Firstlinks
a Morningstar company

Edition 434, 19 November 2021

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Editorial

Has investing changed? Every week, we face new challenges to our understanding of how investing works. Today, a **Bitcoin** is worth over US$66,000. Only 10 years ago, a Bitcoin sold for less than US$1 after **Satashi Nakamoto** published his paper explaining a new payments system:

"A purely peer-to-peer version of electronic cash would allow online payments to be sent directly from one party to another without going through a financial institution."

Last week's IPO of **Rivian** was another startling example of market mania. A company that has manufactured less than 200 cars with no revenues and $1 billion in costs in the September quarter is now valued at over $200 billion (yes, **b**illion). That's more than **Volkswagen** which delivers 10 million vehicles a year with €250 billion in revenue. **Ford** makes over 4 million vehicles a year and is valued at US$77 billion. Rivian's share price has doubled since issue, with famous short-seller **Michael Burry** (played by **Christian Bale** in **The Big Short** movie) calling it:

"More speculation than the 1920s. More overvaluation than the 1990s."

It was impeccable timing in an Australian context this week, when electric vehicles and utes were front and centre in our news for other reasons. Rivian's major vehicle, the R1T, is not a car but what the Americans call a 'pickup truck', and obviously, it's an impressive one judging by the initial reviews. Wait a minute. It's an electric ute! Surely, no self-respecting tradie would want one, as we were told by **Michaelia Cash** in April 2019 (now our Attorney-General):

"What I worry about for people like Johnny is that the car he is driving today, if a Labor Government is ever elected, will not be the car he is driving tomorrow. In fact, if you look behind us at all these apprentices here, 50% of those apprentices will be driving an electric vehicle under Bill Shorten. We are going to stand by our tradies and we are going to save their utes, because we understand choice, and that is what Bill Shorten is taking away from our tradies."

And what is wrong with an electric ute? **Scott Morrison** explained:

"And I'll tell you what ... it's not going to tow your trailer, it's not going to tow your boat, it's not going to get you out to your favourite camping spot with your

family. Bill Shorten wants to end the weekend when it comes to his policy on electric vehicles, where you've got Australians who love being out there in their four-wheel drives, he wants to say 'See you later' to the SUV."

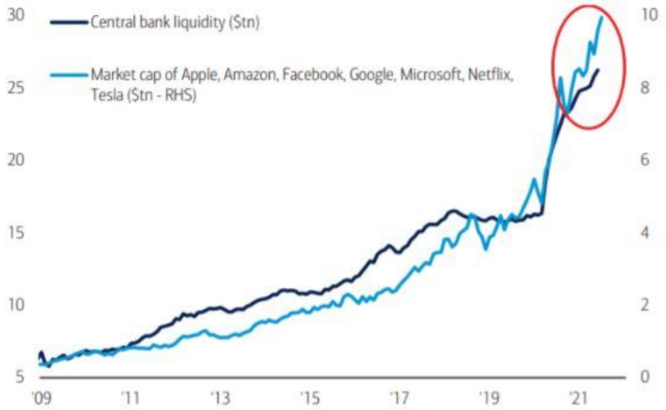
The market's enthusiasm for technology is boundless and the reviews suggest an electic ute can handle the needs of our tradies and Rivian has saved our weekends. Meanwhile, we can rely on technology to fix climate change ...

No revenues, who cares? Famous fund manager **Stanley Druckenmiller** calls current stock prices the biggest bubble of his career:

"... We have crypto craze, we have SPACS, we have booming housing prices, we have these things called NFTs, and equity prices as a percentage of GDP are at an all-time high. And as you also know, inflation is at a 30-year high ... every bust I had ever seen was proceeded by an asset bubble generally set up by too loose policy ..."

Chart 7: FAANG & Fed's Excellent Adventure

Central bank liquidity & tech stocks' symbiotic relationship



Source: BofA Global Investment Strategy, Bloomberg

BofA GLOBAL RESEARCH

And central banks provide whatever liquidity is needed to support the market, including the long-term valuations of tech stocks.

This week we explore whether This Time is Different, and we would love your feedback in two questions. It's our **Living Years Survey**, where we also ask you to share your investing lessons with a 25-year-old starting out in the market. Many of the forces now driving markets did not exist 10 years ago and we did not expect central banks to rescue capitalism every time the market takes a hit. As **Mike + The Mechanics** wrote in The Living Years:

"Every generation blames the one before and all of their frustrations come beating on your door."

Or is this **Morgan Housel** quotation about a young investor describing the moment he went from cocky and overconfident to broke and unemployed illustrative of what will happen to people who think making money is now easy?

"I sat down at my fancy desk on the edge of my chair waiting for the market to open, ready to have another $50,000 day, and thinking life couldn't get any better than this. This time, I was right. It didn't."

On the theme of market overvaluations, **Shane Woldendorp** explains why the investment entry price matters, and returns from starting at elevated levels are usually disappointing. Over the past 30 years, when the median stock in the FTSE World Index has traded at a starting P/E ratio above 30 times, investors have never made a positive real return over the following four years.

Joseph V Amato and his fund manager colleagues sat down recently to explore the key themes facing us in 2022, and identified 10 trends to watch. The end of the year is a good time to review portfolios.

A vital advantage of the companies that thrive in challenging conditions is pricing power, as shown by **Netflix's** ability to regularly raise prices. **Diana Wagner** identifies the companies and sectors that can retain and grow margins, especially if inflation bites.

What if you have plenty of money in superannuation and you want to take out a lump sum, perhaps to spend on a renovation or help children to buy a home? **Meg Heffron** looks at the best ways to withdraw a chunk from super.

Australian banks hold dominant positions in many portfolios, managed funds, ETFs and LICs, and they have come through the pandemic strongly. But while **Hessel Verbeek and Maria Trinci** laud their recovery, they see challenges in the transformation programmes that are supposed to be reducing costs. CBA's biggest-ever price fall yesterday shows how a favourite can be published.

We've all seen the dramatic impact of China's regulatory crackdown on stocks such as **Tencent, Alibaba and Ping An**, but **Chi Lo** explains the country's motivation and how much it is affecting the private sector generally.

This week's White Paper from **VGI Partners** looks at the rising power of Asia's middle class at an inflection point too important to ignore. Asia is forecast to deliver around two-thirds of global growth over the next two decades.

Many thanks to **Harry Chemay** for producing two high quality editions in my absence, assisted by **Leisa Bell.** Our Comment of the Week comes from Harry's excellent paper on the ways our superannuation system needs to change to regain a podium position. **Geoff R** reiterates many comments that retirement planning is compromised by the threat of regulation changes:

"I really just wish politicians would leave it alone and stop meddling. As others have said it is hard to invest with confidence in Super especially if you are young and multiple decades away from retiring. I have recently retired and super has worked well for me but my grown-up children are not trusting enough to put extra contributions in citing the uncertainty and risk involved in locking away their money for 30-40 years - and frankly I can't blame them. Also they possibly recognise I have perhaps lived "too frugally" (likely an outcome of my parents having lived through the Great Depression) and now find I have saved more than I really need in retirement - maybe I should have "let down my hair" and lived it up a little more!"

