Firstlinks
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## Contents



## Editorial

Active fund managers receive a lot of criticism, especially directed at their inability to consistently beat their benchmarks over time. The struggle to outperform is not because portfolio managers are inexperienced or lacking talent. In fact, it's probably the opposite. Almost every fund manager is smart and dedicated, and while there are a few with exceptional skills, everyone is competing against similarly-qualified investors. For every **Sam Kerr**, there are a hundred talented but not star players.

But one person's meat is another person's poison. We all have different tastes. Some investors prefer to see the value of their funds grow steadily over time, allocating to traditional fund managers who buy 'value' stocks, such as mainstream industrials, with less price volatility. Others go for high performance, which might mean up 40% year, down 20% the next in a riskier growth style, as long as the portfolio delivers over time.

Many years ago, I managed the borrowings for **Colonial First State**'s geared share funds. In the 10 years to the GFC, the funds grew rapidly as equity markets rallied, reaching $10 billion at their peak, with borrowings of over $4 billion. It became like a mini-Treasury operation, with funding programmes locally and overseas.

There was never any doubt about our gearing strategy. We always made it totally clear at every presentation and offer document:

*"We borrow to the maximum extent possible subject to the gearing rules."*

We never tried to second-guess the market, up or down. In the main fund, the rules permitted a gearing of up to 60% (that is, for every $100 of assets, $60 was funded by debt and $40 was owned by investors), subject to an interest rate cover test. We figured that anyone investing in the fund wanted the leverage - the supercharging - and if they preferred to avoid the added risk, they would not invest in the fund. So we put the pedal to the metal all the time, which of course led to strong results in a rising market.

Then the GFC hit and the leveraged losses were extreme. As the market value of the shares fell, we repaid debt quickly to ensure the gearing did not go above 60%. It wiped billions from the funds and investors who bailed at the time suffered heavy losses. The price history of the fund below shows the large falls in 2008 and 2020 (the fund is now managed by **First Sentier**) but $10,000 invested in 2002 is now worth over $80,000 (although not using a log scale disguises the fact that half the gain came prior to 2008).

Looking over 20 years of the main geared fund shows how the leverage exaggerates the market's gains and losses. It is what it is - a geared fund - and any investor needs to accept the wild ride.

**Price history of the Colonial First State/First Sentier Geared Share Fund**


After the GFC, when investors complained and said, "*You should have known the market would fall and reduced the gearing in advance, because you are supposed to be the experts,*" well, sorry, that's not the way it works. CFS (and me) had no more insight into the GFC than anyone else, and imagine the complaints if we had de-geared a couple of years earlier and missed the 2006 to 2008 rally.

Investors should know what they are likely to experience when they select a fund, and the manager should continuously explain how its style will respond to different conditions. Consider two Australian boutiques with a strong growth style, **Montaka** and **Hyperion**. Both are believers in the future potential of great global tech companies.

For example, **Chris Demasi from Montaka** wrote last week:

*"While stock prices of some of the world's best companies are up a lot this year, they are only just getting back to where they were at the beginning of last year. Meanwhile, their underlying businesses are much better positioned than they have ever been and keep getting better. These are companies that can multiply in value many times over by the end of this decade."*

And in its latest investor update, Hyperion writes:

*"A key structural theme that Hyperion identified approximately 10 years ago was AI and Machine Learning, however the potential upgrades to revenue streams, efficiencies in productivity and eventually earnings are only now starting to be recognised by market participants."*

In 2022, investors marked down the '*Magnificent Seven*' stocks (as **Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla** and **Meta** are now known) in the face of higher interest rates and lower growth. Then in the first half of 2023, the NASDAQ tech index had its best opening run in 40 years, up 31%. Both Montaka (for example, its global fund listed on the ASX as MOGL) and Hyperion (its global listed fund is HYGG) spent most of 2022 explaining to their clients that they still believed in their investment thesis, and investors should hang in for better times for their growth style. Over 2022, Hyperion lost about 44% while Montaka was down 38%, making for some difficult conversations.

But as shown below using **Morningstar** data, those who gave up and bailed at the end of 2022 have missed the recovery of most of the losses.

**Montaka's MOGL and Hyperion's HYGG global funds since 1/1/2022**


*Source: Morningstar, MOGL in red, HYGG in blue*

Looking at 2023 to date paints a much rosier picture than the pain of 2022. HYGG fell further and has recovered more than MOGL but both have rewarded the stayers.

**Montaka's MOGL and Hyperion's HYGG global funds since 1/1/2023**


Investing in active managers is as much a long-term decision as allocating to the stockmarket itself. The current market is frustrating for some value fund managers who have under-allocated to the Magnificent Seven. For all the hype, analysis, bravado, debating and presenting that goes on in every fund manager each day, recent relative performance comes mainly from one decision: how much was invested in the big tech companies?

These seven stocks are now so valuable that in the main measure of the global stockmarket, the **MSCI ACWI** (All Country World Index), they make up more than the weighting of the entire stockmarkets of the next four countries after the US. Little wonder most US investors cannot see past their own borders, as global diversification has not been a good performer for them.


To complicate matters further, the long-term evidence over 100 years of US data and 50 years of global data that many traditional managers rely on shows that value stocks outperform growth stocks over time. Or perhaps this 'value versus growth' debate itself is overdone, when fund managers should invest in great companies regardless of their label. In Australian equities, a value manager (**Merlon** Concentrated Value Fund) was the top performer in the year to 30 June 2023, beating a growth manager (**Hyperion**'s Australian Growth Fund) and a style-agnostic manager (**Yarra Capital**'s Australian Equities Broadcap Fund) so what does it all matter?

On the subject of 'risk on', there are increasing signs that institutional investors are discounting the possibility of a recession and taking more risk in equity markets, for the first time in about 18 months. It doesn't take much for the mood to change.

***Figure 1: State Street Risk Appetite Index***


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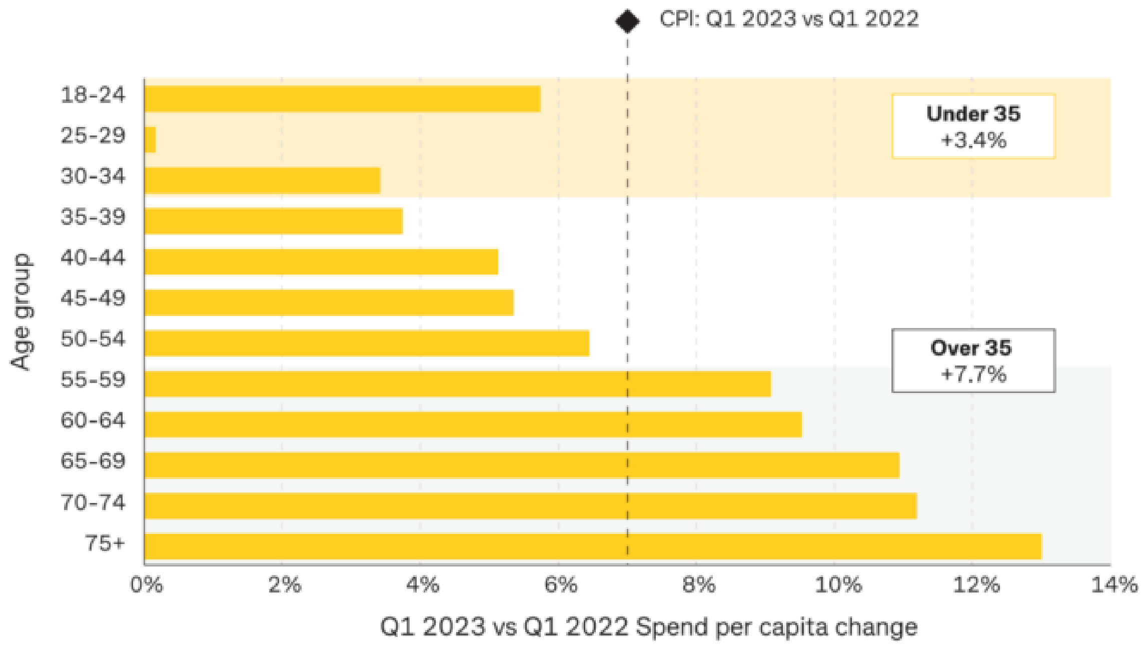
There also is growing confidence that the Reserve Bank has finished its current tightening cycle. **CBA Economics** expects cash rates to be held at 4.1% for "*an extended period*":

*"The data flow before the August Board meeting appears crucial in allowing this more comfortable tone. The Minutes noted "the information received on inflation over the prior month had been reassuring". Q2 23 CPI printed below expectations with headline CPI at 0.8%/qtr and 6.0%/yr. Further detail in the Minutes was provided "Inflation had fallen further and been a little lower than expected in the June quarter". The weak retail trade print for June and confirmation of retail volumes contracting would also have contributed to the on hold decision. The RBA has also expressed its view the labour market is at a turning point, albeit labour market conditions remain tight."*

Data from CBA also shows that the traditional patterns of younger generations spending more to buy goods and services, while older people cut down on consumption to preserve their capital, is not playing out. Older generations have the wealth from rising property prices and interest earned on savings, while younger generations are hit with larger debt repayments.



CBA reports that Baby Boomers increased their spending the most, led by outlays at cafés and restaurants, which grew by 18% year-on-year. CBA says Baby Boomers carry little mortgage debt but hold 43% of total CBA savings. Boomer savings increased 5% over the year while savings shrunk for those households aged 34 and under.

*"The data clearly shows that the RBA's rate hikes are exacerbating intergenerational inequality ... The Baby Boomer generation is also driving Australia's household consumption, which has forced the RBA to respond with higher interest rates to the detriment of young Australians with mortgages. The success in fighting inflation is heavily dependent on curbing spending for those households aged over 55, in particular the Baby Boomers."*

**Treasurer Jim Chalmers** has announced that the latest version of the Intergenerational Report will be released next week. It will make fascinating reading about how future generations will need to cope with challenges facing the nation's finances.

There was also a good indication during the week of the higher costs the banks face as the highly-favourable (and largely unnecessary) Term Funding Facility starts to mature. CBA issued a massive $5 billion debt facility in the wholesale bond market with the following tranches (3m BBSW is currently about 4.15%):

- $1.1 billion 3 year floater at 3m BBSW + 0.75%
- $2.4 billion 5 year floater at 3m BBSW + 0.95%
- $1.0 billion 5 year fixed at 4.90%
- $500 million 3 year fixed at at 4.75%.

