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Editorial

We were preparing to publish a special edition of Firstlinks on Tuesday afternoon, after the Treasurer announced the new superannuation policy, but there was uncertainty in the reporting and we needed to ensure the explanation was correct. Media coverage was ambiguous at least, wrong at worst.

For example, **ABC News** said:

"Australians with more than $3 million in their super will have their earnings taxed at double the current rate."

And **David Crowe** in the SMH wrote:

"People with more than $3 million in super will continue to gain a concessional tax rate on their fund earnings, but it will be 30% rather than 15%."

With journalists rushing to produce copy quickly amid new announcements, clarifications were understandably needed, such as this from the SMH:

CLARIFICATION — The changes to tax apply to earnings on balances of $3 million or more, not to earnings of $3 million or more.

To be clear, it's not individuals with super over $3 million that will have all earnings taxed at 30%. The earnings on the first $3 million will remain taxed at the current 15% (or 0% in pension mode) and only the earnings on the amount over $3 million will be taxed at 30%.

We decided to wait until we knew more and Treasury issued a Fact Sheet the following day, with a surprise in the way earnings will be calculated. Not only will the **Australian Taxation Office** issue tax liability notices to individuals in the 2026-27 financial year, but earnings will include unrealised capital gains. This will have significant consequences.

We take a dive into the politics of the rushed decision and how the tax calculation will be made, using Treasury's examples.

What happened to the 'conversation' **Jim Chalmers** wanted with the Australian people about the best way to tax superannuation? For two weeks, he said he was only opening the debate, then woosh! ... out came the policy. Labor is managing the politics as much as the policy.

It's always a magical mystery tour whenever a Prime Minister or Treasurer says they want to have a 'conversation' because conversations should include listening as well as speaking. A female friend who is currently dating online told me some blokes talk for 95% of the time on how good they are, thinking it's a winning strategy. It isn't. If **Anthony Albanese** and Jim Chalmers were initially simply flying a kite, it came crashing down like the 95% bloke. They even made a decision before considering responses to the consultation on the purpose of superannuation which was supposed to precede any changes to tax concessions.

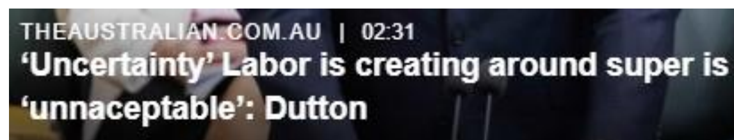
A sign that Labor took a snap decision to avoid the broken election accusation is in the strength of the undertakings prior to the last election. We have uncovered the biggest. The promise of "stability and certainty" in superannuation was repeated four times by **Assistant Treasurer Stephen Jones** in less than three minutes at the **SMSF Association** Conference in 2022, the super sector most affected by the proposed changes. Here's an extract:

*"**Anthony Albanese** wanted me to deliver a **particular message** to everyone in the (SMSF) sector today. And it's about **stability and certainty** ... So the message we want to send to you is around **stability and certainty** in an uncertain time. The **last thing** that we want the SMSF sector, whether it's advisers, whether it's accountants, or the customers that you serve, the last thing that we want you worried about is the **next regulatory hit coming out of Canberra**. We want you focused on delivering great outcomes for members and for retirees themselves. **We want you to have peace of mind in your retirement.** We want to make the case that your nest egg, your retirement savings are **always going to be safer under Labor."**(my bolding)*

It's no wonder Albanese called his troops together before such revelations gained a firm foothold. No weasly "intention" or "major change" qualification there, and even an extraordinary "*the last thing that we want you worried about is the next regulatory hit coming out of Canberra".*

Remarkably, it's exactly what **Scott Morrison** said to the SMSF Association in 2016, seven years ago, only months before he introduced the Transfer Balance Cap of $1.6 million. Opposition Leader **Peter Dutton** is loving the opportunity to accuse Labor of a new tax and broken promises, but Labor is simply playing the same political game as the Liberals.

Until the next election, Dutton will argue the changes are unacceptable, supported by the Murdoch media. It's not the only thing that's 'unnaceptable'.



We dissect the similarity between the two speeches and show that hypocrisy has no political boundaries, especially when it comes to superannuation. Now that's worthy of a conversation.

Anyway, Happy Birthday today to Anthony Albanese, reaching the big 60, and Jim Chalmers, a youthful 45. It's been a stressful week for you both and you should relax over dinner with a bottle of red.

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In a previous life, a team of interest rate traders reported to me. I wanted to experience the ups and downs of making trading profits and losses based on my view on future rates, so I operated a proprietary trading account within the bank's system. I allowed myself a modest trading limit and I did okay on small positions.

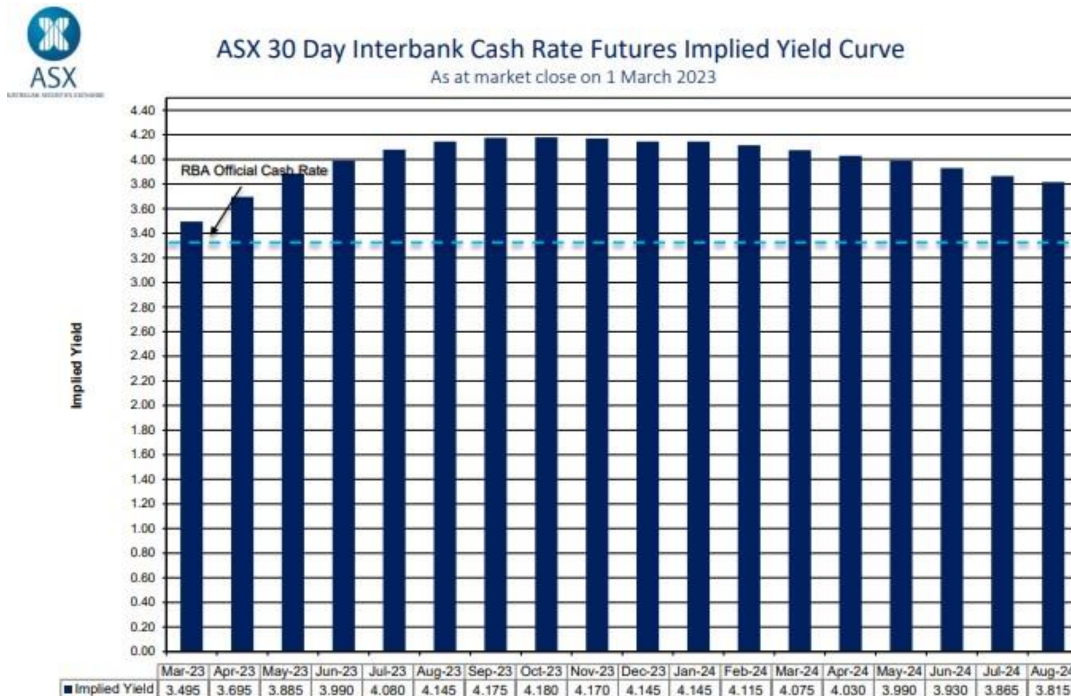
Thank goodness I have not traded bank bill futures over the last 18 months. I would have lost plenty. While everyone knew rates would rise, the market has been well ahead of the Reserve Bank and most major economists, even to the point of **Governor Philip Lowe** saying some of the future rate levels were completely unjustified. But since proven correct. I did not expect cash to go well above 4% because hundreds of thousands of people on 2% mortgages would roll into 7%, and a 5% hit would cripple the future for many families. Where do most people find $50,000 in after-tax dollars on a $1 million mortgage?

There were signs of respite in the CPI this week when it increased by 7.4% in the year to January 2023, below expectations of 8.1%.The major contributors to the annual increase were food, housing, recreation and culture. The Cash Rate Futures fell by about 0.1% on the day. We also saw GDP numbers which, according to CBA economists:

"*The 0.5%/quarter increase in real GDP over Q4 22 was weaker than the market median of 0.8% ... The tailwind of strong population growth in Australia means that the economy means that the economy must expand by ~0.4% per quarter to stop it from going backwards on a per capita basis. Indeed the ABS today reported that GDP per capita was flat over Q4 22. We expect a per capita recession in 2023.*"

The article by Ryan Wells this week is a fascinating look at Australia's population growth due to the recovery of migration, which is why CBA makes this 'per capital' distinction.

The current cash rate is 3.35% and the market is saying about 0.85% higher by September 2023, or three to four more rate hikes. It looks too high with signs of a slowing economy and inflation. If it happens, it is merciless with such a blunt instrument, hitting those who can least afford it. Ironically for a policy which is supposed to reduce demand, wealthy people holding cash and term deposits and no loans are seeing a big income boost and they will spend more. We have progressed nowhere in decades of using monetary policy, leaving rates at zero for too long and now going too high. It's disturbing to recall that the Reserve Bank waited until May 2022, only nine months ago, to make the first cash rate increase from 0.1%.



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For anyone who thinks they can do a better job, a couple of the Board positions are now open. And probably a Governor role by September. But beware. Based on recent years, unanimity is expected and troublemakers need not apply.

15-2023 - Expression of Interest: Reserve Bank of Australia Board

Job no: 15-2023
Work type: Part-time
Location: ACT, NSW, QLD, SA, VIC, TAS, WA, Brisbane, Canberra, Melbourne, Hobart, Sydney, Perth
Categories: Statutory Appointment

