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Contents

Why LIC discount harvesting is a buy-and-hold decision *Graham Hand*

Where Australia's largest ethical investor is finding opportunities *Loyez, Murray*

Which asset class in Australia offers the best value now? *James Gruber*

Are we reaching peak passive investment? *Daniel Taylor*

The future remains bright for industrial property *Sasanka Liyanage, Steve Bennett*

How to be perfectly franked and pay no tax *Chris Cuffe*

Why a $5 coin and not a $5 note repays public debt *Owen Covick, Kevin Davis*

Editorial

It was 10 years ago this week, on 8 February 2013, that we published Edition 1 of Firstlinks (then Cuffelinks). Firstlinks aspires to offer timeless insights and education to its readers, with less of the daily noise of other newsletters. It is pleasing to look back on Edition 1 and see most of the articles remain relevant today, including a piece by former PM, **Paul Keating**. To mark the milestone, we are republishing a simple explanation of franking credits by **Chris Cuffe** which remains as accurate as when it was written. Did you know a super fund only needs to hold 32% of its assets in fully franked Australian shares to pay no tax?

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On the subject of financial education, let's take a quick look at the role of the industry regulator.

Regardless of how much any person believes in capitalism and the free market economy - and **Treasurer Jim Chalmers** has had plenty to say about these in the last week - everyone agrees there is a role for financial markets regulators. Like it or not, the finance industry includes rogues and charlatans who need regulation and in some cases punishment. Many of our most respected businesses step out of line in their pursuit of profit and must face aggressive enforcement of laws to protect investors and the public.

As well as its role in regulating the conduct of Australian companies and financial markets, the **Australian Securities and Investments Commission** (ASIC) offers a wide range of educational resources. Firstlinks provides a section in our Education Centre highlighting the useful material on the Moneysmart website. There is a great selection of financial calculators including:

- Superannuation contributions optimiser
- Super versus mortgage calculator
- Retirement planner
- Super and pension age calculator
- Compound interest calculator
- Budget planner
- Income tax calculator

Links to all these resources and many more are in our Education Centre.

While ASIC performs essential services, it is not beyond criticism, such as when the **Hayne Financial Services Royal Commission** found its enforcement activities around financial advice and wealth management were poor.

The equivalent government agency in the US is the **Securities and Exchange Commission** (SEC), and it has also faced severe criticism for failing to enforce securities laws and sanction major financial institutions. Despite market manipulation and favouring inhouse books over clients, leading US investment banks were bailed out of the GFC and nobody went to jail.

The SEC also provides education services but they have limited relevance to Australians because our system of tax and superannuation is manifestly different. Nevertheless, it's revealing to look around its website for unusual activity and lessons for Australian law enforcement. How about this:

"The Securities and Exchange Commission today announced an award of more than $28 million to joint whistleblowers who provided critical information and assistance in an SEC enforcement action ... Whistleblowers may be eligible for an award when they voluntarily provide the SEC with original, timely, and credible information that leads to a successful enforcement action."

No doubt there was considerable angst involved in earning the US$28 million but it's a lot of money and whistleblower identity is not revealed. ASIC has rules around whistleblower protection but one reason we do not hear many stories about Australian whistleblowers is, according to ASIC,

"Unlike some foreign countries, whistleblowers in Australia are not eligible to receive a financial reward for making a whistleblower report; the Corporations Act does not provide for it."

While every publication needs to decide the right level to pitch its material on its education pages, some of the SEC content is low brow, such as this comparison of (American) football with investing:

*"It's a good time to talk about how investing is a lot like football. Both need a strong **playbook** to be successful. To invest wisely, you should put together a **special team** of professionals so there is **safety** for your **holdings** and you can **hand off** assets to your family without stressing whether your investment is a **coin toss**. It's important to **huddle** with those involved in your future financial plans to identify **goals**. Every investment plan should have a strong **offense** ... As you **kick off** your financial plan, it is vital you keep in mind your level of risk tolerance."*

And on it goes attempting to put a football term into every sentence. Nevertheless, it started me thinking and it misses the most important point when comparing football with investing in retirement.

I play soccer each week with a bunch of guys who are all over 60. Some of them once played at a high level and despite slowing down over the years, they still show some silky skills. But we welcome anybody, and some of the blokes are former rugby players who want to stay fit in a competitive game without the physical brutality of rugby. The problem is, when a rugby player turns to soccer at the age of 50 or later, trouble is not far away. They can't stop. They don't realise they are not supposed to simply barge into a tackle, or run over the top of the player with the ball. At times when it's not comical, it's dangerous.

They think they can play soccer because they played rugby. **Like, how hard can it be?**

It's the same when they start investing in retirement by picking their own stocks. The guys know I work in investing and often discuss markets and even their own portfolios with me. Many enjoyed good careers, earned a lot of money as doctors or architects or engineers, and when they retire, their minds turn to investing. **Like, how hard can it be?** Just open an account with a stockbroker, and like playing rugby, barge in and do it themselves. Anyone can.

This is not investing of the type where they place their money in a cheap, diversified index fund and lie in a hammock reading a book. This is investing by buying and selling stocks. One player told me he owns about 200 stocks worth $2 million. If he sees a stock he likes, he puts $10,000 in it, and this occupies him for several hours a day, checking his portfolio.

He asked me what I thought about his strategy. How could I put it gently to a friend? I told him the only reason to follow this technique is if he enjoys doing it, and it occupies him in retirement. It's highly unlikely that he is doing better than a cheap (almost free) index fund, or a person who has spent 40 years as a portfolio manager. He'll have winners and losers and he'll jump at shadows and he'll tell himself he's good at it. If he's happy, go for it. It's more like entertainment than investing. Just like the beefy rugby player who laughs when the skinny soccer player gets hit by a truck.

What would the 92-year-old **Warren Buffett** say about this instant expertise? Here are four quick gems.

"Among the various propositions offered to you, if you invested in a very low cost index fund - where you don't put the money in at one time, but average in over 10 years - you'll do better than 90% of people who start investing at the same time."

"Risk comes from not knowing what you're doing ... There is nothing wrong with a 'know nothing' investor who realises it. The problem is when you are a 'know nothing' investor but you think you know something."

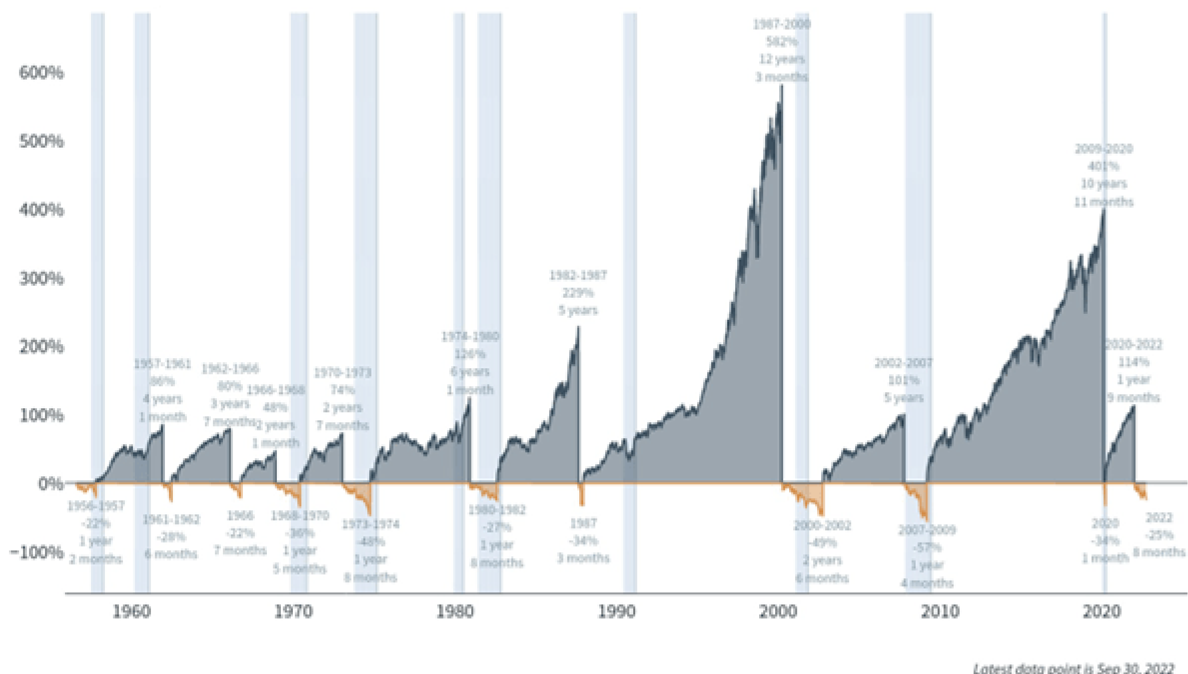
"We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children."

"If you like spending six to eight hours per week working on investments, do it. If you don't, then dollar-cost average into index funds. Just pick a broad index like the S&P 500. Don't put your money in all at once; do it over a period of time."

When I told author **Peter Thornhill** that I was writing about LICs, and asked him why he does not harvest discounts but sticks to the large LICs that trade around NTA, he replied:

"In the recent past I have begun to unwind my direct shareholdings where possible and moving the cash into a small handful of LIC's, about six. As I started with the LIC's some time ago the bulk are the old ones and I have been adding to them steadily so the holdings are substantial. I'm too lazy to go digging for a few bits here and there. As I tell audiences, I have better things to do with my life than spending time on the computer. I have a beautiful wife and family and we love to travel. We live a life we could never have imagined and, the most important lesson I have learnt over the last 40 odd years and after 1000's of presentations, happiness is to envy no one!"

Once invested, it's essential not to panic and sell in a down market. It's not easy with all the talk of a recession and higher rates and investment banks such as **Morgan Stanley** arguing the market is expensive and earnings are falling. But for those who have the temperament to hang on, the data on the S&P500 below shows over the last 70 years, up markets have lasted far longer than down markets, about six times longer. Since World War II, the US has faced 13 economic recessions, but the increases eventually overwhelm the falls.



Source: Clearnomics and Seeking Alpha

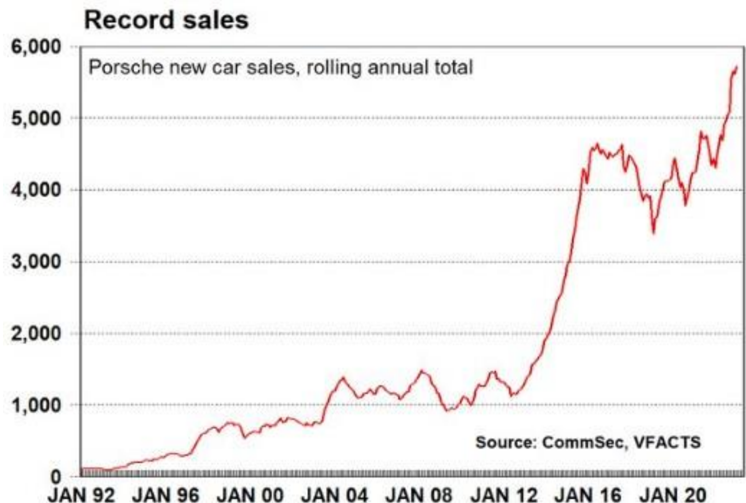
And so to the **Reserve Bank**, which shocked the market with the severity of the wording in Tuesday's release. Here is **Gareth Aird from CBA**.

"To be clear, we do not share those same concerns. We believe that the RBA's 300bp of rate hikes between the May and December 2022 Board meetings had very little impact on price changes in the economy over 2022.

Indeed high inflation last year largely reflected the massive fiscal splurge over 2020 and 2021, coupled with ultra-loose monetary policy, to support the economy through the pandemic. The war in Ukraine also played a role in boosting prices through supply side disruptions. And the pandemic itself disrupted supply chains more generally. Finally, some idiosyncratic factors domestically, like floods on the East Coast of Australia, also boosted prices for some food items.

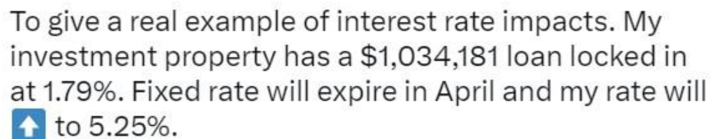
The key point is that rapid interest rate hikes in 2022 will impact demand for goods and services in the economy and by extension price changes in 2023 and 2024. Monetary policy tightening did not impact price outcomes in 2022.

