Firstlinks
a Morningstar company

Edition 429, 15 October 2021

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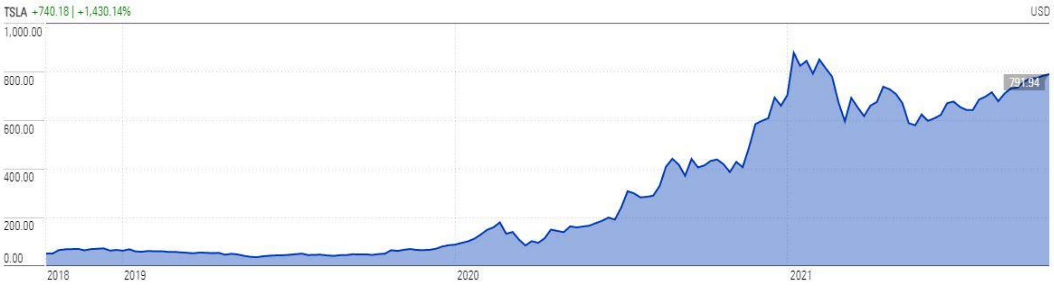
Editorial

There is danger in labelling anything a 'bubble', other than if it's a film of soap enclosing air. One person's asset bubble is another's growth story. When **Bitcoin** went from US$1 in 2011 to US$1,000 in 2017, that was clearly a bubble. It was nearly US$20,000 within a year, another bubble, and peaked over US$60,000 in early 2021. All blowing bubbles. The head of the world's largest bank, **JPMorgan Chase CEO Jamie Dimon,** told an **Institute of International Finance** event this week:

"I personally think that Bitcoin is worthless. Our clients are adults. They disagree. If they want to have access to buy or sell Bitcoin – we can't custody it – but we can give them legitimate, as clean as possible, access. No matter what anyone thinks about it, government is going to regulate it. They are going to regulate it for [anti-money laundering] purposes, for [Bank Secrecy Act] purposes, for tax."

Hamish Douglass wrote the same in this Firstlinks' article. Many comments claimed Hamish simply did not understand. Bitcoin has been written off all along and I have no idea where it is going.

Same with **Tesla**. The **Morningstar** chart below of its share price shows how the true believers have been rewarded. As every major car manufacturer rolls out its electric vehicles and others select hydrogen, some analysts say it's already in a bubble around US$800, while others say it's worth US$3,000.



And so to Australian house prices. It's the Great Australian Dream and panic, FOMO, supply shortage and low rates continue to drive gains at these heady levels. How can a house price be in a bubble if someone lives in a lovely home for 30 years? There is a real estate agent who specialises in an inner west Sydney suburb who hands out a promotional brochure saying he has been selling houses and living there for 20 years. It says he was the first agent to sell a house in the suburb for over $1 million. Must have seemed like a lot for the inner city, $1 million. His brochure says he was first over $2 million. $2 million! And $3 million, and $4 million, and $5 million and $6 million. He just reprinted his brochure to acknowledge the first sale over $7 million, to a local family upsizing. No waterfront, busy street, sloping block.

Gareth Aird and Kristina Clifton** report on how the **Reserve Bank** is leaving it to APRA to [control house prices](), but with a remarkable quote from a previous Governor, **Glenn Stevens.** In 2014, Stevens said the central bank would be 'unwise' to put unemployment above controlling house prices. Now the bank has done a backflip, although they do admit in their latest **Financial Stability Review:**

"Price falls could be widespread if interest rates were to increase sharply due to unexpected inflation or rising risk premiums. Sharp price falls could cause greatest harm to the financial system for assets where leverage is common, notably residential and commercial property."

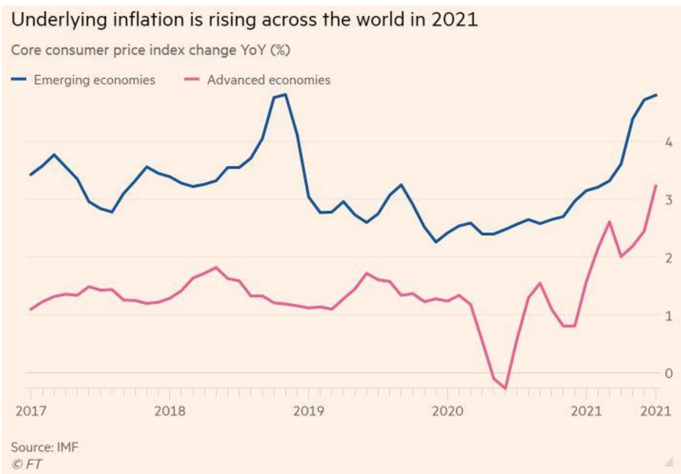
The CoreLogic table on listings shown below is finally showing an uptick in supply which might help take the edge of further price rises.

The first announcement by **APRA** last week was strange because it said a research paper on possible prudential changes would be ready within two months, but then within a week, the first tightening (on the rate 'buffer' calculation) was introduced. Someone gave them a nudge, and more new rules are coming. As **Wayne Byers**, Chairman of APRA, said last week:

"While the banking system is well capitalised and lending standards overall have held up, increases in the share of heavily indebted borrowers, and leverage in the household sector more broadly, mean that medium-term risks to financial stability are building."

The inflation drums also grow louder every day, and many central banks are considering their monetary policy settings. Yesterday at a **Citi Investment Conference**, former US Treasury Secretary **Larry Summers** said the US economy is overheating and a shortage of Labor is another factor pushing up prices, and he criticised the Federal Reserve's lack of action as inflation surges.

It will make **Governor Philip Lowe's** argument about no rate rises until 2024 harder to sustain. This week, the **International Monetary Fund** said the global economy is entering a phase of inflationary risk, and it called on central banks to be "*very, very vigilant*" and take early action to tighten monetary policy if price pressures continue. As we have [discussed before](), household debts are too high to withstand rate increases but inflation needs to be controlled.



We have two articles on the bubble theme. **Amit Nath** explains why so many people miss out on the [great growth stories]() such as **Microsoft and Amazon** until it is too late. There is a misunderstood focus on current earnings and a human inability to understand exponential growth. Are we hard-wired for failure?

Which takes us back to Tesla, and a lively debate summarised by **Emma Rapaport** between the world's highest-profile Tesla bull, **Cathie Wood**, and fundamental value investor, **Rob Arnott**. They [both make convincing cases](), and we can look back in five years and wag a finger at one of them. We also attach an edited transcript of this fascinating look at both sides.

Dawn Kanelleas describes the impact of electric vehicles on the demand for batteries, and she identifies four key commodities and nine Australian companies likely to benefit. While there has been a lot of attention on hydrogen recently, it's hard to ignore the move to electric cars. In Norway, they expect no more petrol or diesel cars to be sold there by early next year.

We have described in detail the problems with ASIC's performance test for some large funds (such as here and here), but the fund letters have now gone to members. We check how super funds which failed the test under the **Your Future, Your Super** legislation are communicating. A modified version of the '**Contrast Principle**' is getting a good workover.

Every company must adapt to change, especially with digital disruption, and **Hendrik-Jan Boer** gives five value chains that 'transition winners' are adopting. Every company needs to adopt one or more of these chains.

Professor Kevin Davis was a member of **David Murray's Financial System Inquiry** a few years ago, and he has taken a swipe at the Government for allowing retirees with super pensions to draw only half the amount required under the normal rules. Anyone planning their cashflow for next year should not expect this favour which allowed wealthy people to leave even more in a tax-advantaged structure.

A shout out to the 2021 **Sohn Hearts & Minds Conference** (where the co-founder of Firstlinks, **Chris Cuffe**, is Chairman of Hearts & Minds Investments (ASX:HM1) which will be held on 3 December 2021, with a stunning headliner in **Charlie Munger**. Tickets and details at sohnheartsandminds.com.au. Chris tells me if people want to hear Munger they must buy a ticket for this charitable cause as the event will not be recorded.

This week's White Paper is a further development of the **Neuberger Berman** piece on value chains, identifying transition winners that are durable, sustainable and adaptable.

And our Comment of the Week is from **Tony** on Ashley Owen's article on property prices (which has already received almost 30,000 views):

"Your analysis leads me to believe that we are in for a significant correction, or even crash, in property prices as soon as interest rates rise. People with mortgages borrowed like drunken sailors, both first timers and "investors", in the belief that property has never fallen in value. They overlook the fact that the current mix of events (zero interest rates, massive mortgages, zero pay rises), never happened before. The confluence of these three events means we are heading for the rocks when it comes to property values. The fallout will not pretty and everyone, the RBA, APRA, the Federal Government, the Opposition, will always be pointing fingers at each other for the blame."

The 'Contrast Principle' used by super fund test failures

Graham Hand

Psychologists use the 'Contrast Principle' to explain how our perceptions are formed using comparisons. The Principle says perception is relative. That is, if we experience two similar things, the perception of one is influenced by the other.

In his book '*Influence: The Psychology of Persuasion*', Robert Cialdini gives many examples of the way buyers are exploited using the Contrast Principle and clever sales techniques. Something can be made more attractive by comparing it to another choice that is less attractive. For example:

"It is more profitable for salespeople to present the expensive item first … presenting an inexpensive product first and following it with an expensive one makes the expensive item seem even more costly."

