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Editorial

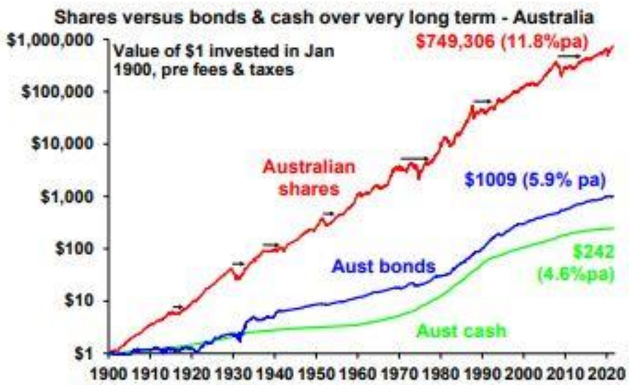
Using an estimate based on publishing 421 editions since 2012, there are over a million words in my articles in the Firstlinks archive, and few million more by other contributors. Investing comes with unlimited nuances and is as varied as the number of investors, but what if I were required to give one investment lesson in one sentence? How about:

"Allocate as much as possible in a diversified portfolio of growth assets, mainly shares, based on your risk tolerance and a long-term time horizon of at least 10 years and preferably up to 30 years."

Of course, this is deliberately open to personalisation. At some point in a 30-year period, the stockmarket will fall 40% to 50%. If an investor panics because they cannot tolerate losing half their portfolio, then they do not have the risk appetite for a large equity allocation, and they need to wind it back, to 80/20 or maybe 60/40. If capital preservation is paramount for a good night's sleep, then maybe 20% is all that can be tolerated.

There is also obvious merit in saving for and buying your own home, the most important step to financial security in retirement and the way most Australians have built their wealth.

Why up to 30 years? It's longer than necessary for the market to recover from a major fall, based on historical precedents in Australia (although not in Japan). It's to encourage long-term thinking. The life expectancy of a 60-year-old Australian is currently about 26 years and many of today's 40-year-olds will work until they are 70. Investing should focus on strategies not speculation.



Source: ASX, Bloomberg, AMP Capital

Why are shares the best for a long-term plan? Look at 120 years of data in this chart. Long-term risk tolerance is required as the chart disguises the short-term pain, and that's the crucial question. Can you hang in for the long term? If not, then you don't have the required risk tolerance.

What does 'diversified' mean? Avoid the idiosyncratic risk of large holdings of a few companies which could perform badly. The best long-term choice is a broadly-based index fund (global and domestic) to reduce costs plus some active management if a particular fund is considered worthy. Add some small and mid caps and include assets such as infrastructure and property to diversify further.

Most of the rest goes into a diversified bond fund with say 5% left over for some fun. Set up the portfolio and stop checking the market every day or week. Here's a trio of classic Buffetts:

- *"Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell."*
- *"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."*
- *"If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes."*

What about the vexed subject of market timing? Investing is not as simple as one sentence. The current equity market looks expensive and returns for the next few years are likely to be lower than the past because the entry price is high. That's where patience comes in. This is a 30-year view. Build a growth portfolio over time by gradually putting money into the stockmarket and then hang in for the long haul. There are always good reasons why a crash is imminent but few people can pick market turns consistently.

It is tempting at the moment to see money being made on hot stocks and hot assets and jump in heavily, but a more measured entry is called for. As **William Green** wrote in his book, '*Richer, Wiser, Happier*':

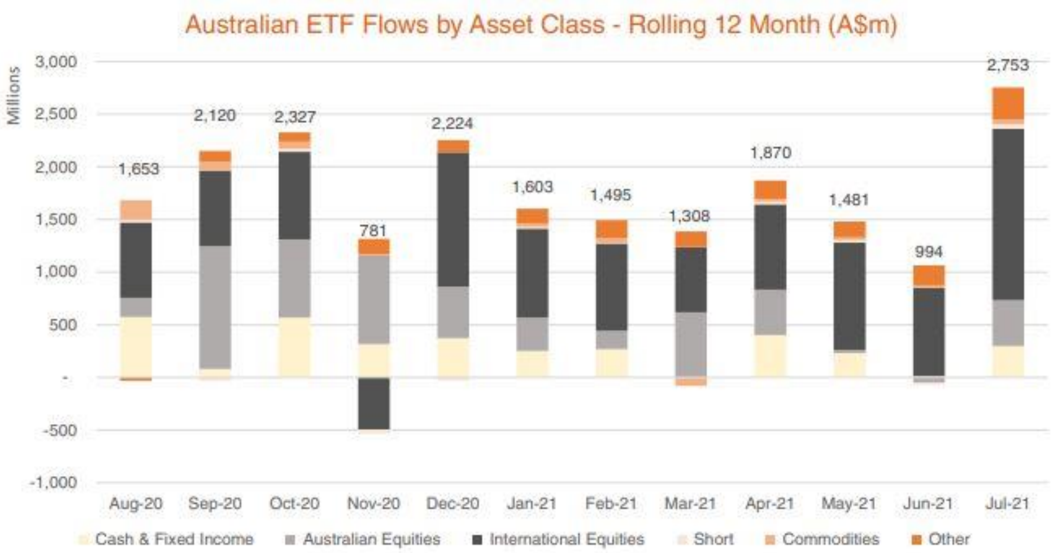
"My costliest mistakes have come whenever I grew impatient or envious of other people's returns and strayed off course by gambling on private companies or individual stocks that held the promise of a racier route to riches. The paradox here is that the slower road almost always proves to be faster in the end. The investors I admire most tend to be heroically inactive, not because they're lazy but because they recognize the benefits of patience."

Romano Sala Tenna supports this theme with three excellent charts for the patient investor. It is extraordinary how well the Australian market has performed for the investor who can accept that one year in five will be a loser.

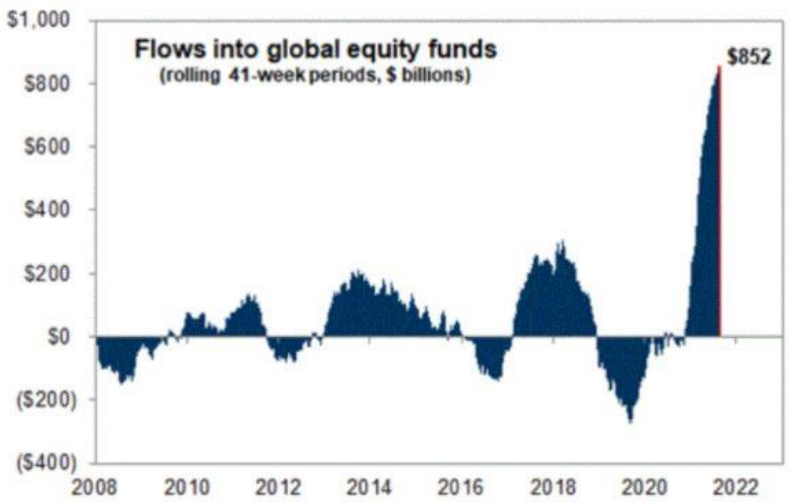
This week's White Paper from **Vanguard** is further evidence, with its annual index chart in a paper called 'The Power of Perspective'. Quoting their founder, **Jack Bogle**:

"Stay the course. No matter what happens, stick to your program. I've said "stay the course" a thousand times, and meant it every time. It is the most important single piece of investment wisdom I can give to you."

Many Australian investors have done well in equities in the last year, and the chart below from **BetaShares** shows how global equities have dominated ETF flows.



It's the same globally. The **Goldman Sachs** chart below shows more inflows in the last 41-week period (+US$852 billion) than for the previous 14 years combined. It can easily reverse without FOMO but it's supporting record highs at the moment.



Source: Goldman Sachs Investment Research Division, Cormac Conners, as of 8/13/21.

Gemma Dale explains what is happening behind the numbers, with the welcome signs that new Australian investors are not speculating as much as the '**Robinhood and Reddits**' in the US, but there has been a change in 2021 versus 2020.

Our interview with **Emma Fisher of Airlie (part of the Magellan Group**) is a lesson in sticking to what you are good at, which might not be long-term trend picking but finding good companies at attractive prices.

Phil Ruthven takes a broader look at long-term trends in growth, inflation, markets and sectors and implores policymakers to overcome their short-term focus. **Stephen Miller** looks ahead to when the US Federal Reserve may be forced to increase US interest rates and asks how the Reserve Bank may react. Global monetary policy will gradually move towards tightening by weighing up virus risks against rising inflation.

Worried that fund cannot sustain its stellar recent results? **Andrew Mitchell** provides his tips on how to separate skill from luck in the performance of a fund manager.

Then in a change of pace, two important articles on superannuation and SMSFs.

Noel Whittaker explains the choices that might face many of our readers, when one person in a couple dies and both have large super balances. What is the best way to manage the limits under the Transfer Balance Cap?

And **Meg Heffron** says we are already six weeks into a new financial year and there are important checks SMSF trustees must make around pensions and payments, as the ATO is increasingly clamping down on compliance.

