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Editorial

A special note to our readers

Many people in the Firstlinks community have been reading my articles and editorials for 10 years or more, and worked with me for decades before that, and deserve an explanation for why I have suddenly stopped writing each week.

We also know from our Reader Surveys in Firstlinks that much of our audience is in older generations and have no doubt been through their own health issues over the years. Life deals a multitude of circumstances that we face, good and bad. So while I don't want to exaggerate my case, I want to outline briefly what as happened.

A couple of weeks ago, I went to Sydney's North Shore Hospital due to numbness on the right side of my body. Initial scans confirmed a brain tumour, and subsequent MRIs showed cancer has spread to many parts of my thalamus, a highly sensitive section in the middle of the brain. Following consultation with a leading neurosurgeon, it was decided the tumour cannot be removed by surgery due to the risks in the location.

I underwent a biopsy and exploratory surgery last week to diagnose the type of cancer, confirming glioma, which can grow quickly and destroy healthy brain cells, but with variable outcomes. Further scans showed the cancer has not spread to other parts of my body. The treatment is expected to rely on radiation targeted directly at the tumour over an initial programme of six weeks, depending on the oncology judgement and doses, supplemented by chemo.

I am 65 and I expected to live a long life, writing productively for maybe another 25 years. I am rarely sick, take no medications, drink little, never smoke, eat well. I write about superannuation and longevity and independence in a long retirement and assumed this was my future. Now, it seems unlikely.

I want you to know that while I am shocked by this turn, I will fight it with the best medical care in Australia, which is as good as anywhere in the world. I have accepted the outcome, whatever it is, and I am not thinking 'why me?' because life takes many turns. I've had a fortunate life and a wonderful family living in this great city and country.

We all have to make the most of the time we have. I am optimistic and no doubt many of you have experienced the full range of outcomes in these circumstances. Perhaps treatment will go well and somebody will remind me in five years that I wrote this too early without enough information. Friends who have faced different types of cancer have lived beyond expectations. But the doctors say I might have a few months or a year or more so I have chosen to write to my readers with some background on my absence.

Morningstar and my colleagues have been highly supportive and encouraging, focussing only on my health needs while they take care of business. I hope to return to Firstlinks in future and resume our conversations. Firstlinks has become a community of over 100,000 active users and it will long continue.

Graham Hand

To this week's edition...

Superannuation funds are fast becoming *the* dominant force in Australian funds management. Today, we feature an interview with one of the most powerful and well-respected investment bosses in the industry, **John Pearce of UniSuper**. John covers an array of topics including UniSuper's recent investments, why the 60/40 portfolio's time has come, how history isn't a guide to the future and governments not central banks are to blame for stubborn inflation.

The ASX 200 is around the same price as it was in 2007. That's excluding dividends, though even with their inclusion, Australian stock returns have been mediocre. It would be easy to blame the GFC or pandemic, though **Roger Montgomery** thinks there are deeper, structural issues at play. And these need to be addressed for returns to improve.

ASX small caps have underperformed larger companies for a long time. It's likely to turn around at some point, but when is impossible to say. **Tribeca's Simon Brown** explains why small caps are worth exploring now and looks at three stocks that he believes are set to take off.

It's said that real estate is Australia's national sport. Sad, though perhaps true. Because of this, there are a lot of opinions on the issue, much of it driven by vested interests and emotion. **Phoenix Portfolios' Stuart Cartledge** has an excellent piece laying out the industry's supply and demand issues, and he also throws in several stocks that should benefit from the long-term housing shortage.

It's difficult to predict when the next recession will happen. That said, it doesn't hurt to consider which investments are likely to do best in a future downturn. **Morningstar's Amy Arnott** takes a deep dive through history to look at investing during a recession from multiple angles, including asset classes, factors, and sectors.

The RBA went on a bond buying spree during the pandemic and is now sitting on tens of billions in paper losses. That's pushed its balance sheet into negative equity. If it were business, it'd be bankrupt. As it's not, what does it mean for the RBA going forward and what lessons can be learned from the poor decisions of the past? **Tony Dillion** has some answers.

For 30 years until 2019, stocks and bonds had a negative correlation - when stock prices rose, bonds declined, and vice versa. Many investors were shocked when the correlation turned positive in 2022. **MFS' Rob Almeida** says get used to it because what investors thought was normal for 30 years was anything but. If he's right, it has huge implications for future asset allocation.

Lastly, in this week's whitepaper, **Meg Heffron**, investigates the ins and outs of SMSF pensions for 2023-2024.

Curated by James Gruber and Leisa Bell

UniSuper's CIO on where he's putting money to work

Graham Hand, John Pearce

This is an edited transcript of John Pearce's interview with Graham Hand on Morningstar's Wealth of Experience podcast.

John Pearce is Chief Investment Officer at UniSuper, Australia's fourth largest superannuation fund by assets, managing about $130 billion for about 615,000 members.

John Pearce: Thanks for having me, Graham. It's going to be very unusual and exciting to be interviewed by my old boss.

Graham Hand: It's particularly good to have John on because we go a long way back. I'm proud to say that John once reported to me, although unfortunately for him, I probably learned a lot more from him than he did from me.

Pearce: Not true.

Hand: If we can start on some big picture issues, I know you're an admirer of JPMorgan CEO Jamie Dimon, and he said recently that now may be the most dangerous time the world has seen in decades. So, how are geopolitics and global economics affecting your investing at the moment?

Pearce: First, you're right. I'm a huge admirer of Jamie Dimon. He is arguably the preeminent bank executive and CEO of our generation.

But as far as Jamie Dimon's grip on financial markets, I don't know if he's got any greater insights than many other people. And if you look back in our time, what was the riskiest time for world global financial markets? It was a month before Lehman collapsed. It was the riskiest time because nobody actually saw the risk apart from a few hedge fund managers that made a lot of money. But the reality is that the riskiest times are the times when risk is not priced. Arguably, just before COVID, it was the riskiest time when that risk was also not priced.

What do we know about these current times? Everyone is talking about risk. It is at the forefront of everyone's thinking. We're all worried about what's happening in geopolitics. Bond markets are taking fright because of inflation. So, I actually think that the pricing of risk now is such that you're at least getting rewarded for taking that risk.

Hand: So, the US 10-year Treasury at around 5% is better for investing than the US 10-year at 0.5%.

Pearce: It absolutely is. The problem is the speed at which it's got here. Now, we can argue whether 5% or 4% is the right number. I think we'd all prefer close to 4%. I certainly do not want it back at a 0.5% or 1% or to the ludicrous situations we still have in Japan where you've got still negative yields. So, to me, the world is getting back to some semblance of normality. So, hopefully, we have a pause here and we can stabilize at these levels or slightly below. But whether it's 4% or 4.5%, that doesn't particularly concern me.

Hand: Managing $130 billion, even only 1% of that is still $1.3 billion. Does that make it more difficult to move the needle to find meaningful investments?

Pearce: I bring it back to what's happening in the bond markets. If you asked me this question in December 2020 when bond yields were 1% in Australia and 0.5% in the U.S., I'd have said, absolutely. There was a big problem because the power really was with the originators. They had people lining up, and we had to overpay for assets. We had to accept certain fee structures. We had to accept certain governance rights. That world has now changed for us. The power is 180-degree changed where it's now with the asset allocators.

Hand: You made an interesting comment that when rates were close to zero, the optimal allocation for a retiree wasn't that much different in the accumulation stage and the decumulation or the spending stage. But that's now changed.

Pearce: Well, if you recall that we had that acronym, TINA, and it was kind of right.

Hand: As in you had to be in equities.

Pearce: You had to be in equities or risk assets of some description because 1%, and we'll add a credit margin, it just didn't cut it for anyone. Why did Australians avoid annuities for so long? Because rationally, it just wasn't the right decision to make. But now as a retiree, you can actually go pretty well down the risk spectrum. And we're not talking about just cash, just some sort of cash enhancement. You can get these bank bonds, top-quality corporate bonds, and get a decent return. So, this notion of 60-40 being dead, I think the opposite. I think the time has come for 60-40 or 70-30 but it was a stupid idea when bond yields were 1%. But why not now?

Hand: So, in your allocation of money, UniSuper is well known these days for your in-house management, and you also appoint active managers, and you also do some index. How do you decide between those three?

Pearce: It starts with a philosophical position and, as you know, my background has always been in investment management, so I've always been comfortable with managing money in-house and that was pretty much my mandate from the day I joined UniSuper. So, philosophically, if we believe that we can do a job as equally as good as external managers, the default will be in-house.

Hand: It's your starting point.

Pearce: Starting point. But we're also very well aware of our limitations. I don't see any merit in us building a team to look at U.S. high-yields or Asian small caps or Australian small caps for example. So, we understand our limitations and that's where we look for outsourcing partners. Indexing, once again philosophically, we do believe in active management, but indexing can be a very efficient way of accessing markets when you're looking at tilts, and quite often our index position will be a holding pattern until we can find good active strategies.

Hand: What do you describe as a tilt? Some theme in the market that you want to invest in?

Pearce: Yeah, what's the last major tilt? We had put a decent chunk of money in US banks, for example. It's pretty easy to get an index position in the US bank sector.

Hand: We've seen a lot of debate, particularly around the industry funds about listed and unlisted assets and how well they've done in the unlisted. Is the glory days of doing that in the past?

