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## Contents

Darryl and Sal Kerrigan are now private equity investors *Kieran Rooney*

What a global tech arms race means for investors *Alison Savas*

It's time to question investment truisms *Tom Stevenson*

Why private equity can continue to outperform *José Luis González Pastor*

Don Sanders: the most distinguished banker in Australia's history *Rob Ferguson*

Opportunities in Floating Rate Notes *Matthew Macreadie*

Director identification numbers – time is ticking! *Julie Steed*

## Editorial

Here's a tweet from a financial commentator I thought worth exploring:

There are 4 types of Wealth:

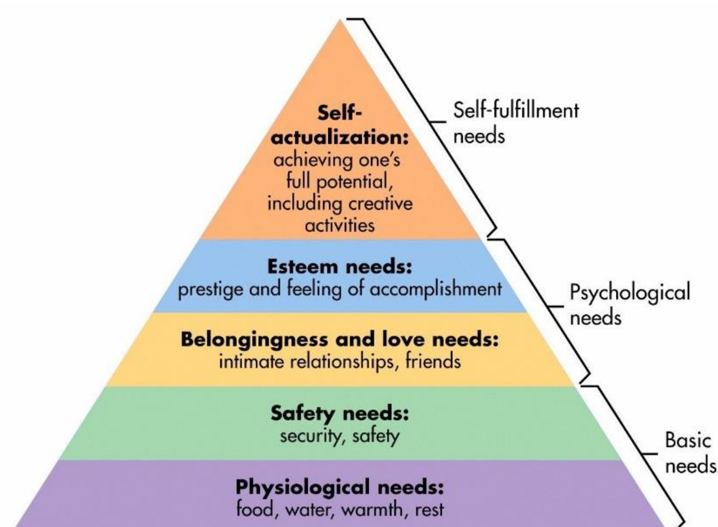
1. Financial Wealth: Money
2. Health Wealth: Physical
3. Social Wealth: Network
4. Time Wealth: Freedom

Most people think #1 buys you 2, 3 & 4.

But that order is incorrect.

#2 & #3 are free and are integral to achieving #1, which then buys you #4.

Let's first look at financial wealth. Almost everyone would agree that money is relatively important. It enables basic human needs to be met such as food and shelter. It also allows potential luxuries or human wants to be met too. Financial wealth helps fulfill the key building blocks of psychologist Abraham Maslow's famous hierarchy of human needs.




The amount of money needed to be financially wealthy is a matter of debate. For people in poorer countries, a few dollars can mean real wealth. In parts of Australia, a million dollars doesn't get you far. Therefore, financial wealth is important but relative.

Turning to health wealth, physical health is undoubtedly crucial. Without it, we can't live. And poor health can impair quality of life as well as the longevity of life.

I would add mental health to this category. Science is uncovering more evidence of how the body and mind are connected. Just the other day I went to the physiotherapist for lower back pain, and he diagnosed the cause to be not physical but stress from taking up a new job. In other words, *Firstlinks* has a lot to answer for!

The third category of social wealth is where my views start to diverge from the author. I suspect by 'network', the author means the creation of a network through networking. In other words, forming a network of people who will help you reach your work or business goals, and ultimately, your financial goals.

I've always thought networking, and the creation of a network, is overrated in the pursuit of goals. Many will disagree with this and provide evidence to the contrary. My view is that if you create value for people, your network will grow organically. Perhaps this is naive.

My idea of a network is different. It's principally the bedrock of family and friends. As well as that organic network of acquaintances who you've helped, or are helping, or vice versa.

Let's move on to the final category of wealth: time wealth. I hear this a lot in the financial community: time is the ultimate commodity. Is it though? I've had enough contact with my parents' generation, retirees in their 70s and 80s, to know that some retirees are financially secure and have all the time in the world but don't have a clue what to do with that time. Golf and bowling don't seem to provide a cure-all for their boredom. Taken to the extreme, you can have 365 free days each year, yet if you don't know how to fill them, they aren't so valuable anymore.

To the above template of wealth, I would be tempted to add a fifth type of wealth: purpose or purposeful wealth. Purpose or meaning may underlie all the other types of wealth mentioned here. As the philosopher, Friedrich Nietzsche, once said: "He who has a why to live for can bear almost any how."

For a vast span of human history, religion has provided purpose. For Christians, it's God and the afterlife. For Muslims, it's the five pillars of Islam, with belief in God and obligations of prayer, charity, pilgrimage and fasting. For Hindus, it's belief in Brahman, and concepts such as Karma and Dharma. Interestingly, Dharma as outlined in the Hindu core text, the Bhagavad Gita, is about the quest to find one's true purpose in life.

With the decline in religion in recent times, many people have sought to find alternative beliefs to fill the void. They've certainly chased the four types of wealth mentioned already: money, physical health if not peak physical performance, networking and freedom.

Perhaps purposeful wealth can be added to the mix. What type of purpose, you may ask? I wish I knew the answer. My own observation of wise and happy people inside and outside the finance industry is that helping others, whether family, friends or strangers, seems to provide meaning. I'm sure there are many things that can provide purpose too.

What are your thoughts on the four types of wealth? I welcome any feedback and suggestions on the topic.

**Also in this week's edition ...**

**Keiran Rooney** of Evergreen Consulting looks at what reforms need to happen for unlisted asset valuations at superannuation funds to reflect real world valuations more accurately. Increased exposure to unlisted assets, such as private equity and venture capital, have helped hold up the returns of many super funds this year.

Where Kieran is somewhat critical of super funds for investing in private equity to smooth out returns over time, **José Luis González Pastor** sees this as a strength of private equity's rather than a liability. He makes the case for private equity offering lower volatility than public markets in turbulent times and attractive performance over time.

**Tom Stevenson** of Fidelity International believes it's time to question several investment tenets that may not stand the test of time. He puts the 60/40 portfolio, gold as an inflation hedge, growth investing and China's ascendancy under the microscope.

Meanwhile, **Alison Savas** at Antipodes Partners sees an underappreciated risk to markets: the global technology arms race between the US and China. She examines how the race may play out and what it means for investors.

