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Editorial

There's never a dull moment at the **Australian Securities and Investments Commission (ASIC)** but the regulator is lax in allowing the exemptions from consumer protections in financial services to operate unchanged for 22 years. I was reminded of the risks when someone I know forwarded to me a transaction which is totally inappropriate for them as an inexperienced investor. The offer from a licenced dealer is a complicated transaction designed to fund the dealer's own company. The only relationship my acquaintance holds with the dealer is signing up for a newsletter but with no other 'Know Your Client' knowledge.

ASIC's role is to promote "*a fair, transparent and efficient financial system for all*" which covers a lot of ground. ASIC is often criticised when it loses a court case or fails to identify poor behaviour quickly but regulating companies, banks, insurers, superannuation funds, financial advisers and credit providers is a never-ending whirlwind.

The ASIC Media Unit is a busy place. Consider these four recent announcements on consecutive days against **AustralianSuper, PayPal**, OTC derivatives and **Westpac**. Each of these projects would involve an enormous amount of background work before ASIC was confident enough to commence proceedings.

With all this work performed with meticulous care and an obligation to protect investors, it is surprising that ASIC does nothing to address the obvious shortcomings in the definitions of '**Sophisticated**' investors, sometimes called '**Wholesale**' or '**Experienced**'. The definitions determine who needs to receive regulated disclosure documents, who can invest in complex transactions and who benefits from consumer protections.

Under section 708 (8) of the Corporations Act 2001(Cth.), a Sophisticated Investor is defined as having:

- Gross personal income over the last two years of at least $250,000, or
- Net assets of over $2.5 million

As proof, a Qualified Accountant must provide a certificate.

There are three obvious weaknesses:

1. Net assets include the family home, and millions of Australians are now eligible as 'sophisticated' due to the rise in the value of their home. That makes them more like gullible targets than sophisticated in their investing.
2. The dollar limits have not been reviewed since they were set in 2001, and if values had been indexed to CPI, the net assets would be about $4.5 million.
3. Family accountants are accommodating when it comes to the wishes of their valued clients and anecdotally, the certificates are not hard to obtain.

The second exemption as 'Experienced' is as bad. In the Corps Act Section 708 (10), offers can be made by a licenced dealer following an assessment of merits and risks and information needs of the investor. This leaves it to the judgement of the dealer to market securities to almost anyone in order to make a sale and generate a commission.

ASIC needs to review these definitions as the door is wide open for unscrupulous activity, and at least remove the family home from the assets definition.

Anyone who believes all brokers and advisers and other financial services licensees only have the best interests of their clients at heart should be reminded of why selling commissions on capital raisings were banned. The finance industry loves the exemptions and it makes marketing easier but clients are giving up the consumer protections which exist for a reason.

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Warren Buffett has warned many times not to underestimate Corporate America and its ability to generate profits in difficult markets. He said:

> *"I have yet to see a time when it made sense to make a long-term bet against America. And I doubt very much that any reader of this letter will have a different experience in the future. We count on the American tailwind and, though it has been becalmed from time to time, its propelling force has always returned."*

The Magnificent Seven companies that have driven the US S&P index higher in 2023 look expensive but they are much healthier than the leading companies in the Tech Bubble of 2000. The S&P 500 has risen 22% in 2023 but NASDAQ is up over 30%. **Berkshire Hathaway** recently announced a record quarterly profit of US$36 billion and cash of US$147 billion. Buffett's biggest problem is finding a way to invest it but at least he is earning a decent rate on short-term US cash and bonds.

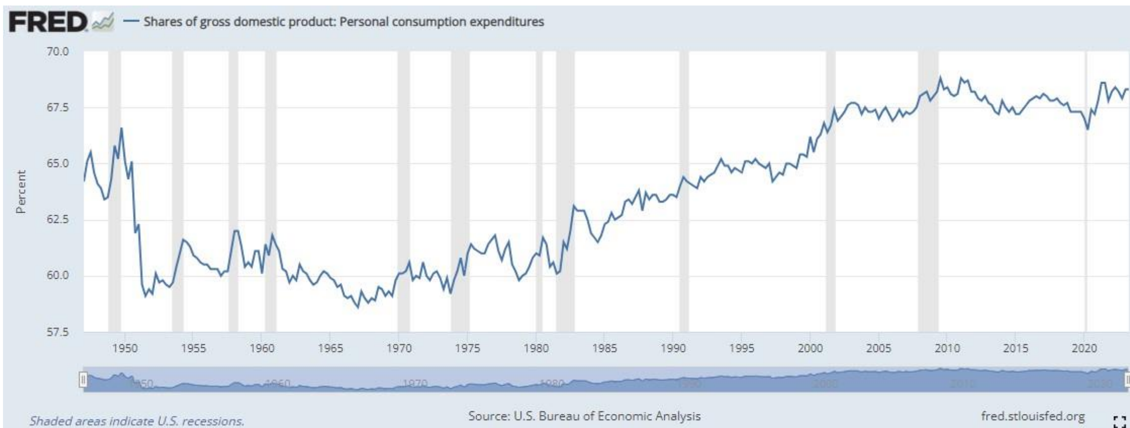
Exhibit 12: The current crop of leaders is already very profitable and cash-generative

Next twelve month estimate for Big Tech & last twelve months for Tech Bubble

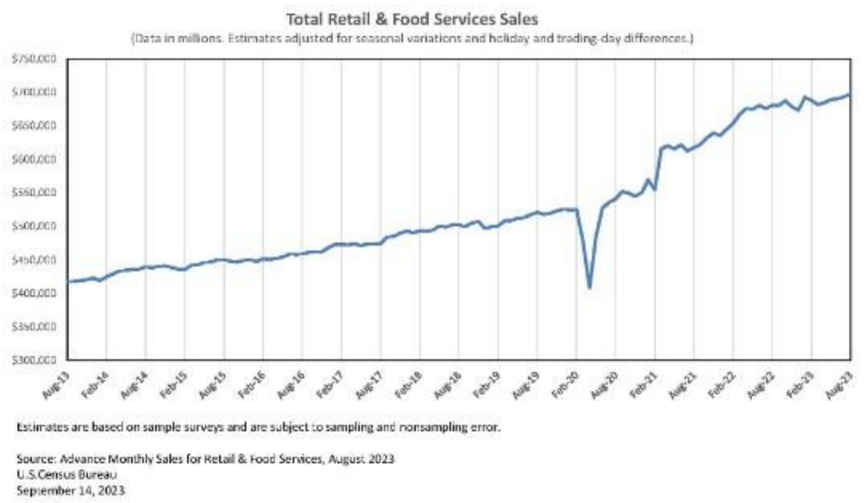
	Market Weight (%)	Fundamentals			
		Cash as % of Market Cap	Net Debt to Equity	Return on Equity (%)	Net Income Margin (%)
Big Tech					
Apple	7.9%	1.6%	-0.3	137%	25%
Microsoft	6.5%	3.8%	-0.3	30%	35%
Alphabet	4.2%	3.9%	-0.4	24%	24%
Amazon	3.8%	8.3%	-0.1	13%	5%
Nvidia	3.2%	3.4%	-0.5	62%	46%
Tesla	2.1%	4.4%	-0.4	21%	12%
Meta Platforms	1.7%	4.8%	-0.3	22%	28%
Big Tech Aggregate	**29.3%**	**4.3%**	**-0.3**	**44%**	**25%**
Tech Bubble					
Microsoft	4.5%	3.0%	-0.6	35%	39%
Cisco Systems	4.2%	0.9%	-0.2	22%	17%
Intel	3.6%	7.7%	-0.3	26%	25%
Oracle	1.9%	0.8%	-0.6	39%	15%
IBM	1.7%	2.7%	1.1	39%	9%
Lucent	1.6%	0.9%	0.4	36%	9%
Nortel Networks	1.5%	1.1%	0.0	-1%	-1%
Tech Bubble Aggregate	**19.0%**	**2.4%**	**0.0**	**28%**	**16%**

Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Bear in mind that the US economy is substantially self-contained, with personal consumption expenditures by Americans as a percentage of GDP rising steadily over the last 50 years to about 70%.



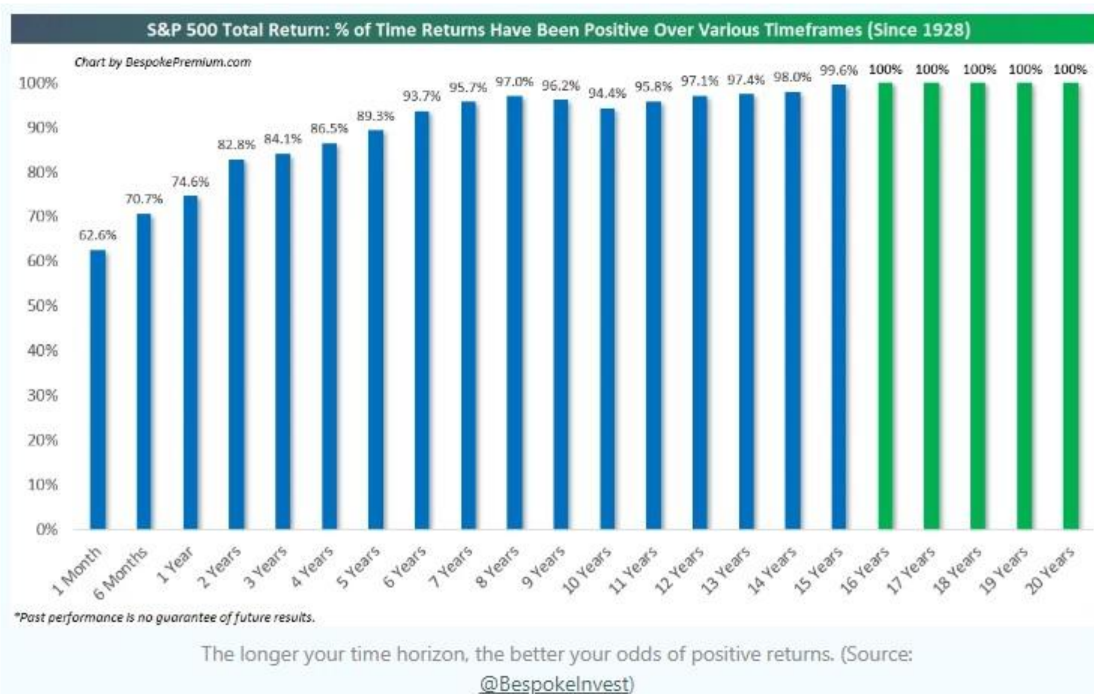
Confirming the resilience of the US consumer, despite rising rates and the threat of a recession, retail and food services continue to rise. So the big question for markets is whether rising oil prices and depleted savings will rein in spending. As usual, investors benefit from taking a long-term view, even if prospects for late 2023 and 2024 look rocky.



Retail sales continue to beat expectations and rise. (Source: @USCensusBureau)

This is why the long run matters. Over a day or two or even a week, the chances of the market rising or falling is close to 50%, but the longer the time period, the more likely the market will rise. As [Bespoke Investment Group](#) in the US says:

> *"Historically, the odds of the S&P 500 being up over any one-month time frame have been 62.6%. Over a year, the odds of being up jump to 74.6%, and over eight years, they jump to 97%. Since 1928, all 16+ year time frames have seen positive returns."*



The longer your time horizon, the better your odds of positive returns. (Source: @BespokeInvest)

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This week, we check the reasons why some managers of Listed Investment Companies (LICs) and Trusts (LITs) are winding up the structures in favour of listed or unlisted alternatives. Many other fund managers should do the same if they have the best interests of their investors prioritised but they will hang on to retain the fees.

Still on LICs and LITs, **Claire Aitchison of Independent Investment Research** gives a comprehensive review of the performance of many asset categories over FY23 and the dividends or distributions paid. It demonstrates how much of the total return is dependent on movements in the share price in and out of discount and premium, and even a good portfolio performance can be undermined by a heavy slip into a wider discount.

Graham Hand

Also in this week's edition...

