Firstlinks
a Morningstar company

Edition 539, 15 December 2023

Contents

Editorial

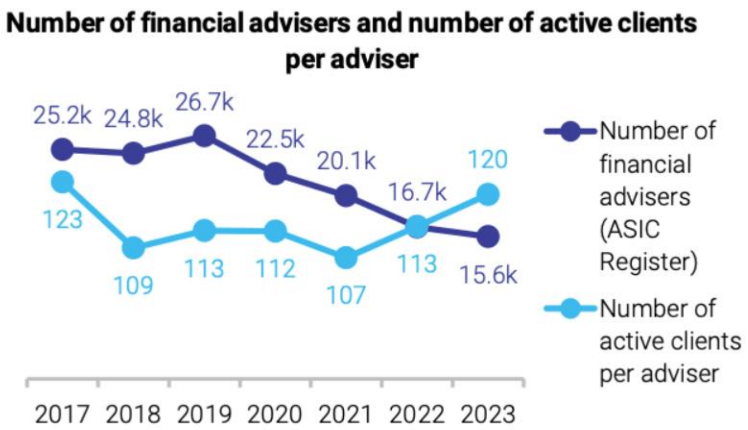
Though it dithered for a long time, the Federal Government has delivered its final response to the Quality of Advice Review (QAR). The Government proposes to implement most of the QAR's recommendations, though not all of them.

Noone is completely happy with the measures, barring some super funds, yet the Government needs to be given credit for trying to fix the financial advice system. Something needed to be done to wind back some of the reforms of the Hayne Royal Commission that's decimated the advice industry and left millions of Australians without the advice they desperately need. Whether Labor's policies will provide all the answers will depend on upcoming consultation and the draft legislation tabled next year.

New research shows why change has to happen

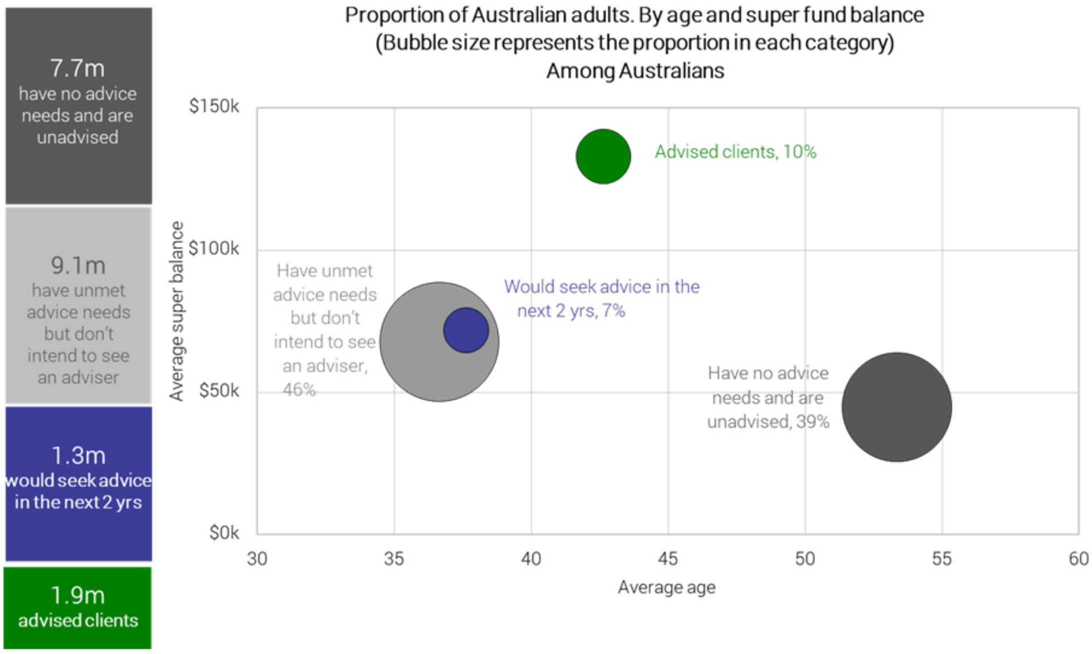
That Labor has pulled the trigger on reforms is testament to the urgency of the problems.

Financial advice has become incredibly expensive because the industry is chronically undersupplied. Since the Hayne Royal Commission, around 11,000 financial advisers have left the industry. Causes for this include greater administrative red tape and increased educational requirements. All the while, demand for advice has exploded.



Source: Investment Trends

Yet not nearly enough of that demand is being met. New research from Investment Trends suggests 11.8 million Australians have unmet advice needs. Breaking that down further, 9.1 million people have unmet needs but don't intend to see an adviser. 1.3 million want to seek advice in the next two year. And, out of the 1.9 million advised clients, 1.4 million of them have unmet needs of some kind.



Source: Investment Trends

The research suggests that the barriers to seeking advice include high (41%) or unclear (30%) costs. And that the top three areas where people would like to get financial advice, but currently aren't, include:

1. Investment strategy (41%)
2. Longevity risk (33%)
3. Growing their superannuation (30%)

The research also shows that Australians receiving advice feel better off financially and are significantly more prepared for retirement than the unadvised. Around 61% of those who have an adviser feel more confident in their financial wellbeing. And 57% of advised people feel more confident in preparing for retirement.

Finally, Investment Trends says 44% of unadvised Australians are likely to turn to their super fund for their unmet advice needs.

The demand for advice is expected to significantly increase with around 3.6 million Australians retiring during the next decade. That means the supply of advice needs to ramp up quickly to meet that need.

What the Government intends to do about it

In its final response to the QAR, the Government proposes to do the following:

1. Introduce a 'best interests' duty that will apply to all providers of personal advice.

This new duty will remove the so-called 'safe harbour' steps. It will also keep the existing obligations to act in the best interests of clients and prioritise the interests of clients in the case of a conflict. Yet it will give clearer legislation for scaled or limited scope advice.

The Government chose not to go with a 'good advice' duty as recommended in the QAR. Financial Services Minister Stephen Jones says this is because, 'Australians deserve the best, not just good'.

But Mr Jones says that advisers will have greater flexibility to provide limited advice on specific subjects, provided it's appropriate in the circumstances.

Clearly, the measure aims to allow more personal advice to be given to more people and to reduce the complexity of current obligations. How this works in practice will depend on how it's legislated.

2. Introduce a new class of financial advice provider called 'qualified advisers'.

The Government says this is intended to increase the availability and affordability of simple financial advice.

A qualified adviser will be able to give personal advice on less complex matters. They won't be able to charge a fee or commission for their services and therefore will likely work for a licensed financial institution. And they'll be required to have minimum educational standards, most likely a diploma.

A qualified adviser will be subject to the best interests duty described above. This advice model will be available to all financial institutions including banks, super funds, and insurance companies.

The Government's proposal provides stricter minimum education standards than that recommended by the QAR. But how the new class of 'qualified advisers' fits in with the current batch of advisers is an open question. Also, the different classes of advisers have the potential to confuse the end-consumer of financial advice.

In saying that, the measure could allow for more simple advice for those at key stages, both before and after retirement. And it might pave the way for greater use of digital advice.

3. Replace Statements of Advice with a 'principles-based' advice record

The administrative burden of Statements of Advice has been a source of irritation for advisers for some time. This is probably the one measure that's been universally welcomed.

4. Expand superannuation advice

The Government proposes to:

- Legislate a list of topics that can be charged to a super fund member's account. The topics will include advice on retirement incomes and investment decisions.
- Give certainty to funds to give members 'personalized nudges', such as switching super into a pension account at the appropriate time.
- Allow funds to consider a greater range of a member's circumstances such as spousal income, debt, and age pension liability.

This measure aims to ease super fund fears about providing advice to its members. Whether there are enough protections for consumers is a matter of debate.

Reactions to the Government's proposals

Reactions to the Government's reforms has been decidedly mixed. QAR Chair Michelle Levy says:

"There is enough here to make a big difference – it will go a long way to making advice more accessible and more affordable."

Most of the super funds are happy, suggesting the changes including the new class of advisers and removal of red tape will increase access to advice to lower and middle-income Australians.

The Financial Services Council, which represents larger financial companies, says its research suggests that removing the safe harbour provision and simplifying disclosure could cut advice costs by 40%.

Consumer groups also cautiously welcomed the Government's measures. Acting Director of Super Consumers Australia, Gerard Brody, says it's positive that the Government will introduce a best interests' duty for personal advice, rather than the weaker 'good advice' duty recommended by the QAR. Though it's wary of potential conflicts of interest in advice provided by banks, insurers, and super funds.