And this week, we have the pleasure of welcoming **Rob Ferguson** as a guest contributor. Rob is widely known as the former boss of BT Australia and a finance industry doyen. In his article, he offers a touching tribute to

Don Sanders, the former Commonwealth Bank CEO and Reserve Bank Deputy Governor. He has high praise for Sanders, calling him the most distinguished banker in Australia's history.

*Firstlinks* has previously written about the potential merits of high-yielding Floating Rate Notes (FRN) in a rising inflation environment. **Matthew Macreadie** from Income Asset Management is also a fan and makes the case for Ampol subordinated notes as being especially attractive.

Lastly, **Julie Steed** reminds us that registrations for director identification numbers (director IDs) are due at month-end. She offers a guide for what you need to know and what you need to do.

This week's White Paper from **Capital Group** suggests that, despite the challenges faced in 2022, attractive opportunities remain across four key credit markets.

**James Gruber**

## Darryl and Sal Kerrigan are now private equity investors

### Kieran Rooney

In 1997, the low-budget cult hit film, 'The Castle', which depicted the quintessential Aussie family and the fight for their home, was released to critical acclaim. The famous line, "*A man's home is his castle*", captured then, as now, the Australian dream of owning a home, traditionally one's largest and most important asset. Little did the Kerrigans, introduced to us a mere five years after compulsory superannuation, realise that we'd accumulate trillions of dollars in superannuation wealth, increasingly concentrated in mega funds that have now become some of the largest allocators of capital in the world.

In the last decade, these mega funds have increasingly been allocating low and middle-income Australia's hard-earned dollars in sophisticated and opaque unlisted assets. Gone are the days of just owning a holiday rental in Bonnie Doon. The Kerrigans are now private equity investors.

The problem is these assets don't trade on an open market and are valued infrequently. Big super, or the mega funds, sell this as a feature, smoothing the ups and downs of the investment cycle. However, as these funds offer thousands of co-mingled members daily liquidity to contribute or withdraw funds, there is a funding mismatch. And are these valuations fictitious or real?

**How private equity returns are calculated**

Private Equity 101 would suggest we ask a private equity manager what their historical rate of return - typically measured as Internal Rate of Return (IRR) - is across all their deals. Breaking up this track record across funds or 'vintages' also helps to consider a manager's performance across the investment cycle. Whilst gross IRR reports total return, net IRR shows the return net of all fees, essential for assessing how much of the pie the manager is eating before they feed you. Realised IRR shows the return to investors from investments that have been exited. If Net IRR is notably higher than Realised IRR, then unrealised investments in the strategy may be getting carried at very high values.

The Total Value to Paid In ratio (TVPI) measures the sum of distributions and carrying value on investments made as a multiple of all funds paid into that vehicle. For example, a TVPI of 2.0x would indicate that at today's carrying value, an investor has doubled the money they have contributed – paper wealth. The Distributions to Paid In ratio (DPI) strips out carrying value and merely shows how much has been paid back to date – money in the bank. The goal is to convert carrying value embedded in TVPI into DPI as a vintage matures and underlying assets are successfully exited. If a manager has old vintages where TVPI is still much larger than DPI, questions need to be asked.

Currently the amount of TVPI over DPI is at record levels at an industry level. As carrying values have become inflated over the last decade, some experts estimate that it will take as much as $600 billion of impairments in Venture Capital alone to get TVPI back down to historical norms. Private Equity is an even bigger beast.

Since 1994, 1,276 private equity funds over $1 billion have been raised around the world. Only 22 have managed to return more than 2.3x, a return considered consummate to compensate for the risk and illiquidity of these investments. The law of large numbers dictates the larger a private equity fund is, the harder to realise returns. Larger 'winners' are required to pay back the invested capital, something data shows is hard to do at scale. Yet the big super funds, due to their size, often preference these larger deals.

**Private market valuations haven't caught up to public markets**

It's hard to know if these dynamics are at play within the super funds, yet as the liquidity tide goes out and public market valuations have been crushed, requisite valuation moves are yet to occur in private markets. Much of the capital globally has been allocated in recent vintages at a time when carrying values and TVPI are far above historical norms. If they invest like private equity investors, Big Super should be required to report like private equity investors. What is the level of unrealised returns they are reporting to members relative to the historical norms they have traditionally been able to realise?

As the illiquidity of these funds' increases, so too does their liquidity risk. Worryingly, APRA has said some funds lack formal liquidity and stress-testing processes whilst others fail to incorporate results into the investment decision making process. All these funds offer daily liquidity and pricing to members who are free to withdraw pensions, contribute funds or switch investment options at the click of a button. Yet many of the underlying assets are valued quarterly at best and are completely illiquid.

**Reform is needed**

Standardised liquidity and stress testing should be introduced, and the findings made public, along with the methodology and assumptions used, just as it is for banks. This way, Australians can assess the funding risks inherent in their super.

Innovations are on the way to provide more liquidity for unlisted assets. Platforms where investors can allocate to private assets, but also realise them sooner by listing them in a secondary market, are now available. Listed Investment Trusts (LITs) and Listed Investment Companies (LICs) are vehicles listed on public exchanges that can hold unlisted assets and provide daily liquidity at prevailing market pricing. Given disclosure requirements in public markets, reporting is essential and far superior to that provided by the mega funds.

Previously exploited by public market equity managers as asset gathering exercises, the image of LITs and LICs has been tarnished by conflicted commissions, poor performance and thin liquidity. Rejuvenation efforts are underway to build and scale these listed vehicles into credible offerings of unlisted assets for the masses.

Further out on the horizon, massive investment in financial technology and innovation is taking place. The best software engineers from the best schools are joining the crypto and blockchain arms race to create the most effective 'Dex's' (Decentralised Exchanges) that contain 'AMMs' (Automated Market Makers), which pool liquidity from users and price assets using algorithms. The aim is to create deep liquidity for all assets at low transaction fees 24 hours a day, 7 days a week, where nearly any asset or ownership right can be tokenised with key terms coded into a smart contract.

Whilst many attempts will fail, the history of finance and money has taught us that innovation always outpaces regulators and governments. It's innovation that is required to reduce these frictions. Such change will take decades, but the irony is some of the biggest problems associated with unlisted assets may come from the private markets themselves.