Retiring means your salary stops and you need to fund your lifestyle using savings plus any social security entitlements. **Jim Hennington** from **Apricot Actuaries** looks at the best ways to maximise income so that it lasts through retirement.

Schroders says BHP and Rio Tinto have eerily similar mining exposures and they've never been more alike than they are now. Yet, it prefers one stock over the other. And analyst **Sally Warneford** also delves into ASX healthcare stocks and why the best days of CSL are likely behind it.

Some investors seeing the explosive share price performance of Nvidia are comparing it to Cisco in the 1990s. It raises the question about what your returns would have been like holding Cisco from its heyday in the mid 1990s to now, compared to a more staid stock such as a bank. **Geoff Saab** from **Low Risk Rules** has the answer.

This week's ***Wealth of Experience*** podcast features **First Sentier's Rudi Minbatiwala** explaining the best strategies for growing ASX dividend income, **Graham Hand** on investing for free (ish), and **MFS' Anne Marie Bernard** on incentivising fund managers and preventing stars from jumping ship.

Australian investors have fallen in love with bonds again as they now offer yields that haven't been there for a decade or more. But **Jeremy De Pessemier** and **Ray Jia** from **The World Gold Council** suggest a resurgence in inflation remains a key risk for bonds, and that's where gold can play a key diversifying role within an investment portfolio.

Lastly, in this week's White Paper, **Schroders** looks at the advantages of private debt as an asset class in a slowing economic environment.

Curated by James Gruber and Leisa Bell

Why LICs are closing and more should follow

Graham Hand

The fundamental strength of Listed Investment Companies (LICs) and Trusts (LITs) is also their fundamental weakness. The **strength** of the structure is the committed capital which means portfolio managers are not forced to sell assets to meet redemptions. The **weakness** is that without the manager providing liquidity, it must come from the market. If there is insufficient buying demand for the selling supply, the price falls to meet investors prepared to buy at a discount to the value of the underlying Net Tangible Assets (NTA) or Net Asset Value (NAV). LICs are companies that issue shares whereas LITs are trusts that issue units, but this article will mainly use 'LICs' for both.

LICs are called ‘closed-end’ because there is a fixed number of shares on issue, as opposed to ‘open-end’ such as Exchange Traded Funds (ETFs) and unlisted managed funds, where managers create or retire units in the fund according to demand. Open-end funds can absorb shocks through the issuing and redeeming of units and trade around the value of their NTAs.

Kicking the can down the road

Managers have developed techniques to compensate for inadequate liquidity in their LICs, including:

- Buying back shares at a discount
- Increasing marketing efforts to improve buyer demand
- Committing to regular payment of dividends

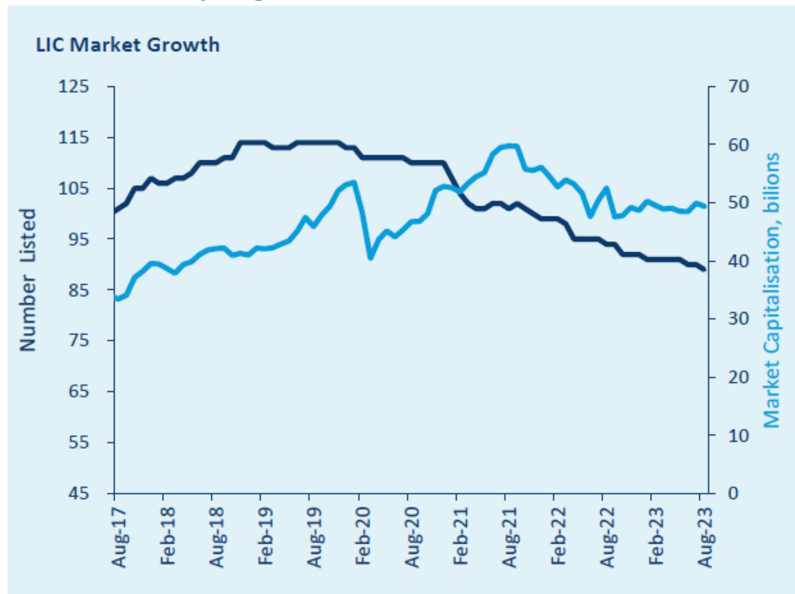
Share buybacks are common but often fail, reduce the size of the company and increase the percentage cost of fixed expenses. Buybacks do not create new buyers but liquidity for sellers and they tend to simply kick the discount can down the road.

In frustration at the poor investor experience, and embarrassment that buyer support is insufficient, managers are giving up, moving their LIC money into another structure which allows investors to redeem close to NTA.

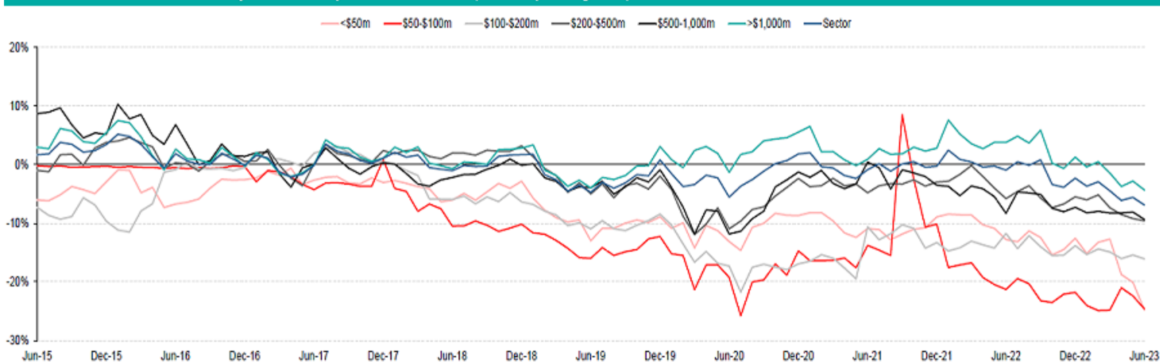
LICs struggling with large discounts

According to the [Australian Securities Exchange](#) (ASX), there were 89 LICs with a market capitalisation of $49.4 billion as at August 2023. Rival exchange Cboe offers 20 listed managed funds. The number on the ASX is down from a peak of 115 in 2019, a reduction of 26 LICs and LITs in four years.

According to Bell Potter, as shown below, LICs are close to their widest discounts to NTA in history, with smaller LICs (less than $100 million) at around 25%. Even the large LICs which have traditionally traded around NTA due to decades of investor support and large shareholder bases are currently at discounts.



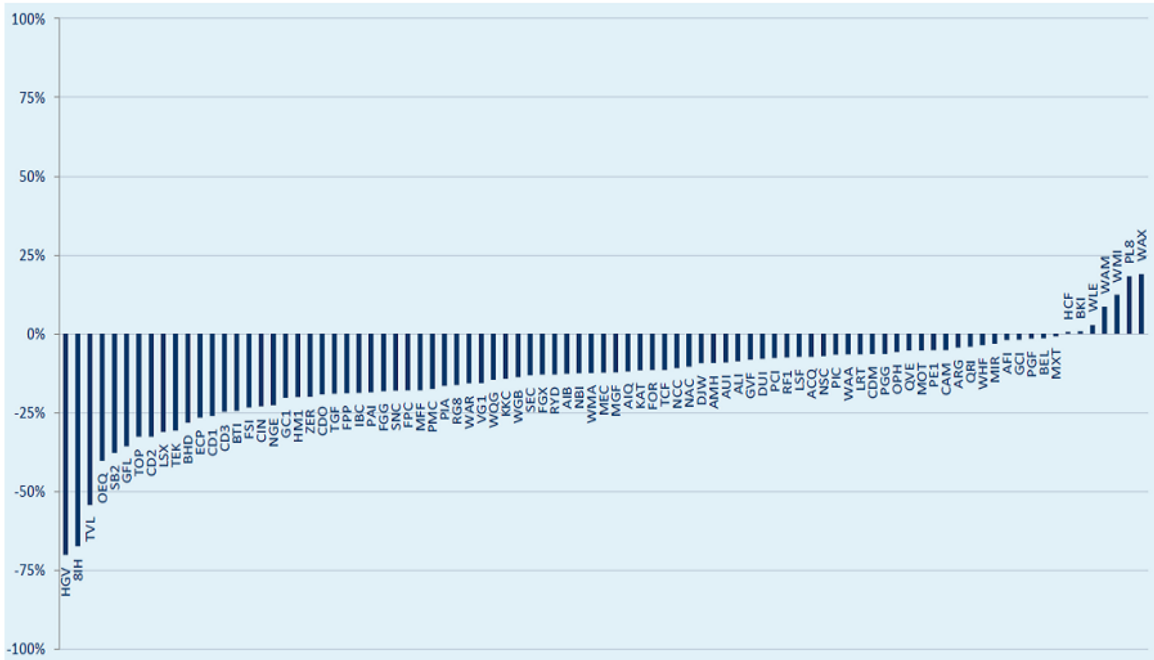
Source: ASX Investment Product Summary, Augst 2023. Black line is number.



Source: IRESS, Company Data, Bell Potter Estimates

The table below identifies the discounts for many of the leading LICs. Two notable exceptions are Plato (ASX:PL8) and three of the Wilson funds (ASX:WAX, WAM and WMI), with the premium driven by a strong reputation for delivering income which encourages buyers to focus on the dividends rather than the premium, plus an ongoing commitment to marketing.

It's a strange investment in Plato at a current premium of about 24% when the unlisted managed fund run with the same strategy is available at NTA and accessed easily via the ASX online mFund service.



Source: Bell Potter LIC Report, 1 September 2023

However, marketing is not a panacea for all funds, as Wilson also has as many funds trading at large discounts, such as WAM Active (ASX:WAA) -13%, WAM Strategic (ASX:WAR) -15% and WAM Global (ASX:WGB) -14%. It is ironic that WAR was launched to buy LICs and LITs at a discount and it suffers the same fate as its targets. In fact, Geoff Wilson says one of the joys of LICs is buying $1 of assets for 80 cents, and with WAR, they can be bought for 15% less, or 68 cents (disclosure, the author owns WAR in his SMSF for this very reason). But it's not much comfort for the investor who bought the initial offer at $1.

Why did Partners Group Global Income delist last month?

On 2 August 2023, unitholders voted to remove Partners Group Global Income Fund (ASX:PGG) from its listing on the ASX. This is not a market minnow shrinking away from its listing because its small size cannot cover listing costs. The fund has a market capitalisation of $465 million and is managed by a leading global fund manager with over $200 billion in assets under management globally (and another declaration, the author owns units in this fund).

Why did its investors who bought into the listed structure, which in theory offers on-market liquidity, vote to delist?

Here are some of the reasons given by Partners Group:

1. The lack of liquidity on the ASX has resulted in PGG trading at a discount to its NTA about 90% of the time, with a discount more than 5% for about 40% of the time. Units have traded in the range of 18% discount to 3% premium, with an average discount of 15% in the last six months.
2. Unitholders continue to give negative feedback about the discount and request Partners Group to address it.
3. Alternatives such as share buy-backs would only increase the unit price in the short-term with no lasting impact.
4. The proposed change to an open-ended unit trust gives an ability for investors to realise an investment at NTA and a better ability for Partners Group to increase the fund's size.

Partners Group advised it will initially limit the liquidity in the new fund, which will give it time to arrange an orderly sale of its investments if needed:

"Currently the Fund is traded on the ASX with liquidity provided from the matching of buyers and sellers on price and volume on market. If the Fund is transitioned to an open-ended unit trust, it is anticipated that net withdrawals of Units in the Fund will be limited per month to 5% of NAV at the end of the preceding month (unless the Responsible Entity waives such restriction). This can potentially restrict Unitholders being able to withdraw their Units in the Fund for a significant period."

Partners Group also said *the "Regulatory changes to the way that LITs are distributed to investors"* have compromised the merit of the LIT structure. Specifically, this is the ability to pay brokers and advisers a stamping fee to sell additional paper to their clients. This was always a highly-dubious distribution method, with sellers incentivised to put clients into new transactions based on the fee rather than the merit of the transaction. As firm evidence that it was the stamping fee driving the market, not genuine demand, the new issue market for LICs and LITs has almost disappeared without these payments.

