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Editorial

Most people have little idea how the machinery of politics works. We occasionally gain insights when ICAC hears that **Gladys Berejiklian** threw money at Wagga to help **Daryl Maguire**, or **Christian Porter** accepts donations behind a blind trust to fund his legal bills, or **Sam Dastyari** asks a Chinese donor to pay a travel bill. But nobody explains what a company that donates large amounts to a political party expects or receives in return.

The companies say it's a contribution to the democratic process, but they are not charities, and few shareholders expect them to fund 'democracy'. No, the payment is for access and influence, but there is far more involved than writing one cheque. It's usually a multi-year strategy.

In 2016 (when Firstlinks was Cuffelinks), a leading Canberra lobbyist invited me to a breakfast with a small group of people. Staff who worked for both major political parties would present on who was best-placed to win the next Federal election. Standing around before the discussion started, armed with coffee and croissant, I sidled up to the Managing Director of the company. It went along these lines:

"Can I ask something I have never understood?" I began, leading with my political innocence. "Let's say I become Minister for Infrastructure. I need to learn about my portfolio and the billions of dollars of construction underway and planned, meet my new staff, gain a full debrief. You ask if I will catch up with your client, an investment bank, the next day. I have many other priorities, why should I see you?"

He paused just long enough to show I was about to be taught a lesson.

"Many years ago, when you first gained preselection for your seat, we helped you rally support from party members. We organised fundraisings when nobody knew you, and arranged for senior ministers to attend meetings with local businesses. We provided staff for your office on our payroll, and we have given you advice for years. We supported your move into the ministry. When we call, you will accept any appointment."

Sam Dastyari was a significant **Labor Party** fundraiser as Secretary and a senator, and he recently told the [ABC TV documentary, Big Deal] about corporate donations:

"There's no point pussyfooting around on this. You can have as many euphemisms as you want. You can call it donations, you can call it contributing, you can call it participating in democracy. That's all bullshit. This is one thing and one thing only. It's pay-to-play ... how do I get a seat at this table?"

On the other side, former Treasurer of the Federal **Liberal Party**, **Michael Yabsley,** writing in *The Sydney Morning Herald* of 25 November 2021, argued political donations should be capped at $200 each. He said:

"Furphies abound in discussions with political insiders about fundraising - one in particular. We're told that big donations from big organisations - trade unions, public or private companies, industry associations, even some community groups - are essential for democracy to function. Without that money, we are told tearfully, democracy would wither. Bollocks ... We need to make so insignificant the amount of money that can be lawfully donated, it could never be considered an inducement in the often Byzantine, sometimes nefarious world of politics."

Strong words from insiders who know. *Bollocks. Pussyfooting. Bullshit. Nefarious.* Politics is no longer an exchange of ideas. It has become small targets and 'gotcha' moments. **Anthony Albanese** dare not utter a policy which will allow **Scott Morrison** to label something as a new tax, despite our need for revenue to address the massive budget deficit. We now face up to six months of generalisations about 'freedom', 'choice not mandates' and 'who do you trust?'. As **Thomas Jefferson** said:

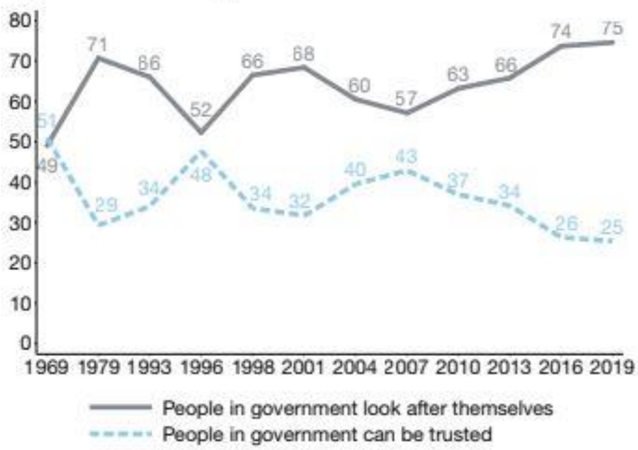
"The government you elect is the government you deserve."

The **Australian National University** carries out a survey called The Australian Election Study after each Federal election to determine why choices were made, covering policies, parties and leaders. The most recent in 2019 prompted lead researcher **Professor Ian McAllister** to say:

"I've been studying elections for 40 years, and never have I seen such poor returns for public trust in and satisfaction with democratic institutions."

The Study includes this chart, showing only one in four people believe politicians can be trusted while three quarters believe that people in government are looking after themselves. What do we think it will look like in 2022?

Figure 3.3: Trust in government



Michael Yabsley concludes his article by saying of his proposed change:

"That's what I would call a good legacy for our children."

What should future generations inherit? Firstlinks has previously fessed up on the beneficial conditions experienced by Baby Boomers and the difficulties for younger generations in owning their own home. Circumstances in retirement are completely different for renters versus owners. **Danielle Wood** makes some contentious arguments in the recent **John Button Oration**, but they are policy issues we should be mature enough to discuss. In 1981, when the Boomer generation was starting families, 67% of 30-year-olds owned their own home, and now it's close to 40%.

Our Reader Survey on whether investing has fundamentally changed drew over 400 responses, and it's surprising how many believe we are in a new paradigm. We publish a selection of comments on why this time is different ... or not. Then **Leisa Bell** sifts through the hundreds of pieces of advice for someone starting out on an investing journey and provides the first 100 insights. It's too difficult to time the market and investors should ride out the ups and downs over the long term. As this chart shows, there are always reasons to sell.

Then **Callan Maclennan** and **Michael Malseed** take a look at different types of **LICs** and the pros and cons of the structure. LICs and LITs have become the poor cousins to **ETFs** in recent years but there are pockets of resilience.

This week, hundreds of thousands of **Westpac** shareholders received the Westpac buyback offer, and this one is different from other buybacks where taxpayers such as SMSFs in pension mode had an easy decision. As **Peter Gardner** explains, the merits of this buyback depend on where Westpac sets the discount level.

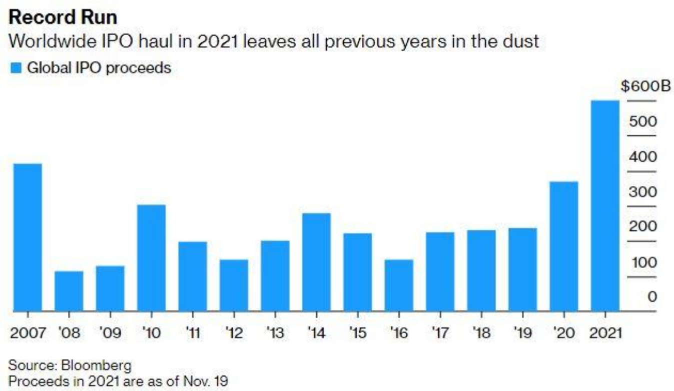
Still on banks, **Hugh Dive** has done a deep-dive into 800 pages on bank reports and awards his gold stars based on margins, capital, dividends, loan impairment and earnings growth. The fall in CBA's share price recently has surprised everyone but what does the future hold, especially for those attractive dividends?

As a sign of how much banks have changed, when I worked at **Colonial First State** (CFS) for a decade until 2012, the **CBA** connection to financial advisers in **Commonwealth Financial Planning** (CFP) was considered a major strength. The complete turnaround was confirmed this week. Not only was the sale of 55% of CFS to **KKR** approved by regulators, but CBA announced it will cease providing financial advice services completely in favour of a referral service to AIA:

"CFP customers with life insurance, superannuation and wealth advice needs ... are being closely supported with a smooth transition to AIA to help manage their ongoing financial planning needs."

While many retail investors have significantly increased their investment knowledge in recent years, one aspect of portfolio management that they do not perform with the rigour and frequency of institutions is rebalancing a diversified portfolio. Investors are told to 'let your winners run' but what happens when it leads to overweighting? **Chamath De Silva** shows the benefits.

This week's White Paper from **ClearBridge**, part of the **Franklin Templeton** group, looks at the US economy after the coming peak in demand caused by massive levels of official stimulus. Either way, 2021 has been a boom year for IPOs with a lot of company owners cashing in their chips, and the year is far from over.



Two **Comments of the Week** because we must acknowledge the potential effort of **Owen** who says he intends to read every edition of Firstlinks to build up his investing knowledge.

"I love that you have an archive. I'm on Edition 5 and aiming to read one a day until I'm caught up. So interesting to read stuff with the benefit of hindsight."

A special prize if he can get through 500 editions by the time he has finished.

We also liked this clever comment by **GG** on **Diana Wagner**'s piece on company pricing power:

"A very interesting article. Netflix's inflation-proof status is similar to Apple's - if they can keep coming up with new hits/gadgets, they'll ride above it all. Netflix managed to do this coming up with The Crown and Squid Games. An enthralling insight into a bizarre world based on unreality and abhorrence, where only the toughest survive, cruelty does down the rest and the occasional victim comes to a terrible end - while the world looks on in grim fascination and disbelief. And Squid Games is a good show, too."

Maybe not the four most-costly words in investing

Graham Hand

Legendary investor John Templeton is credited with the first observation that believing 'This Time Is Different' will be costly in investing. In his 1933 book, *16 Rules for Investment Success,* he wrote:

"The investor who says, 'This time is different' when in fact it's virtually a repeat of an earlier situation, has uttered among the four most-costly words in the annals of investing."

