Firstlinks
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Editorial

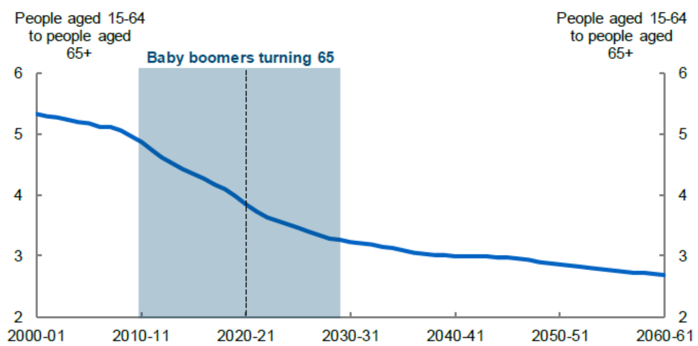
There is a similarity between the projections for 2060 for Australia described in the Intergenerational Report (IGR) and the net-zero climate change debate for 2050. In both cases, we can ignore the threats because they are too far in the future to worry about now, or we can start to make policy adjustments to manage the transition. We may not be 100% sure about the accuracy of the projections but there is enough science behind the numbers to force decisions soon.

Instead of our daily focus on the latest virus and lockdown announcements or weekly preoccupation with central bank vicissitudes, both net-zero and the IGR are opportunities to think about how Australia might look in 30 to 40 years. The IGR projects a population of 40 million people, only 2.7 workers for every person over 65, health demanding a quarter of the federal budget and 8 million people on the age pension despite 70 years of superannuation. That's the latest Intergenerational Report (IGR).

We start this week with a review of the IGR and the big pictures on superannuation, demographics, health, welfare, spending and migration. Gone are the days of budget surpluses. The controversial highlighting that the cost of superannuation will exceed the cost of age pension is sure to arm the critics.

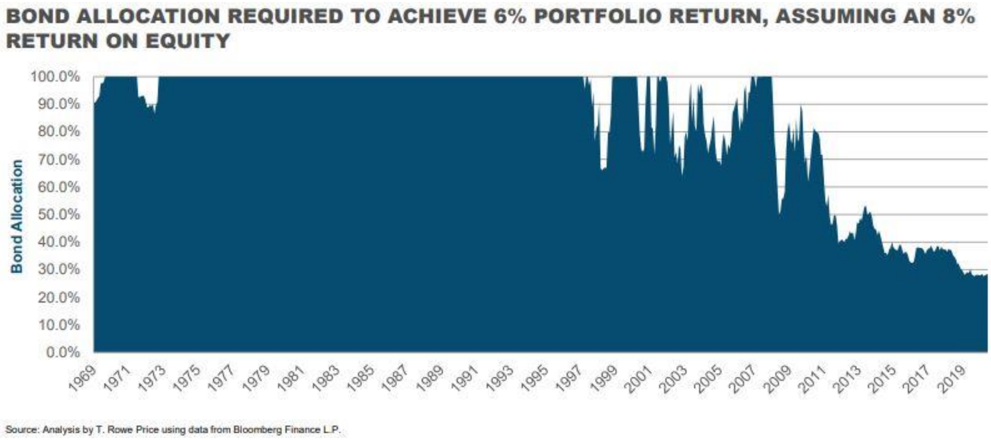
Among the dozens of interesting charts in the IGR, this one sums up the major demographic change (and identifying over 65 as 'old-age' is revealing). With the boomers 'retiring' and a dependency ratio of 2.7 by 2060, what happens to personal income tax rates - the largest source of government revenue - to pay for health and pensions?

Chart 2.17 Old-age dependency ratio

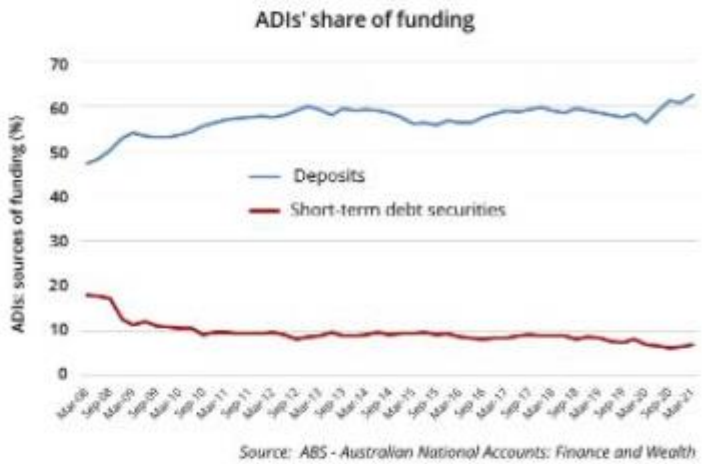


Note: Number of people of traditional working-age (15-64) for every person aged 65 and over.
Source: ABS National, state and territory population, September 2020, and Treasury.

The biggest challenge for most retirees is making the money last in this world of increasing life expectancy, low interest rates and likely lower returns from equities in coming decades (notwithstanding that the All Ords index rose 26% in FY21, its best performance in over 30 years). It's easy to say 80/20 is the new 60/40 but that comes with added risk. The chart below (for the US market but Australia would be similar) shows that for most of the last 50 years, a portfolio could significantly allocate to bonds and still achieve a reasonable 6% return. Now the portfolio needs to rely on company dividends. One day, this will end badly and people will realise that the new role of term deposits and bonds is to protect capital.



After providing a wonderful source of long-term cheap funding in response to the pandemic, the Term Funding Facility where the **Reserve Bank** lends to banks for three years at 0.1% ended yesterday, on 30 June. Although the final results are not yet issued, **Peter Sheahan of Curve Securities** who watches these things closely believes the banks have drawn the full $200 billion in a last-minute rush. For someone like me who spent much of his banking career on asset/liability management and sourcing deposits and long-term funding, the lack of reliance on short-term wholesale deposits is a massive improvement in funding resilience, as shown.



In other articles this week, **Don Hamson** weighs into the debate on the merits of Listed Investment Companies (LICs) by describing the requirements of a good LIC. LIC managers and investors should check his list.

Matthew Davidson looks at the surprising strength of residential property prices to see if it can continue, and as important, the implications for Australian bank share prices.

Lewis Jackson has trawled through the Morningstar database to identify a few Australian stocks which screen well for dividends, valuation and favourable ESG characteristics, suggesting there may be a place for them in portfolios needing more income.

Australian investors have accepted the benefits of an allocation to global equities to access broader opportunities, and **Stan Shamu** describes how to assemble global assets for diversification and income.

Still on portfolio construction, **Jordan Eliseo** shows how gold can sit in a superannuation portfolio, even with a modest allocation, to improve the risk and return characteristics over time.

Over the next three weeks, we will publish a series of articles on modern retirement income products, starting with **David Orford**'s contribution. The Government and the Retirement Income Review have called for the superannuation industry to develop products that address longevity for retirees, and useful additions to the landscape are starting to appear. Next week, we will examine **Magellan's FuturePay**.

Our **Comment of the Week** comes from '**ST**' who provided a simple example of the shortcomings of the **Your Future, Your Super** legislation which comes into effect today (and the comparison tool is expected on the ATO website):

"Another example is fund C: it has a 100% equity SAA but buys out of the money put options to protect against drawdowns. Let's say that protection costs 1% (net of any benefit from brief drawdowns in markets, if you want to be technical). Markets return 10%, the fund returns 9%. The trustee thinks they have done a good job – they have benefited from strong equity markets and perhaps reduced the volatility, they even delivered better returns than Fund A or Fund B. But Fund C has delivered 1% below its benchmark, is marked as underperforming and must write to its members to think about changing funds. Those members think, 'yes we need to switch funds', and move to Fund A."

Thanks to the almost 2,000 people who tuned into our new podcast, Wealth of Experience, and for the encouraging feedback. A new episode will be posted next week.

This week's White Paper from **Fidelity** examines the 'wealth effect' for Australia and its households, especially due to rising residential property prices.

Finally, two quick shout outs.

First, my former colleague at **Lazard Asset Management, Rob Prugue**, is actively involved with PROP (People Reaching Out to People) which does great work on mental health. With nationwide lock downs, many people are doing it tough, and the PROP website includes videos and tutorials to help people. Please forward to anyone who may be struggling.

Second, when I joined CBA in 1979, Investment and Economic Research Department (and later Treasury) was run by **Peter Wilson**. He guided many careers when the Australian market was changing dramatically and CBA dominated liquidity and trading. Sadly, Peter died on 14 June 2021 at the age of 90. Well done for your professionalism, humour and contribution to many careers and the financial market.

Demographic destiny: a snapshot of Australia in 40 years

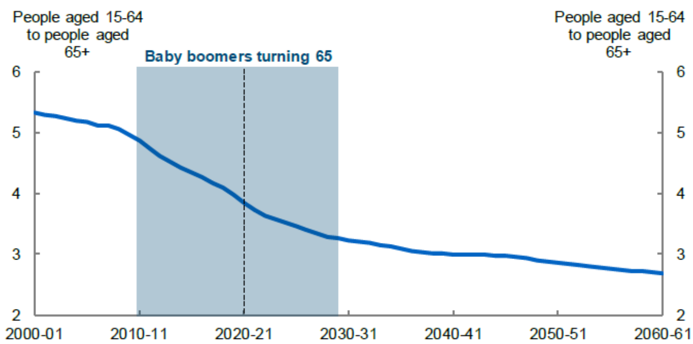
Graham Hand

The 2021 Intergenerational Report, or IGR, is Treasury's educated guess at what Australia will look like in 2060. It should guide big policy decisions, laying a path to better outcomes in our future.