The Living Years Survey: Is this time different?

Graham Hand

The song, *The Living Years*, was written from the viewpoint of a son who regrets not having a more open relationship with his father. In 1989, it reached Number 1 on the Australian, US and Canadian charts for Mike + The Mechanics, which was a side project of Mike Rutherford, guitarist for Genesis. Here is the youtube link to this legendary song. It's hard to believe the hit is over 30 years old, and the eight-year-old son of Rutherford who features in the video is now 40.

What's the connection to the dramatic changes we have seen in the investing landscape in recent years? The opening lyrics provide some clues:

"Every generation
Blames the one before
And all of their frustrations
Come beating on your door

I know that I'm a prisoner
To all my Father held so dear
I know that I'm a hostage
To all his hopes and fears
I just wish I could have told him in the living years"

Experienced investors including high profile market veterans have missed the tech growth stocks, criticise the valuations of companies like Tesla and Afterpay, denounce cryptocurrencies and label a Non Fungible Token costing US$69 million as absurd. Are they right or are they missing a generational change?

Prisoners to what we hold dear

There is no limit to the examples of valuations and market events that seem crazy to many seasoned investors. Jeremy Grantham has long called the current conditions a bubble, but he has seen many cycles over his decades in the market. Here he discusses the 'Top of the Cycle' in August 2021:

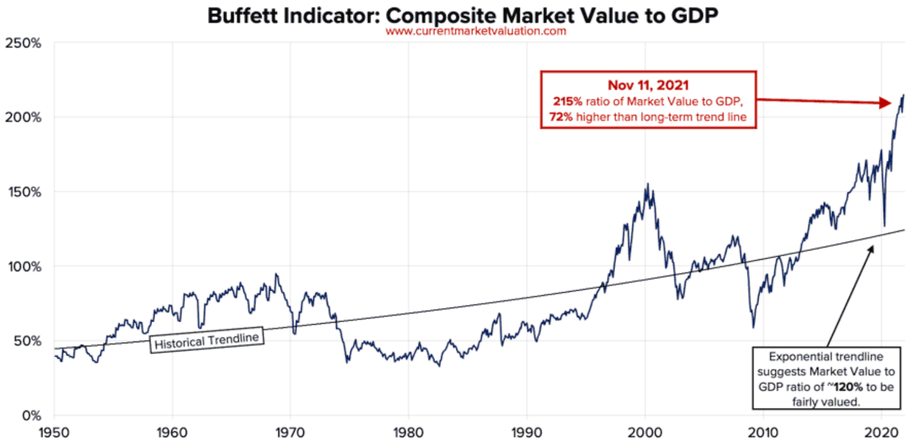
"I think it's clear that we're deep into bubble territory ... most of the data suggests that this is the new American record for highest priced stocks in history. ***Then there's the most important thing of all, which is crazy behavior, the kind of meme stock, high participation by individuals, enormous trading volume***

in penny stocks, enormous trading volume in options, huge margin levels, peak borrowing of all kinds, and the news is on the front page. *This is all characteristic of the handful of great bubbles that we've had." (my bolding).*

Two long-term charts are popular with analysts to show market values over time, and both are at extremes.

1. The 'Buffett Indicator' of total market value to GDP

Warren Buffett calls this ratio "*probably the best single measure of where valuations stand at any given moment*". With the current market value of US stocks reaching US$50.8 trillion versus US GDP of around US$23.7 trillion, the ratio has hit a record high of 215%. Prior to the year 2000, it was normally around 50%, and even allowing for the fall in interest rates and a rising trendline, a number of 120% looks fairly valued. At 2.4 standard deviations above historical average, the market is testing those who look for value signals. But is this time different?



2. The Shiller PE ratio

Again, a widely-accepted measure for the value of the S&P500 is the Shiller PE, and currently it is over 41 times when the long-term historical average is 17.2. It was as low as 4.8 in 1920 or as high 44.2 in the dot-com boom of 2000.

Here are a few examples of valuations and actions testing the incredulity of long-term market watchers:

1. Last week, **Rivian** raised US$11.9 billion in its IPO, valuing the company at over US$100 billion at issue. At time of writing, it has doubled in price. It is the second-most valuable car maker in the world behind Tesla, recently worth over US$1 trillion. Ford Motor Company is valued at about US$77 billion and sells over 4 million vehicles a year. In its IPO prospectus, Rivian advised:

"In the consumer market, we launched the R1 platform with our first-generation consumer vehicle, the R1T, a two-row five-passenger pickup truck, and began making customer deliveries in September 2021. As of September 30, 2021, we produced 12 R1Ts and delivered 11 R1Ts, and as of October 22, 2021, we produced 56 R1Ts and delivered 42 R1Ts."

2. **Elon Musk** is the richest person in the world. Can you imagine Warren Buffett taking investment advice from a Twitter poll? Musk recently tweeted:

"Much is made lately of unrealized gains being a means of tax avoidance so I propose selling 10% of my Tesla stock. Do you support this? … I will abide by the results of this poll, whichever way it goes."

The poll closed with 57.9% of the votes in favour of Musk selling 10% of his stock. Tesla's share price fell and wiped US$200 billion off its market value in two days, which is more than the value of Ford and GM combined. By 16 November, Musk was halfway through his sales for a value of US$8.8 billion.

3. The total market value of **cryptocurrencies** has reached over US$3 trillion, with Bitcoins valued at US$66,000 each and a total market cap of US$1.2 trillion. In 2011, a Bitcoin was worth US$1. Is this time different? Financial markets have never experienced a new technology like this, and while billionaire investor John Paulson cannot be branded as someone who does not understand markets, he told Bloomberg recently:

"I wouldn't recommend anyone invest in cryptocurrencies. I would describe them as a limited supply of nothing. So to the extent there's more demand than the limited supply, the price would go up. But to the extent the demand falls, then the price would go down. There's no intrinsic value to any of the cryptocurrencies except that there's a limited amount."

And Australia's own Hamish Douglass made similar arguments in [this article](#) in Firstlinks where he predicted Bitcoin would become worthless. The market cap of all cryptocurrencies is shown below.

