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Editorial

Last year, two of my close friends died, both in their late 60s. One was undergoing cancer treatment, so it was not a major surprise although he had been improving. The other suffered a heart attack while he slept at night, and his death was a massive shock. Putting aside the personal tragedy, in both cases, their estates were left to their wives who had not been heavily involved in managing their investments. Both are strong women capable of handling the stress but not everyone has their fortitude. One wife turned to the financial adviser her husband had worked with, but the other was forced to quickly pull together the financial pieces.

There are additional complexities with SMSFs. Most are managed by a dominant trustee, usually the husband, yet women have longer life expectancies. It's possible the surviving spouse will not want to continue to manage the investments, there are tax and estate implications and some assets may not be illiquid.

Regardless of personal circumstances - health or financial - we should all take the time to ensure spouses or partners know in advance what steps to take if someone dies or becomes otherwise incapacitated. Making major decisions at a time of grieving is unwise. In any case, it is a legal requirement for SMSF trustees to have a documented investment strategy and to review it regularly. All 'non-dominant' trustees should know a trusted financial adviser they can turn to.

Some people will think it is too early in their lives to worry about such a morbid subject, but do they understand what life expectancy really means? Former leading asset consultant, **Don Ezra**, explained in a recent newsletter that while most people probably know the average age at death is in the early 80s, few people know the age distribution of deaths. He wrote:

"If we don't have a rough, intuitive idea of how large the uncertainty is, we will make decisions that are totally inappropriate ... the distribution is extremely wide. That suggests that longevity is a big risk, and we need to consider it seriously, particularly those of us who are risk averse."

Ezra asked five of his friends to guess what one standard deviation of the longevity data might be. (Stay with me here. Simply put, standard deviation is a measure of variance around a mean, and one SD is about 68% of samples - in this case, ages at death - and two SDs is about 95% of samples). Ezra reports:

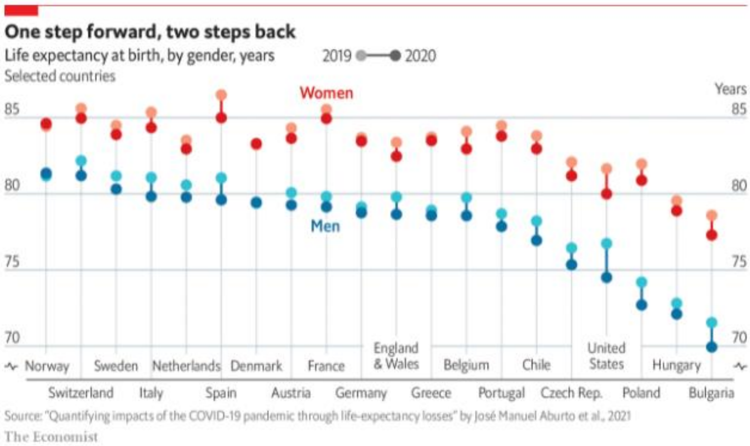
"One colleague, an actuary, clearly had the right mind-set. He said: 'A few will live to 100. Let's say that's a two standard deviation event. If the average age at death is 81, then 19 more years will be roughly two standard deviations. So, in round numbers, I'd say 10 years is the standard deviation'."

Which is about right. Most of Ezra's friends guessed too low. The point is, while life expectancy is a useful measure of how long you might live, there will be outliers like my friends who will live a lot less. We usually worry about outliving our savings but consider also if you drop off the twig earlier than expected.

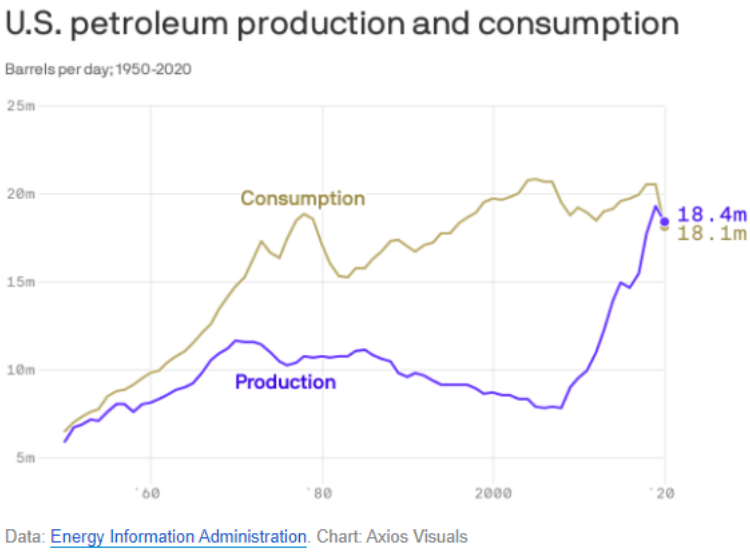
To top it off, **The Economist** reported last week that life expectancy in many countries is falling:

"To assess just how much damage the virus has done according to this (life expectancy) measure, a team of researchers based across Britain, Denmark and Germany compared life expectancy in 28 countries and Northern Ireland before and after the start of the pandemic."

This first chart shows a fall in life expectancy in nearly all countries surveyed. This must be the first time in history. For years, we have talked about living longer, and that might not be right in future.



It has been surprising to read this week how dependent much of Europe is on Russia for its energy needs. Germany relies on Russia for 50% of its gas and Austria is 100% dependent with winter coming. At US$90 a barrel, Russia earns US$1 billion a day in hydrocarbon revenues and that buys a lot of military hardware. In contrast, the US now produces enough petroleum for its own needs. It means the rise in the oil price and supply dependencies impose different economic and geopolitical implications on the US and other countries. Where the US does import oil, half comes from Canada.



In this week's edition, a welcome return to **Peter Thornhill** who updates his 'mothership' chart to prove again the [benefits of holding dividend-producing shares] instead of other assets, especially cash. Peter has no time for diversified investing, but it takes a strong risk tolerance over a long time horizon to be a true disciple.

How many people know **Stephen Jones**, the 'shadow' Labor minister in **Jane Hume's** portfolio of financial services and superannuation (although Hume has a broader remit)? Given Labor has a decent chance at the May election (current Betfair odds, **Coalition** $3.15, **Labor** $1.46), it's worth [knowing what he thinks] about super, advice and other parts of the portfolio.

There are fascinating changes underway in media which perhaps older generations of investors are not aware of. Video games are bigger than the movie industry. **Jody Johnsson and Martin Romo** explain [how traditional media is being disrupted], including some of the market's favourite companies.

While there is an obvious focus on the implications of inflation and a potential war, **Shane Woldendorp** says many companies were already falling and vulnerable due to [their expensive valuations]. They are no place to hide.

The new [Design and Distribution Obligations] (DDO) may sound arcane to most investors, and indeed, many issuers simply bury the regulations in the paperwork. But not so with bank hybrids. **Norman Derham** explains how access to this mainstay of many retiree portfolios is changing, as seen already in a new **ANZ Bank** issue.

Despite the best intentions of a well-considered asset allocation, all portfolios change as asset prices rise and fall. **Inna Zorina** suggests investors undertake a [portfolio rebalance], especially in the context of taking a 'total return' approach during low interest rates.

Michael Batnick is a US financial adviser and author who issues a regular newsletter, and last week, he featured a most-intriguing note from one of his readers. After a lifetime of investing, the reader has come to the conclusion that it's a 'colossal waste of time' listening to all the market pundits. There's at least one good reason, however, why it's worthwhile.

This week's White Paper is **Neuberger Berman**'s Asset Allocation Committee Outlook 1Q22, making the case for holding risky assets through 2022.

