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Editorial

I love looking back through history as it can provide context to the present, and perhaps a glimpse into the future.

Records of financial history in Australia are generally poor. However, I recently stumbled across data from the now defunct database of the Australian Centre for Financial Studies. It shows the top 10 listed companies in Australia dating back almost 80 years.

Here are the top 10 stocks in 1948.

The largest ASX stock today, BHP, was the number one by market capitalization back then too. CSR was a giant sugar company in 1948 and its star has faded since. Meanwhile, there were plenty of banks on the list, which would later merge, or get acquired, to form bigger companies. Likewise for the miners. I hadn't heard of ACI International, though apparently it was a manufacturer of bottles and glassware until eventually closing in 1982.

May 1948

Company	Market cap ($m)
BHP	81.9
CSR	70.2
Bank of New South Wales	46.2
ACI International	34.2
North Broken Hill	30.6
Australasia Bank	25.7
MIM	20.5
New Broken Hill Corp	19.2
Commercial Banking Co of Sydney	19
National Australia Bank	18.8

Notice that nine of the top 10 companies back then were in banking and resources.

Let's go forward a decade to the top 10 companies in 1958.

BHP made big gains during the 1950s. Coles had its first appearance as the second largest stock on the exchange. EZ Industries was a zinc miner and refiner that closed in 1984. Industrial Acceptance Corp later became a subsidiary to US banking giant, Citi. The brewer, Tooth and Company, was eventually delisted in 2010.

May 1958

Company	Market cap ($m)
BHP	265.4
Coles Group	108.4
CSR	93.5
MIM	78.8
Bank of New South Wales	78.5
EZ Industries	70.3
ACI International	70.2
Consolidated Zinc	64.1
Industrial Acceptance Corp	64
Tooth & Company	58.5

A decade later, the market caps of the miners exploded as the 1960s witnessed a commodities mania. Myer made its appearance in the top 10, as did Ampol.

May 1968

Company	Market cap ($m)
BHP	3,049.10
North Broken Hill	1,583.40
Conzinc Rio Tinto	1,489.50
Hamersley	1,250.00
MIM	748.9
Western Mining Corp	660.2
CSR	362.7
Myer Emporium	294.7
New Broken Hill Corp	235.8
Ampol	196.3

By 1978, you can see that the market caps of the miners had shrunk considerably after the 1960s mining boom deflated. ANZ made its first appearance in the top 10 after the merger of Australasia Bank and Union Bank of Australia. And Coles snuck back onto the list.

May 1978

Company	Market cap ($m)
BHP	1,558.50
Conzinc Rio Tinto	826.6
MIM	643.3
Hamersley	567.6
Bank of New South Wales	404.3
CSR	379.2
Australian Guarantee	325.5
ANZ Banking Group	324.5
National Australia Bank	305.4
Coles Group	290.9

By 1988, BHP had a massive decade, growing to be almost twice as big as second placed Westpac. All of the top 10 then had market caps in the billions of dollars. And Elders, Origin, News Corp, and Alumina appeared on the list.

May 1988

Company	Market cap ($m)
BHP	13,488.20
Westpac Banking	7,335.10
Alumina	4,884.50
Conzinc Rio Tinto	4,735.50
National Australia Bank	4,557.10
Elder Smith Goldsbrough	4,516.10
ANZ Banking Group	3,903.20
Origin Energy (Ex Boral)	3,449.90
Coles Group	3,309.00
News Corp 'B' (Lon)	3,062.90

Wow – by 1998, Telstra was number one, thanks to the Internet boom. NAB leaped into second spot after a string of acquisitions, though that all came undone a few years later. BHP dropped to third place. Yet, it’s apparent by now that the banks and miners have bulked up through acquisitions to consolidate and become much bigger entities. Meanwhile, Amatil and Lend Lease entered the top 10.

May 1998

Company	Market cap ($m)
Telstra	48,378.40
National Australia Bank	32,056.30
BHP	28,218.10
Westpac Banking	20,305.60
ANZ Banking Group	17,457.20
Commonwealth Bank of Australia	17,346.00
Rio Tinto	12,363.10
Amatil	11,708.30
Lend Lease Group	8,558.90
Coles Group	8,276.10

A decade later, and just before the GFC, BHP regained first place. China's entry into the WTO in 2001 and subsequent rise sparked a commodities bull market for the ages, and BHP and Rio were key beneficiaries. Consolidation took place in the banking sector though the banks would run into a wall months after this as the world's financial system teetered. Telstra dropped from first place to fifth as the Internet mania faded and the business had poor management at the helm.

May 2008

Company	Market cap ($m)
BHP Billiton	145,989.50
Rio Tinto	63,040.60
Commonwealth Bank of Australia	56,123.10
National Australia Bank	53,778.30
Telstra	49,262.70
Woodside Petroleum	44,741.50
ANZ Banking Group	44,241.10
Westpac Banking	44,042.10
Woolworths	33,851.00
Westfield Group	33,244.40

Westfield made the list for the first time after Frank Lowy worked his magic and Australia enjoyed a property bonanza.

Let's fast forward more than 15 years to the top 10 stocks on the ASX today.

The makeup of the top 10 looks quite different today. Healthcare giant, CSL, is the third largest ASX stocks. Fortescue has grown rapidly to the sixth largest sock. Wesfarmers makes its first appearance, as does industrial property behemoth, Goodman Group.

All up, the different lists show the rise and fall of different industries. Once, manufacturing and agriculture were prominent, but no more. Recently, healthcare and services including retail have become more important.

The lists also reveal that many of the top companies haven't disappeared – they either merged or were acquired. This is confirmed by an RBA study in 2019 which shows that 6 of the top 10 companies back in 1917 are still around today, albeit under different guises.

Company	Market cap (bn)
BHP	226
Commonwealth Bank	188
CSL	133
NAB	103
Westpac	90
ANZ	86
Fortescue	77
Wesfarmers	74
Macquarie	71
Goodman Group	59

Source: Morningstar

Table 3: Largest 10 Listed Companies by Market Capitalisation in 1917

Company name		Market Capitalisation Rank		Notes
1917	2019[(a)]	1917 Sydney Stock Exchange	2019 ASX[(a)]	
Bank of New South Wales	Westpac	1	3	Merged with Commercial Bank of Australia in 1982 to form Westpac
British Tobacco	British American Tobacco	2	na	Delisted from ASX in 2001 following acquisition; British American Tobacco currently listed in the United Kingdom
Bank of Australasia	ANZ	3	5	Merged with Union of Australia Bank in 1951 to become ANZ
Union of Australia Bank	ANZ	4	5	See above
Colonial Sugar Refining Co.	CSR	5	139	Sold its sugar refining operations in 2010, now produces building products
Commercial Bank of Sydney	NAB	6	6	Merged with National Bank of Australasia to become NAB in 1982
Broken Hill Proprietary	BHP Group	7	2	
Union Steam Ship Company of New Zealand	na	8	na	Acquired by P&O and later closed
Howard Smith	Wesfarmers	9	8	Acquired by Wesfarmers in 2001
Mount Lyell Mining Co.	Iluka Resources	10	89	Several rounds of acquisition and mergers in the interim

Note: (a) As at June 2019; if the company has been acquired or merged, this is the name/rank of the acquirer or new entity; see 'Notes'

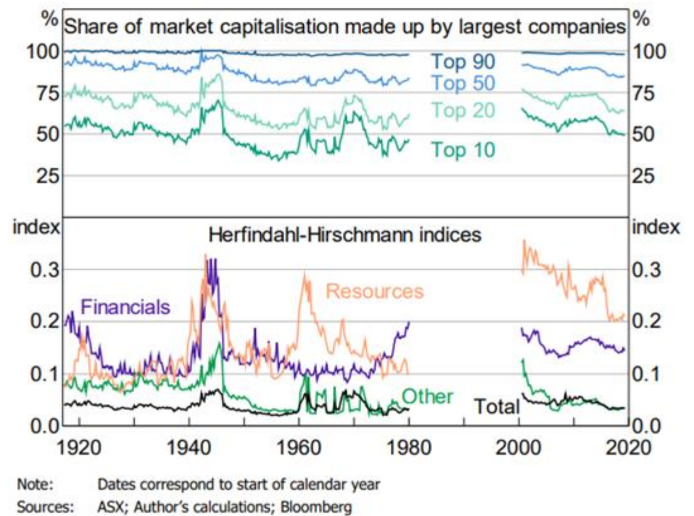
Sources: ASX; Author's calculations; Bloomberg; delisted.com.au; National Library of Australia

How concentrated is our market versus history?

There's been a lot of market talk about how concentrated the S&P 500 has become, with the top 10 stocks accounting for around 33% of the index.