Cialdini followed a real estate agent showing properties to potential buyers. The agent always started with a couple of undesirable properties, which he called 'setups'.

"The company maintained an unappealing house or two on its lists at inflated prices. These houses were not intended to be sold to customers but only to be shown to them so that the genuine properties in the company's inventory would benefit from the comparison."

The agent watched the buyers' 'eyes light up' when they saw the houses he wanted to sell after they had looked at the dumps.

The superannuation fund performance test

The *Your Future, Your Super* (YFYS) reforms are designed to improve outcomes for members. They feature a seven-year investment performance test for MySuper funds against a benchmark imposed by the Australian Prudential Regulation Authority (APRA).

(A point of detail on the regulations. The Australian Securities and Investment Commission (ASIC) is responsible for policy on communications and associated comparisons sent to members by funds. As ASIC advised me, *"that they do so without hyperbole, fibbing, spin and general palaver*". But the benchmarks and judgements are APRA's responsibility).

Last night (Wednesday, 13 October 2021), Senator Jane Hume, Minister for Superannuation, delivered a keynote address to the World Pensions Summit in the Hague where she described how 13 funds with 1.1 million members had underperformed, adding: "*A bright-line test, with no excuses. A fund passes, or it fails."*

Large super funds that failed the test are now applying a version of the Contrast Principle to explain the results to their members. Rather than compare performance against APRA's benchmark, they are using another measure such as a CPI+ or an absolute return target, with more favourable results.

They are correct to use this technique, as their funds have been managed in ways that differ from APRA's measurement. The performance test makes no judgement on the level of returns achieved, only the performance relative the underlying asset class benchmarks chosen by APRA.

Many of the failed funds have delivered returns better than their investment objectives, and yet they are judged as failures. It is possible for one fund to deliver 10% and fail, and another to return 5% and pass, which will confuse many fund members.

For example, a balanced fund may be managed with an investment target of CPI plus 3%, and with an allocation 50% to growth and 50% to defensive, it returned 15% last year, well ahead of its target. But it is benchmarked against a surging equity market with the S&P/ASX300 up 28% and S&P500 about 40% in FY21. It is deemed a failed fund because it was positioned at the defensive end of its asset allocation, which pushed its relative return 0.5% below its benchmark. Contrast this to a defensive fund invested in bonds which returned the same as its 5% benchmark. One fund is a fail at 15%, the other is a pass at 5%.

In explaining to members using a version of the Contrast Principle, it is better for the super fund to justify performance based on the long-term investment target rather than APRA's benchmark comparison.

Examples of how underperforming funds are communicating

ASIC has warned fund underperformers against customising their communications. The regulator has provided a proforma letter which all underperforming funds must send to members. It is precise and critical, and here is an extract from the full ASIC letter.

> Hello *[insert the name of the beneficiary of the superannuation entity]*,
>
> **Your superannuation product** *[insert the name of the superannuation entity and the name of the Part 6A product]* **has performed poorly. You should consider moving your money into a different fund.**
>
> You currently have $*[insert the beneficiary's account balance in respect of the Part 6A product on the date of this letter]* in your *[insert the name of the Part 6A product]*.
>
> Your *[insert the name of the Part 6A product]* has failed the performance assessment conducted by the Australian Government. Your product underperformed its benchmark over the past *[insert the number of years in the lookback period for the Part 6A product in respect of the relevant financial year]* years to *[insert the date of the last day of the lookback period for the Part 6A product in respect of the relevant financial year]* by *[insert the performance measure for the Part 6A product for the relevant financial year, multiplied by -100]*%.

ASIC's Senior Executive for Superannuation, Jane Eccleston, added in a note:

"The text of the letter you send to beneficiaries is mandatory – don't change it. Any communication you make in relation to the [annual performance assessment] or about your performance should provide information in a balanced and factual way that is not misleading and/or deceptive."

Heavy stuff, writing to members that their fund has 'performed poorly' and they should consider moving their money. Surely, a self-respecting fund trustee would not leave it at that in any decent communication to members. Well, they don't.

a) Commonwealth Bank Group Super

The letter from the CEO of Commonwealth Bank Group Super, whose Balanced (MySuper) fund was designated as underperforming, included a two-page glossy cover note from which the following explanation is extracted, followed by a bland A4 version of the official ASIC document.

"We set out to achieve a certain (target) investment return above inflation. The rate of inflation used is the Consumer Price Index (CPI). Our objective is to achieve our target return during times of investment market ups and downs, we do not track an index or benchmark. This target informs how we invest.

Generally, we invest less in shares than many other super funds. Instead, we generally invest more in alternative investments and real assets such as property and infrastructure. This could mean that in strong share markets like we have seen in recent years, our Balanced (My Super) option returns will be lower than other MySuper products. The approach we take can be referred to as diversification. We expect diversification to produce more consistent returns, rather than relying on a smaller range of investments to perform well.

As at 30 June 2021, our Balanced (MySuper) option delivered an annual return of 15% and a long-term return of 7.3% pa over the last 10 years. This long-term return has exceeded our objective which is 2.5% above CPI over a 10-year period.

At the same time, it has also produced a smoother return experience for members compared to the average experience for other MySuper products."

Fair enough. Get that: "*we do not track an index or benchmark".* I'll bet they do now, because the consequences of failing the test for a second year are too severe - the inability to accept new members.

Before we point a finger, who can claim if they were a trustee for this super fund, that they would argue against the emphasis on protecting capital with less volatility? It's a valid defence. Then to top it off, the letter adds:

"To form a more holistic view of a MySuper product's performance, there are other key areas, beyond net returns, that could be considered. Comprehensive evaluations carried out by industry rating agencies assess not just net returns but also insurance cover and premiums, education, advice, fund governance and more."

b) Christian Super

Christian Super may be unique among funds, because it says:

"We believe that God invites us to put our faith into action with everything we do, including how we steward our members' super."

Fund managers need all the help they can get, and no doubt its Christian members support this principle. The super fund includes a Q&A section on its website dedicated to the performance test. Here are two relevant explanations.

"Why is Christian Super's MySuper product labelled 'underperforming'?

Christian Super has historically managed its investments to deliver the investment return objectives outlined in the Product Disclosure Statement. For our MySuper product (My Ethical Super), this objective was to achieve a 3% average annual return above inflation over 10 year periods, which the fund has over-achieved.

We have a more diverse range of members invested in our MySuper product than many other funds and have therefore historically taken a more defensive investment approach, which means we worked to minimise investment losses for our members and took less risk. This approach reflects risk-return investment theory and was made by analysing the way our members respond to market volatility. As well as this more defensive approach, there was also a degree of underperformance in some areas of our investment strategy, which we have addressed.

In response to the changing way that super funds are assessed by the regulator (APRA) in recent years, we increased the amount our MySuper product invests in riskier investments. As a result, we have delivered our investment return objectives, as well as meeting the new performance test benchmark requirements for the past two years ...

How has Christian Super's MySuper product performed compared to its stated investment objectives?

Our MySuper product (My Ethical Super) has consistently achieved its investment objective stated in our Product Disclosure Statement, delivering an average annual return of 7.95% each year over the last 10 years. This means that we've more than doubled our members' money during the last 10 years through investment returns alone."

There's an important highlight here. Christian Super has now invested more in riskier investments to meet the assessment test. That could come back to haunt trustees in a down market, when they supposedly thought the previous positioning was correct for their members.

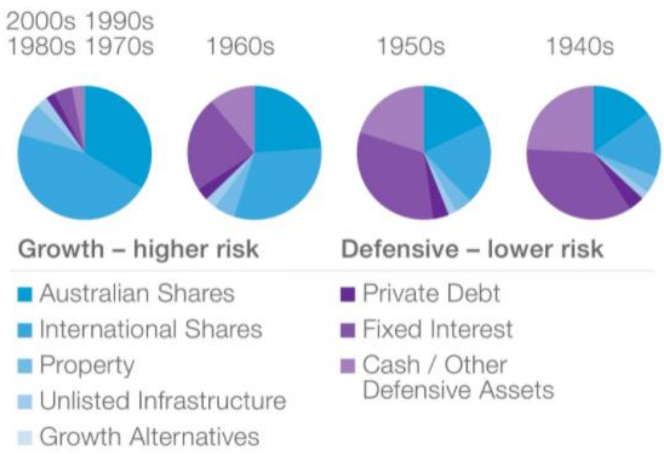
But there's their version of the Contrast Principle in operation. Explain the results in terms of absolute returns rather than focussing on '*a degree of underperformance*'.

c) BT Super

BT Super offers lifecycle or lifestage funds where the defensive allocation increases with age. Younger members gain higher exposure to growth assets and are switched to defensive as they age. In FY21, the younger person's allocation achieved a highly-respectable return over 25% and yet they received a notice about their underperforming fund. No doubt totally confusing to many.

BT Super explains:

"For Lifestage products like those offered by BT, the annual performance assessment takes into account the asset-weighted performance of all Lifestage investment options collectively to calculate a single performance return. The combined seven-year performance of our BT Super MySuper product failed the annual performance assessment, and will be recorded as underperforming on the Australian Taxation Office (ATO)'s YourSuper comparison tool at ato.gov.au/yoursuper."



