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Editorial

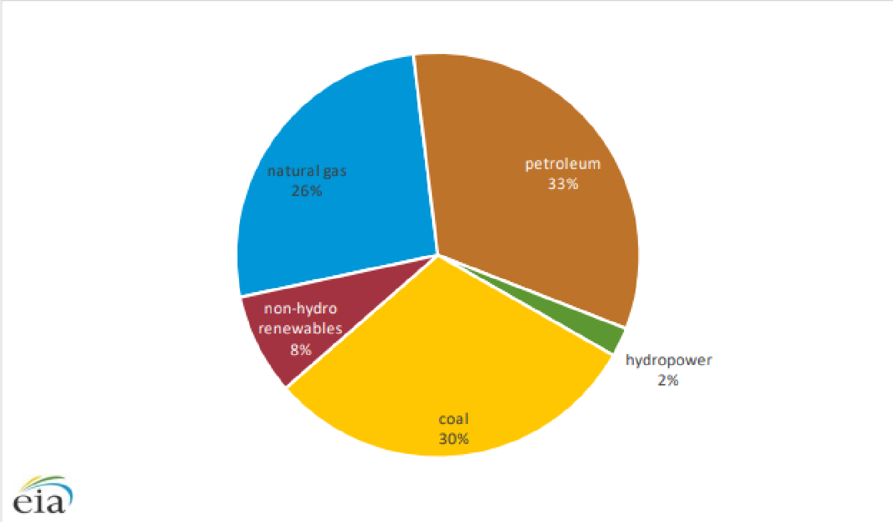
Anthony Albanese experienced a dream first fortnight as Prime Minister, joking with **President Joe Biden** in Tokyo, appointing a record number of women to the new Cabinet, gaining a hard-to-elect Leader of the Opposition and even watching South Sydney win from the stands alongside his partner, **Jodie Haydon**. But he is realistic enough to know that the fun run will not continue, and an early threat is energy.

On the east coast, wholesale energy costs have spiked 600% in a few months, and both businesses and households face large increases in gas and utility costs. The default retail energy prices come into effect from 1 July, rising by up to 18.3% in NSW, 12.6% in south-east Queensland and 9.5% in South Australia. With wages lagging inflation and interest rates increasing, we should expect belt tightening across the economy.

The new Resources Minister is **Madeleine King,** and one of her first acts was to support WA's $16.5 billion Scarborough gas project. She said gas has an *"important role in the transition to a decarbonised world"*. The Government will not support a ban on fossil fuel projects. The energy crisis is intertwined with the climate change debate, including doubts whether new sources such as renewables can be switched on quickly enough to allow an early closure of fossil-fired generators. **Mike Cannon-Brookes'** successful prevention of the separation of the power assets at **AGL** is a long-term project, although there is no doubting his tenacity and optimism (he attached a picture of a path through a forest to this tweet).

There are conflicting reports on how much of Australia's energy consumption comes from renewables, with some data placing it at about 10%, as shown below. Other sources have it higher, but either way, fossil fuels still dominate.

Figure 2. Total primary energy consumption in Australia by fuel type, 2020



Source: Graph by the U.S. Energy Information Administration, based on data from BP Statistical Review of World Energy 2021

Although the election result was a clear sign of a rising climate change focus by Australians overall, amid the best ever result for The Greens, the party's leader, **Adam Bandt**, issued a qualification:

"We need to get out of coal and gas but do it fairly."

This tempering of the message is important, emphasising the so-called transition. **Debby Blakely**, Chief Executive of industry super fund, **HESTA**, a major investor in AGL, said:

"Shareholders are increasingly expecting companies to do more to drive a timely, just and orderly transition to a low carbon future."

Words such as 'fair' and 'just' must be part of the discussion. Fund managers need to allow time for this adjustment, including acknowledging the impact on poorer people and nations. At Firstlinks, articles from fund managers on ESG and divesting from fossil fuels come in every week, and banks now eschew loans to fossil fuel companies. When confronted by a young activist at the recent **AFR** Banking Summit, NAB CEO, **Ross McEwan** said his bank no longer funds new coal, oil or gas projects. Some fund managers, such as **Blackstone** (the world's largest alternative assets manager) have advised clients they will not invest in the exploration and production of oil and gas.

With this background, it is welcome when a leading fund manager, **GQG's Rajiv Jain**, takes an opposing view, to balance the debate. GQG has not only reweighted portfolios to 'energy' due to favourable valuations, but Jain calls the lack of funding for fossil fuel industries "immoral". It's a view that might upset some people but we need to review both sides during this transition which, in reality, will take decades.

Our interview this week is with **Reece Birtles, CIO at Martin Currie Australia**. He explains his approach to generating income from shares for retirees, reducing the focus on price volatility and more on the reliability of dividends. It's also notable that Birtles is a major investor in AGL, and his view against the demerger is:

"It will be a stronger company in 10 years' time being a combined business. The significant investment required in renewables is best supported by the customer base and the ability to deliver a more reliable and sustainable energy supply."

And while my employer, **Morningstar,** takes a strong view on the ESG policies of funds and companies in its ratings, including owning the **Sustainalytics** business, there is obviously a range of opinions. The Head of Equity Research, **Peter Warnes**, cautions that we cannot move too quickly, quoting **Jeff Currie**, the Global Head of Commodities Research at Goldman Sachs, who describes decarbonisation as *"replacing the fuels that we use for the way we do manufacturing, the way we create transportation, and the way we heat and cool ourselves for 250 years."* Peter asks:

"How do poor countries, whose energy generation is based on fossil fuels, fund the transition? A successful transition to zero emissions will take decades, not years. Fossil fuels are part of the transition process and will be required to generate reliable and sustainable base load power also for decades."

The second major challenge facing the new Albanese Government, especially **Treasurer Jim Chalmers** and **Finance Minister Katy Gallagher**, is how to rein in the budget deficit. There are tensions everywhere, from rising interest rates increasing the cost of $1 trillion of debt, greater defence spending and the rapidly rising costs of health, aged care, child care and disability services. It will be extremely difficult, if not politically impossible, to walk away from the legislated tax cuts due to start on 1 July 2024, but they will cost a whopping $137 billion by 2030. The application of a flat 30% tax rate for income earners between $45,000 and $200,000 will put up to $9,000 in the pockets of high income earners. At the same time, the **Reserve Bank** is trying to slow the economy and inflation. Dare Chalmers renege on a policy promise when many (most?) recipients probably feel the tax cut is no longer inappropriate for the times?

And a quick comment on Albo. Anyone tweeting and hoping to link to him using the tag **@Albo** better know it belongs to an Italian adult comic artist and our own Albo can be reached on **@AlboMP**.

Also find time to read these articles in our packed edition ...

Supporting the arguments made by Reece Birtles, **David Walsh** explains why Value stocks have regained some of the ground gained by Growth stocks over 2020 and 2021, including some revealing charts.

Last week's article on democracy received about 50 comments and many opined on the merit or otherwise of the preferential voting system. Actuary **Tony Dillion** has looked at the numbers from the election and gives a fascinating explanation of the impact of our voting system on the result. What seems like a simple design feature actually determines who forms government.

Jeremy Cooper is also in a number-checking mood. Who knew 700 people in Australia retire every day? That's a lot of superannuation, but Jeremy says many are missing a smarter way to hold their retirement savings.

Then following a deep read of the messages from the world's most powerful central bank, the **US Federal Reserve**, **Rudi Filapek-Vandyck** says the popular mantra, 'Don't Fight the Fed' now has a completely different meaning which investors need to understand.

Finally, **Jason Hsu**, who as well as his role as a portfolio manager, has held visiting professorships at many Asian universities, gives a quick snapshot of three Investing 101 lessons he feels are often missed. His main message: if everyone knows it, it's already in the price.

