Firstlinks
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Editorial

The 2022 calendar year will include two Federal Budgets, and despite a gap of only seven months, they are framed against different backgrounds. **Josh Frydenberg** delivered his fourth Budget on 29 March and **Jim Chalmers** will deliver his first on 25 October. With an eye to the election which took place on 21 May, Frydenberg focussed on short-term cost-of-living relief rather than addressing the structural deficit. He cut the fuel excise for six months, increased the low and middle-income tax offset (LMITO) and extended the 50% reduction in super pension drawdowns.

But at the same time that the goodies helped personal bank accounts, the **Reserve Bank** finally and belatedly realised Australia had a serious inflation problem and started increasing the cash rate on 4 May. So here was monetary policy acting to curtail spending while fiscal policy provided more stimulus. It was a policy confusion that Jim Chalmers should not repeat as it may force **Governor Philip Lowe** to go even harder. Chalmers said last week that no new cost-of-living relief should be expected although previous commitments would be honoured:

"*The Budget is about six or seven weeks away, but we have made it very clear to people that our priority is to implement the cost-of-living relief that we have announced. That will be in areas like childcare, medicines, TAFE fees, the cost of electric vehicles and also we want to get wages moving in this economy again. The Budget will be about a few things. It will firstly be about how do we provide some cost-of-living relief in a responsible way that doesn't add to the pressure on the Reserve Bank."*

What is your opinion on some of the major decisions facing the new Government? At some point, Australia needs to decide how to raise the revenue necessary to pay for the services we have come to expect, and maybe repay some debt. In our **Reader Survey** this week, we ask for your views on the Stage 3 tax cuts, mining super profits, cost-of-living relief, the timing of child care subsidies and inflationary expectations, with a brief explanation of each issue. We will send the results to Treasury as input to their Budget (yes, we know, the impact will be minimal).

The Stage 3 tax cuts will not feature in the next Budget because they are already legislated. As Assistant Minister to the Prime Minister, **Patrick Gorman,** said last week:

"The decision has been made, it's been taken to the election. Indeed, these tax cuts have been to two elections. This basically has been legislated."

It's not likely to be so easy, politically or economically. The implementation date is still two years away, on 1 July 2024, and the Government justifies them as an election commitment rather than an economic imperative. It gives opponents a target for two years, especially when a **Parliamentary Budget Office** (PBO) analysis shows the richest 1% of Australians will receive as much in tax savings as the poorest 65% combined. While those earning less than $45,000 do not benefit, there are plenty of so-called working class occupations which earn far more than $45,000 a year, the lower tier of the cuts.

At the same time, the [latest ABS data](#) shows taxation revenue as a % of GDP continues to grow, and taxes can be disincentives to save, earn and spend. But we need to pay for increasing health costs, NDIS, education, defence, social security, all under a Labor Government. This debate has a long way to play out, so please give us your input. The PBO said:

"Studies indicate that some people would choose to work more in response to a lower marginal tax rate, while others would work less. There is considerable uncertainty regarding the direction, magnitude and timing of these effects on labour supply."

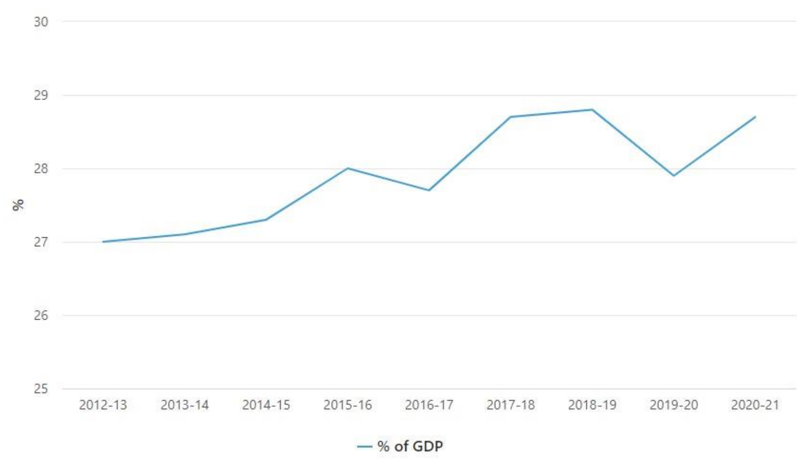
Australia is following the wealth trends that we often associate with the US, with research by the [University of NSW and ACOSS](#) released in July 2022 shows that Australians are now the fourth richest people in the world on average but with increasingly unequal distribution. About 69% of the increase in household wealth during the pandemic was in residential property.

"Once again, this report reminds us that wealth in Australia is distributed very unevenly. We have over 130 billionaires in this country and last year their wealth grew, on average, by $395 million or 12%. It means they now hold almost as much wealth as the 2.8 million households in the lowest 30 per cent of the population."

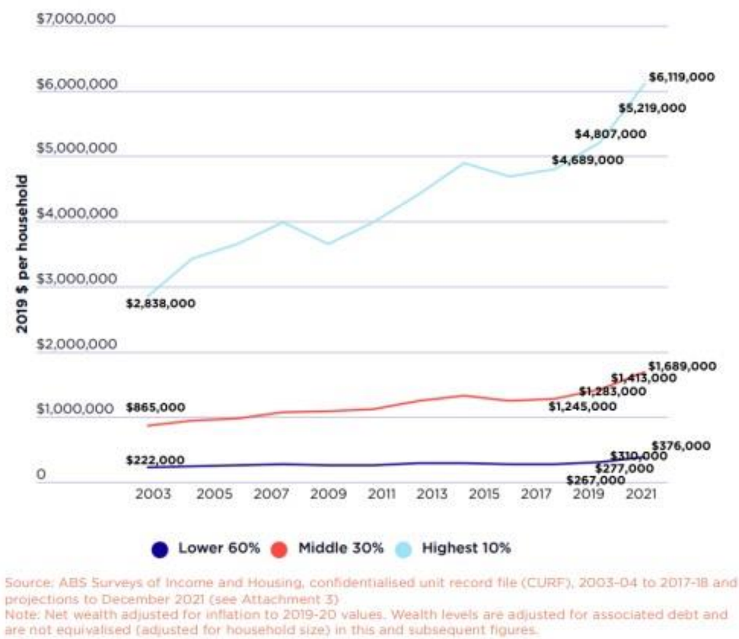
On Tuesday night in the US, the higher-than-expected inflation rate hit stock markets hard, sweeping away the optimism that inflation may have peaked. Large falls of 10% in the price of gasoline gave the market hope for a lower CPI but 'core inflation' rose 0.6% over the month, twice the rate expected, increasing the annual rate to 6.3% from 5.9% last month. The US Fed will have little choice but to cool the market further with at least 0.75% next week with the market giving a 30% chance of 1%. On Tuesday in the US, the S&P500 lost 4.3% and NASDAQ 5.2%.

This tweet from the *Financial Times* shows once again the perils of predicting in this market. The FT quickly went from its morning news that "*Economists expect*

Taxation revenue for all levels of government as a percentage of GDP (a)



Average wealth by wealth groupings in Australia



consumer prices to have moderated again in August" to "*US stocks drop after hotter than expected inflation reading*." Thanks for the advice.

In this week's edition ...

At a time of rapid change and policy challenges, please take our **Reader Survey,** and add any other national policy issues which are at the forefront of your mind. Following some further questions from readers on whether inflation will eat away at the value of household debt and is therefore good for home borrowers, we reached out to more economists for an opinion.

In her continuing series on SMSFs, **Meg Heffron** responds to a previous article on why a young person is waiting for higher balances before establishing her SMSF. Meg moved earlier (before she started working in the SMSF industry) to establish hers and she explains the reasons.

