Firstlinks
a Morningstar company

Edition 564, 14 June 2024

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Editorial

Last month, the Morningstar Investor Conference in Sydney hosted one of the most fascinating panel discussions that I've attended in years. Called "Inflation Confrontation – Dual Perspectives", the panel featured Hyperion Asset Management's Lead Portfolio Manager, Jason Orthman, and Schroders Head of Australian Equities, Martin Conlon.

The discussion turned out to be less about inflation and more about two contrasting styles of investing. For context, Hyperion is an Australian and global equities manager that's found huge success with its growth-style of investing over the past 15 years. Meanwhile, Schroders is primarily known as the investment manager to the ultra-rich – conservative, hard-nosed, principally fundamental and value-driven.

The way Orthman and Conlon dress and talk epitomize the differing investment styles. Orthman sounds and looks like someone working at Microsoft or Google might. He's optimistic, confident that innovation can change the world and confident that Hyperion can capture many of those changes with its investments.

Conlon is old school. He's more pessimistic about the future, less of a believer in technology transforming the world, and more concerned with the here and now of things like industry supply and demand, and company valuations.

The Hyperion view of the world

Despite being a bottom-up investor, Orthman says that Hyperion does have a macroeconomic outlook which it uses to frame the future. He believes that after the financial crisis, the world became a low growth, low interest rate and low inflation environment. The pandemic disrupted that, though deflationary forces including ageing demographics, growing tech automation, weaker secular demand growth and high debt levels, mean a return to that pre-Covid low growth environment seems likely. Interestingly, he infers that we could be headed back to sub-2% interest rates too. Obviously, that would be favourable for long duration assets, like the growth and tech companies that Hyperion prefers.

Orthman explains that his firm is really trying the capture the tail of the market. In Australia, just 1% of companies, or 200-300 of them, have accounted for all the gains of the ASX. In the US, that figure is 4%. Hyperion tries to find these wealth creating companies.

In Australia, the wealth creators of the past were the likes of BHP and the major banks. Now, and in the future, Orthman says that's likely to change. His firm has little interest in investing in miners or the banks, which in aggregate comprise more than half of the ASX 300.

Instead, it looks elsewhere. Hyperion likes to own monopolies – disruptors which are almost creating industries unto themselves. It's famously been early investors in companies such as WiseTech (ASX:WTC), REA (ASX:REA), and Afterpay.

One of its biggest investments now is Block (ASX:SQ2). Afterpay got rolled into Square which then became Block. And Afterpay is about 10% of Block's business.

Orthman acknowledges that Block is a controversial stock though he thinks it's misunderstood, as WiseTech and REA were in their formative years. About 50% of Block's earnings come from its Cash app. It's a peer-to-peer product that's gone from having the sixth largest market share in the US to number one. The product allows you to do things such as easily transferring money to a friend. Block has offered this as a free service but has added services on top, like being able to invest in Bitcoin, owning fractional interests in shares, and so on. Block also has another business with its well-known payments and point of sales system for small businesses.

Orthman believes that the younger generation are often starting off with the cash apps and not with banks, and that gives Block the potential to disrupt the traditional banking system. He says recent earnings issues at the company should be behind Block as it remains a dominant business, yet it lost control of its cost base, which is now being addressed. That should result in much higher earnings over the next few years.

The Schroders view of the world

Schroders has a very different take on markets. Conlon thinks inflation could remain a problem. He says deglobalization, remilitarization, green energy, demographics resulting in increased government spend to support the ageing, is likely to lead to more inflationary pressure.

Conlon says prices of markets are high versus history, driven by growth stocks, especially in tech. He expects a shakeout, and valuation mean reversion, at some point.

He believes long duration stocks aren't without risk. They can operate in cyclical industries rather than be structural growth stories. Also, he finds it hard to look 10 or 20 years ahead to figure out what a company's earnings might be then.

Conlon's prefers to look at sectors and stocks that investors are running from, rather than towards. He cites resource stocks as attractive given his inflation outlook. He also favours pathology and radiology shares. He says they are not only solid businesses, but may also benefit from artificial intelligence potentially replacing people performing scans etc. Conlon also likes that they are preventative healthcare businesses, which are less reliant on government spending than companies that treat people after they become ill.

Both may be right

Hyperion and Schroders are both fabulous investment managers. Right now, growth is the flavour of the month. If it was a kid in a classroom, it would be the cool, hip one that's endlessly attracting attention and followers. Meanwhile, the value investor is akin to the nerdy outcast sitting at the back of the classroom, envious of the attention the cool kid is getting and waiting for them to soon trip up!

There are obvious risks to Hyperion's view of the world. Short-term tech valuations do look excessive. In the 32 trading days to the end of last week, Nvidia (NYSE:NVDA) gained more than US$1 trillion in market value – a six week gain that's greater than the total market capitalisation of Berkshire Hathaway (NYSE:BRKA), which Warren Buffett spent six decades building. That seems far from normal.

There's also the risk that we don't return to the low inflation and interest rate world that Hyperion envisages. If it doesn't happen, the valuations of long duration assets should come under pressure.

There are question marks about how revolutionary AI will be too. Yes, it will almost certainly help with productivity and cut costs, but will it have the effect that the Internet had? It seems highly doubtful at this point.

While Martin Conlon may prove right in the near term, the long-term might be another matter. There are a few issues that value investors must grapple with, and it's not just recent underperformance. First, technology is here to stay and understanding it will be critical to evaluating all companies, not just those in the tech sector. In my experience, a lot of value investors are sceptical of tech, if not tech averse, driven by the experience of large drawdowns in tech stocks in 2000, 2008, and 2022. Yet, a thorough knowledge of technology will be critical to future stock picking.

Second, younger generations will be the customers of tomorrow's businesses and understanding them will be crucial as well. For instance, they seem to value convenience and technology that enables this. It's why Block's Cash App is proving popular. It's why online investment platforms are taking off. It's why ETFs and active ETFs are attracting money at the expense of managed funds. And the list goes on.

Disruption of traditional industries because of our tech-savvy younger generations is likely to continue and grow, whether value investors like it or not.

James Gruber

In this week's edition...

Last month, **Meg Heffron** wrote of how the new $3 million super tax is coming whether we're ready for it or not. The article garnered dozens of questions, many of them about the mechanics of how the tax will work in practice. Meg attempts to answer some of those questions in this follow-up piece.

Recently, **Graham Hand** penned an article on how life expectancy tables can be deceptive, as the data for children born today is quite different from those born decades ago. **Ashley Owen** offers a different perspective. He says preparing for retirement based on your 'median' life expectancy age is an error, as it means a real possibility of living a lot longer than you might have thought. You need to plan accordingly.

We welcome **Peter Thornhill** back, this time on a different topic to his usual fare. Peter writes of how he's used debt recycling - replacing or 'recycling' the debt in your family home with tax-deductible debt from investments - to build his personal wealth. He says that while some people see the strategy as risky, there are ways to reduce the risk and reap the rewards.

All our lives, we're told to 'save, save, save'. And now we're being told by governments that as we retire, we should start to 'spend, spend, spend'. But it's not easy to switch from a savings mindset to a spending one. **Samantha Lamas** explores the psychological barriers to making the shift and what can be done about them so you can make the most of your retirement.

There's been a surge of interest in overseas equities as the Australian market lags. **VanEck's Cameron McCormack** investigates various approaches to determine the best allocation of international equities within a long-term investment portfolio.

Bonds have got a bad rap after four years in the doldrums. **UniSuper's David Colosimo** believes that the recent downdraft means future prospects appear brighter for high quality bonds.

The Ukraine war has brought Russia and China closer together. They seem intent on challenging the West and reshaping global power dynamics, despite their complex historical relationship and differing long-term interests. **John West** looks at the implications of the partnership for the US and its allies, including Australia.

Lastly, in this week's whitepaper, **Schroders** examines why small caps have underperformed in Australia for a long period of time, and why that underperformance may continue moving forward.

Meg on SMSFs: Clearing up confusion on the $3 million super tax

Meg Heffron

My last article on this new tax didn’t actually cover the mechanics of how the tax is supposed to work. But as it happens, the majority of the comments were questions about exactly that.

So consider this a follow up – an opportunity for more considered answers to some of the questions raised. And given how many there were, this might have to be just Part 1!

If you’ve read my articles before, you’ll already know I’m not surprised the Government is seeking to lower super tax concessions for people with a lot of money in the system. But at the same time, I firmly believe this particular way of doing it is dumb. So let me say up front that this article is purely about how it works, rather than trying to defend it.

Some terms to help the explanation

This tax really is deceptively simple in how it’s worked out:

15% x a **proportion** x **earnings**

(The big bone of contention, of course, is how the earnings are worked out – but more on that shortly).

This tax is entirely separate to – and on top of – the tax paid in the super fund itself. That’s calculated as:

15% x the **fund’s taxable income**

The only thing the two taxes have in common is 15%.

The 'earnings' used for Division 296 and the 'taxable income' used for the fund's own tax will have *some* common elements (for example, rent, dividends, interest are included in both). But there are also some big differences. Most importantly, earnings for Division 296 are basically anything that makes the member's super balance go up which will include all growth in assets whether they've been sold or not. Taxable income in the fund, of course, only includes gains from assets that are actually sold.

For example, Dave's super balance increased from $4.5 million to $5 million during 2025/26 and he didn't take any money out during the year or add any new contributions. His earnings for Division 296 would be $500,000 ($5 million less $4.5 million).

Whether this was $500,000 in (say) rent or capital gains really matters when it comes to his fund's tax bill but not when it comes to Division 296. For example, if it was all interest (no growth in the fund's assets), the super fund would also pay tax that year (15% x the interest). If, on the other hand, it was all growth in investments that weren't sold (no taxable income), the fund would pay no tax at all that year.

But for the new tax, none of this matters. All we care about is that Dave's super is bigger than it used to be. We'll come back to Dave shortly but let's address some of the questions first.

Double taxation or not?

A lot of outrage about this tax is directed at the fact that it represents double taxation – super earnings are taxed first within the super fund and then again via this new tax.

