), and 'moderate' inflation as the middle third of years (inflation between 2% and 5.4%).

The first aspect that stands out from the chart is that all asset classes as a group generated lower returns in rising inflation phases (B) and in rising inflation years (D), than they did in falling inflation phases (C) and falling inflation years (E). Similarly, all asset classes as a group did better in low inflation years (H) than in high inflation years (F).

In a nutshell, all asset classes as a group generated significantly higher returns when inflation was low and/or falling, but significantly lower returns when inflation was high and/or rising. There are several major implications for long-term investors.

1. The recent above-average returns are not sustainable unless inflation remains low and/or keeps falling even further.

First, the above-average returns that have been achieved across all assets classes in recent years have been largely thanks to the fact that inflation, along with interest rates and bond yields, have been falling since 2008 and have been 'low' since 2014. This is the ideal 'sweet spot' that has always generated above-average returns from all asset classes, through numerous past cycles.

There is a danger that investors become complacent and assume that these high returns in low/falling inflation conditions are 'normal' and will continue in the future. The good returns in recent years are neither normal nor sustainable, unless inflation keeps falling even further, and remains in the 'low' (sub 2% range).

For example in the case of shares, real estate and bonds, most of the price gains over the past decade have come from increases in the amount of money people are paying per dollar of dividends from shares, rents from properties and interest on bonds, rather than rises in the actual dividends, rents and interest themselves. In the industry jargon, most of the gains have come from 'multiple expansion' and 'yield compression', and this trend has been driven by the global 'search for yield' as inflation and interest rates have declines to zero. These windfall price gains cannot continue unless interest rates and inflation continue to go down below zero indefinitely, which is neither possible nor likely.

2. All asset classes perform worse with high/rising inflation

If we are moving from the recent 'falling inflation phase' into the next 'rising inflation phase'. We cannot merely switch between asset classes and hope to achieve similar returns to the recent past, because the whole group of asset types (including precious metals) generate lower returns in high/rising inflation years than in low/falling inflation years.

In this environment, the key is to invest in companies and other assets with genuinely rising profits and dividends and income streams, rather than rely on speculative gains. This is the reason behind the falls in the speculative tech end of share markets here and around the world in recent months.

3. Housing is adversely affected less than other assets

If we look at how each of the coloured arrows per asset class changes position across the different columns, we can see that Australian housing has been affected less adversely by high and rising inflation than the other assets. The maroon arrows for Australian housing are largely unaffected across all types of inflationary conditions, posting real total returns averaging around low to mid-single-digit returns across the board. Note that the 'housing' asset class is a more complex than other asset classes. The return numbers here are based on 'median' prices and rents, but each house owned by each investor is unique and different. You can't simply 'buy the market' with an index fund of housing like you can with shares and bonds, and returns do not allow for gearing, high transaction costs or the costs of renovations and upgrades, etc.

4. Precious metals

Precious metals (essentially gold, since gold, platinum and silver prices move almost in unison most of the time) have failed to provide a so-called 'inflation hedge' in practice. In rising inflation years (D), and high inflation years (F), returns were flat or negative, and worse than most other asset types.

5. Shares post the highest returns in all inflation conditions

Throughout each of the different inflation conditions, Australian and/or US shares have generated the highest real total returns, and in all types of phases, have been in positive territory. In contrast, so-called 'defensive' bonds have posted negative returns.

6. The temptation to chase speculation in a lower-return world

The recent phase of near-zero interest rates on cash and term deposits lured countless ordinarily conservative investors into a bewildering array of high-risk schemes and scams that promised higher returns. Many of these, including some with 'household name' brands, ended in big capital losses.

The next phase of rising interest rates will be different. This time, rather than low yields and high capital gains on shares and properties like the current phase, the next phase will probably see yields rise (along with interest rates) but capital gains will suffer, especially after inflation. As investors start experiencing lower returns, it will lead to the inevitable temptation to start chasing higher returns in more speculative areas once again. This temptation will be difficult to fight, but it will no doubt lead to the same poor outcomes for innocent victims.