Last financial year threw up a wide range of performance results from our large superannuation funds, amid a controversy in the way some unlisted assets were revalued. **David Carruthers at Frontier** dissects the numbers to find whether fund size, type of assets or level of risk drove the results.

As more investors are tempted by the better yields on offer from bonds, it's important to check the default rates at various levels of borrower quality. **Matthew Macreadie of IAM Capital Markets** takes us through the latest **Standard and Poor's** default data.

Dan Kemp of Morningstar says he is often asked to justify his decisions as Chief Investment Officer, but facing the most important question ever put to him, he explains his priorities.

Professor Kevin Davis has been involved in much of the debate about superannuation policies, including as a member of the Financial Systems Inquiry. He looks into the funding mismatches in banking and super funds and makes the case for long-term investing with retirement savings.

Finally, next Wednesday is the **21st night of September**. So what? Well, apropos of nothing to do with investing, 'September' by Earth Wind & Fire is one of the greatest dance songs of all time, released in 1978. Next Wednesday, just before dinner goes on the table, turn up the sound system and sing along. This official video has been viewed over 600 million times so you won't be alone.

Do you remember
The 21st night of September?
Love was changin' the minds of pretenders
While chasin' the clouds away

Our hearts were ringin'
In the key that our souls were singin'
As we danced in the night, remember
How the stars stole the night away, oh, yeah ...

Graham Hand

Survey: What do you think of these critical policies?

Graham Hand

The new Labor Government and Treasurer Jim Chalmers will hand down their first Budget on 25 October 2022, and the policy conflicts are obvious. Inflation is surging and interest rates are rising without commensurate increases in wages, but Treasury knows giving cost-of-living increases will compromise some of the Reserve Bank's attempts to slow spending. Chalmers said last week that no new cost relief should be expected although previous commitments would be honoured:

"*The Budget is about six or seven weeks away, but we have made it very clear to people that our priority is to implement the cost-of-living relief that we have announced. That will be in areas like childcare, medicines, TAFE fees, the cost of electric vehicles and also we want to get wages moving in this economy again. The Budget will be about a few things. It will firstly be about how do we provide some cost-of-living relief in a responsible way that doesn't add to the pressure on the Reserve Bank.*"

For this Reader Survey into these dilemmas and more, we provide a brief summary of each policy. The issues are not addressed in full detail but we hope to learn the mood of our readers. The Survey questions follow these comments.

1. Should the Stage 3 tax cuts be cancelled?

The Coalition Government with Scott Morrison as Treasurer announced tax cuts in 2018, with Stage 3 commencing in mid-2024. Over 10 years, the final stage is estimated to cost in excess of $240 billion. Stage 3 will cut the rate that applies to incomes over $45,000 from 32.5% to 30%, extending all the way to $200,000 and flattening the marginal tax rates.

Details of who benefits most from the Stage 3 tax cuts are outlined in costings provided by the [Parliamentary Budget Office].

The two main arguments for cancelling Stage 3 are the changed budget outlook after the pandemic, and the cuts at the top end favour the wealthy. Economist Saul Eslake said:

"From the standpoint of economic management, the main argument for abandoning or deferring [them] is that the medium-term budget outlook is now very different from when those tax cuts were proposed and legislated. At that time, the budget was projected to be in surplus throughout the 2020s, and net debt reduced to zero by the end of the decade. Now, deficits are projected to continue as far as the eye can see, and net debt to continue growing in dollar terms into the early 2030s."

On the other hand, Labor has always voted in favour of Stage 3, arguing it includes relief for some lower income earners, and while in Opposition, Labor did not want to carry the label of a high-taxing party. Anthony Albanese will break an election promise if the cuts are reversed. The changes do not take effect for a couple of years so a cancellation would not impact current budget predicaments.

2. Are prices increasing due to embedded inflationary expectations?

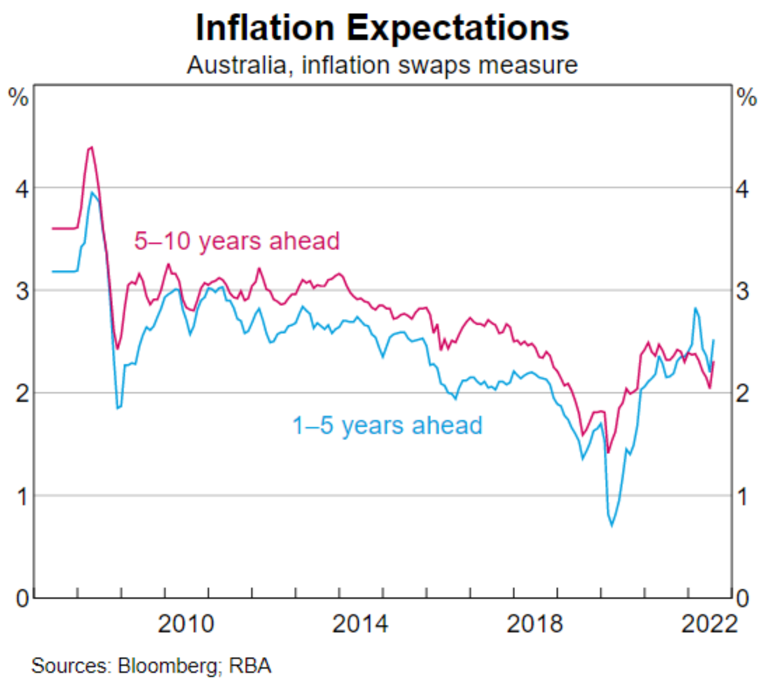
We all experience evidence of rising prices in our daily lives. It is common to see cafes, restaurants and retailers increasing prices, and business remains brisk. We seem to have accepted it with expectations embedded, and this is a worry to the Reserve Bank. However, falling fuel prices and central bank determination to stamp out inflation may have an impact.

At his [speech on monetary policy] to the Anika Foundation on 8 September 2022, Governor Philip Lowe spent much of the time justifying the need to control expectations. We have become more tolerant of prices rising, as the Governor fears:

"There is something here, though, that is worth watching that is not easily captured in our standard models, and that is the general inflation psychology in the community. By this, I mean the general willingness of businesses to seek price increases and the willingness of the community to accept price increases.

Prior to the pandemic, it was very difficult for a businessperson to stand in the public square and say they were putting their prices up. And a common theme from our liaison was that, because most businesses had trouble putting their prices up, wage increases had to be kept modest. That was the mindset.

Today, businesspeople are able to stand in the public square and say they are putting their prices up, and they can point to a number of reasons why. The community doesn't like it, but there is a begrudging acceptance. And with prices rising, it is harder to resist bigger wage increases, especially in a tight labour market. So the psychology shifts."



3. **Should the childcare subsidies be brought forward to 1 January 2023?**

At the recent Jobs and Skills Summit, many speakers claimed the single most-important initiative to ease labour shortages and improve productivity would be to improve access to childcare and bring more women into the workforce.

At the last election, Labor campaigned strongly to extend support for families earning up to $500,000 a year, with a start date of July 2023. Although the cost is estimated at $5 billion a year, it is also claimed that the boost to economic activity would produce even more in revenues. Treasurer Jim Chalmers said the earlier introduction cannot be sustained with tight budgets, but he also recognised the benefits:

"There is a massive multiplier effect investing in childcare. But the way that the budget rules are set up mean that we account for the cost, but not for the benefit ... Childcare is the most obvious example where you provide substantial cost of living relief but it's also good for the economy."

