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Editorial

Whether it's '*The future ain't what it used to be*' or '*It's tough to make predictions, especially about the future*' or '*It ain't over 'til it's over*', these and many other gems are attributed to **Yogi Berra**, a great US Hall of Fame baseball catcher. Yogi tried to explain, "*I never said most of the things I said*" and that the quotes were made up by 'newspapermen' (these days, we would blame the 'media') but nevertheless, we love to use them.

But there's one Yogi-ism that does not have much applicability in financial markets at the moment: '*It's like deja vu all over again.*' (deja vu translation: 'already seen'). There's a lot we have not seen for a long time.

The cash rate in Australia has never been lower, but it will start to rise after the May election. Globally, negative bond rates made up 30% of global bond indexes in 2021 but it's now down to 5% as decades of falling rates are over. The US Treasury 2-year versus 10-year yields spread is at its most deeply-inverted for 15 years. Governments around the world have never bought so many securities but that is also ending. Commodity prices such as for coal are at 20-year highs, while lithium is at record levels. The war in Ukraine threatens global peace and nuclear attacks more than any time since World War 2.

Where once we saw a future of smaller governments, now we face a more intrusive and bigger public sector. Most people in the world now live in an autocracy, while **Donald Trump** is the bookies' favourite to win back the Presidency in 2024 and who knows how divided and aggressive the US will become. **Putin** in one corner, Trump in another ... oh, dear!

Not much *deja vu* in that lot.

Yet despite all these threats, global equity markets remain near all-time peaks, with the major market measured by the S&P500 recovering much of the early 2022 losses.

The threat of a world divided is thwarting previous moves towards closer global links and trade. Europe is struggling to replace the 40% of its gas needs which come from Russia as increasingly the 'iron curtain' is rebuilt. Closer to home, there is a threat of a Chinese military base in the Pacific which demands billions more be spent on defence than previous budgets allowed.

And let's not forget the ongoing impact of the pandemic. Look at how the shutdown in Shanghai is affecting the movements of goods as there are normally about 100 boats waiting to unload and it is currently over 300.

While some fund managers are on the right side of these disruptions, such as those backing resources and energy, others have misjudged the changes. For example, between the start of November 2021 and end of March 2022 (five months), the ASX200 Total Return index was up 4.5%, but the ASX200 Resources Index rising 34% was offset by the ASX All Technology Index down 19%. That's a 53% difference in two sectors of the ASX Index. Never *deja vued* before.

Amid all this, there is reason for optimism in Australia. One big hope for our economy and Federal Budgets, as well as many companies and fund managers, is that the resources boom continues. The global gas crisis is a boon for local producers such as **Woodside. Mark Taylor,** Senior Equity Analyst at **Morningstar**, says:

"We anticipate Woodside's near-term earnings to soar due to higher prices for hydrocarbons but in particular to uncontracted LNG."

The massive upside has already fed into the Budget deficit improvement announced by **Josh Frydenberg** last week. Exports of resources including energy are expected to reach $425 billion in FY22, or 50% more than forecast, feeding a $100 billion improvement into the Budget coffers.

Australia is a major beneficiary of the growth of EVs, and lithium carbonate prices in China have risen from US$10,000 a tonne in July 2021 to US$75,000 now. The share prices of companies such as **Pilbara Metals** have increased 10-fold in two years. While carmakers are scrambling, Australian miners are developing new mines and raising fresh capital to fund future growth. In a sign of the times, **GM and Honda** have just announced a technology-sharing partnership aimed at producing millions of EVs priced at around US$30,000 by 2027.

Resources have a boom/bust reputation but these are reasons to expect success to run for many years, although see **Ashley Owen**'s article on this. Imagine the Budget impact if Australia had introduced the proposed Minerals Resource Rent Tax with a 22.5% tax on super profits. **Norway** now has the largest sovereign wealth fund in the world with US$1.4 trillion in assets based on its 78% tax on income from North Sea oil. In the US, the **Senate Budget Committee** is considering proposals to tax the windfall profits of major oil companies at a rate of half the difference between their current profits and their *average profits between 2015 and 2019.* There is no hint of a resources tax in Australia by either major party going into an election.

Meanwhile, back on the good news, this from the **Australian Actuaries Institute**:

"During 2021, with COVID-19 public health measures, there were only 2 deaths from influenza compared to 840 expected; pneumonia deaths were 31% lower than expected, and across all respiratory diseases deaths were 17% lower than expected."

Graham Hand

In this week's edition ...

What do you expect from your active fund manager? They must select stocks away from index weighting to achieve outperformance, but there is a business temptation to play it safe and hug the index. If you are paying for active management, you want a manager with the skill and risk appetite to back strong convictions, but do you know if your fund manager is really having a decent go?

While the war rages in Ukraine, many pundits have turned their attention to China and Taiwan. **Jason Hsu** was born in Taiwan and his parents still live there. He argues that much of the commentary on the parallels lacks a deep understanding of the political reality in China and Taiwan.

Many investors have soured on bonds and instead seek their fixed interest exposure through hybrids. **Matthew Macreadie** outlines some unique risks to hybrids and urges investors to take a more pragmatic approach when assessing the risk-return trade-off.

The history of commodities prices is riddled with price rises followed by surplus supply causing price falls when new supply or alternatives catch up to and then overtake demand. **Ashley Owen** takes a look at the history of commodity prices and explores how investors can get the timing right on commodities pricing cycles.

When will the election be called? With the Federal Budget done and dusted, and the May deadline looming, we have two pieces focused on politics. One thing's for sure: **Noel Whittaker** was no fan of last weeks' cash splash in the dash for the polls. And with tens of billions being spent on the age care sector and more to come, **Louise Biti** says neither political party has addressed the election killer issue of consumer contributions. She believes individuals need to start the hard conversation about frailty planning.

Finally, Australia's age pension rose in March reflecting inflation and the growing cost of living pressures. This represents the biggest increase in the payment in almost a decade and **Rachael Lane** walks us through the changes to the rules.

This week's White Paper highlights the investing behaviours of **Vanguard**'s clients in 2021, the differences between men and women and generations as well as Covid-related investment trends.

We received many comments on last week's article on the return of conflicted selling fees, where we explained that some financial advisers and brokers are switching their business models towards 'wholesale' clients and reducing investor protections. Among the responses was **Judith Fox** of the Stockbrokers and Investment Advisers Association (SIAA) with a link to their recently published white paper, 'Does the wholesale investor test need to change? It is included in the comments on the article.

Track if your fund manager is taking the best shot

Graham Hand

After an extraordinary career guiding Amazon to the peak of global retailing, former CEO Jeff Bezos delivered a final message in 2021 that was "*of utmost importance I feel compelled to teach*". He wanted all his staff and shareholders to "*take it to heart*".

It contains relevance for fund managers about distinctiveness and keeping alive the skills and risk appetite that make them special. Both retail and professional investors should also take it to heart when talking to the people who look after their money.

Focus more on tracking error

Most asset managers conduct public-access webinars or events, including Q&A sessions, while a more privileged, one-on-one contact is granted to professional analysts. It's a time to learn how fund managers construct their portfolios.

