Firstlinks
a Morningstar company

Edition 450, 18 March 2022

Contents

Editorial

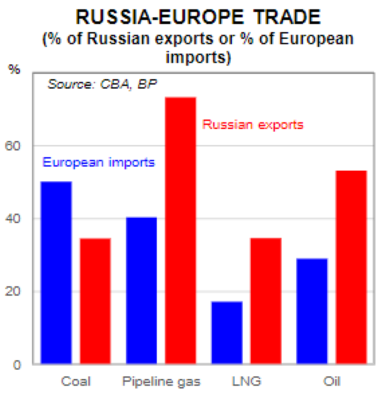
On most days, months, even years, not much truly memorable happens, good or bad. I don't mean nothing interesting or enjoyable ever occurs - we do remember milestones like weddings, birthdays and holidays, etc - but daily living does not stick in our minds. For example, if you are 65 years old today, happy birthday, you have lived 23,741 days. And while you have many memories, you have no recollection of anything from the majority of those days. Who recalls what they did on the weekend a few months ago, never mind 20 years?

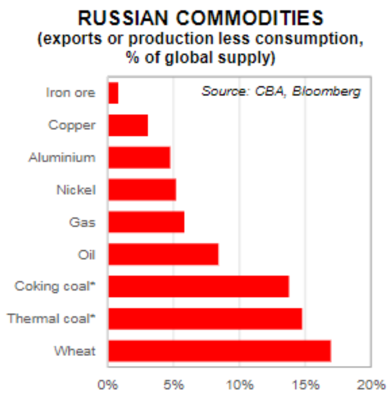
But in 2042, we will remember 2020 and 2022. Two years ago, on 11 March 2020, the **World Health Organisation** declared a global pandemic. And on 24 February 2022, Russia invaded Ukraine. We have seen wars before, but for generations, not one which threatens a nuclear escalation between super powers or even World War III (as the US President warned last week if the US air force closes the skies over Ukraine).

We are living through history, and aside from the terrible human consequences, both these momentous events will change the way we live and perceive the world. Few people at the start of 2020 had an inkling of the impact of a pandemic or a major conflict, not the extraordinary impact of climate change and the bushfires that were raging and the floods about to come.

Inflation is far higher than anyone expected a few months ago, and the oil price which feeds into the costs of many goods is highly volatile around high levels. This is a genuine oil and energy shock which almost guarantees sustained inflation and higher interest rates for longer, and nobody knows how it will play out. New models for globalisation and world trade challenge many of our assumptions about how markets work.

These two charts from **CBA Economics** show Russia's significance in energy supplies, and commodities generally.





Robert Reich is an American economist who served in the administrations of Presidents **Gerald Ford** and **Jimmy Carter**, and was US Secretary of Labor from 1993 to 1997 under **Bill Clinton**. He is currently a Professor of Public Policy at the University of California, Berkeley. He writes a regular newsletter (which will not be everyone's cup of tea) and in the latest edition, he identifies six things that he assumed about the future which he now believes are **false**:

1. Nationalism is disappearing.
2. Nations can no longer control what their citizens know.
3. Advanced nations will no longer war over geographic territory.
4. Major nuclear powers will never risk war against each other because of the certainty of 'mutually assured destruction'.
5. Civilization will never again be held hostage by crazy isolated men with the power to wreak havoc.
6. Democracy is inevitable.

That's quite a list of lost assumptions from someone who sat near the top seat of global power for so long. It makes guessing about the direction of markets, inflation and interest rates appear as banal as most forecasting actually is.

(This week's article by **Phil Ruthven** also examines this turbulent time).

Notwithstanding, we need to invest and that often requires a forecast. The threat of a recession and stagflation has increased, and supply chains will take time to adjust. In the US, petrol over US$5 a gallon and over US$100 to fill a tank feeds into consumer confidence and inflationary expectations, akin to a massive tax increase, especially when combined with rising food costs and other energy increases. Society relies on relatively cheap energy, and this will not be replaced by renewables any time soon. For all the future promise, it is estimated that solar and wind provide less than 4% of Europe's current energy needs with negligible battery storage capacity.

To add a brighter note, here's an extract from Future Crunch, a blog that finds good news in the main stories of the day.

"The invasion has brought a wartime energy transition to Europe. The continent's decades-long timelines for overhauling energy systems that support 440 million people is now being revved up under extraordinary duress. The European Commission has already released a plan to cut most of its reliance on Russian gas by the end of this year, which is insane, considering the continent got 40% of its gas from Russia last year. As the EU's Green Deal chief, Frans Timmermans said, "We are now protecting our vital interest."

And still in a lighter mood on the subject of change, most of us are old enough to remember buying the gear below individually, and in this photo, all the stuff was made by **Sony**. Now a smart phones can do all this and more. Anyone own a Sony smart phone?

Like **Nokia, Blockbuster and Kodak**, Sony was once at the leading tech edge. In 2000, Sony was valued at over US$100 billion, or five times **Apple**. Sony's market value is now about US$80 billion while Apple is the world's most valuable company by market cap at about US$2.5 trillion. Indeed, times change.

Graham Hand

***

In this week's edition ...

Funds management is a tougher business than it appears, as witnessed by the minority of active managers who outperform their benchmarks after fees. In Australia, active fund inflows still dominate passive but what's the difference between investing in the business of a fund manager versus the funds they manage?

We sat down last week with **Roger Morley of MFS Investments** in London to gain a global perspective on the war and its impact on portfolios. Among the opportunities and threats, he also identifies stocks which he expects to hold for a long time regardless of the macro or geopolitical environment.

Speaking of long-term, **Phil Ruthven** goes back to the beginning of the 20th century to look at the tumultuous decades and thinks that the 2020s are already exhibiting many of the traits we've seen before in unsettled times.

One bright spot in any turbulent period is usually gold and it has not disappointed so far in 2022. **Jordan Eliseo** explores a topic that many gold investors overlook and makes a case for holding the precious metal in Aussie dollars.

Thinking about gold to hedge against inflation? The US Federal Reserve also has inflation top of mind as another era of quantitative tightening beckons, writes **Michael Collins**. On Thursday morning AEST, the Fed raised the target range for the Funds rate by 0.25%, its first interest rate hike since 2018. This comes as US inflation is at 40-year highs of 7.9% amid rising gasoline, food and housing costs.

With everything else going on in the world, it's easy to overlook some major US elections are coming soon, the 2022 midterms in November. They can lead to a change of policy control with implications for budgets and spending. **Chris Buchbinder and Matt Miller** explore what has happened in past midterms with an emphasis on likely sharemarket implications.

And finally, Professor **Kevin Davis,** a former member of the 2014 **Financial Systems Inquiry**, offers his solution for how a universal pension might work. This topic is often raised by our readers but the budget and superannuation implications must be addressed.

This week's White Paper from **Fidelity** is the latest research into women and their attitudes to money. There remains a lot of difference in gender attitudes.

Fund managers versus funds: fraternal or identical twins?

Graham Hand

The stockmarket's love affair with Australian listed fund managers has cooled, at least until there's a strong recovery. Going back to before the GFC, there was a frenzy around Platinum, then many years with Magellan and initially VGI Partners, and the dalliance continued well into 2021 for Pinnacle and Australian Ethical. Late last year, the IPO of GQG was also strongly supported, if briefly. Now, the courtship is struggling in the face of outflows, management changes and less optimism about the future of equity markets.

But what's the relationship between a fund manager and its funds? If an investor is willing to support a fund, there must be something about the fund manager – its people, its style, its investments, or its story – that the investor likes. If the investor is so convinced that the fund manager can deliver outperformance, then why not invest in the fund manager itself? After all, if the fund delivers strong results, the fund manager will attract new money and its funds and fees will rise.

One is a business, the other is a fund

At one level, the comparison may seem obscure. A fund manager is a business like any other with revenues, costs and hopefully profits, while a fund is a collection of assets. Although an equity fund is a portfolio of pieces of businesses, returns for an investor come from dividends and capital gains, not the idiosyncratic challenges, revenues and costs of a single business.

The success of the manager's business is 'twinned' with the performance of its funds, but are they ‘fraternal' or 'identical' twins, even if 'conjoined' is going too far? For those who missed Biology 101, fraternal twins develop in separate ova and are genetically different and no more similar than other siblings. They may be different sexes. Identical twins share the same genes and are the same sex.

Listed fund managers in Australia

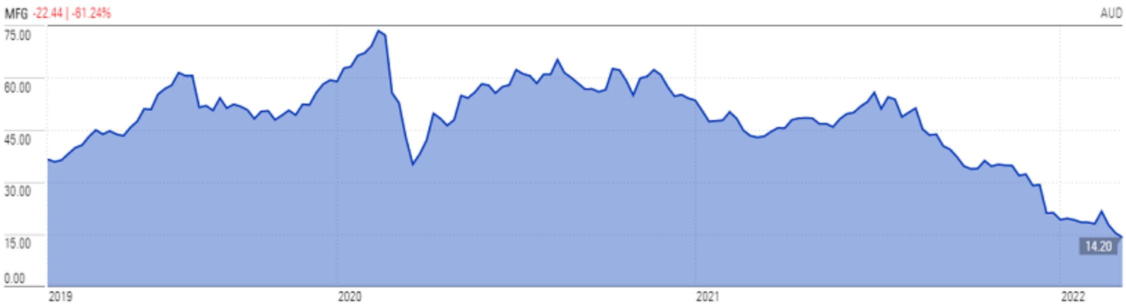
Many of the highest-profile managers in Australia are listed and an investor can buy into the funds management business as well as its fund.

Here is a brief look at six listed fund managers (although there are others such as AMP, Perpetual, Charter Hall, Goodman Group, Janus Henderson and Pendal which could be added), their performance and their funds under management (FUM). All charts are from the Morningstar database.

1. Magellan

a) The company (ASX:MFG)

Magellan’s recent difficulties are well-known. After an impressive first 14 years following its 2007 establishment, the last year or two of fund underperformance and outflows and the recent health leave of Hamish Douglass have dramatically hit its share price. Here is the last three years, peaking at almost $75 in February 2020 and down around $14.00 at time of writing (14 March 2022).



