Firstlinks

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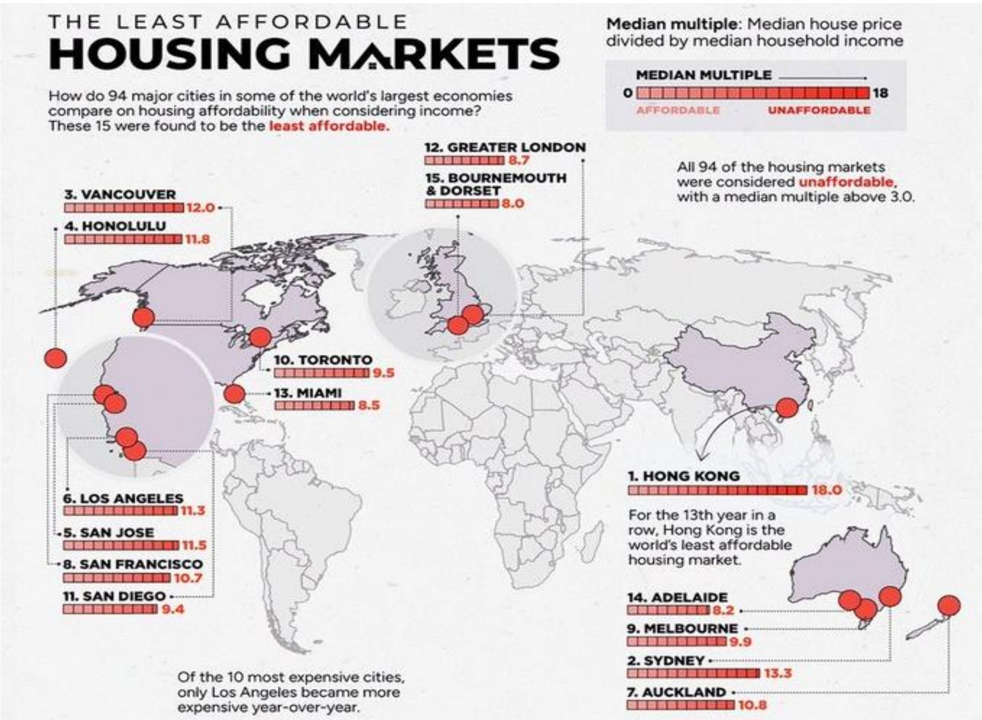
Editorial

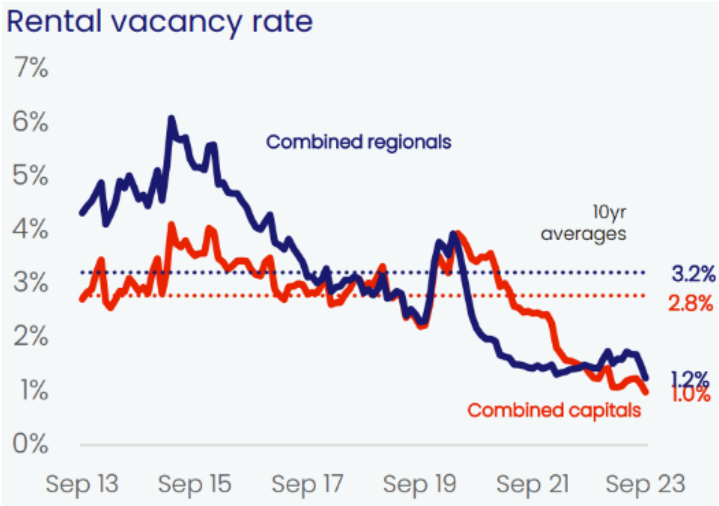
Here we are in little Australia, down under with only 26 million people in a world of 8 billion (0.33%), ranked 55th among all countries by population, with a stock exchange worth less than 2% of global capitalisation. Travel overseas and you'll see we are almost ignored in the news cycle of major countries unless a shark bites someone, a bush fire ravages a town or Australia wins a sporting event. And with thousands of cities on the planet, this tiny country boasts three cities ranked as 'least affordable' housing markets in the Top 15 in the entire world - Sydney at 2, Melbourne at 9 and Adelaide at 14. Let's throw in Auckland at 7 for good measure.



Source: Demographia

Everyone has their own lists of reasons. We have a culture of home ownership, where about two-thirds of Australian adults own their own home (and 80% over the age of 55), unlike say Switzerland which is closer to 40%. The tax system excludes the home from social security tests and capital gains tax, while short-term leases discourage renting. Residential leases of 10 and 20 years are common in Europe but the most frequent in Australia is a vulnerable one-year. Australian banks are eager to lend for home mortgages but less so for business loans, and many families accept they will need two incomes to service their debt while they struggle for childcare. The Bank of Mum and Dad is common.

And then there's population growth, especially through immigration. It will become more of a political issue at the next election as more people cannot find rental properties and owners are increasingly priced out of market. There is a supply and demand imbalance, and many builders have gone into liquidation. The recovery in house prices in 2023 has defied most economists who were expecting a fall, some as high as 30% from the 2022 highs.

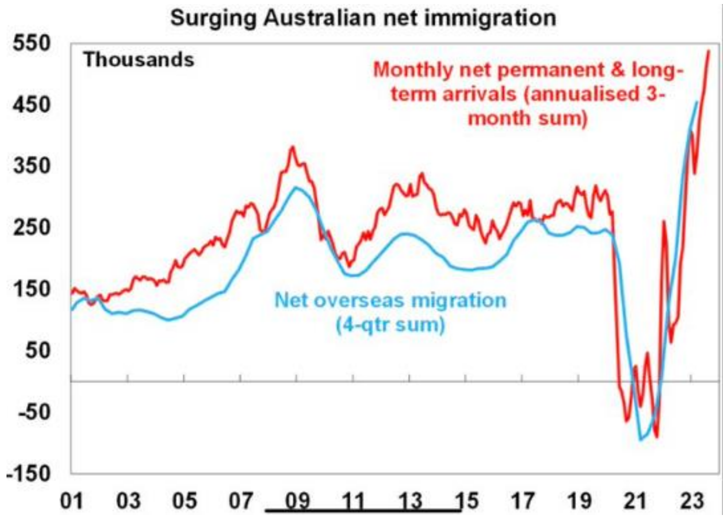


Source: CoreLogic

According to the **Australian Bureau of Statistics** (ABS) Media Release entitled '[Overseas migration drives Australia's population growth]' on 14 September 2023, the population grew by 2.2% to 26.5 million people in the 12 months to 31 March 2023. Head of Demography, **Beidar Cho**, said:

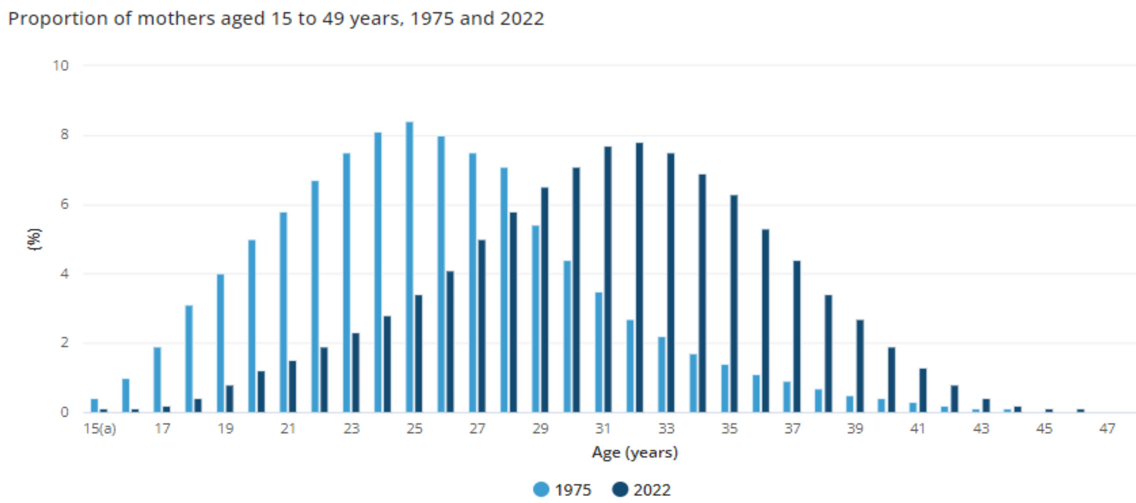
> *"13 months after international borders were re-opened, net overseas migration accounted for 81% of growth and added 454,400 people to the population in the year to March 2023."*

The ABS reported that net overseas migration was driven by a large increase in arrivals (up 103% from last year to 681,000) and only a small increase in overseas migrant departures (up 8.8% to 226,600). Natural increase was 108,800 people, a decrease of 18.5% from last year. Based on even later data, net immigration will top over 500,000 in the 2022/23 financial year making the housing shortfall even worse. It's the main reason economists are predicting further price rises despite higher interest rates.



Source: AMP/Shane Oliver

The dramatic shift in [birth statistics also released by the ABS] shows demographics can change in a couple of generations. This chart shows the age of mothers having children in 2022 peaks at 32 years versus 25 years in 1975. As my wife said, imagine how old the grandparents and great-grandparents will be.



The new **Reserve Bank Governor, Michele Bullock**, at the **Australian Financial Security Authority's** annual forum, highlighted the house price recovery despite the tightening of monetary policy. Here are a [few points she made:](#)

> *"Actually, the housing market has surprised me a bit. So, if you remember the history, when COVID first hit, housing prices actually declined and then, after a few months, they shot up, and they shot up about 20, 25%; they really rose very, very sharply. Then, when interest rates started to rise, housing prices started to decline, and we thought that they would continue to decline, this is of the existing housing stock, if you like. But, actually, they bottomed sooner than we thought and, basically, now they're back to where they were in their peaks of the pandemic.*
>
> *Now, there's a few things going on here, I think. One is that, as you alluded to, there's difficulties in the construction of new housing at the moment. There's a pipeline there; there's an unfinished pipeline of housing stock, detached housing stock, which because of supply chain issues, inflation in construction costs, shortages of labour, particularly subcontractors, that isn't being finished. And so the cost of new housing has risen quite sharply and that, I think, has made the equation between 'build a new house' or 'buy an existing house' change, somewhat. The other thing that's happened is rents have risen a lot, and that's that the supply of housing isn't meeting the demands for housing."*

A recent study by the **University of Adelaide** and **University of Essex** found that [renting leads to faster ageing](#), including:

> *"Our findings demonstrate that housing circumstances have a significant impact on biological ageing, even more so than other important social determinants, such as unemployment, for example, and therefore health impacts should be an important consideration shaping housing policies."*

Housing is such a significant policy and political issue in Australia that financial legislation including superannuation and retirement should be framed in some way by the implications for home ownership.

