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Editorial

Back on the tools after a sabbatical, the new year feels more than usual like a time to stocktake and check the goals for an investment portfolio, especially since I turned 65 a few weeks ago. Nobody hands out a card that profiles the future, and everybody needs to plan their own investments based on their life, their resources, their desires, their objectives.

Although every financial newsletter shares the tea leaf reading of market experts at the start of the year, here's how legendary US fund manager **Peter Lynch** colourfully describes these efforts:

" ... they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."

The most important risks are the ones few people anticipate, and if you could predict them accurately, they would no longer be risks as counter action would be taken. This is a time when US Fed Chairman, **Jerome Powell**, has made it clear that rate rises will not stop until inflation is under control. But flip a coin on where the market is going. The S&P500 is currently about 4,000, and the range of 2023 targets below varies from 3,675 to 4,500. Up, down and flat pretty much covers it.

Wall Street's 2023 S&P 500 Targets (as of Dec. 4, 2022)

Target	Institutions
3,675	Barclays
3,800	Societe Generale, Capital Economics
3,900	Morgan Stanley, UBS, Citi
4,000	BofA, Goldman Sachs, HSBC
4,050	Credit Suisse
4,100	RBC
4,200	JPMorgan, Jefferies
4,300	BMO
4,300-4,500	Wells Fargo
4,500	Deutsche Bank

Source: TKer

The dubious value of this pontificating was emphasised to me over the holiday during a regular quarterly lunch with four chaps I have known for decades. We call ourselves the 4Gs - **Graham, Geoff, George and Gordon** - and we each had long careers in different parts of the financial markets, from actuary to financial adviser to markets to legal SMSF specialist. And while three of the Gs discuss investing and markets, the actuary sits there sipping his beer and smiling at his lamb shoulder.

In the 40 years I have known Geoff, he has been admirably consistent in his investing technique. His portfolio mainly holds shares, directly and through funds, and he cares only about the rising dividends while he worries little if at all about the market value (much like the **Peter Thornhill**'s view). So while

the other three genius Gs solve the economic woes of the world to no practical effect, he collects his dividends confident he has 'enough'.

There's a word we don't hear much in financial markets: 'enough'. I read a lot during my break, including a fascinating small book by **Jack Bogle**, founder of indexing and **Vanguard**, called *"Enough: True Measures of Money, Business and Life"*. What sets Bogle apart from dozens of the famous global wealth icons who became billionaires is that he felt the financial system subtracts value from our society and he should only take enough for his needs and goals. He quotes many examples of the 'Heads I win, tails you lose' by businesses in funds management.

"What I'm ultimately looking for is an industry that is focused on stewardship - the prudent handling of other people's money solely in the interests of investors ... and values rooted in the proven principles of long-term investing and of trusteeship that demands integrity in serving our clients."

How much is enough for Jack Bogle? He founded the second-largest fund manager in the world, and could easily have amassed billions. He says:

"Let me open up my confession about what is enough for me by saying that, in my now 57-year career [the book was published in 2009 and Bogle died in 2019], I've been lucky to earn enough - actually more than enough - to assure my wife's future wellbeing; to leave some resources behind for my six children (as it is sometimes said, 'enough so that they can do anything they want but not enough that they can do nothing'); to leave a mite to each of my 12 grandchildren; and ultimately to add a nice extra amount to the modest-sized foundation that I created years ago."

He says that for 20 years, he has given away one-half of his annual income to various philanthropic causes, but he feels he has done well because of three reasons:

1. He was born and raised to save rather than spend (his Scottish thrift genes).
2. He has been blessed with a 'fabulous' defined benefit plan into which he has invested 15% of his salary over his entire career and in retirement.
3. He has invested wisely, avoiding speculation and focussing only on (you guessed it) conservatively-invested, low cost mutual funds.

And like my mate Geoff, he tries not to watch the balance of his fund.

He says enough should be $1 more than anyone needs, and saving is the key to wealth accumulation.

When I sat down in recent weeks to review my SMSF's investments for 2022 and position the portfolio for the future, there is a focus on 'enough' and protecting the capital in the fund rather than swinging for the fence. I describe some of my investment decisions in the hope there may be ideas there for you.

Finally, the best chart I saw in the last few months acknowledged the major milestone of global population passing 8 billion, with Australia represented by that tiny purple triangle on the left. We love to think we punch above our weight.

Many thanks to James and Leisa for producing such good newsletters in my absence. James will continue to edit Firstlinks content and write for both Morningstar and Firstlinks, while Leisa holds the whole show together.

Graham Hand

Also in this week's edition ...

Chris Joye of Coolabah Capital Investments is the bearer of bad news for those who think stocks and residential property will bounce back this year. He says both have further to drop and even when interest rates start to fall, they're only likely to deliver returns in line with wage growth in the medium term. He is bullish on one asset class though: fixed income.

And he's not alone as **Tim Larkworthy** is also positive on bonds. He makes the interesting case that central bank efforts to tame inflation will depend on their ability to rein in the behaviour of consumers, who've been happy to spend despite rapid rate rises. Until this behaviour changes, the central banks are unlikely to cut rates.

Cameron Murray is frustrated by fearmongering from politicians and the media about Australia's ageing population. He says it's fine for them to make the argument for more immigration, but they shouldn't pretend that the age structure of the population is the reason why.

When investors think about commercial property, they often focus on office, industrial and retail, but specialised sub-segments are starting to get more attention. Student housing, healthcare, life sciences and the like. And **Stuart Cartledge** takes a look at another potentially lucrative, niche segment: pubs.

Meanwhile, **Magellan** addresses the elephant in the room when it comes to LICs: their tendency to trade at discounts to asset values. Magellan explains what it's trying to do about it, as well as addressing the underperformance of its Global Fund last year.

Richard Bernstein notes the sectors that led the last bull market are unlikely to lead the next one. He says investors looking at US tech and meme stocks to bounce back will be disappointed. Instead, they should be eyeing new sectors emerging as market leaders, such as energy and infrastructure.

The sponsor white paper featured this week is **VanEck**'s Portfolio Compass on Australian Equities in 2023. As in Graham's article, it recognises that Australian equity investors had a reasonable year and not the setback many analysts describe.

Curated by James Gruber and Leisa Bell

My SMSF in 2022: the good, the bad and the lucky

Graham Hand

Stop whinging about investment performance in 2022. Every market analyst starts the year with a summary of the previous 12 months, and descriptions of 2022 vary from brutal to terrible to disappointing. Among many examples, fund manager Roger Montgomery, mainly an Australian equity investor, started his first newsletter of 2023 by saying:

"Many commentators point to the 12 months to December 2022 as being one of the toughest annual periods for the performance of the share market and the bond market for several decades."

Morningstar's Director of Personal Finance, Christine Benz, who has more of a US focus, wrote:

"This past year was likely an unnerving one for many retirees. Amid soaring inflation and rising interest rates, stocks and bonds both ended the year with double-digit losses, marking their worst simultaneous decline in more than 50 years."

Not much love there, but was it really so bad for Australian superannuation?

Expectations need a reality check

In fact, including dividends, the broad S&P/ASX200 index rose 1.9% in 2022, and many active equity managers performed well. According to the latest VanEck Australian Investor Survey, 70% of investors plan to increase their allocations to Australian equities in 2023, and what matters most to local investors is local equities.

While US investors saw their broad S&P500 index fall by 18% and the Bloomberg Aggregate index of investment-grade bonds lost 13%, there were plenty of opportunities to avoid the gloom for Australians. Chant West reported in mid-December 2022 that the median superannuation growth fund was down 4% for the year,

hardly a disaster. The top five managed funds in the Morningstar database were all up over 30% in the last year.

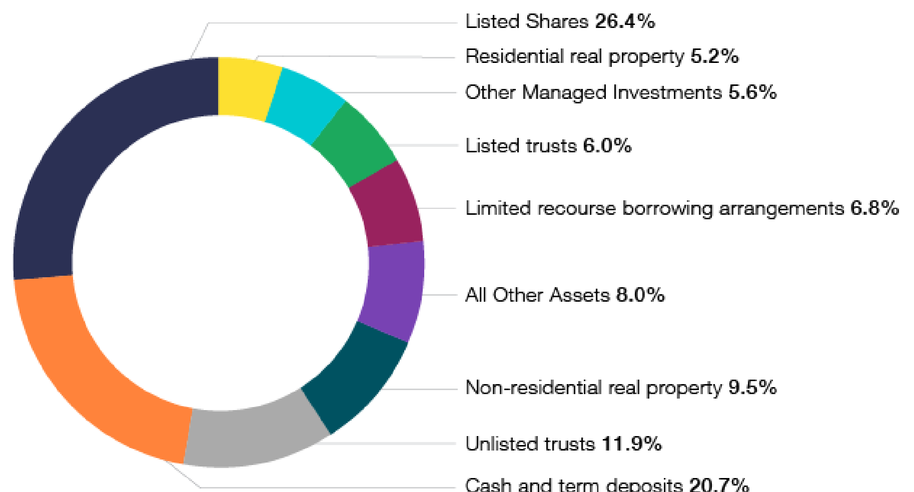
The Standard Risk Measures for Australia show the number of annual negative periods expected over any 20-year period for major asset classes. For equities, the number is '6 or greater'. At least 30% of years should show stockmarket losses. Investors not prepared for equity market downturns once every three years are in the wrong investments.

Yes, there's a lot of red in Ashley Owen's (of Stanford Brown) chart below for asset class performance in 2022 but look at all the green for 2021. While everyone moans about the S&P500 losing 18.1%, it was up 28.7% the year before, giving a respectable two-year return, despite everything that has hit the market.

Much of what was lost in 2022 was giving back the exuberance of 2021 and previous years. Did bond investors believe interest rates would stay at zero or negative forever? Did the valuations on tech stocks deserve to stay lofty and priced for perfection in all market conditions? While some fund managers looked like geniuses riding out the pandemic in 2020 and 2021, many then misread conditions and took little off the table as the market switched from growth to value. On another side of the same coin, plenty of fund managers outperformed as markets corrected. Check Lazard, GQG, Merlon, Allan Gray, Talaria and Katana among many for strong 2022 results.

Limits to fixed rate bond losses in SMSFs

In the portfolios of SMSFs, long-term fixed rate bonds do not feature prominently, and it's unlikely bond losses were significant. The latest SMSF asset allocation data from the ATO (produced with a lag and dated 30 June 2020) shows cash and term deposits comprised about 21% of assets, and income from these rose significantly over 2022. Property gave some of the 2021 gains back in 2022 but depending on who was managing the equities



and the domestic/global mix, it may have been a decent year. SMSFs are overweight Australian equities relative to global.

