Firstlinks
a Morningstar company

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Contents

Editorial

Back in the day, I wrote a monthly column for a **Fairfax** publication called ***CFO***, long before ***The Australian Financial Review*** replaced it with another publication in 2012. Although I was supposed to write about bond and capital markets, in one edition, I vented my frustration about the increasing tendency of companies to outsource important strategy and operational decisions to consultants. I could not understand why a board appoints a new CEO after a global search and the first thing he or she does is bring in a major consulting firm for help and advice. Didn't the board appoint the person for their expertise and ideas for running the company?

Sharing proprietary knowledge and insights with a consultant is annoying for many people in a business. Not only was that internal skill developed over many years, but there's always a suspicion that the knowledge will be shared with another client, probably a competitor. It's not normally as overt as copying a document or declaring the source, but the consultant learns on the job and takes the information to the next client. Moreover, the senior partner who pitched for the work to mates on the executive committee oversees 20 projects at a time. The person sent out on the job is often a few years out of university and less experienced than people who work in the company.

Then three months later, in the final report which costs the company millions, there are the words shared with the consultant looking back at you.

"A consultant is someone who borrows your watch to tell you the time, and then keeps the watch."

In CFO magazine, I also argued that company executives should write the first version of a legal document themselves. Not only is it good skill to develop, but it forces them to write down exactly how the contract or transaction should work. It will also save costs by giving the legal team a start. Of course, legal expertise is required for final drafting, specific legal expertise and accuracy, but at the start, there's now another option. The development of AI and **ChatGPT** and similar tools will allow far more executives to take the first drafting step. Tell AI what you want in a contract and look like a genius.

I gave ChatGPT on OpenAI this request:

> *"Write a legal document to appoint a fund manager to invest in global equities for a super fund including reporting, limits on types of assets, expected performance and size of portfolio."*

If you need evidence of how AI will change many professions, including legal work, the result is impressive. If you own shares in a company which produces legal templates, sell. The first draft produced in 10 seconds is too long to reproduce here but it's a good starting point for a super fund executive thinking about what might be required rather than relying on a legal adviser to take a week drafting a document. In some cases, the legal firm takes a document off a shelf, but they still charge for it.

So at the start of a consulting or legal assignment, check if AI can give you a start. As with any major innovation, there is a dark side. Australian companies are introducing strict guidelines on the use of generative AI, especially due to the potential for data theft or breaches based on information loaded into system.

And so to the **PwC** consulting debacle. Yes, it a disgrace that knowledge of government plans for multinational tax avoidance were openly shared with multinational clients, and there will be severe repercussions for the consulting firm. But there's another side to the story which is less discussed. Why do government department pay billions of dollars a year to external consultants? There are more tax experts in each major consulting firm than there are in the Australian Tax Office, but why does the ATO hire these consultants when they know a major part of their business is helping other clients to avoid tax?

The consultants are responding to the contracts on offer or advice requested, or maybe they are skilled enough to create work for themselves. While PwC's breach was blatant, more common and subtler is simply knowing what is happening inside government and using the knowledge with another client, perhaps against the best interests of the original client.

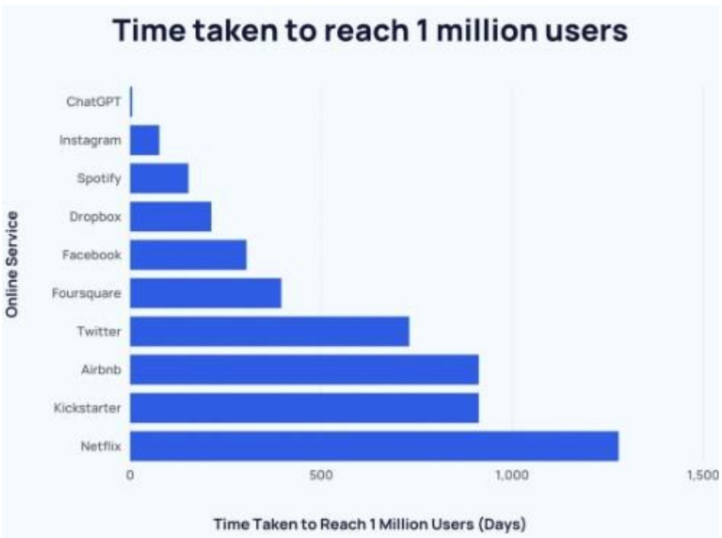
Considering the findings of the [Tax Practitioners Board](#) (TPB) are at the centre of the PwC scandal, their website is a quiet space, with no media release updates since January 2023 on the biggest story in tax land. It's now June. It is to the great credit of *The Australian Financial Review* that it has stayed on top of a story which could have drifted by. Here is part of the TPB January statement:

> *"Peter-John Collins, a former tax partner at PricewaterhouseCoopers (PwC), has been deregistered as a tax agent for integrity breaches by the Tax Practitioners Board (TPB). Mr Collins' deregistration includes a 2-year ban on becoming a registered tax practitioner.*
>
> *The TPB conducted an investigation into Mr Collins' conduct. The investigation revealed Mr Collins, while a partner of PwC, was part of a confidential consultation by Treasury in a confidential consultation to improve tax laws. This included new rules to stop multinationals avoiding tax by shifting profits from Australia to tax and secrecy havens. Mr Collins made unauthorised disclosures of this confidential law reform information to partners and staff of PwC."*

Little more than a rap over the knuckles, plus a requirement to improve internal training. But now we have 144 pages of PwC emails showing Collins' confidential information became a major marketing ploy to avoid the Multinational Anti Avoidance Law (MAAL). PwC has won over $500 million in government contracts in the last two years.

Part of the answer lies in the stripping of experts employed in public service, of reducing departmental budgets, of telling senior bureaucrats that their opinion is not valued, and perhaps politicians lining up some future relationship with a major consulting firm. As **Ross Gittins** writes in *The Sydney Morning Herald*:

> *"These days, much of the big four's income is from consulting to federal and state governments. In 2021-22, the feds paid $21 billion for "external labour" – consultants, but also contractors and labour-hire companies. Senator Barbara Pocock, of the Greens, says this is equivalent to 54,000 full-time workers, and compares with 144,000 directly employed federal public servants.*
>
> *Barrister Geoffrey Watson has asked "why is Australia outsourcing so much of its governing to private enterprise? Policy development and implementation are now routinely taken from the public service and turned over to private consultants."*



Source: [Exploding Topics](#)

Businesses should look around their own operations, check what work is outsourced to consultants and hire the best people to retain skills and knowledge in the firm ...

... and review what AI can do. They will join millions doing the same.

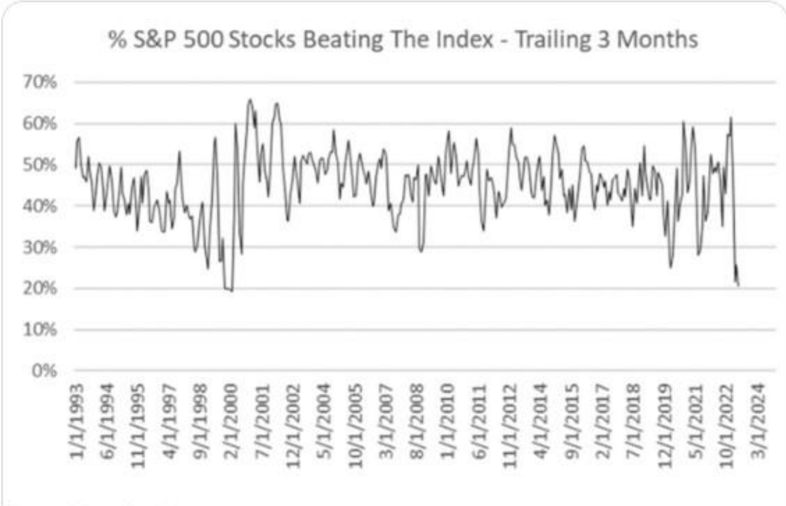
ChatGPT rewritten records and **Exploding Topics** reports:

- ChatGPT currently has over 100 million users
- openai.com receives 1 billion visits per month
- Over 60% of ChatGPT's social media traffic comes via YouTube

When **Bill Gates** says that in his entire life, he has only seen two demonstrations of revolutionary technology, we should sit up and listen. His first was in 1980, graphical user interface, which became Windows. And then in 2022, when he saw the latest iteration of OpenAI after watching progress since 2016, he writes:

> *"I knew I had just seen the most important advance in technology since the graphical user interface."*

It is headline-grabbing to talk about bubbles, but a few stocks riding the AI boom are creating major anomalies in markets that all investors need to appreciate. For example, although it looks like the S&P500 is performing well in 2023, only 20% of companies are outperforming the overall index on a 3-month trailing basis. It's another highly-unusual data point as the smallest % since the dot-com boom in 2000.



Source: Piper Sandler

In the US, only three sectors – information technology, communications services and consumer discretionary – are outperforming the index while all others are underperforming. The winning sectors of communications services holds **Meta (Facebook)** and **Alphabet (Google)**, consumer discretionary holds **Amazon** and **Tesla** while **Nvidia** is in information technology.

As this is such an unusual occurrence, and it may be the start of something revolutionary – or is that what the media says in every bubble? – we dissect how Bill Gates views the AI opportunity and why Nvidia and a few big companies are creating an historical moment in investment markets.

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Mark Delaney is the Chief Investment Officer at **AustralianSuper**, the largest super fund in the country managing almost $300 billion. With a relatively young client base, fund inflows remain strong, and at this stage, a minority of members are old enough to draw down pensions. We highlight the implications from an interview with Mark at the **Morningstar Investor Conference** last week, including why he is confident holding illiquid assets.

He also addressed concerns about internal teams managing assets, a major trend among most of the large superannuation funds. Gone are the days when most investment management was outsourced, but criticisms include that it is more difficult to remove internal staff. He replied:

> *"We've terminated internal fund managers for not delivering the performance we're after. If anything, they get more scrutiny than the external managers do because the investment committee, and everybody else, is all over them. And we've actually hung out, when you look at over our history, we've hung on to external managers who haven't performed for too long. They used to be good ones, and now they'll just come back and they'll come good again. And how long does it take for you to give up faith? It's always when you look back on your record you should have got rid of them, when you first started to worry about them. How many of them come good after you first start to worry about them? One in three. Even when we know this, we still don't do it fast enough. So, reluctance to do anything affects all investment decision making."*

Delaney's claim that only one in three fund managers "*come good after you first start to worry about them*" surprises me, because in my experience, fund managers go through periods when they underperform due to the market not favouring their style, and just after investors give up and redeem, the managers often starts to "*come good*". Delaney has seen far more examples than I have but selection of an active fund manager is a long-term commitment.