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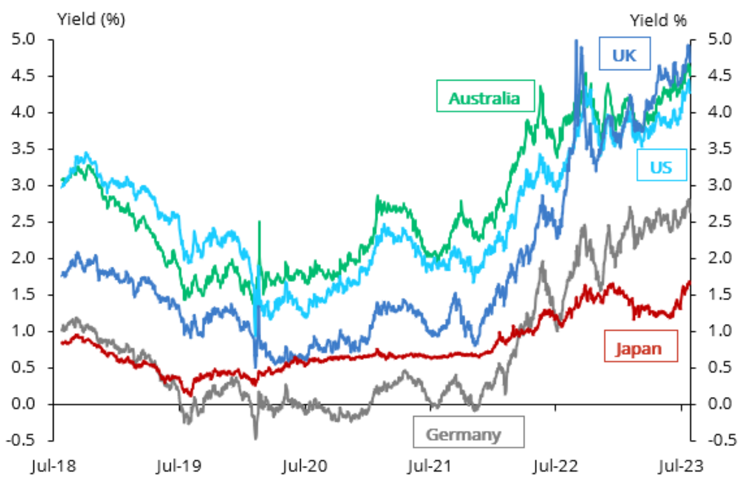
Some fascinating tussles in bond markets at the moment, both locally and in the biggest market of all, the US. The Australian Government issued $8 billion of June 2054 bonds at a yield of 4.93% after receiving $29 billion of bids. Despite the long duration and risk, there are plenty of investors snapping up the near-5% yield which looked highly unlikely in recent years. The Australian Office of Financial Management provided a [report on their issuing activity](#) but a glance at the chart below shows how much cheaper it would have been if they had jumped on the rates of 2020.

Chart 7. A comparison of 30-year sovereign bond yields.



Source: Refinitiv. Yields updated to 24 August 2023.

Action in the bellwether 10-year US Treasury was also lively this week as it briefly exceeded 5% but has since settled back to around 4.9%. US investor, **Bill Ackman**, gained more publicity and notoriety by covering his bond short (buying bonds) two months after publicly taking a big bet that rates would continue rising. Here is the reaction in the following few hours, and he enjoyed it, showing how quickly the rally went from 5% to 4.85%.

Bill Ackman

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Lots of discussion on the proposed new $3 million tax on superannuation, with most of it now centred on taxing unrealised gains. Some useful alternatives are surfacing which Treasury ought to consider. In Firstlinks last week, this example from a reader, '**Tasman**', shows how an SMSF trustee could be severely affected:

"The proposed tax should make anyone considering buying into high risk, growth stocks (exploration ,biotech, technology) tread carefully, maybe reconsider. A biotech our SMSF holds has gone from 1.6c (2019) to 60.5c (2021) to 4.1c (today). A disaster if the new tax had been applied."

Another call out, after **Meg Heffron** expressed her frustration at the $3 million tax being referred to as a 30% tax, not only by the media but by Treasury itself. Journalists continue to swoon over Exchange Traded Funds (ETFs), now reaching $150 billion, such as ***The Australian Financial Review*** leading with its article, '*Why everyone is investing in ETFs*' including describing ETFs as the '*biggest investment trend of the decade*". The total amount in ETFs is about half the funds managed by **AustralianSuper** alone, and the total amount in managed funds is $4.6 trillion, according to the ABS. Which puts ETFs at about 3% of managed funds. No, while ETFs are growing, the majority of Australians are not investing in them.

Graham Hand

In this week's edition...

It's been dubbed 'The Great Wealth Transfer', where Baby Boomers are expected to pass on around $3.5 trillion in assets to their children over the next two decades. A new report by **Fidelity International** suggests Australians are keen to share their wealth with the next generation but are unsure about the best ways to go about it, as **James Gruber** reports.

For much of the past decade, retirees had to deal with issues of low deposit rates on their savings. Since the end of Covid, a new threat has emerged: inflation. By constantly eating away at the value of savings and income, inflation can slowly reduce purchasing power in retirement. **Bob French** at **Retirement Researcher** has tips on how to inflation-proof your retirement portfolio.

Meanwhile, it's well known that any money withdrawn from superannuation after age 60 is tax-free. Less well known is the arrangement that allows a couple over the age of 67 to earn up to $57,948 per year outside super and pay no tax. **Jon Kalkman** has the details.

ASX blue-chip stock ResMed is down almost 40% in less than five months due to concerns that new obesity drugs will reduce demand for its products. **Vinay Ranjan** from **Airlie Funds Management** explains what these drugs are, their effectiveness, and the potential impact they could have on the sleep apnoea market.

Over 10 years of surveying large super funds and the portfolio managers and consultants who help them to invest, **Frontier Advisors' Wayne Sullivan** notes that significant changes include the move to in-house investment staff, a change in the major decision-makers, fee competition and the top worries.

Bonds have been crushed over the past two years, yet equities have held up reasonably well. **Clime's John Abernethy** thinks a reversal in fortunes is probable over the next 12 months. However, he still believes equities are a better place to invest over a longer timeframe.

The assets which have performed well lately have notably come from outside traditional asset classes, such as Bitcoin and gold. Gold is near Australian dollar all-time highs thanks in part to rising tensions in the Middle East. Should gold be part of your investment portfolio, and if so, how much? **The World Gold Council's Jaspar Crawley** offers his thoughts.

And in this week's White Paper, we've gone for something different: two short videos from **Magellan** on AI and opportunities from the energy transition.

Curated by James Gruber and Leisa Bell

Australians unprepared for $3.5 trillion wealth transfer

James Gruber

A new report suggests that Australians, both young and old, are ill prepared for the largest wealth transfer in history.

It's expected that about $100 trillion in assets world-wide will be transferred from Baby Boomers to their children over the next two decades. A 2021 Productivity Commission report estimated that around $3.5 trillion in assets will be transferred in Australia alone by 2050.

The inherited assets will mostly come in the form of superannuation and residential property. Inherited assets are predicted to rise from the current $120 billion per annum to $500 billion per annum over the next 25 years.

A recent report from stock trading firm, AUSIEX, found that the wealth transfer is likely to happen sooner than expected. It suggests Baby Boomers are leaving the workforce at an accelerated pace and they'll be all but gone from workplaces by 2028:

> *"It doesn't stop there. In 2027, the first of the baby boomers will reach their statistical age of death (81 years for men and 85 years for women).*
>
> *Baby boomer superannuation balances will start to deflate out of the system through retirement consumption and then through disbursement via the inheritance process."*

Nest egg mentality

A new report from Fidelity International called '*Rainbow's End*' suggests most Australians want to share their wealth with the next generation but are unsure how to transfer that wealth. Fidelity surveyed 1,500 people over the age of 26, spanning Gen Y, Gen X, Baby Boomers, and the Silent Generation.

The report found about 50% of people are only somewhat confident or not confident at all in knowing how their wealth transfer goals will be met. Part of the issue is that most of those surveyed aren't confident that their retirement savings will be enough to support their desired lifestyle. And most also admit they have a so-called nest egg mentality – that is, they want to avoid spending money, so they won't run out of savings or not have enough to pass on to their family.

Passing on assets now or later?

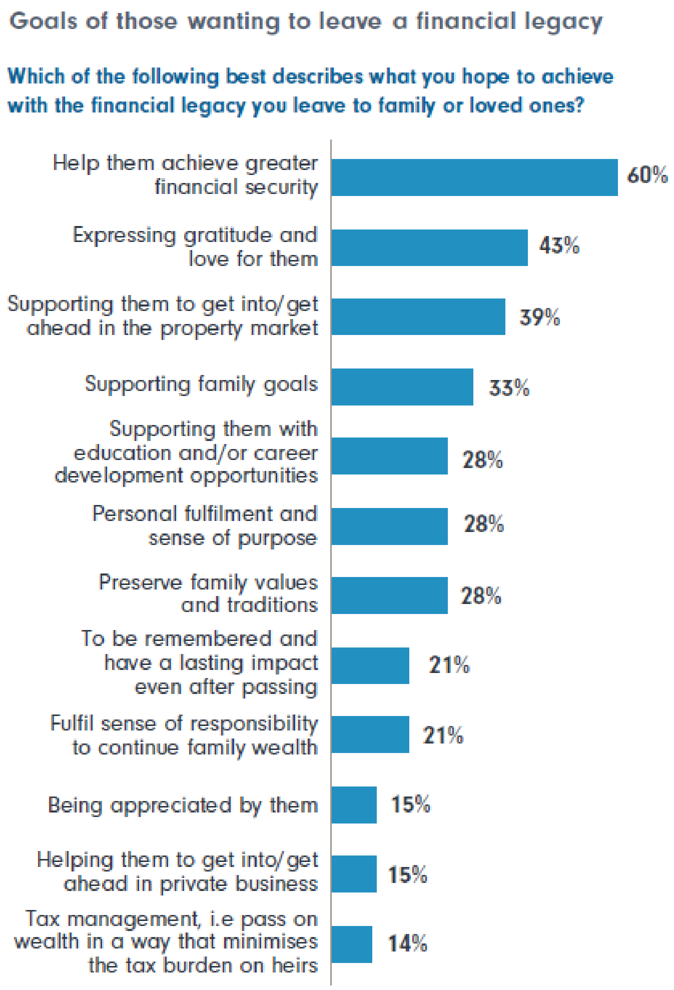
However, around two in five people prefer that their wealth be shared while they're alive. That's almost double the number who'd like to leave their wealth as a bequest.

Interestingly, though, while most of the survey respondents want to transfer assets while they're alive, they want to leave the majority of transferred assets for when they pass away. The report found that two in three people are likely to transfer 60% or more of their assets after they die.

As one survey respondent, a male baby boomer, remarked:

> *"I think not giving away too much, too soon. And also trying to keep my children motivated towards their own self-achievement goals and not falling into the thinking of they can always rely on me."*

As for what people want to achieve when transferring assets, the top two goals of those surveyed are to help their children with financial security and express their gratitude and love for them.

