Firstlinks
a Morningstar company

Edition 428, 8 October 2021

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Editorial

Cognitive dissonance is the mental discomfort caused by holding two conflicting beliefs or values. We might rush into buying a house although we believe prices will fall but the fear of missing out is even worse. We don't like the pain inflicted by excessive gambling but we invest in casinos. Alcohol destroys families but a beer company sponsors our local football club. We believe sugar is detrimental to health but we work for a soft drink maker. A short-term share trade makes a loss and becomes a long-term investment.

F. Scott Fitzgerald even justified dissonance when he said:
"The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function."

Insiders say Steve Jobs could hold completely disparate ideas and values in his mind at the same time and still act on them.

For many people, an inconsistency between a long-held value and a recent action can be troubling, and tension is relieved in different ways. We rationalise, reject, justify and explain. *"Yes, more jobs means higher economic growth but it will lead to interest rate rises and lower economic growth."*

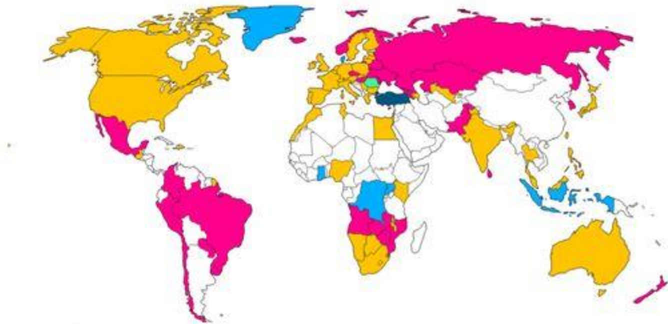
Financial markets are full of conflicting beliefs. Central banks pump trillions into the economy with no apparent downside, where once we believed inflation would be inevitable. Now, as inflation is rising, we call it transitory and interest rates do not need to respond. We know nobody can accurately forecast the next market downturn but we listen to expert predictions every day. The majority of active managers cannot outperform their benchmarks but there is more money under active management than passive.

Consider this paragraph from the weekly newsletter of the highly-respected global financial analyst, **John Mauldin**, typical of much market commentary.

"The latest volatility may or may not turn into something more extended. Some of the most respected market analysts are turning bearish. Still, others expect the bull market to continue. Timing is hard. Yet nothing has happened to make bear markets impossible. Stocks are overextended by many different measurements, so at some point, the bears will take control. More than a few investors aren't ready for that possibility."

Say, what? Some bears, some bulls, markets are extended or maybe not. It's enough to dissonant your cognition.

The Governor of our Reserve Bank, **Philip Lowe**, said Australian interest rates will not rise until 2024 while the **Reserve Bank of New Zealand** yesterday moved up 0.25% to 0.5% with another increase expected in November. Australian rates may need to rise if inflation takes hold as New Zealand is not the first to move up.



Cognitive dissonance is worse in politics, because the number one aim of any political party is to win elections. There is no point being a politician in opposition, so policy is not good if it is too unpopular. The **Labor Party** recently abandoned the negative gearing, capital gains tax and franking credit policies previously argued for. And at his 'back in black' budget in 2019, Treasurer **Josh Frydenberg** said:

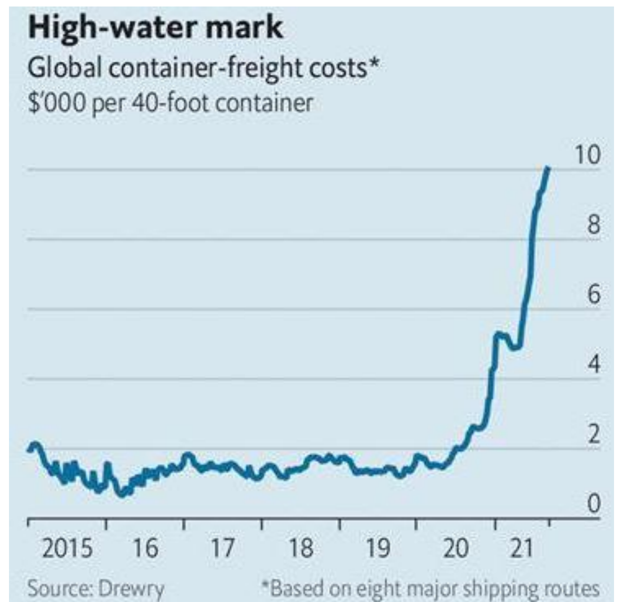
"The country is now living within its means. We have got there by being restrained and disciplined."

Within two years, the FY21 budget deficit was $134 billion due to COVID costs. Fair enough in a pandemic, but Josh Frydenberg presided over a **JobKeeper** programme worth $89 billion where an estimated 31% of recipients were not eligible, with no ability or desire to clawback claims by employers who exaggerated their losses. Australia faces a submarine project costing an unknown amount above $100 billion for equipment not delivered until 2040 at best. At a state level, there are billions for new stadiums that replace good stadiums, light rail that is slower than buses and an unlimited money for favourite local projects. What happened to '*restrained and disciplined*'?

A Federal election is due by 21 May 2022. While most of us have taken our medicine to ward off the virus, we will be less inclined to accept a cure for budget deficits. As befits spending in a crisis, the budget deficit in FY21 was the largest dollar amount in history and the largest as a share of GDP since WWII at 28.6%. Yet the **Parliamentary Budget Office** has estimated that net debt could be reduced by $276 billion by 2030 if we do not proceed with planned personal tax cuts for wealthier people. The Treasurer insists they will proceed.

And there is a cognitive dissonance. The Treasurer says tax cuts are in his Government's DNA but as recently as December 2019, he was proud of the restraint delivering a budget surplus for 2020/21. As the next six months roll into an election campaign, voters will buy the promises of largesse. In 2020 and 2021, it has looked as if central banks can print money and pay for almost anything with no adverse consequence.

Much like the conflict in our minds of our largest trading partner also being our biggest national security threat, that's what's known as a cognitive dissonance.



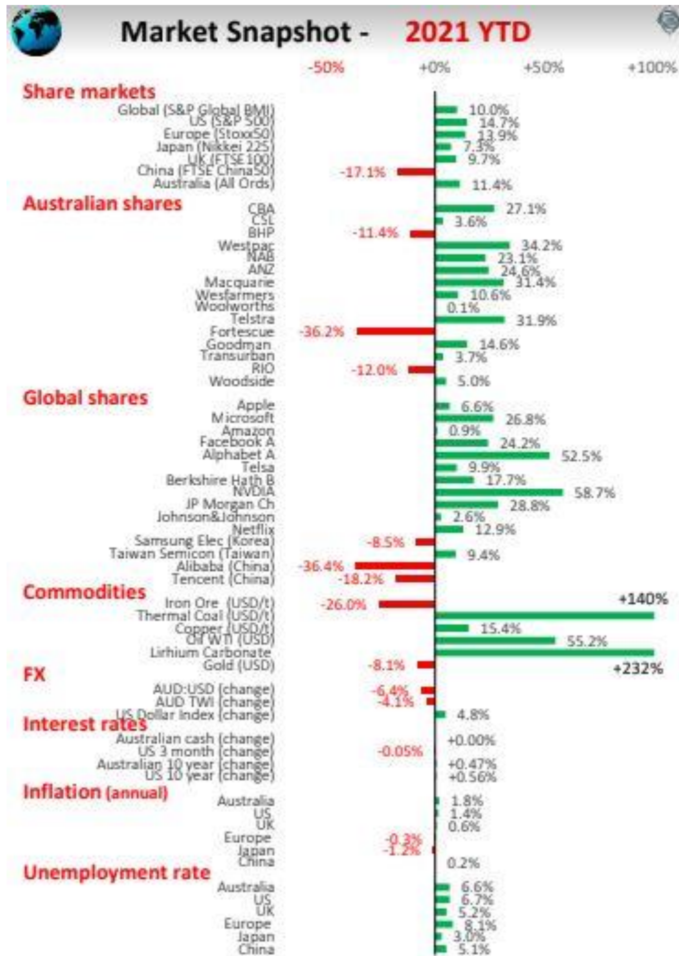
Meanwhile ... signs of inflation are everywhere, such as rising global energy costs, shortages of supplies, increasing house prices and global shipping costs, as shown here.