In Australia, the concentration has always been greater.

This RBA chart shows that the top 10 stocks were almost 75% of the total exchange market capitalization in the 1940s. And they've also been as low as the early-to-mid 30% range. Today, the top 10 account for close to 47% of the total market cap, which is the lowest in several decades.

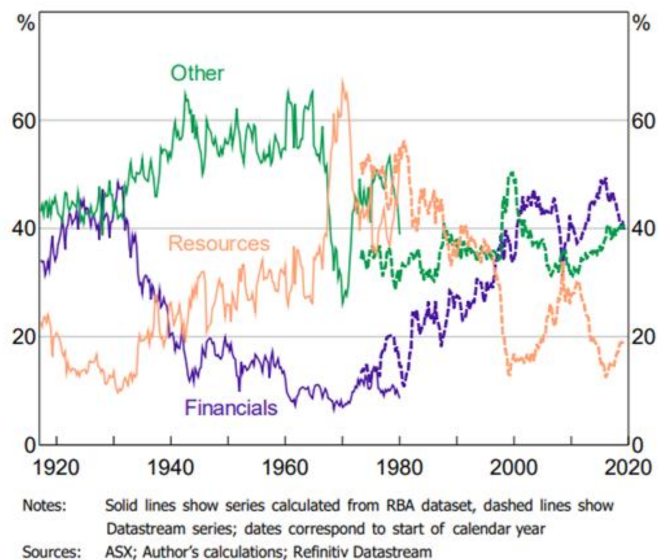


Sector breakdown through history

We all know that banks and miners play a big part in our market, though how much influence do they have versus history?

The RBA study mentioned above has this next chart. Note that it references market capitalisation by sector rather than the more common market weighting by sector (which is different). Nevertheless, it shows that resources were once 65% of the index, and that's declined to close to 20%. Meantime, financials are back close to 40%, where they were back in the 1920s, though they subsequently fell to single digits in the 60s' when mining stocks went ballistic.

You'll see that the 'other' category is ticking up again, and that's mostly composed of industrials, which include healthcare, retail, infrastructure, and so on. These sectors seem to have tailwinds that suggest they'll become an even greater part of the index in future and reduce our concentration in the banks and miners.



In my article this week, I provide a sequel to my previous article, 16 ASX stocks to buy and hold forever. This time, I look at the best US stocks to own indefinitely. The list includes well-known companies such as Microsoft, Coca-Cola, and Visa, but also lesser lights like Northrop Grumman, Fair Isaac, and Union Pacific.

James Gruber

Also in this week's edition...

Dimitri Burshtein has a ripping story on how the $3 million super tax ensnares retired, and soon to retire, public servants and politicians who are members of defined benefit superannuation schemes. They're not happy about it and are furiously lobbying for exemptions from the new tax.

Michael Matusik writes of how baby boomers will account for a third of population growth between 2024 and 2029, making this generation the biggest age-related growth sector over this period. And this means that boomers will shape the property market with their unique needs.

Meg Heffron is back to look at what a surviving spouse must think about when a member of an SMSF dies. A little morbid, I know, yet it pays to know what needs to be done immediately, and later on. Meg gives a guide on all that you need to know.

Small cap stocks have only just started to outperform their larger counterparts, after trailing for the best part of 15 years. **Roger Montgomery** says he was early with his call in May last year for small caps to outperform, yet he believes the investment case has only strengthened since then.

Paul Tilley returns with Part 2 of his series on the mixed fortunes of Australia's tax reform efforts since Federation. Last week, he detailed the history of the tax system and the issues it now confronts. This week, Paul looks at Australia's main tax reviews and examines the key ingredients that make a tax reform exercise work, or not.

What impact will AI have on investing? **RQI Investors' Dr. David Walsh** outlines how investors, advisors and investment managers can better prepare to manage the opportunities and risks that come with AI.

Lastly, in this week's whitepaper, **Franklin Templeton** investigates what the last mile of inflation will look like, and the implications for fixed income.

20 US stocks to buy and hold forever

James Gruber

In a recent article, I compiled a list of 16 ASX stocks that you could buy and hold forever. The idea for the article came from Warren Buffett's shareholder letter this year, where he identified Occidental Petroleum and five large Japanese conglomerates - Itochu, Marubeni, Mitsubishi, Mitsui, and Sumitomo – as companies that he expects Berkshire Hathaway will own indefinitely.

In the letter, Buffett wrote: "When you find a truly wonderful business, stick with it … Patience pays, and one wonderful business can offset the many mediocre decisions that are inevitable."

Given that more of our readers are looking to invest overseas, I thought it would be worth a follow-up article on US stocks that you could potentially buy and own forever.

The criteria

The US market in massive. The ASX has around 2,200 listed companies, which is similar to the New York Stock Exchange (NYSE). Yet, there are also almost 4,000 companies listed on the NASDAQ, albeit there are stocks listed on both the NSYE and NASDAQ.

The larger number of companies listed in the US presents both opportunities and challenges. The opportunities are that there are so many stocks to choose from, and they often operate in large, attractive markets, not only in the US, but often internationally. The challenges involve filtering through the stocks to try to identify the best ones to own forever.

The filtering process isn't straightforward. First, you need to be supremely confident that a company can last a long time, if not indefinitely. That's no easy task given the average company listed on the S&P 500 has a lifespan of close to 20 years. Second, you not only want companies that can stand the test of time but that will deliver returns at least in line or better than the indices. If they can't achieve that, then there's not much point in owning them.

Here's the criteria that I've come with to find the top US stocks to buy and hold forever:

1. In the S&P 500. Ideally, you want to own well-established firms that have some history of success. Funnily enough, there are 503 stocks currently in the S&P 500, as several companies have two share classes. The company with the smallest weight in the index is one of our own, News Corporation Class B shares, with a market capitalization of US$14.2 billion. That type of market cap is large in Australia, though less so in the US.

2. Long runway of growth opportunities. This is critical. It means excluding many companies that operate in mature industries and/or restricted geographies. It also cuts out businesses with short-lived assets. Think of materials and energy companies with mines and oilfields that have finite lives. Or

pharmaceutical companies that rely on a limited number of drugs with patent or exclusivity expirations. This criterion favours companies with global operations and large, untapped opportunities.

3. Economic moats. Moats are sustainable competitive advantages. They help companies defy the laws of capitalism which suggest that businesses with high returns of capital will have these returns competed away. Competitive edges can come from many things including network effects, intangible assets, cost advantages, switching costs, or efficient scale. You can find out more about moats here.

4. Good returns on capital. High returns on capital usually denote a quality company. In simple terms, return on capital is the profit that a company generates from the equity and debt that's put into the business.

5. Solid balance sheets. Excessive debt makes companies fragile. You want to own companies that don't rely on too much debt to generate returns.

6. Don't need exceptional managers. Having good managers certainly helps. But if you're going to own a stock for a long time, it can't be reliant on one or two managers to succeed. The business needs to be so good that it doesn't need an exceptional CEO. Or, put another way, the business needs to be so good that a bad manager will have a hard time messing things up.

7. Disruption resistant. This overlaps with other criteria 2 and 3, but it's worth adding. When you buy a company for the long term, you are essentially betting on things that won't change. This is especially important with the rise of AI or other technology.

The buy and hold forever list

Here is the list of US stocks.

Company	Code	Market cap (bn)	Industry
Altria	MO	70	Tobacco
Automatic Data Processing	ADP	100	Staffing and employment
CME Group	CME	74	Financial data
Coca-Cola	KO	251	Beverages
CSX Corporation	CSX	69	Railroads
Deere & Co	DE	110	Farm and heavy constructio
Fair Isaac	FICO	29	Software - application
Intercontinental Exchange	ICE	75	Financial data
Lockheed Martin	LMT	109	Aerospace and defence
Mastercard	MA	429	Credit Services
Microsoft	MSFT	3,073	Software - infrastructure
Moody's	MCO	68	Financial data
Norfolk Southern	NSC	55	Railroads
Northrop Grumman	NOC	67	Aerospace and defence
NVR	NVR	25	Residential construction
Philip Morris International	PM	138	Tobacco
S&P Global	SPGI	131	Financial data
Union Pacific	UNP	143	Railroads
Visa	V	549	Credit services
Waste Management	WM	82	Waste management

Source: Morningstar, Firstlinks

Let's go through the companies, one-by-one:

Altria (NYSE:MO)

Nothing like a controversial tobacco stock to begin the list. It will surprise many investors that the tobacco sector has been the best performing sector in the US over the past 100 years. How can this be, given the decline in the number of smokers and continued increase in taxes on tobacco companies? These taxes, along with bans on tobacco advertising, have created formidable barriers to entry for competitors. Combined with industry consolidation, it's resulted in significant and enduring pricing power for the existing players. Altria is the leading tobacco company in the US.

