Firstlinks
a Morningstar company

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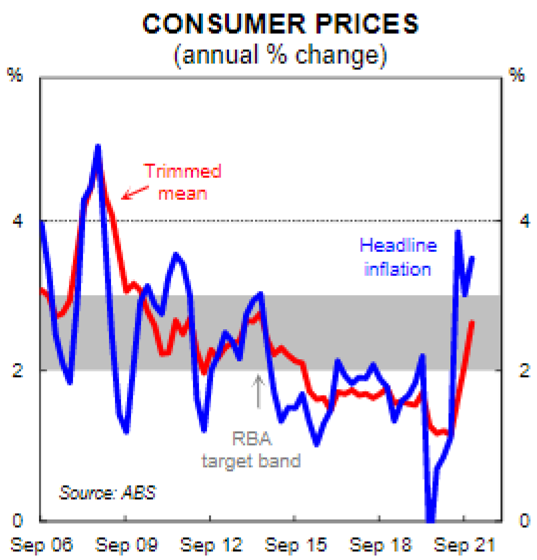
Editorial

Anyone who operates a small business knows inflation has hit them for some time. A shortage of staff builds pressure into wage increases, freight costs rise with fuel prices and supply chain blocks mean greater competition for goods. Restaurants and cafes have long been paying more for meat and vegetables and passing higher costs on to customers.

Yet as recently as 14 September 2021, only four months ago, **Reserve Bank Governor Philip Lowe** took the unusual stance of giving interest rate guidance for years ahead, based on the inflation outlook. It was strange at the time, and it looks even stranger now. He even went as far as to question the market pricing in rate increases. Speaking in an address to the Anika Foundation, Lowe said:

"In particular, the Board has said that it will not increase the cash rate until actual inflation is sustainably within the 2–3% target range. It won't be enough for inflation to just sneak across the 2% line for a quarter or two. We want to see inflation around the middle of the target range and have reasonable confidence that inflation will not fall below the 2–3% band again. Our judgement is that this condition for a lift in the cash rate will not be met before 2024."

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



In the most recent outlook in the December 2021 Board Minutes, inflation was described as *"low in underlying terms"*. Then: *"The central forecast was for underlying inflation to reach 2.5% over 2023."*

Well, it was higher this week. Lowe fronts the RBA Board next week to explain why *"difficult to understand"* is now obvious, and he was firmly off the pace. The RBA's preferred inflation measure, the trimmed mean (which excludes items recording large price increases or decreases) rose 1% in Q4 2021, well above the RBA's forecast 0.6%. The annual rate is now 2.6%, just above the mid-point of the 2-3% target range. On a six-month annualised basis, it is 3.5%.

CBA economists (the source of the above chart) wrote:

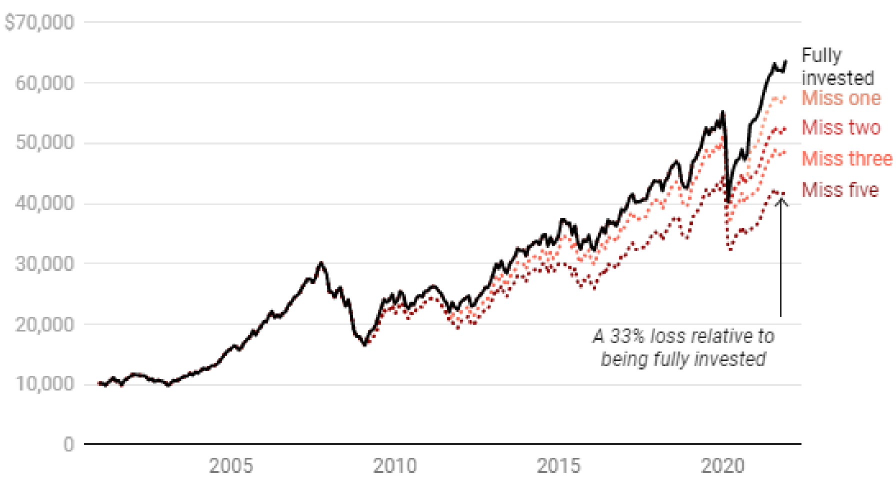
"The trimmed mean outcome was a massive overshoot on the RBA's forecast for underlying inflation. We believe the RBA will need to make a fundamental adjustment to their 'low and gradual' inflation narrative in their upcoming communication next week. We shift our central scenario for the first hike in the cash rate from November 2022 to August 2022 (the risk lies with an earlier hike in June). We retain our view that the RBA will end the bond buying program at its Board meeting next week."

And on the day of the CPI release, the Australian market fell 2.5%. This week showed stockmarket investors what to expect as central banks move into a rate-tightening phase. Monday in the US was remarkable as it initially continued the sell-off from Friday, with the NASDAQ down 5% and the S&P500 down 4%. It looked like a major correction was underway. By the close, the S&P500 was up 0.3% and NASDAQ had gained 0.6% on the day. Heightened volatility has continued since.

Shane Oliver looks at the reasons for the recent sharp falls in stockmarkets and checks seven things investors should consider in deciding their next steps.

The investors most enjoying the market fall are those in cash who have long thought the market was too expensive. If only timing investing was easy. This chart from **Lewis Jackson** shows if $10,000 invested in Australian equities (the Morningstar Australia Gross Return Index) had missed only a few months of good returns, performance over the 20 years would be significantly down.

Change in final return if investors miss a handful of crucial months



$10,000 invested on 1 Jan 2001. Returns data: Morningstar Australia GR AUD

Source: Morningstar • Created with Datawrapper

The rapid increase in wealth of most asset owners in 2021 also saw a surge in the size of Australian Exchange-Traded Funds (ETFs), rising 45% to $130 billion. The growth is impressive and it receives all the headlines for investment funds. But their unlisted competitors, the managed funds which mainly sit on platforms, hold $3.5 trillion. Barely noticed by the media and ETFs are the minnows. Yes, ETFs have a long runway but why are managed funds doing so well?

BlackRock's Larry Fink gave a high-profile talk last week, and **Ollie Smith and Sunniva Kolostyak** extract 10 highlights to summarise the view of the CEO of the largest fund manager in the world. On ESG principles:

"We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients ... Every company and every industry will be transformed by the transition to a net zero world. The next 1,000 unicorns won't be search engines or social media companies, they'll be sustainable, scalable innovators – start-ups that help the world decarbonise."

Ashley Owen looks at the growing inequality around the world and in Australia, with a minority enjoying the benefits of wealth distribution. In a new book published at the end of 2021, **Ray Dalio**, billionaire founder of **Bridgewater**, the world's largest hedge fund, predicts a 30% chance of civil war in the US within 10 years because of 'emotional polarisation'. Eventually, we will all suffer from rising inequality within nations and across the world.

Anyone nearing the ages of 55, 60 and 65 who may be considering ways to legitimately access their superannuation should check the retirement conditions of release. **Liam Shorte** explores some of the nuances and a focus on what 'gainful employment' means is especially important.

With the global worry about carbon emissions, many individuals manage their own lives to minimise their personal footprint. But **Don Hamson** offers an idea that will confront many people, that the typical superannuation fund is producing more carbon than the average Australian household. Check his argument and the numbers.

And **Professor Kevin Davies** explains how the Contracts for Difference (CFDs) work, why ASIC is cracking down on them for retail clients, and why anyone using them must know the highly-leveraged risks.

This week's White Paper is **VanEck's ViewPoint**, reviewing the end of 2021 in the context of decisions that seemed right at the time, in the heat of the moment, but all humans make mistakes.

Check below for the exciting guests and speakers at the upcoming **Morningstar Investment Conference** for individual investors, with online presentations and interviews for a day at a cost of only $25.

Despite the focus on ETFs, unlisted funds still dominate

Graham Hand

In English, we say, "The squeaky wheel gets the oil." The Chinese say, "The baby that cries the loudest gets the milk." In other parts of Asia, they say "The nail that stands out gets pounded down." Any way you look at it, in the Australian funds industry, the 'wheel' or the 'baby' or the 'nail' is Exchange Traded Funds, or ETFs – the noisy upstarts who make investors believe they are the centre of the investible universe.

Well done to them for creating this illusion, and their strong growth has reflected this high profile.

To the great credit of the issuers, the likes of Vanguard, VanEck and BetaShares decided a decade ago that if their ETF businesses were to grow, they needed to promote the benefits of the product structure and education first and their own brand name second. Investors learned about low costs and ease of access as if these attributes were unique to ETFs. And along the way, every milestone was breathlessly celebrated in the media as if they were the second coming.

Managed funds ceded profile to the ETF upstarts

Despite a fraction of the history of managed funds, ETFs have built a reputation that managed funds can now only envy.

