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Editorial

When I started working in global capital markets at **CBA** in the early 1980s, my first Eurobond issue was arranged by **Credit Suisse First Boston (CSFB)**. It was the bluest of bluechip names, among the most prestigious of investment banks. When we visited London, CSFB hosted dinner in a castle and brought out Lord and Lady Suchandsuch to regale guests with stories of royalty and courts in an extravagant meal finished with 50-year-old cognac. I was 25-years-old and rapidly learning how top society lived and worked.

Then CBA generously seconded me to **Swiss Bank Corporation (SBC)** to learn more about capital markets and my wife and I lived in Basle for six months. It was an incredible work environment of wood-panelled walls and floor-to-ceiling bookcases, lawyers sitting in dark offices dominated by massive partners' desks, and Bircher muesli each morning.

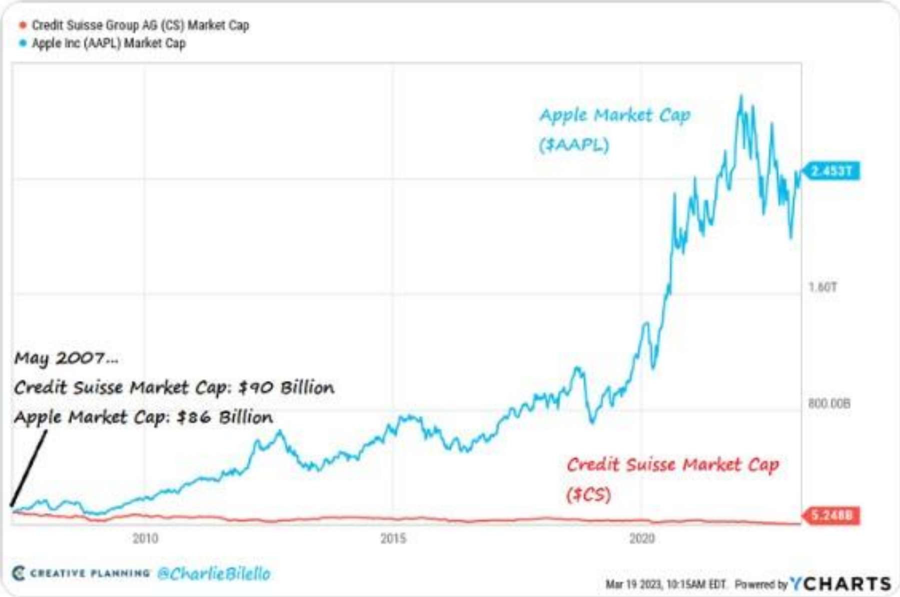
The Head of CBA Treasury, **Campbell Ker**, came over to Europe for a transaction roadshow, and we travelled around Switzerland and Luxembourg, six meetings a day, including an unforgettable flight on a small plane which banked around the snow-capped peak of the **Matterhorn**, so close I felt I could touch it. I still feel goosebumps thinking about it. We visited the offices of Swiss private banks hidden inside stark grey stone buildings, some of them looking like the archetypal **Gnomes of Zurich**. It was a time when the Swiss held the private wealth of the rich (and the Belgian dentists) protected by strict secrecy laws.

While I was there, SBC led CBA in the largest Australian dollar Eurobond issue ever, stuffing the bearer bonds (what tax?) into the portfolios of thousands of uber-wealthy clients and collecting generous fees along the way. It was civilised and efficient and Swiss-like, managing money as it passed from generation to generation among the elite.

Shortly after, I became Head of New Issues and it was the most wonderful job I ever had (looking back 40 years later). For someone who had only known motels and the back of a plane, the first- and business-class travel and luxury hotels soon became familiar. We raised billions of dollars of cheap, long-term debt all over the world, and Credit Suisse and Swiss Bank and **UBS** competed for our business. They were rivals for the funds management and investment banking needs of the world's borrowers and investors and it was unthinkable that they would all merge and remove the competition that banking needs.

But in 1998, SBC merged with UBS to create a powerhouse, the largest bank in Europe and the second-largest in the world with more funds under management than any global competitor. The merger was designed to cut costs and improve profits following a failure to adapt to rapidly-increasing competition.

And now, this greatest of banking nations with the world's once-most prestigious names looks like a banana republic. The Swiss Financial Market Supervisory Authority, **FINMA**, has cobbled together a deal to combine all these banks after a mad panic of a weekend. Credit Suisse has been struggling for years but it still employs about 50,000 staff. The bankers who I worked with in musty and dusty offices in Basle must be shaking their heads in disbelief.



Prior to the GFC, when banking was a more reliable business and markets were riding high, many sensible investors would have preferred exposure to the great Credit Suisse than a technology company such as, say, **Apple**. In May 2007 when the first iPhone was released, Credit Suisse had a larger market value than Apple but US$90 billion of Swiss pride has been destroyed.

And now UBS has paid only US$3 billion for Credit Suisse, which was a sudden loss of value since last Friday when the market cap was around US$8 billion. The bargaining strength of UBS left Swiss authorities desperate to pull together the deal before Monday's open, but the biggest shock in the terms was the complete write down in the value of US$17 billion of Credit Suisse hybrids. If FINMA wanted to settle the markets, this had the opposite impact, sending shockwaves through bond houses and other bank regulators as the Swiss spread the crisis to US$275 billion of global perpetual bonds.

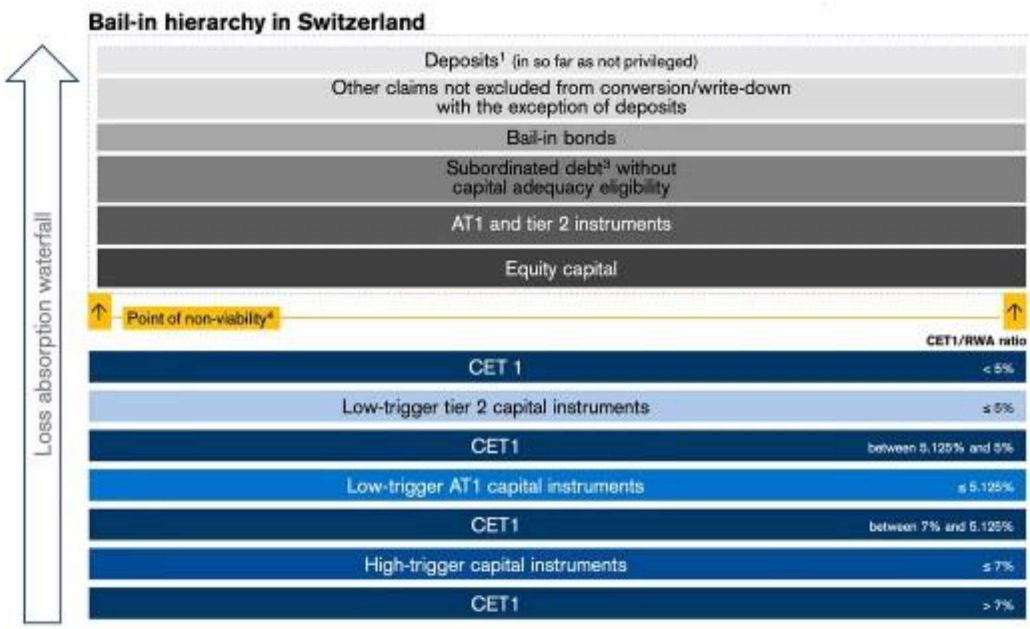
FINMA overturned a general understanding of the hierarchy in bank capital structures. Hybrids or Contingent Convertibles (CoCos) - the Additional Tier (AT1) bonds - were supposedly another buffer above ordinary capital (shareholders) to absorb losses and protect senior bond holders. But critically, markets understood that shareholders ranked last in a crisis and AT1 holders were protected by ordinary equity.

FINMA will argue that AT1 bondholders did not properly read the offer documents. It was easier to assume the Swiss AT1s are the same as any bank preferred shares, but the Swiss bonds had a sting in the tale. The documents say (CSG is Credit Suisse Group):

> *"Furthermore, any Write-down will be irrevocable and, upon the occurrence of a Write-down, Holders will not receive any shares or other participation rights in CSG or be entitled to any other participation in the upside potential of any equity or debt securities issued by CSG or any other member of the Group ... The Write-down may occur even if existing preference shares, participation certificates and ordinary shares of CSG remain outstanding."*

Plenty of bond managers are sweating this week. They need to explain how they misunderstood this, as the meaning seems clear. It says the write-down in AT1 will occur even if ordinary shares of Credit Suisse remain outstanding. The bonds effectively rank behind common stock.

Courtesy of **John Hempton**, here is the Swiss bank capital structure, unlike anything I have seen in 40 years in the business. As John says, it clearly shows 'common equity capital' (CET1) ranks above the 'low-trigger' AT1 capital instruments in the loss absorption waterfall.



This ability of the Swiss regulators to 'bail-in' the AT1 bonds came at the point of non-viability. Credit Suisse did not fail by becoming insolvent due to bad loans but it was facing a liquidity crisis following withdrawal of deposits. As recently as 31 December 2022, its net tangible assets were US$45 billion. Once the Government stepped in to provide support (US$100 billion of liquidity, US$27 billion for write-downs, billions for losses, litigation and legals), the authorities argue they were required to mark down the hybrids to zero. In contrast, shareholders will receive US$3.25 billion in equity in UBS. Class actions and furious legal teams representing bondholders are challenging the decision.

