Firstlinks
a Morningstar company

Edition 512, 9 June 2023

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Editorial

The 2015 screen adaptation of **Michael Lewis**'s book, *The Big Short*, is a tour de force of movie making and it won the Academy Award for Best Adapted Screenplay. The nonfiction book was subtitled *Inside the Doomsday Machine* and describes the growth of derivatives in the US housing bubble during the 2000s. The screen writers were faced with the almost insurmountable challenge of explaining Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDS) in a popular movie, and it could have turned into a poorly-executed farce, like *Bonfire of the Vanities*.

Yet *The Big Short* handled the complexities superbly with a stellar cast. The main technique chosen used characters and real-life authorities looking to camera and frequently interrupting the narrative. It might have crashed but it works well, often humourously. The intricacies of derivatives were explained in colloquial terms, such as this on CDS:

> *"Let me put it this way. I'm standing in front of a burning house, and I'm offering you fire insurance on it."*

There are many subplots to the story, with three main characters, **Jared Vennett (Ryan Gosling)**, **Scion** hedge fund manager **Michael Burry (Christian Bale)**, and one of his staff, **Mark Baum (Steve Carrell)**, realising there was a housing bubble that must pop. The repackaged CDOs were rated AAA but our heroes believed they were fundamentally exposed to house prices, and they set about finding a way to short the market (Burry was a real person, the other two were based on other people).

The actual market experience was that a few people knew something was wrong but thousands of other experts went along with the status quo, that property prices do not fall. The best brains in major investment banks thought the mavericks were stupid, and wrote the other side of the multi-billion dollar trade. Then it became a matter of whether the small players could stay alive long enough to prove their thesis. I won't spoil the rest of the movie for those who have not seen it, but we all know how it ends.

While it's an extreme example of market inefficiency, similar events face investors regularly. A company share price might be super cheap due to a panic selloff after a short-term adverse event, or a one-off market share gain is taken as long term, or a competitive advantage is really a leaky moat.

Legendary investor **Peter Lynch** of the **Fidelity Magellan Fund** (no relation to Australia's Magellan) became known for his 'Going to the Mall' strategy. He sat around shopping malls watching how people were spending, which stores were busy and which were empty or closing, as a guide to buying or selling stocks. It often led to views counter to the market.

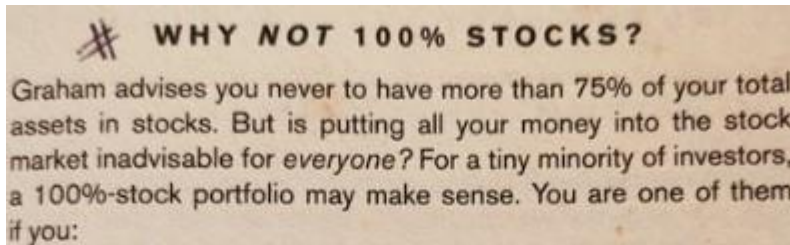
There are two ways individual investors can run with this. The vast majority will accept that they lack the relevant skills or interest or have better things to do than sit around a mall and then investigate companies.

They will leave the investing to others either in an index or active fund. Others will try to find an edge where they know more about a company or industry than most others.

Don't assume the market is right. As **Oaktree Capital's Howard Marks** said:

> *"Investing is a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity."*

Investors should answer this question: over the long term, the best returns come from equities but prices are volatile and losses sometimes painful, so how much of my portfolio should I allocate to equities? We suggest a way to set the appropriate level which at times requires you to ignore what the market is screaming at you. We quote from **Warren Buffett**'s mentor, **Benjamin Graham**, the father of value investing, including what comes next from this book extract:


WHY *NOT* 100% STOCKS?

Graham advises you never to have more than 75% of your total assets in stocks. But is putting all your money into the stock market inadvisable for *everyone*? For a tiny minority of investors, a 100%-stock portfolio may make sense. You are one of them if you:

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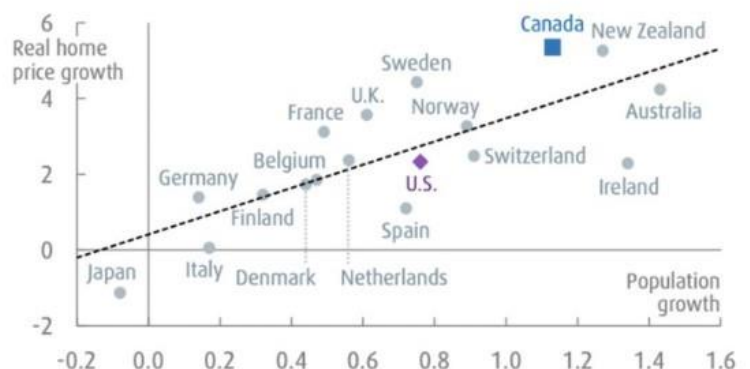
For millions of savers, this week's increase in the cash rate to 4.1% is stimulatory, putting more income into their hands in stark contrast to the years of struggle with zero rates. But wait ... isn't the **Reserve Bank** trying to slow the economy? Ah yes, it's the borrowers who are suffering. The tussle continues for **Governor Philip Lowe,** and there's a suspicion that the wage increase of 5.75% by the **Fair Work Commission** was the vital factor this month. **Treasurer Jim Chalmers** has attempted to push the blame away from the Government and the rumour is he will announce Lowe's replacement within the next month, perhaps someone who is not so hawkish on inflicting more pain on borrowers. So Lowe might be motivated to push hard while he's still in the chair.

Services inflation is Lowe's major concern, but the two largest contributors are 'medical and hospital services' and 'tertiary and secondary education'. Neither of those will fall due to higher interest rates. Do we want people to stop going to the doctor?

Rising house prices also played into the Reserve Bank decision, and it's a fascinating battle between lack of supply and surging migration, versus rising rates. Few people expected property prices to rise as strongly as they have in 2023, and as the chart below shows, there's a relationship between real house price growth and population growth, with Australia leading the way. While price momentum looks entrenched for a while, further rate rises will probably be the final straw for some homeowners or investors to either sell or shelve buying plans. The constraints on construction and rising rents are other factors.



The Reserve Bank decision was a day ahead of the **National Accounts** showing the rate rises are already biting, and Philip Lowe is making his 'narrow path' of controlling inflation without a recession even narrower. Household consumption per capita was negative in the March 2023 quarter, with GDP staying positive at 0.2% only due to population growth. Said **Dwyfor Evans** at **State Street Global Markets:**

> *"Quarterly growth came in at its weakest level since Q4 2018, reflecting the twin headwinds of rising inflation and higher interest rates and their combined impact on underlying demand. Weaker exports*

during the quarter was also a contributory factor – and speaks of a muted China re-opening impact on the Australian economy – and while the labour market remains robust, continued upside surprises on the cash rate (and related rates markets) and sticky inflation expectations will continue to weight over coming quarters."

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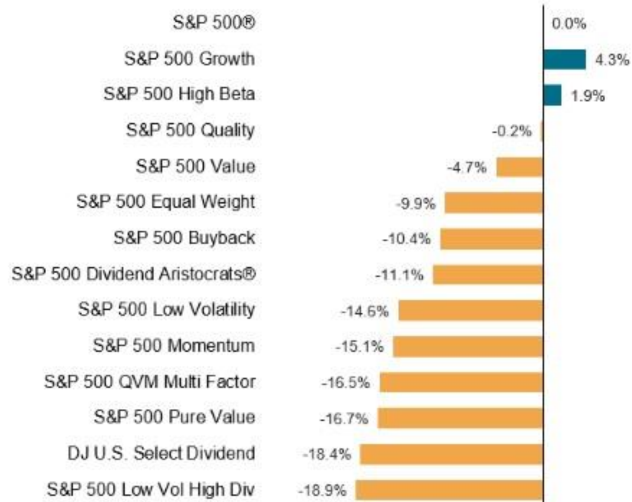
We have written previously about how the rising US market is an illusion for most investors because it is driven by a few large tech stocks. In the interview this week, CEO of **Franklin Templeton, Jenny Johnson**, elaborates on why fund managers diversify away from concentrated portfolios. Funds or individuals who don't own these stocks are missing out, and this chart starkly illustrates the point, showing performance of various equity factors relative to the S&P500. There are some large, traditional sectors having a tough YTD, and look at a favourite such as 'low volatility, high dividends', down 19%. Who doesn't want a fund targeting low volatility and high dividends?



Source: S&P Dow Jones Indices. Data as of May 29, 2023 Chart is provided for illustrative purposes. Past performance is no guarantee of future results. Sign up at bit.ly/spdjidd to receive index insights.

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Another Listed Investment Trust has given up on the battle to remove its discount to the value of its underlying assets, the Net Asset Value. It is embarrassing for some funds when the discount is persistent showing a general lack of interest from new buyers. Following in the footsteps of **Monash** and **Ellerston**, the **Partners Group** Global Income Fund (ASX:PGG) proposes to delist from the ASX and operate as an unlisted fund with monthly redemptions and subscriptions based on NAV. Redemptions from the unlisted fund will be limited to 5% of NAV per month and for 12 months from delisting, an exit fee will be applied to discourage arbitrage. The announcement has already caused the discount to NAV to reduce significantly, showing there are trading opportunities for anyone who can guess which funds might delist. There are plenty of LICs and LITs at significant discounts, as shown in the reports in our Education Centre.

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Finally, thanks to the reader, Tony, who was inspired by recent articles on AI to ask ChatGPT the question: **"Describe the Australian website Firstlinks in 100 words or less"**. To which it replied:

"Firstlinks is a prominent Australian website offering independent insights on finance, investing, and wealth management. It caters to retail investors, financial advisors, and self-managed super funds.

The site features articles, research reports, and educational resources covering topics such as macroeconomics, asset allocation, stock selection, and retirement planning. It also delivers a weekly newsletter summarizing investment news and market developments.

