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Editorial

An older journalist once told me never to start an article with a question. Now that's out of the way, here's the question. Why do experienced multi-asset managers never set up their own boutique fund businesses, while managers of specific asset classes do so regularly? In Australia, there are hundreds of single asset fund managers with their own boutique businesses and supporters, but none are multi-asset. Are there no asset allocators with a strong reputation? More on that in a moment, as the answers reveal a lot about investing.

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Meanwhile, another Federal Budget has come and gone, and while it confirmed some changes already in play, there was not much new on superannuation and retirement. As **Meg Heffron** said in her response, *"I don't recall a Federal Budget with less to say about superannuation in my career of over 20 years."* The inflation forecast looks highly optimistic, given ongoing energy cost and wage momentum, with Treasury forecasting a drop to an annual 5.75% for 2022/2023 and then 3.5% for 2023/2024.

The biggest surprise was preventing off-market share buybacks where franked dividends are 'streamed' to shareholders, as used by BHP and the major banks recently. The strategy allowed a capital return made up significantly on a franked dividend, and the article this week by **Kevin Davis and Christine Brown** covers similar ground.

Then the Australian inflation number released yesterday confirmed what we all knew. Prices are rising mightily, to a 32-year high of 7.3% in the year to the end of the September quarter. It dominates all investing decisions, and **CBA's Gareth Aird** updated his forecast to a 3.1% cash rate peak:

"There are no two ways about it – inflation is red hot in Australia right now, as it is in many parts of the world, and we expect the RBA will respond by raising the cash rate again at the November Board meeting next week. Indeed our call has been that the RBA will deliver one or two more 25bp rate hikes and then pause for an extended period (the base case was one further 25bp rate hike in November which would take the cash rate to 2.85%). Today we incorporate the second 25bp rate hike into our central scenario for the cash rate, which means we see the peak in the cash rate being 3.10%."

There is plenty of evidence that investment conditions are especially difficult at the moment, as **Jonathan Ruffer**, Chairman of Ruffer Investment Company, a large UK hedge funds, said recently:

"In the 45 years I have been an investor, I cannot recall a more dangerous period than today ... We see danger ahead. Markets are still too high, and protection is expensive in an increasingly nervous world; common sense suggests one should invest conservatively, and in safe assets. In a world where people find themselves without the ability to pay commitments as they arise, forced selling drives prices. Among risky assets like equities, one of the counter-intuitive things in a liquidity crisis is that securities perceived as safest and most liquid go down sharply, because investors are forced to sell what they can, not what they want to."

Balanced funds have been the surprise poor performers of 2022, where traditionally a fall in the equity market is offset by reduced interest rates and gains in bonds, protecting a 60% growth/40% defensive portfolio. But both bonds and equities have fallen this year, with returns in the US market among the worst in almost 100 years.

Let's move to the question posed above ...

When anyone starts investing, it must seem as though every professional is smart. They seem so assured and confident in their opinions. But with more experience, we gradually realise that the 'experts' are also befuddled by how markets work. **Gerald Loeb** was an author and founding partner of **E.F. Hutton & Co.**, a leading **Wall Street** trader and brokerage firm. He died in 1974 but what did a long career in sharemarket investing teach him?

"The most important thing I have learned over the last 40 years in Wall Street is to realise how little everyone knows and how little I know. Human nature being what it is, a person buying a stock at the wrong time is very apt to double his error and sell it at the wrong time."

"How little everyone knows ..." So here's the question again. Why are the hundreds of portfolio managers who have left large institutions to set up their own boutique funds always focussed on a particular asset class (such as global equities, domestic bonds or property) and never allocators across multiple asset types? Most of the return in a balanced portfolio comes from asset allocation and not stock selection, and yet nobody steps out of a large fund manager with a strong personal reputation to establish their own boutique multi-asset fund.

I put the question to **Chris Cuffe**, who has spent much of his long and successful career selecting fund managers and allocating assets. Chris gave me a quick four-word answer: *"Nobody can do it."* He then elaborated to add, *"Well, consistently over a long enough time period"* and he reminded me of an article he wrote in Firstlinks called "Why we can't resist tactical asset allocation" which includes this quotation from Nobel Laureate, **Daniel Kahneman**:

"We cannot suppress the powerful intuition that what makes sense in hindsight today was predictable yesterday. The illusion that we understand the past fosters overconfidence in our ability to predict the future."

Chris also noted that multi-asset funds attracted strong inflows in the early days of the managed fund industry, but then financial advisers took over the asset allocation roles. He initially launched his charitable **Third Link Fund** in 2008 as a multi-asset fund, thinking it was the structure to generate the most support, but in 2012, he switched it to invest only on Australian equities to meet the greater sector-specific demand.

I also asked the team at **Pinnacle Investment Management** why asset allocators do not set up boutiques. Pinnacle has alliances with 15 boutiques and assets under management of over $80 billion, and is always on the lookout for investment talent. Managing Director **Ian Macoun** replied:

"From our perspective, we don't think there is a significant market for that service in the 'mainstream' retail or institutional markets. Institutions, financial advice groups and retail platforms have their own professionals who make the asset allocation decisions, and there are plenty of established firms who can provide advice to them if they seek external specialist assistance. It would be a different story in the 'direct to retail' market - but that is a tough market to crack."

And **Chris Meyer**, Director, Listed Products at Pinnacle, who has delivered many boutique funds to an ASX listing, added:

"1. Most of our clients look to boutiques for excellence in individual asset classes rather than outsourcing the asset allocation.

2. Multi-asset funds haven't (historically anyway) enjoyed great success in the Australian market other than through the more captive retail distribution channels and in the default super channel where those firms like AMP or Australian Super build those multi-asset funds themselves (sometimes using external managers or their *in-house capabilities). Unless the independent advice channel start using multi-asset funds more, advisers really aren't on the lookout for multi-asset boutiques/allocators."*

So while nobody has a market-leading reputation for asset allocation, in any case, it is usually done within the large super funds under advice from asset consultants and from in-house resources. Even there, asset allocations are 'range bound' within relatively narrow bands. There is too much business risk in deviating from the range, especially due to APRA's performance tests.

Consider the current market, where the **Morningstar** US market Total Return Index (in AUD terms) has lost 10% year-to-date. It has recently rallied based on expectations that after another 0.75% Fed funds increase in November 2022, the December increase will be only 0.5%. Do we have a market bottom or a 'bear market rally'? We all ask the question but the answer is known only in hindsight.

Many investors have stepped back from equity exposure while they wait for the market to settle, and we take a look at the alternative ways cash can be invested rather than suffering poor returns in the transaction accounts of major banks with six rules to consider.

And in case anyone saw my whinge about **CBA** last week and thought it reflected my technical ignorance, I finally received a response from CBA. The solution to opening a TD online is ... visit a branch.

"As advertised on the CommBank website you should be able to open a Term Deposit online under a personal or Self-Managed Super Fund (SMSF) name. We are aware of a current issue in completing this process within NetBank; that is causing an error message on some attempts (possibly even on repeated attempts). While it is being investigated I can, at this time, provide no timeframe for resolution. I wish to sincerely apologise for the inconvenience this causes. I can confirm that you are still able to open Term Deposits by visiting your nearest branch."

Gosh, opening a TD for an existing customer should be a walk in the park. But then it got worse for my CBA cash account. As I researched my article this week, I discovered that the account linked to my CommSec Trading Account (which CommSec does not want to respond to questions about because it is a CBA account) has been earning interest based on a lower rate scale than the proper SMSF rates, as shown in the following schedule. It was always known to CBA/CommSec that

	Linked to CommSec Trading Account	SMSF*
$500,000 and over	1.85% p.a.	1.80% p.a.
$250,000 - $499,999	1.70% p.a.	1.80% p.a.
$100,000 - $249,999	1.40% p.a.	1.80% p.a.
$50,000 - $99,999	1.00% p.a.	1.80% p.a.
$20,000 - $49,999	0.80% p.a.	1.80% p.a.
$10,000 - $19,999	0.50% p.a.	1.80% p.a.
$5,000 - $9,999	0.00% p.a.	0.00% p.a.
$0 - $4,999	0.00% p.a.	0.00% p.a.

** Option only available for self-managed superfunds (SMSF) that elect the SMSF CDIA option at account opening or have requested to switch onto the SMSF option.*

this was an account for my SMSF, and the name of the account is clearly my superannuation fund. CBA has the audacity to say it's my responsibility to ask for it to be switched. Wouldn't you think the recent fine of $20 million to CommSec for 'systemic compliance failures' would be an incentive to remove these practices? I have asked CBA to go back and calculate my interest at the higher rates.

Also in this week's edition ...

Instead of trying to pick the bottom of the market, **Andrew Clifford and Julian McCormack of Platinum** argue for investing in quality stocks at good prices even if market conditions are not ideal, and waiting for better times to return, rather than staying out of the market.

Jennifer Mead worked with the late **Phil Ruthven** for many years, and in a tribute to him, she describes five lessons she learnt from him which still guide her investment decisions. Ruthven was an adviser to many major companies and a great supporter of Firstlinks.

Australian residential property prices have fallen by about 10% from their February 2022 highs after the extraordinary gains in 2020 and 2021 under misguided central bank stimulus, but **Damien Klassen of Nucleus Wealth** looks at valuation metrics to suggest prices still have a way to fall.

As mentioned above, **Christine Brown and Professor Kevin Davis** examine the Government's proposals on franking credits funded from capital raisings in their submission to the **Treasury** consultation process which just closed, with relevance also to this week's Budget announcement on buybacks.