However, The Financial Advice Association isn't so happy. CEO Sarah Abood fears that it winds back the clock for the industry and invalidates the hard work of advisers to improve standards since the Hayne Royal Commission. She's especially concerned about the new class of 'qualified advisers', who won't have the same qualifications as current advisers. Ms Abood thinks the different classes of advisers will confuse current and potential advice customers.

Ms Abood's concerns have merit though some of them should be clarified before the legislation is finalised.

Where to from here?

After a consultation period in coming months, draft legislation should be tabled later next year. Hopefully, the ambiguities in the current proposals can be resolved so the advice industry can help more people with their financial needs.

***

Most assets classes have bounced back this year after a horrid 2022. But where are the best opportunities for 2024? In my article this week, I compare valuations for cash, bonds, residential property, and stocks, and reveal what's cheap and what's not.

James Gruber

Also In this week's edition...

Kaye Fallick says retirement is the new black and super funds are seemingly expected to do all things for all retirees. She asks wehther we need to better apportion the different responsibilities to create a world class retirement income system.

Meanwhile, **Andrew Gale** and **Stephen Hubbert** agree that our retirement system needs change. They think greater work flexibility and access to equity in their homes would allow people to better plan their futures and fund their lifestyles.

It's great to welcome back **Don Stammer** to Firstlinks. For each of the past 42 years, he's selected the X-factor - the largely unexpected influence that wasn't thought about when the year began but came from left field to have powerful effects on investment returns. Today, Don announces this year's winner.

In recent years, investors have loaded up on bank hybrids, and some are getting nervous by an APRA review into the securities. **Professor Kevin Davis** says they are right to be nervous as hybrids don't work for the purpose that they are designed, and their continued use must be questioned.

Investors have crowded into cash this year. **Capital Group's Winnie Kwan** warns that cash typically underperforms when interest rates peak. She suggests equities are a better bet, and likes companies flying under the radar, including ones benefitting from integrating artificial intelligence into their operations.

In the *Wealth of Experience* podcast this week, **Brandywine Global's Richard Rauch** warns of US and global recession risks, **Vanguard's Duncan Burns** looks at the best way to build a simple, effective investment portfolio, and **Peter Warnes** gives his Australian market outlook for 2024.

Two extra articles from **Morningstar** for the weekend. Shane Ponraj examines Sigma's acquistion of Chemist Warehouse, while Shani Jayamnne looks at an A-REIT that's 33% undervalued.

Finally, in this week's whitepaper, **Cromwell Property Group's Colin Mackay** has a case study on the flight to quality in office property.

Which asset classes are undervalued right now

James Gruber

Every six months, I give an update on the valuations of key asset classes and how they compare. Here's the latest chart on yields for the four major asset classes: cash, bonds, property, and stocks. I've included the inflation rate as a point of comparison.

What stands out from the chart is that the inflation rate of 5.4% (this is the September quarter figure rather than the monthly data which are less reliable) is higher than the yield of almost every asset class. That means that most assets are losing money in real terms (real yield is asset yield minus the inflation rate).

Why is that happening? Part of the answer is that markets expect inflation will continue to ease. Inflation in Australia is by far the highest of the top 15 developed economies in the world. It bottomed in negative territory at the start of Covid in 2020 before climbing to 7.8% at the end of last year, then falling to 5.4%.

Australia inflation rate

The new RBA Governor Michelle Bullock has said that inflation here is largely a homegrown problem. I highly doubt that and see it as a way for the RBA to justify being paranoid about inflation and thereby keeping interest rates higher for longer.

The RBA forecasts inflation will ease to 4% by mid-next year and 3% by the end of 2025. In other words, inflation won't get back to the RBA's target of 2-3% possibly for another two years.

The inflation picture in the US is more encouraging. Data out this week showed the consumer price index dropped to 3.1%. It could well get back to the Federal Reserve's target of 2% next year.

If Australian inflation is principally caused by global issues, with a lag, might that mean inflation here could fall faster than expected? That's entirely possible, though it will also depend on factors including the health of global economies.

What does that mean for interest rates in Australia? As always, it's difficult to tell. We've gone from a rate of 0.10% in April 2022 to 4.35% now. That hasn't impacted the economy, especially spending, as much as most expected. Warnings about the so-called 'mortgage cliff' haven't eventuated. That's not to say that there won't be an impact on the economy in future, though.

Australia interest rate

What's clear is that if the RBA's forecasts of a gradual decline in inflation are correct, then the yields on most assets won't offer much in the way of real returns over the next 12 months.

Moreover, most asset yields trail the Australian 10-year government bond yield – the risk-free rate - of 4.35%. Ordinarily, assets should be priced at a yield above that rate to reflect the risk of owning them versus the risk-free rate. That's not happening now, and it means that risk may not correctly priced with these assets.

Cash is back, or is it?

In 2022, stocks and bonds endured one of their worst years for some time. News headlines proclaimed, "the end of the 60/40 portfolio" and the possibility of a long bond bear market. Then in March this year, Silicon Valley Bank and Credit Suisse both collapsed.

All this shook investors. What did they do? Many chose to switch their money out of stocks and bonds and into cash.

In the US, it's estimated that there's around $5.6 trillion in money market instruments. Australia has a less developed money market, so people turn instead to bank savings accounts and term deposits.

The move from stocks and bonds into cash, especially in the first half of the year, was understandable. After all, money in the bank had earnt next to nothing for 15 years. Suddenly, it had a decent yield.

Though understandable, holding cash even in term deposits this year has been a losing proposition in real terms. That is, cash has returned less than inflation. Therefore, people invested in cash have lost purchasing power.

The big question is whether cash is attractive for 2024? It really depends on inflation. If inflation heads below 5% as almost everyone expects, then having some money in a 6 to 12-month term deposit with a rate above 5% makes sense. That's especially if you're worried about the valuations of stocks and other assets. The risk is that inflation remains high, and cash again loses purchasing power.

Bonds are back, or are they?

Throughout this year, various bond managers have declared that "bonds are back". That didn't make sense for much of the year, at least for government bonds, as yields didn't seem attractive when compared to inflation. By November, as Australia's 10-year bond yield almost touched 5%, and with inflation pulling back sharply, bonds started to offer better value.

After an extraordinary November, the 10-year yield is back to 4.35%. That's more than 1% below the current inflation rate. Inflation has to pull back a lot for that yield to become attractive again.

Source: Trading economics

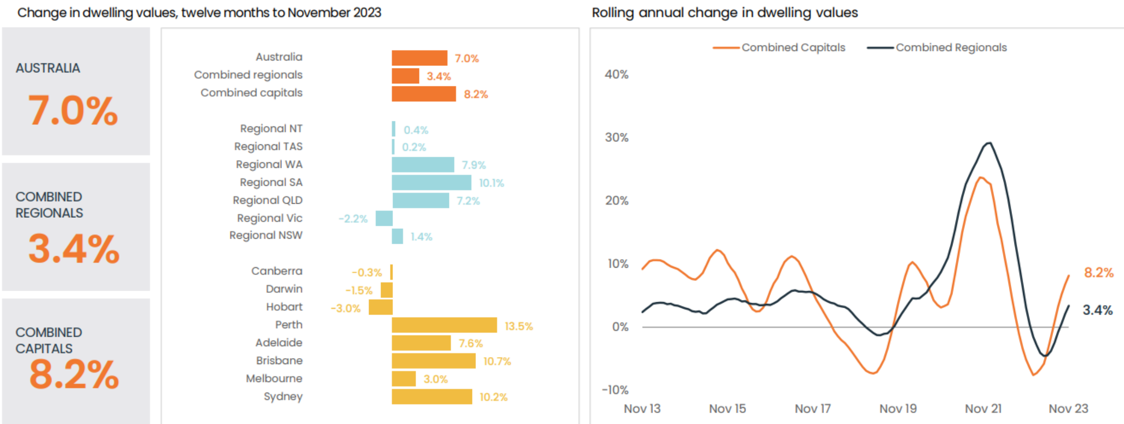
Yes, you can buy other bonds at better yields. Corporate bonds can be purchased with +5.5% yields, and non-investment grade bonds at much higher yields. These other bonds also looked better value a month ago than they do today.

How do bonds compare to cash? At this moment, I think cash offers more value than government bonds. Yet, it's important to note that the two assets serve different functions in a portfolio. Bonds give investors protection if there's an economic slowdown, whereas cash doesn't.

Residential real estate: the gift that keeps on giving

Residential real estate dwarfs all other asset classes in Australia. Valued at $10.3 trillion, it's almost 3x the size of the superannuation sector and 3.7x the size of the ASX.

