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Editorial

When Steve Eisman speaks, investors listen. It helps that he’s a straight shooter, a refreshing trait in an increasingly PR-led world. His own wife described him as “not tactically rude – he’s sincerely rude” in the book that made Eisman famous, *The Big Short*, by Michael Lewis (Steve Carrell played his character under the name, Mark Baum, in the subsequent movie).

Eisman also has unique insights that few in the industry possess. It probably comes from his background as a bank analyst, and his deep knowledge of the finance industry and broader economy.

In the 1990s, he turned away from a corporate law career to become a ‘specialty finance’ research analyst at Oppenheimer and Co. It was there that he discovered the first subprime mortgage companies and wrote a scathing 1997 report on how they operate. Many of the same companies would reappear during the housing bubble that developed in the 2000s. Eisman eventually helped train analyst Meredith Whitney, who became a star with her string of critical reports on the banking industry in 2007.

Eisman is now Managing Director at Neuberger Berman, and recently appeared on the Meb Faber Show to discuss his current thoughts and market outlook.

On the US economy and consumers

Unlike before 2008 when he was uber-bearish on the US banks and economy, Eisman thinks the US economy is in decent shape. Consumers aren’t indebted, unemployment is low, and wages are going up. The banks have healthy balance sheets, with excess capital, if anything.

He does see consumers cutting their spending a little, though. Eisman says data from Visa and American Express shows volumes have slowed and delinquencies have started to tick up. However, it’s nothing to be too concerned about, he says.

If there is a recession at some point, it won’t lead to a financial crisis due to the health of the banks, Eisman believes.

The two great equities stories of our time

Eisman says that in bad times, people focus on the quality of balance sheets and credit quality, while in good times, they focus on stories. And he says there are currently two great equities stories: artificial intelligence (AI) and infrastructure.

Eisman’s interviewer comments that he doesn’t see Eisman as ‘an AI guy’ - understandable given his ‘Big Short’ background. But Eisman makes it clear that he just goes into areas where he can make money.

On AI, Eisman has some fascinating insights. He says that we're at the early stages of the AI cycle. He cites listening to a recent earnings call from Accenture. Accenture has a consulting business and an outsourcing business. The former isn't doing especially well, while the latter is thriving. One of the reasons why outsourcing is picking up is because America's corporates aren't ready for AI. Most companies don't have their data in one place and cleaned up, both essential before they can start figuring out what to do with it. These companies are hiring Accenture to clean up the data. It's why Eisman says that we're not even close to a broad adoption of AI yet.

What are the best ways to play the AI theme? Eisman suggests that hardware companies are likely to outperform software companies in the long term. Over the past 15 years, software has trounced hardware, driven by the switch to the software-as-a-service model. This model provides recurring income, which markets love, and that's led to an explosion in the multiples attached to software businesses.

Going forward, Eisman believes the cost to develop software will collapse because of AI. However, companies will still need hardware.

Eisman also points to cloud providers as beneficiaries of AI. For large companies, whatever they do with AI will be in the cloud.

He also says that there will be AI apps soon enough, and that will drive a major upgrade cycle in phones and iPads.

The other great equity story according to Eisman is infrastructure. He says it's a combination of four mega-themes: onshoring, data centres, electrical grid improvements, and greenification. The industrial policy of the Biden administration, from the IRA to the CHIPS Act, has turbo-charged these mega-themes.

With onshoring, Eisman says the key beneficiaries are mostly industrial companies. He breaks them down into sub-sectors. For instance, companies in the construction and design sector, which can be broken down into three groups: electrification, automation, gas turbines, and materials. Other areas of interest include solar, hydrogen, utilities, and water.

Eisman suggests that at a broad level, the US is too dependent on chips being made in Taiwan. It's a national security issue that's resulting in more factories being built in the US. And that will continue, whichever party wins the US election.

Eisman seems especially bullish on electrical grid improvements. He says electrical consumption hardly grew in the US over 20 years. It's now growing 2.5% a year. That's due to demand from electrical vehicles and data centres. Currently, the US electrical grid produces about 4,000 terawatt hours of electricity. To meet increasing demand, that will need to increase to 5,000 terawatt hours over the next 10 years. It can't be done with just renewables and will need a lot of gas. Hence why he's optimistic on gas turbines, because turbines need to be built to make electricity from the gas.

Eisman suggests one stock as a potential beneficiary of the infrastructure boom: Quanta. It's a company that gets hired by utilities to build renewable plants. He likes the story because it's been a sleepy business for a long time and its price reflects that. Yet a secular change has happened that should catapult their earnings as well as what investors are willing to pay for them.

How the US election may impact the themes

Turning to the odds of a Trump victory in the November election, Eisman says they're 100%. He explains that he watched the movie, Hillbilly Elegy, based on the book by Trump's Vice-Presidential nominee, JD Vance. He says the movie shows areas of America like Kentucky and Ohio where people have been left behind. Half of the towns are boarded up. The stores are gone. The factories are gone. These parts of the US were ignored by politicians until Trump came along. It's one of the main reasons that Trump was originally elected and will likely be elected again.

More broadly, Eisman says that the constituents of the two major parties have changed. The Republicans used to be the party of the rich, but they're now the populist party. Meanwhile, the Democrats used to be the party of unions, yet they've moved from that towards the educated classes and Silicon Valley.

As to how politics may impact his two major equities stories, Eisman says it's not black and white. He believes AI will be largely unaffected. For infrastructure, parts of it may be boosted, and other parts could be de-emphasised. For example, Trump would likely be positive for onshoring, though less so for greenification.

The great non-equities story

Eisman declares there's a third great story of our time and it's a non-equities one. Namely, Bitcoin. However, he doesn't believe in Bitcoin and is staying on the sidelines.

Eisman suggests that there are problems with cryptocurrency. Is it a currency? Some people think it is, some think it isn't. Yet, there is no data point that can prove it is a currency.

Eisman then says to pretend that it is a currency. Why should he own cryptocurrency? Proponents will argue that it's a hedge against dollar debasement, to which Eisman replies:

"That sounds great. And then here's my question to the crypto people … then on days where NVIDIA is up ridiculous amounts and interest rates are low and people are feeling great, crypto should go down. And on days where NVIDIA is down 5% and interest rates are up at the same time … crypto should be up. And that's not how it acts. Crypto has like a 70% correlation to the Nasdaq. So, there's theory and there's practice."

Consequently, Eisman says Bitcoin is a speculation, not an investment.

Coincidentally, we have two articles and a whitepaper this week exploring the two stories that Steve Eisman is bullish on. First, **Fidelity's Tom Stevenson** expresses his bemusement about how sentiment has turned on the AI story, from unquestioning fervour just months ago, to scepticism about whether gargantuan investments in the sector will pay off. He says if you don't know how exposed your portfolio is to AI, now would be a good time to find out. Meanwhile, **TD Epoch** - a **GSFM** affiliate - has a whitepaper on how power constraints will impact the progress of AI.

And, **Firstlinks' Joseph Taylor** has a piece on infrastructure, highlighting lessons that the team at **Magellan** have learned from investing in the sector. They suggest that it's best to focus on quality and have the nerve to buy infrastructure stocks when markets take a dip or companies encounter short-term problems.

In my article this week, I look at Warren Buffett selling almost 50% of his shares in Apple. The move surprised investors given Buffett's propensity to buy and hold companies for the long term, and his lavish praise for Apple as recently as in May this year. Why did he do it? What changed his mind on Apple? And what are the lessons for investors like you and me?

James Gruber

Also in this week's edition...

The great intergenerational wealth transfer continues to attract headlines. Accountant **Danielle Hart** and family lawyer **Jane Koelmeyer** have both seen how the transfer of wealth can work well, with inherited wealth helping families grow and thrive for generations, as well as how things can go horribly wrong. They offer their tips on how to get it right.

The biggest fear voiced by Australians prior to and during retirement is running out of money. **Justine Marquet** at **Allianz Retire+** explores the key risks that should be considered when building a retirement income strategy.

Thank goodness for the ladies who led Australia to a record breaking Olympics gold medal haul. It helped that swimming events featured prominently, a traditional strength of Australia's. **Vaughan Cruikshank, Brendon Hyndman**, and **Tom Hartley** break down all the numbers from the Olympics and the reasons behind our success.

Higher interest rates help tame inflation, right? Not necessarily, says **Chris Bedingfield**. In fact, he says the evidence, both here and internationally, suggests that higher rates cause higher inflation. If right, it means that the RBA's efforts to lower inflation back to its 2-3% band may not be successful.

Warren Buffett changes his mind at age 93

James Gruber

Warren Buffett is widely considered the greatest investor of all time so it's no wonder that his every move is closely followed by markets. On August 3, Buffett made waves by revealing he'd sold 49% of his stake in Apple shares, worth US$88 billion, in the second quarter. After a smaller sell-down of the stock in the first quarter, it means Buffett has reduced his stake in Apple by nearly 56% in 2024. While the second quarter sale of Apple shares wasn't a total surprise, the extent of it certainly was.

Naturally, Buffett's move has generated many questions from investors. About the future of Apple, about whether Buffett is calling a peak for technology stocks, and about whether he's worried that the broader market is looking toppy. That the revelation happened during a dip in markets put investors further on edge.