Sawan Tanna of The Perth Mint then takes a quick journey through the history of gold and other items as money, and explains why gold has retained its money characteristics over the centuries.

And **Kristin Ceva of Payden & Rygel** explains the diversification and yield benefits of emerging markets (EM) debt. Most Australian investors probably think of EM only in equity terms, but some EM debt markets throw up high returns which rely on income rather than capital gains.

This week's White Paper from **NAB/nabtrade** looks at the 2022 Federal Budget and its implications for investing.

I am taking a short sabbatical to recharge the batteries, and the coming weeks will be covered by long-time colleague, **Leisa Bell**, and a new editor at Firstlinks and Morningstar, **James Gruber**. James has written for several global publications and worked for many years as an equity analyst and portfolio manager, and it will be good to hear some fresh perspectives after a decade from me.

Graham Hand

Six guidelines on how to allocate SMSF cash

Graham Hand

Regular readers of Firstlinks may recall I took the unusual step at the start of December 2021 of advising that I was switching some of my SMSF portfolio from equities to cash when I wrote:

"However, while I recommend anyone with a long-term investment horizon should stay substantially invested in equities, I am starting to reduce some equity exposures as I personally believe the market will experience a decent fall sometime in 2022."

My colleagues at Morningstar had asked me to write about why I expected stockmarkets to fall in 2022. I don't normally make such announcements as I'm not a fan of timing markets. However, the frothy valuations of 2021 were due for a correction, and then conditions worsened with the war in Ukraine and higher-than-expected inflation and interest rates. An advantage of running an SMSF is this flexibility to make changes that suit personal risk appetite, or it can be a curse if the ins and outs are badly timed. In most cases, better to leave it for the long term. As legendary investor Peter Lynch famously said:

"Far more money has been lost by investors preparing for corrections, or in trying to anticipate corrections, than has been lost in corrections themselves."

It is also difficult to decide when to restore risk towards equities, and while money is saved by selling before a fall, money is lost in not re-entering before a rise. If the market continues to rally while money sits in cash, the long-term benefits of equity investing may be lost. But unable to resist the timing temptation, the risks to the downside still seem greater than the upside at this stage.

All that involves a decent amount of guesswork, but there is one thing that is a sure-fire way to generate more income. While the money is in cash, make it work harder and earn the higher rates on offer, if other goals are not compromised.

Major banks are enjoying the 'retail inertia' of customers staying in lower-earning savings accounts. My SMSF's transaction account held with CBA is not tracking increases in cash rates, paying 1% or less for under $100,000 and a top rate of 1.85% on high balances versus the current cash rate of 2.6%. On $100,000, earning 1% versus say 3% is a shortfall of $2,000 a year.

The major banks are using the rise in rates to rebuild their net interest margins, and their clients do not give the banks enough incentives to act differently (and I have sat on the Pricing Committees of three Australian banks and lagging rate increases on deposits is an extraordinary source of profits).

Guidelines for investing my cash

It's overdue for me to find better ways to invest what might loosely be called 'cash' as significantly better rates are now available. I have different needs for this money, leaving me to set the following (sometimes conflicting) criteria to drive allocations:

1. Maintain liquidity for opportunistic investments

Regardless of market conditions, investment opportunities arise that may require a quick response. A bond or note issue, such as the recent hybrid offer from CBA, may open and close in a day. Term deposits are a commitment for a given maturity and banks are now pushed by the regulators not to allow easy prepayment, so some level of at-call cash is required.

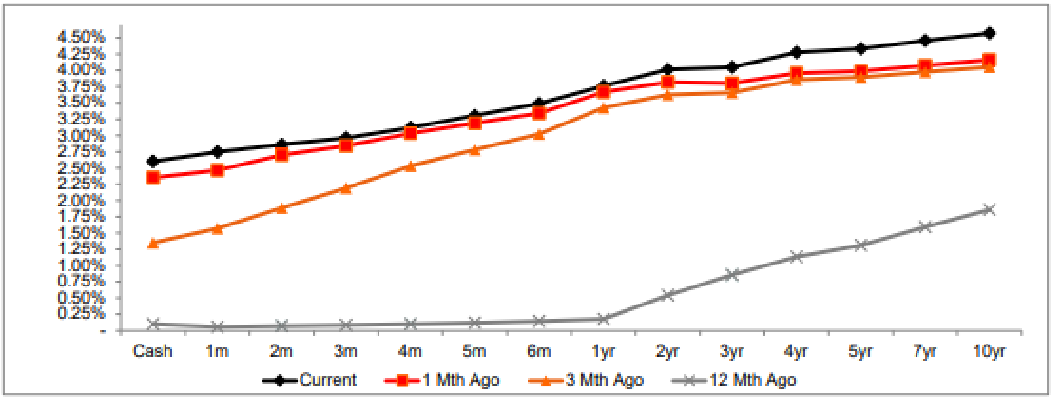
2. Stagger term maturities

Some bank term deposit rates are now offering 4% to 5%, which while not generating positive real returns with inflation over 7%, at least they generate decent income on government-guaranteed deposits (subject to a maximum of $250,000 per entity per ADI under the Financial Claims Scheme). For example, AMP Bank is at 4.8% and Judo Bank is at 4.9% for five years.

But these long terms reduce flexibility and the threat of inflation and interest rates rising more than expected cannot be ruled out. Staggering maturities leaving some at call in a high-yielding cash account, plus term deposits at 3% for 6 months, 3.9% for 12 months and maybe a little longer term at around 4.5% retains more flexibility. Deposits maturing every six months allows deployment elsewhere if needed.

3. Lock some away at decent rates

The chart below from NAB (as at 25 October 2022) shows how much the bank rate curve has increased over the last 12 months and in the last month, with cash rate futures pricing in 4.25% by September 2023. Amid all the market uncertainty, this week's Budget forecasts a return to lower inflation, down to 3.5% by 2023/2024, and there is an argument that market rates have risen too far. Yes, this is having it both ways (fix some, float some) but locking in some of today's higher rates has merit.



4. Minimise the pain and time involved in paperwork

We all feel differently about the effort of investing. I have a low pain threshold. For example, I started filling out what looked like a decent online application process by Judo Bank. It is, after all, a new online bank without legacy systems. But I became bogged down in identifying myself, the company trustee and the super fund, and for some reason, it requires unique email addresses for the trustee company and the directors. Judo Bank then advised me by email:

"I do thank you in advance for the feedback during our 'pilot program'. Can you please send through a screen shot of the sections you have mentioned in your email?"

What! Their SMSF application process is a pilot program? Don't release it to the public, then.

Similarly, I thought I was going well with account opening at Gateway Bank, sending in by email the lengthy application form and various copies of ID, only to receive this reply:

"Please find attached the following documents required to set up a Self-Managed Super Fund with Gateway:
-ID for each signatory (Medicare Card and Driver's licence/Passport – certification not required; a copy is fine)
-Each signatory must sign the membership form
-The membership application – trust is for the superfund itself

We also need:
-A certificate of registration (showing the ABN)
-1st page of the deed that shows the legal name of the fund and page where it shows the number of beneficiaries and Settlors details if any.
-Table of contents
-The last pages of the deed that show the signatories signatures and the confirmation that it has been witnessed.

If the company is involved as a trustee for the super fund, we would need additional documents for the company:
-The membership application – Company
-A certificate of registration (showing the ABN or ACN) /ASIC certificate.
-All the above documents should to be certified and forwarded to us via email or mail. Unless the members can visit the branch with the original documents, and we can certify it here."

Really. I had already provided some of this. Life's too short for all this signing and gathering and certifying, plus who's the Settlor?

Anyway, after more email exchanges, we all gave up on each other. You might have a difference experience or be happier filling in forms.

I finally set up up a TD using a smoother process with Macquarie Bank. Not sure why they did not require a certified copy of my SMSF's Trust Deed but they made the application easy.

5. Consider listed cash (money market) ETFs

The range of Exchange-Traded Funds (ETFs) continues to expand and give opportunities across many asset classes which were previously only available in unlisted funds.

There are three 'cash' ETFs and many bond, note and private credit funds which are worth considering, but sticking to the cash comparison gives the following choices.

ASX code	Base fee	Buy/sell spread	Current rate
AAA (BetaShares)	0.18%	0.02%	2.72%
BILL (iShares)	0.07%	0.03%	2.89%
ISEC (iShares)	0.12%	0.03%	3.04%

Sources: Issuer websites as at 25 October 2022

AAA is the market leader and by far the biggest and offers the best liquidity and tightest spreads. It has become a popular place to leave cash with better rates than bank deposits. For a relatively quick in and out, it's the best choice. But it's also the most expensive on fees, making the others more attractive if money may be left in cash for a while. Note that ISEC carries somewhat more risk than the others as it can hold up to 20% in floating rate notes.

Listed cash funds have become popular globally, as this chart of US retail flows shows (the institutional outflows are due to financing redemptions from other funds). Retail investors are looking for a safer home in the face of equity and bonds funds crashing.

