Firstlinks
a Morningstar company

Edition 485, 25 November 2022

Contents

Editorial

I once received this question at a job interview: what have you changed your mind about in the last decade? I thought it was a good question then and it remains a good question now.

At the interview, some 15 years ago at a funds management firm, I answered I was convinced that a concentrated investment portfolio was a key ingredient to being a successful investor. Previously, I hadn't been convinced of that.

I was being a bit disingenuous because I knew that this answer would be music to this fund manager's ears. But I also happened to believe it, which certainly helped the cause.

Today, I would take issue with my former self; I would take issue with the answer I gave back then.

But let's back up a bit and explain why I gave that initial answer. It probably had deep roots. All the way back to my childhood, in fact. As a kid, I remember seeing a lot of issues in black and white. Right and wrong, good and bad, win and lose, and so on. There wasn't much room for shades of gray. And being somewhat of a stubborn child didn't help either.

When I got my first job in finance as an analyst at a sell-side broker, I was encouraged by my employer to take strong views on stocks and sectors of which I had coverage. The company didn't take kindly to 'hold' recommendations on stocks; 'buy' and 'sell' recommendations were more appreciated as they generated more trading and brokerage fees for this firm!

I carried this type of thinking over when I became an equities portfolio manager, and indeed with my personal investing. It was about having strong views on a small bunch of stocks.

My investment heroes back then all had concentrated portfolios, who's virtues they proselytised. The likes of Erik Metanomski in Australia and Warren Buffett and Mohnish Pabrai overseas.

What's changed over the past decade then? Losing some money during the GFC had an impact, no doubt. But it's much more than that.

I've changed my approach to investing because I've changed my approach to life. I've realised most issues aren't black or white. I've realised how much I don't know about many issues. I've realised that I'm more risk-adverse than the average person about lots of things. I've realised that I don't like the stress involved in taking a big bet. All of this has made me an advocate of having a diverse investment portfolio.

I'm not saying that concentrated investing can't work. It can. If you are a good investor, with the stomach to take volatility and potentially big drawdowns, then a concentrated portfolio can do wonders. It just doesn't work for me.

What have you changed your mind about in the last decade? I'd love to hear your thoughts.

In this week's edition ...

The FTX saga has a bit of everything. Knowing America, books and movies on the subject will already be in the offing. For Australian investors, it might seem the drama is too movie-like to have any relevance to them. Yet there are many lessons to take away from FTX - some obvious; others not-so-obvious.

Jody Jonsson of Capital Group believes investors need to reset their expectations about how a typical investing environment looks. She identifies five seismic shifts happening in economies and markets and the investment implications for each.

Superannuation has become a political football and there's noise around further changes to the system. Former Chair of Retirement Income at Challenger, **Jeremy Cooper**, says we need to take a deep breath: while super isn't perfect, more changes could add further complexity to a system that's served us well.

Meanwhile, the rules for eligibility to contribute to super are relatively simple but there are additional conditions regarding access to the bring forward rule that may result in unintended tax consequences. **Julie Steed** looks at the rules and reviews what happens when they are not fully met.

Retirement has become a central part of the conversation about the future of super. As more post-retirement members have more superannuation savings than ever before, **Andrew Boal** and **Steve Freeborn** of Deloitte believe the time has come to better engage with people about managing their retirement needs.

A sharp spike in bond yields has resulted in Australian Real Estate Investment Trusts being among the poorest performers on the ASX this year. With the RBA prioritising growth over inflation though, A-REITs may be set for a turnaround, according to **Cameron McCormack**.

Private credit - loaning money to private businesses including SMEs - is booming and investors can now get direct access to funds in the space. **Roger Montgomery** is our guide to the benefits and pitfalls of investing in private credit.

This week's White Paper comes from **Vanguard Investments**, whose latest quarterly ETF report highlights that despite the market pullback, Australian ETFs are still attracting substantial inflows.

James Gruber

FTX's lessons for Australian investors

James Gruber

The FTX story has a bit of everything. Fraud, greed, lust, political connections, a relatively new concept in cryptocurrency, wealthy families, large financiers considered 'masters of the universe', suckers, the Bahamas and multiple other locations of business subsidiaries. That's not to mention the employees and average investors who've been caught up in the downfall. Also, the lawsuits and court drama which are no doubt to follow. Knowing America, books and movies on the subject are already in the offing.

For Australian investors, it might seem the drama is too movie-like to have any relevance to them. However, I think there are many lessons to take away from FTX. Some obvious; others not-so-obvious.

Obvious lessons

Some of the key lessons include:

> **Ideas don't make investments.** The idea of a cryptocurrency exchange may appear like a great idea. What's not to like about taking fees via a trading platform in the then hottest idea going around? There are lots of ideas for businesses; many of them are sound ones. Ultimately, though, business is all about execution, and FTX had none of that.

Do due diligence. A big question mark hangs over the funds which invested in this company. One of them, Singapore's Temasek, has defended its due diligence process saying it did eight months of work on FTX before investing. I'm not sure what work they did but it clearly wasn't enough.

Always look at balance sheets. It's alleged that when investors asked to see financial statements beyond profit and loss statements, they weren't forthcoming. No wonder – they didn't have any cash left. The lesson is that balance sheets and cashflow statements are just as important as the profit and loss.

Don't follow the crowd. It seems likely that the funds which invested in FTX thought others had done due diligence on the company and therefore they didn't need to do any themselves. Big error.

Be sceptical about your 'network'. This is related to the prior lesson. I've previously written about how 'networking' and having a 'network' are overrated when it comes to investing and life. It's especially the case when big money is on the line. Do your own work and be sceptical of others piling into investments.

Invest in people with a track record. This may seem obvious, and it is. But the people who invested in Sam Bankman-Fried invested in a guy who was a junior trader for three years and had no track record in anything.

Keep on top of your investments. When you invest in something, it's not a case of set and forget'. You need to keep track of the investment. In the FTX case, Caroline Ellison, who headed the related company Alameda Research, bragged about regular methamphetamine use on social media in May last year. A red flag, one would have thought.

A less obvious lesson

There is a less obvious lesson from FTX and the cryptocurrency sector which I believe is more important than the obvious ones mentioned above. Investors should be wary when significant money is flowing into a sector. Particularly if there are a host of company IPOs in the same sector at around the same time.

The process often goes like this:

1. There is a hot new idea or technology. Startups raise money, which leads to further money raising. That leads to institutions investing alongside venture capitalists. Which leads to more startups trying to raise money in the space.

2. Investment banks will want a piece of the action, so companies will IPO to raise more money and/or cash in for themselves and their investors. After IPO, these investment banks will put buy ratings on companies, and more investors will pile in.

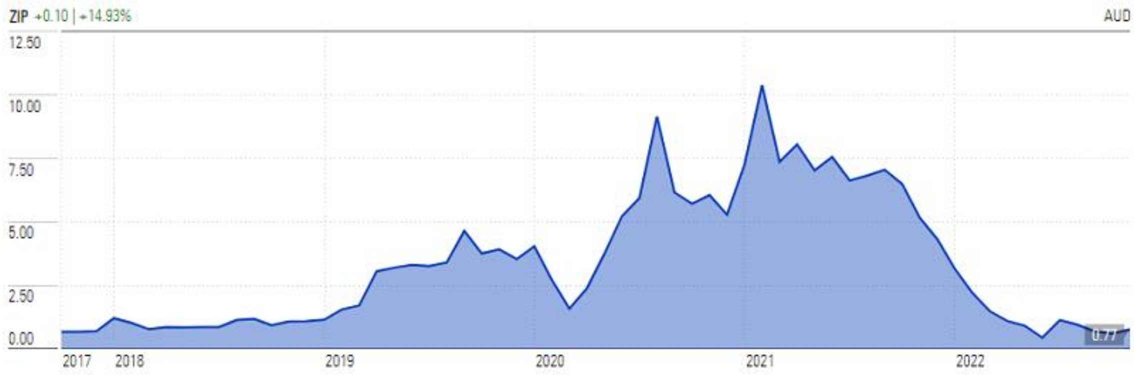
3. All of which results in significant investment in the industry, and often, over-investment. That can lead to lower returns, increased regulation, investments fleeing the sector, cost cutting and eventually, industry consolidation.