Remember also that the ATO defines circumstances where the investment strategy of an SMSF should be reviewed, including a major market change, when fund membership changes or when a pension starts. The fund must have the cash flow to meet pension payments in each financial year.

Our new episode of the **'Wealth of Experience'** podcast with **Peter Warnes** includes a look at buybacks, company profits, our survey results, 'no action' financial advice and we both have a grump. Plus the full unedited interview with **Emma Fisher of Airlie.**

The **Comment of the Week** comes from **Ken** who wants different words in the discussion about 'retirement income'. I agree.

"This one is a hot topic! I wonder if we should refer to this as cashflows or 'spendings', rather than income, which is often interchanged with 'earnings'. "Where does your retirement cashflow come from?" might be a better framing of the question."

Three all-time best tables for every adviser and investor

Romano Sala Tenna

I have read countless books on investing, met an enormous number of financial experts and fund managers, and made pretty much every investing mistake possible!

If I could distil my learnings into one statement, it would be this: **the short term is unknowable, but the long term is inevitable**.

Let me share my three all-time favourite tables from 30 years of investing.

The long term is inevitable

Firstly, the stock market has good years and bad, but over the long term there is only one trend and it is up. Despite this being so obvious, I continue to be astounded at how investors behave during 'bad' years.

We are now into our 146th year on Australian stock exchanges (under vsarious names). That enormous amount of data provides the clearest guide to anyone willing to learn. During this period, the market (dividends plus share prices) has risen 117 years and declined 29 years (returns shown in this article are nominal, not real adjusted for inflation). So 80.1% of the time, the market rises. One in five years on average, the market declines.

SINCE 1875	NEGATIVE RETURNS	POSITIVE RETURNS	TOTAL
# of Years	29	117	146
% of Years	19.9%	80.1%	100.0%
Average Return	-10.4%	16.1%	**10.8%**
SINCE 1979			
# of Years	11	31	42
% of Years	26.2%	73.8%	100.0%
Average Return	-11.8%	21.8%	**13.0%**

Source: Katana Asset Management

When the market rises, it does so by an average of 16.1%, and when it declines the average is minus 10.4%. When combined, we see that over the past 146 years, the market has averaged a return of 10.8% per annum.

Since Australia has become more sophisticated and introduced the Accumulation Index in 1979, the data points to an even stronger outcome. Over the 42 years since 1979, the market has risen by an average of **13.0%** per annum. And this is despite some seriously scary episodes, including the 1987 stockmarket crash, the 1997 Asian financial crisis, the GFC and the fastest crash on record, Covid-19.

If there is a better table than this, send it to me ...

To better understand how the market behaves over different time frames, we can break the data into rolling periods. For example, a rolling five-year period, is the average return over every five-year period since 1875.

What this table demonstrates is extraordinary.

Timeframe (Rolling Average)	Average Return Since 1875	Number of Negative Periods
5 Years	65.1%	**7**
7 Years	100.7%	**2**
8 Years	120.4%	**0**

Source: Katana Asset Management

If you were to invest your money in the ASX (index), turn off your screen, go away and comeback in five years' time, then on average you would have a 65.1% return, and there would have been only seven occasions out of the 142 rolling five-year periods where you would have a negative return.

If you were to invest your money in the ASX (index), turn off your screen, go away and comeback in seven years' time, then on average you would have a 100.7% return, and there would have been only two occasions where you would have a negative return.

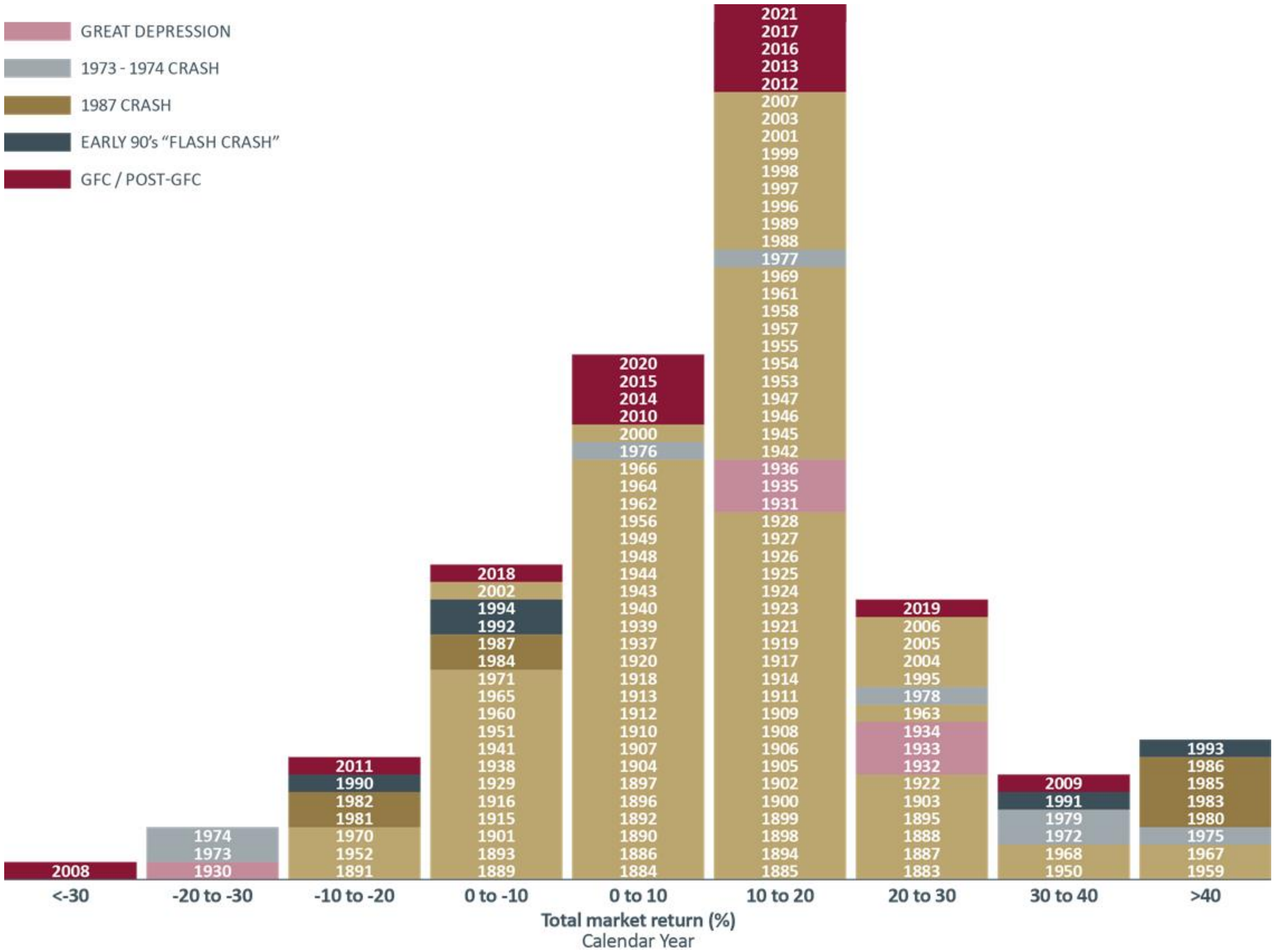
But even more remarkably, if you were to invest your money in the ASX (index), turn off your screen, go away and comeback in eight years' time, then on average you would have a 120.4% return, and there would have been **NO** occasions on record where the dividends and capital growth would have been negative.

There is only one long-term trend, and it is up.

Volatility is the price you pay for a seat at the table

But of course, in the short term – from year to year – markets are volatile.

We've all seen this distribution curve below, but I suspect many investors have failed to grasp the most important aspect.



Source: Katana Asset Management

Crashes are inevitable. Be ready and don't panic at the bottom. In fact, the best time to panic is at the top.

Case in point. There has only been one (calendar) year in the 146-year history where the market fell by 30% or more, in 2008. But if you panicked and sold during that crash, you would have missed an extraordinary recovery. In 2009 the market was up by 39.6% and rose in 11 of the 13 years following the crash, including by 18.8% in 2012, 19.7% in 2013 and 24% in 2019.

Know thyself. If you are prone to doing the wrong thing at the wrong time, stay out of the stock market. Or work with a trusted financial adviser who can coach you through such periods.

Timeframe, timeframe, timeframe

If the short term is unknowable and the long term inevitable, an investor really does need to focus on the long term.

If through age or financial circumstance an investor does not have the luxury of a long-term horizon, then they should understand the extra risk that they are taking on. Remember in the stock market, volatility really is the price you pay for a seat at the table. There will be another crash. Guaranteed.

If your time horizon is not beyond the next crash, or you panic and do the wrong thing at the wrong time, then discretion may be the better part of valour.

Romano Sala Tenna is Portfolio Manager at [Katana Asset Management](). This article is general information and does not consider the circumstances of any individual.

