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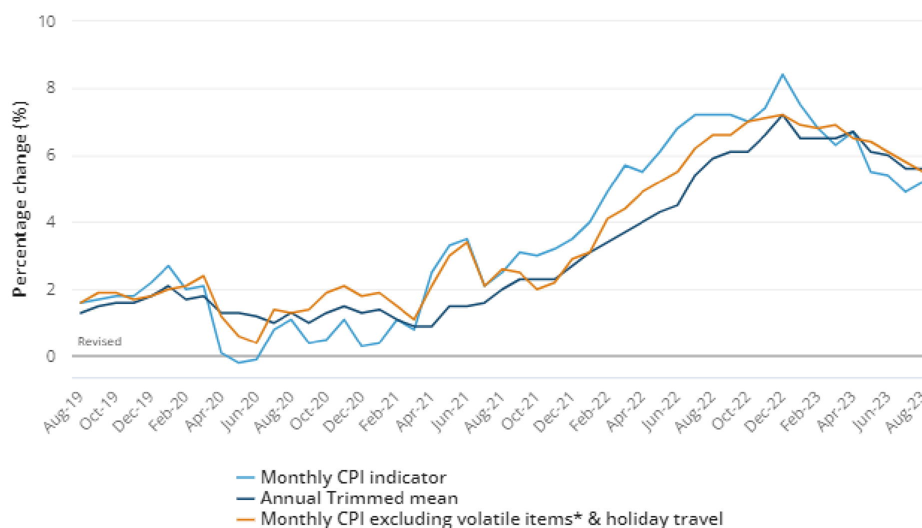
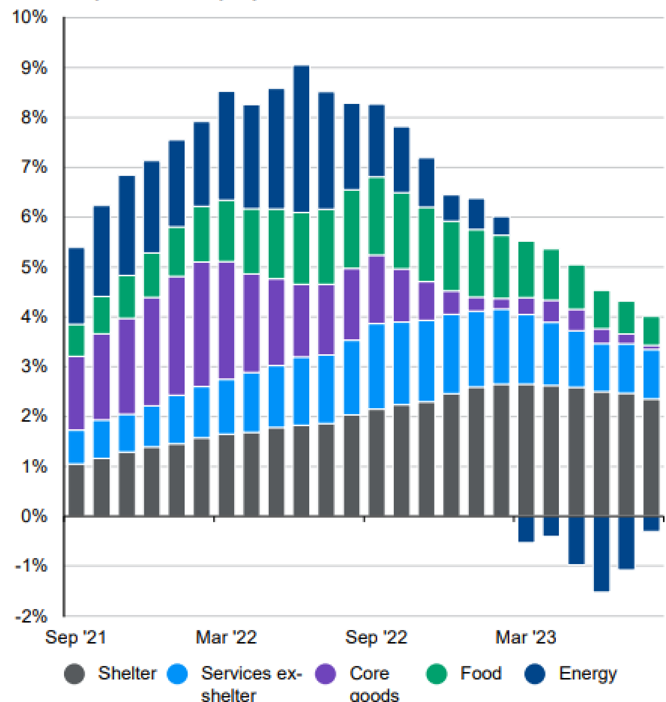
Editorial

Every person has a unique inflation experience and it changes over time. Energy costs shot up in the pandemic but then fell back, 'shelter' and housing are driven by home ownership status while eating out at restaurants and cafes depends on personal budgets and preferences. Retirees might enjoy earning 5% on their term deposits while borrowers are strained by higher mortgage rates. **Taylor Swift** concerts around Australia are sold out with packages varying from $349.90 to $1,249.90 *("Additional transaction fees and credit/debit card processing fees may apply.")* so there are some things where the cost does not seem to matter. And what's with the 90 cents on each package?

The latest official Australian Bureau of Statistics (ABS) CPI measured as the Annual Trimmed Mean (the **Reserve Bank**'s favourite measure) is at 5.6% for August 2023, with the CPI at 5.2%, up from 4.9% in July. This ABS chart shows inflation, however measured, peaked at 7.5% to 8.5% in December 2022 and has been falling since. Nobody told the long bond rate which remains elevated and cash rate reductions are probably at least a year away.



The monthly CPI (excluding volatile items) was not above 5% until May 2022, not yet 18 months ago, and yet it feels like inflation has taken a massive jump in recent years. Here are the major components, and many people would have experienced 7% to 9% or more inflation for at least a couple of years.



Source: BLS, FactSet, J.P. Morgan Asset Management. Guide to the Markets – Australia. Data as of 30 September 2023

In our **Reader Survey** of a few short questions, let us know your inflation experience, both overall and anecdotally. Include some unusual or quirky examples of price increases you have noticed, and how you feel your own costs compare with these official yearly numbers. Does it feel like inflation is now under control? Full results published next week.

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A Treasury review is underway on the new $3 million superannuation tax but with only two weeks for submissions, and the draft legislation showing no practical changes from when the policy was announced in February 2023, it feels like a sham process. Treasury has already received input for six months and done little to amend the most contentious elements. The main complaints are no longer about the need to reduce benefits for people with large amounts in super but the cumbersome and inefficient way the tax will be calculated.

It's notable, however, that the draft legislation does not refer to the $3 million threshold. Rather, it has been replaced by the term 'large superannuation balance', and the policy is now called the 'Division 296 tax law'.

"This Division reduces the concessional tax treatment of superannuation earnings for individuals with total superannuation balances greater than the large superannuation balance threshold at the end of an income year."

While many people are focussed on the lack of indexation in the $3 million amount, the way the legislation is now written opens the way for the amount to be amended easily in future.

So the most objectionable element of the legislation is taxing unrealised gains. My guess is that Treasury did not initially appreciate the can of worms opened until they realised that a person can hold super accounts in many different forms, such as retail, industry and SMSF funds. The only way to tax large super balances is at an individual level, not at a fund level as no fund knows the total balance. And taxing at an individual level based on Total Superannuation Balances includes unrealised gains.

Then the problems began. It is easy to envisage a portfolio where shares and property values rise strongly in one year and deliver a large tax bill on the unrealised gains, but without any income or asset sales. And then the next year, market values fall and there is no tax deduction for a loss.

Peter Burgess of the **SMSF Association** gives this example of how tax may be more in super than outside super:

"John Smith has a super balance of $3 million in accumulation phase. During the year, investment earnings totalling $80,000 are allocated to his account. Under current arrangements, the fund would pay $12,000 in tax based on the concessional tax rate of 15%. Those same assets, if held by John outside super, would incur a maximum $36,000 in tax (at the maximum 45%).

Let's assume John's balance in this super fund appreciated by $800,000 during this income year. There were no contributions or withdrawals for the income year so John's Total Super Balance at the end of the income year was $3,868,000. Under the government's proposed tax changes, John would be liable for 15% additional tax on

the change in value of his balance above $3 million, resulting in an additional tax bill of $28,644, taking the total tax bill to $40,644.

Since unrealised gains are not taxed on assets held outside the fund, John would pay at least $4,644 more tax than if the assets had been held outside super."

And let's stop calling it a 30% tax. It is a new 15% Division 296 tax calculated completely differently from the usual 15% tax on superannuation, which does not incur any liability for unrealised gains.

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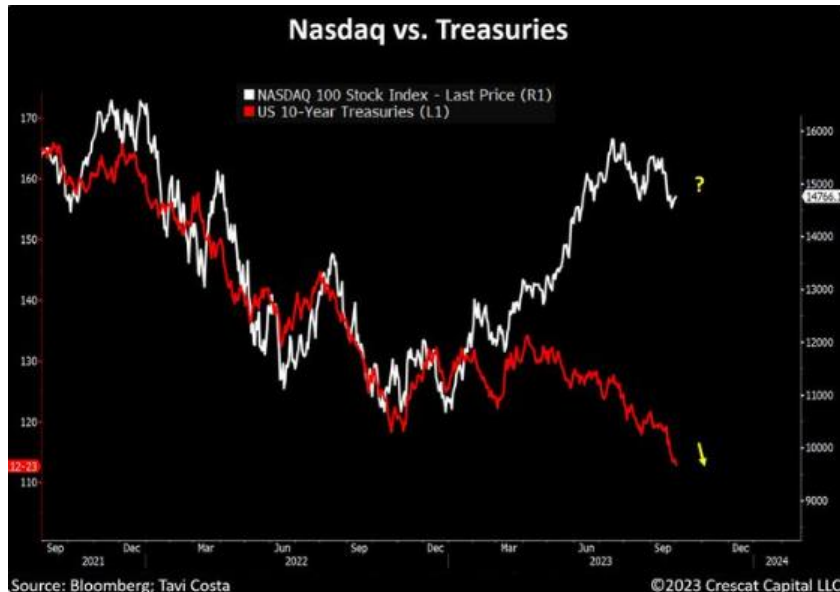
Stockmarkets are going through a decent bounce back after the selloff on inflation and interest rate fears. In Australia, the S&P/ASX200 is up 6.4% over the last 12 months but that number disguises that all the gain happened at the end of 2022. Calendar 2023 is at best flat because we do not have the big tech winners from AI that the US has experienced.

Source: Morningstar Premium

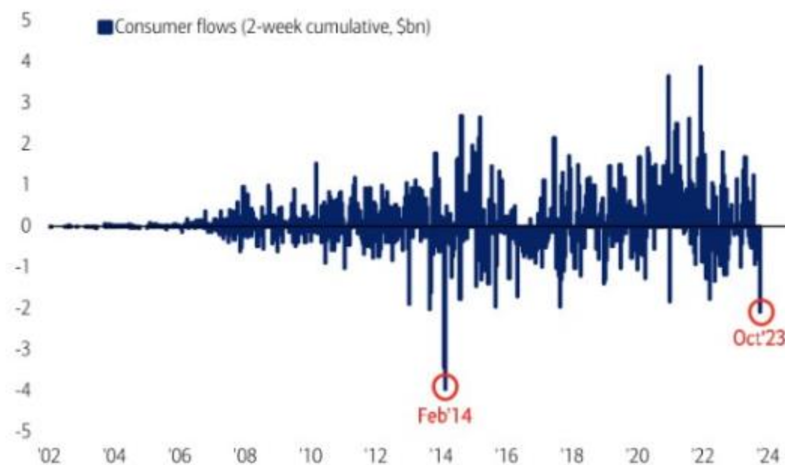
The NASDAQ shows the big winners, although even here, there has not been much gain since June 2023.