Reasons for other delistings

Other managers have removed their LICs and LITs, and here are five examples and their reasons:

1. Simon Shields of Monash Investors closed his LIC (ASX:MA1) in 2021 in favour of an exchange-traded managed fund (ETMF) (ASX:MAAT). He told the **AFR**:

"LICs have been trading at a discount for a long time in Australia and it doesn't seem like that's going to change. We've come from first tier fund managers and stockbrokers. We just felt it was besmirching us to be managing a LIC that was trading at a discount and we weren't prepared to have this situation continue."

To Shields' credit, he knew some large activist managers had bought the LIC at a discount and at least one-third of the fund would be redeemed. Unfortunately, redemptions have continued and the size of the fund is now $18 million from $64 million at the time of the restructure. Said Shields:

"ETMFs are a better solution for having a listed investment product. Any reputable fund manager with their LIC at a discount has got to be worried that that's an unfair situation and reflects poorly on them as fund managers."

2. One of the country's most prominent investors, Ellerston's Ashok Jacob, previously manager of Packer family money, delisted his global equity LIC (ASX:EGI) in 2019, saying in a letter to shareholders:

"It's important to note that the discount, while unacceptable, is an industry-wide phenomena, with the listed global equity sector trading at an average discount of over 17% as at 30 September 2019, and is often a reflection of market sentiment volatility and other events which can reduce investor demand."

3. In 2021, Antipodes converted its LIC (ASX:APL) to its 'Quoted Managed Fund' (ASX:AGX1) after many previous attempts to close the discount. It advised:

"APL's Board has over the past two plus years been actively considering a range of options to address the unacceptable position of the APL share price trading at a discount to its NTA. Initiatives undertaken have included an accelerated on-market buy-back program, enhanced shareholder communication and the Conditional Tender Offer (CTO) approved by shareholders in November 2020. Nevertheless, the discount has persisted."

4. Also in 2021, the Australian Leaders Fund (ASX:ALF) delisted after agitation from shareholders, and investors were converted into the unlisted Watermark Absolute Return Fund. In this case, the delisting was the prevent a takeover and a loss of funds for the manager.

The most common reason funds delist is either forced or voluntary merger or takeover. Wilson has absorbed Premium Investors, Wealth Defender, Century Australia, PM Capital Asia and Absolute Equity into WAM Leaders. The Templeton Global Growth Fund (ASX:TGG) was merged into Wilson's global LIC (ASX:WGB).

5. While in some cases the takeover has been unwelcome, such as the public fight with PM Capital, in other cases, such as Absolute Equity (ASX:AEG), the Board wanted to delist to remove the discount which was not viewed favourably by AEG's portfolio manager, Sam Shepherd. He preferred to focus on his unlisted business. The Board entered a consultation process in February 2022 where:

"the AEG Board and its advisors evaluated a range of alternatives with a view to maximise value for all AEG shareholders."

Alignment of interests

The managers at Monash, Absolute Equity, Ellerston, Antipodes and Partners Group should be applauded for elevating the rights of their investors. They all decided the discount was permanent and not a good reflection on their brand nor beneficial for clients. Investors who supported an IPO at a $1 take no comfort in seeing the price at 80 cents, even if new investors receive a low entry price.

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Why are other managers not acting in the best interests of investors? Mostly, they want to retain the funds and fees of a closed-end vehicle. The heavy redemption experience at Magellan and Platinum in recent years shows how money can leak out of open-ended funds. There is market speculation that Magellan may convert its global LIC (ASX:MGF) after options expire in March 2024. Magellan has form after converting its High Conviction Trust (ASX:MHH) to an ETF. More on this in another article.

One way to judge who else should convert is to evaluate the long-term discount history, as reported for example by Bell Potter and featured in the Firstlinks Education Centre. It shows the average Premium/Discount over various time periods out to five years, and the five-year range of highest premium to lowest discount. If a LIC or LIT has been at a high discount for five years, it is unlikely to recover enough support to push towards its NTA, especially facing such intense pressure from cheaper ETFs.

Another factor rarely discussed is that managers charge fees on the full NTA, not the market value. This can grosses up the percentage fee versus an unlisted fund. For example, if a fund has an NTA of $100 million and a fee of 1% pa, the manager collects $1 million a year. If the LIC is trading at a discount of 20%, $1 million on $80 million is 1.25% pa, and to rub salt into the wound, there may be a performance fee as well.

Here are some funds which have (based on the Bell Potter numbers for 1 September 2023):

- A current large discount
- A five-year large average discount
- A range of high to low discounts over five years which are all negative

Name of Fund	ASX Code	$m Market Cap	Current Discount %	5-year Average Discount %	5-year Low (highest discount) %	5-year High (lowest discount) %
Carlton Invest	CIN	761	-24.2	-20.9	-24.4	-9.8
QV Equities	QVE	207	-9	-9.4	-15.4	-1.8
Thorney Opp	TOP	93	-30.8	-22.6	-32.8	-13.6
NAOS Small Cap	NSC	99	-10.6	-16.1	-37.8	-9.8
Sandon Capital	SNC	89	-19.3	-12.7	-28.1	-5.7
Regal Asian*	RG8	388	-11	-16.0	-25.8	-4.5
Magellan Global	MGF	2,536	-12.1	-10.3	-22.9	-2.5
Pengana Inter	PIA	271	-17	-11.4	-24.7	-2.8
WAM Alternative	WMA	207	-12.5	n/a	-16.2	-8

**Regal Asian is the old VG8 (VGI Partners Asian Investments) formed when Regal and VGI merged.*
All numbers taken from Bell Potter LIC Report Indicative NTA for 1 September 2023.

The boards and management of these LICs need to justify to their investors why they believe in a future turnaround in the discount despite little evidence for at least five years. There are many more in a similar position. It's not that the managers have weak governance, little marketing or even poor reputations, but how are they balancing their own desire for fees against the ability of investors to realise full value?

A small manager such as NAOS or Sandon needs the funds to run their business. Some managers argue that the LIC or LIT structure suits less liquid assets which cannot be sold easily to meet redemptions. Sebastian Evans at NAOS told Morningstar that he needs the committed capital of a LIC structure:

"If we converted to an active ETF and needed to liquidate our holdings it wouldn't work. We have a 30% holding in a business. I can't sell that in a day or two."

But there are plenty of unlisted property funds which manage liquidity by limiting redemptions at NTA to a certain amount or time period.

Larger managers with far more in their unlisted funds should consider whether the hassle of listing a small part of their business is worth it. When I sat on the board of Peter Morgan's 452 Capital, the operations people spent as much time on the small LIC as the rest of the much larger unlisted fund business.

Where do LICs stand now?

The development of active ETFs or ETMFs is relatively recent, opening the way for LICs to convert to listed open-ended versions, as well as unlisted funds, to close the discount. Managers with large discounts face disgruntled investors, activist competitors and the rising demand for ETFs.

Although discounts are historically wide at the moment, many of the large, traditional LICs have a record of drifting in and out of discount, and these can present opportunities for investors. There is a role for the right managers with the right LICs but it's time for many other managers to move on.

Footnote

In a fascinating development for the King of LICs, Geoff Wilson has announced plans for an open-ended version of WAM Leaders, looking to raise $500 million to $1 billion. It will be his first move away from closed-end LICs since his initial fund about 25 years ago.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. Graham holds some of the securities mentioned in this article and was on the Board of Absolute Equity Performance Fund until two years before its delisting.

LIC and LIT performance and dividends in FY23

Claire Aitchison

The FY23 earnings season wrapped up in August. In looking at the performance of Listed Investment Companies (LICs) and Trusts (LITs) over the year, this article examines pre-tax Net Tangible Assets (NTA) after tax on realised gains and before tax on unrealised gains for LICs and the Net Asset Values for LITs, as well as the dividends and distributions declared over FY23.

Performance of NTA/NAV and share prices versus indexes

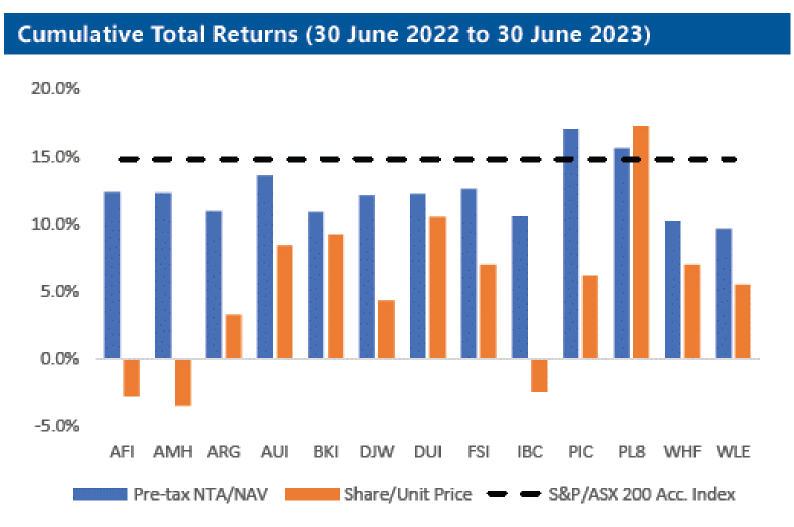
For comparison purposes, we include the performance of relevant broad market indexes but index performance is reported before tax.

Over FY23, global markets performed better than the domestic Australian market with the MSCI World Index in AUD terms increasing 22.4%. The ASX All Ordinaries Accumulation Index rose 14.8%. Australian small caps recouped some of the losses from FY22, although underperformed large cap stocks with the ASX Small Ordinaries Accumulation Index up 8.4% over the 12-month period.

Here is how some major LICs and LITs performed.

Australian Equities - Large Cap

PIC and PL8 were the only two portfolios (based on the pre-tax NTA and NAV) that outperformed the S&P/ASX 200 Accumulation Index over the period, however, PL8's returns are grossed up for franking credits. PIC's portfolio was buoyed by its international equity holdings with its largest global holding, Flutter, up over 100% in FY23.

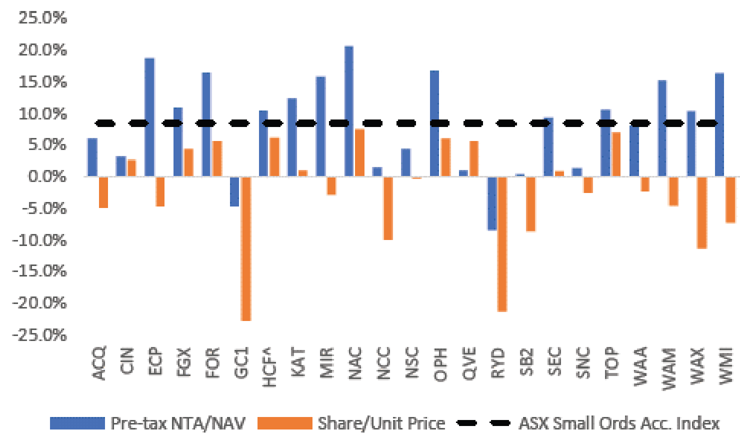


However, while all portfolios delivered positive returns, share prices dislocated from portfolio performance. Notably, AFI's shareholder return was negative for the period as the share price re-rated from a substantial premium back towards the portfolio value. The insatiable appetite for

the fully-franked monthly dividends saw PL8 trade at a substantial premium to pre-tax NTA.

Australian Equities - Mid and Small Cap

The portfolio performance of the Australian Mid and Small Cap category was mixed as only 13 of the 23 LICs/LITs outperformed the ASX Small Ordinaries Accumulation Index although all but two LIC/ LIT portfolios generated a positive return. This compares to the FY22 period where no LIC/LIT in the category had a positive portfolio return, a period where the ASX Small Ordinaries Accumulation Index was down 19.5%.



< HCF returns are from 31 October 2022 to 30 June 2023 as the company has less than 12 months of performance history.