Emma Fisher on picking companies not trends or themes

Graham Hand

Emma Fisher is Portfolio Manager at Airlie Funds Management, the Australian equity manager within the Magellan Group. For a podcast version of this interview, see [Wealth of Experience](), Season 1, Edition 5.

GH: Your style is more to pick companies rather than themes but are there any big market trends or themes that you're backing at the moment.

EF: The short answer is no, as you say, we're really bottom-up stock pickers, but it's probably worth exploring why we don't try to pick trends. The simple answer is because I don't think we'd be good at it. I don't really back myself to identify thematics early, and by the time they're obvious when you turn to a certain trend, they tend to be overvalued for their near-term prospects. So that's why we've always shied away from it.

Another thing is, typically with trend investing you're talking about forecasting demand and I've always found forecasting demand difficult. I prefer to concentrate on supply because it's easier. Typically, you've only got so many players in an industry and you know the supply years in advance and it is supply coming online that tends to drive pricing in an industry. The obvious example is the miners in the supercycle when prices were high. All the supply was coming online, you could see it coming from space. It crushed pricing in the industry and it took years to absorb that supply.

Even with a business like CSL, one of the reasons why that's been such a phenomenal investment over the last few decades is because on the supply side of that industry, there are three players. There are unlikely to be many more because the barriers to entry are so high. And those three players have been rational about expanding supply to meet demand. We just don't back ourselves to pick trends because you risk thinking the same way as everyone else and it can be difficult to make money that way.

GH: Your fund doesn't have what you might call a dominant style, you don't argue for example for value over growth. But do you think that as a consequence, in the market we've had over the last few years where growth has run so strongly, that you distrust the very high P/E stocks, the really big growth stories?

EF: Yes but distrust is probably not the word I'd use. Jealousy is probably a better word. I'm a bit jealous of the things that we missed not going in early enough and riding the rerate in earnings. I think that broadly the market is pretty efficient and usually the businesses that are on very high multiples actually do have very good prospects. It's just that if you're wrong on a business on a very high multiple, it's a long way down, and a long time from when the growth investors start selling a stock to when the value investors start buying. A recent example is a business like A2 Milk: very well loved on a very high multiple, runs into some issues, and it's been a long way down from $20 to $6.

We talk about multiples, price to earnings multiples for example, but it's a shorthand way of comparing different businesses in different industries. You must be aware of its limitations, and it tells you nothing about the prospects of the business. It does tell you something about what the expectations are but it doesn't tell you whether or not those expectations are going to be right. If you look at a business like Afterpay, which we've never owned, people have been calling it crazily overvalued at a $2 billion valuation and a $10 billion valuation and now it's going to be taken over at a $39 billion valuation. So there's no shortcut for doing the work. You have to get into an industry, get into the business, try to understand it and then try to figure out what it's worth, rather than having a fixed mindset that high P/E is bad, high valuation is bad, because I think that can lead you astray.

GH: We talk about the reopening trade as we come out of COVID, although we haven't yet really reopened. Do you think that some sectors have been left behind while the market has been focusing on that?

EF: Yes. When you are searching for stocks to give an exposure in your portfolio, it can lead you astray and into a section of the market that's probably overvalued in the short term. I remember last year in November, we were getting all this efficacy data on Pfizer and Moderna and the markets were rallying because it was so good. I was getting brokers sending me emails with lists of reopening stocks, here are the ones that we suggest you buy. It was everyone crowding into the same ideas.

It was looking silly in terms of valuation for a business like Qantas. We've owned Qantas for a number of years, unfortunately rode it all the way down, then rode the recovery backup. So, when it got to about $5.50 in

January or February this year, you might say, well, the share price was $7 pre-COVID so it has further to go. But while COVID is not the death knell of the business, we know that it's not been a good thing for airlines, the valuation really got ahead of itself. So we sold that 'reopening trade'.

I think the segment of the market that had really been left behind at that time was retail especially bricks and mortar retail. You would never have predicted in March last year that retail was going to be one of the best-performing beneficiaries, but these businesses had phenomenal numbers, they generated a ton of cash in the 12 months. We're all in lockdown and spending money to get the dopamine hit of the postman come over. Retail is a business model that doesn't actually have very high cash needs, which means the balance sheets of these businesses are great, and they're probably going to pay that back out to shareholders.

We were able to pick up cheaply businesses like Nick Scali at $9, which is growing its store rollout by 40% over the next few years. So even if there's an elevated COVID element to their earnings right now, we think that they can absorb that with store growth rollout. Businesses like Premier Investments, with Solomon Lew one of the best retailers in Australia, and Wesfarmers as well. You know Wesfarmers was never hugely sold off or hugely cheap but Bunnings, Kmart and Officeworks is a suite of the best retailers in Australia. So the exposure you want is to these really good businesses that aren't a reopening trade. That's where we've been seeing value.

GH: Let's focus on some stocks that have done well for you recently, such as Mineral Resources, Reece and PWR?

EF: The question is where to from here. PWR is a Gold Coast-based owner-managed business, and the guy that runs it was a mechanic who many decades ago decided he could make the best radiators in the world. And now he supplies every Formula One team with their cooling systems. It's quite incredible. I think it's a brilliant business that has further to run. Reece probably looks stretched on near-term valuation metrics on 44 times next year's earnings. They're Australia's largest plumbing wholesaler and they bought a plumbing wholesale business in the US three years ago and the market was pretty skeptical. But they've actually done a really good job. It's such a huge market In the US but it could trade sideways for a while.

Mineral Resources, I still feel like this business could still double although it's up about fivefold in the last 18 months and I know iron ore prices are falling. But in the next five years in iron ore, they want to get to 90 million tonnes. At that point, they'll be producing half of what Fortescue does and Fortescue is a $70 billion market cap company versus Mineral Resources at $11 billion. So leaving aside price, the iron ore volume expansion story alone is offering considerable upside.

GH: Is there a company that the market is completely under estimating, one that you can't understand why the market is missing?

EF: I can think of a few stocks that haven't worked in the way that I would have hoped. But one thing the market is potentially underestimating is the wave of cash that is coming back to shareholders over the next 12 months. It's quite unusual to see the economic strength that we've seen across the board like it was for the last 12 months. Usually, you've got one part of the economy letting the side down whether it's banks or the mining or industrial businesses or the Aussie consumer, but everything has been firing.

So, all these businesses are sitting on piles of cash. Over the last six months there's been an unwillingness to pay that out to shareholders because of the uncertainty of COVID. And now that we've got vaccines that we know work and we can see the finishing line in sight. Maybe not this reporting season because we're now locked down again and maybe another excuse to hold the cash, but over the next 12 months, I'm expecting a lot of that cash to be paid out to shareholders.

And not only does that support the market because a lot of people just reinvest those dividends but it's a good thing. The market has looked pretty expensive in an absolute sense for a number of years, but in a relative sense, relative to a cash rate of 0.1%, the fact that the Australian market is yielding 3.5% in dividends is very attractive compared to what you can get with your cash. So that relative argument actually makes equities look fair value when looking at it through a different lens.

GH: A couple of questions about your own business. What does being part of the Magellan Group bring to an Australian equity manager?

EF: John Sevior founded Airlie about a decade ago. He'd been working at Perpetual but he wanted to run his own business, but he found after a number of years that more and more of his time was being taken up by non-investment hats that he had to wear – compliance, risk, legal, all the stuff that is increasing in our industry. And it was a real impost on our time as a small business. Magellan brings world class capabilities to the non-investment side, so we let them wear all of those hats and we just focus on investing which is what we love doing.

And the other angle is the Airlie Australian Share Fund which has now been running for three years. Prior to that, we were an institutional-only business since 2012. We run over $9 billion of money for institutional clients, but the Airlie Australian Share Fund is a retail offering. And in order to access the retail market, you need the distribution and marketing that Magellan brings to the table. That would have been quite difficult for us to do on our own.

GH: And Magellan also allows investors to access funds in both listed and unlisted form.

EF: Exactly, and that cannot be underestimated. My friends and family who invest in the Fund all own the listed version. It's just so much easier. You can buy and sell it like any other share. The previous element of a premium or discount that came with a listed investment company was unfair either to existing investors or future investors, depending if it's at a premium or a discount. The single unit structure means you're basically entering at NTA.

GH: Yes, it's been a fantastic development. Final question. Are you tired of answering questions about inflation when nobody knows the answer?

EF: You've worded that perfectly, that question encapsulates exactly how I feel about the matter. The short answer is yes, I think everyone's tired about talking about inflation. I understand why the debate's happening, because the markets are only attractively priced in a relative sense, so the debate is around if that cash is right or wrong. If the cash rate is wrong, then the market valuation is wrong. But I think it's unknowable.

As an investor, you need to separate your stock-picking skills from your honest assessment of yourself as a macro investor. I think I'm a good stock picker. I've got enough of evidence of that but I have no evidence of whether or not I'm a good macro investor. Probably not. So you've got to make sure that you're not taking big macro swings with your portfolio because if you get them wrong and it is a different skill set, it can really overshadow the power of your stock picking. So we try to make sure that we're not positioning our portfolio in a way that is strongly positioned for this inflation narrative, because we don't know the answer. So I am sort of sick of inflation because it's this year's narrative. Next year it will be a different narrative.