Investors who bought into crypto and NFTs on the back of celebrities like Matt Damon telling them that 'Fortune Favours the Brave' have experienced a reality check. Here are the words of Damon's Crypto.com commercial:

"And in these moments of truth, these men and women, these mere mortals - just like you and me - as they peer over the edge, they calm their minds and steel their nerves with four simple words that have been whispered by the intrepid since the time of the Romans: Fortune favors the brave."

Investing rubbish. I'm looking forward to the new ad: '*Fortune Favours the Diversified*.'

Market timing versus risk management

There is a difference between hopeful market timing and considered risk management. Any number of studies show investors struggle to identify market entry and exit points, and as Vanguard's Jack Bogle said:

"The idea that a bell rings to signal when to get into and out of the stock market is simply not credible. After nearly 50 years in this business, I don't know anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has."

And Peter Lynch, who as manager of the Magellan Fund at Fidelity Investments in the US for 13 years from 1977 delivered double the returns from the S&P500, said:

"Thousands of experts study overbought indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply … and they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."

While I agree with these thought leaders, every person needs to set up a portfolio which suits them personally, to meet their goals and to marry with their appetite for risk. When I signalled to Firstlinks readers at the end of 2021 that I was reducing my exposure to equities, it was less a market timing exercise than a desire to preserve capital. I turned 65 a few weeks ago, and while I might live another two or three decades, my focus heading into 2022 was hanging onto my SMSF's assets rather than stretching for another year like 2020 and 2021. On 8 December 2021, I wrote:

"I am starting to reduce some equity exposures as I personally believe the market will experience a decent fall sometime in 2022."

So just as the market legends eschew market timing, so they also encourage investors to adopt a plan and a discipline and not take risks that might compromise their goals. The father of value investing and mentor to Buffett and Munger, Benjamin Graham wrote:

"The best way to measure your investing success is not by whether you're beating the market but whether you've put in place a financial plan and a behavioural discipline that are likely to get you where you want to go."

A phrase adopted by Nobel Laureate, Daniel Kahneman, is that the key to good investing is having *"a well-calibrated sense of your future regret".*

These words provide a context for reviewing 2022.

Delving into my SMSF performance for 2022

No decision made now can change past returns, and the only thing that matters for the future are the buy, hold or sell investments made from this day forward. But looking at the past for lessons can inform the future, both for investment decisions and risk appetite.

Despite no new contributions into our SMSF and drawing the minimum pensions for me and my wife, the total balance in our SMSF increased over 2022. Let's take a quick look at a few of our investments.

The Good

When switching some money out of equities in late 2021, the investment choices were not exciting. The Reserve Bank of Australia did not start increasing cash rates until 4 May 2022, a poor judgement by Governor Philip Lowe who was at least six months late in moving to control inflation. The cash rate was only 1.35% by July 2022.

Bank hybrids and corporate floating rate notes paying a margin above BBSW offered better defensive appeal. Not only did they generate some cash flow, but the income would rise with the cash rate. Hybrids were purchased at varying margins around 3% depending on price opportunities over many months. Money was also allocated into a range of unlisted hybrids and notes, a senior bank debt fund (ASX:QPON), a subordinated debt fund (ASX:SUBD) and various listed corporate floating rate notes (such as Centuria's ASX:C2FHA and CVC's ASX:CVCG).

Less flattering, a listed fund that invests in floating rate bank capital instruments, ASX:GCAP, produced good income but our investment shows a small capital loss. Our average entry price was $9.27 and it is now trading at $9.05 after a recent recovery.

Source: *[Morningstar]*

Three-month BBR is currently around 3.3% (and heading higher) and with margins above that, the income is far higher than anything seen for years. Of course, inflation is also higher and real returns are flat.

These investments down the bank capital structure come with more risk than deposits, but there is reward for risk in a strong Australian banking system. In the deposit market, to increase returns on cash, investments were placed in ASX:BILL and higher-yielding cash accounts.

Listed infrastructure has also held ground despite rising rates, including positions in Argo's ASX:ALI and to a lesser extent, Magellan's ASX:MCSI.

Source: *[Morningstar]*

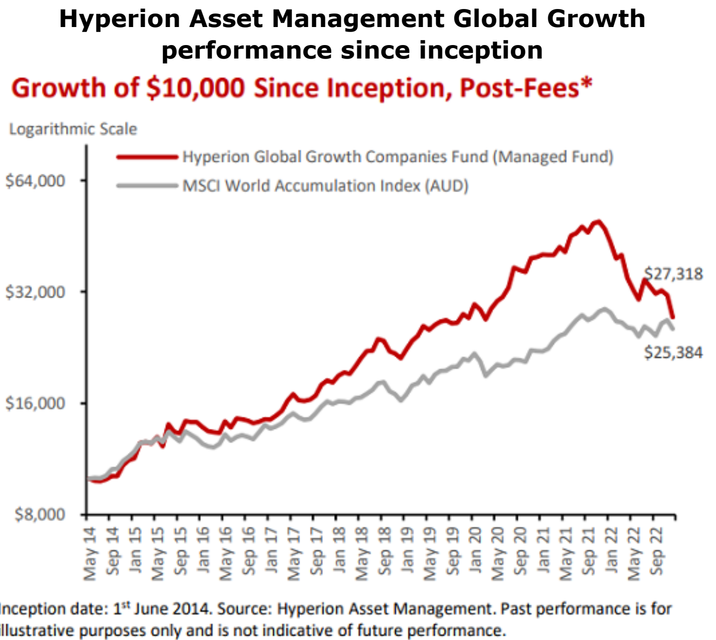
As we moved into beyond the first quarter of 2022, with demand for resources looking strong, exposure to Mineral Resources (ASX:MIN) looked worthwhile given its stake in iron ore and lithium, and industry stalwart ASX:BHP offered potential. Two resource LICs, Tribeca's ASX:TGF and Lion's ASX:LSX, were both trading at a large discount to NTA which seemed to offer added upside potential.

The Bad

While I was generally lightening the load on equities, I still wanted exposure to the growth and dividend potential of good companies. I like the concept of a core/satellite portfolio - where cost is minimised in index (or near index) funds, such as ASX:A200 (with a cost of only 7 basis points, or 0.07%) and a broad LIC available at a discount such as the Djerriwarrh ASX:DJW – while backing some active managers for potential outperformance. For reasons described in the next section where I exited direct holdings in many tech companies, I decided build a position with a few equity growth managers.

These managers included listed vehicles from Hyperion (ASX:HYGG), Munro (ASX:MAET), Loftus Peak (ASX:LPGD) and Hearts & Minds (ASX:HM1). Presentations by these managers were impressive. For example, Hyperion was Morningstar's Fund Manager of the Year in 2021 with outstanding long-term results. Hearts & Minds is a 'fund of funds' with experienced people selecting quality managers, with a philanthropic angle. I also thought buying Magellan's closed-end LIC, ASX:MGF, at a discount to NTA around 20%, was taking advantage of the market loss of appetite for the brand despite the quality underlying companies.

My new satellites took a hard landing when returning to earth over 2022. Yes, I went into this with my eyes open but it was disappointing that the funds did not bank more of their successes in 2020 and 2021. They are all global managers exposed to tech and investors should know what to expect of them. HM1 added fuel to the fire in late 2021 by updating its managers to include up-and-coming tech and growth managers, which were hit in 2022. Hyperion maintains great confidence in Tesla, down 65% in the last year, and 35% of the main portfolio is in three stocks: Tesla, Microsoft and Amazon. All great companies, but the chart shows Hyperion has given back nearly all the outperformance it took eight years to achieve since 2014. Ironically, perhaps the lesson is not to invest with managers after a long and successful run, and wait until they have given some back.

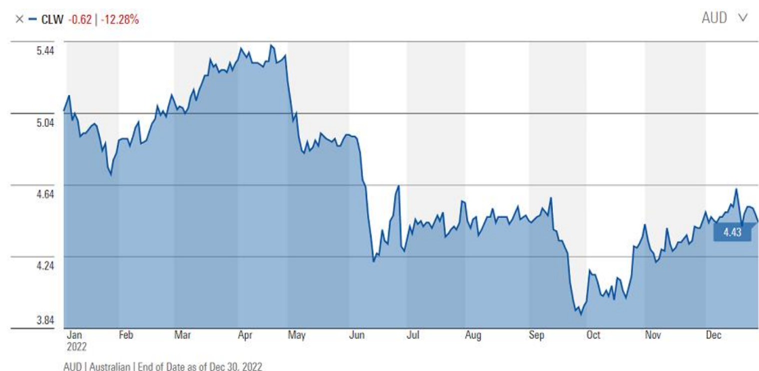


My 'index' Australian equity positions were steady. While intuitively, I believe it should be possible to identify active managers who can deliver over time, it's a long way back since the start of 2022 for some of these growth positions. Fortunately, the build of these active allocations had only started when tech hit problems.

I also held some long-term bond positions, such as in listed bonds, Australian Unity's ASX:AYUPA paying 5% pa, ECP Fund's ASX:ECPGA at 5.5% pa and Mercantile's ASX:MVTHA at 4.8% pa. At the beginning of 2022, selling these would have reduced cash flow from over 5% to around zero, and (like everyone else including the Reserve Bank Governor), I did not expect rates to rise quickly. I decided to take the ongoing income which was likely to be better than cash, notwithstanding the greater (but I judged acceptable for the reward) credit risk.

These three listed securities are now 'trading' at about $88, no bid and $94. Not the end of the world but large capital losses on the defensive part of my portfolio were not part of the plan. Liquidity in these small, corporate bond issues is poor despite public listing. Spreads were wide and I sat on the offer for many weeks to reduce these bond positions at a decent price.

Listed property is delivering good income but with varying capital losses depending on the sector exposure. I thought staying away from offices and discretionary retail would protect the portfolio, but the downside on a fund like Charter Hall's ASX:CLW has surprised. I expected its focus on industrial property, its long leases (average 12 years) to top-quality names (99% blue-chip), 6.8% distribution yield with half of the leases on the 549 properties linked to CPI (and therefore rising rapidly), plus low gearing (29.9% and most leases 'triple-net') were compelling. The market may be doubting the NTA at June 2022 of $6.26 because the share price is languishing at about $4.60, and it's the same with many property trusts. Rising rates weigh on cap values and the market is worried about values. Our average entry price is $4.80.



Source: Morningstar

The Lucky

US author Joe Wiggins focusses on the role of luck in investing, especially 'outcomes bias' where we judge the quality of the investment process by the result:

"From the unique life experience of a star fund manager to the early morning ice bath routine of a successful entrepreneur, we cannot help drawing a causal link between an individual's success and their past actions. Yet so often the outcomes we see are nothing more than a mix of luck and survivorship bias, this is particularly true in the field of fund management."

