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Contents

Editorial

In poker, the 'ante' is an amount of chips, or a compulsory bet, placed in the pot before any cards are dealt. Ante means 'before' in Latin. Its purpose is to force players to participate, to have a vested interest in committing to the round even if their cards are not initially strong.

The same 'table stakes' concept applies in funds management, and it is called 'Environment, Social and Governance'. Every fund manager has its own version of ESG to satisfy clients who will only invest based on ESG principles and beliefs. Go to any fund manager website and there will be an obligatory statement of a belief in ESG. It's the ante for playing the game.

In practice, commitment and interpretation are different. For some managers, it goes to the heart of their investment process, requiring an ESG approval before any company is considered for a portfolio. For others, it's a simple statement about avoiding the easy targets such as tobacco and weapons, then it's off to the races.

The regulator, **ASIC**, is watching the industry closely and has already commenced 'greenwashing' action against several funds which are not delivering on their social representations.

It is difficult to pin down how ESG principles translate into portfolio decisions. Fund managers want successful investments and it's easy to look the other way. Where, for example, does **Qantas** fit in ESG principles? The S is Social and the G is Governance. The new CEO has apologised for problems ranging from illegally sacking 1,700 ground staff, long delays contacting the call centre, selling tickets for cancelled flights, refusing to refund unused credits and involvement in **Qatar Airways**' request for extra flights. The Qantas fleet is now old and maintenance has been sent overseas to save costs. The brand damage will take years to repair yet shareholders widely applauded the tenure of former CEO, **Alan Joyce**.

I'll never forget a fund manager presentation to a large audience some years ago, where for the first 20 minutes, he droned on about how his commitment to ESG principles defined every portfolio decision. Then he explained why his number one investment was **Aristocrat Leisure**. Here is a company that designs poker machines to be as addictive as possible, promoting gambling to those who can least afford it. Australia has 20% of the world's poker machines with high per capita losses placing strains on vulnerable families. ESG can be defined and justified in many ways.

Another central focus of the Social 'S' is Diversity, Equity, and Inclusion (DE&I) and the case for fund managers to pay attention here should pay off in stock picking. Many fund managers who lead their businesses are Baby Boomers who were once the young superstars but are now an older generation. How much do they know about companies that cater to younger generations, 'Millennials' born 1981-1996, 'Generation Z' born 1997-2012 and 'Generation Alpha' born 2013-2025? The 'ante' for a 65-year-old Chief Investment Officer (usually white and male) is a 35-year-old (or younger) colleague to stay on top of new trends. This is not 'diversity for diversity's sake' but a genuine need to hear alternative views.

Take the great man, **Warren Buffett**, now 93-years-old, still highly active and reading for hours every day. He no doubt keeps abreast of many major issues, and his age has certainly not stopped him backing **Apple** as his largest position. But another major holding of Buffett is **Coca-Cola**, and it's easy to see why Buffett owns it. With over 200 brands, their drinks are consumed two billion times per day. But it is also facing serious challenges from younger brands, growing consumption of healthier drinks, non-traditional promotions through TikTok, Instagram and YouTube and the increasing role of influencer partnerships. Buffett says he drinks five cans of Coke a day but is he an impartial judge of the business?

History is replete with companies whose strength seems unassailable but who fail to move with fashions, technology and the tastes of new generations. I hope there's a young person in Warren's office.

Of course, many will point to Buffett's decades of success which make him arguably the world's greatest investor, with **Charlie Munger**. That's all true, but **Ashley Owen** writes this week that **Berkshire Hathaway** has struggled to keep up with the market index for over 20 years, and like many fund managers, the outperformance which makes his 'since inception' numbers look good was achieved decades ago.

In his celebrated 1958 book, *Common Stocks and Uncommon Profits*, **Philip Fisher** posed these questions about the ability of companies to continue to innovate:

"Does management have a determination to continue to develop products or processes that will still further increase total sales potential when the growth potential of currently attractive product lines has largely been exploited?"

"Are there other aspects of the business, somewhat peculiar to the industry involved, which will give the investor important clues as to how outstanding the company may be in relation to its competition?"

Investors should look for companies willing to disrupt themselves by reinventing their business and trying new ideas that give optionality on the future. And ask your friendly fund manager how they ensure they hear a diversity of views.

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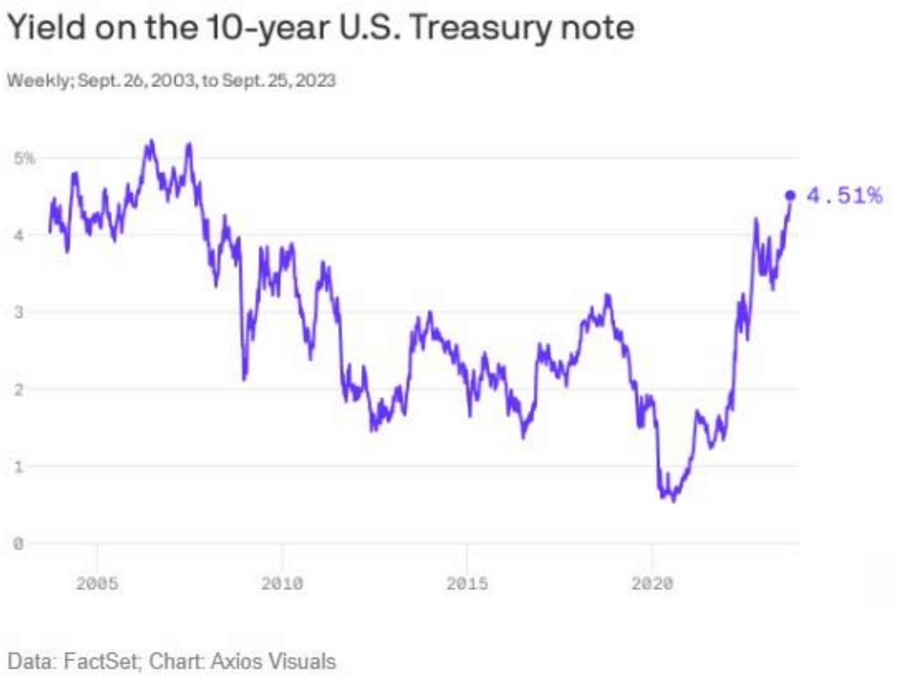
Stockmarkets are going through one of those tricky periods where the focus on rising rates is pushing down share prices, and it's difficult for investors to remain focussed on the long term. In Australia, we watch the cash rate more than any other rate, perhaps because so many of our loans are tied to it. In the US, the 10-year Treasury rate is as important as the Fed Funds rate, as it reveals much about interest rate and economic expectations. It has risen significantly recently, to levels not seen for 15 years, and investors and companies need to accept that the 'lower-for-longer' of 2019 to 2021 has gone. As the current Fed Funds rate is 5.5%, the 10-year shows an expectation of slower economic growth but not to such an extent that rates will fall dramatically.



Nevertheless, over the last 30 years, with many bumps along the way, US$100,000 invested in the US S&P500 would now be worth US$1.7 million. There are plenty of 'drawdowns', or market pullbacks, that caused great angst at the time, but who knows with hindsight when to get in and out? This table from **Charlie Bilello** shows Total Returns in each year since 1928 and the maximum drawdown for that same year, yet the market has averaged about 10% for nearly 100 years. Let's hope the future can be anywhere near as good.

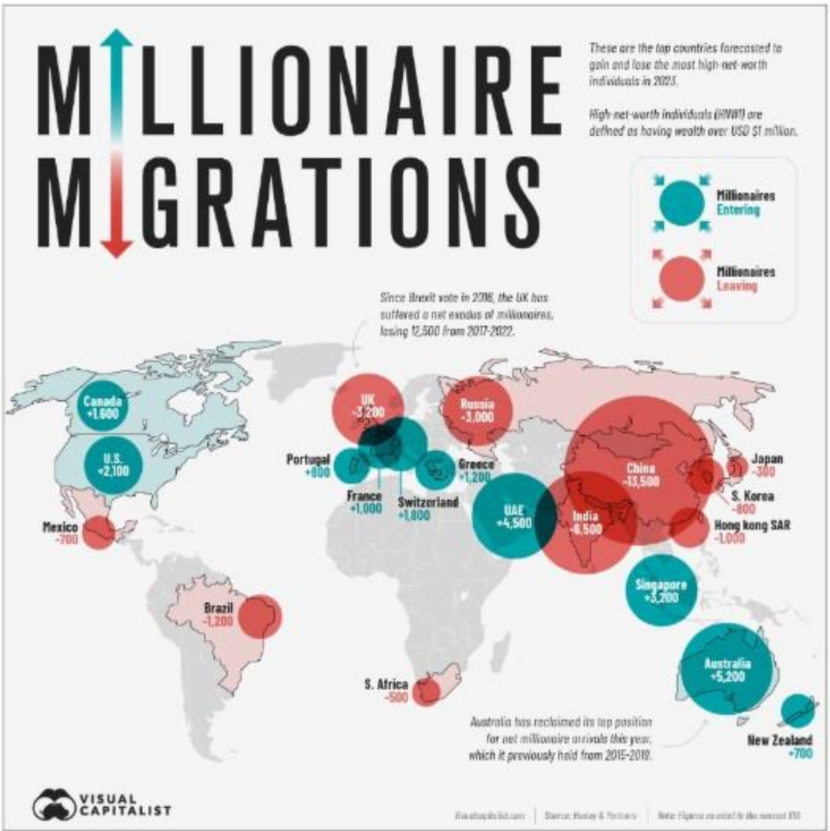
S&P 500 Index: Max Intra-Year Drawdowns vs. End of Year Total Returns (1928 - 2023)

Year	DD	TR	Year	DD	TR	Year	DD	TR	Year	DD	TR	Year	DD	TR
1928	-10.3%	43.8%	1948	-13.5%	5.7%	1968	-9.3%	10.8%	1988	-7.6%	16.6%	2008	-48.8%	-37.0%
1929	-44.6%	-8.3%	1949	-13.2%	18.3%	1969	-16.0%	-8.2%	1989	-7.6%	31.7%	2009	-27.6%	26.5%
1930	-44.3%	-25.1%	1950	-14.0%	30.8%	1970	-25.9%	3.6%	1990	-19.9%	-3.1%	2010	-16.0%	15.1%
1931	-57.5%	-43.8%	1951	-8.1%	23.7%	1971	-13.9%	14.2%	1991	-5.7%	30.5%	2011	-19.4%	2.1%
1932	-51.0%	-8.6%	1952	-6.8%	18.2%	1972	-5.1%	18.8%	1992	-6.2%	7.6%	2012	-9.9%	16.0%
1933	-29.4%	50.0%	1953	-14.8%	-1.2%	1973	-23.4%	-14.3%	1993	-5.0%	10.1%	2013	-5.8%	32.4%
1934	-29.3%	-1.2%	1954	-4.4%	52.6%	1974	-37.6%	-25.9%	1994	-8.9%	1.3%	2014	-7.4%	13.7%
1935	-15.9%	46.7%	1955	-10.6%	32.6%	1975	-14.1%	37.0%	1995	-2.5%	37.6%	2015	-12.4%	1.4%
1936	-12.8%	31.9%	1956	-10.8%	7.4%	1976	-8.4%	23.8%	1996	-7.6%	23.0%	2016	-10.5%	12.0%
1937	-45.5%	-35.3%	1957	-20.7%	-10.5%	1977	-15.6%	-7.0%	1997	-10.8%	33.4%	2017	-2.8%	21.8%
1938	-28.9%	29.3%	1958	-4.4%	43.7%	1978	-13.6%	6.5%	1998	-19.3%	28.6%	2018	-19.8%	-4.4%
1939	-21.2%	-1.1%	1959	-9.2%	12.1%	1979	-10.2%	18.5%	1999	-12.1%	21.0%	2019	-6.8%	31.5%
1940	-29.6%	-10.7%	1960	-13.4%	0.3%	1980	-17.1%	31.7%	2000	-17.2%	-9.1%	2020	-33.9%	18.4%
1941	-22.9%	-12.8%	1961	-4.4%	26.6%	1981	-18.4%	-4.7%	2001	-29.7%	-11.9%	2021	-5.2%	28.7%
1942	-17.8%	19.2%	1962	-26.9%	-8.8%	1982	-16.6%	20.4%	2002	-33.8%	-22.1%	2022	-25.4%	-18.1%
1943	-13.1%	25.1%	1963	-6.5%	22.6%	1983	-6.9%	22.3%	2003	-14.1%	28.7%	2023 YTD	-7.8%	14.0%
1944	-6.9%	19.0%	1964	-3.5%	16.4%	1984	-12.7%	6.1%	2004	-8.2%	10.9%			
1945	-6.9%	35.8%	1965	-9.6%	12.4%	1985	-7.7%	31.2%	2005	-7.2%	4.9%			
1946	-26.6%	-8.4%	1966	-22.2%	-10.0%	1986	-9.4%	18.5%	2006	-7.7%	15.8%			
1947	-14.7%	5.2%	1967	-6.6%	23.8%	1987	-33.5%	5.8%	2007	-10.1%	5.5%			