Firstlinks is highly regarded for its valuable content and is a trusted resource for Australian investors. Its focus on independent analysis and educational materials makes it beneficial for both new and seasoned investors."

Neat. Further evidence of how good this AI is.

Graham Hand

Also in this week's edition ...

Australian investors are sometimes shielded from industry trends overseas so it was refreshing to hear more from **Jenny Johnson** at the recent Morningstar Investor Conference in Sydney. And she didn't hold back, suggesting banning commission-based financial advice is a bad idea for many investors, and explaining why private assets might carry different valuation than listed shares.

Most people love a good bargain, especially when it comes to stocks, though the allure, as well as gains or losses, are often short-term. **Rudi Filapek-Vandyck** thinks quality companies are a better option, as they beat cheap prices in the long run, and act as safe havens when markets get rough. He identifies an Australian tech company that wears the Quality label.

It's nearing the end of the financial year, so SMSFs and other super funds should check the strategies available to them. **Verante Financial Planning's Liam Shorte** gives us a comprehensive 24-point checklist of the most important issues to address.

Should you invest for the short-term or the long-term? There's no definitive answer and much will depend on your personality and investment style. **Chris Demasi** of **Montaka Global Investments** believes there are five things to consider before choosing between investments with shorter and longer time horizons.

While the macroeconomic picture seems volatile with soaring inflation and signs of weakening growth, stock markets remain remarkably calm. **Casey Mclean** of **Fidelity International** says Australia's prospects look better than most other countries and the outlook for consumer staples and small cap stocks is especially attractive.

Kaye Fallick became a retirement publisher in her early 40s and she's learned plenty about retirement planning in the 20 years since. Kaye shares five lessons she's learned about managing retirement savings, including getting out of denial, knowing the detail and embracing delayed gratification.

Curated by James Gruber and Leisa Bell

Invest in equities until you reach your sleeping point

Graham Hand

We can survive longer without food than without sleep. The US Centre for Disease Control and Prevention says most people will show adverse signs of sleep deprivation within 24 hours. Three days without sleep has a profound impact on mood and cognition, and chronic sleep deprivation increases the risk of disease, obesity, and diabetes. Health is more important than wealth, and anyone who regularly loses sleep or wakes in a sweat worrying about the stockmarket must reassess their priorities. And asset allocations.

The dilemma is that over time, equity markets deliver the best returns of any major asset class. With the recent rise in interest rates, anyone who cannot tolerate even a small loss of capital can generate safe nominal returns of around 4%, but for most investors, some equity allocation is needed to achieve long-term goals.

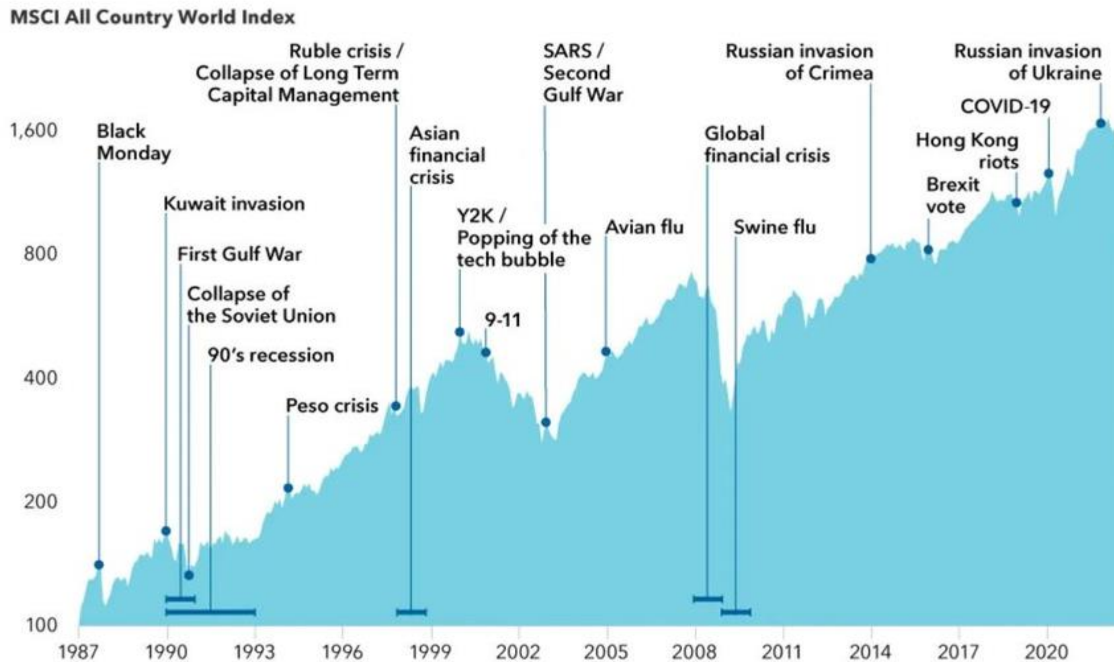
What's the right level? It's personal. I have known someone for 40 years who is always 100% invested in equities and only cares about the income generated (and author Peter Thornhill makes the same arguments). But I know an older person with 95% allocated to term deposits and property and no tolerance for sharemarket volatility. Over many years, she has missed out on significant gains but she sleeps easy.

Why invest in equities?

Investors who can tolerate the volatility of share prices are eventually rewarded with a recovery of their capital as well as better returns. The All Ords Total Return Index (which includes dividends) has not experienced a period of negative returns over any eight-year rolling average on record in nominal terms. The average annual return over the last 100 years is 11%.

It's a compelling result in the context not only of regular scary headlines about inflation, recession, and earnings downgrades, but genuine crises hitting the world such as wars and pandemics, as shown in this chart of the MSCI All Country World Index. While the long-term evidence favours equities (and in Australia, residential property), it requires an ability to think like Warren Buffett, who said:

"Charlie and I spend no time thinking or talking about what the stock market is going to do, because we don't know. We are not operating on the basis of any kind of macro forecast about stocks. There's always a list of reasons why the country will have problems tomorrow."



Source: @QCompounding

The maximum loss (drawdown) for the All Ords Total Return Index during this period was in November 2007, and the 48.3% would have frightened the hardiest of investors. And yet it had recovered to its previous high within 56 months, or less than five years, although the more volatile small company index took much longer.

Maximum drawdown for Australian broad market indexes

Name	Total Return YTD	Total Return Annualised 15 Years	Max Drawdown	Max Drawdown Peak Date	Recover Period (Months)
S&P Australia Small TR AUD	-25.75	3.97	-61.39	1/11/2007	89.00
S&P/ASX All Ordinaries TR	-19.02	6.31	-48.28	1/11/2007	56.00
S&P/ASX 200 TR AUD	-18.39	6.29	-47.18	1/11/2007	55.00
S&P/ASX 20 TR AUD	-15.99	7.07	-40.88	1/11/2007	47.00

Period analysed: 01/01/2000 - 1/06/2023. Source: Morningstar Direct

Herein lies the challenge. Equities will deliver negative returns in about three years out of every 10, often by 20% or more. Investors should expect a 50% loss once every 25 years, which is the time horizon of 65-year-olds with a life expectancy until 90. For most, a 100% equity portfolio is simply too volatile, while a move to say 70% equities/30% cash would deliver 70% of the market volatility. Australian equity returns are also understated as indexes do not include the value of franking credits.

(This article focusses on investible assets, not the family home which comes with special tax and social security advantages and the pleasure of owning the place where you live, as explained here).

Why not invest 100% in equities?

Benjamin Graham taught and mentored Warren Buffett in the principles of fundamental value investing, and he has influenced generations of stock analysts through his two seminal books, *Security Analysis* and *The Intelligent Investor.* The following quotations are taken from the 2009 reprint which reproduces sections of the 1973 edition.

Graham describes most people as 'defensive' who:

> *"… will place his chief emphasis on the avoidance of serious mistakes or losses. His second aim will be freedom from effort, annoyance, and the need for making frequent decisions."*

On this basis of avoiding large losses, Graham recommends an equal balance of 50% bonds and 50% stocks. He is open to allocations between 25%/75% and 75%/25% based on whether an investor perceives stocks are cheap (leaning towards 75% in equities) or expensive (moving back to 25%).

This is not very helpful, however, as he admits that investors attempting so-called Tactical Asset Allocation will struggle, because the usual human tendency is to buy when markets are riding high and sell when depressed and low:

> *"There is an implication here that the standard division should be an equal one, or 50–50, between the two major investment mediums. According to tradition, the sound reason for increasing the percentage in common stocks would be the appearance of the 'bargain price' levels created in a protracted bear market. Conversely, sound procedure would call for reducing the common-stock component below 50% when in the judgment of the investor the market level has become dangerously high. These copybook maxims have always been easy to enunciate and always difficult to follow, because they go against that very human nature which produces the excesses of bull and bear markets."*

He is unable to provide a reliable rule which applies to everyone, except that very few people should place more than 75% of their assets in stocks. But he is willing to identify the characteristics of "*a tiny minority of investors*" for whom holding a near-100% stock portfolio (with some cash) may make sense:

- Enough cash to support your family for at least one year
- Investing steadily for at least 20 years to come
- Did not sell stocks during the most recent bear market
- Bought more stocks during the most recent bear market
- Implement a formal plan to control your own investing behaviour.

He says:

> *"Unless you can honestly pass all these tests, you have no business putting all your money in stocks. Anyone who panicked in the last bear market is going to panic in the next one – and will regret having no cushion of cash and bonds."*

Here are the losses that anyone invested 100% in the US S&P500 would have experienced since World War II. The average bear market decline is 33% but there have been three falls of close to 50% in the last 50 years. The drops have taken as little as one month or up to 21 months of grinding down. It requires fortitude to watch losses accumulate for nearly two years.