4. **Should a mining super profits tax be introduced?**

Oil and gas companies are making record profits, attracting investors such as Warren Buffett who has now ploughed US$37 billion into Chevron and Occidental Petroleum. Nobel Prize winning economist Joseph Stiglitz recently visited Australia and called a windfall profits tax a 'no-brainer'. Prominent Australian economists have argued the resources belong to Australia and the country needs a solution to its massive debt burdens.

For many years, Norway has showed that taxing oil industry gains does not prevent investment, and with a population of around five million, Norway will collect $137 billion from a tax on the oil industry this year, 50% higher than previously estimated.

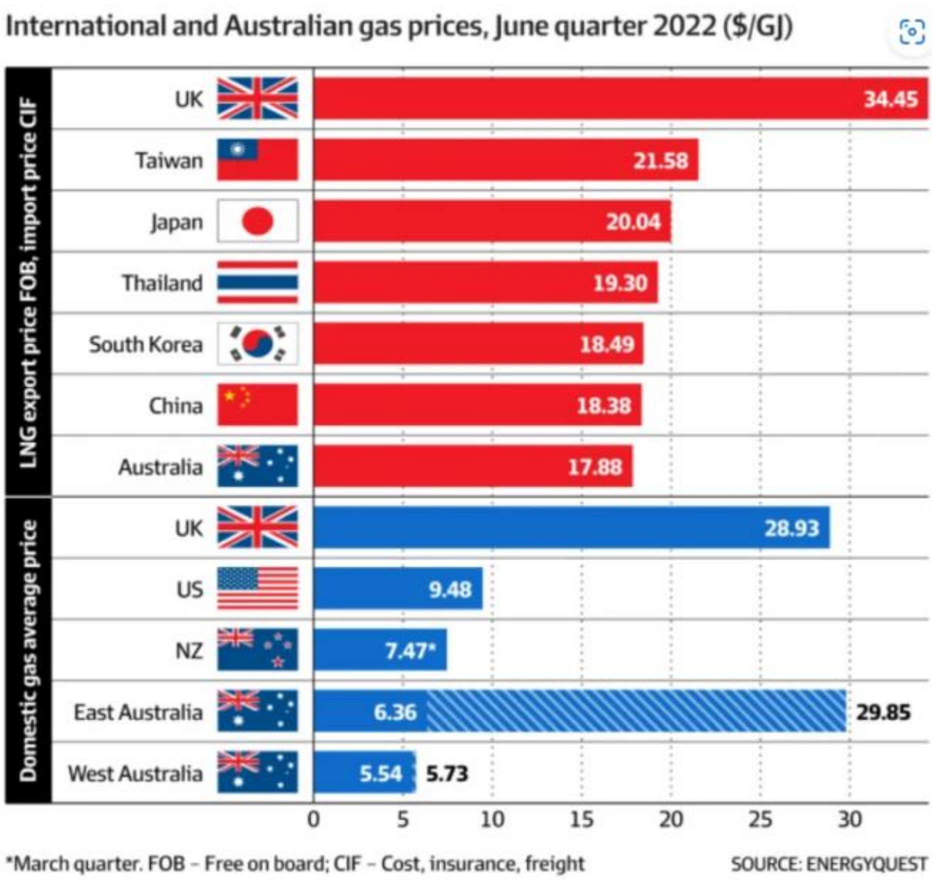
Professor Ross Garnaut advocated at the Jobs and Skills Summit that Australia should tax energy companies more:

"There are many opportunities for raising additional revenue in Australia while enhancing equity and improving or at least not damaging economic efficiency. A significant part of the increase in the profit share in recent years is in mining, where wages are high relative to other sectors. The appropriate public policy response is mineral rent taxation and not pressures for higher wages."

The European Union has also announced plans to cap energy company profits, but Treasurer Chalmers was involved in the failed 'super profits' tax proposal under Treasurer Wayne Swan in 2010 and does not want to revisit the painful experience.

5. **Should gas supplies be reserved for the East Coast domestic market?**

Australia has massive gas reserves and is the world's third-largest exporter of fossil fuels, and yet high prices are being passed on locally for petrol gas and electricity. Australia's own power comes 70% from burning coal while we export most of the gas. Western Australia introduced a simple gas reservation policy, and its residents and businesses are enjoying far cheaper prices than eastern states, as shown here.



6. Should the budget include additional cost-of-living concessions?

At the same time that the Reserve Bank is increasing cash rates to make borrowing more expensive and curb consumer demand to control inflation, Treasurer Chalmers is considering cost-of-living concessions at the coming Federal Budget. It's not only '*one hand giveth, the other taketh away*', but if the Chalmers goodies stimulate activity, the Reserve Bank may be required to increase rates even more. The impact on homeowners, company borrowers and home prices would be severe for sections of the community.

7. What other major policy question should we ask?

Use the comments section to let us know about other critical issues, such as climate change, the potential move to a republic, provision of adequate aged care, or whatever.

We invite you to share your views by completing the survey via this link by Tuesday 20th September 2022.

Meg on SMSFs: my own reasons for early SMSF establishment

Meg Heffron

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

I really enjoyed reading this article explaining why the author, Shani Jayamanne, isn't yet ready for an SMSF. She had lots of good reasons for her decision. So it prompted me to reflect back on some of the reasons I felt I ***was*** ready at a similar stage of life and with an even smaller balance. And back then, I did work within the superannuation industry but not SMSFs. I wasn't an obvious advocate of the 'do it yourself' model.

It probably helped that I was married to an accountant who did all the work. That's a great life hack if ever there was one.

I knew my super balance would increase

But there were other reasons. Like many others in my age group, I've had compulsory super at an ever-increasing percentage of my salary for my whole working life. So even back then, it was clear that my super would become a substantial part of my savings someday.

So I did my research and decided that 'one day' I would want to manage my super myself. I didn't profess to have any great stock picking skills or plan to invest in exotic artwork or gold. My logic was that if I was taking responsibility for my retirement in such a big way, I wanted more control. So the question for me was not 'if' I'd have an SMSF, it was 'when'.

Friction points

I didn't necessarily want to manage it at that point in time, but I did want to make sure the friction of moving later didn't cost me too much. At the time I probably only really appreciated one friction point – capital gains tax.

I knew that if I waited too long to move to an SMSF, my super would grow in value and I would incur capital gains tax moving my money when the time came. Would the future benefit of avoiding the tax outweigh the costs of running my SMSF with such a small balance in the interim? Possibly not, but it was a risk I was willing to take. If it didn't work for me, I could wind up the SMSF.

A second important friction point that I didn't think about at the time was insurance.

Obtaining insurance is cheaper and easier, with fewer medical checks and restrictions, when you're young, fit and healthy. While the premiums will increase each year, you can keep the same policy in place for as long as you like if it's set up in your SMSF to begin with.

I recently arranged some life insurance outside my SMSF and it was a shock to see the price compared with the premium I was paying in my SMSF. The cover specifically excluded death or disability linked to my epilepsy which was not diagnosed when I took out insurance in my SMSF, and therefore I was still covered by that original policy. I definitely wouldn't want to be setting up my SMSF now and trying to find cover. When I needed it, I had much more insurance than I could easily get in a public fund. It convinced me that the earlier the better when it comes to life insurance.

Some people solve this by keeping a small balance in their original public super fund just to keep their insurance running, but that can compromise some great tax planning opportunities that work best if the insurance is in the SMSF.

And there's one last big reason to get started with your SMSF as early as possible that didn't even occur to me back in the day. I'll call it 'resilience'.