Yes.

But that's entirely intentional and exactly what the Government has said right from the start. Their rhetoric about increasing the tax rate from 15% to 30% for people with large super balances tells us so. They haven't changed the way super funds are taxed, they've simply added a ***second*** tax on top that only applies to some people – those with more than $3 million in super. So by definition it's taxing income twice.

We may not like it but to say its unprecedented is actually wrong. If you're a higher earner still receiving employer contributions (or making contributions yourself and claiming a tax deduction for them), you'll already have felt the full force of Division 293 tax (is the very similar name a coincidence? I think not). This is an extra 15% tax on contributions known as 'concessional contributions'. It's paid by people who earn more than $250,000 pa. They have the normal 15% tax (same as everyone else) deducted from their super contributions *in their fund* and then they get another *personal* tax bill on these same contributions as their 'Division 293 tax'. It probably flies under the radar because the amounts are much smaller. The cap on concessional contributions is $27,500 pa (rising to $30,000 from 1 July 2024) so in most cases, the bill is $4,125 at most. But it's still a second tax on income that has already been taxed – just like Division 296.

When it comes to Division 296 (the new tax), of course, there are some extra factors that make the whole situation opaque, and the amounts are potentially much larger. So not surprisingly, the double tax element comes in for much more criticism than it does with Division 293. But it's not new, it's definitely intentional and the Government has been pretty clear about it.

It's also worth noting that people impacted by Division 296 are not paying double tax on ***all*** their super fund earnings. They are paying double tax on just a ***proportion*** of their super fund earnings. The theory behind the proportion calculation is that the Government is quite happy for them to only pay tax once on the bit of their earnings that relates to the first $3 million of their super. It only wants to double tax the earnings on the bit of their super that is over $3 million.

But how that's worked out is another thing that people are definitely finding confusing.

How much of the earnings will be hit with double tax?

To keep things simple, the Government has taken a short cut when it comes to working this out. It isn't worked out by actually breaking up earnings during the year into 'earnings on the first $3 million' and 'earning on the rest of the super balance'. Instead, there is a much simpler approach.

The 'proportion' in the formula above is simply: what proportion of the balance at the end of the year is over $3 million?

In our Dave example earlier, Dave's balance was $5 million at the end of the year. So $2 million (or 40% of his $5 million balance) is over $3 million. That means Dave's proportion is 40%.

It doesn't matter if he had much more or much less ***during*** the year, all that matters for this proportion is the size of his balance at the ***end*** of the year.

So Dave's super earnings in 2025/26 were $500,000. He will pay Division 296 tax on 40% (the proportion) of those earnings ($200,000). He pays no extra tax on the other $300,000.

His Division 296 tax bill will be $30,000:

15% x 40% x $500,000 = $30,000

That's on top of the tax his super fund has already paid.

What about an example

Let's make things simple and assume Dave is the only member of his SMSF. And let's assume for a moment that his super fund bought an asset on 30 June 2025 with all of its money ($4.5 million). Of course in practice this wouldn't work – Dave's fund needs money to pay his accounting fees and ATO levies at the very least but for the moment we're going to ignore that inconvenience.

Let's also assume – really stretching the boundaries here – that this asset doesn't earn any income, ever. It's just growing in value. (The investment strategy for this fund would be super interesting.) It is sold on 1 July 2028. Until then, Dave's super fund (and his balance) looks like this:

	30 June 2025	30 June 2026	30 June 2027	30 June 2028
SMSF (1 asset)	$4,500,000	$5,000,000	$5,500,000	$6,000,000
Dave's balance	$4,500,000	$5,000,000	$5,500,000	$6,000,000
Div 296 earnings		$500,000 ($5m - $4.5m)	$500,000 ($5.5m - $5m)	$500,000 ($6m - $5.5m)
Proportion of the earnings subject to Div 296 tax		40.00%	45.45%	50.00%
Div 296 tax bill		$30,000	$34,088	$37,500

What tax would Dave's super fund be paying during this period? Nothing – until 2028/29 when the asset was sold. At that time, the capital gain would be $1.5 million ($6 million less $4.5 million). When a super fund holds an asset for more than 12 months, it only pays tax on two-thirds of the capital gain. So Dave's SMSF would have a tax bill of $150,000 in 2028/29:

15% x 2/3 x $1,500,000 = $150,000

Importantly, Dave's SMSF would pay tax on this capital gain in the normal way even though Dave has already paid Division 296 tax along the way. And as we can see from the table, each year that gain built up, Dave paid Division 296 tax on 40% - 50% of it (which added up to around $100,000 over those three years). He didn't get any one-third discount either when it came to his Division 296 tax.

Yes, it's definitely double taxation and that's exactly what the Government intended.

This is, of course, really oversimplified:

- the fund isn't earning any taxable income at all (just a capital gain when the asset is sold),
- Dave doesn't have a pension (whereas many people in this position do), and
- the fund's accountant could make provision for capital gains tax each year, effectively recognising each time the asset grows in value there will be a tax bill down the track when it's sold. This would make Dave's balance (and earnings) a little lower each year and reduce his Division 296 tax bill a little.

But hopefully it highlights two points:

- The fund's tax and Division 296 are completely divorced from each other, and
- Dave is being double taxed but not on all the growth in his super, only some.

Would selling assets before 30 June and re-buying on 1 July help?

Not really. It would change all the numbers and result in slightly less Division 296 tax each year but would also bring forward the fund's tax bill and make Dave a bit poorer overall.

Let's imagine that was possible in 2026 for Dave (and let's assume the fund held the asset for a fraction over 12 months so the discount on its capital gains still applied). The position at the end of that first year would be:

	30 June 2025	30 June 2026
Asset	$4,500,000	$0
Cash (on sale)		$5,000,000
Tax on the capital gain		($50,000)
Dave's balance	$4,500,000	$4,950,000
Div 296 earnings		$450,000 ($4.95m - $4.5m)
Proportion of the earnings subject to Div 296 tax		39.39%
Div 296 tax bill		$26,588

The reason the earnings amount is a little lower is that we've allowed for the tax that will be paid by the SMSF when it lodges its 2025/26 tax return. But see how the earnings amount is still pretty close to $500,000? (And in fact, Dave's a little poorer because his super fund has paid tax and can only re-buy $4.95 million in assets, not $5 million.)

As mentioned above, Dave could achieve a better result by hanging on to the asset but specifically recognising in the fund's accounts that there is a future liability building up – the capital gains tax that will eventually be paid on the asset.

Actually ***selling*** the asset doesn't make it any better, it just means paying the ATO quicker.

What would be even worse would be selling an asset bought well before 1 July 2025.

Let's say the $4.5 million asset in our example wasn't actually bought in June 2025. Instead, it was bought 10 years earlier for $2 million.

Selling it in 2025/26 would make no difference at all to Dave's Division 296 tax bill. That's all based on growth during 2025/26, not what's happened before. But it would make a very large difference to the SMSF's tax bill. Instead of $50,000, the fund would part with a much larger amount:

15% x 2/3 x ($5,000,000 - $2,000,000) = $300,000

Ouch.

This is another big difference between fund tax and Division 296. Division 296 is focused exclusively on how much growth Dave sees in his super after 30 June 2025. Growth already factored in (as in this case) won't get double taxed.

These are just some of the areas of confusion around Division 296 tax - it seems I might need that Part 2 after all.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

For more articles and papers from Heffron, [please click here]().

How not to run out of money in retirement

Ashley Owen

Today's story looks at two key factors that determine the answers to the big questions when planning retirement finances: 'How much do I need?', and 'How much can I afford to spend?' - in order to have confidence that you can maintain your living standards, not run out of money, and not have to rely on welfare.

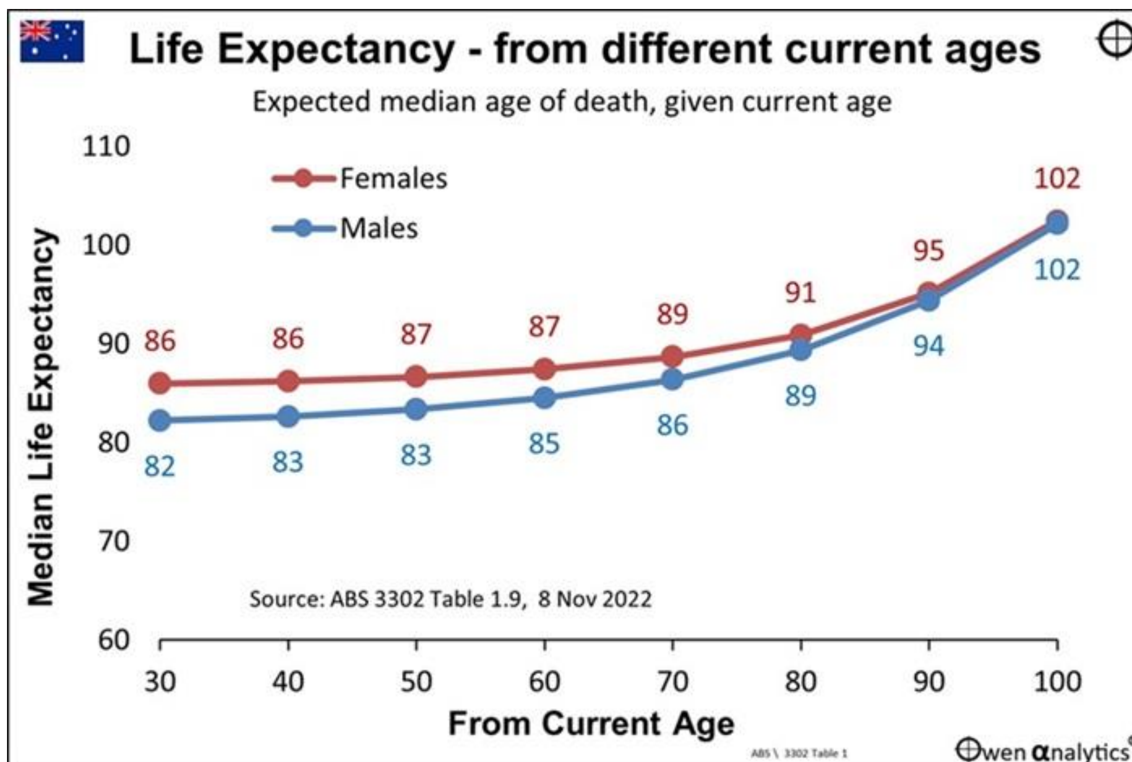
These two factors are: your current age, and your likely life span. In particular, we highlight the four big problems when relying on 'life expectancy' tables that are used throughout the financial advice and retirement industry.