Source: Morningstar Premium

What is most surprising is the disconnect between NASDAQ and the 10-year US Treasury yield. Driven by the dream of universal AI gains, the broken link between rising rates and the NASDAQ index belies traditional market valuations. Tech companies with earnings growth in the future are usually punished as rates rise, as happened in 2022, drawing close correlations between US Treasuries and equities. Now, analysts are looking for what gives first: either US Treasury rates or stocks. Of course, with the massive US deficits to fund, rates may continue rising even if stocks fall. It's a more challenging investing climate than usual.



An early sign of the mood is in the **Bank of America** funds flows data, which show 'consumer' funds experienced their largest two-week outflows since February 2014, double any two-week period during the entire pandemic. Despite the market's strength over 2023, investors are watching for a reason to exit equities.



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Demographer **Bernard Salt** recently posted an article on his LinkedIn page asking at what age we are most content. He cited that life expectancy for the average Australian has increased by 15 years since 1950, when not many people lived long in retirement. The Baby Boomers and younger now have completely different expectations, but there was a surprise response to a new question in the 2021 Census. Australians were asked if they suffer from anxiety or depression as advised by a doctor. Says Salt:

"The results showed worrying results for young women in particular and also for the very old and the lonely. But the results also showed a marked diminution in anxiety and depression across a (roughly) 13-year span from 65 to 78.

Here is the happiest, the least worrisome, the most contented stage of the lifecycle. It is a joyous sweet spot. It is a sunny upland in life's later years. No other decade comes close to this decade for stressless joy when adult kids are finally partnered up, when grandkids arrive, when health matters aren't dire, when there's sufficient super for travel.

This is the happiest time in life. The most contented stage of the lifecycle. The best years of life. All this and more lies ahead for the newly retired."

While Salt explains there are of course exceptions, these years should be seen more as an opportunity for "*the most carefree years of their lives across the late 60s and most of the 70s*." As I've said many times, if you've got money, this is a chance to spend it on yourself and your favourite causes.

Finally, **Noel Whittaker** was visiting his son in California last week and he sent me this note on his 'epiphany'.

"I have long been sceptical of self-driving cars and having had Teslas for four years I think I know what I'm talking about. I have experienced my Tesla stopping on a freeway because it picked up traffic lights on the road underneath the freeway – I've seen it stop at red arrows even though the green light ahead was fine. I've seen it ignore speed signs and red lights and slow down in a major road, because some months before there had been a 40 K limit.

Today I had an epiphany. I was in Los Angeles with my son James who bought a Tesla Y four weeks ago and got three months of fully self-driving as part of the package. He lives in Westchester which is just near Los Angeles airport. We got the car to take us to Manhattan Beach and then bring us home again. I was astounded. All he had to do was enter the destination and the car drove us with no assistance from the driver. Manhattan Beach has very steep, narrow streets going down towards the water and it navigated them, including turns, effortlessly."

No doubt it will seem common a decade from now, although unlike in Australia, **Teslas** are falling quickly in price in the US and a Model Y is now $US3,700 cheaper than the average car with government incentives thrown in.

In my article this week, I look at why so many people who are eligible for tax-free super pensions - including half of all large fund members over 65 (excluding SMSFs) - stay in accumulation funds paying tax. Switching super to pension after the age of 65 and possibly 60 seems an obvious thing to do.

Graham Hand

Also in this week's edition...

The four major asset classes - equities, bonds, cash and property - have experienced a mixed 2023. Bonds have sunk, equities and property have bounced, while cash has offered a decent yield albeit one that still trails inflation. What's the future look like for these asset classes and where is the best place to put your money? **Schroders' Sebastian Mullins** offers his thoughts.

ASX reporting season focuses on how earnings compare with forecasts, yet there's little mention of how dividends perform versus expectations. A new scorecard from **Martin Currie's Reece Birtles** aims to rectify this to help income-focused portfolios.

The efficient-market hypothesis taught at business schools proposes that markets are efficient as they effectively and fairly price all available information. **Montaka's Andrew Macken** isn't convinced and gives recent examples where markets got it wildly wrong. And he thinks they may be wrong again when it comes to Artificial Intelligence and China today.

Neuberger Berman's Niall O'Sullivan has been reading the classics and is keen to apply *realpolitik* to markets. He says there's more pain to come from higher interest rates and now is the time to be selective, focusing on quality businesses that can sustain their margins. But it's also the time to provide capital and liquidity opportunistically when weaker companies falter.

Big changes are upending the US entertainment industry business, and as we know, almost every piece of US content finds its way here. **Loftus Capital's Harry Morrow and Alex Pollak** believe the end of the existing Pay TV model is near as dollars flow from traditional to streamed TV.

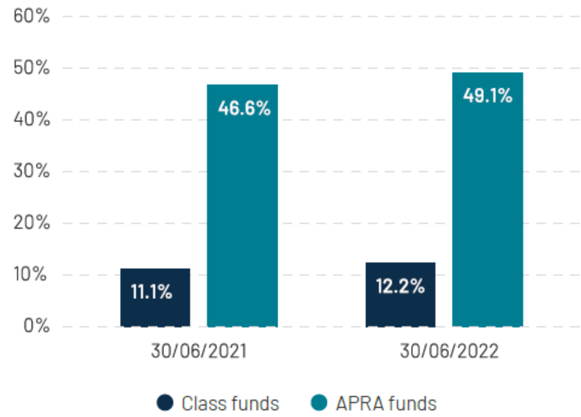
Lastly, in this week's White Paper, **Van Eck's** outlook for global and Australian markets for the rest of the year concludes that inflation should rise, gold could glow, and puts liquidity and balance sheets in focus.

Curated by James Gruber and Leisa Bell

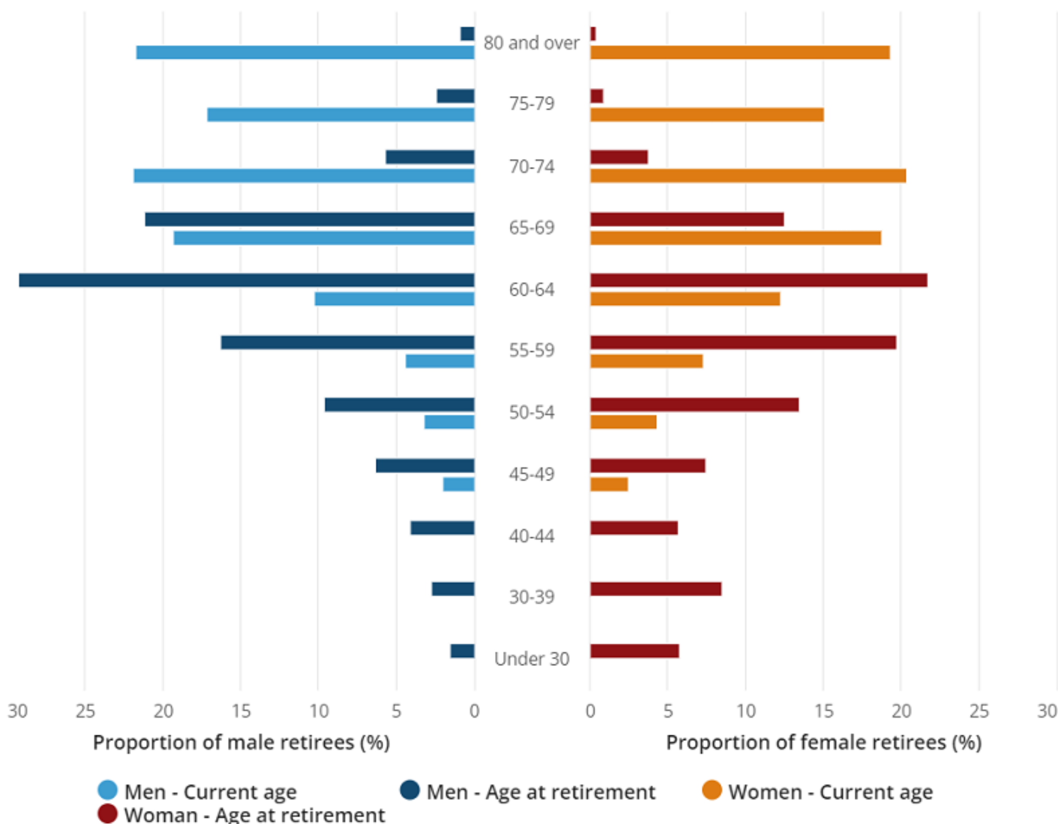
Are you paying tax by not starting a super pension?

Graham Hand

Over age 60, superannuation benefits paid as either a lump sum or pension are tax free and not assessable for income tax. Why doesn't everyone convert from accumulation to pension as soon as possible? In the recent Class Benchmark Report, one graphic stood out. While only 12% of SMSF members aged 65 and over remained entirely in accumulation, half of APRA fund members over 65 had not switched any of their super to pension. The amount not switched to pension by over 65s is estimated at $225 billion. They may be paying too much tax and should be advised of the choice.



In the accumulation phase, investment earnings are taxed at 15%, whereas the tax rate is nil in pension phase provided certain rules are met. As the [ABS data below shows](), retirement from the workforce, and therefore eligibility for a super pension, is most common in the 60-64 age group for both men and women, with high numbers for age 65 and over. For some, the pension opportunity starts at 60.



What are the conditions to start a pension?

Starting a pension in superannuation is not complicated and it does not require a change in thinking from saving to spending. While withdrawals must be made from a super pension account each year, the money does not need to be spent and can be saved outside the pension account. Sometimes, the superannuant can continue working.

(A super pension should not be confused with the Age Pension from the government. There are also Transition to Retirement (TTR) income streams which do not carry the same tax benefits. Check your personal circumstances with a financial adviser before taking any action).

The Conditions of Release to start a super pension are:

- reach preservation age and permanently retire
- cease employment after the age of 60 even if later return to work
- age 65 years and over, even if not retired.

Preservation age varies between 55 and 60 depending on date of birth. There are other special circumstances which we won't dwell on for the purposes of this article.