The asset allocation of the four Lifestage funds are radically different, as shown below, for people born in the 1940s, 1950s and 1960s, versus those born after the 1970s. BT's challenge is to explain how APRA has judged all these against one asset-weighted benchmark, especially when people are ringing up the call centre asking how their failed fund earned 25%.

INVESTMENT OPTION	12 months to 30 June 2021[1]
1940s BT Lifestage investment option	8.36%
1950s BT Lifestage investment option	10.29%
1960s BT Lifestage investment option	16.94%
1970s BT Lifestage investment option	25.52%
1980s BT Lifestage investment option	25.63%
1990s BT Lifestage investment option	25.56%
2000s BT Lifestage investment option	25.10%

And what is BT Super saying in response to failing the test? What everyone else is saying ... nothing to see here:

"We have worked hard and invested heavily to improve member outcomes and are seeing the result of this in our recent performance.

We'll continue to look for ways to provide better performance outcomes for our members, be it reviewing our investment strategies, our fees, or our services. In addition, over the past five years we've also enhanced our member tools, educational offering and digital experience to make it easier for our members to understand and manage their super."

Will it work?

It's the early days of so-called underperforming funds writing to their members, and (to my knowledge) no information is publicly available on fund losses. It's my guess the amounts will not be high, as many people in

MySuper funds are disengaged and do not even open their mail. Then relatively few will change in light of the alternative explanations.

As Robert Cialdini says of the Contrast Principle: *"An advantage of employing this lever of influence is that its tactical use typically goes unrecognised."*

Graham Hand is Managing Editor of Firstlinks. This article is general information.

RBA switched rate priority on house prices versus jobs

Gareth Aird, Kristina Clifton

The RBA's October 2021 'Financial Stability Review' (FSR) comes in the wake of APRA's announcement earlier in the week to increase the minimum interest rate buffer it expects banks to use when assessing the serviceability of home loan applications. In that context, the October FSR was expected to have a stronger than usual emphasis on housing-related risks. And the RBA didn't disappoint.

Prudential controls starting

Recall on Wednesday that APRA announced that authorised deposit taking institutions (ADIs) will need to assess new borrowers' ability to meet their loan repayments at an interest rate that is at least 3% above the loan product rate. This is an increase of 0.5% on the previous 2.5% minimum interest rate buffer (note that some lenders had already applied a rate above 2.5%).

As we wrote at the time, the move by APRA will strengthen serviceability standards. But we do not think the increase of 50bps on the minimum interest rate buffer was enough to materially shift the outlook for the housing market in 2022 (see here).

The FSR adds a lot more colour to the household debt and housing-related issues that are currently weighing on the RBA's mind. To be clear, the RBA has expressed concerns around the overall level of household indebtedness for some time, but without doubt those concerns have been notched up more recently given the acceleration in borrowing.

The FSR notes:

"there has been a build-up of systemic risks associated with high and rising household indebtedness. Vulnerabilities could build further if housing market strength gives way to exuberance, with expectations of further price rises leading borrowers to take on greater risk and banks potentially easing lending standards".

The move by APRA earlier in the week sought to address those risks. But if credit growth remains stronger than income over coming months, pressure is likely to intensify for APRA to make some more policy changes.

On that front, an entire section of the FSR was devoted to "Mortgage Macroprudential Policies".

RBA wants macroprudential to take house price burden ...

It is crystal clear that the RBA will seek to have any concerns around an overheated housing market addressed through more macroprudential policies from APRA. Rapidly-rising home prices or an acceleration in household debt because of record low rates will not directly feed into the RBA's decision making around when they commence normalising rates.

Put another way, the RBA's focus for monetary policy is squarely on the inflation target and achieving full employment. The RBA considers the financial stability component of the charter to be best addressed via macroprudential policies.

... but it didn't in the past

This hasn't always been the case.

In September 2014, the RBA Governor at the time, Glenn Stevens, stated on the case for more monetary policy easing to stimulate the economy,

"while we may desire to see a faster reduction in the rate of unemployment, further inflating an already elevated level of housing prices seems an unwise route to try to achieve that".

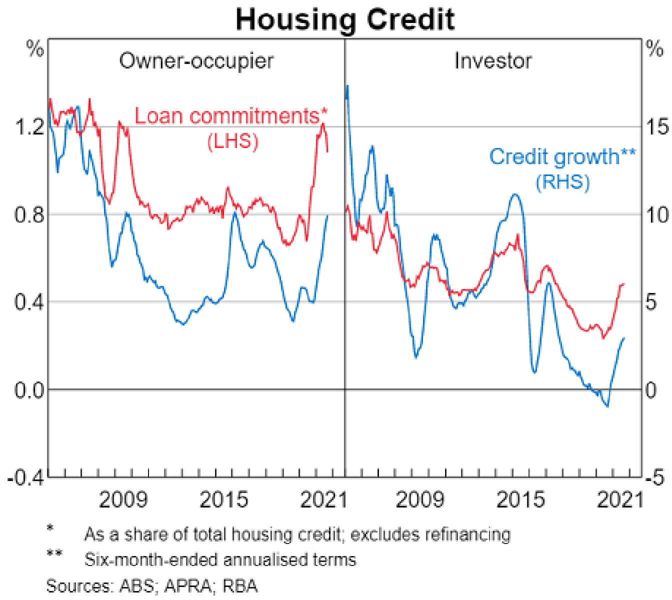
Governor Philip Lowe took a similar mindset to his first few years in the top spot. But now the RBA is fixed on getting inflation and wages up given many years of undershooting their inflation target on an underlying basis.

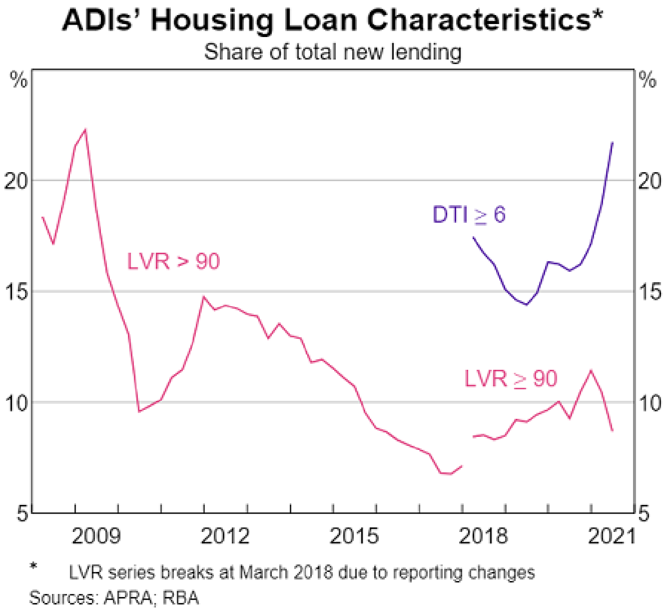
Overall, the FSR today paints the picture of a central bank that will be playing very close attention to the housing market and the dynamics around new lending, debt repayment and leverage.

A selection of charts and commentary

There are concerns around the acceleration in new lending and credit growth given already high debt to income ratios in Australia.

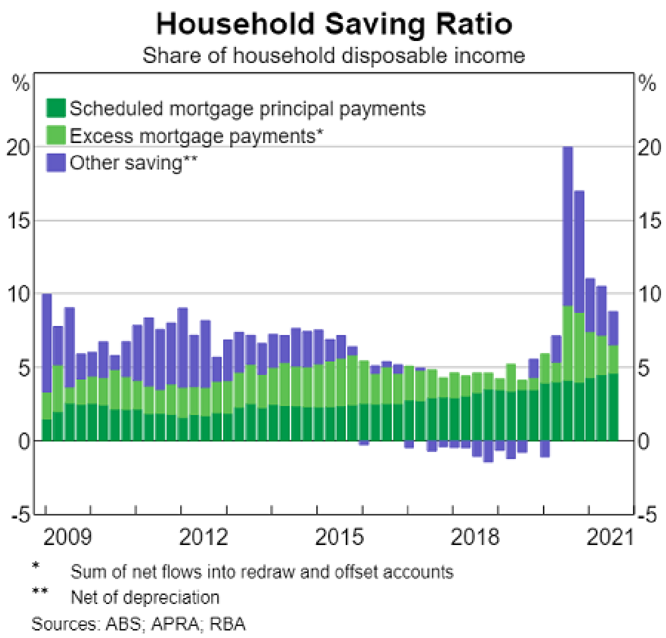
The RBA finds that lending standards remain sound but that the share of lending at high debt to income ratios has risen quickly.