A recent article in *The Australian Financial Review*, for example, shouted the headline, 'Aussie ETFs set to crack 2 million investors in 2022.' Firstlinks does the same, the first publication to note the ETF $100 billion milestone in February 2021. New fund listings are greeted like a cure for cancer.

In 2022 outlook piece, CBA Economics discussed passive investing and the expectation that investors will be more risk averse in 2022. Then:

"the strong performance of diversified portfolios and listed equity Exchange Traded Funds (ETFs) may be difficult to replicate in 2022. As at November 2021, listed equity ETF market capitalisation was up 31.8% on the prior year."

ETFs cleverly associated themselves with index or passive investing, and with that, cheaper costs. But managed funds were offering cheap index funds long before ETFs came along, and there are plenty of 'active' ETFs which are not cheap.

Managed funds ceded the space. When was the last time anyone wrote a headline about managed funds, such as when they 'cracked' $3 trillion (yes, trillion)? There is nobody promoting unlisted managed funds, and if media coverage is the gauge, it would be easy to think managed funds are an historical edifice. While individual fund managers devote their marketing budgets to the launch of their exciting new listed ETF, or their Listed Investment Company (LICs also have their own marketing association, LICAT), or their own brand name, managed funds chug away in the background.

Managed funds dominate the Australian market

According to ICI Global, in its Worldwide Public Tables for the end of 2021, the total assets in Australian unlisted managed funds were valued at about A$3.5 trillion (ICI Global is part of the Investment Company Institute, representing funds globally with total assets of US$43 trillion or about A$60 trillion. This gives Australia a solid 6% of global managed funds).

The total size of Australian ETFs at the end of 2021 was … wait for it … start getting excited at the earth-shattering number … $134 billion.

That makes ETFs in Australia less than **4%** of the size of the managed funds industry. Growing rapidly, tick, attracting new investors, tick, hitting the headlines, tick … tiddlers, tick.

LICs are well down the scale, suffering from their inability to pay selling fees to brokers and financial advisers, and where once they competed for size with ETFs, they hold only $56 billion or 1.5% of the size of managed funds.

Where is all this unlisted fund money sitting?

There is no public database of unlisted funds in the same way as offered by Australian exchanges, the ASX and Chi-X. To learn where the money is flowing requires access to institutional participants who process the transactions or monitor the markets.

Managed funds are the investment vehicle used by most financial advisers, who place their clients on platforms for ease of administration. For example, using the newer technologies of managed accounts, advisers can adjust the portfolio of all their clients in one transaction, greatly improving the efficiency of their back office. Managed funds flows therefore give an insight into what advised clients are doing.

Calastone claims it records 95% of Australian managed fund flows passing across its network, representing transactions between platforms and fund managers on behalf of investors. These flows are not the direct investments on a listed exchange and exclude ETFs.

Calastone reports that managed fund net inflows rose to $36 billion in 2021, up from $14 billion in 2020. The main gains were in equity funds, up 174% to $15 billion from only $6 billion in 2020. Investment flows were strongest mid-year but fell away by December. As ETFs have also experienced, international equity funds rose significantly, as well as small caps. Fixed income was doing well until inflation fears spiked.

This chart shows the strong flows into equity managed funds in 2021, suggesting fears of their demise are exaggerated. The increase from 2019 is especially notable.

Net fund flows into Australian managed funds by equity category

Source: Calastone

At this stage, it is unlikely that 2022 will match 2021, as July 2021 was the strongest month for inflows which then fell each month as Omicron and inflation hit confidence. Both factors will reduce flows this year. The global switch is on for Australian investors, with two-thirds of investments in 2021 in overseas markets compared to only half in 2020.

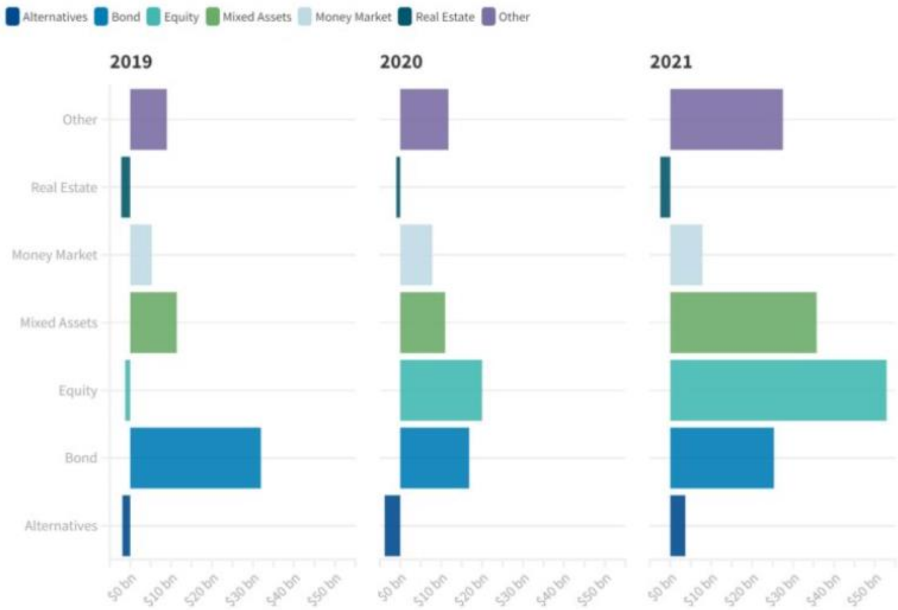
Ross Fox, Head of APAC at Calastone said:

"Australians have saved in record amounts during the pandemic, stowing away a seventh of their disposable income in 2020/21, almost three times more than in 2019. They were rather cautious with all this cash in the first year of the pandemic. But by 2021, as a clearer exit route emerged in the form of vaccines, fund flows

responded dramatically. The flood of capital into managed funds in 2021 is a direct consequence of both higher risk appetite and piles of ready cash on household balance sheets. They are not alone. Investors around the world have behaved in a similar way."*

Equity and bond flows dominate, with equities a clear winner.

Net fund flows by asset class, global



Source: Calastone

What are the Australian platforms?

In **retail** funds under management, according to Plan for Life, the top five administrators are the IOOF Group (boosted by the recent acquisition of MLC), BT Financial, AMP, CBA/Colonial and Macquarie. Each holds over $100 billion on their platforms. The rapid risers over recent years have been the managed account providers, netwealth, Hub24 and Praemium, while Mercer, Perpetual and Challenger are also in the Top 10. Most other providers were in outflow. Annual **gross** inflows have been steady at around $190 billion a year.

The Top 10 hold about $1.1 trillion (as at end September 2021) in retail managed funds, up from about $900 billion a year earlier, across wraps, platforms or master trusts. The wraps are the biggest winners and most of the money is superannuation. For traditional platforms, the surging markets in 2021 contributed most of their fund growth and they will fall if the markets take a hit. They hold large balances built up over prior years before the landscape became more competitive.

In **wholesale** funds under management, Plan for Life data shows total balances of $1.5 trillion in September 2021, up from $1.1 trillion a year earlier. Leading providers who feature for wholesale services to institutions and not retail include State Street, Vanguard, Victorian Funds Management, UBS, First Sentier, Pendal and BlackRock. A lot of this money is passive index, a business Vanguard is stepping away from for institutions. Combined with the changes as AMP and IOOF, the data is highly volatile with earnings and business changes affecting flows.

While it is sometimes difficult to reconcile different sources of data across trillions of dollars, the fact remains that managed funds (in their many formats) continue to thrive in Australia despite the bigger profile given to their ETF competitors.

What are some implications?

These numbers present opportunities for investors and ETF issuers.

ETF issuers know there is a massive runway for growth, as despite their high profile, they represent less than 4% of funds versus 25% in the US.

Investors should realise there is more choice among thousands of managed funds than the 250 ETFs, and with proper platform use, the extra cost can be minor and might be worth paying for the efficient platform functionality. Some platforms can only be accessed via financial advisers, involving an advice fee, but some allow direct participation. It can be an easy way to put all investments in one place for tax and administration purposes.

ETFs are a welcome and burgeoning part of the investing landscape, with ease of access, low cost (for index options) and their variety of sectors and themes. No doubt they will win market share from managed funds, especially as adviser numbers dwindle, but for many years, managed funds will reign.

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

10 lessons from Larry Fink's 2022 Outlook

Ollie Smith, Sunniva Kolostyak

Asset manager BlackRock recently held a 2022 Outlook event. Here are some edited highlights of what its CEO, Larry Fink, said about 10 topics.

