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Contents

Editorial

Inflation ... it seems such a dry subject and Firstlinks does not normally spend much time on a macro theme, but this is a fascinating and unique moment. The US CPI is up 6.8% in the last 12 months but the 10-year US bond is holding at around 1.5%, pushing the real yield to an unprecedented minus 5.3%. Central bankers are responding. US Fed Chair **Jerome Powell** and the Reserve Bank's **Philip Lowe** fear inflationary expectations are becoming baked into prices and wages. Powell said in 2018 of the Federal Open Market Committee (FOMC):

"The reality or expectation of a weak initial response could exacerbate the problem. I am confident that the FOMC would resolutely ‘do whatever it takes’ should inflation expectations drift materially up or down or should crisis again threaten."

'*Do whatever it takes*' in raising rates is a big change for a central banker who has been waiting for firm evidence before moving. For most of his first term, Powell (like Lowe) wanted to see inflation higher, which he referred to as *'achieving the goal'.* He would be happy to see it settle anywhere from 2% to 3%.

Overnight, the Fed doubled the pace of bond tapering and forecast three rate hikes in 2022 and another three in 2023. The Fed noted that:

“*supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation”.*

Powell said the Fed Funds rate increases could start as early as March 2022 as there is a "*real risk high inflation becomes entrenched".*

Meanwhile, as this screenshot from the AFR this week shows, the stockmarket was not worried about the high CPI number as it pushed to a record high. It's a remarkably sanguine view.

S&P 500 closes at record high as inflation threat eases

US stocks rallied strongly in relief as consumer prices matched expectations, providing some breathing space for the Federal Reserve.

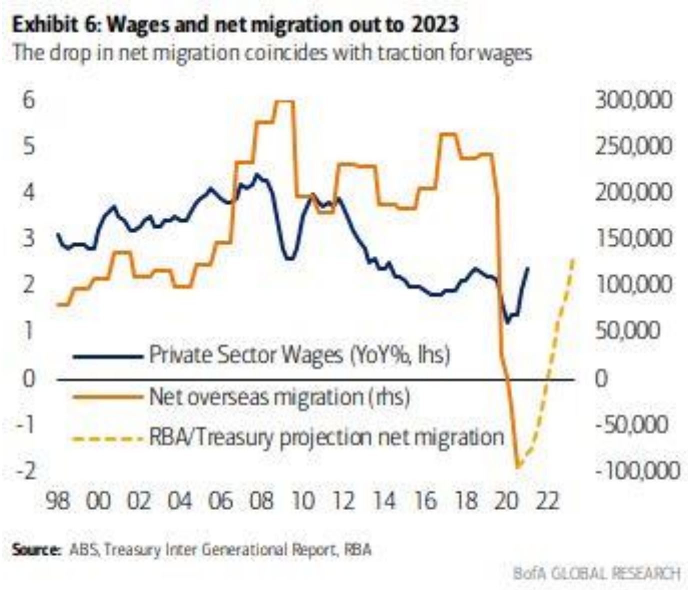
Inflation

US consumer prices climb at fastest annual rate since 1982

The consumer price index climbed 6.8 per cent from November 2020, matching the median forecasts in a Bloomberg survey of economists.

In Australia, the drop in immigration has encouraged a rise in wages, as the chart below shows. Expectations are that a return of net migrants towards the recent norm of 200,000 or more a year would have the reverse effect, and reduce the pressure on rising rates. This is why Omicron is so important for inflation, as case and hospital numbers may threaten the return of foreign labour.

So inflation, wages, the virus and house prices are all linked, and **Hamish Douglass** gives some important warnings in our edited transcript of his presentation to **Stanford Brown** clients this week. Douglass touches on some issues at Magellan that have made headlines this week, including explaining underperformance, but it is his worries about the virus and inflation, plus a black swan of a Middle East war, which are most important for investors. He shows why conditions are so dangerous and the markets are '*playing with fire*':



"We're watching this party of the century occurring at the moment and I feel like the person who is failing the ID check at the door."

Meanwhile, Social Services Minister **Anne Ruston** announced this week that the Pension Loan Scheme would be renamed the **Home Equity Access Scheme** with a couple of important tweaks: from 1 January 2022, the interest rate will fall from 4.5% to 3.95%, and from 1 July 2022, lump sums of $12,000 a year for singles and $18,000 for couples can be drawn. The name change is good because the scheme is open to Australians aged 66 and over who own residential property and not only those on the age pension.

And just when it seemed falling auction clearance rates might deliver some respite for prices and the next generation of buyers, **CoreLogic** produced this chart showing a lift in mortgage activity:

"CoreLogic systems monitor more than 100,000 mortgage activity events every month across our four main finance industry platforms ... the Mortgage Index provides the most timely and holistic measure of mortgage market activity available."

The pandemic has accelerated many trends, particularly in tech, creating faster growth paths for some companies. **Shannon McConaghy** identifies three companies benefitting from such changes. But there is less focus on the other side, where the market is expecting pandemic patterns to continue, and two of these are identified as shorting (selling) opportunities. That's one of the strengths of managing a long/short portfolio.

Two articles from legends of Australian financial markets with well over 100 years in markets between them. For 40 of those years, **Don Stammer** has been recording the market's annual X-Factor ... the big issue of the year likely to have a major impact next year, and he also shows his full 40 year list. Lots of issues long since considered irrelevant. Then **Noel Whittaker** explains why financial advice is worthwhile for all retirees, as he describes some little-known rules that could be costly if ignored.

Still on great hints for later in life, **Rachel Lane** analyses the claim that people need the proceeds from their house sale to pay for aged care services. Owning a home has many advantages and selling it may not be the best strategy.

Fixed interest funds may seem like the poor cousins of equity funds, with less of the glamourous stock stories and elevated returns in booming markets. But as **Andrew Cummins and David Hutchinson** show, many investors and financial advisers still rely on a core group of fixed interest funds for their income, capital protection and diversity, and they reveal the funds that have identified what these investors need.

Then **James Abela and Maroun Younes** reveal the global themes they follow in managing a portfolio of mid-sized companies where the investible universe is immense. What do they look for to whittle down the almost unlimited choices?

Going back a couple of weeks, an article on green hydrogen by **Michael Collins** drew many comments, including an expansion of the ideas by **Allan Blood**. The technology becomes even more relevant when we read this week that our truck transport system depends heavily on diesel topped up with AdBlue, which uses urea, most of which comes from China. We are learning more about our dependency on fragile global supply chains, another subject that Hamish Douglass covers.

And I was struck by a comment by **Harold Mattner** on my article on the stocks I expect to own for decades despite my market pessimism:

"Thanks Graham for all your articles…thoroughly enjoyable and useful. I lost money for the first twenty years of investing, and reached a stage where I had to change, or give it up. I found investing was an extension of who I was as a person, so to change oneself before I could change my investing style was quite an insight."

This week's White Paper from **Antipodes** is a quick read with useful charts on the global outlook for 2022, noting the impact of the withdrawal of stimulus, the threat of inflation and a few surprises.