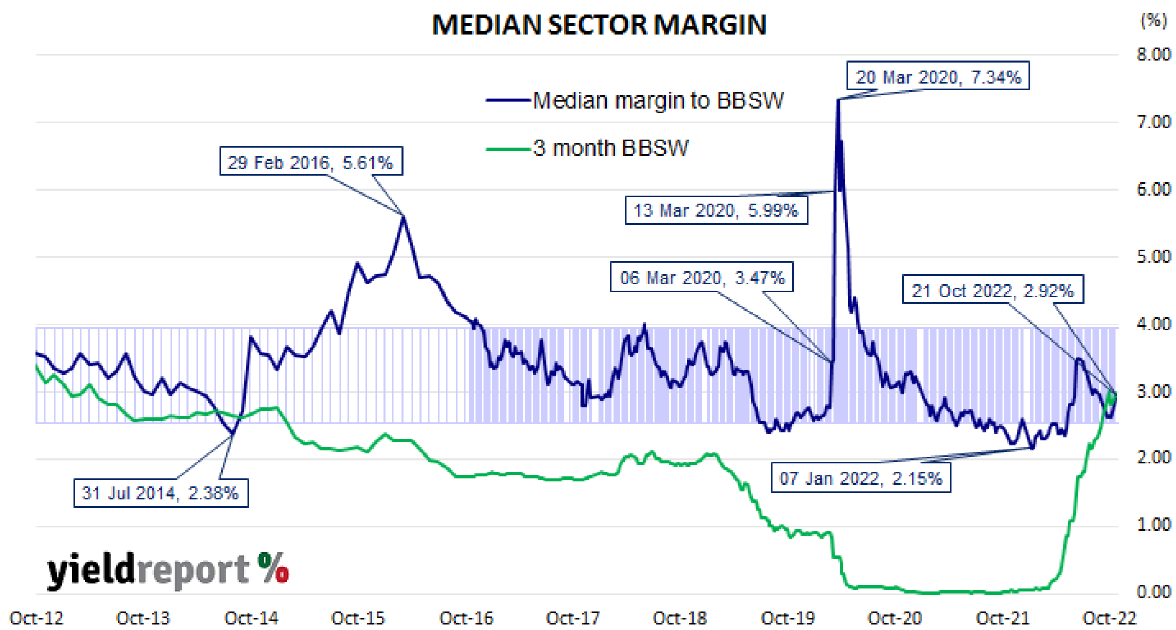
6. Don't compromise on risk in search of returns

A common investment technique to drive better returns during 2020 and 2021 as cash rates were held at 0.1% was move up the risk curve in search of yield. This may include lower tiers of the bank capital structure, such as subordinated debt or hybrids, or high-yield credit, such as non-investment grade company debt.

While there is some room in portfolios for higher risk, they are not direct substitutes for the security of cash and bank term deposits. For example, this week, CBA issued a new hybrid offering a margin of 2.85% over the Bank Bill Swap Rate (BBSW, the rate that closely follows the Reserve Bank cash rate). At current rates, this pays about 5.8%, and if BBSW goes to the predicated 4.2%, then CBA will pay a healthy 7% plus. Not bad for a bank credit of such quality, and the transaction was swamped and closed in a little over a day. Then Bank of Queensland issued at a better margin, indicated at between 3.4% and 3.6% above BBSW, or over 6% for a solid regional bank. But even when issued by quality banks, hybrids carry some equity-like risks.

The following chart from YieldReport shows how margins on hybrids can widen in times of market distress, driving prices lower for anyone who needs to sell. While the current margin on hybrids across the range of transactions is 2.92%, it rose to a remarkable 7.34% in March 2020 at the height of the pandemic when investors were worried about bank loan quality. Another spike hit in 2016. So while the green line, the 3 month BBSW, has risen handsomely for investors, margins are highly variable and at some time in the life of today's new hybrids, there may be better spreads available.

For those brave enough to buy in March 2020 at a margin of 7.34%, if BBSW goes to 4.2%, that's 11.5% on a quality bank name.



So what did I do?

I am not claiming I have surveyed every bank, security and opportunity, and I'm willing to forego returns for ease of execution. The following identifies specific investments I made as a guide to the diversity available but it is not exhaustive.

- Switch some cash to a High Interest Cash account with nabtrade paying 2.75% on the full balance. My SMSF already holds an account with nabtrade, so no account opening was necessary, just a funds transfer.
- Open a new term deposit with Macquarie Bank, 12 months paying 3.9%. As above, I found the application process easier than with others.
- Invest in a couple of listed cash ETFs, BILL and ISEC, where the fees are lower than the market leader, AAA. Unlike cash bank accounts and term deposits, however, there are costs of brokerage and crossing the spread.
- Invest in some hybrids, accepting that these are not like-for-like risk versus cash, but a floating rate exposure in a rising rate environment has a place in my portfolio. Knowing that the CBA issue will face heavy scale back but they are repaying a large investment I have in the existing CBAPD, I bought two hybrids on market, Macquarie's MQGPF set to yield about 8% to maturity and ANZ's ANZPI at about 7.4%. There are also hybrid ETFs available which leave selection to experts for a fee. I know that hybrids in Australia are paying lower rates than banks in offshore markets. I am willing to accept this cost as I do not want more currency exposure and I am more confident about Australian banks than European names. I already hold an investment in the VanEck Bentham ETF (ASX:CGAP) which holds foreign bank capital instruments.
- Plus a couple of modest equity investments in listed companies that I have wanted to own for many years and where the price has fallen to what seems an attractive level.

That will suffice for now with some cash left in my CBA transaction account, provided they fix the rate paid.

I welcome feedback and suggestions on how to manage cash if others have seen better opportunities.

Graham Hand is Editor-at-Large for Firstlinks. This article is general information and does not consider the circumstances of any other investor. These investments may not suit other people and financial advice should be obtained by each investor.

Forget picking the bottom and focus on value

Andrew Clifford, Julian McCormack

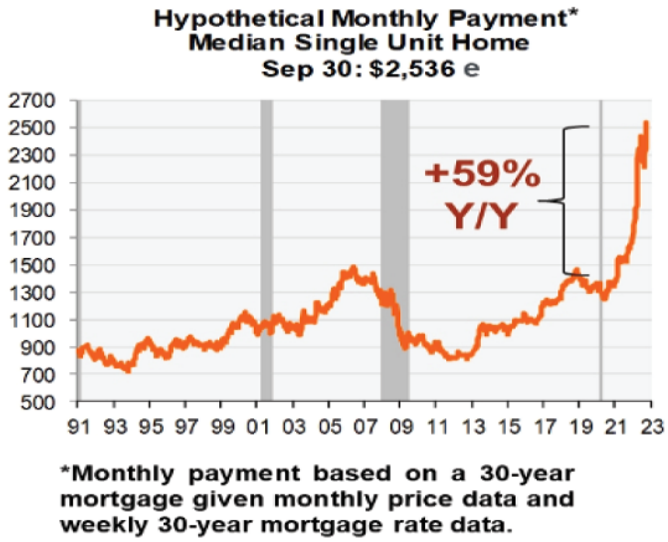
In late September 2022, CEO and Co-CIO of Platinum, Andrew Clifford, sat down with Investment Specialist Julian McCormack to discuss interest rates, inflation, China and Europe. This is an edited transcript.

JM: There is a lot going on in the markets. Let's start with interest rates, how far will they go?

AC: The typical approach to answering this is to examine the underlying components of inflation and where they're heading. There is a lot of evidence indicating that inflation is starting to peak, although one thing that is holding up is the employment market. But at some point, inflation will roll over. I think the bigger issue here is how much interest rates have moved already. We've just been through one of the most extraordinary increases in interest rates. Coming off near-zero rates, yields on two-year US Treasuries are now around 4% and 10-year yields aren't far behind. These are levels we haven't seen since 2008.

When that degree of change in funding costs occurs in the economy, we must expect some fall-out. In the US, average monthly payments on a new mortgage for a median-priced house are up around 60% from a year ago, they have almost doubled from the pre-COVID period, and are up threefold from the lows of 2013/2014 (see below). US households predominantly have fixed-rate 30-year mortgages, so they obviously aren't actually paying the higher payments, but provides a real sense of just how much funding costs have changed, and it's not surprising to see activity in the US housing market in free fall. We need to turn our minds to the damage in the economy. I think what we have ahead of us is a very difficult period for company earnings across the board.

US Monthly Mortgage Payments



Source: Piper Sandler.

JM: If you're the US Federal Reserve, do you pause, keep raising, or cut?

AC:. It's not really a question for us as investors of what they *should* do, it's simply just a question of what they *will* do. Two or three years ago, when central banks were saying rates would be zero until 2024, I said, "Well, you shouldn't believe that". They tell us that because they need to build expectations in. They want you to believe it, so whether you're a consumer or a business, you will act as if rates are going to stay very low.

Similarly, today they have to say rates are going up and build that same expectation. While they might slow the frequency and size of the rate increases, which will, of course, come to an end at some point, I think we're a long way away from seeing dramatic cuts in rates. There is a real risk that if the Fed cuts rates too quickly, with those strong employment numbers and inflation still well ahead of interest rates, that they will reignite those inflationary forces.

JM: What could come out of left field in terms of monetary policy or its reformulation that could really change things?

AC: What I'd say, which is not answering your question directly, is that we've acted for a long time as if there are no limitations on the actions of governments. But the real economy, which is labour, people going to work, and the capital they use, is the real limitation on the economy. All governments are doing is redistributing funds and resources around the economy, and there are limitations on what they can do.

We had a great example recently in the UK where the market didn't respond well to the UK Government's proposed £45 billion mini-budget, comprising unfunded tax cuts and temporary measures to help with energy bills. The market said there is no way they are doing that, because simply, it requires the rest of the economy and the world to fund that decision and the government subsequently backtracked. Inflation is telling us that we've come up against the limitations of how governments can spend.

JM: Let's go to the opposite extreme. How would you characterise China's situation and outlook given its last 40 years of economic history?