There was a super-lively debate on my article about LIC discounts but I need to make two things clear after readers made incorrect comments. First was the claim that ETFs don't pay franking credits, which is wrong, and the second is that NTAs don't matter for ETF prices. Not so ... ETFs are priced off NTA. However, the Comment of the Week goes to **John** on the article about short-let apartments. John confirmed how some of these properties are a disaster yet many people think they are safe investments:

"Excellent article; spot on with all the details. As a public accountant I have seen first hand and in great detail examples of such 'investments' owned by clients! The latest example showed a 32% loss (contract selling price compared to contract purchase price) over a 12 year holding period."

Follow the market trajectory and stop the usual mistakes

Peter Thornhill

(Editor's introduction: Peter Thornhill is well-known to many of our readers, mainly for advocating a multi-decade investment strategy based on the long-term merits of industrial companies for income versus nearly every other asset class. For example, to show his consistency, some of his previous articles in Firstlinks are here and here and here. In this new piece, he again checks what he calls his 'mothership' chart, which shows the long-term return from industrial shares versus term deposits. It's his way of arguing that for investors with the right risk capacity and investment horizon, there's only one place to invest).

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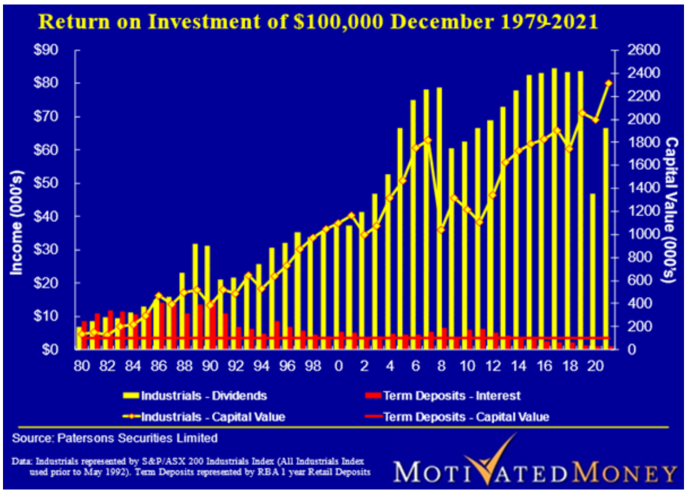
Well, it's the time of year that I look forward to the most, the new year and the updates to my presentation material. It is also a welcome distraction from the mind-numbing boredom of lockdowns, travel bans, etc.

This is my 'Mothership' comparison of industrial shares compared to cash over 40-odd years. The inevitable reduction in dividends in 2020 no doubt caused some concern but, as far as I'm concerned, it has been 'same old - same old'. The chart below spells out the reduction in dividends, a slip in share prices and the inevitable recovery of both as life goes on.



I've always said ... history repeats

Although this chart covers a narrow timeframe, it provides a glimpse of history repeating itself. The 1987 correction stands out clearly and the reduction in dividends is similar in quantum to 2020. This is followed by the dotcom debacle in 2001-02, though whilst share prices fell dividends were not affected as much of the dotcom trash was never going to be dividend paying.

Next came the GFC in 2008-09 when indices halved. Our dividends were less affected as the problem was largely a US invention. I have included below an excerpt from an earlier newsletter as the situation today is eerily reminiscent.

"It will be apparent to most observers that during the last 30 years, any sign of a 'crack' in share markets has been met with a barrage of money from central banks. This behaviour became known as the 'Greenspan Put'. The aim was to ensure that the delicate flower of capitalism known as 'consumer confidence' was never allowed to wilt.

As the public and institutions used more and more of this cheap money to fund property and other speculations, the government's efforts were gradually perverted to ensure that property prices remained propped up; in fact, continued to rise. Rising property prices had become the sole support for consumer confidence and had to be fed at all costs.

This has naturally led to a global bubble in property followed by the inevitable faux handwringing by politicians claiming they are concerned about the housing affordability crisis. The bar to entry for 'wannabee' property owners was lowered to ground level; tax breaks were offered to property speculators (negative gearing) and cash incentives were offered by some governments to potential owners. The irony is that 'dumb policy' has exacerbated the very problem afflicting their constituents.

The seeds for the current debacle were sown some years ago but naturally no one paid any attention. Allow me to quote from an article written on 30 September 1999 (yes, 1999). Space precludes quoting the whole article.

"In a move that could help increase home ownership rates among minorities and low-income consumers, the Fannie Mae Corporation is easing credit requirements on loans that it will purchase from banks and other lenders. The action which will begin as a pilot program involving 24 banks in 15 markets- including the New York metropolitan region- will encourage those banks to extend home mortgages to those individuals whose credit is generally not good enough to qualify for conventional loans. Fannie Mae officials say they hope to make it a nationwide program by next spring".

The rest is, as they say, history. Every opportunist opened a mortgage broking centre flogging loans to those who could not afford them and, eventually, some of them committed fraud.

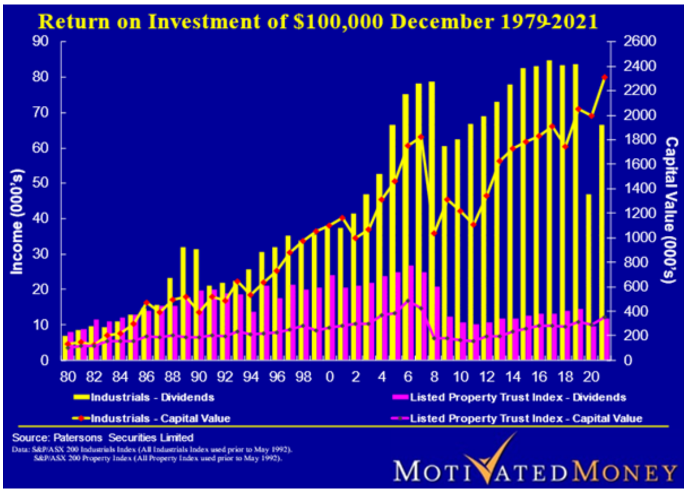
Major Wall Street financial institutions created toxic derivatives and exported them around the world ensuring that the GFC, when it arose was truly global. With a guaranteed buyer of your toxic waste why wouldn't you?"

Propping up residential property always backfires

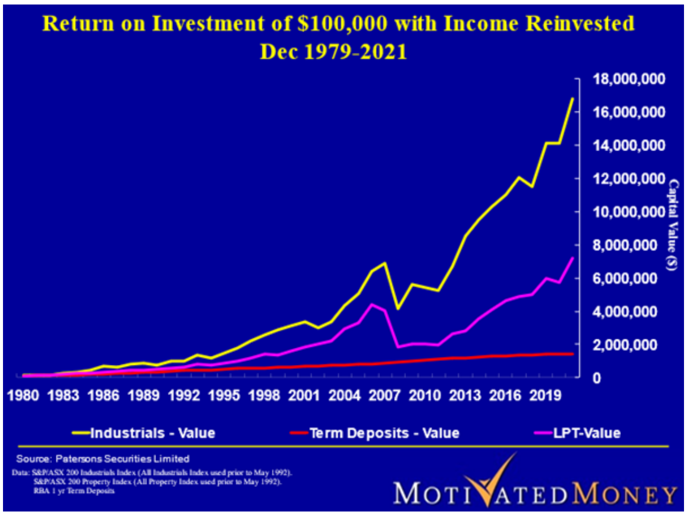
I say reminiscent as an article in *The Sydney Morning Herald* on 12 February 2022 reports on the Government's desire to help home buyers by taking a stake in the property with the would-be owners. This is in addition to grants, deposits of 2% and ludicrously low interest rates.

Continually throwing money at property is only going to make it worse, not solve the problem.

Anyone who has attended my presentations will be aware of my oft-repeated remark that history shows me that we never learn and just go on repeating the same dumb stunts over and over. The only saving grace is that business continues to flourish as it is core to the aspirations of the human race.



Let's look at the property sector vs industrials (first chart). For newcomers, LPTs (Listed Property Trusts) are now called REITs or Real Estate Investment Trusts.