Hamish Douglass on why the movie hasn't ended yet

Graham Hand

On 14 December 2021, amid a backdrop of intense media coverage of Magellan's recent performance and the resignation of CEO Brett Cairns, Hamish Douglass presented online to clients of advice group Stanford Brown. He was interviewed by Stanford Brown Director and Private Wealth Adviser, Hamish Harvey. This is Part 1 of an edited transcript. In Part 2 next week, the Hamishes will discuss house prices, valuations, cryptocurrencies, corporate profits and future returns.

HH: Let's kick things off with the change in CEO. Will this have any bearing on the oversight and management of the Global and High Conviction funds which many of our clients are invested in?

HD: It was a sudden resignation but there was no tension at all between Brett and me. Brett had two roles. One was looking after the back office of Magellan, and the other was the development of our listed products but not on the investments side. He resigned for personal reasons and while the timing was not ideal, I respected the decision and the reasons. I'm the Chief Investment Officer and my job's not changing. Three or four years ago, I used to be Chief Executive as well and we decided to take the pressure off and make sure all our back office and risk and compliance were in good hands with good leadership.

Kirsten Morton is our Chief Financial Officer and effectively Chief Operating Officer as operations report to her and she reported to Brett. She stepped straight into the Acting CEO role seamlessly so there is no risk at all for clients. The Board will make a decision in selecting the right Chief Executive which might be Kirsten but it won't be me. I'm not getting diverted because I'm focused on investments.

Wins and losses and fund performance

HH: Let's talk about the performance of the funds which have not kept up with the market over the last 12 months. Can you start by explaining the objective of the High Conviction Fund.

HD: It is a fund of eight to 12 investments that we call our 'best ideas'. It's more concentrated, we're holding 10% to 15% positions. We've always said that you can get more volatility in the short term, but let's put this in the perspective of what compounding is all about. If we make a single investment of 10% of a fund, and it goes up five to 10 times, we'll make 50% to 100% return on the entire capital in a single investment. Microsoft is up 12 times since we invested and we've made huge returns on Facebook, Visa, MasterCard, Alphabet and Yum Brands over time.

So if we get a stock wrong and we put 10% of the fund in and it falls 50%, that takes 5% of overall returns. But if we get a series of investments right over five to 10 years, it completely dominates a single stock loss.

We’ve probably made two mistakes in the history of the Fund. One was Kraft Heinz a number of years ago and then Alibaba and Tencent. We're out of Tencent, we made money, but Alibaba is down after what happened in China last year and therefore it's affected the short-term return.

Ultimately, we're seeking a premium over the return from our core Global Equity strategy because we're taking more risk in our best ideas. It's about long-term compounding, it doesn't happen in single 12-month periods. We've just gone into Netflix, which is up in the last 12 months but the previous 12 months, it didn't do anything. We have no idea how Netflix will perform in the next 12 months, I may as well throw a dart at the dartboard. But we have a very high conviction that Netflix over the next decade will give at least 15% compound returns.

The MSCI index is 1600 companies but we've got extreme things happening in that index at the moment. Judging this compounding machine against a stock market that's kind of gone crazy, and if you get caught up measuring 12-month periods, maybe you shouldn't be invested in the High Conviction Fund. But if you want to have the opportunity to compound your capital over the medium to long term, the probabilities are in your favor. We tend to hold these names for a long duration and while we made some mistakes in China in the last 12 months, we've fixed that and it’s not going to repeat itself in the future.

We're probably more closely enamored with China exposure in western world companies like the Starbucks or Louis Vuitton. In direct China stocks, you carry some very particular Chinese Communist Party risk, and our mistake was to own two technology companies in China. When you think about the Chinese consumer, the Western world gross national product per head sits in around $60,000. China sits around $15,000 per head. And there's 600 million Chinese who are dramatically under-consumed compared to Western world counterparts. Chinese consumption will grow materially faster than the West in future in a world where it will be difficult in the next 10 to 20 years to find growth. But we're going to do it cautiously with direct China exposure, although we still own Alibaba because it is ridiculously cheap and we think the risks are fully priced in at these levels.

Omicron is not the same movie as Delta and it may spread more rapidly

HH: Can we turn to your 2022 outlook, especially virus mutations and inflation and the likely impact on interest rates and markets?

HD: I could probably tell you more about mutations than how markets will react. We've always been cautious around mutation risk but when we saw Delta and earlier ones, we weren't overly concerned that they would lead to a major event. When we saw Omicron, even before we got any data, when we saw where the mutations were on the spike protein, with our scientific advisers, we thought this is potentially something really different. But the market thinks it's watching the same movie as Delta.

It is very likely this mutation would escape most of the vaccines and that's what we're seeing. The two-dose vaccines are almost completely useless protecting against infection from Omicron which means this is going to spread rapidly on a global basis. It’s already the dominant strain of new infection in the UK and it's only been there for two weeks. You can see how rapidly this can spread because people don't have immunity. The third booster increases your antibody levels and it looks like those antibodies will give protection. We don't have any longitudinal data yet on how long booster protection will last but over the next say eight to 12 weeks, this is going to absolutely explode around the world and it'll make the level of prior infection look like the teddy bear’s picnic.

We have no idea of the relative severity but with many more cases, even if it's less severe, the hospital systems could get completely choked around the world. We don’t know when hospitals hit their breaking points, and in all likelihood, we're going to take measures to slow the thing down which means we have to go back into some form of restrictions, which everybody will hate, but we're not going to go there until we let it to get completely out of control.

If it's super mild, and it's just a bad flu, we've got nothing to worry about. But we've got an event that is going to take people by surprise. If there is a very big shake in markets, we're ready to go into stocks we might have missed before. For example, it isn't going to affect the longer-term outlook for travel demand but it will affect the next six to 12 months and the short-term profitability. We're probably three to six months away of getting mass vaccinations but most people might get infected before they get the next shot for this particular variant.

Will the market look through this or react to the next wave? It's really hard to judge. I'm pretty confident on the infection levels but I really don't know on the severity point.

Defensive stocks and cash take advantage of selloff

HH: So let's say we do have a sell off, have you got particular investments that you expect to be more defensive that you could theoretically sell and go into something that's been beaten up?

HD: We've done a few trades and we've just increased our cash a little bit as markets bounced back. But we have some investments that are pretty pandemic resistant. You think about Netflix and Alphabet and Microsoft. They are investments that have done well during the pandemic through better engagement and will probably hold up well while travel-related activities could be absolutely hammered. So if this sort of dispersion happens, we may well rotate and we are doing a lot of work to make sure we're prepared if the market panics in certain areas. If it doesn't happen, we will look for the next opportunity.

HH: That’s clear, all of us should have booster shots.

HD: If you're eligible for your booster, I would strongly recommend it and it looks highly effective, particularly for a few months.

HH: Inflation is higher at the moment in the US, but what's the impact of higher inflation for the next few months?

Inflation is the big one, but here’s the real risk

HD: This is really the big issue, much more important than views on Omicron but there is an interplay. We largely sit in the camp that many of these pressures on inflation, which will be very elevated for the next three months or so, are largely temporary and transitory factors. They've been caused by the pandemic when people were locked down and given income but they had few things to spend it on because we couldn't go to restaurants and travel. They missed out on three holidays but they still have the income. And therefore their savings have gone up and there was a massive increase in demand for goods.

People were doing things at home, renovating, buying goods online. And the monthly demand for goods went well above levels seen in the world before. The manufacturing system had to churn out more goods and deliver them. Supply chains were asked to do more than ever but they were disrupted by the pandemic, particularly in Southeast Asia.

