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Editorial

In the fast media world of quick grabs and clickbait headlines, it takes quality interviewing and a great subject to hold a listener's attention for 4 1/2 hours. While I was on a long drive over the weekend, I listened to **The Jolly Swagman**'s podcast with **Ken Henry**, **Secretary of the Treasury** from 2001 to 2011 and later **NAB** Chairman, and the senior policy adviser who helped Australia to avoid recession during the GFC in 2008. To the credit of host **Joe Walker**, he allows Henry (a former university colleague of mine) considerable freedom to talk about economic policy, politicians and a wide range of other subjects and it's well worth the time commitment.

Among many highlights, at about the 2'15" mark, Henry talks about the heavy responsibility for raising interest rates before the 1991 recession (when Treasury and the **Keating Government** were active in interest rate policy), after which it was reported that 50% of men above the age of 45 who lost their jobs never worked again. Henry says:

> *"Yeah, it's brutal. It is brutal. And yeah, that's haunted me for a very long time and it was certainly playing on my mind during 2008. You know, actually, my father is now deceased, and actually died 18 years ago, but in that period, in the late 1980s, as we were having these discussions in the office, I did say to him, 'Look, this economy is just going nuts'. And it was I mean, were just having this extraordinary boom in the late 1980s. Inflation was one consequence of it, but it was only one consequence of it. The place was going absolutely nuts. And I said, 'Maybe it is the case that the only thing that's going to stop this is a recession. Maybe that's unavoidable.' And he said to me, and it stuck with me, particularly in the months that followed, he said,* ***'Nothing excuses a recession. You can't allow yourself to think like that.'*** *(my bolding)*
>
> *My father had that sense and had obviously seen it of colleagues of his who had lost their jobs and it just destroyed their lives. Destroyed it. That was it. They lost the capacity, not just the opportunity to find another job, but they lost the functional capacity to go and look for another job. They'd just been so devastated by the experience. I mean, I don't know if it's like many of those who went to war and were not functional when they returned from war, but it's something like that. I think, the trauma that people suffer and there are just so many elements of loss, aren't there? Loss of respect or self-respect and certainly loss of pride in what they're doing for their families and so on, you know, truly devastating."*

Ken Henry is still haunted by decisions made in 1991 and **Reserve Bank Governor Philip Lowe** now faces the same anguish. He wants to preserve the employment gains made in recent years, but by raising rates to control inflation, he may bring on a recession and job losses, and hence his much-referenced 'narrow path'. Lowe is an honest and honourable person and he is aware of the pain some of his decisions are causing and it will become worse.

There's another lesson in the Henry podcast. He also talks about the different obligations and roles of politicians versus policy and economic advisers. Lowe risks straying too much beyond his remit on monetary policy into the realm of political story-telling.

Consider Lowe's recent advice to struggling young borrowers facing rapidly-rising interest rates and million dollar mortgages. It might not feel like it but the Baby Boomer Governor genuinely believes he is saving borrowers from a worse fate by raising rates for the 12th time in a little over a year. But in moving beyond economic commentary, he is not bringing people with him using what Ken Henry describes as the great political skill of **Paul Keating** to tell stories. Keating's ability was unique, such as convincing voters of the dangers of debts and deficits. For example, Lowe has given at least five pieces of advice for renters or borrowers on finding some extra cash:

1. Don't move out of the family home

2. Don't have a home office

3. Rent out a spare room

> *"The way that this ends up fixing itself, unfortunately, is through higher housing prices and higher rents. Because as rents go up people decide not to move out of home, or you don't have that home office, you get a flatmate."*

4. Spend less on other things

> *"People are having to cut back with spending, and I think that's going to be the environment we're operating in for a while."*

5. Find additional work

> *"If people can cut back spending, or in some cases find additional hours of work, that would put them back into a positive cash flow position.''*


People struggling can work more: RBA governor

Reserve Bank governor Philip Lowe says people can cut back on their spending and work more to put themselves back into a cashflow positive position.

While Philip Lowe has every right as the Governor to guide interest decisions and explain them, he is doing himself few favours making obvious and gratuitous suggestions to younger generations.

The past month is evidence that central banks should remain independent of government, as politicians make decisions based on popularity rather than economic merit. Regardless of Lowe's past mistakes, he comes at his role from a place of his best judgement, but in buying into these lodger/get a job/spend less solutions, he opens the door for the politicians to attack on non-economic grounds.

In large companies, if the Chief Executive is straying into areas which do not help the company, it's the Chair's role to have a word and limit the scope to the company's core competencies. The recent Review of the Reserve Bank showed the Governor dominates discussion and decisions, and it's unlikely anyone on the Board will suggest he should limit his comments to monetary policy.

When the Prime Minister, **Anthony Albanese**, speaking at the Sky News-The Australian Economic Outlook Conference, was asked why the recent Budget assumed a cash rate of 3.85% for the next year when it was already at 4.1%, he could not resist joining the pile on.

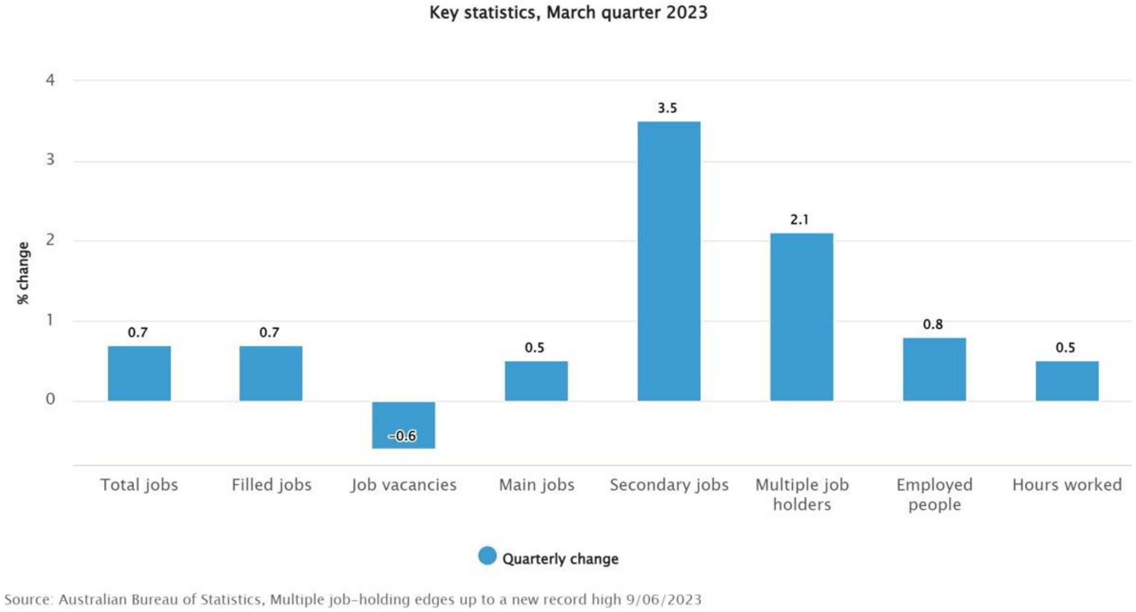
> *"That's not the only prediction on interest rates that have not been correct ... It's not as incorrect as the one saying there'd be no increases until 2024. So these things are all relative ... Interest rates were never going to stay at 0.1, that was never going to happen."*

Treasurer **Jim Chalmers** was similar after the latest cash rate rise, saying:

> *"I do expect there will be a lot of Australians who find this decision difficult to understand and difficult to cop. Ordinary working Australians are already bearing the brunt of these interest rate rises, they shouldn't bear the blame, too."*

"Ordinary working Australians". Not the most dignified sentence ever uttered by a Treasurer, and the Government passing the 'blame' to Lowe is obvious.

While the full impact of rising rates has yet to hit many borrowers, the take up of secondary and multiple jobs is a significant data point already in the **Australian Bureau of Statistics** data.



The ABS shows almost one million of the country's 14.2 million employees had multiple jobs as at 31 March 2023, an increase of 90,000 over 12 months. This ratio of almost 7% of workers holding multiple jobs is the highest on record.

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Out of curiosity, I wondered what a second job might look like these days, beyond the gig economy, so I looked through the situations vacant section of the newspaper (yes, I still read printed newspapers). I came across this advertisement for a Deputy Principal at a high school (obviously, not a second job). If anyone in financial markets thinks they have a tough job, consider what it would be like to face this every working day:

> *"You are hardly through the door when news of today's dearth of casual staff hits your desk. The 5am sports trip to Newcastle calls in to say that the highway is closed and they will miss their game and are turning back. You have two upset parents waiting in reception and no one's turned up to put the desks up for exams. Some early students have kicked a ball through the library window. You've got a presentation on future directions to finish for the Board meeting that afternoon and a difficult conversation to have with a member of staff before their next class. It's 7:45 am.*
>
> *If this sounds like the start of a day that you could handle and still be smiling at the end of the day, read on!"*

I would roll over and go back to sleep. As if that wasn't tough enough, the job required:

> *"When making your application you will upload your cover letter, resume and supporting documents, complete the application screening questions and record a short video."*

Is that now a thing, a video on what 'value add' you can bring?

And then into my Twitter feed came an interview with the wonderful actor, **Richard Burton**, whose mother died giving birth to her 13th child when Richard was only two years old, and he was raised by his elder sister. This really will sound like Baby Boomer advice, but this long extract shows the shit jobs some people will do.

> *"As a matter of fact, I've always had this happy knack of acquiring money, even during the bad days of the depression. I would sometimes earn as much as the minimum wage of a miner while I was at school. It meant a very full day, of course. I would get up when the miners went to work, or rather when they got up before they went to work, which would be half past 4 or 5 in the morning. I still do get up at that time. And I would go up to the mountains with a – I remember I had a green sweater especially for the occasion. I'd go*

up to the mountains with a sack and a shovel and fill up the sack with the horse manure and cow manure and take it back home. Then I would have to take a bath, of course, a cold bath – we didn't have any heat – because I was stinking and put this dreaded green sweater away.

And then, I would go and wait for the express from London and wait for the daily newspapers to arrive. And then, I delivered the newspapers. Then I would have breakfast. Then I would walk to school, the grammar school. And then, I had an arrangement with the fish and chip shop, and with my customers who had the newspapers, I would sell the dung for 6 pence a bucket to the various allotments. People had allotments where they had their own gardens. I got 6 pence a bucket for the dung, and I was paid 1 shilling a week for delivering the newspapers, which in those days, I don't know what that would be in American money, I suppose about $0.25. And then, I would recollect some, not all, but a great many of the newspapers which I delivered during the week, I would recollect them on the Saturday and deliver them to a fish and chip shop. And on Saturday morning, I would eye the potatoes (in a fish and chip shop). And on a good week with tips from my customers and so on, I could earn as much as 30 or 35 shillings, which was the minus minimum wage at that time. And so, I always had a happy genius for getting money."

If it's good enough for Richard Burton, CBE, twice husband of **Elizabeth Taylor**, winner of many acting awards and seven Academy Award nominations, it should be good enough for a struggling mortgagee.

But Phil, let's not hear about collecting bottles for recycling, selling possessions on Gumtree or catching public transport rather than driving a second car. Struggling homeowners will do almost anything to hang on to their castles and the status of the Reserve Bank is not helped by unwanted homilies.

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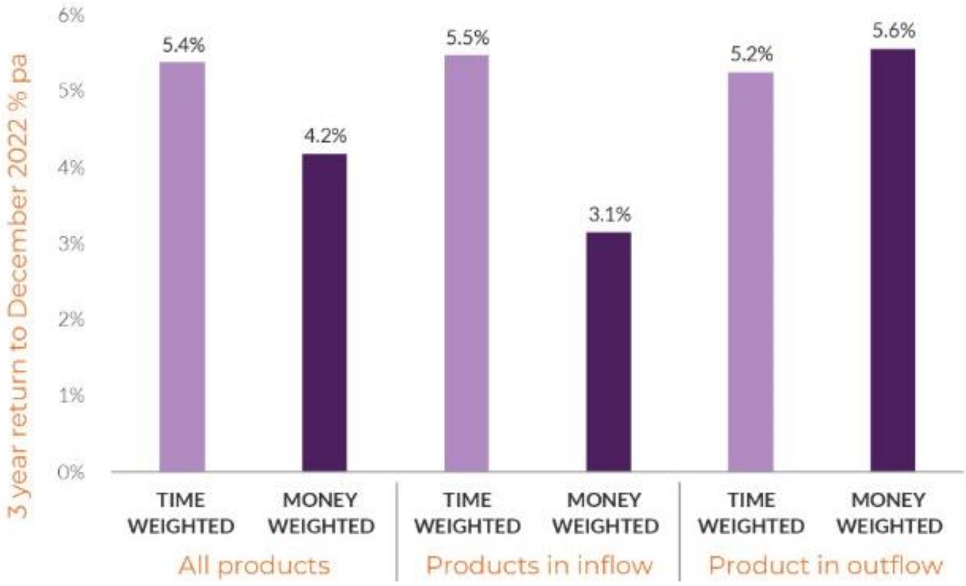
We have often seen research in overseas markets, usually in the US, which shows that investors perform worse than the indexes or funds in which they invest. The reason is that fund performance is quoted in 'time-weighted' terms, where the impact of cash flow timing is ignored. The alternative measure is 'money weighted', where the timing of actual flows into the fund are calculated, reflecting when investors invest and withdraw. The money-weighted results are poor as investors buy high and sell low.