Pearce: Maybe. I don't know the answer, but there's a feeling. The conventional wisdom is that unlisted assets have outperformed listed because of this illiquidity premium. But that's not true. There has not been an illiquidity premium. As a matter of fact, based on our pricing and valuation, the market has been paying a premium to buy illiquid assets. We've stuck with traditionally listed assets because the unlisted equivalents always seem to be trading on higher multiples. Now what has happened over the past two decades is we've seen the massive fall in interest rates. And guess where most of the unlisted assets have been? They've been in infrastructure and property, et cetera, massive beneficiaries of this huge rally in interest rates.

Hand: Like the bond proxy sort of assets.

Pearce: Exactly. We know that that era is gone. So, unless you are genuinely harvesting an illiquidity premium rather than paying one, I think the jury's out.

Hand: In your own case with your position, say, in Transurban and Sydney Airport both in the listed space, that was because of your feeling about the lack of being paid enough to be unlisted.

Pearce: Yeah. Sydney Airport of course is now unlisted, but let me give you a classic real-life example. During COVID, we owned half of Adelaide Airport, unlisted. Sydney Airport was listed at the time. During COVID, Sydney Airport was off 43%.

Hand: Still as a listed entity?

Pearce: As a listed entity. You had pretty much all the unlisted airports being marked down. Now call me biased because I'm from Sydney, but let me tell you Sydney Airport is the best airport in Australia by some stretch.

Hand: Until you have to drive 80 kilometres to another one.

Pearce: That's for you.

Hand: Okay. So, it didn't deserve to be off that much in the listed market.

Pearce: That's right, and that's where you get these opportunities in listed markets.

Hand: A lot of your members go into the balanced option. It's sort of your default 'set and forget' option. But that requires you to allocate across equities and properties. How do you do that sort of allocation process and do your allocations change very much?

Pearce: At the high level, we are not that dissimilar to most of the big funds. So, your typical balanced option in Australia is 70% roughly growth assets, 30% roughly defensive assets or thereabouts. Where we differ from other funds is firstly our exposure to unlisted assets has traditionally been a lot lower than other large funds.

Within our growth allocation, we tend to take sector-specific bets such as we would have large overweight on the tech sector, we'd overweight to Asia or Japan at the moment or India, country-specific bets. That's where we tend to differ. And in defensive, we probably have less in these what we call alternative defensives and more in what we like to pick up a yield for example via at the moment Tier 2 major bank bonds.

Hand: And those big allocation decisions, do they change much?

Pearce: We're pretty active. Post COVID and some sort of normality, our biggest position has been in these Tier 2 bonds. So, if you looked at our portfolio a couple of years ago, you've hardly see any of them. In our unlisted because of Sydney Airport, because we've actually had more opportunities at the pricing we like, we've lifted that unlisted exposure from 6% to about 18% in that balanced option.

Hand: You gave a talk recently where you said that governments are a bigger problem than central banks. What were you talking about?

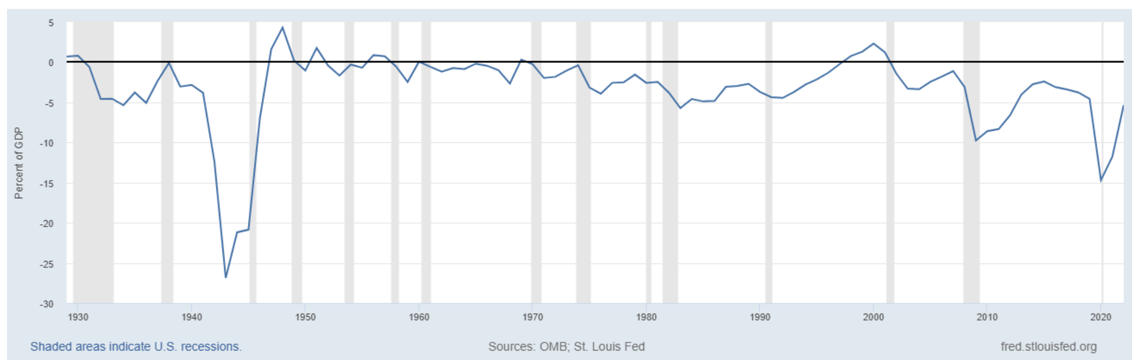
Pearce: Well, if we believe as I do, that the single biggest problem facing financial markets right now is inflation and the economy, well, what's the root cause of inflation? We all point our fingers at central banks that kept rates too low for too long. That is absolutely true. But if you look at some sort of controlled experiment such as Japan or if you even look at that period in most developed markets between the GFC and COVID where rates were close to zero where there was quantitative easing, what was CPI doing? It was hardly doing anything. So, there was very little consumer price inflation. There was asset price inflation but hardly any consumer price inflation. We were still talking about the problems of potentially more deflation than inflation.

What happened during COVID? It wasn't the fact that central banks cut rates to zero. They've been doing that for a long time. It's the fact that governments started putting cash in people's pockets.

Hand: That's what we're recovering from now.

Pearce: That's what we're recovering from now. Central banks have at least realised the errors of their ways. And now they're tightening. We're going through the fastest tightening cycle in history. What's happening with government expenditure? Have a look at what's happening in the US. This is peace time in the U.S. This is boom times in terms of the economy in the US The US is still putting massive deficits. Therein lies the problem. It's not the Fed Reserve. It's the US government.

US budget surplus/deficit as % of GDP



Hand: So, it's almost impossible, isn't it, for someone to run for US President and say the platform is increased taxes, lower spending?

Pearce: It's not going to happen. And if you look at something like the Inflation Reduction Act, have you ever heard of such a silly name? This is just outright inflationary.

Hand: So, as an investor, you have to study history. Are you finding any historical presidents that can guide us in current market because there's a lot to worry about?

Pearce: I think it's very dangerous to look at any period of history. Not only have you got so many variables in terms of economic and financial variables, you've also got the political construct, the institutional construct around it. We were able to escape a depression after GFC because the central bankers like Ben Bernanke studied the Great Depression. So, we avoided the Great Depression because we studied the Great Depression. So, the whole institution concept …

Hand: So, we knew what to do by then?

Pearce: Exactly right. So, I don't like the term but, call it, reaction function, has changed. So, I think looking at history is problematic. If you look what's happened since 1978 when the Fed has paused the interest rate cycle, the bond market has always rallied.

Hand: And the reverse has just happened.

Pearce: Yes, if you were waiting for a Fed pause to buy bonds because that's what's always happened, you've just been run over.

Hand: John, it's been great to see you again, to have a good chat. We had a lot of fun back in the old banking days. Thanks very much for coming on the Wealth of Experience podcast.

Pearce: Thanks very much, Graham. It's been a pleasure.

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John Pearce is Chief Investment Officer at UniSuper, Australia's fourth largest superannuation fund by assets.

Please note that past performance is not a reliable indicator of future performance. The information above is of a general nature and may include general advice. It doesn't take into account your personal financial situation, needs or objectives. Comments on the companies mentioned aren't intended as a recommendation of those companies for inclusion in personal portfolios.

Why the ASX 200 has gone nowhere in 16 years

Roger Montgomery

Here's an interesting piece of information about the S&P/ASX 200 index:

- November 2007: 6851 points
- October 2023: 6853 points
- Total Capital Gain: 0.02%
- Annualised Capital Gain: 0.00182% p.a.

That's some result, don't you think? 16 years and no capital gain. And it's not the first time.

Back in November 2017, in a blog post entitled Active Versus Passive When Prices are Extremely Stretched I asked; "The ASX/S&P200 has gone nowhere in a decade; why invest in the index?"

In September 2017, the S&P/ASX200 index traded at 5672 points, 12 points lower than in December 2006, almost 11 years earlier.

There are many long periods where the broad Australian index does nothing in terms of capital appreciation, even though, according to S&P Global, the S&P/ASX 200 "is recognised as the institutional investable benchmark in Australia" and "is widely considered Australia's preeminent benchmark index." Somewhat disturbingly, it will happen again and again.

Why it's happened

I want to explain the major contributor to this situation, which won't change and will continue to provide material for journalists to ponder over for many years and decades. The explanation will also raise questions about investing in an ASX200 ETF and, if the yield is all you receive, whether it is worth the risk.

Many investors believe the macroeconomic picture determines the performance of Australia's largest companies, as measured by broader Australian market indices such as the S&P/ASX200 index. Others quite rightly point out that it is company earnings that drive share prices and, therefore, the aggregate earnings of the ASX/S&P200 companies that determine the performance of the index. In truth, it is perhaps a combination of both that determines performance over the short and medium term. But earnings and macroeconomics aren't the whole picture.

What is missing is dividends.

The above references to poor long-term performance only look at capital gain and therefore confirm that all of the returns investors have made from investing in the S&P/ASX200 over the last 16 years have come from dividends, either taken as cash or reinvested into the same index that has gone nowhere. It is the compounding of dividends upon dividends that explains the only return investors have received.

And that fits with the payout policy of Australian companies, driven as it is by our taxation system, which produces franking credits that have no value to a company and enormous value to those on lower rates of personal tax than the company tax rate.

Let me break it down.

The mechanics are simple. Suppose a company has $100 of equity, generates a sustainable 20 per cent return on equity and pays out none of those earnings as a dividend. In that case, that company's earnings will grow at 20 per cent per annum. The earnings growth rate always equals the rate of Return on Equity if the payout ratio is zero.