Every diversified portfolio includes strokes of luck. In my desire for floating rate exposure, I am overweight bank hybrids, and if that sector struggles, my portfolio will take a mark-to-market hit. Then if a bank such as CBA or Macquarie fails to meet its obligations, or is forced to convert its hybrids to equity, I'll end up with a large bank share position. Sometimes an investment looks good … until it doesn't.

A big piece of luck came at the end of 2021 when Deutsche Bank advised Chi-X, the alternative exchange competitor to the ASX, that it was discontinuing its Transferable Custody Receipts (TraCRs) business in February 2022. I liked this product because it allowed investments in wonderful US companies such as Apple, Microsoft, Tesla, Berkshire Hathaway, Amazon and Alphabet (Google) on the Australian market with currency covered, including conversion of dividends. I felt these great companies deserved a place in most portfolios, and having built a TraCR position over 2020 and 2021, I planned to hold them for the long term. Chi-X gave various choices to holders, but I avoided the complications by selling at the end of 2021. It was an administration decision, not motivated by investment outcomes, but I missed most of the losses in these companies over 2022. But I gave some back in smaller positions in growth fund managers described above.

What about the future?

My SMSF portfolio probably will not suit you. It is designed for my personality, family, age, goals, risk appetite, experience and outlook. No doubt my overweight in floating rate notes and underweight equities will seem wrong to some readers.

Investors who reduce equity exposure are faced with another timing decision on when to return to the market. For anyone who can hold a portfolio for the long term and not worry about capital fluctuations, the best outcome is likely to come from an equity-heavy portfolio throwing off rising dividends from quality companies, with steady capital growth.

Our SMSF is generating plenty of cash, and since it is in a mix of pension and accumulation mode, tax rates are low (yes, I'm one of those bastards who has contributed heavily to super for 30 years and now benefits from the attractive tax concessions). Hybrids and bonds are also regularly repaid and reinvestment of cash is a challenge. I have started directing some of this to equities, despite no great confidence we have seen the bottom. I feel the market is too confident about small falls in inflation and the expectation of central banks 'pausing', and the Fed will want to show that its work controlling inflation is still underway. This is moving more into the realm of market timing rather than risk management, and no doubt luck will play a part.

Graham Hand is Editor-at-Large for Firstlinks. This article is general information and does not consider the circumstances of any other investor, and is not a recommendation for any of the investments. The securities mentioned are listed securities given the ease of access for all readers, but 'wholesale' investors have many other opportunities, especially in bonds.

Chris Joye on why stocks and property are set for a poor year

Christopher Joye

This is an edited transcript of an interview by Tom Piotrowski of CommSec with Coolabah Capital Investments CIO Christopher Joye.

Tom Piotrowski: There was a point where a significant proportion of the global bond market was negatively yielding. Now, we've seen a rapid increase in rates. I'm interested in the very simple intellectual process that you have in terms of trying to make sense of those moves.

Joye: I think, after the GFC, and really, for the last 30 years, interest rates have come down from circa 17% in 1990 to 0% recently, and that was because we had no inflation. But we always felt that in response to the GFC, we'd get low rates and lots of money printing and the money printing would bid up the value of all assets, and

that would inevitably create excess demand and too much inflation. With the pandemic, we threw in a huge supply shock, and the money printing increased with gusto, and rates were even more stimulatory, and we also had governments through fiscal policy give out record amounts of cash.

We had the mother of all supply and demand side inflation storms. We've been faced with the highest inflation rates in 40 years, and late last year, we argued that rates would have to go much, much higher. So, the RBA cash rate was at zero and same in the U.S., and we argued that the Fed would have to lift its cash rate above 3%. And 10-year bond yields issued by governments, which were sitting around 1% late last year, we argued would have to go to north of 3.2%.

Importantly, that would have a few consequences. We forecast that would reduce the value of equities by more than 30%, specifically U.S. equities. We said crypto would crash in December last year. We said in October last year that Aussie house prices would fall by 15% to 25% and that credit spreads would widen.

And that's actually all negative for my asset class, because fixed rate bonds, their price falls when yields rise. And when credit spreads widen, prices also fall. Bond markets had basically their worst year in about 100 years.

And everything that we thought would happen more or less came to pass. The quid pro quo is now we sit in the world with high interest rates, wide credit spreads, and my asset class, which I really strongly disliked – in fact, we put on $10 billion of bond shorts late last year through to mid this year to express that negative view to profit from bond prices falling. But those assets, bonds which looked terrible for a while, suddenly look attractive.

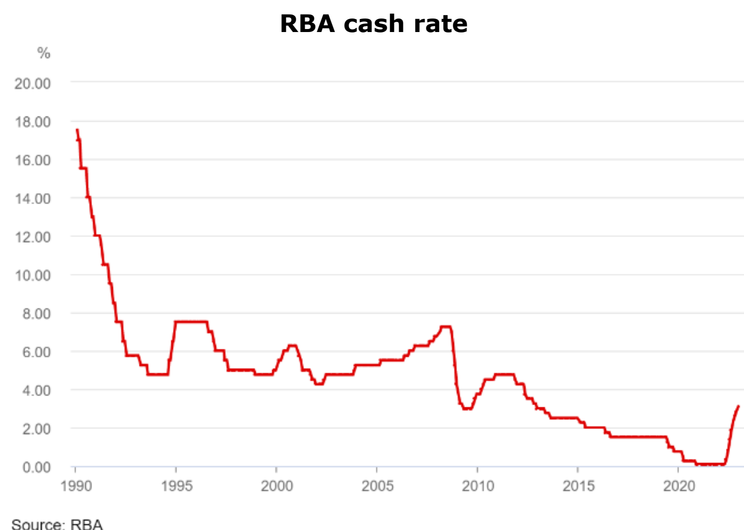
Piotrowski: They look attractive in relative terms given where we've come from. But the question that the markets struggle with is, what's the terminal point at which they stop hiking. What's your thinking?

Joye: Here in Australia, we're at 3.1%. We were at 0.1% last year. And a 300-basis-point increase is the biggest increase more or less ever. When banks were lending home loans to customers in 2020 and 2021, they were offering these super cheap fixed rate deals at circa 2% for three-year or four-year loans. The regulator, APRA, said the banks only need to stress a borrower's capacity to repay by a 2.5% increase in interest rates or a 250-basis-point increase. And the RBA has now increased rates by 300 with more to come.

Piotrowski: Yeah. So, more than redlining.

Joye: We're redlining. To answer your question, the market is saying that the RBA will finish at a cash rate of about 3.7%. Our sense is they may conk out a little bit before then, so maybe low 3s. But we're talking about the difference between two or three meetings.

Make no mistake though, the RBA is absolutely crushing the economy. House prices are falling, consumer confidence is today worse than it was in the GFC, retail spending is nose diving, business confidence has collapsed, and there is a risk the economy will go into recession. And according to the RBA's own numbers, if we get cash to 3.5%, 15% of all borrowers will actually have negative cash loads.



What does that mean? The RBA looked at their incomes, and it took off their mortgage repayments and only essential living expenses. And so, 15% are going to basically not have enough money to repay their home loans at a 3.5% cash rate, which is only a few meetings away. So, we think the RBA has probably overdone it. We think the RBA is aping the Fed. The Fed by March should be at 5%. Market is pricing about 4.9%. We think the Fed could go a little bit further, to 5% or 5.5%.

But I think the good news for everybody, if you're long – if you're in housing, commercial property, equities, crypto, bonds – the good news is, those terminal cash rates are very much just around the corner. They're in sight.

The bad news is – and this is super important for people to understand – the different asset classes adjust with different speeds. In my bond portfolio, if the RBA lifts its rate, that day it's reflected in my portfolio, and my yields instantaneously adjust. If we think about house prices, they started falling in May 2022 in response to the hikes. But they will almost certainly fall for another 6 to 12 months. And if you look at commercial property, they've hardly adjusted. So commercial property yields remain incredibly low. You earn more on government bonds and senior ranking bank bonds than you do on commercial property, which makes no sense. Normally, commercial property pays you about 5% above government bonds, and right now, they're paying basically the same yield as government bonds because it's illiquid and it takes time to adjust. Venture capital and private equity – same deal. They will take time to adjust. Equities are liquid, as you know, and our view is that equities have adjusted to much higher interest.

We are forecasting a non-trivial U.S. recession. We're unconvinced that equities are fully pricing in the impact on earnings of not just a U.S. recession, but we think there will be a global recession. The likelihood is, we've never seen such synchronised global interest rate hikes and it's likely to have a big impact on demand.

Piotrowski: You've written that when the U.S. adjusts to an inflation shock, the decline tends to be north of 20% over that period.

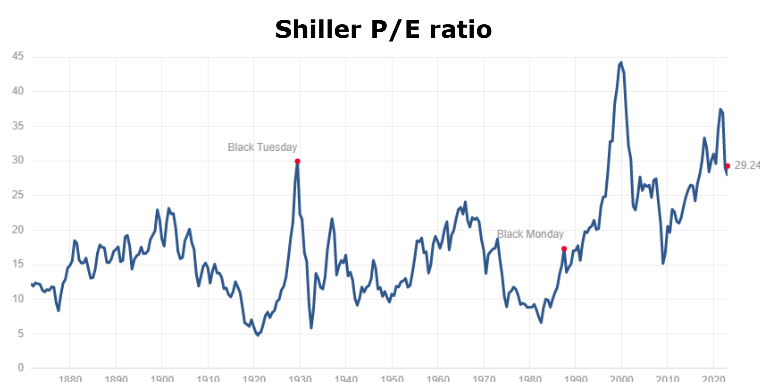
Joye: Robert Shiller, who won the Nobel Prize, produces something called a cyclically-adjusted price earnings (CAPE) multiple that adjusts for the business cycle. So, it's like a longer-term P/E. And the U.S. equity market is a tail that wags the dog. So, when we model equities, we think about the U.S., because everything is going to follow with some sort of correlation or beta. And in December last year, the U.S. equity market had only once in the last 140 years been more overvalued, and that was right at the peak of the tech boom. And we've looked at every time these cyclically-adjusted P/Es get above 30 times, and I think we were at 39 times late last year…

Piotrowski: It's staggering. But then, again, sympathetic to what was happening from a central bank perspective.

Joye: Very sympathetic. But here's the data.

When we look at the CAPE ratios, when it goes above 30 times, in the next decade, equities most of the time give negative returns after adjusting for inflation. There are a few periods where they've given you small positive returns, but the returns are not that flash.

The problem is, we've seen the S&P500, peak to trough at some points has been down as much as 26% and NASDAQ has been down as much as 36%. Equities have adjusted a lot. But the starting point was heinously expensive. The average CAPE is 15 to 16 times. Today, we're still at 29 times. We are still massively expensive compared to history, and I think a lot of that was explained by the idea that rates would remain low for long and also the idea that money would be very cheap for a long time.