Rainmaker's comparison of global equity funds offered in Australia produces a more revealing result, that it is better to invest in unpopular funds. Overall, the money-weighted performance achieved by investors is materially worse than the time weighted but products in inflow do worse than the products in outflow. Rainmaker's **John Dyall**, Head of Investment Research, explains:

"Investors often think that a fund in net outflows is a red flag, indicating that other investors are bailing out and that they should follow them. But this may not always be the case. In fact, investing in managed investment products that are in net outflows may be a smart investment strategy, or at least smarter than chasing returns in the popular funds. This means that people invested in these funds after the good times were over."

International equities product returns



Source: Rainmaker Information RMetrics Equities Report

Rainmaker explains that investors often jump on board following strong performance "*just when the party is starting to end*". Investors and advisers should realise investing is not a popularity contest.

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The desperate shortage of residential properties shows no sign of easing as Australia is forecast to take in 1.75 million net migrants in the next five years, amid a population explosion. We take a closer look at the arguments that the capital gains tax discount afforded to investors in property should be abolished or reduced as there are many different arguments. The home shortage is not going away any time soon, with the 2023 Federal Budget forecasting an increase in population from around 26 million to 28.2 million by 2027.

Table A.2: Population by state, at 30 June

million	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total(a)	Australia
2021-22	8.156	6.620	5.327	2.788	1.822	0.572	0.457	0.251	25.991	25.996
2022-23	8.300	6.780	5.441	2.847	1.849	0.578	0.466	0.254	26.516	26.520
2023-24	8.423	6.929	5.532	2.896	1.871	0.585	0.476	0.258	26.970	26.975
2024-25	8.528	7.057	5.616	2.941	1.890	0.592	0.485	0.262	27.371	27.376
2025-26	8.631	7.186	5.699	2.985	1.908	0.599	0.495	0.266	27.770	27.775
2026-27	8.734	7.314	5.782	3.030	1.927	0.607	0.505	0.270	28.168	28.172

a) 'Total' is the sum of the states and territories shown, and excludes Jervis Bay Territory, Christmas Island, the Cocos (Keeling) Islands and Norfolk Island.

Source: 2023 federal budget

And returning to the subject of podcasts, following many requests, we start Season 2 of the **Wealth of Experience** podcast, this time with **James Gruber,** myself and **Peter Warnes, Morningstar's Head of Equity Research**. In my section, while we know the new $3 million superannuation tax is based on the increase in the Total Superannuation Balance over the course of the financial year, I explain a part of the calculation that many people are overlooking. We also discuss strategies that now come into play as alternatives to large super balances. Meanwhile, Peter talks through the headwinds for Aussie large caps, as well as the energy transition and its investment opportunities.

Graham Hand

Also in this week's edition ...

At Firstlinks, we like investment topics that aren't just designed for this moment in time, but will endure through time. In that spirit, **James Gruber** outlines 23 lessons on money and investing, including that if you're excited about an investment it's probably a bad idea, get rich quick and get poor quick are two sides of the same coin, forecasting is for the weather, and never reach for yield.

Meg Heffron is back with her monthly article, this time to discuss the claiming of tax deductions for personal super contributions. She says it's a great strategy that should be considered before the end of the financial year. Yet Meg suggests there are potential traps that people need to be aware of.

A reader requested an article on investing in the energy transition, and **Magellan's David Costello** believes it is the greatest investment opportunity of our lifetimes. He offers a framework to take advantage and includes stock picks that will benefit.

Shane Woldendorp of **Orbis** says that if history is any guide, the best of times for investors tends to be followed by the worst of times. Given the post-GFC era was an amazing period for global equities, the next decade could prove much more challenging. Shane says valuation spreads between growth and value stocks are reaching extreme levels, and value could be set for long-term outperformance, even if markets cave.

The long-term retirement system allows super funds to buy illiquid assets, yet this component must be prudently managed. Measuring liquidity is complex but how do our five major funds compare and are their levels safe? **Morningstar's Annika Bradley** investigates.

Australian small caps have consistently underperformed large caps and the question is: why? **Van Eck's Cameron McCormack** says structural issues are to blame, including market size, exchange listing requirements and sector exposure. Global small caps don't have the same issues and have traditionally outperformed mid and large caps.

You'd think that with markets nearing all-time highs, investors would be 'all in' for this bull market. Yet new data from **Dan Jowett** at **Openmarkets Group** suggests Aussie retail investors remain remarkably defensive. In fact, they're more defensively positioned than at the height of the Covid crisis, crowding primarily into domestic large cap companies.

Curated by James Gruber and Leisa Bell

23 lessons about money and investing

James Gruber

In his book, *The Laws of Wealth*, behavioural finance expert Daniel Crosby offers this one-page summary of the most important lessons on money:

There are good lessons here as well as some that may be best ignored. Let's go through them one-by-one:

1. The Jones' aren't as rich or happy as you think they are.

This lesson reminds me of a story by finance author Morgan Housel about his days as a hotel valet:

> *"In college, I worked as a valet at a fancy hotel in Los Angeles. When an expensive car drove in, I used to always think, "Wow, he's rich!" But as I got to know these "rich" people, I saw a different side. A few opened up about their finances (people love talking to valets), and I couldn't believe their stories. Some of them weren't that successful. Certainly not like I imagined. Instead, they made modest incomes and spent most of it on a car. It's amazing how fast you can go from admiring someone to feeling bad for them.*
>
> *I learned something from that. When you meet someone who owns a $100,000 car, you only know one thing about their wealth: That they have $100,000 less in the bank, or $100,000 more in debt, than they did before they bought the car. That's the only information you have.*
>
> *We rarely think of it that way. So much of our perception of wealth is driven by what we see other people buying. Since we can't see their bank accounts, that's all we have to go on. But it gives us a distorted view of wealth. Some people we think are wealthy really aren't; they just spend most of their income. Others we think of as less well-off are actually the rich ones. They're rich not despite driving the old car, but because of it.*
>
> ***Financial wealth isn't what you see. It's what you don't see.***"[bold type added]

Comparing yourself to others creates envy. And envy is a shortcut to despair. As Warren Buffett's business partner, Charlie Munger, says: "Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun. Why would you want to get on that trolley?"

Maybe that's why the Stoic philosopher Seneca described a wise man as *"Content with his lot, whatever it be, without wishing for what he has not …"*

2. The more complicated the investment advice, the less useful it is.

Complex financial advice often comes with more risk or more fees going to an adviser. Simple advice and strategies are less profitable for advisers yet can be the best options for individual investors to follow.

3. Get rich quick and get poor quick are two sides of the same coin.

Making a fast buck will inevitably involve taking large risks. Put another way, the greater the returns on offer, the greater the risks.

When you hear of a hedge fund making 600% in a year, or a friend who punted big on a small cap and made a lot of money, it likely means they took on large risks, perhaps with leverage. And it could have easily turned out poorly for them.

4. Time is a scarcer resource than money.

This is a lesson that gets repeated by financial authors who write more about self-help than investments (how did self-help infiltrate finance?), but it's one I disagree with. Time isn't a scarce resource, it's just that we're experts at wasting it.

I can think of many examples where the lesson doesn't match with reality. For instance, I speak to my retired parents and their friends, and they have all the time in the world to fritter away. Yet I'm sure they'd all love more money, no matter what their circumstances.

5. Ask about anything you don't understand.

A 'hard agree' on this one. There's no such thing as a dumb question.

6. A house is a place to live, not an investment.

You can tell this is an American author, not an Australian one! In Australia, it might read: "Every Australian has the right to have a house as an investment."

More seriously, it's amazing how this simple lesson has been ignored over the past 30 years.

7. Admire people who earn more money than you, not people who spend more money than you.

Not sure I agree with this one. Why admire people who earn more money than you? It seems to me that there are far more admirable human traits than earning more money. Wisdom, kindness, compassion, happiness, leadership, intellect, creativity, to name a few.

8. Your mortgage broker is lying to you about how much house you can afford.

This shouldn't be a lesson though it aligns with Warren Buffett's famous saying that you shouldn't ask a hairdresser if you need a haircut.

9. You don't need to be a maths whiz to make good money decisions: finance success is 5% intelligence and 95% discipline.

If you want to get really wealthy from investing, you *will* need to be a maths whiz. Warren Buffett, Jim Simons, George Soros – all are maths geniuses. For the rest of us though, discipline is key.

10. A raise in income shouldn't mean a raise in lifestyle.

This is a good one. British entrepreneur James Caan once said that upon selling his company, he was advised to hold off spending any of the proceeds for 12 months. It was a cooling-off period before he decided on how to spend the money.

A cooling-off period is a good idea for anyone getting a raise or a bonus or any other windfall.

11. Forecasting is for the weather.

Mostly true, though not totally true. Wharton Professor Philip Tetlock suggests there are 'super forecasters' out there yet they're rare, niche experts who focus on forecasts of less than 12 months. Any forecasts beyond 12 months are largely worthless, he says.

If you aren't a rare, niche expert, the lesson is worth following.

12. Never reach for yield.

Yes! It's critical to remember that dividends rely on earnings. Dividends can't continually grow if earnings don't. And earnings growth depends on the quality of the company. That's why Morningstar advocates buying stocks with 'moats', or sustainable competitive advantages.

13. Fees erode performance.

Wherever John Bogle is, he'll be nodding. Bogle founded Vanguard on the premise that low-cost index funds would outperform most investment funds, largely because of the latter's fees. The premise has revolutionized the investment industry over the past 40 years.

14. There is an inverse relationship between investment performance and time spent watching financial news.

This is cute, though not entirely accurate. I think the point it's trying to make is that if you spend all day watching Bloomberg news, you'll be more inclined to trade stocks, and the constant trading of stocks will lead to subpar investment performance.

The flip side is that being better informed about finance issues is a good thing. Watching and reading about investments can make you a better investor.

As with life, being selective about what you consume is important too.

15. Don't pay interest to acquire something that loses value.

Crosby likely had cars in mind and it's a good rule.

16. You don't have to be rich to invest, but you have to invest to be rich.

This reminds me of a quote from Robert Allen: "How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."

17. Invest in your mind and your skills first.

Investing your money and time in other things such as your health as well as your family and friends are also important.

18. Infrequent splurges bring the greatest happiness.

I'm not sure what science says about this, though it rings true in my life.

19. Your life is a better benchmark than the S&P 500.

Or the ASX 200. Money is just one component to living a good life and should never become your *whole* life.

20. Compound interest is the eighth wonder of the world, set yourself up to benefit from it rather than battle against it.

Warren Buffett started his investment firm, the Buffett Partnerships, in his 20s, and had a net worth of US$1 million (US$9 million in today's money) by the time he was 30. Since that time, till now at the ripe age of 92, Buffett has compounded his money at 22% annually to be the world's sixth richest person, worth around US$113 billion.

Yet his net worth could've end up very differently if he'd started his investing career later and retired earlier. If he'd saved US$25,000 by the time that he was 30 and retired at the age of 60, yet still compounded his money at same rate of 22% p.a., then Buffett today would be worth closer to US$12 million or just 1/10,000th of his current fortune.

That's the power of compounding, and it's a lesson that should be drilled into children and adults alike.

21. A penny saved is a penny earned.

Thomas Stanley writes of seven common traits among those who've accumulated wealth in his best-selling book, *The Millionaire Next Door*. One of the key traits is frugality –the wealthy live well below their means and save more than they earn: "They became millionaires by budgeting and controlling expenses, and they maintain their affluent status the same way."

22. If you're excited about an investment, it's probably a bad idea.

Recently, my brother-in-law contacted me and suggested that electric vehicles were the future and key suppliers such as lithium miners would make good investments. My response was that a lot of investors were thinking along similar lines, and that means it's probably a bad idea.

23. Market corrections come more regularly than birthdays – expect them.

If you define a market correction as a market decline of 20%, then this lesson is false. However, the point is valid. Markets go up and they go down, and you need to be able to handle both with equanimity.

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

A capital gains tax discount is legitimate but how much?

Graham Hand

Australia's chronic shortage of housing is prompting widespread calls for changes in a wide range of policies that affect the demand and supply of places to live. A forecast net intake of 700,000 migrants over two financial years to 30 June 2024 (and 1.75 million by June 2028) at a time of construction shortages and rising rates has created an historically-low rental vacancy rate. Contrary to expert predictions, house prices have risen in 2023 as home demand outstrips supply.

At such times, two policies targeted for criticism in favouring investors over owner-occupiers are negative gearing and the capital gains tax (CGT) discount.

With negative gearing, where costs of owning a rental property exceed revenues, the 'loss' can be charged against other personal income. Some people seem to think the loss itself is a good thing because it reduces their tax, but the tax savings only reduces the loss: it is still a loss. This is little comfort to the aspiring homeowner who is beaten at an auction by an investor happy with the income offset in return for future capital gains.

As if that wasn't enough, investors also receive a 50% CGT discount if they sell after holding the asset for longer than 12 months. Little wonder Australians love investing in real estate.