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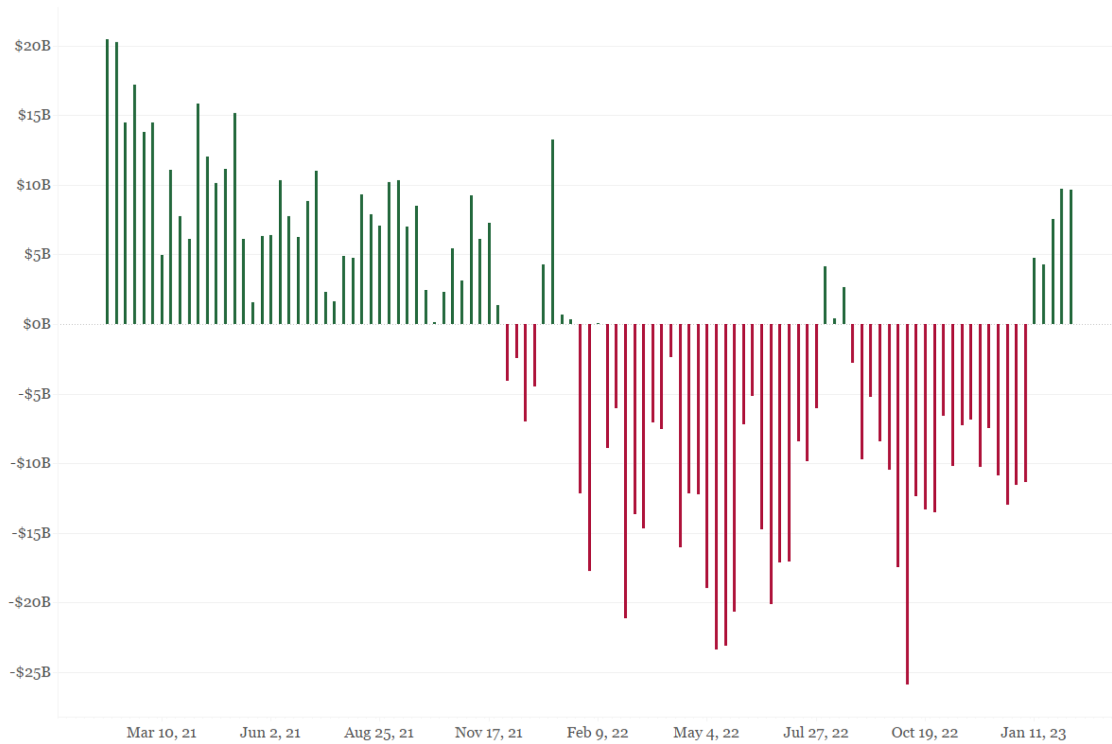
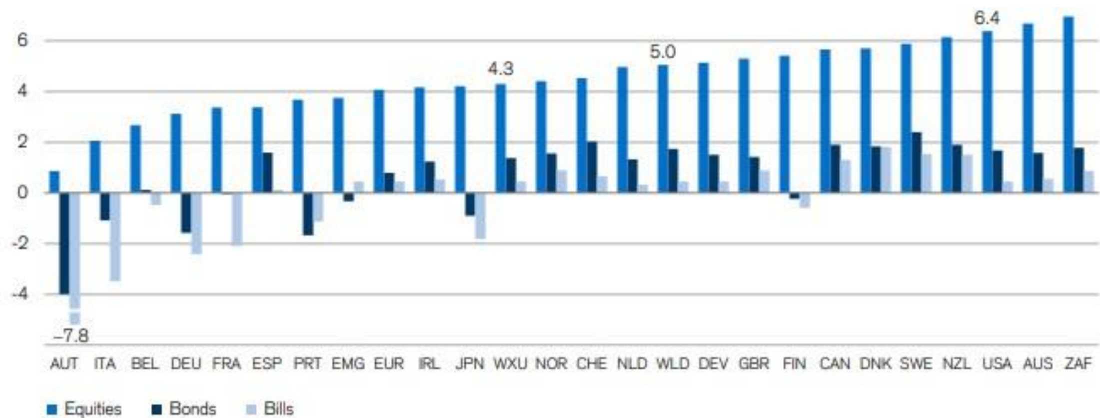
Elsewhere in markets, money is again flowing into bonds after outflows throughout 2022, as the data below for the US shows. Many investors were burnt by the capital losses from rising rates but are now attracted by the higher absolute returns and expectations in the US that inflation has peaked.



But for long-term returns, for those who can tough out the stockmarket falls, equity markets deliver the most rewards. We have featured the work of **Elroy Dimson** and his colleagues previously, where they update global investment returns each year since 1900. The latest edition of the Credit Suisse Global Investment Returns Yearbook was recently released, and the annualised returns on equities versus bonds are shown below, with Australia close to the top on equities. These are real returns, after inflation.



Graham Hand

Also in this week's edition ...

So much going on, make time for our bumper selection of new articles.

Tribeca's Jun Bei Liu says the February 2023 reporting season showed the resiliency of corporate earnings. Looking forward, she says earnings are likely to disappoint market expectations in the first half, but once

Earnings Per Share consensus estimates come down, the market could be ready for take-off. She's positive on the likes of **Ramsay Healthcare, Lottery Corporation and A2 Milk**.

VanEck's Cameron McCormack is also bullish as he thinks economic growth will remain relatively strong thanks to demand from China. He is overweight the resource and consumer staples sectors but neutral on banks given headwinds of competition and higher bad debts.

We're entering a new era of fiscal stimulus and a boom in intangible asset investment, says **Jacob Mitchell** of **Antipodes Partners**. We've seen this movie before in the 1970s and the result is increased volatility in nominal GDP and a decline in equity market multiples.

James Gruber muses that stockmarket prices are like email: they’re distraction machines. With email, it often distracts people from getting work done efficiently. With stock prices, they distract investors from what really matters: the businesses underlying them.

Retirees with large super balances may be required to draw more than they wish to qualify for tax concessions, says **Michael Hutton** of **HLB Mann Judd**. It's a good problem to have but what do you do with the excess money? Michael offers some suggestions.

When the numbers for net migration in 2022 are released, they're likely to be +400,000, much stronger than Government forecasts. **Ryan Wells** says the numbers won't ease off much this year either. This will have many implications including increasing total consumer spending and expanding the labour force.

It's surprising little has been written about the outperformance of gold against almost every other asset class in Australian dollar terms in 2022. **Sawan Tanna** investigates whether gold can continue to shine this year.

Lastly, this week's White Paper by **Heffron Consulting** looks into the ins and outs of SMSF pensions.

Curated by James Gruber and Leisa Bell

How the 30% tax rate will hit large super balances

Graham Hand

The Government has struck a compromise in its desire to rein in the cost of tax concessions on large superannuation balances. Treasurer Jim Chalmers has announced that taxation on earnings from superannuation balances in excess of $3 million will double to 30%. The existing 15% rate on accumulation funds will continue for all super balances below $3 million. Chalmers said:

"The modest adjustment we announce today means 99.5% of Australians with superannuation accounts will continue to receive the same generous tax breaks, and the 0.5% of people with balances above $3 million will receive less generous tax breaks."

However, there is a surprise in the way the extra tax will be calculated, as outlined below. Not only will the Australian Taxation Office issue tax liability notices to individuals for the first time in the 2026-27 financial year, but earnings will include unrealised capital gains.

Although holders of large super balances will be hit by the higher tax, the fears of a hard cap forcing the removal of money from super, or the imposition of tax at the top personal marginal rate, have not been realised. The delay until after the next election also gives time for consultation and modification.

Managing the politics

Although the Government had previously indicated it was only having a ‘conversation’ with the Australian people, it has moved quickly with an announcement in the face of growing criticism. Crucially, the attack on the Government was labelled a breach of an election promise and it raised the prospect of undermining the ‘truth and integrity’ high ground Prime Minister Anthony Albanese campaigned on successfully at the last election. Albanese was especially vulnerable after his undertaking in the May 2022 election campaign:

“We’ve said we have no intention of making any super changes. One of the things we’re doing in the election campaign is we’re making all of our policies clear.”

By postponing the effective date until after the next Federal election, due by May 2025, Labor can claim it took the policy to the people, thereby not breaking an election commitment. Chalmers will argue he has addressed some of the growing cost of superannuation concessions. On the other hand, those affected have three more tax returns at the lower rate assuming Labor wins again.

Both sides blinked at the same time and a middle ground was reached.

It's worth noting there are many assumptions in the $48 billion estimated cost of superannuation concessions, such as the guess that earnings outside super would be taxed at the top marginal rate, whereas it is more likely that many people would find alternative ways to reduce their tax.

The new policy is expected to raise about $2 billion a year. Earlier in the debate, Chalmers suggested he preferred a cap of $3 million on the amount that can be held within super, with the rest removed. He probably wanted to avoid the spectre of increasing taxes, but it would have been an inferior approach. Imposing a $3 million cap would have required the removal of money from superannuation, creating a range of complexities such as forced sales of illiquid assets and realising capital gains in a tax event.

How will the new tax work?

Treasury has issued a Fact Sheet on how the tax will be calculated, based on the increase in individual balances rather than imposing a tax on a super fund. There remains no limit on the size of account balances in the accumulation phase.

Each person will have a Total Superannuation Balance (TSB) and those with over $3 million at the end of a financial year will be subject to a tax of 15% on earnings. Earnings will be calculated using the difference between the TSB at the start and end of consecutive financial years, adjusted for withdrawals and contributions.

Using the same treatment as adopted for Division 293 Tax (the extra tax paid on super contributions where income exceeds $250,000), individuals can choose whether to pay the tax from their super or from other resources. The new tax does not form part of a personal income tax return, and the limit is per person, not per fund such as an SMSF.

Treasury summarises the calculation as:

Tax Liability = 15% x Earnings x Proportion of Earnings over $3 million

The tax liability is calculated at 15% because earnings in accumulation are already taxed at 15%, and this is an additional tax.

It's easier to understand with their worked examples. The surprise is that earnings include unrealised gains and losses. TSBs will be tested for the first time on 30 June 2026 with tax liability notices issued in 2026-27.

Calculation method

a) The below formula will be used for calculating earnings in a financial year:

$$Earnings = TSB_{Current\ Financial\ Year} - TSB_{Previous\ Financial\ Year} + Withdrawals - Net\ Contributions$$

b) The proportion of earnings corresponding to funds above $3 million is calculated as follows:

$$Proportion\ of\ Earnings = \frac{TSB_{Current\ Financial\ Year} - \$3\ million}{TSB_{Current\ Financial\ Year}}$$

c) The tax liability is calculated as follows:

$$Tax\ Liability = 15\ per\ cent \times Earnings \times Proportion\ of\ Earnings$$

Treasury's example on a balance exceeding $3 million

- Warren is 52 with $4 million in superannuation at 30 June 2025. He makes no contributions or withdrawals. By 30 June 2026 his balance has grown to $4.5 million.
- Warren's calculated earnings are $4.5 million - $4 million = $500,000.
- His proportion of earnings corresponding to funds above $3 million is ($4.5 million - $3 million) ÷ $4.5 million = 33%
- His tax liability for 2025-26 is 15% × $500,000 × 33% = $24,750

Note that this is the extra tax, the additional amount above the tax that Warren would currently pay. That's where the estimated $2 billion in revenue comes from.

Treasury's example on the earnings calculation

- Carlos is 69 and retired. His SMSF has a superannuation balance of $9 million on 30 June 2025, which grows to $10 million on 30 June 2026. He draws down $150,000 during the year and makes no additional contributions to the fund.
- Carlos's calculated earnings are: $10 million - $9 million + $150,000 = $1.15 million
- His proportion of earnings corresponding to funds above $3 million is ($10 million - $3 million) ÷ $10 million = 70%
- Therefore, his tax liability for 2025-26 is 15% × $1.15 million × 70% = $120,750

Again, this is an additional tax, not the full tax. Anyone with multiple super funds, such as an SMSF, retail fund or industry fund, can elect where the extra tax is paid from.

Treasury example of a carry-forward loss

- Dave is 70 and has two APRA-regulated funds and one SMSF. At 30 June 2025, his TSB across all funds was $7 million. During 2025-26, he withdraws $400,000 from his SMSF and makes no contributions. At 30 June 2026, his TSB across all funds is $6 million.
- This means Dave's calculated earnings are $6 million - $7 million + $400,000 = minus $600,000.
- His proportion of earnings corresponding to funds above $3 million is ($6 million - $3 million) ÷ $3 million = 50%.
- The earnings loss attributable to the excess balance is $300,000. Dave can carry forward the $300,000 to offset future excess balance earnings.
- At 30 June 2027, Dave's funds make earnings on his excess superannuation balance of $650,000. He carries forward the earnings losses attributable to his excess balance at 30 June 2026 of $300,000 and is only liable to pay the tax on $350,000 of earnings.
- This means his tax liability for 2026-27 is 15% × $350,000 = $52,000.