Automatic Data Processing (NYSE:ADP)

Many of you would have encountered ADP via the payroll and human resource products that it provides to companies. These products are critical to their customers, and they become embedded in company operations. That customer 'stickiness' underpins ADP's moat. Increasing regulatory complexity and the rise of hybrid work should help drive growth in the long-term.

CME Group (NYSE:CME)

Stock exchanges are wonderful businesses as they essentially act as venues to facilitate transactions and take a share of the action without the heavy capital investment, financial leverage, or operating risk that their customers take on. CME owns the dominant exchanges for interest rate futures and WTI oil futures. The low volatility of the past 15 years hasn't favoured CME, though that's starting to change and should provide a tailwind in the decade ahead.

Coca-Cola (NYSE:KO)

Coca-Cola has undergone a transformation over the past ten years or so, moving towards a fully franchised, capital light business that has widened its moat and offers the opportunity for renewed growth. They remain the global leader in soft drinks, and with consistent volume growth, pricing power, and reduced costs thanks to better management, the future looks bright.

CSX Corporation (NYSE:CSX)

Railroads in the US are brilliant businesses. For heavy grains, commodities, steel, and anything that requires a lot of capacity to be hauled over a long distance, rail is the only suitable transport option. That means companies such as CSX have a captive audience. Add in a highly consolidated industry, and railroad companies have little trouble raising prices and earning nice returns. Four companies control almost the entire industry in the US, and CSX is one of them.

Deere & Co (NYSE:DE)

Deere is the leader in agricultural machinery and one of the leaders in construction machinery. Farmers have relied on their tractors and other products for more than 150 years. While the agricultural industry is cyclical, suppliers to the industry have less cyclicality. The construction arm also has growth opportunities from the US$1.2 trillion infrastructure deal in the US.

Fair Isaac Corporation (NYSE:FICO)

Fair Isaac is the industry leader in credit scores. These scores are essential in the US as they are used as benchmarks for investors, lenders and the like. Their prevalence makes them almost impossible to displace. Fair Isaac only started raising prices in earnest about five years ago, and it should be able to continue with that for many years and deliver fantastic returns for shareholders.

Intercontinental Exchange (NYSE:ICE)

With CME, I described why stock exchanges are wonderful businesses. Intercontinental Exchange owns the grandad of exchanges, the New York Stock Exchange. It's also the dominant futures exchange for global energy contracts. Lastly, the company has been building out a mortgage data business that also seems promising.

Lockheed Martin (NYSE:LMT)

History would suggest that it's highly unlikely that the relative world peace of the past 30 years will continue for the next 30. And it would also suggest that the US will need to fend off competitors to maintain its global dominance. If right, the handful of trusted defence contractors that the US government uses are likely to be big winners. Lockheed Martin is one the largest of these contractors. The best thing is that even if peace ensues, the company should continue to deliver satisfactory returns.

Mastercard (NYSE:MA)

Mastercard and Visa dominate electronic payments. Amazingly, global digital payments only surpassed cash payments a few years ago, and the continued shift to digital should ensure continued growth for decades to come. Also, these businesses benefit from a so-called network effect, where the more consumers that are plugged into a payment network, the more attractive that payment network becomes for merchants, which, in turn, makes the network more convenient for consumers. That's allowed Mastercard to report net profit margins of close to 45% and returns on equity of 169%!

Microsoft (NASDAQ:MSFT)

The largest company on the S&P 500 is also one of the best. Microsoft Office is a money-making machine that's essential for corporates and individuals alike. The business also owns LinkedIn, the pre-eminent online recruitment site. Microsoft also has a rapidly growing cloud segment via Azure. And, finally, there's its leadership in AI. Combined, the company has a suite of incredible, mission critical businesses that have long runways for growth.

Moody's Corp (NYSE:MCO)

Moody's is the market leader in credit ratings for bonds. These ratings are essential for capital market players, index providers, and regulators. Moody's and S&P Global dominate the industry, and that's led to pricing power which, combined with capital light businesses, have resulted in spectacular returns on capital over a long period of time. It's difficult to see this changing any time soon.

Norfolk Southern (NYSE:NSC)

With CSX above, I outlined why US railroads are some of my favourite businesses. Norfolk Southern is one of the other four companies that collectively have 90% market share. Price increases and cost control should result in Norfolk Southern delivering high single digit earnings growth for the next 10-20 years.

Northrop Grumman (NYSE:NOC)

I explained with Lockheed Martin above why defence companies in the US have a long, bright future. Northrop is another defence contractor, though it's more focused on producing hardware for classified programs. The US Government relies on trusted partners like Northrop to deliver their military needs and that keeps any potential competition at bay.

NVR Inc (NYSE:NVR)

Including a homebuilder here may seem odd. After all, homebuilding is notoriously vulnerable to economic and housing downturns, and it normally requires heavy investment to boot. Yet, NVR revolutionized the industry with an investment light model that optioned land for development, and though competitors are trying to copy the company's strategy, they haven't quite caught up. NVR has delivered some of the best returns of any US stock over the past 30 years, and I think it will perform well going forward.

Philip Morris International (NYSE:PM)

I outlined the case for tobacco companies with Altria. Philip Morris is an international tobacco producer with leading brands such as Marlboro and Parliament. The company is diversifying away from tobacco to less harmful heatsticks, which are also highly profitable.

S&P Global (NYSE:SPGI)

S&P Global is the second largest player in bond credit ratings. I detailed why these ratings make for fine businesses in my summary of Moody's. S&P Global also has other businesses including indices, such as the S&P 500, and market intelligence and insights with well-known companies such as Platts and IHS Markit. Most of these businesses provide recurring income with high margins.

Union Pacific (NYSE:UNP)

Union Pacific is one of the four railroad behemoths that control 90% of the industry in the US. Railroads are great businesses, as I detailed in my summary on Norfolk Southern. The primary risk for these businesses is from increased government regulation, should profits be deemed anti-competitive.

Visa (NYSE:V)

Visa is the global leader in electronic payments. It and Mastercard dominate the space and the growth from more cash payments turning digital, especially in emerging markets, seems assured. Visa has incredible net profit margins of 53% and its return on equity exceeds 46%. It's a powerhouse.

Waste Management (NYSE:WM)

The waste management industry may seem boring though it's anything but. Waste Management, the company, is number one in the US for waste collection and disposal. The beauty of its business is in its ownership of landfills. Constructing new landfills is extremely difficult given government regulations and the 'Not in My

Backyard' (NIMBY) effect. It puts current owners of landfills in a powerful position, and that power means they can charge healthy prices.

What didn't make the list

Often there's more debate about what doesn't make a list than what does. Let's run through some of the companies that didn't make the cut:

a) 6 of the Magnificent 7. Microsoft is the only member of the Magnificent 7 that made the list. Telsa didn't because it's facing increasing competition in EVs and has a limited moat to protect against itself against that competition. Apple's sales have flatlined for some time now, indicative of a company that's maturing. Nvidia will also face extensive competition in semiconductors and its sheer size will also make growth hard to come by in the long-term. Meta has Facebook, which is a dying app (ask anyone under 16 if they use it, and you'll get strange looks) and is reliant on investments in AI and the Metaverse to deliver future growth. Alphabet's search dominance is under threat from AI, and it hasn't done enough with AI to starve off that threat. Finally, Amazon is primarily reliant on cloud services, as its retail business doesn't make much money, and I can't tell what the cloud industry will be like in five years, let alone 50+ years.

b) Banks. No banks made it onto the list. Investment banks have limited moats, are cyclical, and have historically delivered subpar returns. Retail banks in the US, unlike Australia, operate in a ferociously competitive environment, which makes decent returns hard to come by. I considered the largest retail bank, Bank of America, for the list but it didn't stack up against other contenders.

c) Pharmaceutical companies. The likes of Eli Lilly and Novo Nordisk have been spectacular market performers of late, and many other pharmaceutical companies have also delivered fantastic long-term returns. Why didn't any of them make the list, then? Branded drugs have limited exclusivity periods before generic competition can enter the fray. These companies are then reliant on investment in future drugs for revenue growth. The issue is that it's difficult to pick which drugs will be the next big thing. And that makes it almost impossible to forecast the long-term earnings growth for the pharmaceutical companies.

d) Mining and energy companies. Mining and energy are cyclical and capital intensive, which invariable make for poor long-term returns.

e) Property. Real estate is capital intensive, cyclical, and often reliant on equity markets to fund growth. Infrastructure companies are more interesting, as they are less cyclical and have some serious tailwinds from the US Inflation Reduction Act, however there are few moats among stocks in this space.