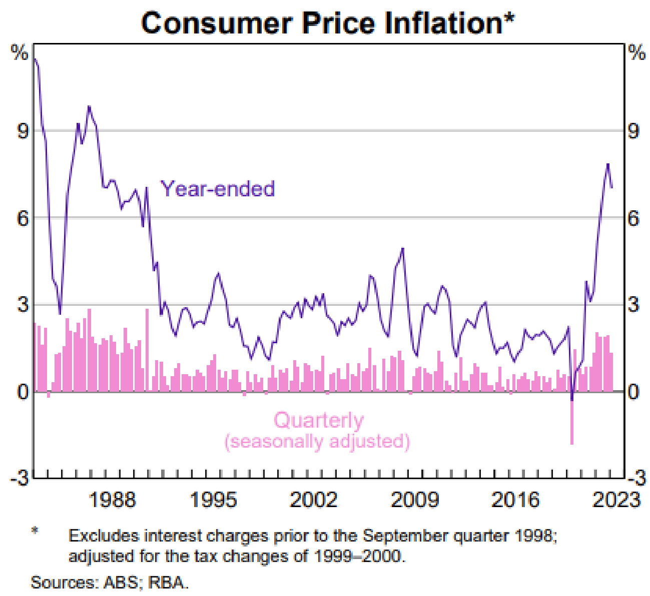
But why should a dollar made as a capital gain be taxed at a lower rate than a dollar earned as income? Nobody can claim a personal income tax deduction if they've held a job for longer than 12 months. That seems a ridiculous notion.

Why do we have a CGT and a discount?

CGT was introduced almost 40 years ago in Australia in 1985 to stop schemes that converted income into capital to exploit its tax-free treatment at the time.

The CGT discount started as a recognition that in calculating capital gains, it is fair to tax the real increase in the value of the asset, after allowing for inflation. Any asset which only keeps up with inflation is not really increasing in value. For example, the annual Consumer Price Index reached 7.8% in December 2022, the highest for three decades. If an asset was bought for $100,000 a year earlier, its value would need to rise to $107,800 to retain its real value. That is, in December 2022, it cost 7.8% more to buy goods than in December 2021, so it is legitimate to adjust a capital gain for inflation. As the chart below shows, inflation adjustment matters again.

So where does the 50% discount come from?



Prior to 1999, the calculation was based on an adjustment to the cost base for CPI, but it was considered overly complicated. Investors needed to calculate the inflation adjustment between buying and selling dates. This seems a trivial reason, as online data and calculators could easily be provided by the Australian Taxation Office (ATO) and others. But at the time of the 50% discount introduction, it was justified on simplicity grounds. And the 15% tax on superannuation in accumulation mode receives a 33% discount, giving a tax at 10% instead of 15%.

It is easy to see who benefits and who loses from the move from CPI to 50%.

Winners: Investors who hold an asset for a little over 12 months when inflation is low.

As with most developed countries, Australia went through a golden period of low inflation starting in about 1996 and running until the pandemic. The timing of the 50% discount was of great benefit to many investors.

Losers: Investors who hold an asset for a long time during high inflation.

It's not all win-win in investor land. Using the Reserve Bank inflation calculator, an asset bought for $100,000 in 1992 and held for 30 years until 2022 would need to rise in value to $212,610 to retain its real value. The cost base would rise by $112,610 under a CPI adjustment. If the asset sold for its CPI-adjusted level of $212,610, the CGT would be zero under the old system. Under the 50% system, half the gain or $56,305 would form part of the investor's taxable income.

So in certain circumstances, the 50% discount is unreasonably low. Now we have a return to higher inflation which looks like sticking around for some years above the Reserve Bank target range of 2% to 3%. Online calculators debunk the idea that the calculation is too complex, and it seems a fairer system to adjust the tax base for inflation.

The CPI adjustment also encourages holders who do not flip investment properties every year or two, and it's easier to sell politically. The 50% number sounds generous, and it was in a low inflation environment. Everyone can understand the legitimacy of a CPI adjustment.

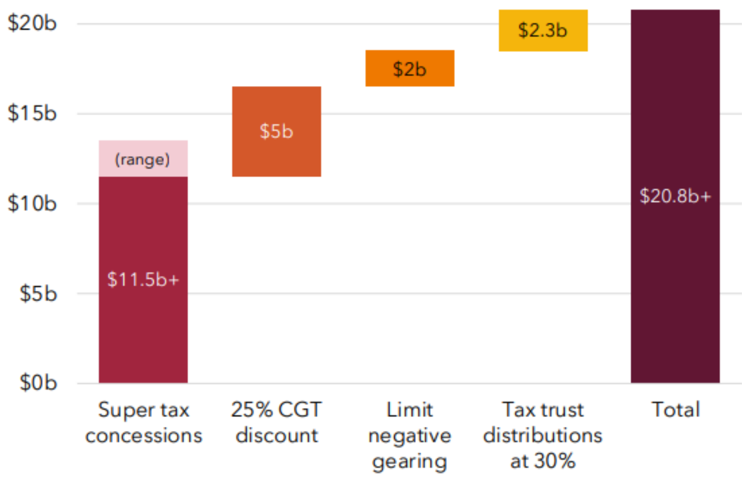
What are some of objections to the CGT discount?

In its 2023 paper, 'Back in black? A menu of measures to repair the budget', the Grattan Institute argued that successive Australian governments cannot continue to massively spend to keep voters happy while not collecting more revenue to pay for it. Among a range of measures was a proposal to reduce the CGT discount to 25% to raise $5 billion a year.

The main rational for the change was:

> *"If income taxes are applied to nominal capital gains, inflation can erode part of an investor's wealth. But given low inflation for most of the past decade, the 50% CGT discount overcompensated many investors for inflation. The policy has also over-zealously protected savings at the expense of competing considerations. The economic benefits of tax neutrality for savings are small, and the 50% CGT discount encourages investors to focus too much on investments with capital growth rather than annual income. This is a major distortion which, together with negative gearing, encourages property speculation over more efficient investments. The current discount also compromises income tax integrity by encouraging artificial transactions and makes the tax system less progressive. The 50% CGT discount for individuals and trusts should be reduced to 25%, with a gradual phase-in (rather than grandfathering)."*

Figure 4.3: The government could raise substantial revenue by reducing leakages in the income tax system
Annual value of reducing income tax leakages



Source: Grattan Institute analysis.

Earlier modelling showed the top 10% of households by income receive nearly three-quarters of tax benefits.

Other critics argue Australians do not need these tax incentives to buy property, and it disadvantages people without the resources to invest in property at the expense of more productive businesses. The discount is available to people who are wealthy enough to own capital and they should not pay less tax than someone who relies on income.

The Henry Tax Review recommended reducing the 50% CGT discount to 40%, but like much of Henry, this was rejected. However, this needs to be read in the context of Henry's sweeping changes, which recommended a move to a broad 40% discount on many forms of personal savings to remove distortions and incentives. The Henry Review said of the different ways income and capital gains are taxed:

> *"There is considerable evidence that such tax differences can have large effects on the assets in which a household's savings are invested. The large variations in tax treatment can therefore alter the allocation, ownership and the management of the nation's savings. This can have adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals. The tax advantages from borrowing to invest in a rental property, also relevant for shares, leads to investors taking on too much debt and distorts the rental property market. A move to a broad 40% discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced, and household investment and financing choices would better suit their circumstances and risk-preferences."*

While economists such as Saul Eslake supported this proposal, a 2016 paper by Professors George Fane and Martin Richardson noted:

> *'the simplest way to repair the capital gains tax is to return to the pre-1999 arrangements'.*

Note also that investors can add to the cost base the expenses incurred in acquiring the asset such as inspections, surveyor costs, stamp duty or costs of transfer. The ATO has a detailed list here. CGT discounts are available to individuals and trusts but not companies.

A discount is justified

As various policies relating to housing and tax are kicked around for change, we can debate the amount of the discount – 25%, 40%, 50%, linked to CPI – but the justification for some level of discount is strong. The CPI adjustment to allow for the real value of the asset seems easiest to justify and explain.

However, the impact on housing supply is uncertain. While owner occupiers would prefer fewer competitors on auction day, renters would not want a policy that materially reduces the availability of rental properties.

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

Meg on SMSFs: watch traps in EOFY contributions

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues on managing your SMSF.

As Liam Shorte said in his excellent article here, there are so many things worth doing at the end of the financial year that we almost need an extra month to do them.

But one of Liam's suggestions (Item 9) caught my eye as being worthy of more discussion: claiming tax deductions for personal super contributions. The article highlights the importance of putting in the right paperwork at the right time, which is absolutely crucial. There are a number of points that are often forgotten.

Eligibility for and use of a deduction

Anyone aged between 18 and 67 is eligible to claim a tax deduction for their personal contributions as long as they have enough income to do so (you can't use one of these tax deductions to create a tax loss). It doesn't matter how the income was earned in the first place or whether the person is working.

Working is only important for people over 67. Someone between 67 and 75 who does meet the relevant work test, though, can also claim deductions for their super contributions. For this purpose, the work test is doing paid work for at least 40 hours in a 30-day period at some point before 30 June 2023. It doesn't need to be met before the contribution was made.

And the deductions can be useful for all sorts of people at different stages of life, for example:

1. Someone who is 60 and retired but made a large (personal) capital gain. The deduction will help reduce the tax they pay on that capital gain.

2. Or perhaps they're 20 and at university but received a distribution from their parents' family trust. The deduction will reduce the tax they pay on that distribution.

3. Or working and just didn't get around to putting a salary sacrifice arrangement in place and have some spare cash they'd like to put into super in the next two weeks.

All of these are scenarios where a tax deductible super contribution could be very handy.

The limit

These contributions (together with any contributions made by an employer) are checked against the member's 'concessional contributions cap'. For most people this is $27,500 but as Liam points out in his article (Item 3) some people can also use limits they haven't used in the past.

Watch for the traps

There are a few traps that can easily bring a good strategy undone and it's largely to do with the paperwork. Liam's article touched on two – it's critical to prepare and sign the paperwork before starting a pension or taking money out of the fund.

1. Starting a pension

There are some quirky rules around these contributions that mean if you (say):

- contribute to your fund in July 2022,
- start a pension with even just some of that super account in December 2022, and then
- complete the paperwork for your tax deduction in July 2023,

your deduction is denied. You have to do the paperwork ***before*** starting the pension.

What if it's too late and you've only just discovered that this is how things work and haven't done your paperwork yet?

That's terminal for your July contribution but you could make another contribution now (June 2023) as long as the paperwork is completed before doing anything with this money (such as starting another pension or making a withdrawal).

What that ***will*** mean is that your July 2022 contribution has to be treated as a non-concessional contribution.

What if you weren't actually able to make these types of contributions in 2022/23? People who had too much in super at 30 June 2022 or who had already used up their 2022/23 cap for these contributions beforehand would be in this boat.

Don't panic, it's not illegal to do that. It just means you'll have an 'excess' non-concessional contribution. The ATO will issue a notice telling you about it in due course and unless you really want to leave it in your fund (don't do this), your fund will eventually be told to refund it to the ATO, together with some interest.

The ATO will use that as an opportunity to grab any money you already owe them (if you have outstanding personal tax bills) but will give the rest back to you less some tax on the interest. It's not a terrible result and will at least mean you get to claim the tax deduction you were aiming for.

2. Taking money out of the fund

Something similar happens if you've taken your money out of your super fund during the year ***after*** making the contribution but ***before*** doing this paperwork. Unfortunately the deduction gets 'scaled back' – if you took 25% of your super balance out of the fund, you can only claim a deduction for 75% of the contribution. In fact, if you took **all** your money out of your fund you'd get no tax deduction at all. That even happens if you just moved your super from one fund to another. Ouch.

3. Changing your mind

What if you planned to claim a tax deduction for $20,000 and put this paperwork in place in July 2023? Then in October 2023 – while doing your personal tax return – you realise you actually have more income than you thought. You'd really like to increase your deduction.

Unfortunately, you can't change a notice you've already done to ***increase*** the deduction you claim. (You can vary it down, even to $nil, but not up.)

A tip for the future is that if you make multiple contributions in a particular year, your deduction can be attached to specific contributions. In this case, let's imagine you contributed $20,000 in August 2022 and $15,000 in May 2023. Your original plan was that the May amount would be a non-concessional contribution. You haven't started a pension or taken any money out of the fund during 2022/23.

If your notice about claiming a tax deduction was specifically attached to the August 2022 contribution, there's nothing to stop you doing ***another*** notice later to claim part of the May contribution as a personal tax deduction. That second notice could even happen in October when you discovered the problem.

In other words, you can do as many notices as you like (one for each contribution in the extreme) and they **can be** specifically attached to individual contribution amounts rather than just "all the contributions made this year".

4. And finally on the paperwork

There are two components to these notices. The member tells the trustee they intend to claim a tax deduction (and which contributions it relates to) and then the trustee acknowledges it. Both components are critical. The tax deduction isn't valid without them. And this is one time when the date it's actually signed is critical.

This is quite different to other SMSF events. For example, it's common for pensions to start on 1 July but for the paperwork to be formally signed sometime later. That can't happen for these notices. They have to be **actually signed** before the **earlier** of:

- the date the member lodges their personal tax return for the year, or
- 30 June of the following year (so 30 June 2024 for 2022/23 contributions).

That means someone who lodges their 2022/23 tax return on 15 October 2023 has until 14 October 2023 to do this paperwork as long as they don't start pensions etc beforehand.

Claiming a tax deduction for super contribution can be a great strategy and definitely something to consider before 30 June. But this is definitely one time when the paperwork really matters.

Meg Heffron is the Managing Director of Heffron SMSF Solutions, a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

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

The energy transition is our biggest investment opportunity

David Costello

Introduction: A reader (and former colleague), John, sent this message to Firstlinks recently.