Although it is another level of complexity, this method was chosen because funds do not currently calculate taxable earnings at an individual member level, and a method was needed to identify taxable earnings for members with balances over $3 million.

The major sting here is the inclusion of unrealised capital gains. For example, many investors in startup companies hold the asset in their SMSF, and such companies often face dramatic swings in valuations based on the last funding round. A member may enjoy a large valuation upswing on which tax is payable without receiving any actual cash, only to see the value fall the following year.

There was no statement about whether people with over $3 million in super can stop new Superannuation Guarantee contributions from their employer and take a higher salary instead. Someone earning less than $45,000 incurs a marginal tax rate of only 19% and might prefer to invest outside super and avoid the 30% tax rate. The lack of indexing in the $3 million is inappropriate and will be a major point of contention.

The Treasury fact sheet is here.

Now watch for articles on alternatives to holding large amounts in super. The case for investing more in a family home, transferring super to a lower-balance spouse or family trusts just received a boost, as did the financial advice industry.

Both sides can take some comfort from the new policy

The politics has a long way to play out before the new tax rate hits the bank accounts of large super holders, and it's likely the Coalition at the 2025 election will argue 'typical Labor' with tax increases to 'pay for their spending'. Chalmers and Albanese will need to persuade voters that it is the right policy to reduce the cost of super. The Prime Minister gave a hint of what is to come when he said:

"If they (the Coalition partners) want to vote against this change and try and prevent this change, then they can explain to people why they're not prepared to back energy bill relief for pensioners ... but they are prepared to go to war for the one half of 1% of people with more than $3 million of superannuation in their accounts."

The objective of super is next

Perhaps the bigger question is what else is to come. Labor has yet to make a firm undertaking that there will be no further changes to superannuation. Yesterday, Jim Chalmers even refused to rule out capital gains on the family home, before Albanese quickly jumped in and corrected him.

For example, what might happen to lump sum withdrawals? The Government intends to legislate an objective of superannuation as follows:

> The objective of superannuation is to **preserve savings** to **deliver income** for a **dignified** retirement, alongside **government support**, in an **equitable and sustainable** way.

Lump sum withdrawals seem incompatible with the objective. Under current arrangements, someone can withdraw all their superannuation on attaining one of the many 'Conditions of Release', such as reaching the age of 65, even if they have not retired. Taking all the money out seems to breach the objective " … to preserve savings to deliver income" in retirement. So the question is … what's next?

Graham Hand is Editor-at-Large for Firstlinks. This article is general information.

Labor's 'stability and certainty' sings from Morrison's hymn sheet

Graham Hand

*"One of our key drivers when contemplating potential superannuation reforms is **stability and certainty**, especially in the retirement phase."*
(Then) Treasurer Scott Morrison, February 2016, SMSF Association National Conference, Adelaide

*"… we understand that you need **stability and certainty** around your regulations and the rules governing superannuation."*
(Now) Assistant Treasurer Stephen Jones, January 2022, SMSF Association National Conference, Adelaide

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The SMSF Association rotates the city where it hosts its National Conference each year. What is it about Adelaide, six years apart, that leads a Treasurer and an Assistant Treasurer to make exactly the same promise to delegates, using the same words, only to renege on the undertaking within a year? Even more bizarrely, Treasurers Jim Chalmers and Scott Morrison defend a change to superannuation by saying it would not apply to 99% of people. Apparently, there is an accepted standard for change if only 1% of people are affected. Or did Scott Morrison leave behind a song sheet, and it landed on the desk of Stephen Jones?

While the words "stability and certainty" are disingenuous, it is also hypocritical of Opposition leaders Peter Dutton and Angus Fraser to claim the moral high ground. Labor's move and words are exactly the same as the Coalition's.

This week, the Government confirmed its plan to introduce a new tax tier at 30% for superannuation balances over $3 million. It's another step in the ongoing windback of superannuation concessions. At least Labor has deferred the introduction until after the next election, effective date 1 July 2025, to deflect claims it broke an election promise, and it forces the Coalition to campaign against the changes.

No partisan politics in these words

In the 2016 Budget, Treasurer Morrison introduced the $1.6 million Transfer Balance Cap, a few months after promising no changes to superannuation regulations. In less than a year since Labor was elected, Treasurer Jim Chalmers is moving against the pre-election undertakings on "stability and certainty".

It is doubtful whether any other country on Planet Earth creates more political stoushes and headline-grabbing stories out of superannuation policy, but we Aussies are passionate about retirement savings and election promises. Hypocrisy reigns when the only thing that matters is winning an election. The media has trawled through videos from the 2022 election campaign and found Anthony Albanese saying in May 2022:

*"We've said we have no intention of making **any** super changes. One of the things we're doing in the election campaign is we're making all of our policies clear."*

Dr Peter van Onselen, Professor of Politics and Public Policy at the University of Western Australia, writing in The Australian, said:

"I was told that when Albanese made that comment Chalmers visibly winced, in the full knowledge his word salad had been defined down by his boss into words Labor couldn't obfuscate."

Faced with a backlash when the word "any" was revealed, Anthony Albanese rushed through the tax announcement on 28 February 2023. Only a few days earlier, he had been far more equivocal, calling it a "hypothetical" change. Labor found out that words before an election matter.

Assistant Treasurer Stephen Jones gave rock-solid promises

In this short speech by Stephen Jones at the 2022 SMSF Association National Conference, pitching for a relationship with the SMSF sector in his potential role as Minister for Superannuation, there is no wriggle room as he said "stability and certainty" four times in only two-and-a-half minutes.

What is different to other 'gotcha' moments is that these undertakings were not in an unscripted doorstop interview with the media yelling questions. Slips there are more understandable. This was a prepared and well-considered speech, emphasising a particular message from the aspiring Prime Minister.

*"**Anthony Albanese** wanted me to deliver a **particular message** to everyone in the sector today. And it's about **stability and certainty**. Anthony and in fact, the entire Labor team understand that we've been through a massive amount of change and challenge over the last three years, and that there's more to come. It's not just COVID although that turbocharged them, it's not just the Haine Royal Commission, which saw a tsunami of regulatory change, which is still only being digested by the industry. But there's a whole bunch of other things that are yet to come as well.*

*So the message we want to send to you is around **stability and certainty** in an uncertain time. The **last thing** that we want the SMSF sector, whether it's advisers, whether it's accountants, or the customers that you serve, the last thing that we want you worried about is the **next regulatory hit coming out of Canberra**. We want you focused on delivering great outcomes for members and for retirees themselves.*

***We want you to have peace of mind in your retirement.** We want to make the case that your nest egg, your retirement savings are **always going to be safer under Labor** … we understand that you need **stability and certainty** around regulations and the rules governing superannuation. And we want to ensure that after we've been through all the change that's been digested at the moment that advisers and retirees can understand that we're going to have **certainty and stability** and that is what we will be offering." (My bolding)*

As election promises go, it couldn't be much clearer. Four times "stability and certainty" in a "particular message" to SMSFs, "peace of mind in retirement", and retirement savings are always safer under Labor.

It is statements like these which have forced Labor to move the effective date of the new 30% tax until after the next election. Labor marketed itself as transparent with integrity, and while relatively few people have over $3 million in super, far more will wonder what is next. The battle lines are drawn for the next election. As in the franking credit debate, adult children want to protect the retirement savings of their parents and grandparents or aspire to large superannuation amounts themselves.

What exactly did Morrison say directly to me in 2016?

Then-Treasurer Scott Morrison misled me in 2016 and I advised readers there would be no changes to super in the Budget. At the conclusion of a talk at Bloomberg in August 2016, I asked Mr Morrison about the statement he made in February 2016 at the SMSF Association Conference. I quoted his previous words directly to him:

*"One of our key drivers when contemplating potential superannuation reforms is **stability and certainty**, especially in the retirement phase. That is good for people who are looking 30 years down the track and saying is superannuation a good idea for me? If they are going to change the rules at the other end when you are*

going to be living off it then it is understandable that they might get spooked out of that as an appropriate channel for their investment. That is why I fear that the approach of taxing in that retirement phase penalises Australians who have put money into superannuation under the current rules – under the deal that they thought was there. It may not be technical retrospectivity but it certainly feels that way. It is effective retrospectivity, the tax technicians and superannuation tax technicians may say differently."

I asked why he had changed his unambiguous thinking when he introduced new superannuation regulations in the Budget only two months later. He told me:

*"I stand by everything I said in that statement for the simple reason that the retirement phase remains tax-free. You know that. The retirement phase account, which under our proposal with a transfer balance cap, will mean that **99%** of people who have balances less than $1.6 million will remain absolutely in exactly the same situation that I referred to.*

The changes that we put forward, which I hope at least from my point of view as Treasurer I never have to revisit, and I certainly have no intention of revisiting them, will ensure that those rules are now set for the future.

Why did we have to change the superannuation system? Because we have an aging population and we have system that is frankly overly generous for large balances, and the cost of having those large balances and the tax concessions ... Those arrangements were brought in when the Budget had a $20 billion surplus and $40 billion in cash."

What we have chosen to do is make the superannuation system more sustainable in future. We have targeted a higher rate of tax, true, at the whopping rate of 15% for earnings on balances above $1.6 million. That enables us to preserve the exact situation that I was speaking in favour of at the SMSF Conference. We allow 99% of people who have saved for their retirement to have the deal that I said they should have, that is, paying no tax on what they have contributed to superannuation over their lifetime."

It could have been written by Labor in the recent debate. It's all there.

What is next?

In 2023, Jim Chalmers is using the same arguments Scott Morrison used in 2016, and there is an important warning for the future. Morrison said:

"The changes that we put forward … I certainly have no intention of revisiting them, will ensure that those rules are now set for the future."

That's what Jim Chalmers is saying now about defining the objective of super, but it will set the rules for the future only until another government revisits them. The $3.3 trillion in superannuation is too tempting for Treasurers to leave alone.

Graham Hand is Editor-at-Large for Firstlinks. This article is general information.

February reporting season is the calm before the storm

Jun Bei Liu

This reporting season has demonstrated the earnings resilience of corporate Australia. It started strong, with several retailers reporting solid earnings results early. Then, in the final weeks, aggregate ASX 200 EPS downgrades were approximately 0.5%. That compares to a normal level of close to 0.7% of downgrades during a reporting season.

These numbers are a solid outcome for corporate Australia. Throughout the reporting season, the key theme was revenue was strong as the demand from consumers and corporates remained relatively high.

Even the trading updates for the first four to six weeks of the 2023 year from some of the retailers highlighted how resilient the Australian consumer is.

On the downside, the biggest factor for downgrades was costs being much higher than expected. Many companies also pointed to high labour costs as an issue behind lower earnings. Higher commodity costs, which were an issue some months ago, have fallen back but higher labour costs are expected to be ongoing.