AC: There are a few questions we need to address around China, but I'll start with the simple economic one; the country is in a recession. Whatever the numbers say, this is the most serious downturn in growth since the economy opened up. At the centre of that downturn is a collapse in sales of new properties that is flowing through to construction and activity. This is a very important part of the Chinese economy and the collapse in volumes has come about as a result of policies designed to cap property prices. It's been a severe policy error that has destroyed households' confidence in the property market and property developers.

The idea, though, that some great property bubble has popped is not really on the mark. They have not delivered nearly the amount of modern housing stock that the Chinese population needs. They have a problem. It's like a liquidity trap. Nobody wants to buy a property because they don't know if the developer is going to honour their commitment to develop the property. Confidence needs to be restored. Rescue funds are being provided to the developers, not to get those developers back on their feet, but to ensure that these half-finished developments go ahead and are completed. I believe they're heading in the right direction on this front, and if they fix that problem, I think that will solve the economic slowdown there. Property sales may not get back to the huge levels they were at, but they will most likely recover.

Of course, China has also had a resurgence in COVID, but we know that countries exposed to COVID get through it, one way or another. I'd be surprised if we weren't moving on shortly from that in China. We are also seeing lots of stimulatory actions. Monetary growth in China, for instance, is now accelerating and at the highest levels for quite a few years.

In sum, we are optimistic that China will come out of this recession, just as we would be for any normal functioning economy coming back from a downturn.

The bigger issue with China is the political tensions with the West. My first response to this is always the same: our systems are so intertwined that for either side to ignore that would have significant implications economically, not just for China, but for the world. We can't predict the outcome; however, we would hope that good judgement prevails on both sides. When it comes to questions like an invasion of Taiwan, I think there is a lot of focus on the unlikely possibility of that occurring rather than the things that might really happen.

The US security agencies that said Russia would invade Ukraine are saying right now that an invasion of Taiwan is highly unlikely and that there are no such preparations. It's more the middle ground where things can really hurt individual companies and portfolios, such as sanctions, for example. Recently, the US imposed sanctions preventing NVIDIA from selling some of its high-end graphic processing units (GPUs) to Chinese customers, which is damaging to its business. As investors, we need to be aware of the risks and ensure that we're not overly exposed.

JM: Moving onto Europe, the outlook there is gloomy. How are you framing the extremely weak consumer confidence, the industrial slowdown, and the vulnerability around energy, versus what is generally a pretty good jurisdiction?

AC: Obviously, the war has had huge humanitarian costs not just in Ukraine but across Africa in terms of food supplies. However, if we just focus on the economic and investment implications, one of the biggest impacts is on the cost of energy. Companies across the board have seen a substantial loss in their competitive positions due to the higher energy prices, and we've certainly seen closures in capacity of fertiliser and chemical plants and the like.

On the other hand, this has also been reflected in a weaker euro. We've obviously seen very dramatic strength in the US dollar versus all currencies, not just the euro, including the Australian dollar and the yen. There's a slightly different story for each, but it's mainly a US dollar story, which benefits the rest of the world in terms of their competitive positions. For Europe, the fall in the euro has helped to level out the impact of the higher energy costs on industrial companies and restore profitability.

The unknown question is how long energy prices will stay at this level. I would expect that over a two-to-three-year period, the intense pain Europe is feeling now will ultimately dissipate as new sources of energy are secured. We have already seen Europe manage to secure a significant increase in LNG imports and the like.

JM: American corporations, which have enjoyed some measure of global dominance, have the reverse problem with respect to the currency impact on revenues. How are you thinking about these headwinds?

AC: You would expect a lot of concern about earnings for US companies, based just on the strength of the US dollar. There's some talk about that, but not a lot. So, the market reaction has been different to what we would have seen in earlier times. I think this reaction partly reflects an aversion to business and geopolitical risk, but there's also recency bias at play here, where we remember what worked well before. It’s also worth noting that the US market was the most pumped up by monetary expansion, and while that's certainly faded, it's still benefiting from the tail-end of that, which is holding up US asset prices.

It's been a really interesting market this year. In one way, there has been a stealth bear market for a number of years now for anything that’s not in the ‘growth’ or ‘defensive’ camp. Their valuations have been continually marked down. When we entered this year, the world was looking like a pretty good place, so you would have expected economically exposed or cyclical companies to do well.

However, we then had the extension of the recession in China due to a resurgence in COVID and Russia’s invasion of Ukraine. As a result, companies that didn’t meet those pure safety criteria have taken big hits, falling to crisis-level valuations - to levels that we saw at the bottom of 2009 - whereas the fade in glory of the great tech stocks is slow. We also saw this happen in 2001. It took a very long time for the likes of Oracle, Cisco, Dell, EMC, and Microsoft to reach their lows in both share prices and valuations, but they all ultimately fell to price-to-earnings (P/E) multiples of 10, having been at 50, 60, or 70.

It will all depend on the earnings that companies deliver, because expectations are very high. The stock that has most severely disappointed investors to date is Meta Platforms (formerly Facebook), followed by Netflix in that group. Meanwhile, Google is an advertising business, and interest rates are rising a lot. I would be thinking seriously about how earnings are going to unfold for that business in the next couple of years.

JM: People are quite obsessed with picking the bottom of markets. Going back to your initial point on interest rates, how much lower can US markets go? Or where are we in the market cycle?

AC: I think the best we can do is to look to history for a guide. We had an extraordinarily speculative bull market, particularly for companies with questionable business models with no earnings, or at the extreme, meme stocks like GameStop and so forth. This was driven by a huge torrent of money thrown at it by various policies that were put in place. Your natural inclination, given that the 'liquidity tap' has now been effectively turned off, is that this is going to be a pretty bad bear market.

In the bear markets of 2000-2003 and 2007-2009, indices fell around 50%. I'm not sure why people are thinking it's going to be a lot different this time. Having said that, though, there are opportunities out there now as many stocks are already down 50-60% or more. Some of those are stable businesses sitting on nice earnings multiples, such as semiconductors and auto companies.

There are some pretty interesting assets out there, but growth and tech stocks have yet to adjust. People have also been hiding in a whole range of other more boring things lately, such as consumer staples (food, household products), utilities, and the like, where their businesses actually aren't performing particularly well, but have managed to hold onto valuations that are well ahead of where they were two or three years ago.

People ask us how we are going to try and pick the bottom. Our response is that we don't try to pick the bottom but just respond to the value in stocks, both in terms of what we want to buy and what we want to sell. We are buying stocks that we think have extraordinary valuations, and we'll wait for the recovery of their businesses to come. On the other side of that, where we see companies that we think are in problematic environments and have high valuations, we're shorting them.

JM: Am I right in asserting that, say three years out, it looks like a somewhat higher nominal growth world than the last cycle that allowed this amazing ebullience for things that could either grow or behave like a bond?

AC: I think we will most likely return to an environment which looks more like what it did a couple of decades ago, where we had reasonable valuations and investors could make money in companies that delivered on earnings. As we've already spoken about, China has an opportunity to recover, and Europe, under a different set of circumstances of dealing with their energy crisis, will also recover. The US economy will need to experience a slowdown first. Economic systems are incredibly robust and it will come back down to the real assets in the economy and what drives growth. In three-to-five years' time, we will come out of these downturns, and companies that are trading on single-digit P/Es with earnings in line with expectations or better, should perform well and reward investors.

The full interview is available in audio format on The Journal page of the Platinum website.

Andrew Clifford is Chief Executive Officer and Co-Chief Investment Officer and Julian McCormack is an Investment Specialist (Retail) at Platinum Asset Management, a sponsor of Firstlinks. For more articles and papers by Platinum click here.

Five long-term investing lessons from working with Phil Ruthven

Jennifer Mead

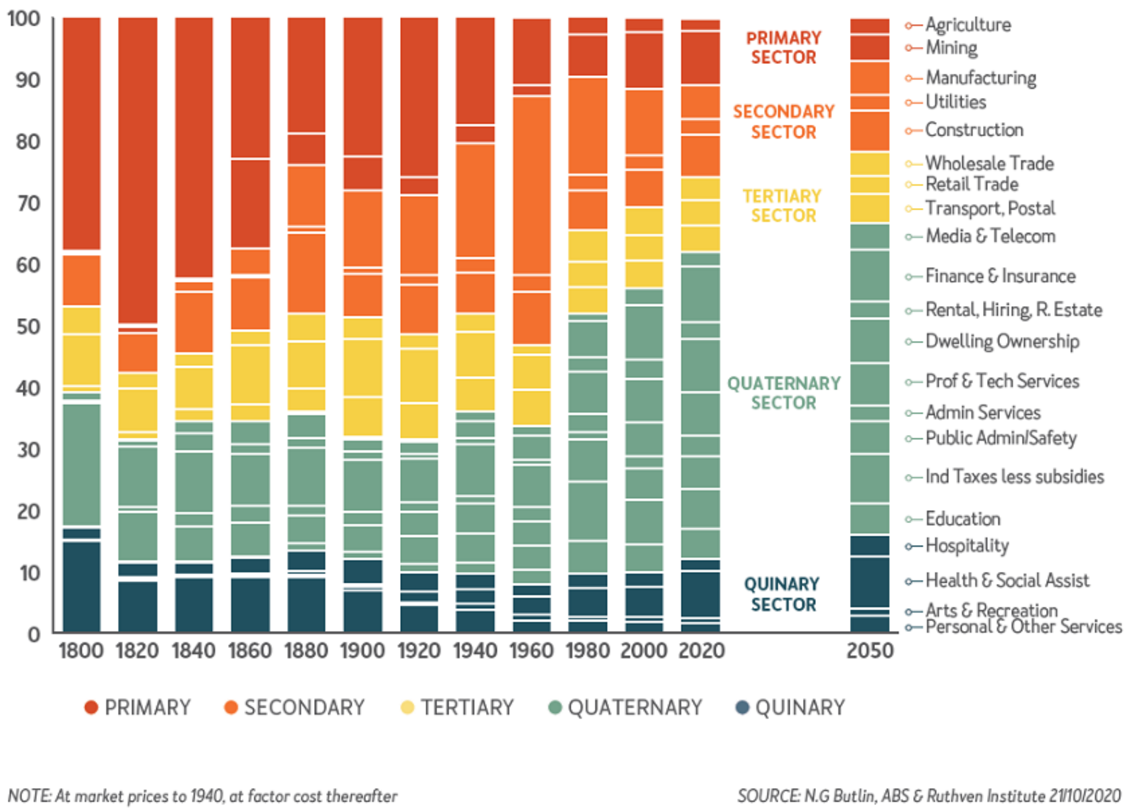
Phil Ruthven's contribution as one of the nation's foremost business commentators and forecasters has been acknowledged in this and many other publications. I worked with Phil in the 1980s and 1990s and it was the research techniques and models for business and strategic analysis he pioneered that led me to change careers and move into investment management.