The opportunity from the age of 60 is probably less known than the eligibility for a super pension at age 65. Super pensions are flexible with a minimum of 4% of the balance drawn out each year, depending on age. New contributions cannot be made to a pension fund but an accumulation fund can operate at the same time and accept contributions.

Super of $400,000 earning say 8% a year generates $32,000 a year of investment income, which at 15% is $4,800 a year.

The maximum that an individual can transfer from accumulation to pension is determined by the personal Transfer Balance Cap (TBC), currently $1.9 million.

Why members do not start super pensions

On the surface, a tax rate of nil versus 15% looks like a no-brainer, but half of APRA fund members do not lower their taxes after the age of 65. Some may be eligible for a pension account from the age of 60.

What's happening?

1. Many members do not know about the tax treatment, especially those in APRA funds. They do not focus on their superannuation, the rules are too complicated, their super fund has not informed them or they haven't opened the mail. Tax is deducted at the fund level so the tax payment is not apparent. It's more likely that SMSF trustees are advised by either a financial adviser or accountant.

Liam Shorte of Sonas Wealth said:

"From experience, the biggest reason is that people who have not received advice think you cannot move in to pension phase until you stop working.

The second biggest reason is that those working often put it in the too hard basket as they have enough from employment income to meet their living expenses and just leave super until they need it as they do not understand or know about the tax benefits of pension phase.

No matter how many letters the industry funds send them, if they don't open the letters or feel it is advertising, they just ignore the call to action.

Last year I took over a client who was 84 and finally retired, closing his business, and had super that he was told 20 years ago he could access when he stopped working and so he never did anything about it until he actually retired!"

Large super funds must accept some blame for not identifying their members at the age of 60 or 65 more actively and explaining the options. AustralianSuper has proposed a scheme where all members over 65 are automatically converted to pension with an opt out, in coordination with the Age Pension.

As ASIC and APRA said in their July 2023 Review on the Implementation of the Retirement Income Covenant (RSE=Registrable Superannuation Entity).

"Overall, there was a lack of progress and insufficient urgency from RSE licensees in embracing the Retirement Income Covenant to improve members' retirement outcomes."

2. Some members do not want to draw down their superannuation preferring to build the balance within super for retirement spending when needed. Perhaps they do not realise that the money does not need to be spent and can be invested in another vehicle.

3. An account-based pension may affect entitlement to social security benefits, although this is unlikely to impact most SMSF trustees. Lyn Formica of Heffron advised:

"In terms of the social security income test, there can be an incentive not to start a pension but only when an individual is below Age Pension age. This is because no amount is counted as income in respect of accumulation account balances (ie there is effectively no deemed income) for individuals below Age Pension age. But when an account-based pension is commenced, whilst actual pension payments are ignored for income test purposes, a deemed amount of income is counted.

Once an individual reaches Age Pension age, the income test treatment of leaving monies in accumulation phase or commencing an account-based pension is effectively the same."

Again from Liam Shorte:

"For some, when they meet a Condition of Release like retiring after age 60 or reaching 65, they deliberately delay the move to pension phase if they are part of a couple where the older one is getting the Age Penson or Disability Pension. They may lose or receive a lower benefit if the younger partner moved to pension phase earlier than when accumulation is counted as an asset at 67."

4. According to the Class Report, far more APRA fund members withdraw lump sums in larger amounts after satisfying a Condition of Release (including reaching 65) than the number of members who commence a pension and withdraw progressively. Their evidence suggests many retirees are withdrawing the entire balance after they become eligible rather than opening a pension account.

This may be financially appropriate where, for example, paying off a mortgage allows higher eligibility for an Age Pension while reducing or eliminating mortgage payments (and the value of an own home does not count in the assets test whereas a superannuation balance does). Says Joshua Williams, writing in the Class Report:

"The total number of members between 60 and 64 (1,573,352) drops to less than half that number 10 years on, in the 70 to 74 cohort (707,353). Most are choosing not to preserve their benefits in the superannuation environment at all. It wouldn't be fanciful to imagine that, after repaying the mortgage on the family home, splurging on a new car and a cruise, most of us will end up relying on the Age Pension after all!"

The need to educate on tax benefits

While it is worthwhile reviewing individual circumstances against this list of reasons, for the most part, the failure to switch to a pension fund is due to a lack of familiarity with the opportunity.

In the 2023 Intergenerational Report, withdrawals from superannuation are estimated to increase from about 2.4% of GDP per annum in 2022-23 to 5.6% of GDP in 2062-63. There is a big incentive for millions of older Australian to realise the tax advantages of pensions.

It's surprising that only one APRA fund member in every eight over the age of 65 has converted their superannuation entirely from accumulation to pension, and educating members on the opportunities is essential. They could save thousands a year in tax.

For more information on pensions, especially in SMSFs, see this paper from Heffron, "The Ins and Outs of SMSF Pensions in 2023/2024".

Graham Hand is Editor-At-Large for Firstlinks. This article is general information. My thanks to Lyn Formica of Heffron and Liam Shorte of Sonas Wealth for input to this article but any mistakes remain mine and are based on my understanding of current legislation. Check your personal circumstances with a financial adviser before taking any action.

Which asset classes are offering the best value?

Sebastian Mullins

The number one rule of investing is to generate a return above inflation, after taxes. Over the long turn, taking on higher risk premia tends to result in higher returns, which helps in achieving this goal. Over the past 30 years, equities generally outperformed bonds, bonds outperformed cash and all three outperformed inflation.

However, many investors do not have a 30-year time horizon and 2022 reminded us that there can be periods wherein nothing outperforms inflation. It's during these times that investors may benefit from focusing on the direction of interest rates and looking to valuations to determine where to allocate over the medium term. With the repricing of bond yields, there are now reasonable alternatives to equities, but is it too early to allocate to sovereign bonds? Below we discuss the current macro environment over the coming months and which asset classes are showing attractive valuations, to help investors navigate where to consider investing money today.

All eyes on the US consumer

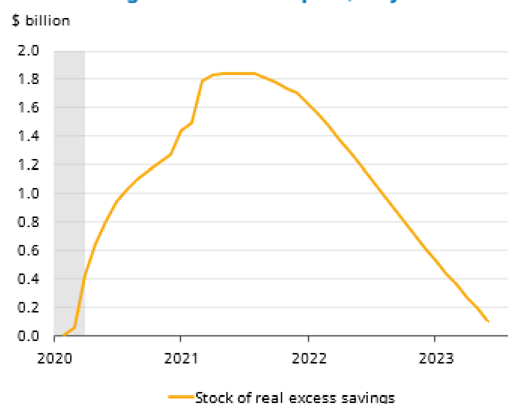
The US consumer has been more resilient than expected in the face of an aggressive interest rate tightening cycle. Unlike in Australia, rising interest rates do not translate to immediately higher mortgage payments, given the majority of home loans are fixed rate, so most of the pain to US consumers was from price inflation from 2022 onwards. Thanks to COVID-19 stimulus payments, US households were able to accumulate US$1.8 billion in excess savings, which helped provide a buffer to these increases in prices rather than relying solely on their wages to make ends meet.

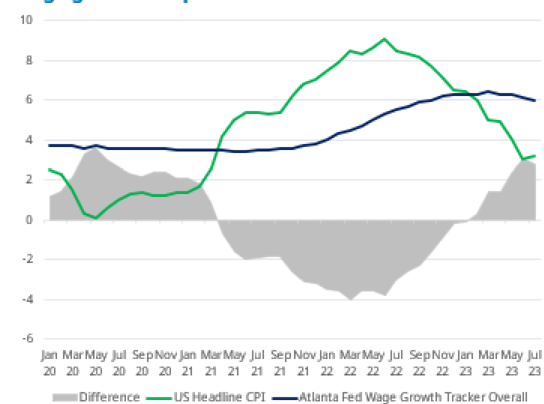
Today these excess savings are mostly depleted, removing an important safety net to households. We have also seen debt levels rise, such as credit card debt per household reaching new heights, and deferred repayment programs ending, such as the moratorium on student loan payments, which points to consumers becoming stretched in the coming months.

However, consumers are now supported by real wage growth, which was absent last year. US households saw strong nominal wage gains in 2022, but these were more than offset by sky-high inflation. Headline inflation (the type of inflation that includes energy prices and the inflation measure that most consumers care about) has more than halved since its peak. This has meant real wage growth has gone from being deeply negative in 2022 to being strongly positive in 2023. Wage growth is rolling over but at a slower pace than inflation, meaning consumers have another few months of strong real wage growth, which will continue to support consumption. That is, as long as workers can keep their jobs.

Consumer spending has kept the US economy afloat thus far

Real income growth has replaced the role of excess savings from the past year





Source: Schroders Economics Group, Bureau of Economic Analysis, Refinitiv. 31 August 2023

Schroders

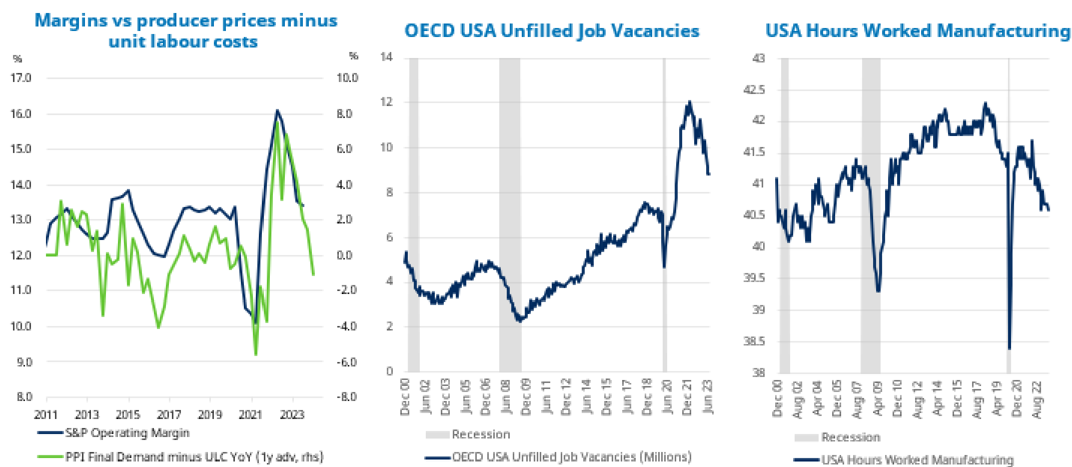
Easing in the labour market

The labour market has been incredibly tight since economies reopened after COVID-19. Companies struggled to find workers to meet the surprise increase in demand from consumers and they are now reluctant to let these workers go, even as demand cools. Small businesses employ 48% of the US workforce, but the NFIB survey of small businesses shows that it's the worst time to expand since 1980, other than the low experienced in 2009. Hours worked in US manufacturing continues to fall, consistent with companies who are holding on to employee labour but have less work to give them. This doesn't suggest a strong case for businesses to continue holding onto excess labour, especially as it starts to eat into profit margins.

