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Editorial

Tax is one of the few subjects capable of producing near-universal dissatisfaction.

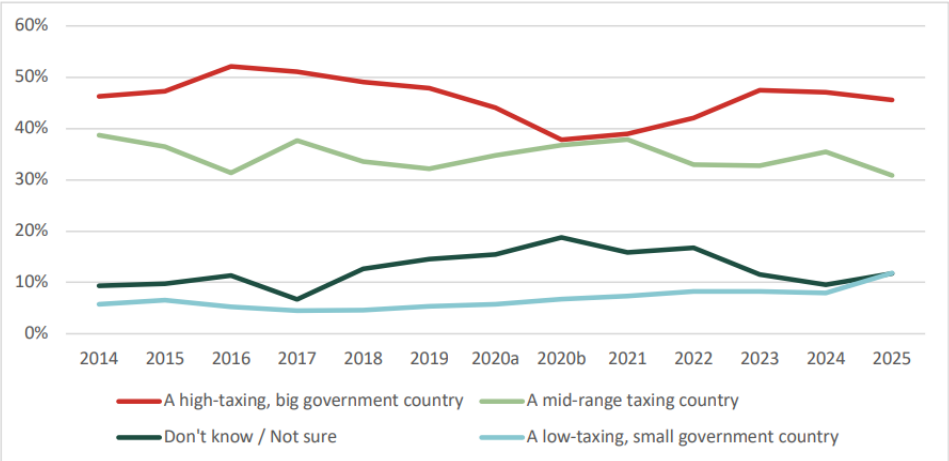
For all the heat generated by ongoing debates, Australians actually appear relatively united on the outcomes they value, though considerably less on how those outcomes should be funded.

Per Capita's Tax Survey tracks community attitudes towards taxation and public spending over time. One important caveat is that these results were collated before the May 2026 Federal Budget, so they shouldn't be interpreted as a verdict on the latest reforms, but rather, a snapshot of the period immediately beforehand.

A nation in the mirror

One of the more enduring findings in the survey relates to self-perception. Nearly half of the respondents continue to describe Australia as a high-tax, big-government country and this has remained relatively stable for over a decade. The consistency of this view is arguably more interesting than the result itself.

Figure 19: Perception of Australia's tax level compared to other countries



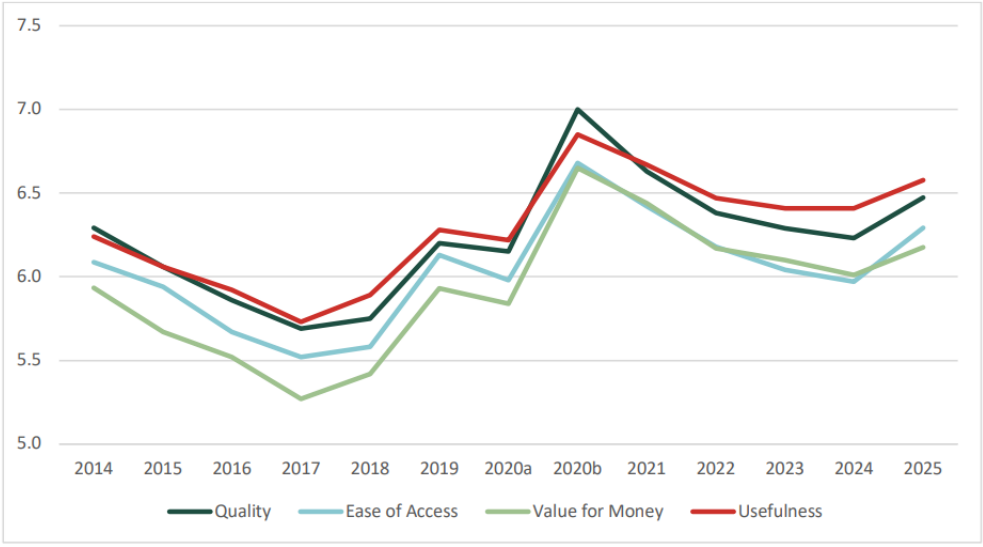
Question: When compared with other developed countries, do you think Australia is...?

Multiple governments have come and gone during the survey period, while tax rates and fiscal settings having repeatedly shifted. Yet our perception of Australia as a heavily taxed nation has barely moved.

Though the proportion of respondents identifying Australia as a middle-of-the-road tax country has fallen, both the low-tax and 'unsure' categories have modestly grown. Instead of converging towards a common understanding, it seems there is a broader range of competing narratives at play.

At the same time, the survey paints a far more positive picture of attitudes towards public services than one might expect. Australians continue to report reasonably high levels of confidence in the quality, accessibility, value for money and usefulness of public services. These ratings have eased from their pandemic-era peak, but remain stronger than they were a decade ago.

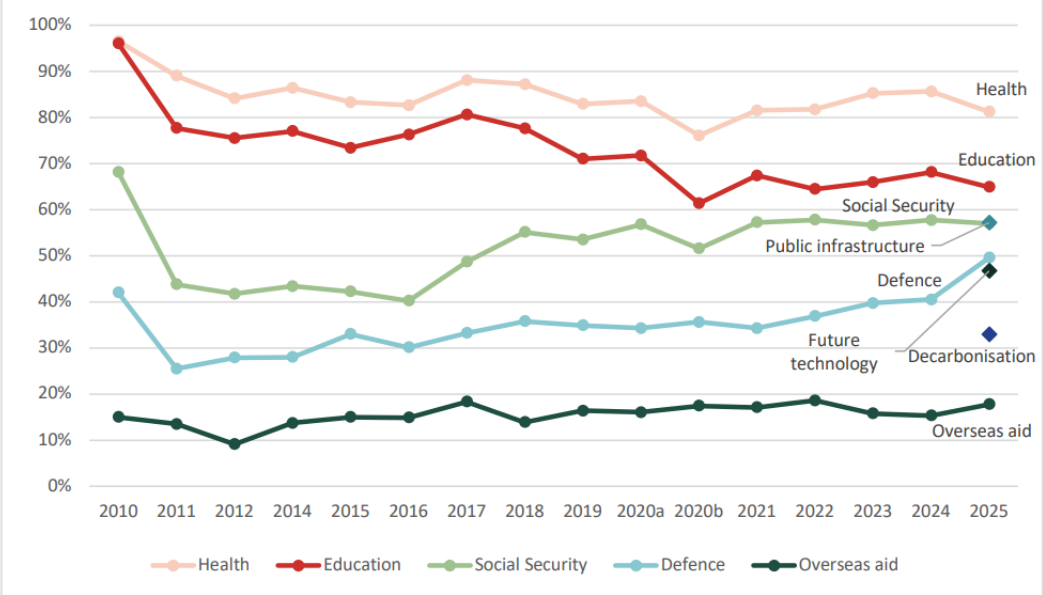
Figure 1: Attitude of Australia's public services generally (e.g. health, education, social security/welfare)



Question: Thinking about Australia's public services generally (e.g. health, education, social security/welfare), on a scale of 0 – 10 how would you rate them on the following factors (where 0 = poor and 10 = excellent)?

Given public debate often operates on the assumption that confidence in institutions has collapsed, this finding surprised me. It also perhaps explains another seemingly paradoxical result. Most respondents believe governments should spend more on public services, particularly health and education.

Figure 3: Would like **much more or a little more** spending in different areas



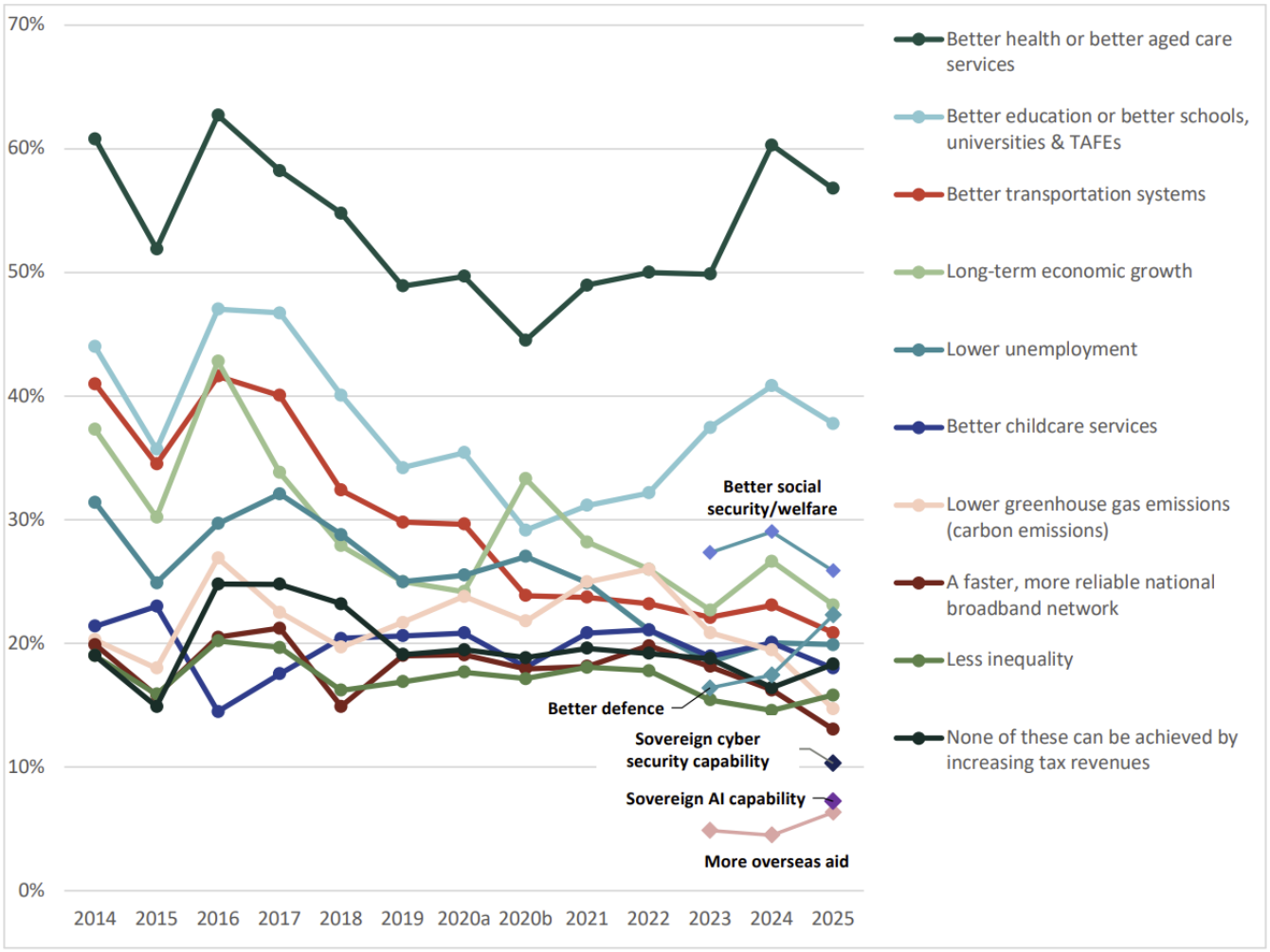
Question: Would you like to see more or less government spending in each of these areas? ['Much more' + 'A little more' combined]