Source: Robert Shiller

I'm not an equity expert. I am an expert on banks. Hence why we're trading bank stocks. But I think balance of probabilities, the returns from equities if we have a synchronised global recession over the next year, which is our central case, the returns for equities would be very poor.

And I think the existential crisis for all the investors listening to this is this. Bank stocks are paying you, as one example, a fully franked dividend yield at 5%. But I can get almost 5% on a CBA senior bond and I can get 6% on a CBA Tier 2 bond, and I can get about 5.5% on the CBA hybrid. So, these are safer securities, much safer than equity, and they're giving higher yield than equity. And that doesn't make sense. It doesn't make sense for commercial property to pay 4.5% to 5.5%. Across the Aussie equity market, the fully franked dividend yield

is about 6%. With government bond yields at 3% to 4% and bank bond yields at 5% to 6%, the yields on everything need to increase, and the way that happens is through much lower prices.

Piotrowski: Are we heading towards anything that's going to look normal in the next little while, given what we've experienced in the last couple of years?

Joye: My view is all the central banks will hike too far. Economies will go into recession. They'll pull back rates, but not to 0.

You'll probably get some sort of modest bounce, but once asset prices, and I mean everything – property, crypto, equities, bonds, et cetera – adjust to the fact that risk-free cash will pay you 3% to 4%, so you'll be able to get term deposits for the foreseeable future paying 3% to 4%, and anything competing against term deposits is going to have to pay much more. Thereafter, I think you're going to see markets driven by income growth not interest rates.

If you think about house prices, all the house price moves really since 2007 have been driven by huge changes in the RBA's cash rate. But once it settles again, I think house prices will track wages. Wages grow at 3% to 4%. House price growth rather than being 7% to 10% is likely to be a lot lower, and I think that's also true of equities and other related assets.

Tom Piotrowski is an economist and market analyst at CommSec. Christopher Joye is Founder, Chief Investment Officer and Portfolio Manager at Coolabah Capital Investments.

This is an edited transcript of an interview in December 2022. Listen to the full version here. Republished with permission.

Population and ageing nonsense … again

Cameron Murray

Fearmongering about Australia's ageing population has ramped up again recently. The headline in this image is a classic example.

Three years ago, I wrote a report about the myths surrounding the population and ageing debate. Find that report here. It debunks much of the nonsense analysis we see repeated uncritically in the mainstream press. I discuss some of the main points below.

Why a smaller Australia means a bigger tax bill for you

There is a sting in the tail for taxpayers from news this week that Australia's population will grow more slowly and be 1.2 million smaller in a decade than anticipated pre-COVID.

John Kehoe
Economics editor
Jan 6, 2023 – 1.49pm
Save Share

There is a sting in the tail for taxpayers from news this week that Australia's population will be 1.2 million smaller in a decade's time than anticipated before the pandemic.

The closure of the international border to migrants for two years means Australia will be older and have fewer workers compared to projections if COVID-19 had not hit our shores.

Source: *Australian Financial Review*

Ageing does not imply fewer workers

Currently, Australia's population is the oldest it has ever been on average. The population share aged over 65 has increased from about 12% to 16% since 2000. Despite this, the proportion of the population working is the highest ever. Over 64% of all Australians, including children and the elderly, are currently working. That's up from 59% two decades back in 2000.

The one-third increase in the share of over-65s is roughly the same proportional increase we can expect over the next half-century. Yet for some reason, we are meant to panic about it.

Another weird aspect of the ageing debate is how one argument is silently transformed into another. The main argument is that ageing means fewer people aged 15-64s compared with those *over 65*. But this is somehow transformed into *fewer workers supporting non-workers* (and sometimes further transformed into stories about your personal tax bill). But this does not need to follow, as the above data shows.

In fact, there is an increasing share of over-65s who are working and a declining share of under-19s. There are now more over-65s working full-time than under-19s working full-time. So why don't we adjust our age

structure metrics to reflect actual modern working lives? I would argue if we did that it would be obvious that there is nothing to fear about ageing (below, LFPR means Labour Force Participation Rate).

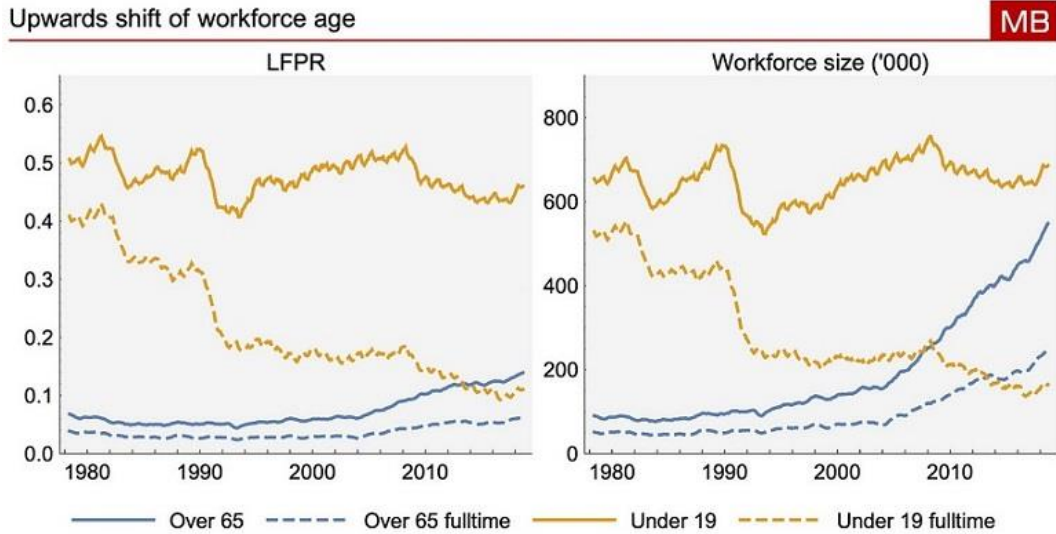


Figure 3: Participation of people over 65 years old and 15-19 years old[10]

Ageing isn't related to economic growth

A 2017 study by economists at the Massachusetts Institute of Technology (MIT) found

"...that even when we control for initial GDP per capita, initial demographic composition and differential trends by region, there is no evidence of a negative relationship between aging and GDP per capita; on the contrary, the relationship is significantly positive in many specifications."

The charts below show a similar relationship.

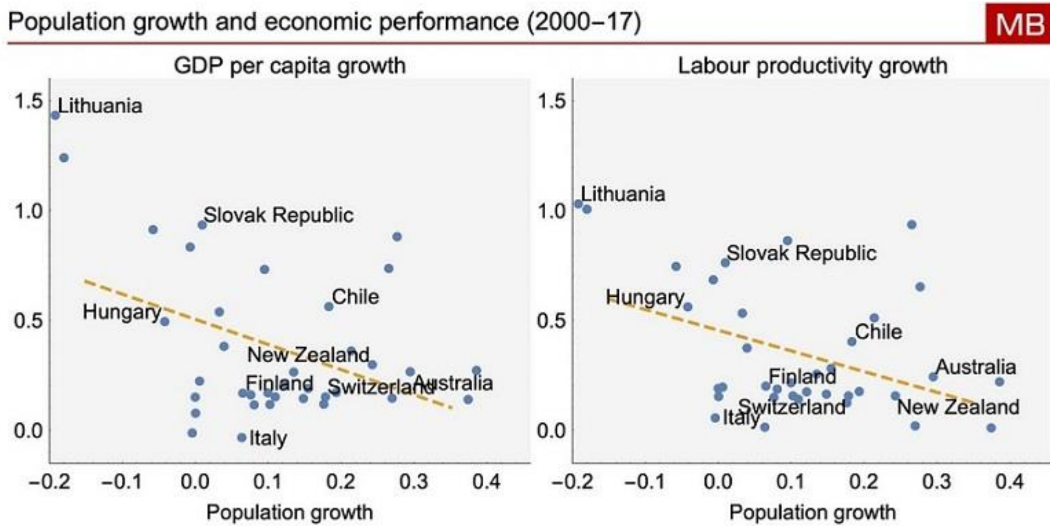


Figure 6: The negative correlation between population growth and economic performance[21]

The relentless uncritical talk of the perils of ageing in Australia's mainstream media has given a distorted view of the world. There is more detail about the growth and ageing issue in my report.

High immigration doesn't change the age structure much anyway

This is the most bizarre part of the whole story. We know every immigrant ages at the same rate as everyone else. Even if you believe that ageing is a problem because the proportion of workers in the economy might decline (despite the facts) the solution is to get more people working.

The effect of immigration on the age structure is not linear. In fact, it is easy to show that a large effect on the age structure can be achieved by relatively few migrants. Age structure simulations have shown that

"the largest and demographically most efficient impact of immigration on ageing occurs with the first 50,000 net migrants and that the impact reduces significantly with each additional 50,000 net migrants."

I show this in the charts below. By the end of the century, an immigration rate of 50,000 per year reduces that share of the population aged over 65 by 3%. The next 50,000 per year only further decreases this population metric by 1.5%. The next 50,000 after that decreases the metric by less than 1%.

In short, to get twice as large an effect as the first 50,000 per year immigration on the ratio of over 65s as a share of the population (if indeed you care about that metric), you would need to not just double the rate of immigration but quadruple it to 200,000 per year.

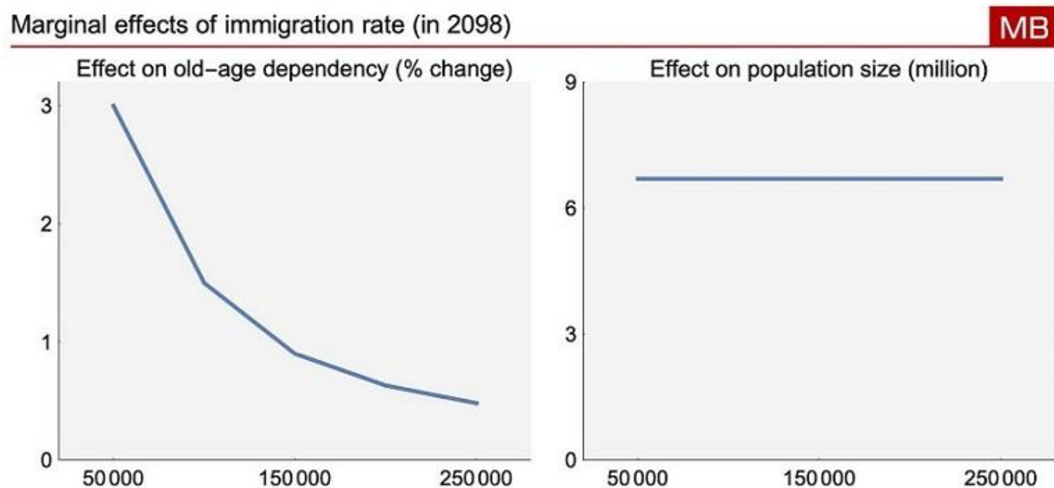


Figure 7: The marginal effect on age structure and growth of each additional 50,000 immigrants[29]

So what?

