Firstlinks
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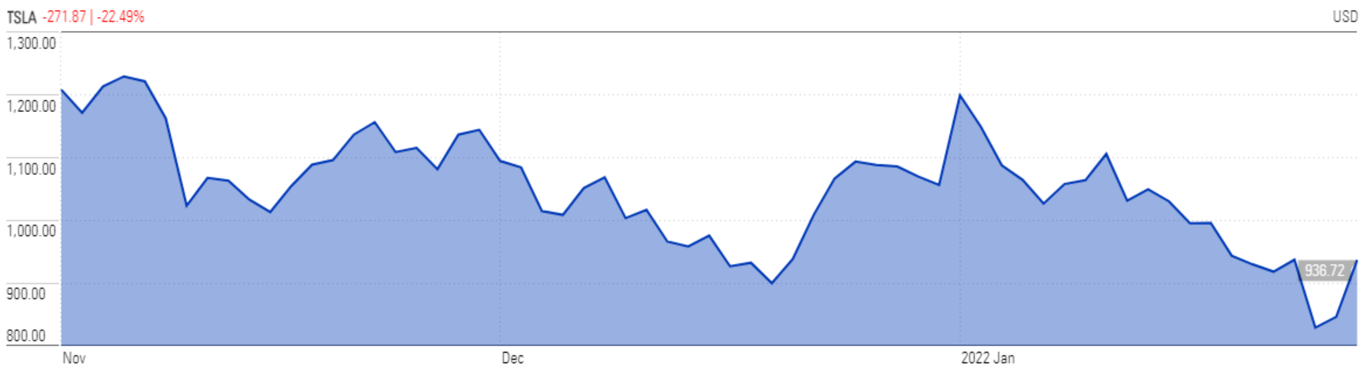
Contents

Editorial

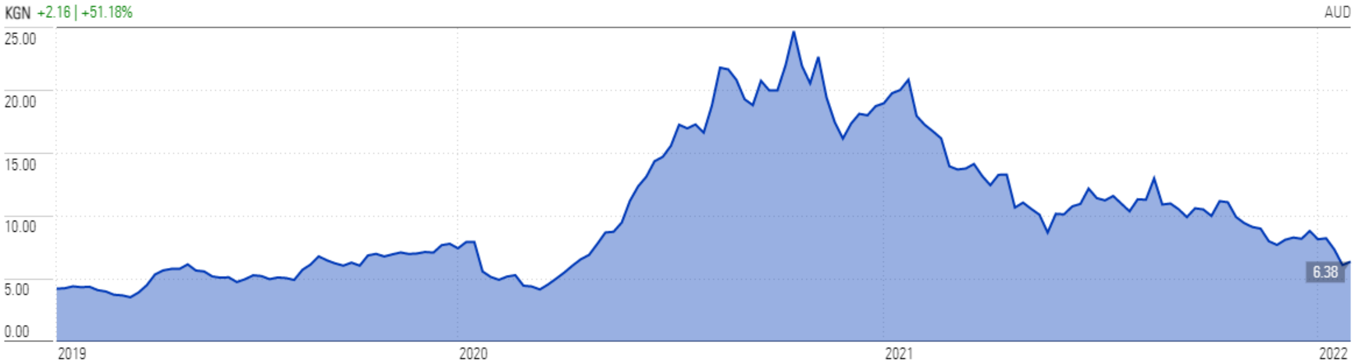
Trust the Germans to have a word like '*schadenfreude*', meaning the pleasure derived from another person's misfortune. The English language has appropriated the word, in the same way it nicked kindergarten, pretzel and doppelganger, although some claim the English '*epicaricacy*' has a similar meaning. It's my guess that many people feel a level of satisfaction at the angst (another German word) now experienced by buyers of hot tech stocks, overhyped IPOs, Bitcoin, stonks and memes that thrived in 2020 and 2021 but are struggling in 2022.

Many US tech stocks that are supposed to be the next big things challenging the FANGs have given back much of their gains. **Twitter** is down 50% from 12-month highs, **PayPal** has lost 40% and each of **eBay, Nvidia, Salesforce and Adobe** have shed over 20%. Even with a recent bounce back, **Tesla** is down 22% in three months (source: **Morningstar**).



In Australia, investors could not get enough of stocks that were supposed to benefit permanently from the pandemic and investors pushed them to all-time highs. Many have since fallen out of fashion and are well off their 12-month highs, such as **Kogan** ($18.01, now $$6.38), **Accent Group** ($3.08, now $2.03), **Airtasker** ($1.97, now $0.84), **Appen** ($25.46, now $10.38), **BlueBet** ($3.03, now $0.95), **IOUPay** ($0.85, now $0.20), **Marley Spoon** ($3.22, now $0.72), **Nearmap** ($2.79, now $1.35), **Nuix** ($10.35, now $1.51) ... on it goes. Jump on bandwagons and it's easy to fall off. If you missed out on the IPO of some of these companies because you did not know anyone on the inside, enjoy your schadenfreude.

Investors often buy the good side of the story and then face a reality check. Kogan boasted a 90% growth in sales, but the market learned about narrower margins, supply constraints, high inventories and rising marketing costs. Here's Kogan for the last three years, showing how critical the entry price was. The three-year return is a healthy 51% but what a ride!



It is estimated that a million Australians have started investing or trading in the stockmarket since the start of COVID, encouraged by lockdowns, social media ramping and plenty of cash in the bank. For a long time, the profits were easy, and some even quit their jobs. The market has delivered a reality check, although overall, the 'correction' to date has been modest.

This week's focus is on risk tolerance and loss aversion. Everyone knows the cost of participation in the long-term gains from equities comes with the risk of greater price volatility in the short term, and only you know if you have the temperament to stick it out when the market sells off.

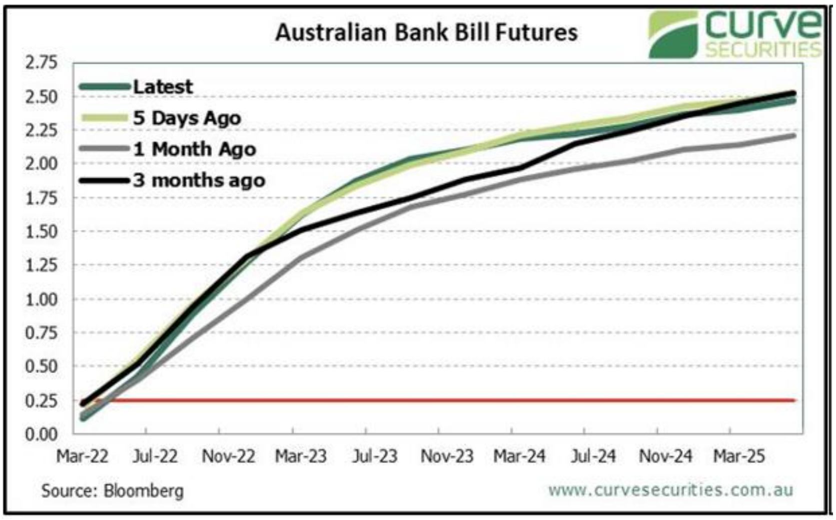
The Australian market recently fell by 10%, although it has recovered 4% at time of writing. The most common advice is to look past the noise, but **Christine Benz** describes four circumstances where it might be appropriate to sell. It depends on where an investor sits in a long-term investing journey.

John Leske spent 20 years as a financial adviser and developed five checks on the personal financial health of his clients. He describes his framework which is a good guide for anyone wanting to measure their financial health.

During the GFC, bank hybrids fell heavily in price as bank share prices tanked, although not by as much. **Norman Derham** runs the numbers on recent bank and bank hybrid prices to see if changes to hybrid structures seem to have made them more resilient.

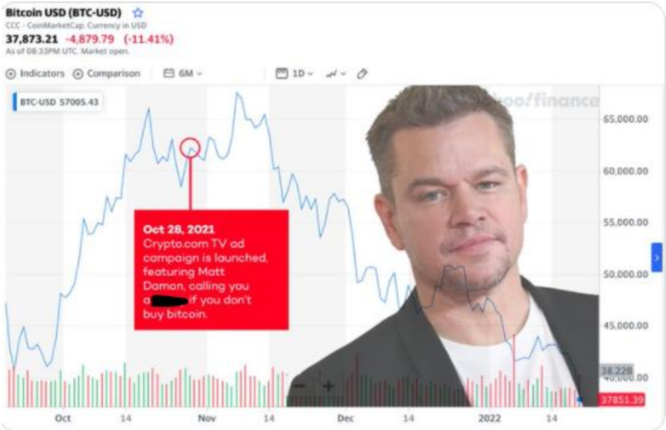
As investors look for alternatives to term deposits and low-yield bonds, they must decide how far up the risk curve they are willing to go in the search for yield. **Andrew Lockhart** explains why corporate debt carries acceptable risks for the rewards.

The Reserve Bank continues to show little sympathy for investors living on cash and deposit income, as it signals a resolve to hold cash rates down even in the face of rising inflation. Lowe by name and low by nature. We report on Governor **Philip Lowe**'s statements and speeches this week where he stands firm waiting for inflation and wages numbers to confirm a longer-term trend. In fact, he sees 2022 as an historic moment to push unemployment to 50-year lows while managing inflation. However, the market disagrees, pricing in a continuous series of rate increases starting with four this year.



Nothing divides opinions, and perhaps generations, as much as **Bitcoin**. Cryptos are either the next tulip bubble or the currencies of the future, and everything in between. The doubters say anything with a 12-month range of $A38,000 to $A93,000 cannot be a means of exchange. **Dan Annan** is firmly in the other camp, and he explains how cryptocurrencies work and the activities of 'miners'.