However, when the question shifts from spending in the abstract to individual contributions, people's enthusiasm naturally becomes selective.

On the surface, it seems that we're willing to pay more when the outcome is tangible and immediate. Health services, aged care and education continue to attract the strongest support. By contrast, the willingness to pay more for decarbonisation, sovereign AI capability and other less direct outcomes remains comparatively low.

I'll play devil's advocate and suggest that doesn't necessarily reflect a reluctance to contribute. Rather, there is a strong desire to see clearer connection between the cost and its outcome. The further an expense or objective moves from the everyday experience, the harder it becomes to persuade people to pay for it.

Figure 4: Outcomes people are prepared to pay higher taxes for



Question: Which of these outcomes would you be prepared to pay higher taxes for?
Note: In 2023, an additional response option of "better education" was added. This has been combined with the response option "better schools, universities, and TAFEs". The share of respondents who ticked either response option is presented.

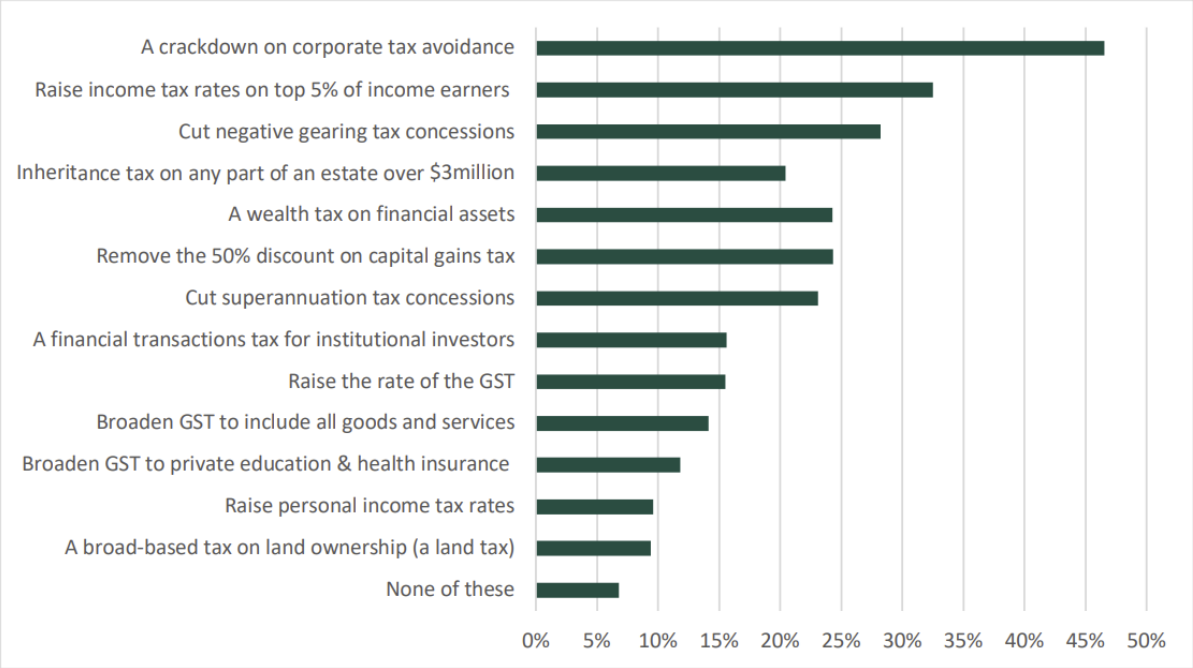
Who should foot the bill?

This willingness to support public spending while remaining cautious also appears in the survey's findings on revenue raising.

A crackdown on corporate tax avoidance remains the most popular option. Higher tax rates on top income earners also continues to attract support. Measures such as negative gearing and capital gains tax reforms, which have since moved from debate to policy, attracted only moderate support in the survey.

There is an old tendency in public policy for agreement to diminish in proportion to specificity. Agreement is often easiest at the level of principle, but once pen is put to paper, that consensus is difficult to sustain.

Figure 7: Approaches to raising additional revenue



Question: If you wanted to raise more tax in Australia to pay for quality public services, which of the following approaches would you support?

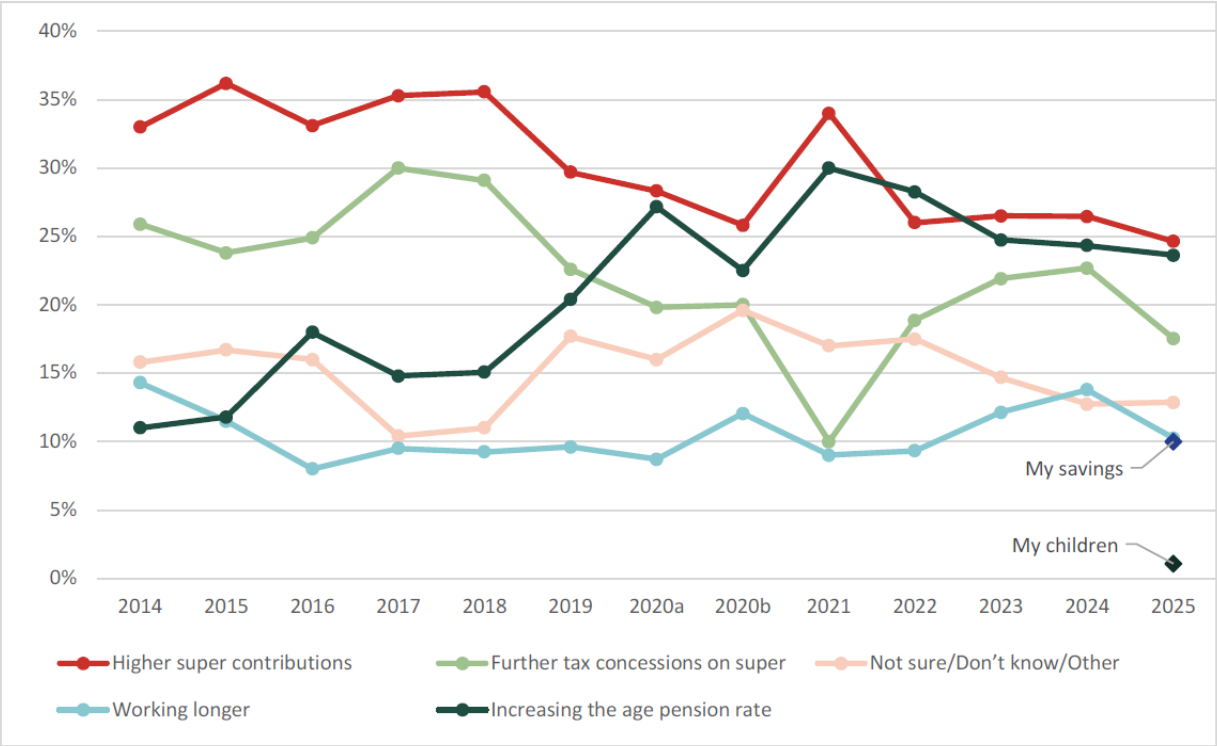
Whether one agrees with these policy positions or not, they suggest many Australians place considerable weight on perceived fairness. The survey indicates a preference for targeted measures aimed at those seen as better placed to contribute, rather than approaches that distribute the burden more evenly across the population.

Retirement income funding

Australia is often described as one of the world's great compulsory savings systems. The Super Guarantee now sits at 12%, but debate continues about whether the system will ultimately provide adequate income for retirees.

Some believe individuals should aspire to save more, while a similar number argue that the Age Pension should play a larger role. Others see the answer in further strengthening superannuation itself through concessions.

Figure 23: Retirement income funding



Question: When thinking about retirement income to provide for longer life expectancies, do you think this income should be funded by...?
Note: Respondents may only select one option.