In the interim, Big Super will argue that increased disclosures and scrutiny will divulge commercially sensitive information that is contrary to their members' interests. The reality is the information can be presented in a way that respects these concerns. Whilst a reasonable allocation to unlisted assets can improve portfolio outcomes, transparency is key, so risks can be properly scrutinised.

*Kieran Rooney is a Senior Consultant at [Evergreen Consultants](). This article is general information and does not consider the circumstances of any investor.*

## What a global tech arms race means for investors

Alison Savas

It's fair to say geopolitics is the most fraught it's been in the last two decades.

The battle over energy between Russia and Europe has been dominating headlines, while more recently, Nancy Pelosi's visit to Taiwan has set the US and China on a pathway of competitive escalation.

Semiconductors and tech independence play a critical role in US-China relations, and this cannot be resolved quickly given both countries are dependent on Taiwan – or specifically Taiwan Semiconductor Manufacturing Company (TSMC) – for the manufacture of leading-edge chips.

For some time now the US has prevented a small number of Chinese firms from accessing US-designed semiconductors and the equipment to make these chips where it was assumed this technology was being used for military purposes. As tensions between the two global superpowers soured further, we noted the tail risk was how far the US would push to more broadly limit China's ability to innovate.

The US has indeed now taken a further step – introducing sweeping new controls that can limit exports to China of critical technology used to manufacture semiconductors.

Here's what the US Department of Commerce said in an announcement regarding the move:

*"The Department of Commerce's Bureau of Industry and Security (BIS) is implementing a series of targeted updates to its export controls as part of BIS's ongoing efforts to protect U.S. national security and foreign policy interests. These updates will restrict the People's Republic of China's (PRC's) ability to both purchase and manufacture certain high-end chips."*

The details of the new controls show the US is targeting GPU, CPU and DRAM (memory) chips designed in the last five years and the equipment to make these chips, as well as NAND (memory) chips designed over the last three years. There are also specific rules limiting China's ability to import certain AI chips widely used in datacentres and critical to many modern consumer applications.

While this policy stops short of a blanket ban, the goal is to restrict China's access to chips and other technology related to advanced AI and super-computing as these have military applications.

**What are the consequences of this move?**

Most leading-edge semiconductor chips essential for high performance computing are *designed* by US or European companies such as Nvidia, AMD, Broadcom, Marvell, Intel. But the chips are not necessarily *manufactured* by these companies.

In fact, at the leading-edge these semiconductor chips are almost entirely *manufactured* by TSMC.

TSMC has actively retained its leading-edge chip capacity at home in Taiwan, a strategy referred to as the 'silicon shield'. But what's interesting here is that more than half of the equipment used to manufacture globally critical chips comes from the US, with the rest from Europe and Japan.

If Europe and Japan choose to follow the US' lead, it places China in an extremely challenging position. Inability to access chips and furthermore the equipment used to manufacture these chips will meaningfully hamstring not only China's ability to keep up with tech developments in the West, but also hinder China's capacity to develop tech independence.

At first blush, the development of Chinese hyperscalers such as Tencent, Alibaba and Baidu could be impacted as the bulk of datacentre spend is AI-centric even for current consumer use around content creation, search and natural language programming.

Chinese EVs may also see progress curbed relative to Western peers as ADAS chips (advanced driver assistance systems) could be affected. At this stage restrictions on handset chips appears unlikely given the limited crossover with military applications. The language framing these restrictions, which are some of the most comprehensive we've seen to date, suggests these restrictions could be part of a rolling series.

**Much remains up in the air**

How rigorously will the US enforce these license approvals? Will Europe and Japan follow suit? How might the US expand export restrictions or worse initiate bans? Will China retaliate, and on a longer-term basis can China develop this technology internally?

China could choose to respond in a targeted fashion directed at high profile US brands with large profit pools in China such as Apple, Tesla, Nike and Estee Lauder amongst others. China could limit US access to strategic markets that it dominates such as rare earths in the EV battery supply chain.

If the US were to escalate further via an embargo on all investment in China, it would be an extremely negative outcome, not just for China but for the global economy and asset markets.

At this stage we still consider a Taiwan 'hot war' scenario relatively remote given the US and China's co-dependence on Taiwan, or should we say TSMC. For now, China and the US are critically aligned in maintaining a stable Taiwan for the sake of their respective economic stability.

**Uncovering winners in an evolving geopolitical landscape and new market regime**

With regards to the escalating tensions between the US and China, we think it is critical investors monitor developments closely and consider global vulnerabilities should China choose to retaliate.

When it comes to the broader global macroeconomic environment, stagflation (high inflation combined with lower economic growth) remains our base case, and with a mild recession, as China has the potential to loosen monetary policy even as the West is tightening.

The US economy, however, bears close watching as the risk of a 'hard landing' is rising. If the Fed over-tightens to control inflation it risks dragging the US into a deeper recession.

The year so far has been challenging for global equities. Economic data is rapidly weakening, consensus estimates on our analysis are broadly still too high and equity inflows have been slow to reverse. Despite this, opportunities exist. The likely winners in today's world look very different to the winners of yesteryear.

The QE-led growth/long duration regime that dominated the post-2008 investing period is transitioning to a regime that will see policy makers lean on fiscal stimulus to prop up economic activity. In the near term this stimulus will focus on the cost-of-living crisis (as already seen in the UK and Europe), but over the longer term it will focus on investment around decarbonisation, infrastructure and security (defence and supply chains).

The US' Inflation Reduction Act is a great example of this trend. It supports $370 billion worth of investment in energy security and climate change with almost one-quarter of the programme dedicated to re-shoring solar, wind and battery production in the US.

In global markets, there are great opportunities for investors to position for these trends.

While the range of outcomes around inflation and global economic activity remain high, our view is that defensive exposures and beneficiaries of longer-term investment trends can outperform.