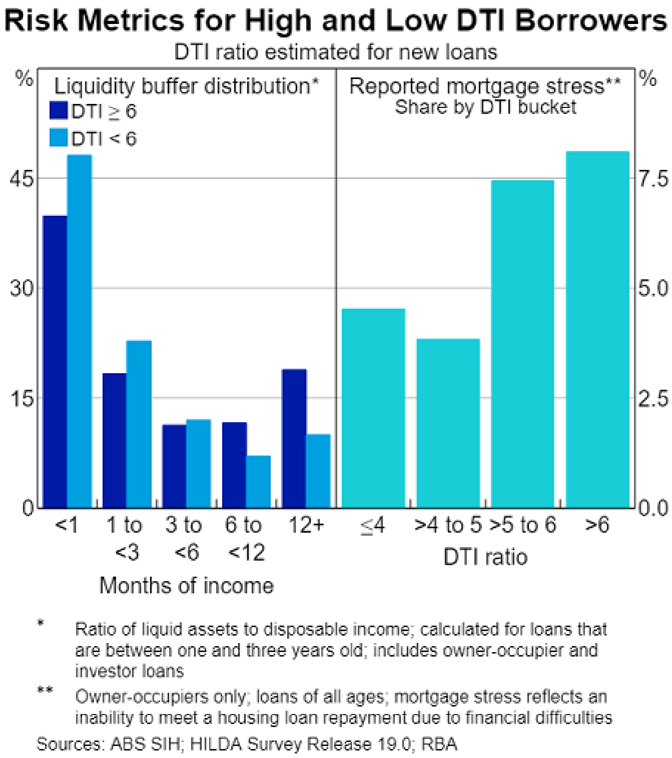




Borrowers with high debt to income rations more often experience mortgage stress, although in the case of investors, liquidity buffers are often higher.

Household savings have lifted through the pandemic. Some of these savings have been put towards additional mortgage repayments.





Gareth Aird is Head of Australian Economics and Kristina Clifton is a Senior Economist with the Global Economic & Markets Research (GEMR) team at Commonwealth Bank of Australia. This report is not investment research and nor does it purport to make any recommendations. Rather, this report is for informational purposes only and is not to be relied upon for any investment purpose.

Disruptive innovation and the Tesla valuation debate

Emma Rapaport

If a company made 600,000 cars over the last year, sold at around US$100,000 each, how much would you pay for a piece of that business?

It's a question that stirred a lively debate at this years' Morningstar Investment Conference in Chicago, where the company in question was Tesla.

For the opposing managers, Rob Arnott, the founder of Research Affiliates, and Catherine Wood, founder of ARK Investment, the answer comes down to how much they believe the company is going to grow, and how quickly. On this, they couldn't be farther apart.

For Arnott, a contrarian value-oriented manager, he acknowledges Tesla's incredible growth and the explosive potential of the electric vehicle market but asks 'at what price'? He believes investors are getting ahead of what's likely to happen and that Elon Musk's shares are in bubble territory.

"To justify Tesla's current price, you'd have to assume roughly 50-fold growth over the next 10 years," he says. "Is that impossible? No, anything is possible. Do you believe it's plausible? I don't. So I view it as a bubble."

For Catherine Wood, a disruptive technology-focused investor, Tesla is a technology pioneer that sceptics are massively underestimating and whose shares are still the buy of a lifetime.

Wood believes Tesla is primed to take advantage of falling costs having created four major barriers to entry for its competitors - battery technology, proprietary artificial intelligence chips, customer data collection and over-the-air software updates to improve performance.

She expects the average electric vehicle price will drop below that of the average gas-powered price in the next year or so and will continue to decline so that in the year 2025, the average electric vehicle will be 18,000 while a regular car will still be roughly $25,000.

Asked what her base price target would be for Tesla in five years, Wood answered $3,000. Today, the stock is trading around $750.

This spar over the specifics of Tesla makes for interesting watching, but it's their widely different approach to valuation and forecasting the future which gives me pause for thought.

Disruption is everywhere. Upstarts challenging the status quo, entire industries transforming overnight, disrupt or be disrupted. But for every Apple, there's a Blackberry. For every Facebook, there's a MySpace. For investors, the struggle to put a price on so-called blockbuster technologies is harder than ever.

ARK Investment's Cathie Wood and Research Affiliates Rob Arnott spar over Tesla's future at the Morningstar Investment Conference in Chicago.

Pricing the future

For the Rob Arnott's of the world, their assumptions about the future are informed by the past. They remember periods of wild market speculation and sudden dramatic declines. Of big, successful 'disruptors' like Cisco crashing in the 2000s tech bubble and shattering expectations. From the largest market-cap stock on the planet to a decline of 80%, Cisco's share price is still lower than it was at the peak in 2000 even though they've delivered double digital growth for the last 21 years. Where markets are pricing in stupendous growth, delivering impressive growth isn't enough, he remarks:

"Things that are expensive are always expensive based on a narrative of everything going amazingly well, of path-breaking disruption – and here's the trick: narratives are true," he says.

"The narratives that drive these companies to lofty valuation are for the most part true. But the important question to ask is not is this an amazing narrative, but what about this narrative isn't known to the broad market and isn't already reflected in the share price.

"Bubble stocks have to *exceed* the narrative that shapes their expectation and price in order to go up.

"I love growth, I love disruption, I love technological innovation. I agree that a brave new world in which technological innovation advances humanity in amazing and wonderful ways is our future. Where I would question is how much of this isn't already reflected in the prices when you have companies priced at multiples of aggregate revenues rather than multiples of profits.

"Those companies are pricing in extravagant growth that may be possible – but in many cases, there will be shortfalls, and they have to produce that growth just to justify where they are on price."

Arnott himself believes deeply in the theory of mean reversion - that asset prices and historical returns gradually move towards the long-term mean. When there is very rapid earnings growth, this tends to mean the price will revert downwards. Similarly, when earnings are tanking, they tend to revert up (except in the case of value traps). His job is to estimate the trading range for a security and purchase it below that range to pick up a bargain. As any value manager will tell you, the last decade has not been kind to this strategy.

ARK Innovation ETF (ARKK) | Top 10 Holdings

Name	Ticker	Portfolio Weighting %	Sector
Tesla Inc	TSLA	9.64%	Consumer Cyclical
Teladoc Health Inc	TDOC	5.87%	Healthcare
Roku Inc Class A	ROKU	5.69%	Communication Services
Coinbase Global Inc Ordinary Shares - Class A	COIN	5.51%	Technology
Unity Software Inc Ordinary Shares	U	5.27%	Technology
Zoom Video Communications Inc	ZM	4.37%	Technology
Square Inc Class A	SQ	4.10%	Technology
Spotify Technology SA	SPOT	3.87%	Communication Services
Shopify Inc Registered Shs -A- Subord Vtg	SHOP	3.82%	Technology
Twilio Inc Class A	TWLO	3.28%	Communication Services

Data as at 07/10/2021. Source: Morningstar Created with [Datawrapper]

For the Catherine Woods of the world, they believe markets are entering a new era. Her firm believes the world is on the cusp of transformations in every sector globally, the likes which we have not seen since the early-1900s. She likens innovations like DNA sequencing, adaptive robotics, energy storage, artificial intelligence and blockchain technology to the telephone, electricity and the automobile. She says the full potential of these technologies is only just beginning to be understood, and that dramatic and accelerating declines in costs will deliver outsized growth.

"We’re looking forward, not backward. We are looking at exponential growth opportunities that have evolved as these innovation platforms have started to mature and move into prime time," Wood says.

"These seeds were planted in the 20 years that ended in 2000. The power of the exponential growth rates that we're going to see is a function of how long they've gestated. When I throw out a number like 88% annual growth in units, that sounds preposterous, but Wright’s Law gives a very nice guide – here's how the costs should decline, if you pass those costs down in prices, the uptake will be there."

She adds:

"We got a glimpse of exponential growth during the internet – it turned so many people off because it was so wrong. The costs were too high, the technologies weren't ready. Now, technologies are ready and not only are we seeing these five innovation platforms evolving, [artificial intelligence, robotics, energy storage, DNA sequencing, and blockchain technology], we are beginning to see them converge."

To value exponential growth opportunities, Wood projects out a company's cash flows based on Wright's Law and ARK's cost trajectories to arrive at an EBITDA in year five. This Law says that for every cumulative doubling in the number of units produced, the costs associated with new technologies decline at a consistent percentage rate. Then, she'll slap a FAANG-type multiple (a mature innovation company multiple) on the projection to reach a price – implying she believes today's multiples are sustainable.

Wood believes the book values some analysts rely on to assess a company's value include "bloated figures". Many sectors, she says, will be forced to deal with "stranded assets" due to the pace of innovation and the "creative destruction that will cut them in half". She's on record saying that almost half of the S&P 500 index is threatened by technological disruption.

Courage of your convictions

Where you sit in this debate defines you as an active investor today – between waiting for the "big crash", cash in hand, or doubling down on any dips in the market, no matter how small. Watching on, I was sceptical of Wood's brand of technophilia but could not help being irked by value's long stretch of underperformance. Some of Wood's bolder predictions for Bitcoin and Tesla have come true, to the dismay of analysts who called them out as ridiculous. What I am impressed by is their unwavering commitment to their investing philosophy. Both Wood and Arnott will have good years and bad, but it's the courage of their convictions in the face of great criticism which will keep investors sticking with them for the long term. Chasing short-term performance is no recipe for success.

Emma Rapaport is Editor Manager at Morningstar, owner of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Read the transcript: The Tesla 'bubble or not' debate

4 key materials for batteries and 9 companies that will benefit

Dawn Kanelleas

The world is on the cusp of a revolution in low-carbon technologies, and they are set to reshape many of our supply chains.

