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Contents

Five features of a fair performance fee, including a holiday *Graham Hand*

Ned Bell on why there's a generational step change underway *Graham Hand*

Meg on SMSFs: Powers of attorney for your fund *Meg Heffron*

The great divergence: the evolution of the magnetic workplace *Liyanage, Bennett*

Bank reporting season scorecard May 2022 *Hugh Dive*

Why gender diversity matters for investors *Nash, Guido*

Is it all falling apart for central banks? *Canobi, Siniakov, Rout*

Editorial

With some share prices down 80% and funds off 30% from their peak, there are plenty of investment professionals looking for ways to explain performance. All fund managers have their marketing patter, much of it similar to others. They describe their unique process of whittling down the investable universe by applying magic potions, they show their genius when selecting stock winners in their portfolio (what, no losers?) and then present the performance numbers of the best fund in their stable.

Then comes the part that every manager, for some misguided reason, considers mandatory. "*We have skin in the game*" and "*We are coinvested with you*". In some cases, the earnest vow is even stronger, with statements such as these taken from pitch documents in the last week:

*"It is never pleasant to experience market falls or underperformance. We and the rest of the investment staff have **100% of our investable wealth** in our funds. To fellow investors we say: we feel your pain."*

*"I am frankly dumbfounded by the events of the past 6 months; it feels like the rules of investing I have applied successfully for the past twenty years have been thrown out the window. Nonetheless, with **my entire investable asset base in the fund and a substantial portion of the asset base of most friends and family** also invested alongside us, I will continue to work hard to turn around the poor performance of the past half year." (my bolding)*

Is that what we want from our fund managers? I prefer them to lead a balanced life with good relationships with family and friends, and to wake up refreshed and ready for another day of calm and rational analysis. Not sweating because their net worth is buried in their fund, mum and dad have mortgaged their family home and friends avoid the elephant in the room.

How does this complete lack of diversification accord with Investing 101? What if they are a bond manager, shouldn't they hold some equities? Every financial planner advises clients to run a diversified portfolio based on their future goals, yet here are the genius fund managers telling everyone that 100% of their investable assets sit in one fund. Why is that smart or desirable?

How does the conversation go at home with the spouse when the one-and-only investment is down 30%?

"Darling, you know how we're saving for a bigger house because we just had our third child and the first two are already sharing a room? How you want a decent garden? I'm sorry, I put all the money in one fund and it's collapsed, and we no longer have enough deposit. Oh, and since it's my own fund, my salary and bonus will also be hit."

Every fund manager has a professional and personal interest in their fund doing well. It determines their remuneration, their career progress and maybe the value of their business. They don't need to bet their house. The argument that 'alignment of interest' needs the fund manager to invest all their money in the fund is overdone. There is already a full alignment if a manager is trusted with the retirement savings of an investor. The "*we're in this together*" is redundant. Why should an investor care if the manager shares the pain? Does anyone think, *"Oh, that's fine, thank goodness you're losing money as well as me"?* Is it supposed to show greater commitment? Working 16 hours a day instead of 12 will not produce better results. Better to spend an afternoon with the family.

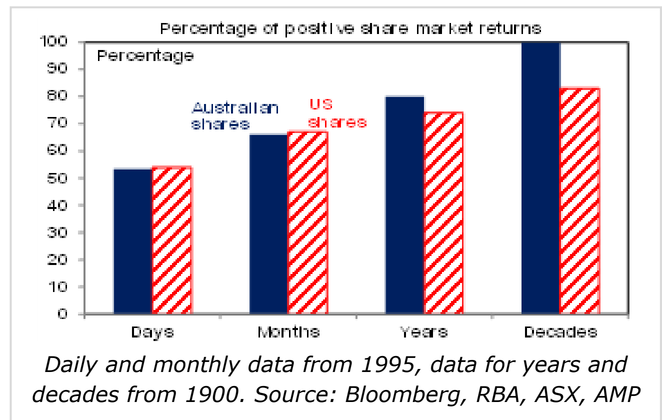
And with this '*all my investable wealth*" claim, nobody reveals how much of their total wealth is so-called investable and the definition. If like many (younger) Australians, most of the wealth is tied up in the Great Australian Dream, then maybe "*investable assets*" makes up 10% of their wealth.

Cut it out, fund managers, it's meaningless. We know you want to win. Who doesn't? You're giving me enough pain without sharing yours.

Which takes us to performance fees. Are they part of this alignment of interest argument or just another way to charge a fee? Love them or hate them, there is no market standard but they should be designed to be fair to investors. Check these features and decide if the fee on your fund is fair, and surprisingly, there may be a fee holiday coming up.

Among many messages investors receive when markets fall is this useful reminder from **Shane Oliver of AMP**:

"If you look at the daily movements in the share market, they are down almost as much as they are up, with only just over 50% of days seeing positive gains. But if you only look monthly and allow for dividends, the historical experience tells us you will only get bad news around a third of the time. Looking only on a calendar year basis, data back to 1900 indicates the probability of a loss slides to just 20% in Australian shares and 26% for US shares. ***And if you go all the way out to once a decade, since 1900 positive returns have been seen 100% of the time for Australian shares and 82% for US shares."***



Daily and monthly data from 1995, data for years and decades from 1900. Source: Bloomberg, RBA, ASX, AMP

Markets experiencing rapid rises and falls often trigger algorithmic, computerised responses and stop-loss orders, rather than a reflection of general market sentiment. For example, this week, **City Index analyst Tony Sycamore** said that 10,000 ASX200 futures contracts were sold close to the open of our trading day, possibly by an overseas hedge fund, quickly sending the market down. He said:

"About $1.75 billion worth of selling went through in a very short period of time. Typically that is representative of a get-me-out type order, I've seen it firsthand on trading desks. Just get the heck out, I can't take the pain anymore."

Other investors may panic and join the sale, especially when analysts start to justify the fall with all the usual excuses, and a bearish tone can take hold. Although there is a fear of catching a falling knife, it's at times of drawdowns that subsequent rewards are the best, but who knows where the bottom is.

And so to the election.

Today, let's visit a factory and wear a high viz vest and operate the equipment. Then a trip to my old school to announce funding for a swimming pool. A marginal electorate needs an updated road. How about $4.5 million to build a new distillery for a profitable, listed company? Hold a media conference where journalists scream gotcha quiz questions and concoct headlines of outrage.

The second leader debate was a feisty yelling match, and **Nine**'s graphics and inadequate technology compromised the polling system (right).

Which party do you think will win the election?

COALITION

LABOR

COALITION

It would be easy to dismiss the **United Australia Party** as a distraction, with their policies to cap home loan rates at 3% for five years (and watch the banks withdraw from home loans) and bringing back $1 trillion of super from overseas (and deny access to 98% of companies). But money buys influence and votes, and the party has dealt itself into the outcome by directing preferences to the **Liberal Party**. **Clive Palmer** told *The Saturday Paper:*

"I write all the ads personally. Because I originally started in campaigning with the National Party years ago, I ended up becoming [campaign] director and state spokesman, so it's easier for me to write the ads than it is for me to instruct someone to do it."

Clive, among the $50 million you're spending on ads, find a few thousand dollars for an editor. The grammar mistakes and style inconsistencies in your ads are doing my head in.

Graham Hand

In this week's articles ...

Ned Bell has been managing global equity portfolios for about 20 years, but he sees a generational step change underway. It feels like a moment in investing history when the rules are rewritten, with rising rates, an inflation spiral, record debts, wars and geopolitical conflicts. Is Ned correct when he says it's the best time in his career for active stock pickers?

In **Meg Heffron**'s latest monthly column, she continues her deep dive into future-proofing your self-managed super fund, this time looking at the importance of preparing a power of attorney.

May's bank reporting season has wrapped up, and **Hugh Dive** delivers his take on the sector, awarding his gold stars to the top performers.

It is widely accepted that equal representation is the right thing to do. **Dr Joanna Nash and Dr Ron Guido** dig through the data on 2,500 large cap companies in 30 countries and find that more gender diverse leadership teams deliver better performance outcomes. We also feature **Realindex**'s research report "*Beyond lip service: tracking the impact of the gender diversity gap*" as our white paper this week.

Andrew Canobi argues that the probability of central banks gently landing the plane looks to be shrinking by the day with global financialisation facing its biggest hurdle since the GFC. It is unlikely central banks will push rates up as far as markets are pricing in.

The pandemic has had profound implications for the way we use real estate. **Steven Bennett and Sasanka Liyanage** go beyond the headlines and explore the future of the office sector.

Five features of a fair performance fee, including a holiday

Graham Hand

There is no standard method for charging performance fees on funds, and it's likely most investors don't know how their fees are calculated. What might look like a simple difference can cost investors dearly, and the impact may be more than the base management fee which receives far more attention.

Investors should at least know what a 'gold standard' looks like from their perspective, especially when funds with a well-structured high-water mark may not charge a performance fee for many years, offering new investors a special opportunity.

Should performance fees exist?

A reasonable justification for a performance fee is where the fund manager limits capacity because it operates in a universe with constraints on liquidity, such as in small or micro cap companies. This restricts the potential of management fees to grow based on overall fund size. An example is a small cap manager in Australia such as 1851 Capital which closed its fund to new investors when it reached $400 million (although existing investors can add money, making it a 'soft close'). Its base fee is 1.25%, which on $400 million, is $5 million in

fees. That's not bad for a fund manager which opened its doors in February 2020 and now employs only three investment professionals but higher base fees could be earned without the close.

On this fund, investors pay a 20% performance fee for excess returns above the S&P/ASX Small Ordinaries Accumulation Index. 1851 manages only one fund which to 30 April 2022 had delivered 20.6% per annum after fees against the index of 7.1%.

My estimate is that returns before fees were about 25.25%, less base fee of 1.25% to give 24%, less the index of 7.1%, giving an excess of 16.9%, 20% of which is 3.4%. So the performance fee (not confirmed by 1851) is almost three times the base fee, taking total fees to about 4.6%.

This shows why it's worth capping fund size if a manager can deliver.

A common sharing ratio is 80/20, with 20% of the excess return over a benchmark accruing to the fund manager. If a fund manager delivers say 5% over the benchmark, most investors would be satisfied receiving an extra 4%. In his popular article, "*My 10 biggest investment management lessons*", Chris Cuffe wrote:

"Don't be afraid of performance fees. I believe managers deserve their high fees based on their performance. In my own personal investment portfolio, I don't care about paying a 20% performance fee (as long as the right hurdle exists) if I'm getting 80% ... I'm agnostic to fees so I just look for the best managers."

How do performance fees differ?

Charging a fee sounds straightforward but it is anything but. I have been involved in drafting Product Disclosure Statements for platforms which offer funds from many managers, and the performance fee section is complex and convoluted. Most investors skip over it. The performance fee may be calculated:

- before management fees*
- after management fees*
- over zero (commonly used for hedge funds or 'absolute return funds' which do not have a market index, or beta, exposure)
- over the cash rate
- over the bank bill rate
- over an equity market index such as the S&P/ASX300 Accumulation Index or MSCI World
- over an absolute return like 5%
- inclusive or exclusive of franking credits
- based on 10% to a mouth-watering 27% of the excess return.