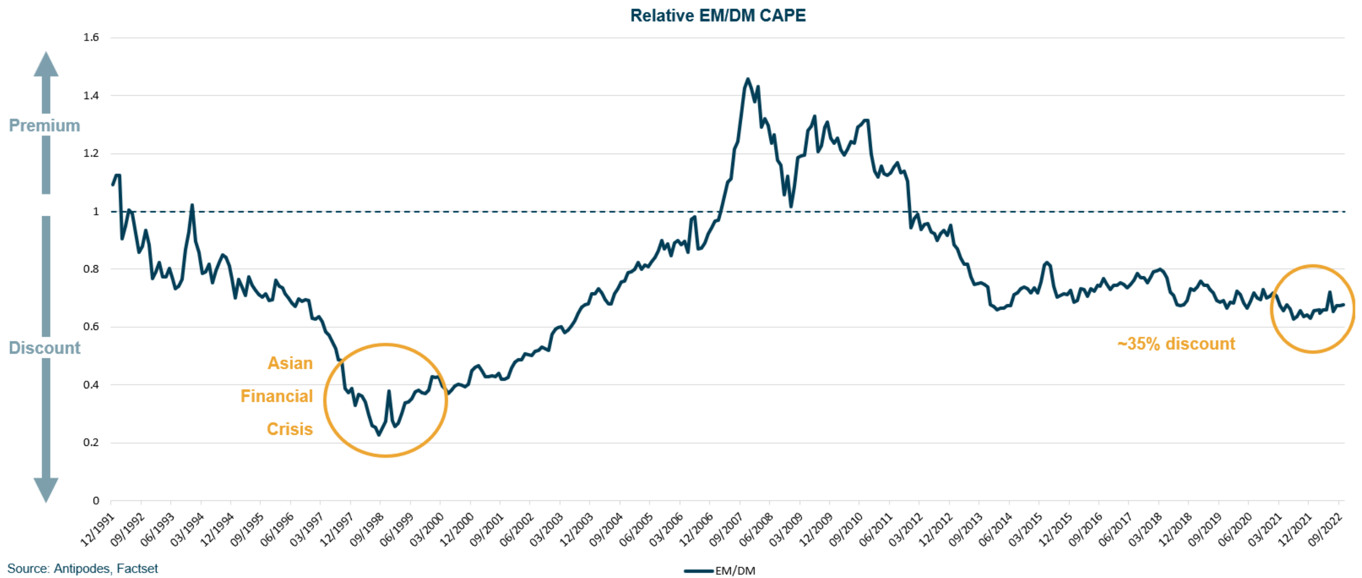
Examples of these exposures in Antipodes' portfolios include:

- **Merck** (NYSE:MRK): lower drug pricing risk and manageable patent risk relative to peers, and a diversified earnings stream from long duration businesses including vaccines and animal health.
- **Gilead** (NASDAQ:GILD): HIV patent cliff pushed out while new treatments are developed to extend dominance, and an under-appreciated pipeline.
- **SAP** (NYSE:SAP) and **Oracle** (NYSE:ORCL): dominate the ERP/enterprise resource planning market (general ledger and accounting software) where transitioning this mission-critical software to the cloud has become a priority in our post-COVID hybrid work environment, and this transition is continuing in even a tougher economic environment.
- **Diageo** (LON:DGE): leading spirits business with 5% share of total alcohol consumption globally that is taking market share in categories that are growing and is facing lower inflationary pressures than other defensive parts of the market such as consumer staples.

**Thinking outside the unipolar lens**

Finally, when looking at geographic diversification, global investors may be well served by considering the world through a multipolar lens.

Emerging markets are valued at around a 35% discount to developed markets – one of the largest discounts in the last 20 years. But while EM hasn't been a popular asset class in recent times, we have been increasing increase exposure to emerging countries such as Indonesia, Mexico and Brazil which are beneficiaries of the evolving multipolar geopolitical landscape, and where valuations and growth rates are attractive.




*Source: Antipodes, Factset*

Indonesia, for example, is benefiting from structural reform following almost a decade of political stability. It has a large and young population, and hurdles around labour laws and infrastructure are being removed. It is a beneficiary of higher commodity prices and can also benefit from diversifying manufacturing bases that are heavily centred in China.

Likewise, Mexico can be a beneficiary of on-shoring and near-shoring manufacturing, which has become a major initiative for US corporations.

In Brazil, the recent passing of the election reduces political risk and balancing the cabinet with more centrist candidates could see President Lula achieve an attractive balance between spending and reform.

Further, currency and bond markets in these countries are showing a high degree of resilience due to much tighter long-term fiscal and monetary policy settings versus many Western equivalents.

So, while we are witnessing one of the most complex environments investors have had to navigate in decades, it's an environment that has also presented pragmatic global investors with great opportunities.

*Alison Savas is a Client Portfolio Manager at Antipodes Partners. Antipodes is affiliated with Pinnacle Investment Management, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.*

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## It's time to question investment truisms

### Tom Stevenson

For almost all of my working life, we've been able to hold onto a handful of truisms about investment. Expressions like 'time in the market not timing the market' become investment adages because their truth endures through the ups and downs of the cycle.

But sometimes, as Jim Callaghan noted about politics in the 1970s, there is a sea change about which we can do nothing, and which is only clear in hindsight. In investment, the most famous of these may have been the start of the so-called 'cult of the equity' in 1956 when George Ross Goobey, the manager of the Imperial Tobacco pension fund, made the then radical claim that shares offered better inflation- and risk-adjusted returns than bonds.

He was right and the rest is market history.

Looking for the equivalent sacred cows today, I was unsettled to discover just how many things I could list about investing that I used to believe unreservedly and about which I'm now not quite so sure.

**1. Balanced fund durability**

First on my list is the foundational belief that dividing your portfolio between shares and bonds will always smooth your investment journey, ironing out the peaks and troughs and helping you sleep better at night. This year has been a shocking reminder that in certain circumstances (think high inflation and central banks prepared to risk recession to get it under control) both bonds and shares can perform extremely badly at the same time. The last ten months or so have tested the reassuring idea that when one of these two asset classes falls the other tends to rise. Risk averse investors who have sought the shelter of a traditional balanced fund are quite reasonably asking their advisers what has just hit them.

**2. Gold as an inflation hedge**

The next myth recent events have skewered is that gold is a hedge against inflation. This illusion gained traction in the 1970s when the precious metal performed well alongside sharply rising prices but there is more correlation than causality at work here. The truth is that gold performs well when inflation is higher than interest rates and bond yields. Then, the metal is forgiven its most glaring disadvantage, the fact that it does not pay an income.