It has become a timeless reference, with the warning commonly used by financial analysts who prefer to draw on the history of stockmarkets, economic cycles and long-term company valuation metrics. It's a way of saying, "We've seen it all before" ... the manias, the over-pricing, the FOMO. The argument that circumstances are now unique is often rejected using a version of Winston Churchill's phrase that:

"Those that fail to learn from history are doomed to repeat it."

In which case, many of our respondents are in for a shock because a high percentage believe investing has fundamentally changed.

The Firstlinks Survey results

The Firstlinks audience is generally older and more experienced in investing than the readers of most newsletters, based on our past surveys. For example, three-quarters of our readers in over 2,000 responses reported they are over 55.

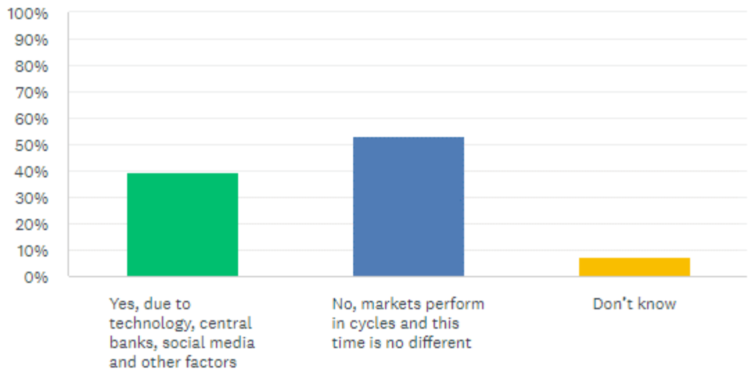
So it was expected that they would overwhelmingly vote 'No', that this time is not different, as they have seen markets rise and fall in many economic cycles, and the current high valuations and record stockmarket levels are yet another top in a long history of market over-reactions.

Yet almost 40% believe This Time Is Different, and with over 7% in the 'Don't Know' camp, that leaves slightly over half falling back to a more traditional view on market ups and downs.

We have compiled many of the hundreds of comments into the attached report as they are too long to publish in an article, but here are selected highlights from both sides. And for those who are bemused, take comfort from this reality check:

"I'm a veteran of 30 years in the industry and I'm paralysed. I've got no idea any more."

Q. Do you think investing has fundamentally changed in the last 5-10 years?



Yes, this time is different

*Definitely. Young investors are thinking: ethical, sustainable, climate crisis. What's the point in having a pack of money in the future when the world is caving in due to our warming climate.

*Everyone now has access to the same information, almost as soon as it's available. So no one has an "edge" in the market, it's completely democratised.

*On-line brokers have made it so much easier to invest and to follow your investments. Also, one can "invest" in quality on-line commentary like Eureka Report and Firstlinks.

*Three reasons. A. Interest rates effectively zero. B. Central banks creating wealth from thin air, printing money. C. Simple and straight forward access to investments, historically people either didn't know how to invest or were put off by the 'suits'.

*The massive reach and world wide scalability of the big tech companies is something quite different in the last 20 years.

*Exponential technology has made it easier for businesses to grow quicker.

*yes things have changed. Everyone is an investor. The money has to go somewhere. But valuations are made on profits. The pigeons will come home to roost and many people will be affected. But its hard to stay out while the party is still going.

*Tech expansion provides a level of scalability at margins unseen in previous generations. In the 'olden days' you could basically only sell one copy of what you made (eg a car, a barrel of oil) and rely on capital intensive distribution channels (eg ships/trucks/dealers, oil rigs/tankers/petrol stations) and analogue marketing (eg TV, newspapers, magazines) to sell the one unit. Now you can build various levels of technology/apps in your garage, advertise it free of charge to multiple social media channels that can generate high volumes of highly targeted views and create sales/ subscriptions with limited costs. Build one app, but sell it 50 million times over. This type of business model transformation clearly does not apply to every sector, however the hyper inflated PE of many tech stocks is seemingly lifting the assessment of worth of some 'traditional' companies. A current 25 - 35 year does not know any different from the world they have grown up in. This is all normal.

Crypto, FAANG, Elon, Melanie Perkins etc - what is their to be scared of? …… So, I'd suggest it is 'different' but that doesn't make it wrong. Understanding the difference is the key.

*I believe that, as a wise American observed, that the media has become the message, thanks to influencers and an emerging preference for a less rigorous examination, if at all, of fundamentals. A glitzy presentation, not on Powerpoint, wins over the gullible. Hard facts are too hard and inconvenient truths.

No, this time is not different

*Humans haven't changed. We are (on average) still greedy, biased, over confident and love to follow the crowd. Until human kind changes, nothing else will. We are in a bubble, and the more retail investors who start trading like we have see during covid, the bigger the pop will be. The question is who long will it take to recover when it does pop. Will people be scared off, or will the craze of 'stocks only go up' flood more people in to buy cheap.

*It is undeniable that markets go through cycles - periodic bouts of extreme irrationality, be it be pessimism or optimism. They spend the time in between these two extremes fluctuating in a band that we might for want of a better term call "fair value". Of course, innumerable factors exert their influence throughout these cycles and act to either exacerbate or moderate these cycles, but one should not confuse cause with effect. The cycle will always exist; the factors that amplify its effects will come and go according to fad and fashion.

*When central banks print unlimited amounts of money and drop interest rates to zero, the discount rate on future earnings also approach zero and valuations of everything go through the roof. We are in for an all mighty crash when central banks reverse their policies.

*I have been investing (and a financial adviser) for 20 years - same old - biggest bubble i've seen though (other than US real estate in 2007)

*Bubbles burst, and huge bubbles burst more catastrophically. I've been a professional investor since 1986 and the simple reality is always true - an asset only provides long term worth if it can throw off cash and you did not pay too much for the free cashflow.

*The twelve most dangerous words in investing are: "The four most dangerous words in investing are, it's different this time."

*Every cyclical episode is, in fact, different in some respect. But the key drivers - especially behavioural factors such as fear, greed, over-confidence and certain cognitive baises -remain essentially unchanged.

*I have heard the comment "This time it is different" multiple times in my 40 years of investing only to find out it wasn't. Fundamentals always matter.

* In every boom we hear the note: This time it is different. It is only different until things fall apart. When the interest rates are finally start rising and maybe even rising quickly to catch up with inflation, we might see that this time is no different. Surely Tesla and others that are extremely overvalued will be crumbling at some stage. It can't go on forever.

Firstlinks survey: the first 100 tips for young investors

Leisa Bell

From the hundreds of responses to Firstlinks' recent survey question, "*What investment advice would you give to a 25-year-old starting an investing journey?"*, we have compiled a comprehensive list of dos and don'ts for young (and perhaps not-so-young) investors.

As there are so many, we'll present these tips over the next few weeks, and here are the first 100.

1. never invest in something you don't really understand. Get rich slowly
2. invest in companies that make money or have a unique product people really want/need which will one day give them a massive advantage
3. reinvest returns / dividends
4. get a secure full-time job. Save for a house deposit. Do night courses in carpentry and plumbing. Buy the most rundown house in a good street. Renovate the house nights and weekends for two years. Sell the house and buy another one requiring less renovation. Get a higher paying job and repeat the cycle

5. take a total portfolio approach
6. investment is built on small repetitive positive actions, understand risk and factor that into decisions, read the Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay and apply it to current times
7. look for good yields
8. take the time to research what an investment can do to throw off cash and then imagine closing your eyes for 10 years and absolutely knowing you will have made adequate returns
9. 100% of the experienced investors I know and admire have hunkered down as we have never seen anything so ridiculous as what's happening now. It's the final blow-off of 42 years of falling interest rates, now zero interest rates and it will be ugly when rates rise. Rates falling from 16% to 1% move a $200,000 home to $3.2 million - what do people think happens when rates rise. Greed and slothfulness (not researching) always combine to see this cohort devastated - except for the few that get out before it ends
10. be patient, focus on the long term
11. invest in 'growth' while you have time on your side to recover from the bumps along the way
12. start as early as possible to benefit from the effects of compounding
13. look for long-term trends
14. maximise tax deductible super contributions, but no more
15. invest 10% of your income into investments outside super, as a hedge against higher taxes or rule changes
16. seek out, learn and listen to those with investment knowledge - not your mates over a beer or the chat forums
17. read widely
18. don't fret about buying a house until you have kids
19. buy quality shares/property and hold for the long term but make sure to keep reviewing their strength
20. invest in a diversified portfolio
21. read the Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay and apply it to current times
22. keep investment costs low
23. invest regularly (and automatically, if possible, no matter what the outlook is or what markets are doing)
24. salary sacrifice a small extra % of your salary from day one
25. keep it simple
26. understand the cycles and where we are in the cycle
27. if you do not have the right knowledge, seek out the services of a professional
28. if it sounds too good to be true, steer clear
29. only invest what you can afford to lose in speculative stocks and cryptocurrencies
30. wealth held on pieces of paper can blow away
31. buy LICs and ETFs forget the rest and enjoy life
32. accept the peaks and troughs
33. read as much as you can about investing before you invest
34. diversify your investments
35. time in the market is way more important than timing the market
36. stick to quality and worry less about growth
37. know when to hold them, know when to fold them, know when to walk away and know when to run
38. keep some cash in reserve and buy when everybody else is selling
39. panic selling is your buying opportunity
40. stay fit and healthy enough to enjoy it along the way and at the end
41. invest in a diversified portfolio of quality stocks over the long-term
42. don't get sucked into the fear of missing out
43. stick with a disciplined and diversified approach
44. don't be afraid to take profits when returns seem excessive and don't be afraid to invest when we are told the world will be in a bad place for a long time
45. use logic and common sense
46. invest in equities, but with diversification of managers, indices, and geography
47. there are many possibilities, few probabilities and no certainties when looking into the future
48. research the advisor to determine if they are worthy of your trust before and during your engagement with them
49. buy some ETFs or maybe bank shares to keep forever if spare money becomes available at any time
50. make an investment plan and be prepared to update that plan as you mature and increase your knowledge
51. be patient and hold investments for long periods unless they don't pass your investment plan
52. buy good quality shares and hang on to them
53. invest in a diversified index fund
54. wise, long-term investment into companies that are committed to ethical and sustainable investment
55. be invested, be diversified, be patient but make decisions if they need to be made
56. unless your investment portfolio is weighted towards dying industries you have time on your side
57. OWN, not rent your home. Put up with commuting, if need be, you can move up later as your career growth moves upwards
58. live within your means and use debt sparingly
59. small investment steps are important because the power of growth is exponential
60. utilise professionally managed active funds and diversify