*An example of the difference is: assume a fund has a management fee of 1%, delivers 2% above its benchmark, and a performance fee of 20%. If the performance fee is calculated 'before management fees', it is 20% X 2% equals 0.40%. If it is 'after management fees', it is 20% X (2%-1%) or 0.20%. Easy to overlook but double the fee.

What is the gold standard for investors?

Some investors might argue that the gold standard is no fee, as a base fee should be sufficient reward, and managers have enough incentive to do well.

But let's look to the real world where some fund manager can change a performance fee due to their popularity. What are the fairest terms among an almost infinite array?

1. Outperform an appropriate benchmark

With few exceptions, an equity fund should not be benchmarked against a non-equity benchmark, such as the cash or bank bill rate.

Consider this from Sandon Capital (ASX:SNC). In its monthly fund reports, it rightly compares its performance against the All Ordinaries Accumulation Index, but what about the performance fee calculation? From its prospectus:

"Performance Fee - the Manager is also entitled to be paid by the Company 20% (excluding GST) of any outperformance over the Benchmark Reference Rate each year, subject to a high water mark."

So far, so good. Delving deeper into the definitions on page 58 (where nobody goes) for the Benchmark Reference Rate:

"the average of each 1 month Bank Bill Swap Reference Rate published on the first day of each month across the Performance Calculation Period"

It's an equity fund benchmarked against a bank bill rate, and one month is effectively the cash rate. In a year where the All Ords is up 20% and the bill rate is 0.1%, matching the index delivers 4% in performance fees.

Better to have something like this from Bennelong Concentrated Fund, which includes a hurdle over an equity index:

"15% of any amount by which the Fund's return is more than 2% greater than the return generated by the S&P/ASX 300 Accumulation Index."

Or a fund such as the Montaka Global Extension Fund (ASX:MKAX) which invests long and short and uses a 7% per annum absolute return hurdle.

2. Not charged on negative returns

It seems unfair that a manager who loses 10% should also hit investors with a performance fee, even if the market is down 15%. The client has lost 10% and further investor pain should be avoided rather than an additional 1% fee.

However, for example, in two pages describing performance fees in the Colonial First State Product Disclosure Statement which covers many funds on its platform, it says:

"It is also possible for the investment manager to exceed the relevant benchmark (and therefore be entitled to a performance fee) even where an option has had negative performance over a period, as that option may have performed better relative to the benchmark."

3. Subject to a high-water mark with no resets

Performance fees should only be paid once the manager has recovered previous underperformance. This is called a 'high-water mark' because the highest price of the fund must be reached before the performance fee kicks in again.

For example, assume the market index is up 10% in the first year, while a fund is up only 5%. Then in the second year, the index is up 10% again but the fund rises a healthy 15%. Ideally, there should be no performance fee in the second year, because the manager has delivered index performance over two years (ignoring the impact of the base fee). In calculation terms, where the performance fee results in a negative dollar amount, it should offset entitlements to future performance fees.

Even if a fund seems to include a high-water mark, watch for it resetting to zero, either after a short period or due to a change in manager on the fund. The negative accrual is then removed. An example is Thorney Technologies (ASX:TEK). This is from its Annual Report, with the relevant part highlighted:

*"A Performance Fee, the greater of zero and the amount calculated as 20% of the Increase Amount for the relevant period. The Increase Amount is the movement in the Measurable Portfolio value from the previous period plus or minus any applicable adjustments. The Increase Amount is reduced by the amount of Base Fee applicable to the relevant period. Measurable Portfolio includes measurable financial assets, including cash. If there is no Increase Amount for a financial period, **the shortfall is not carried forward and not deducted from any increase in future financial period(s) for the purposes of calculating future Performance Fees.**"*

There is no high-water mark in subsequent years. TEK could underperform by -10% in a year, then because the high-water mark is reset, there would be a 2% performance fee in the subsequent +10% period despite index performance over two years.

Perhaps this contributes to the relatively poor trading levels of TEK, with a share price of $0.28 and an NTA of $0.43, the discount is a hefty 35% at time of writing.

4. Smooth the impact over a vesting or measurement period

Another variation which seems fairer to investors is to smooth the impact of large performance fees over a vesting period, such as three annual payments. It defers the fees in case performance deteriorates. For example, if a fund outperforms by 15%, rather than paying a fee of 3% in the first year, it could pay 1% over three years. Then if it drops under the benchmark in the next two years, there may be no fee payable.

Another example is used by TDM Growth Partners, a Sydney-based investment firm specialising in global equities. It started the business with no base management fees and only fees for outperformance. However, realising it might not even cover its costs in a market downturn, it moved to a system where a base fee of 1.5% per annum is fully rebateable against performance fees to smooth its cashflows. It acts like a pre-payment of future performance fees.

5. A rationale for the fee

How does the fund manager justify including a performance fee? Limited market size? Alignment of interests? In most cases, it's to earn a higher fee from managing money.

The 'alignment of interests' argument is a stretch. If investors trust a fund manager with their precious retirement savings, and of course the manager wants to do as well as possible, there is already a significant alignment without the need to pay extra for performance. The reward is ongoing support from investors.

It's more persuasive if there's a reduced base fee. The Information Pack issued for MySuper products includes this parameter:

"In any performance-based fee arrangement with a fund manager in respect of assets of the MySuper product, trustees must include ... a reduced base fee that reflects the potential gains the investment manager receives from performance-based fees, taking into account any fee cap ..."

If this is not included, then:

"a trustee must be able to justify that the differing arrangement continues to be in the best financial interests of the members of the MySuper product."

A performance fee holiday, but with a nasty sting

Following the rapid fall in the share prices of a wide range of companies since September 2021, many prominent fund managers who earned handsome performance fees in previous years are now in fee deficit. Their results in the 2022 financial year will be strongly negative.

Here is an opportunity for a new investor. If an investor enters the fund in FY2022, there may be no performance fee in FY2023 and FY2024 even if the fund manager outperforms in those new financial years. There will be a negative accrual from FY2022 in the future performance fee calculation.

Ask any fund manager for a list of funds with negative performance fee accruals.

However, this also demonstrates a weakness of pooled unit trust structures which Individually Managed Account-type products are designed to avoid. Performance fees in a unit trust must be calculated at the trust level as a whole, not by investor. The negative accrual from prior losses is shared with future investors in a pool, which may result in a return to paying performance fees earlier. This is a nasty sting for investors who lost money in FY2022 in the example above.

It's a fee holiday … but some holidays are no fun

Investors willing to pay performance fees should at least know how they are calculated. Variations from the gold standard – a resetting of high-water marks or the wrong benchmark – could deliver bumper extra fees when performance is nothing special over time.

There is also the problem of giving the wrong incentives. A fund manager may swing the bat and fortuitously outperform and earn big fees, then the next year, the market gives all the gains back without a fee recovery for the investor.

But where an investor is happy to back a talented fund manager who is going through a rough period, and especially if the base fees are lower due to the performance fee, there could be good opportunities to avoid a performance fee while previous high-water marks are recovered.

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

Ned Bell on why there's a generational step change underway

Graham Hand

Ned Bell is *Chief Investment Officer and Portfolio Manager at Bell Asset Management, a global partner of Channel Capital.*

GH: The Bell Global Equities Fund was launched in 2007, that's 15 years ago, and you were recently awarded the Undiscovered Manager award in the 2022 Morningstar Fund Manager of the Year awards. What's been happening?

NB: We've been managing institutional money, building the team and focussing on distribution via platforms and advisers with more retail exposure recently. We believe company quality drives share prices but markets have not always rewarded fundamental analysis in recent years.

GH: How have markets changed in the last 15 years?

NB: Passive investing has had a massive impact, especially in the way they buy more as the market rises. Both active and passive buyers of the large FAANG stocks created an almost corkscrew impact pushing up the market. This is unravelling as we speak, and we are seeing very sharp drawdowns in massive companies like Netflix and Meta.

So the market composition has changed a lot but there's also been a generational shift. When markets are so good for so long, and many of the more experienced participants have retired, they are replaced by younger participants, whether investors or investment consultants, and many have never seen a falling market. It's a different dynamic.

GH: The market delivers surprises every year, but are you seeing something more significant now, a sort of generational step change?

NB: I am. If you think about the environment, what's on the whiteboard for this year … the highest inflation since the 70s, a raging war in Europe, a rapidly decelerating China which has accounted for a large proportion of global GDP growth in the last 10 years. The gap between GDP growth expectations for emerging markets (EM) versus developed markets has shrunk to the smallest in 20 years plus. It's a monumental turning point. Investors in EM markets must ask themselves, if the whole reason for being there in the first place is to capture a growth premium and it's no longer there, then why are we still there?

GH: Yes, and EM is one of those markets that is always about to happen, but it never quite delivers.

NB: Yes, but no matter what markets you invest in, it comes down to the companies. And in EM, we've not seen the earnings growth in the companies over 10 years. The phenomenal GDP growth is disconnected from the earnings growth of locally-domiciled companies, yet we've seen the likes of Apple and LVMH and countless terrifically-managed global companies prosper from a revenue perspective.

GH: Your emerging companies fund invests in the global small and mid (SMID) cap space in a universe of thousands of companies. How do you filter that vast choice?

NB: The first point is we're only investing in developed markets and companies with a minimum market cap of US$1 billion. We screen for a return on equity above 15% for three consecutive years and that gives us about 700 names as a starting point. After some bottom up fundamental analysis, we end up with around 150 names in this SMID sector, then it's a matter of the right price.

GH: Running an investment business from Australia, do you have good access to talk to the CEOs and management of those companies?

NB: We absolutely do. I start every meeting saying I'm not a hedge fund and that usually gets an extra 10 minutes. The fact that we are long-term shareholders endears us to them, we're not trading them, our average holding period is well over five years. In a normal year, we do 500 research engagements a year and this is our 20th year.

GH: I heard you speak recently about looking for companies with earnings resilience, but to what extent do major macro themes play into your investment decisions and that resilience?

NB: It does play into how we define quality. We look for great management, strong business franchises, consistently high levels of profitability, balance sheet strength, sound ESG principles. But also strong business

drivers, and that's when macro comes in. Our investment meetings at the moment are dominated by the effects of inflation plus China and supply chain disruptions.

GH: Are there a couple of examples of companies in your portfolios with strong pricing power that can be resilient in the face of this inflation?

NB: Sure. Among the large cap names, the luxury goods are hard to go past, LVMH and Hermes, which have phenomenal pricing power and exposure to an economically-insensitive market …

GH: … the more expensive a handbag, the more desirable it becomes.