Negative inflation-adjusted or real yields are the key to a rising gold price. These are often associated with periods of high inflation but not always. Today's rapid swing from negative to positive real yields and the associated underperformance of gold this year make the point.

**3. Growth investing**

The third truism is a more recent arrival in the conventional wisdom and this year's reversal of it might be seen as a return to a more durable fact of investment. The cult of growth, most obviously the outperformance of technology shares in recent years, has run into the sand as rising interest rates have changed the arithmetic of discounted cash flow models that put a high value on future earnings. Investors are once again looking for the bird in the hand that less exciting but steady cash generators and dividend payers can offer. Twenty years ago, we were reminded by the dot.com crash that shares on low multiples of earnings or assets, or which paid a high and sustainable income, were worth more than the market often acknowledges. I suspect we are relearning that today.

**4. China to rule the world**

A final investment truth that has dominated market thinking for years but has been undermined by recent events is that China will in due course be just like America but bigger. Beijing's recent prioritisation of 'common prosperity' over economic growth confirms that China has long since given up slavishly following the western development model. Ten years ago, the relentless growth of the Chinese middle class and their journey through the acquisition of household goods and towards the consumption of leisure and financial services still looked like a one-way bet for investors. A property bubble, regulatory squeeze and Zero-Covid policy later, things look harder to navigate.

What does all this add up to? In some ways a more difficult backdrop than was in place during what we will come to see as a golden age for investors. But also, I hope, a period ahead in which there will be opportunities that have been lying dormant for many years. There won't be a shortage of ways to make money in the markets in future or to protect its value; we will just have to look for them in different places.

*Tom Stevenson is an Investment Director at [Fidelity International](), a sponsor of Firstlinks. The views are his own. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity*

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## Why private equity can continue to outperform

### José Luis González Pastor

During the last 18 months, the Australian private equity (PE) market has continued to demonstrate strong momentum, with annual transaction volumes above pre-pandemic levels. While exits had slowed down in 2020, they rebounded strongly in 2021 in the context of a favorable valuation environment, availability of cheap leverage and significant dry powder. There continues to be strong investor interest in Australia, given the overall resiliency and low volatility of PE investments. And also due to the relative under-penetration of the PE market compared to other developed markets globally.

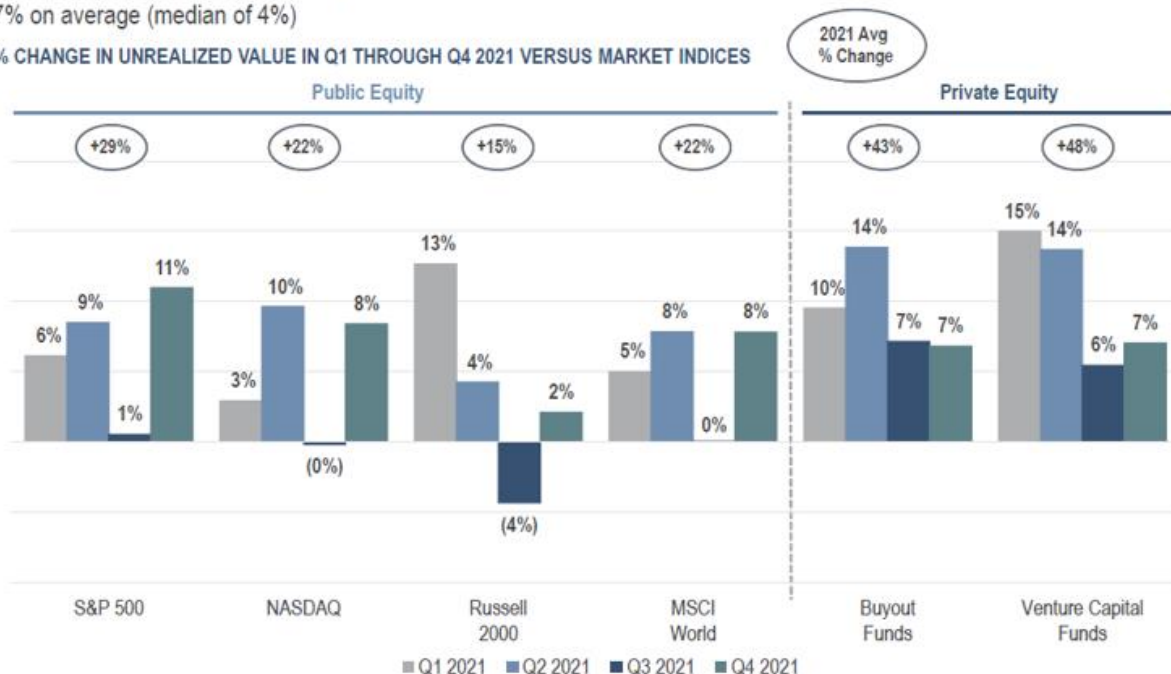
2021 was a record year for Private Equity investments around the world both in terms of capital invested (close to $1.6 trillion) as well as per deal count c.35,000 transactions. The North American market represented approximately 65% of the buyout activity, one of the largest proportions in the time series of the last decade.

For relative context, capital invested was 50% higher than the prior record pre-pandemic year in 2018. That made the dry powder to yearly capital invested ratio to drop to its lowest level in more than 15 years, to 2.8 years (i.e., assuming the deal making pace of 2021, it would take 2.8 years to invest all the uninvested capital).

It's been interesting to see that as of 2Q22, deal making activity globally is still strong, although slightly behind 2021, marking $638 billion and c.15,000 investments by private equity. Those figures are still on track to beat 2018 stats, as referenced in the chart below.

Performance of private equity portfolios in 2021 was strong. Neuberger Berman's large portfolios of buyout funds increased in value during the year by 43%. In comparison, the S&P500 was up 29%, the NASDAQ 22% and the MSCI world also 22%. Russell 2000 lagged other stock indexes and went up by 15% in the year.

**Summary Findings: Quarterly Performance in 2021**




*Source: GP materials, capital account statements, preliminary GP guidance, Capital IQ.*

In the first half of 2022, despite the volatility in capital markets that drove global stock exchanges down, with the S&P500 and MSCI world down 4% in 1Q22 and an additional negative 16% in 2Q22, performance in private equity buyout based on a wide range of buyout portfolios, weathered the storm well, with just a drop of 2% in the first half of the year (vs. the negative 20% of S&P and MSCI). This is a good recent example of some characteristics of the private equity asset class - lower volatility than public markets in turbulent times and attractive performance over time.