1. Consumer behaviour has completely changed

“We saw a vast change [in 2021]. Because of what we're witnessing now with the new variant, we're spending much less money on services. We're not commuting as much. We're not going to restaurants as much. And the pool of savings has built up dramatically, but when we spend it we're spending it much more on capital goods. Some of the fundamental reasons why we have supply chain problems is the demand side is just so much greater than it's ever been.”

2. Inflation is not transitory

“Inflation is a big, big issue going into 2022 because of this change in consumerism. And we see it in wages too. We have the largest quit rate [leaving jobs] in the United States we've ever had, which is a great statement of the confidence of the worker. People… quit because they have confidence they could find something better and easier. That in itself is now stimulating more wage inflation. So the question is: are we going to have more wage inflation, or more core inflation? That’s going to be a big issue politically.”

3. ‘Sustainability inflation’ is a thing

“We are a big believer in the world moving faster and in a decarbonised way. But if we don't have proper government policies to navigate the demand side of energy versus its supply, we're going to have big imbalances. That’s what we experienced late last year, where there was so much pressure and supply mitigation of hydrocarbons, without any negation of demand. I believe this is going to be with us for some time. I could almost call it sustainability inflation. In 2022 this will be a backdrop that will lead to changes in the behaviour of central banks, especially the Federal Reserve.”

4. Equity investors shouldn't expect bumper returns

“The S&P was up 27% last year. It would be very hard for me to see those type of outcomes [again].

There's no question some valuations are very extreme. And there's so much momentum in the equity markets. Our clients are aggressively investing in more and more privates, whether it's private debt, private equity, or real estate. So we are seeing real changes in investor behaviour worldwide. But it should create less fear of higher inflation. So that’s why I’m not fearful of equities. I am a big believer of owning equities in 2022. Likewise, I’m a big believer that you can find opportunities in fixed income even with rising rates. So I am not that worried about global capital markets. The pool of money sitting on the sidelines is enormous. That’s probably the biggest question I’m being asked: ‘Where do I put my money?’ not ‘How do I protect my money?’”

5. Technology boosts resilience …

“I don't believe remote working can create culture. There is a great need for interconnectedness with your team and with your organisation. Having the banter of a conversation about an economy, or having a political debate over dinner is far more expansive than doing it on a virtual call. We have to be mindful that human connectivity is the essence of so much of the culture of an organisation. I truly believe culture is the number one difference between a bad company and a good company, or a good company and a great company."

6. … but watch for mental health issues

"I feel bad about the young people who have joined with our organisations and spent so little time in the office. I don't know how they are going to grow out of their vertical. Virtually and independently, it is hard to move people to different parts of organisations (…) and bringing back the essence of an organisation in person is going to be vital. There is so much evidence of growing mental health issues, loneliness is growing, despite how well everything is going in evidence by corporate profits. But it doesn't mean it's perfect, it doesn't mean it's lasting. It means we're resilient, and I don't think it's lasting."

7. The private sector can't be the environmental police

"The issue around climate and climate risk is going to be the biggest change in capital markets. At the same time, politicians have two, four, six-year terms to effectuate a proper policy, and we're talking 20-30 years. Therein lies the imbalance we're facing. Right now, governments are asking the private sector to do more because they are incapable of doing as much as they would like to. The risk is, we cannot be the environmental police on behalf of governments, so there is a delicate balance there. We are all going to have to be astute in terms of navigating our portfolios, and some industries that are going to be left behind if they are not adapting. I believe the opportunity of finding those new technologies to rapidly create a decarbonised world is going to be fascinating and it's going to create huge sums of profits for those who discover those firms and technologies."

8. We should decarbonise slowly

"Right now, we do not have enough technology to decarbonise in a fair, just way. If we want to decarbonise tomorrow, we probably could do it, but it would create hyperinflation, it would create more inequalities. We have to go from all these different granular shades as we move to green, and we're going to create and find those technologies to accelerate this pathway. But all the money we manage is not ours. Our job is to inform and educate our clients – how should they be thinking about decarbonisation in a world that needs hydrocarbons, and how do you manage that transition?"

9. Hydrocarbon companies will become leaders

"Some of the best meetings I had in 2021 were with hydrocarbon companies. They are going to be the leader in the transition, and we are going to have some nascent new companies that are going to become leaders too. Just like what we may be seeing in EV, you had Tesla as the innovator but within time you had GM, Ford, Volkswagen, Toyota rapidly create an acceleration in this pathway."

10. Stakeholder capitalism is not political

"There is no question in our evidence of research that the companies who focus the most on their stakeholders have more resilient, more durable long-term profitability. And let me just say one thing to everybody, stakeholder capitalism is not political. Stakeholder capitalism is the essence of what drives a company. It is a culture of an organisation moving forward, building connectivity with their clients, their employees and their communities, and these are the companies that you want to invest in."

Ollie Smith is an Editor and Sunniva Kolostyak is a Data Journalist at Morningstar UK. This article does not consider the circumstances of any investor. Minor changes have been made to the original version for an Australian audience.

If rising inequality leads to social unrest, we all suffer

Ashley Owen

The holiday season was an ideal time to pause and ponder the big questions about our personal and family wealth:

- How much money do we need to live the lifestyle we want?
- Will we run out of money?
- Should we tighten our belts, or can we afford to spend a bit more?

- Will we have enough to leave the next generation or to help out our family before we go?
- Did our investment returns in 2021 get us closer to our goals?
- Do we need to change strategy or put away more or less?

These are all great conversations to have with your family and with your adviser. Meanwhile, it is also a good time to think more broadly about wealth, and how it shapes the world around us.

Amid a pandemic, the rich did well, others not

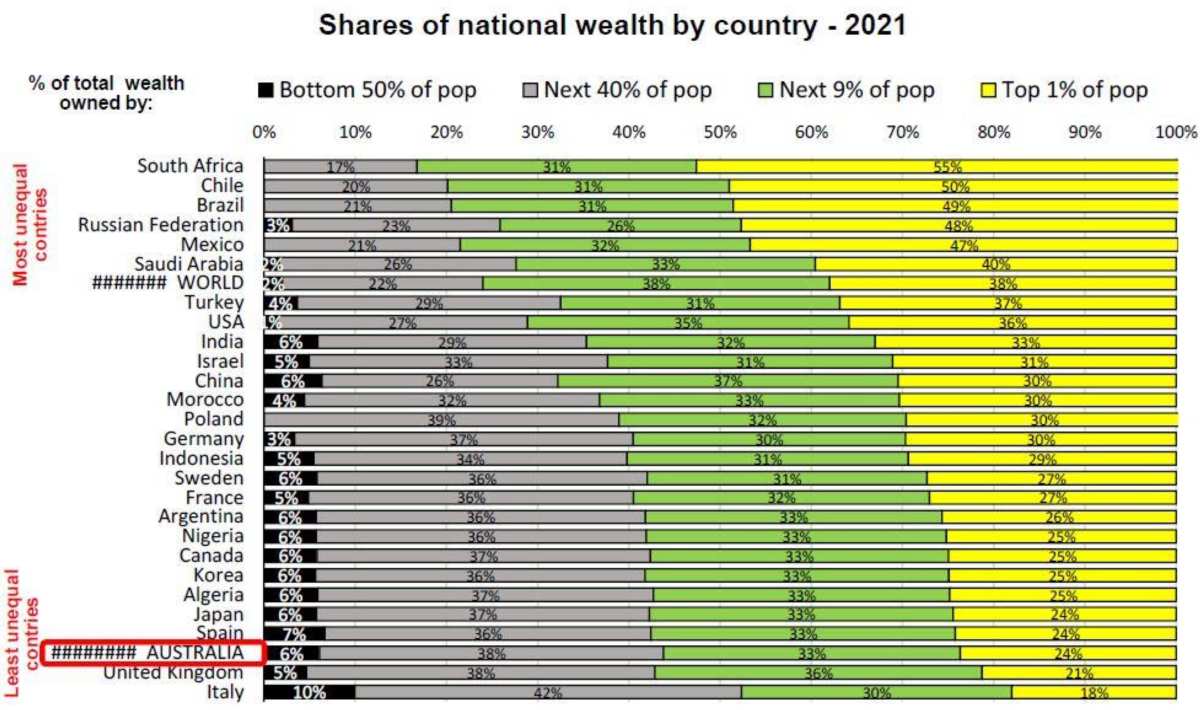
2021 was another year when the rich got richer, without even getting out of bed. The value of our shares and real estate rose magically without us having to do anything at all. Covid stimulus policies accelerated the post-1980 trend toward inequality of wealth and incomes, which are now at extreme levels of inequality not seen since the 1920s.

2021 also saw the creation of record numbers of wealthy people ('billionaires', 'millionaires', or any other definition) in Australia and in every other country, although 100 million people were sent back into extreme poverty ([World Inequality Report 2022]). Inequality rose in terms of access to vaccines, not just in wealth and incomes.