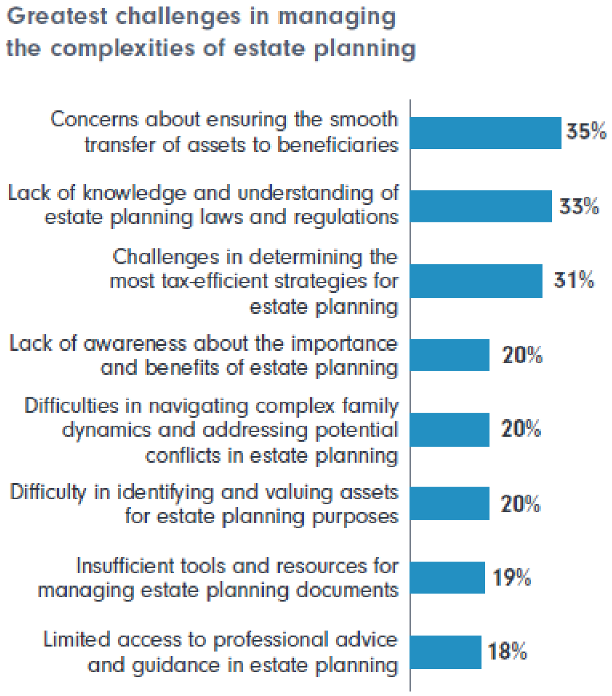


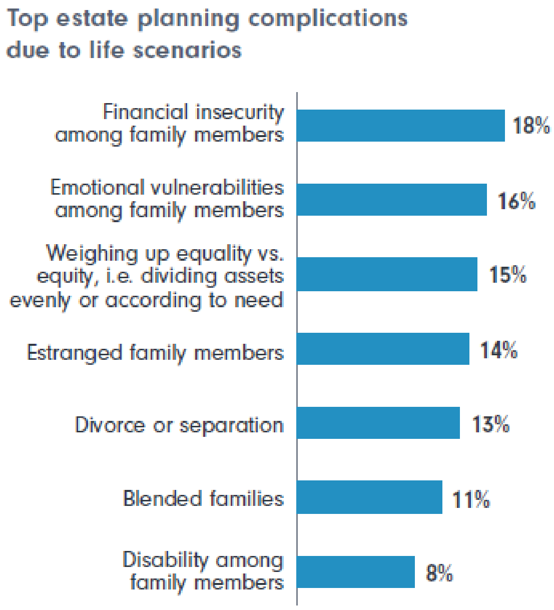
Source: Fidelity International

The challenges with transferring wealth

Those surveyed in the report highlighted several key challenges in leaving a bequest or transferring assets while they're alive:

- Financial worries: having enough money to leave due to worries about the rising cost of living, insufficient savings, and the impact of taxes and fees.
- Managing family issues: potential conflicts over the inheritance, disagreements over the distribution of the assets, differing expectations and interpretations of a will, and the possibility of rifts developing in the family.
- Legal and administrative issues: ensuring the validity of the will, finding a trustworthy executor or trustee, and understanding tax implications.
- Ensuring wishes are upheld: choosing the right person to receive the bequest, ensuring responsible use of the assets, and avoiding misuse or wastefulness.
- Uncertainty and lack of knowledge: uncertainty about how to proceed, unfamiliarity with legal requirements, and a lack of information or guidance.





Source: Fidelity International

One of the more fascinating aspects of the survey is what children are expected to do with the money from their parents. One in three think it will used to pay down existing debts. One in four believe it will be spent to maintain the children's desired lifestyle, while 16% expect it to go towards education.

Financial and estate planning advice

The upcoming wealth transfer has financial advisors licking their lips, and this report will leave them even more optimistic.

The report found that while most people aspire to transfer their wealth, far fewer have made concrete plans to do it. Nearly two in three intending to leave a bequest have a will, yet less than 10% have a comprehensive estate plan.

As for the popular source of advice for those receiving assets or an inheritance, a professional financial adviser tops the list, followed by self-reliance, and family.

The problem is that there may not be enough financial advisers to handle the increased demand for their services. There are now less than 16,000 advisers, down from almost 28,000 in 2018, before the Hayne Royal Commission.

Given the stringent education requirements to become an adviser, increasing those numbers won't happen quickly. And superannuation funds being able to provide advice is unlikely to help much given most people require customised guidance for their personal circumstances.

Source: Fidelity International

A limited supply of advisers and growing demand can only mean one thing: prices will have to rise from current levels. With ongoing financial advice fees averaging close to $5,000 and out of reach for most people, it's clear that industry change is needed. And fast.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au

SAPTO and LITO, or do you really need an SMSF?

Jon Kalkman

It is well known that any money withdrawn from superannuation after age 60 is tax-free. Less well known is the arrangement that allows a couple over the age of 67 to earn up to $57,948 per year and a single person up to $32,279 per year outside super and pay no tax.

This is because of the operation of two tax offsets which together eliminate all the tax payable. It is important to note a tax deduction reduces the income on which tax is payable, a tax offset reduces the tax payable on that income.

The current tax-free threshold is $18,200. For low-income earners, there is also a Low-Income Tax Offset (LITO). It effectively allows working Australians to earn up to $21,884 per year before they need to pay any income tax or Medicare Levy.

In addition to the LITO, people who have reached pension age are entitled to use another tax offset called the Senior Australians and Pensioners Tax Offset (SAPTO). The important element here is not that the person receives the age pension, but that they have reached pension age.

SAPTO works in tandem with LITO. This means that a single person over age 67 can earn $32,279 before they pay any tax as the LITO and the SAPTO together offset the tax payable. The SAPTO for each member of a couple means they can each earn $28,974, or $57,948 together, tax-free. There is also no Medicare levy payable for taxpayers eligible for SAPTO.

Rates and rebate income thresholds for SAPTO

Status	Maximum tax offset amount	Shading-out threshold	Cut-out threshold
Single	$2,230	$32,279	$50,119
Each partner of a couple	$1,602	$28,974	$41,790
Each partner of an illness separated couple	$2,040	$31,279	$47,599

Source: Australian Taxation Office

Just as the LITO is tapered as income exceeds the threshold, the same applies with SAPTO but the taper rate is much more severe. The SAPTO is reduced by 12.5 cents per dollar of income so there is no SAPTO available when income reaches $50,119 for a single person or $83,580 combined income for a couple.

Implications of the two working together

Thanks to the LITO and SAPTO, a couple with a taxable income below $57,984 pay no tax. In that case, their tax position is the same as if their income was drawn from super. If we assume that these assets were generating an income yield of 6%, it would mean that this couple could hold over $900,000 in assets outside super and have the same tax-free income as if those assets were held inside super, assuming no other taxable income. A single person could have over $500,000 invested in their own name and still pay no tax.

For some seniors over the age of 67 this may encourage them to close their SMSF with its fees and regulations. By holding those assets in their own name, they would have to go back to completing a tax return, particularly if they wanted a refund of their unused franking credits.

It also means that, in addition to tax-free income derived from investments held inside super, seniors over the age of 67 can also hold substantial assets outside super with no income tax to pay. Withdrawals from a super fund are tax-exempt, after age 60, and are not declared on a tax return and as shown, SAPTO allows substantial tax-free income from assets outside super.

Risks of moving money out of super

If the assets are held outside super and as the income grows over time, some tax may become payable if the income progressively exceeds the tax-free threshold, which is not indexed.

Similarly, capital gains are taxable income in the year the asset is sold. Outside super, any capital gains on assets sold may trigger a tax liability whereas that is not be the case in a super fund paying a pension.

If one member of a couple survives the other, their effective tax-free threshold is reduced from the couple rate of $57,984 to the single rate of $32,279. If the surviving spouse continues to hold all the assets in their own name, the income produced could trigger a tax problem which may not arise inside a super fund. Holding assets in their own name requires different estate planning and asset protection arrangements from those who hold assets in a super fund.

Assets transferred out of a super fund to benefit from SAPTO are difficult to put back into super because of the contribution caps. Removal of the work test makes this somewhat easier for those under age 75, but this decision is almost irreversible.

SAPTO is another example of seniors paying less tax than the working population and is often suggested for removal as a way of improving taxation equity. There is a legislative risk that it may be removed in future, although that would affect mainly age pensioners and seems unlikely.

SMSFs are considered by many to be the investment platform of choice because of the tax concessions they offer, but they are not cheap, particularly for retirees with modest investment balances. SAPTO may provide people with modest investment balances the same tax-free income as a super pension with none of the fees or regulations.

Important to note

This article is not meant as financial or tax advice as I am not qualified to offer either. It is important to stress that any decision to close down a SMSF has enormous implications for future tax liabilities and should not be taken without sound advice from a qualified accountant and/or financial adviser who can consider individual circumstances.

Jon Kalkman is a former Director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor. This article is based on an understanding of the rules at the time of writing and anyone considering changing their circumstances should consult a financial adviser.

Is ResMed a trap or an opportunity?

Vinay Ranjan

During the [third] quarter, we added ResMed (RMD.ASX) to our top ten holdings. ResMed is the global leader in sleep and respiratory care primarily focused on the development and sale of positive airway pressure devices and accessories for the treatment of obstructive sleep apnoea. ResMed's share price has fallen 30% since the release of its FY23 results in August largely in response to concerns GLP-1 (Glucagon-Like Peptide-1) drugs may reduce its addressable market. In this article, we discuss the business in more detail and why we think the GLP-1 concerns are overdone.

What is Obstructive Sleep Apnoea (OSA)?

Obstructive sleep apnoea is a chronic illness that occurs when the muscles that support tissues in the back of the throat relax during sleep, blocking or narrowing the upper airway. This obstruction leads to impaired breathing for a short period (usually 10-20 seconds), which results in lower oxygen in the blood. The brain senses the impaired breathing, causing the individual to subconsciously rouse from sleep in order to reopen the airway. The severity of OSA is characterised by the number of events per hour: Normal < 5; Moderate 15-30; Severe > 30.

Continuous Positive Airway Pressure (CPAP) devices are the accepted standard of care for treating OSA, delivering a stream of pressurised air through a mask to prevent the collapse of the upper airway during sleep. ResMed is the largest manufacturer of these products, and we estimate the company currently has ~80% market share with its major competitor Philips out of the market for the past two years due to an FDA-imposed product recall.

Large, undiagnosed addressable market

The OSA market is large and mostly undiagnosed. According to the company, there are 936 million people globally with sleep apnoea and 424 million of these suffer from severe sleep apnoea. The size of the addressable market is evidenced by the fact ResMed had grown its device revenue at over 9% p.a. in the six years prior to the Philips recall (FY13-FY19). Recent growth rates have been even higher. ResMed estimates that penetration currently sits at 20% in the US and well below this percentage globally, which implies a long runway for future device and mask sales.