After a sharp pullback in 2022, real estate has come back again. Housing prices have risen 7% over the past 12 months across Australia. In capital cities, they're up 8.2%. Perth was the strongest market, rising 14%, with Brisbane and Sydney the next strongest. Perth, Adelaide, and Brisbane, now have real estate prices back at record highs, and Sydney's are not too far away.

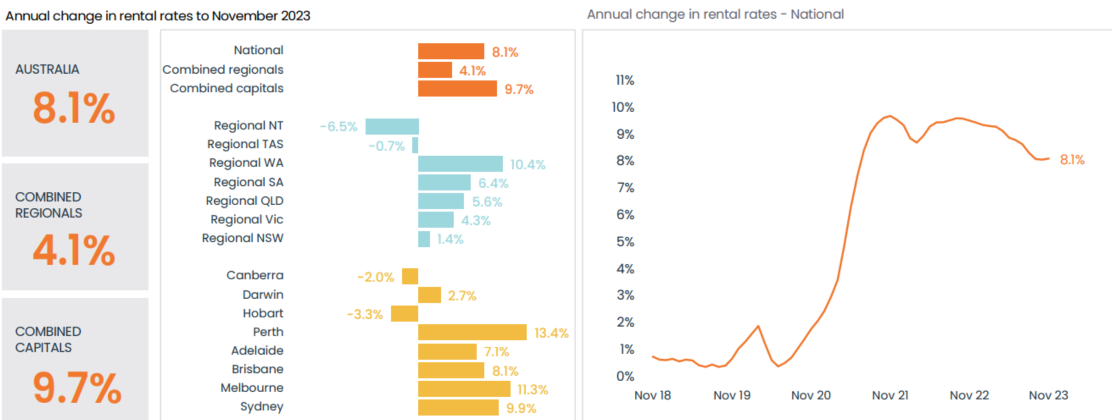


Source: CoreLogic

If I'd told you in April 2022, that rates would rise by 425 basis points over the next 19 months and that housing prices would be at or near record highs, you probably would have sent me to the nearest psychologist. But as mentioned earlier, the 'mortgage cliff' fears haven't been realised as people had enough cash in reserve to handle the higher rates.

It's not only that demand has held up. Supply has been pitiful as construction firms struggle to meet costs, and governments and councils make big promises yet fail to deliver on land releases and development approvals.

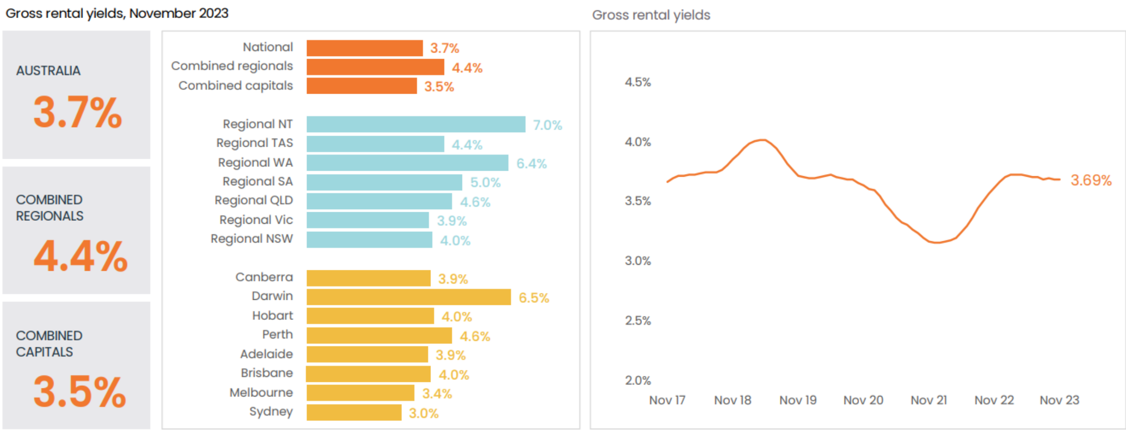
The undersupply is reflected is rents having increased by 8.1% nationwide over the past year. It's interesting to me that even coming off a Covid-inspired boom, regional rentals have also held up remarkably well (commercial property and other assets have been hit much harder).



Source: CoreLogic

Where does that leave valuations for residential housing? As has been the case for a long time, they're terrible.

Nation-wide, the average rental yield is 3.7%. In capital cities, it's 3.5%. In Sydney and Melbourne, it's 3% and 3.4% respectively. These are gross yields, before costs.



Source: CoreLogic

These yields don't make sense from a valuation perspective. They significantly trail the risk-free rate of 4.35%.

Buying residential housing is relying on capital gains over time. And those capital gains are dependent on governments continuing to undersupply the market and juice demand through subsidies such as the first homeowners grant and negative gearing. Governments have had homeowners backs for a long time, and it's a reasonable bet they'll continue to in future.

The main potential snag with that is with affordability. Over the past 15 years, income growth has been anemic, and as a result, people have had to take on more debt to be able to afford ever expensive housing. With rates where they are now, Australians are practically maxed out on debt. That means for house prices to continue to rise, they'll be more reliant in income growth than previously.

Either way, valuations don't stack up to me.

The extraordinary bounce in US stocks

12 months is a long time in stock markets. In 2022, the S&P 500's total return was -18%. This year to date, that's swung around to +22%. Large cap stocks, especially the 'Magnificent Seven' have led the way. The Nasdaq 100 has jumped an astonishing 48% in 2023.

Not a day goes by without a commentator mentioning the crowding of investors into US large caps and tech stocks. But it isn't just something that's happened this year. Since 2011, the Nasdaq has returned 18% per annum (p.a.) in price terms, while the S&P 500 is up 13% p.a. Yet, over the same period, US mid-caps have returned an annualized 10% p.a. while US small caps have risen 8% p.a.

What's led to this disparity in returns? Software "eating the world" and the rise of artificial intelligence may be factors. The increasing influence of passive investing could also be a factor. As could the growing global dominance of the US economy as China slips.

Whatever the reasons, they've left US large cap valuations looking stretched while the rest of the market seems less so. The S&P 500 is trading at a trailing price-to-earnings ratio (PER) of 21.2x and a forward PER of 18.7x. Yet, midcaps and small caps are both trading at an undemanding forward PER of less than 14x.

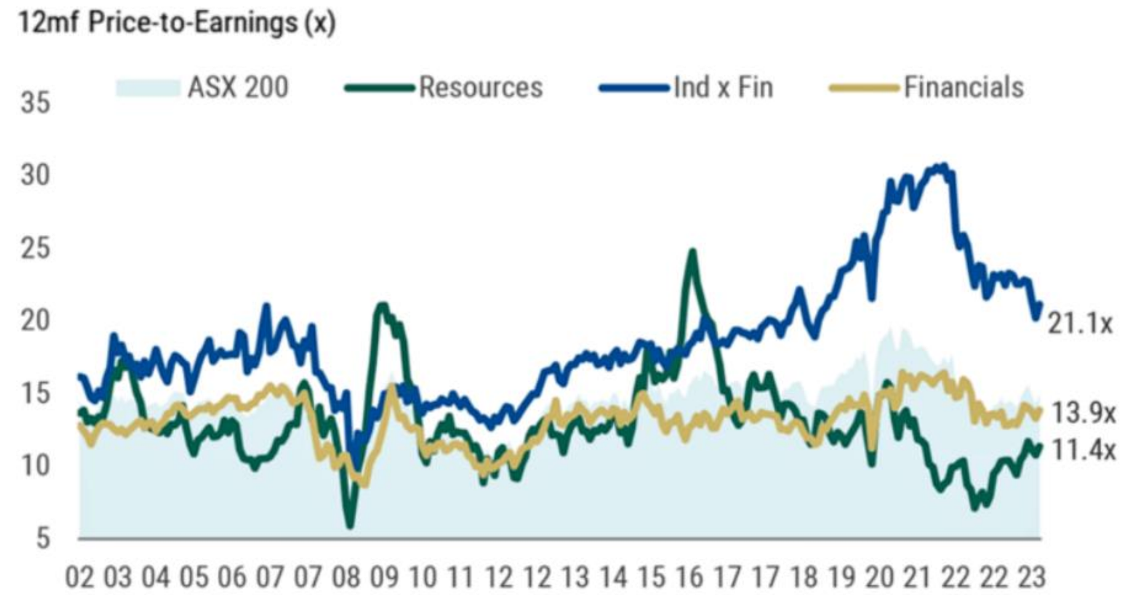
Some investors are betting that the concentrated rally in large-cap tech stocks will broaden to include mid and small caps in 2024. That's not an unreasonable assumption. For long-term investors too, valuations at the small end of the US market look far more compelling than at the large end.