If the same company pays out 100 per cent of its earnings as a dividend, no money will be retained as additional equity for the next year, and therefore, the company will earn the same 20 per cent on the same equity as last year. And therefore, earnings won't grow at all.

If I start a business with $100 of equity and generate a 20 per cent return on that equity each year – which is $20 of earnings – and I then pay out that $20 each year, then my equity will stay at $100 every year, and my earnings will stay at $20 per year and won't grow.

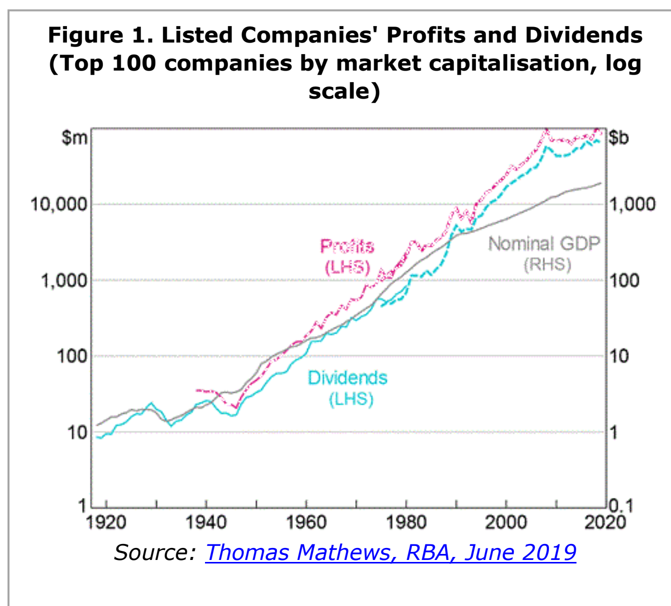
Putting aside changes in the popularity of stocks, which is reflected in the Price-Earnings (P/E) ratio, the only way I can sustainably grow the share price of my hypothetical company is if I grow the earnings. But if I pay out all the earnings as a dividend each year, and the return on equity remains the same, the earnings will also stay the same, and so will the share price.

I must grow the earnings to grow the share price. If the earnings don't grow because I pay out as much as possible in dividends, the share price won't grow either.

This is happening in aggregate at Australia's biggest 200 companies and is why the index is not going anywhere. Before Covid-19, the average dividend payout ratio of S&P/ASX 200 companies was 72 per cent. That means 72 per cent of all company earnings are paid out as a dividend rather than retained and compounded to grow their earnings in the future.

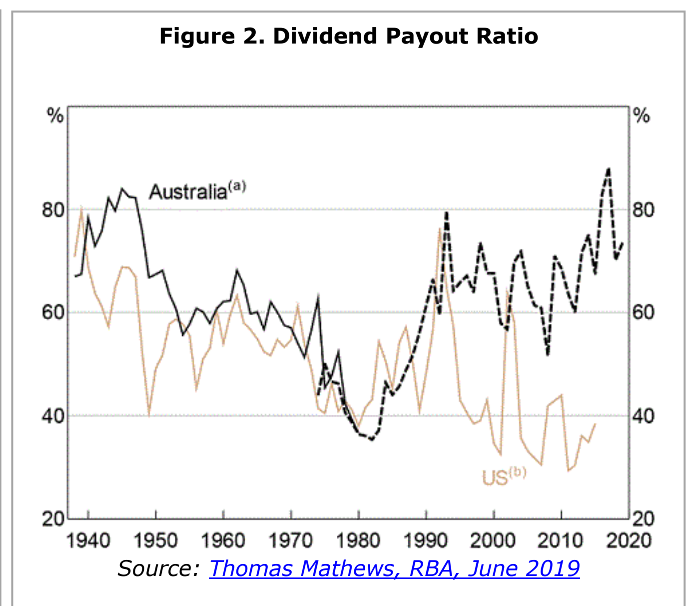
As Figures 1. and 2. reveal, a high proportion of Australian company earnings are paid out as dividends.

Figure 1. Listed Companies' Profits and Dividends (Top 100 companies by market capitalisation, log scale)



Source: *Thomas Mathews, RBA, June 2019*

Figure 2. Dividend Payout Ratio



Source: *Thomas Mathews, RBA, June 2019*

Reasons behind the dividend fetish

Why is the payout ratio persistently so high in Australia (and compared to the U.S.)? It's all to do with tax and franking credits in particular.

To avoid the double taxation of dividends in Australia - at both the company level and at the recipient level - franking credits are attached to dividends to the extent that corporate tax has been paid on a company's

profits. These franking credits are equivalent to additional cash for dividend recipients whose tax rate is lower than the corporate tax rate. But these franking credits are of zero value to a company.

The result? Australian companies tend to pay out the franked dividends to make their super fund and retiree shareholders happier. Of course, shareholders would be better off if a company earning a high rate of return on equity kept the dividends and reinvested them. Even after discounted capital gains tax and franking credits are considered, the investor who insists their company retain profits at 20 per cent rates of return on equity will be far better off than if they take the dividend.

Warren Buffett's Berkshire Hathaway is a prized example of this decision in action. Berkshire has generated circa 20 per cent returns on equity (ROE) for over 50 years and never paid a dividend. Most income investors would be aghast. But the result is that the equity grows each year by 20 per cent, and as long as the ROE stays at 20 per cent, the earnings also grow by 20 per cent per annum. That's why Berkshire's share price today is US$512,000 per share. If an investor needs some income, they can sell a share. And if they want a really entertaining year, they can sell two!

If Warren and Charlie can generate 20 per cent per year on your shareholder money, why would you want them to pay it out to you? The best you might do is five per cent in a term deposit. It's smarter to let Warren and Charlie keep the money and earn 20 per cent a year for you.

I explain how the math works in this blog post entitled: If You Are an Income Investor, It Pays to Think Long Term.

Change is unlikely

For investors in the broad Australian stock market index, the other problem is that the average return on equity isn't 20 per cent. Many of the businesses are mature and already dominate their market, so they have few places to reinvest their earnings for growth.

Indeed, if a company cannot earn a rate of return on its equity better than you can generate elsewhere, its board should pay out its earnings to you as a dividend. If they don't, you are worse off. For example, suppose a company can only generate a five per cent return on equity, which is the same as you can achieve in a Term Deposit at the time of writing. In that case, you are better off taking the dividends as cash and reinvesting in the Term Deposit because it has lower risk. In fact, in that example, you might want to ask why you are invested in that company at all. Some companies listed in Australia need to retain profits, not because they want to grow, but because they need to reinvest just to stay in the same competitive position and to stop them from going backwards. That's the worst treadmill to be on and a company you don't want to own.

Of course, when you invest in an index like the S&P/ASX200, you don't have a choice about which companies you invest in, so you will inevitably be holding these cash burners too (think Telstra and look at its share price performance over 20 years!).

Thanks to our system of franking credits, our companies will be incentivised to keep paying out most of their earnings as a dividend. Go back to Figure 2., and have a look at Australia's dividend payout ratio versus the U.S. payout ratio. With more profits retained for growth, it should be no surprise the U.S. market, as measured by the S&P500 has, and will continue to, outperform the Aussie equivalent. And that certainly raises questions about which index ETF you should not invest in.

When dividends are high, capital gains are low. The only exception is when a company can pay all its earnings as a dividend and expand its Return on Equity.

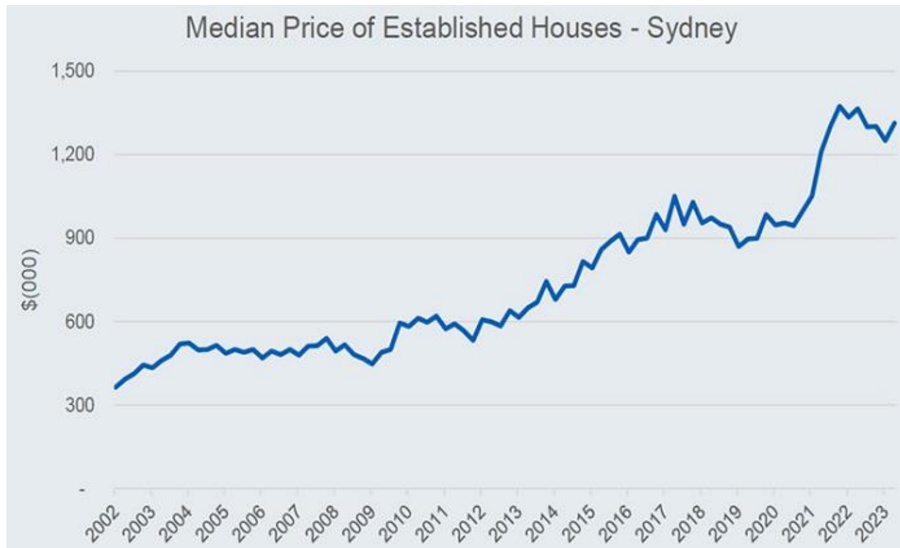
For investors in Australian companies, the onus is on you to find better businesses, big or small (those generating high rates of return on equity and are simultaneously able to reinvest large portions of their profits) in which to reinvest your dividends, ensuring you grow your wealth and maintain your purchasing power. Or find an active fund manager who can do that for you.