7. Asset allocation does not change radically in rising/high inflation conditions

One key observation is that, although the overall grouping of assets class returns is significantly lower in rising and /or high inflation conditions than with low/falling inflation, the *ranking* of real returns from the different asset classes is more or less the same in each type of inflationary environment – ie shares do best, then commercial property, then housing in the middle, then bonds and cash at the bottom with the lowest real total returns.

It follows that the overall shape of asset allocation is probably not going to be very different in these different inflationary environments. The main change will be that returns are going to be lower if we are shifting into a 'rising inflation' phase.

On the other hand, the positive aspects of this shift will be that portfolio income (dividends from shares, rents from real estate, interest from bonds) is likely to be higher than in the low/falling inflation phases. A second benefit is that price volatility is also likely to be lower, especially for share markets.

8. Asset selection and tactical shifts

The likely trend to lower real total returns will increase the importance of tactical adjustments as conditions change within these 'big picture' shifts. Also important will be the selection of specific sectors within asset classes. For example: within share markets: the bias toward different sectors and themes like healthcare, sustainable quality, the country/regional mix, the mix of large/mid/small companies, currency hedging of international shares, and so on. Within bond markets, these decisions include: corporate bonds versus government bonds, high yield versus investment-grade, Australian versus international, and the use of floating-rate notes to complement fixed rates, active management versus passive/ETF, and so on.

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Where will investment returns come from in 2021?

Andrew Mitchell

As Australian equities have rebounded from the lows of late March 2020, many investors have doubted the rally's staying power. Pessimists argue that, based on most valuation metrics, stocks are pricey, which implies weak returns ahead.

But we believe that this overrates the predictive power of valuations, particularly in the short term. Instead, investors need to understand that long-run equity returns are driven by multiple components, of which valuation is often the least important.

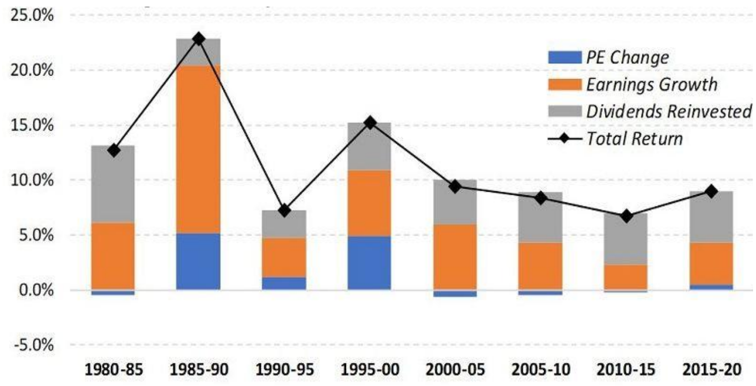
Indeed, it is likely that in coming years investors won't be able to rely on rising equity valuations for their returns. To achieve high returns and realise their investment goals in this environment, they are going to have to become even more focused on identifying the companies that can produce strong earnings growth and cash flow.

There are only three components of returns

Figure 1 decomposes Australian equity market returns into their key components. As you can see, there are only three sources of returns:

- Income (grey bar) – dividends
- Earnings (orange bar) – how fast have companies grown their earnings?
- Valuations (blue bar) – how has price/earnings multiple changed? Does the market now value companies more or less for a given level of earnings?

Figure 1: Components of ASX Total Returns (% p.a.)



source: Refinitiv

The first two components of return are generally referred to as the 'fundamental' components, whilst valuations are often referred to as the 'speculative' component of return. The latter has earned this moniker because it is driven by unpredictable investor emotions, such as fear and greed, in the short term. (The sum of these components approximates the return on the stockmarket, shown with a black diamond.)

An erratic contributor

The sources of return never change but their order of importance does. That is, during any of the five-year periods presented, one of these variables will exert a disproportionate influence on total equity returns. Conversely, there will be periods where a component makes little contribution.

There is no doubt that when valuations expand it can have a dramatic positive impact on total return. But valuation's contribution is highly erratic: sometimes positive, sometimes negative. When the P/E ratio expands, the stock market generally produces double-digit returns. And when the ratio contracts, returns fall into the single digits.

In the second half of the 1980s and the second half of the 1990s, for example, the P/E ratio was a strong driver of the era's spectacular market returns. But P/E detracted from market performance through the years 2000 to 2015 when valuations subsided from the start of the high-tech bubble.

