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Editorial

With Firstlinks' editor James Gruber out sick, I had the privilege of editing this week's edition for you.

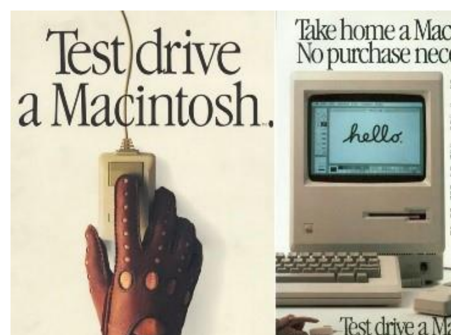
For those of you who don't know me, I write about investing for Morningstar Australia. I guess you could say my route up to this point has been quite eclectic.

I started off in an intern role promoting America's role in European security. I then traded frozen seafood in London for a while. I then set up a business writing adverts and other marketing material for various clients before specializing in investments.

As a freelance "gun for hire", I sold everything from refurbished computers to fitness classes and giant personalised soccer gifts. Like any other job, the easiest way to get better was to seek wisdom from the industry's greats. So with world domination in mind, I read everything I could from geniuses like David Ogilvy and Claude Hopkins.

One thing I picked up was that great advertising – no matter the era it comes from – speaks to the mood and ambitions of people in society. This makes looking at an era's advertising one of the best ways to understand what was going on in society at the time.

You don't need to look at an advert from the 1940s to know there was a war going on. But the era's adverts offer a different window into the norms and emotions of the era. Look at adverts from the 1980s and the *awe* inspired by new technology jumps off the page.



When people look at our generation's ads, what will they think?

They will probably think we spent a lot of our time ordering takeaways, gambling and watching trash TV. If they look at Australian ads in particular, they may pick up on your love for utes. They might also pick up on how big 'Big Super' has become and the daily battles being fought to attract retirement assets.

I say that because I have never seen retirement products advertised as much as I have here.

Before moving to Australia, I had never heard an investment fund being touted on the radio. Tune in here and you'll hear a fund's average 10 year return in between Taylor Swift songs. Watch the footy and there'll be ads

from HostPlus, Cbus and other giant super funds at half-time. Again, something I never saw in the UK. When the game is on, there'll also be super fund logos on the advertising hoardings. Super fund logos on one of the team's shorts. Super fund logos plastered around the coach's box and on their laptops, ready for the camera panning there after a try. I've never seen anything like it.

Maybe I am just in a state of hyper awareness. After all, I recently chose my first super fund. It might be like when you buy a new car and start seeing the same model everywhere. But maybe it *isn't* just me.

An AFR article in December 2023 estimated that the top 8 industry funds spent a combined $197 million on marketing over the previous 12 months. It's hard to know exactly what is included in that number – I think it includes big payments to labour unions too. But it isn't that far from the $238 million gambling firms spent on TV, radio and online ads in the year to May 2023, according to Nielsen.

Giant super funds are now giant ad buyers. And these ads aren't being placed for the fun of it. Their presence suggests that Aussies are engaged enough with their retirement goals for the investment to pay off – an assumption that appears to be backed up by survey data.

MoneyMag's Love Your Super study in 2023 suggested that almost half of Australians check their super balance monthly and that 17% check *every day*. A different study by Findex found that 30% of Australians had only a "vague or no idea" of their Super balance, meaning 70% have a better than vague idea. That's a lot better than in the UK, where a study by Standard Life suggested that 75% of people don't know how much they have in retirement savings.

I think these higher levels of engagement are partly a result of having more to lose.

At the end of 2022, the Global Pension Assets Study estimated that Australia's 26 million people had total retirement assets under management of 2.1 trillion (in US dollars). The UK had about 25% more assets with 2.6 trillion. But this amount came from over *two and a half times* the number of people. That's a huge gulf on a per capita basis, even if the UK number was depressed by the gilt crash in 2022.

By moving here from the UK, I've gone from being ahead of the average retirement balance for my age to being behind.

You Aussies (and your huge compulsory contributions) are obviously far too responsible for us Brits to keep up with. The effect of this has been that I've found myself thinking more about my retirement pot and how to grow it than ever before. Here's to this edition of Firstlinks keeping you one step ahead.

Joseph Taylor

In this week's edition...

Most people would prefer to have more money than less of it. But at what point do the trappings of wealth and success start to outweigh the benefits of striving for more? **Mark LaMonica** urges you to think about what financial success really means to you. Arriving at a clearer and more personal definition of this won't just change the way you invest, it could change the way you approach every aspect of your life.

Inflation has been front of mind for policy makers, investors and mortgage payers for three years. Yet while commentators obsess over every monthly inflation print, they seem to have forgotten what causes it in the first place. **Warren Bird** charts the impact of money supply on inflation and what it suggests is coming next. Fortunately, the picture looks cheerier than the reaction to May's monthly data.

Valuations in developed equity markets have looked stretched for some time. Meanwhile, emerging markets look cheap versus history. The set up looks compelling but investors shouldn't ignore the huge differences between countries and companies housed in emerging market indices. **Shane Woldendorp** from **Orbis Investments** highlights three tailwinds that selective investors can benefit from in the coming years. As well as some common pitfalls to watch out for.

Houses have never been more expensive relative to the average person's salary. This is often used as evidence that young Australians have it harder than their parents for the first time. According to **Ken Atchison**, there is more pain on the way for a very different reason. He identifies two policy oversights that benefit today's Australians at the cost of tomorrow's taxpayer.

On one hand, nuclear power is a source of zero emission energy that is far more reliable than wind power. On the other, building reactors includes massive up-front investments that take several years to bear fruit. As

Roger Dargaville from **Monash University** shows, a switch to nuclear power could also leave Australian households and businesses paying even more for their electricity.