The bottom line: be prepared for the real possibility of living a lot longer than you might have thought!

'Median life expectancy' tables

Most retirement planning calculators provided by government services, super funds, banks, and product issuers, are based on the assumption that you will run down your capital during your lifetime. (They also assume you will be relying on government welfare, as do two thirds of all retirees in Australia, when you run out of money).

The Australian Bureau of Statistics (ABS) publishes Australian life expectancy tables regularly. Here are the most recent life expectancy numbers for Australians (ABS report):



From this we can see, for example, that for people who are now 60, the life expectancy for males is 85 (ie 25 years of life left), and 87 for females (27 years left). This sounds depressing - I certainly hope to live a lot longer than that if I can.

There are four big problems with relying on median life expectancy tables like these to estimate how much capital you will need in retirement, and how much you can afford to spend.

Problem 1 – there is at least a 50% chance you will live longer than the 'median'

Statistical life tables show 'median' life expectancy. Every 60-year-old alive today will not suddenly die when they are 85 for males, or 87 for females. Some will die tomorrow (unfortunately), and some will live well past 100.

The term 'median' means 'middle'. That means that half of all today's 60-year-olds are projected to die before the median life expectancy, and half will live longer than the median life expectancy.

If you use the median life expectancy as the forecast term of your retirement fund, there is a 50% chance you will fall short, because there is a 50% chance you will live longer than the median life expectancy for your age group.

A 50% probably of failure of your retirement investment plan is far too high for comfort. It would be much safer and more comforting to plan for your funds to last say 15 or so years longer than the median life expectancy tables indicate. We all know, or know of, people who lived past 90 or 100. What if that is us? We can't suddenly decide to 'work longer, or 'go back to work' or 'save more'.

Problem 2 – The older you get, the longer you are likely to live

Take another look at the first chart. We can see that the median life expectancy for 60-year-old females today is 87. But the median life expectancy for 70-year-old females today is 89, the median life expectancy for 80-year-old females today is 91, and the median life expectancy for 90-year-old females today is 95, and so on.

The longer you live, the longer you are likely to live. And these are just the medians. Half are expected to live longer than the medians. We take this further below.

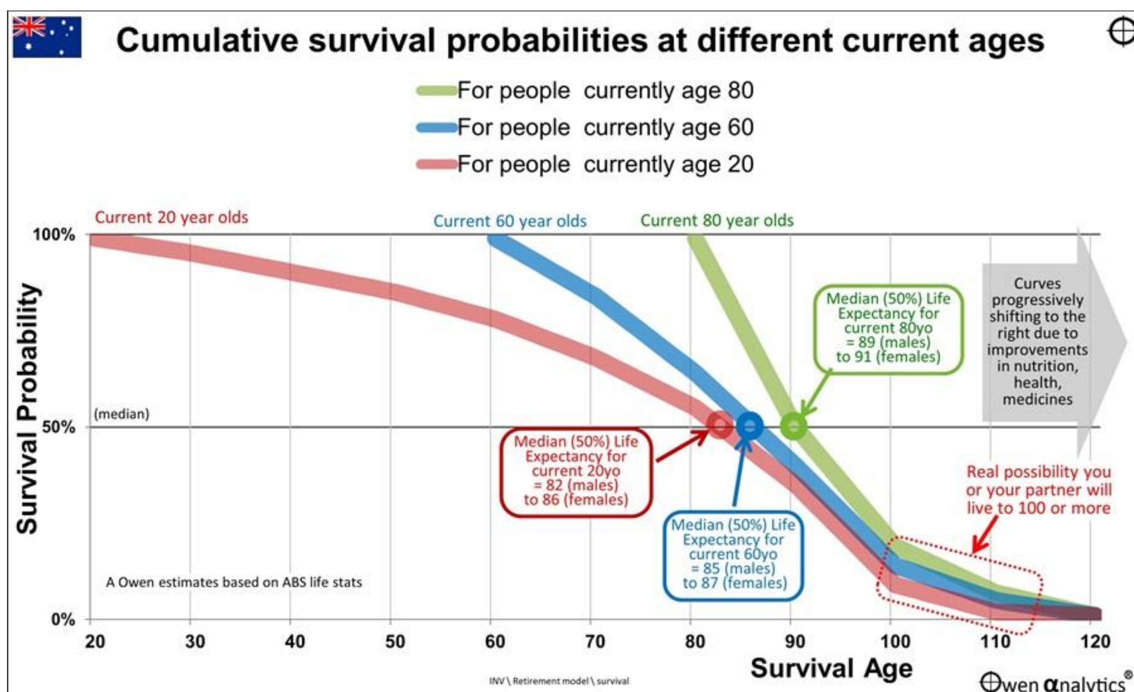
Real possibility you or your partner might live to 100 or more

Whenever I talk to investors about financing their retirement, I always insist on both partners being present at every meeting (even if one of them has taken responsibility for 'looking after the money'). I always say to them:

"One of you might live to 100, and [as I look to the male] it's probably not going to be you!"

The first chart above is based on 'medians', but the next chart spreads life expectancy over the full gamut of possible outcomes.

It shows survival probabilities (vertical axis) and survival ages (horizontal axis) for three cohorts – current 20-year-olds (pink), current 60-year-olds (blue), and current 80-year-olds (green).



All three curves start out at the top at 100% because they are alive today, and there is a near-100% chance of surviving tomorrow. The curves decline over time – slowly at first – as people start to fall off the perch in untimely, early deaths.

All three curves decline over time, and they cross the 50% probability line ('median') at their current estimated median age of demise (death). These median ages are the same numbers from the first chart, except this

second chart shows how today's current 20-year-olds, 60-year-olds and 80-year-olds are likely to remain on the planet over time.

The three curves are deliberately depicted as broad lines to allow for the differences in life expectancy for males and females (and all of the various gender categories in between!)

For example, looking at the 60-year-olds (blue line) alive today, approximately 84% are likely to live to age 70, 64% are likely to live to age 80, 50% are likely to live to the median age of 85 (a mix of male/female/other).

Looking beyond the median age of demise (ie below the 50% line), 40% of today's 60-year-olds are likely to live to age 90, around 14% are likely to live to age 100, and the rest are likely to live beyond 100.

The area in the **red box** in the lower right of the chart is to highlight the fact that in any couple, there is a real possibility that one of them will live to 100 and beyond.

Problem 3 – life expectancy has been steadily increasing throughout history, and this will probably continue

The life tables calculated by actuaries reflect current experience, current conditions, current technology and current medical knowledge. The problem is that human life expectancy has been rising steadily over time with improvements in medicines, hygiene, nutrition, health care, vaccines, technology, and many other factors.

There is every reason to believe that every decade that passes will further increase expected life spans, especially in 'rich' countries like Australia.

This means that the probability curves in both of today's charts have been shifting steadily to the right (longer lifetimes) over time, and will probably keep shifting to the right in future. What you consider now as a remote possibility of living to 100, will become more and more likely over time.

Problem 4 – your own individual factors - health, fitness, lifestyle, diet, genetics, etc – may mean you live even longer

We can't change our genetics, but we can try to remain as fit and healthy as possible for as long as possible. That is fine, but it will increase your chances of running out of money if you just use the standard calculators and life tables in planning for how much capital you need, and how much you can afford to spend.

If you consider yourself fitter and healthier than average for your age group, then it would be prudent to err further on the side of caution and plan to be on the high side of the 'median'.

100 is not a bad age, and a nice round number to lock into your numbers to enhance confidence and peace of mind.

My parents

My father died a decade ago at age 80. He was born on a rubber plantation in Malaya (now Malaysia) and grew up on the bombed-out streets of war-torn, Japanese-occupied Singapore. He spent the next 30 years smoking five packets of cigarettes per day, and then a pipe at night (as a kid I remember stacking his pipe for the nightly puff). He ended up having a bunch of cancers (lung, prostate, bone, bone marrow), and had an excruciatingly painful last few years due to a twisted arthritic spinal cord. Was mentally very sharp to the end, but physically wrecked.

At birth, his life expectancy was probably around 50 at best (poor, rural third world country), so he ended up outliving that by probably **three decades**.

My mother is still battling on at 96. Mentally shot, but physically very durable. She's had numerous broken bones from countless falls (she literally got out of hospital last month after an operation on a broken femur – again), has had cancers removed (thyroid, bowel). In hospital about every month or so for a variety of things and has major operations once or twice per year. She has advanced vascular dementia from multiple minor strokes.

At her birth in 1928 in outback Australia, her life expectancy was 63 (Australian Year Book 1926, p.971), so she has also out-lived that by **three decades** so far, and she's still going.

In both cases, their 'survival curves' shifted **three decades** to the right over their lifetimes. Mine and yours will probably do the same.

Me

In my own case, I was also born in a poor third world Southeast Asian country in the midst of colonial battles for independence and communist uprisings, so my life expectancy at birth would have been perhaps 50 or 60 at best.

Had I been born in Australia (where I have been lucky enough to have lived most of my life), my life expectancy at birth would have been 67 (Australian Year Book 1959, p.346). But having survived thus far, my life expectancy is now 85 (ABS 3302 Table 1), so my survival probability curve (even if I had been born in Australia) has already shifted two decades to the right, and I'm not done yet.

Homework!