Despite decades of discussion about self-reliance, retirement continues to be viewed as a collective challenge.

We may disagree on the mechanism, but there remains a broad expectation that longevity risk and income security should not rest solely on the shoulders of individuals. That is perhaps unsurprising. If an increasing number of people reach retirement age without adequate resources, the consequences are ultimately endured more broadly through taxation. In that sense, retirement policy occupies an unusual space where we must balance personal responsibility with the recognition that the consequences rarely stop at the individual.

Simonelle Mody

Also in this week's edition...

Politicians are fighting over access to super, but **Ron Bird** argues they may be ignoring three key structural failings that cost Australians more than we realise.

Why do some families preserve wealth for generations while others struggle? **Peter Roach** explores this phenomenon in the great wealth transfer myth.

The demise of bank hybrids leave investors with a problem. **Kanish Chugh** asks what comes next, and are the obvious replacements enough?

After a recent trip to the US, **Emma Fisher** shares the latest market themes emerging out of the technology sector and how company moats are being reshaped.

Warren Buffett's departure marks the end of an era. **Jason Phol** discusses whether Berkshire's success can continue without the man responsible for much of it.

Jeremy Duffield and **Mikhail Walden** evaluate whether the 4% retirement withdrawal rule has been lost in translation.

For more than a decade, investors lived through an era of near-zero interest rates. **Michael Collins** believes this was not without side effects.

Superannuation's structural failings

Ron Bird

Australia's superannuation system is often described as "world-class". It is a phrase repeated by governments, industry bodies, and fund executives, and it has become part of the national mythology. Yet when judged against the basic economic principles that should guide a retirement income system, the claim does not hold.

In this piece we concentrate on three important structural failings of our system which impose real welfare losses on Australians, particularly lower-income earners. Any discussion of reform, including the proposals now being floated by One Nation and the Coalition, must begin with these failings.

Superannuation is ultimately about consumption: giving up consumption during one's working life in order to fund consumption in retirement. A retirement income system should help individuals achieve the best possible pattern of consumption over their lifetime.

How we got here

The system originated as a compromise between the Hawke Government and the ACTU to deliver a 3% pay increase in the form of superannuation rather than wages, thereby avoiding additional inflationary pressure.

In 1991–92 the Keating Government made this arrangement universal through the Superannuation Guarantee, beginning with a contribution rate of 3% and legislating a gradual increase to 9%.

Subsequently, the 2012 Gillard Government legislated a further increase from 9% to 12%.

An absence of analysis at each stage has played a central role in creating the failings that follow.

1. The contribution rate

Four major studies — by the Grattan Institute[1], Treasury[2], ANU[3] and our study at UTS[4] — were conducted between 2017 and 2020, when the contribution rate was frozen at 9.5% and consideration was being given to increasing it further. All four studies reached the same conclusion: 9.5% was more than adequate and there were no grounds for increasing it.

At 12%, most accumulate more retirement savings than they require, at the expense of consumption during their working lives. Our analysis showed that the current system leaves most individuals worse off, with welfare losses for lower-income earners reaching as high as 30%[5].

2. Home ownership

The second structural failing concerns home ownership, which — along with the Age Pension — has always been a central pillar of Australia's retirement safety net. When mandatory superannuation was introduced in 1992, around 85 to 90% of individuals owned their home outright by the time they retired. Since then, this figure has steadily declined and now sits at around 75 to 80%, with almost half of homeowners retiring with a mortgage.

The decline has been particularly severe for younger Australians, with ownership among those in their early thirties falling from around 50% in 1992 to around 35% today.

Superannuation is not the only cause of this decline, but it is a significant one, with the timing of the turnaround in home ownership being closely linked to the introduction of mandatory superannuation contributions. Mandatory contributions reduce the ability of younger Australians to save for a deposit and to meet mortgage repayments, crowding out the very asset that underpins retirement security. This distortion is particularly harmful for lower-income earners, who face the greatest difficulty entering the housing market.

Our analysis suggests that home ownership will be unattainable for those in the bottom third of income earners in the absence of family assistance. A generation entering retirement without secure housing is likely to face higher living costs and greater reliance on government support. A retirement system that undermines home ownership ultimately undermines itself.

3. Tax concessions

The third failing concerns the fiscal and distributional impact of superannuation tax concessions. Based on Treasury's estimates, the current cost of these concessions is $63 billion, which on current trends will reach $80 billion by 2030. They have never been given a clear policy justification, and it is questionable why they are needed at all in a system where contributions are compulsory.

They are sometimes defended on the basis that compulsory superannuation reduces the demand for the Age Pension. The Age Pension currently costs about 3.1% of GDP, or roughly $80 billion a year. When compulsory superannuation was introduced in 1992–93, the Age Pension cost around 3.8% of GDP. Given the demographic ageing that has occurred since then, we estimate that in the absence of compulsory superannuation, this figure would currently be around 4.2%, translating to a current cost of almost $110 billion. The saving in the Age Pension attributable to compulsory super is therefore in the order of $30 billion a year.

Australia therefore spends more than two dollars in concessions for every dollar saved on the pension. This is a poor fiscal trade-off. Worse, it is inequitable. The concessions overwhelmingly flow to high-income earners, while the Age Pension savings come from lower-income earners. Superannuation is now a major contributor to Australia's widening wealth gap. Governments have chipped away at concessions for two decades, but their cost continues to grow. The structural problem remains: the system delivers large tax benefits to those least in need of support, while imposing welfare losses on those least able to bear them.

Why these failings persist

These failings create structural weaknesses that weigh most heavily on lower-income earners, who suffer the greatest welfare losses, the greatest barriers to home ownership, and effectively no benefit at all from the tax concessions. And they have persisted for a simple reason: the system has never been built on rigorous economic analysis.

The original 3% contribution was introduced as a wages workaround during high inflation, not as part of a coherent retirement income model. When the Keating Government later made superannuation universal and set the path for future contribution rates, it did so without releasing any detailed modelling of the system's economic or fiscal impact. The Howard Government then extended generous tax concessions to voluntary contributions without serious analysis of their behavioural or distributional effects. And the Gillard Government legislated the increase in the Superannuation Guarantee to 12% without publishing modelling of its impact on wages, consumption or retirement incomes.

Treasury and the Retirement Income Review have since acknowledged this history: at no stage has compulsory super been subjected to the level of assessment that a policy of this scale demands. The result is a $4.8 trillion system shaped more by political policy decisions than by coherent economic design.

The new proposals

Against this backdrop, the proposals now being advanced by One Nation and the Coalition are best understood as political responses to cost-of-living pressures and housing affordability rather than serious attempts to correct the structural failings of the superannuation system.

Neither proposal was designed with the system's underlying weaknesses in mind, and neither is supported by the kind of economic analysis that those weaknesses demand. Even so, they intersect with the failings — and in some cases, partially address them — not because they were conceived as reform, but because the failings are now so large that almost any change to the system brushes up against them.

One Nation's proposal

The One Nation proposal would allow individuals to access 25% of their compulsory superannuation contributions for three years. This would temporarily reduce the effective mandatory contribution rate to 9%, with the additional 3% being optional.

The current contribution rate of 12% should not be regarded as sacrosanct. The consensus of the studies previously discussed was that a contribution rate of around 9% is closer to the rate that would facilitate an optimal consumption pattern. In this sense, the One Nation proposal does address the first failing at least for a short period of time.

What is worrying is the calls being made to increase the rate even further, with figures as high as 18% being suggested to improve retirement outcomes for women.

More recently, some economists have proposed increasing the contribution rate, as an alternative to raising interest rates, as a means of addressing inflation. This suggestion is reminiscent of why mandatory superannuation was introduced in the first place and reflects a tendency to treat superannuation as a tool for solving almost any economic problem, while ignoring its role within retirement income policy.

The Coalition's proposal

The Coalition's proposal directly addresses the second failing. Allowing first-home buyers to access their superannuation for a deposit — and potentially for mortgage payments or as collateral — would improve access to home ownership for younger Australians. The details of the proposed extensions are unclear, but the overall direction is sound: superannuation should not stand in the way of home ownership.

The Coalition proposal acknowledges this, even if it does not fully address it.

What neither proposal addresses

Neither proposal touches the enormous and inequitable cost of superannuation tax concessions. Fixing this problem requires politically unpopular decisions. If concessions are to remain, their scale and distribution should be reconsidered. No party appears willing to undertake meaningful reform in this area.

Conclusion

A system built without rigorous analysis and marked by structural failings will not be repaired by politically driven proposals that only brush against its weaknesses.

The proposals advanced by One Nation and the Coalition intersect with some failings but do not confront the deeper design flaws. Until policymakers are willing to rethink the system, Australia will continue to devote billions each year to a retirement structure whose outcomes fall well short of its potential.

[1] Daley, J., Coates, B., & Young, W. (2018). Money in Retirement: More Than Enough. Grattan Institute, Melbourne
[2] Commonwealth of Australia (2020). Retirement Income Review: Final Report. The Treasury, Canberra.
[3] Khemka, G., Tang, Y., & Warren, G. (2020). The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means. College of Business and Economics, Australian National University.
[4] Bird, R, Hue, J, & Hulley, H (2017), How Good is the Australian Superannuation System, In Reality? Paul Woolley Centre, University of Technology Sydney
[5] Welfare is calculated as the present value of lifetime consumption and wealth at time of death.

Emeritus Professor Ron Bird (ANU) is a finance and economics academic and former fund manager.

The great wealth transfer myth

Peter Roach

The hardest part of transferring wealth is not only transferring the assets. It's preparing the people who will inherit responsibility for them.