61. mostly buy income earning real estate and shares in boring stocks with reliable earnings
62. ignore the daily market noise
63. don't get sucked-in to fads and fashions
64. once-in-a-lifetime investment opportunities come every 7 to 10 years
65. the Warren Buffett value investing era just doesn't seem to work now. Despite having invested for many years, I would say a 25-year-old would know as much as me, maybe more, not being handicapped by what now seems to be an outmoded style of investing
66. focus on the things that matter and the things that you can control
67. invest passively to reduce cost
68. tax consequences pervade every decision - but don't let the tax tail wag the investment dog
69. set goals and accept that you will have to make trade-offs
70. no asset is guaranteed to increase let alone hold value
71. just start, add a regular amount to a broadly diversified all equity fund - at 60 it will be way beyond your imagination
72. buy well managed companies with franking credits
73. selectively diversify across asset classes and HOLD
74. if you have spare funds 'let the experts' look after your money (fund managers) who have the expertise and time to investigate and then invest in companies.
75. back 'self-interest' every time. Put money into businesses that provide products and services that serve and build the community, because it's human nature that no one wants to go without or provide for their loved ones
76. buy active value funds
77. leave superannuation to a quality industry fund split 50/50 in growth and balanced.
78. take advantage of superannuation tax breaks within reason e.g., salary sacrificing
79. avoid SMSFs unless you really really want or need to tailor your investments to very specific requirements e.g., own your business premises
80. rather than try to time the market, stay in for the long haul
81. use ETFs etc, preferably simple indexed ones, unless you have a very strong desire to become an equities researcher
82. use 'high growth' while young, moving to 'balanced' in later years
83. buy ETFs and keep building them with available cash and hold, hold, hold
84. invest 10% of every pay for the long term and don't be tempted to dip into it for any reason/fad/hot idea
85. don't borrow money to invest, other than for your own home
86. don't invest money that you will need in the next three years
87. learn the difference between investing and speculating, and the difference between an investment and an indulgence
88. look at management expense ratios on managed funds. Put most investments in diversified index funds. Save for a house first
89. expect the highs and lows despite the effort of due diligence
90. you do have to be an active investor to be really successful and if you don't want to manage your money actively then choose an LIC or ETF and let them do it for you… even then keep an eye on things
91. you will make mistakes, but learn from them and keep losses minimal
92. be cautious until you have some understanding and experience in the investment area you have chosen
93. do the Buffet numbers as there is true value still to be found high yield with a low PE
94. buy on any dips and hold for the long term. Don't rush in because everyone else is
95. invest in companies you know will be around in 10 years
96. study investment strategies as soon as you can
97. start off with some tried and tested ETFs i.e., Index funds tracking the Australian and US share market and the Nasdaq. Then as your knowledge and experience grows, invest in companies you know a bit about, or have done some research on. Only after that, should you consider investing into anything we might consider less well known or higher risk. The purpose of investing after all, is to park the money you have earned through your endeavours, into a safe place where it can grow over time. Be patient.
98. start now and continue to make regular contributions to a reputable fund
99. buy stocks in companies whose products you, your friends, and your employer use frequently and diversify over several industry sectors
100. buy value stocks as the base of your portfolio and diversify into growth/thematic stocks

Leisa Bell is an Editorial Associate at Firstlinks. The investment tips provided by our survey respondents are general in nature and are not tailored to your individual financial circumstances or goals.

John Button Oration: The Next Generation's Australia

Danielle Wood

This article extracts sections from the 2021 John Button Oration, and for detailed footnotes, to view the webinar, or to read the full Oration, click here.

In this speech about generational obligation, I want to recognise the way traditional owners of our land fostered the invisible bond between their people past, present and future. Through the idea of care for country – nurturing land, water, flora and fauna – and passing on the knowledge of how to maintain the equilibrium via stories and lores, the bonds between generations were self-perpetuating.

The very idea that people at a point in time would draw on resources at the expense of others to come would be very foreign to them indeed. I think there is much we can learn.

John Button was Australia's longest-serving Industry Minister and by all accounts a man of principle. I suspect he would be both dismayed but galvanised by the state of affairs I want to touch on today.

John Button's legacy made a big impression on me as a young economist. He led the transformation of Australia's industry policy, helping ensure Australia was competitive in increasingly global markets. This was forward-looking and brave. Some jobs were lost – as in any transition – but huge number of jobs were also created elsewhere, and the changes helped improve Australian living standards for decades to come.

The management of this transition has important lessons for today.

Economic change comes, regardless of actions by governments. By being on the front foot and actively managing the transition, disruptions to jobs and lives can be minimised and Australia given the best chance to flourish.

Putting one's head in the sand might be politically easier, but it generally leads to more pain in the long run.

John Button, like the best leaders, was able to see what was on the horizon and take the necessary actions.

Have you ever had a pay rise?

What do generational labels even mean? The Silent Generation, Boomers, Generation X, Millennials, Gen Z – the boundaries are fuzzy, but generational cohorts are often grouped by demographers and sociologists to draw generalisations about those who grew up in similar times with perhaps similar formative life experiences.

In an economic sense, it is also true that generations share experiences that shape their ultimate living standards.

If I had only one question to ask to identify someone's age by their economic experience it would be this: have you ever had a pay rise? For most of us, it seems a silly question. But for many under-35s, the answer – at least in terms of a pay rise that improved their real living standards – would be no.

The 2008 GFC, like all economic crises, saw employment take a hit. But unlike other crises, we were still seeing the effects in labour markets at the time the coronavirus began to disrupt our lives in 2020.

While weak wages growth has bitten all ages groups, for younger people it has been particularly pronounced. Workers aged 20-34 experienced close to zero growth in real wage rates from 2008 to 2018.

Contributing to poor outcomes is that younger people are 'falling down the jobs ladder', in the words of former Bank of England Chief Economist Andy Haldane.

The Australian Productivity Commission has found that people joining the workforce in the past decade have graduated into less-attractive occupations on average, for a given level of education, than previous generations.

And with young university graduates moving into lower-level roles, other young people without the same qualifications are pushed even further down the ladder into jobs more likely to be characterised by part-time and causal work.

This has been accompanied by a big rise in underemployment (workers not getting all the hours they want) particularly among younger age groups.

The overall effect of flatlining wages and rising underemployment? Under-35s in 2018 had, on average, lower incomes than those of the same age a decade earlier.

Australian youth are far from alone in this experience.

Just before the COVID crisis, the Institute of Fiscal Studies in the UK released analysis that showed those born in the 1980s were the first post-war generation not to have higher median incomes in their early 30s than those born a decade earlier.

Similarly in the United States, Millennials are less well off than members of earlier generations were when they were the same age, with both lower earnings and less wealth.

The take-out is clear: when growth is weak and labour markets have excess capacity, younger people bear the brunt through stagnant wages and high underemployment. Without strategies to boost activity, productivity, and wages, generation-on-generation progress on incomes is NOT guaranteed.

Where young people emerge from the more recent COVID shock remains to be seen. Youth unemployment hit 16% at the worst of the crisis, and underemployment touched another 24%. While jobs are bouncing back strongly, it is not yet clear whether we have the right policy settings to have our young people climbing that jobs ladder again.

This must be a priority.

But while the impact on labour market outcomes remains uncertain, what is clear is the COVID shock has widened even further the generational chasms in wealth.

The Great Australian Nightmare

Since World War 2, Australia has been a nation of homeowners. Home ownership rates peaked at more than 71% in 1966. Almost three-quarters of the nation was on the property ladder and living the dream – home ownership was celebrated as an indicator of success, security, and quality of life.

Ownership rates declined very gradually in following decades but then sharply since the early 1990s, when house prices and incomes started to diverge. At the 2016 Census, home ownership rates were at their lowest level since 1954.

But what has been particularly striking is the drop among young people.

In 1981, when the Boomer generation was settling down and having families, 67% of 30-year-olds owned their own home. In 2016, the equivalent figure was 45%.

But even this hides an even more concerning disparity in the huge fall among poorer young people. In 1981, 60% of the poorest 25–34-year-olds owned a home. Today the figure is just 20%.

In contrast, for the richest 20% of young people, ownership rates have fallen only modestly in 40 years – demolishing the suggestion that plummeting homeownership rates reflect different preferences or the breakfast choices of today's young people.

Young people want to own their home as much as ever, but the fact remains that it is now only the richest ones, or the ones with the richest parents, who can afford to.

Along with the challenges of renting in a country that has some of the least-friendly rental laws in the world, the locking of young people out of the housing market has undercut their capacity to accumulate wealth, especially compared to older generations that have reaped the windfall gains in wealth that have come from the spectacular rises in house prices, and those of other assets, over the past 25 years.