> *"I am an avid reader of your newsletter and remember fondly our time together at CFS.*
>
> *I sometimes still find myself torn when one of my speculative trading decisions turns out to be a great long-term investment. These are usually in the technology and/or energy sector. I am constantly trying to keep up with new potential trends in these industries. Hence my email to you.*
>
> *I wonder if you have published any articles on the energy sector potential winners.*

> *I am reminded of the old Gold Rush days in Australia where the big winners were the companies who serviced the mining entrepreneurs who saw an opportunity to serve or exploit thousands of fortune-hunters.*
>
> *Sometimes I wonder what part of the energy sector will be the big winner in the rush to find non polluting sources and controlling/storing/distribution the power. I read a lot about Sources (Solar, Nitrogen, Wind, Gas, Oil, Gas and Nuclear) as well about storage and distribution offers.*
>
> *I would love to see some of your articles simplify this."*

We checked around our regular contributors and David Costello of Magellan recently presented to the Portfolio Construction Forum on the energy transition, and this is an edited transcript.

***

We're on the verge of an abyss and we cannot afford a step in the wrong direction. These are the words of António Guterres, the United Nations Secretary-General, reflecting upon the narrowing path that humanity will have to traverse if we're to avoid a climate disaster. Analysis by the Intergovernmental Panel on Climate Change (IPCC) suggests that under current policy settings, we're on a path to more than 3 degrees of global warming by the year 2100. Scientists warn that a world with more than 3 degrees of global warming would be a dystopian place, with temperatures representing a threat to human life at the equator for more than 200 days each year, a world in which massive crop failures risk undermining global food security.

These projections are confronting but they should be viewed as a rallying cry. Climate scientists are clear that we still have the opportunity to avert the worst consequences of climate change and limit global warming to 1.5 degrees if we drive deep cuts in greenhouse gas emissions this decade and go on to achieve net zero around mid-century. The central estimate is that we need to cut greenhouse gas emissions by approximately 43% this decade.

Now, we have the means to achieve these deep near-term cuts in emissions. Virtually all of the technologies required to do this exist today and are already economically viable. What's required to realize their potential is capital. The International Renewable Energy Agency projects that limiting global warming to 1.5 degrees will require cumulative total investments of US$115 trillion over the period of 2050, a nearly fourfold increase in prevailing levels of investment in clean technologies.

So, as allocators of capital, we're confronted with a choice. We can choose to continue to allocate capital in a manner that yields destruction. Or we can allocate capital for impact and preserve our planet for future generations.

Compelling financial and economic reasons

John Kerry, the U.S. Special Presidential Envoy on Climate, has described the energy transition as the greatest economic opportunity since the Industrial Revolution.

I believe the energy transition, the decarbonisation of the global economy, will represent the defining investment thematic of our lifetime. And capturing the potential of this thematic will require a tailored investment framework to optimise results.

My conviction in this opportunity rests on two key inferences.

The **first** is that those companies that provide the products and services that enable the decarbonisation of the global economy will sustain growth at a multiple of global GDP throughout the energy transition.

And the **second** inference is that a thematic investment exposure to the energy transition will serve to mitigate prominent business and market risks and therefore enhance the risk-adjusted characteristics of a portfolio.

Electric vehicles

The capacity for the energy transition to sustain growth at a multiple of global GDP stems in large part from its capacity to seed vast new markets. The IEA projects that electric vehicle sales, for instance, will grow at a compound annual rate of more than 10% over the next 30 years. In the near term, those rates are more like 20% to 30% per annum. They project that battery storage capacity and EV charging capacity will grow at compound annual growth rates of approximately 20%, while clean hydrogen production in net zero scenarios is expected to grow at 25% per annum. And there will be opportunities all throughout the value chains.

Growth Thesis: The energy transition will seed vast new markets

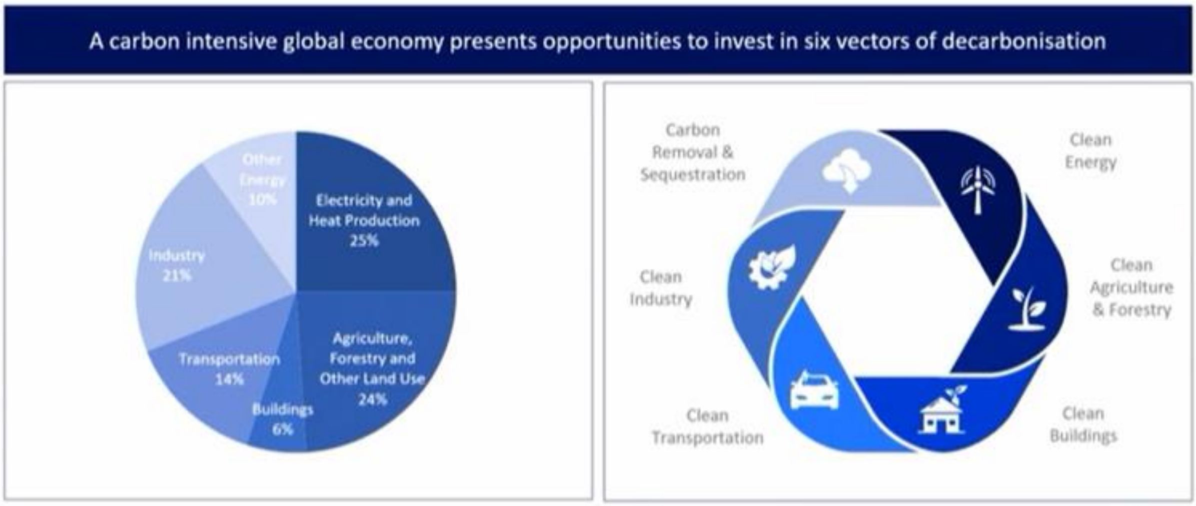
	Projected CAGR (2020 – 2050)	Projected Multiple of Growth (2020 – 2050)
EV sales (million units p.a.)	~11%	21x
Battery storage capacity (GW)	~19%	> 170x
Public EV charging capacity (GW)	~21%	>250x
Clean hydrogen production (Mt p.a.)	~25%	>700x

The six key vectors of decarbonisation

Our extensive reliance on fossil fuels as an economy means that they will pervade the global economy. On the left-hand side of the chart below is the world's inventory of greenhouse gas emissions attributed by economic sector. And we see significant contributions from all of the major segments of the economy – electricity and heat production, agriculture, buildings, transportation, industry.

The implication of this is that the energy transition will present compelling investment opportunities in six key vectors of decarbonisation – five that broadly correspond with the major sources of the world's emissions, clean energy, clean agriculture and forestry, clean buildings, clean transport and clean industry and a sixth which acknowledges that we'll never abate all of the world's emissions. So, we'll need to withdraw carbon from the atmosphere requiring carbon removal and sequestration.

Growth Thesis: The opportunities arising from the energy transition pervade the economy



The breadth and quality of these opportunities is also enhanced by inextricable links between digitalization, automation and decarbonization in the energy transition. For example, it will only be possible to achieve net zero if we deploy for instance semiconductors that radically enhance the energy efficiency of products in industry, in transportation and communications. It will only be possible to achieve net zero emissions and decarbonise our global building stock through the deployment of smart building controls and building management systems that use insights derived from machine learning and artificial intelligence to optimize energy efficiency in real time to reflect factors like occupancy and ambient temperature. So, an abundance of opportunities to grow at a multiple of GDP created by the energy transition.

Optimising the investment framework

There's a particular investment framework that's likely to optimise your prospects of delivering outsized financial returns and meaningful environmental impact.

Seek to identify opportunities at the intersection of environmental impact, economic leverage to the energy transition, and businesses of exceptional quality. Now, those three elements, that framework, reflect three deeply held beliefs or convictions.

An Investment Framework: The unique investment characteristics of the energy transition demand a tailored approach

The **first** conviction is that we ought to pursue a net zero world, not just a net zero portfolio. Now, this distinction carries critical implications for the kind of companies you might invest in.

AbbVie appears in a lot of energy transition benchmarks. It's a global biopharmaceutical company with revenues of approximately $58 billion last year. Now, AbbVie's business model is inherently low emissions. In 2021, its full value chain carbon footprint was estimated at approximately 1 million tons, Scope 1, 2, and 3. Now, frankly, you could decarbonize all of AbbVie's operations, all 1 million tons. The company is not targeting that just yet. They're targeting a 50% reduction by 2035. But you could fully decarbonize its operations. And it would be a rounding error in the context of the world's 59 billion tons of anthropogenic carbon dioxide equivalent emissions last year. So, AbbVie's environmental impact is limited. And I'd contend that the energy transition will alter its financial results not one bit.

If, however, you believe that we ought to pursue a net zero world, then you might like to consider investing in a company like American Electric Power. American Electric Power is a U.S. electric utility, serving approximately 5.5 million customers in 11 predominantly Midwestern U.S. states. Now, unlike AbbVie, American Electric Power screens with a high level of carbon intensity, more than 3,000 tons of carbon dioxide equivalent emissions per $1 million of revenue. Last year, it generated 56 million tons of Scope 1 and 2 carbon dioxide emissions. On a full value chain basis, that rises to more than 100 million tons. But AEP has a plan to get to net zero by 2045. They've already made significant strides along that journey, investing to replace aging coal-fired power plants, replacing them with renewable clean energy. They're augmenting distribution and transmission networks to connect more renewables and to support the electrification of the economy in support of the energy transition.

Delivering Tangible Environmental Impact: Pursue a net-zero world, not just a net-zero portfolio

	abbvie	AMERICAN ELECTRIC POWER BOUNDLESS ENERGY
Profile	Global biopharma company with revenues in excess of US$55b	Electric utility serving 5.5m customers in 11 US states
Scope 1 + 2 Carbon Intensity (tCO_2e/US$m revenue)	13	3,330
Emissions Abatement Opportunity (tCO_2e)	~1m tonne footprint (scope 1, 2 & 3)	All 36m tonnes of downstream scope 3 emissions
Environmental Impact	Limited	Tangible

Now, when American Electric Power decarbonizes their operations, and again, they've achieved a 70 % reduction relative to a 2000 baseline already, not only will they decarbonize and abate all 56 million tons of their own Scope 1 and 2 emissions, but all 36 million tons of carbon dioxide emissions attributable to the use of their products by customers downstream. So, relative to AbbVie, American Electric Power's environmental impact is more than 90 times greater. But that's important not just for the environment, it's important financially because it points you to the most significant beneficiaries of the energy transition. You see under the regulatory construct, every dollar that American Electric Power invests in its network earns the authorized rate of return. So, all of the money they're spending to replace aging infrastructure, to build out new renewable generating capacity and to augment their distribution network, delivers highly visible growth in earnings per share, and we can foresee a world of high-single-digit growth in earnings per share at this business for a multi-decade period.

The **second** element of the framework is economic leverage to the energy transition. This reflects the conviction that we ought to pursue economic leverage to the energy transition, not exposure. Comparing a company like Toyota with Sensata reveals a critical distinction. Of course, Toyota is the world's largest car company, but the transition to clean transportation doesn't materially change the long-run volume outlook for cars. Car sales will continue to grow at a low-single-digit level in the long run.

But think further about Toyota's positioning within this ecosystem and what its returns might do. The transition to electric vehicle involves Toyota having to undertake a meaningful CapEx cycle, which will weigh on returns at least in the near term.

It appears that Toyota may have backed the wrong technology. They've prioritized development of hydrogen fuel cell vehicles, where it appears that battery electric vehicles are likely to dominate. And they'll continue to face fierce competition from companies like Ford and General Motors and Hyundai, who might perceive this transition as an opportunity to take significant market share. But of course, they'll also be confronted with growing competition from companies like Tesla and BYD. So Toyota is exposed to the energy transition, but not necessarily in a favorable way that's likely to deliver attractive financial returns.

By contrast, Sensata is an industrial developer of niche automotive sensors. Today these sensors measure things like brake and tire pressure in your vehicles. But as we transition to electric vehicles, Sensata has already seen a 20 % uplift in the value of their content on an electric vehicle relative to an internal combustion engine vehicle. Secured contracts give this company visibility to a doubling of the value of their content relative to internal combustion engine vehicles. And management is guiding to a 50% per annum compound annual growth rate in electrification revenues over the next five years.

Economic Leverage to the Energy Transition: Pursue economic leverage to the energy transition, not exposure

	TOYOTA	Sensata Technologies
Profile	World's largest car company	Niche industrial technology company that develops automotive sensors
Content Opportunity	Modest expected long-term unit growth	20% uplift in content from shift to EVs today, growing to 2x in five years
Competitive Positioning	Confronted with fierce and growing competition	Market leadership protected by switching costs and barriers to entry
Positioning for the Energy Transition	Exposed	Economically Leveraged

Now, unlike Toyota, where your leverage to the growth in EVs might be a bit tenuous, Sensata's market leadership in these industrial automotive sensors is protected by imposing switching costs and formidable barriers to entry. They design these products in collaboration with the auto OEMs, they're subject to a strict qualification process, which means that they're almost never replaced during the life of an automotive platform that might span seven to ten years. So, Sensata is economically leveraged to the energy transition.

The **third** element of the framework is businesses of exceptional quality. If you took the view that growth in and of itself is paramount, you might invest in a business like JinkoSolar. Jinko is a Chinese manufacturer of commoditised solar cells and modules. Now the rapid deployment of solar PV means that Jinko is going to grow significantly. Bloomberg consensus suggests something like 70% revenue growth this year and another 30% next year.