Note: Closing Prices for Drawdowns as of 9/21/23 (does not include intra-day or dividends)

CREATIVE PLANNING @CharlieBilello

It has become commonplace for the media to report houses and apartments selling in Australia for $20 million, $30 million, $40 million and multiples more. **Lendlease Property** reported a $140 million sale at **One Sydney Harbour** in Sydney's Barangaroo and there are now plenty of $50+ million houses. In the entire world, it is forecast that Australia has reclaimed its position as the number 1 destination for millionaire migrants.



At the other end of the spectrum but still on property, *The Sydney Morning Herald* reported the death of a man who lived frugally in a derelict Clovelly home bought decades ago. It was "*held together with weeks and pigeon poo*". The man would visit the Clovelly Bowling Club every afternoon for a few beers and go home for a frugal dinner of baked beans. He lived "hand to mouth". The house sold for $4.55 million with the proceeds going to the **Bill Crews' Exodus Foundation**. The man could have been living a fine life with a combination of the Age Pension and a reverse mortgage, borrowing say $1 million at 22% loan to valuation. I doubt Mr Crews would have minded if the bequest was smaller. Don't forget to draw on all your resources to live a good retirement.

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Moving on ... in my article this week, I look behind the intriguing contest between **Magellan** and **Keybridge's Nick Bolton** due to the discount in the listed **Magellan Global Fund** (ASX:MGF). Bolton is trying to force

Magellan's hand to close or eliminate the discount and give value to his options (ASX:MGFO) but Magellan needs to ensure all unitholders are treated equally.

Graham Hand

Also in this week's edition...

Antipodes Partners' Jacob Mitchell identifies three features of global equities currently: a concentrated market, wide valuation dispersions and different cyclical and structural opportunities. Value stocks look especially cheap, according to Mitchell.

Australian banks have the ability to access emergency capital from the Reserve Bank by holding bonds to trade with the RBA. **Jeremy Cooper** believes super funds should have similar access to emergency funds. He suggests that it's unusual from a global perspective that the Treasury Department oversees super policy, and he'd favour a more formal relationship between the RBA and super funds.

While much of commercial property remains in the doldrums, industrial real estate continues to stand out. And **Charter Hall's Steven Bennett** says growth in online retailing and a shortage of facilities should continue to drive industrial demand and rents higher.

Aussie banks haven't had a great time of it over the past decade, though that could be about to change with higher interest rates, less competition and cost savings opportunities. **Morningstar's Nathan Zaia** suggests CBA is overvalued while Westpac can outperform.

Super concessions are forecast to overtake the cost of the Age Pension in the 2040s. **Kaye Fallick** reckons these concessions are creating a skewed system of reward for higher super balances in retirement and will widen the gap between rich and poor.

Lastly, in this week's White Paper, **First Sentier** shares several tools for assessing the environmental risks of companies.

Curated by James Gruber and Leisa Bell

This year's conference is bringing high-quality industry insights, with an unmissable lineup of speakers. You'll also see me in conversation online on October 11, joined by Noel Whittaker and Danielle Ecuyer, two of the country's most highly respected personal finance authors.

The event is in-person and digital, so you can access the conference however suits you best. To lock in your attendance, simply click here to register now. Tickets are just $27.50 for both days. I look forward to seeing you there – come and have a chat.

The fascinating battle between Nick Bolton and Magellan

Graham Hand

Many intriguing confrontations occur behind closed doors in the world of Listed Investment Companies (LICs) and Trusts (LITs) but much of the fight between Nick Bolton's Keybridge and Magellan is playing out in the public domain. It is an insight into the machinations caused by the closed-end structure, where issues commonly trade at a wide discount to their underlying value, opening the door for activists and competitors to exploit investor disquiet.

Background to the billions involved

On the surface initially, Nick Bolton's move on Magellan seemed mispriced. He had acquired options (ASX:MGFO) which gave the right to acquire units in the listed Magellan Global Fund (ASX:MGF) at an exercise price of 92.5% of the estimated NAV of MGF on the date the option is exercised. They are not traditional options with a fixed dollar exercise price. The options were issued in 2021 with an expiry of 1 March 2024. But in the year to end August 2023, MGF had traded at an average discount of 18.6% with a high discount of 22.9% over five years, and a current discount of about 12%. Bolton is obviously aware of the discounts but why did he pay for the right to a 7.5% discount?

(Declaration, my SMSF holds shares in MGF).

The amounts involved are huge. The Magellan Global Fund includes an open-ended class (ASX:MGOC) comprising about $7 billion and the closed-ended trust (ASX:MGF) worth about $2.8 billion. There are over 1 billion MGFO options on issue with a potential exercise value of about $1.8 billion. Whereas large shareholdings are often reported through nominee companies or trustees, Keybridge's position is shown in the Magellan Global Fund 2023 Annual Report. Keybridge has acquired 143 million options, currently priced at about 1 cent each.

Twenty Largest Option Holders

The names of the 20 largest MGFO holders of the Fund as at 16 August 2023 are as follows:

	Number	Percentage on Issue %
Keybridge Capital	142,676,240	13.42
HSBC Custody Nominees (Australia)	91,795,282	8.64
Netwealth Investments (Wrap Services A/C)	40,688,417	3.83
Nulis Nominees (Australia) (Navigator Master Plan A/C)	22,672,244	2.13
BNP Paribas Nominees Hub24 Custodial Serv (DRP A/C)	19,845,920	1.87
Citicorp Nominees	19,129,385	1.80

What is Bolton doing?

Nick Bolton hit the headlines in 2006 when he acquired BrisConnections options for 1 cent and forced a $4.5 million settlement after he voted against the proposal he put forward. Bolton's plan is to force Magellan to pay him the discount or change the structure of MGF to realise the NTA value. Based on the current share price of $1.68 and NTA of $1.89, Bolton could exercise into MGF at a price of $1.75 (that is, $1.89 X 92.5%) and sell for around $1.89. In other words, his 143 million options could buy $270 million worth of MGF on which 7.5% is over $20 million.

Nick Bolton has sent a note to select MGF shareholders, and here is an extract:

> *"With the assistance of 99 other members, we are looking to request a meeting of unitholders to consider a resolution that requires the redemption of our units at the full NAV of the fund (i.e. $1.94 at today's value). We fundamentally believe members of the trust should be entitled to access all of their beneficial interest at any time and not just what a third party might pay for that interest from time to time on the ASX.*
>
> *Importantly, if you also hold options in the fund (MGFO), then if the current trading discount persists it will cause a loss of what otherwise would be a ~15c entitlement when those options expire on 1 March 2024. In aggregate, unitholders and option holders, including yourself, are leaving some $500 million on the table as a result of the current trading discount.*
>
> *We are not asking other members, at this stage, to make a decision on whether to redeem their units, we are simply looking to collectively request a meeting such that we all have that option available to us."*

If Bolton manages to convene a vote of all investors to wind up the trust, he would require the support of 75% of unitholders.

Recent media reports suggest Bolton and his associate Anthony Catalano approached Magellan offering to sell the options and drop the campaign in exchange for a payment that only Keybridge would receive, not other unitholders, although this version of events is disputed.

But therein lies the challenge for Bolton. To gain cooperation, Magellan will need convincing that anything Bolton does on his tactics is acting in the interests of all unitholders.

What has Magellan said in public?

In an update on MGF by Magellan in January 2023, reported in Firstlinks, CEO David George and Head of Listed Funds, Jennifer Herbert, spent considerable time explaining how Magellan planned to handle the MGF discount. Herbert was asked why Magellan did not convert MGF to open-ended active ETF, and she said:

> *"It's actually not that simple unfortunately. Firstly, MGF is a class within the greater Magellan Global Fund, it's not a standalone fund. And secondly, we have over a billion options out on issue. So, the option holders are a class of members within the Global Fund and Magellan as the responsible entity of the fund has a duty to treat those option holders fairly. So, unfortunately, we can't just wrap up the LIT to an active ETF while those options exist …"*

There's a clue: *"While those options exist".* Then David George was asked if Magellan delivers on its performance objectives, but the discount persists, what might he do?

> *"Well, delivering on the objectives should support a narrowing of the discount and the fund can continue to engage in the buyback. But if the options expire in March 2024, that may provide us with other avenues to explore."*

In the 2023 Annual Report for the Global Fund, Magellan references the work that had already been done to narrow the discount:

> *"While it is pleasing that the discount has narrowed considerably since our update in November 2022 from 22.6% on 9 November 2022 to 12% on 17 August 2023, we believe there is more that can be done."*

Showing their commitment to the buyback, Magellan has now spent $465 million of MGF money buying MGF units, probably the largest LIC/LIT buyback programme in history.

Some factors determining the outcome

There's a lot at stake in a $10 billion combined fund, and here are some factors influencing the outcome over the next five months or so:

1. The options were issued when MGF was restructured in December 2020, designed as a pro-rata bonus at a rate of one option for every two closed-class units held on the record date. Magellan said:

"We believe this is an attractive bonus issue and provides Eligible Unitholders with the opportunity to increase their investment in Magellan Global Fund, over a three year period, at a discount to net asset value."

If MGF had continued to trade around its NTA, the options would have carried decent value and Magellan would have raised a large amount of additional funds. Magellan needs to bear in mind what it said to investors in the original option PDS.

2. Magellan did not offer the option out of the goodness of its heart, although it may have expected a win-win. The annual management fee is a healthy 1.35% plus a performance fee. Assuming Magellan would earn fees of say 1.5% a year, the 7.5% discount would be covered in five years. MGF is a closed-end fund and investors cannot redeem, and Magellan decided the NPV of future fees would exceed the discount.

3. Which leads to a crucial feature of the discount. It is funded by the Magellan Group, not the Global Fund (closed or open). And the NPV calculation only works for a closed-end fund from which investors cannot withdraw. Magellan will not want to fund the 7.5% discount and then convert to an open-ended fund if they expect investors to withdraw.