Firstlinks has been criticised for not understanding the potential of cryptocurrencies, which is fair enough, but it is too volatile and unpredictable for a major role in retirement investment (although SMSFs held $228 million in cryptocurrencies at September 2021, according to the ATO). Many traders and speculators and true believers have done well, but one thing is for sure. Famous actors and footballers are unlikely to be the best place to go for guidance on investing. Somehow, I doubt **Matt Damon** or **Neymar** know much about crypto, although this is a great marketing video.



This week's White Paper from **Epoch Investment Partners** examines China's 'common prosperity' and its impact on large tech companies. With the US looking to delist some Chinese companies by 2024, equity market decoupling is destined to accelerate.

The Comment of the Week among many differences of opinion comes from **Pippa** on **Ashley Owen**'s article on wealth inequality.

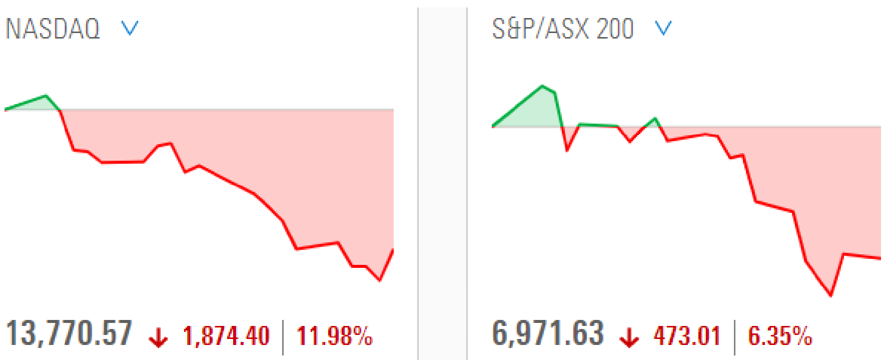
"Very interesting visuals and although Australia does relatively well on the inequality scale, look at the widening gap in income trend since the 1980s. So much for the promises of trickle down economics and globalisation. Goes a long way to explaining the rise of populism as the masses wake up to the fact they've been hoodwinked."

Market fall reveals your risk tolerance and loss aversion

Graham Hand

"Each person has to play the game given his own marginal utility considerations and in a way that takes into account his own psychology. If losses are going to make you miserable – and some losses are inevitable – you might be wise to utilise very conservative patterns of investment and saving all your life. So you have to adapt your strategy to your own nature and your own talents. I don't think there's a one-size-fits-all investment strategy that I can give you." - Charlie Munger, 1998, answering, "*How do you learn to be a great investor*?"

A week ago, the S&P/ASX200 entered what is known as a 'market correction' when it fell more than 10% from its recent peak in August 2021. Like the US S&P500 and NASDAQ, the index has recovered some ground in recent days, but here are the moves since the start of the year.



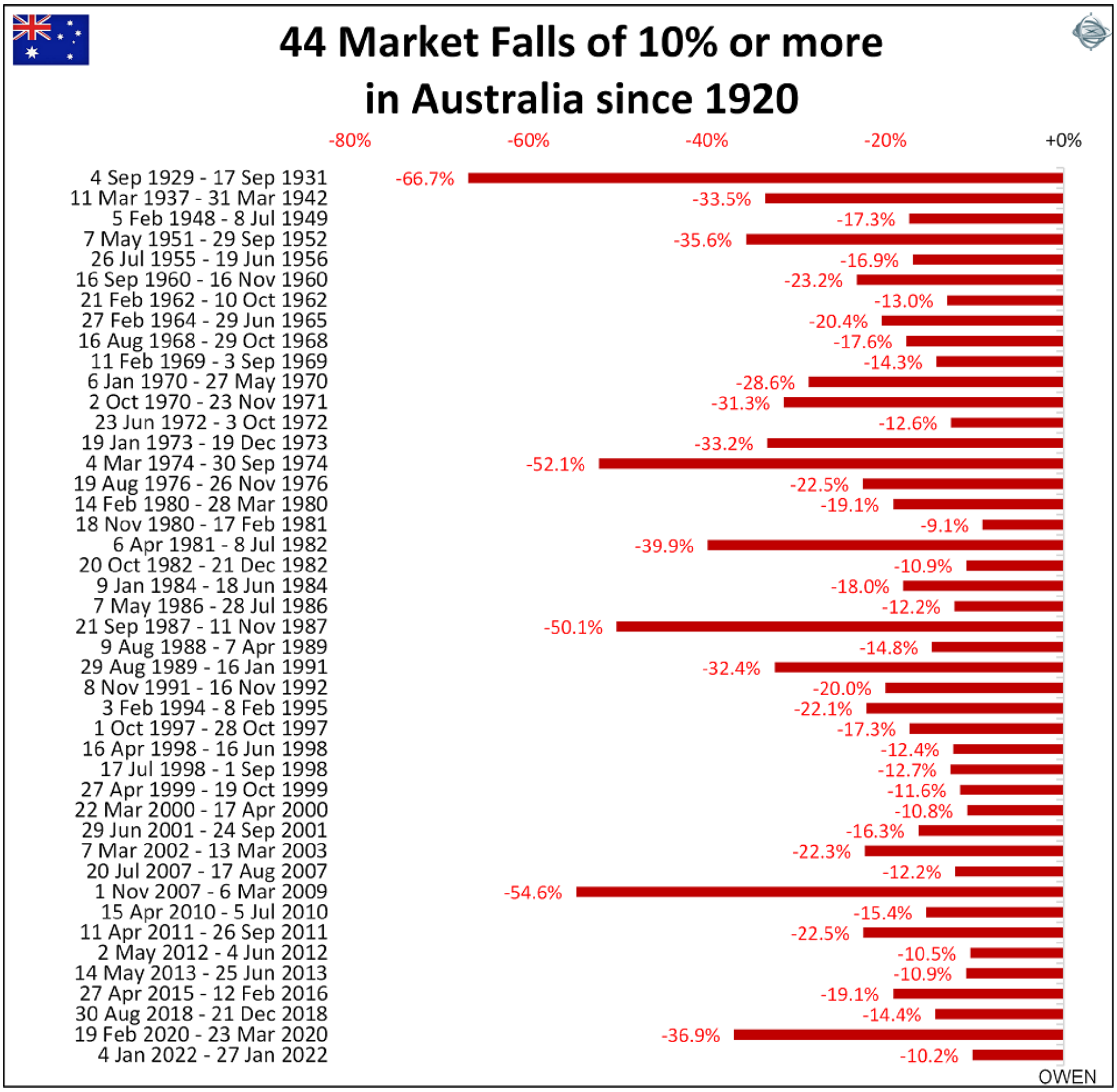
Experiencing a 10% fall is a good time to take stock of your risk tolerance. If you held $1 million in equities and the value fell $100,000, what did you think?

A) No big deal. That's the price of investing in shares and I'm focussed more on the long term, OR

B) $100,000!!! What I could do with $100,000! That's a year of hard slog to earn that much. There goes the mortgage repayment and new car.

Or maybe a worse reaction if you are in retirement and living on your savings. Retirement planning requires guesswork about the future, and 'losing' 10% might seem like a big hit when you are carefully drawing down 4% a year.

Are you someone who welcomes lower share prices as a buying opportunity, or loses sleep when the market falls? What if it goes down another 20%? Or 50%? If this seems unlikely, consider the following chart from Ashley Owen of Stanford Brown. Over 100 years, there have been 43 falls of over 10%, meaning equity investors should expect one every couple of years. And a 50% fall has happened every 25 or so years.



There is no single and simple answer to how much market risk an investor should take. There is a difference between 'risk tolerance' and 'risk capacity' but we tend to interchange the two. Tolerance is an investor's comfort (or discomfort) with risk, whereas capacity is how much risk an investor can take without ruining their financial plans.

Tolerance for risk

Everyone has a different loss discomfort level and it varies over time and according to market conditions. While any number of risk appetite tests can be done in advance, nobody knows their tolerance until they face a real rather than imagined loss.

Some people genuinely look to an investment horizon decades into the future and have a strong ability to ignore market noise and fluctuations. They remain heavily exposed to equities for long-term growth and are sanguine about the potential for half their retirement savings to be wiped out.

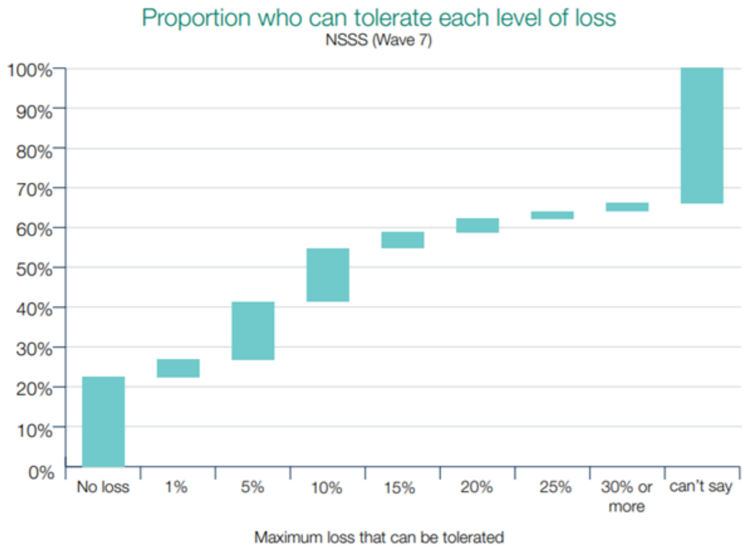
But they are likely in the minority. For many, a $100,000 correction means doubt sets in, as it might be heading towards a loss of $200,000 or $300,000 which would compromise plans. In choosing to sell before it gets worse, another investor exits in a down market.