It still gives me pain to listen to the finance industry telling people to invest in 'balanced' portfolios to reduce risk. At no stage do they ever tell people the opportunity cost of this. I flatly refuse to add cash and property to my assets to drag the whole thing down, see the chart (right).

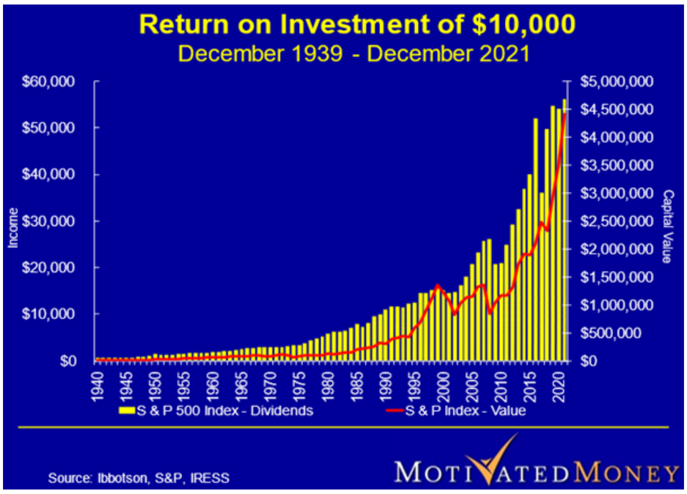
If only we could provide education to increase financial literacy and enable people to make informed decisions regarding their financial future.

The fear associated with shares is fostered by focussing on volatility. Fear is based on ignorance and if we educate, I am confident that more people will make better quality decisions.

Let's go even further back

I am restricted in what I can demonstrate using Australian shares as the Industrials Index was only established in 1979. To reinforce the value of investing in the backbone of a nation - shares - consider the chart below.

This chart speaks to me: 80 years of US endeavour despite wars, pandemics of HIV aids 2005-12, flu 1968, Asian flu 1956-58 and so on to COVID-19.



I can reproduce a similar chart for virtually all the developed countries in the world. One example is a listed investment company in the UK that has flourished for over 160 years and has supported many families over that time.

Finally, I will be commencing full day courses again in the vain hope that not everyone is frozen with fear so watch this space.

Peter Thornhill is a financial commentator, author, public speaker and Principal of [Motivated Money](). He runs full-day courses explaining his approach to investing "in the vain hope that not everyone is frozen with fear".

This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.

Who is Stephen Jones, aspiring Minister for Financial Services?

Graham Hand

Stephen Jones MP is the Labor Shadow Minister for Financial Services and Superannuation. He was elected to the House of Representatives in 2010, holds a law degree and was involved in the union movement before entering Parliament. He has been a leader on progressive political agendas. He recently came to prominence during debate on the Government’s proposed religious discrimination bill when he spoke about the suicide of his gay nephew and Jones’s worries for his 14-year-old son who wears high heels and make-up.

This is an edited transcript of a talk to clients of PritchittBland Communications on 27 January 2022.

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The pandemic has exposed some of the weaknesses within Australian society, whether in our labour market, the problems with insecure work, the over reliance in some sectors on workers from other countries, short-term workers, our supply chain fragility, or the lack of depth within our manufacturing capacity. The pandemic has also shone a spotlight on some of the social and economic strengths of Australia and the resilience of the Australian people. We've grown to honour and respect our healthcare system underpinned by Medicare in the public health system, run by our states.

One of the underlying strengths within our economy is that over my lifetime, we've transformed Australia from an economy that was in significant part driven by manufacturing to one that is now overwhelmingly in the services-based economy. We've also seen the strength of our financial services sector. The RBA stepped up and our regulators provided security to our financial markets, ensuring a flow of credit to the banks so credit was provided where it needed to be, albeit lots of businesses and households were reticent to take on additional debt.

We've seen a phenomenal transition. How many people pay cash today? That one shift in consumer behaviour has transformed payment networks. Mobile phone companies are now acting as financial services intermediaries but better regulation and the way we deal with them hasn't kept pace.

The strength of superannuation

Our superannuation sector has played a remarkable role as well. It's hard to think how we would have gone through that first wave of the pandemic without the support of the $3 trillion super industry. The early release scheme, while the concept wasn't wrong, was poorly administered. There are questions around how some of the money was used and there'll be a long-term cost of that. But $30 billion was released into the economy over a short period of time, which supported the retail sector. Many small businesses were paying their staff from their superannuation, which is a remarkable community response to a crisis.

The super sector provided liquidity to prop up some of the biggest companies on the stock market. The fund managers were seeing through the crisis, they weren't engaging in opportunistic behavior. And over the long haul, providing stability, through some very uncertain times as large shareholders providing security and stability within our financial markets.

But this is ironic. At the same time, we were relying on the superannuation system to provide ballast and support and battling the pandemic, there was a war going on against superannuation. At every level of the three pillars of superannuation - the inputs through the Superannuation Guarantee Levy, the preservation rules – there were some really wacky, crazy ideas, and they'll come around again. What was different this time, though, was they were being seriously considered at the highest levels of government. In the past, we've had Treasurers who have wacked them away and pointed out the nuts of some of their propositions, such as super for housing or super for domestic violence, but this time around, they were seriously being considered.

We didn’t need the war on superannuation as an institution from those responsible for its governance. It detracted from some serious policy debates that we needed around governance and capital deployments. The whole bandwidth was being directed around the existence of the system as a whole. For somebody who is deeply fascinated and engaged and passionate about the sector as a whole, I found that incredibly disappointing. I think we lost opportunities for a bunch of things that we could have done that would have made the recovery stronger.

Financial advice

I want to say something also about the train wreck in slow motion around financial advice and the administration, the regulation, the operation of financial advice in this country. I've been an active participant in the debates for over 10 years. Some of the core decisions were made 10 years ago that we need a professional financial advice service and we have never been in greater need of professional, competent financial advice. But FASEA was a train wreck. We need a fixing up of some obvious problems around recognition of prior learning and experience if somebody has 10 years of unblemished experience. We need those people in the industry, we shouldn't be putting them out the door. They’ve probably got more like 30 or 40 years of experience, not 10.

Australians have been retiring with more wealth than ever in our nation's history. I think about when my Dad retired, he retired with his last paycheck. In the period of my lifetime, people are retiring with a lot more than that. That is a phenomenal achievement. They need advice and need to ensure that their nest egg is working for them. They need advice that is appropriate to them to live a long, happy, healthy retirement.

Superannuation Guarantee must move to 12%

The announcements around the Retirement Income Covenant are absolutely the right decisions for a maturing system. But some tidy ups are needed, such as the SG going to 12%. We need more effort into the retirement phase, as much as we had for accumulation and the management of those savings. But the Covenant will fail if the advice place is not fixed.

Another thing raised with me, industry funds would like to see us relax some of the rules around intrafund advice. They say we should allow all funds to have vertically integrated arrangements. This is not a policy announcement but I'm telling you that I'm intensely uncomfortable with a model that looks like that. Because I think problems with vertical arrangements exposed during the Hayne Royal Commission were not just subject to one part of the industry. I think that's naive to think so.

Traditional advice business models aren't working anymore except for wealthy people, so we need other business models and other modes of delivery to ensure that we get the advice piece. It's absolutely critical.

Stop the ongoing changes in regulations

The second key message is around stability and certainty. Each and every part of the financial services sector has been through a tsunami of regulatory change over the last five years. I sit down with many of the CEOs within the sector and they pull out their regulatory change logs, and they go to pages and pages and pages and pages … individual initiatives, some of them legislative, some of them administrative, some of them ASIC-driven, a lot of it APRA-driven, some of it Treasury-driven. Labor is strongly of the view that we have to let the industry digest and implement that change.