But, despite a sluggish backdrop, most of the company guidance pointed to good dividends. And many pointed to higher capital expenditure as well.

This reflects the strength in demand that many companies are currently observing. However, it does pose some concerns about what might happen if demand falls quite quickly, especially when higher interest rates start impacting consumers and their balance sheets.

The retail sector

The most surprising outperformance during earnings season was the retail sector which has performed well so far in 2023. The market has been surprised by how well consumers are holding up, despite excessive spending during the past three years courtesy of the government's COVID support. Consumers continued to deliver a very strong Christmas for retailers, and their trading updates were strong.

Consumer resilience drove much of the upgrade for 2023, though many pointed to uncertainty into 2024 as the expected slowdown hits home.

Retailers have also demonstrated expanding margins for H2 2022. But most companies in the sector flagged that margin compression is likely within the next six months or so, as demand eases.

Banks and financials

The banks' results were in line with high expectations – and these are some of the best results in recent years from the sector. Earnings grew more than 20% on the back of rising interest rate margins.

Looking forward, the sector is facing many headwinds in the next six to twelve months including rising labour costs and heightened mortgage competition. The Commonwealth Bank was the first of the majors to report and it highlighted the challenges ahead despite higher interest rate expectations.

We expect banking margins (NIM) to compress as economic activity slows and competition across mortgages increases.

Resources

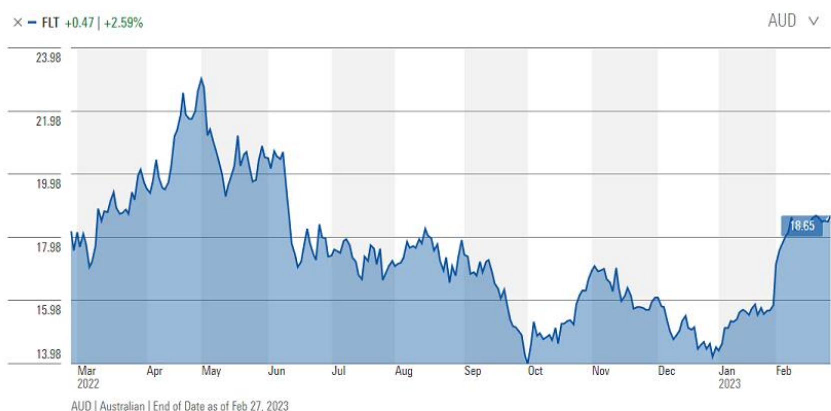
Results in the resource sector were also in line with expectations. Along with reporting earnings, companies in the sector also all pointed to high capital expenditure. This is unsurprising given the high cost of inflation, higher labour costs and the labour shortage.

This more cautious outlook means some of the majors have been forced to cut dividends. For instance, BHP cut its interim dividend by 40% and Fortescue Metals cut its interim dividend to 75c (from 86c for the same time last year).

M&A activity

Also of interest during the most recent earnings season were two recapitalisations and acquisitions - Flight Centre and Star.

Flight Centre bought a business at the beginning of reporting season and then raised funds to shore up the balance sheet ahead of a potential slowdown.



Source: Morningstar

Star is going through several issues – a weak balance sheet, potential fines around money laundering and increased tax – and the recapitalisation will help boost its balance sheet as it awaits the decision by the government regarding tax.

Source: [Morningstar]

We expect these recapitalisations will pick up as corporates strengthen their balance sheets before any slowdown. While some companies continue to pay out special dividends or conduct share buybacks, they also want to keep that strong balance sheet (or war chest) ready as the economy inevitably slows in the next 12 months.

Both of these recapitalisations have done incredibly well, and we expect there will be a lot more of these coming through in the next few months and they will be well supported.

Earnings rebasing required

Given the volatility expected over the next three to six months, earnings downgrades are expected to be widespread and dramatic. Right now, the consensus is still expecting a high single digit earnings growth for Australia for the next four months. Our view is that this is just too high. And the earnings downgrades of 0.5% mentioned above are just too low.

We need earnings to be much more realistic in the next six months. And once that takes place, then the share market can begin to recover. We see a fair bit of earnings risk around the May update, particularly in consumer names. We do think that by the time we get to May, activity will have slowed down substantially for quite a lot of them.

Long-term outlook is good

After investors become more realistic in terms of earnings over the next three months and earnings are rebased, the outlook for the share market is expected to be positive heading into the second half of this year.

Companies are not expensive, and in the next six to eight months we will start cycling through weaker numbers from the second half of last year. Earnings will be picking up into 2024 as inflation comes under control, and interest rate expectations have already been built into the market.

All in all, that represents a solid environment for the share market in the long term. A sell off over the next few months puts equities in a much stronger position for the second half. We may well have a bull market by the second half of this year.

Take opportunities where you can

Investors need to be mindful that when markets experience volatile periods, instead of taking money off the table and sitting on the sidelines, they should use the opportunity to invest in good quality companies at low prices.

Stocks such as Ramsay Healthcare and CSL are countercyclical and should be able to maintain, or even grow, earnings into economic slowdowns. These companies' earnings are expected to grow over the next few years underpinned by a recovery in demand post COVID – as well as from structural growth drivers.

Stocks with the ability to pass on cost increases or where demand is inelastic such as Goodman Group and Lottery Corporation should be able to protect their margins in a slowdown.

And finally, some stocks are exposed to structural growth tailwinds strong enough to offset short term cyclical headwinds such as A2 Milk Company and Treasury Wine Estates.

Jun Bei Liu is Lead Portfolio Manager, Alpha Plus Fund at [Tribeca Investment Partners](), a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information in this article is provided for informational purposes only. Any opinions expressed in this material reflect, as at the date of publication, the views of Tribeca and should not be relied upon as the basis of your investment decisions.

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Australia's migration reopening boom

Ryan Wells

Westpac estimates net migration totalled more than 400,000 people in 2022, reflecting a temporary 'catch-up' in migration flows. A gradual easing is then expected to emerge over the course of 2023 and 2024, to +350,000 and +275,000 respectively.

In the days after the first reported case of COVID-19 in Australia in late January 2020, the government began implementing a staggered closure of the international border. On March 20, the border was officially closed to all non-residents and non-citizens, and Australians were banned from travelling overseas.

The general border closure – which remained in place for nearly two full years – saw annual net migration turn negative (i.e. net emigration) for the first time since 1946 and Australia's population growth plummet to its lowest level in over 100 years.

To determine whether a migrant adds to the population size, the ABS uses the 12/16 framework, meaning a migrant must stay in Australia for a period of 12 out of 16 consecutive months.

The ABS estimates that over the 2020-21 financial year, there was a net emigration of 84,900 people, the bulk of this being concentrated in H2 2020. That loss is in addition to the opportunity cost of the net migration that would have materialised had the pandemic not occurred, which according to the four-year pre-pandemic average, would have been 235,000.

Over this period, many temporary visa holders were forced to return to their country of citizenship or move onto a bridging visa, some of which have limited work rights.

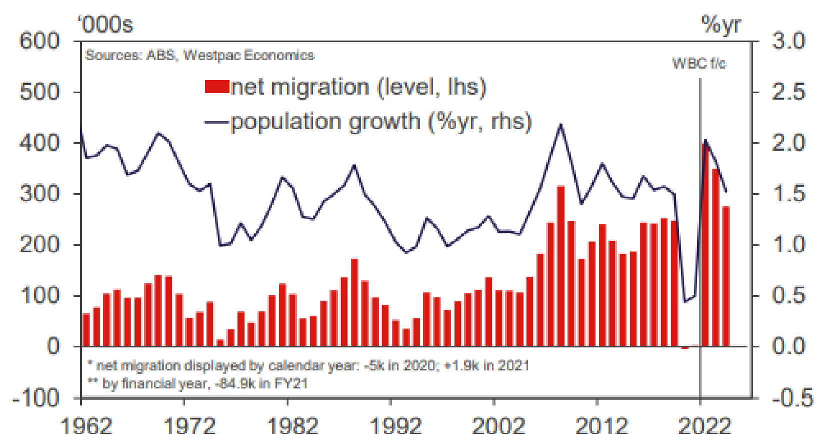
Indeed, data from the Department of Home Affairs suggests that between March 2020 and December 2021, the 'stock' of temporary visa holders among key visa classes in Australia (including working holiday makers, skilled employment, and students) collapsed by 400,000. Over that same period there was a significant take-up of bridging visas, totalling 77,000.

The pandemic caused a sudden and extreme shift in population dynamics in Australia. That is reversing quickly given the major threats from the pandemic have now passed.

2022: the boom

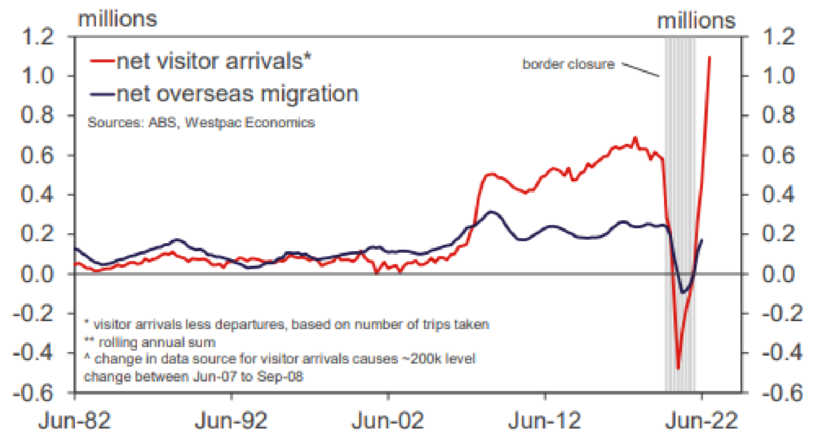
On 21 February 2022, Australia's borders reopened to fully vaccinated individuals across the world. Since then, it has become increasingly evident that a net migration surge is well underway, stronger than what was initially expected coming out of the pandemic.

According to the official quarterly population estimates from the ABS, net migration has totalled 156,000 over H1 2022. Despite having closed borders to most of the world for nearly two months, net migration in H1 2022 was just 3,000 under the H1 record of 159,000 in 2008.



Although we have not yet received any official data regarding net migration beyond H1 2022, limited but timely indicators are pointing to a further strengthening over H2 2022.

Monthly data on overseas arrivals and departures (recording number of trips taken) indicates that net visitor arrivals have lifted from 419,000 in H1 to 676,000 in H2. Given that the border reopening began in late February, the recovery in visitor travel only started to pick up around mid-year, with this strength being sustained through to the end of 2022.



A similar theme is also found within net visa arrivals (distinct from 'net visitor arrivals'). H1 2022 was characterised by a substantial backlog of visa applications and extreme delays in visa processing. As these issues began to resolve, net arrivals surged in the 'temporary work' group of visas (including skilled, working and other temporary visas), and the strength in net student arrivals was largely sustained too.