NB: Exactly, and that's a good spot to be in. Companies like Moody’s and S&P, terrific businesses and essentially service providers but not subject to inflation such as rising labour costs. Costco is a brilliant retailer with pricing power. In the small and mid cap side, someone like Poolcorp, the biggest pool company in the US, has no problems putting up prices. And Estee Lauder in the consumer space. There are lots of great companies to own at the right price.

GH: How do you feel about the tech stocks that seem to be forming two tiers, with names like Microsoft and Apple in the top tier and Netflix and Zoom without the same quality?

NB: We are underweight the big FAANG stocks by about 8% versus the index, and that hurt a lot until about September last year. We do have exposure to the likes of Alphabet and Amazon and Microsoft but not Apple although we owned it for about 16 years from when the first iPhone came out. We sold that due to its stretched valuation in 2020. Those first three are terrific businesses with longevity but growth is slowing. Stocks like Meta and Netflix on high multiples of 50 in growth manager portfolios can quickly derate and the prices keep falling because the value managers are waiting at 18 times earnings. Rising interest rates means one thing … multiples compress.

GH: Do you feel there are pocket of stocks, either expensive or cheap, where your team has noticed something that the market is completely missed?

NB: Yes, absolutely. I always make this point, but the global small and mid cap universe is extraordinarily inexpensive for an asset class that’s consistently added value over 20 years. It's less risky than emerging markets as an asset class and the fundamentals are better. They didn’t keep up in the so-called ‘growth rally’ until September last year, and the valuation differential is huge. If you compare the SMID MSCI index with the World Growth MSCI index, it’s a 40% discount. Just buying the index is 17 times earnings versus 27.

GH: Where is it historically?

NB: It's the biggest discount in 10 years, historically, SMID has traded at a premium to large cap value. Why is this? Through COVID, many companies had to tighten their belts quickly, and smaller companies were efficient and fast and more nimble, with a lot of family ownership. They took a lot of costs out of their businesses. The earnings estimates for this year versus 2019 pre-COVID for the SMID index are 70% higher, yet prices are only marginally up. The value for money is exceptional in businesses you can own for 10 to 15 years.

GH: Every fund manager has its winners and losers. Is there a stock that you've sold recently that didn't do well and it taught you something about your investment process that caused a rethink?

NB: Yes, a Danish company called Ambu, a leader in medtech equipment, and it had been one of our better performers. We sold some when the thesis was moderating, growth was slowing, change of management, but we should have sold the whole position. The lesson is that when the thesis changes, you need to take a really hard look at it and we should have done better.

GH: Your portfolios are unhedged. Do you have any advice for how an Australian investor should think about the currency?

NB: The main point is there’s a degree of inbuilt currency hedging in the portfolio. If we’re buying US dollars to buy Nike, then their revenue exposure is very diverse across currencies. In fact, if you invest in a hedged product, you may be inadvertently taking more of a currency view.

GH: Are you considering a listed version of your funds, particularly with the development of Active ETFs?

NB: Not immediately but it’s not out of the question. At the moment, we're working diligently on getting the funds onto platforms. We don’t want to go down the LIC path which is fraught with danger and can be a distraction from what we should be spending time on.

GH: What's your pitch for active over index in your sector?

NB: The environment we're going into now will be brilliant for active management, the best for 20 years. If you think about capturing alpha (outperforming the market), it's when we see these market dislocation events, we see irrational behaviour by investors who are not used to the environment. That's what bottom-up stock pickers want. In the last five years, our disciplines of only investing in quality companies and not paying too much has done us no favours. Ironically, this is when many super funds have moved more to passive.

The last five years have been upside-upside-upside … now let's see who can manage the downside risk. Investors have become frustrated by active managers but this environment will suit skilled stock picking and portfolio construction.

GH: You're making the case for a particular type of active management, because some active managers have backed the growth story of the last five years and done well, although they've given a lot back in the last six months. Sounds like you expect league table positions to change a lot.

NB: Yes, but it's about quality. History demonstrates that quality does well in inflationary environments. There's still a lot of valuation risk in the growth end of the market and lot of poor companies at the value end. In an economic slowdown with inflation, you want to own companies where earnings are dictated by the quality of their franchise, not the direction of the economy.

Graham Hand is Editor-at-Large for Firstlinks. Ned Bell is Chief Investment Officer and Portfolio Manager at Bell Asset Management, a Channel Capital partner. Channel Capital is a sponsor of Firstlinks. This information is not advice or a recommendation in relation to purchasing or selling any assets. It does not take into account individual investment objectives or needs.

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Meg on SMSFs: Powers of attorney for your fund

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues relating to managing your SMSF.

For regular readers of this column, I promise I will stop talking about future-proofing your SMSF very soon.

But questions on last month's article and several recent discussions with clients highlight how tricky it can be to explain how powers of attorney can help plan for aging in an SMSF.

It's an important topic no matter how young, fit and healthy we may feel.

A quick re-cap

The term 'power of attorney' is generally well understood. It involves one person (the donor) giving some important legal powers to someone else (the attorney). The attorney can stand in and do whatever the donor could normally do for themselves when it comes to a wide range of financial matters.

For example, I (the donor) could grant power of attorney in favour of my son (the attorney) and he could sign contracts on my behalf to sell my house. The key here is that he is standing in for me and doing something in my place. He must be careful that he's acting in my interests and not his own. Other than that, he can do pretty much anything I could do for myself when it comes to financial matters. (If I wanted him to also make decisions about my health, I would need different documents.)

Normally, a power of attorney ends if the donor cannot make decisions for themselves (for example, they have dementia). But a special power of attorney – an 'enduring' power of attorney – continues even if the donor becomes incapacitated.

There are some things my attorney cannot do for me no matter what type is in place. For example:

- I am a qualified actuary and can sign certain certificates that need an actuary. The fact that my son holds an enduring power of attorney for me does not allow him to do that,

- I am a director of the company that runs my business. He cannot fulfil my duties as a director just because he holds that power of attorney – a power of attorney for **me** only covers my **personal affairs**. (The company itself could grant a power of attorney but that is something else entirely.)
- If I was the trustee of a trust (individually rather than via a company), he cannot do that for me either.

How are enduring powers of attorney helpful for SMSFs?

So far, powers of attorney are not sounding particularly helpful for SMSFs. However, running alongside these rules about powers of attorney we have entirely separate legislation about self-managed funds.

That legislation says that if you belong to an SMSF, you have to also be a trustee (or director of the company that is the trustee). The idea is that if you are going to step into the world of running your own super, you really must run it.

There are a couple of exceptions. If you have someone who holds an **enduring** power of attorney, they can be a director or trustee instead of you. This sounds just like my son stepping in for me and selling my house, but it's completely different.

If my son were allowed to use his power of attorney for my SMSF just like he can use it to sell my house, I would remain a director and from time to time he would sign documents "as me". But that's not allowed – fulfilling my duties as a company director is one of the things my attorney can't do for me.

The rules for SMSFs instead allow me to **step aside entirely** (for example I would resign or be removed as a director) and have him take my place (he would be appointed as a director). Normally this would be a problem – I'm a member but not a director. But there is a special carve-out that says that's fine, as long as I've been replaced by someone holding an enduring power of attorney for me.

My son would be a director of my SMSF trustee and have the full responsibilities and powers as a director just as if it was his own SMSF.

Legally, this different approach is profound. For a start, he doesn't have to fulfill his duties in line with the power of attorney anymore. For example, I have two sons. My enduring power of attorney requires them to make decisions together. To sell my house, they'd both have to agree. But if only one of them became the director of my SMSF trustee, then he (and he alone) would be making decisions about my SMSF. He could not defer to his brother or share decision-making with his brother.

He would also – like any other trustee – have to act in the best interests of **all** members, not just me. The fact that he's only there because of me is irrelevant. He's not my "representative", he is a director of a company charged with running an SMSF for all its members.

It's different in a practical sense too. On documents, for example, my son's name would appear as the director and he would sign in his own right. He's not signing 'as attorney for mum'. In contrast, if he was signing something on my behalf as a member (for example, a request to start a pension or withdraw my super) he would be signing as attorney for me as an individual.

Some important points to make this work

Often an enduring power of attorney only comes into effect if the donor becomes incapable of making their own decisions. Normally, that makes sense – you might not want anyone to have the power to control your life until you cannot do it yourself. But that will mean your attorney can't be the trustee of your SMSF while you are still mentally able. Anyone intending to use this as a mechanism to allow (say) an adult child to be the trustee of their SMSF would need to make sure the power had been activated.

It's also possible to impose limits that **only** allow that person to be the trustee of your SMSF – so they can't control decision-making in other areas.

In my SMSF, it's fine for just one son to be the director of the trustee or both. The SMSF rules will be satisfied either way. I might prefer both (so that indirectly they are still making decisions jointly) but there's also nothing to stop one of them from resigning later. I cannot control that.

Often if the SMSF has two members (a couple), they will have enduring powers of attorney for each other. That means it's possible for just one of them to be the director of the trustee without breaking the SMSF rules or even (unusually) for just one person to be the sole individual trustee. That can be particularly useful if one

member of the couple is slowly declining when it comes to mental capacity, but the other is still willing and able to run the SMSF.

When do people use this structure?

While dealing with diminishing capacity is one driver for this structure, there are others. For example, it's common if the SMSF members are moving overseas. There are important rules about residency that depend on the physical location of the people who are making decisions about the fund. Sometimes they can only be satisfied if the people who move overseas actually stand down and their attorneys take over the running of the fund. Often the roles are reversed in this case – the (adult) children are the donors and it's their parent(s) that fill the attorney role.

There are alternatives and protections

It's not always essential to give up as much control as it sounds when older generations are inviting the next generation to assist with their finances.

When it comes to SMSFs, for example, I could do a number of things other than step aside and have one or both of my sons control everything.

Because my fund only has one member, it's allowed to have a second director without any of this enduring power of attorney rigmarole. If I felt I wanted more support in decision-making, I could invite one of my sons to become a director (not both) and continue to be a director myself. That option wouldn't be available to us if the fund had two members.

Alternatively, I could invite them both to be members as well – then we could all be members and directors of the corporate trustee together. If I eventually lose capacity, then I would just stop being a director but remain a member. They don't even have to put all their super in the SMSF. They could leave their own super savings elsewhere (possibly even in their own SMSF – now that would make their mother proud!) and have just a nominal amount in the fund they share with me.

This option is available to couples too – in fact, the new rules allowing SMSFs to have up to six members means a couple and their four children could all belong to the same SMSF and run it together.

Another alternative for couples is **shared control**. This one is common when (adult) children are moving overseas for a time and enlist help from a parent to run the SMSF while they are away. They could have **just one** person resign as a director and their attorney (a parent) replace them. The other member of the couple would remain a director.

The attorney could even be someone completely different (a friend, a professional). The only requirement is that the attorney is over 18 and mentally capable of making financial decisions.