Regulators from other countries are assuring markets that the Swiss rules do not apply widely. For example, the **Bank of England** issued a clarification:

> *"AT1 instruments rank ahead of CET1 and behind T2 in the hierarchy. Holders of such instruments should expect to be exposed to losses in resolution or insolvency in the order of their positions in this hierarchy."*

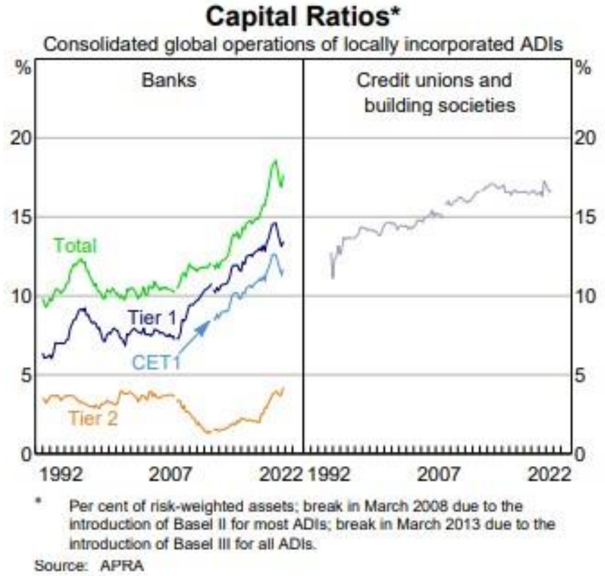
Over the last couple of days, AT1 prices have rebounded as some level of confidence returns. For example, the ASX-listed **VanEck Bentham Global Capital Securities Fund** (ASX:GCAP) fell from $9 at the end of last week to a low of $7 on Tuesday and closed above $8 on Wednesday.

Investors considering the opportunity to buy into the turmoil don't know whether the financial system will face further problems. Liquidity levels at Credit Suisse looked high but no bank can withstand a massive loss of depositor support without government intervention. Banking is all about trust and this was a classic loss of confidence. Any investor jumping in should confine activity to the big Australian banks.

Why is Australia different? The first major point is the quality of our banks, which are making healthy profits, unlike Credit Suisse. Our hybrids documentation is also materially different. Whereas the Swiss can write off the hybrids in an intervention, it is common here for the documentation to say:

> *"XYZ Bank must convert these notes (to shares) if the common equity capital ratio of the XYZ Bank as prescribed by APRA falls to or below 5.125% or if a non-viability event occurs."*

While there are variations in the documentation for Australian issuers, there are no known circumstances where hybrids would be subordinated to common equity. In the absence of an extreme black swan event, the hybrid should be converted to shares in the bank in a crisis. And here are the latest capital ratios for Australian banks provided by the [Reserve Bank]() and APRA, showing how much work has been done raising capital since the GFC.



One consequence of greater uncertainty is the impact on the Reserve Bank's plans to control inflation. The futures market for cash is now a full 1% lower at the end of the year than it was a few months ago. The 10-year bond rate is down to about 3.2%. Cash is currently 3.6%, futures is about 3.2% by August and not long ago it was at 4.2%. Then to 3% a year later, although this week's Reserve Bank Board minutes suggest optimism is a little early for embattled borrowers.

> *"Members observed that further tightening of monetary policy would likely be required to ensure that inflation returns to target and that the current period of high inflation is only temporary ... Members noted that the staff's most recent forecasts were for inflation to return to the 2–3 per cent target only by mid-2025, and this was on the assumption that the cash rate is increased a little further"*

Market rates fell due to the follwoing sentence, and economists are increasingly on the side of a pause after 10 consecutive increases:

> *" ... members agreed to reconsider the case for a pause at the following meeting, recognising that pausing would allow additional time to reassess the outlook for the economy."*

The **US Federal Reserve** increased rates by 0.25% overnight (Wednesday) but signalled that the banking crisis might end the tightening cycle sooner than previously expected.

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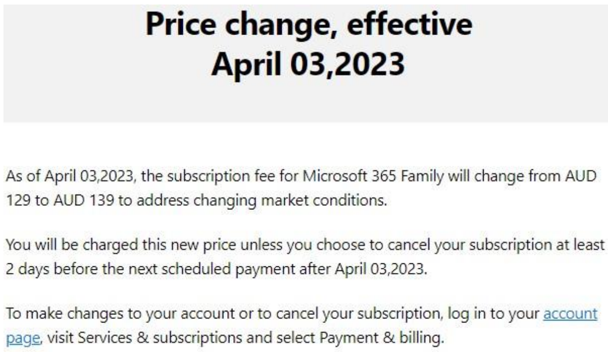
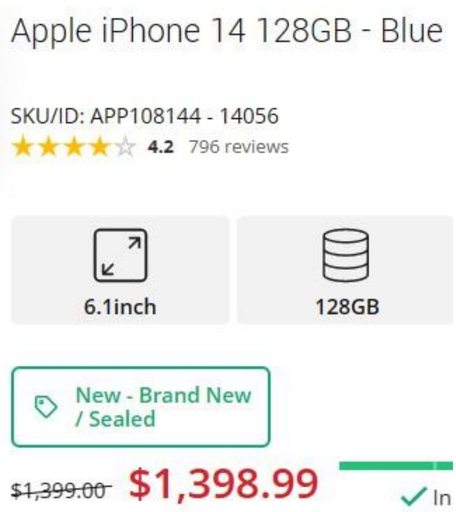
A reminder of how we have accepted price increases with barely a whimper came for everyone who uses **Microsoft** (and who doesn't?). Nobody will cancel Microsoft due to this increase "*To address changing market conditions*". Which is a non-attempt to disguise the desire for more profit. Look for a neat rise in revenue for this quality company.



And still on great technology companies, one of Apple's strengths is its pricing power and ability to avoid discounting, as this spectacular 'discount' offer for a new iPhone 14 shows.



As we come to the end of a momentous week for investing, banks and bonds, we have yet another financial chapter which will be be quoted and analysed forever. It was not only the demise of the venerable old Credit Suisse, but the day common equity sat above a bond issue in the payment pyramid. There are few certainties in investing.

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Interest in the $3 million super 'surcharge' or 'tax' or whatever it will be called remains strong, and our Reader Survey showed surprising support for the change despite many of our readers being adversely affected. Perhaps the Government deflected attention away from the $3 million amount with its clumsy unrealised capital gains and lack of indexing in the calculation, and if those things are fixed, many people will be more relaxed.

Here is the voting on the support for the $3 million proposal.

Yes, super is for retirement spending and $3 million is enough	27.08%
Yes, the Government needs to find new sources of revenue	3.30%
Yes, but the taxing of capital gains and lack of indexing must be fixed first	41.49%
No, people with large balances have used the super system as intended	15.45%
No, if the tax changes, people will find alternative tax-effective structures	12.67%

There has been a great response to the Reader Survey but we will leave it open for a few more days to improve the sample size (and financial advisers, we need more of you as it's mainly the SMSF trustees and retirees who have responded).

Graham Hand

Also in this week's edition ...

Romano Sala Tenna of Katana reminds us that regardless of these short periods of turmoil, there is only one long-term trend for the stock market, and that's up. And he presents four of his best charts to prove it. Romano says the real rewards of the market come from being able to ride out the inevitable crises and crashes along the way.

Turning to the current banking fallout, and **Damien Klassen** suggests that this time really might be different. Normally, credit crunches come before banking crises, but now it might happen the other way around. Damien provides a roadmap for how things may unfold and how investors should play it. Overnight in the US, **Fed Chair Jerome Powell** said he expects the banking crisis to lead to tighter lending conditions which may help the Fed to restore price stability.

Meanwhile, Morningstar's **Dave Sekera** advises investors not to panic because this isn't 2008. He reviews what's different this time around, what to watch for that could make the situation worse, as well as the market and economic impacts. Dave believes there are opportunities to find undervalued stocks unfairly pulled down with the bank carnage.

We've pulled in four experts to clarify misconceptions about the super tax and franking. They suggests that the super tax is a progressive tax not a flat tax, we have many ways of taxing 'income', concessions are overstated and franking has a common value.

Here's a question that concerns most of us: is early retirement an achievable reality for the masses – particularly in the current volatile economic climate – or is it just a pipedream, reserved for the lucky few? **Cromwell's Peta Tilse** has some good news: it is achievable. And she has some advice on how to do it.

James Gruber reports on one of Australia's oldest listed investment companies that few have heard of (unless you're a regular reader of *Firstlinks* contributor, **Peter Thornhill**). Though it likes to keep a low profile, **Whitefield** took the time to celebrate its 100th birthday in a closing bell ceremony at the ASX last week.

Martin Lau of FSSA is undeterred by China's critics. He says the structural drivers for China's growth remain intact. Namely, rising incomes and wealth, increasing demand for premium goods and services, and burgeoning sophistication in technology and manufacturing. Martin highlights three long-term themes and companies that are likely beneficiaries.

Owen Covick and **Kevin Davis** provide a cheeky take on Treasurer Jim Chalmers' recent pledge to create "a new sustainable finance architecture, including a new taxonomy to label the climate impact of different investments". They have some helpful, or not-so-helpful, suggestions for Mr Chalmers.

Four all-time best charts for every adviser and investor

Romano Sala Tenna

I have read countless books on investing, met an enormous number of financial experts and fund managers, and made pretty much every investing mistake possible.

If I could distil my learnings into one statement, it would be this:

The short term is unknowable, but the long term is inevitable.

Let me share the <u>four best tables</u> from 30 years of investing.

1. The long term is inevitable

The stockmarket has good years and bad, but over the long term there is only one trend, and it is up. Despite this being obvious, I continue to be astounded at how investors behave during 'bad' years.

Calendar year 2022 marked the 147th year of trading on Australian exchanges (under various guises). That enormous amount of data provides the clearest guide for anyone willing to learn. During this period, the market (dividends plus share prices) has risen 117 years and declined 30 years. So 79.6% of the time, the market rises. One in five years on average, the market declines.