The wealth of households under 35 has barely moved in 15 years. And poorer young Australians have less today than poorer young Australians did 15 years ago. In contrast, wealth for older households has grown rapidly.

These growing wealth gaps are not because young people don't work hard. More young people today combine work with post-school study to get by, and if they are lucky enough to get a full-time job on graduation, they can expect to be working about 38-39 hours a week, the same as their parents were in the 1980s.

Nor can we blame too many avocado brunches. Young people spend less on 'discretionary' items such as recreation, alcohol and tobacco, clothes and personal care, household services and furnishings in real terms today than people of the same age three decades ago.

To the extent that they are spending more it's on essentials – housing, power, food, medical care, and transport – with rises in housing costs being the biggest contributor.

Let me be clear about what younger people (and indeed some older people) are up against.

Think about your job for the past year, if you were one of the lucky ones who had one, and everything you put into it. The hours, the physical, mental, and emotional energy. For those life-dominating efforts, the average Australian worker earned about $68,000, or just over $90,000 for the average full-time worker.

Now think about your house, if you own one. Your shelter, the place you return home to. I'm sure you spent some time on maintenance and upkeep. But unless you are featuring in the next season of *Grand Designs*, I'm guessing it consumed substantially less of your time and energy than your job did.

Guess what your house made you last year – about $140,000 for the average house in Victoria, and more than $200,000 for the average house in New South Wales.

How can it be that a relatively low-risk, low-effort investment can often provide greater returns than a year of hard work? And for those saving for a deposit? They are almost invariably further away than they were a year ago.

An intergenerational swindle

'Demography is destiny' or so French sociologist Auguste Comte told us.

Every five years the Australian Government releases an Intergenerational Report, reminding us of one facet of this destiny: that, without action, an ageing population and other changes will leave public finances looking ugly.

The fallout from COVID means the 2021 report was a sea of red. Budget deficits for 40 years, with net debt still at 34.4% of GDP in 2061, and the interest cost of serving that debt growing to 1.7% of GDP.

But even these numbers are based on rosy assumptions about productivity and discounting the future costs of climate change.

The underlying structural challenge comes from the different size of generations and the implicit generational bargain we have weaved into our tax and welfare system.

Working-age Australians, as a group, are net contributors to the budget – they pay more in taxes than they receive in either welfare benefits or spending. These contributions support older Australians who take a lot more out in spending and pension payments than they contribute in taxes.

Today's working-age Australians of course anticipate that the generation after them will support them in the same way as they age.

So far so fair.

But what will make it more challenging for today's young people to uphold their end of the bargain is that the destiny of demography is working against them.

The number of working-age Australians for every person aged 65 and older fell from 7.4 in the mid-1970s to 4.4 in 2015, and is projected to fall to just 3.2 in 2055.

This could be seen as just bad luck for today's young people. There are swings and roundabouts that all generations have had to grapple with.

But what I think is less easy to accept is a series of policy decisions that have substantially increased the size of the intergenerational transfers, supercharging these future demographic pressures.

First, health spending is climbing. Commonwealth health spending has been climbing by 3% a year over and above inflation for the past decade. State health spending has grown at 3.7% a year in real terms.

The increase has been particularly stark for those in their 70s and 80s – with average health spend per person increasing by more than $4,000 in just 12 years.

Second, age care spending is also growing strongly.

Australian Government spending on aged care has increased by more than 40% in real terms since 2012-13. While the number of people living in residential aged care facilities has remained relatively stable in recent years, the number of people on a Home Care Package has increased markedly, growing from about 60,000 in 2015 to about 170,000 by the end of last year.

Changes in the recent Budget are expected to add about $4.5 billion per year in extra spending. Most Australians support increased health and aged care spending. And the result – providing older people with longer, healthier, and more fulfilled lives – is something we should be proud of as a nation.

But at the same time as we have decided as a country to pay more to support better outcomes for older Australians, we have made a series of tax policy decisions – tax-free superannuation income in retirement, refundable franking credits, and special tax offsets for seniors – which mean we now ask older Australians to make a much smaller contribution to the delivery of services than we once did.

Incomes for households over 65 have more than doubled over the past 25 years – substantially faster growth than for households under 55.

But households over 65 pay virtually no more income tax than people of the same age 25 years ago. Indeed, the share of older households paying *any* tax has fallen from 27% in the mid-1990s to 17% today.

And that has contributed to a tax system where someone's date of birth is almost as important as their income in determining their tax contribution.

An older household with income of $100,000 pays about the same tax as a working-age household on $50,000. There is simply no policy justification for this degree of age segregation in the system.

One argument that is sometimes advanced to defend the generosity of age-based tax breaks is that older Australians have 'paid their taxes'. But the idea of the tax system as an individual's piggy bank is silly if you believe in a progressive tax and welfare system and the provision of public goods such as roads and defence.

Nor does it does not hold water in a generational sense. Younger households today are underwriting the living standards of older households to a much greater extent than in the past.

People born in the late-1940s, at the beginning of the baby boom generation, reached their peak contribution to the tax system in their early 40s – and at that point they were contributing an average of $3,200 a year in today's dollars to support older generations in retirement. An average 40-year-old today, born at the tail-end of Generation X, is paying $7,300 a year.

That is more than they are contributing to their own retirement through compulsory superannuation.

Under current policy settings, the child of today's 40-year-old will need to pay an inflation-adjusted $11,400 by the time he or she reaches 40 just to sustain the current levels of benefits in retirement.

That's what the Intergenerational Report reminds us of: that without policy changes, budget deficits are set to grow ever bigger over time, and net debt will increase as a share of the economy in decades to come.

The unwanted fiscal inheritance will fall on the generation of Australians who have seen their incomes and wealth stagnate – the same generation who missed the property boom and entered the workforce during a period of flatlining real wages.

What does better look like?

What would make a better Australia for the next generation is not a simple question.

We should listen to the voice of young people and what they think is needed.

A coalition of youth-organised groups including Think Forward, the Foundation for Young Australians, Youth Action, Youth Development Australia, and the Youth Affairs Councils from several states have called for a parliamentary inquiry to start the conversation on intergenerational fairness.

They take their inspiration from the 2018 House of Lords inquiry in the UK. The report from this inquiry, *Tackling Intergenerational Unfairness,* published in 2019, observes that intergenerational fairness had become an 'increasingly pressing concern for both policy makers and the public'.

They found that:

The relationship between older and younger generations is still defined by mutual support and affection. However, the action and inaction of successive governments risks undermining the foundation of this relationship. Many in younger generations are struggling to find secure, well-paid jobs and secure, affordable housing, while many in older generations risk not receiving the support they need because government after government has failed to plan for a long-term generational timescale.

It all sounds very familiar.

I wholeheartedly support young people's calls for an Australian parliamentary inquiry, and if I could treat this as a pre-emptive submission I would highlight the following priorities:

- **First**, getting our macroeconomic policy settings right, with a focus on creating jobs and lifting wages growth. That means not being trigger happy on interest rates at the first sign of inflation, and not pushing for budget consolidation until unemployment is durably low and wages are rising.
- **Second**, revisiting the long list of productivity-enhancing reforms advanced by Grattan Institute, federal and state productivity commissions and others to boost long-term living standards.
- **Third**, not increasing the Superannuation Guarantee – compulsorily taking more money off young people now when they need it, given that they are already being forced to save for a higher living standard in retirement than they enjoy today.
- **Fourth**, serious steps on housing affordability including boost housing supply by changing planning rules to allow more homes in the inner and middle rings of our capital cities, reducing tax breaks for investment in housing including reducing the capital gains tax discount to 25% and winding back negative gearing, and exploring more innovative proposals such as shared-equity schemes.
- **Fifth**, improving outcomes for people who don't own their homes, by changing rental laws to give tenants more rights, increasing the supply of social housing, and boosting rent assistance for those on income support.
- **Sixth**, increasing support for accessible and affordable early learning and care – giving the next generation the opportunity for enriching early childhood development while supporting their parents to participate in the paid workforce without facing prohibitive out-of-pocket care costs.
- **Seventh**, winding back aged-based tax breaks by taxing superannuation earnings in retirement at 15%, and removing the seniors' and pensioners' tax offset, and the special Medicare levy rate for over-65s. This would re-establish the principle that existed pre-Howard, that income tax contributions should be based on income rather than age. And crucially it would represent a de-escalation of policy decisions that cumulatively ask working-age Australians to underwrite much larger transfers to older Australians than any previous generation has supported.
- **Finally**, seriously grapple with taxes on intergenerational transfers, at least for very large ones. If the money collected were used to fund income tax cuts, most people under 50 would be ahead financially. At a minimum, we should not be subsiding inheritances via some of the existing rules that allow the accumulated value of super tax breaks to be inherited by the next generation as well as the exclusion of virtually all the home from the age pension asset test.

And whether or not it is in scope for such inquiry, Australia must align with other developed countries to set more ambitious targets for emissions reduction by 2030 – including a proper set of policies to help us get there. If governments are looking for inspiration, the recent Grattan Institute *Towards Net Zero* series is filled with evidence-based suggestions of relatively low-cost things we could do right now that would help put Australia on the right trajectory.

The alternative is we continue to be part of the problem rather than the solution to this generational, indeed existential, global challenge.

Calling time on generation warfare

I understand my comments today are strong, and my policy suggestions might feel confronting.

I may be accused of trying to whip-up generational conflict. But, let me be clear, that is the exact opposite of what I hope to achieve.

I believe that most Australians care deeply for other generations and want to restore that hopeful bargain.

