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Editorial

There's a well-known Irish joke about a tourist in the countryside who asks a local for directions to Dublin. The Irishman replies: *'Well sir, if I were you, I wouldn't start from here'.* It's the same with investing. If I were on a long-term investment journey, I wouldn't start from here. But like the tourist, there is no choice, because all that matters for future outcomes are the decisions made from here and now - buy, hold or sell. We can't go back or make a deal with God, and get him to swap our places.

Which brings me to **Kate Bush.** Ms Bush and I were born a few months apart, and it's great to see her discovered by younger generations with the most-streamed song in the world in July 2022 and top of the **Billboard Global 200** chart. It took 'Running Up That Hill' 37 years to reach the UK Number 1, the longest time it has ever taken a song. As new fans (due to use of the song in *Stranger Things* on **Netflix**) acclaim Kate, it's sobering to realise that 'Wuthering Heights' was released in 1978 when she was 19.

While every generation faces different challenges and opportunities, from an investment perspective, I would not swap places with anyone from a younger generation, unlike the words from her hit song.

"And if I only could
I'd make a deal with God
And I'd get him to swap our places
Be running up that road
Be running up that hill
Be running up that building
If I only could, oh"

Chorus from *'Running Up That Hill (A Deal With God)'* by Kate Bush

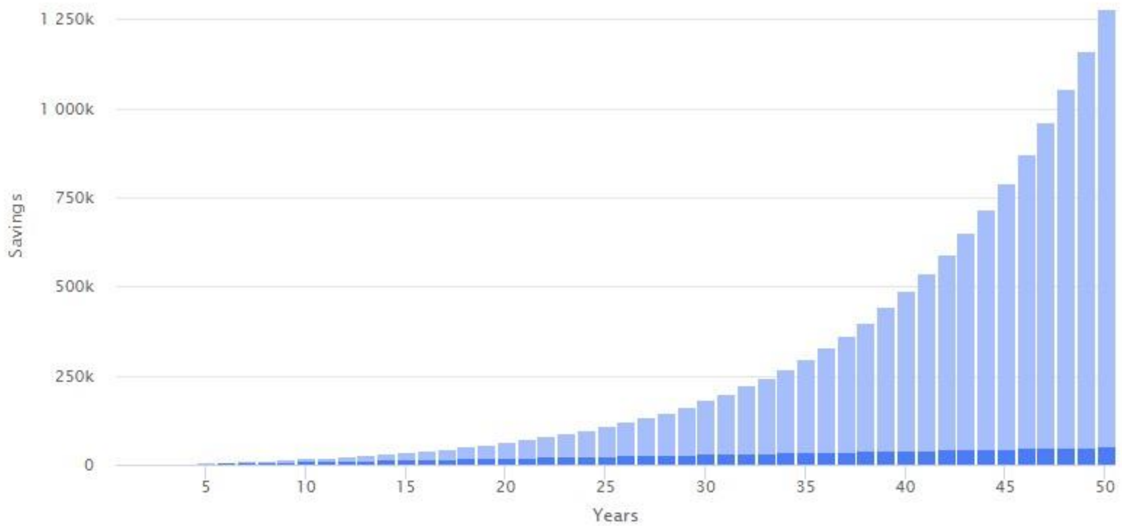
(There's a fantastic version sung by thousands in the **Brisbane Pub Choir**).

I've previously described the favourable conditions enjoyed by Baby Boomers in an article which has been viewed 20,000 times and received (with follow ups) hundreds of comments. Free education, generous superannuation, rising property prices, economic growth ... on it goes. For 30 years, falling interest rates ensured that even the defensive part of a 60/40 allocation performed well.

As the chart below from **Vanguard**'s Digital Index shows, for a Baby Boomer who started investing in 1970, the long-term (nominal) returns of 10% pa to 12% pa on equities and around 8% on fixed interest made investing easy. Pick a balanced fund and enjoy 10% pa for 50 years. The value column shows the amount reached by the end of 2021 of $10,000 invested in 1970.

Asset classes	Value at 31 Dec 2021	Return since 1 Jan 1970
Australian Shares	$1,289,354	9.8% p.a.
International Shares	$1,518,751	10.1% p.a.
US Shares	$3,610,527	12.0% p.a.
Australian Bonds	$499,803	7.8% p.a.
Cash	$431,387	7.5% p.a.

Start with $1,000 and invest only $1,000 a year for 50 years at 10% pa and the balance will grow to $1,281,299 of which $1,230,299 is interest. Now that's the astonishing power of compounding, and our article on bank hybrids shows some current opportunities. The table below uses the calculator on the **Moneysmart website**. The dark blue shows the money contributed and light blue shows the interest.

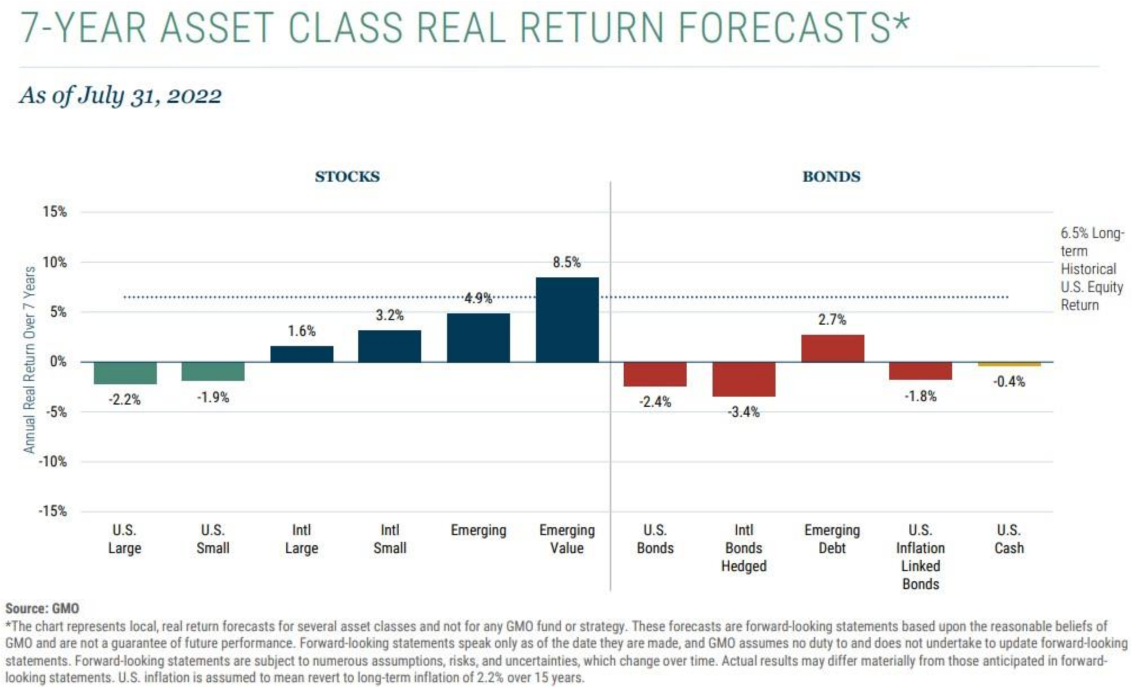


Investors now face the highest inflation in the US for 41 years, a major war after decades of relative peace, a transition to zero carbon during an energy crisis, reliance on Russian gas threatening previously strong countries like Germany, China with expansion plans and the military to support it, and recession looming. No, an investor would not to choose to start from here.

Despite all this, the Shiller P/E ratio for the S&P500 which has a long-term mean of 17 and a median of 15.9 remains highly elevated at 31 even after the recent market falls.

Shiller Price/Earnings Ratio for the US S&P500

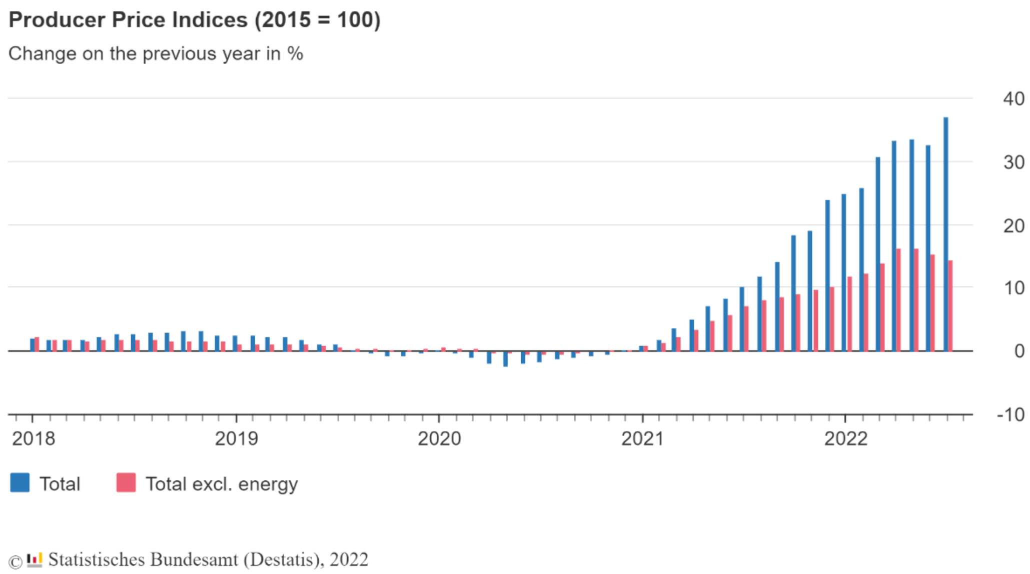
This week, the Asset Allocation team at **GMO** issued their seven-year forecasts for real (after inflation) asset class returns. They identify the long-term historical US equity return in real terms as 6.5% but expect US and developed markets to deliver significantly less in coming years, including negative in the US.