S&P 500 Bear Markets Since WWII

Peak	Trough	% Decline	Peak-to-Trough (Months)	Breakeven (Months)	Peak-to-Breakeven (Months)
5/29/1946	10/9/1946	-26.6%	4	36	40
6/15/1948	6/13/1949	-20.6%	12	6	18
7/15/1957	10/22/1957	-20.7%	3	10	13
12/12/1961	6/26/1962	-28.0%	6	11	17
2/9/1966	10/7/1966	-22.2%	8	6	14
11/29/1968	5/26/1970	-36.1%	18	20	38
1/11/1973	10/3/1974	-48.2%	21	46	67
11/28/1980	8/12/1982	-27.1%	20	3	23
8/25/1987	12/4/1987	-33.5%	3	17	20
3/24/2000	10/9/2002	-49.1%	31	48	79
10/9/2007	3/9/2009	-56.8%	17	37	54
2/19/2020	3/23/2020	-33.9%	1	6	7
Averages		**-32.7%**	**12**	**21**	**33**

Source: A Wealth of Common Sense

Market conditions are less favourable

It is easy to list the threats in the current market, and they are higher than normal with the Ukraine war, withdrawal of monetary stimulus and inflation as serious dangers. Nobody holds up a red flag to signal a market top, although plenty of leading names in investing are issuing warnings. For example, Warren Buffett is also a great fan of Oaktree Capital's Howard Marks, and Marks wrote in his client memo on 13 December 2022:

> *"In my 53 years in the investment world, I've seen a number of economic cycles, pendulum swings, manias and panics, bubbles and crashes,* ***but I remember only two real sea changes. I think we***

may be in the midst of a third one today …** What are the factors that gave rise to investors' success over the last 40 years? We saw major contributions from (a) the economic growth and pre-eminence of the U.S.; (b) the incredible performance of our greatest companies; (c) gains in technology, productivity and management techniques; and (d) the benefits of globalization. **However, I'd be surprised if 40 years of declining interest rates didn't play the greatest role of all." (his bolding)

Marks included this table showing how almost everything is worse for investing than it was in the period 2009 to 2021, which he looks back on as a golden age of favourable conditions driven by ever-falling rates.

	2009 to 2021	Today
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal
Prospective returns	Lowest ever	More than ample

So the risks are real, and it is legitimate for someone in retirement to prefer to protect their capital rather than make a bit more money when they already have enough to meet their goals. Future earnings from paid work will be limited, and there is less time to recover from a major stockmarket fall. Where a comfortable way of life may be compromised, the risk may be too great.

Retirees should not feel embarrassed by reducing equity exposure to a point which reduces anxiety, to the sleeping point. The personal big picture of age, assets and risk tolerance are all relevant.

Cost of staying out of the market

Notwithstanding these heightened risks, caution often comes at a cost. Using US data, Vanguard studied each 3-month period in which equities declined 10% or more from 1 January 1980 through to 31 December 2022. These are times when investors are tempted to move to cash. They then checked returns in the following periods of 3 months, 6 months and 12 months. For example, there was an 87% chance of underperforming a 60/40 portfolio by spending a year stuck in cash, with an average underperformance of a hefty 13.5%.

Determining your sleeping point

So what are the questions that retirees or people near retirement should ask themselves in deciding the maximum equity allocation?

A useful check is whether the value of a share portfolio dominates your mind when going to sleep or waking up. Checking the market and worrying whether you can finance a future lifestyle is no way to start each day. A good question is:

What is the equity exposure where you are indifferent whether the market rises or falls?

You want some skin in the game to enjoy the rewards from equity investment, but you are not worried if the market falls because it gives an opportunity to buy equities at a lower price. Another check of the absolute dollars:

How much money are you prepared to lose without worrying about it?

If you have $1 million invested with 70% in equities and the market falls 30%, are you fine 'losing' over $200,000 in a short period?

Stay committed in a heavy market fall

Benjamin Graham says that with all the planning in the world, you still need to control your investing behaviour. There is no point going all-in equities because you know the rewards are the greatest, and then dumping in a sell off.

Some investors believe they can catch a falling knife, but it doesn't work like that. If the market falls 10% and that's a trigger price to sell, it's just as likely to recover quickly as it is to fall further. The worst outcome is to continuously switch as markets swing around.

Although the daily market noise commands attention, there is much to support a portfolio that invests in a broad index and is left untouched for decades. And allows the investor to sleep easy.

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

Franklin Templeton CEO on valuations and advice commissions

James Gruber

This is an edited transcript of an interview between Morningstar's Aman Ramrakha and Franklin Templeton President and CEO, Jenny Johnson, at the 2023 Morningstar Investor Conference in Sydney.

Aman Ramrakha: We've had some superannuation fund executive on stage earlier, and there's a debate of valuation of listed versus unlisted assets. How do you think about that in terms of capabilities and is it a simple arbitrage? Is there any liquidity premium? When you're offering some of the private market product sets to retail, how do you think about packaging them up?

Jenny Johnson: On the valuations, there's no question. The average private equity (PE) firm delays public market valuation decreases for about six months. And it's usually marked down about half of what the public markets do. So, does that mean it's not a real valuation?

For those who don't know about secondary PE, I've become a huge fan. The concept behind it is, here's a true transaction that Lexington [Lexington Partners, a Franklin Templeton company] had with a U.S. state pension fund. So, they've got an investment mandate that says I'm going to allocate 20% maximum to private equity, 10% to private credit, whatever. Here's my public equity, public fixed income. What has happened? In 2022, the stock market dropped 22%, fixed income dropped 15%. That's really unusual. Now, you have to pay your pensioners. So, you're pulling from your liquid portion of your portfolio. You're continuing to sell down your public equities and your public fixed income. And meanwhile, the 20% allocation to private equity is suddenly 25%. You're now about to breach your limit because your cash ATM is the public markets.

So the State of Florida will call up Lexington Partners and say, listen, in 30 days, I need a billion dollars out of my private equity portfolio because I have to report my quarterly allocations and I'm over-allocated. Lexington comes in and they'll say, okay, I'll take this manager's Fund 7, this manager's Fund 2, this manager's Fund 5, and I'll buy them. And right now, the discounts are anywhere from high teens, in the case of real estate about 22%, in the case of venture capital, it's 50% discounts or more for later stage and the earlier stuff is not even moving.

But it's not that those assets should be rightly valued there. In that case, it's a supply and demand issue. There's so much oversupply in the primary market and not enough buyers in the secondary. I think those end up being part of the reason why you see this arbitrage essentially or a mismatch, what feels like could be a mismatch in valuations.

My grandfather got into the mutual fund business because the average investor couldn't get access to the equity markets and there were excess returns in the equity markets. We're facing that same moment today where there are excess returns in the private markets that right now we've left out 85% of the population. The problem is, they're illiquid. They're difficult to understand.

And, by the way, the top managers are far superior to the bottom quartile managers in the space. I mean, you picked the wrong growth equity fund and maybe you're 200 basis points (2%) off. But top-performing private equity outperformed the bottom quartile by 20%. Top-performing real estate manager outperformed the bottom quartile by 10%. Top-performing private credit manager outperformed the bottom quartile by 5%. The biggest issue in retail is, what have we taught everybody? It's all about fees. It's only about fees. Guess who's on sale in the private markets?

Ramrakha: On financial advisers, I think the US was ahead of Australia in the move to fee-based or fee-for-service. Can you comment on what you're seeing in a global sense and perhaps, what you're seeing advisers do well in this changed environment?

Johnson: I think people are much better served with a financial adviser helping them for a few reasons. Back in 2008, we had a regulatory push that said if people are paying for advice, we want to make sure that's external. They need to be able to see it, so we're going to take it out of the product. So, that pushed a lot of people into fee-based.

I do not agree, and I think that's the model that has come up in both Australia and the UK. I do not agree that 100% of advice should be delivered fee-based. I think there's about 20% to 25% of the population that is better served paying a commission, a one-time commission and maybe at a small trail versus paying the external fee. Because what happens is, a client is too small for an adviser to take on and the adviser will do it if they can get a commission and we leave out a huge percentage of the population.

Advisers can coax people into saving. I often tell people that Australia has set up compulsory saving through the employer, that this is one of the best markets and much of the world should look to Australia and have a similar model. But in too many places, young people aren't getting any advice. And the difference between starting to save between 20 and 30, if you save, say, $5,000 a year and earn a 7% return from age 20 to 30, you will have more money at the end than somebody who starts at 30, saves for 30 years, $5,000 a year from 20 to 60. So, that first 10 years when you turn 20 of savings is so important to retirement.

Ramrakha: The banks were servicing that sort of lower end and are no longer doing that. Is that an opportunity for others to step in for the end investor?

Johnson: The average person will buy high and sell low. There's tons of studies on that, and Morningstar's ratings volatility is one of the things that you ding managers on, right? Because that experience is a real problem for the end investor. So, while in theory, we say people are going to fight that, it's not true. They don't do it. It's emotional.

And what a financial adviser does is in those most difficult times, it keeps a person invested and says don't look at it today. Just stay in. And maybe it's even a time to add more to your equity portfolio because it's been down. So, I think that that's very important, and that is hard to deliver in scale. The beauty of the financial adviser is they're at the tip of the spear. They understand an individual's debt, they understand the family spending, they understand the family dynamics. There's no way you can deliver if you're not close to that end investor.

Ramrakha: We have seen leading up to maybe the last year a big shift towards passive investing. Now, it's fair to say most of that's fee driven, but how do you think of countering that wave of passive to some extent?