SINCE 1875	NEGATIVE RETURNS	POSITIVE RETURNS	TOTAL
# of Years	30	117	147
% of Years	20.4%	79.6%	100.0%
Average Return	-10.1%	16.1%	**10.8%**
SINCE 1979			
# of Years	12	31	43
% of Years	27.9%	72.1%	100.0%
Average Return	-11.0%	21.9%	**13.0%**

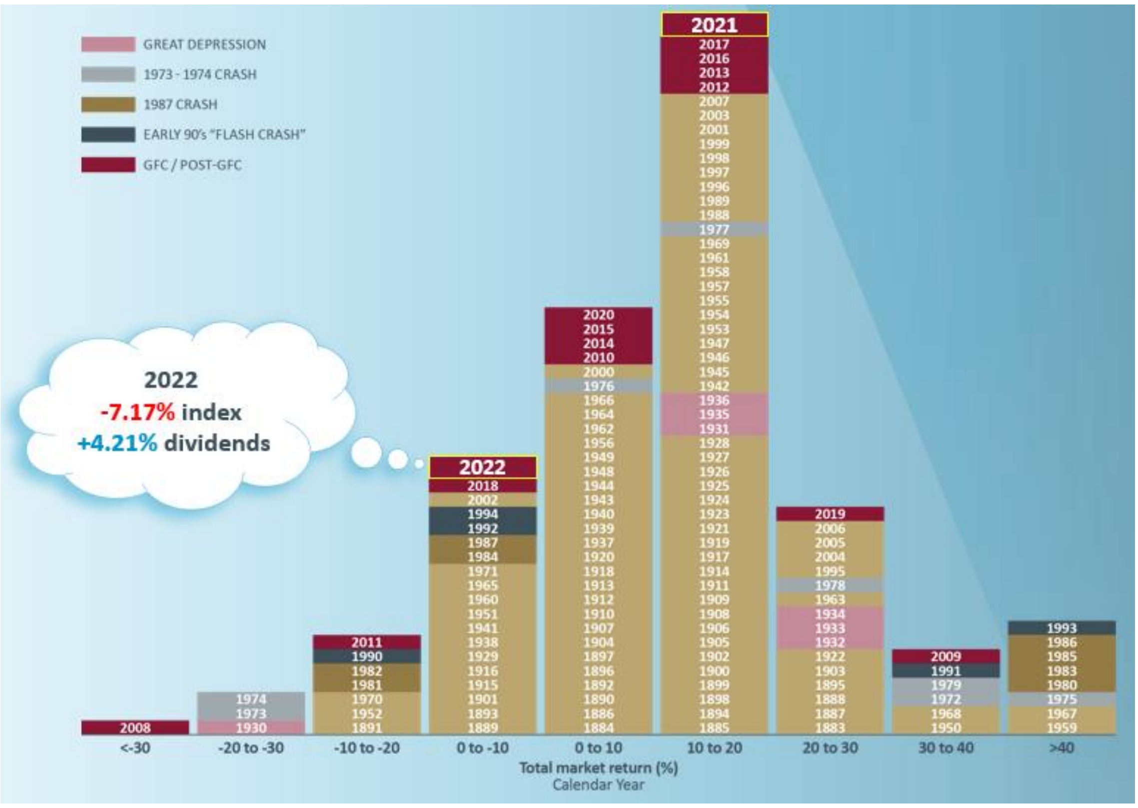
Source: Katana Asset Management

When the market rises, it does so by an average of 16.1%, and when it declines the average is minus 10.1%. When combined, we see that <u>over the past 147 years, the market has averaged a return of 10.8% per annum</u>.

Since we have become more sophisticated and introduced the Accumulation Index in 1979, the data points to an even stronger outcome. Over the 43 years since 1979, the market has risen by an average of **13.0%** per annum. And this is despite some seriously scary episodes, including the 1987 stockmarket crash, the 1997 Asian Financial Crisis, the GFC and the fastest fall on record, Covid-19.

2. Volatility is the price you pay for a seat at the table

But of course, in the short term – from year to year – markets are volatile. The distribution curve is shown below but many investors have failed to grasp the most important aspect.



Source: Katana Asset Management

The main oint is that crashes are inevitable: be ready and don't panic at the bottom (the only time to panic is at the top).

There has only been one (calendar) year in the 147-year history where the market fell by 30% or more, in 2008. But if you panicked and sold during that crash, you would have missed an extraordinary recovery. In 2009 the market was up by 39.6% and rose in 11 of the 14 years following the crash, including by 18.8% in 2012, 19.7% in 2013 and 24% in 2019.

Know thyself. If you are prone to doing the wrong thing at the wrong time, stay out of the stockmarket. Or work with a trusted financial adviser who can coach you through such periods.

3. Rolling period returns … my favourite and best

To better understand how the market behaves over different timeframes, we can break the data into rolling periods. For example, a rolling five-year period is the average return over every five-year period since 1875.

Timeframe (Rolling Average)	Average Return Since 1875	Number of Negative Periods
5 Years	65.0%	7
7 Years	100.6%	2
8 Years	120.2%	0

Source: Katana Asset Management

What this table demonstrates is extraordinary.

If you had invested your money in the index, turned off your screen, went away and came back five years later, then on average you would have a 65% return. There would have been only seven occasions out of the 143 rolling five-year periods where you would have a negative return.

If you had invested your money in the index, turned off your screen, went away and came back in seven years later, then on average you would have a 100.6% return, and there would have been only two occasions where you would have a negative return.

But even more remarkably …

If you had invested your money in the index, turned off your screen, went away and came back eight years later, then on average you would have a 120.2% return, and there would have been NO occasions on record where the dividends and capital growth would have been negative.

There is only one long-term trend, and it is up.

4. Wait … here's a better table!

Timeframe (Rolling Average)	Average Return Since 1875	Times One Year Returns	Average Return (KAEF)	Times One Year Return (KAEF)
10 Years	179%	17x	255%	24x
15 Years	366%	34x	568%	53x
20 Years	678%	63x	1,159%	107x

Source: Katana Asset Management

We've literally compiled hundreds of tables over the past three decades, and this is our best. There are two critical points.

First, we see even more dramatically, the true power of compounding. Compounding for 10 years, produces the equivalent of 17 one-year returns. Impressive. But compounding for 20 years produces the equivalent of an extraordinary 63 one-year returns!

And **second**, the importance of generating an extra margin. The Katana Australian Equity Fund has generated an extra 2.7%+ per annum net of all fees for 17 years. If we take a 2.7% per annum margin and compound it over 10, 15 and 20 years, the effects are mind-boggling. Over 10 years, it is the equivalent of 24 one-year returns. Over 20 years, this generates the equivalent of 107 one-year returns. Difficult to believe, but true.

Generating an extra 2.7% per annum (net) generates the equivalent of 107 one-year returns versus 63 one-year returns without it.

Timeframe, timeframe, timeframe

If the short term is unknowable and the long-term inevitable, an investor really does need to focus on the long term. If through age or financial circumstance an investor does not have the luxury of a long-term horizon, then they should understand the extra risk that they are taking on.

Remember in the stock market, *volatility is the price you pay for a seat at the table*. There will be another crash. Guaranteed. If your time horizon is not beyond the next crash, or you panic and do the wrong thing at the wrong time, then discretion may be the better part of valour.

Romano Sala Tenna is Portfolio Manager at [Katana Asset Management](). This article is general information and does not consider the circumstances of any individual. Any person considering acting on information in this article should take financial advice. Past performance is not a guarantee of future performance. Stock market returns are volatile, especially over the short term.

A banking crisis is here, the credit crunch may be next

Damien Klassen

There is a banking crisis playing out at the moment. On its own, it is unlikely to create major issues, but the credit crunch following the banking crisis will create the major issues.

This time is different

Dangerous words, I know. But this time has already been different.

Banking crises usually evolve from a wave of defaults as economies slow and corporates go bankrupt. Then investors get worried about bank solvency and start pulling their money from banks. The next step is a credit crunch which makes the situation worse. Banks swimming in capital a few months earlier find themselves abandoned by investors and deposits hard to come by.

In response, banks scale back on their own lending. At the same time, they lift credit standards, only loaning to the better quality corporates. This is known as a credit crunch.

A credit crunch has the effect of making things worse. Corporations find credit hard to come by and expensive, leading to more defaults. And this is usually when we get a banking crisis. After the credit crunch, not before.

Three paths forward

A credit crunch is not inevitable. Let's group the possibilities into: bull, bear and base cases.

Bull case

This is the most optimistic. It relies on a 'whatever it takes' type of speech from the US central bank. There are lots of different forms this could take. Basically, it needs to keep credit flowing to the corporates. The problem is if central banks do this, they will effectively be stomping on the brake and accelerator at the same time.

Central banks are trying to slow credit down. They are raising interest rates to slow credit growth, slow economic activity and therefore bring inflation back under control.

If they go all out quickly and in a big way, they are torpedoing the inflation goal. The bull case is not impossible. But it seems unlikely.

Bear case

In this scenario, the banking crisis is allowed to get out of control, such as if Credit Suisse had been allowed to fall over. Or, the next major bank that runs into trouble is allowed to fall. It is the consequence of markets chasing from one questionable bank to the next to the next. Allowed to run unchecked, a full-blown, 2008-style financial crisis would occur.

But it is highly unlikely. Generals are usually good at fighting the last war. For central banks, preventing a re-run of the 2008 Financial Crisis is very high on the list of priorities.

Base case

Central banks and regulators do enough to prevent a financial crisis. They continue to bail out and help banks where possible, but they fall short of a broad 'whatever it takes' approach.

What does that mean?

Bank funding costs increase. Deposits flee the smaller banks. Both have already started.

As a consequence, banks scale back their lending. Interest rates charged are higher. Corporates bear the brunt, the US falls into recession and default rates spike. Inflation is no longer a concern. Central banks can now roll out the big guns.

Net effect: a mini-banking crisis, followed by a credit crunch, possibly followed by a traditional banking crisis. Bad for stocks, good for government bonds, not pretty for corporate bonds.

What to watch for

The key question from here is which of the three cases is most likely, and how we are going to know which one is happening.

First, we look at surveys of credit availability. Bank officer surveys already suggest that banks were restricting credit before the latest round of bank bailouts. Some purchasing manager surveys show the same thing, but from the point of view of the corporate.

Talking to companies directly about the issue is probably only of limited value. Companies do not want to advertise problems with funding.

The more reliable data comes later. Credit growth data will be important. Probably not as important as early indications of bankruptcy statistics.

Funding costs are important. Credit default swaps on banks and corporate bond spreads are two of a host of indicators.

Where to hide

Which investments will be safe in this environment? Government bonds will be the key beneficiary of the base or bear case. Corporate bonds give a higher yield but capital loss is the danger.

Cash will be an attractive option, but if you are over the deposit guarantee limits, choose a larger bank. In Australia, it is highly likely governments will step in and bail out depositors for a large bank.

From a country perspective, you might need to be more nimble as most regions have their own issues:

- US regional banks have structural reasons to be the epicentre (more loans, more concentrated deposits, more exposure to commercial property, low reserves).
- However, the European Central Bank has a reputation for being late when it is time to start rescuing. So Europe is not without its risks as well.
- Australian stocks are typically a leveraged play on world growth. If world growth tanks, then the same will likely be true for Australian stocks. And Australia has a much larger banking sector relative to most other markets.