But our job is to call what we think the RBA will do and not what we think they should do. As such, we now expect the RBA Board to raise the cash rate by a further 25bp at both the March and April Board meetings. This would take the cash rate to 3.85%."



Look no further than new car sales in Australia, as the chart shows for **Porsche**, to see how slowly higher rates are impacting buyers. In 2022, new car sales in Australia totalled 1,081,429 units, the highest since 2018. December 2022 alone achieved sales of 87,920, well up on 2021. The top two models were **Ford Ranger** and **Toyota HiLux**, suggesting a few tradies have done well.

The Reserve Bank's forecast of more rate rises in the "months ahead" was especially surprising given the nine consecutive cash rate increases already delivered. With 800,000 borrowers coming off fixed rates over the rest of 2023, frugality must gather some steam soon. Why is the Governor again looking far ahead by warning of rate rises regardless of what the future data says when his forecasting track record is far from impressive. This borrower will pay far more than 5.25% in April.



Graham Hand

Also in this week's edition ...

The 2022 calendar year was challenging for most investors, yet it was especially difficult for ethical investors like **Mike Murray of Australian Ethical** who don't touch the energy sector - by far the best performing sector on the ASX. Nonetheless, Mike is sticking to his principles and sees opportunities in several areas of the market, including lithium, insurance and software.

Looking more broadly across major asset classes in Australia - cash, bonds, property, and stocks - **James Gruber** drills down to compare how the valuations of each stacks up. And he reveals what's cheap and what's not.

Passive investment's rise seems to know no bounds, though **Daniel Taylor of Man Numeric** believes a top may be nearing. He admits that as a investment manager, his views are self-serving but he gives evidence that active investing may soon come back in vogue.

Industrial property has been in favour for some time now, given the ascent of online retailing and limited supply of land to build new warehouses. That's resulted in record rental growth and vacancy rates of less than 1%. **Steve Bennett and Sasanka Liyanage of Charter Hall** don't see the momentum shifting any time soon, with supply imbalances driving continued rental growth.

Did anyone tell the Treasurer that if he had replaced the $5 note with a $5 coin, he could have saved $1 billion? **Owen Covick and Kevin Davis** argue the merits for a $5 coin, and even delve into the thorny issue of whether a monarch should appear on it.

Lastly in this week's whitepaper, **Perpetual** and the **Australian Securitisation Forum** look at the reasons for the growth of non-banks in Australia and New Zealand, as well as the sector's opportunities and challenges for future growth.

Curated by James Gruber and Leisa Bell

Why LIC discount harvesting is a buy-and-hold decision

Graham Hand

Investors do not need to look too closely at a Listed Investment Company (LIC) report in our Education Centre to see that the majority trade at a discount to the value of their Net Tangible Assets (NTA). This is disappointing for existing investors who cannot realise the market value of their investment but it's potentially an opportunity for a new buyer.

While it's not a good look for LICs generally, it also reflects poorly on the market's opinion of the fund manager when there is little appetite for their investment skills even when available at a 15% discount. For members of the board of a LIC, as I have been in the past, the discount dominates board meetings with much time spent on near-fruitless attempts to remove the discount. If the manager also runs a large unlisted business, why would anyone invest at NTA in an open-ended fund when the struggling closed-end LIC is much cheaper?

It's also problematic to grow the fund by issuing new shares at a discount because existing holders are diluted when buyers come in at a lower price. Loyal investors are already disadvantaged when their outlay at NTA is now worth 15% less than if they had gone into an equivalent unlisted fund at initial issue of the LIC.

Fund managers often start off loving the LIC structure because it locks in funds and fees with no potential for redemption and outflow, but they underestimate the work involved in managing a listed company and coping with the flak if performance is poor. When I was on the board of 452 Capital, the small LIC took as much management time as the multi-billion-dollar unlisted portfolio. Many fund managers, such as Simon Shields at Monash, Sam Shepherd at Bennelong and Bill Pridham at Ellerston have exited the closed-end LIC structure to focus on other funds.

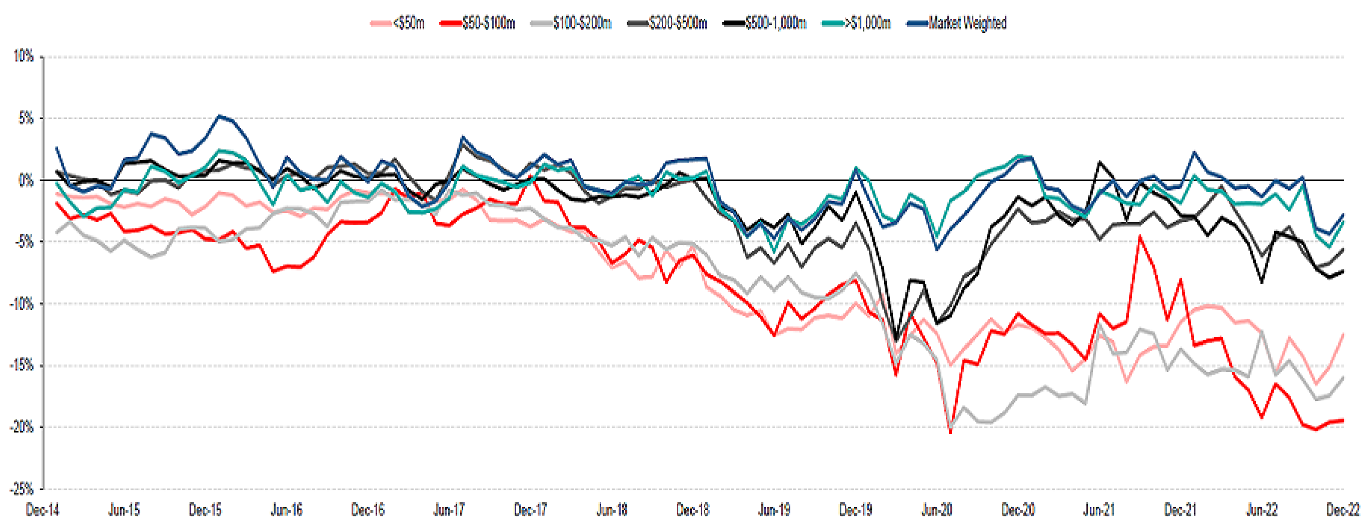
Why are investors reluctant to buy discounted LICs?

If boards, fund managers and existing holders are vexed, one group of stakeholders which can benefit is new buyers. As the dominant spokesperson and promoter of LICs, Geoff Wilson, loves to say, the best feature of LICs is buying $1 for 80 cents. He criticises other fund manager for not knowing how to nurture a LIC investor base and relying too much on the committed capital to retain their funds.

It sounds straightforward to buy a $1 worth of assets for 80 cents but investors may be reluctant because:

- They are not confident the fund manager (or perhaps any active manager) can deliver consistently strong performance in future, at least matching an index.
- There is often poor liquidity in the smaller LICs, and buying or selling a decent quantity can take time.
- The bid/offer spreads may be wide, and a loss of some percentage points may occur simply in the buying and selling process.
- The active fees are high in a world with ETF and index competition. It is common for LIC annual management fees to be 1% or more with an additional performance fee. Some academic work suggests the discount is the present value of the future cost of the active fee.
- Some LICs are poorly supported by their managers, committing little effort to marketing such as regular webinars and writing for newsletters to raise their profile.
- The discount may widen. The chart below on premiums and discounts since 2014 shows they are volatile and there are examples of 10% discounts moving to 20%, making what was a 10% 'saving' look expensive.

Premium/Discount by Market Capitalisation Band



Source: IRESS, Company Data, Bell Potter Estimates

When is it worth discount harvesting?

Given these drawbacks, what are the circumstances where a LIC might be more worthy of support?

1. Use a buy-and-hold strategy

The starting point, regardless of the discount, is to find a good fund manager.

Investing into any equity fund is a long-term decision, at least five years and preferably 10. Investing should be contrasted with trading, where a short-term view is taken based on a perceived anomaly or near-term opportunity. As part of a long-term portfolio, investors must accept that markets rise and fall, fund managers have good and bad years, investment styles ebb and flow.

This is even more so with LICs versus unlisted funds. At least with a managed fund or ETF, the investor can be confident of entry and exit at NTA, plus or minus a small spread.

One way to mitigate the risk or loss on sale due to the discount deteriorating further is to commit not to sell, or to hold for a long time. It also matters less if liquidity is poor or trading spreads are wide if an investor considers the LIC a core part of a portfolio. With no desire to sell, the benefits of the large discount can accrue.

2. Enjoy the larger income or dividend flow

Once the discount fear is removed, the appreciation can start. If a portfolio of underlying assets is paying 5% net income on a $100 investment, that's worth 6.25% if bought for $80. LICs are companies which pay tax, and dividends are decided by the board, with the ability to smooth the payments and create a more consistent income flow. This contrasts with ETFs and unlisted funds where income and capital gains must be paid out each year. LICs disclose in their accounts the amount in their Profit Reserve and Franking Account Balance as a sign of ability to sustain future dividends.

Managers such as Wilson's Leaders (ASX:WLE) and Plato (ASX:PL8) have realised that retirees want income and have focussed their LICs on yield, so convincingly that they both trade at premiums of around 12% (despite availability of Plato's unlisted fund at NTA). Clime (ASX:CAM) has embarked on the same income strategy but it is still available at a discount of about 6%. If the latest quarterly fully franked dividend of 1.32 cents is sustained for a year to give 5.28 cents on the current price of 86 cents, that's a healthy 6.1% fully franked or 8.7% grossed up.

Some LICs are fixed interest which hold debt instruments rather than relying on share dividends, and again, these interest payments are grossed up for the discount. For example, Neuberger Berman (ASX:NBI) and KKR (ASX:KKC) are at discounts of 15% and 17% respectively.

3. Find a size sweet spot

The chart above of premiums and discounts shows the largest discounts to NTA are in the smaller LICs worth less than $200 million. The large, traditional LICs valued at over $1 billion, such as AFIC, Argo, Djerriwarrh and BKI offer high liquidity, good trading volumes and decent support, and usually trade around their NTA. WAM Capital is large with similar support. However, at the other extreme, tiny LICs of less than $50 million do not have the resources to market actively, and suffer from fixed costs as a high percentage of their FUM. Although still small and therefore often suffering poor liquidity, those between $50 million and $200 million may be in a sweeter spot of large enough to cover costs but available at a decent discount.

Katana (ASX:KAT) is a manager with a strong long-term track record and a LIC at a 10% discount, but its small size means it does not receive much broker coverage and supply is limited.

4. Identify a potential recovery story or turnaround

To remove the discount, a manager needs at least two things: sustained good performance and the ability to promote their story. Investors who see a fund manager perform well while the LIC stays at a discount could move ahead of the recovery. There is sometimes a delay in the share price realising the NTA has improved.

Everyone has different views on particular fund managers, and some well-known fund managers do not have well-supported LICs. These vehicles are unusual animals that respond strangely to market vagaries. Perhaps a seller owns a large parcel that must be liquidated, and they hit bids hard and push down the price. It may be that a long-established manager has hit a rough sport and gone out of style for a while. Perhaps there are options overhanging the price, or a high-profile portfolio manager has departed recently. There are many reasons the market ignores a LIC.

Rob Luciano’s VGI Partners Global Investments (ASX:VG1) holds around $540 million in assets but trades at a hefty discount around 16% due to poor recent performance (down 22% in 2022). However, the business was recently acquired by Regal and Phil King is the new manager of the sister Asian Fund (ASX:RG8) and he should have more supporters to reduce its 15% discount.

Magellan’s Global Fund (ASX:MGF) Closed Class is also at a considerable discount around 17%, while billions rest in the unlisted fund around NTA. There is an instant arbitrage opportunity for thousands of investors. It is well known that Magellan’s conservative positioning in 2021 left its relative performance struggling, but it holds a high-quality portfolio of leading global companies. Other well-known funds or portfolios include Pengana (ASX:PIA) at 16% discount, Hearts and Minds (ASX:HM1) at 19% off and Alex Waislitz’s Thorney Technologies (ASX:TEK) at a whopping 36% discount. A recovery of popularity of any of these names may produce a windfall return. HM1 recently changed many of its managers in an attempt to reduce its discount.