Graham Hand is Managing Editor of Firstlinks. Emma Fisher is Portfolio Manager at Airlie Funds Management, the Australian equity manager within Magellan Asset Management, a sponsor of Firstlinks. This article is for general information purposes only, not investment advice.

For more articles and papers from Magellan, please click here. This is an edited transcript of the original recording which can be heard on the podcast version at 'Wealth of Experience', Season 1, Episode 5.

Optimal ways to use the Transfer Balance Cap after a death

Noel Whittaker

In 2016, the Turnbull government made major changes to superannuation, which took effect from 1 July 2017. Their aim was to restrict how much you could place in the low tax superannuation environment. The changes included reducing the amount that can be held by retirees in the zero-tax pension mode by introducing a Transfer Balance Cap (TBC) that limited the amount an individual can transfer into their pension fund to $1.6 million.

Four years have passed since then, and thanks to indexation, since 1 July 2021, the new TBC is $1.7 million. If you have already used your $1.6 million TBC, you will be unaffected by the indexation changes but if you have transferred only a portion of your TBC – say, $800,000 – you will be entitled to a proportional increase to the cap based on the unused portion.

But the TBC is not well understood

Many people are under the false impression that it is the maximum you are allowed to *hold* in the tax-free pension fund. But actually, the TBC is the maximum amount an individual may *transfer* from accumulation mode to pension mode in their lifetime. When you have transferred up to your TBC, you are not allowed to transfer any new funds into pension mode but the money you hold in pension mode can continue to grow.

Four years have passed since the changes and I regularly receive emails asking what happens when a person with superannuation dies and wishes the balance of their fund to be left to another beneficiary.

Case study on joining two balances

What follows is a case study based on a typical scenario with the names changed for privacy.

Jack and Jill have $3.5 million combined in their SMSF. Jack's total balance of $2.7 million is comprised of $1.8 million in pension phase (having initially transferred $1.6 million), and $900,000 in accumulation. Jill has $800,000 in pension phase, having previously transferred $700,000 to pension mode.

What would happen on the death of either Jack or Jill? I am indebted to John Perri of AMP technical who worked the numbers for me.

1. If Jack dies first…

The first job is to establish how much pension transfer cap is available to Jill.

By starting an account-based pension with $700,000, Jill has already used 43.75% of her original $1.6 million pension transfer cap. So she had an unused pension transfer cap percentage of 56.25%. This is important because from 1 July 2021, with the pension transfer cap indexing by $100,000 to $1.7 million, Jill was eligible for an extra 56.25% of the $100,000 increase as well, ie, $56,250.

Accordingly, from 1 July 2021, her maximum pension transfer cap is $1,656,250 (ie original $1.6 million plus 56.25% of the $100,000 increase). Given that she has already used up $700,000 of the $1,656,250 pension transfer cap, she therefore has $956,250 available to use.

Let's assume that both Jack and Jill's account-based pensions have a binding nomination to each other, and that Jack has died and has nominated Jill to receive all the money he had in super. Jill is considering to receive some of this super death benefit as death benefit income stream but cannot receive all of it as an income stream as it would count towards her pension transfer cap, and clearly exceed it.

The options available to Jill are:

- Commence a $956,250 death benefit income stream from Jack's pension and receive the balance of Jack's super of $1,743,750 as a lump sum, which will need to be cashed out of the superannuation system.
- Commute her existing pension account of $800,000 which she rolls back into super accumulation. By doing this, the $700,000 amount previously counted against the pension transfer cap when she commenced her original ABP is 'removed', effectively permitting her to commence a new income stream with her maximum pension transfer cap of $1,656,250. She then commences a $1,656,250 death benefit income stream from Jack's ABP and receives the balance of Jack's super of $1,043,750 as a death benefit lump sum, which will need to be cashed out of the superannuation system.

Under either option, Jill will have fully exhausted her transfer balance cap of $1,656,250. The key difference is the amount Jill will keep in super.

With the first option, she has $1,656,250 in super, all in pension phase, with the rest of Jack's super withdrawn as a death benefit lump sum.

With the second option, Jill still has $1,656,250 in pension phase. However, by commuting her own pension, she also has $800,000 in accumulation phase. The balance of Jack's super withdrawn as a death benefit lump sum has also reduced to $1,043,750. This option boosts her super holding by $800,000.

2. If Jill dies first…

First, let's establish how much pension transfer cap is available to Jack. By starting an account-based pension with $1,600,000, Jack fully used up his $1.6 million pension transfer cap. He therefore has no unused pension transfer cap.

We have assumed Jill has nominated Jack to receive her $800,000 pension balance. However, Jack cannot receive any of Jill's super as an income stream, as he has already used up all of his pension transfer cap of $1.6 million.

The options available to Jack are as follows:

- Receive Jill's superannuation interest of $800,000 as a tax-free death benefit lump sum, which would have to be cashed out of the superannuation system, or

- Partially commute $800,000 of his superannuation income stream and retain it in the accumulation phase. By doing so, this would free up space under his transfer cap, allowing him to take Jill's super as death benefit income stream of $800,000.

Using the second option, Jack still has $1.6 million in pension phase, but also has an additional $800,000 in accumulation. By choosing this option, he would not need to cash any of Jill's superannuation interest out of the superannuation system as a death benefit lump sum.

I appreciate this is complex and advice should be taken before any changes are adopted when a person with a large superannuation balance dies. However, what these examples do is show how choosing a different option could make a huge difference to the outcome.

Noel Whittaker is the author of 'Making Money Made Simple' and numerous other books on personal finance. See www.noelwhittaker.com.au for details. He is also a Non-Executive Director of VGI Partners Global Investments (ASX:VG1) and Adjunct Professor at the QUT Business School. This article is general information and does not consider the circumstances of any investor.

In a short-term world, take a longer-term view

Phil Ruthven AO

There is an old saying that when you are up to your knees in alligators, it is hard to remember that the original plan was to drain the swamp. In 2021, that swamp is the COVID-19 pandemic.

But the developed world has been thinking in shorter and shorter timeframes for some decades now, and some things like climate change are starting to tell us we have to take a longer view.

The increasing focus on the short term

So, this article is about standing back and taking a longer view of economic and financial issues, mainly in Australia, although a lot of the observations apply to the developed world at large. Just why is the western world into short-termism and slowing in resolve, and growth?

There are many reasons:

- Relative world peace for some 75 years has led to a lower need of a re-building catch-up following wars, depressions and recessions which none of us want to repeat.
- The well-off countries (in the OECD) are less hungry for growth than poor and emerging nations.
- Productivity in the post-industrial infotronics age of services and technology is not matching the productivity growth of the previous industrial age of goods and electricity and telephony.
- The new political dialectic of Rationalism versus Emotionalism (gut feel) is seeing the latter winning.
- National and state leadership across the world is at levels similar to the 1930s (dictatorships, saber-rattling, fascism, corruption, short-termism or incompetence) and becoming rife.
- Climate change is demanding preventative and alternative measures to avoid global catastrophes, that will slow many economies' growth for some decades.

Australia's long-term economic growth

Australia's growth over more than one and a half centuries is as good as anywhere. We can be thankful that in the post-WWII years, economic growth has been less lumpy, with fewer recessions and no depressions.

The absence of recessions is mainly due to agriculture shrinking from 20% of our GDP to 2%, thereby removing the recessions caused by droughts, floods and low export demand. Modern fiscal and monetary management helped avoid depressions, and some recessions.

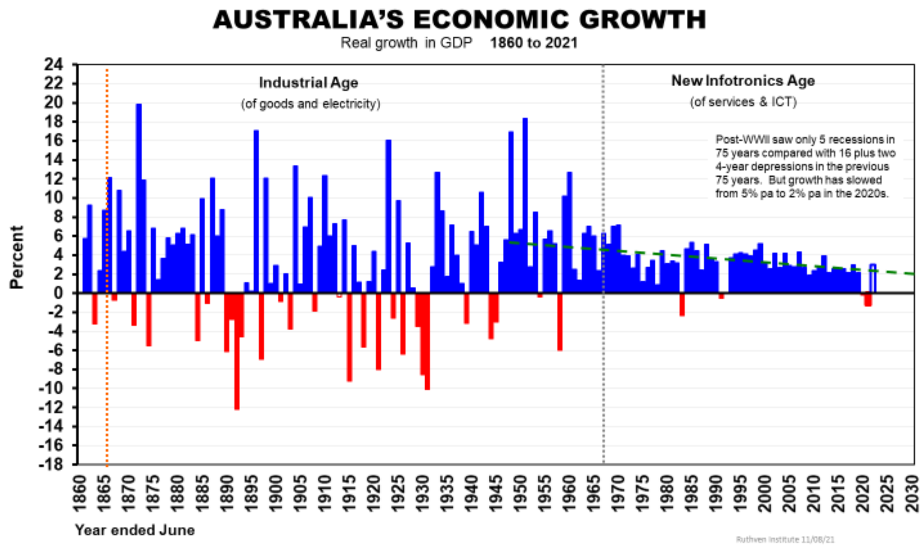
But our economic growth has slowed from 5% pa in the 1950s to 2% pa in the 2020s.