In our view, the surge in net migration is beginning to have a material impact on the labour market too, with growth in the working age population rising to be well above pre-pandemic levels at an elevated 2.1% per year.

Data from the Department of Home Affairs on visa applications and grants are also positive for the outlook. Across the key working visas such as working holiday makers, temporary skill shortage and temporary graduates, grant volumes have all lifted above their respective pre-pandemic levels and are continuing to rise. There has also been an appreciable lift in student visa applications and grants through to end-2022, coinciding with the relaxation of work-hour and industry conditions in order to alleviate extreme labour supply pressures in Australia.

Also, with the removal of COVID-zero restrictions in China now freeing up travel and the Chinese Government's mandate for students to return to in-person learning, arrivals from China are set to jump this year, complementing the strength already being seen in arrivals from India, which has been the key support in Asia since the border reopening.

It is important to note that the precise relationships between these data sources are not direct and there is uncertainty about how the strength of these indicators are reflected in the official estimates of net migration from the ABS.

2023 and 2024: the recovery

Given the severity of the collapse in net migration over the course of the pandemic and evidence emerging on the 'surge' to date, we believe that the recovery in net migration will be much stronger and more sustained than the government's forecasts, which assumes a return to the pre-pandemic trend level of 235,000 in FY23.

By calendar year, Westpac estimates net overseas migration to print +400,000 for 2022. This historic high – well above the +316,000 print in 2008 – represents a temporary 'catch-up' from the substantial loss of net migration flows over the pandemic

This will be followed by a gradual easing over the course of 2023 and 2024 as migration targets are likely to be pared back in response to the boom over 2022.

There is a great deal of uncertainty around what the near-term net impact of a historic surge in net overseas migration will be on inflation, especially during a period of rising interest rates and slowing growth.

On the one hand, sudden growth in the population represents an expansion in the aggregate spending capacity of households, materialising as stronger demand-side inflationary pressures. While small at the margin, the effects of this may be larger in markets with an extremely tight supply-demand balance, such as rental markets in major capital cities.

Simultaneously though, a surge in net migration will expand the size of the labour force. Given the current strength of labour demand as evinced by business and household surveys, more job vacancies would be filled, leading to an increase in employment growth. If this were to be large enough to see increases in unemployment or underemployment (unemployed and those who want to work more hours), then on balance, the labour supply effects would be enough to outweigh the demand-side impacts.

Ryan Wells is an Economist at [Westpac Banking Corporation](). This information is for general information and has been prepared without taking into account your objectives, financial situation or needs. It is not intended to reflect any recommendation or financial advice and investment decisions should not be based on it.

Buying resource and consumer staple stocks

Cameron McCormack

Australian shares are likely to outperform in 2023 helped by stronger economic growth than in other developed nations, and ultimately increased demand from China supporting commodity prices. Certain sectors could be set to sizzle while others may be left behind.

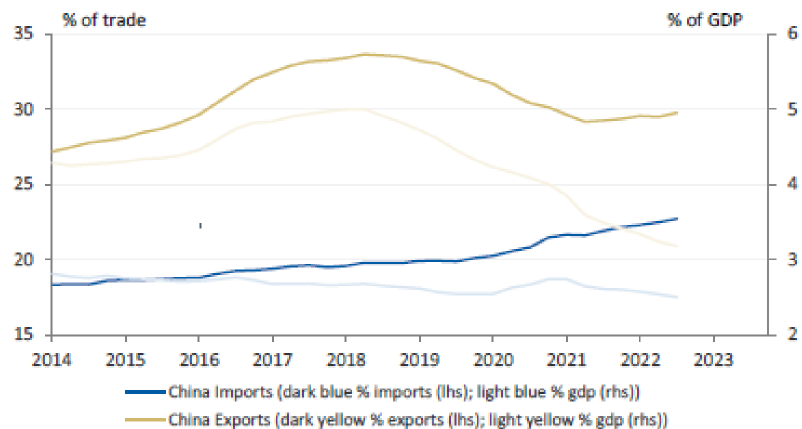
Resources

Australian resources stocks could continue their upward trajectory this year if China's demand for Australian mining resources ticks higher as the country rapidly reopens.

The reopening of a country with 1.4 billion residents offers investment opportunities, particularly within Australian sectors that have high revenue exposure to China. The country makes up around 30% of Australia's total exports and 23% of total imports. China remains Australia's largest trade partner by a significant margin, despite its exposure falling somewhat in the last few years.

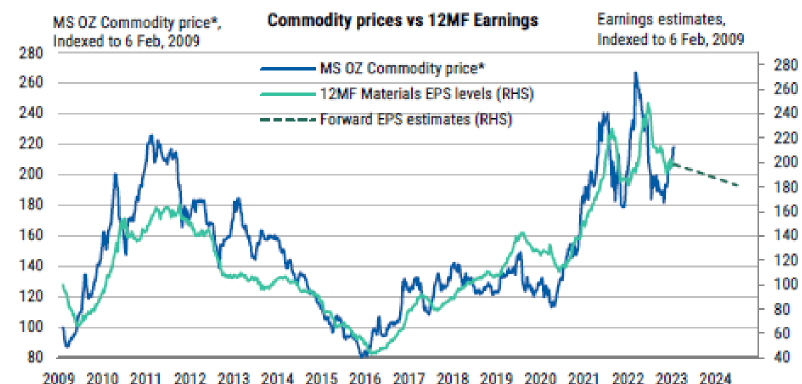
Australia is distinct globally in terms of economic links with China. Specifically, we see a tailwind to Australian resource sector earnings. Recent positive sentiment towards China has seen commodity prices move higher.

Chart 1: China remains Australia's largest trading partner



Source: ABS, Morgan Stanley Research

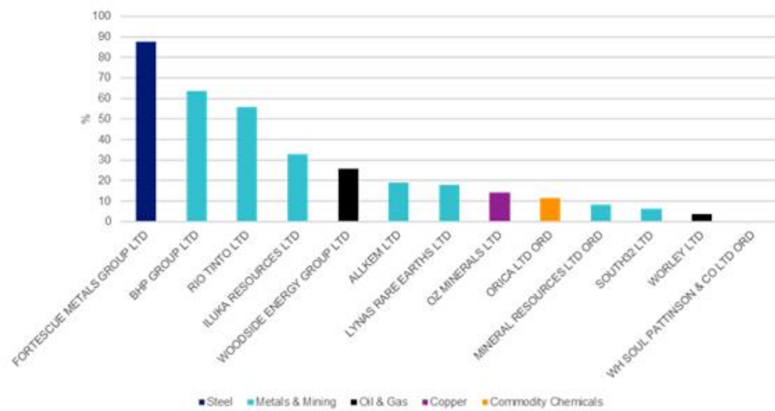
Chart 2: China reopening has supported prices for Australia's key commodities



Source: Bloomberg, Morgan Stanley Research. *MS OZ Commodity price is a revenue weighted commodity price using MS Metals and Mining coverage.

Despite geopolitical tensions, and Chinese sanctions on some major Australian exports, China remains reliant on Australian mining resources. 19% of Australian mining revenue is attributed to China, based on the constituent weighting of MVIS Australia Resources Index.

Chart 3: Australia resources revenue attributed to China

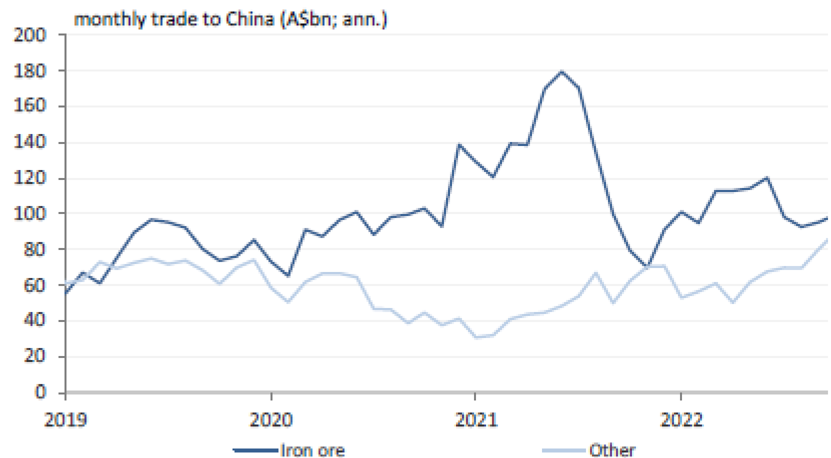


Source: Factset, as at 30 June 2022.

The lion's share of Australia's trade exposure to China remains in commodities, particularly iron ore, which is still worth more than all other merchandise exports put together.

Chinese President Xi Jinping has cited infrastructure spending as the government's main lever to rescue economic growth, like it was during the global financial crisis. Australian resources sector could once again be a major beneficiary of this investment, as it was during the GFC.

Chart 4: Iron ore still represents the majority of Australian exports to China



Source: DFAT, Morgan Stanley Research

Consumer discretionary (underweight)

Consumer discretionary was the third worst performing sector on the ASX in 2022, lagging the benchmark by over 19%. The challenging landscape is likely to extend into 2023 for discretionary stocks as household savings continue to diminish and the majority of fixed mortgages roll off later this year. A number of discretionary companies have flagged tougher times ahead in their half year earnings.

As the cumulative effects of lower savings, higher costs of living, negative wealth effect from falling property prices and increased interest rate payments start to hit consumers back pockets we anticipate a pullback in discretionary spending. Based on Corelogic Data, the aggregate housing value in five capital cities have contracted 7.3% yoy, resulting in a negative wealth effect among households.

The solid results from Wesfarmers this earnings season are unlikely to be repeated. Cracks in the confidence of consumers are starting to show, with shoppers shifting to value-orientated retailers like Wesfarmer's Kmart chain. As rates go higher, we see sales of Wesfarmers retail brands declining as the company manages softer demand due to inflation and rate hikes. We expect discounting and competition between value orientated retailers will become fierce.

Consumer sentiment has tanked to recessionary lows. We think investors should be very wary of consumer discretionary stocks with widespread weakness on the not-so-distant horizon. The latest Westpac consumer sentiment survey shows weakness is broad based with conditions, family finances and time to buy a household item all close to historical lows.

Markets are generally optimistic, and prices reflect sentiment – a lot of the factors that support higher prices are factored in. Management outlooks and guidance should be a leading indicator for investors to assess if the

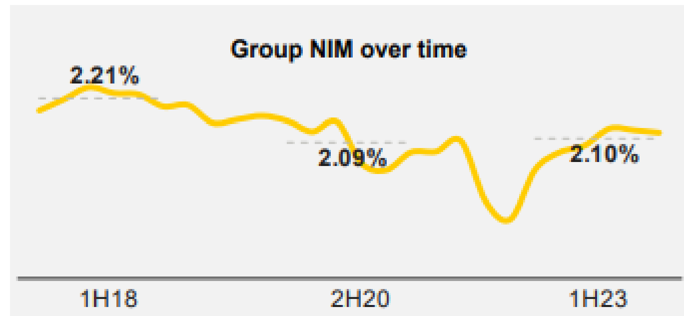
current price reflects future earnings and hurdles. A number of discretionary retailers including JB Hi-Fi have signaled discounts are on the way as sales across the industry slow.

