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Editorial

Two conversations last week with people at opposite ends of their financial journeys confirmed that a vital part of the investment decision is often overlooked. Where should the assets be held? Placing money in a personal account, joint names, company, super fund or SMSF, family trust, spouse or child can have vastly different consequences for tax, capital gains, estate planning, social security and access.

There are tradeoffs. A young person starting an investment plan with regular contributions from a salary has a tax incentive to use super, but that will compromise access to money to buy a first home. An older person with accumulated wealth may be eligible for the age pension or a tax-free super pension if assets are held in the right places. It's better for each member of a couple to fill their own $1.6 million cap to create a generous $3.2 million tax-free pension but what if their ages are significantly different?

Much of the decision is driven by marginal tax rates. The income tax-free threshold is $18,200 and for low balances, it might be better holding investments outside super. And an inheritance paid from super to a non-dependant child is taxed at 17%, so what is the right time to get the money out ... the day before death!

When considering a financial plan, always check where the investment should be held for the long term. In my case, I am looking to sell an investment property held in my own name but the tax bill will be severe compared with if I had held it in my SMSF.

And then the rules may change, stuffing up the best-laid plans. The Transfer Balance Cap was introduced a few years ago, with some justification. Similarly, there's a strong argument to include the family home in the age pension assets test subject to a threshold, and as our survey results show, there's a lot of support for this change. Politically impossible? That's what they said about the GST.

Leisa Bell reports on the results of our survey last week. With over 2,000 responses and about 1,000 comments, the response was excellent and it's worth taking the time to read the comments. Lots of strong feelings on both sides but, among our readers, a clear winner.

Surging property prices are only one sign of the asset price inflation around the world. In Australia, the surprisingly strong statement from the RBA Governor, **Philip Lowe**, that the market is misunderstanding future interest rates and they will stay lower for longer, serves to drive debt and house prices even higher.

This statement from an RBA Governor is so clear on intentions **for years** ahead that it's worth quoting in detail. Speaking in an address to the Anika Foundation, Lowe said:

"In particular, the Board has said that it will not increase the cash rate until actual inflation is sustainably within the 2–3% target range. It won't be enough for inflation to just sneak across the 2% line for a quarter or two.

We want to see inflation around the middle of the target range and have reasonable confidence that inflation will not fall below the 2–3% band again. ***Our judgement is that this condition for a lift in the cash rate will not be met before 2024."*** *(my bolding)*

"Meeting this condition will require a tighter labour market than we have now. Our assessment is that wages will need to be growing by at least 3%. We remain well short of this."

And then Lowe specifically tells the market they have it wrong:

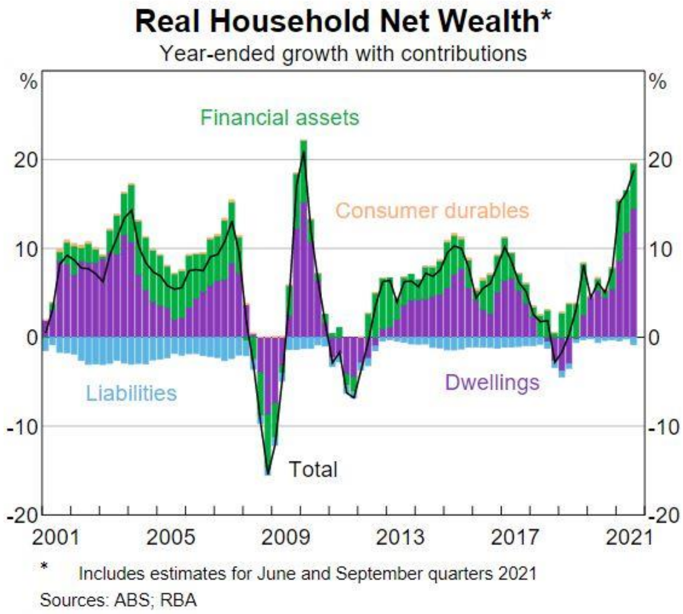
"I find it difficult to understand why rate rises are being priced in next year or early 2023. While policy rates might be increased in other countries over this timeframe, our wage and inflation experience is quite different."

Furthermore, not only are rising house prices not the RBA's problem - despite a generation of families being unable to buy a house - but rising wealth due to home inflation will help the recovery:

"This lift in the net wealth of the household sector is one of the things that suggest that once the restrictions are eased, households will be well placed to start spending again.

While it is true that higher interest rates would, all else equal, see lower housing prices, they would also mean fewer jobs and lower wages growth. This is a poor trade-off in the current circumstances."

He provided this chart to illustrate his point about rising wealth.

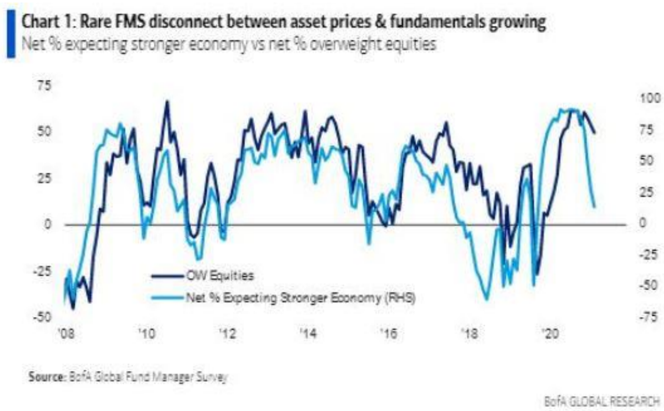


But in a somewhat inconsistent message, **Michele Bullock**, Assistant Governor (Financial System) at the RBA, told [Bloomberg Inside Track Online]() this week:

"However, while household debt to income in Australia hasn't increased much over recent years, it is at a high level, both historically and relative to other countries. So sustained strong growth in credit in excess of income growth may result in ***vulnerabilities*** *building in bank and household balance sheets." (my bolding)*

So while Lowe says higher house prices are "*outside the domain of monetary policy and the central bank*", Bullock says "*developments in the housing market (including prices) provide information on the emergence of financial stability risks*". Subtle difference?

Globally, central banks are eager to raise the wealth of existing wealthy people, doing whatever is necessary to hold up markets. The latest Bank of America fund manager research shows a rare disconnect between the economy and a willingness to hold equities. Normally, the net % overweight equities and net % expecting a stronger economy are closely correlated but we now have a divergence.



Many investors would like the greater upside of equity exposure but cannot accept the downside, where every generation sees a 50% fall and plenty of drops of 10%. We have two articles showing the [opportunities for buying LIC options]() or convertible notes. **Rodney Lay** explains the pluses and minuses of these options and why investors need to know about [share price dilution]().

Leading this week, it is difficult to think of a time in recent years when geopolitical tensions were as high on the agenda. The submarine deal has locked Australia into a military future with the US and the UK and alienated our largest trading partner in China and allies in France and Europe (maybe we should let the French into our deal and call it FAUKUS). It is opportune to read the perspective of **Joe Hockey**, former Treasurer and Australian Ambassador to the US, talking about investment implications over a wide range of geopolitical issues.

Then **Roger Montgomery** looks at an equally-pressing issue, the decarbonisation of the world and opportunities in power and transport. Roger identifies stocks that will benefit but says technological change does not mean every participant is a winner.

Long-term demographic trends can guide investment sections, and **Aneta Wynimko** outlines three factors which everyone should overlay in their decisions.

And **Damien McIntyre** observes that many people tend to think about bonds as low return and low risk, while equities are the opposite, high returns with high risk. There is an asset type in the middle.

This week's White Paper from **MFS International** called '*It's the Second Mouse that Gets the Cheese*' says they expect high-priced financial assets to deliver underwhelming returns while some sectors will benefit from a scarcity premium.

Comment of the Week from **Sean** (among a thousand others) in response to our asset test survey.