The not-so-humble battery sits at the heart of this shift. The growth of electric vehicles (EVs), and renewable power generation/storage, will increase demand for a range of raw materials. It's estimated that the global EV stock will reach 245 million vehicles by 2030, or more than 30 times above today's level.

Installed wind capacity is expected to rise almost fourfold in the same period, from around 700 gigawatts today to around 2000 gigawatts in 2030 [*Source: IRENA, CGAU*].

However, a rapid ramp-up of such technologies will require a concurrent increase in the materials used in them. Significant investments in mining and technology will be required to meet the needs of the burgeoning battery market.

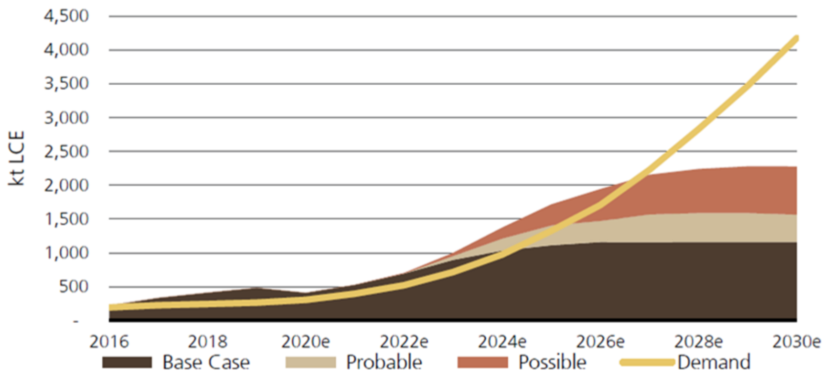
This article outlines the key materials required for battery production, and their related investment opportunities.

1. Lithium

It's the metal that everyone is talking about. Australia is extremely well positioned to supply into this market and has a number of projects across the board among large companies such as IGO and Mineral Resources, as well as a lot of smaller companies that are trying to also establish a position in this space.

Lithium is the prerequisite metal for all batteries that are used in electric vehicles. As shown in Chart 1, it is clear that future demand is massively outstripping the supply that's coming on. Most lithium processing companies are in China, and they'll tell you that the curve is nearing vertical in terms of the demand they are seeing.

Chart 1: Lithium supply and demand balance



Source: UBS, Battery Raw Materials, 4 March 2021.

There are two sources of supply for the lithium that goes into a battery: brine, and hard rock called spodumene.

Brines are usually found in South America, in the form of an underground salt that can be dissolved and then taken up to the surface and spread out into an evaporation pond to leave lithium chloride which is converted to lithium carbonate. Everything can go wrong, due to being an open-air chemical reaction exposed to the elements. Because of this, and due to the lesser energy density that this type of material provides, brine is not the preferred source of lithium to be used in the batteries.

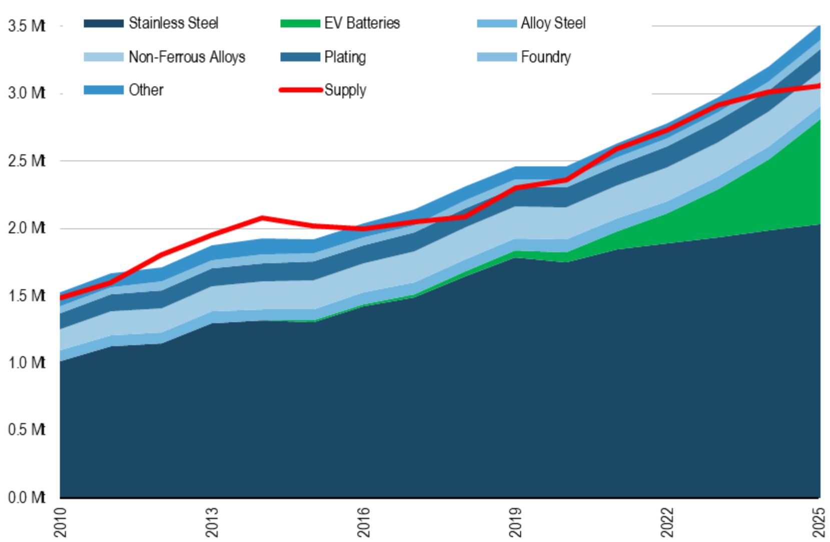
Spodumene is what we have here in Australia. Spodumene is a hard rock and is found mostly where iron ore is found, for example in the Pilbara region. Spodumene is even harder than iron ore and is very difficult to break. A concentrate is formed by crushing and separating the ore, and Australia has become very good at this over the years. For example, Mineral Resources is a world leader, crushing and concentrating spodumene to 6% lithium, which is the optimal concentrate for this ore for conversion into lithium sulphate and then lithium hydroxide and lithium carbonate. Spodumene is where the supply and investment is going. The capital intensity has been coming down, and the ability to reliably concentrate it has improved dramatically.

2. Nickel

The best batteries in the world have very high nickel content. Tesla and its EV peers want the best batteries, and this is what is going to drive demand. Nickel is favourably exposed to demand from electric vehicles due to nickel use in battery cathodes, and a trend towards using more nickel and less cobalt in cathodes.

As shown in Chart 2, currently nickel is predominantly used in stainless steel and other steel alloys. However demand for nickel is increasingly going to come from EV batteries.

Chart 2: Nickel demand forecast (kpta)



Source: UBS, Battery Raw Materials, 4 March 2021.

There are two nickel ore types: laterite ores and sulphide ores. Demand for nickel sulphide is going to be very high, compared to laterite ores, because a sulphide can be converted to a nickel sulphate for batteries at a relatively low financial and environmental cost. To meet future high demand, nickel sulphide is going to be the precursor material that is going to go into batteries.

3. Copper

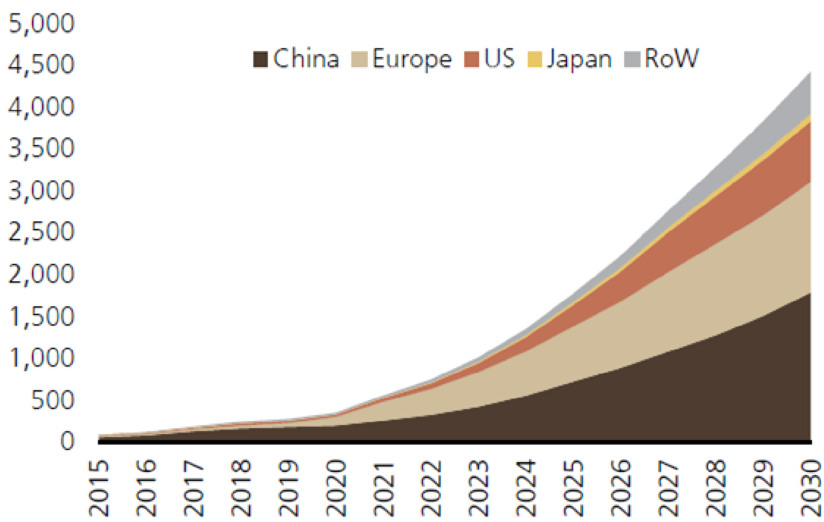
Copper supply is declining. It is becoming increasingly difficult to mine, with new discoveries typically being lower grade, deeper underground, or in regions such as the Democratic Republic of Congo which, from an

ESG perspective, are unviable. These factors combine to make copper one of the few commodities that are increasingly rare to find in the earth's crust in an economic way.

EVs rely on the movement of electrons, and there is no material known that is better than transmitting electrons than copper. Therefore EVs are going to have a lot more copper, along with the charging stations and the electricity grids which support them. Therefore copper demand for EVs and supporting infrastructure, along with the copper price, is expected to be very strong.

As shown in Chart 3, by 2030 copper consumption in electric vehicles is expected to represent 4.4Mt of copper or approximately 13% of total demand. At face value, this is modest demand growth compared to the markets of lithium, nickel, rare earths or graphite. But EVs serve to accelerate demand growth towards around 3% p.a., which is above the long-term historic trend of 2.4% CAGR (1976-2019) [*Source: Wood Mackenzie, Company Filings, UBSe, August 2021*].

Chart 3: Copper demand from Electric Vehicles (ktpa)



Source: UBS, Battery Raw Materials, 4 March 2021.