There is a common argument that younger people have greater risk tolerance, because they have more time to recover from a drawdown. But often the young person is saving over a shorter-term horizon than retirement, especially the deposit on a house, and a loss can be a setback toward the Great Australian Dream. Young people suffering a market loss may be discouraged from investing later in their lives.

Lack of capacity for losses in older people

Retirees may be hit by a market fall at the point when their retirement savings are at their maximum, the so-called 'sequencing risk'. A loss of capital at a time of regular withdrawals may reduce the estimated period until the money runs out.

National Seniors Australia released a survey of nearly 5,000 of its members in 2018 which showed little capacity to tolerate losses in retirement savings. About 23% reported they could not accept any annual loss on their portfolio, as shown below. Most respondents could not tolerate losses of over 10%, and only one in 14 a loss of 20% or higher (note in the table that the large box on the right is 'can't say'). National Seniors reported:



"Of those who could quantify their risk tolerance, only 11% could tolerate a loss equal to the impact of the GFC. Those who admitted in the survey to not knowing how to manage their market risk are twice as likely to report 'no tolerance for any loss' as those who said they could manage it."

The theory of loss aversion under challenge

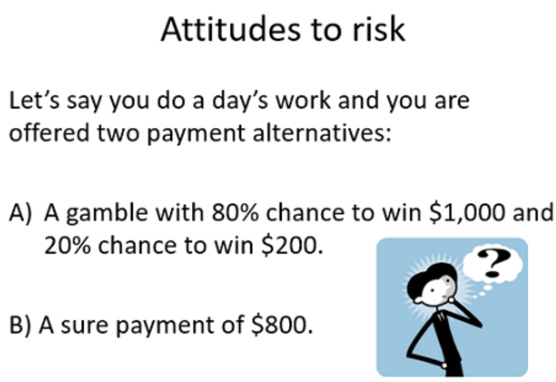
We're all different but if there was one widely accepted behavioural trait, it was that most people are influenced by 'loss aversion'. Loss aversion is a notion that we dislike losses far more than we enjoy equivalent gains. Daniel Kahneman, the 2002 Nobel Prize in Economics winner, in his bestselling book, *Thinking Fast and Slow,* went as far as saying:

"…the concept of loss aversion is certainly the most significant contribution of psychology to behavioral economics."

His colleague, Richard Thaler, was awarded the 2017 Nobel Prize in Economics, and 'loss aversion' featured 24 times in the Nobel Committee's description of his contributions to economics.

It seems to reflect a fundamental truth. Dozens of academic studies have attempted to quantify loss aversion, and Kahneman says:

"You can measure the extent of your aversion to losses by asking a question: What is the smallest gain that I need to balance an equal chance to lose $100? For many people the answer is about $200, twice as much as the loss. The 'loss aversion ratio' has been estimated by several experiments and is usually in the range of 1.5 to 2.5."



It doesn't seem logical, but for many years, I have used this slide to reveal how loss averse people are. Say someone does a day’s work, and is offered two payment alternatives, as shown. The expected value of A) is $840 (80% X $1,000 plus 20% X $200) and B) is $800, yet nearly everyone chooses B). In fact, when I change the slide to lower B) to $600, most people still want the certain payment rather than the gamble.

However, now there is a body of work saying loss aversion is a fallacy, that there is no general cognitive bias that leads people to avoid losses more vigorously than to pursue gains. For example, David Gal, Professor of Marketing at the University of Illinois at Chicago, writing in Scientific American, says:

“People do not rate the pain of losing $10 to be more intense than the pleasure of gaining $10. People do not report their favorite sports team losing a game will be more impactful than their favorite sports team winning a game … To be sure it is true that big financial losses can be more impactful than big financial gains, but this is not a cognitive bias that requires a loss aversion explanation, but perfectly rational behavior. If losing $10,000 means giving up the roof over your head whereas gaining $10,000 means going on an extra vacation, it is perfectly rational to be more concerned with the loss than the gain."

Yet Kahneman’s statement that ‘*losses loom larger than gains*’ has much support and to me, feels right, based on my personal experience with investing. I don’t enjoy gains anywhere as much as I dislike losses, and it influences my investing. I have long accepted the estimate that loss aversion:

”…is a cognitive bias that describes why, for individuals, the pain of losing is psychologically twice as powerful as the pleasure of gaining.”

But even Kahneman now says loss aversion was not so much the result of rigorous experiments as an intuition. When David Gal reproduced a typical Kahneman study about how much students would sell their mugs for, he found his subjects were largely indifferent. The desire to buy or sell at certain prices was met more with inertia than a feeling of gains or losses. Other researchers have expressed similar concerns, arguing that we are not hard-wired to give negative results such significant weights. So Gal calls loss aversion theories ‘fuzzy and loose’, when often actions can be explained by other factors such as the endowment effect or a bias towards inaction.

Asked to react to Gal’s work, Kahneman, now aged 87, said:

“It’s not a law of human nature that you have to find it in every context ... There are experiments where people don’t find loss aversion. And, again, there’s an explanation for every one of them. That doesn’t violate loss aversion, because there are exceptions to loss aversion ... Having a principle that helps understand a wide body of phenomena - that’s considered useful. That doesn’t mean that loss aversion’s true. It means that it’s useful.”

Find your own risk tipping point

As Munger said: "*If losses are going to make you miserable – and some losses are inevitable – you might be wise to utilise very conservative patterns of investment and saving all your life.*"

But an investor with a highly-conservative, long-term portfolio will forgo substantial returns over multiple decades, and the opportunity cost might deliver as much angst as a short-term market loss. It would feel like everyone else is drinking punch and dancing at the party while you're lying at home in your bed.

The best strategy is to find that point where there is enough equity market exposure to enjoy the gains, but not too much that losses cause great worry. If being a little conservative is what it takes to get a good eight hours, it might be worth the cost.

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

Five personal checks on your financial health

John Leske

What is good financial health? Are there a minimum number of 'big picture', timeless, universal and objective indicators of financial health that can be easily measured and monitored? What benchmarks or targets for those indicators should be met or exceeded to signify good financial health?

These were the questions we asked at my previous financial planning firm, Wealth Foundations, starting around 2010. Our aim was to provide a simple but robust, high-level framework for assessing good financial health, both for existing and potential clients.

After a number of iterations, in mid-2012 we finally settled on five indicators and, subsequently, saw no need for any further change.

Having now retired as a financial planner, and with the consent of Wealth Foundations, the purpose of this article is to introduce this personal financial health framework to a wider audience.

The hope is that it will provide anyone who is willing to do a little homework with a sound basis for understanding the current state of their financial health and the direction they need to head to improve it.

What is good financial health?

First, "What is good financial health?". We equate good financial health with financial independence. Financial independence is having sufficient accumulated investment wealth to support your desired lifestyle, indefinitely, without the need to work.

Of course, you can choose whether and how much you want to continue to work but you don't **need** to earn exertion income. So, financial independence isn't necessarily retirement.

Five key indicators of good financial health

The **first** indicator is the **Investment wealth ratio**, defined as your net investment wealth (i.e. investment wealth less debts), divided by your net worth. It's examining the question *"Is too much of your wealth allocated to lifestyle assets?"*.

For good financial health, the benchmark for this indicator is set at a minimum of 55% i.e. at least 55% of net worth needs to be held as net investment wealth and no more than 45% as lifestyle assets (e.g. own residence, holiday home, cars, boats etc.).

The benchmark was chosen based on experience with Sydney-based, high net worth/high income financial planning clients and is, admittedly, a little arbitrary. But its rationale is to highlight that if too much of your wealth is tied up in lifestyle assets, financial independence may be elusive.

The **second** indicator is called the **Retirement expenditure multiple**. It's calculated as your net investment wealth divided by your desired annual retirement (or financial independence) spending. It's looking directly at the issue of *"Will you run out of money?"*.

The financial independence benchmark for this indicator is a requirement for net investment wealth that is at least 25 years of desired annual retirement spending. It's the equivalent of the often criticised '4% safe withdrawal rate'.

For those who argue that the benchmark should be more than 25, the reality is that most Australians fall so far short of it that pushing for a higher number is largely academic. And, for those who argue it's overly conservative, my retort is that you better not plan on living to age 100.

Regardless, the Retirement expenditure multiple benchmark, like all the benchmarks, is a 'rule of thumb', rather than a hard and fast dictate. The benchmarks provide meaningful targets that those who desire to be financially independent can compare their circumstances with.

The **third** indicator is the **Tax effectiveness ratio**. It's your total superannuation holdings divided by your Projected lifetime investment wealth. Projected lifetime investment wealth is your current net investment wealth *plus* an estimate of the amount you expect to save between now and the date of your desired age of financial independence or retirement.

The Tax effectiveness ratio is a proxy measure to answer the question *"Are your investments held tax effectively?"*. The benchmark for this measure is at least 75%. Its basis is that since superannuation is currently a very tax effective environment in Australia and it's where most people should hold the majority of their investment wealth.

Again, it's a rule of thumb rather than a dictate. There will often be legitimate reasons why the benchmark won't or can't be achieved, without jeopardising the goal of financial independence.

The **fourth** indicator is the **Growth asset allocation ratio**. It's your growth investment assets (i.e. shares, direct property, share and property managed funds/ETFs) as a percentage of Projected lifetime investment wealth, discussed above.