Roger Montgomery is the Chairman of Montgomery Investment Management and an author at www.RogerMontgomery.com. This article is for general information only and does not consider the circumstances of any individual.

Australia's housing battle: Interest rates versus supply and demand

Stuart Cartledge

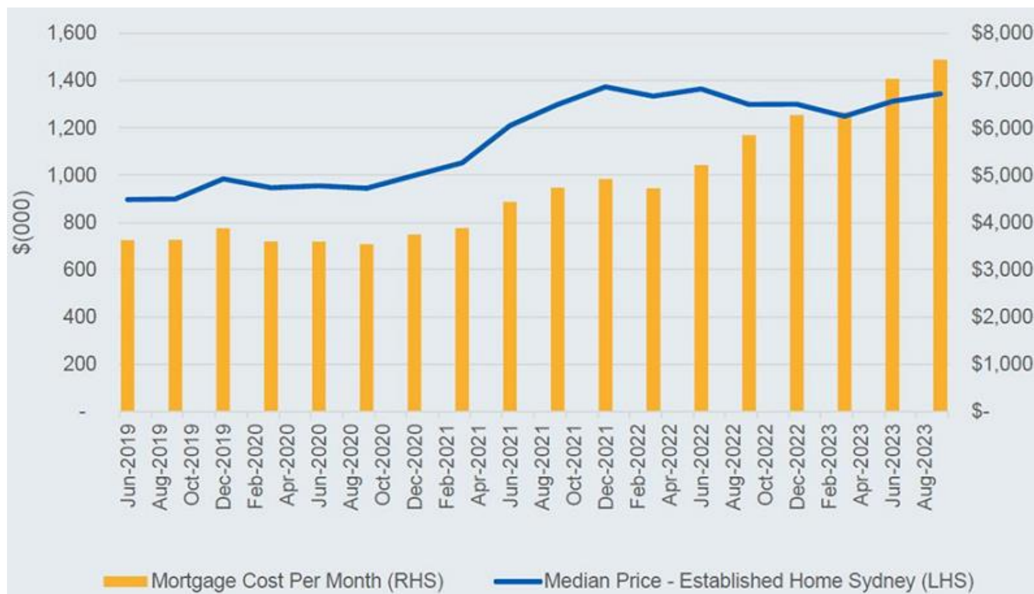
It seems all of us have heard comments like "house prices always go up". Anyone with a basic understanding of maths and economics have told those people they cannot be correct. With that, let's look at the median house price in Sydney since 2002:



Looking at the chart above it almost does seem like house prices always go up. But wait: what happens when interest rates go up, surely house prices will crash? Let's zoom into the chart above and look at the effect of recent interest rate rises on the value of homes in Sydney:

Despite interest rates on new home loans more than doubling off their lows, it is clear that house prices have been stunningly resilient, growing once more after marginally decreasing when rates began to increase.

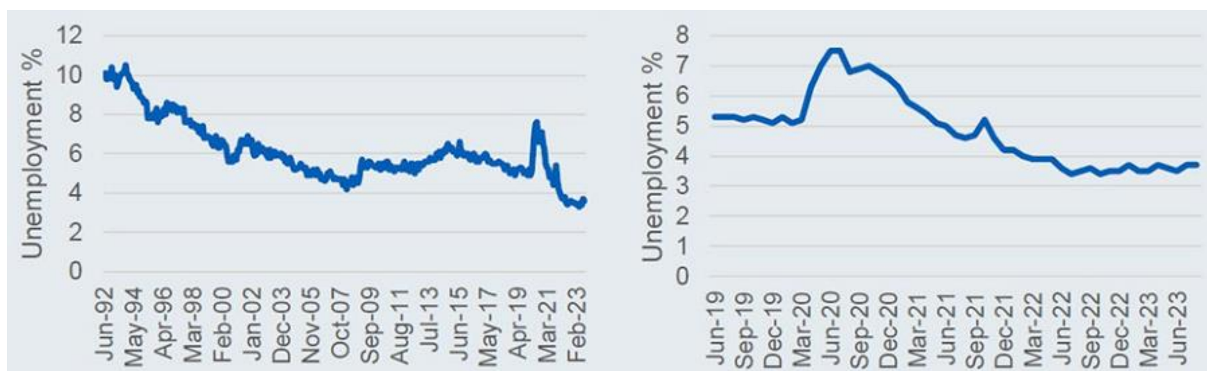
Those concerned about the sustainability of current house prices will correctly point to just how much it costs to own a home. Approximately 75% of home purchases are supported by the use of a mortgage. Obviously, those making the purchase can only do so if they can service the payment on that mortgage. To show this, the chart below looks at the monthly cost of servicing a new mortgage (Loan to Value = 90%) on the median home in Sydney and how it has changed over the same period.



The cost of servicing a mortgage has clearly risen dramatically. A mortgage obtained on the median home in Sydney now costs more than $7,400 per month to service. This has increased by more than 50% since December 2021, less than two years ago. Common sense suggests that this must have a limit. Surely at some point people can't afford to service their mortgage anymore and surely even the ~25% of people who buy a home with cash won't have enough cash to buy the home they want. That all has to be true, but house prices prove that at this stage we have not reached that breaking point.

How can we afford this?

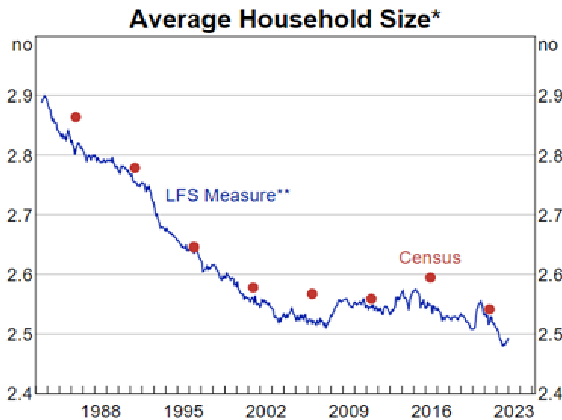
Basic economics states that in a market economy, the price of a good or service is a function of its supply and demand. Housing is no different. The demand for housing should be simple to understand. All Australians have demand for a place to live. To support 'elevated' house prices and increased mortgage servicing, there has to be a capacity to pay monthly costs. This capacity is most commonly tied to a person's income. When entering into a 30-year mortgage, someone's view of their job security is also front of mind. In this context, a chart of long-term and more recent unemployment rates in Australia is presented below:

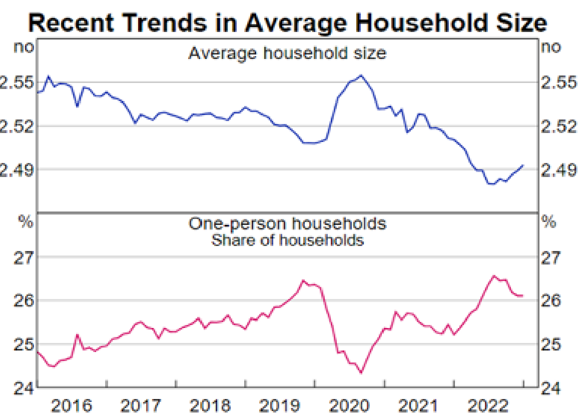


As can be seen, unemployment rates are at multi-generational lows, serving to add to demand for housing at ever-increasing prices.

Housing demand

In the most basic sense, the quantum of dwellings needed in Australia is related to the amount of people in each dwelling and the population of the country. The Australian Bureau of Statistics (ABS) and Reserve Bank of Australia (RBA) have compiled the nation's historic average household size and recent trends as shown below:

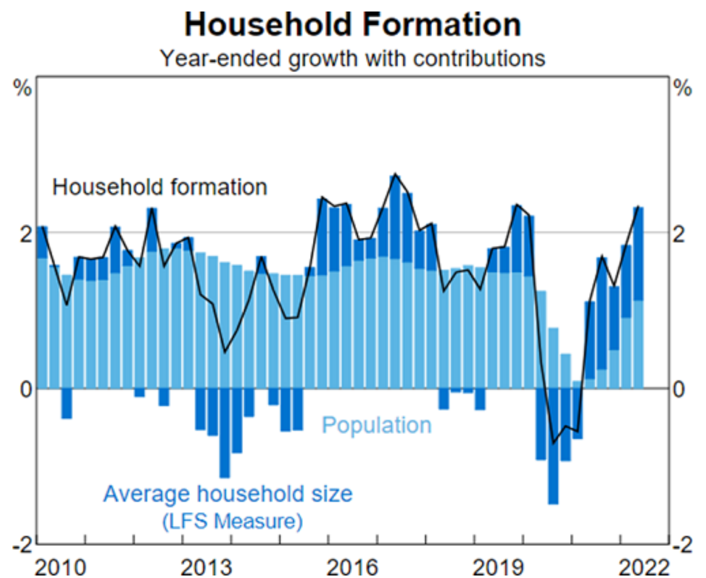




While perhaps a controversial figure, former RBA Governor Phillip Lowe summed up recent changes astutely, saying:

"During the pandemic, the average number of people living in each household declined. People wanted more space. They were working from home. Rents actually declined for a while. People said, 'Rather than have a flatmate I will just have an office at home,' so the average number of people living in each dwelling declined and that increased the demand as a result for the total number of dwellings".