In the interest of investor education and for the long-term investors out there with a Buffett-style investment philosophy, here are a few things Phil taught me that helped make me a better long-term investor.

Lesson 1. Follow the money

One of Phil's more famous charts illustrates the changing structure of the economy over the past two centuries as we moved from the agricultural age when our primary industries dominated wealth creation through to the industrial age where secondary industries and particularly manufacturing were the major wealth creators. Now into the information or digital age, it is the quaternary (information industries) and quinary industries (service industries) that are winning share of the earnings pie.

Industry Division: Changing Importance
Australia, shares of GDP by industry division, 1800–2050



Intuitively, I use this backdrop as an input into portfolio construction where my preference is to skew the portfolio towards companies in industries that are increasing their share of the earnings pie. This is not to say there are not some wonderful Australian and international companies in mature industries that continue to grow and deliver excellent returns by winning market share. There are. But at the portfolio level, my tilt is toward companies well positioned (see lesson 4) in this change.

Lesson 2. Understand a company's competitive operating environment

Critical to long-term stock outperformance is understanding the industry in which a company operates and its competitive operating environment. We cannot begin to think about the potential size of the opportunity set and threats facing any company without this. To quote the great business strategist, Peter Drucker, the first question to answer is: what business are you in?

This is not as easy as it sounds, and it is made harder by the GICS classification system which often classifies companies according to the markets they serve rather than what business they are in. This often leads to muddled thinking and flawed analysis.

How often have we read that we should invest in internet companies with the usual list of names such as Uber, Amazon, and Netflix. There is no internet industry as such. Uber is in the taxi and ride-sharing industry, Amazon is in the department store industry and Netflix is in the broadcasting industry.

All these companies represent new disruptive technologies in these industries. The IBIS industry database is based on the official Standard Industrial Classification system (SIC) used by statistical agencies the world over to define industries and with a few exceptions is a good place to start when defining and analysing a company's competitive operating environment. It is also where you can get official statistics on the size of the industry when quantifying the size of the opportunity set and the positioning and market share of industry participants.

Lesson 3. Know the development phase of the industry in which the company operates

Michael Porter, another famous business strategist, stressed the importance of knowing the development phase (i.e. pioneering, growth, maturity, decline) of the industry in which a company resides. While some long-term investors acknowledge its importance when assessing the short, medium, and long-term outlook for earnings, few to my knowledge have come up with a methodology to determine it. Phil did, using the industry's value added as a share of the value added of the total economy, (i.e. our Gross Domestic Product) and tracking it over time.

Again, I find this a powerful valuation tool when thinking about the longevity and future growth of the earnings stream of any company. The average industry cycle is around 35-40 years with each new cycle characterised by a new disruptive/transformational technology or system. This is the average, but some are much longer, and some much shorter. Think of the motor vehicle manufacturing industry where the basic technology and systems has changed little since the first model-T Ford rolled off the production line over 100 years ago. The motor vehicle industry peaked as share of the economy and business earnings in the late 1960s and after declining relative to the total market for 50 years is now clearly back into a new cycle pioneered by electric vehicles and the likes of Tesla. Compare this to the television broadcasting industry where the cycle length is much shorter with new cycles around colour TV, pay TV and now streaming all in living memory.

Lesson 4. Understand a company's position within its industry

Years of research by Phil confirmed that there are only two sustainable positions within an industry that can deliver long-term outperformance.

A company must be either a major player with significant cost and scale advantages or a niche player usually focusing on one product group within an industry. Caught-in-the-middle players rarely outperform or survive over the long term. My observation over many years is niche players often have stronger and more sustainable competitive advantages than the industry majors and therefore can be one of the best hunting grounds for companies delivering superior long-term outperformance. This is particularly true where one or two players dominate a niche globally. Australia is blessed with some outstanding niche players across a range of industries. Examples include pharmaceutical manufacturing (CSL in blood products), medical device manufacturing (Cochlear and ResMed) and internet publishing and broadcasting (Carsales, REA, and Seek).

Lesson 5. Learn from history

Applicable in life and investing, Phil was renowned for his long-term charts and time series on the macro business environments and individual industries. Tracking the economy from the macro to the micro often enabled Phil to see linkages and trends well before anyone else. This alone is a very valuable investing tool, but for me even more valuable is using history as an input into weighting risk when valuing a company. It is the risks you can't measure that can often hurt you the most.

Studying the history of any industry, the key drivers of every cycle and the changing composition and market share of participants is always valuable in weighting risk at both the industry and company level.

Thank you, Phil.

Jennifer Mead worked with Phil Ruthven in the 1980s and 1990s before changing careers and moving into investment management. Firstlinks' archive of Phil Ruthven's contributions can be viewed here.

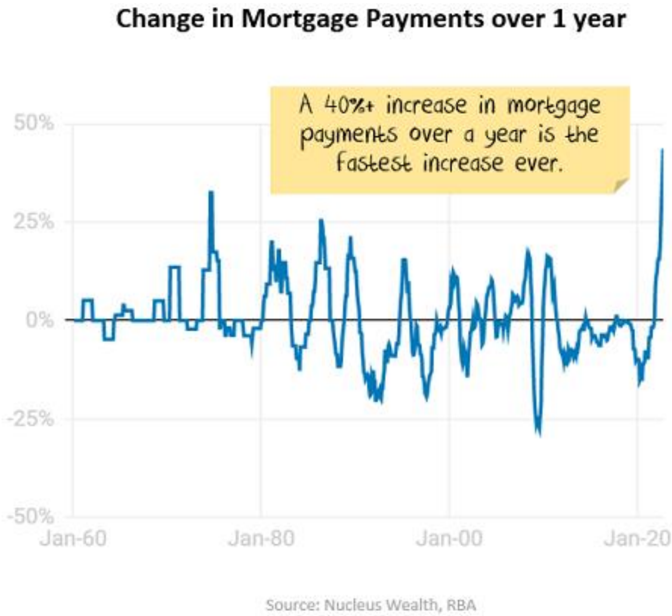
Valuations still stretched in Australia's housing market

Damien Klassen

Australian property market prices are falling, and rents are rising rapidly. Interest rates are rising even faster, and affordability statistics have diverged quite sharply between houses and units. The affordability of houses is as poor as it has ever been, and while the affordability of units is below average, it is nowhere near as bad as houses. This is likely reflecting:

- a change in living preferences following the pandemic, and
- the effect of lower population growth (particularly students) over the last few years.

In terms of mortgage payments, a 40%+ increase in one year is higher than any other time since the 1970s. The Reserve Bank has started to express some doubt over further rate rises, but the market is expecting another 1.25%+ of rate rises.



Affordability was already as poor as it had ever been in some markets before the rate rise, and housing valuation and affordability statistics worsened over September 2022. For investors, rental yields improved a little as rents rose while prices fell, but yields are still very low versus history, and interest rate rises would have swamped any gains for investors looking to borrow.

Markets are pricing in an extraordinary 7%+ mortgage rates over the next year. That would double the 2021 mortgage repayments for a 20% deposit mortgage. Given Australia has (a) the second most-indebted consumers in the world and (b) mostly variable interest rates, it seems unlikely that interest rates can rise that far without crashing the property market.

What are the limits to house prices?

Valuing the overall housing market is difficult given the rise in Australian house prices over the last 30 years, but there are limits. If house prices grow at 10% p.a. for the next 20 years, and wages/rents kept going up at their historical rates then:

- The median Sydney house price would be over $7 million.
- The median Sydney house price would be 45x higher than the median wage.
- Even if you managed to scrape together the 5% deposit (only twice the median annual pre-tax salary) to qualify for a 95% mortgage, the mortgage payment would come in at almost 3x the median pre-tax salary.

That's not a realistic vision of society to me. There are a number of key inputs into housing valuation, but interest rates are the most important. Other limiting ratios are:

- **Mortgage payments to rent:** comparing the cost of a mortgage with the cost of renting the same house. Using this ratio to constrain house prices, we assume that people will prefer to rent when the ratio gets high rather than buy.

- **Mortgage payments to wages:** assuming when the ratio gets high, people rent because they cannot afford to buy.

- **Property prices to wages:** assuming when the ratio gets high, people rent because they cannot save enough money to afford a deposit. We treat this as less important than the above two ratios.

