Firstlinks
a Morningstar company

Edition 604, 28 March 2025

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Editorial

With an election likely called any day, the 2025-26 Federal Budget was always going to be more of a political document than an economic one. So it came to pass.

Inevitably, it sought to address a key sore point for voters: the rapid increase in everyday costs over the past 2-3 years. And it tried to do this without blowing a hole in the Budget. Hence, why the Treasurer Jim Chalmers has sold the measures as “modest but meaningful” relief for households.

The key surprise from the Budget was a promise to deliver personal tax cuts for all Australians. Most of the other measures were announced earlier.

Let’s look in more detail at the key Budget initiatives:

Cost-of-living relief

- **Tax cuts:** the marginal tax rate for the bottom tax bracket will be lowered from 16% to 15% from 1 July 2026 and then to 14% in 1 July 2027. It will give an average wage earner an additional $268 a year in 2026-27 and $536 a year in 2027-28. The measure is expected to cost $17.1 billion. Here’s how it will look for each tax threshold:

Current rates	
taxable income up to $18,200	nil
taxable income of $18,201 to $45,000	nil plus 16% of excess over $18,200
taxable income of $45,001 to $135,000	$4,288 plus 30% of excess over $45,000
taxable income of $135,001 to $190,000	$31,288 plus 37% of excess over $135,000
taxable income of more than $190,001	$51,638 plus 45% of excess over $190,000
Proposed rates 2026–2027	
taxable income up to $18,200	nil
taxable income of $18,201 to $45,000	nil plus 15% of excess over $18,200
taxable income of $45,001 to $135,000	$4,020 plus 30% of excess over $45,000
taxable income of $135,001 to $190,000	$31,020 plus 37% of excess over $135,000
taxable income of more than $190,001	$51,370 plus 45% of excess over $190,000
Proposed rates 2027–2028	
taxable income up to $18,200	nil
taxable income of $18,201 to $45,000	nil plus 14% of excess over $18,200
taxable income of $45,001 to $135,000	$3,752 plus 30% of excess over $45,000
taxable income of $135,001 to $190,000	$30,752 plus 37% of excess over $135,000
taxable income of more than $190,001	$51,102 plus 45% of excess over $190,000

Source: Australian Treasury, Firstlinks

- **Energy bill relief:** every household to get $150 off their power bills over the next two quarters.

Health

- **More bulk billing:** incentives for doctors to increase bulk billing, costing $8.5 billion over four years.
- **Cheaper medicines :** Pharmaceutical Benefits Scheme (PBS) medications will be capped at $25 each, down from $31.60.
- **Public hospital funding:** a one-off injection of $1.8 billion to public hospitals nationally.
- **Urgent care clinics:** 50 new Medicare Urgent Care Clinics to open across the country.

Housing

- **Help buying a house:** an additional $800m will go towards expanding the Help to Buy scheme by increasing the income caps for eligibility to $100,000, from $90,000, and $160,000, from $120,000, for single and joint applicants, respectively. Under the Help to Buy Scheme, the Government provides first home buyers with between 30-40% of the purchase cost of a property, with only a 2% deposit required from a buyer. It's capped at 10,000 places per year.

Childcare

- **Three day guarantee:** most families will receive three days of subsidised childcare per week from January 2026, at a cost of $427 million.

Education

- **Student debt cut:** those with HECS and HELP debts will see a 20% reduction in what they owe.
- **National school funding:** a plan to fully fund public schools in line with the 2011 Gonski review recommendations, costing $406 million over the next four years.

Infrastructure

- **Bruce Highway upgrade:** Queensland's major highway gets a $7.2 billion redevelopment.
- **Melbourne Airport Rail link:** an upgrade to Sunshine station will cost $2 billion.

Communications

- **NBN expansion:** 622,000 premises will get full fibre access to the NBN, costing $3 billion over seven years.

Savings

- **$2 billion in cutbacks:** there are cuts to consultants to Government and "reprioritising" spending.

Deeming rates

- Another freeze to these rates.

One important thing to note from the Budget was a 'non-announcement'. There were no changes to the proposed revenue that the Government is expecting to raise from the proposed $3 million superannuation tax. This would suggest that it's still on Labor's agenda, should it win the election.

But the Division 296 bill is still in the Senate currently, and if the election is called before the measure is passed, the bill will lapse and it will need to be reintroduced in Parliament after the election.

Economic assumptions

The Government forecasts a pick-up in economic growth, despite current uncertainty from Trump's tariff measures. It predicts GDP growth will increase from 1.5% this financial year, to 2.25% next year, and 2.5% and 2.75% in the 2027-28 and 2028-29. These forecasts, especially in later years, look a stretch given the tepid growth of recent years.

The Government sees inflation remaining in the 2-3% target range, helped this year by energy subsidies reducing CPI by around 0.5%.

It's marginally reduced unemployment forecasts to 4.25% going forward.

And, interestingly, there are large falls expected with immigration numbers in coming years. The Government expects net immigration of 335,000 this financial year to drop to 225,000 in two years' time. If right, that would mean population growth would fall to 1.2% in 2026-2027, from a peak of 2.4% in 2022-2023.

The Government has kept its medium-term iron ore price assumption at $US60/tonne. With iron ore are closer to $US100/tonne, this remains a source of potential upside for Budget revenue over the next few years.