With margins expected to roll over as unit labour costs rise above producer prices (PPI final demand), there is a strong case to shed labour. The recent fall in both unfilled job vacancies and the US quit rate (a high quit rate implies employees are confident they can find a new job easily) could perhaps signal to small businesses that it's now safe to downsize their workforce, which will place upward pressure on unemployment.

But how long will businesses hoard labour?

Companies may be more likely to let staff go as margins fall and the labour market eases



Source: Schroders, Refinitiv, August 2023. ULC refers to unit labour cost. Subtracting ULC from PPI Final Demand gives a measure of how much profit producers are making after accounting for labour cost.

Schroders

US equity valuations look stretched

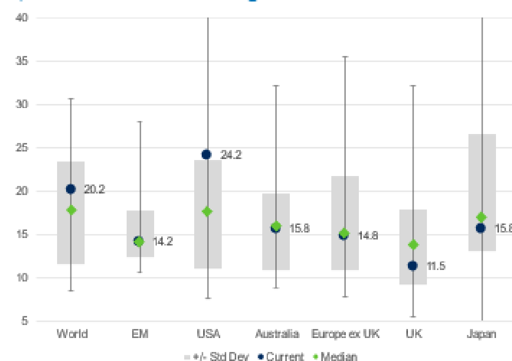
For these reasons, we remain more wary of the US economy looking forward. Our recession models are still suggesting a high probability of recession in the coming few months. This is in stark contrast to the market, which is still pricing in a soft landing, where growth holds up but the Federal Reserve can cut interest rates as inflation falls under its own weight.

The recent 28% rally of the S&P 500 off the September 2022 lows has pushed the trailing Price to Earnings (P/E) ratio up to over 24x, which is expensive relative to its own history and when compared to other major regions. Forward looking P/Es are more reasonable at 17x, however this assumes earnings growth in 2024 of 12%, which seems ambitious, especially when the majority of this comes from expectations of margins expanding, which is contrary to what we discussed above. When averaging five different valuation metrics, the US is in the 89th percentile expensive, which has dragged the global equity valuation up to the 74th percentile. Typically, this does not bode well for longer-term forward-looking returns.

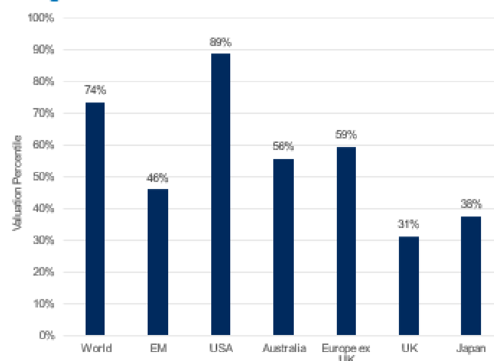
Strong equity performance has eroded valuations

Many valuation metrics have moved closer to or above their median

P/E Ratio vs historical range



Average Valuation Percentile



Source: Schroders, MSCI, Refinitiv as at August month end 2023. The average Valuation Percentile chart takes an average percentile of the P/E ratio, CAPE ratio, Price to book, Price to Cash earnings and. EV/EBITDA. Data for all measures is from MSCI, except for EV/EBITDA which is from Refinitiv. For DM markets (except Japan) data is based on history going back to 1970 for all valuation measures except for EV/EBITDA which is from 1980. EM data is from 1995, Japan data is from 2000.

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That said, while a case can be made for being underweight equities overall, valuations are fairer in other markets such as Australia, where valuations are around or below the 50th percentile. Simply looking at valuations, investors would favour Australian over global equities, and within global equities favour cheaper markets like Japan over the US.

For now, the income is back in fixed income

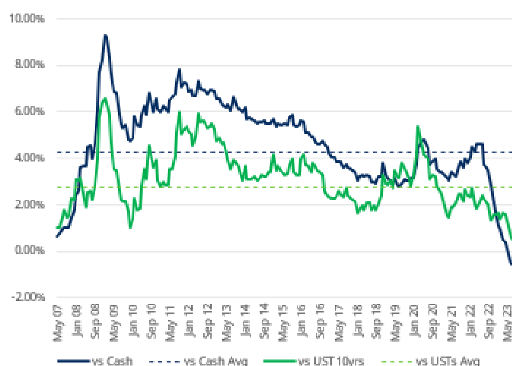
It may feel strange after over a decade of near zero interest rates, but fixed income is now offering attractive yields. 10-year government bonds in Australia and the US, along with the RBA cash rate, now yield over 4%. That is the same yield that was on offer from US high yield corporates (aka junk bonds) throughout all of 2021. After over a decade of there being no alternative to equities, investors now must decide the relative attractiveness between equities and fixed income.

One way to determine the relative attractiveness of equities is to calculate the Equity Risk Premia (ERP), which is to compare the earnings yield of an equity market (the inverse of the P/E ratio), to the yield on offer from either government bonds or cash. Based on this metric, the ERP for the Australian market is around 2% above both bonds and cash, which is around its 20-year average. However, US equities have seen their ERP collapse to the lowest levels in 20 years. This means an investor really has to think about whether US equities are a better investment than government bonds, or even whether they would be better off in cash.

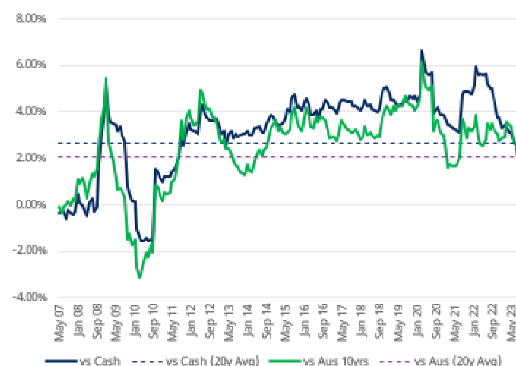
US equities have almost no risk premium above bonds or cash

ERP in the US is well below the 20 year average, ERP in Australia average

S&P 500 earnings yield relative to cash and UST 10yrs



ASX earnings yield relative to cash and Aus 10yrs



Source: Schroders, Bloomberg. Note: Earnings yield is 1 divided by the P/E ratio. US cash is proxied by the US Federal Funds Effective Rate Aus cash proxied by the RBA Cash Rate Target. Both countries used the current 10 year bond yield to maturity.

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Our cash rate models suggest we are approaching the end of the tightening cycle, which is typically the best time to add duration (buy longer dated government bonds). These models suggest cash rates should be around 4% in both the US and Australia, which is at or below current policy rates. However, we still believe it is too early to add duration, given the uncertainty over inflation and growth. Longer dated government bond yields in the US still look too low, given the level of inflation and growth expected in the US economy.

Our model for 10-year government bonds suggests Australian and US bond yields are close to fair value. Therefore, while investors would typically like to add more duration as the economy slows, adding too early will be painful. For now, the front end of sovereign curves (less than 5-year maturities) and cash looks like a more suitable place to hide, until we get more confirmation economies are rolling over.

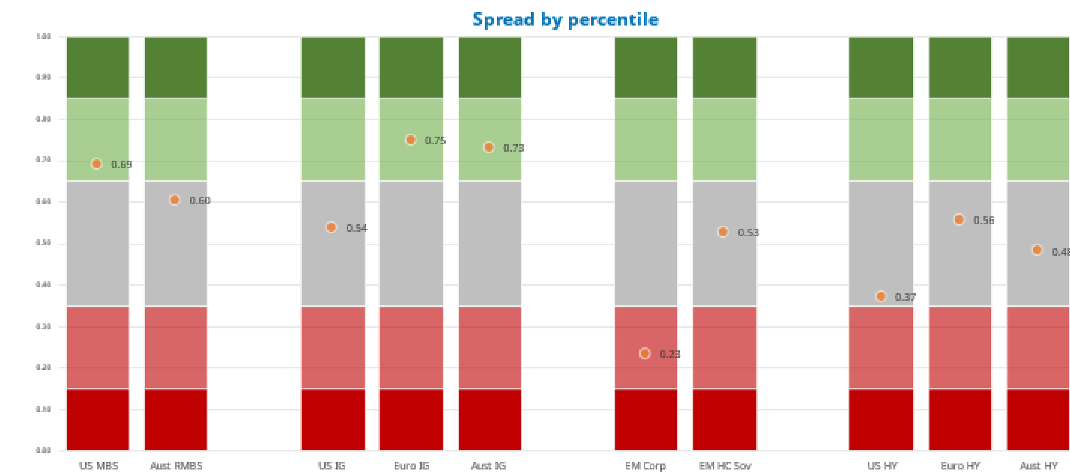
Let carry do the heavy lifting

The above suggests the market could be quite choppy as equity valuations come under pressure and government bonds plateau. In the meantime, investors may benefit from investing in high quality fixed interest investments that offer higher yields than government bonds (known as carry).

Corporate credit is typically lower duration than sovereign bonds and therefore has less interest rate risk, while also providing extra yield (spread above sovereign bonds of the same duration) to compensate for credit risk. Current yields in credit securities are between 5% and 8%, providing a healthy pick up above cash or sovereign bonds. Investors can use managed funds to access a globally diversified portfolio of credit securities. Valuations are more attractive in investment grade credit, where spreads are between 50-75th percentile cheap, whereas higher risk non-investment grade credit spreads are more expensive in the 35-50th percentile.

Credit spreads have tightened but dispersed across regions

Australian investment grade credit remains attractive



Source: Schroders, Datastream, Bloomberg, to 31 August 2023.

