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Editorial

Don't believe what **Treasury** and others say about a 30% superannuation tax. It is not a 30% tax on large balances, represented by the sum of the existing 15% tax on accumulation funds plus another 15% on balances above $3 million. It is a completely new tax with a different calculation method. If anyone disagrees with this, answer the question: '30% of what?' There is no answer. It's also not a 'doubling of the tax rate', as many journalists are now writing. The new tax is not 2x, it is x plus y.

The implications of taxing unrealised gains are slowly dawning on people, but it's doubtful **Treasurer Jim Chalmers** and Treasury understood the consequences of their new measurement method when it was proposed. Their first press announcement was incorrect:

> *"From 2025-26, the concessional tax rate applied to future earnings for balances above $3 million will be 30%."*

Consider a simple example. An SMSF holds one asset, an investment property, which delivers taxable income, net of deductions, of $10,000 in a financial year. In an accumulation fund, tax at 15% is $1,500. Assume the property increases in value by $100,000. The new tax is calculated at 15% of $115,000 (income plus unrealised capital gain) with adjustments according to Treasury's formula. That's not another $1,500. These are two different 15% taxes, not a 30% tax.

Chalmers now needs to defend the new tax, including the unrealised gains. In a press doorstop on the weekend, within the space of a few sentences, he said the word 'modest' five times and 'simple' four times. It might be simple for large super funds who do not need to administer it, but it is not simple for the individuals affected. They could receive a large tax liability notice without the cash to pay it, and revaluing unlisted assets will become a major headache.

It's a **Shakespearean** reminder of **Hamlet**, where his mother, **Gertrude**, is asked about the queen in a play who repeatedly states she would not remarry if her husband dies. The famous reply, "*The lady doth protest too much, methinks*" means a point is made so much that the opposite is probably true.

Chalmers has taken comfort from the support given to the new tax by the Managing Director of **National Australia Bank, Ross McEwan**. However, when interviewed by **Patricia Karvellas** on **ABC's Radio National** on 3 March 2023, McEwan was not asked about the unrealised gains. Did he know the implications or was he still on the 30% bandwagon?

> *"Actually, I think $3 million is a lot of money to have a super fund. I'm sure I'll put myself out there and people say, "You should never have said that" but I think $3 million is a lot of money. And a 4% return on that, I'm pretty sure after tax somebody could live on $120,000. It's not a bad sum of money. It's a*

move that probably needed to be made ... So that's just a reality of where we are. If we're all going to have to play our part to get this economy back into shape, get the debt down to the country. There's lots of decisions we don't like. We get a chance every three-odd years to make a decision."

How much will support waver as people realise there is far more to this policy than a simple tax on amounts over $3 million?

Following McEwan, **Samantha Maiden from News** was asked why the Government made such a hasty decision:

"Look, it was a very peculiar thing, right? Because they started this conversation and conversations can be very dangerous. And then, you know, two seconds before they announced it, Anthony Albanese was telling people that they hadn't made a decision then all of a sudden, they had. One of the most extraordinary elements of it is that the Government just doesn't seem to have been very consistently effective about selling it. It's actually other actors in this debate who are far more effective. So for example, that interview that you've just done with the NAB CEO is the best birthday present Jim Chalmers didn't get yesterday.

And you know, this morning, Richard Marles has been on the Today Show with Karl Stefanovic, where he was completely unable to answer questions about how they were going to deal with this profit. So he was asked three times by Karl Stefanovic, it was a GST birthday cake moment if I've ever seen one ... Even though they do have the broken promise thing and I'm not minimising that but it should be something that's not so difficult to sell."

The first major survey question by **Newspoll**, detailed below, only mentions the $3 million and not the tax on unrealised gains or lack of indexation. The surprise in this result is that one-third either disapprove of the policy or don't know, which is strong support for no change given only 0.5% of people will be adversely affected.

NEWSPOLL
EXCLUSIVE TO THE AUSTRALIAN

CHANGES TO SUPER

		Political Support				Gender		Age				Education		
	Total	Coalition	Labor	Greens	Other	Male	Female	18-34	35-49	50-64	65+	No tertiary	TAFE/ College	University
Approve	64	54	80	79	50	66	63	66	70	60	61	62	60	72
Disapprove	29	42	13	15	44	29	28	26	23	32	35	29	34	23
Don't know	7	4	7	6	6	5	9	8	7	8	4	9	6	5

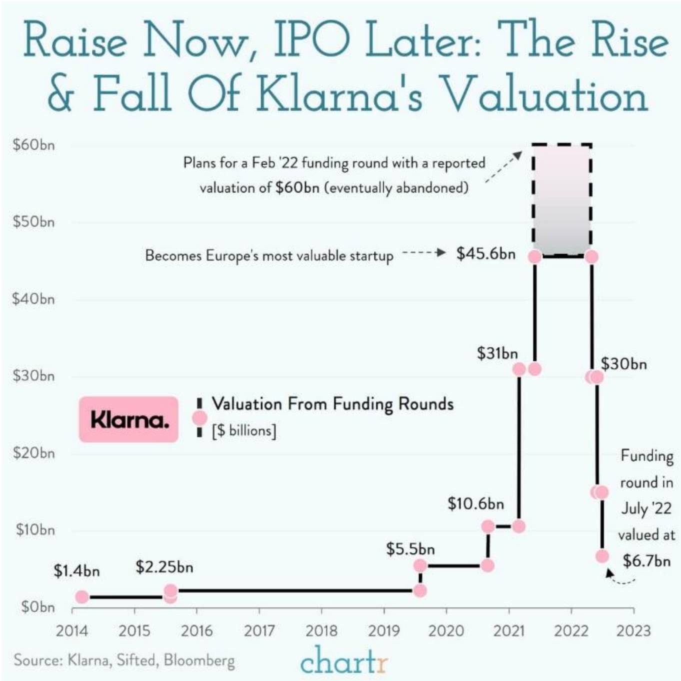
Question: Treasurer Jim Chalmers has announced that the Albanese government will change how it taxes some super accounts. The change will only apply to super balances over $3m. These super balances will be taxed at 30 per cent, rather than 15 per cent currently. Approximately 80,000 people are expected to be affected by the change, and the government says it will generate $2bn in revenue for the budget in its first full year. Do you approve or disapprove of this change?

Then speaking on ABC Radio on 6 March 2023, political commentator **Michelle Grattan** was asked about the Newspoll survey supporting the Government's super changes and what it demonstrates. She replied:

"Certainly, it will be a great relief for the Government because the whole issue has blown up into a huge argument, but it does show that the bottom line has cut through and people are accepting this is a fair change, and one that's necessary to make the system sustainable. Having said that, I think that the Government still has a big argument in front of it over the detail of the change and whether that high level of support holds. We'll see as that argument unfolds."

This week, we take a deep dive into [10 aspects of the new superannuation tax]() which are receiving less attention, but which show the implementation will be far from straightforward, despite Jim Chalmers' Hamlet-like protestations. Many in his party are wondering whether the angst is worth it for only $2 billion in tax revenue a year.

The splendid chart on the valuation of **Klarna**, the Buy-Now-Pay-Later business part-owned by the CBA, shows how the unrealised gains tax can hit hard (and we use some local BNPL examples in the related article). As recently as 2019, Klarna raised funds at a $5.5 billion valuation but reached a $60 billion valuation at the start of 2022. Struggling with losses and cash burning, it recently raised $800 million at a valuation of $6.7 billion. Many people choose their SMSFs to hold such assets, potentially creating massive tax liabilities when the value has not really changed over four years.



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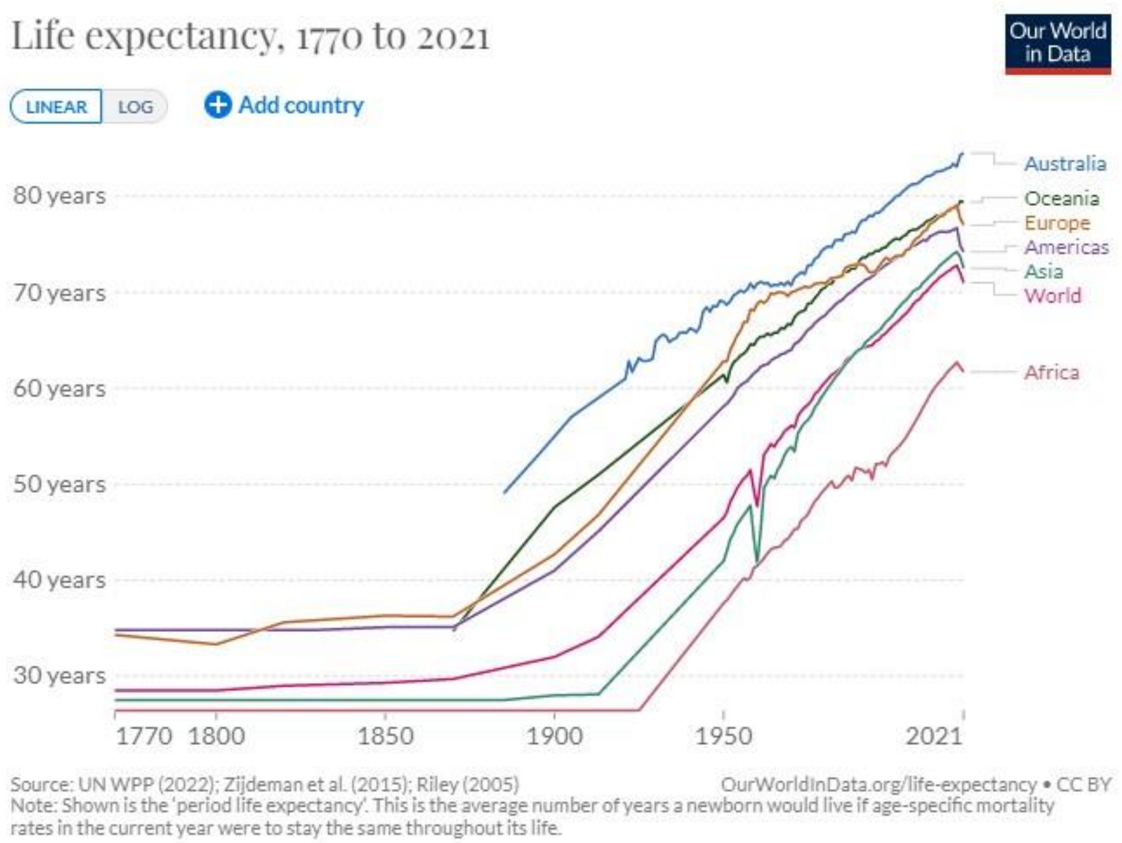
On the subject of living a long time (that is, superannuation), the latest life expectancy data has good and bad news for Australians. On the bad side, around the world, the pandemic has shortened life expectancy like no other single health issue for many decades, and this has continued into 2022/2023. On the good side, the data below shows Australians have the longest expectancy of any of the data sets in the comparison. Hanging on to decent superannuation balances is important for Aussies as we will live so long.