Economic assumptions

	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Real GDP (%)	1.4	1.5	2.25	2.5	2.75	2.75
Inflation (%)	3.8	2.5	3.0	2.5	2.5	2.5
Wages (%)	4.1	3.0	3.25	3.25	3.5	3.75
Unemployment rate (%)	4.0	4.25	4.25	4.25	4.25	4.25
Net migration	435,000	335,000	260,000	225,000	225,000	225,000

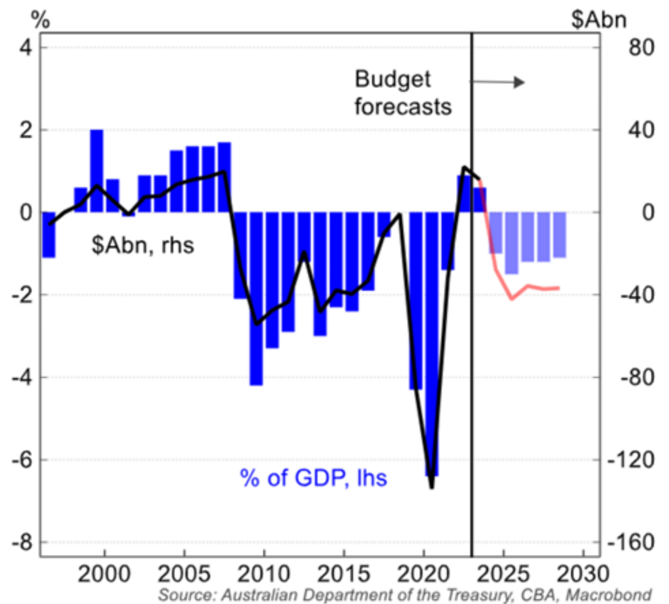
Source: Australian Treasury, Firstlinks

Budget position

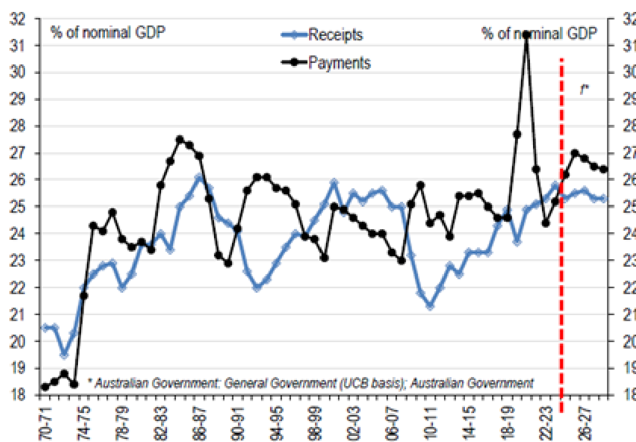
Over the past two years, the Government has delivered two consecutive Budget surpluses, thanks to extra revenue from tax receipts due to higher employment and better-than-expected commodity prices.

The Government forecasts that the surplus will disappear and there'll be deficits equivalent to 1% of GDP in 2024-25 and 1.5% in 2025-26. That's primarily down to the conservative iron ore prices assumed, as well as the increased spending initiatives.

Economists have bemoaned the forecast of deficits for the next decade as well as the increased spending as part of that. Indeed, spending is expected to rise by 8.7% in 2024-25 and by an average 5.5% over the five years to 2028-29.

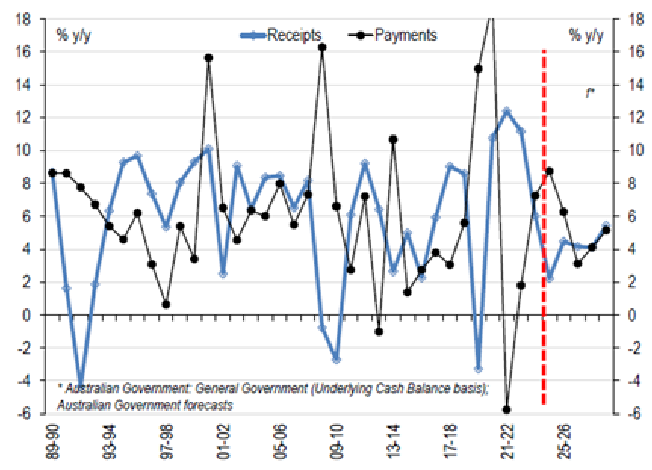


Payments are expected to rise sharply to 27.0% share of GDP in 25/26 (was 27.2%), around the highest on record (ex COVID)



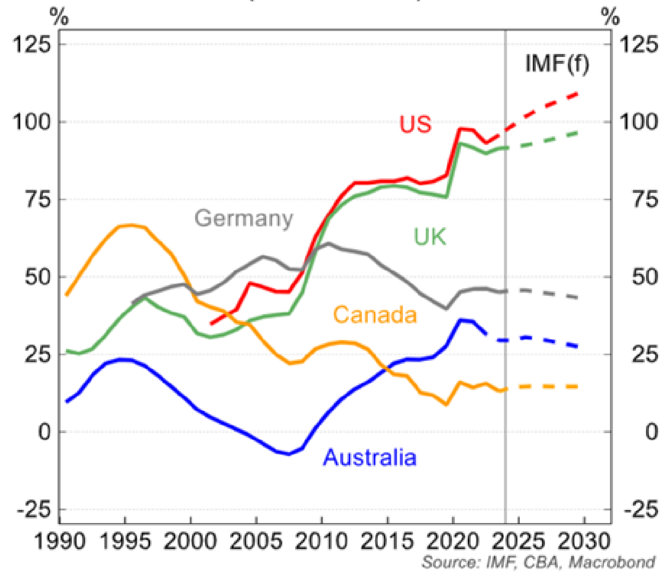
Source: Australian Government, Macrobond, UBS

Payments (i.e. spending) in 24/25 to boom 8.7% y/y; & average a strong 5.5% y/y over the 5-years to 28/29



Source: Australian Government, Macrobond, UBS

The economists have a point, to a degree. However, the deficits are still relatively low and Australia's debt-to-GDP also remains healthy when compared to other OECD countries.



Impact on investors

The main takeaway from this Budget for investors is that the tax cuts and other initiatives may boost consumer spending. That could help retailers and other companies on the ASX exposed to domestic spending.

Of course, the big shadow looming over this Budget and markets is the impact that Trump's tariffs will have on global trade and economic growth.

My two cents

I'm not as concerned as most about the deficits. Yes, we've had good times which have brought in higher-than-expected revenue and it would be good to put more aside for a rainy day. But the deficits are still relatively small and manageable.