Flexibility to change

If one thing is certain, it's that things will change. The best public super fund when I set up my SMSF certainly isn't the best today. It might not even exist. The best investments today won't necessarily be where we want to put our money in the future, but super is about planning for the long term.

This is where an SMSF works well. You can change absolutely everything about your SMSF, such as where it invests, who helps you look after it, who belongs as members, who provides the insurance, etc, but you can leave the SMSF itself intact. It can change with you. Changes which would be significant in a public super fund can be handled less intrusively in an SMSF.

I've had an SMSF since I was in my 20s, starting in the 1990s. In all that time, I've never invested in anything as exotic as artwork, gold or crypto. I've never borrowed to buy property through my super. But if I wanted to do those things, I couldn't have used a public offer fund.

I've invested in managed funds recommended by my financial adviser. Although some are mainstream, they were not on the menus of many public funds at the time. At the time, new funds often took many years to be added to public funds. In my SMSF, I've taken advantage of Initial Public Offerings (IPOs) and investment opportunities such as share buy backs and rights issues. These are common in investing but often not available in a public fund.

Move to pension phase

My fund now pays a pension and that was created instantly without moving assets to a different fund or investment account. My fund is still one investment portfolio and my accountant keeps track of how much is in the pension versus accumulation. Because I'm still working and contributing, the minimum pension payments are financed by my own super contributions. I don't need to isolate a special cash reserves to pay the pension. In fact, if there were other members of my fund making super contributions, we could even use the cash from *their* contributions to pay my pension without disadvantaging them.

There are also some investments that I've owned for what seems like forever and if I sell them now, part of the capital gains will be exempt from tax (thank you, pension).

All in all, if you think you're likely to end up in an SMSF 'one day', then that day might be sooner than you think.

And then to top it all off for me, just like the Remington electric shaver advertisement of my youth:

"I liked it so much I bought [or in my case, started] the company."

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.

Super performance based on fund size, risk and unlisted assets

David Carruthers

While market performance during the first half of last financial year was mainly impacted by COVID-19 factors, the second half was predominantly affected by Russia invading Ukraine, global central banks raising interest rates and the continuation of China's zero COVID-19 policy.

Over the entire FY22, the median superannuation fund returned -3%, while property and infrastructure returned in the double digits. With equity markets struggling and a selloff in bond markets, performance was quite weak for MySuper member options. Most funds produced negative returns, with performance across the top 10 funds ranging from -1.9% to 1.6%. Strategies with a larger proportion of unlisted assets across infrastructure, property and private equity performed better.

Table 1 below ranks the performance of the top 10 super funds covered by SuperRatings' reporting for the one-year period through June 2022. It includes growth asset ratio, size of the fund and multiple rolling time periods through 10 years.

Table 1: Performance through 30 June 2022

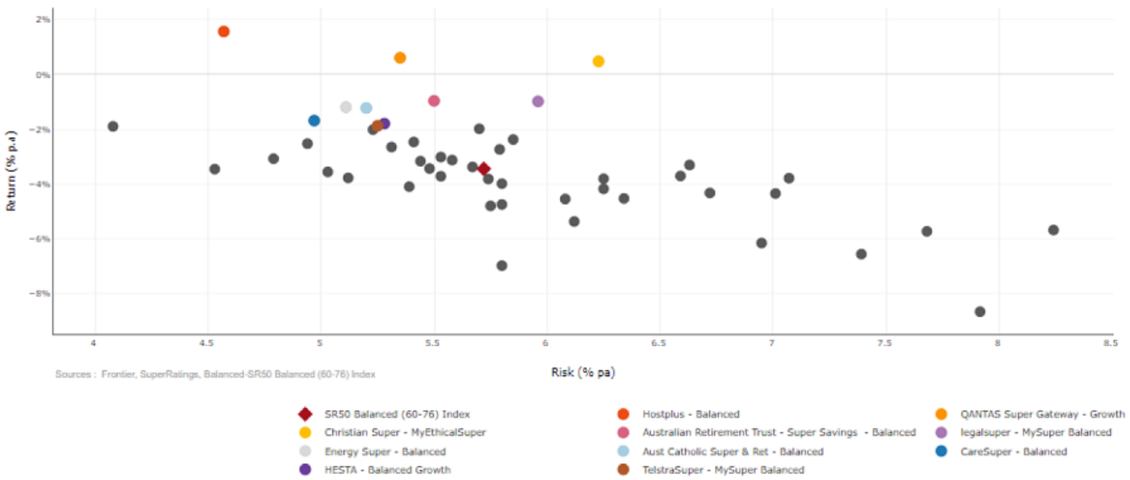
Fund	Growth asset ratio	Size $m	Rolling 1 year %	Rolling 1 year rank	Rolling 3 year %	Rolling 3 year rank	Rolling 5 year %	Rolling 5 year rank	Rolling 10 year %	Rolling 10 year rank
Hostplus - Balanced	76	34,966	1.6	1	6.5	2	7.8	1	9.7	1
QANTAS Super Gateway - Growth	70	759	0.6	2	6.7	1	7.5	2	8.1	19
Christian Super – My Ethical Super	75	1,199	0.5	3	5.8	3	6.3	14	7.9	28
Australian Retirement Trust - Super Savings - Balanced	70	6,678	-1.0	4	5.5	5	7.2	5	9.0	3
legalsuper - MySuper Balanced	76	2,588	-1.0	5	5.0	13	6.2	17	8.3	16
Energy Super - Balanced	75	916	-1.2	6	4.2	30	5.3	38	8.0	24
Australian Catholic Superannuation and Retirement Fund - Balanced	74	472	-1.2	7	4.8	17	6.1	18	7.8	34
CareSuper - Balanced	69	13,516	-1.7	8	5.0	11	6.4	13	8.7	6
HESTA - Balanced Growth	70	51,082	-1.8	9	5.3	6	6.8	6	8.5	8
TelstraSuper Corporate Plus - Balanced	69	2,371	-1.9	10	4.9	14	6.0	23	8.5	12
SuperRatings SR50 Balanced median	**70**	**2,020**	**-3.4**	**-**	**4.3**	**-**	**5.9**	**-**	**8.0**	**-**

Source: SuperRatings

Outperforming funds with lower risk

Chart 1 shows performance and risk as defined by the standard deviation of returns for the 12 months to 30 June 2022. The majority of the outperformance of the top 10 funds exhibited lower standard deviation (risk) than the median with the exception of legalsuper and Christian Super.

Chart 1: SR50 Balanced funds standard deviation versus one year return to 30 June 2022



Note: The dark grey circles on the chart represent all other funds

Asset allocation

Based on the most recent asset allocations shown in Table 2, funds with greater exposure to unlisted assets across private equity, property and infrastructure performed well (noting some funds classify these exposures as alternatives or other).