We expect a transition from buying goods to consuming services. The demand for goods will come back down and it will start releasing the pressure on the supply chains. And as the pandemic eases, the supply chains will catch up as well. And the same thing in labour constraints caused because borders were closed. We have 200,000 to 300,000 people who work in the Australian economy every year who are not residents. They are students and people under 35 visiting Australia who work in our restaurants and pubs and everywhere else. And none of them are here. So it's not surprising to see a scramble for that type of labour in the world and complaining no one wants to work. It's not that no one wants to work.

The real risk here is in the United States, when we get to their summer, let’s say June, July, August next year. And we don't have this rollover changing demand patterns and reopening of borders. And let's say Omicron is still going. We’ll see more inflationary effects passed to consumers, but if it hasn't rolled over from goods to services by the US summer, inflation will move into expectations.

If inflation takes hold, the game is up

And at that point, I think the game's up. Central banks will be forced to respond by tightening monetary policy, with rate rises next year from the Fed. That isn't a response to the current inflation, that's just a modest tightening as we go through the cycle. But if inflation really is the issue next year, hold on to your chairs. We ain't seen anything. These markets are wound up, there are so many crowded trades. And what happens when they start to materially tighten monetary policy is we're going to have massive asset price volatility. I think I could name 200 stocks that could drop 40% in a day. People are playing with fire.

Even the reopening trade, it's so crowded, if people change their view when monetary policy tightens, you have the whole world in overvalued trades and everyone's running for the same door at the same time. And normally when we've had a shake after a financial crisis, it's the central banks who come to the rescue of asset markets by printing money and buying bonds and driving down interest rates and flooding the world with liquidity. The issue if it's inflation, the central banks are going in the opposite direction. They're actually stopping quantitative easing and tightening monetary policy to stop inflation. They're no longer here to help.

And that's what makes this so dangerous. Central banks can't help us anymore because they're solving an inflation problem. The governments are constrained because rates are going up and therefore how much more deficit spending can they take on? It's very, very dangerous situation for asset owners. Does it worry me? No, we got an defensive portfolio and we don't own that extremely expensive stuff. It's not gonna be fun, by the way, but the volatility would be our friend.

I put a 30% probability on it. I think it's probably going to roll over. But if it happens, people are getting their shirts ripped off. This movie hasn't ended yet. We've been judged over 12 months of being conservative.

Another black swan, and the risks are obvious

I'll throw another black swan into this, Israel and Iran. Iran is heading rapidly towards nuclear enrichment. It doesn't look like the US will reach an agreement with Iran and I think there's a reasonable possibility in the next six months that Israel strikes Iran. The question is what Iran does in response, such as do they strike the Saudi Arabian oil facilities? The last thing in the world needs is an event in the Middle East.

So this whole thing could be triggered by something we're not even looking at. We're only halfway through the movie. The press has judged the end of the movie, but in 12 months' time, we're either going to get through this with a rollover (away from goods to services), and everything's pretty calm despite a modest tightening. Or we're going to have an event that's ugly and that's fairly likely, so we're cautious. To us, the risks are obvious.

That doesn't mean they're going to happen but no-one can say, 'Oh, we couldn't see that coming.' There's so many warning signs here with extreme behaviour going on. And Charlie Munger said at the Hearts & Minds Conference that he believes this is more extreme than 1999. This is one of the most extreme markets he's ever seen in his life, and he's 98 so he's seen a few of them. There is just some crazy stuff occurring at the moment and we're watching this party of the century occurring at the moment and I feel like the person who is failing the ID check at the door.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information only and does not consider the circumstances of any investor. This is Part 1 of an edited transcript of a client event hosted by Stanford Brown. In Part 2, the two Hamishes will discuss house prices, valuations, cryptocurrencies, corporate profits and future returns.

Five global trends point to buys and sells for 2022

Shannon McConaghy

Many of our holdings are not well known in the Australian market, and we also own familiar global brands not likely to be held by most Australian investors. While the Australian Securities Exchange (ASX) ranks in the Top 20 of major global exchanges with a market capitalisation around US$2 trillion, it is dwarfed by the leaders, such as the New York Stock Exchange at about US$27 trillion and NASDAQ at US$24 trillion. Australia represents about 2% of listed global company opportunities.

Consequently, there are many industries and themes not available to investors who focus only on the ASX, such as in the leading global tech, health and consumer brands. Even where a similar business exists in Australia, the global company is often operating on a significantly higher scale in many more markets.

This article focusses on five opportunities, three buys and two sells based on expected market developments for 2022 building on themes now opening.

Chicago Mercantile Exchange (CME) and US stimulus spending

CME is a derivatives exchange with an effective monopoly in trading of US interest rate derivatives. It also operates a dominant position in trading commodities, foreign exchange and energy derivatives. We believe the record level of issuance of US Treasury bonds to fund stimulus spending provides a future tailwind for interest rate derivatives and volatility trading.

The anticipated upside is hidden in future earnings, and the trigger for the earnings power will be an acceleration in interest rate increases and volatility in 2022. CME is ideally positioned to take fees from this activity as well as the ongoing issuance growth of US Treasuries, as shown below.

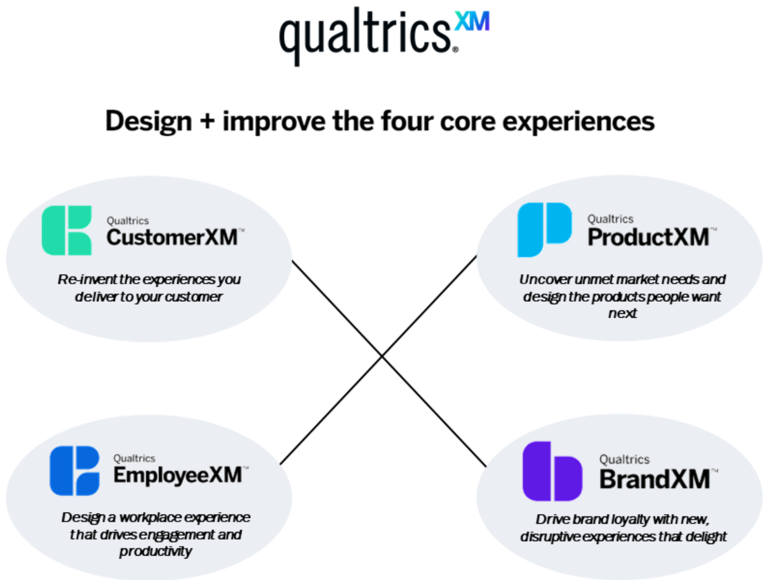
Qualtrics and easy use of data

Qualtrics is a cloud software business and the leader in a category called Customer Experience Management. Businesses today are faced with a growing wave of data, whether from customers, employees, or data about specific brands within a product portfolio. And all this data is flowing in from different channels, such as social media posts, inbound emails, customer service interactions, or survey responses. Qualtrics takes all of this unstructured data, analyses it and presents it on a user-friendly platform so that executives can quickly check customer or employee feedback or use real-time insights to make decisions.

A good example is JetBlue airlines, a major US low-cost airline which uses the platform to analyse customer feedback and better tailor pricing for flights. It also improves the inflight experience and enhances net promoter scores, and ultimately increases customer retention.