Here, I'm going to explore the likely reasons for Buffett's sale, why he's changed his mind on Apple, and some of the key lessons for investors.

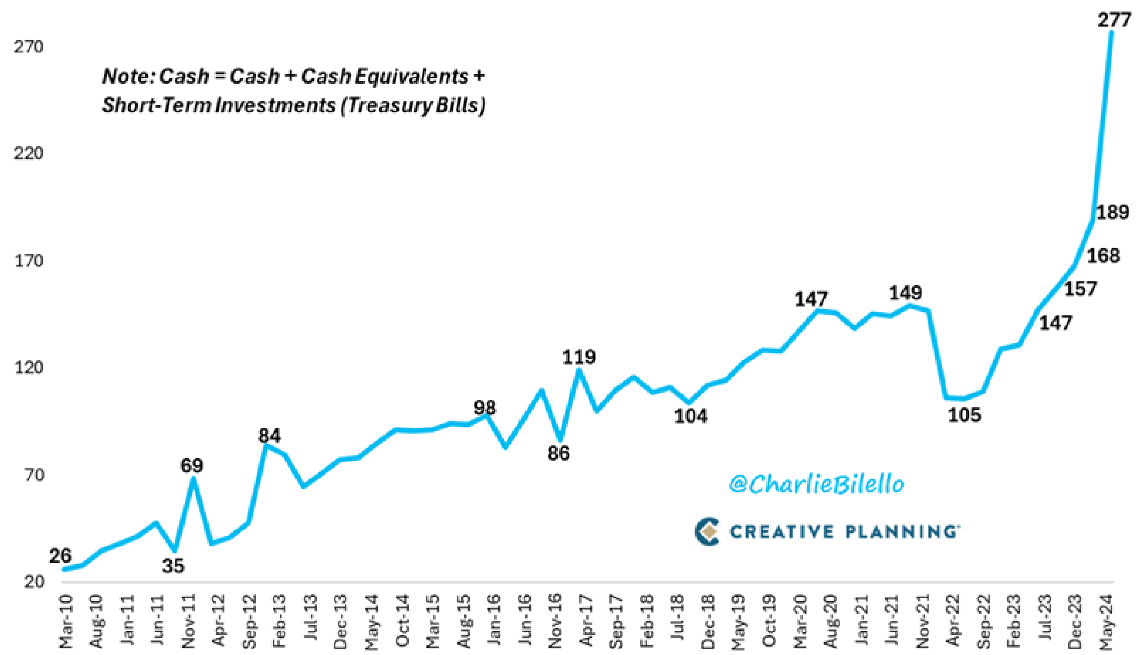
Details of the sale that shook markets

In its second quarter earnings release, Buffett's conglomerate, Berkshire Hathaway, announced that it'd sold about 390 million Apples shares in the quarter, on top of the 115 million shares it offloaded from January to March. Berkshire said it still owned around 400 million shares, worth US$84 billion as of June 30.

Apple remains Berkshire's largest stock holding. It's close to 30% of the stock portfolio, more than double the second largest holding, Bank of America – which it's also been selling. At its peak, Apple was more than 50% of the stock portfolio.

The sale means Buffett's company is gushing with cash, totalling US$277 billion. Berkshire is holding 25% of its assets in cash, the highest percentage since 2004. The average cash position versus assets across its history is 14%.

Figure 1: Berkshire Hathaway's Cash Pile (billions)



A large chunk of the cash is in Treasuries. The company held US$235 billion in short-term US Treasury Bills at the end of the second quarter, up 81% from the end of last year. Staggeringly, Berkshire now owns more Treasury Bills than the US Federal Reserve.

From effusive praise to selling

Buffett's sale of Apple caught investors off-guard for two reasons:

- Buffett has said he likes to buy stocks and hold them forever. The share sale runs counter to that.
- Buffett has praised Apple on numerous occasions since owning a stake in the company.

On the first point, it's intriguing that Buffett has previously named stocks he'd like to hold "indefinitely" – and Apple hasn't been among them. Instead, he's nominated Coca-Cola, American Express, and Occidental Petroleum as companies that he wants to own forever.

That said, Buffett has gone out of his way to talk up Apple since first purchasing the stock in 2016. After the initial purchase, he said he liked the stock and the company's "sticky" product, although he didn't use it.

In 2018, Buffett said Apple users are "very, very, very locked in, at least psychologically and mentally" to the product and the ecosystem.

"Apple has an extraordinary consumer franchise," he said.

Last year, when asked how Berkshire can defend having Apple make up so much of its public portfolio, Buffett said, "It just happens to be a better business than any we own." He also hailed CEO Tim Cook as one of the "best managers in the world."

One of the reasons that Buffett has liked Cook's management is that Apple has been consistent buyer of its own shares.

"When I buy Apple, I know that Apple is going to repurchase a lot of shares," Buffett said in 2018.

And he's noted how buybacks result in getting a bigger stake in the company without buying more shares.

"The math of repurchases grinds away slowly, but can be powerful over time," Buffett said in 2021.

Buffett's kind words for Apple even extended to May this year at Berkshire's annual meeting. He declared that two of his long-time prized investments, Coca-Cola and American Express, were "wonderful" businesses, but lauded Apple as "an even better one."

At the same meeting, when asked why he'd sold some Apple stock during the first quarter, Buffett alluded to tax rates as a reason to take profits. He said selling now would benefit Berkshire shareholders should the U.S. raise capital gains taxes in the future "to plug a climbing fiscal deficit."

Why has Buffett changed his mind?

The big question is: why is Buffett selling Apple now? The's been much commentary about how the move indicates that Buffett is calling a market top. In effect, that markets are expensive and it's time to bail.

Yet, this seems unlikely given Buffett has repeatedly said that he doesn't believe in timing markets. He's always focused on stocks, not markets.

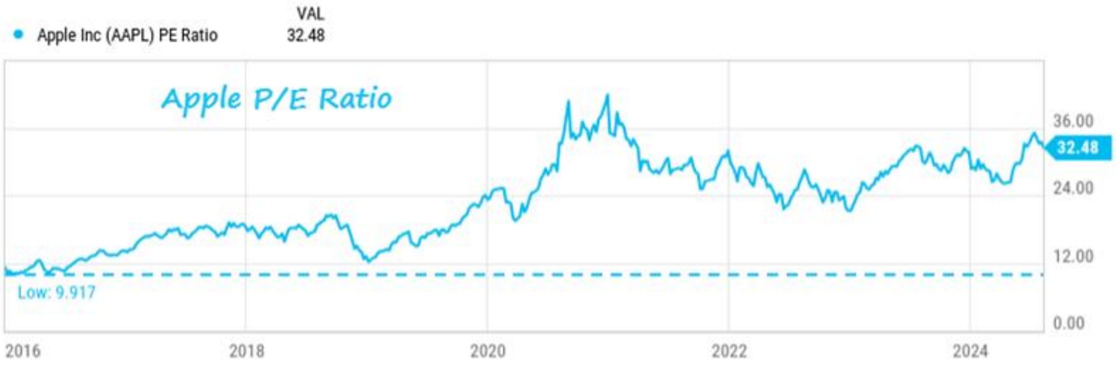
Yet his reference to taxes as a reason to sell also doesn't make sense. While it may have been a small part in the decision, it surely couldn't have played a major role. More likely, it was to give as an explanation, so he didn't have to reveal the true reasons for the sale.

What were the real reasons, then? I think there are four probable factors behind the decision:

1. Apple is expensive

By any measure, Apple is priced for perfection. It trades at 32x earnings, compared to 10x when Buffett started buying it in 2016. The price to sales ratio has also moved from 2x to 9x – the highest in the company's history.

Figure 2: Apple Inc. Price to Earnings and Price to Sales Ratios



Buffett remains a value investor and a believer in purchasing stocks at a price that offers a "margin of safety". Perhaps, Apple no longer offers that margin of safety.

And perhaps, Buffett has learned his lesson from not selling another of his beloved shares, Coca-Cola, in 1998. Back then, Coke's stock reached more than 50x earnings and 11x sales as the market exploded higher. As markets came back to earth, the shares didn't reach their 1998 highs again until 16 years later.

Buffett has since said that he regrets not selling Coca-Cola in 1998.

"Coca Cola is a fabulous company that was selling at a silly price… You can definitely fault me for not selling the stock. I always thought it was a wonderful business, but clearly at 50 times earnings it was a silly price." - Buffett, 2006 annual meeting

2. No growth

While valuations may have been one reason for Buffett's selling, a deterioration in Apple's earnings power may have been another. Between 2010 and 2020, Apple revenue grew at a 15.5% average annual rate. During the pandemic, Apple enjoyed a surge in revenue — growing at a nearly 20% annual rate in 2021 and 2022. However, between 2022 and March 2024, Apple's revenue declined almost every quarter. Apple's revenue broke that run by rising 5% in the June-2024 ending quarter – still anemic by most measures. Unless AI can kickstart growth, Apple pricey stock doesn't make a lot of sense.