Other high-profile managers such as Anton Tagliaferro's IML and its listed fund, QV Equities (ASX:QVE) and Perpetual's equity fund (ASX:PIC), are available at more modest discounts. Platinum Global (ASX:PMC) once dominated international equities and prices at a 13% discount, while Spheria Emerging Markets (ASX:SEC) at 16% off was previously more popular.

5. Potential to convert from LIC to open-ended fund

When a fund manager converts a closed-end LIC to an open-ended fund, investors enjoy the benefit of the discount removal, less some transaction costs. One downside is the conversion takes a lot of work, up to a year, subject to shareholder approval.

Reports from large fund managers whose LICs trade at a discount sometimes reveal a restructure is a possibility, flagged well in advance. Based on a comment in a recent interview, Magellan may be a candidate although the committed capital of a LIC is especially valuable as their other funds are in outflow. Here is a short extracts from a discussion between Head of Distribution, Frank Casarotti, CEO David George and Portfolio Manager, Nikki Thomas:

“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."*

No special insights known but Magellan needs to address this.

6. Asset classes without broad support

LICs cover many asset classes which may fall in and out of favour, and once at significant discounts, price improvement is an ongoing problem. Bailador Technology (ASX:BTI) has produced impressive results over time, including converting many of its positions to cash in recent years, yet its discount approaches 30%. Tribeca Resources (ASX:TGF) seems well positioned in a sector with growing demand and supply shortages, and yet it cannot shed its significant 13% discount. In the fixed income space, Neuberger Berman (ASX:NBI) and KKR (ASX:KKC) probably suffer from holding lower-rated corporate paper with a threat on the horizon of a US recession.

Or perhaps investors do not like what is in the portfolio. An example is Carlton Investments (ASX:CIN) which is a large fund of $850 million, suggesting liquidity and strong support, yet it trades at a 22% discount. A closer look at the portfolio reveals about 40% is in one asset, EVT (formerly Event Hospitality and Entertainment), so any holder needs to like that company.

In contrast, a specialist LIC such as Global Value Fund (ASX:GVF) holds assets which are not available in other funds, and it has developed a following based on its steady performance and strong marketing effort. It trades well at around NTA, although its market cap of around $200 million is not among the big boys. The market has rewarded its consistency.

Take a view and sit on it

Warren Buffett was talking about finding cheap companies, but the same can apply to LICs:

"It is extraordinary to me that the idea of buying dollar bills for 40c takes immediately with people or it doesn't take at all. It's like an inoculation. If it doesn't grab a person right away, I find you can talk to him for years, and show him records, and it just doesn't make any difference. They just don't seem able to grasp the concept, simple as it is … I've never seen anyone who became a gradual convert over a 10-year period to this approach."

Nothing beats good performance, but it is elusive for investors to identify future returns. Some of the problems faced by LICs in trading at a discount can be turned into an advantage if the investor is not worried about liquidity, a wider discount or fees. Investing in assets at 20% below their underlying value can be an attractive buy-and-hold opportunity, as the income or dividend will be 20% higher regardless of share price performance. But if it's a dog, leave it to the fleas.

Some final comments from Peter Thornhill

Many readers of Firstlinks will see similarities between the buy-and-hold in this article and author Peter Thornhill's preference for buying LICs and holding them for decades. However, Peter likes the large LICs without worrying about harvesting discounts. I asked him why. He prefers the consistency of a long-term proven investment process and:

"I have never bothered with discount or premium with the LIC's. I have begun to unwind my direct shareholdings where possible and moving the cash into a small handful of LIC's, about 6. As I started with the LIC's some time ago, the bulk are the old ones and I have been adding to them steadily so the holdings are substantial. To be honest, I'm too lazy to go digging for a few bits here and there. As I tell audiences, I have better things to do with my life than spending time on the computer."

Yes, it can take a lot of time and effort to harvest dividends, and each investor needs to decide if it worth the effort. At least with buy-and-hold, once the job is done, there is nothing more involved except enjoying the enhanced income flow.

**For consistency in this article, prices and NTA are taken from the latest Bell Potter Report in our Education Centre, where other details can be checked by readers. Discounts are based on pre-tax NTA, in line with the buy-and-hold message in the article. The indicative NTA has been adjusted for dividends. Dividends are removed from the NTA once the security goes ex-date and until the receipt of the new cum-dividend NTA. In some cases, Bell Potter has been unable to verify the Indicative NTA within a reasonable level of accuracy. There is no dilution due to unexercised options. See notes in their table.*

Graham Hand is Editor-at-Large at Firstlinks, and he owns many of the investments mentioned in this article. This content is not personal advice and does not consider the circumstances of any investor. The prices and discounts quoted are as at 3 February 2023 and change regularly.

Where Australia's largest ethical investor is finding opportunities

Maria Loyez, Mike Murray

An edited transcript of an interview between Australian Ethical's Head of Domestic Equities, Mike Murray, and his colleague, Maria Loyez.

Maria Loyez: In our asset allocation and particularly our multi-asset funds, Australian Ethical factors in inflation and what's happening in the macroeconomic environment, but from a domestic equities' perspective, you think about that a little bit differently. How are you thinking about inflationary pressures?

Mike Murray: Inflation matters a lot to long-term returns, but just because we're in a higher inflationary environment that's had consequences for, for example, resources companies, oil companies, we're not actually changing what we do. Just because the oil price is higher, we're not going to start investing in fossil fuel companies. We're a true-to-label ethical investor. We spend a lot of time explaining to people what we stand for and we don't intend to change.

But I think the difference between running a multi-asset portfolio and running a bottom-up equities fundamental portfolio is that we're spending less of our time trying to understand what the next inflation number might be and more time with the individual companies, understanding their business models, making sure they're resilient to a higher inflation environment. For example, do they have pricing power? Do they have too much debt, which they're going to have to pay a higher rate of interest on? Or in the case of some smaller capitalization companies, do they need to pivot their business model from growth to free cash flow generation? We're focused on identifying resilient and sustainable business models than we are about trying to pick macro trends.

Loyez: A lot of ESG funds are not invested in fossil fuel companies. What's the difference between ESG integration and what we do as an ethical fund?

Murray: It's important to distinguish between ethical investing, which often involves negative screens and aligning portfolios with an ethical charter in our case, which we hope represents our customers' values and a sort of light touch strict ESG integration approach. And I'd characterize light-touch ESG integration as being prepared to invest in most companies as long as you've integrated a particular ESG risk or concern into your valuation. And so, you may invest in a fossil fuel company if you're comfortable that on a risk-reward basis, the returns exceed the risks of investing in that company. So, we're different. We wouldn't invest in fossil fuel-oriented companies really under any circumstances.

Loyez: Which sectors or ASX companies have outperformed or surprised you this year?

Murray: One area that we do invest in in resources is lithium. And we came across Pilbara Minerals [ASX:PLS] several years ago, and we put money into it at around about $0.70, and it promptly fell the $0.15. So, we're no strangers to volatility. It's currently trading over $4. So, that's been an example of a company that's really outperformed our expectations.

I'll give you another example. It's a little bit more normal. Insurance companies are a bit more boring. General insurance companies, you would have expected them perhaps to do poorly, given we've had such severe weather events around the country. They've actually held up quite well, and I think it's an example of companies like Insurance Australia Group [ASX:IAG] and Suncorp [ASX:SUN] that have very strong business models with strong degree of pricing power. And what those companies have found is actually as interest rates

have risen, they're getting more return or high yield on their investments. So, we've found those companies quite a defensive place to invest in this environment.

Loyez: Are there any themes in the ASX at the moment that you're particularly excited about?

Murray: Yes, and I think that's a really good question, because even though markets have bounced, we're still finding companies and opportunities that we like. One of the companies we think that hasn't benefited to the extent it should have from higher energy prices is Contact Energy [ASX:CEN] based in New Zealand. We've just had two of our analysts actually visiting Contact Energy. And the reason we like it is because New Zealand is about 85% renewable power and it will probably go to sort of 90% or 95% renewable power, and they are a major player in geothermal hydroelectric power over there, and they've actually got a major new geothermal project coming online. And you can buy that company today for about 12 times EBITDA, which we think is very reasonable for that sort of asset. It's quite defensive. It gives you a dividend yield of about 4.5%, and we think that dividend will grow at about 5%, giving you a total return of probably somewhere around 10% for an asset we think is sort of below average market risk. So, that's an example of the kind of thing that we're excited about at the moment.

There are also other things we're excited about. I'll give you a different example. Capitol Health [ASX:CAJ] is a Victorian community radiology player. We got involved in that some time ago as a turnaround situation. They've been improving their margin. Their earnings are improving as they come out of a COVID lockdown period. They're conservatively geared. And we think those earnings being radiology-based are quite defensive to a higher interest rate environment. So, they are two examples of things that we like at the moment.

Loyez: Looking forward to, again, to 2023, are there any themes or opportunities – we talked about renewable energy, we talked about healthcare – what are you seeing as the opportunities in those or other sectors for 2023?

Murray: Look, one of the things that we've seen quite recently is we've seen small cap software technology companies, and in fact small cap companies in general sold off quite aggressively in an environment of higher interest rates. And I gave you the numbers before that actually that's been where we've found some of our best long-term opportunities through time.

So, to give you an example, we're very early investors in Pilbara Minerals at around about $0.70. Another company CogState [ASX:CGS], which is a global cognition, a digital cognition company providing services on big pharmaceutical clinical trials. It's another example of a company we identified very early and has grown very significantly in valuation and earnings terms for us. So, we do think that the environment for small caps recently has been challenging, but that's likely to throw up opportunities.

What we're seeing at the moment, and particularly in small cap software companies, is those valuation multiples have come back to what we think are very, very attractive levels, and that's bringing corporate activity into the sector. So, we've got a company in that space at the moment called Nitro Software [ASX:NTO] that's under takeover and that plays against some of the big boys, Adobe and productivity-oriented enterprise software.

Another company we really liked that upgraded – it's a smaller cap company – its earnings recently is called Gentrack [ASX:GTK]. It's a billing software company. It's positive free cash flow. It's got no debt, and it trades sub 2 times EV to revenues, which is, again, we think a very attractive level for that style of company.

Maria Loyez is Chief Customer Officer and Michael Murray is Head of Domestic Equities at Australian Ethical, a sponsor of Firstlinks. This information is of a general nature and is not intended to provide you with financial advice or take into account your personal objectives, financial situation or needs.

This is an edited transcript of Maria and John's interview published 1 February 2023. View the original interview here.

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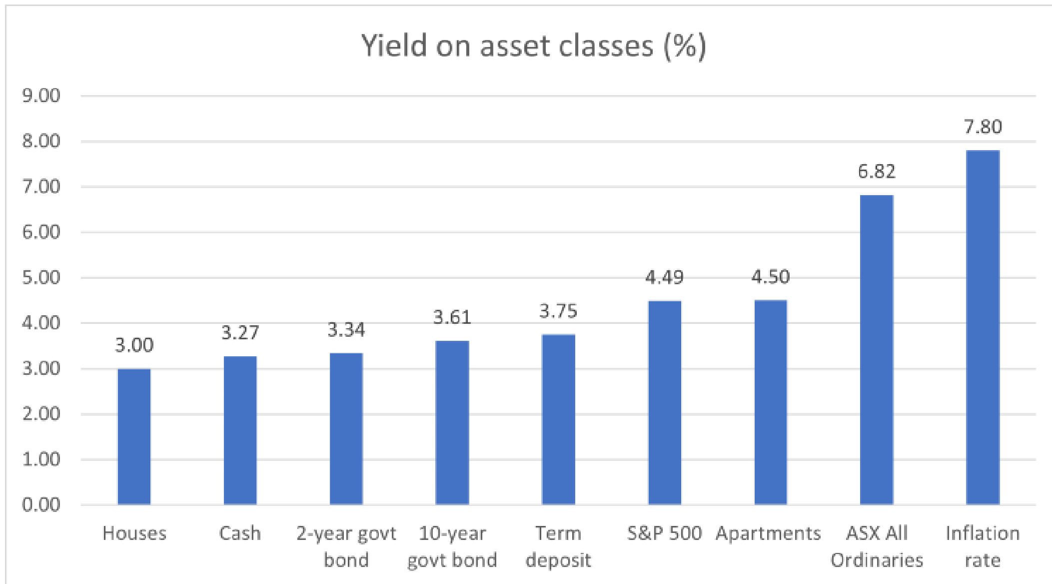
Which asset class in Australia offers the best value now?