The TFF was provided by the Reserve Bank at rates of 0.1% to 0.25%. A gift.

In my article, I check the latest demographic data on life expectancy at the age of 65, and draw on **Vanguard**'s 30-year performance chart as a guide to what retirees can expect in a long retirement. It should give more people confidence that their savings will keep up with their spending, rather than leaving most of it to the kids to enjoy. Do what the CBA data shows and get out there and enjoy your hard-earned.

**Graham Hand**

**Also in this week's edition ...**

Most agree that financial advice is a good thing yet not enough people, especially heading into retirement, access it. Whether the Federal Government's response to the Quality of Advice Review is enough to bring about much-needed change remains to be seen. **Kaye Fallick** examines what's gone wrong with financial advice and offers some solutions.

Electric vehicles are the future as the world targets net-zero emissions by 2050, but as **Magellan's Ben McVicar and Ofer Karliner** write, the current system isn't equipped for dealing with the shift to EVs. Trillions of dollars will need to be spent to address the issues and Magellan believes electric utilities are a low-risk way to play the multi-decade theme.

China is in the headlines for all the wrong reasons. Economic growth is tanking as the country grapples with deflation. It doesn't help that geopolitical tensions mean Western countries are trying to reduce their reliance on Chinese products. The big question is: which country or countries can replace China as the world's manufacturing powerhouse? **Jason Hsu** of **Rayliant Global Advisors** has some answers.

It's ASX reporting season and sometimes all isn't what it seems in a company's financial accounts. **Hugh Dive** of **Atlas Funds Management** offers a guide on analysing financial statements to help you spot potential red flags.

What went up in 2020-21 - cryptocurrency, commodities, real estate and economic growth - has retreated starting late 2021 and early 2022. Now, **Brandywine Global's Francis Scotland** says, it's inflation's turn, and central banks are behind the curve again.

Superannuation is a valuable investment structure and contemplating the intended recipient of these savings in the event of death is crucial. Yet as **Rohani Bixler** suggests, there's a significant limitation: super benefits can't be directly allocated to charities.

This week's White Paper from **Neuberger Berman** examines 10 key market themes for the remainder of this year.

**Curated by James Gruber and Leisa Bell**

## 30-year chart is pointer to retirement outcomes

### Graham Hand

Every retirement financial plan includes a variety of assumptions, as nobody knows what life will throw at them. Retirement often comes with the added uncertainties of a loss of income from work, ongoing health problems and greater flexibility in using time. In a world where headlines prefer gloom over optimism, retirees face perhaps 30 years of investing not knowing the returns or risks they face. However, while '*failing to plan is planning to fail*' is an exaggeration, a long-term plan can draw on the past to make more informed decisions.

Each year, Vanguard releases an Index Chart which shows the performance of major asset classes over the previous 30 years. It is an appropriate period for retirees and advisers to judge long-term investing plans and outcomes as it also coincides with the likely period of retirement.

Balaji Gopal, Head of Financial Adviser Services at Vanguard Australia, says:

*"While investors shouldn't rely on past performance, 30 years of market history has proved that the impact of geopolitical, economic and social events on performance is usually short-lived, and markets will typically recover and rise over time. Looking back over the last few decades, bear markets on average last only 0.9 years and are generally followed by a bull market, averaging 6.5 years. Investors who stay invested through downturns are therefore best poised to benefit when markets inevitably bounce back."*

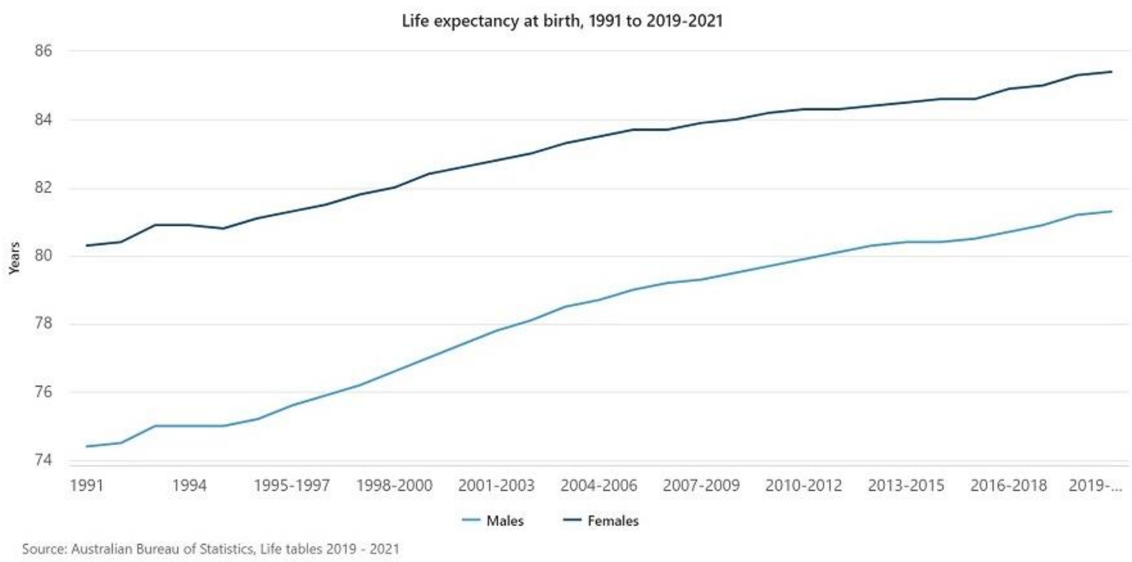
Let's first look and how long people are likely to live then check the asset performance numbers.

**Life expectancy at 65 is not the same as at birth**

There is a common misunderstanding about life expectancy as quoted in the Life Tables issued by the Australian Bureau of Statistics (ABS). The latest ABS release shows life expectancy at birth is:

- In 2021, 81.3 years for males (in 1991, 74.4 years), and
- In 2021, 85.4 years for females (in 1991, 80.3 years).

In the 30 years since 1991, the gap between male and female life expectancy has narrowed from 5.9 years to 4.1 years. Males are living 6.9 years longer than in 1991, rising at the rate of a year of life expectancy for every four to five years. Perhaps add another seven years of life expectancy over the next 30 years, although diet and the pandemic may compromise long-term trends.



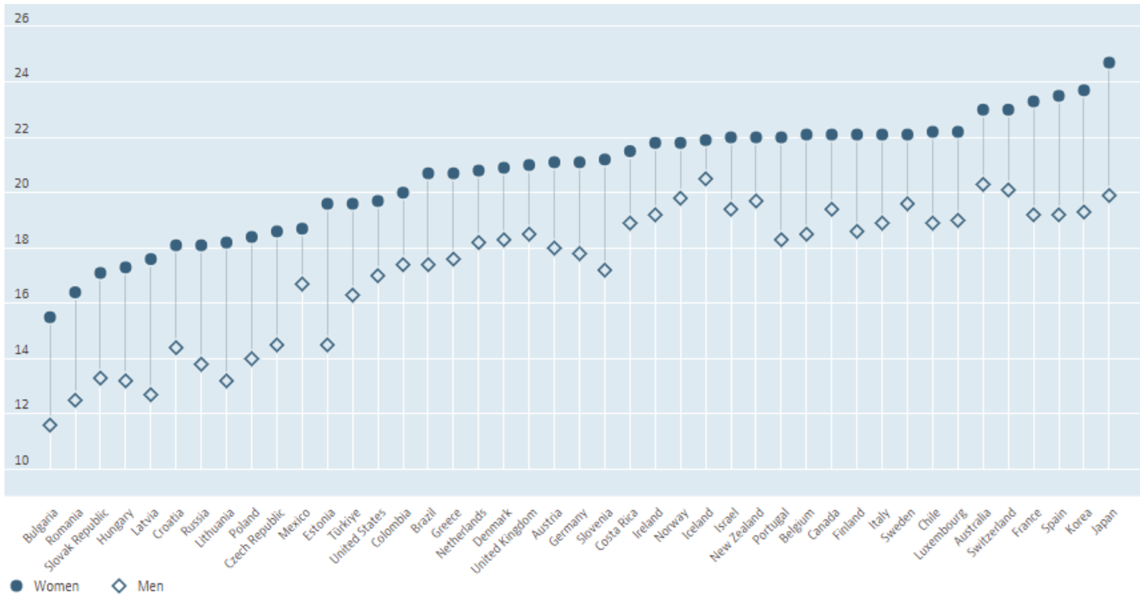

But these numbers are life expectancy *at birth*, while life expectancy generally is defined as:

*"The average number of additional years a person of a given age and sex could be expected to live, assuming current age-sex specific death rates and experienced throughout their lifetimes."*

Here's the common mistake. The ages above should not be used when planning the retirement spending and savings of a couple retiring at age 65. They have the benefit of not dying between the ages of 0-65, and the relevant statistics for them are life expectancy at age 65. A male aged 65 is not expected to die at age 81 nor a female at 85 and anyone planning for only 16 to 20 years of retirement is likely to underestimate.

**How long will most people spend in retirement?**

The latest OECD statistics for life expectancy at 65 show Australia is near the top for both men and women, in a group of six at least a year ahead of other countries. The longest, as shown below, are Japan, Korea, Spain, France, Switzerland and Australia.

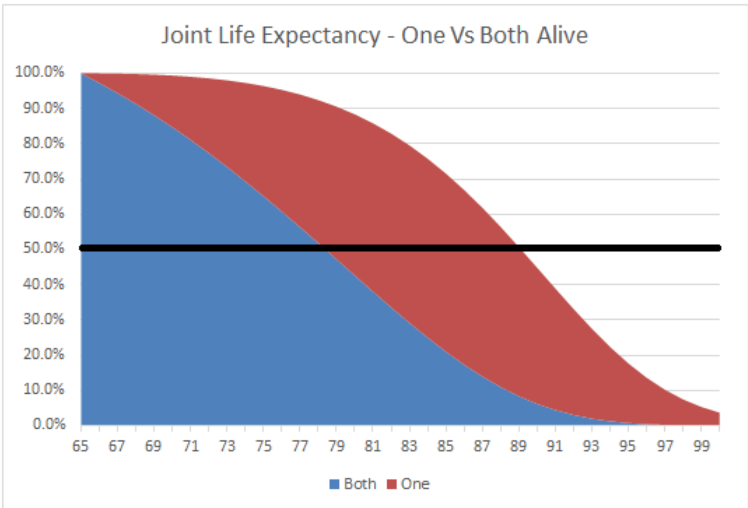



For Australia, the statistics for life expectancy *at age 65* are:

- Men, 20.3 years
- Women, 23.0 years

Which suggests men will live to about 85 and women to 88 on average.