Magellan would be paying from its own shareholders' funds the $20 million on Keybridge's $270 million position. The options may also have value if the discount narrows to less than 7.5%, which is not impossible but unlikely.

4. Does Magellan have an incentive with 1 billion options on issue to encourage investment of around $1.8 billion of new money? While this might have been conceivable at the height of the fund-raising powers of Hamish Douglass and Magellan, it is unlikely investors will commit billions of new money, even at a 7.5% discount. They did not respond much when the discount was over 20% and most of the push in the discount back to the current 12% is buyback demand. Nevertheless, Magellan may argue it is motivated to reduce the discount so the options are exercised, adding billions to its funds.

My expectation

I expect Magellan to tough it out and refuse to change MGF until well after the options expire. If the discount narrows towards zero (and it has already moved from about 18% to 11% in 2023), it may raise money through the exercise of MGFO.

At some stage, with the options expired and better performance, but faced with the ongoing discount problem of many LIC/LIT issuers, I believe Magellan will convert MGF holders to the open-ended unit class (ASX:MGOC).

But Nick Bolton will find 100 like-minded investors, giving him the right to request a meeting of unitholders, and he will not go away easily.

The clock is ticking and the alarm will ring on 1 March 2024.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any investor. Graham's SMSF holds units in ASX:MGF and Magellan is a sponsor of Firstlinks. This analysis should not be relied upon for any transaction and financial advice should be sought.

Even Warren Buffett lost his edge 20 years ago

Ashley Owen

The world's best investor, Warren Buffett, has suffered from the same disease that plagues every other successful fund manager in the world - fading out-performance over time. My analysis here is not covered in any of the books or articles on Buffett that I have seen.

Even Warren Buffett peaked long ago

In my last article (1), I showed how even the very small proportion of fund managers that ***do*** add value by beating their market benchmark over a decent time period, that their out-performance ***always*** fades over time.

After studying hundreds of funds, my conclusion was:

"All active fund managers peak early in their careers (in terms of beating their market index anyway) and then it is all downhill from there. Even for the best in the world."

This includes the greats like Warren Buffett, Peter Lynch, George Soros, John Templeton, and local 'stars' like Kerr Neilson, Hamish Douglass, and everybody else. The reasons are different in each case.

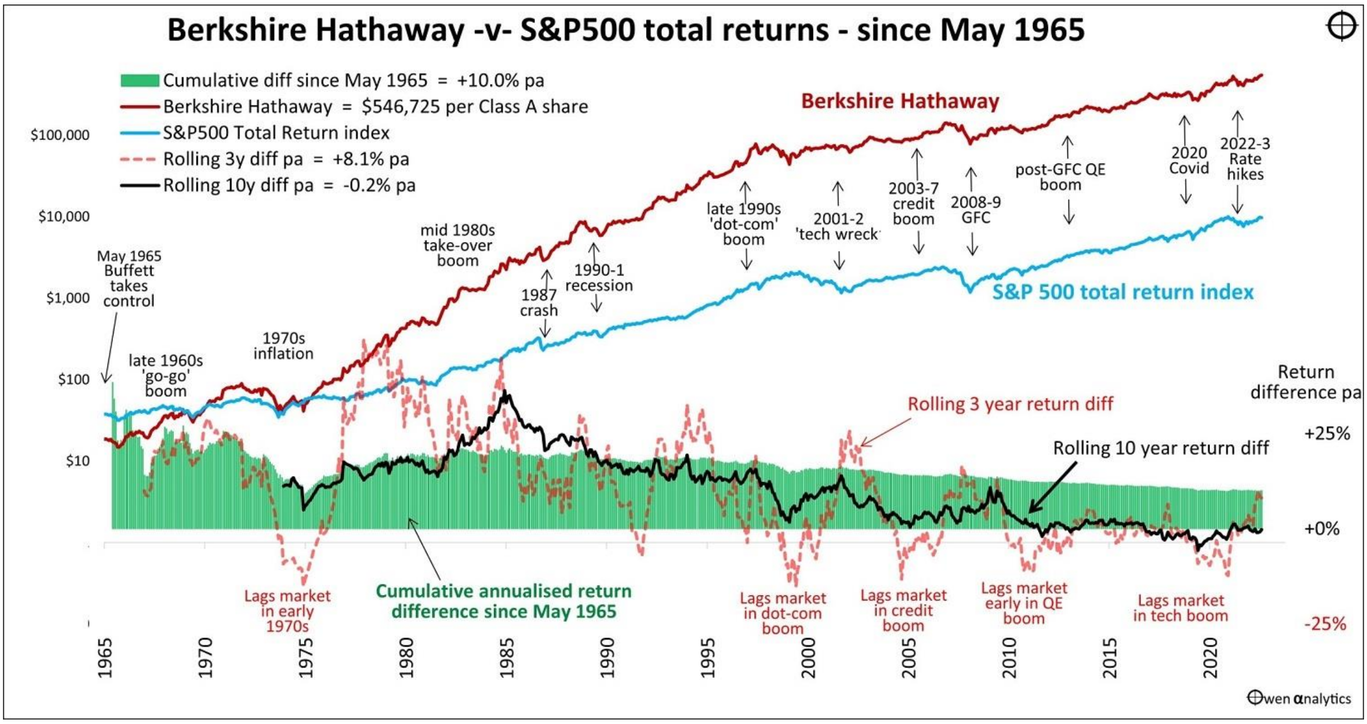
Yes, the pattern is the same for Warren Buffett.

I am a long-term shareholder in Berkshire Hathaway, so I have a vested interest in measuring its performance. It has beaten the S&P500 total return index by an astounding 10% pa since May 1965 when Buffett took over, but most of that out-performance was in the early decades.

Berkshire Hathaway has not added any value against the S&P500 index since 2002. Its out-performance fade curve is the same as other value-adding share funds in Australia and other markets.

Tracking performance decay over time

Here is my chart for Berkshire Hathaway since May 1965 when Buffett took control.



The red line is the Berkshire's share price. Since 1965, the company has paid no dividends and has reinvested all earnings, so the share price is essentially the 'Total Return' series. The shares have not split over the period and the price of BRK Class A shares has grown from $12.37 to $546,725 ***per share*** at the end of August 2023.

The blue line is the S&P500 total return index. This is the most appropriate benchmark because Berkshire's investments have always been US companies (listed and unlisted), with few exceptions (notably Chinese car maker BYD).

The black line shows annualised rolling 10-year excess returns above the benchmark. This is our main historical measure for long-term investors.

The orange dotted line is the annualised rolling 3-year excess returns above the benchmark. This is a good way to see performance through different cycles and market conditions.

Beat the market by 10% pa since inception

The green bars in the lower section of the chart show the annualised cumulative excess returns over the benchmark since May 1965. This is the annualised 'since inception' out-performance over time. It has beaten the S&P500 total return index by 10% pa compound over 58 years! No other fund manager in history has ever come close to this over such a long period.

Warren Buffett, along with his side-kick Charlie Munger, is without doubt the greatest portfolio share investor in history. I use the term 'portfolio investor' to differentiate him from founder/owners like Rockefeller, Carnegie, Musk, Bezos, Gates, etc. They built their own companies, but Buffett invested in other peoples' companies, which is a different skill.

Buffett put just $100 of his own money into his first fund in 1956. He earned the rest of his stake by taking his out-performance fees in units in his fund, rather than cash, and then rolled it into Berkshire Hathaway in 1965. So, he turned his original $100 in 1956 into $120 billion today.

Peaked in 1965 (year one) then downhill

Like all active fund managers, Buffett peaked early. In fact, he peaked in the very first year in Berkshire. He beat the S&P by a whopping +37% in 1965, and that was the peak of the annualised cumulative value add (green bars).

1965 was actually not his best individual year. He had several better years – and they were all early on. He beat the market by +105% in 1976, +84% in 1979, +67% in 1968, +66% in 1971, +54% in 1977, +53% in 1989. These were partially offset by some poor years in between, so the cumulative 'since inception' peak was in 1965.

It was all downhill from the early peak, albeit still generating higher returns than anyone else in history.

- By the end of the 1960s, the annualised cumulative value add was +27% pa.
- By the end of the 1970s it was +19.7% pa.
- By the end of the 1980s it was +20.4% pa.
- By the end of the 1990s it was +15.1% pa.
- By the end of the 2000s it was + 13.1% pa.
- By the end of the 2010s it was +10.5% pa.

Today, the annualised cumulative value add is down to 'just' 10% pa. What's not to like? As a prospective investor you might say: *"Wow the since inception return is still 10% pa over 58 years. It should still be a great investment!"*

That's why fund managers and their sales reps love talking about 'since inception' returns. But they are meaningless.

The problem with 'since inception' numbers

This highlights the big problem with 'since inception' numbers. The great-looking 'since inception' return of 10% pa masks the fact that most of that out-performance was generated in the early years, half a century ago.

We see a clearer picture of performance by looking at returns per decade (right).

Berkshire Hathaway since May 1965

	BRK-A	S&P500 TR	Excess return pa (arith)
1960s	31.2%	4.2%	+27.0%
1970s	22.2%	5.9%	+16.4%
1980s	39.1%	17.6%	+21.5%
1990s	20.5%	18.2%	+2.3%
2000s	5.9%	-0.9%	+6.8%
2010s	13.1%	13.6%	-0.5%
2020s	13.9%	11.3%	+2.6%

(to end Aug 2023) Owen analytics

In the 1990s, it added almost no value as Buffett lagged the market by deliberately avoiding the crazy 'dot-com' boom. This earned him a lot of derision at the time but he was vindicated when he added value in the 2000s by avoiding the 'tech wreck'. However, virtually no value was added in the 2010s and 2020s.

Rolling 10-year value-add

The black line (rolling 10-year value added pa) is the key. It shows rolling 10-year annualised value add is currently zero. In fact, the black rolling 10-year value add line has been running at around zero for the past 10 years since 2012, because it has added no value at all since 2002.

That's a long time going nowhere. It didn't actually go nowhere of course. It has gained 650% since 2002, but so has the passive S&P500 total return index. That's better than the 490% return from the Australian market over the same period.

Rolling 3-year value-add

The orange dashes (rolling 3-year value added pa) is a good way of showing where the value is added or detracted through market cycles.

Buffett's pattern has been very consistent over seven decades. His 'value investing' strategy lagged the overall market in booms (by avoiding fads/bubble stocks) but then added value in the busts when the fads/bubble stocks collapsed. The only exception was poor returns in the 1973-4 crash, but that was recovered big time in the late 1970s and 1980s.

True to form, Buffett was also vocal in avoiding the most recent 2020-21 Covid stimulus tech bubble, and the share price lagged the market (orange dash line below zero) as expected. There were also some poor deals in the recent cycle – notably Kraft-Heinz, and the disastrous Airline bets in 2020.

In the rebound over the past year, performance has improved, thanks to huge bets on Apple and oil/gas.

Reasons for performance fade

Buffett and Munger certainly have not succumbed to the problems that afflict many older fund managers, such as selling out, no longer lean and hungry, family problems or diversions, buying football teams, hubris, ego, etc, etc.