If you want a big Australia, then make your argument for it. But don't pretend that the age structure of the population is the reason why.

Dr Cameron Murray is an Economist and co-author of the Book [Game of Mates](). Subscribe to his written work at [Fresheconomicthinking.substack.com](). This article is general information.

A parma, a pint, and a profit

Stuart Cartledge

There is much written about office, industrial, and retail property; however, the proliferation of specialised real estate investment trusts (REITs) is also becoming a noticeable factor in local and global markets. Historically, many investors viewed these trusts sceptically, though there is now a growing recognition of the strong fundamentals of many specialised property types.

A specialised property category that has traditionally been lucrative for Phoenix Portfolios is pub properties. Australians love going to the pub, and it is estimated that there are 9,500 licensed venues across the nation, representing a market size of more than $15 billion.

Pubs are an often-misunderstood, niche investment. The properties have often been housed in unique structures with unusual dynamics but provide interesting investment opportunities for those willing to take the time to understand their intricacies. In many cases, pubs are some of the safest investments, with secure income streams.

Real old school

In the mid-1800s, John and James Toohey (yes, the founders of their eponymous beer) took control of a site – previously a schoolhouse – on the corner of Flinders and Swanston Street in East Melbourne and opened the *Princes Bridge Hotel*. Irish diggers and cousins Henry Young and Thomas Jackson later took over the pub, and unimaginatively renamed it *Young and Jackson*. People from all walks of life have been socialising, eating, and drinking in this building for more than 150 years. Despite all the changes to technology, communication, transportation and so much more, the Young and Jackson pub of today would be eminently recognisable to those who patronised it in the 1800s.

A refreshing ALE

The Cromwell Phoenix Property Securities Fund (PSF) previously had a stake in ALE Property Group (previously traded on the ASX under code LEP), which had ownership of the *Young and Jackson*.

Indeed, LEP owned more than 80 pub properties previously leased to ALH Hotels, which was majority owned by Woolworths (WOW) - now mostly owned by Endeavour Group Limited (EDV) after a spinout transaction completed in June 2021. EDV is the owner of ALH Hotels, along with BWS and Dan Murphy's, and has a market capitalisation of approximately $11.5 billion.

LEP made history when it was spun off from Fosters Group in 2003. It became Australia's first pub rental securitisation and the nation's first listed pub trust. One of the unique characteristics of the LEP portfolio was the presence of an uncapped market rent review for the properties in 2028. Due to the outperformance of the ALH operating business and long-term nature of the leases, the portfolio was rented significantly below market levels. In 2021, LEP suggested under renting was 35.6% - a figure which may have understated the true amount. LEP had also been curating their portfolio of assets, selling those that happen to be over rented at significant premiums to book values.

Due to the nature of the portfolio, Phoenix considered its cash flows to be amongst some of the lowest risk in the sector, with significant upside over the longer term, due to its significant under renting and the goodwill value of the operating businesses.

That proved to be the view of at least one other market participant, with funds managed by Charter Hall Group (CHC), including Charter Hall Long WALE REIT (CLW), announcing a proposal to acquire LEP in September 2021. The proposal included consideration in the form of both cash and CLW securities and represented a 25.2% premium to the prior day's closing price. Securityholders approved the proposal, and Phoenix successfully exited its investment in LEP.

A hero in a red cape: Redcape

Redcape Hotel Group (previously traded on the ASX under code RDC) was another pub owner in which PSF invested. Another unique structure, RDC traded at what is known as an OpCo/PropCo, whereby RDC was the owner of both the pub operating entity (OpCo) and the entity which owns the pub property (PropCo).

MA Financial Group externally managed RDC, which begun life as an unlisted fund and subsequently listed on the Australian Stock Exchange, with a mandate to grow quickly by acquiring more pubs.

RDC traded at a consistent discount to its director's net asset value (NAV), frustrating its external manager. To combat this, in August 2021, RDC announced a complex transaction in which RDC shareholders could chose to redeem their investment for $1.15 per share, or remain invested in an unlisted fund with quarterly liquidity windows, presenting an opportunity to redeem at a pre-set (and reducing) discount to director's NAV. As an indication, RDC traded at less than $1.00 per share prior to the transaction's announcement, compared to the director's NAV of $1.31 per share.

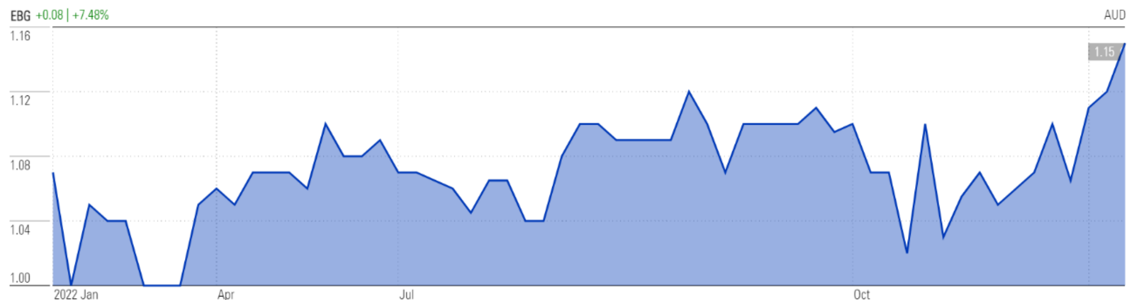
Phoenix Portfolios believed that at the time of the announcement the NAV was conservative and redeeming RDC units with reference to a future NAV represented an attractive investment opportunity. Furthermore, given the operating business and commitment to pay out earnings quarterly, there would be a strong running yield generated by holding the unlisted investment. A position was established.

The actual results surpassed expectations. Phoenix redeemed its investment on 30 June 2022 at a unit price of $1.5277. After becoming an unlisted fund in November 2021, the portfolio also received 6.55 cents in distributions from RDC. The portfolio's cost base for RDC was approximately $1.12 per unit, meaning the investment returned a total of a just over 42% during its short holding period, representing an internal rate of

return (IRR) of 61%. During this period, the S&P/ASX 300 Accumulation Index returned -15.8%. This was truly a fantastic outcome for investors.

How about today?

PSF has two current holdings with pub exposure – the small Queensland-based Eumundi Group Limited (EBG) is a long-term holding, with a strong management proposition, that we remain comfortable with.

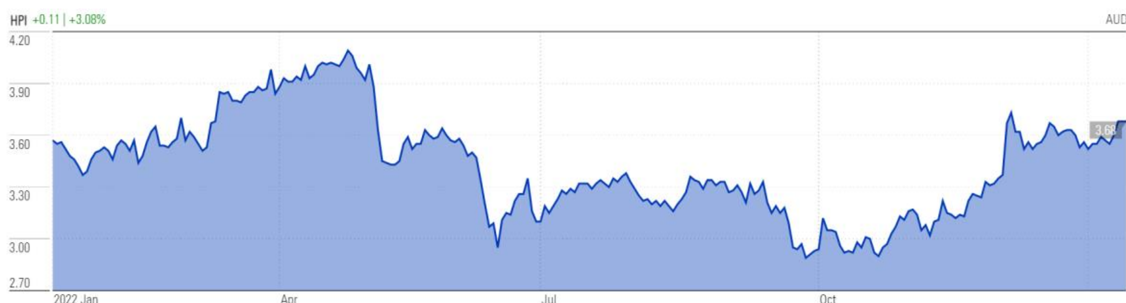


Source: Morningstar

The other holding is Hotel Property Investments (HPI), which was a meaningful contributor to performance of PSF in the December quarter. HPI owns 62 pub properties, predominantly leased to Australian Venue Co (AVC), which is owned by private equity firm KKR.

AVC traces its origins to Coles' past ownership. HPI's large exposure to Queensland is no mistake. Under Queensland law, to apply for a detached bottle shop license, the licensee must operate a "commercial hotel" (in common language, a pub), within 10 kilometres of the proposed bottle shop. As Coles desired to operate bottle shops in Queensland it also needed to be a pub operator, hence its ownership of AVC. Under a complex transaction, KKR took ownership of AVC in a manner which allowed Coles to continue operating its bottle shops. Under KKR's ownership, AVC has grown rapidly and produced fantastic financial results.

At the start of the quarter, HPI traded at $2.93 per share, or a 30% discount to its net tangible asset value. HPI has also periodically engaged small scale sales of some properties at premiums to book value. In late November and early December, entities associated with Tony Pitt's 360 Capital Group purchased a 13.81% stake in HPI at prices as high as $3.67 per share. Those familiar with Tony Pitt's history know that corporate activity is likely to follow. HPI was the second-best performing security in the REIT index over the quarter (only behind URW) rising 24.6%, closing at $3.56 per share. How any potential corporate activity will play out remains to be seen.



Source: Morningstar

Finding a niche

For many, not much time is devoted to specialised, niche investments. Phoenix, however, often finds that its best ideas are found by looking at smaller, more complicated opportunities.

If others are unwilling to look into these unique situations, the reward can often be better for those committed to put the time and effort in to find potentially misunderstood opportunities.

Clearly over time, the pub sector has represented one such opportunity and in recent times has provided some good outcomes for investors. This is representative of only a part of the unique opportunities that are looked at. With more uncertainty than ever in "core" property asset classes, being willing to look far and wide will hopefully be a continued advantage for those invested in this portfolio.

Stuart Cartledge is Managing Director of Phoenix Portfolios, a boutique investment manager partly owned by staff and partly owned by ASX-listed Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.

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Magellan on LIC discounts and fund changes

David George and colleagues

Editor's Note: A common problem for Listed Investment Companies (LICs) is their tendency to trade at a discount to their Net Asset Value. While it gives new investors the opportunity to buy into a manager at a discount, it can be frustrating for sellers wanting the realise the underlying value of their investments. In this extract from a recent discussion, Magellan explains why the discount may persist for some time despite the efforts of the manager, and why steps such as converting the LIC to an open-ended fund are not as easy as they sound. In this edited transcript, Magellan also describes its actions to address the performance disappointments in its Global Fund in 2022.