After NAC, OPH, ECP and FOR had the worst-performing portfolios in the FY22 period, these four LICs/LITs had the best-performing portfolios in the FY23 period. While all four LICs and LITs bounced back strongly, none recouped all the declines experienced in FY22.

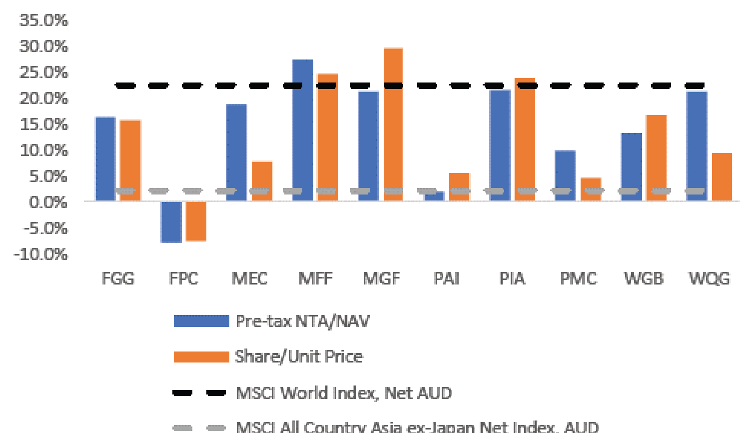
While portfolios performed strongly, the same can't be said for shareholder returns, with shareholder returns weak compared to portfolio performance. Despite only two portfolios posting a negative return over the FY23 period, 13 had negative shareholder returns, with the two LICs/ LITs that had negative portfolio returns hit the hardest.

WAA, WAM, WAX and WMI all had negative shareholder returns as the market prices re-rated back towards portfolio values. While WAM maintained its dividend for the FY23 period, the sustainability of the dividend is coming under increasing pressure with the share price reflecting the increased risks associated with the sustainability of the dividend. WAM traded at a discount in the FY23 period for the first time in 10 years. While the share price has factored in some of the risk, we think the share price will likely come under further pressure in the event of a dividend cut.

Despite ECP and MIR generating portfolio returns of in excess of 15%, shareholder returns were negative with both LICs trading at discounts as at 30 June 2023.

International Equities - Diversified and Emerging Markets

All but one LIC/LIT delivered a positive portfolio performance over the period with those portfolios with large exposures to the US market delivering the best performance.

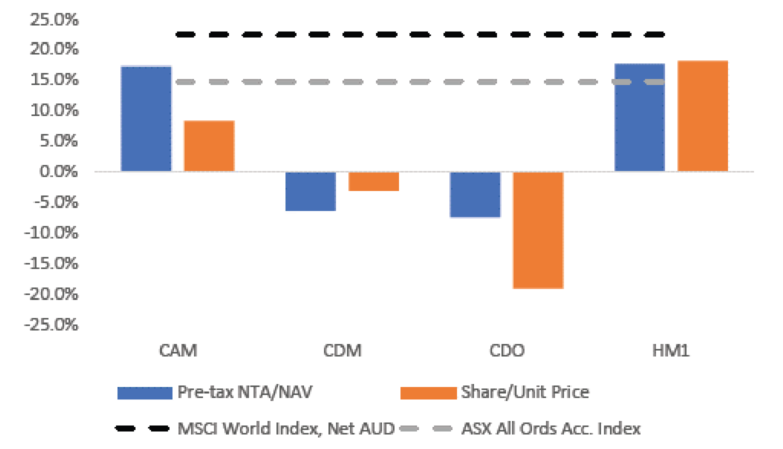


PAI invests in the Asia ex Japan region, a market which significantly lagged the global market over the FY23 period. The MSCI All Country Asia ex- Japan Index in AUD terms increased just 2.1% with China being a significant drag for the region. This weighed on the returns of PAI, the pre-tax NTA of which delivered just below market returns for the period.

PMC had an overweight exposure to China over the period and a heavily underweight net exposure to the US which weighed on its returns for the period.

International/Australia Equities – Blended

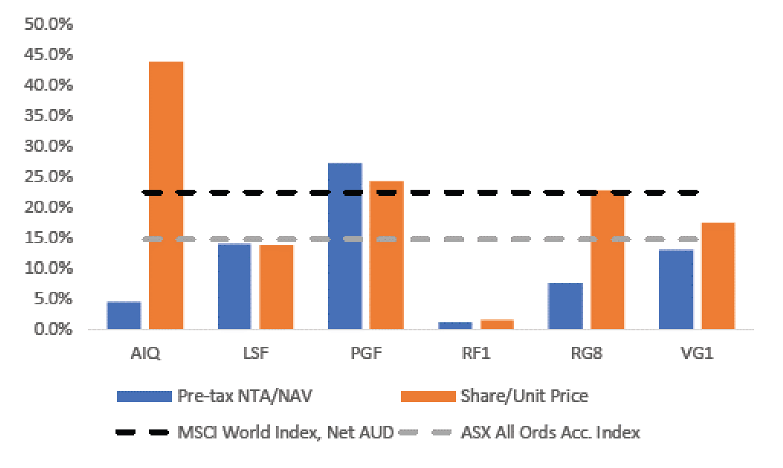
The portfolios of CAM and HM1 performed strongly over the FY23, rebounding from the declines in the FY22 period. While improved, the HM1 portfolio still has some way to go to make up for the substantial declines in FY22. HM1 has embarked on a number of changes with regards to the construction of the portfolio in response to the declines experienced in FY22.



CDM and CDO both experienced declines in the portfolio performance. Both LICs had high levels of cash over the period, which provided a level of downside protections but was also a drag on the portfolio when compared to the market returns. CDO's shares sold off to a greater extent than the portfolio decline which resulted in the LIC trading at a discount at 30 June 2023.

Absolute Return

PGF continued its strong performance over the FY23 period with the portfolio being the best performer in the category. After the substantial underperformance of the broader market in FY22, the VG1 portfolio pared back some of the losses, with the pre-tax NTA increasing 13.0% for the FY23 period. Shareholders also received some reprieve with the shareholder return outperforming the pre-tax NTA as a result of the discount narrowing. However, the company continues to trade at an expanded discount.



LSF generated a positive return over the period with the pre-tax NTA being one of the better performers of the peer group over the short-and-medium term periods. However, with the high watermark as the performance hurdle, shareholders have seen significant fee leakage in the last two financial years.

RF1's portfolio saw a marginal increase over the FY23 period. During the year, the Trust added three new strategies to the portfolio, diversifying the portfolio by asset class and strategy with the addition of the Water Strategy, the Private Credit Strategy and the Resources Royalties Strategy.

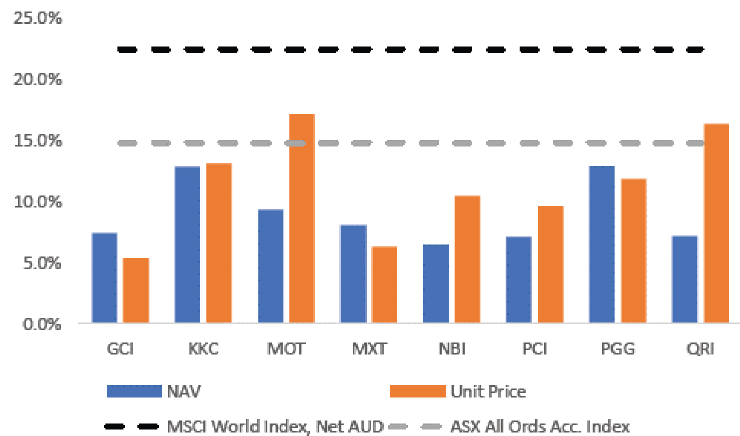
Fixed Income

The Fixed Income LITs performed strongly with the unitholders of portfolios exposed to floating rate securities benefiting from the rising interest rate environment.

The LITs that provide exposure to direct loans continued to maintain steady NAVs, providing an increased income stream and low levels of capital volatility.

During the year, there were periods at which some of the LITs providing exposure to direct debt were trading at elevated discounts with the expectations of a slowdown weighing on market prices. As fears eased and inflation subsidised from its peak the private debt LITs that are considered to provide riskier exposure, MOT and QRI, re-rated back towards their NAV with unitholder returns outperforming NAV returns over the period. QRI's unit price was further buoyed by the introduction to the ASX All Ordinaries Index after being reclassified as a MREIT.

Cumulative Total Returns (30 June 2022 to 30 June 2023)



After experiencing significant declines in FY22 due to the exposure to predominantly fixed rate high yield bonds, NBI generated a positive performance for the FY23 period.

Dividends and distributions

LIC and LIT share/unit holders fared well with 79% of LICs and LITs either maintaining or increasing their ordinary dividends/distributions on the prior year. The trust structure of LITs means they are required to pay out all income and realised capital gains generated in any given year. As such, distributions are dependent on the performance of the portfolio in any given year which can lead to high levels of distribution volatility. This compares to the company structure of LICs, which allows them to reserve income and capital gains for future dividend payments.

Tribeca Global Natural Resources Limited (ASX: TGF) and H&G High Conviction Limited (ASX: HCF) paid maiden dividends during the period with HCF listing during the FY23 period. As a category, the Fixed Income LITs delivered the greatest increase in distributions with a median increase in distributions for the FY23 period of 34.6%. Fixed Income LIT unitholders benefited from the increasing interest rate environment.

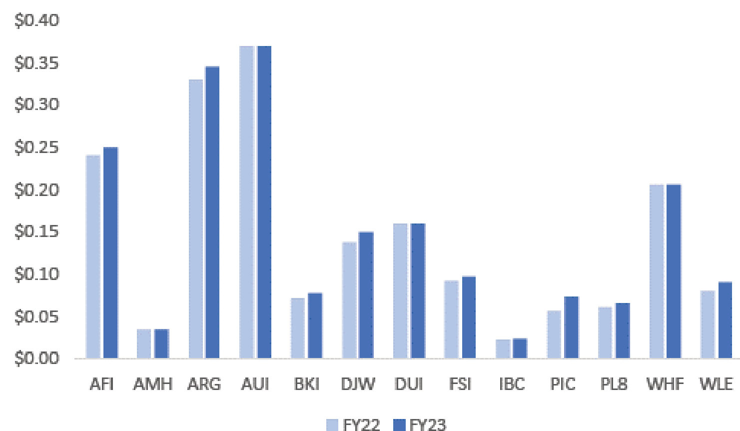
Australian Equities - Large Cap

All Australian Large Cap LICs and LITs either maintained or increased the ordinary dividends/distributions for the FY23 period.

PIC delivered the greatest increase in dividends with a 30.4% increase in ordinary dividends with the LIC delivering the greatest full year dividend in its history in the FY23 period. The dividend increase was a result of strong portfolio performance with PIC's portfolio being the best performer in the category over the FY23 period, as discussed above.

WLE continued to increase the dividend with the LIC increasing the dividend amount in each financial year period since the commencement of dividend payments in 2017.

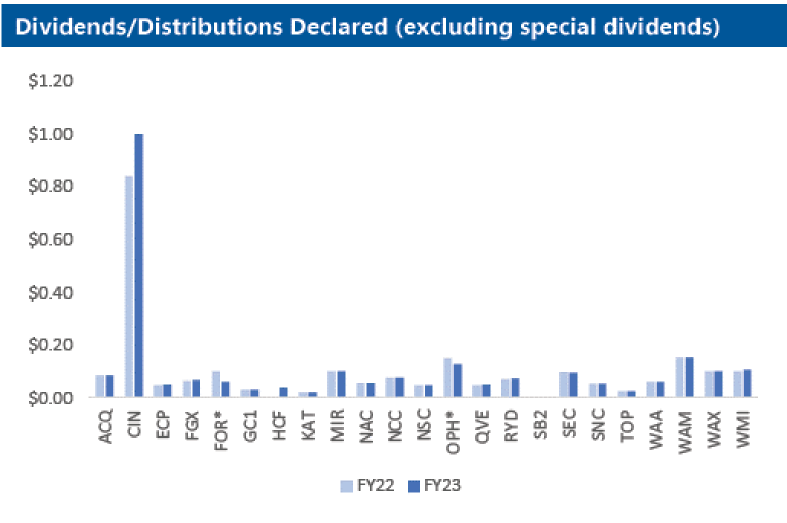
Dividends/Distributions Declared (excluding special dividends)



DJW continued to deliver improved dividends with dividends increasing 9.1% for the FY23 period to 15 cents per share. The increased dividend reflects the Company's revised dividend policy in which the dividend will reflect the Net Operating Profit per share (which excludes the impact of open option positions). The amended dividend policy provides a more sustainable dividend policy for the Company while allowing for potential NTA growth. The Company has paid an increasing dividend in each semi-annual period since the lows of the interim dividend in FY21, reflecting the improved Net Operating Profit, which was back above 2019 levels in FY23.