So we don't come to the May election (it will be a May election) with this secret list of things that we want to do. Important recommendations need to be digested, but that is not a signal that we want to do nothing. Because I think there is a bunch of stuff that we need to do. But it's about the way we go about it and stability and certainty are critical. You need to know, if we are going to go through changes, you're not going to wake up and read about it in *The Australian Financial Review.* There'll be a long period of engagement and consultation about the things that need to be done ... advice, performance benchmarks of superannuation funds … we see superannuation in the financial services sector as the answer to the problem and not the problem itself. So yes, the Superannuation Guarantee must be delivered. And we'll be pressing the Prime Minister to make a definitive statement about that.

But I think there's something else. If all we are offering is certainty and stability, that’s doing about 10% of our job. Australians want more from their government than somebody whose greatest ambition is holding the job. We want a government which is able to articulate ambition for the country to make Australia even better, even wealthier, even more secure.

What does ambition for better financial services look like?

So what would it look like if we had more ambition for a vibrant financial services sector in this country, that is the engine room for another generation of productivity and economic growth and wealth creation for Australians? There are a few crucial things that have to underpin this.

The **first** thing is an understanding that in 2022, financial services is both an international and a technology industry. Unless we are investing and nurturing and generating the technology skills, we are not going to have the workforce to drive the industry forward.

And the **second** point is understanding the importance of multilateral institutions. Capital is international and multinational; we've always understood that. Certainly those who work in the industry have always understood that Australia has been reliant on international capital markets. Yes, we have the ballast of home-based savings, but we're still highly integrated into international capital markets. Whether it's marketing our products or receiving them, whether it's dealing with cybersecurity threats, whether it's accounting for or managing the risk of carbon, whether it's dealing with transnational payment systems, we have got to be active players in multinational multilateral forums.

The **third** thing is that financial services should be seen as an export. We've got Australians working in every major financial capital in the world but can be doing so much more. We fly over Jakarta to go to Beijing, but we can be doing so much more in Asia and in the Pacific as well. We should celebrate the benefits of the export and deployment of Australian capital in the same way we celebrate iron ore and our farm-based products. In my lifetime, the services sector has transformed the way our labour market works. It should be as important as any of the other traded goods or services that we normally celebrate.

The **fourth** thing is we need transparent markets and transparent rule making, not capricious, ideological, ill-conceived regulatory changes have been the hallmark of the last three years … the opposite of stability and certainty. This thing about regulating proxy advisors, you could be forgiven for thinking that was the biggest economic challenge we had in this country. It's absolutely nuts. I think it sends the wrong signal around transparency and accountability on the to the managers of capital. Can you imagine if Labor did that, and then included within the Bill a direction on how a superannuation fund could or could not invest its funds. Forced divestment. If Labor did that, it would have been laughed at. Transparent rulemaking and engaging with industry has got to be the hallmark of stable certain, competent professional governance.

National and personal interest

We think we can be deploying superannuation funds in the interests of the members who own them but also in the national interest. And we think government has a role to play. Government has an important role to play as facilitators and bringing people together, and ensuring that, particularly in the infrastructure sector, there is deal flow in certain strategic markets. There is an important role in government working with industry to create investment opportunities, not with taxpayers money, and ensuring that the national interests and the interests of the owners can be married and deployed to the better interest of everyone.

I'm keen on working really hard to show what Labor would mean for workers, businesses, participants in the financial services sector. I don't want to wake up the day after the election and think, if only I'd just done one more meeting or done one more thing to explain things a little better. I don't want to still have the shadow thing in front of my title.

Graham Hand is Managing Editor of Firstlinks and attended the talk as a guest of PritchittBland Communications. This is not verbatim but an edited transcript based on Graham's interpretation of Stephen Jones's presentation.

The future of media: It's game on, now!

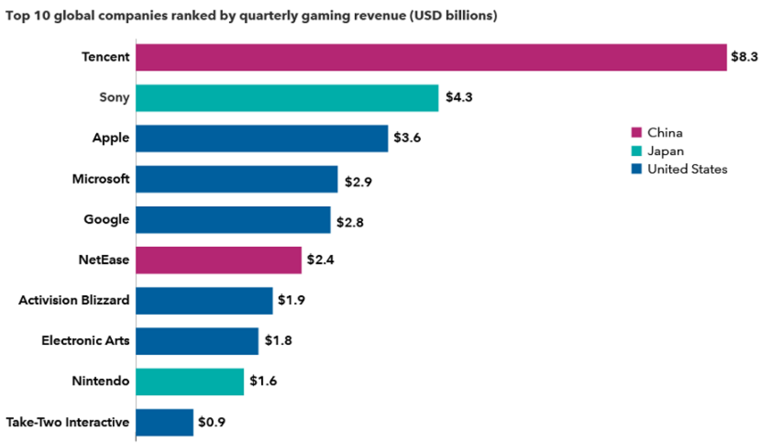
Jody Jonsson, Martin Romo

During a span of just 21 days in January 2022, the rapid pace of change in the media and entertainment industry inspired three blockbuster deals.

Microsoft announced its intention to buy video game publisher Activision Blizzard for US$75 billion, a transaction that aims to bring the iconic *Call of Duty* and *World of Warcraft* franchises under the tech giant's umbrella. Take-Two Interactive unveiled its plan to shell out US$12.7 billion for mobile game maker Zynga, best known for the *FarmVille* franchise. And Sony agreed to purchase Bungie, creator of the popular *Halo* and *Destiny* games, for US$3.6 billion.

If all three deals close, that's US$85 billion of M&A activity centred on video games, the fastest growing segment of the media sector. The Activision deal is Microsoft's largest acquisition ever and could vault it to the top of the US$200 billion gaming industry, just behind China's Tencent.

Gaming's global appeal fuels industry leaders in Asia and the US



Sources: Capital Group, Newzoo. Quarterly revenue figures are estimates by research firm Newzoo, as at 30 September 2021.

Driven in part by a pandemic-era gaming boom, the fast-changing media landscape is fundamentally transforming the way people interact and entertain themselves in a world where traditional TV viewing and movie attendance are in serious decline. That dynamic makes interactive games even more valuable to the likes of Microsoft, Sony and others. Portfolio Manager Martin Romo says:

"I think it's a testament to how powerful and alluring video games have become. The global gaming industry provides compelling entertainment at a reasonable cost and it's already surpassed the movie industry in terms of annual gross revenue. Fundamentally, I think that growth is likely to continue and even accelerate in the years ahead."

Streaming and social media competition heat up

The disruption extends to other areas of the media world, as well. Jody Jonsson, a Capital Group Portfolio Manager, says:

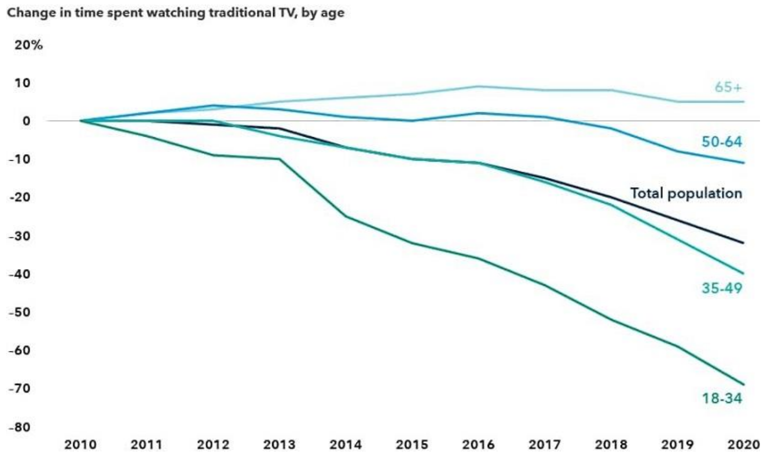
"Another big theme playing out here is that you have a lot of companies trying to get into each other's business. There was a time when they had these sandboxes all to themselves, but that's changing. Everyone is looking at everyone else's sandbox and trying to jump in."