"Geez, are we meant to be sympathetic for the pensioner with a $2 million dollar house that instead of receiving a full tax-payer funded pension has to use a portion of their equity to enjoy their retirement? Unfortunately their kids will inherit only maybe $1.5 million after repaying the pension loan scheme used to make up the difference. What a terrible situation to be in to help pay off the trillion dollars of government debt used to help protect our older citizens from covid."

Joe Hockey on the big investment influences on Australia

Joe Hockey, Jon Howie

The Honourable Joe Hockey is the former Australian Treasurer and retired Australian Ambassador to the United States. He was interviewed by Jon Howie, CEO of VGI Partners, as part of the VGI Advisory Council series. VGI's Advisory Council provides a broader perspective to deepen VGI's investment insights. Below is an edited extract of their discussion.

Howie: Joe, to borrow from a famous quote: "*There are decades when nothing happens, and there are weeks when decades happen*", and it feels like there's a lot going on. Starting with your most recent experiences in the United States and roughly a year on from the presidential election, what are your perspectives on what's going on in that country and do you think that some of the divisions in that country are starting to heal?

Hockey: Well, there's no doubt that we've had some political stabilisation, and America was calling out for that. People were tired of the wild rides. But having said that, business certainly knew the direction of the Trump administration, which was essentially lower taxes, less regulation, and more tariffs. The market responded accordingly. But Donald Trump was a pretty wild ride.

If you were in Washington as I was, you could see firsthand and, as you say, a decade would occur in a very short period of time. So, Joe Biden comes along, his administration is very stable, very predictable. His messaging is very controlled. The senior members of his administration are very low key. Certainly even Tony Blinken, Secretary of State, is probably the lowest key Secretary of State in many years. COVID might have had some impact on that, but you really don't hear much about the rest of his team. And Joe Biden's messaging is very controlled, even when people interact, senior people in the administration never have one-on-one phone calls, it's always two or three people on the line. They're all cautious about doing anything inappropriate, following the Trump era.

So, having said that, they're rolling out a very aggressive agenda. And Joe Biden is predictably doing everything he can to appease the left without going too far. And in international relations he's certainly, on both climate change and in the Indo-Pacific region, forging a more aggressive path towards some of America's adversaries.

Howie: On his agenda, we've seen over the course of the last 12 months, and really over the last decade or so, a continuation of monetary policy which evolved into what has been called 'unconventional policy'. It feels like that's continuing and that it's hard for governments to walk back some of those measures, including the infrastructure bills.

Hockey: Well, the Republicans were meant to be the fiscal conservatives, and they weren't under Donald Trump, they weren't fiscal conservatives at all, in fact, until Joe Biden they had the biggest deficits in percentage terms of any administration, effectively since World War Two. So they were big spending at a time when they had high growth, low inflation.

Now, Joe Biden's elected, he has the first significant stimulus package and that's gone through and it wasn't a delayed package, it was money in people's pockets so it's an immediate fiscal stimulus. Then you've got the infrastructure package which is an additional stimulus. Now infrastructure is the slowest stimulus, but it's an increase in government expenditure. And now there's a third stimulus package, very significant, in excess of $3 trillion. And the US economy is roughly around $17-18 trillion, this is a big stimulus. And this is a recurrent stimulus so the first half of next year will be a monstrous year for money in the economy. The Fed keeps playing down any real increases in interest rates, and there's still not enough inflation in the American economy to be concerned, but I think inflation is coming.

Howie: Do you think COVID, perhaps coupled with the efforts being put towards the infrastructure build, has unleashed a productivity trend within the economy, an inflection point potentially bringing forward of consumption and technology?

Hockey: I don't know. I always had debates with Treasury when I was Treasurer about the definition of productivity, roughly, output per hour for effort. I said, well, I feel a lot more productive, everyone does, you know, cell phones, mobile phones have made us all more productive. I mean the plumbers, electricians, billing you on their way home instead of doing it at home, and spending hours trying to deal with their paperwork at night. And there's no doubt that Zoom, and the equivalent, has changed the interaction, but I'm deeply suspicious about whether you can truly replace human interaction by looking at someone on the screen. Personal communication is sophisticated. It's not just about the visual or the sound. There are inflections, there are changes of subject, there are shared moments that give you an insight into someone.

What do I mean by that? You know, I learned a lot about Donald Trump playing golf with him. We weren't in a Zoom call, you couldn't have been in a Zoom call. You actually learn a lot about someone's personality, you learn a lot about what interests them, you know their temper. You learn a lot about their character. You know, as they say, sport reveals character. And so, I'm not so sure about the whole remote engagement story, and whether that really does improve productivity.

I have an office in Washington DC, but we've been remote. We've got 10 people, half of them currently have COVID and I said to them, what do you want to do? Why am I paying say $30-40,000 a month to rent an office if you guys aren't going to turn up? They said, oh no, this is the flu, it'll will pass, we want to interact with each other. So it's a balancing act.

Howie: I'd be interested in your views on China's historical desire to open up their capital markets in a disciplined fashion. But more recently, their willingness to interfere in profit-making businesses, education being the most recent example. Is that a playbook for how western economies and the growth in government may evolve? And then, what are you seeing in China and what the next five years looks like?

Hockey: Well, in China there's not so much government interference on the tax or income side. But gee, they're heavy-handed in the middle with the regulation and they can because they've got centralised power. So it's all regulation, whereas western economies traditionally control some industries by increased taxes or gambling taxes, whatever. Or you might control them on the income side with government contracts.

They know that enterprise is a big driver of prosperity in China. The challenge they have is trying to regulate enterprise in such a way that they don't have an uprising by the workers about the fundamental disadvantage of people, be it in western China or outside of the major cities. And, they use the heavy hand of Beijing, and Beijing is not afraid to use any tool at its disposal. A corruption crackdown basically means anyone who is wealthy that they don't like, they can use the judicial system to impose heavy penalties.

A lot of businesses are pretty naïve about how it works in China. The sole focus of China is the sustainability of the Chinese Communist Party. It's right through all of its manifestos, it is the mantra. So much is focused on the sustainability of the Communist Party, it's about centralised power and controlling whoever you think represents a threat to the interests of Beijing. Having said that, China can't afford to have a recession because it has no welfare safety net. In many areas, the West is far more socialist than China but we have ingrown protections.

And in the case of China, they started to toy a little bit with the thought of democracy, and then, no, because Beijing was losing control. So Beijing comes back in, takes control, and it's a managed economy. And anyone that does business needs to understand you need to have the institutions that will give you regulatory certainty in a volatile time.

Howie: Australia has had an increasing reliance on China over the last couple of decades and that relationship feels like it has been evolving over the past few years in particular. I'd be fascinated in your thoughts about our political and neighbourly relations across the region, with a focus on China over the next couple of years.

Hockey: Well, there's no doubt that Australia is more exposed to China than the US or many other countries primarily because, as a trading partner, it is three times larger than our next biggest trading partner, the United States. So we have such a skewed trading relationship and, bear in mind that we're one of the few countries that have a trade surplus with China. Given all of that, you say to yourself, okay, how do we, you know, manage the shop, keep our biggest customer happy, but at the same time have a business partner that's fighting with them, our business partner being the United States. They're by far our biggest investor, they're unquestionably our key ally. How do we do it?

The fundamental point is that it's a balancing act. We're quite lucky in one sense that there's just a handful of businesses that really do make up a large part of the trade with China. And that's obviously in iron ore, and Western Australia does a pretty good job as well from the political perspective, managing the relationship with China. But overall, it's good to sell to China but you don't want to be beholden to them. Simple as that. Because you've got regulatory risks. Now, some people legitimately say we had regulatory risk with the United States. I get that. You've got regulatory risk everywhere. Here in Australia you have regulatory risk. But it's unpredictable and consistently volatile in China.

Howie: I'm interested in your thoughts about social media generally and how governments are thinking about it going forward.