From a sector perspective, you want defensive stocks and high-quality stocks, but which stocks are truly defensive? Commercial real estate is looking a little dicey, so REITs, often considered defensive, are more at risk than other defensive sectors. Energy utilities and infrastructure can have structural issues as they transition away from (suddenly cheaper) fossil fuels, so pick carefully.

High-quality stocks are those with high margins, low debt and good returns on capital invested. Over the last year, because of inflation, every company has been able to increase prices. The question is which companies can hold on to those price increases as demand tanks, and which will have to return the price rises. Oligopoly sectors, or those with low levels of competition, will be more likely to hold onto the price rises. Sectors with lots of players or competition are significantly more at risk.

Value is not going to save investors during this downturn. It is not the type of recession where value outperforms. This type of recession is where valuation gets hit quite hard because earnings in these value stocks will be more at risk.

Picking up a great company at a decent price

Just as importantly, you want to have a shopping list of high-quality companies that you always wanted to buy but were too expensive. There is a good chance you will be able to pick them up at a discount.

Damien Klassen is the Chief Investment Officer at Nucleus Wealth. This article is general information and does not consider the circumstances of any investor.

Don't panic, this isn't 2008

Dave Sekera

Don't panic: This isn't 2008. In fact, it's an opportunity to find undervalued stocks unfairly pulled down with bank carnage. Here's what to do now.

In the US, deposit flight instigated by the failure of Silicon Valley Bank (SIVB) and Signature Bank (SBNY) has wrought carnage across regional bank stocks. Investors were shocked by how fast a bank can fail and looked to dump these stocks before a bank run could lead to a complete wipeout. Deposit flight slowed once the FDIC guaranteed all the deposits, not just the insured amount, and just recently the largest U.S. banks committed to deposit $30 billion with First Republic Bank (FRC), one of the most troubled regional banks. However, there could still be a few banks that may not survive. These banks are quickly evaluating their options, including selling themselves to larger banks, raising enough capital to restore depositor confidence, and/or appealing to the regulators for a backstop.

Meanwhile, in Europe, UBS agreed to buy troubled rival Credit Suisse for the lowly sum of 3 billion Swiss Francs. In a surprise twist, the Swiss regulator ordered of Credit Suisse's hybrid bonds while equity holders will still get about 40% of the most recent share price under the deal. Given debt holders are higher up the capital structure than equity holders, the move has uneased debt markets globally.

Here we'll review what's different this time around, what to watch for that could make the situation worse, as well as the market and economic impacts.

How is the current situation different from the 2008 global financial crisis?

Except for the rapidity as to how fast these stock prices have fallen, the current situation is much different from what prompted the 2008 global financial crisis. While there are negative economic and market consequences to this liquidity crunch, it will not result in a wholesale freeze across the financial system. The 2008 banking crisis was driven by the fact that no bank understood the extent of losses on each other's balance sheets. The managers that oversee credit-counterparty risk on trading desks halted trading with other banks as they feared what known as jump-to-default risk, the risk that the other bank could default over the near term. Commercial paper markets froze, interbank lending stopped, and trading ground to a halt. What is different now is that banks do not have the same size holes in their balance sheets as they did then.

In the run up to the credit crisis, banks took on low-quality mortgages, collateralized debt obligations, and CDO-squared. Once the housing bubble popped, these assets were worth anywhere from zero to pennies on the dollar. In most cases, these losses wiped out the amount of equity capital on banks' balance sheets. Today, the losses on long-dated bonds in hold-to-maturity accounts is much less. For example, a 10-year U.S. Treasury bond bought at historically low yields in 2021 is still worth more than $0.80 on the dollar.

Banking crisis redux?

While we think the fallout of the bank failures in the U.S. will be manageable, the downfall of Credit Suisse may have much broader implications in Europe. In addition to the economic and market-related damage, more disconcertingly, similar to the 2008 financial crisis, its failure raises the spectre of counterparty risk.

Counterparty risk is the risk that the entity that you enter into a trade or long-term agreement with files bankruptcy and is unable to perform their part of the contract. For example, a refiner and an oil company may enter into a forward agreement where the refiner agrees to purchase a set amount of oil per year at an agreed-upon price over the next five years. A common contract in the financial community is an interest-rate derivatives contract, where a bank may enter into a 10-year swap agreement with a corporation to exchange fixed rates for floating rates. Often, banks trade with one another, and may have a large economic exposure to another bank depending on how the value of these contracts may change in relation to the change in the underlying exposure. If one bank were to fail, then these hedges would become worthless.

At this point, the issues with Credit Suisse have been well recognized for months. From a systemic point of view, according to o Morningstar banking analyst Johann Scholtz, "Given that the profitability and capital concerns of Credit Suisse have been publicly discussed for about two years now, we also think that other banks' exposure to Credit Suisse should be limited. Most exposures will likely be of short-term nature, mostly overnight, and backed by collateral."

Implications of bank failures in the U.S.

According to Morningstar equity analyst Eric Compton, for now, it appears that the risk of regional banks being placed into receivership and wiping out the equity value has greatly diminished. The question in the marketplace is, What are these stocks worth now?

The key uncertainty is, it all comes down to deposit movement. No one knows for sure how many deposits will move and from whom. An investor has to accept this uncertainty to invest in banks today.

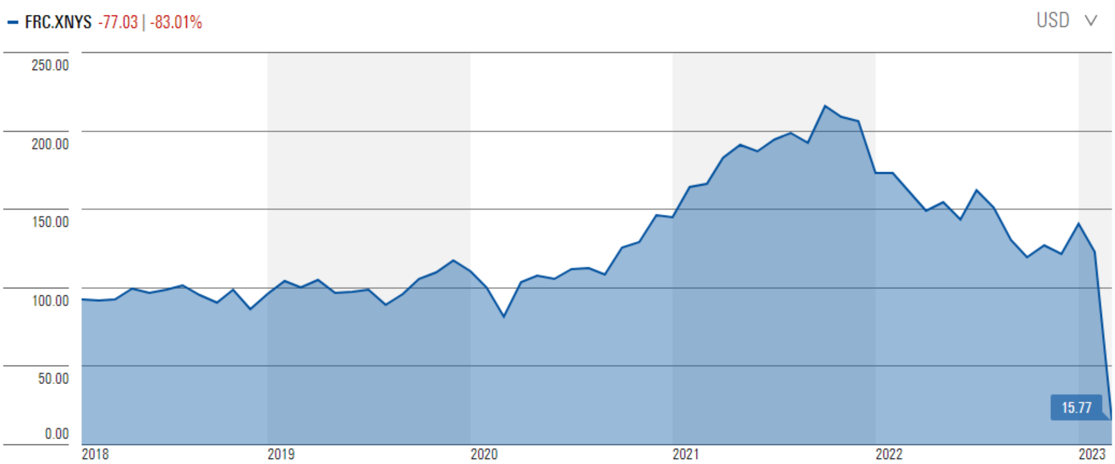
Why does this matter?

- Funding costs are likely to increase as banks have to raise interest rates on deposits in order to retain/attract new deposits.
- If a bank starts to lose deposits, they will replace that lost funding with more-expensive forms of funding, putting even more pressure on costs.
- If depositors move their money to another bank, they are more likely to move their other fee-oriented banking business.
- Ultimately, if any bank loses too many of its deposits (a run on the bank), it becomes an impaired franchise.

Compton notes that the psychology of the depositor has shifted negatively and this probably has not been completely solved even with the actions of the Fed. However, he notes that there are realistic paths for most of the regional banks we cover to recover, although there are paths where things get more difficult as well.

He sees reasons to believe Silicon Valley and Signature were uniquely vulnerable to the types of bank runs we've seen so far, and also sees unique vulnerabilities for First Republic. The other banks under our coverage are much more diversified in their business activities.

First Republic Bank share price



Source: Morningstar

To account for this heightened uncertainty, we've raised the Morningstar Uncertainty Rating on several of our regional banks. While acknowledging that we won't know more until first-quarter earnings are released, we still think that regional banking will remain an important part of the U.S. financial system.

Economic implications from the bank crisis

From a macroeconomic point of view, the market is grappling with the investment impact if banks pull in lending, and how much could it slow economic growth. Businesses could be pressured by their banks to reduce their borrowing and/or face higher borrowing costs. Other firms may have a difficult time finding new lenders willing to take on new business. We also could see heightened bankruptcy risk as a weaker global economy may result in lower free cash flow available to pay interest costs. Lastly, those borrowers with riskier credit profiles may not be able to roll over debt when it matures. The severity of an economic contraction could also be affected by lower consumer spending if the markets were to sell off more meaningfully.

Equity market implications

Reductions in credit availability and a resulting slowdown in economic growth would lead to a reduction in near-term earnings expectations for the second half of 2023. While we continue to view the U.S. equity markets as broadly undervalued, we note that there could be additional near-term downward price pressure. Cuts to earnings guidance could lead to a combination of risk-off sentiment as well as lowering the P/E multiple they use to value stocks.

In such a downside scenario, lower earnings in the short term do slightly reduce the intrinsic value of a stock; however, the value of a stock is the present value of all the free cash flow it will generate over its lifetime. As such, while present value may decrease slightly, its decline will be limited as cash flows would grow back over time once the economy regains its footing.

What should an investor do now?

First, revisit your appetite to withstand downside risk. Would you be able to sleep at night if we were to revisit October lows? If so, then your current allocations probably don't need to be revised. If not, then you might want to take a fresh look at your investment needs, strategy, and time horizon.

Dave Sekera, CFA, is a senior U.S. market strategist for Morningstar Research Services LLC, a wholly owned subsidiary of Morningstar, Inc. Firstlinks is owned by Morningstar. This article is general information and does not consider the circumstances of any investor. This article was originally published by Morningstar and has been edited slightly to suit an Australian audience.

Four experts clarify super tax and franking misconceptions

Aaron Minney, Jon Kalkman, Tim Walker, Tony Dillon

Firstlinks has received hundreds of comments on the Government's $3 million superannuation tax proposal, similar to the lively exchange when Labor proposed a change in the treatment of franking credits at the 2019 Federal Election. With few exceptions, it is an informed and quality debate adding understanding and fresh perspectives.