The exhaustion of PE expansion

When P/E multiples are expanding, interest rates are typically falling, and vice versa. For the two decades between 1980 and 2000, the downward trend in interest rates boosted P/Es, which resulted in huge growth in total equity returns.

More recently, we have seen this play out as central banks worldwide have drastically cut interest rates to support economies facing pandemic pressures.

But with interest rates now having already been reduced to the floor, the era of P/E expansion has been exhausted: it is unlikely that rates can fall much lower and push further P/E expansion. Instead, rising rates over the coming years – as economic growth recovers -- are likely to force a modest decline in equity valuation multiples, similar to what markets digested through the years 2000 to 2010.

This negative outlook for P/E ratios emphasises the other two sources of equity return: earnings and dividends. As you saw in Figure 1, earnings and dividends, unlike the highly volatile P/E ratio, have had a consistently positive effect on total return over the last 40 years. In fact, for much of the last 20 years, earnings and dividends have continued to boost total return, while P/Es have hindered market performance.

The emerging primacy of earnings and dividends

But while earnings and dividends become more important as sources of returns, the period of double-digit earnings gains for the broader equity market will soon be behind us as economies normalise post the COVID-19 pandemic. Going forward, earnings growth will likely occur at a more modest single-digit rate.

Fortunately, our investment process has always focussed on finding the companies that can materially grow earnings. In this environment, our expertise in identifying the profitable growing businesses of the future comes to the fore.

Meanwhile, because they are often a preferred method of free cash flow deployment, dividends are set to emerge as a more important component of total equity returns. Although we are biased to companies that can grow earnings faster than the market, we will continue to learn everything we can about a company's free cash flow and what it signals for the businesses capital management policies.

A solid year of returns from equities

Valuations are not good predictors of short-term market returns. It is futile for investors to use valuations to time the market day-to-day or month-to-month.

Valuations could fall but that does not mean returns have to be negative if the other two drivers contribute enough.

For long-term investors, the best course is to continue investing according to your plan, regardless of what the market does. You may, at times, buy when valuations are high; on other occasions, you will buy when valuations are low. It should all come out in the wash over the long term.

Our base case is we expect a year of solid returns from equities in 2021, but with the usuall high degree of uncertainty. The global economic recovery, which is currently playing out, suggests that earnings growth should positively contribute to markets in 2021.

The big differences could arise from valuations. Dividends should also be well supported this year, particularly in commodity and consumer-related stocks.

We think investors can no longer rely on a rising tide of higher valuations to lift all stocks. Alpha or outperformance, where it can be found, will be a larger portion of total investor returns. We focus on finding undervalued small and mid-cap companies that through a superior product or service can become the future leaders of tomorrow. These types of businesses will continue to be rewarded with expanding valuations as the market recognises their superior growth trajectories.

Andrew Mitchell is Director and Senior Portfolio Manager at [Ophir Asset Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Portfolio composition and what you find under the bonnet

Richard Jones

As many economies have bounced back from the worst of the pandemic, concerns about central banks, the rate of money printing and inflation have returned. Since late 2020, markets have responded to the arrival of better times by selling off bonds and bond-like equities. The stocks that benefited most from lower discount rates, have fallen. The most speculative, Covid-bolstered, technological and crowded end of the market have been hit the hardest.

Against this backdrop, many investors are considering how to position their portfolio for the post-pandemic world.

Focus on structural changes but watch definitions

Although we are bottom-up investors, we look to the powerful structural themes that support the underlying businesses we have invested in, such as the growing middle class, rising consumption, an ageing population, better healthcare and technological disruption.

This can be seen in the concentrated sector breakdown of our Asia Pacific portfolio, where the largest exposure is to consumer companies, with Consumer Staples and Consumer Discretionary businesses amounting to 25% of the portfolio according to MSCI's categorisation.

However, these categories don't tell the whole story. Investors need to look 'under the bonnet' of their portfolio to truly understand the themes that are driving returns. The sectors to which their portfolio holdings 'look through' may in reality tell a different story.

In our view, for example, Techtronic Industries, Shanghai International Airport (SIA) and Jardine Matheson are consumer-driven companies, even though MSCI classifies them as Industrials.