James Gruber

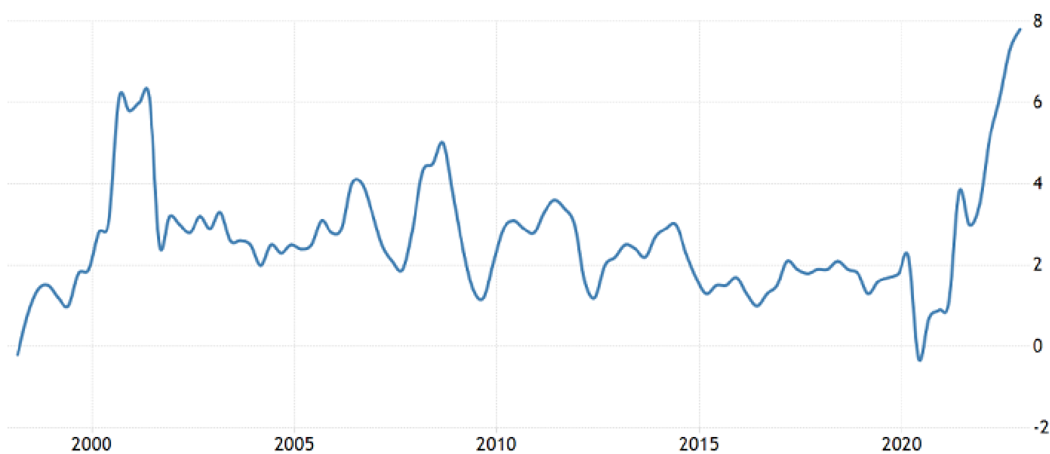
Here's a chart of the current yields for the four key asset classes: cash, bonds, property and stocks.



Note: houses = avg rental yield across capital cities. Cash = bank bill index. Term deposit is CBA 12-month. Apartments = avg rental yield across capital cities. S&P 500 = earnings yield, trailing 12 months. ASX All Ordinaries = earnings yield, trailing 12 months.

You'll quickly notice that the chart includes Australia's current inflation rate of 7.8%. What the chart shows is that every major asset class isn't earning enough to keep up with inflation. In real terms (inflation minus asset class yields), the yields are all underwater.

Australia inflation rate (% YoY)



That should tell you something, though: most people don't expect inflation to stay where it is. Otherwise, the pricing and prospective returns of these asset classes wouldn't make much sense. If inflation was to stay at these levels or rise in 2023, then the yields on all assets would need to rise too, and conversely, their prices would need to fall.

Given that inflation is expected to fall, then the next big question is: to what level? From the chart above, it's reasonable to think that most markets expect inflation to drop back towards 3%. The reason I say this is that if inflation stays above 4%, the pricing for many assets would need to adjust and yields would have to rise.

The great inflation debate

Whether inflation falls to 3% or lower is the great debate in financial markets.

The majority of economists and central banks suggest that it will because broken supply chains during Covid caused the inflation spike, and therefore as these chains heal, inflation will fall.

There are others such as monetarist economists like Tim Congdon who argue excess money supply caused the inflation uplift, but that supply has fallen dramatically, and the risk is more of deflation than inflation this year.

There is another camp that suggests inflation will prove structural and stay high for some time. Global strategist, Russell Napier, suggests that governments rather than central banks control the levers of money creation now, and that means inflation will be here to stay. Financial commentator and author, Jim Grant, has some sympathy for a more recent school of thought arguing that inflation is a characteristic of politically weak societies – these societies tend to ovespend and are naturally expansionary.

Others in the 'structural inflation' camp such as author Edward Chancellor point to the long inflation and interest rate cycles of the past 200 years. In the US, bear markets in bonds (which mean rising interest rates and inflation) have lasted 30-40 years, albeit with a lot of volatility.

And then there are the commodity bulls who argue supply shortages in commodities, especially in oil, copper and lithium, are long-term problems, and that will lead to higher inflation. They believe there's a perfect storm brewing for commodities, where supply will be limited due to environmental pressures on energy and mining companies not to produce, price caps and other governmnet intervention also disincentivising production, as well as reduced credit and equity availability to companies in this space.

Almighty cash

In 2022, cash outperformed most asset classes - thanks to the RBA lifting the cash rate from an all-time low of 0.1% to 3.35%. The RBA was late in responding to rising inflation and had to play catchup.

There's been heated criticism of the RBA Governor after he reneged on a previous promise that rates were unlikely to rise until 2024. While that criticism is warranted, there's been less attention paid to the decade prior where rates were kept extraordinarily low. When real rates (cash rates minus inflation) are kept negative for a long period of time, it's no surprise that asset bubbles form, and then burst.

Cash is now yielding 3.27%, which appears bountiful compared with recent returns but remains low versus history. Markets are pricing in a peak cash rate of 3.9% in August this year. A cash rate at these levels will be welcome news for savers.

RBA cash rate (%)

Have bonds become 'certificates of confiscation' again?

Bonds have had quite the ride over the past three years. 10-year bond yields bottomed in March 2020 at just 0.6% before climbing to above 4.1% in July last year and easing back to 3.61% now. Recent falls reflect market expectations of decreasing inflation.

Institutional fund managers appear to be warming to bonds again, though I wonder whether this is a case of them appreciating getting *some* yield on their bonds, whereas previously there was almost none. Are bonds attractive on an absolute basis, or just compared with recent history?

To be fair, many of these managers are looking more at investment grade corporate bonds and high-yield bonds where yields of 5-8% are common.

The future performance of bonds will depend on the direction of interest rates and inflation. If inflation falls back to central bank targets of 2%, then bonds are attractive at current prices. If inflation proves stickier, then prices may have further to fall.

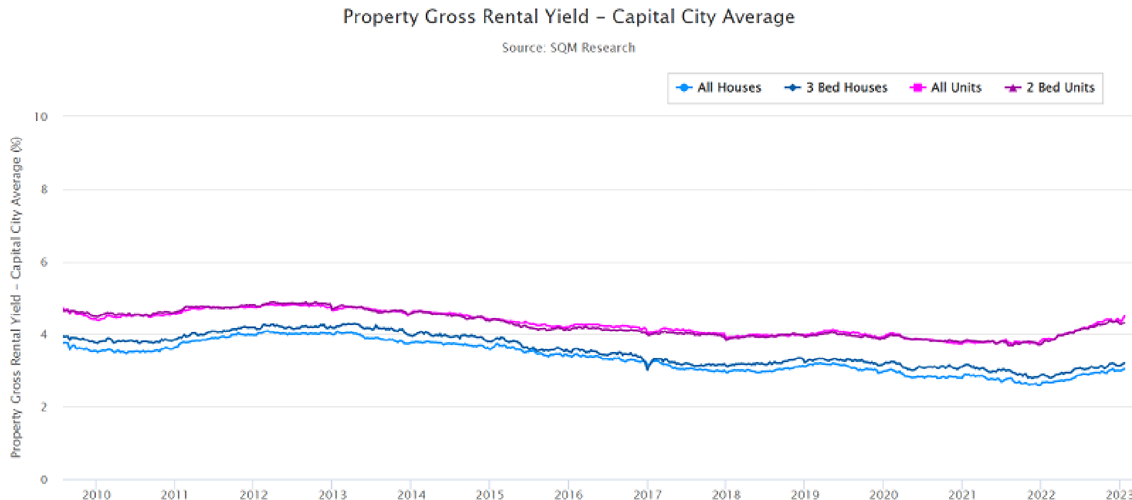
As noted above, bond bear markets tend to last 30-40 years. Zooming out from the short-term outlook, the bigger issue is whether a long-term bond bear market is upon us.

The 'Australian dream' or nightmare?

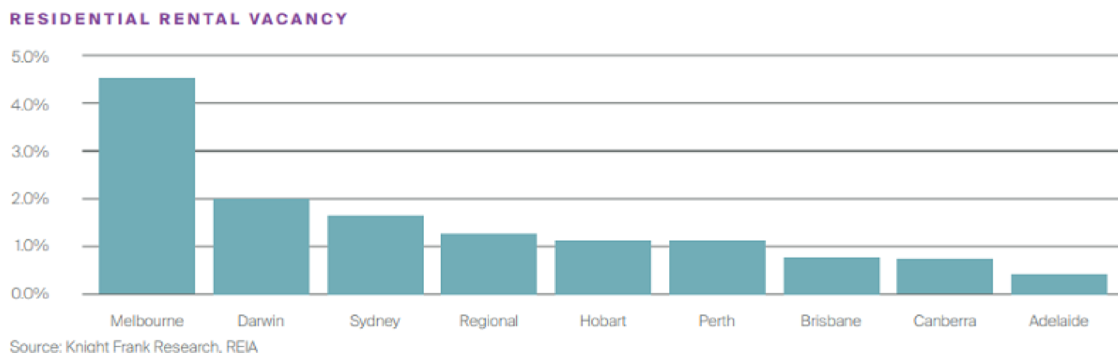
Australian residential property prices fell 5.3% in 2022. The largest falls were in Sydney (-12.1%) and Melbourne (-8.1%). Three capital cities saw prices rise: Adelaide +10.1%, Darwin +4.3%, and Perth +3.6%.

Prices fell on average because interest rates rose. The price reductions in residential property were relatively mild though and reflect the illiquidity of the asset class. Assets such as stocks quickly priced in the interest rate rises of 2022. More illiquid assets such as property, private equity, venture capital, and infrastructure have been slower to adjust to higher rates. That is still to play out.

Put bluntly, current residential property prices make zero sense from a valuation standpoint, despite the recent correction. With risk-free 10-year government bonds yielding 3.5%, and many bank deposit and term rates above 4%, apartment and house price rental yields of 4.5% and 3% look mispriced. And that doesn't take into account the costs of owning a property - these are gross yields not net. Why invest in a risk asset such as property when you can earn as much, or more, in cash?



Bulls will argue that low rental vacancies mean continuing rises in rents, which will be supportive of property prices. And they have a point. The welcoming back of migrants, including skilled workers, should continue to boost rents this year.



Property bears will point to the avalanche of fixed-rate mortgages expiring this year, and the pain to come for households. About one-third of outstanding housing loans in Australia are on fixed rates, and of these, about two-thirds are due to expire in 2023. Mortgage rates for households with these loans will rise by 40% or more.

Further property price falls seem inevitable in the first half of this year, and beyond that, much will depend on whether interest rates peak at close to 4%, as current market pricing implies.

Commercial property: more pain to come

In the first chart in this article, I didn't include commercial property yields, though I think they are worth discussing. If other illiquid assets have been slow to adjust to higher interest rates, then commercial property in Australia has been the tortoise!

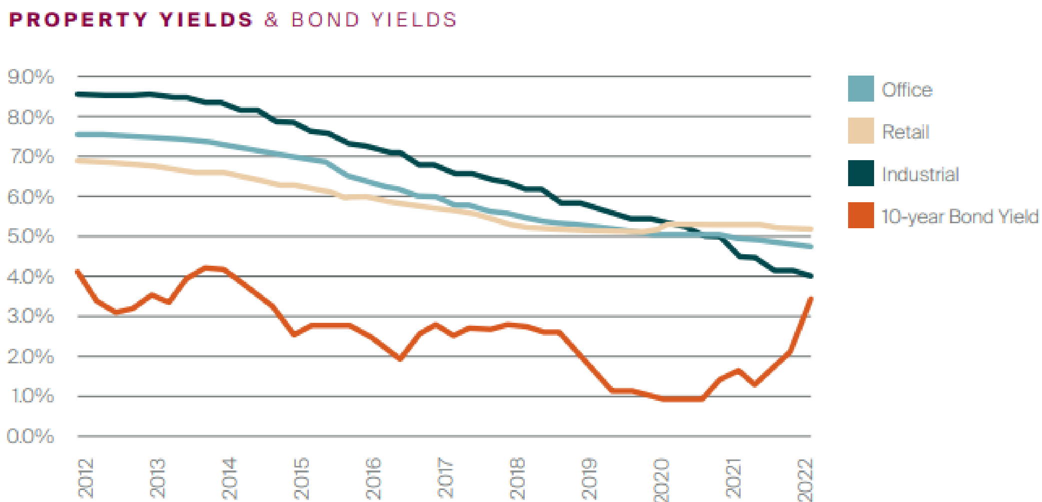
The stock market has quickly priced in the adjustment, which is why many listed REITs are trading at 30-40% discounts to their net asset values. The market is saying that, 'we don't believe your asset valuations and they'll need to come down to reflect the rate rises'.