For example, Netflix - the clear leader in streaming video - is encountering fierce competition from Amazon and Apple, as well as old guard media companies such as Disney. In less than three years, Disney's streaming service, Disney+, has grown to 130 million subscribers.

In the social media space, TikTok is challenging Facebook parent Meta Platforms, attracting hordes of young viewers thanks to the power of its short-form videos. Facebook has responded by launching its own short-form video offering, dubbed 'Reels', which is growing in popularity, just not as fast as TikTok, which was the most downloaded app of 2021.

Other battles in the media business were lost years ago. For instance, a precipitous decline in traditional TV viewership - especially among young people - raises the possibility that cable TV packages, once a must-have in the US, may no longer exist in a few years. If live sports and news programmes ever move en masse to streaming services, that could spell the end of cable TV in its current form.

Young people are increasingly shunning pay TV in the US



Sources: Capital Group, Nielsen. Traditional TV includes live TV and recordings of live TV (for example, using a DVR).

There's no business like show business

This type of momentous change and disruption may appear surprising to some, but it's par for the course in the media and entertainment biz, explains Capital Group equity analyst Brad Barrett, who has covered the industry for two decades:

"Media is always being roiled by technological change. It felt like a huge amount of change when the internet started disrupting traditional media outlets in the early 2000s. It felt huge when YouTube burst onto the scene. And then came social networking, smartphones and video streaming. They all caused a great deal of disruption and continue to do so."

A new trend is the globalisation of content production and consumption. Case in point: Three of Netflix's most popular series - Squid Game, Lupin and Money Heist - are filmed in South Korea, France and Spain, respectively. And they come with English subtitles, which had previously been a deterrent for many native-English speaking viewers. Not so anymore. Consumers are watching content from all over the world and English speakers embrace these non-English shows with enthusiasm. It's a breakthrough for global creativity.

Metaverse now?

Looking ahead, what will be the next source of media disruption?

Based on the rising number of sensationalist headlines, the metaverse is certainly one candidate. Depending on who you ask, the much touted metaverse is either the future of the internet or a virtual reality pipe dream.

As technologists have described it, the metaverse is an incredibly immersive and expansive digital world in which people can interact, transact, play games, attend concerts, watch movies, meet co-workers in a virtual office and engage in myriad other activities through user-created avatars.

The idea is so powerful it prompted Facebook to change its name to Meta Platforms, promising to transform the social media giant into a 'metaverse company'. It will have plenty of competition, however. Microsoft declared the Activision deal is, in part, driven by a desire to develop compelling content for the metaverse, a world where virtual reality headsets may become as common as smartphones.

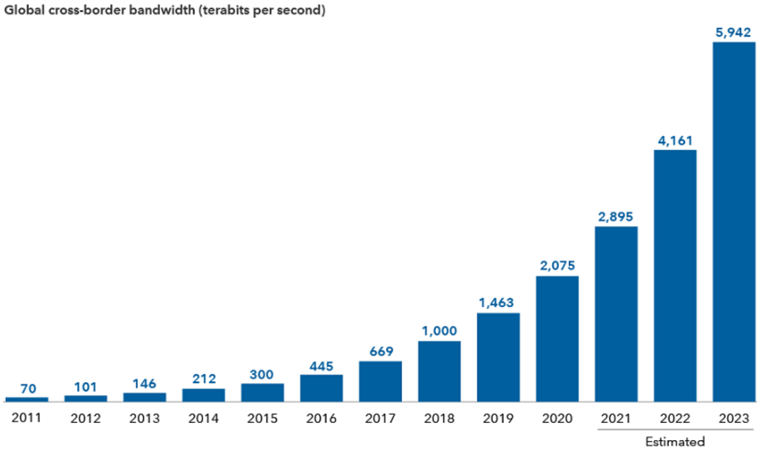
There are also many independent websites with a metaverse focus, including Sandbox, founded in 2012, and Decentraland, launched three years later. Users of these sites are already buying virtual land, virtual houses and virtual artwork, often with cryptocurrencies such as Bitcoin, Ethereum, Cardano and Solana.

The term metaverse was originally coined by Neal Stephenson in his 1992 novel *Snow Crash*. The concept was further popularised by Ernest Cline in his 2011 sci-fi novel *Ready Player One*, which was subsequently turned into a movie. One oft-cited answer when people ask, "What is the metaverse?" is to read *Ready Player One* or at least watch the movie.

Clearly, the concept has been around a while and it's not all hype, says Peter Eliot, a Portfolio Manager:

"When I ask friends what they think of virtual reality, very few have tried it. That's going to change fast, and it means the race is on for investors to appreciate and understand the metaverse. There's already a lot happening, and it's growing exponentially. I don't think this is 10 years away. It's more like metaverse now."

Bandwidth needs are expected to soar amid the growth of the metaverse



Sources: Capital Group, TeleGeography. Actual data through 2020. 2021 to 2023 are estimates.

Jody Jonsson and Martin Romo are Equity Portfolio Managers at [Capital Group](), a sponsor of Firstlinks. This article is neither an offer nor a solicitation to buy or sell any securities or to provide any investment service. The information is of a general nature and does not take into account your objectives, financial situation or needs. Before acting on any of the information you should consider its appropriateness, having regard to your own objectives, financial situation and needs.

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Why are some companies vulnerable in 2022?

Shane Woldendorp

As markets have become ever-more driven by an ever-narrower group of shares with ever-larger index weights and ever-higher valuations, the risk is biting. The pain has not been shared equally. While shares outside the US fell only 4% in January 2022, and lower-priced global 'value' shares by only 2%, the tech-heavy Nasdaq fell as much as 16%. There was an end-January bounce but markets are again sagging at time of writing in February.

More recently, the market has been concerned about inflation, rising rates and the threat of war between Russia and Ukraine. But many companies, particularly in the speculative parts of the market, were vulnerable before these recent concerns as a result of stretched valuations.

Valuations by revenue not profit

The valuations of speculative stocks may have fallen, but only from the exosphere to the stratosphere. At year-end, there were 77 companies in the US trading at over 10 times sales (that's sales, not profits). That is, 10 times all the money coming in the door before any expenses, effectively pricing the companies as though they will grow to be the next Amazon or Microsoft. After January's turmoil, there are roughly 60 companies still trading at those rich levels. That's fewer than the end of 2021, but before 2020, the record was 39.

The good news is that the market momentum of the past few years has left lots of good companies trading at reasonable prices, and on nearly any metric, the valuation gap between lowly- and richly-priced shares remains vast.

Record number of US stocks trading >10x revenue

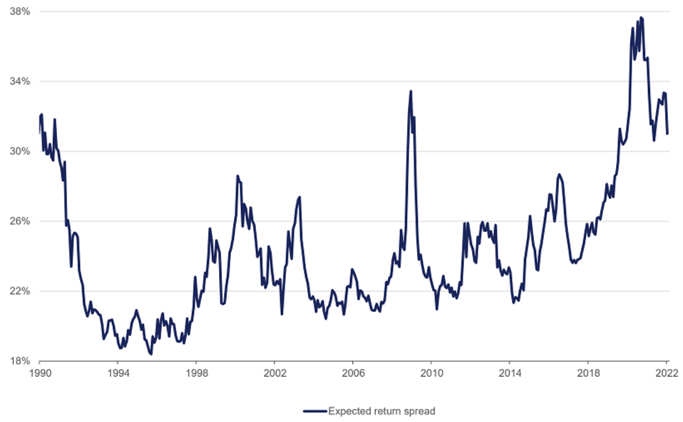
As at 21 Jan 2022. Source: Worldscope, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Price to revenue data is for the trailing 12 months.