In their case, there are probably two reasons:

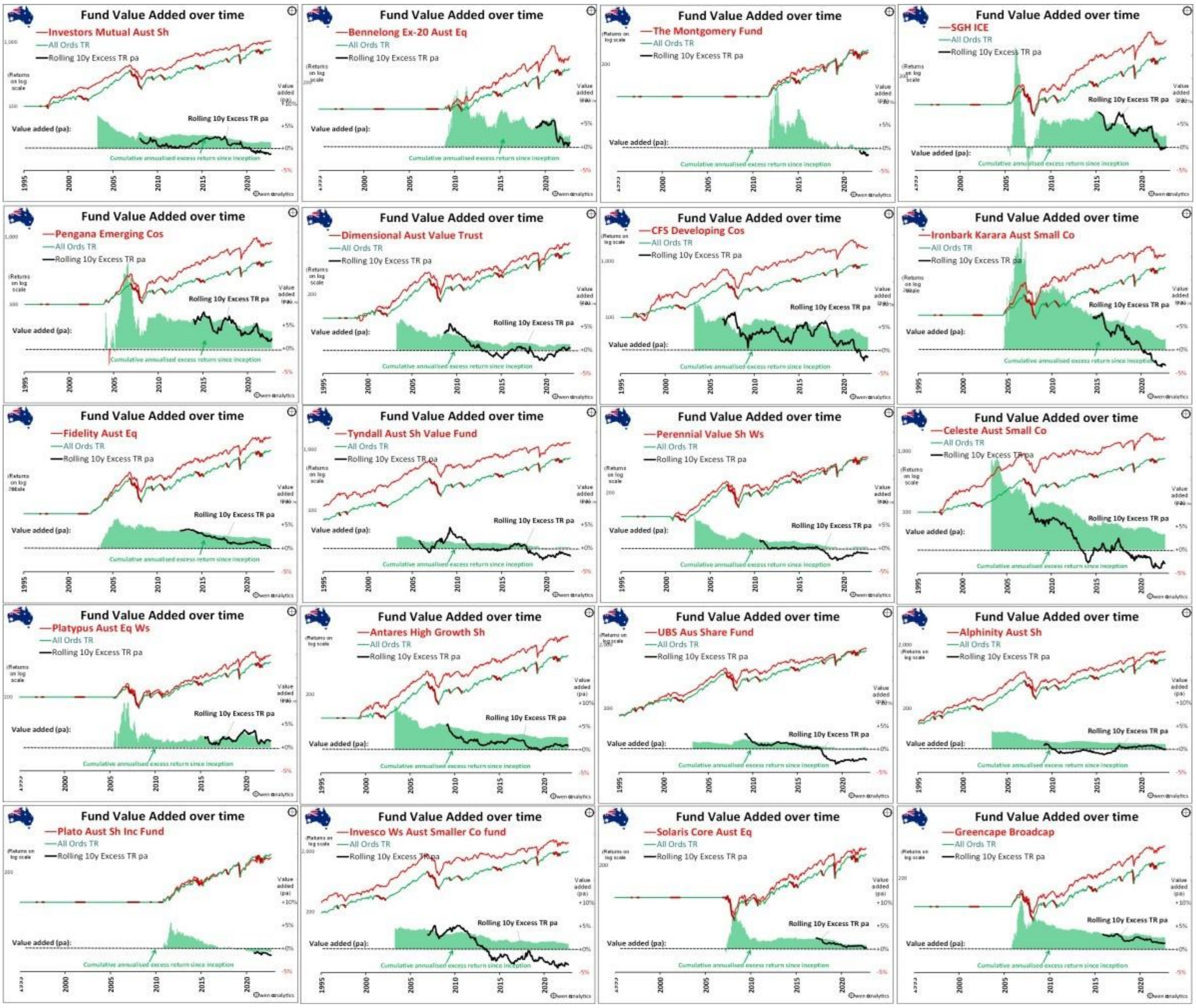
1. Berkshire has become too large and they cannot deploy the huge sums effectively without moving markets.
2. It has too much cash, which is largely the result of the first problem.

Am I a seller? Probably not until my SMSF is in tax-free pension mode, so I avoid CGT on sale!

Same pattern of fading out-performance

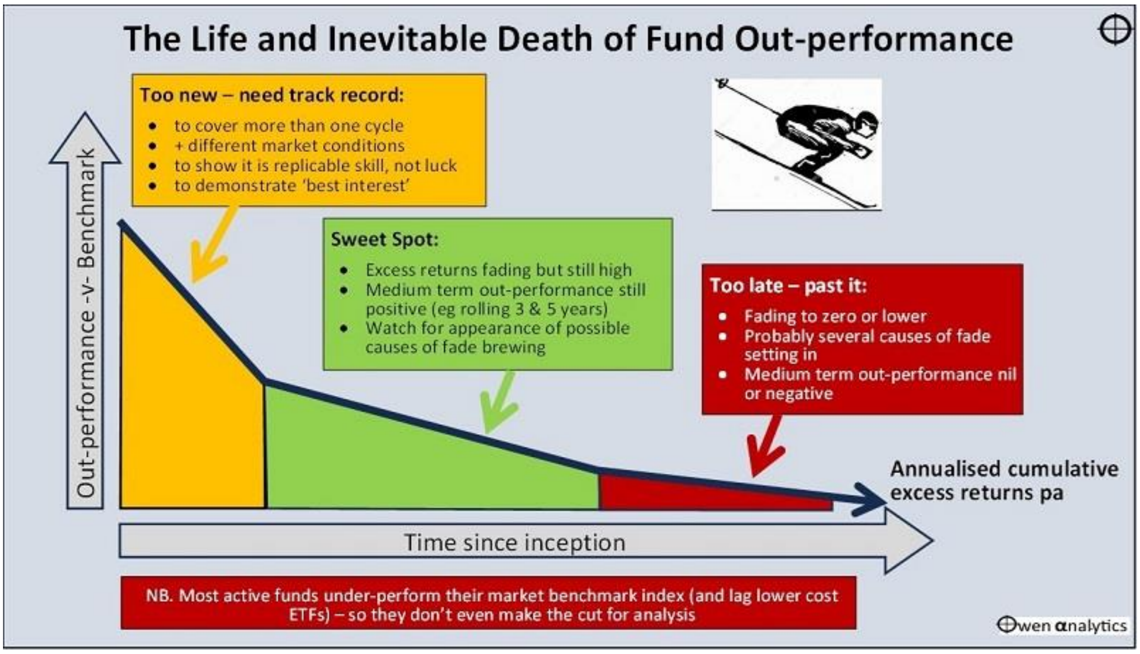
For reference, here is a copy of the charts on 20 'value-adding' Australian share funds. Just as with Berkshire Hathaway, the general pattern is the same. Excess returns (green bars) start out with a bang early in the fund's life, but then fade over time in every case.

The difference is of course that Buffett and Munger added a lot more value for a lot longer than anyone else.



Three stages of out-performing fund managers

Here is the chart from my last article, outlining the three stages in the life of an out-performing fund:



Berkshire Hathaway was in the Sweet Spot for decades but has probably been in Stage 3 since the early 1990s. The orange 3-year value-add line on the main chart shows there are certainly some short-term opportunities through the cycles, but as a long-term investor, the black 10-year value-add line has flat-lined.

(1) OwenAnalytics Newsletter is currently published on LinkedIn. '[Few active fund managers add value, but even value-adding managers almost always fade over time.'](#)

Ashley Owen, CFA is Founder and Principal of OwenAnalytics. Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual.

Investment opportunities in markets priced at extremes

Jacob Mitchell

Global equities feature three key ingredients at the moment: a concentrated market, wide valuation dispersions and different cyclical and structural opportunities. Investors have gone through a tough interest rate tightening cycle but monetary policy acts with a lag, and the delayed reaction is coming through in leading indicators. But at the same time, we have the US Treasury and politicians expanding the fiscal deficit, which is one reason why inflation is staying sticky.

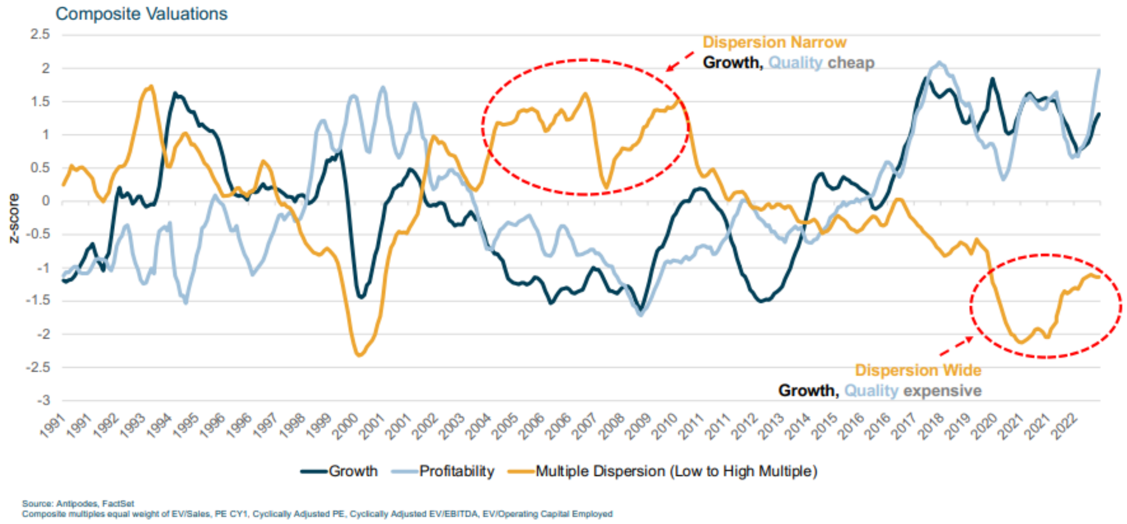
Market valuations and policy variations

Factors are working against each other with a lot of policy volatility and variations in nominal GDP growth. What happens to market multiples in that environment? In the 1970s, the Price/Earnings ratio averaged around 11 times in US broad equities. That wasn't just because the discount rate was higher because we had inflation. It was because of this volatility and it derated equities (that is, lowered P/Es). Today, the P/E multiple is 30 times. The takeaway is that US equities are offering a narrow margin of error based on valuations today and the inflation and rate regime that we've shifted into.

Let's talk factors. In the chart, the yellow line is what many investors think about as the value factor. We refer to it as valuation dispersion between value and growth. The yellow line is tracking the multiple paid for the lowest P/E stocks in the market by quintile versus the highest. It's been trending down for a dozen years, so there's a lot of valuation dispersion in the market today.

Owning quality or growth is more expensive than normal. While we know investors should pay a higher multiple for those characteristics, they are paying a very high multiple today. Is it durable growth and durable quality?