Of course, the donors should also choose them carefully! They need to make some very important decisions. And while your accountant or lawyer might appear a great first choice – that's usually not possible. For a start, they can't get paid (either directly or indirectly) for being a trustee (or director) of an SMSF. They also have to take on the role personally rather than via their business – so they are accepting huge personal responsibilities not covered by their normal business insurance.

For corporate trustees, this article is simply about the directors. The ***shareholders*** of the trustee company would normally continue to be the original members. That actually does give some control back to them. If things really go bad with my son(s), for example, as long as I continue to own the shares in the trustee company, I have the power (under the company's constitution) to sack directors. Similarly, many SMSF trust deeds give the members the power to remove individual trustees or remove the company in its entirety. There are options but it can get time-consuming, stressful and risky.

And finally

So far I've looked at this issue on the assumption that I'm still mentally able to make decisions and the only issue here is whether I **want to** hand over the SMSF reigns to the next generation (or someone else entirely). If I lose mental capacity, I will have no choice. It is illegal for someone who is no longer capable of making their own decisions to be the trustee of a trust or director of a company. They **must** resign or be removed.

At that point, I would really hope the enduring power of attorney is in place so that someone else can be the trustee of the SMSF. Otherwise, the fund might need to be wound up or converted to a small APRA fund. Winding up might make perfect sense but not in every case. It's good to have options.

That's the main reason I think enduring powers of attorney should be a given for anyone with an SMSF.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

To view Heffron's latest SMSF Trustee webinar, 'Super contributions unpacked', click here (requires name and email address to view). For more articles and papers from Heffron, please click here.

The great divergence: the evolution of the magnetic workplace

Sasanka Liyanage, Steve Bennett

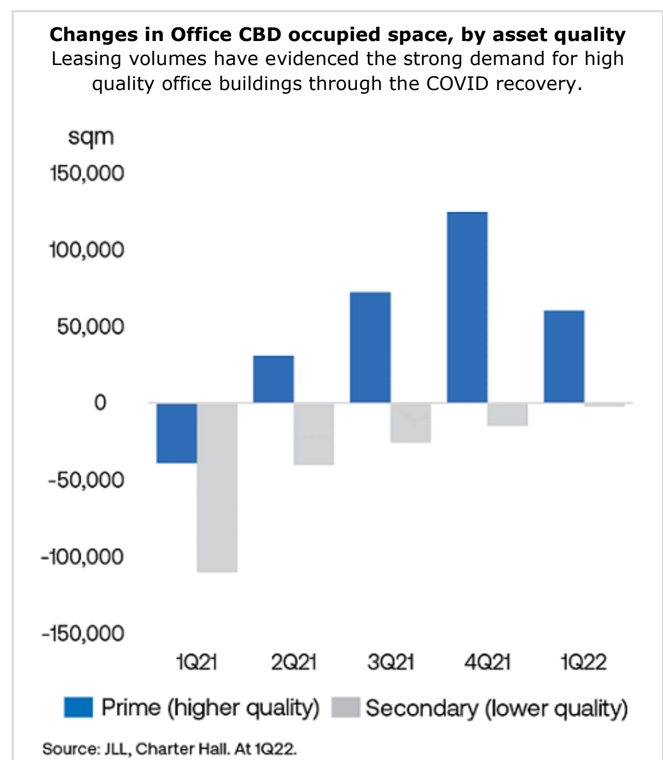
The pandemic has had profound implications for the way we use real estate. As we transition into a post-pandemic environment, tenant preferences and behaviours are now providing more certainty to the outlook of our major real estate sectors.

Evolution of office space between two extremes

The office sector is emerging from one of the largest experiments workplaces have undergone, manifesting from mandated social distancing requirements which forced people to transition from working in offices to homes. This underpinned a proliferation and advancement of communicative technologies while broadening the perceptions around working remotely. The speed at which this transition occurred attracted significant levels of commentary and polarised opinions. Overarching views ranged between two extremes: 'the office is dead' versus 'the pandemic was temporary and will have no impact on the sector'.

With the benefit of time and evidence from market activity, we can comfortably dispel both these extreme perspectives. The office is not dead but is certainly undergoing changes as tenants adapt to working in a COVID normalised world. The counterbalancing elements from those two extreme perspectives will influence the outlook of the sector, generating diverged performances across various assets.

Looking through the lens of tenant leasing enquiries and actual leases being signed, it's evident that the market rebound has accelerated quicker than originally anticipated. The recovery in tenant demand advanced despite the COVID related lockdowns across the major markets in the second half of 2021. Occupied office space (as measured by leased spaced) across national office markets increased by 185,700 sqm over the December quarter - the strongest result since September 2018.



Moreover, sentiment surveys also reflected the growing appetite for office space from tenants. Demand drivers such as new set-up and expansion as the economic recovery gathers momentum have increased by 119% since May 2021 across the region (Source: CBRE Asia Pacific Leasing Market Sentiment December 2021).

A focus on quality space

However, headline figures masked one important trend. We are witnessing a significant divergence based on building quality. Prime sector occupied stock posted the highest quarterly growth in tenant demand since December 2007, up 228,000 sqm, with strong results

across both CBD (124,600 sqm) and metropolitan (103,800 sqm) markets. Over 2021, Prime (higher quality) occupied space increased by 497,000 sqm, the largest annual increase since 2016. Over the same period, Secondary (lower quality) occupied space reduced by 73,700 sqm, highlighting the markets focus on a flight to quality (see chart above).

Workplaces are now more than ever a statement of purpose. The quality of an office will be a pivotal part of attracting workers and promoting collaboration, learning, innovation and productivity. Quality offices will host experiences and environments which cannot be replicated working remotely.

The dawn of the magnetic workplace

The industry term for this development is 'magnetic workplace'. Businesses will need to deliver magnetic workplaces to incentivise visitations while attracting and retaining employees. The Australian unemployment rate is approaching 50-year lows (currently at 4%), so the battle for talent is set to intensify. Further, extended periods of remote working have generated higher reports of cultural decay and growing mental health challenges resulting from lower social interaction with colleagues and ineffective onboarding and induction of new staff.

At Charter Hall, we believe a holistic perspective should be adopted for an employee experience. The asset quality, amenity and technology are essential for creating an environment which supports an employee's productivity and wellbeing. This requires a collaborative approach that includes an asset's offering beyond just office space and includes the retail offering and end of trip facilities (things like change rooms and bicycle racks). It can also extend to the surrounding area.

Establishing precincts that enhance the overall offer and amenity are also becoming important. Understanding this optimal offering requires a deep knowledge of our tenant customers, and not just the industries they operate in and their revenue potential, but their values, personality and culture and how we can work with them to create environments that deliver workplaces that support productive collaboration. As a business, we have certainly benefited from our on-going partnership and engagement with more than 2,500 tenant customers, many of whom have space in more than one property sector with us, to deliver quality workplace eco-systems. Nonetheless, it will be crucial that we continue to adapt and evolve in line with our tenant customers workplace requirements.

Buildings assessed in a broader context

The impacts of the pandemic also encouraged many organisations to assess other elements that resonate with their business objectives and company purpose. This has subsequently advanced the standards relating to sustainability and governance, with many tenants and investors increasing the priority on sustainable buildings. These requirements have been further amplified by the rising costs of energy.

For owners of lower quality buildings, these requirements will accelerate asset obsolescence. These landlords will need to contend with the dramatically changing requirements around workplace design and the escalating costs of repurposing these assets to remain viable. By contrast, the combination of these factors will support the continued occupier and investor demand for quality assets, contributing to the divergence of performances across the market.

Steven Bennett is Direct CEO and Sasanka Liyanage is Head of Research at Charter Hall Group, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

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Bank reporting season scorecard May 2022

Hugh Dive

In 2021, Australia's banking regulator APRA warned that banks potentially faced negative interest rates in 2022 and should upgrade their systems to deal with zero or negative market interest rates. A situation not faced by bankers since 1772 BC, when Babylonian king Hammurabi regulated the interest rates that the temple bankers

of Babylon could charge to 20%. Instead of the expected discussions about zero or negative interest rates, the May 2022 bank reporting season was dominated by rising rates and talk of expanding net interest margins.

Here, we look at the themes in the approximately 800 pages of financial results released over the past two weeks, including CommBank's first half 2022 results, awarding gold stars based on performance over the past six months.

Reporting Season Scorecard - May 2022

Company	Share Price	Market Cap $B	Cash earnings per share growth	Increase in Dividends	Net interest margin	Credit Impairment charge	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2022 total return
Westpac	$ 24.60	$ 86.1	-12.0%	5.2%	1.85%	0.14%	11.30%	8.70%	14.5	5.2%	14.4%
ANZ	$ 26.03	$ 72.7	5.0%	2.9%	1.58%	0.20%	11.50%	10.00%	12.7	5.5%	-5.0%
NAB	$ 31.68	$ 102.0	4.9%	21.7%	1.63%	0.00%	11.65%	11.30%	14.9	4.7%	7.9%
Commonwealth	$ 102.66	$ 175.2	24.6%	16.7%	1.92%	-0.02%	11.80%	12.30%	19.4	3.9%	1.5%
Macquarie (Full Year 2022)	$ 182.00	$ 69.8	51.0%	32.0%	n/a	0.18%	14.10%	18.70%	16.6	3.4%	-13.4%

Source: Company reports, IRESS, Atlas Funds Management

Recovered from the pandemic

The key feature of the May results for the banking sector was profits trending back to pre-Covid-19 levels. Instead of seeing a steep increase in unemployment and falling house prices as was expected in May 2020, the unemployment rate has continued to decline from 7.5% in June 2020 to 4% in March 2022, with expectations that the unemployment rate will trend lower in 2022. While growth in house prices is now slowing, the median Australian house price as measured by CoreLogic at the end of April 2022 was 37% ahead of the price pre-pandemic in January 2020. Low unemployment combined with growth in house prices had seen the banks record minuscule loan losses in 2022, solid loan growth and profits close to or above those recorded in 2019.

For CBA, their first-half profit of $4.7 billion and earnings per share (EPS) of $2.73 were ahead of the comparable pre-Covid-19 period. Westpac and ANZ remain behind their pre-Covid levels though profits continue to recover. NAB's headline profit ithis year was ahead of May 2019, though EPS still lag due to a dilutionary $3.5 billion capital raising conducted in April 2020 to strengthen the bank's capital base anticipating losses. In May, the gold star is awarded to Macquarie Bank, which grew profits by 10% in 2021 and then by 51% in 2022. Macquarie has benefitted from market volatility in their trading business, M&A fees, and management fees from their $775 billion assets under management.

Show me the money!

Excess capital and share buybacks continued to be a feature of the results season, an unthinkable situation two years ago when banks were either cutting dividends or raising capital in the expectation of heavy loan losses that would erode their capital base. All banks increased their dividends over the first half of the 2022 financial year. Additionally, share buybacks were conducted or announced in 2022 by Westpac ($3.5 billion), CBA ($2 billion), NAB ($2.5 billion) and ANZ ($1.5 billion). All banks have a core Tier 1 capital ratio well above the APRA's 'unquestionably strong' benchmark of 10.5%, aided by asset sales in wealth management and insurance, lower than expected loan losses and meagre dividends in 2020 and 2021.