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The Australian dollar fell to its lowest level since November 2022 after hawkish commentary from Federal Reserve Chairman **Jerome Powell** contrasted with RBA Governor **Philip Lowe**'s dovish turn. Powell warned of interest rates rises including a possible return to 0.5% levels. He told the US Senate:

> *"The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated."*

But Phil Lowe told the **Australian Financial Review**'s Business Summit that the Reserve Bank Board had discussed a potential interest rate pause and that rates were already in "*restrictive territory*". Lowe stressed an important difference between the US and Australia:

> *"In the US, when the Federal Reserve raises their mortgage rates, if you've got an existing mortgage you don't pay more. In Australia, you do."*

Graham Hand

Also in this week's edition ...

Ron Bird says the Albanese Government has lost sight of the real purpose of superannuation. Sure, it involves setting aside savings to fund retirement, but these funds come from somewhere. Contributions to superannuation involve sacrificing current consumption with the expectation of being able to consume more in the future. This trade-off should be the focus in making policy, and super is benefitting the wrong people.

The Government is determined to limit early access to super to help pay down a mortgage, much to **Jon Kalkman's** chagrin. He says younger people should have the option to draw on their super balance, within limits, to assist with their housing needs at the time in their lives when they need it most. Current policy is inequitable and hypocritical as it allows retirees to access their super early to pay off their mortgage.

ATO figures show about 20% of the $890 billion in SMSFs is allocated to cash and term deposits. **Vanguard's Jean Bauler** says while this is understandable to an extent, more of the money is likely to make its way into bonds given the now attractive yields on offer.

Warren Buffett's partner, **Charlie Munger**, is famous for applying disciplines outside of finance to give him an edge in markets. **James Gruber** follows suit by looking at how ecological niches can be applied to stock markets and may help you become a better investor.

Matt Reynolds of **Capital Group** says the pandemic has permanently changed global supply chains. Businesses are moving away from being too reliant on China or other countries, and that has vast implications for both companies and markets.

Brad Potter of **Tyndall** says the recently passed Inflation Reduction Act is poised to have a significant impact on the US economy, especially in the renewable energy sector. The Act includes provisions that incentivise the growth of the renewables sector, creating a 'supercycle' of investment and development, and Australia is well placed to benefit.

Earlier this week, to celebrate **International Women's Day**, Morningstar's **Annika Bradley** led an empowering and thought-provoking panel discussion with industry leaders **Katie Hudson**, **Elizabeth Kumaru**, and **Dr Laura Ryan**. They shed light on how to #EmbraceEquity, discussed the importance of financial literacy for women and shared experiences and learnings on investing. If you missed out on the livestream, watch the recording here.

Lastly, in this week's white paper, **Capital Group** explores various scenarios for inflation and interest rates, and the analysis points to one clear conclusion: the importance of investing in fixed income.

Curated by James Gruber and Leisa Bell

10 revelations about the new $3 million super tax

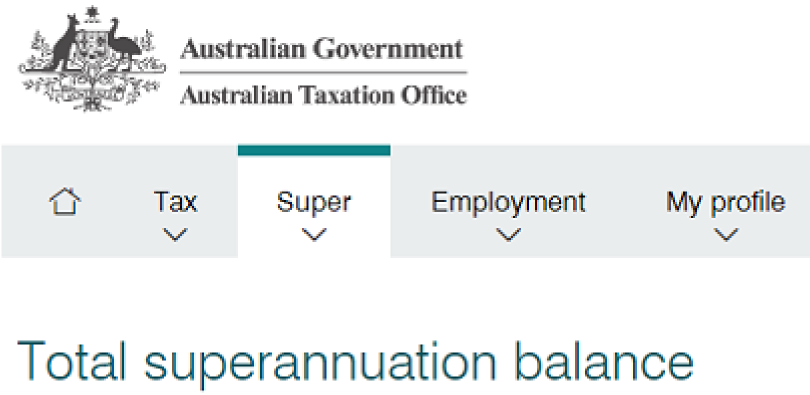
Graham Hand

The initial attention around the new superannuation tax focussed on the $3 million number but analysis has moved to the method of calculation, especially taxing unrealised gains and not indexing the amount. The measurement difficulties started when the Government decided to clamp down on individuals with large balances. Super funds and SMSFs calculate taxable (assessable) income within each fund, but the Government wanted to impose an extra tax on super balances above $3 million. Super funds do not know the Total Superannuation Balances (TSB) of their members, and a method was needed which avoided a major systems redesign within each fund. Labor has too many friends in large funds to cause such angst.

It looks increasingly like a rushed job where Treasury nominated the simplest method, and later the problems began to surface. The only place that records all superannuation balances is the Australian Taxation Office (ATO), where the amounts are:

> *" … used to determine your eligibility to make contributions, receive co-contributions, and your spouse's eligibility to claim a tax offset for spouse contributions."*

Most people can find their TSB using ATO online services, usually accessed via MyGov, listed under 'Super', as shown here.



These records do not hold or calculate taxable (assessable) income across all super funds, so Treasury decided to tax the change in the TSB over the financial year for those with over $3 million. Easy peasy.

Treasurer Jim Chalmers was asked on the weekend if he would change the unrealised gains tax treatment.

> *"That's the advice of Treasury, working with other relevant agencies, that that is the most efficient, simplest and best way to go about it, and so that's what we intend to do."*

As the surprises reveal themselves, here are 10 aspects of the super tax worth knowing.

1. It's a new 15% tax not a 30% tax and not a doubling of the tax

The title in my article last week calling it a 30% tax, as everyone does, was wrong. The article received over 180 comments and nobody pointed out the mistake. If it's a 30% tax, we must be able to answer the question, '30% of what?'. And there is no answer.

Nobody would argue that a 45% personal tax rate and a 10% on GST gives a total tax rate of 55%. The two taxes cannot be added together because the components are different. It's the same with this new super tax (which does not have a name).

It is doubtful either Jim Chalmers or Treasury understood the calculation when they announced the new tax on 28 February 2023:

> *"From 2025-26, the concessional tax rate applied to future earnings for balances above $3 million will be 30%."*

This is incorrect. Rather, there are two different 15% taxes.

There is no 15% tax on 'Earnings' (as defined to include unrealised capital gains) in accumulation funds inside the $3 million limit. The tax is paid on taxable (assessable) income. The new tax is separate from personal income tax or the current tax on a superannuation fund. Although it is based on TSBs, the tax is imposed on the individual, not the fund.

The reason it is incorrectly called a 30% tax is not because the new tax itself is 30%, but it is on top of the 15% tax paid on accumulation funds. In fact, if a member held $3 million in a pension account, then it would be a 15% tax in total with 0% on the first $3 million.

Many journalists are calling it a 'doubling of the tax rate', but this is also wrong. It's not x becomes 2x, it's x plus y.

Consider how the new calculation will be made:

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

'Taxable income' and the new 'Earnings' are radically different. An SMSF might hold an investment property which produces taxable income (net of expenses) of $10,000 in a financial year, but the property increases in value by $100,000. A 15% tax is applied to the $10,000 in an accumulation fund, but the new tax is imposed on the full $115,000 (income plus unrealised capital gain) according to the formula.

As the new tax is based on the growth in assets over a financial year, including unrealised gains, it is taking taxation into new ground.

In another sign that the policy was rushed, the complexities of Defined Benefit super schemes are not addressed. Many of these arrangements do not define an amount in super. Someone may expect to retire on $100,000 a year but they do not have a TSB.

2. Payment date can be delayed until FY28

There is some good news. Given the start is 1 July 2025 and first end-of-financial-year measurement is at 30 June 2026, SMSF trustees will have until 15 May 2027 to lodge their annual report. When the ATO receives the information, it needs to issue an assessment with timeframes for payment. With hundreds of thousands of SMSFs now given an incentive to report as late as possible, it's unlikely payment will be required before 30 June 2027. It will be well into FY28 before the payment is due. A lot can change between now and FY28.

The point above is not only about delaying for tax flow or present value purposes, but it affects the actual calculation. Recall that tax liability relies on the definition of Earnings:

Earnings = TSB (end of FY) – TSB (start of FY) + Withdrawals – Contributions

A tax payment is a withdrawal. When the first measurement is made for FY26, there are no withdrawals for this new tax in that year. With delays, there may be no payment in FY27 either. So the first payment added to the Withdrawal definition is not until FY28, where Earnings as defined will be reduced.

3. The $3 million must be indexed or increased at some point

At some time in a future universe, the $3 million will be increased as it will capture too many people and remove the incentive to save in superannuation. The tax on super will be above some personal marginal tax rates. Jim Chalmers conceded as much on the weekend:

> *"What we're proposing is to leave it at $3 million, so that the system becomes more sustainable over time. But there's absolutely nothing preventing a government of either political persuasion, in the near term or in the longer term, from adjusting that threshold."*

The $3 million amount becomes worth far less in future dollars under various assumptions. Finance Minister Katy Gallagher admitted in Parliament this week:

> *"In 30 years, Treasury predicts that roughly only the top 10% will retire with superannuation balances of around $3 million."*

The Financial Services Council (FSC) which represents large superannuation fund states:

> *"If the Government does not index the proposed $3 million superannuation balance cap, 500,000 Australian taxpayers will breach the cap in their life and face a 30% earnings tax, including 204,000 Australians under the age of 30 ... Leaving the cap stuck at $3 million will mean that in today's dollars a 30-year-old will have a real cap of around $1 million, calling into question the intergenerational fairness of an unindexed cap."*

(Again, an incorrect reference to a '30% earnings tax'. What are 'earnings'?).

The FSC gives the example of a 25-year-old professional earning $100,000 with a current superannuation balance of $35,000 would reach the $3 million threshold by the time they retire at age 65. The FSC provides this table showing the real value of $3 million at various inflation rates.

Table 2: real value of the $3m cap for various age cohorts at the retirement age of 65

Age	Real value of $3m cap at retirement age of 65 and inflation 4%	Real value of $3m cap at retirement age of 65 and inflation 3%	Real value of $3m cap at retirement age of 65 and inflation 2.5%
25	$624,867	$919,671	$1,117,292
30	$760,246	$1,066,150	$1,264,113
35	$924,956	$1,235,960	$1,430,228
40	$1,125,350	$1,432,817	$1,618,172
45	$1,369,161	$1,661,027	$1,830,813
50	$1,665,794	$1,925,586	$2,071,397
55	$2,026,693	$2,232,282	$2,343,595
60	$2,465,781	$2,587,826	$2,651,563

Source: FSC, ATO.