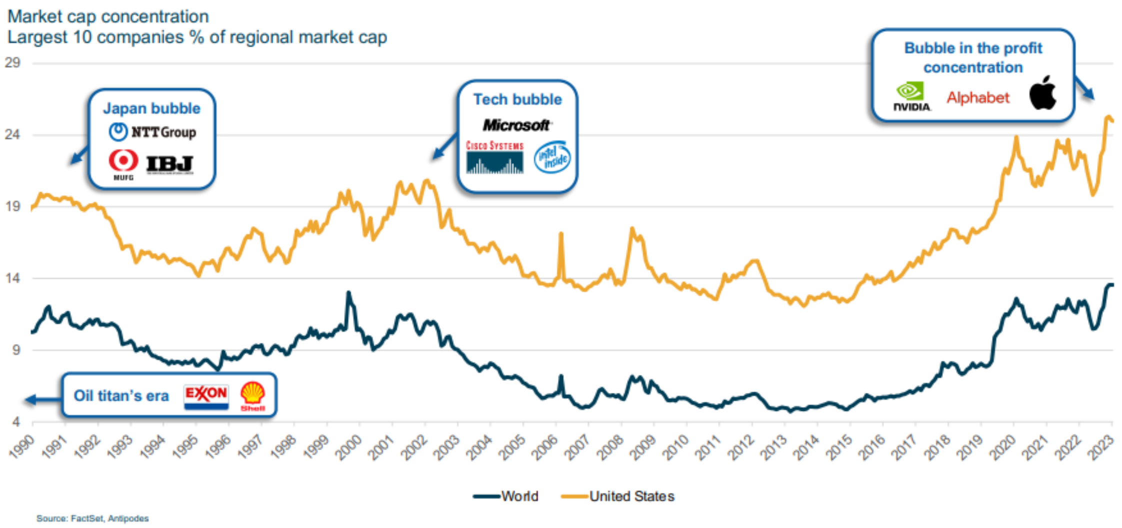
Multiple dispersion is wide and value stocks are cheap



Market cap concentrations

Another observation is that market cap concentration is going through a crazy period that will not last. We've seen it before, from 1990 in Japanese equities, 2000 in US tech stocks and today, it's concentrated in the Magnificent Seven. The average is P/E multiple is about 36 times, with Tesla on a really high multiple and Meta and Alphabet on much lower multiples. But we're seeing a concentration of profit in the economy in a small number of companies.

Market capitalisation concentration also high



Everything else is on a lower multiple and the more we move away from the US, the lower that multiple goes. So, arguably, there are many sectors in many regions that are already pricing in a relatively hard landing.

Why have the Magnificent Seven re-rated? Will Alphabet or Meta sell more digital ads in a recession than they do today? Will Tesla sell more cars in a recession? Investors must be very certain that the high multiple is justified and we argue conditions will be tougher. Now, we also have companies in that group that are arguably more defensive, such as Microsoft. It's got a great business and AI is giving it more pricing power.

Past winners often fall behind

So is it rational to play defense in some of these companies that are maturing, that are becoming more economically sensitive? Let's do a history lesson. In 1980, the number 1 company in the world was IBM, effectively the inventor of the PC. But IBM was famously dependent on two other companies, Intel for chips and Microsoft for the operating system. It saw those two companies as suppliers.

Now let's go to 1990. The biggest company in the world was NTT, a very boring company. It's the Japanese equivalent of Telstra. Then by 2000, IBM has been disrupted by its two suppliers. Microsoft and Intel which have taken all of that profit pool in personal computing. Then coming out of the GFC, China delivered a massive stimulus and companies exposed to China became the largest companies in the world. Today, Apple has brought desktop computing power to our fingertips on a mobile device.

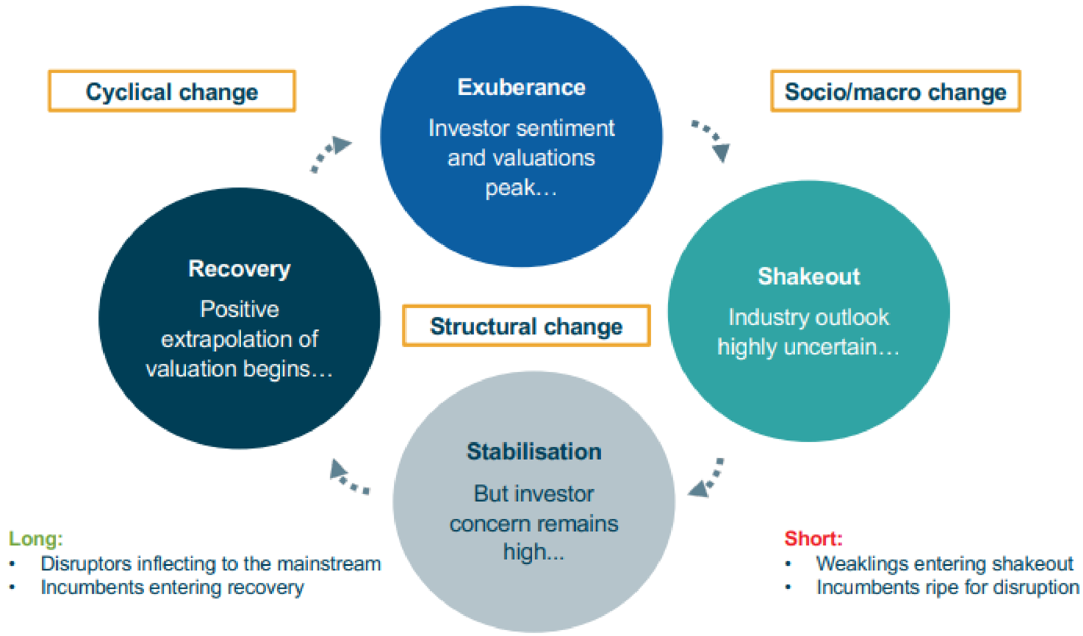
Investors should expect a reshuffling of winners

> "Over the long term, the companies behave more like biology than they do anything else. In biology, all of the individuals die, so do all of the species. It's just a question of time"
> – *Charlie Munger*

The point of this history lesson is the top 10 companies are constantly turning over because of the competitive dynamic in the market. Investors need to navigate structural and cyclical change, avoid the cyclicals that become value traps and miss the growth stocks that become growth traps as they mature, with an eye on socio and macroeconomic change.

In our portfolios there are four pillars:

1. Lower-growth companies have a role at multiples where they're attractive investments.
2. Companies that are transitioning into strong structural growth.
3. Defensive or secular growth companies that are benefiting from structural growth but are still mispriced relative to that growth.
4. In our long-short fund, single stock shorts and tail risk hedges that are mispriced.



Here are some examples.

It is hard to find anyone who has a positive case for China, but valuations are at record lows and there are opportunities in really high-quality companies. For example, Alibaba today and its equivalents like Baidu, which are Chinese versions of the Magnificent Seven, are trading at 10 to 12 times earnings. They are very strong businesses, they're hard to break, they are run for shareholders, and they are priced for an extraordinarily high level of geopolitical risk and a very bad economic outcome. There's a significant margin of safety and we think there are opportunities in these companies.

In our second example, a structural transition story is Total, an oil company, but it is an oil company that has been biasing its investments towards natural gas as a transition fuel, as well as renewables. More than half of its investment is going into those areas. There has not been the supply response to higher oil prices that we've had in the past. At a 15% free cash flow yield, there is a lot of value in Total.

And then, a third area of structural change, and AI adoption is a very long-term trend. The companies that we think are in the best position to benefit from AI adoption are those ones who can monetise it with their business customers. We think it will be hard to make money out of selling AI services to consumers, but we think there is a big productivity gain for companies like Microsoft. We don't think it is priced in for Oracle, Microsoft, SAP.

The bottom line

There is a massive amount of concentration in the market, valuation dispersion is high and value as a factor is cheap. These will lead to opportunities.

Investors should avoid paying yesterday's prices to solve for tomorrow's uncertainty. Crowding into some of the Magnificent Seven is not a defensive move, and investors should be wary of the potential for economic sensitivity in some of those names.

Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, managing over $10 billion and an affiliate manager of Pinnacle Investment Management. Pinnacle is a sponsor of Firstlinks. Jacob spent 14 years at Platinum Asset Management before starting Antipodes in 2015.

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Jeremy Cooper on super becoming too big

Jeremy Cooper

This is an edited transcript of Jeremy Cooper's radio interview with Geraldine Doogue on ABC's RN Saturday Extra Programme recorded on 16 September 2023.

Jeremy Cooper is a former ASIC Deputy Chair, former Chairman of Retirement Income at Challenger and chaired the 2010 Federal Government Review into Super.

Geraldine Doogue: The Labor Government has tabled a bill in parliament formally describing the purpose of the superannuation system, building on a definition offered by the Morrison Government. Jeremy Cooper has been deeply involved in the industry's development over many years.

Jeremy, why do we need a newly-defined or fleshed-out definition, given that we had one just a few years back, about which we talked to you for this 30-year-old system of ours?

Cooper: Yes, it does seem like an odd question. Indeed, 30-odd years ago – and I'll call out one specific instance when the legislation creating compulsory super was passed in 1993 - Treasurer John Dawkins tabled a report that was called '*Security in Retirement: Planning for Tomorrow Today*'. When you read that document, it seems obvious that the people involved in writing it that knew exactly what super was for. They'd be somewhat bemused that here we are 30 years later defining a purpose.

It's all about politics. The vast sum of money in super has become more and more contested. I suppose that's modern life, isn't it? Everything's contested, and super is no exception, and so it gets pushed and pulled in all directions. “It should be doing this, it should be doing that, people should be able to access it for housing” and so on. And so, what this purpose does is gives super some sort of direction to point in.

Doogue: What are the words being used?

Cooper: Well, look, the words are worth reading. It's only one sentence.

“The objective of superannuation is to preserve savings to deliver income for a dignified retirement alongside government support, in an equitable and sustainable way.”

It picks up all the key words, and it's nice and sharp. So, as a set of words, I think it's excellent.

Doogue: And is it very different from the Morrison Government one?

Cooper: It is. The Morrison version was missing a lot of those adjectives. So, it was too anodyne. It didn't have any ambition in it, I think, was probably the main criticism. When you look at words like equitable, dignified, sustainable, they are sort of ambitious. Now there are critics who say those words will cause trouble, they'll cause arguments, but I think it's landed in a good place.

Doogue: There are now regular reports of how big super is investing its money. Apparently, it's put a lot into our much-discussed electricity transmission systems. AustralianSuper's $2.5 billion investment in a European data center, Vantage Data Centers, is causing comments. Now, would you say from your observation that priorities are shifting, the bigger the system gets?

Cooper: They are. But if we're talking about the single biggest issue facing us at the moment, it is climate change. And a system like super requires growth to derive profits to then pay back to retirees for the money they sacrificed into super. And growth is largely from economic activity involving the emission of carbon, such as building, agriculture, extraction of coal, steel.

Doogue: So, it's our modern world.

Cooper: It's our modern world. And a system that benefits from that growth and economic activity for our wellbeing, I think carries an obligation to reach the 2030 targets, which in Chris Bowen's language, are “ambitious but achievable”. I think it's going to be very difficult for an economy like Australia's to get there. And I think the super system needs to do a lot more than just outsourcing these issues to some relatively small so-called proxy advisors.

Doogue: Greg Combet’s remarks were interesting. "One of the things in my mind is to be thinking about how we can open up investment opportunities for commensurate risk-adjusted returns for institutional investors, including super funds, to be in the energy transition in a more significant way, to be in the decarbonisation process by taking stakes in companies or being lenders to assist that happening, to co-invest with institutions like the Clean Energy Finance Corporation. But that's something we've not unlocked yet." Now, are you hearing other views like that, Jeremy?

Cooper: Absolutely. We're seeing overseas participants cutting our lunch again in our market. So, a lot of the players doing wind and solar and investing in projects like in Gippsland, they’re Canadians, the Danish. We need to be careful that we participate accordingly.

Doogue: But the question is, are they giving their recipients back in Canada and Denmark full bang for their buck for their investment, for their retirement? I mean, this is the great question. By doing this, do we need some form of co-investment by government capital in order to be sure that we're not selling our retirees short? Are our policies and approach keeping up with the sheer scale of this industry?