But that's half the story. Life expectancy is based on the 50th percentile, meaning there is a 50% chance of living beyond the average. Plus most people enter retirement as a couple sharing income and expenses rather than as two individuals. Life expectancy plans for a couple need to head towards the ages of 95 to 100, as shown in the following table (based on US data) by Michael Kitces, a leading US financial adviser and consultant to the advice industry.




There is a useful overlap between the investment planning horizon for an Australian couple of 30 years after retiring at 65, and the Vanguard data of 30 years.

**Retirement planning is not only about savings**

A reminder that Australia's retirement system includes three components, and I argue, a fourth for most people. They are:

1. Savings inside the superannuation system
2. Savings outside the superannuation system

3. Age pension and other social security benefits
4. Access to equity in the family home.

A complete picture of all components should be included in any comprehensive retirement plan, bearing in mind there will always be calls for the age of access to the age pension to push out. [Recent research](#) includes:

*"With protests against raising the pension age raging in France, statistical modelling from the Macquarie Business School suggests Australia's optimal pension age should be increased to 68 by 2030, 69 by 2036 and 70 by 2050."*

**Investment performance over the last 30 years**

Over the last 30 years, Australian shares on average have returned 9.2% per annum, with a healthy 14.8% in 2022/2023 in contrast to a sobering -7.4% the previous year. All asset classes except cash delivered negative returns in 2021/2022, including an unusual correlation between equity and bond returns. Defensive assets generally did not provide protection, although usually, diversification reduces market volatility.

Vanguard provides the following chart on the performance of an initial investment of $10,000 invested in the major asset classes, with US shares winning handsomely. In the past, therefore, taking equity risk has been rewarded for those who can tolerate the greater risk, and there is a cost to pay for cash's defensive qualities. Note these are nominal not real returns, so there is no adjustment for inflation.


The Vanguard chart is detailed and complicated, so [click here to view or download a larger version](#).

| $10,000 invested in 1993 | Accumulated investment value at 30 June 2023* | % returns per annum |
|---|---|---|
| Australian Shares | $138,778 | 9.2% |
| U.S. Shares | $176,155 | 10.0% |
| International Shares | $87,584 | 7.5% |
| Australian Bonds | $49,394 | 5.5% |
| Australian Listed Property | $83,326 | 7.3% |
| Cash | $34,737 | 4.2% |

**with no acquisition costs or taxes, and all income reinvested. Source: Vanguard*

**Check the fees**

As a major provider of funds based on various indexes, Vanguard makes the case for investing in index funds to reduce costs, but investors should note that Exchange Traded Funds are not all index funds, and neither are managed funds all active. Check the fee and don't assume ETFs are always cheap as some are actively managed with high base and performance fees.

For example, Morningstar data on ETFs, as shown in the table below, shows the weighted average cost of passive (index) ETFs is 0.24%, while active ETFs are at 0.65%. The simple average (all funds given equal weight regardless of size) is 0.92% which shows some active ETFs are as expensive as managed funds.

**Fee Comparison for ETF Cohort**

| ETF Cohort | Simple Average | Asset Weighted Average |
|---|---|---|
| Pure Passive ETFs | 0.44% | 0.24% |
| Strategic Beta ETFs | 0.43% | 0.36% |
| Sustainable ETFs | 0.57% | 0.48% |
| Active ETFs | 0.92% | 0.65% |

*Source: Morningstar Direct, Morningstar Research. Data as of December 31, 2022.*

**Would you bank these returns for the next 30 years?**

Given the chance to earn these returns for the next 30 years, how many investors would say earning 9-10% (in nominal terms, not adjusted for inflation) on their equity portfolio throughout retirement is adequate and bank that level now? It's my guess that the vast majority would accept. I would, but the numbers come with the benefit of only considering the handsome 30-year returns and not the volatile journey endured to get there, including losing half the value of shares during the GFC.

A qualification is that there are always reasons to argue future returns will be lower. We could now say that past returns benefitted from cheap energy while the future of energy transition will cost trillions, that past Chinese growth will be replaced by a stagnating economy, that the Ukraine war disruptions will disrupt for years, that demographic changes and an ageing population will hit growth, that younger generations with different values, etc, etc. But stockmarkets have delivered opportunities for centuries, and the more optimistic outlook is to place faith in the ingenuity of people to solve problems.

Most retirees find the volatility of a 100% exposure to equities unacceptable, so some mix into other asset classes is required to manage the risk. The results show that staying invested for the long run is likely to be rewarded, although investing broadly and diversifying is a safer route.

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

## Fixing advice needs for retirees frozen in the headlights

### Kaye Fallick

Research tells us that those retirees who seek and receive advice feel in more control of their money and have better financial outcomes. But those who might benefit the most often aren't seeking it.

The number of planners is shrinking, the price is increasing (now around $3,500- $4,000 for a comprehensive plan) and trust, in the wake of the Royal Commission into Banking and Finance, is still low. With increasing numbers of Baby Boomers heading into retirement, the need for advice has arguably never been greater.

Retirement income rules are complex. The mix of age pension entitlement and super drawdown is hard to understand. Then layer in all possible options and strategies (Bring Forward, Carry Forward, Downsizing, Younger Spouse, etc.) and it remains difficult for the average retiree to maximise wealth without professional support. A $4,000 investment with no guarantee of a return on this money is a hard sell.

And then there's fintech ...

Let's explore this dilemma. To test the proposition that the advice offering available to retirees is not delivering, I shared the following question with three experienced industry experts. Here's how they responded.

**Q1. How would you describe the state of Australia's advice industry?**

**David Orford** (founder Financial Synergy, Optimum Pensions):

*"It's adversary and unfair. We need more advisers, not fewer, and more efficiency."*

**Jeremy Duffield** (founder SuperEd, Retirement Essentials):

*"It's clearly not currently up to the task. Sure, the affluent can buy good service through talented financial planners - if they can find them. But the bulk of the population struggles to get the help it needs at an affordable cost."*

**Mark Hoven** (Consultant, Adviser Ratings):

*"It's at a turning point for the better after an extraordinary period of sustained regulation, over-regulation and multiple changes in direction."*

It's no secret that the adviser sector has been through a hard time, but it's fair to assume that by now remedies would have been put in place. The spike in decumulation due to retiring Baby Boomers (called a 'silver tsunami' by ASIC's Danielle Press) should hardly have come as a surprise. This has been projected for decades.

**Why we haven't found a better advice model**

The Royal Commission into Banking and Finance delivered its report in February 2019 just as we were about to enter a global pandemic. There have been four years to address problems.

And along the way, fintech has been hailed as a possible 'saviour' to truly scale advice. But where is this at? Why have we yet to move towards a better advice model that suits the needs of a majority of Australians?

There are a few reasons.

As the number of potential clients increases rapidly, supply has gone backwards. The post-Royal Commission divestment of advice divisions by banks and other organisations is a factor. This has resulted in a reduction in the number of advisers and type of advice that it is commercially feasible to deliver. Most advisers admit their service is not really viable unless they are dealing with a high net worth individual. They are probably right. For retirees who will be on a full age pension, the average price of advice is almost 10% of their combined annual income. Will they really risk this amount?

The most recent thorough investigation into retirement income, the *Retirement Income Review* (2020) noted the need for more support for those hitting the decumulation phase of super. The consequence was the Retirement Income Covenant (1 July 2022) which required super fund trustees to take a more active role in the explanation of decumulation to their members. They were also expected to take responsibility for guiding members during their retirement transition.

On 18 July 2023, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA) shared a damning report on the job that super funds have done in the first 12 months in assisting retirees to transition. According to the report there had been an overall lack of progress, coupled with insufficient urgency.

And then there's the overblown and sometimes unrealistic expectations of fintech. We're still waiting for fintech solutions to come galloping over the horizon. Yes, technology probably can deliver easier, cost-effective answers. But the theory of 'build it and they will come' hasn't quite worked. T

here are probably a few reasons for this. Trust remains a factor, whether it's trust in humans or algorithms. Complexity is another issue. Retiree needs are so nuanced that there needs to be at least a part-human component to fully understand and explain options for individuals and their family situation.

Industry experts believe that regulatory uncertainty has also played a role.

Orford says that:

*"there is a large role for fintech, but it needs the appropriate regulation."*

Duffield notes that:

*"… the investment in tech has been stymied by the regulatory uncertainty."*

And Hoven believes that:

*"…a significant additional level of spending is required in the advice technology sector."*

So here we are with far too few qualified advisers to serve the ballooning needs of the 800 people who are entering retirement every day.

David Orford offers a back of envelope calculation:

*"Let's say there are 15,000 advisers now, with say 100 clients, that's 1.5 million availability to support 26 million people. Yes, clients who are couples will mean that the need for appointments is slightly reduced, but not by that much."*

**Who can step up to help retirees?**

So who (or what) is ready to service the needs of the three million superannuants who will retire over the next 10 years?

Despite their poor performance in implementing the Retirement Income Covenant, super funds seem to be confident that they are up to this challenge. In a recent article (in the *The Australian Financial Review*), Paul Schroder, Head of Australia's largest fund, Australian Super, discussed the possibility of funds (alongside government) delivering a 'single retirement income payment', a mix of age pension, super drawdowns and household equity.

But are super funds really up to this much more sophisticated solution delivered at scale, if they haven't got the basics of better 'information, advice and offerings' under control yet? And will retail funds, banks and other industry providers sit quietly by while industry super funds secure an even bigger slice of the retirement income cake? It doesn't seem likely.

**Some possible solutions**

To return to the question posed in the title of this article, along with Jeremy Duffield, David Orford and Mark Hoven, I agree that our current advice model is not working well. And I doubt it will be solved by offering more of the same just for those who can afford it.

The solution is probably a hybrid model, allowing fintech to do a lot of the preliminary work and a 'human' component for specific, episodic general advice consultations to cover the basics of retirement income planning, including pension eligibility, decumulation options, mortgage management and tax implications.

Mark Hoven emphasises the importance of the need for intervention at preservation age.