While every meeting, public or private, features fund performance and macro trends, analysts delve more into specific measurement metrics. Some of the numbers, such as the Sharpe Ratio or Information Ratio (and heaven help us, kurtosis and skewness) may seem a little arcane, but tracking error is easy to understand, yet it is rarely discussed in retail presentations.

It’s a useful concept which deserves a regular check. Put simply, tracking error shows how closely an active portfolio follows its benchmark index. It measures the active risk due to decisions made by the portfolio manager. It should not be called an 'error', as it should be the result of a conscious action.

For a cap-weighted index fund, such as an Exchange Traded Fund (ETF) designed to follow a standard index, the tracking error should be as low as possible. A competent index provider should have processes which ensure index replication wherever possible. For example, the five-year tracking error for the Vanguard Australia Share Index Fund is a low 0.43% but it is 4.32% for the Vanguard Australia Shares High Yield Fund. The latter is not trying to track the broad index.

For active managers, a low tracking error should be the kiss of death. They should be having a crack - or if you prefer, swinging the bat or giving it their best shot - weighting and selecting stocks away from the index. Nobody should pay high active fees for a low tracking error fund.

For an active fund, what’s the right number?

Jeff Bezos’s final letter to Amazon shareholders

Let’s digress before returning to that question.

Jeff Bezos's business acumen changed the face of retailing around the world and created a company by the end of 2020 with 1.3 million employees, 200 million Prime members, 2 million small and medium-sized businesses selling in their store and wealth creation of almost US$2 trillion. He wrote his first letter to shareholders in 1997, and his final in 2021 when he left as CEO.

Here is a long quote from Bezos’s final letter:

“This is my last annual shareholder letter as the CEO of Amazon, and I have one last thing of utmost importance I feel compelled to teach. I hope all Amazonians take it to heart.

Here is a passage from Richard Dawkins' (extraordinary) book The Blind Watchmaker. It's about a basic fact of biology.

"Staving off death is a thing that you have to work at. Left to itself – and that is what it is when it dies – the body tends to revert to a state of equilibrium with its environment. If you measure some quantity such as the temperature, the acidity, the water content or the electrical potential in a living body, you will typically find that it is markedly different from the corresponding measure in the surroundings. Our bodies, for instance, are usually hotter than our surroundings, and in cold climates they have to work hard to maintain the differential. ***When we die the work stops, the temperature differential starts to disappear, and we end up the same temperature as our surroundings.*** *Not all animals work so hard to avoid coming into equilibrium with their surrounding temperature, but all animals do some comparable work. For instance, in a dry country, animals and plants work to maintain the fluid content of their cells, work against a natural tendency for water to flow from them into the dry outside world. If they fail they die.* ***More generally, if living things didn't work actively to prevent it, they would eventually merge into their surroundings, and cease to exist as autonomous beings****. That is what happens when they die." ...*

We all know that distinctiveness – originality – is valuable. We are all taught to "be yourself." What I'm really asking you to do is to embrace and be realistic about how much energy it takes to maintain that distinctiveness. The world wants you to be typical – in a thousand ways, it pulls at you. Don't let it happen.

You have to pay a price for your distinctiveness, and it's worth it. *The fairy tale version of "be yourself" is that all the pain stops as soon as you allow your distinctiveness to shine. That version is misleading. Being yourself is worth it, but don't expect it to be easy or free. You'll have to put energy into it continuously."* ***(my bolding)***

It’s the same for active fund managers

Investors should apply the same principles to their active fund managers. Any with low tracking errors of 1% or 2% are replicating their surroundings, and to use the Dawkins analysis, their funds deserve to die. That is not what they are paid to do. They should take a view that differs from the market, or they should pack up and save their clients the active fees.

The problem is often acute in large funds where, having spent years building a business and collecting loyal clients, the temptation is to remove the business risk of underperformance. Some large funds have small tracking errors, where the fund managers have decided there is career risk in losing money and index returns are sufficient. Management has decided, to use Bezos's words, *"to bring us into equilibrium with our environment."*

Funds industry veteran, Chris Cuffe, wrote in this article:

"It's astounding in Australia the number of managers who won't risk being too different from the index. If they underperform for a short period due to departure from the index, they worry they will lose funds (and maybe their job will go as well).

I listened to an active Australian equity manager tell me how proud he was of being index-unaware, yet his exposure to financials was 27%, not the 30% per the index. This is not an active position at all and he is surely being driven by the index. I would think that a position of half or double or nil is more like an active view.

The best investors I deal with are totally benchmark unaware, even as to what markets they invest into, local or overseas or cash or whatever.

The lack of willingness to be different from a benchmark has a lot to answer for in encouraging mediocre investing across the world. The dominance of these behaviours is far greater than anyone will admit. It drives many professionals to bizarre investing."

What is a reasonable tracking error for an active fund?

Tracking error is a measure of how actively a fund is managed. It is calculated as the standard deviation of the difference between the returns of the portfolio and the returns of the benchmark.

The index might be considered the neutral starting point for portfolio construction, and the tracking error informs the investor what to expect in variations from the benchmark. It's also an explanation of a fund's volatility not caused by market beta.

An active manager should accept a tracking error of at least 5% and 10% is considered normal. According to Fidelity, the tracking error of the median fund using the US S&P500 as a benchmark is 9.1%. A number such as 20% or 30% is expected from a manager taking strong bets in a concentrated portfolio.

Jose Garcia Zarate, Associate Director of Passive Strategies at Morningstar, writes:

"A useful analogy to understand these concepts is that of a race between two cars, where one car is the index and the other is the fund. Tracking Error tells you how close the two cars were to each other during the race."

He gives the following example to calculate the tracking error:

- Tracking Error = Standard Deviation of (P–B)
- P = the return of the investment
- B = the return of the benchmark

Assume there is a fund benchmarked to the ASX200 index with fund and index returns as follows over a five-year period:

Fund Return (P)	ASX200 Return (B)	Series of Differences (P-B)	% Differences
11%	12%	(11-12)%	-1%
3%	5%	(3-5)%	-2%
12%	13%	(12-13)%	-1%
14%	9%	(14-9)%	+5%
8%	7%	(8-7)%	+1%

The standard deviation of this series of differences, the tracking error, is 2.8%. If the sequence of return differences is normally distributed, it can be expected that the fund will return within 2.8%, plus or minus, of its benchmark approximately every two years out of three. This manager is a benchmark hugger.

Investors should also expect a fund with less volatile investments, such as bonds and loans rather than equities, to have a lower tracking error.

Here is a sample of active equity fund tracking errors. Measuring over time may show whether the manager is changing active bets.