Cooper: It wasn't so obvious in the most recent Intergenerational Report. But certainly, in the previous one, the sheer projected scale of the super system was almost terrifying in future dollars in the 2060s. It will be 10 times the size of the existing system and would dwarf the stock exchange and GDP. Now, to date, we've only had positive impacts from such a large amount of money that's not under the government's control. The flows of capital in super, where and when capital is allocated, are not really under any sort of regulatory control. When the GFC happened, the Australian super system repatriated vast amounts of capital that was overseas, and it was then used for everybody's benefit, but certainly for the system's benefit, to recapitalise our banks and major companies and so on. That was an incredibly positive outcome. The danger is that if we're not careful, we're not watching what the negative implications of such free-flowing capital that's very large versus our economy.

Doogue: What do you mean?

Cooper: Well, at the moment, our annual GDP is about $2.5 trillion and the super system's at $3.5 trillion in round terms. Switzerland, Canada, the Netherlands and us are in that elite league where we have pension systems that are big in relation to our economies. There are very few big countries in this position.

Norway is a really good example of where they have a sovereign wealth fund and rather than giving the oil wealth away to companies and so on, they kept it for Norway and put it into a vast fund to when the oil ran out, they'd have all the wealth. What they said though was not one Kroner of that was allowed to be invested in Norway because of that relationship between the huge pot of money and a much smaller economy. But we're approaching a world where we have this awesome amount of capital, and half of it is already invested overseas for that very reason.

Doogue: And what about the way we govern it? You've also been talking about that, just whether we're structurally ready within government for this type of challenge. Treasury governs super policy, doesn't it?

Cooper: It does. And that's relatively unusual around the world. So, in China, in the US, it's the Department of Labor. In the UK, it's the Department of Workplace and Pensions. It's unusual to have such a large pension system in policy terms within Treasury where it's not even a second-order issue, it's more like a ninth-order issue. And I'm not being critical of Treasury, but there are millions of other jobs that rank ahead of looking after the super system. And this might be a reason why we keep having all these ad hoc reviews. If you look over the last decade, we've had significant reviews done outside Treasury, into the system.

Doogue: So, what do you think ought to be happening? Because what you are describing is coming, it's this giant thing on the horizon. And anybody who wants to be powerful or influential in the future in Australia will need some involvement with the super industry, because it's just going to be this giant pot of money.

Cooper: It seems to be the case. It would be very expensive and tedious to reengineer it, and with all of the other priorities, probably doesn't rate highly enough. I've always thought that the super industry ought to have a more formal relationship with the Reserve Bank. And I don't want to get too technical here, but much like the way that the banks themselves can access emergency capital from the Reserve Bank by holding bonds to trade with the Bank, the super system could have a similar relationship, and that would be one piece of engineering that I would push strongly forward.

This is an edited transcript of Jeremy Cooper's radio interview with Geraldine Doogue on ABC's RN Saturday Extra Program recorded on 16 September 2023.

Jeremy Cooper is a former ASIC Deputy Chair, former Chairman of Retirement Income at Challenger and chaired the 2010 Federal Government Review into Super.

Unique factors drive Industrial and Logistics property demand

Steve Bennett, Sasanka Liyanage

A range of idiosyncratic factors continues to generate significant demand across the Industrial and Logistics (I&L) sector of commercial property. Commercial property is generally defined as real estate used for business purposes rather than residential, but is not one single investment type. Industrial units, rentals, offices and retail assets carry different dynamics at points in the property cycle.

I&L demand is currently driven by:

1. An evolving ESG requirements and the growing prevalence of automated technologies which have increased the demand for prime I&L assets.
2. A focus on supply chain resilience and increased cost pressures have shifted strategies in favour of holding larger inventories.
3. Insufficient supply response with geographical constraints, tight planning restrictions and limited connecting infrastructure and availability of suitably-zoned land.

4. Historically low vacancies and unprecedented rental growth, with an imbalance between supply and demand forecast to continue over the near term, with rents increasing at notable levels.
5. The rapid growth in the population intensifying the existing shortage of stock.

The chart below shows low vacancy rates, more future demand than coming supply and rising rents across the major Australian capital cities.

Industrial market indicators Q2 2023*

	Vacancy	Supply additions	Demand		Prime net face rent		
	(%)	2Q23 (sqm)	12-month gross take-up	Differential to 10-year average	$/sqm	Q/Q change (%)	Y/Y change (%)
Sydney	0.2%	63,549	674,186	0.75x	$197	3.5%	31.7%
Melbourne	1.1%	144,098	1,221,703	1.25x	$126	4.0%	22.0%
Brisbane	0.5%	121,032	717,234	1.39x	$139	0.3%	13.4%
Perth	0.4%	-	213,157	1.02x	$135	0.0%	21.2%
Adelaide	0.8%	28,276	59,068	0.45x	$110	0.0%	6.3%

Source: CBRE, JLL Research, Charter Hall Research. At 2Q23.
*Values are market indicators, not Charter Hall portfolio indicators.

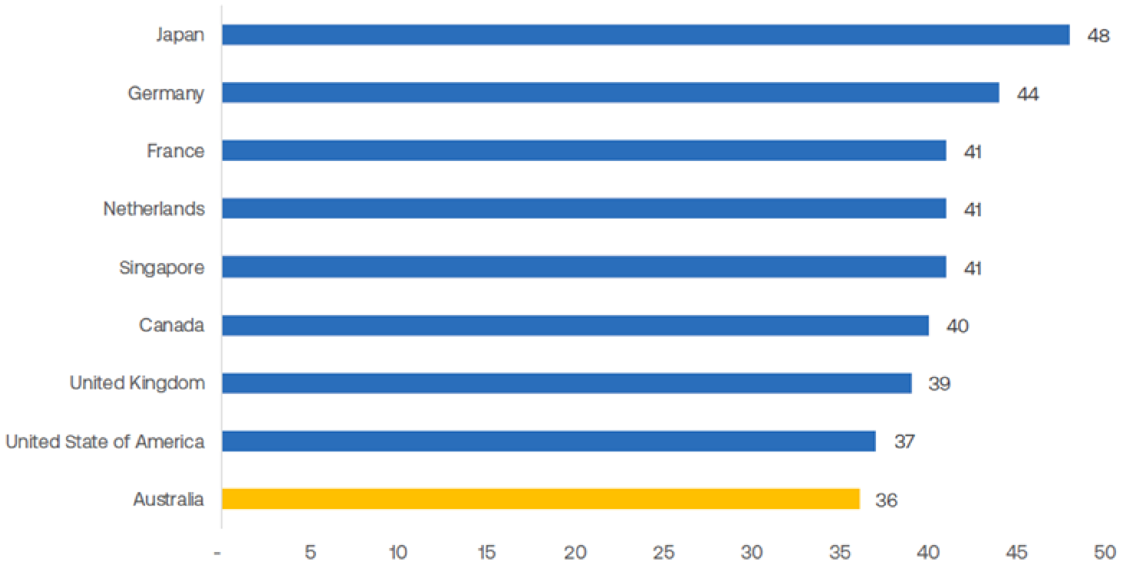
Demographics and industrial property

The relationship between population and industrial demand is intertwined: additional people introduce increased consumption requirements.

Overall demand can also be influenced by second-order demand factors such as consumption per person, supply chain efficiencies and inventory holding levels.

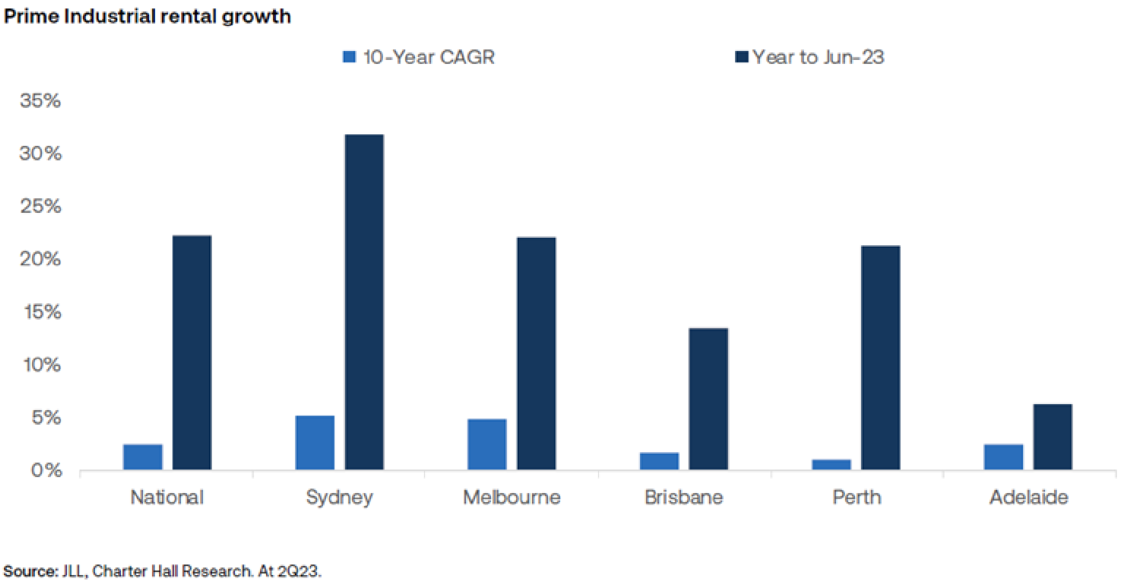
Australia's population growth will be favourable to consumption from a demographic perspective. Australia has had a long track-record of sourcing a younger and more productive population from across the globe. It also benefits from having the wealthiest population on a per capita basis. Additionally, given the nature of relocating, new migrants have higher and immediate propensities of consumption.

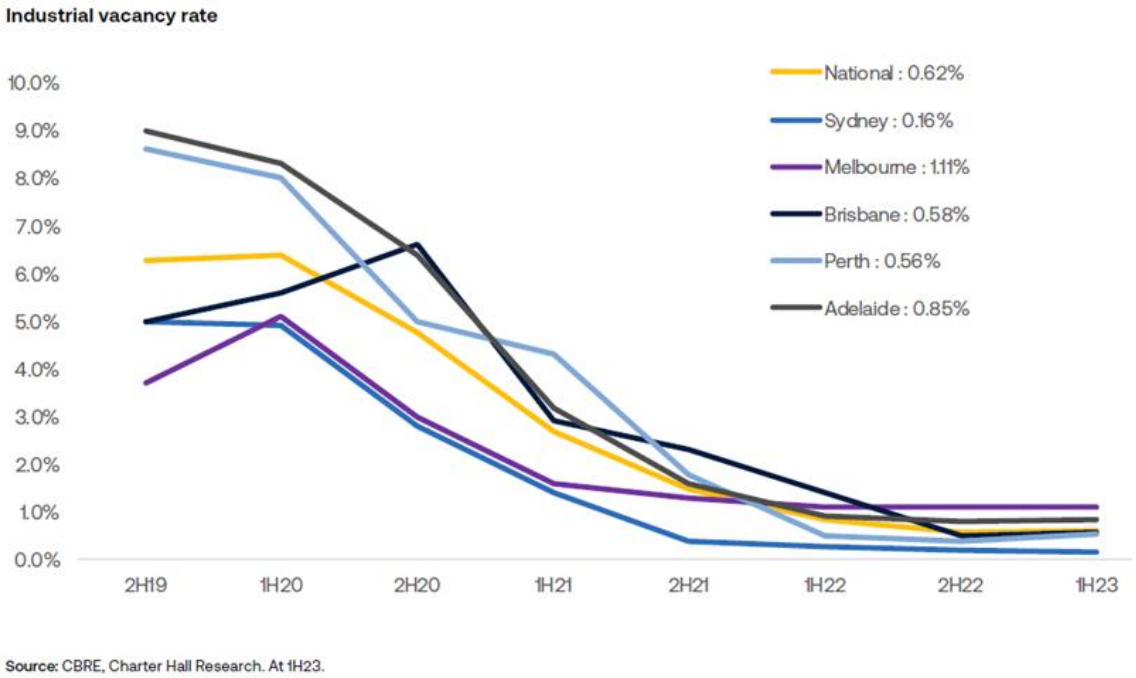
Median age by country



Source: United Nations Population Division (Oct-22), Charter Hall Research.