In other words, January's market moves have simply brought valuation spreads from the mind-blowing extremes of 2020 to the merely mind-boggling extremes of 2019. The following chart shows the difference in expected returns from what we consider 'cheap' stocks in the top half versus 'expensive' stocks in the bottom half of the FTSE World Index, using our internal proprietary model.

Of course, if the trends of the last decade persist, we know what to expect. Having briefly wobbled, fast-growing US technology companies will resume their dominance of stockmarkets, benefitting from a combination of low interest rates and scarce earnings growth.

The valuation gap has narrowed recently, but remains wide

Spread of expected return between the top half and bottom half of shares in the FTSE World Index ordered by expected return



31 Jan 2022 | Source: Worldscope, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Spread is the dispersion of expected returns in the market as a whole. Expected returns are estimated using an internal proprietary model.

But what if those trends don't continue?

In the past two years, we saw a global pandemic that ground businesses to a halt, unprecedented transfers of money to individuals from government, limitless money printing from central banks, and the return of inflation high enough to frighten both central bankers and the markets that depend on them. When so much in the world has changed, it wouldn't shock us if the drivers of markets did, too.

If they do, the future may look very different from both the pandemic and the years that preceded it, and the recent outperformance of less expensive shares may have a very long way to run.

While no two sell-offs are the same, it's always useful to ask *why* the market is down. In recent years, stockmarkets have tended to drop due to some sort of economic crisis, such as the GFC in 2008, the Euro crisis in 2011, China's currency devaluation in 2015, the oil and credit crash in 2016, fear of the Fed in 2018, and most recently the pandemic lockdowns. When the threat to markets comes from the economy, the companies most sensitive to the economy suffer most.

But stocks can also go down because they simply became too expensive. If expectations get too high, and would-be sellers can't find ever-more-enthusiastic buyers, prices stall. If the market is down because overvalued stocks are getting less expensive, it is generally the most expensive stocks, not the most economically sensitive, that suffer most.

That could mean a lot more pain for richly-priced shares. In January 2022, the Nasdaq had its worst week since the initial Covid crash, falling 8% in five days. But in the aftermath of the tech bubble in 2000, the Nasdaq suffered 11 weeks worse than that in less than two years. Quick recoveries are not guaranteed.

In risky markets, what you don't hold matters as much as what you do. In the Orbis Global Equity Fund, for example, our companies have similar growth characteristics to the average global stock, in aggregate, but trade at 16 times expected earnings, versus 23 times for the MSCI World Index. And with an active share above 90%, less than a tenth of the portfolio overlaps with the Index. That's a very different portfolio of companies trading at much lower valuations.

In the long run, valuation always matters, so given the stretched backdrop and rapidly-changing sentiment, the shift within markets this month is in some ways unsurprising to us. But it is a very welcome un-surprise.

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

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Is DDO change to hybrids a bank treasurers' nightmare?

Norman Derham

(Editor's introduction: Banks are the major issuers of hybrids in Australia, and each is considering the implications of DDO regulations (explained below) on hybrid distribution. For example, ANZ Bank has decided it cannot offer hybrids to the general public and some investors may find it difficult to access new issues. For example, ANZ sent a note to holders of its Series 2 that will be replaced by Series 7, advising:

"The Offer period is expected to open on 23 February 2022. The Reinvestment Offer closes at 5.00pm AEDT on 15 March 2022 and the New Money Offer closes at 10.00am AEDT on 22 March 2022."

... but also saying any applicant must apply through a broker. When I contacted my broker on 18 February, he replied:

"Both new money and rollover applications have closed for ANZ Capital Notes 7 (ANZPE). This was open to Sophisticated Investors (must be registered as SI) from Tuesday midday until yesterday 4pm (new money) and 12pm today (rollovers). Unfortunately bids/rollover requests for these notes are closed."

As far as my broker was concerned, the whole thing was finished even before the new offer opened while ANZ said it would close on 15 March. This is a big change in distribution.

This article explains some potential implications.

***

DDO stands for Design and Distribution Obligations, and it means that certain financial products can only be sold by initial public offering or IPO to appropriate consumers. For bank hybrid IPOs, this means wholesale investors or retail investors who receive the appropriate level of financial advice. We assume there will be material negative consequences for issuers who breach the rules by issuing to inappropriate investors.

So how does this affect banks and hybrids?

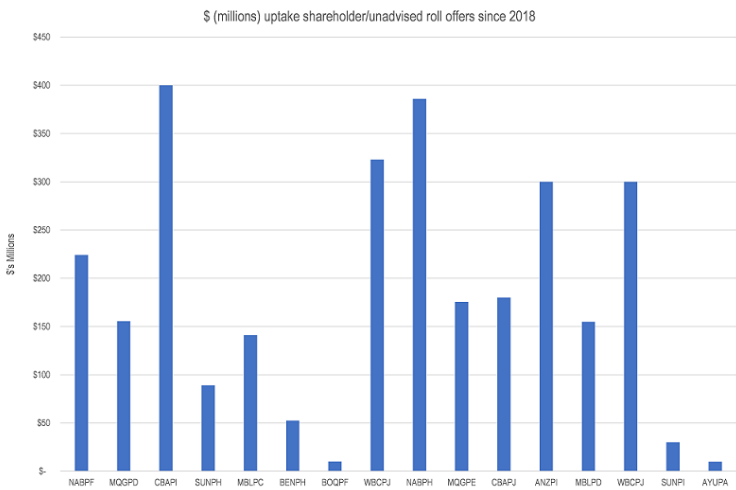
From ASIC's perspective, investors in hybrid IPOs have traditionally fallen into five categories:

1. Wholesale investors
2. Investors who receive a high level of financial advice
3. Investors who receive a lower level of financial advice
4. Investors who receive no financial advice or are unadvised
5. Investors who apply after receiving a shareholder offer

The last three categories will most likely be deemed inappropriate under DDO guidelines.

Offers to shareholders/hybrid holders/unadvised Investors who elect to rollover

The typical bank hybrid issuance process is usually a bookbuild conducted by brokers. The investor cohort includes potential new investors and existing hybrid security holders that use an adviser and wish to roll their investment. Then there is a post bookbuild process which includes shareholders and unadvised security holders who did not participate in the bookbuild. This cohort is not immaterial. The chart below shows the level of uptake in shareholder/unadvised security holder offers since 2018.



For the average major bank issue, the shareholder/unadvised cohort constituted just over $300 million or typically 18% of the total issue size. Bank treasurers loved this method of raising money because they did not pay stamping (brokerage) fees.

It looks like this category of offer type is dead. There is no way that the issuer can determine if the hybrid is appropriate for the investor. ANZ's new issue includes no unadvised existing security holder offer.

Advised Investors with inappropriate levels of financial advice

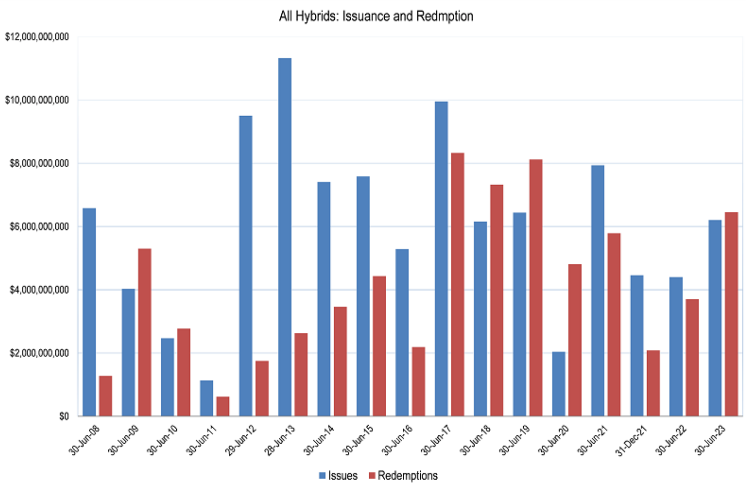
This category is trickier to analyse. Different advisers and issuers will have different thresholds as to what is required to provide a recommendation. We understand that up to 30% of demand for hybrid issues for some advisers originates from investors who will be deemed to be not appropriate because they were not receiving the necessary level of financial advice.