Delaney also discusses the controversial subject of investing in illiquid, private assets, explaining why it works for his funds and the limits he sets. It's a big advantage for industry funds as these assets have performed well with lower price volatility. Recent research from **WealthData** estimates that unlisted assets comprise 21.7% of industry fund asset allocations, 21.5% of public sector fund allocations but only 4.5% of retail fund allocations.

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Yesterday's release on the CPI for the year to April 2023 showed an increase of 6.8%, higher than the 6.3% in March 2023 but below the high of 8.4% in December 2022. **Michelle Marquardt, ABS** Head of Prices Statistics, said:

"A significant contributor to the increase in the annual movement in April was automotive fuel. The halving of the fuel excise tax in April 2022, which was fully unwound in October 2022, is impacting the annual movement for April 2023."

CPI inflation is often impacted by items with volatile price change such as automotive fuel, fruit and vegetables and holiday travel. Excluding these volatile items, the annual movement of the monthly CPI indicator was 6.5%, lower than 6.9% recorded in March.

It's a mixed result but it was enough for the stockmarket to sell off amid heightened concern of another cash rate increase.

Finally, my personal thanks to **Jamie Wickham** who left his role as Managing Director at **Morningstar** this week after 25 years of achievements and major milestones. Jamie was primarily responsible for Morningstar acquiring Firstlinks in 2019, giving our readers access to greater resources and ensuring sustainability of the newsletter. Jamie has always personified 'putting investors first' and my best wishes for his next step.

Graham Hand

Also in this week's edition ...

The fixed-rate mortgage cliff is front-page news and former **RBA Governor, Ian Macfarlane**, says seemingly radical solutions may be needed. He thinks APRA may need to lower lending buffers and the government could intervene to provide lending to those unable to refinance bank loans. Macfarlane also says rates could stay high for the next two to three years.

Daniel Pennell from **Plato Investment Management** reports that after two solid years of post pandemic global dividend growth, strong momentum has continued this year, providing great news for retirees. And the outlook for dividends remains positive, despite a challenging macroeconomic backdrop.

Last week, we featured a story on **Jack Gance**, the entrepreneur behind two market-leading businesses, including Chemist Warehouse. In Part 2, **Lawrence Lam** delves into how Gance built Chemist Warehouse from scratch and why he's succeeded in creating a national pharmacy chain, while many of his competitors have failed.

Despite a long laundry list of economic and geopolitical challenges, most stock markets are near all-time highs. Why? **Erik Knutzen** of **Neuberger Berman** attempts to provide a rationale for the markets' relentless drive higher, and the likely path ahead.

Anthony Kirkham from **Western Asset Management** says recent rate hikes have done wonders for bonds as an asset class. The key attractions for owning bonds are back, including high income and total return potential, diversification benefits via a low to negative correlation with growth assets, and defensive attributes linked to potential capital appreciation in times of stress.

And in this week's white paper, **Brandywine Global Investment Management**, part of **Franklin Templeton**, looks at the business cycle and suggests a US economic recession may be baked in.

Curated by James Gruber and Leisa Bell

Opening Gates: AI is as revolutionary as the internet

Graham Hand

> *"In my lifetime, I've seen two demonstrations of technology that struck me as revolutionary ... For decades, the question was when computers would be better than humans at something other than making calculations. Now, with the arrival of machine learning and large amounts of computing power, sophisticated AIs are a reality, and they will get better very fast."*
> *Bill Gates, Founder Microsoft, The Age of AI Has Begun*

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Most people can recall their first experience with a new piece of technology that changed how they lived or worked. I remember the excitement of watching satnav in a car, the first decent computer in the home and office, the beginning of email at work and the wonder of a smart phone with a screen in your hand. As Head of New Issues at CBA, we acquired the first fax machine in the entire bank to allow documents for Eurobond issues to travel to London and back overnight. It cost $7,000 and filled a small room, and people came from around the Bank to gaze at it. We take all these innovations for granted.

And now a bigger technology is unfolding before our eyes. We have scratched the surface on what Artificial Intelligence (AI), ChatGPT and the like will achieve, and how it will change our lives.

The simplistic view is that OpenAI can write answers, stories or legal documents and journalists and lawyers should fear for their jobs. Play around with OpenAI, ask it some questions, and indeed, it will amaze. In 2022, Bill Gates reviewed the technology in the way many of us have, and was awestruck.

> *"In September, when I met with them again, I watched in awe as they asked GPT, their AI model, 60 multiple-choice questions from the AP Bio exam - and it got 59 of them right. Then it wrote outstanding answers to six open-ended questions from the exam. We had an outside expert score the test, and GPT got a 5, the highest possible score, and the equivalent to getting an A or A+ in a college-level biology course.*
>
> *Once it had aced the test, we asked it a non-scientific question: "What do you say to a father with a sick child?" It wrote a thoughtful answer that was probably better than most of us in the room would have given. The whole experience was stunning.*
>
> *I knew I had just seen the most important advance in technology since the graphical user interface."*

Bill Gates has been at the forefront of watching AI since 2016 and he sees considerable potential:

1. Productivity enhancement

There will always be jobs where humans are better than AI but tasks such as sales (digital or phones) and document handling (payables, accounting, insurance) will be handled by AI. Its ability to express ideas will be like having an assistant to help, such as writing emails and managing email. Gates argues that when productivity rises, society benefits because people are free to do other tasks. This is an optimistic outlook as many will also be left behind.

2. Health and equality

Healthcare staff spend an inordinate amount of time on measuring, filing, insurance, paperwork, taking notes and record-keeping, and AI will streamline most of this. Gates works full-time on philanthropy and sees much potential in poor countries for people who cannot visit a doctor. For example, AI-powered ultrasound machines can be operated by someone with little training. Diseases can be identified remotely. Gates sees a future advising people in poor countries on crops or livestock, better seeds for local conditions, soil and weather information, drugs and vaccines for animals.

3. Creation of a personal agent

A personal agent will help with scheduling, communications and e-commerce across all devices. We will need to work out how much we allow the agent to make decisions for us, such as what to buy and what to tell other people.

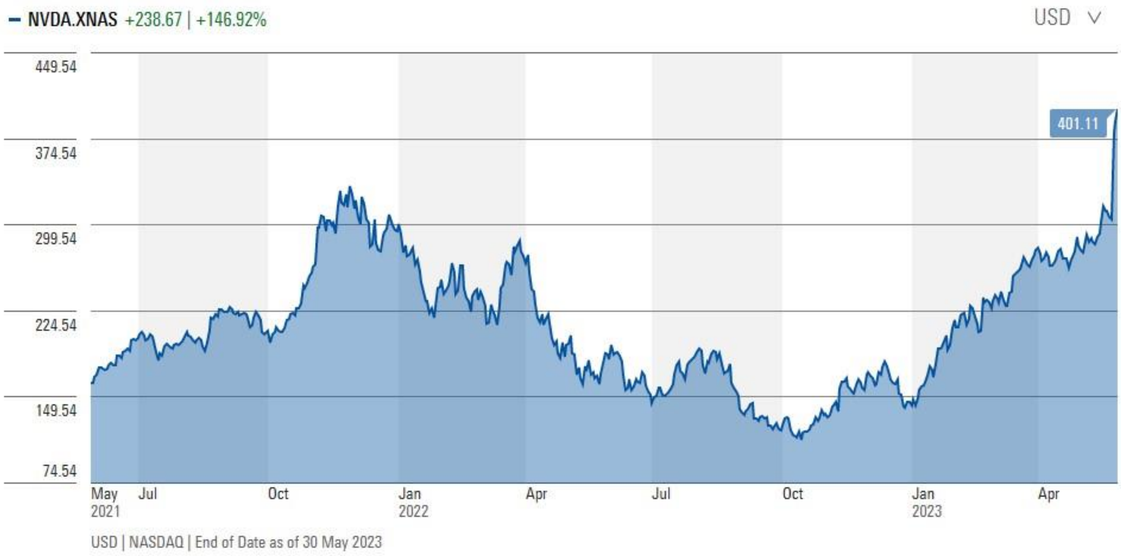
4. Education

Gates says computers have not delivered the widespread gains in education that he hoped, but AI-driven software promises a revolution in teaching and learning. Content can be increasingly tailored to specific children or communities, understanding can be measured, and motivation and weaknesses monitored. It might give advice on career planning.

The investment implications, with a warning

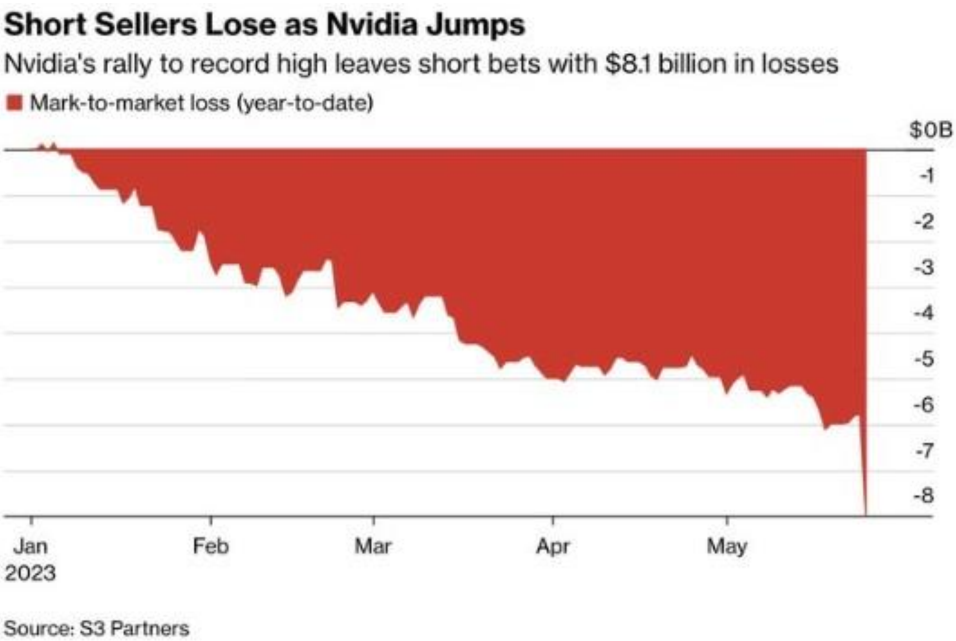
The market is recognising this potential with massive enthusiasm, and as always happens in equities, there will be overreactions. At some point, as too many investors jump into the same idea and hedge funds algorithms follow the trends, prices will be pushed beyond reasonable valuations. It is the nature of markets and the human condition, as happened in 2000.