This week's White Paper from **Vanguard** is an update on the numbers and rationale for index investing. While Vanguard is clearly an advocate of passive, it is also a major active manager, so it's not a one-way street.

Is the fossil fuel narrative simply too convenient?

Graham Hand

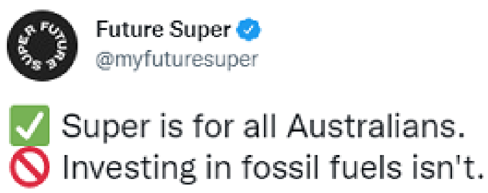
The impact of climate change and the need to move away from fossil fuels is infinitely nuanced. In the 2022 Federal Election, there was a swing to a faster climate change agenda with strong support for The Greens and 'teals'. Then AGL, the country's heaviest carbon emitter, was prevented from demerging its power generation assets by the judgement of Mike Cannon-Brookes and other shareholders that the move would slow the closure of its coal-fired sites. Into this mix comes a $100 billion fund manager, GQG Partners, saying the energy transition may take up to 60 years and it is immoral to underinvest in fossil fuels.

Many portfolio managers privately believe their businesses are too extreme in their anti-fossil stance. In the investment industry where everyone seems to fall over each other to show their green credentials, it is a refreshing change when someone is willing to go on the record to put the other side, not simply whisper in the corridors of their offices.

GQG has some support in Canberra and Perth. Both the new Resources Minister, Madeleine King, and Western Australia Premier, Mark McGowan, are backing the $16.5 billion Scarborough gas project. King said gas has an *"important role in the transition to a decarbonised world"* and the Government will not support a ban on fossil fuel projects.

It's all about the timing

The prevailing view is that immediate action is needed to prevent catastrophic climate change. The majority of fund managers have adopted strong ESG (Environment, Social and Governance) principles front and centre, and large superannuation funds compete to divest from fossil fuels the quickest. No doubt a motivation is to satisfy their investors and members, as most surveys show climate change is a major issue Australians expect leaders to act on.



An example of the policy intensity on fossil fuels soon surfaced after the election. Dr Monique Ryan, the conqueror of Treasurer Josh Frydenberg, said she wants a 60% emissions reduction target by 2030, much higher than Labor's current 43% level. She said Anthony Albanese needs to be "… *prepared to come to the table on effective and immediate action".* Maybe Mr Albanese is not quaking in his boots now he has a majority in the Lower House.

The reality of a long transition from fossil fuels

GQG Partners held its first Annual General Meeting on 27 April 2022 following its listing on the ASX in October 2021. Rajiv Jain is the Executive Chairman, Chief Investment Officer and Portfolio Manager at GQG. At the AGM, leading activist Stephen Mayne asked the following question:

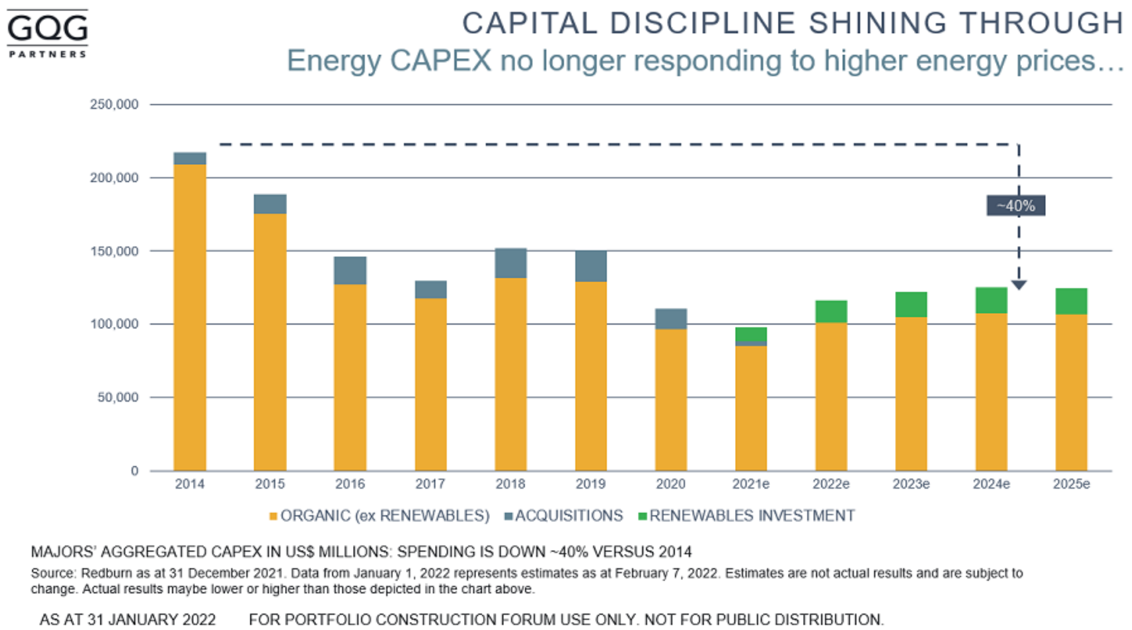
"Executive Chair Rajiv Jain made some very strong comments at a forum in February saying that reducing investment in fossil fuels was elitist and immoral because of the impact it could have on developing economies ... can Rajiv update shareholders on what responses to these comments have been from stakeholders?"

Good question, so what exactly had Jain said? Speaking at a [Portfolio Construction Forum] on 23 February 2022, in a presentation with the provocative title of '*Growth managers that lack energy may be left out in the cold*', Jain said (with some paraphrasing):

"We believe that investors have always made a bit of an ideological call not to invest in fossil ... Like so many times, there's a narrative that is convenient, but most of the time, the narrative takes a life of its own and becomes too strong a belief which ultimately tends to negatively impact returns. And I think if you look at the energy side, we believe that the narrative seems to be way too convenient."

The devil is in the detail, said Jain, as the transition is much longer and more complex.

"Because if we choke off capital to fossil, whether it's oil and gas, coal, and so on, the narrative is that we would be better off. Well, it's ideological, there's no commercial merit to it. And the reason is that if you don't do anything with demand, choking off or reducing supply will only create a crisis ... The biggest problem on the energy front is capex, as the vast majority of banks are under pressure not to lend to the oil and gas industry. And capex has gone down by almost 40% over the last seven or eight years, which is very different to 2010 when everybody believed in the commodity supercycle, Chinese urbanisation and emerging market growth."



(Published with the permission of GQG Partners and Portfolio Construction Forum)

Jain explained how the free cash flow from many high-quality energy companies, such as Exxon, has risen rapidly, but investors are missing the opportunity that will last a long time.

"We feel that investors are making non-commercial decisions, because these energy transitions last, if you look at human history, they last decades. And in those transitions, you need companies that are part of the solution, not part of the problem. So we should squeeze out bad players, bad actors, but some of the good actors are needed because otherwise you'll get an energy crisis. In fact, you're seeing demand for coal going up and coal

prices have gone up because ironically, there's a gas shortage when the wind didn't blow (in Europe), and we were having power shortages. They've been forced to actually import more coal and so we might be having a perverse outcome if we're not careful. Our job is to find companies that are good that are truly part of the solution, which will allow us to make the transition to clean a better world. We feel a lot of growth managers have become too complacent. In fact, 65% to 70% of global growth managers have no energy."

Jain argues that forcing fossil fuel companies into private equity hands is the worst outcome as their business practices will move away from the gaze of active managers in the listed, regulated space. Aspirations for 2030 are ahead of what is technically possible to meet energy demand.

"I think that's the sad part, that it'll take a long time to truly transition. This transition could last 40, 50, 60 years. And the question is, to what extent will it be successful, because we need to find a lot of other commodities to make that transition. As you know, electric vehicles are six times more copper-intensive. Well, we need to find a lot of copper to be able to make the transition. So we feel buying better companies, trying to lean on management to get their act together and be better corporate citizens, we actually can make a much bigger difference."