Rick Friedman from GMO said:

"Despite valuation compression across all countries, U.S. equities remain expensive relative to their history and other countries. We still prefer non-U.S. equities to U.S. and find Value especially attractive outside the U.S. in places like Japan and Emerging ex-China. That said, we believe the cheapest parts of the U.S. market have become more attractive."

There are few hints yet that we have seen the bottom of the current market cycle. While stockmarkets fell heavily between January and mid-June 2022, then rose for a few optimistic weeks, but pessimism has returned. The German Producer Price Index released for July 2022 was up 37.2%, the biggest increase ever recorded due to rising energy prices, as shown below.



While the medium-term outlook is not encouraging, we have three articles this week to guide positioning of portfolios.

Nick Griffin of Munro Partners says nobody waves a red flag when it's time to buy, but he is watching three main factors to determine when the worst is over. He also picks out a couple of favourite stocks. **Christophe Braun of Capital Group** explains the sectors and companies that can do well during inflation, saying it's a time to rely more on dividends than share price rises. And **Sawana Tanna from Perth Mint** highlights the particular issues with stagflation (inflation with slower growth) for asset allocation.

Then three articles that help to understand how products or regulations work.

First, the returns on major bank hybrids are reported as over 7% (enough to allow a doubling of an investment in only 10 years), a far cry from only a year ago when such income from strong banks was unattainable. Yes, hybrids come with more risks than a deposit but where does the 7% yield come from when the bank bill rate is only around 1.9%?

Meg Heffron continues her popular series on managing an SMSF with the response to a reader question. The intriguing look at withdrawals from pension and accumulation accounts and the use of partial commutations looks like a little-known secret.

Following last week's article on the perils of financial advice, former Managing Director of **Norwich Union, Rob Garnsworthy** sent Firstlinks a note saying it's all too complex for most young people starting a journey. When he said he had written a one-pager for his 18-year-old grandchildren, many of you wanted to see it. So did we, and he obliged.

There has been much controversy about the reported performance of balanced superannuation funds in FY22, where despite heavy market falls in both equities and bonds, three funds - **Hostplus Balanced, Qantas Growth and Christian Super** - recorded positive results. **Annika Bradley from Morningstar** looks at the debate about the way unlisted assets are revalued. Chief Investment Officer at **AustralianSuper, Mark Delaney**, said of his current positioning:

"After more than 10 years of economic growth, our outlook suggests a possible shift from economic expansion to slowdown in the coming years. In response, we have started to readjust to a more defensive strategy, as conditions become less supportive of growth asset classes such as shares."

Some comments on jobs data, which the **Reserve Bank** says is critical in its decisions on interest rates. Although the July 2022 unemployment rate fell to its lowest since 1974 at 3.4%, it hides the fact that the number of people employed fell by over 40,000, as shown in the **ABS** table below. The unemployment rate fell due to a decline in participation. **Dr Brendan Rynne**, Chief Economist at **KPMG**, said:

"Overall, with momentum in the economy now easing and global inflationary pressures falling, particularly in commodity markets, the outlook is suggesting that the economy may require less of an interest rate handbrake from the RBA in coming months than financial markets are currently assume."

While it's good news that there are 167,000 fewer unemployed people than a year ago, especially the long-term unemployed, the Reserve Bank will be watching the number employed as well.

	Jun-2022	Jul-2022	Monthly change	Monthly change (%)	Yearly change	Yearly change (%)
Seasonally adjusted						
Employed people	13,599,300	13,558,400	-40,900	-0.3%	398,500	3.0%
Unemployed people	493,900	473,600	-20,200	-4.1%	-167,600	-26.1%
Unemployment rate	3.5%	3.4%	-0.1 pts	na	-1.3 pts	na
Underemployment rate	6.1%	6.0%	-0.1 pts	na	-2.3 pts	na
Participation rate	66.8%	66.4%	-0.3 pts	na	0.4 pts	na
Monthly hours worked in all jobs	1,855 million	1,840 million	-16 million	-0.8%	61 million	3.4%

Last week's article on financial advice drew dozens of comments, and it's well worth returning to them to see what many advisers and clients think. ASIC released updated figures this week showing six Australian banks have paid $3.6 billion in compensation to customers due to fees for no service misconduct or non-compliant advice. It's a pity for the availability of financial advice that such large financial institutions could not make advice a sustainable business.

Are major bank hybrids really yielding 7%?

Graham Hand

Hybrid securities issued by banks have become mainstays of many portfolios, especially those of retirees looking for income. The four major Australian banks plus Macquarie have issues worth almost $40 billion currently listed on the ASX. Hybrid structures have evolved over time but they are complex and idiosyncratic including characteristics of both equities and bonds. They have an ability to absorb losses like equities but pay a defined income like bonds. With income at a tempting 'yield' of 7%, it's important to understand what the number means.

This article is not a primer on hybrids but focusses on why hybrid yields seem strangely high in the current market conditions. Here is an example of recent hybrid pricing on five prominent issues (updated from NAB on 24 August 2022).

ASX Code	Last Price	Current Dividend Rate	Trading Margin	Yield to Call
ANZPJ	$99.06	4.54%	3.00%	6.99%
CBAPK	$99.00	4.46%	3.06%	7.06%
MQGPF	$101.95	5.85%	3.46%	7.47%
WBCPK	$99.63	4.76%	3.08%	7.09%
NABPI	$100.90	5.08%	3.09%	7.11%

The table shows 7% or more 'yield to call' from every major bank plus Macquarie Bank (ASX:MQGPF) at a healthy 7.47%.

The double-your-money magic

There has always been something magical about compounding, as demonstrated by the famous 'Rule of 72'. Albert Einstein is quoted as describing compound interest as *'the greatest mathematical discovery of all time'*, although this is probably apocryphal. One of the richest bankers in history, Baron Rothschild, described it as the *Eighth Wonder of the World*. The founder of Vanguard, Jack Bogle, said, '*Compound interest is a miracle*.'

The Rule of 72 is a simplified mathematical construct which provides an approximation of how long it takes to double an investment. Dividing 72 by the rate of interest earned gives the number years it takes to double the capital. It's sometimes called the 'doubling time'. A return of 7% - and heroically assuming interest payments can also be reinvested at 7% - doubles an investor's money in about 10 years in nominal terms (no adjustment for inflation) and ignoring tax.

Why are hybrid yields reported so high?

At first glance, the reported 7%+ returns on hybrids look incorrect. Let's consider a specific example of one of the more liquid hybrids, NAB Capital Notes 6 (ASX:NABPI), issued with a margin of 3.15% over the 90-day bank bill rate.

How can a hybrid security with a margin of 3.15% over the bank bill rate, currently 1.93%, give a reported yield of around 7%? Shouldn't it be 3.15%+1.93% equals 5.08%? Moreover, hybrids pay distributions adjusted for the corporate tax rate (requiring the investor to claim the value of the franking credit to gross up the return), so the actual distribution rate is only 3.56%.

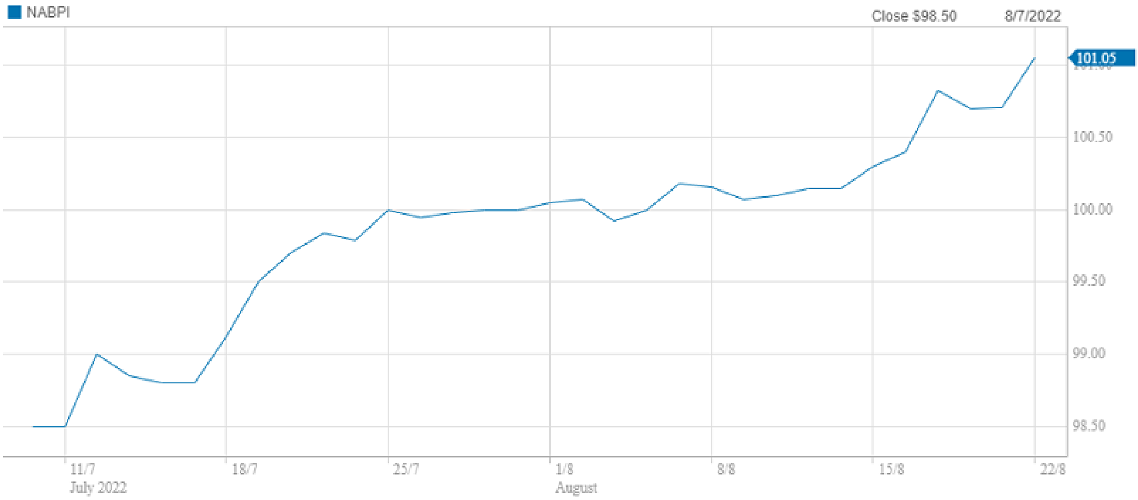
Here is a typical calculation in a hybrid distribution report.

BBR: 1.93%
Margin: 3.15%
Total: 5.08%
Multiplied by (1 - tax rate): 0.7
Distribution rate: 3.56%

How do we reconcile the investor receiving 3.56% with the reported yield of around 7%, as in the hybrid pricing reports in our Education Centre?