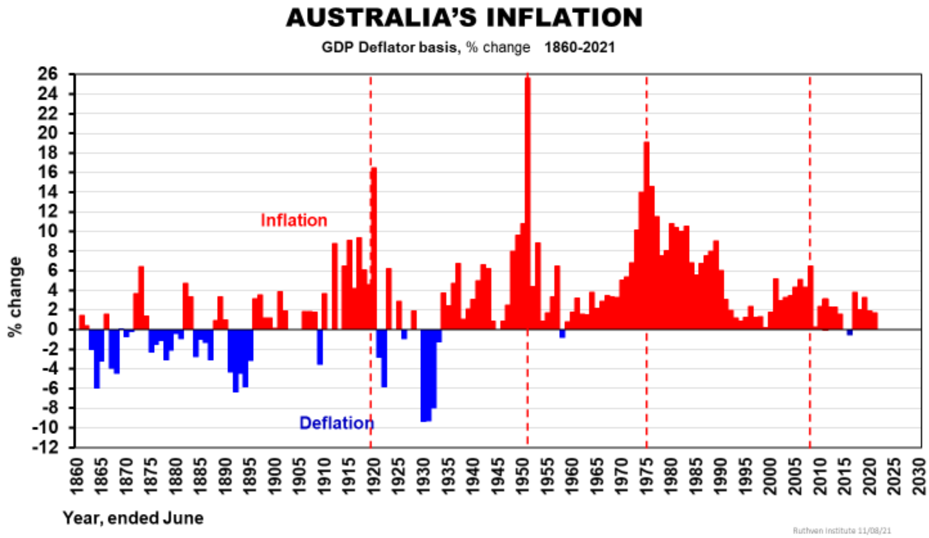
Inflation was non-existent (averaged over any decade) for 217 years to WWI due to the Gold Standard. Since then, we have had four inflation cycles - unevenly - with average 25-year cycles, as we see below. The peak of the current fifth cycle is probably not due till later in this decade, perhaps into the early 2030s.

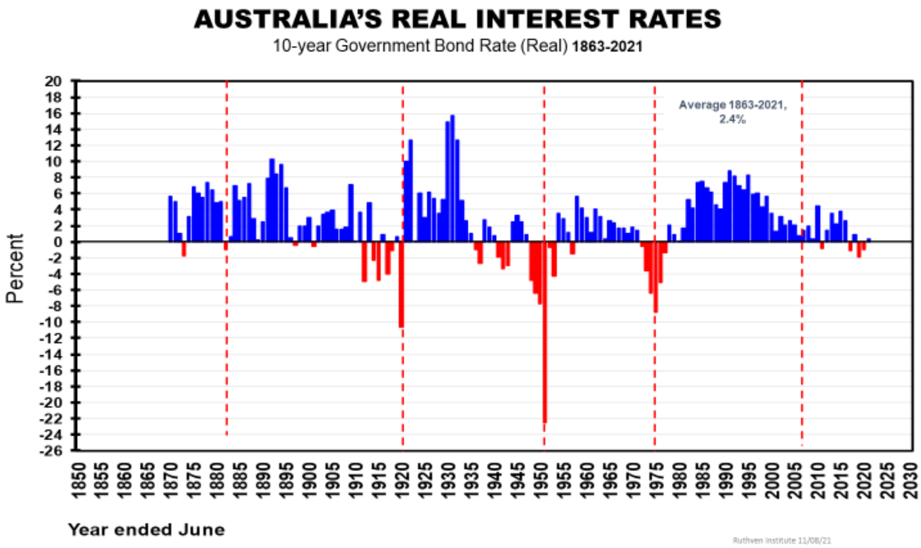
In turn, inflationary cycles create interest rate cycles, at least in real terms as we see in the bottom chart.

Focus should be on real rates

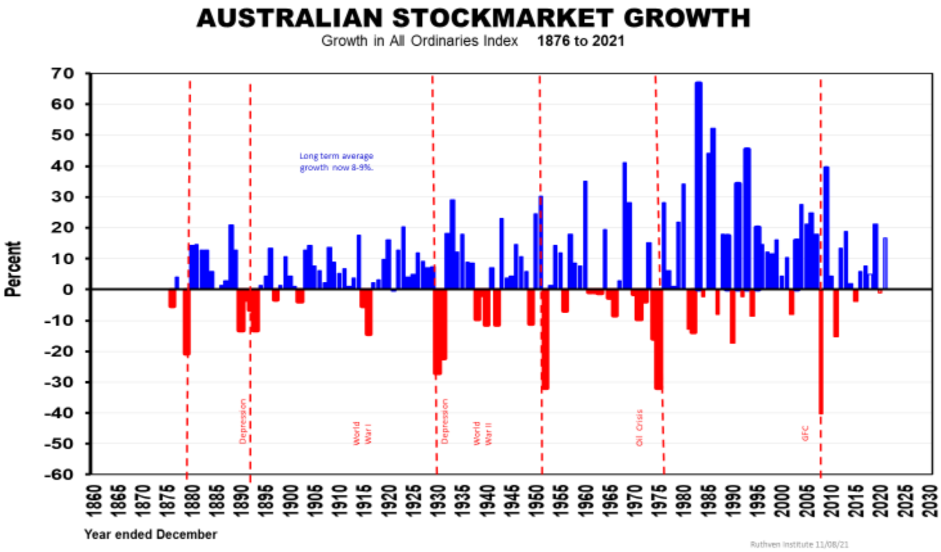
As we are regularly informed by our RBA Governor, we need not expect nominal interest rates let alone real rates to rise anytime soon. But, when we hear interest rates are at record 'lows', it’s not true. There have been 20 individual years when **real rates** have been much lower than recently. And the average real bond rate has averaged 2.4% pa for 160 years compared with an average 5.5% pa in nominal terms over the same time frame.







Then there is the sharemarket as measured by the All-Ordinaries Index over a century and a half as we see here.

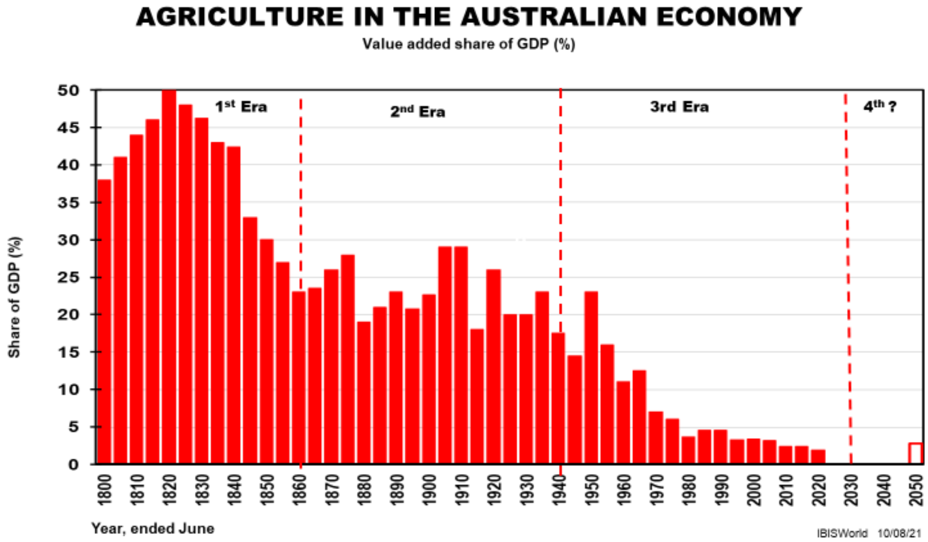


What stands out is the extraordinary volatility over eight decades from the 1930s depression until the GFC in 2008-09, when deviations of ±30 to 60% were common. That said, there is no saying it won't happen again with Price/Earnings ratios in some stockmarkets of over 40:1.