Table 2: Universe asset allocation

Option	Growth	Defensive	Australian shares	International shares	Private equity	Property	Infrastructure	Alternatives	Bonds	Cash	Other
Hostplus – Balanced	77.7%	22.3%	24.5%	29.9%	10.4%	9.5%	7.8%	7.1%	4.1%	6.7%	0.0%
Christian Super – My Ethical Super	72.9%	27.2%	27.7%	29.6%	7.9%	10.0%	6.1%	1.2%	15.6%	0.1%	1.8%
Australian Retirement Trust – Balanced	73.8%	26.2%	26.5%	27.0%	6.5%	8.5%	9.5%	5.5%	12.5%	4.0%	0.0%
legalsuper – Balanced	73.7%	26.3%	26.8%	28.3%	3.6%	12.8%	10.2%	0.0%	7.3%	4.0%	6.9%
Energy Super – Balanced	74.5%	25.5%	26.2%	29.9%	0.0%	9.9%	9.0%	8.3%	13.7%	2.9%	0.1%
CareSuper – Balanced	69.1%	30.9%	22.0%	26.0%	5.0%	10.0%	10.0%	13.5%	6.0%	5.0%	2.5%
Australian Catholic Superannuation and Retirement – Balanced	78.0%	22.0%	26.9%	26.9%	4.1%	11.8%	15.0%	9.7%	4.4%	1.2%	0.0%
HESTA – Balanced Growth	74.5%	25.5%	25.3%	29.4%	7.2%	6.7%	10.2%	3.2%	7.9%	8.4%	1.7%
TelstraSuper - MySuper Balanced	69.0%	31.0%	22.0%	28.0%	5.0%	12.0%	7.0%	0.0%	12.0%	7.0%	7.0%
Top quartile	74.6%	30.1%	27.0%	33.2%	5.0%	10.0%	9.5%	7.9%	21.3%	8.2%	4.3%
Median	**71.4%**	**28.6%**	**26.2%**	**29.1%**	**0.0%**	**8.2%**	**5.6%**	**1.8%**	**14.2%**	**4.8%**	**0.0%**
Bottom quartile	69.9%	25.4%	23.0%	26.5%	0.0%	5.8%	0.0%	0.0%	8.0%	2.8%	0.0%

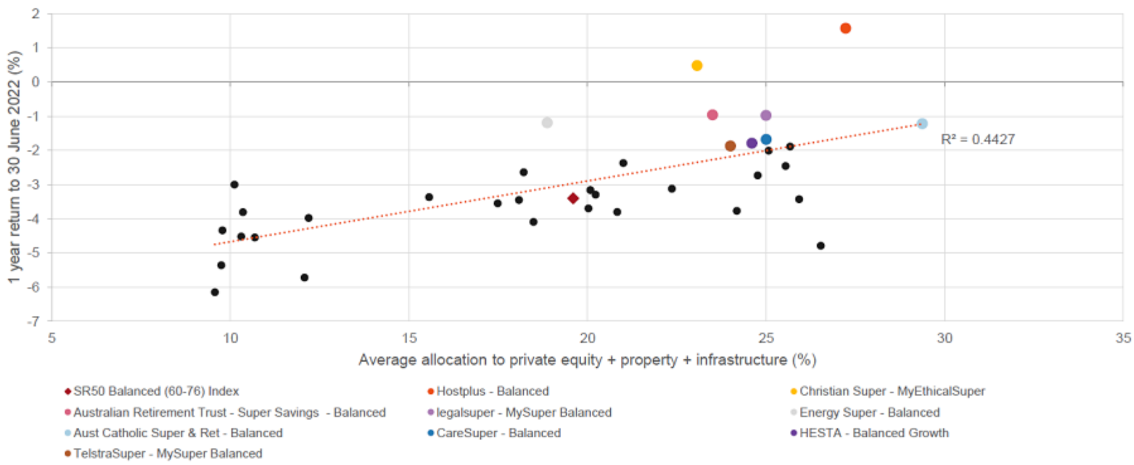
Source: Frontier, SuperRatings

Unlisted assets boosted returns

Chart 2 shows the correlation between the total allocation to private equity, property and infrastructure versus the performance during the year.

It shows a strong correlation. Funds with higher allocations achieved better performance. Most of these assets are unlisted (particularly for profit-for-member funds) and undergo periodic revaluations which often lag listed markets and indices. As a result, they have held up better during a period of risk-off sentiment across markets.

Chart 2: SR50 Balanced funds – correlation of private equity, property and infrastructure allocation versus one-year performance to 30 June 2022



Note: The dark grey circles on the chart represent all other funds

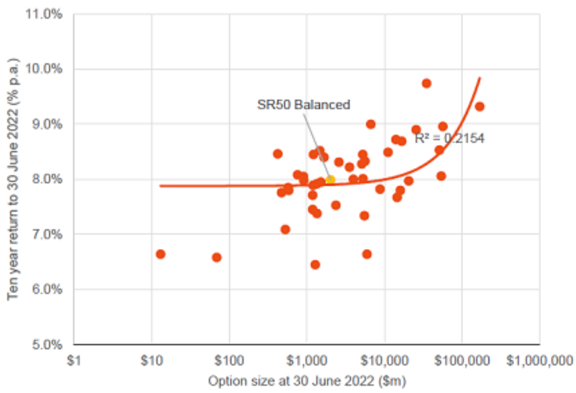
The question of whether size matters

Funds are required to undertake an annual member outcomes assessment of whether its members are disadvantaged by virtue of the fund's scale.

Similar to last year, size of fund was not a significant predictor of return. Only three of the top ten performers had assets greater than $30 billion, while five had less than $15 billion. Other 'small' funds, such as First Super and MIESF not included in the SuperRatings survey, also posted positive returns. While the poorest-performing funds all had less than $5 billion, many other funds of similar size produced very good performance.

Over a 10-year period, this metric shows a stronger correlation between size and performance. Funds greater than $10 billion have had better performance on average. While funds with better performance attract more new members, it is unclear whether the larger funds have better performance because they are large, or whether they are large because they have better performance.

Chart 3: One-year to 30 June 2022 | Chart 4: 10 years to 30 June 2022



Source: SuperRatings

Does longer-term performance equate to persistent outperformance?

With superannuation being a long-term investment, members should be looking for a fund with good performance consistency rather than just one good year. When examining the performance of the top 10 funds over the 10 years to June 2022, only four of these funds were ranked in the top 10 for FY22. In fact, four of the funds were below average over FY22.

AustralianSuper and HESTA stand alone in terms of performance consistency in this analysis. They are the only funds which have outperformed the average fund in each of the last 10 financial years. Somewhat unsurprisingly, given their higher allocation to growth assets and younger membership demographic, Hostplus has either appeared near the top or the bottom, but never near the middle, in individual years, while much more frequently in the former.

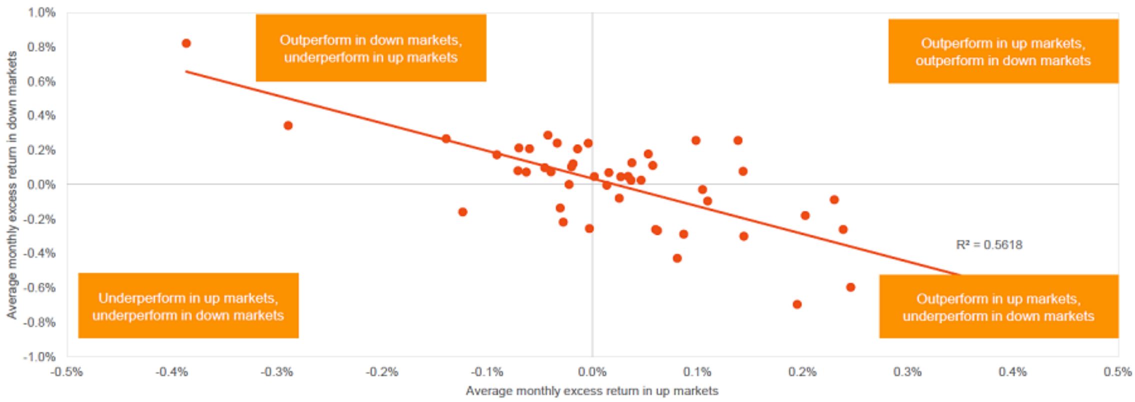
Most of these funds have had two or more years when their performance in a year has been below average. Only three funds have had at least one year when their return ranked them in the bottom quartile of peers.