Australian stocks: boring is beautiful?

Compared to the euphoria of the US market, the ASX has been decidedly dull in 2023. The ASX 200 and All Ordinaries have barely risen in price terms, and up more than 4% when including dividends.

The difference in performance can be partly put down to Australia lacking the large-cap tech stocks that the US has. The ASX relies far more on banks, where earnings have been pedestrian, and resources, where earnings have struggled.

The All Ordinaries, trading at a trailing PER of 17x, doesn't look especially exciting. That PER is deceptive though as there are considerable differences in valuations between the different sectors. The largest sectors of financials and resources trade at much lower multiples than industrials. That reflects both their cyclicality and earnings potential.



Source: Morgan Stanley

Does the ASX offer value, then? The market here has healthy dividends with limited prospects for capital gain. That may not be a bad thing, though. If investors can get close to a 4.5% fully franked dividend with some earnings growth, that should produce nice returns in the long run. And it's not hard to see decent earnings growth as Australia's economic outlook seems bright, given we have plentiful resources to fuel the energy transition, strong population growth, abundant capital via the superannuation sector, and low government debt.

Of all the assets, ASX stocks seem to offer the best value.

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

Super wars: who needs to do what for retirees?

Kaye Fallick

There's no doubt that retirement is the new black. We've now reached the point where super fund accounts have moved beyond accumulation. We're well into the decumulation phase seemingly suddenly noticing the massive wealth held by the nation's super funds. As well as how they wield the power that comes with these significant investments.

Of course, quite a few academics and commentators have noted this influence along the way. But we do seem to have experienced an explosion in coverage of what super funds could and should do for the nation. It's head spinning to say the least. Which begs the question whether we need to stop expecting super to be *all* things to *all* people and better apportion the different responsibilities to create a truly impressive, world class retirement income system?

What do we expect from our super?

A lot!

A quick look at some of the talking points about superannuation this year reveals a long list of nation saving activities we somewhat blithely expect super to deliver. To be fair, this 'bonfire' has been stoked by the funds themselves with grand responses to the news that they have not been delivering well on the Retirement Income Covenant requirements. Look over here, they seem to be saying, we'll get those right and then take on even more responsibilities. But unrealistic expectations for the role of super are spread across the population. Australian super funds are being variously asked to:

- invest the funding needed to move seamlessly to alternative energy,
- provide investment to solve the housing crisis,
- ensure members have sufficient wealth for later life,
- support the use of super savings to provide a deposit on first homes
- fund aged care
- undertake extensive financial literacy education for all members
- and now create a 'package' or 'product' which rolls income streams and the Age Pension into one smooth flow of cash

The mind boggles – this is cradle to grave intervention indeed.

Particularly since basic adherence to the Retirement Income Covenant requirements has yet to be delivered by many funds, which means that members of these funds are not informed nor fully cognisant of their options and opportunities as they reach decumulation. This is a critical time and a critical need for such members.

Where does the fault lie?

Contrary to the popular aphorism, this failure is not an orphan. It has, in fact, quite a few fathers and mothers.

Perhaps it's worth questioning whether Australia has been a victim of its own success? Back in the early 1990s, we were praised by the World Bank for having a world class retirement income system, which was then believed to consist of just three pillars (Age Pension, superannuation and private savings). But as mandatory superannuation was legislated in 1992, we have now had 30 years to anticipate the challenge of mass decumulation. And along the way countless inquiries and reports have confirmed disengagement and a worrying lack of financial literacy. And how have we responded at a national level? We haven't.

The latest Treasury discussion paper again notes the need for solutions. But instead of jumping to the proposed 'all-in-together' product (combining income stream, Age Pension payments, maybe even home equity access), let's start where we should have 30 plus years ago – by providing basic information for people who remain dazed and confused by the complexity inherent in our retirement income system.

There is also a problem of equity in retirement savings, the haves and have-nots. The playing field of superannuation has been systematically tilted over a decade or two, to the point that the more you have in super, the more your money will grow. Contrast this with the trajectory for those with median amounts in super ($178,808 for 60-65 year old males, $137,051 for same age females). Then there are those with zero super balances – 23% of women – and renting retirees (about 13%) who struggle to cover even basic bills.

So how can we rethink super?

It's high time that we ceased our fixation with 'pot of money' style thinking. Let's face it, $3.5 trillion in savings *is* eyewatering. Most of us don't actually understand what that amount of money even means. When I last wrote about super savings compared with Australia's GDP it was 2016 and the ratio of super to GDP was 117%. It's now 150% and rising. But obsessing over how much money we have amassed doesn't solve the basic challenges super members are now facing.

Let's start afresh by agreeing that just because this amount is huge, it does not follow that super should be everything to all people. As noted above, there's a never-ending stream of ideas of how super funds should be invested to help different levels of government in Australia play catch up with infrastructure and energy initiatives that should have been tackled years ago. The role of super fund trustees is *not* to fill the gap left by governments. It's to put members' interests first by investing well and delivering well. Delivering well is not confined to returns on funds but also the delivery of support in both accumulation and decumulation phases. The type of support which is covered by the Retirement Income Covenant, in fact.

Prioritising super's roles

We still seem to be working out the new definition of what super is and does. Back when it was introduced to the Australian Parliament, then-Treasurer John Dawkins stated:

'The increased self-provision for retirement will permit a higher standard of living in retirement than if we continued to rely on the age pension alone. The increased self-provision will also enable future Commonwealth governments to improve the retirement conditions for those Australians who were unable to fund adequately their own retirement incomes.' (superannuation guarantee bill 1992).'

The three-pillar system has since evolved into a five-pillar system of funding retirement, including home equity and work income. This is retirement 2020s style and with so many Australians entering retirement with a mortgage, these extra two pillars are both important.

How could we write a 'job description' for super that's fit for purpose?

Here's a suggestion, in order of priority:

- Manage members funds well to deliver enhanced wealth for them to enjoy as one of their forms of income in the later years of their lives
- Fully adhere to the requirements of the Retirement Income Covenant by assisting members to better match their needs with the opportunities and rules attached to the move from the accumulation phase to that of decumulation.
- Offer appropriate retirement income products, relevant to superannuation. Do not try to 'own the world' or control access to other types of income such as Age Pension entitlements and home equity. Get your own house in order before creating these types of hybrids.
- Offer financial guidance and general advice as legislation allows.
- Consider whether the investment of member funds in different sectors which are favourable for the Australian economy also offers outcomes that are best for members. Or both? Members' interests clearly must come first.

Who else needs to do some of the heavy lifting?

To be fair to super funds, although they are major players at the trigger point when members retiree, they should not be expected to play catch up with their members' overall financial literacy.

The Federal Government needs belatedly to get serious about financial literacy. Very serious. Given our world-leading, chest-thumping, eye-glazing $3.5 trillion in super, why does this nation still lack a coherent financial literacy program? Successive governments have squibbed on this for decades and now, suddenly, super funds are meant to fill the gap? Which means that we are asking them all to separately reinvent the wheel? What a waste of time, money and resources. A comprehensive nationally approved financial literacy program could be delivered through workplaces with far greater efficiency.

And then there's advice

We've been around the block a few times on the topic of financial advice. The Haynes Royal Commission which reported in 2019 shone a light on many wrongs. Sadly, the fallout has been a mass exodus of financial planners, to the point that there are insufficient advisers left to deliver support to the 800 or so Australians who retire daily. Full financial plans are too expensive for most Australians anyway. So more attention on the delivery of 'episodic' or 'situational' advice is key to helping retirees as they encounter the many different ages and stages during their transition to retirement. Short, subject-focussed financial advice at age 58, 60, 65 and 70 would help so many retirees to weigh up options and make informed decisions. But where are we at with this type of offering? Are we still desperately hoping robo-advice will fill the gap?

In short, we have a lot of catching up to do when it comes to the large-scale decumulation phase taking place in Australia right now.

Moving from saving to spending superannuation is not a simple process. Individual retirement income needs are based upon about 8-10 different factors, including

- preferred retirement age
- household expenditure
- super savings
- other savings
- current housing

- employment prospects
- retirement goals
- family needs and
- health issues.

Centrelink entitlement is a highly targeted calculation. Super decumulation needs to be understood as *equally* complex, but just as doable. As a nation we became complacent while our super coffers were swelling. Now we need to step back and take stock. Not to roll all forms of retirement income into one, but to separate the processes of the five very different pillars of retirement and support retirees to understand each and every piece of the puzzle, in plain language.

Now that's not too much to ask, is it?

Kaye Fallick is Founder of STAYINGconnected website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.