Australia is in the midst of what has become known as the Great Wealth Transfer. In JBWere's recent *Great Wealth Transfer Myth* report, I set out to challenge the familiar idea that significant family wealth

rarely survives beyond three generations and to show that stewardship can be a much longer-term process.

Much of the focus is on the legal and financial mechanics of that transfer, including wills, trusts and tax structures. But far less attention is given to preparing current and future generations to steward that wealth.

There can be a misplaced assumption that if the paperwork is in order, the transition will largely take care of itself.

However, successful succession is not an event triggered by the passing of a loved one. It is a long-term process of preparing people to exercise stewardship, make good financial and non-financial decisions together and uphold a shared sense of purpose well into the future.

Governance starts where estate planning ends

Many people take comfort in knowing they have an up-to-date will, enduring powers of attorney and well-structured trusts. While these are critical foundations, they're not succession plans.

Particularly in Australia, where significant wealth is held through family trusts and private entities, the key issue is often not simply who owns assets, but who controls them.

Questions such as who becomes the trustee, who makes decisions about investments and capital allocation, how disagreements are resolved, and what happens when different family members have different priorities, risk appetites or views about the future of the family's wealth are often sidelined.

Through our work with families across generations, we have found that legal and tax structures are rarely the source of family breakdown.

More often, difficulties arise because expectations have never been discussed, responsibilities are unclear, or the next generation has not been properly engaged in the role they will eventually play. The challenge is often even greater for families that own operating businesses, where governance frameworks can help coordinate decision-making across multiple asset pools and generations.

Reducing the governance gap

Over the years, I have worked with many individuals who have devoted decades to building successful businesses, property portfolios and investment holdings. They have been disciplined, strategic and deeply involved in every major decision. Yet when I ask how often the family comes together to discuss the future of those assets, the answer is often "not very often".

When families hear the term governance, they often think about bureaucracy and unnecessary formality. In reality, governance is much simpler than that. It's about creating a framework that helps families make decisions consistently over time.

For some families, that might mean a quarterly family meeting. For others, it could be a family council, an investment committee or regular discussions involving advisers and future decision-makers. The structure itself is less important than creating a consistent forum where family members can learn, contribute and understand how decisions are made.

Trusted advisers may help facilitate these discussions, particularly where expectations or responsibilities are unclear. Ultimately, however, the objective is to create a process that enables family members themselves to engage constructively and make informed decisions together.

For larger family enterprises, independent directors or chairs can help keep discussions constructive and focused on the long-term interests of the family. But governance is not reserved for the largest families or those with formal family offices. Any family seeking to preserve wealth across generations can benefit from clear communication, documented processes and regular conversations about purpose, priorities and stewardship.

Preparing the next generation

One of the most effective approaches is to involve younger family members early. They can sit in on meetings, observe discussions and begin to understand not only what assets the family owns, but why decisions are made in the way they are.

Over time, stewardship becomes something familiar rather than something daunting. When responsibility eventually transfers, family members understand the governance process, know who is responsible for what and have a clear appreciation of the family's values, priorities and long-term objectives.

Encouragingly, this involvement can challenge the perception that younger family members are less prepared or less engaged than those who came before them. In my experience, many are asking thoughtful questions about the purpose of wealth, the family's role in the community and the impact they want their capital to have.

Conversations around responsible investing, philanthropy and long-term legacy are frequently being driven by younger family members. Good governance creates space for those perspectives to be heard and allows families to evolve while remaining anchored to core values.

Structured philanthropy can in fact act as a springboard for family members to gain experience in financial and investment oversight, develop distribution policies and build an understanding of long-term stewardship and perpetuity.

In some cases, a philanthropic strategy may also enable family members to consider lifetime giving as well as the option to bequeath assets to a Family Foundation or Giving Fund as part of their estate planning. By growing philanthropic capital, families can demonstrate their ethos and foster a connection to community across generations.

Start with purpose

Another lesson I've observed is that governance works best when it is anchored by a clear sense of purpose.

Many families spend significant time discussing investment performance, but surprisingly little time discussing why they're keeping their wealth together in the first place.

Yet some of the most successful multi-generational families around the world continually return to that question.

The answers will be different for every family, but having those conversations creates alignment.

One way families can do this is to articulate the family's shared values, family ethos and purpose of wealth in a succinct Family Legacy Statement. Having this clearly defined gives people a shared understanding of what they're working towards and provides a moral compass when difficult decisions inevitably arise.

As Australia moves through the largest intergenerational transfer of wealth in its history, there will be plenty of attention paid to estate planning, tax structures and legal arrangements. Those things matter. But we've observed that the families most likely to succeed across generations are the ones that devote just as much attention to communication, governance and preparing people for responsibility.

The families that navigate generational change most successfully are rarely those with the most sophisticated structures. More often, they are the families that have spent time investing in the people who make up the family, not just the assets.

Peter Roach is a Senior Consultant, Family Advisory at JBWere Ltd. JBWere ABN 68 137 978 360 AFSL No. 341162 is a wholly owned subsidiary of National Australia Bank Limited. This article is general information only and does not take into account your personal objectives, financial situation or needs. It does not constitute financial, legal or tax advice. You should consider the appropriateness of the information and seek professional advice tailored to your circumstances.

What comes after bank hybrids?

Kanish Chugh

Bank hybrids have long been a familiar source of income for Australian investors. But that source is drying up.

More than A$9 billion of bank hybrids are expected to be redeemed by mid-2027, with approximately A$30 billion more maturing through 2032 as APRA's phase-out of Additional Tier 1 (AT1) securities progresses.

So, what happens when those securities disappear? How can investors maintain portfolio income without materially increasing risk?

Australian bank subordinated debt is often cited as one of the closest structural alternatives, particularly as Tier 2 debt is expected to replace much of the capital previously raised through AT1 securities.

But there is an important distinction: subordinated debt is not a like-for-like replacement for hybrids. Sitting higher in the capital structure, it generally offers greater payment priority and has historically exhibited lower volatility, but typically also lower expected returns.

This creates a practical reinvestment challenge for income-focused investors. Based on PIMCO's illustrative modelling, Australian hybrids had an expected total return of 7.2%, compared with 5.2% for an investment-grade Australian subordinated debt index. That difference highlights why subordinated debt may not fulfil the same role in a portfolio.

Bridging that gap by moving into lower-rated borrowers, longer maturities or more complex structures can introduce additional risks. Those risks may be appropriate for some investors, but they need to be understood rather than treated simply as a way to replace lost income.

Perhaps the better question is not “what replaces hybrids?” but “what were my hybrids actually doing for me?” Hybrids have historically provided income, floating-rate exposure and access to Australian bank credit. Some investors also valued their diversification benefits relative to equities. Any alternative portfolio should therefore be assessed not only on expected returns, but on how closely it replicates the specific characteristics investors valued in hybrids.

The relative importance of those characteristics will vary across investors. But by focusing on the outcomes that need to be replaced, rather than the security itself, investors can broaden the range of potential solutions and take a more flexible approach to portfolio construction. That means looking beyond a single segment of the market for sources of income and diversification.

A broader opportunity set

The global fixed-income market spans government bonds, investment-grade credit, securitised assets, emerging-market debt and other sectors that can each contribute differently to portfolio income and risk.

That means income does not need to come predominantly from bank credit or corporate credit. As of 31 August 2026, the global aggregate bond market offered a yield of 4.4%. Meanwhile, emerging-market local debt has offered a higher yield than many developed-market sectors at 6.33%. Naturally, this comes with additional currency and sovereign risk. Additional income opportunities also exist across investment-grade credit and securitised sectors, including agency mortgage-backed securities.

The principal benefit of global fixed income is diversification of return drivers. Rather than relying on a single segment of the credit market, investors can draw income from global credit and securitised assets, with interest-rate exposure adding another source of diversification and return. That interest-rate exposure is a shift from the floating-rate coupons hybrids pay. Bond prices can fall when interest rates rise, however, high-quality bonds have historically provided diversification benefits during many equity market drawdowns.

This flexibility may become increasingly important in a more fragmented investment environment. PIMCO's secular outlook highlights a world characterised by greater dispersion across economies, markets and policy cycles. In that environment, investors may place greater value on diversification across income sources and risk factors.

High-quality bonds can help provide both income and portfolio resilience.

Accessing global fixed income

For Australian investors, accessing global fixed-income markets is also easier than it once was. Exchange-traded funds (ETFs) now provide efficient access to a wide range of fixed-income sectors, including global bonds, global credit and diversified income strategies. For investors transitioning away from hybrids, ETFs can provide daily liquidity, transparency and straightforward access to a broader opportunity set.

The decision also need not be framed as a binary choice between liquid and illiquid investments. PIMCO's analysis suggests that when targeting return outcomes comparable to Australian hybrids, a

portfolio can remain predominantly invested in daily liquid bond strategies, while selectively incorporating private market exposures where appropriate and where investors are comfortable accepting reduced liquidity.

The point is not necessarily to replace one security with another, but to consider whether a combination of public and private assets better aligns with an investor's return and risk objectives.

Private credit may appeal to investors seeking additional income, but return expectations should be considered alongside liquidity constraints, manager selection risk and valuation transparency considerations.

Greater flexibility in portfolio construction is another benefit of drawing on multiple fixed-income sectors. Rather than relying on one investment to replicate everything hybrids previously provided, investors can combine different building blocks that each contribute differently to income generation, diversification and risk management.