While the prices of listed REITs have come down, physical commercial property hasn't budged to the same degree. Industrial property in Australia yields close to 4%, while office and retail property yields hover closer to 5%.

Traditionally, investors command commercial property premiums above the 10-year government bond yield of 4-5%. With the 10-year yield at 3.61%, commercial property remains a long way from offering these traditional premiums.

It's true that different segments have varied outlooks. Industrial property continues to benefit from the rise of e-commerce and build-out of warehouses to support it. Yet, that appears to be more than priced in.

As for office and retail property, the outlooks are challenging. Work-from-home is here to stay, and as office leases expire in coming years, it will put downward pressure on office rents and prices. Retail has only held up from a buoyant consumer which has benefited from government largesse during Covid. With higher mortgage rates, lower house prices, and the continuing move away from physical retail to online, retail property doesn't appear to offer much value.



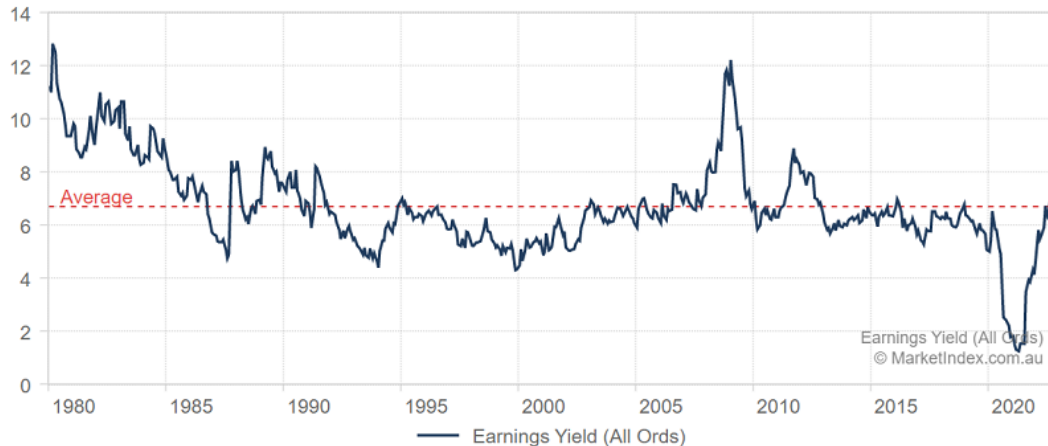
Aussie stocks: the global outperformer

Australian stocks outperformed most markets last year, with the ASX 200 falling just 1.08%. There was a wide disparity in returns between sectors, with energy and utilities up 49% and 30% respectively, while information technology got pummelled, down 34%.

Where to from here? The All Ordinaries price-to-earnings ratio (PER) is 15x, and is close to its long-term average. The earnings yield on stocks of 6.8% compares to the 10-year government bond yield of 3.61% - which isn't unreasonable.

The outlook for stocks will depend on earnings and the economy. Costs pressures will remain a major theme in the coming earnings season and for the remainder of the year. Higher interest rates, wages, and commodity prices (albeit some have come off in the past 6 months) will continue to pressure margins. And company sales will depend on how much rate hikes slow economic growth.

The good news is that company balance sheets are in good shape and dividend yields remain healthy, which should provide a buffer if there's economic turbulence ahead.



US stocks: off to the races

After a dismal 2022, US stocks have come roaring back. The Nasdaq had its best January in 20 years. Large caps like Meta have more than doubled since November. Despite the FTX fiasco, Bitcoin has risen almost 50% from its low last year.

The S&P 500 is valued at 22x trailing earnings or an earnings yield of 4.49%. The PER is about 30% above its long-term mean and is clearly pricing in a peak in the Fed funds rate this year.

Long-term valuations appear more expensive. The Shiller PE ratio, which measures US stock prices versus earnings smoothed out over a 10-year period, shows the S&P 500 is valued at 29.9x. That ratio has only been higher in two periods: 1929 and the late 1990s.

Shiller PE ratio

Whether on a PER or Shiller PE basis, US stocks seem expensive despite last year's correction.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

Are we reaching peak passive investment?

Daniel Taylor

A little more than five years ago, we wrote about the migration towards passive investing in the US. We argued that "the shift from active to passive is warranted" and that passive investing "does not appear to be close to any kind of theoretical limit." We also stated that the "continued flow from active to passive presents a contemporaneous risk to active performance" but "it increases the odds and risks of crowding and bubbles within passive strategies."

There are still a number of benefits associated with passive investing, but we increasingly believe the next decade will be a more productive environment for active strategies. While this is somewhat self-serving from the perspective of an active manager, we will walk you through our rationale.

Why does passive investing 'work'? And how passive is the market today?

The two major advantages of passive investment are low management fees and low transaction costs.

While a good active manager can arguably produce gross alpha in excess of management fees and transaction costs, if one views the market as a zero-sum game, it has to be that the average manager will *underperform* a nearly costless index by the sum of fees and transaction costs. Other advantages that are either investor-specific or debatable are tax efficiency, diversification, and eliminating behavioural biases (from which systematic strategies often attempt to profit).

Over time, these advantages have become so obvious that the US market has become extremely passive. In fact, we will argue that the US market is even more passive than conventional metrics would suggest. Figure 1 shows the largest 13F filers of Russell 1000 securities and our estimate of their active share.[1] Only four of the top 10 (or top nine if we aggregate BlackRock) are "active" managers, as measured by having a significant active share. Three of those four even have a lower active share today than they did in 2017 (the exception being Wellington, whose active share increased from 43.7% to 44.8%).

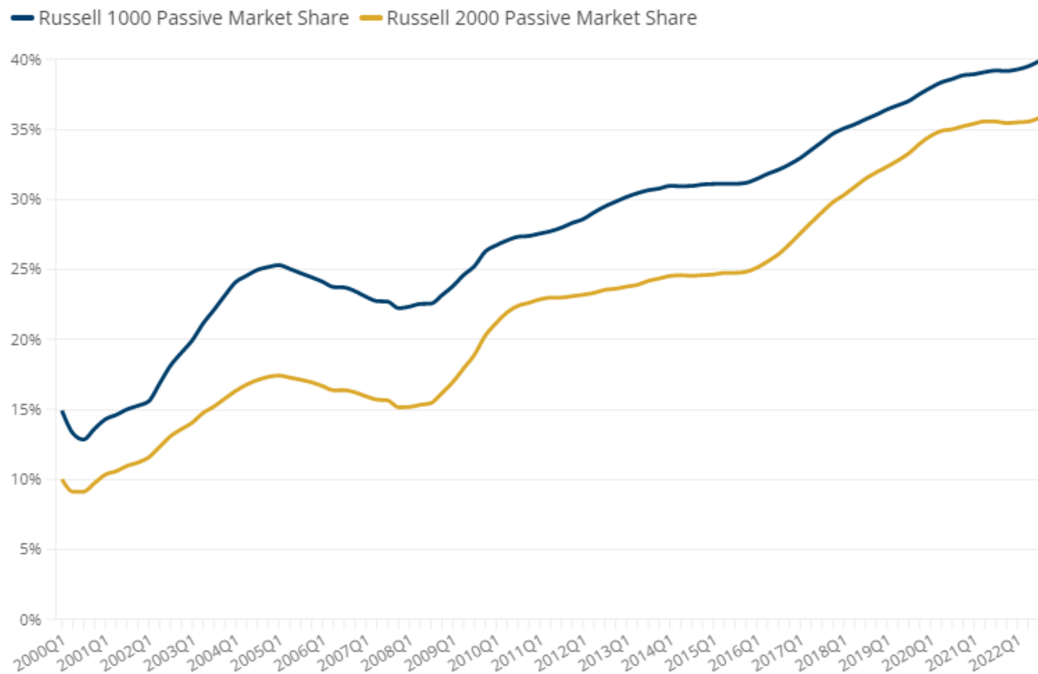
Figure 1. Q3 2022 Largest Asset Managers (AUM in USD millions)

Russell 1000	AUM	Active Share
Vanguard Group, Inc. (Subfiler)	2,958,993	6.5%
State Street Corp.	1,469,251	9.0%
BlackRock Fund Advisors	922,602	10.6%
BlackRock Institutional Trust Co. NA	742,060	2.9%
Geode Capital Management LLC	610,250	4.1%
Fidelity Management & Research Co. LLC	593,197	32.3%
T. Rowe Price Associates, Inc. (Investment Management)	554,514	37.6%
Wellington Management Co. LLP	410,940	44.8%
Capital Research & Management Co. (World Investors)	399,878	54.0%
Northern Trust Corp.	372,902	6.1%

Source: Man Numeric, Russell, FactSet; as of 30 September 2022. The organisations and/or financial instruments mentioned are for reference purposes only. The content of this material should not be construed as a recommendation for their purchase or sale.

Figure 2 shows the estimated passive ownership within the Russell 1000 and Russell 2000 over time. We characterise a 13F filer as active (passive) if their active share is above (below) 20%. Note that among 13F filers, we currently estimate that 40% is held by passive investors.

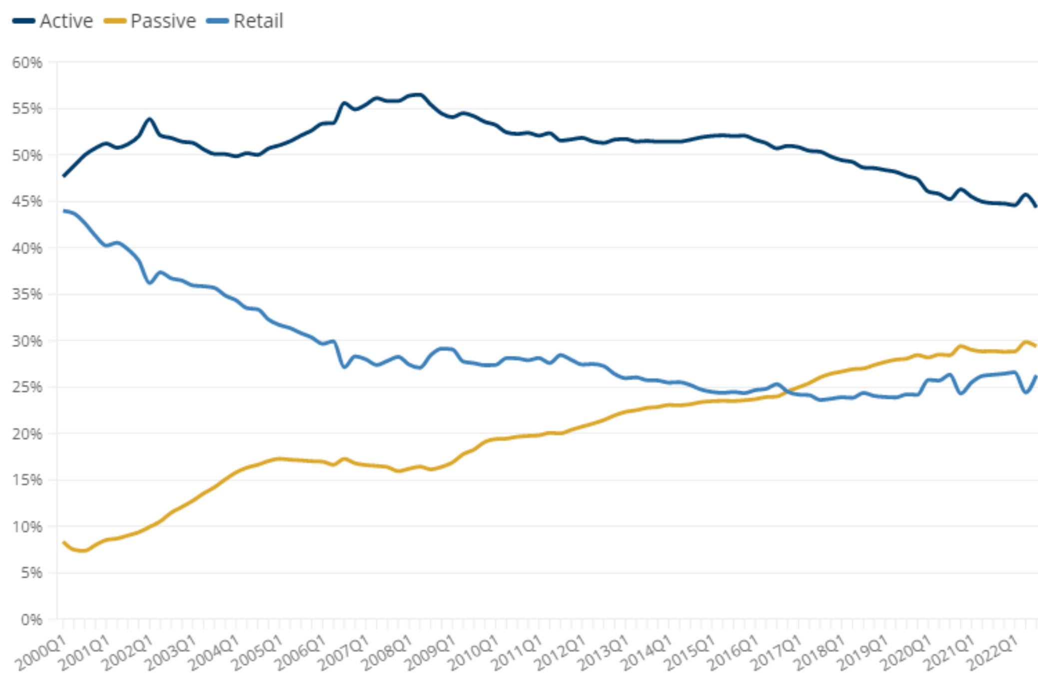
Figure 2. Estimated Passive Ownership within Russell 1000 and 2000



Source: Man Numeric, Russell, FactSet; as of 30 September 2022. Please see the important information linked at the end of this document for additional information on hypothetical results.

One issue with focusing on 13Fs is it ignores retail holdings.[2] We can include an estimate of retail ownership of any company as shares outstanding of a company less what is held across all 13Fs.[3] Figure 3 incorporates our estimate of retail ownership across the Russell 1000, and we now get a less aggressive estimate of passive ownership (~30% rather than ~40%). This might suggest that there is further room for the migration to passive investing, and while we would concede that point, there is an attenuating circumstance.