We also receive contributions by email which make good points but are not long enough to include as a separate piece. In this article, we bring together four observations which add to the super tax and franking debate. Of course, we could fill a dozen articles with the great comments on our existing articles (such as here and here), but these four are worth highlighting.

We already tax income in different ways, by Aaron Minney

Many commentators have noted that the proposed additional tax on super balances over $3 million will tax any unrealised gains in the investment portfolio.

Normally only realised gains are taxed. This is a difference between economic and accounting income. Generally, the concepts are the same, but there will be timing differences, largely driven by unrealised gains but there are also some differences in the tax treatment, such as a discount for capital gains. There is a clear benefit in delaying the taxation point, so investors will often avoid realising capital gains for as long as they can. Taxing the economic value-add (income) on an annual basis will prevent this.

But taxing economic income is not as unusual as it sounds.

Another intriguing Australian tax consideration is franking credits. They are designed so that the ultimate owner is only taxed once on earnings. In this, it could be said that as they are taxed on an economic income basis as they remove the accounting construct of double-taxation to provide economic neutrality.

In theory, the two taxes proposed by the new super reforms, each at 15% will result in a 30% tax rate for the higher balance super members. In practice, the normal tax rate is more like 8% with franking credits and capital gains discounts but there are no offsets to the economic income tax. There is even a risk that a carried forward loss, which would be a deferred tax asset on the balance sheet, might be lost resulting in an effective tax rate of over 15%. In total, the tax will be more like 23% than 30%.

The $3 million super tax proposals highlight that we can think about income in different ways. With a growing number of Australians relying on super and other investments to provide their income in retirement, it is helpful to understand the differences.

The other super proposal - to legislate an objective for super - uses a third income concept: retirement income. With the start of the retirement income covenant last year, we saw how that income is different again because it includes capital consumed over retirement. Ultimately this is the aim of super to provide income through retirement using the capital that is accumulated in super across our working careers.

Stop perpetuating franking credit myths, by Jon Kalkman

There is a myth that needs regularly correcting that franking credits are a tax refund and that the refund applies only to taxpayers on low marginal rates.

Franking credits are primarily additional income. CBA recently announced a dividend of $2.10. If you owned 1,000 shares, your additional taxable income is not $2,100 but $3,000 because the $900 the company pre-paid as tax (30% of $3,000) before you received that dividend is also part of your taxable income. That's why you need to 'gross up' the dividend in your personal tax return. Here is a simple way to understand what is happening:

- This additional taxable income is held by the ATO, so you have to pay tax on income you never received.
- As it is held by the ATO, it becomes a tax credit when you complete your own tax return.
- It is a tax credit so you can use it to pay some or all of your personal tax.
- If your tax obligation is lower than the tax credit, the ATO is holding some of your income on which no tax is payable and you receive a tax refund

It is just like an employee whose employer has overpaid their tax obligation through fortnightly PAYG salaries. A franking credit refund is NOT a refund of tax never paid, it is a refund of income never received.

At present we have a myth that a zero-tax pension fund collects $2.10 in dividend from CBA but also a tax refund of 90 cents ($3.00 altogether) even though it has paid no tax. It would be more honest if the income derived from shares were quoted as a pre-tax distribution (in this case $3.00 not $2.10) because that applies to all other investments and makes comparisons more valid. In that case it would be obvious that a zero-tax pension fund received $3.00 per share in income - because it pays tax on its income at a zero marginal rate.

And if dividend income was quoted on a pre-tax basis, it would be obvious that everyone was paying tax on their income from shares on the 'grossed up' dividend **($3 not $2.10)** at their personal marginal tax rate - as they do now.

Moreover, every shareholder receives a $0.90 tax credit which can help to pay some or all of their tax obligations. That tax credit *has the same value for every Australian taxpayer.*

Stop overlooking the proportionality in new super tax, by Tim Walker

Please read the Better Targeted Superannuation Concessions fact sheet carefully. Even Jim Chalmers does not seem to have read and understood it.

The statements in the Overview and Application sections are wrong in stating that is a flat tax rate of 15% on earnings over $3M. It is really a progressive tax starting at 0% at $3M, growing to 3.75% at $4M, 7.5% at $6M, 10% at $9M, etc in an upward trending curve that can never quite reach 15%.

Take special note of the definition of 'Proportion of Earnings'. It is not Total Superannuation Balance (TSB) - $3M as many seem to think. It is (TSB - $3M) divided by the TSB. Therefore nobody pays an extra 15% on earnings over $3M. A member with a TSB of $3.2M pays only 0.9375% extra tax on their earnings. A member with a TSB of $4M pays 3.75% extra tax on their earnings. The infamous SMSF member with a TSB of $400M pays 14.8875% extra tax on their earnings.

As an example, say you start the year with a TSB of $3M, earn income and have (realised and unrealised) capital gains of $200K, withdraw $100K as a pension/lump sum and make no contributions. At the end of the financial year, you will have a TSB of $3.1M and will have to pay extra tax of 0.48387% on earnings of $200K. This works out to be $968 of extra tax.

I can see many people with TSBs around $3M paying much more than $1K in financial advice and fees setting up trusts and companies to try and avoid this extra tax.

Also, I think that a lot of people are misunderstanding the taxing of unrealised capital gains. Earnings does include unrealised capital gains, but only the unrealised capital gains during the financial year just completed, not the unrealised capital gains since the asset was purchased.

Cost of super tax concessions is overstated, by Tony Dillon

The impetus for the recent imposition of an additional 15% tax on earnings on the portion of super balances exceeding $3 million was undoubtedly the almost $50 billion worth of superannuation tax concessions as detailed in the recently released Tax Expenditures and Insights Statement (TEIS) compiled by Treasury.

The tax concession cost is determined by comparing ordinary income tax rates on super income versus the tax actually collected at concessional super tax rates.

The estimated tax concessions are absolute numbers at a point in time. They say nothing about the cumulative nature of superannuation and the ultimate rate of superannuation tax paid by a worker over long periods of a working life.

To assess the validity of the tax concession estimates, we estimate the **fund tax** rate paid by a middle-income-earning employee on their Superannuation Guarantee Contributions (SGC) over a working career and compare it to their **marginal personal income tax** rate.

Consider the following scenario.

A working career starts on a salary of $95,000, with compulsory super commencing at an annual $10,000. Assume their salary grows at a modest 2% per annum over a 30-year career, and their super fund earns a before-tax rate of 6% per annum. Applying 15% tax to the SGC contributions and investment earnings results in a super fund balance of $760,000 at the end of 30 years.

If no tax had applied to contributions and earnings, the fund would have grown to $1,042,000. Lost funds due to the super taxes is therefore $282,000, which yields an implied rate of tax paid over the full period of:

$282,000 / $1,042,000 = 27%

For someone whose marginal personal tax rate was 32.5% for the first 14 years, this is hardly a big concession, particularly when the employee has no access to their compulsory savings for the full 30 years. And under the Stage 3 tax cuts regime, should they eventuate, their marginal tax rate would be just 30% for the entire 30-year career, reducing the concession even more.

Drilling down further, the $282,000 drop in end-fund balance is made up of $61,000 in contributions tax, $73,000 tax on earnings, and critically, a $148,000 reduction in fund earnings as a result of the taxes.

Meanwhile, the $760,000 final balance consists of $407,000 in contributions, plus $488,000 in interest, less the taxes. Noting:

$61,000 = 15% x $407,000
$73,000 = 15% x $488,000.

The wage earner in this example moved from a personal marginal tax rate of 32.5% to 37% on current tax scales after year 14. Let’s assume an average marginal tax rate of 35% for the full 30-year period.

Under Treasury’s method of determining tax concessions, in this case it would estimate $179,000 in total super tax concessions, over this worker’s career:

(0.35 - 0.15) x ($407,000 + $488,000) = $179,000

What the calculation hasn't factored in, however, is the employee's lost earnings of $148,000 over the journey, which shouldn't be lost to the system. In fact, it effectively transfers to the government along with the tax take, if you assume that government return on investment (social or otherwise) is comparable to that of the super fund earning rate. The net concession to the employee therefore is just $179,000 - $148,000 = $31,000, which over 30 years of compulsory saving is really just a pittance.

What we are seeing is an implicit rate of tax on the end fund balance close to the employee's marginal tax rate. Such that overall tax concessions are far less than:

(marginal rate - 15%) x (fund contributions plus investment income)

Superannuation is an earnings-related concept over long-term investment horizons, and the super tax concessions do not reflect the compounding nature of super earnings and taxes.

Aaron Minney is Head of Retirement Income Research at Challenger Limited. Jon Kalkman is a former Director of the Australian Investors Association. Tim Walker is a retired database administrator and SMSF trustee. Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any person. The comments are based on an understanding of the proposed tax change and existing franking credit rules at the time of publication.

Retiring young: Is 50 really the new 65?

Peta Tilse

Retiring in your 60s is considered by many as the right time to give up work for good.

Out of 8,000 people surveyed by the Australian Bureau of Statistics for the most recent Retirement and Retirement Intentions data release (May 2020), the average age people said they intended to retire was 65.5 years.

But, what about those who are currently in the workforce and are targeting an 'early' retirement?

The same ABS data release revealed that the average retirement age in 2018-19 was 55.4 years – considerably earlier than the 'average' intended retirement age.

This poses an interesting question: is early retirement an achievable reality for the masses – particularly in the current volatile economic climate – or is it just a pipedream, reserved for the lucky few?

For the purposes of this article, "early retiree" refers to a person who has, or intends to, permanently cease employment earlier than 55.4 years – the average retirement age in 2018-19.

Aspiration vs reality

In October 2022, an independent survey commissioned by finance platform money.com.au found that roughly a quarter (26%) of people aged 35-44 want more than $100,000 annually during their retirement (this is compared to only 20% of 45-54-year-olds and 10% of 55-60-year-olds).

Early retirees would arguably have an extended 'active' phase of retirement, meaning they'd have additional time to enjoy things like exercise, hobbies, overseas travel, home renovation, volunteering, and family gatherings.

The fact that these people would be spending more money on leisure items and activities for a longer period is surely reflected by the younger survey respondents' desire for an annual retirement income in excess of $100,000.