What about the morality?

In what started as a potential 'gotcha' question, Jain was asked, "*Taking this position in energy, do you feel it's* ***morally*** *the right position to take?*", he replied somewhat indignantly:

"Look, I think it's actually immoral not to invest in energy. Unless we're willing to live by burning candles or willing to walk rather than drive. In fact, one could argue that reducing supply is a bit elitist with a third of the world still making the transition from wood to something else. We need cheap enough energy for the world to make the transition to get a certain level. You know, 25% of the world doesn't have a power supply yet. So if you raise prices too much, you'll have perverse outcomes. So I believe it's morally wrong to reduce supply. Go to India, go to Africa, go to parts of China, and saying the oil price should double is not a realistic argument."

So would Jain duck the issue in a more public forum? No, as he expanded at the AGM.

"If you look at 80% of the world, (they) cannot afford a $10,000 car. To say that they all will drive Tesla is absurd. If you stop producing fossil fuel, 80% of the world will not be able to drive a car. So I think if you look at it realistically, globally, we do need fossil to make the transition to a greener, better world and from a client perspective, our clients understand and appreciate our investment processes and I think we feel pretty comfortable in terms of our core investment proposition."

Jain then answered the question about whether institutional clients are moving away from GQG.

"There's not enough copper for Europe to switch to EV, let alone the world to switch to EV. It's kind of fascinating, in fact, we are getting quite a bit of interest and attraction because the majority of global managers have decided not to invest in fossil, which is why a lot of them are struggling. In fact, one could argue the problem with aggressive growth managers is they have no energy … So I think there's always two sides and look, the world is a big enough place. I'm sure some investors don't want to invest in fossil while others do want to invest in fossil. So our job is to find like-minded investors to agree that for the world to transition to a greener world, we need energy to allow us to transition."

ESG definitions and principles are far from settled

It would fair to expect that a company such as Tesla, the market leader in electric vehicles and the move away from gas-guzzling internal combustion engines, would be a priority name for ESG investing. However, Standard & Poor's Dow Jones recently removed Tesla from the S&P500 ESG index while oil companies remain. Hector McNeil, co-CEO and Founder of HANetf, explained why this happened:

"On the surface, Tesla's deletion from the S&P500 ESG index looks shocking. Tesla is a real pioneer of climate solutions. Meanwhile, big oil names like Exxon are in there ... If you read the reasoning of SPDJI, it's quite clear why Tesla was excluded. It doesn't have a low carbon strategy and has questionable labour practices ... But the key is that there's no inherent right of Tesla or other EV or battery makers to be in the index."

Not surprisingly, Elon Musk was unimpressed, tweeting:

The investment industry and regulators are still attempting to define ESG principles, with the US Securities and Exchange Commission announcing proposals to manage the trend to 'greenwashing' to take advantage of ESG demand. Investors struggle to know whether a company or fund really values ESG principles, or treats it as 'table stakes' to win money. The regulations extend to the 'Names Rule', or what a fund or fund manager can call itself. SEC Chair Gary Gensler said,

"A fund's name is often one of the most important pieces of information that investors use in selecting a fund."

In Australia, Dugald Higgins, Head of Responsible Investment & Real Assets at Zenith, said:

"We are essentially at the point where any company or fund that cannot demonstrate deep environmental, social and governance credentials, which naturally spans a wide range of sustainability and social issues, will simply be 'investable' to institutional investors."

Try telling that to Warren Buffett. In 2022 to date, Berkshire Hathaway has acquired 14.6% of Occidental Petroleum costing US$10 billion and invested US$26 billion into Chevron, making it one of his Top 5 holdings. Analysts say Berkshire has placed a US$40 billion bet on the oil sector.

This article will not venture into the vexed questions of whether adoption of strict ESG principles enhances portfolio returns or the anthropogenic contribution. People want action and ESG investing clearly has a strong future. However, uncertainty about definitions, voluntary nature of ESG disclosures, limited enforcement and need to allow the underprivileged of the world a chance to access cheap energy show the debate about speed of reducing fossil fuel use is far from settled.

In the meantime, some fund managers are benefitting from fossil fuel companies enjoying a surge in prices, and every investor needs to decide whether this fits with their personal morality and understanding of the broader issues.

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

Reece Birtles on selecting stocks for income in retirement

Graham Hand

Reece Birtles has been Chief Investment Officer at Martin Currie Australia since 2006 and is the lead Portfolio Manager on several funds including the Equity Income Fund. Martin Currie is a Franklin Templeton investment manager.

GH: In your presentations, you talk about having 'sufficient income for life'. How does this investment method differ from other equity income funds?

RB: Going back to the late 2000s, a few of us in the investment team had parents approaching retirement and it was also the time of the GFC with massive market volatility and uncertainty. There was a perception that equity portfolios were very risky, so we set about designing a portfolio specifically for Australian retirees and their circumstances. When a typical couple retire, they might have about $600,000 in superannuation and they need about $50,000 a year of income to support their standard of living. They want the $50,000 to grow with inflation over time as they still have a very long life expectancy.

GH: What are you assuming about age pension entitlement?

RB: Yes, they are probably eligible to get the pension of about $20,000, so that means they need about $30,000 a year from the super portfolio. As an investment objective on $600,000, we need to generate about 5% to give $30,000, but more than aiming for a percentage income, we want to produce $5 on each $1 growing on a steady and reliable basis, faster than inflation. That's what we think is a sufficient income for life for an Australian retiree.

We also want to reduce the risk and the variability of that income. We take franking into account and we ignore the benchmark weight for individual stocks and sectors. We don't want 40% of the portfolio in one sector where all the dividends could get cut at one time and we don't want 15% in one stock. We're building a highly-diversified income stream that can grow over time.

GH: You are asking retirees to think in terms of income rather than volatility. Do you think this message and the strategy has worked and is understood?

RB: The standout feature of this equity income strategy compared to say a term deposit as a retirement income investment is that the latter has fallen by about 80%. So the income volatility of a term deposit is amazingly high, even though it is capital stable. Whereas when you look at equities, whilst the share price volatility might be 15% to 20% per annum, the variability of the dollar income stream from the dividends of companies has been significantly lower. The COVID year was a big challenge to dividends and the income stream on our strategy was down about 20%. It was significant but far less than the 34% fall that the ASX200 dividend stream suffered. The income stream has now fully recovered, driven by the diversification and owning high quality companies.

GH: In the last six months, there has been a change in the investment environment with an acceptance that inflation is rising, central banks increasing interest rates and now a war in Europe. Have these factors changed the way you're investing?

RB: In the current environment, there's more appeal in industrial-style businesses that can pass on price increases to their end customers, given demand is strong and they're not impacted by travel restrictions. Commodities have more appeal, and we're also looking at names such as Aurizon (ASX:AZJ) where demand is locked in and, if anything, improves with the current market. We look for regulated assets where inflation flows through to increases in prices automatically.

GH: Are there other Australian companies you feel have this strong pricing power and can withstand the inflationary shock.

RB: We like Medibank (ASX:MPL), it has a strong market position and lower cost to serve than its competitors. While there are always discussions about private health insurance increases, it's the best player in a regulated business. It's the type of resilient income stream we look for. We think Telstra (ASX:TLS) is strong, mobile phones are not a discretionary purchase and the demand for data is always rising. We also look at companies which benefit from change, such as the demand for renewables construction and a name like Downer (ASX:DOW) has improved the quality of its business and become a more reliable dividend-paying company.

GH: So how does Equity Income differ from the Real Income Fund, launched in 2010 with positive returns every year except 2020? And what happened in that year around COVID?