For all the Gen Z 'OK Boomer' eye-rolling, young Australians gave up their social lives and in some cases their jobs to protect the welfare of the older and more vulnerable Australians during COVID. Polling throughout the pandemic suggested young Australians were more strongly in favour of lockdowns than any other age cohort.

And for all the pious Boomer lectures about brunch choices, much of the concern I hear about house prices and their impacts actually come from the older generations, many of whom say they would be happy to see the prices of their own assets reduced to ease the pressure on future generations.

Similarly, look around any climate-change lecture or protest, and you will find grey haired attendees as common as tattooed ones in the crowd. Care about the future is alive and well.

A proper debate about the impacts of policy settings on the outcomes for different generations can only occur when we reject once and for all 'generational exceptionalism': the damaging belief that differences in life outcomes between generations are driven by differences in work ethic, talent, or attitude, rather than luck and policy choices.

American political philosopher Michael Sandel notes how such belief systems corrode civic sensibilities:

For the more we think of ourselves as self-made and self-sufficient, the harder it is to learn gratitude and humility…

And without these sentiments, it is hard to care for the common good.

While every generation has its own unique challenges and opportunities, the only rational place to start is the idea that people born at different points in time are no less deserving than others.

So let's drop the petty generational warfare, and work together to ensure that the Australia we leave to our children is better than the one we inherited. With the right policy settings, I believe we can restore the hopeful bargain.

Danielle Wood is the CEO of Grattan Institute, where she heads a team of leading policy thinkers, researching and advocating policy to improve the lives of Australians.

For detailed footnotes, to view the webinar, or to read the full oration, click here.

Bank results scorecard: who deserves the gold stars?

Hugh Dive

Midway through 2020, the prevailing view was that 2021 would be a challenging year for Australia banks, which were expected to face an unemployment rate above 10%, a 20% fall in house prices and significant declines in lending as the economy was expected to be beset by large company collapses.

This scenario would have seen the banks eat through their carefully-hoarded capital reserves and probably encouraged by a nervous regulator to issue more equity at deeply discounted prices.

The November 2021 reporting season proved these forecasts incorrect, with bank dividends increasing sharply, loan loss provisions taken in 2020 written back, all banks conducting share buybacks and demand for business and home loans robust.

In this piece, we will look at the themes in the approximately 800 pages of financial results released over the past two weeks, including CBA's 1st Quarter 2022 Update, awarding gold stars based on performance over the past six months.

Reporting Season Scorecard - November 2021

Company	Share Price	Market Cap $B	Cash earnings per share growth (pcp)	Increase in Dividends	Net interest margin	Credit Impairment charge/ benefit $M	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2021 total return
Westpac	$ 22.14	$ 81.2	31.0%	280%	1.98%	$ 590	12.3%	9.8%	12.6	6.0%	19.1%
ANZ	$ 27.30	$ 77.0	65.0%	82%	1.64%	$ 567	12.3%	9.9%	12.7	5.9%	25.3%
NAB	$ 28.57	$ 93.6	38.6%	111%	1.71%	$ 217	12.2%	10.7%	14.7	5.1%	31.2%
Commonwealth (Q1 FY22 Trading Update)	$ 97.81	$ 166.9	20.0%	17%	1.97% (estimate)	-$ 103	11.2%	11.6%	19.4	3.9%	21.5%
Macquarie (First Half 2022)	$ 208.00	$ 78.3	100.0%	101.0%	1.97%	-$ 176	11.7%	17.8%	23.0	3.3%	53.8%

Source: Company reports, IRESS, Atlas Funds Management

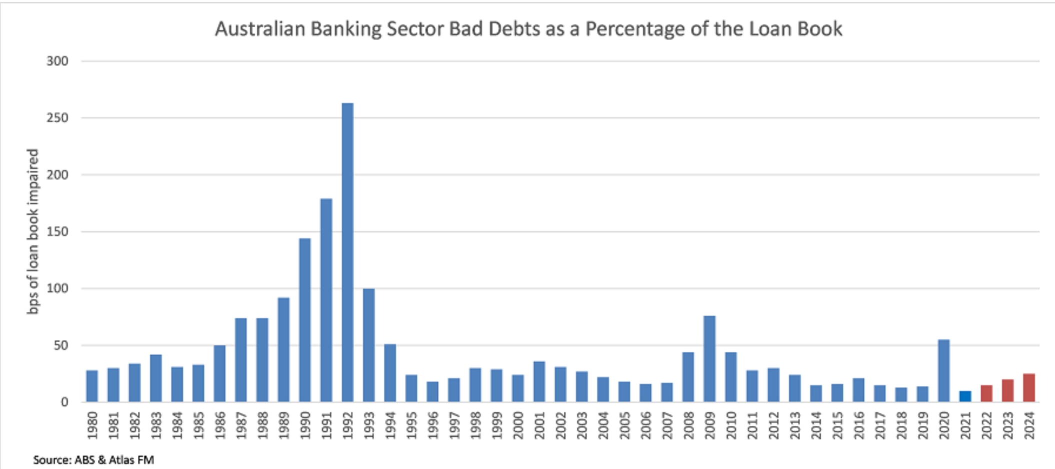
Recovering from the pandemic

The key feature of the November results for the banking sector was the continued recovery in the financial health of corporate and household Australia.

Instead of a steep increase in unemployment and falling house prices, thus increasing bad debts for the banks, the unemployment rate has declined from a peak of 7.5% in June 2020 to 5.2% in October 2021. The CoreLogic Home Property Value Index increased by 20.6% over the 12 months ending in October, led by Sydney houses and apartments that gained 25.2%.

This vast improvement in the outlook saw Westpac, ANZ and NAB continue to write back provisions taken against expected COVID, with CBA and Macquarie only recording minimal loan losses. The discrepancy between loan losses is due to the different times that the various banks report their results. Bank management teams were facing a bleak and uncertain outlook during COVID and made provisions of approximately $2 billion each for expected losses. Additionally, NAB raised $3.5 billion from its shareholders. As CBA has a June year-end, its management team had the advantage of observing a recovering economy and the impact of $311 billion in Australian government stimulus measures.

The chart below shows banking sector bad debts over the past 40 years. The recovery from COVID has been faster than the GFC, and nothing like the decade it took the banks to recover from the 1991/92 recession.



Give me my money back

Excess capital and share buybacks have been a feature of the recent results season, a theme that would have been unfathomable 18 months ago.

All banks have a core Tier 1 capital ratio well above the Australian Prudential Regulation Authority's (APRA) 'unquestionably strong' benchmark of 10.5%, aided by asset sales in wealth management, COVID provisions, as well as low to no dividend payments and lack of the expected loan losses.

The second half of 2021 has seen the four major banks buy back $13.5 billion worth of their own shares, with CBA ($6 billion) and Westpac ($3.5 billion) buying back off-market due to a higher level of franking credits which can be paid directly to investors. NAB ($2.5 billion) and ANZ ($1.5 billion) have been gradually buying back shares on the ASX, due to their lower level of excess franking credits stemming from these two banks offshore adventures, which limited the amount of tax paid in Australia.

The rationale for buying back shares is couched around neutralising the impact of lost earnings from divested insurance and wealth management businesses. However, reducing the share count will make it easier for bank management teams to hit the return on equity targets (ROE) as the equity divisor is reduced. NAB, ANZ and Westpac all have similar levels of Tier 1 capital post their capital management initiatives, with CBA's current lower level of capital reflecting both a large buyback in 2021 and not taking large loan loss provisions in 2020.

Gold Star
Australian banking oligopoly

As APRA appears content allowing CBA to have a lower level of excess capital, investors in the other three banks can probably expect further share buybacks in 2022 if economic conditions remain benign.

Falling Net Interest Margins

Net Interest Margins (NIM) were a major topic during the November banks reporting season, with the share prices of CBA and Westpac both falling after reporting declining margins. Banks earn a NIM [(Interest Received - Interest Paid) divided by Average Invested Assets] by lending out funds at a higher rate than borrowing these funds either from depositors or on the wholesale money markets.

When the prevailing cash rate was 6%, it is much easier for a bank to maintain a profit margin of 2% than when the cash rate is 0.1%. Falling interest rates reduce the benefits banks get from the billions of dollars held in zero or near-zero interest transaction accounts that can be lent out profitably. However, this cheap source of funding continues to benefit the banks. In their result, Westpac revealed that as of September 2021, the bank held $282 billion on accounts earning less than 0.25% and a further $126 billion paying interest between 0.26% and 0.49%.

The November 2021 reporting season saw NIM compress for Westpac and CBA as they competed to take market share off the two Melbourne-based banks. In a competitive market for loans, Westpac and CBA were able to grow their loan book by offering cheaper rates, though this comes at a cost. ANZ's margin was broadly stable though this came at the expense of lost market share as the bank struggled to process the elevated level of home loans over the past six months. The banks more heavily exposed to mortgages (CBA and Westpac) traditionally have higher margins than the business banks (NAB and ANZ) which face competition from international banks when lending to large corporates.

Westpac posted the highest net interest margin in November with 1.98%. However, this declined over the past six months due to growing market share and borrowers concerned about rising rates shifting to lower margin fixed-rate loans and the bank continuing to reduce its exposure to interest-only loans and loans to investors. While this looks concerning, Westpac's lower margins will be offset by the growth in its loan book.

Gold Star

Expenses

Containing growth in expenses has proved challenging for the banks, with low unemployment contributing to wage growth combined with the need to hire more compliance staff after the 2018 Banking Royal Commission. Additionally, compliance teams have grown in response to CBA and Westpac getting hit with hefty penalties from AUSTRAC for not complying with Anti-Money Laundering and Counter-Terrorism Financing Act 2006. Westpac surprised the market after growing expenses by 8%, mainly due to the bank hiring 3,000 new staff to set up new financial crime and complaints handling procedures and meet other regulatory obligations.