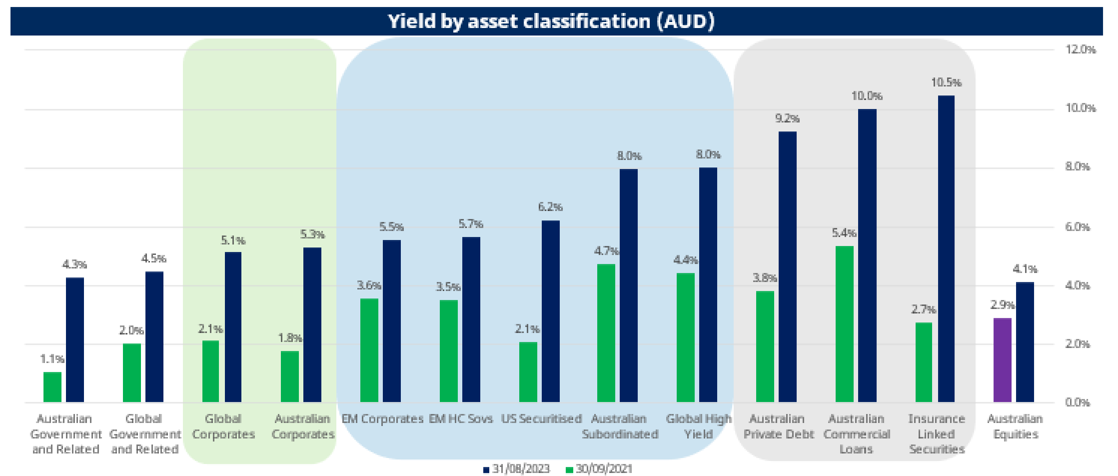
Schroders

Moreover, the credit spread in investment grade is enough to break even if we see a default cycle similar to those seen in past recessions, whereas high yield is only compensating investors for a standard mid-cycle default regime. This seems complacent, given the increase in defaults this year and tightening lending standards, which historically would lead to much wider high yield spreads. Australian investment grade looks particularly attractive, with spreads wide relative to history and compared to global credit and is also compensating investors for a default cycle worse than a recession.

Firstlinks
a Morningstar company

Yields – from desert to oasis?

For now, 'income' is back in fixed income



Source: Schroders, Aladdin, ICE BofA as at 31 August 2023. All yields are hedged to AUD. Insurance linked securities yield is net of expected loss. Australian equities yield is the dividend yield of the ASX 200.

Schroders

Alternatives are an alternative

While high yield corporate bonds may not be providing adequate compensation for risk, that doesn't mean there aren't attractive high yielding assets. Looking broader and widening the opportunity set allows investors to find assets that have high total yield, low interest rate risk and provide diversification to portfolios.

For example, banks have stepped away from lending in certain areas of the market, causing yields to rise to attract investors to take their place. A collection of US securitised credit offers over 6% in Australian dollar (AUD) terms, that's more than Emerging Market sovereign Debt (EMD), but has a credit rating of A- versus BBB- and zero duration risk versus 6.7 years for EMD. Fixed rate Australian commercial loans are currently offering around 10% yield, but with less than 1-year duration, and floating rate Australian private debt offers AUD cash +5-6% (currently yielding over 9%) but with no interest rate sensitivity. These offer potential for strong yield to investors and more adequately compensating for credit risk, without taking on interest rate risk, albeit taking on liquidity risk.

When sovereign bonds are no longer providing diversification, other assets need to be considered. For example, insurance linked securities pay high yields but can lose money during catastrophic weather events, such as hurricanes. These assets have next to zero correlation to equities or bonds as they are unrelated to the economic cycle and instead driven by the weather. They are currently yielding over 13% or 10% in AUD terms once expected loss is removed but have negligible interest rate risk with duration less than 1-year. There are plenty of places to invest even when equities or bonds look unattractive, but it requires investors to look broader and deeper to find interesting opportunities.

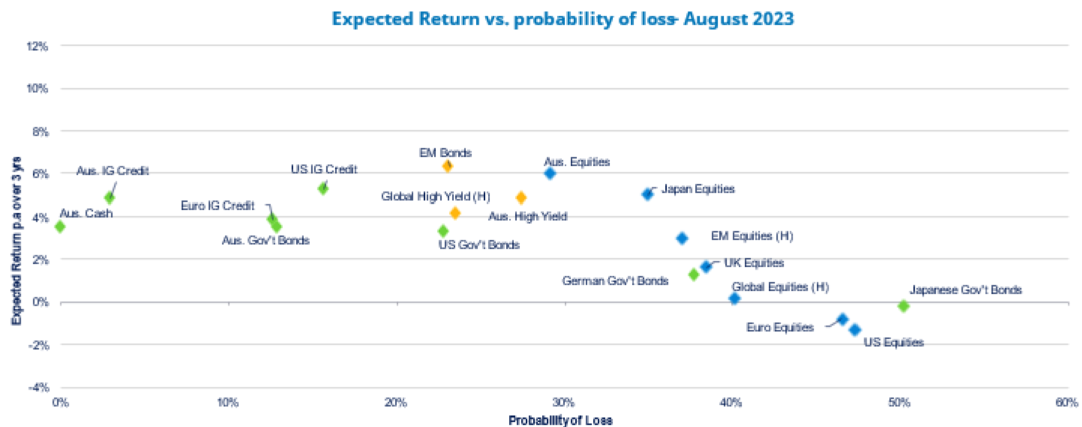
So where are the opportunities?

Pulling this all together, where do we see the opportunities for investment? The above would suggest being cautious on equities, especially US equities, but favouring countries like Australia and Japan. While duration may be an attractive buy soon, we believe that short term volatility will likely remain high, favouring cash in the interim. While we wait for equity risk premia to rebuild to more attractive levels, taking carry in credit helps deliver consistent returns in the meantime. Investment grade credit (and in particular Australian credit) along with select higher yielding alternative credit looks attractive.

A similar picture is evident below, where we plot valuation adjusted forward looking 3-year returns versus their probability of loss. Most assets are offering similar levels of return today, but with very different levels of risk, so holding high levels of equities is not rewarded. Investors may consider taking the carry in credit instead. Cash may be used as a safety net while looking to add to duration as we approach the end of the year, and the economic slowdown may become more pronounced. Then, when valuations adjust and expected returns for equities migrate into the top left quadrant below, investors may consider re-setting their asset allocation back to favouring equities and go back to focusing on harvesting that risk premium for the long run. But we're not there yet.

Where are the opportunities?

Valuations drive risk & return over the medium term



Source: Schroders, as at 31 August 2023. Countries, stocks and sector weightings and returns are mentioned for illustrative purposes only and should not be viewed as a recommendation to buy/sell. **Past performance is not indicative of future performance. Forward looking projections are not a guarantee of future performance.**

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*Sebastian is the Head of Multi-Asset for the Australian Multi-Asset team and co-portfolio manager of the Schroder Real Return Fund strategies and the Global Total Return Fund. Schroders is a sponsor of Firstlinks. This document is issued by Schroder Investment Management Australia Limited (ABN 22 000 443 274, AFSL 226473) (**Schroders**). This document does not contain and should not be taken as containing any financial product advice or financial product recommendations. It does not take into consideration your objectives, financial situation or needs.*

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A new income scorecard for the ASX 200

Reece Birtles

For many years, we have produced an analytical, market-wide view of the Australian reporting season's results. This framework has allowed us to logically judge the pulse of the market and assess the themes that would be 'hard to see' when looking at each company result in isolation.

While our framework has always looked deep into the revenue, earnings and dividend environment (which has highlighted the difficulties for company gross profit margins and earnings growth), this season we have also introduced an '**Income Scorecard'** to look more closely at income outcomes for the stocks in the S&P/ASX 200.

Introducing the Income Scorecard

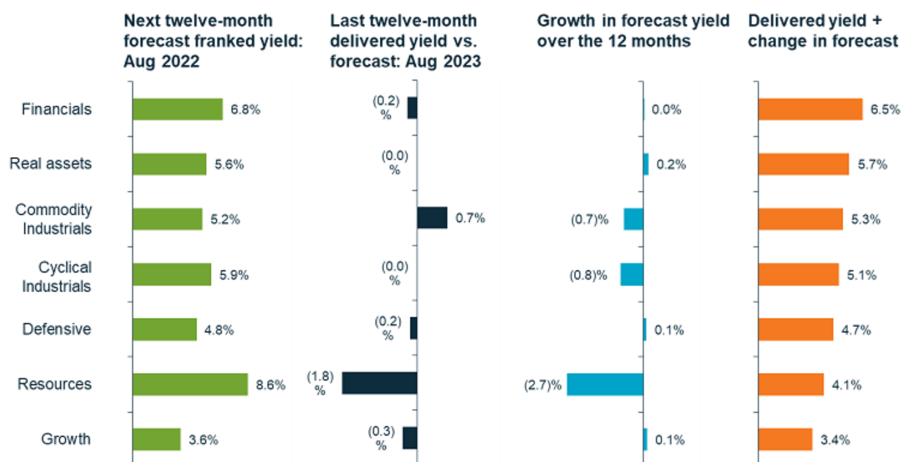
We have looked at reporting season winners and losers from a pure income perspective, rather than stock price performance, as this reflects how we think about portfolio construction for our retirement income-focused portfolios.

Retirees require a reliable income stream. By investing in stocks where stable franked dividends are a larger component of total return, we seek to provide more certainty in income generated by our income portfolios, no matter what the capital gains or losses may be for a stock.

August 2023 income results

We have tracked how companies have delivered on the market's forecast dividend expectations over the last 12 months, and how their dividend growth expectations have changed to review if they are providing any inflation protection. We then ranked them on the sum of their delivered yield and forecast yield growth and aggregated the results by super sector average.

Note that we have stripped out the impact of stock price movement on forecast yield changes over the last 12 months by assuming a static stock price based on the start of the period. We have also limited the income universe to stocks with at least a 3% franked yield, and our proprietary assessment of sufficient quality and liquidity for an income investor. This leaves us with around 115 stocks out of the S&P/ASX 200.