Hockey: Social media makes the voice of the critic much louder than the voice of the advocate. So traditionally, particularly when you're in politics, you are able to mount an argument for particular reform. And you might have newspapers in favor of it, you might have televisions against, you might have talkback radio taking the pulse. Social media is really a sophisticated tool for the critic and it's a weak tool for the advocate. And so, you need to, from a business perspective, prepare a rescue case for a social media shellacking, in order to get your policy up. So you need to create a crisis that you then solve. Rather than having a solution that fixes a problem that no one knows about, you've got to make sure everyone knows about the problem, then solve it.

Howie: How do you judge what's happening in the South China Sea and then more generally, how do you see technology evolving in the way nations compete and countries move into conflict with each other?

Hockey: From a Chinese perspective, so much of its prosperity relies on trade. And of its top 20 trading partners really only one is an ally. And that's Russia, which I think is number 12 or 13 on the list. And even then, we can't say that there are warm and fuzzy relations between China and Russia. They have a few skirmishes up there on the border. They've got a bit of a history.

The United States has, through its good values and its history, in the 20th century in particular, won a constellation of friends and allies. And in the Trump era, it took them for granted, not Australia, for various reasons, but essentially didn't treat those allies well. And then they started to drift, and China was too slow to pick up the opportunity. Now with the United States, you know, when 800-pound gorillas are dancing, someone's going to get trodden on, but Australia is there saying to the United States: Hey, don't bully. Or other countries can say it, because they're trusted friends. China hasn't got that and doesn't like that criticism either.

Trade is lifting the wealth of the average Chinese person. Trade is so important to China but 80% of its trade goes through the South China Sea, so they're going, hang on, this is our lifeline, this is our blood and it's called the South China Sea by the way. It's not, you know, the Sea of Texas or northern Australia or whatever right. Therefore, this is our sea lane. And they are incremental, they're patient, they're incremental as they were on Hong Kong, as they'll be on Taiwan, as they'll be on various other things. They're in for the long haul. South China Sea is no different.

It's almost inevitable there'll be some challenge over Taiwan. Maybe in the next five years? That will sorely test the United States, because even if they've got a President that doesn't want to do anything about it, the mood in the Congress is very definitely stand by Taiwan. And they're very much equal powers, unlike the Prime Minister and the Parliament here in Australia, it's different.

Howie: I'm interested in your take on Afghanistan and what appears a relatively messy withdrawal on the US part, and whether that's changed the power structures within that region.

Hockey: Well, Afghanistan's a very hard country to govern. I'm mean, I'm stating the obvious, I know. Quite a few people have tried over the years. And you got Kabul and then you got a whole lot of warlords and provinces, some of which don't really recognise borders. The mysterious part of the evolution of the world over the last 150 years is that there are a large number of tribes in the world that never saw a boundary. You know, Africa is made up of tribes, so when the British or the French or other imperialists came along and said, here's a line that separates you from me, you think hang on, where's that line? That's your land, this is your land, that's my land. I've been going there for 1000s of years to that water hole. Where's the line? It's very much the case in Africa, but also in the Middle East and obviously, in Afghanistan.

And so, the American presence in Afghanistan did prevent terrorist attacks, but it had to come to an end at some point, because you can't continue to run a country on the other side of the world, where they aren't able to run themselves. And the argument being, you can't keep pouring money into it, and resources and blood. So, yes, there's no doubt, it was bungled. What struck me was the conviction of Joe Biden about getting out. He has massive American public support for getting out. The way he got out was very bad. There were many failures. And unlike Saigon, where they left, they didn't leave anyone behind, here they left tens of thousands behind.

Will it do big damage? Only if it's one of a series of events that give rise to a hostile and real threat to the American people or if it is part of a series of bungles in the administration. I don't think that's the issue. The issue in my mind about it will be the treatment of women. And I don't think the world, and particularly fueled by the #metoo movement, is going to sit back and watch women being treated today the way they were 25 years ago by the Taliban, or extremists of any sort. You're going to see powerful, big-voiced and influential women, starting with the Vice President of the United States, but it could be celebrity women like Oprah or High Net Worth females, female business leaders. That's a problem for Joe Biden on the left. That's where he will get the anxiety.

Howie: I'm conscious that we might want to just bring it home before we finish. I'm interested in your perspective, as a former treasurer, of the current treasurer having to navigate very challenging circumstances in the domestic economy, and COVID and support payments to keep everything going.

Hockey: Well, the difference between the private sector and government is you can print your own money and gee, they're giving it a good whack. In Australia because we traditionally import capital, we're more constrained. And so, if government builds up debt, the only way we can pay off that debt or pay it down, is you can sell assets, which is what the Howard Government did and that was very successful. You can earn more, by having economic growth but usually that means you have to tax more. So that's not very popular. Or you can have inflation and inflation eats away at government debt. And traditionally, that's been a very powerful tool for governments.

So go right back to one of my first answers to you when I say I fear inflation, because, you know, for example, when the US Social Security system starts to run out of money. So they either have to increase taxes on fewer people effectively, or they're going to pay less to the most disadvantaged. Everything comes to an end at some point, we know that, that's inevitable. And if you keep printing, you have massive asset price inflation.

But I think also you're going to have the two biggest drivers really of inflation, wage inflation and fuel, because that hits right across the economy. Wage inflation is already starting to pick up because we haven't got immigration. So we need immigration to provide a bigger pool of labour. We're also going to start to see wages go up, and now we've got new workplace demands, but people want to earn the same as working five days a week. On fuel, the drive on green fuel, heavily subsidised by government, sooner or later there's going to be an inflationary impact there. We've seen coal prices go up dramatically, for example. And that's not even green, right, so green prices are heavily subsidised by government at the moment, but sooner or later that tap has to wear off. Then you start to see fuel prices go up to more realistic levels.

So, you know, I think there are two looming challenges on the economic front, which means you go into inflation, which means you start to look at what are the stocks, what are the investments that cope well with an inflationary environment. And sooner or later the central banks are going to stop printing. And they're going to stop with very low interest rates. The challenge is trying to pick the cycle. And, frankly, if I could do that, I'd be sitting on a boat in the Caribbean rather than sitting here with you, Jon.

This interview contains general information only and does not consider the circumstances of any investor. [VGI Partners](#) is a sponsor of Firstlinks. For articles and White Papers by VGI, including 'A Guide to Listed Investment Companies (LICs)', [see here](#).

The Honourable Joe Hockey is the former Australian Treasurer and retired Australian Ambassador to the United States. Jon Howie is CEO of VGI Partners (manager of the listed vehicles ASX:VG1 and ASX:VG8).

The tipping point for investing in decarbonisation

Roger Montgomery

Back in April this year, I wrote in [this article](#):

"Electric vehicles, clean energy, and decarbonisation will take a more prominent role in the headlines than they already are ... Australia, of course, is rich in all the minerals required for the manufacture of lithium batteries, including lithium itself, and the ASX is rich with listed suppliers, developers and explorers."

A prescient aphorism referring to the end of the oil age, and the declining power of oil producing nations, was offered by 1970s Saudi Oil Minister Sheikh Zaki Yamani, who quipped, *"The stone age did not end for a lack of stone."*

It's no longer about running out of oil

Newer and superior bronze tools replaced stone, rendering the former redundant. Today, we are witnessing the same dynamic as electric power supersedes oil, at least as a fuel. Where once it was predicted the last barrel of oil would command an astronomical price, purchased by the wealthiest car or jet owner, it now appears we will leave oil in the ground with its extraction being uneconomic.

Throughout time, transformative technology has maintained its power to change the course of human history. And of course, as investors, it is easy to be lulled into believing new technology will also transform investment returns. And while it's true steam engines, horseless carriages, television, the PC and commercial air travel have seen fortunes made, not everyone wins. Meanwhile fortunes are also lost when legacy technology is kept on life support by nostalgic but misguided management teams and shareholders.

Battery electric vehicles (BEV) momentum has built to a tipping point and underestimating the transformative impacts, failing to unearth the pan and cradle sellers of the coming BEV boom, or avoiding the space for fear of a bubble will, I believe, be an expensive mistake.