Seeking hybrid-like returns through diversification

Investors do not need to rely on a single replacement for hybrids. A broader fixed-income allocation can help diversify return drivers while maintaining a high average credit quality profile. Australian subordinated debt may remain an important component of that allocation, complemented by diversified income-oriented strategies drawing on opportunities across global fixed-income markets.

For investors seeking additional income potential, private market strategies may also form part of the opportunity set, although any potential return benefits need to be weighed against the associated liquidity and risk trade-offs.

Rather than seeking to maximise returns, PIMCO's analysis considers how complementing an Australian subordinated debt portfolio with a global multi-sector income strategy can provide a similar risk/return profile to that of the hybrid portfolio investors are trying to replace. The analysis was calibrated to target the same expected return as Australian hybrids, estimated at 7.2%, while examining how diversification affected the portfolio's risk characteristics.

The analysis suggests that broadening the sources of return can produce a different risk/return profile from relying primarily on Australian subordinated debt. Diversified portfolios targeting similar return outcomes exhibited lower modelled volatility and equity sensitivity. Under the assumptions used in the analysis, this suggests that combining complementary fixed-income exposures may improve the balance between income and risk.

Income-oriented analysis

Portfolio built around a multi-sector income strategy and Australian sub-debt portfolio.

Metric	Including allocation to global multi-sector private credit	Excluding allocation to global multi-sector private credit
Estimated Return	7.9%	7.3%
Estimated Volatility	5.4%	4.9%
Equity Beta	0.16	0.10

Source: PIMCO illustrative portfolio analysis. Portfolio including private credit: 20% Australian subordinated debt, 50% global multi-sector income, 30% global multi-sector private credit. Portfolio excluding private credit: 25% Australian subordinated debt, 75% global multi-sector income. Hedged to AUD. Average duration: approximately 4.2 to 5 years. Hypothetical illustration only, not a forecast.

These are hypothetical illustrations rather than forecasts, and there is no assurance the stated results will be achieved. They nevertheless suggest that maintaining hybrid-like return expectations does not necessarily require concentrating risk in subordinated debt. Across this portfolio framework, diversified fixed-income portfolios achieved a more favourable balance between risk and return.

An opportunity to rethink portfolio construction

The phase-out of bank hybrids creates a choice for income investors. They can look for the next security that most closely resembles what they already own or use the transition to reconsider how their portfolio generates income in the first place.

Domestic subordinated debt is likely to remain an important component of many portfolios. However, it need not carry the entire burden of replacing hybrids. Global bonds, securitised assets, diversified credit strategies and private lending may each contribute differently to portfolio income and risk. For many investors, that may mean combining domestic and global fixed-income exposures across both listed and unlisted markets.

The opportunity created by the hybrid phase-out is therefore not simply to replace one security with another, but to build portfolios with a broader range of income sources and risk drivers. Whether implemented through ETFs, active funds or other investment vehicles, a more diversified approach may help investors achieve portfolio objectives while reducing reliance on a single source of income.

Hybrids may be on their way out, but the job they did isn't. The investors who are best placed for what comes next are likely to be the ones who spread that job across more than one source.

Kanish Chugh is Head of ETF Sales for Australia at PIMCO. This article is for general information only and has been prepared without taking into account your objectives, financial situation or needs. Before making an investment decision you should obtain professional advice and consider whether this information is appropriate having regard to your objectives, financial situation and needs.

Investment insights from the US

Emma Fisher

I attended the Goldman Sachs 'Communacopia' technology conference in San Francisco in September with panel sessions from, among others, OpenAI, Nvidia, SpaceX and Google Cloud. These are the key takeaways coming out of the 40 sessions I attended over three days.

1. Token-cost economics

If 2025 was the year of "token-maxxing", with corporates aiming to drive LLM usage across companies and get employees using the tools for anything and everything, then 2026 has been about token-cost optimisation. There was much discussion of using the right model for the right task; not every task requires frontier intelligence, and there was a broad consensus that the rise of (significantly) cheaper open-source, open-weight models is a good thing for the AI ecosystem and broader adoption.

The Pinterest CEO was blunt: “Any CEO who is not heavily leveraging open-source models is almost certainly wasting shareholder money… we are able to get cost at less than 8% of the comparable frontier model by using open source.”

2. Cybersecurity: the agents are here

Cybersecurity is clearly the next “killer app” for the frontier labs after coding: every company in the world will need the greatest defender tool set, and this will drive significant agentic workflow. While computing demand to date has been driven primarily by consumer queries, which are relatively low token intensity, agentic workflows such as cybersecurity run 24/7. Jensen Huang called this out: “Cybersecurity will be the next big market [with] agents running all the time.” This links to a broader theme: agents are here. Meta released its personal agent ‘Muse’ while I was in the US, offering a consumer-facing agentic application that could further compound token demand, as agentic workflows run 24/7.

3. The models will likely keep improving as scaling laws work across multiple variables

“Moore’s Law is coming to the end. Moving down the process node cannot drive double the performance. We are trying to substitute Moore’s Law with something else. Moore’s Law on one semi chip is limited by the radical law of physics on optics, so you can only cram so many transistors into one. Now you can put two die together into one chip, gets you double the performance. The current generation has four die, the next will have eight die… this will drive exponentially better LLMs… driving more and more value out of superintelligence. We do not see a limit at all yet.” CFO of Broadcom.

Jevons paradox: what does it mean for our portfolio?

The question that is fascinating global markets right now is whether or not we’re in an AI bubble. The case for a bubble is not hard to make. The scale of the AI build-out is historic. The largest US tech companies are spending c2% of US GDP on capex this year, a comparable level to the building of America’s railroads in the 1850s and approaching the peak of the 1990s internet boom. More importantly, funding has changed. Until recently, the build out was paid for out of the hyperscalers’ enormous free cash flow. It is now increasingly funded by debt, and the credit market has noticed: default protection on heavy borrowers such as Oracle and CoreWeave has widened sharply.

The case against is that the demand is real, and it far exceeds compute supply today. Wherever we look, compute is short: customers are committing, in some cases prepaying, to secure access to energised GPUs; capacity is being sold before it is built, and the revenue that can be earned from a megawatt of AI capacity is rising: SemiAnalysis reports that one-year rental contracts for Nvidia’s H100 rose almost 65% between October 2025 and August 2026. This is a classic price signal that the market needs more supply. On the usage side, the cost of each token is falling fast – Epoch AI estimates the price to achieve GPT-4’s performance on a set of PhD-level science questions fell by 40x per year. Meanwhile, total token demand, driven by more tasks and users, is increasing – a classic “Jevons paradox” – a term used to describe what often happens with new technology. It gets cheaper and more efficient, so people end up using far more of it. The phenomenon is named for William Stanley Jevons, who predicted in 1865 that more efficient steam engines would increase rather than decrease coal consumption in British factories.

Overall, from a portfolio perspective, we watch the debate rage and are more interested in the question of what the diffusion of this extraordinary technology will mean for company moats across the world.

Everything is changing, and at an accelerated pace. The two big themes of the conference, namely token cost optimisation and the rise of open-source, open-weight models, are related themes that in our view broaden the health of the AI ecosystem and will drive adoption. Knowledge is becoming a commodity, and change is coming for every company.

The models are getting better and cheaper

The first clear area of change will be in the operating costs of enterprises. While many companies are still struggling (or reluctant to) publicly outline clear ROI on AI spend, in our one-on-one reporting season catch ups with companies we noted a marked shift between February and August. While most companies in February pointed to the ability to accelerate product roadmaps with existing resources (i.e., use AI to 'do more' with the same resources), by August more than half were conceding they could likely do more with fewer resources over the coming years. As the models get better and token costs fall, the cost to achieve an outcome falls dramatically, driving ROI on the spend.

Who banks the savings?

We believe it is reasonable to assume that AI will lead to greater productivity for most companies. Some companies will choose to bank the savings; others will reinvest proceeds into revenue-generating activities. However, this does not logically lead to higher margins for all. The extent to which shareholders enjoy banked savings and hence higher margins will depend on the pricing power of the business, as it always has with any technological advancement.

Taking banking as an example: in the 1970s, banking meant visiting a branch during limited hours, queuing for a teller who wrote deposits into a passbook, and waiting days for cheques to be sorted by hand. Since then, ATMs, core banking systems, the internet and mobile banking have cut the cost of a transaction to a fraction of what it was. Yet banks' returns haven't structurally risen, because every bank adopted the same technology at roughly the same time, so savings were passed on to consumers via lower fees, as well as paying for the investment in technology. More companies now 'clip the ticket' between a customer and the bank. A clip is paid to cloud service providers, payment rails (Visa and Mastercard), Apple Pay, core banking vendors like Oracle and Fiserv, SAP, per-seat SaaS fees to companies like Microsoft, cybersecurity vendors and credit data providers. The same dynamic is likely to be true in an AI world.

Companies with unique pricing power are likely to hold onto more of the gains of AI. Businesses like James Hardie, with its near 100% share of the fibre cement siding category, The Lottery Corporation, which has exclusive monopoly licences to run state lotteries in Australia, and Aristocrat, which can save on game design and development spend while charging casino floors the same clip of the ticket, have an attractive combination of unique pricing power and (likely) undisrupted business models that mean they should be able to hang onto any productivity gains from AI.