The latest IGR is notable on two fronts:

First, it comes at a time of major demographic change, with baby boomers retiring as they are now aged between 57 to 75. As recently as 1982, there were 6.6 people of working age for each person over 65. It is now 4 and in 2060 will fall to 2.7, as shown here (and someone should have a word with Treasury about labelling over 65 as 'old-age dependency'). There will be profound implications for health, pensions, taxes and aged care.

Chart 2.17 Old-age dependency ratio



Note: Number of people of traditional working-age (15-64) for every person aged 65 and over.
Source: ABS National, state and territory population, September 2020, and Treasury.

Second, the outlook for the economy and the Federal Budget over the next 40 years has been affected by COVID-19. The main impact is the smaller population due to lower migration during the pandemic. The IGR forecasts a population of 38.8 million by 2060, down from 40 million by 2055 forecast in 2015. This is the first downward population revision since IGRs started in 2002.

Treasurer Josh Frydenberg summarised the changed in this release speech, offering three key insights:

- The population is growing slower and ageing faster than expected. This impacts economic growth and workforce participation.
- The Australian economy will continue to grow but slower than previously thought. Growth will depend on productivity gains.
- While Australia's debt is sustainable and low by international standards, the ageing of our population will put significant pressures on both revenue and expenditure.

Let's break down the 200-page IGR into population, life expectancy, budgets and debt, age pensions, government revenues and spending, superannuation and health.

1. Population

Australia has always relied on immigration to drive population growth, with fertility rates at 1.6 well below the replacement rate around 2. Low fertility and fewer young migrant arrivals will also contribute to an ageing population.

As Chart 2.3 from the IGR shows, the 2021 population projections for 2021 are below both 2015 and 2010. While migration has its impact, Treasury also highlights:

"The most significant of these trends is the fertility rate being further below the rate required to sustain the size of the population than previously projected."

Net overseas migration accounted for about 60% of population growth in the last decade, and with lower fertility, migration is expected to contribute around 74% of growth by 2060. This depends primarily on government policy, but it shows the impact on the economy of a sustained annual intake of migrants. A strong post-pandemic recovery is forecast.

Treasury favours migration as a major factor in economic growth and recovery, although recognising the rise in health and pension costs. There is little allowance, however, for the infrastructure cost of adding 13 million people to the population. While many of these costs fall to individuals and state governments, the bulk of the financing needs to come from the Federal Budget.

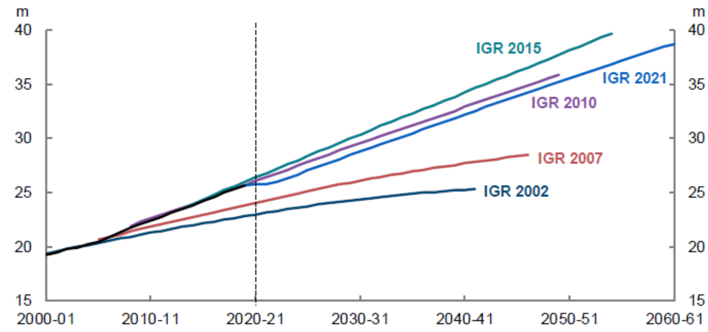
2. Life expectancy and an ageing population

Treasury calls the ageing of the population "Australia's greatest demographic challenge". In fact, the life tables always underestimate actual outcomes due to faster advances in medical science than expected, and it's more likely that most Australians born today will live beyond 90 years-of-age.

Treasury estimates that from 2020 to 2060, the number of people aged 65 and older will double to about 9 million, or 23% of the population, up from only 16% in 2020. As dramatic, the number of people aged 85 and older will more than triple to almost 2 million, representing a rise from 2% to 6% of the population. The number of centenarians will rise from the current 6,500 to over 40,900.

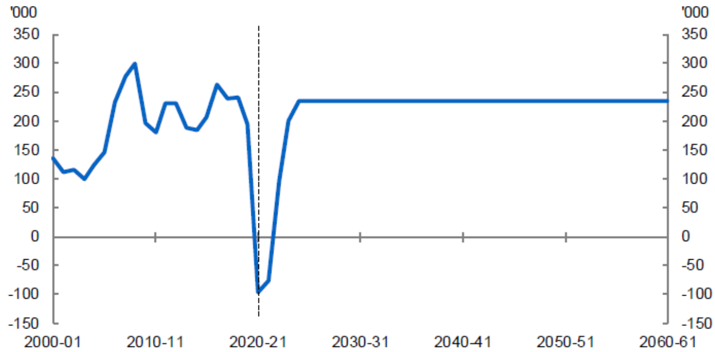
The old-age dependency ratio, forecast to fall to 2.7, presents economic growth and fiscal challenges as most taxes are paid by working-age people.

Chart 2.3 Population projections across intergenerational reports



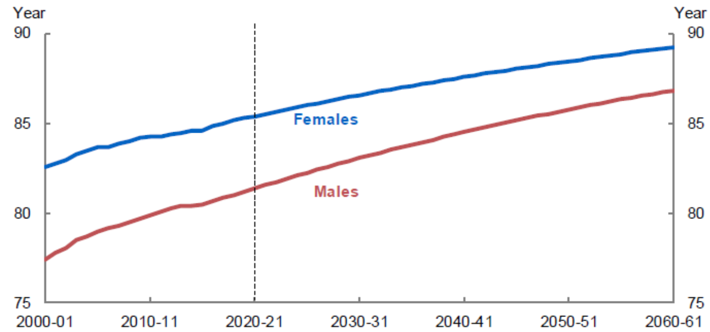
Source: ABS National, state and territory population, September 2020, and Treasury.

Chart 2.4 Net overseas migration



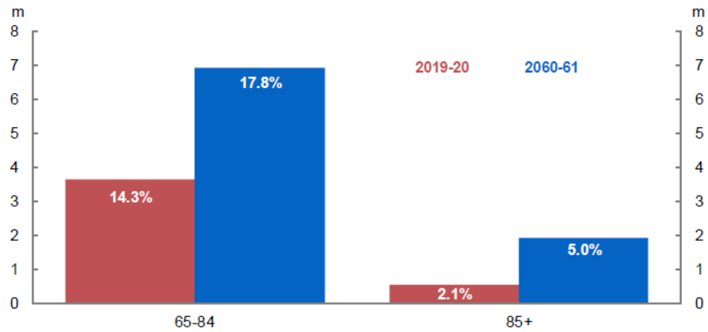
Source: ABS National, state and territory population, September 2020, and Treasury.

Chart 2.13 Life expectancy at birth



Source: ABS Australian Historical Population Statistics; ABS Life Tables: States, Territories and Australia, 2016-18; ABS Life Tables, 2017-2019; and Treasury.

Chart 2.15 Older Australians by level and share of population

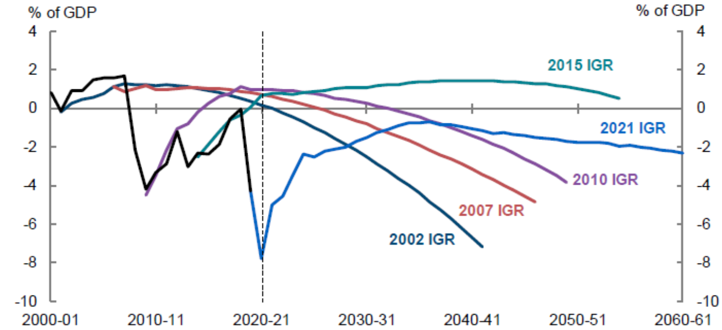


Source: ABS National, state and territory population, September 2020, and Treasury.

3. Budget and debt

Remember the 'Back in Black' budget of a couple of years ago? The green line in chart 6.3 from 2015 showed a healthy budget outlook for decades ahead. However, the pandemic's impact leaves the underlying cash balance in deficit for the next 40 years, reaching 2.3% of GDP by 2060.

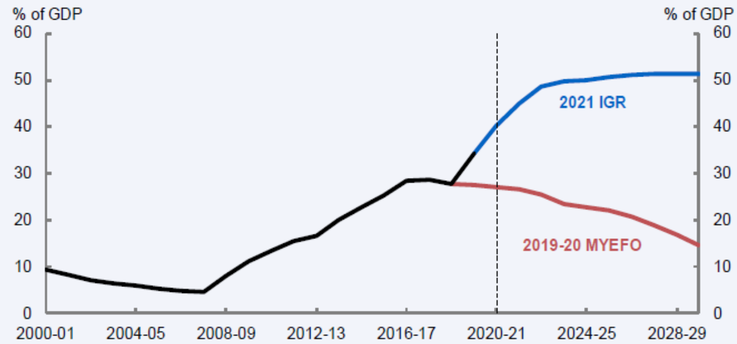
Chart 6.3 Underlying cash balance across intergenerational reports



Source: Treasury.

Gross debt is projected at 41% of GDP and net debt 34% of GDP in 2060. As shown in Chart 6.5, in the most recent 2019-20 MYEFO, gross debt was expected to fall to only 15% of GDP but is now forecast to peak at over 50% of GDP by 2030. Although the new numbers are high, the net debt is less than half the average of G20 advanced economies.

Chart 6.5 Face value of gross debt



Source: Australian Office of Financial Management and Treasury.