Time to announce the X-factor for 2023

Don Stammer

42 years ago, I experienced what is now called 'a light bulb moment'.

In the six months to May 1982, Japanese institutional investors purchased about 8%of Australian government bonds on issue. At a lunch-time discussion at the time, I suggested we should see the unexpected surge in Japanese holdings of Aussie bonds as an Factor-X in our investment markets.

A few months later, I felt early signs of a new and urgent obsession. It grew into a compulsive need to select the Factor-X in investment markets each year. That obsession has stayed with me for 42 years. And "the rules of the game" have changed just once - in 2009, when a sub editor at *The Australian* re-named Factor-X as the X-Factor.

The X-Factor is the major influence on investment markets that had not been generally predicted or allowed for, but which came out of the woodwork with a powerful effect. My list of all 42 years of the X-Factors is set out below.

To be a fan of the X-Factor, as I am, doesn't preclude taking a view on where the economy, shares, interest rates, property and the exchange rate seem to be headed. Rather, it's a reminder that investors need to allow for uncertainties and surprises; and diversification and awareness of risk are important to successful investing.

Sometimes, the X-Factor is favourable for investors. Examples of positive X-Factors include, in chronological order:

- the floating of the Australian dollar in 1983
- the collapse of inflation here in 1991
- our economy being little affected during the global financial crisis of 2008
- the powerful surge in share prices that began in March 2009
- the boost to most commodity prices in each of 2016, 2018 and 2020 as China avoided the hard landing forecast for it
- the sharp recoveries in the global economy and share prices soon after the Covid panic.

Other times, the X-Factor has been unfavourable. For example, and again in chronological order:

- the sharp rise in bond yields in the fake crisis of 1994
- the terrorist attacks in the US in 2001
- the Enron frauds in US markets in 2002
- the near meltdown in the global bank system in 2008
- the powerful disinflation in the 2010s
- Covid in 2020
- the sharp increases in inflation and interest rates in 2022

THE FINALISTS FOR 2023:

No world-wide recession

Some investment banks and brokers spent much of 2023 updating their earlier warnings of an imminent global recession. From mid-2022, they'd been advising investors to switch from shares to interest-bearing assets, including bonds, to limit the harm that the (expected) recession would cause.

Recession didn't eventuate. In fact, in the second half of 2023 - the favoured timing for the economic crisis that was to trigger recession – US economic growth surged. News bulletins in the US dropped their gloomy talk. Instead, they used phrases such as "soft landing", "economic resilience, and even the "Goldilock's economy".

Australia also avoided recession. Though we've shared the US experience of a strong labour market, our recent growth has been more subdued because our preference for variable rate debt adds to the impact interest rates have on spending.

Of course, there will be recessions in future years – but investors can be sure recessions will be fewer in number and more widely spaced over time than the predictions of 'financial markets' will suggest. Paul Samuelson, a famous US economist, pointed out 60 years ago that the stock market had predicted nine of the previous five recessions. Investors should keep his wise words front of mind.

Bonds v shares in 2023

Traditionally, bonds appeal to investors in difficult times because they're seen as better at preserving investors' wealth than shares. But this view was tarnished in 2023, when shares moved (unevenly) higher over the year, while the market value of bonds was hurt by rising interest rates. At their peak, yields on 10-year bonds rose to be more than four percentage points than at their lows in the worst days of the Covid epidemic. (When interest rates move up, the market price of bonds declines – and the longer the bond's term to maturity, the greater the impact. (Thankfully, Australia did not follow the example of Austria in issuing a 100-year bond carrying an annual coupon of 1%.)

In 2022 and early 2023, the best ways to reduce risk while cash rates and bond yields did not appeal were floating rate securities including bank hybrids.

US tech stocks

Every review of investment markets for 2023 will doubtless feature the massive increases in share prices of US tech stocks. At times, capital gains from shares in the 'Magnificent Seven' tech companies (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) exceeded those in all share markets around the world.

The reasons are not hard to find: the US often generates the best commercial technology and is quick to apply it (think of Artificial Intelligence), many investors have happy experiences using the products or services of the tech companies to influence their choice of investment, and most US tech companies are adept at cutting costs when necessary to maintain high rates of growth in their earnings.

In valuing these shares, investors should avoid traditional valuation metrics such as price-to-earnings ratios and assess opportunities using GARP (that's the acronym tor Growth at a Reasonable Price), along with carefully thought-out numbers for the increase in earnings over the next five years.

The outlook for cash rates

These days, there's a flood of analysis and prediction of decisions the Fed and other central banks will make on their cash rates. Two things stand out. One is the high degree of market confidence that cash rates will soon stabilise and be cut in the first half of 2024. And secondly, even stern suggestions by the Fed's Jerry Powell that interest rates could be higher for longer, have little effect on market thinking beyond about day and a half.

My thinking aligns with that of Escala's Mark Cooper who's said, "we've recently seen bond markets make the seventh attempt this cycle to price in a dovish central bank pivot. Even though the other six have reversed it doesn't necessarily mean this one will, as well… (But) I would say that unless the US sees a recession, it will be tough to see a big imminent global easing cycle."

My view is inflation will run at 3-4% in both the US and here in 2024, high enough to preclude cuts in cash rates. And there's a 2 in 10 chance of both cash rates being raised next year.

The Federal Government's argument is that it's a global inflation problem. In my view, the Government should recognise that much of our inflation is made in Australia.

New taxes

The Treasurer is preparing plans to substantially increase total tax revenues. His recent outline of a new tax on superannuation, and the effort going into rescinding Stage 3 of the tax reform Labor voted for in the last Parliament, shows how difficult - and brave – these will moves will be.

Clearly, the appeal of superannuation to middle Australia would be reduced. And super funds would have less incentive to invest in small companies, whose share prices are often more variable year by year.

Immigration

In the last 12 months, net immigration has increased the population by around 500,000. The intake has enabled businesses to fill vacant positions, especially in heath, retail, cafes, and construction. It's also contributed to inflation in house prices and rents. Can I ask for tolerance in debates on immigration - many people seeking a considered reduction should not be accused of dog whistling.

And the winner is?

My pick for Factor-X in 2023 is US tech stocks. Even when the current surge in prices cools, US tech stocks can provide worthwhile returns to patient investors who have a reasonable understanding of how they should be valued.

Don Stammer has been involved in investing for many decades as an academic, a senior official of the Reserve Bank, an investment banker, the chairman of nine companies listed on the ASX, and columnist for The Australian and Business Review Weekly. The article is general information only and does not consider the circumstances of any investor.

42 years of the X-factor file

2023 The surge in share prices of US tech stocks, and the better understanding of how they should be valued

2022 High inflation, tighter monetary policies, and sharp rises in interest rates

2021 The fracturing of the long-dominant view low inflation is here to stay

2020 Covid-19

2019 Strong share markets despite repeated predictions of global recession

2018 The impact from the royal commission on financial services

2017 The positive macro influences that, globally, restrained volatility, boosted shares and kept bond yields low

2016 Election of Donald Trump as US president

2015 Widespread experience of negative nominal interest rates

2014 Collapse in oil price during severe tensions in middle east

2013 Confusion on US central bank's "taper" of bond purchases

2012 The extent of investors' hunt for yield

2011 The government debt crises in Europe

2010 The government debt crises in Europe

2009 The resilience of our economy despite the GFC

2008 The near-meltdown in banking systems

2007 RBA raises interest rates 17 days pre-election

2006 Big changes to superannuation

2005 Modest impact on economies from high oil prices

2004 Sustained hike in oil prices

2003 Marked fall in US dollar

2002 Extent of US corporate fraud in Enron etc

2001 September 11 terrorist attacks

2000 Overshooting of exchange rates

1999 Powerful cyclical recovery across Asia

1998 Resilience of our economy despite Asian crisis

1997 Asian financial crisis

1996 Global liquidity boom created in Japan

1995 Powerful rally in US markets

1994 Sharp rise in bond yields

1993 Big improvement in Australian competitiveness

1992 Souring of the vision of "Europe 1992"

1991 Sustainable collapse of inflation**1990** Iraq invasion of Kuwait

1989 Collapse of communism

1988 Boom in world economy despite Black Monday

1987 Black Monday collapse in shares

1986 "Banana Republic" comment by Paul Keating

1985 Collapse of A$ after MX missile crisis

1984 Measured inflation falls sharply

1983 Free float of Australian dollar

1982 Substantial Japanese buying of Australian bonds

The reforms that our retirement system needs

Andrew Dale, Stephen Huppert

Since the concept emerged in the late nineteenth century, retirement has evolved from a point in time to a short period before death to a multi-phased time of renewal, reinvention, and discovery.