The focus here is *"How much investment risk are you comfortable with?"*. The target or benchmark will differ for each investor. "The target asset allocation decision" discusses this choice in more detail.

However, for most, we advocate that your maximum risky growth asset exposure when financially independent and/or retired shouldn't exceed a level that would cause you to lose sleep, due to anxiety, and, perhaps, abandon a sound investment strategy in troubled markets. This is generally guided by an assessment of your attitude to investment risk.

The **final** indicator is the **Investment diversification ratio**. It's calculated as your diversified investment assets (i.e. your total investment assets less, primarily, concentrated holdings such as investment properties and large individual share holdings) divided by your total investment assets.

The issue this indicator addresses is "*Have you too many investment eggs in one basket?*". Investment theory suggests that concentrated investment holdings offer no **expected** return premium for their additional investment risk compared with the relevant, well diversified, asset class. Consequently, they aren't regarded as consistent with good financial health.

While our benchmark for the Investment diversification ratio is a minimum of 75%, our view is that you should diversify your investment holdings as broadly as you cost effectively can.

Summarising a universal framework to assess your financial health

The table below summarises the five financial health indicators discussed above and their recommended benchmarks.

Good financial health is revealed by being at or above each of the indicator benchmarks. You'll notice that it's not directly dependent on how high your income is or how much you're worth.

While shortfalls on some benchmarks may not be a major problem, the framework encourages you to address the reasons for any divergences.

Financial health indicator	What is it?	Benchmark
Investment wealth ratio	Net investment wealth ÷ Net worth	>55%
Retirement expenditure multiple	Net investment wealth ÷ Desired annual financial independence/retirement spending	>25 years
Tax effectiveness ratio	Total superannuation ÷ Projected lifetime investment wealth	>75%
Growth asset allocation ratio	Growth assets ÷ Projected lifetime investment wealth	Varies by individual, but no greater than indicated by your attitude to investment risk.
Investment diversification ratio	Diversified investment assets ÷ Total investment assets	>75%

And, of course, should you fall well short on a number of the benchmarks, the direction of the changes you need to make to improve your financial health, in terms of the framework, should be apparent.

So, how's your financial health?

*John Leske is Founder and CEO of **finhealth**, the provider of an approach to assessing the state of your personal financial health. The article describes a general framework to compare your current situation with some meaningful financial benchmarks. No specific personal financial advice is provided and it is up to readers to determine what actions, if any, they take in response to the article. A more detailed explanation of the indicators can be found in the free eBook, "What is finhealth?".*

Four good reasons to sell stocks now

Christine Benz

"Don't do something, just stand there!" - Jack Bogle
"Be greedy only when others are fearful." - Warren Buffett
"You make most of your money in a bear market; you just don't realise it at the time." - Shelby Cullom Davis

Stocks have been volatile recently, seesawing all over the place but mostly trending down. At the time of writing, the S&P 500 has lost about 9% so far in 2022, and the tech-stock-heavy Nasdaq 100 has lost more than 13%.

Usually best not to sell in downturn

You don't have to be an investment legend to know that it's rarely wise to be a seller in such environments if you can avoid it. Selling into a downturn violates one of the key tenets of successful investing: selling high. And investors who panic-sell are prone to make emotional decisions that undermine the success of their plans. Even the emotional relief that selling might bring is fleeting, as it's so often quickly replaced by another nagging worry: Is it time to get back in?

For all of these reasons, the admonition to stay the course in a falling market is often - indeed usually - sound advice. But it also presupposes a few key things that may or may not apply. The biggie is that it assumes the underlying investment plan and asset allocation are well-thought-out and well-tended.

At least until recently, however, we were living in an era of FOMO, fear of missing out, in which many novice investors barrelled into risky assets with the hopes of overnight riches. It's a big leap to assume that many of these newbies were operating with an underlying plan or even an appreciation of investing basics like asset allocation, diversification, and the role of time horizon.

And even investors who did have a plan at one point in time may well have found themselves unmoored from it. U.S. stocks have trumped almost everything in sight over the past decade. A portfolio that was 60% U.S. stocks/40% bonds five years ago would be 72% stocks/28% bond today.

Yet getting investors to peel back on a winning asset class in favour of one with a dinky yield (cash and bonds) or underwhelming long-term results (international stocks and also cash and bonds) is an uphill climb. Just as important, many investors' natural tendency is to do nothing with their portfolios, often for years on end, and that's especially true when the market is marching steadily upward. They may have heard the advice to rebalance, but they're busy or not sure how to do it. The path of least resistance beckons.

For all these reasons, I think there are plenty of investors who should, in fact, be lightening up on stocks during the current market downdraft, even though the conventional wisdom is to do nothing.

Here are a few key situations when selling stocks might be warranted right now.

Reason 1: You're getting close to retirement and need to de-risk

Something has dawned on me as I've interacted with older adults over my career (and, gulp, have gotten older myself). Even as our comfort level with risk-taking usually grows as we get our sea legs as investors, our plans' ability to absorb risk usually diminishes. I think that explains why it's so tough to get older investors to de-risk their portfolios in the years leading up to and in retirement. They've seen this movie. They know stocks usually recover, and their stocks have beaten everything else in their portfolios by a big margin.

And stocks' current run really dates back to early 2009; the big losses that stocks endured during the GFC have been erased. Is it any wonder that so many older investors are standing pat with equity-heavy portfolios?

Yet even as risk tolerance grows with experience, risk capacity - the ability to absorb big losses in our equity portfolios - declines as we get close to drawing from our portfolios. At that life stage, it's wise to begin building out positions in cash and bonds as a bulwark.

If a lousy market materialises early in retirement, the investor can 'spend through' the safe stuff versus tapping depreciating equity assets. Heading off sequence-of-return risk helps explain why my bucket portfolios generally hold 10 years' worth of spending in cash and bonds. It's also why, in our recent research on in-retirement withdrawal rates, we found that balanced portfolios generally supported higher withdrawal rates than more equity-heavy ones.

Reason 2: You have a short-term investment goal

New investors have been flooding into the market during the pandemic, thanks to strong gains on stocks and other assets as well as the fact that many individuals have extra time and cash to invest. Research in 2021 from investment firm Charles Schwab found that these newbies have a median age of 35 and their incomes are about $20,000 less than investors who were in the market pre-pandemic. Half of the new investor group - what Schwab calls 'Generation I' - are living paycheck to paycheck. A healthy share of the new investor group was expecting to hit big lifetime milestones within the next few years, such as buying a home or having a baby.

Those statistics suggest that some new market entrants are not laser-focused on amassing investments for their retirements in 30 or 40 years. Rather, they may need to tap their portfolios sometime soon to cover an emergency expense, tide them through job loss, or fund some shorter-term, nonretirement goal like a house down payment. If they need to get out of their stock investments at an inopportune time, they could lock in losses.

For a bit of context on why investing in stocks for short-term goals can be so risky, over rolling 10-year periods since 1986, the S&P has posted a loss roughly 18% of the time. The index has posted losses in about 12% of three-year windows over that same stretch. Some of those short-term losses were punishing, especially in one-year windows. The unlucky soul who invested in the S&P 500 in early 2008 and needed to get his money out a year later would have had to settle for a 43% loss, for example.

With U.S. stocks still up more than 10% over the past year, new investors who find themselves with too risky portfolios should feel absolutely no shame in liquidating some of their equity holdings in favour of a portfolio mix that adequately reflects their potential need for liquid assets within the next few years.

Reason 3: There's a chance you'll capitulate if things get worse

The preceding two situations relate to risk capacity, where a too-aggressive portfolio might be at odds with someone's spending horizon. In other words, their spending goal dates could force a liquidation at an inopportune time (or even worse, force them to change their goals and plans).

But even if an investor has an adequately long time horizon to hold stocks, there's another issue that can crop up with too-risky portfolios, and that's *capitulation risk.* That's my own term, referring to the chance that the investor could become so nervous during periods of losses that he sells himself out of stocks, thereby turning paper losses into real ones.

Recent market losses are minor relative to the depth and duration of some previous market downturns. The S&P 500 lost half of its value in the bear market that began in March 2000, for example, and that bear market was a grinding one, lasting 31 months. The bear market that ensued during the GFC was quite a bit shorter, just 17 months, but the losses were an even sharper at 56%. In other words, if the recent market volatility has you spooked, you ain't seen nothing yet.

While throwing stocks overboard won't make sense, lightening up on stocks while adding a bit more to bonds and cash just might. In addition, nervous investors can take a closer look at the complexion of their equity portfolios, making sure they have a balance between value and growth stocks and hold some international as well as domestic stocks.

Alternatively, investors might use their response to the recent market action as an impetus to delegate their portfolio management to a professional adviser. Doing so can help reduce the worry, ensure a situation-appropriate asset allocation, and help protect the investor from his or her own worst impulses to trade at inopportune times.

Reason 4: You have tax losses

Granted, this is a niche case. But for investors who recently purchased securities in their taxable accounts that have subsequently declined, selling to harvest a tax loss may be a way to find a silver lining (subject to complying with relevant legislation). Those losses may be used to offset capital gains. Be sure to consider the 45-day holding period rule in Australia if you'd like to maintain ongoing exposure to an asset. Also in Australia, where a transaction is entered into with the dominant purpose to access a tax benefit, the Tax Act provides the Tax Commissioner with powers to cancel the transaction and make a compensating adjustment.

Christine Benz is Morningstar's Director of Personal Finance. This article does not consider the circumstances of any investor. Minor changes have been made to the original US version for an Australian audience.