**Private markets are 'democratising'?**

This term has gained momentum in recent years and refers to the accessibility of private market products that traditionally were only accessible to institutional investors.

Historically, across the globe, the main hurdles were both regulatory requirements (for instance, the requirement to qualify for a wholesale investor status in Australia) and investment minimums (usually the minimum investing amount is in the millions of dollars).

Today, both regulators and fund managers globally are helping individual investors to overcome those hurdles through the launch of suitable products with retail-friendly regulation. It also means making private market products more accessible or advantageous for investors in a particular jurisdiction. For instance, in Australia, Neuberger Berman expects to broaden the offering in the Australian market by launching a local Investment Trust providing access to private equity, mainly through direct investments and secondaries. Investors will have the ability to subscribe and redeem on a monthly basis and with a low investment minimum.

**PE market trends**

Neuberger Berman is currently seeing additional selectivity in the buyout market. New buyouts are still happening, but investment firms are carefully selecting the sectors and companies that they want to have exposure to, and valuations are being contested. The pace of deployment has slowed down in the short term compared with 2021 but remains strong in historical terms. Nevertheless, this is the type of environment that may create opportunities for well-positioned investors.

In terms of sectors, continuing with the trend accelerated by the lockdowns, Neuberger Berman continues to see significant interest in resilient, cash generative, asset-light businesses and with recurrent or high-level visibility of revenues. This includes software, technology, and healthcare, but also sectors disrupted by new technologies such as financial services.

One interesting comparison between current investment opportunities and those from a decade ago or more, is the revenue growth and EBITDA margins of these asset-light businesses. For instance, prior to the GFC, a large number of industrial companies were bought, and the plan was for them to grow about single digit on an annual basis. And for that it required significant investments in fixed assets, additional investment in working capital and potentially increasing their footprint, with a potential gain of modest improvement in EBITDA margins.

Today, many businesses acquired by private equity require limited investment to grow, perhaps more sales teams (think about an accounting software), but don't have to invest in fixed assets or working capital, so they have significant more free cash flow available than an industrial or traditional company selling goods. Also, their revenues don't involve any logistic service, as it can be delivered online, so there is no need to worry about energy or oil prices. And usually, they grow faster organically as they can upsell by selling additional add-on services, without any additional cost.

Out of this comparison, it stands out that the quality of the businesses targeted today by the private equity industry is of a higher standard than just a decade ago. And not surprisingly, returns have been attractive across funds.

**Pain points for investors entering private markets**

The main pain point is the limited access to the funds and vehicles of this asset class given the regulatory hurdles (imposing for instance eligibility requirements like 'Qualified Purchaser' status in the US or 'Professional Investor' status in the EU or 'Wholesale Investor' status in Australia) and the minimum commitments.

Then, the next pain points are the illiquidity of these products (usually capital is locked for 10 years, although there are distributions over time), the time difference between making the commitment and having all the capital committed actually invested (usually private funds don't take the money from investors upfront but rather 'calls capital' and usually those calls happen during the 3-5 years that it takes them to put the capital to work).

And lastly, the reporting cycle (once every quarter) and method (through a secure platform).

In response to these pain points, a few large managers like Neuberger Berman are offering fully funded vehicles, either with or without liquidity, shorter investment periods and monthly reporting or monthly updates.

*José Luis González Pastor is a Managing Director of [Neuberger Berman] in the Private Equity team and a senior member of the Firm's Private Investment Portfolios group.*

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## Don Sanders: the most distinguished banker in Australia's history

### Rob Ferguson

When I recently reread the obituary of Don Sanders, who died in November 2020, I reflected on an amazing but largely unheralded career. Don lived to a good age of 93 after retiring at 65 and was as humble in retirement as in work. He didn't gradually fade away; he left the financial markets stage entirely for his final 28 years.

I asked myself where Don ranks in the banking pantheon. Then it struck me that there really is no such memory place for bankers. Bankers as CEOs in Australia's banking oligopoly are normally given a licence to print money, a de facto guaranteed franchise. Their job is to collect their economic rents, not to impatiently rev the place up.

For regulators, yes, there has been the occasional deserved pantheon placeholder. Central bankers are sometimes called to put out the raging fire of inflation, and Paul Volker was my hero as Chairman of the US Federal Reserve from 1979 to 1987. He possessed the ability to be incredibly tough while avoiding the hubris.

Sanders was of this ilk. Humble, learned and vastly experienced, he straddled both central banking and commercial banking, and I nominate him as the most distinguished banker in Australia's history.

**His career path**

Sanders first joined the Commonwealth Bank in 1943 as a teller in Wollongong, at a time when the Bank also functioned as Australia's central bank. After completing an economics degree, he moved to Canberra for a stint in Treasury, then spent a year at the Bank of England and on to the Reserve Bank of Australia in 1960 under its first Governor, Nugget Coombs. He stayed at the Reserve Bank for the next 27 years where for the last 12 years, he was Deputy Chairman and Deputy Governor.

Sanders was therefore perfectly qualified to become the Reserve Bank Governor, and his chance came in 1982. John Howard was then Treasurer and John Hewson his principal adviser but there may have been some appeal to Howard in having a Governor of lesser status and grounding than Sanders. Further, I suspect there were professional and personal differences in style between Hewson and Sanders and so, to the profound shock and dismay of many at the Reserve Bank, the role went to Bob Johnston.

This decision must have been a terrible disappointment to Sanders, but he soldiered on, although at the age of 55, his opportunity for Governorship had gone. He stayed at the Reserve Bank for another five years.

**CBA comes calling**

In 1987, aged 60, he was offered the role of Managing Director and CEO of the Commonwealth Bank. He was instantly tempted but he knew the appointment would be received with mixed feelings in some quarters. Early in the deregulated era, the Commonwealth Bank was a bloated and protected species, and more out of touch with the real world than its private sector bank competitors.