What was your life expectancy at birth? (If you were born in Australia, life expectancy tables are included in most Year Books. You can download Australian Year Books going back to 1901 here: **www.abs.gov.au/**)

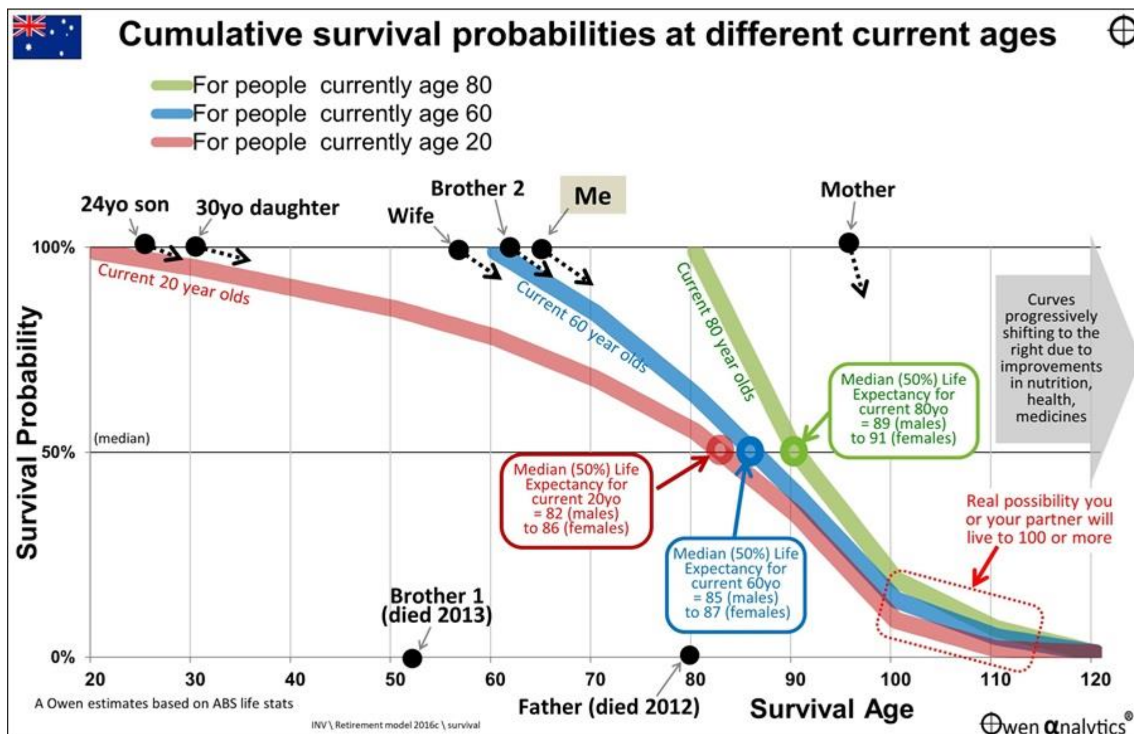
Having survived thus far, what is your life expectancy now? See ABS 3302 - **https://www.abs.gov.au/statistics/people/population/life-expectancy/latest-release**

How far has your own survival probability curve shifted to the right over your lifetime so far? Be prepared for the real possibility of a much longer life than you might have thought.

Where are you and your family on the Survival Probability Curve?

You can plot yourself and your family on the Survival Probably Curve to get a rough picture of the future paths you are on.

Here is the second chart again – this time showing the positions of me and my family (including my father and younger brother who have passed away. Father's circumstances outlined above. Brother died in a plane crash at age 52 – flying his own single-engine plane).



The arrows are all heading down, reflecting the ever-present risk of demise every day. But the good news is that every year you survive, you remain at the top 100% line, and shift one year to the right!

Where are you and your family on the Survival Probability Curve? Do you have better or worse genetics, fitness, health than other people your age?

What are the prospects of you living to 100 or beyond? How will you finance it?

Ashley Owen, CFA is Founder and Principal of [OwenAnalytics](). Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. You can subscribe to OwenAnalytics Newsletter [here](). Original article is here: [How to not run out of money in retirement - 4 big problems with life expectancy tables]()

How to use debt recycling to your advantage

Peter Thornhill

When we returned from the UK in 1988, we discovered that mortgages here had no tax breaks at all. In England, the interest on your home purchase was tax deductible up to a certain point.

We put up with that for the first few years we were back, but I then decided to sort out a strategy to solve this problem. Having sold our house in the UK, we had a substantial deposit for our first home purchase, so I approached our bank manager to arrange a second separate "home loan".

Initially the bank wanted to classify it as a "line of credit" which enabled them to charge a higher rate of interest. After persevering I managed to get the bank manager to agree that; yes, it was a home loan secured against our property. With the tax office it was agreed that this second loan was for investment alone and the interest was therefore tax deductible. I did not draw the full amount so had scope to increase it further.

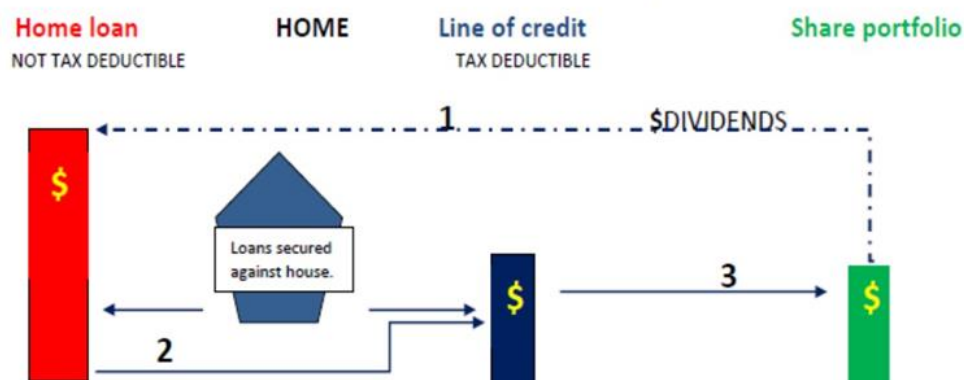
I then purchased quality, dividend paying shares and arranged for the share registrars to pay all dividends into the initial non tax deductible loan. These dividends were therefore additional repayments over and above our existing mortgage repayments.

To tweak it, I was also paying this existing mortgage on a weekly basis by dividing my present monthly repayment by 4 and then rounding these weekly payments up to the nearest $100.

As the non-tax-deductible loan decreased I had arranged a redraw facility on the investment loan. I could then add to the shares which increased the dividends.

Assumption is you have a house with a mortgage (RED) that is not tax deductible and you are making mortgage repayments.

If you have equity in your property you arrange an interest only **line of credit (BLUE)** separately from the mortgage. Using this to buy **shares (GREEN),** the interest and any costs associated with the line of credit will be fully tax deductible. Also ensure that the **line of credit** is flexible so that you can draw additional amounts as your mortgage reduces.



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This meant my non tax deductible loan decreased at an ever increasing amount as the dividends were growing each year and as I was reinvesting I had more shares. A form of double compounding. The end result was a

non tax deductible loan decreasing and a fully tax deductible loan replacing it. When the non tax deductible loan was wiped out all dividends and "home loan" repayments were directed to wiping the investment loan.

Having done this with all our properties, having moved several times since our return, it has remained in the back of my mind. When I retired and started our SMSF paying a pension, I decided to utilise the dead cash locked up in our home.

Back to the bank, arrange another investment loan and invest in more shares. I can always borrow at home loan rates which are still quite low. I should add at this point the blindness of many people. I have been told I was silly because the dividends didn't cover the loan repayments; yeah right, and what is the Australian love affair with negative gearing into property all about; double standards perhaps?

Now in retirement and still carrying a reasonably substantial loan. Interest tax deductible and dividends with a tax credit (franking) growing to ensure our retirement remains a lot of fun.

Peter Thornhill is a financial commentator, author, public speaker and Principal of [Motivated Money](). He runs full-day courses in the major capital cities explaining his approach to investing "in the vain hope that not everyone is frozen with fear".

This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.

The psychological shift from saving to spending in retirement

Samantha Lamas

The narrative of a miserly, Scrooge-like figure hoarding his wealth for years instead of enjoying his retirement might seem unbelievable—but unfortunately, it isn't relegated only to fiction. It's a cold reality for many retirees.

Although most retirees' stories aren't as dramatic as Scrooge's, it's not uncommon for retirees to have more than enough to live comfortably for the rest of their lives but still think a vacation is out of the question. In fact, a number of retirees actually experience a sharp decrease in spending and increase in savings in retirement.

According to the Life Cycle Hypothesis, this shouldn't need to happen. A retiree who is financially prepared for retirement should keep a consistent income in retirement, and overall consumption should not change. So why does this conundrum—known as the retirement consumption puzzle—happen, and what can we do about it?

Who is struggling to spend their retirement income?

About 25% of retirees fall into the camp of people who decrease spending during retirement. So although this doesn't impact a majority of retirees, it's still a meaningful number, and it's concerning to see so many people not enjoying the fruits of their labour.

Moreover, research suggests this problem may worsen. Researchers found that the issue was most pronounced with individuals who use their own savings for retirement income—whereas people with guaranteed sources of income, such as annuities or the age pension, were more likely to spend their income.

Thus, as more retirees (in some cases unwillingly) use super for their retirement savings, the group of 'decrease spenders' may grow.

Why do people have trouble shifting from a saving to spending mindset?

The idea of a person hoarding their money in retirement is not new, but researchers still haven't been able to pinpoint the exact cause. There are plenty of theories, though—some with more support than others.

One line of thinking posits that people simply don't need to spend as much in retirement. For example, when people retire, they may experience a drop in work-related expenses. They may be able to spend more time doing things they had to pay for in the past—now making meals at home or mowing their own lawn—and

searching for the best deals for their purchases. And they may pay off their mortgage, thus decreasing their expenses.

Another line of thought points to more psychological reasons behind a change in spending patterns.

Before retirement, a person may be more susceptible to present bias (the tendency to focus more on the present situation at the expense of long-term planning) because their future labour income is uncertain, and they don't yet feel an ownership of that money. That uncertainty gives them the flexibility to think things like, "I'll work more hours next month to make up for this trip," or "My boss will cough up that bonus soon."