EV purchases have skyrocketed from just over 500,000 in 2015 to over two million vehicles in 2018 and three million in 2020. My confidence however stems from the support developers have received from governments globally. Already more than 14 countries and over 20 cities around the world have proposed banning the sale of fossil fuel-powered passenger vehicles (primarily cars and buses) in the near future. Denmark's ban will be in force by 2030 – less than nine years away.

Meanwhile China, Japan, the UK, South Korea, Iceland, Sweden, Norway, Slovenia, Germany, France, the Netherlands, Spain, Portugal, Canada, Sri Lanka, Costa Rica and 12 U.S. states have proposed bans on the sale of internal combustion, or implementing 100% sales targets of zero-emissions vehicles.

More evidence of a tipping point

In response, and by necessity, global car and truck manufacturers have formed a conga-line announcing transitions from ICEs (Internal Combustion Engines) to BEVs.

Earlier this year Porsche, Audi, Skoda and VW owner, the Volkswagen Group announced a €25 billion capital expenditure program to develop a comprehensive range of EVs – from affordable to luxury and performance, as well as a network of tens of thousands of fast-charging stations across the world, and additional 'gigafactories' and battery recycling plants.

If VW's announcement isn't evidence of a tipping point, perhaps their tripling of EV deliveries in 2020 to over 212,000 and expectations of over a million EVs this year is.

So is General Motors's plan to sell more than a million EVs annually by 2025, spending US$35 billion by 2025 on EV (electric vehicle) development. And Ford's announcement back in June, to spend US$30 billion on EV development by 2030, sell 1.5 million EVs that year, while aiming for 40% of its global model range to be electric further strengthens the tipping point argument.

US President Biden's proposed infrastructure bill has set aside US$174 billion to encourage EVs, with nearly US$18 billion for a national charging network.

This last development – a network of ubiquitous rapid charging stations - will feed EV adoption even more.

Rising demand for EVs amid mandates and decrees to reduce carbon emissions will inevitably lead to rising demand for 'upstream' inputs. And while quantifying EV demand precisely is a fool's errand, there is no shortage of experts trying.

Ernst & Young believe EV sales in Europe, China and the US will outstrip internal combustion engine vehicles (ICEs) by 2033, which is five years earlier than previous projections. A plethora of predictions typically expect the global EV market to grow 10-fold by 2025, and forecasts of a 50-fold increase by 2030 are not uncommon.

EVs need batteries and the currently favoured Lithium-ion batteries also contain metals such as cobalt, nickel, graphite and manganese.

Meanwhile demand for batteries will also come from power utility projects, many increasingly adopting battery technologies, as are residential power consumers.

Evidence of a virtuous circle

A virtuous circle of declining battery prices, leading to increasing demand, in turn leading into increasing investment in battery technology, is well entrenched. In 2010, a 1KWh capacity lithium-ion battery pack cost more than $1,000. Two years ago, prices were $156, according to Bloomberg New Energy Finance. Cheap batteries will of course lower the cost of manufacturing cars as well as commercial and residential storage solutions, accelerating their adoption.

Demand is one side of the equation. Supply is the other. Currently global lithium (carbonate production) is roughly 500,000 tonnes per annum. If current predictions for the 2025 EV market alone are correct, demand will exceed 2.7 million tonnes per year. And if 2030 predictions are correct, expect demand to exceed 15 million tonnes.

Citi predicts 75% of all mined lithium will be consumed by EV batteries by 2025, while the IEA predicts a 40-fold increase in lithium demand by 2040.

In investing in this theme, one of the lithium players we own in the Montgomery Small Companies Fund is Pilbara Minerals (ASX:PLS). PLS has risen almost 160% year-to-date and its share price is up approximately six-fold in the last 12 months.

Source: Morningstar.com.au

Back in March, Pilbara Minerals launched a sales and trading platform for its Pilgangoora project to provide "*flexibility to transaction by auction, tender process or bilateral sale.*"

In July, its inaugural battery materials online exchange (BMX) auction, received just over 60 online bids ranging from US$700/dry metric tonne (dmt) to US$1,250/dmt for a 10,000 dmt shipment of spodumene concentrate.

This week the company revealed the highest bid at its latest auction was almost double that of July's inaugural auction, accepting a bid of US$2,240/dmt for an 8,000 dmt (5.5% spodumene concentrate shipment.

Lithium prices are skyrocketing but the evidence for growing demand and limited supply suggest prices are some way off a bubble. Decarbonisation is an investment theme that appears to have plenty of durability. With that in mind our small companies fund has been invested, for some time, in companies including Orocobre (ASX:ORE), Mineral Resources (ASX:MIN), Pilbara Minerals, Aeris (ASX:AIS) and IGO Ltd (ASX:IGO). Despite substantial gains, we believe there is yet more to this story.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

The options to gain equity exposure with less risk

Graham Hand

After 11 consecutive positive months to August 2021, Australian stock indices will probably fall in September. Although the market has recovered well during the pandemic, it's a reminder that equity investors must tolerate short-term volatility.

On average, the Australian stockmarket falls about one year in every four or five years. It has delivered a 10% fall at some stage every couple of years since 1950, including three falls over 50%:

- 1 November 2007 to 6 March 2009, down 55%
- 4 March 1974 to 30 September 1974 down 52%
- 21 September 1987 to 11 November 1987 down 50%.

The ASX200 index fell over 30% at the start of COVID in March 2020. Will such falls happen again? Certainly.

Retail fund managers that offer a range of funds with different risks must include a statement in their offer documents advising clients how often a fund is expected to deliver negative returns. For example, Colonial First State includes this table, where Australian and global equities are given a 'Very high' risk label, meaning they are expected to lose money in six or more years in every 20.

Risk band	Risk label	Estimated number of negative annual returns over any 20-year period
1	Very low	Less than 0.5
2	Low	0.5 to less than 1
3	Low to medium	1 to less than 2
4	Medium	2 to less than 3
5	Medium to high	3 to less than 4
6	High	4 to less than 6
7	Very high	6 or greater

However, there are investments on Australian stockmarkets that substantially limit downside risk while leaving much of the upside. This article explores options and convertible notes issued by many Listed Investment Companies (LICs) and defines the maximum loss possible.

(Options over specific stocks are also discussed at the end).

1. Options on LICs

The table below shows the range of options listed on the ASX (and full disclosure, I own some of these options, although that should not be considered a recommendation).

This article explains how they work and for further details, see also the accompanying article by Rodney Lay. We both use the same example for consistency and it is the largest option issue in the market (other than Magellan Global which is not a usual option exercisable at a fixed price).

Perpetual Investments manages an equity LIC (ASX:PIC). In June 2021, PIC issued options (ASX:PICOA) to buy a share in PIC at $1.35 exercisable on or before 2 September 2022.

Here is where the market stands at the time of writing (20 September 2021):

1. The latest Net Tangible Assets (NTA) of PIC as at 17 September 2021 is stated as before tax at $1.43 and after tax at $1.35.
2. The option to buy PIC at $1.35 was trading at $0.013. **Note that is not 13 cents but 1.3 cents**. That is, you could buy (subject to liquidity) 1 million options for $13,000, 100,000 options for $1,300 or 10,000 for $130 if on a tight budget. Plus brokerage.
3. PIC itself (the underlying shares) are trading at $1.30/$1.31.
4. So this option is slightly in-the-money based on both pre-tax and post-tax NTA, it has 12 months to run, and it costs 1.3 cents.

The most an investor can lose is 1.3 cents on each option, plus brokerage. An option gives the right but not the obligation to buy. If PIC is trading at less than $1.35 in a year and the investor logically does not exercise the option, the loss cannot be more than 1.3 cents per option.

However, this is not an option over the value of the index such as the ASX200. It is an option over a specific LIC, and it can trade at a discount to the NTA. So even if the market rises, if the discount widens, the option may go out-of-the-money.

This article makes no judgement about Perpetual Investments, a traditional value manager with a long history. This article is explaining options, not recommending managers.