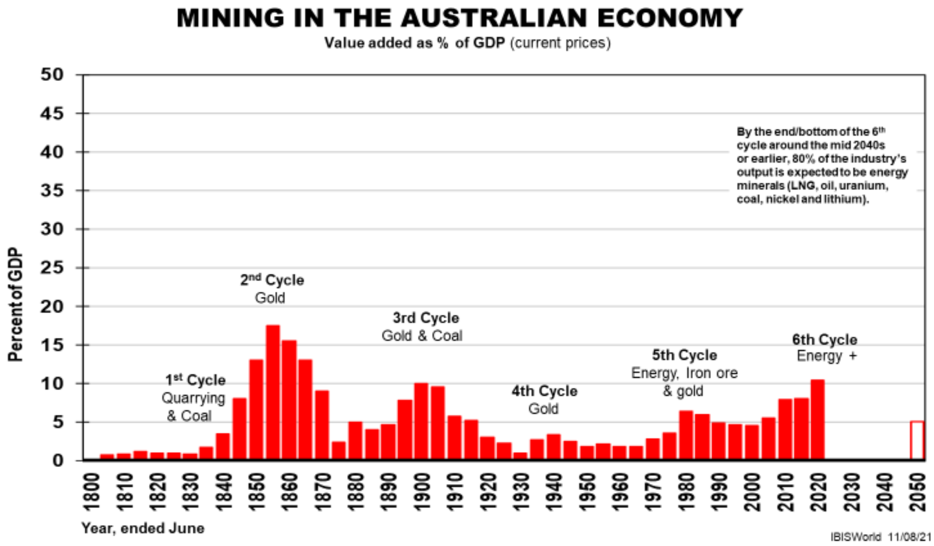
Australia has not gone that far into the stratosphere, fortunately, so we may experience less volatility when the next (inevitable) corrections come. There is a prima face average cycle of some 30 years at play, but of unequal lengths, so the next wide gyrations - if we get them at all - are due around the turn of the decade, or soon after.

Industry divisions: mining and agriculture

Then there are long cycles in the nation's 19 industry divisions. The two industries that have dominated our exports for the past 233 years since British settlement (or 'invasion') are mining (our first export ever as coal was backloaded) and agriculture.



In 2021, however, agriculture has shrunk to just 2% of our GDP and around 5% of our exports, having dominated our total exports for most of the first 200 years. Mining now accounts for over half our exports although likely to be half that within 15 years or so.



They remind us that our industries run in cycles too when measured by their contribution to the nation's economy (GDP). They are very different in their lifecycle lengths and peak shares of GDP, as are the other 17 industry divisions that make up our $2 trillion GDP these days.

Taking a long view creates much-needed perspective

We need longer-term vision of the sort we once had, and the sort that is now in evidence in fast-growing emerging markets, most which are in our own region - the Asia Pacific, headed by China - and in our mega-region of Asia including the Indian sub-continent, headed by India. Perhaps getting rich has made us soporific. Time to wake-up to the operational and competitive challenges as well as the fabulous opportunities.

Phil Ruthven AO is Founder of the [Ruthven Institute] and Founder of [IBISWorld]. The Ruthven Institute was created to help any business that wants to emulate world best performance and profitability using the Golden Rules of Success, based on over 45 years of corporate and industry analyses and strategy work.

6 quick SMSF tips for the 2021/22 financial year

Meg Heffron

A new financial year always brings a new 'to do' list. With six weeks over already, we've put together a list of six tips that are worth checking.

Tip 1: Pensions often start early in the financial year. Don't forget that if the member made personal contributions in 2020/21, the relevant notices about the deduction must be dealt with *before the pension starts* (a "Notice of Intent to claim or vary a deduction for personal super contributions" and the relevant acknowledgement from the trustee). In fact, if the pension started on 1 July 2021 it's already too late to give this notice to the fund. The deduction will be denied.

A related issue is to think about these notices when a *lump sum* is paid from an account that received personal contributions in 2020/21. If a lump sum is paid before the notices are given, the deduction is reduced.

Tip 2: If a member is going to use the 'contribution splitting' rules to transfer some of their concessional contributions in 2020/21 across to their spouse, do this as early as possible. It means these contributions will be earning income in the spouse's name rather than the account of the original contributor. And if the contributions being 'split' are personal contributions, the notices mentioned in Tip 1 need to be dealt with first.

Tip 3: Some people with more than one job can be in danger of exceeding their concessional contributions cap even if they never receive more than the minimum Superannuation Guarantee amount from each employer. People can now 'opt out' of Superannuation Guarantee contributions if they meet certain conditions. One of these conditions is that the relevant forms must be lodged at least 60 days before the first quarter to which it applies.

Tip 4: Remember that the minimum pension amounts for 2021/22 are still only 50% of the usual levels. Clients who need the full normal minimum pension to meet their income needs could consider treating the excess over the minimum as a lump sum payment from their accumulation account or a partial commutation from their pension account. The best way to achieve this is to have documentation in place *now* – before the minimum pension payments are met – that request the trustee to treat the payments this way. This makes it abundantly clear to auditors and the ATO that all decisions about how to treat payments were made prospectively rather than backdated after the event.

This is exactly one of the moments when Tip 1 becomes crucial. If the payment ends up being a lump sum from the member's accumulation account it will be vital that the notices about tax deductions for personal contributions have already been given to the trustee for the 2020/21 contributions.

Tip 5: Revalue the fund's assets before the auditor asks you to. This is particularly relevant for funds with assets such as property where values can change during the year. A current market value will be needed for the 30 June 2021 financial statements and it's much easier to get that as close as possible to the applicable date. Asking an agent (or trying to find your own external evidence) to value your residential unit as at 30 June 2021 when it's already (say) April 2022 makes the job harder than it needs to be. Don't forget the same rules apply to properties held within any unlisted companies or unit trusts in which the fund invests. Similarly, check things like lease agreements to see if rental payments made by the fund should be increased in line with CPI.

Tip 6: SMSFs owning bullion or similar assets will be familiar with the difficulties in proving to the fund's auditor the existence of the asset at 30 June, particularly where it is stored in a private vault or deposit box with a bank. Often the auditor will ask for a photo of the bullion on top of a newspaper showing the date. Getting this evidence documented now will make the year end audit a lot simpler.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](). This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances.

Is your fund manager skilful or just lucky?

Andrew Mitchell

There is no doubt in the world of sport that the likes of 20-time tennis Grand Slam winner Roger Federer outperforms because of skill, not luck. When investors evaluate the performance of equity funds, however, it's not as obvious which funds are skilled or have just been lucky.

Fund manager league tables were recently released for the last financial year, and the media, as usual, trumpeted funds with hot performance.

But now is a particularly difficult time for investors to assess fund managers. With markets rising, some funds have just been lucky and ridden strong market gains. There is now a danger that investors chase these hot, lucky funds and become saddled with poorly-performing investments for years.

In this article we outline how investors can tell which funds managers have 'skill' and can be expected to outperform for a long time versus those that are simply lucky and likely to disappoint when markets change.

If investors can spot the difference, they are significantly more likely to choose the right fund that ultimately helps them reach their financial and lifestyle goals.

The skilled few

The big problem for investors is that few funds are truly skilled.

In a 2014 report on equity investing, Willis Towers Watson, the global investment consulting firm, argued that only 10% of fund managers could be considered genuinely skilled over the long term, while 70% show mediocre performance and 20% are inferior.

The fact that so few managers were deemed truly talented is a product of the multiple forces which influence portfolio performance, such as

- Luck
- Gambling on high-risk stocks during a rising market
- Having exposure to the right investment style at the right time
- Taking on hidden risks like selling put options
- Skill

Obviously, managers that perform via the first four should be avoided, but how can we tell who has the right qualities to be considered genuinely talented?

Four attributes of the skilled

Although no specific rule book exists on how this should be judged, we believe that skilled investors have four characteristics in common.

1.They perform through time

The number one attribute of skilled investment managers is their performance over time. By studying this, we can observe if performance has aligned with their intended investment style. For example, if they are a 'growth'-style manager have they performed well when that style is in favour? If they are an 'all -weather' manager, have they performed well through all different kinds of market environments? We can also measure how persistent returns have been across different stages of the market cycle.

2.They have a high number of winning bets

Investors can also check the number of bets made over time. A manager who makes many bets over time, and wins a reasonable number of them, deserves to be rated far higher than a manager whose success is solely attributable to one or two knockouts. The former manager has been tested more times, and hence we can be more confident in their ability to replicate that success in the future.

3.They are on a quest for 'better'

Besides only looking at each manager's track record of returns, those with skill at investing have an attitude to their craft that combines intensity, flexibility and humility. These managers have a passion for investing and are constantly striving to put in the work to become more skilled investors.

4.They accept the role of chance

At the same time, best-in-class investors are aware of the role of chance in their investment outcomes and don't try to paint their success as pre-ordained. By contrast, fund managers who don't realise how much chance impacts their results can end up being painfully stubborn or arrogant. And when the environmental variables that help outperformance eventually stop, a humble manager is more likely to adapt and evolve their process commensurately.

The harsh reality is that even a skilled investment manager will underperform at times, and an unskilled manager can outperform, potentially for years.

Still, the longer the period over which an investment manager delivers superior performance, and the larger the investment base involved, the more likely the results reflect skill rather than luck. To put this another way, over time as an investor becomes more skilful, their performance should become more consistent.

Like medical research

So how do professional fund manager selectors statistically test whether a fund manager's performance is truly different from their benchmark, or the market?

They perform tests similar to the type used by medical researchers to test whether a drug's treatment of a condition is statistically different from a placebo.