Rapid change in moats

If knowledge is a commodity, there is no longer any moat in how hard it is to produce that knowledge. Coding was the first advantage to get wiped out: the cost of producing code has collapsed and legacy companies that find themselves with messy data and legacy 'tech debt' can have a disadvantage vs AI-native companies in the new world. The question shifts to what becomes scarce in an AI world. From an intangible perspective, companies that own proprietary data and own the customer relationship should

be able to use AI to produce better revenue-generating products. Car Group (CAR) is an example of a business in the portfolio that is almost as much a critical B2B business in car dealer supply chains as it is a meeting place for buyers and sellers.

The biggest disruption risk for CAR isn't a competitor building a classified site, it's the consumer interface moving to AI agents. If agent search proliferates, the Carsales 'meeting place' will lose some of its pricing power. We believe the best hedge for this risk is for Car Group to move deeper into dealers' systems, thereby ensuring it stays essential, and monetises its proprietary data, even if parts of search shift to agents (something we see no evidence of to date). We believe management recognise this: at the August result, the company announced the launch of Nexgate, an AI-powered dealer platform that connects inventory, leads and workflow.

The portals have the advantage of the fact that they are two-sided marketplaces, and they are free for buyers to use. This means that you cannot 'dislodge' a portal by offering a cheaper product.

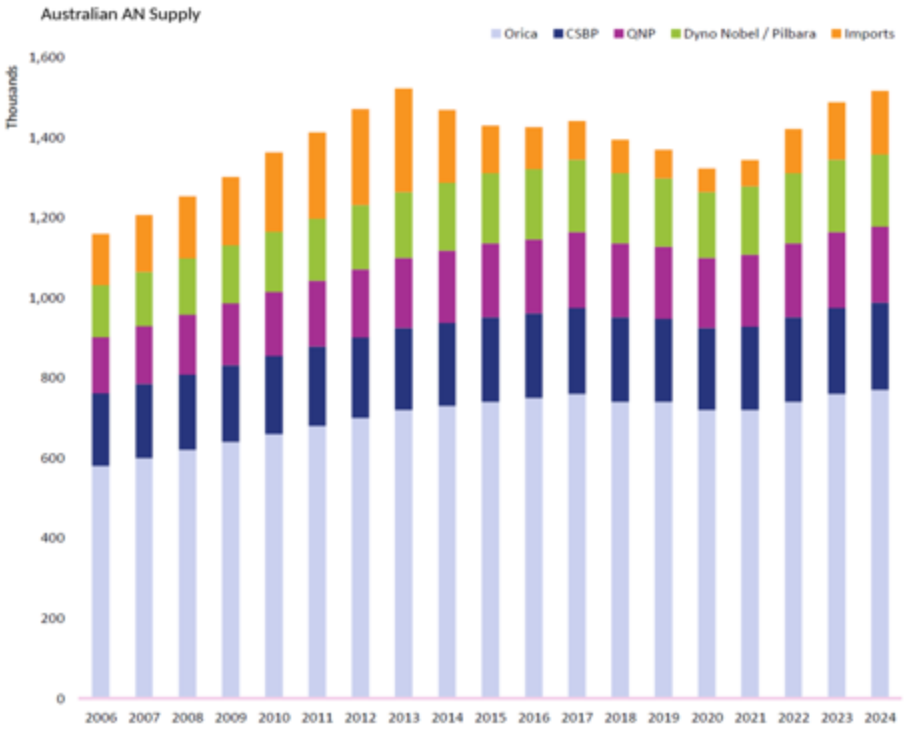
On the seller side, you can't dislodge a portal by offering cheaper listings, as the sellers go where the buyers are. By contrast, we are concerned that Xero's pricing power may erode over the coming years. Xero users are paying customers who see the bill every month. The bear case for Xero is that increasingly capable AI agents could automate many of the bookkeeping, reconciliation and administrative tasks that have traditionally underpinned accounting software. A big chunk of Xero's current competitive advantage is the high switching costs of the user experience. Busy small business owners simply cannot be bothered learning a whole new accounting software interface. The more workflow that becomes agentic, the lower the switching costs of the product. While we continue to track how this space may evolve.

The return of the physical economy

Sometimes, when considering change, it's also worth inverting the question and asking what is unlikely to change. The physical world of mines, commodities, physical supply chains, energy, land and power remains unchanged by artificial intelligence, and in fact the AI expansion is highly dependent on pulling on stuff in the physical world.

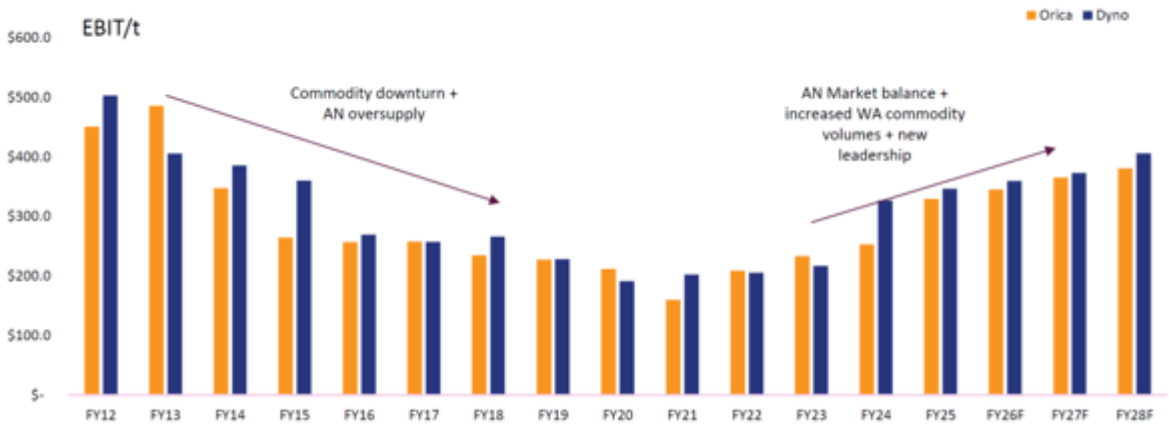
It takes around 15 years on average to bring a mine online, which means the commodities available today to meet demand are a function of the projections made about demand 15 years ago. It would have been difficult 15 years ago to accurately predict the electrification of the energy grid, the reshoring renaissance of industrial capacity in the US (incentivised by tariffs), and the mother of all AI-capex builds. Additionally, these demand drivers have arrived at a time when physical assets have languished under years of low commodity prices, and a long period where shareholders have demanded more disciplined capital allocation from management teams.

The mining explosives market in Australia is a perfect case in point. Ammonium nitrate (AN) is a controlled chemical made from gas-backed ammonia, and plants take years to gain permits and to build. The 2010s saw a wave of supply added by Wesfarmers, Dyno Nobel and Orica. Supply has been flat since 2017, yet the addition of new greenfield capacity led to declining industry returns from 2013 onwards and it took a decade for demand to grow into current supply.



Source: Company data, Airlie Research

We believe the market has now moved from balance into tightness, driving a pickup in EBIT/t that we expect to continue as no new supply is planned to come online, while elevated global pricing (due to higher global gas prices) plus shipping costs mean the economics of importing AN to Australia are unattractive unless pricing lifts.



Source: Company data, Airlie Research

This restricted supply dynamic has played out across many commodities in a similar fashion. Portfolio beneficiaries of this dynamic include BHP, Rio, Orica, Dyno Nobel, Santos, and Ampol.

Emma Fisher is a Portfolio Manager and Deputy Head of Australian Equities at Magellan-owned, Airlie Funds Management. Magellan Investment Partners is a sponsor of Firstlinks. This article has been

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Can Berkshire thrive without Buffett?

Jason Pohl

For almost six decades, investors have studied Berkshire Hathaway for lessons on how to allocate capital. The events of 2026 offer a rarer lesson: what a well-run succession looks like, and how to judge whether the discipline behind a great business survives the departure of its founder.

On 18 September, Warren Buffett, now 96, stepped down as chairman, a position he had held since 1970. He becomes chairman emeritus and stays on the board. His son, Howard Buffett, takes over as non-executive chairman, while Greg Abel, Chief Executive since January, continues to run the company.

The change in title matters less than what has happened around it. Over the past three quarters, Berkshire has bought back its own shares, completed a large acquisition, built a sizeable stake in a listed company and signalled patience in Japan. Each offers a lesson that applies well beyond one company.

Succession is a risk investors rarely price

Most investors analyse a company's products, margins and balance sheet. Far fewer ask what happens when the person who built it leaves. Yet for long-term holders, a poorly handled succession can destroy more value than a weak quarter ever could.

Berkshire separated the two jobs at the top deliberately. The Chief Executive allocates capital and oversees the operating businesses. The chairman leads the board and acts as custodian of the culture. Howard Buffett has sat on Berkshire's board since 1993, so he brings more than three decades of familiarity with how the company works.

The arrangement was flagged years in advance and carried out as described. That is a test worth applying to any holding: did management say clearly what would happen, and then do it? A transition that unfolds exactly as communicated is a sign of good governance, not merely good fortune.

Buybacks only make sense below fair value

A share buyback is not automatically good for shareholders. Buying back stock for more than it is worth transfers value from the owners who stay to those who sell. Berkshire's policy has long been to repurchase shares only when management believes the price sits below a conservative estimate of 'intrinsic value', meaning what the business is worth based on the cash it can generate over time.

Under Abel, that policy has been applied with conviction. Berkshire resumed buybacks on 4 March 2026, its first since May 2024. It spent roughly US$234 million in the first quarter, then about US$4.5 billion in the second, the largest quarterly amount since 2021. Abel has also said he will use his after-tax salary to buy Berkshire shares.