But competition in this industry has historically meant that Jinko has generated returns on tangible invested capital of about 8%, a level that I'd suggest is broadly in line with their weighted average cost of capital. Now, rudimentary corporate finance theory will tell you, you can grow all you want, but if you don't earn a return in excess of your cost of capital, no incremental value accrues to shareholders.

Businesses of Exceptional Quality: Pursue value accretion, not growth

	JinKO Solar	HUBBELL
Profile	Manufacturer of commoditised solar cells and modules	Manufacturer of mission critical utility and electrical hardware
Expected Medium Term Earnings Growth	Significant	"Double Digit+ CAGR" in EPS (FY22 – FY25)
Return on Tangible Invested Capital	~8% Broadly in-line with reasonable estimates of WACC	>25% ~3x WACC
Impact of Growth	Marginal	Highly Accretive

By contrast, if value accretion is paramount, you might invest in a company like Hubbell. Hubbell is a manufacturer, US-based, of mission critical electrical and utility hardware. If you imagine the power pole in your local neighbourhood, Hubbell makes virtually everything that connects to that power pole, but for the line itself. Hubbell won't deliver anything like the growth that JinkoSolar will see over the next couple of years, but the energy transition, the replacement of aging infrastructure, the need to augment the grid will deliver a double-digit-plus compound annual growth rate in earnings per share over the next four years.

But unlike Jinko, formidable barriers to entry and a profound set of competitive advantages mean that Hubbell generates returns on tangible invested capital of approximately 25%, approximately 3 times reasonable estimates of their whack. So, while growth at Hubbell is lower, value accretion is far more significant.

A thematic of a lifetime

To summarise, I've advanced two propositions.

The **first** is that the energy transition will be the defining investment thematic of our lifetimes, presenting investors with the opportunity to compound attractive risk-adjusted investment returns over a multi-decade horizon.

The **second** proposition is that it will require a tailored investment framework to optimise the intersection of environmental impact, economic leverage to the energy transition, and businesses of exceptional quality.

And if you read beyond the popular press and into the literature of the IPCC reports, the International Energy Agency and the International Renewable Energy Agency, you will share my belief in a portfolio tailored for the energy transition.

David Costello, CFA, is Portfolio Manager at Magellan Financial Group in Sydney. This article is general information and does not consider the circumstances of any investor. Magellan is a sponsor of Firstlinks. This material was originally presented at the Portfolio Construction Forum on 3 May 2023 and is republished with permission.

From stockmarket boom to stockpicker's opportunity

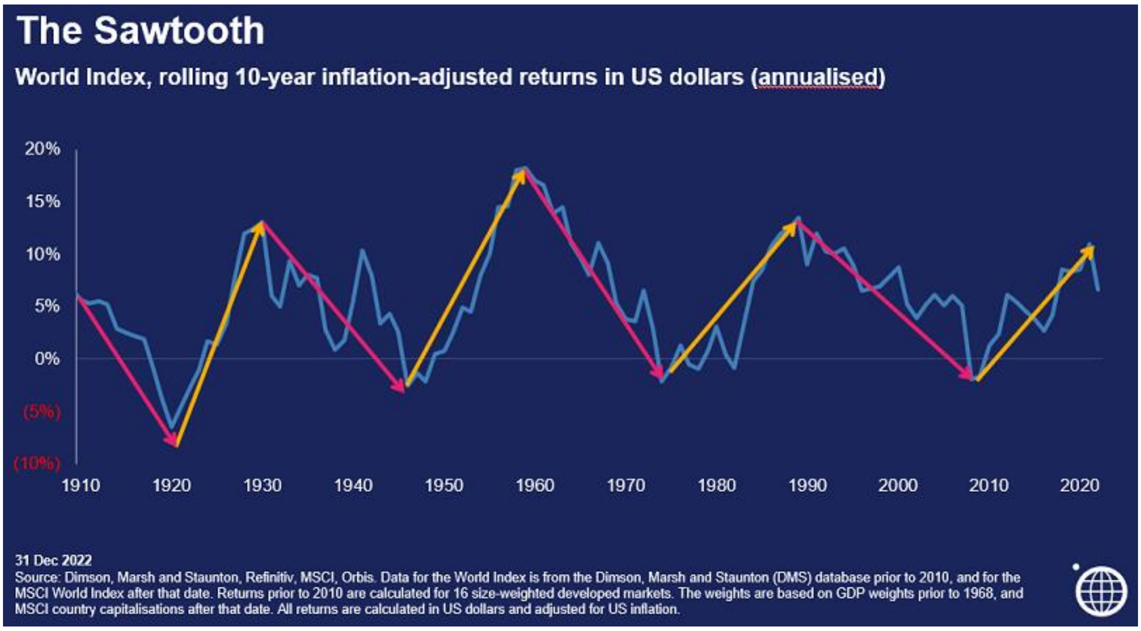
Shane Woldendorp

For anyone expecting the phenomenal stockmarket returns of the last decade to keep rolling, we have some sobering news. They probably won't. If history is any guide, the best of times for investors tends to be followed by the worst of times. Given the post-GFC era was an amazing period for global equities, the next decade could prove much more challenging. But more than 30 years of contrarian investing has taught us that good stock picking results can make an enormous difference when equity markets are generally weak, and now, more than ever, is the time to invest differently.

Below are our observations of the current market environment that investors should consider when making decisions.

The good times don't roll

If the best of times really have come to an end, what can investors expect from the coming period? Whilst we don't own a crystal ball, the following chart (which we call 'The Sawtooth') paints quite an ugly picture of what the next decade or so could look like. History demonstrates that periods of incredible up-cycles are followed by decades-long periods where returns are disappointing (and sometimes negative after inflation).



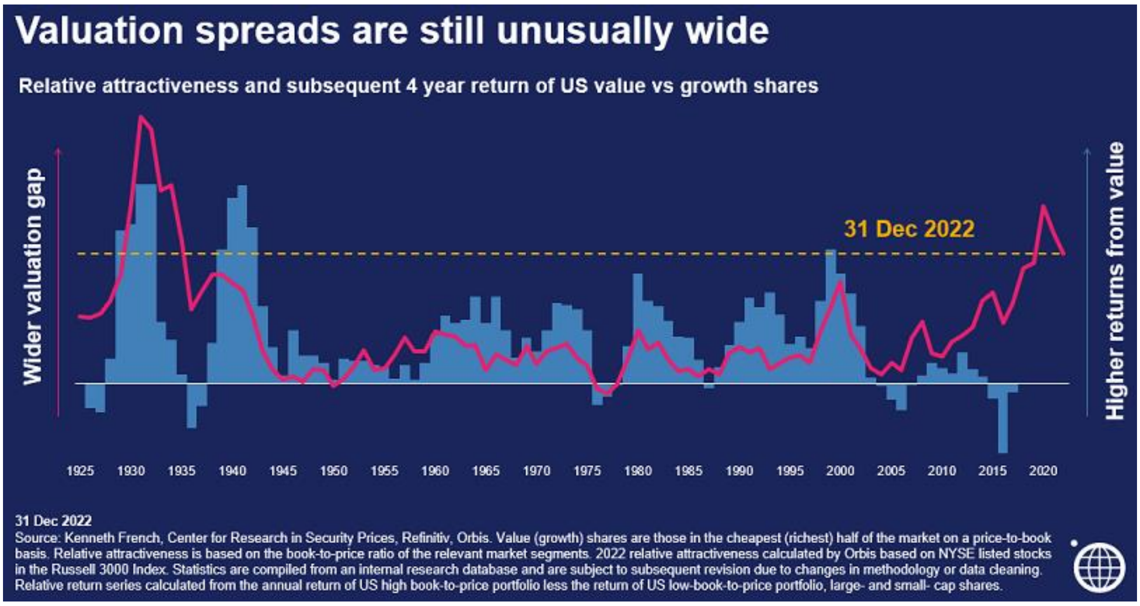
With the bubbly excesses of the previous decade only just starting to deflate, and valuation gaps still astonishingly wide, it's likely markets are a long way from completing the post-bubble deflation process that has been typical of history. Put simply, we think there is likely more pain to come.

Embrace regime change

Faced with the reality that the worst of times are upon us, how can investors do better than the market? One of the most important lessons from history is that the winners (the stocks that perform well) rarely persist from one cycle to the next, meaning investors hoping to outperform can't simply invest in the same things that did well in the previous decade. To do better than the market, you need to invest in things that are *different* from what's been winning lately – the stocks likely to become the market leaders in the new regime. And that's where things get exciting for active, contrarian, value-orientated investors.

Valuation matters

Because the most recent 'everything bubble' rose to such dizzying heights, it gave rise to historically wide valuation gaps between the 'haves' (growth stocks) and the 'have-nots' (value stocks). In fact, valuation gaps today are as wide as they have been at any time since the Great Depression—almost 100 years ago—and remain wider than they were at the peak of the Tech bubble! Valuation gaps matter because they are a good indicator of forward returns for value stocks compared to their growth counterparts. As the "everything bubble" continues to deflate and valuation gaps narrow, richly priced growth stocks may suffer, giving cheaper value stocks the opportunity to thrive. This provides some exceptional opportunities for astute investors who combine the benefits of a long-term view with a willingness to look very different.



Exploiting the opportunity

As contrarians, we are naturally drawn to areas of the market that are out of favour and thus potentially undervalued. Although we are not beholden to any particular style of investing—be it value or otherwise, today we are finding the best opportunities in the market are among value stocks. Given its current attractiveness, it should come as no surprise that Orbis Global's exposure to the value factor is currently at a record high, with value-oriented holdings accounting for around 70% of the portfolio. In particular, we are finding opportunities in areas like critical infrastructure, energy and materials, quality cyclicals, and selected banks, as illustrated in the chart below, which makes us excited about the potential for relative returns, even as the broader market eyes a protracted 'worst of times' phase.

Perhaps the most striking feature about the value-orientated holdings our bottom-up, contrarian research has identified is just how cheap they are compared to the World Index, which trades at about 20x earnings. These are a collection of businesses that we believe are better positioned for the coming environment and trade at much lower multiples than the World Index.

Blunting 'The Sawtooth'

If, as 'The Sawtooth' predicts, the market is facing a prolonged period of disappointing returns, there's one clear way investors can avoid the same fate – invest *differently* to the market. Whilst the good times might be over for the market in general, the future is much brighter for savvy value-orientated investors willing to think and invest differently.

Shane Woldendorp is an Investment Specialist at [Orbis Investments](), a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. For more articles and papers from Orbis, please [click here]().

Is your industry super fund too illiquid for its safety?

Annika Bradley

Despite the very long-term nature of the Australian superannuation system, investors can move between options and super funds on a daily basis. This liquidity mechanism means the liquidity profile of a fund cannot be ignored. But looking at the level of illiquid assets as a proportion of total assets is only part of the story. Understanding the future cash flow profile and member demographics of the fund also gives an indication of the sustainability of the level of illiquid assets. While liquidity stress-testing is required to be conducted by funds under SPG530 – Investment Governance, the level of public disclosure on this issue is limited.

We attempt to piece together some key metrics of a handful of large funds to see how they stack up.

Which funds?

The five funds selected for the purposes of the analysis are: Australian Retirement Trust, AustralianSuper, Aware Super, Cbus, and UniSuper. Of the roughly $2.25 trillion of total fund assets reported to APRA as of 30 June 2022, these five funds represented almost 40% of this pool.

Unlisted as a proxy for illiquid?

Measuring illiquidity is challenging. The number of days an asset can take to trade is often a guess, particularly when it comes to individual assets not traded on exchanges. Even when the assets are traded on an exchange, asset managers try to predict liquidity by understanding average daily trading volumes, which can fluctuate wildly depending on the security and market conditions. The available liquidity of unlisted assets is even more of a challenge to predict.

As imperfect as it may be, this analysis uses the Portfolio Holdings Disclosures, which specifies a super fund's allocation to 'unlisted' assets for a particular option. The funds' larger options, typically in the balanced and growth categories, have been selected for the analysis.

'Unlisted' does not necessarily equal 'illiquid'; 'unlisted' is defined as a security not traded through an exchange under the regulations. There are plenty of 'unlisted' funds that hold listed equities that are traded daily through an exchange, and you could receive your money back from the 'unlisted fund' in a matter of days - which is a highly liquid proposition. There will also be 'unlisted' funds that hold illiquid assets.

'Illiquidity' is a spectrum. A security or unlisted fund could take a few days, a few weeks, months or even years to return money back to the investor. Unfortunately, the liquidity ladders of super funds are not made available. That is, the assumed proportion of a fund that could be liquidated in one week, four weeks, three months, one year, and so on is not disclosed. So, in the absence of disclosure, 'unlisted' will crudely be used as a proxy for 'illiquid'.

Unlisted allocations of the big funds

There are varying levels of unlisted assets held across these large super funds' options. Australian Retirement Trust's Lifecycle Balanced Pool holds the highest level of unlisted assets at 34%, UniSuper's Balanced Option holds the lowest level at 13% and AustralianSuper's Balanced Option sits at around 31%.

The level of illiquid allocations as a percentage of the total portfolio will move around, particularly in periods of volatile listed markets. When listed markets are declining in value and illiquid markets are either remaining static (due to mark to market pricing stability) or declining to a lesser degree, the illiquid allocation will naturally become a higher proportion of the portfolio through this period.

During 2022, we witnessed a strong selloff in both listed equities and bonds, and a weak Australian dollar. This selloff did not impact the asset prices of private markets to the same degree and, as a result, it's likely that some of these unlisted allocations are slightly higher than fund targets.