RB: The Real Income Fund is designed with the same purpose for retirees to have a stable growing income stream, but it is focussed on what we call hard assets or real assets, such as property, infrastructure and utilities. The idea is that they're less susceptible to the business cycle and they have pricing power with mechanisms on tariffs or rents and they benefit from population growth over time. In 2020, COVID changed the circumstances for many of those assets significantly, such as consumers not able to go to shopping centres and less travel on toll roads. There was even a reduction in demand for electricity and gas due to industrial closures. But income streams and dividends did significantly better than share prices, and then the income recovers as the economy reopens.

GH: Does that Fund have fewer opportunities in Australia with ongoing privatisations, such as Sydney Airport and CIMIC leaving the ASX?

RB: Yes, it's true that a some high-quality companies have been privatised given how attractive these real assets are in an inflationary environment, so we're increasingly looking to offshore stocks such as Zurich Airport to find suitable replacements such as for Sydney Airport while retaining a predominantly Australia-orientated exposure.

GH: We're seeing a stock rotation in Australia with some hefty corrections in company share prices that did well over 2020 and 2021 but are there market segments that you consider expensive or cheap at the moment?

RB: There's still one of the biggest distortions in markets as the price of typical value-type stocks versus growth-type stocks has been extraordinarily wide. If you look at the Price to Earnings (P/E) ratio, for example, of the MSCI Growth Index versus the MSCI Value Index, we're coming off one of the most extreme events.

The biggest dispersion in P/Es have been in the tech bubble, during the GFC and in 2020. Clearly, that has started to reverse, but we started with a P/E on the Growth Index in excess of 30 times and the Value Index was around 15 times. The typical spread is about three points, and the current spread is still over 10 points. We think there's been a great distortion in terms of valuation across stocks.

Relative performance of MSCI Style indices

Past performance is not a guide to future returns.
Source: Martin Currie Australia, FactSet, MSCI. As of 30 April 2022.

The inflation dynamic is driving a rebalance back to more normal levels, especially as inflation is better for value stocks. They tend to be more 'materials-type' businesses, with pricing power when demand for goods is strong, supply is restricted and even with ESG pressures. We think this will play out over 10 years.

GH: Do you think the market has missed a big theme that is undervalued or under-appreciated?

RB: The strongest when we look at the stocks that we own that we think are undervalued is what we call 'ESG inflation' and the clear path needed to reach net zero and reduce carbon exposures. It creates a supply reduction in some parts of the economy but also the amount that needs to be spent to achieve net zero is over US$3 trillion a year over the next 30 years. Whereas we used to fund the world economy on about $500 million a year of fossil fuel investment. We need to create a new fleet of energy generation rather than use aged equipment, with the capital intensity of renewables higher dollar per unit of generation than traditional sources across a range of fossil fuels.

It includes different types of fuels, commodities, construction requirements, engineering skills and the like. A name we really like is Worley (ASX:WOR), not only do they service traditional oil and gas companies, but also the engineering required for large-scale renewable projects such as carbon capture or offshore wind projects. Already, 30% of their order book is in the renewable space and we expect that to grow strongly.

GH: It's easy to be a fan of resource stocks at the moment but they have a boom-and-bust reputation including in the good times, not spending capital well. How do you feel about resources?

RB: We've been overweight in Woodside (ASX:WPL) and Worley, leveraged to the energy cycle, but we're underweight iron ore. There's been a shortage of iron ore and strong demand out of China but that's changing and the long-term price for iron ore looks a lot lower than where it is today. We like to buy the names that are unpopular, but right now, it's hard to find a commodity that is not trading well above normal. We owned South32 (ASX:S32) and did well out of it.

GH: Can we turn to identifying something which has not gone well in your portfolio, perhaps a stock you strongly believed in but eventually, you decided to sell because the thesis didn't played out? What did it tell you about your investment process?

RB: Yes, QBE (ASX:QBE) has been difficult for us. We avoided it for so long from about 2000 when it was an extremely strong stock and they had some management changes. It was hit by the commercial pricing cycle and it came back a long way, and it was looking attractive to us. New management was in place, building trust and we took a long time to build faith in the new management. Then COVID came along and they had greater losses from credit insurance than we expected and then they did a rights issue. We thought we had taken the time to understand it but there were further management issues. The lesson is that in many opaque types of companies such as insurance, management trust and board competency are really important. QBE is resetting itself again and the fundamentals are there, there's a new CEO and a recent profit downgrade but things look better now.

GH: And every investor has the one that got away, the one that you were looking at but maybe it didn't meet your price target. Is there a company that has done a lot better than you expected?

RB: In recent times, it's the copper names. We were very positive on the demand side but found copper stocks expensive for a long time. Then in March and April 2020, there was a great opportunity to get those copper exposures at a good price and we missed that one. There was so much happening but we didn't buy into it at the right price and it got away from us.

GH: And on the positive side, something you own that has delighted you?

RB: We have owned JB Hi-Fi (ASX:JBH) for so many years and thought it was a quality retailer, a great brand proposition, best in class and yet it always traded as a consumer cyclical. Most people didn't have much faith in it, and it traded at low multiples and sold off every time a problem hit the economy. But what they achieved and executed especially during COVID led to a rerating and we did remarkably well out of it, we owned about 8% of the company at one point.

GH: Last question, what do you think are the key requirements of a fund manager?

RB: The importance of team and investment process. It's a complex, uncertain world and the benchmark has lots of names in it. You need a disciplined investment process with experienced analysts and investors on the same page in what they are looking for. You need to capture people's insights in the art of investing and getting that blend right takes time.

Graham Hand is Editor-At-Large for Firstlinks. Reece Birtles is Chief Investment Officer at [Martin Currie Australia](), a Franklin Templeton specialist investment manager. Franklin Templeton is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual. Past performance is not a guide to future returns.

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Inflation: friend or foe of Value stocks in 2022?

Dr. David Walsh

Time flies in the world of investments, and the themes that were emerging last year have gathered speed, including high realised and anticipated inflation, a risk of a global recession and the outbreak of the Russia-Ukraine conflict. In this context, we have revisited the question of how Value stocks are performing, especially versus Growth.

(Note. A Growth stock is any share in a company that is anticipated to grow at a rate significantly above the average growth for the market. A Value stock is a share trading at a lower price than the intrinsics of company's performance may otherwise indicate).

The story so far

Inflation commentary has moved from 'transient' to 'temporary' to 'sticky' and is now approaching 'entrenched' at a fast clip.

During this period of uncertainty, Value stocks have performed well, which coincides with (but is not entirely driven by) higher inflation. Very expensive Growth stocks, hit both by slowing growth and by inability to source materials, have sold off significantly.

We believe Value will continue to do well for some time (or Growth will do poorly), as the issues driving inflation are unlikely to be resolved any time soon, and the knock-on impacts will take some time to filter through.

How has Value performed?

While there is a fairly well-known, positive relationship between the returns to Value and inflation, the relationship is by no means simple. It was probably greater in the high-inflation period of the 1970s when oil prices were high and inflation was not targeted by central banks, as it is today.

However, two comments on this relationship:

1. Inflation is up, is sticky and is expected to stay high for some time

We know that higher inflation means higher nominal interest rates, and higher cost of debt for companies. Companies that rely on longer-dated cash flows for their valuation – so-called 'long duration' companies – are much more affected by increases in interest rates than those with shorter duration. These longer duration names are typically the expensive Growth stocks and are devalued and sold off more than shorter duration stocks, which are typically the cheaper Value-style companies.

2. Economic growth expectations are muted

When projections of expected growth and future cashflows are positive, the market is willing to pay up for expensive stocks, betting that things will go well. However, if this growth is interrupted, as it has been recently, the expectations are less optimistic and expensive companies are sold off in favour of companies with more certain short-term opportunities, especially those that are cheaper.