Amid all this turmoil, the market has experienced a few wobbles but hangs on to its gains. Courtesy of **Ashley Owen** (next page) here are the major markets and other data points for 2021 to the end of September. Stay away from China and it's nearly all green, and there's a cognitive dissonance between rises in coal prices at a time when the world is supposed to be turning away.

As we emerge from lockdowns, with freedom to move and billions to inject into the economy, it will be a volatile time for economic growth and prices. Good luck finding a builder for a renovation in the next year. **APRA** has announced the first of the prudential controls on housing that we called for last week. In itself, it will have little impact as the 3% 'buffer' now required by banks on loan repayments is close to the 'floor' many banks are already using, but there is more to come.

So it's a good time to take a quick stocktake with five charts on who pays the taxes, who owns the assets and who earns the income. What do an average 100 Aussies look like?

Ashley Owen then takes us through the recent history of Australian house prices, when and why they rise and fall, and he justifies his price views for the coming year or two. Nobody has better charts than Ashley.



The world is experiencing another disconnect between the timing of renewables and batteries coming online and the cutback in investment on fossil fuels. **Roy Chen** explains the consequences drawing on Europe's chilling experiences. In the short term, it's great for Australian gas exports but it will feed into inflation.

Amy Arnott summarises **Morningstar** research in the US which shows the poor investment results for many investors compared to the funds they invest in due to the timing of cash flows (the dollar-weighted returns). Combined with taxes and fees, it's a major impediment to investment success.

Drawing on a speech that **David Gonski AC** gave to the **UNSW Graduate School**, he delivers nine pearls of wisdom from his vast business experience and leadership. Mr Gonski is considered the best-connected of businessmen and has chaired many companies, and he knows what works and what doesn't.

Still on lessons into how to run a business, **Delian Entchev** dives into the success of the prestige goods company **Louis Vuitton Moet Hennessy (LVMH)**. Its amazing collection of 75 brands in cosmetics, wines, spirits, watches, travel goods and fashion are at the top of their game and will benefit from spending coming out of lockdowns.

And **Michael Collins** gives a fascinating update on ransomware, which is not only hitting homes and businesses but national security, and he offers a radical solution to stop the payments feeding to problem. I personally faced a ransomware attack some years ago which did not end well, and I've been wary of clicking on unrecognised email links since.

The Comment of the Week comes from C, among many excellent thoughts on Saul Eslake's housing article:

"Do you know who are those people priced out these days? It's not just the waitresses and childcare workers but also those well educated and qualified professionals in their 40s with family income 200k-300k. The problem is they don't have rich parents. Are those families expecting too much for wanting to live in a 3 bedroom house in a reasonably good school catchment?
In all honesty, how many of you have helped your children with house deposits? I know a couple with $150k family income bought $3m and several couples with approx. $250k family income bought $4m houses. All with parents' help. Their parents' houses are now worth $7m, $8m.
The way things are going, I will have to help my kids in the future too. My kids have no interest in money professions. They want to be engineers and build things, or scientists who cure cancers. With their intelligence and maths skills, frankly speaking, I think it would be a waste of talent if they end up working for banks and financial engineering products. I have nothing against bankers. Just thought it would be a tragic loss to society if all intelligent people need work in banking just so they can afford a house in north shore."

100 Aussies: five charts on who earns, pays and owns

Graham Hand

Each year, the Australian Taxation Office (ATO) publishes a snapshot of the 14.7 million individuals who lodge tax returns. Many returns are not lodged on time, so the latest data is for FY2019, but it reveals some surprises. The ATO also summarises some of the demographics of taxpayers (and non-taxpayers).

We are heading into a period of opening up the economy after COVID, with the need to repair the budget, an election looming by May 2022, the threat of inflation and a withdrawal of central bank stimulus. Any policy steps should recognise who pays the bills and who owns the assets.

For every 100 Australians lodging returns:

- 10 are from Generation Z (born from 1996 to 2009)
- 35 are from Generation Y (born from 1980 to 1995)
- 31 are from Generation X (born from 1965 to 1979)
- 19 are from Baby Boomers (born from 1946 to 1964)
- 4 are from the Silent Generation (1945 or earlier).

So over 75% of returns are lodged by people younger than Baby Boomers. Of the 100 people, 80 received a refund, 13 owed tax and 7 were perfectly balanced. Only 5 declared a capital gain, while 15 earned rental income (9 declared a net rental loss, 6 a net rental profit).

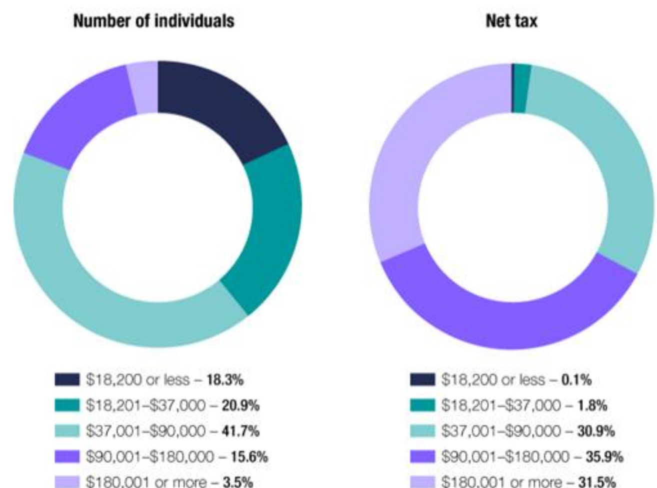
Let's look at five big pictures on who we are.

1. Who pays tax?

Every decision on tax rates and welfare involves a trade-off which requires wealthy people to support poor people. That's part of a fair society and a progressive tax system. At a high level, those who have look after those who have not.

There are infinite nuances. What about people who are able to work but choose not to? Should they be supported? That is why Centrelink has rules that some welfare recipients need to demonstrate they have tried to find employment.

The data (right) shows nearly 40% of individuals pay only 2% of personal income taxes. Many of these would also receive welfare so many people make no net contribution to government revenue (ignoring other taxes such as GST).



At the other end of the scale, 3.5% of people pay nearly one-third of personal taxes, and another 15.6% pay 36%. That means less than 20% of people pay two-thirds of personal income tax.

That's our system, but policy and society need to recognise that, as it should be, high-income earners provide the services for low-income earners.

The ATO provides a further breakdown by ranking the 100 people by their taxable incomes:

- the top 3 paid 29% of all net tax
- the next 6 paid 19% of all net tax
- the next 31 paid 40% of all net tax
- the next 35 paid 12% of all net tax
- the final 25 didn't pay any tax.

2. Investment properties

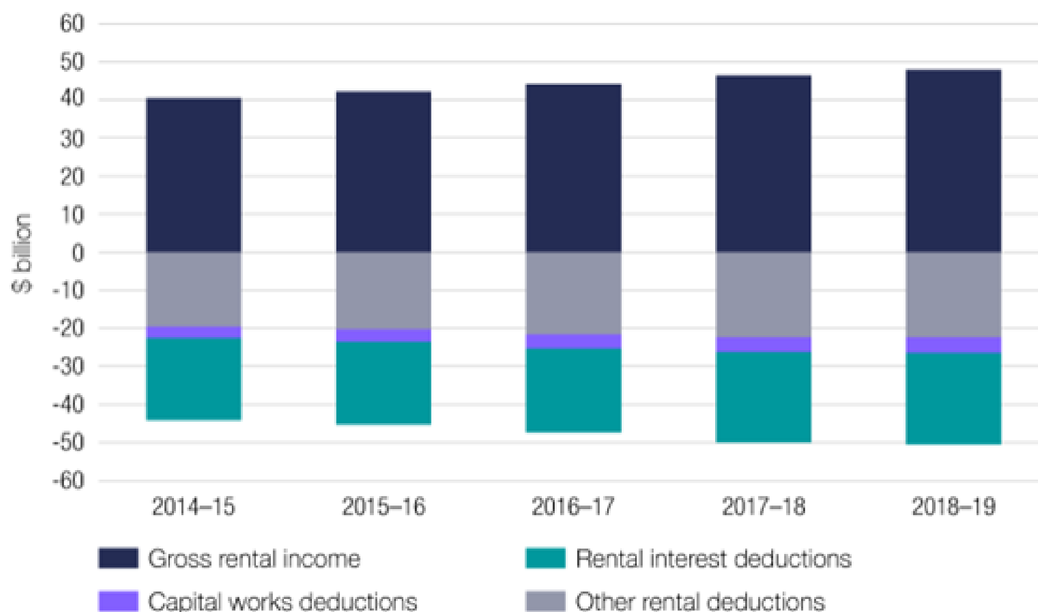
Let's turn to assets, with most household wealth held in residential property, soon to top $10 trillion after the recent price surge compared with about $3.2 trillion in superannuation.