Bernie Fraser was Secretary of the Treasury beginning in 1984, and he told me:

> *"I always had a soft spot for Don. He was tough but he didn't outwardly display that toughness. In fact, he covered it with a facade'.*

Fraser was also a director of the Commonwealth Bank and was aware of the magnitude of the task for the new CEO. He said that prior to the appointment of Sanders, he saw presentations by management at board meetings that were "*unbelievably bad*" to the point of being "*bloody hopeless*".

Two of my favourite paragraphs on banking deregulation, written by Al Wojnilower, formerly of First Boston, say:

> *"The system pre-deregulation is correctly described as a well-kept and orderly zoo. Different species such as banks, brokers and insurance companies were neatly housed and fed in separate cages divided for function and geographic scope. The bars between the cages prevented the various species from preying on one another. Within each cage to be sure there was, as in a real zoo, competition as respect the pecking order, the best food, and so forth, but the vigilant keepers made sure this never led to serious injury or death. Relations between the animals and the visitors, between the financial institutions and their clientele, were sober and sedate.*
>
> *Deregulation of the 70s and 80s destroyed this idyllic arrangement … this was unfortunate for the prosperous inhabitants of the gilded cages who naturally tended to attribute their own wellbeing to their own efforts, and believe they could do even better, if set free to forage on others turf … Most of the caged animals had enjoyed a sheltered existence like that of farm animals or even house pets. Now they were freed to become both predator and prey in an unfamiliar jungle that offered reduced nourishment …"*

**How CBA transformed under Sanders**

When Sanders took the reins at the Bank he had joined in 1943, after 44 years in the wings, he knew he had only six years till statutory retirement and much to do. Fraser saw first-hand Sander's wonderful bedside manner, sitting down and chatting with private sector CEOs and how *'the organisation really blossomed under his lead'*.

Sanders was ably assisted by young tyros like David Murray and Ian Payne and an older head like Bruce Asprey, who knew where the bodies were buried. David Murray remembers a bank trying to catch up to its trudging fellow cage dwellers, out in the jungle now.

The Commonwealth Bank's biggest handicap was the longstanding issue of the Board and the Government not seeing eye-to-eye, like Bureaucracy A versus Bureaucracy B, and the enemies within included unions, position holders and seniority rules.

According to Murray, *'Don quickly found a way.'* The two big issues were dividend policy and capital shortage. After all, if the Bank was the only Australian bank with a government guarantee, why did it need capital? Sanders put himself in the shoes of the politicians and argued back to his armour-wearing board colleagues and bridged the divide.

Things started to get sorted. At management level internally, fiefdoms were common, especially in Staff Department. It existed more for the industrial relations to satisfy unions and the Canberra bureaucracy than managing human resources.

**His management style**

To sum up Murrays' views on Sanders, he said:

> *"He was a one-off special, he had such a soft nature, but on matters of intellectual or administrative importance he was very, very, tough. It's a rare combination and it comes with the best people I have learnt from."*

Other glimpses come from Tony Aveling, a BT colleague who worked on corporate matters with Sanders, including the acquisition of State Bank of Victoria (SBV). It was a particularly difficult transaction, signed after months of negotiations with a reluctant Victorian Government. The Victorian opposition, perceiving political opportunity, threatened to block completion of the deal. Aveling and Sanders met the opportunists, and after hearing their concerns, Sanders underwent a metamorphosis into a gentle professor, eyes half-closed, seemingly musing to himself, in an academic matter, along these lines:

> *"Well, SBVs customers have been told they will shortly become depositors in the Commonwealth Bank, at which time they will become my responsibility. But if you fellows block this you could see a run on the bank. I suppose Bernie Fraser would have to step up … No, no, I am forgetting … state banks are not regulated by the Reserve Bank, are they? So it's not Bernie's problem. I guess it would become your problem."*

Message received.

Garry Mackrell, a strategist and member of the Commonwealth Bank Executive Committee for many years, worked almost his entire career in the Bank. He tells a story where a pushy investment banker was seeking a last-minute spot on the underwriting panel for the prized Commonwealth Bank float. He lobbied the politicians successfully, to Sanders' annoyance, and so stood to present his case. Sanders swivelled his chair, took out his pocketknife and nail file, and proceeded to manicure his nails, filing away for 20 minutes with no eye contact. Then he called time and out the door trudged the banker with not a sausage.

Sanders was as old-fashioned as anybody born in 1927, and operating in the 1990s, would be. David Murray tells how one day, Sanders confided that he would retire on a seemingly undistinguished date. The date fitted no plan, no calendar, nothing, just a random date. Murray asked its significance and Don replied, *"It's my 65th birthday."*

From a distance, I observed how Sanders avoided the nonsense and hubris, especially sorting out bank credit problems of the late 1980s. Former Reserve Bank Governor, Ian Macfarlane, was also a fan of Sanders, and he commented to me that,

> *"Two state banks failed, and two of the Commonwealth Banks' three big competitors made losses and had to be recapitalised."*

But Sanders focused closer to home, on making the Commonwealth Bank worldly and ready to compete. He avoided the excess while picking up one of his fallen competitors, SBV. Over a 52-year career, Sanders only really worked in one place, finishing his amazing career as CEO of the Commonwealth Bank. Once passed over for the Reserve Bank Governor role on a political whim, Paul Keating eventually righted a wrong. Speaking at the funeral of Sanders, Keating said,

> *"Don was fundamentally a great public servant, he was very important figure, he was central … in the transformation of Australia from a closed economy to an open economy."*

So true.

*Rob Ferguson was Chief Executive Officer of BT Australia from 1985 to 1999, and after chairing several large, listed entities, he co-owned Magic Millions and is now retired.*

## Opportunities in Floating Rate Notes

### Matthew Macreadie

In consideration of further rate increases from the RBA, fixed income markets are largely 'pricing in' the current rate hike cycle. Whether markets are right or not is another matter and often hard to predict. They'll form a path on forward rates expectations based on the outlook from the RBA, view on local inflationary dynamics and global central bank activity.

**Floating Rate Notes for a rate hike cycle**

Typically, investors will favour floating rate notes (FRNs) over fixed coupon bonds during a rate hike cycle as the coupon on FRNs ratchets upwards as rates increase. Conversely, fixed coupon bonds decline in value.