3. Lost faith in management

One reason for Buffett selling that I haven't seen in any commentary is that he may have lost faith in Apple's CEO. Buffett has said that he looks closely at leaders and how they allocate capital. Previously, he's lambasted CEOs who've bought back company stock when the shares were expensive.

While Buffett has applauded Apple's large buybacks in the past, he's probably less happy with continued buybacks now. Why? Because buying back shares when the company was cheap made sense. With the company now expensive, it makes much less sense.

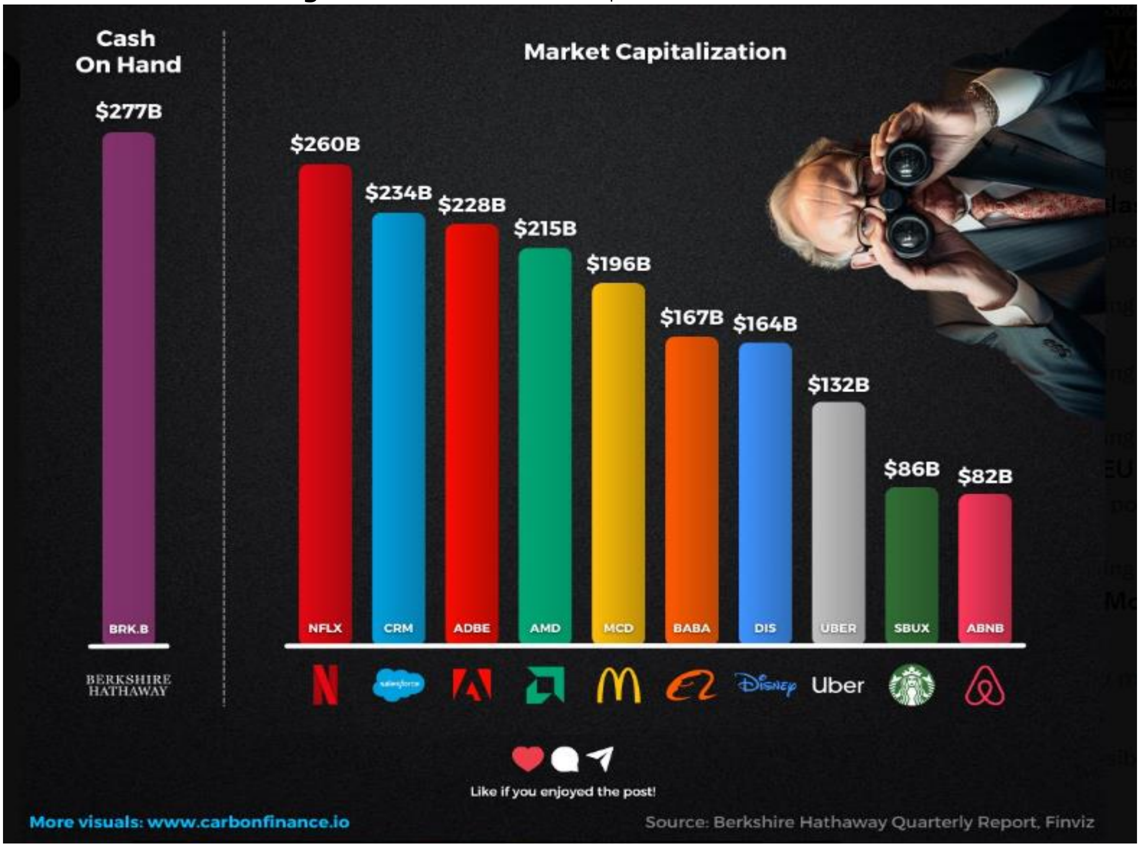
4. Money is safer in Treasuries

It's clear that Buffett assesses the value of stocks against other asset classes. By buying a gargantuan amount of Treasury Bills yielding more than 5%, he clearly believes that these Bills offer the prospect of a better risk-adjusted return than Apple stock.

Where it leaves Berkshire Hathaway

Intrigue has already started into what Buffett will eventually do with his US$277 billion cash pile. The below chart puts it into context.

Figure 3: Warren Buffet's $277 billion Cash Pile



Buffett has said for many years that he's seeking an "elephant" of a deal to put Berkshire's cash to work. That need is greater after the Apple sale.

Taking over a whole company is an obvious prospect. Taking minority positions in stocks is becoming much harder.

Buffett has warned Berkshire shareholders that the size of the company will limit outperformance going forward. Firstlinks contributor, Ashley Owen, wrote a fabulous article last year on how Buffett lost his edge 20 years ago for the following reasons:

- Berkshire has become too large, and it can't deploy the huge sums effectively without moving markets.
- It has too much cash, which is largely the result of the first problem.

Ashley has a point.

Buybacks are an option for Buffett, though at these prices, it's less attractive.

As for the possibility of dividends, it seems doubtful. Buffett probably believes keeping the money in Treasury Bills inside the company is better than giving it to shareholders who may turn around, after the government has taxed their dividends, and invest it in Treasuries anyway, or worse, in an overvalued share market.

Takeaways for investors

Here are the five lessons that I think investors can take away from Buffett's sale of Apple shares:

1. **It's ok to change your mind.** Think about how hard it must have been for Buffett to lavishly praise a stock and then later start selling it. Most people when taking a strong stand initially would dig in and find reasons to keep the stock, even if valuations got out of hand. To his credit, Buffett didn't.

2. **Price matters, always.** In a market like today's, there are plenty of people who are "buy quality stocks no matter what the price" type investors. Buffett has stayed true to his value investing roots. For him, price always matters.

3. **Focus on stocks, not the market.** Buffett doesn't get caught up in the noise of markets. He focuses on stocks and their fundamentals, and that's it.

4. **Weigh stocks against values of other asset classes.** The return versus risk of stocks should always be assessed against other assets. Buffett thinks Treasuries offering 5% yield are better value than Apple stock.

5. **Be patient.** Buffett has been sitting on a lot of cash for a while now, and he's endlessly patient, waiting for the right investment opportunity.

James Gruber is the Editor of Firstlinks.

Wealth transfer isn't just about 'saving it up and passing it on'

Danielle Hart, Jane Koelmeyer

There has been a lot of 'noise' in the media lately about the dilemma faced by many families looking to pass on wealth and assets from parents to their children. It's clearly a concern for many families, particularly those who have different – and often divided – generational perspectives on why this should be done, and how to best do it. As an accounting partner and a family law specialist, we've both seen how the wealth transfer process can work well, with inherited wealth helping family groups grow and thrive for generations. We've also seen how things can go horribly wrong, either through poor financial structuring, inaction or unwise decisions made around who should get what, and why.

Families aren't like they used to be

Today's families are complex, frequently involving second spouses, step-children, step-grandchildren and a wide variety of partnering relationships. The mechanisms to pass on wealth to these dependents are varied, can be complex, and frequently require clear communication, the right timing, right execution and unity amongst the family members, to be successful.

We often don't see both these accounting and relationship perspectives provided to clients as one strand of advice. So here are some useful points from us, to give you that combined perspective and hopefully help you and your nearest and dearest navigate a successful path through the intricacies of wealth transfer across the generations.

Get the financial structures right, from the start

It's important to set up the right financial structures, early on, if you as the 'wealth holder' are planning to transfer your assets across your family.

Setting up either discretionary trusts or companies are both options that are worth considering as useful structures to hold any asset or investment purchased. As well as offering asset protection and flexibility for distributing income, these can also provide continuity when 'control' is transferred from parent to child. When these are properly set up, there is no sale or transfer of assets and the entity continues operating and investing as before, but with the next generation making the investment decisions.

Structuring your family home ownership as 'tenants in common' rather than joint ownership can be an important mechanism for passing ownership of the family home to children. In this scenario, once one tenant (owner) dies, their portion of the property can pass directly to their estate. Their Will can then grant the surviving spouse a life interest in the home, so they can continue to live there. This helps to protect against the possibility that future partners of the surviving spouse might claim all or part of the property, instead ensuring that their children retain an interest in the home.

Many parents assist their children with cash and assets while they are alive to see their children enjoy them. But it's important to properly document the intention and terms of this help. As a parent, you should consider who you want to help and on what basis. Is it a loan or a gift? Is it for your child, or your child and their spouse? A loan should be in writing, on commercial terms and complied with. Loans that do not meet these criteria are unlikely to be considered a liability.

Take a less taxing route

Minimising tax is also important in these situations. Again, having the right asset structures in place is critical here. Conversely, if the right structure is not in place, there can be significant capital gains tax and income tax liabilities that result.

Where assets (including businesses) and investments are owned via trusts and companies, there will often be no adverse tax outcomes when control is passed from parents to children. The children can be appointed directors when appropriate and will already be general beneficiaries from when the trust was established. As the ownership of the asset is unchanged, there are no tax consequences.

Many people don't consider the significant tax that can be payable by adult (non-dependent) beneficiaries who receive superannuation benefits upon the death of a parent. A member's superannuation account is made up of both taxed and untaxed benefits. When these taxed benefits are directly paid out to a non-dependent, they are taxed at 15% plus 2% Medicare levy.