A much bigger issue is that the Budget doesn't do anything to promote business and economic growth. Business growth is the backbone of the economy. Without it, there are less jobs, less taxes and less money to pay for public goods and services. And a lack of business investment is the key reason why Australia's real GDP growth has stalled over the past decade.

Earnings growth for ASX 200 companies has also flatlined during the past three years because costs have risen more the revenues. To address this, we need to cut red tape, reduce energy prices, keep wages growth in check, and promote innovation and research and development.

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It strikes me that many people live according to others' expectations of them, leading to poor choices including with their finances. My article this week looks at how you can live life by design rather than by default.

James Gruber

Also in this week's edition...

The recent market dip has naturally got many investors thinking about how resilient their portfolios are and whether they need more defensive exposure. **Jamie Wickham** offers a timely overview of the different defensive asset classes and how they might help deliver on your goals and increase the reliability of your desired outcomes.

While on the topic of defensive assets, the Government has not-so-subtly been pushing for lifetime income streams as a potential solution to retirement income challenges. A common question from Firstlinks readers has been: what are the hard numbers that annuities can deliver for retirees? **Kaye Fallick** has followed up and done the maths, and what's she's discovered is that apples-to-apples comparisons are tough and the Government should perhaps be prioritising other, more pressing problems.

Hybrids have been a defensive go-to asset for many investors, but now they're being phased out, what are the alternatives to replace them? One is subordinated debt, and **Macquarie Asset Management's Blair Hannon** provides a useful primer on what this debt entails and what role it can play in portfolios.

The Big Four banks have had a recent reality check after they delivered staggering shareholder returns of 33% in 2024. **Airlie's Jack McNally** drills into the fundamentals to see whether value is emerging in these banks.

Europe is back! After badly trailing many markets over the past decade, especially the US, Europe has roared back to life in 2025. **Alantra's Francisco de Juan** and **Jacobo Llanza** believe the rally is sustainable because Trump has awoken European Governments, which are now determined to both increase spending in areas such

as defence and explore ways to insulate themselves from the impact of Trump's tariffs. They think European small caps are likely to soon follow larger caps higher.

Founder-led companies have been in the news of late for all the wrong reasons, as Mineral Resources and WiseTech deal with governance issues surrounding Chris Ellison and Richard White. **Lawrence Lam** delves into the attractions and challenges of investing in founder-led companies and how to identify those that will succeed in the long-term.

Lastly in this week's whitepaper, **RQI** extends its previous paper on extreme market concentration and looks at the implications for Australian and Emerging Markets' equity investors.

Designing a life, with money to spare

James Gruber

Recently, I was listening to an interview with writer, Pico Iyer, and it struck me like a lightning bolt: Iyer had managed to do what few people have, and that is to design the life that he wanted.

In his 20s, Iyer was living the high life, employed as a travel writer and venturing to all parts of the world, while also living in New York and having a wide and active social life. Yet, he realized that wasn't the life that he wanted. He wished to be an independent writer that earned enough to get by, and he craved a quieter life outside the bubble of New York. He ended up marrying a Japanese woman and dividing his year between two homes, one in a small town in Kyoto and another in California.

Iyer largely organized his life around three things: his family, writing, and his quest for solitude. And he prioritised times of solitude because he believed they made him a better husband, father, and writer.

What stood out was the contentedness and wisdom that came from Iyer making these choices.

And it quickly dawned on me that I wasn't living my life exactly the way that I wanted. Like a lot of people, I'd made conscious and unconscious decisions that had led me to living parts of my life that met others' expectations, but not my own.

From a court through to Firstlinks

Regular readers would know that I mostly grew up on a tennis court. I was always an introvert so the sport suited me well. Yet, that didn't prevent me from being a ratbag on the court. Think John McEnroe, and I'm not exaggerating. Tennis seemed to bring out an extreme level of competitiveness and perfectionism in me.

Those traits served me well, to a point, in tennis, and then later as I took education more seriously, and entered the workforce.

In my first job as a journalist, I was ambitious, and after a time when I didn't rise up the ladder as quickly as I wanted, I switched into a growing interest of mine: finance.

My new field of work as an analyst at a stockbroker delivered competitiveness, on steroids. It was a few years before the 2008 GFC, when the finance industry was wild and bubbly.

The crisis changed all that, of course, and I soon switched into funds management, determined to carve out a high-flying career there.

I remember having an offsite with my equities fund team, and we were discussing what our goals should be – a mission statement. Everyone's view was sought, and when it came to mine, I said, "To be the best fund manager in the industry", or something similar. Then, a more senior team member had the floor and suggested, "To help our clients fulfill their financial goals." It quickly dawned on me how inadequate my answer had been. The competitive beast from my tennis days hadn't diminished.

Then, something life-changing happened: I got fired from my job. Though no fault of my own, it hurt and made me angry, and those emotions lingered for a long time.

Driven by the hurt, I tried various business ventures before eventually figuring it what I really wanted to do: have a job that enabled me to write about finance, with the flexibility to also be an active father to my two young children.

That’s how I ended up applying for a role at Firstlinks, and though I was a little unsure, my wife piped up and said, “You’re made for that role.” She knew me well.

Lesson learned

What I’ve slowly come to realise is that when taken too far, competitiveness has a dark side: it leads to choices which can help you climb the corporate or life ladder but may not suit you or your circumstances; it results in you not being the nicest person; and it’s deceptive because it makes you feel in control of your life, though what you’re really doing is trying to be better than other people, and being acknowledged as such *in their eyes*.

In other words, competitiveness can lead to a life where you’re trying to meet others’ expectations as much as your own.

Though this is my story, I don’t think I’m alone in living parts of my life to meet someone’s, or society’s, expectations. Often without knowing it, we are creatures of the environments in which we live – in its attitudes, mores and expectations.

I recognize now that though I have work that suits me and I’m an active father, there are other aspects of my life that should be prioritised. There’s a creativity that needs to be further nourished (I’d argue competitiveness can prevent you from seeing the beauty in things, including art) and, like Iyer, a yearning for moments of solitude to balance out the hecticness of family life.