This cycle has played out many times before cryptocurrency came along. There was TMT in the late 1990s and subprime lending in the US prior to 2008.

In Australia, it's recently played out in industries such as aged care and fintech. Think about Afterpay and all the Afterpay wannabees. In essence, these are subprime lenders who've been marketed as extending credit to the average person.

Venture capitalists piled into these digital payment providers from 2015 and a slew of companies IPO'ed on the ASX and the Nasdaq. More investors got on board and investment banks promoted their virtues with buy ratings. That got the attention of mum and dad investors. And the share prices of these companies skyrocketed.

About 12 months ago, online spending growth started to come down from the highs of Covid, the share market started to decline, and large question marks came upon these digital payment providers. Investors have since fled the sector.



Price chart for Zip Co Ltd (ASX:ZIP). Source: Morningstar

The capital cycle theory

This whole process of industry investment, over-investment and creative destruction isn't new: it's related to two well-known economic theories: Porter's Five Forces and Joseph Schumpeter's process of creative destruction.

Recently, it's been successfully adapted to the share market by a London-based funds management firm called Marathon Asset Management and given a name: the capital cycle theory. The firm's capital cycle theory has gained a wider following after the publication of two books on the subject (*Capital Account* and *Capital Returns*) by well-known finance author Edward Chancellor.

In the book, *Capital Returns*, Chancellor provides a hypothetical example of the capital cycle theory at work:

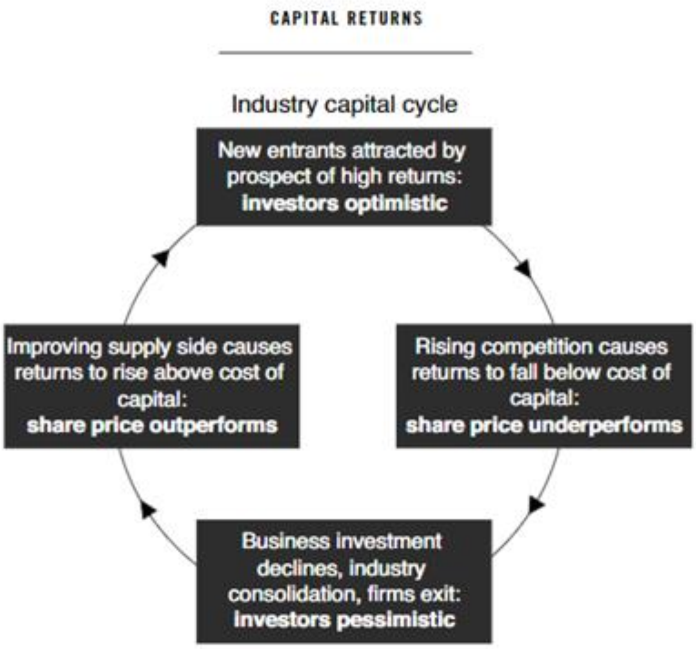


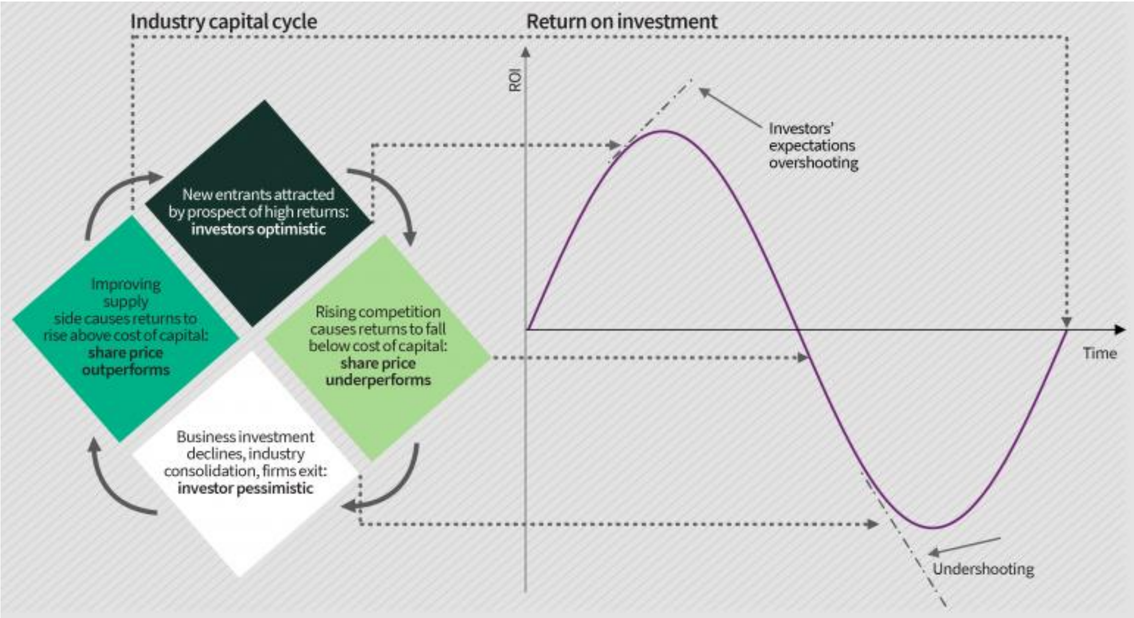
Chart I.1 The capital cycle
Source: Marathon.

"Here's how the capital cycle works. Imagine a widget manufacturer — let's call it Macro Industries. The firm is doing well; so well, that its returns exceed Macro's cost of capital. The firm's CEO, William Blewist-Hard, was recently featured on the front cover of Fortune magazine. His stock options are in the money, and his wife no longer complains about being married to a boring industrialist. Of the nine investment bank analysts who cover Macro's stock, seven have buy recommendations and two have holds. The shares are trading at a price-earnings multiple of 14, below the market average. Macro's stock is held by several well-known value investors.

Macro's strategy department anticipates strong demand growth for its products, especially in emerging markets where widget consumption per capita is less than one-tenth the level found in the advanced economies. After discussions with the board, Macro's CEO announces his plans to increase manufacturing capacity by 50 percent over the next three years in order to meet growing demand. A leading investment bank, Greedspin, arranges the secondary share offering to fund the capital expenditure. Stanley Churn of Greedspin, a close friend of Macro's Blewist-Hard, is the lead banker on the deal. The expansion is warmly received in the FT's Lex column. Macro's shares rise on the announcement. Growth investors have lately been buying the stock, excited by the prospect of rising earnings.

Five years later, Bloomberg reports that Macro Industries' chief executive has resigned after longstanding disagreements over corporate strategy with a group of activist shareholders. The activist, led by hedge fund Fantastic Investment, want Macro to shutter under-performing operations. Macro's profits have collapsed, and its share price is down 46 percent over the last twelve months. Analysts say that Macro's problems stem from over-expansion — in particular, its $2.5bn new plant in Durham, North Carolina, was delayed and over budget. The widget market is currently in the doldrums, suffering from excess supply. Macro's long-established *competitors have also increased capacity in recent years, while a number of new low-cost producers have also entered the industry, including Dynamic Widget, whose own shares have disappointed since its IPO last year.*

The market for widgets is suffering from the recent slowdown in emerging markets. China, the world's largest consumer of widgets, has vastly expanded domestic widget production over the last decade and has lately become a net exporter. Macro is reportedly considering a merger with its largest rival. Although its stock is trading below book, analysts say there's little near-term visibility. Of the remaining three brokerages that still cover Macro, two have sell recommendations with one hold."



Conclusion

It's easy to get caught up in the drama of the FTX saga and wonder how sophisticated investors got caught up in the firm's downfall. The capital cycle theory helps explain how such events happen and what investors can do to avoid similar things happening to them.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

5 big trends shaping markets for the next decade

Jody Jonsson

There's a new reality taking shape in global markets.

Commentators have in the last few months mostly focused on a rotation from growth to value, but I think that view is too simplistic. I see many shifts happening simultaneously that could define the next decade in markets around the world.