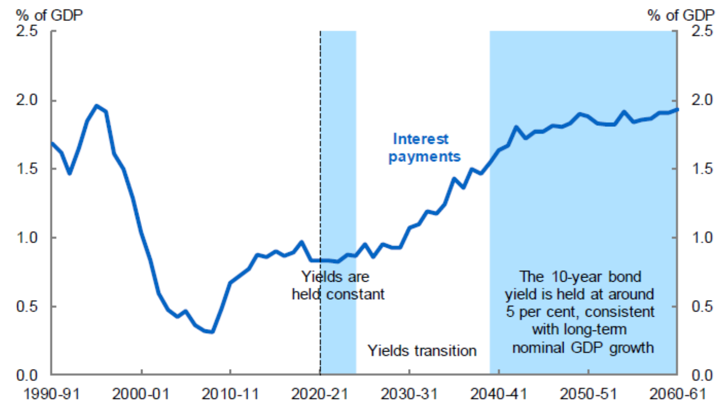
The prediction that debt will remain high for 40 years under current policy settings may at some stage lead to the fiscal repair the Treasurer is promising. He said on release of the IGR:

"But once our economic recovery is secure, we have a responsibility to again do the work necessary to restore our finances and rebuild our fiscal buffers."

Expect to hear this message and arguments about which party is best to handle it many times during the upcoming election.

Chart 6.11 shows low interest rates are helping the affordability of the debt, at less than 1% of GDP until 2030. But from around 2040, the assumption that long-term bond rates will normalise at 5% has interest payments doubling to around 2% of GDP. Josh Frydenberg is using these numbers to justify spending to grow the economy, as the more GDP increases, the more manageable the debt seems.

Chart 6.11 Interest payments on government debt



Source: Treasury.

4. Spending on generations

The IGR issues plenty of warnings about the demographic transition, the composition of welfare recipients and demand for services as the population ages. It highlights that spending on health and aged care will increase while payments to families and education will see a reduction in growth. Over 40 years, intergenerational tension will come to the fore.

In particular, health spending will increase from 4.6% of GDP currently to 6.2% in 2060, much of it due to the costs of new health technology. Aged care spending will rise from 1.2% of GDP now to 2.1% in 2060. However, spending on welfare such as the age and service pensions is projected to fall from around 2.7% of GDP now to 2.1% in 2060, mainly due to rising superannuation balances.

Yet, as Chart 7.4.1 shows, even by 2060, about 60% of Australians will still rely to some extent on the age pension, although full-rate pensioners will more than halve to around 25% of people. The assets test will push many onto part-pension, up about 25%, although there is no sign of inclusion of the family home in the test. Treasury emphasises that while the proportion of older Australians receiving the age pension falls by about

10%, the number of older Australians increases. There will be a doubling to 8 million by 2060 in the number of Australians of age pension age by 2060.

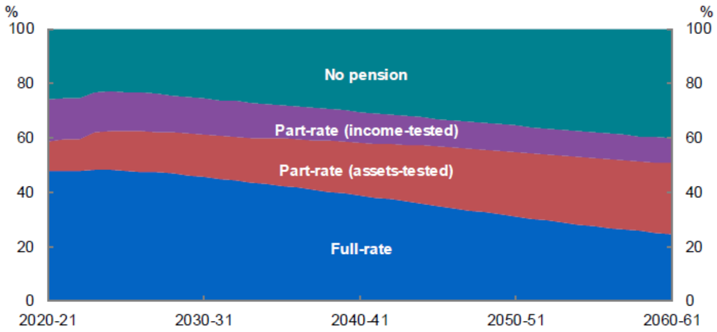
5. Superannuation

Superannuation assets are forecast to reach almost 250% of GDP from the current level of around 150%, with three-quarters in the accumulation phase. Annual withdrawals will move from a current 2.3% of GDP to a massive 6% in 2060. These withdrawals by retirees needing money to live on will become a major factor in the income of the nation, but balances are still expected to grow due to the size of contributions. Superannuation will remain a socially and politically divisive issue for all of our lifetimes.

Super balances will increase significantly as the system matures, with the average amount increasing from $125,000 in 2020-21 to around $460,000 in 2060, measured in current dollars. About three-quarters of Australians will retire with balances over $250,000.

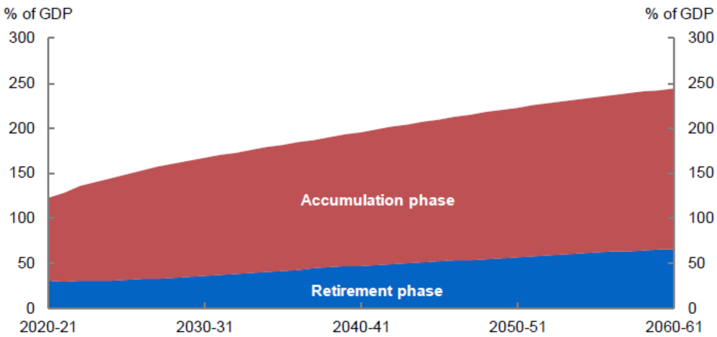
This will become the most-quoted section of the IGR:

Chart 7.4.1 Persons of Age Pension age or over, by pension category



Note: Age Pension recipients include Age, Service, Carer and Disability pension recipients. For further information, see the Appendix.
Source: Treasury.

Chart 7.4.2 Total value of superannuation assets under management



Note: Includes superannuation balances for defined contribution funds for people over 25 years. Excludes defined benefits, regulatory capital and life office statutory funds. For further information, see the Appendix.
Source: Treasury.

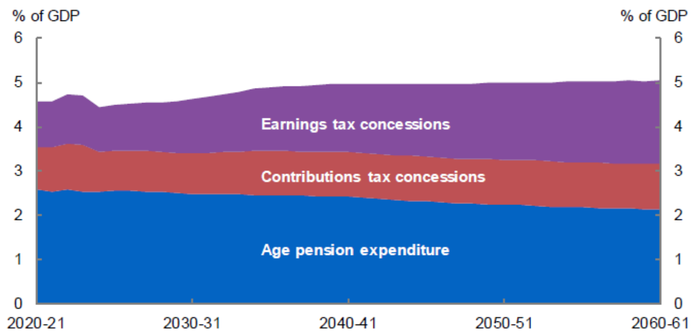
"The total projected cost of age pension expenditure and superannuation tax concessions together is expected to increase from around 4.5% of GDP in 2020-21 to 5.0% of GDP in 2060-61. As a result of the maturing of the superannuation system, government spending on the Age Pension is projected to decline as a proportion of GDP but the cost of superannuation tax concessions is projected to grow. ***By around 2040, the cost of superannuation tax concessions will exceed the cost of Age Pension expenditure.****" (my bolding)*

This final sentence will be used to illustrate the generosity of the superannuation system, especially as most of the 'cost' is due to high super balances for 'wealthy' people and related reduction in income tax revenues. Two points here:

1. The cost of the retirement income system is mainly due to the ageing population and more people with higher balances who will support themselves without the age pension. This makes superannuation look more expensive and age pensions less expensive.
2. If the superannuation tax benefits were withdrawn, wealthy people would use other methods to reduce their tax, so the budget savings would not be as great as expected.

Chart 7.4.6 shows the increase from 4.5% of GDP to 5% in these retirement concessions.

Chart 7.4.6 Cost of the retirement income system



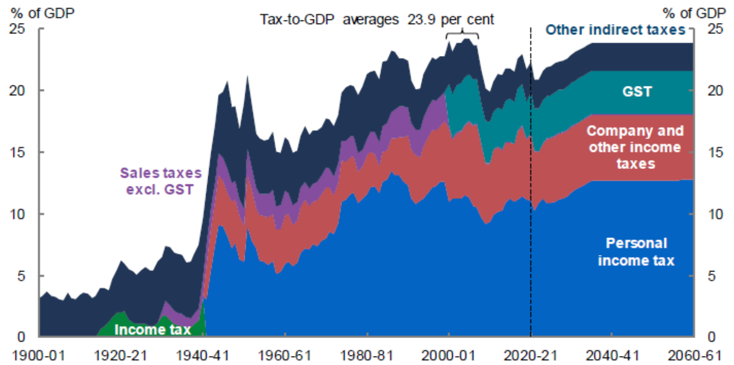
Note: Includes service pensioners. For further information, see the Appendix.
Source: Treasury.

6. Revenue

The Government has a fiscal strategy to maintain the tax-to-GDP ratio at or below 23.9%, and the IGR is developed using this ratio. It is already at the high end of the Australia's tax-to-GDP ratio range of 20 to 25% of GDP over the past 30 years.

A major policy area over coming decades will be whether the reliance on personal tax shown in Chart 8.1 should continue, or is it a disincentive to work? This chart will be used to make the case for a higher GST.

Chart 8.1 Composition of Australian Government tax receipts



Note: Reporting of tax receipts has changed across time. At present, personal income tax includes individuals and other withholding taxes, and the Medicare levy. Company and other income taxes includes company tax, superannuation fund taxes, fringe benefits tax, and petroleum resource rent tax.
Source: Treasury.

It's better than the alternative

A growing population living longer needs good policies to accommodate it, and Australia has the capacity to manage the change, although the days of budget surpluses are long gone.

However, there are worries that Australia is reluctant to reform the economy to drive the next gains in productivity. The IGR assumes productivity growth at 1.5% a year, the average of the last 30 years, but annual growth was only 0.5% over the five years before the pandemic hit.

There are obvious strains on future budgets. One quarter of government expenditure will be on health, and as measured by Treasury, superannuation will cost more than welfare pensions. Expect concessional tax treatment for super to face further reform.

Two major shortcomings are evident reading through the IGR. For all its discussion of intergenerational tension, there is no mention of declining rates of home ownership. There is no greater contribution to a secure retirement than the ability to stay in the home you own, but what was once considered a basic right is now beyond many people.

And while climate change is regularly cited as a major long-term concern of most Australians, there is no insight into how the Government plans to manage the next 40 years.

Overall, the IGR confirms Australia is well placed, with lower debt to GDP than other developed countries and the capacity to spend on health and welfare. And living longer is better than the alternative.

Graham Hand is Managing Editor of Firstlinks.