It's both an 'expensive' and 'risky' story

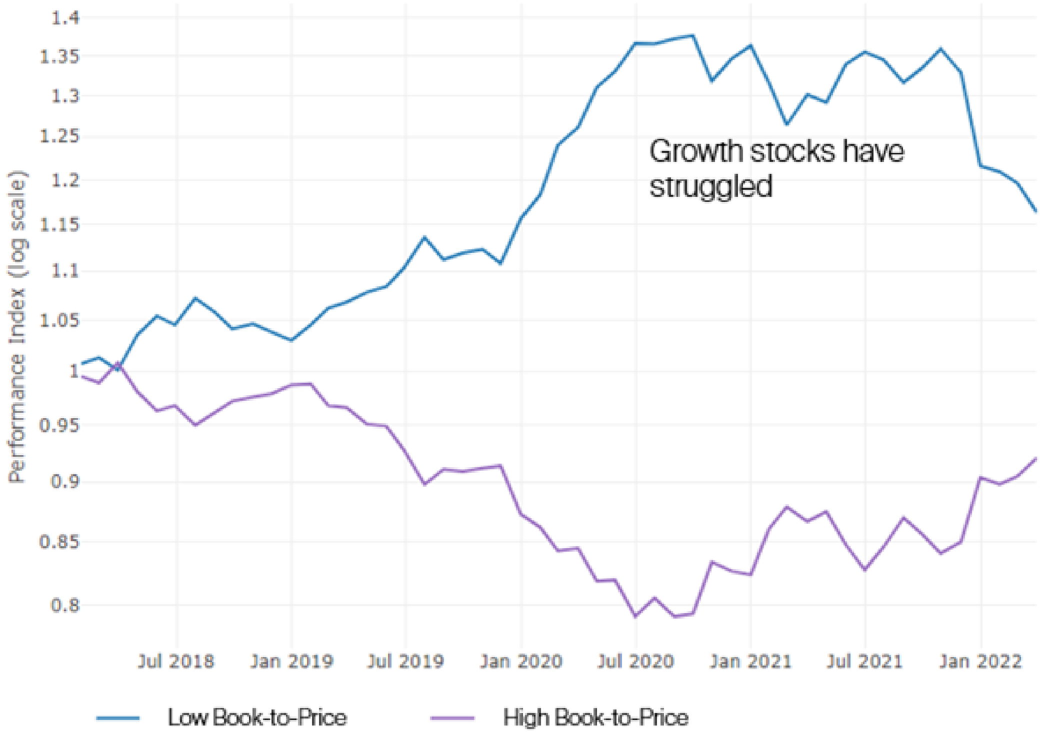
In combination, these two effects have played out as expected with Value significantly outperforming Growth over the last 6-9 months in most markets. The charts below show this.

The first chart shows that the performance of Value and Growth (measured here as the top and bottom quintiles of Book-to-Price) stopped diverging in the middle of 2021, and Value has had a resurgence. However, as the second chart shows, the story has also been about certainty. Low volatility (i.e. low risk) stocks have significantly beaten high-volatility/high-risk names since the middle of last year.

(Note. Book to Price is a valuation metric that compares a company's current market value to its book value).

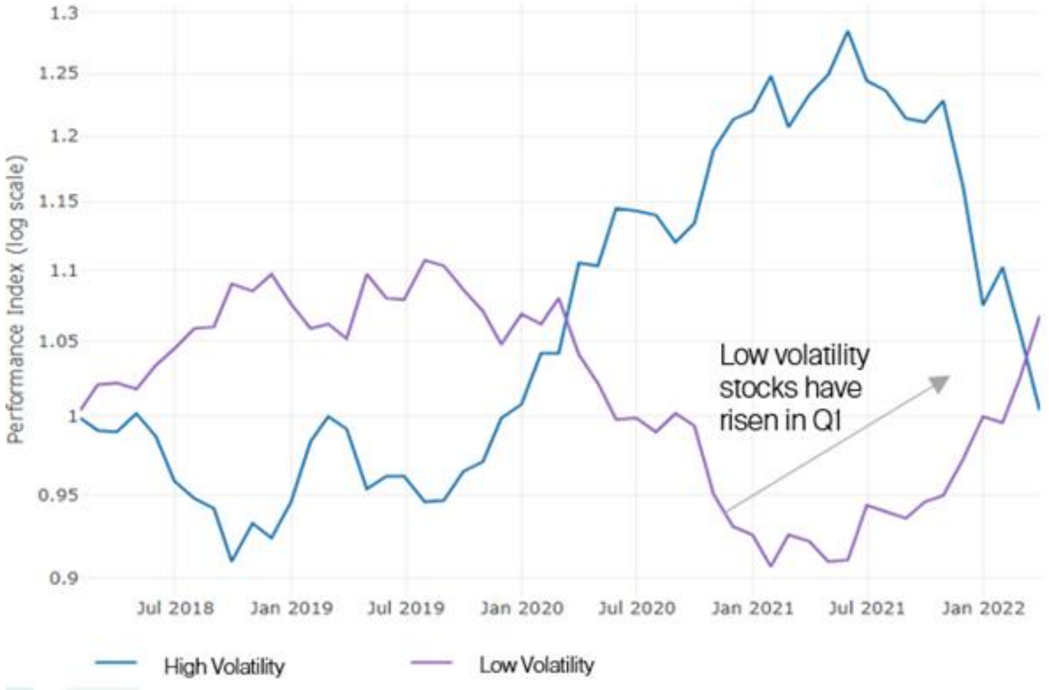
We have thus seen a two-fold rotation – away from *expensive* Growth to *cheaper* Value, and away from *risky* Growth to more *stable* Value.

Chart 1: Top and bottom quintile performance of 12-month volatility (MSCI ACWI ex AU)



Source: Realindex, Factset. Data as at 30 April 2022

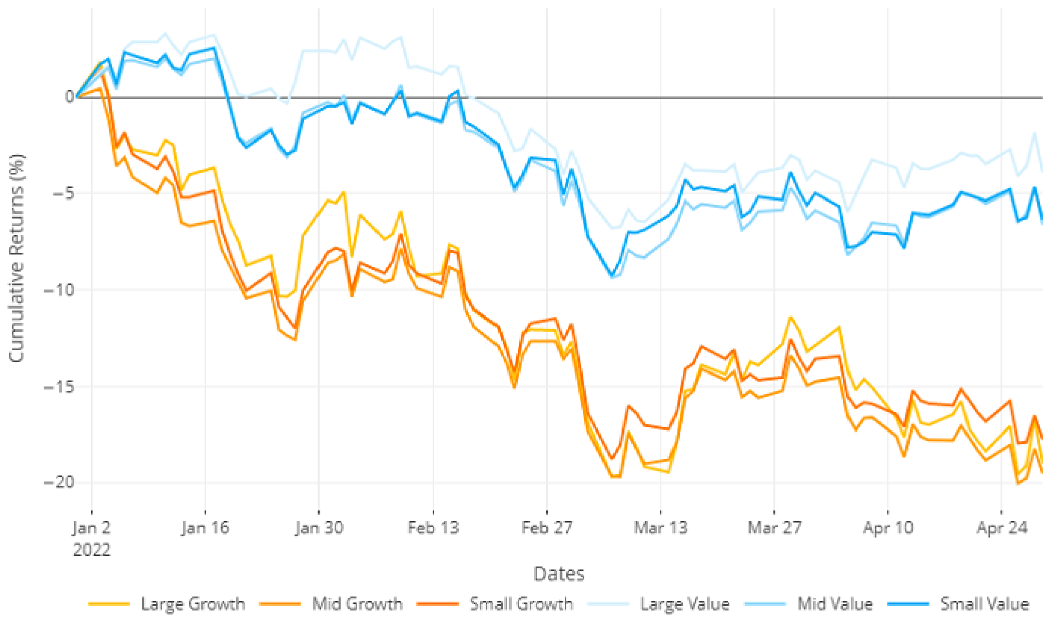
Chart 2: Top and bottom quintile performance of Book-to-Price (MSCI ACWI ex AU)



Source: Realindex, Factset. Data as at 30 April 2022

The next two charts break down this difference in performance between the All-World (ACWI) and Australian universes since the start of 2022. In each case, the outperformance of Value over Growth has been stark.