Many investors are expecting a return to normal after inflation subsides and central banks stop raising rates. But I believe the world is undergoing significant changes and that investors will need to reset their expectations about how a typical investing environment will look. Here are five seismic shifts happening in economies and markets right now, as well as the long-term investment implications of each:

1. From falling rates to rising rates and higher inflation

The market is grappling with a macro environment it hasn't seen in a long time. Inflation is its highest since the early 1980s. And until recently we've had 40 years of declining interest rates. That's longer than most investment managers' careers, if not lifetimes. That's part of the reason we see a market struggling to adjust to this new reality.

It's easy to assume these are market dislocations that will quickly reverse — bond markets are currently pricing a return to 2% inflation within two years, for example. But these cycles often last much longer than people anticipate, and there is reason to believe higher inflation is structural and likely to persist.

Is this the end of a 40-year disinflation cycle?

Sources: Capital Group, Refinitiv Datastream.

In this new environment I'm especially cautious of highly levered companies, or those raising new debt. Money isn't "free" anymore, so a larger slice of earnings will go to service debt. Companies with the ability to fund their own growth as well as those with strong pricing power and dependable cash flows will remain attractive in a high-inflation, higher-cost-of-capital world.

2. From narrow to broader market leadership

I think we're going to be in a much less narrowly concentrated market in future. The last decade was dominated by a handful of tech stocks that you basically had to own to keep up with the market. I don't think that's going to be the case anymore.

I expect opportunities to arise from a variety of companies, industries and geographies. Well-managed companies beyond the tech sector may have their chance to shine again.

For example, e-commerce companies have gone from being the disruptors to being challenged themselves. They're often very low margin and expensive to scale with difficult delivery logistics to manage. Very few have done it well. Some traditional retailers that have combined the benefits of brick-and-mortar stores with a compelling online shopping experience are starting to take share from pure e-commerce companies.

Market leaders are becoming less concentrated

Sources: Capital Group, Refinitiv Datastream, Standard & Poor's. As of September 30, 2022. Indexed to 100 as of 1/1/05.

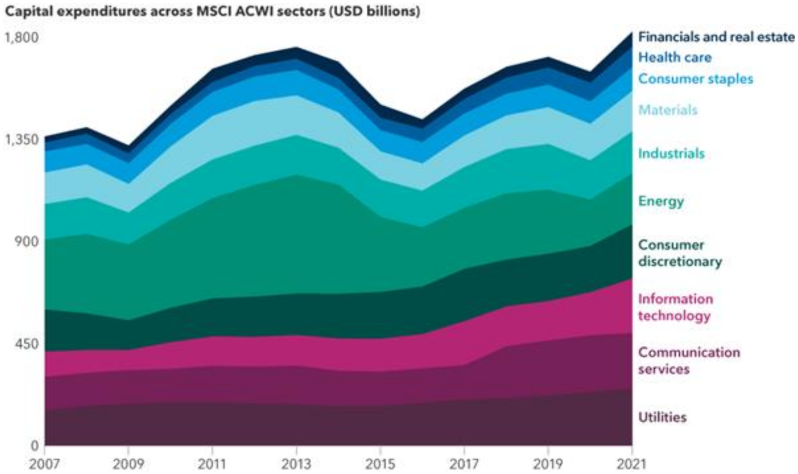
After the market's dive in 2020, I expected leadership to broaden, and it has done so. In my view, this is a healthy development and supports why I have been trying to de-concentrate my own portfolios. In theory, it should be a positive backdrop for stock pickers over indexers.

3. From digital to physical assets

The last bull market was dominated by tech companies that made their fortunes on digital assets, such as online marketplaces, streaming platforms, search engines and social media. This overshadowed the fact that you can't build a new economy without older industries. Not that digital-first companies are going away, but I think investors will start to place greater emphasis on commodities and producers of physical assets.

Some might assume that trends like the shift to renewable energy will squeeze out incumbents in traditional sectors like industrials, materials or energy. On the contrary, there may be winners among businesses that are helping other companies be more energy efficient — whether that's smart buildings, power management or HVAC systems that reduce gas emissions. Other global trends such as grid modernization, reshoring and energy security may cause a boom in capital investment across industries. These are areas where smartly managed industrial companies might have a real renaissance.

Capital spending super cycle could power a new industrial renaissance



Sources: Capital Group, FactSet, MSCI. In current U.S. dollars. As of December 31, 2021.

4. From multiple expansion to earnings growth

Many newer investors got comfortable with stocks being very expensive over the last five to 10 years and now assume stocks will return to those levels during the next bull market. When rates were near zero the market could support loftier multiples, but I think those days are over.

An exercise I'm trying to apply when evaluating my portfolio is to ask: "What if stocks don't return to 25x earnings in 2027? What if they only trade at 15x earnings?" If I can make a stock work at that level, then I can probably limit my downside. Using that lens, I'm trying to find emerging and growth-oriented companies that are not valued as such. I like those that may also offer potential upside to the valuation, but where the investment thesis doesn't depend on it.

If multiple expansion is limited in the next bull market, stock returns will have to be powered by earnings growth. That means markets aren't likely to be as patient with unprofitable companies. Stocks whose business models depend on cheap money are going away. Companies that funded losses while trying to scale rapidly even where the economics didn't work are going away. Markets once paid up heavily for future growth, but now with higher interest rates they are less willing to do so. The market is calling time on business models that don't work when money is no longer free.

5. From global supply chains to regional supply chains

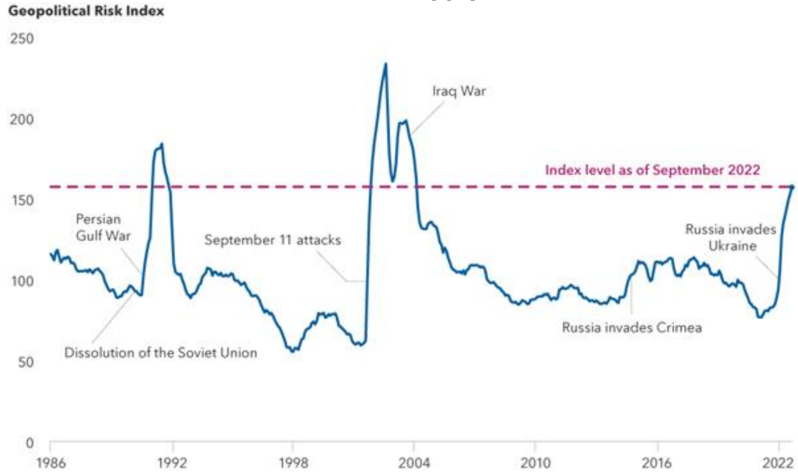
The globalization of supply chains is another multi-decade trend that is shifting. For a generation, companies moved manufacturing to foreign soil to cut costs and boost margins. But the limitations of placing efficiency over resilience are now clear. Rising geopolitical tension and pandemic-induced disruptions have led companies to consider bringing supply chains closer to home.

While bottlenecks caused by COVID shutdowns have improved, many companies are still being impacted. The auto industry is a prime example. Major automakers have tens of thousands of unfinished cars waiting for final parts, and that missing component is often as minor as an inexpensive semiconductor chip. Now companies are creating supply chain redundancies so that a single disruption doesn't derail their entire operation.

Even as pandemic-related issues ease, I believe increased geopolitical conflicts are here to stay and will continue to fuel this change. The current environment reminds me of the 1970s, with tension between Russia and the West, more aggressive confrontations with China, the rise of authoritarian leaders around the world and less global cooperation. Since the fall of the Berlin Wall, we've had more than 30 generally peaceful and prosperous years. But there are more risks now, and this backdrop suggests lower valuations are warranted and "surprises" should feel less surprising.

Consider Taiwan Semiconductor Manufacturing Company (TSMC), the world's dominant manufacturer of cutting-edge semiconductors. After having concentrated the bulk of its capacity in Taiwan — a focal point of geopolitical concerns — the company is building its first manufacturing hub in the United States. It's also constructing a new plant in Japan. That regionalization should create a more efficient supply chain for some of its top U.S.-based clients, including automakers and technology companies like Apple, Qualcomm and Broadcom.

Higher global tensions have increased risk of relying on international supply chains



Sources: Capital Group; Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review, April, 112(4), pp.1194-1225. The Geopolitical Risk Index is a measure of adverse geopolitical events and associated risks based upon the tally of newspaper articles covering geopolitical tensions, using a sample of 10 newspapers going back to 1985. Index level values reflect a 12-month smoothed average of monthly data. As of September 2022.