Having a life plan before a financial plan

The lessons flow through to investing. For me, taming my competitiveness has meant lowering my expectations for portfolio returns. I no longer try to 'shoot the lights out' with my portfolio, aiming instead for above average returns, and am ok with even average returns.

I’ve now to come to think that extreme competitiveness can result in poor portfolio decisions. I’ve seen many hedge funds try for market-leading returns by taking on more risk through leverage, market concentration and other tools, only for them to blow themselves soon after. Of these funds, even the ones that do deliver great performance in one year seem to give that back and then some in the following years.

There’s a larger learning here too. And that is, you need to have a life plan before a financial plan. Having financial goals without having life goals is worthless.

You don’t have to take my word for it. The greatest of all investors, Warren Buffett, was working under his mentor and hero, Benjamin Graham, in the early to mid-1950s when he realized that he couldn’t be happy or be the best investor he could be while living in New York. He subsequently went back to his hometown of Omaha, set up a hedge fund at the tender age of 26, and the rest is history.

Buffett knew much earlier than I did that a life plan needs to come before a financial plan.

James Gruber is Editor at Firstlinks.

A closer look at defensive assets for turbulent times

Jamie Wickham

With financial markets again experiencing turbulence, it is timely to take a closer look at the defensive asset classes – what they are, why you hold them, and how you can use them to both deliver on your goals and increase the reliability of your desired outcomes.

It’s fair to say eyes typically glaze over when bond markets come up in conversation. Unlike the dazzling and high-profile world of equities that tends to dominate the daily headlines, bonds are frequently cast as necessary but boring infrastructure in diversified portfolios.

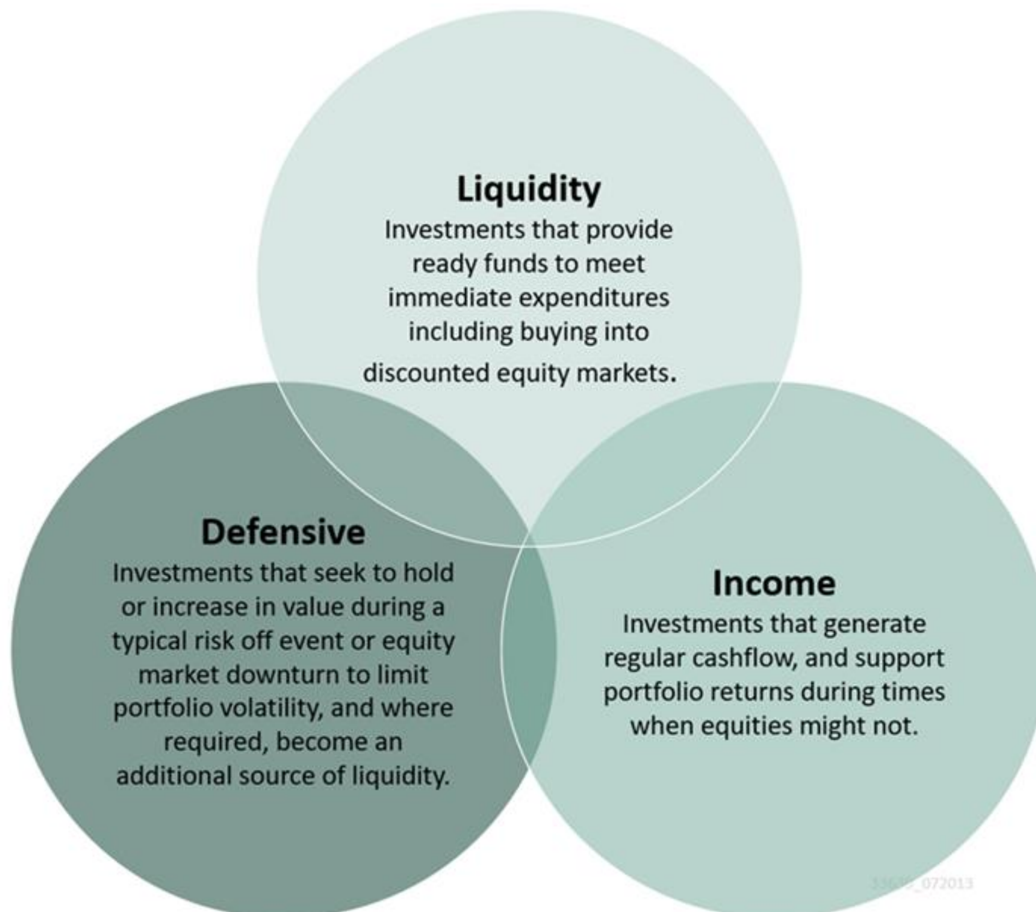
But the truth is that there are a lot of nuances to defensive investing that if overlooked can deprive you of the tools necessary to solidify your portfolio and ensure it behaves as expected, particularly during more volatile periods as we have seen recently.

To return to the analogy of my previous article, bonds are akin to the foundations of a house, providing the structure upon which everything else rests, while playing multiple roles of their own in ensuring ongoing liquidity, generating income and offering defence.

So using a top-down approach, can help fine-tune your approach to the defensive part of your portfolio. The aim here is to add flexibility, while improving intended outcomes – not just in terms of returns, but in bolstering reliability, predictability and providing peace of mind.

Start with the objectives

To start, lets disaggregate the defensive part of your portfolio into three objectives:



Source: Minchin Moore Private Wealth

There are a couple of points about these three objectives that can be overlooked. First, no single investment will fulfill all these roles all the time. Second, the three objectives and the investments that meet them aren't mutually exclusive. There will be some overlap.

Just look at the options. Investors can employ a mixture of cash, term deposits, bank bills, corporate bonds, floating rate securities/hybrids, and fixed term and rate government bonds. Securities can be issued locally or offshore. As well, they can be directly held (such as hybrids and ASX-listed, Australian Commonwealth Government bonds) or via a managed fund or ETF, which is often diversified based on an indexed mix of issued securities.