4. The limit is worth only $2.5 million now

Even now, we should stop referring to the limit as $3 million, as that is a future value set now, years before its start. It will never be worth $3 million in today's dollars. With the earliest calculation date for the new tax at 30 June 2026 which is over three years away, assuming inflation at 6%, the future value of $3 million is equivalent to $2.5 million now. Anyone considering the likely impact should think in terms of the value on 30 June 2026 which is about $2.5 million in today's terms.

To be clear, the new tax will be limited to individuals who have more than $3 million in superannuation at the end (not the beginning) of a financial year.

5. Valuations will become critical, even the wild guesses

An SMSF can hold almost anything and there is a vast range of investments where valuations vary widely, even between experts. Valuations are needed at the moment for super funds, for example, to determine the TSB because non-concessional contributions cannot be made where (currently) balances are over $1.7 million. But where the valuation directly drives the amount of tax paid by the member, they become far more critical.

In future, arguments will arise between trustees and valuers due to the taxation of unrealised gains, and it's likely that trustees will shop around valuers for the best number. Trustees will want as high a value as possible for 1 July 2025 and as low as possible for 30 June 2026. Consider these examples:

- A farm bought 10 years ago which has gone through cycles of drought and floods with harvests varying from the best to the worst years on record.
- A factory built 30 years ago where the land is now be worth more without the factory.
- A doctor's surgery in a country town that cannot attract a doctor.
- A restaurant that struggled during Covid, recovered with JobKeeper, closed during lock downs, fought to attract staff, raised prices to combat inflation, benefitted from high migration but will be hit in a recession.

And then there are art collections, vintage cars, wines, NFTs … if Treasury thinks an accurate, independent value can be placed on all assets and then a tax imposed, it is creating an administrative headache.

6. No discount on (realised or unrealised) capital gains

Assets held in superannuation and sold receive discounted capital gains tax if held for longer than 12 months at two-thirds of 15%, or 10%. Not only will unrealised capital gains be taxed at the full 15%, but so will realised gains which increase the TSB at the end of the financial year.

In addition, if Earnings as defined show a loss, such as due to super balances falling over the financial year, there will be no tax refund.

7. Equalise balances as divorce becomes a plan

The TSB applies per person, not for an entire SMSF, and where one member of a couple has $5.8 million in super and the other none, the tax implications are profound versus two people with $2.9 million.

However, it is not possible to transfer super to a spouse except in small amounts. For example, up to 85% of concessional contributions can be split with a spouse in any financial year, but the cap on these contributions is $27,500. For a person earning less than $37,000 per year, their spouse can contribute up to $3,000 each year and receive a $540 tax rebate.

Where a strategy is desired to quickly transfer millions to take advantage of two limits, and it may become a meaningful plan to divorce and give half the super to the spouse as settlement, then take any mandatory separation requirement, and remarry with the super split. This is only one example of the creativity which the new tax will unleash.

While we're on the subject of couples, if one member of a couple dies and passes their super to their spouse as a pension, the balance will be included in the survivor's TSB, and become subject to the new tax if the TSB is large enough.

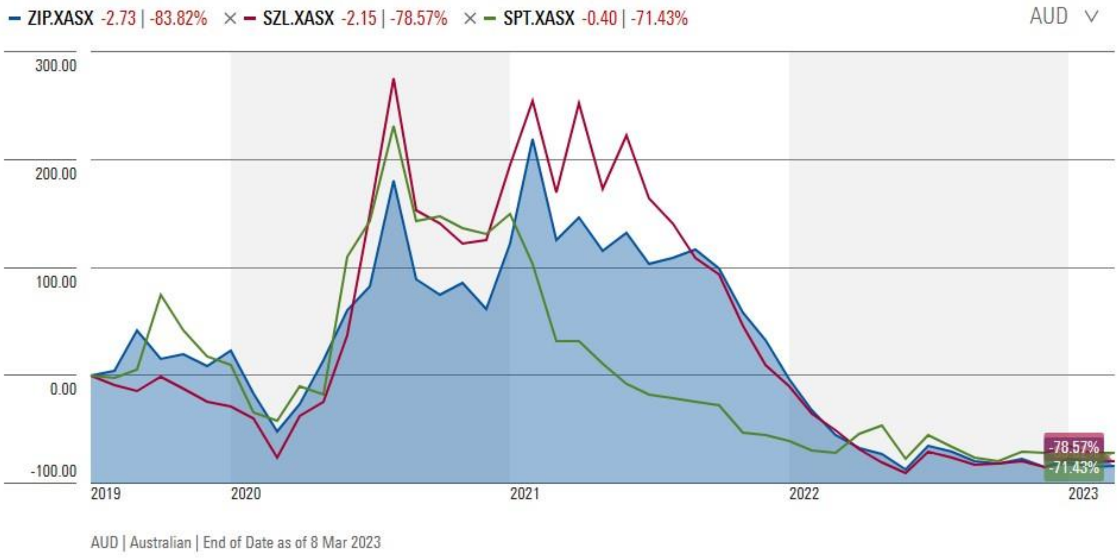
8. No tax refund or recovery if super balance falls below $3 million

A 'loss' in the new 'Earnings' calculation can be carried forward into subsequent years to reduce a future year's Earnings. However, if the TSB is lower at the end of a following financial year than at the beginning, and there are no contributions or withdrawals, there will be no refund for tax paid in the prior year.

If money is removed from super and the TSB falls below $3 million permanently, or the individual dies, there many never be an opportunity to use the carry-forward loss.

There are many examples where an asset placed into an SMSF rises quickly in value over a financial year, and the member will be presented with a large tax bill. The asset may then fall in value and never recover. Imagine if this new tax operated during the boom and bust of BNPL stocks such as Zip, Sezzle and Splitit, which were popular with retail investors including SMSF trustees.

Share prices of three BNPL stocks since 1 July 2019



Source: Morningstar Investor

9. Inability to remove excess from super without a Condition of Release

The new tax of 15% on Earnings on top of 15% on taxable income (deliberately not calling it 30%) will turn people away from large superannuation balances. Articles are already appearing about alternatives, such as the tax-free family home, family trusts, investment bonds and private investment companies.

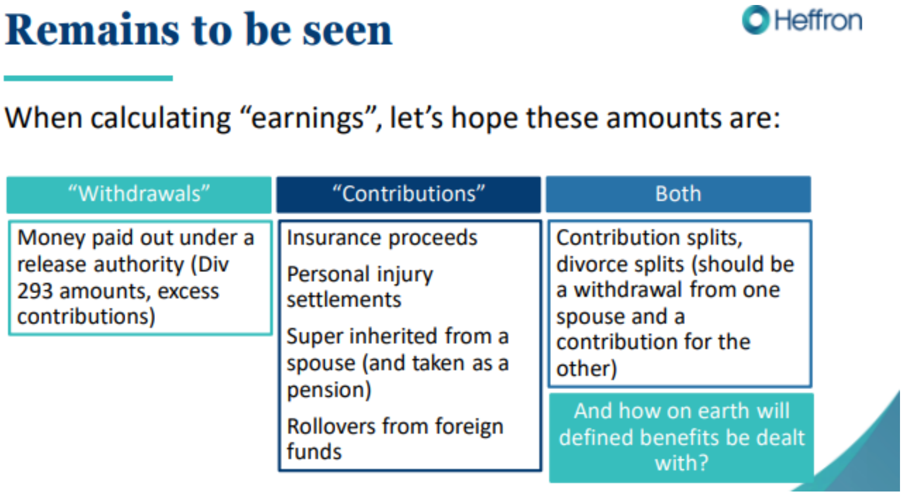
Many members will move money out of super where a 'Condition of Release' has been met. The Government is unlikely to resist this, and probably welcome it, as Treasury must believe anyone with over $3 million in super has enough to meet the 'Objective of Super' to provide income in retirement. Removal of assets from the taxadvantaged vehicle may rank as a job well done for Treasurer Jim Chalmers, although putting more money into expensive family homes is hardly nation-building.

But that's not possible for people with large balances who have not met a Condition of Release. The Government will need to decide if they will give the option for anybody to remove money from super provided the balance does not go below $3 million.

For those who have achieved a Conditon of Release and who know they face a large tax bill, they may consider withdrawing money from their super in June to avoid the $3 million limit, especially if they are only just over it.

10. Wide range of potential impact on Earnings

The definition of TSB is critical, being the difference between the EOFY balance and SOFY balance, minus Contributions plus Withdrawals. These flows come in many forms within superannuation, as this graphic from Heffron shows. It 'Remains to be seen' what is included.



Taxing unrealised gains causes super reassessment

In an Institute of Financial Professionals Australia (IFPA) webinar this week, speakers said they were already fielding calls from clients who were asking about alternatives to holding money in superannuation. Planned additional contributions had been postponed and decisions to place assets in an SMSF were being reconsidered.

There is plenty of such anecdotal evidence that the role of superannuation in long-term investment planning is being reassessed, not only for those currently with large balances, but for those aspiring in that direction. It's highly unlikely that the Treasurer and Treasury wanted to bring doubt to our lauded superannuation system.

Graham Hand is Editor-at-Large for Firstlinks. This article is general information based on interpretations of the Fact Sheet provided by Treasury. The final version of any legislation may differ from current intentions and any person should consider financial advice before acting on the proposed changes. Thanks to Heffron for additional insights.

The current super system fails the poor

Ron Bird

There are good aspects and bad aspects to the Albanese Government changing the superannuation rules to claw back some concessions. To start with the bad, the Government like almost everyone else, fails to recognise that superannuation is not a magic pudding. Sure, it involves setting aside savings to fund retirement, but these funds come from somewhere. Contributions to superannuation (like all forms of investment) involve sacrificing current consumption with the expectation of being able to consume more in the future.

Over 30 years ago, the Government of the day decided when making superannuation contributions mandatory, to place limitations on people making their own choice when deciding between current and future consumption.