The features of the following table include (with the PIC example on the second line):

1. How long the options lasts, the expiry date. For an investor, the longer the better (the more time value).
2. The price at which the option can be exercised, in this case, buying a share in a LIC.
3. The current share price at time of writing.
4. The current price at which the option itself is trading.
5. The volume of outstanding options. If many options are exercised at cheap prices, holders of the underlying shares are diluted. Rodney Lay explains this in more detail.

As other examples, investors can:

- Pay 14 cents per option for the right to buy WCM Global Growth (ASX:WQG) at $1.50 until 31 August 2022, and it is currently trading at $1.61.
- Pay 1.3 cents to buy WAM Active (ASX:WAA) at $1.10 and it is now trading at $1.06.

Check the ASX website for latest NTAs and ensure the concept of dilution is understood.

Listed Investment Company Options

Issuer	ASX Code	Expiry Date	Exercise Price	Share Price (as at 20/9/21)	Option Price (as at 21/9/21)	Outstanding Options (m)
MFF Capital Investments	MFFOA	31-Oct-22	$2.60	MFF - $2.93	$0.32	93.47
Perpetual Equity Investment	PICOA	2-Sep-22	$1.35	PIC - $1.31	$0.013	372.41
Glennon Small Companies	GC1AI	29-Oct-21	$0.75	GC1 - $0.83	NA	4.90
Glennon Small Companies	GC1AJ	28-Apr-23	$0.95	GC1 - $0.83	NA	8.77
Naos Ex-50 Opportunities	NACOA	31-Mar-23	$1.03	NAC - $1.16	$0.15	22.07
Naos Small Cap Opportunities	NSCOA	28-Jun-24	$1.02	NSC - $0.90	$0.05	50.91
Ryder Capital Limited	RYDOA	10-Dec-21	$1.50	RYD - $1.77	$0.20	11.74
WAM Active Limited	WAAOA	31-Oct-22	$1.10	WAA - $1.06	$0.013	67.39
Magellan Global Fund	MGFO	1-Mar-24	7.5% Disc*	MGF - $1.79	$0.015	1065.33
WAM Global Limited	WGBO	12-Sep-22	$2.54	WGB - $2.65	$0.11	184.95
WCM Global Growth Limited	WQGOA	31-Aug-22	$1.50	WQG $1.61	$0.14	53.54

* 7.5% Discount to NAV, not comparable as not fixed exercise price.

Options give wary investors some skin in the game without committing the full share price. In fact, as the table shows, options often cost less than 1% of the current share price, although the relationship with the exercise price is most important. For example, MFF Capital (ASX:MFF) has an exercise price of $2.60 but MFF is already trading at $2.93 so the option is more expensive at $0.32. Options do not earn dividends until exercised into shares.

2. LIC Convertible Notes

Convertible notes are debt instruments which can be converted into shares under certain conditions. They are not common on the ASX but some have emerged. The advantage of these notes is that investors can treat them as fixed income bonds, and the share price gain is a bonus if it pays off.

For example, Flagship Investment (ASX:FSI) has issued a $20 million note (ASX:FSIGA) with the following terms. Again, I am not recommending either the note or the manager, just showing how it works:

- Total offer size: $20 million
- Offer price: $2.70 per note
- Interest rate: 5.50% paid quarterly until Step Up date of 30 September 2024
- After Step Up date if not redeemed, rate increases to 6.50%
- 1 Convertible Note converts to 1 ordinary share
- Maturity date of 1 October 2026 (5 years) if not converted or redeemed earlier
- Loan-to-value (LTV) cap of 50%. Coupon steps up 2% and dividends cannot be paid on FSI if this level is breached.

The investor buys a note for $2.70 that ranks ahead of ordinary shareholders. The note pays 5.5% for the first three years with the right to convert each note into a share in FSI, which is currently trading at $2.45. The notes are unsecured debt of the issuer which has a current market value of about $60 million, although FSI could borrow up to 50% of the value of FSI.

Which means FSI could halve in value and noteholder should be covered, assuming no other problems with FSI. The terms above are a summary to illustrate the point.

Here is the range of listed notes available. The notes issued by NAOS are trading above their issue price so the yield on the notes has fallen.

Listed Investment Company Convertible Notes

Issuer	ASX Code	Coupon	Expiry Date	Exercise Price	Share Price (as at 20/9/21)	Bond Price (as at 21/9/21)	Outstanding Bonds (m)
Glennon Small Companies	GC1PA	5.60%	30-Sep-30	$0.86	GC1 - $0.83	Illiquid	0.57
Clime Capital Limited	CAMG	6.25%	30-Nov-21	$0.94	CAM - $ 0.97	$0.97	27.79
Naos Ex-50 Opportunities	NACGA	5.50%	30-Sep-27	$1.15	NAC - $1.16	$107.50	0.18
Naos Emerging Opportunities	NCCGA	4.50%	30-Sep-28	$1.15	NCC - $1.15	$102.60	0.23
Flagship Investments*	FSIGA	5.50%	1-Oct-26	$2.70	FSI - $2.45	not yet listed	20.00

* lists on 29/9/21, coupon steps up to 6.5% after 2024.

The current range of convertible notes is small as other issues have already matured so investors may need to wait for new issues (and Clime matures soon so it is probably not worth bothering with given its low liquidity). The three others listed in the table are recent issues and new opportunities do arrive.

3. Listed options on specific stocks

In addition, a wide range of options are traded across dozens of stocks with different strike prices and terms, mainly by professional traders, as previously explained in this article, while this article showed how to use options to protect downside. This professional pricing and trading of options using implied volatility is beyond the scope of this article.

Thanks to Rodney Lay of RRMetrics and Hayden Nicholson of Bell Potter for some of the data in this article, although errors remain my responsibility.

Graham Hand is Managing Editor of Firstlinks. The author owns some of the investments described in this article, but this is not a recommendation and investors must do their own research. As the Rodney Lay article shows in more detail, options have many characteristics and react to market conditions in different ways. This article is general information and does not consider the circumstances of any individual.

8 ways LIC bonus options can benefit investors

Rodney Lay

The general investor opinion of the Listed Investment Company (LIC) and Listed Investment Trust (LIT) sector has returned to a more sensibly-balanced view after the criticisms around stamping fees, with a recognition of the potential benefits of a close-ended vehicle structure.

One benefit is the ability to issue bonus options to existing investors, and we will use the example of Perpetual Equity Investment Company (ASX:PIC) to explain how these issues work. Many other LICs have used a similar technique.

We were previously not overly keen on the bonus options structure but after speaking to Perpetual and hearing the positive feedback it has received from shareholders, our views have changed.

There are pros and cons to bonus options but our prior negative view was mainly due to the adverse impact of Net Tangible Asset (NTA) dilution on performance. In some cases, a year or two after the options had expired, no one remembers that there was a known NTA dilution which opens up a manager to criticism of poor relative performance.

Inside a bonus options issue for a LIC

The key terms of the PIC bonus options are an exercise price of $1.35 per share (share price at the time of issue was around $1.30) and an options expiry date of 2 September 2022. Investors can choose to exercise the option and receive the shares any time up until the expiry date.

This examination compares an options issue with alternative means of rewarding existing shareholders, such as an entitlement offer (issued at a slight discount to NTA), which typically comes with a shortfall placement to the broader investment community.

Potential investor benefits

From an investor perspective, the benefits of bonus options are potentially eight-fold:

1) Bonus options reward existing investors (and by a greater degree than an entitlement offer) by providing a free 'kicker'. Investors gain a free look at the market and LIC over the duration of the issue date to expiry date. An entitlement offer is a here-and-now decision.

2) Investors have perfect choice – a time window before which to exercise, hold or sell the options on-market to raise cash (if the share price exceeds the exercise price or the options have a market value due to the time value).