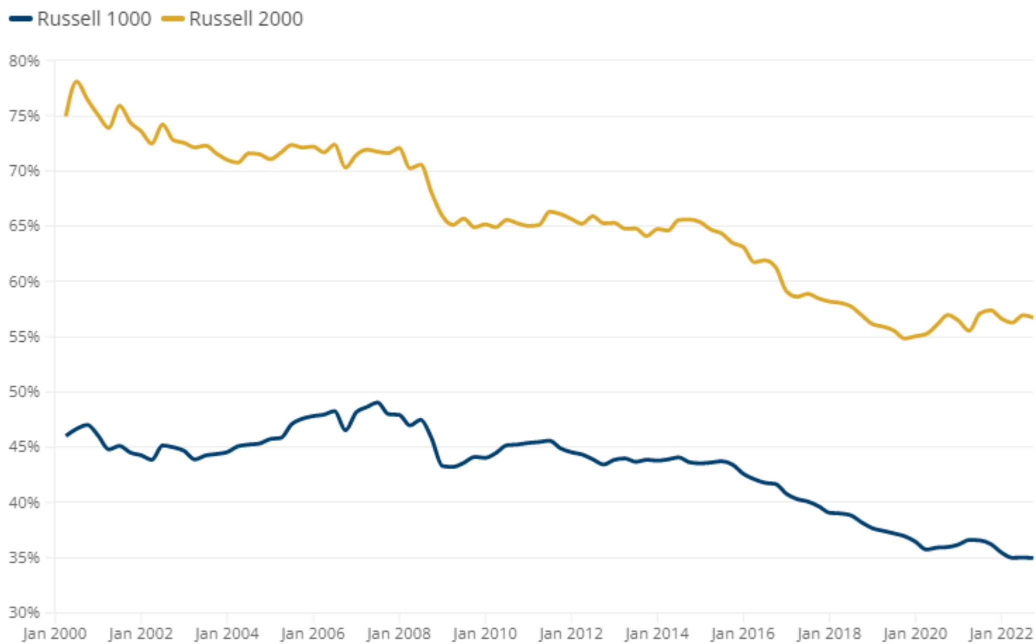
Figure 3. Estimate of Active, Passive, Retail Ownership – Russell 1000



Source: Man Numeric, Russell, FactSet; as of 30 September 2022. Please see the important information linked at the end of this document for additional information on hypothetical results.

One of the issues with classifying 13F filers as active or passive is that it is quite a blunt distinction. What do we do with active managers that have become increasingly benchmark-oriented due to tracking-error considerations? To address this, we introduced the concept of asset-weighted active share to account for changes in benchmark-hugging across the entire market. Figure 4 shows this across both the Russell 1000 and Russell 2000. In the Russell 1000, our estimate of asset-weighted active share has fallen from nearly 50% to 35%, including a material drop over the past five years. Simply put, this means that only one out of every three dollars (held by institutions) deviates from a cap-weighted benchmark. So, while we have previously estimated passive "market share" at 40% or 30% in Figures 2 and 3, this view provocatively suggests that the US equity market might actually be two-thirds passive.

Figure 4. Estimated Asset-weighted Active Share within Russell 1000 & Russell 2000



Source: Man Numeric; as of 30 September 2022. Please see the important information linked at the end of this document for additional information on hypothetical results.

The US market has become increasingly passive, for a lot of good reasons, and we are not making an argument that this will (or should) reverse. However, conditions today do warrant another look at active investing.

What has changed so active investing may recover?

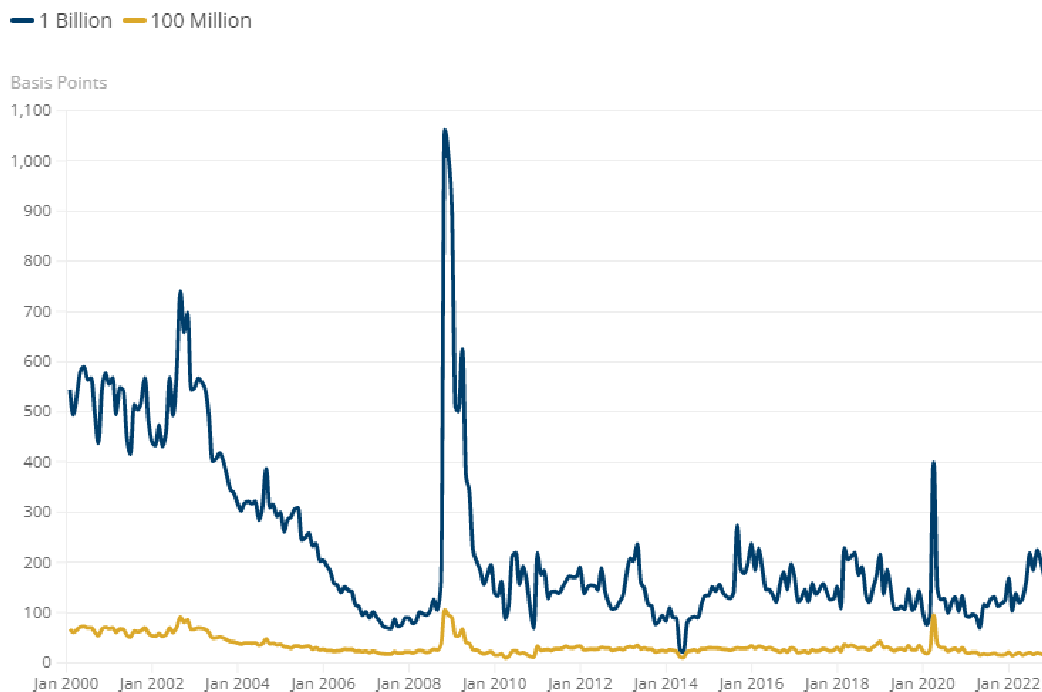
Let us start with the two clearest benefits of passive investing: very low fees and transaction costs. Passive fees have always been very low on a relative basis, and over the past decade have fallen to near zero for virtually everyone (and possibly zero or slightly negative in certain situations). Sadly, while there are sources for mutual-fund pricing (that show steep declines over the past two decades), we do not know of a good source of institutional management fees over time across the active space.

That being said, active management fees in the US (and globally) have fallen quite substantially over the past two decades. Let us suppose, for the sake of discussion, that 20 years ago active management fees for US equities were 0.5% to 1%, and today are closer to 0.2% to 0.4%.[4] The main point of this supposition is that in a zero-sum game, 50 to 100 basis points (bps) of fees is a significantly higher hurdle than 20 to 40 bps, and this increases the viability of active management from a client value-add perspective.

Transaction costs can vary significantly over time and across regions. Typically, small-caps and emerging-market equities would be more expensive to trade than large-caps and developed-market equities. Let us assume that a US large-cap equity trade will cost 10 bps to trade (one can certainly do better or worse than this). The difference in costs between $0.15 of trades and $1.50 of trades is 13.5 bps. This is another hurdle that the active manager must overcome, and the higher the turnover, the higher the hurdle. But it should be noted that transaction costs in most equity markets have fallen due to increased liquidity, meaning that this hurdle has likely diminished over time.

We have talked about direct costs associated with active investing (relative to passive investing), but what indirect advantage has passive had over the past few decades that is unlikely to repeat over the next decade or two? Over the past few decades, several trillion dollars has likely moved from active to passive strategies. Morningstar estimates that in 2021, active US equity mutual funds had net outflows of $195 billion, while passive funds had net inflows of $346 billion.[5] This would indicate that on a typical day, there was a net flow advantage of $2 billion for passive funds that are buying stocks solely based on market capitalisation!

Figure 5. Estimated Market Impact of Buying $100 million or $1 billion of Russell 1000



Source: Man Numeric; as of 31 October 2022. Please see the important information linked at the end of this document for additional information on hypothetical results.

Figure 5 shows our estimated impact (in basis points) of buying either $100 million or $1 billion in the Russell 1000 over time. As liquidity has improved, over the past decade the rough range of estimated impact has been 15 to 20 bps and 100 to 200 bps for $100 million and $1 billion, respectively. To the extent that there has been serial and one-sided flow going from active to passive managers, this presents a range of potential impact that may contemporaneously advantage passive performance at the expense of active performance.

Besides explicit costs and what we believe to be a material headwind from a flow perspective, there is the nature of cyclicality in returns. Cyclicality appears to be a feature of many types of strategies (including passive) and, relating to the prior discussion on market impact, good performance tends to lead to positive flows, which can then lead to too many assets in a particular strategy, which can then lead to underperformance.

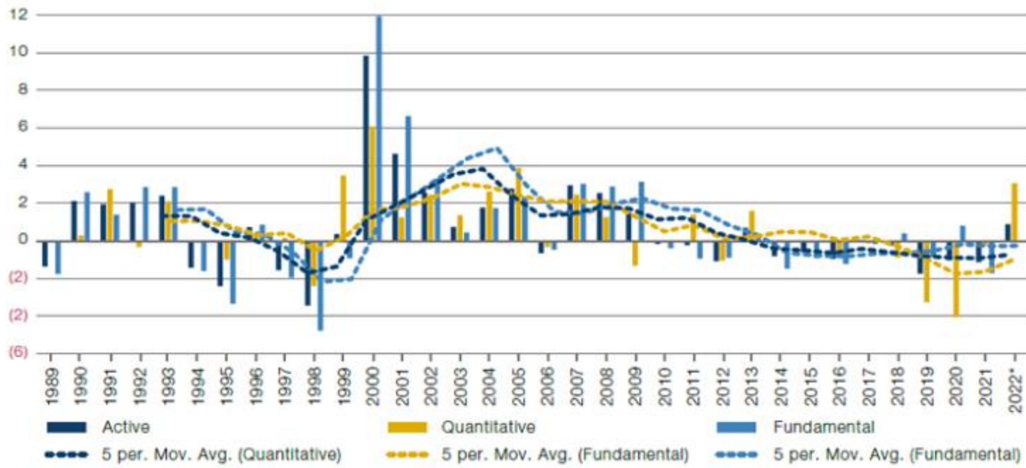
Do we see any evidence of cyclicality within active-versus-passive performance and, if so, where are we today? Using the eVestment database, we analysed the relative gross of fee[6] performance of US active large-cap managers, and then separated by both (self-described) quantitative and fundamental groups.

Figure 6 shows the annual gross relative performance of active, quantitative, and fundamental managers, as well as the five-year moving average. We should mention that we have equal-weighted and not asset-weighted these calculations as the assets data are unfortunately sparser. We also believe that asset weighting would likely lower the typical outperformance that is represented below. We believe the data below suggest some interesting observations. It does appear there is some cyclicality in active performance, as the periods from 1990 to 1993 and 2000 to 2008 appear quite productive for active managers, while the periods from 1994 to 1999 and 2010 to 2021 are more challenging.

As an additional data point, the annual autocorrelation of active manager performance is 40% over this period. We can also see that 2019 and 2020 were extraordinarily challenging for quantitative managers – in fact, they

were the two most difficult years over this 30-year period. But conditions have improved over the past two years, and we would like to think this augurs well for the cyclical prospects of active managers.