The risk associated with this, of course, is that people burn through their savings during their early retirement, without budgeting for non-discretionary items – food, medical bills, housing – in later life.

Longevity risk is a crucial consideration for anyone entering retirement, regardless of their age. Significant social and medical advancements mean that Australians are living longer, healthier lives, which require more financial resources – people are living longer, so individuals need more money in retirement.

A healthy Australian retiree at 50, for example, could be expected to live well into their 80s, meaning that individual would need to be assured of more than $3 million ($100,000 x 30 years) to comfortably fund the remaining years of their life.

Interestingly, the Australian Government is currently proposing doubling the tax rate on earnings from super investments for balances above $3 million. The proposed changes would see the tax rate rise from 15% to 30% for people who are still adding money to their superannuation. If implemented, this tax change would need to be an additional key consideration for those considering early retirement.

As a broad rule, Australians can access their superannuation from 65 years old, or when they reach the preservation age – depending on the year they were born – so, our 50-year-old retiree would have to live self-funded for at least 15 years before a superannuation income stream became a reality.

Given that the household savings ratio (via ABS) was 6.9% for the June-September 2022 quarter – and 90% of all employees reported earning less than $2,720 per week (90th percentile) – the reality of a self-funded early retirement may be a stretch for many.

Opportunity exists

Despite the challenges, there are genuine opportunities for savvy individuals to retire before their peers. Factors like longevity risk – as well as other variables like inflation and interest rate fluctuations – will always exist, but these can be mitigated with appropriate strategies.

In the case of those aspirational early retirees, there may be additional considerations before permanently leaving the workforce. Some suggested considerations are highlighted briefly below, though individuals are encouraged to consider their own personal circumstances.

1. It's important to determine lifestyle

It's often hard to plan next month's activities, let alone those in 10 years' time; however, deciding on the kind of life you want to live post-retirement is seen as the essential, foundational step to preparing for early retirement.

2. Planning is essential

Once you've settled on your chosen lifestyle choice, a comprehensive retirement plan is a good next move – this involves laying out everything from potential timelines to mock budgets, and more. According to the Australian Government's Retirement planning, saving and attitudes: survey report 2020, only 32% of respondents had a retirement savings goal – this is despite a wealth of resources available to assist you in planning your financial future.

3. Evaluate your current situation

Examine your current financial situation. Once you've decided on your lifestyle and created a plan, you can work forward by evaluating your financial situation; your starting point. Be realistic in your assessment.

4. Determine your retirement age

At the completion of these first three steps, you may have enough information to determine the age at which you can retire and live the life you want.

5. Budget, budget, budget

Almost half (47.1%) of Retirement planning, saving and attitudes: survey report 2020 respondents said they don't have enough income to save for the long-term – including their retirement. 'Tightening the belt' by budgeting, reducing expenses, and cutting out luxuries is a critical step if early retirement is your goal. Paying off debt early is another key consideration when reducing your expenses.

6. Earn more money

Easier said than done, yes, but increasing your income can be the difference between retiring at 60 or retiring five years earlier. Additional income streams might include investing wisely in shares or property that is likely to appreciate – as well as income-producing assets.

With high inflation rates presently impacting savings, having a diversified investment portfolio can be seen as a smart way to mitigate investment risk – and a way to make your money work for you as you prepare for retirement. Commercial property, for example, is regarded as an inflationary hedge – and tends to fare well in times of high inflation.

The Retirement planning, saving and attitudes: survey report 2020 revealed that roughly 35% of respondents invest their savings in other ways than super, though only 8.3% of respondents expected shares or a property portfolio to be their highest valued asset when they retire.

7. Track your progress

There's no use setting a plan in motion if you don't know where you are on the journey! Regular, routine progress checks allow you to pivot your plan of action if required, and let you know whether your tactics are working.

While early retirement may not be the norm – only 2.3% of Retirement Planning Survey (2020) respondents say they intend to retire between 50 and 54 – it certainly is achievable for those who plan to make it happen.

Peta Tilse is Head of Retail Funds Management at Cromwell Funds Management, a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.

For more articles and papers from Cromwell, please click here.

The 100-year-old Australian investment company you've never heard of

James Gruber

It's one of Australia's oldest listed investment companies, yet few investors have heard of it.

While household Listed Investment Company (LIC) names such as Australian Foundation Investment Company and Argo Investments grab the limelight, low key is how Whitefield Ltd (ASX:WHF) prefers it.

Late last week, Whitefield took the time to celebrate its 100th birthday in a closing bell ceremony at the Australian Stock Exchange in Sydney.

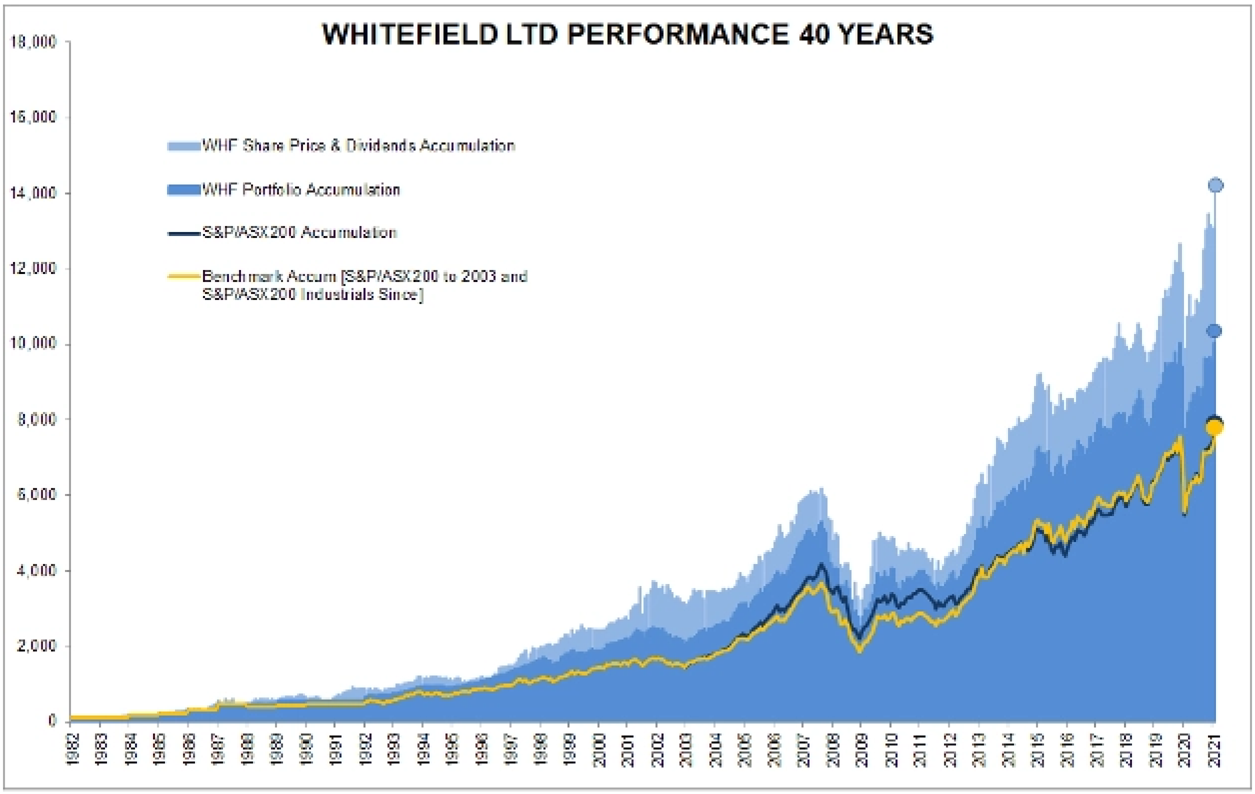
Whitefield MD Angus Gluskie at the 100th birthday celebrations in Sydney. Picture: Supplied

The secrets to Whitefield's longevity

Whitefield is a specialist LIC. It only invests in industrials stocks and excludes the resources sector from its portfolio. The company invests in about 160 companies in the ASX 200 industrials index.

The industrials exposure seeks to give investors a benefit from exposure to the long-term growth of the Australian economy, the historically lower volatility of companies operating in non-resource industries and has the incidental benefit of lowering exposure to fossil fuel producers and emitters.

Over the past 40 years, the company has returned close to 14% per annum, including the benefit of franking credits.



So what are the keys to Whitefield's longevity?

Managing Director Angus Gluskie puts it down to some simple principles:

> *"We believe there are three important contributors to durability: 1) having a sound investment strategy, that invests sensibly across a high diversity portfolio that targets consistent small increments of outperformance. 2) Alignment of interest between managers and shareholders. 3) A listed investment company structure, which encourages long term planning."*

Born in the 'roaring '20s'

It's ironic that the publicity-shy Whitefield was born during the roaring '20s'.

A.S. White was a young man then when, after the death of his father, he was put in charge of the financial operations of his family's baking and milling business, the stock exchange listed Gartrell White.

By 1923, A.S. had built an accounting practice, created one of the nation's first workers' compensation insurers and listed a financing company.

In March of that year, he launched Whitefield as an investment company with a 5,000-pound public share issue. The company found an enthusiastic following and after several capital raisings, Whitefield's issued capital swiftly increased to 300,000 pounds.

Initially, the company invested in mortgages, taking advantage of a resurgent housing market during the 1920s. But with the Great Depression, and then price controls on house prices and rents during World War Two, Whitefield pivoted to investing in companies that would benefit from growth in the broad industrial economy.

That's how the investment strategy evolved towards owning a diversified portfolio of Australian shares for long term wealth creation. By the 1950s, Whitefield had 300 stocks in its portfolio.

While the investment strategy has broadly stayed the same since that time, Angus Gluskie says the tools of the investment trade have changed dramatically.

Whereas once, the company used manual mathematical calculations and handwritten records, now everything is computerised. That's allowed the firm to use quantitative tools to assess stocks and develop proprietary assessments of quality, earnings, and growth.

Remaining a LIC is central to long-term success

Gluskie says the benefits of being an LIC far outweigh any negatives. While investors are free to sell Whitefield shares on the stock exchange, he says most see the company as a closed-end long term investment vehicle.

The stability of this investor money has allowed Whitefield to think about investments in decades rather than years or months.