Australian Equities - Mid and Small Cap

There were three LICs and LITs that declared declines in dividends/ distributions, two of which were LITs. Distributions of LITs can be volatile given LITs payout the distributable income in any given year which is impacted by both income received and realised gains. The third was Spheria Emerging Companies Limited (ASX: SEC), whose dividends represent a percentage of the post-tax NTA at the end of each calendar quarter. As such, dividends will increase or decrease in line with the post-tax NTA, subject to the company having sufficient Profits Reserve.



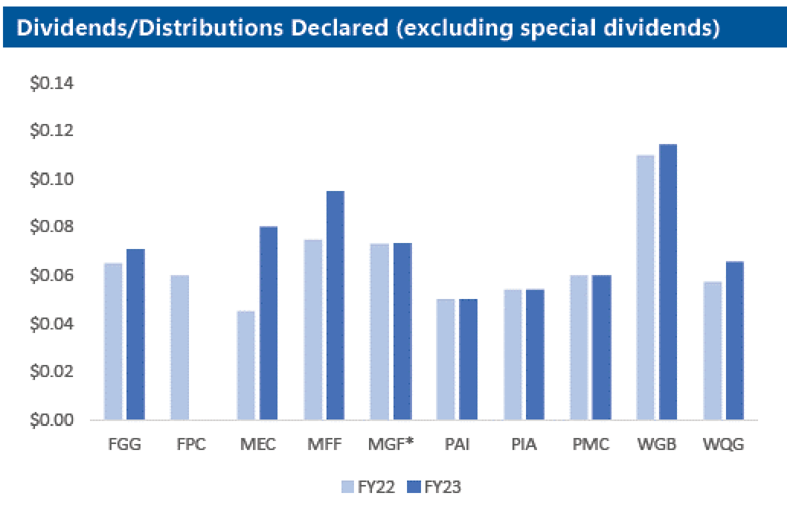
**LIT structure.*

CIN delivered the greatest dividend increase, with the FY23 ordinary dividend 19% higher than the ordinary dividend declared for the FY22 period. The Company also paid a special dividend of 9 cents per share in the FY23 period. Despite the muted portfolio performance, QVE dividends increased 8.3% in the FY23 period.

WAM maintained the full year dividend for the FY23 period of 15.5 cents per share. The dividend coverage levels are depleted at the annual dividend rate, however in an investor webinar the Chair made it clear that the Company would be seeking to maintain the dividend until it is forced to make a cut. To continue to maintain the dividend, the portfolio will have to supplement income received by the investee companies with sufficient capital gains. WAX maintained the final dividend for the FY23 period, however the dividend was 60% franked as opposed to being fully franked.

International Equities - Diversified and Emerging Markets

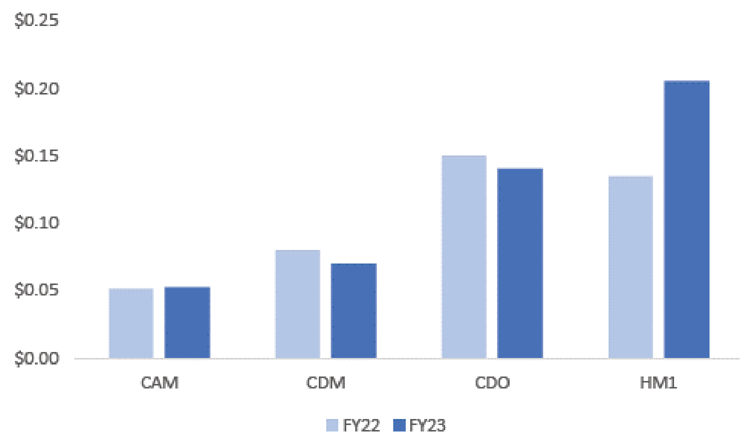
All but one LIC/LIT in the International Diversified and Emerging Markets category at least maintained the dividends/distributions for the FY23 period with 60% of the LICs/LITs in the category increasing the dividend/ distribution.



**LIT structure.*

MEC declared the greatest dividend increase for the FY23 period in the category, with dividends increasing 77.8% to 8 cents per share. Post the FY23 interim dividend, WQG increased the frequency of dividends from semi-annual to quarterly with the Company paying one semi-annual and two quarterly dividends for the FY23 period. Dividends declared for FY23 of 6.55 cents per share represented a 13.9% increase on the prior year.

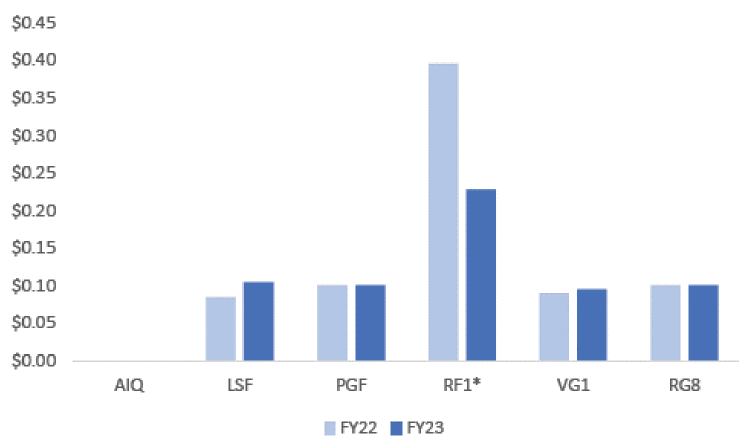
International/Australia Equities - Blended



HM1 has increased the frequency of dividends from annual to semi-annual. HM1 declared the first semi-annual dividend for the half year period to 30 June 2023 of 7 cents per share. This was in addition to the annual dividend of 13.5 cents per share paid in April 2023. This saw the dividends declared for the FY23 period increasing 51.9% on the prior year.

CAM's dividends slightly increased in the FY23 period with dividends up 2.5% when compared to the prior year. CAM paid an increased dividend in each of the quarterly dividend payments for the FY23 period. CDM and CDO dividends declined 12.5% and 6.7%, respectively, in the FY23 period with the final dividend for both LICs declining from the pcp. The dividends were cut for both LICs due to the depletion of the franking credit accounts. To maintain a fully franked dividend, the Company will need to accrue additional franking credits or alternatively potentially cut dividends further.

Absolute Return



**LIT structure.*

The majority of Absolute Return LICs/LITs either maintained or increased ordinary dividends/distributions for the FY23 period. PGF maintained the full year dividend for FY23 of 10 cents per share, fully franked, in line with guidance provided to the market at the beginning of the financial year. PGF announced in their FY23 results that the Company intends to pay a minimum dividend of 10 cents per share, fully franked, for the FY24 period.

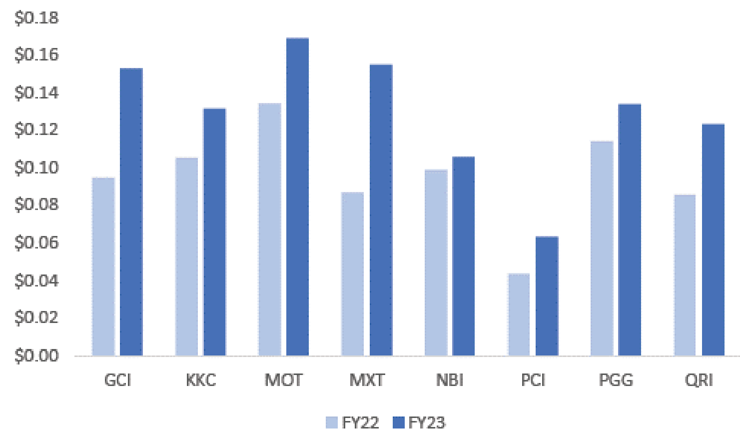
VG1 increased the final year dividend for the FY23 period to 5 cents per share, fully franked, resulting in a 5.6% increase to the full year dividend declared for the FY23 period. VG1 has a dividend policy to pay a semi-annual dividend of at least 4.5 cents per share, franked to the maximum extent possible.

LSF continued to steadily increase the dividend, with the Company declaring a full year dividend of 10.5 cents per share, a 23.5% increase on the prior year. LSF has paid an increasing dividend in each semi-annual period since the Company commenced paying dividends.

Fixed Income

Fixed income LITs experienced the greatest increase in distributions as a category with those LITs with exposure to floating rate securities benefiting from the increasing interest rate environment.

MXT delivered the greatest increase in distributions with distributions increasing 77.9% on the prior period. GCI, PCI and QRI also delivered substantial increases in distributions of 61.3%, 43.8% and 43.3%, respectively.



KKC's distributions increased 26% on the prior year and in June 2023 announced the target yield for the FY24 period would increase 52% to 20 cents per unit. NBI is largely exposed to fixed rate securities and therefore did not realise the same uplift in distributions as those LITs that are exposed to floating rate securities.

Potential gains from active management and discounts narrowing

Given the uncertainty in markets, we believe this is a good time to be exposed to actively-managed investments with active managers often outperforming markets during periods of uncertainty and heightened volatility. We saw this in the rebound from the COVID-19 market declines where a number of managers outperformed.

With a number of LICs and LITs trading at elevated discounts, this may be an attractive time to invest in closed-ended vehicles with the potential to generate additional capital returns in the event the discounts narrow. We note however, that it is important to understand the investment strategy and mandate of a LIC/LIT and the impact that differing market conditions may have on the performance of a LIC/LIT.

Claire Aitchison is Head of Equities & Funds Research at Independent Investment Research. This article is general information and does not consider the circumstances of any investor.

For a copy of the full report, see the Firstlinks Education Centre or this link.

A framework to maximise retirement income

Jim Hennington

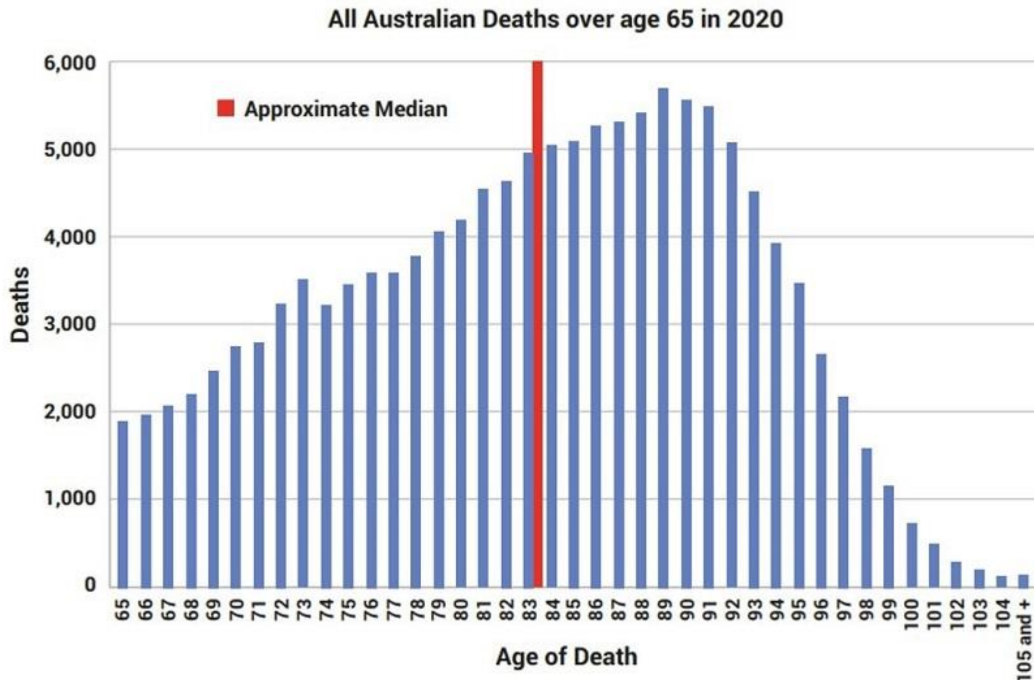
When you retire, your salary stops. From that point on, you need to fund your lifestyle using your own savings plus any Age Pension income you might become entitled to.