But there are ways to handle this: some strategies to reduce this tax include ensuring the benefits pass to an estate upon death, (not directly to the member), recontribution strategies, and ensuring all estate planning documentation is in order and includes permission to withdraw superannuation benefits for an incapacitated family member.

Managing those tricky interfamily relationships

Structuring is important, but it is not the only thing to get right. Family law – and lawyers – can look beyond the structure, and can alter these arrangements, if necessary, through the courts.

This requires thoughtful management, and we would advise that when it comes to relationships and your financial future, "hope for the best and plan for the worst".

Relationship breakdown and the financial consequence is a material risk that should be managed. Here are some ways to do just that:

Before you advance money to your children: ask them to sign a financial agreement with their existing or future de facto or married spouse. This should confirm the terms on which you will provide financial assistance, and your requirements for repayment during your lifetime, after your lifetime or if their partnership/marriage ends. Clarify your intentions in your will also. A clear will and associated agreement will help to ensure your wishes are implemented in future.

Before you or your children move in or marry your respective partners: consider whether they or you need a financial agreement to document how things will be dealt with if your relationship does not endure.

Get good advice and get it early. If you are concerned about your relationship or the relationship of a child, consult a specialist lawyer and an accountant as soon as possible, to assess whether there is risk there and if so, how to manage the relationship.

While these conversations seem tricky, they are increasingly common and accepted discussions particularly among those who seek certainty and clarity. In our experience, couples and their families will prefer to do these to avoid the compounding effect of protracted, costly and uncertain litigation upon the pain of separation.

Divorces, wills and other legal instruments

Legal documents are useful things but often forgotten about when it comes to keeping them up to date. You should make sure that all legal documents reflect your current wishes and your current relationship status.

If you have separated from your married spouse, then you should obtain a divorce to sever the legal relationship. There are some good reasons for this, painful though it may be.

If you have separated, the legal relationship and responsibilities of marriage endure until divorce. Significantly, the provisions in a will appointing your married spouse to be the executor or a beneficiary are not revoked by your separation, even if you have formalised a financial settlement. Similarly, the appointment of your married but now estranged spouse to be your attorney in the event of your incapacity is not revoked by your separation.

If you are separated from your de facto spouse, you should get advice urgently about whether and if so how you should properly document that your financial relationship has ended, and revise your will.

Wills often get forgotten about in times of relationship turmoil. Clarify your wishes by updating your will and documents such as a power of attorney. If you intend to benefit your child and their spouse, notwithstanding their separation, then make your intention clear in your will. This will help to avoid uncertainty or painful controversy about who you really intended to benefit. In a recent case, the Federal Circuit and Family Court of

Australia considered the circumstances in which a will maker had left gifts to both her child and her former child-in-law.

Our final top tips for the generations

Five top tips to bear in mind in these situations:

1. Always consult your accountant when making investment and business decisions.
2. Before you hand over funds, check in with a specialist family lawyer and/or your accountant about how your contributions can be best protected.
3. Review your superannuation member statement to see if you are potentially gifting the ATO a small fortune on your death.
4. Ensure that your current relationship and wishes are clearly reflected in all agreements, wills and legal documents. Engage a specialist lawyer to review them regularly.
5. Plan ahead, always. Get advice early. Forewarned is forearmed.

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Navigating the risks of retirement

Justine Marquet

The world has undergone a transition in its financial climate, moving from low-rate, stable inflation conditions to a period of higher rates, a spiralling cost of living and rising uncertainty across financial markets.

Retirees need to navigate through the immediate market turbulence knowing a wrong move now might have long-term implications, impacting retirement plans for what could be decades. Given the prevalence of these risks, it's no surprise that funding their post-work lifestyle is a cause of stress for Australians close to retirement.

'Controllable' risks

There are several retirement risks that are often described as 'controllable', although that might not always be the case. Unforeseen circumstances can derail the best of plans, although personal insurance may provide a safety net for those forced to retire earlier than expected due to ill health or accident.

Controllable risks may include:

- The timing of retirement – although 43%[1] of Australians surveyed in 2021 were unexpectedly forced into early retirement due to ill health, accidents, carer responsibilities, job loss or business failure.
- The quantum of retirement savings available – while increasing contributions can mitigate the risk of insufficient savings, that's not always possible.
- The rate of withdrawal – the higher the rate of capital drawdown, the faster retirement savings will be consumed.

Uncontrollable risks

Uncontrollable risks are often interrelated and can result in retirees questioning how long their money will last or whether they can afford the lifestyle they want. These risks may have longer term ramifications: lower investment risk tolerance, increased uncertainty, a reduction in spending or unwanted lifestyle adjustments.

Will the savings last?

The biggest fear voiced by Australians prior to and during retirement is running out of money. This is known as longevity risk – or the risk of outliving retirement savings.

With the expectations of a longer life, how much can a retiree afford to draw down each year? For many, it's a dire choice: live more frugally today or risk running out of money.

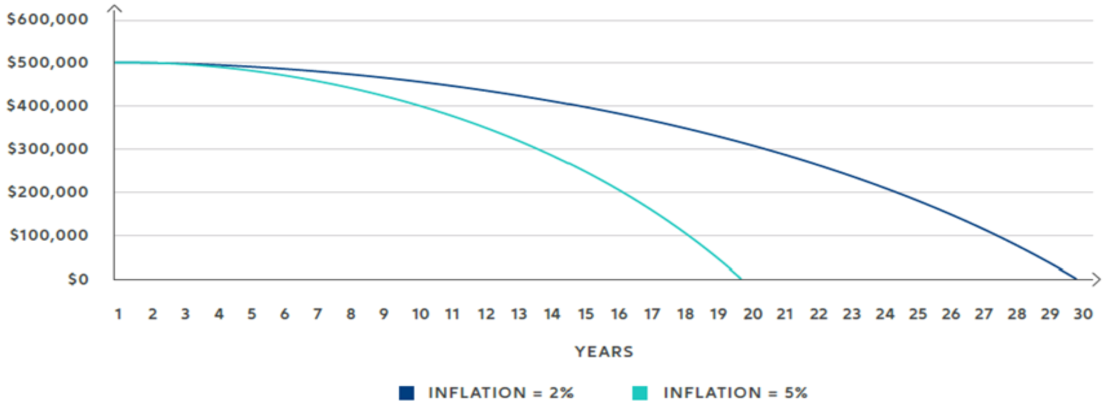
Inflation chips away at the value of savings

Inflation risk is once again top of mind as Australia's cost of living rapidly increases. Higher inflation reduces the purchasing power of every dollar saved. It can exacerbate the fear of running out of money and increase loss aversion.

The compounding impact of inflation over time can erode retirement savings as illustrated in Figure 1, which uses the example of a retiree with $500,000. An annual inflation rate of 5% would result in their savings running out 10 years sooner than if inflation stayed at 2%.

Concerns about inflation and rising costs are top of mind for many pre-retirees; for those already living on a fixed income, the figure is likely to be much greater.

Figure 1: The impact of inflation



Source: Allianz Retire+, March 2022.
For illustrative purposes only. Assumes a fixed rate of inflation applied to the withdrawal amount for the entire investment period. Fixed rate of investment return for the entire investment period. Not reflective of historical or expected capital market outcomes.

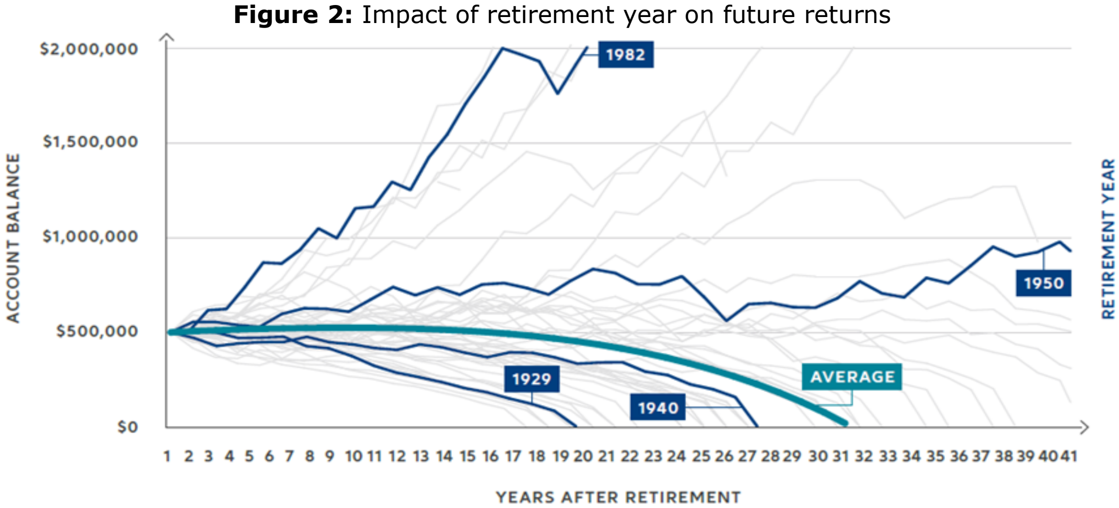
Market volatility erodes income producing assets

Financial market volatility is once again making headline news. The prevailing market conditions prior to and during retirement can affect the longevity of retirement capital and the level of income generated.