A lesson well understood by many in the industry, but perhaps less so by fund members and other parties, is that a single year of good performance does not necessarily result in good long-term performance. Similarly, a couple of underperforming years across a decade does not translate to poor longer-term returns.

Performance in different markets

Chart 5 shows the average monthly excess return in down markets versus the average monthly excess return in up markets. The chart, analysed over a 5-year period, shows that not many funds are good in both up markets and in poor markets. The majority of funds are taking more risk (outperform in up markets) or less risk (outperform in down markets).

Chart 5: Up and down market analysis five years to 30 June 2022



Source: Frontier, SuperRatings

The final word

Superannuation is a long-term investment and it is long-term returns which impact final member outcomes. Analysing short-term performance can be helpful, especially in understanding how performance was achieved and whether there are any trends. Waiting 10 years to determine a fund is persistently underperforming could negatively impact a members' final benefits.

However, basing an assessment of a fund on one year of good performance has limitations. As we have highlighted in this report, funds which do well in strong equity markets can find it more challenging when those markets decline. Allocations to unlisted assets can help returns, as their valuations are less influenced by the fluctuations in market sentiment.

Basing an assessment on longer-term performance has more appeal. However, care is needed to differentiate between those funds which have done well in the past and those funds which may do well in the future.

A robust assessment across a wider range of factors is needed to be satisfied each fund is of appropriate quality and provides good value for members. A 'bright line' test based on a single metric will misrepresent the complexity of 'past performance being a guide to the future'. Instead, we believe a better outcome comes from analysing:

- Investment performance measured across multiple time periods, and consideration of the level and nature of investment risk.
- Level of fees and costs, particularly where these are increasing.
- Size of assets and cashflow position, especially if the cashflow is negative.
- Fund governance, business management and trustee oversight.
- Other factors, such as member services and other qualitative factors.

The focus should be on improved outcomes for members over the long-term.

David Carruthers is a Principal Consultant and Head of Member Solutions at Frontier Advisors. A full copy of this report can be accessed here. This article is general commentary and should not be regarded as financial, legal or other advice. It has been prepared without taking into account your objectives, financial situation or needs. Investors should seek individual advice prior to taking any action on any issues raised in this article.

S&P default rates and the risks in bond investing

Matthew Macreadie

While yields have increased in Australia, including on investment-grade bonds which are rated in the BBB space, it's also good for investors to know their money is relatively safe.

Standard & Poor's (S&P Global Ratings) releases a report every year looking at default rates for each categoty of credit ratings over time. The 2022 report will be released in 2023 but the most recent report provides some good illustrations and commentary.

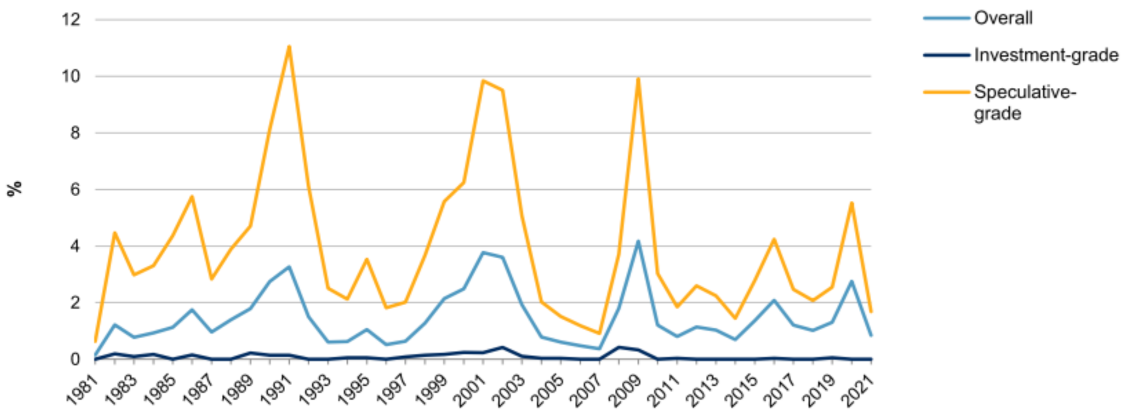
Global and Australian defaults statistics

In 2021, 72 global corporate issuers defaulted but most of these were in the non-investment grade CCC/C/B categories. The only default in 2021 from an Australian corporate was from Australian drilling services provider, Boart Longyear, and this was well flagged.

Company name	Reason for default	Country	Industry	Debt amount outstanding (mil. $)	Default date	Rating 1 year prior to default	Rating 3 years prior to default	First rating	Date of first rating
Boart Longyear Ltd.	Foreign bankruptcy	Australia	Energy and natural resources	488.0	5/19/2021	-	-	CCC+	7/1/2020

The majority of defaults were in the US, reflecting the breadth of the bond market over there.

Global Default Rates: Investment-Grade Versus Speculative-Grade



Source: S&P 2022

The statistics show that global default rates in investment-grade have been extremely low over time.

Historically, the Australian default statistics are lower than the Global default statistics, in part due to it being a largely investment-grade market locally but also a concentration towards the major banks, which are all rated AA-.

Over the 30-year study period, investors should take confidence in investment-grade bonds. The table shows the probability of default for AAA rated to CCC/C rated, including average default rates of investment grade, speculative grade and all rated.

Global Corporate Average Cumulative Default Rates (1981-2021)

(%)	--Time horizon (years)--														
Rating	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
AAA	0.00	0.03	0.13	0.24	0.34	0.45	0.50	0.58	0.64	0.69	0.72	0.75	0.78	0.83	0.89
AA	0.02	0.06	0.11	0.20	0.30	0.40	0.48	0.55	0.62	0.68	0.74	0.80	0.86	0.91	0.96
A	0.05	0.13	0.21	0.32	0.44	0.57	0.73	0.87	1.01	1.15	1.28	1.40	1.52	1.63	1.76
BBB	0.15	0.41	0.72	1.09	1.48	1.85	2.18	2.50	2.80	3.10	3.40	3.64	3.86	4.09	4.34
BB	0.60	1.88	3.35	4.81	6.19	7.47	8.57	9.56	10.45	11.24	11.90	12.52	13.09	13.57	14.08
B	3.18	7.46	11.26	14.30	16.67	18.59	20.10	21.34	22.45	23.50	24.40	25.10	25.75	26.35	26.92
CCC/C	26.55	36.74	41.80	44.74	46.91	47.95	49.08	49.82	50.48	51.05	51.49	51.92	52.45	52.91	52.97
Investment-grade	0.08	0.23	0.40	0.61	0.83	1.05	1.26	1.45	1.63	1.81	1.98	2.13	2.27	2.40	2.55
Speculative-grade	3.60	6.97	9.86	12.23	14.16	15.75	17.06	18.16	19.14	20.04	20.80	21.44	22.05	22.58	23.09
All rated	1.50	2.93	4.17	5.22	6.10	6.83	7.45	7.97	8.43	8.86	9.23	9.54	9.84	10.10	10.36

Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.

Source: S&P 2022

For example, a BBB-rated bond has a probability of default over five years of 1.48%. This increases to 6.19% and 16.67% for a BB and B rated bond. Digging deeper, a US BBB-rated bond has a probability of default of 1.83% implying that an Australian BBB-rated bond would have a probability of default over five years of significantly less than 1.48%.

Again, this shows the safety net of the Australian corporate bond market.

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

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The most vital question ever put to me as a portfolio adviser

Dan Kemp

What are you doing with his money?"

This is the most important question I have ever been asked as a professional investor and it seems especially important in an environment where both equity and bond prices have fallen sharply. The reason this question is significant is it encapsulates core tenets of investing. Still, before we dig into these tenets, let me tell you more about the client, Terry.