Tracking errors of selected Australian funds over different time periods

Fund (ASX code where relevant)	1 year (%)	5 year (%)
ETFs		
VanEck Aust Equal Weighted (MVW)	3.46	3.54
Vanguard Aust Shares High Yield (VHY)	5.99	4.32
BetaShares Dividend Harvester (HVST)	4.06	8.71
LICs/LITs		
AFIC (AFI)	4.74	2.90
Argo (ARG)	4.48	2.74
Cadence (CDM)	19.41	12.68
Djerriwarrh (DJW)	5.60	3.62
Forager (FOR)	13.25	14.85
Ophir High Conviction (OPH)	21.65	na
Pengana International (PIA)	9.28	9.46
Perpetual Equity (PIC)	13.88	10.12
Platinum Capital (PMC)	13.58	9.93
QV Equities (QVE)	9.18	8.72
VGI Global (VG1)	9.89	na
WAM Capital (WAM)	6.40	6.37
Managed Funds		
Magellan Global Open	4.29	6.58
Magellan High Conviction	9.36	9.04
Pendal Aust Shares	9.64	14.48
First Sentier Equity Income	9.44	12.38
MFS Global Equity	11.59	11.67
Tribeca Global Resources	17.36	23.66
Fidelity Australian Equity	12.98	14.71
Australian Ethical Aust Shares	13.44	15.49
Orbis Emerging Markets	11.69	12.78
Montaka Global Long Only	18.87	14.54
Plato Australian Shares Income	11.11	14.44

Source: Morningstar Direct database, benchmarks vary by fund.

As investors should hope and expect, some of the smaller boutiques such as Montaka, Tribeca Resources, Ophir, Forager and Cadence are having a good go. Their clients should appreciate that there will be significant divergence from the benchmark, as they are high conviction managers. The long-established LICs such as AFIC and Argo are closer to their benchmarks, but also cheaper and safe and reliable options. The big active managers tend to sit somewhere between, but names such as Fidelity and Australian Ethical are taking decent bets. ETFs by nature are closer to benchmarks.

In summary, individuals select active fund managers to outperform, and that is only possible if positions are taken away from the index. A tracking error of 1% cannot achieve much, and it’s not worth paying active fees.

But don't complain if a boutique fund manager with a high tracking error delivers a bad year. It is an inevitable part of diverging from safety.

Next time you are at a presentation, ask about the fund's index and the tracking error. If it's not at least 5%, ask why the manager is not having a decent go. If it's over 15%, expect wide variations but at least you know what you're paying for.

Final words from Bezos

If Jeff Bezos had gone into funds management, you can be sure there would be high tracking errors and no index hugging, but he goes much broader than that. He implores all of us to be distinctive.

"I would argue that it's relevant to all companies and all institutions and to each of our individual lives too. In what ways does the world pull at you in an attempt to make you normal? How much work does it take to maintain your distinctiveness? To keep alive the thing or things that make you special?"

Graham Hand is Editor-at-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor.

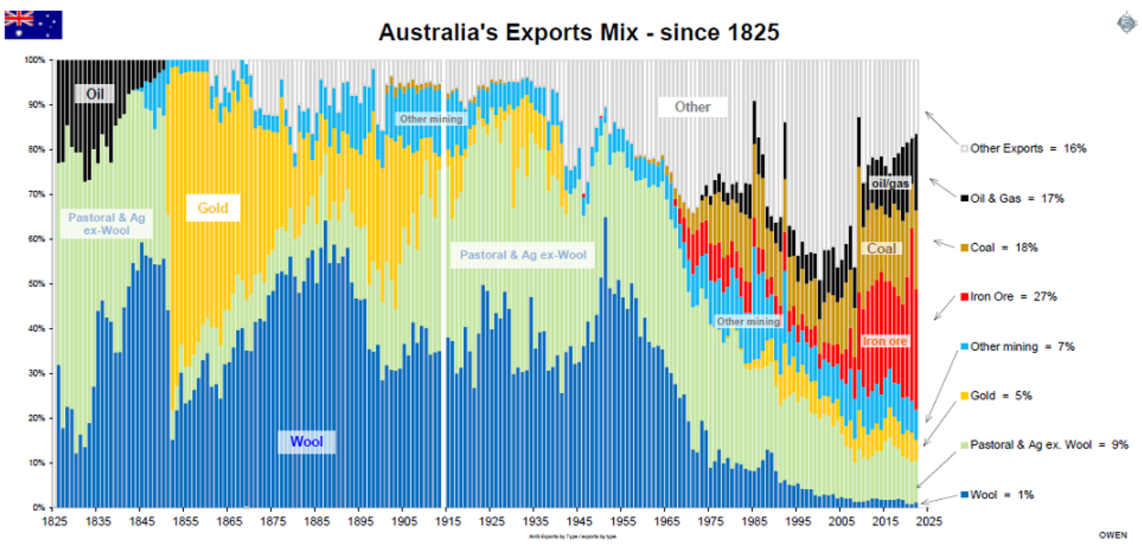
Australia's bounty: is it just diversified luck?

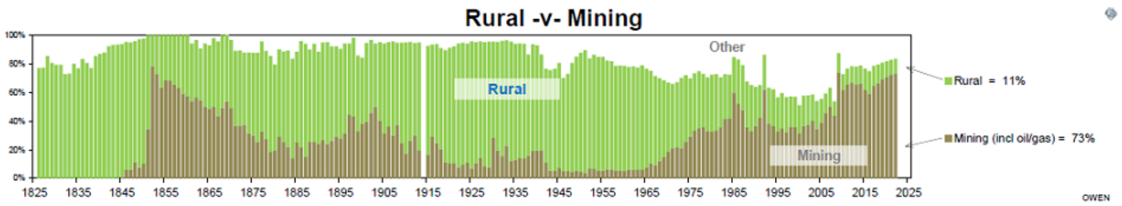
Ashley Owen

Aside from fuelling global inflation, rising commodities prices are particularly good for commodities exporters like Australia. Last week's Federal Budget was little more than a vote-buying cash splash, funded by unexpected windfall mining royalties and taxes.

The rise in commodities prices over the past two years has been a combination of increasing global demand as the world recovers from Covid lockdown recessions, and also favourable supply restrictions, especially in the case of our two largest export earners – iron ore and coal, and now gas with the Russia-Ukraine war. China has been extending its restrictions on its imports from Australia since the trade war began in 2018 and especially over the past year, but these have mostly been picked up by other buyers across Asia.

Post-settlement Australia has always relied on raw commodities exports to raise the foreign exchange needed to import everything we need for our daily lives. Unlike most 'banana republics', Australia has been blessed with a host of different types of commodities – from the land, the earth beneath the land, and the sea. Here is our updated chart of Australia's export mix over the past two centuries. It is a remarkable story of dramatic shifts in our export mix over time – starting with oil (from whales and seals!), to crops, wool, then gold and base metals in the 19th century, back to pastoral, wool and crops for most of the 20th century, then the rise of East Asia built with our coal, iron ore and base metals after WW2, and back to oil and gas. This illustrates not only our vast diversity of resources, but also the ability to adapt and prosper from changing global economic and political conditions.