Exhibit 1 Super fund options by asset class, investment type, and management type

			Fund Name and Option Name									
			Australian Retirement Trust - Lifecycle Balanced Pool		AustralianSuper - Balanced Option		Aware Super Balanced Growth Option		CBUS Growth Accumulation Option		UniSuper Balanced Option	
Asset Class	Investment Type	Management Type	$ (m)	%	$ (m)	%	$ (m)	%	$ (m)	%	$ (m)	%
Cash			3,769	8%	8,718	5%	1,253	5%	4,082	7%	3,488	9%
Fixed Income	All Assets	Externally Managed	5,301	11%	16,138	9%	3,200	13%	7,795	13%	1,592	4%
		Internally Managed	-	0%	11,730	6%	460	2%	976	2%	5,273	14%
Private Debt	*Unlisted*				*5,894*	*3%*	*334*	*1%*				
Equity	Listed		22,542	46%	85,585	47%	12,955	52%	27,934	47%	17,800	48%
Property	Listed		862	2%	2,044	1%	514	2%	1,438	2%	1,582	4%
Infrastructure	Listed		0	0%	1,253	1%	189	1%	132	0%	2,670	7%
Alternatives	Listed		3	0%	5	0%	1	0%	-	0%	0	0%
Alternatives	Unlisted	Externally Managed	2,670	5%	552	0%	269	1%	286	0%	-	0%
Alternatives	Unlisted	Internally Managed	-	0%	243	0%	13	0%	2	0%	-	0%
Equity	Unlisted	Externally Managed	3,789	8%	9,170	5%	1,538	6%	898	2%	448	1%
Equity	Unlisted	Internally Managed	-	0%	855	0%	27	0%	263	0%	476	1%
Infrastructure	Unlisted	Externally Managed	5,635	12%	14,463	8%	1,470	6%	7,491	13%	268	1%
Infrastructure	Unlisted	Internally Managed	243	1%	14,160	8%	1,313	5%	824	1%	2,049	5%
Property	Unlisted	Externally Managed	4,280	9%	5,089	3%	1,152	5%	2,816	5%	979	3%
Property	Unlisted	Internally Managed	-	0%	4,895	3%	334	1%	3,789	6%	739	2%
Total			$ 49,096		$ 180,794		$ 25,023		$ 58,726		$ 37,366	
Total - Unlisted	Unlisted		$ 16,617	34%	$ 55,321	31%	$ 6,452	26%	$ 16,368	28%	$ 4,959	13%

Source: Portfolio holdings data disclosed on fund websites as of Dec. 31, 2022. [Click to enlarge]

Illiquidity through another lens

Another way of understanding the nature of assets held by superannuation funds is to dig through the annual financial statements where the accounting standards require a breakdown of estimated fair values for different market types using a hierarchy. The hierarchy basically scales from Level 1 (mainly listed equities where there are readily available quoted market prices) through to Level 3 where there isn't observable market data and therefore fair values are based on unobservable inputs. The more-illiquid assets such as infrastructure, private credit, property, and private equity are typically included in this third level.

Exhibit 2 Level 3 assets (fair value in an inactive or unquoted market) as a % of total fund net assets as of June 30, 2022

	Level 3 Assets ($m)	Fund Net Assets as of 30 June 2022 ($m)	Level 3 Assets as a % of Total Fund Net Assets
Australian Retirement Trust	55,677	231,685	24%
AustralianSuper	69,119	258,984	27%
Aware Super	24,038	145,773	16%
CBUS	18,156	69,909	26%
UniSuper	14,423	101,070	14%

Source: Annual financial statements 2022.

Exhibits 1 and 2 are not perfectly comparable given one considers each fund's assets invested in Level 3 assets and the other considers a particular fund option's exposure to unlisted assets.

What do the funds say?

Of course, the other method of defining levels of liquidity is to just ask the superannuation funds, and their interpretations are displayed in Exhibit 3.

Exhibit 3 Fund- and option-level illiquid allocations at Dec. 31, 2022, as reported by the funds

	Fund level	Option level
Australian Retirement Trust	29%	34%
AustralianSuper	27%	30%
Aware Super	27%	24%
CBUS	26%	28%
Unisuper	12%	13%

Source: Fund responses.

Money coming in and money going out

When it comes to liquidity, the money coming into or moving out of a fund is highly relevant. To illustrate the point using an extreme example, if a fund has net assets of $500, and in Scenario 1 the net assets double each year, the illiquid allocation diminishes quickly. Conversely, if a fund has net assets of $500, and in Scenario 2 the net assets halve each year, the illiquid allocation ramps up quickly.

Each year under APRA's annual fund-level superannuation statistics, funds must disclose the level of flows broken down by member contributions (inflow), member benefit payments (outflow), rollovers (inflow/outflow), and flows as a result of merger activity.

Scenario 1: Fund in Inflow With Net Assets Doubling Annually

	Year 1	Year 2	Year 3	Year 4
Illiquid allocation (A$)	$50	$50	$50	$50
Net assets (A$)	$500	$1,000	$2,000	$4,000
Illiquid allocation (%)	10%	5%	3%	1%

Scenario 2: Fund in Outflow With Net Assets Halving Annually

	Year 1	Year 2	Year 3	Year 4
Illiquid allocation (A$)	$50	$50	$50	$50
Net assets (A$)	$500	$250	$125	$63
Illiquid allocation (%)	10%	20%	40%	80%

The Conexus Institute established a neat framework for thinking about the types of flows in their State of Super 2023 Booklet. For the purposes of considering the liquidity profile of a fund, Exhibit 4 considers 'total members' benefit flows in' (that is, superannuation employer and member contributions) and 'total benefit payments' (that is, lump-sum withdrawals and pension payments), termed 'Natural flows' in the Conexus Institute's research.

Exhibit 4 'Natural flows' as a percentage of total fund net assets as of June 30, 2022

	Natural Flows	Fund Net Assets as at 30 June 2022	Natural Flows as a % of Total Fund Net Assets
Australian Retirement Trust	$ 5,582,532	$ 231,685,036	2.4%
AustralianSuper	$ 10,191,875	$ 258,984,191	3.9%
Aware Super	$ 3,516,868	$ 145,773,385	2.4%
CBUS	$ 2,595,643	$ 69,908,832	3.7%
Unisuper	$ 2,212,694	$ 101,069,616	2.2%

Source: APRA annual fund-level superannuation statistics as of June 30, 2022.

Exhibit 4 shows that when it comes to natural flows, both in absolute terms and as a percentage of total fund net assets, AustralianSuper is winning the war. It's worth highlighting that Cbus is also doing a good job of capturing flows as a percentage of its net asset base.

Member demographics and cash flows

'Natural flows' will be impacted by the demographics of a member base. For example, an older member base will likely be drawing down their superannuation rather than contributing to it. Further, how the profile of a member base changes over time should also impact the liquidity profile of a fund. If a fund knows that a significant portion of its member base is nearing retirement and will either start drawing down its super balance or switch funds, liquidity levels should shift in response.

As shown in Exhibit 5, some funds have a significantly higher proportion of their member base who are decumulating. Hostplus and Rest superannuation funds have been included in Exhibit 5 to contrast the proportions for funds with a substantially younger member profile.

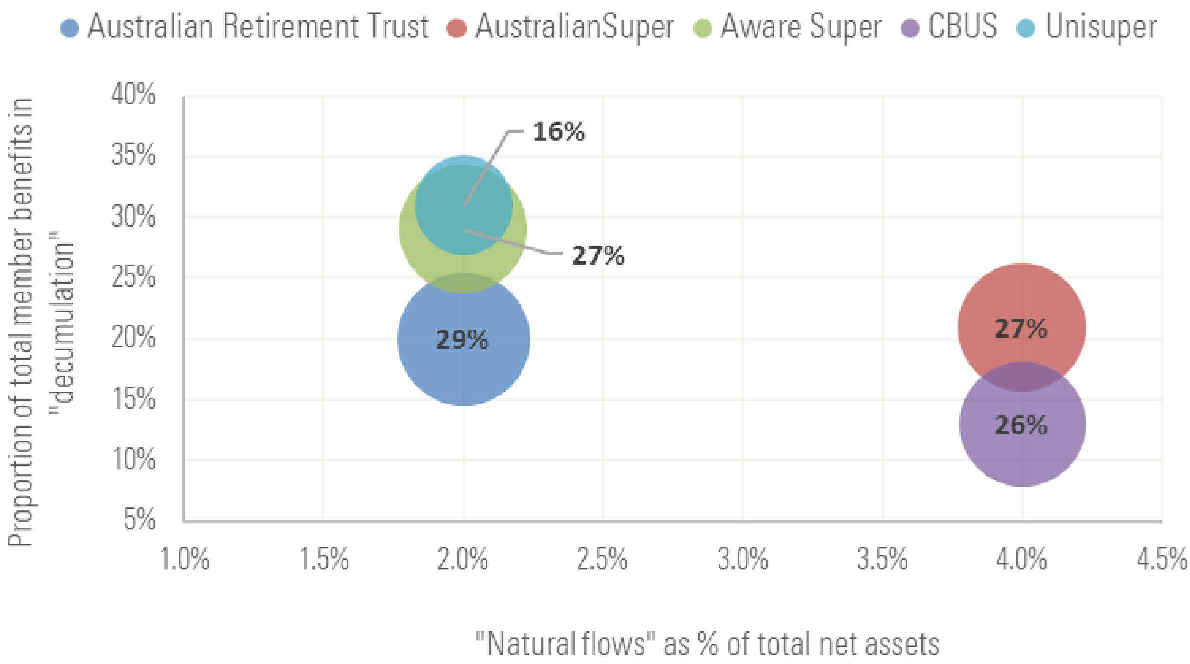
Exhibit 5 Proportion of total member accounts and member benefits by member age bracket at fund level

	Proportion of total member accounts by member age bracket			Proportion of total member benefits by member age bracket		
Fund name	Accumulators (Ages: 0 - 49)	Readying to decumulate (Ages: 50 - 64)	Decumulating (Ages: 65 +)	Accumulators (Ages: 0 - 49)	Readying to decumulate (Ages: 50 - 64)	Decumulating (Ages: 65 +)
Australian Retirement Trust	68%	23%	7%	36%	44%	20%
AustralianSuper	68%	24%	8%	36%	43%	21%
Aware Super	52%	29%	18%	30%	41%	29%
CBUS	69%	24%	7%	44%	43%	13%
HOSTPLUS	79%	16%	5%	55%	35%	11%
REST	85%	12%	3%	57%	31%	12%
Unisuper	61%	25%	14%	26%	43%	31%

Source: APRA annual fund-level superannuation statistics as of June 30, 2022.

Theoretically, this logic should be applied at the option level, too. If a fund were to segment their member base, some options should hold higher proportions of illiquid and riskier assets (that is, options invested in by much younger, accumulating members), and other options invested in by older members may need a lower level of risk and more liquidity. Fund-level analysis is only part of the story, but this level of portfolio personalisation is still a way off for many funds.

Exhibit 6 Comparison of proportion of illiquid assets* at fund level (as labelled in bubble) relative to natural flows as a percentage of total fund net assets and the proportion of total member benefits in decumulation.



*Source: Morningstar. *Bubble size reflects proportion of illiquid assets at fund level as reported by the funds.*

Given the higher proportion of decumulating members at UniSuper and the lower levels of 'natural flows' relative to these other funds, it makes sense that UniSuper have lower levels of illiquid assets under the measures considered. But there is no perfect answer to the right level of illiquid assets.

How illiquid is too illiquid?

Under the Corporations Act, guidance is provided for managed investment schemes. The provision states that "*a scheme is liquid if liquid assets account for at least 80% of the value of the scheme property.*"

The best we can hope for is that fund trustees are focused on their Liquidity Management Plans and how they stand up to different market conditions. Notably, the funds passed the test handed down in early 2020 - including the Early Release Scheme introduced, the aggressive selloff in listed markets, and the level of switching that occurred in response to volatile markets.

But it would be remiss to get too comfortable. A run on a fund (or a bank) can happen at any time, and Silicon Valley Bank is a timely reminder. Large member outflows, a risk-off environment where listed markets selloff aggressively, and the Australian dollar in free fall would see funds' allocations to illiquid assets likely increase as a proportion of total assets. Ongoing regulatory oversight of this issue is critical, and increased public disclosure on funds' liquidity profiles would be welcome.

With its long-term framework, the retirement system supports the ability of superannuation funds to buy multigenerational (often illiquid) assets, which should deliver great returns for investors over time. However, we need to preserve the sustainability of such a system to ensure the illiquid component of these funds are prudently managed.

Measuring liquidity is complex with interrelated factors, but currently there isn't cause for alarm across these five funds.