3) Bonus options provide an alignment between management and the shareholders as a result of the duration of the options. In the PIC case, for example, the exercise price was at a premium to the share price/NTA and the goal posts change as distributions are paid. This provides management with a clear mandate to perform in order to raise capital.

4) An investor's exercise has the potential to be NTA accretive for that investor. However, there may be an NTA dilutionary effect overall for the LIC/LIT based on the relation between the share price and the options' strike price when the options are exercised. Dilution for some investors occurs when other investors buy shares at prices below NTA.

5) An increase in FUM scale leads to increased secondary market liquidity and market relevance with broader market interest. PIC has a FUM of about $486 million (based on a pre-tax NTA of $1.39/share). The bonus options issue has the potential to increase the PIC FUM to circa $973 million, assuming a 100% exercise rate, making it the 12th largest LIC/LIT out of 98 in total following the disappearance of MLT.

6) In the LIC/LIT sector, larger FUM scale is strongly correlated historically to superior premium/discount to NTA performance (read, potential share price upside over and above NTA growth, assuming a recalibration occurs).

7) The greater FUM scale leads to lower fixed costs per share incurred by investors, improving net post-costs returns, all things equal.

8) A manager has greater capacity to capitalise on compelling investment opportunities using the additional capital raised. Given bonus options are American style, that capital is not raised all in one hit which may otherwise lead to digestation issues.

Investor risks

Bonus options come with some downside risks, including:

1) Some shareholders may 'suffer' NTA dilution. NTA dilutionary risk is, in turn, driven by:

a) the degree to which the strike price is below the NTA over the full time period in which options can be exercised, and

b) the percentage of options that are exercised.

2) The degree of NTA dilutionary risk is an unknown and a function of investor behaviours (when they exercise) and moves in the share price relative to the options strike price. With an entitlement offer, the dilution risk is a known and limited to the offer discount to NTA at the time.

3) An options 'overhang', namely the market share price often will factor in some degree of NTA/share dilution risk, leading to a drop in a premium or discount to the published (non fully diluted) NTA.

4) Should some shareholders exercise options then sell shares on market, there is a risk of more sellers than buyers than otherwise the case (greater adverse premium/discount to NTA risk).

5) The strong likelihood that the shareholder register will go through an unsettled period, with more marginal sellers than buyers than would otherwise be the case (adverse share price to NTA dynamic).

6) Have a lasting adverse impact on the investment vehicles performance metrics over time assuming NTA dilution risks transpired.

A comment on peer relativity analysis with ETFs

Bonus options are just one of several reasons why a direct comparison of LIC/LIT performance to an industry benchmark or the unlisted trust or ETF universe lacks validity. Other reasons are Share Purchase Plans and Dividend Reinvestment Plans issued at a discount (dilutionary), share/unit buybacks (accretive) and most importantly, LICs/ LITs report a pre-tax NTA figure which is after all operating expenses.

The term 'pre-tax NTA' is a misnomer. The measurement of a LIC/LIT's performance is calculated after all operating expenses and the provision for realised capital gains tax (and the reinvestment of dividends, but does not incorporate franking). LIC/LIT returns will consequently be understated relative to an index return given benchmarks do not factor in operating costs or provisioned capital gains taxation while unlisted unit trusts are not measured on an after-tax basis (provisioned capital gains taxation) and therefore do not provide a like-for-like comparison.

Rodney Lay is an Analyst at [Risk Return Metrics](). This article is general information and does not consider the circumstances of any individual.

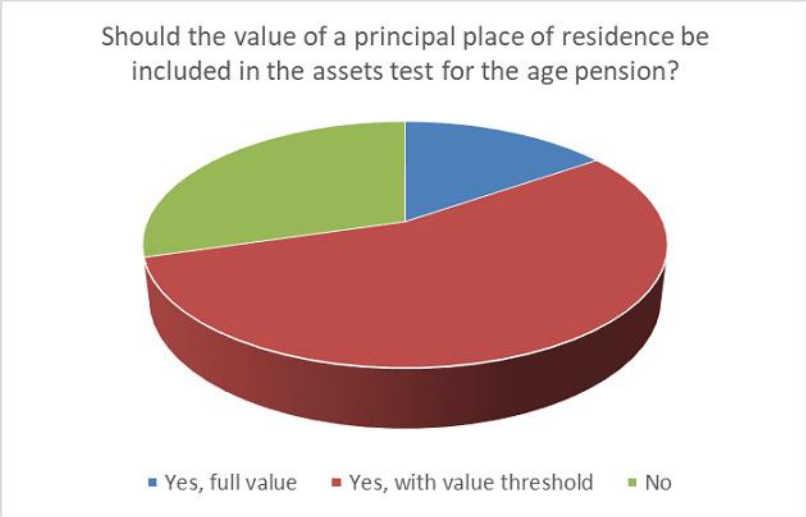
Survey responses on pension eligibility for wealthy homeowners

Leisa Bell

Last week's survey on whether to include the value of the principal place of residence in eligibility tests for the age pension drew 2,000 responses and much debate. We thank everyone who shared their views and opinions.

Our readers had a lot to say - for and against the policy change - so here we present a summary of the findings. If you want to delve into more detail, including the 1,000 plus comments, linked here is a complete results report.

Q1 Should the value of a principal place of residence be included in the assets test for the age pension?



In the 'yes' corner, we had 70% of respondents with 15% wanting to see the full value of the home included in the asset test and 55% thinking a value threshold is needed. That left 30% opposing inclusion totally.

Threshold values

We asked for views on what threshold might be appropriate. After zero, suggested amounts ranged from $500,000 all the way up to $2 million with varying caveats and allowances, including indexation, basing off median values by suburb/LGA/region (or median + a percentage), different levels for couples versus individuals, taking into consideration price fluctuations, stepped introduction over many years, using unimproved (land) values only, no retrospective changes ... the list seemed almost endless.

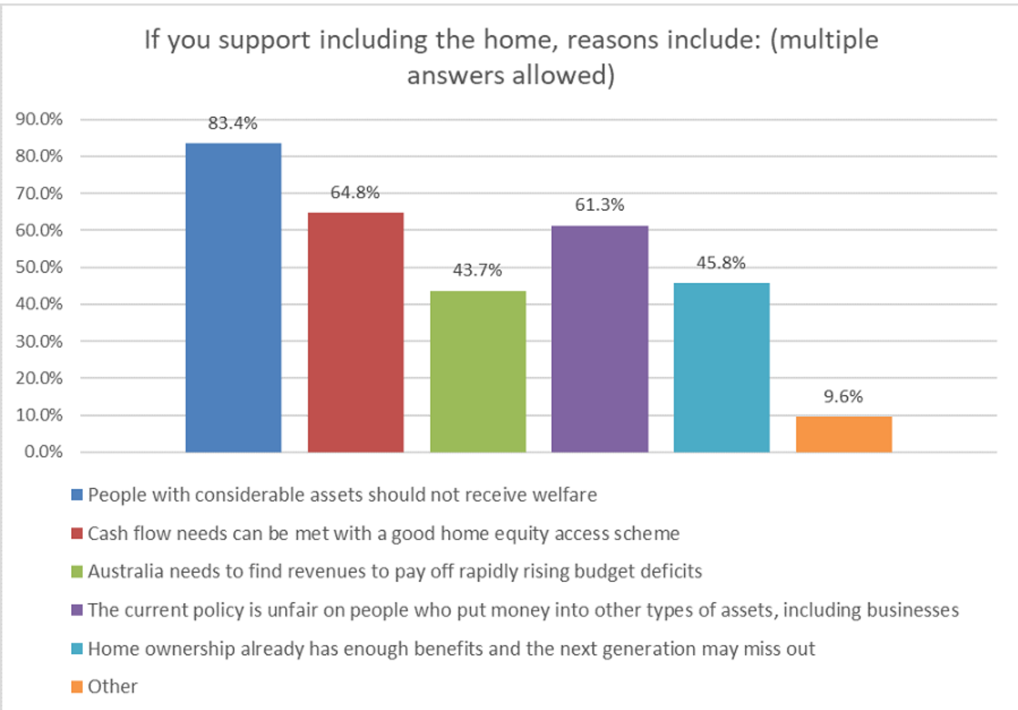
There were calls for the entire tax system to be overhauled (mmm, no small task), the reintroduction of death or inheritance duties for homes that are left to the next generation, or the abolition of negative gearing.