Morningstar rates the company MFG as a 5-star Buy at $14.20 with a fair value estimate of $33. Equity Analyst Shaun Ler writes:

"Magellan is for the patient investor. For shares to re-rate, Magellan Global needs to outperform. We are confident this will happen over the medium term, as markets currently remain in correction amid expectations of rising rates … No client engagement can save the current prolonged underperformance by Magellan Global, however, so we expect redemptions to persist in the near term. CIO Hamish Douglass's indefinite leave, fund downgrades, and above-average retail fees won't help."

b) The funds

Magellan offers a wide range of listed and unlisted funds, including a significant infrastructure business and 100% ownership of Airlie Funds Management offering Australian equities. Here is the track record of the main Global Fund (ASX:MGOC) since inception in 2007:

PERFORMANCE	3 MONTHS	6 MONTHS	1 YEAR	3 YEARS (% PA)	5 YEARS (% PA)	7 YEARS (% PA)	10 YEARS (% PA)	SINCE INCEPTION** (% PA)
Magellan Global Fund (Open Class) (Managed Fund) (ASX:MGOC)	-7.09%	-8.06%	9.12%	8.98%	11.65%	9.63%	15.23%	11.06%
Benchmark*	-5.94%	-3.96%	18.15%	13.69%	13.36%	10.85%	15.22%	7.53%
Out/Under Performance	-1.15%	-4.10%	-9.03%	-4.71%	-1.71%	-1.22%	0.01%	3.53%

* MSCI World Net Total Return Index (AUD)
** Inception date 01 July 2007

Magellan has delivered on its long-term absolute goal target of 9% per annum since inception. At 11.06%, it has a strong 3.5% annual outperformance. The underperformance at 4.7% for three years and 1.7% for five years shows investors focus more on relative than absolute returns.

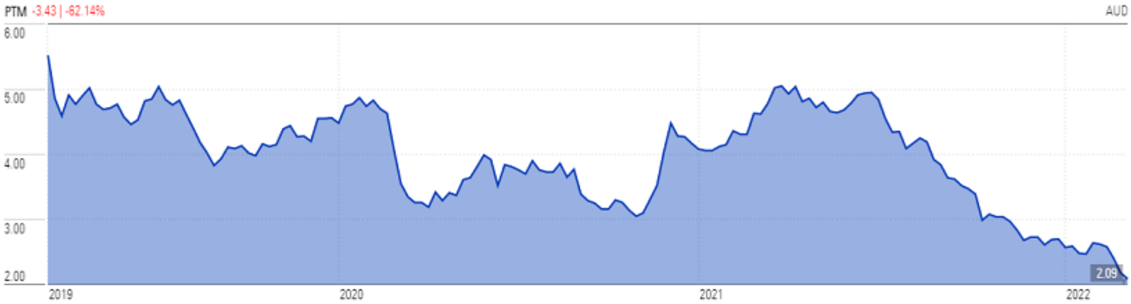
Funds are leaking heavily, especially from major institutions. In the most recent announcement on 11 March 2022, FUM totalled $69 billion, down $5 billion since 25 February 2022. However, most of the money was lost from institutional investors, down $4.7 billion. The fund mix includes infrastructure, $20 billion, and Australian equities (Airlie) $10 billion and they are less affected by the global losses. However, showing how far Magellan's FUM has fallen, it was $117 billion in August 2021.

2. Platinum

a) The company (ASX:PTM)

Platinum under Kerr Neilson once reigned supreme in global equities for Australian investors, floating on the ASX on 23 May 2007 at an offer price of $5 and closing its first day at $8.50. Neilson became a billionaire amid the love affair with investors and advisers. Here is the last three years of the share price, and with the current PTM price of about $2.15, it's been a sad journey for most investors after a decent kick up in 2021.

Morningstar also rates Platinum at 5-stars, with a price target of $3.70. Shaun Ler says:
"Precursors for new money include sustained outperformance, client diversification, improvement in fund ratings, and low fees. We expect progress on the first two fronts. It's likely that Platinum can continue delivering positive alpha in current markets. The firm also has new product enhancements for both retail and institutional clients, and is dialing up client engagements."



b) The funds

Platinum has a wide range of global funds, with the longest rack record is for the Platinum International Fund since April 1995. Like Magellan, its since-inception return of 11.7% versus its benchmark of 7.5% is exceptional, but more recent numbers have disappointed as it invested less on the great tech successes of US companies and more on Asian opportunities. The 3-year return of 6.8% is well under the index at 12.7%.

As at 28 Feb 2022	1 mth	3 mth	6 mth	1 year	2 yrs p.a.	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.	Since inception p.a.	Inception date	Portfolio value (A$ mil)
Platinum International Fund - C Class	-4.6%	0.7%	-1.5%	1.5%	8.0%	6.8%	8.4%	11.2%	11.7%	30 Apr 1995	7,686.4
Platinum International Fund - P Class	-4.5%	0.8%	-1.3%	1.7%	8.2%	7.1%	-	-	6.8%	3 Jul 2017	27.3
MSCI AC World Net Index in A$	-5.4%	-5.9%	-4.6%	15.0%	11.7%	12.7%	12.7%	14.3%	7.5%	30 Apr 1995	-

In February 2022, its FUM was $21.1 billion, down from $24.9 billion in February 2021. Says Ler:

"Most Platinum funds remain Bronze medalists after being downgraded from Gold by Morningstar in 2020. Fees (especially retail) remain higher than average. Rebalancing activity by institutional clients, or platform consolidation by major wealth manager platforms could continue to extend outflows."

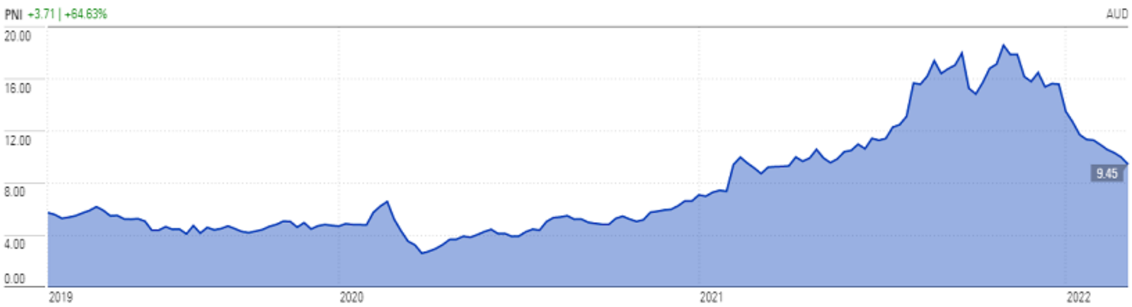
3. Pinnacle

a) The company (ASX:PNI)

Whereas Magellan and Platinum need to rebuild past glories, many of the fund managers in Pinnacle's stable of boutiques have been on a roll. Pinnacle is not itself a fund manager, but it provides capital, marketing, distribution services, business support and responsible entity services to 16 'affiliates' in its network. It charges fees for its services and earns a share of profits as equity holder in the businesses.

Pinnacle has a strong track record of picking successful fund managers. Its share price went on a massive run from the depths of COVID-19 in March 2020 at about $2.40 to a remarkable $19+ in May 2021. It has since fallen to around $9.50, and at this price, is rated 4-stars by Morningstar with a Fair Value estimate of $13.90.

Whether an investor sees Pinnacle as a strong recent performer depends on the entry point. Someone who bought in mid-2021 has seen the price fall 50%, but it's four times the price of two years ago.



Analyst Shaun Ler says:
"We lift our fair value estimate to AUD 13.90 from AUD 13.20, mainly from increasing our affiliate profit share and parent-level revenue forecasts. Shares trade at a 17% discount to fair value at current prices. We expect

lower returns on invested capital over fiscal 2022-23 (below the three-year average of 25%) as Pinnacle spends on distribution and contends with choppy markets and fund flows, before improving to exceed 30% by fiscal 2026 from earnings leverage as FUM compounds."

For now, the market has rerated Pinnacle's growth prospects after a stellar 2020 and early 2021 created a high multiple.

b) The funds

Affiliate FUM grew to $94 billion at 31 December 2021, up $23 billion or 33% from $70 billion at 31 December 2020. Particularly impressive was retail FUM at $24 billion versus $17 billion a year earlier. Morningstar expects Pinnacle's boutiques to continue to increase their share of domestic retail and wholesale managed funds.

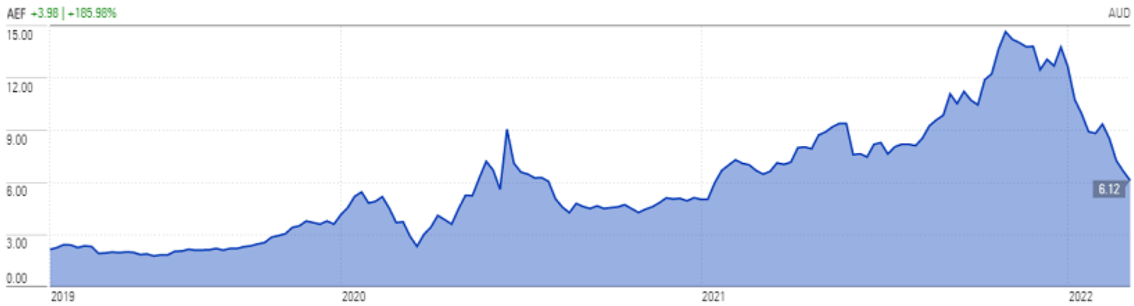
At the moment, according to Pinnacle, 77% of its affiliate strategies and products have outperformed their benchmarks over five years to 31 December 2021. The strategies of Hyperion, Solaris, Resolution, Antipodes and Firetrail (which collectively manage 64% of Pinnacle's FUM) are assigned medallists by Morningstar Manager Research.