The current Government's proposed objective for superannuation is:

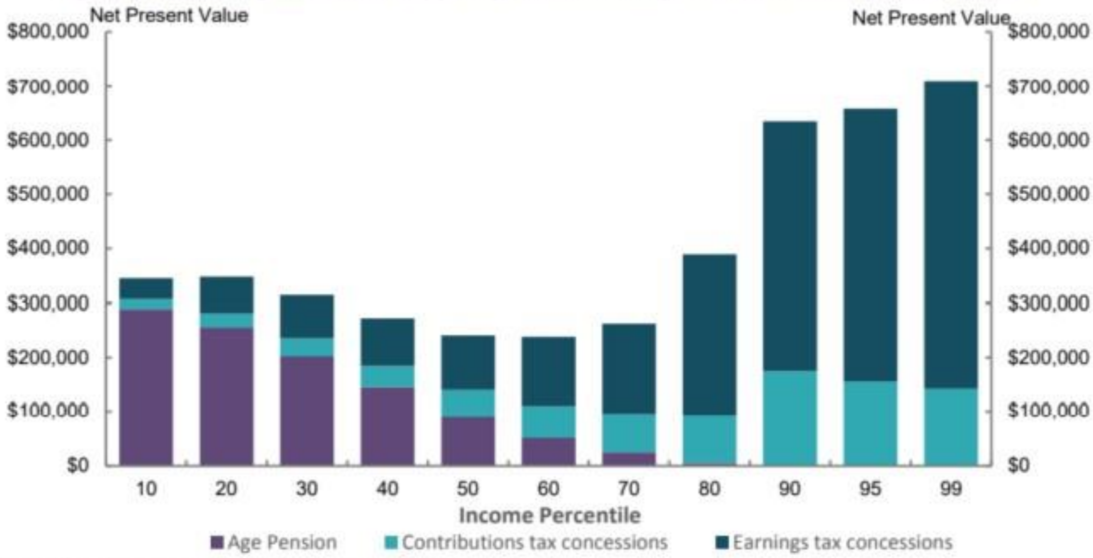
> *"to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way"*

It fails to recognise that the benefits in retirement come at the cost of consumption in prior years, and that this trade-off should be the focus in making policy and implementation decisions with respect to the superannuation system.

Why the super trade-off should be central to policy

A number of studies examined this trade off as part of analysis conducted in the period leading up to the progression to the 10% contribution rate. Their findings are best summarised by saying that the 9.5% contribution rate existing at the time was found to be already too high for the poorer among us, it was in the ballpark for middle-income earners, and it was largely irrelevant for the wealthy who have the resources to make their own choice without jeopardising their ability to enjoy a dignified retirement. Treasury research used in the Retirement Income Review shows lifetime government support though superannuation concessions accrue to the highest income earners.

Figure 4: Lifetime government support provided through the retirement income system[9]



Source: Treasury calculations using a hypothetical cameo model

Superannuation should be judged based on its contribution to facilitating individuals and households to achieve the best possible pattern of consumption through time, rather than just concentrating on the post-retirement period. The recognition of this trade-off when setting an objective for superannuation will result in much better decision-making at both the policy and implementation levels. Hence, bad policy will almost certainly be the outcome if the objective for superannuation does not explicitly recognise the trade-offs involved between consumption now and in the future.

An objective purely voiced in terms of retirement, will always favour ever higher contribution rates and/or be used to oppose any thoughts of eating into superannuation balances to fund other activities. For example, the ALP is using the objective to beat up on the Coalition because they allowed people to access their superannuation balances in the early period of the pandemic and thus reduced the balance they will accumulate at retirement. Judged on the objective proposed by the government, it is a no brainer that any early access to superannuation funds will never be able to be justified.

However, when the decision to provide this access is judged on the basis of the trade-off between current and future consumption, the policy is not obviously bad as there will be cases where the particular circumstances of individuals or groups of individuals are better off if they are able to consume more now, even if it means lesser consumption in the future.

It may be that the Coalition can be criticised because it did not police access to the withdrawal process sufficiently, but the actual concept of letting people access at a time of need should not be impacted by a bad objective that concentrates solely on the post-retirement period.

How using super for a home deposit should be assessed

Another area in which better policy may emerge if the trade-off that superannuation involves is recognised is the use of superannuation balances to accumulate a deposit for a first home. The recognition of the trade-off is even more important here as people are trading off the opportunity to accumulate assets (a house) outside of superannuation, rather than accumulate their superannuation balance.

The bottom line is that based on the return on equity invested, housing has delivered a higher return over the last 30 years as compared to superannuation, and household welfare from allowing the lower-income earners access to their superannuation balance to purchase a house would have increased by their welfare by around 30%.

Indeed, what we have seen is a continual fall in home ownership dating back to the introduction of mandatory superannuation and a recognition that this is a trend that will only continue. The longer-term negative effect that will have on individuals and households in retirement must be factored into any consideration with a high probability that it will more than negate any benefits flowing from the higher superannuation balances for those who face retirement without owning a home.

Tax subsidies on mandatory contributions were always an error

When the Keating Government introduced mandatory superannuation over 30 years ago, they made the curious decision of offering tax subsidies on contributions even though individuals had no option other than to make the contributions. Even stranger, they applied the same tax rate on contributions and fund earnings across contributors, irrespective of the marginal tax rate of the contributor. Consequently, they opened up the opportunity for mammoth tax benefits for the high-income earners while, if anything, punishing the poorer amongst us. Of course, the subsequent Howard/Costello Government saw this as a good opportunity to use a favourable revenue situation to continually expand access by the wealthy to the superannuation tax incentives.

Despite subsequent governments playing around at the edges and containing the growth of the tax subsidies, we see that they have grown to more than $50 billion a year. We now have a Government acknowledging the inequity of these subsidies and the unnecessary demands that they are placing on an already stretched budget. The bottom line is that we never should have offered tax subsidies to encourage people to so something that was mandatory.

You might point out that these subsidies have encouraged people to contribute above the mandatory amount. This is true but then this is the problem – the vast majority of these discretionary contributions are from wealthy people who are channelling money they would have saved anyway through superannuation in order to exploit the tax benefits.

Undoubtedly, the subsidy should be removed completely, there was no reason to have them in the first place and they have only served as a mechanism to increase the inequities in our society by taking from the poor and giving to the rich.

It is a vain hope that this or any government would go this far, with even the possibility of reduction in the tax subsidies immediately leading to a groundswell of opposition from the coalition and from an industry that is highly reliant on the revenue earned from servicing those who obtain the greatest tax advantage from placing their savings in superannuation.

Immediately, the Government went weak-kneed and announced a reduction in the tax subsidy on the earnings of funds with assets more than $3 million. By so doing they are reducing the tax subsidies by around 1% and affecting 0.5% of superannuation funds. In other words, a proverbial drop in the ocean which the suggests that this (and future) governments will allow the inequities to continue.

The current super system fails the poor

The Government should be applauded for its willingness to address meaningful deficiencies in our superannuation system. It is amazing that the current system can exist for 30+ year without its objective ever being defined. The Murray Inquiry pointed out this deficiency about a decade ago, Treasury then produced three objectives, but these died without ever being legislated. Undoubtedly, superannuation needs an objective, but it does not need an objective that distorts policy and implementation decisions to the extent that it makes individuals worse off.

An objective needs to be crafted that gives recognition of the role that superannuation plays in influencing an individual's/households' welfare over their whole life and not only in their retirement years. The Government should also be applauded for opening the debate for cutting the overly-generous tax subsidies offered on superannuation.

These subsidies are unjustifiable and are a major contributor to the inequities within our society, but we have just seen another instance of a government not having the fortitude to do anything of significance about it. Indeed, we currently have a superannuation system that is overly generous to the wealthy who do not need it, but totally fails the poorer amongst us who should be our main concern.

Ron Bird is a finance and economics academic and former fund manager.

Why are SMSFs holding so much cash?

Jean Bauler

There's a lingering statistic across Australia's legion of 600,000 self-managed superannuation funds.

Collectively, SMSFs have about $890 billion invested into different assets on behalf of roughly 1.1 million people, according to the most recent Australian Tax Office (ATO) quarterly data.

But a more interesting number to look out for in the ATO data is the total amount that SMSFs still have allocated to low-yielding cash and term deposits.

Over the last decade it's been hovering around the $140 billion mark, at times surpassing 20% of total SMSF assets under management.

The pros and cons of cash

Why many SMSF trustees choose to hold large amounts of cash is understandable, to an extent.

There is a common misconception that cash is a risk-free asset. It's not prone to daily market volatility like shares are. It's also liquid – you can generally get your hands on it quickly and easily.

Furthermore, cash savings up to $250,000 per account holder (including SMSF trustees) on deposit with an Australian authorised deposit-taking institution are guaranteed by the Commonwealth in the event the institution fails.

For self-funded retirees using an SMSF, holding cash enables quick withdrawals to fund everyday life in retirement.

Yet, cash does have inherent investment risks. Firstly, a decade of record-low interest rates has meant that cash as an asset class has delivered an average annualised income return of just 1.9% since 2012.

That's lower than any other major asset class. Worse still, after taking high inflation levels into account, real cash returns have been negative for some time.

Bond inflows on the rise

What's startling in the ATO's latest SMSF asset allocation statistics is the low amount of money trustees have invested directly in fixed income debt securities (namely investment grade bonds).

It's only about $10.5 billion in total, less than one-tenth of the amount invested in cash.

While the actual number is probably somewhat higher, considering that it is likely some SMSFs have invested in bonds indirectly via bond exchange-traded funds (ETFs), unlisted bond funds, and diversified funds that hold both equities and bonds, it is still surprisingly low given the superior risk-adjusted returns potentially available from fixed income.

Bonds are securities issued by governments or companies that they use to borrow money, and the investor buying the bond can expect to receive full repayment of their principal if they hold it until maturity as well as steady regular interest payments until then.

As such, bonds are considered a lower-risk type of investment than shares which can't offer any expectations to investors of either full repayment or a steady income stream and which are usually more prone to market volatility.

Likewise, being slightly higher risk than cash, bonds are generally expected to outperform cash over the long term.

What's clear is that a growing number of investors worldwide are liquidating their cash in order to take advantage of higher-returning, relatively low-risk, high-grade bonds, especially government-issued bonds.

That's showing up in a range of other data, including statistics from the Australian Securities Exchange (ASX) covering monthly inflows into ASX-listed ETFs that invest in Australian and international bond issues.

In the latter half of 2022 investment inflows into bond ETFs ($2.2 billion) exceeded the inflows into Australian shares ETFs ($1.6 billion) – that's rare.

What's behind the heavy bond inflows?

There are three major factors underway that have led to the increased, and accelerating, inflows into bond products around the world.

1. Higher interest rates

To counter surging inflation, central banks around the world have rapidly increased official interest rates to quell consumer demand.

As official interest rates rise, so do the yields available to bond investors on new and existing bond issues. That obviously makes bonds more attractive to investors seeking higher steady income streams.

The higher income payments now available from bonds are expected over time to partially (if not fully) offset the bond price declines that occurred in 2022.

In 2023, Vanguard's return expectations for fixed income have significantly increased compared to a year ago.