Let's map the three core objectives to specific investments:

1. Defensive – government bonds (Australian and international)
2. Income – hybrids and short duration, floating rate credit
3. Liquidity – cash and term deposits

Using this framework, you can enable *targeted and controlled* exposure to the three objectives via each component of the 'debt investment' universe. In contrast, a standard diversified, bundled mix such as the global aggregate bond index may not deliver as intended during different market cycles.

Source: Minchin Moore Private Wealth

The problems with bundles

While convenient, bundled bond investments combine both higher yield securities (e.g. less defensive corporate bonds) with more defensive securities (e.g. lower yielding government-issued bonds) in mixes that evolve with issuance.

Further, the characteristics of bonds in the index vary greatly in terms of issuer credit quality, term to maturity, coupon level, and interest type (fixed or floating). The frequent result here is a portfolio whose behaviour changes markedly depending on market conditions and macroeconomic drivers.

This can create some challenges. In an equity downturn, government bonds are often more sought after, while corporate bonds can be less likely to increase in value. Holding these different types of bonds together in a pooled fund can therefore mute the defensive role of the asset class.

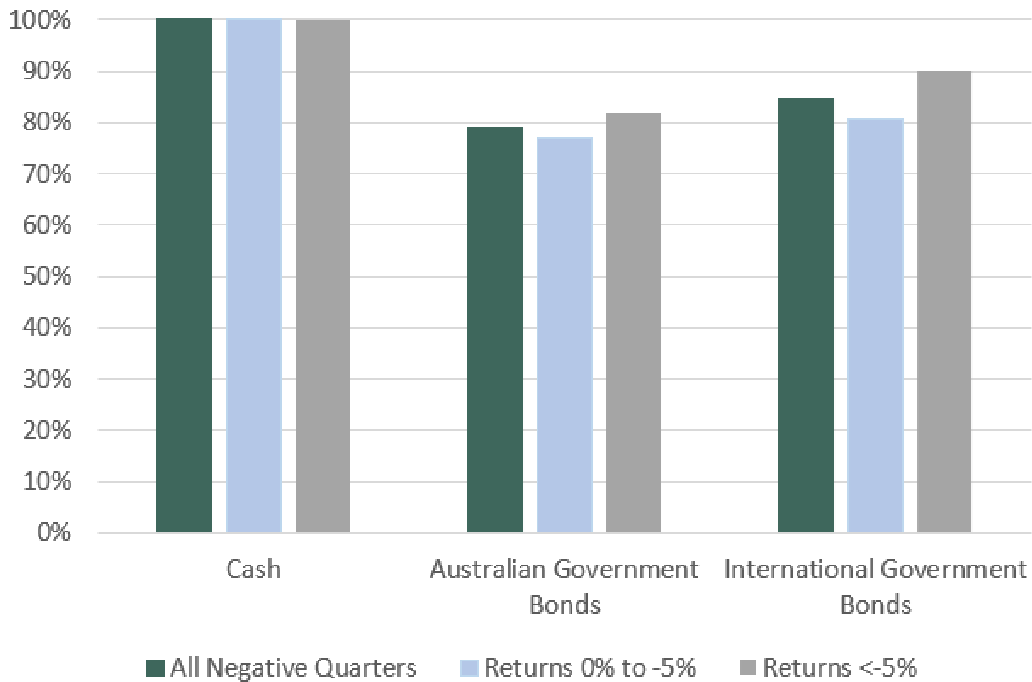
Investing in an index also means you lose control of composition. The mix of government and corporate bonds on issue changes over time, as does the interest rate duration of the index.

The equity vs bond correlation debate

Since 2022 – a year when equities and bonds both experienced negative returns – there has been debate about whether bonds remain an effective defence against equity market volatility. Some observers have even read the last rites for the traditional 60/40 balanced portfolio.

We don’t agree. The fact is special circumstances combined in 2022, including the inflation breakout post-COVID and subsequent aggressive interest rate increases from central banks. In fact, our research shows that over the last 30 years, government bonds have demonstrated positive returns approximately 80% of the time when Australian shares have been down over a three-month period (a period long enough to spark investor angst). Not perfect, sure, and there will be outliers like 2022, but most of the time such as in the current environment, bonds play their role.

Why not just use cash? Because while cash holds it value 100% of the time, its expected returns over a long horizon are lower than for credit and bonds. Furthermore, the expected returns from bonds during periods of equity market drawdowns is higher than cash because bonds have the potential to increase in value whereas cash does not. Of course, you should have a cash allocation (for reasons tied to the liquidity objective), but there is an opportunity cost to holding too much.



Source: Minchin Moore Private Wealth

The case for going direct

For those with larger portfolios and willing to be more hands-on in managing them, holding securities directly can provide additional benefits in the form of lower costs, increased flexibility and more reliable income. Owning domestic securities directly, rather than in a pooled vehicle gives you that control, while avoiding issues related to fund accounting treatments.

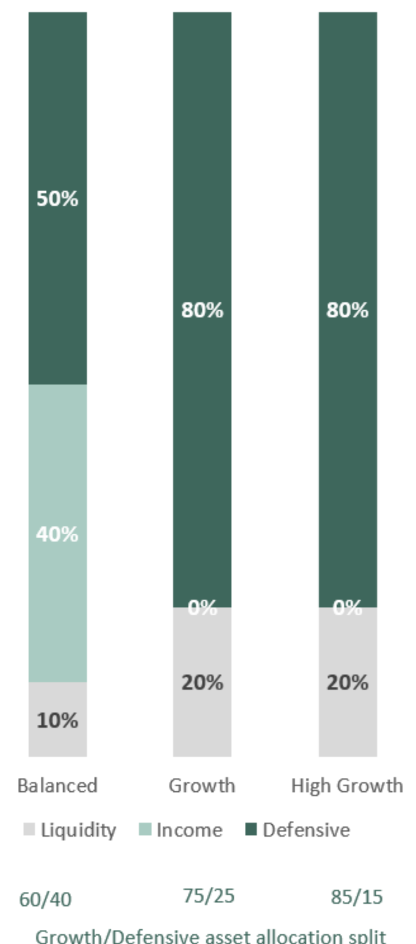
With their benefit of yield and franking credits, hybrids are still favoured by many retail investors to meet their income objectives. While it looks almost certain APRA will phase out hybrids, there will be alternatives such as subordinated debt and corporate bonds. No doubt product providers are working in the background to make them more accessible.