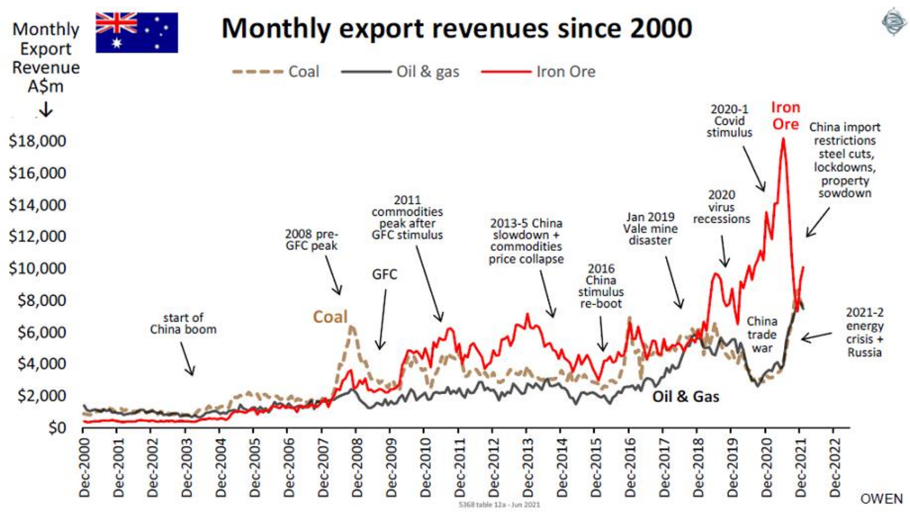




The second chart shows the changing mix between rural and mining exports. Rural has dominated for most of the whole period, with the notable exception being the 1850s gold rush. The turning point was 1960. At the time, wool made up 50% of total export revenues, but the lifting of the iron export embargo in 1960 diversified the export base and dramatically reduced Australia's vulnerability to the vagaries of the weather. Mining finally overtook rural in the mid-1980s and has dominated ever since. Australia may have got rich riding the sheep's back, but it is a far more diversified and robust export mix now.

Australia's commodities export revenues

The next chart shows monthly export revenues from the three 'big ones' (iron ore, coal and oil/gas) since 2000. Iron ore prices and revenues had an extraordinary spike after the Vale mine closures at the start of 2019. The Covid restrictions catapulted Australia to overtake Brazil as the world's largest iron ore exporter, and also overtake South Africa as the world's largest exporter of coal. While China's restrictions have hit coal and agricultural exports, and now iron ore, it has not all been bad news. Despite rising Canberra-Beijing tensions, China has now overtaken Japan as our largest LNG buyer.



How long will the commodities boom last?

In the case of most commodities, the current price spikes are probably temporary. Most of the spikes are due mainly to supply constraints with a range of causes, from Covid lockdowns, unrelated disasters (like mine tailings dam collapses), trade war restrictions, a host of unrelated weather events, and now the Russia-Ukraine war. In time these supply constraints will ease.

The global shift to renewables has also led to elevated prices of old fossil fuels for probably longer than anticipated.

The bigger picture is that price rises always trigger increased investment in new sources of supply and in alternatives. New developments always take time, stretching from a few months to many years in some cases. The history of commodities prices is riddled with price rises (for whatever reason) followed by surplus supply causing price collapses when new supply and/or alternatives catch up to, and then overtake demand. The price collapse leads to bankruptcy of some producers (which reduces supply), and a hiatus in new development. Meanwhile rising demand (from rising populations and rising living standards) slowly but surely catches up to, and over-takes supply, causing prices to rise once again. This kicks off the whole cycle in an endless cycle of booms and busts fuelled by these supply time lags.

The key to success with investing in commodities markets (and producers) is understanding these commodities prices cycles and getting the timing right.

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

We need hard conversations about frailty planning

Louise Biti

Observers of this year's Federal Budget would have thought it was light on aged care reforms, and they'd be right. But I'd remind them that last year's Budget delivered an aged care reform package with a five-year timeline. This year, the government reinforced its commitment to that plan and committed an additional $20.1 million in funding. That brings the total additional spend to $18.8 billion over five years, on top of the $21.5 billion-plus per year we already spend on aged care.

Whether enough is being spent on aged care, or whether we're spending the money in the right places, is a contentious issue. But you can be sure this year's Federal election is gearing up to be a debate on aged care:

- The current Government is promoting its current program of reform – i.e., the five-year plan that is already one year into reform
- The opposition is promising improvements in services and care
- Unions are pushing for wage rises
- The aged care industry is pushing for more funding to help stem the operational losses arising from increasing costs of care and wage pressures, and
- The general public are confused.

What the Government announced

In this year's Budget, the Government reconfirmed its commitment to the five-year plan announced in the 2021 Budget. This included a five-year, five-pillar package of reforms.

Demand for home care continues to increase, and the next tranche of 40,000 new home care packages (to be released over 2022-23) will continue to increase availability and reduce waiting times. While waiting times have reduced by approximately 25%, the reality is that waiting time for a Level 3 or Level 4 package is still estimated to be 6-9 months.

Navigating home care should be easier when the current Commonwealth Home Support Program (CHSP) and Home Care Packages are combined into one new Support at Home Program from 1 July 2023. Details are yet to be developed, with advisory committees and older Australians providing input into the development.

In residential aged care, concerns around adequate funding levels continue to dominate discussions. Last year, the Government introduced an additional supplement of $10 per day per resident to help care providers improve the quality of services, particularly food and nutrition. This $10 came with increased reporting requirements to provide data on services provided.

A new funding model to reset the cost of care for residents is currently being trialed (called AN-ACC), with implementation set for later this year. In this year's Budget, an extra $20.1 million in funding was announced over the next three years.

The 2021 Budget also committed to a minimum of 200 minutes per day of care on average for every aged care resident.

Across the 2021 and 2022 Budgets, the government has committed to reforms costing $18.8 billion over a five-year period, and these reforms picked up on 126 of the 148 Royal Commission recommendations, with 12 more under consultation.

Labor's Budget reply

The Budget reply from Labor outlined an intention to improve aged care, based on recommendations made by the Royal Commission:

- A mandatory requirement to have a registered nurse on site at all times
- A minimum of 215 minutes of care per day for every aged care resident
- Support for the 25% pay case lodged by aged care workers with the Fair Work Commission, and a commitment to fund the outcome
- Better food for aged care residents
- Increased powers for the Aged Care Quality and Safety Commission and increased reporting requirements for aged care providers.

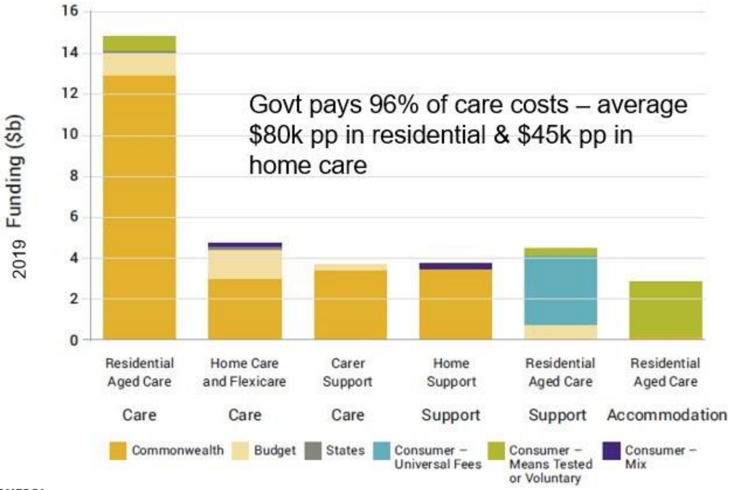
Labor has costed this reform package at an additional $2.5 billion over four years. But, this does not include funding pay increases for aged care workers. Given that wages represent around 70% of the costs for residential care, any wage increase will require significant amounts of extra funding and well over the $2.5 billion quoted.