In the current market, anything written about the stock at the height of the AI frenzy, Nvidia, can lose relevance in a day. It recently rose 30% in after-hours trading following an upbeat announcement on future revenues. A week ago, I wrote about Nvidia going above US$300 and it touched US$418 intraday on Tuesday NY time to enter the exclusive US$1 trillion club occupied by only Apple, Microsoft, Alphabet and Amazon. At time of writing, close of Wednesday, it was back below US$380.



Source: Morningstar Premium

The other side of such meteoric rise is the hedge funds and others who are negative on the stock and take short positions, with losses heading to US$10 billion.



For the moment, Nvidia dominates the AI landscape, a leap above the Central Processing Unit (CPU) technology of other companies. Nvidia CEO Jensen Huang told CNBC:

> *"The flashpoint was generative AI … we know that CPU scaling has slowed, we know that accelerated computing is the path forward, and then the killer app showed up."*

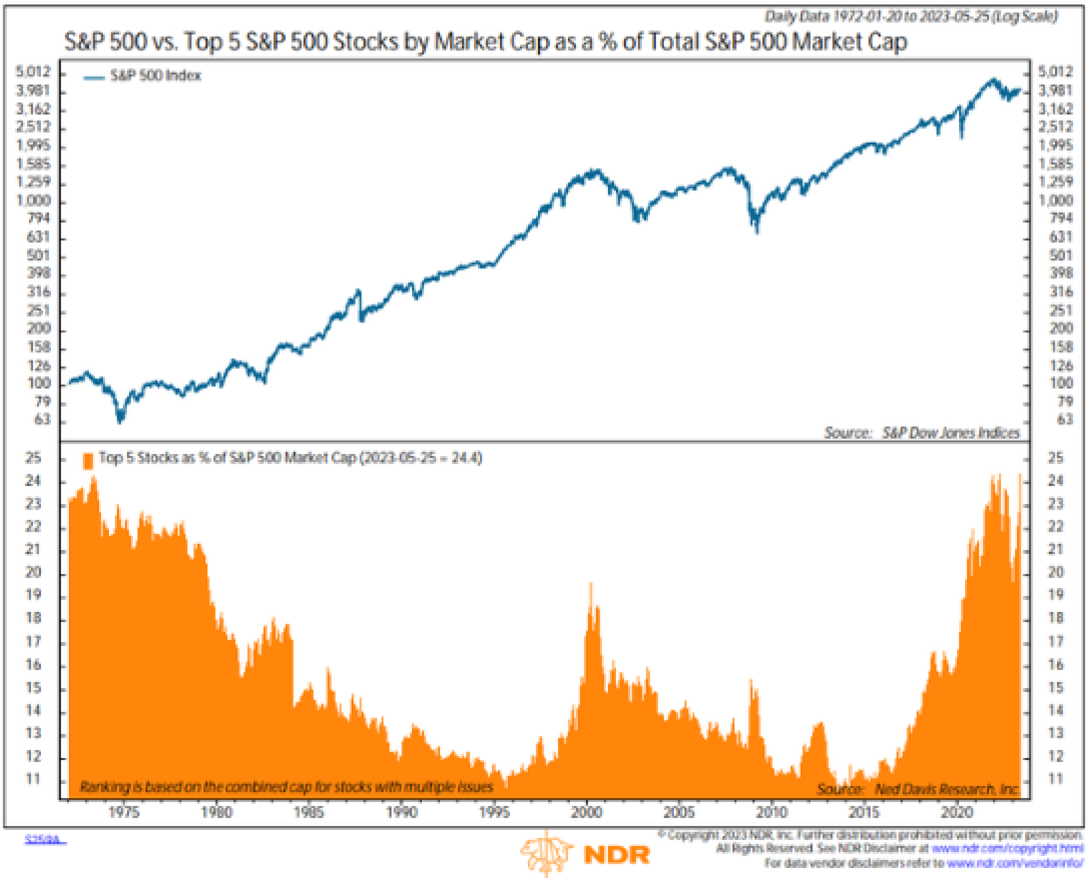
At some point, other companies will catch up. Nvidia is currently trading on a Price to Revenue ratio of 37 and a Price to Earnings of 204. There is a famous statement from Scott McNealy, then CEO of Sun Microsystems, speaking to Bloomberg in 2002 about the crazy valuations of his company in 2000 and the subsequent collapse:

> *"Two years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends.*
>
> *That assumes I can get that by my shareholders. That assumes I have zero costs of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate.*
>
> *Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

Three charts on how the market is reacting

Here are three charts selected from various sources which summarise AI's rise.

1. The five largest companies in the S&P500 (Apple, Microsoft, Alphabet, Amazon and Nvidia), comprise almost a quarter of the index of 500 companies, the highest percentage for 50 years, pushed up by the AI promise.



2. The tech Nasdaq index is outperforming the Dow Jones Industrial index by 22% in 2023, the widest margin in any year since Nasdaq launched in 1971.

3. Analysts have widely-different expectations. Morningstar analyst, Abhinav Davuluri, recently updated his valuation for Nvidia, saying:

> *"Wide-moat Nvidia reported first-quarter sales ahead of management's guidance, while providing guidance for the second quarter significantly above our prior estimates. Management expects second-quarter revenue to be at a midpoint of $11 billion, which would be up 64% year over year and 53% sequentially. Yesterday shares in the company leapt from around $305 to $386 on the news.*
>
> *We are raising our fair value estimate on Nvidia stock to $300 per share from $200 per share, as we raise our forecast for Nvidia's data center segment revenue to grow at a 30% compound annual growth rate over the next five years (up from 19% previously)."*

Other analysts report they have never seen such a wide guidance range on technology stocks as they struggle to understand the consequences of the monetisation possibilities of AI. Within 24 hours of the recent earnings update by Nvidia (NVDA), here are the analyst announcements, with a range of US$320 to US$600.

Back to Bill Gates, who reads more widely in a week than most of us do in a year, who concludes:

> *"I think back to the early days of the personal computing revolution, when the software industry was so small that most of us could fit onstage at a conference. Today it is a global industry. Since a huge portion of it is now turning its attention to AI, the innovations are going to come much faster than what we experienced after the microprocessor breakthrough. Soon the pre-AI period will seem as distant as the days when using a computer meant typing at a C:> prompt rather than tapping on a screen."*

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person.

Former RBA Governor's interest rate and mortgage cliff warnings

James Gruber

This is an edited transcript of an interview between Stanford Brown CEO Vincent O'Neill and former RBA Governor and Stanford Brown Investment Committee member Ian Macfarlane.

Vincent O'Neill: Where do you see inflation now versus where we were 12 months ago?

Ian Macfarlane: There has been progress made on inflation, particularly in the U.S. So it peaked at 9.1% and it's now 4.9%, which is quite a big fall. And the reason it's falling is that it's the transitory bits that jumped up, either stopped going up or are, in many cases, falling again, like energy.

But you should look at measures of core or underlying inflation. The most obvious one there for the U.S. is to take out energy and food. If you look at that, it never went up anywhere near as much as the total CPI and hasn't gone down much either. It's running about 6%. So that's a better indication of ...

US core inflation rate

O'Neill: Where true inflation levels are up.

Macfarlane: In Australia, our CPI has gone down a lot less than the U.S. CPI. But we have three different measures of our underlying inflation. Our underlying is also somewhere between 5% and 6% and so really, we've got to think of ourselves as being in a world where underlying inflation is probably somewhere between 5% and 6%.

O'Neill: Certainly quite a bit higher than where the central bankers would want it to be.

Macfarlane: A lot more.

O'Neill: Probably quite sticky at those levels as well.

Macfarlane: I think so, but the market doesn't. This is the interesting thing. The market has been optimistic on the economic outlook. It's also been optimistic on inflation, implicitly, we're not permitted to call inflation because we know that through last year, and it's also the case this year, the market has expected interest rates to go up a bit, but then start coming down within the year.

O'Neill: Cuts before Christmas.

Macfarlane: Early fall in interest rates that could only happen if there was a pronounced fall in inflation and which I don't think is going to happen. In that sense, I think the markets have got it wrong. They're too optimistic on both activity going up and inflation coming down. Some people have used this phrase 'immaculate disinflation', a play on immaculate conception. In other words, you can have disinflation without any other bad things happening.

O'Neill: Some magical outcome.

Macfarlane: Yeah.

O'Neill: Very tall scenario. Do you think perhaps markets are reading central banks resolve, misreading, I should say, the resolve of central banks in terms of balancing. How hard they want to go…

Macfarlane: I think they have all the way along. I can remember when we first started putting up interest rates in Australia, there were economists [saying] the cash rate couldn't go up by more than 1.5%. It's gone up by 3.75%. I think the central banks are more determined than markets give them credit for.

O'Neill: And they are not going to be comfortable with allowing inflation to lead.

Macfarlane: Powell made a speech where he just said quite bluntly, yes, it might cause a recession, but that would be a lesser harm than having inflation just continue entrenched in the system.

O'Neill: It's possibly happened, they didn't act fast enough or strong enough.

Macfarlane: Yeah, they already were a bit too timid at the very beginning because a lot of central banking and particularly academic economists got sucked into this belief between 2010 and 2021 that we had entered a new world of permanently very low inflation, possibly even risks of deflation. And we will be in a permanently low interest rates or in some cases 0% interest rates. That became very widespread, and it was a shock to them how quickly it turned around. Having been caught a little bit behind, they're determined that, as Powell said, he'd prefer to go down as someone who caused a recession than as someone who allowed entrenched inflation to continue.

O'Neill: So you paint a picture inflation is sticky, interest rates are higher and will need to remain higher for longer. Maybe we step across and start to think well, okay, what is the impact of this composition, what's the impact on the real economy. And I'm thinking here in Australia, with possible debt levels and we've heard a lot about this fixed rate mortgage cliff that we are on the cusp of. How do you see the outlook, if you were a central banker in terms of the likely impact to the real world?