There are too many different strategies to identify performance individually, but Pinnacle has the advantage of boutiques that manage many different asset classes which are not subject to the vagaries of equity markets (such as Metrics in private debt).

4. Australian Ethical

a) The company (ASX:AEF)

Like Pinnacle, investors bid up the shares in Australian Ethical to above $15 in May 2021 from a low of $2.20 at the depths of March 2020, but the rerating of fund managers has brought it down to earth at about $6. Again, if an investor bought at $15, their timing was terrible but share price performance over three years has been a strong +185%, as shown below. Morningstar has a Quantitative Rating for Fair Value of $9.17 putting the company into a 4-star band.

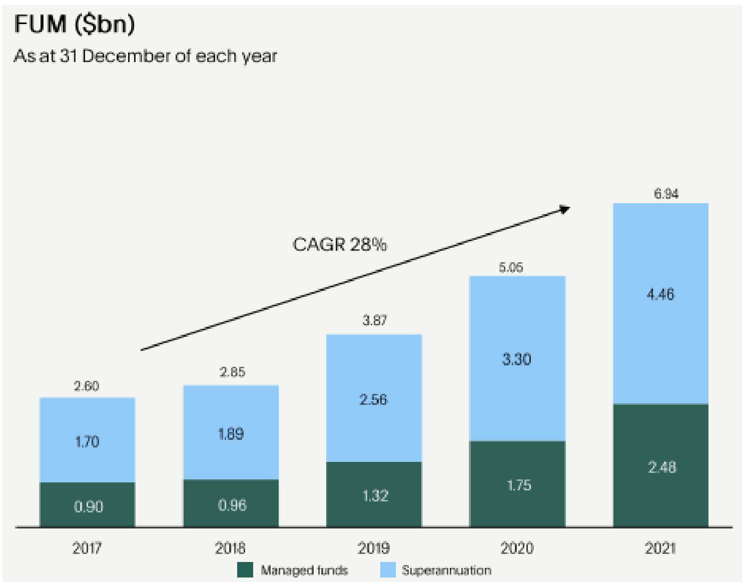


b) The funds

Australian Ethical is benefitting from increased investor demand for funds with solid ESG principles, and the long-term increase in its share price is driven by strong FUM growth, as shown below.

Australian Ethical offers an unusual option in allowing direct access to a superannuation fund (for example, not via an SMSF), and its Balanced Accumulation (MySuper) option has performed well, staying ahead of its benchmark over most periods.

This demonstrates that the manager rerating is not simply a function of underperformance. The market is factoring in lower growth prospects and now recognises that the multiple expansion to mid 2021 was ahead of revenues.

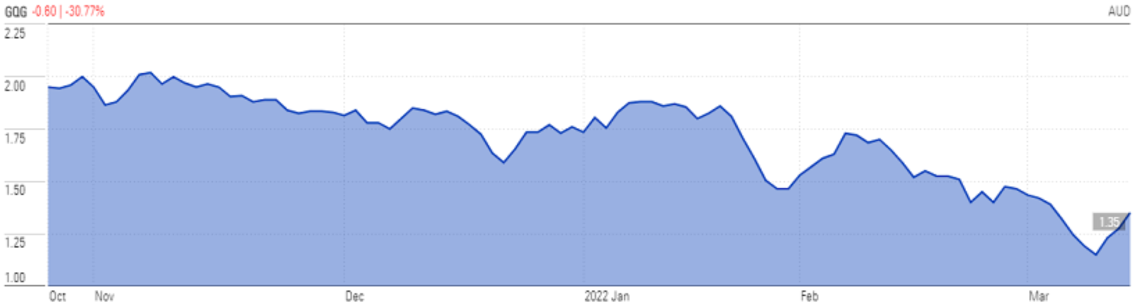


	6 mths	1Y	3Y (%pa)	5Y (%pa)	7Y (%pa)	10Y (%pa)	20Y (%pa)	Since inception (%pa)*
Absolute Performance ~	5.2%	12.7%	12.4%	9.3%	8.3%	9.0%	6.2%	6.8%
Performance gross of member fee	5.3%	12.9%	12.5%	9.4%	8.4%	9.1%	6.3%	6.8%
Benchmark#	4.3%	13.3%	10.5%	7.7%	6.6%	7.6%	5.4%	5.4%
Relative Performance**	**1.0%**	**(0.4%)**	**2.0%**	**1.7%**	**1.8%**	**1.5%**	**0.8%**	**1.4%**

5. GQG Partners

a) The company (ASX:GQG)

GQG Partners Inc is a global boutique asset management firm offering long-only strategies to institutions and individuals. It listed on the ASX in October 2021 at $2 a share raising $1.2 billion on a market valuation of $5.9 billion. It was the biggest IPO of 2021 at the time. GQG was mostly owned by the founders and staff, and selling in October before the rerating of fund managers was inspired timing for them but far from ideal for investors. Supporters have seen the shares fall to a low of $1.12 before a recent improvement to $1.35, still down 30% since the IPO. Morningstar’s Quantitative Rating gives the company a 3-star Fair Value estimate at this price.



b) The funds

GQG is benefitting from outflows at Magellan and Platinum and is in positive fund inflow. FUM was reported at US$90 billion at the end of February 2022, down US$2 billion in a month due to market movement falls of US$3 billion. Net inflows were still positive.

Its main global equity strategy to the end of February 2022 has delivered good long-term results, consistently outperforming its index.

GQG Partners Global Equity

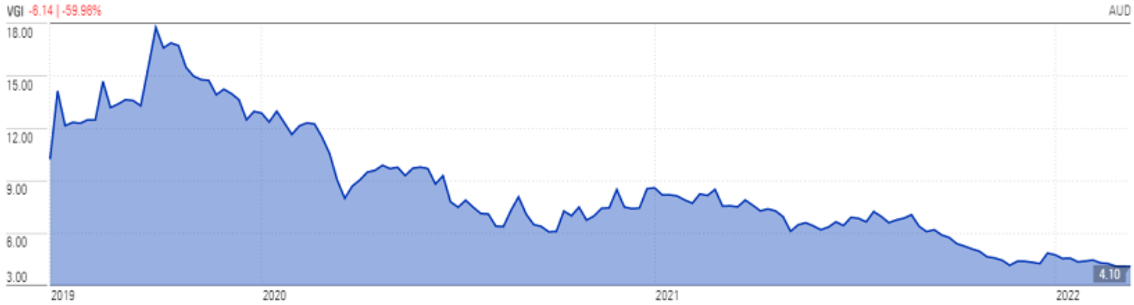
INVESTMENT PERFORMANCE AUD %	1MO	3MO	YTD	1YR	3YRS	SINCE INCEPTION (02-JUN-17)
Fund – A Class (gross of fees)	-3.68	-1.26	-1.20	25.52	16.79	16.06
Fund – A Class (net of fees)	-3.74	-1.45	-1.32	24.58	15.89	15.11
MSCI ACWI ex Tobacco	-5.43	-5.98	-7.27	14.94	12.73	11.39

6. VGI Partners

a) The company (ASX:VGI)

The VGI Partners funds comprise unlisted and listed investments across global and Asian investment strategies, including the ability to short stocks. In some ways, VGI's share price trajectory has been similar to Magellan and Platinum, with a need to recover past glories. It listed in June 2019 at $5.50 and anyone who could get hold of the stock did well initially, with a September 2019 peak close to $18. Over the last three years, its share price has fallen significantly to the current price of around $4.

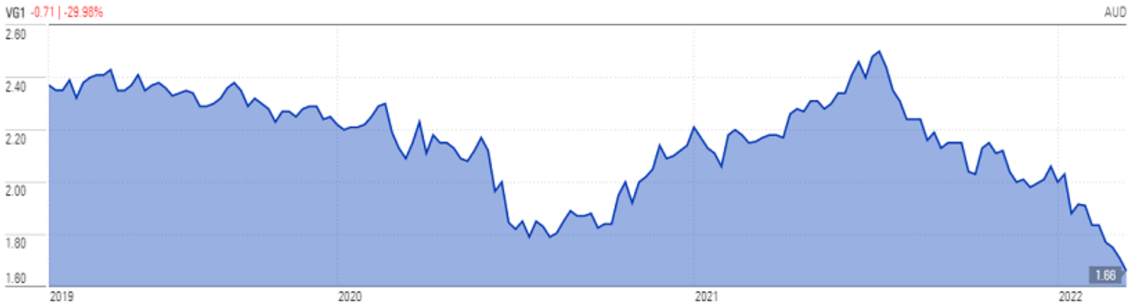
Discussions are currently underway between VGI and specialist alternative investment manager Regal Funds Management on a potential merger. The rationale for the move is that VGI is also a long-short manager, and it would combine two market-leading providers of alternative investment strategies. Regal is not a listed company.



b) The funds

VGI's FUM was last reported for 31 December 2021 as $2.5 billion, down from $3.1 billion a year earlier. It includes two Listed Investment Companies, a global fund (ASX:VG1) and an Asian fund (ASX:VG8). VG1 was floated on 28 September 2017 and has fallen out of favour with investors, trading at a significant discount to its Net Tangible Asset (NTA) backing per ordinary share, estimated at $2.04 on 11 March 2022 against a share price of $1.66.

Here is the share price performance of VG1, from a heady $2.50 as recently as September 2021.



In the January 2022 report to shareholders in VG1, its performance was reported as -5.9% over the last year and 4.7% since inception.

Is there a conflict for a listed manager?

Chris Cuffe has spent much of his long career in wealth management selecting managers for various portfolios or businesses. He has argued in Firstlinks that for many asset classes, he sees a limit to how much a fund manager should manage. For example, Chris wrote in this article, '*My 10 biggest investment management lessons':*

"Watch the level of funds under management

I do look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than $1 billion concerns me. And I am cautious about investing with a larger cap manager in Australian equities with more than say $6 billion under management. At that level, I need more convincing. It's less of a problem for a global large cap manager operating in a massive universe of stocks.