Let's look more closely at NABPI. Although many retail investors might feel they missed out on a NABPI allocation due to the Design and Distribution Obligations (DDO) preventing access during the offer period, NABPI opened trading at around $98 (for a $100 note) giving easy entry to anybody. It has steadily traded up and is now around 101 giving a neat gain to anyone who bought early on-market.

Price of NAB Capital Notes 6 from issue to 22 August 2022



Source: CommSec

The following screenshot shows how NABPI is summarised in [NAB's daily hybrid report.](#) Most columns are self-explanatory, on issue size, issue date, first call date for the issuer, years remaining to call and issue margin.

ASX Code	Issue Size	Issue Date	First Optional Call Date	Years to First Optional Call Date	Issue Margin
NABPI	$2,000m	07-Jul-22	17-Dec-29	7.4	3.15%

At the date of the screenshot, the bank bill rate was 1.92% and with the margin of 3.15%, the 'Current Dividend Rate' was reported as 5.08% (1.93%+3.15%). The reason the price is above par but the Trading Margin is higher than the yield (which again seems intuitively wrong) is because the Last Price includes accrued interest. So far, so good.

ASX Code	Last Price	Current Dividend Rate	Trading Margin	Yield to Call
NABPI	$100.07	5.08%	3.22%	6.77%

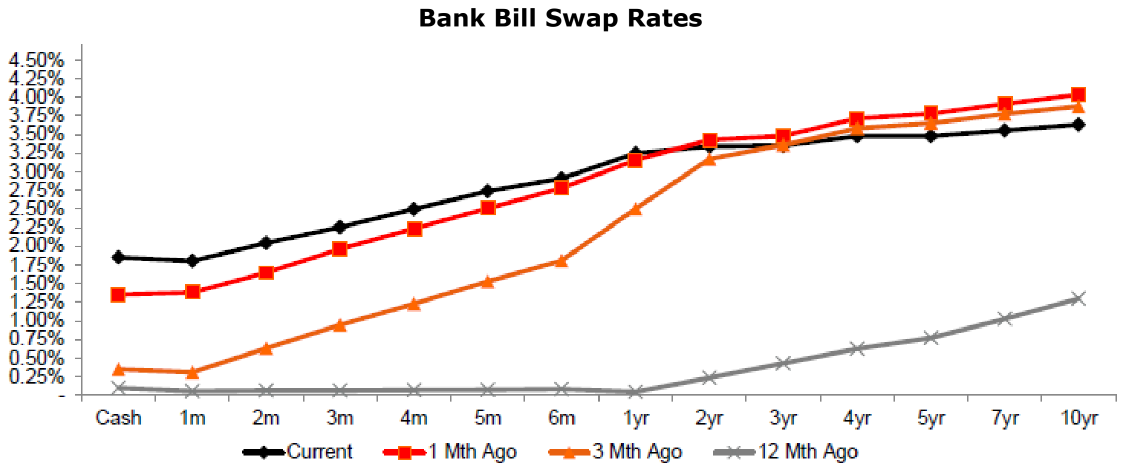
But the question remains. How do we get to 6.77% yield as the headline return?

Reported hybrid yields are based on the future

The 90-day BBSW rate is crucial for the distribution received by hybrid investors, and a rising BBSW leads to higher distributions. The reported margin in the table above allows for the market's future projection of the 90-day BBSW rate over the life of the note, in the case of NABPI, over 7.4 years.

The 6.77% 'Yield to Call' (YTC) is based on the future distributions until the optional redemption date, not the current distribution. Although the option to repay in December 2029 is NAB's choice, Australian banks are expected to pay on first call as an act of good faith to the market. Banks often rollover to a new issue at the time of first call, giving the market confidence about the term.

NAB (and the entire market) uses an interpolated swap rate, as shown in the chart below. Based on 7.4 years, the swap rate was 3.55%. The YTC figure is the Trading Margin (to call date) plus the swap rate (6.77%=3.22%+3.55%).



Source: NAB as at 9 August 2022.

(At the date of final edit of this article on 24 August 2022, the YTC on NABPI was 7.11%, significantly higher than the 6.77% used in this example).

Is it worth investing in major bank hybrids at 7%?

For income-starved retirees, an investment in a major bank note paying 7% has plenty of appeal. It is not far off the long-term return expected on major bank shares, with considerably less price risk. If inflation is persistent and high, and the Reserve Bank goes harder on cash rates, the bank bill rate may rise higher than anticipated by the current swap curve, at least in the early years. But while the structure gives some protection against this rising inflation, there is always a risk that higher rates will lead to a recession and a need to lower rates, forcing returns below the 7% level.

This floating return is not like buying a fixed rate bond paying 7%. The distribution will rise and fall with short-term rates, and the 7% is only indicated until the 2029 call, not the full 10 years required for a doubling.

There's no free lunch in investing, and hybrids come with greater risk than bank deposits. This article is not a full review of hybrid terms, but there is an enormous range of different features, most notably the ability to suspend payments in certain circumstances. Hybrids can also be converted to bank shares during periods of severe difficulty, placing capital at greater risk.

But it's worth understanding how the pricing is calculated and whether investors are paid adequately for the extra risk. The 7% rate depends on the shape of the current yield curve, but these hybrids may deliver a doubling of capital in a decade for the first time on a major Australian bank note for many years.

Graham Hand in Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. Disclosure, Graham's SMSF holds an investment in NABPI although this is not a recommendation, it is used for illustration purposes only.

A one-page introduction to investing

Rob Garnsworthy

Introduction: In last week's article on the predicaments facing financial advice, Rob made this comment:

"As someone who has seen the very best and the very worst of financial advice, I just shake my head at the complexity and the BS. Is total paranoia with protecting backsides and protecting consumers where, in reality, it does neither, so it is very frustrating! When complexity fails to improve outcomes, it is fatally flawed. I now have two >18 grandkids and set myself a challenge to give them an introduction on one page! Simplicity is always harder than volume, but if we can educate young people in the basics, they have half a chance to ask the right questions and look after their own futures."

We received many requests to see Rob's one-pager, so we asked him for a copy. Turns out he is Rob Garnsworthy, former Managing Director of Norwich Union Australia.

Meeting a difficult challenge (and readers are welcome to send in their own ideas), here is the one-pager.

What are asset classes?

Essentially the broad name given to things you can 'invest in' – property; shares, which give you a fractional ownership of a company; bonds which are effectively 'loans' to companies or governments; then a whole range of things like gold, bitcoin [dumb], infrastructure, art, classic cars [!] and the list goes on.

'Growth assets' vs 'safe assets'

In simple terms, property and shares are regarded as 'growth' assets – they 'should' grow faster than inflation – some do, some don't. Over time, they have had very similar rates of growth BUT they can be volatile.

Bonds on the other hand have historically been regarded as 'safe' assets – returns will generally be lower but so will volatility. At times like this however, with all the geopolitical noise, Covid, Ukraine, China, nothing is particularly safe.

Know what it is

If you do not understand something, do not invest in it.

Time is your friend

At your age, you have time on your side. You can weather the ups and downs, you can stay invested through the down times, indeed that is always the best time to invest, and you can allow the 'magic' of compound interest to work for you. Take a long-term view with a well-constructed portfolio and you will be ok – 7-10% over 50 years is powerful.

Inflation is your enemy

Inflation 'eats' cash and spending power. It has been quiet for decades but now it's re-emerging. A cup of coffee that now costs you $4.50 will cost you $12 in 50 years if inflation rises at 2% per annum so the challenge is to have investments that increase faster than inflation – inflation + 4-5% is a good target.

Financial independence

Trust any government at your peril. There are two simple things you should aim for – to own your own home [lifestyle] and to be financially 'independent' [investment] in retirement. Tick both of those boxes and you will be ok.

Achieving the right balance

Rough guide – if your 'lifestyle assets' are approximately equal to your 'investment assets' at the point of retirement, that is not a bad balance. You cannot 'eat' your home. If you have investments around 20 times your cost of living, that is also not a bad target.

Superannuation

Super is not an 'investment' per se. It is a tax-advantaged structure that 'holds' investments. The trade-off is that you cannot access it until you are in your 60s. If you live with it day to day, you can manage it yourself. If not, a low cost professional manager is a better option.

Start your journey early

What we are doing here is but the start of a journey. By starting early and learning early, by going through cycles of euphoria and fear, you will learn. The challenge? To take responsibility for a future which is yours and yours alone.

Rob Garnsworthy is a retired former Managing Director of Norwich Union Australia.

Meg on SMSFs: pensions and the power of partial commutations

Meg Heffron

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

A reader recently highlighted a confusing sentence in an article they'd read and asked what on earth it meant. The sentence in question was:

"They have treated any income stream payment amounts above the required minimum pension as a partial commutation to enjoy a transfer balance cap benefit."

I can see why that was confusing but it is a sentence that captures a lot of good ideas and is worth unpacking.

Classifying a withdrawal

Anyone with an account-based pension in an SMSF can pretty much take whatever they like out of their pension, unless they haven't retired yet and their pension is still a 'transition to retirement' pension. And once they reach 60, the tax treatment of payments taken from the account is the same no matter what sort of payment it is.

So why would it matter how the payment is classified?

As the sentence suggests, it's all about the Transfer Balance Cap (TBC). This is the $1.7 million limit (or somewhere between $1.6 million and $1.7 million for some people) on the amount that can be transferred across to retirement phase pension accounts (pensions for people who have retired) over our lifetime.