Qualtrics is the leader in this market with around 14,000 customers and by far the largest player. In fact, 85% of Fortune 100 companies are customers. As an enterprise Software as a Service (SaaS) solution, the revenue model is highly scalable and profitable with strong recurring revenues based on the number of modules that a customer wants.

This graphic shows how a business maps out customer feedback data, or employee feedback data, or more information about a specific brand. Existing customers are on average increasing the spend with Qualtrics by over 20% each year. We think this type of software, and this category of customer experience management, is mission critical for businesses that need to better understand their customers and employees and then adapt in real time. Increasingly, investors will appreciate the long runway of growth, and the business is starting to generate significant free cash flow, despite ongoing investments in the software.



Mercari and online marketplaces

Turning to our Asian portfolio, Mercari is Japan's leading marketplace to buy and sell second-hand products online, anything from clothes to electronics to toys. They have made the online experience seamless, both in terms of listing products for buyers and sellers and also in terms of shipping and delivering items. Now with 20 million monthly active users in Japan, Mercari is used by one in six Japanese individuals each month and has become pervasive throughout society in Japan.

As Mercari grows, it attracts more sellers and buyers creating a classic network-effect flywheel. The business model is capital-light, scalable, and has winner-take-all economics, which has allowed it to capture over 60% market share in the second-hand goods market in Japan. It is so dominant in Japan that the company estimates that products sold on the Mercari platform account for 5% to 10% of all Japanese home delivery parcels. The domestic business is highly profitable and cash flow generative, which is allowing the business to reinvest into new growth opportunities. One of these is in digital payments, including Buy Now Pay Later services. It has also expanded overseas, particularly in the US, where it has launched a similar second-hand goods marketplace that now captures about US$1 billion a year on transactions with almost 5 million monthly active users.

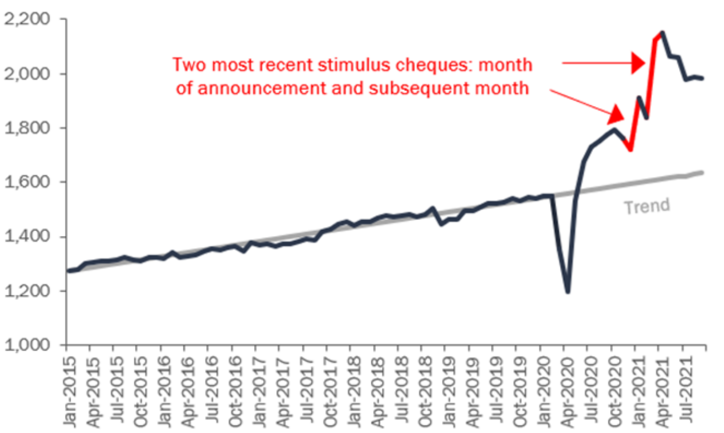
Now let's consider two shorting or selling thematics.

Personal consumer goods

First, there has been a substantial surge in durable goods consumption in the US in the last year. As households, unable to spend on services such as restaurant and travel, have funneled more expenditure into goods. This trend was amplified by US stimulus checks handed directly to households, and some stock valuations now appear to be pricing in a new paradigm of the recent growth rates and margin expansion continuing.

However, consumption is reverting towards trend as services consumption picks back up. People will return to restaurant and travel, and the inventory levels for some of the consumer companies are extremely elevated, which will be priced to clear at some stage.

US Durable Goods Personal Consumption Expenditure
(US$bn, Seasonally Adjusted Annual Rate)



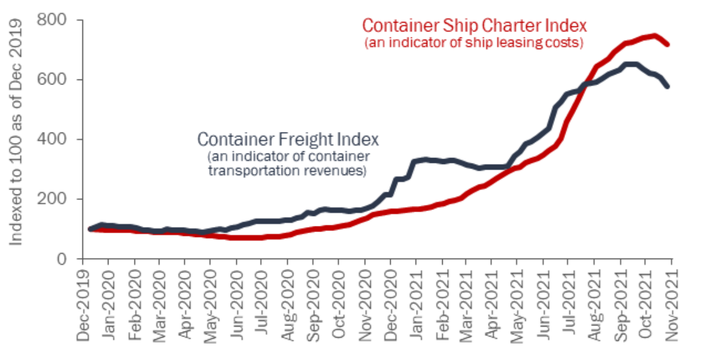
Source: U.S. Bureau of Economic Analysis. Trend has been extrapolated from 2015 to 2019 actual data.

Container shipping lines

The consumer trends are also feeding through in container shipping lines. Again, the huge surge in durable goods consumption in the US led to an overwhelming order flow for Asian manufacturers and a massive strain on supply chains. Amplified by COVID delays, this led to ships anchored in ports and an increase in freight rates. Now, the high frequency forecasts that we track based on actual container bookings show this inflow is starting to slow.

Meanwhile, measures to improve the supply chain have led to a 30% decline in the number of containers stuck on the Port of Los Angeles docks (a key pinch point) over recent months. Indeed, the CEO of the Long Beach Harbor Trucking Association suggests that cargo showing up in the docks is moving quickly. Walmart, the largest retailer in the US, reports an increase in throughput over the last four weeks of containers clearing ports. The chart below shows the early signs of this impact on the Container Ship Charter Index, which is an indicator of revenue for the shipping lines.

Ship Charter Costs Have Grown More than Freight Prices since 2019



Source: WCI Composite Container Freight Benchmark Rate per 40 foot box, Container Ship Time Charter Assessment Index (both via Bloomberg).

Many people in the market don't understand that a key cost indicator for the shipping lines, the charter rates they pay to lease ships, have risen to record levels. These elevated charter costs are now being locked in on average for two years. This may lead to an earner squeeze which is not priced into current elevated valuations.

That's a brief overview of two areas we find appealing for shorts, but it also shows key trends which will affect many parts of the global economy.

Operating a fund with both long and short capacity gives portfolio managers the ability to back good investments while benefitting from declining thematics and companies. Of course, in a strong market, the shorts can be challenged by the sheer momentum of the market, which requires a patient approach for strategies to pay off over the long run.

Shannon McConaghy is a Senior Investment Analyst at [VGI Partners](), a sponsor of Firstlinks. This article contains general information and does not consider the circumstances of any investor.

For more articles and White Papers by VGI, including 'A Guide to Listed Investment Companies (LICs)', [click here](). VGI Partners manages two LICs, a global portfolio (ASX:VG1) and an Asian portfolio (ASX:VG8).

It's time to reveal the 2021 X-Factor in investment markets

Don Stammer

In the first half of 1982, Japanese institutional investors made a surprising move. They came into the Australian bond market in scale and quickly acquired 5% of Australian government bonds. At a meeting of investors in Sydney at that time, I suggested we call the sudden surge in demand in Japan for Australian bonds as the Factor X in our investment markets.

Forty years on, keeping a watch out for Factor X (in 2007 re-named as the X-Factor) has become an obsession of mine, even an addiction.

What is an X-Factor?

The X-Factor is the major influence on investment markets that had not been generally predicted or allowed for, but which came out of the woodwork with a powerful effect. My list of all 40 years of the X-Factors is set out below.