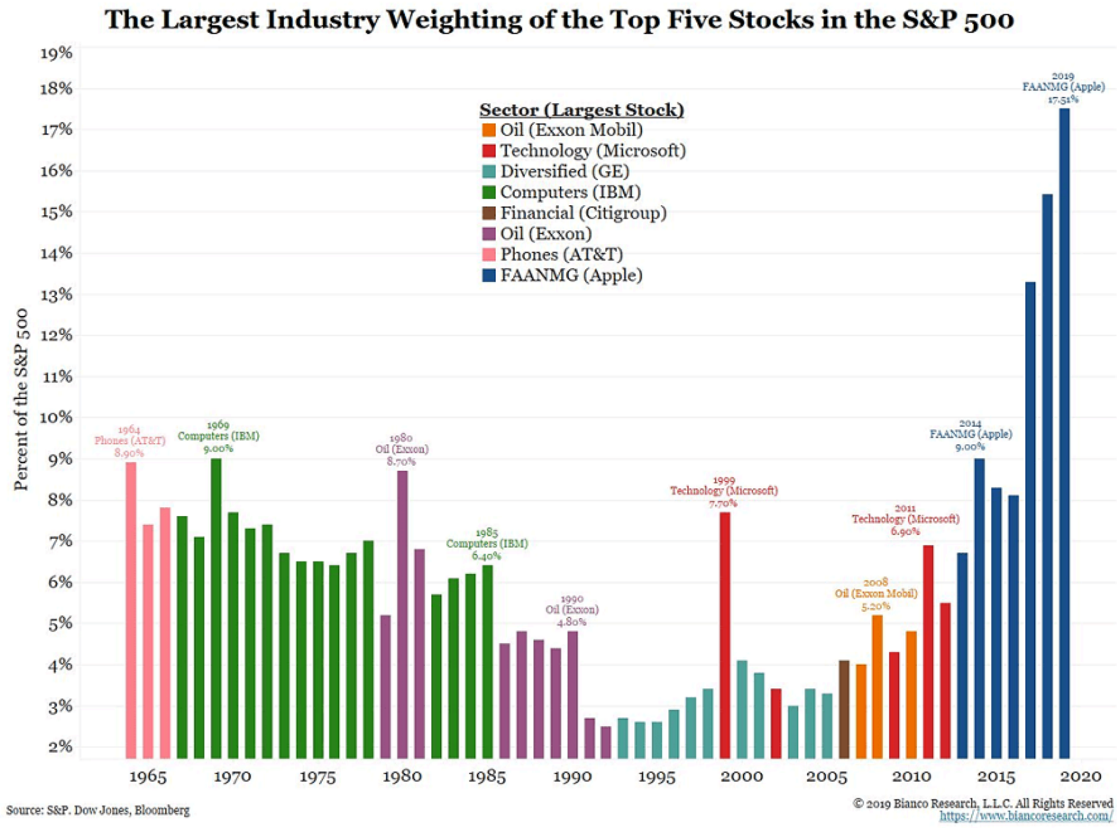
Source: https://coinmarketcap.com/charts/

Over the long term, does it matter?

Part of the market's unlimited optimism stems from recent experience that the US Federal Reserve and other central banks will protect the market. Central banks inject liquidity and lower rates during a crisis. In any market condition, there are always reasons to sell, but even in a global pandemic, the market recovered quickly.

So is all this talk of bad news and excessive valuations just noise in the long-term growth of the equity market and the success of wonderful companies?

It is with some justification that the market is expensive because it is driven by wonderful tech companies with strong growth prospects which deserve their high P/E ratios. For example, Microsoft's P/E is about 42 but Apple is only 27, then we have the super-bullish examples of Nvidia at 90 and Tesla 230 (or thereabouts). The concentration of the largest five stocks in the S&P500 is higher than it has ever been in history and the destiny of the index lies significantly in the fortunes of a few great companies.



Conversations with a 25-year-old

In this survey, we want to draw on the experience of our readers. While this is not necessarily a father/son (or mother/daughter) piece - although it is an opportunity to share opinions with the next generation - what would you now say to someone who is 25-years-old and starting out on investing?

Do you feel you have learned life-long lessons or are conditions so strange to you that you are wondering if times really have changed? For example:

- Should a young person go heavily into shares and remain invested?
- Is active stock management a waste of effort and it's better to stick to indexes?
- Is investing via an SMSF more trouble than it is worth?
- Is it better to invest in a diversified fund and leave it to the experts?

Nobody knows the future, and it does not matter if your opinions are imperfectly formed …

"Oh, crumpled bits of paper
Filled with imperfect thought
Stilted conversations
I'm afraid that's all we've got

You say you just don't see it
He says it's perfect sense
You just can't get agreement
In this present tense
We all talk a different language
Talking in defence

Say it loud, say it clear
You can listen as well as you hear
It's too late when we die
To admit we don't see eye to eye"

Let's open up a quarrel …

You may have a new perspective on a different day, but as the market now stands, what do you think? Take it away Mike + The Mechanics …

"So we open up a quarrel
Between the present and the past
We only sacrifice the future
It's the bitterness that lasts

So don't yield to the fortunes
You sometimes see as fate
It may have a new perspective
On a different day
And if you don't give up, and don't give in
You may just be okay … "

(Songwriters: B.A. Robertson and Mike Rutherford, The Living Years lyrics © BMG Rights Management, Concord Music Publishing LLC)

What do you think?

Let's take the pulse of our audience with two big questions.

1. Is this time different? Do you think investing has fundamentally changed in the last 5-10 years?
2. What investment advice would you give to a 25-year-old starting an investing journey?

Go to Survey

Full results will be published next week and all responses are anonymous. Meanwhile, note that the other big hit for Mike + The Mechanics was a prophetic "*All We Need Is a Miracle*".

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Why starting points matter

Shane Woldendorp

It's why millions of dollars are spent on Grand Prix qualifying cars and house prices are higher near good schools. The better your starting point, the more likely you are to succeed.

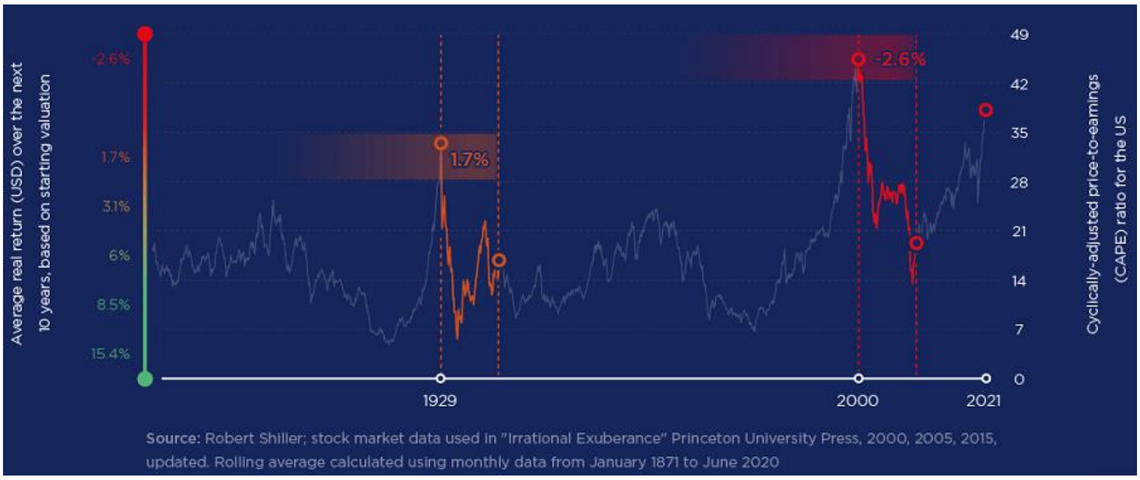
Long-term investing is no different. The lower the starting price of an investment, the better it is likely to do, all else being equal. At its heart, a company's stock price is made up of not just of what its assets, ideas and people are currently worth, but also the profits the market expects it to generate in the future.