The timing, as well as the size, of a market downturn can have dramatic consequences. As modelled in Figure 2, the prevailing market conditions at the time of, and after, retirement can determine how long a retiree's capital could last when investing in a balanced portfolio. It was chance that dealt 1982's retirees buoyant markets, and chance that presented 1929's retirees with a crash and rapid capital depletion.

Because retirees usually can't align their retirement date with ideal market conditions, the decision (forced or not) to leave work can be a big gamble, particularly without the right mix of strategies and products. Unfortunately, chance can have a much greater impact on retirement outcomes than good planning.

Figure 2: Impact of retirement year on future returns



Source: Wealth benchmarks™
$500,000 invested in a diversified, multi-sector balanced portfolio — rebalanced annually. Income of 5% drawn in year one, then an annual amount adjusted by 3% p.a. for inflation.

A significant capital loss requires a significant gain to get back to the same point. As illustrated in Figure 3, there is a nonlinear relationship between gains and losses; as the loss grows, the gain required to recoup the loss escalates.

Figure 3: The math of recovery from portfolio loss

Percentage loss	Gain needed to restore loss
10%	11.1%
20%	25.0%
30%	42.9%
50%	100%

Source: Craig Israelsen, Ph.D.

A fall in market value can exacerbate longevity risk and increase loss aversion. While clients in the accumulation phase generally have the advantage of time to recover losses, retirees in the decumulation or pension phase generally don't have this opportunity.

Timing risk impacts the longevity of retirement savings

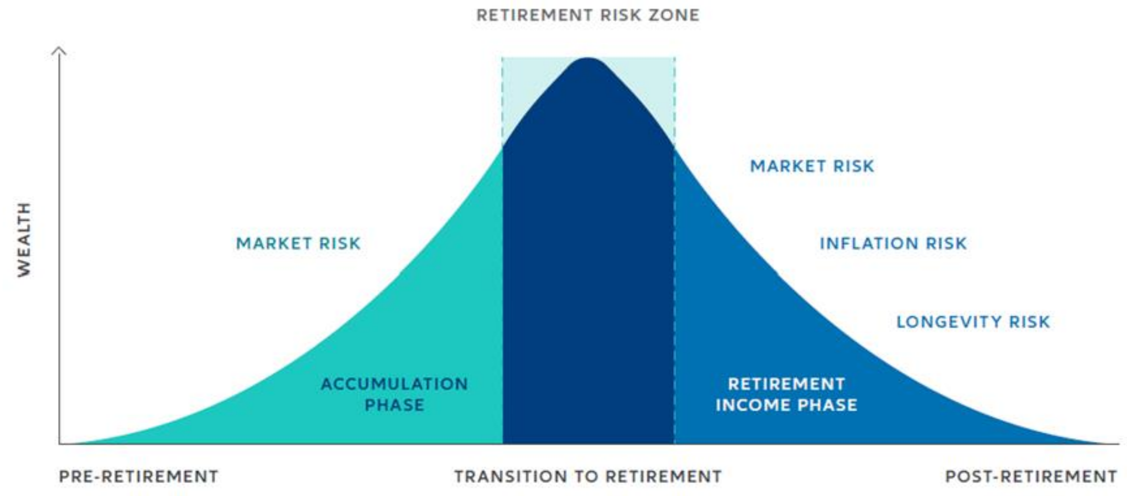
The market conditions that prevail in the years just before and after a person retires can make an enormous difference to how long their funds last. Those crucial years are often called 'the retirement risk zone'; a period when retirees are most vulnerable to market volatility.

If someone is fortunate enough to retire in a period of upbeat markets, then their income drawdowns will be fully or partially offset by investment returns.

However, if the 'retirement risk zone' (see Figure 4) coincides with a period of negative returns, retirees may start eating into their savings at an accelerated rate, potentially emptying the nest egg[2]. Market shocks during the vulnerable period will leave Australian retirees with less time to recover, while falling asset prices and drawdowns for income can magnify the scale of capital losses.

Ultimately, any losses will diminish the total value of the remaining assets.

Figure 4: Timing risk zone



Source: Allianz Retire+

Loss aversion can negatively influence retirement decision making

Loss aversion, sometimes called behavioural risk, can impact how a retiree invests, how much income they draw – and can even impact their lifestyle. A range of behavioural studies have illustrated that the pain of a loss is exacerbated in retirement, and that there are other traits and biases that can impede people from making reasonable decisions about their retirement savings.

These biases might stem from others' experiences, the fear of outliving their savings or the fear of losing capital. Investment Trends[3] identified three retirement fears pertinent in the current environment.

Expect to outlive their super	47%
Concerned about medical costs	43%
Concerned about inflation & rising costs	42%

Loss aversion is a major factor influencing investor behaviour, particularly in retirement when it's difficult to recoup losses. Understanding the biases and fears that can negatively impact decision making is an essential part of retirement planning.

Navigating retirement risks

Successfully navigating the (somewhat) controllable and non-controllable risks facing retirees and pre-retirees is challenging but not unachievable. Certainly, a more comprehensive set of considerations and features need to be incorporated into this cohort's future income and estate plans to effectively address retirement risks. This is likely to include guaranteed lifetime income, market-linked returns and downside protection, as well the flexibility to make withdrawals and to have appropriate beneficiaries receive any death benefits.

Retirement income strategies will benefit from a layered and diversified approach that includes not only a super account-based pension with the usual mix of assets and perhaps an investment property, but also more innovative income solutions that help manage the unique risks of retirement and provide for longevity without sacrificing financial flexibility.

Justine Marquet is Head of Technical Services at Allianz Retire+, a sponsor of Firstlinks. This article is for general information only and does not take into account your objectives, financial situation or needs. For personal financial advice please speak to your financial adviser.

Allianz Guaranteed Income for Life (AGILE) is a next-generation retirement income solution that delivers certainty in the form of a guaranteed income for life. To learn more, visit www.allianzretireplus.com.au/about-us/certainty.

[1] *Allianz Retire, [Project McFerrin], July 2021*
[2] *Allianz Retire+, 'Talking about sequencing risk', February 2019*
[3] *Investment Trends, 2022 Retirement Income Report, October 2022*

The numbers behind Australia's record-breaking Olympics

Vaughan Cruickshank, Brendon Hyndman and Tom Hartley

Australia has a proud history at the Summer Olympics. We have won at least one medal in every Summer games all the way back to 1896.

We have secured top-ten finishes on the medals table every Olympics since 1992. The fact there are more than 50 countries with larger populations makes these results ever more impressive.

The 2024 Olympics were no different.

Most gold medals

There are different ways to measure Olympic success, however the International Olympic Committee (IOC) medal tally ranks countries by the number of gold medals won.

By this measure, Paris 2024 was Australia's most successful Olympics.

Our 18 golds breaks the previous record of 17 set in Athens (2004) and Tokyo (2021).

So how did this happen?

	DAY 16 TALLY				
1	USA	40	44	42	126
2	China	40	27	24	91
3	Japan	20	12	13	45
4	Australia	18	19	16	53
5	France	16	26	22	64
6	Netherlands	15	7	12	34
7	Great Britain	14	22	29	65
8	Rep. of Korea	13	9	10	32
9	Italy	12	13	15	40
11	New Zealand	10	7	3	20

The golden haul was led by our swimmers, particularly the women.

Swimming is Australia's most successful Olympic sport. We have a strong swimming culture and very demanding national qualifying times.

Importantly, there are a lot of swimming events at the Olympics – in Paris there were 35 golds available in the pool. In comparison, sports such as hockey and handball only had two gold medals on offer.

Australia won 18 swimming medals including seven gold.

Traditionally, when the swimming events finish, Australia starts to slide down the medal tally as other countries with strengths in other sports surge.

This slide did not happen as fast in Paris. Day 12, with four golds and two bronze (none from swimming) was our most successful day in Olympic history.

We also won gold medals in events for the first time. One of those went to Arisa Trew, 14, who became our youngest gold medallist and first gold medallist in women's park skateboarding.

Other first-time golds included the women's time trial (Grace Brown), men's 50-metre freestyle (Cameron McEvoy), women's BMX (Saya Sakakibara), women's pole vault (Nina Kennedy), women's canoe slalom (Jess Fox) and women's kayak cross (Noemie Fox).

One-third of Australia's gold medals came in less traditional Olympic sports such as canoe slalom, skateboarding and BMX.

In fact, if the Fox sisters, Jess and Noemie, were a country, their combined three gold medals would have ranked them 29th, ahead of countries such as Denmark and Austria.

Comparing to previous results

Comparing medal tallies historically is difficult, as many things have changed.

New sports have been added in recent Olympics, resulting in more medals being available. But the world population has nearly tripled since 1956, which means more competition for medals.