The amount transferred across is only checked against the TBC when a pension first starts. Someone whose pension account grows over time doesn't use up more of their cap when that happens and similarly someone whose pension account drops in value doesn't automatically get some of their cap back. All that matters is what the pension was worth when it started. So how can payments taken later impact the cap?

An example is the easiest way to explain.

The power of a partial commutation

Mary (65) has $1.8 million in super and starts a retirement phase pension with $1.7 million (i.e., she uses up all of her TBC when her pension first starts). She leaves the remaining $100,000 accumulating in her fund. Each year, she takes exactly what she has to from her pension account (the minimum payment) and when she needs extra money, she takes that from her accumulation account.

Her strategy makes sense. She leaves as much as possible in her pension account so a proportion of her SMSF's investment income (capital gains, rent, interest, dividends, distributions etc) is tax free. The bigger her pension account, the bigger this proportion. It makes sense to run down her accumulation account rather than her pension account.

But what happens when her accumulation account runs out? At that point she would be taking everything she needs from her pension account.

Let's say that in a particular year, she needs to withdraw $100,000 but her minimum pension is only $60,000. If she makes a specific choice to treat the extra $40,000 as a payment called a 'partial commutation', something special happens. The ATO records this and adjusts her TBC records. Instead of having none of her cap left, she gets $40,000 of it back. This doesn't happen if she just treats the full $100,000 as a pension payment.

So who cares?

Well, if it's only ever $40,000, Mary probably doesn't care. But if this happened a few times and over time her 'partial commutations' add up to a more meaningful amount (let's say $300,000) it does matter.

For a start, getting some of her TBC back means she can start more pensions in the future. If she gets $300,000 back, she can start more pensions with a value of up to $300,000. That might sound completely irrelevant to Mary initially – after all, she doesn't have any more super.

But what if Mary put more money into super at some point? What if she made a downsizer contribution (special contributions for people who sell their home after owning it for more than 10 years and meeting some other conditions)? A key feature of these contributions is that Mary can make one no matter how old she is and how much she already has in super. Or what if she inherited some super from her spouse? All of these might mean Mary has more super in the future that she'd love to convert to a pension. Getting some of her cap back would help her do that.

Use of standing orders

A common approach for SMSF members is to put standing instructions in place with the trustee. They might read something like this:

"Make sure the minimum amount required is taken from my pension account then take anything extra as a payment from my accumulation account. Once the accumulation account runs out, take anything extra as a partial commutation from my pension account."

In other words, they don't have to think about exactly how they want to treat their payments every single time, they just make sure they provide the right instructions in advance.

And the 'in advance' bit is important. Legally, a commutation only occurs when a member makes a decision to swap some or all of their future pension payments for a lump sum. It's not possible to do that after the fact. The member must ask for this treatment to apply up front before taking the payment. Otherwise, any payment from a pension account is just a pension payment.

So for a short sentence, it captures a lot of good ideas for anyone receiving a superannuation pension.

For more explanation on why partial commutations are so powerful, see this article.

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.

Three factors shape whether we are at the bottom yet

Nick Griffin

The rapid increases in global interest rates this year came as a shock to many investors. While the interest rate setting for the world was way too low last year, it was also completely understandable. It seems nobody, including central banks, had anticipated how quickly economies would recover from Covid-19.

But once they did, spending rose and demand, combined with tightening supply for many goods, pushed prices up and necessitated the rapid increases in rates.

The good news is that we believe markets have now fully priced in interest rate hikes. The bad news is the majority of earnings downgrades are probably yet to come.

As investors we need to respect the history of bear markets - and the history of bear markets is they are normally worse than this. But there are still opportunities in this environment if you know where to look and we have been deploying cash even as we wait for earnings downgrades to play through.

The outlook

When considering whether 'we are there yet' in terms of reaching the market bottom, we believe there are three important factors to consider.

1. Interest rates

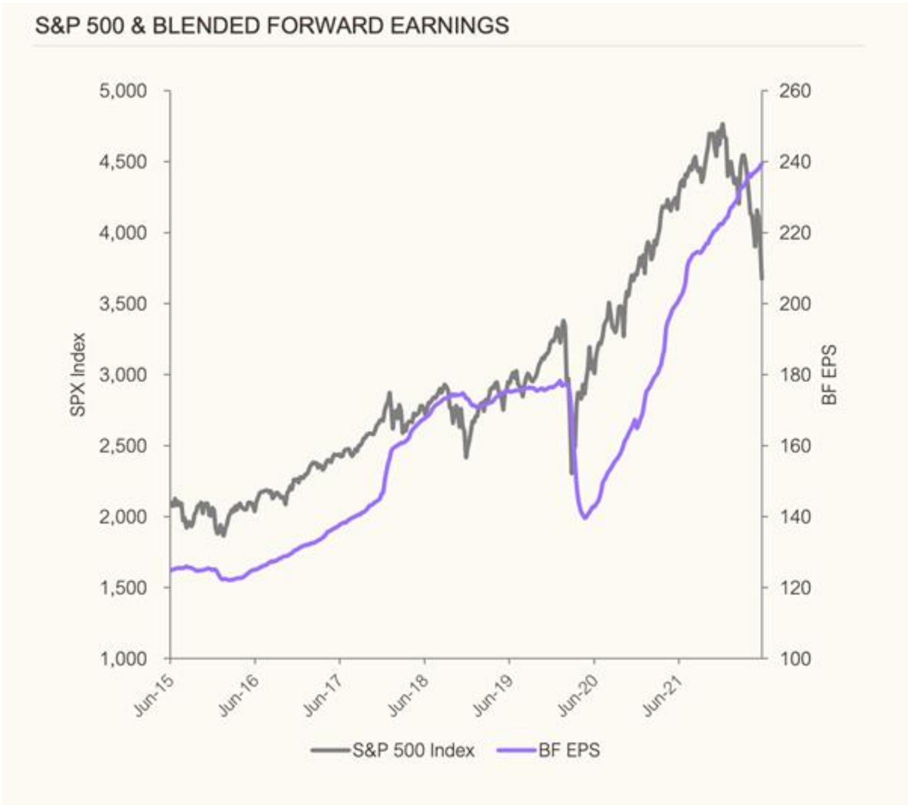
When interest rates rise, the price of everything generally falls. The multiple then comes out of the market and growth assets usually get hit first, which is what we saw in January 2022. Falls in other asset prices, such as housing and private equity, followed.

We think the market is now adequately pricing where cash rates have to reach, which is roughly 3% in the US and Australia. This is apparent from the bond market where short-term rates are still rising but long bonds are not, and the yield curve is inverting. The bond market is telling us that 3% is enough to get the desired outcome of slowing the economy.

2. Earnings

You cannot have interest rates rise at the speed at which they have and not have people and investors change their behaviour and spending decisions. Earnings downgrades in this environment are a function of factors such as over-ordering and subsequent discounting of inventory, and general falls in asset prices.

So, while we might be there on interest rate expectations, we are certainly not there on earnings downgrades which have just started and which we expect to continue for potentially the next two quarters.



Source: Munro Partners

3. Time

The other factor to include when considering if 'are we there yet' is time. The average bear market lasts 12 months and falls approximately 37%. This one has lasted eight months and has fallen about 27%. That is in the realm of an average bear market. But we could be in a mild bear market, an average bear market or it could be a bad bear market. Only time will tell.

In terms of those three things that we are looking for, we can tick off interest rates as peaking, earnings downgrades as just beginning, and when it comes to time, we could potentially only be halfway there.

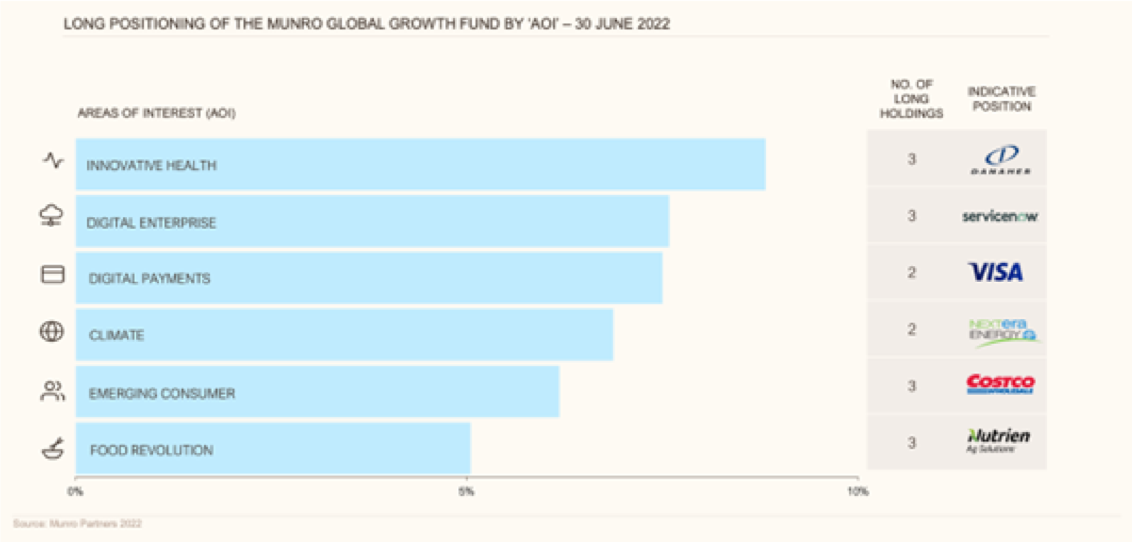
What to do about it?