A flexible investment approach can help weather the storm

The combination of low rates and rising markets made the last 10 years feel like one long sunny day at the beach. While some rain showers have now driven beachgoers indoors, they're still looking out the window waiting for the storm to pass. They don't realize that there's a new weather system upon us with more clouds, colder temperatures and much stronger winds. The world's not ending, but it may be a wetter, cloudier and colder place — and life won't be a day at the beach.

That may sound like a dark outlook, but I actually see this as a really exciting time to be an investor. New market environments present new opportunities, and that's where experience and flexibility can be essential.

Jody Jonsson is an Equity Portfolio Manager at Capital Group, a sponsor of Firstlinks. This article is neither an offer nor a solicitation to buy or sell any securities or to provide any investment service. The information is of a general nature and does not take into account your objectives, financial situation or needs. Before acting on any of the information you should consider its appropriateness, having regard to your own objectives, financial situation and needs.

For more articles and papers from Capital Group, click here.

No change to super should be urgent

Jeremy Cooper

This is an edited transcript of Jeremy Cooper's radio interview with Geraldine Doogue on ABC's RN Saturday Extra Program recorded on 19 November 2022.

Jeremy Cooper is a former ASIC deputy chair, former chairman of retirement income at Challenger and chaired the 2010 federal government review into super.

Geraldine Doogue: Since compulsory super was introduced by the Hawke-Keating duo back in 1992, there have been several significant changes. Now there's increasing talk of more to come, though quite when and what isn't completely clear. Maybe a genuine effort to precisely define what this whole system is for. It's become phenomenally successful. But what exactly is its purpose? The answer is not entirely clear, and there's many trillions resting on that answer. I'll check with Jeremy Cooper, who's never far from these dilemmas.

What are the tom-toms saying about possible changes to our super system?

Cooper: Well, the drums seem to be constantly beating with super. There are just so many ideas about change, and that's part of the problem. So, really, getting back to basics is what this idea of having a purpose of super is about, to dampen down the noise and really focus on, I guess, simplifying it down to a fairly sort of sparse economic concept that super is really a consumption smoothing mechanism...

... basically, you are spending a little bit less during your working years by money being taken out of your wages and put into this thing called superannuation with the idea of then being able to spend – now, that spend word is somewhat lost in all the noise – spend some of that money that you've put away, which is compounded by interest and investment returns over the period, and then that makes your lifestyle in retirement better than it would have been if that mechanism hadn't been there. That's the basic idea.

The problem is, it's become too politically contested, because there's about $3.5 trillion sitting in our system, which is probably the most successful retirement income system in the world. It's not perfect, but it's become very politically contested, and it has, what I call, barnacles all over it. In other words, there's franking credits; there are downsides or concessions; there are small business concessions and on it goes.

And most of it's about tax. It's not about retirement savings. It's basically about what can I get out of this system. It's a little bit like housing. It's all about negative gearing and capital gains tax exemptions and exemptions from the age pension. So, housing becomes financialized. It's a bit of a funny word, but I think that's happened to superannuation. We've basically forgotten this basic, simple, consumption smoothing that it's not about building wealth and passing it on to the next generation. It's actually about having a better retirement than just the age pension could give you.

Doogue: Well, I mean, David Murray, who did another review, said that taxpayer supportive super should help "provide income in retirement to substitute or supplement the age pension." That was his sort of clarifying definition.

Cooper: No, you can't disagree with that, but it's too anodyne. In other words, you might go well, of course it is. Of course it's about that. The trouble is, if you only had a purpose that consisted of that, what you're not doing is you're not ruling out – and I'm getting too many negatives here – but you're not ruling out what it's not for – that it's not for early access for housing. It's not for passing on to the next generation. So, you need to go further than just this very simple statement, which is basically just plainly obvious. Of course, that's what it's about and what it's for. But then, there are all these other subsidiary things that tend to be the tail wagging the dog.

Doogue: I suppose what I'm getting at is, if it's correct that – well, the implication was you take the load off the age pension provision so that then there's something in it for all taxpayers, because the consolidated revenue isn't bearing that load. Is it doing that?

Cooper: Well, you see, it depends on where you set the level of the age pension. Now, various governments have decided to be more generous with the age pension than they would otherwise be. So, the age pension is not some sort of static thing. As living standards improve and as we all get better off, which we are phenomenally well off in this country, it seems appropriate to keep being aspirational about the age pension. Otherwise, you'd leave those not working and reliant on the age pension, you leave them behind the rest of the community. And I don't think there are too many people who want that.

So, the age pension is not some sort of static target. In fact, if you look at the way the age pension has grown, it's quite dramatic, which I think is appropriate in a wealthy country. So, it's got to be about more than that. And I think we need to include things like the benefits of having a pool of national savings that is not owned by the government. It's basically owned by us, the people of Australia, and administered by a system that's doing that on our behalf. That's actually an important purpose.

And the reason I say that is that we're now in a position not unlike Switzerland, where we own more shares in the rest of the world than they own in us. And what that means is that we now have something that because of super, basically all the investing that super does around the rest of the world, has built up a pile of money that's really quite significant in terms of our GDP.

Doogue: Well, it makes you much less brittle as a nation. Is that the idea?

Cooper: It does. Exactly. Yes. It's like a – think of super as a sovereign wealth fund, a very large one, that isn't owned or controlled by the government, but by the citizens.

Doogue: Now, I mean, I was going to ask this later, but I'll ask it now. Therefore, this talk as well in this great debate that is on quietly at the moment, about super possibly being put into things of national development like infrastructure or like, say, the provision of housing. How do you react to that?

Cooper: Cautiously. I'm open minded, I'd like to hear more about exactly what we mean by that. There are some fairly unhappy examples in other countries where well-meaning politicians have sought to get their hands on the large slabs of – that's happening in the U.K. at the moment. The politicians there are talking madly about the pension system, investing in infrastructure and so on. Chris Bowen said that there are very few policy problems for which the superannuation industry hasn't been put forward as the solution. So, you've got to be cautious. But I'm interested in hearing there can be win wins with these sorts of things that we could do something that was beneficial to the super system and also to the nation.

Doogue: Okay. Go back then to what might come because I noticed, for instance, John Kehoe writing in the Financial Review the other day. These are the sort of headlines that are around that why super tax breaks for retirees can't go on like this. Or there was another – with tax concessions totalling more than $40 billion last year, which areas are likely to be targeted? So, there is a growing view from what I've read, even within the industry that these generous concessions cannot last. Do you agree with that?

Cooper: Broadly, yes. I think that's right. And it's not about the budget for me. It's about basically equity and fairness. So, just consider somebody – let's just assume that I'm nearing retirement. I could go into retirement soon, and I could be earning, let's just say, several hundred thousand dollars a year upon which I would pay absolutely no tax and even better than that for me personally, but not so much for society, I would actually probably receive franking credit rebates as well, possibly in the tens of thousands of dollars. Let's just think I've got two kids who are 30 somethings. They're carrying HECS debts. They're trying to buy a house in Sydney at the moment. They're on relatively modest incomes upon which they're paying more tax than I would be.

Doogue: Yeah.

Cooper: I'd be interested in who could explain to me why that's an equitable setting. It's embarrassing. I sort of choke having just said that. It's just unequal and illogical and frankly, dangerous. I mean, when you set up parts of a society in different age groups and on different income bands, that's just so unequal, it's just not good policy. Now, of course, that's easy for me to say. I'm not a politician going out there and actually rendering that change. I mean, once you've given – particularly retirees, once you've given somebody a state of affairs, winding it back, it's very difficult. But that's not to say that we shouldn't be having the conversations. People have picked a figure of $5 million. If you've got $5 million in super, the excess above that should be treated as effectively being in the ordinary economy, not being in super, and should be taxed appropriately.

Doogue: What are the various options as you see then? What would you choose?