A final word

It's worth noting that the list isn't a buy *now* and hold forever one. Instead, it's meant to be a wishlist of stocks to own in the future when the price is right. In other words, I didn't take valuations into account when compiling this list.

The list also doesn't take into consideration your personal financial needs. As always, please seek financial advice if needed.

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

The public servants demanding $3m super tax exemption

Dimitri Burshtein

All Australians are equal. But when it comes to superannuation and tax, some Australians are more equal than others.

The super honeypot

Given its near $4 trillion size and relative immobility, superannuation has long been seen as a taxation honeypot for government and Treasury. It should thus have not surprised when in February 2023, Prime Minister Albanese and Treasurer Chalmers announced that from 1 July 2025, the tax rate on superannuation earnings for those with balances over $3 million would double to 30%.

This superannuation tax increase neatly followed the breadcrumb trail left by Treasury.

Treasury regularly produces a Tax Expenditures Statement which calculates the tax revenue 'lost' to the budget from taxes being charged below a benchmark. This report is as much a perversion of language as it is of accounting whereby taxes not collected are defined as (tax) expenditures.

In the 2023 edition of this statement, released not uncoincidentally on the very same day as Albanese's and Chalmers' tax increase announcement, Treasury indicated that because superannuation contributions and superannuation earnings are not charged at the marginal tax rate, the budget suffers a revenue loss, a (tax) expenditure, of $45 billion per annum.

It is no wonder that Australians are paying record amounts of tax when Treasury seems focused not on productivity or efficient resource allocation, but rather revenue maximisation. It is indicative of the cognitive mindset of Treasury, or as well described elsewhere:

"*Treasury has become the department for revenue, with officials obsessed with finding new and novel ways to increase revenue as well as milking existing means*."

One can only imagine conversations with the ATO were businesses to commence expensing revenues not collected in their tax returns.

When announcing this superannuation tax increase, Albanese said it would be "*irresponsible to not take any action whatsoever*". Apparently, it is more fiscally responsible to increase taxes rather than to address out of control government spending. This new tax is estimated to generate an additional $2 billion per annum once fully operational, but meanwhile the cost of the NDIS is expected to increase by $5 billion this year alone.

The super tax dragnet

Notwithstanding, it has now been reported that "*an unlikely coalition of public servants is making a last-ditch attempt to avoid being caught in the government's new super tax for high earners*." The Australian Council of Public Sector Retiree Organisations says its members should not come under the new tax. Similarly, retired judges are also seeking exemption.

If this *"unlikely coalition"* has not yet expanded to include retired politicians, give it a moment.

Unfortunately, and possibly unexpectedly for Albanese and Chalmers, this new tax dragnet will capture retired (and soon to retire) public servants and politicians who are members of defined benefit superannuation schemes. This includes Prime Minister Albanese himself having entered parliament before the 2004 close of the politician defined benefit scheme to new members.

Defined benefit superannuation is not like ordinary (defined contribution) superannuation where contributions and earnings determine your balance and how much is available in retirement. Defined benefit superannuation instead provides payments in retirement in amounts linked to final salary income. Payments to government financed defined benefit superannuants usually never run out as they can for ordinary superannuants. And in some cases, they are partially transferrable to a spouse upon death.

As a bonus, many defined benefit superannuation schemes are inflation indexed. With a hat tip to intergenerational equity, while retired public servant and politician defined benefit pensions were recently indexed by some 7%, so too were HECS-HELP debts by an equivalent amount.

Although the budgetary cost of superannuation tax incentives is frequently noted and quoted, the cost of defined benefit pensions is not. In 2024, the Commonwealth will be expensing more than $19 billion for Commonwealth defined benefit pensions. This is approximately two thirds of what is expensed on Medicare benefits.

A 2021 Commonwealth Superannuation Corporation analysis showed that there were 41,000 retired Commonwealth public servants receiving pensions of greater than $75,000 per annum. The average net present value of these accounts was $3.4 million suggesting this cohort would be captured under the Labor Government's new tax. Notably, this 41,000 excludes military, politician, judicial and Governors-General pensioners.

More interestingly, this calculation was prepared before recent inflation outcomes inferring higher average account values today. Should the government not index the $3 million tax threshold as has been suggested, increasing numbers of retired politicians and public servants will be captured.

Notably, many retired senior public servants and politicians who receive multi-hundred-thousand-dollar defined benefit pensions continue to work – as professional directors (on public and government boards), consultants (including to government), and as government lobbyists. This creates an interesting (mis)alignment of interests. When your government guaranteed and funded superannuation is perpetual and inflation indexed, there is limited downside to advocating for fiscally irresponsible and inflationary policies.

For yet-to-retire politicians and public servants who are members of defined benefit pension schemes, including Prime Minister Albanese and Opposition Leader Peter Dutton, under the proposed new tax law, if a tax liability is assessed, it will be deferred through what is effectively an interest-free loan. Such a luxury will not be afforded to already retired defined benefit superannuants nor to ordinary superannuants who may be required to sell assets to meet tax liabilities when tax has been assessed on unrealised gains.

How will it play out?

The government's response to public and private lobbying from defined benefit superannuants will be interesting to watch. Will the modern political demarcation line again be enlightened? The line that exists not between rich and poor or conservative and progressive but rather between insiders and outsiders.

Dimitri Burshtein is a principal at Eminence Advisory.

Baby Boomer housing needs

Michael Matusik

In Australia, baby boomers, born between 1946 and 1964, are shaping the housing landscape with their unique preferences.

Today, this cohort are between 60 and 78 years of age. There are over 4.1 million baby boomers in Australia, and this generation is expected to grow by 133,500 people per annum over the next five years.

If this happens, baby boomers will account for a third of Australia's population growth between 2024 and 2029, making this generation the biggest age-related growth sector over this period.

Australia: Growth in generations, 2024 to 2029

Generation	Total change	Annual change	% Growth
Generation Alpha	103,505	20,701	5%
Zoomers - Generation Z	422,608	84,522	21%
Millennials - Generation Y	541,043	108,209	26%
Generation X	133,939	26,788	7%
Baby Boomers	**667,366**	**133,473**	**33%**
Silent Generation	173,453	34,691	8%
Greatest or G.I. Generation	3,991	798	0%
Total population growth	**2,045,905**	**409,181**	**100%**

Matusik + ABS, medium population projections (Financial 2022 base)

Boomer's needs for housing

So, what does this generation want when it comes to housing?

As they transition into retirement or semi-retirement, many baby boomers are opting to downsize from larger family homes to more manageable properties.

This trend is driven by a desire to reduce expenses and simplify their lifestyles.

Age-friendly housing options are increasingly sought after, with features like single-level layouts and room to house visiting family and friends becoming essential.

This 'spare' room - given our polling over recent years - is best if it can play a multifunctional role (i.e., used as an office or escape space) and is somewhat distant from the rest of the home.

This can be achieved via a backyard home or dual occupancy arrangement. Also, when it comes to apartments and townhouses, this distance can be achieved by thoughtful layout and the provision of an ensuite.

Being able to lock-up this new home and travel is also of importance to many.

Proximity to amenities is crucial and healthcare services important, as baby boomers prioritise convenience and accessibility in their housing choices. While some opt for traditional retirement communities, many prefer mixed-age neighbourhoods that offer opportunities for social interaction and community engagement.

Location plays a significant role, with preferences leaning towards either very urban locales with cultural attractions or regional hubs with facilities plus natural beauty.

Financial considerations are paramount, with baby boomers aiming to maximize home equity and secure their long-term financial well-being. Downsizing allows them to free up funds for retirement savings or lifestyle pursuits, while options like reverse mortgages provide flexibility in accessing home equity.

Yet, as a general rule of thumb, baby boomers like to have at least 20% cash in their pockets when it comes to selling the family home and buying their downsizing residence.

Sometimes - well to be honest, often - downsizers cannot find value for money when it comes to selling their family home and securing a nearby smaller housing option. So a backyard home can also work, allowing them to move into this new smaller space and 'renting' out the main residence to their children or others.

Overall, baby boomers in Australia seek housing options that cater to their evolving needs, from downsizing to age-friendly features, proximity to amenities, and financial security. Understanding and addressing these preferences are central for meeting the housing needs of this demographic.

In summary baby boomers are after these housing related items:

1. **Age-in-place features**: Incorporate design elements such as single-level layouts, wider doorways, accessible bathrooms and functional to accommodate potential mobility issues and allow for aging in place. Also make sure there is room to house family and friends, via a spare bedroom plus ensuite.

   Again backyard homes and/or dual occupancy style housing is in high demand here.