I can attest to the stability of the investor base having met Margaret Dobbin at the ASX event, who'd been an investor in Whitefield since 1955.

It's also no accident that there's been little turnover in management since the company's founding. Only five people have had the role of either Chair or CEO. The tenures of each, across the combined roles, has been between 30 and 50 years.

How does Whitefield stack up against other LICs?

With a market capitalisation of $603 million, Whitefield is a small-to-mid cap company in the LIC space. It's one of the few LICs that currently trades at a premium (2.1%) to its net tangible assets (NTA). Its share price versus NTA fluctuates more than some of the larger LICs, though less so than smaller peers.

Over the past one, three and five years, Whitefield has lagged many similar-sized or larger LICs due to the outperformance of commodities during these periods and Whitefield doesn't have any exposure to this sector.

Yet over the past decade, the company's investment portfolio performance (NTA growth of 8% p.a.) has been more than credible. Whitefield also offers a 100% fully franked dividend and the current net dividend yield of 4% compares favourably with other LICs.

And the company has maintained or increased its dividend in every year since the introduction of the dividend imputation system in the 1980s.

What does the future hold for Whitefield?

Whitefield has been a tremendous success story, though past performance is no guarantee of future performance.

Gluskie says the company's history provides a guide for what works best for investor outcomes. Using investment experience, integrity, and innovation, Gluskie believes Whitefield can continue to thrive for another 100 years.

** Note that you can find detailed reports on LICs including Whitefield in Firstlinks' education centre.*

James Gruber is an Assistant Editor for Firstlinks and Morningstar.com.au. This article is general information and does not consider the circumstances of any person.

Three themes and companies to play China's rise

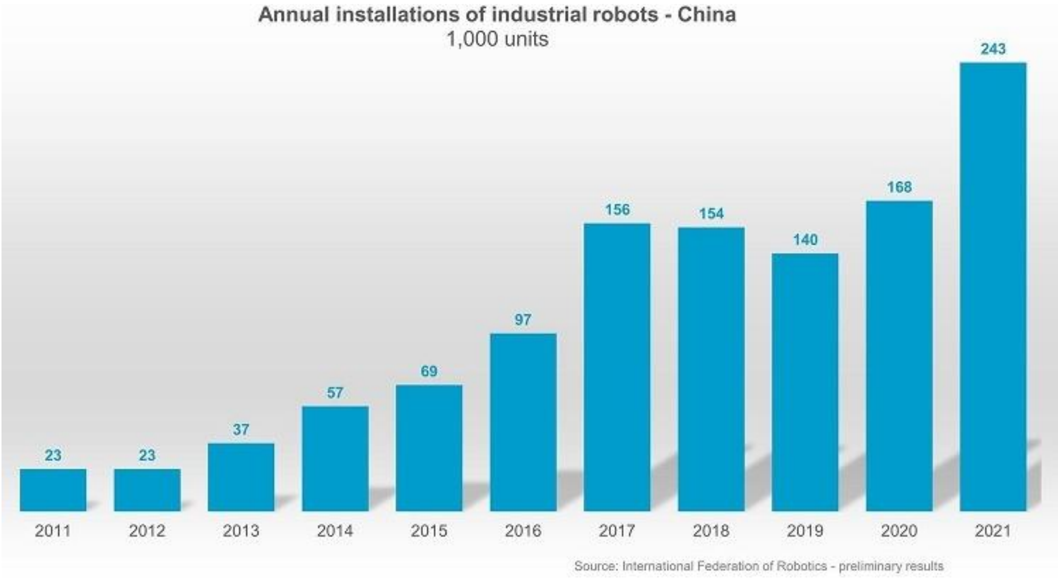
Martin Lau

The structural drivers for China's growth remain intact, and we expect Chinese companies to benefit from trends such as rising incomes and wealth, increasing demand for premium goods and services, and burgeoning sophistication in technology and manufacturing. There will also be opportunities for companies to innovate and move up the value curve. This, coupled with China's increasing role in global trade, should bode well for exports as well as domestic consumption.

We highlight three examples of long-term themes and companies which are likely beneficiaries.

Industrial automation aims to offset a shrinking workforce

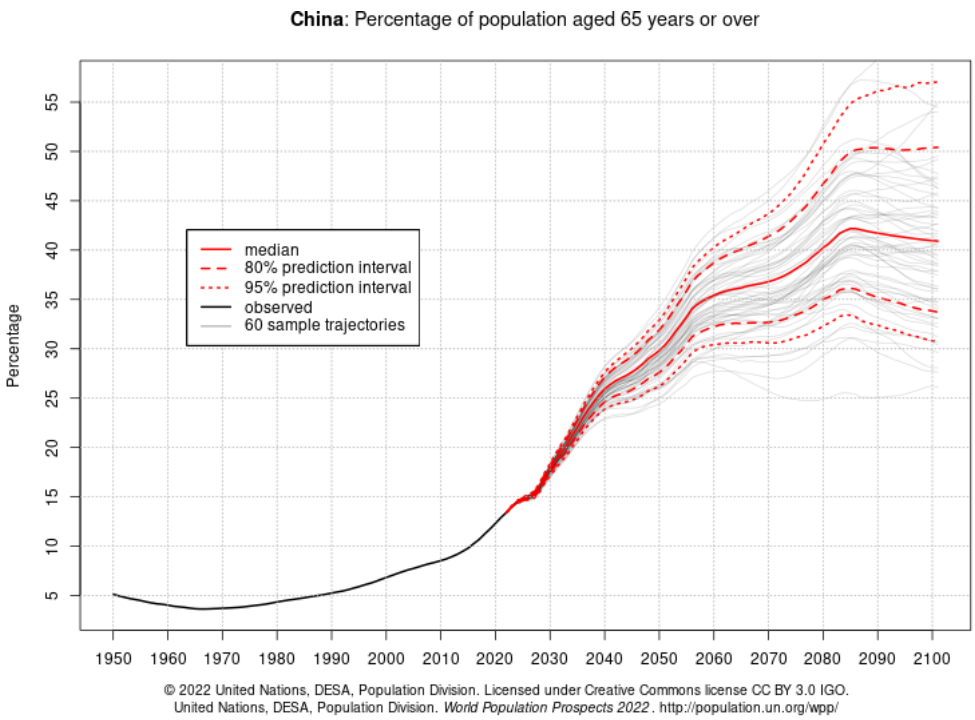
The impact of China's earlier one-child policy will continue to be felt in the coming decades. Its working age population, or people between 15 and 64, will contract by 22% or 217 million people. To counter the anticipated labour shortages, the government seeks to improve manufacturing through automation and robotics, which means China's automation market will see strong secular tailwinds. For example, the country set a record of 243,300 industrial robots in 2021, a 44 per cent increase from the previous year.



Shenzhen Inovance is an industrial automation company with leading positions in inverters, servomotors and new energy vehicle (NEV) controllers. It has repeatedly proven its capability in developing new products and entering new markets, where it can compete with multinational peers. As of March 2022, the company has generated 28% per annum shareholder returns since its IPO in 2010, with 40% compound annual growth rate (CAGR) in sales and 35% net profit CAGR*. Despite its size, our view is that Inovance can continue to generate attractive growth over the next 5-10 years as it gains market share and continues to innovate.

Healthcare companies stand to gain market share

Healthcare spending, while much lower than in developed countries, is expected to grow as China's population ages. The population over 65 will increase from 14% of the total population in 2022 to 30% in 2050.



Shenzhen Mindray is China's largest domestic medical devices company and a market leader in patient monitors and life support systems. Growth across categories has picked up in recent years, and Mindray's market position for each category has been improving as well. It has gained market share from global leaders as it expands its presence overseas and has more than 40% of its sales through exports*.

In the domestic market, we expect increased hospital spending on medical equipment to contribute significantly to its revenue. There are also growth opportunities ahead, as the penetration level of medical devices in China is still low and there is a growing preference for import substitutions.

Domestic brands may benefit from premium consumption

Structural growth is expected to return to domestic spending with the recovery of consumer confidence. Amid weaker consumer demand resulting from the pandemic in the last two years, we focused on buying high-quality franchises and market leaders – those companies with above-average margins and returns, and which can increase selling prices.

One sector we looked at was China's beer market, which is different from most other countries. It is highly consolidated with the top three companies, China Resources Beer (CR Beer), Tsingtao and Anheuser-Busch InBev, sharing 75% of the market as per our research in 2022*. Despite beer volumes declining since 2014, the improving economy and a growing middle class has seen some brands looking to develop more premium products, improving unit economics. Sales and profitability have also improved as beer companies consolidated their breweries.

CR Beer's share of premium sales has grown with the help from a 2019 merger with Heineken China, resulting in higher average selling prices. Although the company is a state-owned enterprise, China Resources businesses have typically been well run, with returns comparable to private enterprises. Additionally, while investors were worried about higher prices of inputs like aluminium cans, historically beer companies have been able to pass on costs, while the gross profit margin of circa 40% should limit the impact on profits.

Conclusion

This year marks the 30th anniversary of the FSSA China Growth strategy. While China has changed significantly over the last three decades, the key driver of share prices over the long term remains companies' ability to generate value by growing their earnings or net asset value. Therefore, we use bottom-up analysis and focus on quality companies, with capable leaders who are aligned with shareholders.

**N.B. Source: FSSA Investment Managers, company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As of February 2023 or otherwise noted.*

Martin Lau is a Managing Partner and Lead Portfolio Manager at FSSA Investment Managers, based in Hong Kong. FSSA is part of First Sentier Investors, which is a sponsor of Firstlinks. This article is intended for general information only.

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A helping hand for Treasurer Chalmers' proposed taxonomy

Owen Covick, Professor Kevin Davis

In his recent Monthly Essay, Treasurer Jim Chalmers stated:

"we will create a new sustainable finance architecture, including a new taxonomy to label the climate impact of different investments. That will help investors align their choices with climate targets, help businesses who want to support the transition get finance more easily, and ensure regulators can stamp out greenwashing. This strategy begins with climate finance, but over time I see it expanding to incorporate nature-related risks and biodiversity goals".

To assist the Treasurer in this process we offer the following (slightly tongue in cheek) suggestions, sometimes going beyond the climate risk focus to address the two additional goals stated:

Guilt-edged securities: All securities that are not aligned with the government's climate agenda. These are to be traded on Under-the-Counter Markets. Authorized dealers on these markets to be required to wear dirty white raincoats whenever conducting trades.