The main drivers of change have been lengthening life spans and health spans and, with that, changing expectations for life after full-time work. Many people will choose not to follow conventional retirement patterns, and the economy and business must adapt, including valuing mature workers. Some people have even observed that the word 'retirement' may have certain unfortunate connotations and that we should consider retiring the word 'retirement'!

Beyond Three Pillars

In the same way the retirement income system increased from one pillar to three pillars to adapt to changing conditions, it needs to keep evolving.

Several submissions to the Retirement Income Review (RIR) in 2020 said there were more than three pillars in Australia's retirement income system. Additional pillars include work, equity release, non-financial arrangements such as pensioner discounts, other government payments, and inheritances. These are all sources of income that people may be able to draw on in their retirement.

We should no longer talk about a three-pillar retirement income system. It is time to give more voice to additional sources of retirement income, such as home equity and part-time work, providing an additional two pillars.

Accessing equity in the home was one of the options listed in the RIR for boosting retirement outcomes. It observed that:

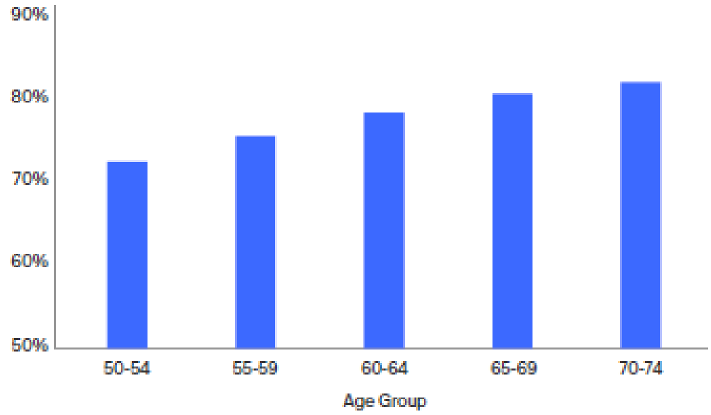
"For most retirees, the family home is their main asset. Using relatively small portions of home equity can substantially improve retirement incomes."

As well as introducing a new source of retirement funding, there is the added benefit of potentially staying in familiar surroundings (both home and neighbourhood) for longer.

As well as commercial providers of equity release products, the Federal Government, in recognition of the importance of home equity, also runs a scheme that allows senior Australians to supplement their retirement income by accessing the equity in their home through a government loan.

The Actuaries Institute's public policy position on home equity supports measures that allow retirees to keep their home but access the equity to boost retirement incomes effectively, whilst acknowledging that the home provides significant financial and emotional benefits to retirees.

Home ownership by age group



Source: Australian Institute of Health and Welfare, Home ownership and housing tenure

It is important to note that, while levels of home ownership are strong for current retirees, home ownership rates have been falling for several decades for those of pre-retirement age. The retirement planning needs for retirees who do not own their own home are very different. There is a high rate of poverty amongst retirees who are renters. The Institute's public policy position supports measures that aim to improve the retirement outcomes of retiree renters, such as significantly increasing the rate of Commonwealth Rent Assistance.

Financial advice, where art thou?

The RIR said that "the retirement income system is complex". Add that complexity to longevity and other risks, and it is no wonder that Investment Trends research found that only 37% of non-retirees felt prepared for retirement.

It is as if we expect individuals to become experts in risk management — maybe even become their own defined benefit actuary!

The big challenge for individuals is effectively transitioning into retirement, including efficiently converting their retirement savings into retirement income. Alexis George, CEO of AMP, says: "We're financially illiterate when it comes to retirement and the financial solutions available to us".

Complications include:

- the need to optimise the use of their assets and access social security.
- how to best navigate health care and, ultimately, aged care.
- the uncertainty of future lifespan and whether their money will last.
- the disruption and emotional stress that can often be associated with retirement relate to both financial and non-financial issues.

The RIR noted that:

"Complexity and uncertainty, a lack of financial advice and guidance, and low levels of financial literacy are impeding people from understanding the system. As a result, some people fail to adequately plan for retirement and make poor decisions about how to use their savings in retirement."

How can we better support individuals with their transition from full-time work? With a combination of timely and targeted Help, Guidance and Advice (HGA).

The gap between advice supply and demand

A great deal has been written on the gap between the demand and availability of financial advice. Less is said about the demand and availability of Help and Guidance.

Some Quality of Advice Review (QAR) recommendations risk categorising nearly all one-to-one interactions between superannuation funds and members as personal financial advice based on presumed knowledge. This compounds the challenge of identifying when simple guidance approaches would be helpful.

Fundamental to expanding the availability of advice, let alone the help and guidance components, is streamlining advice processes for financial advisers without compromising quality and expanding advice through superannuation funds.

Trustees currently face a conundrum: on the one hand, they are obliged by the Retirement Income Covenant to have a strategy that "identifies and recognises the broad retirement income needs of the members of the fund; and presents a plan to build the RSE's capacity and capability to service those needs". On the other hand, they must navigate the dangerous waters of personal advice obligations.

The interaction between the Retirement Income Covenant and the changes in financial advice regulation arising from the QAR is essential. The QAR has the potential to improve access to advice, specifically for advice related to retirement planning. Recommendation 6 is that "Superannuation fund trustees should be able to provide personal advice to their members about their interests in the fund, including when they are transitioning to retirement'.

The QAR views all advice to members as personal advice in the following circumstances: "the provider of the advice has considered one or more of the person's objectives, financial situation and needs". If these recommendations are accepted and legislated, it is likely that the vast majority of advice provided by superannuation funds and one-to-one interactions with members, including intra-fund advice, would be classified as personal advice and subject to the QAR "good advice" recommendations.

General advice will tend to be limited to other than one-to-one interaction between funds/trustees and members. As noted by the QAR, "Research reports, seminars and newsletters that are not individualised – directed to individual clients or adjusted or otherwise personalised for individual clients – will continue to be general advice". Other examples may include websites.

For personal advice, the QAR recommends a shift from a prescribed "best interests" advice standard (with safe harbour steps) to a "good advice" standard and a fiduciary best interests duty for financial advisers. But what is "good advice"? The QAR suggests that it is "fit for purpose" and has the "usual consumer protections". However, this is arguably ill-defined, subjective and untested (in courts). The apparent caution by many superannuation trustees regarding the QAR advice recommendations is understandable if most advice is deemed personal and a "good advice" standard is not yet defined.

An issue for both the Retirement Income Covenant and the QAR is the challenge for trustees to know enough about their members. Trustees only have a limited window into their member's financial affairs and other important considerations such as home ownership arrangements and marital status. Furthermore, where a member is in a relationship, retirement planning is best done as a couple, and, as Wayne Swan, Chair of Cbus and former Treasurer, said at the recent AFR Wealth Summit, "We need to have a situation where we can provide financial advice to couples, but you can't do that at the moment. [Plus] the social security system works on couples". This requires further work.

Thoughts for Moving Forward

The future of Help, Guidance and Advice is a big discussion and here are a few ideas to get the ball rolling:

- Develop a well-defined HGA Framework. Actuary Michael Rice recommends matching regulatory requirements with the risk from the consumer's perspective—for example, with requirements varying depending on whether personal advice is Simple (low risk), Comprehensive (medium risk) or Complex (high risk). The aim of this framework should be to expand the supply of HGA, making it easier for consumers to obtain the support they need, when they need it, and in a format that makes sense to them. The RIR contends, "While guidance of this nature is unlikely to fall with the definition of regulated financial advice, the definition of what constitutes financial advice is not always clear, and this ambiguity may explain funds' reluctance to offer guidance".

- Address barriers to superannuation funds knowing more about their members. Many trustees are reluctant to collect too much data from members directly due to concerns they may inadvertently be providing personal financial advice. In addition, trustees and members have privacy and information security concerns that must be addressed. Surely, it should be in members' best financial interests for trustees to know as much as possible about their members to provide the best support possible as they make the difficult transition to retirement.

- Consider innovative regulatory approaches to expand the use of digital tools and technologies. While HGA offerings will always require a hybrid approach, we see the role of tools and technologies continuing to evolve, often involving triaging or providing initial guidance and advice before passing the consumer on to a personal advice provider, according to their needs and preferences. There is also a role for tools and technologies to support the personal advice provider.

- Be bold with advice reforms, including finding a new home for financial advice legislation.

We acknowledge that these initiatives are not straightforward and not without risks requiring careful management. The environment is constantly changing, and the demand for retirement planning support is growing. The time to act is now.

This is an edited extract from the Actuarie Institute's Retirement Matters paper.