Is the value already in the price?

The higher the valuation, the more of those future earnings are already included in the price and the better the company has to do just to meet those inflated expectations, let alone surpass them. In addition, the higher investors' expectations, the greater the number of possible scenarios wherein the company disappoints the market. Conversely, the lower the starting price, the less the company has to do to beat low expectations.

When it comes to long-term investment returns, your starting point matters

The chart below demonstrates this. It plots the average cyclically adjusted price-to-earnings (CAPE) ratio for the US market over the past 140 years. The CAPE ratio is calculated in a similar way to the standard price-to-earnings (P/E) ratio, but instead of dividing a company's stock price by one year's worth of earnings, it uses the average earnings figure for the past 10 years (adjusted for inflation) to smooth out the impact of economic cycles.



Investors tend to use the CAPE ratio as a barometer for how expensive or cheap a market is. A high CAPE ratio tends to indicate that the market is expensive, with the long-term average for the US market somewhere around 17 times.

As you can see, US stockmarkets in aggregate have seldom traded above 30 times. In other words, there have been few times in the past 140 years when investors were willing to pay for more than 30 years' worth of average earnings upfront and, when they have, the average real return over the following 10 years has been underwhelming, to say the least.

Markets looking expensive in aggregate is not just a US phenomenon. A similar case can be made for the broader FTSE World Index, albeit over a shorter time frame. Over the past 30 years, when the median stock in the FTSE World Index has traded at a starting P/E ratio above 30 times, investors have never made a positive real return over the following four years. At the end of October 2021, the median stock in the FTSE World Index traded close to 30 times.

What does that mean for investors today?

Judging from the chart above, the prospect of stellar returns at an aggregate level over the next few years looks modest at best. If one looks below the headline level, at the individual stocks that make up the market, however, much of the increase in recent years has been driven by a handful of expensive stocks that have become extremely expensive, rather than a groundswell of growth that has pushed up the whole market.

Among those companies that have been left behind, there is a great deal of opportunity to be found, even in a market that is as expensive as the US.

One such example is AES, an independent power producer listed in the US, and a stock held by the Orbis Global Equity Fund. A popular theme for many investors at the moment is the energy transition space, and companies positioned to benefit have been rapidly and, in some cases, extremely bid up. As such, it's been hard for many investors to find good value in this area. In our view, AES is a rare exception, given it currently trades at around 15 times forward earnings, significantly lower than its peers such as NextEra Energy, which, despite similar levels of earnings growth, trades at more than 30 times forward earnings.

Part of the reason this discount exists is AES's history and, in particular, its rapid, early expansion. Founded in 1981 as an energy consulting firm, it soon moved into energy generation. By 1988 it had become the largest independent power producer in the US and by 2002 was operating in 29 countries. But, while its share price rose dramatically during these years, it also took on considerable foreign exchange risk, overpaid for assets and consistently missed estimates.

Since 2012, however, the firm has been under new management and overseen a fairly dramatic transformation. While, at a headline level, the firm still does most of the same things, where and how they do them has been significantly improved. Not only has its foreign exchange exposure been dramatically reduced by both its shrunken global footprint and the fact that now around 85% of revenues are denominated in US dollars, but more importantly it has become a leader in green power.

At first glance, AES might not appear very 'green' given currently around 25% of the company's total electricity production is from coal. But, the remainder is derived from renewables and natural gas, and AES is aggressively moving away from coal. Indeed, AES expects coal to account for less than 10% of its total electricity generation in 2025. In addition to its core unit, AES also owns an energy storage joint venture with Siemens called Fluence, currently the second largest energy storage provider globally – second only to Tesla. Management expects Fluence revenue to grow from $100m in 2019 to around $3bn by 2025, with the potential of real blue-sky upside. More recently, Fluence was listed separately, making it one of the largest pure-play energy storage companies in the world. On top of that, late last year, AES announced a 10-year strategic partnership with Google, which we believe, should help to expand its renewable energy project pipeline.

There are, of course, risks to the thesis. AES does have a history of overpromising and underdelivering, albeit under previous management. Then there is the fact that increased competition within the renewables space would put downward pressure on the economics of selling power. And, there does remain some forex risk, especially as not all of its assets are in politically stable jurisdictions. However, we believe these risks have been priced in.

The market overlooks some sectors

And, AES is not alone. There are many other examples, all over the globe from technology to healthcare, from banks to logistics, of companies that are being overlooked by a market focused on a small subset of existing winners.

As bottom-up stock pickers, we are able to search underneath the uncomfortable heights of the headline indices to find exciting opportunities at compelling valuations. By focusing on the starting point and the price we pay, we think this increases the likelihood that we will be successful over the long-term.

Shane Woldendorp, Investment Specialist, Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

For more articles and papers from Orbis, please click here.

10 key investment themes for 2022

Joseph V. Amato

with Erik L. Knutzen, Brad Tank, Anthony D. Tutrone, and Suzanne F. Peck.

The heads of Neuberger Berman's investment platforms identify 10 key themes they anticipate will guide investment decisions in 2022, as summarised below. A link to the full paper with more detail is included at the end.

Macro: entering a new age

1. The start of another long cycle—but also a more volatile one?

We are moving from the recovery phase of the current cycle to its middle phase. But what kind of cycle is it likely to be? The previous cycle was the longest in history and it ended only due to the exogenous shock of the pandemic. If anything, we believe that the willingness of fiscal and monetary authorities to support the cycle is even greater today. Inflation and new redundancies built into supply chains could introduce more business-cycle and market volatility, but we think we could be in for another long expansion.

2. Inflation: higher and more problematic

After 40 years of declining inflation and interest rates, the direction of travel appears to be changing, due to new central bank policy priorities, China's strategic reorientation, the energy transition, pressures in supply chains and labor's increasing bargaining power in negotiations over the spoils of growth. The tilt toward supply-side, cost-push inflation in this dynamic will likely pose a challenge to central banks. How central banks choose to navigate a changing inflation environment will likely generate market volatility in the coming year.

3. A new age of politicized economies—and not just in China

China's ongoing strategic reorientation of its economy explicitly elevates social and political objectives such as "common prosperity" and "internal circulation" over outright growth. But this is not just a China story.

Worldwide, political and monetary authorities now have more tools, more capacity and more willingness to direct economic activity than ever before—in pursuit of climate, social equality, political, geopolitical and security goals, among many others. That likely means higher taxes. As the role of markets in resource allocation diminishes, we could also see more supply-and-demand mismatches, inflation and volatility.