Over 2.2 million Australians own investment property. That's a lot of people enjoying the current housing boom (in addition to owners of Principal Places of Residence). Over 20,000 own six or more properties and it's party time funded by low interest rates.

Of the 2.2 million, about 60% or 1.3 million claim a net loss, which can be charged against other personal income.

Property interests (no.)	2017–18			2018–19		
	Net rent loss (no.)	Net rent neutral/ profit (no.)	Total individuals (no.)	Net rent loss (no.)	Net rent neutral/ profit (no.)	Total individuals (no.)
1	943,092	628,125	**1,571,217**	931,132	658,431	**1,589,563**
2	254,508	164,298	**418,806**	250,035	170,494	**420,529**
3	76,304	53,480	**129,784**	74,955	54,861	**129,816**
4	27,300	20,169	**47,469**	26,719	20,600	**47,319**
5	11,298	8,563	**19,861**	10,935	8,578	**19,513**
6 or more	11,613	9,143	**20,756**	11,226	9,208	**20,434**
Total	**1,324,115**	**883,778**	**2,207,893**	**1,305,002**	**922,172**	**2,227,174**

In total, the gross rental income of almost $50 billion (thank you, renters!) is offset by a slightly larger amount of capital works deductions and other rental deductions (mainly mortgage interest) to produce a net loss for the 2.2 million people overall. It's thoughtful of tax policy to allow the loss to be charged immediately against income rather than the treatment of business losses which must be carried forward and charged against future profit.



3. Taxable incomes

For FY19, the average taxable income was $62,549. As this number is inflated by some very high earners, a more representative number is the median (as many people above the number as below) of $47,492.

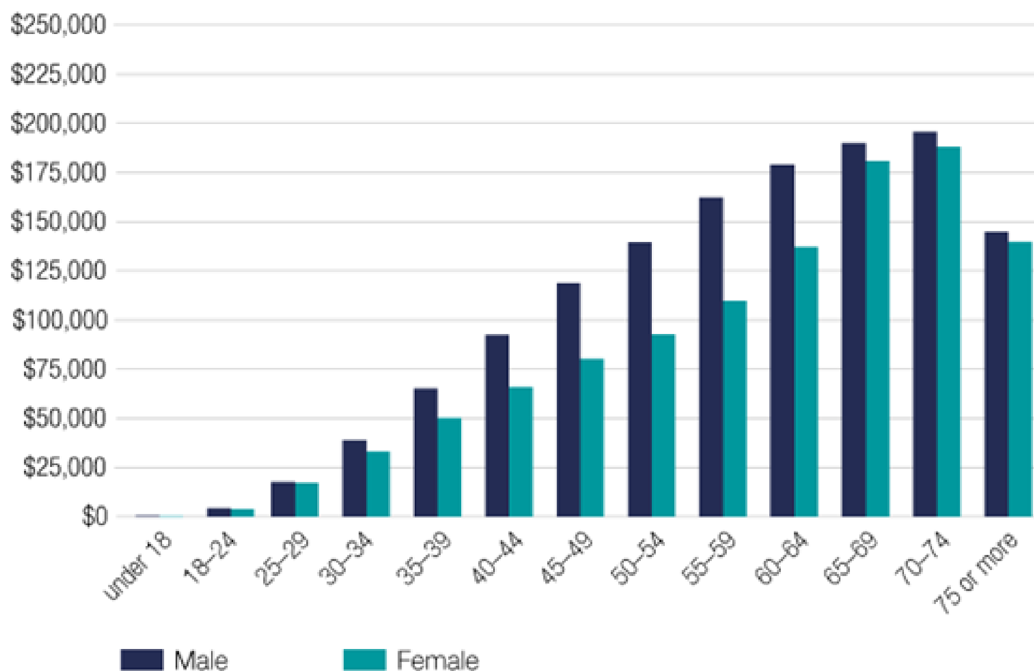
This number is worthy of a moment's reflection. Half of Australians earn less than $48,000 a year. While this number includes many who are asset rich/cash poor (retirees, superannuants, owners of valuable properties on age pensions, etc), there are millions not earning the big bucks who are renting and not participating in surging property and stock markets.

	2017–18			2018–19		
	Male	Female	Total	Male	Female	Total
Average taxable income ($)	71,917	49,922	**61,217**	73,218	51,382	**62,549**
Median taxable income ($)	54,252	39,058	**45,882**	55,829	40,547	**47,492**
Average net tax ($)	23,241	14,582	**19,248**	23,365	14,687	**19,344**
Median net tax ($)	14,036	8,699	**11,266**	13,801	8,405	**11,024**
Average superannuation account balance ($)	153,288	120,185	**134,770**	162,275	128,068	**143,979**
Median superannuation account balance ($)	53,810	41,776	**45,235**	57,883	45,118	**49,413**

4. Average superannuation balances by age

Most people do not have much in superannuation, with the median stated at less than $50,000 (and women $45,000), as shown above.

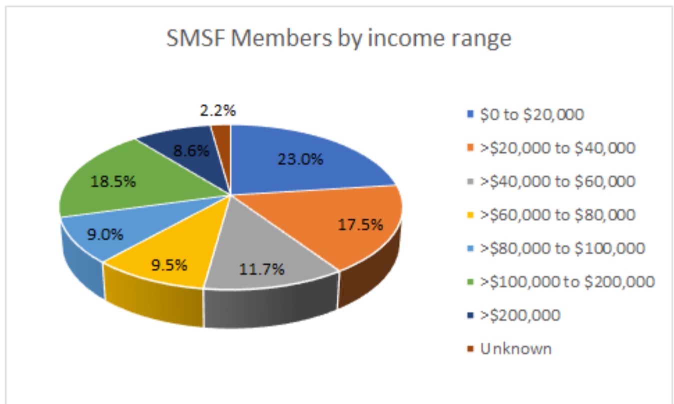
This disguises balances by age. Obviously, older people have more super. Most have been in the system longer, have benefitted from compounding and good market returns, earn more than younger people with more opportunities to contribute extra. But even for people aged 65 and over, average superannuation balances of less than $200,000 will only finance a decent retirement if there are other assets such as owning a home and investments outside super.



5. SMSFs

Turning to another ATO report, the [SMSF statistics for June 2021](), reveals there are almost 600,000 SMSFs with over 1.1 million members holding assets of $822 billion. The top two asset types are direct holdings of listed shares (28% of total SMSF assets) and cash and term deposits (18%). In addition:

- 86% of SMSF members are 45 years or older
- average assets per SMSF member were $696k
- average assets per SMSF were $1.3mn
- member contributions into SMSFs were $12.6bn
- employer contributions into SMSFs were $5.4bn



Although SMSF members are usually older, this does not mean they are high income earners. In fact, the chart (right) shows that only 18.5% have income over $100,000 to less than $200,000, with 8.6% over $200,000. That leaves nearly three-quarters of SMSF members earning less than $100,000, and a quarter less than $20,000.

The main reason is not that younger people on lower salaries represent a high proportion of SMSF members. Rather, super funds are legal entities and tax is paid within the fund rather than being passed into an individual's taxable income. A person may operate a $10 million SMSF but have little in personal income.

Graham Hand is Managing Editor of Firstlinks.

