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Contents

That horse has bolted: super is not only for retirement *Graham Hand*

$10 trillion manager moves into Australian super *Graham Hand with Daniel Shrimski*

Investment opportunities in the global energy crunch *Shane Woldendorp*

Globalisation is morphing into something less promising *Michael Collins*

Reporting season shows companies meeting challenges *Jun Bei Liu*

Is the best value for Australian credit not in Australia? *Phil Strano*

Six misconceptions and demystifying long/short funds *Sean Roger*

Editorial

For a Government that ran a small-target strategy prior to the election, this week's 100-days-in-office milestone for **Anthony Albanese** and his team was a reminder of how much is on the table in only a few months. While some policies around the jobs summit and the Indigenous Voice to Parliament were expected, unanticipated changes in the financial services landscape are coming thick and fast. Anyone who hoped superannuation and financial advice would go through a period of stability had better strap in for the ride.

Last week, at the annual **Superannuation Lending Roundtable**, Treasurer **Jim Chalmers** created plenty of industry angst when he advocated that the $3.4 trillion super sector should invest more in local social and nation-building investments such as housing and clean energy. There is an obvious potential conflict with generating the best returns for members, and he overlooked that about $900 billion is in SMSFs which are not likely to invest much in these projects without the right incentives.

The Treasurer also revived the seven-year-old commitment from the previous Government to legislate a purpose for superannuation. It's likely to say that super is for income in retirement. There is an attempt to rewrite history here as potentially hundreds of thousands of Australians do not see their superannuation this way. Entirely within the rules, people have been encouraged by successive governments to put money into super as a savings vehicle, and many have no intention of spending it all in their retirement. Making a statement about the objective of superannuation will not change anything for these people.

The Government has even announced a review of the Your Future, Your Super regulations and the performance test for super products.

But most notable was the release of the Quality of Advice Review - Consultation Paper - Proposals for Reform (a process started by the previous Government). If adopted, the proposals will have a profound impact on financial advice. We summarised the current predicaments in a 'whither or wither' article on financial advice a couple of weeks ago, but the Consultation Paper prepared by lawyer **Michelle Levy** will put financial advice back on a growth path. It proposes a relaxation of many regulations which have stifled financial advisers and forced many out of the industry. The challenge for the final paper (submissions are accepted until 23 September 2022) will be to strike the right balance between making more advice available while not compromising the protections built into the system for 20 years. They exist for a reason.

Consider a couple of highlights which have already attracted praise and criticism. The biggest change is the removal of the best interests duty, which is currently extremely broad in its application, including (from section 2.1 of the Review):

"Chapter 7 of the Corporations Act requires a person who provides personal advice to a retail client to ... a) act in the best interests of the client in providing the advice ... d) give priority to the client's interests if there is a conflict between the interests of the client and the provider or the interests of the client and the interests of an associate of the provider."

This will be replaced under the proposals by a 'good advice' requirement:

"A person who provides personal advice should be required to provide 'good advice'. 'Good advice' is advice that would be reasonably likely to benefit the client, having regard to the information that is available to the provider at the time the advice is provided."

It is far from straightforward what 'good advice' means. A person can visit five financial advisers and receive six opinions.

Then section 6.3 says:

"Proposal to remove the requirement for SOAs (Statements of Advice)
I query whether consumers want written advice at all, especially when the advice is simple or limited or when they have a regular relationship with the provider. In my view, the law should encourage and allow providers to provide advice in the way that best suits their customers."

Moving from the current administrative headache all the way to providing no written record of the advice is a radical step. Reactions were varied depending on whether they represented the industry or consumers. For example, the **SMSF Association** called the changes a "*breath of fresh air*":

"We have also stressed that how advice is provided to clients needs to be commensurate with the level of complexity and the number of issues to be addressed. Simple, single-issue pieces of advice should be able to be delivered through a simple letter of advice. Currently, SOAs are risk management documents with a significant amount of their content compliance oriented. They have stopped being a consumer-centric document for the provision of financial advice and information."

Critics argue the concept of 'good advice' is too vague, and it might allow conflicted advice that promotes second-tier products that are only good in comparison to something worse. The obvious targets are banks cross-selling their own funds or financial advisers pushing funds where the issuer pays a selling fee. Michelle Levy conceded some form of best interests duty may be required for complex advice or where a commission is paid.

The Chief Executive of **Choice, Alan Kirkland**, said:

"We have grave concerns. If the government removes the best interests duty, as proposed in this report, we'll go back to the bad old days. The Review's proposals to weaken consumer protections will fuel a revival of vertical integration, by making it easier for large banks and super funds to use their data to flog products to existing customers."

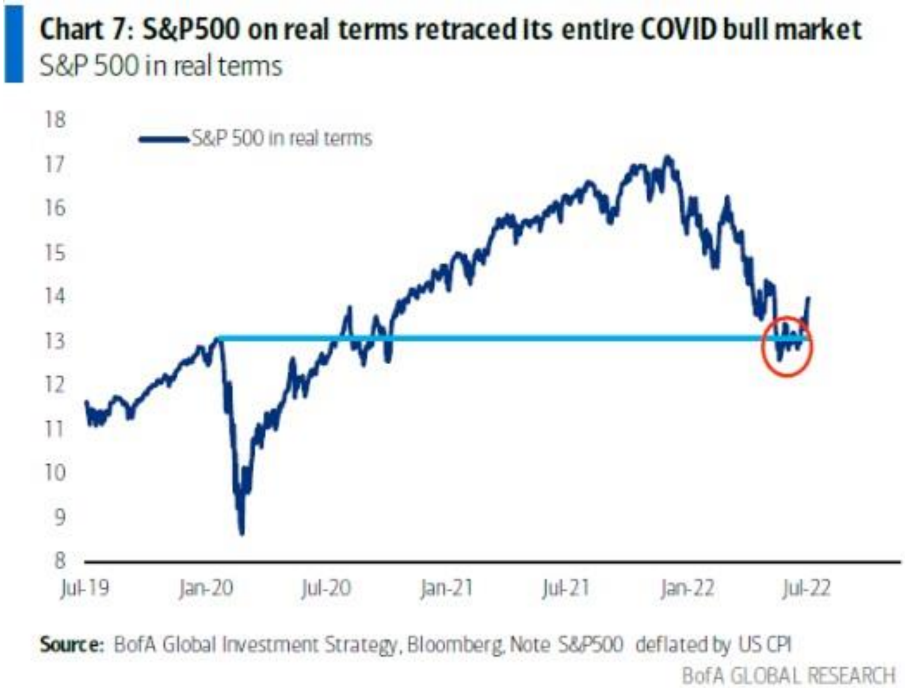
A brief comment on why the stockmarket is so spooked by **Fed Chairman Jerome Powell**'s speech at Jackson Hole last week. It was the strength of his words, including "*greater pain*", which has caused the sell off:

"Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions. While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

Also in this week's edition ...

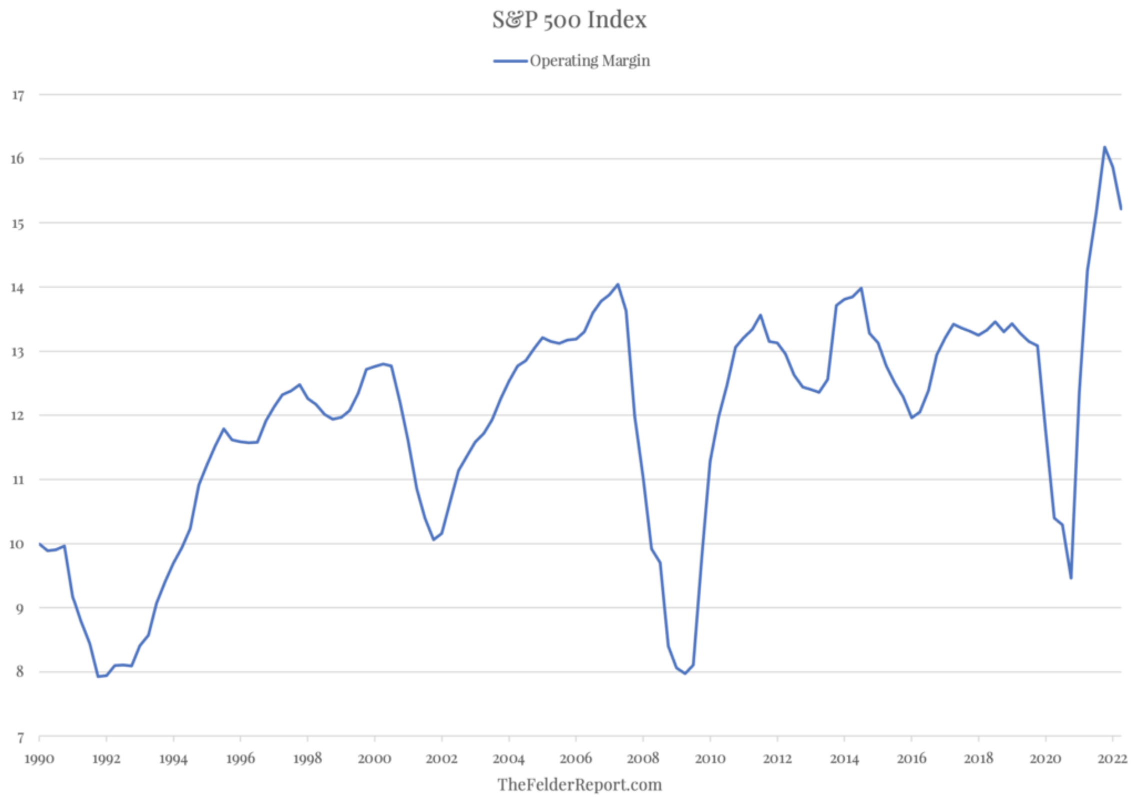
We interview **Daniel Shrimski** from the $10 trillion global fund manager **Vanguard**. Vanguard manages three times the amount in the entire Australian super system, considered one of the best in the world. He outlines their plans to move more into retail and adviser segments and out of institutional management.