2. **Low maintenance**: Offer housing options that require minimal upkeep, including features like manageable outdoor spaces, durable materials, and optional maintenance services.

3. **Community amenities**: Provide opportunities for social engagement and recreational activities within the community, such as clubhouse facilities, walking trails, and fitness centres, to support active lifestyles and foster a sense of community.

4. **Location and accessibility**: Offer housing options in walkable neighbourhoods with easy access to amenities such as grocery stores, restaurants, and public transportation, allowing for independent living and maintaining social connections.

5. **Proximity to healthcare**: Ensure convenient access to medical facilities, pharmacies, and healthcare services to meet the healthcare needs of aging residents.

Michael Matusik is an Australian housing market specialist, providing commissioned housing and demographic market reviews, updates and outlooks for over 30 years, and shares his thoughts in his blog, Matusik Missive.

Meg on SMSFs: When the first member of a couple dies

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues on managing your SMSF.

I've written before about some of the steps we can all take to 'future-proof' our SMSFs in anticipation of the death of a member and even steps that can be taken after a member dies. But some recent work with a longstanding client who has just lost his wife reinforced for me that there is a vital period shortly after the death of the first member of a couple that is probably unique enough to warrant a separate discussion.

So at the risk of being unduly morbid – this article is about exactly that: what to do quickly and what to do slowly when your spouse dies. Throughout, I'll assume the intention is that the surviving spouse will inherit the money one way or another. While not all couples work this way, it's the most common outcome and certainly the one with the widest array of decisions to make.

Perhaps the most important thing to realise is that *legally*, very little needs to happen urgently in an SMSF when the surviving spouse is already a member and trustee. We know the deceased is no longer trustee and that needs to be reported to the ATO and, in the case of a corporate trustee, to ASIC. In fact, the death may prompt a move to a corporate trustee for the first time which has its own stream of work (setting up a company, moving the investments to their new owner etc). That's important but the long-term trustee structure doesn't have to be resolved urgently. There's a 6-month window where it's entirely legal to have, for example, just one individual trustee.

We also know that 'something needs to happen' with the deceased's super benefit – it's not allowed to just stay in the fund or get moved across to the surviving spouse's super account. But again, the legal requirement is to deal with the death benefit "as soon as practicable". The ATO has a rough rule of thumb that this means somewhere within 6 months. There's no urgency.

Moving quickly

To my mind there are really only two things that should happen quickly.

First, if the deceased was receiving a pension, double check to see whether it was reversionary (continued automatically to the spouse). If it was, the normal minimum pension has to be paid before the end of the financial year. This will be the amount worked out at the start of the year – ie, whatever it would have been if the member hadn't died.

If the pension wasn't reversionary, nothing more should be paid out of the deceased's pension(s) after they died. Any payments made after death will be death benefits – and that's not necessarily the ideal result. So unless the spouse also has a pension and wants to keep taking the regular payments (knowing they'll all come from their own pension instead of being shared), adjust any existing direct debits out of the fund.

The second thing to check is more about the surviving spouse: ***if*** they were to inherit as much as possible of this super as a pension (and we'll come to that decision later) what would that do to their total super balance? The reason this is important is that sometimes it means there is a limited time available to make decisions about contributions for the survivor.

To explain using an example, consider Trish (age 70). At 30 June 2023, she had $1.5 million in super. Her husband Matt (also 70) just died in April 2024. He also had $1.5 million in super. Let's assume they intended their super to go to each other and Trish wants to leave as much as she can in their SMSF. If Matt's super had already been converted to a pension and it was **reversionary** to Trish, her total super balance will immediately become $3 million.

That's significant.

It means she has too much in super to make non-concessional contributions in 2024/25 and beyond. That's because she can only make non-concessional contributions in 2024/25 if her total super balance at 30 June 2024 (the previous 30 June) is less than $1.9 million. Trish might want to move quickly and get one last contribution in (say $330,000 non-concessional contributions) during the last few months of 2023/24. (To do this, she'd use the special rules that allow people with balances at Trish's level - $1.5 million at 30 June 2023 – to contribute three years' worth of the normal $110,000 non-concessional contributions cap at once. Effectively using her 2023/24, 2024/25 and 2025/26 caps all at once while she still can.)

Even though her super has now gone up to $3 million in value in April 2024, it doesn't affect her ability to make contributions ***this year***. For this year, that's all based on the size of her super balance back at 30 June 2023 ($1.5 million).

She might not want to add to her super (she does have $3 million now, after all). However, she might still value the chance to make some last ditch non-concessional contributions. She could, for example, quickly take a lump sum from Matt's pension account that she re-contributes to her own super before 30 June 2024. Why? Because if Matt's super has all come from employer contributions and earnings, it will all be taxed at 15% (+ Medicare) if their adult, financially independent children inherit it when ***she*** dies. If she takes some out and puts it back in again, that bit will be tax free to them when they eventually inherit it.

But this all assumes Matt's super went to Trish automatically via a reversionary pension. What if his super was paying a **non reversionary** pension? Or not paying a pension at all (ie, still accumulating)?

The key difference here is that Matt's super doesn't automatically get added to Trish's total super balance. In fact, that will only happen if and when Trish uses that money to start a new pension from his balance.

Moving slowly

What if she moves ***slowly*** so that doesn't happen until **1 July** 2024?

Then, Trish's total super balance will still be less than $1.9 million at 30 June 2024 (it will be just her own $1.5 million until the next day). So she can make non-concessional contributions in both 2023/24 and 2024/25. For example, she could contribute $110,000 in June 2024 (using just one year's contribution cap) and a further $360,000 in July 2024, using the next three years' caps all at once while she still can. (Contribution caps are going up next year – that's why it's $360,000 rather than $330,000.)

Importantly, Trish should ***think*** about these things urgently so that she can take action before 30 June 2024 if she needs to.

Another big decision to make, of course, is what she's going to do with Matt's super in the long run. It can only stay in their SMSF if it's paying a pension to Trish. What if Trish already has a pension and has already used up her 'transfer balance cap' (the lifetime limit on the amount anyone is allowed to put in a super pension in retirement). It may look like she hasn't – after all, this cap is $1.9 million these days and her balance was only $1.5 million. But in fact, back when her pension started the cap might have been $1.6 million. Perhaps she started a pension with the full cap amount, and it's drifted down in value over the years as she's taken pension payments. Unfortunately, she won't get to put anything extra into a pension now just because the cap has increased. If she used it in full in the past, she's considered to have used it in full forever.

But she ***can*** stop her own pension and put that balance back into an accumulation (non-pension) account. The reason that's a good thing is that it gives her $1.5 million worth of transfer balance cap 'back'. Conveniently in this example, that's just enough to allow her to turn Matt's super into pension. People often find they switch their own super back to accumulation phase when they inherit super from a spouse for exactly this reason – they want to leave their inheritance in super. They can only do that if they can convert it to a pension, and so they replace their own pension with one from their spouse's super.

Of course, if Matt's pension was reversionary to Trish, it will have moved to her name immediately – she'll have two pensions (adding up to $3 million – way too much) running at the same time. Fortunately, the law recognises people won't be able to respond instantly when that happens. There is a specific rule giving people like Trish up to 12 months to sort things out.

And this is another scenario where thinking quickly but moving slowing could be helpful for Trish. The great thing about having both those pensions running is that Trish's SMSF doesn't pay any income tax on investment income like interest, rent, dividends and even capital gains. (This is a generous tax break available for super pensions in retirement.) As soon as she sorts things out by stopping her own pension and putting it back into an accumulation account, the SMSF will start paying income tax again – on roughly half its investment income.

If I was Trish, I'd be wanting to put that off for as long as possible – probably the full 12 months.

In fact, funnily enough, this great tax benefit for the SMSF will continue for a time even if Matt's pension wasn't reversionary (so technically it stopped as soon as Matt died). That's because – again – the law recognises that people can't re-arrange their affairs immediately. So while this pension is in limbo, tax law continues to treat it as a normal pension.

Finally, Trish's position is such that she's able to leave all Matt's super in their SMSF because, after some re-arranging of her own pension, she could convert the full amount to a pension. What if Matt had a lot more super? Too much for Trish to put into a pension? Well, that has to be paid out of their fund. That creates a whole other stream of decisions – what assets will she sell to move a large amount out of super? If Matt has both a pension and an accumulation account, which one will she take this large amount out of? Is there an ideal time to make the payments (quickly or slowly)? And more. Believe it or not there are options and 'best approach' answers to all of these questions. A topic for another day.

All in all, the surviving spouse has a lot to think about when a member of an SMSF dies. And while it pays to understand the options quickly, often they're best served by moving a little more slowly.