4. Net-zero goes mainstream

The 26th United Nations Climate Change Conference of the Parties (COP26) wrapped up as our themes went to press. Many countries went into COP26 lagging in their commitments, but impetus appears to be growing. The European Union's "Fit for 55" legislative agenda sets an aggressive standard. Just as important, the private sector is pressing ahead: we see critical mass in corporate net-zero pledges and plans, and in signatories to asset managers' and asset owners' net-zero initiatives. It will become increasingly imprudent in our view to ignore climate and climate policy risks in portfolios.

Fixed income: rates adjust, investors embrace flexibility

5. An orderly adjustment for bond yields and spreads

Core government bond yields remain low, particularly relative to current inflation; and credit spreads, in our opinion, are priced for perfection. We think the direction of travel in 2022 is up and wider, respectively. Finding income with modest or no duration will continue to be the priority, in our view, but major market disruption or significant credit issues appear unlikely. We believe a more tactical fixed income investment environment is developing.

6. Investors pursue a more flexible approach to seeking income

Faced with a combination of low and rising rates and tight credit spreads, investors are likely to double down on their search for short duration, floating rate, and less correlated sources of income. They may complement this with more tactical positioning, whether that be in interest rate risk exposure, asset allocation or into narrower, niche, but attractive markets. The opportunities likely to draw attention range from short duration credit, loans and collateralized loan obligations (CLOs) to China bonds and European corporate hybrid securities. We believe a mix of these short-duration, less-correlated and tactical sources of income could pay dividends in the year ahead.

Equities: reflationary themes

7. A reflation tailwind for value and cyclical stocks and regions

We think inflationary expansion is likely to support cyclical over defensive sectors, value over growth stocks, smaller over larger companies and non-U.S. over U.S. markets. That pattern was interrupted after Treasury yields hit their peak in March 2020, but could reassert itself as yields start to edge up again—particularly if this is accompanied by a weaker U.S. dollar. This environment would normally bode well for emerging markets, but substantial headwinds mean we tend to favor only specific opportunities, such as leading companies in India's innovation sectors.

8. With stretched market valuations, income becomes more important

The story of value underperformance is well known. But income, as a subset of value, has fared even worse over the past decade. There are three sources of equity returns: multiple expansion, earnings growth and compounded dividend income. Multiples appear stretched, and earnings have been growing above trend—which suggests to us that income may be more reliable over the coming year. Over the past 50 years, income has accounted for around 30% of equity total returns. Moreover, in an inflationary environment with low but rising rates, equity income is also a way to get short duration and inflation exposure into portfolios at relatively attractive valuations.

Alternatives: no longer alternative

9. A bigger menu of non-traditional diversifiers for investors

Investors face high valuations in many growth markets, combined with rising yields and diminished diversification benefits from core bonds, and the potential for inflation running above recent trend levels. This appears likely to encourage all types of investor to make larger, more diverse allocations to alternatives, liquid and illiquid, as well as assets that can mitigate the impact of transitory and secular inflation, such as commodities and real estate. Individual investors may have the ability to make the most notable move, as private equity and debt products become more accessible to them.

10. Execution risk, not market risk, will likely determine success

Valuations are high in current private equity deals. However, while starting valuation can be a strong determinant of long-term public equity returns, the relationship has not been so strong in private markets. We think that could be especially true with today's deals, from venture to buyout. Whereas historical vintages often relied on buying cheap and applying leverage, we see that today's average deal is comprised of more than 50% equity, and depends for its potential returns on successful operational and strategic enhancements, and merger-and-acquisition (M&A) 'roll-up' programs.

These 10 themes are discussed in more detail in the [Solving for 2022 White Paper](#).

Joseph V. Amato is President and Chief Investment Officer, Equities; Erik L. Knutzen is Chief Investment Officer, Multi-Asset Class; Brad Tank is Chief Investment Officer, Fixed Income; Anthony D. Tutrone is Global Head of Alternatives; and Suzanne F. Peck is Head of Investments, Private Wealth Management at Neuberger Berman, a sponsor of Firstlinks.

Which companies have the pricing power to fight inflation?

Diana Wagner

Remember in 2011 when Netflix raised prices by dividing its streaming subscriptions from its DVD service? The announcement sparked an uproar that forced the company to issue an apology and hammered the stock price.

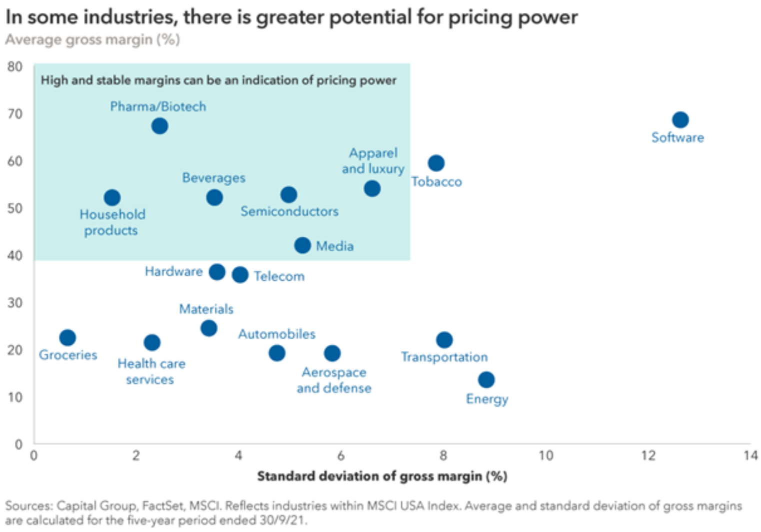
Today the world is in a very different place, and so is Netflix. The company is now a dominant streaming service and a megahit-making machine with more than 213 million subscribers worldwide. Its latest breakout, 'Squid Game' — a Korean drama about children's games played with deadly consequences — captivated some 142 million households, making it the most viewed show in Netflix history.

This rising popularity has empowered the company to boost its prices. It has increased subscription rates in the U.S. four times since 2014, a period of robust subscriber growth globally. This is an example of pricing power, the ability to increase prices without losing customers.

Pricing power can be an antidote for inflation

Pricing power, always a positive for companies that can sustain it, may be a crucial competitive advantage in the year ahead. Inflation has surfaced across many global economies, and there are signs that it could linger in the coming months. The annual inflation rate in the U.S., as measured by the consumer price index, rose to 5.4% in September, its highest level in 13 years. Rising costs can erode a company's profit margins and, ultimately, investor returns. But companies with clear, sustainable pricing power can protect their profit margins by passing those costs along to customers.

With growth slowing and inflation pressures building, I am focused on investing in companies with proven pricing power that are also the beneficiaries of secular growth trends.



Health care services: A prescription for inflation's ills

High medical costs are a perennial 'hot button' issue for the government, and for good reason. Over the last 20 years, health care costs have risen at about 2.5 times the rate of broad inflation, as measured by the PCE inflation rate followed by the U.S. Federal Reserve.