LICs need a genuine raison d’etre

Don Hamson

Listed Investment Companies (LICs) have been given a lot of stick lately[1]. Many LICs have traded at substantial discounts to their Net Tangible Assets (NTA), causing much angst for their shareholders. One small LIC – Monash Absolute Investment Company (MA1) - has recently taken the bold move to convert to an Exchange Traded Managed Fund ETMF). As reported in Morningstar on 10 June 2021, Monash founder and co-portfolio manager Simon Shields said about the discount problem:

“Within two years of its listing, we thought, this is reflecting badly on us. We felt it was besmirching us to be managing a LIC that was trading at a discount and we weren’t prepared to have this situation continue.”

As the manager of a LIC that has been successfully trading at a premium - Plato Income Maximiser (PL8) – we have a different take on LICs. In the absence of a mechanism to arbitrage the difference between NTA and market price, the price of a LIC simply reflects relative supply and demand for the LIC. LICs trading at a discount have more shareholders wanting to sell the company than buy it, simple as that.

So, here are five reasons why a LIC may trade at a discount.

1. No raison d’etre

We feel LICs should have clear reason for being, that is, a clear appeal for investors - for investors are the people who buy and sell the LIC. If a LIC is simply a carbon copy of a managed fund, with no special features, and perhaps a more costly fee structure (taking into account listing and directors' fees) then one might question what is the raison d'etre for that LIC.

Our LIC has a clear reason for being. A LIC structure lends itself to banking profits and smoothing income payments across financial years, providing a regular income stream to retirees. PL8 is still to our knowledge the only LIC that pays its shareholders regular monthly fully franked dividends, fulfilling retirees needs for regular income in a time when many traditional income assets can't even keep pace with inflation.

Other good reasons for a LIC or LIT structure may be to access assets that don't lend themselves to traditional managed funds or ETFs, such as illiquid assets like real infrastructure, private equity or private debt, or assets that retail investors are less likely to have in their portfolio like small cap or micro cap stocks.

2. Manager greed

Manager greed can take many forms. LICs are a great way of raising permanent capital for the manager but that doesn't help the investors in those vehicles.

Greed can be reflected in fees. The fee structures of some LICs can be excessive. In my opinion, it's difficult to justify fee structures in excess of 1% pa, particularly when the company also has to pay for the costs of a listed vehicle. (For comparison, PL8 charges a management fee of 80bp pa + GST).

And many managers also charge performance fees on top of that! Some argue that performance fees align interests, but should not all managers seek to maximise returns for their clients in any case? And they can be aligned by investing in their own funds/LICs/LITs.

Greed can also be reflected in asset size. In the hype and hubris of an IPO campaign, managers might issue more capital than they initially planned, or more than a normal market, not an IPO campaign-influenced market, can bear. Once the hype of the IPO dies away, if there are more sellers than buyers, then the LIC will likely trade at a discount. In this case, a buy-back may help equalise supply and demand.

3. Inadequate size

There is a reasonable amount of evidence that size matters, with bigger LICs more likely to trade at or above NTA. Partly, this may reflect economies of scale in terms of costs. Buying back stock exacerbates the size problem.

4. Poor performance

Whilst its not always the case, company performance is often the reason why LICs trade at a discount, with shareholders wishing to exit an underperforming asset. Trading at a discount then exacerbates the underperformance, causing a potential vicious circle.

The problem is that no manager can outperform all the time, and investment styles like growth or value can have long periods of underperformance. Until recently, value has performed miserably around the world for about 10 years.

Of course, if the manager is just rubbish then the LIC deserves to be trading at a discount, but if it's purely a matter of style, contrarian investors may use the discount to enter the contrarian asset at an attractive price.

5. Lack of communication

As in all things, communication is also key. LICs and their managers need to clearly communicate with their shareholders, keeping them regularly informed. Lack of communication may also help explain why some LICs trade at a discount to NTA.

Summary

I believe that well-managed, reasonably-sized LICs with a real raison d'etre for investors (not the manager) and reasonable fees should trade pretty close to their NTA over time. For small LICs with little investor appeal and excessive fees, perhaps they may be better off closing or converting to another structure.

Dr Don Hamson is Managing Director at Plato Investment Management. This article is general information and does not consider the circumstances of any investor.

[1] Throughout this paper, the same arguments can largely be made for Listed Investment Trusts (LITs).

Will the house price boom be a boon for Australian banks?

Matthew Davison

Recent data released by the ABS and CoreLogic shows that median house prices in Australia rose 14.9% in the year to 31 May 2021[1]. This has taken house prices to record levels, with a near unprecedented acceleration triggered by, among other factors, the COVID-19 pandemic crisis response to cut interest rates to near zero levels.

House Price Index

Source: Martin Currie Australia, ABS, CoreLogic; as of 31 May 2021. $ value represents average CoreLogic value April / May

National Housing Price Cycles

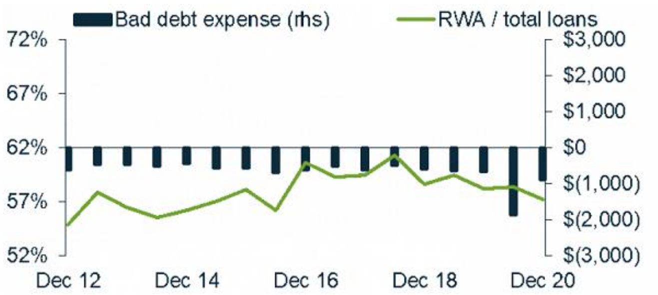
Source: Martin Currie Australia, ABS, CoreLogic; as of 31 May 2021

House prices have supported improving risk metrics for the banks

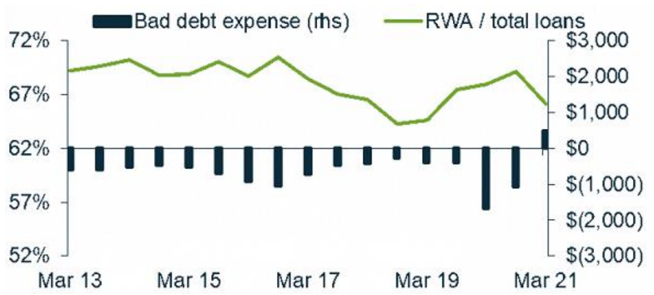
This boost in house prices has aided banks by contributing to credit growth, but more importantly, rising house prices have been a feature of the improving economic backdrop that has supported bad debt releases and lower risk weights.

This trend can be seen in recent reporting for banks, such as in the improvement in the level of bad debt expenses and risk-weighted assets (RWA) ratios[2].

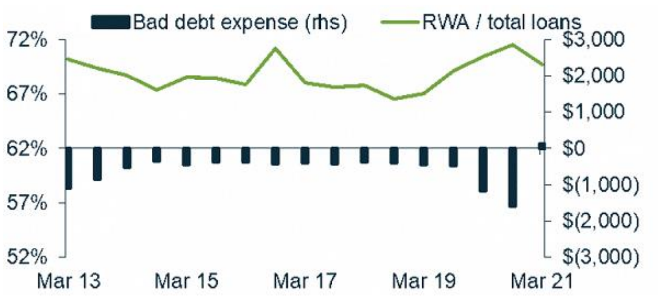
Commonwealth Bank



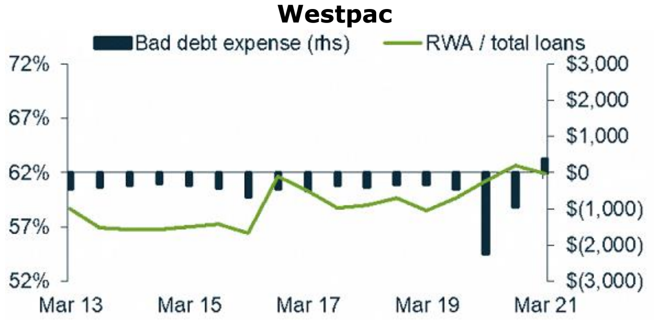
ANZ Bank



NAB



Westpac



Additionally, the consequent consumer confidence lift should support spending, as we cycle off stimulus payments, and this should in turn afford banks more comfort with the outlook for bad debts.

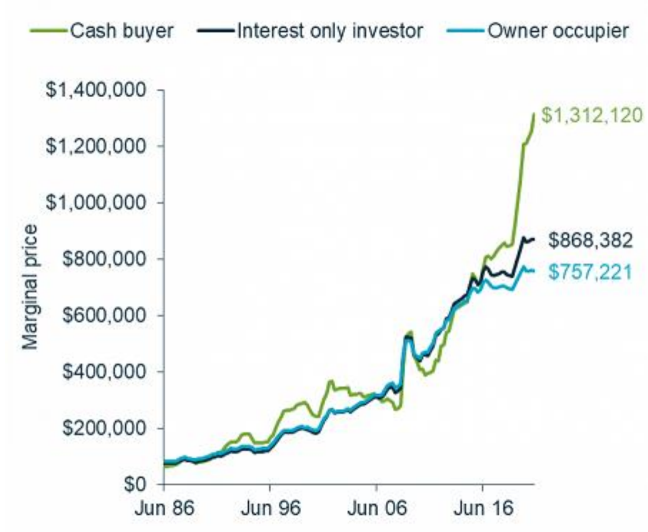
House prices seem stretched, but loan growth should improve

In October 2019 we published an [article that described the credit-centric outlook model we use for forecasting house prices](). This model looks at both credit supply from banks and demand from borrowers, and is grounded in the theory that house prices and debt levels largely reflect the capacity of borrowers to service and access debt.