The market is forward looking so investors don’t have to wait for earnings to bottom before the market bottoms. Interest rates peaking is the most important factor. Earnings downgrades are harder to price. But at some point, in the next quarter or two, you'll be able to see the other side of the valley and the market will just move on.

If we are in an environment where interest rates have peaked but earnings deratings are occurring, then companies with more resilient earnings are likely to fare better.

Stock ideas

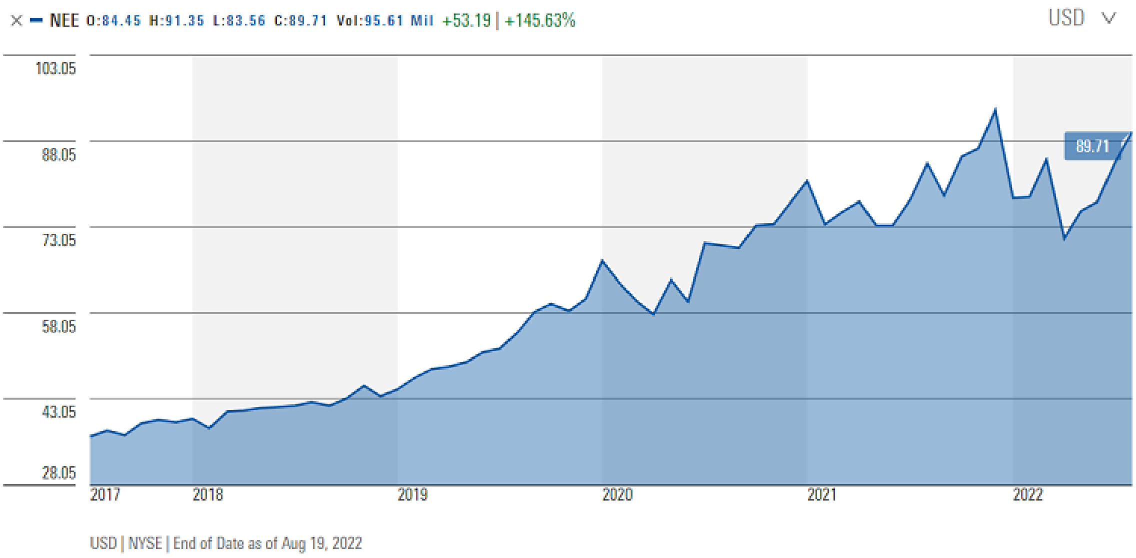
There are some areas of interest which we are constantly monitoring at Munro where we have identified long-term drivers of growth, as highlighted in the below chart.



NextEra Energy

At Munro we believe decarbonisation will be one of the bigger trends over the next three decades and [NextEra Energy](#) is the largest renewable utility in the US. They are a $US200 billion company that is dominant in renewable infrastructure across the US. Following the signing of the Inflation Reduction Act in the US, which includes $US375 billion to be invested over the decade in climate-fighting initiatives, the US is now irreversibly on the path to decarbonising.

As a result of that bill, you now have 10 years' worth of credits for wind, solar, nuclear, hydrogen, carbon capture, etc. The regulatory framework for the next decade is now in place, which should allow the earnings of NextEra to accelerate as they develop these projects. No economic slowdown is going to stop that.

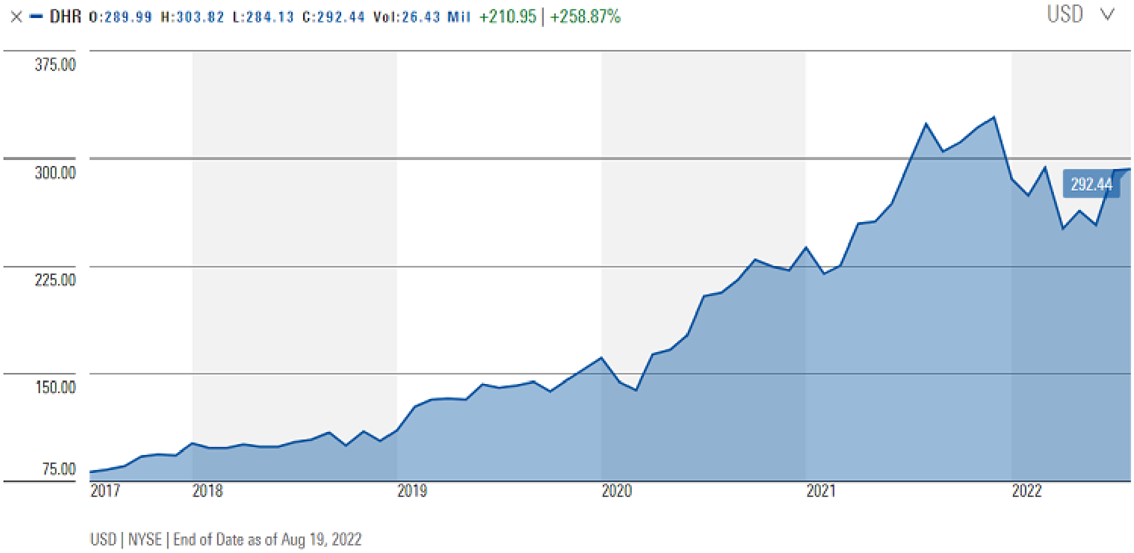


Source: Morningstar

Danaher

Danaher is a US-based equipment supplier to the life sciences industry. It is also leveraged to the development of biologic drugs. Biopharmaceuticals, or biologics, differ from regular pharmaceuticals in that they are developed, derived or semi-synthesized from biological sources, rather than being completely synthesized. A simple example is the mRNA vaccine Pfizer, which worked better than the protein vaccine AstraZeneca in protecting against severe infections of Covid-19.

As more biologics come to market, they will need more of the equipment that Danaher supplies. As such, Danaher is a fairly macro insensitive company in the healthcare sector. If you think interest rates will peak at 3%, at roughly 25 times earnings and growing at 10% per annum, Danaher is a reasonably good investment. We bought the company five years ago and it has continually done what it says it is going to do.



Source: Morningstar

Glass half empty or half full

As we wait for the earnings story to play out, we have already invested around a third of the funds we had sitting on the sidelines in companies where we believe there are long-term drivers of earnings, and which will not suffer downgrades.

Market highs and lows will always have twists and turns. The market may have already bottomed, or it could still be on the way down. The market doesn't give a big 'all clear' sign when it reaches a bottom, but we believe the three factors we have outlined above provide helpful signposts for working out when the worst will be over.

Nick Griffin is Chief Investment Officer at Munro Partners. Munro is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information included in this article is provided for informational purposes only. Munro Partners do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions.

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How to position your portfolio for stagflation

Sawan Tanna

It's hard enough to protect wealth in the current environment, let alone grow the value of investments. The prospect of stagflation is the latest black cloud on the horizon. Stagflation is broadly defined as a period of high and rising inflation, slow economic growth and relatively high unemployment. Whether Australia is susceptible remains to be seen, and even if there's no need to panic, fears are on the rise.

The origins of stagflation

The term stagflation is often attributed to Iain Macleod, who was Britain's shadow Chancellor in 1965 when he declared:

"We now have the worst of both worlds – not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of 'stagflation' situation."

According to economic theory of the day, inflation and unemployment were inversely related. Rising prices were seen as a sign of an expanding economy which, in turn, drove employment up. It formed the basis of misguided policy which is largely blamed for the rise of UK stagflation. But it was the oil crisis of 1973 that triggered the problem in other parts of the Western world.

Arab members of the Organization of the Petroleum Exporting Countries (OPEC) proclaimed an embargo on nations that supported Israel during the Yom Kippur War. The supply side shock caused 'gas' prices in the US to take off. The stock market crashed, and the country fell into a deep recession. Unemployment climbed globally and in Australia annual inflation topped 15% by the middle of the decade.

Similarities to current shocks

Some commentators have been quick to see alarming parallels with the situation today.

As the world began reopening after the pandemic, the global economy was hit by a number of shockwaves. Pent up demand and supply chain issues caused price rises for goods including essentials like groceries and petrol.

The war in Eastern Europe has exacerbated these inflationary pressures. Prices for commodities that Russia and Ukraine supply, including energy, wheat, fertilizers, and some metals, have moved sharply higher.

In Australia, the cost of energy faces a number of additional challenges. The onset of winter, falling coal output, reduced coal-fired power generation, the transition to renewables are all playing into the current crisis.

As in other developed economies, the Reserve Bank of Australia is attempting to dampen demand and contain rising inflation with higher interest rates - heaping pressure on consumers and mortgage owners. We're seeing financial market instability around the world and with the loss of confidence in global growth, increasing worries about recession.