One of the few bright spots this year in investment portfolios is the energy sector, but some analysts are questioning its long-term merit. **Shane Woldendorp from Orbis** explains why it has years to run. It is sobering to realise that the US market has now given back in real terms (adjusted for inflation) all the rapid gains it made after COVID hit in early 2020. Those who stayed out in the pandemic and kicked themselves for missing the run up can relax a little.



With reporting season coming to a close in Australia, **Jun Bei Liu of Tribeca** summarises her [main conclusions and companies that stood out]() to her.

Many investors watch only Price/Earnings ratios, but it only has relevance if the earnings are sustainable. Investors need to watch company results to learn whether margins are under pressure, and this chart from **Jesse Felder** in the US suggests the elevated margin levels are rolling over.



This week, the former President of the Soviet Union, **Mikhail Gorbachev**, died. He won the Nobel Peace Prize in 1990, helped to end the cold war and hoped his country and its people would be more open and free. Until a couple of years ago, the drive towards greater globalisation and trading and cooperation between countries seemed ongoing, and there were few signs of serious conflict. Russia and China have changed all that, and **Michael Collins from Magellan** says the change will drive down living standards and growth for everyone.

As we described last week, retail investors in Australia hold a large proportion of the $40 billion in bank hybrids (sometimes called T1 securities) issued on the ASX. But **Phil Strano from Yarra Capital** reports that T1 paper issued by Australian banks offers better yields in offshore markets (issued in foreign currency so hedging or accepting FX risk is required). Investors can access the securities via funds or fixed interest brokers.

Many Australian equity funds have the ability to 'short' the market, but it comes with criticisms of its impact on prices and risk. **Sean Roger of Perpetual** gives a simple explanation of how long-short funds operate. and he answers the criticisms.

Please note the special offer from **Morningstar** for the upcoming Conference for Individual Investors on 13 October 2022, where I will be hosting a panel on asset allocation. The first 50 Firstlinks readers to register using the code below receive a free ticket, and even those who miss this offer receive a discount of over 80%. Check the full agenda, it should be a great day at the ICC.

That horse has bolted: super is not only for retirement

Graham Hand

Over 30 years since 1992, both Liberal and Labor Governments have encouraged Australians to save large amounts in super with generous tax concessions as compensation for forgoing present-day consumption. In 1995, for example, the Labor Budget of Treasurer Ralph Willis announced the intention to lift the superannuation guarantee (SG) from 9% to 15% by 2002. In 2007, Liberal Peter Costello encouraged people to add up to $1 million to their super. As recently as 2017, a couple could put up to $1.08 million into super in one year using the bring-forward rule.

As Treasurer in 1991, Paul Keating was the main architect of Australia's compulsory superannuation system. He said recently:

“I wanted a system where the individual retained the capital and didn’t give it to the government. It was an account with your name on it. The capital is yours and it doesn’t belong to the government.”

Savers with enough money followed the rules - "*the capital is yours*" - over decades and watched their investments grow with compounding and good returns. No government should now demand they spend it all during their retirement. That was not the deal. Defining the purpose of super as only for providing income in retirement is rewriting history.

Whatever the future, that was not the past

Last week, at the annual Superannuation Lending Roundtable, Treasurer Jim Chalmers gave the old hobby horse another run around the track, when many thought the nag had gone to the knacker's yard. At the event, hosted by *The Australian Financial Review* and industrialist Anthony Pratt, Chalmers said:

“We see the lack of a legislated objective of super as a source of ambiguity which left the gate open for early access, and so we will legislate one.”

Way back in 2015, the previous Government announced it would enshrine the objective of superannuation in legislation, as recommended by the Financial System Inquiry (FSI). The Government even released a discussion paper entitled *‘Objective of Superannuation’* with background and questions, and received 118 submissions. The intention was to adopt the following:

"The objective of the superannuation system is to provide income in retirement to substitute or supplement the Age Pension."

Now, some seven years later, the Treasurer has made defining an objective a priority for his office. Already, a recommendation of the FSI that was adopted from 1 July 2022 requires all super funds to have a Retirement Income Covenant that includes a strategy that balances:

• maximising retirement income
• managing risks to the sustainability and stability of retirement income
• having some flexible access to savings during retirement.

But however the proposed objective is drafted, a large cohort of investors will have no problem funding their retirement and they have no intention of spending their superannuation.

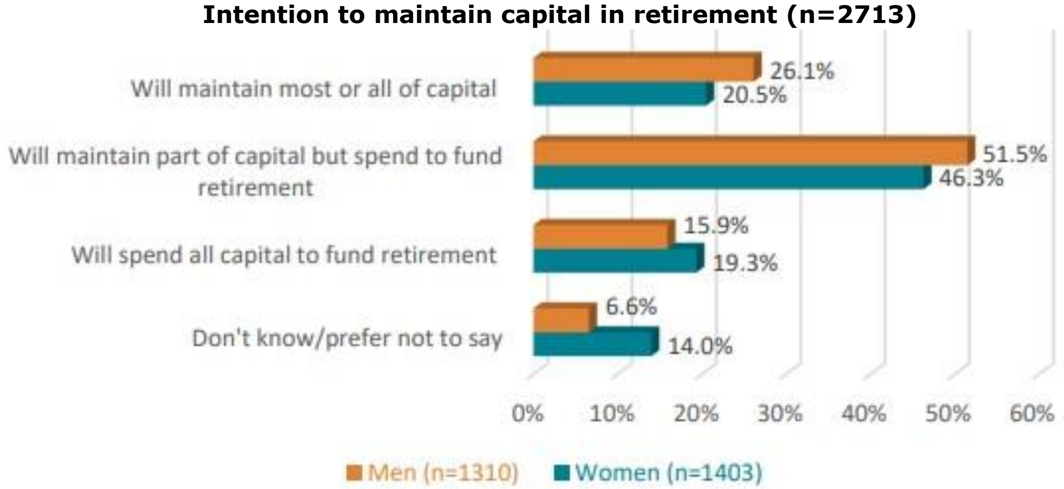
Evidence of intention not to spend super

Like it or not, hundreds of thousands of Australians use their superannuation as more of a tax-advantaged savings vehicle than a source of retirement income.

At a 2015 CSIRO and Monash University Superannuation Research Cluster, a study reported that 90% of the amount an average retiree enters retirement with (including the family home and non-super) remains unspent upon their death.