We estimate that the 'roll' portion of bookbuilds is around 30%-50% of the new issue and unless these investors are receiving personal advice, they won’t be able to take part in the new issue.

That's 20% shortfall plus up to 30% shortfall ... maybe 50% of previous investors are cut out of IPOs? No one actually knows as this is new ground for everybody, but there will certainly be a smaller pool of investors who can buy new issues.

What does the demand/supply outlook look like?

This chart shows issuance and maturities for the market in aggregate (which we calculate by considering the banks' current and targeted AT1/hybrid ratios and issuance/redemptions). We’ve also assumed in our 2022 and 2023 forecasts growth in risk weighted assets or RWA which will result in increased AT1 issuance (last year RWA grew by $100 billion resulting in a pro forma $2 billion of additional AT1 issuance).



Prima facie, it's not a big year of net demand for either the remainder of this year or next year, but it’s still a chunky gross amount to issue given that up to 50% of the market may have disappeared.

Why this might not be as bad as these numbers suggest

There are some potential mitigating factors:

- Maybe some of the investors who do not receive personal advice or are investor in the shareholder/non-advised rollover categories are classified as wholesale investors (it’s relatively easy nowadays to be a wholesale investor) in which case they can invest as long as the qualification is held by the broker.
- Typically, issues are heavily oversubscribed and that might be enough to fill any shortfalls. We’re sceptical about this as most oversubscription is an attempt to gain higher allocations.
- All investors, including those locked out of the IPO process, can buy the same hybrid in the secondary market on the first day of trading. This may encourage ‘wholesalers’ who buy at IPO (if the yield is sufficiently good enough) and sell on the secondary market for a profit on day one. Of course, the secondary yield is unlikely to be as good as primary.

So, what happens now?

Our inclination is that banks will need to issue at a higher margin than they did prior to DDO, either to ensure sufficient demand from qualified investors or to encourage ‘wholesalers’.

We'll soon find out. ANZ and CBA both have around $1.6 billion in issues to refinance in March 2022 and both don’t have a lot of slack in terms of their capital positions. Neither bank is positioned to abandon the issues should there be insufficient demand.

Overall, we think hybrids at IPO will be cheaper. Spread margins and return outcomes will be determined by long-run supply and demand but there may be issuance spikes.

What does this mean for investors?

For some, nothing at all. They can still bid in IPOs and elect to roll existing issues. For others, it's a big deal. They won't be able to roll existing investments or buy new issues. There are alternatives. They can buy on the secondary market or (*sales plug following*) invest in a managed fund which provides a diversified and managed exposure to hybrids. Or they can wait for the redemption amount and invest in cash or other investments.

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 under ticker EHF1.

Is your portfolio in need of rebalancing?

Inna Zorina

Summer's nearly over and it's almost time to relegate the swimwear and shorts to the back of the cupboard. Items on the 'to do' list include mentally preparing for a physical return to the office and restarting an exercise regime. Regardless of which life stage you're at, it is also good to put a review of your investment portfolio on your list and consider whether a rebalance is necessary.

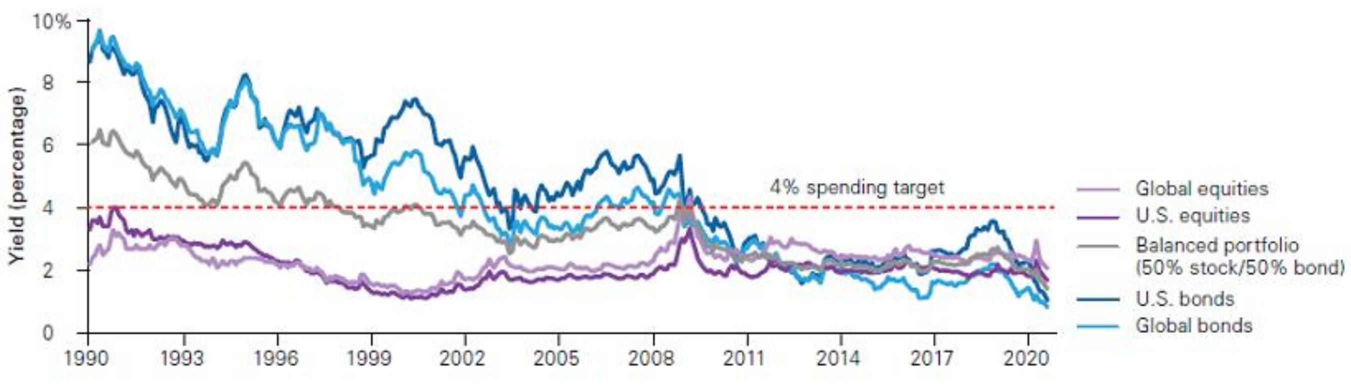
The value of rebalancing

Does the allocation of your portfolio to shares, fixed income, property and cash look right? If your portfolio allocations have shifted, such as due to the recent falls in many share prices, take this opportunity to retune your asset allocation for the eventual rebound in the stockmarket.

Or if recent market falls felt more like a downhill run than momentary ups and downs in the road, now may be a good time to reconsider your risk tolerance as it is likely that your risk appetite and asset allocation are not in sync.

The low-yield environment poses a challenge to income-focused investors who hope to use portfolio income to support spending. In the past, as illustrated in Figure 1, a broadly-diversified portfolio of equity and fixed income could generate a 'natural yield' (that is, the return of the portfolio in the form of dividends and interest) equal to 4% or 5% of the portfolio's value, consistent with conventional guidelines for spending from a portfolio. Today, that is no longer the case.

Figure 1. Yields on traditional asset classes continue to fall below 4% spending target



Notes: Yields are from January 1, 1990, to August 1, 2020. Asset classes and their representative indexes are: for global bonds, Bloomberg Barclays Global Aggregate Index USD Hedged; for U.S. bonds, Bloomberg Barclays US Aggregate Index; for global equities, MSCI World Index USD; and for U.S. equities, MSCI USA Index. The balanced portfolio is made up of a combination of the indexes for U.S. bonds (35%), global bonds (15%), U.S. equities (30%), and global equities (20%).

Sources: Vanguard calculations, using data from Thomson Reuters Datastream.

Unless investors are willing or able to make radical cuts in spending, there are two broad options to address the shortcoming of portfolio yields in meeting spending goals:

- Alter the portfolio asset allocation in search of higher yielding and potentially riskier assets, or
- Spend from capital in addition to the portfolio income yield.

For retirees or those approaching retirement, it could be tempting to increase your portfolio's allocation to equities in the hopes of making up for the shortfall caused by capital losses. But this could mean taking added risk at the most conservative phase of your investment journey and is likely not in your longer-term best interest. If you take on more risk than you can tolerate, then losing your nerve and selling out of your strategy at the worst possible time can be damaging both emotionally and also to your hip pocket.

Higher rates should eventually lead to better fixed income returns

Vanguard expects that rising interest rates will likely reduce rising inflation and create a higher real interest rate environment that could potentially provide a boost for fixed income returns. The transition to higher rates is likely to curtail the most speculative parts of the financial markets at the edges but is unlikely to upend bond markets.