Historically, health insurance companies have had pricing power and passed on rising health care costs to their customers through higher premiums. Today, companies like UnitedHealth Group are no longer mere toll collectors on the freeway of rising health care costs. They actually manage care. It is focused on helping governments and health care providers reduce spending and improve outcomes for patients. The company has been investing in predictive analytics and care delivery to reduce inefficiencies in the U.S. health care system.

They determined that the most powerful person in the care delivery ecosystem is the primary care doctor, who represents 3 cents of every dollar we spend on health care but determines where another 85 cents is spent. By getting primary care doctors involved earlier in decisions about care, UnitedHealth is seeking to keep members healthy and get more value for every dollar spent. By delivering more value, UnitedHealth can maintain its pricing power while helping to tackle a long-term problem in the US.

Semiconductors: Everywhere, in everything

The story of pricing power in the semiconductor industry is simple: Soaring demand meets limited supply. Today semiconductors can be found not only in mobile phones and laptops but also in everyday household products like refrigerators and ovens. New cars can require as many as 100 chips. Indeed, the auto industry has felt the brunt of the global shortage in semiconductor supply.

The rollout of new technologies, like 5G, artificial intelligence and cloud computing have further fuelled the world's appetite for chips. In August, Taiwan Semiconductor Manufacturing disclosed that it would raise chip prices by as much as 20%.

Demand for semiconductors is soaring – along with pricing power

Chip content per unit	High-end smartphone	Automobile	Data center server
2015	$100	$310	$1,620
2020	$170	$460	$2,810
2025 (estimated)	$275	$690	$5,600

Sources: Applied Materials, Capital Group. Figures for 2025 are estimated. All figures are in USD.

Consolidation in the semiconductor industry has transformed the competitive landscape, leaving a few dominant players with potential pricing power in specialized areas of the market. For example, companies with proprietary chip designs, like Broadcom, or Dutch chip-equipment manufacturer ASML, could raise their prices in an inflationary environment.

Beverages: Thirsty for leading brands

The ability to raise prices without serious backlash not only varies across industries but also within them. In the food and beverage industry, drink companies tend to pass along higher costs to consumers better than many food companies. That's because the beverage industry is dominated by a few players with strong brand recognition.

One example is Keurig Dr Pepper, the producer of sodas and single serving coffee pods. The company has a history of pricing power, particularly for its most popular soft drinks, which include Canada Dry, Snapple and, of course, Dr Pepper.

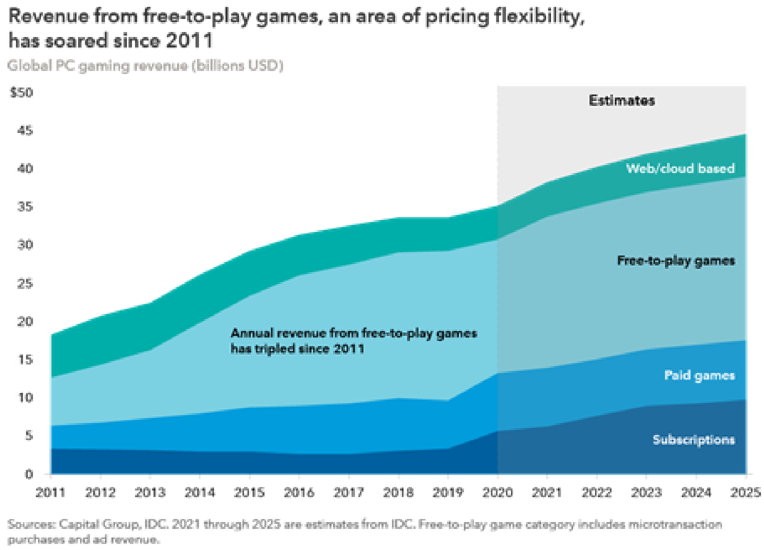
Video games: Not just child's play

Once considered a minor niche in the entertainment industry, video games have soared in popularity and now represent the fastest growing segment of the world's media entertainment industry. The global gaming industry is expected to grow to $225 billion in annual revenue by 2025.

Manufacturers have recently been flexing their power to raise prices. With Microsoft and Sony introducing updates to their Xbox and PlayStation consoles, respectively, game makers have disclosed plans to raise prices on console games to help account for the cost of creating more sophisticated games.

A prime example of pricing power potential in the industry is the annual revenue from free-to-play games like Apex Legends from Electronic Arts and Fortnite, published by Epic Games. Tencent has a 40% ownership stake in Epic. Activision owns King, the publisher of popular mobile game Candy Crush. Free-to-play games generate revenue through advertising, whose rates can be increased as costs go up and through in-game purchases.

Believe it or not, players spend real money on virtual clothing, weapons and other supplies for their gaming characters. Essentially, industry leaders can set the price for such items as they please.



The bottom line for investors: Focus on pricing power

I don't think we are headed into a period of sustained inflation but I do believe rising costs are likely to linger in the coming months, making it the biggest risk investors will face in 2022.

With slowing growth, rising inflation and other uncertainties on the horizon, 2022 may seem a daunting environment for investors. But I'm optimistic that an active portfolio of select companies with strong pricing power can help investors thrive in the years ahead.

Diana Wagner is an Equity Portfolio Manager with Capital Group. Capital Group Australia is a sponsor of Firstlinks This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

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Tips when taking large withdrawals from super

Meg Heffron

I recently talked to a client about taking a large benefit (withdrawal) from their SMSF. Believe it or not, there's a lot to consider in working out how to structure the payment.

Just taking a very large pension amount is often the worst possible thing to do.

What are the alternatives?

It's easiest to explain the thought process using an example. Consider a couple where John (age 70) has a pension worth $1.65 million that he started several years ago. At the time he fully used up the limit that can be converted to a super pension ($1.6 million at that time). John had a very large super balance so he had super money left over that he left accumulating in his fund. That account (often referred to as an 'accumulation balance') is now worth $500,000.

His wife Julie (age 71) also has a pension that's currently worth $1.65 million but no accumulation balance. In both cases, as they used their $1.6 million limit in full when they first started their pensions, they didn't get an increase when the general limit was increased to $1.7 million from 1 July 2021.

They've always taken the minimum pension in the past but now want to withdraw an extra $400,000 in 2021/22. What should they do?

As a pension fund, their SMSF is entitled to a tax exemption on a lot of its investment income. Currently, around 87% of the fund's capital gains, rent, dividends, interest, managed fund distributions etc is treated as exempt from tax. In practical terms, John and Julie's fund usually receives a tax refund, thanks to their franking credits. The '87%' is calculated by me as the fund's actuary each year. I work out what proportion of their fund 'belongs' to their two pension accounts. If the pension accounts make up around 87% of the total fund over the year, then 87% (the 'actuarial percentage') of the investment income is exempt from tax.

Where to take the payment from

These tax rules make it much more attractive to take their large payment from John's accumulation account rather than either of their pension accounts. It means that in future years, the proportion of fund income that will be exempt from tax will be closer to 97%. In contrast, if they took this big payment from their pension accounts, the percentage would be 85%.

Would things be any different if Julie also had an accumulation account?