For the defensive objective, ASX-listed, Australian Commonwealth Government bonds are available today. Owning a portfolio of these bonds gives you the flexibility to control for duration and tailor this defensive exposure to your needs.

As always, the usual rules of portfolio management apply – have a clear investment program and objective, be well-diversified (including international exposure via a managed investment) and systematically rebalance periodically to keep your portfolio aligned with your program.

Tailoring allocations to objectives

Combining these objectives in your portfolio should be tailored to reflect your priorities. This graph provides an example of the percentage to allocate to each of the three objectives - for a balanced, growth or high-growth portfolio.



For the 60/40 portfolio, typically held by more risk-averse investors and those relying on cashflow, a blend of defence and income is prioritised.

For investors with 75%+ in growth assets, in contrast, the defensive role in periods of market stress becomes the priority. The composition of these portfolios prioritises compound growth and a longer time-horizon, with less need for cashflow. Liquidity/cash provides additional protection and flexibility when it comes to portfolio rebalancing and investing in equity market downturns.

Summary: The benefits of tailoring

If cash and debt investments play multiple roles, it makes sense to deploy a tailored, flexible approach that maximises your control in this part of your portfolio.

If anything, recent market volatility reminds us of the importance of paying attention to these nuances to optimise your portfolio and outcomes.

To recap, the benefits of this tailored and nuanced approach include:

1. Design flexibility, enabling you to better balance the sometimes-competing objectives of liquidity provision, income generation and ensuring a defensive cushion in an equity downturn.
2. Taking a disaggregated approach will allow you to more directly control your exposure to key factors, including credit and duration.
3. Shifting to direct investing will provide a closer connection to income, increase reliability of cashflows and cut fees. Given the lower expected returns from defensive assets, it is even more important to save every possible basis point.
4. More effective and efficient rebalancing of portfolios, particularly during periods of volatility. Rebalancing is critical in ensuring your portfolio doesn't drift and expose you to greater risk and volatility than what you originally intended.

Jamie Wickham, CFA is a Partner at Minchin Moore Private Wealth and former managing director, Morningstar Australia.

Are lifetime income streams the answer or just the easy way out?

Kaye Fallick

Will lifetime income streams solve the challenges of meeting the Retirement Income Covenant? Or does this 'solution' raise more questions than it answers?

There's a reason why I find lifetime income streams difficult to understand and write about. And that's because they are. Yet this third level or 'bucket' of retirement income seems to be the preferred 'next wave' of retirement funding, as evidenced by the strong support of the Australian Government.

But can these products really be the answer, when so many questions about them remain?

I approached this article with a rather contradictory attitude.

Firstly, a hunch that the emphasis on lifetime income streams as a way to solve many retirement income issues for ordinary Australians was misplaced. And secondly, a determination to ignore this hunch and to try to explore these products with as open a mind as possible; to better understand if they do indeed meet the 'fear of running out' and will therefore become a valuable part of the retirement income system.

The Government push

Lifetime income streams have been in the news a lot lately. These 'longevity protection products' are described as a 'central component of … retirement income strategy' in the not-so-secret Treasury draft paper on 'best practice for superannuation retirement income solutions'. They are also part of a 'big push' by the Grattan Institute for government guaranteed products in its recent *Simpler super: taking the stress out of retirement* report.

The subtext here is that the greatest fear of retirees is running out of money and so they won't spend what they could. Or, by refusing to spend enough and leaving overly large bequests, retirees are deliberately 'gaming the system'. Ergo, guaranteed income through a product that is largely spent down while they are alive must be the solution.

But this emphasis on lifetime income streams as a fundamental part of retirement income is erroneous. It pushes retirees straight to step five of a logical retirement income journey, without first securing steps one to four - those most relevant for about 70% of Australians. These steps are:

1. understanding super
2. understanding how super combines with an Age Pension,
3. understanding work options after 60 and how work income can affect both super and Age Pension entitlements, and
4. knowing how the family home can also be accessed as a source of funding.

Each one of these four steps is interrelated, so there is a lot to understand here. In reality, they represent Retirement Basics #101. And that's before contemplating the later life need to contribute to aged care, whether at home or in a residence.

So how can any single specific income stream really be 'the answer' to all the various challenges throughout a long retirement journey?

Further questions about lifetime income streams were usefully identified by Professor Ron Bird in an article published in Firstlinks on 12 February. One of his main concerns is that there is a distortion of forced accumulation and spending, asking why Australians should be forced to spend to a certain level if they 'just don't want to'? Professor Bird's conclusion is that "our current system is able to adequately fund retirement, but it is not working to the lifetime benefit of all."

Running the numbers

As part of my preparation for this article, I approached two product suppliers and asked them to run some numbers for me on a fictitious couple, Barbara and John, aged 70 and 78, who had about the median amount of super ($400,000) and received a full Age Pension. The plan was to test how an investment of half the amount in their Account-Based Pension (i.e. $200,000) would work in an annuity or lifetime income stream.

It didn't work that well. To be fair, it was probably not a useful example as the assets of this couple were too low. I had hoped for an apples with apples comparison, but the two different companies were offering different solutions, with different features, so I am none the wiser. I'm grateful to Patrick Clarke from Genlife and Aaron Minney from Challenger for running calculations and explaining the many different benefits and variations. And both sets of calculations showed a reliable annual income of between $11,000 - $14,000 for the couple through to their 90s. Did one product offer a better outcome than the other? Not as far as I could ascertain, it depended on too many different factors. And therein lies the problem.

The one thing I do now clearly understand now is why these product providers insist their products are sold by a financial planner. They are just too complex for most retirees to make sense of by reading a PDS or researching online.