To be a fan of the X-Factor does not preclude taking a view on where the economy, inflation, shares, property, interest rates and exchange rates seem to be headed. Instead, it's a reminder that investors always need to allow for the surprises and over-reactions that drive returns up or down often at short notice. Risk-management - including a sensible diversification - is always important to successful investing.

The effects on investors from the X-Factor can be negative or positive. Examples of the former are the near melt-down of global banking in 2008, the initial effects from the outbreak of Covid-19 in 2020, and the disruptions caused by the terrorist attacks in 2001. By contrast, Factor-X resulted in better-than-expected returns in 1991 when Australia's trend inflation collapsed, and in 1998 and 2008 when our economy showed unexpected resilience during, respectively, the Asian financial crisis and the GFC.

The last 12 months provide a bounteous harvest of X-Factors, from which I've selected these finalists for the awards this year, presented in no particular order.

1. The shape of the pandemic

It's in the nature of pandemics to quickly change their shape and impact, making it difficult to take a view on what the future will hold. In 2021 there have been many surprises from Covid-19 as mass vaccinations took place, variants (notably Delta and Omicron) emerged, and lockdowns came, went and returned. However, the changing shape of the pandemic and the uncertainties it generated were, for most investors, less of a worry than was experienced in 2020.

2. The global economy

The massive easings in budget and monetary policies announced by mid-2020 and maintained through 2021 have boosted the global economy, average share prices and many parts of property markets. The world-wide impact of the Covid-19 pandemic on global GDP and on most asset prices didn't follow the L-shaped or U-shaped paths that were widely predicted. Instead, economic conditions and share prices tracked along the deepest and sharpest V-shapes ever seen.

Around the world, budget deficits are huge and will be for a long time. So far, the rapid increases in government bonds on issue have been funded relatively easily. Bond yields have moved up from their all-time lows but remain well below long-term averages, and many real interest rates are negative.

Looking ahead, the Reserve Bank's forecast of 5.5% growth in Australian GDP in 2022 seems a big ask. But I share the thinking of Ausbil's Paul Xiradis on the world economy, where he says:

" ... expect forward estimates for the next two years will be upgraded, driven by an under-appreciated pick-up in activity beyond Covid lockdowns ... the economic environment is favourable for shares and will be for the next year or so."

I would add as someone already a little over-weight in shares, I'm happy to wait for periods of market weakness before topping up further on shares and I expect average return on shares in single digits in 2022.

3. Share market valuations

In rich countries, share market indexes have made strong gains over 2021, thanks to the combination of fiscal boosts, highly accommodative monetary policies, and negative real interest rates. There was also support from the good recovery in average profits and dividends after they collapsed in mid-2020. To quote Paul Xiradis again:

"I do not believe Australian equities are too expensive on average when you consider them in relative terms against where long-term interest rates are sitting, and their forward earnings growth outlook."

4. Monetary policy ... and inflation

Over much of the last two years, the dominant expectation in financial markets was monetary policy settings would remain highly expansionary for a very long time, particularly in the US and Australia where central banks have re-stated that higher interest rates were unlikely until 2024 at least and would await a pick-up in the pace of increase in nominal wages.

Recently, this near-unanimity of view of the outlook has fractured and the gap between the two camps could widen further. Many investors and commentators now expect higher interest rates in the US and Australia from 2022 or 2023. In the US, headline inflation jumped to 6.2% in the 12 months to September 2021, the highest rate of increase for 30 years. Canada, Korea and New Zealand have already raised their cash rates.

It seems to me that the majority of investors still view that recent increases in inflation as transitory. They're focused on the short-run effects of supply disruptions, the temporary nature of high energy prices, and the boost in consumer spending as lockdowns were eased. The current bump in inflation is seen as disappearing as global growth slows, energy prices drop, globalisation picks up; and as unions have less power to raise wages than in earlier decades.

A growing minority of investors now expect inflation will be a lasting problem in the medium-term and longer. They emphasise: a continuation of supply disruptions; a quickening in wage increases led from businesses finding it hard to recruit or retain staff; perhaps, the return of expectations of higher inflation in coming rounds of wage negotiations; and they expect energy prices to increase as countries switch from coal, oil and gas to renewables.

And the winner is ...

In my view, inflation isn't transitory. Inflation could be 3-5% in a year's time and then move up another notch or two. Thus, the widening split in expectations for inflation is my selection of the X-Factor for 2021.

See the full list below.

To all who read this article on the X-Factor, I wish for you good health, good humour and good investing in the years to come.

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

40 years of the X-Factor files

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

2020 Covid-19

2019 Strong share markets despite repeated predictions of global recession

2018 The impact from the royal commission on financial services

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

2016 Election of Donald Trump as US president

2015 Widespread experience of negative nominal interest rates

2014 Collapse in oil price during severe tensions in middle east

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

2012 The extent of investors' hunt for yield

2011 The government debt crises in Europe

2010 The government debt crises in Europe

2009 The resilience of our economy despite the GFC

2008 The near meltdown in banking systems

2007 RBA raises interest rates 17 days pre-election

2006 Big changes to superannuation

2005 Modest impact on economies from high oil prices

2004 Sustained hike in oil prices

2003 Marked fall in US dollar

2002 Extent of US corporate fraud in Enron etc

2001 September 11 terrorist attacks

2000 Overshooting of exchange rates

1999 Powerful cyclical recovery across Asia

1998 Resilience of our economy despite Asian crisis

1997 Asian financial crisis

1996 Global liquidity boom created in Japan

1995 Powerful rally in US markets

1994 Sharp rise in bond yields

1993 Big improvement in Australian competitiveness

1992 Souring of the vision of "Europe 1992"

1991 Sustainable collapse of inflation

1990 Iraq invasion of Kuwait

1989 Collapse of communism

1988 Boom in world economy despite Black Monday

1987 Black Monday collapse in shares

1986 "Banana Republic" comment by Paul Keating

1985 Collapse of A$ after MX missile crisis

1984 Measured inflation falls sharply

1983 Free float of Australian dollar

1982 Substantial Japanese buying of Australian bonds

Little-known pension traps prove the value of advice

Noel Whittaker

The age pension is a major source of income for the majority of Australian retirees. A bonus is that eligibility for a part pension gives them access to most of the pension's fringe benefits, including the prized Pensioner Concession Card, even if their age pension is only minuscule.

But the system is complex, and many people find it hard to work their way through the labyrinth of regulations. As a result, they may fail to qualify for a pension, lose their pension, or receive less than they would if they took advice.

Eligibility is tested under both an income and an assets test, and the one that produces the least pension is the one used. There is an age pension calculator and a deeming calculator on my website.

1. Additional income

Most wealthier pensioners are asset tested, yet I keep receiving emails from them asking if it's okay to earn some more money. Of course it is – the income test is not relevant if you are asset tested. A couple with assets of $800,000, receiving a pension of $136.80 a fortnight each, could have assessable income of $68,000 a year including their deemed income, and employment income, without affecting their pension because they would still be asset tested.

2. Valuing assets

Your own home is not assessable, but your furniture, fittings and vehicles are assets tested. Many pensioners fall into the trap of valuing them at replacement value. This could cost them heavily because every $10,000 of excess assets reduces the pension by $780 a year. Make sure these assets are valued at garage sale value, not replacement value. This puts a value of $5,000 on most people’s furniture.