Andrew Gale is an actuary, public policy expert in financial services, a non-executive director and a former Chairman of the SMSF Association. Stephen Huppert is a superannuation adviser.

The views expressed in this article are focussed on public policy and are personal views not made on behalf of any organisation. This article is not financial or tax advice and it does not consider the individual financial circumstances of any person.

The future of bank hybrids is open to question

Professor Kevin Davis

The Australian Prudential Regulation Authority (APRA) is currently undertaking a review of hybrid capital bonds (often referred to as 'bail-in bonds') issued by banks, with a focus on those known as Additional Tier 1 (AT1) instruments. This is hardly surprising since recent international experience (particularly the demise of Credit Suisse) has shown them not to work for the purpose for which they are designed. Their continued use, rather than just redesign of some of their features, is open to question.

Context to the review

Bail-in securities were introduced as part of the Basel 3 regulatory framework following the Global Financial Crisis, and introduced in Australia in 2013. AT1 securities are intended to provide the next line of protection, after common equity, against bank failure. This is meant to occur by them being 'bailed-in' to convert into equity should the bank’s equity capital base fall sufficiently for the bank to reach a point of “non-viability”.

APRA would make the decision to require the 'bail-in', but the exact features of what a bail-in would entail (exactly when, how many, and which of, the securities to be bailed-in) has been left purposely vague. Should a bail-in of all AT1 securities be insufficient to adequately recapitalize the bank, then another class of bail-in securities (Tier 2) would be bailed in.

It can be argued that the existence of bail-in securities (used to keep capital ratios above APRA-required levels) helps to reduce risk of depositor (or other creditor) runs by the psychological effect of them providing a larger buffer to absorb losses. But that could also be achieved by simply requiring higher levels of equity, and avoiding the question of whether a bail-in will work when it is implemented.

Problems with bail-in bonds

One reason for doubting the robustness of the bail-in approach is found by asking what happens when a bail-in occurs? The total capital (equity plus bail-in securities) ratio of the bank won’t be changed, just its composition.

So, the bank will likely need to issue new securities to increase its capital ratio - and what investors would want to subscribe to a new issue by a bank which has just been seen to be in difficulty? And larger depositors not covered by the Financial Claims Scheme will likely think it prudent to move their funds elsewhere.

Bail-in is meant, in theory, to enable the bank to continue operations, but in practice is more likely to sound the death-knell of the bank.

Other issues

There are further complications in the specific Australian situation. AT1 securities generally pay franked dividends, and have hence been attractive to Australian retail investors, and unattractive to foreign investors who do not value the franking credits. The foreigners prefer the AT2 securities which pay unfranked distributions.

It is difficult (impossible) to imagine John Lonsdale (CEO of APRA) not consulting the Australian Treasurer before doing a bail-in of a bank's AT1 securities. And it is even more difficult to imagine the Treasurer being willing to have Australian retail investor holders of AT1 securities being bailed-in while foreign investors holding Tier 2 hybrids are not bailed in. The politics would prevent the bail-in regime from operating in the way it is designed to.

One way to overcome that problem might be to preclude retail investors from the AT1 market. The introduction of Design and Distribution Obligations (DDOs) powers to ASIC has meant that retail investors are no longer generally able to participate in new issues of AT1's. But, paradoxically, once issued, the AT1's trade on the ASX and so are available to retail investors.

Given the difficulties in pricing the bail-in risk of these complex AT1 securities, and thus identifying their appropriate yield, it is also paradoxical that they should be available to retail investors who really cannot evaluate the risks. If nothing else, legislation to prevent AT1 securities from paying franked distributions could be expected to diminish retail investor interest.

There are numerous other problems with the bail-in approach – most particularly that it is unlikely to work! But the fundamental question which should be asked is why require these complicated bail-in securities as part of the bank's capital base rather than simply having a higher required level of common equity. It is by no means apparent that replacing bail-in securities with common equity would substantially increase the overall cost of bank funding.

Kevin Davis is Emeritus Professor of Finance at The University of Melbourne.

Cash underperforms when rates peak

Winnie Kwan

As we approach the end of 2023, a 'new normal' has emerged for investors in global equities.

Firstly, the era of quantitative easing is firmly behind us and investors need to adjust to a new environment of higher interest rates across developed markets. Further, despite its popularity, history tells us that "T-bill and chill" might not be the best approach to employ when interest rates peak.

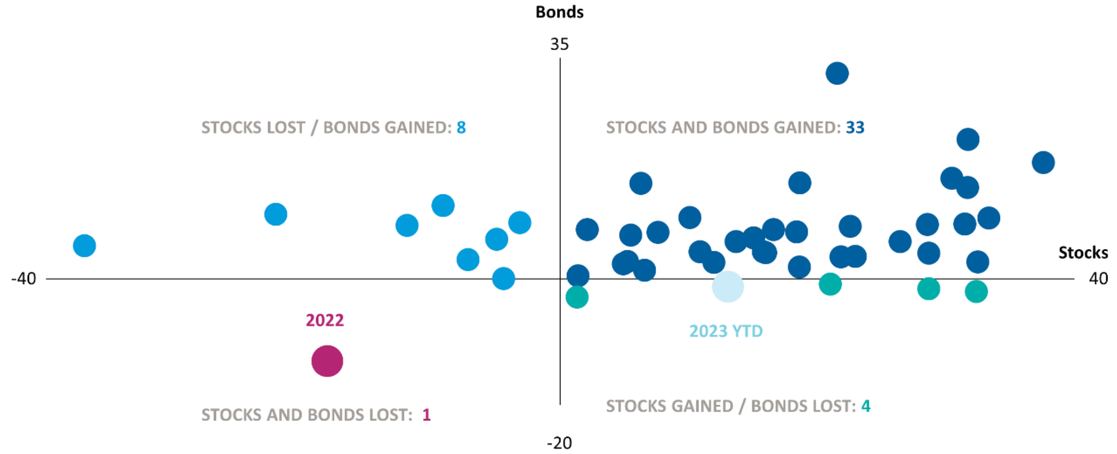
And while equity markets have had a strong year driven by the 'Magnificent Seven' stocks, the rally might broaden to other sectors in 2024.

Heading into 2024

The key word for me is normalisation. We are entering an investment environment where inflation and interest rates are likely to be more normalised. The era of quantitative easing (QE) is over, and we need to start getting used to seeing real interest rates in developed markets sit between 1% to 2%, higher than levels many have been accustomed to for over a decade.

Another aspect that is normalising is the relationship between equities and fixed income. Looking at historical data, the two asset classes generated positive returns alongside one another in 33 of the past 46 years (as the following chart shows). The only year when the exact opposite happened was in 2022. But given how they have been performing in 2023, it seems that we are returning to a more normalised relationship between both asset classes.

US markets are normalising after breaking down in 2022
Distribution of stock and bond returns (%), 1977-2023



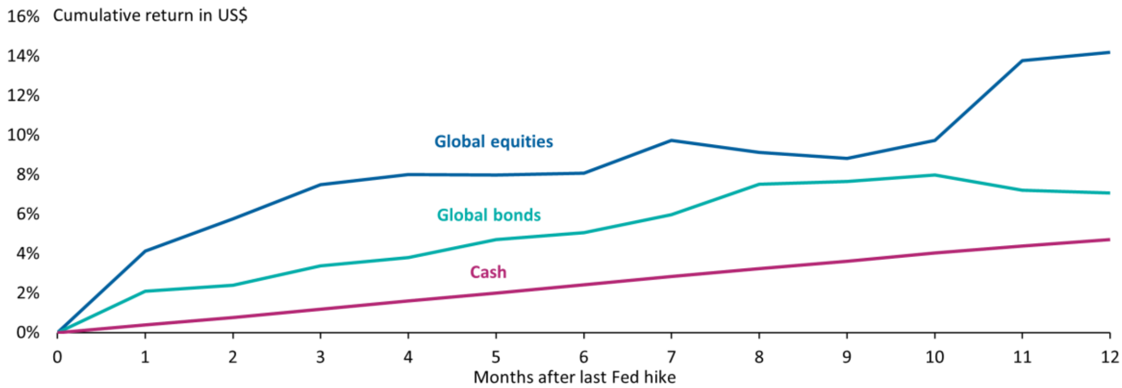
Sources: Capital Group, Bloomberg Index Services Ltd., Standard & Poor's. Returns above reflect annual total returns for the S&P 500 ("stock returns", depicted on the x-axis) and the Bloomberg U.S. Aggregate index ("bond returns", depicted on the y-axis) for each year between 1977 - September 2023. As of 30 September 2023.