*"If's there's one time above others for the need for advice, it's around age 55, at the beginning of the Transition to Retirement strategy period. For those already in retirement, it's arguably too late."*

I don't agree that it's too late for retirees as there are many trigger points post-55 that require knowledge of the rules and support to help retirees properly compare the pros and cons of their various options. But *whenever* advice is most needed is not the point.

**The cost issue**

The burning issue is the huge gap between the $4,000 personal advice offering available from too few advisers to a limited number of wealthy upper quintile clients … and a more affordable, say $500, single issue consultation which could serve hundreds of thousands more Australians in need.

The ultimate irony is that the majority of those who have sought advice are extremely positive about it. They typically report higher confidence and better outcomes. Surely it's up to everyone in the industry to ensure that this experience is available to the majority of (non) wealthy individuals.

Many who enter retirement funded by a mix of age pension and super, but who are so overwhelmed by the complexity of rules, are frozen in the headlights, wondering what to do next.

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

## The current system is ill-equipped for shift to EVs

Ben McVicar, Ofer Karliner

*This is an edited transcript of an interview between Magellan account manager, Nicole Morell, and Ben McVicar and Ofer Karliner, two of the company's Infrastructure Managers.*

**Nicole Morell:** One of the big themes in the economy is the rising interest rates, rising living costs, and the pressure that this is putting on household budgets. Are you seeing any sign of governments pushing back on price increases from companies in the infrastructure sector?

**Ben McVicar:** So certainly this is one of the big themes we've seen in global markets. Global economies in recent years has seen both rapidly increasing in prices, as well as really strong interest rate responses to that. What that has meant is very often consumers and households, who are least able to deal with this often, are dealing with what is a rapidly rising cost of living.

So how does this impact infrastructure? Well, ultimately you think about the nature of what infrastructure is, what we're doing, it's about delivering essential services to consumers. So I should add, this is exactly why we're in this space. The provision of essential services makes for a great investment because this is really where we can get reliability of demand. When you're selling essential services, people need this day in, day out. The other factor as well is these are monopoly businesses, often near monopoly-type businesses. So really reliable investment.

And the way that governments often deal with this, this sort of monopoly power is by price regulating these businesses. So if you think about toll roads, often what they do is they have a price path that's defined in a contract. I think in France as an example, you've got a CPI times 70% uplift of prices each year. Electric utilities, very common in the US to pass through the cost of the electricity generation so you don't have to bear that inflationary pressure. Overall, that can still work as a solid investment.

The risk you face in all of this as investors is that in a period of rising prices, obviously there's the risk that the governments decide to politicize this process, and that creates risk as investors. The thing that we're seeing at the moment, as an example, we are seeing some of this starting to occur.

In France at the moment, what we're seeing is press reports that the government there is looking to create effectively a new tax that they're going to apply to the motorways there. Now, what is interesting here is they're looking to potentially try to sidestep the way the contracts are written. And in order to do that, what they're going to do is potentially tax all of the concessions in the market - rather than just a specific tax, which is not allowed in that country. That's obviously a risk. And by the way, when we've done the analysis on that, it looks like it's pretty minor in terms of the impact on valuation, but obviously it's a net negative in terms of the trajectory.

But what is interesting here is I think it's what the government's not doing. They're not trying to tear up the contracts, they're not trying to rewrite the contracts unilaterally. They're working within the contracts to find ways to increase this tax. This is a common thematic.

We're seeing the same thing in New South Wales. The Labor government here with their toll pricing policies certainly acknowledged and respected existing contracts that were in place.

And going all the way back to your initial question around the ability to increase prices as per these contracts, globally, we're seeing this is very consistently being allowed by governments. We're not seeing that pressure because of the way we invest, focusing on those really high quality jurisdictions.

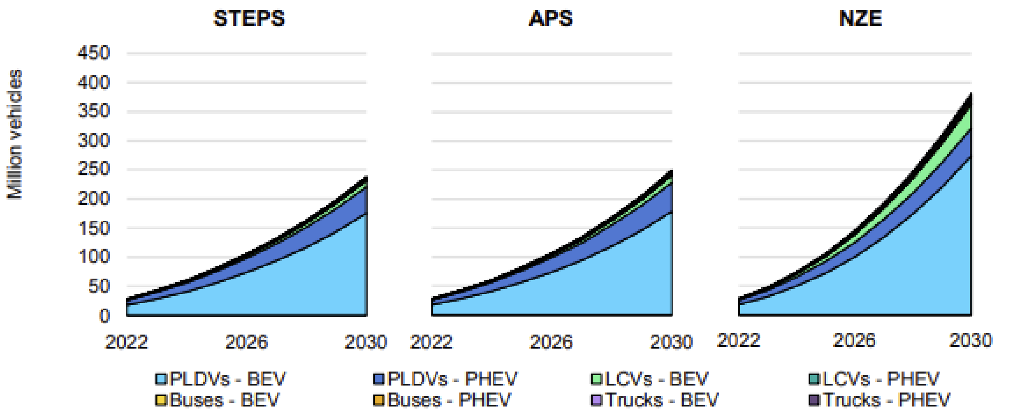
**Nicole Morell:** All right. Well, let's change gears a little here and move to the topic of electric vehicles. And this one's for you, Ofer. What would a global shift to electric vehicles look like? And I guess the bigger question is how would the current system cope, if at all?

**Ofer Karliner:** Yeah, in very basic terms, the system couldn't cope right now with a shift to electric vehicles. It's a multifaceted problem, so you have a number of things we need to solve to get there. The generation has to increase significantly: the grid. Transmission distribution has to be significantly enhanced, and charging infrastructure needs to be in place.

Now, there's not a lot of good data on what this is going to cost in isolation for electric vehicles to 2050. It's more about the whole transition costs. But there's some really good data to 2030 that gives you kind of an idea and it's quite instructive of the quantum of the changes that need to be made.

The IEA, International Energy Agency, estimates that about 30 million electric vehicles are now on the roads. They expect that to be between 240 and 250 million by 2030. That's out of a global car fleet currently of 1.45 billion.

**Figure 3.1. Electric vehicle stock by mode and scenario, 2022-2030**




IEA. CC BY 4.0.

Notes: STEPS = Stated Policies Scenario; APS = Announced Pledges Scenario; NZE = Net Zero Emissions by 2050 Scenario; BEV = battery electric vehicle; PHEV = plug-in hybrid electric; PLDV = passenger light-duty vehicle; LCV = light commercial vehicle.

IRENA, the International Renewable Energy Agency, estimates that at a 20-25% penetration, we need 37 million public charges for recharging cars. At the end of last year, there were 2.2 million. That's not including the quarter to half a billion private charges that need to be built. And they estimate that alone will cost between 900 billion and 2.2 trillion just to get to 20-25% penetration. Again, quite a big number.

We then get to the generation and grid piece. Well, there's an Australian government report from 2021 that looked at their high case scenario of 20-25% penetration again of electric vehicles by 2030. In that case, they estimate about a 3 to 4% increase in total electricity demand, which in and of itself doesn't sound like a lot and it's not really a problem.

The problem becomes that people get home from work around the same time and plug in their cars all around the same time. They estimate it could lead to a doubling of peak demand. So when you're building a grid, all those things, all those components and if you built for that peak load, so a generation has to double, the transmission system needs to be reliable enough to cope with that additional electricity. The grid needs to be enhanced, not just for the amount of electricity, potentially for two-way flows. So that 20 to 25%, you're looking at four to five times scaling up to 100%. Not quite that simple because cars could be used as home batteries, and you could be selling a power back to the grid. But even then you have to upgrade the grid systems to deal with that.

Globally, there's tens of trillions of dollars need to be spent. And one of the reasons we really like electric utilities is this really long-lived theme of growth. It's really low-risk way to play what is a multi-decade story of growth, and we think it's not reflecting the share prices of a lot of these companies.

**Nicole Morell:** So the shift to electric vehicles, and electrification more broadly, is one theme that is obviously of interest to you as infrastructure investors.

Ben, can you step us through the key themes that are running through the infrastructure strategies currently, where you're investing and what interests you about those?

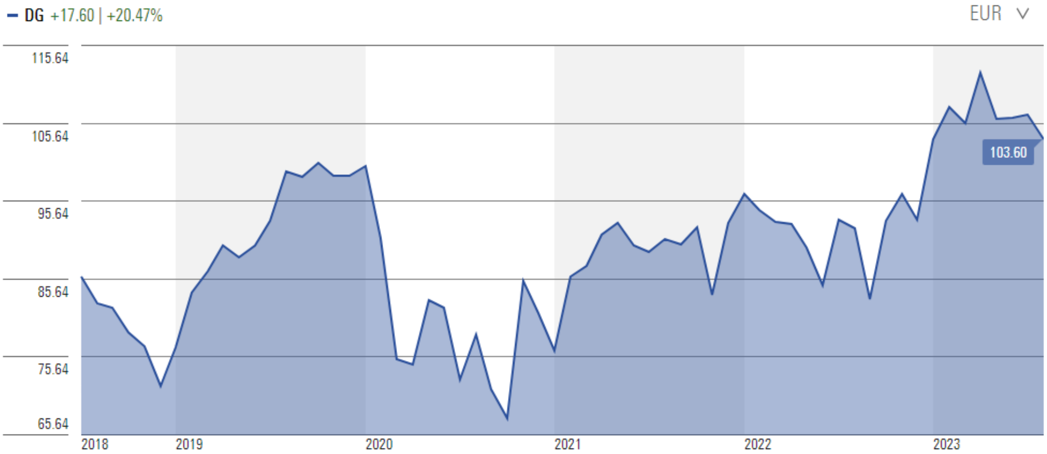
**Ben McVicar:** Yeah, certainly. One is obviously the thing we just pointed out, which is that this net-zero transition creates a lot of investment required in the utility sector. And Ofer just spent a bit of time talking about the impacts from electric vehicles. Now broaden your thinking on that topic to think about what if we want to take gas-powered or gas heating, electrify that. What if we want to take some industrial loads and electrify that? And you can start to see how this multiplies out to be just a huge, huge load that gets put on the grid.

And when we think about the portfolio as it stands today, this is one of the themes that we really like, the utilities stand to benefit significantly. Electric utilities in particularly, these are regulated businesses. Historically you'd be looking at these things as a low-growth but very reliable return. The nice thing now is they're very reliable returns, but we're starting to see the growth rates and the guidance from companies in recent years looking like a sustained 5, 6, 7% per annum EPS. It's not going to shoot the lights out in the year, but it does add up over time. And the nice thing is about this investment opportunity is that really drives their business for the decades to come. And so that's a significant part of the portfolio. Over a third or around a third of the portfolio is invested against assets with significant exposure to electricity.