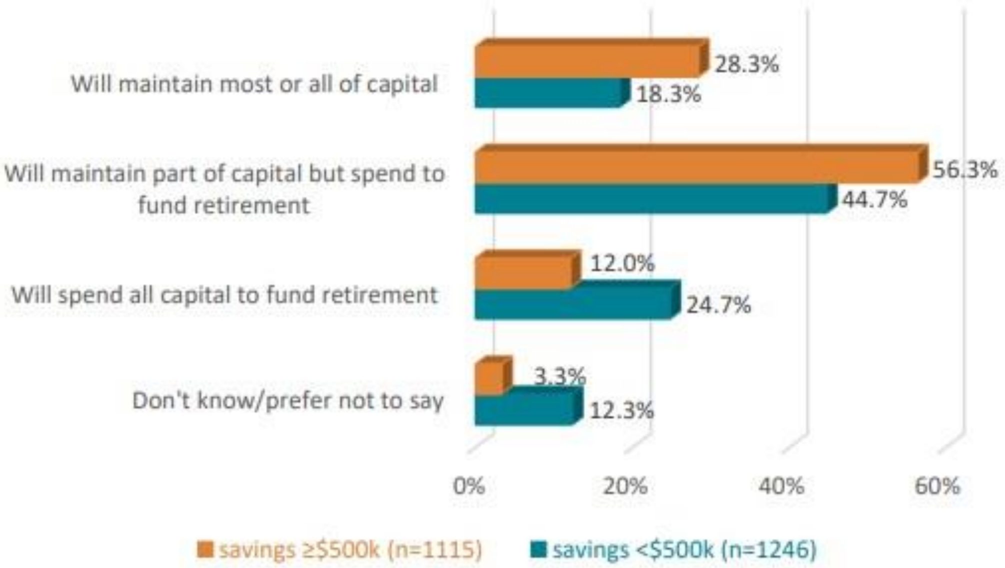
In a recent 2022 survey by National Seniors and Challenger of 3,345 members, more respondents reported they would 'maintain most or all of capital' than 'spend all capital to fund retirement', as shown below.

Intention to maintain capital in retirement (n=2713)



As expected, those with over $500,000 in retirement savings have a significantly higher intention of maintaining their capital.

Intention to maintain capital according to wealth (including super but not the home) (n=2361)



When asked why they are maintaining capital, 41% nominated 'for beneficiaries'. On whether retirement savings are a nest egg or income stream, the Report concludes:

"Super capital was not meant to accumulate and remain unused. In practice, however, many people only spend earnings from their super to preserve the capital or take the required minimum drawdown. This can reduce available spending money by as much as 30%. The results of this survey align with the observations made by the (Retirement Income) Review that many retirees do not want to consume their super as income. Only 1 in 3 people were intending to draw down their capital to generate income from super in retirement."

Is that first sentence correct? When in the first two decades of SG did Keating, Costello, other Treasurers and Treasury advocate that **all** super balances must be exhausted in retirement?

Diving deeper into SMSF and super balances

Consider the latest SMSF data, recently released by the Australian Taxation Office for June 2020. There is a significant lag due to delays in SMSF tax reporting, and the amount will be higher now. The ATO data reveals $854 billion (of the $3.3 trillion in super) was held in 605,000 SMSFs for 1.1 million members.

As shown below, 17.1% of funds held over $2 million in assets, equal to about 103,400 funds for 188,100 people. This data focusses only on SMSFs as they are likely to hold the largest super balances, but in addition, total super data from the ATO shows 575,000 people with annual incomes above $180,000 hold an average of $575,000 in super each.

As most people enter retirement as a member of a couple, and it's likely if one partner dies, the entire balance will pass to the other, the data indicates there are at least 200,000 Australians with access to super balances of $2 million or more and far more with $1 million plus.

Table 8.1: Proportion of funds, by asset range of fund

Asset Ranges	2019–20	2018–19	2017–18	2016–17	2015–16
$0 to $50,000	4.9%	5.9%	5.9%	6.1%	6.3%
>$50,000 to $100,000	2.7%	3.1%	3.4%	3.8%	4.3%
>$100,000 to $200,000	6.6%	7.0%	7.8%	8.5%	9.3%
>$200,000 to $500,000	22.3%	22.1%	23.0%	23.5%	24.4%
>$500,000 to $1m	25.8%	24.8%	24.5%	24.2%	24.1%
>$1m to $2m	20.7%	20.1%	19.5%	19.0%	18.1%
>$2m to $5m	13.4%	13.2%	12.5%	11.9%	10.9%
>$5m to $10m	2.8%	2.9%	2.6%	2.5%	2.2%
>$10m to $20m	0.7%	0.7%	0.7%	0.6%	0.4%
>$20m to $50m	0.1%	0.1%	0.1%	0.1%	0.1%
>$50m	<0.1%	<0.1%	<0.1%	<0.1%	<0.1%
Total	100%	100%	100%	100%	100%

Any way these numbers are cut, an enormous number of Australians have more money than they will use to finance their retirement. In the National Seniors data, 81% owned their homes outright with a further 11% owning with a mortgage. It is likely that their homes are worth more than their super, as well as owning considerable other assets. Given the tax efficiency of super, it is prudent to use non-super assets (other than the family home) before drawing on super.

Large balances can still accumulate

The caps imposed on contributing to super will go some way to eliminating the mega balances of $5 million or more, but they still allow significant wealth to be stored in super. For example, current rules allow:

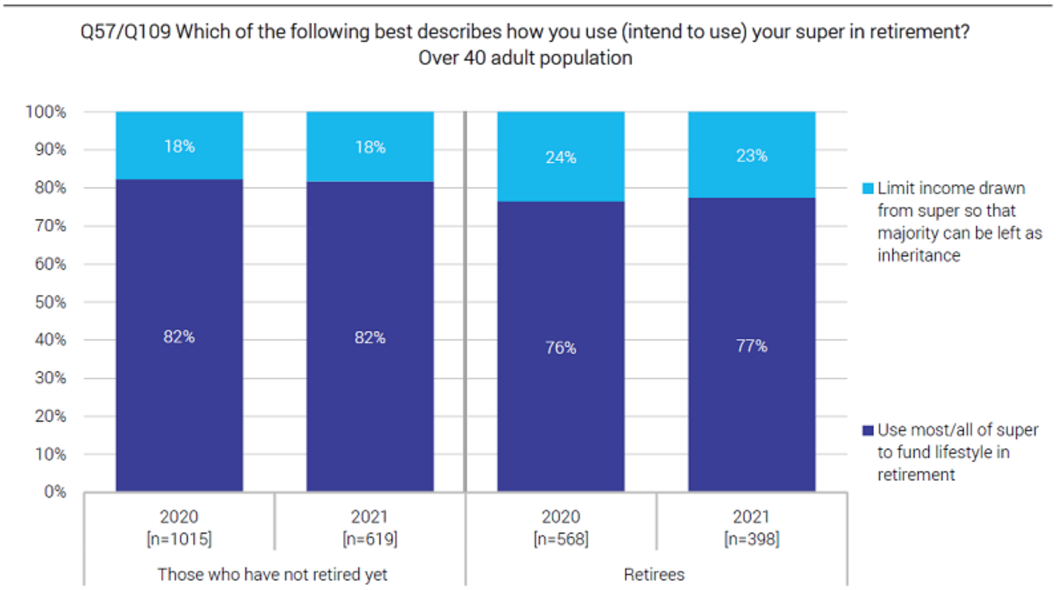
- $1.7 million in a pension account ($3.4 million for a couple) subject to no tax on income and withdrawals
- No limit to the size of accumulation accounts taxed at 15%
- Non-concessional contribution cap of $110,000 a year
- Concessional contribution cap of $27,500 a year

Plus various schemes such as carry forward concessions and downsizer payments (of $600,000 a couple) which do not count towards the contribution caps.

Well-paid executives using these amounts over a long career will accumulate multi-million superannuation accounts long into the future. For example, invest $100,000 at the start and add $120,000 a year for 20 years compounded at 5% gives a balance over $4 million.

In research from Investment Trends, 18% of people over 40 who have not yet retired expect to limit drawdowns for income to ensure most super can be left as an inheritance. Fully one quarter of retirees are already doing this.