Macfarlane: We'll work our way towards it. As I said I would have thought there'd been more impact by now. The central question you have to ask yourself is with the increase in monetary policy to date and in my view probably future increases - is it going to bring about a major slowing in economies and possibly recession? I think there is a lot more to come.

O'Neill: Surely it must.

Macfarlane: I mean the adjustment to date has been quite minor. There must be more to come. I think you have to be cautious, you have to say that the markets are more optimistic than they should be, the outcome is probably going to be worse than they think. And how's -- what's the form it's taking? Well, you don't really know how they adjust -- what form the adjustment will take, particularly in financial markets.

Now … the U.S. system where the banks are the ones that are under pressure and part of that is because of the structure of U.S. banks where obviously the deposits are variable. If you want to keep your deposits, you have got to put the interest rates up where competitors are. But so much of your lending book is absolutely fixed in 30-year mortgages, which have been taken out in the ultra-low interest rate period and everyone has got an ultra-low.

O'Neill: No one's rushing to refinance in this environment.

Macfarlane: That's right. So that puts the pressure on the banks.

O'Neill: They've got lower income from that, but rising cost of capital.

Macfarlane: Yeah. Now in Australia it's the other way round. The banks are in very sound position because both on the deposit side and the lending side, there's variable interest rates. You don't get squeezed. What you lose on one, you gain on the other. But what that means is it puts the pressure on the borrower because the borrower, unlike the U.S. borrower, who sits on their low interest 30-year mortgage, the Australian borrower in most cases is either on a variable mortgage or if it's a fixed rate mortgage, it's only a 3-year mortgage.

O'Neill: So that's the point we're at right now, where the those that were fortunate enough to be on the 2, 3-year fixed mortgage are now coming towards the end of that, and realizing they're heading for rates at least doubling, likely more.

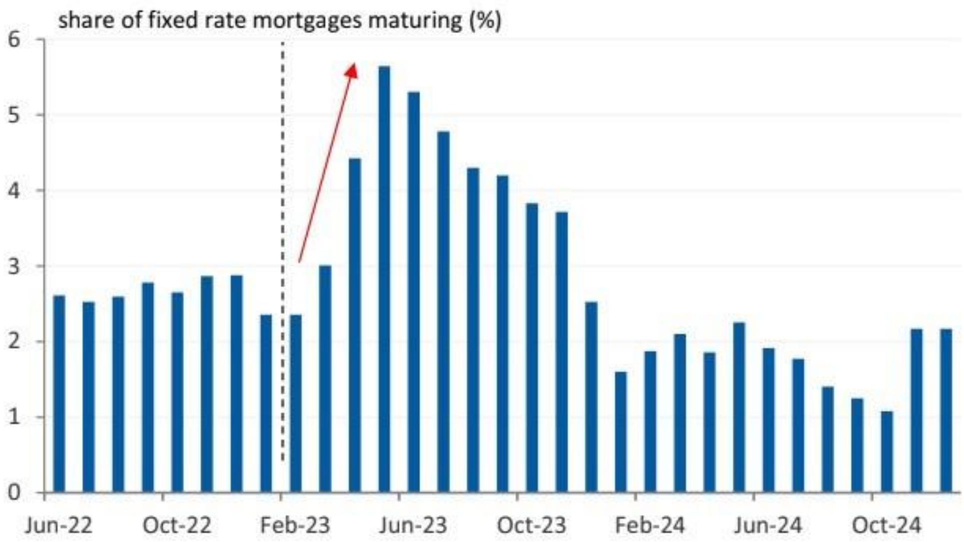
Macfarlane: And the problem is let's say they've got, for arguments sake, an $800,000 mortgage, which is quite common these days. And they're going to have to come to the end of the three years. They've got to pay it back. And the idea is you roll it out; you go and get a different mortgage - a new variable rate mortgage, probably to try and pay back the old one. But at this higher level of interest rates, you cannot borrow $800,000. You're only eligible to borrow $700,000 because the servicing costs determine the size of the mortgage. Clearly there's a potential for serious problem there. It'll be resolved by both the bank [and] the borrower taking a haircut, probably APRA [the prudential regulator: ed] have to bend a few rules, and conceivably, in the last resort, the government having to step in because no one wants…

O'Neill: That's quite an extreme situation for the government to step in.

Macfarlane: I think they would.

O'Neill: I think they certainly would if that was required.

Exhibit 5: Fixed rate maturities accelerate noticeably in 2Q23



Source: RBA, Morgan Stanley Research

Macfarlane: I mean there's hundreds of thousands of people with fixed rate mortgages that are going to mature, and if half of those were not able to get new funding to pay out their old loan, it would be serious issue and the last thing the banks want to do is just foreclose.

I think the borrower is going to have to pay more if they are coming out of a low fixed rate. They're going to pay a lot more. And quite possibly APRA is going to have to relax the rule that says when you work out how much you can borrow, you've got to assume that interest rates could rise by 300 basis points.

O'Neill: Very sensible rule when rates are 0%.

Macfarlane: That's right. Maybe you don't need as big a buffer as 3%. As I say, I think if it really got nasty, there would have to be some form of additional lending coming from the government.

I think it's the pressure point in Australia and this is the problem. The biggest effect of tightening monetary policy is on anyone who's got a lot of borrowing. And in Australia, that is the household sector.

This is an edited transcript of an interview between Stanford Brown CEO Vincent O'Neill and former RBA Governor and Stanford Brown Investment Committee member Ian Macfarlane.

James Gruber is an Assistant Editor for Firstlinks and Morningstar.com.au. This article is general information.

Key trends in global dividend income

Daniel Pennell

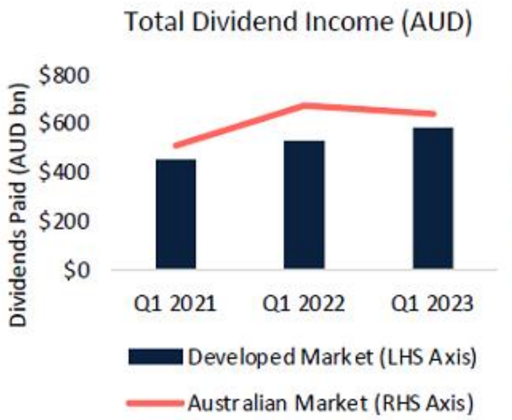
After two solid years of post pandemic dividend growth, it is pleasing to see the trend in Q1 2023, providing great news for retirees.

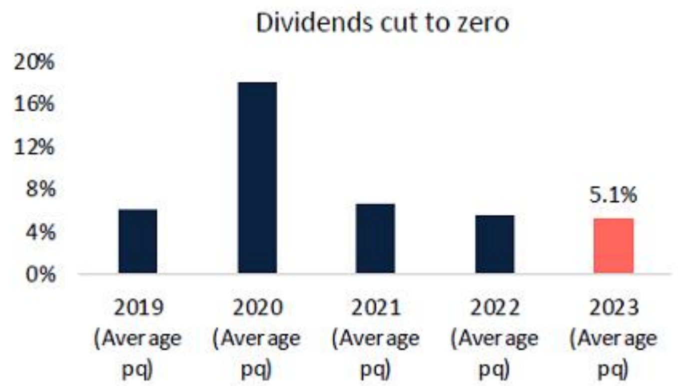
In AUD terms income growth was very strong (+10.1% v Q1 2022). Approximately half of this was due to currency moves, with payouts still growing a solid +5.8% in local currency terms.

Global developed market companies had a strong quarter, paying out $A571 billion of dividends in Q1. Strong payouts continue to mask significant differences across countries and sectors.

Importantly, the number of companies cutting to zero remained low in Q1 (5.1%). This supports our house view of future dividend strength.

The Plato Global Equity fund continues to distribute just under 6% p.a. yield since inception, despite lower index yields in recent years. This highlights the continued importance of both income generation via active management and avoiding dividend traps.





Source: Factset

54% of dividend paying companies increased or initiated dividends compared to the same quarter last year. The number of companies decreasing payouts, has ticked up significantly due to the challenging macro environment, but remains moderate at 12%.

We continue to see some large companies, such as Visa Inc, Costco Wholesale, and Shell Plc, increase their dollar payouts. In addition businesses, like shipping company AP Moller - Maersk, have paid out significant special dividends, a continuing post pandemic feature.

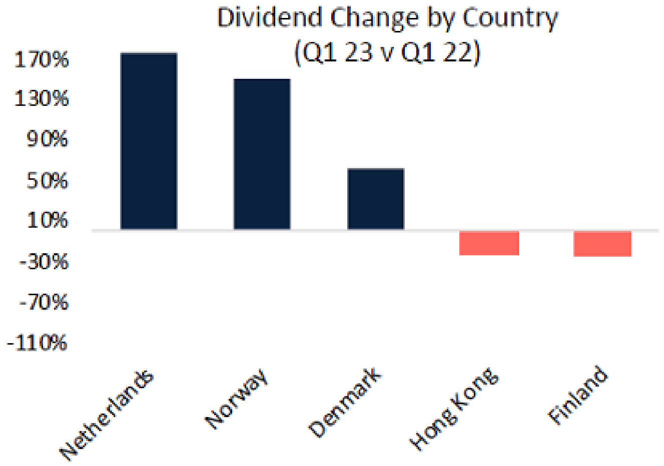
North America and Europe increased quarterly income, in contrast to weakening payouts in Asia, when compared to the previous corresponding period in 2022. (North America +13.1%, Europe +16%, Asia -1.4%)

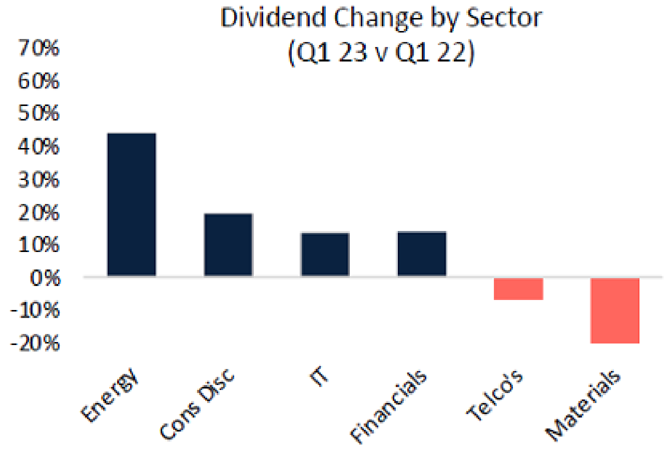
Which countries are leading the charge?