One of the other thematics, if you want to call it that, that we like at the moment is really around the toll road space. Toll roads represent around a quarter of the strategy. The thing that's quite attractive about these assets is number one, there's a valuation opportunity that we see.

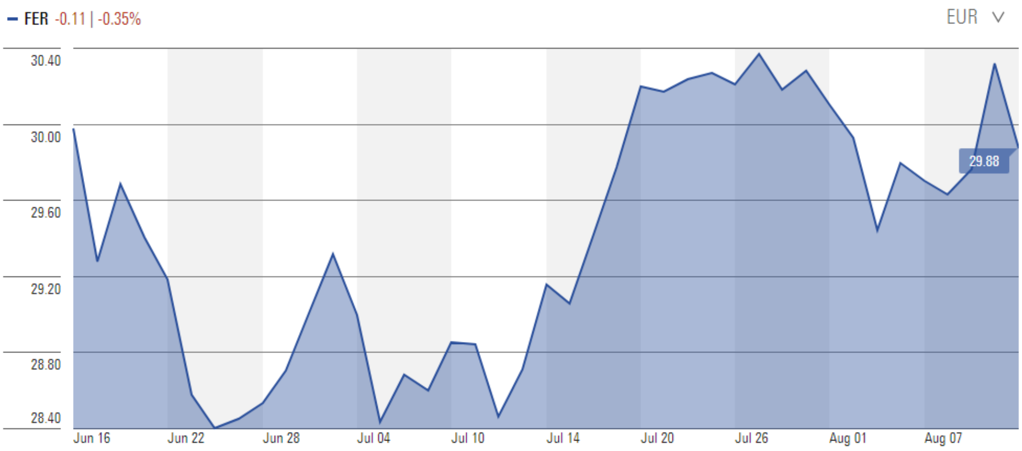
The next piece that's quite interesting is obviously like a lot of transport assets, there's really been a catch-up coming out of the COVID era as they sort of get back to those 2019 levels of traffic. And most motorways we look at, you're kind of back at that level of traffic. And so a couple of examples in that space be like a company called VINCI in France, they have a demonstrable portfolio of toll roads in France. They also have a very large airport platform.

*VINCI share price*




Another company, Ferrovial, who's a European based management team, but they're primarily a North American business these days. Some really nice toll roads in that market, a really particularly attractive one in Toronto, in Canada, which is a really, really nice long-lived asset in that market. So it gives you a sense. And the other thing as well, obviously they're really inflation protected type assets.

*Ferrovial share price*




The last piece that sort of fits into that general situation is airports. And airports, again, the recoveries gaining ahead of steam, and they're representing just under 10% of the portfolio.

*Ben McVicar and Ofer Karliner are infrastructure portfolio managers at [Magellan Asset Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. For more articles and papers from Magellan, please [click here]().*

## Which country will be the next China?

Jason Hsu

I've been wondering lately which country—if any—can be the next China. Much of what made China a manufacturing powerhouse didn't happen overnight; it took generations.

For example, when I was growing up in Taipei, my grandpa took piecework from the local hairbrush factory. I would sit next to him and insert thousands of plastic bristles into wooden handles, one at a time, until we hit his quota. Then he'd return the assembled brushes to the factory and get a new order.

My story isn't unique.

Growing up, one of my elementary school friends worked alongside his grandpa on handicrafts worth no more than a few dollars a week. Another girl I knew worked on an unproductive farm in a tier 5 China city. Today, she's managing a cleanroom worth hundreds of millions of dollars producing four-nanometre semiconductor chips at TSMC, and she's training AI to improve autonomous driving for EVs at BYD.

Along with hundreds of millions of emerging market workers, low value-add manufacturing is our origin story. This is where we started. But the sophistication of our skills and education grew alongside the infrastructure of our emerging economies. Most of my childhood friends now work in facilities and have careers that their grandparents couldn't have imagined.

**Cultivating a 'manufacturing ecosystem'**

Unfortunately, this success hasn't been repeated in other emerging economies like Mexico, Argentina, Brazil, Philippines, Malaysia, or even India. The divergence obviously isn't driven by disparity in skill, work ethic, or culture. It's driven by much more mundane factors.

1. *Favorable Policy*. Some emerging market (EM) governments adopted policies that supported the development of manufacturing ecosystems over time; others did not. For example, China and Taiwan both offered substantial tax breaks and land subsidies for foreign firms setting up factories, along with a special agency to assist investors with local bureaucracy. Singapore, famously, installed air conditioning.
2. *Education and Innovation.* To 'emerge', EM economies needed homegrown talent that reduced dependence on outside experts. This required an educational system to produce high-quality engineers and advanced research capable of adding value. Some EM countries invested heavily in higher education and retaining homegrown talent; others did not.
3. *Reliable Infrastructure.* A manufacturing ecosystem requires critical infrastructure. At a minimum, it requires cheap and reliable electricity and water. But it also requires quality rail, roads, airports, and seaports. Building this infrastructure on a national scale is harder than it seems, and some EM countries could not overcome the challenges.
4. *Local Government.* Local governments can be a boon to local factories, moderating labor issues to effectively drive regional economic growth. But local governments can also be populist business-killers, shaking down factory owners under the pretext of protecting labor. Given the cost of infrastructure and facilities, it's hard to secure investment without balanced, competent, and reasonably non-corrupt local officials.

Collectively, these factors create the necessary conditions for a thriving manufacturing ecosystem. Favorable policies and reliable infrastructure attract foreign companies who set up local factories. As time passes, the domestic economy learns from these foreign investors even as its local population becomes more skilled and better educated. Eventually, foreign experts, facilities, and investment can be replaced with domestic talent and capital. Like cultivating a garden, this process takes planning, discipline, and—more than anything else—time. [Note: one thing it doesn't take to establish these conditions is a particular form of government. For example, Taiwan, Singapore, Hong Kong, and China all made huge strides in GDP while they were essentially one-party states. Meanwhile, Mexico, Brazil, Argentina, and India have made less progress despite being proper democracies.]

We've seen this template for growth repeated in Japan, South Korea, Taiwan, and Mainland China. These manufacturing powerhouses have been the world's factories for decades, increasing quality even while cutting costs. We've also seen this process repeated at a smaller regional scale: the quality products produced by some of the world's most successful regions (e.g., Napa Valley wines, Silicon Valley tech, Hollywood movies, Taiwan semiconductors, German automobiles, etc.) did not emerge because of a single person, firm, or policy. Rather, they emerged as part of robust ecosystems that took decades to cultivate.

And so, while the movement to 'decouple' from China is understandable, it's difficult to see which country—if any—can fill China's shoes in the near term.

**The difference between 'labor' and 'talent'**

It is an easy mental trap to believe China's manufacturing success is a simple product of cheap labor. While inexpensive labor may be necessary to 'emerge', it is far from sufficient. Indeed, the question of "who will be the next China?" is not about labor price—after all, low-cost labor is plentiful in Africa, South America, and parts of Europe. Rather, it is a question about labor value.

As with investing, cheap stocks are often cheap for a reason. What you want are value stocks, which are priced below their fair value. Similarly, you'll get little value from low-cost labor in an economy that is also low skill and poorly educated, with unreliable infrastructure and a corrupt or unsupportive government. It takes a long time to transform 'low cost labor' into 'high value labor'. If a country hasn't already made that investment, it can't transform overnight just because workers in Japan or Taiwan or Mainland China have become more expensive.

For decades, China's manufacturing economy has been learning and practicing with deliberate coaching from foreign companies and local government development centers. Meanwhile, they've overcome intense global competition that demanded survival of the fittest. A hungry young person in this environment competes, learns, and thrives; and a hungry young company emerges as a world-beating TSMC or Toyota. But if you put these same people and companies in an economy with unproductive red tape, inadequate infrastructure, no government vision, populist policies, and leaders with a short-term focus on local political gain—well, those people and firms will wither.

As a personal example, my company has offices in both Taiwan and China. As it turns out, highly educated financial engineers in Taipei earn about one-third of those in Shanghai. But I still don't hire financial engineers in Taipei.

Why not?

Well, it isn't about raw talent or work ethic or attitude. I find super intelligent, kind, and hard-working young people everywhere we operate. But industry-specific work experience and intuition are not easily trainable. To become valuable, young people must have tried, failed, and competed fiercely to become productive. They must be exposed to the right kind of challenges at an early age. This is how 'labor' turns into 'talent'.

Many C-suite executives scoff at this idea; they think manufacturing labor is fungible. I think the evidence says otherwise. As many companies have recently learned, the cheapest manufacturing talent isn't necessarily found where wages are lowest. Instead, it's found where competition amongst workers is most intense for the specific kind of work you need done—regardless of wages. This is why firms move to Silicon Valley to compete for highly skilled programmers; they don't move to Bentonville to poach Walmart's IT team to gain a cost advantage over Amazon.

And as it relates to high-value manufacturing, nothing compares to China.

**The Importance of Infrastructure**

Years ago, Beijing explicitly concluded that imitating the German growth model was most likely to yield economic success for the country. China viewed itself as an exceptional manufacturer, and it was increasingly engaged in high-end and value-add processes. It also had the internal infrastructure—transportation, facilities, machinery, and labor—to support a manufacturing economy. The government felt poised to build on its past success.

In at least this one area, it looks like Beijing got it right. China has incubated phenomenal factory operators, process engineers, and factory professionals. It has mastered global logistics and financing. It has gradually offloaded low value-add manufacturing (e.g., textiles) and pivoted to high value-add manufacturing (e.g., smart phones, laptops, iPads, and LED TVs). In recent years, production quality has even improved enough to command a brand premium.

Could another EM country replicate China's success? Of course. In fact, China wasn't even the first—Japan, Taiwan, and South Korea were building comparable infrastructure while the CCP was still tackling food security and clean drinking water.

But China is the largest. And its exceptional manufacturing infrastructure was built over decades and at great cost. And like China's skilled generational workforce, this cannot be reproduced overnight. There is simply no other EM country that is China's equal in terms of manufacturing infrastructure.

**Between a rock and a hard place**

China is great at what it does, and I don't envy companies trying to diversify their supply chains. Consider Foxconn, the 'gold standard' for operating factories that manufacture high-end electronics. In response to increasing geopolitical pressure, the Taiwanese firm has made several efforts to expand beyond China.