We expect further buybacks in 2022 if the environment remains benign, though recognising that the optics of banks increasing dividends and conducting buybacks while raising mortgage rates could be challenging and attract negative political attention. However, as all banks have sold businesses primarily in wealth

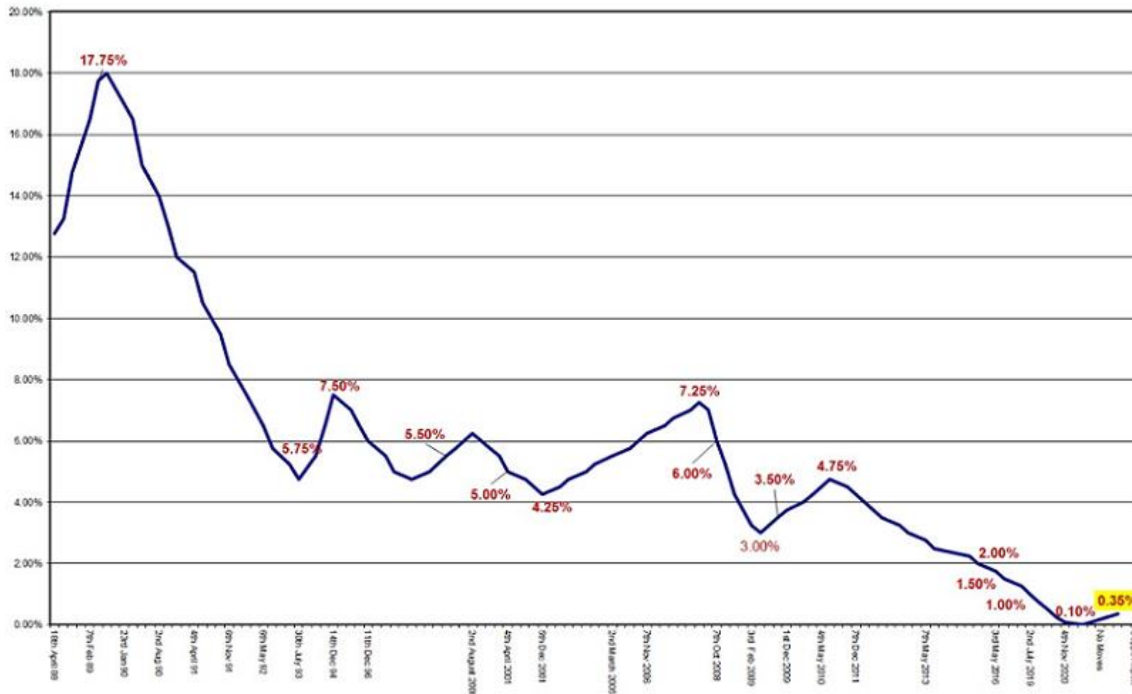
management, buying back shares neutralises the impact of lost earnings and dividends per share by reducing the number of shares on issue. Additionally, management teams are incentivised to buy back shares rather than offer the sugar hit of a special dividend. Reducing equity makes it easier for them to hit their return on equity (ROE) targets which triggers performance bonuses. In the words of Charlie Munger, "*Show me the incentive, and I'll show you the outcome*".

Net interest margins

Net interest margins (NIMs) were a major topic this reporting season and the primary source of optimism despite all banks reporting falling NIMs and historically low margins on lending. The source of this optimism was the RBA raising the cash rate in May for the first time since November 2010. As you can see from the below chart sourced from Richard Coppleson, the cash rate has been trending down consistently since 1988.

When the prevailing cash rate is 6%, it is much easier for a bank to maintain a profit margin of 2% than when the cash rate is 0.1%. Falling interest rates reduce the benefits banks get from the billions of dollars held in zero or near-zero interest transaction accounts that can be lent out profitably. In May, Westpac revealed they have $601 billion in customer deposits (earning between 0% and 0.5%), enough to fund 83% of the bank's net loan book. This deposit pool reduces the bank's need to fund lending by borrowing at higher rates from the wholesale money markets.

RBA Rate Moves since 1988 - so the last 34 years



In a rising rate environment, this pool of deposits held in transaction accounts and term deposits will continue to be a cheap funding source and should allow bank NIMs to expand. Last week, when the RBA raised the cash rate, all banks responded by passing this increase on to their variable lending rates, though we saw no movement in the 12-month term deposit rate (still at 0.25% to 0.5%) or cash accounts (mostly at 0%). We calculate that a 0.25% rise in interest rates equates to a 3-4% increase in profits for the banks due to an expanding NIM.

The banks more heavily exposed to mortgages (CBA and Westpac) traditionally have higher margins than the business banks (NAB and ANZ) which face competition from international banks when lending to large corporates. CBA posted the highest NIM for the first half with 1.92%, and the other banks reported falling NIMs for March 2022. However, there was a palpable sense of optimism from bank management teams towards their NIMs over 2022 and beyond as they face the first rising interest rate cycle since the initial Rudd administration.

Expenses

Managing expenses was another central theme, with the market expecting growth in expenses predominately due to low unemployment contributing to wage growth. Additionally, compliance teams have grown in response to fines from AUSTRAC for not complying with the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 and after the 2018 Banking Royal Commission. Westpac's expenses were under the microscope in May after surprising the market in November 2021 with expenses that were 8% higher than expected due to the addition of 3,000 new staff and consultants temporarily to set up new financial crime and complaints handling procedures and meet other regulatory obligations. This saw Westpac's share price fall 10%, as analysts assumed these additional expenses would be mostly permanent.

While there was minimal discussion around cutting expenses through branch closures, it is clear that the banks have been utilising Covid-19 to rationalise their footprint. We view the rationalisation of branch networks to be the easiest way for banks to grow earnings and contain expense growth. The major banks have between 1,000 and 800 branches each around Australia, but there has been a significant decline in their usage over the past decade, as most transactions are now conducted online. Indeed, NAB reported processing 1,300 digital transactions for every in-person transaction conducted at a branch. In May, Westpac was the only bank to detail changes to their branch network, revealing that 70 branches have been closed over the past year, showing benefits in reducing expenses in coming years.

While ANZ and NAB kept expenses unchanged (an excellent outcome in an inflationary environment), we award the gold star to Westpac for controlling costs (reducing expenses by over $600 million).

Our take

The May reporting season showed that Australia's banks are in good shape and face a better outlook than many sectors of the Australian market. One of the major questions confronting institutional and retail investors alike is the portfolio weighting towards Australian banks, with the banks comprising 25% of the ASX 200. We expect the banks to outperform in the near future, enjoying a tailwind of a rising interest rate environment and very high employment levels and minimal exposure to events in Europe.

Rising interest rates will see declining discretionary retail spending as a higher proportion of income is directed towards servicing interest costs. While bad debts will increase, this is expected with bad debt charges between 0% and 0.2%, currently at the lowest in Australian history and far below historical averages of 0.35%. In any case, bank loans will be priced assuming higher bad debts. Additionally, bank share prices are likely to see support over the next 12 months from further share buybacks and higher dividends.

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

Why gender diversity matters for investors

Dr Joanna Nash, Dr Ron Guido

The debate about the importance of gender diverse leadership has been settled for the most part. Companies, investors and governments have all played a part in boosting the participation of women in the boardroom and on management teams. While progress has been patchy, female representation is higher than ever in companies around the world.

It is now possible to take a detailed look at the impact of this diversity on the way companies operate, and to see if it creates opportunities for investors.

Realindex's research report, '*Beyond Lip Service: tracking the impact of the gender diversity gap*', is based on a global data set spanning over 2500 large cap companies, in 30 countries, over more than a decade. It looked beyond easy-to-find board diversity data, to include executive team composition.

The findings of the data are clear: more gender diverse leadership teams deliver better performance outcomes.

Diversity and firm performance

To understand the potential drivers for gender diversity, we looked at firm level attributes of the global large and mid-cap companies using the MSCI ACWI index. The correlation of gender diversity was examined with a variety of firm specific characteristics: the type of indicators that we would look for in our quantitative company analysis process.

Table 1 reports the average cross-sectional correlations of the firm gender diversity (as captured by the percentage of females in senior management - *senior management gender diversity,* and the percentage of females on the board – *board gender diversity*) with a number of firm characteristics. The highest correlation of 1 is represented in the lightest colour, and the lower correlations are shown in the darker colours.

Table 1. Correlation of gender diversity metrics with other firm characteristics MSCI ACWI

	BY	EY	ROA	ROE	SIZE	Net Profit Margin	Gross Profit Margin	MOM12M	VOL12M	Senior Management Gender Diversity	Board Gender Diversity
BY	1	0.35	-0.49	-0.52	-0.27	-0.18	-0.01	-0.37	0.11	-0.16	-0.16
EY	0.35	1	0.20	0.34	-0.08	0.32	0.05	-0.29	-0.04	-0.03	-0.07
ROA	-0.49	0.20	1	0.79	0.06	0.56	-0.08	0.02	-0.06	0.05	0.01
ROE	-0.52	0.34	0.79	1	0.13	0.54	0.04	0.00	-0.07	0.11	0.08
SIZE	-0.27	-0.08	0.06	0.13	1	0.10	0.16	0.22	-0.28	0.17	0.26
Net Profit Margin	-0.18	0.32	0.56	0.54	0.10	1	0.47	-0.01	-0.13	0.14	0.04
Gross Profit Margin	-0.01	0.05	-0.08	0.04	0.16	0.47	1	0.01	-0.07	0.16	0.10
MOM12M	-0.37	-0.29	0.02	0.00	0.20	-0.01	0.01	1	-0.17	0.02	0.02
VOL12M	0.11	-0.04	-0.06	-0.07	-0.28	-0.13	-0.07	-0.17	1	-0.12	-0.13
Senior Management Gender Diversity	-0.16	-0.03	0.05	0.11	0.17	0.14	0.16	0.02	-0.12	1	0.42
Board Gender Diversity	-0.16	-0.07	0.01	0.08	0.26	0.04	0.10	0.02	-0.13	0.42	1

Colour scale: 1.0, 0.8, 0.6, 0.4, 0.2, 0.0, -0.2, -0.4

Source: FactSet, Realindex, 1 January 2009 – 31 December 2021
Note: For the purposes of this study, we define senior management as the chief executive officer, and their direct reports which would typically include, the chief financial officer, chief operating officer, head of human resources, and chief legal officer.

We found that gender diverse firms (both board and senior management) are typically higher quality firms, where gender diversity has positive correlation with return on assets (*ROA*), return on equity (*ROE*), and profit margins (*Gross and Net Profit Margins*). They also tend to have higher price returns over the previous year (*MOM12M*) and lower market volatility as evidenced by the negative correlation to 12-month price volatility (*VOL12M*).