Meg Heffron is the Managing Director of Heffron SMSF Solutions, a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.
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Small caps are compelling but not for the reasons you might think...

Roger Montgomery

I advocated - prematurely as it turned out - investing in small caps almost 12 months ago. Since then, the investment landscape has changed, prompting the narrative and, with it, many other investors to pivot towards smaller companies domestically and internationally.

Importantly, my belief in the benefits of small companies isn't arbitrary but instead rooted in an analysis of historical investment performance and predicated on the relative underperformance of small caps. It's also based on the current macroeconomic climate, which appears uniquely poised to favour smaller enterprises over their larger counterparts.

Back in May last year, I argued that innovative companies with growth and pricing power would outperform. Given the small cap universe in Australia, which has about 1800 companies, is replete with such innovative growers, I made the tactical decision to back small caps.

While innovative growth companies with pricing power did indeed outperform, the outperformers in 2023 were confined to largely seven mega-cap tech companies that were labelled the 'Magnificent Seven'.

As an aside, don't ever fall for the trap inherent in those labels. Whether it's the FAANG stocks of 2013, the MAMAA stocks that followed (Meta, Apple, Microsoft, Amazon, and Alphabet), the Nifty Fifty of the 1960s and 70s, or the Magnificent 7 of 2023, these labels denote the most popular stocks of the time. The trap is investing in them, usually in a late-to-the-party ETF - after they have been labelled. If you keep in mind the only thing common to each stock in the group is their popularity and, therefore, their share price performance, you will certainly be more discerning.

The reason for the outperformance of the largest innovative companies in 2023 probably has something to do with perceived safety. You'll recall many people last year still feared a recession, and many others weren't certain central banks had completed their rate-hiking exercises. With concerns about further rate hikes and a recession, it's understandable investors loitered close to the most liquid companies that also displayed growth, innovation, and pricing power.

So why did I believe innovative growth companies would do well in 2023? The argument for my strategic portfolio pivot was anchored in seminal research conducted by Gavekal Research in the late 1970s. This body of work revealed the principle that innovative firms possessing robust pricing power—a trait abundantly present among smaller companies—tend to outperform in environments characterised by disinflation in conjunction with positive economic growth. This is precisely the scenario that dominated 2023. And it's the scenario we find ourselves in today, making the case for investment in smaller companies compelling and timely.

However, today, the conjunction of disinflation and economic growth is not the sole premise for advocating an investment strategy favouring small companies. Recent developments have presented additional, compelling reasons that I trust will fortify my argument.

Other compelling reasons to own small caps

The first and perhaps key among these developments is that the underperformance of small caps against large caps, here in Australia, is perhaps the widest it has been since the GFC. That underperformance rarely persists because large caps eventually become relatively expensive and professional investors seeking higher returns with lower risk look for relative value lower down the market capitalisation spectrum. Their actions work to close the gap. It doesn't mean large caps sell off, it may mean however large and small caps both rise, but small caps rise faster and therefore outperform.

The other development is a change in the narrative concerning interest rates, recession risks, and corporate earnings forecasts.

In 2022 and 2023, the investment community grappled with rapid interest rate hikes, a pace unparalleled for younger market participants. This environment has since shifted, with both investors and central banks now accepting interest rates have peaked, with cuts on the horizon possibly this year.

Moreover, the dominant narrative in 2023 of an impending recession, which steered investors towards defensive and highly liquid mega-cap technology firms, has gradually given way to a more nuanced expectation of a 'soft landing' and an associated reshaping of anticipations around monetary policy. As expectations of recession give way to a belief in soft landings, investors feel more comfortable moving out along the risk

spectrum. That process, by the way, can take a couple of years, which may mean the equity market rallies up to 2026.

Amid fluctuating interest rates and the shadow of a recession, concerns regarding corporate earnings were understandable. Yet, these anxieties have largely been allayed, with earnings, especially from the higher-quality names we invest in, demonstrating resilience during the latest reporting season here in Australia and also in the U.S.

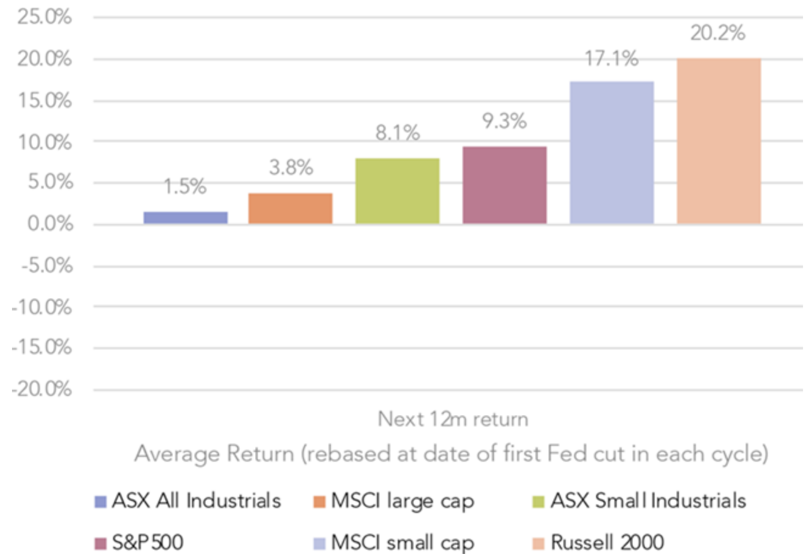
Investors are taking on more risk

Consequently, there is a discernible shift in portfolio allocation. Investors are moving from a cautious stance, characterised previously by high cash/liquidity levels, to a more assertive approach. Investors are now more inclined to engage in selective company investments, signalling a readiness to embrace measured risk, which in turn facilitates higher equity prices.

This newfound optimism is also partly predicated on historical analyses of equity index performances after the U.S. Federal Reserve begins cutting rates. Although the exact timing of the commencement of rate reduction cycles remains uncertain, prevailing expectations suggest that such a phase may begin in the latter half of this calendar year. A scenario of rate cuts would significantly bolster the argument for the superior performance of small caps, as evidenced by analysis from Wilson Advisory.

According to Wilsons Advisory, in the 12 months immediately following the Fed's first rate cut, the ASX Small Ordinaries has, on average, gained 8.1%. This compares to the ASX All Industrial Index, which has, on average, risen just 1.5% in the twelve months after the Fed's first rate cut. Globally, the story is even more compelling with the U.S. Russell 2000 small cap index, gaining, on average, 20.2% in the year following the first rate cut.

Global small caps typically perform well after Fed rate cuts



An intriguing additional aspect of this analysis is the comparison of the Small Ordinaries index against the S&P/ASX100 over the past decade. This comparison reveals a widening performance gap, suggesting a period of pronounced underperformance by small caps relative to large caps, the likes of which have not been seen in a decade. If we plot the Small Ordinaries against the S&P/ASX100 and zero the two indices back to a decade ago, we discover the gap between the performance of the large caps and small caps has widened to approximately 25%.

Source: IRESS, ASX 100 Accumulation index, ASX Small Ords accumulation index returns over last 10 years, Index data December 2013 to COB 29/02/24, Gap = Performance from 31/12/21

Earnings will be key

While this discrepancy is noteworthy, the rationale for its potential narrowing and the consequent outperformance of small caps likely hinges on the expectation of faster earnings growth among smaller companies.

According to FactSet data, at 15 February 2024, consensus expectations for ASX100 large cap compounded earnings per share growth over the next two years is just 3.1% per annum. For the small ordinaries, however, earnings are expected to grow 15.2% per annum over the same period.

The strategic case for investing in small companies is underpinned by a confluence of factors: small caps have underperformed, are relatively reasonably priced, are expected to generate substantially higher earnings growth over the next two years, and investors can access the opportunity through managed funds knowing that the median and top quartile small cap managers have delivered better returns than the market.

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The mixed fortunes of tax reform in Australia, part 2

Paul Tilley

This article is based on edited extracts from Paul Tilley's book, Mixed Fortunes: A History of Tax Reform in Australia, published by MUP https://www.mup.com.au/books/mixed-fortunes-paperback-softback. Part 1 can be read here.

Part 2: Tax reform episodes

Australia's tax reform efforts since Federation have been mixed. Part one of this two-part series looked at the history of the Australian tax system and the issues it now confronts. Part two will look at Australia's main tax reviews and examine the key ingredients that make a tax reform exercise work, or not.

Tax reform efforts at the Commonwealth level can be viewed in three main phases. The first covers the early decades of the 20th Century with governments establishing their roles in the new Federation. The second covers the post-war period leading into the major tax reforms of the 1980s and 1990s. The third covers the 21st Century to date. State tax reform efforts overlap these phases.