Donor promissory notes: A form of stapled security to be stapled to the receipts for significant donations to major political parties. The promise is hot air additional to that from global warming. Attractive to short sellers wanting to hedge against increases in temperature.

Mezzanine finance: A category of investment that offers an element of protection against the risks of flooding caused by severe rainfall events and rising sea levels. A handy alternative to floating-rate securities.

WINDUP bonds: thought by many unsophisticated investors to be providing financing for, and returns from, operations of wind turbines, but actually designed to avoid any liability of the issuer upon the failure and wind-up of the operating entity. Also known as Kamikaze bonds, after the Japanese term for 'Divine Wind'.

GAPs: Good Advice Providers who leave gaping holes between their advice and that which would be in the best interests of their clients.

BNNPL: Buy Now Never Pay Later vehicles, a once-off chance for negligible net worth (NNW) people to make a little purchase with no interest charged and no principal repayment required. Only those holding equity in the providers stand to lose.

SOLAR securities: Source of Life and Riches securities. To be issued by triple-D rated solar panel operators supposedly to finance their businesses, with the promised riches accruing to the issuer and extracted prior to default.

Down-under bonds: For financing underground carbon capture operations. Not to be confused with underwear products bearing a similar labelling.

NUKE floaters: Nuclear Und Kinetic Energy floating rate notes. Issued for nuclear power financing. These are investments with a half-life longer than the average investor and are guaranteed to be around for a very long time. Have the added advantage that they can be seen in the dark.

CALMs: Carefully Aimed Laundering of Money facilities. Arrangements guaranteed not to be caught by AUSTRACs AML activities. Should be popular with Gambling Operators and Payments Providers. All waste-products left from the laundering to be sequestered to protect the ecosystem.

DINGO bonds: Driven into near extinction in the early 1980s, the remains of some specimens of these financial derivatives are believed to be held in a number of private collections. If enough of the DNA can be extracted, recent advances in cloning techniques might mean that it is feasible for a reintroduction of these uniquely Australian creatures into our environment – a precious positive for biodiversity!

Fungible financial products: The descriptor 'fungible' should henceforth be used only in cases where there is a direct and quantitatively significant nexus with the production and promotion of naturally occurring species of fungus identified as priorities in the government's published biodiversity goals. Investors should not be kept in the dark about the merits of such products.

Short-term investments: All financial instruments and investment vehicles which have a maturity date which is earlier than the year identified by the government as the target year for net-zero emissions should be clearly labelled as being short-term. The RBA and Commonwealth Treasury should only describe bonds as 'long dated' where conformity with this aspect of the new taxonomy applies.

Insurance product nomenclature: All insurance products which provide cover against nature-related risk must be 100% explicit about the risks they are providing safeguards and /or guardrails against. Consistent with this, life insurance products should be relabelled 'death insurance'.

Pro-cyclicals: The terms 'counter-cyclical' and 'anti-cyclical' will be gradually phased out. Cycles and cyclists need to be encouraged to reduce carbon emissions. Greater numbers of MAMILs will align with the government's bio-diversity goals.

CCS Forestry MIS: Managed Investment Schemes to provide retail investors with part ownership of forestry developments aimed at harvesting carbon credits from the planting of trees for carbon capture and sequestration. Double jeopardy may be involved – the Timbercorp and Great Southern MIS disasters of a decade ago spring to mind, while the delivered social value of carbon credits is unclear.

Centigrade futures: Futures contracts with payoffs based on the difference between the year-average temperature in 2050 and that in the year the contract opens. Pessimists on climate change can go long and use profits to offset heat induced misery. Climate sceptics could put their money where their mouth is by going short and publicize the fact that they are doing so.

Owen Covick is a Research Associate at the South Australian Centre for Economic Studies, and Kevin Davis is Emeritus Professor of Finance at The University of Melbourne. Kevin's free e-text reference book 'Bank and Financial Institution Management in Australia' is available on his website. Kevin was also a member of the Financial Systems Inquiry ('The Murray Report') in 2014.

Some Reader Survey results, and time to respond

Graham Hand, James Gruber

It is many years since we found out more about our readers and what they like and don't like about Firstlinks. We have received hundreds of responses to our Reader Survey, but we will leave it open for a few more days to maximise the sample size.

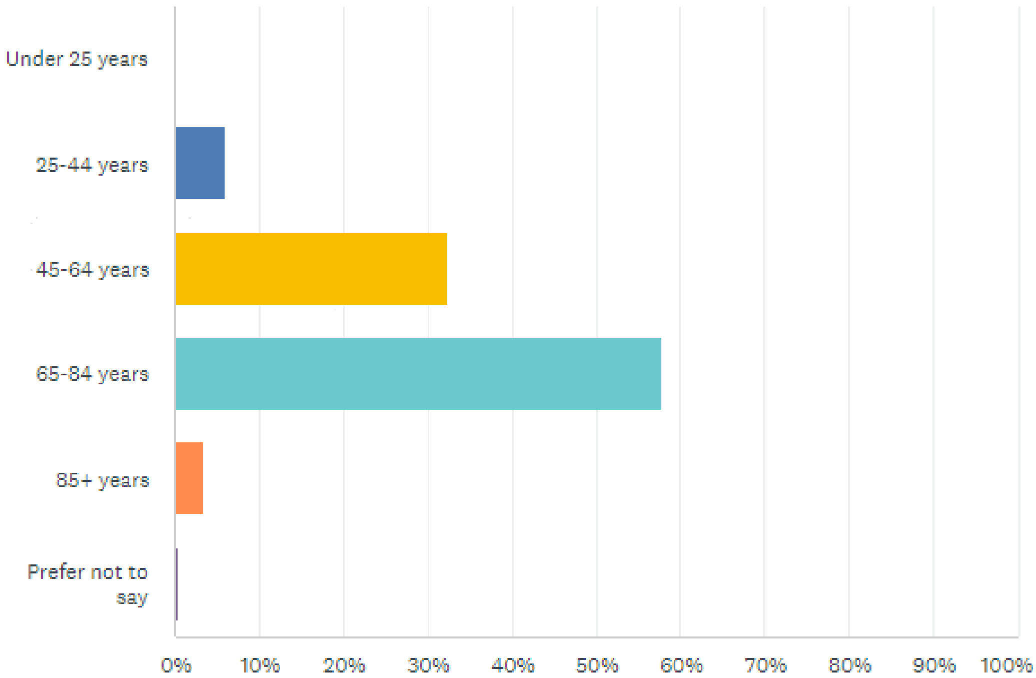
We promise we read and take onboard every one of the thousands of comments received. It is appreciated to hear so many of you look forward to receiving our newsletter.

Your feedback across a dozen quick questions will help to improve our content and it should take only a few minutes. The survey can be accessed via this link, or using the embedded form below.

The responses have been both insightful and surprising. Many have pointed to our independence and breadth of articles as strengths, and subcribers enjoy reading the comments attached to articles.

Age and SMSFs

One surprise has been the age of our subscribers, as the chart below reveals. We're sure there are more younger readers than shown here! Where are all the Gen X and Y?



Reflecting this age distribution, most respondents are members of an SMSF, and a high proportion are retired. This is far higher than in previous surveys, and probably shows who is willing to put the time into responding rather than representing our audience.

SMSF member	51.28%
Active investor but no SMSF	31.86%
Retired from paid work	57.75%

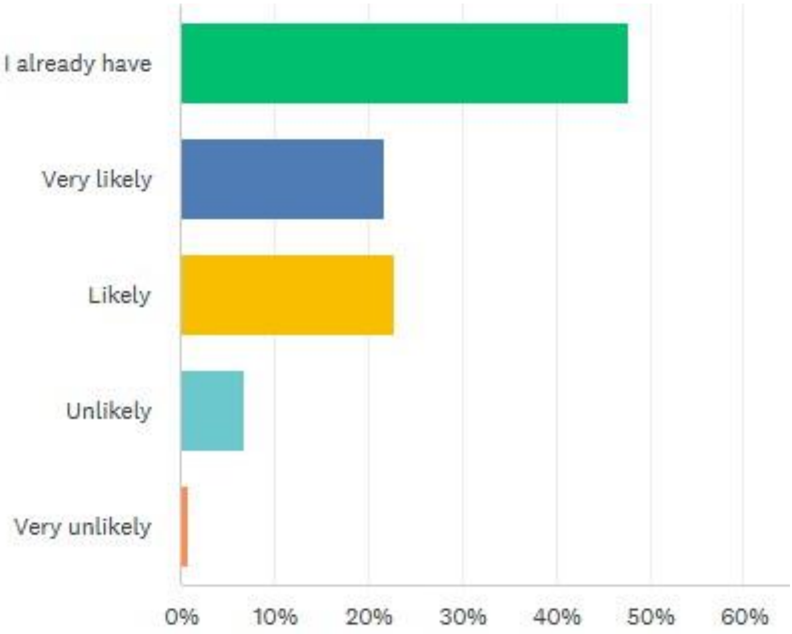
Passing to a friend or colleague

Firstlinks does not play the clickbait game of many newsletters, nor have we ever bought a mailing list, and we rely on our readers to refer the newsletter to friends and colleagues. We are grateful that 93% of respondents have either already referred, or are very likely or likely to, with some reasonable explanations of why they do not:

- Most of my friends are not interested, simply pay and have others do it
- I never refer or recommend anything to anybody
- Most of my friends are dead already
- I recommend to nobody. A problem with you becomes a problem with me
- Most folk don't want to know and invest in term deposits and are too afraid to seek paid advice.

How likely are you to refer a friend or colleague to Firstlinks?

It's also useful for us to learn more about the subjects you would like Firstlinks to cover.



What part of your investing do you want most help with?

Portfolio construction and asset allocation		23.39%
Selection of specific investments		28.27%
Fund manager selection		2.97%
Compliance and legal advice		4.71%
Structuring for tax efficiency		17.10%
Macroeconomic education		8.90%
Execution or trading advice		2.27%
Insurance or risk protection advice		0.52%
Other (please specify)	Responses	11.87%

So thanks again to all the respondents and please jump aboard if you have yet to share your views.

Disclaimer

This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.

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