When comparing Q1 2023 with Q1 2022 the story varied significantly within countries. Asian countries ranged from Hong Kong (-23%) to Singapore (+27%), whilst European countries spanned Finland (-24%) to the Netherlands (+175%).

The US posted strong (+12.5%) dividend growth when based in Aussie dollars. Although not yet a substantial driver, it’s worth noting the US buyback tax did come into effect at the start of Q1.

Despite falling in Q1 (-5.2% v Q1 2022), Australian dividends posted $A32 billion, the fourth highest from a developed country. Despite strong increases from CBA and Woodside, the drop in payout was driven by miners including RIO, BHP, and Fortescue.





Source: Factset

What happened in global sectors through Q4?

Mirroring the trend in countries, sectors were also mixed versus Q1 2022. The stand out increase was once again energy companies (+44%), followed by consumer discretionary (+19.4%). At the other end of the spectrum, materials (-19.9%) payouts fell the most, with telco's (-6.5%) also cutting significantly.

The drivers of yield, energy and consumer discretionary, continue to be consistent from 2022.

This is similar to the domestic landscape, where big miners are cutting in contrast to energy companies who are lifting dividends to reflect surging gas prices. After a stellar 2022 energy stock prices underperformed in Q1, but strong dividends reflect the balance sheets from the earlier commodity rally. Increased payouts were seen from businesses in the sector, including Equinor and Japan Petroleum Exploration. Co. In contrast materials businesses, for example Rio Tinto and BHP, cut.

Consumer discretionary yield strengthened further, driven by surprisingly strong household balance sheets. In 2023 the sector has overcome cost of living pressures, posting strong stock price return. Many Japanese companies in the sector, like Fast Retailing Co and Suzuki Motor Corp, grew their distributions in the most recent quarter.

Interesting facts in global income

When incorporating dividend cuts and initiations, 3.4 companies increased or initiated dividends for every one company that reduced or completely cut dividends versus the previous corresponding period. This is further proof of dividends continuing to strengthen.

46% of US companies paid a dividend in Q1. Strong ratios were also evident in Japan (72%), Canada (65%) and Australia (52%).

What's the outlook for global income?

Plato's proprietary dividend cut model provides insights into future dividends. It represents Plato's macro view regarding the likelihood that global developed markets will cut their income.

Our model predicts a low probability of global developed market dividends being cut (12%). Q1 is slightly higher than a year ago, which reflects the increasing concern around inflation and global growth. The risk to income remains around the long-term average and continues to indicate a positive outlook for retiree income.

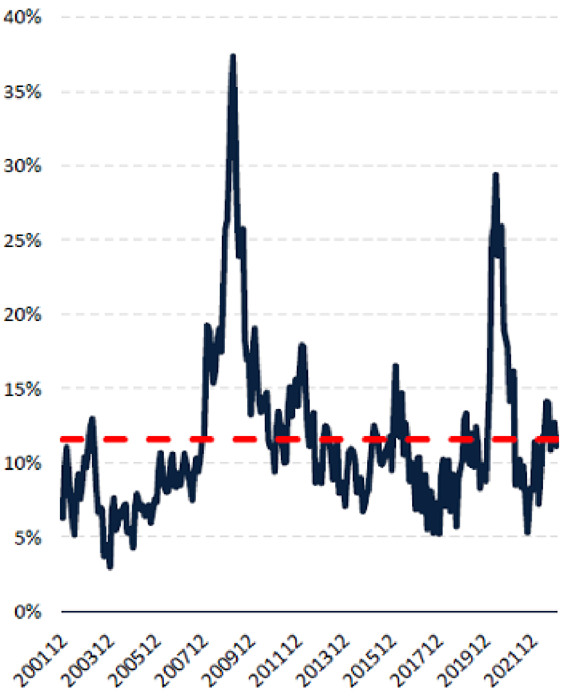
Real Estate and telcos are the highest risk industry groups, the former continuing to reflect the cost of living crisis.

In conclusion

After 2020 pandemic driven cuts to global market income it is important to see two years of strong growth, albeit from a low base. Global equity markets have continued this trend in Q1 2023, reflected in strong headline numbers. But, this masks divergence within sectors, highlighting the importance of vigilance and active management in income generation.

As we look forwards, the low probability of dividend cuts paints a strong dividend picture for yield investors.

Global Dividend Cut Probability Monthly



Methodology

1. The methodology uses dividends paid, in AUD, however the ex dividend date is used to allocate the dividends in the relevant time period e.g. Q3 2020.
2. Dividend paid ($) for each stock in each calendar quarter is calculated as the shares outstanding as of quarter end multiplied by the total gross dividend per share (DPS) paid out in the calendar quarter. The DPS paid excludes spin offs but includes capital returns and special dividends. Conversion to AUD is done using the prevailing WM/Reuters London exchange rates at the time of dividend payment.
3. Full year dividend paid ($) is the summation of dividend paid ($) from Q1 to Q4 using the methodology (1).
4. DPS movement is based on total DPS paid out (in local currencies) over each calendar quarter. DPS movement from quarter to quarter is then categorised as initiating, increasing, unchanged, decreasing or cut to zero.
5. Secondary issues are removed from the calculations to prevent double counting of income.

Daniel Pennell is a Senior Portfolio Manager with Plato Investment Management. Plato is affiliated with Pinnacle Investment Management, a sponsor of Firstlinks. This article is for general information only and does not consider the investment objectives, financial situation or particular needs of any investor.

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Chemist Warehouse founder reveals his success secrets, Part 2

Lawrence Lam

Last week, we detailed how Jack Gance and his brother, Sam, built the sunglass and cosmetics distributor Le Specs before selling the business in 1990. The Le Specs business was originally launched as a pharmacist-to-pharmacist wholesaler, and Jack and his brother Sam were themselves qualified pharmacists with their own established pharmacies.

Separate to the Le Specs business, Jack was concurrently cultivating a footprint of pharmacies in Victoria which grew from 2 to 35 through a series of partnerships. This chain of stores would eventually be branded as the MyChemist. It would be the first iteration of what would spark the creation of Chemist Warehouse - the second phase of Jack's career and his biggest success. It would become a pharmacy brand that would dominate the Australian market.

Creating new opportunities in crowded markets

Prior to Chemist Warehouse, the pharmacy market in Australia was fragmented and traditionally hard to scale due to strict regulations and the requirement to have qualified pharmacists on premises. That was until Jack changed the business model.

Traditionally, the local chemist was a member of the community, just like the local doctor. Roughly 70% of revenues of the average pharmacy store were from prescription drugs, and the remaining 30% being from non-prescription drugs and other health-related products.

The Chemist Warehouse model flips this script. Most sales are from non-prescription drugs such as vitamins, fragrances, cosmetics, skincare, and natural medicines. This segment, often referred to as the 'front-of-shop' sales, accounts for approximately 70% of revenues, whereas prescription medicines (behind-the-counter) are 30% of revenues. Readers should not misinterpret Chemist Warehouse as generating less prescription sales, but rather it sells far more front-of-shop products than the average pharmacy in Australia. Prescription sales remain on par, if not more, than the average pharmacy.

Chemist Warehouse's growth comes from the ability to create a new market within an established industry. It does this by increasing the floorspace allocated to front-of-shop products, changing the traditional drug-focused pharmacy model into a warehouse focused on showcasing all the non-prescription products.

Jack's retail philosophy centres around bombarding customers with such a wide variety of products that they will eventually find something that they want. "If you walk into a shop looking for a tie and the shop has three ties, you might not buy one. But if the shop has 1,000 ties, you're more likely to find one or more that suit you", Jack says.

This philosophy also gives the ability to cross-sell more products. Like the Costco model, customers of Chemist Warehouse often walk out buying more than they intended simply because of the overwhelming product range and overt signage which serves as a reminder of all the forgotten shopping list items. On average, the revenue of a Chemist Warehouse store is roughly four to six times that of an average pharmacy store due to the velocity at which they turn over stock. This brings scale and buying power from suppliers which in turn enables low pricing for customers.

From an investment perspective, Chemist Warehouse is akin to a platform business. It's reputation as the preeminent low-cost pharmacy brand means consumers will gravitate to their shops. They match these consumers with vendors selling cosmetics, vitamins, skincare, and health products. Their 'platform' is the network of 500 stores that give them the footprint to be the country's number one pharmacy retailer.

The physical store network is connected by unified sales systems and inventory management systems which allow head office a centralised view of the platform. Like most platform businesses, they have self-perpetuating monopolistic characteristics as buyers and sellers reinforce the need to transact through Chemist Warehouse. Ultimately this creates scale and reduces inventory risk for Jack's business. The more they sell, the lower the prices they can offer, and the more customers they win.

A founder's connection to their business

Many pharmacy retailers have attempted to create a national chain though none have dominated the market like Chemist Warehouse.

From the outset of my interview with Jack, it's abundantly clear he retains intimate knowledge of the business despite much of the daily operations now being run by his team of 500 at head office. He cites store sales figures from the prior week and tells me which products are trending in his stores. He receives daily reports from the centralised sales and inventory management systems.

What he detests are business leaders detached from their customers. Jack tells me about a conversation he had with the CEO of a leading Australian health company selling a significant amount of product to Chemist Warehouse. Jack asked the freshly appointed CEO, a non-founder, if he knew the name of Chemist Warehouse's representative buyer - the key influencer who determines which products Chemist Warehouse will buy and in what quantity. The CEO was not able to. Jack asked if the CEO knew the buyer's name from one of Australia's largest supermarkets, another key client. "Jack, I know the CEO of the supermarket chain, but I don't know the buyer by name. I'm a CEO of a multinational business, I have thousands of clients and it's impossible for me to know every buyer by name", he said.

But that is the essence of why founder-led businesses are different. As Jack points out, both Chemist Warehouse and the supermarket chain represent a significant portion of this company's revenues. In his view, a CEO must foster a close relationship with those individuals at the heart of the decision-making process of their customers.

In search of the next Jack Gance

Jack is cautiously aggressive when it comes to business. An example is Chemist Warehouse's expansion into the New Zealand and Ireland. "Many companies have failed with big overseas expansion plans," he tells me, reeling off names of Australian companies that have expanded too fast overseas. Although the eventual plan is to expand into the United Kingdom, Chemist Warehouse has opted to test the market in nearby Ireland first by piloting a small number of stores.