Johnson: I'd say two things. We know passive outperforms in momentum markets. I'm just going to take the U.S. The U.S. Fed balance sheet went from $800 billion in 2008 to 2020 at $4.1 trillion, and we wonder why Silicon Valley Bank had a problem. From 2020 to 2022 it went from $4.1 trillion to $8.7 trillion, I think. That is just money pumped into a system. And the interest rates were essentially zero. If you're going to make an investment, there was no reason to be in the bond markets. You didn't have access as the average investor into the private markets. And so, you put your money in equity markets, and the equity markets took off and it's going to be hard when you're trying to be a managed risk portfolio to beat that. Why? Look at the concentration. The concentration of the winners in the last decade. It's the FAANG stocks.

If you were running a portfolio, you'd say that's too much concentration and too few companies, I'm going to diversify, and you immediately would have underperformed. One of the things that there's not enough conversations about is that market beta is not static risk. The day Tesla was added to the S&P 500, beta became riskier. But you never heard people talking about passive becoming riskier.

If you tracked all the big momentum markets and the top 10 performing companies going back to the NIFTY 50, the next round there was only one company that made it through four of those peaks, and that was Exxon. Every other company didn't make it into the top 10. And the top 10 in this past decade probably aren't going to be the top 10 in the next. And so, again, that's looking at that market beta risk. In momentum markets, passive is going to tend to outperform, but you're going to have to time it exactly such that when it flips that you've been able to turn into a more diversified, less risky portfolio.

This is an edited transcript of an interview between Morningstar's Aman Ramrakha and Franklin Templeton President and CEO, Jenny Johnson, at the Morningstar Investor Conference in Sydney.

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

A top-quality company shows cheaper is not better

Rudi Filapek-Vandyck

As investors, we all like to snap up a bargain, but cheaply-priced stocks tend to provide short-term, temporary pleasures. Meanwhile, a genuine quality gem is the gift that keeps on giving, and giving, and giving.

Investors need not look any further to find evidence of that statement than the recent interim financial report release by IT services provider TechnologyOne [ASX:TNE].

While the numbers and metrics were once again of the superb kind, building on a remarkable track record and legacy spanning close to two decades and counting, most analysts and market observers would not describe the shares as 'cheaply priced'.

Trading on a forward multiple of 48x market consensus forecast for FY24 EPS (54x for FY23), it should be no surprise there is to our knowledge only one Buy rating left, from a mesmerised Wilsons, alongside an upgraded price target/valuation of $18.12.

Most targets and valuations congregate around $15-$16 while the share price since the H1 release has risen from $15.50 to $16.30 this week. Management at the company has stuck with its guidance for EPS growth between 10-15% but just about everyone, including management itself, believes this will prove conservative when final FY23 numbers will be released later in the year.

Already speculation is growing over how much sooner the longer-term target of achieving $500 million in annual recurring revenue (ARR) - still set for FY26 - will be achieved. And by how much *can* the ARR number exceed the target by then? Some believe $700 million by FY26 is not impossible, which implies there's more upside in the share price, irrespective of today's metrics and share price gains already booked.

Herein lays the first major challenge when dealing with a perennially outperformer such as is TechnologyOne: what kind of 'valuation' is appropriate?

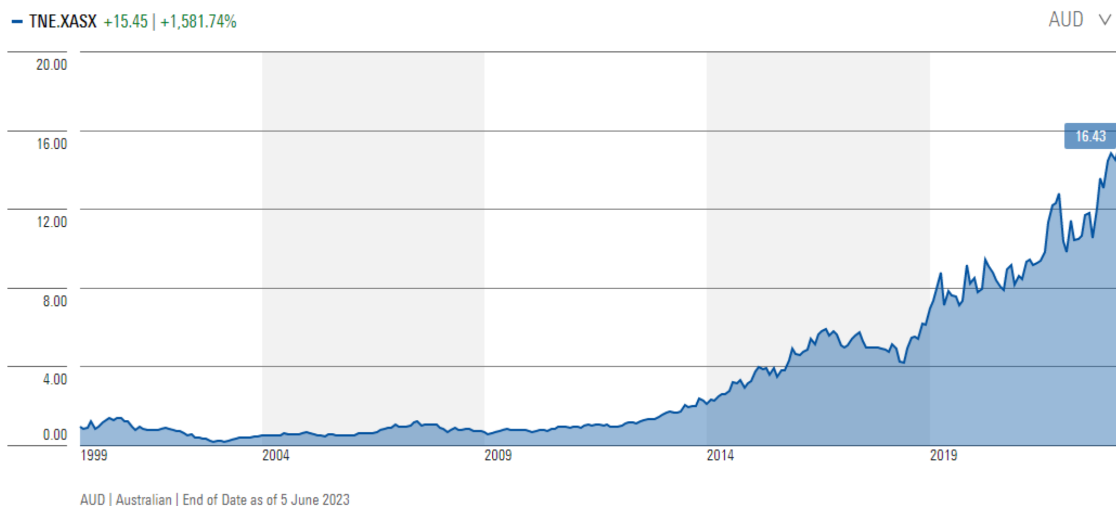
True quality 'values' differently

If you're a religious disciple of Benjamin Graham's *The Intelligent Investor*, shares in TechnologyOne have probably never been on your radar.

Sure, they must have been 'cheap' at some stage, the years immediately following the Nasdaq meltdown in March 2000 come to mind, but it's only fair to say the company back then was nowhere near the Quality offering we are discussing today.

Having said all of that, the returns for shareholders have been nothing short of exceptional over the past 20 years. Let's ignore for the time being that shares could have been snapped up as low as 7 cents a piece during the post-2000 bear market.

By early 2008, shares were trading above $1. Five years on, they reached $1.50. Five years after that, we're in 2018 now, the shares approached $5. One year ago, on the 31 May 2022, the shares closed at $10.50.



Source: Morningstar

With the assistance of Harry Hindsight, there's one conclusion that stands above any form of debate: when shares in TechnologyOne sell off, you buy. This long-term growth story is still nowhere near ending. If anything, both analysts and investors laud the underlying acceleration that is taking place through customers migrating towards the Software-as-a-Service (SaaS) offering.

SaaS literally creates a win-win for both sides of the ledger. For customers, migrating to the cloud brings increased flexibility and significantly lower costs (reportedly up to -30%), while for TechnologyOne those same benefits accrue into rising margins. Current forecasts are for a gradual increase towards a profit margin of 35%-36% from 30% a few years ago.

Contracts typically allow for price rises in line with inflation which, this time around, is providing an extra-kicker for growth. Equally typical for a rare Quality corporate wealth generator, management at the firm is using this year's additional windfall to spend more on R&D and new product development.

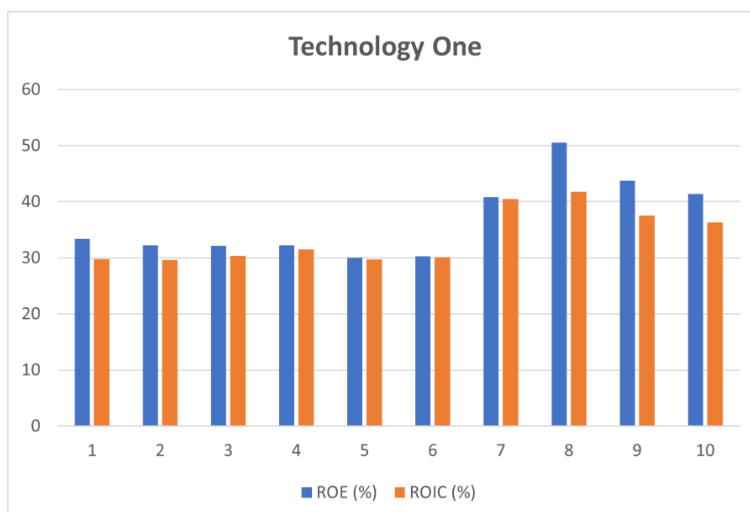
Plenty of companies would be discussing a higher dividend, or a share buyback, or both, but genuine Quality thinks longer term, and realises tomorrow's growth is built on the seeds planted today. Back in 2008, TechnologyOne's offering consisted of 11 products. Today, the product suite tally stands at 16, with over 400 modules.

How to be 'special'

Officially, TechnologyOne is an IT services provider, conveniently lobbed in the same Software & Services basket with dozens of other ASX-listed 'peers'. In practice, the company delivers mission-critical products and services, often specifically tailored for corporate clients in targeted sectors of financial services, utilities, government, education, and health.

Clients have proven extremely sticky with annual churn remaining below 1% throughout most of the past two decades. Recently, the percentage of client losses has increased with management indicating it'll probably end up around 1.60% for the running financial year as smaller businesses shy away from migrating to the cloud while clients of UK acquisition Scientia are proving less loyal.

Acquiring Scientia has provided TechnologyOne with the opportunity to sell its enterprise resource planning (ERP) solutions to circa 100 Scientia customers in the UK. At the time of the purchase, Scientia was not yet profitable. It is marginally profitable today and contributing positively through a 20% rise in ARR in the UK.



As one would expect, TechnologyOne is highly cash generative, virtually debt-free, and it pays out a steadily growing dividend, though its high valuation means the stock never features for your typical yield/income investor. Financial metrics are persistently among the better performers in the market. Last financial year's Return on Equity (RoE) was above 41%, with Return on Invested Capital (RoIC) above 36%.

Maybe one of the biggest surprises is, after all these years of market-beating performances, the company's market capitalisation only recently surpassed the $5 billion as shares responded favourably to the recent financial result. In other words: despite all the accolades, TechnologyOne still is a relatively small fish in a big ocean where multi-national competitors such as ServiceNow, Workday, SAP, Salesforce and Oracle roam around like big whales.

Management usually flags double-digit growth ahead, say between 10%-15%, and rarely disappoints. In fact, so consistent has performance been, it attracted a report from a foreign based short seller in 2020 whose attack was mainly based around the premise that no company is ever able to perform as consistently over such a long period of time.