Cooper: Well, one of – some time ago, when I was thinking about – I did another smaller job for the Labor government in 2013 on topics related to the purpose of super, and I came up with the – it's a bit of a slogan really – that no change to superannuation should be urgent. In other words, there should really never be a budget night surprise change to what's effectively in some cases a 70-year saving and spending system, which is what superannuation is. You might spend 40 years in work and then 30-odd years in retirement, spending that money down. That is a very, very long-term bargain that you're making with the government effectively. And so, if you were to change the settings for retirement, there would need to be a long conversation about it, and lots of warning for people as to what to expect if they were nearing retirement, time to rearrange their affairs, possibly while they're in retirement. So, I'm totally sympathetic to that.

This is an edited transcript of Jeremy Cooper's radio interview with Geraldine Doogue on ABC's RN Saturday Extra Program recorded on 19 November 2022.

Engaging retirees on the journey to manage retirement risks

Andrew Boal, Steve Freeborn

At the recent AFR Super & Wealth Summit, the Assistant Treasurer and Minister for Financial Services used his opening address to say how important it was that superannuation had a defined objective, similar to other initiatives such as Medicare. *"We can't get everything settled for the long term unless we have an understanding of what we are trying to do"*, he said.

Following the opening address, a number of speakers during the Summit suggested that the objective for superannuation should reference the following three items – retirement income, all Australians and dignity. For example:

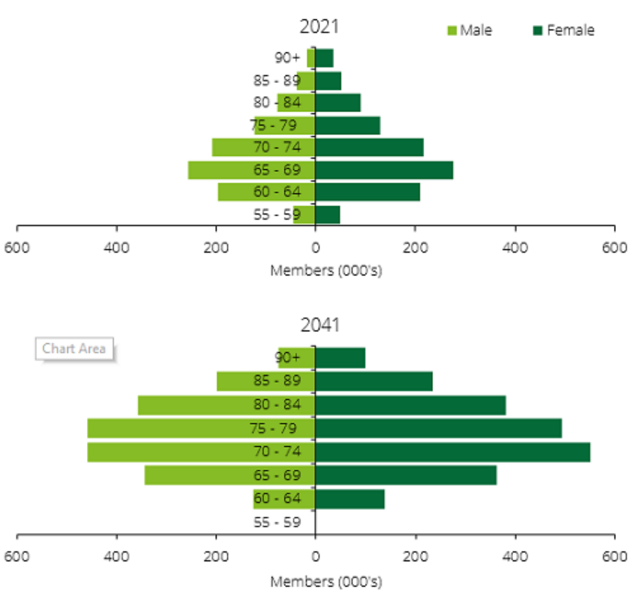
"To provide income in retirement that helps all Australians to live with dignity, by supplementing or substituting the Age Pension."

It is interesting, this is entirely consistent with the sole purpose test and the guidance provided in Superannuation Circular No. III.A.4 issued by APRA in February 2001. In particular, section 3 of that Circular states that:

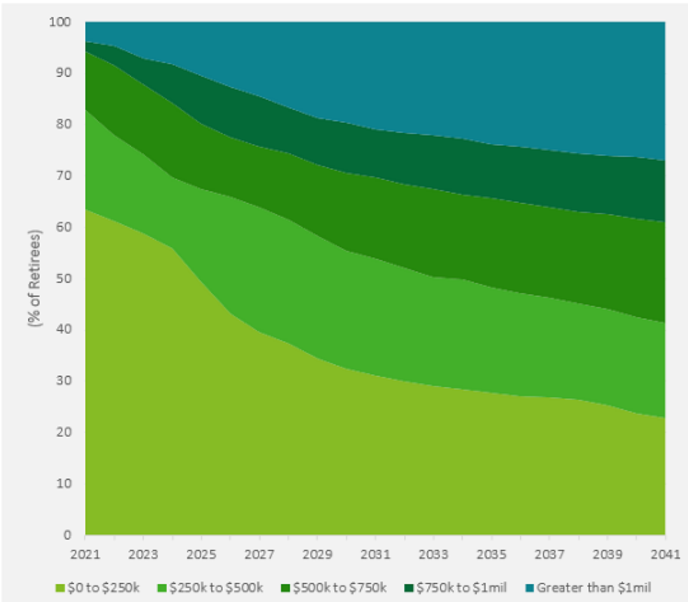
"The sole purpose requirements contained in section 62 of SIS (the "sole purpose test") limit the provision of superannuation benefits by regulated superannuation funds to a range of prescribed or approved retirement or retirement related circumstances. The test is the legislative expression of the retirement income objective which is the key rationale for superannuation savings."

One thing is clear: retirement has become a central part of the conversation about the future of superannuation and member needs. Over the next 20 years we will have more post-retirement members with more superannuation savings than ever before. There are just over 3 million Australians currently aged 55-64 and approaching retirement in the next decade. In 2021, around 65% of retirees had less than $250,000 in super 'at retirement' but this is expected to quickly reduce to about 30% over the next 10 years. By 2031, almost 50% of retirees will have more than $500,000 in super.

Projected growth in post-retirement members



Proportion of superannuation balance ranges at retirement



Research has shown that superannuation fund members start to engage more with their super when they reach age 50 and/or their account balance reaches $250,000 (even more so when it reaches $500,000). So, the time has come, with demographics turning in our favour, to engage more people with their retirement.

To help, there have been two very important developments with effect from 1 July 2022.

First, the Retirement Income Covenant (RIC) came into effect on 1 July, which requires every superannuation fund to have a retirement income strategy for the benefit of members who are retired or who are approaching retirement. The retirement income strategy must address how the trustee will assist those beneficiaries to achieve and balance the following three retirement objectives:

- Maximise expected retirement income
- Managing expected risks to the sustainability and stability of expected retirement income
- Having flexible access to expected funds during retirement

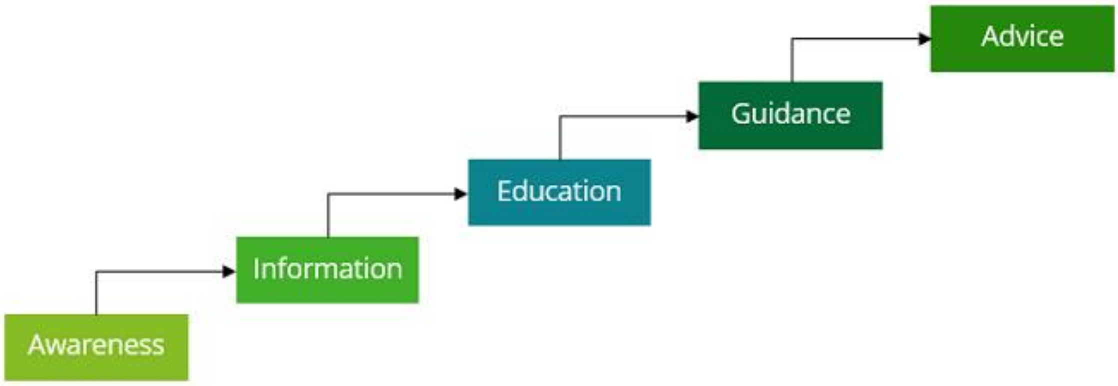
Trade-offs will need to be made to balance the competing objectives (for more information on the trade-offs).

As part of their retirement income strategies, superannuation funds are looking at different cohorts that might have similar objectives to potentially offer them different retirement product combinations, including an Account Based Pension (ABP), a longevity protection layer and of course the government Age Pension (for more information on cohorting).

Importantly, for retirees who are (or will become) eligible for at least a part Age Pension, there is a 40% exemption from the means tests for certain longevity protection products that can provide an immediate uplift in the Age Pension payments.

Second, new relief for superannuation calculators and retirement estimates set out in *ASIC (Superannuation Calculators and Retirement Estimates) Instrument 2022/603* also took effect on 1 July 2022. However, ASIC has provided a transition period of six months, during which providers of superannuation forecasts may rely upon either the existing relief or the new relief. Only the new relief will be available from 1 January 2023. For more information on the new ASIC relief, we will shortly be publishing a separate blog, including details about the Flexible Interactive Retirement Estimate API that the team here at Deloitte has built to efficiently assist trustees who wish to better engage their members approaching retirement using retirement income estimates and calculators.