Who is going to pay?

Neither party has addressed the 'election killer' issue of consumer contributions.

The government (which means we as taxpayers) currently pays 96% of all care costs – across the combined areas of home care and residential care. Whether consumers can afford to pay more and whether they should pay more are big questions still looming on the horizon.

The options any government has to increase aged care funding are:



Source:
Actuaries Institute, *Aged Care Funding: Assessing the options and implications*, Green Paper, Dec 2021. Figure 4.1.

- Increase tax revenue
- Reduce spending on other areas to redirect to aged care
- Raise an aged care levy (like Medicare levy) to fund aged care as suggested by the Royal Commission
- Dive further into debt
- Shift some of the cost to consumers, or
- Create efficiencies within the aged care system to reduce cost pressures.

The costs of aged care will only continue to increase as the Baby Boomer generation moves into their frailty years, increasing not only the demand for services but also higher consumer expectations around quality of service. Add to this an increasing level in the care needs of those who make the move into care.

Whichever party comes to power in May, there is a chance that in the new mini-Budget or the Mid-Year Economic and Fiscal Outlook statements we might expect to see some reforms to consumer contributions.

What individuals need to do

We need to start the hard conversations about frailty planning. Aged care is no longer an issue that can be ignored when planning for retirement. If people are not prepared for their frailty years, it can leave them exposed for around 15% - 25% of their retirement. This is a major gap. Australians need to start planning for how to contribute towards their cost of care. Even today, with money and financial resources the range of choices is wider and provides better quality of life.

Louise Biti is a Director of Aged Care Steps.

Budget cash splash will do more harm than good

Noel Whittaker

It was always going to be an election budget. There are some good things, but the cash handouts are fiscal irresponsibility at its worst. Think about it: the Treasurer revealed a deficit of $78 billion over the forthcoming 12 months. This is money we, as a nation, must borrow.

One of the first rules of good money management is to avoid bad debt and use good debt. Bad debt is when we borrow for consumption. Think travel, clothing or a wedding. Good debt is when we borrow for assets such as property and shares – things that will provide lasting benefits. I have no problem whatsoever with governments borrowing for roads, infrastructure and items that have a long-term payback, but I see no point in cash handouts for the sole purpose of getting the government back into power.

Take the decision to cut petrol excise by 22c a litre for six months. Petrol accounts for no more than 4% of most household budgets but it's always in the news, and thanks to huge display signage, is one of the few commodities for which everyone knows the exact price. The price of petrol can generate strong emotions but there are other ways to reduce the cost. The major motoring organisations have associations with petrol stations to provide a discount of between four and five cents a litre. And there are apps such as the 7 Eleven fuel app, which lets you lock in today's fuel price for the next seven days with no penalty. We've been using it for years and saved a bundle.

Where I live, it's normal for petrol to fluctuate by 30c a litre or more over the cycle. So, you can expect your 22c a litre discount to vanish in the next few cycles. Even though this measure has been announced as being for six months only, the cost will be a staggering $3 billion – all borrowed. Think what you could do with $3 billion towards flood mitigation programs.

Then there is $1.5 billion used to give 6 million welfare recipients a once-only payment of $250. Let's face it, that kind of money won't change their lives one bit. Wouldn't it be better to use that kind of money to provide better dental facilities or improve aged care?

These are just expensive band-aids. They won't do anything to slow down inflation, which is the actual problem. Despite the official figure of 3.5%, I am told the average rise in groceries like red meat and vegetables is nearer 10% – ignoring the current post-flood highs. A cash payment of $250 now, combined with six months of slightly less expensive petrol won't do a thing to change it.

The big issue about to be felt by most Australians is interest rates. We are in a unique position where inflation is running hot and interest rates are at historic lows. It's a virtual certainty that we'll see at least an interest rate rise of a full 1% in the coming year. Thanks to low-interest rates, and rapid housing price rises, the average mortgage in Australia is now a breathtaking $600,000. A rate rise of just 1% would add $6000 a year or $115 a week to the average family's mortgage repayments. How will people cope with that?

There are also budget moves to help first homeowners, but the problem with all these schemes is that they drive up house prices by increasing the number of potential purchasers. And it gets worse. The government is encouraging single parent homebuyers to borrow on just a 2% deposit, with no mortgage insurance. In that scenario, a person can buy a home costing $400,000, with starting equity of just $8,000. Offering home loans to couples with a 5% deposit is bad enough, to entice single people to borrow with just a 2% deposit is as bad as it gets. At least a couple may have the income of one of them to fall back on if for some reason one of the breadwinners is unable to work. Single people don't have that luxury. Think what would happen if that house falls in value by just 10% – and this is not unknown, especially in some regional areas – they are $32,000 underwater. If they're forced to sell the property because of rising interest rates they could be suffering a big capital loss. It won't affect the lender, who is covered by the government's own mortgage insurance scheme. So how does that help struggling homebuyers?

Let's have some straight talk. The global financial crisis was born when President Bill Clinton instructed mortgage lenders in America to reduce lending standards so that poorer people had a chance at homeownership. Consequently, hundreds of thousands of Americans were lured into buying homes they couldn't afford, and most of them lost what little they had. That's the last thing we want to happen in Australia

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. Email: noel@noelwhittaker.com.au. This article is general information and does not consider the circumstances of any individual.

Why I'm not afraid for Taiwan

Jason Hsu

Many pundits are speculating that Russia's aggression will embolden China to invade Taiwan. As is often the case, this speculation comes mostly from a casual reading of the popular press. As the founder of an investment firm specializing in greater China with offices in Taipei, Shanghai and Hangzhou the China-Taiwan relationship is always front of mind.

I was also born in Taiwan, my parents still live there and I am a Professor in International Finance at the Taiwan National University of Political Science.

In short, I monitor the Taiwan situation very closely. And my view is that while Russia's invasion of Ukraine is a terrible tragedy, it is likely to improve, not exacerbate, the China-Taiwan problem. There are four reasons I feel this way.

Reason 1: The cost of conflict

Beijing, as advised by its more militant faction, has been testing U.S. resolve ever since Biden took office. The biggest risks during this period have been:

(1) accidental engagement during 'fly-over' provocations, and

(2) over-confidence of an easy victory if conflict escalates.

But Russia's invasion of Ukraine has given Chinese analysts numerous data points to re-consider the costs and risks of full-on conflict with the West. At the same time, the Ukrainian conflict has provided the dovish faction, which prefers diplomacy and peaceful reunification, talking points to restore balance in the conversation on Taiwan.