"I don't assume I know more than the local market," Jack emphasises. He looks to form partnerships with local operators to minimise the learning curve and expansion costs.

Like many founder-led companies, Jack runs Chemist Warehouse with very little debt. The focus has been on positive cashflow generation and long-term financial stability, an awareness he gained from his Le Specs days which was an operation hungry for working capital.

He favours organic growth over large acquisitions. In 2017, Chemist Warehouse expanded into New Zealand with its first stores initially funded with $5 million of starting capital. New Zealand, with its less stringent regulatory framework compared to Australia, has proven a fertile ground for Chemist Warehouse's expansion. Aside from the initial capital, the expansion has not required additional investment - the new stores continue to be self-funded by revenues from existing New Zealand stores.

With organic opportunities in abundance, very few acquisitions make sense to Jack. Like most long-term minded founders, that is exactly the way he prefers.

Jack's style errs on self-reliance rather than outsourcing. Early on he chose to run his own centralised sales software system on Chemist Warehouse's cash registers to centralise the sales data. The vertically integrated model is a core strategic advantage of the business. It gives head office granular visibility over the entire store network and standardises the technology infrastructure, enabling efficiency when rolling out new stores and products.

A lesson on risk taking

Jack believes true entrepreneurs are risk mitigators. He did this with the marketing deal he struck to launch Le Specs, paying no upfront costs, and instead sharing a percentage of subsequent profits, thereby reducing the expenditure outlayed in case the venture was unsuccessful. And Chemist Warehouse's cautiously aggressive UK expansion plan has Jack's risk management philosophy written all over it.

Though a success story, Jack has experienced his share of failures. After he sold Le Specs, Jack remained in management for two years, working with the new owner during the transition. He watched Le Tan decline under new ownership as he lost the decision-making power to reverse the trend. He attributes the experience as a lesson in the importance of maintaining good relationships with suppliers, not just customers. When the new owner took over, suppliers were strong-armed into renegotiating contracts with unfavourable terms for them. This proved successful in the short-term but eroded the quality of the product as relationships later deteriorated.

Companies that localise an already proven global model

Smaller niche markets may appear less appealing to investors, but even in the sunglasses and pharmacy market in a relatively small country like Australia, Jack Gance has managed to create significant value. The conventional view teaches investors to focus on markets with a large Total Addressable Market ("TAM"), but with larger TAM comes greater attention and increased competition. Instead, investors may find opportunity in companies that localise products and services that have already been proven to work overseas.

For instance, Le Specs introduced a tougher, more flexible sunglass range that was first manufactured and sold in France. Jack localised it for the Australian market after his wife Evelynne visited a trade show in France.

Similarly, he describes how the idea of Chemist Warehouse came about after having visited the "busy, in-you-face, warehouse-style" pharmacies in the US during the 1970s.

The localisation strategy epitomises Jack's focus on risk minimisation; adapting a proven model overseas is much less risky than creating an untested one.

Lawrence Lam is Managing Director and Founder of [Lumenary Investment Management](), a firm that specialises in investing in founder-led companies globally.

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Why high-flying markets are ignoring economic challenges

Erik L. Knutzen

To make sense of today's market conundrum, remember that things could have been worse than they are, and that investors are more defensive than they appear.

There was a question implied at the start of our last *Asset Allocation Committee Outlook*: How could we have called the overall challenging economic outlook, but then watched markets move in unexpected directions?

We are still asking that question deep into the second quarter, with another big bank failure under our belts and rising interest rates, yet equity markets are bouncing around seven-month highs.

What are we missing, in the economy or the structure of the market, that might explain these apparent disconnects?

Squeeze

Each time we run through all the reasons to be bearish on equities, we are struck by just how long the list is.

Monetary and credit conditions are tightening simultaneously, as both central banks and commercial banks rein themselves in. Yield curves remain steeply inverted, with high volatility at the front end.

Inflation is proving sticky everywhere, especially in Europe and the U.K., where the Bank of England faces a growing dilemma, and increasingly in Japan. Monetary policymakers who were tentative a few weeks ago, as the banking sector wobbled, have grown hawkish again. The market-implied probability of more rate hikes is rising again. Bank rescues and the Bank of Japan's (BoJ) decision to maintain its yield-curve control provided unexpected liquidity flows earlier in the year, but the effects are beginning to fade and reverse.

At the corporate level, realized and forecast earnings are declining and inflation is beginning to squeeze margins.

Add it all up, and closely watched aggregate indicators put the probability of a U.S. recession at around 70 – 80%. And that's without an equally long list of exogenous tail risks: trouble within commercial real estate and regional banks, disruptive global flows when the BoJ begins its expected policy normalization, and an escalation of U.S.-Russia and/or U.S.-China tensions.

Nonetheless, equity markets keep nudging higher.

Starting over

One way to make some sense of this is to remember the starting point, as well as the direction things appear to be headed.

Yes, central banks and commercial banks are withdrawing liquidity, but there was a vast amount of liquidity to begin with, and there is still plenty out there. While the consumer may be softening slightly in the face of inflation, employment is high, wages continue to rise and there is still cash in pockets—and, among the more affluent, in savings accounts. Companies are generally not over-leveraged or facing imminent refinancing pressures. And the fiscal impulse remains positive, even as the monetary impulse has turned negative.

Another thing to remember is that, while some things seem bad, they could have been even worse.

Yes, inflation is proving sticky. But imagine, for a moment, that you'd been offered all the good news associated with the reopening of China and the resilience of jobs markets at the start of the year. Might you have turned that good news down over worries that it would stoke commodity prices and inflation more than it has?

Looking at it this way reminds us that interest rates could have been far higher today than they are, and companies and consumers could have been much more sensitive to them than they have been. Where there is sensitivity—bank balance sheets, for example—central banks have shown themselves ready and willing to intervene and take out the tail risk. Perhaps investors are recognizing that the cycle may be less volatile than they feared nine months ago.

Signals

Another way to square things up is to question the signals we are taking from the markets.

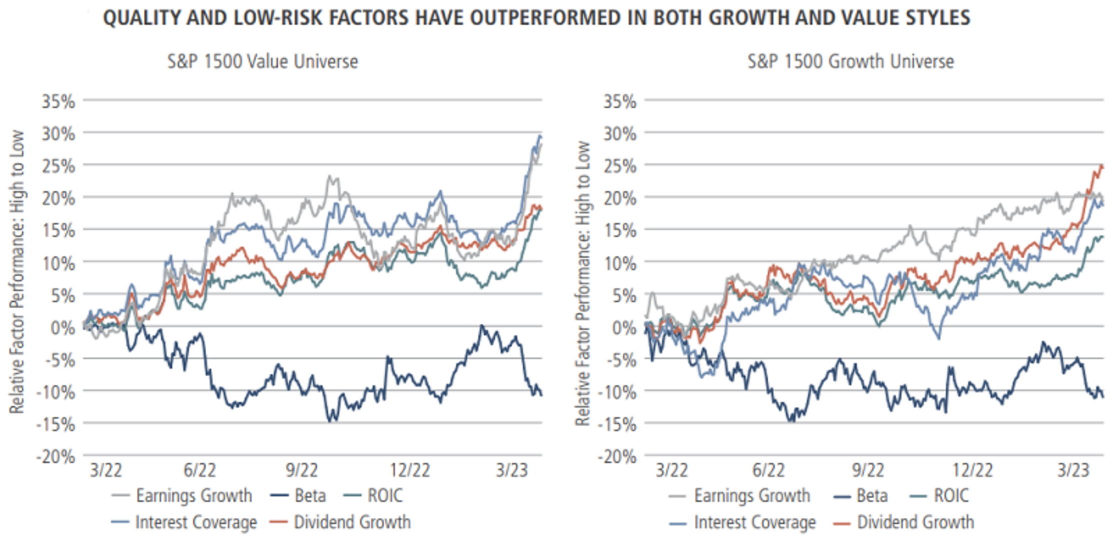
It may appear that investors are strangely calm in the face of flashing red recession alarms and swirling tail risks, but appearances can be deceiving.

A month ago, I noted the contrast between low volatility in equity markets and exceptionally high volatility in fixed income. Two weeks later, Joe Amato wrote a "Tale of Two Indices," noting how a handful of mega-cap tech stocks were making the S&P 500's performance and valuation look much better and higher than the underlying reality. Nvidia, having more than doubled in price already this year, was up almost 25% in a single day last week, after smashing analysts' earnings expectations.

It is an observable fact that underlying factor and sector volatility is actually very high but masked by the dominance of that handful of mega-cap tech stocks. There is a good deal more market uncertainty about the path of the economy than the index return suggests.

Why has this small group of mega-cap tech stocks broken free of the underlying uncertainty? Given the sudden flurry of excitement around advances in artificial intelligence, investors may be seeking out potential beneficiaries of this kind of transformative technological change.

But it is also possible that they have started to trade like safe-haven assets at a time when traditional havens such as U.S. Treasuries and the dollar are beset by doubt. As noted by my colleague, Raheel Siddiqui, it is not the growth or value style factors that have outperformed so far this year, but quality, low-beta and low-risk factors *across every style.*



Source: PSC. Data from March 1, 2022, to March 24, 2023. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Perhaps market participants are more concerned than they look, after all.

A mix of dynamics

To resolve the puzzle, recognize that the reality is likely a mix of these dynamics. The global economy could easily have been in a much worse state than it is, given the conditions it faced toward the end of last year. And investor positioning is more defensive than it appears.

With that in mind, while we may need to look again at how we think about quality and safe havens, the main pillars of our outlook remain intact. Now is not an opportune time to seek out broad equity market risk, in our view—and the market seems to agree. We don't think long-duration assets are the place to be over the coming cycles: The more resilient the economy is to higher rates, the more likely they are to stay high. And with short-dated rates as high as they are, the opportunity cost of waiting out the uncertainty is low—even if the frustration of waiting is occasionally high.

Erik L. Knutzen, CFA, CAIA and Managing Director, is Co-Head of the Neuberger Berman Quantitative and Multi-Asset investment team and Multi-Asset Chief Investment Officer. Neuberger Berman is a sponsor of Firstlinks. This information discusses general market activity, industry, or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. It is not intended to be an offer or the solicitation of an offer.