The lesson is to ask two questions of any buyback: what price is being paid, and does management have a record of buying only when shares are cheap? When a disciplined team buys its own stock, it is stating that the business is worth more than the market recognises. Done at the right price, buybacks lift each remaining owner's share of the business without any action on their part.

Buying when sentiment is weak

Two decisions recent show how Berkshire approaches an industry that is out of favour.

On 24 July 2026, Berkshire completed its purchase of US homebuilder Taylor Morrison for US$72.50 a share in cash, valuing the company's equity at about US$6.8 billion. Taylor Morrison will be combined with Clayton Properties Group, Berkshire's existing collection of 15 regional homebuilders. Together they delivered nearly 23,000 homes in 2025 across 21 states, making the combined business the fourth-largest homebuilder in the United States.

Berkshire also more than doubled its holding in Lennar, another major homebuilder, during the third quarter. It now owns about 11% of the company, roughly 26 million shares worth around US$2.1 billion. Because the stake now exceeds 10%, Berkshire must disclose further purchases within two business days.

A reasonable reading is that Berkshire is taking a long view of American housing. A shortage of homes, steady household formation and the prospect of lower interest rates over time could all support demand and affordability in the years ahead. Berkshire is not trying to call the bottom of the cycle. It is building scale in an essential industry while sentiment is subdued, consistent with Buffett's long-held view that it rarely pays to bet against America.

The broader lesson is that periods of weak sentiment are often when long-term owners can buy quality assets at sensible prices, provided they are prepared to wait.

Patience in Japan, and the limits of public filings

Berkshire's stakes in Japan's five major trading houses (Itochu, Marubeni, Mitsubishi, Mitsui and Sumitomo) are among its largest commitments outside the United States. It first invested more than six years ago.

Abel made his first visit to Tokyo as Chief Executive on 2 and 3 September 2026, meeting the leadership of each company and of insurer Tokio Marine. He described the holdings as investments Berkshire plans to keep for decades, and said each company has agreed to Berkshire lifting its ownership above the original 10% ceiling. He also said raising the stakes further is the goal, although no increases were discussed on the trip and any decision would be reviewed back in Omaha.

In mid-September, Itochu chairman Masahiro Okafuji said Berkshire intends to hold for the long term and that he would not object to its stakes rising towards 15%. Bloomberg reported this as Berkshire considering a move to that level.

The positions are large. Berkshire's six Japanese holdings, the five trading houses plus Tokio Marine, were worth about US$44 billion on 28 August, compared with a cost for the trading-house stakes of about US$15.4 billion at the end of 2025.

There is also a practical lesson for investors who follow Berkshire's moves. Its quarterly US holdings report, known as a 13F, covers only US-listed securities, so the November report will say nothing about Japan. Under Japanese rules, once a large shareholding has been disclosed, a new report is needed only when the holding changes by one percentage point or more. Smaller additions can go unreported for some time, surfacing later in a Japanese filing or in Berkshire's annual report. Public filings show what a company owned at a point in time, not necessarily what it is doing now.

What investors can take from this

Berkshire's year offers a checklist that applies to any long-term holding. Is succession planned and communicated? Are buybacks made only when shares are cheap? Is management willing to commit capital when an industry is unpopular? And are public disclosures being read with an understanding of what they do and do not show?

None of these questions depend on short-term market moves. They are about whether a business is run in a way that allows capital to compound over many years, which is the measure that matters most for patient investors.

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The Bengen 4% Rule: Lost in translation

Jeremy Duffield, Mikhail Walden

It's challenging to work out how much a retiree can withdraw from super to fund a spending level that's sustainable throughout their retirement. So, it's disappointing that so much space is wasted in Australia talking about the so-called 4% (Bengen) rule. This imported US concept is misleading for most Australians who fund their retirement spending from a combination of super and a means-tested Age Pension, which adjusts as their assets deplete. Consequently, it doesn't give them a useful idea of how much they can spend in retirement. To illustrate this at an extreme, even in the worst market environment of the last 140 years, a Full Age Pensioner's sustainable spending rate amounted to 35% of their super balance, nearly ***nine times*** the Bengen level.

Bengen's study was a groundbreaker in the US

The Bengen rule, commonly known as the "4% rule," was a pioneering concept in US retirement planning introduced by financial adviser William Bengen in 1994. It posits a safe withdrawal rate for retirees, suggesting that by initially withdrawing 4% of a portfolio's value and adjusting that dollar amount annually for inflation, a retiree can sustain their spending for a 30-year retirement period without running out of money, based on US historical market data.

That's useful in the US for planning purposes where the other major source of retirement income is Social Security, which is a known payout rate. Add Bengen's safe withdrawal rate from a retirement portfolio (A) and a personalised Social Security payout (B) and you have an estimate of a sustainable spending rate.

Crossing the Pacific though, we have increased local complexity in the Age Pension — a unique component of retirement income which, unlike US Social Security, is means-tested against an individual's retirement savings. Correctly factoring in the Australian Age Pension is critical as more than half of Australian retirees rely on it for over 50% of their retirement income. It currently contributes over $60 billion annually to the retirement incomes of everyday Australians.

A percentage withdrawal rule *may* be useful to consider for someone on the Full Age Pension – although it doesn't serve as a useful guide to sustainable spending. Their situation is analogous to the US retiree, funding retirement spending from a withdrawal rate from super (A) and an inflation-adjusting Age Pension (B), which stays fixed as long as they continue to meet the conditions for the Full Age Pension. And it may be useful for someone who may never get the Age Pension, like someone with a $5 million or $10 million portfolio.

But there's a vast swathe of the population who are on the Part Age Pension, where the Income or Assets tests mean that funding retirement isn't as simple as A plus B. Instead, for them, the Age Pension itself is a function of the amount of their super assets (among many other factors). A safe withdrawal percentage concept for them makes no sense as they have to master the maths of combining interdependent income sources.

The wondrous ways the Age Pension changes the maths

The Age Pension's means test is a wonder of administrative complexity, designed to act as a taxpayer-funded safety net targeting those who need it. The three tests of Residency, Income and Assets are complex. But for retirement planning purposes it's the taper rates on the Income and Assets tests that matter most to the payout level. The Income and Assets tests are also interdependent because what counts is so-called "deemed" income (income deemed to be earned on your financial assets), not actual investment income.

Means testing results in Part Pensioners getting more or less of the Age Pension as their assets fall or rise. The current rate of change is $78 per annum for each $1,000 of assets.

The typical result is that the Part Age Pensioner's payout is expected to rise over the course of retirement as assets are spent down to pay for retirement.

The other twist in retirement planning in Australia is that Account Based Pension streams have minimum withdrawal rates set as a percentage based on age (Table 1 below). This is now getting very confusing; retirees have to add a variable Age Pension rate to a mandated minimum percentage level of superannuation withdrawals. (And the Minimum Drawdown rate is higher than Bengen's 4% for anyone over 65.) No wonder, in our *Retirement Essentials* Retirement Checklist quiz, we found that 51% of people are uncertain as to how to combine super and the Age Pension to meet their spending needs.

Table 1: Minimum Pension Drawdown Rates — Account-Based Pensions

Age	Minimum Annual Payment (% of Account Balance)
Under 65	4%
65–74	5%
75–79	6%
80–84	7%
85–89	9%
90–94	11%
95 and over	14%

SuperEd research on historical sustainable spending rates

The easiest way to show that spending a fixed percentage of assets is misleading is to delve into the numbers.

We simulated sustainable retirement spending over each 30-year time horizon in the last 140 years of financial market history. We tested four personas — a Full Age Pensioner, a Part Age Pensioner, a Future Age Pensioner and a Never Age Pensioner[1] — differentiating them by super assets at retirement.

The question was: if you started retirement in year X with Y in super, how much could you have spent each year over the next 30-year period without running out — given the past market conditions and current Age Pension rates and thresholds?

As there are 112 30-year periods since 1885, there are 112 observations for each persona. We calculate the achieved spending rate for each starting year's "retirement era" in current dollars — so in real terms, keeping up with inflation. The results vary dramatically by the year retirement commenced, revealing the impact of very different financial market return regimes.

Table 2 shows the results for our four different personas. For each persona we show the Low (worst markets), Median and High (best markets) outcomes.

It's the dollars that count. But we also show the sustainable spending rate calculated as a percentage of the starting level of superannuation assets.

Table 2: Sustainable Retirement Spending by Persona
Historical Simulation (1885–1997 Start Years) (60/40 Portfolio)

Persona	Outcome	Assumed Initial Assets ($)	Sustainable Spending ($ p.a., today's dollars)	Sustainable Spending Rate (% of initial assets)
Full Age Pensioner	*Low*	$150,000	$51,800	34.5%
	Median	$150,000	$55,400	**36.9%**
	High	$150,000	$63,000	42.0%
Part Age Pensioner	*Low*	$500,000	$62,900	12.6%
	Median	$500,000	$73,400	**14.7%**
	High	$500,000	$94,400	18.9%
Future Age Pensioner	*Low*	$1,500,000	$83,700	5.6%
	Median	$1,500,000	$104,600	**7.0%**
	High	$1,500,000	$163,300	10.9%
Never Age Pensioner	*Low*	$10,000,000	$323,400	3.2%
	Median	$10,000,000	$544,400	**5.4%**
	High	$10,000,000	$985,100	9.9%

Assumptions: a homeowning couple both aged 67, retiring at 67, with combined super assets equal to the total. Personal assets of $10,000. Planning horizon of 30 years.

Observations

The results are quite remarkable.

There are wide discrepancies between poorest, average, and best market periods. Market returns and sequencing matter a lot.