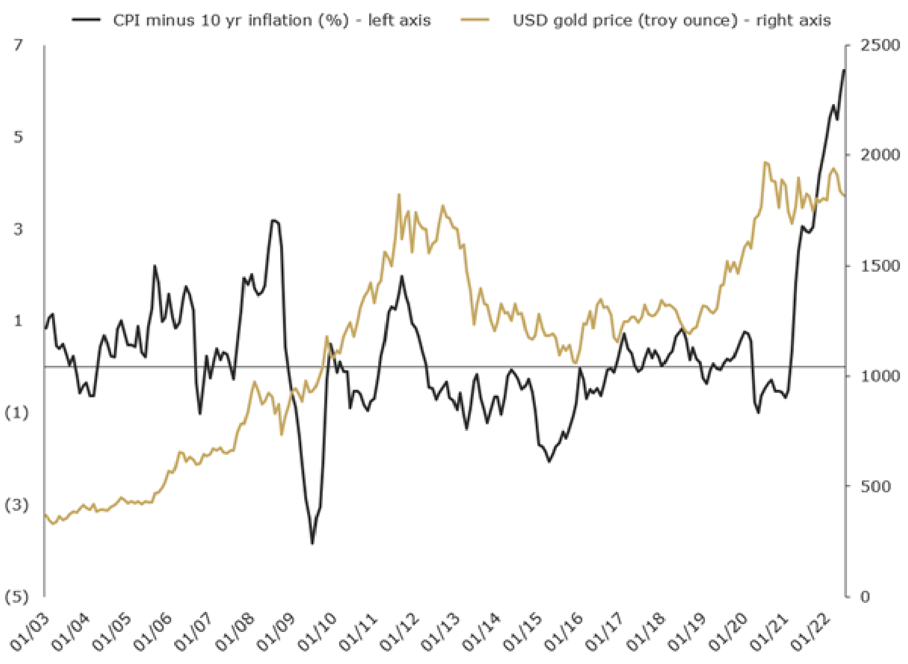
Diversification to weather tougher times

In this scenario, it's a good idea for investors to make sure their portfolios are positioned and diversified to weather higher inflation and lower GDP growth.

Every investor needs to assess their own situation, risk tolerance and investment priorities, but historically we've seen moves into defensive equities, also known as noncyclical stocks, because they are less correlated with the business cycle.

These include well established blue-chips that have stable operations, strong cash flow, and pay dividends which can cushion the stock's price during a market decline.

On the alternative side of their allocation, investors have also added tangible assets such as gold. The precious metal has a proven 50-plus year track record and has shown historically to perform well in most inflationary environments.



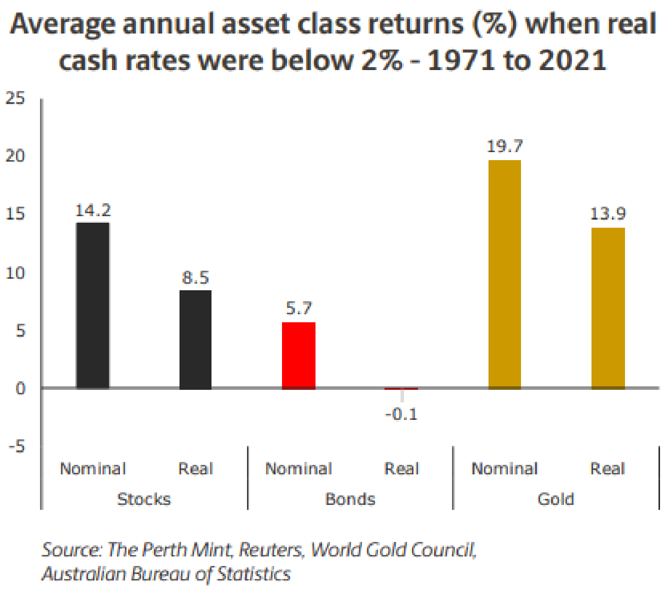
The breakeven inflation rate in the table represents a measure of expected inflation derived from 10-year Treasury Constant Maturity Securities. The chart highlights gold price in USD, as well as the gap between annual CPI and 10-year breakeven inflation rate.

According to Schroders Strategist Sean Markowicz, CFA, gold is the top performer during periods of stagflation. He said:

"Gold is often seen as a safe-haven asset and so tends to appreciate in times of economic uncertainty. Real interest rates also tend to decline in periods of stagflation as inflation expectations rise and growth expectations fall. Lower real rates reduce the opportunity cost of owning a zero-yielding asset such as gold, thereby boosting its appeal to investors."*

[* nominal interest rate minus rate of inflation]

This chart illustrates the average annual returns (both real and nominal) for Australian stocks, bonds and gold during years when real interest rates were below 2%



While employment in Australia remains strong, GDP slowed in the March quarter. Unfortunately, it's clear that inflation is not the temporary phenomenon predicted six months ago. With promises of more rate rises from the Reserve Bank until demand softens, some see the trigger for stagflation.

In such a scenario it will pay investors to be prepared.

Sawan Tanna is the Treasurer of The Perth Mint, a sponsor of Firstlinks. The information in this article is general information only and should not be taken as constituting professional advice from The Perth Mint. You should consider seeking independent financial advice to check how the information in this article relates to your unique circumstances.

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Equity investing in an inflationary environment

Christophe Braun

After a long hiatus, the resurgence of inflation has become a key concern for investors over the past year. We also face falling real incomes dampening consumer spending, rising input costs eroding profitability and higher discount rates hurting the present value of future cashflows. This article considers the effects that inflation has had on equity valuations in the past and review ways to build resilience into equity portfolios. Looking ahead, dividend-income investment could play a more important role in the total return of a portfolio.

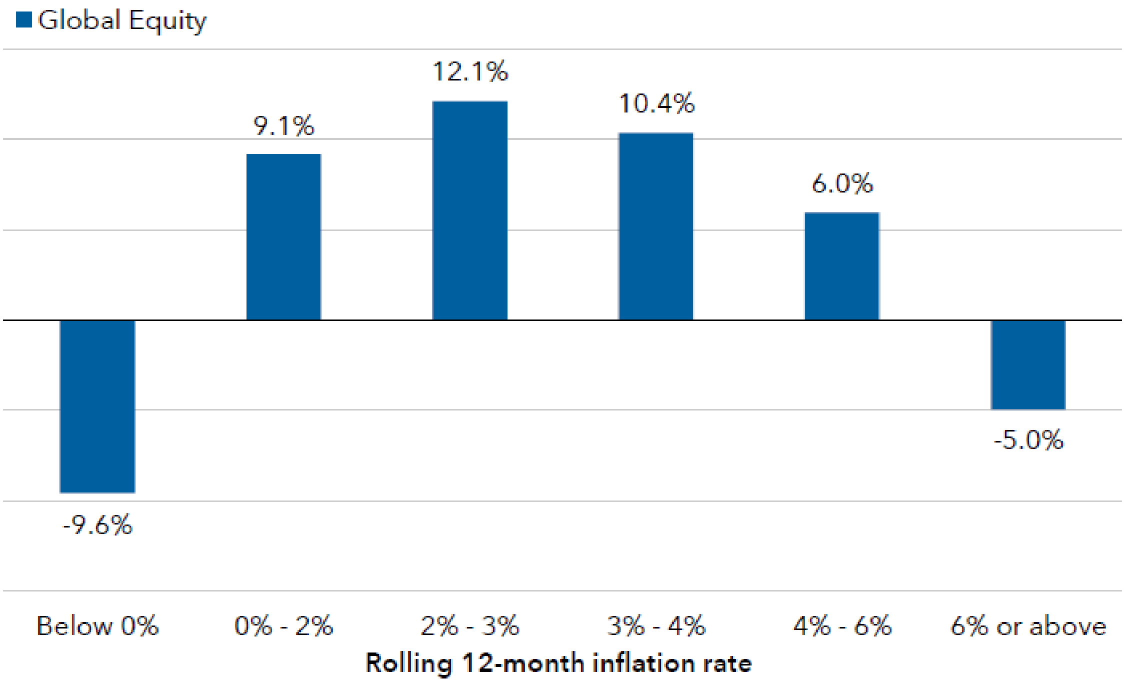
Inflation is not necessarily bad news for equity valuations. Some inflation can be beneficial for companies' bottom lines as it allows them to raise prices and protect profitability in ways they may not have been able to do in recent years. It also helps banks and commodity-linked companies that have struggled in a low inflation, low interest rate environment.

Equity returns during inflation

Even during times of higher inflation, stocks have generally provided positive real returns (see chart below). Global equities have historically provided an effective inflation hedge when US inflation is between 2-6%, powered by real earnings growth and real dividend growth.

It's mostly at the extremes (when inflation is above 6% or negative) that global equities have tended to struggle. However, sustained periods of elevated inflation are rare. The ultra-high inflation of the 1970s was a unique period, while deflationary pressures, such as during the Great Depression, have often been much more difficult to tame.

Average annual real returns at different US inflation rates (1970-July 2022)



Past results are not a guarantee of future results.

As at 31 July 2022. All returns are inflation-adjusted real returns. Global equity returns represented by MSCI World to 30 September 2011 and thereafter MSCI ACWI. Inflation rates are defined by the rolling 12-month returns of the Ibbotson Associates SBBI US Inflation Index. Sources: Capital Group, Morningstar, MSCI

The relationship between inflation and stock prices is not linear

The **impact of inflation on earnings** can be quite positive in nominal terms, especially over the longer term. However, it can create short-term headwinds for corporate cash flows, particularly for companies that report earnings on historic cost accounting (using the original price of assets), rather than on a current cost basis. With earnings being overstated, the need for working capital increases as companies must meet higher corporate taxes, sparking the risk of a short-term valuation de-rating. The net impact of these factors varies from cycle-to-cycle and industry-to-industry.

The **impact of inflation on valuations** varies depending on the level of interest rates and the economic environment. When rates are high, future earnings get discounted back to a lower price, suppressing valuations. However, as interest rates decline, future earnings get discounted back to a higher price and hence valuations increase. Additionally, if the economy is in distress, valuations decline sharply reflecting the poor outlook for earnings, whereas, if the economy is relatively robust, valuations have followed a more linear path.

Impact on sector behaviour can vary

History shows that some companies and industries have delivered consistent relative returns during past inflationary environments, while others are more of a mixed bag.