Home Depot accounts for 50% of Techtronic's sales, while Chinese tourism (both domestic and international) should give SIA a strong tailwind. Although Jardine Matheson is a conglomerate, its two largest businesses (Jardine Cycle & Carriage and Dairy Farm) are both consumer businesses. We would additionally consider Voltas, the Indian air-conditioning manufacturer, to be another consumer business, although MSCI categorises it as another Industrial company. If you add all of that together, consumer companies more broadly account for 35% of our portfolio.

This is no accident. We see the growing middle class in India and China as one of the most important thematics. Thanks to these regions' favourable demographics, companies with dominant consumer franchises can offer good growth potential over the long-term.

Incorrect perception of technology

Looking at technology, according to MSCI, Information Technology (IT) accounts for just 25% of our portfolio. However, Naver, Tencent and Seek are all categorised as Communications Services businesses, even though we see them as IT companies. But even that is not specific enough: all three are broad IT-platform businesses.

What really drives them is again the rising wealth of Asian consumers and the growing middle class. JD.com is already categorised by MSCI as a Consumer Discretionary business, which rather proves the point, in our view. Putting all of that together, IT accounts more correctly for around 35% of the portfolio.

We segregate IT exposure into three segments: IT platforms, hard-tech, and IT services companies. Hard-tech companies manufacture and supply the global multi-nationals with components and services and includes Taiwan Semiconductor (TSMC), Mediatek, Largan and Advantech.

Together, the IT services companies amount to about 10% of the portfolio. These Indian-based multi-national companies (MNCs) are, quite simply, digitising the world, and COVID has given them multiple additional tailwinds. We believe they are collectively very high-quality companies, with high returns, strong cash flow and typically net cash balance sheets. We own Tata Consultancy Services (TCS), Tech Mahindra and Cognizant in this sector.

The other major sector exposure is to financials. The main exposure is to the Indian private banks where we see plenty of growth runway for these high return-on-equity (ROE) compounding businesses. Though the news from India has latterly been dire in human terms, businesses appear to have mostly endured.

Outside of these three broad sectors, other company holdings are individually attractive, such as Fanuc (the Japanese manufacturer of robots), Indocement in Indonesia and Central Pattana (the shopping centre owner in Thailand). Fanuc's biggest source of growth has been China, with the business in particular benefiting from a recovery in the capital investment cycle in IT (particularly smartphones) and autos.

Understand company dynamics, not broad sector definitions

Ultimately, we think about portfolio construction on a company-by-company basis. We are benchmark agnostic and do not look at over- or under-weighting sectors or even countries. But sector classifications by the major index providers do not always tell the whole story. We believe we are better off holding firm to our bottom-up investment philosophy, and being clear on the growth drivers that underpin the companies we own.

Richard Jones is a Lead Manager, Asia-Pacific Equities at [FSSA Investment Managers](), based in Hong Kong. FSSA is part of [First Sentier Investors](), which is a sponsor of Firstlinks. This article is intended for general information only. Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.

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When rates rise, it's time to look for new players on the team

Simon Petris Ph.D.

Recently, there's been a lot of discussion about whether the significant government stimulus, combined with record low interest rates and unconventional monetary policy will finally result in rising inflation, something markets have not experienced for some time. It appears that almost every central bank is committed to these measures until they achieve their objective of realised inflation.

It's a risk of which investors should be aware. On a practical level, it means taking a look to see whether the assets in your portfolio are still match-fit in an environment of rising inflation. We have previously written on the critical role of the attacking defender as it relates to private debt illustrated through soccer, so we'll extend this soccer team analogy to explore this dynamic and the role private debt can play to help investors navigate an environment of rising inflation.

Moving market dynamics

Long-duration assets like government bonds, infrastructure, property, and high-growth equities benefit when interest rates fall by lowering the discount rate applied to all their future cashflows. These are the first assets selected in your team when rates are falling. We have seen these champion investments perform exceptionally well over the bull market of the last 40-years, when interest rates have dropped from double digits to near-zero levels.

With the potential for rates to rise from zero and with the prospect of inflation, it's time for the coach and team manager – in markets, the portfolio manager – to make some difficult decisions about whether champion players in the twilight years of their career – for example sovereign bonds – should still be on the field, at least for the whole match.