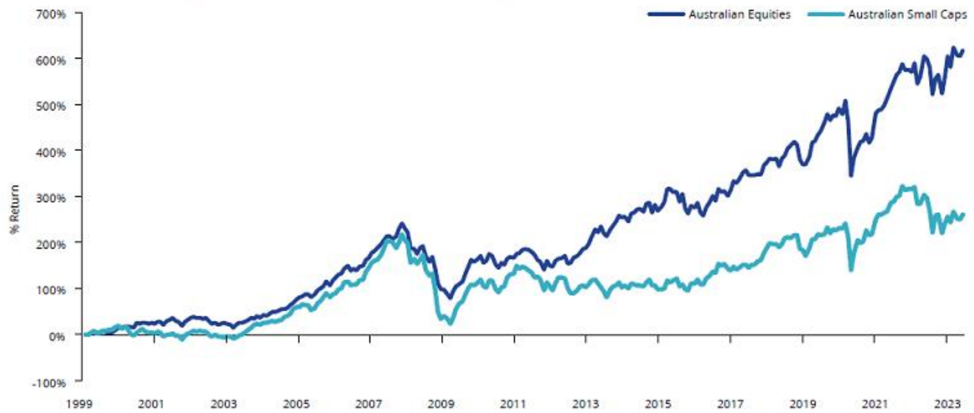
Annika Bradley is Morningstar Australasia's Director of Manager Research ratings. Firstlinks is owned by [Morningstar](). This article is general information and does not consider the circumstances of any investor. This article was originally published by Morningstar.

Why Aussie small caps are consistent underperformers

Cameron McCormack

An anomaly an Australian investor must contend with is that the alpha evident elsewhere in the world is not evident in local small-cap indices. The S&P/ASX Small Ordinaries Index has delivered lower cumulative returns relative to the broader Australian equities benchmark since 1998.

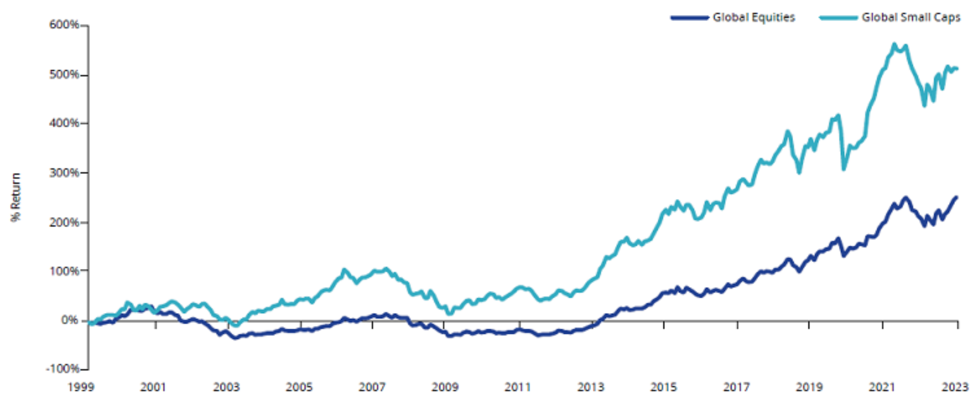
Cumulative historical performance of Australian small-caps and broader benchmark



Source: Bloomberg, Australian Equities is S&P/ASX 200, Australian Small Caps is S&P/ASX Small Ordinaries, 31 December 1998 to 30 April 2023. Past performance is not indicative of future performance. You cannot invest in an index.

Unlike Australian small companies, global smaller caps have historically demonstrated outperformance relative to large companies over the long term. Below is the cumulative performance of MSCI World ex Australia versus MSCI World ex Australia Small Cap indices.

Cumulative historical performance of global large caps versus small-caps



Source: Bloomberg, MSCI, Global Large Caps is MSCI World ex Australia Index, Global Small Caps is MSCI World ex Australia Small Cap Index. 31 December 1999 to 30 April 2023, returns in AUD terms. Past performance is not indicative of future performance. You cannot invest in an index.

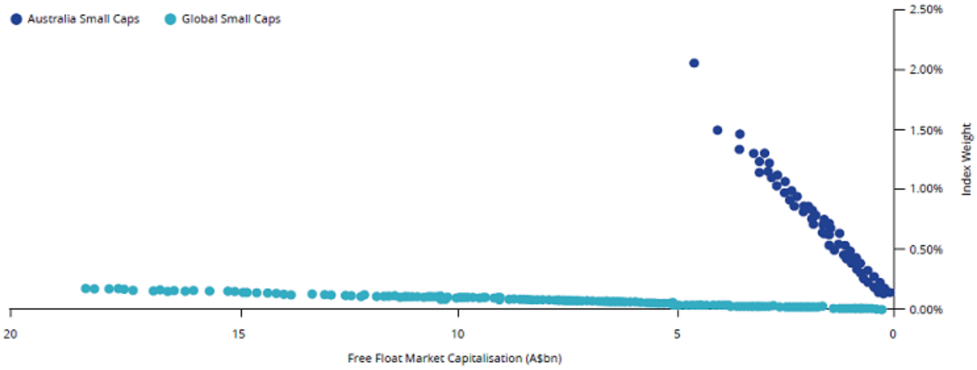
Australian small-cap conundrum

The Australian small-cap universe is hamstrung by structural nuances, not present globally.

1. Market size

An observation that might surprise Australian investors is that the global small-caps, in the context of market size, would be characterised as mid-caps in Australia when measured by market capitalisation. Global small-caps are, on average, two times larger than Australian small-caps, as represented by MSCI World Small Cap and S&P/ ASX Small Ordinaries. Furthermore, the largest global small-cap, in the context of Australian listed companies by market capitalisation, would rank as approximately the 20th largest on ASX, 80 places ahead of the largest Australian small-cap determined by the S&P/ASX Small Ordinaries Index (stock 101).

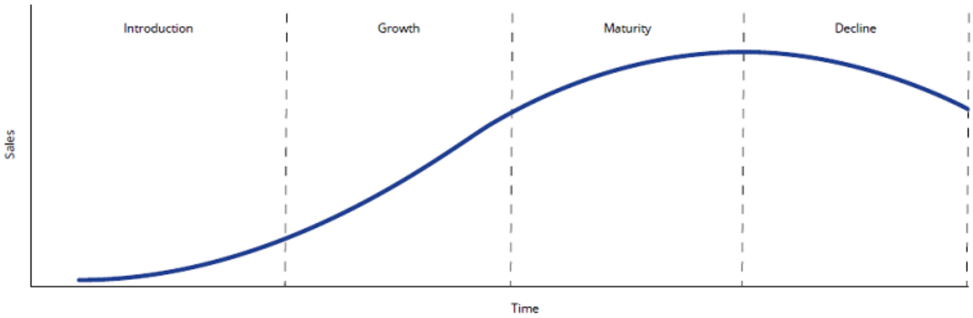
Index coverage by market capitalisation



Source: S&P, MSCI, as at 30 April 2023. Australian Small Caps is S&P/ASX Small Ordinaries Index, Global Small Caps is MSCI World ex Australia Small Caps Index.

Higher average market capitalisation of global small-caps relative to Australia small-caps implies that these companies are more established businesses in the 'growth' phrase of the business cycle. They have grown to a size to be included in the MSCI World ex Australia Small Cap market coverage range by demonstrating an increase in sales and earnings growth. Australian small-caps by comparison have a higher proportion of companies in the 'introduction' phase, meaning that sales and earnings growth are likely to be more mixed, with a shorter track record.

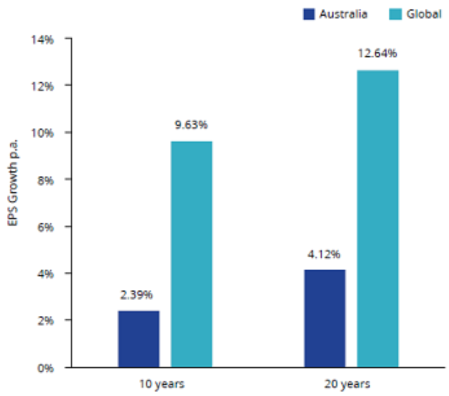
Business life cycle



Source: VanEck. For illustrative purposes only.

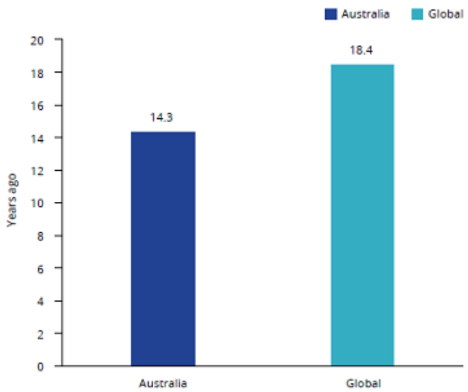
This observation is reflected when comparing earnings per share (EPS) growth of small-cap benchmarks over the past 10 and 20 years. Global EPS growth outpaced Australia by more than three times. Average time since listing of global small-caps is also four years longer than Australian small-caps.

EPS growth comparison



Source: Bloomberg, as at 30 April 2023. Australia as S&P/ASX Small Ordinaries, Global as MSCI World ex Australia Small Cap. Past performance is not indicative of future performance.

Listing date comparison

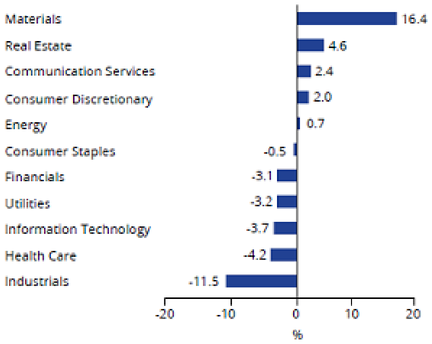


Source: Bloomberg, as at 30 April 2023. Australia as S&P/ASX Small Ordinaries, Global as MSCI World ex Australia Small Cap. Past performance is not indicative of future performance.

2. Unprofitable company coverage

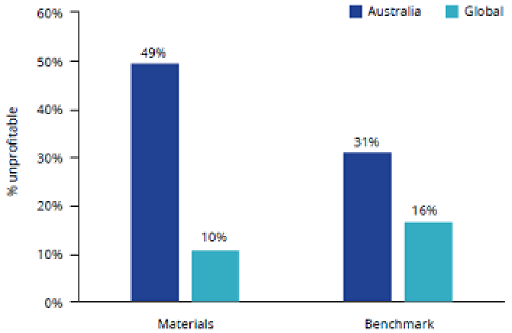
The largest Australian small-cap sector is materials. In the global index, it is one of the smallest sectors. Many small unprofitable mining companies list on the Australian stock exchange in the 'infant' stage of the business cycle to raise capital for exploration or mine development where debt and private equity financing is unavailable. This is less common globally as offshore exchanges have stricter rules around profitability and financial viability requirements for listing[1]. This means that exposure to an Australian small-cap strategy may not be a sound investment approach. Australian small-caps have almost double the exposure to non-profitable companies, compared to global.

GICS Sector Weight Differential:
S&P/ASX Small Ordinaries versus MSCI World Small Cap



Source: Bloomberg, as at 30 April 2023.

Percentage of unprofitable small cap companies by index weight



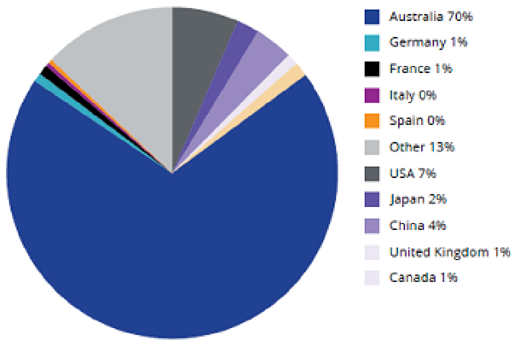
Source: Bloomberg, as at 30 April 2023. Australia is S&P/ASX Small Ordinaries, Global is MSCI World ex Australia Small Cap.

3. Geographic revenue exposure

Australia accounts for 1.7% of global gross domestic product (GDP) and 0.3% of the world's population. If you exclude mining companies, Australian small-caps tend to be Australian centric operations with low global revenue. Primarily servicing Australian customers limits scope for expansion, unless the company goes through a capital raising to expand operations globally, often resulting in the company dropping from S&P/ASX Small Ordinaries coverage. However, global small-caps are more likely to have global operations, or, if they are only locally based offer the potential for significant market expansion by servicing countries that are larger by GDP.

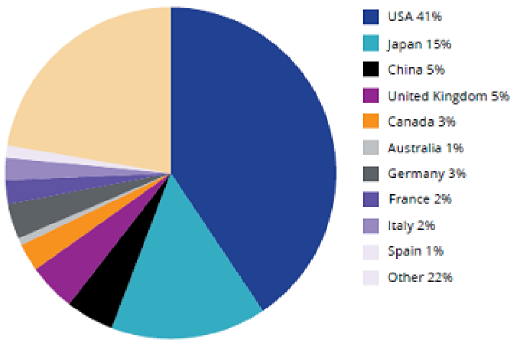
Australia accounts for 1% of global small-cap revenue compared to 70% locally. Williams-Sonoma, Inc is a good example of a US small-cap that operates globally. The company is an American publicly traded consumer retail company that sells kitchenware and home furnishings, operating approximately 600 brick and mortar stores and distributes to more than 60 countries. Listed in 1983 and has a market capitalisation of A$11.9 billion [As at 31 March 2023].

Geographic revenue exposure comparison
Australian Small Caps



Source: MSCI. MSCI Australia Small Caps Index. As at 30 April 2023.

Global Small Caps



Source: MSCI, MSCI World ex Australia Small Caps Index. As at 30 April 2023.

Drawdown

Adding small-cap exposure to large- and mid-cap exposures in portfolios is known to increase the risk of losses. This is true globally with small-caps historically having slightly larger drawdowns during the global financial crisis (GFC) and COVID-19 market shocks. However, it is also worth noting that global small-caps returned to pre-shock highs faster following the GFC and 2001 dot com bubble. Noting, this should not be relied upon as an indicator of future performance.