The new retirement estimates will provide a great start on the engagement journey for members who are approaching retirement, providing a much-needed wake-up call with meaningful insights about what retirement could look like. Once "awareness" has been raised, the superannuation fund will then be in a better position to provide further information about retirement, its risks and how to deal with them. As members get closer to retirement, more education materials and financial calculators can be used to help guide members to better outcomes. Ultimately, in some cases, members who are about to retire may seek some form of advice to help them to confirm their preferred retirement strategies and to implement them.



While that may sound simple, it's obviously not. Retirement is complex and personal, and everyone's personal circumstances are different. That's why we have built a range of calculators and tools to assist members to understand how the various components of our retirement income system might interact. While it is tempting for product providers to think about how best to distribute their retirement product, we think that a better approach is to solve the retirement problem from a customer's perspective – that is, we have a financial literacy problem, not a product scarcity problem.

How much superannuation do I expect to have at retirement? What my spending needs are likely to be, and what additional spending 'wants' would be nice? What product strategy is most likely to meet my needs and help me to manage my retirement risks? What drawdown strategy will meet my spending needs at various stages of retirement?

There is plenty of research to show that one of the scariest things about retirement is the fear of running out of money, but on the positive side, retirees are willing to use technology to help them plan for a better retirement.

Five customer insights will shape future offerings

Insights generated through Deloitte's recent D5 Retiring Australians open innovation research.

That is where the next generation of retirement calculators come in. Calculators that clearly show variations in how long your money is expected to last under poor, average or strong market conditions. Those that allow you to compare outcomes under a variety of investment portfolios, from conservative to high growth. And are integrated with different longevity protection products to show not only how much Age Pension uplift you can expect, but also how different retirement products might be blended to produce different expected spending patterns during retirement. After all, this is what a retiree is most interested in.

Andrew Boal and Steve Freeborn are both Partners, Actuarial Consulting and Anthony Saliba is a Director, Actuarial Consulting at [Deloitte Australia](). This article is of a general nature and has been prepared without taking into account your objectives, financial situation or needs. It has been prepared with due care but no guarantees are provided for the ongoing accuracy or relevance.

A guide to excess non-concessional super contributions

Julie Steed

From 1 July 2022, individuals under age 75 do not need to meet a work test to be eligible to make a non-concessional contribution. In addition, clients who are 74 or under at 1 July 2022 may be eligible to access the bring forward rule and contribute up to $330,000 in 2022/23.

The rules for eligibility to contribute to super are relatively simple however there are additional conditions regarding the eligibility to access the bring forward that may result in unintended tax consequences. In this article we will look at the rules and review what happens when they are not fully met.

Eligibility to contribute

The superannuation law rules for eligibility to contribute to super are relatively simple – make the contribution before your 75th birthday. There is a small grace period where a fund may accept a contribution for a member up until 28 days after the end of the month in which the member turns 75.

Contribution limits

Individuals who are eligible to contribute to super pay no personal tax on contributions that are within the contribution caps contained in tax law.

For 2022-23 the general non-concessional contribution (NCC) cap is $110,000 and individuals who are eligible for the bring forward rule may contribute up to $330,000.

Being age 74 or under as at 1 July is only one of the conditions for being able to access the bring forward rule. Two other requirements are in respect of the individual's total super balance at the previous 30 June and not currently being in a bring forward period.

The following table illustrates the relationship between the total super balance and the non-concessional contributions cap for 2022/23:

Cap	Total super balance at previous 30 June	Cap amount
Annual cap	< $1.7 million	$110,000
Three-year bring forward	< $1.48 million	$330,000
Two-year bring forward	$1.48 million to < $1.59 million	$220,000
Annual cap only	$1.59 million to < $1.7 million	$110,000
Nil	≥ $1.7 million	Nil

The total super balance includes all superannuation benefits, accumulation accounts, pension accounts and defined benefit pensions. Sadly, some individuals have misunderstood this definition and will exceed their NCC cap.

It is also important to understand that the NCC cap is zero in a year if the total super balance at the previous year is greater than the maximum total super balance threshold, even if the individual had triggered a bring forward in an earlier year.

Contributing above the cap – associated earnings

Where excess NCCs exist, individuals are liable for tax on associated earnings. The associated earnings amount is a substitute for fund earnings on excess NCCs and is the general interest charge rate (currently 9.1% per annum).

The associated earnings amount is calculated by the ATO and applies from the start of financial year in which the contributions were made up to the day the ATO issues the excess NCCs determination. The amount compounds daily.

The associated earnings amount is included in the assessable income of an individual and taxed at their marginal tax rate with a 15% offset in lieu of tax paid on earnings by the super fund.

Members may minimise the amount of associated earnings payable by lodging their tax return as early as possible. APRA regulated funds report contributions to the ATO when received and 30 June balances by 31 October, and the ATO will make the determination following receipt of this information. If the contribution was made to an SMSF, the associated earnings will be reduced by the SMSF lodging its annual return as soon as possible. If an SMSF lodges its annual return on 1 May, the associated earnings calculation applies for at least 670 days. If the member and the SMSF lodge returns by 30 September, the number of days reduces by approximately 200 days.

Excess determination

Where an excess exists, the ATO issues a determination notice to the member. The determination notice includes:

- the excess NCCs
- the associated earnings amount
- the total release amount (excess NCCs + 85% of associated earnings)
- an election form to release the total release amount

If the member makes an election to release the total release amount, the ATO:

- adds the associated earnings amount to the member's taxable income
- calculates the adjusted tax amount
- includes a tax offset of 15% of the associated earnings amount
- issues an amended tax assessment to the member
- issues a release authority to the fund

The super fund then pays the release amount to the ATO. The ATO retains the amount of tax liability calculated on the associated earnings and forwards the remainder to the member. If the member does not make an election within 60 days of the ATO issuing the determination, the ATO will default the election to release the total release amount and will serve the release authority on the super fund

If the member elects not to release the total release amount (or doesn't make an election), the ATO issues a notice of assessment for 47% of the excess contributions. The tax must be paid from the super fund and the ATO will issue a compulsory commutation notice to the fund who will pay the tax to the ATO.

Case studies

The following case studies highlight some of the areas where there is misunderstanding, and where care needs to be taken and advice sought.

1. Total super balance threshold

At 1 July 2022 George is age 73 and Mildred age 74. George read an article in the newspaper about the lifting of the work test and the ability to use the bring forward rule until age 74. The article explained the withdrawal and re-contribution strategy to potentially save tax for their adult child beneficiaries and the potential benefits of equalising the account balances of members of a couple.

In July 2022, George withdrew $660,000 and then re-contributed $330,000 to his account. George contributed $330,000 to Mildred's account as a non-concessional spouse contribution.

The 30 June 2022 financials for the SMSF had not been completed at that time.

Now that the financials have been completed, George's total super balance at 30 June 2022 is $1,750,000 and Mildred's is $450,000.

The 30 June 2022 SMSF accounts and tax returns have been audited and lodged.

What is the result of George and Mildred's contributions?

Unfortunately, George has an excess NCC of $330,000. As his total super balance at 30 June 2022 was $1,700,000 or above he has a NCC cap in 2022-23 of nil.

The SMSF trustee is not able to return the contribution as it was not made in error and the SMSF is eligible to receive the contribution because George is under 75. It just has unfortunate personal tax implications.

George has met a condition of release by virtue of being over 65, however making a benefit payment will not reduce the excess NCC. Associated earnings will accrue on the excess, compounding daily (currently at 9.1%) until he receives a release authority from the ATO.

The only thing he can do to reduce the amount of the associated earnings is to lodge his 2022-23 personal tax return and the 2022-23 SMSF annual return as soon as possible after 30 June 2023.

If George lodges his personal tax return and the SMSF tax return on 28 July 2023, his associated earnings will be approximately $34,500, which will be taxed at his marginal tax rate. If George can't arrange for the SMSF annual return to be lodged until November and the ATO issues an excess NCC determination on 14 November 2023, the associated earnings increase to approximately $45,000.

As Mildred had a total super balance of $450,000 at 30 June 2022, she is eligible to contribute up to $330,000 in 2022-23.

2. Total super balance definition

Babak was age 69 at 1 July 2022 and is the sole member and director of the corporate trustee of the Babak SMSF. Babak had rolled back $250,000 to an accumulation account at 30 June 3017 to ensure she only had $1.6 million in pension phase at 30 June 2017.