The winners of 2021 were the owners of shares, real estate, businesses, especially those with gearing on cheap debt. For the working, the winners were the 'knowledge workers' who can work from home or anywhere. The losers were the physical workers who can't 'work from home' in the lockdowns, and border closures, and disruptions.

Also among the losers are people relying on bank interest, fixed incomes, bonds (although indexed bonds and pensions did get a rise at last with inflation finally arriving) They are the savers, renters, and ordinary workers of the world, with rising prices of food, petrol, utilities, rents, and falling real wages.

This chart shows the proportion of total national wealth owned by the wealthiest 1% down to the poorest 50%.



'Wealth' includes financial and non-financial assets (eg housing), net of debt. Source data: World Inequality Report 2022- (for 2021 year)

A world of growing inequality

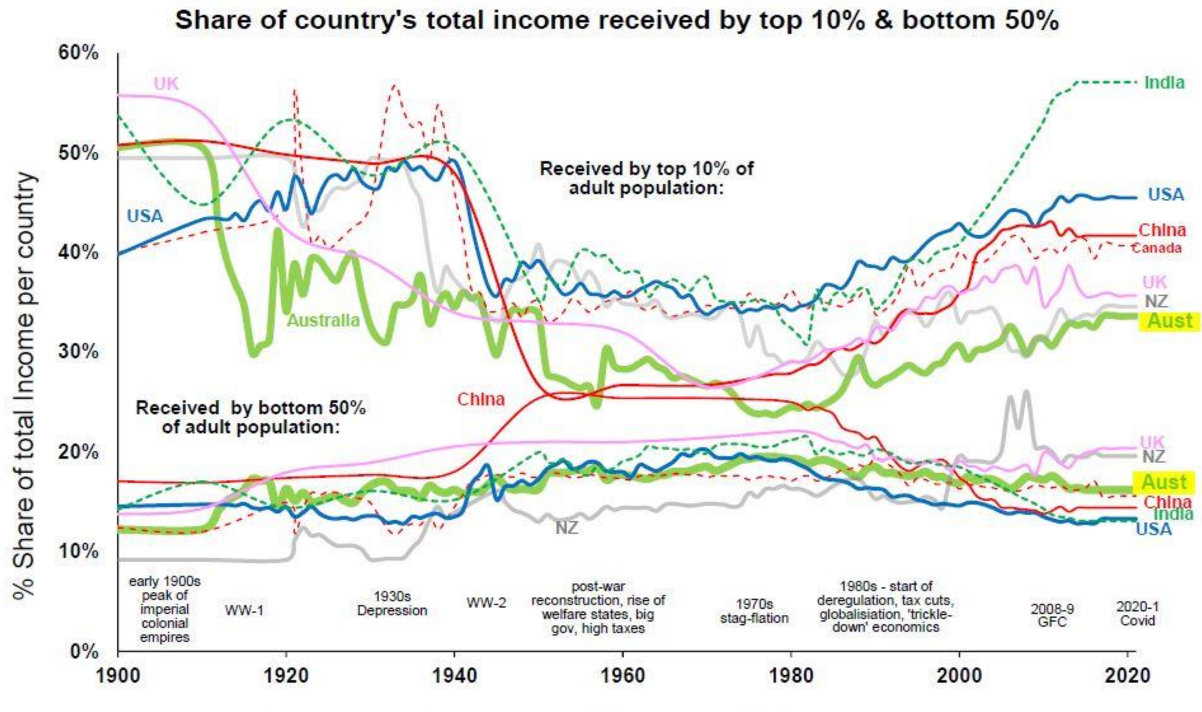
Half of the world's population (3 billion adults) between them own less than 2% of the world's wealth (black bars in the chart above), while the richest 10% own 76% of it. The richest 1% (gold bars in the chart) owns 38%, the richest 0.1% owns 19%.

Before we go any further, we need to remind ourselves that *we* are in the richest 1% that own 38% of the entire world's wealth. The entry-level to get into the world's richest 1% is just US$1.1 million (A$1.5 million) in net assets, *including* the family home. We have been conditioned to believe that A$1.5 million in net assets (the family home) is nowhere near enough to fund a 'comfortable' lifestyle, but 99% of the world's population has less than this. 50% of the world's population owns assets worth less than US$4,000 each.

Australia among the 'least unequal'

The above chart is sorted from most unequal distribution at the top to least unequal at the bottom. Australia (along with the UK and Western Europe) is one of the least unequal countries near the bottom of the table thanks to our long history of relatively high wages, broad welfare systems and, more recently, compulsory 'super'.

The next chart shows the trends in inequality since 1900 in terms of the share of national income received by the top 10% (upper section) and by the bottom 50% (lower section) for selected countries.



'Income' includes pensions & welfare payments, before tax. Source data: World Inequality Report 2022- (for 2021 year)

Here we also see that Australia has been among the least unequal – i.e., relatively low share of total income going to the top 10%, and relatively high share going to the bottom 50% of adults. Inequality peaked in the roaring 1920s, then reduced dramatically in the 1930s depression, WW2 and in the post-war boom, but has been rising steadily in the post-1980 era of tax cuts, deregulation, globalisation of trade, outsourcing of jobs to low-wage countries etc.

Social and political reactions to post-1980s inequality accelerated in the GFC, when government bail-outs of banks and bankers' bonuses gave rise to movements like 'Main Street not Wall Street', 'Occupy Wall Street' and the' 99 percenters' in the US and across Europe. It was coupled with high unemployment and xenophobia. Rising inequality has fuelled the dramatic rise of populist, nationalist, anti-globalisation movements across the world.

Why rising inequality matters for everyone

Why is rising inequality important for investors? From a personal perspective, it is natural for the rich to say, '*I've earned it, so I deserve it, and I'm hanging on to it!'* Rising inequality is important because it fuels social divisions and unrest across the world, and social unrest can spark events that disrupt investment markets, sometimes resulting in the widespread destruction of wealth.

There are two main schools of thought on how rising inequality plays out.

On the one hand, we have the optimists like Simon Kuznets and Robert Solow (as well as Adam Smith and Jean Baptiste Say) who believed that inequality will automatically self-correct so that the benefits of growth are shared around to all (cue the magic fairy dust here!).

On the other hand, we have the pessimists like Thomas Robert Malthus, David Ricardo and Karl Marx, who believed that rising inequality does not magically self-correct but it rises in a self-perpetuating spiral to a point where social unrest flares up in the form of revolution or regime change, to bring about a 'fairer' distribution of the spoils.

At a personal level, we can each make plans about how we distribute our wealth, including via charitable foundations or sub-accounts (with financial advice).

From a portfolio perspective, social and political disruptions are medium-term risks that should be tracked to assess possible impacts on financial markets. Our base case is for slow economic growth and rising wage pressures (ageing populations, fewer workers) fuelling further inequality, social and political disruptions, made more volatile by interest rates rising to fight inflation, and budget pressures to raise taxes and cut government spending.

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

Share market falls: seven things for investors to consider

Shane Oliver

Most of the time share markets are relatively calm and don't make the headlines. But every so often they have a tumble and make the 'front page' with headlines (or these days clickbait) like "billions wiped off share market" and "biggest share plunge since…".

Each one is met with analysis and prognostication from experts. Sometimes the plunge ends quickly and the market heads up again and is forgotten, like last September when I last wrote a note like this. But once every so often share markets keep falling for a while. Sometimes the falls are foreseeable, but rarely are they forecastable (which requires a call as to timing and magnitude) despite many (who got lucky) claiming otherwise. In my career, I have seen many sharemarket falls, and I even saw the market fall 25% one day.

And so it is again, with sharemarkets starting the year on a sour note. From their highs, US shares have fallen 8%, with the tech heavy Nasdaq down 14%, global shares are down 7% and Australian shares are also down 7%. Always the drivers are slightly different but from the point of basic investment principles, it's hard to say anything new. So apologies if you have seen my "seven things for investors to keep in mind" before, but at times like this they are worth reiterating.

What's driving the fall in share markets?

The decline in share markets reflects a range of factors.