3. Don’t spend just to increase pension

There is no penalty for spending money on holidays, living expenses and renovating the family home, but don’t do this just to increase your pension. Think about it. If you spend $100,000 renovating your home your pension may increase by just $7,800 a year, but it would take almost 13 years of the increased pension to get the $100,000 back. Of course, the benefit of money spent should be taken into account too – money on improving your house or travelling could have huge benefits for you. The main thing is not to spend money with the sole purpose of getting a bigger age pension.

4. Revaluations

Each year on 20 March and 20 September, Centrelink values your market-linked investments, such as shares and managed investments, based on the latest unit prices held by them. These investments are also revalued when you advise of a change to your investment portfolio or when you request a revaluation of your shares and managed investments. If the value of your investments has fallen, there may be an increase in your payment. If the value of your investments has increased, then your payment may go down.

The rules are in favour of pensioners. If the value of your portfolio rises because of market movements, you are not required to advise Centrelink of the change. It will happen automatically at the next six monthly revaluation. However, if your portfolio falls you have the ability to notify Centrelink immediately.

5. Gifting

You can reduce your assets by giving money away but seek advice. The Centrelink rules only allow gifts of $10,000 in a financial year with a maximum of $30,000 over five years. Using these rules, you could gift away $10,000 before June 30th and $10,000 just after it, and so reduce assessable assets by $20,000.

6. Superannuation

There is devil in the detail. If a member of a couple has not reached pensionable age, it’s prudent to keep as much of the superannuation in the younger person’s name because then it is exempt from assessment by Centrelink. However, the moment that fund is moved to pension mode, it’s assessable irrespective of the age of the member.

7. Mortgaged assets

A common trap is when a loan is used to purchase an investment property with the loan secured by a mortgage against the pensioner's own residence. The debt against an investment asset is only deducted from the asset value if the mortgage is held against the investment asset. If the mortgage is secured against an asset other than the investment asset, the gross amount is counted for the assets test and the loan is not deducted.

The effect on the pension could be horrendous.

8. Family trusts

Family trusts can cause problems with both income and assets tests for the age pension. Thanks to the information sharing and matching abilities between Centrelink and the ATO, you can bet that Centrelink will know if a family trust is involved in your affairs.

Even if you have a high-risk child (such as a child with a relevant disability) who makes Mum the appointer or default beneficiary for asset protection and there is no ‘pattern of distribution’, Mum could be caught.

It’s a complex topic. If there is a family trust somewhere in your financial affairs, I suggest you take expert advice long before you think about applying for the age pension. It may pay big dividends.

9. Bequests

Bequests are another trap. There is a big difference between the asset cut-off point for a single person and that for a couple. As at 20 September 2021, the single homeowner cut-off point was $593,000, whereas for a couple it was $891,500. Many pensioner couples make the mistake of leaving all their assets to each other, which can cause a lot of extra grief when the surviving partner finds they have lost their pension as well as their partner.

An example Jack and Jill had assessable assets of $740,000 and were getting around $11,800 a year in pension. Jack died suddenly and left all his assets to Jill. This took her over the assets test limit for a single person and she lost the pension entirely. Had he left the bulk of his estate to their children she would have been able to claim the whole pension plus all the fringe benefits.

10. Jointly owned assets with adult children

A wrong decision in the past can have serious consequences in the future. Think about a couple aged 52 who want to help their daughter into her first home. Without taking advice, they bought a 50% share of a house worth $400,000 so that the daughter could obtain a loan. Fast forward 15 years when the house is now worth $900,000 of which their half share is $450,000.

Their other financial assets were worth $600,000 so they believed they would be eligible for a part pension. To their horror they discover that their equity in the daughter's home of $450,000 took them over the assets test cut off point. If they transferred their share to the daughter the capital gains would be $225,000 after discount, on which capital gains tax could well be at least $80,000.

Furthermore, they would have to wait five years to qualify for the pension because Centrelink would treat the $450,000 as a deprived asset for the next five years. The total value of the CGT payable and the pension lost could be at least $150,000. If they had been aware of the trap, or taken advice, they could have gone guarantor for their daughter, possibly putting up their own home as part security and this would have had no effect on the future pension eligibility.

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. Email: noel@noelwhittaker.com.au. This article is general information and does not consider the circumstances of any individual.

Do you really need to sell your home to fund aged care?

Rachel Lane

The most common aged care myth is that you need to sell your home to pay for aged care. People seem to believe that either the government or the aged care home will force a sale, but it's simply not true. Whether you choose to sell your home to pay for aged care is up to you. So before you decide to sell your home, there are a few things you should consider first.

1. The aged care means test

Your home receives special treatment in the aged care means test. This test includes your assets such as your investments and personal assets at market value but with the exception of your home. Your home is not included in your aged care assets if a protected person lives there. A protected person includes:

- your spouse
- a carer who has been living in the home for at least two years, or
- a close relative who has been living in the home for at least five years who is eligible for an Australian income support payment.

If there is no protected person living in the home, then the value of the home up to the capped amount of $175,239 is included in your aged care assets. If your home is worth less than the cap, the market value is used. If the home is worth more, only the first $175,239 is assessed. In most cases the value of the home is far greater than the cap.

So if you decide to sell the home, you are potentially increasing the amount of assets captured in the aged care means test by hundreds of thousands, in some cases, millions of dollars.

2. Pension asset test exemption

The value of your home receives special treatment in calculating your age pension eligibility. While you or your partner live there, the home is exempt from assessment, and that exemption extends for two years after the last person leaves. Beyond the two years, the home is assessed at the market value but your pension assessment changes from a homeowner to a non-homeowner giving a higher asset test threshold.

While the asset value of the home receives special treatment for both pension and aged care means tests, if you receive income (rent) from the home, it is assessable income for both pension and aged care means testing.

3. Special tax treatment

Your home also receives special tax treatment. As a general rule, you can keep the main residence Capital Gains Tax exemption on your home for six years after moving into aged care. If the property is not rented, then you may be able to keep the exemption beyond this. Be careful and seek specialist advice as the tax implications for both you and those who stand to inherit the home are complex.

Deciding to hold or sell the home

So with all these special concessions why are most people so quick to sell the former home?

Often it is a combination of reasons. They believe the myth that they have to sell especially when a lack of liquid funds and an inability to finance the cost of aged care from their cash flow reinforces the decision. It's an easy conclusion to jump to.

Let's say you have a home, not a lot of investments and you are receiving the age pension. If there is no protected person living in the house, then you will need to pay the market price for your accommodation which could easily be $500,000 or more in most capital cities depending on location and the size of the room.

The daily payment equivalent of a $500,000 refundable accommodation deposit (RAD) is $54.93 per day ($20,050 per year) which is on top of the Basic Daily Fee of $53.56 per day ($19,549 per year) and then you will need to pay for any additional services, means tested care fees and your personal expenses on top of that. If your only income is the single age pension ($25,155 per year) and a small amount of interest it can seem like the only option is to sell the home.

But for all of the reasons listed above as well as the potential impact on your estate planning wishes it is vital to crunch the numbers or get a Retirement Living and Aged Care Specialist® to crunch them for you. The treatment of your home is unique from any other asset and once it's sold, it's too late.