A simplified example of this test is below:

$$t = \frac{\bar{x} \times \sqrt{n}}{s}$$

Where:

T = the so-called 'test statistic'

X = a measure of the outperformance (if positive) or underperformance (if negative) of the fund versus the benchmark (the benchmark should be 'risk-equivalent' to the fund)

N = a measure of how long the fund has been operating

S = a measure of the volatility of the outperformance or underperformance of the manager through time

A 'test statistic' greater than about 2 means gives 95%+ confidence that the manager's outperformance or underperformance is different to zero. This level of confidence is the most commonly used to determine if something is truly different from its comparator or baseline.

Three takeaway lessons

The size of the outperformance and the longer the manager's track record are both positive attributes. Also, the lower the volatility of the outperformance, the more likely that outperformance is 'statistically significant' (different to zero) and due to skill rather than luck.

Some takeaways from this are:

1. You should pay less attention to 12-month returns reported by the press in the newspaper because returns this short have a greater potential to be due to luck, rather than 3, 5 or 10-year returns.

2. The larger the outperformance, the more likely this is to be due to skill, which can sometimes make up for a short track record. A word of warning though on this one: it is a good idea to test whether a manager has simply been 'punting' the fund and has made a big lottery-type payoff on one or a small number of bets, or whether it is due to a broader series of unrelated investments.

3. Smaller, consistent outperformance may potentially be more likely to be due to skill than large, but volatile outperformance. There is a trade-off here.

Managers secretly skewing to small caps

More sophisticated statistical tests also exist to ensure managers aren't simply outperforming by taking more risk than is embedded in the benchmark or market they are trying to outperform. A manager, for example, might claim outperformance during a bull market, but they only outperformed because they used leverage in their fund to increase its risk, and hence returns, in that market environment.

Finally, we need to question whether a fund's investment returns represent exposure that could be obtained at a much lower cost by investing through passive-type products. In such instances, there is no need to pay fees to a skilful investment manager to access these returns.

For example, small cap equities, which is our space, have tended to outperform large caps across many different equity markets over long periods of time. Investors should turn their nose up at large cap managers who skew their funds to small caps, and where their small cap holdings have accounted for a meaningful share of their outperformance over their large cap benchmarks.

Sorting the skilled from the plain lucky

Don't put too much weight on a manager's short-term annual returns reported in the so-called 'leagues tables'.

At Ophir, we judge the performance of our funds, and our analysts who contribute to it, primarily on its size, duration, consistency and number of unrelated positions that have led to the result. We also seek to control for excessive risks that could jeopardise absolute performance over the long run.

We think there are two other key criteria that help the skill of any manager:

1. Alignment: Nothing focuses your mind and skills like having your own money on the line when investing. As Charlie Munger has said: "*Show me the incentive and I'll show you the outcome."*

2. Capacity constraints: Size kills performance. Managing a lot of money is hard and it can impact nimbleness and force managers to operate in larger, more efficient markets where it is more difficult to outperform. As Warren Buffett has said: "*Anyone who says that size does not hurt investment performance is selling*". A skilled manager who has been outperforming for years can quickly turn into an apparently unskilled manager whose performance drops off when they start managing a lot more money.

There are of other factors to consider when trying to disentangle the skilled from the unskilled but the above is what we consider the most important.

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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Changing times as share investors settle in for the long haul

Gemma Dale

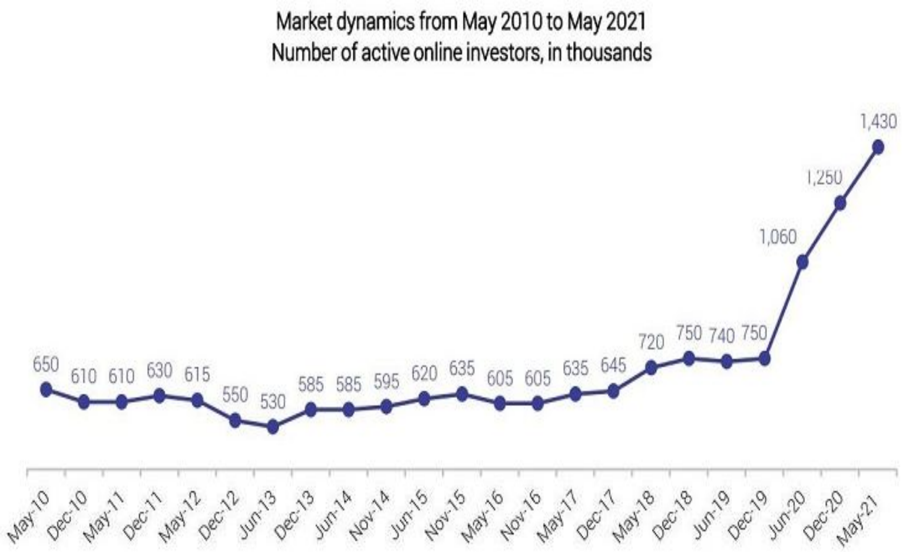
Sharemarkets around the world, including the ASX200, fell over 30% in only three weeks in early 2020, as investors began to factor in the likely impact of Covid-19. A fall of this magnitude has historically damaged retail investors, who were often late to the party, buying in toward the peak of the bull market, and quick to realise losses as the market fell.

A different response

But 2020 was a completely different story. Retail investors flooded to the sharemarket as stock prices fell, and enthusiastically bought up shares and ETFs throughout the lows, benefitting when the market returned rapidly to former highs. This was both a global and a domestic phenomenon, although Australia punches above its weight, having more direct share investors than Germany and the second highest of any country after the US.

The incredible rise in activity by retail investors in 2020 was considered to be a negative by many commentators. The fear was Australia may also be developing a Robinhood (later Reddit) army of leveraged and inexperienced traders who were destabilising the market, driving share prices to unthinkable levels and likely to lose their shirts in a downturn.

Number of retail online investors



Source: Investment Trends, May 2021 First Half Australia Online Investing Report.

Typically, though, new investors in 2020 were just like existing investors. They were keen to build wealth in the sharemarket, and sufficiently knowledgeable to 'buy the dip'. nabtrade saw an increase of more than 30% in total investors in 2020. The average new investor was slightly younger, slightly more likely to be female and somewhat less wealthy than existing investors. These factors are usually true of new investors, as those with existing share portfolios are generally older, more likely to be male, and much more likely to have benefited from asset price appreciation.

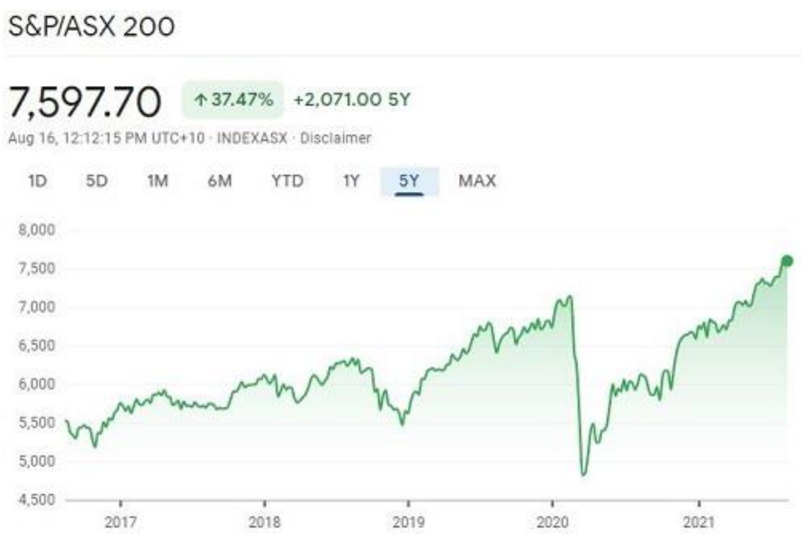
New investors, not new speculators

Contrary to concerns about irrational behaviour, both new and existing investors saw 2020 as an opportunity to buy high quality shares at a discount. Cash balances had risen to record levels by February 2020 and were put to good use as investors bought into the falling market. The buy-sell ratio was higher than 3:1 from late February to end July.

The average investor bought less than 10 shares, the most popular of which were the big banks, Afterpay and Zip Co and three key travel stocks (Qantas, Flight Centre and Webjet). An ASX200 ETF also featured in the top 10, although if all ETF products covering the ASX200 were aggregated, they may have made the top 5. Young investors were twice as likely to buy an ETF as older investors.

Here's a five-year chart of the ASX200 showing the rise to March 2020, the buying opportunity created by Covid-19 and the quick recovery.

Generally, investors are sitting on profits from well-timed purchases in 2020, and even those who were fully invested prior to the crash have seen the index rise above its pre Covid highs.



Source: Google Finance

What has 2021 delivered?

After such an extraordinary year, retail investor behaviour in 2021 was always going to be interesting to watch. Would investors turn to trading to eke out further gains? Would they be astonished by their good fortune, and sell to lock in profits, or hold tight to their winners? Would they continue to trade 'reopening' stocks and favourites from 2020, or look to other sectors for upside?