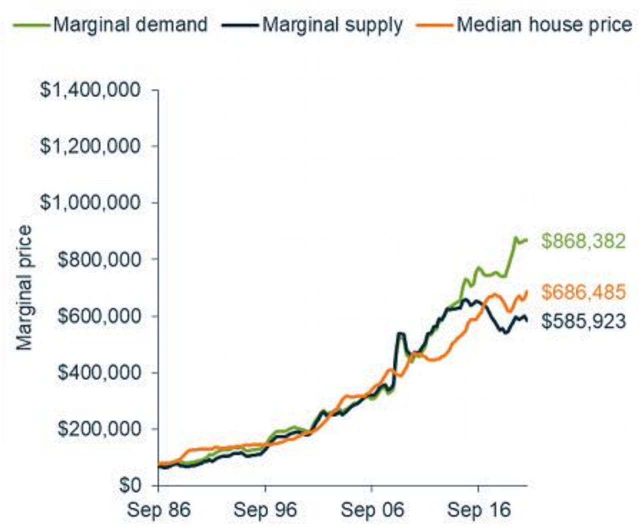
The model creates a property demand curve that looks at the 'average' property and the average available funds to purchase that property from three cohorts of buyers – 'theoretical' cash buyers, geared investors and geared owner occupiers. It follows that at any given time, the marginal demand price setter will be the second highest of these three categories.

Generally, for house prices to rise, the supply of credit to purchase property must match or exceed the demand from borrowers. Our assessment is that despite the reduction in variable mortgage rates supporting higher prices, floor rates and maintenance of reasonable lending criteria by the banks mean the marginal supply curve will not support a continuation in the current demand driven spike in house prices.

Property buyer demand[3]

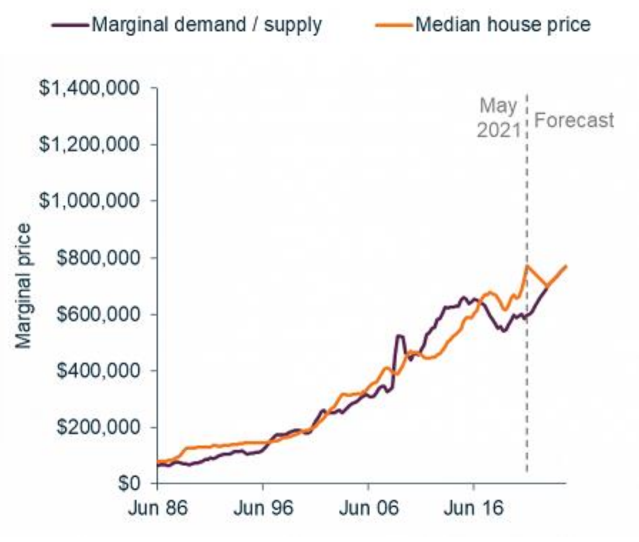


Credit supply and housing demand[3]



Prior to COVID-19, in mid-2019, our model had foreshadowed a healthy period of house price growth, but today, this approach suggests the national price move has outrun the fundamentals and should again fall to meet more constrained credit supply from banks.

House price forecast[3]



Lending growth and approvals[3]

Saying this, post the one-off paydowns driven by superannuation withdrawals and stimulus payments, and a restart in paused spending during COVID-19, we do expect to see a reduction in paydown activity and a higher average size of loan.

This means that despite a potential fall in future house prices, credit growth should rise, and this will support bank earnings.

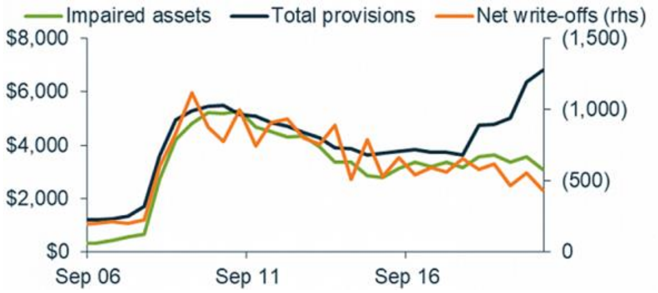
More provision unwinding to come...

As such, we believe that the benefits to bank capital and asset quality have further to run.

A combination of accounting and risk models dealing with an unprecedented pandemic resulted in collective bad debt provisions being raised well ahead of problem loans, and capital buffers created to deal with risk weighted asset inflation.

While bank management is still digesting the recent movements in house prices and better than expected economic growth data, this process should inevitably drive a more sanguine view of overall asset quality, and flow into lower capital intensity and capital releases[4].

Commonwealth Bank



ANZ Bank

NAB

Westpac

... leading to a strong earnings outlook for the banks[5]

We believe that the over-zealous provisions have further to be released as the broader economic buoyancy flows through to an improved outlook for bad debts and further earnings momentum.

The outlook for consensus bad debts assumes much of this provision build is still utilised into 2022. We think the evidence is to the contrary, and as a result we should continue to see positive earnings momentum as the market improves their forward-looking bad debt forecasts for the banking sector.

Overall, in our Value Equity strategy, we are favouring on overweight position to banks, with higher active weights in **ANZ Bank** and **NAB,** a neutral position in **Westpac**, and an underweight in **Commonwealth Bank** (albeit we materially reduced this earlier in the year), due to the potential for valuations to better reflect bad debt unwinding, capital returns and improved credit growth.

From our Equity Income strategy, which focusses on Sustainable Dividends, we like the dividend opportunities from all banks, but we see **Westpac's** dividend having a slower dividend recovery than its peers.

[1]*Source: Martin Currie Australia, ABS, CoreLogic; as of 31 May 2021. For established houses across the eight capital cities.*
[2]*Source: Martin Currie Australia, FactSet, company reports; as of 31 March 2021*
[3]*Source: Martin Currie Australia, ABS, Bloomberg, CoreLogic, FactSet; as of 31 March 2021*
[4]*Source: Martin Currie Australia, FactSet, company reports; as of 31 March 2021*

[5]Source: Martin Currie Australia; as of 31 May 2021. Based on a representative MCA Value Equity (Index: S&P/ASX 200 Accumulation) and MCA Equity Income account.

Matthew Davison is a Senior Research Analyst at Martin Currie Australia, a Franklin Templeton specialist investment manager. Franklin Templeton is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual. Past performance is not a guide to future returns.

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Finding sustainable dividend stocks on the ASX

Lewis Jackson

Rio Tinto (ASX:RIO) has been a top dividend payer on the ASX for years. In 2019 the iron ore miner topped the list, paying 47% more in dividends than second placed Macquarie Group (ASX:MQG).

A year later the miner blew up a 46,000-year-old Aboriginal cave site. The fallout from the Juukan Gorge incident took the Chief Executive and the firm's Head of Iron Ore with it.

With bond yields still anchored to the ocean floor, dividend payers such as Rio Tinto are a crucial portfolio fixture for income investors. But many reliable payers are in the resources sector and carry high environmental, social and governance (ESG) risks. What can income investors do?

To untangle this Gordian knot, I've looked through the Morningstar database to find reliable dividend payers who also meet stringent ESG and carbon risk criteria.

ESG risk ratings measure the economic value at risk from unmanaged environmental, social and governance factors. In the case of Rio, this could range from water pollution to legal action from First Nations groups.

Over 1,300 data points are analysed to give a score which classifies companies on a 5-point scale from 'Negligible' to 'Severe'.

The carbon risk rating focuses on the unmanaged risks to a company's value stemming from the transition to a low carbon economy, through the amount of carbon emissions in its operations, products, services and investments.

To begin, I look for companies that are:

- Low ESG risk: Classify as 'Negligible' or 'Low' on both ESG risk and carbon risk
- Reliable payers: Have at least a 3% trailing 12-month (TTM) dividend yield and five year average dividend yield
- Fairly valued: Trading in a range Morningstar considers fairly valued.

Real estate investment trusts (REITs) and narrow-moat asset manager Pendal (ASX:PDL) top the list for sustainable dividend yields.

Cromwell Property Group (ASX:CMW) is first, with a distribution yield over the TTM and five year horizons north of 7%. The other REITs on the list are near or above the 5% mark.

Of the five REITs, only Dexus (ASX:DXS) qualifies for a Morningstar narrow moat, implying a 10-year competitive advantage.

Sustainable picks based on historic dividend/distribution performance – fairly valued

Name	Ticker	Morningstar Rating Overall	Economic Moat	ESG Risk Classification	Carbon Risk Classification	Dividend Yield % TTM	Dividend Yield % 5 Yr Avg
Cromwell Property Group	CMW	3	None	Negligible	Low Risk	7.97	7.90
Abacus Property Group	ABP	3	None	Low	Low Risk	5.54	5.40
Pendal Group Ltd	PDL	3	Narrow	Low	Low Risk	4.91	5.07
Dexus	DXS	3	Narrow	Negligible	Low Risk	4.84	4.78
GPT Group	GPT	3	None	Negligible	Low Risk	4.67	4.80

Source: Morningstar Direct. Data as of 22 June. While similar to a dividend, REITs technically pay a distribution.

Beyond the REITs: G8 Education, Sydney Airport, and IRESS

Australia's largest private childcare operator G8 Education (ASX:GEM) and narrow-moat Sydney Airport (ASX:SYD) are options for those looking outside the REIT sector.

G8 Education and Sydney Airport meet the sustainability criteria and have a five year average dividend yield greater than 4%. Neither has paid a dividend since COVID hit, but Morningstar analysts expect both to provide a dividend yield in excess of 4% in 2022. G8 Education is currently trading at a 53% discount to its fair value estimate.

If the net is widened to stocks Morningstar considers somewhat overvalued, investors can consider narrow-moat toll-operator Atlas Arteria (ASX:ALX) or narrow-moat financial software provider IRESS (ASX:IRE). They are trading at an 11% and 19% premium to fair value, respectively.