Babak read an article in the newspaper about the lifting of the work test and the ability to use the bring forward rule until age 74.

As at 30 June 2022 Babak's pension account was valued at $1.65 million and her accumulation account was valued at $280,000. Babak mistakenly understood that her total super balance at 30 June 2022 was $280,000 so she contributed $330,000 during 2022-23.

Unfortunately, Babak has an excess NCC of $330,000. As her total super balance at 30 June 2022 was $1,980,000 ($1,700,000 or above) she has a NCC cap in 2022-23 of nil.

3. Total super balance exceeds threshold after bring-forward triggered

Cesare was age 61 on 1 July 2021 and he had a total super balance of $1.3 million at 30 June 2021. In 2021-22 he triggered the three-year bring forward rule by contributing $120,000. He intends to contribute $210,000 in 2022-23.

As at 30 June 2022, Cesare's total super balance is $1,750,000. Accordingly, his NCC cap for 2022-23 is nil and he cannot contribute in 2022-23 without having excess. However, if his total super balance at 30 June 2023 is below the threshold at that time, he may be able to contribute the remaining $220,000 of his bring forward. We expect that the total super balance threshold will be indexed to $1.8 million, possibly even $1.9 million.

Conclusion

Understanding *all* the rules that apply to the eligibility to contribute and access the bring forward concessions can assist in ensuring excess contributions and the associated tax penalties are avoided.

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.

What the private credit boom means for investors

Roger Montgomery

Did you know 97% of all businesses in Australia are small and medium enterprises (SMEs)? And did you know the financial gap between what SMEs have and what they would like to spend and invest to grow is approaching $100 billion? More on that in a moment.

Hands: they're the tell-tale sign of hard work. From bakers to builders, tilers to teachers, and from jackaroos to jewellers, the lines, scars and colour of our nation's hands tell the story of hard work. And it's work that has supported families, founded partnerships and built a nation. Our land's hostile climate, rugged landscape and vast distances ensured it would only yield to hard work. Those hard-working hands are the account of our modern history and the source of our global status.

There are investment managers backing and fuelling hard-working Australian SMEs but they're in an asset class you may not have previously had access to. Formerly the exclusive preserve of family offices, high net worth and ultra-high net worth investors, private credit is fast becoming an important inclusion in the portfolios of almost all Australians who want to support and back hard work.

Previously dominated by big banks

Private credit is one way businesses raise capital. Access to finance is essential for SME growth and unlike private equity, where investors contribute funds in exchange for a shareholding in the business, with private credit, investors provide loans and receive interest payments in return.

It's an activity said to have been conducted in Mesopotamia, five thousand years ago. And up until recently, it was dominated by the big four banks.

If you ask the Australian Banking Association, they'll tell you that in 2019 more than 80% of SME lending applications were accepted by banks. According to the ABA, most SMEs that seek access to finance also report they receive it.

According to that same body, in the three months to August 2021, new lending to small businesses jumped 26% from the same period in 2020 to $10 billion. Meanwhile, lending to medium businesses in the three months to August 2021, jumped 49% from the prior corresponding period to $19.3 billion.

Whether hard-working SMEs are being properly and fairly served depends on whom you ask.

Growing funding gap

According to a recent report released by fintech Judo Bank, the funding gap – which is the amount between what SMEs have and what they would like to spend – continues to grow, revealing credit and finance are not available to small businesses at the rate that they would like.

According to Judo Bank's 2021 SME Insights Report, carried out by East and Partners after surveying 1750 SMEs, the funding gap for SMEs with turnover between $1 million and $20 million in 2021, widened by $4.6 billion, from 2019, to $94.3 billion - an increase of 5.1%. The annual increase in the funding gap prompted one Judo Bank spokesperson to say, "banks have retreated, leaving SMEs out in the cold".

It certainly suggests there's a limit to the big banks' capacity and appetite to provide financing solutions, covering hundreds of customers, tailored to SMEs' individual needs.

Most recently, findings from an RFI Global survey of 4,700 owners and operators in Oceania, revealed 70% of SMEs in the Asia-Pacific were less than satisfied with access to credit provided by their main bank.

When choosing a loan provider or financial institution, the top driver cited by 45% of Australian SME respondents, was competitive interest rates. Perhaps more importantly, however, 77% cited access to funds and flexibility in repayment options.

Where banks might take six weeks to approve a small, short-term loan, many non-bank lenders have enabled technology to approve loans in 24-48 hours.

Think of a wheat farmer, with a record crop, who needs to take advantage of ideal harvesting conditions and a window of only a few weeks. Now imagine, in the middle of harvest, their header breaks down and needs $140,000 of clearly critical repairs. A six-week approval process is simply not going to cut it.

The RFI Global survey revealed Australian SMEs have made it clear, should they require financial support in 2022, they're less optimistic about obtaining it from their main banks.

Private credit fills breach

Enter private credit, to fill the gap. Growth in this asset class was first driven by institutional investors before capturing the attention of family offices and high-net-worth investors. The continuing growth in the funding gap however has meant there's more than sufficient demand from SMEs to permit wholesale and retail funds to be established.

And the growth should be welcome. U.S. journal *Institutional Investor* found private credit funds can lend capital when it's otherwise unavailable, smoothing the credit cycle and stabilising the market. In anticipation of an economic downturn, banks decrease lending. But private credit funds, being already well-established, can offer credit that banks are unable to. This can keep businesses going, mitigating the severity of a downturn and helping a return to economic normality.

A growing number of private credit funds are being established in Australia. And the returns, even during the pandemic have been alluringly high, stable and regular. The Aura High Yield SME fund, which Montgomery distributes in Australia through a unique partnership, has returned a compounded 9.85%, and monthly income for over five years with no negative months, even during the Covid-19 pandemic when stock markets were collapsing.

What investors should look for

But as with any asset class, not all funds are created equal and there are risks. Investors need to dig deep to uncover how much diversification exists, whether any leverage is being used to boost returns and whether 'lock-up' periods exist, preventing investors from leaving.

Investors should first demand wide diversification. A fund with many thousands of small loans arguably offers diversification benefits that a fund with a handful of very large individual loans cannot offer. Similarly, investors need to look under the hood to ensure the loans are indeed to businesses and people they want to support. One fund may offer loans to cattle farmers and chickpea growers, but another may be lending for property development or a management buy-out.

One must also uncover whether lockups prevent an early redemption, which of course might be required when one's needs and circumstances change. With some, you may not be able to retrieve your money within twelve months or even longer. Look at least for monthly liquidity and no lockups.

Investors should also find out what the average duration of the loan book is. If the average duration is four months, your returns are more likely to follow interest rates as they rise. If the average duration is a year or two, you may find your returns lag any increases in rates.

And finally, be sure to understand the structure. What I want to see, and what you should demand, is alignment between your money and the capital of the lenders who are the businesses originating the loans, processing applications, and providing the finance directly to the borrower. Good alignment sees the originators put their capital and returns at risk first. That way, if there are some defaults and the security that was provided cannot be retrieved and therefore a loss occurs, it is the originator's returns and capital that are impacted first, offering some initial protection to returns and capital of fund investors.

Private credit is a growing asset class, but it isn't new. Your bank has been lending to SMEs for a century and now they're pulling back, opening the opportunity for others. Previously you had to own bank shares to see some of the returns from SME lending. Private credit funds now provide direct access to this income stream and growing asset class. As always be sure to seek and take personal professional advice.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

Are A-REITs set for a comeback?

Cameron McCormack

Australian Real Estate Investment Trusts (A-REITs) have been hit hard by this year's sell off, underperforming the market by over 18%. But while REITs are down, they are not yet out. The REITs' rough run has mainly been driven by a sharp increase in the 10-year bond yield, which has more than doubled. However, we believe long dated government bond yields could be close to reaching their peak, and with the Reserve Bank of Australia (RBA) prioritising growth over inflation, this could provide a tailwind for REIT performance in 2023.

The RBA has started to temper the rate of cash rate increases over the past two months despite Australian inflation reaching a 40-year high in Q3 and expectations it will further increase in Q4 2022. The RBA increased the cash rate in October and November by 25 basis points, below market expectations of 50 basis point hikes on both occasions.