For wealthy people, this might be easy, even without an age pension. For those with little, it can also be straightforward, if they're able to live on the age pension as this provides them a lifetime income stream.

But for those in between, referred to here as 'middle Australia', the maths to get this right is difficult. A key issue is that no one knows how long each retiree will live. It's therefore not possible to calculate how much someone can safely draw from super as you don't know when their balance needs to reach zero.

The key points summarised below form the basis of an Actuaries Institute Dialogue Paper *A Framework to 'Maximise' Retirement Income*, which I co-authored alongside Andrew Boal.

The following chart illustrates the actual age of death for all Australian retirees who died during 2020 as published by the ABS. Nobody can predict how long they will live.



Source: Australian Bureau of Statistics figures. Note: median is the 50th percentile.

In Australia's retirement conversation there can be a lot of confusion around the terms 'retirement income' versus 'retirement spending' and 'investment income'.

'Investment income' is a term used by the Australian Taxation Office (ATO) to include interest, dividends, rent and income you receive from trusts.

'Retirement income' can be broken down into two categories:

i. For assets outside superannuation, it is likely to mean the investment income that ends up in your bank account and can be spent (or re-invested).
ii. For superannuation assets, it's likely to mean the amount drawn down out of your superannuation fund and paid into your bank account to spend. With most super funds, this is a choice you have to make, subject to a minimum level. There can be a disconnect between the investment income earned on a superannuation fund's underlying assets, the amount that is drawn out each year and the amount that is actually spent by the retiree each year.

When we examine the needs of middle Australia retirees, it's clear they're likely to want their income from superannuation or their SMSF to last for life. It means their 'retirement income' should end upon the death of each individual, rather than ending at a pre-set age (e.g. based on 'average' life expectancy).

In order to fully maximise their retirement income, retirees would have to consume all the capital in their superannuation fund as well as all the investment earnings (i.e. there would be no death benefit payable from superannuation).

Measuring retirement income

So how do we quantify retirement income if it's based on drawing down a balance over an uncertain timescale?

An approach used in other countries when doing retirement projections is to base the figure on a lifetime annuity formula. This is the formula an insurer or defined benefit pension fund would use to calculate the annual income that could be provided for life.

What is a lifetime annuity?

A lifetime annuity is a product that provides you with an income for the rest of your life, which you buy with your superannuation or other savings. With a traditional annuity, the payment level is guaranteed by an insurer and continues for as long as you live. The amount of income you receive from the annuity is based on multiple factors, which include:

- Your age and sex (which indicate how long you're likely to live)
- The amount you invest
- What options you select (common examples are to have a lump sum benefit in the event of an untimely death, or to have income that increases with inflation each year)

As an indication, a 65-year-old male investing $200,000 in a lifetime annuity with an early death benefit and payments that increase with CPI for life may get an income of around $10,000 per year (as of September 2023).

What is a lifetime income stream?

The term 'lifetime income stream' encapsulates a broader range of products that let you use your superannuation or savings to buy an income that lasts for life. Lifetime annuities are a just one example of lifetime income streams. Other examples are:

- Guaranteed lifetime pensions. These are the same as lifetime annuities but are provided by a superannuation fund not an insurer. Public sector pensions are an example of these. The government Age Pension is also a guaranteed lifetime pension (so long as means-testing doesn't apply to you).

- New lifetime income streams. In 2017, SIS reg 1.06A was introduced to allow a broader range of lifetime income streams, including ones that pass on the benefits of investing in growth assets whist still guaranteeing that payments can continue for life. Since 2017 at least 5 new products have been launched in Australia. An example is Generation Life's LifeIncome product (an investment-linked annuity).

Government reviews have consistently observed that retirement incomes can increase between 15-30% by combining lifetime income products with an account-based pension. In effect, lifetime products redistribute money that would otherwise be paid as death benefits later in life. Individuals who pass away leave behind reserves that get used to increase and protect the annual incomes that are paid to all customers.

Balancing risk and reward

The idea of referencing a particular product type to inform strategy can be met with a form of skepticism from some practitioners – with comments like "you cannot do that, it's about strategy first, not product". Perhaps this reaction is due to unfamiliarity with the importance of annuities as a risk management tool globally and historically, or a perception that annuities are poor value for money (due to traditional annuities providing long-term investment guarantees in addition to longevity).

In the field of investments, cash is often regarded as an 'risk-free' benchmark for making decisions. Before investing in risky assets, investors assess the merits of taking on risk in the hope that they can do better than cash returns. Cash is used as a reference point for this decision.

Similar thinking can be applied to retirement income. With retirement income, the three main risks are: uncertain lifespan, uncertain inflation and uncertain investment returns. The asset that protects from all these is the traditional inflation-linked annuity. Retirees may be willing to take on risk in the hope that they can do better than this 'risk-free' income level, but it's important to have a benchmark to measure expectations against.

In 2018, the Australian Government Actuary (AGA) proposed an Income Risk metric that can apply to all retirement products, including the account-based pensions that most super funds currently offer in retirement. The risk metric is calculated by simulating projected year-by-year payments from a particular retirement strategy under a full range of market sequences. This gets compared with a benchmark level of income up to an age where the vast majority of the population would have passed away. The results from the simulations are summed up to give a single metric that captures market, inflation, and lifespan risk at once.

If an individual wants to be, say, 90% confident that their retirement income plan will last as long as they live, then they need it to last up until the age that gives them a 90% chance of covering their potential lifespan.

Maximising retirement income (in light of risk tolerance)

The highest expected retirement income (i.e. based purely on averages) might be to invest in growth assets and draw down savings to zero at life expectancy. But we need a framework for making informed decisions and trade-offs. A possible framework is as follows:

Determination	Possible metric to use
Period of retirement end date	The death of each individual retiree.
Safe retirement income (Benchmark)	Annual income that can be expected using a 'risk free' lifetime income stream (or partial use of a lifetime income stream). This could be informed by market rates and would provide a reference point when designing retirement income strategies for retirees.
Expected retirement income (from a given strategy)	Commencing level of annual income from a particular retirement strategy. A 'strategy' may combine a number of product types, investment strategies and drawdown strategies.
Retirement income risk (for a given strategy)	The AGA's proposed Retirement Income Risk Measure.

A lifetime annuity gives a benchmark 'safe' level of retirement income that other strategies can be compared against. Where a strategy involves taking on some risk, this should come with sufficient reward – in a way that reflects the retiree's risk preferences and other needs. The Australian Government Actuary's Retirement Income Risk Measure is a good example of how risk could be measured an assessed. It involves sophisticated stress testing through a full range of market sequences that retirees might experience.

Ultimately, a long-term risk-return framework is needed when designing retirement strategies.

Jim Hennington is a consulting actuary and specialises in retirement income and strategy. He is the Founder of [Apricot Actuaries] and an active member of the Retirement Incomes Working Group.

Banks, BHP, RIO, CSL and the tyranny of size

Justin Halliwell, Sally Warneford

This is an edited transcript of a webinar hosted by Schroders. Part II features Natalie Morcos, Head of Product, Solutions, and Client Service with Justin Halliwell, Head of Research in Australian Equities, and Dr Sally Warneford, Equity Analyst. Part I, featuring Natalie Morcos with Martin Conlon, Head of Australian Equities, can be viewed here.

Natalie Morcos: We hold [RIO and BHP]. Both very similar in iron ore and copper. Can you share with us your current views on these stocks?

Justin Halliwell: The first thing to say is the companies have never been more similar. If you reflect back, say, 10 years ago, BHP still had the South32 assets, and they had petroleum. And in the last 10 years, they've done the South32 demerger, and they've also demerged the petroleum assets. So, now, about two-thirds of each company is iron ore. Those assets go through cycles. Sometimes the costs are a bit lower. Sometimes the profits are a bit higher. But by and large, they are identical. BHP produces a little bit more at a lower profitability, but the net dollars of profit are almost identical.

Then they both own a share in Escondida, which is the largest copper mine in the world. And so, by that stage, you're almost at three quarters of the valuation for both businesses are identical. And so, we're really arguing around the tail. They both have more copper. BHP has a bigger extra copper business than Rio. But really, the difference is coking coal for BHP versus aluminium for Rio Tinto.

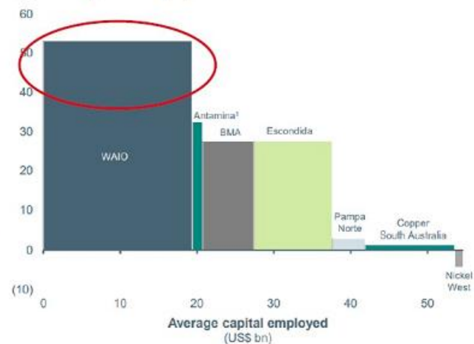
And we own both, but we're underweight BHP and we're overweight Rio. One reason is our outlook for those two commodities. You can see on the chart [below], and where the prices are today, Rio's aluminium business is unquestionably one of the best in the world. It's powered by green energy. And we think over time, not only with aluminium price rising, as I mentioned earlier, but also the green energy, you're going to get either carbon getting priced into commodity prices, so the price goes even higher, or you get green credits, one or the other green premiums, one way or another, Rio's aluminium business will make a lot more money. And you can see at the moment, it's providing a 4% return on capital. Now, look at the iron ore businesses there, they're generating 60% to 70% return on capital.

Bifurcation remains significant in commodities

Iron ore remains a pot of gold, aluminium an ugly duckling

Pilbara Iron Ore, Canadian smelters and Oyu Tolgoi driving our momentum

$bn, except where stated	Iron Ore Sustained operational improvement	vs H1 22	Aluminium Kitimat ramping up	vs H1 22	Copper Unlocking growth	vs H1 22	Minerals Challenging market conditions	vs H1 22
Production	160.5mt[1]	+7%	1.6mt[2]	+9%	0.3mt[3]	-1%	0.6mt[4]	+4%
Underlying EBITDA	9.8	-6%	1.1	-60%	1.1	-29%	0.7	-45%
EBITDA margin[5,6]	69%	-1 pp	21%	-20 pp	43%	-11 pp	30%	-10 pp
Capex	1.1	-26%	0.6	-4%	0.9	+26%	0.3	+13%
Free cash flow	5.6	-20%	0.2	-89%	(0.5)	-45%	(0.2)	-165%
ROCE[6]	63%	-9 pp	4%	-16 pp	4%	-6 pp	13%	-8 pp



Source: BHP RIO, Schroders

These iron ore businesses are making supernormal profits. And we think that has to correct. It will impact both of them. But also coking coal prices are elevated at the moment. But obviously, with the focus on decarbonisation, coking coal is the source of carbon. So, over time, that's going to have to come out of the production of steel. And therefore, as you look forwards, the demand for coking coal is not as strong as for aluminium. So, we think, well it's pretty clear that we want to be in green aluminium versus coking coal, and hence the difference in positions. And also, having said, they're so similar, Rio is a $100 billion company, BHP is $150 billion company.

Morcos: Turning to banks, Justin, with rising bad debts expected, has our view on banking stocks changed? And how do our local banks compare to the global banks in particular?

Halliwell: We've been on the more cautious side for a while. And the reason for that is really around when you look back over the last two decades, credit has ballooned. There's been huge, huge credit growth and we think that's over. So, that's really, if you think about what we'd call revenue for an industrial, for a bank, credit is the volume and then the NIM is the price. NIMs are under pressure due to competitive forces. Even if nothing else changes, we think they're pretty dull and boring and there are better places to be, especially with the looming threat of bad debts.