This growth must be accommodated but the supply response faces ongoing challenges. Construction costs remain elevated, supporting infrastructure projects are delayed, and forward pipelines are largely pre-leased. As such, conditions remain constructive for above-trend I&L rental growth over the near-term.





Forecast I&L demand and supply

Historically low levels of vacant stock continued to restrict leasing volumes over the second **quarter** of 2023. Gross leasing volumes reached 786,000sqm, above the 10-year average of 688,000sqm. Activity over the quarter was led by the East Coast markets: Sydney (312,000sqm), Melbourne (275,000sqm) and Brisbane (126,000sqm).

Annual leasing volumes were broadly in line with longer-term averages, reaching 2.9 million sqm. Activity was particularly strong across the Melbourne market, which recorded gross absorption of approximately 1.2 million sqm. This was followed by Brisbane (717,000sqm), Sydney (674,000sqm), Perth (213,000sqm) and Adelaide (59,000sqm) markets.

Approximately 358,000sqm of completions were recorded over 2Q23. Completions over the quarter were concentrated across the East Coast markets: Melbourne (145,000sqm), Brisbane (121,000sqm), Sydney (64,000sqm) and Adelaide (28,300sqm).

Approximately 1.53 million sqm of developments are currently under construction and expected to complete by 2023. The forecast additions to vacancy from this remain limited, with 41% of the pipeline secured by pre-lease. This figure typically increases as lease deals are completed through the construction process.

Prime rental growth

The imbalance between occupier demand and available modern, efficient warehouse space supply, continued to generate significant rental growth.

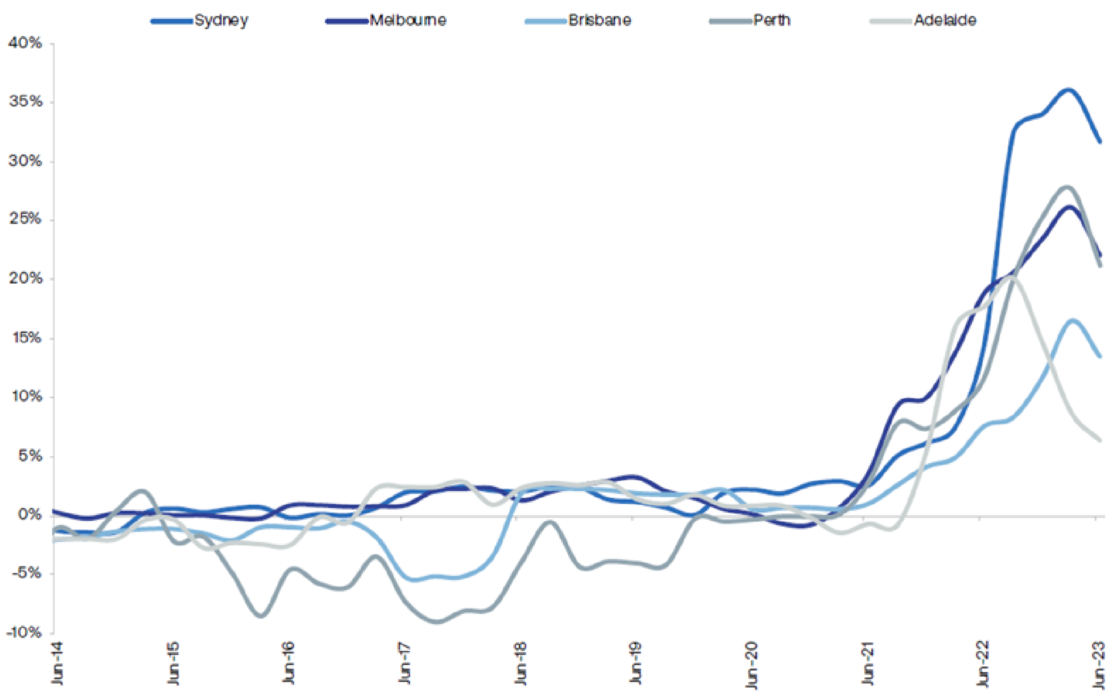
National prime rents grew by 4.4% over 2Q23 to $172/sqm. Solid q/q rental growth was recorded across Melbourne (4.0%), Sydney (3.5%), Brisbane (0.3%). Meanwhile, Perth and Adelaide were unchanged.

Solid rental growth was recorded across Sydney and Melbourne precincts over 2Q23: led by Sydney South (12.4%), Sydney Outer South West (6.0%), Melbourne West (5.3%), Melbourne North (3.9%), Sydney Outer North (3.8%), Sydney Inner West (2.9%), Sydney Outer Central West (1.9%) and Melbourne South East (1.9%).

Annual national weighted face rents increased by 22.2%, the second highest level since 1Q 1989. This was underpinned by significant rental growth across all major markets: Sydney (31.7%), Melbourne (22.0%), Perth (21.2%), Brisbane (13.4%) and Adelaide (6.3%). At a precinct level, the strong annual rent growth was led by Sydney Outer South West (35.3%), Sydney Outer North West (34.8%), Sydney Outer Central West (31.7%), Melbourne North (28.9%), Sydney South (27.2%), Melbourne West (25.0%), Perth East (23.7%) and Sydney Inner West (22.5%).

Rental growth is expected to remain above long-term averages over coming quarters, underpinned by high pre-commitment levels, a rise in construction costs delaying potential projects and above-trend occupier demand. The levels of demand continue to outweigh the new supply of stock.

Prime industrial rent growth (Rolling annual)



Source: JLL Research, Charter Hall Research. At 2Q23.

The growing demand for e-commerce facilities

The rapid growth of e-commerce has contributed to historically high levels of demand for facilities over recent years. Australia is in the early stages of e-commerce growth. Online penetration rate is forecast to increase from ~14% to 23% by 2027, while total online retail spending is forecast to increase from $53 billion in December 2022 to $95 billion in December 2027.

It all adds up to favourable trading conditions in coming years for the I&L segment of commercial property. Commercial property should not all be considered the same.

Sasanka Liyanage is Head of Research and Steven Bennett is Chief Executive of Direct Property at Charter Hall Group, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

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Can Aussie banks rediscover their glory days?

Nathan Zaia

We could have opened with a quote from a famous value investor like Benjamin Graham, Warren Buffet, or Charlie Munger. But let's take a more modern approach: Let's use Chat GPT.

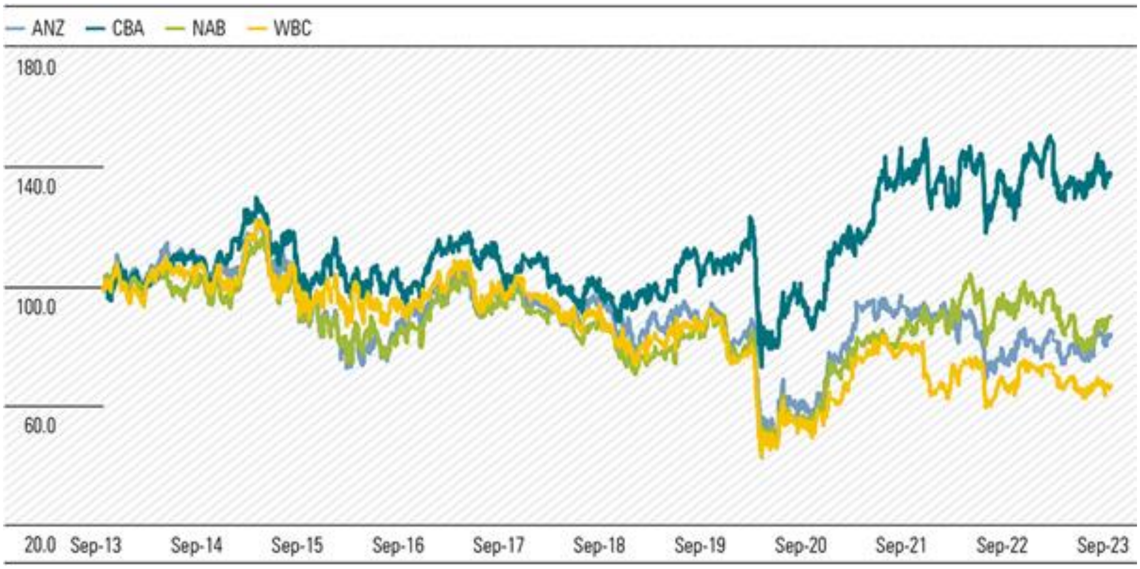
According to this AI tool, "*Value investing is an investment strategy based on the fundamental analysis of stocks or other assets to determine their intrinsic value. The core principle of value investing is to identify and purchase assets trading below their intrinsic value, in the expectation the market will recognise and correct this undervaluation, leading to price appreciation.*"

It is an approach we believe in at Morningstar. Figure out what something is worth, then invest with a margin of safety. Keep this front of mind.

Two things we hear from clients:

1. Bank share prices are below where they were 10 years ago, why would I buy bank shares?
2. People have said Commonwealth Bank is expensive for years, but it just keeps going up!

Exhibit 1: Only CBA share price is up in last 10 years



Source: Pitchbook data

Shares have gone nowhere, why invest?

Westpac and ANZ shares are down 33% and 17% respectively, in the last 10 years. With dividends, the returns are more respectable but still not great. Since August 2013, Westpac has paid fully franked dividends totaling $15.49 per share, ANZ not far behind at $15.19. This lifts 10-year total shareholder CAGR to 1.4% for Westpac and 3.6% for ANZ. National Australia Bank has done a little better with total shareholder CAGR of 4.3%. The S&P/ASX 200 total return index has returned around 8% per year for the period.

We forecast Westpac's ROE to be 9.5% in FY24, down from 15% ten years ago. The financial services royal commission, anti-money-laundering breaches, asset divestments, and lower interest rates have driven the earnings decline. Net interest margins, or NIM, has weakened, asset divestments have halved non-interest income, and operating expenses have risen on risk, compliance and technology spend. Meanwhile, Westpac now holds an additional $24 billion in shareholder equity, a more than 50% increase. Not a pretty story and explains the share price weakness.

But we think the next five years will look different. Margins are recovering from FY22 lows and smaller banks and nonbank lenders are struggling to compete as funding costs rise. Cost savings look achievable given the bloated cost base while recent changes make it unlikely APRA will again lift capital requirements.

Market expectations are now low, which we think is an opportunity. At the current share price, the FY24 PE of 11x and price/book of 1.0x seem to imply no operational and profit improvement. By contrast, Westpac traded on a P/E of 13x and price/book value of 2.2x in 2012 and an average price/book of 1.6x for the 10 years to 2022.

Exhibit 2: Higher multiple expected on improved profitability

Source: Company Reports, Morningstar

Our fair value estimate of $28 for Westpac, which is 30% above the current share price, implies a FY25 PE of 12.7x and price to book value of 1.3x. National Australia Bank, for comparison, trades on a price to book of 1.5x, showing that if Westpac can improve profitability as we expect, a modest multiple rerate is likely and can deliver attractive shareholder returns. We only expect Westpac's ROE to improve to 10.5% in FY25, still much lower from 15% in FY13.