Intentions for super in retirement – views from the over 40 adult population



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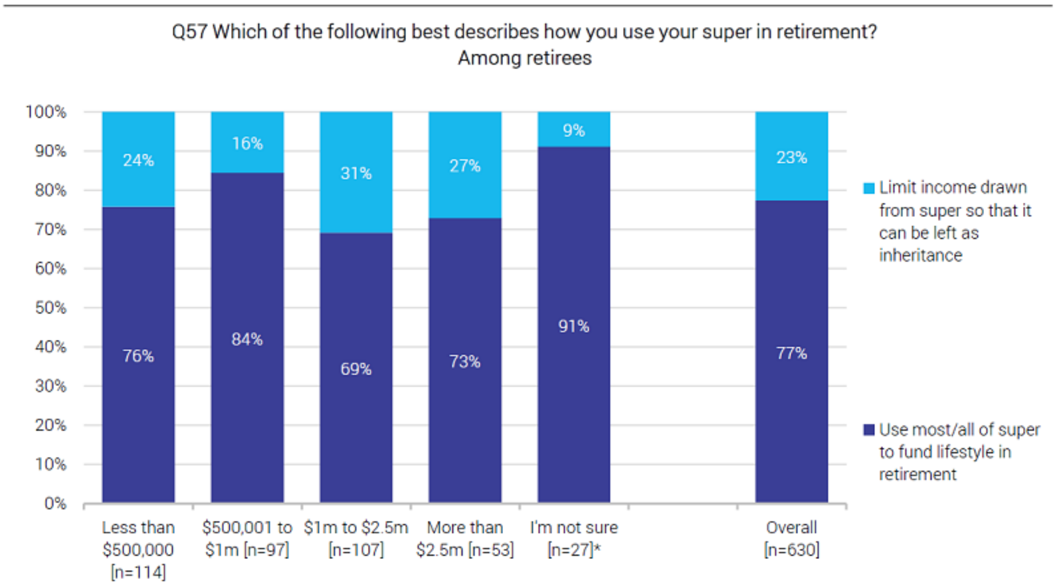
Cutting the data by super balances, even among retirees with less than $500,000 in super, 24% plan to leave most money as an inheritance. At larger balances, the proportion rises as high as 31%.

Use of super in retirement – among retirees & Super balance



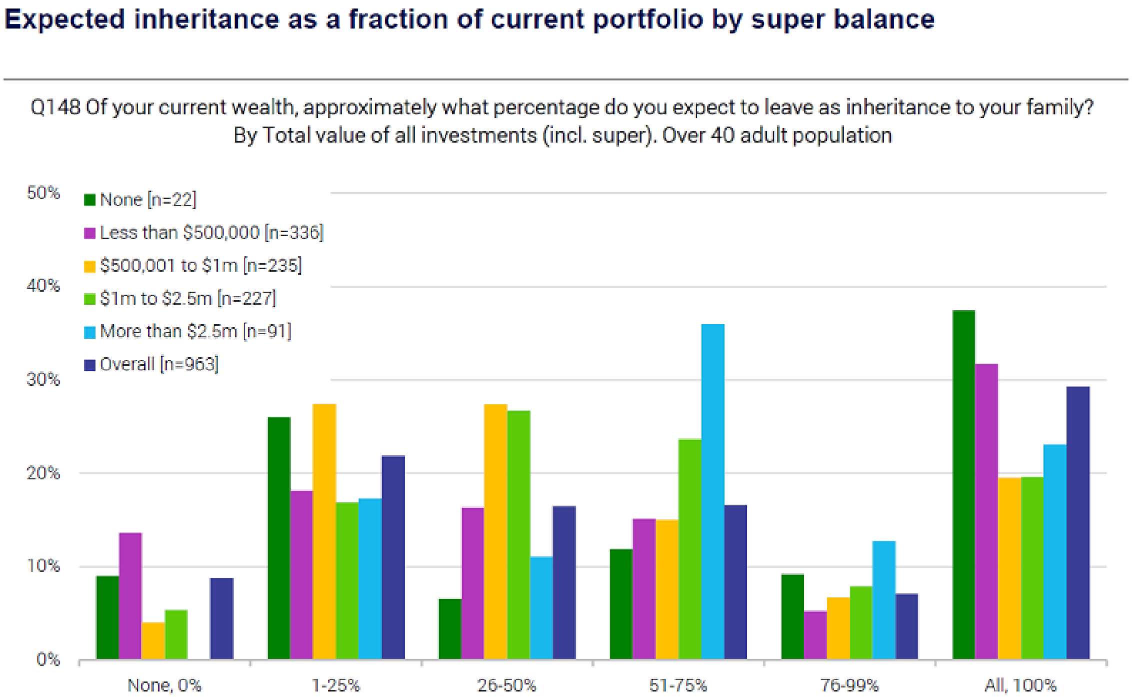
**Small sample, indicative only. Copyright 2021 Investment Trends. November 2021 Retirement Income Report: Industry Analysis.*

Superannuation specifically acknowledges bequests

Superannuation legislation has specific features designed for appropriate bequeathing. Binding Death Nominations (BDNs) ensure superannuation is distributed according to the wishes of the deceased member, not at the whim of another trustee of the fund or executor of the estate. Superannuation is not an asset of the estate and a trustee is not obliged to follow directions in a will, even if super is specifically mentioned in the will. The instructions in the BDN define the money flow.

The superannuation rules facilitate bequests to non-dependants. There is no restriction on withdrawing money from superannuation for anyone who has reached preservation age and satisfied a condition of release (including retiring). However, on death, if it is given to anyone other than a spouse or a dependent child, there is a tax (on the taxable component) of 15% plus the Medicare levy (currently 2% for most people). The obvious approach is to gift it before death, if possible.

Again using Investment Trends research, large proportions of people in every wealth bracket intend to leave substantial parts of their estate to beneficiaries, and in some cases, the total value of all investments.



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The system was designed to allow large balances

Treasurer Chalmers will define the objective of superannuation as 'providing income in retirement' or similar, ignoring the fact that both Labor and Liberal Governments designed a system which allowed people to accumulate more than they need. As stated above, the current chair of the Future Fund allowed $1 million into super in only one year, and more recently, a couple could put up to $1.08 million into super in only one year.

Unless some much stricter legislation is passed requiring all balances over a certain amount to be removed from super, then the objective will not result in a behavioural change by hundreds of thousands of Australians. They have no intention of running down their super to one dollar on the day they die. As Keating said, "*I wanted a system where the individual retained the capital.*"

Labor badly misjudged the opposition to its policy on restricting franking credit refunds but would be on safer ground with most voters if superannuation were capped at a high amount, say $5 million per person. There is no knowing, however, how much extra tax this would generate as the very wealthy have other tax minimisation techniques.

Go ahead, clarify the objective of superannuation, but don't expect those with large balances accumulated by the completely legitimate (and government sponsored) use of the system to change their plans. Their spending intentions extend beyond their lives and beyond their graves. For many, the objective will be flogging a dead horse.

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

$10 trillion manager moves into Australian superannuation

Graham Hand with Vanguard's Daniel Shrimski

Daniel Shrimski is Managing Director of Vanguard Australia. He joined Vanguard in 2011 and moved to the US in 2017 to become the CFO of the US Retail Investor Group, which managers over $US2 trillion in assets for more than seven million retail investors. He returned to Australia for the MD role in October 2021. Globally, Vanguard manages $10 trillion of assets for 30 million investors.

GH: It's been almost a year since you became MD in Australia. You've worked and lived here before, but has anything surprised you this time around?

DS: Yes. First, the makeup of our business here is very different. I left in the beginning of 2017 when we were predominantly institutional with a financial adviser business. We have pivoted away from institutions to become a direct retail business that serves financial advisers. We're more mature in marketing, corporate affairs, compliance and government relations as part of the move into retail.

Secondly, the acceleration and pace of growth in ETFs has been exciting. When I left, the total market was about $22 billion and now it's about $130 billion. We're proud to be the ETF leader with about 30% of the market.

Finally, the consolidation in superannuation has surprised me, and there's better member engagement, although I think there's a long way to go.

GH: Do you mean consolidation of industry funds?

DS: Super funds across the board, encouraged by the requirements of the APRA performance test, which should give a better chance of investment success for members.

GH: Stepping away from big institutional clients must have been a tough decision because while the margins are fine, billions of dollars was involved.

DS: Yes, it was a bold decision. We walked away from the something like $100 billion of institutional business, but we did it with a long-term focus on what's the best chance for us to work directly with retail investors rather than through other financial institutions.

GH: Which leads to Vanguard Personal Investor (PI), your direct offer which was launched in Australia in 2020. What's been the experience so far?

DS: Yes, two-and-a-half years into the retail journey, we have tens of thousands of new clients, although obviously this year has been tougher than we expected but the market has changed. The data suggests we're winning market share and we've launched useful enhancements. We started off with individual account types, then joint accounts, SMSFs, company accounts, and there'll be more account types in future. We have a new 'auto invest' feature for managed funds and we plan to launch it for ETFs. Clients can put in as little as $200 monthly or quarterly and it aligns with our long-term investing approach. We build for scale to manage hundreds of thousands of clients and independent financial advisers. We have also included a lot more educational material on our new website.