The big banks (neutral)

The four big banks were some of the best performing stocks in 2022 as rapid increases in mortgage rates and delayed marginal increases in deposit rates helped expand net interest margins. But this year we see storm clouds gathering over the banks. CBA in their half yearly results announcement specifically addressed concerns around the looming fixed rate cliff, deposit rates and cyber security risk.

Chart 5 suggests CBA's NIM peaked in October 2022 and trended down toward the end of the reporting period.

Chart 5: CBA's net interest margin (NIM)



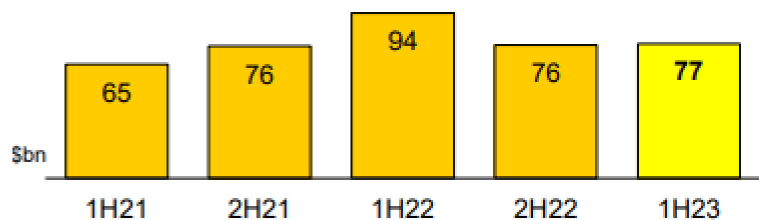
All the good news has already been priced in. We can't see NIMs expanding any further as rates continue to rise and the majority of fixed rates roll off later this year.

The bank is increasing its capital buffer, a sign of caution as headwinds for the economy increase. Meanwhile, CBA's loan impairment expense of $511 million for the six months leapt higher with the bank saying it reflected ongoing inflationary pressures, supply chain disruptions, rising rates, and declines in house prices.

As evidenced by CBA's share price slump post results, investors are concerned that if NIMs have peaked it could lead to downgrades of profit forecasts. And with the economic outlook weak, at best, the bank has headwinds of slowing growth and higher bad debts.

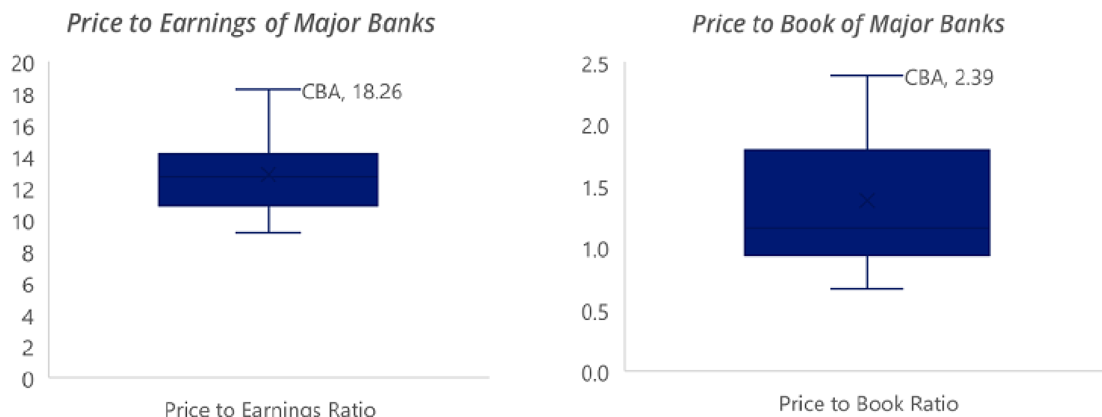
For years Australian banks have been able to grow their mortgage books as new home buyers looked to take advantage of record low rates. You can already see in the chart below, CBA experienced a significant slowdown of new loans during the 2nd half of 2022. The concern for investors is how has the slowdown impacted the other banks.

Chart 6: CBA's Home lending new funding



CBA in particular looks unattractive from a valuation perspective. It is the most expensive bank in Australia and one of the most expensive globally based on price to earnings and price to book ratios.

Chart 7: Price to book value of CBA



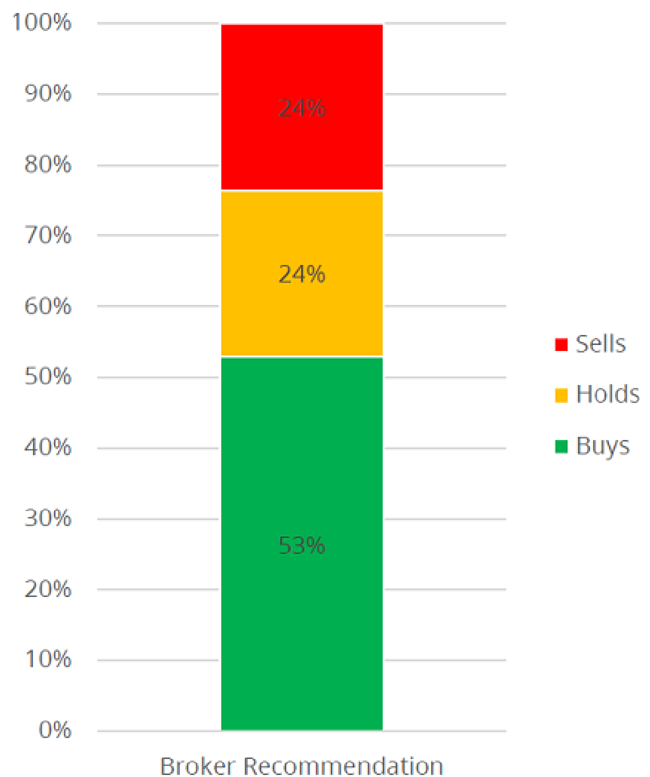
Consumer staples (overweight)

Consumer staples stocks returned -4.7% in 2022, lagging the benchmark by over 3.6%. While the performance in the past year was underwhelming, we think the sector will offer some defensive benefits this year as inflation remains elevated. Generally, the demand for staples are price inelastic – volume holds up well even with price increases.

Woolworths is well positioned as we move into the new year. The company is Australia's largest supermarket chain and has a sticky consumer base with the ability to pass through any cost inflation to protect its margins. Additionally, the steady increase in food retailing bodes well for the company's growth into 2023 and offers defensive characteristics. The company also continues to sharpen its e-commerce capabilities via personalised shopping trends and targeted discounts, which may prove to be a competitive advantage among its rivals.

Australia on balance, is much better positioned than most countries to manage economic challenges in 2023. This year we expect Australian equities to continue to outperform international equities. We favour resources and consumer staples, are neutral on banks and underweight consumer discretionary.

Chart 8: Woolworths buy-hold-sell



Source: Bloomberg as at 16 February 2023

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

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The coming supercycle in tangible assets

Jacob Mitchell

This is an edited version of a presentation by Jacob Mitchell, Founder and CIO of Antipodes Partners, at the Pinnacle Insights Live 2023 event.

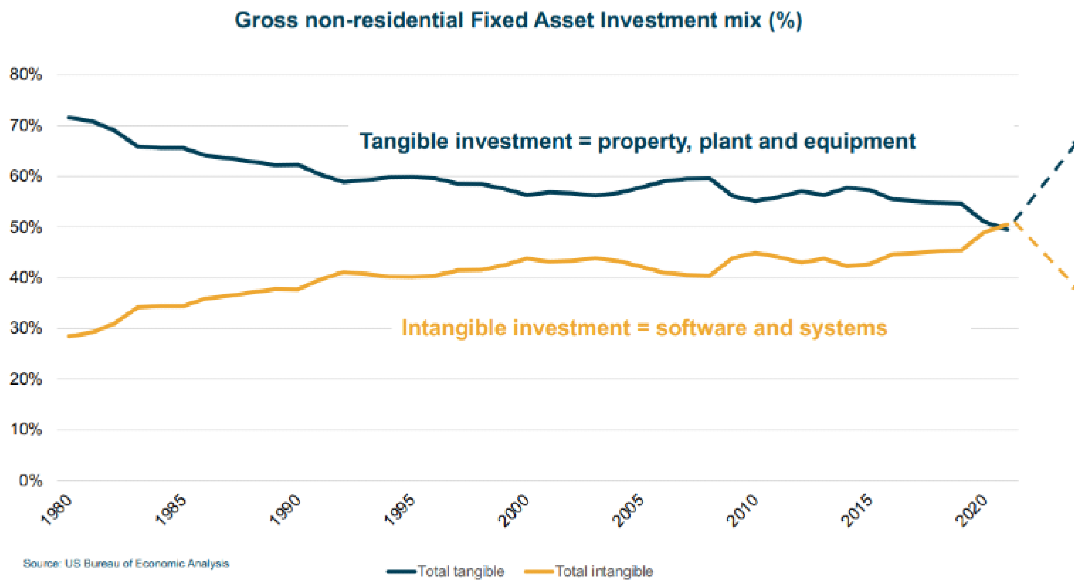
We've been observing for some time now, and it really started in 2018 with the Trump Tax Cuts: fiscal activism. There's been a real shift in the backdrop. And it was a result, I think, of the failure of QE. QE stimulated asset prices, but it was less than optimal when it came to stimulating the economy. So, it led to very wide wealth differentials, populism, then we had Trump, and then we had COVID.

And through all of this, what we saw was the response to every crisis was stimulation on the fiscal channel and also central banks reinforcing that. So, central banks normally act in a countercyclical manner, and they were reinforcing it with procyclical central bank policy. And it really reflects the fact that we think the central banks are increasingly captive to their political masters. We've really gone down the pathway of losing central bank independence.

Out of this, you'll start to see policy-led winners - that increasingly fiscal stimulus will start to go towards decarbonization, towards onshoring, and infrastructure projects. We're seeing it, but we're going to see a lot more. Let's unpack what that means for the composition of investment in the economy.

Tangible vs intangible investments

If you go back to 1980, most investments – 70% of investments went into tangible stuff, equipment structures as opposed to intangible, which is software and intellectual property. Fast forward to today and the split is 50-50.



We know why that happened. We had the emergence of the Internet; we had ecommerce, streaming video-on-demand, social media; and we also had things like the digitization of the enterprise, the emergence of the cloud. All of those things – the interesting thing about them is some of them led to productivity growth. Not all of them. I don't think Netflix has improved productivity, but the digitization of the enterprise definitely did.

Now, what we see happening is that's not going to go away, but the step change is going to come in tangible. It is all of the investment we need to solve for climate risk, to solve for geopolitical risk. And we think it will end up being more inflationary because it doesn't have a big productivity payoff.

Structurally higher inflation

The inflation backdrop - we think pressures are there; structural pressures are there. You have this fiscal activism, you have the wage pressure, which is a combination of the participation rate having fallen through COVID in the U.S. and in the U.K. We also have a big skills mismatch and part of that mismatch is really the change. And when you change the investment in the economy in a major way, you don't necessarily just all of a sudden get the skills that you need to take that tangible investment forward. You need electrical engineers, because it actually is just a super-cycle in investment in the power sector. Those skill shortages are real. The Fed is very concerned about the level of wage growth in the U.S. economy, and that's why it's been tightening.