Size can get in the way of performance. It's no coincidence that most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money but my experience is most don't do that, especially when there's an institutional owner. It's compelling to take more money.

Boutiques are best at watching capacity as they can make a lot of money from performance fees if they are good."

Chris believes that listed fund managers have a potential conflict of interest because the stockmarket and external investors constantly demand rising FUM, and fund managers are incentivised to grow assets.

A global equity manager fishing in a massive global pool has less of a problem than a manager in a smaller market, but an unlisted manager does not face the intense public scrutiny of monthly FUM disclosures. In some cases, such as the now-closed Blue Sky Alternatives investment business, where fund inflows were stronger than deal flow, the manager may be forced into investments that would have been overlooked at smaller FUM levels. At the moment, the media pounces on every FUM announcement made by Magellan.

There are many successful Australian fund managers who have resisted the urge to list and the primary reason is they do not want the distraction of continuous scrutiny.

Here is a summary of the above details for the six managers:

	MFG	**PTM**	**PNI**	**AEF**	**GQG**	**VGI**
Current share price (as at 14/3/2022)	$14.00	$2.18	$9.48	$6.00	$1.35	$4.10
Morningstar Fair Value estimate	$33.00	$3.70	$13.90	$9.03	$1.44	$7.41
Morningstar rating at current share price	5 stars	5 stars	4 stars	4 stars	3 stars	3 stars
Latest FUM (billion)	$69.0	$21.1	$94.0	$6.9	US$90.0	$2.5

What do these numbers tell us?

The correlation between the fund manager's share price and its funds is weak because there are many other factors involved. Neither Pinnacle nor Australian Ethical have lost much FUM in the recent market weakness but their share prices have fallen at least 50%. GQG remains in net inflow, but the market is still absorbing the weak buyers from its massive float.

The highest-profile listed names, Magellan and Platinum, are suffering fund outflow from recent underperformance, and both need to turn this around before the FUM and share price will recover. At Magellan, the share price fall is far greater than the FUM loss indicating price recovery is probably leveraged to the performance outcome. Improvement could signal support for the new managers, Chris Mackay and Nikki Thomas.

It's fraternal twins

So let's call fund managers and their funds 'fraternal twins' rather than identical, and they're certainly not conjoined. There is a strong sibling relationship between the two. As far as investing in the fund manager, it's likely to be a leveraged exposure on both the upside and downside, whereas the fund itself will always be the benchmark plus or minus performance.

Funds management is a wonderful business when the portfolio managers are picking winners, but it's difficult to recover if investors lose confidence.

Graham Hand is Editorial Director at Morningstar. This article is general information and does not consider the circumstances of any investor. ***Disclosure****: Magellan, Australian Ethical and VGI are sponsors of Firstlinks, and Graham Hand holds investments in some of the companies or funds mentioned in this article.*

Roger Morley on the merit of obstinacy in global investing

Graham Hand

Roger Morley is a Portfolio Manager with MFS Investment Management in London. He is Co-manager of the firm's Global Equity and Global Concentrated Strategies and lead manager of the European Core Equity strategy. He has been with MFS for about 20 years. Globally, MFS manages almost $A1 trillion across all asset classes, with headquarters in Boston, USA.

GH: As a global equity manager with offices around the world, what do you consider some of the major investment implications of the war in Ukraine for either the near term or longer term?

RM: To start, we must say the humanitarian and social costs are terrible. From an investment point of view, there are implications for individual businesses, but in aggregate, it's not such a big deal for the global economy with one major exception. Russia is about 1.5% of global GDP, similar to Canada's. The Russian economy is not particularly integrated into global trade, again, with one big exception, which I'll come to.

We like multinational businesses and we typically like businesses that operate in emerging markets because there's good growth there. But for our typical business, Russia is 1 to 3% of sales, such as for AkzoNobel (paints and coatings), WPP (advertising agency), Nestle, Linde (industrial gases). There will be some surprises, such as Visa, MasterCard and American Express. Russia and Ukraine together represent about 5% of revenues for Visa, one of our biggest holdings. That's because Russians travel and spend a lot on cards and cross border business is more profitable than domestic business. But even that shows Russia is not a major part of the world economy. We own Carlsberg, which has about 15% of its business in Russia and Ukraine.

The one caveat is the Russian supply of raw materials, principally energy. It's one of the world's largest oil exporters and a huge exporter of natural gas to Europe. Natural gas is 25% of European energy consumption and 40% comes from Russia, of which a vast majority goes to Germany and Italy. So the company level modest exposure exception is where companies are particularly exposed to high energy and raw material prices.

A few companies will be clear beneficiaries. We met at a couple of US defense companies last week, talking about the low state of preparation of many European militaries and the need to increase resources. It's a medium-term benefit because it takes a long time to ramp up the manufacture of missiles, engines, fighter planes.

GH: I was surprised when I saw a map of Europe on the gas pipelines coming from Russia through Ukraine, with an extraordinary level of dependence. Is there a feeling now among European governments that the dependence was too complacent?

RM: Very much so, especially in Germany. There was a lot of controversy over the building of the Nord Stream 2, which was supposed to reduce the reliance on the pipelines that went through Ukraine. Russia could then turn off the gas to Ukraine without turning off the gas to Germany because they pay the bills.

GH: Let's look at some broader portfolio matters. To what extent do macro factors influence your investment decisions? For example, if you had a chemical company in Europe and another in the US, do you consider whether the economy in the US is better than Europe for the next few years?

RM: Through our global investment platform, we uncover what we believe are the best investment opportunities in the market. We are looking for an analytical advantage by evaluating the long-term quality, sustainability, improvement potential and value of businesses. It's fundamentally bottom up, research driven. We invest in businesses, not markets, we invest in companies, not stocks. You can't escape the macro but we focus on understanding the business and on the equity side, we have 60 research analysts based around the world. They tend to follow companies on a regional basis so we do compare stocks across a region, but then the global managers sit above that and it's easy to pull the analysts together to compare ideas and get the best on a risk-adjusted basis globally. Internally, we never talk about regional overweight and underweight. We don't care where a company's headquartered or listed with the single exception of governance, as there are different country regulations.

GH: You manage a concentrated portfolio as well as a broader global equity portfolio. What's the difference?

RM: It's the same team-based approach, with Ryan McAllister and I co-managing both portfolios. We run them in parallel, but the concentrated one holds between 20 and 30 stocks as a subset of the diversified portfolio which is usually between 80 and 100 stocks. We pick what we consider the best names on a risk-adjusted basis. Sometimes, I think people confuse concentration with aggression, but the stocks we pick are a little more conservative because we own a bigger position. So we may have a stock in the diversified portfolio where there's a wider range of outcomes that we think is a good stock on a risk-adjusted basis, but there could be a lot of potential downside because of technological change or balance sheet leverage or political exposure or regulatory exposure, something like that. We can limit that downside with position sizing, but in a concentrated portfolio, we own 2.5% minimum and the average position size is 4%. So a company like that doesn't go into the concentrated portfolio. It's not aggressive investing in that way because we worry especially about the downside in the concentrated portfolio.

GH: And how's the relative performance of the two funds over time?

RM: Over the long term, the concentrated portfolio has marginally outperformed. In a way, I find that slightly annoying because a constraint on a portfolio manager should detract from performance. I think there are a couple of explanations. One is that we're better at managing a concentrated portfolio than a diversified one. By being forced to have conviction, you get the better ideas. In times like these, it can be difficult to differentiate between active skill versus the market environment, but it reinforces the importance of security selection by focusing on quality growth companies and considering all risks.

GH: In your current valuations of companies, are you seeing pockets of expensive or cheap? In other words, where are you seeing the best opportunities?

RM: In the areas that we think are cheap, I'd call out medical devices in particular and healthcare in general. We own large positions in stocks like Medtronic, Stryker, Abbott. A company like Medtronic is still somewhat depressed because a portion of its business is elective surgery. Many elective procedures have been postponed in the last two years, clearing the decks for COVID. The recovery of these businesses has been slow because staff are off work and isolating. They weren't defensive stocks in the downturn because of their exposure to the realignment of the healthcare system but they look inexpensive.

Another area is US cable companies, such as Comcast and Liberty Broadband. We all know how vital a fixed broadband connection is, and those businesses are increasingly not pay TV companies. They are broadband and telecommunication providers. There's always fear of technological change, whether it's Elon Musk sticking satellites up or 5G wireless broadband but fixed broadband connections are not going away anytime soon for the vast majority of consumers.

GH: And on the expensive side?

RM: I would still call out some technology stocks even after they've been de-rated, the ones with no profits and no clear path to a free cash flow. There are some remarkable businesses in the technology space that we would happily own at lower valuations.

GH: Is there a stock you would identify that you think has such a good long-term runway, a compounder that you're confident you will own for the next 10 years?

RM: I probably call out a railroad stock, Canadian National or Canadian Pacific. Perhaps not the world's most exciting companies, but it's the 10-year picture that's important. Canadian National has been known to us for over 25 years. Railroads face relatively little technological change, they are pieces of infrastructure that are vital to the North American economy. They are very hard and very expensive to replicate. They are oligopolistic and probably monopolistic. We love monopolies from an investing point of view. We don't like monopolies from a regulatory point of view, so I'd rather call them oligopolistic, but they have monopolistic qualities. They've got tailwinds from the ESG side with a much lower carbon footprint to move something around North America than by road. Vastly better than air freight or other alternatives.

Canadian National will grow at GDP plus with a bit of pricing on top of volume growth and operating leverage from the vast fixed cost base. It's still a capital-intensive business so it's hard to see any form of disruption coming. We don't really worry about driverless trucks that may dramatically change the economics of rail versus road transport. That floats out there in the far distance. From the economic cycle, volumes tend to vary a little but pricing doesn't.

GH: Is there an investment lesson that you've learned recently, despite all your years in the business, due to a stock that didn't work out and perhaps you sold it? Perhaps something you missed?