Australia's gold medal haul vs the pool of all gold medals

The number of gold medals on offer has increased by more than 200% since the 1956 Melbourne Olympics

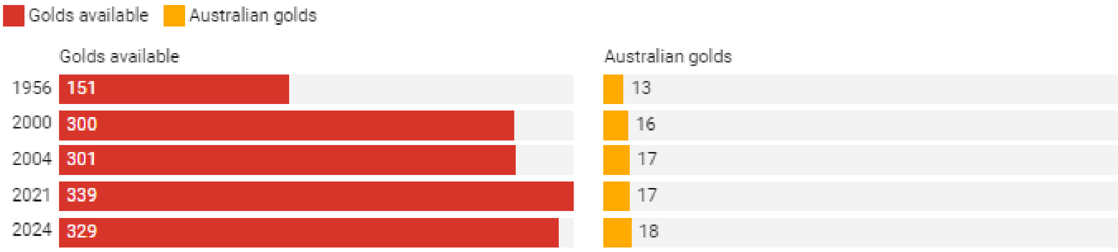


Chart: The Conversation • Source: International Olympics Committee • Get the data • Embed • Download image • Created with Datawrapper

In 1956, Australia won 8.61% (13 out of 151) of the gold medals available and were ranked third on the medal tally. This is our highest percentage of golds and our highest rank.

So, was this actually our best Olympic performance? Maybe, but it is important to acknowledge we had a lot less competition. Australia's remoteness and international conflicts resulted in many countries not attending the games. China did not compete. Neither did most of Africa. Only 72 countries competed and nearly 10% (323 out of 3314) of competing athletes were Australian.

The percentage of Australian golds has surpassed the percentage of Australian athletes

At the 2024 Paris games Australian athletes made up 4% of all Olympic athletes but won more than 5% of the gold medals

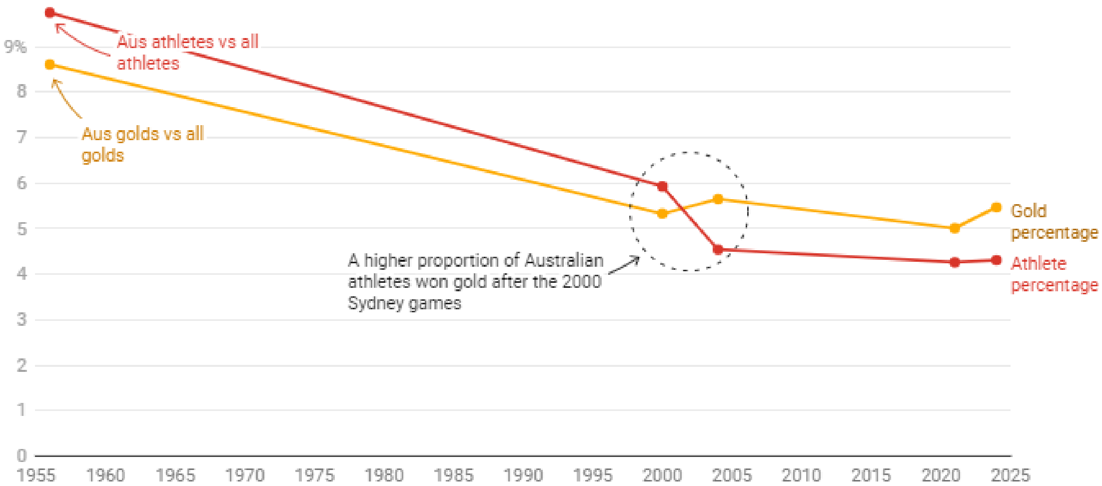


Chart: The Conversation • Source: International Olympics Committee • Get the data • Embed • Download image • Created with Datawrapper

In 2000, Australia won its most medals (58, including 16 gold), but were likely advantaged by a vocal home crowd and featuring our biggest team ever (632 athletes).

Athens 2004 probably ranks slightly ahead of Tokyo 2021 as our team won their 17 golds from 301 events, whereas there were 339 events in Tokyo.

But there were slightly more total competitors in Tokyo.

In Paris, 10,714 athletes from 206 countries competed; 462 (4.31%) were Australian.

The 2024 team may have been advantaged by the non-attendance of most Russian athletes. However, Russia's most successful Olympic sports are wrestling, gymnastics and athletics, not swimming, skateboarding and canoe slalom.

Also, Australia only won four gold medals last time Russia did not attend the games, in 1984. So we don't know what difference it would have made to our medal tally.

One thing we can all agree on is that Australia has had a very successful Olympics.

What was the secret to Australia's success in Paris?

A search of the Olympics subreddit provides some plausible ("strong sporting culture") as well as humorous ("all the slow Aussies got eaten by wildlife") answers to this question. But what other reasons are there?

Funding boosts

The Australian Sports Commission directly invested a record $398.3 million in high performance funding for Paris. This money funded projects such as developing a replica Paris BMX Freestyle track and launching a new canoe slalom kayaking program. This preparation helped contribute to Olympic success for Australia.

Direct athlete support

Since the Tokyo games, $47 million in direct athlete support grants have been awarded. The AOC also invested in Indigenous Athletes Support Grants and financial incentives for medal winners. Mining magnate Gina Rinehart also personally supported our swimming, rowing, volleyball and synchronised swimming teams. This support allows athletes to train more and work less.

Female role models and inspiration

Some of Australia's finest recent Olympic performances have been from women. This has included Cathy Freeman's iconic 400m win and the more recent performances of swimmer Ariarne Titmus. More media exposure, equal representation, federal funding and presence for female sports has made it easier to inspire and support new generations of elite female athletes. These developments may have contributed to the success of our female athletes, who won 13 of Australia's gold medals in Paris.

Science and innovation

Australia has always been at the forefront of sports science. For example, Australia was the first country in the world to use underwater cameras to extract data from the pool. They are planning to increase their use of AI in the lead-up to the 2028 Olympics. Australia also used environmental measurement units in the Olympic village to help athletes avoid the negative effects of hot summer temperatures and humidity during the games.

Australian athletes continue to benefit from state-of-the-art facilities at the Australian Institute of Sport. The (AIS) European Training Centre in Italy tripled its accommodation in the lead-up to Paris. It now provides a "home away from home" and competitive advantage for more Australian athletes training or competing in Europe.

Enhanced wellbeing focuses

All major Australian sporting bodies have been committed to the "Win Well 2032 Pledge". The pledge focuses on ensuring national sporting organisations are committed to supporting mental, emotional, cultural and physical wellbeing to foster the best chance for athletes to succeed.

Historical precedent

Australian athletes have consistently performed better in the Olympics than other developed countries with bigger populations, like Canada and Spain. Australians have always had a strong interest in sports, with many of us believing sport contributes to our national identity. In 1962, Sports Illustrated identified Australia as the best sporting nation in the world per population level.

These foundations set a precedent for modern and future generations, creating an expectation to maintain Australia's global sporting status.

Vaughan Cruickshank, Senior Lecturer in Health and Physical Education, University of Tasmania; Brendon Hyndman, Associate Professor of Health & Physical Education (Adj.), Charles Sturt University, and Tom Hartley, Lecturer in Health and Physical Education, University of Tasmania

How exposed is your portfolio to the AI story?

Tom Stevenson

The dominant investment theme of the past two years has been under an unforgiving spotlight in recent weeks as six of the Magnificent Seven have lifted the lid on their second quarter results. Technology, and in particular artificial intelligence (AI), has been the most popular and crowded trade in the two-year-old bull market, accounting for the lion's share of the US market's gains so far in 2024 – 60% of them from just six stocks. But both the sector and theme have recently come under intense scrutiny.

Will the massive AI investment generate adequate returns?

In particular, investors are starting to question whether the gargantuan sums being poured into AI-related infrastructure - the key talking point of the Big Six's earnings statements - will ever earn investors an acceptable return. Comparisons are being drawn with the dot.com bubble of 25 years ago and even, more worryingly, with the railway mania of the 1840s, with which the ongoing AI mania has some similarities.

The rotation in the leadership of markets away from technology is partly about the improving case for the smaller companies that have underperformed for so long. But it is also in large part a sign that investors are becoming anxious about the amount of unproven growth baked into the AI leaders' share prices. Markets have become less tolerant of companies' inevitable failure to beat expectations quarter in quarter out. Perhaps most worrying from an investors' perspective is that where these stocks go, the rest of the market inevitably follows, given their weight in the index and the growing importance of value-agnostic passive investment.

The mistake investors made a generation ago was to think that the big winners from the internet would be the companies that built its infrastructure. The likes of Cisco and Intel went to the stars but crashed back to earth when the scale of their over-investment became clear. Investors today are becoming increasingly concerned about the daunting gap that appears to be opening up between the revenue forecasts implied by the current breakneck AI infrastructure build-out and the actual sales that are likely to be delivered off the back of it.

Sequoia Capital's David Cahn thinks US$600 billion of annual revenue is required for a reasonable payback. But OpenAI, which dominates the industry's sales, has reached only just over US$3 billion. He reckons there might be a US$500 billion shortfall. Total annual investment in AI might top US$1 trillion by 2027, according to former OpenAI executive Leopold Aschenbrenner. This is a large sum - worth 3% of US GDP - and it easily outstrips both the Manhattan and Apollo projects, which at their peak reached just 0.4% of economic output - US$100 billion a year in today's money.

Comparisons to past investment bubbles

But spending US$1 trillion a year on AI investment, while dramatic, would not be unprecedented. In the five years to 2001, telecoms companies spent a similar amount. Many trillions are being spent on the green transition. For years, China has spent 40% of its output on investment. We borrowed 100% of our GDP in the Great War and then did it again 20 years later in the Second World War.