The early results of our 2024 Reader's Survey are in. The importance of independent views, having a wide range of topics to pick from and being able to read your fellow readers' thoughts were common threads. For a selection of reader comments and details on how to have your say, see **Leisa Bell**'s summary here.

This week's white paper gives you **VanEck's** view on the market outlook for the second half of 2024.

Curated by Joseph Taylor and Leisa Bell

Our finances should enable and not dictate our lives

Mark LaMonica, CFA

The most motivated and successful people take a problem, outline a solution, and relentlessly pursue it. This is a good model to achieve success. And following it creates momentum. It provides a sense of empowerment as obstacles are overcome. It is self-motivating as each milestone is achieved and each new one appears on the horizon.

The inherent flaw in this approach is that it assumes that the problem we are striving to solve will bring us the results we ultimately want. And we can lose that perspective during the relentless effort to make progress. We can fall into the trap of continuing to add new milestones in a misguided belief that if we can only reach them, we will achieve what we want.

We pursue wealth because we believe our problems will be solved by more money. And to be clear this is not the Communist Manifesto. I am not arguing against building financial assets. They can make a big difference in our lives. Having an emergency fund relieves the debilitating stress of living on the edge of poverty. Amassing wealth brings us material goods and experiences that bring us joy. But more than anything wealth buys time and freedom. Time to do what makes us happy. Freedom to dictate our own schedule and to walk away from jobs and situations that are harmful or make us unhappy.

In saying this I believe that after a certain level of financial security is established the thoughtless pursuit of a higher net worth is counterproductive. We shuffle through life attempting to add zeros to our bank accounts without pausing to ask ourselves if we are measuring financial success in the right way.

Not having 'enough'

Kurt Vonnegut brought his good friend Joseph Heller to a party on Shelter Island off the coast of Long Island in New York. Shelter Island is a popular and expensive location for second homes of the wealthy. At the party Kurt Vonnegut commented that the hedge fund manager hosting the party made more money in a single day than Heller had ever earned from his hit novel Catch-22.

Joseph Heller turned to his friend and said, "Yes, but I have something he will never have – enough."

This quote brings me back to one of those ordinary moments in life that we tend to mythologise into a defining occasion. What I am reminded of is the genesis of my financial philosophy.

I spent my high school years in a town named Greenwich which is a suburb outside of New York City. It was - and is - considered a desirable place to live and had the home prices to match. After I graduated Uni and started working, I had to commute to New York from my parents' house one day. I found myself standing on the freezing cold train platform at 6am glancing around at my fellow commuters.

They stomped their feet to stay warm and prepared to charge onto the always crowded train in the hopes of finding a seat for the 40-minute ride into Grand Central Station. This was likely followed by a 20-minute subway ride to Wall Street.

I couldn't help but think that the men and women on that platform had 'made it' in every conventional sense. They likely lived in expensive houses and had all the trappings of wealth along with the requisite high paying jobs needed to support that lifestyle.

The pathway those men and women took to that platform was probably similar. They worked hard to earn promotions and higher salaries. The higher salaries facilitated increased borrowing power. They financed a starter home and a car. Soon they had a bigger home in a better suburb with a nicer car in the driveway. Eventually they ended up in Greenwich.

Each step on this ladder meant more obligations. My interpretation of my brief time on that train platform and the myth I created in my mind was that these people were sacrificing freedom by not having 'enough'. This may have been their dream and I respect that. My caricature of people I don't know may come across as critical. But we can just as easily be motivated by what we don't want to become as what we do. And I wanted to follow a different pathway.

I saw the trappings of success simply as traps that kept those people coming back to that platform day after day. Buying the material possessions that denoted success including the big mortgage just seemed like a pathway to lock me into a life that I didn't want.

What I wanted was freedom. And I wanted to convert my labour into financial assets that enabled that freedom.

How does not having 'enough' impact our investing approach?

Not having 'enough' means we haven't properly defined our goals. And when it comes to investing our goals may be expressed in financial terms but they need to be aligned with our life goals.

I speak to a lot of investors. If I ask them about their goals, I repeatedly hear the same thing. They tell me they want to be rich. They tell me they want the most money possible. Fair enough. There are few people that would rather have less money than more money.

The issue is that when your goal is to have the most money possible it starts to dictate your actions. If you want the most money possible you should always be in the best investments. This mindset is counterproductive.

A goal of having the most money possible makes it more likely you panic when markets drop. It makes it more likely you fall victim to greed when markets surge.

It means you trade frequently because you are always trying to position your portfolio perfectly. It means you fall prey to recency bias and chase performance.

For most people the results are predictable. Returns are lower. Tax outcomes are worse. Transaction costs are higher. And ultimately this pursuit of the most money possible takes people to a very different outcome.

The larger issue is that this view of financial success drives the way many investors approach money. It ignores the true value of money as an enabler of security and happiness. Money and wealth are a means to an end. Treating it that way can change your relationship with money and the decision-making process for your own finances.

Why build wealth?

The real question for each of us is why we build wealth in the first place. And I had trouble articulating this for a long time. I just saw the pathway others pursued and I knew it wasn't for me. Eventually I came to the philosophy that continues to guide my own investing and view of my finances.

Many investors tend to think the biggest problem is finding the right investments to buy. This leads people down strange paths. They stare at stock charts trying to manifest the direction of prices. They sell in May and go away. They nervously await signs of a Santa Claus rally with more excitement than a kid on Christmas morning. They search for clues in each utterance by a central banker. In short, they do everything possible to make sense of short-term randomness.

I've developed a different view. My view is not for everyone. That is because each of us is different. What isn't different is the need to align our investing and financial approach to the lives we want. Our financial choices should enable our lives. Not dictate them.

My investing principals are the following.

1. **My own vision of financial success is using my financial resources to enable freedom.** To me this is freedom from worry and freedom from the burdens of committing time and efforts to things that aren't important to me - it is the freedom of choice. This is not synonymous with growing my net worth.