We forecast global bonds to return 3.9-4.9 per cent and domestic bonds to return 3.7-4.7 per cent over the next decade – a 2 percentage point increase on the 10-year forecasts we made a year ago.

The prospect of higher returns underscores the increased demand for fixed income from investors, and this demand is only expected to grow over the short-to-medium term.

2. Higher capital growth

Bond prices typically move inversely to interest rates, which means that as bond yields have increased, bond prices have fallen.

That's made bonds cheaper to buy on the market than when yields were at ultra-low levels.

Bond investors can expect this to change over time, because once inflation levels fall it's likely that central banks will start to reduce official interest rates.

For bondholders (whether they hold bonds directly or indirectly), lower interest rates will likely ultimately translate to higher bond trading prices, which will likely result in capital appreciation on their investment over time.

This is another key attraction for fixed income investors with a longer-term horizon.

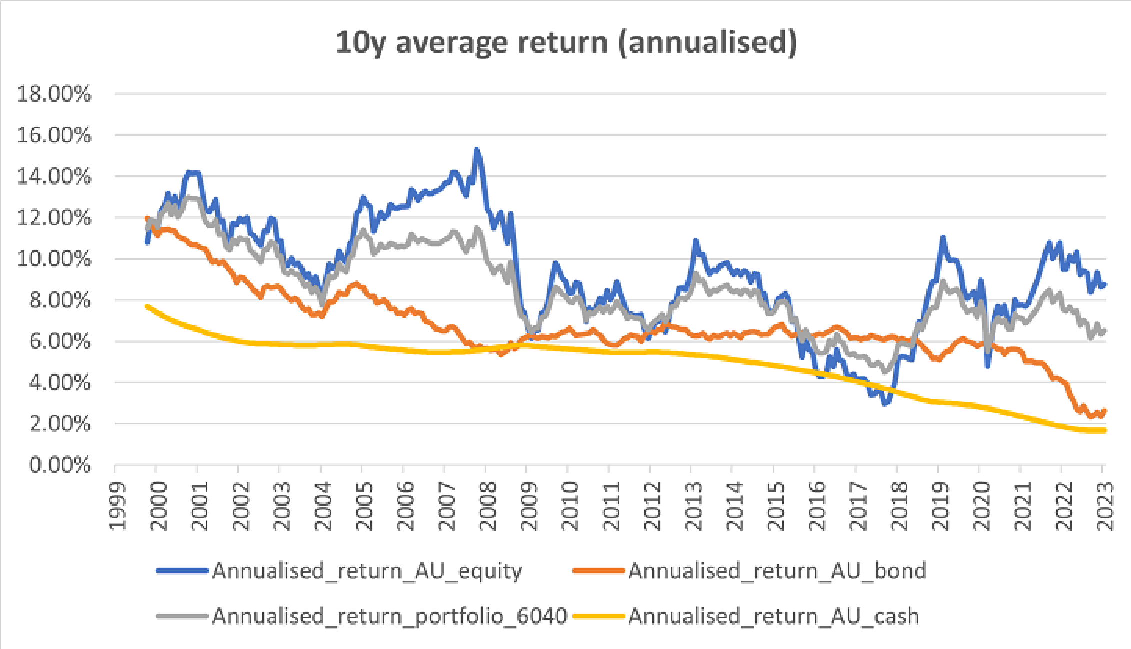
3. Improved portfolio diversification

Lastly, it's important to look at the traditional role of bonds in investment portfolios, which is to provide asset class diversification to help smooth out total investment returns over time.

There are strong diversification benefits to investors who hold both shares and bonds in their portfolios over longer periods.

For example, Vanguard analysis shows the average annualised return from a 60/40 portfolio split between Australian equities and bonds over a 23-year period from 2000 to 2023 has been only slightly lower (around 1%), and with notably lower volatility, than an all-Australian equities portfolio.

Meanwhile, fixed income has consistently outperformed cash.



Source: Vanguard

While bonds do not outperform riskier asset classes such as shares over the long run, they typically have a more stable return profile because they are not prone to the same level of market volatility.

You can see this by comparing the orange line in the chart above (fixed income) to the blue line (equities).

Historical returns across a 23-year period show that bonds can deliver income, capital returns and diversification benefits at a manageable cost to total portfolio returns.

This underscores the worth of well-balanced portfolios, no matter the market conditions.

The key takeaway for investors from this data is that sticking with a diversified asset allocation covering fixed income and equities is a sound long-term investment strategy.

So, expect to see more portfolio rebalancing as investors capitalise on higher interest rates, lower bond prices, and the potential price upside from share markets.

This may see a reduction in the high amount of cash currently being held by SMSF trustees operating through a trust deed that authorises investments in bonds.

Jean Bauler is Head of Fixed Income at Vanguard Asia-Pacific, a sponsor of Firstlinks. This article is for general information purposes only. Vanguard has not taken your objectives, financial situation or needs into account when preparing this article so it may not be applicable to the particular situation you are considering.

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The sheer hypocrisy of different access to super rules

Jon Kalkman

The Government is determined to limit early access to super to help borrowers pay down a mortgage.

It is striking that the consultation paper on this proposal makes little mention of the age pension, even though super and the age pension are closely linked in providing retirement income. Under our retirement system, the family home is exempt from the pension assets test. It means the family home can have any value and it will not reduce the pension.

According to the Retirement Income Review, some 15% of age pensioners live in houses worth more than $1 million, mainly in Sydney and Melbourne. By contrast a person's super balance is an assessable asset and a large super balance significantly reduces the age pension. A homeowner couple with a combined super balance of $1million do not qualify for the age pension.

Moreover, the age pension is heavily biased against non-homeowners. Non-homeowners are allowed to have more assets than homeowners before their pension is reduced, but the income generated by these additional assets plus any Centrelink rent assistance is insufficient to cover today's market rents. Age pensioners who are also renters are at significant risk of poverty in retirement.

The hypocrisy of current rules

One of the changes to super introduced by Treasurer Costello in 2007 gave people access to all their accumulated savings, tax-free, once they reach their preservation age and they meet a condition of release. Many people now use some or all their super to pay down their mortgage as soon as they can access it, tax-free after age 60. The reason is quite rational. It will minimise or eliminate the debt on their family home in retirement, while also maximising their age pension on reaching pension age.

Some see this as double-dipping; enjoying the tax concessions of super and enjoying the taxpayer benefits of the age pension as well. But if the purpose of super is to encourage dignity in retirement, this strategy saves many pensioners from poverty in their later years. This behaviour is now so entrenched, that many people enter retirement with higher debt levels than previously in the expectation they can access a tax-free lump sum from their super savings after age 60.

Therefore, to deny people access to lump sum withdrawals from their super in retirement would upset the plans of many people and the government should expect a significant political reaction.

The current proposal foreshadows a prohibition on allowing young people early access to their super to reduce or eliminate their mortgage. The reason is that early access will significantly reduce their super balance at retirement and make their dependence on the age pension more likely.

It is the height of hypocrisy for a set of rules that allows retirees to legitimately use their super to reduce their mortgage after age 60 and simultaneously increase their dependence on the age pension on retirement but denies young people early access to their super to reduce or eliminate their mortgage on the grounds that they will have with a lower super balance at retirement thereby increasing their dependence on the age pension. Whenever super is accessed to reduce the mortgage, surely the outcome is the same; there is less super available to provide income in retirement.

Moreover, if younger people are denied early access to their super to reduce their mortgage earlier, they pay more interest on that mortgage for longer while they wait to get access to their super. It also means that the industry funds collect more fees for longer while that money is retained within the fund. Some suspect that this is the real motive for this proposal.

The mathematics of compounding are clear: early access to super will certainly reduce the final super balance, but the point often overlooked in this discussion is that young people have time on their side. At their age they are able to "catch up" by making additional contributions later in life when there is more discretionary cash available. By contrast, people who reduce their mortgage only when super is available tax-free after age 60 are seldom able to make extra contributions.

How policy has evolved

Before 1992, when a person changed jobs, their super was paid out in full. That payout allowed families to put a larger deposit on a house and it often meant they were also able to pay it off sooner. From a housing perspective, early access to super was very positive. However, it meant starting a new job with little or no super, and without those earlier contributions and subsequent compounding of investment earnings they would have had to save really hard to make up the difference. It's not called salary sacrifice for nothing.

The critical element at that time, however, was that were higher limits on concessional (before-tax) contributions. Employees over the age of 50 were able to salary sacrifice $100,000 per year. With more discretionary money available, that period when the kids have left home and the mortgage is greatly reduced, is a great opportunity to build super balances.

After super became compulsory in 1992 for all workers, the budgetary impact of super tax concessions increased dramatically, but the expected reduction in the cost of the age pension has taken much longer. One reason is that people can access their super tax-free many years before their super balance is assessed for the age pension. Another reason is that a home-owner couple, can have $419,000 in super and still receive the full age pension.

The tax receipts flowing from super increased significantly from 2017, when members with large super balances were forced to move the money in excess of the TBC from a tax-free pension fund to an accumulation fund paying 15% tax on income.

To limit the total cost of super tax concessions, however, the main strategy employed by successive governments has been to severely restrict contributions and increase the tax on contributions for high income earners. Perversely, the impact of these limitations on contributions has been to severely limit the size of the super balance that present day workers can now accumulate.

In other words, to limit the tax concessions flowing to large super balances in retirement, the government has severely limited the capacity of younger people to achieve financial independence. Successive governments have attacked the problem of excess tax concessions from the wrong end. The intention is clearly to prevent present workers from accumulating large balances, but it has also removed incentives for young people to save through super and it has had absolutely no impact on these existing large super balances in retirement. It is inequitable and leads to intergenerational envy.

At present, a couple who owns their own home with more than $935,000 in super, which is mostly their own savings, is independent of the age pension and save the taxpayer $40,000 per year for possibly 30 years. Any rational approach for the government would be to encourage people to contribute more rather than less to their super to reduce the cost of the age pension. And yet the trend since 2007 has been to restrict both concessional and non-concessional contributions.

Young people deserve the option of accessing super early

Super is a long-term project and it makes more sense to people if these forced savings are available to them as their needs change through their life cycle. Younger people should have the option to draw on their super balance, within limits, to assist with their housing needs to provide financial assistance at the time in their lives when they need it most.

People typically begin to concentrate on their retirement plans in their 50's when they have discretionary resources and their kids and careers are relatively settled. That is why the current contribution caps should be relaxed especially for people over the age of 50 to allow them to make catch-up contributions.

By adopting a life-cycle approach to super savings, workers could have the best of both worlds.

Firstly, super could be used to help young people become homeowners and mortgage-free much sooner.