Cash underperforms after rates peak

There is loads of cash on the side lines with around US$5.6 trillion invested in money market assets as at end-September 2023. Cash has been generating nice returns given rising interest rates across developed markets. But when the amount of cash hits such an unprecedented level, it's often a sign that investors ought to be thinking about diversifying their investments.

Investment professionals at Capital Group like to study history because even though none of us can predict the future, we can learn from past data and obtain clues as to how markets could potentially fare. If we look at the previous four hiking cycles in the US (from 1977 to 2023), global equities generated an average cumulative return of 14% in the 12 months following the last US Federal Reserve (Fed) interest rate hike. Cash only generated a return of 4.5% while fixed income finds itself somewhere in between the two. If history were to repeat itself, money market fund yields would decline once rates peak, and investors would be better served by diversifying into stocks and bonds.

Equities and fixed income have outpaced cash after rate peaks



As at 30 September 2023. Returns reflect the average cumulative return in US$ terms over each of the first 12 months immediately following the last increase in the target US Federal Funds Rate ("last Fed hike") over the prior four hiking cycles. The specific ending months for the periods included in the average calculations are: February 1995, May 2000, June 2006, and December 2018. Global equities are represented by the MSCI ACWI (with net dividends reinvested). Global Bonds are represented by the Bloomberg Global Aggregate Total Return index. Cash is represented by the Bloomberg US Treasury Bills 1-3 months total return index. Fed: US Federal Reserve. Sources: Capital Group, FactSet

Equities

The S&P 500 has had a strong run in 2023 (year-to-date returns of 14.6%[1]) but a lot of that was driven by the 'Magnificent Seven' – Alphabet, Amazon, Apple, Meta Platforms, NVIDIA and Tesla. If we look outside of these seven companies, valuations are considered fairly normal. In fact, some sectors are down for the year because the US economy is in the midst of a rolling recession where different sectors are undergoing downturns at different times.

US residential housing, for instance, contracted sharply in 2022 after the Fed started aggressively raising interest rates. Now it looks like the housing market is starting to recover while other parts of the property market, such as commercial real estate, remains in a downturn.

Likewise, the semiconductor industry was plagued by supply chain concerns and lower demand for chips in 2022. That sent semiconductor stocks plummeting. The environment has stabilised in 2023, with demand returning and semiconductor stocks becoming one of the driving forces in global equity markets.

The chemicals industry is also showing signs of inventory bottoming and a similar situation is playing out in certain segments of the industrials sector. So, the key message is that equities still have a lot to offer and investors who have been on the side lines so far can still benefit from investing in the asset class.

Areas to focus on

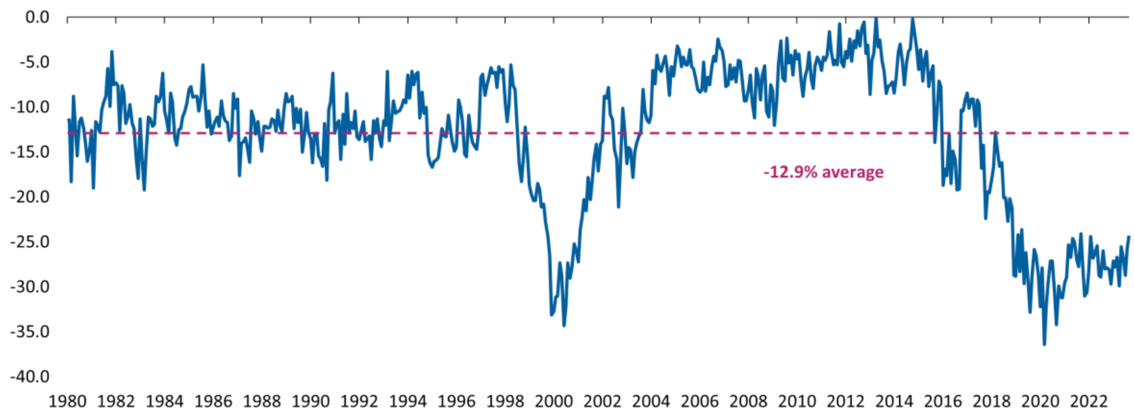
One area that I am keen to highlight is dividend stocks. Dividend-paying stocks acted as a cushion to offset some of the downside in 2022 but have lagged the broader market in 2023. Some of the underperformance is justifiable because long-end US Treasuries have been yielding higher, which have hurt the performance of many bond proxy[2] stocks.

But there are certain parts of dividend land that I feel have been unduly punished. This includes dividend growers or stocks that consistently pay and grow the dividends. Capital Group's analysis shows that dividend growers are typically higher quality companies with better capital allocation. This is because dividend growers typically generate earnings growth and free cash flow that back dividend growth. As a result, these stocks tend to be lower volatility investments that have a higher chance of doing better than the underlying market. Given how many of these companies have been negatively impacted by the wider dividend stocks decline, dividend growers are certainly an interesting area to look for opportunities heading into 2024.

What this also means is the potential broadening of the current equity market rally. History tells us that narrow market rallies coming out a recession have often been followed by steady gains for the broader market, which means opportunities outside of the magnificent seven.

In terms of sectors, I have been doing work with our analysts in the industrials, health care and energy sectors. The combination of low valuations and supply constraints has created several attractive opportunities across US and European energy companies. The US medical technology industry is also interesting because of its derating in 2023 despite continued innovation.

Large opportunity set remains in dividend-paying stocks
P/E ratio of high dividend stocks vs. S&P 500 Index (%)



Data as at 30 September 2023. P/E ratio = price-to-earnings ratio. Source: Goldman Sachs

Innovative new technologies, especially artificial intelligence (AI)

Capital Group is of the view that innovation is critical to successful long-term investments. Innovation drives growth and enhances productivity. And better productivity could help cap inflation. Our investment professionals continue to conduct research around AI and the conclusion, so far, is this is going to be a big deal.

We are starting to see many companies globally adopt generative AI to accelerate their digital transformation (DX) and drive productivity gains by improving on existing work processes.

An example of this is a Europe-based multinational drinks and liquor company. The company spent five years transforming its operational data into a machine-readable, digital format. And through the use of generative AI, it has been able to build on the data by instantly analysing on-premise and off-premise sales data. That, in turn, enables the company to attain real-time feedback on how much inventory is required to go into a particular outlet or restaurant. The end result? With the same budget, it is now able to conduct 15 brand marketing campaigns concurrently as opposed to just five in the past.

Recently, I also met with the Chief Technology Officer (CTO) of an Asia-based insurance company to discuss their DX journey. The insurer has developed a direct-to-consumer app, which is effectively a one-stop portal for the company to engage in customer acquisitions and KYC (know-your-customers) processes as well as for customers to reallocate their portfolios and even submit claims. The central cog to the platform is the incorporation of a Gen AI co-pilot[3] that enables interactive as well as iterative learnings. One important question asked during the meeting was how did the CTO managed to convince stakeholders to invest in these tech initiatives? His answer was: the hurdle rate for their technology investments is 20% and the return is reflected in relatively flat operating costs while insurance premiums are growing at the low double digits. So even though AI is still at an early stage of development, companies are already seeing considerable benefits incorporating the technology into their operations.

1. *Data as at 8 November 2023. Source: S&P*
2. *Refers to stocks with stable cashflows and therefore dividends. The defensive qualities of these stocks tend to generate safe and predictable returns that are similar to bonds*
3. *Refers to a conversational interface that uses large language models to support users in various tasks. It effectively provides AI assistance in every aspect of an application’s workflow.*

Winnie Kwan is an Equity Portfolio Manager at Capital Group Australia, a sponsor of Firstlinks. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

For more articles and papers from Capital Group, click here.

Podcast: US recession risks and a simple wealth-creating strategy

James Gruber

Season 2, Episode 14

Richard Rauch, Investment Director at Brandywine Global, gives a fascinating tour of the global economic landscape. He says economic normalisation post Covid is almost done, the inflation scare is over and there's even the possibility of deflation happening in the US in future. Rauch believes that as the economic cycle extends, the odds are increasing that the US, and the world, has a hard economic landing.

Duncan Burns, Asia Pacific CIO at Vanguard, says investors are too hung up on beating the marketing and sticking to a simple, long-term strategy can deliver hassle-free, excellent results. He describes how to allocate assets to deliver such results and the key traps to avoid.

Finally, regular guest, Peter Warnes from Morningstar's Your Money Weekly, gives us his outlook for the Australian market and economy next year.

The podcast is also available via our dedicated website page, Google Podcasts, Apple Podcasts, Spotify, and BuzzSprout.

Please share with friends and colleagues, and a favourable rating would help spread the word. We welcome questions and suggestions at firstlinks@morningstar.com.

Grab a cuppa and settle in for our chat.