As such, if the RBA doesn't raise rates as fast as the market expects then the returns on FRNs would decrease. However, if the RBA raises rates in line with the market and/or higher even, then FRN returns are improved. With this uncertainty involved, it's worthwhile having a diversified portfolio across FRNs and fixed coupon bonds to act as protection when markets melt down. Either way, the outright yields available to investors right now can help to manage the detraction caused by inflation.

**Ampol subordinated notes**

Below we discuss the merits of an FRN by using the Ampol subordinated notes (ALDAU 0 12/09/2080) as an example of a high grade, BBB-rated security.

This bond pays a coupon of 3.6% above the 3-month Bank Bill Swap Rate (BBSW) and is callable in March 2026. Coupons are paid quarterly – in March, June, September, and December respectively. In September 2021 (only a bit more one year ago), this bond only paid a total coupon of 3.6%. However, the latest coupon (September 2022), ratcheted upwards to a significant 6.2%. The increase in coupon of around 2.6% from last year is purely a result of the 3-month BBSW being reset as rates increase. For an investor, holding this bond results in higher income from their fixed income allocation. Many investors have struggled to be able to drawdown this as an income stream for many years without eating into their capital.

The table (right) shows the past coupon resets on the Ampol Subordinated notes (ALDAU 0 12/09/2080) and below is the current Australian Bank Bills Curve.

**Past Coupon Resets**

| Accrual Start | Rate |
|---|---|
| 09/09/2022 | **6.209900** |
| 06/09/2022 | 5.083100 |
| 03/09/2022 | 3.745800 |
| 12/09/2021 | 3.660700 |
| 09/09/2021 | **3.610400** |
| 06/09/2021 | 3.625000 |
| 03/09/2021 | 3.638800 |
| 12/09/2020 | 3.620000 |

*Source: Bloomberg*

**Australian Bank Bills Curve**

| DATE | 1 month | 2 month | 3 month | 4 month | 5 month | 6 month |
|---|---|---|---|---|---|---|
| 04/11/2022 | 2.8400 | 2.9800 | 3.0593 | 3.2250 | 3.4300 | 3.6300 |

*Source: ASX*

Currently, the market is expecting rates to reach 4% by June 2023 based on the 30-day cash rate futures curve. In June 2023, a coupon reset with a margin of 3.6% would give a return over 7.6% (3.6%+4%) [note 3-month BBSW usually trades at a premium to the cash rate]. This is a very healthy return for a BBB-rated security in only 8 months' time.

Furthermore, the expected return on the Ampol subordinated notes looks very good into the future. The notes are callable in March 2026 so have an expected life of 3.25 years. The 3- and 4-year bank swap curve is currently sitting between 4.1%-4.3%. So based on 4.1% (3-yr bank swap curve) and 3.6% margin, this note may earn 7.6% (3.6%+4.1%) into the future. This is commonly referred to as the yield to maturity (YTM) on a security.

For context, one year ago, the 4- and 5-year bank swap curve was between 0.6-0.8%. The notes would have had an expected life of 4.25 years (being one year longer in life). Thus, the notes would have had a YTM of 4.2% (3.6%+0.6%) – 3.4% lower than the current YTM.

A reminder for investors, though, is that the credit risk of Ampol still needs to be assessed and monitored carefully.

**Opportunities too in fixed coupon bonds**

With all the focus on the cash rate, many investors do not always realise how much medium and long-term bond rates can move very quickly ahead of short-term rates. Nonetheless, short-term rates have now somewhat caught up, creating income opportunities not seen for decades. Although some investors might shy away from adding fixed coupon bonds given the current rate hike cycle, it's worth acknowledging they currently provide an opportunistic entry point with many bonds trading at a discount to par. If we see a recessionary scenario play out, then we could see upside on those fixed coupon bonds as the curve should flatten and even invert (all-else-equal). Both in Australia and the US, markets are now pricing in rate cuts to start from the middle to late 2023.

*Matthew Macreadie is Director of Credit Strategy 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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## Director identification numbers – time is ticking!

Julie Steed

Do you have an SMSF with a corporate trustee or are you a director of a charity or not-for-profit organisation? Do you know you have to register for a director identification number (director ID) by **30 November 2022**?

Both the ATO and ASIC have recently expressed concern that many individuals are unaware that they need to apply for a director ID and others may miss the deadline.

**What is a director ID?**

As part of the government's Modernising Business Registers (MBR) program it is a requirement for all company directors to have a director ID.

A director ID is a unique identifier every corporate director will need to apply for once and will keep forever. A director can only have one director ID that they must use for all companies.

**Why is the director ID being introduced?**

The director ID will help to:

- prevent the use of false or fraudulent director identities
- make it easier for external administrators and regulators to trace directors' relationships with companies over time
- prevent director involvement in unlawful behaviour

Directors keep their director ID forever, even if they change companies, cease to be a director, move interstate or overseas, or change their name.

**Who needs a director ID?**

All company directors need a director ID. A director can only have one director ID that they must use for all companies.

Some of the most common companies include a:

- company registered with ASIC
- corporate trustee of an SMSF
- charity or not-for-profit organisation that is a company.

**When do I need to have obtained a director ID?**

When you need to apply for a director ID depends on when you first became a director. If you:

- were appointed on or before 31 October 2021, you have until 30 November 2022 to apply
- were appointed between 1 November 2021 and 4 April 2022, you need to apply within 28 days of your appointment
- are appointed on or after 5 April 2022, you need to apply before you are appointed.

The requirement also applies to anyone who is not currently a director of a company but was at 31 October 2021.

**How do I apply for a director ID?**

You must apply for your director ID yourself; no one can apply for you.

To apply for a director ID you can visit www.abrs.gov.au and select the 'Apply for your director ID' link. It will also step you through setting up a myGovID, which you will need to login to the Australian Business Registry Services online. Note that myGovID is different to an individual's myGov account.

You can also phone the Australian Business Registry Services on 13 62 50.

**Resources**

If you have any questions regarding director IDs, please visit www.abrs.gov.au. You can also watch this ATO video designed to assist directors of SMSF corporate trustees on applying for a director ID.

*Julie Steed is Senior Technical Services Manager at Insignia Financial Ltd (formerly Australian Executor Trustees). This article is in the nature of general information and does not consider the circumstances of any individual.*

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