2. **I focus on growing the portion of my salary going to discretionary spending.** I don't use salary increases to fund more fixed obligations and instead pay for experiences. I actively battle against lifestyle creep that doesn't bring me joy and simply resets my expectations for a life I don't want. This gives me choice over my spending which to me is true independence.

3. **I use my savings and investments to provide cash flow**. The more cash coming into my bank account the more options I have. Those options provide freedom. And I spend some of this money now on things I love like travel. This is why I'm an income investor and the value of my portfolio is a secondary concern. This has made me a better investor. I don't chase each shiny new 'can't miss' investment. Building an income stream takes patience as the incremental impacts of savings, dividend reinvestment and dividend increases work their magic. It keeps me focused on the long-term, tax minimisation and low transaction costs.

I understand that this concept is different from what we are typically told. We are told to focus on our net worth. To use debt as an enabler of acquiring more assets. To find tax minimisation strategies involving negative gearing to sacrifice current cash flow for a lower tax rate. To focus on growth investing when we are young and only worry about income when we are retired.

We are told someday this will pay off. Someday we will be able to sell our assets to fund the experiences we really want now. That when we sell those assets, we will still be young enough to enjoy the experiences they buy. And on we trudge, buffeted by the headwinds, towards an unappraised mirage of financial success.

Mark Lamonica is Director - Editorial and Content at Morningstar.

This vital yet "forgotten" indicator of inflation holds good news

Warren Bird

Reducing inflation to an acceptable rate is an important policy priority. Although much progress has been made over the past couple of years, the goal has not yet been achieved. We are close and the trend is in the right direction, but some of the hysterical headlines that followed the May monthly CPI release would have us believe that inflation is re-accelerating and requires higher interest rates.

To be sure there's a chance that the Reserve Bank of Australia (RBA) will see it that way, especially if the June monthly and quarterly CPI data don't unwind some of the recent increases seen in the monthly series. They may consider progress to be too slow and elect to tighten a little further. Personally, I suspect that we will see an easing back because I believe there's some seasonality to the monthly CPI series in which prices rise above-trend in summer then fall back again through autumn. Not many people realise that the May CPI print – the index, not the rate of change – was actually lower than the April level, which is a bit of a pattern at this time of year since the monthly series kicked off 7 years ago. Plug in monthly increases of 0.3% (equals 3.6% per annum) over the coming months and the year-to rate will be back down at 3% by September. (That's not a forecast, by the way, merely a projection to illustrate my point.)

My concern in the discussion of the inflation trend is that a key piece of information is being ignored. This data was widely ignored ahead of the outbreak of inflation in 2021 and continues to be absent from almost every commentary on inflation and monetary policy. This key piece of information is the money supply.

All of us who learned our economics in the 1970s knew the aphorism that "inflation is always and everywhere a monetary phenomenon." That phrase, uttered by the famous Chicago economist Milton Friedman almost 70 years ago, has been discarded in recent decades, which I think is a shame. Although there are some good reasons for the move away from simplistic monetarism, the fact that the link between money supply growth and inflation has been largely forgotten goes a long way towards explaining the mess we've been in for the past few years.

Let me explain what I mean. It starts with an economic identity that may or may not be familiar to you.

$$MV = PT$$

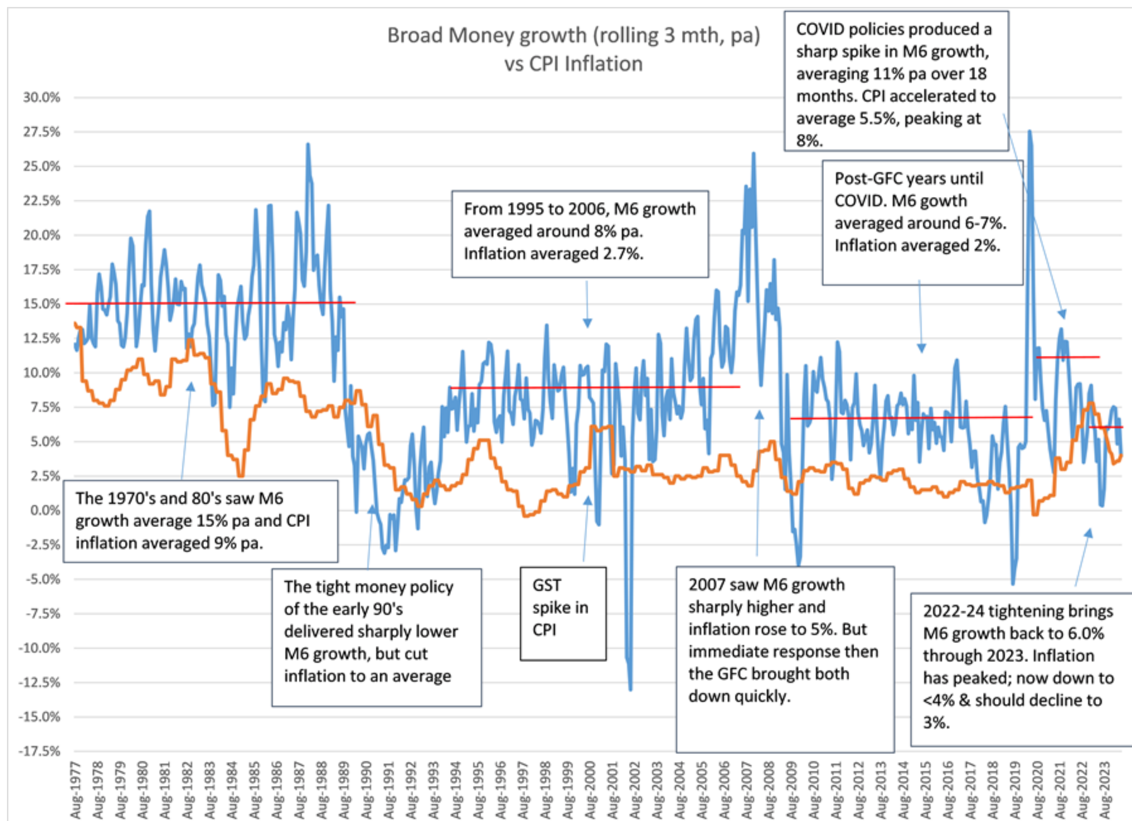
You don't have to be a Friedmanite quantity theorist to find analytical usefulness in the identity that states that the nominal value of goods and services produced in the economy (P, for prices, times T for real value of transactions) is equal to the amount of money (M) in circulation and how rapidly it circulates (V, for velocity).