Figure 1 – ResMed device revenue (US$)

Source: Company filings

One of the highest-quality companies on the ASX

As with any new position, we tested ResMed against our key investment criteria and consider the business to be high quality based on the following factors:

- Financial strength: ResMed has a strong balance sheet with less than 1x ND/EBITDA
- Business quality: ResMed has a dominant market position (~80% share), sells defensive products that improve patient quality of life and are reimbursed by Medicare/health insurers in the US, and earns high returns on capital (22% average over last 5 years).
- Management quality: We consider ResMed a "founder-led" business. Founder Peter Farrell is Chair Emeritus, and his son, CEO and Chair Mick Farrell, has presided over an exceptional track record in product development and market share gains in his 10+ years as CEO.

GLP-1 concerns and valuation

ResMed has historically traded on a forward multiple of 28x PE but is currently trading on less than 21x PE due to market concerns about GLP-1 drugs reducing ResMed's addressable market.

Figure 2 – ResMed NTM Rolling PE

Source: FactSet

GLP-1 drugs (branded as Ozempic, Wegovy and Mounjaro) act by mimicking hormones that are released into the gastrointestinal tract in response to eating. These drugs were initially developed to target type 2 diabetes by stimulating more insulin production but have evolved to potential applications in weight management and cardiovascular indications. Given obesity is a key risk factor for OSA (see Figures 3 and 4), there is a view that significant weight reduction from taking GLP-1s may result in reduced demand for CPAP therapy.

Figure 3 – OSA severity by AHI (>5 mild) and (>15 moderate)

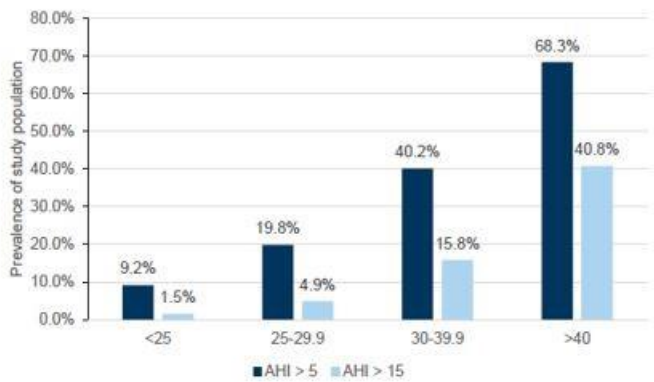
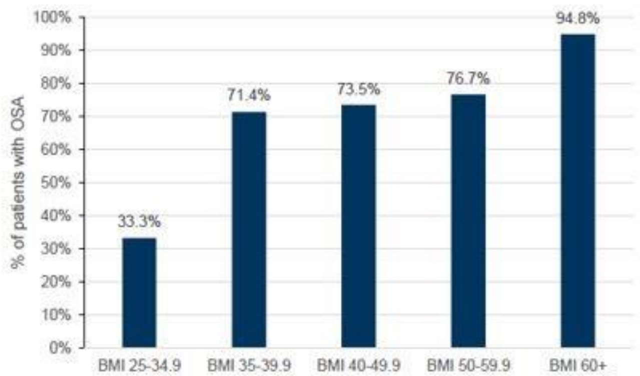


Figure 4 – Prevalence of sleep apnoea in morbidly obese patients who presented for weight loss surgery evaluation



Source: Goldman Sachs Research

While we are not medical experts, we consider the significant de-rating to be an overreaction for the following reasons:

- GLP-1 drugs have been around for almost a decade in managing blood sugar, and other competing therapies such as oral devices and bariatric surgery have not been able to displace CPAP as the standard of care. We note CPAP also has the advantage of being able to track patient adherence and compliance through cloud-connected devices. We believe this data is valuable to third-party payors.

- While we acknowledge weight gain is a leading risk factor in developing OSA, it is not the only cause. Based on our conversations with sleep physicians and the company we estimate one-third of OSA patients are not obese. While the remaining two-thirds of the patient pool is highly likely to test GLP-1 drugs (as they become more accessible and affordable) we don't expect adherence to be 100% given the potential for side effects such as nausea and the impact on lifestyle. We also don't expect GLP-1s to fully eliminate OSA in all cases (the drugs may simply reduce severity). As a result, we think it's more likely you could have a scenario where a combination of GLP-1 drugs and CPAP therapy are prescribed as treatment.
- Finally, these drugs with an average retail price of ~US$1,000/month are currently unaffordable for most patients. Pricing will need to come down significantly to attract broader reimbursement and mass adoption.

Overall, we think the uncertainty as to the potential penetration and success of these drugs in treating OSA has created a rare opportunity to invest in one of the highest quality companies on the ASX. While we are unlikely to pick the bottom, we believe the company is trading well below its intrinsic value.

Vinay Ranjan is a Senior Equities Analyst at Magellan-owned, Airlie Funds Management. Magellan Asset Management is a sponsor of Firstlinks. This article has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not consider your investment objectives, financial situation or particular needs.

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How to generate inflation-adjusted income in retirement

Bob French

Inflation is a fact of life. It's also not so great for retirees. In fact, it's one of the biggest risks that retirees face. By constantly eating away at the value of our savings and income, inflation will slowly reduce our purchasing power in retirement – if we don't do anything about it.

This means that we need to figure out how to deal with the effects of inflation over time. It's not always easy, but there are a number of different ways to tackle inflation that you can use depending on your approach to retirement income. The first step is your social security benefits.

Beyond social security is your security blanket

There are a lot of reasons to like social security, but from a financial planning perspective, one of the big ones is that your social security benefits are adjusted for inflation. However big of a piece of your social security benefits make up of your retirement income, you'll always be able to (roughly) buy the same amount of stuff with those benefits.

So, it's essential to ensure you get the most out of your social security benefits as you can.

As great as social security is, it's unlikely that it will cover all of the spending that you want to do in retirement. So how do you want to deal with the rest of your spending?

Well, that's going to depend on how you want to approach your retirement income. There are two basic approaches to retirement income: Safety First and Probability-based planning. Their overall philosophy is pretty clear from the names. But in short, the Safety First approach is based around having enough reliable Income to cover at least your most essential expenses. Reliable income is income from sources that you *know*, to some very high degree, and usually contractually obligated, will pay you a specific amount of money on a specific date. Probability-based approaches are more willing to deal with uncertainty in how they are funding retirement income in return for higher levels of expected return.

As you would expect, these approaches will go about keeping up with inflation in very different ways.

Safety First planning and inflation

Annuities are the other big source of reliable Income. So, what can we do here?

The inflation adjusted options here for reliable income are a little thin, but we can get creative.

Even though we are focusing on reliable Income, it is worth mentioning variable annuities. There are variable annuity products that offer varying levels of reliability and inflation protection. The specifics will depend on the individual annuity that you are looking at, but the inflation protection will likely be tied to some form of investment in some way (I think I've put enough qualifiers here.) These can be great tools, but how you feel about the investment risk involved will play a big role in whether you think variable annuities are a viable solution.

So that leaves us with income annuities. As I write this[3], I am not aware of any income annuities with inflation adjusted payouts. Which means we need to get creative.

One approach that you can use is what you might call 'sequential' deferred income annuities to top up your reliable income over the course of your retirement when you start feeling the pinch of inflation. By using multiple annuities over time (or partially annuitizing one annuity over time) you have a good amount of control over how your income level evolves over time. You likely will not track inflation exactly, but that's okay because your desired spending won't track inflation exactly either.

Using this approach means that you will need to estimate how much inflation we are likely to see over the course of our retirement (and how our spending will evolve, but we need to do that anyway) so that you can create a large enough pool of deferred annuities to (roughly) maintain your desired spending levels.

Probability-based planning and inflation

If you are comfortable using risky sources of income, like your investment portfolio, to generate your retirement income (or at least part of that income – retirement planning is very rarely all or nothing), dealing with inflation is a little more straightforward. Instead of trying to tie your income to inflation, the probability-based approach is just to try and outgrow inflation and increase your distributions to keep up with inflation.

Just like anything with your investment portfolio, this approach comes with risk. Your portfolio isn't always going to beat inflation, but it's worked well historically. To see this, let's start by looking at the returns of the S&P 500 over time compared to inflation, ass the US has a long history of data that we can analyse.

	Annualized Return	Standard Deviation	Growth of $1
S&P 500 Index	10.18%	18.64%	$12,639
US CPI (Inflation)	2.95%	1.83%	$17

Data from 1/1926 – 5/2023. Indices are not available for direct purchase. Past performance is no guarantee of future performance.

It's not a particularly big shock that stocks beat inflation over the long term. Though, it is still impressive by how much. With how much stocks bounce around, we should be thinking about what the short term looks like - how often would stocks lose to inflation when we actually want to spend our money?

To get at this, we can use rolling returns of different lengths of time and see how often stocks beat inflation.

	% of times Stocks beat Inflation	Average Annualized Outperformance
1 Year	70.12%	9.24%
3 Years	76.46%	7.73%
5 Years	77.30%	7.20%
10 Years	86.57%	7.24%
15 Years	95.45%	7.08%

Data from 1/1926 – 5/2023. Rolling returns of varying lengths, starting in 1-month steps. Stocks represented by the S&P 500. Inflation is the US CPI. Indices are not available for direct purchase. Past performance is no guarantee of future performance.

As you can see, stocks do well against inflation even over shorter time periods. Even for periods as short as one year, the S&P 500 Index outperformed inflation (just) over 70% of the time – and by a lot. In the average one-year period stocks outperformed inflation by 9.24%. Though it's always important to turn these sorts of statistics around – that means that stocks lost to inflation a little less than every third year. However, outperformance here makes up for a lot, as we can see in the longer time periods.

As we would expect, the longer the time frame we are looking at the more likely stocks are to outperform inflation (though the average outperformance does come down a bit). Once you get out to 15-year periods you have a better than 95% chance of outperforming inflation. As always, with a probability-based approach, we're talking about probabilities, but stocks definitely seem to outgrow inflation, even over reasonably short periods of time.

But very few retirees are using a 100% stock portfolio. So, let's bring bonds into the picture. How do they do against inflation? To keep things simple, we'll use 5 Year Treasury Notes as our stand in for bonds.

	Annualized Return	Standard Deviation	Growth of $1
S&P 500 Index	10.18%	18.64%	$12,639
5 Year Treasury Notes	4.88%	4.34%	$103.78
US CPI (Inflation)	2.95%	1.83%	$17

Data from 1/1926 – 5/2023. Indices are not available for direct purchase. Past performance is no guarantee of future performance.