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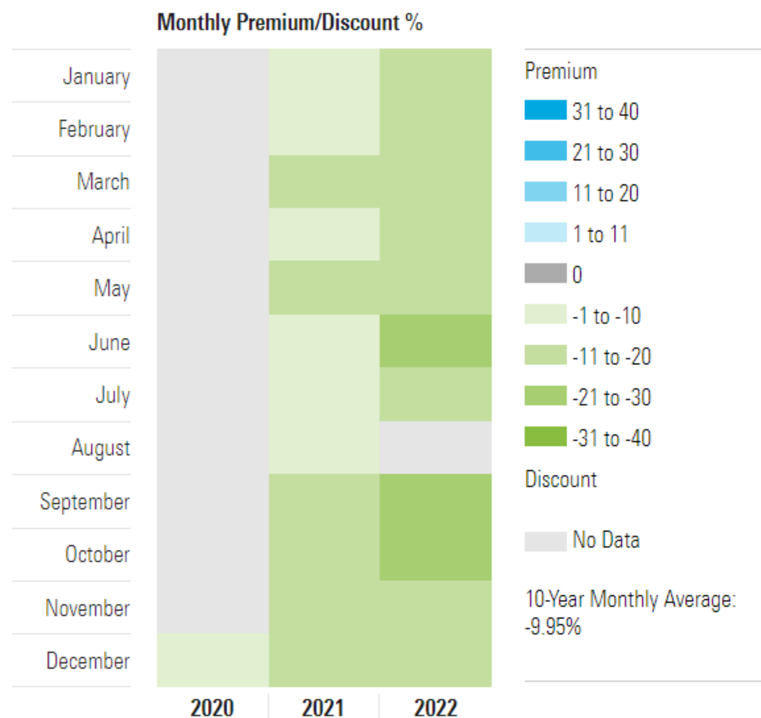
Frank Casarotti: In this MGF update, we acknowledge there have been concerns and frustrations around the significant trading discount to the underlying net asset value in the ASX-listed MGF, which is the closed-class version of our flagship fund, the Magellan Global Fund. We want to address this head on and share our thoughts on the discount as well as discuss the actions that we're taking to address it.

I'm joined by Magellan's new CEO, David George; our Head of Listed Funds, Jennifer Herbert; and one of the portfolio managers on the Magellan Global Fund, Nikki Thomas.

David George: The investor experience for MGF unitholders has been frustrating for both unitholders as well as brokers and advisers. We acknowledge that the discount is both persistent and significant, and we are very focused on solutions.

Casarotti: Jen, there are obviously structural issues with both listed investment companies and listed investment trusts. We're not alone, are we?

Jennifer Herbert: LICs and LITs have been around for a long time. They are a very well-understood fund structure. However, they do have their limitations, particularly in difficult markets, and the recent environment of uncertainty and volatility has not been kind across the board. Currently, there are about 14 global equity LICs and LITs on the Australian market and of those 14, 13 of them are trading at discounts to their net asset value. Of those 13, more than half of them are trading at discounts of greater than 10%. We're going to do everything we can to address this issue.



Source: Morningstar

Casarotti: So, David, why is the discount there and what will it take to close?

George: A discount can appear and persist in a closed-end fund because of a lack of demand from buyers of units, or if that demand is overwhelmed by additional selling pressure. In this way, they trade a lot like a listed company in that supply and demand determines the price. Now, unlike a listed company, in a closed-end fund, you are able to see what the value of the company is each day to compare that against.

So, these conditions may persist. Quite often, they appear during periods of market volatility or when markets are falling, or when an investment manager may be experiencing a period of relative underperformance. In the Magellan Global Fund, we've had a period of underperformance relative to benchmark. Despite our long-term investment horizon, we suspect that relative underperformance may be creating some additional selling pressure.

Now, ultimately, what we want to create is more demand for the MGF units, and the best way to do that is by delivering strong investment performance. We've recently announced a couple of role changes and these are particularly focused on how our analysts work and also interact with our portfolio managers.

Casarotti: Jen, is there anything else ultimately that we can do within the discount-related issue that might solve and help?

Herbert: Sure. A tool commonly used by managers when discounts persist is a share buyback, and in our case, that would be a unit buyback, where the fund itself steps in and buys units over the trading day, and then those units are cancelled. And the buyback has two benefits. Firstly, it provides additional liquidity for investors. And secondly, when the buyback is executed at prices lower than the net asset value as it is in the case of MGF, then it's accretive to the NAV and therefore a benefit to unitholders. Now, we're currently engaged in a very aggressive buyback and have been since November 2020, and so far, we've brought back over 200 million units, and that equates to around 17% of total units on issue.

Casarotti: Jen, we often get asked why we don't simply convert MGF to an open-class active ETF like we did with the High Conviction Fund.

Herbert: It's actually not that simple unfortunately. Firstly, MGF is a class within the greater Magellan Global Fund, it's not a standalone fund. And secondly, we have over a billion options out on issue. So, the option holders are a class of members within the Global Fund and Magellan as the responsible entity of the fund has a duty to treat those option holders fairly. So, unfortunately, we can't just wrap up the LIT to an active ETF while those options exist, and they have value.

Casarotti: Jen, what about other structural solutions?

Herbert: It's a very complex issue. Any solution needs to factor in the unitholders in both the classes of the Global Fund but also MGF option holders. And each of these groups is likely to consider this issue from a different angle, and Magellan must act and consider the best interests of all of these groups.

And the solution must be simple and straightforward enough for advisers and investors to understand and process. You can imagine that if we come out with something extremely complex and labour-intensive, it will not be well received by the market.

Casarotti: Nikki, as one of the portfolio managers on the Global strategy, maybe you could reinforce the objectives and how we're placed to achieve those objectives.

Nikki Thomas: The objectives for the Global strategy have been unchanged for 15 years, and they're quite simple – to minimise the risk of a permanent capital loss and to deliver an absolute compound return, minimum 9% objective, through the cycle. That's what we're trying to do.

The macro environment has been very challenging this year, but global markets are generally down around 20% in 2022 and that gives you better opportunity to buy at better prices. We look at achieving those objectives through thinking about high-quality world-class companies. Those are the companies that come through difficult periods like this and actually don't just survive but they thrive. They tend to see their competitive advantages increase.

As we look at the sort of companies that we own in the portfolio, it's exciting as an investor. I am able to buy wonderful businesses like Microsoft or McDonald's or Visa or Mastercard at prices that have become compelling. And I see a forward return prospect for this portfolio that's well ahead of our objective from current prices. I

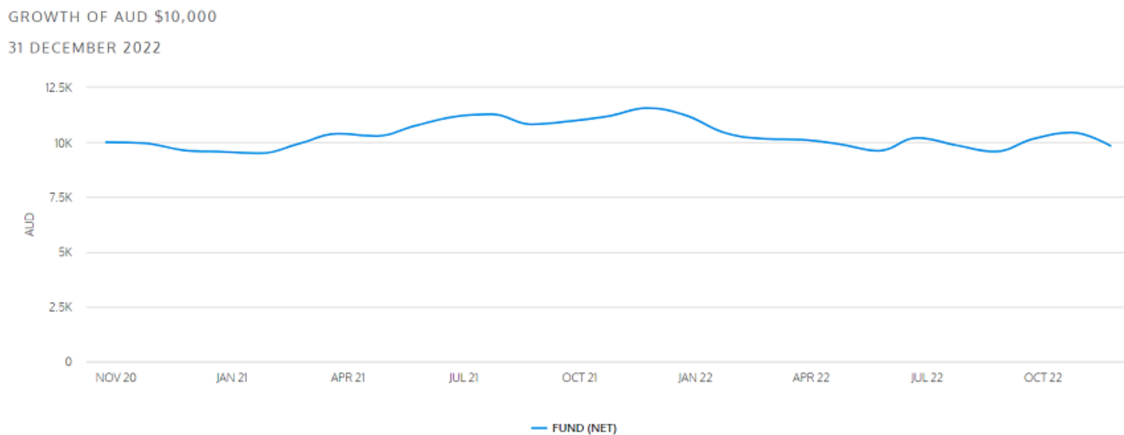
can't tell you that the market wouldn't go down further from here, but if you're thinking about a long-term return objective of compound returns approaching that double digit, I think we're well placed.

Casarotti: So, David, what if the fund actually does deliver on its objectives and absolute returns and relative returns and yet, we're still seeing this persistent discount, what then?

George: Well, delivering on the objectives should support a narrowing of the discount and the fund can continue to engage in the buyback. But if the options expire in March 2024, that may provide us with other avenues to explore. In the meantime, we'll be looking at fund disclosures and client engagement plans to make sure that we're communicating frequently and transparently.

Casarotti: So, Nikki, any closing thoughts?

Thomas: I see Magellan closed class as an opportunity to buy a world-class group of companies at about a 20% discount at the moment, and potentially that discount closes. Anyone investing in a global strategy like ours should be thinking three- to five-year horizons for investing, and you don't want to think that this could happen overnight with the difficult times we're living in.



Important Information: Calculations are based on NAV prices with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 30 November 2020 (inclusive).

Source: Magellan

David George is CEO, Jennifer Herbert is Head of Listed Funds, Nikki Thomas is a portfolio manager and Frank Casarotti is General Manager of Distribution and Marketing at Magellan, a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. The full video is here.

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3 investment themes for 2023

Richard Bernstein and team

It may be another difficult year for investors who hope 2023 will relive the speculative markets of 2020 and 2021. Consensus seems poised for a signal from the Fed that it will lower interest rates which could reignite investors' interest in more speculative investments.

However, the Fed seems very hesitant to prematurely remove tighter monetary policies. With inflation the highest in 40 years, the entire credibility of central banking is being challenged. The odds, therefore, seem to favor too much tightening of monetary policy rather than too little.

However, 2023 could be a rewarding year in the early stages of secular outperformance. Stock market volatility always signals a change in leadership. Prior leadership is typically geared to a specific economic environment and volatility occurs when the macroeconomy changes. Volatility is a changing of the guard during which the old leadership exits, and new leadership emerges that is better suited for the new economic environment.

History shows that investors are usually slow to adopt the new leadership as the economy changes. Rather than repositioning their portfolios for the new economic backdrop, they cling to the old leadership hoping that the economy returns to its pre-volatility state.

Such investor denial seems to characterize today's consensus. Many investors want the Fed to change course or "pivot" simply because they want low interest rates to again spur speculation supporting the outperformance of investment themes like Technology, Innovation, Disruption, Venture Capital, cryptocurrencies, SPACs, meme stocks, and the like.

Chart 1 shows that Bitcoin's performance has been closely tied to Fed policy. When money is free, as it was during the immediate post-pandemic period, investors tend to wildly speculate. However, speculation tends to fade when interest rates increase, and investors are increasingly forced to make rational choices.

Despite significant underperformance during 2022, the Technology, Communications, and Consumer Discretionary sectors still comprise over 40% of the S&P 500®'s weight (See Chart 2) and 38% of the MSCI All-Country World Index. The sectors' underperformance so far reflects leadership is changing, but it has not changed.

Theme #1: Play defense. Worry later about playing offense.

There are two main inputs to equity valuation: 1) earnings and 2) interest rates. Investors have so far seemed to focus on #2 (the Fed and interest rates) and relatively ignore #1 (earnings).