The chart below shows how different US equity sectors have performed during periods of higher inflation (above 2%) and during periods of lower inflation (below 2%). The 'hit rate' is the percentage of periods when a sector achieved a return higher than the Standard & Poor's 500 Composite Index (S&P 500).

While the hit rates are within quite a narrow overall range, there do appear to be some trends. During periods of higher inflation, real estate, consumer staples and health care outpaced the S&P 500 in more instances than other sectors. Whereas, consumer discretionary and information technology outpaced more when inflation was low (below 2%).

Sector returns relative to S&P 500 when US inflation higher/lower than 2%

Sector	Hit rate CPI>2	Sector	Hit rate CPI<2
Real Estate	53	Consumer Discretionary	61
Consumer Staples	53	Information Technology	57
Health Care	53	Industrials	51
Financials	51	Financials	48
Consumer Discretionary	50	Health Care	48
Information Technology	50	Materials	46
Utilities	50	Real Estate	46
Energy	49	Communication Services	46
Communication Services	48	Energy	45
Industrials	48	Utilities	44
Materials	46	Consumer Staples	42

Past results are not a guarantee of future results.

Data from 30 October 1989 to 30 June 2022. CPI: Consumer Price Index. Sources: FactSet, RIMES

The channel through which inflation impacts sectors can vary widely and often the impact is through second derivative effects such as growth and interest rates.

Sometimes sector behaviour is a direct impact of inflation:

- **Consumer discretionary**. Consumers' discretionary spending is likely impacted by higher borrowing rates and also energy prices (specifically, gasoline). As the consumer burden decreases (falling inflation), the outlook for consumer discretionary can improve relative to the broader market.

Sector behaviour can also be driven by the impact of inflation on the economy:

Consumer staples. When the economy moves into distress and consumer spending declines, the consumer staples sector, which generally benefits from stable consumer spending patterns through a cycle, can do well relative to the broad market. Similarly, when inflation starts to decline and the economy recovers (along with consumer spending recovering), other sectors can recover and consumer staples may lag.

And other times sector behaviour is driven by what is happening to interest rates:

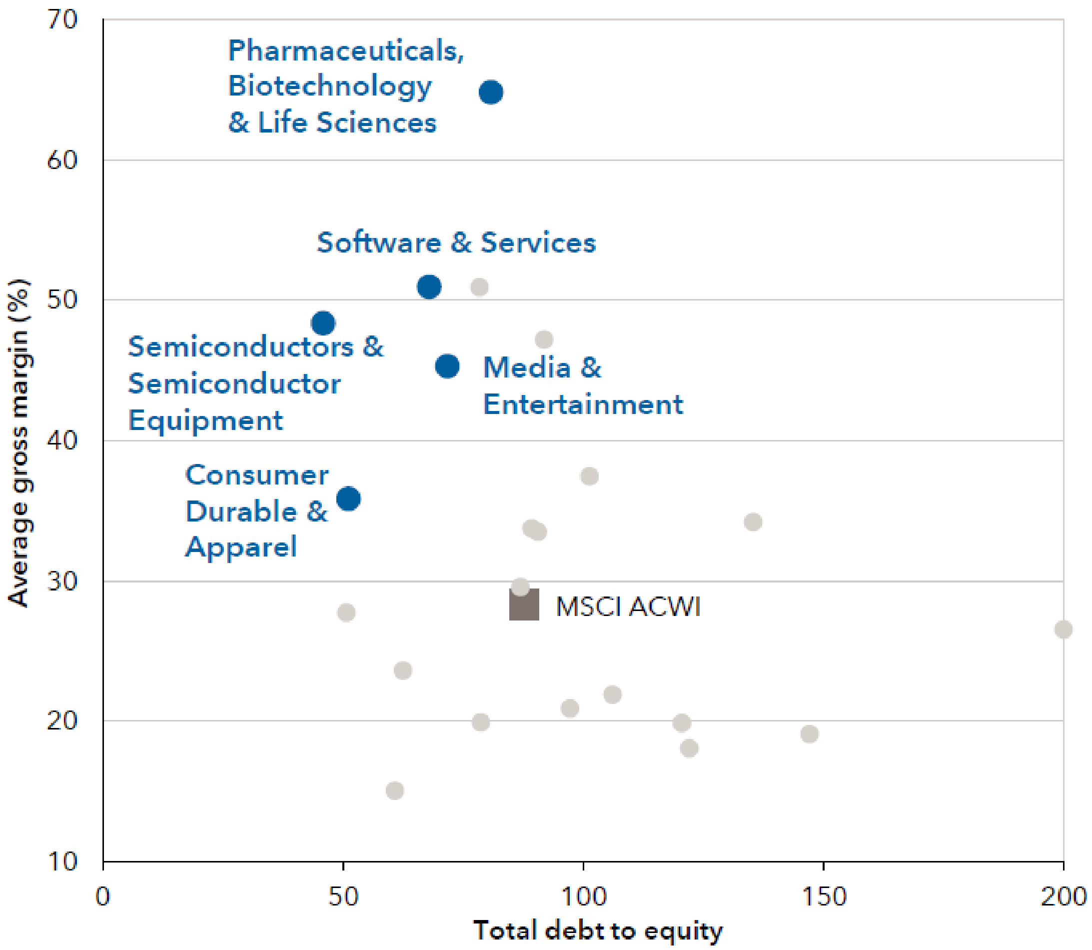
Life insurance companies and banks. Companies for which interest income is a meaningful part of their business will benefit in a period of higher interest rates which generally accompanies higher inflation.

A positive characteristic in an inflationary environment is companies whose top line can 'inflate' at a higher rate than their costs.

Addressing a higher inflation and interest rate environment

It is likely that rising costs will linger in the months ahead. Companies with high average gross margins and low debt may be better suited to weather this new environment.

MSCI ACWI industry groups by gross margin and debt ratio



Past results are not a guarantee of future results.

Data as at 30 June 2022 in US dollar terms. Sources: FactSet, Capital Group

Companies that could succeed in such an environment include:

- Businesses that provide **essential services**, like health care giants Pfizer, UnitedHealth Group and Abbot Laboratories. The average gross margin in the Pharma/Biotech sector tends to be around 65%, as shown in the chart above.
- Companies with **quality products**. Tesla's technological lead in electric vehicles has allowed it to pursue a highly dynamic pricing strategy. In March 2022, Tesla increased prices across its entire range by as much as 10% (source: Reuters, 15 March 2022).
- Companies enabling **lower costs**. Companies offering products and services that improve cost bases are likely to be in high demand. Cloud infrastructure and software-as-a-service have seen strong uptake as network and scale effects drive structural reductions in unit costs.
- Companies in industries with **favourable supply and demand dynamics**. Semiconductor and chip equipment makers like TSMC and ASML are experiencing huge demand with limited supply. TSMC's pricing power was evident in August 2021 after it announced it would raise chip prices by as much as 20% (source: Reuters, 23 October 2021). While TSMC and ASML have been caught up in the recent sell-off of growth stocks, their supply and demand dynamics should help protect them against rising inflation.
- Businesses serving customers who are relatively insensitive to changes in price, like **luxury goods companies** LVMH and Kering.

Sustainable dividend growth can offer inflation protection

Companies whose top line can 'inflate' at a higher rate than their costs are more likely to improve their capital allocation by expanding return on equity for shareholders and consequently improving dividend payouts.

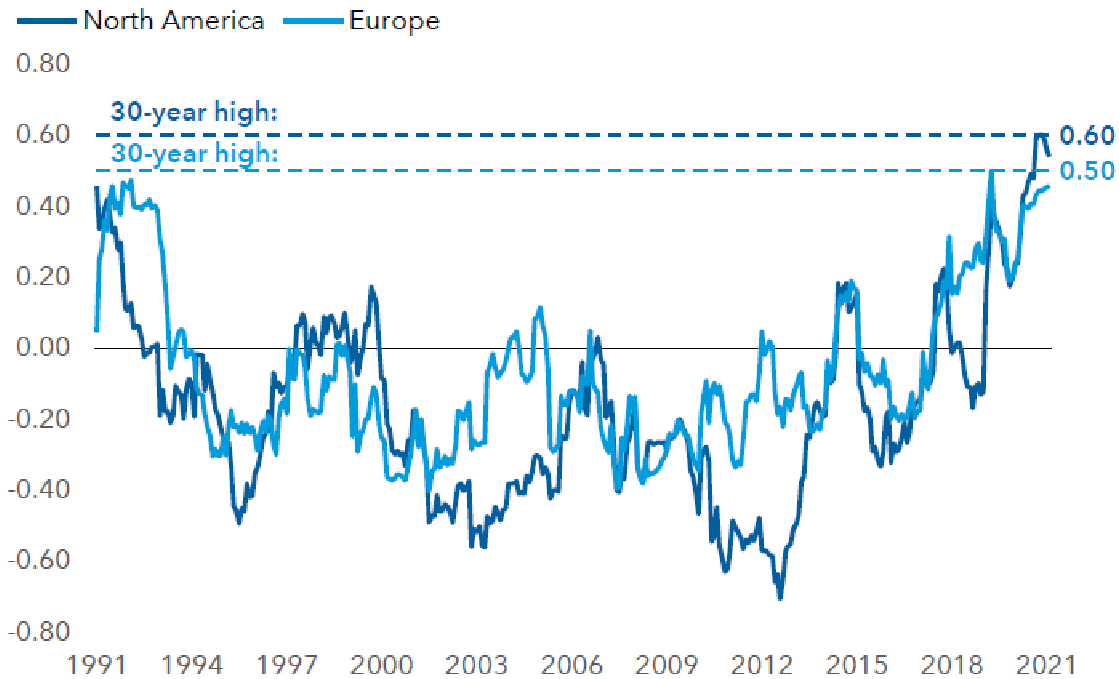
Last year, 2021, saw global dividends recover strongly, more than making up for the cuts made during the worst of the pandemic in 2020. Of the 242 companies that either suspended or cut their dividend in 2020, 98 have reinstated payments and only three companies cut their dividend in 2021.