Nor do you have to believe in a simplistic causal relationship between money supply growth (M) and inflation (P) to accept that there is, nonetheless, a key relationship between the two. And, therefore, that if the growth of M changes markedly then there is a likelihood that the growth rate of P will change in the same direction.

A related saying is that inflation results from "too much money chasing too few goods". When we have just the right amount of steady money supply growth in the context of steady real output growth, then we'll have steady inflation. When there's excessive money supply growth, beyond the capacity of the real economy to keep up, then the macroeconomic outlet is rapidly rising prices for goods and services – aka inflation. And when money supply growth is too tightly restricted, then inflation is driven down by recessionary tendencies in the real economy.

Monetary policy, therefore, has a great deal to say about the inflation rate that the economy will experience. That's why much of the task of preventing excessive inflation and bringing it back under control if it gets away, falls to the RBA.

The following chart shows the relationship between money growth (M) and inflation (P) over time in Australia. Here, I take the broadest definition of money that the statistics can give me, which in Australia is called 'broad money'. The chart (sourced from the RBA and ABS) shows how its growth has behaved over the years and how inflation has behaved at the same time.



The notes within the chart address the various phases of the last 45 years, but basically the relationship is that broad money growth equals inflation plus a margin, with the margin holding quite steady for prolonged periods of time. Much of that margin is the growth of T in the MV = PT identity, that is the rate of real economic growth, which has varied between around 2-3% in different periods. The rest (another 1-2%) captures a range of factors, including a trend decline in the velocity of money and a factor that monetary economists call 'financialisation' or the growth in the ratio of financial wealth to national income as the asset base of the economy grows in value.

In my opinion, the sharp increase in Australia's inflation rate in 2022 was both caused by and was predictable because of the surge in money supply growth during 2020. Readers of Firstlinks were warned of this as early as April 2020 in an article by Prof Tim Congdon, Magic money printing and the reality of inflation. Soon after, broad money growth in Australia accelerated to almost 20%, so it came as no surprise to me that inflation rose to 8% soon after.

But it did surprise most analysts. Then when the inflationary outbreak was finally recognised, the majority rushed to lay the blame at the feet of a host of individual issues, in particular supply constraints in some markets because of the pandemic and the impact on oil prices of the Russian invasion of Ukraine. Those factors were definitely at work – they contributed to the 'too few goods' part of the story – but in my view can only become widespread inflation if allowed to by 'too much money' chasing the goods and services being produced and supplied.

In any case, the focus on supply-side issues led to a widespread questioning of the RBA's policy response of increasing the cash rate to tighten monetary conditions. My view, however, is that they were too slow to do this. The time to respond to bring the growth in the economy and the money supply back to more acceptable levels was in early 2021. They had the monetary evidence in front of them by then but ignored it.

That's history now and to their credit the RBA eventually defied much opposition, lifting the cash rate rapidly from near zero to 4.1% by early 2023, then took it a bit higher in November 2023 to 4.35%. As a result, inflation has fallen from that 8% peak 2 years ago to the 3-4% region now.

What's the current story with money supply growth? After the 2020 spike, things have settled very well in response to tighter policy. Broad money grew in the 3 months to May at an annualised rate of just under 4%, bringing the year-to May growth rate in at 4.76%. That's the ninth month in the last 12 where the year-to rate of growth has had a 4 in front of it and it now looks more like the trend rate of broad money growth is slowing to less than 6%.

That being the case, the chances of inflation falling back into the RBA's 2-3% medium-term target band are improving – whatever the latest monthly CPI might say! And this in turn means that the current interest rate settings for monetary policy are, to use an old RBA word, 'appropriate'.

There may yet be some bumps along the way as Australia is navigated towards a lower and more stable inflation rate once again. I'm pleased that this outcome is universally regarded as a desirable one. Inflation is also always and everywhere a pernicious outcome that has negative consequences for both the efficiency and fairness of the way our economy performs. The RBA was right to begin focusing on it 30 years ago and, whatever they choose to do with interest rates at their next few meetings, they'll be right to continue to focus on it now.

From an investor's point of view, I believe this means that the building blocks of asset pricing calculations can now start with an inflation rate assumption of 2.5-3.0%; a neutral cash rate of 3.75-4.0%; and a long bond rate of 4 – 4.5%. As I said, those levels might not be achieved immediately, but at this stage that's where things seem to me to be trending.

Warren Bird has over 40 years' experience in public service, business leadership and investment management. He is currently a Director of the WA Government Employees Super Board (GESB) and Chair GESB's Investment Committee. He is also Chair of the independent Audit and Risk Committee of the Illawarra Shoalhaven Local Health District. This article reflects the personal views of the author.

Emerging market equities are ripe with opportunity

Shane Woldendorp

The term 'Emerging Markets' (EMs) first emerged (if you'll excuse the pun) in the early 1980s, and it took several years for the MSCI Emerging Markets Index to be launched in 1988. The EM Index initially consisted of 10 markets and accounted for less than 1% of the global equity universe. Over time, countries have been added and removed from the index, and today the EM Index comprises 24 markets and represents over 10% of the global equity universe. Furthermore, EMs and developing economies contain around 85% of the world's population and contribute roughly 60% of its GDP at purchasing power parity.