Rachel Lane is the Principal of Aged Care Gurus where she oversees a national network of adviser dedicated to providing quality advice on retirement living and aged care. She is also the co-author of a number of books with Noel Whittaker including the best-seller 'Aged Care, Who Cares?' and their most recent book 'Downsizing Made Simple'. To find an adviser or buy a book visit www.agedcaregurus.com.au.

The leading 2022 themes for global mid-sized companies

James Abela, Maroun Younes

We expect global mid-cap equities to continue generating healthy returns for investors, although at a more moderate and sustainable level relative to the gains since the bottom of the pandemic-induced crash of March 2020. The initial phase of a market upturn is usually driven by expansion, as investors anticipate the recovery. This period usually produces explosive gains. However, as the economy recovers and business fundamentals improve, the earnings recovery takes over as the primary driver of shareholder returns.

This is where we are now. There is usually some increase in volatility as we move into this phase and it is quite typical to have mild market pullbacks from time to time.

The benefit that the equity market still holds is its real earnings recovery and growth outlook relative to low-yielding bonds.

Potential surprises in 2022, positive or negative

In our 2021 outlook, we cautioned that inflation was likely to pick up, and it did. Some of this was due to temporary or transient factors that would subside over time once the lockdowns ended and manufacturing and global supply chains normalised. In recent weeks, company management teams have warned about rising labour costs, which tend to be sticky. Labour cost is a key component of inflation, alongside housing.

Bond markets have already anticipated that central banks will need to act sooner than they had previously communicated. However, equity markets have yet to adjust, as rising yields impact equity valuations, while increased labour costs can impact corporate profit margins. This could lead to some choppiness and volatility as the equity markets digest this new reality.

Our holistic investment approach in 2022 will consider the risk of broad-based inflation, higher debt costs, rising commodity and property prices, and tighter labour markets, as well as increasing wages and higher levels of competition.

The themes and sectors of opportunities and risks

The Global Future Leaders strategy scans the global small and mid-cap universe for the leaders of tomorrow and explores a range of themes that are expected to experience structural growth.

The table provides insight into the sectors and associated themes that we are exploring.

Sector	Global Future Leaders' Themes
Technology	▪ Software as a service ▪ Data centres and cloud ▪ Subscription-led content models ▪ Connectivity enablers and 5G ▪ Artificial Intelligence
Energy, Resources, and Utilities	▪ Solar ▪ Wind & hydro ▪ Other Renewables ▪ Electric vehicles ▪ Green steel
Consumer	▪ Online retailers ▪ Environmentally conscious ▪ Plant-based foods ▪ Social gaming ▪ Mass market luxury
Financials	▪ Fintech services ▪ Virtual banking ▪ Global exchanges ▪ Trust and advisory ▪ Customised insurance
Healthcare	▪ Medical technology ▪ Contact development outsourcing ▪ Managed care ▪ Pharmaceuticals

The highest levels of conviction and avoidance

The best opportunities lie in high-quality companies with competitive advantages in good industry structures. These are managed by competent individuals and bought at reasonable prices. Such businesses will have some inherent pricing power, allowing them to protect margins by passing on increases in labour costs to consumers.

Areas that we would deem vulnerable are loss-making businesses or those with valuations that exceed their peers. The former require access to outside capital to keep funding their aggressive growth ambitions at a time when this funding is becoming more expensive. At the same time, the latter may experience significant corrections in their stock prices as discount rates continue to increase.

The impact of sustainability factors on returns

Sustainability is one of the three key pillars we use to assess companies (the other two being viability and credibility). In looking for the future leaders of tomorrow, we are primarily interested in finding firms that operate under sustainable business models.

Businesses that harm the environment fail to respect their employees, customers or society at large. Furthermore, these companies do not honour the rights of minority shareholders and are filled with executives whose primary aim is to enrich themselves at the owners' expense. In our view, these names have a finite corporate life.

Within the context of the portfolio and at an individual stock level, we will refuse to invest in harmful corporations that include tobacco or cluster munitions whilst simultaneously investing in businesses that enable clean energy (e.g. solar). Our carbon footprint at a total portfolio level is a fraction of that seen in our benchmark.

The Global Future Leaders strategy scans the global small and mid-cap universe for the leaders of tomorrow and explores a range of themes that are expected to experience structural growth. We have an acute focus on sustainability, pricing power, market structures, brand strength, product differentiation and valuation discipline.

James Abela and Maroun Younes are Portfolio Managers of the Fidelity Global Future Leaders Fund at Fidelity International, a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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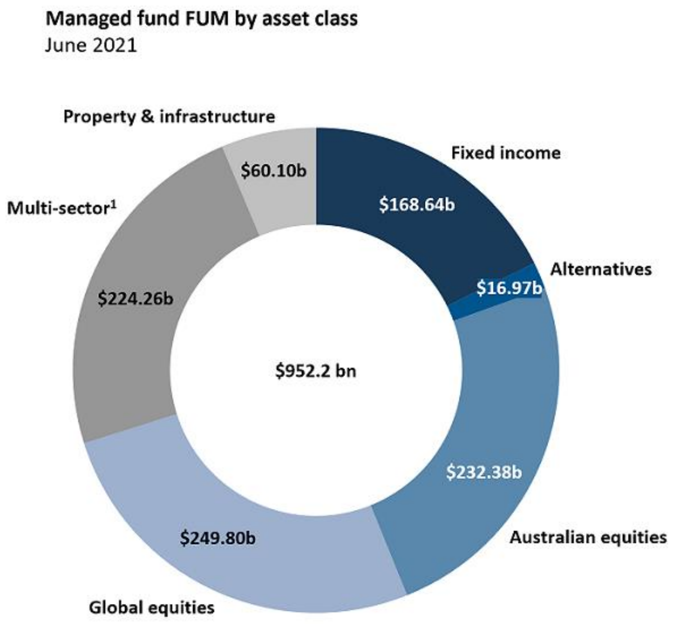
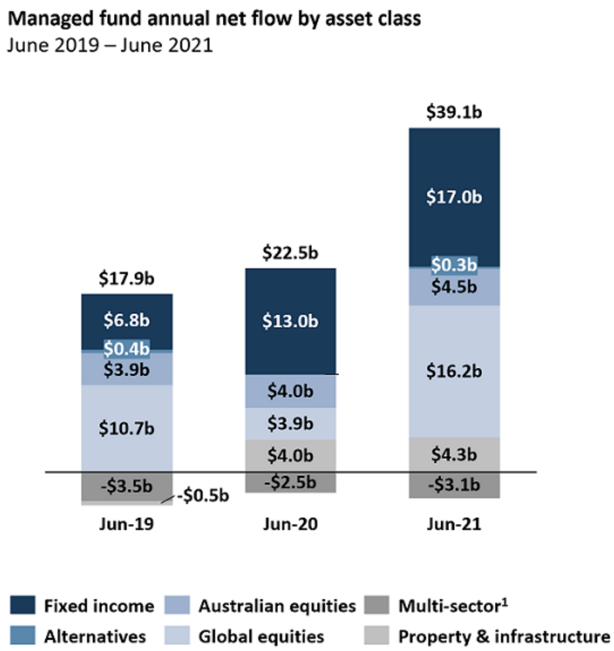
Fixed income flows are strong, but who's winning and why?