- **Rental yield:** Rental yield is the annual rent divided by the property price. By using this ratio to forecast prices, you are assuming when the ratio gets low, investors will not buy property as they are not getting a return that is high enough.

Cheap or Expensive: Current vs Historical Values

Current Value as a Percentile. 1% = Cheap, 100% = Expensive

House affordability at record poor level except Perth.

		Affordability			Investment Returns	
		Mortgage Payment / Rent	Mortgage Payment / Full Time Wage	Property Price / Full Time Wage	Gross Rental Yield	Net Rental Yield Less Interest Rate
Houses	Sydney	100%	100%	98%	98%	55%
	Melbourne	100%	100%	98%	98%	62%
	Brisbane	97%	98%	99%	99%	68%
	Adelaide	91%	99%	100%	99%	56%
	Perth	62%	86%	92%	58%	58%
Units	Sydney	97%	91%	89%	95%	44%
	Melbourne	93%	82%	83%	95%	65%
	Brisbane	72%	50%	74%	61%	38%
	Adelaide	83%	78%	92%	87%	50%
	Perth	52%	41%	53%	[illegible]	34%

Source: Nucleus Wealth, RBA, ABS, Domain, Rismark, SQM

Units not terrible in Brisbane + Perth

Absolute rental return very poor, relative to mortgage rates=average.

3 month Change in Valuation Ratios

Green = becoming cheaper, Red = more expensive

3 affordability measures smashed by rising interest rates, the other 2 improved

		Affordability			Investment Returns	
		Mortgage Payment / Rent	Mortgage Payment / Full Time Wage	Property Price / Full Time Wage	Gross Rental Yield	Net Rental Yield Less Interest Rate
Houses	Sydney	36.9%	15.4%	-0.1	0.1%	-1.7%
	Melbourne	27.6%	10.8%	-0.1	0.1%	-1.7%
	Brisbane	20.6%	8.4%	-0.1	0.1%	-1.7%
	Adelaide	22.8%	10.4%	0.2	0.0%	-1.7%
	Perth	18.8%	6.4%	0.0	0.0%	-1.7%
Units	Sydney	18.2%	8.2%	0.0	0.2%	-1.6%
	Melbourne	18.9%	6.1%	0.0	0.1%	-1.7%
	Brisbane	20.0%	6.7%	0.3	-0.1%	-1.8%
	Adelaide	23.6%	6.4%	0.3	-0.2%	-1.9%
	Perth	13.3%	3.5%	0.0	0.2%	-1.6%

Source: Nucleus Wealth, RBA, ABS, Domain, Rismark, SQM

Property Valuation Ratios

Syd about to crack 100%

Melb joins 200% club, i.e. mortgage cost = double the cost of renting

		Affordability			Investment Returns	
		Mortgage Payment / Rent	Mortgage Payment / Full Time Wage	Property Price / Full Time Wage	Gross Rental Yield	Net Rental Yield Less Interest Rate
Houses	Sydney	237%	99%	16.0	2.7%	-4.2%
	Melbourne	209%	70%	11.4	2.9%	-3.9%
	Brisbane	158%	55%	9.0	3.9%	-3.3%
	Adelaide	147%	57%	9.3	4.2%	-3.1%
	Perth	118%	39%	6.3	5.2%	-2.4%
Units	Sydney	162%	51%	8.2	3.8%	-3.4%
	Melbourne	144%	38%	6.2	4.3%	-3.0%
	Brisbane	119%	32%	5.1	5.2%	-2.4%
	Adelaide	119%	30%	4.9	5.2%	-2.4%
	Perth	100%	21%	3.4	6.2%	-1.7%

Source: Nucleus Wealth, RBA, ABS, Domain, Rismark, SQM

Detailed charts for the above locations can be found in the property detail update. For more on how and why we use these ratios see our residential real estate forecasting methodology.

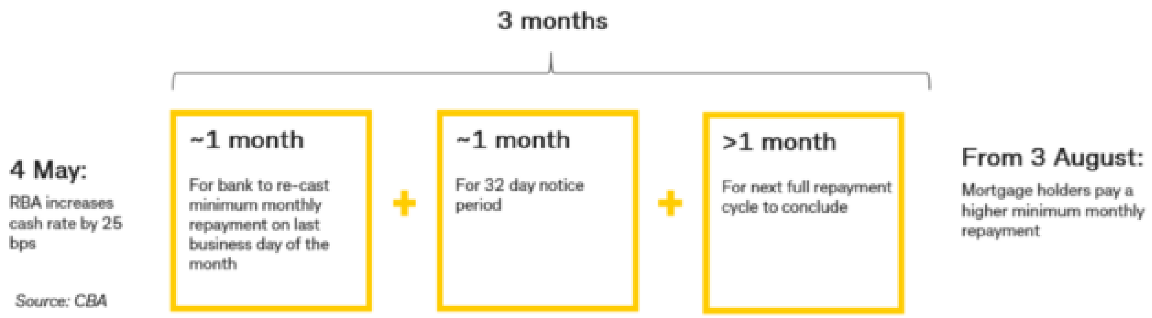
Waiting for the effects of rate rises

CBA economist Gareth Aird has an apt analogy of the person at the bar who has just downed five shots in a row but doesn't feel drunk yet. The effect is coming but it is delayed.

The delay is in four parts:

1. Delayed direct impact of rate rises. Typically rate rises take 2-3 months before affecting cash flow for a borrower. i.e. only 0.25-0.75% of recent increases have actually been felt by borrowers.

Flowchart 1: Example of May 25bp cash rate increase for a CBA mortgage holder on a monthly repayment cycle



2. Delayed effect due to greater than usual concentration of fixed-rate mortgages. In March 2020, the Reserve Bank also introduced a facility where they lent directly to the banks at 0.1% for three years. This facility (and other market interventions) allowed banks to drop three-year fixed mortgages to around 2%. In response, fixed mortgages went from 10-15% of refinancing to over 40%. These will roll off, but in the interim, there are far more people who will be unaffected by the rate rises until they refinance.

3. Delayed indirect impact of rate rises. From the 3 months, for borrowers to actually notice and change spending patterns. For businesses that rely on consumer demand, it can take another few months before the effect flows through.

4. Delayed second-order and above effect. The economic multiplier compounds the effect for months going forward. i.e. consumers spend less on eating out which means that restauranteurs have less money to spend and then may lay off staff who also reduce spending. The effect of this echoes multiple times through the economy. Typical estimates suggest 1-2 years for changes in monetary policy to have the full effect.

The net impact is that the valuation ratios we have included in this report reflect the latest interest rate hikes announced by the central bank. The economic impacts, and the impact on house prices, are largely yet to come. When these factors are considered, we find that with higher interest rates, we need never-seen-before valuation ratios for house prices not to fall.

Damien Klassen is the Chief Investment Officer at Nucleus Wealth. This article is general information and does not consider the circumstances of any investor.

The proposal on capital raisings and franking is misguided

Kevin Davis, Christine Brown

The Government currently proposes two changes to legislation involving franking credits.

1. Preventing franked distributions when funded by certain capital markets raisings

Federal Treasury recently completed a consultation process on a Bill that amends taxation law to prevent certain franked distributions that are funded by capital raisings. In its background document, Treasury says this on imputation:

"The imputation system has the effect of allowing income tax paid by Australian corporate tax entities to be taken into account when determining the taxation of their resident members on the distributed profit of the entity. When an Australian corporate tax entity distributes profits to its resident members, it can also pass on a credit for income tax it has paid. This is done by franking the distribution ... If an entity is unable to frank a distribution and makes an unfranked distribution instead, the receiving entity includes the amount of the distribution in its assessable income, but it is not entitled to a tax offset."

The Bill proposes an integrity measure to prevent this distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities, such as when distributions are made outside or additional to the company's normal dividend cycle.

2. The 2022 Budget clamp down on off-market buybacks

No specific details other than to "align the treatment of off-market buybacks with on-market buybacks" have been announced, but it is expected that no franked payments will be allowed as part of an off-market buyback (that is, it will be a capital return).

The following article, written as a submission to Treasury before the Budget announcement, explains why the first proposed change above is wrong but the second proposal has merit.

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1. The proposed legislation [the first item above] on disallowing franking on certain capital raisings is misguided and addresses the wrong problem. It also unnecessarily complicates tax legislation via the discretion given to the ATO to determine when franking of dividends involved is to be disallowed. It is not the (near) simultaneous raising of equity to finance a distribution to shareholders which is the problem. It is the streaming of dividends which should be the concern.

2. A much simpler solution to the problem of preventing streaming of franking credits (with its inherent cost to government tax revenue) would be to abolish the ability of companies to undertake what we have called TOMBS (Tax-driven Off Market Buybacks). Companies wishing to make returns of capital (one component of TOMBS) would still be able to do so via buybacks where the amount involved is treated solely as a return of capital. Companies wishing to pay franked dividends which would reduce their franking account balances (FABs) would be able to do so by way of a special franked dividend paid pro-rata to all shareholders.

There is nothing inherently wrong with raising cash needed to do so by issuing new equity. Under the imputation tax system, company tax paid is meant to be a prepayment of investor level tax, and unused franking credits in a company's FAB are a withholding of tax credits due to shareholders.

3. The original ATO Taxpayer Alert (TA 2015/2) from which this proposed legislation stems, posed the problem as being the linking of an equity capital raising with:

"[a]t a similar time …, the company makes franked distributions to its shareholders, in a similar amount to the amount of capital raised. This may occur as a special dividend or through an off-market buy-back of shares, where the dividend forms part of the purchase price of the shares."