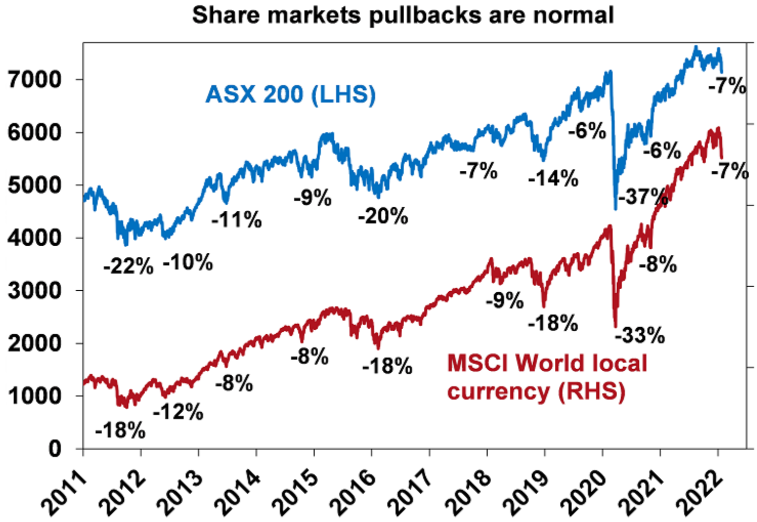
- Inflation readings have continued to surprise on the upside most recently for the US where inflation is now 7% and is at its highest in nearly 40 years. But Europe, the UK and Canada have also reported sharp increases in inflation.
- Along with hawkish comments from central banks, this has seen increased expectations for central bank interest rate hikes this year. Markets now expect four or more rate hikes from the Fed, Bank of England, Bank of Canada, Reserve Bank of New Zealand and the RBA this year.
- This has come at a time when the surge in Omicron cases globally has disrupted economic activity, recent economic releases have been mixed and investors fret the rate hikes will depress economic activity and hence profits.
- There is a high-risk Russia will invade Ukraine or part of it as talks around its demand for Ukraine not to join NATO and NATO countries not to station strategic weapons there failed to resolve the issue. While it's hard to see NATO countries going to war with Russia in Ukraine, an invasion will likely trigger sanctions on Russia, further worsening Europe's gas shortage and threatening European growth and inflation.

- And share markets have had huge gains since their March 2020 lows. US shares rose 114% and Australian shares rose 68% to their recent highs. Shares are no longer dirt cheap. There has been froth with meme stocks, SPACs and the crypto craze. And relatively calm years – with the biggest drawdowns last year being 5% in US shares and 6% in Australian shares – are often followed by a rough year. So, some are talking of crashes (as they often do).

Seven things for investors to bear in mind

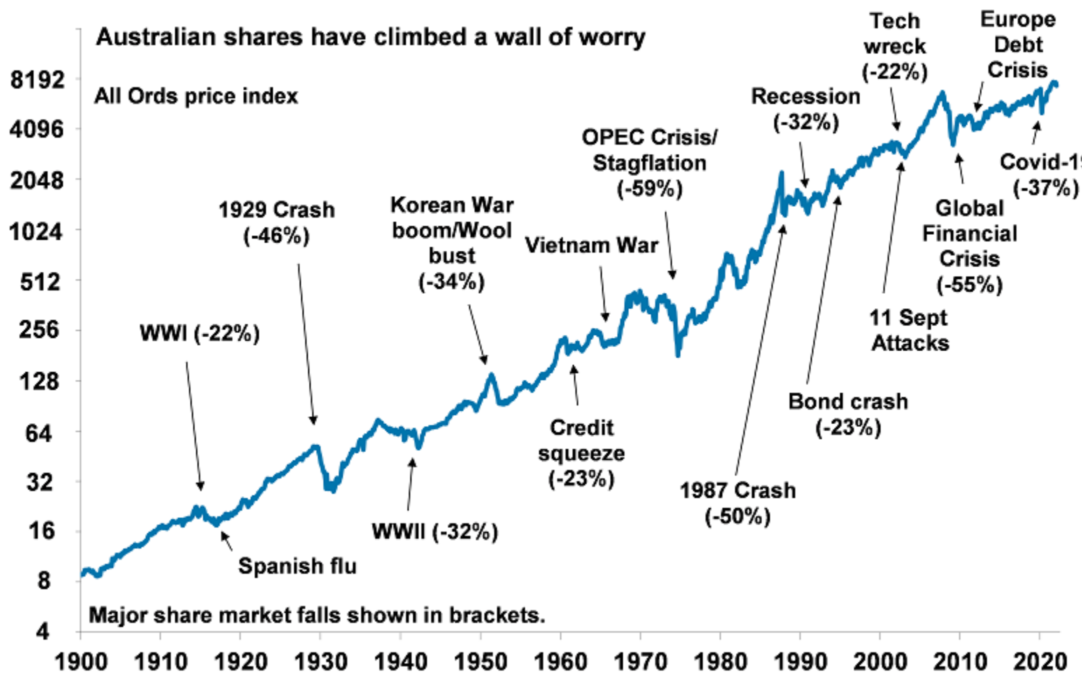
Sharp market falls are stressful for investors as no one likes to see their investments fall in value, but keep these things in mind.

First, while they all have different triggers and unfold differently, periodic share market corrections of the order of 5%, 15% and even 20% are healthy and normal. For example, during the tech/dotcom boom from 1995 to early 2000, the US share market had seven pullbacks ranging from 6% to 19% with an average decline of 10%. During the same period, Australian shares had eight pullbacks ranging from 5% to 16%. All against a backdrop of strong returns every year. During the 2003 to 2007 bull market, the Australian share market had five 5% plus corrections ranging from 7% to 12%, again with strong positive returns every year. And the last decade regularly saw major pullbacks (see chart).



Source: Bloomberg, AMP

But while sharemarket pullbacks can be painful, they are healthy as they help limit complacency and excessive risk taking. Shares climb a wall of worry over many years with numerous events dragging them down periodically (see next chart), but with the long-term trend ultimately up and providing higher returns than other more stable assets. Bouts of volatility are the price we pay for the higher longer-term returns from shares.



Source: ASX, AMP

Second, historically, the main driver of whether we see a correction (a fall of say 5% to 15%) or even a mild bear market (with say a 20% decline that turns around relatively quickly like we saw in 2015-2016 in Australia or in 2018 in the US) as opposed to a major bear market (like that seen in the global financial crisis (GFC), or the 35% or so falls seen in early 2020 going into the coronavirus pandemic) is whether we see a recession or not. The US sharemarket tends to lead most major global markets.

Of course, short-term forecasting is fraught with difficulty and should not be the basis for a long-term investment strategy, but right now, while inflation and worries about monetary tightening are concerning, it seems premature to expect a US, global or Australian recession:

- New coronavirus cases in the US, Europe and Australia are slowing with vaccines providing protection against serious illness and the Omicron variant proving less harmful than prior variants. This should see business conditions indicators rebound. While the risk remains high, coronavirus could finally be moving from a pandemic to being endemic.
- Excess savings of around $US2.3 trillion in the US and $250 billion in Australia will provide an ongoing boost to spending.
- While central banks will tighten monetary policy this year it will still be easy as rates will still be very low.
- It's usually only when monetary policy becomes tight that it ends the economic cycle and the bull market and that's a fair way off.
- Inventories are low and will need to be rebuilt which will provide a boost to production.
- Positive wealth effects from the stronger than expected rise in share markets and home prices since early 2020 are still feeding through and will help boost consumer spending.
- China is starting to ease policy which will boost Chinese growth over the next 6 to 12 months.

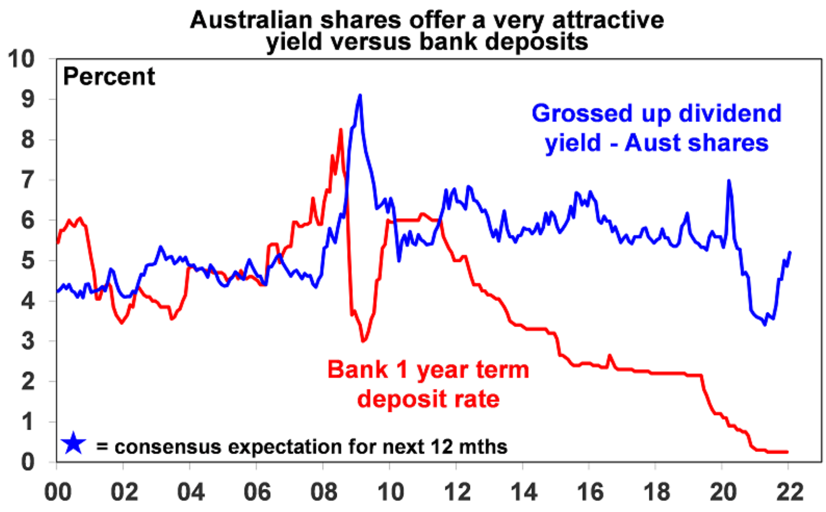
Global growth is likely to slow this year but to a still strong 5%, with Australian growth of around 4%, despite the Omicron wave resulting in a brief set back in the March quarter.