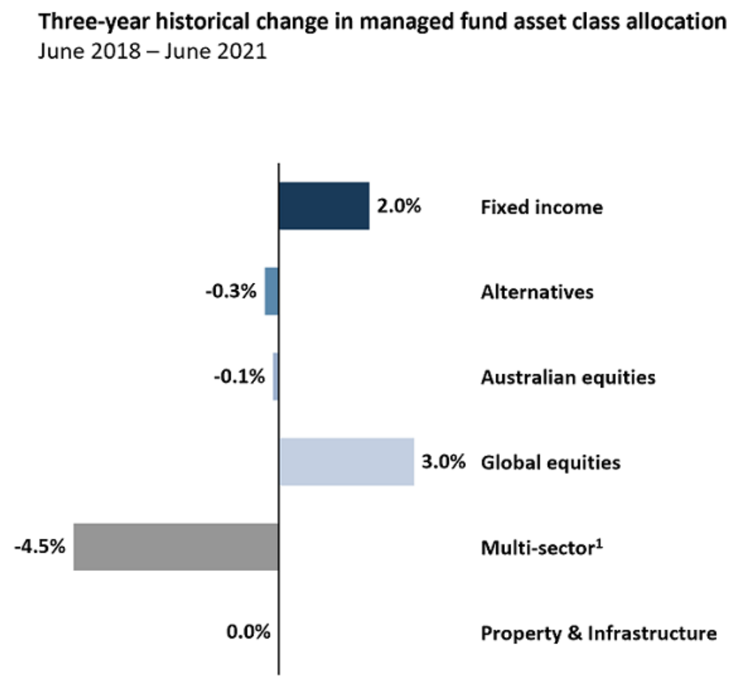
David Hutchison, Andrew Cummins

Fixed income is typically the quiet achiever in the Australian retail asset management industry. Recently, it has benefited from strong net flows with the mass exits from term deposits due to ultra-low rates and a steadily declining risk profile across the retail asset management industry as the market continues to mature and shift towards a retirement focus.

The role of fixed income in Australian retail asset management



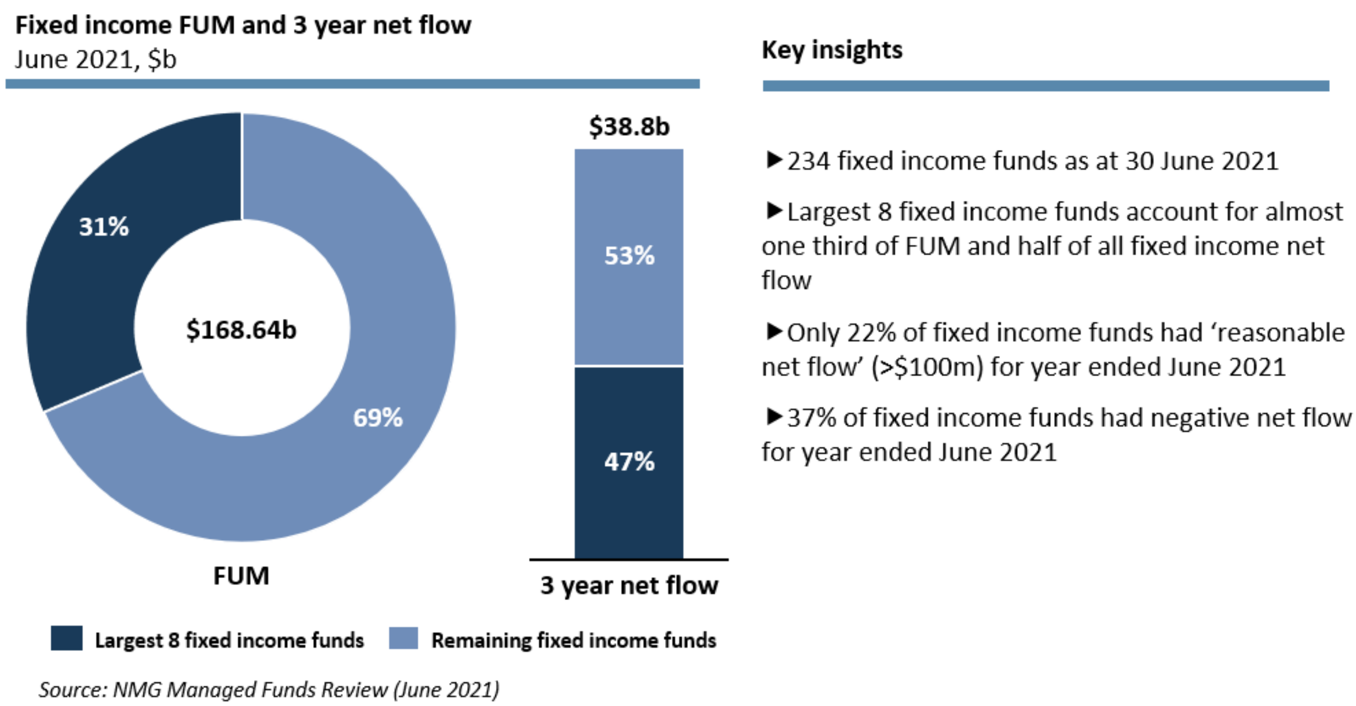




Source: NMG Managed Funds Review (June 2021)
[1] Multi-sector FUM and net flows excludes that attributed to MySuper

However, that tailwind is not treating all fixed income funds equally, and there is only a handful of winners.

Concentration of fixed income funds



As part of our engagements on building portfolios, advisers and their clients state they have different primary core objectives in their fixed income allocations:

1. Yield: nil (or very limited) potential for capital loss while seeking to generate a consistent yield
2. Defensive: reduce the volatility versus the growth asset allocations
3. Diversifier: lower risk than growth assets but still generate some returns.

While these objectives are not mutually exclusive (in fact, most advisers have a primary and secondary objective), the primary objective has a significant impact on the types of products used and the resulting allocations.

Which fund managers are the winners?

Those eight products grouped in the exhibit above currently receiving half of fixed income net flow are particularly relevant to one of the objectives, and are therefore heavily supported by investors who use that as their primary approach to allocating to fixed income.

The leading funds are:

- Ardea Real Outcome Fund
- La Trobe Australian Credit Fund
- Janus Henderson Tactical Income Trust
- Vanguard Global Aggregate Bond Index Fund
- iShares Australian Bond Index Fund
- Vanguard Australian Fixed Interest Fund
- Franklin Absolute Return Fund
- PIMCO Diversified Fixed Income Fund

Instead of trying to appeal to all investors, these funds recognise they may be too hot or too cold for some objectives. Instead, they understand where they are 'just right' for a particular objective that advisers want from their fixed income allocations, and then target their product, sales and marketing activity accordingly.

Just as we have seen with equity fund allocations moving away from benchmark-relative products towards a barbell approach with a blend of passive and high conviction product, we are seeing fixed income allocations shift away from traditional products towards those targeted to one of these core objectives.

For fixed income managers, this means finding a 'Goldilocks' position, and making sure products are 'just right' and designed to meet one of these primary fixed income objectives.

David Hutchison and Andrew Cummins are Partners at NMG Consulting, part of the NMG Group. This article is general information and does not consider the circumstances of any investor.