So, we have less people living in each dwelling and the other component of household requirements, population, is also increasing strongly. Again, the RBA and ABS help by showing both the impact of population growth (in light blue) and change in household size (dark blue) over time in this chart (right).



Again, Phillip Lowe sums up the situation:

"The other thing that is now happening is a big increase in population. The population is increasing by two per cent this year. Are there two per cent more houses? No. The rate of addition to the housing stock is very low. We have a lot of people coming into the country."

This comment touches on the other key element to home prices in Australia. Namely, the supply of new property.

Housing supply

So there clearly is a need to build new houses. Given the voracious demand for residential properties at elevated prices, one would think that residential developers would address this demand and supply the properties the population clearly want. Two major factors are holding back the supply that would otherwise naturally occur.

Firstly, the cost of building new homes is a major factor. A residential property developer will require approximately a 20% profit margin on top of their costs to put new housing supply into the market. The costs of developing that property comprise:

- the cost of the land on which it is built,
- the hard costs of the materials used,
- finance costs,
- architectural and planning costs and
- the cost of labour to physically build the property.

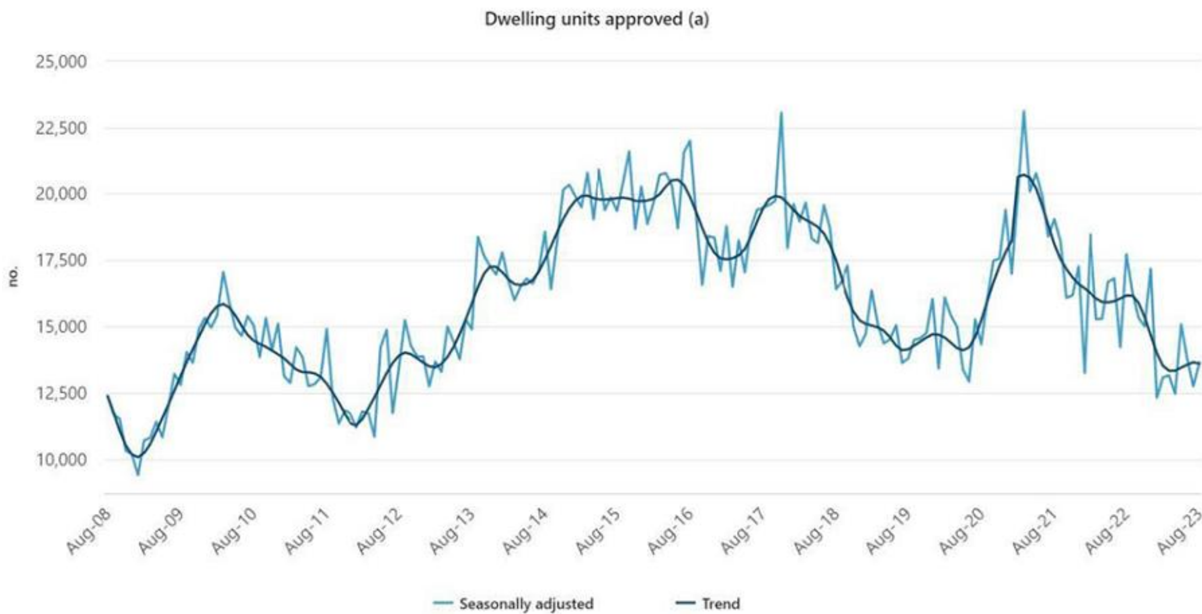
In recent times, all of these costs have been increasing. Materials costs increased significantly with supply chain disruptions during the COVID-affected period and only now is the "rate of growth" slowing. Labour costs are

also ever increasing, as even the availability of workers is a significant challenge in many cases (see unemployment rates). Each of these increased costs place downward pressure on the supply of new properties.

The real issue

Arguably the biggest factor limiting new supply however is simply being allowed to build new properties. New building requires a myriad of approvals, principally development approvals, from local councils or state governments. Local constituents tend to be against development in their area, often known as NIMBYs (Not In My Backyard). Local councils and members of parliament are voted in by existing residents of a geographic area and hence are incentivised to block the building of new houses.

To provide one such blatant example, one member of parliament (MP) made the comment: "Housing in Australia is in crisis," describing the cost of housing forcing "families [to sleep] in their cars". This same MP has vehemently opposed the development of more than 800 dwellings on an unused site in their electorate. Going further, in an attempt to justify the position, he argued that such development activity "drives up the cost of rent and house prices." This is demonstrably false and fails to pass even the most basic test of common sense. We are not referencing it to call out an individual, but rather providing an example of just how difficult it is to obtain approval to address the housing supply shortage, even from those aware of the need. To see how dire this supply issue has become, see the chart below, provided by the ABS, showing the trend in approvals for dwelling units despite the obvious need for housing.



What are we doing about it?

Amending the long-held planning practices, incentives of government and fixing global supply chains is above our pay grade. What we can do is observe and acknowledge the situation and make investments that benefit from the realities of housing undersupply. This can be done by investing in companies that either have development approved housing projects, or a history of working with planning authorities to obtain approval, despite all the complexities inherent in residential development.

One such investment in the portfolio is Mirvac Group (MGR). Most of MGR's development takes place in urban infill locations. These projects often increase density and at times have included iconic projects across Australia. MGR is currently developing the old Channel 9 headquarters in Willoughby in Sydney's North, which will deliver 417 lots, with a total development value of $800 million. Existing iconic projects completed by MGR include The Melbournian, and The Eastbourne in Melbourne. MGR has also been a pioneer in the embryonic 'build to rent' property sector. This involves building large apartment buildings, with all lots held for rent on an ongoing basis as opposed to being sold on completion. Those in Melbourne can inspect LIV Munro, adjacent to Queen Victoria Markets, which was recently completed and has 490 apartments available for rent. In the midst of record low rental vacancy, this business both addresses a need and provides low risk returns to investors.

Another investment in the portfolio is Peet Limited (PPC), which specialises in master planned communities across the country. These tend to be extremely large plots of land on the urban fringe of major cities and will effectively be new suburbs and in some cases almost new cities. PPC's largest project is Flagstone, located between Brisbane and the Gold Coast in Southeast Queensland. It will take a generation to complete, however once built will house 120,000 people and become Australia's 20th largest city, a similar scale to Cairns. It will include a 100-hectare town centre, with a regional shopping centre similar in size to Chatswood Chase and will have a bigger town centre than the Brisbane CBD. This project has all relevant approvals. It is projects such as this that will go a small way to addressing Australia's housing undersupply.

A closing note

The current balance in Australian housing is a bit like an unstoppable force meeting an immovable object. Interest rates are having a meaningful impact on the affordability of housing and clearly are putting downward pressure on housing prices. Fighting against this, ever increasing demand and insufficient supply are supporting home values. Over time, these factors should find an equilibrium. Investing in those who are helping to address this undersupply is prudent both from an investment perspective and for the benefit of the nation.

Stuart Cartledge is Managing Director of Phoenix Portfolios, a boutique investment manager partly owned by staff and partly owned by ASX-listed Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.

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Best investments to own during a recession

Amy C. Arnott

The market has been anticipating a US recession for quite some time. Since July 2022, the US yield curve has been inverted, which has often been a precursor to recessionary periods. So far, a recession hasn't materialised. Economic growth has remained strong, with generally positive corporate earnings reports and unemployment still close to historic lows.

But even if an economic slowdown isn't imminent, there will be one eventually. The economy moves in cycles, with periods of economic strength followed by contractions and vice versa. Historically, recessions (generally defined as at least two consecutive quarters of declining growth in gross domestic product) have occurred about once every five to 10 years, although the length of time between recessionary periods varies.

It's impossible to predict the timing or severity, but it's often only clear that a recession has happened after the fact, or after the market has already started reacting to slower economic growth.

Looking at which types of investments have historically fared best during economic downturns can help limit some of the damage. In this article, I'll look at investing during a recession from multiple angles, including asset classes, factors, and sectors. Though it's focused on the US, much of it is applicable to Australia too.

Asset classes

From an asset-class perspective, stocks are usually one of the worst places to invest during a recession. Recessions happen when there's a decline in economic activity, which is usually accompanied by weaker trends in revenue and earnings growth.

Stocks had negative returns in most (but not all) previous recessions dating back to the Great Depression. Some of the worst recent results were during the GFC, when stocks lost an annualised 24% between late 2007 and mid-2009.