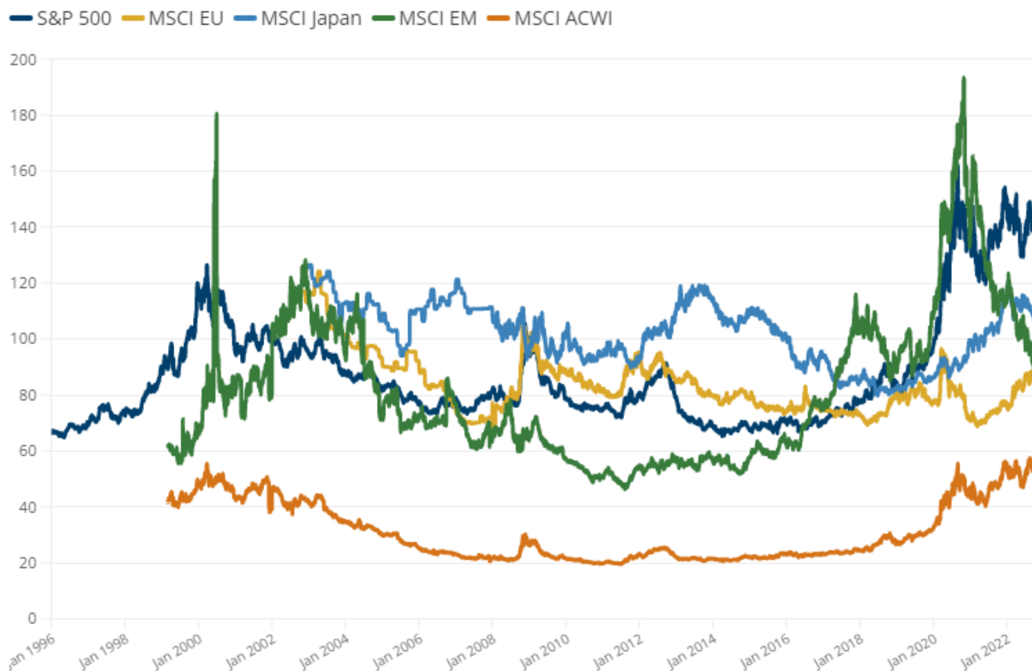
Figure 6. Average Gross Alpha (%) of US Active Managers with Five-year Moving Averages



*Source: eVestment and Man Numeric; as of 30 September 2022. *2022 the trailing four quarters through 30 September 2022. The periods selected are exceptional and the results do not reflect typical performance. The start and end dates of such events are subjective and different sources may suggest different date ranges, leading to different performance figures.*

Furthermore, if we look at the concentration of equity indices globally through a Herfindahl-Hirschman Index, we can see that the cyclical underperformance within US equities coincides quite nicely with increasing concentration (Figure 7). Globally, while concentration has fallen quite materially within MSCI Emerging Markets, concentration still sits near highs in the US, Europe, Japan, and All Country World indices.

Figure 7. Equity Herfindahl-Hirschman Indices



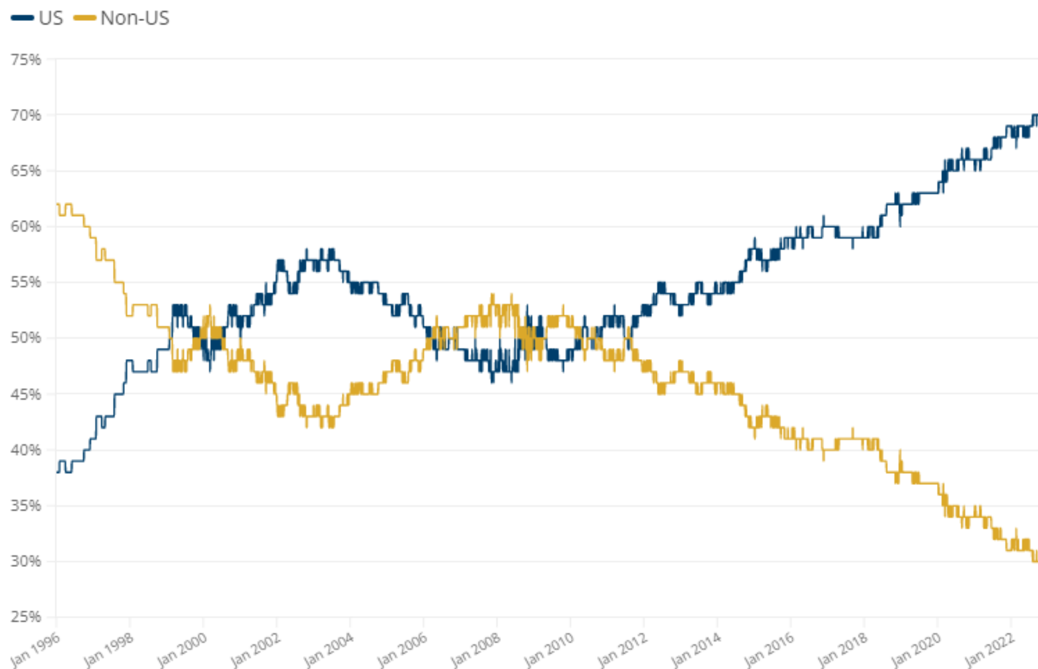
Source: Man Numeric; as of 30 November 2022.

What are the broader implications for global equity investing?

While we have focused on active and passive investing in the US, we do believe that many of the observations here are relevant outside the US. But even if that were not the case, and this was only a US phenomenon,

global equity indices are now heavily dominated by the US. Today, the US represents 70% of the MSCI World index (Figure 8) and has steadily risen over the past dozen years. Is it a coincidence that this has occurred during a period of increased passivity and increased concentration with the US equity market?

Figure 8. MSCI World Benchmark – US versus Rest of World



Source: Man Numeric; as of 30 November 2022. The periods selected are exceptional and the results do not reflect typical performance. The start and end dates of such events are subjective and different sources may suggest different date ranges, leading to different performance figures.

Where is the equilibrium between active and passive strategies?

So why do we believe now is a good time to start revisiting active investment strategies in the US? We will highlight three points:

1. Active fees and transaction costs have declined over time and because the spread between active and passive has shrunk along this dimension, the hurdle for active strategies to add value is as low as it has ever been.
2. The massive flows from active to passive strategies have been a significant headwind to active strategies and a tailwind to passive strategies. While those flows may continue, we believe we are approaching an upper limit to the passivity of the market, and thus this headwind is likely to abate.
3. Active relative performance appears to exhibit cyclicality (as do many investment styles), and active managers recently went through a prolonged period of difficult performance that may have started to reverse. We also note the US had a bull market of nearly a dozen years that was barely interrupted by the onset of Covid. Passive may have disproportionately benefited from the continual bouts of quantitative easing, when the best strategy was simply to own the market and buy the dips. A different environment may call for more discretion and less complacency among equity investors.

1. Note that we are looking at the sub-filer level, so for example BlackRock has multiple entities, some of which do not appear here.
2. For further analysis of retail investors, please see our April 2022 paper "Active, Passive, Retail, ESG and Value; Oh My!"
3. Note this is imperfect because of short selling, where total shares held exceed shares outstanding.
4. Of course, fees generally depend on a number of considerations, including but not limited to universe, tracking error, and mandate size.
5. www.morningstar.com/articles/1075161/us-fund-flows-smashed-records-in-2021
6. Managers report gross performance here so it would still be important to consider the impact of management fees.

Daniel Taylor, CFA is CIO, Man Numeric. Man Group is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information included in this article is provided for informational purposes only. Munro Partners do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions.

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The future remains bright for industrial property

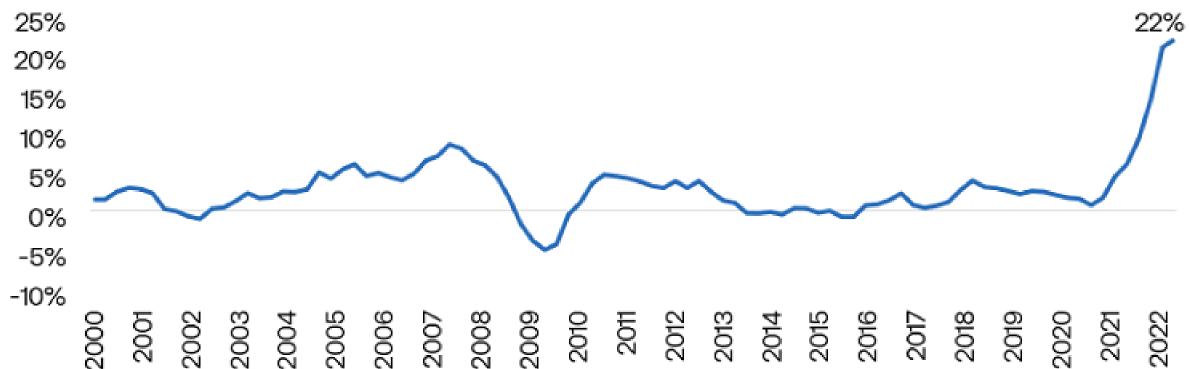
Sasanka Liyanage, Steve Bennett

High levels of inflation and rising interest rates have shifted the investor landscape. Many investors have pursued cashflow growth and its contribution to investment outperformance. Commercial real estate is often considered to be a defensive asset class given the contractual cashflows offered through periods of uncertainty. These contracts typically have fixed rental increases or other rental features linked to inflation/CPI rates.

Growth in demand for Industrial & Logistics (I&L) assets has been unprecedented over recent years and the sector has adapted to changes in technology and consumer behaviour. Yet the construction of new I&L assets has been insufficient to meet tenant demand. New supply has been inhibited by a lack of zoned I&L development land and supporting infrastructure. This imbalance between demand and supply has translated to record rental growth (+22% pa), significant increases in land value and ultra-low vacancies (<1%).

Rental growth across the Australian Industrial sector reached the highest level on record

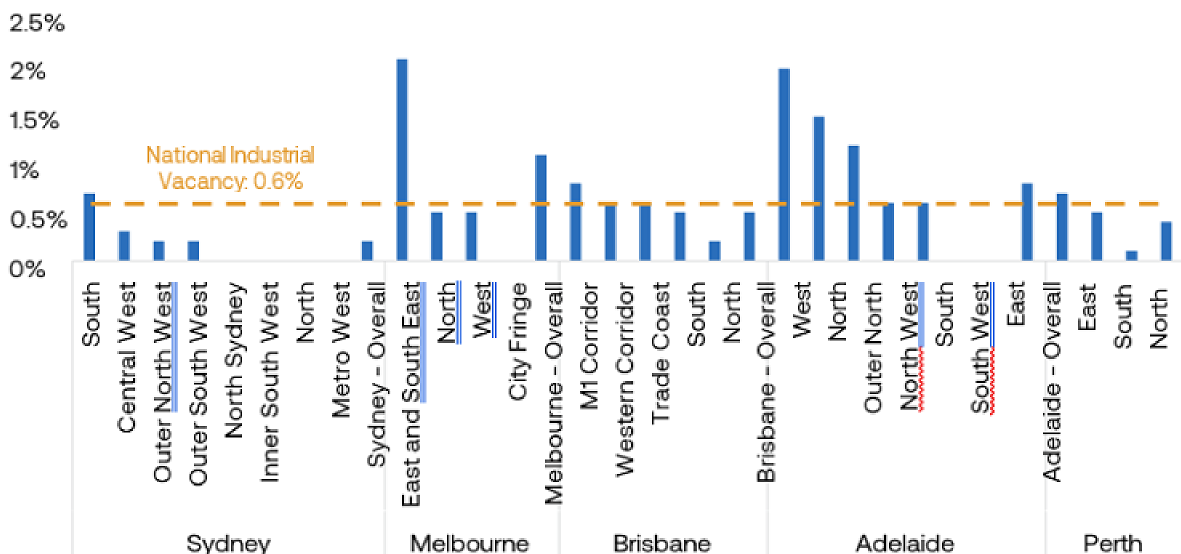
Figure 1: Prime Annual I&L Rental Growth (%)



Source: JLL Research, Charter Hall Research. At 4Q22.

The imbalance between I&L supply and demand has reduced vacancies to the lowest level on record

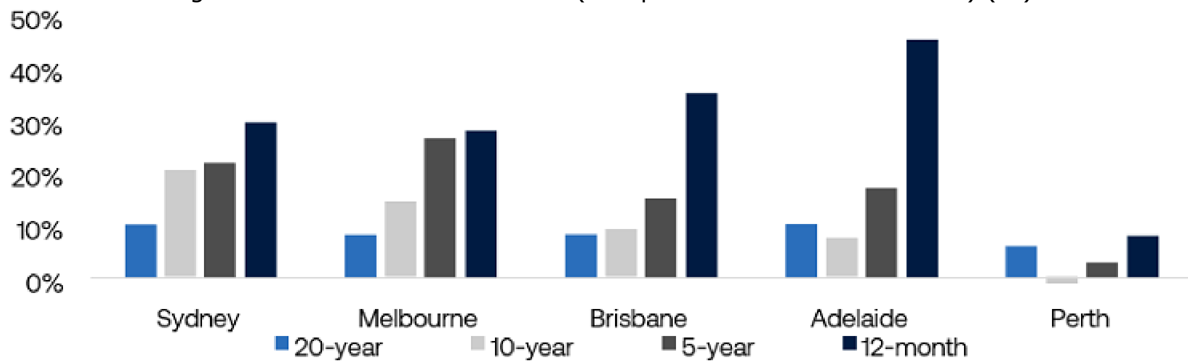
Figure 2: I&L Vacancy Rates, by Market (%)



Source: CBRE, Charter Hall Research. At 2H22.