However, after retirement, they are on a fixed income and the money they are spending is coming from their own pocket. This shift triggers loss aversion—that is, the desire to avoid losses outweighs the desire to experience gains. In retirement, we know that overspending today will result in a sure loss in future consumption. In a world where that future you is 85 years old and unable to work, that future loss looms much larger than an extra extravagance today.

This bias may be further aggravated by the fact that though your future retirement income is certain, your future expenses are uncertain. These stressors may push retirees to remedy preretirement overconsumption, thus prompting them to spend less.

How to manage retirement spending woes

Each of these theories has some merit, but none of them completely solve the retirement consumption puzzle. I believe that there is no one culprit behind the retirement consumption puzzle because no one retiree is the same.

For example, for Scrooge, the loss aversion theory may fit the bill. He became so preoccupied with the dollar amount he has that he ended up drastically underspending in retirement. But because every retiree is different, and different explanations may ring true based on their personal circumstances, retirees may benefit from taking stock of their retirement spending.

This exercise may help you understand if your spending is lining up with your retirement funds and needs. In some cases, that might mean that not spending all of your monthly retirement allocation is 'OK'.

Step 0 is to gauge your financial affairs and have a clear understanding of how much you can spend. Assuming Step 0 is complete, here are three ways to diagnose if you have a retirement underspending problem:

1. Refer back to your financial goals and life values (and if your financial goal was to retire, it's time to set new ones). Consider: Are you meeting your financial goals given your current spending? Are you upholding your life values? If your life value is to experience new cultures, is your current spending allowing you to do that?

2. Try tracking your spending using an online tool that breaks down spending by category. It's ideal to do this before you retire, but not essential. On a quarterly basis, check your overall spending and take note of any categories where your spending patterns have changed. Do these changes align with your financial goals? Did your spending on eating out suddenly drop, even though you love trying new cuisines with friends?

3. Take a moment to recognize your emotions when spending your retirement income. (Research finds that retirees who underspend are more likely to be worriers.) Are you constantly pinching pennies and afraid to spend?

The pieces to the retirement income puzzle

If you fall into the underspending camp, research suggests that people using guaranteed income sources are more willing to spend their income.

Although the causes of the relationship between annuitizing and spending are still up in the air, there are a couple of theories.

For example, maybe people with an annuity feel they have more of a "license to spend" because they know they will always have money coming in. Or, maybe this phenomenon relates to how retirees think of their payments: If a payment comes from an annuity, it may feel like it's someone else's money they are spending (akin to labour income they earned before retirement). Since it's not coming out of their own pocket, they may not be as prone to loss aversion and thus more at liberty to spend.

If you don't want to take the leap to guaranteed income sources, try reframing your retirement income as a paycheck that someone else is paying you.

You can also try refocusing on your financial goals and life values. Put your goals and/or values on a Post-it note and stick it on your fridge, put them in your wallet, or add them to the notes app on your phone. Constant reminders of why you need to spend money—whether it's to buy a condo near your grandchildren or to book that trip to Italy to taste authentic Italian cuisine—can be the nudge you need to make sure you make the most of your retirement.

Although not spending enough money in retirement may not be a universal problem, it does represent a huge, missed opportunity for the retirees in question. It's important to remember that this is the money you've spent years toiling over and protecting. Now, during a long and happy retirement, is the time to put that money and free time to good use, funnelling both resources into your version of a life well-lived.

Samantha Lamas is a behavioural researcher at Morningstar.com. The author does not own shares in any securities mentioned in this article. This article is general information and does not consider the circumstances of any investor. Originally published by Morningstar and edited slightly to suit an Australian audience.

Four ways to determine your international equities allocation

Cameron McCormack

In the first decade of the new millennium, emerging markets equities were stars, collectively outperforming their developed markets peers. According to Morgan Stanley, the second decade of the 2000s was "the worst decade for emerging stock market returns since records began in the 1930s." As we approach the halfway point of the third decade, emerging markets are returning to investors' radars.

These investors are drawn to attractive valuations (with record-high valuations elsewhere) and better-run economies. But the issue many investors ponder with emerging markets is how much to own. The answer is not simple and depends on the investor, but we will try to help.

How much emerging markets equities should you own for a long-term portfolio?

For many reasons, emerging market equities may experience enduring outperformance over developed market equities into the rest of the decade. Some of these include:

- Many emerging markets economies are growing at a faster pace than developed markets, in turn potentially offering higher equity returns, albeit at higher volatility.
- Export orientated emerging markets economies are strong beneficiaries of rising commodity prices.
- As many emerging market economies did not have the resources to spend their way out of the pandemic, many pressed ahead with economic reforms and didn't accrue massive debts, which could accelerate economic growth in coming years.
- The acceleration of the digital revolution, which is unfolding faster in emerging markets than in developed countries.

You can see in chart 1, since 2001, emerging market equities have outperformed their developed markets international peers.

Investors allocate to emerging markets for growth. They are a long-term investment, but how much of an investor's international equity allocation should it be? It will depend on the risk tolerance of the investor, as emerging markets (EM) are considered riskier than developed markets (DM). You can see this risk in chart 1 with EM's rises and falls being of a greater magnitude than those experienced in DM.

So, let's consider a few popular approaches some investors have taken when considering their long-term EM allocation within international equities. But before we begin, it is useful to understand what EM equities are not.

The EM equity universe tends to be under-researched so there are opportunities to exploit inefficiencies. For this reason, sometimes comparisons are made with the small companies universe, which also tends to be under-researched. Investors allocate to small companies for growth too.

Chart 1: Developed versus Emerging Markets cumulative performance

Source: Morningstar Direct, 31 December 2000 to 30 April 2024. Developed markets international equities is MSCI World ex Australia Index, Emerging markets equities is MSCI Emerging Markets Index. All returns are in Australian dollars. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

Under-research and growth are about where the similarities between small companies and EM equities end. Some of the largest companies in the world are in EM. To give you an idea of the companies in the emerging market equity universe, the average size of the ~1,400 companies in the MSCI Emerging Markets Index is A$169,163m. In the S&P/ASX Small Ordinaries, the average size of those 200 companies is A$2,630m. Considering EM equities like small caps is fraught with danger.

We, therefore, think an allocation to EM needs to sit beside all-cap DM international equity strategies as part of a diversified international equity portfolio.[1]

So, how much of this international equity portfolio should be allocated to EM?

1. Allocate to EM by market share

A basic approach for international equities, including EM, would be to consider the size (market capitalisation) of all the markets and proportionally allocate. There are different ways to do this, in the example below we have taken an index approach.

Market capitalisation indices include companies based on their size and each constituent of the index is weighted relative to its total market capitalisation. The larger companies represent a larger proportion of the index, likewise, those countries with bigger and more companies make up larger parts of international equity indices.

The most used EM equities index is the MSCI Emerging Markets Index (for ease of reading we'll call it MSCI EM) which includes stocks from 24 countries MSCI consider 'emerging'. The most used DM international equities index is the MSCI World ex Australia Index which includes companies from 22 countries MSCI considers 'developed'.

The MSCI All Country World ex Australia Index (MSCI ACWI ex Aus) includes all 46 international developed and emerging markets.

As at the end of April 2024, MSCI ACWI had a 10% allocation to emerging markets.

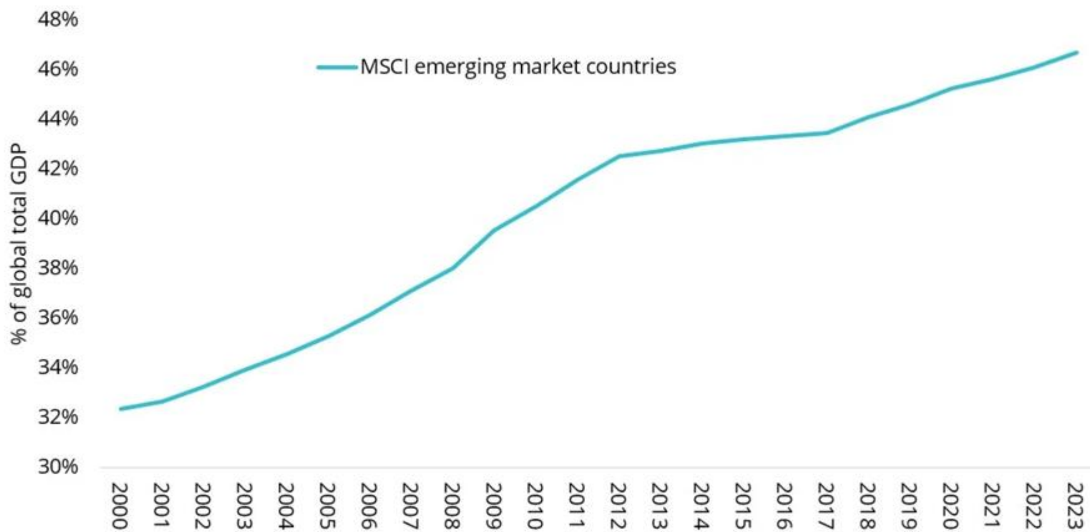
This would imply a 10% allocation of the total international equity portfolio to EM. But when you consider that EM represented roughly 5% of the index in the year 2000, its market share has increased because of its higher growth, at the expense of DM. For more risk-tolerant investors, a higher allocation to EM would be needed to take advantage of that long-term growth.

2. Allocate to EM by GDP weight

One of the lures of EM investing is the faster economic growth within those countries. This growth can often flow through the share markets.

Economic output is measured by GDP (Gross Domestic Product) and you can see in the chart below, the percentage of global GDP generated by those countries with the MSCI EM index has been growing. At the beginning of this year, it was close to 47% of global GDP. That would suggest an allocation of 47% to EM equities, which from a risk perspective is far too high.

Chart 2: Contribution to total global GDP of MSCI EM countries



Source: IMF, VanEck, MSCI. Gross domestic product, current prices, purchasing power parity; international dollars.