RM: In this job, you think by the time we retire, we'll be geniuses because you make mistakes and you say, "Well, I won't do that again." And then a mistake is around the corner and sometimes you repeat a mistake because the situation looks different. A quality we have is that we're very long term, we're pretty obstinate. That the market overreacts on the downside, it overreacts to fears of disruption and change and usually that disruption and change is less than anticipated.

But sometimes we're slow to spot that an investment case is just wrong. For example, for many years we owned the US trust banks, State Street and Bank of New York. Our view was that these trust businesses would discover pricing power but that just hasn't been the case. And what's annoying is that I had people tell me that their prices only ever go down. I talked to people internally at MFS and they said prices always go down when we renew our contract. And why, I don't know. The business is just competitive enough, there are just enough players in it. So that's a case where we ignored the fundamental evidence that was before our eyes or we didn't look for it properly.

They weren't terrible stocks, they did all right, but they were always relatively cheap so that limited the downside. But if you own stocks like that for a long time, they become a big hole in your attribution over time. It's the grinding underperformance where we've been too dogmatic in hanging on to them.

GH: Final question. You've done this job for a long time. What's the attraction?

RM: It's fascinating, particularly at a time like this, when so much is going on in the world. As a portfolio manager at a firm like MFS, you're like a fly on the wall of the world. You get to meet people like the CEO of a supplier of Stinger missiles and anti-tank missiles. A month ago, we met with a former security adviser to Donald Trump. He said the prospect of a war in Ukraine was 80% and it will probably happen. Very hawkish. It was a striking contrast between his certainty and others being generally laid back. It's the access to people that makes the job so fascinating.

Roger Morley is a Portfolio Manager with at MFS Investment Management, a sponsor of Firstlinks. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice. No forecasts can be guaranteed.

For more articles and papers from MFS, please click here.

A discombobulation decade for investors

Phil Ruthven AO

Discombobulation has a meaning that sounds like the word's pronunciation: volatility and unpredictability. Every decade brings surprises, good and bad, but discombobulating ones are more rare - being the 1910s, 1930s, 1940s and 1970s in the last century.

In the early part of one of those decades, the 1970s, a one-time US Vice-President said at the midst of his problems and an investigation by the District Attorney, '*if you're not schizophrenic these days, then you're just not thinking clearly*'. This statement could be used again as an excuse these days by a lot of aberrant leaders.

That was half a century ago, but the 1970s were the last truly discombobulating decade. The United States were defeated in Vietnam and their president, Richard Nixon, was impeached and subsequently resigned. Australia elected a Labor government for the first time in 23 years which was controversially, some would say unlawfully, sacked by John Kerr our then Governor General in 1975. A huge stock market crash occurred in the late seventies. We had runaway inflation that took decades to bring under control and unprecedented oil price rises. These were some of the standout events that punctuated the decade.

We are just into the 2020s, but it already looks like another volatile decade with issues such as:

- a pandemic
- warmongering (Russia into Ukraine, and others thinking of equivalent incursions)
- fascist dictators-cum-kleptocrats by the handfuls
- democracy now falling to less than half the world's eight billion citizens
- a stock market correction, perhaps 'crash', in some countries
- rising inflation and interest rates, off a very low base
- scary climate changes with inadequate responses by too many nations, and
- the rise of populism based on fiction and lies instead of rationality.

And they are only the ones we know about. What else lies in store?

We all want to know what trends are taking place. Firstly, on a positive note, it is more than likely that Australians will be better off, with longer lives, better health and higher household incomes by the end of this decade. That's been true for each decade for well over a century.

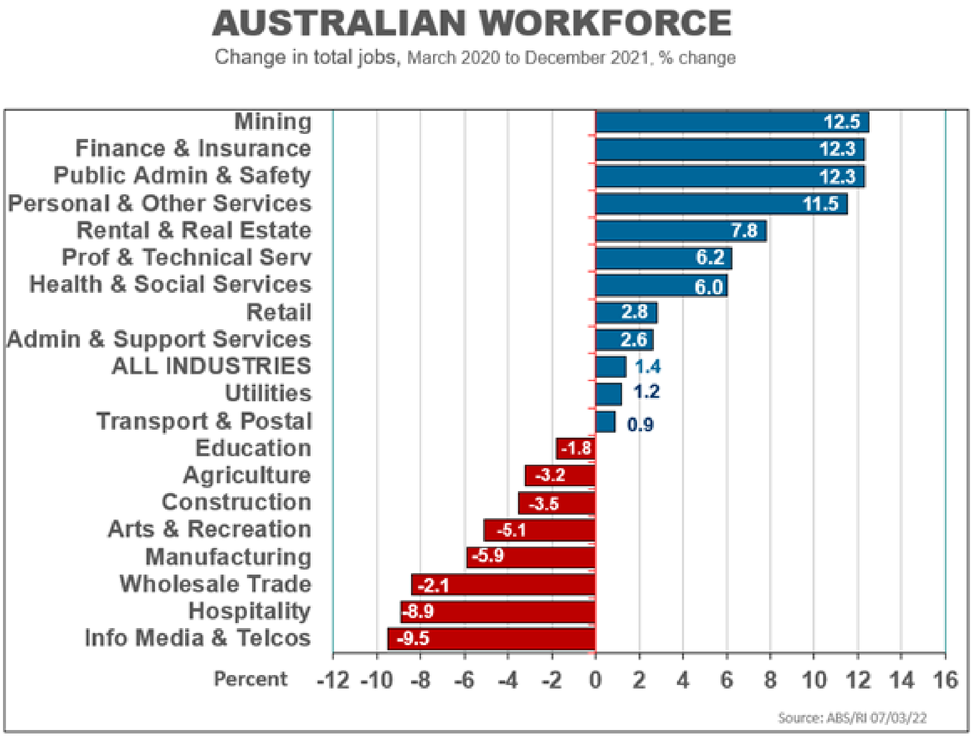
But change is constant, and we humans have been in an exponential rate of change since the Industrial Revolution started in the 1760s in the United Kingdom. Since that time we've seen rapid population growth, technological change, economic output and socio-political ideologies and protocols.

Australia has gone along with these changes, some of which it created. So, short summaries of some of these key changes, hopefully create a picture of our emerging world.

Jobs

With a quarter of the year behind us, we are back to 'full employment' (being under 5% unemployed) and the total hours of work by all 13.4 million employed, has finally overtaken the December 2019 level.

The following chart shows the disproportionate impacts on the nation's 19 industry divisions over nearly two years, using the seasonally adjusted change in total jobs. Some growing very fast, but many of our industries have some way to go to restore their equanimity.



One trend before the pandemic, was the gradual increase of working from home. In early 2020, around 30% of our 13 million workforce was working part-time or full-time from home. This jumped to 69% at a peak during the pandemic, but is now down to 45% (25% FT and 20% PT). It may settle nearer to 35% before resuming its long-term trend growth upwards, particularly the part-time trend.

So, working from home was already a pre-existing trend, as said, aided by technology and boosted with the advent of the Digital Era in 2007, and will continue as one of the important changes in this decade.

Technology

Technology and innovation played a transforming role in the Agrarian Age, mainly with transport.

But technology has played a bigger, if sometimes subliminal role in our lives since the birth of the Industrial Revolution in that age of goods-dominance in the economy. Then, a ubiquitous new utility emerged in the form of power that came in two eras. The first era was waterwheel, wind, and steam power; and the second era came in the form of electricity. We can also add telegraphy to those power changes.

This phenomenon of a new utility for a new age is yet again a vital feature of the current Infotronics Age of service industries growth over more than five decades since the mid-1960s with its new information communication and technology (ICT) utility. It too has come in two eras. The first was computers and software; and the second era - since 2007 – came with the advent of the digital era of fast broadband, artificial intelligence, big-data and analytics.

In the 2020s, this new utility is changing our living, working and leisure patterns at a fast and often seemingly giddy pace.

In some cases, the impact of this new utility on Australia's economic growth has been more disruptive than growth generating. Evidenced by our continued slide in GDP growth over the past 5-6 decades, from 5-6% per annum to 2.25% per annum in the 2020s. We are seeing - since the 2007 stage two of the ICT utility - traditional industries using hi-tech and other success factors to make a break from the old methods. This is especially true in the United States, where some visible or spectacular examples can be seen in the following:

- Tesla is a car manufacturer, creating a new third lifecycle with batteries instead of ICE, using robots, and dispensing with dealer networks, service outlets and petrol stations;
- Amazon is a huge global online department store and bookseller;
- Alibaba is also an online department store;
- Alphabet (mainly Google) is a new generation online encyclopedia;
- Spotify and Netflix are online music stores and cinemas, termed streaming;
- Apple iconized and miniaturized computers and took telephones to online multi-dimensional devices; and
- Uber and Uber Eats are new-generation taxi operators and express couriers.

So hi-tech is not a new industry, it's a must-use utility to be incorporated in all industries. And there are more than 500 classes of industry in the United States and Australia, over and above the examples cited, that will transition or metamorphose over time to a greater or lesser extent. This is part of the discombobulation of the 2020s.

And of course, the Digital Era technology is having transformational impacts on our working protocols and lives as we will return to shortly.

Households and lifestyles

Like all developed economies, spending on goods in Australia has shrunk from the majority of spending (62%) when we federated in 1901, to around 21% at the outbreak of COVID-19 in early 2020.

However, the pandemic saw a temporary reversal of this trend as households spent more money on home durables – especially electrical and electronic goods – as they made their enforced incarceration more communicable, entertaining and livable. Home delivered fast foods boomed, as restaurants were closed.

Entertainment and hospitality shrank, transport shrank both domestically and (especially) internationally, and savings ballooned as there was far less opportunity to spend incomes.

In 2021, we then saw the biggest rise in housing prices - over 20% – supported by record-low nominal mortgage interest rates.

Of course, our transport and communication activities have been through an astonishing transformation via teleconferencing (Zoom, Teams etc.) and social media (Facebook, TikTok et al). But online shopping for both goods and services has been equally spectacular and contributed to the decimation of high street retailing, and the topping-out of the growth of shopping centres.