GH: Member engagement is tricky because you don't want most retail investors checking their balances every day, worrying about every movement of a few percent. That might lead to repeated switching at the wrong time.

DS: Yes, trading every day is another story but as long as people are doing it responsibly with a long-term investment philosophy and we certainly don't believe in trying to time the market. For many people, superannuation is their second-largest asset and they should be closer to their super, such as knowing that small changes in costs can mean a lot over time.

GH: That's a good segue into Vanguard's plans in retail superannuation. How is that going and what will it look like?

DS: Well, we have some big news, you're the first external person to hear this, but we received our Registrable Superannuation Entity (RSE) licence today. It's very exciting for the team. We've been building the superannuation offer for about two and a half years and it's a massive responsibility to manage people's retirement savings. We'll make a public launch before the end of 2022. It will focus on simplicity, transparency, our investment expertise, high levels of diversification and low cost.

GH: That's been much anticipated. It's September now, so launch within the next three months?

DS: We think so. We will also focus on the investment experience and we've partnered with a third party that will enable us to really be nimble in employing technology and continually improving.

GH: As you know, for most younger people, it is an industry fund connected with their first workplace that captures their superannuation. Do you see Vanguard competing for that source?

DS: Longer term, absolutely yes. Incremental choice for members is a good thing, with more Australians engaged with super early. The competition will be tough but we've also got a great brand in the adviser space and we will leverage that as well as our PI platform.

GH: Back to your existing business, where have been the best flows for 2022 and have any funds done much better than you expected, listed or unlisted?

DS: One that has surprised me is our Australian Shares ETF, VAS. It held $2 billion when I left five years ago now sits at $11 billion, the biggest ETF in Australia. Also, the range of diversified funds, where investors can access the entire market with a low minimum at a low cost, have done well. And international equities. They're the three main areas of growth. This will be the first year where we see ETF flows bigger than unlisted managed funds.

GH: On ETFs, some of your competitors make regular launches of thematic or niche funds but I don't see Vanguard playing in that market. Is that a conscious strategy?

DS: It definitely is. Our founder, the late Jack Bogle, always said, "*Don't try to buy the needle in the haystack, buy the haystack*" and in terms of launching products, that's how we run our business. New products go through a rigorous process and we look at four different elements:

One, does it have investment merit over the long term?
Two, will clients be better off over the long term with the product?
Three, is it feasible from a legal and a regulatory standpoint?
Four, is it something where we think we have an advantage over our competitors?

When you look at those four, and you run some of the thematics and cryptos through it, they don't stack up. Crypto is more speculation in a largely unregulated space and it's something we've steered clear of.

GH: And often, the thematics are launched at the peak of their popularity to catch a demand wave, such as the crypto funds that have lost 70% of their value. If we have this conversation five years from now, how will your business look different?

DS: Our strategy is locked in for that time frame and now it's about good execution.

First, we will work more with like-minded financial advisers, that's a real position of strength, including technology solutions for them around things like retirement income builders. We're also building a portal that will enable advisers to access our retail offers in superannuation and PI. We're helping advisers with their offer, their practice management.

Second, on the direct-to-consumer side, it's about growth and scale. We want a much louder voice in the retail investor and superannuation space.

And third, active and diversified funds will become a bigger part of our offering. It's a small but growing part of our story.

GH: Many advice businesses divide their clients into the As and Bs, the profitable high net worths, but the Cs and Ds have less to invest and are finding it difficult to access advice. Do you work with advisers across all these groups so they can service the Cs and Ds as well?

DS: Yes, and giving clients access to a low-cost personal investor offer with no platform fees is even more important as advisers are struggling with, as you say, the Cs and the Ds. We worry that advisers are leaving the industry and good advice matters for investment returns. We want advisers to be able to scale their business in terms of practice management.

GH: Final question. Do you think future investment returns will be able to match the generally good outcomes we've seen over the past 30 to 40 years?

DS: I don't really have a strong view about 10-year returns but we always encourage clients to stay the course. Although we do see a 40% to 50% chance of a recession in Australia over the next couple of years, nobody knows how much of that is already priced into the market. Vanguard has been in Australia for 26 years and we're not focussed only a few months ahead. I couldn't be more excited about the growth opportunity in the retail space in coming years as many fundamentals work in our favour.

Graham Hand is Editor-At-Large for Firstlinks. Daniel Shrimski is Managing Director of Vanguard Australia, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.

For articles and papers from Vanguard, please click here.

Investment opportunities in the global energy crunch

Shane Woldendorp

As we look across businesses exposed both negatively and positively to longer-term energy prices, we believe the risk of a prolonged energy shortage is not truly appreciated by markets. And this dislocation offers significant opportunities to investors willing to look at the whole picture.

Traditionally, high energy prices would trigger new investment in the sector creating increased supply that would bring prices back down. This conventional capital cycle in the energy sector typically takes five to 10 years to play out in full.

An extended cycle

Over the past six to eight years, however, there has been a noticeable lack of investment in the sector, as companies have either cut or not increased their capital expenditure.

The current underinvestment is the result of a number of factors.

1. In recent years investors have been more attracted to high growth companies, and as a result are valuing the future promise of cash as highly as having cash in their pocket today. This means they've tended to pour investment into startups that burn money to grow quickly, and drained capital from 'old economy' businesses – such as traditional oil and gas - that already make money but grow more slowly.

2. Increasingly urgent climate concerns have also been a headwind to traditional energy companies. The growing recognition that a clean energy transition is critical to our survival has clouded the demand outlook for new projects and the capital required to build them has become far less abundant and far more costly.

Together, these factors have created a longer and less efficient capital cycle in the energy sector that not only heightens the possibility of longer-lasting volatility and energy shortages but also presents opportunities to contrarian investors with a truly long-term mindset.

For while the fundamentals of these energy companies look better than they have in years, in our view they remain cheap. At current oil and gas prices, the sector offers an average free cash flow yield of around 20%. The challenge, however, is distinguishing the deservedly cheap from the attractively undervalued. A 20% free cash flow yield doesn't count for much if a company has no future, and some energy companies probably don't. But we believe some producers, like Shell, Inpex, and Chesapeake, as well as infrastructure companies like pipeline operator Kinder Morgan, will have a role to play for years to come.

Shell – relic or future leader?

Let's take Shell as an example.

Most people see it as a fossil fuel company, but we see it more as a diversified energy business that is well-positioned to aid the energy transition. Shell has already committed to net-zero emissions by 2050 - a target that includes not only its own emissions but also the impact of the energy products it sells to customers.

A key part of this is Shell's exposure to natural gas—a fuel that we see as key to facilitating the energy transition— but also through its renewables, its infrastructure and its petrol stations. In addition, it has a trading arm that matches energy supply and demand around the world, which could be increasingly valuable in a volatile and energy scarce environment.

On top of this, not only is it highly cash generative, but the nature of its business means it offers longer-term inflation protection and resilience against energy shocks.

Given all this, you might expect Shell to trade at a premium, especially in light of the concerns around energy security that are beginning to emerge in all corners of the global economy.

However, the market currently seems to be disregarding these issues. Shell, for example, is one of those with a double-digit free cash flow yield – a measure of how financially stable a company is – which is clearly attractive. This is demonstrated by the fact it is returning money to shareholders through share buybacks and a divided yield of around 4%, as well as earnings growth.

A bumpy ride?

Of course, there are always potential headwinds that we would be foolish not to consider. When investing in energy companies today, we are mindful about the risk of stranded assets. Particularly if the demand for oil declines sharply through recession, or from the world transitioning away from fossil fuels faster than we are expecting.

This would create uncertainty about the future and deliver a bumpy ride for investors.

The environmental, social and governance (ESG) risks associated with energy companies are also something that cannot be overlooked. While we believe Shell is responsibly running down its oil business, harvesting existing assets and investing in its transition and growth groups, which have much longer lives ahead of them, others may disagree and question our approach to responsible investing principles.

For the first time, the world is trying to optimise the global economy not just for efficiency, but also for emissions, and our challenge as responsible stewards of our clients' capital is to understand how much of this energy transition is priced into current valuations.

Thinking differently

There are no easy answers to these issues, but ultimately, we would prefer to be an engaged shareholder of a company like Shell – holding them to account on their commitments – rather than divesting. If Shell, for example, disappeared tomorrow, demand for its products would remain and would be filled by a different producer. Potentially one that is a private or state-owned entity that is less transparent regarding ESG and climate issues such as emission reporting and targets.