Bonds obviously don't have (nearly) as high returns as stocks, but they also don't have (nearly) as much volatility as stocks. There's less randomness around those returns. So how often do bonds beat inflation?

	% of times 5 Yr Treasury Notes beat Inflation	Average Annualized Outperformance
1 Year	63.73%	1.98%
3 Years	67.81%	2.05%
5 Years	71.62%	2.06%
10 Years	74.10%	1.94%
15 Years	77.17%	1.86%

Data from 1/1926 – 5/2023. Rolling returns of varying lengths, starting in 1-month steps. Inflation is the US CPI. Indices are not available for direct purchase. Past performance is no guarantee of future performance.

Still often. Not quite as often as stocks. And certainly not by nearly as much as stocks do, but it's likely that even a 100% bond portfolio would stay ahead of inflation, even over short time periods.

But, again, most retirees don't have a 100% bond portfolio. You build your portfolio to fit your risk tolerance and goals. You intentionally find the mix of stocks and bonds that fits you. So, let's take the stereotypical 'retirement portfolio' of 60% stocks and 40% bonds and see how it does over time.

	% of times a 60/40 Portfolio beat Inflation	Average Annualized Outperformance
1 Year	71.07%	6.23%
3 Years	79.10%	5.71%
5 Years	84.05%	5.48%
10 Years	88.95%	5.47%
15 Years	95.66%	5.33%

Data from 1/1926 – 5/2023. Rolling returns of varying lengths, starting in 1-month steps. 60/40 Portfolio is 60% S&P 500 Index and 40% 5 Year US Treasury Notes. Inflation is the US CPI. Indices are not available for direct purchase. Past performance is no guarantee of future performance.

It does well. In fact, this is a good example of the magic of diversification. If you go back and compare the numbers, over every length of time we looked at, the 60/40 portfolio is more likely to beat inflation than the 100% stock portfolio (though not by quite as much).

But even over a 15-year period, there's still a nearly 5% chance that our 60/40 portfolio won't outpace inflation. That's not a big chance, but it's something – and longshots *do* land once in a while.

There is no perfect solution to inflation. It's like most things in retirement planning – there are a whole bunch of different solutions, all with their own set of tradeoffs. The trick is finding the set of solutions that has the right mix of tradeoffs.

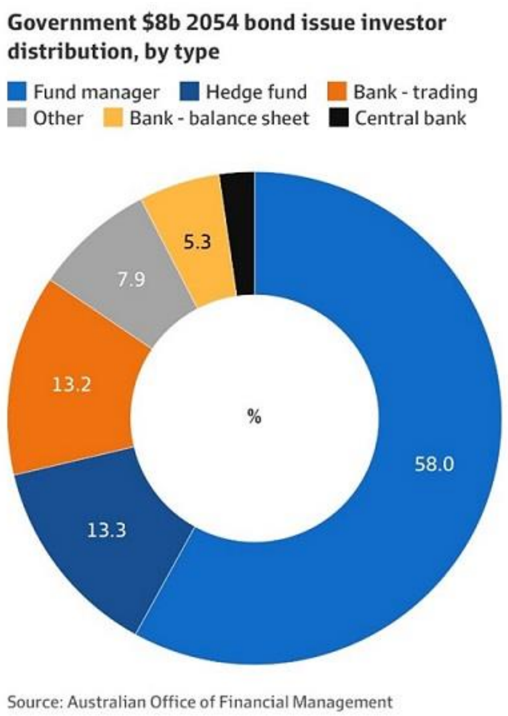
Bob French is an investments specialist at Retirement Researcher and the Director of Investment Analysis at McLean Asset Management. This article was first published by Retirement Researcher and is reproduced with permission. This article provides general information only and as such, does not consider your personal financial situation or goals.

Clime time: why this time really is different

John Abernethy

With ten-year US and Australian bonds marching towards 5% yields, I will explain the effects of higher bond yields - that normally create headwinds for equity markets.

In this post-Covid cycle, with interest rates lifting from extraordinary lows, the headwinds are now obvious, but I suggest that they will have a milder effect on equity prices than historic precedents. Whilst history gives investors an insight for how equity prices perform when bond yields rise, we must acknowledge how this time is different given that cash interest rates remain below inflation.



With rates lifting from ridiculously low levels, there can be little doubt that the interplay between rising bond yields and equity markets has been muted up until recently. However, it is likely that if long dated bond yields leap through 5%, equity markets will begin to feel pain. But then again, so will last week's $8 billion of buyers in the 31-year Australian Government bond tender. Those bonds cleared at a yield of just under 5% p.a.

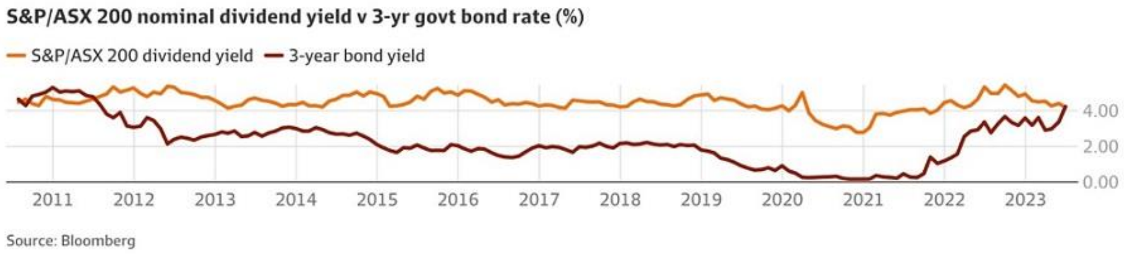
What impact of higher bond yields on stocks

The effect of higher bond yields on equity prices is fairly simple. If risk free returns measured by interest cash flows (receipts) rise, then the required cash flows from higher risk assets (such as equities) will be required to rise as well. If earnings growth is not pushing against the PER decline, then share prices must decline to create the appropriate return for the investor.

Whilst the actual cash flows for individual companies can be calculated by deep financial analysis, they can also be quickly estimated by calculating the "earnings yield" of a company from market forecasts. The earnings yield (the inverse of the PE ratio) is the percentage of the company's earnings per share.

For instance, a company that is forecast to be trading on a PER of 15x has an earnings yield of 6.66%. The earnings yield allows for a comparison of the company's propensity to pay dividends (from cash flow) with the yields in fixed interest markets or with bond yields (the "risk-free" rate of return). From the earnings yield, both the dividend payment and yield can be estimated noting that a dividend yield should not normally exceed an earnings yield. From a PER of 15x and a payout ratio of (say) 60%, a dividend yield of 4% is attained. With franking, the pre-tax yield lifts above 6%.

In the chart below we see the lift in Australian bond yields (3-year bonds) towards 4% as ASX dividend yields pull back to 4% (pre-franking). We have not seen ASX 200 dividend yields being matched by bond yields for over a decade.



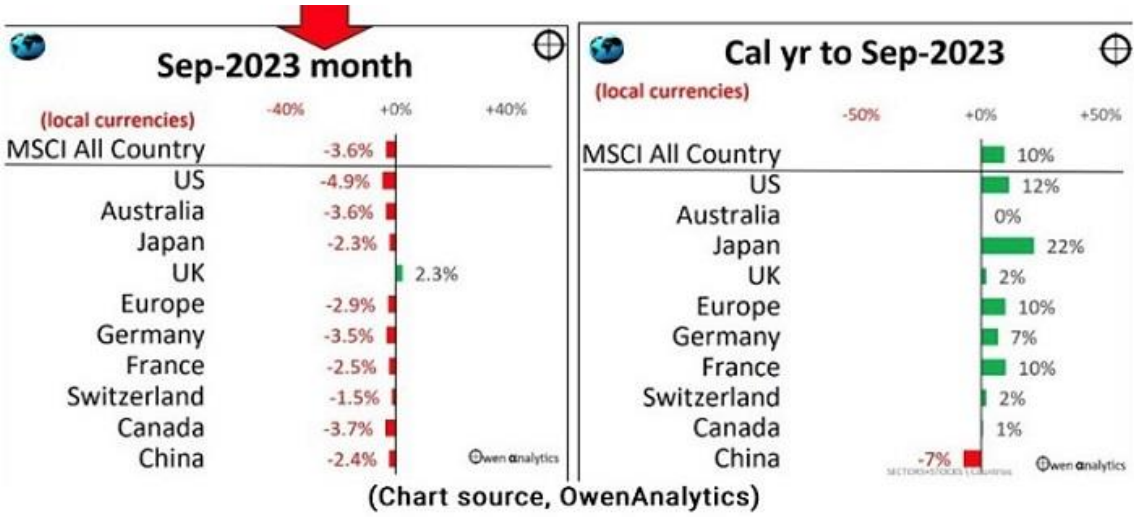
As yields (and cash flows) from bonds increase, asset allocators and investors consider re-allocating funds from equities towards bonds or fixed income securities.

However, the allocation between equities (growth) and bonds (income) is complicated by actual or predicted inflation and the anticipated level of economic growth. This is because economic growth supports equities over bonds. Inflation devalues the cash flow or yield from fixed income bonds, particularly if those yields are below actual inflation (known as negative real yields). Indeed, that has been the feature of the last decade – a period where Central Banks utilized quantitative easing (QE) to manipulate interest rates to negligible levels.

Equity markets have been mixed

Over the last 18 months, interest rates have risen and chased inflation higher. Up until the end of September, in the face of rising interest rates, equity markets have performed reasonably well and contrary to dire predictions by some commentators. The world index had risen by about 10% in the 9 months to 30 September, driven by the heavy weighting to the US market (which has risen by about 12%). However, we should remember that over the last 2 years, the US market index is flat (including dividends) with this year's gains recovering prior year losses.

A disappointment has been the Australian market, seemingly dragged down by weakness in the Chinese economy and a devaluing AUD. In recent times, the Chinese Administration has lowered interest rates as economic growth forecasts for 2023 have been lowered from 5% to 4.5% by the OECD. While the Chinese equity market has pulled back given fears of financial issues across the property sector, the consumer has been resilient. Meanwhile European markets have produced reasonable returns, and the Japanese market has been the star performer.