Financials

Financials came out on top, broadly delivering on the 6.8% franked yield expectation set in August 2022, with no reductions in forecast yield. Within the sector, **Bendigo and Adelaide Bank** was a standout as stable player with delivered yield and growth expectations benefiting from higher rates and Net Interest Margins (NIMs).

We would note that given much-publicised concerns over the capacity of borrowers to navigate the transition from low fixed-rate mortgages, bank sector earnings growth risks are skewed to the downside. Saying this, our proprietary estimates of the resilience of dividends for the big four banks does remain attractive. We are comfortable with retaining bank exposures for their income generating ability, however our focus on downside income risk means that this is at a significant underweight relative to a yield-weighted view of the index.

Real assets

In Real Assets, we also saw strong delivery against August 2022 expectations. We saw the strongest income winners in the electricity generators **Origin Energy** and **AGL Energy**, with higher dividend growth expected from higher electricity prices.

Within REITs, being discriminatory was important, and **Scentre Group** was a standout, delivering CPI+ rental increases. This varies with many other REITs who have fixed rate increases despite rising costs. Debt tenure was also important as those with shorter debt books are now paying higher interest costs. Higher interest rates (and cap rates) are leading to pressure on leverage and an inability or unwillingness to invest in development growth. It is evident that many companies have not hedged their interest rate positions adequately.

While **Aurizon** was a poor performer due to the impact of weather conditions on dividends versus expectations, its regulated rail network earnings and group dividends are well-placed to benefit from this year's regulatory reset and inflation-linked contract prices.

Commodity industrials

Within Commodity Industrials companies, petrol retailers such as **Ampol** and **Viva Energy Group** helped the sector to deliver higher dividends than expected 12 months ago through improved margins in refining, but growth is expected to be muted going forward.

Cyclical industrials

Within the more Cyclical Industrials, discretionary retailers such as **Super Retail Group** and **JB Hi-Fi** stood out due to super profits translating into strong dividends and strong balance sheet positions. The next 12 months will be harder, but as dividends have been conservative, there is still a good buffer.

For cyclical companies, the boom period for gross profit margins really is over. Selling prices are no longer rising to offset falling volumes as consumers (in particular younger people and families) hold back as interest rates continue to normalise. At the same time, the cost of doing business is rising, and rising faster into FY24 than FY23. Companies are starting to suffer from wage rises, accelerating rent rises, and other things like higher insurance, electricity costs and tech spend.

Defensives

Income for the Defensives as a whole did not do as well as expected in a downturn, as revenue has not grown with inflation. However, stocks such as **Lottery Corporation** delivered both a good dividend and growth expectations in a tough environment as they raised prices and continue to move ticket sales online away from newsagents. **Telstra** also had good inflation protection in its revenues through its mobile plan price rises.

Resources

Resources companies, while seen as strong dividend payers on an absolute basis 12 months ago, have failed to deliver versus expectations.

They have suffered, stemming from the weak outlook for China property policy and the impact of lower forward commodity price expectations and higher costs for capex programs for mine replacement and net zero initiatives feeding into weaker earnings expectations. Forward dividend growth has been severely reduced, with fundamentals for iron ore looking the worst among the commodities. From an income perspective, **BHP** is in our view better placed to deliver than others in the sector.

Growth

The Growth bucket is small for income stocks given poor dividend yields, but within the qualifying names, **Carsales.com** did better than most.

What this all means

At the aggregate market-weighted level, we are expecting to see another year of poor dividend growth, dominated by the ongoing decline in expected profit margins for the Resources names. In our view, pockets of potential growth reside in the Real Assets, Industrials, and the Insurers (but not the Banks) within Financials.

Positioning our income portfolios

For some time, our portfolios have been positioned for a possible earnings or GDP recession. We have focused on companies that can support fundamentally higher franked dividends in the higher rate environment and not be exposed to valuation risk. Our retiree-focused **Martin Currie Equity Income strategy** is designed to limit the portfolio to no more than 6% in any one stock and 22% in any one economic sector. This leads to a structural underweight towards large caps.

Our highly diversified portfolio includes high-quality names such as **Medibank Private**, **ANZ Banking Group**, **Telstra Group**, **Suncorp Group**, and **Aurizon Holdings**.

*As of 30 September 2022, on a forward-looking basis, the strategy is expected to provide a franked dividend yield of 6.7% over the next 12 months, which compares to the 5.4% expected franked dividend yield for the S&P/ASX 200.

Reece Birtles is Chief Investment Officer at Martin Currie Australia, a Franklin Templeton specialist investment manager. Reece is also the lead portfolio manager for MCA's Value Equity, Equity Income and Diversified Income & Growth strategies. Franklin Templeton is a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any individual. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

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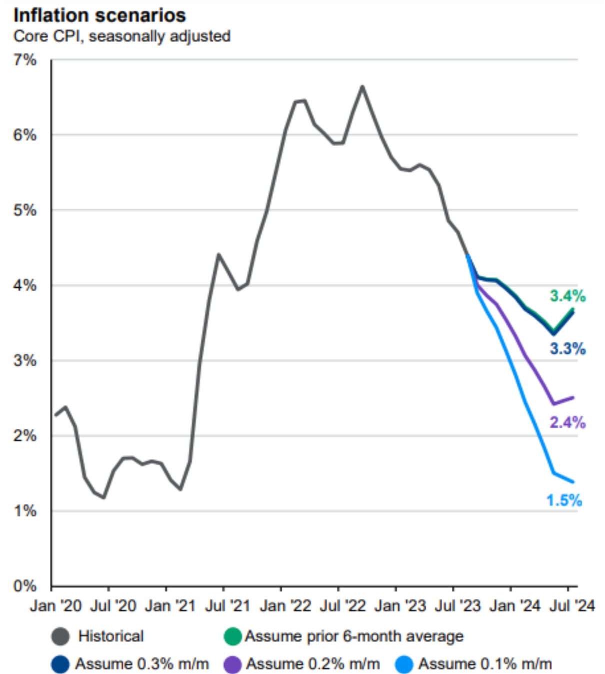
Reader Survey: your personal inflation experiences

Graham Hand

What has been your personal experience with inflation in recent years? Are you shocked by how expensive some items have become? Have you stopped any activity or purchase due to the increase?

The recent peak in the Australian Consumer Price Index (CPI) was 8.4% annual in December 2022, and less than a year later, the latest annual CPI for August 2023 is 5.2%. That's a decent fall, is the inflation surge over? At a recent presentation by analysts at JP Morgan, a number of inflation scenarios were included which paint a rosy picture and justify a major exposure to long-term bonds, which would rally strongly if these scenarios play out.



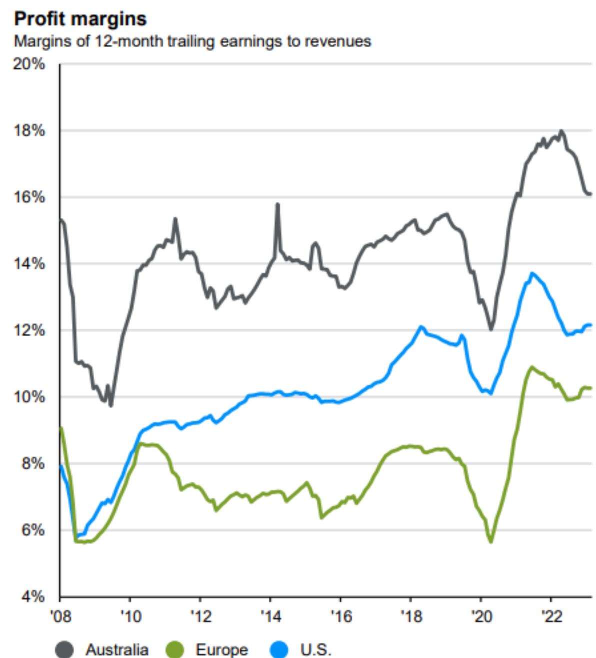
Source: BLS, FactSet, J.P. Morgan Asset Management. Guide to the Markets – Australia. Data as of 30 September 2023.

We all buy different combinations of goods and services and the impact varies. For example, the world's largest global producer and exporter of sunflower oil was Ukraine, and with supplies reduced, all cooking oils have risen in price significantly. Labour costs in hospitality and restaurants have increased and eating out is noticeably more expensive.

And how about the extra cost impact that inflation fails to measure. The shrinkflation where chocolate bars and bottles of drink are 30% smaller. The service charge automatically added to the bill. It's the little things that add up, such as:

- The restaurant that adds a 6.5% 'venue loading' to the final bill.
- The bakery with a 10% surcharge on Sundays, plus a new 'slicing fee'.
- The passing on of credit charge costs by retailers in excess of the fee charged by the bank (or are they bad at negotiating fees with their bank?).
- The car mechanics adding an 'environmental levy' at the bottom of each invoice, on top of high labour and parts costs.

Do you believe businesses have taken advantage of the ready acceptance of an inflationary environment by consumers, allowing increased prices and charges to slip through? There is evidence that profit margins have increased since the start of the pandemic in 2020.



Source: BLS, FactSet, J.P. Morgan Asset Management. Guide to the Markets – Australia. Data as of 30 September 2023.

What has been your experience with inflation in the last two to three years. Does it feel like a step change to higher prices, not 5% to 8% a year but 30% to 50% on many items?

You are unique in the way you consume goods and services. Take our quick survey on the impact of inflation on you. What have been the major price rises you have noticed? Give us quirky examples of the ways businesses are either covering their costs or improving their margins?

Let's look at what's happening in the real world.

Is the market wrong on AI and China?

Andrew Macken

In October 2022, a renowned analyst at one of the world's leading investment banks published a report that downgraded the stock of Meta Platforms (formerly Facebook) and halved his price target to $105 per share. The analyst had been spooked by Meta's guidance on the scale of its future capital investments – largely for AI. The spending was simply too much, too scary. It was 'thesis changing', the analyst said. After the analyst's report was published, Meta's stock crashed 24% the next day.

But fast-forward 10 months, and the market now loves AI investments, and the more the better, seemingly. From the lows reached in late 2022, Meta's stock has nearly quadrupled.