House prices surge but falls are common and coming

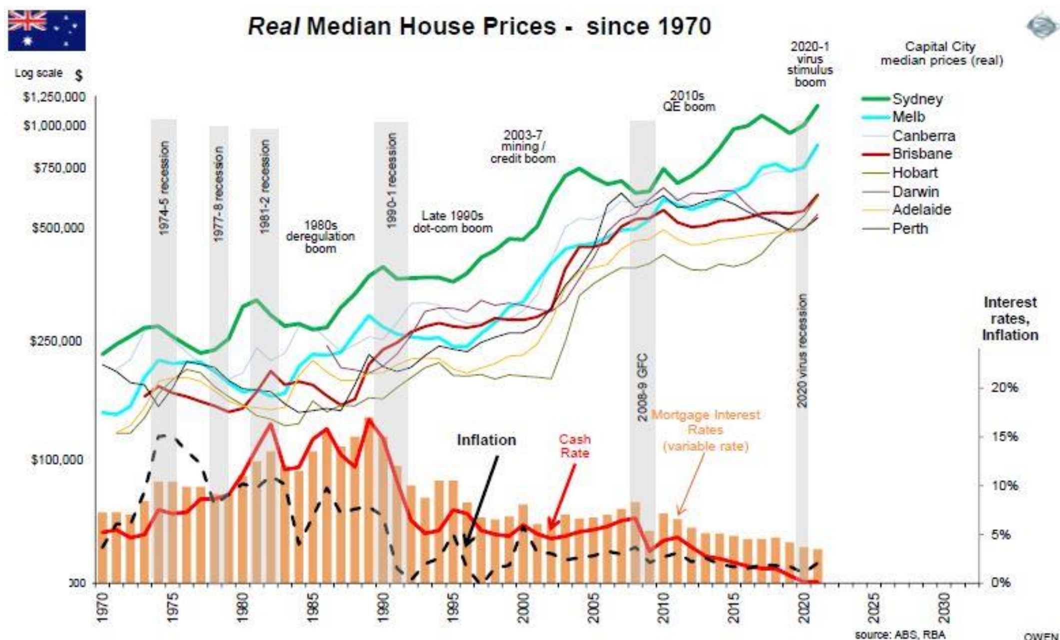
Ashley Owen

Residential house prices have surged well above pre-covid levels, despite lockdowns, high levels of underemployment, a dramatic reduction in migrant arrivals and jobs uncertainty.

Plenty of short periods of falling house prices

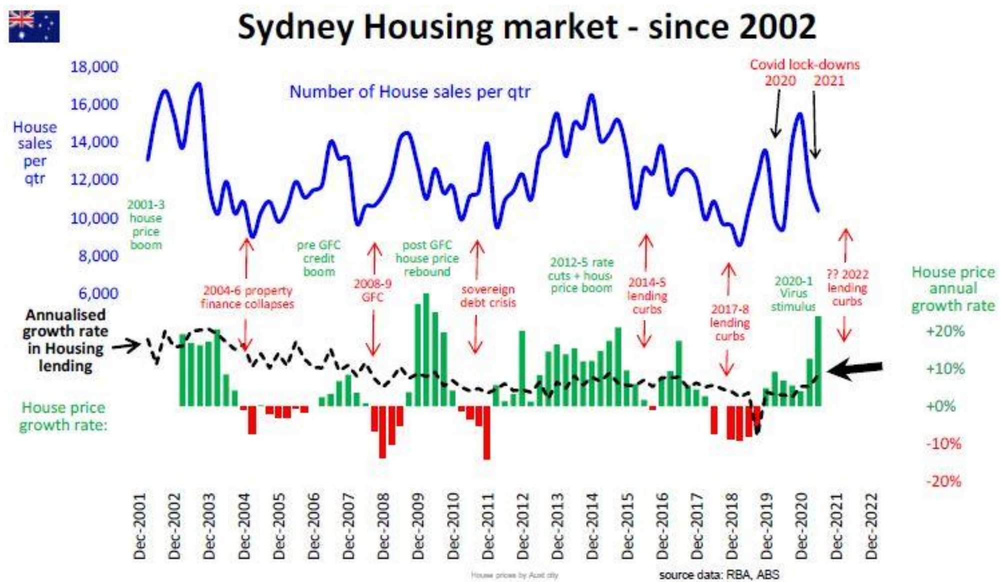
The general impression is that house prices always rise. In fact, prices slowed or contracted during the 2001-5 property finance collapses, the 2008-9 GFC and the 2010-11 sovereign debt crisis. More recently, prices were also brought down by government-imposed lending curbs, first in 2014-15 and then in 2017-18. New Zealand and several other countries have introduced lending restrictions in recent months to slow runaway house prices fuelled by debt at ultra-low interest rates. In Australia, the regulator APRA is likely to do more soon and has already announced an increase in the lending rate 'buffer' to 3%.

The chart below shows 50 years of real (inflation adjusted) house prices in Australian capital cities, and there are plenty of periods of falling prices. Another may be coming soon.



The next chart shows the Sydney housing market pulse in more detail. The blue line tracks the number of house sales per quarter, swinging widely between 16,000+ house sales per quarter in the booms, and then halving in the slowdowns. The green and red bars in the lower section show the annual rate of growth in median prices. It is currently running at 24% growth.

The black dotted line in the lower section of the last chart is the annual rate of growth in housing lending. To the right we see that in 2021, lending growth shot up again to levels that are above the those right before the 2014-5 lending curbs, and above the level right before the 2017-8 curbs.



Direct lending curbs are dressed up in a fancy name these days ('macroprudential policy') but they are nothing more than old-fashioned pre-deregulation lending controls in the 1950s to 1970s. Direct lending controls are better than general interest rate rises because they affect the volume of money for the lenders, not the price of money for everyone else, including business borrowers, who should be borrowing more, not less.

House prices rising but why?

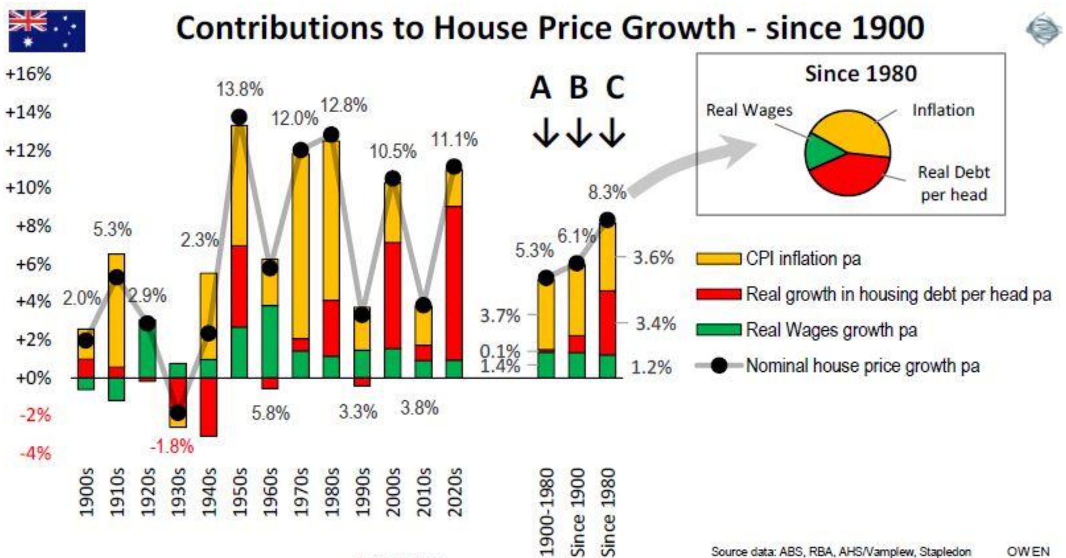
House prices are rising because buyers are paying more for them, of course. But where does the extra money come from?

In 1900, the median house price in Sydney was £890 (A$1,780), and the Australian capital city median house was £730 (A$1,460). In the most recent figures (ABS June 2021) the Sydney median was $1,187,500 and the capital city median was $888,000. Over 120 years, that represents average price growth of 6.1% p.a. for both Sydney and the capital city median.

The extra money buyers pay today has come either from their own pockets (higher incomes), or from other peoples' pockets (debt). If we strip out inflation from each of these, we can separate the sources of house price growth into three components:

(i) real wages growth above inflation
(ii) real growth in the level of debt above inflation, and
(iii) inflation.

The next chart breaks out the overall growth in median capital city house prices into these three components by decade since 1900. The three bars in the middle show the summary periods. Column 'B' shows the overall average



contributions since 1900; column 'A' is for the period 1900 to 1980, and column 'C' (and the pie chart) is for the period since 1980.

More than half of the overall growth in house prices has been due to inflation with CPI inflation averaging around 3.6% pa from 1900 up to now.

Recent price rises, funded by debt, outstrip inflation

By itself, declining real wage growth should *reduce* the rate of real house price growth (because people have relatively less money to spend) but this has been more than offset by a dramatic rise in housing debt. The red bars in columns A (pre-1980) and C (post-1980) show that real (ie after inflation) level of housing debt per head of population did not increase at all from 1900 to 1980 but, since then, it has grown by 3.4% pa *above inflation*.

Since 1980, three quarters of the growth in real house prices has come from increases in debts and only one quarter of the growth has been due to higher incomes.