(Chart source, OwenAnalytics)

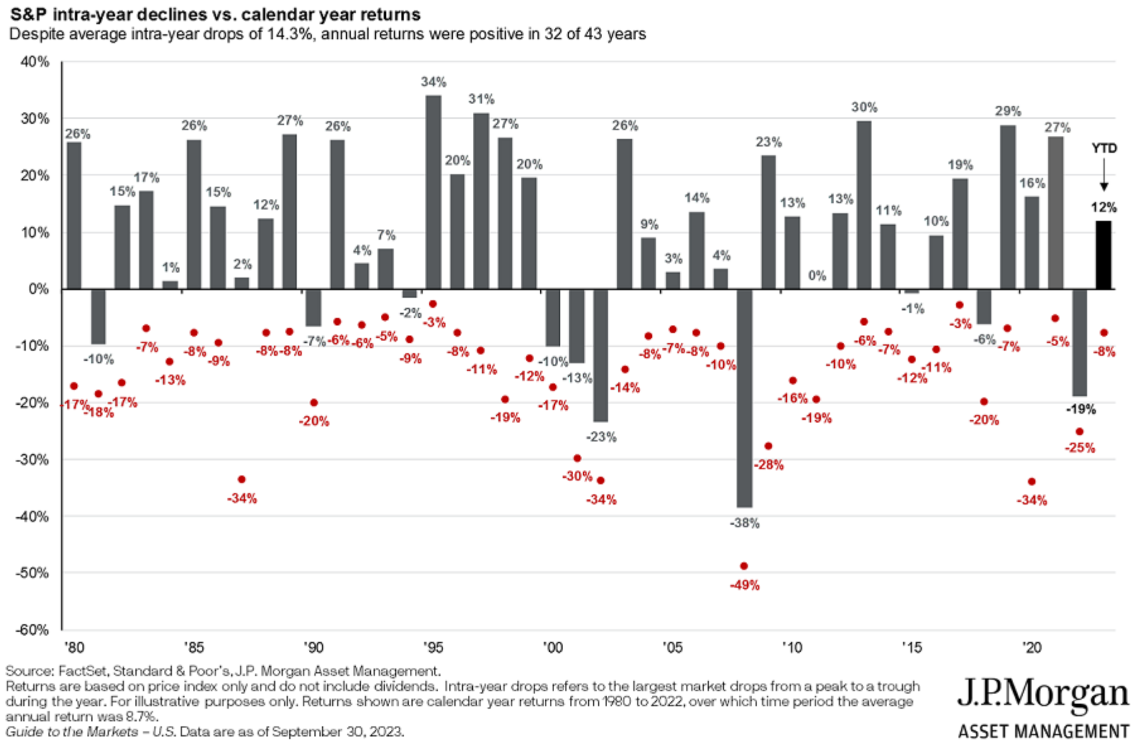
Also, we must remember that the strength in the Japanese equity market follows decades of poor returns. The Japanese equity market has lifted even as its ten-year bond yields have risen from 0.5% to 0.8% over the last 9 months. This is the clearest example that rising interest rates don't always push equities lower and particularly when those interest rates are well below inflation. The latest inflation reading in Japan is 3.5% and a full 2.5% above long dated bond yields.

Focus on the long-term

Investors should always remember that investing is a long game that requires a constant eye to asset allocation – between growth and income assets. It also requires an acknowledgement of the volatility of returns that characterise the equity market. The equity market performance in October emphasises this point with 5%

corrections across the world. In effect the world equity indices have given up one PER point as long gated bond yields rose by (on average) 0.5%.

The following chart (S&P500) shows equity markets invariably suffer drawdowns during each year. However, they are more likely to rise than fall. Over the last 40 years, equity markets have often risen in the face of rising interest rates and following an initial sharp drawdown (driven by fear that Central Banks will tighten too aggressively and cause a recession).



Moving back to a long-term focus on asset returns, the next table from Vanguard is instructive. It shows (over the last 30 years) that equities have produced a compounding annual return that is at least 3% higher than Australian bonds, but remarkably similar to international bonds. Why is this so, and what does it mean for future returns from asset classes?

The Vanguard data assumes no transaction costs or taxes and the reinvestment of all income, with a $10,000 investment in 1991 potentially achieving the following growth:

$10,000 Investment in 1992	Investment value in 2022	Per annum returns
Australian Shares	$131,413	9.8%
US Shares	$182,376	11.7%
Australian listed Property	$90,243	9.3%
International Shares	$94,184	9.1%
Australian Bonds	$55,588	6%
Cash	$35,758	4.4%

First, the international bond returns (above) were bolstered by the extraordinary utilization of QE to drive bond yields to negligible levels. Remember negative bond yields in Europe and Japan. As bond yields decline, both the value and price of bonds rise. The major period of bond price appreciation was the second decade of this century (2010 to 2020) as yields across all bond maturities moved to or below zero.

In Australia, the utilization of QE was belated and started with Covid. Therefore, our bond returns could not match those of overseas returns. Notably as bond yields everywhere have risen over the last 20 months, all bond markets have produced negative returns. Simply stated, whilst higher yields are generating higher cash flows for today's buyers of bonds, the buyers of bonds over the previous 3 years (in particular) are suffering significant capital losses.

Some predictions on future returns

As for the future, in terms of predicting asset returns, it is always easier to predict the longer term (say 5 years) than it is to predict the next 12 months. That is because history for long term asset returns is fairly stable. Equity returns will outperform bond returns over the long term because economic growth and inflation aids growth assets more than it does for income assets.

However, the next year will see the cashflow benefits of higher interest rates flowing to fixed income investors at rates that have not been seen since before the GFC (14 years ago). As fixed income returns have become attractive, the relative attractiveness of equities is contested and as explained in my opening paragraphs. Therefore, I think it is likely that fixed income returns will match and possibly exceed those of equities for the next 12 months at least. However, I do not subscribe to the belief that equities returns will be negative. Whilst I suspect that they will not be as good as those from fixed income, franking credits bolsters cash returns and dividends will grow with inflation and economic growth over time.

Based on the last 10 years it is clear that bond yields of 5% are now confronting, but they are still too low compared to inflation. Further, given the amount of government debt overhanging the markets, I do believe that Central banks will have no choice but to reintroduce QE again to hold bond yields lower for their governments.

What should self-directed investors do?

The acronym that was so popular a few years ago – TINA (There Is No Alternative – to equities), has now clearly reversed. There are plenty of alternatives to equities – at least at the moment.

Does that mean that investors need to sell out of equities? Absolutely not. But they should consider diverting any cash and cash flows from their portfolios appropriately into fixed income yield. They should mildly de-weight equities and move into fixed income – especially if high quality yields can be accessed at above 6% and thus above inflation.

My final chart re-focuses attention towards the long term returns from the Australian equity asset class. Add in franked income that greatly benefits low taxed investors, plus a disciplined strategy of reinvesting dividends, and attractive returns will accumulate over time.

John Abernethy is Founder and Chairman of [Clime Investment Management Limited](), a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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What super funds and their fund managers now think

Wayne Sullivan

Despite the rapid and considerable growth of internal investment teams at some of the largest asset owner organisations, 'external' fund managers still play a major role in the investment of trillions of dollars of funds in the Australian market - $3.5 trillion in superannuation assets alone. While we believe asset allocation is the biggest contributor toward portfolio performance, returns are ultimately gained from the efforts of those actually investing the money.

As their portfolios increase in size, asset owners are keen to optimise the benefits of their growing scale both through demanding reduced fees and, in many cases, internalising investment management. In the last few years, superannuation fund consolidation has impacted managers significantly through the merger of portfolios and increasing internal expertise within funds.

In the 10 years since our Annual Fund Manager Survey began, the number of Australian superannuation funds (ex-SMSFs) has exactly halved from 268 to 134. At the same time, money continues to pour into the Australian superannuation system with assets under management in that sector growing 89% over the period of our survey history, from $1.85 trillion in June 2014 to $3.5 trillion in June 2023.

So, while this pool of capital might be growing, the proportion being invested with managers is not and the fees being paid to managers are tightening.

Potential death march shaping institutional behaviour

Fund managers tend to be optimistic and bullish, although this confidence has been tested a little in recent years with two instances of negative returns in the last four financial years. Over the duration of our 10-year study, returns have been generally strong with only three of the last 10 years producing a median balanced fund (60-76% growth assets) return of under than 6% – a generally accepted long-term average return target.

This is a strong result across a low-inflation environment for most of the last decade. The search for outperformance in this increasingly competitive and low-return expectation environment, along with well-resourced, inquisitive and competitive internal investment teams, has also shifted the way many investors approach their portfolio construction, often away from traditional managers and into newer or niche strategies. With the introduction of *Your Future Your Super* legislation, funds now also face the risk of underperforming benchmarks.

This is not just a matter of underperforming competitors, but potentially a death march. Super funds have always wanted to outperform, but the behaviour is now much more benchmark-aware. The risk appetite for seeking alpha (outperformance) now depends much more on how much risk 'budget' a fund has based on previous outperformance.

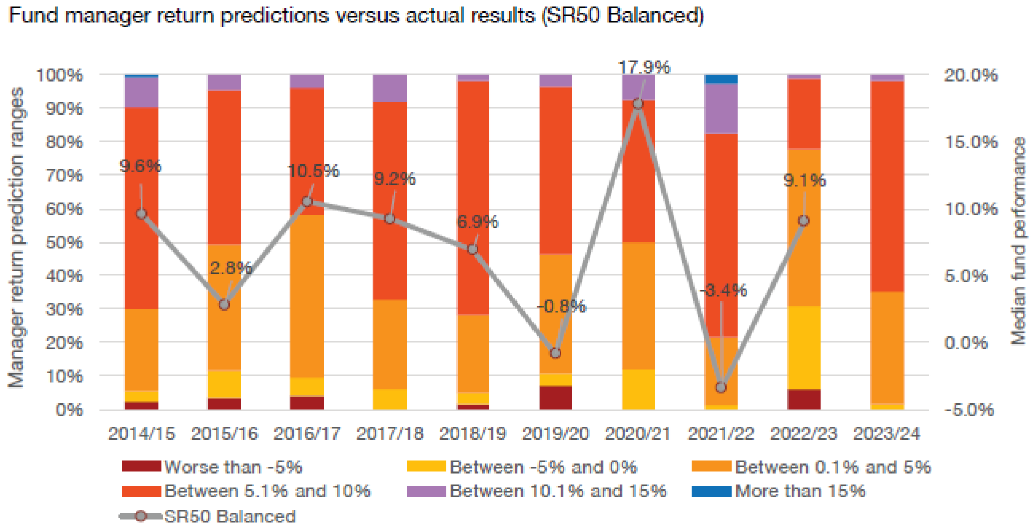
How has the mood and attitude of fund managers changed over the last 10 years?

Balanced fund return predictions

Last year, when asked to predict returns for 2022/23, the prior year (2021/22) of negative returns seemed to influence judgement with more than three-quarters of fund managers predicting a return below 5%, including almost a third predicting another negative result. The actual result for last year, measured as the SuperRatings median balanced fund, was a very healthy 9.05% with only 21% of managers successfully forecasting that result.