Third, selling shares or switching to a more conservative investment strategy whenever shares suffer a setback turns a paper loss into a real loss with no hope of recovering. Even if you get out and miss a further fall, trying to time a market recovery is hard. And the risk is you don't feel confident to get back in until long after the market has fully recovered. The best way to guard against deciding to sell on the basis of emotion after weakness in markets is to adopt a well thought-out, long-term strategy and stick to it.

Fourth, when shares and growth assets fall, they're cheaper and offer higher long-term return prospects. So, the key is to look for the opportunities pullbacks provide. It's impossible to time the bottom but one way to do it is to 'average in' over time.

Fifth, Australian shares are offering attractive dividend yields compared to banks deposits. Companies don't like to cut their dividends, so the income flow you are receiving from a well-diversified portfolio of shares is likely to remain attractive, particularly against bank deposits.

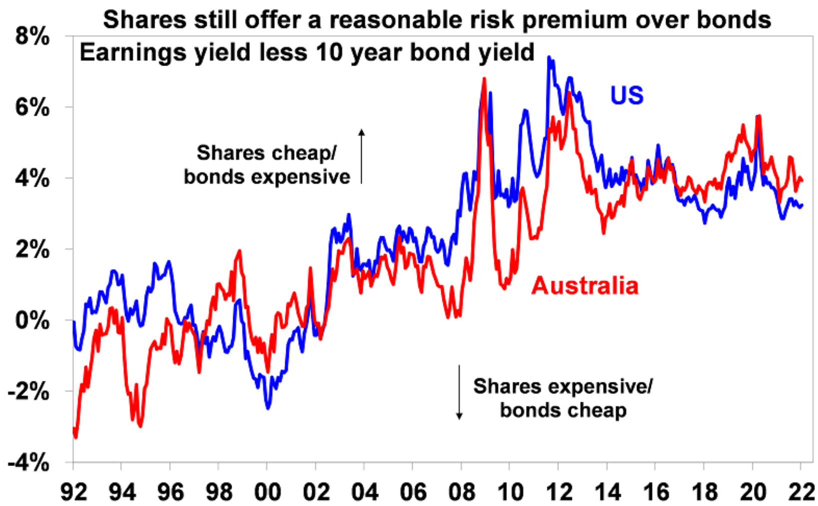
More broadly, while bond yields are well up from their lows, the risk premium shares offer over bonds – as proxied by their earnings yield less the bond yield – remains relatively attractive.



Source: RBA, Bloomberg, AMP

And in the last few days bond yields have started to fall again, reflecting safe haven demand which along with the fall in share markets has helped improve share market valuations.

Sixth, shares and other related assets often bottom at the point of maximum bearishness, ie, just when you and everyone else feel most negative towards them. So, the trick is to buck the crowd. The last month has seen investor sentiment swing negative again which is positive from a contrarian perspective. Of course, investor sentiment could still get more negative in the short term before it bottoms.



Source: Reuters, AMP

Finally, turn down the noise. At times like the present, the flow of negative news reaches fever pitch and this is being accentuated by the growth of social media. Talk of billions wiped off share markets and talk of 'crashes' help sell copy and generate clicks and views. Such headlines are often just a distortion. We are never told of the billions that market rebounds and the rising long-term trend in share prices adds to the share market.

All of this makes it harder to stick to an appropriate long-term strategy let alone see the opportunities that are thrown up. So best to turn down the noise and watch Brady Bunch, 90210 or Gilmore Girls re-runs!

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at [AMP Capital](), a sponsor of Firstlinks. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

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The importance of retirement conditions of release

Liam Shorte

Most people believe that they can only access their superannuation when they retire and stop working. But there are many other circumstances that could trigger an all-important 'condition of release' and make retirement funds available.

In this guide for SMSF trustees, I will concentrate on retirement but you can find out about the other conditions of release here. Acknowledgement: I have relied on the excellent guidance of the AMP TapIn technical team for much of the content in this article.

What is the retirement condition of release?

Since 1 July 2017, the tax exemption on investment earnings supporting a Transition to Retirement Income Stream – Accumulation Phase is no longer available. However, a TRIS will regain its tax-exempt status once the 'retirement' condition of release is satisfied and it becomes a Transition to Retirement Income Stream - Retirement Phase.

Therefore, understanding what constitutes 'retirement' for an SMSF member in a TRIS is critical, to achieve that holy grail of a tax-free retirement pension.

Conditions of release overview

Death is the only condition of release that requires compulsory cashing of benefits. There is no requirement under any other condition of release to either cash out a benefit or commence an income stream from your SMSF and member accounts can remain in accumulation phase indefinitely.

A member account in accumulation phase is subject to an income tax rate of up to 15% instead of a 0% tax rate for investments backing a pension income stream. There is also now a $1.7 million limit on how much can be transferred into an income stream with people who already had some money in pension phase having as pro-rata limit of between $1.6 million and $1.7 million.

Check on my.gov.au> ATO service> Super Tab> Information to see your limit.

The most common condition of release to access your account is reaching preservation age and retiring.

Date of birth	Preservation age	Preservation year
Before 1 July 1960	55	2014-15 (and prior)
1 July 1960–30 June 1961	56	2016–17
1 July 1961–30 June 1962	57	2018–19
1 July 1962–30 June 1963	58	2020–21
1 July 1963–30 June 1964	59	2023–24

SMSF members who are under 65 and have reached preservation age but remain gainfully employed on a full-time or part-time basis may access their benefits as a non-commutable income stream called a **TRIS – Accumulation Phase**. However, that income stream will not be tax exempt until you meet a further retirement condition of release on reaching the age of 65, when a member may access their benefits any time without restrictions.

If a person has never been gainfully employed in their life, they cannot use the retirement condition of release to access their preserved benefits. Such a person would need to satisfy another condition of release to access their benefits (eg reaching age 65, invalidity, terminal illness, severe financial hardship).

Preservation age but under age 60

Where a member has reached a preservation age that is less than 60, their retirement occurs when:

1. An arrangement under which the person was gainfully employed has come to an end, and
2. The trustee is reasonably satisfied that the person intends never to again become gainfully employed on either a full-time or part-time basis (i.e. for 10 or more hours per week).

To evidence retirement, the SMSF trustee should request a declaration from the member that they have ceased work and they have no intention of being gainfully employed for more than 10 hours a week ever again.

Age 60 but less than 65

When a person has reached age 60, retirement occurs when an arrangement under which the person was gainfully employed has ceased on or after the person reached age 60. It does not matter that the person may intend to return to the workforce. **This condition presents an opportunity for many people to move a taxed pension to tax exempt phase earlier.**

Example: Reaching age 60

Michelle has worked as a nurse for many years. She resigns from this employment on her 61st birthday. Three months later, Michelle takes up a three-day a week position as a grief counsellor. Because Michelle has ceased employment as a nurse after her 60th birthday, she can access all her superannuation accumulated up until that point.

Situations sometimes arise where a person, aged 60 or over, is in two or more employment arrangements at the same time. According to **APRA Prudential Practice Guide SPG 280**, the cessation of one of the employment arrangements is the condition of release in respect of all preserved benefits accumulated up until that time.

However, the occurrence of the 'retirement' condition of release in these circumstances will not enable the cashing of any benefits which accrue **after** the condition of release has occurred. A person will not be able to cash those benefits until another condition of release occurs (e.g., she also leaves her second employer).

Example: Two employment arrangements

Frank is 63 and works part-time as a school janitor. During the school holidays, he had a short-term six-week contract to work as a census form collector. The contract finished in September 2021.

Because Frank has ceased one of his employment arrangements, he can access all his superannuation up until that point. However, any later contributions made (employer and personal contributions) and earnings will be preserved.

Director and employee of own company

Sometimes a person is both an employee and director of their own company. They may wish to cease their employment duties with the company but retain their directorship. The question arises as to whether such a person (age 60 – 64) can access their preserved superannuation benefits.

If a person is engaged in more than one arrangement of employment, the person can cease any arrangement of employment to meet the 'age 60' definition of retirement.

Therefore, as long as a person's two roles are separate and they terminate in their capacity as an employee of the company, then even though they are still employed in the capacity as director, that person can access their preserved superannuation entitlements.

Note that there must be a distinct termination, i.e., cessation of all duties as an employee, and the person should now only operate in the capacity as a director for the company.

We see this a lot where a spouse had helped out for years but as the children join the business or the business matures, the requirement for the spouse to continue turning up day-to-day reduces. They can step away from the duties as an employee, but they may still handle the liaison with the tax agent on the financials and the ATO to pay tax instalments, which are more akin to director's duties.

When is a person gainfully employed?

Someone is gainfully employed for superannuation purposes where they are employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation, or employment.