Will house prices continue to rise?

Looking at the outlook for each of these three components of house price growth:

(i) For inflation - we estimate around 2-3% pa in the coming years, which is lower than the 3-4% average since 1900.

(ii) For real wages growth – we are unlikely to see a reversal of the post-1980 trend of lower real wages growth. Although we are starting to see signs of a return to protection and onshoring of some jobs in some industries, it is unlikely to reverse the effects of technology, automation, casualisation and 'uberisation' of work.

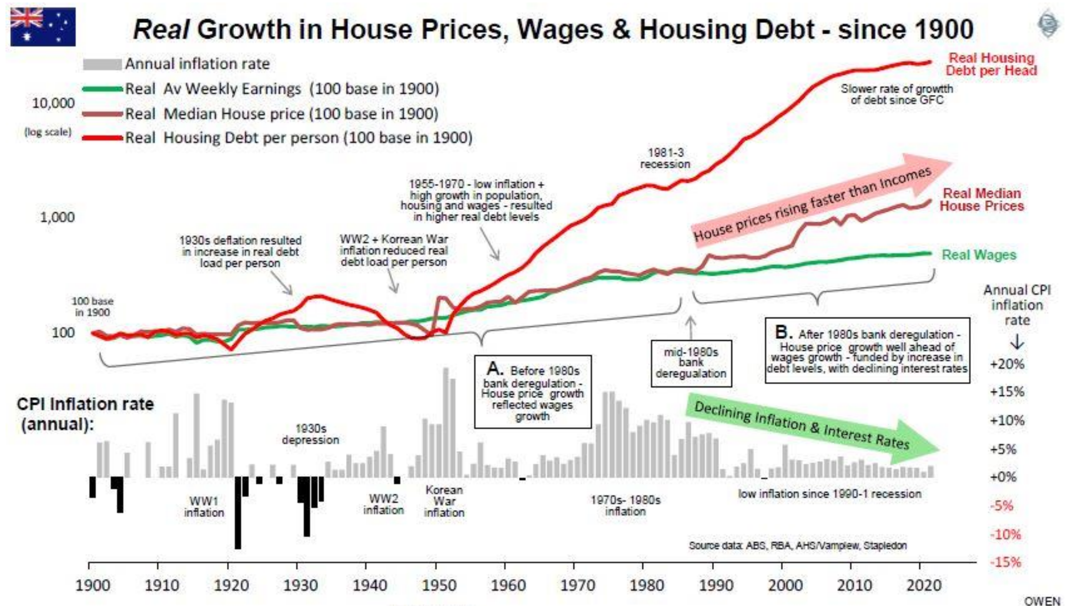
(iii) For debt – house prices can only keep on rising at the same rate if buyers keep increasing their level of housing debt. We consider this next.

House price growth driven mainly by increase in debt

The next chart shows the growth in Australian capital city median house prices since 1900 (maroon line), and the three main components of price growth – real wages (green line), real debt per head of population (red line), and inflation (grey bars).

Until the 1980s (box 'A'), house prices (maroon line) followed wages (green line) in almost in lockstep, which is logical because people can spend more money on housing only if they have more money to spend.

However, from the 1980s onward (box 'B'), house prices and wages started to diverge onto different paths. What happened in the 1980s?



First, real wages growth (green line) slowed, as a result of the factors listed above. Despite the RBA pining over illusory wages growth, the trend will not reverse.

Second, the key turning point in the 1980s was bank deregulation, in particular the removal of government controls on interest rates, lending volumes, and the entry of foreign and non-banks. The ready availability of credit from many sources has increased substantially.

Third, inflation and interest rates fell (grey bars), allowing much larger loans per dollar of repayment. For example, in the late 1980s, I had a $240,000, 25 year 'principal and interest' mortgage. In 1989 the rate was hiked up to 18% (inflation was 8%). This increased repayments to $3,640 per month, which was more than half of my net income. This year, my daughter bought her first house, borrowing $475,000 from ANZ at 2.0% 'interest-only' with repayments of $791 per month, which is a small fraction of her net income. At the same age as I was, she borrowed twice the amount of my loan, but her repayments are one fifth of mine.

This huge expansion of debt (red) at lower interest rates, pushed up house prices (maroon) at a greater rate than wages growth. The chart only shows official housing debt, but there is now a sizeable amount of 'Bank of Mum and Dad' debt on top. Every dollar of family money pushes up prices by another dollar, creating an upward spiral fuelled by 'FOMO'.

Interest rates cannot go lower

The 30-year boom in house prices rising well ahead of income growth is nearing an end. House prices can continue to keep on rising at rates above incomes only if interest rates continue to decline further. Interest rates have not only ended their 30-year decline, they are now more likely to rise than fall from here. The only question is when - and it will be soon.

(We have not discussed some other elements in housing – population, immigration, home ownership and supply constraints – the list goes on. Australia's heavy reliance on immigration took a hit in the lockdowns but is likely to remain favourable for housing in the medium term, especially from China, Hong Kong and Taiwan).

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

Why do investors earn less than the funds they invest in?

Amy C. Arnott

Why would investors earn less than the funds they invest in? It all comes down to timing.

Our *'2021 Mind the Gap'* study of dollar-weighted returns finds investors earned about 7.7% per year on the average dollar they invested in equity funds over the 10 years ended 31 December 2020. This was about 1.7% less than the total returns their fund investments generated over that time span.

This shortfall, or 'gap', stems from inopportunely-timed investment in and redemptions from funds, which cost investors nearly one-sixth the return they would have earned if they had simply bought and held.

The persistent gap makes cash flow timing one of the most significant factors – along with investment costs and tax efficiency – that can influence an investor's end results.

What is the gap between investor returns and total returns?

To use a simple example, let's say an investor puts $1,000 into a fund at the beginning of each year. That fund earns a 10% return the first year, a 10% return the second year, and then suffers a 10% loss in the third year, for a 2.9% annual return over the full three-year period. But the investor's dollar-weighted return in this simple example is negative 0.4%, because there was less money in the fund during the first two years of positive returns and more money exposed to the loss during the third year. In this case, there was a 3.3% per annum gap between the investor's return (negative 0.4%) and the fund's (2.9%).

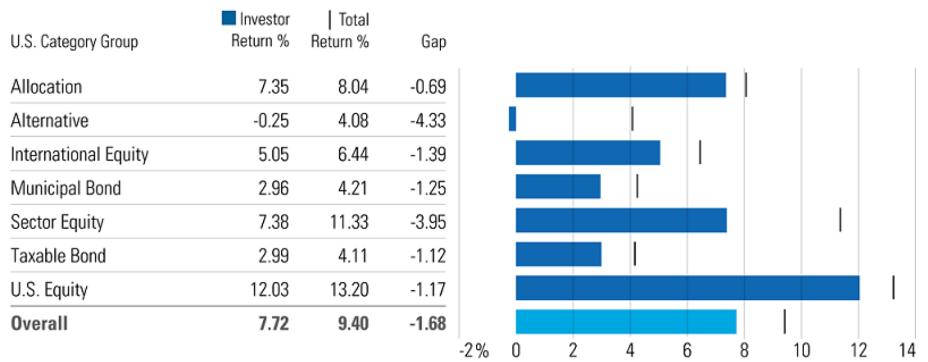
In our study, we estimate the gap between investors' dollar-weighted returns and funds' total returns in the aggregate. This allows us to assess how large the gap is and how it's changed over time.

The results by different fund types

More specialised areas with the most volatile cash flows - namely, alternative funds and sector equity funds - fared much worse than average and pulled down the aggregate results. The more mainstream areas that are home to the majority of investor assets such as broad equity and bond funds fared much better, with return gaps of about 1% per year.

In this US study, equity fund investors experienced a 1.2% annual gap while bond fund investors suffered a 1.1% gap per year.

The Gap by U.S. Category Group (10-Year Returns)



U.S. Category Group	Investor Return %	Total Return %	Gap
Allocation	7.35	8.04	-0.69
Alternative	-0.25	4.08	-4.33
International Equity	5.05	6.44	-1.39
Municipal Bond	2.96	4.21	-1.25
Sector Equity	7.38	11.33	-3.95
Taxable Bond	2.99	4.11	-1.12
U.S. Equity	12.03	13.20	-1.17
Overall	**7.72**	**9.40**	**-1.68**

Source: Morningstar. Data as of Dec. 31, 2020. Excludes commodities category group. Gap numbers may not match differences in returns because of rounding.