3. Combining GDP and market share approach

Some investors use a combination of the above two approaches. A simple average of the two implies a 28% allocation. Some investors will adjust further for DM revenue that is derived from EM (for example Apple derives much of its revenue from emerging markets), bringing the allocation to EM down further still.

According to Morningstar Data, 25% of the revenue from the MSCI World ex Australia Index is derived from EM (as at 30 April 2024). This could imply that the allocation to EM equities should be reduced by 25%, so be 21%.

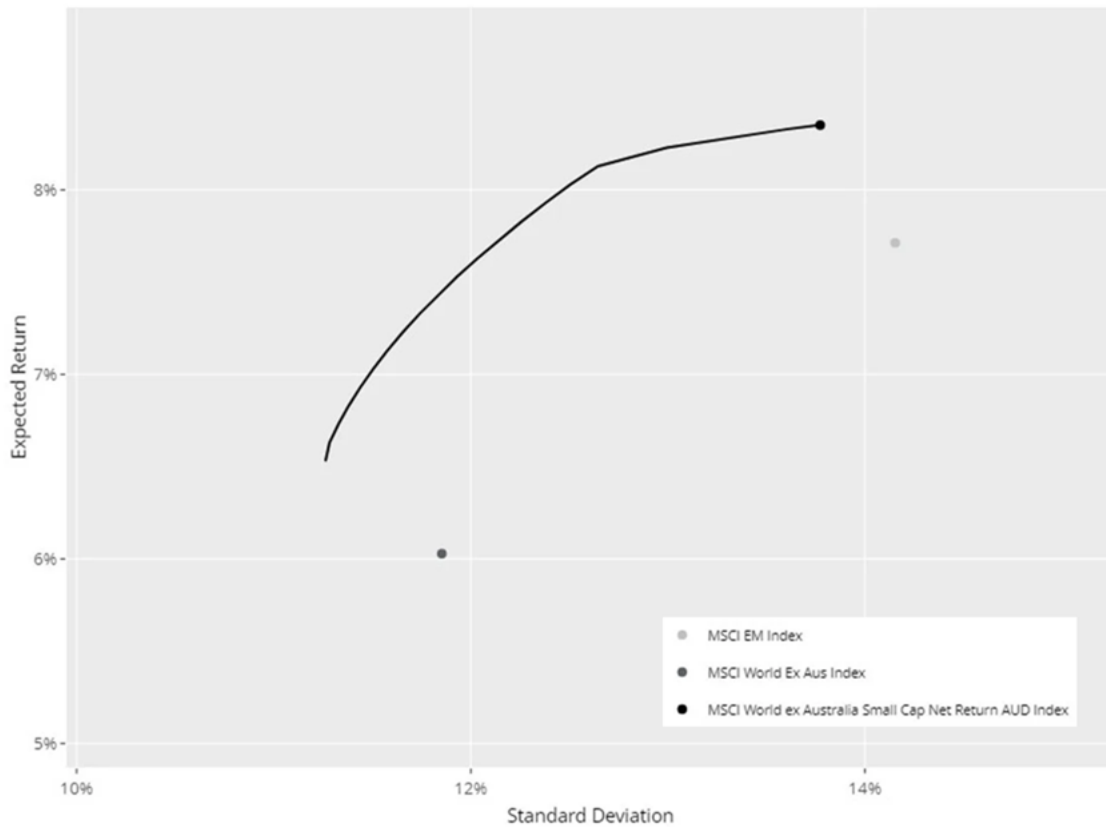
4. Using The Efficient Frontier

Another approach investors may take to construct long-term portfolios is by using The Efficient Frontier. The Efficient Frontier is derived from the Modern Portfolio Theory (MPT), and it suggests the most 'efficient' investment portfolios to generate returns for a set level of risk. The risk measure used is the standard deviation of returns. Using the past 20 years of returns and the standard deviation of those returns, we can plot the efficient frontier for a global equity portfolio allocating between developed markets and emerging markets.

The efficient frontier allows you to extrapolate the implied allocation between the asset classes considered depending on the level of risk. The results show that EM has outperformed DM large and mid caps but underperformed DM small caps.

The math shows that for a standard deviation of returns between 11% and 13%, which would be considered high growth, an optimal allocation to EM would be as high as 37.68%.

Chart 3: Efficient Frontier



Source: VanEck, Bloomberg, MSCI, 31 December 2000 to 30 April 2024. All returns are in Australian dollars. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

Table 1: Efficient Frontier implied allocation between developed markets and emerging markets

Standard deviation	EM allocation	DM allocation
11.3%	29.68%	70.32%
11.9%	37.68%	62.32%
12.6%	34.88%	65.12%

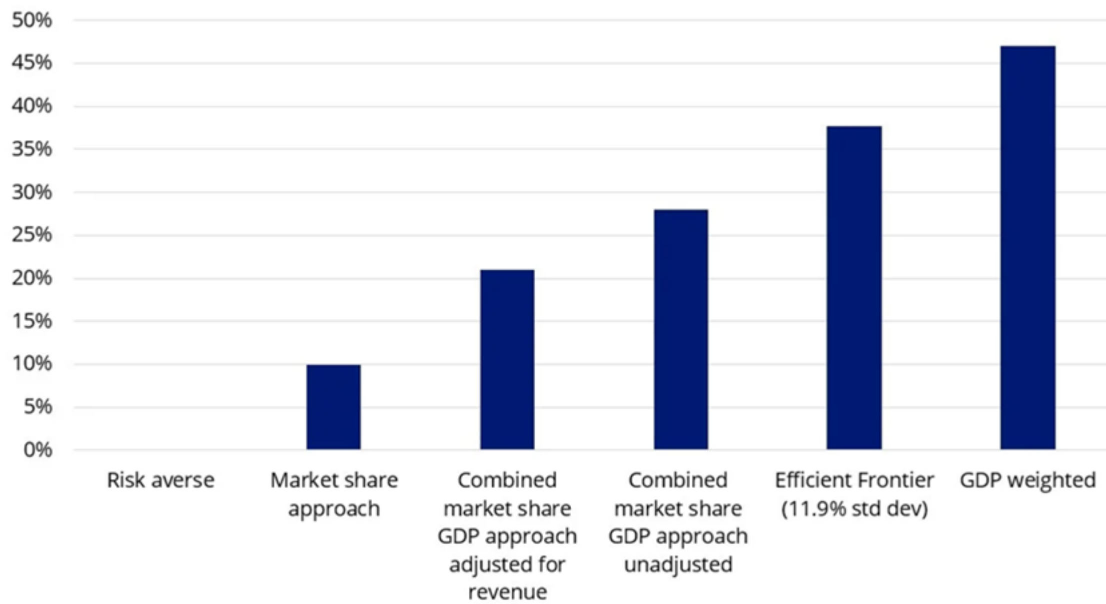
Source: VanEck, Bloomberg, MSCI, 31 December 2000 to 30 April 2024. EM allocation is MSCI EM Index. DM allocation is MSCI World ex Australia Index and MSCI World ex Australia Small Cap Index. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Not a recommendation to act.

The efficient frontier suggests an allocation higher than the market share and the combined GDP and market share approaches. An allocation this high would be a high-growth strategy for a client with a high level of risk tolerance.

Risk-averse investors may be more comfortable with a smaller allocation closer to the market share approach or avoid the asset class altogether.

Investors willing to take on risk may find an emerging market allocation that sits somewhere between the extremes we've presented here, either way, we think EM equities warrant its own allocation as part of a well-diversified global equities approach.

Chart 4: Implied allocation to EM based on the approaches outlined above



Source: VanEck. Not a recommendation to act.

We would warn however that taking the right approach is important.

As always, we would recommend you speak to a financial adviser or broker to determine which international equity allocation is right for you.

Key risks

An investment in emerging market funds carries risks associated with: financial markets generally, individual company management, industry sectors, ASX trading time differences, foreign currency, sector concentration, political, regulatory and tax risks, fund operations, liquidity and tracking an index.

Cameron McCormack is a Portfolio Manager at VanEck Investments Limited, a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act. For more insights on bonds, visit: vaneck.com.au/blog/income-investing/.

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Do Government bonds still have a role to play for Australian investors?

David Colosimo

The past four years have been quite turbulent for fixed income, an asset class that is generally characterised as defensive. An important question to ask is whether Government and other high-quality fixed rate bonds still have a role to play for Australian investors.

To answer that question, we must first ask, what is the purpose of bonds in a portfolio?

The role of bonds in a diversified portfolio

While priorities may differ from one investor to the next, in a diversified investment portfolio bonds play four different roles.

- **Income/Return**: As its name suggests, fixed income generates an income stream. Ideally this should be above the return on cash (you earn a premium for taking duration or interest rate risk) and the rate of inflation (you earn a real return).

- **Defensiveness**: A concept not easily measured, but relative to riskier assets like shares, we generally expect fixed rate bonds to experience fewer and smaller drawdowns, with falls recovered more quickly. The very nature of a bond means that high quality fixed income should also have a lower probability of a permanent loss of capital.

- **Diversification**: Bonds often exhibit low or negative correlation against shares (when shares go up, bond prices fall and vice versa). These diversification benefits can reduce the overall volatility of a portfolio that also contains risk assets.

- **Liquidity**: High grade bonds should be easily saleable and at little cost, which can provide a readily available source of funding when market opportunities arise.