Early Federation reviews and the 1942 Income Tax Unification

At Federation in 1901, the Constitution gave the Commonwealth exclusive access to customs and excise duties, but with other taxes open to both levels of government they were soon competing, and efforts to resolve these overlaps were a focus of early Commonwealth-State finance negotiations and tax reviews.

After the Commonwealth introduced income tax in 1915, the overlap with state income taxes was problematic for taxpayers. Two Royal Commissions considered ways to achieve greater uniformity. The 1923 commission recommended that income tax be raised exclusively by the Commonwealth, but this was not actioned by governments. The 1934 commission recommended a compromise with separate income tax acts containing a uniform set of core provisions defining those elements of the tax base that could be agreed on. This was implemented by governments, as the *Income Tax Assessment Act 1936* at the Commonwealth level, but over time ongoing changes across jurisdictions eroded the uniformity.

Financing Australia's involvement in World War Two required large revenue increases and the Commonwealth asked the states to suspend their income taxes to allow it unfettered access. The states refused, so the Commonwealth appointed a committee which duly recommended that it be the sole collector of income tax. The Commonwealth then acted unilaterally in 1942 to force the states out of income tax, making it a Commonwealth monopoly.

This episode showed that a crisis, even a war, can provide the opportunity for reform. In this case, the royal commissions had established the foundational case for income tax unification, and a new government needing war finance provided the determinative opportunity.

Asprey tax blueprint and reforms of the 1980s and 1990s

In the post-war period in Australia through the 'golden years' of the 1950s and 1960s there wasn't an imperative to tackle basic economic reform, and structural problems in the tax system went largely unactioned. High inflation in the 1970s, though, pushed taxpayers onto higher tax rates and exposed Australia's flawed income tax base. Dissatisfaction with the tax system was acute as tax avoidance and evasion became pervasive.

A comprehensive external tax review was commissioned – the 1975 Asprey review – which laid out a blueprint for the Commonwealth tax system, entailing broadening of both the income and consumption tax bases. With the review reporting in the final tumultuous year of the Whitlam government, though, its recommendations were not implemented.

In 1985, the Hawke government conducted an internal tax review that sought to implement the Asprey blueprint, with structural broadening of the income and consumption tax bases. Support for the consumption tax proposal could not be established at the 1985 tax summit but income tax base broadening was implemented, with a capital gains tax, a fringe benefits tax, a foreign tax credit system, and a dividend imputation system.

In 1998, the Howard government conducted an internal tax review that focused on reform of Australia's indirect taxes. The Commonwealth then used its constitutional power to introduce a 10 per cent GST to replace the WST and a raft of the state transaction taxes, with all the GST revenue going to the states. While practical and political considerations resulted in health, education and basic food being excluded from the GST base, the package was a major consumption tax reform that complemented the 1985 income tax reform and went a substantial way to completing the Asprey blueprint.

Associated with A New Tax System Act (ANTS) was the 1999 Ralph Review of Business Taxation, which set up a cut in the company tax rate funded by the removal of accelerated depreciation, along with a raft of other more modest reforms.

These tax reviews can be seen as a group. The external Asprey review was the foundational review that established a blueprint for the Australian tax system, while the 1985 and 1998 internal reviews were the determinative reviews that sought to implement that.

21st century tax reform

At the beginning of this century, Australia's emerging resources boom drove economic growth and revenues. The 2008 GFC and the COVID-19 crisis, however, interrupted that momentum, pushing budgets deep into deficit. A fraught political situation further obviated reform opportunities.

The 2009 Henry report outlined a comprehensive reform agenda addressing long-term directions for the Australian tax system. In the context of the GFC and a difficult political environment, however, those reforms were largely not implemented. The main initial reform, a resource rent tax, was short lived. The review report has provided a useful ongoing role, though, with over a third of its recommendations actioned since.

The 21st Century has also seen greater efforts at the international level to tackle profit-shifting by multinationals to minimise their tax liabilities. Domestically, advances in computer programming and information technology have revolutionised aspects of business accounting and tax administration.

State tax bases generally suffer from poor design and erosion due to interstate competition. State and territory tax reviews have established some broadly consistent reform themes, in particular reductions in transaction taxes such as stamp duties and broadening the bases of land tax and payroll tax. While there have been some tax policy measures of note, including the replacement of transaction taxes by the GST and efforts to harmonise payroll taxes, many problems remain.

Why is tax reform so hard?

With the tax system establishing a community's sharing of the burden of funding government, any rearrangement will inevitably be contentious. The economic and social benefits of tax reform can be substantial, but the 'winners' are often dispersed through the community, while the 'losers' tend to be more concentrated

and politically vocal. Aspects of tax policy are also inherently subjective, requiring a balancing of objectives, making the establishment of unambiguous arguments unrealistic.

Tax reform is part of a change-management process, and several stars need to align. The arguments for the nature of the reform need to have been established and broadly understood and accepted. A reformist government then needs political capital that it is willing to spend on tax reform, and most likely a fiscal position capable of accommodating a budget-negative reform package. A political window, perhaps early in a government's tenure or during a crisis, then needs to present as a catalyst for reform.

What history shows us is that where reforms have been achieved, there have been certain prerequisites. First there needs to be a burning platform, that is the arguments need to be made that there is a major problem that needs solving. Second, a government needs political capital to manage the inevitable short-term difficulties. Third, fiscal room is desirable to accommodate a reform that is budget negative in the short term to enable compensation of 'losers' in certain socio-economic groups. Finally, skilled politicians are needed to effectively advocate the reforms, in particular Prime Minister/Treasurer partnerships of the ilk of Curtin/Chifley, Hawke/Keating and Howard/Costello.

Prospects for tax reform

Flaws in the Australian tax system provide numerous opportunities for a reformist government. At the Commonwealth level, an obvious starting point is the inconsistent approach to the taxation of savings, as well as the taxation of companies in an increasingly global economy and the taxation of Australia's natural resources. At the state level, the most obvious reform is to continue the transition away from transaction taxes such as housing conveyance duties to broad-based land taxes.

Overlaying these generally microeconomic tax reform concerns is the more macroeconomic consideration of the size of government in Australia. Budgets face large spending pressures but also significant structural deficits. This has spawned a debate about whether Australia's tax burden will need to rise and, if so, how that should be done to avoid transferring the burden to future generations.

What is the role of tax reviews?

A formal review is one tool available to governments considering reform. History shows us that a well-constructed review can provide an effective vehicle for community consultation and expert advice, away from the political hothouse of government. It can be helpful in making the case for, and designing the nature of, a tax reform package and can lend credibility to the reform proposals.

Formal reviews, though, need to be seen as just one part of a government's broader change-management process. The complexity and contentiousness of major tax policy changes means that the arguments need to be made over a longer period and reinforced by governments and ongoing academic and community debate. A review provides a tool but not a solution.

Life wasn't meant to be easy

Given how difficult the achievement of tax reform has proven to be, one may well ponder whether it is worth the effort. But what is at stake in terms of the broad social contract between government and citizens, and the pervasive effect a tax system has on the economy, means that it is too important to leave in the too-hard basket. To paraphrase George Bernard Shaw, the lesson for potential tax reformers is, perhaps, that tax reform is hard, but take courage, for the benefits can be great.

This article is based on edited extracts from Paul Tilley's book, Mixed Fortunes: A History of Tax Reform in Australia, published by MUP https://www.mup.com.au/books/mixed-fortunes-paperback-softback.

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8 ways that AI will impact how we invest

Dr. David Walsh

The advent of Artificial Intelligence (AI) is affecting ever expanding fields of human activity. And the way we invest is no exception. It's never been timelier for investors, advisors and investment managers to take deep stock of the impacts, real and potential, of AI, so we can better prepare to manage them – whether by leveraging opportunities, managing new risks or, more likely, both.

This article summarises a recent discussion paper containing insights into AI and, in particular its effects – current and future – on both the way we invest and how investments are sourced, implemented and managed.

Not all machine learning is AI

For the purposes of this article, we define AI broadly as *"a machine's ability to perform the cognitive functions we usually associate with human minds".*

Importantly, while all AI relies on the kind of machine learning that we may already be familiar with, such as algorithms that push certain information our way or trading apps that monitor and act on market changes, *not all machine learning is AI.* Rather, AI is characterised by the added nuanced 'human' and 'cognitive' aspects evident in the way a machine 'makes decisions' based on inputs, rules and using the resulting connections that govern its ultimate outputs.

Eight ways AI will affect the way we invest

There are eight key areas where AI is likely to affect, or continue to affect, the way we invest. These areas further divide into 'personal' and 'institutional' impacts.