Since the inception of the EM Index, EMs have delivered on investor hopes and outperformed the MSCI World Index (which only represents developed markets), as shown in the following chart. This long-term relative outperformance may come as a surprise to many investors, given it's been a tale of two halves as indicated by the green and red arrows. In the first 20 years, EMs beat the World Index by around 6.5% p.a. In the last 16 and a half years, however, much of that outperformance was given back with EMs lagging the World Index by over 5% p.a.

EMs have outperformed world markets since their inception in 1988

Total return in USD of World and Emerging Market stockmarkets, 1988 to 2024

Disappointing recent returns have left many investors wondering whether EMs are worthy of their capital. To them, we have a simple answer: Yes. We think this is an unusually attractive time to invest in EMs, and the universe is ripe with opportunity for bottom-up stock pickers. But like any investment universe, EMs are not without risk. The table presents three risks to keep in mind and three opportunities to get excited about. It is by no means exhaustive but makes for a good starting point. Let's briefly discuss each.

Opportunities and risks in EMs

#	Opportunities
1	Attractive valuations
2	Undervalued currencies
3	Wide spreads
#	**Risks**
1	Governance concerns
2	Country-specific risks
3	Geopolitical tensions

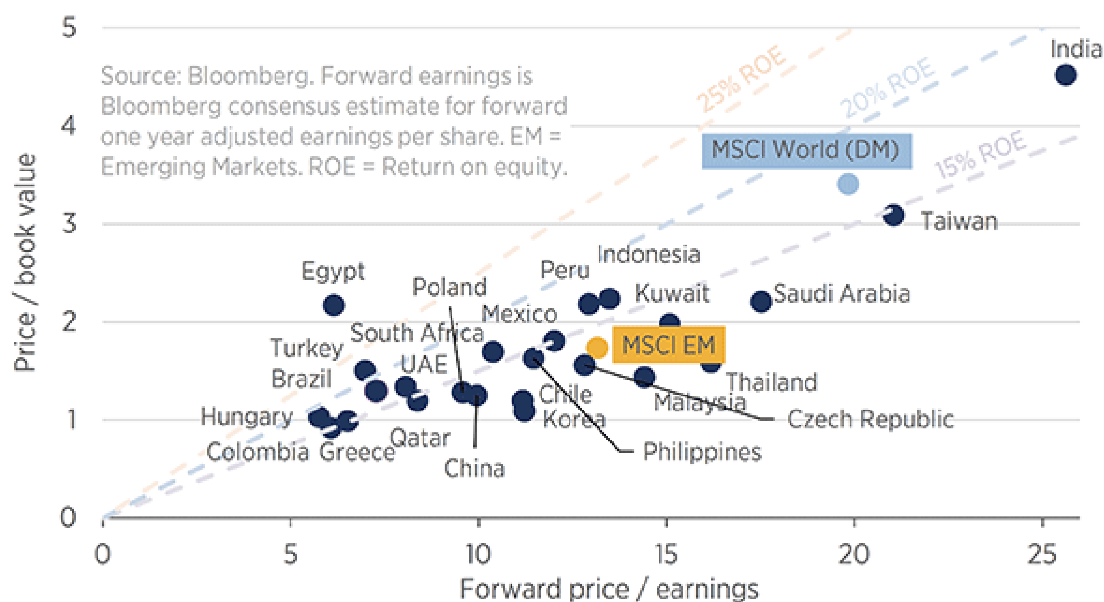
Source: Orbis.

Risks

In EMs, governance issues are rampant. At many private businesses, investors endure poor capital allocation, related party transactions, and heavy dilution as companies issue ever more shares. It's all well and good to grow the profit pie quickly, but not when it's cut into too many slices. China makes for an instructive example: the net profits of listed companies have grown by around 25% p.a. since the early 1990s, but that translated into per-share earnings growth of just 5% p.a., and disappointing equity returns. State-owned enterprises (SOEs) layer on additional governance risks, as their priorities are often not aligned with those of shareholders. Whilst the weight of SOEs in the EM Index has declined in recent years, they still account for a substantial chunk of the universe today. But EM companies are not all alike. Mindful of elevated governance issues, we have a strong preference to partner with owner-managed businesses. Managers who are themselves shareholders are often more aligned with our clients' interests and tend to make better capital allocation decisions. Current examples in the portfolio include our longstanding positions in Jardine Matheson, NetEase and Kiwoom Securities.

EM companies are not homogenous, and nor are EM countries—even if some investors treat them that way. In reality, every market is unique and presents different opportunities and risks. A quick glance at valuations confirms this, as shown in the following chart. For example, India appears very expensive on a variety of

aggregate valuation metrics. Unsurprisingly, we are struggling to find many attractive ideas there, though with hundreds to choose from, we have found some, including HDFC Bank. Compared to India, China looks inexpensive—but it comes with very different risks, and commands a 25% weighting in the EM Index. Given the risk, that is higher than we are comfortable with, and as active investors, we can afford to be selective. We have found relatively more ideas in other countries.



China calls to mind another source of risk: geopolitics. In that, China is hardly alone—as we were painfully reminded in 2022 when we wrote our small position in Sberbank of Russia down to zero. Between military campaigns in the Middle East and presidential campaigns in America's Mid-West, geopolitical uncertainty is high. We address that not by trying to guess what is in world leaders' heads, but by focusing on companies and their prices. As bottom-up investors, we spend most of our time estimating what businesses are truly worth, and only buy shares that trade at a deep discount to our estimate of intrinsic value. This discount provides our first and most important line of defence against permanent losses. When we buy a stock, we also carefully manage the weights of our positions. But in some cases, no price is too low to guard against catastrophic events, and the right weight to have is none.