Equally, there are potential economic and political headwinds that could affect some parts of the energy sector. High energy prices have resulted in bumper profits for many energy companies – Shell included – that have caught the eye of governments looking to introduce so-called 'windfall taxes'.

The impact of these policies is still uncertain, as different jurisdictions have different approaches, but with the cost-of-living crisis unlikely to abate any time soon, this is not an area that should be ignored.

That said, even after considering these potential risks we think certain critical energy infrastructure holdings such as Shell, Sunrun (solar), Vestas Wind Systems (wind), Constellation Energy (nuclear) and Kinder Morgan (gas pipelines), among others, are in a good position - with higher margins, better capital discipline and lower debt. They are also in a cycle of harvesting healthy oil/gas prices while returning capital to investors.

We believe that is a recipe for attractive potential returns, and a good example of how our contrarian bottom-up approach can identify inefficiencies and dislocations in the market to spot interesting opportunities.

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

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Globalisation is morphing into something less promising

Michael Collins

Tennis staged its first 'open' tournament in 1968, when the British Hard Courts were staged at Bournemouth. The open tag meant professionals were welcome to play in national tournaments including Grand Slams, which until then were restricted to amateurs. For more than five decades, prestigious tennis tournaments welcomed players from any country.

The globalisation trend is over

No more. This year's Wimbledon has banned players from Belarus and Russia. Their offence? Russia attacked Ukraine, and Belarus was a base for some of the Russian invaders. While no one will call it the Wimbledon Almost-Open, the fracturing in the global nature of sport competitions reminds how the era of hyperglobalisation is over. Hindering the movement across borders of commodities, components, culture, goods, ideas, money, people and services appears an irreversible trend.

The most recent impetus is that war between Russia and Ukraine has elevated a strategy known as geoeconomics, when economic and financial tools are used to promote national political goals. About 30 Western countries are choking Russia with the most draconian financial sanctions and export controls ever imposed on a leading power. The freezing of half of Russia's foreign-exchange reserves is such a breach of trust and property rights it portends an unfixable tear in the US-dollar-dominated global financial system.

Europe's need to move away from Russian hydrocarbons shows how free trade only happens when the world feels secure.

The pandemic was the previous setback to globalisation because it showed that producing essential goods far away from where they are needed is too risky, no matter the cost savings from cheap labour.

A change in the emerging market winners

An initial impediment in advanced countries for the globalisation that occurred from the 1980s was the cultural pushback against the loss of local political accountability, and the political reaction from those who lost jobs as manufacturing shifted abroad. The winners were the billion-plus people in emerging countries who soared out of poverty. These countries, foremost China, expanded in political muscle.

The post-hyperglobalisation era too will come with winners and losers and economic and political consequences. Winners will include emerging countries close to, and friendly with, Western powers. Countries such as Mexico stand to gain from any 'near-shoring', or 'regionalisation', of production. US allies stand to gain from "friend-shoring". Other victors will include Western businesses producing essential items deserving of protection.

Unworthy winners will be companies of lesser offerings that are talented at 'rent seeking' – manipulating policymakers to boost their profits. Losers will include emerging countries that miss out on investment that would have created jobs and wealth. A notable loser might be China.

Other also-rans will be multinationals that seek customers across the globe and companies that had production arrangements that spanned the world. The 'splinternet' will be starker as governments block access, protect local data and toughen cybersecurity.

Potential to lower living standards for all

For consumers, production 'misallocated' to higher-cost locations, steeper tariffs and rent seeking spell lower living standards.

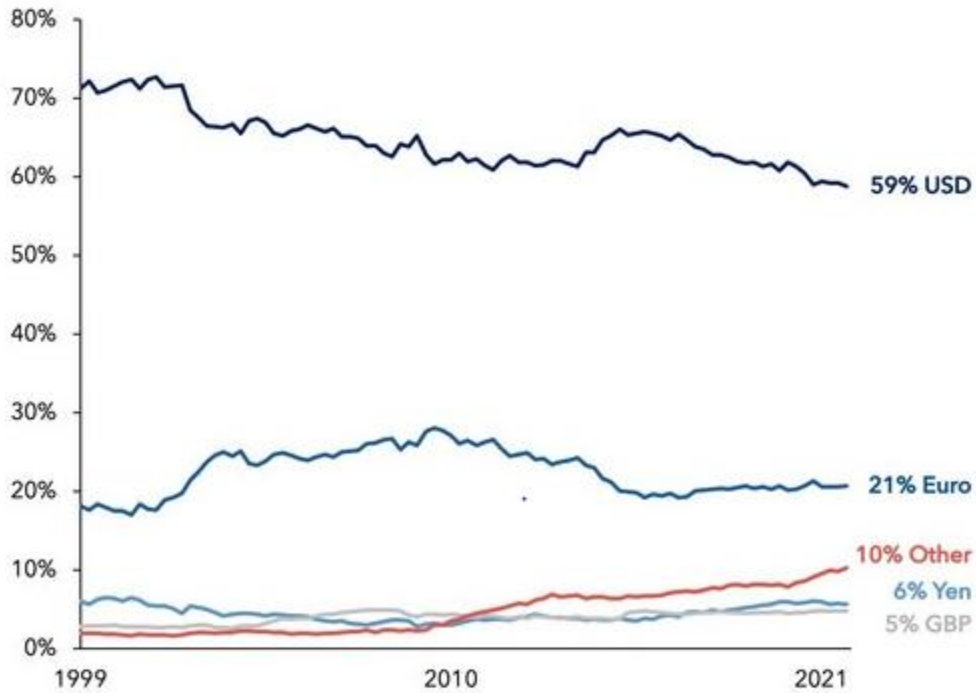
The economic consequences of 'slowbalisation' are faster inflation (at least initially) and slower growth. Emerging countries will miss out on know-how and an opportunity to build wealth through exporting. Barriers preventing investment in emerging countries, however, could give workers in advanced countries greater bargaining power and a greater share of national income.

While inequality might decline, there might be less wealth to fight over because profits might be lower in a more-fenced world. Returns on capital might be reduced because protectionism will inhibit economies of scale and companies will carry larger inventories. Reduced profits spell lower corporate tax takes. Hindered capital flows suggest investors might have to stomach lower returns from accessible investments.

Politically the world is likely to split. A US-led group will favour a rules-based order among themselves. A China-led bunch will group authoritarian countries extolling a power-based world. The Chinese-US "lose-lose tech war" will create a schism across tech platforms and 'data sovereignty', and will mean less innovation. A split world means less international cooperation on global challenges such as climate change. Within countries, globalists will battle patriots for political power.

What might remain the same? The US currency is bound to stay the world's reserve currency because it lacks a credible rival, even as US opponents seek alternatives.

Currency composition of foreign exchange reserves since 1999



IMF. June 2022

To be determined? The cleverness of policymakers. The West would best avoid a permanent stand-off against a rival bloc and advanced countries might need to rejig the international financial system for a multipolar world to support emerging countries. But even if policymakers prove sound, the era of inefficient globalisation heralds a poorer future than otherwise.

But with some qualifications

Globalisation always proceeded at different speeds and security considerations were never ignored. Globalisation is so layered it's hard to generalise about its direction or pace. Any retreat from the recent pace of globalisation has natural limits, as does the China-US split, because too much is intertwined and too many vested interests favour the status quo. The internet might make people feel they are as tied to a globalised world as before.

People and businesses will be connected but not like they were. Their state of mind has turned away from the hyperglobalisation that, for all its drawbacks, enriched the world. A more-stunted form of globalisation points to less prosperous times. Even winning Wimbledon will lose a little of its glamour.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: [magellangroup.com.au/insights]().

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Reporting season shows companies meeting challenges

Jun Bei Liu

The August reporting season was far better than originally feared by many market participants. Analysts downgraded aggregate earnings by close to half a percent against an historic average of 0.8%. Downgrades were mainly on well-publicised cost headwinds, including raw materials price inflation and rising wages combined with now more expensive debt.

Pleasingly, offsetting costs, revenue growth was far stronger than expected, particularly for industrial companies. ASX200 non-financial revenue has been upgraded by 0.8% for the next 12 months, amongst some of the largest revenue upgrades in the last 20 years.

Fear leading up to the reporting season

There was a lot of uncertainty in the past 12 months, as the world moved from pandemic fears to the reopening of economies, while rampant inflation also caught the world by surprise. The share market is a fantastic gauge for fear and greed and has been on a rollercoaster ride, with investors switching from inflation fear to recession fear.