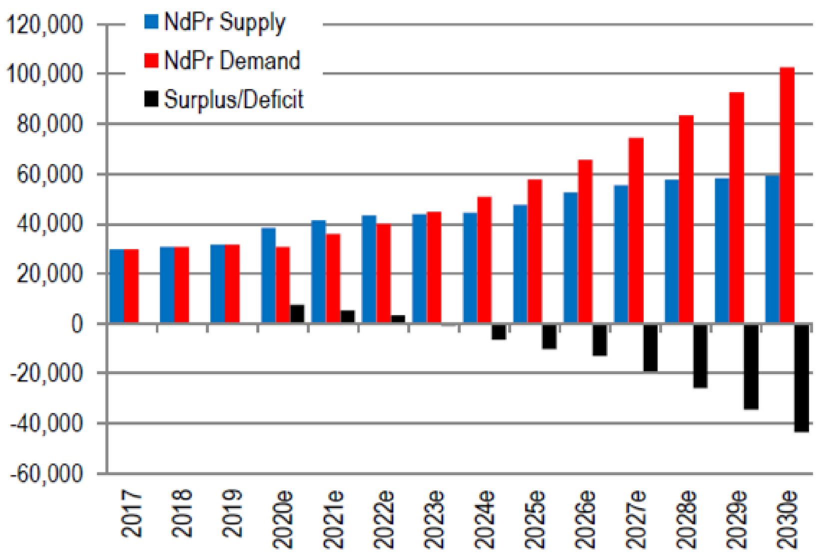
4. Rare Earths

Rare Earths (RE) refers to a group of transition metals that have magnetic, nuclear and electrical properties. Their name refers to their rare occurrence in economically viable concentrations, rather than scarcity. Neodymium (Nd) and Praseodymium (Pr), or NdPr, are two rare earth elements that face a step change in demand from forecast EV sales because they are the strongest type of permanent magnet, used in high performance applications such as electric motors and wind turbine generators. Currently, permanent magnets represent the largest end-use for rare earth elements, at around 30% of demand.

China has the best deposit in the world, with the second largest deposit in the world being in Australia; a highly strategic asset owned by ASX-listed Lynas Rare Earths Ltd.

Current demand for NdPr is less than 40,000 tonnes per year, but this is forecast to reach over 100,000 tonnes by 2030. Supply projections suggest producers will be unable to keep up with this demand [*Source: UBSe, Company Filings*].

Chart 4: NdPr demand and supply projections (tpa)



Source: UBS, Battery Raw Materials, 4 March 2021.

Investment opportunities in Australia

We believe that Australian companies are well-placed to benefit from the growing demand for batteries and EVs, with a number of established companies already operating in the sector, including:

- IGO - Hard rock spodumene (lithium), nickel sulphide copper
- Mineral Resources - Hard rock spodumene producer (lithium)
- Pilbara Minerals - Hard rock spodumene producer (lithium)

- Syrah Resources - Graphite
- Oz Minerals - Copper, undeveloped nickel sulphide
- Sandfire - Copper
- Western Areas - Nickel sulphide
- Lynas - Rare Earths
- Iluka - Potential Rare Earths producer

The Federal Government is focused on fostering a resilient commodity supply chain and has developed a roadmap for critical minerals processing and manufacturing, with the goal of becoming a regional hub for the sector over the coming decade.

The Australian Small and Mid Cap Companies team continues to monitor the opportunities in this sector, in particular leading companies that are positioned to benefit from the fundamental changes the next decade will bring as a result of the growing demand for electric motors and battery technology.

Dawn Kanelleas is Head of Australian Small and Mid-Cap Companies at First Sentier Investors, a sponsor of Firstlinks. This article is for general information only and is not a substitute for tailored financial advice. Any stock mentioned does not constitute any offer or inducement to enter into any investment activity.

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Why valuation multiples fail in an exponential world

Amit Nath

"That company is expensive because its valuation multiple is high". This is one of the most used and repeated phrases of market commentary. In fact, multiples are probably the most enduring pieces of investment analysis of all time.

Unfortunately, they are often completely useless.

The law of the instrument, or 'Maslow's hammer', is a cognitive bias where people rely too much on a familiar tool. The renowned American phycologist, Abraham Maslow, articulated this concept with his hammer and nail metaphor:

"It is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail".

Multiples are a short-cut, lazy approximation for valuing a business

For many market commentators and armchair enthusiasts, valuation multiples are their Maslow's hammer, and they apply it indiscriminately, perhaps because it is the only valuation tool they possess in their toolkit.

Valuation multiples are a simplified, abbreviated and short-cut methodology for thinking about the value of a company. They blindly take a company's price (market cap, enterprise value) and divide it by a fundamental metric (revenue, operating income, EPS, etc).

But they don't tell the whole story or give a complete picture of underlying value and are prone to sizeable error when applied in isolation. And, sadly, multiples have never been less useful than they are today.

If investors can understand how multiples can mislead, and how to value companies in this new complex market, they will be better placed to identify and ride 'multi-decade compounders', such as the current and next generation of Amazons and Microsofts that build massive long-term wealth.

Multiples were not designed for today's world

For traditional valuation multiples to be effective, a company needs stable and predictable cashflows, which are generally found in mature industries like utilities, real estate and infrastructure.

Multiples do a poor job of valuing privileged business models that have advantaged economics, including barriers to entry, network effects, and unique datasets. They also fail to reflect the value of emerging opportunities (aka real options) embedded in the world's best businesses, including the likes of Facebook's AR/VR platform and Alphabet's AI unit.

Multiples provide an inadequate view when companies have high and relatively sustained growth rates, particularly for the world's best software-driven ecosystems like Microsoft, Google, Amazon or in the alternative asset management space, like Blackstone, KKR, and Carlyle.

Basically, multiples simply break down when investors are analysing a disruptive company in the midst of an inflection or an industry that is adapting to a new world, a world we are seeing across myriad of sectors such as technology, healthcare, financials, transportation, and energy.

Humans are bad at exponential thinking

The core of the problem can be traced back to the fact that humans are very bad at exponential thinking. We prefer to use a simplifying linear concept (like a multiple) for a more complex non-linear concept (high growth business).

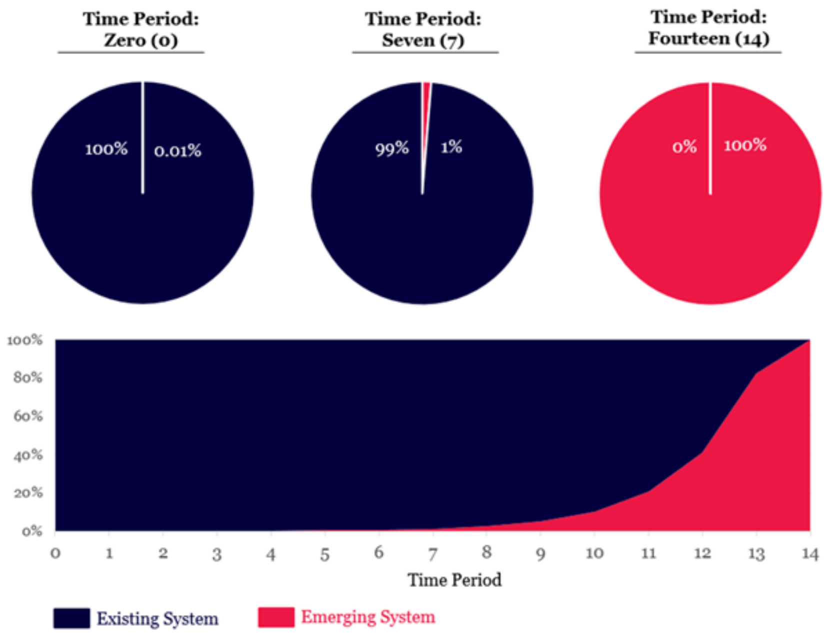
But we lose information, and that mapping mismatch can lead to errors and ultimately incorrect conclusions.

Google's world-renowned futurist and Director of Engineering, Raymond Kurzweil, believes humans are linear thinkers by nature, whereas technology, biology and our environment are often exponential. That, he says, creates enormous blind spots when we pursue higher-order thinking and seek to solve increasingly complex problems.

Let's consider a simple thought experiment often sighted as Kurzweil's 'law of exponential doublings'. It takes seven doublings to go from 0.01% to 1%, and then seven more doublings to go from 1% to 100%. So within 14 time periods an emerging system has gone from being completely invisible in the linear world (0.01%) to entirely encompassing it (100%).

The Covid-19 pandemic and the exponential spread of the virus gave us a real-world look at what exponential growth feels like as our lives were significantly disrupted. Yet most of us are simply not built to intuitively reconcile this phenomenon.

Visualizing exponential growth through doublings



Source: Montaka.

Multiples meant investors missed massive Microsoft gains

Microsoft is an example of a company where the use of multiples fail. For the last decade the company has been consistently criticised by some investors for having an 'extremely high multiple' and is on the verge of a sharp pull-back.

This narrative continues to persist in parts of the market even today, yet Microsoft's multiple has consistently expanded for the entirety of that time.

A linear conversation about Microsoft's multiple ignores several underlying drivers of Microsoft's valuation, from its virtual monopoly in enterprise computing (Windows), stranglehold on productivity applications (Office), to the enormous opportunity ahead of its cloud business (Azure).