While there was minimal discussion around cutting expenses by closing branches, Atlas sees that rationalising the branch network will be the easiest way for banks to grow earnings. On average, the significant banks each have over 1,000 branches around Australia. They have experienced a decline in usage of these branches over the past decade, as most bank transactions are now conducted either online or via smartphones.

In November, NAB reported processing 1,300 digital transactions for every in-person transaction conducted at a bank. Westpac said that it had closed 98 branches over the past year, which should show benefits in coming years. The gold star goes to ANZ, who kept expenses unchanged at $7.4 billion despite higher revenue.

Gold Star

Dividends

All banks sharply increased their dividends in the most-recently completed reporting season. However, there was an element of catching up for reduced payments to shareholders in 2020 after APRA placed a cap limiting dividends to 50% of earnings. ANZ increased its semi-annual dividend by 66% to 72 cents, though this is still 10% below their pre-COVID levels. Macquarie wins the gold star, increasing their dividend by 100%, but what is more important for investors is that the $2.72 paid to investors is ahead of the $2.50 per share paid to investors in November 2019. As a global investment bank, Macquarie Bank has enjoyed a good pandemic, growing earnings in 2020 and 2021, profiting from market volatility.

Gold Star

Our take

Investing in Australian banks is one of the major questions facing institutional and retail investors alike, with the banks comprising 25% of the ASX 200.

We expect the banks to deliver around 5-10% earnings growth over the coming year as earnings continue to recover from the hit from the pandemic. However, growth will be muted by lower credit growth, normalising bad debts and reduced earnings support from provision write-backs. In the wider Australian market, the banks look relatively cheap and are well capitalised. Unlike other income stocks such as Telstra, they should have little difficulty maintaining their high, fully franked dividends.

Additionally, their share prices are likely to see support over the next 12 months from share buybacks. Looking further ahead, Australia's banks have historically performed well in an environment of rising interest rates. They have seen expanding profit margins by being swift to increase interest rates on loans but slower to increase the rate paid on term deposits and transaction accounts.

Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.

In the beginning, there were LICs. Where are they now?

Callan Maclennan, Michael Malseed

While exchange traded funds, or ETFs, are a relatively recent innovation in the investment universe, Listed Investment Companies, or LICs, can trace their origins in Australia to the 1920s. Of the roughly 100 LICs currently listed on the ASX, a handful have seen a half-century or more of market activity, with the five oldest companies boasting an inception date prior to 1972.

Growth in the last decade has been influenced by many factors:

- investor demand for listed vehicles
- the popularity of SMSFs
- demand for predictable fully-franked income
- a desire from fund managers to raise long-term capital
- the availability of stamping fees (a commission paid to the adviser for their 'work' on capital raising) on new LIC listings (banned from 1 July 2020).

Exhibit 1 Growth of ASX-listed LICs

Source: The Listed Investment Companies and Trusts Association (LICAT) | Morningstar Direct. Data as of 31/10/2021.

Exhibit 1 shows the growth in the LIC market by number and assets under management, or AUM, since 2012.

Traditional versus Trading LICs

For our purposes, the Australian LIC universe can be broadly split into two camps: Traditional and Trading.

Traditional LICs, largely the domain of incumbents such as Australian Foundation Investment Company, or AFIC (ASX:AFI), with its $9.4 billion AUM, embody a long-term buy-and-hold ethos, which grants them the ability to pass on Capital Gains Tax, or CGT, concessions to investors.

Trading LICs tend to be more actively managed, with higher average annual turnover. Trading LICs forgo the CGT concessions available to traditional LICs, instead paying the company tax rate on trading profits. This gives them the freedom to trade in and out of positions which provides greater scope to outperform a relevant benchmark and peers. It also enables them to generate franking credits over and above those received from underlying portfolio holdings. This cohort is dominated by the likes of Magellan Global Fund (ASX:MGF), with its AUM of $3.4 billion and WAM Capital (ASX:WAM) at $1.7 billion.

For the purposes of our analysis, we have defined Traditional LICs as those that account for investments on the capital account rather than on the revenue account.

Benefits and drawbacks

LICs provide investors with a few key benefits.

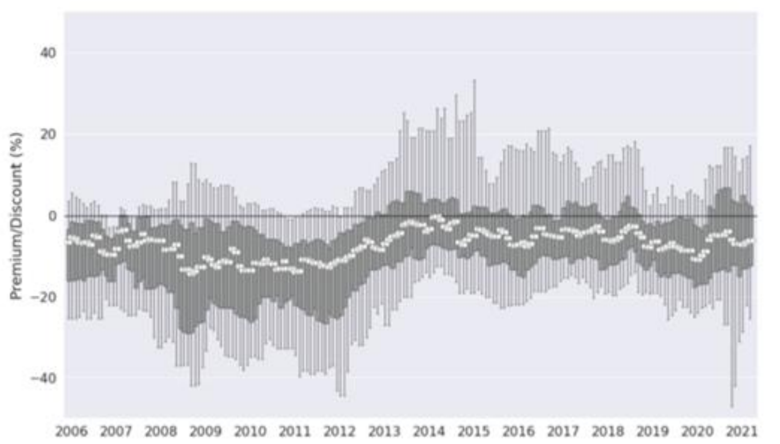
Traditional LICs tend to be a low-cost entry point to an actively-managed investment, especially when compared with the broader actively-managed fund market. The average annual total cost ratio, or TCR, for Traditional LICs is 0.29% compared with 1.13% for Morningstar's Australian Equity Large Blend Category.

Trading LICs, though, tend to be more in line with the broader actively-managed market, at an average annual TCR of 1.29%.

Additionally, LICs provide convenient access to a diversified portfolio through an ASX vehicle. An argument can also be made that a closed pool of capital can be more effectively invested for the long term without the concern of managing inflows and outflows.

While those features are advantageous for investors, there are some downsides. Chief among them is the tendency for their share prices to trade away from the underlying net tangible assets, or NTA. This is due to the closed-end nature of the investment whereby investors are buying and selling a fixed pool of shares, unlike a unit trust, where new units are issued or cancelled on application or redemption.

Exhibit 2 Median and Range of LIC Share Price Premium/Discount (in Percentage Terms) to NTA, Across Australian Equities LICs--2006-21



Source: Morningstar Direct. Data as of 31/10/2021.

A LIC's share price is influenced by underlying demand and supply dynamics, rather than being strictly pegged to its NTA. Given the relative youth of the Trading LIC cohort, they are generally smaller in scale, and the market of natural buyers and sellers is not as deep. This relative liquidity can have a large impact on price volatility and results in larger premiums or discounts.

Notwithstanding their scale benefits, Traditional LICs are not completely immune to this problem. Exhibit 2 above shows the range of share price premiums and discounts of the LIC cohort from June 2006 to September 2021. The darker bars represent the interquartile range, while the lighter lines plot the fifth to 95th percentile.

Difficulties removing discounts

The difference between share price and NTA is a significant obstacle to consider when surveying the LIC landscape. Prolonged discounts have led to attempts from company directors to close the gap, with share buybacks a primary lever in the battle. Nearly 25% of the market has announced buybacks in the last 24 months, each intent on reducing the trading discount to appease shareholders as well as to ward off internal and external activists.

Nevertheless, the impact has been muted. Over the 24-month period to 31 August 2021, the median discount only shifted by 1.4%, from negative 10.9% to negative 9.5%, with some in the cohort trading even further from NTA.

The issue for directors is share buybacks don't create demand from new buyers. Rather, the process only creates liquidity for sellers in the present, further reducing liquidity in the future. Effectively, directors can only kick the metaphorical can down the road. Despite colossal efforts from LIC directors across the market, discounts remain ever-present and are once again in the spotlight as competitors seek to capitalise on investments that can provide a margin of safety.

On the WARpath

The LIC market has seen a flurry of consolidation activity in the past few years, with Geoff Wilson and WAM Capital Limited (ASX:WAM) in acquisition mode. Further cementing Wilson's position as a consolidator is WAM Strategic Value (ASX:WAR), which was launched in June 2021, intent on targeting LIC and LIT peers trading at a discount to NTA. WAM will seek to close the discount gap by driving investor engagement and creating new buyers or taking an activist approach through corporate action.

Elsewhere in our LIC universe, Washington H. Soul Pattinson acquired Milton Corporation in October 2021, bringing a total of nearly $11 billion under management for the group and removing a significant player in the sector (Milton represented roughly 6.5% of the LIC market).

With WAM's acquisition of Templeton's ASX:TGG, the consolidation process is in full swing, thinning the ranks of the LIC market. Since January 2019, the number of ASX-listed LICs across all asset classes has declined by roughly 20, with the likes of Australian Leaders Fund ALF, Contrarian Value Fund CVF and CBG Capital CBC all subject of takeover or liquidation activities. While some LIC managers across the country nervously wait for hostile approaches, others are learning to adapt and survive.