The ATO forecast that implementing a ban on these practices (as proposed in the draft legislation) would resulting in a saving to tax revenue in the order of $10 million p.a.

4. This is a trivial amount compared to the cost to tax revenue arising from the use of TOMBS. In our research1 on TOMBS, we estimated that in 2018 the tax revenue cost from TOMBS conducted in that year alone to be in the order of $2 billion. Recent calculations we have made for the years 2019 and 2020 (years which had many fewer TOMBs, partly due to the COVID pandemic in 2020) suggest that the tax cost for those two years together was in the order of $500 million.

These costs arise regardless of whether or not the company needs to undertake an equity issue to finance the cash outflow involved – indicating that the focus of the legislation on the 'near simultaneous' equity raising is addressing a trivial, rather than the real, problem.

5. The ATO Taxpayer Alert also refers to concerns over special franked dividends where the cash outflow is essentially financed by a cash inflow from a separate equity raising. This is misguided. For example, a company may have a positive franking account balance, be legally able to pay a dividend, but not have cash on hand. There is nothing inherently wrong with raising cash via an equity issue to pay a franked dividend. For example, the company may have had a period during which it was profitable and paying tax, but adopting a low dividend payout ratio due to opportunities to profitably invest the available cash flow. Subsequently it may find itself in a position where it is profitable and 'asset rich' but 'cash poor' and wishing to reward existing shareholders for forgoing past dividends and associated franking credits. There is nothing inherently wrong with raising cash via an equity issue to pay a franked special dividend.

6. We conclude that the proposed legislation [proposal one above] is inferior to an alternative course of action which:

a. Effectively bans TOMBS by legislating that off-market share buybacks involve only a return of capital and no dividend component. (This is more consistent with practices found in other jurisdictions. The inclusion of a dividend component is solely an artifact of dividend imputation and willingness of the ATO to allow a franked dividend component).

b. Does not place unnecessary restrictions on the use of special franked dividends by companies – particularly by not precluding simultaneous equity raisings.

Submission to the Treasury Consultation, September 2022 by Christine Brown, Emeritus Professor of Finance, Monash University and Kevin Davis, Emeritus Professor of Finance, The University of Melbourne.

1 Christine Brown and Kevin Davis "Tax-driven Off Market Buybacks (TOMBs): Time to Lay them to Rest" Australian Tax Forum, 35, 2, Jun 2020: 232-257.

Christine Brown and is Emeritus Professor of Finance at Monash University and 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.

Why gold is often regarded as money

Sawan Tanna

In his testimony before Congress in 1912, American financier and investment banker, J.P. Morgan stated:

"Gold is money. Everything else is credit."

In this article we look at the definition of money and discuss why many still regard gold as 'real' money.

According to the classic definition, money must have three fundamental properties:

1. It must function as a medium of exchange – that is any item that is widely accepted to facilitate transactions between buyers and sellers of goods and services.
2. It must be a unit of account – that is a standard unit of measurement for the value of goods and services.
3. It must also be a store of value – that is any item that holds its value over time.

Commodities as money

Money was invented because of the shortcomings of barter, the act of trading one good or service directly for another one.

Commodities – items for which there was consistent, broad-based demand – were particularly sought-after. These special items could be on-traded for a wider choice of goods at some time in the future. Thus, certain commodities acquired monetary value.

Once commonly used in parts of Asia, Africa and Oceania, cowrie shells were a popular form of commodity money.

When the convict colony of New South Wales was established in 1788, the authorities saw no need for money. This policy led to the acceptance of rum (or strong alcoholic spirits) to fulfil the role.

As well as shells and alcohol, commodities used as mediums of exchange have included barley, salt, peppercorns, tea, cocoa beans, silk, silver and gold.

Of these, the last two were most widely acceptable and hence most strongly identified as money.

Why is gold valuable?

Some people argue gold has little or no intrinsic value. It's undeniable, however, that its relative rarity and beauty has intoxicated humanity for millennia.

In *The Power of Gold*, Peter L. Bernstein, declares:

"Gold has motivated entire societies, torn economies to shreds, determined the fate of kings and emperors, inspired the most beautiful works of art, provoked horrible acts by one people against another, and driven men to endure intense hardship in the hope of finding instant wealth and annihilating uncertainty."

Associated with power and wealth for as long as humanity's collective memory can recall, gold has always been valuable and will continue to be so in the future. The first gold coins appeared in Lydia as long ago as the 6th century BC. The ancient Anatolian kingdom recognised other vital properties of gold as a suitable material for coins.

Gold is malleable enough to be easily worked, resistant to tarnish, and all but indestructible. As the prime example of commodity money, the value of gold coins is linked to their weight and precious metal content.

Representative money

The idea of 'representative money' emerged in Europe during the 17th century. Its roots lay in the receipts issued by goldsmiths to their depositors. Not only could these promissory notes be exchanged for their face value in metal, but they became a convenient way of making payments.

In 1694, the Bank of England was the first public bank to issue official notes which could be exchanged by the 'bearer' for gold.

By the late 19th century, many of the world's paper currencies were pegged to gold at a set price per ounce under an international monetary system known as the Gold Standard.

While the use of gold as an international means of valuing currencies was helpful in stabilising rates of exchange for trade, it also restricted governments' ability to print money at will.

Gold certificates, used as paper currency in the United States from 1882 to 1933, were freely convertible into gold coins. (Image credit: Public domain)

In this article, Nick Liondis states:

"The appeal of a gold standard is that it arrests control of the issuance of money out of the hands of imperfect human beings. With the physical quantity of gold acting as a limit to that issuance, a society can follow a simple rule to avoid the evils of inflation."

However, the ever-increasing demand for paper money put the Gold Standard under enormous strain during the 20th century. Banks were simply unable to hold enough gold and the failure of the final effort to reform the system after World War II prompted US President Richard Nixon to announce the suspension of dollar convertibility to gold in 1971.

Fiat money

The new era hailed the predominance of 'fiat money'. A Latin word meaning 'let it be done', fiat is defined in modern dictionary terms as a 'decree' or an 'order'.

From this time on, the world's major currencies were no longer linked to a physical commodity, but to the will (and creditworthiness) of the governments that issued them.

Fiat increases governments' abilities to stimulate their economies by increasing the money supply – simply through printing more notes or through measures such as quantitative easing, which has been described as creating money out of thin air.

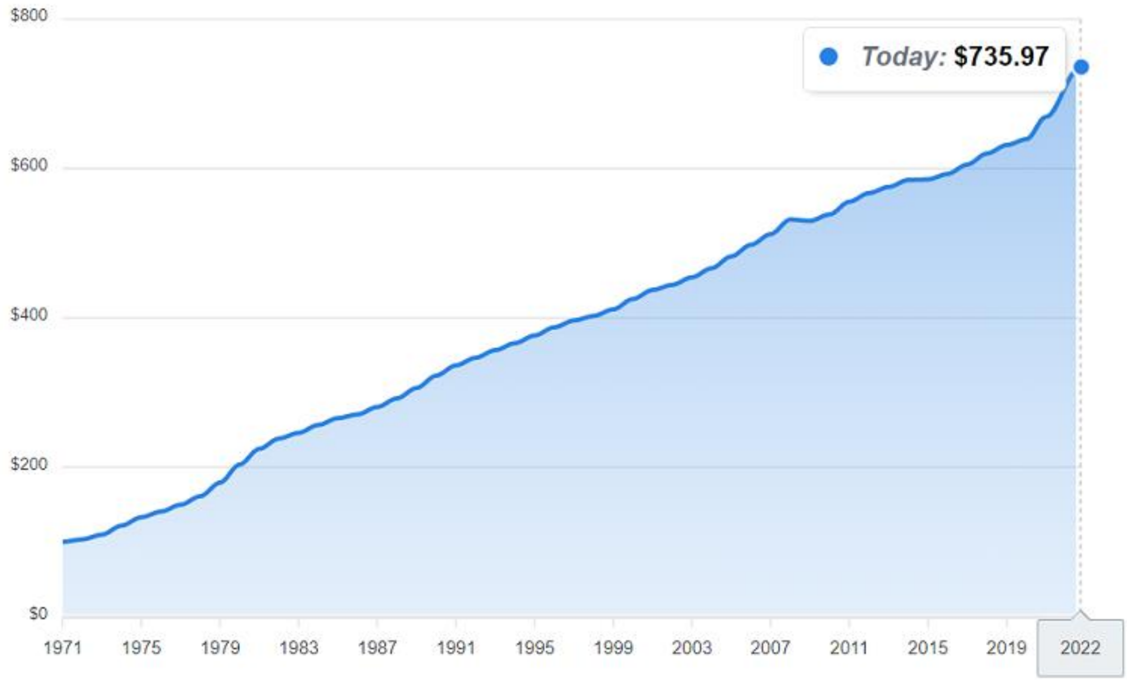
However, increasing the money supply faster than growth in real output is a major cause of inflation – the decline of purchasing power of a currency over time.

The curse of inflation

History is littered with examples of currencies that have fallen victim to extreme inflation, among them the German papiermark, Hungarian pengo and Zimbabwean dollar which became worthless in the face of rapidly-rising prices.

Even the mighty US dollar is far from immune from the effects of inflation. Since 1971, the greenback has lost huge amounts of purchasing power. According to inflationtool.com, average annual inflation in the US during this period to 2022 equals 3.99%, meaning that US$100 in 1971 are equivalent to US$735.97 today.