Waiting for a cheap entry point is a lost opportunity

Becoming a true Quality stalwart, and receiving market recognition, takes time.

Investors will be wasting their time if the strategy consists of only buying stocks on a below-market average valuation. Stocks like TechnologyOne don't trade on low double-digit multiples, let alone single digits, unless a meteor hits their headquarters or something extraordinary destroys the business case.

I believe markets have become smarter in distinguishing companies with valuable quality characteristics, as experiences and performances accumulate, and there's more sophistication, and appreciation, for companies supported by a long runway of growth - for as long as the market believes that runway remains intact.

As things are lined up post FY23 interim result, the odds remain in favour of TechnologyOne continuing its pathway of growing at 10%-15% for longer, with FY23 expected to outperform. Most analysts assume EPS growth for FY23 will beat the top of that range and come in at 17% or 18% instead.

The current forecast, expressed with confidence, is that today's business will be double its current size in five years' time.

The conundrum for today's investor is the shares are now trading at a sizable premium versus the broader market, as also illustrated by the fact upgraded price targets and valuations remain below today's share price, with one exception (Wilsons, $18.12).

But if in five years' time the size of the company will be 100% higher, including the profits accompanied by continuously rising dividends, then the share price will reflect this too. TechnologyOne management is confident economic recession in Europe, the UK or the US will not have a significant impact on the current growth trajectory, which adds yet another reason as to why the shares are unlikely to sell off anytime soon (unlike so many others).

TechnologyOne might be ‘special’, it is truly difficult arguing it is not, the company is by no means unique. Research by W.P Carey School of Business Professor Hendrik Bessembinder already established there is a select group of companies worldwide that is able to provide sustainable shareholder rewards over long periods of time.

If ever Bessembinder focuses his research on the Australian share market, there should be no doubt TechnologyOne will feature in his local selection, alongside the likes of CSL (CSL) and REA Group (REA); larger cap stocks that tend to create similar dilemmas and end outcomes for investors.

In all cases, 'value' will always be in the eyes of the beholder rather than in a simple multiple of next year's forecast earnings per share. The question for investors is merely whether they'd like to get on board, and at what price, assuming the market offers them that opportunity.

Those already on board can simply take regular volatility for what it is with the understanding that true Quality beats a cheap price in the long run, plus it also acts as a safe haven when conditions get really, really rough.

Rudi Filapek-Vandyck is Editor at the FNArena newsletter, see www.fnarena.com. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

The ultimate superannuation EOFY checklist 2023

Liam Shorte

Here we are with a few weeks left to the end of the financial year to put our SMSF or other super funds in order and ensure we are making the most of the strategies available to us.

Here is a checklist of the most important issues that you should address with your advisers before the year-end.

Warning before we begin

In the rush to take advantage of new strategies, don't forget how good you may have it already. Be careful not to allow your accountant, administrator or financial planner to reset any pension that has been grandfathered under the pension deeming rules that came in on 1 January 2015 without updated advice on the future consequences of losing the grandfathering. Point them to this document.

1. It's all about timing

If you are making a contribution, the funds must hit the super fund's bank account by the close of business on 30 June. Some clearing houses hold on to money before presenting them to the super fund.

In addition, pension payments must leave the account by the close of business unless paid by cheque in which case the cheques must be presented within a few days of the EOFY. There must have been sufficient funds in the bank account to support the payment of the cheques on 30 June, but a cheque should be your very last-minute preference!

Get your payments in by Friday 23 June or earlier to be sure (yes I'm Irish). This is even more important if using a clearing house for contributions.

2. Review your Concessional Contributions (CC) options and new rules

The government changed the contribution rules from 1 July 2020 to extend the ability to make contributions from age 65 up to age 67. Read more here. Maximise contributions up to CC cap of $27,500 but do not exceed your limit unless you have Unused Carried Forward Concessional limits and Total Super Balance under $500,000 as of last 1 July 2022. Guidance on how to check your Unused Carried Forward Concessional limits via MyGov records available here.

Some of the sting has been taken out of excess contributions tax but you don't need additional paperwork to sort out the problem. Check employer contributions on normal pay and bonuses, salary sacrifice and premiums for insurance in super as they may all be included in the limit.

3. Consider using the 'Unused Carry Forward Concessional Contribution' limits

Broadly, the carry forward rule allows individuals to make additional CC in a financial year by utilising unused CC cap amounts from up to five previous financial years. Eligibility requires a total superannuation balance just before the start of that financial year of less than $500,000 (across all your super accounts).

This measure applies from 2018-19 so effectively, this means an individual can make up to $130,000 of CCs in a single financial year by utilising unapplied unused CC caps since 1 July 2018.

Beware that once your income (including salary, investment income, employer SGC, and personal concessional contributions) goes over $250,000 you will be subject to Div 293 Tax.

4. Review plans for Non-Concessional Contributions (NCC) options

From 1 July 2022, the new age limit of 75 (28 days after the end of the month your turn 75) applies to NCCs (that is, from after-tax money) without meeting the work test. Check out ATO superannuation contribution guidance.

NCCs are an opportunity to move investments into super and out of personal, company or trust names.

Even up spouse balances and maximise super in pension phase up to age 75. Couples where one spouse has exhausted their transfer balance cap and has excess amounts in accumulation are able to withdraw and recontribute to the other spouse who has transfer balance cap space available to commence a retirement phase income stream. This can increase the tax efficiency of the couple's retirement assets as more of their savings are in the tax-free pension phase environment.

Make your tax components more tax free by using recontribution strategies. SMSF members can cash out their existing super and re-contribute (subject to their contribution caps) them back into the fund to help reduce tax payable from any super death benefits left to non-tax dependants. From 1 July 2022 you can do this until they turn age 75 (contribution to be made within 28 days after the end of the month you turn 75).

The Bring Forward Rule for 2022-23 compared to after 1 July 2023

Maximum NCC cap	Current	From 1 July 2023
$330,000	< $1.48M	< $1.68M
$220,000	$1.48 – $1.59M	$1.68 – $1.79M
$110,000	$1.59 – $1.7M	$1.79 – $1.9M
NIL	> $1.7M	> $1.9M

Bring Forward Limits affected by TSB

5. Recontribution strategies

Consider doing the drawdown before 30 June 2023 so that your Transfer Balance Cap and Total Super Balance on 1 July 2023 gets some additional space with the rise in the TBAR and TSB full limits to $1.9 million. Note that if you have existing pensions your new limit will be anywhere between $1.6 million and $1.9 million (frustrating for advisers!).

6. Downsizer contributions

If you have sold your home in the last year and you are over 55, consider eligibility for downsizer contributions of up to $300,000 for each member.

From 1 January 2023, the eligibility age to make downsizer contributions into superannuation will be reduced from 60 to 55 years of age. All other eligibility criteria remain unchanged, allowing individuals to make a one-off, post-tax contribution to their superannuation of up to $300,000 per person from the proceeds of selling their home. These contributions will continue not to count towards non-concessional contribution caps.

The $300,000 downsizer limit (or $600,000 for a couple) and the $330,000 bring forward NCC cap allow up to $630,000 in one year contributions for a single person and $1,260,000 for a couple subject to their contributions caps.

Please be careful as this is a once only strategy and if you would benefit more in later years using the strategy then maximise NCCs first.

7. Calculate co-contributions

Check your eligibility for the co-contribution, it's a good way to boost your super. The amounts differ based on your income and personal super contributions, so use the super co-contribution calculator.

8. Examine spouse contributions

If your spouse has assessable income plus reportable fringe benefits totalling less than $37,000 for the full $540 tax offset or up to $40,000 for a partial offset, then consider making a spouse contribution. Check out the ATO guidance here.

From 1 July 2022 you can implement this strategy up to age 75 as a Spouse Contribution is treated as a NCC in their account (and therefore counted towards your spouse's NCC cap).

Consider splitting contributions with your spouse, especially if:

- your family has one main income earner with a substantially higher balance or
- if there is an age difference where you can get funds into pension phase earlier or
- if you can improve your eligibility for concession cards or age pension by retaining funds in superannuation in the younger spouse's name.

This is a simple no-cost strategy I recommend for everyone here. Remember, any spouse contribution is counted towards your spouse's NCC cap.

9. Give notice of intent to claim a deduction for contributions

If you are planning to claim a tax deduction for personal concessional contributions, you must have a valid 'notice of intent to claim or vary a deduction' (NAT 71121).

A notice must be made before you commence the pension. Many people like to start their pension in June and avoid having to take a minimum pension in that financial year but make sure you have claimed your tax deduction first. The same notice requirement applies if you plan to take a lump sum withdrawal from your fund.

10. Act early on off-market share transfers

If you want to move any personal shareholdings into super (as a contribution) you should act early. The contract is only valid once the broker receives a fully valid transfer form so timing in June is critical. There are likely to be brokerage costs involved.

11. Review options on pension payments

The government extended the Temporary Reduction in Minimum Pensions as part of the COVID-19 response for FY2023 (but will revert to normal rates from 1 July 2023). Ensure you take the new minimum pension of at least 50% of your age-based rate below. If a pension member has already taken pension payments of equal to or greater than the 50% reduced minimum amount, they are not required to take any further pension payments before 30 June 2023. For transition to retirement pensions, ensure you have not taken more than 10% of your opening account balance this financial year.

Minimum annual payments for pensions for 2022/23 and 2023/24 financial years

Age at 1 July	2023-24 Back to Standard Minimum % withdrawal	2022-23 50% reduced minimum pension
Under 65	4%	2%
65–74	5%	2.5%
75–79	6%	3%
80–84	7%	3.5%
85–89	9%	4.5%
90–94	11%	5.5%
95 or older	14%	7%

If a pension member has already taken a minimum pension for the year, they cannot change the payment, but they can get organised for 2023/24. So, no, you can't sneak a payment back into the SMSF bank account!