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Super prospects from Australia's most powerful CIO

Graham Hand

AustralianSuper is the largest superannuation fund in Australia, rapidly growing driven by member contributions and mergers, with about $270 billion in assets under management. Despite its size, it has retained an impressive long-term performance track record, and Mark Delaney has been the Chief Investment Officer (CIO) since 2006. The enormous size of savings in his funds makes him the most powerful investor in the country, in both public and private markets.

At the Morningstar Investor Conference last week, Director of Manager Research Ratings at Morningstar, Annika Bradley, asked Mark about his current portfolio, especially since earlier in the conference, BlackRock had called for an increased allocation to alternatives, while Vanguard made the case for staying the course on a basic 60/40 stock/bond portfolio. Delaney replied:

"The argument is that higher inflation is going to make it harder for bonds to work and more difficult for stocks, and there's a degree of truth in that. More than likely higher inflation, if it manifests itself over the medium term, will result in lower returns in all the investment classes. The absolute total return comes down but the relative ranking of asset class returns probably won't change that much, i.e. on a 10-year view, stocks will beat bonds, bonds will do better than cash, et cetera. Instead of getting, like AustralianSuper's Balanced plans have done, 8.25% over the last 20 years, you'll be getting 6.5%."

Delaney made the case for the role of private assets, such as infrastructure and private equity, in portfolios. While no longer sold at a discount to public market valuations, there is greater operational leverage and growth potential. With private assets, it's not so much what the revenue is today but what the revenue can be in the future with good active management. He cited the boost in profits at airports when managed by private investors.

Bradley highlighted the suspicion about valuation practices and the amount that is allocated to illiquid, private assets. Delaney explained that if a fund holds a material percentage of its portfolio in private assets, it must be appropriately valued because smart members can take advantage of a lagging private market valuation. They can transfer value from the existing pool of members and that's not the right thing for a fund to allow. But he emphasised that private assets are not market-valued but appraisal-valued. It's like saying there is no stock price for a house. There is no stock market price for a private equity investment. AustralianSuper has added resources to its independent valuations team which sits outside the investment team and performs stress testing of valuations to make sure they are not transferring value between members.

Morningstar's analysis across five large industry super funds showed net inflows and member demographics play a part in determining an appropriate allocation to private markets. AustralianSuper has strong net inflows and a relatively young member demographic, but how did Delaney feel his fund's characteristics permitted illiquid assets in his portfolios?

He explained he thinks about sources and uses of liquid assets. The sourcing might be covered by large inflows, but the future uses of liquid assets, particularly in stress markets, might include taking advantage of buying cheap stocks. For example, if equity markets halve as they did in 2008, the illiquid allocation will rise by 40% to 50% because private values will not fall much in the first phase of the equity market selling off. He said:

"You need enough liquidity to be able to rebalance your portfolio, when the chance to buy stocks is the best ... So we've got a figure of around 30% for our balanced plans is about the maximum (in private assets). And that's a function of the sources and uses and the ability to rebalance the portfolio if equity markets were to halve."

Bradley turned to AustralianSuper's unlisted property book, which has not performed as well as some of its other unlisted, illiquid parts of the portfolio. Delaney gave an honest appraisal:

"It has been really disappointing. It was the long and the short the wrong strategy. We had a strategy of overweighting retail and having more international property than Australian property. Both of them were the wrong decisions. And with property, when you've got one, which is underperforming, it's very hard to get out of because you never want to accept how bad it is until it gets really bad. Retail got disintermediated by online shopping, and we had a short exposure to industrial. So that was the worst of all worlds, and that's performed really poorly. Our response basically has been to freeze the allocation to reduce the amount of capital going in there and then have to work our way out of that problem. So with private market investments once you've got a problem, they take five years or 10 years to work your way out."

Delaney said he is short stocks and long bonds because he expects recessionary conditions. First he expects a bear market in US stocks due to a derating as the money bubble is popped, but the second leg will be when earnings go down. He expects central banks to continue to push against inflation until it is tamed. He sees a paradox where the market finally expects inflation to remain stubbornly high for the medium term, but the short term might look better. So the market will think inflation is under control but in two or three years, structural factors such as tight labour markets, deglobalisation and the energy transition will push inflation up a bit higher again.

So he likes floating rate bonds but does not see this as the right time to go overweight equities:

"When do you want to own stocks? You want to own them when they're cheap, and when you're at the bottom of the cycle, so you've got a long runway to come back up again, and you've also got to think of buying. And so you want to buy stocks in 2009 when the U.S. on a P/E of 14 times, U.S. unemployment was 9%, and really

hold them for the next 13 years and just go on holidays. And when do you want to sell stocks? Well, you want to sell them when they're expensive. And when the economy has run out of runway.

So if you start with those two anchors in your thinking, it just provides a very good discipline as to how you should do it. And what happens is people get confused too much about the short-term noise of what's going on and the short term just provides opportunities to get in or get out. It doesn't really change the underlying trend. Investing is always about a view of the future ... (you need) that degree of detachment from where your current circumstances are and typically the worse you feel, the better it is to invest."

Delaney said when his funds have more members in the retirement phase, perhaps in the 2030s, when there's a lot of money going out, it will be a different world for managing liquidity. In preparation, and recognising the aging of members, the next big frontier for industry funds is a focus on retirement rather than accumulation.

"There's another million Australians in the next 10 years going into retirement. AustralianSuper's already got $36 billion of assets in retirement pool that's going to double or triple. And those people will want their pension managed and need affordable advice, and they want super tailored to deliver the total outcome. And the challenge for the industry is to put all those three legs together rather than having separate legs."

In managing a downturn in both economic activity and equity markets, Delaney is trying not to be too precise, but to be decisive at the same time. Precision is not possible, as he summarised:

"I think that you're better to be broadly right than precisely wrong. People spend too much time generating precision in all their numbers rather than getting the broad framework right. So broadly right, rather than precisely wrong."

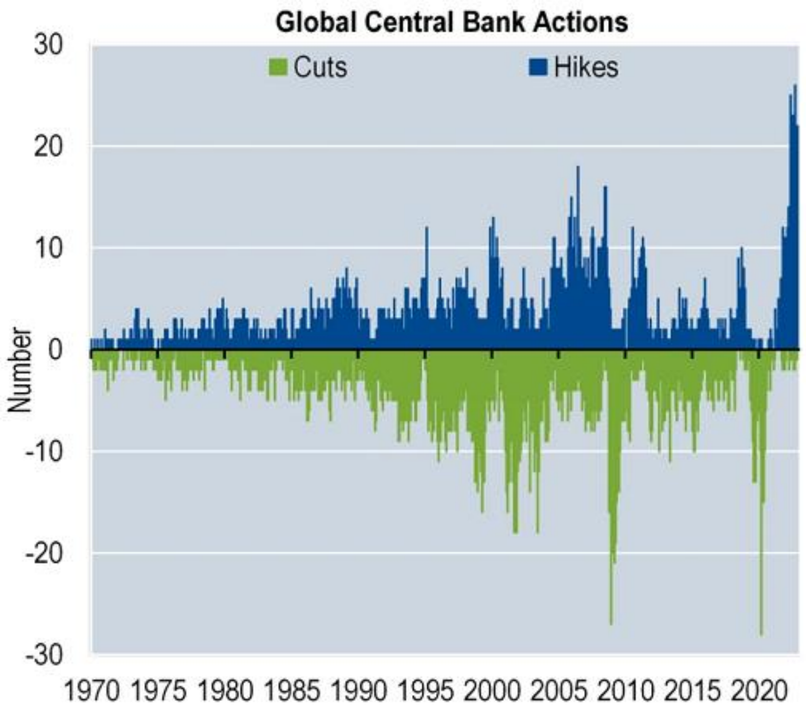
Graham Hand is Editor-At-Large at Firstlinks and Editorial Director at Morningstar.

The bright outlook for Australian fixed income

Anthony Kirkham

The Australian fixed income landscape is very different to a year ago. At the onset of 2022, investors scouring the globe for yield opportunities were continuing to stretch risk and liquidity budgets in their pursuit of reasonable prospective returns.

By the end of March 2022, negative yielding debt outstanding had fallen to US$3 trillion, after peaking at US$18.4 trillion in December 2020. In hindsight this was a preliminary sign of the conclusion of the 'easy policy' era. Central bankers, who had driven yields to near zero or beyond to provide cheap funding and promote growth, were being forced to reverse course. Then, rising inflationary pressure linked to aggressive monetary and fiscal stimulus, COVID related supply chain disruptions and energy supply shocks all combined to push inflation to record levels.



Source: Haver Analytics, Bank of International Settlements. As of 31 Dec 22

The war in Ukraine only exasperated these challenges on the energy and agricultural fronts and central bankers' policy rate normalisation quickly followed suit. By the start of 2023, the balance of negative-yielding debt evaporated following Japan's unexpected policy shift and more widely, the yields on fixed income assets had hit compelling levels.

While a huge challenge for fixed income investors, coordinated central bank actions caused a remarkable reset for the asset class. With that, the asset class' key attractions, including high income and total return potential, diversification benefits via a low to negative correlation with growth assets, and defensive attributes linked to potential capital appreciation in times of stress, are back after a long period of rate manipulation that started post GFC.

Income and total return potential is back, especially in select credits

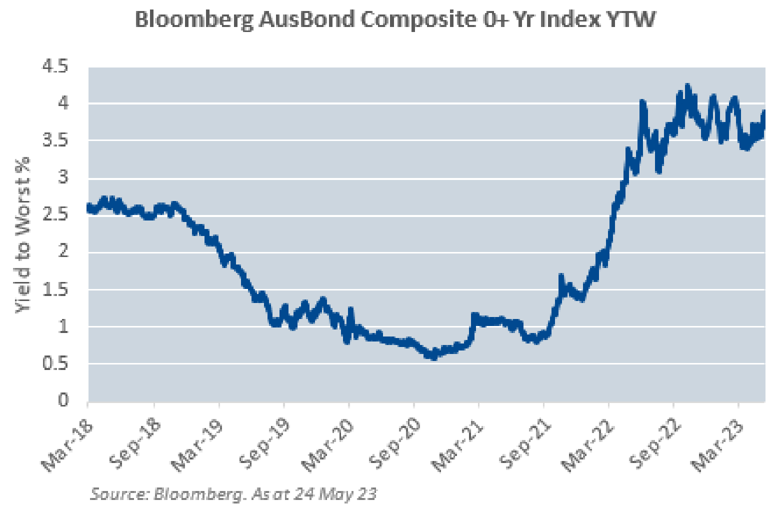
Comparing the yield on the Bloomberg AusBond Composite Index at approximately 3.7% as at the end of April 2023, to a yield close to 1% just 19 months ago illustrates how far yields have moved in a short space of time.