Sustainable picks based on historic dividend performance - premium to fair value

Name	Ticker	Morningstar Rating Overall	Economic Moat	ESG Risk Classification	Carbon Risk Classification	Dividend Yield % TTM	Dividend Yield % 5 Yr Avg
Harvey Norman Holdings Ltd	HVN	2	None	Low	Low Risk	7.36	6.68
Atlas Arteria Ltd	ALX	2	Narrow	Negligible	Negligible Risk	3.84	2.16
IRESS Ltd	IRE	2	Narrow	Low	Negligible Risk	3.52	3.85
ASX Ltd	ASX	2	Wide	Low	Low Risk	3.12	3.50

Source: Morningstar Direct. Data as of 22 June.

Future dividend payers

Past performance is no guarantee of future result, so I've included those companies that Morningstar analysts estimate will have a dividend/distribution yield greater than 3% in 2022.

The list includes three more REITs, as well as Southern Cross Media (ASX:SXL). The latter has not paid a dividend since September 2019 and closed at a 43% discount to fair value.

Sustainable firms estimated to pay a dividend yield greater than 3% in 2022 - fairly valued

Name	Ticker	Economic Moat	Morningstar Rating Overall	ESG Risk Classification	Carbon Risk Classification	Dividend Yield % TTM	Dividend Yield % 5 Yr Avg
Cromwell Property Group	CMW	None	3	Negligible	Low Risk	7.97	7.90
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Dexus	DXS	Narrow	3	Negligible	Low Risk	4.84	4.78
GPT Group	GPT	None	3	Negligible	Low Risk	4.67	4.80
Mirvac Group	MGR	None	3	Negligible	Low Risk	2.67	4.22
Scentre Group	SCG	None	3	Negligible	Low Risk	2.48	5.04
Vicinity Centres	VCX	None	3	Negligible	Low Risk	2.08	6.29
Link Administration Holdings Ltd	LNK	Narrow	4	Low	Negligible Risk	1.61	2.20
Sydney Airport	SYD	Narrow	3	Low	Negligible Risk	Not paid	4.62
G8 Education Ltd	GEM	None	5	Low	Negligible Risk	Not paid	6.05
Southern Cross Media Group Ltd	SXL	None	5	Low	Negligible Risk	Not paid	8.39

Source: Morningstar Direct. Data as of 22 June. While similar to a dividend, REITs technically pay a distribution.

Lewis Jackson is a reporter/data journalist at Morningstar, owner of Firstlinks. This article is general information and does not consider the circumstances of any investor.

How to build a global equity portfolio

Stan Shamu

Global equities can provide significant benefits to a diversified investment portfolio, ranging from higher return opportunities, enhanced portfolio diversification, as well as exposure to specific themes and currencies.

In this piece, we provide an overview of how we approach the construction of global equity portfolios, the strategies and styles we adopt to build resilience and maximise opportunity within the portfolio, as well as some of the pitfalls investors should be aware of.

What's the starting point when building a global equity portfolio?

MSCI indexes are a good starting point for constructing and monitoring portfolios from an investable universe perspective. Investors will often design portfolios that aim to beat the MSCI All Country World Index (ACWI) benchmark, which is a good representation of the full opportunity set, providing exposure to large and mid-cap stocks across 23 developed markets and 27 emerging markets.

MSCI ACWI breakdown

COUNTRY	WEIGHT
US	58%
Europe ex-UK	15%
UK	4%
Emerging markets	11%
Other	12%

Source: MSCI as at 2021.

According to MSCI, the investment universe covers more than 3,000 companies across 11 sectors and approximately 85% of the free-float adjusted market capitalisation of each market.

The approximate regional breakdown is summarised above and is a good starting point to understand how a global equity portfolio should be structured.

How do we approach strategy and style?

From a strategy and style perspective, we separate our strategies into benchmark-aware/core, quality, growth, value, high conviction, small to mid-caps caps, quantitative and regional markets. Some of the broad definitions of these strategies and styles are summarised below.

Equity strategies and styles

STRATEGY	DESCRIPTION
Core	Benchmark-aware and typically holds a large number of positions.
Quality	Typically focuses on businesses with strong balance sheets, limited leverage, good cashflow and strong management.
Growth	Typically focuses on companies with high projected earnings growth rates.
Value	Typically focuses on businesses trading at a discount to their intrinsic value.
High conviction	Typically holds a smaller number of sizeable positions. Also referred to as a concentrated portfolio.
Quantitative	Typically employs a systematic approach that utilises various metrics/factors to forecast stock returns.

Source: Crestone Wealth Management.

While strategies can be generalised under a specific style, over time there can be some overlap. For example, a 'quality' strategy may also exhibit a 'growth' bias, while a quantitative strategy could exhibit elements of core, quality or value.

Core strategies help to reduce benchmark risk

Depending on the size of the portfolio, five to eight strategies are ideal for a typical global equity portfolio. As there is generally a desire to reduce the sensitivity of the overall portfolio, this means most exposure should be core, as core and benchmark-aware strategies are generally expected to have low tracking error (i.e. limited deviation from the benchmark).

The main purpose of these strategies is to reduce asset class volatility and to be an anchor for the portfolio. This then enables the portfolio to include strategies with higher tracking error (such as growth, value, high conviction, small-mid cap, and emerging markets) that can potentially generate extra returns.

The sizing of the different strategies is key to generating a smoother return profile for the asset class. Allocating the risk budget to these return drivers should be proportional to the attractiveness of the opportunity from a risk-return perspective.

As the table below shows, we tend to allocate a larger weight to the core strategy. Our preference is to utilise active strategies for downside protection. However, core strategies can also be implemented by index exchange-traded funds (ETFs) at competitive fees. This enables the portfolio to utilise the fee budget by gaining exposure to more style-based strategies in less predictable parts of the market.

The pitfalls of under- and over-diversification

High-conviction strategies tend to be benchmark-unaware with high tracking error and can take on the characteristics of growth or value at different points in the cycle. However, the global universe is much broader than the stocks that a high-conviction strategy would generally hold. This means that the investor's portfolio may lack diversification and is under-exposed to the broader investment universe.

Investors should also resist the urge to use strategies that are not necessarily optimising the portfolio in any way. Unnecessary over-diversification can be costly, dampen outperformance and increase portfolio redundancy. Redundancy risk is where the investor has multiple exposures to the same securities across various funds.

Additionally, the desire to hedge varies depending on the overall portfolio's hedging strategy. Funds can be a cost-effective way to implement hedging.

With this in mind, we aim to build a global equity portfolio with an allocation to the following strategies at the following weight ranges:

Typical allocations within a global equity portfolio

MANAGER	GLOBAL EQUITIES	WEIGHT
1	Core broad-cap unhedged/hedged	15-25%
2	Core broad-cap hedged/unhedged	15-25%
3	Broad-cap growth	10-20%
4	Broad-cap quality/ high conviction/thematic	10-20%
5	Small-mid cap	5-15%
6	Emerging markets 1	5-15%
7	Emerging markets 2	5-15%
	Total	**100%**

Source: Crestone Wealth Management.

Areas where we tend to identify gaps in portfolios

Small and mid-cap exposure

Global equity performance has been dominated by giant-cap tech stocks for a prolonged period. The US market is approximately 60% of the global index and the top five publicly traded US companies make up approximately 20% of the S&P 500 index. Concentration in a market with narrow leadership is a risk. Consequently, there is a strong argument for a small and mid-cap (SMID) strategy which captures the opportunity set in the smaller part of the market.

Global SMIDs can act as a good diversifier in an environment where diversifying style has become less effective. The MSCI World All Cap index has exposure to 73% giant and large caps, 19% mid-caps, 6% small caps and 2% micro caps. Most broad-cap strategies tend to only capture large and mid-cap exposure.

Listed small and micro-cap stocks are, therefore, largely ignored, which creates a gap in portfolios. Investment manager skill is particularly important in this part of the market and can be a differentiator in gaining exposure in this space.

Regional exposure

Emerging markets continue to provide a strong investment thesis and diversification opportunities. Similar to small-caps, the degree of dispersion in manager returns in this space tends to be wide. Therefore, manager skill is important. Additionally, active managers can run quality filters on a range of issues, such as environmental, social and governance (ESG) factors, which tend to be more prominent in emerging markets than developed markets.

When considering direct emerging market strategies, investors should recognise the indirect emerging markets exposure through broad-cap strategies. Broad-cap strategies are generally not restricted from investing in emerging markets, unless their mandate strictly prohibits them from doing so. Therefore, on a look-through basis, the portfolio will likely have inherent exposure to the region. The MSCI ACWI has approximately 13% emerging markets exposure.

Thematic exposure

There are several themes at play in global markets that tend to be niche investments that can generate significant long-term sustainable growth. Not all investment managers have the ability to research and understand the full potential of some of these themes. Holdings in these strategies tend to be unique and are generally not found in more traditional broad-cap strategies. A capable investment manager can generate significant returns in some of these themes, such as biotech, energy efficiency, and other disruptive technology.

In summary

The MSCI ACWI provides the primary building block for a global equity portfolio. At Crestone, we believe the key is to ensure the portfolio is well diversified across styles, regions and market capitalisation, as this will ensure it is best placed to deliver attractive risk-adjusted returns without being overly dependent on a particular outcome. There are several additional ways investors can potentially enhance returns from their portfolio, and this includes investing in less researched parts of the market, as well as thematic-based and other opportunistic strategies.