Chart 3: Outperformance of Value over Growth MSCI ACWI ex AU



Source: Realindex, Factset. Data as at 30 April 2022

Chart 4: Outperformance of Value over Growth ASX 200

Source: Realindex, Factset. Data as at 30 April 2022

Do we expect it to continue?

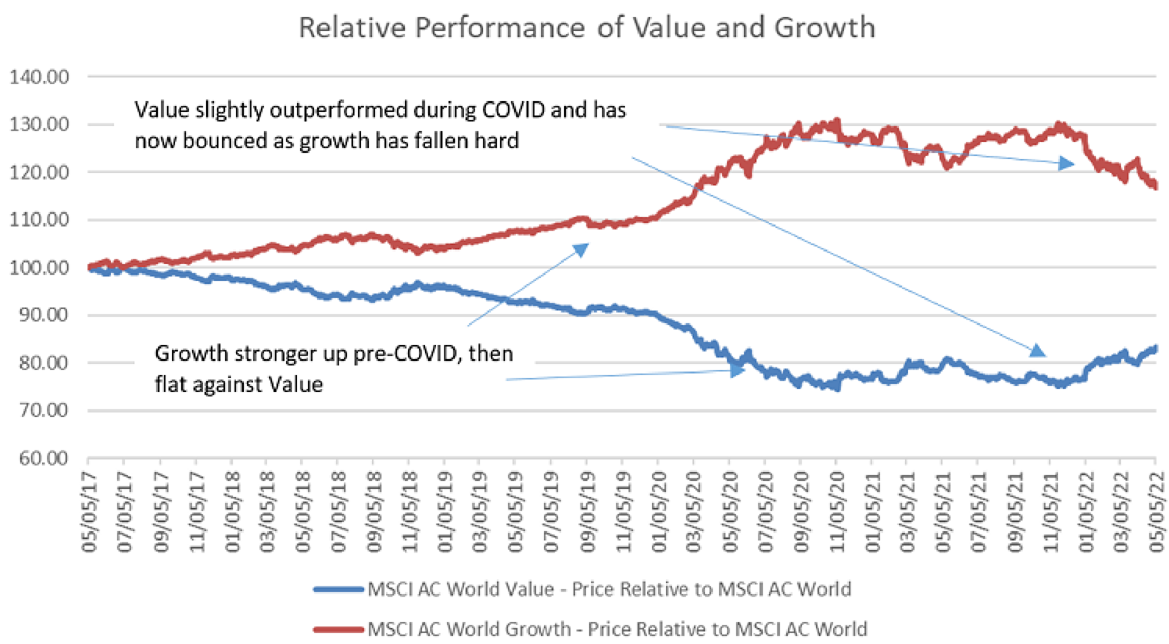
Increases in realised or expected inflation tend to be correlated with a positive, relative return to Value, when compared to Growth.

Prior to COVID, an average inflation rate of around 2% was expected by the market over the following 10 years. With COVID, this fell sharply as economic contraction was likely. Since then it has rebounded, passed back through 2% and is now approaching 3%.

The standard measure for expected inflation is known as 'Bond Breakeven Inflation Rate" (BBIR), and in the most recent two months, the BBIR has spiked from 2.5% to near 3%.

The recent outperformance of Value has tracked some of this change in inflation expectations, more because of the sell-off in Growth than a strong bounce in Value (although this has happened too).

Chart 5: Breakeven Inflation and the Value-Growth Spread



Source: Realindex, Factset. Data as at 5 May 2022

We cannot, of course, draw a direct link between expected inflation and future performance of Value, although there is clearly a strong recent relationship.

While Value has done well recently, the cumulative outperformance of Growth over Value over the last decade is still much larger, and we can see that the trend in spreads of Valuation metrics has only corrected a little. This gives us some comfort that the Value resurgence still has a long way to run.

David Walsh is Head of Investments 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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How our preferential voting drives the election result

Tony Dillon

With the so-called 'teal independents' arriving on the scene, and the primary vote well down for the two major political parties, preference votes counted more than ever at the 2022 Federal Election.

The reality is that the preferential voting system in Australia gives relevance to independents and minor parties. But imagine if we didn't have preferential voting, and instead had say, the UK electoral system of first-past-the-post (FPTP).

How preferential voting works and the impact

Our preferential system requires that the winning candidate in a seat acquires a majority of votes, made up of in order:

1. first preference votes, then
2. allocated second preference votes, and so on,
3. until a majority is achieved.

We have had this electoral system since 1918.

The UK has always used a FPTP electoral system, whereby each voter casts one vote for one candidate, and the candidate with the most votes takes office. If we'd had a FPTP system at this election, the results would have been quite different.

Of the 151 seats contested at this election, 16 were won by candidates who did not win on first preference votes (see table).

Seat	Winner after preferences	First preference winner
Bennelong	Labor	Liberal
Boothby	Labor	Liberal
Brisbane	Greens	Liberal
Curtin	Independent *	Liberal
Fowler	Independent	Labor
Gilmore	Labor	Liberal
Goldstein	Independent *	Liberal
Higgins	Labor	Liberal
Kooyong	Independent *	Liberal
Lyons	Labor	Liberal
Mackellar	Independent *	Liberal
North Sydney	Independent *	Liberal
Robertson	Labor	Liberal
Ryan	Greens	Liberal
Tangney	Labor	Liberal
Wentworth	Independent *	Liberal
	* = 'teals'	

Incredibly, six 'teal' independents can therefore put their success down to preference voting, all reversing an initial Liberal Party primary vote lead. Seven Labor seats and two Greens also leapfrogged Liberal with preferences, with one non-teal independent (Fowler) gaining at the expense of Labor.

Similar analysis of the 2019 election revealed that 10 Labor and two independent wins came after the Liberal Party had won the primary vote. Intuitively it makes sense that preferential voting benefits the Labor Party because some 80% of the Greens preferences go to Labor. And while Labor's primary vote has been steadily falling in recent elections, its two-party preferred vote has not.

Our voting system drives the outcome

Instead of the actual outcome of: Coalition 58 seats, Labor 77, minorities and independents 16; under FPTP, the parliament might have consisted of: Coalition 73, Labor 71, minorities and independents 7.

That is, a hung parliament, with the major party seats more broadly aligned to the national primary vote of the Coalition 36.1%, and Labor 32.8%.

This alternative outcome assumes first preference voting behaviour doesn't change voting under a different system. We will come back to that but in reality, a move from preferential voting to FPTP may have produced a result somewhere between the actual and alternative outcomes.

Which is a better system?

With preferential voting, the ability to vote for a minority party, then direct a second preference vote to a major party that you would prefer to form government, arguably enhances the democratic process. It gives minor parties a voice, because it encourages major parties to broaden their policy platform in order to garner a reasonable flow of preferences. For example, would the Coalition have pledged net-zero emissions by 2050 under a FPTP system?

Preferential voting however, should not benefit extreme minorities, because major parties will not broaden policy to that extent. A preferencing system therefore, encourages more centrist politics.

As noted, voting behaviour may differ under a FPTP system compared to preference voting. Voters may employ so-called 'tactical voting'. An example is a voter who favours a minor party in a two-party dominant system, votes for a major party closest to their ideology so as not to waste their vote. It is a tactic that entrenches a two-party system.