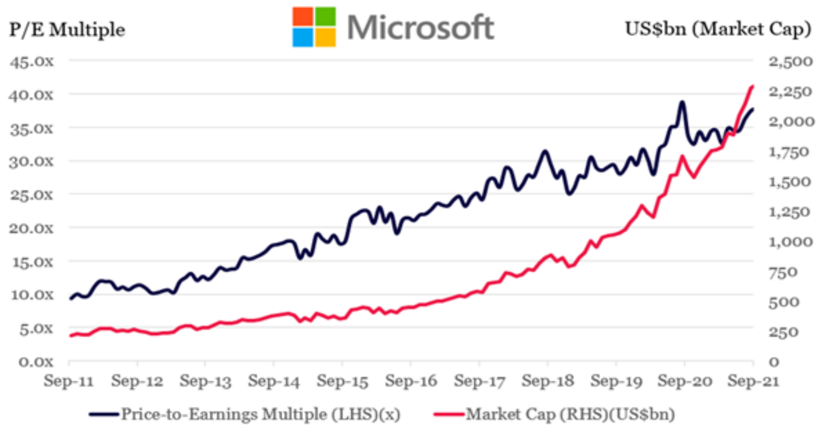
Some six years ago Azure was an invisible real option within Microsoft, but it certainly feels real today after growing from basically zero revenue to an estimated $40 billion annualised run-rate (June 2021). Azure continues to grow at around 40-50% year-on-year with enormous runway ahead.

Another fallacy is that Microsoft's market capitalisation gains have been entirely driven by multiple expansion and the low interest rate environment. Those factors certainly play a role, but multiple expansion only explains a third of Microsoft's value gains.

While Microsoft's multiple has expanded four-fold over the last decade, its market cap has increased nearly eleven-fold during that time, driven by a massive earnings inflection and exponential growth within Azure. That's an extremely significant error produced by the unhelpful market heuristic of multiples.

Entrenched habits and lazy analysis have a long tail and multiples are a seductive short cut.

Microsoft's multiple has expanded for a decade



Source: Bloomberg, Montaka.

How to value companies in today's complex market

So if multiples mislead, how do investors value companies in this new environment?

There are no short cuts in valuing a business. It is a hard, detailed, and rigorous exercise that takes considerable time and insight to get right. At Montaka, our investment theses are fundamentally driven and we gain insights across the following areas:

- Detailed, bottoms-up, DCF (discounted cash flow) assessment of each company we invest in with an exploration of business model economics, TAM (total addressable market), competition, etc
- Top-down perspective of the markets the company currently serves and potentially will serve in the future
- Considerable time is spent considering what the business and industry will look like in 5 to 10 years and what challenges / opportunities may be encountered (this is a never-ending cycle of course)
- We also establish a set of valuation scenarios that are weighted by the probability of the scenario being reached. They guide our view around upside and downside, and color our level of conviction in the position.

We then effectively take a 'time machine' to several points in the future. For each time period we observe the multiple our valuation implies. This helps us check whether we are being too conservative, or too exuberant relative to what the market is willing to pay for the business today. In fact we often find instances where our DCF has compressed multiples in an unreasonable way or the market is being too conservative with its current price level.

Getting comfortable with high multiples

If we continue with Microsoft as an example, the current share price (US$300) implies the market is being extraordinarily bearish on the Azure cloud business, and also believes Microsoft's future multiple will materially compress over the coming decade (from 37.0x to 13.5x).

We strongly disagree with the market's assessment on both fronts and believe it is significantly underestimating Microsoft's earnings potential and opportunity set, plus unreasonably discounts the quality of these earnings by slashing its multiple by more than half.

Significant multiple compression implied by current share

Source: Montaka.

In fact, under our bullish scenarios, we believe Microsoft's share price could increase several fold, even from here.

Compounding your wealth over decades

When an investor looks at a multiple, it may seem high at first glance. Certainly, a high multiple can be a red flag for overvaluation. However, in isolation an investor can't draw any real conclusions from that multiple.

Let's also look at Amazon for example. In 2006, it was trading at an EBITDA multiple of 26x versus the market (S&P500) which was trading at 10x. Certainly not cheap by typical measures.

But as a thought experiment, if we were to discount the current Amazon enterprise value at an annual rate of 10% back to 2006, an investor should have been willing to pay close to 690x EBITDA and they still would have quadrupled their money today. The market, however, materially undervalued Amazon and it went on to deliver investors 115x over that period. In fact, you could have paid double the share price for Amazon in 2006 and still made nearly 60x your money today.

Amazon (NASDAQ: AMZN)	2006	2021
Actual Performance		
Enterprise Value (EV)(US$bn)	15.6	1,793.1
EBITDA (US$bn)	0.6	65.3
EV / EBITDA (x)	$\boxed{26x}$	27x
Return over period (x)	--	$\boxed{115x}$
CAGR over period (%)	--	$\boxed{35.8\%}$
Thought Experiment		
Enterprise Value (EV)(US$bn)	409.3	1,793.1
EBITDA (US$bn)	0.6	65.3
EV / EBITDA (x)	$\boxed{689x}$	27x
Return over period (x)	--	$\boxed{4x}$
CAGR over period (%)	--	$\boxed{10.0\%}$

Source: Montaka. Based on June-2021 LTM earnings for 2021 column.

At Montaka, our clear goal is to maximise the probability of achieving multi-decade compounding of our clients' wealth, alongside our own. We are convinced that the months and years ahead will present opportunities to make attractive, multi-generational investments.

To achieve that, we won't let multiples become our Maslow's hammer!

Amit Nath is a Senior Research Analyst at Montaka Global Investments. This article is general information and does not consider the circumstances of any investor.

Five value chains driving the 'transition winners'

Hendrik-Jan Boer

The most promising global companies identify opportunities and sustain profitability using what we call 'global sustainable equity'. Sustainable has three pillars:

1. a durable competitive position
2. do no harm
3. adapt to change.

The most obvious sense of sustainability is in companies that do no harm. On environmental, social and governance (ESG), good performance and planning around those factors can have a direct relationship with a company's broader financial performance.

But the sustainability of a business clearly overlaps with its durability. Companies must reinvest profits to sustain their core business and take advantage of attractive opportunities. The ability to adapt to change makes a company much more likely to sustain today's profitability into tomorrow.

Transition winners come from value chains

We identify five value chains in the modern economy.

1. Digitalisation of the economy (the Digital Enterprise value chain)
2. Demand for renewable energy (the Energy Transition value chain)
3. Lower-cost solutions for unmet or high-cost medical needs (the Access to Healthcare value chain)
4. Products and services that recognise the increasing focus on ethics and convenience (the Conscious Consumer value chain), and
5. Solutions in the rapid shift to digital payments and online access to finance (the Fintech and Financial Inclusion value chain).

Much investment management still tends to think in terms of industrial sectors, but the shift toward services and the growth of information technology has substantially blurred the lines between the traditional sectors.

For example, Amazon's tools are the internet and logistics, but its impact has been felt in the retail sector. Today, the performance of a manufacturer in the industrials sector is less likely to be determined by what it has in common with other industrials stocks than by whether it makes things for, say, the renewable energy industry rather than the extractive commodity industry.

Look through a value chain lens

Value chains offer a more realistic view of what's going on in today's economy. We look for the companies that are best positioned to adapt to and take advantage of the major transitions identified by those value chains. These are 'transition winners'.

To identify companies with durable competitive positions, look for businesses that can sustain high profits for an extended period by building 'economic moats', especially with intangible capital such as a lead in a particular technology, a unique consumer offering, protected intellectual property, an unassailable cost advantage or a hard-to-replicate platform, network or ability to scale.

As a starting point, we look for two important quantitative markers of a business that is compounding profits due to economic moats: **Cash Flow Return on Investment** (CFROI) and **Asset Growth**.

CFROI tells us how efficiently cash flow is generated from capital invested, and therefore the level of cash resources that are available for reinvestment. Asset Growth tells us whether or not a company is finding opportunities to invest that cash.

When both are relatively high, that indicates to us that a company is investing for growth while simultaneously guarding its profitability from potential competitors. When CFROI is high but Asset Growth is low, that suggests a company whose past investments remain profitable but which is struggling to find new opportunities. When CFROI is low and Asset Growth high, that may indicate an early-stage business that has not yet established the moat that will protect its profitability.

Companies with high CFROI and high Asset Growth are not always likely to be among the 'transition winners'. Let's take an example of one of our value chains, Energy Transition.

It is perhaps obvious that a lot companies working in this value chain with low CFROI and low Asset Growth are fossil-fuel producers threatened by cheaper and more sustainable alternatives and weighed down by stranded assets. It is clear why these companies struggle to adapt to change as they are massively geared to yesterday's economy.

But how do you think a manufacturer of batteries, electric vehicles or solar panels looks, according to these metrics? Asset Growth tends to be high but CFROI does not follow, because these products are easily commoditised and competition is fierce. We tend to find high CFROI and high Asset Growth in the manufacturers of solar invertors, equipment for electricity grids and specialised home energy services. We think it is much harder to identify the obstacles that will prevent the best of them from emerging as transition winners generating sustainable, durable profits.

There is a simpler way in which high CFROI makes a business more likely to be a transition winner. Profitable businesses usually have established brands and reputations which they can bring to new markets, and their cash flows remove the necessity to borrow or sell more equity if they identify an opportunity to pivot and invest in new opportunities.

That opens the possibility for a mature, old economy business with high CFROI and low Asset Growth today to adapt to change and find new growth opportunities tomorrow— but in our experience, successful examples are rare.

A focus on ESG shows a focus on the future

A lot of ESG investing remains top-down and quantitative. These screens are useful for weeding out the very riskiest businesses, but they are much less useful for differentiating between businesses that pose similar levels of risk or identifying attractive opportunities.