The idea of a universal pension, which is taxed along with any other income, was also commonly floated.

A big concern was if pensioners would be forced to sell the family home, rather than make use of home equity redraw products. Many suggested more equitable access to the Pension Loans Scheme or similar. Issues surrounding proximity to family and social networks, medical care, and even using the eventual sale of the home to fund age care costs were also raised.

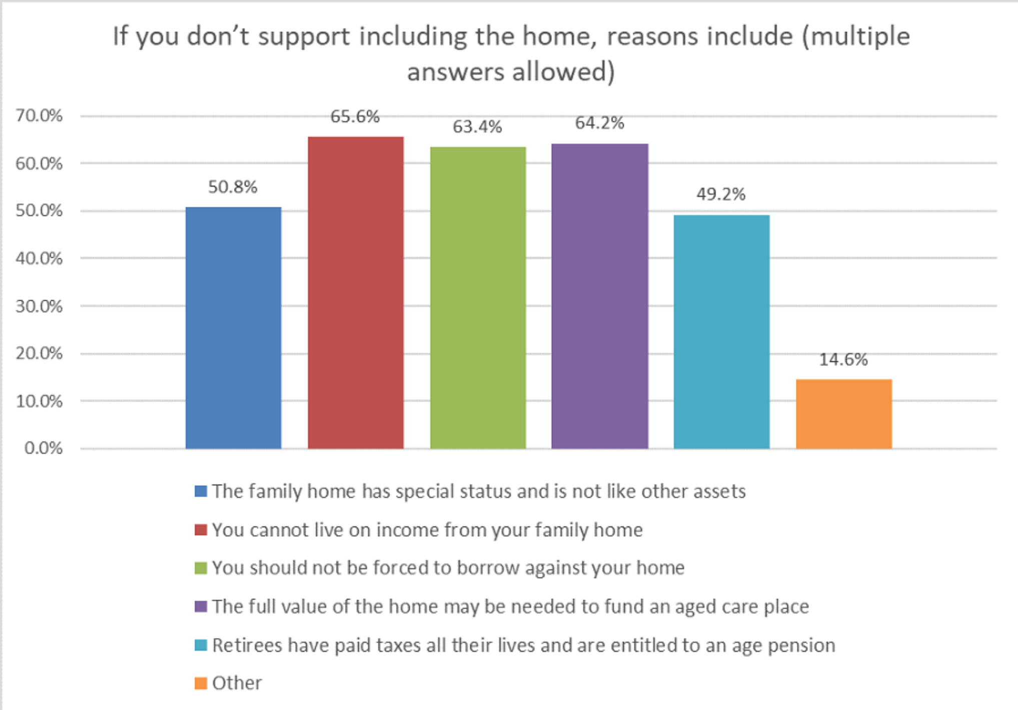
Q2 If yes, for what reason(s)?

The most common reason given by those answering 'yes' was that people with considerable assets should not receive welfare (83%), followed by the use of home equity to fund retirement cash flow needs (65%), and the inequity of the system compared to those who have invested into other assets throughout their lives (61%).



Q3 If no, for what reasons(s)?

The top reason given for not including the value of the home was that people's primary residence is non-income producing (65.6%), closely followed by using the home to fund an aged care place (64%) and an aversion to being forced to borrow against the home (63%). Over half still viewed the home as having a special status that should be left alone.



Further comments

We received over 450 comments in the final open-ended section, which can be viewed in this full report (a meaty 58 pages).

Leisa Bell is an Editorial Associate at Firstlinks.

Three demographic themes shaping investments for the future

Aneta Wynimko

With significant demographic shifts occurring around the world, one useful approach for investors is to use demographic themes and trends as a compass for future investing.

Focussing on companies that will benefit from slow moving, long duration and highly predictable demographic trends can help investors predict areas of future opportunity.

There are three main themes that stand out – an aging population, population growth, and a growing middle class. The long-term implications of all three are far-reaching.

Longevity and aging population

A quick look back at history offers a guide to how much older society is becoming, and how quickly. During the Roman empire, the average life expectancy was only 25 years. Life expectancy then increased to 33 years in the Middle Ages, with a big jump to 55 years in the 19th century.

More recently, the average life expectancy across the globe has increased to 72 years, with the Western world at 80 years and Japan at 84. Dutch scientists expect that in 50 years’ time, life expectancy might reach over 125 years.

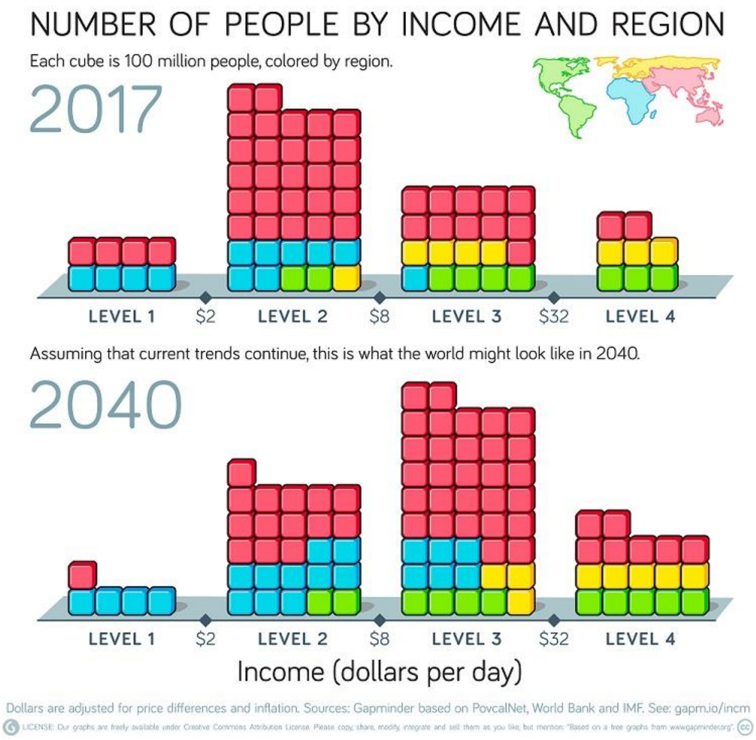
At the same time, the overall population itself is becoming, on average, older. For the first time in human history, people older than 60 will soon outnumber 15-year-olds and younger. This has profound implications on how people are spending, which in turn has repercussions for what industries and companies will succeed over the longer term.

Population growth and shift to the middle class

There are noticeable shifts within this population growth. We are at a point where, for the first time in human history, the number of people in the middle class will make up the majority of the population.

From an investment perspective, this means that the level of household wealth is, on average, rising globally.

This increase in household wealth is noticeable in Australia, particularly due to the effects the pandemic and Australia's reaction to it, with household savings levels reaching historically high levels. The US and China are still the two largest economies in the world, but even with the pandemic downturns in 2020, Australia is now the 13th largest economy in the world, overtaking the likes of much bigger countries such as Spain. Australia is still a country with just 25 million people, making it comparatively rich on a per capita basis.



Source: www.gapminder.org.

Movements from cities

Another shift that is a direct result of the pandemic is the significant change in where people choose to live. For many decades there has been a one-way movement from regional and country areas into Australia's cities. However over the past 18 months there has been a trend of younger people, particularly millennials moving away from the cities and into the regions, creating a property boom in these areas.

Younger people are looking for a lifestyle change and prioritising more space for their young families. Some potentially are wanting to get away from the spread of Covid in the higher density city areas, which of course bring more lockdown measures. Regional housing is also cheaper for younger people and 'working from home' measures have allowed younger people and families to work from the regions, rather than just commuting to the city.