Total returns (%) by asset class

Asset Class Benchmark	Jan. 1980 - July 1980	July 1981 - Nov. 1982	July 1990 - March 1991	March 2001 - Nov. 2001	Dec. 2007 - June 2009	Feb. 2020 - April 2020	Average
Bloomberg Global Aggregate	n/a	n/a	9.46	3.07	3.79	0.35	4.17
Bloomberg US Agg Bond	6.20	25.48	8.93	6.45	4.70	3.00	9.13
FTSE Nareit All Equity REITs	15.46	10.38	8.21	11.86	-33.90	-17.72	-0.95
IA Bloomberg US HY Corporate Bonds	8.09	26.45	6.47	-2.95	-2.16	-8.78	4.52
IA SBBI US 30 Day TBill	6.25	12.13	5.33	2.73	1.21	0.25	4.65
IA SBBI US IT Govt	8.01	24.79	9.10	6.34	5.46	5.26	9.82
IA SBBI US Large Stock Ext	16.39	10.01	7.64	-7.18	-24.16	-9.26	-1.09
IA SBBI US LT Govt	1.26	28.57	8.16	3.59	5.21	13.41	10.04
IA SBBI US Small Stock	17.78	9.71	-0.79	8.72	-22.95	-21.80	-1.56
LBMA Gold Price PM	17.22	1.65	0.98	3.30	11.77	7.48	7.07
MSCI EAFE GR	13.21	-6.50	-6.18	-15.29	-27.31	-15.91	-9.66
MSCI EM GR	n/a	n/a	3.71	-13.74	-24.56	-12.48	-11.77
MSCI World ex USA GR	15.32	-7.06	-5.86	-15.09	-26.69	-16.11	-9.25
S&P GSCI	9.99	2.15	27.29	-26.12	-27.34	-41.60	-9.27

On the flip side, bonds have been the best place in most previous recessions. The Federal Reserve often cuts interest rates in an attempt to stimulate economic growth, also resulting in higher bond prices, with long-term bonds historically faring best during recessions, although intermediate-term bonds and cash have also been pretty resilient.

Gold has also been a winning asset class during recessionary periods, with positive returns during the eight most recent recessions since 1993. But the yellow metal had a relatively anaemic showing during recessions in the early 1980s and early 1990s, with returns were negative after inflation.

Investment style

I used Morningstar's U.S. equity fund categories as a proxy for measuring investment style. As shown in the table below, growth stocks have typically held up better during recessionary periods. Companies that have growth-oriented stocks typically have higher earnings growth, cleaner balance sheets, and better profitability, all traits that often help them hold up better than companies with cheaper stock prices during recessionary periods. But growth stocks haven't fared well during every recessionary period. Growth stocks were hit hard in the tech-stock correction in the early 2000s, which coincided with a brief recessionary period in 2001.

From a style perspective, large has generally been better than small during periods of economic weakness. Larger companies tend to have more stable earnings, diversified business operations, and the financial wherewithal to sustain their operations even during recessions. Smaller companies, on the other hand, may depend heavily on a single line of business and often have fewer financial reserves to sustain them during recessions.

Total returns (%) by investment style

Morningstar Category	July 1990 - March 1991	March 2001 - Nov. 2001	Dec. 2007 - June 2009	Feb. 2020 - April 2020	Average
Large Blend	7.07	-8.65	-23.91	-10.86	-9.09
Large Growth	6.96	-12.37	-23.64	-5.27	-8.58
Large Value	6.17	-4.70	-25.29	-16.22	-10.01
Mid-Cap Blend	6.12	-4.02	-23.08	-17.23	-9.55
Mid-Cap Growth	7.72	-13.21	-25.17	-9.97	-10.16
Mid-Cap Value	5.07	0.93	-23.06	-21.02	-9.52
Small Blend	4.89	2.20	-22.51	-20.54	-8.99
Small Growth	5.14	-5.61	-24.29	-12.68	-9.36
Small Value	3.13	5.11	-20.92	-23.46	-9.04

Equity factors

Equity factors are another way of examining the drivers of equity market returns. Factors describe additional characteristics (beyond traditional metrics such as sector, market cap, and value/growth) that help to explain investment management styles and resulting performance differences.

Because equity market returns are generally negative during a recessionary period, no investment factor consistently generated positive returns. In relative terms, the quality factor has historically fared best during periods of economic weakness. Definitions for quality vary, but the MSCI index that I used for this study focuses on stocks that score well on three main metrics: high return on equity, stable year-over-year earnings growth, and low financial leverage.

Total Returns (%) by Investment Factor

Factor Benchmark	July 1990 - March 1991	March 2001 - Nov. 2001	Dec. 2007 - June 2009	Feb. 2020 - April 2020	Average
IA SBBI US Small Stock	-0.79	8.72	-22.95	-21.80	-9.20
MSCI USA High Dividend Yield GR	7.26	-3.85	-21.60	-11.49	-7.42
MSCI USA Minimum Volatility GR	8.92	-4.80	-18.02	-11.51	-6.35
MSCI USA Momentum GR	7.65	-7.77	-27.55	-8.28	-8.99
MSCI USA Value GR	6.83	-9.71	-26.30	-15.75	-11.23
MSCI USA Quality NR	10.92	-3.18	-16.29	-5.72	-3.57

The minimum volatility factor, which is designed to capture stocks with lower betas, volatility, and idiosyncratic risk, has fared second-best, and dividend stocks have also held up relatively well.

On the negative side, the value factor has performed the worst during most recessionary periods by a fairly wide margin. (Note: This benchmark for this factor is similar to the value fund categories I discussed above, but it has more extreme performance traits because it has a more pronounced value bent than the typical value fund.) The value factor tends to be overweighted in economically sensitive sectors, such as basic materials, consumer cyclicals, and financials. This is usually a negative, but the early 1980s' recession—a "stagflation" period that featured sluggish growth, high inflation, and high unemployment rates—was an exception. The value factor posted the best returns during that period.

Equity sectors

From a sector perspective, healthcare and consumer staples stocks have been the most resilient performers during periods of economic weakness. Consumers can't easily cut back on prescription drugs, medical devices, or household basics like canned goods and paper towels even if they're feeling the effects of a weaker economy.

On the negative side, energy and infrastructure stocks have been the hardest hit in recent recessions. Companies in these sectors are acutely sensitive to swings in demand. Financials stocks also can suffer during recessions because of a rising default rate and shrinking net interest margins.

Total returns (%) by sector

Morningstar Category	July 1990 - March 1991	March 2001 - Nov. 2001	Dec. 2007 - June 2009	Feb. 2020 - April 2020	Average
Communications	6.52	-26.03	-27.85	-7.04	-13.60
Consumer Cyclical	7.73	-7.77	-25.20	-11.62	-9.21
Consumer Defensive	16.13	4.04	-15.90	-8.56	-1.07
Energy Limited Partnership	n/a	n/a	-8.70	-30.08	-19.39
Equity Energy	-5.38	-17.08	-27.13	-30.96	-20.14
Equity Precious Metals	-12.27	8.18	-10.23	2.69	-2.90
Financial	5.47	-1.97	-31.63	-25.57	-13.42
Global Real Estate	-5.00	4.22	-32.70	-21.63	-13.78
Health	30.21	0.29	-14.53	1.19	4.29
Industrials	-1.89	-2.68	-28.48	-20.53	-13.39
Infrastructure	n/a	-13.80	-21.28	-16.68	-17.25
Natural Resources	-2.11	-13.90	-24.05	-16.20	-14.06
Real Estate	7.39	8.65	-35.42	-21.01	-10.10
Technology	5.48	-21.88	-20.55	-3.96	-10.23
Utilities	8.18	-19.17	-22.62	-15.71	-12.33

Technology and communications stocks have a mixed record. During the 1990-91 recession amid the Gulf War and oil supply issues, the communications and technology sectors held up relatively well, and tech leaders such as Microsoft MSFT, Apple AAPL, and International Business Machines IBM continued to generate double-digit

returns. After surging during most of the 1990s, the tech bubble finally popped in 2000, followed by a brief recession in 2001. Because valuations were still inflated leading up to the recession, the communications and technology sectors suffered the deepest losses.

Does the prospect of a looming recession mean an overhaul of portfolios? No. In fact, making wholesale shifts in portfolio holdings is usually a bad idea. But studying how the market has historically performed can help you set expectations for how your holdings might react if and when the economy weakens.

Amy C. Arnott, CFA, is a portfolio strategist for Morningstar Research Services LLC, a wholly owned subsidiary of Morningstar, Inc. The author owns shares in one or more securities mentioned in this article. Find out about Morningstar's editorial policies. This article is general information and does not consider the circumstances of any investor. It has been edited somewhat from the original US version for an Australian audience.

Three ASX small caps set to shine in 2024

Simon Brown

While smaller companies can offer much greater growth than the broader share market, they have underperformed in the past two years. That is not unexpected given small caps typically underperform in an environment when interest rates are rising and economic growth is slowing.

Indeed, over the past 12 months to 30 October 2023, the S&P/ASX Small Ordinaries Total Return Index has fallen 3.6%, compared with a rise of around 4.0% for the S&P/ASX 200 Total Return Index.

With interest rates still rising and the geopolitical landscape – including the war in Gaza – uncertain, markets are more volatile. There is potential for more downside risk for all shares, but especially for small caps, because they are more exposed to economic cycles and investor sentiment.

However, if investors maintain a longer time horizon, and look through this volatility, investing in small caps can be rewarding. When they turn, small caps generally grow at a faster rate than large cap stocks. But investors may need to be patient to reap returns.

The lure of small caps

The small caps sector is attractive because of the opportunity it offers to invest in high growth businesses early in their business cycle. Stock pickers who choose well can enjoy the benefits of above-average earnings growth early in a company's growth phase, along with possible re-rating benefits, as investors become more aware of the company's potential over time.

The small cap universe has the added advantage of being more diverse than the large cap universe, so growth opportunities are greater (although so is the risk). The ability of fund managers to generate outperformance depends on whether they can identify opportunities that other investors have not yet recognised. This usually involves unearthing information about a company's prospects through close scrutiny, regular visits, and rigorous financial analysis.