It also occurred to me as I struggled to understand the many details of these income streams that the $200,000, if left in an Account-Based Pension, might just earn more and be less trouble and more accessible while still able to be left to nearest and dearest.

I also asked independent analyst, Harry Chemay, how he thought an everyday retiree might compare lifetime income streams or annuities:

> *'The problem is that these products are complex by nature and require a level of explanation that is often hard to convey purely online. It is thus hard for retirees to compare the features and benefits of different products to determine if one might be appropriate for their circumstances.*
>
> *A further complication is that these products may interact with and impact the Age Pension benefit, and understanding how is vital to any individual or couple considering a lifetime income stream. Because of the complexity involved, people may need to seek financial advice on whether and how lifetime income stream products should be considered in their retirement planning.'*

Another problem is whether there is a potential conflict of interest when white label products are positioned as 'chosen' by a fund and promoted as a single choice lifetime income stream solution without offering any other similar comparisons?

But not every retiree really wants to manage their own money and that's a good call to make if they do not feel up to the task of ensuring their own best returns over the long years of retirement. Some individuals are keen to achieve a guaranteed income and lifetime income streams can offer this low-risk income, with the added benefit of favourable Centrelink treatment.

So, where have I landed?

I now know a lot more about lifetime income streams, but not enough to say I understand them well. Sadly, the more I learned, the more questions arose.

I can see why they could be appealing to those wanting the 'problem' of managing their retirement income to simply go away. But as per my less than useful example of Barbara and John, you have to have sufficient assets to make the exercise of evaluating them with a financial planner worthwhile.

Regardless, the main problem hasn't gone away. Retirement funding is still a compulsory, largely 'hands-off' system where someone else will manage your funds for you for the 40 or so years of accumulation. And then, with little in the way of warning, support or preparation, you're tossed out on your own to manage and navigate the five separate pillars of retirement income during 30+ years of decumulation. And, worse still, to understand how these pillars can combine in the most tax-effective, risk-controlled way.

I still believe that the most urgent need right now is a three-step educational program which offers:

- prompts at trigger ages and stages, commencing at age 50
- training in how super and the Age Pension combine, before preservation age, delivered by workplaces and local councils
- reminders of your broad options as you age, including what to read, who to see, who can help?

Only when we have successfully supported a majority of Australia's retirement cohort to fully understand the way their super, savings, work and home might combine with an Age Pension, will today's retirees have the basis for understanding the many features of lifetime income streams as an add-on layer to their Account-Based Pension.

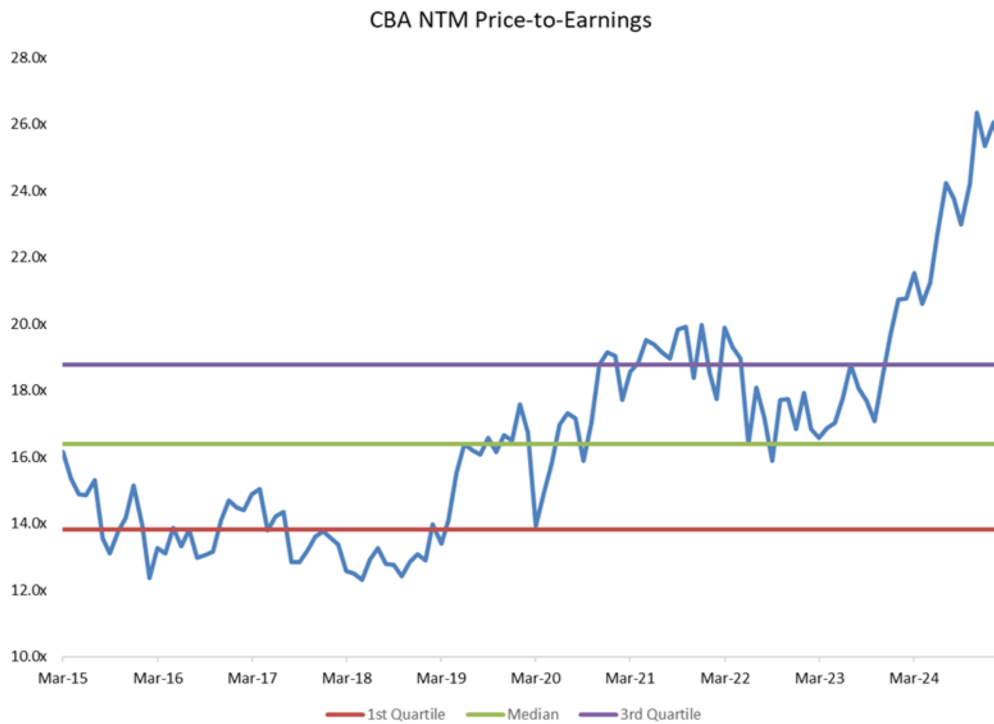
Which means, there's a long, long way to go.

Kaye Fallick is Founder of STAYINGconnected website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.

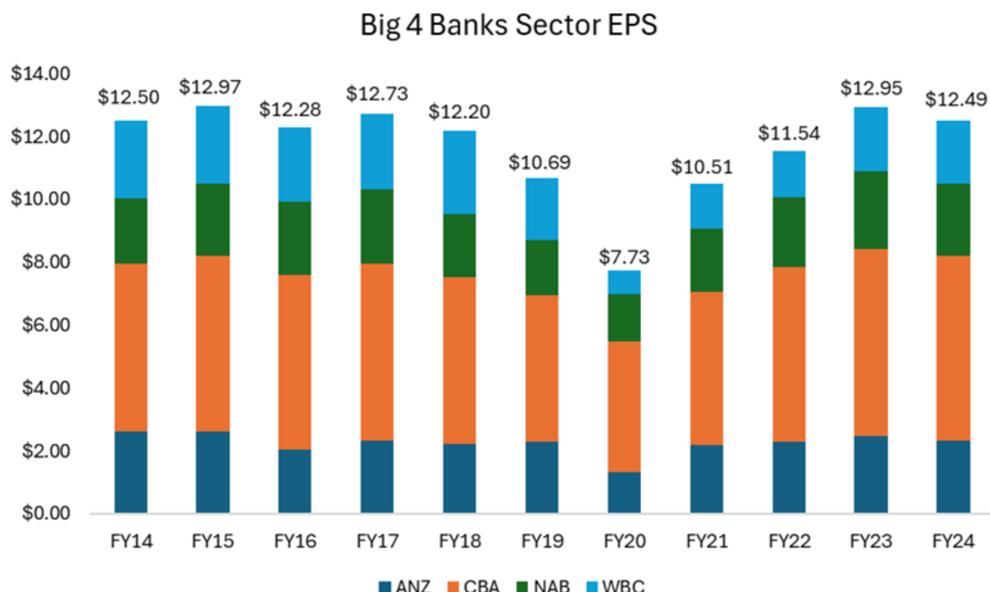
Is it time to buy the Big Four banks?