If you still need pension payments for living expenses but have already taken the 50% minimum, then it may be a good strategy for amounts above the 50% reduced minimum to be treated as either:

a. a partial lump commutation sum rather than as a pension payment. This would create a debit against the pension members transfer balance account (TBA). Please discuss this with your accountant and adviser asap as some funds will have to report this quarterly and others on an annual basis.

b. for those with both pension and accumulation accounts, take the excess as a lump sum from the accumulation account to preserve as much in tax exempt pension phase as possible.

12. Check your documents on reversionary pensions

A reversionary pension to your spouse will provide them with up to 12 months to get their financial affairs organised before making a final decision on how to manage your death benefit.

You should review your pension documentation and check if you have nominated a reversionary pension in the context of your family situation. This is especially important with blended families and children from previous marriages that may contest your current spouse's rights to your assets. Also consider reversionary pensions for dependent disabled children.

The reversionary pension has become more important with the application of the $1.6-1.9 million Transfer Balance Cap (TBC) limit to pension phase from 1 July 2023.

Tip: If you have opted for a nomination instead then check the existing Binding Death Benefit Nominations (many expire after 3 years) and look to upgrade to a Non-Lapsing Binding Death Benefit Nomination. Check your Deed allows for this first.

13. Review Capital Gains Tax on each investment

Review any capital gains made during the year and over the term you have held the asset and consider disposing of investments with unrealised losses to offset the gains made. If in pension phase, then consider triggering some capital gains regularly to avoid building up an unrealised gain that may be at risk to legislation changes.

14. Collate records of all asset movements and decisions

Ensure all the fund's activities have been appropriately documented with minutes, and that all copies of all statements and schedules are on file for your accountant, administrator, and auditor.

The ATO has beefed up its requirements for what needs to be detailed in the SMSF Investment Strategy so review your investment strategy and ensure all investments have been made in accordance with it and the SMSF Trust Deed, including insurances for members. See my article on this subject here.

15. Arrange market valuations

Regulations now require assets to be valued at market value each year, including property and collectibles. For more information refer to ATO's publication Valuation guidelines for SMSFs.

On collectibles, play by the new rules that came into place on 1 July 2016 or remove collectibles from your SMSF.

16. Check the ownership of all investments

Make sure the assets of the fund are held in the name of the trustees (including a corporate trustee) on behalf of the fund. Check carefully any online accounts and ensure all SMSF assets are separate from your other assets.

We recommend a corporate trustee to all clients. This might be a good time to change, as explained in this article on Why SMSFs should have a corporate trustee.

17. Review estate planning and loss of mental capacity strategies

Review any Binding Death Benefit Nominations (BDBN) to ensure they are valid and check the wording matches that required by the Trust Deed. Ensure it still accords with your wishes.

Also ensure you have appropriate Enduring Powers of Attorney (EPOA) in place to allow someone to step into your place as trustee in the event of illness, mental incapacity or death.

Check your Trust Deed and the details of the rules. For example, did you know you cannot leave money to stepchildren via a BDBN if their birthparent has pre-deceased you?

18. Review any SMSF loan arrangements

Have you provided special terms (low or no interest rates, capitalisation of interest etc) on a related party loan? Review your loan agreement and see if you need to amend your loan.

Have you made all the payments on your internal or third-party loans, have you looked at options on prepaying interest or fixing the rates while low? Have you made sure all payments in regards to Limited Recourse Borrowing Arrangements (LRBA) for the year were made through the SMSF trustee? If you bought a property using borrowing, has the Holding Trust been stamped by your state's Office of State Revenue.

19. Ensure SuperStream obligations are met

For super funds that receive employer contributions, the ATO is gradually introducing SuperStream, a system whereby super contributions data is made electronically.

All funds should be able to receive contributions electronically and you should obtain an Electronic Service Address (ESA) to receive contribution information.

If you change jobs your new employers may ask SMSF members for their ESA, ABN and bank account details.

20. Ensure you are ready for Quarterly TBAR Reporting (from 1 July 2023)

All SMSFs will be required to report quarterly, even if the member's total super balance is less than $1 million. This means you must report the event that affects the members transfer balance within 28 days after the end of the quarter in which the event occurs.

All unreported events that occurred before 30 September 2023 must be reported by 28 October 2023. This means you cannot report at the same time as your SMSF annual return (SAR) for the 2022-23 income year. More info here.

21. ASIC fee increases

ASIC is increasing fees by $4 for the annual review of a special purpose SMSF trustee company $59 to $63. The Government is moving gradually to a 'user pays' model so expect increases to accelerate in future years. Before 30 June for $407 you can pre-pay the company fees for 10 years and lock in current prices with a decent discount. There is a remittance form linked here.

22. Improving the Home Equity Access Scheme – Social security benefits for you or your mum and/or dad

The Home Equity Access Scheme formerly called The Pension Loan Scheme is now up and running. The Government introduced a No Negative Equity Guarantee for HEAS loans and allow people access to a capped advance lump sum payment.

- No negative equity guarantee - Borrowers under the HEAS, or their estate, will not owe more than the market value of their property, in the rare circumstances where their accrued HEAS debt exceeds their property value. This brings the HEAS in line with private sector reverse mortgages.
- Immediate access to lump sums under the HEAS - Eligible people will be able to access up to two lump sum advances in any 12-month period, up to a total value of 50% of the maximum annual rate of Age Pension (currently $13,882 for singles and $20,852 for couples).

23. Careful if replacing Income Protection or TPD Insurance (Total Permanent Disability)

Have you reviewed your insurances inside and outside of super? Don't forget to check your current TPD policies owned by the fund with an own occupation definition as the rules changed a few years ago so be careful about replacing an existing policy as you may not be able to obtain this same cover inside super again.

There were major changes to Income Protection insurance in 2021 so be very careful about switching insurer unless costs have blown out as new cover is often vastly inferior to current covers. Read more here before switching cover.

24. Large one-off personal income or gain – Bring forward Concessional Contributions

For those who may have a large taxable income this year (large bonus or property sale) and are expecting a lower taxable next year you should consider a contribution allocation strategy to maximise deductions for the current financial year. This strategy is also known as a "Contributions Reserving" strategy, but the ATO are not fans of Reserves so best to avoid that wording! Just call it an Allocated Contributions Holding Account. See my article on this strategy here.

Liam Shorte is a specialist SMSF adviser and Director of Verante Financial Planning. He is also a Director of the SMSF Association and he writes under the social media identity of 'The SMSF Coach'. This article contains general information only and does not address the circumstances of any individual. It is based on an understanding of relevant legislation and rules at the time of writing, which may change.

The pros and cons of short-term versus long-term investing

Chris Demasi

Investors have a strong desire to make money *now*, to have their investments pay off sooner rather than later. There are certainly opportunities that can play out successfully over shorter periods, but a short-term strategy is not fool proof because it requires more 'guess' work about where multiples will be and how and when sentiment will change, if at all.

The alternative is for investors to be patient, take a long-term approach and focus on earnings, which are more durable and predictable than changes in valuation multiples. Investors may face down years and periods of lacklustre returns along the way, but they will likely be rewarded with a bigger payoff in the end.

Therefore, one of the most important decisions an investor faces is whether to pursue investments over a short or long investment horizon.

Both approaches have benefits and drawbacks and understanding the differences is critical to effectively managing an investment portfolio. Clearly discerning between strategies can help investors improve their research process to identify money-making opportunities while minimizing risk and successfully navigating inevitable bouts of market volatility. So how do investors decide whether to invest for the short term or long term?

We believe there are five key considerations that investors should evaluate before choosing between investments with shorter (18-month horizon) and longer time horizons (7 years).

1. Source of opportunity (structural versus cyclical)

Long-term investment opportunities are typically underpinned by structural transformations that take place over many years or decades, such as the explosion of artificial intelligence and cloud computing, rising allocations to alternative assets, online shopping increasing, and payments shifting from cash to card.

These transformations can create massive markets with sustainably high growth rates, which the best companies capitalise on. For example, over the last eight years global card payments have more than doubled to over $US20 trillion. Over the same period Visa, the world's largest card payment networks, has increased revenues 2.3 times and its stock price has risen four-fold.

On the other hand, short-term investment opportunities often arise from differences in market perceptions around economic cycles and near-term idiosyncratic events. Stocks of banks and retailers may sell off heavily in an economic downturn but can rebound quickly when the environment turns and profits jump.

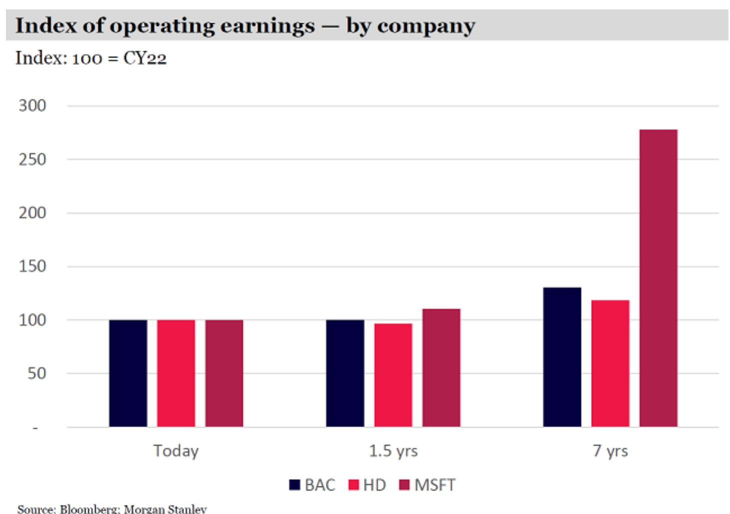
For example, the share price of Foot Locker, an athletic apparel company in the US, halved during the COVID pandemic as reported profits fell by more than half in 2020. Then in the following year profits almost tripled and the stock price rose more than three-fold from trough to peak when the economy rebounded.