Gainful employment can either be on a part-time (at least 10 hours per week and less than 30 hours per week) or full-time basis (at least 30 hours per week).

The definition of gainful employment involves two clear components:

1. Employment or self-employment, and
2. Gain or reward.

The term employee is not specifically defined in the SIS Act for this purpose so its common law meaning must be considered. One definition of employee is:

'a person in a service of another under any contract of hire (whether the contract was expressed or implied, oral or written), where the employer has the power or right to control and direct the employee in the material details of how the work is to be performed.'

In contrast, self-employed people work for themselves running their own business (e.g., have a business plan, financial records, an ABN, a regular and frequent level of activity in the business, advertising, etc).

The superannuation legislation provides no guidance as to what 'running a business' is. However, taxation law does. In particular, paragraph 13 of Tax ruling 97/11 outlines relevant indicators.

Gain or reward is not defined in the superannuation legislation and therefore takes its ordinary meaning. The Macquarie Dictionary defines gain as '*to get an increase, addition or profit'.* Reward is defined as '*something given or received in return for service, merit, hardship, etc'.*

In the context of satisfying the gainful employment definition, it follows that the service, merit, or hardship must be completed with some expectation of an increase, addition, or profit. There must be a direct link (or nexus) between the activity undertaken and the reward provided for the activity. The actual level or amount of gain or reward does not necessarily have to be commensurate with the level of effort or activity undertaken. The reward doesn't necessarily have to be received as cash, but could be received as services, fringe benefits, or other valuable consideration.

The gain or reward element is typically difficult to satisfy in the case of charity or volunteer work. Non-paid work for a charity, for example, would clearly not qualify as gainful employment. Mere reimbursement of expenses would not seem to constitute gain or reward.

Transition to retirement pensions

A Transition to Retirement Income Stream (TRIS) condition of release allows a member to access their superannuation as a non-commutable income stream once they have reached preservation age, subject to a maximum annual draw down of 10% per annum. Preserved benefits cannot be accessed through a TRIS as a lump sum until it meets the new 'pension phase' position. It's a fairly simple process to confirm to your pension provider that you have met that further condition of release and they may automatically move you to Transition to Retirement Income Stream - Retirement Phase at 65, but it's worth confirming with them in writing.

SMSF trustees should immediately contact their fund accountant or administrator should the member retire permanently from the workforce or terminate employment on or after age 60. When the administrator is notified that a no cashing restriction condition of release occurs (e.g., retirement), the balance of the TRIS account (at that stage) will be converted to a retirement phase account-based pension (ABP), and the tax exemption on earnings will apply. However, it will then also count towards the individual's transfer balance cap and needs to be reported to the ATO within the new reporting guidelines.

Reaching age 65 will automatically result in a TRIS pension becoming a Transition to Retirement Income Stream - Retirement Phase and obtaining tax exemption on earnings, if within the individual's $1.6-$1.7 million pension transfer balance cap.

Evidencing cessation of gainful employment

Genuine terminations of employment will typically involve the payment of accrued benefits, such as annual and long service leave. SMSF trustees should retain written evidence of the member's cessation of gainful employment on file and copy to the administrator, so the fund auditor has access.

Penalties apply to members, trustees and those who promote 'illegal early access schemes' to improperly access superannuation prior to meeting a condition of release.

Liam Shorte is a specialist SMSF adviser and Director of [Verante Financial Planning](). He is also a Director of the SMSF Association, and he writes under the social media identity of 'The SMSF Coach'. This article contains general information only and does not address the circumstances of any individual. It is based on an understanding of relevant legislation and rules at the time of writing, which may change.

We need to limit retail investor harm from CFDs

Professor Kevin Davis

A Contract for Difference (CFD) is a highly leveraged investment in an underlying financial instrument, such as a share or an exchange rate.

Why has the financial regulator, ASIC, placed restrictions on the features of CFDs provided by financial institutions to retail clients?

How do CFDs work?

The client places a sum of money (say $10,000) in a margin account with the CFD provider and obtains exposure to gains or losses on a much larger (say $100,000) amount of the underlying instrument (say 4,000 shares in XYZ currently trading at $25 each).

If it is a 'long' CFD position (and 'short' positions can also be taken), an increase in the XYZ price to $30 would mean a gain of $20,000 ($5 on each of the 4,000 shares). The gain is credited to the investor's margin account which would now be worth $30,000. The 20% increase in XYZ share price translates into a 200% increase in the investor's position via the leverage of 10 to 1 in the CFD.

But, should the share price move in the opposite direction, the investor suffers similarly magnified losses. In this example, a decline to $22.50 would mean a loss of $10,000, wiping out the amount in the margin account.

If the position is not closed out and the share price declines further the investor loses more than the original investment.

There are other complicating features of CFDs such as interest charged to the investor (or, in principle, paid to a short investor) reflecting the implicit loan in the CFD. And note that while gains or losses to the investor could be at the ultimate expense of the CFD provider, they generally won't be, because the provider will have hedged the position in the underlying market (or by other means such as over the counter deals with other institutions).

The CFD provider makes profits through the interest rate involved, spreads on CFD prices quoted, and fees and charges.

ASIC intervention on behalf of retail investors

ASIC is currently considering the long-term extension (till 2031) of its restrictions on the features of Contracts for Difference (CFDs) provided by financial institutions to retail clients. It announced those restrictions in October 2020, with effect from 29 March 2021, under its Product Improvement Powers (PIPs) which were legislated in response to a recommendation of the Australian Financial System (Murray) Inquiry.

ASIC's Consultation Paper (CP348), issued in October 2021, highlighted a number of claimed effects of the PIP restrictions, most notably a reduction in the losses suffered by retail investors in CFDs. Previously losses far exceeded gains for investors, but the two are now more evenly balanced. But the data in CP348 also raises questions regarding whether the PIP restrictions go far enough.

Some history

CFDs first emerged in the UK in the 1990s to exploit a differential in stamp duty on share trading applying to brokers and others. Brokers paid no duty so that by purchasing physical stock on own account and providing the matching CFD to institutional investors, they gave the latter a synthetic stock position (with no market risk to themselves) which avoided stamp duty.

CFDs emerged later in Australia targeted at retail investors. Since large scale wholesale/institutional investors can replicate a CFD position via a bespoke equity swap with an investment bank, the absence of tax arbitrage possibilities means they have little need for the complex structuring of CFDs.

Even the ASX got into the act. It introduced exchange-traded CFD contracts in 2007, giving retail investors the opportunity to take highly geared investment positions. But their contract was even more complicated than the unlisted CFDs provided by institutions such as CMC and IG Markets, and a lack of investor interest saw the contracts terminated in 2014. Had they survived, they would probably have fallen foul of the ASIC PIP restrictions on leverage.

The PIP restrictions

The PIP restrictions imposed by ASIC primarily involve restrictions on the amount of leverage and mandatory close out to prevent margin accounts going into the red. The mandatory close out effectively prevents a situation where the client's margin account has been reduced to zero, but they still owe additional money to the CFD provider.

But note that margin calls will typically be made by the CFD provider as losses occur, requiring the investor to provide more funds to keep the account in credit, such that losses on a position could have exceeded the original amount invested (even with the mandatory close out).

The leverage restrictions limit how large an exposure position an investor can take given the funds they deposit into their margin account. Prior to the PIP restrictions CFDs on major currency pairs (such as the value of the AUD/USD exchange rate) a retail investor could take a leverage position of 500 to 1. After, the maximum allowed is 30 to 1. In the case of major stock indices, it declined from 200 to 1 to a maximum of 20 to 1.

The retail/wholesale investor 'distinction'

The PIP restrictions only apply to retail investors and, not surprisingly, since the PIP announcement there has been a significant switch in CFD business to wholesale clients, some of whom were previously designated as retail.

This highlights a major weakness in the PIP restrictions, but which reflects the more general problem of inadequate legislative distinction between retail and wholesale investors. It is far too easy for an unsophisticated investor (including SMSFs) to be classified as wholesale/sophisticated and exposed to risks they do not fully understand.

As well as the market risk involved in CFD positions, another risk is that of a failure of the CFD provider (of which there are around 60) and losses of the investor's money. Hopefully, rigorous adherence to segregation of client money accounts would limit that risk.

Limitations of ASIC's analysis

ASIC's analysis of the effect of the PIP restrictions is a useful start but could go much further.

First, it does not consider whether the leverage (or other) restrictions imposed are optimal. And allowed leverage remains high: 30 to 1 for CFDs on major currency pairs; 5 to 1 for CFDs on shares. By way of comparison, major banks will provide margin loans for shares but with leverage ratios of around 4 to 1 (a loan/valuation ratio) for a diversified portfolio of blue-chip shares, or less for more volatile stocks.