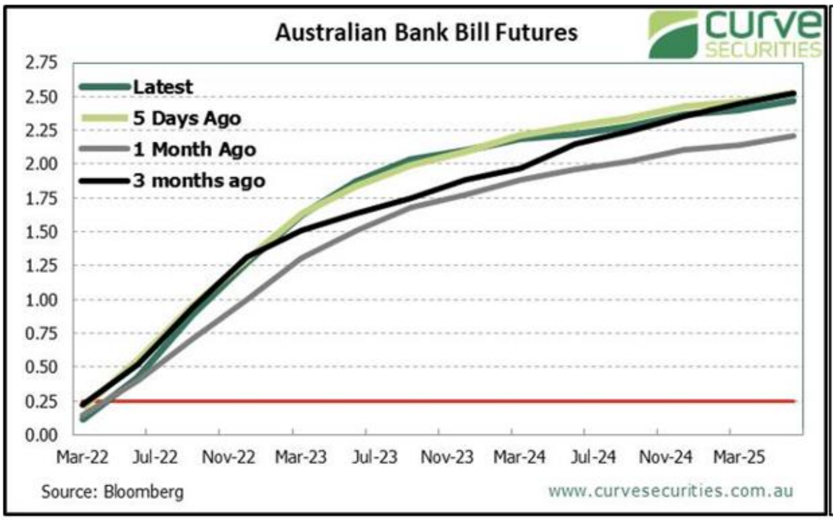
Happy RBA refuses to blink while market runs ahead

Graham Hand

Reserve Bank (RBA) Governor, Philip Lowe, looked surprisingly happy this week, given the recent criticism of his judgement a few months ago that conditions for an increase in cash rates would not be met until 2024. Both wages growth and inflation are much stronger than he expected, but Lowe sees this as an early achievement of two RBA targets.

Although he conceded the RBA does not really know what's happening, he seems delighted with progress. Underlying inflation is up around 2.5% for the first time in seven years and the unemployment rate is heading for a 50-year low. In his speech to the National Press Club, Lowe argued that low rates and bond buying have done exactly what they were supposed to and *"More people have jobs than ever before. It's a real benefit to people and the community."*

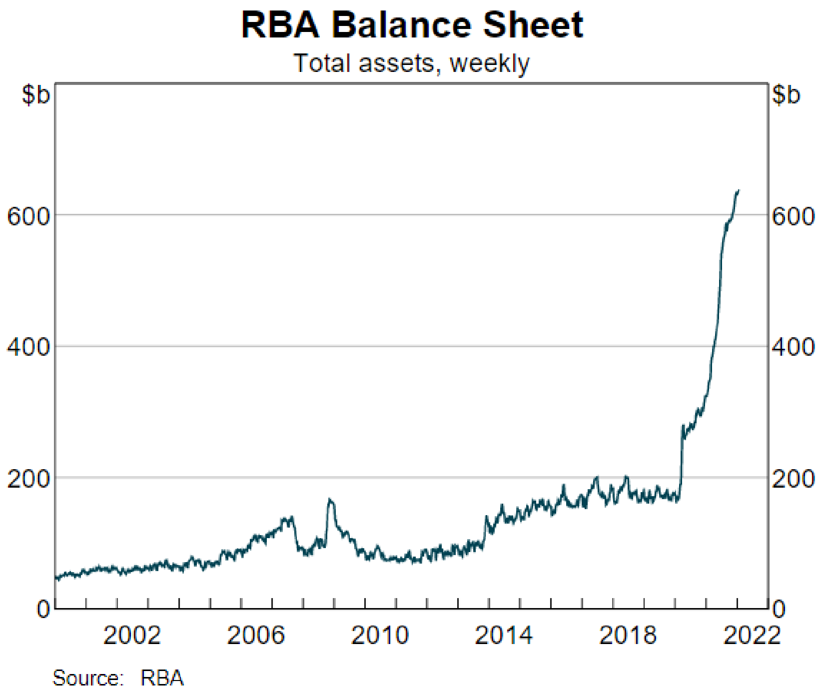
When challenged that he is moving too slowly on rates, he reminded the audience that inflation has just hit the mid point of the RBA 2-3% target. He is prepared to wait before moving, seeing many factors such as supply chain blocks as temporary. Although he said a rate rise in 2002 is 'plausible', he believes the market's expectation of four rises this year is highly unlikely. Here is where the market is pricing short-term rates over coming years.



RBA Board meeting

The RBA made important announcements on Tuesday this week which will set the tone for interest rates, and everything that flows from them, for the rest of 2022 and beyond.

First, the RBA decided to cease further bond purchases under its stimulus programme, as the economy now seems resilient enough to sustain a recovery. Since the start of COVID, the RBA's balance sheet has more than tripled to around $640 billion.



Here are some highlights of the monetary policy announcement:

"The RBA's central forecast is for GDP growth of around 4¼% over 2022 and 2% over 2023 ... The labour market has recovered strongly, with the unemployment rate declining to 4.2% in December ... The RBA's central forecast is for the unemployment rate to fall to below 4% later in the year and to be around 3¾% at the end of 2023."

"Inflation has picked up more quickly than the RBA had expected, but remains lower than in many other countries. The headline CPI inflation rate is 3.5% is being affected by higher petrol prices, higher prices for newly constructed homes and the disruptions to global supply chains. In underlying terms, inflation is 2.6%. The central forecast is for underlying inflation to increase further in coming quarters to around 3¼%, before

declining to around 2¾% over 2023 as the supply-side problems are resolved and consumption patterns normalise."

"As the Board has stated previously, it will not increase the cash rate until actual inflation is sustainably within the 2 to 3% target range. While inflation has picked up, it is too early to conclude that it is sustainably within the target band."

Governor's speech to the National Press Club

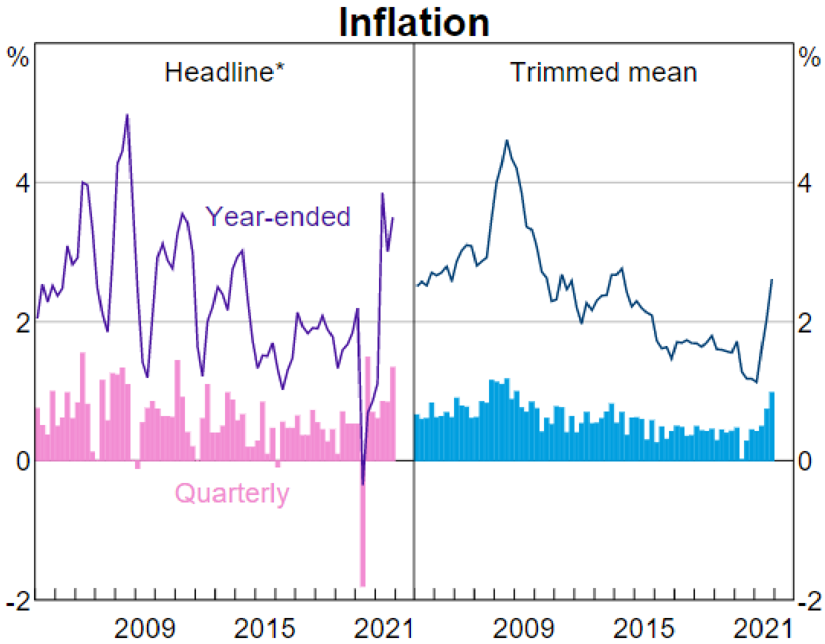
Although much of his speech was a confession that the RBA's forecasts had been wrong in 2021, Lowe was upbeat about the economic recovery.

"That recovery is being underpinned by a number of factors. These include household balance sheets that are in generally good shape, with households having accumulated more than $200 billion in additional savings over the past two years. An upswing in business investment is also underway and there is a large pipeline of residential building to be completed over the next year or so. The decline in the unemployment rate has been accompanied by a welcome decline in underemployment, which is at its lowest rate in 13 years."

While he accepts inflation will increase modestly, he expects supply problems will be resolved. He said wages growth remains low and he will be patient reviewing monetary policies. Several times in response to questions, he emphasised that underlying (trimmed mean) inflation has just entered the target range, and that is a good thing. He wants inflation neither too low or too high.

"We are in the position where we can take some time to obtain greater clarity on these various issues. Countries with higher rates of inflation have less scope here. The Board is prepared to be patient as it monitors the evolution of the various factors affecting inflation in Australia."

And there was no mistaking his pride in the unemployment achievement:



* Year-ended series is not seasonally adjusted.
Sources: ABS; RBA

"It is also relevant that Australia is within sight of a historic milestone – having the national unemployment rate below 4%. This is important because low unemployment brings with it very real economic and social benefits for many Australians and their communities. Full employment is one of the RBA's legislated objectives and the Board is committed to playing its role in achieving that objective, consistent with also achieving the inflation target."

When asked whether he would borrow at a fixed or floating rate if he had a mortgage, he was not prepared to commit, but rather, he advised borrowers to manage their obligations with a suitable buffer.

Although we like to think the RBA has some magical insights, this week confirmed that the information that will determine interest rates this year has yet to be released, and the Governor is guessing as much as any economist.