Consumer and corporate confidence plunged, and news reports of falling house prices become common place. As central bankers in Australia (and overseas) appear committed to raising rates, analysts were consistently downgrading the earnings outlook for corporates.

This reporting season was heavily anticipated, as investors prepared to assess just how bad the state of our economy is.

And the truth is, it’s not that bad.

How we fared on specific companies

Consumer sentiment, by and large, seems to be holding up well. Most retailers reported strong FY22 performances and even the July and August trading updates have been exceptional (partly due to cycling lockdowns last year in Sydney and Melbourne).

The likes of JB Hi-Fi (ASX:JBH) and Super Retail Group (ASX:SUL) have both seen strong share price recovery post result as trade remains buoyant.

Consumer staples such as Coles Group (ASX:COL) and Woolworths Group (ASX:WOW) that have been the investor favourites off the back of expectations they would be inflationary beneficiaries, have both disappointed. They have been unable to pass on all the cost inflation to consumers and say they need to provide more promotions to draw consumers into stores.

Not surprisingly, costs were highlighted as an issue for most businesses during reporting season, though most are able to pass through higher prices. Labour costs have been cited as most acute and the margins outlook over the next 12 month will be under pressure. This is perhaps an indication that inflation is likely to be elevated for some time yet.

Source: Morningstar.com

Housing stocks experienced continued demand and there is an extended pipeline for the building materials businesses. We are seeing sharp falls in forward new builds as rates rise. For building materials businesses though, rising cost pressure is the main issue, with many unable to offset this with price increases. This is the area of concern in the next 12 months as demand falters.

Commodities businesses have mostly reported strong revenue growth, however they have been dampened by sharp rising costs. Despite being awash with free cash flow, many have chosen to pay out less than expected in dividends, as they contemplate acquisitions and growth in capital expenditures.

Mixed results from tech

The big laggard in performance over the past 12 months has been the technology sector. It is true that most of them have reported better results, although this is more as a result of cost savings, rather than a brighter revenue outlook.

Equally, we have heard from many unprofitable businesses this season that are setting out a clear path to profitability and have subsequently been rewarded by sharp share price jumps, some of up to 50% on the day. One such company is Kogan (ASX:KGN).

Source: Morningstar.com

We also seen takeovers in this sector as many of those fast-growing businesses are now trading on their cheapest revenue multiples in years. Aerial imagery technology and location data company, Nearmap (ASX:NEA), is a good example, defying sceptics and delivering good results with a takeover bid at a 40% premium.

Some of the other bright spots of this reporting season also include likes of China-facing companies such as Treasury Wines and A2 Milk. Both former market darlings underpinned by structural demand from Asian consumers experienced significant earnings challenges as China has undergone regulatory reform and lockdowns. Pleasingly both have now come through with strong outlook for the coming years as they overcome near term challenges. We believe businesses such as these will continue to deliver returns regardless of economic cycle.

In better shape than expected

There has never been a dull moment during this reporting season, and it was good to see many corporates continuing to experience buoyant trading conditions and managing rising costs. We are heading into a weaker FY23 as consumers and corporates tighten their belts, though we are still expecting above trend earnings growth in the high single digits (excluding resources companies). In short, our economy still in good shape.

Jun Bei Liu is Lead Portfolio Manager, Alpha Plus Fund at Tribeca Investment Partners, a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information in this article is provided for informational purposes only. Any opinions expressed in this material reflect, as at the date of publication, the views of Tribeca and should not be relied upon as the basis of your investment decisions.

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Is the best value for Australian credit not in Australia?

Phil Strano

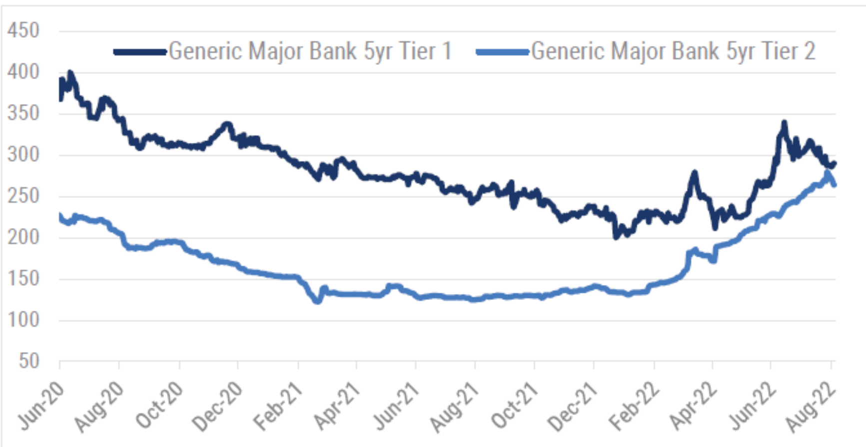
While Australian major bank hybrids (sometimes called T1s reflecting their position in the capital structure) are rightly held in high regard, their USD-issued equivalents now trade at a substantial premium and offer much higher risk-adjusted returns. Investors able to access Australian credit in offshore markets remain at a distinct advantage to those constrained to local shores.

(Editor's note: access to these securities is generally available via fixed interest brokers for investors who qualify as 'wholesale' - which is not a difficult test - or through funds which invest in them. In Australia, we commonly refer to T1 securities as 'hybrids' and T2 as 'subordinated' and T1 ranks below T2 in the capital structure. That is, T1 carries more risk because it would be paid out after T2 in an event of default).

Small yield gain for lesser credit quality

In May 2022, we were surprised when major bank BBB-rated Tier 1 (T1) hybrid securities in Australia were trading just ~40bps (0.4%) higher in yield than the lower risk major bank BBB+ rated Tier 2s (T2) despite being two notches lower in credit quality. Incredibly, that gap has narrowed further to just ~20bps following the recent T2 (subordinated) issuance from NAB and ANZ which priced at very attractive margins of BBSW+280bps and BBSW+270bps respectively (refer Chart 1).

Chart 1: Major Bank Securities (bps) – Domestic T1s Continue To Represent Poor Relative Value



Source: Yarra/Bloomberg, Aug 2022.

Based on historical averages, T1s currently look incredibly expensive and should be trading ~200bps wider of current valuations.

Moreover, based on offshore hybrid pricing, it seems this disconnect in bank hybrid capital pricing is more of an Australian phenomenon.

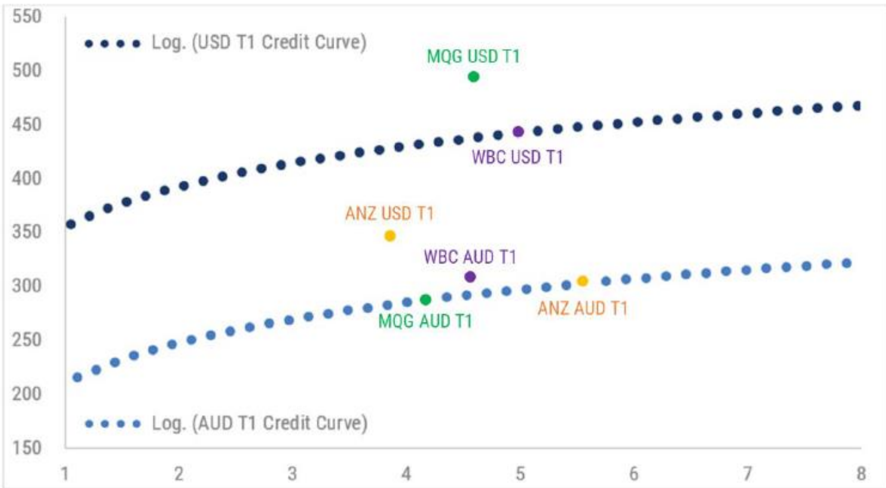
After diverging in late 2021, there is now a dramatic gap between the two, with US T1s now trading ~200bps wider than their Australian comparatives (refer Chart 2).

Chart 2: T1 In The US Trading Well Wide Of Domestic T1s (bps)

Source: Yarra/Bloomberg, Aug 2022.

Looking at T1 curves in Chart 3 - the US (dark blue line) and Australia (light blue line) - there are several opportunities for domestic investors to extract a significant premia by choosing the US dollar denominated Australian T1s. Australian investors either need to accept the foreign currency exposure or hedging out the currency and interest rate risk.