Stan Shamu is a Senior Portfolio Strategist at Crestone Wealth Management. *This article is for information purposes only and is not intended to constitute a solicitation or an offer to buy or sell any financial product. It has been prepared without taking into account your objectives, financial situation or needs.*

The case for a modest allocation to gold in super funds

Jordan Eliseo

The price of gold rose at its fastest pace in a decade in 2020, ending the year trading at USD 1,888 per troy ounce. Despite a pullback in the first six months of 2021, including a sharp fall in June, gold is back on the radar of investors after a 70% rally between September 2018 and August 2020. At one point, the precious metal hit all-time highs in nominal terms above USD 2,050 per troy ounce.

The price rise over this period and the factors driving it have also resulted in a notable increase in demand among developed market investors.

This is best visualised through the almost 900 tonnes and USD 48 billion worth of gold purchased through gold ETFs globally in 2020, a number that in monetary terms more than doubled demand seen in any previous calendar year.

The increase in demand is not only being driven by retail investors including SMSF trustees, but HNW investors, Family Offices, and increasingly, institutional portfolio managers, many of whom are allocating to gold for the first time.

Our latest report, *The case for gold: A special report for institutionally managed superannuation funds*, highlights the multiple reasons superannuation funds may wish to incorporate a modest allocation to the precious metal in their portfolios.

Time period studied

The findings contained in the report cover the time period from June 1993 through to the end of December 2020 for growth strategies, essentially capturing the entire compulsory Superannuation Guarantee era.

The first table highlights some of the key economic indicators and how they have changed over that time period. Oh, to be able to buy a house for $161,000 again!

Economic Indicator	June 1993	End 2020	Source
RBA cash rate	5.25	0.10	RBA
Australian 10 year bond yield (nominal)	7.37	0.97	RBA
Average Australian house price	161,000	787,000	REIA, Core Logic
Household debt to income (%)	73.7	179.9	RBA, ABS
ASX 200 price index	1,734.6	6,587.1	ASX, Yahoo finance
Size of superannuation industry (AUD)	$169bn	$2.89tn	Parliament, ISC Annual Report, ASFA
Gold price (AUD)	573.6	2,446.2	World Gold Council
AUDUSD	0.67	0.77	RBA
Fed funds rate	3.04	0.09	St Louis Federal Reserve
US 10 year bond yield (nominal)	5.80	0.93	US Treasury Department
S&P 500 - price index level	448.1	3,756.1	Reuters, Yahoo
S&P 500 (Shiller CAPE)	20.6	33.7	Shiller, Yale
Bloomberg Commodity Total Return Index	99.9	166.3	Bloomberg
Gold price (USD)	378.5	1,887.6	World Gold Council

What do the numbers say?

Historical data analysis suggests strategic allocations to gold would have improved risk adjusted returns (RARs) for diversified investment strategies from conservative through to all growth portfolios.

This is primarily due to the fact gold has historically had a positive correlation to rising risk assets, and negative correlation to falling risk assets.

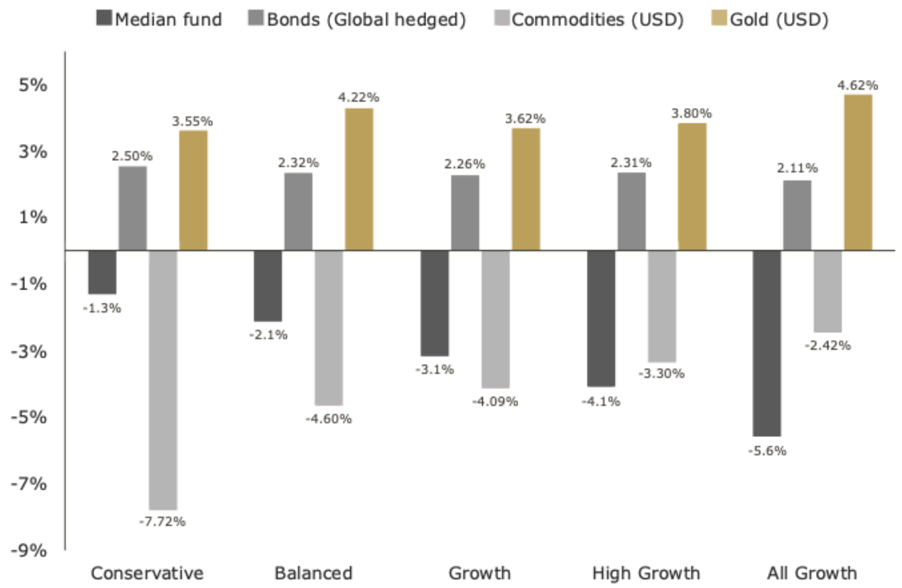
The latter is seen in the second table, which highlights the performance of the S&P500, gold, and a basket of commodities in some of the major risk off events that have afflicted markets in the past 30 plus years.

Crisis Event	S&P 500	Gold (USD)	Commodities (USD)
Black Monday	-31.6	9.1	0.0
LTCM Crisis	-18.0	2.8	-2.8
Dot-com bubble	-23.1	-6.7	15.1
September 11 Terrorist attacks	-8.0	5.2	1.8
2002 recession	-31.7	7.8	1.7
Global Financial Crisis	-47.8	47.5	-36.1
Sovereign debt crisis v1	-11.1	6.4	-10.4
Sovereign debt crisis v2	-9.0	30.2	-2.1
2018 pullback	-19.6	6.6	-10.1
COVID market crash	-20.0	6.2	-23.5
Average return	-22.0	11.5	-6.6

Source: The Perth Mint, World Gold Council

Within the context of superannuation portfolios, the chart below reinforces the above point highlighting the average returns for a range of asset classes in the quarters median superannuation funds fell in value, as well as the average decline of the median funds themselves.

Average US dollar and global asset class and median fund returns (%) in quarters median funds declined in value



Source: The Perth Mint, Chant West

Given gold is characterised by some investors as a risk asset and by other investors as a defensive asset, the above chart also highlights the returns from commodities and fixed income in the quarters when median funds declined in value, with gold the clear outperformer.

This flows through to the detailed findings in our report which model the portfolio impact of 1% through to 5% allocations to gold, bonds and commodities. This modelling demonstrates that gold has historically provided portfolio benefits not easily replicated by another asset class.

It's not all about performance

While improved risk adjusted returns alone could justify a gold allocation in a portfolio, they arguably do not fully capture the benefits of holding the precious metal, given they only look at performance and volatility, rather than the full range of risk investors need to factor in when allocating capital.

All other things being equal, an allocation to gold will also likely improve the liquidity, as well as lower the investment costs, dispersion and credit risk of an institutionally managed portfolio.

These attributes are particularly relevant when assessing the precious metal against other alternative assets.

The findings from the research report are just as relevant for self-directed investors, including SMSF trustees.

Not only do SMSF trustees face the same challenge in terms of low to negative real rates, which impact their cash and term deposit holdings, but they also lack the scale to allocate to many alternative assets, from private equity to unlisted infrastructure to hedge funds (with some exceptions).

Given gold is liquid, efficient to allocate money to, and has a track record of protecting portfolios during equity market turbulence or a long period of low to negative real interest rates, it could be useful to SMSFs and the intermediaries who advise them on their portfolios.

But isn't gold expensive now?

Given gold hit all-time highs in nominal terms in 2020, it's fair to question whether now is the right time to look at incorporating an allocation to the precious metal in a diversified portfolio.

While no longer as cheap as it was, a variety of metrics from measuring the real gold price relative to inflation (see chart below), to gold's share of global financial assets, to its price relative to equity market indexes, all suggest it is still inexpensive relative to history.

Real gold price – 1970 to 2020

Source: The Perth Mint, Reuters, St Louis Federal Reserve, US Bureau of Labour Statistics

To that end, the almost 15% pullback in the USD gold price in the past eight months looks like a healthy correction in an ongoing bull market.

Outlook

Like all asset classes, gold isn't perfect, with its short-term volatility and the lack of income it generates likely to remain a barrier for some investors for the foreseeable future.

From an economic standpoint, while economic growth has picked up in 2021, ageing demographics, high private and public debt levels and the likelihood of a continued pushback against globalisation, may provide headwinds.

From a monetary perspective, policy makers stress we will remain in a low to negative real interest rate environment for years to come, with central bank balance sheets continuing to expand.

Finally, from a market perspective, current valuations and real yields suggest traditional diversified investment strategies will deliver lower returns in the future.

Combined, these factors may well provide a favourable backdrop for gold, given it has a proven track record of:

- Generating strong long-term returns in its own right.
- Generating positive absolute returns and outperforming other assets in low real interest rate environments.
- Being positively correlated to rising equity markets and negatively correlated to falling equity markets.

Jordan Eliseo is Manager of Listed Products and Investment Research at The Perth Mint, a sponsor of Firstlinks. The information in this article is general information only and should not be taken as constituting professional advice from The Perth Mint. You should consider seeking independent financial advice to check how the information in this article relates to your unique circumstances.

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How to manage the run down in your income in retirement

David Orford

Australia's superannuation system ranks among the world's best but running out of money is still a major concern for most Australians in or approaching retirement.

There is good reason to be concerned. Most super funds still lag in offering suitable retirement products to ensure this is not the reality.

What can you do about your concerns?

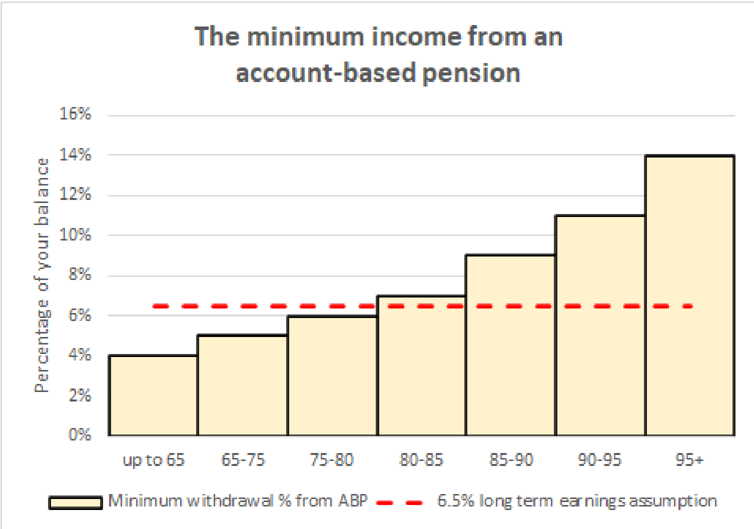
If your superannuation is with a large institution, the reality is that your fund might not yet offer a modern retirement income product so your balance is likely to move into an Account Based Pension (ABP) when you retire.