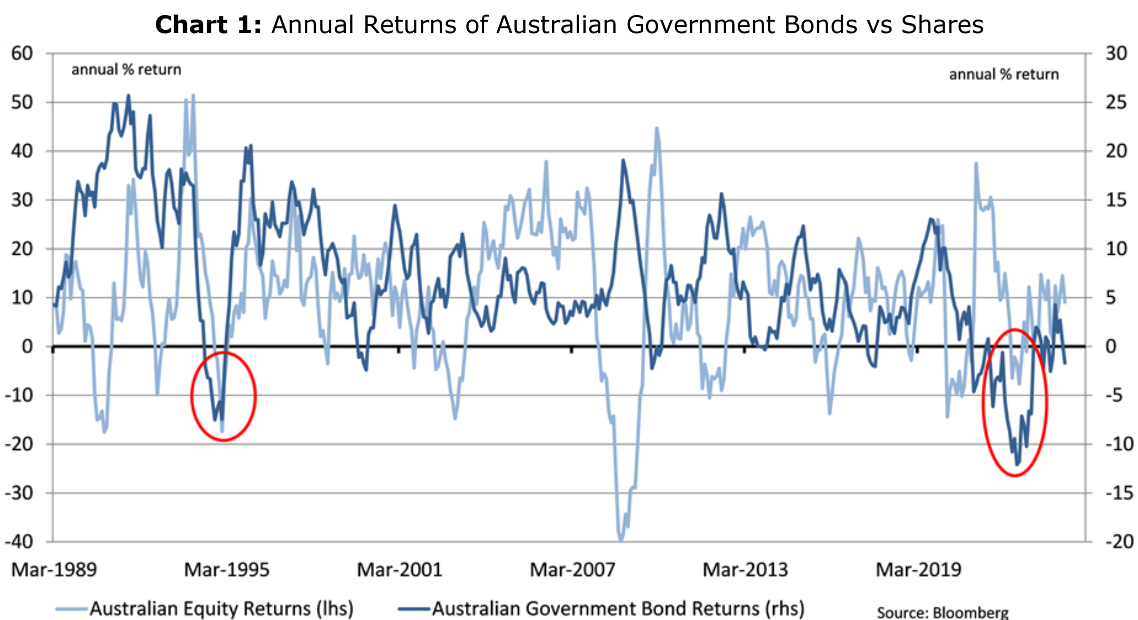
On every one of those measures, Australian bonds have failed investors at some point since the onset of the pandemic.

The reality of the past few years

In 2020, when financial markets were concerned about pandemic induced stagnation and possible deflation, the yield on the Ausbond Australian Government Bond benchmark portfolio of Australian government bonds was as low as 0.6%[1] implying its forward-looking ability to provide income or return was negligible.

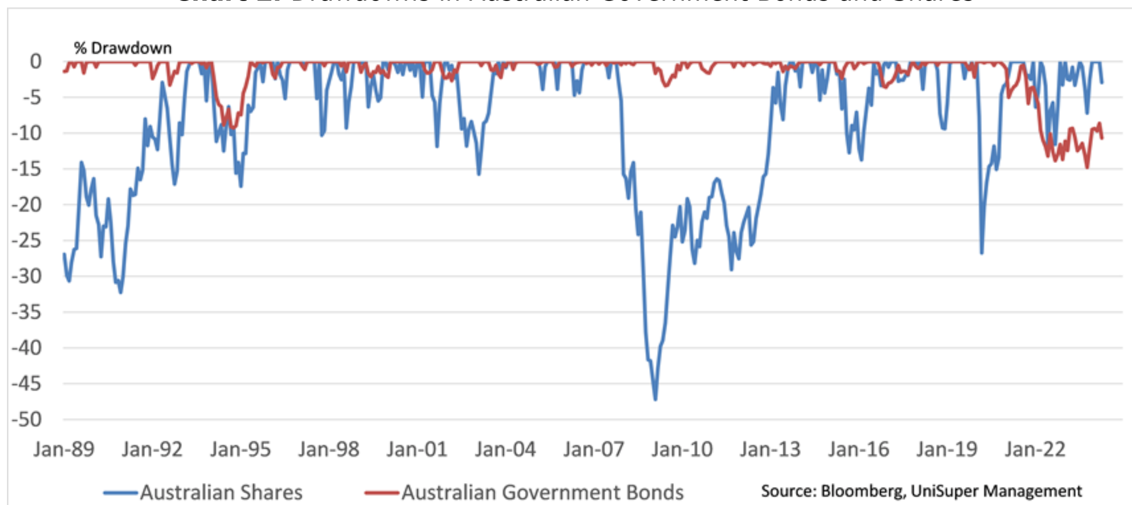
Between 2020 and its lows in 2023, as concerns transitioned towards excessive inflation amongst supply chain problems and strong labour markets, global central banks including the Reserve Bank of Australia (RBA) hiked rates aggressively and bond yields surged. The Australian Government Bond benchmark lost nearly 15% of its initial value[2] and more than four years since the onset of the pandemic is still 10% below its peak (chart 1). This marked the largest and longest lasting drawdown in bonds in decades.

Chart 1: Annual Returns of Australian Government Bonds vs Shares



The upshot of this is that bonds and shares have in recent years been positively rather than negatively correlated, which can reduce the diversification benefits of owning bonds as a hedge for shares. During 2022, as share markets faltered, bonds were even weaker and bond holdings compounded the loss for diversified investors (chart 2).

Chart 2: Drawdowns in Australian Government Bonds and Shares



The question remains then - looking forward, what benefit can we expect from holding high quality fixed rate bonds?

Well the good news is that the experience of recent years has set up a far better environment, both in respect of the prospective return income bonds can be expected to generate and the defensiveness that investors can expect from them.

Income and return expectations

In terms of income expectations, a good starting point for annual average return expectations for a diversified portfolio of government bonds over a five-to-six-year horizon (which is the average maturity of the bonds), is the current yield of that portfolio.

Realised returns may differ from that initial yield depending on the movement in bond yields over the period.

Recall that bond prices move inversely to the yield so realised returns can be higher than the initial yield if yields have fallen. This is what occurred over the three decades leading up to the pandemic when yields were in long term structural decline.

In contrast realised returns can be lower than the initial yield if yields have risen which is what has occurred since the pandemic (chart 3).

Chart 3: Yield on Government Bond Index vs 5 year forward realised returns

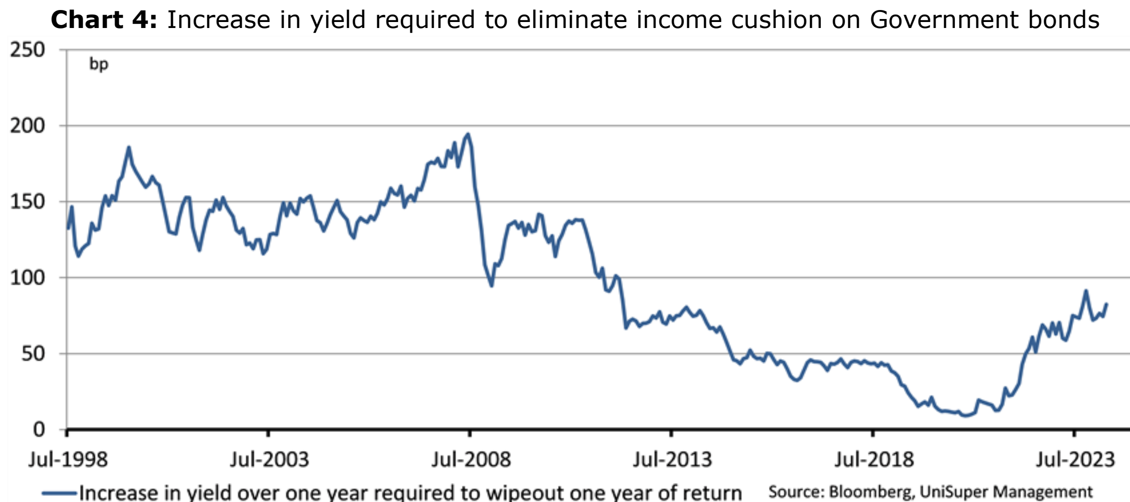
The current yield on the Australian Government Bond benchmark is approximately 4.4%. This can be a good starting estimate for expected returns for a portfolio of Government bonds over coming years, though a large swing in bond yields in either direction would impact realised returns.

It's important to note that while this yield is below current returns on cash and recent inflation outcomes, it does appear to represent a reasonable premium over the likely forward looking cash return (which we expect to be in a 3-4% range) and the expected rate of inflation (the RBA target is inflation of 2-3%).

How defensive are bonds right now?

In terms of defensiveness, you could argue that at higher starting yields, future drawdowns in bonds could once again be both less frequent and of smaller magnitude. This is because there is a higher income cushion to protect against price falls for a given increase in yields (chart 4).

Chart 4: Increase in yield required to eliminate income cushion on Government bonds



At the peak of the pandemic, when the yield on the Australian Government Bond benchmark was just 0.60%, just a 0.1% point increase in yields was enough to wipe out the income cushion for the year and deliver a negative return on bonds. Now that the starting yields of the benchmark portfolio is higher at 4.4%, it would take around 0.8% of an increase in yields to deplete the higher income cushion.

A higher starting yield can also impact the range of potential return outcomes looking ahead. Though it is plausible that yields could still move higher and deliver further drag on performance, there is less pressure to do so at a higher starting yield. Similarly, starting at a higher level of bond yields can also open up a greater potential for yields to fall in the event of a downturn in the economy, which can create the opportunity for price appreciation in bonds.

Will bonds regain their diversification benefits?

As highlighted earlier, the celebrated diversification benefits of bonds are at their maximum when bond returns exhibit negative correlation with equity returns i.e bond prices rise (or bond yields fall) when share prices fall.

Indeed, this has been the dominant experience of investors for most of the past 30 years and has contributed to the popularity of a diversified portfolio of shares and fixed rate bonds.

While the breakdown of this relationship in recent years might feel like the exception to the modern investor, over a broader sweep of history there are long periods where shares and bonds have been positively correlated.

So, in what circumstances are bond correlations positive and negative?

The experience of negative correlation of recent decades coincided with the introduction of inflation targeting central banks which helped keep inflation low and stable. Policymakers were assisted in keeping inflation low by globalisation, particularly the integration of China into global supply chains, technological advances, more flexible labour and product markets, economies that were more resilient to supply shocks and an unusually benign geopolitical backdrop. In this environment, the main driver of financial markets was economic growth. When growth trends dictate financial market moves, shares and bonds move in different directions. An improvement in growth is good for shares but bad for bonds as interest rates move higher and vice versa.