This year's predictions for 2023/24 are notably more bullish than last year (again possibly reflecting the actual result of the prior year) with 63% of managers predicting a return of between 5.1% and 10% and almost all other managers tipping a lower return of between 0 and 5%. This is the most concentrated range of predictions of any year in this study.

So, it seems recent past performance is seen by some as an indicator of expected future performance, at least in the case of our survey.



Asset class performance leans to private equity and debt

It's not surprising to see that over time, the asset classes predicted to be the best performing in the year ahead have tended to correlate with the sectors covered by those fund managers. Over the life of the survey, international equities has tended to be the most nominated sector each year, albeit alternating between developed and emerging markets.

However, this year there is a strong preference for alternative debt (33%) to deliver the strongest results, with private equity (17%) also coming in ahead of developed and emerging markets (13% each). The increasing number of managers nominating private equity as the sector most likely to produce outperformance has been climbing each year for the last half of our study. In the first four years of our study not a single fund manager had flagged private equity as their nominated top performer.

The most influential in making investment decisions

When we started this survey in 2014, superannuation funds made up around three quarters of our client numbers but now they are only around 40%.

It has been interesting to watch the evolution of how managers answer the question of *"who are the most influential parties at superannuation funds when it comes to investment decision making"*. From five choices of CEO, CIO, Board/Investment Committee, internal team or asset consultant, managers historically nominated the fund CIO as the most influential person. In 2021, for the first time, internal teams began to outrank their boss in terms of influence. And, outrank their boss's boss as well, with CEOs ranked the least influential from our set of five options.

CIOs were at the peak of their perceived influence in 2017 when 52% of respondents ranked the CIO as the most influential in decision making, with 27% nominating the internal team at that time. Since then, those rates have steadily transferred with this year seeing 32% of managers ranking the CIO as the most influential and 48% throwing their weight behind internal teams. The Board and Investment Committee remain in third spot ahead of asset consultants and the CEO.

The growth of internal investment teams across the 10 years of our study has been perhaps the most significant evolution for funds management businesses to negotiate. Historically the comment that *"internal teams will change the philosophy and culture of funds for the better"* was the most supported sentiment, while *"internal teams are best placed to research and advise on investments for their fund"* was the second most favoured comment for managers to agree with. However, this year there has been a strong shift away from the "*positive culture*" sentiment, now ranked fifth at just 10%, with the notion of teams being "*best placed to research and advise on their investments*" climbing to the top spot, chosen by 39% of respondents.

Fund manager responses on internal teams

Internal teams…	2014 (%)	2022 (%)	2023 (%)
Change the philosophy and culture of funds for the better	30.5	20.3	10.2
Best placed to research and advise on investments for their fund	23.4	21.5	39.0
A major cost for funds but worth it for their value add	17.1	16.5	11.9
A major cost for funds and just adds to the process	11.7	16.5	17.0
Change the philosophy and culture of funds for the worse	3.9	10.1	13.6
Other	13.4	15.1	8.3

There has been a sharp turn in sentiment towards internal teams over the last 12 months, which is unusual given the relatively steady transition over the prior nine years. It may be that managers now accept large and capable internal teams. Most would agree the power balance, or relationship dynamic, between internal staff and managers has shifted considerably with the 'rock star' persona now more likely to reside in the asset owner organisation than in the fund manager.

Returns compromised to contain costs

In our most recent survey, 83% of managers feel returns are being compromised in the quest to contain costs. This score has been steadily climbing each year since 2015 (70%). In the last three years of our study, we have asked managers to rank the most fee sensitive investor groups from across the institutional investment market.

Perhaps the most significant element to come out of this question is a strong sense the largest investors, the large super funds (>$50 billion), are the most fee sensitive with 86% of managers nominating that group first. Virtually the remainder of managers gave their number one vote to small super funds. In a weighted sense (considering the full range of 1-7 scores), behind super funds, managers ranked insurers behind the super funds, then universities and charities next.

Most fee sensitive investors – rank (weighted score)

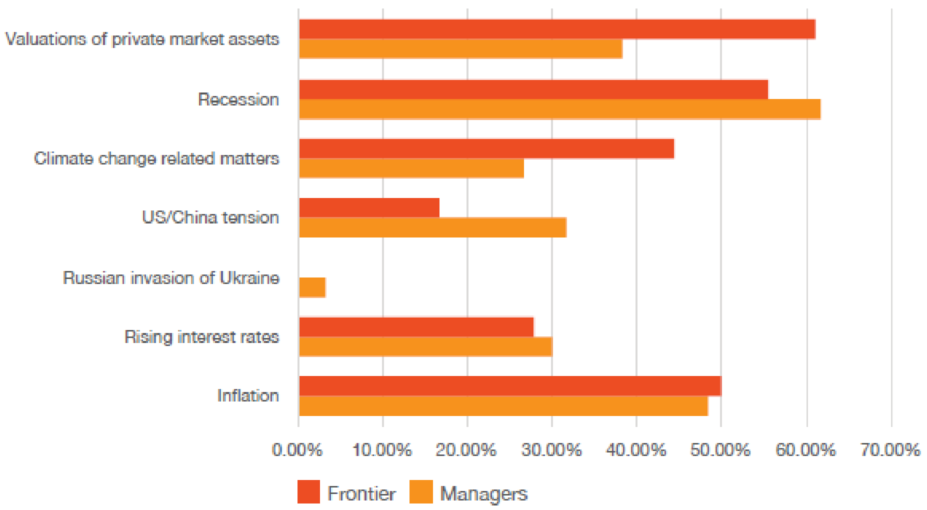
	Managers	Frontier
Large super	1 (6.7)	2 (5.3)
Small super	2 (5.9)	1 (5.6)
Insurers	3 (4.3)	5 (3.7)
Universities	4 (3.3)	4 (3.8)
Charities	5 (3.1)	3 (4.4)
Private wealth	6 (2.5)	6 (2.6)
Family offices	7 (2.4)	7 (2.6)

Issues of concern to clients

Effective managers will have a strong understanding of the key issues their clients are concerned about, rather than simply focussing on what products and ideas they want to put in front of investors and consultants.

Most managers ranked the impact of impending recession across the globe as a factor concerning their clients (62%) with inflation ranked second (48%), remembering that respondents were asked to nominate three issues. In terms of geopolitical matters, US and China tension was seen as far more concerning that the Russian invasion of Ukraine.

Issues of most concern to asset owners



External fund managers at odds with trend to internal

When asked about their own businesses, external fund managers have felt strongly they provide a depth of research and development that internal teams can't match. Alignment with this comment is virtually identical to the first year of the study, after reaching a high of 58% in the 2021 results. This consistency is at odds with the trend increase regarding internal teams being best placed to research and advise their own funds highlighted earlier in this paper.

On the notion external fund managers should primarily be remunerated on performance, again managers are close to the same position offered 10 years ago, however this metric did climb to a high of 42% in 2017 before returning to levels of 2014. This may be a factor of the pattern of returns over that period (wanting to be remunerated on performance when it is high) and indicative of a view future alpha might be more muted. In the table below, fund managers were asked to choose the statement they most agree with.

Statements on fund managers

Statement	2014	2023
Should be primarily remunerated on performance	34.1%	33.3%
Provide a depth of research & development internal teams can't match	44.2%	45.0%
Will need to trim fees to remain competitive	5.4%	6.7%
Will reduce product complexity and performance to meet fee targets	0.8%	5.0%
Other	15.5%	10.0%

*Other includes will drop in numbers, increase product complexity, be additive to internal teams.

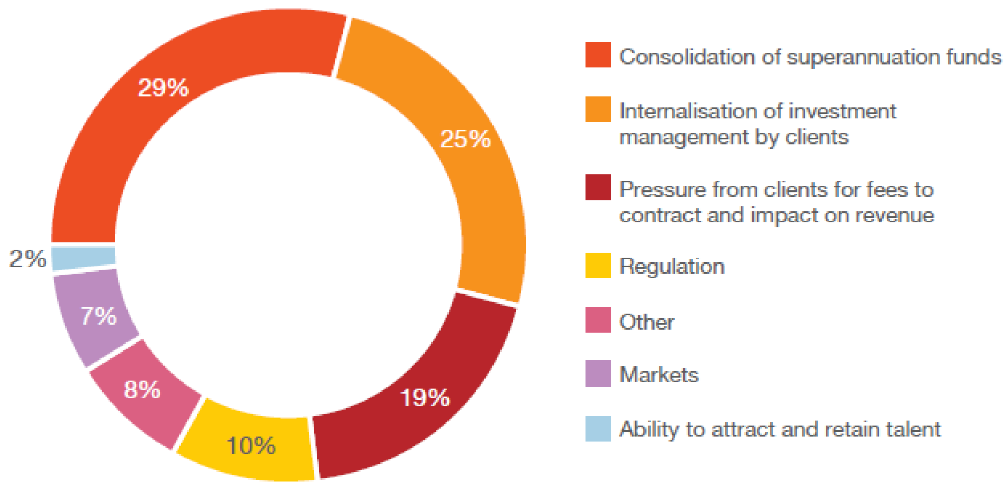
Growth perspective

Despite the many challenges facing them, managers are a remarkably positive lot when it comes to their own business prospects. When asked if they expect their businesses to grow over the next five years (other than via market growth) the overwhelming majority are optimistic, a trend which has not wavered since our study began in 2014. Indeed, this year 93% of managers are predicting business growth between now and 2028. This figure has been as high as 97% back in 2016, and only ever as low as 86% the following year.

Despite that optimism, there are a number of headwinds to the growth of fund managers' institutional businesses. The pattern around these factors was quite consistent in the first four years of our study, from 2014 to 2017, with *"pressure from clients for fees to contract and impact on revenue"* clearly being offered as the single biggest challenge, generally by around 30% of managers.

However, in more recent years, two other factors have emerged as significant threats. These are internalisation of investment management by clients, and consolidation of superannuation funds.

Primary concern for funds management businesses



The final word

The institutional investment market has evolved significantly over the last decade and particularly so for fund managers and asset consultants alike.

Over the life of the study, the number of superannuation funds has reduced while assets in the sector have climbed. For larger funds, strong internal capability has been developed both in terms of in-house research and direct investment.

This 10-year period has been generally very positive markets for investors, although the last four years have produced periods of significant negative returns and volatility driven by a global pandemic and significant geopolitical developments.