We also found that larger capitalised firms (as captured by *Size*) tend to have higher diversity, especially in the boardroom, while diverse firms also appear to have high valuation multiples, as seen by the negative correlation between the diversity metrics, and book yield (*BY*) and earnings yield (*EY*).

Diversity and future operating performance

The questions that follow are:

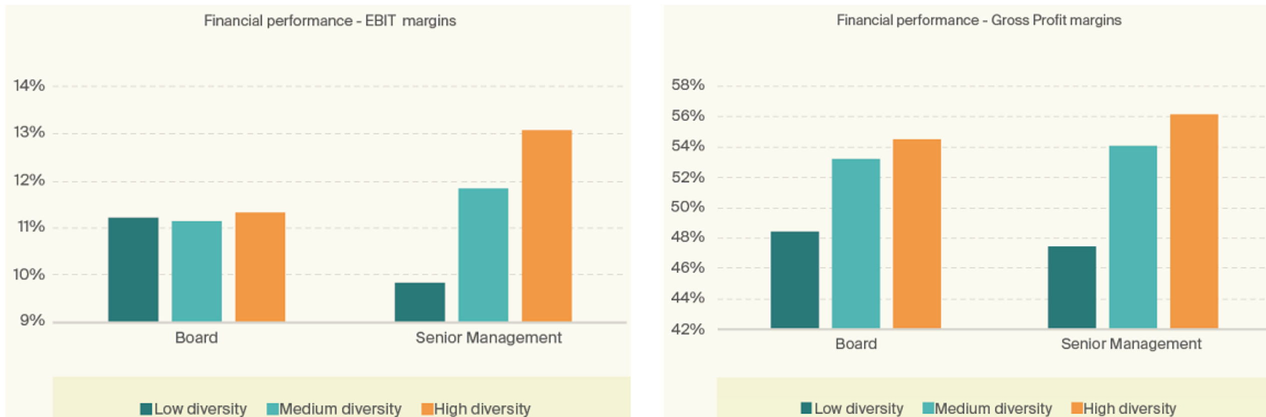
- Has increased female representation made a meaningful impact on firms by improving their operating outcomes?
- Does senior management gender diversity have a more material impact than diversity in the boardroom?

The central proposition behind this is that diversity in management, and leadership more generally, would lead to greater innovation and, in turn, better financial or operating performance. To answer these questions, we looked at whether there is a link between diversity and profitability / performance of the firm.

For both board and senior management gender diversity, we analysed profitability metrics commonly investigated in other studies, such as gross and net profit (EBIT) margins. Some interesting results emerge over the sample period, as highlighted in the charts below.

- In any given year, higher-diversity firms (those approximately in the top one-third of all firms) have about 20% higher margins in the following 12 months than lower-diversity firms (those approximately in the bottom one-third of all firms).
- In terms of EBIT margins, diversity in senior management is correlated with approximately 30% higher future profit margins, while the diversity at the board level board has less significant effect.

Figures 1-2. Gender diversity and one-year ahead margins



Source: FactSet, Realindex, 1 January 2009 – 31 December 2021

Our analysis then examined future operating performance over multiple years by testing whether the Return on Equity (ROE) of a firm is impacted positively by gender diversity. To do this, we again ranked firms based on their level of senior management or boardroom gender diversity and examined ROE performance over the next 5 years.

The data (in the tables, right) shows that for senior management, higher-diversity firms are able to generate cumulative ROEs that are almost 30% higher than lower-diversity firms over a 5-year period. Similarly, for boardroom diversity, cumulative ROE for high boardroom gender diversity firms outstrips firms with low diversity, by 20%.

Table 2: Senior management gender diversity and ROE

Gender Diversity	Cumulative ROE				
	year 1	year 2	year 3	year 4	year 5
Low	12.1%	23.9%	35.3%	46.1%	56.4%
Med	14.1%	27.8%	41.4%	54.7%	67.9%
High	15.2%	30.2%	44.9%	59.2%	73.1%
% Difference (High v Low)	**25.7%**	**26.8%**	**27.3%**	**28.5%**	**29.6%**

Table 3: Boardroom gender diversity and ROE

Gender Diversity	Cumulative ROE				
	year 1	year 2	year 3	year 4	year 5
Low	12.4%	24.5%	36.3%	47.7%	58.8%
Med	14.1%	28.2%	42.2%	55.3%	68.0%
High	14.7%	28.9%	42.9%	57.0%	70.9%
% Difference (High v Low)	**18.6%**	**17.6%**	**18.2%**	**19.4%**	**20.5%**

Source: FactSet, Realindex, 1 January 2009 – 31 December 2021.

Testing the findings

To understand whether these results are robust, we examined whether the relationship remains after controlling for several other common factors, in order to determine if diversity is essentially just picking up other characteristics of the firm that are known to be related to future operating performance.

This analysis confirmed the results shown earlier and revealed several insights:

- Controlling for sector and region effects, as well as other firm level characteristics, both senior management and board gender diversity are strongly statistically significant in predicting future firm level profitability.
- For either metric, we can see that firms in the top decile of gender diversity are able to generate approximately an additional 5% of ROE over the next five years, compared to firms in the bottom decile of either diversity metric, after controlling for other effects that drive firm performance.
- Furthermore, despite their correlation, the presence of both diversity metrics within the same regression does not invalidate the significance of either metric. In fact, we find that firms in both the top decile of senior management and board diversity generate approximately an additional 10% of ROE over the next 5 years compared with firms that have low (bottom decile) diversity in both senior management and the board. This suggests the importance of gender diversity for both boards and senior management teams, as predictors of financial performance.

Overall, the data sends a clear message: companies with a boys' club approach to leadership are a red flag for investors.

On the other hand, companies that walk the talk on women in leadership roles perform better, potentially making them more attractive investments.

Beyond this, we must not forget that equal representation is the right thing to do. This study has focused on gender diversity in leadership roles, but we acknowledge diversity is multidimensional, such as diversity in skills, experience, and backgrounds. Future work will look to see how we can build a more comprehensive picture in team diversity, thereby gaining greater insights into the management quality or organisational capital of the firm.

Dr Joanna Nash and Dr Ron Guido are Senior Quantitative Portfolio Managers at Realindex Investments, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Is it all falling apart for central banks?

Andrew Canobi, Chris Siniakov, Joshua Rout

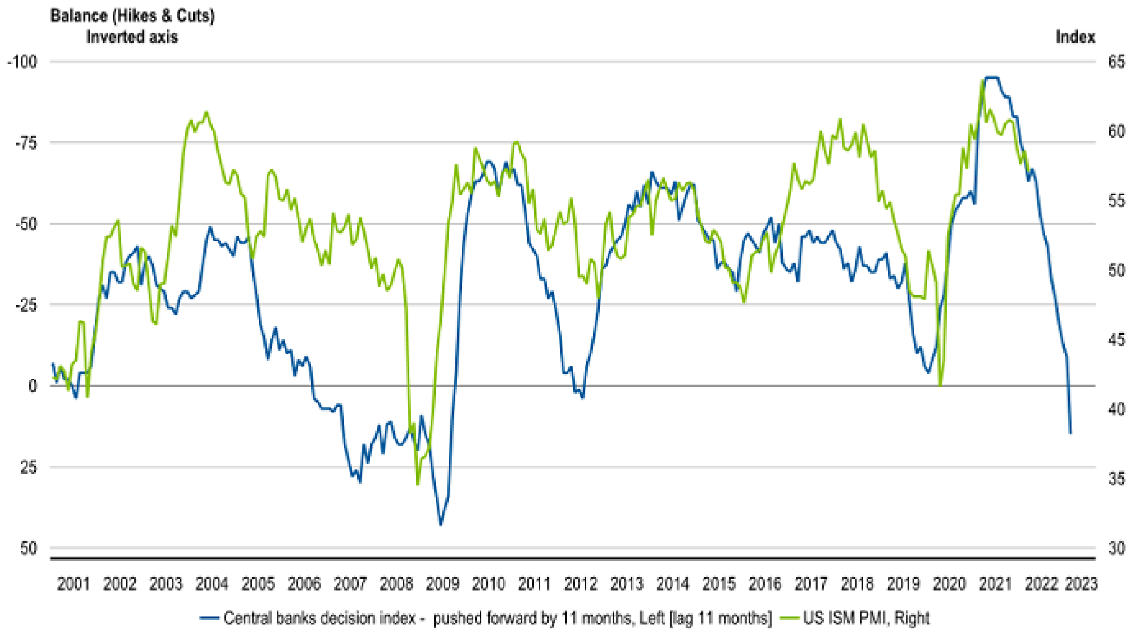
Years of rapid financialisation has led to colossal debt growth with low interest rates and quantitative easing (QE) helping to push asset prices higher. The tide is rapidly reversing, at least for now. Central banks are unable to ignore inflation, but both inflation and employment are lagging indicators.

We are now working through the consequences of the excessive fiscal and monetary stimulus delivered 18 months ago in the pandemic. A good example of the scale of that excess is real disposable income rising more than 15% in the US over the 2020/2021 period despite the economy being in recession as a deluge of fiscal transfer payments overwhelmed the actual loss of salaries and wages.

As well-intentioned as fiscal policy was, with the benefit of hindsight, it clearly exceeded requirements across the world. Global Debt/GDP is at record levels and markets have unquestionably been fuelled by an extended era of ultra-easy money. Unfortunately, the probability of this ending well is extremely low as the monetary action being taken right now will manifest itself in significantly weaker growth over the coming twelve months.

The chart below shows that across 125 central banks, we have seen a monetary tightening campaign to take conditions into the most restrictive since the GFC (blue line inverted). This is before moves this week, particularly from the Fed which likely moves by 50bps.