Secondly, relaxed contribution caps could help older people to gain financial independence in retirement with accelerated savings when they have the financial resources to save for their retirement and save the taxpayer the cost of the age pension. That really would be a dignified retirement.

Jon Kalkman is a former Director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor. This article is based on an understanding of the rules at the time of writing.

Finding your investment niche

James Gruber

Comedians are a foul-mouthed bunch though their humour can bring nuggets of wisdom. In his latest Netflix series, Australian-born, US-based Jim Jefferies, recalls a recent trip back to his homeland.

*"I just got back from touring Australia; the whole place was flooded. Remember three years ago, the whole place was on *** fire. Remember that, just before Covid, all of Australia was on fire, and we're all like, "The world can't get any worse than this".*

People died. People lost their homes. But the only thing reported in North America about the fires was … the koalas, yes. You all seemed very concerned about the koalas…

The koala is the laziest animal on earth. It sleeps for 22 hours a day. The sloth sleeps for 21.

*It only eats eucalyptus leaves. Eucalyptus leaves are its source of food and water. There is a chemical in eucalyptus that reacts the same way to them that THC reacts to us. So, they're stoned all *** day."*

Source: Netflix

In his off-beat way, Jefferies highlights that the koala is not only an adorable animal but a highly specialized one. It's found a way to survive over thousands of years by finding a niche: only feeding on the leaves of eucalyptus trees. It's restricted to areas that have eucalyptus trees i.e., certain parts of Australia. And some koalas specialize even further by only eating leaves from one or two specific trees.

Eucalyptus leaves are poisonous to most animals and humans. Consequently, koalas have little competition when it comes to living off these leaves. The downside is that the eucalyptus leaves have limited nutritional value. That's why koalas have little energy and sleep so much.

Most other animals also find a niche – a method of behaving and competing for survival. They usually select one for which they're best adapted. If they compete for the same niche with other species, then they risk limited resources running out. That's how species become extinct.

Today, we're going to talk about biological niches, how they may apply to markets, and how understanding them can help you become a better investor.

Ecological niches

In ecology, there are two types of niches: general and specialist. Classifying a species as a generalist or a specialist is a way to identify what kinds of food and habitat resources it relies on to survive. Generalists can eat a variety of foods and thrive in a range of habitats, while specialists have a limited diet and stricter habitat requirements.

Koalas are specialists. Another example of a specialist is the Canada lynx (pictured below). Unlike koalas, the lynx is a carnivore. It preys on snowshoe hare that are mainly found in forested, mountainous areas. The lynx has adapted to hunt in deep, soft snow.


Source: National Geographic

Raccoons are an example of a generalist species. Raccoons can live in a diverse range of environments. They live in large cities, mountains, and forests throughout North America. And they can eat a variety of foods – everything from eggs, to nuts and fruit, and even insects, frogs, and human garbage.

Niches aren't just confined to the animal world; they're also found in plants. Some plants need a narrow range of rain, soil conditions and temperatures to survive, while others don't. For example, a cactus is a specialist species as it will die if it gets too much water or if it spends time during winters at high altitudes.

There are pros and cons to being specialist and generalist organisms. Specialists have more clearly defined niches and encounter less competition from other species. But when environmental conditions change, they can struggle to survive if they don't adapt quickly.

Generalists have more competition from other species and therefore less resources to source. Yet, they are more adaptable to changes in the environment than specialists. This has been particularly advantageous with the acceleration of climate change in recent years.

The ideal business

This distinction between generalists and specialists can be applied to the business world. Some businesses thrive by being highly specialized and operating in an environment with little competition. Former investment newsletter writer, Richard Russell, once told a story of such a business:

"I once asked a friend, a prominent New York corporate lawyer, "Dave, in all your years of experience, what was the single best business you've ever come across?" Without hesitation, Dave answered, "I have a client whose sole business is manufacturing a chemical that is critical in making synthetic rubber. This chemical is used in very small quantities in rubber manufacturing, but it is absolutely essential and can be used in only super-refined form.

My client is the only one who manufactures this chemical. He therefore owns a virtual monopoly since this chemical is extremely difficult to manufacture and not enough of it is used to warrant another company competing with him. Furthermore, since the rubber companies need only small quantities of this chemical, they don't particularly care what they pay for it — as long as it meets their very demanding specifications. My client is a millionaire many times over, and his business is the best I've ever come across." I was fascinated by the lawyer's story, and I never forgot it."

This business has, in Morningstar's parlance, an economic moat, or sustainable competitive advantage. Because of the moat, it presumably generates a high return on capital.

Specialist businesses can be highly profitable. Though like in the ecological world, changes in the environment can prove their undoing. For instance, the business above could have a competitor move in with the production of a similar chemical. Or synthetic rubber may go out of fashion in favour of a superior product. In these cases, the business would have to adapt or die.

Other businesses are generalists rather than specialists. Think of large conglomerates like Wesfarmers. Or the big four banks. Or for that matter, giant resource companies such as BHP and Rio Tinto.

All these companies operate across multiple segments. If one segment doesn't have a bright future, they can invest in another one that may provide a better return on capital.

Yet, because they're generalists, they compete against many other companies. And this competition brings lower returns as the products are largely commoditized.

Investment niches

Niches are also present in the investment world. Generalists include multi-asset funds, most Australian equity funds, and macro funds. In the case of multi-asset and macro funds, they trade across a broad range of asset classes. If one asset class isn't doing well, they can invest in an alternative class.

Most Australian equity funds are generalists. They trade the whole, or large parts, of the market. For instance, if they take a dim view of banks, they can switch into commodities or industrials.

All these funds are highly adaptable. But they compete against many other funds and ETFs which are trading the same stocks.

Then there are specialist investors. Think of micro-cap funds, arbitrage funds, specialist property funds, and a host of others. These investors focus on a small segment of the market, where the competition is less crowded. They hope that gives them a sustainable edge.

Specialised investing can be difficult. Consider value funds since the GFC. Value focuses on buying stocks cheaply. This style of investing has been out of vogue for 15 years, while so-called growth investing has thrived. It's been almost impossible for value funds to keep up with their benchmarks and many have shut down because of this.

What can the average investor learn from this?

As an individual investor, you need to decide whether you want to be a generalist or a specialist. That decision entails knowing yourself and what you might be good at. It also entails how much time you can devote to investing.

Being a generalist is a lot of work as it requires being across the whole market and all its businesses. For the average investor, that requires too much time.

There is the option of outsourcing your investing to a generalist fund or an ETF which covers the broader market.

If you choose to invest yourself, then it's easier focusing on one or two segments of the market. One idea is to devote your time to an industry where you have some background knowledge. If your background is in insurance, perhaps you should focus on insurance companies and brokers. Or if you've had experience in retail, the retail sector would be a great area to apply your knowledge. Or if you have owned businesses in the past but don't want to compete against the big institutional funds, then companies with market capitalisations under $50 million may be a happy hunting ground.

Investing in what you know can give you an edge over the competition, as Peter Lynch outlined in his famous 1989 book, *One up on Wall Street*.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

How the global renewables arms race will benefit Australia

Brad Potter

The recently passed Inflation Reduction Act (IRA) is poised to have a significant impact on the US economy, especially in the renewable energy sector. The Act includes provisions that incentivise the growth of the renewables sector, creating a "supercycle" of investment and development. Australia is well placed given our close relationship with the US and our resources of critical minerals vital for decarbonisation.

So, what is the Inflation Reduction Act?

The IRA was enacted into law in August. It is one of three pieces of legislation that has been passed since 2021 with the goal of enhancing economic competitiveness, innovation, and industrial productivity. The IRA aligns with the priorities of the Bipartisan Infrastructure Law (BIL) and the CHIPS and Science Act, resulting in the introduction of US$2 trillion in new federal spending over the next decade.

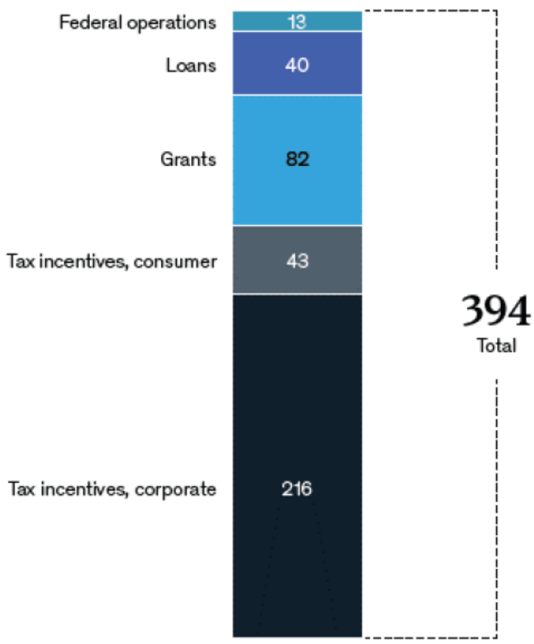
The IRA encourages investment in renewable energy, enhances energy efficiencies, and helps companies tackle climate change via tax credits, incentives, and various additional provisions. The pathway to decarbonisation is expected to be enhanced since the IRA will increase demand for electric vehicles (EVs), clean technologies, and low carbon materials/construction.

The IRA allocates approximately US$394 billion in federal funding towards clean energy, with the primary objective of reducing the nation's carbon emissions by the end of the decade. This is primarily accomplished through a combination of tax incentives, grants, and loan guarantees (see Figure 1).

The majority of the $394 billion in energy and climate funding is dispensed in the form of tax credits. Corporations are the largest beneficiary, receiving an estimated $216 billion worth of tax credits. This funding mechanism is aimed at increasing investment in clean energy, transport, and manufacturing in the US.

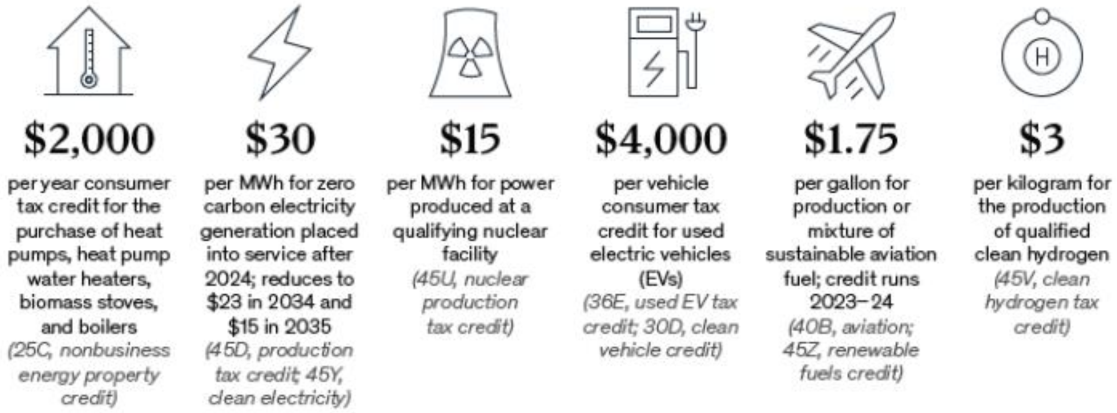
Consumers can take advantage of roughly $43 billion of these tax credits by investing in EVs, energy-efficient appliances, rooftop solar panels, geothermal heating, and home batteries (see Figure 2).