In some ways, yes, as they would need to decide whether to take some of this payment from her accumulation account as well. The main factor to weigh up is the relative sizes. If John's accumulation account is much bigger, it's generally better to take it from his, and vice versa. If they are about the same, split the payment between them to even up their accumulation balances.

This is driven by what happens when one of them dies. In Julie's case, if John died, she may want to leave as much as possible of his super in their SMSF. But she can only do this if she is able to receive it as a pension. Her challenge is that there is a cap on how much she can convert to a pension ($1.6 million), inherited super counts towards this cap and she's already used it anyway by starting her own pension.

To some degree we can manage this. We can switch off ('fully commute') her own pension which will mean $1.65 million is 'reversed out' of the amounts that count towards her $1.6 million cap. She can fill that space with up to $1.65 million from John's super. But anything else in John's super will have to be paid out of the fund. It would have been better for Julie if some or all of John's accumulation balance had actually been in her name. She can leave her own super just accumulating in the fund but not John's.

Since we never know who is going to die first, keeping the accumulation accounts roughly equal hedges our bets.

What about next time?

What if John's accumulation account eventually gets down to zero and they have another need for an extra payment?

Then the money will need to come from one or both of their pensions. But even then, there is a better answer than just a large pension payment.

They should consider a 'partial commutation'. Partial commutations feel the same as a pension payment to anyone who receives one but with an important difference: a partial commutation 'gives back' some of the $1.6 million pension cap that has already been used up whereas a very large pension payment does not.

Let's imagine, for example, that sometime in the future John takes a partial commutation of $200,000 from his pension. He will then have an extra $200,000 'space' in his pension cap. That could be really useful if (for example) he and Julie sell their home in the future and make special contributions known as 'downsizer contributions'. He could convert $200,000 of his downsizer contribution into another pension. If he hadn't created this space, the whole contribution would need to stay in an accumulation account.

It's also useful in a scenario if Julie dies and he wants to leave as much as possible of her super in a pension that's paid to him. Remember that inherited super counts towards the $1.6 million pension cap if it's paid to the survivor as a pension. John can manage this by switching off some of his own pension to create 'space' to absorb a pension from Julie's super. But the less he switches off the better. If he's already created some space by taking partial commutations in the past, he'll be able to leave more of his own pension in place.

Pensions are fantastic structures to have in place in an SMSF but the careful thinking about structuring doesn't end when the pension starts.

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

Australia's major banks go from turnaround to transformation

Hessel Verbeek, Maria Trinci

Australia's big four banks (the Majors) have seen a turnaround from last year, as the economy entered a new phase of its COVID-19 pandemic response. After the Majors played a significant role in supporting Australia's recovery in 2020, they benefited from the country's improved economic performance in 2021. But now they need to turn their attention to transformation as they look to their future performance.

KPMG's Major Australian Banks Full Year Analysis Report 2021 shows the Majors reported a combined cash profit after tax from continuing operations of $26.8 billion in the last financial year, up 54.7% on FY20, but down 2.3% on FY19.

However, the underlying performance trajectory is less turbulent than the headline numbers suggest.

Asset writebacks in a recovering economy

Writebacks of collective provisions of $1.7 billion this year, compared to large collective impairment charges totalling $6.9 billion in 2020 in response to COVID-19, have had a big impact on the shape of the Majors' profit results. Total operating income (on a cash basis) was up 0.1% on 2020 and down 1.5% on 2019. This almost flat revenue picture is more consistent with the single-digit percentage decline of cash profits between 2019 and 2021.

In 2021, the banks shifted their focus from economic support to recovery.

The most recent results show they will be moving forward with reinforced balance sheets. While the Majors have resumed more generous dividend payments, they continue to retain profits and proceeds from simplification divestments to further raise their CET1 ratio (Tier 1 capital) by 1.31% to an 'unquestionably strong' 12.7%. They have also managed to raise their capital levels while collectively buying back $13.5 billion worth of their own shares.

On the flip side, costs remain stubborn. Even though the Majors remain committed to their long-term cost efficiency targets, they have been unable to structurally reduce costs in 2021. Excluding notable items, total operating costs increased by 3.6% to $38.2 billion. This is due to several factors including regulatory compliance requirements, ongoing customer remediation and increased processing volumes that have resulted in strong FTE growth across all the Majors.

Hitting a transition point

Having stabilised themselves from the initial impacts of the pandemic, Australia's banks now arrive at a new transition point. In 2022, they will need to start delivering on their transformation programmes and positioning for a future that will be very different to the past. 2021 saw growth across both housing (up 5.2% on 2020) and non-housing lending (up 1% on 2020). Much of this growth has been the result of strong increases in house prices and underlying economic recovery. It is unclear if these trends will continue, especially if interest rates are raised in the 2022 financial year.

To successfully transition to post-pandemic performance, the Majors will need to lower their operating costs while continuing to invest in growth. The transformation imperative includes a revenue challenge. The Majors are all looking at new ways to create value that will better serve their customer needs while opening up new revenue opportunities.

It will be a delicate balancing act, one that will require the banks to re-think and transform their operations while genuinely innovating around their business models.

See the longer report for more detail, here KPMG's Major Australian Banks Full Year Analysis Report 2021.

Hessel Verbeek is Partner, Banking Strategy Lead and Maria Trinci is Partner, Financial Services at KPMG. This article is general information and does not consider the circumstances of any investor.

Is China's regulatory reform stifling 'animal spirits'?

Chi Lo

Some investors worry that regulatory tightening in China could strangle growth in its private sector, which is now dominated by technology companies and e-commerce platforms. Such concerns have wiped about USD1 trillion off valuations on China's stock market over the past year. The poor sentiment has spilled over to other Asian markets and their tech sectors.

Why is China taking the risk of damaging these new drivers of economic growth when building a high-tech economy is part of its 'common prosperity' policy framework? Is there evidence of China's regulatory overdrive negating investment incentives in its private sector?

How badly damaged is the private sector?

Many players see Beijing's regulatory campaign, which started in 2020, as a move to exert greater control over the private sector and the technology firms and make them subservient to the Communist Party under the guise of an anti-monopoly policy. According to this school of thought, the survival of China's private sector is under threat.

On closer examination, though, the e-commerce and technology companies subjected to the crackdown are a small share of the large and growing private sector. We have found no evidence of significant damage done to the private sector despite media reports to the contrary.

Reflecting the continued growth of the private sector is:

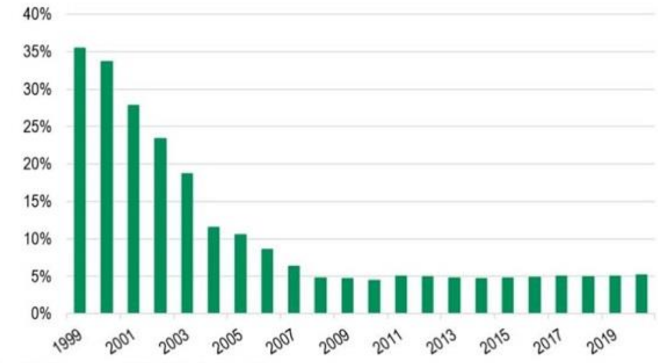
1. The sharp decline in state-owned enterprises (SOEs) as a share of total industrial firms (Exhibit 1)
2. The strong increase in private-sector employment in the industrial sector (Exhibit 2)
3. The significant rise in the share of private investment at the expense of the SOEs' share (Exhibit 3).