The US, and many other countries, are in the early stages of profits recessions, yet both equity and fixed-income markets have been very slow to anticipate the

CHART 1:

Bitcoin and The Fed Funds Rate
(Dec. 2017 – Dec. 2022)

Source: Richard Bernstein Advisors LLC, Bloomberg L.P.

CHART 2:

S&P 500® Technology, Communication & Consumer Discretionary Weight in Index
(Sep. 2000 – Dec. 2022)

Source: Richard Bernstein Advisors LLC, ML BofA Quantitative Strategy

CHART 3:

US Corporate BAA 10-Year Bond Spread
(Jan. 1987 – Dec. 2022)

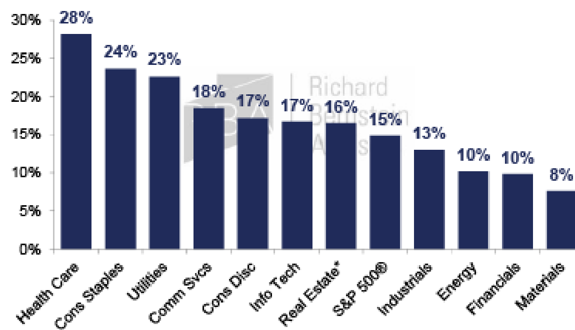
Source: Bloomberg Finance L.P.

potential falloff in corporate profits. Chart 3 shows corporate bond spreads through time. Although spreads have widened a bit in anticipation of corporate cash flows coming under pressure and an increasing probability of default or bankruptcy, the spread remains very low relative to historical recession periods.

An apparent limited fear of a potential profits recession suggests investors should start 2023 playing "defense". Investment discussions continue to highlight a false dilemma of growth vs. cyclicals and omit the third option of defensive sectors. Defensive sectors tend to outperform during profits downturns, and our portfolios are overweight those sectors (see Chart 4).

CHART 4:

Average Performance When Profits Decelerate: S&P 500® Sectors
(Sep. 1989 – Dec. 2020 total returns)



Source: Richard Bernstein Advisors LLC.S&P Global, FTSE, Bloomberg Finance L.P. For Index descriptions see Index Descriptions at end of document. Dec. 2020 was the end of the last full profits deceleration cycle. Real Estate performance is proforma as it was not a stand alone sector until 9/30/16 and was included within the Financials Sector. We use the FTSE Nareit All Equity REITS Total Return Index as a proxy for its performance from 9/1989 through 10/2002 when the GICS Real Estate Industry Index performance becomes available for data from that point on. Communication Services was Telecom Services prior to GICS reclassification in 9/30/18.

Some investors remain fearful of missing out on a positive shift in fundamentals, i.e., the second half of 2023 will be a stronger period for the economy and for markets. One must remember that "being early but being there at the bottom" always sounds like a prudent strategy, but is actually a strategy for underperformance because one never knows when "the bottom" will occur and waiting implies underperformance.

If there is a fundamentally-based turn in the economy and in the stock market, such bull markets last for years and not for weeks or months. Missing out on the first month or two tends not to hurt long-term performance. In fact, our past research has consistently shown that being 6 months late is preferable to being 6 months early.

Theme #2: Diversify geographically

Investors probably should not be geographically myopic, and consider increasing geographic diversification. Ten years ago, emerging markets were investors' favorites, but global profit fundamentals signalled the potential for long-term US outperformance. Today, consensus favors US equities, but profit fundamentals for the US are among the worst for major regions of the global equity markets.

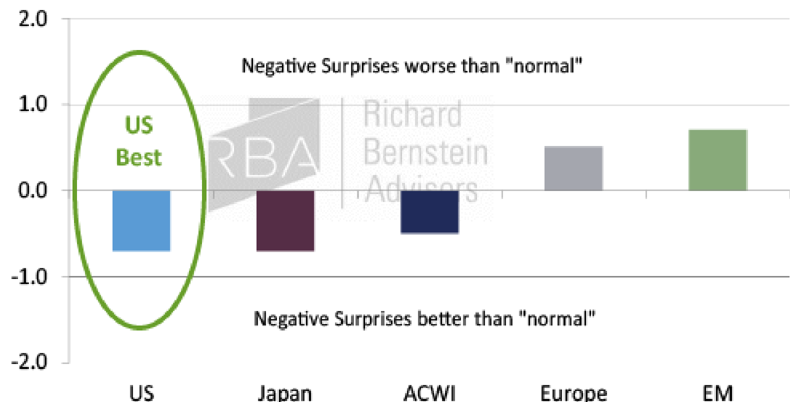
Negative earnings surprises are a reliable indicator of corporate health. Although positive earnings surprises have through time offered less insight because companies frequently guide analyst expectations down to then beat the lowered expectations, negative earnings surprises contain significant information because negative surprises indicate companies are having trouble managing their businesses. No company ever guides to a negative surprise.

Charts 5 and 6 examine negative earnings surprises by region today and from 5 years ago. In 2017 the US had the best profit fundamentals when using this gauge, but today they are the worst.

In addition, the US equity market is dominated by the most speculative sectors: Technology, Communications Services, and Consumer Discretionary. The sector exposures of some non-US markets are often considerably more defensive, which

CHART 5:

Negative Surprises by Region
(z-scores) 3Q 2017



Source: Richard Bernstein Advisors LLC., Bloomberg Finance LP.

might support outperformance as global profits cycles decelerate.

Chart 7 shows 2022 country performance relative to the percentage of the country's market capitalization that is in the three more speculative sectors. Country performance has been closely related to sector exposure and sector performance.

In fact, despite the USD's strength in 2022 over 70% of non-US equity markets outperformed the US in USD terms as shown in Chart 8.

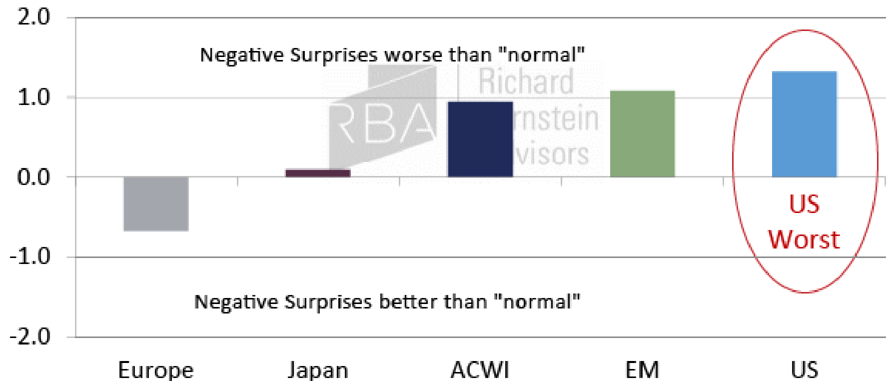
We continue to have lower-than-normal exposure to US equities within our portfolios because of the combination of US sector weights and the deterioration in US profits fundamentals.

Theme #3: Accept that the world is changing

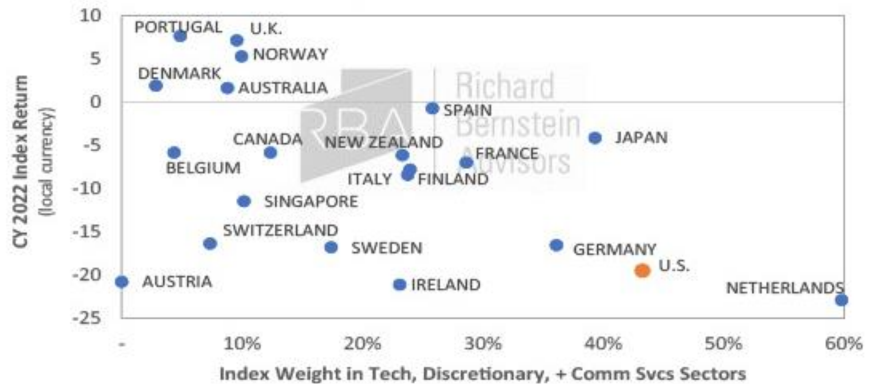
Long-term investment themes appear to be changing as well. Some growth investors rationalize ongoing investments in significantly underperforming sectors or themes by claiming they are long-term investments. However, the long-term structure of the US and global economies appears to be changing, and such changes could foster a different set of long-term investment themes.

The Energy sector is currently the #2 sector for dividend yield in the US and it is the #1 sector for long-term growth. In fact, its long-term projected earnings growth rate is roughly twice that of the Technology sector! Chart 9 shows comparisons of sectors' dividend yields to bottom-up long-term earnings growth projections. The Energy sector seems to stand out in this chart, whereas the former leadership (Technology, Communications Services, and Consumer Discretionary) don't seem to offer unique growth opportunities.

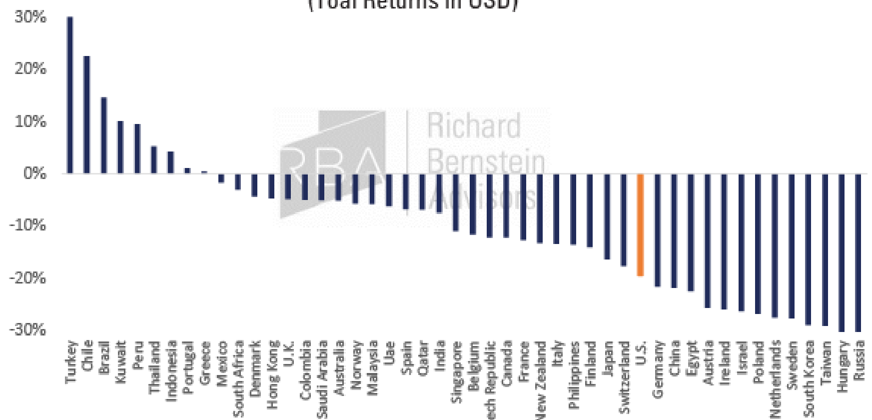
The global economy is changing, leadership is changing, and analyst projections are changing. Growth



Source: Richard Bernstein Advisors LLC., Bloomberg Finance LP.



Source: Richard Bernstein Advisors LLC., Bloomberg Finance L.P. For index descriptions see Index Descriptions at end of document.



Source: Bloomberg Finance L.P. Returns truncated at +/- 30%. Turkey return +91%, Hungary -31%, and Russia -100%.
For index descriptions see Index Descriptions at end of document.