In short, investors have adapted quickly to an entirely different kind of market in mid-2021. As volatility has fallen away, so has activity. Many are clearly concerned about another fall in the market, as cash balances are now well above their pre Covid peak. In a zero interest rate environment, this is more of a reluctance to take risk than an asset allocation choice. Investors are much less likely to buy new shares than they were in 2020, with sell trades now slightly outweighing the buys. And the nature of the shares traded has also changed, with less interest in anything perceived to be 'risky'.

Interestingly, with the exception of BHP, investors had been largely indifferent to the large cap resources companies in previous years (although small cap miners attract a specific subset of investors and traders during all periods but are not widely represented). The soaring iron ore price has changed that, with Fortescue Metals now nabtrade's most traded stock.

Rolling border closures and lengthy lockdowns have exhausted interest in the travel sector, and none of the aforementioned travel stocks has consistently made the top 10. And while Zip is sufficiently volatile to attract active traders, Afterpay is less favoured than it once was (note, this article was written just as Square's offer was made for Afterpay). Instead, investors have looked to Telstra, CSL and Woolworths, as blue chips return to favour. One consistent buy is the ASX200 ETF, as newer investors look to build wealth through dollar cost averaging.

After the wild ride of 2020, investors appear to be settling in for the long haul.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

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US rate rises would challenge multi-asset diversified portfolios

Stephen Miller

The Reserve Bank of Australia (RBA) Board surprised the markets at its August meeting by continuing with the scheduled reduction in bond purchases announced in July. It had been thought that the COVID-induced lockdowns and inflation outlook would push the Board into formalising a delay. The relative sanguinity of the RBA Board can be attributed to a number of factors.

First, as the RBA Governor noted in his statement "t*he experience to date has been that once virus outbreaks are contained, the economy bounces back quickly"*. Additionally, the recovery from the pandemic has to date exceeded expectations.

Second, in the context of what looks to be an interruption to growth from current lockdowns, it is not going to be meaningfully attenuated by delaying for a month or two a decision to taper bond purchases by $1 billion a week from September. Other approaches are more effective.

Third, the Governor noted, the "*recent fiscal responses by the Australian Government and the state and territory governments are also providing welcome support to the economy at a time of significant short-term disruption."* Of course, one hopes that such measures are intelligently crafted and targeted. Regrettably that hasn't always been the case.

Flexibility the key differentiator

Most important is the emphasis given by the RBA to its 'flexibility'. This flexibility is a key differentiator between the RBA and some other central banks who have appeared to foreshadow policy rate increases in 2022. Given the uncertainties ahead, the RBA has done well to avoid any such undertaking, even if it has been of a conditional nature in other jurisdictions.

In other words, if the situation deteriorates the RBA has already communicated that its process allows it to quickly flick the switch and increase bond purchases.

For this reason, it would be a mistake to see the August RBA Board meeting as an indication that the RBA was following the lead of other commodity-intensive economy central banks such as the Bank of Canada, the Norges Bank and RBNZ or even the Fed 'dot plot' in indicating a significant retreat from historically high levels of monetary accommodation, including policy rate increases in 2022.

The RBA's expects that the condition (or 'outcome') for any increase in the policy rate "will not be met before 2024".

In this context, the RBA is best viewed as a 'caged dove' (a 'dove' is defined as a central banker who generally favours easy monetary policy).

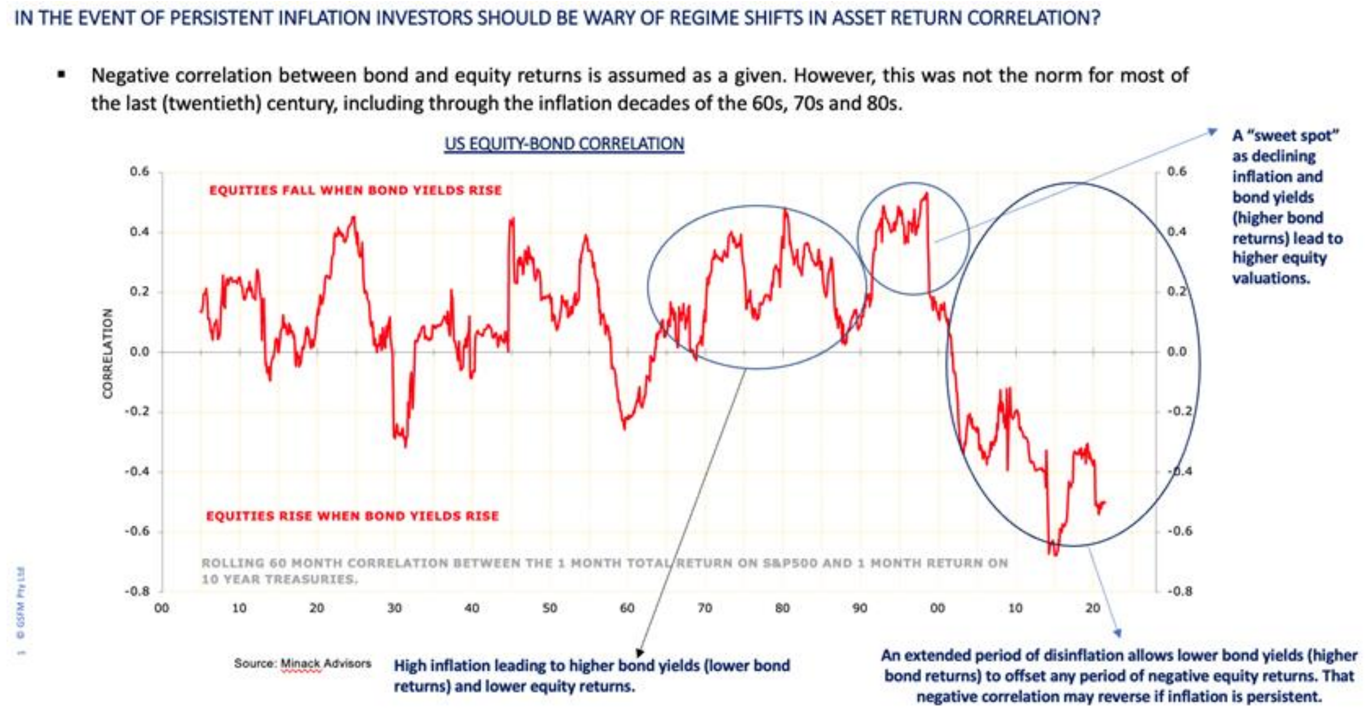
That will likely persist, at least until the RBA gets some clarity on the US Federal Reserve's (the Fed's) approach. It is the Fed's approach to inflation that looms large as a challenge for investors.

Certainly the Fed has commenced "talking about talking about" tapering, and strong economic data and clear inflation pressures are likely to escalate that chatter turning the Fed into a 'reluctant hawk' (and 'hawks' generally favour tighter monetary policy).

Investment portfolio diversification

It may be for investors that any escalation of tapering talk, particularly given clear and present inflation danger, necessitates a questioning of portfolio diversification practice, including the assumed negative return correlation between bonds and equities.

As the chart below shows, in the period beginning with the 'tech wreck' at the turn of this century, bond and equity returns have been negatively correlated. In essence, once inflation had been purged, any periods of stress in the outlook for economic growth and associated downdraft in equity markets could be quickly addressed by easier monetary policy (lower interest rates and lower bond yields).



However, with bond yields at historic lows, and policy rates approaching the 'zero-bound', it is reasonable to question whether yields can go meaningfully lower, particularly given inflation pressures, and what that might imply for the diversification properties of high credit quality nominal government bonds, particularly as long-dormant inflation pressures emerge.

If, in the wake of persistence in inflation, the Fed has to jam down hard on the monetary brakes, leading to sharp upward movements in bond yields, there may well be a significant correction in equity and bond markets.

Multi-asset investing implications

Such a scenario looms as a major challenge for investors, including how multi-asset investors react to a potential reversal of long-held assumptions regarding asset return correlation. That is equity returns and bond returns become positively correlated in the worst possible way - in extremis, both deliver negative returns.

Clearly the search for differentiated portfolio exposures uncorrelated with conventional equity or bond returns looms as a particular challenge.

In the defensive space, inflation-linked bonds or absolute return or 'unconstrained' bond funds are worth consideration. Gold may also be a candidate but its traditional role as an inflation hedge is undermined somewhat by rising bond yields increasing the opportunity cost of holding gold.

If the RBA lags the Fed, which seems likely, then the Australian dollar (AUD) is likely to come under some pressure which may ameliorate any negative performance of unhedged global exposures.

One thing is clear, even if the RBA remains a 'caged dove', emerging inflation may cast the Fed as a 'reluctant hawk', heralding a requirement for investors to think more imaginatively about portfolio diversification.

Stephen Miller is an Investment Strategist with GSFM, a sponsor of Firstlinks. He has previously worked in The Treasury and in the office of the then Treasurer, Paul Keating, from 1983-88. The views expressed are his own and do not consider the circumstances of any investor.

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