Inflation timeline in the United States (1971-2022)
(equivalence of US$100 due to compound inflation and CPI changes)



Source: inflationtool.com, accessed 19 September 2022.

This has serious implications for savers and investors, and challenges the contention that money, under its classic three-pronged definition, is a long-term store of value.

As George Selgin has written:
"To insist that money must serve as a 'store of value'… begs the question: in what meaningful sense could Papiermarks be said to have served as a 'store of value' in Germany during the autumn of 1923?"

Where gold shines

Judged against this viewpoint, fiat currency fails the definition of money and yet even when it becomes almost worthless, continues to be regarded as a unit of account and medium of exchange.

On the other hand, gold, which served as money for a long period of time, no longer retains these two characteristics. You can't easily buy something with a gold coin! What gold has done, however, is retain a historical store of value characteristic.

Among the studies that have analysed this assertion in depth is Roy Jastram's seminal work *The Golden Constant*. Originally published in 1977, it examined gold's purchasing power from 1560 in Britain and in the US from 1800. Economic adviser Jill Leyland, who updated the work to look deeper into the post-1971 world, said it is: "*the first statistical proof of gold's property as an inflation hedge over the centuries."*

Central banks around the world – the very institutions that replaced gold with paper – understand this well, evidenced by the continuation of their buying spree that's now at a 30-year high. As the De Nederlandsche Bank is often quoted:

"A bar of gold always keeps its value. Crisis or not. That gives a safe feeling. The gold holdings of a central bank are therefore a beacon of confidence."

What can we conclude?

From the above discussion, it's possible to conclude that:

- The role of paper money as an easy medium of exchange that is recognised and accepted globally will continue.
- Inevitably, fiat currencies will remain subject to manipulation and failure.
- Since 1971, the price of gold has floated against global currencies and as such rises whenever they weaken.
- Although no longer a primary form of currency, gold can be used as an effective hedge against inflation.

Gold acts as an insurance policy against inflation and global uncertainties and is an asset diversification strategy for risk management.

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Diversified opportunities in emerging market debt

Kristin Ceva

While most investors think that investment in emerging markets (EM) must be through equities, it may be that emerging market debt is the better option. EM debt offers diversification and potentially a more attractive risk return profile for investors wanting to benefit from exposure to emerging markets.

Of course, the past 12 months has been a challenge for equity and fixed income investors globally. We have seen inflation surprises in almost all countries and central bankers have been forced to pivot to extreme hawkishness as a result. Adding to this global stress is the ongoing geopolitical tension caused by the war between Russia and Ukraine.

Clearly, this year has been particularly challenging for fixed income investors, who are not used to seeing equity-like market downturns.

However, there are still plenty of opportunities in this asset class in certain sectors and we would argue that EM debt is one such area that investors should explore.

Potential benefits of emerging market debt

EM debt is well diversified across countries and types of debt. In a fully 'blended' EM debt approach (three equal parts sovereign, corporate, and local debt), the top 10 countries combined only have a 50% share. More than 80 countries are represented in EM **debt** indices, versus 52 countries between the mainstream/frontier EM **equity** indices. The main EM equity index is almost one-third China risk, while the top four countries (China, India, Taiwan and South Korea) together make up about 70% of the opportunity set.

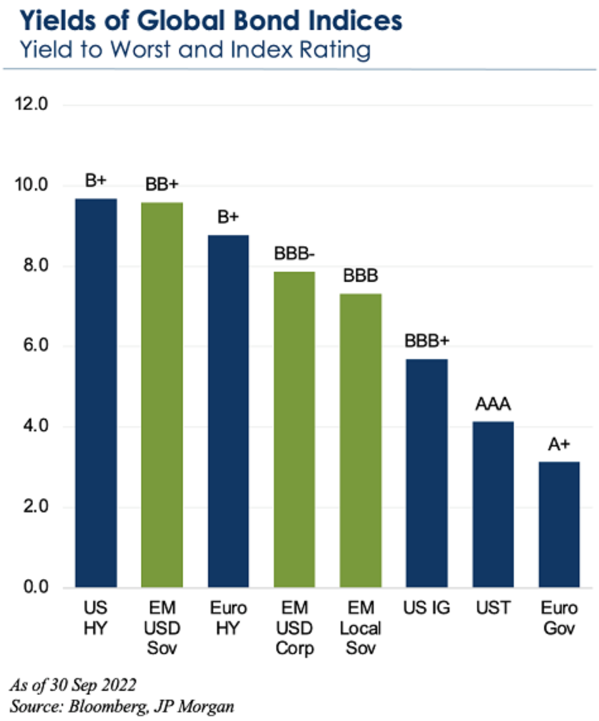
EM debt investors engage with both governments and companies, and almost all their return is derived from income, with capital appreciation playing a minimal role in the long-run return.

EM debt also offers more return for less risk than EM equities. Over the past 20 years, the main EM equity index has approximately 2.5 times the volatility of the main EM debt indices (either sovereigns or corporates). And while EM equities have generated higher absolute returns over this time, when adjusted for the volatility, EM debt returns are about 40% higher than EM equities.

Where are the opportunities?

While fundamentals are under varying degrees of pressure the world over, within the diverse EM debt market there are some countries that are holding up better than others.

The key opportunity that has emerged is the long-run carry available to investors in EM debt. The EM sovereign debt index offers a yield of over 9%, EM corporate debt is yielding almost 8%, and many EM local markets (aside from China) offer yields of 7-13%. Based on history, the forward-looking return profile for entering EM debt markets today looks attractive.



Cyclically, the best opportunities are likely to be in EM high-yield credit. While a few countries and companies are struggling in this environment, many have sold off based more on market conditions than any fundamental issue. As a result, we see yield levels in high-yield credit that don't come around often.

We like exposures in Mexico (particularly corporates and local rates), Brazil (also corporates and local rates), Indonesia (sovereign-related and corporate issuers), South Africa (local rates), India (corporates), Uruguay (inflation-linked local rates), and among high-yield sovereigns we favor Ivory Coast, Dominican Republic, Guatemala, Paraguay, Angola, Jordan, and Uzbekistan.

In these markets there are opportunities across proactive central banks, resilient sovereign and corporate balance sheets, issuers with less reliance on regular market access (or those that still have market access), beneficiaries from commodities - like higher food and energy prices, and countries maintaining some reform momentum and/or fiscal discipline, sometimes along with support from institutions like the IMF.

In corporate debt, we prefer exposures in utilities, telecoms, consumer names and infrastructure. Good investors need to focus on issuers that are resilient to the current backdrop and look for names that have healthy and predictable cash flows, stronger sovereign support, good transparency, and/or investor-friendly structures.

Here are three examples that we believe exhibit those characteristics.

Central America Bottling Corp. (CAMEBO)

Central America Bottling Corp is a leading producer, distributor and seller of beverages in Latin America. The company has been the anchor bottler for PepsiCo in Central American since 1998 and has a joint venture with Ambev for distribution in Guatemala, El Salvador, Honduras and Nicaragua. The company is well-diversified geographically and experiences limited foreign exchange volatility given the currencies in the countries it operates in are relatively stable. Camebo has a long-standing relationship with PepsiCo and has a 30-year contract with Pepsi in Peru and Ecuador. The company has low net leverage of 2.3 times debt to equity, and revenues of US$1.9 billion with EBITDA of US$250 million. We think the bonds are attractive based on the 7.5% yield for bonds that mature in 2029 and think the company will be relatively defensive in the face of weaker global growth trends.

Cable & Wireless (CWCLN)

Cable & Wireless is a telecom provider offering mobile, broadband, video and fixed-line services for residential customers in Panama, Jamaica, The Bahamas, and Barbados. C&W also has IT and wholesale services for the commercial segment. The company is owned by Liberty Latin America and has moderate net leverage of 3.8 times debt to equity. In the most recent quarter, revenues were up 5% year on year to US$596 million and EBITDA was up 9% year on year to $254 million resulting in relatively high EBITDA margins of 43% (up by 200 basis points relative to last year). Subscribers increased by approximately 11,000 over the quarter, to 2.1 million. The company maintains strong liquidity with cash of US$770 million and US$792 million of undrawn credit facilities. We think the unsecured notes due 2027 are very attractive at 11.5% yield.

India Cleantech (ACMSOL)

India Cleantech is a solar power producer based in India. The company has 12 solar facilities across India, totaling 450 MW of capacity. About 60% of India Cleantech's counterparties are central government entities and the remaining 40% consists of seven state electricity distribution companies. Total debt at the entity is approximately US$325 million and we estimate scheduled amortization for 2023 will total US$6 million. This compares to EBITDA of US$55 million, providing for a significant cash flow buffer relative to debt service. Given the strong cash flow generation, we expect additional amortization of approximately US$15 million in 2023, which will enable the company to organically deleverage. Moreover, India Cleantech's parent company Acme

Solar has a strong financial profile, with US$1.7 billion of assets and 3.4 GW of total operational capacity. ACMSOL 2026 notes yield 13.5% which we find very attractive relative to BB credits within emerging markets.

Final points

Overall, we believe a lot of the global bad news has already manifested in valuations this year, and more nuances will emerge into 2023-24 as inflation rolls over, growth slows, and central banks pause or even turn to easing. The playbook for investors will likely change considerably over the next 6-12 months, so being nimble and alert to the evolving economic data will be important.

Kristin Ceva is Managing Director at Payden & Rygel, 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 Payden & Rygel and should not be relied upon as the basis of your investment decisions. EM debt exposure is included in the Payden Global Income Opportunities Fund.

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