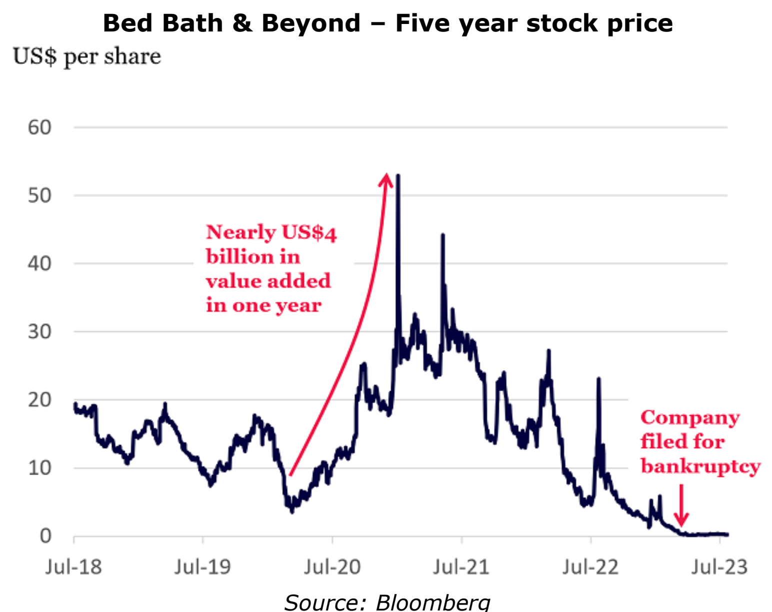
Put simply, the market was wrong on Meta.

Here is another example. In 2020, Bed Bath & Beyond, a US big box retailer of homewares and furniture – a company that had earnings declines each year since 2013 – experienced something unusual.

Over a 10-month period, its stock increased by 14x, adding nearly US$4 billion in value to the company. To put this in perspective, the value of the entire company – including all its indebtedness – amounted to only $3 billion at the beginning of this escapade.

Did this share price surge fairly represent the intrinsic value of the business? Or was the market simply swept up in some Covid-stimulus-related exuberance at the time? It was surely the latter. Two years later, Bed Bath & Beyond filed for bankruptcy.

Bed Bath & Beyond – Five year stock price



Source: Bloomberg

The dangers and opportunities in a market that misleads

The conventional, academic view is that markets are 'efficient' – they price in all available information effectively and are therefore fairly valued. But as you can see in the stock stories above, the truth is that the market is often wrong: that is, stock prices can deviate from true value from time to time, and sometimes significantly. Ben Graham was certainly right to dub the stock market 'Mr. Market', a manic-depressive character prone to bouts of pessimism and optimism.

And that means stock prices are not reliably good at telling you whether your investment ideas are right or wrong. Shareholders of Silicon Valley Bank, for example, probably 'felt right' for nearly 40 years based on the continual steady rise in the bank's stock price. But ultimately, their investment would turn out to be worthless.

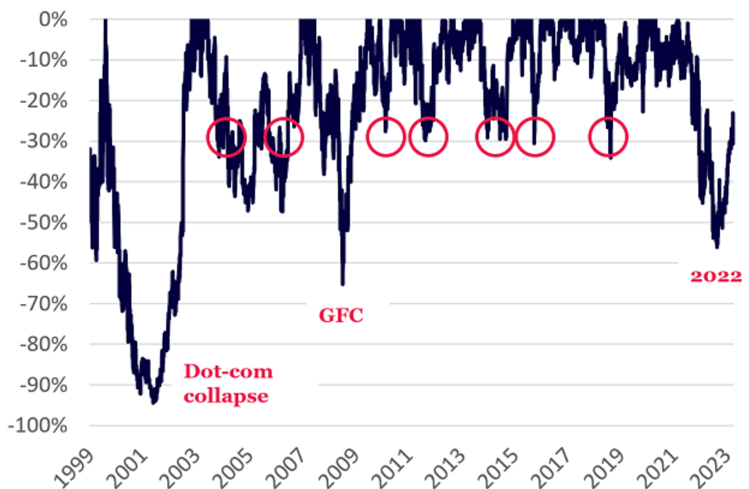
So what should investors do when investing in a market that can be wildly wrong? The secret to navigating periods of market mispricing is simple, but not easy: remain focused on business fundamentals – revenues, earnings, cash flows – and how these evolve relative to prior expectations.

Investors should view a stock price as simply a window of opportunity to buy or sell. The window might be closed most of the time, but sometimes a window opens to buy a stock when its price becomes cheap – that is, the market is pricing-in the future earnings power of a business too low. Conversely, a window of opportunity may open to sell a stock, even the stock of a world-leading company, if its price becomes too expensive.

The huge rewards to holding onto Amazon when the market was wrong

With this approach, investors would view the large stock price drawdowns that Amazon has suffered throughout its history, for example, as nothing more than an opportunity to buy more shares – and not an indictment on their original investment thesis.

Amazon, one of the world's best businesses, has arguably remained structurally undervalued by the market for most (if not all) of its corporate lifetime.



Source: Bloomberg; Montaka

Not only has Amazon's stock halved on three occasions – the dot com bust, the GFC, and the 2022 price downturn – it has experienced a 30% decline on numerous occasions. History has always shown these drawdowns to be unreasonable.

But if an investor could have held on when the market was wrong, they would have been rewarded with an annual return of 33% for 26 years, or compound growth of 1,800x).

Is Mr. Market wrong today?

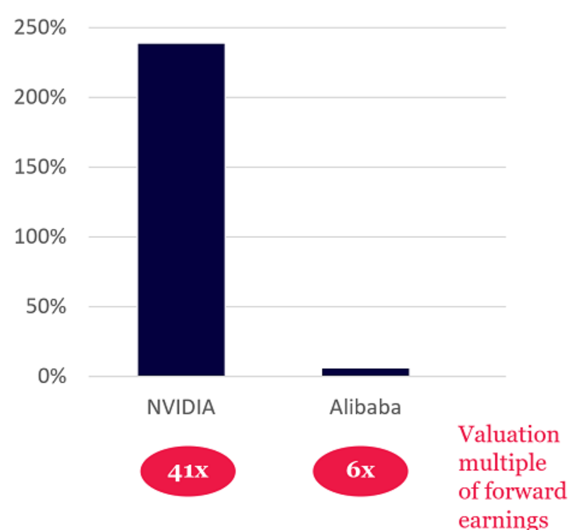
So where could the market be wrong today? Two areas are AI and China.

There is clearly a lot of hype about AI. And while the technology itself appears to be genuinely revolutionary, history shows that mercurial Mr. Market is not always as discerning as he should be in periods of great hype.

Take NVIDIA, the designer of the world's most in-demand accelerator chips for AI today. The stock has rallied more than 3x this year alone. The stock now trades at 41x next year's (substantially upgraded) earnings. Has the market got this valuation right? Time will tell.

Today, NVIDIA's AI chips are essentially the only game in town. This is an extraordinarily attractive position for the company to find itself in. But the competition in the chip design space is intensifying. Most of NVIDIA's largest customers are investing in their own competing chip designs. It would not be a complete shock to look back in a few years and conclude that today's valuation was unreasonably elevated.

On the other end of the spectrum, Chinese equities have had a miserable time of late. A weakening economy, combined with geopolitical concerns, has led many investors to sell.



Source: Bloomberg; Montaka

As a result, shares in Alibaba, China's largest e-commerce platform and cloud computing platform, are flat year-to-date (but down by two-thirds from its 2020 peak). Yet investors might be surprised to learn the following:

- Alibaba's revenue is growing at double-digit percentage annual rates,
- Its employee count is down 7% compared to last year,
- Group profit margins are expanding,
- Free cash flow is double where it was a year ago,
- Cash is being returned to shareholders via large buybacks (the equivalent of 1/6th of today's enterprise value has been returned in the last two years alone), and
- The stock now trades at just 6x next year's earnings.

Has the market got this valuation right? Or is it being overly pessimistic?

Again, time will tell. In this instance, one needn't dispute the risks of investing in China. Instead, it's a question of what price for Alibaba is simply too cheap. It would not be shocking to look back in a few years and observe an Alibaba stock price that is materially higher than current levels.

Remain anchored in fundamentals, not stock prices

It's human nature to view stock prices as a feedback mechanism – an adjudication of investments that were right and wrong. So it's important to remember the market can mislead and is often wrong.

Instead, view stock prices as nothing more than offers to buy and sell. And divorce prices from your assessment of business fundamentals. Own businesses when your fundamental expectations greatly exceed those embedded in stock prices. And sell those when the reverse is true.

Andrew Macken is the Chief Investment Officer at [Montaka Global Investments](), a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation.

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Backing strong companies over weak ones

Niall O'Sullivan

"The strong do what they can and the weak suffer what they must."

When, in his account of the Siege of Melos, the ancient historian Thucydides put this hard-headed ultimatum into the mouths of the Athenian negotiators, he inaugurated the realist school of history. Human affairs were not decided by the whims of the gods, but by naked interest and the often-brutal assertion of the balance of power.

Today, when we look across many asset classes and think about how to invest, we think a realist would recognise that relative strength and 'quality' characteristics will be key factors.

There is a top-down *deus ex machina* at work in the economy, in the form of inflation and the wave of central bank rate hikes implemented to contain it. The European Central Bank hiked again at its last meeting, the recent pause by the U.S. Federal Reserve was framed in notably 'hawkish' language, and markets pushed their expectations for the first rate cuts of the next cycle deeper into 2024. Furthermore, this policy tightening can also be thought of as a tourniquet. Each hike represents a further twist, but the previous twists also have a cumulative constrictive effect on blood flow.

However, while the painful adjustment to this shock is just beginning, it will likely be more painful for some than others. At this stage in a cycle, more than any other, the strong are defined by their flexibility to do what they can, despite the macroeconomic headwinds, while the weak, defined by their lack of options, suffer what they must.

It is important to ensure exposure to stronger over weaker companies. It is also the time to be opportunistic because a price can be gained for helping some of the weak to survive.

Who are the strong?

First, the strong are those with relatively low and stable costs. That means asset-light businesses that do not need a lot of manufactured or raw-commodity inputs. It means people-light businesses with modest operational leverage, where wage bills are not spiraling upward. It means cash-generating businesses that can invest in growth with little or no financial leverage, and therefore low and stable interest costs. Some companies with large cash balances have even seen their net interest expense decline as rates have gone up.