ABPs require you to withdraw a minimum percentage of your balance each year as your 'income' in retirement. The following percentages apply to your ABP balance at the start of each year and are the minimum you must withdraw (although these levels have been temporarily reduced by 50% in FY20, FY21 and FY22 in response to the pandemic).

Account Based Minimum Annual Pension Payments:

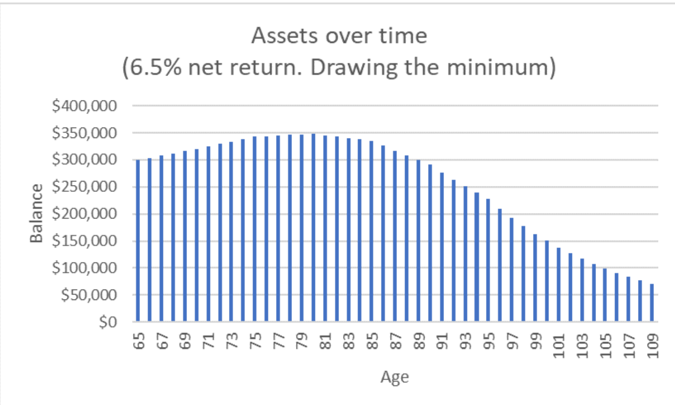
Age in years at start financial year?	% account balance to be paid as a minimum
Under 65	4
65-74	5
75-79	6
80-84	7
85-89	9
90-94	11
95+	14

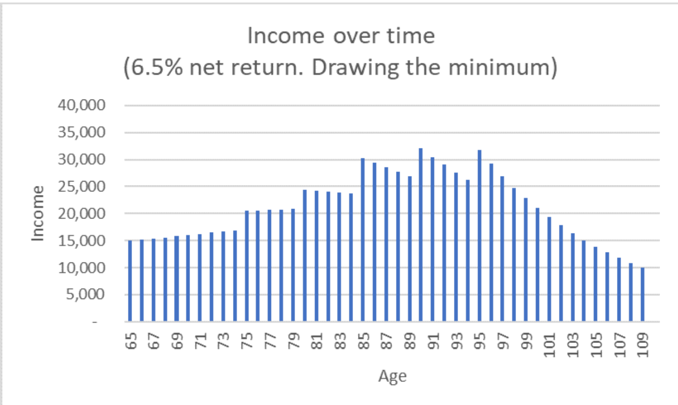
For this purpose, let us assume that a member can earn 6.5% p.a. each year in retirement and inflation is a fixed 3% p.a. Notice how the minimum percentages are initially *less* than the assumed investment return and from age 80 are *greater* than the assumed investment return.



When the investment return is higher than the minimum withdrawal, your account balance (assets) increases in dollar terms. Later, when the investment return is less than the minimum withdrawal, your account will correspondingly decline in dollar terms.

Remembering we have assumed the same investment return every year (6.5%), when in reality we know it will change regularly and the real-life experience could show greater variability than assumed here for ease of understanding.





So how is this reflected in your actual annual pension income each year of retirement? An income projected to the end of the Australian Life Tables would look like this:

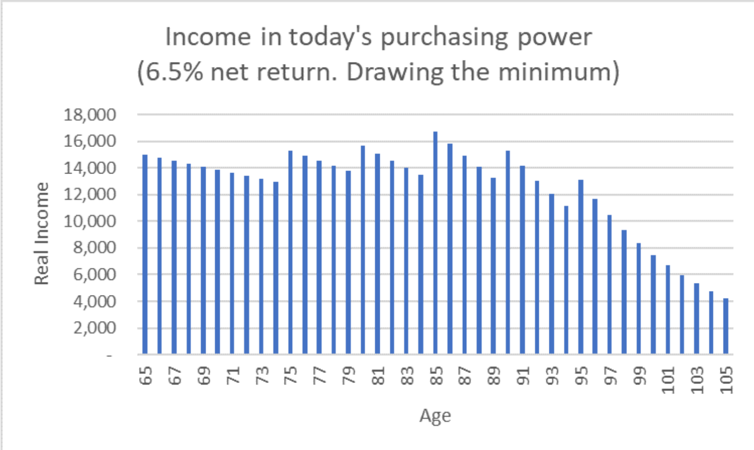
But will that be enough income when you need it most?

Planning cash flow in retirement is extremely difficult because of so many uncertainties around – expenses, health, investment returns and of course - how long we are going to live.

To maintain your standard of living, you will need your income to increase in dollar terms, and maintain its value in real terms i.e., in purchasing power. To view the income from the above ABP in real terms (today's purchasing power) we remove the effects of future inflation and ignore any income from other sources such as the age pension.

So, let's take a closer look.

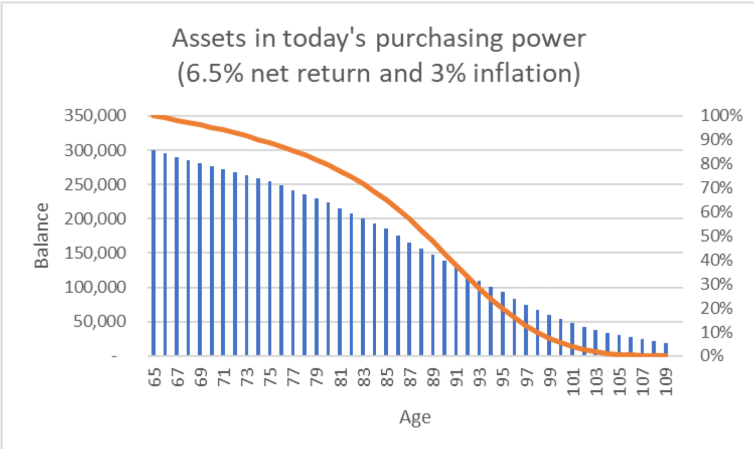
The ABP income in real terms maintains its value (broadly) until just after average life expectancy. So, the maximum offset provided by an Account Based Pension against having to claim an Age Pension occurs before life expectation.



Many existing ABP pensioners have not yet reached this age as ABPs (and their predecessor, the allocation pension) have not been available for long enough to see many pensioners experiencing this decline in income in real terms (unless their actual rate of investment return is less than the assumed rate of investment return).

We can also look at an ABPs projected balance in real terms as shown in the chart below. Only if the investment return earned is greater than the minimum percentage *plus* the rate of inflation, would the account balance increase in real terms. Between ages 65 and 75 this requires an investment return of at least 8%.

The orange line on this graph shows the percentages of 65-year-old males who are projected to still be alive at each future age.



Females and couples have a higher percentage projected to still be alive at each future age as their life expectancies are longer, and as a result they will spend more time where income and assets are declining in real terms and need to plan accordingly!

Since the mid-1980s the mortality rate for a 65-year-old male has fallen by more than 50% and this trend is expected to continue. This means, the orange line is expected to shift to the right and you will live longer than you think and spend more time when your real income might decline.

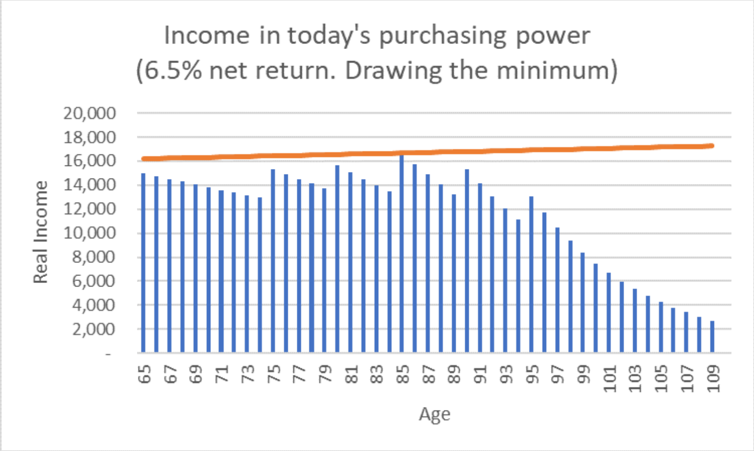
How can I make my money last the distance?

The good news is that more modern retirement income products are starting to be offered by superannuation funds to provide an increasing (in dollar terms) pension that lasts for life of a single person or a couple, and ought to provide income that on average does not decline in real terms.

An example of the income that an investment-linked lifetime annuity might provide is indicated by the orange line in the chart below and provides a direct contrast to the previous declining income projection.

This is assumed to be supported by the same investment choice as the ABP, but with a deduction of 0.5% p.a. from the net return to allow for the costs of providing longevity insurance.

There is an urgent need to deal with the high levels of worry about retirement income for all Australians. For greater peace of mind, security, and a better retirement outcome from one of the world's best retirement systems, in one of the world's best countries to retire in, longevity needs to be addressed.



David Orford is the Founder and Managing Director of [Optimum Pensions](). Optimum Pensions was launched in late 2017 with the objective of providing innovative sustainable retirement income solutions. This article is general information and does not consider the circumstances of any investor.

This is the first of three articles which will examine alternative solutions to reduce the potential to run out of money for retirees.