Positive correlation in contrast occurs when economic developments push shares and bonds in the same direction. Historically there are two situations in which this can arise:

1. When a sovereign becomes so deeply indebted that the perceived credit worthiness of the government is exacerbated by weak growth. This is the situation that the Italian Government found itself in for about a decade after the Global Financial Crisis.
2. When inflation is high and there is increased uncertainty as to whether it can be contained. This has been the environment since the onset of the pandemic. In an environment when inflation is the dominant driver of policy making and interest rates rise potentially at the cost of economic growth, this pushes share prices and bond prices in the same direction.

Given that the Australian Government maintains very low debt, the former situation is unlikely. However, it is far from assured that Australia will return to the low and stable inflation environment of the preceding three decades.

There are a few reasons for this: Governments around the world seem more comfortable with fiscal excess, globalisation has given way to deglobalisation and a more fractured supply chain, a falling proportion of working age population and higher dependency will reduce the availability of labour relative to demand. Climate change leading to more extreme weather and supply shortages will make the cost of food and transportation more variable, and the cost of funding the energy transition, may also lead to higher energy prices.

Looking forward, while there will be periods, such as in a growth shock, that bonds and shares will move in opposite directions. Investors need to be aware that there will likely be more frequent periods where bonds and shares move in the same direction, reducing the diversification benefit that bonds provide.

Final comments

In our view high grade fixed rate bonds can offer a reasonable prospect of return in excess of both inflation and cash and are likely do so with fewer and smaller drawdowns that are recovered more quickly. But bonds are unlikely to deliver the outsized returns that we saw over the three decades leading up to the pandemic, and we can expect more frequent periods where bonds move in the same direction as shares.

David Colosimo hosts UniSuper's monthly investment podcast (SuperInformed Radio) talking about what's happening in the economy and investment markets. Subscribe and find all previous episodes via Apple Podcasts, Spotify, SoundCloud, or wherever you get your podcasts. UniSuper, a sponsor of Firstlinks.

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[1] September 2020
[2] November 2020 to June 2022

Why China and Russia's partnership threatens the West

John West

Pundits have been flooding the media and Internet with their analyses of China's support for Russia's invasion of Ukraine and, more generally, the China/Russia axis following Vladimir Putin's very recent visit to Beijing. You can find speculative responses to each of the following questions and many more.

Why is China providing substantial support for Russia's war efforts against Ukraine, thereby further exacerbating its already tense relations with the West? Is the China/Russia axis a new strategic alliance, bolstered by Iran and North Korea, that represents a strategic challenge for the West? Or is it a marriage of convenience based on their shared opposition to the Western-dominated rules-based order? Could the West drive a wedge between China and Russia and relieve Russia of its junior partner status?

In reality, the future of the China/Russia axis is profoundly unknown, much as it was on the eve of Russia's invasion of Ukraine. However, it is important to attempt to understand the issues.

China/Russia partnership is not new

A good starting point is remembering that these two countries have shared a very long history, as Philip Snow writes in his recent magnum opus, which examines "four centuries of conflict and concord" between them. There have been great shifts in the balance of power, from the wealth and strength of early Qing China to the Tsarist and Soviet ascendancies and episodes of intense conflict followed by harmony.

During the early postwar period, the Soviet Union had the upper hand, while today, the pendulum has swung back in favour of a dynamic China, under the assertive leadership of Xi Jinping. A superficial reading of history might suggest that China and Russia's relations will continue to have ups and downs. Thus, the current tight relationship may not last.

In any event, these two countries can hardly avoid each other. They share a 4,000-kilometre border. And they are both geopolitical heavyweights. China's population of 1.4 billion is the world's second-largest (slightly less than India's), and Russia is the world's largest country in terms of land area. While Russia's economy is only one-tenth the size of China's, Russia does have an extraordinary endowment of energy, mineral, and agricultural resources. This provides a great source of economic complementarity between the two in light of China's relative lack of such resources.

Post Cold War China/Russia alignment

Following a brief period of close alignment with the West under Boris Yeltsin during the early 1990s, Russia quickly decided to foster good neighbourly relations with China. During Russia's economic difficulties in the 1990s, China helped Russia's military-industrial complex by very large imports of military equipment. And the attractiveness of developing a deep partnership with China was enhanced when Russia's hoped-for Western-financed "Marshall Plan" did not transpire. Over the years, the two sides resolved all their border disputes. In sum, they have become "Leaders of the Opposition in a world dominated by the United States."

The strengthening relationship in the 21st century

The period around 2014 would see a dramatic strengthening of China/Russia relations. Russia's relations with the West deteriorated following its invasion of Crimea and the fomenting of rebellion in the eastern regions of Ukraine. Around the same time, China occupied and built structures in the South China Sea, much to the displeasure of the US, other Western countries, and many of China's neighbours.

In sum, this period around 2014 saw both Russian and Chinese interests collide with the West, and having a common adversary led to a substantial strengthening of China/Russia relations. In 2015, they agreed on a comprehensive strategic partnership. Throughout this period, Russian exports of energy and military equipment (including technology transfer) grew substantially. Ever closer relations reached a new peak when Xi and Putin announced a "no limits friendship" at their February 2022 summit on the eve of Russia's invasion of Ukraine. One byproduct of the axis is that China's military modernisation has greatly benefited from cooperation with Russia.

Partnership strengthening following the invasion of Ukraine

It is unclear how much Putin informed Xi of his planned invasion of Ukraine. But certainly, Xi never imagined (nor did Putin) that more than two years down the track, the two sides would be bogged down in a quagmire resembling the trench warfare of World War 1.

Western countries responded to the invasion by applying strong sanctions against Russia and offering massive assistance to Ukraine. At the same time, China has offered substantial support for Russia's invasion of Ukraine, though it attempts to steer clear of the "red lines" of the West out of fear of being hit with secondary sanctions.

China has played a big role in filling Russia's trade hole caused by Western sanctions. Trade between the two countries has soared to $240 billion in 2023, more than twice what it was in 2019. Chinese exports have been filling the gap for consumer goods, while Russia now sells large quantities of gas and oil, albeit at discount prices, to China, as well as military equipment and nuclear technology.

The military aspects of the partnership

China also provided significant military support, notably "dual-use items," like trucks or excavators that can be used for civilian and military purposes. It claims that it has not provided any lethal aid, although there have been recent UK reports of Chinese exports of lethal equipment. Hong Kong's shipment of Western

semiconductors and electronic products to Russia has been a growing concern for the US and the European Union.

While China has abstained from many UN resolutions condemning Russia's invasion, in its public pronouncements, it has supported Russia's narrative that NATO aggression was the fundamental factor leading to the conflict in Ukraine. Underpinning China's support for Russia has been the relationship between Xi and Putin. These two leaders have met over forty times in the past decade, and most importantly, they met face to face twice since the beginning of the Ukraine conflict, once in Moscow and once in Beijing. These meetings underscore the close political relationship and demonstrate that the Western efforts to isolate Russia on the global stage have, in fact, failed.

From China's point of view, it is critical that Russia not lose the Ukraine war. If Putin's regime were toppled, that would result in instability on China's border, with regime security risks for China. In the minds of many Chinese leaders, the US is hellbent on regime change in both China and Russia. And following China's strong support for Russia, defeat would make Xi lose face domestically. Moreover, China would also lose its key partner in its quest to weaken the US and the West. In short, China is strongly committed to helping Russia and will never abandon Russia.

Decoding the China/Russia relationship

Some analysts are wont to downplay the importance of the China/Russia partnership. There is no formal alliance between the two countries, like that between NATO countries. Today, it is an unbalanced relationship, with Russia very much a junior partner, something which is an affront to Russian national pride. Russia (like China) does not want to be subordinate to any other country, especially an Asian country! China is also becoming more active in Central Asia, Russia's traditional sphere of influence. And Russia's demographic and economic decline exposes the vast Asian side of Russia to possible de facto Chinese colonisation, as Chinese people migrate across the border.

Against this, the current phase of the China/Russia partnership has been developing for some three decades, and it has only become stronger over time. There is a strong personal dimension to the relationship with the very strong bond between Xi and Putin, and they frequently refer to each other as the best of friends.

Further, as China and Russia have become more authoritarian over the past decade or so, and their leaders have entrenched themselves as potential leaders for life, they are increasingly united in seeing the US and the West as political threats. They are also working together to build elements of an alternative world order through the Shanghai Cooperation Organisation and the BRICS. And this is being supported by parts of the Global South, as the US and the West have fallen out of favour.

Could the West drive a wedge between China and Russia?

With a return of Donald Trump to the White House increasingly likely, there is, of course, speculation about what this could mean for the China/Russia axis. Would Trump withdraw US support for Ukraine and seek to build a new relationship with Russia based on his affinity for Vladimir Putin? Some European countries like Germany and France may also be happy to cut a deal with Russia in the hope of restoring peace to the old continent, especially in light of their own weak defense capabilities. And peace with Europe would be in Russia's economic interests, as it has much more energy infrastructure directed to European markets than to Asia.

But it is difficult to see Putin jettisoning China for the US when US foreign policy can change every four years based on the outcome of presidential elections. Such uncertainty is much less likely with authoritarian China.

Moreover, China would likely mount great efforts to prevent a wedge between Russia and itself. Xi's China believes the US and the West are existential threats bent on "regime change" – and it sees Russia as a critical partner in protecting itself.

Conclusion

There are too many unknowns and unknowables – like the outcomes of the Ukraine war and the US presidential elections – to draw any firm conclusions. But at the moment, the China/Russia partnership is very consequential and has only become even more so through the Ukraine war. It represents a great challenge to the US and the West's global leadership and the future of the rules-based liberal order. In sum, while China/US might be the most important bilateral relationship in the world, China/Russia has also emerged as a significant relationship of the 21st century.

As he left the Kremlin one year ago, Xi said to Putin: "Right now there are changes – the likes of which we haven't seen for 100 years – and we are the ones driving these changes together." The Russian president responded: "I agree." Xi then shook Putin's hand and said: "Take care, please, dear friend." Putin responded by holding Xi's hand with both of his and saying, "Have a safe trip."

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This article was first published on econcurrents.com.

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