Opportunities

Those fearful factors are well known, but they are only half the story. Over the long-term, the price you pay for an asset is one of the most important drivers of future returns. After years of disappointing returns in EMs, many investors have headed for the exits, and it remains an under-owned asset class. The good news is that this has translated into substantially lower valuations versus stocks in the developed world. Consider the cyclically adjusted price-to-earnings (CAPE) ratio, a well-established barometer for the expensiveness of a market, and a reasonable indicator of long-term real returns. In aggregate, EMs trade at a CAPE ratio of around 12 times, which is low versus its own history, and low compared to about 20 times for world markets. EMs are also discounted versus world markets on conventional price-to-earnings, price-to-book, and price-to-free cash flow measures—to name just a few.

And it's not just the stocks that look cheap. EM currencies trade at deep discounts to their valuations on a purchasing power parity basis. An equally-weighted basket of the largest EM currencies, such as the Chinese yuan, Taiwan dollar and Korean won, is as cheap as it's been since the early 2000s—trading at around a 20% discount to the US dollar. Historically, much of the volatility experienced in EMs has been due to currency fluctuations. But given many EM currencies already appear cheap today, there is a lower-than-average risk of a nasty currency shock. Indeed, what has been a headwind for EMs could be a tailwind going forward.

Lastly, the gap in valuations between cheap and expensive shares within EMs is unusually wide relative to history, as we discussed in December. Apart from the extremes of the last few years, the only time this valuation gap has been wider was during the Asian Financial Crisis in the late 1990s—arguably a once-in-a-

lifetime buying opportunity. In our view, the opportunity for stock picking to add idiosyncratic value looks unusually good today.

We continue to believe it's an exciting time for EMs. Whilst recent performance has been disappointing for EM investors, it has provided a great setup today for long-term returns: attractive valuations, undervalued currencies, and wide spreads between cheap and expensive stocks. We think our bottom-up approach is well placed to navigate the risks and capitalise on the opportunities.

Shane Woldendorp is an Investment Counsellor at Orbis Investments, a sponsor of Firstlinks. This article contains general information at a point in time and not personal financial or investment advice. It should not be used as a guide to invest or trade and does not take into account the specific investment objectives or financial situation of any particular person. The Orbis Funds may take a different view depending on facts and circumstances.

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Tomorrow's taxpayers pay for today's policy mistakes

Ken Atchison

There are two very significant intergenerational inequities in Australian public policy. They are the age pension and revenue from our natural resources. Both involve government spending today which will be paid for by future generations of taxpayers. Interest rates are higher today as a result of this stimulus.

In the May 2024 Australian budget, the Treasurer, Jim Chalmers, announced a surplus of $9.3 billion and gross debt of $1 trillion. With government spending growing at 4.5% in 2023/24 and 3.6% in 2024/25 (in real terms) gross debt will exceed $1.1 trillion through 2025/2026. As is common, no mention was made of the unfunded liability for age pensions. This is an inappropriate policy.

There are three pillars to the retirement income system being the age pension, compulsory superannuation, and private savings. In current public policy, unfortunately without any clear framework, the three pillars are independent of each other. This is inappropriate, as was made clear in the 2020 Retirement Income Review Report. A proposed change in the superannuation regime with a cap of $3 million and taxing of unrealised capital gains has introduced yet another layer of separation and complexity.

Payment of age pensions is made on an emerging cost basis. Obligations for the age pension arise with residents of Australia turning 67 years. Under an emerging cost basis, the payments will be financed by future generations. This liability represents an intergenerational inequity which should be addressed in the intergenerational report prepared by the Federal government every five years. It was not addressed in the 2023 report.

While the age pension is not a binding legal obligation, it is an integral component of the expectations of the community. Australians, including new immigrants, have an expectation that the age pension is a key part of Australian life in retirement.

Extraordinary growth in Australian immigration has occurred under the current Federal government. It is now approaching 550,000 per annum. Consequences are extensive and include an increase in the prospective age pension obligation. This increase must be factored into an estimate of the liability.

In 2023 the Federal Government released the latest intergenerational report which considered the outlook for Australian finances through to 2063. It foreshadowed a reduced entitlement of Australians for the age pension in part reflecting the growth in superannuation savings. Subsequent superannuation policy changes indicate that this was a heroic assumption. Nevertheless, an ageing population is expected, and limited policy action can change this. It is assumed for the estimation of the unfunded age pension liability that policy levers are largely unchanged.

Estimated unfunded age pension liability for the current population is $2.05 trillion. This indicates that the current declared Federal Government net debt of $1 trillion, growing to at least $1.1 trillion, materially understates the extent of financial obligations. It is a liability which, without any policy change, will be met by future generations of Australian taxpayers. It is a clear case of intergenerational inequity.

Government 'wealth funds'

Many governments have attempted to address this intergenerational inequity by directing revenue from taxation, royalties or rent for natural resources of the nation into a wealth fund.

In Norway a wealth fund was established "which would ensure the long-term management of revenue from oil and gas reserves so that the wealth benefits both current and future generations". Wealth funds reflect a policy where revenue is generated from natural resources of the country today for the benefit of the population in the future not just the current population.

Australia is generating significant wealth from commodity resources including gas and iron ore. Through taxes and royalties, it is generating revenue for federal and state governments. In Victoria, where the ALP has an aversion for gas, the prospect of revenue from natural gas resources which are estimated at a minimum of 4,996 trillion cubic metres would contribute a partial solution to the extraordinary debt nightmare of the state. A future Victorian wealth fund might be contemplated.

In the 2010 Henry Taxation Review a statement was made regarding natural resources as follows *"The current structure fails to collect a sufficient return for the Australian community"*. In other words, revenue from current charges is being applied to pay benefits for the population today without consideration of future generations.