All in all, profound changes in spending and lifestyles. And by the middle of this decade, most of the pre-pandemic changes - favouring spending on services, will resume - especially travel and hospitality, curtailed so heavily as they have been during the pandemic.

Finance and stock markets

Where to invest is an important challenge right now. For businesses, the answer is easy: on intellectual property (IP) and digitization (fast broadband, data, AI and analytics), not hard assets; these should be leased.

For households, it is a case of playing safe through the first half of this decade with shares, property and interest rates all gyrating if not collapsing in the case of shares and homes. Superannuation is probably the safest, having - as it does - a mixed portfolio of shares, property, infrastructure, and interest-earning assets.

It is worth touching briefly on international shares as they now form a major part of the shares segment in superfunds with local shares now being a minority, due to under-performance compared with our American and European cousins, and the sheer size of superfunds (over $3 trillion) with limited availability of local equity stocks.

The two charts below show the impact of the internet, then the Digital Era that underpinned the rise in Indexes such as the S&P 500, and new innovative stocks such as Alphabet, in creating upward share price trends in the United States.

Corrections if not crashes will occur in both indexes and stocks, but good new-age stocks will recover.

US S&P 500 Index

Alphabet Share Price

Politics

We will finish this insight with a brief look at politics.

Unlike the Industrial Age when major parties who stuck resolutely to one or the other ideology, the parties in our new age have not been so committed. The Labor party has had stints of rationality and reform as well as emotionalism and populism. Ditto the Coalition of the Liberal and National parties.

The inadequacy of the major parties has enabled splinter and minority special-interest parties to increase their power since the 1980s, and they now have veto power in the undemocratically elected upper house (the Senate). They are generally more 'emotionalist' than 'rationalist' and are making it harder to effect overdue reforms.

Sadly, populism has been the winning ideology in the social, political and media arenas for some 15 years - and well and truly through the pandemic and into 2022 - with negligible reforms, very little long-term vision, and old-style cronyism at the expense of talent. As a human race, we live with both ideologies, but need more rationality than emotionality to progress our standard of living.

Hopefully the balance will favour more rationality by the end of this decade. But as said, expect it to be a turbulent and discombobulated decade indeed.

Phil Ruthven AO is Founder of the [Ruthven Institute] and Founder of [IBISWorld]. The Ruthven Institute was created to help any business that wants to emulate world best performance and profitability using the Golden Rules of Success, based on over 45 years of corporate and industry analyses and strategy work.

Benefits of holding gold in Australian dollars

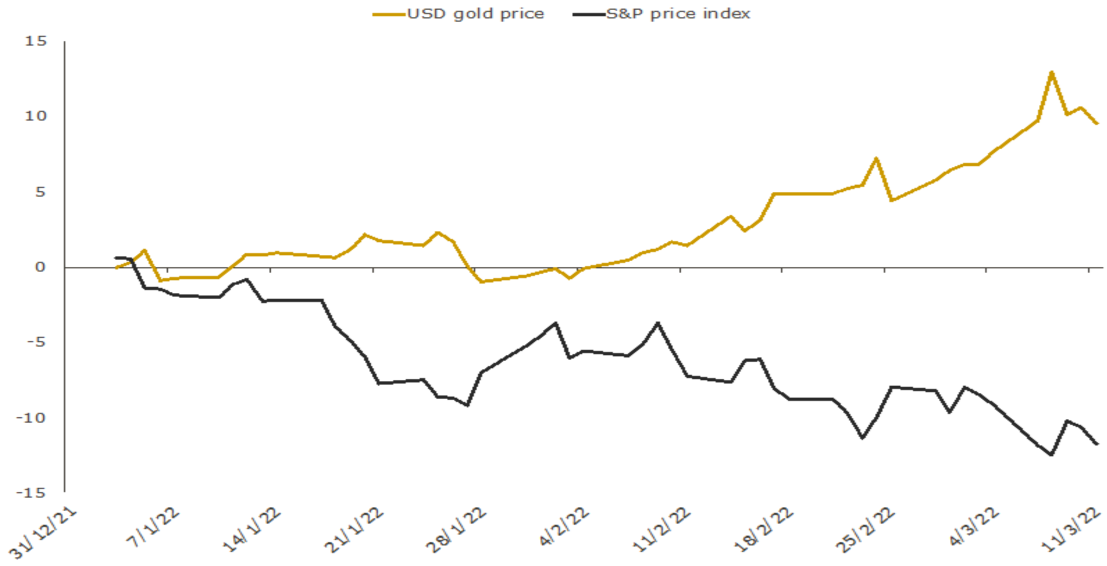
Jordan Eliseo

Gold prices have risen to more than USD 1,950 per troy ounce (oz) in early March as the conflict in Ukraine, heightened inflationary concerns, and slowing economic growth combine to reignite demand for the trusted safe haven.

These events have seen a return to inflows for global gold ETFs, with holdings increasing by just over 2% in the first two months of the year (after falling by 5% in 2021). Concurrently, speculators in the gold futures market have more than doubled their net long position (i.e. positions that will profit if the gold price rises).

Performance wise, gold (priced in US dollars) has now outperformed US equities by approximately 20% since the start of the year (data to March 11), seen in the chart below.

US dollar gold price and the S&P 500 price index
YTD performance (%) to 11 March 2022



Source: The Perth Mint, MarketWatch, World Gold Council

The chart highlights that what we've seen so far in 2022 is another example of gold providing portfolio protection when it's needed most.

Local investors have also benefitted from gold's protective qualities. In Australian dollar terms, the YTD outperformance of gold relative to the local equity market is closer to 13%, with gold up by almost 8%.

The slight 'underperformance' of the Australian gold price compared to its US equivalent has led some to question whether it matters what currency you buy gold in, should you decide to include it in your portfolio.

Does it matter what currency you buy gold in?

Over the long-run, gold prices in many developed market countries have delivered relatively similar returns, with the difference between the US dollar gold price and the gold price in other currencies often explained by a combination of inflation and interest rate differentials.

The similarities can be seen in the table below which shows the average annual returns for gold across a range of currencies from the year 2000 to the end of February this year.

Average annual returns (%) – gold in various currencies, 2000-2022 YTD

US dollar	Australian dollar	Euro	British pound	Canadian dollar	Japanese yen
9.6	8.6	9.0	10.6	8.6	9.9

Source: Reuters, Incrementum Monthly Gold Compass – March 2022, data to end February

While long-run returns and the role that gold can play in a portfolio tend to be similar irrespective of the currency we are looking at, there are differences in shorter term price movements, volatility and drawdowns.

The following table, looking at the same currencies, highlight these differences.

Best year, worst year, maximum drawdown and volatility – gold in multiple currencies, 2000-2021

Statistic	US dollar	Australian dollar	Euro	British pound	Canadian dollar	Japanese yen
Best year	62.5	55.6	67.4	87.3	46.0	68.7
Worst year	-27.2	-9.9	-25.9	-26.2	-17.9	-7.6
Maximum drawdown	-36.0	-15.7	-30.5	-29.5	-22.5	-15.4
Volatility	25.5	17.0	22.4	26.1	18.5	19.5

Source: The Perth Mint, World Gold Council. Based on calendar year data

Currency impacts magnify protective benefit of gold for Australian investors

When buying gold unhedged in Australian dollars, investors are taking on an additional source of risk and return. They are not only exposed to movements in the US dollar gold price, but also movements in the AUD/USD exchange rate.

Rather than proving problematic, this additional source of risk and return has historically been beneficial for Australian investors looking to hedge equity market risk with a gold allocation, because the Australian dollar typically falls against the US dollar when equity markets fall.

Indeed, since the turn of the century, the Australian dollar has fallen against the US dollar 60% of the time the local equity market has seen a monthly decline. The average decline for the Australian dollar in the months the currency fell alongside the equity market was 3.5%.

In the 40% of times the Australian dollar rose against the US dollar while local equity markets sold off (as it has in 2022 so far), its average increase was just 2.6%.

Over this entire period, this exchange currency effect has been worth almost 1.2% in terms of the enhanced portfolio protection Australian investors would have received in the months that equities declined, assuming they held a gold position unhedged in Australian dollars.

Gold price moves when Australian equities fall, 2000 to 2021

Currency	Average monthly returns (%)
US dollar gold	0.82
Australian dollar gold - unhedged	2.01

Source: The Perth Mint, World Gold Council, RBA, MarketWatch

Home bias a factor

Most Australians have a home bias when it comes to their portfolio and total pool of assets, a fact underlined in a 2019 article published by Vanguard stating: "*The level of equity home bias in Australian portfolios is among the highest in the world.*"

This is entirely natural, given the largest asset most of us own, the family home, is priced in Australian dollars. Additionally, people earn most, if not all, of their income in local dollars, and it is a similar story with the cash and term deposits they hold.

Lastly, as it relates to the equity market and Australian investors specifically, there are understandable reasons investors prefer to be 'overweight' the ASX (hello franking credits), reinforcing the home bias.

Given this reality, the logic of holding gold unhedged in Australian dollars is arguably even more compelling.

Should the Australian dollar rise, then most of the assets you own will benefit from this currency appreciation, even if the unhedged gold position you hold underperforms a hedged equivalent.

But if the Australian dollar weakens, then the unhedged gold position will provide additional protection, not only within a portfolio of financial assets, but across the broader pool of real estate, cash and superannuation that most Australians are looking to grow and protect.

Jordan Eliseo is Manager of Listed Products and Investment Research at [The Perth Mint](), a sponsor of Firstlinks. The information in this article is general information only and should not be taken as constituting professional advice from The Perth Mint. You should consider seeking independent financial advice to check how the information in this article relates to your unique circumstances.

For more articles and papers from The Perth Mint, [click here]().

Can quantitative tightening help the Fed fight inflation?

Michael Collins

Hurricanes Harvey, Irma and Maria may have smashed parts of the US in 2017 but Janet Yellen's Federal Reserve was determined to persist with an unprecedented way to tighten monetary policy. By October, the central bank commenced selling assets on its balance sheet to unwind eight years of on-and-off quantitative easing.