This approach indicates that for 2023 the RBA is prioritising economic growth over containing inflation quickly. RBA increased their Australian CPI forecast for 2023 from 2.75% to 4.75% over the past four quarters. In contrast, the US Federal Reserve (Fed) is resolute in driving down inflation to 2% despite its actions increasing the risk of a US recession 'hard landing'.

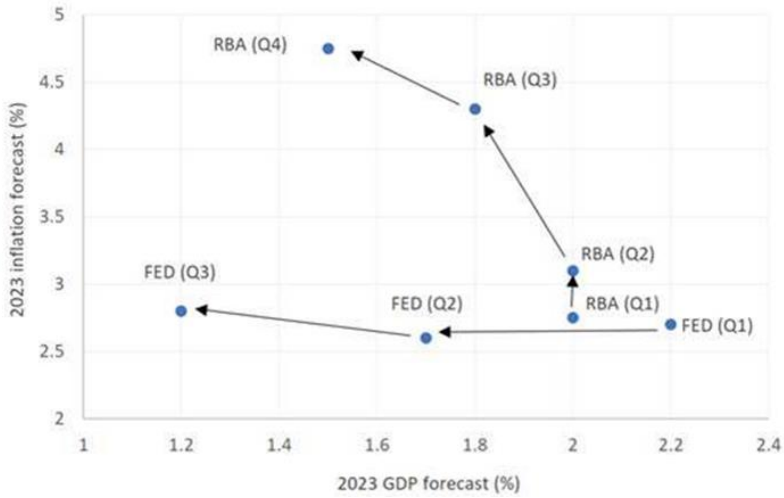
The RBA's focus is positive for potentially oversold A-REITs for 3 reasons.

1. REIT income is inflation linked

REITs historically outperform during persistent inflation periods. The RBA is forecasting inflation to be above its target in 2023.

Commercial leases and contracts in office and logistics typically have inflation-linked annual increases in rents written into the contract, providing inflation protection on income. Take for example the period between the end of the dot-com bubble and Global Financial Crisis. During these years, Australian CPI year-on-year was 2.9% on average and Australian 10-year government bond yields steadily increased over this time where Australian REITs as represented by S&P/ASX 200 A-REITs outperformed S&P/ASX 200 by 3.99% between 1 January 2002 and 31 December 2006.

Central bank forecasts for inflation and GDP growth in 2023



Source: RBA, Federal Reserve

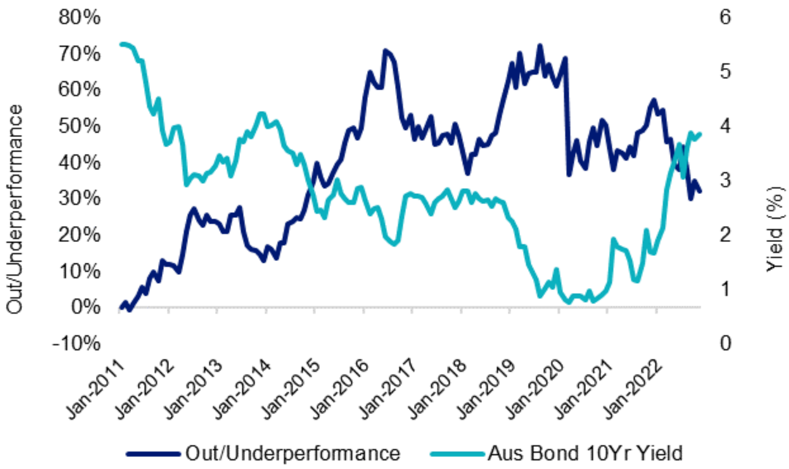
2. In the case of peaking rates, pivot to A-REITS

REIT performance is negatively correlated with bond yield movements due to the change in borrowing costs impacting property valuations. The increase in government bond yields year to date, due to rapid increases in the expected RBA cash terminal rate has been a major headwind for REIT performance.

However, long dated government bond yields could be close to reaching their peak. Broker consensus is Australian Government bond 10-year yield will remain at similar levels over the next two years. Bond markets have priced in expected further RBA cash rate increases and there is a chance the RBA starts cutting the cash rate in late 2023 as the global economy slows, putting downward pressure on government yields.

If yields fall, this would be a tailwind for REIT performance.

A-REITs performance relative to S&PASX 200 versus Australian government 10-year bond yield

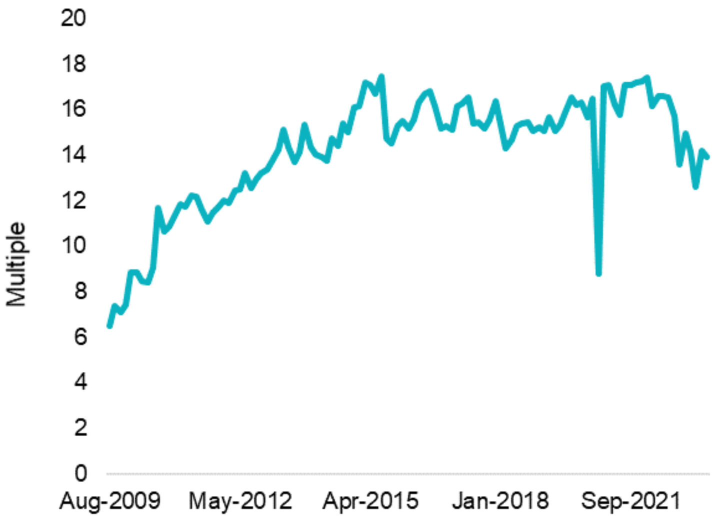


Source: Bloomberg, Out/Underperformance as MVIS Australia A-REIT cumulative performance relative to S&P/ASX 200. Past performance is not indicative of future results.

3. Attractive valuations

The asset deflation bear market we have seen year to date has improved the valuation profile of REITs. Price to Adjusted Funds from Operations (AFFO multiple) is at a 9-year low and price to net tangible assets (NTA) is at a 15% discount. These measures are preferred to metrics such as price-to-earnings ratios when it comes to REITs.

A-REIT AFFO Multiple

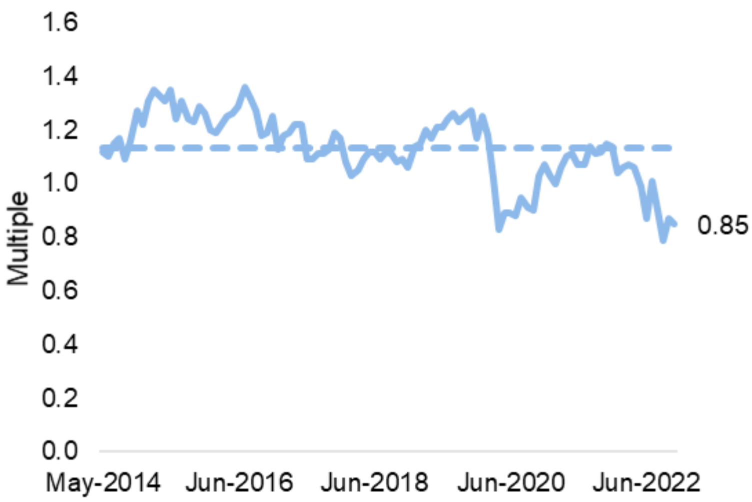


Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index

VanEck favours the outlook of industrial REITs such as Goodman Group and Centuria. We anticipate cap rates and net operating income to remain sticky as tenants manage excess inventory levels and expand e-commerce channels amid low vacancy rates. Retailers will continue to invest in optimising delivery chains as they address demand for both in-store and online consumer spending. Warehousing provided by industrial REITs will be key beneficiaries.

VanEck is cautious on Retail REITs including Scentre group and Vicinity Centres. Rapid RBA cash rate increases have yet to shift consumer spending patterns. Retail sales year-on-year growth is almost 7 times pre-COVID trends (2017-2019) which is not sustainable in a higher inflation and rates environment. These REITs will come under pressure when retail spending decelerates.

A-REIT Price to NTA



Source: Bloomberg, A-REIT as MVIS Australia A-REIT Index

Cameron McCormack is a Portfolio Manager at [VanEck Investments Limited](), a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.

For more articles and papers from VanEck, click here.