While managing fees remains a critical factor for funds, government regulations may also start to influence investors' strategies and broader objectives. This will likely impact the type of products investors seek and managers will need to respond.

Wayne Sullivan is Director of Marketing and Business Development at Frontier Advisors. This is an abridged version of the survey for the Firstlinks audience, with the full version available here.

The survey was completed in September 2023 by 60 representatives from funds management organisations and 36 members of the Frontier consulting team. Frontier Advisors is one of Australia's leading asset consultants offering institutional investment advice on over $630 billion of assets. Frontier Advisors does not warrant the accuracy of any information or projections in this paper and does not undertake to publish any new information that may become available. Investors should seek individual advice prior to taking any action on any issues raised in this paper.

Why your portfolio should consider 5% gold

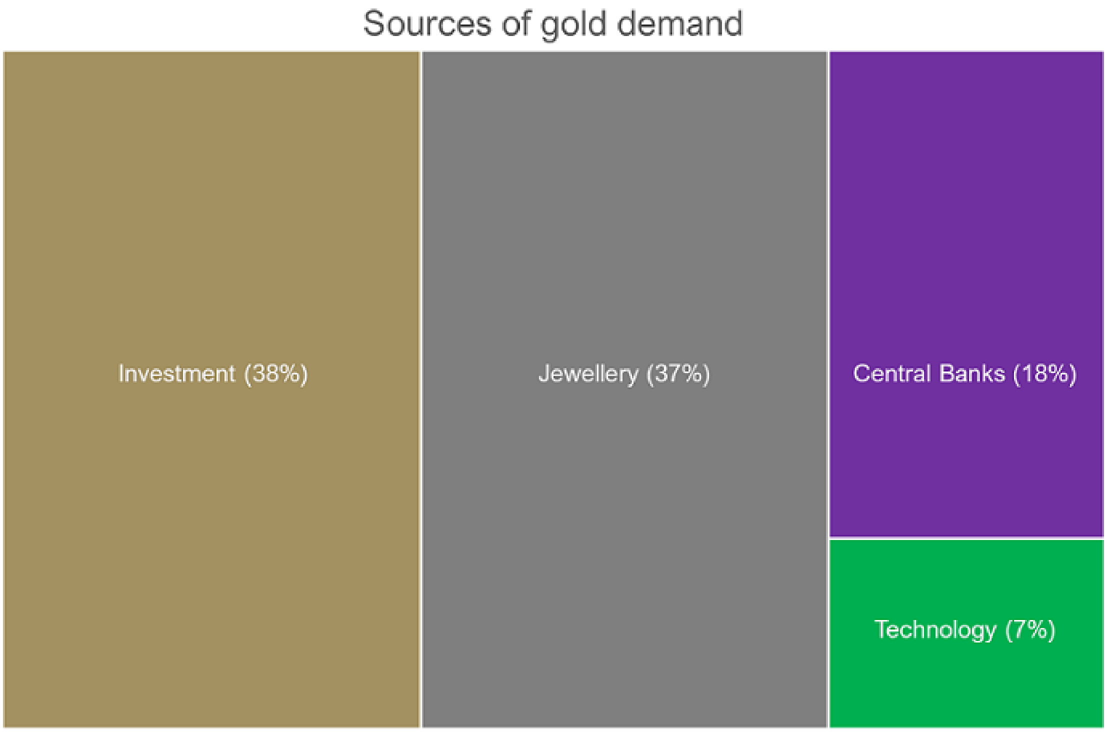
Jaspar Crawley

Determining the value of gold can at times make potential investors hesitant. Being unable to judge what the price might do reduces confidence in making an informed decision. Gold in Australian Dollars (AUD) breached A$3,000 this year dipping slightly by the end of the first half of 2023, before reaching a record high in the last week. Now sitting above A$3,100, the geo-political events over the last three weeks demonstrate how hard it is to time the market. So, **when is the right time to buy, or even increase, a gold allocation into a portfolio?**

The global gold market is valued in US Dollars (USD). Gaining insight into such aspects as US real rates and the strength of the USD can help indicate what the price might do in the short to medium term. However, the gold market is much deeper and broader than just these two factors. Its demand is boosted by both economic growth and uncertainty. Since gold is a global asset, demand tailwinds from one region may counteract headwinds from another. These counterfactors pose their own challenges but also give gold its core characteristics as a unique investment.

Factors influencing the gold price

Without interest or dividends, typical discounted cash flow models fail when assessing gold. So too do other valuation tools often used for shares and bonds. Gold does not have any expected earnings or book-to-value ratios. But there is a good reason why it does not pay a coupon: with no issuer; it carries no credit risk. Its price is determined by the intersection of demand and supply, (with Australia being one of the world's largest suppliers). Understanding these drivers, can give more assurance into what determines performance.



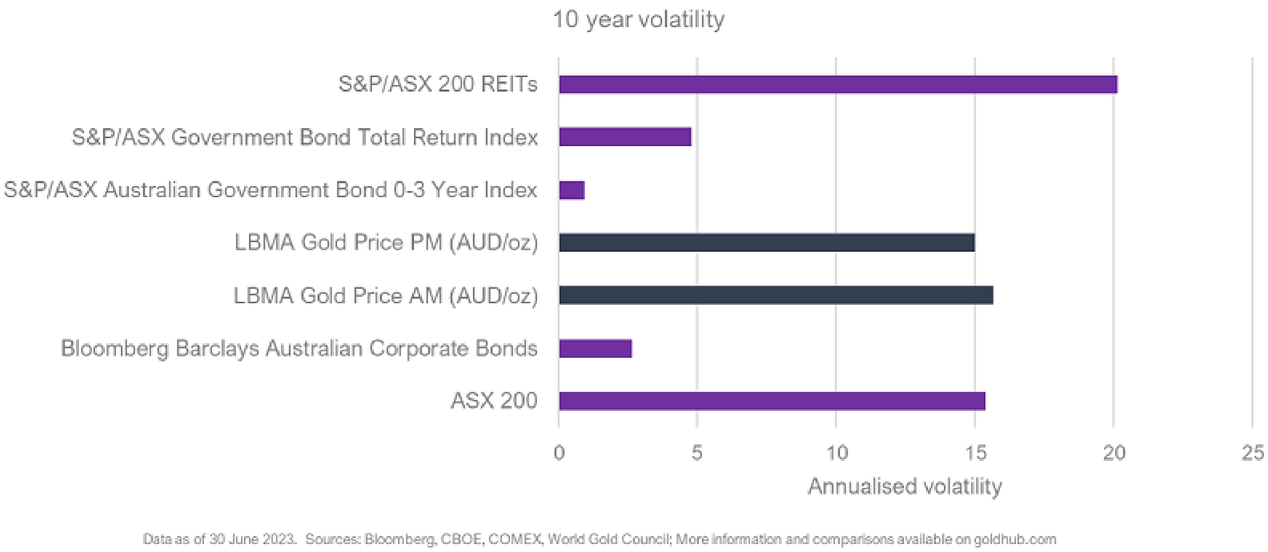
*Based on 10-year average annual net demand estimates ending in 2022. Includes: jewellery and technology net recycling, in addition to bars and coins, ETFs and central bank demand which are historically reported on a net basis. It excludes Over-The-Counter demand owing to limitations in data availability. **Net jewellery and technology demand computed assuming 90% of annual recycling comes from jewellery and 10% from technology.

Source: Metals Focus, Refinitiv GFMS, World Gold Council. Latest Gold Demand Trends can be found on goldhub.com

There is often a misconception that positive economic growth is bad for gold. The recent inflation figures from both the RBA (5.2%) and the Fed (3.7%), as well as other major economies has been encouraging. While these Consumer Price Indices (CPI) numbers have ticked up slightly, the consensus view is that we're reaching late stages of the inflation cycle, with rates close to peaking. Eventually, there be come a time when talk shifts to rates decreasing to help kickstart local economies, and thereby enhance consumer spending.

As almost half (44%) of gold's demand originates from the jewellery and technology sectors, economic improvement generally results in increased appetite for such items. This is where regional demand tailwinds are relevant. Consumer demand, while global, is heavily weighted towards China and India who account for over half of jewellery demand.

Investment demand (38%) can over the short term, exert strong pressure on gold's price. This type of tactical demand from physical markets, exchange-traded securities and over-the-counter (OTC) products has historically experienced increases during periods of economic and political uncertainty, and falls as confidence grows. As gold is one of the most active daily traded assets, there is a tendency to suggest that it is highly volatile. Yet, in reality, over the medium to long-term, it is less volatile than Australian Real Estate Investment Trusts, and on par with the ASX 200.



Central Banks account for almost a fifth (18%) of gold demand to help diversify reserves. In the past, many have been forced to print more money. This increase in supply, while helping to stave off economic turmoil, carries the cost of devaluing the currency. Gold, by contrast, is a finite physical commodity whose supply can't easily be added to. It is a natural hedge against inflation.

But diversification matters

All prudent investors will be mindful that protecting long-term investments is fundamental. When determining an investment strategy, questions over protection are generally focused upon;

- Is the portfolio diversified enough?
- Are the right defensive assets in place?
- Does the portfolio have liquidity available?

There is no standard diversification model. Investment appetite, fund life stages, and personal sentiment can result in allocations varying from one portfolio to another. But, according to a recent Calastone report, Australian investors fled managed international equity, property and mixed asset funds at a record level during Q2 2023. Fixed income funds were the beneficiaries. Given the higher interest rate environment, this is not too surprising. Many investors look upon these products as fulfilling a traditional role of diversification, offering protection during periods when risk assets have come under pressure. In the main, fixed income products certainly help, but they are not absolute.

When inflation is below 2%, the correlation between global equities and treasuries has been negative, providing diversification. At levels above 2%, this relationship has historically started to break down.

The right gold allocation

Understanding the broader drivers of gold's price can improve investor confidence, and unlike some other defensive assets, gold has various demand sources, which complement the other over different economic and market conditions.

The answer to when there is a good time to buy gold depends upon the investor's strategy and objectives. A diversified portfolio needs the insurance over the medium to long term to help ride out unforeseen market events. Gold can help achieve that, but can also stand its ground in calmer times (if history is anything to go by). Therefore, there is never a bad time to think about the right allocation.

Jaspar Crawley is Head of Institutional Investor Relationships, APAC ex-China at [World Gold Council](), a sponsor of Firstlinks. This article is for general informational and educational purposes only and does not amount to direct or indirect investment advice or assistance. You should consult with your professional advisers regarding any such product or service, take into account your individual financial needs and circumstances and carefully consider the risks associated with any investment decision.

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