Investors wondered: What would happen when the Fed shrank a balance sheet that had swollen from US$900 billion in 2008 to US$4.4 trillion by 2017 (by not reinvesting as much as US$50 billion in bonds that matured every month)? Some turbulence eventuated, but things went smoothly enough for a Fed led by Jerome Powell from February 2018 (until they didn't).

By September 2019, the Fed balance sheet had shrunk by about US$600 billion. Strains in the repo market spilled into the money market and the secured overnight financing rate jumped from 2.43% to above 5%, an event the Fed described as "surprising". To ensure short-term interest rates behaved, the Fed restarted asset purchases.

The Fed's expanding balance sheet

Assets: Total assets (less eliminates from consolidation): Wednesday Level (WALCL)

Source: [Federal Reserve of St Louis. FRED economic data.]() Shaded areas signify recessions.

Investors might keep this episode in mind when the Fed restarts asset sales accompanied by at least the Bank of England.

To understand what might happen when the biggest buyers of debt become the biggest sellers, it helps to revisit what happens when central banks undertake quantitative easing. Under the non-conventional policy, a central bank creates money (electronically) as an asset on its balance sheet and buys financial securities in the secondary market with interest-paying reserves. The purpose is to reduce long-term interest rates. Quantitative tightening, as the name suggests, is the reverse process. Once central banks 'destroy' money, long-term interest rates should be higher than otherwise.

Why do central banks need to reduce their balance sheets? A valid answer is they have no need to. The bloated balance sheets are not causing financial instability, even if pumping them up comes with side effects such as asset inflation and excessive risk-taking and is a culprit behind consumer inflation.

But central banks are intent on shrinking their balance sheets. The main reason is central bankers worry that an overstuffed balance sheet could shake the financial system. At some level, the public might lose confidence in the value of their fiat money. Central banks fret that the extra reserves they create might be lent out and inflation might accelerate. They worry too the policy option is, in Powell's words, "habit-forming". By this, Powell meant it's another 'Fed put'. This is slang for the moral hazard whereby investors take more risk because they are confident the Fed, to protect the economy, will act to cut their losses.

Another reason for quantitative tightening is political. Quantitative easing has led some to accuse central banks of making it easier and cheaper for governments to run fiscal deficits. Reversing the process would depower those accusations.

One motivation the Bank of England has for selling assets appears to be that higher short-term interest rates could turn central bank profits into losses for government budgets. If short-term rates rise enough, the interest central banks pay on their balance sheet liabilities will exceed the interest they earn on their assets. The bigger the balance sheet, the bigger the losses. The Fed would be aware of the political storm created if it were to become a loss-maker for Washington.

It's notable that the Fed and the Bank of England talk of undertaking quantitative tightening in a "predictable manner". That's probably because so much surrounding the stance is unknown. No central bank has ever reversed its asset-buying over the medium to long term.

The danger today is that central banks want to shrivel their balance sheets when they are raising their key rates to combat inflation at decade highs. No one knows how high bond yields might rise as central banks raise their key rates and shrink balance sheets, especially if inflation accelerates further. Nor does anyone know how high bond yields could rise without triggering the financial mayhem that occurs when investors anticipate a recession.

But the bigger menace of quantitative tightening is that it might show the Fed is not serious about curbing inflation. Even though all US inflation gauges have exceeded the Fed's comfort levels for months, the Fed is buying assets until the end of March. A Fed that couldn't immediately end asset purchases when inflation first reached 5% mid-last year is unlikely to allow asset sales to destabilise markets. It's likely that if trouble comes, the Fed will cease asset sales or even resume asset buying. With the cash rate close to zero, quantitative easing is the best Fed put around. Don't be surprised if it resumes.

To be sure, the pressure is mounting on the Fed to control inflation. But adjusting the key rate will be the means to curb price rises, not asset sales. A Fed balance sheet at double the size of 2018-2019 must be riskier to puncture without mishap – so even timid asset selling could stir trouble. The risks will increase if other major central banks join in. An inflation outbreak that requires an abrupt tightening of monetary policy could escalate the risks of doing nothing about a swollen balance sheet.

Amid the uncertainty, it's best to frame the Fed's balance sheet as a tool to ensure today's asset bubbles don't burst. The longer-term problem, of course, is that one day the Fed put will be kaput. Investors might confront a hurricane.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.

For more articles and papers from Magellan, please click here.

An opt-in, universal pension can fix several super problems

Professor Kevin Davis

Allowing all retirees to opt-in to receive a non-means-tested age pension, which would trigger application of a different tax schedule for wealthier retirees (let's call it the retiree tax schedule (RTS)) could solve several current problems with our existing super system without breaking the government budget.

Some super problems

What problems could it solve?

First, there is an enormous waste of resources in the financial planning industry aimed at enabling individuals to structure their financial affairs so as to access the means-tested age pension.

Second, managing a means-tested pension system involves considerable government resources and burdens individuals with excessive 'red-tape' and administration.

Third, superannuation tax concessions in retirement create an unlevel playing field favouring superannuation funds, and reducing external competitive forces, in the market for the management of retiree wealth.

Fourth, the Howard Government's introduction of a zero tax rate for superannuation earnings in retirement was a major policy mistake which is politically infeasible to reverse – unless combined with some offset such as the opt-in universal pension to make it palatable to voters.

The mechanics of an opt-in universal pension

How would such a system work?

At retirement (or later if the option has not yet been exercised), individuals would be able to elect to receive the non-means-tested pension (which is set at the same level as the means-tested pension). However, in doing so, the retiree agrees to be subject to a different tax schedule (the RTS) which has two main features:

1. superannuation account earnings would be included in the retiree's taxable income and subject to personal income tax at the rate specified in the RTS.
2. the RTS would be no different to the normal tax schedule up to some income level, such as that which enables a retiree to currently receive (say) a 25% part-pension. Above that income level the RTS would involve a higher marginal tax rate than the normal tax schedule, designed to offset the additional income to be received by wealthier retirees from the universal pension.

For those currently on full or significant part-pensions, opting into the universal pension can leave their after-tax position no worse off, and avoids the costs of tax-driven financial advice and the hurdles of means-testing. For the wealthier, the decision to opt-in requires some analysis, but no more than could be readily available from web-based calculators.

The information required would include:

- superannuation balances and their expected annual return
- other financial assets outside of super and expected earnings therefrom
- other (part-time employment) income, and
- the RTS and normal tax schedules.

A simple example

A simple example (obviously ignoring many complications, such as uncertainty of returns) may be useful.

Take a retiree with $500,000 in super which generates a pre-tax return of $30,000 p.a. (untaxed). The retiree has $400,000 in other assets generating a pre-tax return of $25,000. Under the current system (with super earnings tax-exempt), no pension is received and tax of $1,292 is levied (at 19% marginal rate on income over $18,200). After-tax income is thus $30,000 + $23,708 = $53,708.

Under the opt-in alternative, the full $55,000 of earnings (inside and outside super) plus the universal pension amount of $25,000 (approximately) would be taxable, giving taxable income of $80,000. To leave the retiree equally well-off from opting in, the RTS would involve levying $17,292 of tax on that income to leave $53,708 after tax. The current (non-RTS) tax schedule would levy $16,467 on that income, indicating that the RTS needs to be set above the normal tax schedule to leave such an individual indifferent.

The exact specification of the RTS would reflect government objectives regarding budgetary considerations and possibly weaning retirees off the super-subsidy teat.

Once set and fixed for all time at specified margins above the normal tax schedule, retirees could make a decision to opt-in or not depending on their individual circumstances.

Political feasibility

Could it be sold politically? Yes, individuals are given a choice to stay with the status quo or opt into an alternative system, rather than simply having a tax-break taken away from them.

Would it be difficult to implement? No.

Would it be difficult for retirees to understand and make sensible decisions? Not with the aid of web-based calculators.

Would the super industry and financial advice industry support it? No, because it goes against their self-interest, even though it has social merits.

What are the scheme's social merits?

Less resources spent on financial advice aimed at maximising pension income.

Less public sector resources spent on means-testing (and less hassles for individuals subject to means testing) and other activities associated with implementing a means-based pension scheme.

A level playing field for the management of post-retirement wealth by removing the tax concession only applied to superannuation earnings in retirement. Unless super funds can provide higher pre-tax returns (or design better retirement products) than other funds, they will be subject to loss of funds under management via the competitive process.

A politically-feasible method of watering down the zero-tax subsidisation of retirement earnings which primarily benefits the wealthier members of society, and which would also reduce the tax incentive for not running down superannuation balances in retirement due to bequest motives.

It would be a major policy change and invoke howls of protest from vested interests in the financial sector. But one well worth considering.

Kevin Davis is Emeritus Professor of Finance at [The University of Melbourne](). Kevin's free e-text reference book 'Bank and Financial Institution Management in Australia' is available on [his website](). Latest update is December 2021. Kevin was also a member of the Financial Systems Inquiry ('The Murray Report') in 2014.

Five charts show investors should care about US midterm elections

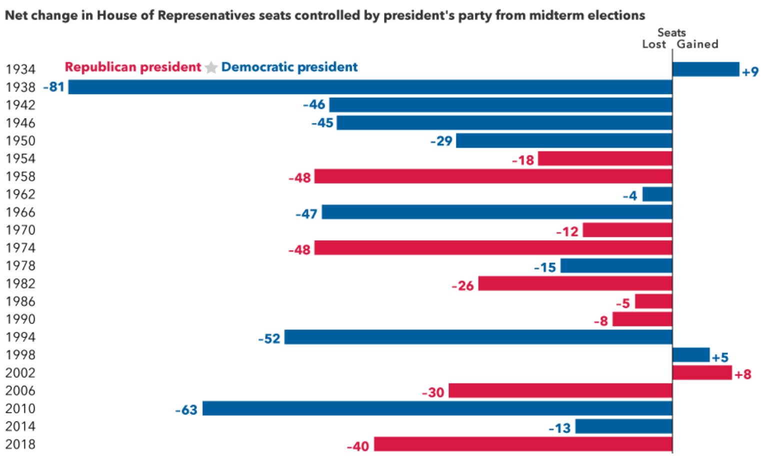
Chris Buchbinder, Matt Miller

Although there are more than seven months to go, US midterm elections are already top of mind for politicians. And with good reason. Capital Group believes 2022 could be one of the more consequential midterm elections in US history. Every move in Washington right now is being carefully calculated with the midterms in mind.