Successful fund managers need a good eye and an inquiring mind. While large cap stocks are researched intensively, small cap companies are generally less researched. Investing successfully requires greater leg work to understand industries, companies and their management teams and business models. In-person visits are important to understand companies and what drives them. Thorough research provides the opportunity for the small-cap investor to sift through and find undiscovered gems that will deliver strong gains over the long term.

Some sectors will likely perform better than others

Looking ahead to 2024, there are some sectors in the small cap universe that are expected to do better than others and offer good prospects for growth. They include building materials, as well as companies linked to renewable energy, including miners and mining services companies.

In the building materials sector, we expect that strong population growth in Australia will support the prospects of building materials companies like Maas Group (ASX:MGH) and Boral (ASX:BLD). Despite rising interest rates, there is still a huge demand for housing in Australia and a chronic shortage of supply. Both of these companies stand to benefit from housing construction ramping up demand for supplies of construction materials.

The decarbonisation trend will also likely propel miners of critical minerals ahead. The transition from fossil fuels to clean energy technologies, such as renewable energy generation and electric vehicles (EVs), depends on critical minerals such as lithium. While lithium prices have suffered through 2023, we believe that over the longer term, they will rebound and with it, the prices of lithium miners listed on the ASX.

Uranium too may gain in importance, and we expect that some uranium miners such as Paladin (ASX:PDN) and Boss Energy (ASX:BOE) may potentially benefit from any rise in demand for uranium. Boss, for example, is focused on the re-start of the Honeymoon Uranium Project in South Australia. Honeymoon is one of the few uranium projects globally ready to come on-stream in an emerging bull market, with first production targeted for the fourth quarter of this year. Paladin's Langer Heinrich Mine in Namibia is also on track to be a significant player in decarbonisation, with uranium production targeted for the first quarter of 2024.

In terms of sectors that may lag, technology and healthcare sectors could underperform. Some technology companies are still trading on high multiples and could continue to de-rate if long bond yields continue to rise. Already, the US 10-year yields are sitting at 16-year highs and look set to climb over 5%. This could hurt the tech sector further.

In the healthcare sector, some biotechnology companies that are not yet at the earnings stage could be vulnerable to price falls. More broadly, healthcare has underperformed this year, which is an anomaly as it is normally more defensive. But we have seen vulnerability in some larger companies such as CSL (ASX:CSL) and ResMed (ASX:RMD), which has fed through to the smaller cap healthcare sector as investors de-rate earnings multiples due to the more difficult economic environment.

Small cap winners

We believe the following three small companies could outperform in 2024 and beyond.

Champion Iron (ASX:CIA)

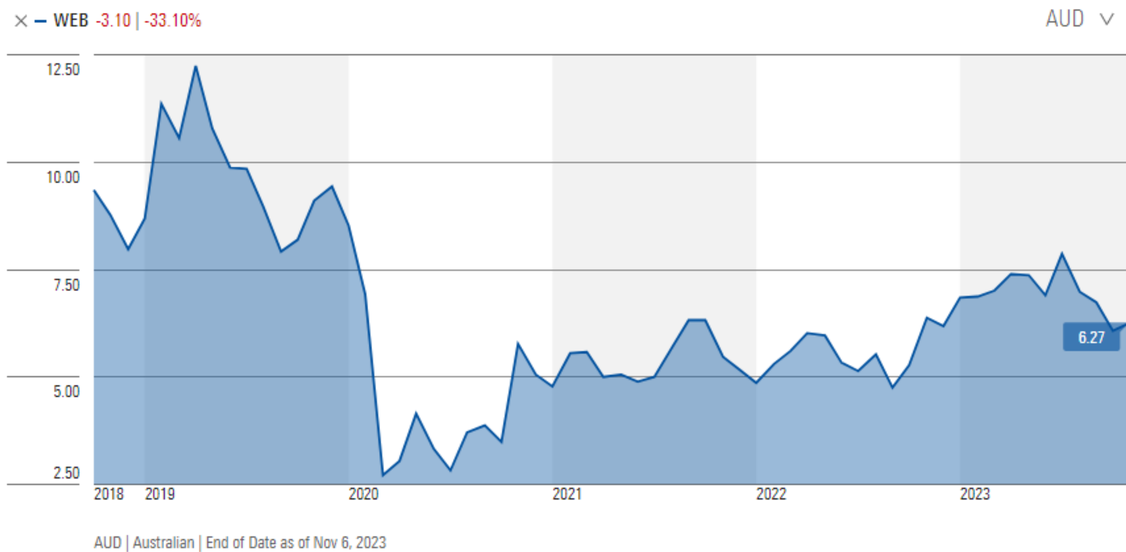
Champion Iron mines high grade iron ore and is playing an increasingly important role in the 'green steel' market. The company provides high grade ingredients that help reduce carbon emissions in steel production. This is important as producing steel accounts for around 7-8% of global carbon emissions, so Champion has a key role in the decarbonisation process.

The miner also has a long mine life and relative to other global green steel producers, it has a lower cost of production. Yet the company has been put into the same boat as the bigger miners BHP and Rio Tinto when it comes to valuations. However, we believe it should be trading at a material premium. In the short term, we see the iron ore price well supported over US$100/tonne given that inventories of iron ore in China are at a multi-year low and steel demand has remained steady. We are also heading into a period of re-stocking ahead of the Chinese New Year. Longer term, while Chinese demand is likely to ease, steel demand will likely strengthen in other emerging markets led by India. We also anticipate a growing 'green steel premium' for producers of high-grade, low impurity iron ore as demand in this segment of the market rapidly expands in the countdown to net zero.

Source: Morningstar

Webjet (ASX:WEB)

Webjet is a global digital travel business operating in both consumer and wholesale markets. While it is better known for its online travel agent portal webjet.com.au, its global marketplace WebBeds, is the second largest wholesaler of hotel beds globally. WebBeds provides a single point of digital connection for a geographically diverse range of hotel operators. Importantly, it is a large market, with $70 billion of Total Transaction Value (TTV) on offer; WebBeds currently holds around 5% market share. The company has emerged well capitalised post the pandemic, having used that time to materially upgrade its platform technology. Webjet is now poised to take market share and is targeting $10 billion in TTV from around $3 billion currently. We expect a re-rating of its shares to reflect that strong expected growth, which is being underestimated by the market.



Source: Morningstar

Smartgroup Corporation (ASX:SIQ)

Smartgroup delivers novated leasing to employees across Australia. Novated leasing demand is rising strongly on the back of greater demand for EVs as the federal government has created incentives for people to buy EVs through such leases. In particular, fringe benefits tax (47%) is not charged on EV purchases below the luxury car tax threshold of $90,000, which means it can be significantly cheaper to buy an EV through a novated lease than outright. We expect this to propel earnings growth for Smartgroup. In the month of July 2023, for example, EV orders represented around half of Smartgroup’s new car orders in its corporate segment, and this could accelerate as EV adoption grows as the Australian economy decarbonises, setting Smartgroup up for outperformance.

Source: Morningstar

Simon Brown is a Portfolio Manager at [Tribeca Investment Partners](). Tribeca is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. Tribeca may have holdings in the companies mentioned in this article. This information is general in nature and has been prepared without taking account of the objectives, financial situation or needs of individuals.

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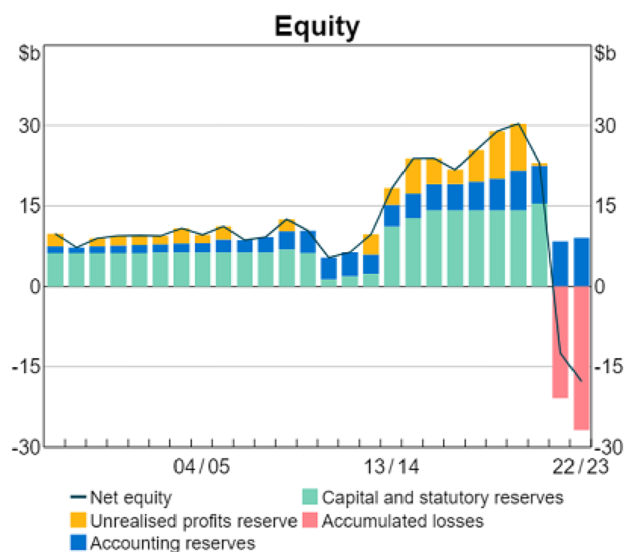
The RBA's QE losses

Tony Dillon

Accounting losses from a pandemic inspired bond buying spree has wiped out the Reserve Bank of Australia's (RBA) equity and more, pushing its balance sheet into negative equity territory.

Its 2022/23 annual report shows a loss of $6 billon for the financial year, which following the $36.7 billion loss in the previous year, now has the bank's liabilities $17.7 billion in excess of its assets (see chart). But being a government entity that can create money to pay its bills, it remains secure.



How it happened

How did the RBA get into this predicament? To understand why the RBA is losing money, we need to follow the flow of money building up to the losses.

When the pandemic exploded in early 2020, the federal government commenced fiscal support packages such as JobKeeper, raising government debt significantly. At the same time, the RBA introduced unprecedented monetary stimulus including ultra-low interest rates and increased commercial bank reserves via quantitative easing (QE).

When the federal government raises debt, it is a loan to the government from the private sector via commercial banks. The banks transfer deposits to Treasury, and a matching liability of government debt arises. That debt is recorded as an asset for the banks, offset by the loaned funds it transferred to Treasury. Treasury pays interest on the government debt to the banks. The resulting balance sheet movements are depicted in this first table.