For example, the Part Age Pensioner with $500,000 in starting super balances at retirement would historically have experienced a range of outcomes from $62,900 in annual spending in the worst market progression to $94,400 in the best market sequence of returns. The worst was 14% less than the median outcome, and the best was 129% better.

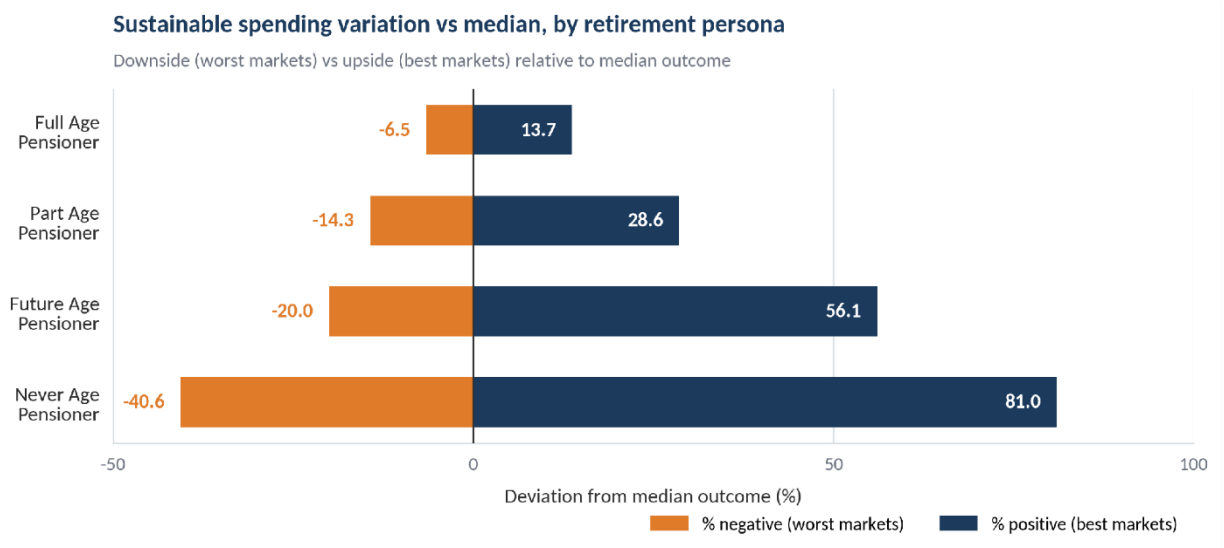
The percentage calculation of sustainable income vs the initial starting balance shows no relation to Bengen's 4% rule. A Full Age Pensioner, even in the worst mraket conditions, was able to spend an amount equal to almost 35% of the starting super balance — almost entirely thanks to the Age Pension.

The same finding holds for the Part Age Pensioner and the Future Age Pensioner; again, their sustainable spending is not reflected by Bengen's 4% rule.

The only exception is the Never Age Pensioner, who could only spend an annual amount equivalent to 3.2% of the starting balance. This finding is comparable — if lower — than Bengen's results. It shows that, using our 60/40 allocation, 4% wasn't quite achievable in the worst of times.

There's remarkably less uncertainty for those relying more heavily on the Age Pension. The chart below shows the discrepancy between worst and best outcomes vs median for the different Age Pension personas. Those with access to more Age Pension have much less volatility in their retirement outcomes — a result of both the lower exposure to markets and the optionality implicit in the Age Pension.

Figure 1: Sustainable spending variation vs median, by retirement persona



Conclusion

Our analysis of historical retirement scenarios, with today's Age Pension rules and rates, shows that the Bengen rule can be widely misleading for most Australians — those who will benefit from the Age Pension at some point.

This analysis does not suggest Bengen's work was incorrect. Bengen examined sustainable withdrawals from a private portfolio, while Australian retirees often fund consumption from a combination of superannuation and Age Pension entitlements. The interaction between these two sources means that a portfolio withdrawal rule alone may provide an incomplete picture of sustainable retirement spending.

Instead of using a US rule of thumb, older Australians are better off focusing on the dollars — not percentages — they can spend in the future, using a forecasting tool that incorporates the Age Pension and its interdependence with assets and income. As markets are anything but a straight line, retirees need access to strong stochastic models using reasonable return expectations; and they need to be prepared for a range of outcomes, because the one certainty is that there's volatility in retirement outcomes ahead.

[1] We define a Never Age Pensioner as someone who is unlikely to get the Age Pension until very late in life, if at all.

Jeremy Duffield is Co-founder and Director and Mikhail Walden is Senior Financial Engineer of SuperEd/Retirement Essentials.

Super low interest rates came with side effects

Michael Collins

In mid-2019, a third of investment-grade bonds including government bonds – worth US$17 trillion – had negative yields. Compare that with now.

US 10-year Treasury yields, which fell as low as about 0.55% in 2020, have topped 5.20% in recent weeks, as investors fret about inflation and Washington's strained public finances, and investors redirect money to fund infrastructure tied to artificial intelligence.

UK 10-year Gilt yields have almost reached 5.5% as London's debt topped 3 trillion pounds for the first time. French 10-year government bond yields have breached a 24-year high of 5.1% due to concerns about Paris's debt sustainability and the country's political instability. Australian 10-year bonds are trading around 5.25% even though Canberra's deficit and gross debt are modest compared with peers.

These are the four advanced countries whose 10-year government yields have recently exceeded 5% amid a worldwide surge in sovereign yields to decade highs. Needless to say, as benchmark government yields climbed, interest rates for consumers and business have soared too.

It can safely be said that the era of low interest rates has ended. One upshot is the era of promiscuous monetary policy can be assessed for its benefits and costs.

Recall that after the global financial crisis of 2008, central banks cut key rates to record lows – including below zero for the first time, promised to keep these policy rates low for years and conducted massive asset-buying to reduce the yields of all maturities.

Central bankers took such steps even though they knew that interest rates as a macro tool lose their stimulus fizz when they are close to zero, let alone if they are even mildly negative.

UK economist John Maynard Keynes in 1936 spoke of the 'liquidity trap' when describing the limits of low interest rates as an effective policy tool. He stated how uncertainty could be so great even low interest rates would fail to generate enough demand to ensure full employment.

While Keynes was indicating that low interest rates could be ineffective as a macro tool, the bigger worry is ultra-loose monetary policies produced side effects that made them counterproductive. Ten side effects stand out.

One is that Keynes's liquidity-trap concept seems to underestimate the dampening effect of emergency measures. Low rates seem to dent consumer spending and business investment because they signalled that authorities were gloomy, even panicked.

A second side effect is that low interest rates encouraged so much borrowing that business, consumer and government debt soared to record highs in nominal terms. As a proportion of GDP, they collectively amount to 310% of global output. At some point, the debt build-up must unwind and pose a systemic risk. Even without such mishaps, future repayments are likely to reduce the consumption and investment that drives economies.

A third side effect is that low and negative rates super-charged the price of assets. This always risked future trouble because if low and negative rates help the economy as intended bond yields must move higher and puncture asset prices.

The fourth side effect is soaring asset prices especially for housing widened inequality between asset owners and others, complicated by the fact that people were forced to heavily mortgage themselves to own ever-more expensive homes. It's not a stretch to say that the resentment from how low interest rates have indebted one generation of homeowners – they are most at risk from higher rates and a housing crash – and pushed housing beyond the reach of later generations is fanning the populism that troubles so many countries today.

A fifth problem is that low and negative rates troubled the business models of insurers and pension funds that typically use the safety and positive returns of government bonds to help meet long-term liabilities (that, in Europe especially, are often income guarantees). A sixth spillover was that low and negative rates squeezed bank margins, sometimes to the point of threatening financial stability, even when asset values on balance sheets rose and bad debts were generally lower.

Any crimping in bank margins brings a seventh problem; that at some level, low rates could backfire by forcing banks to restrict lending – a level known as the 'reversal rate'.

An eighth handicap is that central banks have faced political pressure for hurting savers and rescuing reckless borrowers. This could have undermined their independence to control consumer inflation. A ninth side effect is low and (especially) negative rates, perversely again, forced people to save more to attain a targeted level of savings. In such cases, low rates were a drag on growth.

A tenth drawback is that low rates encouraged unproductive investment and preserved zombie firms, which reduced productivity, a problem that plagues living standards today. If money has no 'time value' – the concept that money is worth more now than in the future – there is no hurdle for investment and firms struggling to earn their cost of capital don't collapse, which impedes capitalism's creative destruction. Negative interest rates, in fact, send this 'time value' concept haywire.

These risks might explain why low rates often failed to spark sustainable economic growth. The question arises as to whether such risks are worth taking to fight mild deflation which, in economic effects, is not much different from negligible, or zero, inflation.

If such a world were to reappear, policymakers should rely less on hyper monetary stimulus. In the meantime, the world is struggling to cope with the damage wrought by decades of the lowest interest rates in history.

It must be noted that central bankers have largely kept their economies at full employment, an achievement that avoids much social cost. But they seemingly brushed aside the longer-term costs of doing that. Another thing to note is that real interest rates are more critical economically than nominal ones. Low nominal rates essentially failed to bolster economies because they never approached the negative real rates that stimulated economies over much of the 1940s to the 1970s. That said, low nominal rates helped stoke some economic growth. For all their side effects, no upheaval occurred during the era of low interest rates.

But even with these qualifications, central bankers appeared to see the side effects their ultra-loose monetary policies provoked. They were among the most vocal in calling for instruments other than monetary policy to lead the world back to prosperity.

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