Second, have the regulations simply shifted the problem elsewhere? An expected consequence of regulation of a financial product is that activity may switch to alternative, similar, substitute products. In the case of CFDs there are quite a few. Margin loans from banks are one, but there is no apparent evidence of a boom in this product. (Changes to the collection of official statistics in 2019 make it hard to identify trends). Similarly, the ASX statistics on activity in the warrants market (where, for example, "Minis" provide a highly leveraged position with some downside loss protection) also show no signs of increased activity.

Third, the relative proportion of gains and losses to investors' accounts in different periods will depend on both the behaviour of various market prices and the positions held by investors in the various financial instruments. If, for example, all investors only had long CFD positions in an equity index and in one period the index declined while in the second period it increased, there would be losses for all in the first period and gains for all in the second period. Controlling for those factors is needed to give more robustness to the conclusions.

Finally, ASIC's focus on gains and losses in CFD accounts could be misleading if investors were using CFD positions to hedge physical positions in the underlying instrument. But realistically, this is likely to be an extremely small proportion of CFD usage.

Rather CFDs are another example of our financial markets being used for speculative and gambling activities by retail investors without private information or enough knowledge to warrant taking such risks.

Kevin Davis is Emeritus Professor of Finance at The University of Melbourne. Kevin's free e-text/ reference book 'Bank and Financial Institution Management in Australia' is available on his website. Latest update is December 2021.

Time to assess your super fund's carbon footprint?

Don Hamson

We now hear it from just about all corners of our industry - *the race to net zero emissions is an investment thematic that can't be ignored*.

However, here in Australia (and many other parts of the world) investors can draw little confidence from the political environment.

Our government is willing to keep kicking the can down the road, begrudgingly agreeing to a net zero 2050 target with a pathway full of technological holes. The problem is 2050 is about 10 election cycles away.

So, we face a hugely-consequential economic transformation that's not yet a priority for governments and oppositions.

Bigger than government

Despite the lack of political leadership, Australia is in fact doing reasonably well on the climate front. Emissions are falling at the total level, while emissions from electricity generation have halved from their peak. At one stage in September 2021, around 60% of Australia's electricity demand was fulfilled by renewables.

But it is individuals and corporates responsible for this change, not governments. For families, not only does renewable energy make economic sense, but feeling good for our planet's future is no doubt part of the motivation.

The same goes for corporates. Many of Australia's largest companies (and largest emitters) have already adopted some very aggressive carbon reduction targets.

As an example, we recently met with Mineral Resources, which mines lithium and iron ore. Mineral Resources has scoped out over 80 Net Present Value positive projects that will help put it on its path to net zero by 2050, as it moves from a diesel-fueled mining company to a renewables-based electrified mining company.

Companies such as Amcor, CIMIC, Coles, RIO, Telstra and Woolworths have adopted targets of 50% or more carbon emissions reductions by 2030. Wesfarmers' retail businesses (Bunnings, Kmart, Officeworks) are targeting net zero in 2030.

In some areas companies are literally falling over each other to make their businesses green. Aldi, Coles and Woolworths are all moving to 100% renewable electricity for their stores and distribution centres by 2025 or earlier. Charter Hall is looking for its buildings to go net zero by 2025, not 2050.

Overall, we estimate that approximately 75% of Australian ASX/S&P200 companies by market value have adopted net zero, carbon neutral or net positive carbon targets.

But a damaging carbon footprint remains in investment portfolios

Despite this positive progress, Australian and global companies have a long way to go.

Using Plato's carbon database, we can assess the carbon footprint of leading investment indices. The chart below shows that if an investor placed $US1 million in an ASX/S&P200 index fund, the equity ownership share of those holdings was responsible for annual emissions of over 133 tonnes of carbon dioxide.

The Australian index is far more carbon intensive than the US or MSCI World markets, reflecting Australia's industry mix, which is highly weighted to materials and energy stocks and relatively lowly weighted to information technology.

Index Carbon Footprint

	ASX 200	**S&P 500**	**MSCI World**
Carbon Footprint (tonnes CO_2e/USD $M invested)	**133.66**	**52.81**	**87.58**

As of June 30, 2021. Source: Plato, FactSet, MSCI, scope 1 and 2 emissions.

Using this information, we can also estimate the carbon footprint of a typical superannuation investment.

According to the latest information from the ASFA's superannuation statistics, we find that a typical couple aged 60-64 has assets worth around $650,000. Using just the average exposure to listed equities and property, we estimate this equates to approximately 28 tonnes of CO2 equivalent per annum in emissions through their equity ownership of company emissions.

This is larger than the average emissions of typical Australian household, which sits at around 15-20 tonnes.

For perspective, 28 tonnes is equivalent to 63 return Sydney-Melbourne economy flights, 2.8 return economy flights Sydney-London, or 8.4 medium petrol cars driving around 12,000 kilometres per year.

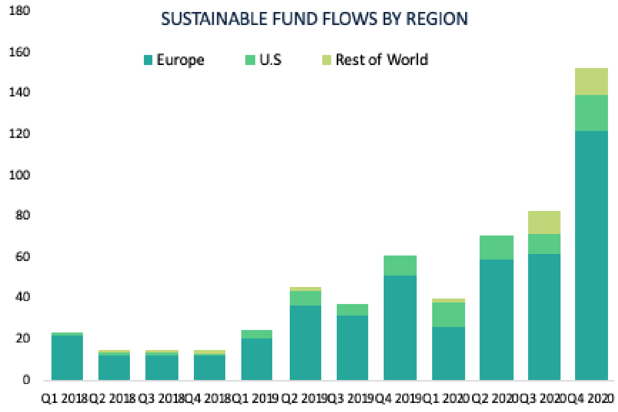
Unlocking a 'net zero now' investment portfolio?

Plato has been able to achieve a net zero carbon footprint without using costly carbon credits in the portfolio of our Plato Global Net Zero Hedge Fund. This is through a combination of shorting high carbon emitting global stocks and going long stocks with below average carbon footprints.

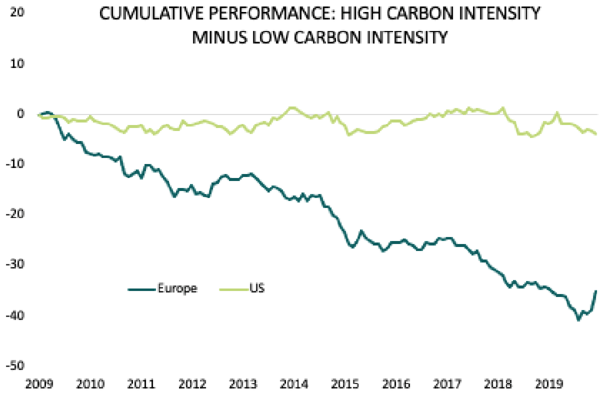
There are also a growing number of other low carbon investment alternatives rapidly emerging in the broader listed and unlisted managed funds space.

Why? The sceptics might argue it's opportunistic, but like the families and corporates, investors (and many investment managers) are growing more and more carbon conscious and the economics are growing more and more attractive.

An insight into the European market illustrates this, and perhaps provides an insight into why going 'net zero now' could be so lucrative for investors in the years ahead. Europe is the most advanced economic block when it comes to decarbonisation, so it provides a strong indication of what's to come for the laggard economies, such as Australia.



Source: Morningstar



Source: Plato Research

You can see above (left of page), European capital has dominated flows into sustainable funds since 2018. The rest of the world remains markedly behind.

This is no surprise when comparing performance of high carbon intensity stocks versus low carbon intensity stocks in Europe after controlling for sectors. Right of page we see that in Europe high carbon intensity stocks within a sector have underperformed low carbon intensity stocks by cumulative more than 30%.

Remember, Europe has had a price on carbon since 2005. In a regulatory sense it is the most developed market globally when it comes to decarbonisation. This, along with the aforementioned proliferation of flows into sustainable funds has led to that significant outperformance seen by low carbon intensity stocks.

We compare this to the US (light green line) and there is little different between the performance of high carbon and low carbon stocks. However, the rest of the world has no choice but to catch up and we believe a similar market dynamic to what's occurred in Europe will likely play out across the globe in the years ahead.

Action begins at home

Regardless of what our politicians do, the buck stops with all of us to help limit climate change. When a company or an individual makes an investment decision, be it for a new mine or office building or a new house or car, or even a new appliance, that decision is locking in future emissions for many years.

Indeed, we think the race to net zero will be the most important thematic for investment returns over the next 30 years, but we think the time to reach net zero in your investment portfolio can be now.

Dr Don Hamson is Managing Director at Plato Investment Management. Plato is affiliated with Pinnacle Investment Management, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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