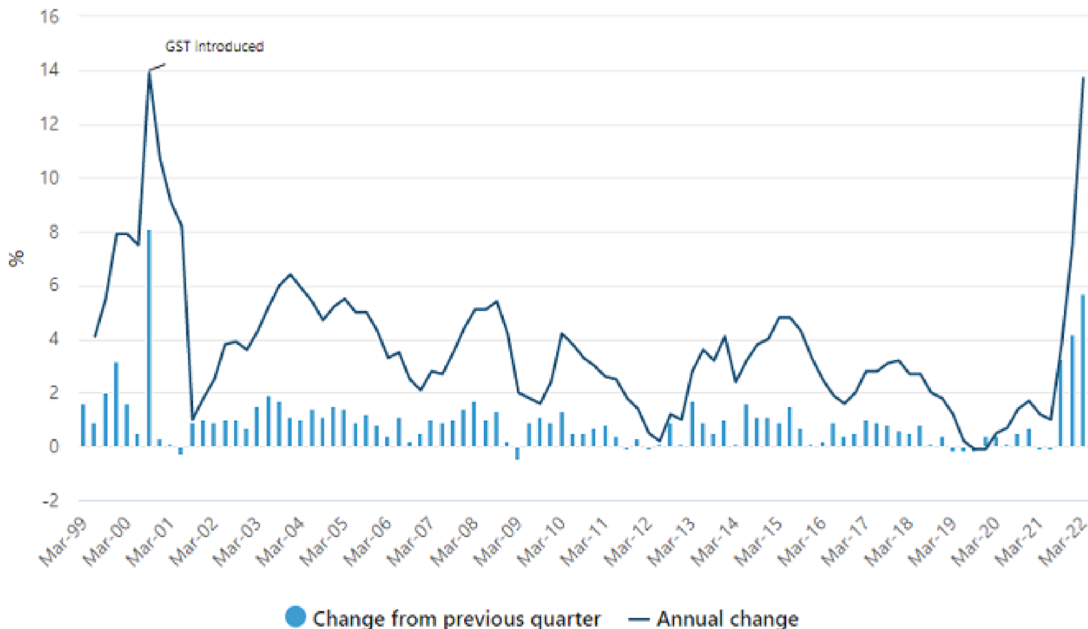
Advancing this index by 11 months against the US manufacturing ISM PMI shows how this story will end. Recession and early signs are already confirming that downturn. Just as inflation is a lagging indicator so changes in monetary policy work with lags which will show up over coming months and quarters.



The difficulty is central banks must respond to the here and now even as lags prevail. Last week's first quarter Australian CPI cannot be dismissed easily. 5.1% annual headline CPI is the fastest in more than 20 years and the measure showed some ~88 items in the ABS' basket recorded price gains. It's not the end of the world and its certainly not the 1970s. In many respects, everything that could have conspired to push prices higher in Q1 did. But there are some slivers of hope to consider:

1. Housing

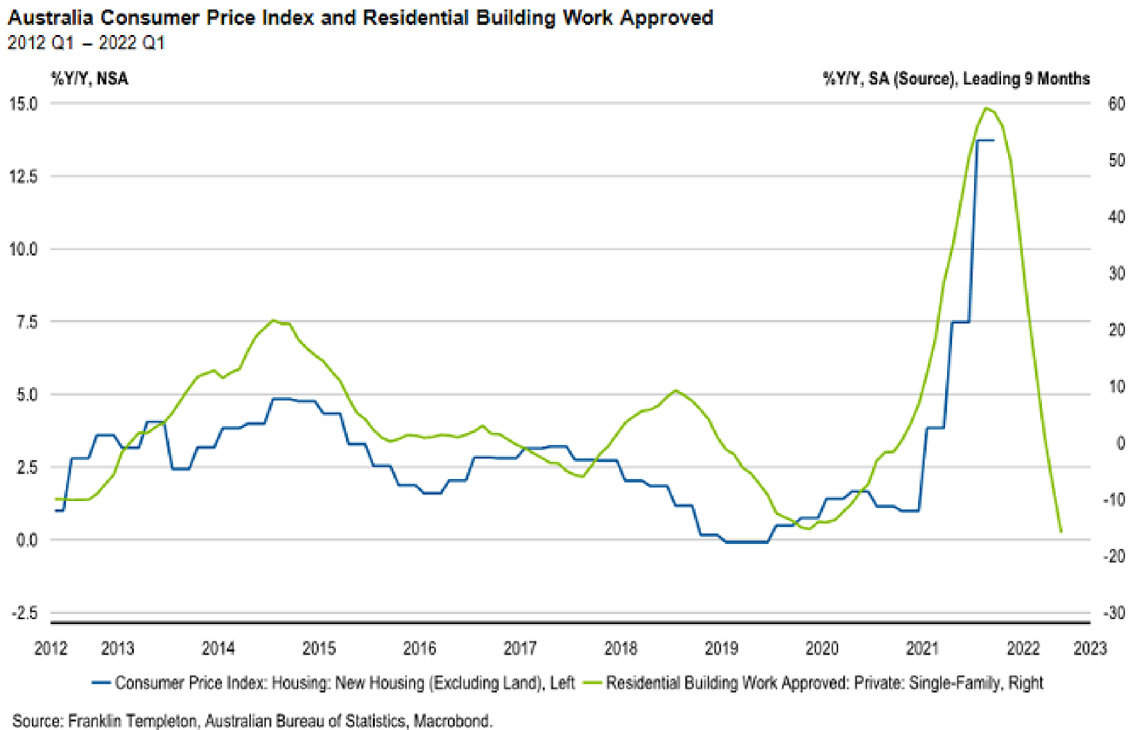
Housing has been one of the strongest sources of inflation pressure in the last 12 months. We are now experiencing the consequence of over stimulating housing at a time when supply of construction materials and labour was materially constrained. Construction costs for building a new home was one of the larger components that exceeded forecasts contributing 0.62% of the 2.1% quarterly number alone.



Source: Australia Bureau of Statistics

There are many reasons to suggest that we are moving past peak housing mania but it will take time to show up. Higher costs, the winding down of homebuilders, higher interest rates (which have already been moving as banks raise rates on fixed rate products in particular) and just the natural normalisation of housing demand will all cool construction.

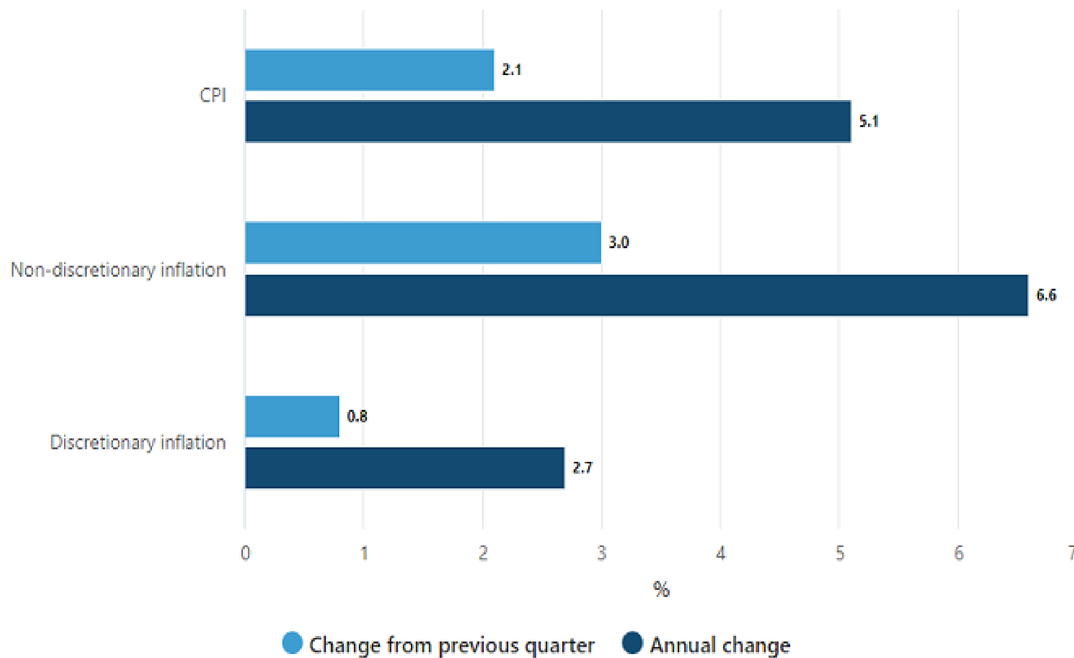
The chart below highlights the relationship between residential building approvals which exploded in 2020/21 (but is now in the rear-view mirror) and construction costs. In short, the worst might be past. We pay particular attention to the housing market because, as per the saying, as goes the housing market so goes the economy. Even the hint of higher interest rates is clearly starting to add to the list of headwinds for the sector with auction clearance rates already at multi year lows and Sydney house prices now down for two consecutive months (Corelogic data).



2. Non-discretionary prices

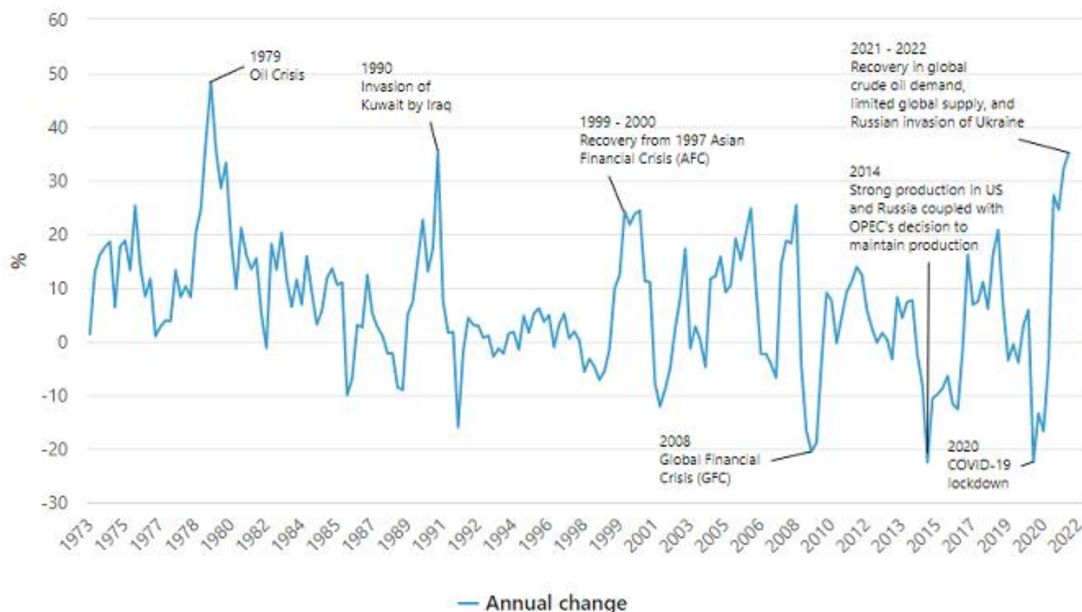
The RBA, along with other central banks, will be mindful of the moves in areas like food and energy and key non-discretionary prices. Increases in these areas act as de facto tightening as households can't choose to not eat or fill up the car. That is why core inflation ex these items is the focus for them. Core inflation of 3.7% is a concern but it's not seismically above the 3.25% in their 2022 forecasts. The ABS points out that non-discretionary CPI grew at more than twice the pace of discretionary.

In some ways, in Q1 everything that could go wrong, did. From the Ukraine conflict impacting energy prices to floods in NSW and QLD adding to food inflation. Which doesn't mean the RBA won't respond but it highlights that prices of non-discretionary items are already doing some of the work for them in curbing demand. The risk when price pressures spread is a more broad-based cycle leading into a wage-price spiral. So doing nothing is not an option.