All this suggests that the large private and tech companies hit by Beijing's measures play a small part in the overall private sector. While they may have made the news headlines, their situation is not representative of the whole private sector.

We have also found no evidence as yet of the much-feared decline in private investment in the wake of the regulatory tightening.

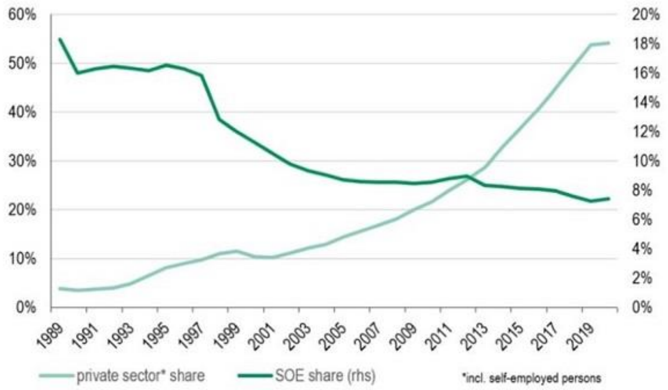
High-frequency investment data shows that while the growth rate of fixed asset investment by non-state-owned companies [1] has slowed, it has continued to outperform SOE investment by a wide margin since the regulatory campaign began (Exhibit 4). In fact, SOE investment has been contracting since early 2021, while non-state and private investments have continued to grow.

Exhibit 1: Share of state-owned industrial enterprises
(% of total industrial enterprises)



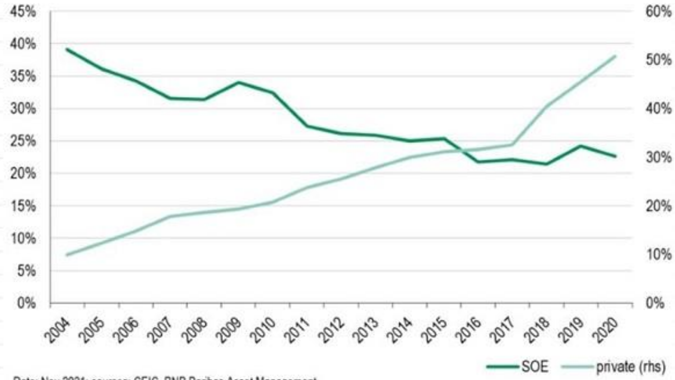
Date: Nov 2021; sources: CEIC, BNP Paribas Asset Management

Exhibit 2: Share of industrial employment (by ownership)
share of total employment

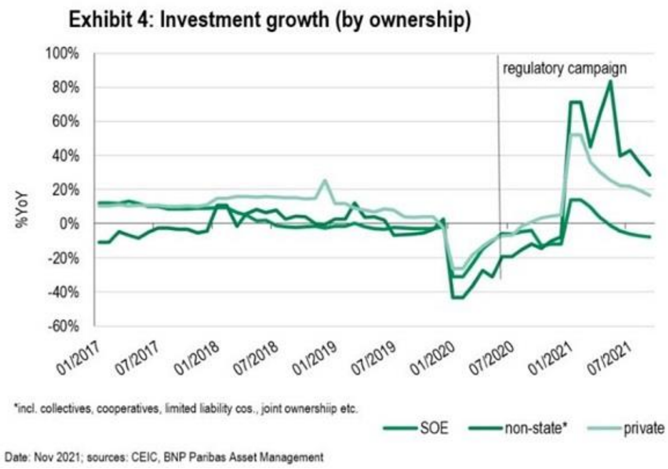


Date: Nov 2021; sources: CEIC, BNP Paribas Asset Management

Exhibit 3: Share of fixed-asset investment (by ownership)
share of total fixed asset investment



Date: Nov 2021; sources: CEIC, BNP Paribas Asset Management



Why the crackdown?

Beijing is taking the opportunity arising from the economy's Covid recovery to tighten oversight. It aims to align the private sector's interests with Beijing's strategic targets. Indeed, such reform is long overdue, as poor oversight has allowed many Chinese private companies, notably the internet firms, to prosper and add to moral hazard problems in the system.

Granted, China needs proper regulation for its private and tech sector. The question is whether it has now over-tightened and, thus, risked strangling innovation and incentives in the private sector. This concern has understandably spooked markets, leading to a sharp sell-off in Chinese equities, especially tech and e-commerce stocks.

However, we believe China is just catching up with global practices of tighter supervision of tech companies rather than pursuing a more aggressive agenda to rein in corporate profits or destroy private capital.

Evidence shows that other countries, notably the US, the EU, South Korea and Japan, have been active in probing technology firms for alleged collusion and monopolistic practices and bringing anti-trust cases against global tech companies. [2]

What makes China different is that it has stepped up tightening efforts on the internet sector faster than other countries. An examination of Asia's new regulations and remedy measures suggests they are broadly in line with those implemented by Europe and the US. [3]

For example, Chinese anti-trust laws allow for fines of 1-10% of annual turnover for anti-monopoly violations. This is consistent with most practices around the world. However, China and most Asian countries have been lagging in implementing the laws. They are catching up now and China has become even more active in enforcement.

Market implications

In a nutshell, China's regulatory tightening since 2020 is, arguably, a tactical shift of its reform policy under the 'dual circulation' framework to tackle intensifying domestic and geopolitical challenges. Beijing still wants the private sector to drive innovative change and fund the development of high tech.

The regime change may have been abrupt, hurting the valuations of some of the best-known private companies and unsettling the stock market. However, the resultant correction now appears to have priced in most, if not all, of the regulatory concerns.

Repricing the internet sector under the new regime should give China's tech sector a new investment horizon when the dust has settled.

Chi Lo is the Senior Market Strategist APAC of [BNP Paribas Asset Management] based in Hong Kong. The information published does not constitute financial product advice, an offer to issue or recommendation to acquire any financial product. You will need to seek your own advice for any topic covered in the article.

[1] Non-state-owned firms include private firms, collectives, cooperatives, joint enterprises, foreign private firms and sole propriety ownership.
[2] "*A Cheat Sheet to all of the Antitrust Cases Against Big Tech in 2021*", Quartz, 29 September 2021 at https://qz.com/2066217/a-cheat-sheet-to-all-the-antitrust-cases-against-big-tech-in-2021/.
[3] "*APAC Regulatory Fears Drive US$1tn Selloff: Overreaction or Signal of More to Come?*" UBS Q Series, Global Research, 20 October 2021.

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