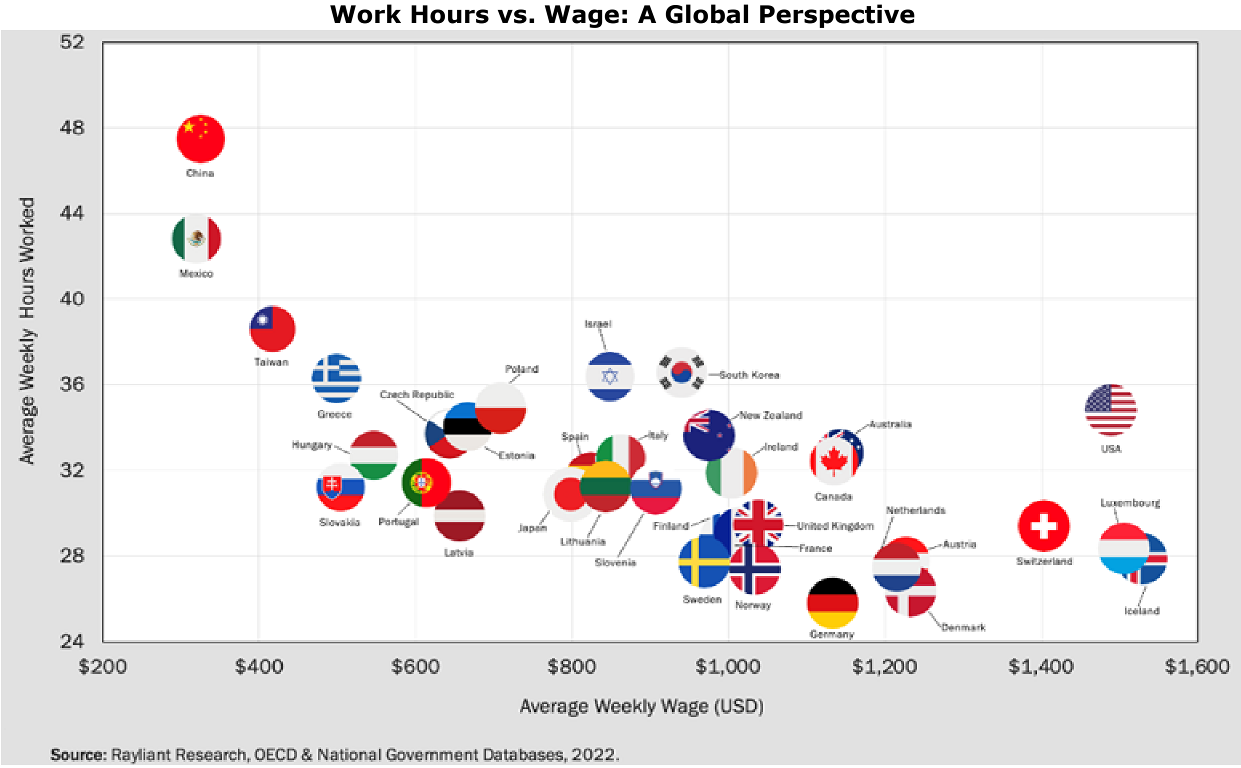
In the United States, Foxconn reached agreements in both Wisconsin and Arizona to invest many billions of dollars in manufacturing plants. And recently, Foxconn signed a partnership with Vedanta Group to manufacture components in India. But as most of my readers know, these deals have all been scaled back or cancelled altogether, including some recent drama in which Foxconn said parts of the US lacked the skills and infrastructure to launch a plant.

I don't want to speculate too wildly about specific cases like Foxconn's. But it's a simple business fact that the United States, United Kingdom, Germany, and other developed countries are simply too expensive and lack sufficient labor to replace Chinese manufacturing. In addition, cultural, employment, and labor norms have hampered Chinese manufacturing attempts in Western countries. (For those who haven't seen it, American Factory is an excellent case study.)

At the other end of the spectrum, Africa offers inexpensive labor and investment opportunities. However, the infrastructure and labor force cannot currently support high-end and value-add manufacturing.

EM is the only viable option. But as Foxconn's efforts in India demonstrate, there are challenges even within these markets.

**Work Hours vs. Wage: A Global Perspective**




**From T-shirts to iPhones**

China didn't start with high-end electronics; it started with t-shirts and toys. And today, there are many EM countries that manufacture t-shirts and toys. The question is this: which of these countries will mature to become the next China?

My answer may be controversial: None of them. There will never be another China.

The conditions giving rise to China's manufacturing prowess have been unique, including the country's scale and centrally managed hybrid economy. These will not be replicated, and no country in the near term will match China's manufacturing capabilities. Despite short-term noise around decoupling—like Foxconn's misadventures—China will continue to play a critical role in global manufacturing, especially for high-end and value-add products.

That said, there's no doubt at least some offshoring will occur. And there are certainly a handful of EM countries that are better positioned than others to benefit from this trend. The countries most likely to benefit are those that already look like a "mini-China," with significant local manufacturing but global distribution. You must look for economies where the infrastructure is already present and growing.

You simply can't teach infrastructure or generational talent. These either exist or they don't. And American buyers (e.g., Amazon and Walmart) are not in the business of teaching Mexico how to build globally competitive factories, ports, and rail. Mexico must already be doing that on its own. So, as an EM investor looking to benefit from China decoupling, I am looking to EM economies that are already on the path.

*Jason Hsu is Founder and CIO at Rayliant Global Advisors and Portfolio Manager of Rayliant ETFs. Republished with permission from the author's LinkedIn newsletter, The Bridge.*

## The accounting tricks that ASX companies play

### Hugh Dive

It's ASX reporting season and sometimes all isn't what it seems with a company's financial accounts.

Here are some red flags to look for when analysing company financial statements:

**Red flag 1: the statements don't match**

"Daddy doesn't know any magic tricks. Daddy knows accounting tricks."

On results day, most attention is focused on a company's profit and loss statement. In particular, analysts and the financial press scrutinise whether the company achieved the expected profit or earnings per share guidance, usually given at the last result or an update like the company's annual general meeting three to four months ago. Whilst the profit and loss statement usually provides good guidance as to how the company's business has performed over the past six months, it is also the statement most open to manipulation and should be read in conjunction with the cash flow statement. When we look at a company's reported profits, we compare them to the operating cash flow. If there is a big divergence, then the accounts should be looked at carefully.

The red flag we are looking for here is when a company's cash flow and profit and loss statements are moving in different directions over an 18-month period and where a company is showing growing profitability but declining cash flows. In the table below from the 2015 accounts, electrical retailer **Dick Smith Holdings** reported income growing from $19 million to $38 million, greeted with applause, yet operating cash flow fell from $52 million to -$4 million. This suggests that the sales generating profits reported on the profit and loss statement were pushing the company towards administration, which happened the following year. Insolvency investigators found questionable management decisions, such as holding 12 years' worth of sale as inventory in private-label AA batteries!

| | Note | Year ended 28 June 2015 $'000 | Year ended 29 June 2014 $'000 |
|---|---|---|---|
| Revenue | 3 | 1,319,670 | 1,227,604 |
| Cost of sales | | (992,828) | (919,602) |
| **Gross profit** | | **326,842** | **308,002** |
| Other income | 3 | 969 | 1,217 |
| Marketing and sales costs | | (112,935) | (130,544) |
| Occupancy and rental expenses | 3 | (93,288) | (79,257) |
| Administration costs | | (57,287) | (45,173) |
| Finance costs | | (4,111) | (2,854) |
| Other expenses | 3 | (6,811) | (22,710) |
| **Profit before income tax** | | **53,379** | **28,681** |
| Income tax expense | 5 | (15,474) | (8,855) |
| **Net profit for the year** | | **37,905** | **19,826** |
| **Other comprehensive income** | | | |
| **Items that may be reclassified subsequently to profit or loss:** | | | |
| Exchange differences on translating foreign operations | | (1,149) | 3,522 |
| Net fair value gain/(loss) on hedging instruments | | 647 | (3,906) |
| Other comprehensive income, net of tax | | (502) | (384) |
| **Total comprehensive income for the year** | | **37,403** | **19,442** |

| | Note | Year ended 28 June 2015 $'000 | Year ended 29 June 2014 $'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Receipts from customers | | 1,445,971 | 1,316,364 |
| Payments to suppliers and employees | | (1,430,877) | (1,261,131) |
| Interest and other costs of finance paid | | (4,111) | (2,854) |
| Tax paid | | (15,355) | (721) |
| Interest received | | 432 | 519 |
| **Net cash (used in)/provided by operating activities** | **15(a)** | **(3,940)** | **52,177** |
| **Cash flows from investing activities** | | | |
| Payments for plant and equipment | | (31,615) | (30,523) |
| Proceeds on sale of plant and equipment | | - | 518 |
| Payment for acquisition of business, net of cash acquired | | - | (24,000) |
| **Net cash used in investing activities** | | **(31,615)** | **(54,005)** |
| **Cash flows from financing activities** | | | |
| Proceeds from issue of shares | | - | 343,611 |
| Payment in relation to corporate reorganisation | | - | (358,611) |
| Proceeds from borrowings | | 122,500 | 57,598 |
| Repayment of borrowings | | (52,000) | (57,598) |
| Dividend paid | | (35,476) | - |
| **Net cash provided by/(used in) financing activities** | | **35,024** | **(15,000)** |
| Net decrease in cash and cash equivalents | | (531) | (16,828) |
| Effects of exchange rate changes on cash and cash equivalents | | 98 | 234 |
| Cash and cash equivalents at the beginning of the year | | 29,944 | 46,538 |
| **Cash and cash equivalents at the end of the year** | | **29,511** | **29,944** |

Another recent example of this can be seen in **Lark Distilling**. Last year the whisky company reported robust profit growth and record annual sales. However, the cash flow statement painted a different picture, one of a company in negative cash flow requiring equity raisings to remain solvent. This appears to have continued in 2023, with the distiller of Tasmania's finest seeing their cash balance fall from $16 million to $7 million.