Global companies paid out a remarkable US$1.9 trillion of dividends for the 12 months ended 31 May 2022, which is a 20% jump from the prior 12 months. Dividend growth records were broken in a number of countries in 2021, including the US, China and Sweden though the pace of expansion was fastest in those parts of the world that had seen the biggest declines in 2020, especially Europe, the UK and Australia.

Looking ahead, dividend-income investment could play a more important role in the total return of a portfolio. Dividend-paying stocks provide a combination of income along with the potential for capital appreciation, especially since the valuations of many of these companies appear reasonable. However, it's important to be cautious on companies with heavy debt loads or excessive leverage on their balance sheets in a rising rate environment.

For the past few years, the relative returns of high dividend-yielding stocks have exhibited a positive correlation to changes in US Treasury yields, reversing 30 years of being negatively correlated (see chart below). If this trend continues, a rise in US interest rates may not dampen prospects of dividend stocks as it has in the past.

Rolling correlations of yield factor with change in US 10-year Treasury yields



Data as at 31 December 2021. Yield factors constructed by ranking dividend yields within region and then breaking them into terciles, rebalanced monthly. The return reflects the average return of the high yielding cohort minus the average return of the low yielding cohort. Returns are market cap weighted. The change in the 10-year US Treasury is measured as the monthly basis points change in the 10-year US Treasury yield. The correlation is calculated over 24 months and rolled forward on a monthly basis. Sources: Capital Group, MSCI, Datastream

The financials, energy, materials and health care sectors represent a substantial chunk of the dividend-paying universe. A confluence of factors support the case of rising dividends from each of these areas:

Financials. Banks have been building up excess capital on their balance sheets since the GFC and most are now well-capitalised, having undergone a number of regulatory stress tests. Some banks in the US and Europe are poised to redeploy surplus capital in the form of regular and catch-up dividends after facing regulatory limitations during the pandemic.

Energy and materials. A surge in post-pandemic demand for various products and services has led to a rise in the prices of commodities on which these products and services rely, and an increase in demand for the energy needed to produce them. Supply chain disruptions further exacerbated the increase in commodity prices.

Large integrated oil companies have long been good sources of consistent dividends for income-oriented investors. They've also become more disciplined on supply, having curtailed investment in existing reserves and pursuing new sources of oil. Over the past couple of years, European oil majors BP and Royal Dutch Shell have cut their dividends amid their transition to investing in renewable energies that are capital intensive and where the return on invested capital is still uncertain. Having reset their dividends to lower payout ratios, the European oil majors have left sufficient room to increase dividends over time.

Health care. Pharmaceutical companies historically have exhibited relatively strong pricing power. While the industry has faced political pressures on drug prices, more innovative pharmaceutical companies will likely be positioned to raise prices at modest levels.

Major pharmaceutical companies recognise that a sizeable portion of their value proposition is the dividend payout. It gives confidence in equity income when combined with a robust pipeline over the next few years at several major companies.

In addition, some companies, particularly in highly cyclical industries such as mining and energy exploration and production, are adopting innovative approaches to balance their business needs and a commitment to dividend payouts. Dividend payouts are determined by a formula tied to operating metrics, resulting in a variable dividend yield over time. This gives companies an enhanced ability to manage their balance sheet and cash flows in a sustainable manner through multiple commodities cycles, helping them to avoid excessive stock price volatility. A similar approach is also being observed within the semiconductor and chip equipment industry.

Move to dividend growers

We are in the early stages of an equity market that is starting to show more breadth after a heavy focus placed on technology-related growth stocks in the IT, consumer discretionary and communication services sectors, especially those in the United States.

As market volatility increases due to monetary tightening, elevated levels of inflation and geopolitical tensions, dividend-income investment could play a more important role in the total return of a portfolio. Historically, dividend growers have tended to generate greater returns than other dividend strategies, while also keeping up relatively well with the broader market. Dividend growers can also offer a measure of resilience against higher inflation and interest rate hikes, mainly due to their stronger earnings.

Christophe Braun is an Investment Director, based in Luxembourg, with Capital Group, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any person.

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Can you trust industry super fund valuations?

Annika Bradley

The financial year-end performance data of industry super funds was met with suspicion from investors, advisers, and even between super funds. The regulator's recent commitment to update its practice guide (APRA's SPG531) on valuation methods cannot come soon enough.

However, the reality is the industry has come a long way in recent years. Many funds have clear valuation policies that involve external expert reports, asset revaluations are conducted during heightened periods of volatility to support member equity and board valuation sub-committees have been established. But the debate over superannuation fund valuations of unlisted assets continues to rage.

Growth in allocations to unlisted assets

Many superannuation funds have embraced more use of unlisted assets recently. According to ASFA's Superannuation Statistics, on average MySuper fund holds over 20% of assets in unlisted property, infrastructure, and private equity. Given the inflow profile and investment time horizon of some super funds, these large allocations to illiquid assets have remained manageable.

MySuper Funds' Aggregate Asset Allocations

MySuper funds

Characteristics	Amount ($billion)	%
Cash	35	4
Australian fixed interest	78	9
International fixed interest	53	6
Australian listed shares	192	21
Listed property	24	3
Unlisted property	57	6
International shares	277	30
Infrastructure	78	9
Hedge funds	0	0
Unlisted equity	53	6
Other	71	8
	928	**100**

Source: APRA March quarter 2022.
*Number of MySuper products: 75,28 lifecycle.

Source: ASFA Superannuation Statistics – May 2022

From the due diligence data Morningstar receives, the results for members have been impressive. Both AustralianSuper and Australian Retirement Trust's Private Equity programmes have generated returns in excess of 16% per annum over the last five years (as of 31 March 2022).

But APRA didn't undertake their recent Unlisted Asset Valuation thematic review for nothing. The review highlighted:

"the need for considerable improvement in industry approaches to valuations and the need to conduct valuations proactively and regularly.''

Following the review and update of SPS530 – Investment Governance, APRA now intends to update SPG531 – Valuation. It is expected that the update will address valuation governance, valuation methodology (including independent assurances), frequency and monitoring of valuations and types of valuation risk.

Canva illustrates transparency need

Australia's own start-up success story, Canva, is the subject of the most recent unlisted asset valuation controversy. According to U.S. SEC 'Statement of Investments' filing, Franklin Templeton Growth Opportunities Fund has written down the value of their Canva investment by over 58% already this year.

This write-down calls into question the valuation responses of the Australian superannuation funds that also hold this investment through their private equity programmes.

The answer became obvious in a recent Morningstar discussion with a large super fund about how private equity managers need to be more transparent in a world of heightened standards around environmental, social and governance (ESG) considerations, with a focus on transparent disclosure.

Whether the write-down taken by Franklin Templeton is precisely right isn't the point. The point is it was transparently disclosed. But under SEC regulations, Franklin Templeton didn't have a choice. Revealing the holdings and valuations isn't just good governance - it's the law.

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Here in Australia, Portfolio Holdings Disclosure at the security level for unlisted assets isn't required. Instead, the industry and media are trying to back-solve based on the inadequate disclosure currently required.

For example, Aware Super has publicly stated they own Canva, but based on the Portfolio Holdings Disclosures posted on its own website, the best guess is that the investment is held through a Blackbird Ventures position. As to the carrying value of the investment, it is impossible to say, although to be clear, Aware Super's disclosure is compliant and more than adequate under the current regulations.

Resistance to transparency of valuations

There are lots of arguments against increasing levels of transparency. After all, the Portfolio Holdings Disclosure regulations were watered down following significant industry criticism of the draft regulations. But wouldn't sunlight solve the ongoing suspicion in relation to unlisted asset valuations?

It's good enough for many of the large listed real estate investment trusts. For example, Scentre Group clearly publishes Westfield Bondi Junction's valuation. It's good enough for our offshore counterparts, as Franklin Templeton publishes Canva's valuation along with DataBricks and its other listed and unlisted assets.

Obviously, no valuation is perfect, whether listed or unlisted, daily or otherwise. We all know that the listed equity market in the short run is a voting machine. But it is a transparent voting machine and one that applies the same price consistently across market participants.

Funds need to disclose their unlisted valuations

It's doubtful many super fund members would be venturing in to check valuations, but regardless, better disclosure would create enough industry scrutiny around who was taking what write-downs, when, and using what methodology that it would put to bed the cloud of doubt and suspicion that currently exists.

If we are really going to resolve this once and for all, funds need to be regulated to disclose their holdings at the security level and associated valuations following quarter end. I'm not suggesting that this is a 10-business day post-quarter end proposition. But following an appropriate lag, this information should be made available to investors and the broader industry.

This will be the only way to quell the doubt that exists. Instead, the industry remains under a cloud of suspicion as to who really was the best performing fund of the year.

Annika Bradley is Morningstar Australasia's Director of Manager Research ratings. Firstlinks is owned by Morningstar. This article is general information and does not consider the circumstances of any investor. This article was originally published in Morningstar on 16 August 2022.