It has become increasingly likely that Russia's invasion of Ukraine will end in strategic failure—even if a face-saving victory can ultimately be claimed by Putin. Beijing is watching keenly and is taking note. The West knows that as well. Perhaps, Beijing could tolerate significant military losses to invade Taiwan. Perhaps, Beijing is willing to ignore its own citizens who would not support substantial casualties to Taiwanese citizens, with whom they share a common, language, culture and heritage. But, the cost and scope of the crippling sanctions being applied to Russia and its oligarchs has forced Beijing to reconsider the economic and political cost of an invasion of Taiwan. In fact, because of China's greater economic entanglement with the West, comparable sanctions levied against China could hurt far more than they will against Russia. China is the world's biggest seller and creditor. It has now realized that the West is not beneath seizing assets and denouncing debt in a spat. Russia's invasion of Ukraine has proven how costly it would be for China to follow suit in Taiwan.

Reason 2: The value of peace

Even as the cost of war becomes evident, the value of a peaceful China-Taiwan relationship is growing. In the coming months, China will have a chance to ascend as the more sensible and mature leader of the global communist brotherhood. The West will work with China and honour Beijing for managing and reining in Russia's belligerence. Indeed, Western leaders are openly appealing to Xi to help negotiate with Putin to end the conflict in Ukraine. The West is well aware of the bigger game being played in the shadows. If China stays on the fence, even if it isn't perfectly sincere in its neutrality, the world could stave off an undesirable plunge into Cold War 2.0.

Western leaders have been willing to interpret China's abstention from the UN resolution to condemn Russia as "an encouraging sign" of rational neutrality rather than support for Putin. The EU thus far has pursued an approach that is polar opposite to the popular press. The media has quickly painted China as an affiliate of Russia in forming a new front against the West. The EU, publicly, has only focused on China's neutrality, its critical role in bringing about peace and its unique ability to foster a dialogue with Putin. The West knows the harm of pushing the world's second largest military and economy to join "Putin's Axis of Evil".

It is in everyone's interest for China to be Switzerland, at a time when even Switzerland has stopped wanting to be Switzerland. Being the swing vote, the player who can change the balance of power with a simple tilt is a newfound global influence that Xi has craved since taking office. It will also be a lucrative global role for China that the leadership in Beijing would not want to jeopardize.

It is a foregone conclusion that Russia will widely adopt CIPS (China SWIFT), and it will likely adopt RMB as its primary reserve and settlement currency. China will likely be the biggest buyer of Russian crude, natural gas and palladium. In fact, Russia's Gazprom just announced a new pipeline deal, which will deliver 1.8 trillion cubic feet of natural gas a year to China via Mongolia.

There is an enormous economic advantage to being the only viable buyer for the world's most important resources from Russia. There should be little doubt that China will also seek to establish itself as a top exporter of derivative materials based on petroleum and palladium—essentially playing intermediary to facilitate critical resource trading with Russia that global economies are not ready to forgo.

This newfound geopolitical role will be a bonanza for China. Xi will use this influence to establish his legacy as one of China's most transformative leaders. Mao established the Party; Deng opened up China and brought prosperity; now Xi has transformed China into a true global superpower. The political and economic value of China's "swing vote" role, and the value that role presents to Xi in the coming years, far outweigh the value of a costly invasion of Taiwan now. After all, Taiwan will always be a stone throw away; the island isn't going anywhere. China's marine and naval capabilities are converging toward the U.S. over time. The value of patience is substantial.

Reason 3: The role of dissent

It is important to recognize that while Xi is the undisputed leader of the CCP, he is not the Party. Beijing is not China. There are powerful factions, some visibly soft-spoken and others, influential in the shadows. Many underestimate the complexity and the delicacy of Chinese politics and the political process by naively assuming a one-man show. Note that the previous two presidents (Jiang and Hu) are both still alive and their sphere of influences remain; they are respected party elders, who have elevated many of the most powerful members in the party and in the military. And the princelings each represent a powerful influence within the party. Some control regional politics and resources, and others different military units inside China's massive but decentralized armed forces.

Potentially the most important internal battle between China's powerful political elites is on the proper path forward for China as it continues to emerge and leverage its significant economic and geopolitical influence. The show of force from the West is extremely valuable as it provides an example of a collaborative diplomatic approach to the doves within the CCP. In isolation, the West's muscle flexing does little to deter the hawks in China who want a fight and are committed to ignoring rational analysis. Plenty of people in China and in the top echelon of the CCP are willing to speak for peace, prosperity and diplomacy out of either purpose or rational self-interest. Don't underestimate that influence.

Reason 4: The impact on Taiwan politics

Predicting politics is a dangerous game, but Beijing will likely spend the next few years observing what impact Russia's invasion of Ukraine has on local Taiwan politics. Prognosticating on Taiwan elections is one of Beijing's favourite activities. Taiwanese voters' sentiment toward the mainland ultimately drives the internal debate inside the CCP regarding eventual peaceful re-unification or armed invasion.

The West's response to Russia's invasion of Ukraine not only provides data points to Beijing's military top brass but also to the people of Taiwan. Many Taiwanese voters likely have concluded that "U.S. support" won't translate to military support for Taiwan in an invasion. Cutting China off from SWIFT is quite a bit different from having the U.S. Pacific fleet get in between PRC's advancing forces and Taiwan.

This uncomfortable realisation may help the struggling KMT (the opposition party) in the upcoming Taipei City mayoral election, which often sets the tone for the presidential election afterward. KMT's advocacy for a better relationship with China and respecting the "one-China" policy has been its chief weakness but may be shifting into a strength. Certainly, the incumbent DDP party's assumption of U.S. military protection has come under serious challenge by local media pundits observing the tragedy unfolding in Ukraine and its very direct implications for Taiwan.

The potential shift in public sentiment and the fortune of the KMT party in the next election will dictate Beijing's calculus as much as any Western economic sanctions and military might on the reaction to Putin's aggression.

Conclusion

Whatever one may think of China's values or political system, its leaders have thus far seemed to have made rational decisions. I expect them to continue doing so. Russia's invasion of Ukraine has laid bare the military, economic and political cost of a unilateral invasion, which will undermine China's hawks and strengthen its doves.

Equally, the lack of Western commitment and actions to deter Russia's military advance will weigh heavily on Taiwanese politics as the path of diplomacy with Mainland China or antagonizing Beijing are again debated. The war in Ukraine has likely reduced the delusion that lives in the mind of both the Beijing hawks and the supporters for Taiwan independence.

This gives hope to a less antagonistic relationship, when those eager for a fight reassess the true cost of a fight. More importantly, the current situation presents to Xi a unique opportunity to ascend as one of the most important global leaders—he will be counted on to reign in Russia by the West and he will be Russia's best and only hope to avoid complete economic collapse if international sanctions remain. Both will reward China and honour Xi for playing the middle well.

Thus, I predict China will deescalate with Taiwan in the coming years because it simply has too much to lose by invading – and too much to gain through patience.

Jason Hsu is Founder and CIO at [Rayliant Global Advisors](), and Portfolio Manager of Rayliant ETFs: $RAYC and $RAYE. Republished with permission from the author's LinkedIn newsletter—[The Bridge]().