2. Driver of return (earnings versus multiples)

Over a longer-term horizon, investment returns are dominated by the change in earnings power, which tends to overwhelm the change in earnings multiple. That's especially the case for the most successful businesses in structural growth industries.

However, over shorter investment horizons, the opposite is true, and the valuation multiple is a greater driver of investment returns than earnings growth.

To illustrate the point, we projected the earnings growth of three large well-known but different US companies: Bank of America, one of the largest banks in the US; Home Depot, the leading home improvement retailer in the US; and Microsoft, a global leader in cloud computing and AI.



Over an 18-month forecast period, the earnings growth is almost unnoticeable across the three companies, even though they operate in different industries with vastly different prospects. The projection period is just too short for these differences to show up in differentiated financial performance. This means the stock returns over this horizon will be *fully determined by the change in trading multiples*.

For an investor with a much longer 7-year horizon though, the calculus flips upside down.

Bank of America and Home Depot are forecast to moderately grow their profits … but Microsoft's earnings are projected to nearly triple as cloud computing revenues expand driven by the rapid uptake of AI services. Even if Microsoft's multiple halved and the others' multiples remained unchanged, Microsoft stock would still handily outperform the others.

3. Potential for outsized gains (multi-baggers versus singles)

A natural corollary is that longer-term investments have the power to become proverbial 'multi-baggers' with total stock returns that are many times the initial investment outlay.

For example, if Microsoft's trading multiple held its ground, earnings grew in line with our projections, and excess cash flows were paid out to shareholders in dividends, then Microsoft stock could be a 'four-bagger' over the 7-year horizon.

In fact, the potential for upside can be even greater when burgeoning companies go on to achieve 'outlier' levels of success over extended periods.

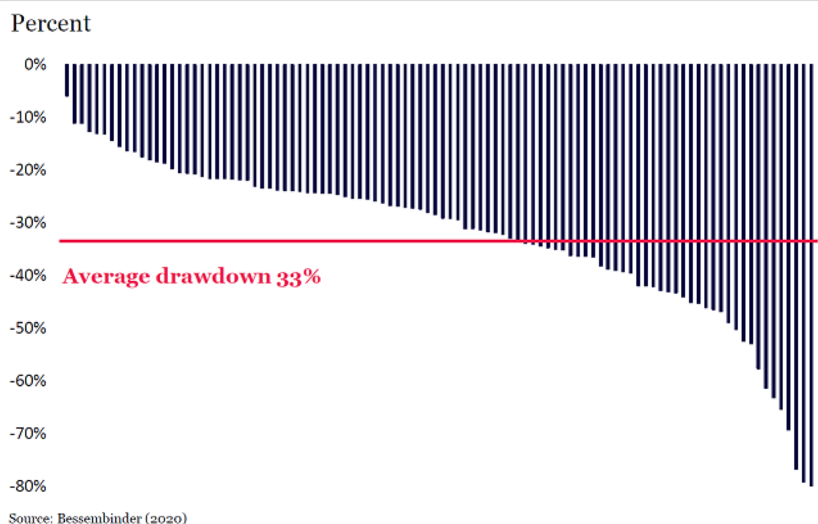
Spotify, the world's most popular streaming service, could end up being a 'ten-bagger' over the next decade as its base expands past one billion listeners worldwide, more services are offered, advertising takes off, and profitability inflects from break-even today.

Unfortunately, the possibility of making multi-bagger gains is considerably diminished by investing over much shorter horizons, because earnings growth does not have time to change exponentially and changes in valuation multiples do not usually themselves multiply so quickly, if at all.

4. Degree of deviation (rougher versus smoother)

While a long-term investment horizon has the power to boost returns exponentially, the path can be highly unpredictable, and returns can deviate significantly – often wildly – from the performance of broadly diversified stock market indexes.

In a 2020 research paper, Professor Hendrik Bessembinder observed that the companies that created the most value over a decade-long horizon [did not avoid dramatic share-price retracements] along the way. On average, the 100 most successful stocks recorded a maximum price 'draw down' of 33% before going on to create trillions of dollars of shareholder value.



Conversely, investments made over a shorter horizon tend to deliver a smoother journey even if the destination is ultimately less fruitful. Shorter hold periods can lend themselves to less stock price variability, and the associated trimming of positions as they move against investors, or deviate from the market, dampens losses. Of course, trimming positions as they run to take profits can also hold back total returns.

5. Portfolio turnover (low versus high)

The distinctions between long-term and short-term investments reach beyond the nature of returns and risk, to meaningfully influence portfolio management and process.

Investments with longer-time horizons lower portfolio turnover rates, which means that investors have more time to spend researching the companies they will hold for years to come.

Deeper research offers investors the opportunity to discover novel insights about their holdings that can increase their conviction to see through difficult markets or, alternatively, to unearth risks that may be avoided by selling a stock early.

By contrast, shorter-term investments necessarily create higher turnover within a portfolio, which requires investors to find new ideas more frequently and leaves less time to acquire an intimate understanding of each investment.

Choosing a horizon

We believe that a long-term approach to investing will provide a more rewarding experience for investors by delivering superior compound returns, even though the journey will almost certainly be much more uneven and unpredictable.

However, that doesn't mean that investors need to completely shun shorter-term money-making opportunities when they arise.

We reserve some space in Montaka's portfolio for investments that may play out over short horizons. We just make sure they complement a large core of long-term compounders rather than replace them.

7 year horizon	1.5 year horizon
Opportunities driven by multi-year, structural transformations	Opportunities driven by short-term variant perceptions around cycles/idiosyncrasies
Return in 7 years dominated by change in earnings power	Return in 1.5 years dominated by change in valuation 'multiple'
Retain opportunity to own 'multibaggers'	Forgo opportunity to own 'multibaggers'
Unpredictable 'journey' with big deviations from the market	Smoother 'journey' of returns with smaller deviations from the market
Lower portfolio turnover & greater opportunity to go deeper on long-term investment theses	Higher portfolio turnover & greater requirement to replenish idea pipeline

Chris Demasi is a Portfolio Manager at Montaka Global Investments, a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation.

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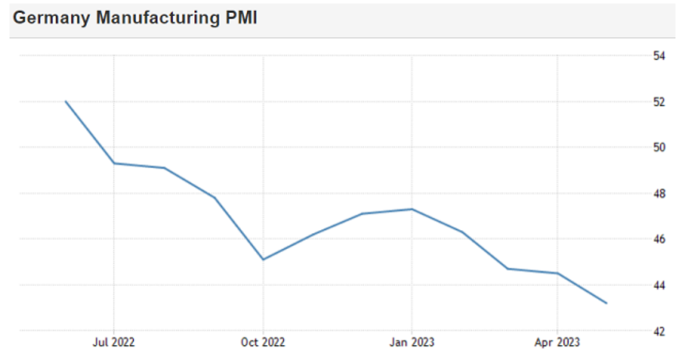
Where investors should look given mixed economic picture

Casey McLean

Although financial markets are averse to uncertainty, there has been a remarkable lack of volatility recently. Is this the calm before the storm?

Take the stark divergence between services and manufacturing Purchasing Manager Indexes (PMIs). This trend is present globally, but nowhere is the divergence larger than in Germany, a historic bellwether for the global economy. In May, the German Services PMI rose to a strong 57.8 whilst the Manufacturing PMI declined further to a lowly 42.9, with a reading above 50 indicating an expansion and below 50 a contraction.

In normal cycles, Manufacturing PMIs are a good leading indicator of what will happen to the broader economy. But it's fair to question if this is a good indicator this cycle, given the magnitude of the divergence and desynchronisation. One read is that the manufacturing weakness is just a hangover from the pull forward of goods demand during COVID, and therefore, merely a rebalance in the composition rather than a broader slowing in the economy. Another read is that services strength will soon roll over as the lagged effect of monetary policy works its way through the system.



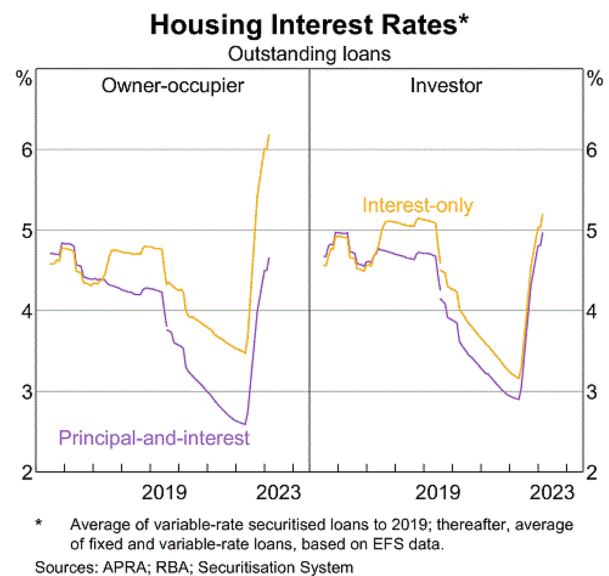
Source: tradingeconomics.com

The path of inflation and the impact on interest rates will likely provide the answer to this question.

The current interest rate hiking cycle has been one of the steepest on record. Yet despite this, a question remains whether the economy has become less sensitive to interest rate increases. On the surface, households and corporates have been able to navigate the pressures relatively well with growth sustaining and retail sales is slowing but not collapsing. But there are signs of cracks. The Silicon Valley Bank collapse and Credit Suisse takeover were a clear signal that the hiking cycle has exposed some frailties in the system.

Further rate rises will amplify the pain

In Australia, the real pain of interest rates is yet to be felt. Westpac commented in May that only 8 of the 11 interest rates increases had been passed onto borrowers thus far. On top of this, we are right at the precipice of the fixed rate cliff where the majority of borrowers lucky enough to lock in 2% mortgage rates will reset to 5-6%. With the last couple of interest rate rises, the cacophony of complaints has grown noticeably louder indicating the pain threshold has been reached. Further rate rises will only amplify this pain.