But while control of Congress may be at stake, do midterm elections have any effect on US equity markets?

To find out, we examined more than 90 years of data and found that the answer is yes, markets have behaved differently during midterm election years. Here are the five key lessons about investing in this political cycle.

1. The president's party typically loses seats in Congress



Source: The American Presidency Project, "Seats in Congress Gained/Lost by the President's Party in Mid-Term Elections."

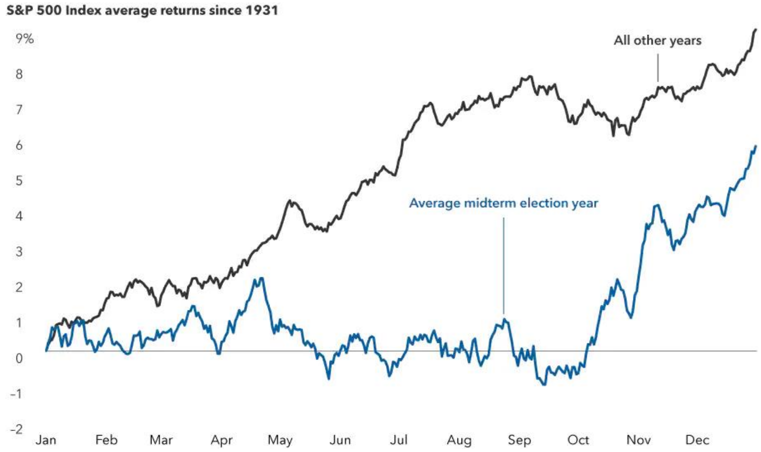
Midterm elections occur at the midpoint of a four-year presidential term and usually result in the president's party losing ground in Congress. Over the past 22 midterm elections, the president's party has lost an average

28 seats in the House of Representatives and four in the Senate. Only twice has the president's party gained seats in both chambers.

Why is this usually the case? First, supporters of the party not in power usually are more motivated to boost voter turnout. Also, the president's approval rating typically dips during the first two years in office, which can influence swing voters and frustrated constituents to seek change.

Since losing seats is so common, it's usually priced into the markets early in the year. But the extent of a political power shift and the resulting policy impacts remain uncertain until later in the year, which can explain some of the other trends we've uncovered.

2. US market returns tend to be muted until later in midterm years



Sources: Capital Group, RIMES, Standard & Poor's. The chart shows the average trajectory of equity returns throughout midterm election years compared to non-midterm election years. Each point on the lines represents the average year-to-date return as of that particular month and day and is calculated using daily price returns from 1/1/31–12/31/21.

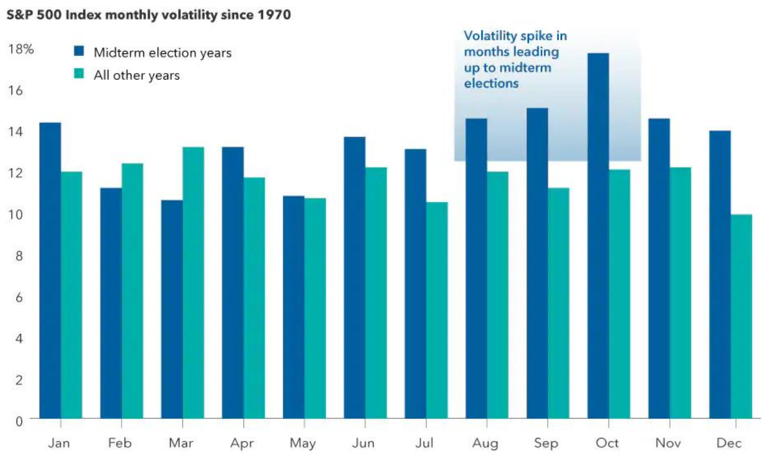
Our analysis of returns for the Standard & Poor's 500 Composite Index since 1931 revealed that the path of stocks throughout midterm election years differs noticeably compared to all other years.

Since markets typically rise over long periods of time, the average stock movement during an average year should also steadily increase. But what we found was that in the first several months of years with a midterm election, stocks tend to have lower average returns and often gain little ground until shortly before the election.

Markets don't like uncertainty, and that adage seems to apply here. Earlier in the year there is less certainty about the election's outcome and impact. But markets tend to rally when results are easier to predict in the weeks before an election, and they continue to rise after the polls close.

Knowing that markets may be choppy in 2022 can be helpful, but investors shouldn't consider this a reason to sit on the sidelines or try to time the market. The path of stocks varies greatly during each election cycle, and the overall long-term trend of markets has always been positive.

3. Midterm election years have had higher volatility

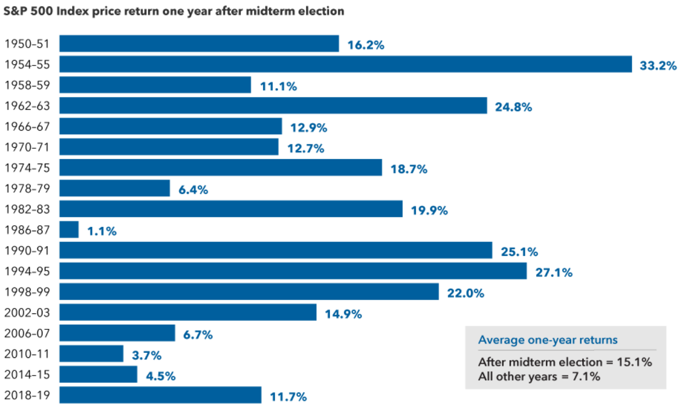


Sources: Capital Group, RIMES, Standard & Poor's. As of 12/31/21. Volatility is calculated using the standard deviation of daily returns for each individual month. Standard deviation is a measure of how returns over time have varied from the average. A lower number signifies lower volatility. Median volatility for each month is displayed on an annualised basis.

Elections can be tough on the nerves. Candidates often draw attention to the country's problems, and campaigns regularly amplify negative messages. Policy proposals remain uncertain but often target specific industries or companies.

So it may not be surprising that US market volatility is higher in midterm election years, especially in the months leading up to Election Day. Since 1970, midterm years have a median standard deviation of returns of nearly 16%, compared with 13% in all other years.

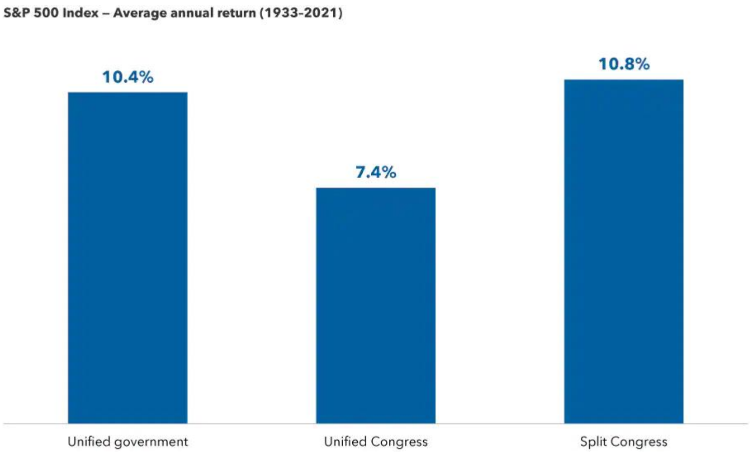
4. US market returns after midterm elections have been strong



Sources: Capital Group, RIMES, Standard & Poor's. Calculations use Election Day as the starting date in all election years and November 5th as a proxy for the starting date in other years. Only midterm election years are shown in the chart. As of 12/31/21.

The silver lining for investors is that after such bouts of volatility, markets tend to rebound strongly in subsequent months. And the rally that often starts shortly before Election Day isn't just a short-term blip. Above-average returns are typical for the full year following the election cycle. Since 1950, the average one-year return following a midterm election is 15%. That's more than twice the return of all other years during a similar period.

5. US stocks have done well regardless of the makeup of Washington



Sources: Capital Group, Strategas. As of December 31, 2021. Unified government indicates control of the White House, House and Senate by the same political party. Unified Congress indicates control of the House and Senate by the same party, but control of the White House by a different party. Split Congress indicates control of the House and Senate by different parties, regardless of White House control.

There's nothing wrong with wanting your preferred candidate to win, but investors can run into trouble when they place too much importance on election results. That's because, historically, elections have had very little impact on long-term investment returns.

In 2020, many investors feared the 'blue wave' scenario, or Democratic sweep. But despite these concerns, the S&P 500 Index rose nearly 35% following the 2020 election (through January 12, 2022).

Going back to 1933, markets have averaged double-digit returns in all years that a single party controlled the White House and both chambers of Congress. This is just below the average gains in years with a split Congress, a scenario which many believe is a strong possibility in 2022. Even the 'least good' outcome, when the president's opposing party controls Congress, notched a solid 7.4% average price return.

What's the bottom line for investors?

US midterm elections — and politics as a whole — generate a lot of noise and uncertainty. While midterm election years have exhibited these five trends in aggregate over long periods, it is important to remember that each year is different and follows its own path.

There is a good chance of higher volatility in 2022, but no need to fear it. The reality is that long-term equity returns come from the value of individual companies over time. Smart investors would be wise to look past the short-term highs and lows and maintain a long-term focus.

Matt Miller is a Political Economist and Chris Buchbinder is an Equity Portfolio manager at [Capital Group](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any person.

For more articles and papers from Capital Group, [click here]().