Shortage in development stock manifesting in significant growth in industrial land values

Figure 3: I&L Land Value Growth (Compound Annual Growth Rate) (%)



Source: CBRE, Charter Hall Research. At 2H22.

A sector adapting to fundamental shifts in demand

Demand should continue to remain strong driving further rental growth, due to the following:

The ongoing rise in online retailing: The growth in online retailing has been an impetus for growth the I&L sector. More goods are transported directly from I&L assets to the consumer. Like retailing of the past, success is fundamentally predicated by cost, range of product, stock availability, and time to consumer. As such, retailers have been competing for I&L assets with:

- proximity to consumers;
- greater storage capacity; and
- the ability to move goods faster.

Advancements in technology and the longer-term shifts in consumer behaviour is driving a sustained growth in digital retailing. Online sales continued to increase over the year, reaching $53 billion equating to 13.3% of total retail sales. Total volumes are ~75% above pre-COVID levels. Total online retailing volumes are forecast to grow by 123%* over the next five years – requiring significantly greater capacity across the I&L market.

A shift in supply chain strategies: The pandemic has increased occupier focus on supply chain resilience. Supply chain strategies shifted to higher levels of holding inventory and greater stock security. With the risk of escalating geo-political tensions, strategies will continue to support stock security and supply chain resilience.

A growing focus on Environmental, Social and Governance (ESG): Institutions and consumers have increased scrutiny about where and how goods are sourced. Additionally, frameworks are being developed to measure the emissions across supply chains.

With higher costs of transportation and a focus on reducing emissions, there will be increased demand for well-located assets with high sustainability credentials.

The rising feasibility of automation: Online retailing will rely on stocking a wider variety of goods, moving them faster and reducing operating costs. Given specific sets of requirements, advanced automated systems can usually only be installed in higher quality assets. High upfront investment costs and increased scrutiny on emissions will influence the feasibility of asset locations – thereby increasing the value placed on location.

Restrictive conditions on new construction: The challenges to the construction of new I&L assets are expected to persist over the medium term. The rise in construction costs, ongoing shortages in labour, and supply chain disruptions have increased the costs of developments. These issues are further compounded by the rise in interest rates.

A combination of these factors and the ongoing rebound in Australian population growth will continue to generate demand for the sector. But the performance of portfolios will be distinguished by asset quality and active management. The deficit of modern assets with high sustainability credentials will drive income and value growth for well-curated portfolios.

Good quality managers will continually review their portfolios and seek to divest older buildings and properties at risk of obsolescence as they may erode future value growth. Over the near-term, the quality of the tenant is crucial. The higher interest rate environment will exert pressure on certain firms, particularly those across low-margin industries.

We’re also approaching a period where there may be market price declines, possibly providing further buying opportunities. As such, it is essential that managers have the capital structure and strategies in place to outperform, whilst having the capacity to acquire quality opportunities at attractive pricing.

Sasanka Liyanage is Head of Research and Steven Bennett is Direct CEO at Charter Hall Group<, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

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How to be perfectly franked and pay no tax

Chris Cuffe

This article was originally published in Edition 1 of Firstlinks (then Cuffelinks) on 8 February 2013, 10 years ago this week. Firstlinks aspires to offer timeless insights to its readers, with less of the daily noise of other newsletters. It is pleasing to look back on Edition 1 and see most of the articles remain relevant today, including a piece by former PM, Paul Keating.

Similarly, this explanation of franking by Chris remains as accurate and informative today as when it was written.

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Kerry Francis Bullmore Packer would have loved superannuation and franking credits. In 1991, he was subpoenaed to appear before a Parliamentary Committee enquiring into the print media, and it was wonderful theatre. He bellowed out his responses and left most of the Committee members cowering. But his most memorable response came when asked about his company’s tax minimisation schemes:

"Of course I am minimising my tax. And if anybody in this country doesn't minimise their tax, they want their heads read, because as a government, I can tell you, you're not spending it that well that we should be donating extra!"

You may not feel quite as critical as Mr Packer, since our taxes pay for health, schools and pensions, but the superannuation system has been designed to encourage people to finance their own retirement, so it makes sense to use it. Income in superannuation is taxed at 15% in the accumulation phase, and personal marginal tax rates hit 19% when earnings exceed $18,200, so income in superannuation is tax effective for anyone earning above this amount.

But that’s only half the story. Let’s put franking credits into the mix by understanding how dividend imputation works. Companies pay tax on their profits at a full rate of 30% before dividends are paid to shareholders. In the hands of an investor receiving the dividend, the tax paid is called a franking credit or an imputation credit. For tax purposes, the shareholder receives both a cash dividend plus the imputation credit, and is treated as if they paid tax equal to the imputation credit.

The system operates like this to avoid double taxation of income. In effect, the shareholder receives back the tax that has already been paid by the company and instead pays tax at the investor’s own tax rate. If the owner of the shares is on a tax rate less than the 30% company tax rate, such as superannuation funds, they are entitled to a rebate of the overpaid amount.

Let’s consider a simple example. A company earns a profit of $10,000, and pays tax of $3,000, leaving $7,000. It pays this amount as a franked dividend to its only shareholder, which is a super fund. In its tax return, the super fund adds the tax already paid by the company to the cash dividend received. The 'grossed up dividend' is $10,000, and the super fund pays tax on this at 15%, or $1,500. However, it receives a credit worth $3,000 for the amount of tax already paid by the company, leaving a tax refund of $1,500. Neat!

So it’s a matter of maths to calculate how much fully franked dividends is needed to offset the income tax due on the rest of a super fund’s portfolio, and pay no tax, meaning that no investments need to be sold to fund the tax bill.

Skip the following box if you don’t have a mind for numbers.

Assume:

P = dollar value of total superannuation portfolio
S = percentage of the portfolio invested in Aussie shares paying fully franked dividends
(1-S) = percentage of remaining portfolio
D = net dividend yield from portfolio invested in Aussie shares paying fully franked dividends
Y= yield from remaining portfolio with no franked dividends
Value of franking credits is 3/7 x D x S x P

Taxable income = gross income from Aussie shares + income from remaining portfolio

= grossed up dividend income (being dividends received plus franking credits) + income received from remaining portfolio (unfranked)

$$= [P \times S \times (1+3/7) \times D] + [P \times (1-S) \times Y]$$

Tax payable = 15% x taxable income – value of franking credits

So, by substituting formulas for words, it follows that:

$$\text{Tax payable} = 15\% \times [(P \times S \times (1 + 3/7) \times D) + (P \times (1-S) \times Y)] - [3/7 \times D \times S \times P]$$

If we want the tax payable to be zero and we want to "solve for S" (ie to find out how much we need to invest in fully franked shares), the formula reduces to:

$$\mathbf{S = 0.15Y / (3D/14 + 0.15Y)}$$

So with some current day numbers, this formula can be used with values for D (the dividend yield on the shares) and Y (the yield on the rest of the portfolio) to determine how much of a portfolio needs to be invested in fully franked shares to have a zero tax rate on the entire portfolio.

- a franked dividend yield on the Australian shares portfolio of 6%
- an unfranked yield on the remaining portfolio of 4% (bonds or bank bills).

The portfolio would only need to contain 32% of Australian shares paying fully franked dividends to pay a zero tax rate. And without getting into a discussion on portfolio construction, most Australian super funds can justify an allocation to Australian shares of at least one-third.

The calculation ignores the impact of any realised capital gains and expenses from running the portfolio.

The combination of favourable tax rates and dividend imputation shows the power of saving in a superannuation vehicle. Once a fund converts to paying a pension, there is no tax payable by the fund on earnings. In this case, imputation credits are refunded in cash. Furthermore, if the pension recipient is aged over 60, then pension drawdowns are also tax free.

Kerry Packer would have loved it. All that income and no tax. And later, a refund from the government. Kerry probably learned a lot from his father, and maybe it's no coincidence that this powerful process carries the same name as that equally powerful man. Sir Frank.

Why a $5 coin and not a $5 note repays public debt

Owen Covick, Professor Kevin Davis

Over 30 years ago we published an academic paper explaining how the replacement of the $2 note with the $2 coin in June 1988 had led to a short-term reduction in the Commonwealth Government's recorded budget deficit. The reason was the budgetary accounting treatment of the seigniorage profit to the Mint from creating coins compared to when the Reserve Bank (RBA) prints notes.

We doubt many people have ever read that paper. It's an arcane topic and the title (typical of academic papers of the time, or maybe reflecting our lack of imagination) was hardly 'sexy'. But the analysis there explains why today's government, with a massive budget deficit (and a recent change of monarch) might find introducing a $5 coin attractive.

What is seigniorage, other than a lovely word?

Seigniorage is the profit the government makes from producing fiat money (notes and coins) at close to zero cost. The public is willing to accept these in exchange for supplying the government with labour, goods and services, or assets etc of equal nominal amount. Wouldn't we all like to create such a 'money machine' (and the explosion of cryptocurrencies reflects attempts by their promoters to do so).

So, if the Mint, a part of the Government, makes a $5 coin at virtually zero cost, when that coin is put into circulation, its profit of $5 is treated as revenue to the Government, reducing the budget deficit in that year. In contrast, if the RBA puts an additional $5 note into circulation (also at virtually zero cost) that is treated as a financing item, i.e., a liability in the RBA's accounts.

Because the RBA is 100% owned by the Commonwealth Government, that $5 note is then effectively treated in the budgetary accounting as a component of Australia's 'national debt'. This is hard to spot because the RBA's balance sheet is never published on a consolidated basis with that of its 100% owner.

A $5 coin would reduce public debt

This means that when a $5 note is taken out of circulation and replaced by a $5 coin, the $5 profit made on the coin is effectively treated as a reduction in the national debt through the cancellation of the note. In today's budgetary situation, the latter effect is a $5 reduction in the recorded government borrowing requirement rather than a 'redemption' of public sector debt.

If, however, new $5 coins simply replace the public's holdings of old coins of lower denominations, this budgetary effect does not occur. The same applies if reduced holdings (and use) of $5 notes outside the RBA are matched by increased holdings (and use) of higher denomination notes.

Will the government want to take this step? One perhaps minor consideration would be that the coins would have the image of King Charles on them while the existing notes (many of which would continue to circulate for some years) would feature Queen Elizabeth. Those who don't want to see the Queen replaced by the new King on the notes might be diverted! The Royal Australian Mint says:

"Q. Who will be on Australia's new coins?

A. The obverse of Australian coins are struck with an image of the reigning Sovereign.

Q. When will a new effigy appear on our coins?

A. Arrangements for the King Charles III effigy are still being finalised by the Australian Government."

The impact of inflation

Another consideration is that inflation since the $2 coin was introduced might mean it is time. The Consumer Price Index for 31 December 2022 is just over 130. In 1988 when the $2 coin was introduced it was around 50. So a $5 note (or new $5 coin) would be worth about the same in real terms as the $2 coin was at the time of its introduction.

Today's circumstances mean it is more relevant that there is the opportunity for the Government to have an additional contribution to reducing the recorded budget deficit. There are today over 200 million $5 notes in circulation with an aggregate value of over $1 billion. Assuming that the Mint produced, and 'sold', that value of coins in one year, the recorded Government revenue (and budget deficit) for that year could increase (and

decrease) respectively by that amount. It would probably be in the Government's interest to spread the effect over two years, as happened with the $2 coin.

Do we even want coins?

Of course, whether the public would want to accept that amount of new $5 coins is problematic. Unless there was a compulsory exchange requirement (or equivalently by making $5 notes no longer legal tender by some date) it is not clear what the public demand to obtain and use such coins would be.

The public is continually moving away from physical money into electronic transactions, and in any event a $5 coin would seem likely to be regarded by many as less convenient than a $5 note. It would be well worth assessing whether the populace would appreciate such a change. Also, many may currently prefer to maintain the Queen's image on the notes, although that preference may decline over time.

Long live the King ... and Queen

We learnt recently that King Charles III will not feature on the new $5 note, and the new design will tribute to 'the culture and history' of First Nations people, the RBA says. Perhaps a middle road which maximises 'freedom of choice' would make sense since having the monarch's image on our currency is only a tradition and not a legal requirement. That could involve introducing the $5 coin (with the King's image) while allowing the existing notes (with the Queen`s image) to remain in use and keeping the circulation in 'good repair' by replacing damaged and worn-out notes with new replacements, as per the RBA's standard practice.

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