Whether the RBA is done raising rates for this cycle will come down to the usual suspects: inflation and employment. Whilst growth has slowed from the dizzying pace of 2021, employment continues to hang in there at record levels. As immigration returns there is likely to be some easing in employment markets. Some companies are telling us that positions they have had open for 18 months have all been filled in the last few months and that poaching of staff by competitors has also dried up.

On the inflation front, it looks increasingly clear that headline inflation has peaked in the US and Australia is following with a lag. But it is the core or underlying inflation that remains a problem. It is the services element of the economy, the non-discretionary items like haircuts, dentist, and childcare, which remains stubbornly high. This is translating directly into wage growth and risks fuelling a wage-inflation spiral. The recent Federal budget will only add to these pressures with large handouts to the people that need it and will spend it.

Putting this together, it means that even if we are close to the peak in interest rates, they are unlikely to be cut quickly. Unless economic conditions become dramatically worse.

Consumer staples are attractive

Either way, the consumer is likely to be under sustained pressure. Whilst some consumer discretionary stocks might be pricing in a consumer recession, many of them have not seen the downgrades to earnings that would be expected before there can be comfort that the cycle has bottomed. Especially considering the huge pull-forward of goods demand that occurred during COVID. Do you really need another coffee machine or big screen TV now?

Consumer staples are far more attractive in the current environment. Everybody needs food and drink. If you've got to go to the hospital, you've got to go to the hospital, even more so now considering the number of surgeries that were postponed over COVID. Insurance is another non-negotiable, especially in light of the amount of natural disasters Australia has seen recently. So, people will spend on these essentials regardless of inflation.

Despite this uncertainty, Australia is well placed in the global context. Firstly, the RBA has been more cautious than their Central Bank peers in raising rates, such that Australia has the lowest real interest rates amongst the major economies. Secondly, growth should continue to outpace the global averages supported by our linkages with a reopening China and abundance of natural resources. Thirdly, the Australian banking system is arguably the strongest globally, and unlikely to see significant contagion from events in the US or Europe. This is critical in periods of slower growth as weak banks lend less and further constrain growth. Finally, Government policies are generally expansionary with strong immigration inflows a key highlight.

The importance of immigration should not be under-estimated. Australia's 29 year run without a recession is the stuff of legend, even able to navigate the Global Financial Crisis without falling into recession - on aggregate. However, what many don't realise is that Australia did experience a technical recession in 2009 on a GDP per capita basis. It was only the growth in population from immigration that saved us.

Small caps look cheap

Contrary to this supportive growth backdrop, the ASX 200 has been one of the worst performing equity markets year to date. This has left the Australian market looking good value, trading in line or below historic average multiples. Small caps look particularly compelling, having underperformed their large cap peers by 15% over the last two years, and having the tendency to perform well in a cyclical recovery. The value is also being recognised by corporates, with the amount of takeover activity picking up recently over a wide variety of sectors, from utilities to resources and consumer.

So, while there is great value to be had in certainty, opportunities to take advantage of the robust growth in Australia are emerging which we expect will help set up the market when the cycle turns.

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What I know now about retirement income

Kaye Fallick

Back in the day my husband and I ran a publishing business. He was very good commercially, I was studying journalism so, by default, I found myself creating content. One day he and our accountant had the bright idea that we should buy a retirement magazine.

Seriously? I was in my early 40s and had no affinity whatsoever with writing about matters of interest to older people. Or so I thought.

Of course, I was overruled, and we bought it and within a short space of time converted the print edition to a website, eventually growing the subscription database to 250,000 baby boomer readers.

And I ended up writing about the various life stages of retirement for the next 20 years.

I'm now at the very pointy end of that demographic and actively managing our own retirement savings. Here are five things I've learned along the way.

1. Get out of denial, fast

Moving from denial of ever retiring into planning for this life stage is the first step. If you are lucky enough to live a long time, it's highly likely that you will need to manage the transition of your retirement income from accumulation mode to decumulation. This is not a bad thing. But assuming you don't need to think about it now is a huge error.

Part of denial is a vague hope that we won't grow old. It's a childish thought, at best, because the corollary is that we'll die young. But many of us look at advertisements for retirement planning and see silver-haired couples strolling on sunlit beaches and feel no sense of connection at all.

That's okay. Why would we? Most of these images of aimless couples are often neither relevant nor aspirational. But the plain truth is that we *probably* will, if lucky, have an active early and mid-retirement life, with perhaps a few later years when we will need more support.

The greatest favour we can do ourselves is to ensure that we have enough in the kitty to maintain our independence and allow us to have choices. The two most important assets in any retirement are not your super or your home, but your health and independence, the combination of which ensures you have choices.

2. Know the detail

After moving from denial, the next part of the puzzle is another thing that many of us avoid. And that's getting our heads across the detail. When we first started publishing the retirement magazine, I recall an editor reporting that deeming rates were one of our most read topics. My eyes rolled in their sockets. Who cares, I thought? I couldn't have been more wrong. With nearly three out of four Australian retirees affected by these government calculations on their assets, deeming rates remain a hot topic indeed. There is a lot of similar detail which needs to be understood across the spectrum of retirement income. You don't have to know each and every rule, but you do need to know about the main pillars of income – superannuation, the Age Pension, household equity, private investment and work income. And how these moving parts can and do combine to create income streams in your later years. Why not start with the detail of something tangible, for instance, your super? Top of head, do you know:

- your current balance?
- your net super increase over the past financial year?
- how much you are likely to contribute this financial year?
- what your balance is likely to be in the year you plan to retire?

This is very entry-level information. But it's surprising how many don't know these numbers. And knowing them is a first step to accurately forecast your likely retirement income. Knowing the detail is clearly not confined to just your super. As noted above there are at least five main sources of retirement income, all with rules and opportunities attached.

3. Ask questions

To fast-track your knowledge of the necessary detail, it's important to educate yourself. This is easier than it may sound. When we moved our print magazine online, I had no clue about running a website or sending e-newsletters. I had to learn, fast. So I took in information from everywhere. I spoke to those who knew, I read technology updates in newspapers and specialist magazines, attended conferences, and 'googled' most of the rest. No question was too dumb in my learning journey. It's the same with retirement income. It's complex and scary from the outside, so Q&A articles are your best friends, offering bite-sized insights into how others manage the building blocks of their savings.

It helps, of course, to have a good accountant. Given their access to your longer-term income and outgoings, they can talk you through ways of better managing both, particularly within the rules that leverage your assets or income to increase your retirement nest egg. Using such rules while you are still in the workforce is the best plan, particularly when you are at, or near, peak earning capacity. Ask your accountant about the many ways to contribute to super beyond the more obvious Super Guarantee or salary sacrifice.

Educate yourself *now* about Bring Forward rules and Downsizer Contributions. Or how a younger spouse strategy works? Are any of these strategies suitable for you right now? Or something to factor in for later? What about household equity? Or managing a mortgage? Should it be paid down, or should more money go into super? Yes, like other homeowners, you may feel that rapidly rising interest rates are all that you have headspace for right now. But how your home, your mortgage and your net household equity combine now and how they might work in the future are of critical importance. Start asking questions like these and don't assume you know all the answers. The rules can change and frequently do.

4. Know how much you spend

Now that's an uncomfortable thought, isn't it? If it's not, then congratulations, you are probably managing your household budget very competently. (Or in blissful ignorance, but that's another story). If, however, you don't know how much you regularly spend then you are reducing your likelihood of maximising your retirement income. Now is the time to change things. Yes, it was much simpler pre-easy credit days when the cash in your pay packet ran out, you were forced to stop spending. Now widespread access to credit means most of us can overspend – a lot – before things catch up with us.

Living within your means is powerful. Knowing if you are not, is equally important.

This clearly means you will need to do your sums. The advent of fintech applications means that most of our spending has already been categorised and calculated by our banks. Based on this head start, you can make your household budget as complex or as simple as you like – but living within it is non-negotiable. And once you've created a basic budget, the really hard work is out of the way. You now just need to honour it by keeping it up to date and making the hard calls if there is a net deficit.

The most ironic aspect about keeping a household budget is how determined most of us are to avoid it. But how much easier life gets once we finally start.

5. Embrace delayed gratification

The fifth thing I've learned about retirement income is not really financial at all, but it does influence our behaviour and can encourage a steady progression towards higher net wealth.

Best-selling US psychologist, M Scott Peck noted in the opening lines of his book, *The Road Less Travelled*, 'Life is difficult'.

Isn't it just? But Scott Peck went on to explain the undeniable benefits of delayed gratification, citing research which demonstrates that those willing to work for their rewards generally feel better and do better across life's journey.

This feeds into the power of compound interest, a marvel of mathematics celebrated by those with proven financial track records.

Put simply, compound interest occurs when you earn interest on interest on your original principal, and so multiply your gains over and above the original inputs – as long as you leave your money in the kitty. That's where delayed gratification kicks in. It's knowing that putting extra into savings and leaving these amounts in place is a sure way of growing your nest egg as steadily and successfully as possible, despite market fluctuations. (The principle of compound interest is neatly explained on the government's Moneysmart website.) There's a reason why financial experts love the power of compounding, and that's because it works.

And one more thing

You may have noticed that I haven't mentioned the need to see a financial planner. There's a reason for that.

I'm not convinced that a wholistic financial plan is necessarily the answer if you haven't done the hard yards first. A good financial planner can be a helpful partner, but not until you know your own situation inside out.

And maybe that's the sixth and best takeaway – when it comes to money, how well do *you* know yourself?

Kaye Fallick is Founder of STAYINGconnected website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.

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