Terry is a retired coalminer who has entrusted his savings to the team at an adviser that has, in turn, invested those savings in a Morningstar managed portfolio. Terry is not a typical client for this adviser but he has been with them for a long time and the team obviously cares deeply about making sure he is well looked after. Hence, we were posed this question by the adviser team when reporting on the progress of the portfolios.

Whose money?

The first element of this question that deserves our attention is the fact it is focused on a person's money. In a world where professional investors tend to spend our time focused on index levels and percentages, comparing our returns with benchmarks and peers, it is vital to remember that we are making decisions about money.

This money has the power to transform lives for better or for worse. Our clients are ultimately unconcerned by our quartile rankings and benchmark-relative returns but are instead focused on whether they are progressing towards their financial goals and will be able to support themselves in retirement.

Aligning ourselves with this view can be challenging, especially when experiencing a valuation bubble, such as the one we have seen in technology stocks over the last couple of years. It is essential, however, if the work we do is to be of benefit to our clients and society as a whole.

As professional investors, we typically manage pools of money on behalf of a large number of investors. This pooling approach has transformed professional investment from a service that was only available to the wealthy and made it accessible to all. The drawback of pooling, however, is it is easy to forget we manage money on behalf of individuals, each of whom has a unique situation.

While we cannot know each of these investors individually, when making decisions about the portfolio, it is essential to keep in mind how these decisions will impact Terry. For our part, we summarise this approach as 'putting the end investor first', which forms our first and most important investment principle.

By focusing on an individual rather than a group, we can reduce the psychological distance to those we are trying to serve, which in turn can help us make better decisions on their behalf.

The future not the past

Note too that the question is not 'What have you done with his money?' but 'What are you doing with his money?' The importance of the future is implied in the question but, unfortunately, is easy to forget when working with clients.

At the recent Morningstar Investment Conference, more than two-fifths (44%) of the advisers who responded to a poll reported their clients '*have clear financial goals we are working towards*'. Yet less than one-third (30%) of advisers reported spending the majority of their client meetings focused on progress towards those goals. This is a similar proportion (31%) to those who reported spending most of their client meetings focused on markets and past performance.

We know that focusing on the past can trigger the behavioural biases that are so harmful to investors, yet we still tend to focus too much on the things we cannot change in the past and not enough on those we can influence in the future. This latter point is especially relevant in the current environment where the outlook for investment has changed significantly over the last six months and requires us to approach the future with fresh thinking.

As we do this, it is essential to have a clear mental framework for assessing opportunities and avoid being 'whipsawed' by changing economic and geopolitical circumstances. Within our own team, we use valuation as our guide. While this is not the only way to invest, we have found it to be the approach that is best aligned to the welfare of our end-investors and helps us avoid accepting risks that are uncompensated by higher expected returns over the long term.

Whatever approach you use yourself, I would encourage us all to remain focused on the first and most important question when making investment decisions. So what are we doing with Terry's money?

Dan Kemp is Global Chief Investment Officer at [Morningstar Investment Management](). This article is general information and does not consider the circumstances of any investor. This article was originally published in [Portfolio Advisor]() on 12 August 2022. Minor modifications have been made for an Australian audience.

Will a high CPI 'inflate away your debt'?

Graham Hand

This article develops a question in last week's editorial with additional input from four leading economists.

While the media attention focusses on the disquiet of borrowers facing rising interest rates, are borrowers winning from rising inflation in another way?

It's commonly argued that governments can *'inflate away their debt'* because they repay their maturing bonds with money that is worth less in future than when they borrowed it. In effect, the debt requires a smaller amount of the government's revenue as inflation eats away at the value of the borrowing.

Does the same argument apply for households?

It doesn't feel like inflation is helping borrowers

Recently, a friend asked whether, as a borrower with a large mortgage, he should be happy to see high inflation. That is, does inflation *'inflate away his debt'*? In theory, if wages increase in line with the CPI, he still owes the same amount of money but he earns more. He said that rising inflation is leading to higher interest rates on his mortgage, but his salary is not increasing to match CPI. So how can his debt be *'inflated away'* when it is costing him more and he does not earn the salary to match it. In what sense is his debt becoming less? How can someone with a large debt be pleased by high inflation when all he sees is mortgage pain?

Good question. How have governments '*inflated away their debt*' in the past but the same logic does not apply now for households?

We put this question to four economists who responded as follows:

Shane Oliver, AMP

Governments did inflate their way out of high debts left over from the end of World War 2 because post-war inflation combined with strong economic growth helped reduce the value of their debts relative to GDP. But that was a period of low bond yields. If bond yields had risen more in line with inflation, then governments would have found it a lot tougher.

It's harder for individuals. High inflation can help reduce a person's mortgage debt burden if interest rates stay low and wages growth is strong. This happened in the early part of the inflation surge in the first half of the 1970s when wages growth was well above inflation (in 1974 inflation rose to nearly 18% but wages growth was 25% or so) and interest rates were slow to move up with inflation. And back then, mortgage debt was relatively low (compared to people's wages anyway). My parents benefitted in that period.

But right now we have the worst possible combination of high mortgage debt levels, rapidly rising interest rates and wages growth running well below the rate of inflation. Wages are nowhere near making up for the rise in interest payments on mortgages. So while the real value of the debt may be falling in the sense that consumer prices are rising faster than the value of the debt, it's not helping people with a mortgage due to slow wages growth.

It is more than just inflation that matters. From the mid-1970s, bond yields didn't really compensate investors for inflation but through much of the 1980s, they more than compensated for it (basically because inflation expectations move with a lag so bond yields were slow to adjust to high inflation through the 1970s and then slow to adjust to its fall from the early 1980s). Which made the early 1980s horrible for borrowers but great for bond investors (bond yields were around 14% when I started work and inflation was 'only' 8%).

So I don't think the old concept of '*inflating the debt away*' applies now to those with a mortgage. In the current inflationary conditions, it is the savers who feel better off than the mortgage holders.

Saul Eslake, Independent Economist at Corinna

Governments have historically been able to '*inflate away*' their debt in times gone by when, with compliant central banks, they were able to 'engineer' higher inflation (for example by allowing the economy to 'overheat') and preventing interest rates from rising in response to the ensuing higher inflation. In those days, up to the 1970s and 1980s, households with large mortgages or other forms of personal debt were also in a sense beneficiaries of higher inflation because wages tended to rise in line with, or (in the 1970s), at a faster rate than prices.

But these conditions haven't really applied since the 1990s, at least in Australia and most other developed economies. Central banks are independent of governments (as they're demonstrating at the moment), and aren't going to be party to any attempts by governments to engineer higher inflation rates in order to reduce the real value of government debt. And of course wages are much less likely to match inflation when inflation is high.

So your friend is essentially correct. Any possible advantage to him from a period of high inflation in reducing the real value of his outstanding debt is likely to be offset, and possibly more than offset, by the pain associated with higher mortgage rates

Stephen Miller, GSFM

The notion that high inflation favours borrowers over lenders only applies when the interest payable on that debt is in ***fixed*** rate form. When price inflation accelerates, the real burden of servicing that debt falls. In general wage inflation accompanies price inflation, sometimes leading and sometime lagging. As wage inflation gathers pace the real burden of servicing household debt subject to a fixed rate will occur to the detriment of the lender and the advantage of the borrower.