Source: Australia Bureau of Statistics

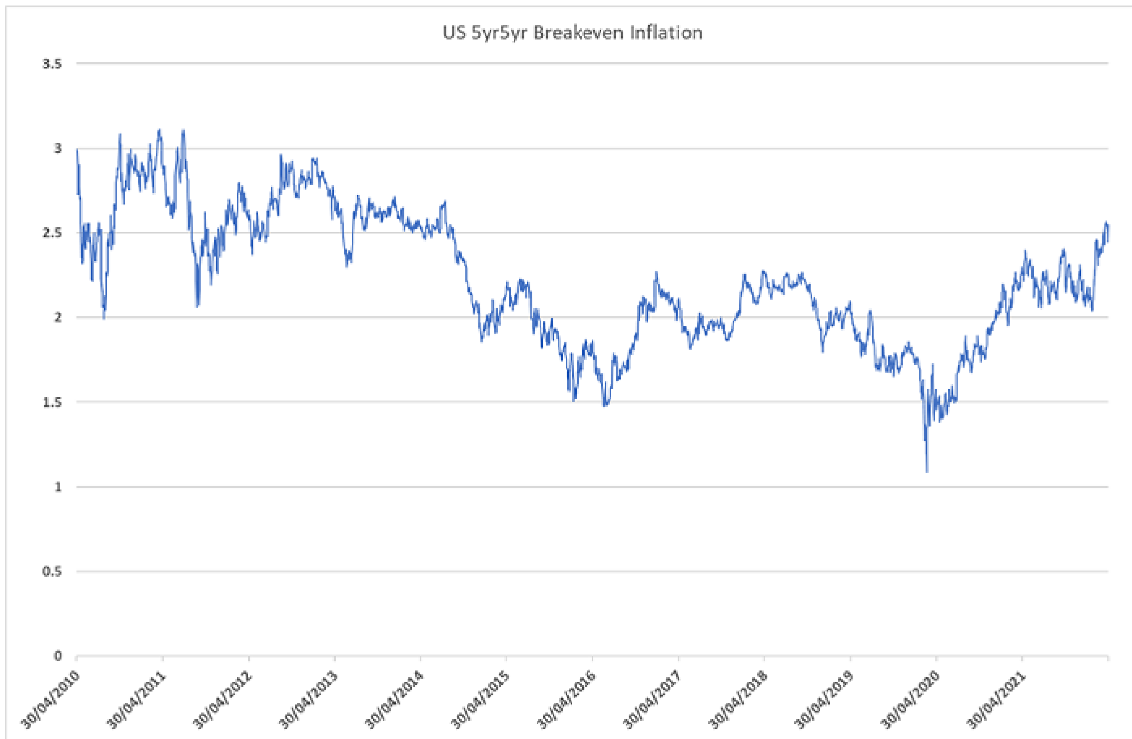
Within this category, energy prices faced a perfect storm in Q1. Prices may stay elevated for some time but a 30% plus move from here is clearly much less likely.



Source: Australia Bureau of Statistics

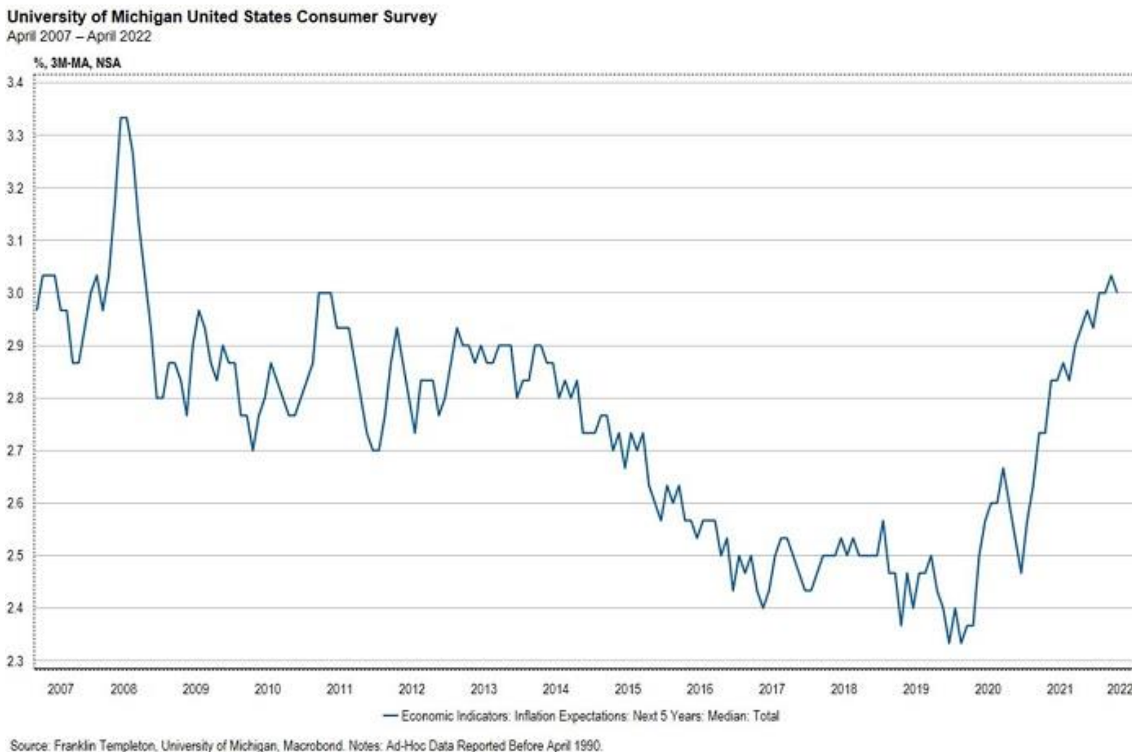
3. Inflation

Markets continue to believe inflation is not likely to be a persistent phenomenon and that central banks are going to be effective in dealing with it. The US led the developed world in this inflationary cycle and we continue to look to at the US economy for signs of a peak. Longer term expectations for inflation remain well anchored. It is striking that despite a ~8.5% headline inflation level in the US (as at the most recent print) the closely watched US 5yr5yr forward breakeven rate remains only a little above recent averages at ~2.54%.



Source: Franklin Templeton, Bloomberg

Survey based measures of inflation expectations also remain anchored albeit higher than their previous low levels. The University of Michigan Consumer Sentiment survey of longer-term inflation expectations has risen but is still at levels around 2012/13. Policy makers don't want to see these rise much further but if a peak is close that risk should be limited.



Source: Franklin Templeton, University of Michigan, Macrobond. Notes: Ad-Hoc Data Reported Before April 1990.

The risks are that the longer headline inflation persists the greater the risk that longer term measures of expectations become 'unanchored' leading to a wage-price spiral. We are not there yet and markets do expect it. There is no disagreement that US inflation will slow from its current lofty heights. There is disagreement about the pace and extent, but the signalling this will convey will be powerful for the world. This will be an

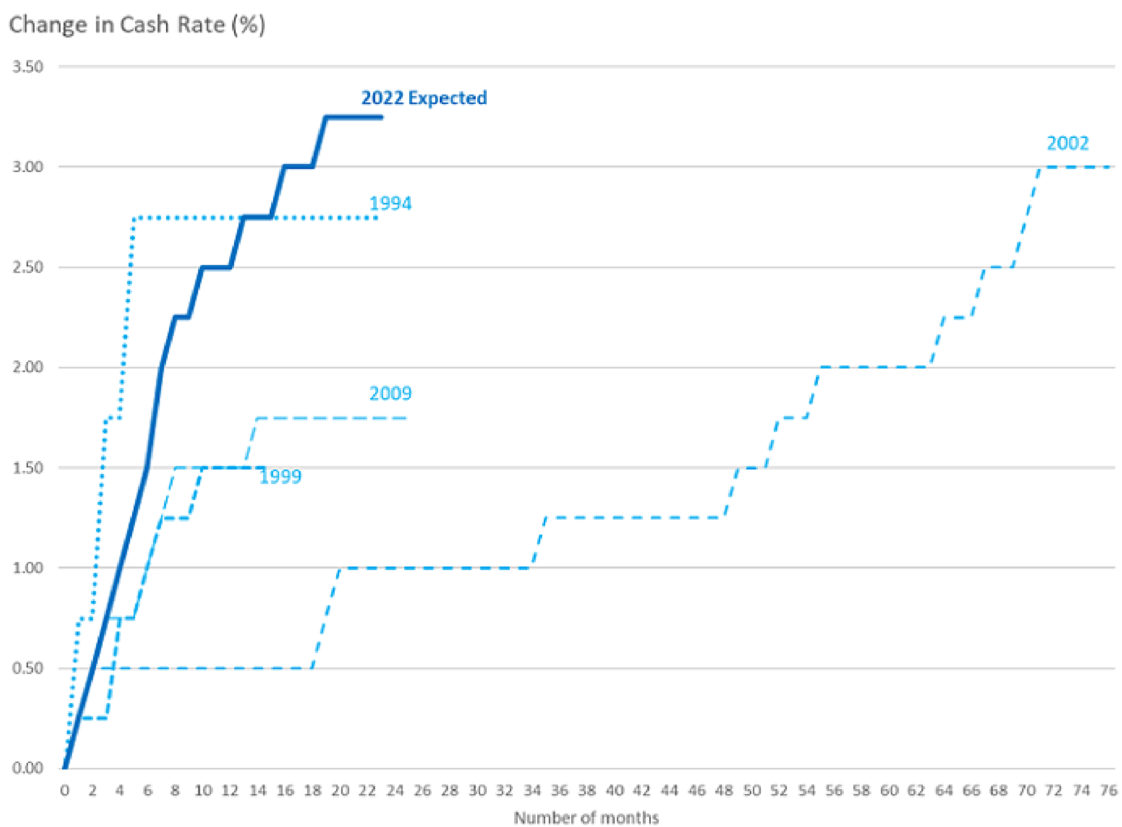
important and powerful signpost that we are passing a peak in the developed world which will be important for Australian dynamics where an unhelpful assumption has been made that so the US goes, so goes Australia.

4. Monetary policy

Monetary policy will still not be anywhere near as aggressive as markets expect. Below we show what is implied by current market pricing for the RBA versus the last 4 rate hike cycles going all the way back to 1990. In short, markets continue to project the most aggressive tightening cycle to ensue in more than 30 years. Both in terms of speed of move and size of rate hikes themselves.

With household debt levels at record highs and consumer confidence already weak, a cash rate as implied by current markets would likely push Australia into a housing led recession. What the RBA actually delivers and where the cash rate ends up is the most significant driver for bond market returns over the next year.

Our view hasn't changed that the RBA will take a measured approach to raise rates and likely end up with a terminal rate in the 1.25% area. It could be slightly higher, but it is almost certainly not going to be the 3.5% now priced by markets.



Source: Franklin Templeton, Bloomberg

These are perilous times with markets already feeling the chill of the monetary deep freeze underway - the Nasdaq is down more than 20% YTD, emerging market currencies have fallen significantly and real estate markets are showing signs of weakness. The probability of central banks gently landing the plane looks to be shrinking by the day. Global financialisation is facing its biggest hurdle since the GFC.

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