Global Equities Drawdown comparison

Source: Bloomberg, 31 December 1998 to 30 April 2023, Global Small Caps is MSCI World ex Australia Small Cap Index, Global Equities is MSCI World ex Australia. Past performance is not indicative of future performance. You cannot invest in an index.

In Australia, small-caps drawdown was materially worse than large caps during the dot com, global financial crisis and COVID-19 market shocks. This is in line with expectations as investors typically seek large companies during market stress events as their business models are seen to be more viable during economic downturns. The higher dispersion in the scale of the drawdown between small- and large-caps is a function of the market size of Australian small-caps relative to global.

Australian Equities Drawdown comparison

Source: Bloomberg, 31 December 1998 to 30 April 2023, Australian Equities is S&P/ASX 200 Index, Australian Small Caps is S&P/ASX Small Ordinaries Index. Past performance is not indicative of future performance. You cannot invest in an index.

Access to global small cap equities

Global small-cap investing has been an effective way to achieve excess returns relative to large and mid-caps over the long term. It is supported by modern portfolio theory, academics and illustrated through empirical research. However, when small-cap investment strategies are applied in Australian equities, they fail to achieve excess returns for three reasons: size, exchange listing requirements and sector exposure.

[1] ASX listing rules profit test – A$1 million aggregated profit from continuing operations over past 3 years + A$500,000 consolidated profit from continuing operations over the last 12 months. NYSE listing profit rules - US$10 million aggregated profit from continuing operations for last 3 years.

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

The VanEck MSCI International Small Companies Quality ETF (ASX:QSML) launched in March 2021 and is a passive strategy that tracks the MSCI World ex Australia Small Cap Quality 150 Index. Since March 2021 many investors have benefited from using QSML as the core of their global small cap equities exposure.

For more articles and papers from VanEck, click here.

Investors remain remarkably defensive during bull market

Dan Jowett

More than three years have passed since February 2020, a once-in-a-century month that saw economists, governments and healthcare leaders brace for impact as the COVID-19 global pandemic took hold. Shortly after, many global borders closed and markets tumbled.

To the world's surprise, the acute market fallout quickly reversed. Australian equities climbed almost 60% to all-time highs, with Big Tech and ETFs dominating headlines. But fast forward three years to today, the rebound is not so clear-cut. Global economic and political events – including the war in Ukraine, rising energy costs and persistent inflation – have created challenges for investors.

For the average Australian retail investor, 2023 has already delivered its fair share of financial challenges. The Reserve Bank of Australia's 12 interest rate rises in response to inflation has further driven up the cost of living and the average family now pays [$7,102 per month just to live and pay bills].

When it comes to equities, retail investors not only have less free cash available to invest, but are also weighing up increasingly competitive cash and fixed interest products such as fixed income, term deposits and savings accounts. As Wall Street forecaster Jim Bianco said, rightly or wrongly, "Cash is no longer trash… you are going to get two-thirds of the long-term appreciation of the stock market with no risk at all".

So how are today's equity investors positioning their portfolios compared with how they invested several years ago?

Fintech platform, Openmarkets, recently assessed the portfolios and trading behaviours of almost 100,000 sponsored accounts between February 2020 and today. We've noted a number of interesting themes.

Today's equity investors have a low risk appetite

Australia's equity investors are the most defensive they've been in some time, focusing their trading on large cap companies with large cash reserves and minimal exposure to inflationary pressures in their supply chains.

According to our Investor Defensiveness Index, which ranges from -10 (defensive) to +10 (offensive), Australians were defensive in February 2020 as investors weighed up the market implications of closed borders and global lockdowns. By 2021, a year where hype stocks and finfluencers dominated the press, this cohort shifted to an offensive mindset who were more likely to take on risk. This offensiveness remained in 2022 through the Russia-Ukraine war and the beginning of interest rate rises, before rapidly reducing in 2023. Today, investors have adopted a stance significantly more defensive than at the start of the COVID-19 pandemic.

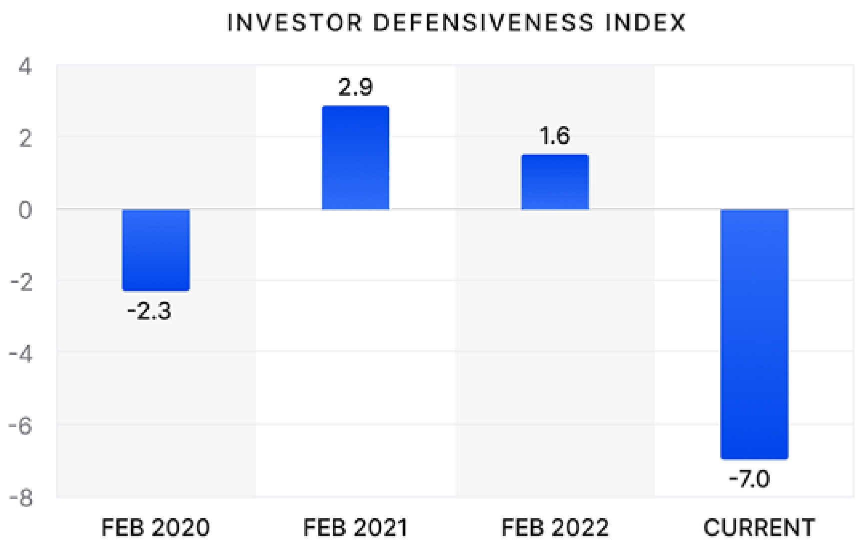


Fig 1. Openmarkets Investor Defensiveness Index Feb 2020 - May 2023 (Openmarkets data)

From a company size perspective, the past 12 months saw the highest volume of large cap ASX equities traded compared with the prior three years. Interest in higher risk small caps has fallen from a peak in 2021 to 42% of total equities traded. These findings point to a reduction in appetite from investors to take on risk in current market conditions.

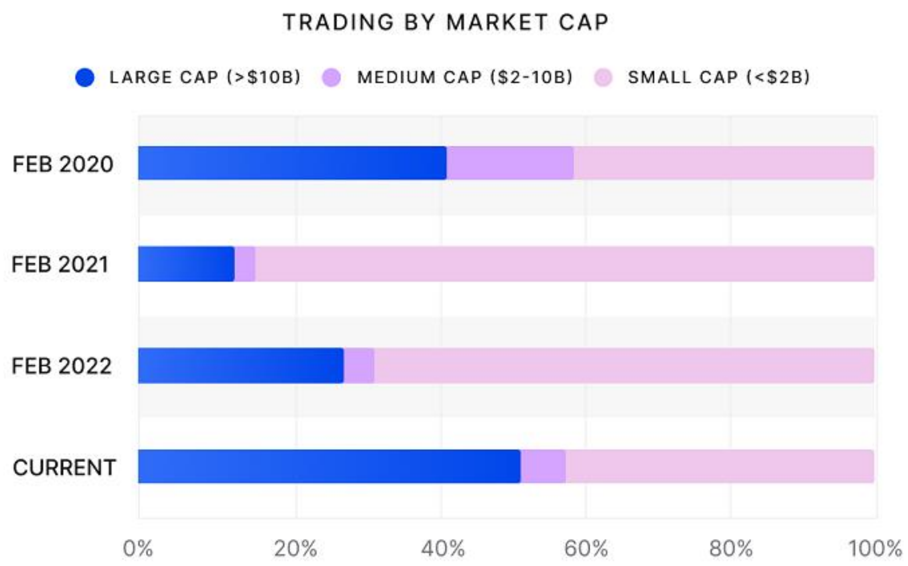


Fig 2. Trading by market cap in Feb 2020 vs May 2023 (Openmarkets data)

Diversification is on the decline in 2023

Despite Australian equity investors focusing on lowering risk, our data shows that not all investment behaviours are defensive.

Over the past 12 months, we have seen a surprising decline in the number of equities held by the average sponsored account holder. Portfolio diversity on average has fallen between 4.3% and 5.6% depending on age bracket, with Generation Y and Z showing the greatest portfolio reductions to hold an average of 4.5 stocks.

Baby Boomers reduced their ETF holdings by 7.4%, while Gen Y and Z reduced their ETF holdings by 3.3%.

Despite this decrease, Baby Boomers remain the age group with the most diversified holdings. The average Boomer holds nine stocks in their portfolio, compared with Gen X who hold six and Gen Y and Z who hold 4.5 stocks.

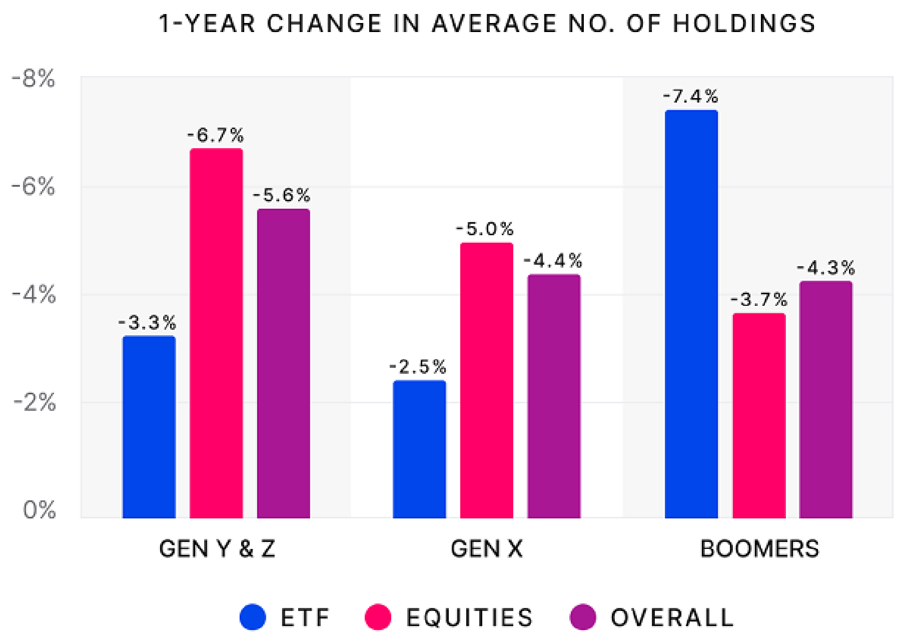


Fig 3. 1-year change in average number of holdings by generation (Openmarkets data)

Selling materials while navigating tech sector price swings

Throughout the pandemic, materials was our cohort's most bought sector, topping buying activity in both 2020 and 2021. Materials buying stayed strong in 2023 until Q2, where concerns of stagnating economic growth in China have now driven a major reversal in sentiment. The subsequent selling in Q2 has led to a flip in materials to become the most sold sector over 12-months. The most sold stock is Mineral Resources Ltd (ASX: MIN) and the most bought is Iluka Resources Limited (ASX: ILU). Back in February 2020, it was Fortescue Metals (ASX: FMG) that saw the highest buying activity.

Despite this sentiment reversal, it barely compares with the magnitude of price swings that Australia's technology sector has seen since February 2020. Tech was famously prized in 2021 and 2022 as investors recognised skyrocketing demand for online cloud-based and remote working services. The 'tech wreck' followed in early 2023; a period where many sold their tech holdings off the back of poor US third quarter earnings performance, staff cuts and a general shift away from growth stocks. Now, in May 2023, we've seen appetite rebound as the transformative potential for generative artificial intelligence (AI) is recognised. In February 2020, our most bought Australian tech stock was Link Administration Holdings (ASX: LNK) but today, it's TechnologyOne (ASX: TNE), an enterprise SaaS software developer that uses AI in its products.

Financial advisers and wealth managers have a vital role to play

Volatile market conditions will likely prevail heading into the next quarter. Markets are now expecting a mild US recession and possibly a recession in other major markets. Australian households will continue to feel the impact of higher interest rates, putting more pressure on household budgets and creating less free cashflow with which to invest. Despite this, we expect trading activity will remain steady in the period ahead.

In these conditions, wealth management and financial advice providers have a critical role to play in ensuring their clients' portfolios have robust risk management approaches in-place, such as via diversification, exposure to defensive sectors and balancing resilient income with capital growth.

Note: The Investor Defensiveness Index measures the buy/sell ratio of low beta (defensive) stocks relative to high beta (volatile) stocks. We consider -10.0 to 0.0 to be defensive, and 0.0 to +10.0 to be offensive.

The investor defensiveness calculation is:

1. *Over the measured period (May 2023 for example), each trade across all ASX stocks is allocated to one of seven groups based on the beta of the underlying asset. Each of group has an approximately equal number of trades.*
2. *The buy/sell ratio of each group is calculated and converted into an index based on the historical buy/sell ratio of that group (the greater the value, the higher the buy/sell ratio is now relative to historical data).*

A linear regression is conducted on the sentiment index against beta, with the negative slope of the line-of-best-fit being the Investor Defensiveness Index.

Dan Jowett is CEO at Openmarkets Group. This article is general information and does not consider the circumstances of any investor.

Return of our 'Wealth of Experience' podcast

Graham Hand, James Gruber, Peter Warnes

Season 2, Episode 1

In this week's episode, we discuss how the new $3 million super tax will work with an important clarification, the impact on other investment pools, the headwinds for Aussie large caps, as well as the energy transition and its investment opportunities.

(For more details on the $3 million tax, read here).

The podcast is also available via our dedicated website page, Google Podcasts, Apple Podcasts, Spotify, and BuzzSprout.

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Grab a cuppa and settle in for our chat.

James Gruber
Editorial, Firstlinks and Morningstar

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