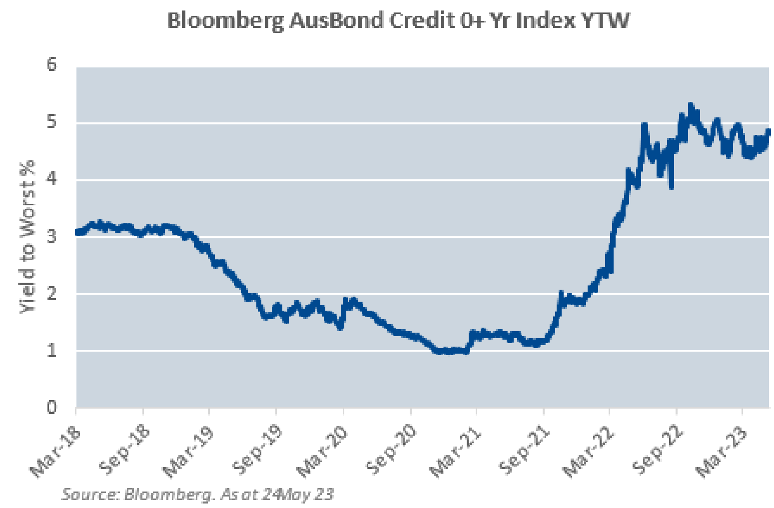
The yield on the Bloomberg Aus Bond Credit 0+ Year Index of 4.5% as at the end of April 2023, paints a similar picture, with that index also yielding close to 1% just 19 months ago.

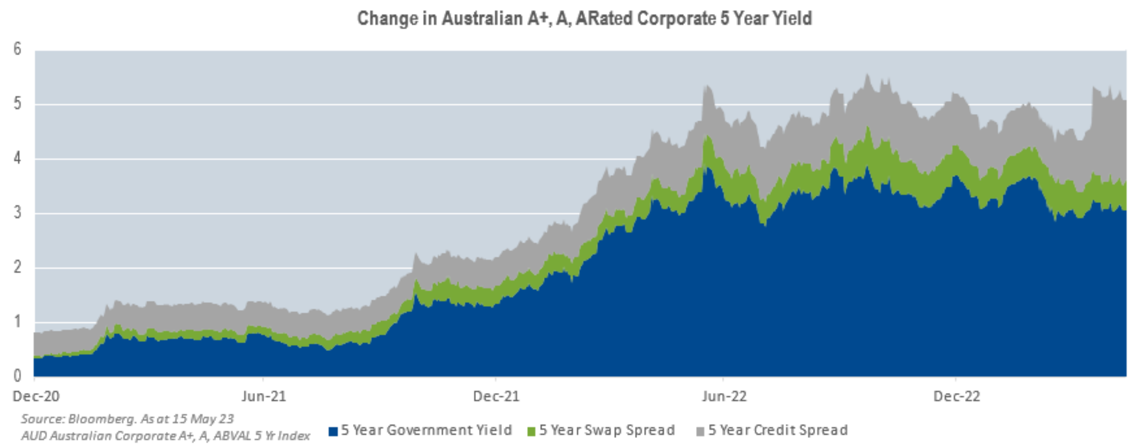
Along with the higher rates caused by the aggressive monetary policy shift, index yields moving higher in Australia are tied to two additional factors.

The **first** was swap spreads widening across the curve, as liquidity tightened, and rate volatility impacted trading markets.

The **second** was credit spreads widening as investors re-evaluated the earnings profile of corporates in a rising rate environment. In combination with higher yields, the path for returns was a challenge.







In combination, these moves present fixed income investors with an opportunity to achieve higher prospective returns, without taking on additional credit or illiquidity risk. For investors in Australian fixed income and credit, the opportunity set is particularly compelling.

Credit spreads, which represent a credit investor's compensation for the increased risk of default above risk free government securities of equivalent terms, are trading at similar levels in Australia compared to offshore markets. This comes despite Australia boasting a relatively high-quality issuer base and a fairly unique market structure.

Australia's higher quality market is tied to Australian credit being dominated by investment grade issuance and a limited high yield market. Increases to the cost of capital that result from downgrades to sub-investment grade are particularly punitive in Australia. Issuers therefore are conscious of adhering to debt covenants to appease rating agencies and maintain investment grade ratings - which is comforting for investors.

The unique structure of the Australian market is linked to the monopolistic and duopolistic nature of a range of industries commonly issuing into the domestic market. Especially valuable for more highly levered BBB rated issuers in the infrastructure and utility sectors, this brings about pricing power allowing inflationary pressures to be passed on to consumers.

Identifying the businesses best placed to deal with the current economic picture and those trading below fair value requires both in-depth credit analysis and active management which we believe will prove particularly worthwhile as we move toward a likely economic contraction.

Defensive attributes for growth uncertainty

As discussed, 2022 was a standout year not just for the magnitude of the moves in equity and fixed income markets but also because it reminded investors that fixed income and equity markets can decline in tandem. 2022 appears to be the exception rather than the rule as the COVID policy backdrop pushed interest rates exceptionally low and equity markets reached near all-time highs due to cheap financing and the ongoing hunt for returns.

A historical low to negative correlation between stocks and bonds is driven in part by the fundamental structure of each asset class's cash-flows. Equity cash-flows/dividends are not contractually guaranteed and are therefore subject to the fluctuations of the business cycle. Whereas fixed income securities' cash flows are predetermined and contractually guaranteed.

In times of stress, growth expectations typically fall, and equity valuations follow. Customarily, market stress also causes a coincident reassessment of the path for rates, with expectations of monetary easing by central banks to promote growth causing bond prices to rally. The move higher in yields recently promotes greater capital appreciation potential in such times of stress and correlation benefits. Recent financial stability issues serve to highlight this.

The month of March 2023 was characterised by a drastic recalibration of cash rate expectations and terminal rates for central banks off the back of financial sector concerns caused by issues at Silicon Valley Bank and subsequently Credit Suisse. Fixed income rallied strongly in that environment.

5 Year Correlation

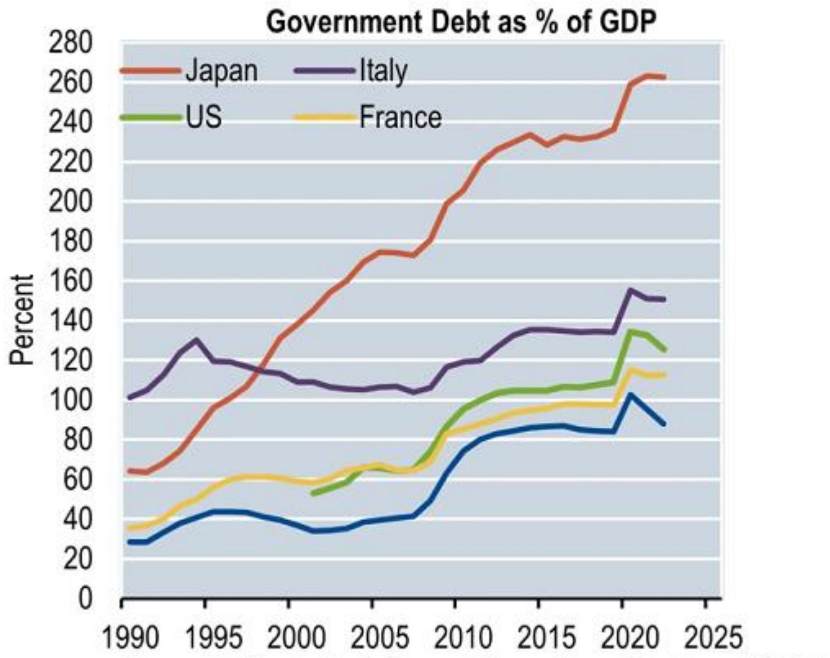
	1	2	3	4	5	6	7	8	9	10	11
Global Equities (AUD H)	1.00										
Australia Equities	0.82	1.00									
EM Equities (AUD H)	0.74	0.61	1.00								
Hedge Funds (AUD H)	0.80	0.80	0.73	1.00							
Private Equity (AUD H)	0.93	0.82	0.75	0.83	1.00						
Global Aggregate Bonds (AUD H)	0.43	0.39	0.41	0.24	0.50	1.00					
US Aggregate Bonds (AUD H)	0.38	0.31	0.43	0.21	0.45	0.96	1.00				
Global Government Bonds (AUD H)	0.26	0.22	0.21	0.05	0.32	0.97	0.91	1.00			
US Treasury Bonds (AUD H)	0.06	-0.02	0.12	-0.11	0.11	0.85	0.91	0.89	1.00		
Global Credit Bonds (AUD H)	0.63	0.62	0.63	0.53	0.72	0.92	0.88	0.80	0.63	1.00	
Australia Bonds Composite	0.18	0.21	0.08	-0.04	0.20	0.81	0.72	0.86	0.71	0.63	1.00

Source: Bloomberg. As at 30 April 2023

Revisiting asset allocations

After a rapid and challenging reset, there is growing evidence to suggest that central bank actions are having their intended consequences, slowing economic growth to balance demand and supply and moderate inflation. Our analysis also indicates that the forces that preceded the recent inflation shock, including high government debt, ageing demographics and technological displacement will ultimately reassert themselves.

With that in mind, higher yields and wider spreads offer compelling investment opportunities for fixed income investors. A combination of higher income and potential capital appreciation, matched with renewed diversification benefits and the likelihood of a more stable return profile going forward, sees the asset class well placed to deliver the attributes sought out by investors.



Source: IMF, Organisation for Economic Co-operation and Development (OECD).

Fixed income remains a critical building block for portfolio construction and investors should always consider the advantages of the differentiated cash flow characteristics offered. Investors should be encouraged to revisit their strategic allocations.

Anthony Kirkham is the Head of Investment Management Australia at [Western Asset Management](), a Franklin Templeton specialist investment manager. [Franklin Templeton]() is a sponsor of Firstlinks. This article is for information purposes only and does not constitute investment or financial product advice. It does not consider the individual circumstances, objectives, financial situation, or needs of any individual.

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