Exhibit 3 Australian & Global Equity LICs delisted between September 2019-November 2021

Name	Inception Date	Delisting Date	Net Assets 3 Mo Prior To Delisting	Prem/Disc 12 Mo Avg 3 Mo Prior To Delisting	1Y Trailing Returns 3 Mo Prior to Delisting
Australian Governance & Ethical Index Fd	7/16/2018	17/02/2021	29,774,786	-2.80	-11.33
CBG Capital Ltd	12/19/2014	25/09/2019	28,270,465	-14.43	6.65
Concentrated Leaders Fund Ltd	2/6/1987	20/04/2021	70,687,801	-3.99	-13.14
Contrarian Value Fund Limited	1/5/2015	26/02/2021	67,078,923	-18.41	-14.93
Ellerston Global Investments Ltd	10/17/2014	24/08/2020	114,293,047	-12.91	-3.95
Evans & Partners Asia Fund	5/17/2018	29/01/2021	132,785,555	-3.07	5.43
Evans & Partners Australian Flagship	6/27/2018	17/02/2021	23,680,946	-3.65	-10.47
Evans & Partners Global Disruption Fund	8/1/2017	29/01/2021	293,809,799	-2.96	35.02
Evans & Partners Global Flagship Fund	10/11/2012	29/01/2021	163,319,848	-3.14	-
Mercantile Investment Company Ord	4/5/2007	18/10/2019	56,224,210	-16.40	-2.34
Milton Corporation Ord	1/30/1962	06/10/2021	3,559,936,321	-3.52	6.96
Templeton Global Growth Fund Ord	5/28/1987	01/11/2021	335,576,421	-9.74	26.02

Source: Morningstar Direct. Data as of 10/11/2021.

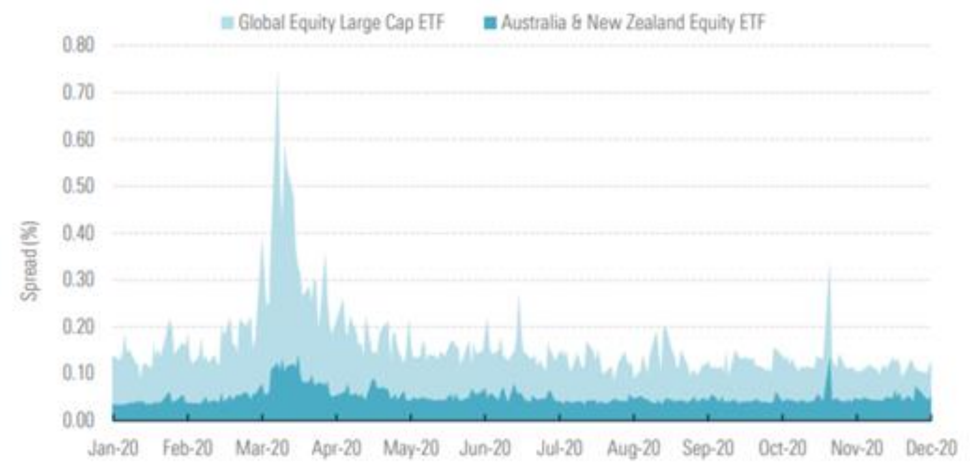
Open-ended solution

This persistence in the trading discount has also seen several LICs convert into active ETFs, otherwise known as exchange-traded managed funds, or ETMFs. ETMFs are open-ended vehicles, meaning that supply and demand for units won't push the price far from the NTA. It is a better structure for investors, with the same benefits that come from a listed access point.

Several fund managers, such as Magellan (ASX:MHH), and Monash Investors (ASX:MA1) have taken the leap from closed-ended to open-ended structures in search of a solution to the discount problem. At the time of writing, Antipodes (ASX:APL) has a scheme meeting scheduled to vote on a transition to AGX1 (the ETMF vehicle of Antipodes' long-only strategy).

While the active ETF structure will largely resolve the NTA issue, investors should remain vigilant for occasional spread and liquidity issues. Volatility can lead to spreads widening materially for short periods, and it has the potential for market makers to reduce their orders. Intraday indicative NAVs, or iNAVs, are published on each manager's website and should be referred to before trades are placed (though this is not without fallibility).

Exhibit 4 ASX-listed ETF Average Daily Spreads



Source: Morningstar Direct. Data as of 31/10/2021.

Exhibit 4 shows the average bid-ask spreads over time for the Global Equity Large Cap and Australia & New Zealand ETF categories.

You can have your cake and eat it too

Another innovation emerging in the managed investment universe seeks to cover all bases and extend the reach of unlisted managed funds.

Magellan, Hyperion, Antipodes, and Fidelity are among a growing number of fund managers to launch product structures that are tradable both on and off market, at the investor's discretion. The Hyperion Global Growth Companies Fund (ASX:HYGG), for example, gives investors listed access to the Global Growth Companies Fund through the ASX. Here, though, unlike our LIC-to-ETMF conversions above, investors still have use of the unlisted access point.

This hybrid structure provides an interchangeable product that can theoretically remove liquidity risk from the equation. When liquidity is poor, as was the case in March 2020, investors can trade off market through the unlisted vehicle at a price much closer to NTA (albeit without price transparency at the time the order is placed). The on-market bid-ask spread purely represents the cost of securing intraday liquidity, if needed, and relative price certainty during volatile periods.

All things considered

Progressive iterations of access points for investments continue to whittle away at the pricing inefficiencies driven by product structures. While this may limit arbitrage opportunities for those seeking to capitalise on historical pricing variations, more-efficient markets are a positive for most investors.

Today there are more choices than ever as markets and products continue to evolve. So, while this round of LIC consolidations looks to be far from over, there will be more active ETF launches and LIC-to-ETMF conversions from managers and directors who want to close the discount to NTA, appease shareholders, ward off would-be activists and secure their piece of the exchange-traded pie.

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Should you bank on the Westpac buy-back?

Dr Peter Gardner

Here's an example of reader feedback

"Graham – I wonder whether you might do something about the benefits of off-market buybacks. For small retail investors, especially those of us who can't afford financial advice, it's a bit of a mystery.

For example, Westpac is offering to buy back shares at between 8-14% (discount) to their value. I mean, why is this so? I'm sure I could read the hundreds of pages accompanying it, but I'm told to get financial advice. Well, if you've only got a few hundred shares…

So I wonder whether you might be able to explain in retail investor language what this is all about – at least in principle."

Firstlinks does not offer personal financial advice but here are the general principles.

Westpac has announced an off-market buy-back, with the size at $3.5 billion.

Off-market buy-backs are a tax-effective mechanism for returning franking credits to shareholders who most value them. The buy-back will have a $11.34 capital component, with the balance being a fully franked dividend.

The buy-back will be based on a tender, with investors tendering to sell shares at a discount of between 10% to 14% below market price. Shareholders who don't participate will still benefit from the buy-back, to the extent that shares are effectively bought back at a cash discount to market price. This compares with on-market buybacks, where companies buy-back stock at market price.

For tax-exempt investors such as pension phase super

We have analysed the value of the buy-back for tax-exempt investors such as charities, foundations, pension phase superannuation and individuals below the income tax threshold using the market price of Westpac on 22 November of $21.79, as shown in Chart 1 below.

Using $21.79 as a guide (the actual price used for the buy-back will be the volume weighted average price (VWAP) of Westpac shares in the five trading days up to and including 17 December 2021) the maximum 14% discount would equate to a $18.74 buy-back price. With the capital component being $11.34, the other $7.40 would represent a fully franked dividend, which would have a $3.17 franking credit attached.

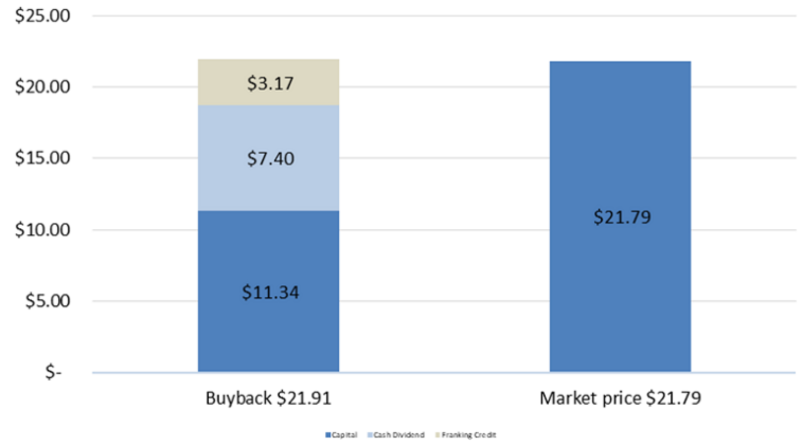
For a tax-exempt Australian investor, we estimate the buy-back at a 14% discount would be worth approximately $21.91 (disregarding the time value of money), representing an after-tax profit of just $0.12 or 0.6% compared to the market price of Westpac.

Please note that the buy-back is expected to be completed on 20 December 2021 based on volume weighted prices from the previous week.

The value of the buy-back for other investors will depend on the tax situation of each investor. At current prices, we would expect the buy-back to be of marginal if not negative value for 15% tax rate Australian investors.

The precise value will be determined by investor circumstances, the deemed capital value that the ATO will issue after the close of the buyback and the final buy-back price relative to the closing market price.

Chart 1. Estimated value of the Westpac buyback for tax exempt investors



Source: Plato, Westpac buy-back announcement 1 November 2021.

Potential for price set at lower discount

Given that we estimate the buy-back is only just valuable for tax-exempt Australian investors at the maximum discount rate, we expect the final buy-back price could be possibly set at below the maximum 14% discount to market price. This price will not be known until after investors make a commitment to sell.

For example if the buyback went off at an 11% discount, then the after-tax value for tax-exempt Australian investors would rise to 4.8% for every share successfully tendered. The scale-back may also be not as high as it has been for other recent buy-backs.

So whilst we expect the buy-back to not be as valuable for tax-exempt Australian investors as previous buy-backs (which have often been worth 20% for every share successfully tendered), a lower scale-back will potentially increase the overall value of the buy-back at the portfolio level.