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

Bank hybrids response to equity market weakness

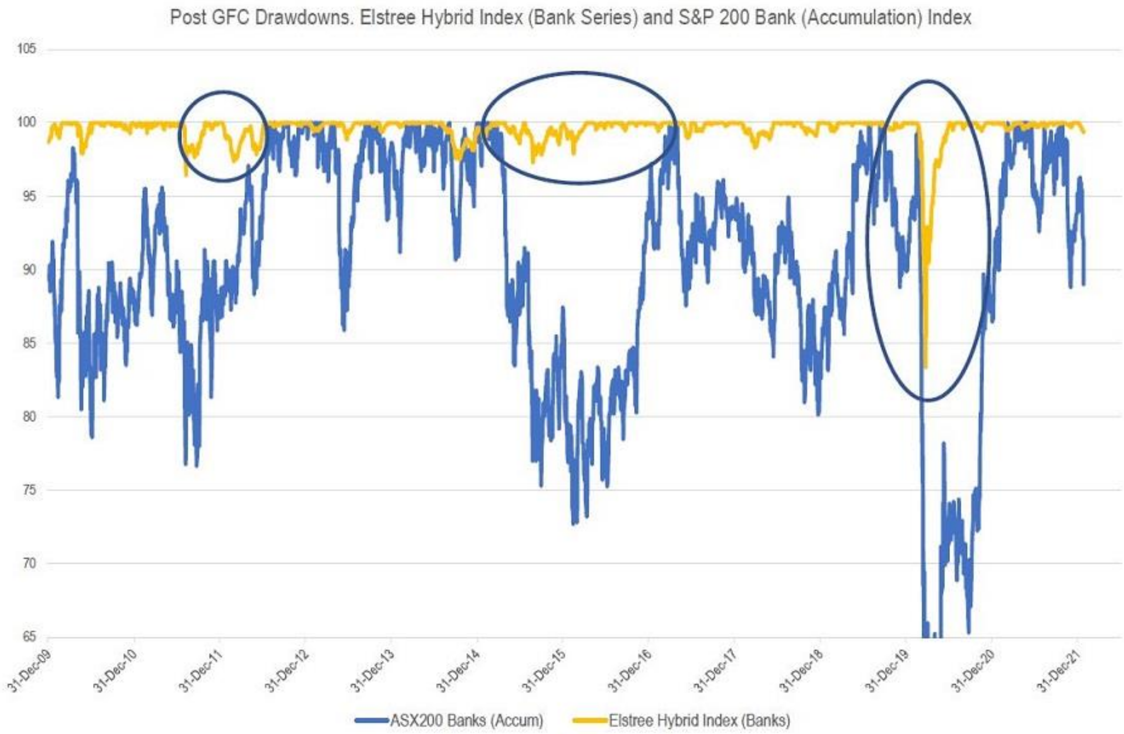
Norman Derham

What's the relationship between hybrids and equities when equity markets are weak? Probably the best comparison are the couples that appear on the Bachelor/Bachelorette: it's 'complicated'. There's almost no correlation between the two assets most of the time, but sometimes there is and sometimes it can be material.

Price markdowns on bank hybrids and bank shares

The chart below details the drawdowns (markdowns in prices) for the Elstree Hybrid Index (Banks Series – yellow line) with the S&P/ASX200 Banks Accumulation Index (source IRESS – blue line).

Banks are actually a bit more volatile than the All Ordinaries Index but the bank index is a better like-for-like comparison. At the time of writing, bank shares are around 10% off their highs and hybrids are weaker by around 0.60%. If you are into statistics, that's a 1 standard deviation move for both markets. You get worse than that most years.



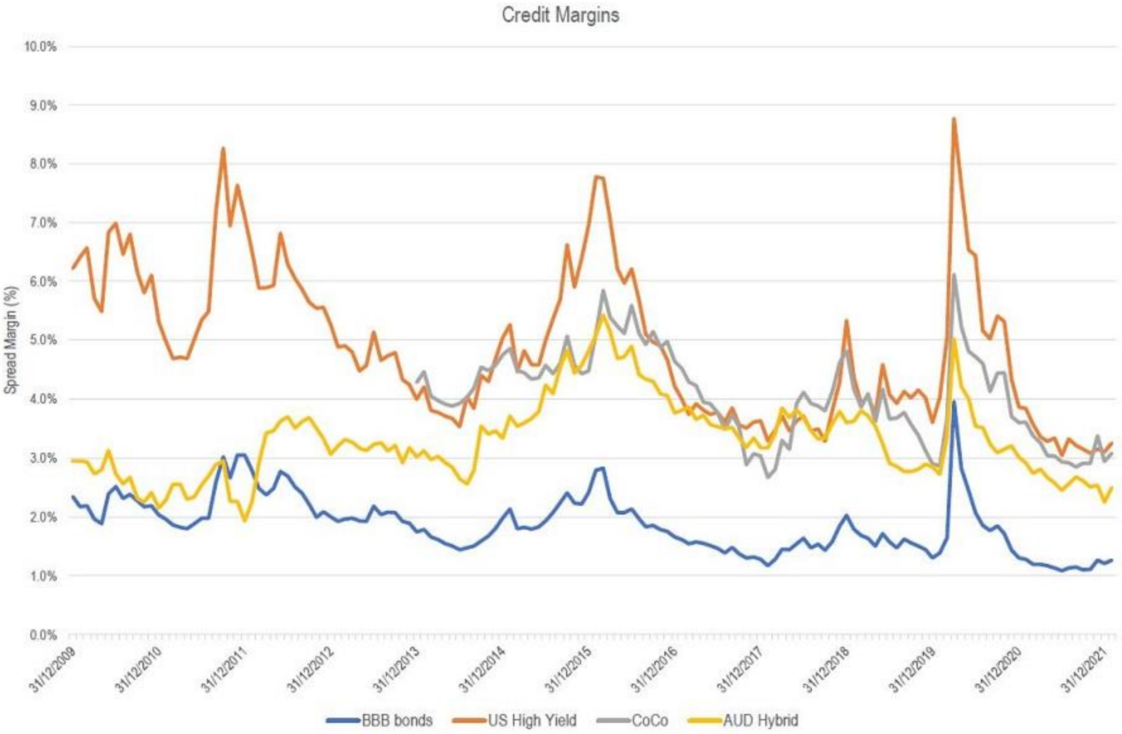
The three circled areas are the periods of material weakness since the GFC and there are some common factors for each of those periods which aren't present to date in the current sell off:

- Fears of material economic slowdown/economic chaos (China slowdowns, Euro bank problems, Greece, Covid, etc)
- Protracted equity market weakness
- Big drawdowns. Bank equities had to have sold off by more than 15%.

This sell off is not echoing the previous three. It's an inflation/too fast growth/interest rate led sell off and so far, it's only around 10%. At this stage, it looks like normal noise for hybrids. We might see another 0.5% - 1% weakness before we get a full recovery, or this might be the bottom if equity markets stabilise.

Nothing to see on credit margins yet

The chart below gives a longer-term perspective of credit margins (source BofA/ICE, Elstree) for four types of credit investments: 'BBB' rated bonds, High Yield bonds, CoCo (non AUD AT1/hybrids) and Australian AT1/hybrids. The last data point is 26 January 2022.



Will the last month lead to a surge in defaults down the track?

That would be nasty. We would be adjusting hybrid portfolios if we thought defaults were coming.

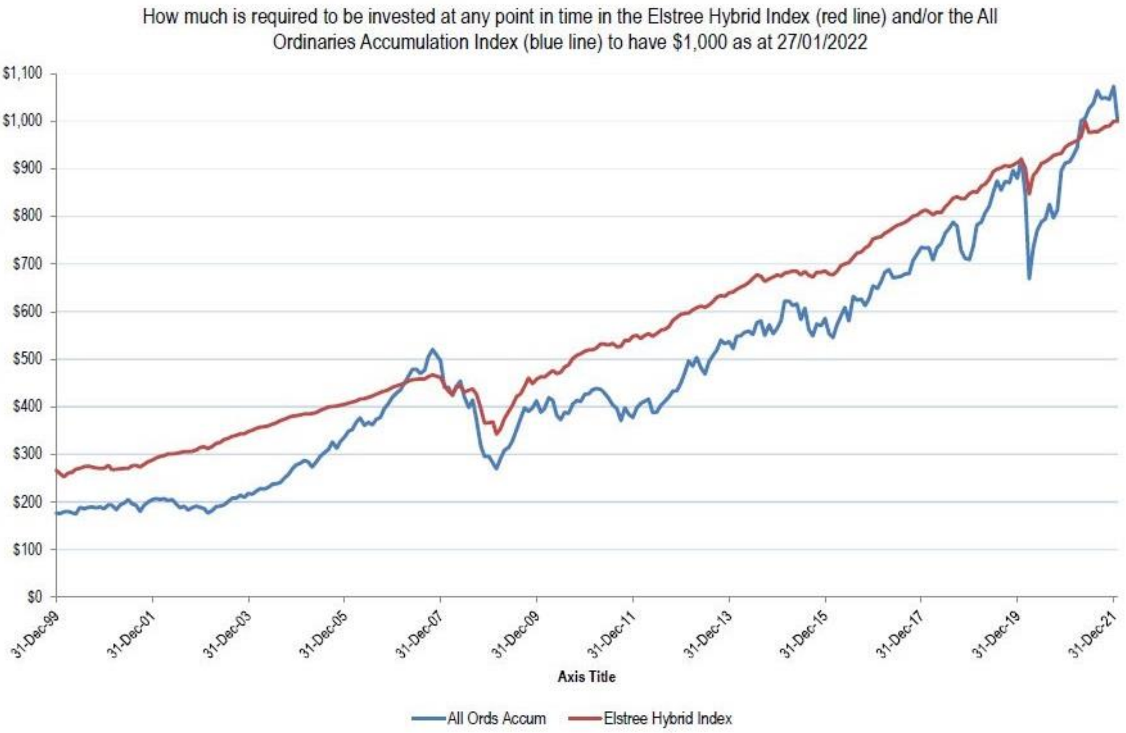
But at this stage it's a non-event. Our favourite indicator is the Kamakura Troubled Company Index (source Kamakura). The index details the proportion of companies globally in various degrees of difficulty. While it's a black box model, with its major inputs being equity markets and volatility, it has been extremely accurate predictor of default activity with a 12 month lead time. Credit conditions are still in the 11% of best periods since 1990, despite the month of market falls and its 1/3 as scary as what happened during Covid. There's no default threat yet. The chart below is the 26 January 2022 update.