Then you have China. China is no longer a low-cost manufacturing hub. We have the aging population in the West. We're losing workers, but we still have to take care of our elderly folk.

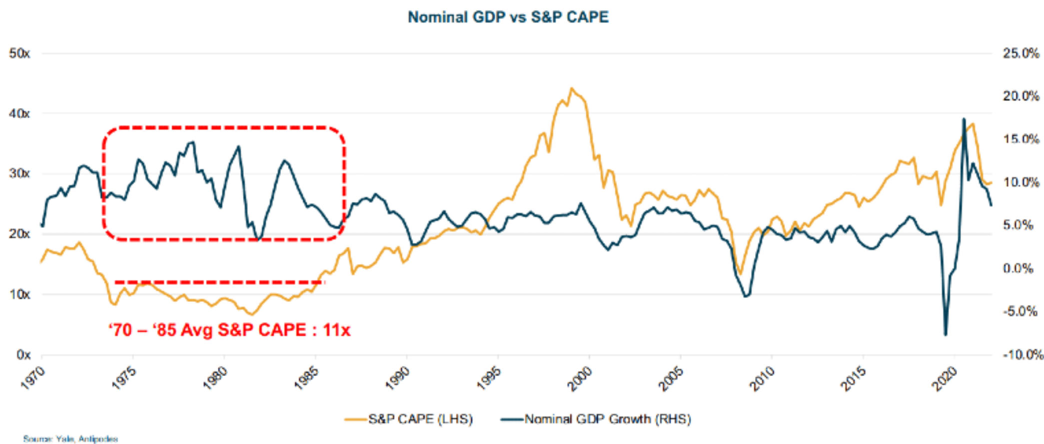
We have AI. AI, machine learning, certainly will start to deflate some of the service sector. AI will be very powerful actually in removing some of the most expensive jobs from the economy. But that is a longer-term trend, and it won't necessarily fix the issue that Fed has in the medium term.

We've seen this story before

Have we seen this playbook before of fiscal policy being much more active, of central banks having to try and deal with governments and their policies, which ultimately reflected a much more volatile nominal GDP growth era? And we have.

Will history repeat?

70s and 80s characterised by extreme policy swings and roundabouts



Source: Yale, Antipodes

It was the 70s and the 80s. Nominal GDP growth went through these big swings. And we know equity markets don't like volatility. It drives up the discount rate and it results in lower multiples, and that's what we saw in that period. The average multiple on the U.S. market on a cyclically-adjusted CAPE basis was around 11 times versus where we are today at 30 times. We think there is a real risk of volatility in the economic cycle, and it's already starting. You can see that leads to a derating.

What you're seeing with the euphemistically-described Inflation Reduction Act in the U.S., which should be more accurately titled the inflation reacceleration act, is US$400 billion of investment targeting the energy transition. And we say $400 billion, but actually no one really knows, because it's open-ended. It's actually production credits; it's investment credits; it's manufacturing credits; and there's no cap. And renewables are already competitive in Midwest of the U.S.; they're very competitive in the sunny parts, the windy parts of the U.S.

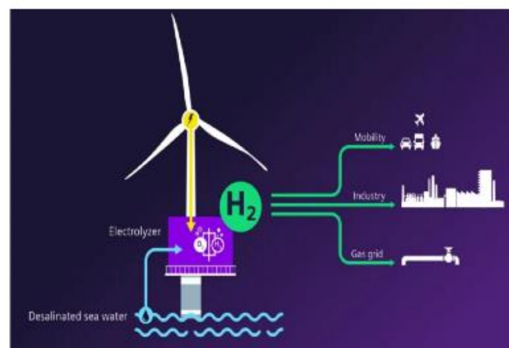
You don't need these incentives to encourage utilities to invest. It's actually happening anyway. So, it will really accelerate the market opportunity.

A large cap stock to play the theme

Siemens Energy: we describe it as the Swiss Army knife of decarbonization. It's a leading manufacturer of wind turbines and a leading manufacturer of high-voltage transmission equipment. It also solves for hydrogen. And look, this investment cycle is genuinely structural. Even if you just take the reality of having to decarbonizing the existing power grid, if you want to remove hydrocarbons, we need to resize the power grid by 3X. It's very hard for investors to get their heads around that number, and that's why we think this is a great opportunity to buy. You don't need to go onto the lunatic fringe. You can buy very sensible companies run by sensible people on sensible multiples because they were perceived to be cyclical companies that are transitioning to a structural growth profile.

Siemens Energy: the "Swiss Army Knife" of decarbonisation

- #1 in offshore wind turbines and leader in onshore wind
- Utility scale gas turbines: oligopoly and a critical enabler of renewable build out
- Next gen solutions: electrolysers and hydrogen-fired utility scale turbines
- Benefits from investment needed to strengthen the grid
- Backlog €100b equals 3 years' sales
- 5x EV/EBITDA (2025)



Source: Siemens Energy

In summary, we need to position for a real change in regime: fiscal activism and a super cycle in tangible investment. We need to be selective around yesterday's winners. We really should be focusing on tomorrow's and take advantage of the current valuation divide in markets. There are some very attractive choices. And as always, a pragmatic value approach in this environment is about finding resilient businesses that offer us a margin of safety and are really well-placed to deal with this economic volatility and looking for opportunities to protect our investors via hedging out tail risks when we see that sort of risk when it's very cheap to do that.

Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, part of the [Pinnacle Group](), a sponsor of Firstlinks. This article is an edited transcript of a [February 2023 presentation]() and the general information does not consider the circumstances of any investor.

Why stock prices are a distraction

James Gruber

Stock market prices are like email: they're distraction machines. With email, it often distracts people from getting work done efficiently. With stock prices, they distract investors from what really matters: the businesses underlying them.

Ralph Wanger, a legendary US small cap fund manager, knew this well. Wanger ran the Acorn Fund from 1970 to 2003, clocking 16.3% annual returns compared to the S&P 500's 12.1%. He used the following analogy to describe the behaviour of a typical investor:

"There's an excitable dog on a very long leash in New York City, darting randomly in every direction. The dog's owner is walking from Columbus Circle, through Central Park, to the Metropolitan Museum.

"At any one moment, there is no predicting which way the pooch will lurch. But in the long run, you know he's heading northeast at an average speed of three miles per hour.

"What is astonishing is that almost all of the dog watchers, big and small, seem to have their eye on the dog, and not the owner."

Wanger's point is that investors are transfixed by stock prices (the dog), when they should focus on businesses (the dog owner).

Put another way, the performance of a business will be ultimately reflected in its stock price.

100 baggers

What parts of a business' performance should be tracked?

Thomas Phelps, a US-based financial analyst and advisor, had some answers. Phelps wrote a well-known book called '100 to 1 in the Stock Market' in 1972. It was about his quest to find stocks that could increase by 100x.

In the book, Phelps created a table of basic financials for Pfizer over a 20-year period.

Simple stuff.

Phelps then went on to ask: "Would a businessman seeing only those figures have been jumping in and out of the stock?" His conclusion: "I doubt it."

True enough. The table shows Pfizer sales went up 6.7x over 20 years, earnings increased 4.7x, dividends climbed 3.5x and return on shareholder funds was consistently high, averaging close to 17%.

	Share Earnings	Dividends	Share Sales	Book Value	Return on Equity
1970	$1.28	.63	$13.68	$7.67	16.6%
1969	1.13	.57	12.73	6.94	16.2
1968	1.03	.50	11.85	6.77	15.6
1967	.96	.48	10.47	6.11	15.6
1966	1.02	.48	10.32	5.49	18.6
1965	.90	.43	9.01	4.89	18.3
1964	.76	.38	8.04	4.48	16.8
1963	.69	.35	7.01	4.29	16.0
1962	.64	.32	6.64	4.16	15.3
1961	.58	.28	5.69	3.56	16.2
1960	.52	.27	5.37	3.34	15.7
1959	.50	.27	5.12	3.03	16.5
1958	.49	25	4.56	2.73	18.0
1957	.47	.23	4.24	2.49	18.8
1956	.37	.19	3.75	2.25	16.5
1955	.33	.17	3.66	1.93	17.1
1954	.33	.15	3.29	1.75	18.8
1953	.30	.14	2.88	1.58	18.9
1952	.24	.13	2.44	1.53	15.7
1951	.27	.18	2.05	1.42	19.0

If you'd focused on Pfizer's price, you may not have hung on to the stock. The stock had highs and lows, and significantly underperformed the market over a five-year stretch during that period.

And because so many people have been "sold on the nonsensical idea of measuring performance quarter by quarter - or even year by year - many would hit the ceiling if an investment advisor failed to get rid of a stock that acted badly for more than a year or two."

Bailing on Pfizer would have been costly. The stock went up 25x excluding dividends over the 20 years.

Phelps issued a challenge to his readers:
"The secret of success in your quest for 100-to-one stocks is to focus on earnings power rather than prices. Can you do it?"

Similar strategies

Several current fund managers use similar metrics to Phelps to track business performance.

Warren Buffett's business partner, Charlie Munger, zeros in on a business' return on capital to determine whether it can deliver satisfactory returns:

"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."

Francois Rochon, a Canadian-based global fund manager, uses a comparable table to Phelps to explain his investment philosophy.

The first thing to note is that Rochon has crushed the market over the long period. He's done it by focusing on companies that can deliver +15% EPS growth over the long term. In the table, he measures the value of his portfolio by calculating the EPS growth plus dividend yield of his fund holdings each year. The 13.3% annualized return is close to his target of 15%.

Compare that to the S&P 500, which has delivered 8.2% annualized growth in value, as measured by annual EPS growth plus dividend yield.

Rochon's theory is that the EPS growth plus dividend yield will eventually be reflected in stock prices. And the table demonstrates that he is largely correct.