Few companies have uniformly strong performance across all ESG factors, and this tends to make the aggregate ESG scores of many businesses bunch around the average regardless of how well or badly they perform on the factors that matter most to them.

Furthermore, the historical data that feeds into quantitative ESG scores does not fit well with our focus, as active investors, on businesses that are making marginal ESG improvements that are yet to be priced into securities. They offer no insight into a company's sustainability action plans. They tell us nothing about the likelihood of changes in regulation or consumer attitudes, which could alter a company's material ESG exposures. For us, low current ESG risk is a plus, but we see the most attractive alpha opportunities in active efforts both to manage and to change ESG exposures.

In addition, a forward-looking view on ESG helps both investors and company management teams to appreciate how societal change can make what were once non-material ESG risks into potentially material threats or opportunities. A forward-looking plan of action on ESG often indicates a general adaptability to new practices and changing circumstances, and therefore an enhanced ability to adapt to change to sustain profitability. We find that companies like these are more likely to be thinking ahead and taking a holistic view of their position in society, the economy and the wider environment and it's no coincidence that this way of looking at the world overlaps considerably with the value-chain lens that we apply in our own research.

Bringing it all together

High Asset Growth suggests that a company has found a way to adapt to change happening in the economy. High profitability gives companies the reputational and financial means to adapt to change. Moreover, a greater reliance on intangible over tangible capital, which we often find associated with durable competitive positions, can also give companies the operational means to adapt quickly to change. It is often easier to change the productive focus of technology or knowledge than to change the productive focus of specialised machines and factories.

Hendrik-Jan Boer is Senior Portfolio Manager and Head of Global Equities Group at Neuberger Berman, a sponsor of Firstlinks. This material is general information and does not constitute investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. You should consult your accountant or tax adviser concerning your own circumstances.

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Halving super drawdowns helps wealthy retirees most

Professor Kevin Davis

On 29 May 2021, the Government announced by way of a media release the extension of an emergency COVID measure. The temporary halving of minimum drawdown rates for retirement superannuation accounts - introduced in March 2020 while the Australian stock market was in freefall - would continue for another year.

The explanation was terse and does not stand up to scrutiny.

The biggest beneficiaries of the extension are wealthy retirees who use super to escape tax on funds they are building up to hand on to their children. It provides no benefits to less well-off retirees who need to use money in super to live on in retirement.

> Today the Morrison Government announces an extension of the temporary reduction in superannuation minimum drawdown rates for a further year to 30 June 2022.
>
> As part of the response to the coronavirus pandemic, the Government responded immediately and reduced the superannuation minimum drawdown rates by 50 per cent for the 2019-20 and 2020-21 income years, ending on 30 June 2021.
>
> Today's announcement extends that reduction to the 2021-22 income year and continues to make life easier for our retirees by giving them more flexibility and choice in their retirement.
>
> For many retirees, the significant losses in financial markets as a result of the COVID-19 crisis are still having a negative effect on the account balance of their superannuation pension.
>
> This extension builds on the additional flexibility announced in the 2021-22 Budget.
>
> The Morrison Government will continue to support retirees as part of our plan to secure Australia's economic recovery from COVID-19.

Before the temporary halving of drawdown requirements in March 2020, a retiree aged between 65-74 would be required to withdraw at least 5% of their account balance each year. The minimum withdrawal rate increases with age.

The merit in the requirement (even if the numbers used have an unavoidable element of arbitrariness) was that it limited the ability of wealthy retirees to use super as a pure tax dodge. Funds in super retirement accounts have a zero tax rate on earnings and are untaxed when withdrawn.

Super is meant to be for retirement

The original decision in March 2020 to halve minimum withdrawals possibly made some sense. Following a peak on 20 February 2020, stock markets plunged and super funds suffered negative returns (minus 10.3% in the March 2020 quarter, according to the Australian Prudential Regulation Authority).

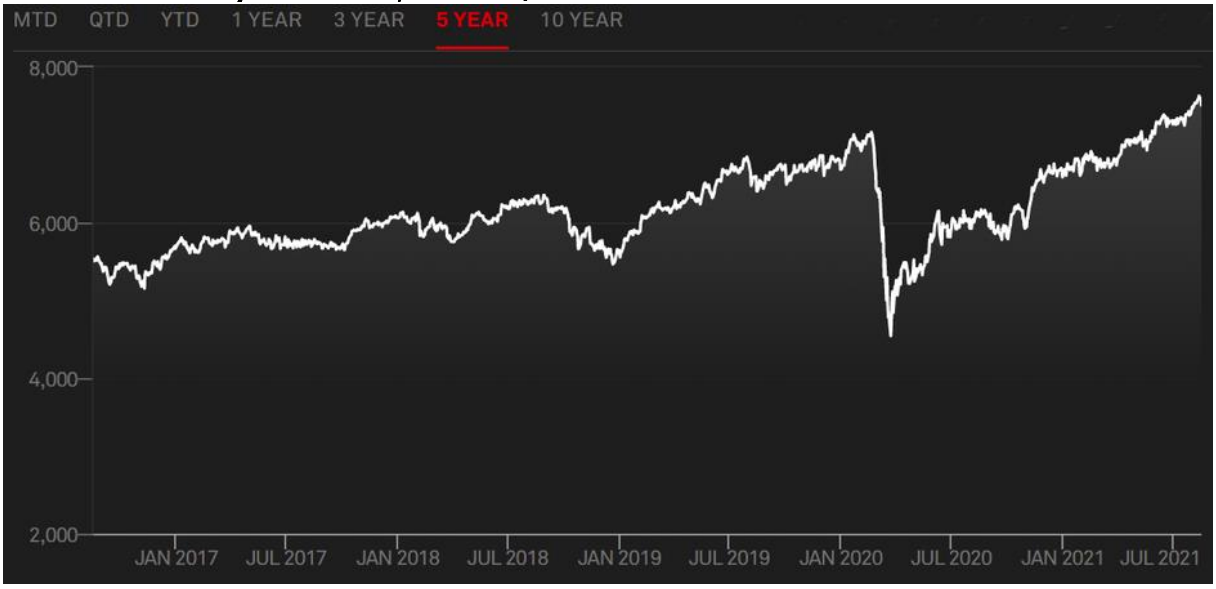
Withdrawing funds, possibly not currently needed, from a tax-preferred portfolio at a time when its value was (hopefully temporarily) depressed was not an optimal wealth management strategy.

Those sufficiently well-off and able to draw on assets outside super, could now draw down less in order to maximise super tax benefits. The less well-off (without significant financial assets outside of super) got no such benefit. They still needed to draw down at a similar rate for living expenses, or cut back consumption.

There are possibly some (probably not many), between these two groups, for whom the policy change meant improved whole-of-retirement living standards given the subsequent recovery in super fund returns. And the announcement may have had some beneficial psychological effects!

So it might have been possible to give the original decision a tick of approval.

By June 2021, the S&P/ASX 200 had more than recovered



Source: [S&P Global]

But what about the decision to extend the halving of minimum withdrawal rates for another entire financial year?

The explanation in the media release is little more than unsubstantiated waffle.

Today's announcement extends that reduction to the 2021-22 income year and continues to make life easier for our retirees by giving them more flexibility and choice in their retirement.

For many retirees, the significant losses in financial markets as a result of the COVID-19 crisis are still having a negative effect on the account balance of their superannuation pension.

The second sentence certainly warrants scrutiny.

APRA statistics show that in the year to March 2021 the rate of return for institutional super funds was 18.2%. This is well in excess of what was required to reverse the temporary loss in the March quarter of 2020 that prompted the original decision.

These APRA statistics for March 2021 were published on 25 May 2021. The information underlying them was presumably available to the Government well before its announcement on 29 May 2021.

Superannuation performance (excluding self-managed funds)

	Year End Mar 2020	Year End Mar 2021
Net assets at beginning of the period ($m)	1,939,702	1,914,395
Income tax expense/benefit ($m)	-11,033	19,434
Net earnings after tax ($m)	-59,161	310,557
Rate of Return (%)	**-3.3%**	**18.2%**

Source: APRA Quarterly superannuation performance statistics, March 2021, Table 1C

The APRA figures are aggregates. There might be some individual funds that had not recovered from the losses of a year earlier, but each of the *categories* of institutional funds in the APRA statistics appeared to have done so.

The APRA statistics do not include SMSFs and some of them might not have fully recovered (we don't know). But even if so, that would reflect decisions about asset allocations in the control of the fund members.

This means the second sentence of the explanation reproduced above is at best unproven, and likely wrong. The first sentence is, of course, tautologically true. The extension will indeed give retirees more flexibility in their retirement.

Super as a tax dodge

The rationale for the drawdown requirement was to limit the use of super as a wealth maximisation strategy for the benefit of heirs.

The purpose of super is meant to be to provide income security and a reasonable standard of living in retirement. That's what the 200-page report of the Retirement Income Review commissioned by Treasurer Josh Frydenberg told him in November 2020.

The key beneficiaries of the reduced drawdown extension are the well-off who already get the most benefit from Australia's super system. Retirees who need super to live on won't benefit in the least.

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