Chart 3: Aussie Issuers in USD much better value than AUD (bps and yrs to call)

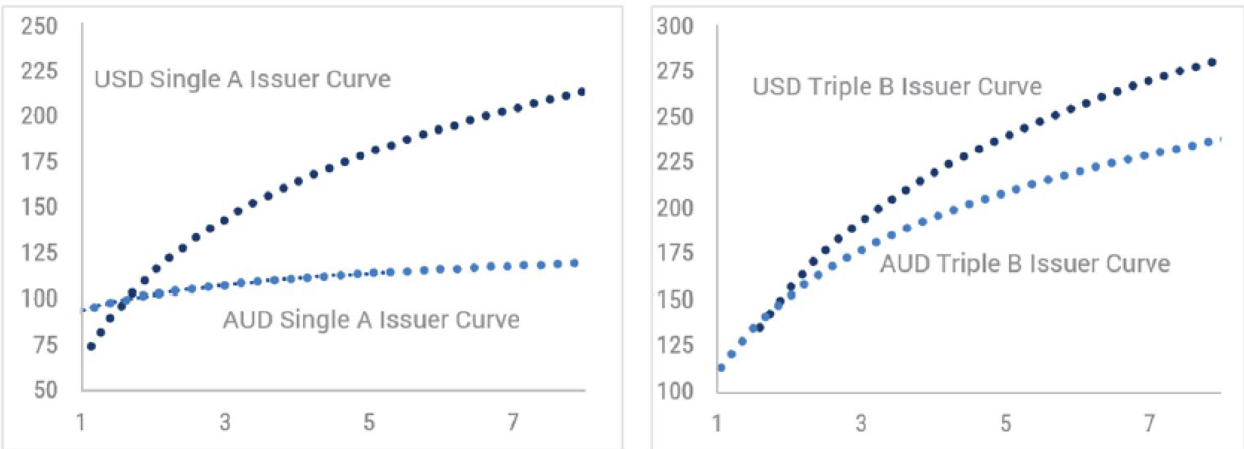


Source: Yarra/Bloomberg, Aug 2022.

We recently purchased the 2027 Westpac USD T1s. The security swapped back to a credit margin of BBSW+480bps, ~200bps wider than the equivalent ASX-listed security, with all currency and interest rate risk hedged throughout the life of the security.

By comparison, given their more attractive pricing domestically compared to T1, the same pick-ups in credit margins offshore are not currently available in bank senior or T2 segments. However, there are similar opportunities in Australian corporate credit with both the single A and triple B rated curves for Australian issuers significantly wider in USD than in AUD (refer Chart 4 and 5).

Charts 4 & 5: Corporate issuers offer significant margin pickup in USD over AUD (bps and years)



Source: Yarra/Bloomberg, Aug 2022.

Benefits of taking a global perspective

This approach is enabling us to harvest higher risk adjusted returns across most sectors of Australian credit, while maintaining diversity across the spectrum of household Australian names which are a mainstay of most equity portfolios but typically do not issue debt in AUD. This long list includes major corporates such as BHP, Rio Tinto, Brambles, Bluescope and CSL, to name only a few.

Where it makes sense to do so, the Yarra Higher Income Fund is investing in Australian issuers across major currencies and hedging out currency and interest rate risk to optimise risk adjusted returns. With a current yield at ~5% which we expect will increase alongside rising interest rates, the Fund remains well placed to continue delivering consistent monthly income to its investors.

Phil Strano is a Portfolio Manager, Higher Income Fund at [Yarra Capital Management](). The information provided contains general financial product advice only. The advice has been prepared without taking into account your personal objectives, financial situation or particular needs.

Six misconceptions and demystifying long/short funds

Sean Roger

Long/short funds are a type of fund that aims to maximize the upside of markets, while limiting the downside risks. To do this, these funds take both long and short positions in investment positions, often from a specific market segment. Here we look at long / short funds in more detail, specifically how fund managers go about shorting what they perceive to be overvalued stocks.

Traditional long-only funds

Fund managers analyse an investable universe created according to certain investment criteria, for example, sound management, quality of business, conservative debt and recurring earnings. They then rank stocks on valuation metrics. With the discretion of the portfolio manager, these highest-ranking stocks are generally included in the portfolio. Importantly, nothing is done with the low-ranking or rejected stocks.

Shorting low-ranking stocks

Fund managers employ teams of analysts to evaluate risks and opportunities. This means assessing a great deal of both positive and negative factors impacting both sectors and individual companies. Most fund managers do nothing with the bad news, other than avoid certain stocks. But long/short funds provide investors a way to potentially profit from the bad news, as well as the good. This is done by actively utilising the low-ranking stocks by shorting them. Taking this view can benefit a long/short fund in the following ways:

- It increases the opportunity set for the fund manager
- If the stock declines in price, a profit is made when the short position is closed
- Profit from short positions can be used to increase exposure to high conviction, long stocks
- Gross exposure to markets increases, increasing the opportunities for the fund manager.

These opportunities are particularly valuable in volatile or sideways-trading markets.

The importance of risk management

Shorting is not without its risks. The Perpetual view is that shorting requires a specific skill set and a prudent risk management process to achieve a favourable balance in its funds that allow shorting. While the ability to short stocks is periodically criticised in the mainstream media, the main issue for investors is the nature of the risk involved. When an investor buys a share, the worst-case scenario is that he or she loses all the money they paid for it. However, when an investor shorts a share, the investor could lose more than their initial investment. There is no limit on the maximum loss because there is no upper limit on the share's price. In other words, the loss will continue to increase as the security's price rises. While well-chosen short positions can generate returns, especially during periods of market uncertainty, taking short positions does involve higher levels of risk than taking long positions only.

The benefits of a shorting strategy

1. **Source of return diversification**
Shorting allows investors to profit from declining share price. Not only can this boost portfolio return, but it can also provide diversification from the traditional 'long only' portfolio. If the investor's assumptions are correct and the share falls in value, the short investor can actively generate a return.

2. **Increased opportunity**
Being able to short stocks increases a portfolio manager's opportunity set. If a 'long' investor finds a share to be unattractive, their only option is to sell the share if they own it, or not buy the share.

How does it work?

Profiting from a falling share price takes a great deal of stock picking skill. This example demonstrates how it works in practice:

On those occasions where an investment manager finds a company that they believe will decrease in value, rather than increase, they can take a 'short' position in this company. This involves borrowing shares from a broker and selling them at the current price. The investment manager will be required to purchase the shares to return the borrowed stock to the broker in the future. If the share price decreases, the investment manager buys back the share at the lower price and returns it to the broker, keeping the difference as profit. If the share price increases, the investment manager buys back the share at the higher price incurring a loss.

Six shorting misconceptions debunked

While shorting strategies have the potential to generate returns in both up and down markets, there are several myths about shorting that may leave some investors reticent to pursue this investment strategy in their portfolio. And some who are overly enthusiastic!

"Shorting can make a company go bankrupt"

Shorting a share is no more sinister than selling a share for less than you paid for it. Assuming a company has a reasonably strong balance sheet, even if its share price fell to zero, it would still be worth the value of its balance sheet.

"Shorting was a major reason for the GFC"

Prior to the GFC, there were a lot of companies with over-stretched balance sheets that were exposed during this period. Shorting did not create the downward pressure on these shares during the GFC. However, during the extraordinary circumstances of the GFC, it can certainly be argued that it compounded the pressures already at play.

"Shorting is the secret sauce for positive returns"

While shorting provides the opportunity to profit in both rising and falling markets, not all short positions generate a positive return. In fact, shorting is a specialist skill, as picking companies that will decline in price can often be much harder than picking companies that will rise in price.

"Shorting is not transparent"

Since June 2010, the Australian Securities and Investments Commission (ASIC) has required all stockbrokers to report their total short sale positions daily. This information is released four business days after the trade on ASIC's website.

"Shorting is not ethical"

In 2021, Elon Musk described shorting as "a scam legal only for vestigial reasons", echoing a view that shorting a company is tantamount to wanting it to fail. This is not the case. In fact, shorting can be a benefit to the overall market because it adds liquidity, improves trading efficiency and helps to highlight where poor company management is not delivering on its promise to shareholders.

"Shorting doesn't work"

The positive long-term performance of market indices may lead some to believe that shorting does not work. However, the aim of short selling is to profit from shorter-term factors, such as negative news or earnings downgrades, and can be used as a complement to a long portfolio that benefits from share price gains over the longer term.

Sean Roger is Deputy Portfolio Manager for the Perpetual SHARE-PLUS Long-Short Fund at Perpetual Investment Management, a sponsor of Firstlinks. This article contains general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs.

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