This and other forms of tactical voting that FPTP lends itself to mean that mapping first preference votes to FPTP votes is not necessarily one to one, but should be indicative. Tactical voting is possible under preference voting, but is much less common as it requires good predictability of preference flows.

Another issue with the FPTP system is that winning candidates can be elected with a minority of the vote. Suppose a seat has five candidates. As little as just over 20% of the total vote could see a candidate elected. And if that kind of result was replicated across enough seats, a party could form government with a minimal share of the overall vote.

Consider the 1979 election in the UK when Margaret Thatcher first became Prime Minister. The Conservatives won 339 seats with 43.9% of the total vote, while the Liberals won just 11 seats with 13.8% of the vote. That is, the Conservatives won about 30 times as many seats as the Liberals, with just three times the votes.

By contrast, our preferential voting system requires the winning candidate to have a broad base of support that represents a majority of their constituents. For example, suppose a left-leaning seat has two left-wing candidates and one right-wing. Under FPTP, the right-wing candidate could win because the left-wing candidates share votes. Under a preferential system, the more popular left-wing candidate gains the other left-wing preferences and wins. That is, a preferential system gravitates towards the broadest support.

A consequence of preferential voting is the increased probability of minority governments. Consider a seat with multiple minority parties running on policy platforms, such that they would likely preference each other. After preferencing, one of the minor parties could be elevated into a two-party preferred contest with a major party, and indeed go on and win the seat with far less first preference votes. A scenario that would not be possible in a FPTP system.

Our preferential voting system in Australia arguably strengthens democracy by maximising votes, broadening policy and representation in the electorate, and offering more choice overall.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.

Too many retirees miss out on this valuable super fund benefit

Jeremy Cooper

Of the 700 Australians who retire each day, around three in five do so with a pension account from their super fund. That's according to the latest APRA data that provides superannuation fund pension balances for the year ended June 2021.

According to this data, a little over 350 new superannuation pension accounts are opened every day across Australia's large super funds. Another 70 people a day will be retiring with an SMSF (self-managed super fund) and moving into a tax-free pension.

The Retirement Income Covenant, recently legislated by Parliament, will require super funds to have an appropriate retirement income strategy for their members from July 2022. Regardless of the legislation, many members already need better retirement solutions. Over time, as the super system fully matures, the proportion seeking to maximise their expected retirement income from their super will increase.

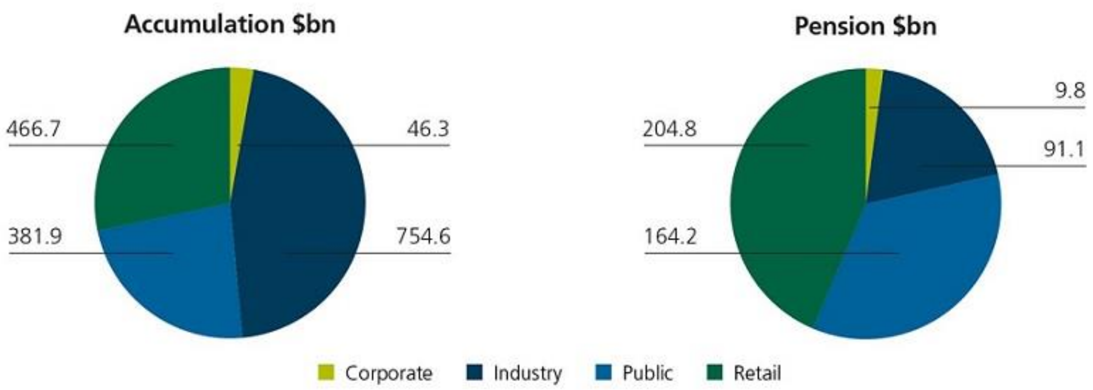
How much money was in the retirement phase?

APRA-regulated funds had a total of $477 billion of member money in retirement income accounts in June 2021. A further $18 billion was represented by members with transition to retirement accounts.

The $477 billion of retirees' money in large super funds was weighted more heavily to the retail sector (typically run by banks or other types of financial institutions). This effect is largely demographic. Industry funds typically capture members when they join the workforce and so have a younger average member base. The relatively older members in the retail sector have a greater need for advice as they approach retirement, which traditionally was more likely to be provided in that sector.

Public sector super funds also have a larger proportion of members in retirement, reflecting the sector's more mature status.

Figure 1: Total APRA-regulated super member benefits by phase and sector, June 2021



Source: APRA fund-level statistics June 2021

APRA reports there were over 1.4 million pension accounts in super funds in June 2021.

The average value in a retirement pension account across all APRA-regulated sectors was over $330,000. This included a notional value for defined benefit pensions which have no account balance, but a higher-than-average retirement benefit.

The average balance varies across the sectors. The highest average balances are typically in the corporate and public sectors, where defined benefits were historically more common.

Millions of retiree accounts kept in accumulation

Average balances in industry fund pension accounts were higher than in retail funds. One explanation could be that the average age of retirees was higher in the retail sector. This could mean that those older retirees did not have the benefit of super for as many years as today's retirees and so retired with smaller balances.

In APRA-regulated funds, there were many accounts belonging to members who were above preservation age (the age that you can access your super) that had not been rolled over into a pension account.

There were 2.6 million accounts where the member was over 65 (so had met at least one condition of release) but only 1.4 million of these were pension accounts. There were an additional 1.5 million accounts where the member was between 60 and 64 and could have met a retirement condition of release; and 250,000 of these were in a pension account.

Members in retirement who have met a condition of release pay no tax on income or withdrawals from their pension account. So there were potentially around two million accounts where tax at a headline rate of 15% per annum was being levied (unnecessarily) on investment income.

The question is why? What is driving this behaviour? Is it just an oversight? A lack of engagement? Super fund inaction or older members making a conscious decision to treat accumulated super like a savings account?

The fact is, there doesn't seem to be an answer to these questions.

While most pension accounts are held by members over 65, some are for members younger than 65 (i.e. aged 60-64) who have satisfied a condition of release. There are also those over 65 (so satisfying at least one condition of release) who have super in an account in the tax-paying accumulation phase.

It is often lower balance accounts that are left in the taxed accumulation phase. Higher balance accounts are more likely to be rolled into a pension account.

The average balance in the pension phase tends to be higher than the average for all accounts for people over 65. The table below shows the average balances in pension accounts and accounts (whether pension or accumulation) held by members over 65.

Sector Average member account balance – June 2021

	Pension account	**Member 65+ account**
Corporate	$487,699	$383,645
Industry	$396,655	$204,573
Public	$482,164	$307,029
Retail	$291,834	$207,000
Overall average	**$330,860**	**$235,870**

Source: APRA Annual Superannuation Bulletin & Fund-level Statistics, June 2021

There was a significant difference between the average balance in a pension account and the average balance of all accounts (including pension accounts) for members over 65. Across the industry sectors, the difference was greatest in the industry fund sector due to the smaller proportion of pension accounts. These funds will have had a higher proportion of lower balance accounts that remained in the accumulation phase.

There was also a skew in the average pension account balances because members with low balances are more likely to withdraw all their super as a lump sum. With the Seniors and Pensioners Tax Offset (SAPTO) allowing a relatively high level of tax-free income, the benefits of tax-free super are less relevant for many retirees – hence the reason for the likely higher rates of withdrawal.

Summary

The latest APRA data on super fund balances show that super is delivering more than ever for new retirees.

Retirees today have had half their career (if unbroken) with 9% or more of their annual income contributed to super, delivering a significant asset for their retirement.

In the coming years, retirees will have had longer in the system and they will have had more years with higher (ultimately 12%) contributions.