Why you own hybrids

Here's our favourite chart that gives a rationale for investing in hybrids. It shows the amount (in dollars) you need to invest in the hybrid (red line) or equity market (blue line) at any one time over the past 21 years to have $1,000 today. Clearly, a lesser amount is better.

If you invested in our funds, the amount invested to have $1,000 today is even lower than that of the benchmark hybrid index.

The key takeaway is the delivery of similar return outcomes with lower risk. If you wanted to cherry pick data points, hybrids have outperformed equities since 2007 and also since just pre Covid. If you bought equities at the bottom of the Covid drawdown, you would have outperformed, but in general, hybrids have been great for much of the past 14 years. We think that is still a valid reason to invest in the asset class.



Norman Derham is Executive Director of [Elstree Investment Management](), a boutique fixed income fund manager. This article is general information and does not consider the circumstances of any individual investor. Elstree's listed hybrid fund trades on ticker EHF1.

How risk is managed in private debt investing

Andrew Lockhart

Australia's private debt market is entering the mainstream, both as a funding option for Australian businesses and as an asset class for income-conscious investors. Renewed interest in this form of lending is driven by the retreat of the banks from business lending and by record low interest rates that have enhanced the investment appeal of well-managed private debt funds.

Risks in both the fixed income and equity markets are rising because of sustained low official interest rates that have forced investors to chase higher prices and forced down yields. Equities prices have enjoyed a sustained run that has stretched valuations and reduced prospective capital and income returns.

The S&P ASX 200 Index is two-thirds above its historic average price earnings (P/E) ratio of 15 times, while the earnings yield is around one-third below its long-term average of 6.5%, according to the Australian Securities

Exchange. With disruptions to supply chains creating inflation pressures since the middle of last year, investors risk exposure to rising official interest rates that may push equity prices down.

Exhibit 1: Shiller PE – S&P 500 and US 10 Year Bond Yield last 20 Years

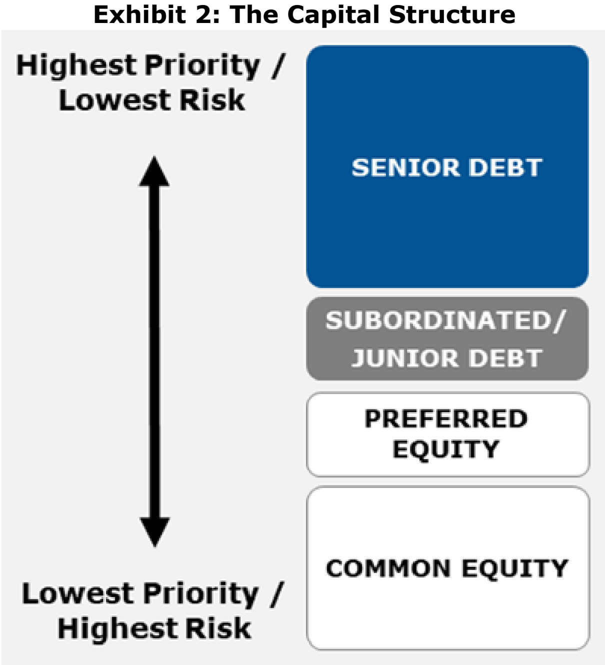
Public versus private markets

Public market investors rely on selling their assets to manage risk. In the current environment, it is a far from sustainable strategy because it relies on liquidity that may disappear when prices move lower.

In contrast, private debt transactions are designed to allow the lender and – through them - the investor to manage risk in both best and worst-case scenarios. The nature of private debt brings lender and borrower closer together. From the outset, lender and borrower develop a close relationship and use frequent reporting arrangements that allow timely responses to any change in circumstances.

Another key attraction of private debt is its ability to offer superior protection of capital because of its position in the capital structure. Loans are typically secured against assets such as property and Australian insolvency laws ensure priority of debt repayment over other liabilities lower down in the capital structure. Equity takes the first loss or – put another way – is the last to be paid in the case of a borrower becoming insolvent.

Exhibit 2: The Capital Structure



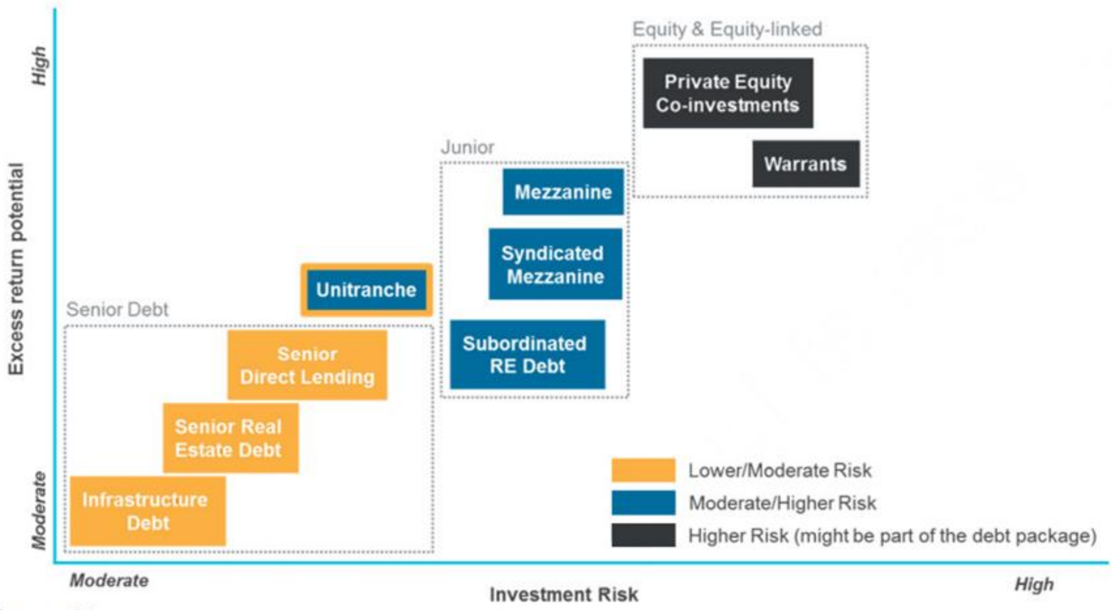
Returns across the spectrum

Loans from private debt providers typically span senior secured investment grade debt through to sub-investment grade with potential for equity-like enhancements such as warrants or options. Investors receive returns in the form of interest and fees on corporate loans paid as monthly distributions at an annual rate of about 4%, up to total returns of 10% or more after factoring in returns from equity-like enhancements.

These enhancements are usually taken as a sweetener to a particular loan and as a sign that the borrower is working to the mutual advantage of both parties. But private debt providers still assess them with the same rigorous process used to evaluate a loan.

Sub-investment grade loans do not automatically mean sub-par borrowers. A sub-investment grade loan that delivers a higher yield will usually be secured and the lender takes other measures to protect its capital such as more restrictive terms, conditions and covenants. Often a company will decide that the benefits of operating with a sub-investment grade credit profile – such as higher leverage - outweigh the costs, such as the higher price of borrowing. Lenders and investors to such companies are focused on ensuring the borrower strikes the right balance and can generate sufficient cashflows to service and repay the debt owing.

Exhibit 3: Private Debt Risk/Return Levels by Category



Source: Mercer

A lender might require the borrower to maintain certain ratios, such as net debt to earnings before interest, tax, depreciation and amortisation, or debt servicing costs to operating income that, if breached, trigger repayment or security terms. It can impose limits on equity 'cures', or injections of capital by the shareholders that, if too frequent, may indicate the borrower is having difficulty servicing the loan.

Loan agreements can also restrict dividend payments until interest and principal repayments are secured. The original focus on terms, conditions and covenants, combined with the close relationship and frequent reporting requirements allow the lender to act to protect its capital if circumstances change.

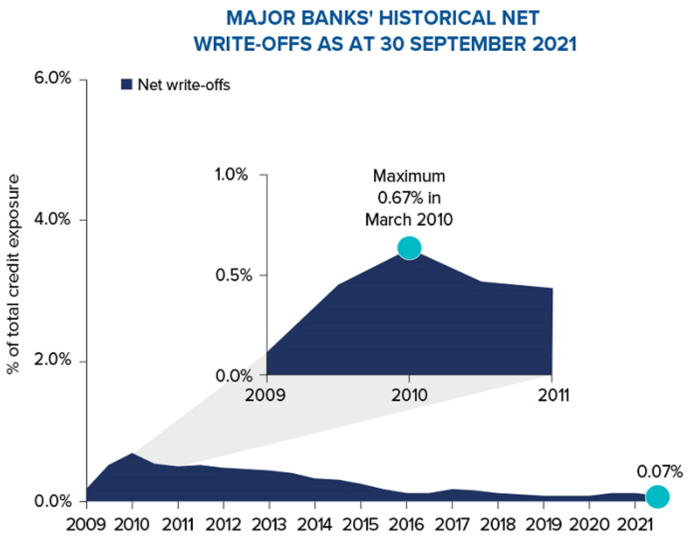
Macro conditions remain supportive

The value of this approach is highlighted in data for corporate loan exposures. As the chart shows, losses peaked at just 0.67% of total Australian business loans in March 2010 – towards the end of the GFC. Since then, they have steadily declined and were just 0.07% in September 2021, according to Bloomberg data.