Now, to be fair, to date, they've surprised us and everyone on the fact that they've stayed very low. But clearly, the potential pressure on the consumer, the mortgage cliff and the like, there's still the risk around bad debts. And then, also looming in the background, is he threat of increased taxes on banks, as seen in Europe. It makes us pretty cautious about the outlook for profits.

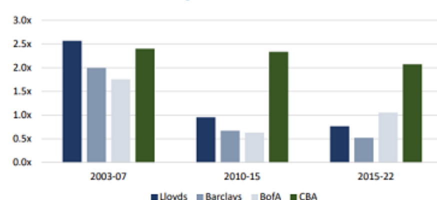
And then, there's this chart to the point about how they trade against the international peers.

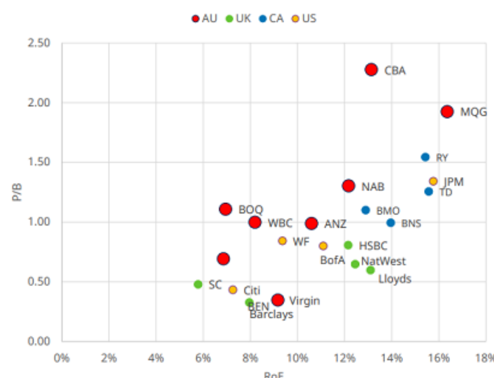
BANKS: Learnings from offshore

Are overseas banks cheap or are our banks expensive?

- For the same level of Return on Equity, Australian banks are the most expensive in the world on a P/B multiple.
- Hasn't always been this way, pre GFC all banks.

Price to book history





Source: Refinitiv, Company data

You can see here, especially on the right-hand charts, the best one to look at is, for a given ROE, which is the X-axis, the Australian banks, in particular CBA and Macquarie, look very expensive, not only relative to the domestic peers but the international peers. So, there are key underweights in the sector.

Morcos: [Sally], I'm keen to get your current views on CSL.

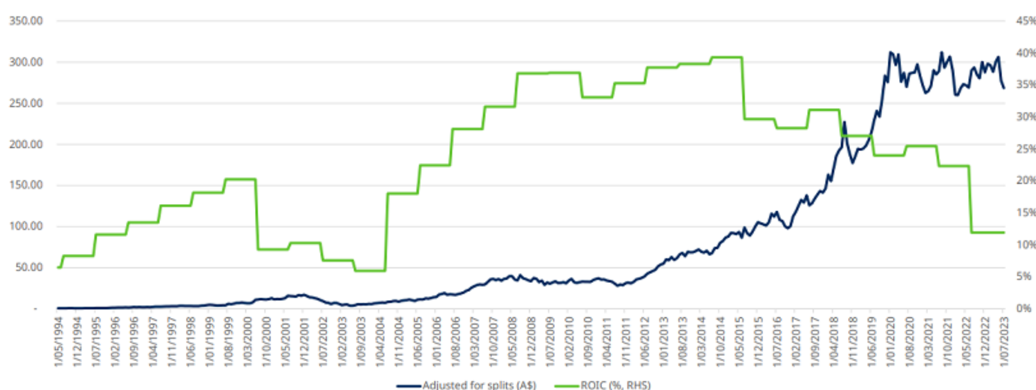
Sally Warneford: Yes, I wrote my very first report on CSL back in 1994 for the IPO and the share price was $2.30 and the market cap was about $130 million. Since then, it split its shares three times. So, that share price was actually $0.77. Now, it's something like $270 and its market cap is something like $130 billion, which makes it about the 18th largest pharmaceutical company in the world. That's been an extraordinary journey and it's been an incredible performance by the company and the management team over time.

But if we have a look at the chart where the dark blue shows the share price performance, and it's been marking time for a number of years now. And then, the green line shows us the return, so the earnings before interest and tax that you get for the invested capital, which is the net assets plus the net debt.

CSL – growing pains

The bigger you are...the harder it gets to grow

CSL Share price and POIC since IPO



Source: Schroders

You can see where they've made large capital raisings and acquisitions. For example, in 2000, they bought the Swiss Red Cross, and they raised equity then. And then, again in 2003-2004, they bought Aventis Behring, and they raised equity then. And then, going forward, it took another many years before they made another acquisition which was the flu vaccine business of Novartis in about 2015. So, you can see some step changes in returns when you have some new equity coming in or a loss-making new business. But that doesn't get away from that steady downwards trend in returns despite the great success of the flu vaccine business.

And this is where you're seeing the problem of being such a large company. New investments have come with large amounts of goodwill and also intangible assets in the form of intellectual property. So, it's getting a lot harder for CSL to grow. And people invest in CSL for its growth, and that growth is coming at a cost, and that cost is more acquisitions, more goodwill in the balance sheet and more intangible assets in the balance sheet. And CSL has to try and generate a meaningful return on those investments for shareholders in order to justify being the number 18 market cap pharmaceutical company in the world.

Morcos: What about Ramsay Health Care? This reporting season, we saw them halve their dividend. Can you share with us your current views on Ramsay?

Warneford: When we were talking about COVID earlier, Ramsay was a classic example of a COVID loser. They were forced by governments to close their hospitals and that meant that they couldn't earn any money. They were relying on grants for governments to cover their fixed costs, and they were forced to treat COVID patients, which is good. We needed that at the time, but not good for Ramsay's ongoing business.

We're seeing a big hangover from COVID and that is labour shortages, elevated labour costs, labour inefficiencies because there's been increased absenteeism and people wanting reduced hours. And then, we've got this very modest recovery, slower than I would have thought, of volumes of elective surgeries which is their bread and butter around the world. The share price has been derated substantially.

And then, unfortunately, Ramsay is one of those companies with significant gearing in the balance sheet and that has meant that interest costs with the rising interest rates have been very substantial and depressed the bottom-line profit for the company. That is why we've seen that fall in the dividend.

But with this gradual return in activity, we expect that the profitability will gradually return as will the cash flows to pay down the debt. So, Ramsay should continue to improve from here.

Morcos: ResMed, another beneficiary, but this time of the growing trend in sleep apnea. Now, obviously, with the correlation between sleep apnea and obesity the question here is around whether weight loss solutions such as Ozempic have actually going to become a threat to a company like ResMed.

Warneford: Yes, it's a fascinating situation. ResMed has recently been the beneficiary of its major competitor Philips being absent from the market due to a recall, but there was a COVID-related shortages of components. But over the last two years something that's been weighing on investors' minds has been the impact of the new class of GLP-1 agonist drugs for diabetes and now for weight loss or obesity. And the ones that spring to mind are the brand names Ozempic, Wegovy, both from Novo Nordisk in Denmark and then Mounjaro from Eli Lilly, which is currently in clinical trials. These drugs are amazing. They are able to generate weight losses of 10% to 30% and they're a simple injection. One of the problems that has been there have been shortages of the drugs. Eli Lilly and Novo Nordisk just haven't been able to keep up with the demand.

Now, why is this important for ResMed? It's important because obesity is probably the single biggest risk factor for obstructive sleep apnea, which is what ResMed's machines treat. If you can cure obesity, we then in turn cure obstructive sleep apnea. And that's the question that investors are wrestling with. Now, I don't believe that that will be the case because something like 15% to 40% of obstructive sleep apnea cases are not solely due to obesity, and in addition to that, the obesity drugs are drugs for life. The weight piles back on if you stop them. So, that will be an issue.

This is an edited transcript of a webinar hosted by Schroders, a sponsor of Firstlinks. Part II features Natalie Morcos, Head of Product, Solutions, and Client Service with Justin Halliwell, Head of Research in Australian Equities, and Dr Sally Warneford, Equity Analyst. Part I can be viewed here.

For more articles and papers from Schroders, click here.

Defence beats offence in investing

Geoff Saab

Offense sells tickets, but defense wins championships. - Paul 'Bear' Bryant

The momentum of Nvidia's stock price seems unstoppable. Many are comparing Nvidia's historic run to a certain stock from the late 90's, Cisco Systems (I drew the same comparison back in May). And so I thought this would be a good time to revisit a section from my book, Low Risk Rules that compares an early-90s investment in Cisco to a more conservative alternative.

The results might surprise you. With the benefit of this hindsight, how might you build your portfolio today?

In the late 1990s, while the whole world was on offense, seemingly getting rich on the promise of this amazing new thing called the 'internet', I debated a friend who refused to play the growth stock game. Steady and stoic, he invested defensively in Canadian bank stocks. "Bank stocks never go down for long" he told me. I mocked his conservatism in what I perceived as stocks more well suited for a retiree's account. "You go ahead and wait for your measly little dividends," I told him, "while I get rich".

History, of course, has been very kind to the Canadian banks—a government-protected oligopoly who have just become more entrenched into the economic fabric over time. And not so kind to the internet stocks of the 1990s.

Does boring pay off?

So I became curious. What if, instead of chasing internet stocks back in the 1990s, one had just stuck to this boring approach that the younger me looked down upon?

I ran some numbers—keeping it simple with two very high profile and successful companies.

In the low-risk corner… Toronto Dominion Bank (now known as TD Bank)—a Canadian banking powerhouse that also built a strong US presence with retail branches and discount brokerage.

In the growth corner… Cisco Systems. One of the hottest stocks of the 1990s, and the most valuable company in the world for a brief period of time. It would have been too easy to pit TD Bank against Pets.com, so let's go with Cisco. An undeniably great company, Cisco is still around (and thriving) today.

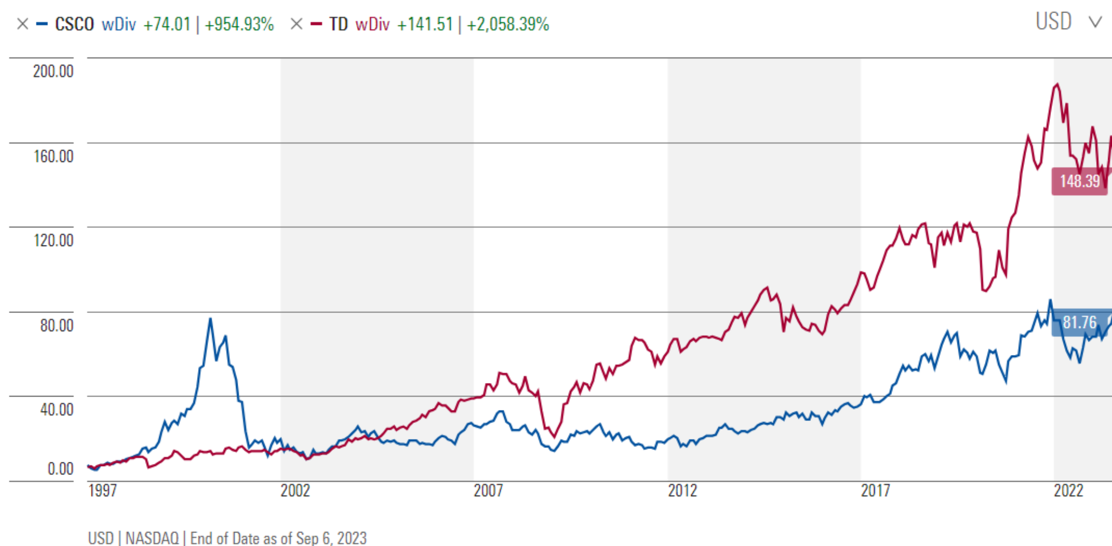
I started keeping track in mid-1996, just as the internet bubble really began to pick up steam. This allows us to take fully into account Cisco's meteoric rise. As you can see in the chart below, in early 2000 the investment in Cisco would have been about 8x as valuable as your investment in the boring, old, plodding TD Bank.

Source: Morningstar.com

However, the subsequent crash wasn't kind to Cisco at all. It was dead money for a decade, only starting to recover well into the middle of the 2010s. Meanwhile, like the Tortoise to Cisco's hare, TD Bank plodded along and, except for a scary episode in the 2008-09 global banking crisis, has generally outperformed the faster grower.