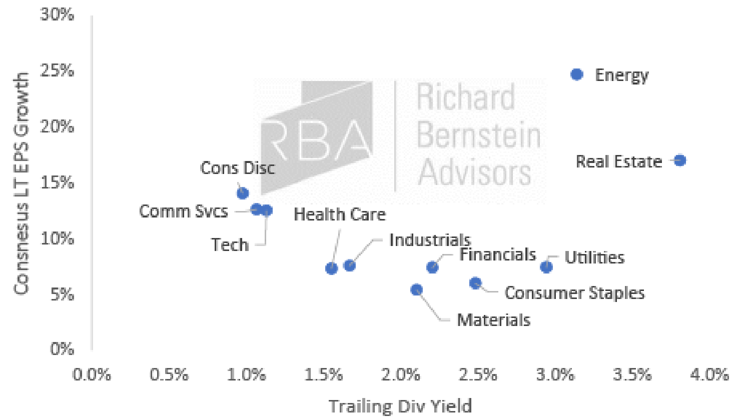
investors should not become mired in the old growth themes and should be on the lookout for new ones. After all, relatively few investors ten years ago were looking at Technology as a primary growth sector.

Geopolitics seem increasingly unstable, and it seems globalization is contracting. Whether it is the Ukraine/Russia war, US/China controversies, refugee trends, extremist politics in many countries, and other factors, the trend toward reduced globalization seems to be gaining strength.

This isn't unique as globalization has historically expanded and contracted. Chart 10 shows a measure of trade uncertainty, i.e., a proxy for expectations regarding successful globalization. Uncertainty spiked at the beginning of the recent era of globalization with the passage of NAFTA. Uncertainty spiked again more recently when there were increasing trade disputes, which one could argue was the beginning of the end of globalization.

CHART 9:

S&P 500® Sectors: Consensus LT EPS Growth vs Trailing Div. Yld
(as of 12/30/2022)



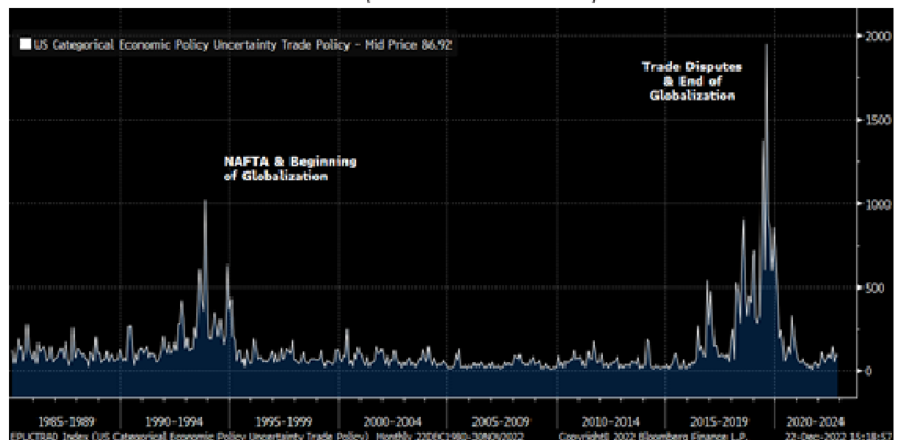
Source: Richard Bernstein Advisors LLC, Factset Global

Increasing globalization was perhaps the main catalyst for US secular disinflation. Inflation occurs simply when demand outstrips supply, and increasing globalization provided an increasing number of suppliers. Increased competition put downward pressure on prices.

If globalization retreats, then global competition might contract. Some are arguing that certain industries' critical production should be limited to US producers. That might be important for national security and other considerations, but secular inflation might replace secular disinflation as the "supply of suppliers" decreases.

CHART 10:

US Categorical Economic Policy Uncertainty Trade
(Dec. 1980 – Nov. 2022)



Source: Baker, Bloom & Davis, Bloomberg Finance L.P.

The US has woefully under-invested in real, productive assets for decades. Energy infrastructure, manufacturing capacity, transportation infrastructure, electrical grid capacity, and other critical public and private goods need significant re-building and modernization. As globalization contracts, investment in such real assets could prove critical to the ongoing stability and health of the US economy.

We've joked many times about how investors look to "cute wiener dogs in the metaverse" as the future of the US economy. Joking aside, if that is the future of the US economy, then the US economy will probably suffer because other nations will be investing in the production of goods and services that people actually need. We believe the underlying capitalistic tendencies of the US economy and the resulting trends in the investment of real productive assets will improve US competitiveness and provide interesting long-term investment opportunities.

Chart 11 perhaps supports our contention. Without hype and fanfare, small cap industrial stocks have outperformed ARKK by about 300 bp/year since ARKK's inception in 2014, and mid-cap Industrials have

outperformed by about 400 bp/year. Perhaps there is a message in that outperformance regarding the true future trends of the US economy?

CHART 11:

Small Industrial Stocks vs. ARK Innovation ETF
(Oct. 31, 2014 – Dec. 30, 2022)

Source: Richard Bernstein Advisors LLC, Factset Global. For index descriptions see Index Descriptions at end of document.
RBA is not currently holding AARK in any of its portfolios.

2023: It won't be back to the future

Consensus is still focused on the leadership of the last 5-10 years. However, the global economy is changing and leadership within the financial markets is likely to reflect that changing economy. Investors missed the first 5-10 years of the bull market in US equities, and they seem poised to miss the first 5-10 years of new opportunities in non-US markets and real productive assets.

We strongly doubt 2023 will somehow return to the speculative nature of 2020s and 2021s markets. Rather, we think the markets will continue to gravitate toward newer themes.

Richard Bernstein is CEO of Richard Bernstein Advisors LLC and is widely recognised as an expert in style investing and asset allocation. He has over 40 years' experience on Wall Street, including most recently as the Chief Investment Strategist at Merrill Lynch & Co. This article is general information and does not consider the circumstances of any investor.

Markets appear too optimistic on central bank pivot

Tim Larkworthy

A new year is an opportunity both to reflect and to look forward, but I will not attempt to forecast particular outcomes. The last year was a stark reminder of how foolish predictions can look 12 months later, so I'll cover some more general themes.

What went wrong in 2022?

The main culprit was inflation and more importantly how persistent inflation proved to be after central banks initially believed that it would be transitory. This forced the banks to shift to the most aggressive tightening cycle since the 1980s in an attempt to restore price stability.

The picture was further complicated by the war in Ukraine and ongoing supply chain blockages thanks to China's zero-Covid policy.

In response, the Fed increased the Fed Funds rate by 4.25% over the year and was still warning that it had more to do as recently as its last meeting in December, with officials looking to raise rates further this year to between 5% and 5.5%.

To highlight the impact this all had on markets, below is a table showing the markets I tend to watch the closest and the gains or losses that they experienced from the start of 2022 to the end of the year.

These are my numbers so might be a little different from the 'official' record, but they are still consistent with the underlying trend.

	1/01/2022	31/12/2022	Change	High	Low
Dow	36,800	33,147	-10%	36,800	28,700
S&P500	4796	3840	-20%	4796	3575
Nasdaq	16,500	10,466	-37%	16,500	10,700
US10-Year	1.60%	3.85%	141%	4.25%	1.60%
US2-Year	0.75%	4.40%	487%	4.70%	0.75%
Curve	85	-55	140	90	-84
AU10 -Year	1.74%	4.04%	132%	4.20%	1.74%
AU3-Year	0.98%	3.50%	257%	3.80%	0.98%
AUDUSD	0.7200	0.6800	-6%	0.7580	0.6200
10-Year Gilt	1.00%	3.65%	265%	4.50%	1.00%
10-Year Bund	-0.15%	2.50%	-1767%	2.55%	-0.15%
10-Year Italy	1.15%	4.58%	298%	4.80%	1.15%
Brent (USD)	$ 77.00	$ 86.00	12%	$ 123.00	$ 76.30
UK Gas (GBP)	£ 183.00	£ 184.00	1%	£ 640.00	£ 132.00
Copper (USD)	$ 4.40	$ 3.80	-14%	$ 4.90	$ 3.20
Iron Ore (USD)	$ 114.00	$ 117.00	3%	$ 160.00	$ 81.50
Bitcoin (USD)	$ 45,760	$ 16,340	-64%	$ 48,020	$ 15,690
Fed Funds	0.00%	4.25%	4.25%		
RBA Cash	0.10%	3.10%	3.00%		

The outlook for this year

What does the next 12 months have the potential to look like?

The burning question at this stage is will the US economy enter into a recession and how will the Fed respond.

In a recent Wall Street Journal survey, two-thirds of economists at the 23 major financial institutions that directly deal with the Fed predicted a US recession this year with an increase in the unemployment rate to above 5% from its current historical low of 3.7%.

What became clear towards the end of last year was that the market was starting to bet that the Fed was being too negative in its outlook and that it was close to the end of its tightening cycle. It may be in a position to invoke the much anticipated 'pivot' by mid-year with the Fed cutting rates towards the end of 2023, which is in contrast with the Fed's mantra of 'higher for longer'. The very tight jobs market in the US has been a major obstacle in the Fed's fight against inflation.

The reality, and it is a similar story locally, is that consumers are still happy to keep spending despite the rapid rate increases and until there is a change to this behaviour it is going to stymie central bank's ability to win the fight.

Record Christmas spending further underlines the challenge and is adding to inflationary pressures, compounded by governments that continue to undermine central banks by adding fiscal stimulus in the form of subsidies as well as talking up wages.

As has been a theme of mine for a while now, consumer behaviour is not changed by warnings alone. This could well be a generational phenomenon with many never having lived through the brunt of a recession and the shock this can have on asset prices and rising unemployment. They know only a prosperous period of economic growth which ironically has been perpetuated by central bank policy that is undermining their battle now.

As such, if the dramatic rate increase from last year does start to bite hard in the first half of this year, then we are close to the top of this cycle. However, if that level of pain is insufficient to alter behaviour, then rates must go higher.

Given Australia's exposure to the risk of 'mortgage stress' and the much-talked about cliff we are approaching as massive number of fixed mortgages switch to higher floating rates, maybe we are closer to the top than other economies.

However, this has been known for a while and mortgage holders should already have started to adjust their spending to reflect this. But maybe not.

Central banks warnings continue

In summary, for the year ahead, central banks and the market are in somewhat of a disagreement as to how high and for how long interest rates will remain elevated. Central banks continue to warn that they are 'not for turning' until they are confident that price stability has been restored. The outlook is further clouded by the war in Ukraine as well as the Chinese doing a 180-degree flip and letting Covid rip and this will have an impact on global growth.

Therefore, I am not confident we are close to a bottom in US equities although bonds should have a better year as markets sweat on the Fed pivot.

Tim Larkworthy is a Director - Fixed Income Sales at Fixed Income Solutions. The views expressed herein are the personal views of the author and in no way reflect the views of the BGC Group. Individuals should make investment decisions based on a comprehensive understanding of their own financial position and in consultation with their own financial advisors. No liability whatsoever shall accrue to the author or the BGC Group as a result of individuals or entities making investment decisions based wholly or partly on this material.

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