A few other areas worth noting:

- *Asset allocation funds* had the smallest gap, suggesting that their built-in asset-class diversification makes them easier for investors to buy and hold over time. Investors in these funds, which combine stocks, bonds, and other asset classes, experienced a dollar-weighted return lag of only 0.69% per year over the 10 years.
- *Alternative funds* have proved difficult for investors to use successfully. The average dollar invested in these funds lost about 0.3% annually over the 10 years, which was a remarkable 12% per year less than the returns in US equity funds.
- *Sector-specific equity funds* also saw negative gaps for investors, by about 4% per year. These specialised funds were doubly disappointing, with returns lagging diversified equity funds and investors failing to capture the full benefit of those lower returns.

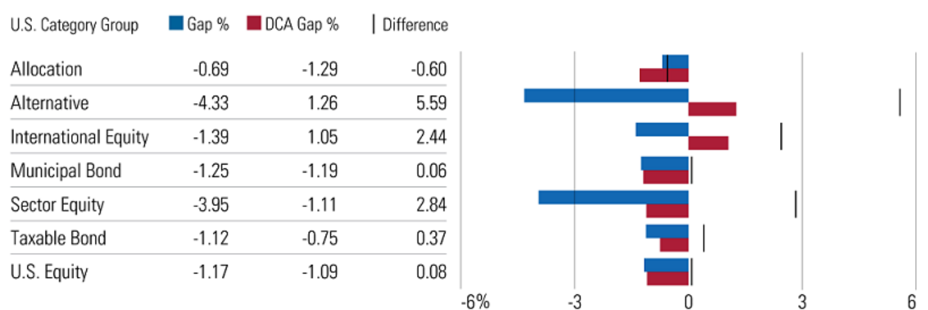
How does dollar-cost averaging impact investor returns?

We also added a series of returns to see how the results would look in a hypothetical scenario in which an investor contributed equal monthly investments (dollar-cost averaging) to funds in each broad category group.

Dollar-cost averaging doesn't usually lead to better results compared with a buy-and-hold approach. In fact, because market returns are often positive, dollar-cost averaging often leads to lower investor returns.

This simply reflects the underlying maths of total returns: If returns are generally positive, investors are typically better off making a lump-sum investment and holding it for the entire period. Investors who contribute smaller amounts over time often have fewer dollars invested during periods with strong returns.

How Dollar-Cost Averaging Can Help



U.S. Category Group	Gap %	DCA Gap %	Difference
Allocation	-0.69	-1.29	-0.60
Alternative	-4.33	1.26	5.59
International Equity	-1.39	1.05	2.44
Municipal Bond	-1.25	-1.19	0.06
Sector Equity	-3.95	-1.11	2.84
Taxable Bond	-1.12	-0.75	0.37
U.S. Equity	-1.17	-1.09	0.08

Source: Morningstar. Data based on total returns for the 10-year period ended Dec. 31, 2020. We determine the dollar-cost-averaging data by assuming equal monthly investments made within each category group and then calculating an internal rate of return.

The results show dollar-cost averaging can help investors avoid some of the ill effects of poorly-timed cash flows by enforcing a more disciplined approach. In fact, following such a systematic investment approach would have improved investors' returns in six of the seven major category groups. With international-equity and sector-equity funds, for example, investor returns based on dollar-cost averaging came out more than 2% per year ahead of investors' actual returns.

What to do to improve investor returns

The persistent gap between investors' actual results and reported total returns may seems disheartening, but investors can take away a few key lessons about how to improve their results. The study's results suggest:

1. Keep things simple and stick with plain-vanilla, broadly diversified funds.

2. Automate routine tasks such as setting asset-allocation targets and periodically rebalancing.
3. Avoid narrowly-focused funds for long-term investing, as well as those with higher volatility.
4. Embrace techniques that put investment decisions on autopilot, such as dollar-cost averaging.

These findings shine more light on the merits of keeping things simple. In particular, funds that offer built-in asset class diversification, such as balanced funds, help investors keep more of their returns.

Finally, we found that investors' trading activity is often counterproductive. Investors can improve their results by setting an investment plan and sticking with it for the long term. Investors who follow a consistent investment approach and avoid chasing performance will likely reap rewards over time.

Amy C. Arnott, CFA, is a Portfolio Strategist for Morningstar.

For more details on the results and methodology, see the 2021 Mind the Gap Report. We changed the way we calculate the total returns used as benchmarks for the gap numbers in this year's study. In past studies, we used an equally-weighted average but this year we used an asset-weighted methodology to calculate the average. This change had the effect of increasing the average total return figures used as a benchmark for the gap calculations, leading to a wider return gap overall. This article is general information and does not consider the circumstances of any investor. It has been edited somewhat from the original US version for an Australian audience.

9 ways to position the business of today for tomorrow

David Gonski AC

As business leaders around the world continue to adjust to the unprecedented disruption brought about by the global COVID-19 pandemic, embracing new ideas and planning for bad times is more important than ever, said the Chancellor of UNSW Sydney.

During his speech on 'How do we position business today for what is likely tomorrow?' at a meeting of YPO (Young Presidents' Organization) Sydney Pacific Members, Mr Gonski said practices such as long-term planning and meaningful research and development are important to leaders for future success.

Here are some other future-proofing insights Mr Gonski shared in his speech at the event, which was hosted at and designed by UNSW Business School's Australian Graduate School of Management (AGSM).

David Gonski AC spoke about ways business leaders can better adjust to the unprecedented disruption brought about by the COVID-19 pandemic. Photo: Supplied.

1. Run your business with a long-term view. During his time at Singapore Airlines as a Non-Executive Director, Mr Gonski was very impressed with their long-term planning. The planning for the arrival of the A380 Airbus preceded his appointment to the Board. The arrival of the A3890 at the end of his eight-year term there was smooth and effective as a result.

"Singapore Airlines was commendably absolutely obsessed with the long term," Mr Gonski said. "I put to you that generally in Australia … the long-term is next Tuesday. And it seems to me that we should look much further out."

2. Improve the future of business with R&D. Investing in the right R&D for a company is important to reduce the risks of disruption in the supply chain and from potential competitors, said Mr Gonski. Referring to his time on the board of Fairfax in the early nineties, the Chancellor described the reluctance at the time within the media industry to believe that "the rivers of gold" (advertising revenue derived from newspaper classifieds) would ever dry up.

Of course, fast forward a few years and online competitors such as Seek, for example, overtook Fairfax on revenue from online advertising associated with job opportunities. Mr Gonski concluded that if R&D had been better respected, "I suspect that the concept of the disruptors… would not have been able to so easily steal our lunch."

3. Consider how much capital you need. Just because someone is willing to lend you a certain amount of capital, does not mean you should accept it. "The question should not be how much is the bank willing to lend, but rather how much capital does this business actually need?" said Mr Gonski.

4. Your choice of staff is vital – as is caretaking corporate memory. According to Mr Gonski, a pitfall for many gifted businesspeople has been in hiring the wrong people. Instead of choosing those that challenge established points of view and argue for alternatives, they often opt for yes-people.

In the Chancellor's opinion, hiring the right people should be a matter of balance: not necessarily having "the disrupter [or] the person that wants to punch you, but rather the staff member who means well, but has a strong point of view".

And while it is inevitable that valuable employees do sometimes resign, leaders should be careful about the loss of knowledge of key learnings from past successes and challenges within the business.

5. Seek diversity within business. Diversity is not only something that is encouraged at a macro level, but can help with future-proofing businesses too.

"A board made up of people exactly the same as me, is a disaster waiting to happen," Mr Gonski said. "The way to see whether there's a disruption coming is to have a diverse and questioning view around the table."

6. An excess of regulation in Australia. While expressing support for regulation during the initial COVID-19 period, Mr. Gonski said a major cause for concern is Australia's status when it comes to placing more regulation on its directors than in any other country.

"It is too easy for politicians to solve problems by putting on more regulation," he said. "We must watch that [our rights and freedoms] don't get continually taken away from us, because as business people, we will regret it enormously.

7. Risk of liquidity drying up. Another area of concern for businesses looking to the future identified by the Chancellor was the eventual end to the current liquidity within the system.

8. Awareness around mental illness. Recognition of mental health and mental health issues has grown greatly over the years, moving from an issue years ago that was perceived to be a personal issue, to one that can occur anywhere in life – including in business. But despite this increased level of awareness, Mr Gonski still stressed how important it is to consider the ramifications of mental health issues, not just amongst an organisation's staff, but its customers too.