When the debt in question is subject to a ***floating*** or variable rate, it is not clear that the borrower is advantaged. Indeed, it is likely that the lender may receive an advantage. During periods of high inflation central banks adjust the (floating) policy rate upwards. Moreover, the magnitude of that adjustment often must exceed the increase in inflation as central banks need to move policy rates to 'restrictive' territory which means increasing the real rate (nominal rate less price or wage inflation) higher. That means household debtors face a higher real debt servicing burden while borrowers receive higher real interest returns.

In a floating rate environment, householders may also suffer as the asset over which the mortgage is held (mostly residential real estate) also falls in price as interest rates rise.

In the US, the bulk of household debt is subject to a fixed rate hence the 'received wisdom' regarding inflation. In Australia, most household debt is subject to a floating rate and that 'received wisdom' does not apply.

Russel Chesler, VanEck Australia

In my opinion inflation is not good for households in this environment. Property values are falling and mortgage repayments are rapidly increasing because the Reserve Bank is raising interest rates to combat inflation.

To inflate away mortgage debt, you need strong wages growth, increasing property values and stable or moderately increasing interest rates. The first two are not evident now and we don't believe that the economic environment will change sufficiently to lead to this scenario. Property prices are falling and the rate of the fall could accelerate as interest rates rise to the highest levels for several years.

We have seen the cash rate increase from 0.1% to 2.35% and we expect it to be over 3% by the year's end. Repayments on interest-only mortgages will have more than doubled by then. To date, wage growth has remained benign with the annual increase to 31 May 2022 of 1.9% compared with inflation of 6.1%, so real wages are falling significantly. At the same time, falling property values are reducing home owners' equity and we expect this continue with interest rates rising.

In summary

Household borrowers who hope a high CPI will inflate their debt away are out of luck, facing rising interest rates, falling property prices and lower real wages. Of course, when they bought their property influences the net outcome as prices peaked in early 2022. Rents are rising rapidly and everyone needs a place to live, and buying your own home usually pays off in the long run.

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

Superannuation funds should be long-term lenders

Professor Kevin Davis

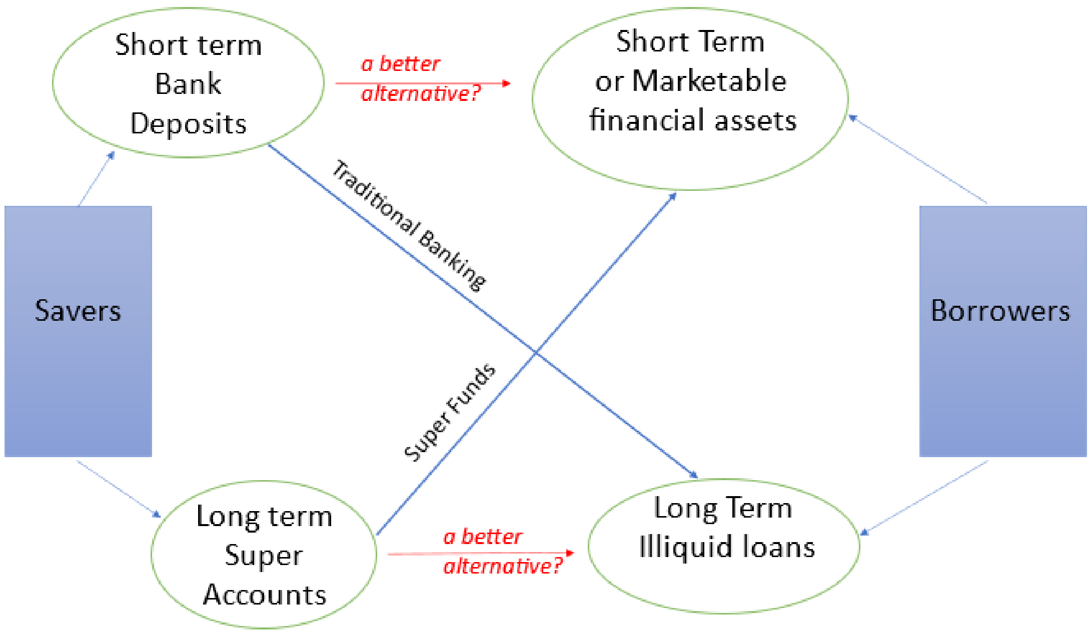
The view (strongly expressed in the AFR Superannuation Lending Roundtable for example) that super funds should do more long-term lending has much merit, despite bank objections. There is, in fact, a fundamental mismatch in terms of the channels by which household savings flow to those wanting finance for investments in real assets.

The Australian financial system has still not caught up with the realignment of household savings into long-term investments brought about by the growth of superannuation.

A fundamental mismatch

Essentially, and at only minor risk of over-simplification, the mismatch is as follows. Banks provide liquid (short-term) facilities for savers but tend to make longer-term loans.

Super funds provide long-term saving facilities, but tend to invest primarily in liquid and marketable investments, such as equities and debt securities tradeable in markets. The figure illustrates this mismatch.



Bank profits benefit from investing in longer-term loans because of the liquidity premium built into the expected return on such loans, but they need to hold some liquid assets to manage the resulting liquidity risk mismatch. Super funds, by investing predominantly in marketable (liquid) securities rather than longer term less-liquid loans, forgo the available liquidity premium to a cost to their members.

It makes sense to have long-term savings directed more to financing long-term investments and short-term savings (which involve liquidity risk for the institutions accepting them) invested in shorter-term investments. Otherwise, the growing stock of long-term savings needs to be diverted to banks for their credit creation via super funds on-lending to banks, involving, at least, a cost of double-handling.

Traditional roles

Of course, there is more to it than just a realignment of investment patterns. Banks are generally seen as creators of new financial assets in the form of loans (or facilitating companies to access debt and equity markets) and use their expertise in credit risk assessment to do this (hopefully) well. Super funds are traditionally seen as investors in already existing assets (such as securities traded on financial exchanges).

Yes, eventually the investments made by super funds will provide the ultimate funding of securities created by banks (bonds, securitisations, equities, etc.). But might it be better to have the ultimate funding aligned with the initial funding via the super funds being the creators of new financial assets?

More generally, with the growth of illiquid (super) savings, is there as much need for the risky liquidity creation traditionally undertaken by banks and the high liquidity premium cost built into longer-term funding?

The banks will argue that credit risk assessment and management of illiquid loans is a skilled task, involving expertise which super funds do not currently have. That may be so, but three counter-arguments are relevant.

First, individuals with, and systems providing, credit risk expertise and capabilities, are transferable resources which can be ‘poached’ or purchased.

Second, it would be possible for super funds to outsource the credit risk task to a trusted third party who has sufficient ‘skin in the game’ to ensure their objectives are aligned with the super fund.

Third, the explosion in data availability due to the digital revolution (and open banking) is reducing the value of the traditional customer relationship role in credit risk assessment.

The banks also have a strong self-interest rationale for their stance. More competition in long-term lending can be expected to impact adversely on bank profits. And if they are undertaking less liquidity creation and holding more short-term assets, profits will be affected by less liquidity premium rewards.

Of course, super funds have already moved into the creation of new long-term financial assets, through such investments as funding new infrastructure projects. But there is scope for more long-term financial asset creation from a lending role.

There are clearly risks involved which warrant attention. There is also the problem of valuing illiquid assets and the potential for mis-valuation of non-traded assets to adversely affect the ability of APRA to identify underperforming funds. But discussion of a lending role for super funds is warranted.

Kevin Davis is Emeritus Professor of Finance at [The University of Melbourne](). Kevin’s free e-text reference book 'Bank and Financial Institution Management in Australia' is available on [his website](). Kevin was also a member of the Financial Systems Inquiry ('The Murray Report') in 2014.

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