Government raises debt ($1B from Commercial Banks)			
Treasury			
Assets		Liabilities	
Deposits	+$1B	Government debt	+$1B
Banks			
Assets		Liabilities	
Deposits	-$1B		$0
Government debt	+$1B		

When QE occurs, it is mostly seen as money creation. But it could also be construed as a loan, this time from the private sector to the RBA. Being the "borrower", the RBA gains an asset and a liability, in the form of government debt and commercial bank deposits respectively. The deposits having been created electronically by the RBA, which only central banks can do. The RBA pays interest on those deposits to the banks. Again, the balance sheet movements are shown in the second table.

Quantitative Easing (RBA creates $1B)			
Reserve Bank			
Assets		Liabilities	
Government debt	+$1B	Deposits	+$1B
Banks			
Assets		Liabilities	
Government debt	-$1B		$0
Deposits	+$1B		

When QE and government debt raising occurs simultaneously, the commercial banks' balance sheets net out (third table).

If Treasury then transfers its deposits to the private sector to fund say a JobKeeper scheme, then the RBA will have effectively financed that fiscal spending via electronically created deposits. That financing will remain in place until such time that the RBA pays back the government debt it "borrowed" from the banks, and its self-created liabilities are extinguished.

QE ($1B) with Government Debt Raising ($1B)			
Treasury			
Assets		Liabilities	
Deposits	+$1B	Government debt	+$1B
Reserve Bank			
Assets		Liabilities	
Government debt	+$1B	Deposits	+$1B

The impact of interest rate rises

The illustrative RBA balance sheet built above reveals a double whammy when interest rates rise. On the assets side, the value of the debt it holds falls with rising interest rates. And on the liabilities side, higher interest rates translate into higher servicing costs on the commercial bank deposits created in the QE process.

With the RBA purchasing some $330 billion worth of government bonds during the QE program at a coupon of around just 0.25%, a rapid rise to 4.1% in the official cash rate has wreaked havoc on the mark-to-market value of its portfolio. And what began as a cost of just 0.1% on the increased bank deposits, has blown out substantially with 4.1% now being paid.

With less than ten per cent of its bonds holdings having matured thus far, the RBA at this stage does not plan to actively sell bonds to wind down its portfolio faster, which would realise capital losses. All the while recognising the risk of further losses if interest rates continue to rise.

This situation is not confined to Australia, with central banks in other advanced economies suffering extensive losses with their QE programs.

The lessons

The question might therefore be asked, did central banks go into the QE caper with eyes wide shut, given the poor financial outcomes of high inflation, rapidly increasing interest rates, and impaired central bank balance sheets?

Many would say that losses should have been expected when buying low-yielding bonds, and when interest rates can really go only one way, up. And that it was not such a good idea after all. While others would say that the stimulus kept businesses afloat, unemployment low, and that it was all for the greater economic good.

In the fullness of time, governments will need to balance whether significant monetary stimulus is appropriate in times of global turmoil, being mindful that there really is no such thing as a free lunch.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.

The far-flung past as prologue

Robert M. Almeida

Does a fish know it's swimming in water? Probably not until it's no longer submerged. This illustrates that it can be difficult to know — never mind understand — the paradigm you're living in until there is an abrupt change.

The water we used to swim in

Interest rates are the reward for savers foregoing the ability to consume in the present. Since all economic and financial activity takes place across time, the world requires positive rates. Without positive interest rates, market signals in the economy and financial markets become distorted. All projects are funded, asset values inflate and capital is misallocated.

In the 2010s, the economic and financial market waters were comprised of suppressed rates that, at some points, reached the zero-bound and into negative territory. Financial markets swam in waters comprised of extraordinary returns, below normal volatility and lower than average correlation and thus historically good Sharpe ratios.

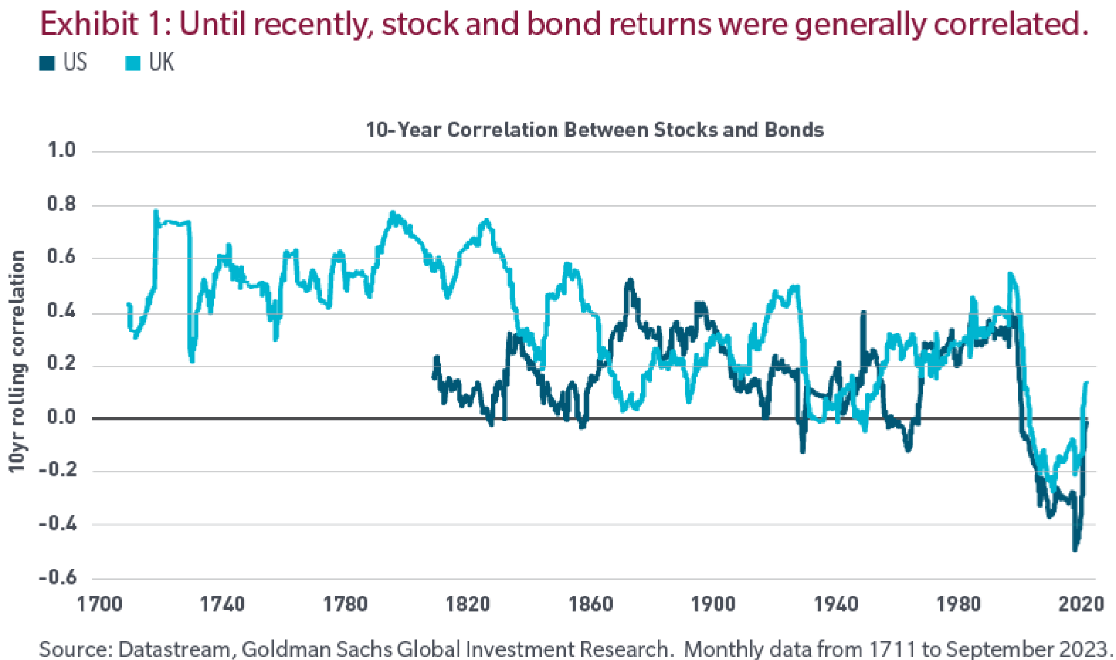
Until 2022, when the water (or paradigm) shifted.

Three decades versus three centuries

Still reeling from the interest rate shock of 2022, investors have been forced to confront what looks like an anomaly: the positive correlation between stocks and bonds.

However, the painful reality is that 2022 wasn't so anomalous when viewed through a long-term prism. It was an example of the dangers of allowing the recent past to obscure protracted historical patterns. The water, or paradigm, is merely shifting back to its natural form as the hurdle rate for all investments, interest rates, has begun its normalization process.

In a November 2021 piece titled *Respecting Three Centuries of Correlation*, we highlighted the positive long-term correlation between nominal stock and bond returns and warned that recent decades of negative correlation were unsustainable. The historic correlation is illustrated below, going back three centuries in the United Kingdom and two in the United States.



Long-term positive correlation explained

Like the fish in the parable, this comes as a surprise to many today because it's not what their experience has taught them. And it's not what is taught in business schools (but should be).

Taking a step back, investors bunch varying investments into labels such as stocks and bonds, public and private debt, growth and value equities, etc. While these distinctions are important, material and worthwhile, what often gets lost is that they all ultimately rely on the hope or promise of cash flows.

Every investment requires a commitment of capital from a saver in exchange for future returns that compensates them for not only the commitment of time but also the risk that the project may fail. When viewing sub-asset classes in this way, there is one asset class: cash flows. The more predictable or stable the future cash flows, the lower the volatility that asset should exhibit relative to assets with greater time commitment and cash flow risk. This is where the benefits of diversification normally come from: a portfolio whose sources of returns (i.e., future cash flows) are diversified across time and risk levels.

While there have been and will remain diversification benefits between equities and fixed income securities, those benefits have been overstated in recent decades due to low inflation and artificially suppressed interest

rates. Investors who were allocated across stocks and bonds not only enjoyed outsized returns with abnormally low volatility, but also uniquely high risk-adjusted returns, in part due to this negative but unsustainable negative covariance.

Why is this important?

The inflation and interest rate shock of 2022 has changed the water.

While we can't predict the terminal value of real interest rates, we're certainly closer to a more normal rate environment than before, which would imply a normalization of the long-run stock/bond relationship. Investors who have targeted future Sharpe or information ratios based on the recent past may be set up for underperformance.

What can we do?

As time passes, areas where capital was misallocated will be exposed. For instance, projects and cash flows that were a function of financial gearing will crumble under the weight of high debt burdens and bad projects will need to be recapitalized.

While correlations of asset classes such as stocks and bonds normalize, the importance of security selection and manager allocation will matter immensely, as these not only become drivers of return but also larger drivers of covariance and portfolio diversity.

Conclusion

As a famous investor once said, price is what you pay, but value is what you get.

In our view, while prices are high, the value of some financial assets is too low. The paradigm of suppressed capital costs and low labour expense has changed. There will be fish that will, at best, fall down the food chain and others that, at worst, get eaten. Conversely, the fish with the ability to deliver cash flows to investors that are less dependent on the prior regime may become scarce assets, and why we think the type of fish you have in your portfolio will be what matters in this new, but old, paradigm.

Robert M. Almeida is a Global Investment Strategist and Portfolio Manager at MFS Investment Management. This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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