9. Ill-thought-out disruption. While disruption might play a role in creating new business opportunities, disruption divorced from an understanding of your business and where the margins are can be more damaging than rewarding.

David Gonski AC is Chancellor at UNSW and serves as Chairman of a number of organisations including the Australia and New Zealand Banking Group. This article was originally published on Business Think, an alliance partner of Firstlinks.

Luxury in a pandemic: five grand ways LVMH delivers grandeur

Delian Entchev

Consumers have never been more fickle, in a world of fast fashion and next-day delivery. Covid has further upended our purchasing behaviours and expectations, but some companies have benefitted.

Against the odds, luxury goods giant LVMH (EPA:MC) has become more desirable over many centuries and emerged from this disruptive period stronger than ever. What's its secret?

LVMH (Louis Vuitton Moët Hennessy) is the largest global luxury goods company, owning 75 iconic brands such as those in its name as well as Christian Dior, Sephora, Bulgari and Tiffany. It has a long history of growth and profitability, even in difficult market environments – in fact it has not made a loss in a single year of its existence.

Let me share with you five features of this business that have allowed it to prosper in the face of ever-changing consumer preferences.

1. Heritage

The Clos des Lambrays vineyard dates back to 1365. Chaumet was founded in 1780 as a jeweller for the French Empress. Louis Vuitton was born 200 years ago and founded his business to make suitcases, featuring the classic monogrammed logo design, for the French royal family.

LVMH's brands are steeped in history and tradition. There is a story behind their products, they stand for something. The depth and authenticity of their heritage cannot be replicated by younger luxury goods brands. This heritage and desirability only builds over time, making it even more difficult for new entrants to succeed.

2. Innovation

But they aren't just old, tired brands. LVMH has done a great job of straddling tradition with innovation, remaining contemporary and relevant with consumers. It invests over €20 billion each year into creating new products (which represent about a quarter of its sales in a given year), advertising its brands through engaging campaigns, and refurbishing its stores with vibrant and constantly evolving displays.

LVMH also has an ongoing annual intake of thousands of new apprentices and talented young designers that bring with them new ideas. Half of LVMH's employees are under the age of 34, which is remarkable for such a longstanding business.

3. Agility

There are 75 brands owned by LVMH which operate as largely independent businesses, keeping them agile and entrepreneurial. The company's response to the Covid pandemic was a great validation of this strength.

Consumer behaviour changed drastically, with retail stores shut and travel grinding to a halt (which is when a large portion of luxury sales are traditionally made). LVMH adapted more rapidly than its competitors, resulting in massive market share gains and a quick recovery in profits. Its brands continued to invest in new product launches, virtual fashion shows and marketing, unlike others which withdrew their investments. They also found novel ways to serve a local clientele, such as these incredible mobile stores which brought a caravan with a bespoke selection of products directly to the homes of their most valued clients.

4. Control

LVMH makes most of its products in-house and sells most of its products through directly-operated stores, giving it full reign over the quality of its products, how they're priced (Louis Vuitton is notoriously the only luxury brand that never discounts its products), and the customer experience. Contrast the look and feel of a

Louis Vuitton store and the attentive customer service you'd receive in one, to the unorganised mess of a department store.

The company is obsessed with product quality, taking the long-term view that if you can focus on satisfying your customers, the financial outcomes will naturally be favourable. It has a high degree of control over its supply chain and materials usage, e.g. recently acquiring a sustainable crocodile leather tannery in Singapore to ensure its supply of a scarce resource, which is proving valuable amid the current global disruptions.

5. Breadth

LVMH sells a lot more than Fashion and Leather Goods; it also has businesses across Wines and Spirits (where it is the largest global producer of champagne and cognac), Perfumes and Cosmetics, Watches and Jewellery (where it recently acquired Tiffany) and Retailing (where it owns Sephora).

Its breadth across these five divisions, 75 brands and many countries provides valuable balance and resiliency to the inevitable ups and downs in any one area of consumer spending.

LVMH's breadth is important when considering the Chinese government's increasingly intrusive stance on the behaviour of its citizens. China has certainly been an important contributor to LVMH's growth, and today Chinese consumers represent a third of its sales across a very broad range of goods. However, LVMH is a truly global business that is growing strongly in other geographies as well. The company reported exceptional results in the first half of 2021, where sales grew faster from its US and European customers than in China. LVMH shares have fallen by 10% over the last month, and some of its luxury peers have fared worse, but the market's focus on these events may be masking the business' finer qualities.

In conclusion

These five attributes have contributed to LVMH's growing desirability, long track record of growth, and enviable profitability. In the Aoris International Fund we own a portfolio of 15 durable, all-weather businesses like LVMH, which we expect to keep compounding in value for many years to come.

Delian Entchev is a Senior Equity Analyst at Aoris Investment Management. This article is general information and does not consider the circumstances of any investor.

Ransomware threatens home, office and national security

Michael Collins

Tobias Vernon of the UK owns two small galleries that sell 20th-century ceramics and artworks. Thanks to marketing efforts, the business has almost 50,000 Instagram followers.

In May 2021, an email appeared from Instagram congratulating the business for getting a 'blue tick', which bestows on the account 'authentic presence'. Vernon clicked the link in the email and logged in. Not long after, a message soon appeared:

"We have seized control of your Instagram account …We require US$1,000 to grant you your account back."

Even the hackers want to be 'trustworthy'!

Vernon eventually paid US$750 in bitcoin to Russians, who released the account. But get this. Three days later, Vernon got an Instagram message from a bakery in Australia that had been hacked by the same group. The baker had been told to contact Vernon for a Tripadvisor-style testimonial that the hackers were trustworthy, so to speak, in that they would release the kidnapped device when paid.

Such traumas are proliferating because the malware-based crime known as ransomware is reaching menacing proportions. Criminally installed encryption that is reversed only by ransom is rising "almost exponentially" in the words of FBI Director Christopher Wray because the virtual private networks that enable working from home have made business systems more vulnerable.

US cyber-security firm Mimecast found that 61% of the 1,225 global IT firms it surveyed suffered ransomware attacks in 2020, a 20-point jump from 2019. The Australian Cyber Security Centre, a government agency, said

ransomware attacks in Australia rose 15% last financial year to 500 incidents. Global security group, Institute for Security and Technology, estimates 2,400 ransomware victims in the US paid nearly US$350 million in ransom in 2020, a 311% jump in payments from 2019.

Ransomware "*is an urgent national security risk*" because "*attacks on the energy grid, on a nuclear plant, waste-treatment facilities … could have devastating consequences,*" the Institute cautioned. As such warnings signal, ransomware has evolved from a cottage industry into something resembling a "criminal franchising arrangement", according to the Australian Cyber Security Centre.

Nothing is safe from virtual kidnappers

Among notable attacks this year, in March, US insurer CNA Financial reportedly paid a then-record US$40 million ransom. In May, ransomware disrupted Colonial Pipeline, which carries 45% of US east coast fuel supplies, for 11 days until a US$$4.3 million ransom was paid for a malfunctioning decrypter key. In July, a ransomware attack on the US-based software company Kaseya was notable for gifting up to 1,500 global victims to the criminals and that the ransom demand was a record US$70 million. The biggest ransomware attack in terms of victims is still the 'WannaCry' one in 2017, when up to 300,000 computers were infected though the criminals received limited payment.

Ransomware is flourishing because the risk-reward calculation favours the attackers. What choice do companies have but to pay a government-protected group that might destroy their mission-critical computer system?

Paying the ransom, however, often fails as a solution. The Mimecast survey found that 52% of ransomware victims paid the ransom but only 66% of those recovered their data – the others were double-crossed.

The hope is that the risk part of the calculation might increase to the detriment of the scammers because western governments are enhancing and coordinating efforts to stop ransom attacks. Officials too are warning internet users to be better prepared for these attacks.

Eradicating the threat seems far off. Computer systems are impossible to secure and it's expensive to try. Phishing emails and other scams too easily trick people into installing malware. Enough employees are willing to sell passwords on the 'dark web'. Perhaps, though, the greatest asset ransomware criminals have is that cryptocurrencies are hard to trace. Many advise that a government crackdown on cryptos is the best way to reduce the menace.

The US's unprecedented move in September to blacklist a Russian-owned crypto exchange shows Washington might agree. Something needs to tackle this mobster shakeout for using the web before the damage reaches national-security proportions.