We believe opportunities such as this Westpac buy-back highlight the importance of tax-exempt investors like pension phase superannuants having their investments managed from their tax perspective.

Dr Peter Gardner is a Senior Portfolio Manager at Plato Investment Management. Plato is an affiliate of Pinnacle Investment Management, a sponsor of Firstlinks. Please note that this analysis depends very much on the particular tax status of the investor. We would suggest individual investors should seek professional tax advice based on their individual tax circumstances.

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Understanding the benefits of rebalancing

Chamath De Silva

Good Strategic Asset Allocation (SAA) modelling should factor in rebalancing rules, as the rebalance benefits may be material, especially in a low-return environment. Using a simulation-based approach is sensible as it can help capture path dependencies and rebalance rules, but unfortunately it's not implemented in practice as much as it should be.

As a result, the rebalance benefits of bonds are often ignored in formal SAA modelling and the diversification benefits are simply limited to the volatility reduction benefits only, resulting in a lower allocation to liquid defensive assets than would otherwise be the case.

Rebalancing benefits are not, however, the result of statistical anomalies or luck, but can be attributed to a unique source of risk premia (the additional return derived from accepting unique, or non-diversifiable, sources of risk).

How does Strategic Asset Allocation modelling work?

The standard approach to SAA modelling is largely as follows:

1. Make your capital market assumptions, including asset class expected returns, confidence intervals and return correlations between asset classes
2. Input the capital market assumptions into a mean-variance optimisation engine
3. Observe the output (commonly called an 'efficient frontier'), select the appropriate efficient portfolio based on overall risk tolerance, and tweak where appropriate.

While in theory this makes sense, the way this is often applied in practice has some glaring issues, including conflating the return volatility over time with the dispersion of the future return distribution over a set horizon.

The other big flaw is applying a one-period approach to the entire SAA horizon despite the existing of rebalancing rules. Ignoring path dependency and one's own rebalancing rules result in not appreciating that actual portfolio returns do not equal the weighted average returns of each building block in a multi-period framework.

The long-run benefits of rebalancing

The following waterfall charts and tables demonstrate the material *performance* benefits rebalancing provides, using US data in 50/50 balanced portfolios of stocks and bonds from 1925 to 2020.

Chart 1 shows the total return contributions of the various building blocks to overall real returns of a balanced portfolio. In contrast, Chart 2 decomposes the contributions into risk premia, specifically:

* the ***term premium*** for duration exposures (both equities and long-term government bonds) and

* the ***equity risk premium*** (the excess returns of stocks in excess of long-term government bonds, stripping out the effects of valuation changes).

Chart 1: Real Total Return Decomposition by Asset Class Contribution

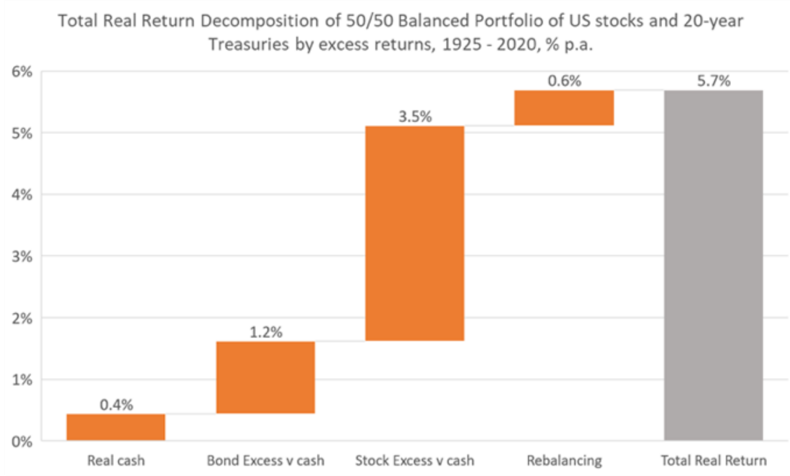
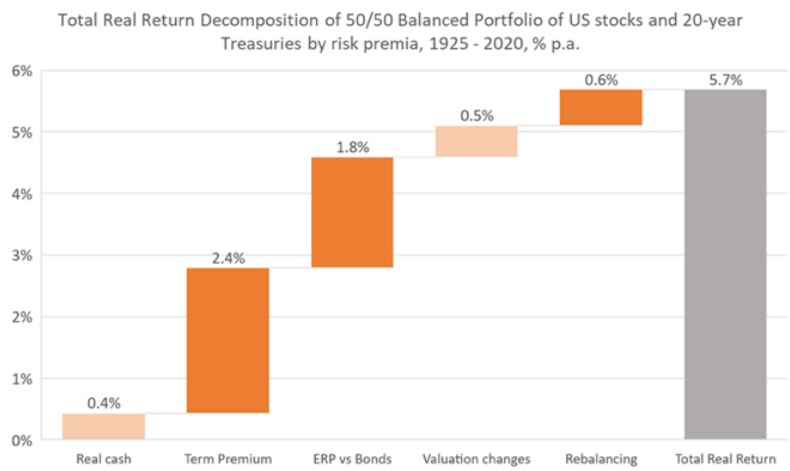


Chart 2: Real Total Return Decomposition of Balanced Portfolio by Risk Premia Contribution



Sources: Morningstar, BetaShares Capital

The 'costs' of chasing yield

It's important to be aware that rebalancing benefits are not equal across fixed income exposures.

Cash and government bonds generally provide the greatest rebalancing benefits, with the benefits eroding as more credit risk is taken on. This is important, as it may be tempting to replace high-grade bonds with high-yield credit on the basis of standalone expected returns. This however ignores not only the volatility and drawdown reductions of high-grade bonds, but also their rebalancing benefits in balanced portfolios.

Table 2 (next page) illustrates this using the S&P 500 (SPX) and five different fixed income indices: 10yr+ US Treasuries ("Long UST Agg"), 1-10yr US Treasuries ("Intermediate UST Agg"), 10yr+ Investment Grade (IG) corporate bonds, 1-10yr IG corporate bonds, and US high yield corporate credit (i.e. junk bonds).

For example, on a standalone basis, US high-yield credit delivered identical returns to long duration US Treasuries, but the latter provided a much higher marginal total return contribution to a balanced portfolio.

Why does a rebalancing risk premium exist, and who 'pays' it?

There is a common belief that what matters for diversification benefits is simply correlation. This, however, is an incomplete explanation. Correlation can assist with volatility suppression, but rebalancing benefits arise from a combination of correlation, volatility (covariance), absolute return dispersion, and mean reversion in relative returns.

Table 2: 50/50 Balanced Portfolio, Quarterly Rebalancing, 1983-2020

	SPX + Long UST Agg (10y+)	SPX + Int UST Agg (1-10y)	SPX + Long Corp Agg (10y+)	SPX + Int Corp Agg (1-10y)	SPX + HY
50/50 Portfolio Returns (qrtly rebalancing)	10.8%	9.1%	10.7%	9.7%	10.4%
Stock contribution	5.8%	5.8%	5.8%	5.8%	5.8%
Bond contribution	4.4%	2.9%	4.5%	3.5%	4.4%
Rebalance contribution	0.7%	0.4%	0.4%	0.3%	0.2%
Effective Bond Return (including rebal benefits)	10.1%	6.7%	9.8%	7.7%	9.1%
Rebalance risk premia provided at 50% bond weight	1.3%	0.8%	0.7%	0.6%	0.4%

Sources: Bloomberg, BetaShares Capital

One interpretation is the rebalancing premium can be seen as compensation for mean-reverting rebalancing rules, which on their own expose the investor to risk of unlimited underperformance relative to not rebalancing at all (such as being on the wrong side in a heavily trending market).

The other interpretation is the rebalancing premium is compensation for providing liquidity on demand (i.e. automatically buying stocks/selling bonds during equity drawdowns) and using liquidity when the market is supplying it (selling stocks/buying bonds during a strong equity rally).

This begs the question: who is taking the other side and therefore 'paying' the premium to balanced portfolios?

Observation would suggest it is the type of investor who benefits from an environment of trend, momentum and growing return dispersion between asset classes (i.e. leveraged, trend and momentum based strategies). Leveraged strategies benefit from getting a magnified exposure to higher risk premium assets, but the cost is the risk of losses exceeding capital.

In order to insure against the risk of a complete wipe-out, rules around leveraged ratios are typically employed, such as periodic rebalancing to a leverage target or threshold levels. However, this insurance in the form of rebalance rules comes at a cost, with the benefits accruing to unlevered multi-asset strategies.

In one way or another, all types of leveraged strategies, whether they are leveraged ETFs, trend-following strategies, active managers taking positions against a benchmark, or discretionary retail investors trading in margin or CFD accounts, are all subject to Loan-to-Value (LVR) rules that limit downside losses, and this rules-based insurance comes at a cost. This is the whole 'cutting losses early and letting winners run' mantra embedded into LVR-based rules.

In conclusion, rebalancing a multi-asset portfolio takes on increased importance, not just from a volatility mitigation perspective, but as a source of risk premium that can be captured through the systematic and counter-cyclical nature of the rebalancing process.

Chamath de Silva is a Senior Portfolio Manager at BetaShares, a sponsor of Firstlinks. This article contains general information only and does not take into account any person's objectives, financial situation or needs. It is not a recommendation to make any investment or adopt any investment strategy. Before making an investment decision you should consider the relevant product disclosure statement ('PDS'), your circumstances and obtain financial advice. See the BetaShares website (www.betashares.com.au).

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