Figure 1: Funding the Inflation Reduction Act (US$b)



Source: McKinsey & Company

Figure 2: Selected tax credit modifications in the IRA



Source: McKinsey & Company

Many of the tax incentives offered by the IRA come with conditions related to domestic production or procurement. For instance, to receive the full EV consumer credit, a certain percentage of the critical minerals in the vehicle's battery must either be recycled in the US or sourced from a country with a free-trade agreement with the US. The battery must also have been manufactured or assembled in the US.

Europe powers up in response to IRA clean energy push

The European Green Deal established in December 2019 was set up to make Europe the first climate-neutral continent by 2050. The goal of reducing net greenhouse emissions by at least 55% by 2030, compared to 1990 levels, is a bold target. The REPowerEU Plan was launched in response to the Russian invasion of Ukraine, with the purpose of hastening the transition away from fossil fuels and mitigating the economic effects of rising natural gas and electricity prices.

As anticipated, the European Union (EU) has raised concerns that the US IRA will lure investment in crucial green economy manufacturing away from EU-based companies. In response, the European Commission (EC) has introduced a new "Green Deal Industrial Plan" aimed at fostering an environment that attracts net-zero investments by supporting EU manufacturing of green technologies and products. This plan explicitly mentions photovoltaic cells, heat pumps, wind turbines, hydrogen electrolysers, batteries, and carbon capture.

Despite its grand ambitions, the Green Deal Industrial Plan has yet to be fully fleshed out, as limited additional funding has been proposed at this stage and the plan has not yet been discussed by the member states. The plan is built around four key elements: (i) a simplified regulatory framework, (ii) better access to funding, (iii) upskilling, and (iv) open trade to strengthen supply chains. At present, the EC's primary proposal is to loosen its stringent state aid constraints until 2025, allowing member states to match incentives from other countries (eg. USA). The expectation is that further incentives and improvements to the plan will emerge with negotiations and discussions with the member states.

Supply chains will shift

Car makers in the US will need to eventually eliminate China from their supply chains. POSCO Chemicals and Samsung SDI recently signed a 10-year cathode supply deal, showcasing the shift towards supply chain re-organisation. Value chains will migrate toward the US or nations with trade agreements in place (e.g. Australia and South Korea).

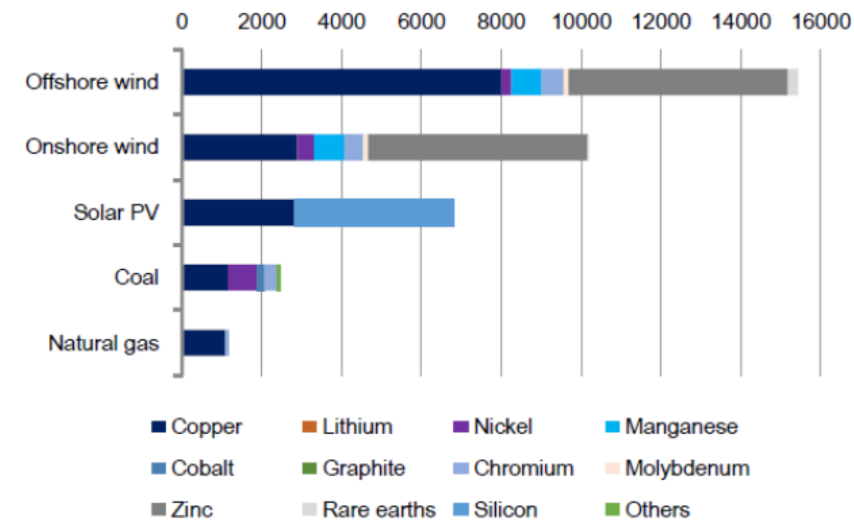
Since the passage of the IRA, several clean ammonia projects have been announced, nearly all located on the US Gulf Coast. The attractive IRA tax credits for hydrogen are driving the growth in ammonia production. For example, Linde has committed US$1.8 billion to supply clean hydrogen to OCI NV's greenfield blue ammonia project in Texas. This is an example of two non-US companies taking advantage of the IRA by developing projects in the US.

Ford will invest US$3.5 billion in an EV battery plant in Michigan with technology support from CATL, the world's largest EV battery manufacturer. The factory is due to open in 2026 and will produce enough batteries for 400,000 EVs a year.

Low carbon technology is mineral intensive

Low carbon technologies and enabling infrastructure are significantly more mineral intensive compared to traditional fossil fuel technologies. For instance, an onshore wind plant requires nine times more mineral resources than a gas fired power plant (see Figure 3), while an EV requires six times the mineral inputs of a conventional car (see Figure 4) according to the International Energy Agency (IEA). Both the IEA and World Bank warn that current mineral supplies and investment plans fall far short of what is required for these technologies to reach their full potential.

Figure 3: The mineral intensity of low carbon energy (kg)



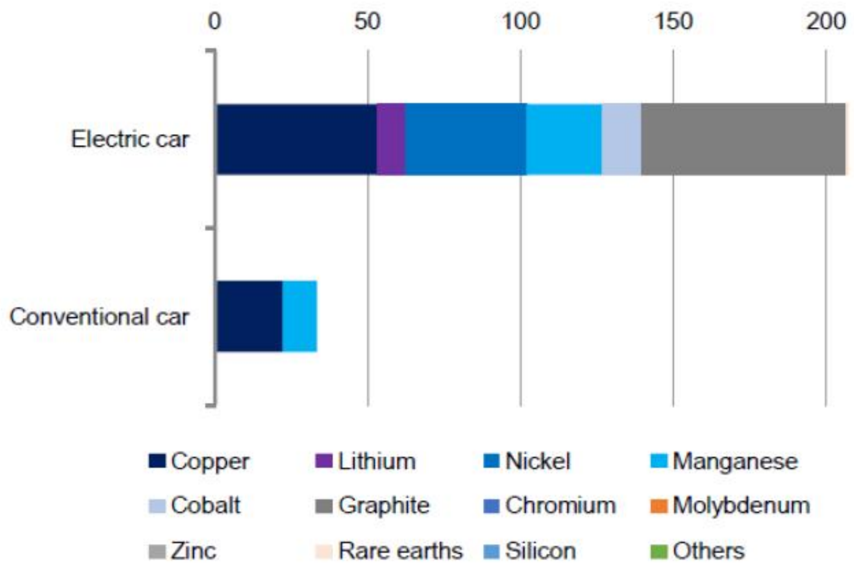
Source: IEA, Credit Suisse

Implications for Australia

The current trend sees nations competing to secure supplies of critical minerals required for global decarbonisation. In many ways, it is starting to resemble a global renewables trade war that will be fought both technology and supplies of critical minerals.

It is obvious that China will react to the IRA and Europe's Green Deal. China has been strategically acquiring supplies of critical minerals through investments in Australia and Africa, as they are the largest manufacturer of wind, solar, and batteries.

Figure 4: The mineral intensity of low carbon transport (kg)



Source: IEA, Credit Suisse

As we mentioned in a recent article, an instance of a nation's efforts to secure the development of critical minerals can be seen in the Australian Federal government granting a non-recourse loan of $1,250m to Iluka Resources to develop the Eneabba Rare Earths Refinery in West Australia. The funding is from the Commonwealth Government's $2b critical minerals facility. Additionally, lithium-boron producer Ioneer has been one of the early beneficiaries of the IRA, with the US Dept of Energy (DOE) offering a conditional US$700m loan for approximately 10 years to develop its Rhyolite Ridge project in Nevada.

Australia is in a pivotal position given it has a free trade agreement with the USA and is also rich in resources of critical minerals. The IRA – and perhaps eventually the new Green Deal in Europe – support our view that we are entering into a renewables supercycle that will keep the prices of critical minerals elevated for many years to come.

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Reshoring supply chains: What does it mean for investors?

Matt Reynolds

Of all the lessons learned during the pandemic — wash your hands thoroughly, avoid crowded lifts, working from home can be productive — perhaps the most consequential lesson for companies is now obvious in hindsight: relying on single links in the global supply chain was a mistake.

Major components of the supply chain fractured during the COVID-19 crisis, resulting in shortages of everything from medical supplies and equipment to furniture and auto parts. Geopolitical events also entered the fray as US-China tensions and Russia's invasion of Ukraine underscored the risks of relying too much on one place for critical supplies, including energy, food, and computer chips.

As my colleague Julian Abdey recently noted:

> *"With the rapid spread of globalisation over the past few decades, companies moved their manufacturing operations to the cheapest and most efficient countries. That was great for company profits and consumer prices. But what we found out more recently is that when supply chains get disrupted it can cause real problems. For example, Europe has realised it was too dependent on Russia for natural gas. And I think the same is true for other products like computer chips. The world is too dependent on Asia, and Taiwan in particular, for semiconductors*."

Reshoring replaces offshoring

Fast forward to 2023, and many companies — in some cases spurred by massive government subsidies — are taking big steps to diversify their supply chains, focusing on reliability and robustness over cost and efficiency. That means bringing some manufacturing back home, or "reshoring" and moving some of it to other countries.

The trend has raised questions about whether the world is moving into a period of de-globalisation. However, based on trade activity in recent years, the new path looks more like a measured adjustment to global supply chains, partially interrupted by the pandemic and the 2007–2009 financial crisis.

Globalisation marches on — at a different pace

Sources: Capital Group, Organisation for Economic Co-operation and Development (OECD), World Bank. World trade is calculated as the sum of exports and imports of goods and services and is represented above as a share of global gross domestic product. Trade data as of 2021.

Rob Lovelace, Portfolio Manager at Capital Group says:

> *"When we talk to companies and look at the data, we are not seeing what I would call de-globalisation. I think it would be more accurate to call it a rewiring of global supply chains. And I don't think it's really*

all that dramatic when you consider the rapid growth of digital trade, which is harder to track using traditional metrics, as opposed to physical trade."