Even if defensive efforts increase, ransomware appears unbeatable when five billion people are connected to the internet. As ransomware is online, the public seems to be unable to come to terms with the magnitude of the threat, which hampers the fightback. It's true that ransomware would exist even if cryptos didn't but it might barely register as a danger because how would the criminal be paid?

Some victims refuse to pay and the criminals back down. The 'WannaCry' attack emanating from North Korea generated little ransom for the attackers but according to the world's anti-laundering body caused an estimated US$8 billion in damages to hospitals, banks and businesses across the world.

Attack the problem at the payment end

Such calculations show that the ransomware threat needs to be taken much more seriously. The non-virtual world provides the clue to defeating the menace. Kidnapping is a rare crime nowadays because the police caught kidnappers when they spent the cash. The solution to ransomware might be to regulate cryptocurrencies, possibly – as is the intention of China's ban on crypto activities – to the point where they are unviable.

Such actions might mean the world loses the (disputed) benefits of cryptocurrencies. But that's part of the cost-benefit analysis governments need to undertake to defeat the scammers that hound legitimate users of the internet, be they UK gallery owners or bakers in Australia.

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

The global energy crunch is creating new megatrends

Roy Chen

Earlier in 2021, energy markets were pre-occupied by the price of crude oil and what the OPEC + (Russia) cartel might do in terms of future production. The pandemic placed pressure on OPEC's meeting schedules but this masked the real developing energy problem, especially in Europe: the looming shortage of natural gas.

This is now headline-grabbing, with the UK's wholesale energy markets reaching record highs in recent weeks. Half of the UK's electricity is generated in gas-fired plants.

But ageing nuclear power plants have been forced to undertake unplanned outages for maintenance and less windy conditions have increased demand for gas in the UK. A fire shutdown a high-voltage power cable bringing electricity from predominantly nuclear-powered France, further increasing demand for gas power.

At the same time, a very cold 2020-21 winter depleted gas stockpiles. The UK reportedly only has about seven days' supply of gas in storage facilities. Overall, gas storage levels in Europe are very low at 70%, barely covering two months of consumption. In the previous two years gas storage levels have been over 90%. Gas storage capacity in itself may not have directly driven gas prices, but it is likely to be a factor in the overall energy equation.

There are 36 LNG import terminals across Europe with many of the largest ones in Spain. Another 27 import terminals are under construction.

Problems with gas supply

Europe's gas supply has traditionally come from three sources:

1. Imports from Russia via pipeline (Gazprom)
2. Imports from Algeria via pipelines (State-owned Sonatrach)
3. Indigenous Norwegian production, mainly from offshore (Equinor)

For whatever reasons, Russia is not increasing its gas supply to Western Europe. In Algeria, a breakdown in diplomatic relations with Morocco threatened the flow of gas in one of the two pipelines to Europe. Production is stagnating and a rapid domestic gas consumption growth increases pressure on export potential.

Norway provides about 25% of European gas demand. But Norway's gas production is falling with easily-accessed gas fields being exhausted and less investment in the sector spurned by domestic energy policy that favours renewables.

Indeed, Europe (and the World) is experiencing declining investment in fossil fuels at the same time as there is increased dependency on intermittent sources of energy such as solar and wind. Magnifying Europe's gas supply and demand equation, the UK had one of its least-windy summers since 1961, meaning wind power has been low.

High energy costs hit businesses

UK and European energy suppliers who have to buy gas at very high prices will suffer from shrinking margins. Many smaller operators have already collapsed. Government intervention is likely to offer some protection for consumers who are facing increased energy costs. Business, particularly heavy industry, will also face higher energy costs.

How much have European energy prices increased?

Source	Indicator	Q3-20	Q2-21E	YOY Change
Gas	Dutch TTF (€/MWh)	8.20	47.3	477%
Coal	Rotterdam($/tonne)	50.70	147.0	190%
Power	Germany baseload (€/MWh)	35.90	100.0	179%
CO_2	EU ETS (€/tonne)	27.36	56.5	107%

Source: RC Global Funds Management

While the gas supply crunch is particularly acute in Europe with the TTF (Dutch import) benchmark also at record highs, there is strong demand and limited new supply globally.

The (global) gas grab

Industrial activity has rebounded as the world starts to emerge from the pandemic, with the global energy demand set to increase by some 4% in 2021. It is anticipated that the global gas demand will correspondingly increase, in part to meet this demand but also to replenish gas supplies before the onset of the next northern winter.

In Asia, which relies heavily on LNG imports, prices are also just shy of the record reached in January 2021. The JKM (Japan and Korea import benchmark) spot price may reach a fresh record again this coming (northern) winter. Currently there are many LNG carriers lining up to load in Qatar and Australia, the world's two largest LNG exporters. Europe is fighting for every LNG cargo with equally-hungry Asian buyers.

Investment winners and losers

As with any supply/demand 'crunch' there are winners and losers. High energy-user industries such as those involved in the production of fertilizers and by extension, some in the food and drinks industries, will also face headwinds.

Some of the biggest winners are in fact those that don't even produce any natural gas. They are the utilities that generate electric power using either hydro or nuclear, both of which are characterised by high upfront capital costs but low on-going operating costs. They benefit from higher power prices and have fairly fixed operating costs.

Examples of such companies include BKW Switzerland and Verbund Austria, which are mainly generating energy using hydropower taking advantage of the mountainous geography of these two countries.

LNG shipping companies who transport LNG based on spot prices are of course clear winners in the 2021 Energy Crunch. Companies like Nippon Yusen and Mitsui OSK are prime examples.

But the point is that a subtle shift in the circumstance could make picking winners and losers difficult. Remember this Energy Crunch had its genesis hidden behind an oil price headline. If some of the factors had been different – wind in the UK during the summer of 2021 was at historic averages, Russia did open the gas tap a little more, there was no pandemic – the winners and losers from a (share) investment perspective might have been different.

In any event, a particular investment approach, such as only investing in renewable energy or within certain ESG parameters, could influence returns.

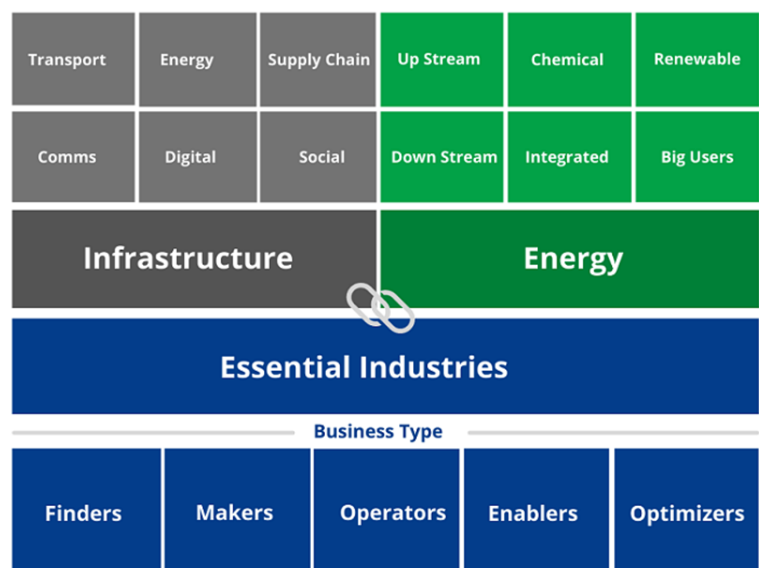
A broader view of energy

Understanding the energy value chain helps a more informed view about potential energy investments. Sure, diversification is a well-trodden path but with energy it's more than just the value chain in a linear sense.

One of the key factors is a big investment universe for companies operating in essential industries. There is a much better investment selection potential when the interconnection of both the infrastructure and energy segments are considered. After all, infrastructure needs an energy source to work and energy needs infrastructure to allow it to be produced, converted, stored, distributed, and transmitted.

A holistic value chain reveals the broad investment universe for essential industries in the (related) infrastructure and energy business segments.

This wider lens of viewing energy investment opportunity means investors are automatically tapping into global megatrends such as urbanisation, digital transformation and of course energy



Source: RC Global Funds Management

transformation. Importantly, potential investment is being done at an essential economic layer that is supported by both private and public spending.

Roy Chen is the Founder, CIO and MD of RC Global Funds Management The material in this article is general information only and does not consider any individual's investment objectives.

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