But the most salient comparison is perhaps with the British railway mania of the 1840s when a cumulative 40% of UK GDP was poured into the AI of the Victorian era. This was the equivalent today of US$11 trillion over a decade, roughly the run rate that's being forecast for the upcoming AI investment round. Nearly 200 years ago, this did not end well.

In the two years after 1843, according to bubble historian Edward Chancellor, the value of British rail stocks doubled. Hundreds of railways were proposed, with investment peaking at £40 million, or 7% of national income. Inevitably it turned out to be a massive misallocation of resource. There were three separate lines between Liverpool and Leeds, for example. To pay investors a satisfactory return, revenues and passenger numbers would have needed to rise five-fold in five years. Growth was overestimated and costs spiralled out of control. Dividends were slashed as returns collapsed. Within five years, railway shares had lost 65% of their value.

Technology bubbles are always subtly different, but they have shared characteristics. They latch onto a new technology about which vaunting claims can plausibly be made. Investors put to one side traditional valuation measures. A massive over-commitment of capital is made and poorly directed.

There is a key difference between the railways of the 1840s and AI today. When the mania took hold in Victorian Britain, the case for the new technology was already well understood. Railways then benefited from greater intrinsic pricing power than computer processing today because there is a physical limit to how many tracks you can lay between one place and another. Without this advantage, prices inevitably are competed down to their marginal cost.

Investors often underestimate the pace at which expensive kit becomes obsolete. Sequoia's Cahn said it well: 'speculative investment frenzies often lead to high rates of capital incineration'. Literally, money to burn.

The four phases of AI

Goldman Sachs has identified four phases in the AI value chain. Worryingly the investment returns are falling away fast from one to the next. Nvidia was phase one; year to date its shares have risen 165%. Phase two are the infrastructure builders creating the chips, data centres and large language models. The average stock in this group has risen 26% so far in 2024. But investors are sceptical about the returns in the later phases - the software firms in phase three have already provided disappointing forward-looking commentary about their ability to monetise AI. Phase four companies are those with the biggest potential earnings boost from widespread AI adoption and productivity gains. For them the wait goes on.

While share prices were heading higher, no-one was looking too hard at reasons not to believe. If the rotation of recent weeks persists, that willing suspension of disbelief could be tested. If you don't know how exposed your portfolio is to the AI story, now would be a good time to find out.

Tom Stevenson is an Investment Director at Fidelity International, a sponsor of Firstlinks. The views are his own. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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Short-term panics create opportunity in real assets

Joseph Taylor

Imagine you could dream up the perfect business to own for the rest of your life. What qualities would you want it to have?

If you could ask for *anything*, you'd probably want a monopoly of some kind. You'd probably want cash flows to be predictable rather than unpredictable. You might look for some protection against inflation. And while you're at it, you might as well chuck in some supportive long-term trends.

Infrastructure assets often combine all four of those qualities in one. Which makes it little surprise that a certain gentleman from Omaha seems to like them so much.

Warren Buffett's crown jewels

In Berkshire Hathaway's 2021 shareholder letter, Warren Buffett highlighted "four jewels" within Berkshire's collection of businesses.

- One was the company's stake in Apple, though Berkshire's reduction of this stake by 50% recently might cast some doubt on that.
- Another was Berkshire's insurance operations. These provide low-cost funds in the shape of premium payments than can be invested in advance of any claims being paid out. If the insurance firms can eek out an underwriting profit, the cost of these funds is negative.
- The other two gems – the Burlington Northern Santa Fe railroad and Berkshire Hathaway Energy – are infrastructure assets.

While Berkshire's two infrastructure jewels are unlisted, plenty of high-quality assets remain available for purchase in public markets. In a recent episode of Magellan's *In The Know* podcast, members of their infrastructure team shared lessons from 50+ years in the space.

The essence of infrastructure investing

"The essence of what we are investing in are assets with massive capital expenditure upfront, followed by a long series of very reliable, predictable cash flows", says Magellan's Head of Infrastructure Gerald Stack. "Our main areas are regulated utilities and transport assets like toll roads and airports."

The chief attraction of this kind of asset is the predictability of long-term demand and, therefore, their cash flows.

Unless humans stop drinking water, washing themselves or using toilet facilities, there will be a need for water and sewage businesses in the future. Meanwhile, rising populations and prosperity have historically led to more drivers on roads, more flights being taken and growing demand for energy.

My main question, then, would be this: how could investors ever find these assets at an attractive or reasonable price?

According to Magellan's team, the answer is that short-term panics often lead investors to forget how durable these assets and their demand trends really are. As Ben McVicar put it, *"Some interesting opportunities come out if you are able to look through short-term issues and project into the long-term what you've seen happen for the decades in the past."*

An obvious example of a short-term issue comes from Covid, when air travel fell towards zero before returning towards historical trends. But that was just the latest of many episodes, explains Ofer Karliner.

"If you look back at September 11, people were never going to travel again. Sure enough, within a few months, traffic was back on trend. In SARS, people were never going to go to Hong Kong again. In a few months, people were back travelling to Hong Kong like nothing happened."

Other situations where short-term uncertainty can reveal long-term value include concerns over regulation or a company's financial position. Investors can also be guilty of throwing the baby out of with the bath water, as happened with British water stocks in 2023.

Thrown out with the bath water

The opportunity arose after several operational and financial missteps by Thames Water, which serves around 25% of Britain's population and therefore has a big public profile.

"Thames Water has very serious balance sheet issues. They've got very poor operating performance metrics. Their regulated return on equity for the first few years of the current regulatory period is something anaemic like 1.9%. So it's absolutely tiny" says Ben McVicar.

Other British water utilities – like the publicly listed United and Severn Trent – have shown far better returns on equity, cleaner balance sheets and better service stats over time. Yet their stocks suffered as investors projected Thames' problems to other companies in the sector.

McVicar said the Magellan team felt that investors misunderstood the impact that Thames Water's travails could have on its better-run peers.

"The market said "Okay, you've got this problem with Thames Water, the government must therefore look at the rest of the sector and try to penalise [it]. If anything, it could give them an opportunity to continue to grow their asset bases. For most infrastructure businesses, that's the main growth engine".

Recognising these differences in quality and having a different take on the main issue bugging markets – the prospect of more investments in their service – served up what McVicar saw as a compelling opportunity.

"There were times last year where these companies traded at close to one times regulated capital value, which is not that typical for us".

A different perception of Capex

Stack sees the perception of capital expenditures as a key difference between infrastructure assets and investing in other companies.

As he put it, "you're providing an essential service in something like a monopoly setting. It's the CapEx that gives you the right to charge for that. Many investors get a bit scared when they hear CapEx. Our eyes tend to light up a bit."

This can lead to situations, like the UK water utilities case, where concerns regarding future CapEx weigh on a stock price yet actually provide an opportunity for the company to grow their earnings base.

Another example could be the US electric utilities and the huge investments they'll need to make to support any energy transition.

"These guys are not that heavily levered by global standards or by historical standards" said Ofer Karliner. "Yet people will look at them and say they've got to fund massive CapEx. People look at it as a problem, we see it as a massive opportunity".

The importance of incentives

Magellan's team also touched on the power of incentives to inform outcomes.

Examples here include pre-GFC utilities being managed by external managers compensated for how much and how quickly they could grow the asset base. Several companies, quite predictably, ended up with far greater asset bases and far too much leverage heading into the GFC.

More recently, huge cash rewards for investment bankers pitching toll-road deals to buyers led to aggressive traffic forecasts that ultimately disappointed. "Incentives drive behaviour" said Karliner. "Getting management wrong and getting their incentives wrong can have a material impact on your outcomes as an investor."

The most important lesson I took from the discussion, though, was the overarching opportunity to turn short-term worries to your advantage as a long-term investor. As Ben McVicar put it, "you're investing in high quality, reliable businesses. Short-term issues don't tend to sink the ship. They are just gate issues you've got to get through".

Joseph Taylor is an Associate Investment Specialist, Morningstar Australia and Firstlinks.

Here's a link to the full podcast from Magellan: https://magellan.podbean.com/e/lessons-learnt-from-investing-in-essential-services/

Why the RBA has been ineffective in curbing inflation

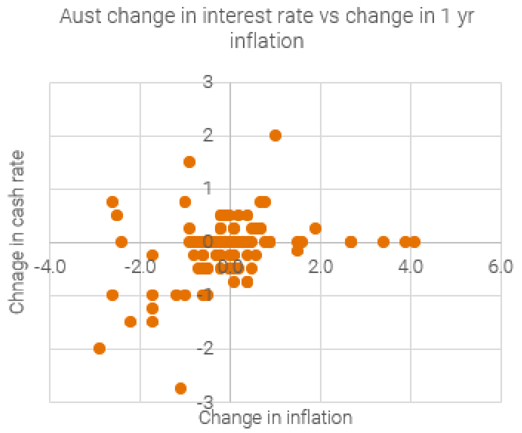
Chris Bedingfield

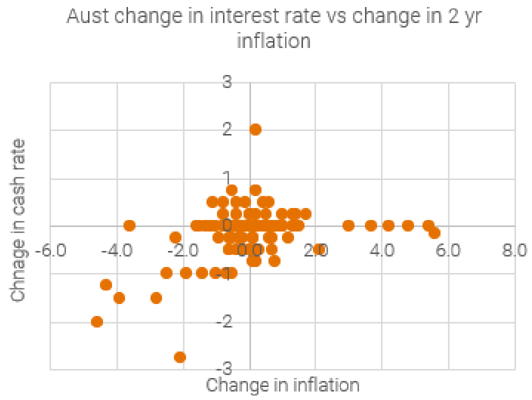
In the aftermath of the financial crisis, the monetary policy mantra was 'lower for longer'. In a post-pandemic world, that has been replaced with 'higher for longer' to keep inflation down.