The Reserve Bank of Australia Financial Stability Review in October 2021 noted that business insolvencies have declined and stayed much lower since the onset of the pandemic in early 2020.

If conditions deteriorate, such as the economy suffering a recession and increasing the risk of loan defaults, there are protections built into private debt transactions, including security

Exhibit 4: Historical Australian Corporate Loan Loss Rates



Source: Major Bank APS 330 reporting. Past performance is not a reliable indicator of future performance.

arrangements, that may act to protect investors capital. If emerging inflation pressures are sustained and trigger a rise in official interest rates, private debt investors' capital and purchasing power is protected because it is priced at a floating rate above the benchmark Bank Bill Swap Rate (BBSW).

Rising inflation that may trigger central bank interest rate increases is a growing risk to investments. Inflation readings in developed economies are at multi-decade highs, spurred by supply chain disruptions and rising energy costs, and officials at the US Federal Reserve have indicated that rate rises are coming soon. The Reserve Bank of Australia, meanwhile, has reaffirmed its intention to avoid rate moves until at least 2023 when it expects to see sustained wages growth and inflation.

The macro environment remains supportive for business, with governments and institutions focused on nurturing economic recovery and jobs growth to help the country re-emerge from the pandemic. Ahead of a Federal election this year promised personal tax cuts are due to be delivered. Re-opening the economy to international travel would also help to restore population growth, in turn spurring demand for housing and supporting the construction and property industries that are among the users of private debt.

How to access private debt

Private debt (or corporate loans) is not an asset class that investors can easily access directly, and therefore need to be accessed via a manager with scale and expertise in this market.

Investors have the option of investing in private debt via credit-focused Listed Investment Trusts (LITs) and unlisted funds. Listed Trusts provide daily liquidity, similar to shares, so investor can sell their fund units on the ASX, whereas well-diversified unlisted funds can also offer liquidity on a regular basis.

For both types of investments, there are options to suit an investors risk appetite, from predominantly senior secured loan portfolios yielding ~4% income p.a. through to equity-linked loan portfolios that provide a higher yield of ~7% with potential for upside gains through equity participation.

Andrew Lockhart is Managing Partner and Co-Founder of Metrics Credit Partners, an Australian debt-specialist fund manager, and sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. Its listed vehicles operate under the tickers MXT and MOT.

For more articles and papers from Metrics Credit Partners, click here.

Understanding and investing in cryptocurrency

Dan Annan

The market capitalisation of cryptocurrency assets surpassed US$2 trillion (AU$2.8 trillion) in late 2021. Since the initial release of Bitcoin in 2009, numerous debates have surrounded cryptocurrencies and questions about its future role have been asked. Most people do not understand how they work and the potential impact on our global economy.

The basics of cryptocurrencies

In the past, the value of a currency was weighed against the value of precious materials. Gold was usually the option of choice, with many of the world's modern currencies starting out as a form of token that signified the value of a previous metal. This has changed over time, with the value of currencies becoming tied more to the fortunes of a country and its economy. Cryptocurrencies aim to change this through decentralised finance or Defi.

Cryptocurrencies are decentralised and are not controlled by governments, countries, or any body, and the value of each cryptocurrency is based on a resource. This resource is usually computing power, generating coins like Bitcoin, Ethereum and many more.

Cryptocurrencies like Bitcoin have seen a huge surge in popularity since their launch, making them valuable to investors.

What Is Bitcoin?

Bitcoin is currently the most popular cryptocurrency, with a single Bitcoin valued at US$38,000 (about AU$53,000) at the time of writing this article. How did Bitcoin reach this point?

The original creator of Bitcoin is unknown, other than by an alias, Satoshi Nakamoto. There have been many attempts through the years to develop a decentralised form of currency, until Satoshi cracked the code to create Bitcoin in 2009. When Bitcoin hit the market, it promised to change the way that money works forever.

Bitcoin is a decentralised digital currency that does not have a central bank or single administrator. The network that Bitcoin (and most cryptocurrencies) operate on is called blockchain, the technology backbone behind cryptocurrencies.

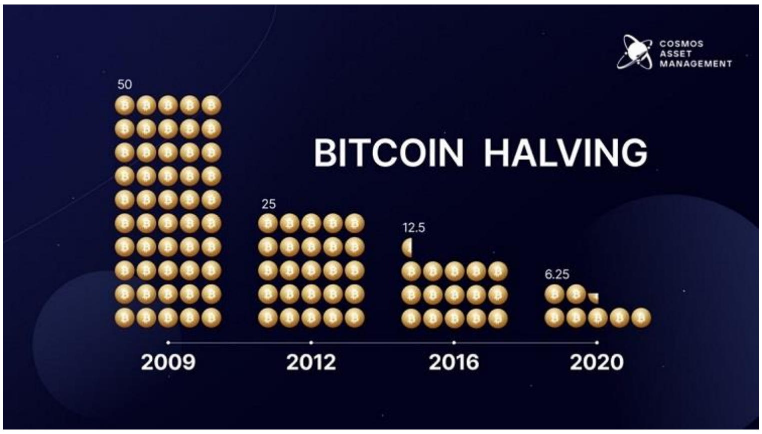
How are cryptocurrencies created?

Cryptocurrencies are created through the concept of mining. The mining extraction of gold and other metals has existed for centuries and cryptocurrency mining is the digital equivalent.

Cryptocurrency mining is required for the creation of new coins. For stable coins such as Bitcoin and Ethereum, the process involves the validation of digital transactions. Miners' computer systems work to solve numerical puzzles, essentially guessing a string of numbers in order, relating to digital coins' transactions. Once the puzzle is solved, a new block of coin (Bitcoin or Ethereum) is created and added to the blockchain ledger.

For the miners' efforts in validating transactions and providing security to the networks, they are rewarded digital coins. For example, the Bitcoin miner who solves the computational guesswork to arrive at the approximate number is rewarded 6.25 Bitcoins. This validation of transactions and rewards occurs every 10 minutes, but solving for the puzzle and winning the Bitcoin prize is difficult.

In the past, currencies like Bitcoin were minable with gaming computers, but it soon became much harder. As each block is mined, the next one is a little harder to get through, and this means that the currency's value can rise as the challenge of mining it increases.



In 2009, a single block reward was worth 50 Bitcoins. The model is engineered so that the reward is halved every four years. The last Bitcoin is anticipated to be mined in the year 2141, approximately 119 years from now.

Over the past several years, entrepreneurs and entities have realised the investment opportunity in mining digital currencies. Most people don't have access to the hardware required to mine Bitcoin and other digital coins. Globally, we now have companies known as digital miners, like Marathon Digital (NASDAQ:MARA), Galaxy Digital (TSX:GLXY), and Mawson Infrastructure (NASDAQ:MIGI). Their primary business focus on investing in top quality hardware has the sole purpose of mining digital currencies such as Bitcoin and Ethereum. Recently we have also seen top blue-chip companies such as Intel Corp investing resources to get into digital mining. Moves such as this give institutional credibility to the future uses of digital currencies and the investment opportunity.

Understanding the cryptocurrency asset class

Many people have already made their fortunes from their investment in digital coins, but like any emerging asset class, there is significant volatility. Investors must understand the risks versus rewards that cryptocurrency presents within their investment portfolios.

Over the past several years, the prices of digital currency coins such as Bitcoin and Ethereum have experienced low correlation to traditional markets such as gold and broad equity markets, delivering outsized returns. A small allocation to Bitcoin in a traditional 60/40 portfolio can be a fruitful contribution to the returns of some asset allocators. However, as this research paper from Morningstar called '*A little Bitcoin can change your balanced portfolio a lot*', the investment comes with high volatility.

The price of Bitcoin has undergone a technical correction in recent months, falling from a high of about AU$90,000 at the start of November 2021 to around AU$54,000 at time of writing. However, as a sign of its potential as well as volatility, the 12-month low in mid 2021 was about AU$38,000. In a change from the past, the price movement in Bitcoin over the past few months has been highly correlated to price changes in the US Russell 2000 index of US stocks.

Importantly, the amount of money in the stock market (estimated at US$125 trillion) dwarfs the dollar value of the entire crypto asset class, and it will only take a small movement out of stocks into crypto to achieve rapid price rises in Bitcoin along with other crypto assets. It is also worth noting that the majority of Bitcoins are owned by long term "HODLers" (Hold On for Dear Life) and liquidity in Bitcoins represents a small portion of mined Bitcoin.

Investing in cryptocurrencies

There is always a limit to the number of coins that can be generated with each cryptocurrency, and while anyone has the chance to mine them, it can take a huge level of resources to produce anything. But mining for cryptocurrencies yourself is not the only way to invest.

Global digital miners are companies listed on global exchanges with a primary focus on providing sustainable and efficient Bitcoin mining services. These listed companies provide exposure to cryptocurrencies such as Bitcoin and Ethereum.

Cryptocurrencies are here to stay and offer an alternative to the fiat money that a lot of people find easier to trust. Investor need to commit to research and learning to understand whether the crypto opportunity is suitable for them.

Dan Annan is the Chief Executive Officer of Cosmos Asset Management. The Cosmos Global Digital Miners Access ETF (DIGA) is traded on the Cboe (formerly Chi-X) market in Australia. This article is general information and does not consider the circumstances of any individual investor. Investing in cryptocurrencies involves high risk and potential investors should ensure they are fully informed in how the market operates.

Investors with interest to learn more can check the latest Bitcoin Mining Council (BMC) report here, including an analysis of energy usage focussed on renewable resources.