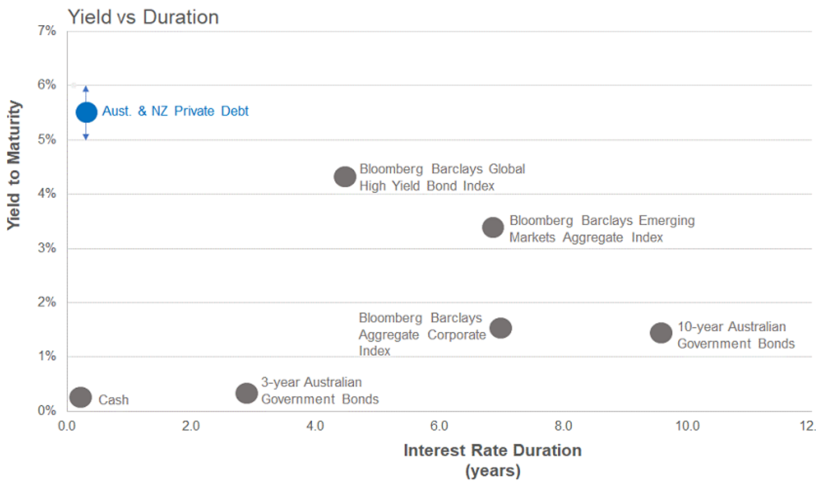
When inflation expectations rise, interest rates tend to increase, and the yield curve steepens. Long duration assets may no longer be fit for purpose. It might be time for short duration asset classes such as private debt to step into their role in the team.

In a rising interest rate environment, the value of long-duration assets like fixed rate corporate and sovereign bonds fall in value because their future cashflows are discounted more than before. Senior secured private debt is short duration and in a rising interest rate environment does not fall in value, giving true diversification benefit.

The duration of various fixed income investments

This chart illustrates various credit and fixed income investments with differing levels of duration. The longer the duration, the more sensitive the investment valuation will be to interest rate changes.

The overall yield on floating rate private debt rises in line with interest rate movements because the total interest earned is the floating rate benchmark plus the credit margin.



Source: Revolution Asset Management and Bloomberg. 'Aust & NZ Private Debt' is based on realised investment experience of the Revolution private debt strategy from December 2018 to May 2021.

The trade-off is that investors need to be comfortable with increased credit risk and the illiquidity that comes along when investing in private debt.

Re-positioning for the times

Overall, what's important is to have the right balance of attacking and defensive assets in a portfolio for the current conditions. You pick a different team when the game is played in rain and snow compared with when the conditions are fine. When it comes to investing, what's important is to choose the right assets for the prevailing economic and market environment.

Think of private debt as the attacking defender or wingback in the team, it provides the right balance in a portfolio because it produces uncorrelated returns to other assets, as we demonstrated in our previous article. It's an investment that's first and foremost a defender that aims to preserve capital, but at the same time, it can contribute to the attack and goals in the form of regular income that can either be spent or used to re-balance.

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How are high net worths investing and thinking now?

Gofran Chowdhury

The pathways to wealth are many and varied. For one person it may come from manufacturing, for another it may be entrepreneurial flair, while for another it may come from working the land.

A common misconception is that people that have achieved significant wealth are automatically good at managing it and understanding the investment opportunities available to both protect and grow that wealth. The reality is while someone may be very clever in their area of expertise, most of us cannot be experts across multiple disciplines.

Investing has become more difficult

Since the GFC of 2008-09, there has been a series of events that have made investing more problematic, including:

- The descent into an extended low interest rate environment, making some of the more common investment products like savings accounts and term deposits less attractive.
- Less stable global environment, driven by a retreat from globalisation and the rise of nationalist interests and leading to real and threatened trade wars.
- Increased digital disruption creating both rapid transformation and disruption in many industries, making equity investments more difficult to formulate.
- 'Black swan' events like COVID-19 have made forward forecasting particularly difficult, even impacting resilient markets like property.
- Lack of knowledge of investment alternatives outside of the big three – cash, shares and property.