Price matters and Commonwealth Bank looks expensive

Past performance does not equal future performance. Yes, Commonwealth Bank shares have outperformed peers, and materially since 2019, but there is no guarantee history will repeat. Commonwealth Bank has delivered an annual total shareholder return of 8.8% over the last 10 years. ROE is down from over 18%, but still at a respectable 14%. But current share price implies a FY24 price to book of 2.3x, above the 10-year average of 2.2x.

Commonwealth Bank shares trade on a forward PE of 17.5x and Westpac 11x. It seems valuation is being ignored by many investors. Index aware investors likely gravitate to the largest lender for bank exposure. It's an easy argument to make—digital leader, most efficient, cheapest funding sources, strongest loan growth from direct channels (branches and mobile lenders), a sound balance sheet, conservative provision levels, and market share gains in home loans.

The 4.5% dividend yield for Commonwealth Bank is not overly attractive either, you can get 4.8% in a Commonwealth Bank term deposit. Granted, it is not like-for-like comparison, given the dividend yield grossed up is 6.9%, and income of term deposits has no franking credits. But the equity risk premium in Commonwealth Bank shares looks slim.

Total return is ultimately what investors should focus on. Our fair value estimate of $90 per share for Commonwealth Bank implies a FY24 dividend yield of 5.1% and price/book ratio of 2.1x. The capital loss if the share price falls back to our fair value estimate, would essentially offset two and a half years of dividends.

What's in the price?

A simple answer is what's the implied cost of equity based on the current stock price. We use a 9% cost of equity in our valuation for all the major banks, given their similar exposures, business models and the common regulatory environment. If we lower the discount rate on Commonwealth Bank to 8%, our fair value estimate increases around 15% to the current share price. All else equal, lifting the discount rate to 10.5% gets our Westpac fair value close to the current Westpac share price. We don't think such a large difference is warranted though.

Alternatively, to justify the current stock price, we need to assume Westpac loses more market share, its cost base blows out further, and profitability remains sub-par with a return on equity of just 8% in five years. For Commonwealth Bank, we'd need to assume significantly stronger loan growth, further substantial cost efficiencies and the return on equity grows back up to 17% from 14% now. This seems unrealistic longer-term given the competitive landscape and similarities in the big four banks' business models.

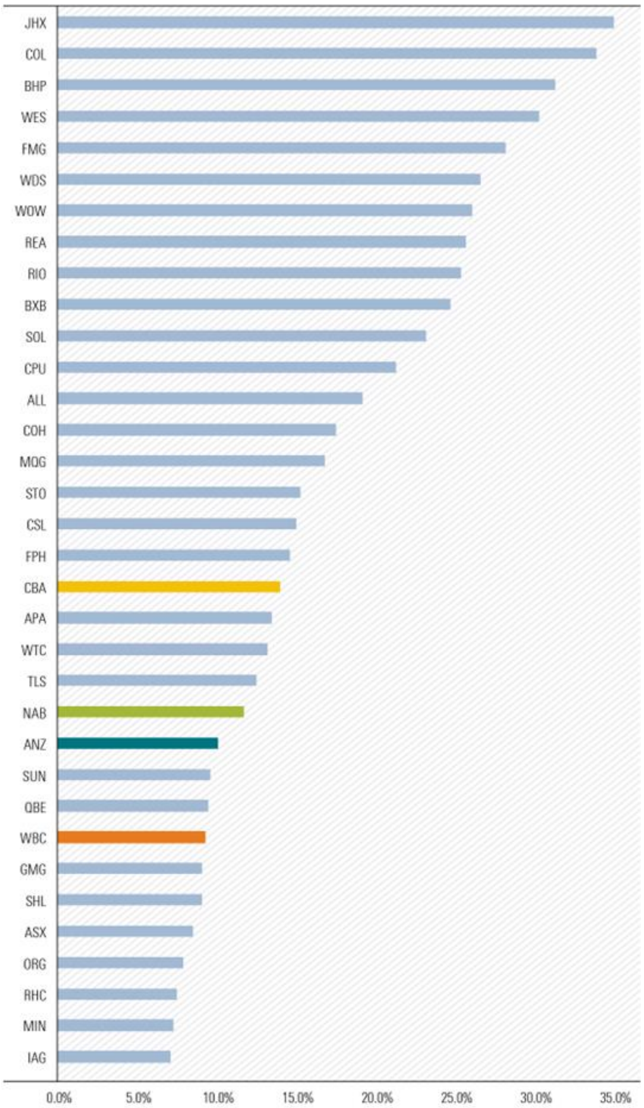
What about regulation?

Politicians and media talking heads love to pop up when Commonwealth Bank hands down earnings. They like to express outrage at such large profits from a single company. This populist view is shared by many. I for one prefer profitable and well-funded banks with low risk of failure, unlike Silicon Valley Bank, First Republic Bank, and Credit Suisse which all recently imploded.

However, government may see record profits as a green light for levies and taxes. This seems unfair given profitability has fallen materially over the past decade. Commonwealth Bank's return on equity of 14% compares to 18.5% ten years ago, and it is expected to fall more in the short-term on weaker margins and bad debts. We forecast the other major banks to make returns on equity of 10.5-11.5% in FY23, solid but not spectacular. When the bank levy was introduced in 2017, the average major bank return on equity was at least 13.5%.

Australia's biggest retailers, Wesfarmers, Woolworths and Coles delivered ROE's of 30%, 26%, and 34% respectively, in FY23. There are a host of other big corporates across many sectors making very large profits and attractive returns—generally a good thing and a sign those businesses are performing well. Against that backdrop, we think any additional bank specific regulations and tax are hard to justify. That is the base case assumption for our bank sector fair value estimates.

Exhibit 3: Banks slipping down the ranks of the highest ROE firms



Source: Morningstar

Nathan Zaia is a Morningstar equity analyst, covering the banking and insurance sectors. This article is general information and does not consider the circumstances of any investor. Please consult a financial adviser before making investment decisions. This article was originally published by Morningstar.

Super concessions to overtake Age Pension costs

Kaye Fallick

My father would be turning in his grave.

Jack grew up in Birdsville, served in WW2 and settled down in suburban Melbourne to raise a family, supporting us by his work as a carpenter. He was big on social equity, having a go, and the government's responsibility to ensure everyone *got* a fair go.

So what would he make of the recent Intergenerational Report (IGR)? I suspect he'd see straight through the smoke and mirrors and call it for what it is. A portrait of a retrograde step for the vast majority of older Australians.

How we got here

How is it a retrograde step? First some background.

At this year's National Press Club launch of the 2023 IGR, both ABC political journalist Laura Tingle and *The Conversation's* Peter Martin made joking references to the fact that they had been around way back in 2002 when the first of the series of IGRs was released. I was reporting on retirement income way back then as well.

Let's face it, regardless of your politics, the establishment of the first IGR was a visionary initiative by the then Treasurer Peter Costello. Such long-term thinking was unusual in Australia and badly needed, but few understood that before the first report was released. Since then, subsequent IGRs have succeeded in informing us of the key indicators we need to make a judgement whether the Australian economy is future fit across the next 40 years.

Most of the IGRs have been sincere attempts to project those future trends which will have the highest impact on the Australian economy. Despite a couple of more overtly political versions, including an at times seemingly willful refusal to even countenance the effect of climate change, the IGRs provide analysis based on statistics which allow us to future gaze and make useful policy changes to meet that future. They often also spark useful debate.

And that has happened at high volume this year. I don't recall any previous IGR being so selectively leaked in advance, nor receiving such ongoing coverage in mainstream media. That's a good thing as the major changes needed to shore up our budgets will need popular buy-in.

But this article is not about the five key aspects in the 2023 IGR – namely population ageing, digital and data technology, climate change, increased demand for care and support services and an increased geopolitical risk and fragmentation.

My interest is in exploring the predictions of the sustainability of our retirement income system.

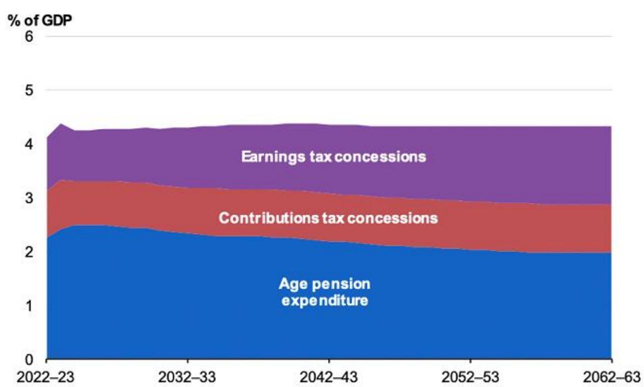
The super sleight of hand

And here's where I believe we are victims of a certain sleight of hand. If we listen to the words of Treasurer Jim Chalmers and read the summary both in the IGR and media commentary, we can all relax: retirement income is AOK.

That view is based upon a graph which shows the percentage of GDP needed to fund the Age Pension gradually decreasing (from 2.3% of GDP 2022-23 to 2.0% 2062-63). This will happen while total super balances rise over the same 40-year period, from 116% of GDP to a whopping 218%.

And that, of course, leads to statements by the Treasurer that 'super is delivering on its promise, providing a better retirement for more Australians …'

Chart 7.21 Fiscal impact of the retirement income system



Note: Includes Service Pensioners. Further information is in Appendix A3.
Source: Treasury.

And headlines such as that in *The Australian Financial Review*, where super is portrayed as a 'saviour' by Phillip Coorey when he declares: 'Super to ease Age Pension budget burden over next 40 years'.

But hang on a minute.

The concessions on super (contributions and earnings) are set to increase from 1.9% of GDP 2022-23 to 2.4% in 2062-63. These concessions, as has been predicted by the Australian Institute, will overtake the cost of the Age Pension in the 2040s.

Let's think about this. Australia already has one of the lowest outlays on its Age Pension (as a proportion of GDP) in the OECD. This is set to reduce even more as super will 'pick up the slack'. But what will actually happen is that we will spend more on supporting super than on the Age Pension.

Favouring those with more super

Super has worked well but it is far from equitable. The mandated contribution (currently 11%) is calculated as a proportion of wages or salaries. If you earn $50,000 per annum, the contribution is $5,500 per annum. If you earn $200,000 per annum, the yearly contribution will be a minimum of $22,000. Why a minimum? Because unlike your neighbour on $50,000, you will probably have enough discretionary income to consider salary sacrifice contributions.

And you'll thereby enjoy further benefits from concessions along the way. In the world of super concessions, the more you have, the more you get. Yes, there has been an attempt to cap some of this largesse with the March 2023 'Better Targeted Superannuation Concessions' increase with an additional 15% tax on balances over $3 million, but this is nibbling at the edges.

Meanwhile the base rate of the Age Pension has not been adjusted since the Rudd Government legislated a $30 increase in 2009, some 15 years ago (it's still gone up via indexation). Those on a full Age Pension who rent have been living well below the poverty line for years. Given the current 10% year-on-year increase in rents, their situation is worsening. The rapid increase in homelessness for women aged 55 or over is uncomfortable evidence of this lack of basic shelter.

Yet the Australia Institute reports that the top 20% of earners receive 50% of the benefits of super concessions, with men receiving 71.6% of these benefits.

Put simply, the gap between rich and poor in Australia continues to widen. This is then exacerbated by a fundamentally skewed system of reward for higher super balances in retirement.

I doubt Jack would have seen this as fair go at all.

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.