In fact, there is ample evidence that many companies are becoming more global as they seek to create redundant supply chains. The poster child for this development is Taiwan Semiconductor Manufacturing Company or TSMC, the world's largest semiconductor foundry. To expand its global reach, TSMC is building new manufacturing plants in Arizona and Japan. Semiconductors have become such a sensitive issue, given their use in the defense industry, that the US government has placed aggressive restrictions on where and how they can be exported.

Other examples abound in the tech sector and elsewhere. Apple announced in September that it would start producing the iPhone 14 in India, adding to its manufacturing capabilities in China, the Czech Republic and South Korea among others. In the auto sector, Tesla added to its US and China manufacturing hubs last year by opening its first European outpost in Gruenheide, Germany.

In the energy sector, Texas-based ECV Holdings has announced plans to build a power plant for industrial parks near Ho Chi Minh City, Vietnam, supplied primarily by US liquified natural gas. Meanwhile, the list of US companies establishing new manufacturing plants at home has grown dramatically in recent years to include General Motors, Intel and US Steel — fueling hopes of an American industrial renaissance.

The China+1 strategy

Amid this drive to diversify supply chains, a common misconception is that China may be displaced as the world's largest manufacturing base. As my Capital Group Portfolio Manager colleague Winnie Kwan has observed, many companies are shifting to a "China+1 strategy" by maintaining operations in China while adding new facilities elsewhere. Incremental investments in China are likely to focus on serving mainly the domestic market, while additional investments in other locations cater to the rest of the world.

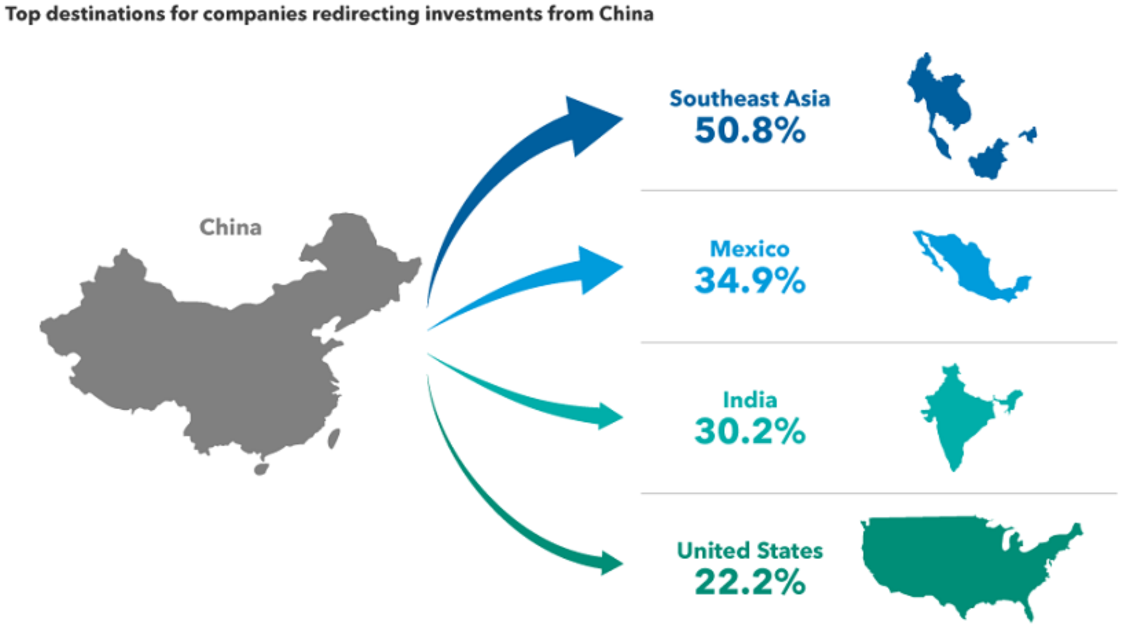
> *"A key question is whether the China+1 strategy will be scalable or not. Can you add a new plant in India or Mexico, for example, and scale up production as needed? Is the labour and power supply sufficient? Is logistics infrastructure in place? Can management handle the added complexity? Those are the questions I am focusing on as we research these developments and look for investment opportunities. Not every company is going to get it right"* she says.

Indeed, the flow of incremental investments is an important metric for investors to track. According to a 2021 survey of foreign companies doing business in China conducted by AmCham Shanghai, the top destinations for redirected investments were Southeast Asia, Mexico, India, and the United States. However, only 63 of the 338 companies surveyed said they had such plans, which suggests the process of reshoring may be slower and more deliberate than some market participants are expecting. Winnie observed that:

> *"It could take a decade for companies to fully transition. But the process has certainly started, and I think it will be one of the more important investment themes of the 2020s."*

Based on a survey of 338 foreign companies doing business in China. Of those companies, 63 said they were redirecting investments from China to other locations, including Southeast Asia, Mexico, India and the United States, among others.

Southeast Asia is well positioned for the rewiring of global supply chains



Source: AmCham Shanghai 2021 China Business Report, published September 22, 2021.

Who benefits from reshoring?

With such a large undertaking, the investment implications are widespread across a number of sectors and geographies. Here are four areas expected to benefit from reshoring in the years ahead.

1. India Thanks to its proximity to China, a well-educated labour force, and a fast-growing, business-friendly economy, India may be the best-positioned country to capitalise on supply chain diversification. India's government has taken bold steps to encourage the expansion of manufacturing operations, particularly in the smartphone space, where Apple works with contractors such as Foxconn to build the latest iPhones. The manufacturing sector is expected to accelerate over the next decade, driving growth in the Indian economy and boosting other industries such as banking, energy, and telecommunications.

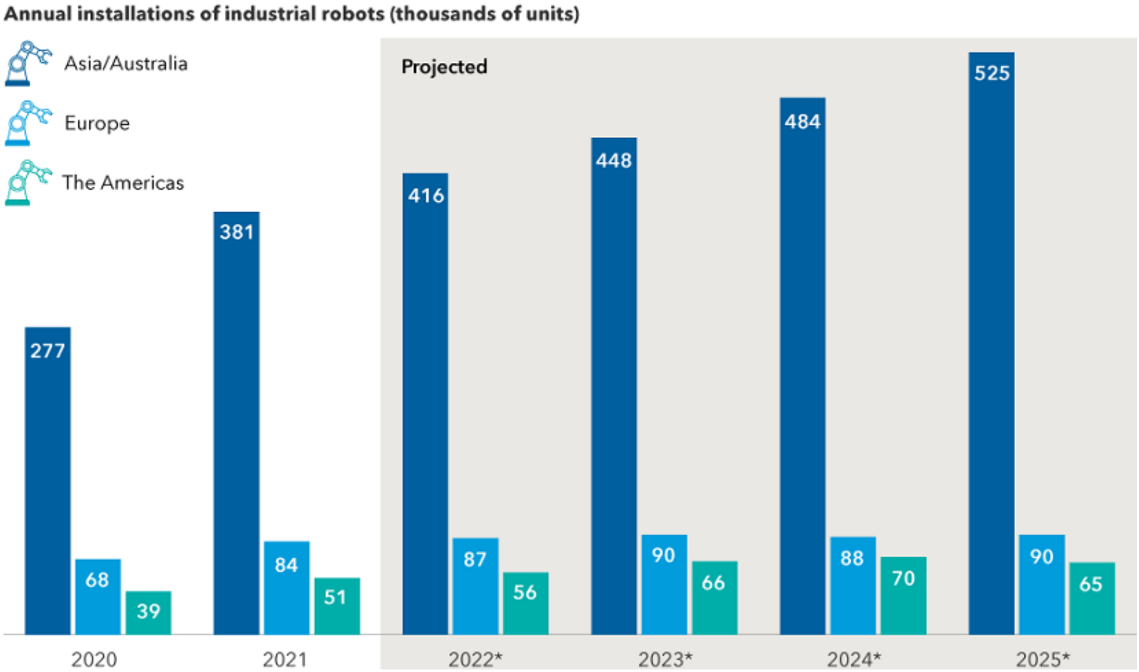
2. Mexico Similar to India, Mexico's proximity to one of the world's largest economies makes it an attractive base for expanded manufacturing and logistics operations. Many US companies flocked there in the 1990s after the adoption of the North American Free Trade Agreement (NAFTA). That process has only accelerated under a revamped trade deal, the US/Mexico/Canada Agreement (USMCA), ratified in 2020.

Mexico's annual exports to the US have increased sharply in recent years. Although much of that is due to the influence of American companies, China is also ramping up in Mexico. For example, Hisense Group, one of China's largest appliance makers, is currently building a $260 million industrial park in Monterrey, aiming to produce refrigerators, washing machines and air conditioners for the US market. In the auto sector, BMW and Nissan have also recently expanded their capabilities south of the border.

3. Automation providers One of the biggest hurdles to diversifying the world's manufacturing capabilities is a chronic labour shortage, especially in developed economies. Automation powered by artificial intelligence (AI) is likely to provide an answer to this problem, says my colleague, portfolio manager Mark Casey. He believes many Asian countries are setting the trend with high rates of industrial automation, with the US and Europe expected to follow. Both regions have room to grow, proving a bright outlook for top companies in the global robotics industry, including Japan's Keyence, France's Schneider Electric and Switzerland's ABB Ltd. Amazon is also developing its own impressive AI-driven technology.

"Amazon has a new robotic picking-and-packing device called Sparrow that can grab more than 60 million different products and pack them into shipping boxes — completing each pick in a matter of seconds. Just seven years ago Amazon's experimental robots could handle only a small number of items, and each pick would take a couple minutes. I think this sort of technology is coming along sooner than we think, and I don't see it accounted for in the stock prices of any major American or European company" Mark recently noted.

Automation, powered by smart robots, is ready for take-off



Sources: Capital Group, International Federation of Robotics. As of 2022.

4. Multinationals Capital Group portfolio manager Jody Jonsson recently noted that:

"Although it may seem counterintuitive, the same multinational companies that benefited most from the rapid pace of globalisation in the past may be best equipped to navigate the brave new world of re-globalisation. The world's largest and most dominant companies rose to that position for a reason — they often have the experience and resources to adapt to changing trade patterns better than smaller companies operating in single markets."

In Jody's view, well-managed multinational companies will remain global in their production facilities and customer bases, but they will increasingly build more local redundancy into their operations. She calls it 'multi-localisation.' That includes bringing some parts of the supply chain back to the US, continuing to outsource other parts and establishing new production facilities in key areas throughout the world. As Jody observed:

"If there is one lesson we've learned from the COVID crisis, it's that companies must have diverse supply chains. We aren't there yet, but the process is well underway."

Matt Reynolds is an Investment Director for Capital Group Australia, a sponsor of Firstlinks. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

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