Second, those with competitive 'moats': providers of essential products or services with dominance in their markets. These businesses can absorb the inevitable rise in their costs by passing them onto customers, thereby maintaining or even continuing to grow their margins.

These characteristics are often said to define 'quality' companies, and at the moment, they also come with some sectoral and even regional implications.

As [the U.S. auto-sector strike]() is likely to demonstrate, in some competitive industries it may be difficult to pass rising costs onto customers without losing critical market share. Manufacturers in general are struggling more than the services sectors, which is also one reason the US is coping better than Europe and China. And,

eventually, countries with high levels of debt and rising interest costs, among both developed and emerging market sovereigns, are likely to find the 'kindness of strangers' running low.

Operational flexibility

That said, strength and quality are not found exclusively in, say, large caps rather than small caps, investment-grade rather than high-yield borrowers, or public rather than private companies.

For example, our Fixed Income team's bottom-up analyses anticipate rising defaults and credit stresses among high-yield issuers. Due to the idiosyncratic nature of these stresses, however, they do not anticipate the kind of broad widening of spreads that was seen in 2007–08, 2015–16 or 2020. Similarly, our Direct Lending team is happy to help a very select group of private companies refinance with senior debt at double-digit rates because it is confident those firms can grow their margins to more than cover those rates.

Tony Tutrone, our Global Head of Alternatives, has explained how buyout deals based on financial engineering won't thrive in conditions where borrowing costs are much higher. Rather, a focus on stronger companies and management that can achieve results through operating excellence is more likely to be rewarded.

Today, it's all about the quality of the business, the quality of management and the operational flexibility to 'do what they can'.

Disruption, reconstruction and reorganisation

And the weak?

What they must suffer will depend on their circumstances. For some, it will merely be tighter margins. Others will incur losses. Some will lose market share, some will be forced to restructure, many may not survive.

Still others will become takeover targets for the stronger companies in their sectors: Event-driven investment strategies could be a way to get opportunistic exposure to this period of disruption, reconstruction and reorganisation.

There may also be some businesses, especially in the private markets, that are fundamentally strong but whose balance sheets have become an Achilles' heel of weakness in the current environment. These companies should be investing in their growth or be out there making acquisitions, but they cannot afford to borrow more to do so. Here, providers of specialist capital solutions can provide solutions such as preferred or structured equity to these businesses, which effectively means equity-like contractual returns despite having, on average, a 50% value cushion of common equity below them in the capital structure. These can often be attractive equity investment opportunities.

The weak falter

Investing is not as brutal as ancient history. It is not always wise to be long the strong. When rates are low and stable, and cycles are smooth, the market is apt to reward companies that move a bit too fast and take a bit too much risk.

That's not where we are today. Now is the time to be very selective, focusing on quality businesses that can sustain their margins. But it is also the time to provide capital and liquidity opportunistically when you see the weak falter - as we believe they surely will.

Niall O'Sullivan is Chief Investment Officer, Multi Asset Strategies – EMEA at Neuberger Berman, a sponsor of Firstlinks. This information discusses general market activity, industry, or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. It is not intended to be an offer or the solicitation of an offer.

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Disney blinks in the TV streaming wars

Alex Pollak, Harry Morrow

If you have noticed that there are fewer new US programs on your Netflix feed, that's because there has been both an actors' and a writers' strike in America. The same goes for Foxtel and Binge - the HBO content on which their businesses are built is also subject to the US talent strike.

But there are other big changes that are upending the entertainment industry model in the US, and as we know, almost every piece of content from the US in the end finds its way here. Allied to this, Netflix streaming has changed the way the small screen looks in Australia.

The Disney changes relate to the very core of the US industry, the cable businesses, on which virtually all television is carried (excluding the satellite players and some other legacy technologies).

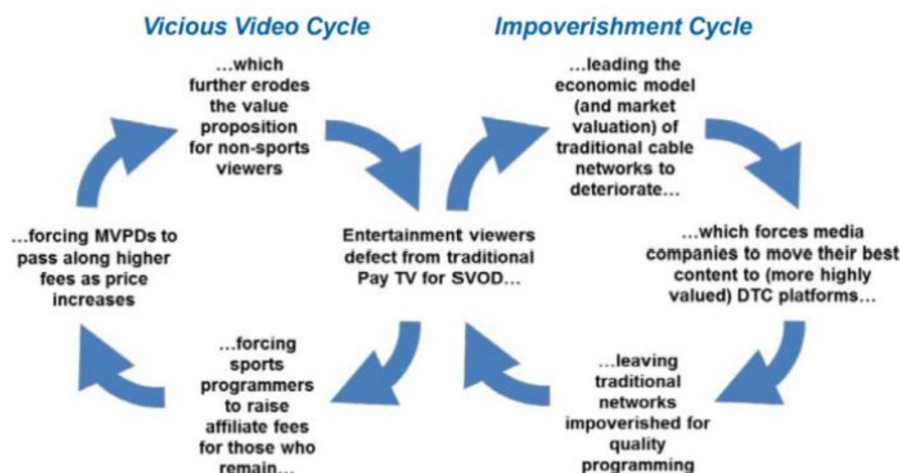
For decades, the running assumption has been that traditional TV media players (Disney, Warner Bros. Discovery, Paramount and Fox) could continue growing their businesses by increasing charges to their main US distribution channels, the cable companies, at a rate exceeding that which was lost due to cord-cutting (cable subscribers cancelling in favour of streamers like Netflix). In some parts of the US, it has been noted that in just three years the price of cable TV has ballooned from $100/month to $150/month - up 50%!

These companies had the power to do so because of ownership of tentpole sports content rights like the NFL, NBA and more. Live sport is the powerful glue holding the cable bundle together.

Disney does not have a friend in Charter

That was until recently when Charter Communications, with 15 million TV subscribers through its cable service, said enough was enough. In response to Disney's 10%+ increase for carriage of ESPN, Charter issued a press release titled 'The Future of Multichannel Video: Moving Forward, Or Moving On'. It included the demand that if Charter were to accept the price rise, Disney would have to make available its ad-supported streaming services (Disney+ and ESPN+) to Charter's eligible cable subscribers.

There was also the following slide, which was remarkable:



Source: Charter

Charter was (rightfully) frustrated that Disney was hiking its prices for no additional value and that those price hikes were being used to fund its streaming service - both of which were accelerating the decline of its cable distribution business (in terms of subscribers and profitability). After all, why subscribe to cable for $150/month when you could get all of the general entertainment you ever wanted (and then some) by way of streaming services for $50/month? Millions were 'cutting the (cable) cord' each year as a result.

Accordingly, Charter was prepared to “largely exit the traditional video business” if Disney didn't agree to its terms. The industry, and the cable business model in place since the 60s, had been put on notice. Read that sentence slowly: it means the end of the existing Pay TV model.

At risk to Disney is US$2.2 billion in annual affiliate fees and any associated advertising. At risk to Charter is the potential loss of subscribers as a result of the blackout right before the beginning of the NFL season. The effect of that would almost certainly be an exodus of Charter's sport fans who would find what they were looking for elsewhere.

Source: Oscarrboltongreen

Disney blinked

As has happened in the past, the dispute was resolved at the eleventh hour. But in this case, for the first time possibly ever, it was the content owner, Disney, that wound up making the concessions - including acceding to Charter’s demands on its streaming services, albeit at a wholesale rate. In our view, Charter will not be the last of the US cable operators to demand such concessions.

This signifies a shift in power that will have implications for the way individuals consume entertainment, especially sports, and how much they pay for it, not just in the US, but globally.

Content is still king, but distribution is dominion

The cable bundle was not a bad business model.

In fact, it was arguably the best business model the content providers could have asked for: they were all participating in fantastic economics - at its peak the US TV market generated revenue of ~US$200 billion per year - and by bundling all of the content together it effectively locked those users in and reduced churn (unsubscribes).

It is the lucrative nature of the bundling business model that explains why Charter made the move that it did. Charter is attempting to disrupt the cable bundle that is 70 years old with a streaming bundle.

Charter believes it still has an important part to play given it provides the cable over which 30 million+ households in the US access the internet (the same one it offers for its cable/video services). It has a salesforce already trained in up-selling a video bundle and in-person store locations for customer service. And for what it’s worth, it seems to have strong-armed Disney into the beginnings of this process. Other internet service providers like Comcast, Frontier and Verizon are also likely to be lining up for this opportunity.

However, despite a role in the carriage of internet and streaming services which should be an obvious bundle, both US consumers and even those in Australia have not found this offer particularly compelling to date. It isn’t surprising these cable companies (Telstra and NBN in Australia) have often been described as providing a 'dumb pipe'.

Which company will pull together the ‘new’ bundle?

A smarter pipe for the re-bundling of streaming services could be the television operating system itself. The operating system offers important advantages for the bundling of services, e.g. a smart, visually rich interface with the user, existing subscriptions (what don’t they have?) and viewing habits (what they watch the most/least). These are important in a world where surfacing good content becomes the basis of the monetisation of the new bundle.

Roku’s TV operating system, in nearly half of US households, has better distribution than any of the US internet companies. It already offers discounted subscriptions to many premium streaming services (Paramount+, Discovery+ and AMC+) on its platform. Amazon has a sizable US$1 billion+ distribution business through its Prime Video Channels here, too.

Perhaps best positioned due to its global scale is Alphabet's (Google's) YouTube, which has over two billion users already in the habit of coming to its platform for user-generated video content. Is it too great a leap to imagine the platform offering a bundle of higher-end video content?

Too early to tell, but for cable bundle, sports content losing its stick

While the position of the streaming bundler remains up for grabs, what is clear is the direction of viewership in favour of streaming.

Just this week Warner Bros. Discovery signalled that it would make available its entire sports catalogue (which includes MLB, NHL, NBA and College Football games) by way of simulcast through an add-on to its streaming service Max. Another huge blow to the cable bundle, and a move we expect the other holders of sports rights will be forced to follow (Disney, Paramount and Comcast).

The more viewership that flows from traditional to streamed TV, the more dollars that are unlocked for the streaming ecosystem and the more revenue potential for the beneficiaries of the streaming theme, namely Netflix and Roku).

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