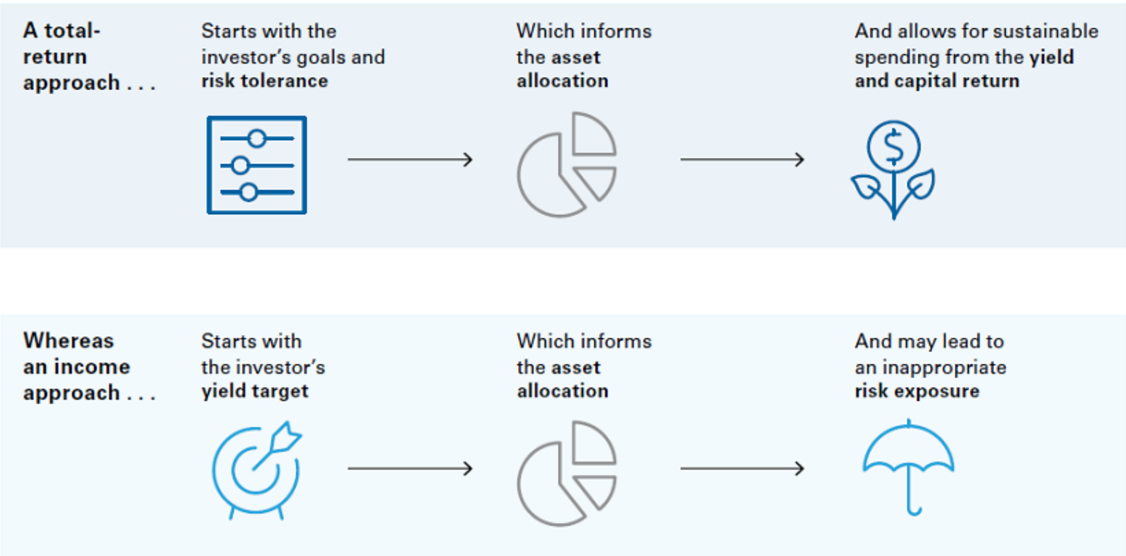
There are a few ways that you can rebalance your portfolio, but ultimately, you must decide how far you are willing to let your portfolio drift from its target asset allocation while also considering how much you are willing to pay in rebalancing costs.

The other element to consider is how you construct your portfolio. Some portfolios are designed with an income-oriented strategy in mind, with the goal of spending from interest and dividends while preserving capital. But Vanguard research has found that adopting a total return approach provides a better alternative to most investors.

The total return approach

So what is a total return approach? Instead of targeting a desired level of income, it begins with your goals and risk tolerance and then matches the asset allocation to your risk-return profile. It takes into account all sources of return from your portfolio, both income and capital (hence the term 'total return'), while controlling risks by using diversification, minimising costs and remaining disciplined over time. Then you set a prudent spending rule that sustainably supports your spending needs.

Figure 9. Total-return approach versus income approach



Source: Vanguard

As yields on traditional bond and balanced portfolios have fallen over the past 20 years, some investors opted to chase additional yield by overweighting higher income producing assets, taking on more equity or credit risk and introducing unintended factor or sector tilts.

The total return approach ensures that portfolio risk is aligned to the investor's risk tolerance, it also allows investors to control the size and timing of withdrawals, using the capital returns when necessary.

With a total return approach, the capital gains of the portfolio are spent to make up shortfalls in periods where the income yield of the portfolio is less than your spending needs or goals. This approach helps smooth out spending over time, as long as the total return drawn from the portfolio doesn't exceed the sustainable spending rate over the long term.

It also requires you to be disciplined to reinvest a portion of income yield during times when the income generated by the portfolio is higher than the sustainable spending rate. Since capital returns can be volatile, taking a long-term view is paramount.

The ongoing volatility and market turbulence can be worrying over the short term, but history has proven that those who build their portfolios in line with their goals and risk tolerance and who remain disciplined by rebalancing their portfolios back to their target asset allocation are rewarded over time.

Inna Zorina is a Senior Investment Strategist at [Vanguard Australia](), a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.

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A colossal waste of time, but what if it's fun

Michael Batnick

Introduction: Michael Batnick is a US author, podcast host and Director of Research at Ritholtz Wealth Management, focussed on developing risk management and portfolio strategies for the firm's clients. He writes a regular newsletter under the name [The Irrelevant Investor]().

A recent edition struck me as highly relevant to many of our readers who wonder whether they should manage their own investing, follow market experts or just put their money in a diversified fund and focus on something else.

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An email came in tonight with the subject line "You're my Rukeyser." It's a lovely email, filled with life lessons. I wanted to share it, and not just because it paints us in a good light.

I'm a 56-year-old college professor who grew up watching Louis Rukeyser on Wall Street Week with my Dad every Friday evening. Now I listen to you two. I can't believe the amount of outstanding content you produce, and I wanted to thank you for your contributions.

I thought an outstanding point in a recent "listener mailbag" was about the difference between "reading" through historical data and "living" through historical data. There's no substitute for experience.

I've been an active investor since I was in graduate school, and I tell my students today that the mistakes I made managing a $3k portfolio have helped me now that it is many times that. But what I tell my children is different – buy target date funds and never look at the balances.

Yes, it's a hobby, but when I think of the mistakes I've made:

-Selling Nvidia in 2008 to pay off my house
-Failing to execute on Apple at $17 because I thought it would go lower
-Panic selling in March 2020

They aren't balanced out by the successes I've had. Every major purchase (my house, my cars, vacations, etc.) I buy with cash from the profits from stock sales. This makes them 'free' – literally – everything I own is because someone was wrong and sold me a security that increased in value. That gives me some comfort, but in the end, I wish that I had just put everything into Vanguard funds instead of reading about nanotechnology stocks, FOREX trading, crypto, and every other investment fad since 1989. ***It's been a colossal waste of time.***

But you two aren't wasting your time (or mine). Your insights, humor, and friendship are infectious, and I look forward to hearing (and reading) your insights into markets and life.

Thank you for the hours of joy you've provided me and the rest of your readers and listeners. You two never discuss "bond ghouls" or where the elves see the market going, but you're my Rukeysers – trusted voices in every market environment.

The reason I shared this email, and again the praise doesn't hurt, is because I want to talk about that line, "It's been a colossal waste of time."

I think I know what this person means; had he just used a couple of index funds, he would have come out financially ahead of where he is today. There's no doubt, that for most people, most of the investments you make today will be better served in an index fund. When viewed through a financial lens, then sure, most of the earnings calls you listen to will be a waste of time. Most of the articles you read won't provide you with any real insight. Most of the charts you go through will provide a false sense of security. But does that really mean it's all a waste? All of it?

The thing that really interests me, which I've written about before, is who gets to decide what's a good use of your time? You today, or you in the future? Does regret later in life supersede how you felt at the time? And this is where my brain starts to hurt; Sure, you're the same person, but you're a different version of yourself. And again, I ask, which version gets the final say? My kneejerk reaction is to favor our older self. But you only got wiser and a better perspective on things because of the mistakes you made along the way.

This email made me think about how I'm spending my time. I'm not a great example because a lot of what I'm doing is in service to the podcast. Like, would I trade stocks and buy NFTs if I wasn't sharing it on the show? Hard to say with certainty, but probably not.

It's likely that I'll look back at this point of my life with financial regret. Why don't I just put all my money in index funds and do literally anything else with my time?

Because I enjoy it. It's fun. I may not be maximizing my money, but that's never been my primary motivation. I should point out that I'm eating my financial vegetables. I max out my 401(k), I auto contribute to various accounts. I can afford to speculate with a small portion of my money.

Time is the most precious resource on earth. It must be protected at all costs. So I understand where this listener is coming from, and I might agree with him when I'm his age, but right now, I don't view this as a waste of time. A waste of money, perhaps, but not a waste of time.

Maybe I grow out of it, and if and when I change my mind, I will change my habits. But until then, I'm going to stay overweight today. Basically all my money in the stockmarket is in index funds. I don't trade stocks in any meaningful size.

Michael Batnick is the Director of Research at US-based Ritholtz Wealth Management LLC. For disclosure information please see here. This article is general information and does not consider the circumstances of any investor. Republished with permission.