Opportunities for investors

Some of the industries that are set to grow from these demographic shifts include healthcare, technology, and logistics, which will offer attractive opportunities for investors.

For example, since more people are working from home and living outside of the cities, the warehousing and logistics sector is set to grow even further. Although shops are closed, people are buying just as much as ever, but consumption is moving online, driving demand for more warehouses and delivery services. Therefore, quality logistics and freight companies that have a good geographic range through warehousing and distribution centres, along with a wide range of delivery capabilities, display a good pipeline of growth.

Another industry set to grow is healthcare, specifically technological advancements in healthcare due to the aging population.

As people age, they have different healthcare needs, ranging from hearing aids, hip replacements, glasses, certain drugs, or heart operations. For example, eyesight declines with age, so the eyecare sector is likely to grow. The increased use of screens and electronic devices is also having a negative impact on eyesight. Out of a global population of 7.6 billion, it is estimated that 60% of people need eye correction, but only 40% are getting it done. So, the opportunity here is set to expand. For investors this means finding healthcare opportunities that seek to improve patient care through leading niche technologies that are already out in the market.

The aging population creates more people needing surgery. This is where technology advancements in healthcare come in through the likes of robotic surgery. The use of robotic surgery allows for treatment in a minimally invasive manner. The benefits of this are greater accuracy, lower complication rates, and ultimately, reduced days in hospitals, which saves the healthcare system money.

The healthcare industry is expected to innovate more to get ahead of any future variants and other viral infections. Innovation in the case of Covid-19 and other viral infections can open a new world of opportunities for investors. Investors can put money behind companies to help accelerate these treatments, while allowing these companies to bolster their cash flows, in turn, creating a solid investment.

Therefore, there is ample amounts of opportunity to invest in a more dynamic future through changing demographics. Industries of healthcare, technology, and logistics, along with many more, will thrive from these demographic trends.

For investors, a good place to start is with those companies where a significant proportion of value creation comes from demographic factors.

Aneta Wynimko is Co-Portfolio Manager, Fidelity Global Demographics Fund at Fidelity International, a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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It's not high return/risk equities versus low return/risk bonds

Damien McIntyre

A thorough understanding of how sub-investment grade bonds work, and the reasons for their high yield, can help investors discard the 'junk' label, and potentially replace it with 'juicy'.

Interest rates might be predicted to rise in the US but for many months they have been kept notoriously low globally as governments use monetary policy to stimulate economies out of COVID-19 induced lulls. As a result, the return on investment grade bonds has also been low, and not much better than cash. But it is possible to generate equity-like returns from bonds, with a lower risk than previously thought.

What is junk?

Whether going by the name of speculative, junk or high-yield, any bond with a rating less than BBB is sub-investment grade. These bonds are given lower ratings because the issuer is deemed to be less likely to pay the bond back (in other words, they are more likely to default), therefore the investor is compensated for the increased risk with the higher return.

The US high-yield bond market accounts for $US1.5 trillion in issuance, with more than 1,000 issuers that include Netflix, Tesla, Ford American Airlines and MGM.

The Bloomberg Barclays Global Aggregate Bond Index includes almost all investment grade bonds and accounts for $US60 trillion in debt. Its average yield is around 1%. The smaller Global High Yield Index has a market value of $US2.3 trillion but an average yield of 5.8%. Despite its smaller size, this index generates $130 billion in annual income.

To put that in perspective, the global high-yield market is just 4% the size of the investment-grade market but generates 20% of the income.

Risk versus return

Of course, investing in high-yield bonds is not all smooth sailing, and when the aggregate index is broken down, a negative price return can be observed. That is because over time some of the bonds in the index do default or fall in price when investors start to get nervous about an issuer's credit standing.

But there are enough bonds in the index – potentially hundreds - to compensate if any one company defaults. And even if a bond falls in value, the yield, or coupon, is fixed and the investor will continue to receive that income.

Since 1996, the US High Yield Index had an average return of 7.8% from coupons and -1.1% from price, resulting in a total return of 6.6%. Since 1986, the US High Yield Index has had an annualised total return of 8.2%. The S&P 500 returned an annualized 10.6% over the same period. Not bad for bonds!

Bonds versus equity

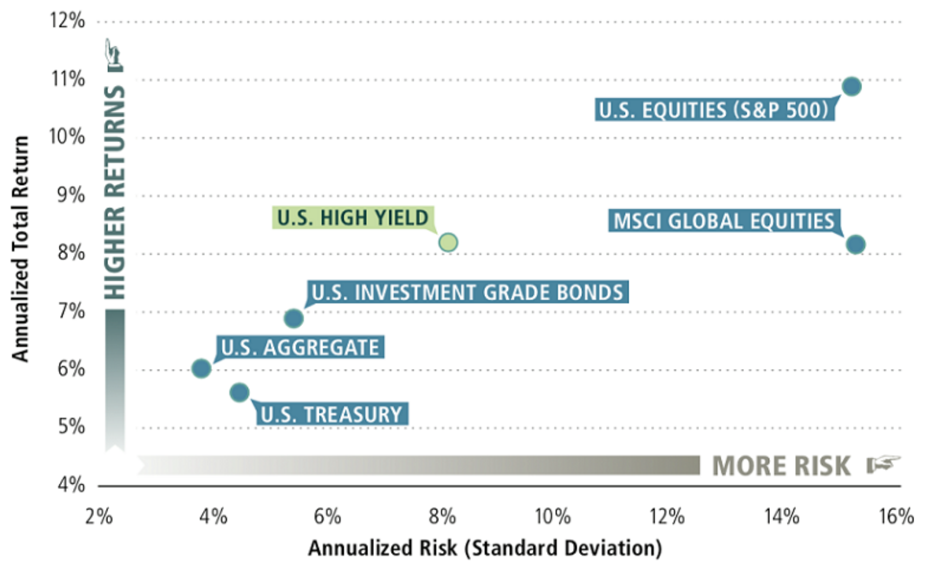
The elephant in the room here, of course, is that while an annualised total return of 8.2% for high-yield bonds is attractive, it's not as good as an annualised return of 10.6% which is what the S&P 500 has returned since 1986.

But we're not arguing that high-yield bonds are a substitute for equities here. Rather, as a yield-producing investment, they can play a role in a portfolio alongside equities, traditional fixed income and other asset classes.

The income-producing features of high-yield bonds are also attractive to investors at certain life stages. Retirees, for example, are much more interested in income returns than capital returns and do not like volatility.

When comparing the standard deviations of the high-yield bond index and equities, high-yield bonds have far less volatility than equities but higher returns than other bond classes, as per the table below.

fig 4. BALANCED DIET:
RISK VERSUS RETURN FOR SELECTED STOCK AND BOND INDICES SINCE 1986



Sources: Bloomberg, Payden Calculations

Another factor working in high-yield bonds' favour is their lack of sensitivity to interest rate changes, compared to other bonds. Traditionally when interest rates rise, as is expected to happen in the US in the not-too-faraway future, bond prices fall as there is an inverse relationship between interest rates and bond prices.

However, high-yield bonds offer investors higher interest rates over and above official cash rates, and the differential between the cash rate and the bond's higher coupon is likely to be a much bigger influence on high-yield bond prices.

Furthermore, cash rates usually increase during periods of economic growth, which are positive environments for high-yield bond issuers, as their creditworthiness improves.

A place for everything

It's time to shake off the traditional idea of high-return, high-risk equities and low-risk, low-return bonds. Every asset class has value in its own right.

High-yield bonds carry more risk than investment grade bonds, but they also offer higher income returns, less volatility and less sensitivity to cash rate movements. All factors which make an allocation to high-yield bonds in an investment portfolio - alongside traditional equities and bond allocations – worth considering.

Damien McIntyre is CEO of GSFM, a sponsor of Firstlinks and distributor of the Payden Global Income Opportunities Fund in Australia and New Zealand. This article contains general information only. Please consider financial advice for your personal circumstances.

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