The role of AI in advice and personal investing

1. AI the great equaliser? Boosting financial literacy

Financial literacy has been falling in Australia and is lower among women and younger people than the general population[1]. Further, without higher literacy, the sheer volume of online 'financial' information increases susceptibility to inaccuracy and misuse – the Gamestop and cryptobubble experiences are cases in point.

AI offers a prime opportunity to boost financial literacy, especially given that a lot of existing fintech is already popular with younger people: as many as 20% use automated savings tools and more than 50% hold some kind of investment. Use of digital assistants, already widely accessible, can also help overcome the barrier of uncertainty and fear of seeming ignorant.

Against this backdrop of opportunity, perhaps the major immediate barrier to using AI to boost financial literacy is slowness and inconsistency in incorporating financial literacy as core curriculum in schools.

2. Freeing advisors to grow business and focus on the personal: AI for advice and analytics

Artificial intelligence is already changing the way advice is delivered. It can dramatically reduce administration, reporting and communication loads, update legal changes, support client on-boarding, portfolio rebalances and so on – all customisable for client and advisor.

This allows the advisor to focus on the most important part of advice – the human factor. The personal touch becomes more significant because, as it currently stands, AI is broad, not deep. Despite many attempts, it can't provide the depth of knowledge and personalisation required for genuinely tailored advice.

Scepticism about AI is also common, perhaps deepened by the older skew of both advisors and clients. Further, as a senior advisor recently pointed out: "AI is not likely to prevent a client from panic selling at the bottom". Or not yet anyway.

For advisors, then, AI offers significant opportunities to maximise the number and quality of client relationships and expand business development by freeing them from more routine administration and compliance.

3. Stock selection and trading using AI: still stuck on the transactional track

Despite their proliferation, very few trading apps seem to incorporate significant AI. Apps tend to compete on usability and cost rather than the intelligence of their research or advice. Significantly, some apps offer

traditional financial services, highlighting the importance of the human side and more holistic services, rather than pure tech or AI.

The role of AI in institutional investing

4. More time for research and adding value: automated coding and reporting

In the institutional context, the speed and volume at which AI can summarise and report on markets and research, with the length, detail and content focus pre-specified, gives portfolio managers more time for value-adding activities such as research.

For example, the 3,600 word Reserve Bank of Australia's *Statement on Monetary Policy August 2023: Economic Outlook* report was summarised into 200 words in just four seconds.

AI coding is also a timesaving gamechanger. Chat GPT can write code fast and accurately. For example, code to chart or track any available data (for example, inflation), and software that will write natural language into the coding of choice, can now be easily used.

The proviso here is that, as with all AI, the quality of outputs is dependent of the quality of inputs and weights (that is, the linkages set up to help guide the decision model). This is especially the case because current options are public and generic, potentially lacking nuance, accuracy and depth, although more sophisticated options are coming onstream.

5. Mining hidden alpha though pattern recognition and topic modelling

It's the nature of humanity to look for patterns where they may not exist, and the role of human cognitive bias in finding patterns is well established.

AI is not only free of those cognitive biases, but it also has the potential to capture and analyse data at volumes and speeds not possible for humans. That includes the ability to see similarities or differences among topics, groups or clusters that would be beyond the usual scope of human analysis. This offers the very real potential to exploit previously hidden alpha sources.

6. Finding the wheat in the chaff: Natural Language Processing and summarising unstructured data

We know AI can support swift access and analysis of structured financial information such as reports, market prices and volumes and so on.

However, much financial information is unstructured, known as 'alternative' or 'alt' data. Examples include textual reports or news, images, point of sale or weather data, all of which can have a significant impact on investment performance and outlooks. It is here that AI – perhaps unexpectedly – can offer significant value, primarily using Natural Language Processing (NLP).

NLP can extract useful information from news, spoken word transcripts, regulatory reports and other sources, allowing measurement of the underlying intent, concerns and sentiment. Extracting such sentiment or tone from a company CEO or CFO may help assess future price or earnings.

At RQI Investors we have used NLP by inputting the AI with a domain specific dictionary, along with words and phrases that signify positive and negative sentiment. From there, it can be trained to identify more nuanced language that may indicate performance or prospects. As well as written texts and images, it can analyse 'live' language via transcripts, including more fluid contexts such as Q&A sessions or conference calls at earnings announcements.

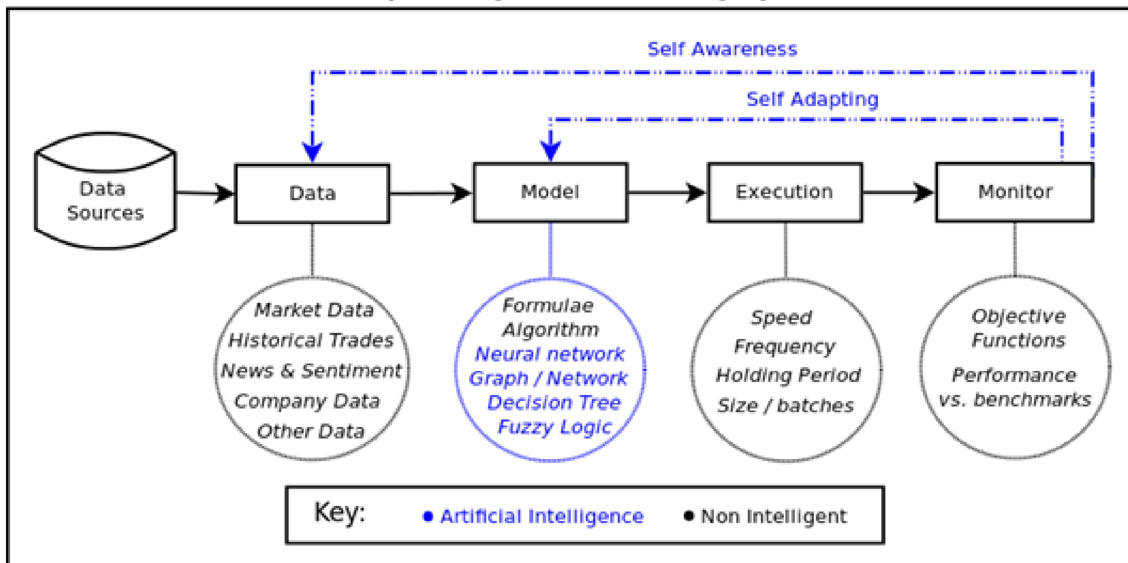
Examples of such language nuances include:

- A filibuster signal for management that speak for too long
- An obfuscator signal for management that use speech which is too complex
- Sentiment or tone signals based on both prepared management speech and more free-form Q&As

7. Trading algorithms: automated flexibility and adaptability but still a way to go

Conventional trading algorithms are based on setting up objective functions and other customised criteria – maximise profit, or minimise net exposure, and so on. While non-AI models are fairly simplistic, enhancement with AI allows for more variables and can be built to adapt and learn from news or order flow 'on the fly'.

Conceptual Algorithmic Trading System



Source: https://www.turingfinance.com/dissecting-algorithmic-trading/

AI trading algorithms can adjust and reweight data sources automatically, and the algorithm itself can be adapted and optimised while in use, or as part of the training process.

Thus, AI can support a more nuanced and flexible trading platform that is adaptive to circumstances and market conditions. However, its work can be difficult to monitor and understand and is heavily reliant on historical data and its performance is dependent on the quality of its platform.

8. Portfolio optimisation: tackling the complex problems

Traditional manual portfolio construction works well when the market or portfolio behaves 'as it should'. It is when the market 'misbehaves' that AI construction can come into its own, enabling us to divide and analyse data differently, more quickly and in particular, to address more complex problems.

A prime example is forecast errors in returns or alphas, which are problematic for conventional optimisation techniques. Here, AI that learns which return forecasts create problems can be employed, aiming to iteratively or sequentially train the model to handle outliers or errors better.

AI is here to stay

Using AI in investing is already shown to improve efficiency and financial knowledge and has vast further potential to add value through clever implementation of ideas, improved trading and portfolio construction.

The big truth? AI is not going away. While it is certainly not the universal panacea and will never replace the power of human thinking and ingenuity, for investors, advisors and investment managers, staying close to the latest AI applications and using its potential intelligently alongside their own unique human skills and experience will be the key to success.

Download the full paper here. In addition to the investment-related discussion, the paper canvasses some of the broader societal and ethical issues raised by AI, including its impact on work and some interesting detail about the creation of different AI models.

[1]HILDA Survey (2016-2020). Household, Income and Labour Dynamics in Australia (HILDA) Survey from the Melbourne Institute.

Dr. David Walsh is Head of Investment at RQI Investors (previously known as Realindex Investments), a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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