We recognise that some of this is due to the working capital nightmare of whisky and wine production and cellaring, where costs of distilling, storing in oak barrels and taxes are incurred upfront and revenue collected many years later. However, in all businesses growing profits and increasing negative cash flows indicate profit-less growth and invariably result in dilutive equity raisings or worse.

| A$'000 | FY22 | FY21 | % change |
|---|---|---|---|
| Net Sales[2] | 20,279 | 12,916 | *57.0%* |
| **Gross profit** | **13,482** | **8,654** | ***56.0%*** |
| GP % to Net Sales | 66.5% | 67.0% | *(0.5) ppts* |
| Other income | 633 | 723 | *(12.0%)* |
| Operating costs | (13,314) | (7,856) | *69.0%* |
| EBITDA | 801 | 1,521 | *(47.0%)* |
| Add Non - Recurring Items | 599 | (451) | |
| **Normalised EBITDA[3]** | **1,400** | **1,070** | ***31.0%*** |
| EBITDA % to Net Sales | 6.9% | 8.3% | *(1.4) ppts* |

**Lark Distilling Co. Ltd**
**Statement of cash flows**
**For the year ended 30 June 2022**

| | Note | Consolidated 2022 $ | Consolidated 2021 $ |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Receipts from customers (inclusive of GST) | | 25,087,220 | 17,589,777 |
| Payments to suppliers and employees (inclusive of GST) | | (17,344,696) | (8,669,289) |
| Purchase of inventory | | (15,835,380) | (15,778,286) |
| Interest paid | | (260,715) | (271,343) |
| Interest received | | 3,378 | 2,167 |
| Government grants and tax incentives received | | 634,861 | 751,878 |
| Net cash used in operating activities | | (7,715,332) | (6,375,096) |

**Not always bad if the statements don't match**

Some businesses' earnings on the profit and loss statement can diverge from the cash flow statement. For example, a construction company such as **Lend Lease** or **Downer** might not physically be paid until July of the following year for work done on a railway or apartment high rise, with significant costs and cash outflows incurring in the current period. Here the profits at a point in time may be greater than the cashflows, though the lumpiness of the cash flows received from large individual contracts should even out over time. Though Downer may not be the best example after being the poster child for accounting irregularities over the past year, slashing profit guidance and restating past years' profits, overstated by $30-40 million.

**Red flag 2: A company consistently reports extraordinary items**

Extraordinary items are gains or losses included on a company's income statement from unusual or infrequent events. Importantly, they are excluded from a company's operating earnings. These items are excluded from earnings to give investors a more 'normalised' view of how the company has performed over the period. For example, if an industrial company such as **Boral** books a $50 million gain from selling excess industrial land, including this profit would obscure information about how the company's building materials businesses have performed over the past six months.

While reporting extraordinary items can be valid and useful, investors should be wary or make adjustments to company earnings where a company has frequent (and almost always negative) extraordinary items they seek to exclude from their reported profits.

As a long-term observer of the Australian banks, almost every year, they put through a write-off of the software below the profit line. In my view, investing in banking software is a core part of their business model, and it seems curious that the institution is willing to take the productivity benefits in their normalised earnings whilst ignoring a portion of the costs needed to achieve these gains.

**Red flag 3: Significant divergence from comparable companies**

The warning sign we are looking for here is when a company consistently has higher average profitability, revenue growth or better working capital management than their industry peers. Invariably when management is asked, they will give an answer that relates to management brilliance or superior controls. Realistically mature companies operating in the same industry tend to exhibit very similar characteristics. As such, their financial statements should, to some extent, correspond to the statements of companies operating in the same industry.

For example, supermarkets such as **Woolworths** should have a similar cash conversion profile to **Coles** (operating cash flow divided by operating profits) and not dissimilar profit margins, as they are selling identical products to largely the same set of customers. Further, the major banks should exhibit similar bad debt charges on their mortgage books, though the overall bad debt charge could diverge if a particular bank was overly exposed to specific large corporate bankruptcies.

**Hollow logs?**

Occasionally management teams may be incentivised to under-report profits in any current period. This generally occurs when a company is under heightened union scrutiny due to wage negotiations with their employees, excessive government attention from perceived excessive profits, or expects a problem in the next year and wants to smooth their profits. For example, in the current environment of extremely low bad debts, a bank could be incentivised to boost its bad debt provisions aggressively. Increasing provisions would reduce current period profits, with excess provisions, if not required, could be written back later to boost future profits. This is potentially a politically astute move when politicians are getting extensive press coverage for calling out a company's headline profits, as Commonwealth Bank found out recently. What was ignored by politicians here was the divisor of 1.67 billion CBA shares on issue that saw earnings per share increase by only 8%.

**Our take**

Earnings misrepresentation is difficult for investors to detect from the publicly available accounts, but when revealed can sometimes have extreme results for a company's share prices. In my experience, this is more an art than a science, as the investor gets a sense that something is not right with the accounts rather than definitive proof of earnings manipulation. Normally actual manipulation generally only becomes obvious ex post facto after management has been removed or a company goes into administration.

*Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.*

## A world out of sync with inflation

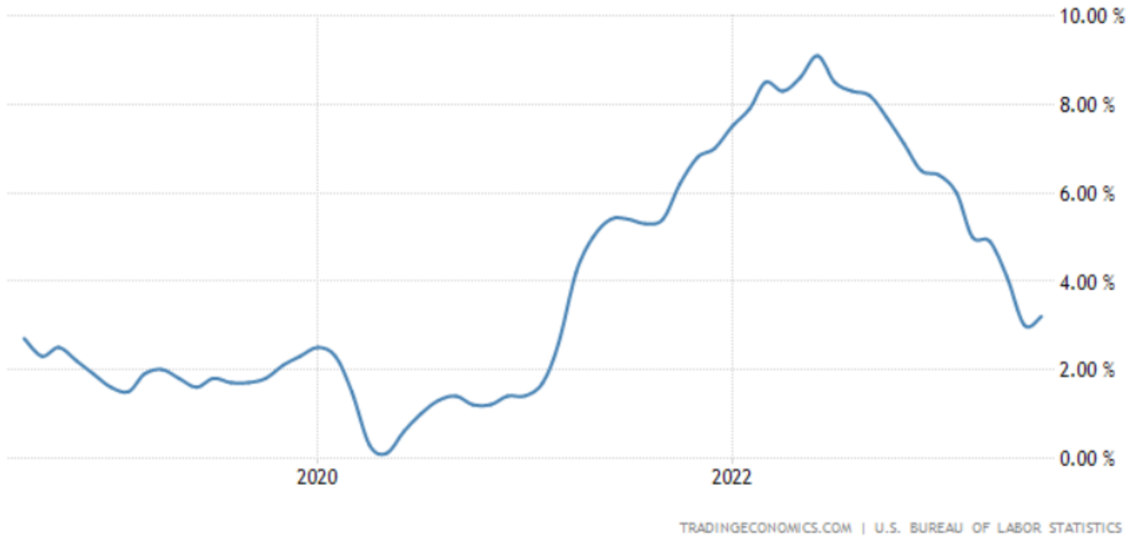
### Francis A. Scotland

It's a turbulent market environment. The S&P 500 Index and the U.S. economy have defied consensus pessimism this year. Investment hype surrounding artificial intelligence (AI) has gone manic. Europe's war keeps escalating. The Wagner Group's revolt could be a sign of even more instability. Climate change anxiety has been ramped up by the Canadian forest fires. The Organization of the Petroleum Exporting Countries (OPEC) has tried twice this year to support oil prices and failed. China's reopening has been underwhelming. The U.S. is facing massive budget deficits as far as the eye can see and a contentious presidential election race. The free market era of Thatcher/Reagan-ism has given way to populist political tribalism, big government, and industrial policies.

Handicapping the investment implications for any one of these developments is a major task. But for now, we still believe that the thing that matters most is inflation, despite all the noise.

Inflation has fallen a lot in the U.S. Optimism that it will keep falling is what has supported risk assets. We think it is going to keep falling, too. But the decision-makers at the Federal Reserve (Fed) are not convinced. Their job is to keep inflation on target. They believe policy rates and the unemployment rate need to go higher in order to push inflation back to target.

**United States Inflation Rate**




No one has the inside track on the inflation outlook, especially the Fed. Its credibility eroded, this is the same group of people who did not believe inflation could rise and remain as high as it did in 2022. Now they think it cannot fall without more pressure despite the second most inverted curve in history, the collapse in money supply and credit growth, and the disintermediation underway in the regional banking system. The Fed might be right but the justification for its viewpoint is mainly the inflation rate itself and the low level of unemployment. This stance implies no change in view or policy until after inflation has fallen, as was the case after inflation rose. And it is not just the Fed. Its perspective is the orthodoxy these days among western central bankers and high-profile economic commentators: higher for longer on rates.

**Inflation is set to ease**

Our view on inflation is more optimistic because:

- The financial and monetary variables point in that direction.
- Inflation is the final piece in a falling line of dominoes. What went up in 2020 and 2021—cryptocurrency, commodities, real estate, economic growth, and inflation—have retreated in perfect sequence starting late 2021 and early 2022. Now it is inflation's turn.
- We believe keeping conditions tight until inflation has receded to target is a strategy for overshooting the objective and moving straight to deflation. A lot of lip service—but perhaps not enough credence—is given to the notion of policy lags. What the Fed implements today affects the economy months or years later. The retreat in inflation seen since June of last year has little to do with Fed policy, in our view. The reaction to what the Fed has done or is going to do is yet to come.

For three years, we have stressed that post-pandemic economic developments should not be considered a business cycle. Our perspective is of an economy normalizing around a barrage of unprecedented shocks, beginning with the lockdowns and the bust. Next came the reopening and mega-stimulus. And lastly, the sudden and plunging reversal in monetary conditions. We wondered if all this unprecedented churn of excess savings, liquidity, and rising income growth as employment normalized would allow enough time for inflation to retreat and U.S. monetary policy to pull back. The worst-case scenario would be a shallow recession or below-trend growth—the economic profile more a case of sector-by-sector adjustment from the post-pandemic churn with some industries retreating and others expanding.

So far, that is what has been playing out. Falling energy prices and improved supply chains are positives for growth, which offset some of the negatives. Personal income and spending growth offer the best perspective on the enormous distortions; after three years, these two measures have realigned but with a very low savings rate.

What is not normalizing and what makes the Fed's job even harder is fiscal policy. Based on my calculations using U.S. Treasury data, government spending was US$6.6 trillion and rising for the 12 months ending May of this year, over US$2 trillion more than in December of 2019 or 46% higher and roughly US$1.2 trillion above the pre-pandemic trajectory. Despite the strength in the economy and the low level of unemployment, government spending relative to gross domestic product (GDP) is running at a pace more comparable to levels seen during recessions.