	Rochon Global Portfolio			S&P 500		
Year * **	**Value ***	**Market ****	**Difference**	**Value ***	**Market ****	**Difference**
1996	14%	29%	15%	13%	23%	10%
1997	17%	35%	18%	11%	33%	22%
1998	11%	12%	1%	4%	29%	25%
1999	16%	12%	-4%	12%	21%	9%
2000	19%	10%	-9%	15%	-9%	-24%
2001	-9%	10%	19%	-21%	-12%	9%
2002	19%	-2%	-21%	13%	-22%	-35%
2003	31%	34%	3%	12%	29%	16%
2004	21%	8%	-12%	20%	11%	-10%
2005	14%	15%	0%	15%	5%	-10%
2006	14%	3%	-11%	24%	16%	-8%
2007	10%	0%	-10%	-4%	5%	9%
2008	-3%	-22%	-19%	-31%	-37%	-6%
2009	0%	28%	28%	6%	26%	20%
2010	22%	22%	0%	50%	15%	-35%
2011	17%	6%	-11%	18%	2%	-16%
2012	19%	23%	4%	9%	16%	7%
2013	16%	42%	26%	8%	32%	24%
2014	13%	19%	6%	10%	14%	4%
2015	11%	4%	-7%	1%	1%	0%
2016	9%	10%	1%	4%	12%	8%
2017	14%	20%	7%	14%	22%	11%
2018	20%	-8%	-28%	23%	-4%	-26%
2019	10%	31%	20%	3%	31%	29%
2020	-2%	15%	17%	-9%	18%	27%
2021	32%	28%	-4%	48%	29%	-19%
Total	2474%	2817%	343%	676%	1152%	476%
Annualized	13.3%	13.9%	0.5%	8.2%	10.2%	2.0%

* Estimated growth in earnings plus dividend yield
** Market performance, inclusive of dividends (refer to Appendix B for disclosure statements on our returns)
*** Results estimated without currency effects

Terry Smith, a UK-based manager of the highly successful Fundsmith, provides a more sophisticated table of his global fund's key metrics:

	Fundsmith Equity Fund Portfolio								S&P 500	FTSE 100
Year ended	2015	2016	2017	2018	2019	2020	2021	2022	2022	2022
ROCE	26%	27%	28%	29%	29%	25%	28%	32%	18%	16%
Gross Margin	61%	62%	63%	65%	66%	65%	64%	64%	45%	42%
Operating Margin	25%	26%	26%	28%	27%	23%	26%	28%	18%	18%
Cash Conversion	98%	99%	102%	95%	97%	101%	95%	88%	88%	66%
Interest Cover	16x	17x	17x	17x	16x	16x	23x	20x	10x	11x

Source: Fundsmith LLP/Bloomberg.

From the table, you can see that Smith is a growth investor who likes businesses with high returns on capital employed (it's like ROE but includes debt in the calculation), high margins, ones that converts profits into cashflow (a check on whether there's any funny accounting involved) and have high interest cover (ensuring earnings before interest and tax can comfortably cover interest expenses).

If you compare Smith's metrics to the S&P 500, you'll notice that the businesses in his fund have much higher ROCEs, margins, and interest cover, with identical cash conversion rates.

Smith thinks that if he owns businesses with superior fundamentals as outlined in this table, and he buys them at a multiple similar to the market, then he should deliver market-beating returns. And he's been proven right with his long-term track record.

The Morningstar point of view

Morningstar analysts focus on identifying moats or sustainable competitive advantages. While the assessment may be qualitative in nature the financial statements will reflect the impact of the sustainable competitive advantage. A company with a moat will have a return on invested capital ("ROIC") that exceeds the weighted average cost of capital ("WACC"). In layman's terms this means the company will be able to generate a return by investing in the business that exceeds the cost it takes to raise capital. If a company can raise capital at 7% and earn a 10% return the difference will accrue to investors over time.

Buffett's take

Like so many things in investing, the final word on the topic should go to Warren Buffett:

"Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays."

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

Drawing more than you need to fund your super pension

Michael Hutton

Pension paying super funds are required by the government to make minimum annual pension payments essentially to ensure they are being used to provide a retirement income rather than just being used as a tax-advantaged method of building wealth for beneficiaries. If a super fund, including SMSFs, fail this minimum pension test, they lose concessional tax treatment, and the tax rate reverts to the normal 15% rate applicable to accumulation superannuation accounts rather than the 0% applicable to a pension paying fund.

Many in retirement live a reasonably frugal lifestyle and those with large super balances find themselves with excess cash coming in each month. This will likely be exacerbated from 1 July 2023 if the rates revert to normal after three years of half rates. Just getting older exacerbates the situation as the required pension drawdown percentage increases.

The minimum pension drawdown

Consider a retiree couple that has $1.7 million each in pension mode in super, making it $3.4 million in total. They are both 76 years of age, which means they are each currently required to draw a minimum of 3% per annum from their super to fund their super pension, or $102,000. This is tax free income to them.

Age on 1 July	Standard Rates % of pension balance	Reduced rates for FY20 - FY23
Under 65	4%	2%
65-74	5%	2.5%
75-79	6%	3%
80-84	7%	3.5%
85-89	9%	4.5%
90-94	11%	5.5%
95+	14%	7%

From 1 July 2023, the required minimum pension drawdown is likely to revert to 6% for a 76-year-old, after

which the couple must make combined payments of at least $204,000 from their super for the 2023/24 financial year.

When the couple reaches 80 years of age, the standard rate increases again to 7%. If the pension balances for a couple managed to be maintained at $1.7 million each, the required combined pension payments amount to $238,000, tax free.

Due to indexation, those who start a pension from their superannuation after 1 July 2023 may have a pension account limit of $1.9 million, or up to $3.8 million for a couple. From this, they could be required to draw $190,000 per year at 5%, or $266,000 at 7% if they are over 80. This is after tax income to them.

Equalising superannuation balances

Since pension account caps were introduced from 1 July 2017, at a rate of $1.6 million per individual, it has made sense for those couples with large superannuation balances to aim to equalise their superannuation accounts or at least build each towards the $1.6 million limit. Prior to this, when pension accounts were not limited, there was no major incentive to do so. Due to contribution limits and limitations, equalising member accounts has been fraught with complication.

The requirement to pass a work test to contribute was often a difficulty. The removal of this for those aged between 67 and 75 for non-concessional (non-tax deductible) contributions from 1 July 2022 has certainly simplified the process of evening out superannuation accounts between a couple.

For example, for a couple in their late 60s early 70s where one has a $3 million balance and the other has a $1 million balance, the higher balance member could withdraw $110,000 (to be indexed) each year tax free, gift it to their spouse who then makes a non-concessional contribution to their superannuation account. Over time, the lower balance member can build towards the current limit of $1.7 million (to be indexed). This way a greater proportion of the couples combined superannuation can qualify to be placed in tax-free pension mode. It is also permissible to turbo charge the reallocation by doing a triple contribution in a given year, then sitting out the next two years.

As with all superannuation contributions, care needs to be taken to get it right. SMSFs can be handy when extra flexibility is sought and to enable easier access to withdrawals and contributions.

Where to put the excess from your pension drawdown

A retired couple can live a comfortable lifestyle with a mandated yearly pension drawdown and still have plenty of money to spare. So what can they do with that money?

An alternative could be to set up another non-superannuation investment account – either in joint names or, if there is other substantial wealth, in the name of a family trust or investment company. The pension payment can then be paid to that investment account and the couple can draw only what they need and invest the remaining balance. Depending on whether they have any other taxable income, investment earnings could attract very little tax due to the individual’s tax-free threshold.

The decision as to the name in which the portfolio is held will depend on a number of factors. For example, a personal or joint portfolio will be the simplest, but doesn’t provide asset protection or tax benefits. Income is just taxed at the individuals marginal tax rates. A tax return may need to be lodged in the future whereas maybe this hadn’t been required prior to the portfolio being established.

For larger portfolios it can be useful to use a structure, a family trust or a personal investment company, to house portfolios that can’t be added to a superannuation account due to limits imposed thereon. Family trusts and investment companies can be flexible and can add tax efficiency and asset protection advantages. However, there is a cost involved in preparing annual accounts and tax returns.

This strategy of having a secondary investment portfolio can be particularly useful when one spouse dies, and a large lump sum superannuation death benefit may be paid out. This death benefit can also be added to the non-super portfolio.

Some wealthy retirees also use the spare income to assist their children or grandchildren. Using a tax-free superannuation pension income is a great way to fund the part payment of a grandchild’s non tax-deductible school fees, for example.

You may even wish to donate more to your charities of choice and get to see the benefits conferred, rather than leaving bequests as part of your estate planning.

Whatever you do, all the money accumulated over a working life should be doing something useful, and not just sitting idle. You've worked hard for your money, and now that you're in retirement, make it work for you.

Michael Hutton is a Partner of Wealth Management at [HLB Mann Judd, Sydney](). This article is general information and does not consider the circumstances of any individual.

Will gold continue to shine in 2023?

Sawan Tanna

Gold outperformed almost all other asset classes in Australian dollar terms in 2022 and there are reasons to believe it can outperform again this year.

Looking back at 2022

Last year, the price of gold experienced three distinct phases. The Ukraine invasion and surging inflation pushed gold prices higher during the opening three months of the year.

The solid start softened from mid-April. Pressured by rising interest rates and the rocketing value of the US dollar, prices trended downwards with little reprieve until the beginning of November.

The turning point for gold arrived on 2 November when the US Federal Reserve hiked its benchmark rate by 75 basis points to 4%. With Chairman Jerome Powell appearing steadfast in his determination to target 2% inflation, the news increased investor jitters about a possible global recession.

Gold price (USD/t.oz) 1 Jan 2022 - 26 February 2023

Source: [Trading Economics]()

In short, sentiment in the gold market turned positive, prices rapidly recovering losses to finish December at US$1,812.35, up US$3.30 on the year.

We now know that central banks also started buying up large amounts of gold and, coincidentally, pressure was heaped on gold-rival bitcoin with the collapse of FTX crypto exchange.

Will gold thrive in 2023?

Investor interest in gold is dependent on a number of factors.

Historically, gold has had a negative correlation to stocks and other financial instruments, making it an effective portfolio diversifier.

While fiat currency is likely to lose purchasing power to inflation over time, the price of gold tends to rise in line with inflation. Thus, in periods of higher inflation, it's viewed as a good store of value.

Gold has typically performed strongly in periods of financial market stress, making it a simple and effective hedge against market, geopolitical and event risk.

Furthermore, gold has provided sound long-term returns. Using average closing prices, the price of gold rose from US$279 in 2000 to US$1,800 in 2022, providing an annual average gain of 8.8%.

The question now is, will the gold price trend seen in late 2022 continue during 2023? And one of the key factors to watch will be whether the Fed pivots on interest rates.

What is a Fed pivot?

A 'Fed pivot' occurs when the US central bank reverses its policy outlook and changes course, which in the current scenario would be from a contractionary (tight) to an expansionary (loose) monetary policy.

According to some experts, the Fed can rarely keep tight policy as long as it wants to because inevitably something will happen that threatens the stability of the financial system.

Already we have seen lower rate rises in order to relieve pressure on businesses and the markets. Because revised monetary policy usually takes weeks or months for its effects to be felt, some say an actual cut in interest rates in order to avoid a hard landing may be prudent sooner rather than later.

Analysts at Bank of America have said that should this occur, it's likely a falling US dollar (in which gold is denominated) and treasury yields will encourage more investors to buy bullion across 2023:

"BofA says the price could exceed $2,000 an ounce next year as of all the precious metals "gold has the most to gain…on a Fed pivot".

At this point, the picture remains unclear with divergent views on how long the Fed will continue to hike rates. Even so, it's likely many investors are already preparing for the inevitable change of tack.

A safe haven

Gold appears to be one sector with the potential for further growth. While fears of recession and central bank buying may provide support for gold going forward, a less hawkish Fed should see a weaker US dollar – which may help to drive gold prices higher in 2023.

Sources: World Gold Council, LBMA, ASX, Investopedia, Reuters.

The Perth Mint ETP PMGOLD is designed to track the international price of gold in Australian dollars and offers investors a simple way to access the returns on the precious metal.

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