There's more to it though

But here's the thing with the chart above—it's not quite accurate. It completely ignores the dividends you would have earned on the TD shares. When we take those dividends into account, and reinvest them in TD shares, the picture looks very different.



Source: Morningstar.com

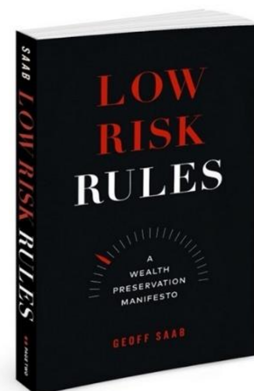
This isn't even close. Your investment in the 'boring' bank shares has outperformed the exciting, high-growth company by more than 2x, and it's done it with a lot less drama.

My friend who refused to take part in the internet stock craze, who I openly mocked, had the last laugh. He has experienced decades of steady growth in his portfolio of safe, dividend-paying stocks. And meanwhile, I spent far too much time in search of the next great growth company, completely ignoring these massive wealth creation machines because I perceived them as 'too boring'.

Lest you think I'm cherry-picking, the reality is that I actually gave the growth stocks the benefit of the doubt here. I could have chosen any number of optical equipment makers who languished post-crash, but instead I chose Cisco, a company that since the turn of the century has grown revenue at 4.9% per year and earnings at 8.5% annually for 20 years. That's a solid track record through several economic cycles, including a crash that laid waste to the industry that Cisco sat at the core of. The problem, and the reason for the underperformance of Cisco, is that expectations were so high, that the odds were stacked against anyone betting that growth would continue.

It took me a few market cycles to finally learn that the simple investment strategy I had mocked is actually far superior to more elaborate, exciting, and seemingly intelligent strategies.

Most amazing of all is that it's surprisingly easy to follow, as long as you don't let your biases and weakness get in the way of doing what's best. Always remember, as the old sports saying goes, defence wins championships.



Geoff Saab is the author of [Low Risk Rules: A Wealth Preservation Manifesto](), and writes a free newsletter at [lowriskrules.substack.com]().

Podcast: Boost share income, free investing, managing stars

James Gruber

Season 2, Episode 8

Special guest Rudi Minbatiwala, Head of Equity Income at First Sentier, explains why he thinks buying high-yield, dividend-paying stocks is a flawed way to get consistent income from the ASX. He reckons there are better strategies, which he runs through today.

For a different perspective on the investment world, our other special guest is Anne Marie Bernard, the senior director of HR at MFS Investment Management. Anne Marie tells us of the best ways that investment firms can incentivize fund managers, how to prevent star stockpickers from jumping ship, and how the concept of reverse mentoring can help fund managers keep on top of the latest industries like artificial intelligence.

As usual, Firstlinks' Managing Editor, Graham Hand, also joins us, this time to go through the ways that investors nowadays can invest for free, or at least close to free. We discuss ETFs, listed investment companies, robo advice, and much more.

Morningstar's Peter Warnes is having a well-earned break and will be back with us for the next episode.

Investors need to look beyond bonds for safety

Jeremy De Pessemier, Ray Jia

Frustrated that inflation isn't falling fast enough, major central banks have continued their monetary tightening, in some cases coming back to it after a brief hiatus. And as the lagged impact of these aggressive rate hikes ripples through the economy, the broad trend remains for slowing growth for the remainder of this year.

From May last year till now, the Reserve Bank of Australia (RBA) has lifted its policy rate by 4% to 4.1% to tame inflation. And as the RBA reiterated in its September policy meeting, Australia may continue to experience

the below-trend growth in the future, as cost-of-living pressures and the rise in interest rates continue to weigh on domestic demand.

With the balance of economic forces tilted against capital markets, investors have been rushing out of risk assets into safer ones (**Chart 1**). According to Calastone, equity, multi asset and property funds saw major outflows throughout H1 2023, while fixed income funds added A$1.3bn. In addition, there were signs of investors flocking to cash after rolling out of riskier assets.

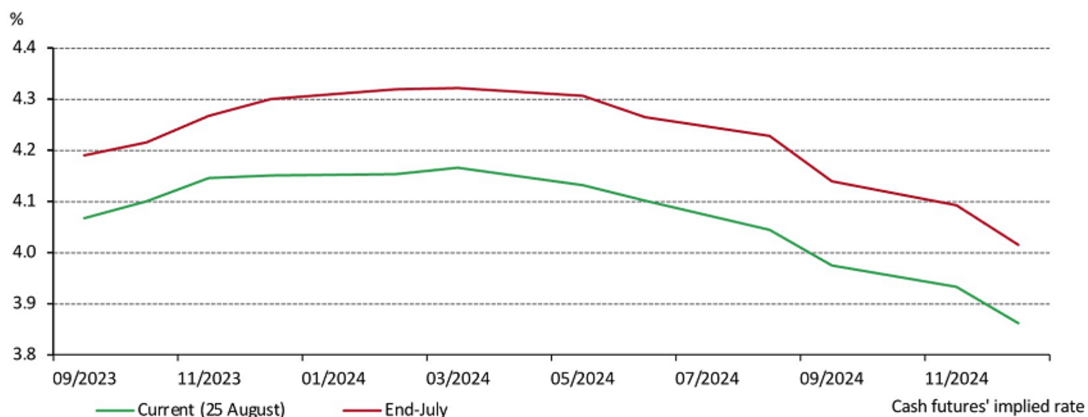
Chart 1: Australian investors are fastening their seatbelts*

**As of 30 June 2023. Source: Calastone, World Gold Council*

The risks for bonds

Fixed income assets currently seem like an attractive choice for investors. The sharp rise in bond yields since early 2022 and the rising possibility of rates peaking soon (**Chart 2**), after another rate pause in August, have improved the return potential in many fixed income sectors. And while flat to inverted yield curves make it less compelling to extend duration, a modest increase in duration could be prudent for investors seeking to hedge against a growth shock.

Chart 2: Investors are expecting lower rates than previous projections
Implied rates of Australian cash rate futures *



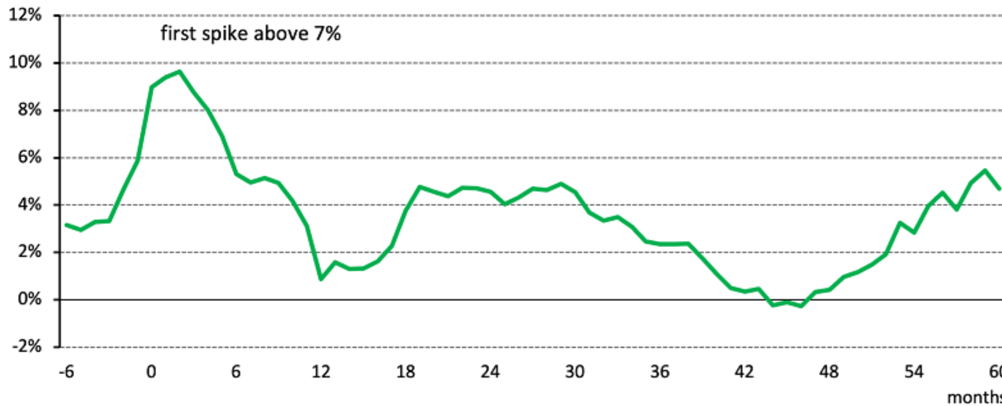
**As of 31 August 2023. Source: Bloomberg, World Gold Council*

But there are risks associated with this view. Persistent inflationary pressure remains the primary obstacle to monetary easing and could even result in further tightening. Moreover, inflation volatility may be just one part of the medium-term inflation story. In fact, looking at the US experience, where we have data going back to 1870, inflation has tended to reappear in echoing waves at two and five years after it first spiked above 7% (**Chart 3**).

And the combination of short- to mid-term factors – such as surging unit labour costs and a tight rental market – as well as longer-term impacts from the green transition, deglobalisation and geopolitical uncertainties,

indicate an environment in which there could be more frequent inflation shocks. The RBA also stressed in its latest policy meeting that sticky service inflation and the lag of monetary policy's impact could provide further fuel for inflation to rebound.

Chart 3: Inflation cycle in the US since 1870
US inflation experienced multiple bounces after the first spike above 7%



**Based on monthly US CPI y/y growth between January 1872 and June 2023. Source: Bloomberg, World Gold Council*

Such an environment would require ongoing and fairly dramatic adjustments to monetary policy from the RBA, which in turn could introduce volatility, potentially below-trend growth, and the possibility of negative returns in Australian fixed income allocations.

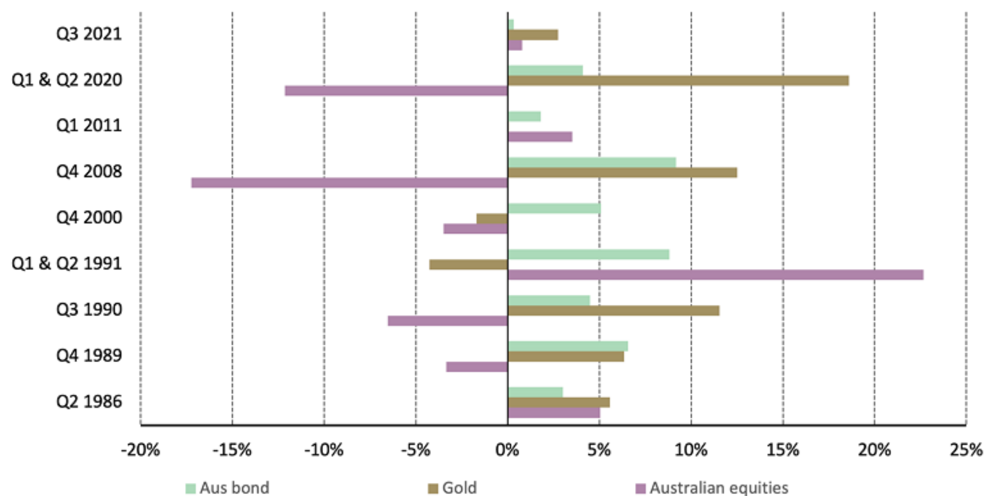
Why a gold allocation makes sense

Against this backdrop there are advantages to diversifying the sources of safety in an investment portfolio beyond just high-quality government bonds.

Here's why gold can be a useful addition to portfolios:

1. Diverse sources of demand make it resilient and give it the potential to deliver solid returns in various market conditions (**Chart 4**). That's evidenced by recent gold performance: *following a strong 2022 (+7%), gold in AUD capped another gain of over 12% during the first eight months of 2023, once again outrunning other major assets.*

Chart 4: Gold and bonds can together be a potent portfolio diversification strategy
Returns from equities, bonds and gold during negative quarterly GDP growth in Australia, 1985 to 2023



**Data from Q4 1985 to Q2 2023. Based on LBMA Gold Price PM, Bloomberg AusBond Composite Index and MSCI Australia Index. All calculation in AUD. Source: Bloomberg, World Gold Council*

2. Gold is a particularly useful hedge against stagflation, a combination of stubborn inflation and slowing economic growth. During past periods of stagflation, gold in AUD has delivered a 27% annual average return, significantly outperforming other assets.[1]

These characteristics underscore our belief that gold has a key role as a strategic long-term investment and as a mainstay allocation in a well-diversified portfolio alongside equities and bonds. Looking ahead, gold and government bonds are likely to perform differently. That feature alone should appeal to investors, particularly those of Self-Managed Super Funds, and could be key to managing the potential risks ahead.

[1] Based on data between 1973 and 2022, all calculations in AUD. For more please see: The relevance of gold for Australian investors in 2023 | World Gold Council

Jeremy De Pessemier is an Asset Allocation Strategist, and Ray Jia a Senior Analyst at World Gold Council, a sponsor of Firstlinks. This article is for general informational and educational purposes only and does not amount to direct or indirect investment advice or assistance. You should consult with your professional advisers regarding any such product or service, take into account your individual financial needs and circumstances and carefully consider the risks associated with any investment decision.

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