It's clear that future taxpayers are getting the worse end of the deal when it comes to unfunded age pension liabilities and how natural resource revenues are used. To right these inequities, we must examine a policy that acknowledges and funds the age pension. In addition to this, a Federal and/or state sovereign wealth fund drawing on the Norwegian model to invest natural resource revenue should be considered.

The two issues can be addressed concurrently, as was done with the Future Fund and the commonwealth government employees superannuation liability.

Ken Atchison has been involved in financial markets since the early 1970s and is Founder of Atchison Consultants.

How would a switch to nuclear affect electricity prices?

Roger Dargaville

Peter Dutton has announced that under a Coalition government, seven nuclear power stations would be built around the country over the next 15 years.

Experts have declared nuclear power would be expensive and slow to build.

But what might happen to energy prices if the Coalition were to win government and implement this plan?

How might we estimate the cost of nuclear?

By 2035, 50–60% of the existing coal-fired fleet will very likely have been retired, including Vales Point B, Gladstone, Yallourn, Bayswater and Eraring – all of which will have passed 50 years old.

These five generators contribute just over 10 gigawatts of capacity. It's probably not a coincidence that the seven nuclear plants proposed by Dutton would also contribute roughly 10 gigawatts in total if built.

Neither my team at Monash University nor the Australian Energy Market Operator has run modelling scenarios to delve into the details of what might happen to electricity prices under a high-uptake nuclear scenario such as the one proposed by the Coalition. That said, we can make some broad assumptions based on a metric known as the "levelised cost of electricity".

This value takes into account:

- how much it costs to build a particular technology
- how long it takes to build
- the cost to operate the plant
- its lifetime
- and very importantly, its capacity factor.

Capacity factor is how much electricity a technology produces in real life, compared with its theoretical maximum output.

For example, a nuclear power station would likely run at 90–95% of its full capacity. A solar farm, on the other hand, will run at just 20–25% of its maximum, primarily because it's night for half of the time, and cloudy some of the time.

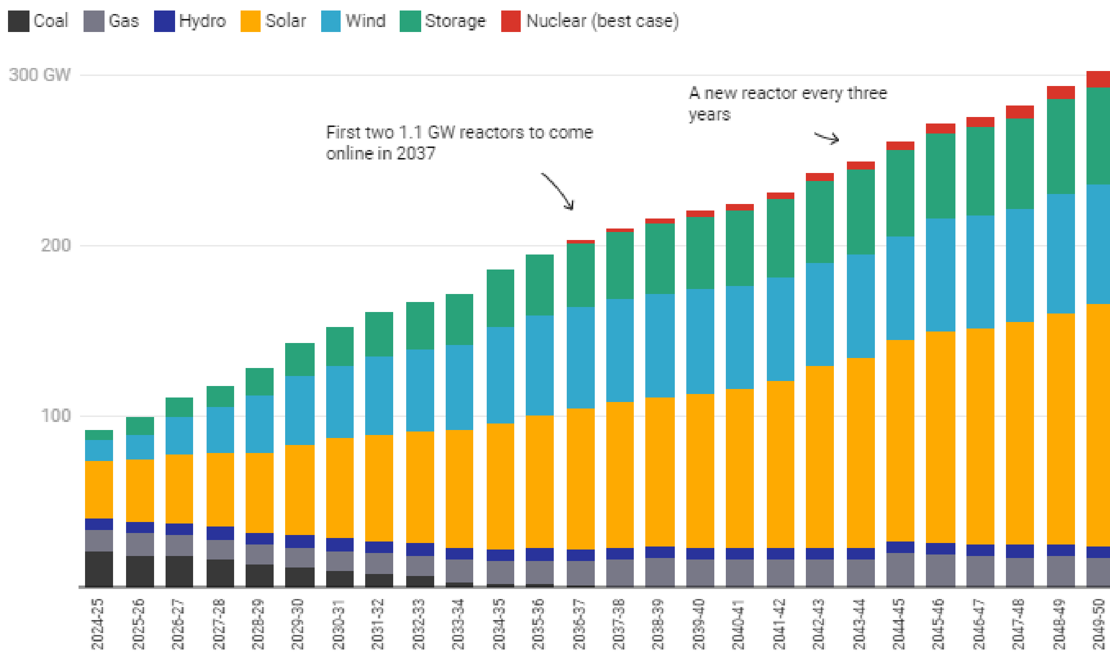
CSIRO recently published its GenCost report, which outlines the current and projected build and operational costs for a range of energy technologies.

It reports that large-scale nuclear generated electricity would cost between A$155 and $252 per megawatt-hour, falling to between $136 and $226 per megawatt-hour by 2040.

The report bases these costs on recent projects in South Korea, but doesn't consider some other cases where costs have blown out dramatically.

The most obvious case is that of Hinkley Point C nuclear plant in the United Kingdom. This 3.2GW plant, which is being built by French company EDF, was recently reported to be now costing around £34 billion (about A$65 billion). That's about A$20,000 per kilowatt.

CSIRO's GenCost report assumed a value of $8,655 per kilowatt for nuclear, so the true levelised cost of electricity of nuclear power in Australia may end up being twice as expensive as CSIRO has calculated.



Other factors play a role, too

Another factor not accounted for in the GenCost assumptions is that Australia does not have a nuclear industry. Virtually all the niche expertise would need to be imported.

And very large infrastructure projects have a nasty habit of blowing out in cost – think of Snowy 2.0, Sydney's light rail project, and the West Gate Tunnel in Victoria.

Reasons include higher local wages, regulations and standards plus aversion from lenders to risk that increases cost of capital. These factors would not bode well for nuclear.

In CSIRO's GenCost report, the levelised cost of electricity produced from coal is $100–200 per megawatt-hour, and for gas it's $120–160 per megawatt-hour. Solar and wind energy work out to be approximately $60 and $90 per megawatt-hour, respectively. But it's not a fair comparison, as wind and solar are not "dispatchable" but are dependent on the availability of the resource.