The last point showed up clearly in research undertaken this year by Citi, with over half of wealthier investors citing lack of knowledge as the greatest impediment to examining other investment opportunities.

Outlook gives investors optimism

However, investors are also eager to take advantage of what they perceive as improving economic conditions. The research showed wealthier investors are 2.5 times more optimistic about the outlook this year compared to lockdown riddled 2020.

COVID-19 remains the main concern to the outlook, followed by trade wars. Low interest rates are a major concern for less than one-third of surveyed investors.

That is likely because many wealthier investors are also approaching or in retirement and are more concerned with preserving wealth than high growth strategies. For that reason, they can build portfolios that carry less risk but still provide an acceptable return.

Diversification remains an elusive goal

The research shows wealthier investors are still struggling to embrace portfolio diversity, with 54% only holding domestic shares in their portfolio. It's likely increased education on the benefits of diversity both by asset class and geography would see this concentration reduced. Citi's clients tend to favour greater exploration of investment opportunities available, with 57% taking some form of international investment by the end of the first quarter of 2021.

Investment areas of interest

Two areas that wealthier investors are showing particular interest in is healthcare and property.

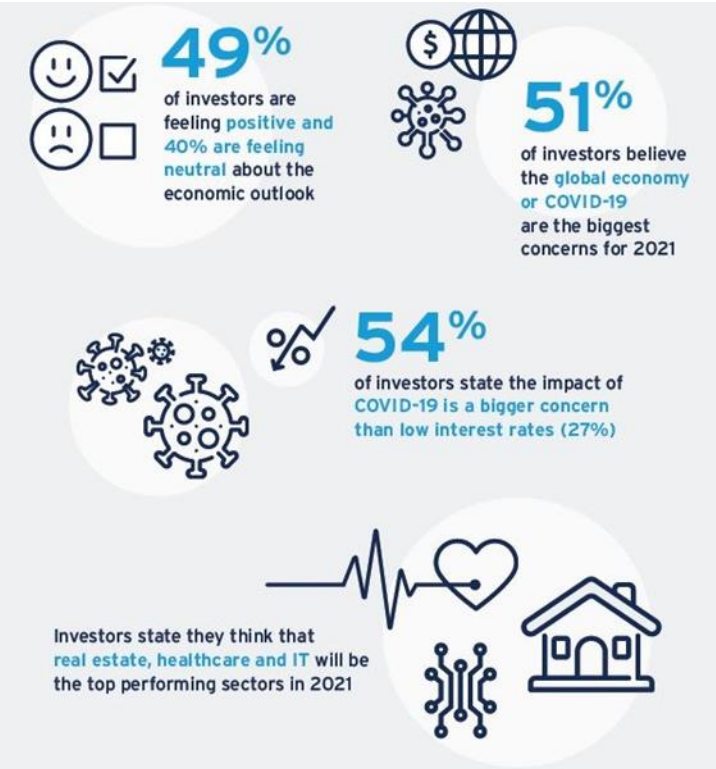
Australian healthcare stocks, which include some leading global companies, have underperformed the ASX200, by 30% over the past 12 months. It is not a phenomenon restricted to Australia. In the United States the price of healthcare stocks, based on forward earnings estimates, trade at a 30% discount to the S&P500 index.

This is an real opportunity to gain an exposure to one of the few sectors remaining that we do not consider expensive following 15 months of stocks rising since markets started pricing in a COVID-19 recovery.

In property, we expect buying strength to remain robust for the remainder of the year with price growth exceeding 10% for the year. However, we view increasing issues with affordability to temper growth next year, with growth contained below 4%.

How do Australia's HNW investors feel about investing?

How do Australia's HNW investors feel about today's economic outlook?



Despite outbreaks of the pandemic continuing to impact many parts of the world we are solidly in a global recovery phase. It aligns us with investors optimism going forward, but we remain cautious that volatility has been a consistent driver of markets over the past decade and will likely remain a significant element in portfolio construction for the foreseeable future.

Gofran Chowdhury is Head of Investment Specialists at Citi Australia, a sponsor of Firstlinks. Information contained in this article is general in nature and does not take into account your personal situation.

For other articles by Citi, see here.

Where do Australia's HNW investors choose to invest?