Addendum: This piece was originally penned on 5 March 2022 to address concerns over how the invasion of Ukraine might exacerbate a potential conflict between China and Taiwan. For those asking my opinion, I predict China will deescalate with Taiwan in the coming years because it simply has too much to lose by invading—and too much to gain through patience. In the three weeks since this article was originally published, my conviction in this conclusion has only strengthened.

Hybrids alongside corporate bonds a good balance

Matthew Macreadie

In today's low interest rate environment where term deposit rates have remained sustainably low, investors have been attracted to the regular distribution payments and higher-return profile from hybrids. However, despite their many positive features, hybrids do carry higher risks versus Australian corporate bonds - which many investors don't realise.

While allocating a small portion to hybrids can be effective, an approach highly focused on this asset class will pose problems. There are three primary risks to hybrids that will be explored:

1. Hybrids historically have had a higher correlation to equity markets
2. Hybrid debt issues are less frequent than Australian corporate bond issues
3. Hybrids have significant call risk relative to Australian corporate bonds

Our suggested approach would be to adopt a diversified portfolio with adequate exposure to Australian corporate bonds alongside hybrids. Particularly in today's environment, we place an emphasis on downside protection during market turbulence – like we have seen in the past few months.

There's no doubt hybrids have a place, though the current returns from hybrids (especially financial hybrids) do look on the expensive side on a risk-reward basis. The yield to expected maturity/first call on bank hybrids are around 3-4% (unfranked). We believe five-year bank hybrids offer better value at around the 5-6% mark (unfranked).

1. Hybrids historically have had a higher correlation to equity markets

Over the GFC period, bank hybrids experienced close to a 20% drawdown (or price decline), which was primarily attributable to capital losses from the discount margins on these securities increasing from around 1% pre-GFC to around 5.5% post-GFC. Using this as a proxy for the current environment, if discount margins were to increase from the current 2.75% to around 5% over the next year, the capital loss would be around 6.5% offset by 2.75% income – thus, a drawdown of around 3.75%.

The recent experience for bank hybrids has been more muted. Bank hybrids are down by around 2-3% (in price terms) over calendar 2022 YTD compared to the ASX200, which is down by closer to 10%. On the other hand, the Australia corporate bond index has outperformed being down by around 1-2% (in price terms).

The GFC period was highlighted by:

1. A fear of economic slowdown/banking crisis
2. Protracted equity market weakness, and
3. Large drawdowns (bank share prices falling by 20% plus).

The current sell-off is different in that it has revolved around higher inflation/higher interest rates alongside the Ukraine/Russia conflict.

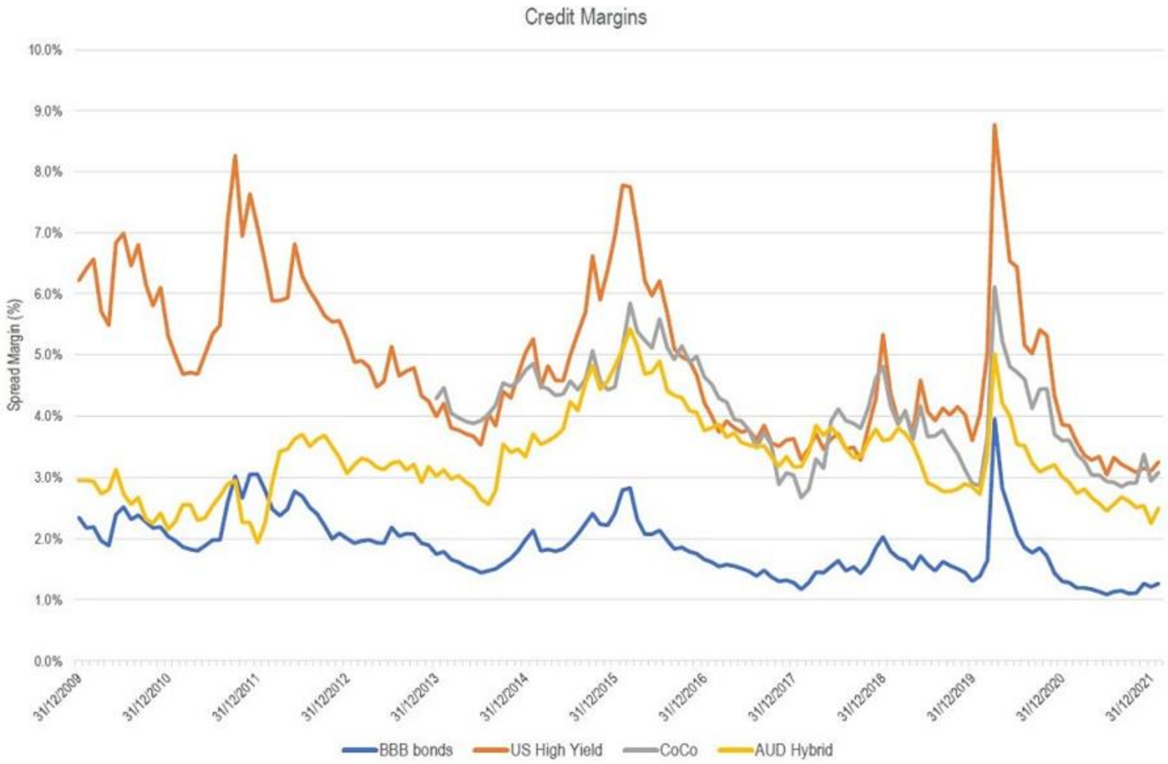
Table 1. ASX Listed Bank Hybrids

Abbrev	Security Name	Chg net ytd	Px last	Yld ytc mid	Is perpetual	Industry sector	Cpn	Currency	Callable	Nxt call dt
ANZPI	ANZ 2.57599 PERP	-2.7	102.3	5.09	Y	Financial	3.18	AUD	Y	20/03/2028
CBAPJ	CBAAU 2.57619 PERP	-1.6	101.2	4.89	Y	Financial	2.905	AUD	Y	20/10/2026
NABPH	NAB 2.57619 PERP	-2.0	104.4	5.14	Y	Financial	3.66	AUD	Y	17/12/2027
WBCPK	WSTP 2.57619 PERP	-1.8	101.8	5.27	Y	Financial	3.08	AUD	Y	21/09/2029

Source: Bloomberg

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

While BBB rated bonds do have some spread volatility (albeit, less so than AT1/hybrids), the bulk of the Australian corporate bond market sits in the A rating and above. A rated bonds have historically had very low spread volatility and risk-reward characteristics are better given potential drawdown risk.



Source: BofA, ICE

2. Hybrid debt issues are less frequent than Australian corporate bond issues

The Australian corporate bond market has grown by more than 40% since 2010. Currently, there are over A$1 trillion Australian corporate bonds outstanding across governments, semi-governments, asset-backed securities, financial and non-financial corporates, inflation issuers, and hybrids.