One would think that if monetary policy worked, there would be no need to keep waiting 'longer' to get the desired policy outcome. Despite a zero-interest rate policy and unending quantitative easing (QE), Japan has waited 25 years for inflation to re-emerge. That policy was ineffective and talk about waiting a long time!

Even our own Reserve Bank of Australia (RBA) arguably falls into this category of ineffectiveness. After the recent June monetary policy decision, the central bank board indicated the economic outlook was "highly uncertain". This highlights a lack of confidence in the central banks' own framework and policy prescription for the current environment. This is of little comfort for the future 200,000 to 300,000 people targeted to lose their jobs in the name of its monetary policy prescription.

And that prescription may not work to lower inflation into the bank's 2 to 3 per cent target band. If anything, there appears to be a positive correlation between interest rates and inflation. That is, higher interest rates cause higher inflation, as the charts below suggest.



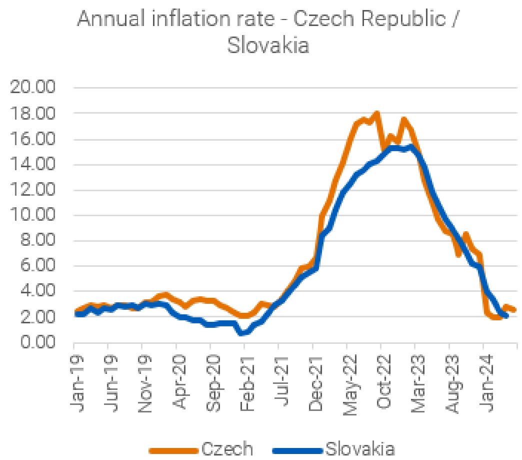


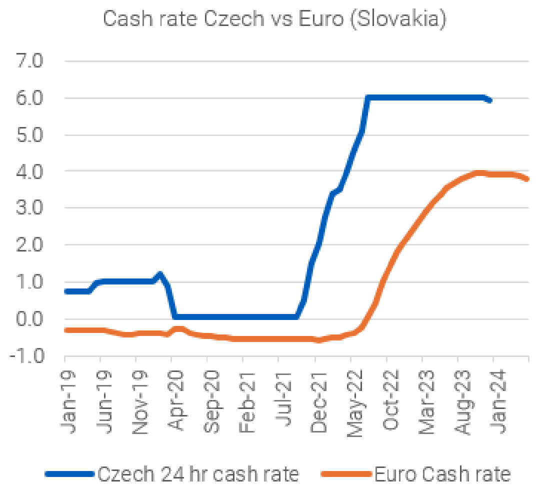
Source: ABS, RBA, Quay Global Investors

Other examples

Outside of Australia and the US, we have additional examples of the lack of effective impact of monetary policy. Japan is a classic case in point. However, we note some like to make excuses for Japan, such as its old demographics. But we can see inconsistencies between monetary policy and inflation just about everywhere we look.

Moving to another part of the world, the charts below highlight the data between the Czech Republic and the Euro member, Slovakia. Both countries share similar demographics and geographies. And as such, both had similar economic growth of around 1% gross domestic product (GDP) growth in 2023. Despite the delay in interest rate hikes in Slovakia, and a lower end cash rate, the inflation outcomes for both countries are identical. Surely, if interest rates worked effectively, these like-for-like examples would show different inflation outcomes.





Source: Fred, OECD, Quay Global Investors

Whether it's the US, Australia, Japan, Slovakia or the Czech Republic, the data simply does not support the idea that interest rates deliver desired inflationary outcomes.

Reasons why rates have little impact on inflation

Generally, there are three reasons for this. First, monetary policy advocates argue changes in interest rates impact borrowers; higher rates are negative, curb spending, and slow the economy with a corresponding decline in inflation, while lower rates are positive. However, as we have written previously in our Modern Monetary Theory Part 2 article, and as highlighted by the Bank of England, loans create deposits. That is, for every private creditor there is a private debtor. Therefore, any pain or benefit felt by a borrower from a change in interest rates is offset exactly by the pain or benefit felt by savers or deposit holders. Higher interest rate may hurt some, but it also allows other people with money to earn more money.

It’s little wonder then why, in the current rising interest rate climate, luxury retailers are trading so well while low-income retailers are struggling. From a private sector income flow perspective, monetary policy is like driving a car with one foot on the accelerator while the other is on the brake. Different dynamics are at work and it's not just a slowdown.

Second, higher interest rates add to the money supply. An emerging excuse for why interest rate policy is not working as intended is that the government is ‘spending too much’, which is working against the central bank’s actions. Of course, the main reason governments are spending is because of interest rate policy.

Take the US, for example. Like most countries, the US government has a net debt position. This means any interest paid is a net positive flow to the private sector. As interest rates increase, this flow accelerates, effectively becoming stimulus. In this context, is there any surprise the US economy recovered so strongly after the US Federal Reserve began to increase interest rates? And since GDP growth began to accelerate, inflation has declined.

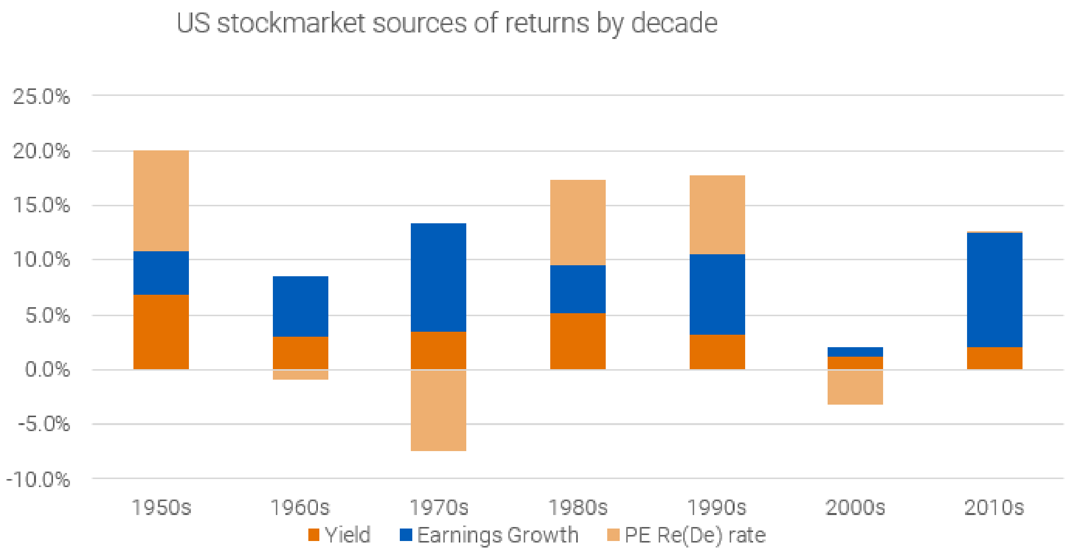
Finally, higher interest rates increase the cost of production and prices. One of the long-held economic beliefs is that higher wages lead to inflation. Quite often referred to as a ‘wage-price spiral’, the idea is simple enough. Higher input costs for businesses are readily passed onto consumers – who in turn demand higher wages, and so forth.

What is less discussed is businesses also have a ‘cost of capital’. Higher labour costs can be passed on, why not higher capital costs? We see this today in real estate, especially housing. Current interest policy has resulted in a higher cost of funding, and hence, making new projects less viable. Less supply results in higher prices and rents, feeding into higher inflation.

Best to ignore the RBA

The bottom line is that the use of interest rates policy as a tool for controlling inflation is an accident of history. It should, therefore, come as no surprise its track record is dubious, at best. At Quay, we never position for interest rate policy. It seems jumping from one policy statement to the next is not helpful when investing, especially when those making the statements are equally lost and confused as the impact of their own policy choice.

Instead, we fundamentally believe that buying high-quality companies with structural tailwinds and deep discounts is the best way to preserve capital and generate sustainable long-term returns. For long-term investors, interest rates matter far less than total returns driven by earnings growth and dividend yield. And if history is any guide (see the chart below), we’ll be proven right.



Source: Jack Bogle, Ben Carlson, Quay Global Investors

Chris Bedingfield is Principal and Portfolio Manager at [Quay Global Investors](). This article contains general information only, and does not constitute financial, tax or legal advice. It has been prepared without taking account of your objectives, financial situation or needs.