Outcomes for members at retirement will continue to improve. The commencement of the Retirement Income Covenant in July will help members benefit from better retirement outcomes to match our world-class accumulation system.

Jeremy Cooper is Chairman, Retirement Income, at [Challenger](). This article was first published by [YourLifeChoices]() and is reproduced with permission.

Important note: All the data used in this article have been extracted from APRA's [Annual Superannuation Bulletin]() June 2021 edition and [Annual Fund-level Superannuation Statistics]() report June 2021 edition, issued on 31 January 2022 and 15 December 2021, respectively. The validity of the conclusions we have drawn depend on those data being accurate and our being correct.

Why 'Don't fight the Fed' now has a different meaning

Rudi Filapek-Vandyck

One of the defining events for global finance in 2022 happened during the Wall Street Journal Future of Everything Festival at which Fed Chair Jerome Powell spoke on 17 May and - finally! - got the message out. The world's most powerful central bank is now singularly focused on bringing inflation down towards 2% (from 8%-plus).

His admission this would not be possible without causing some pain, including the unemployment rate rising, would have rattled a few, but that was the explicit intention.

Relying on the 'Fed put' to save markets

For many years, investors have relied on the Federal Reserve to bail them out (the so-called 'Fed put') when markets showed their vulnerability and proved at risk of breaking down. With the 2020 experience still fresh in mind, many an investor the world around has become used to the fact that buying-the-dip is a simple but highly effective strategy.

Now the Fed is no longer aiming to prop up the economy through rising financial assets, and thus attitudes towards risk-taking and spending need to change. Across the USA, but preferably including the rest of the world too.

While inflation is stuck between ongoing Covid restrictions and supply-side disruptions and challenges, with the Russia-Ukraine war adding its own twist, the only way to tame inflation is by reducing demand. And in order to reduce demand, consumers need to become less comfortable with their financial situation and prospects.

Central banks have no control over global supply chains, but they wield enormous leverage over credit and financial assets. Bringing down asset values, and thus make consumers feel a lot less comfortable, seems but the most logical policy aim to pursue in 2022.

Risk is back in play

The exposure of US households to US equities has never been greater. Plus add a whole new generation of young 'investors' who don't genuinely know the practical implication of 'risk' and believe, with conviction, that owning cryptocurrencies and NFTs is the quickest route to becoming a billionaire before celebrating their 30th birthday.

In Australia, a similar observation can be made about a general perception that housing prices never fall, mate.

The Federal Reserve needs to change all of that in order to successfully rein in what it had mistakenly considered as a temporary, 'transitory' phenomenon throughout 2021. For the record: it is still possible inflation post-2020 might prove transitory on many accounts, but central bankers can no longer afford the luxury of sticking with a wait-and-see approach.

The risk of inflation becoming embedded is simply too high and would be many times over more damaging than the pain inflicted through an aggressive path of tightening. The Fed is all too aware of this. Note, for example, how Powell himself has recently started to include references to Paul Volcker, the central banker widely credited with slaying the inflation dragon in the early 1980s.

The Volcker Fed's aggressive tightening caused two economic recessions at the time, but it did pull down high inflation to manageable levels.

The message Powell has been trying to get across is that today's Fed is just as determined to put inflation back in its bottle. However, after more than a decade of explicit central bank support for financial assets in order to stave off structural deflation, most investors still have failed to comprehend the deeper meaning of the change in central bank messaging.

Redefining 'Don't fight the Fed'

We know what to do, and we know how to do it, Powell declared at the WSJ Festival, adding there should be no doubt, the Fed *will* do what is necessary.

"What we need to see is inflation coming down in a clear and convincing way, and we're going to keep pushing until we see that" - those were his exact words.

Judging from price action since, it appears markets have finally understood the old saying of 'Don't Fight The Fed' now has a different meaning. The Fed wants less risk-taking, less confidence and less spending. Jobs will be lost. Asset prices will come down. But it's the pain that needs to happen, because inflation is a much, much bigger threat to everybody's wealth and future prospects.

Of course, it goes without saying, the Fed does have an ideal scenario in mind:

"What we need is to see really growth moving down from the very high levels that we saw last year, moving down to a level that's still positive, but that will give the supply side a chance to catch up, and a chance for inflation to come down as we get supply and demand back together."

This sounds great, except for the fact that Powell also acknowledged the Fed does not control everything that impacts on the economy.

"There are many global events going on ... that are really not under our control as well."

But, and this was clearly the message Powell was pushing across, it won't deter this Federal Reserve from executing on what, simply put, needs to be done:

"We know how people are suffering from high inflation. And we have both the tools and the resolve to get inflation back down. And no one should doubt our resolve in doing that."

What Don't Fight The Fed in 2022 means for investing

The world of investing has shifted since 2021:

- bond yields need to be higher, demand for credit needs to be tempered
- asset prices, including equities and real estate, need to be lower
- demand for products and services needs to be lower, which implies economic growth needs to be tempered.

Fighting inflation is now the main goal and everything else is of secondary importance, at best.

"What we need to see is clear and convincing evidence that inflation pressures are abating and inflation is coming down. And if we don't see that, then we'll have to consider moving more aggressively."

Let's all hope inflation is, indeed, transitory, and highly susceptible to slowing growth and rising interest rates. The alternative might prove devastating in a way only few among us are willing to contemplate.

But it also means bond yields may not have much further to rise from here, but the focus already is shifting to economic growth and corporate margins and profitability. Key question: how low?

Rudi Filapek-Vandyck is Editor at the FNArena newsletter, see www.fnarena.com. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

Investment 101 and the greatest risk in investing

Jason Hsu

I have been trying to correct some basic investment misunderstandings, apparently with little success. Here are three lessons in Investment 101.

Three incorrect assertions

Some people interpret:

1. Shorting Tesla as being against the amazing Elon Musk, against Green, against innovation.

Lesson 1: A great firm with a great leaders and great products - so long as these are understood by the market and priced in - will deliver a fair return only. To drive great returns, the firm must surprise the market with even more amazing products. Empirically, storied firms tend to be priced for perfection. The market expects the impossible and the forward returns tend to be poor. It's not because the company becomes bad but because the current price has baked in unreasonable growth and profitability assumptions.

2. Underweighting US as anti-American values, betting against US ingenuity, disapproving all that is wonderful about US and its contribution to global prosperity.

Lesson 2: While prices may not be rational, they do reflect consensus. If your views and information are similar to consensus, that's not a bad thing. It just means you read similar information and analysis as other market participants and then your views cannot be predictive of better future returns. For example, we can agree that the US economy is wonderful and that China has a lot of issues. That this is obvious means prices reflect this consensus. Indeed US valuation has been 50% more expensive than China. China's equity performance relative to the US will not be determined by the consensus that China isn't a democracy with checks and balances. It will be determined by whether the US proves to be infallible and China remains as bad and incompetent as headlines have sold it.

3. Diversifying into China as supporting the CCP, favoring autocracy as a political system, ignoring obvious risks posed by China's political agenda, ignorant of China's slowing down.

Lesson 3: Investment risk is not related to an investor's familiarity or comfort with an asset. A tech executive investing in a tech stock doesn't make that stock less risky to him. American's home country bias doesn't make US stocks less risky to US investors. Familiarity and comfort tend to cause people to underestimate the true risk. That overconfidence is far riskier. Having access to Bloomberg, to broker research and CNN doesn't make your portfolios safer. It makes you overconfident and liable to ignore the unknown unknowns. It makes you confuse priced common knowledge as if they are unique insights that give you an edge in forecasting stock prices.

Is your view already a consensus and priced in?

Despite the best efforts of almost every investment book, many investors, including those that manage money professionally, continue to confuse a good company or country with a good investment.

So what is the greatest risk in investing? It is in not understanding that your fears and insights are common and already priced in, or already over-priced.

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