Federal Open Market Committee (FOMC) board members do not think they are done, maybe because they are fighting with fiscal policy. More things will break if the Fed follows through, and we are right in our inflation outlook. The first sign of systemic stress emerged last year in the UK pension industry. The second shoe to drop was this year's regional bank failures in the U.S. and ongoing disintermediation. The Fed's position means another shockwave is likely to hit before the central bank begins to ease up.

**A de-coupled world**

The diverse conditions outside of the U.S. do not change the story to any major degree. The Fed wants things to slow; China's leaders want things to pick up; the European Central Bank's (ECB's) monetary vice already has the economy in a technical recession, but it must do more because of stubbornly higher inflation; and in select emerging countries policy is even more stringent than in the U.S., judging by yield curves. This divergence explains why global growth is uneven and argues for much reduced inflation.

China's reopening has fizzled due to feeble domestic consumption. Nothing could be more crystal clear about the state of domestic demand in China than its inflation data. According to the latest data from China's National Bureau of Statistics, core CPI is close to zero, producer prices are falling, and China is exporting its deflation to the rest of the world.

Efforts to reflate the system with public policy are compromised by a number of factors. China's augmented budget deficit is probably already over 10%, based off an April 2022 report by the Institute of International Finance. The authorities do not want to boost leverage, nor do they want to fire up property speculation. However, the priorities of President Xi Jinping are the biggest impediments to rebooting China. Under his leadership, anti-corruption, national security, oversight of private companies, property speculation, and the stability of the Chinese Communist Party have taken priority over economic growth. President Xi did a U-turn on COVID containment late last year and elevated growth as a priority in the wake of public protests. But the follow-through has been tepid.

ECB rate hikes have already led to a technical recession, but it seems likely to worsen because of the economic zone's stubbornly high inflation rate. Europe's monetary profile is horrible, in my view; banks are not lending—annual growth in lending to both households and businesses dropped close to zero in April, according to the ECB. Bank lending is much more important in Europe than the U.S. and accounts for the majority of financial intermediation. The poor lending data rhymes with the June production manager surveys, showing a generalized contraction in European manufacturing. Meanwhile, the non-manufacturing survey is barely holding above 50. One reason for the stubborn nature of inflation is fiscal policy. Roughly 800 billion euros in fiscal support have been provided to EU business and households to help offset energy costs.

**Strategy**

We are bullish bonds, which is expressed across portfolios through investments in Treasury bonds, mortgage-backed securities (MBS) bonds, and select emerging market bonds.

The biggest pricing anomaly in the fixed income markets is the U.S. yield curve, more extremely negative than at any time in modern history except for the early 1980s. Yield curves in some emerging countries are even more inverted. We believe the risk/reward profile warrants long duration positioning. Everything mentioned earlier points to a bull steepener in the yield curve. A Fed-provoked recession could trigger a bond rally; our base case of falling inflation and a mild economic downturn would also support the bond market but with less upside.

There is some near-term risk to the upside in yields if the Fed continues to raise rates and nominal GDP growth remains strong a while longer. However, history shows GDP itself is a poor early warning indicator of a sudden drop-off in activity, the data generally remaining firm right up to the moment it weakens.

On the currency front, the U.S. dollar is overvalued based on most metrics but not in the extreme. In addition, tight monetary policy and expansionary fiscal policy is typically constructive for a currency, which is the current policy backdrop in the U.S. Consequently, our foreign currency allocations out of dollars are on a selective bilateral case-by-case basis.

*Francis A. Scotland is a Director of Global Macro Research at Brandywine Global, an independent affiliate of Franklin Templeton. Franklin Templeton is a sponsor of Firstlinks. This article is for information purposes only and does not constitute investment or financial product advice. It does not consider the individual circumstances, objectives, financial situation, or needs of any individual. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.*

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## Reform needed to allow donations from super to charity

### Rohani Bixler

Most Australians consider superannuation as their most valuable asset. Contemplating the intended recipient of these funds in the event of one's death is crucial. Nevertheless, this objective is accompanied by a significant restriction: Australians cannot allocate their superannuation benefits to charitable organisations.

**The need for reform**

As Australians' wealth continues to rise, superannuation is one of the most significant assets in an Estate. According to Association of Superannuation Funds of Australia (ASFA), superannuation accounts in Australia are worth $3.5 trillion in 23.4 million accounts as of March 2023.

Over the next two decades, it is projected that approximately $2.6 trillion will be transferred to future generations, presenting numerous Australians, particularly those with higher incomes, with the chance to financially support their dependents and extend it further by leaving part of their bequest to charitable organisations. Although Australians can nominate bequests to charities within their wills; for charities, being solely reliant on gifts in wills has some limitations.

It is estimated that only 59% of Australians have a will, and of those wills made, not all meet the formal validity requirements. Some donors also decide to leave behind non-monetary gifts in wills, where the emotional value far outranks the gift's financial value and cannot always be used like a pecuniary donation.

Despite some concerns, the contested rate for wills in Australia is generally low, with less than 5%, which may lead to intended charitable beneficiaries potentially receiving a somewhat reduced inheritance compared to the donor's original intentions.

Under current superannuation law, funds cannot pass directly from a superannuation fund to a charity. However, where assets pass from a superannuation fund into an Estate to be distributed through a will to a charity, the superannuation death benefits are subject to taxation, as the charity is not a tax dependent of the deceased member.

Given the tax advantages individuals receive when donating to Deductible Gift Recipient (DGR) charities while they are alive and the necessity for philanthropic contributions to grow in Australia, it is worth considering additional reforms to the regulations within the superannuation industry. These reforms would allow for direct donations from a superannuation fund to a tax-deductible charitable organisation, with the added benefit of ensuring that such contributions are received tax-free.

**Leaving a legacy to charities through your Super**

Enacting reforms that allow charitable organisations to directly receive death benefits from a superannuation fund within the current tax framework would have a limited financial impact. Still, it could potentially enhance benefits for charities. This is especially true considering the number of individuals who make superannuation nominations without creating a will. Since many Australians already possess a superannuation fund, they would not need to undertake the additional step of drafting a will and explicitly include a charitable donation. However, enabling tax-free charitable giving through superannuation will likely provide further incentives for philanthropic contributions from this source.

Ideally, the suggested reform in the superannuation sector would be complemented by tax reform that allows deductible gift recipients (charitable organisations) in Australia to directly receive superannuation death benefits as tax-free payments from the fund.

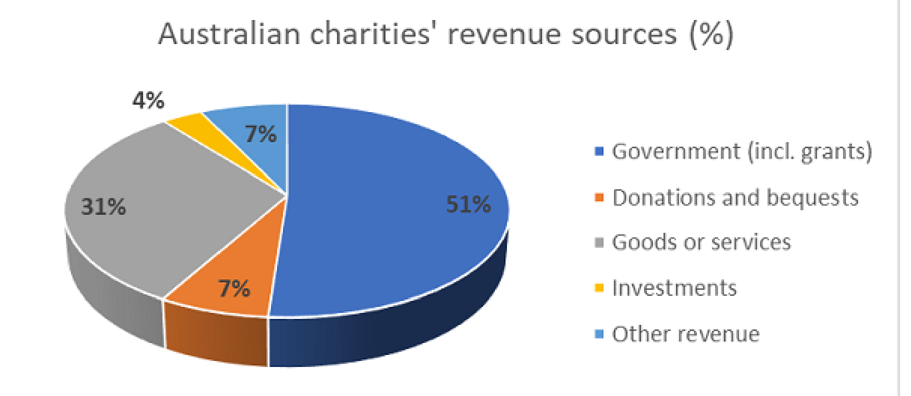
The current government has pledged to double philanthropic giving in Australia by 2030, to mirror giving levels in other countries. Prioritising and promoting charitable giving is crucial. This reform would generate a substantial upsurge in philanthropic contributions across Australia, leading to a transformative change in the philanthropic landscape.

**Giving back to society**

The Fundraising Institute of Australia and its Wills and Legal Taskforce are advocating for reform allowing Australians to make bequests through their superannuation. Institute CEO Katherine Raskob says:

"*We are working diligently as the peak body for the fundraising sector to bring about policy changes like this, which will have a profound impact on the further development of charitable donations in Australia. It is also an opportunity for all Australians to use their trusted asset to ensure the charity organisations that they hold dear or the causes they believe in continue to thrive, leaving a lasting legacy for themselves that extends beyond their lifetime.*"

She further adds, "*Over the next two decades, $2.6 trillion will be passed on to the next generation – if just five per cent were left to charity, this would release $130 billion to help all charities, big or small. So, you can imagine the impact. The reform is crucial for social change in our society to normalize philanthropic giving – particularly through gifts in Wills.*"



*Source: Australian Charities Report - 9th Edition. Figures from 2021 reporting period. https://www.acnc.gov.au/tools/reports/australian-charities-report-9th-edition*

**Empowering Australia's charitable future**

Allowing a nomination in superannuation enables a supporter to quickly provide their own 'future legacy' distribution for causes dear to them, underpinning donor support and charitable intentions. Even a small share of superannuation income donated to a charity can significantly impact the charitable cause (or causes) that the person cared about and supported during their lifetime.

Superannuation funds can serve as a significant source of income for charities. It can become a popular choice for individuals who regularly make charitable donations and offers an easy option for those who may be hesitant about donating during their lifetime. This approach will foster a sense of 'giving back to society' and allow Australians to leave a meaningful legacy through their wills or superannuation.

Australia's annual charitable giving amounts to approximately [$13 billion] and the new pledge to double the philanthropic giving by 2030 will substantially increase contributions towards various vital causes, such as children's health and education, care for the elderly and individuals with disabilities, human rights protection, and more. While also addressing broader concerns such as environmental conservation, preservation of natural resources, animal welfare, and the safety of endangered species. Charitable giving through wills and superannuation entails no cost during the donor's lifetime, yet it has the potential to impact numerous lives and causes after their passing. By leaving a lasting legacy, individuals are remembered for their contributions long after they are gone.

*By Rohani Bixler is, Principal Lawyer at Sage Succession Law. This information is intended for general use only, and is not intended as legal advice. If you intend to rely on any of the content, we recommend that you speak with a lawyer and/or seek out the source material to verify the legal position as it relates to your own circumstances.*

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