However, the hybrid market is only a tiny segment of the Australian corporate bond market at around A$47 billion or 5% of Australian corporate bonds outstanding. Most of the debt issues are classified as 'convertible preference shares and capital notes' and issued from several financial institutions (mostly the major banks and Macquarie) – which also creates significant concentration issues with the Australian banking sector.

In years past, hybrids were also used by corporates (for example, Crown, Nufarm, and Qube) to obtain a level of equity credit for which to improve credit metrics. Rating agencies have since made this process more onerous on issuers, which, alongside issuers being able to get cheap funding from the corporate bond market, has seen a tailing off in corporate hybrid supply.

The issue hence becomes one in which investors can only get exposure to hybrids via the banks. As debt issues are less frequent in nature, replacement of capital then becomes very difficult, which poses reinvestment risk.

Generally, the hybrid market is also not a heavily secondary traded market – the number of trades per day is around 1,500 with a value of approximately A$700 million. For example, the bid-offer spreads (i.e., the difference between the market price at which the hybrids can be bought and sold) for CBA hybrid securities can be larger than those for its shares.

Australian Bond Segments

Month: Feb-22 **Trading days:** 20 **Period ending:** Monday, 28 February 2022

Snapshot by Category

Australian Segment Bond Segment	Number listed	Market Cap ($m)	Trades Total (#)	Trades per day (#)	Volume (#)	Value $m
Convertible Preference Shares and Capital Notes	44	43790.9	28,385	1,419	4,722,879	642.0
Convertible Bonds	6	318.0	241	12	1,813,460	6.0
Hybrid Securities	4	2875.2	2,105	105	68,395	56.2
Total	**54**	**46984.12**	**30,731**	**1,537**	**6,604,734**	**704.2**

Source: ASX Hybrids monthly report, February 2022

3. Hybrids have significant call risk relative to Australian corporate bonds

The perpetual nature of many hybrids (especially the financial hybrids) means there is essentially no guarantee of getting your money back and thus no reliable yield to maturity (%). There are 'reset periods' with 'reset margins' but there is no end date for getting paid back. For this reason, investors are generally better placed to assess the running yield (%) for that period and then make a judgement as to whether they are comfortable or not.

Call risk also tends to rise in a higher interest rate environment as the issuer can hold onto old, low-rate hybrids rather than issuing new hybrids which have a higher rate of interest. Generally corporate bonds have a hard bullet maturity. All-else-equal, investors can be comfortable with the yield to maturity (%) on offer.

The other issue is that if a hybrid isn't redeemed it's probably going to be a result of wider market turbulence. So, if an investor wanted to exit, they'd be selling into the eye of the storm and potentially running into liquidity issues and realising a sizeable capital loss to do so.

Matthew Macreadie is a Credit Strategist at Income Asset Management, a sponsor of Firstlinks. To discuss this topic further and access corporate bonds please reach out IAM. This article is general information and does not consider the circumstances of any investor. Please consider financial advice for your personal circumstances, including eligibility for these investments.

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Age pension is increasing: what you need to know

Rachel Lane

Australia's age pension rose in March reflecting rising inflation and the growing cost of living pressures. This represents a pay rise of just over 2% and is the biggest increase in the payment in almost a decade.

Single pensioners will be $20.10 better off per fortnight, and couples up to $30.20 per fortnight (where both members of the couple are eligible).

Indexation also means that some people who were previously ineligible for a pension may become eligible as the cut-off amounts of assets and income are also increased.

But older Australians receiving aged care need to know that an increase in the pension also means an increase in their Basic Daily Fee. This means they'll only see $4 of the $20 pension increase.

In this article, we'll walk through the changes step by step and what they mean for you.

Payments

The maximum rate of age pension payment for singles increased by $20.10 per fortnight from $967.50 to $987.60. The maximum rate for couples increased by $15.10 each from $729.30 per fortnight for each eligible member to $744.40.

A couple where both members are eligible to receive the maximum payment can receive $1,488.80 per fortnight or $38,708.80 per year combined.

Per fortnight	Single	Couple each	Couple combined	Couple apart due to ill health
Maximum basic rate	$900.80	$679.00	$1358	$900.80
Maximum Pension Supplement	$72.70	$54.80	$109.60	$72.70
Energy Supplement	$14.10	$10.60	$21.20	$14.10
Total	$987.60	$744.40	$1488.80	$987.60

Source: Services Australia

The assets and income level before pensions are disqualified under the means tests have also increased.

Assets

For homeowners who are single, the asset test cut-off increased from $593,000 to $599,750. For couples it increased from $891,500 to $901,500.

For couples who are separated by illness, as is the case when one or both move into aged care, the cut-off increased from $1,050,000 to $1,063,500.

*It's important to remember that the value of your home is not included in these assets.

Income

For singles, the amount of income you can earn before the age pension ceases has increased from $2,115 per fortnight to $2,155.20. For couples, the cut-off has increased from $3,237.20 per fortnight to $3,297.60.

*It's important to remember that income earned under the work bonus (up to $7,800 per year) is not included. Income from investments is based on deemed income, rather than the actual income earned.

In announcing the changes Minister Anne Ruston said, "*This is putting money in the pockets of all Australians who rely on our social security system and, in particular, older Australians.*"

But older Australians receiving aged care, whether that's a Home Care Package or residential aged care, need to know that an increase in the pension also means an increase in their Basic Daily Fee.

The Basic Daily Fee you pay towards your cost of aged care is set based on a percentage of the Age Pension. In a Home Care Package, the maximum Basic Daily Fee is set at 17.5% of the basic Age Pension (and applies to people on a Level 4 Package) it was $11.02 per day and has increased to $11.26 per day from 20 March.

In a Home Care Package, the Basic Daily Fee is based on the level of your package:

- Level 1 was $9.88 per day increasing to $10.08
- Level 2 was $10.44 per day increasing to $10.66
- Level 3 was $10.74 per day increasing to $10.97
- Level 4 was $11.02 per day increasing to $11.26

So, if the fortnightly pension increases by $20.10, up to $3.36 will be needed to meet the increased cost of a home care package.

In residential aged care, the Basic Daily Fee is set at 85% of the basic Age Pension, it was $53.56 per day, increasing to $54.69.

This means that the Basic Daily Fee increase is $15.82 a fortnight, so of the extra $20.10 in Age pension, people living in aged care will only have $4.28 per fortnight to cover increases in their cost of living.

While the Basic Daily Fee does cover some of the cost of living in aged care such as meals, utilities and insurances, many aged care residents need to pay extra or additional service fees to cover alcohol, food, entertainment, and personal services. Personal expenses such as clothing, medications, health care, other insurances, transport, and communication costs remain the responsibility of the resident.

A $4 per fortnight increase in the Age Pension for people living in aged care is definitely a pay cut, not a pay rise.

Rachel Lane is the Principal of Aged Care Gurus where she oversees a national network of adviser dedicated to providing quality advice on retirement living and aged care. She is also the co-author of a number of books with Noel Whittaker including the best-seller 'Aged Care, Who Cares?' and their most recent book 'Downsizing Made Simple'. To find an adviser or buy a book visit www.agedcaregurus.com.au.