When you combine the cost of a mix of wind and solar energy and storage, along with the cost of getting the renewable energy into the grid, renewables end up costing $100–120 per megawatt-hour, similar to coal.

If we were to have a nuclear-based system (supplemented by gas to meet the higher demands in the mornings and evenings), the costs would likely be much higher – potentially as much as three to four times if cost blowouts similar to Hinkley Point C were to occur (assuming costs were passed on to electricity consumers. Otherwise, taxpayers in general would bear the burden. Either way, it's more or less the same people).

But what about the impact on your household energy bill?

Well, here the news is marginally better.

Typical retail tariffs are 25-30 cents per kilowatt-hour, which is $250–300 per megawatt-hour. The largest component of your energy bill is not the cost of generation of the electricity; rather, it's the cost of getting the power from the power stations to your home or business.

In very approximate terms, this is made up of the market average costs of generation, transmission and distribution, as well as retailer margin and other minor costs.

The transmission and distribution costs will not be significantly different under the nuclear scenario compared with the current system. And the additional transmission costs associated with the more distributed nature of renewables (meaning these renewable projects are all over the country) is included in the estimate.

According to my back-of-the-envelope calculations, your retail tariff under the nuclear scenario could be 40–50c per kilowatt-hour.

But if you are a large energy consumer such as an aluminium smelter, you pay considerably less per kilowatt-hour as you don't incur the same network or retailer costs (but the cost of generating electricity in the first place makes up a much bigger proportion of the total cost).

So if the cost of electricity generation soars, this hypothetical aluminium smelter's energy costs will soar too.

This would be a severe cost burden on Australian industry that has traditionally relied on cheap electricity (although it's been a while since electricity could be described as cheap).

A likely increase in energy costs

In summary, in a free market, it is very unlikely nuclear could be competitive.

But if a future Coalition government were to bring nuclear into the mix, energy costs for residential and especially industrial customers would very likely increase.

Roger Dargaville, Director Monash Energy Institute, Monash University

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Reader feedback from our 2024 survey

Leisa Bell

Thank you to those who responded to last week's reader survey. We love to hear what you think of Firstlinks and appreciate your engagement.

Some trends that have become clear already include:

- Over 65% do not use a financial adviser
- Favoured investments are Australian equities and cash deposits

- Articles are mostly easy to understand, quick to read, and credible
- Readers enjoy being able to comment on articles, and read others' reactions
- Keeping Firstlinks free and independent is important
- Relatable, personal investing stories are well received
- Most popular topics are superannuation / SMSFs and retirement planning

I've included a selection of comments below. Do you have anything to add?

If you had planned to do the survey 'later' and haven't quite got there, we'll be keeping it open until Wednesday 17th July.

Lastly, thanks to the majority of readers who recommend Firstlinks to friends and family. If you know someone who would benefit from regularly reading Firstlinks, please forward this subscription link to them.

Leisa Bell is Assistant Editor at Firstlinks.

Survey comments

- Firstlinks is a great source of information that helps guide me in planning my own investment. I have been reading Firstlinks for years since the days of Cuffelinks.
- Not all articles apply to my situation but I generally read them with varying degree of interest. Never too old to learn something new.
- Easy to understand and often give no value or knowledge to the reader .Keep them hard but useful.
- Relatable and educated articles. Like reading the comment sections as well.
- Variety of topics, mostly not pushing anything, free, short pieces and the reports on LICs at the bottom.
- Covers a multitude of issues. Allows access to authors of topics [if of interest] , allows reader feedback, provides factual info, w/out bias in most articles.
- I find the articles quite well written and easy to follow. Not particularly bogged down with too much detail unless the subject demands it.
- Needs a lot more focus if this newsletter is directed to the long term on market trends and the primary investment vehicles of ETFs and shares.
- Wide range of topics excellent authors and comments section is always really worth reading and contributing to.
- Not too many articles each week.
- Relevant and interesting.
- I like the super and retirement focus.
- Aside from articles that inform about my personal situation, I also skim read most of the other articles for general interest.
- The writing approach appears to be more considered, with great discussions in the comments. The overall feeling is that this is information being provided, as opposed to an attempt to sell the reader on a particular idea.
- Takes time to digest and time is not always available.
- Your focus on structuring of affairs and planning ahead for SMSF changes is excellent.
- It must be hard to come up with new ideas. Keep up as you do, I am not looking for changes, but I do miss hearing from Graham H.

- The occasional webinar would be useful depending on the topic. It is a very good newsletter already. Well done.
- Keep doing what you have successfully been doing & don't put it behind a paywall!
- Broad range of articles. I really like how people share personal experiences warts and all. James and Graham are best at this. (Mark Lamonica is also good at this). I don't do what they have done. But it is refreshing. Not just the standard stuff which is rehashed regularly. It makes me think. It sometimes opens up new ideas....that I can look into via Morningstar....and see how/if they work/don't for me.
- I reckon you have the mix pretty right. A broad range of subjects and presenters. Not everything is relevant...but that is what happens with a broad range. I don't know what I don't know. So...keep throwing stuff at me. Sometimes some of the articles are biased to the authors' company. I know you are aware of that. Not sure it is a huge problem. Keep up the great work.
- It's all about the curated articles. Some are very useful, others not. Which, I suspect, is what this survey is about.
- While I check the new articles every week I don't read that many. There are a lot of articles about retirement and SMSFs that are not relevant to me as a middle-aged woman with no intention to start an SMSF. More content relevant to women, people who are some way away from retirement and those with more moderate income/investments would be great. There also too many articles by fund managers justifying the outlook for their active funds or LICs, but I suppose that is necessary to keep the website content free.
- Steer readers towards long term investing. Avoid subjects and topics that are mainly short-term in nature and gambling such as Cryptocurrencies. In simple terms aim to be a high-class publication to attract high class readers.

Disclaimer

This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.

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