Jack McNally

The banking sector enjoyed an extraordinary rally in 2024, with the Big Four Banks delivering an average total shareholder return of 33%. As recently as February, Commonwealth Bank (CBA), for instance, enjoyed a price to earnings multiple of 26x- a 60% premium to its historical average. This raises an important question: are these valuations justified for a sector that has not grown its overall earnings per share over the last 10 years?



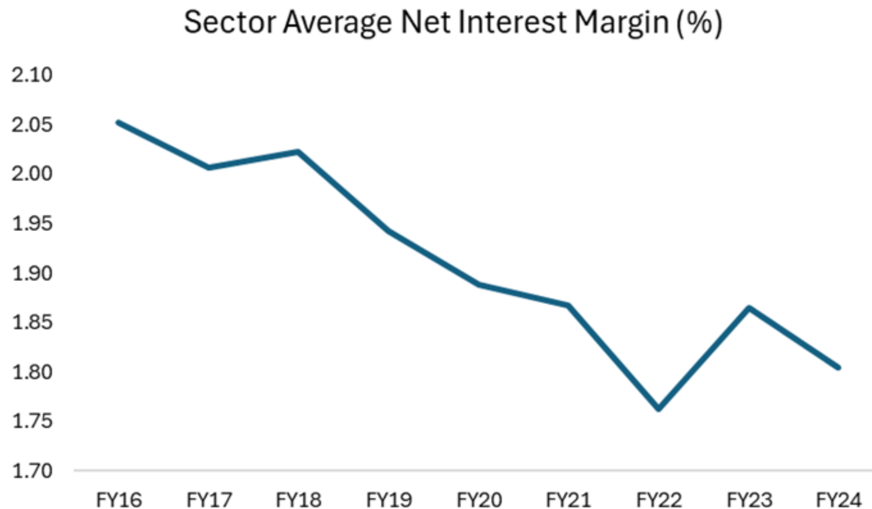
To look at this in another way, you can see in the chart below that the collective earnings of the Big Four are only today back to where they were in 2018. Yet if we add up the cumulative share prices of the banks, you're paying $233 in total for all four banks versus $157 in 2018 for the same level of earnings. And this is after the recent share price rout; at the banks' peak in February, you would have paid a cumulative $276 for these earnings.



Are banks really making more money? The net interest margin story

At its core, banking profitability hinges largely on a single key metric: Net Interest Margin (NIM). This is the difference between what a bank earns on loans and what it pays on deposits. The higher the margin, the more profitable the bank.

However, over the past few decades, this margin has been steadily shrinking. This decline has been driven by three key structural changes in the industry:



1. Mortgage brokers

Over the past decade, the share of mortgage broker-originated loans has surged from ~50% to 75%, significantly squeezing bank margins. Banks pay the broker a large upfront commission of ~0.65% of the loan value ($6,500 for every $1 million lent) and a trailing commission of 0.15% per year. Moreover, because brokers focus on securing the lowest possible rate for customers, mortgages have become increasingly price-driven, reducing banks' ability to charge more favourable rates. Since brokers earn their largest commission when writing a new loan, they have an incentive to refinance customers regularly, which further erodes bank margins. The Commonwealth Bank estimates that the broker channel is 20-30% less profitable than a loan originated through a bank's proprietary channel.

2. Entrance of Macquarie

Over the last decade, Macquarie Group has entered the banking sector, employing a digital, broker-led model where it can operate a lean model without the tech debt and branch costs of its traditional competitors. The company has successfully grown its share to ~5% and its ease of use has made it popular with brokers. Unlike the major banks, Macquarie doesn't need to maintain a constant presence in the mortgage market. It has entered when risk and pricing are attractive and exited when margins tighten, making it a highly agile competitor. This dynamic prevents periods of excess profitability for the Big Four, as Macquarie re-enters the market whenever rates become too favourable for banks.

3. Exit from broader business lines

In the past, banks operated in higher-margin businesses such as wealth management and insurance. While these divisions may have distracted them from mortgage competition, they also provided additional profitability. With banks now exiting these areas, mortgage lending has become their primary battleground, intensifying competition and further pressuring margins.

Bad debts are low but can this last?

One of the biggest risks for any bank is loan defaults, which result in bad debt expenses; that is, the losses banks take when borrowers can't repay their loans. Historically, Australian banks have averaged bad debt expenses of ~0.15% to 0.20% of gross loans and acceptances.

In FY24, this figure was just 0.08% – about half the long-term average. While this looks like a positive for bank earnings, the key question is: is this sustainable?

Why are bad debts so low right now?

There are three key reasons bad debt expenses remain unusually low:

1. Favourable economic conditions. Strong employment and rising house prices mean most borrowers can still meet their repayments. Even if someone loses their job, they can often sell their home at a premium, allowing the bank to recover the loan without taking a loss.

2. Covid-era provisions act as a buffer. During the pandemic, banks set aside large provisions for expected loan losses that never fully materialised. These reserves have been gradually released, reducing reported bad debt expenses in recent years.

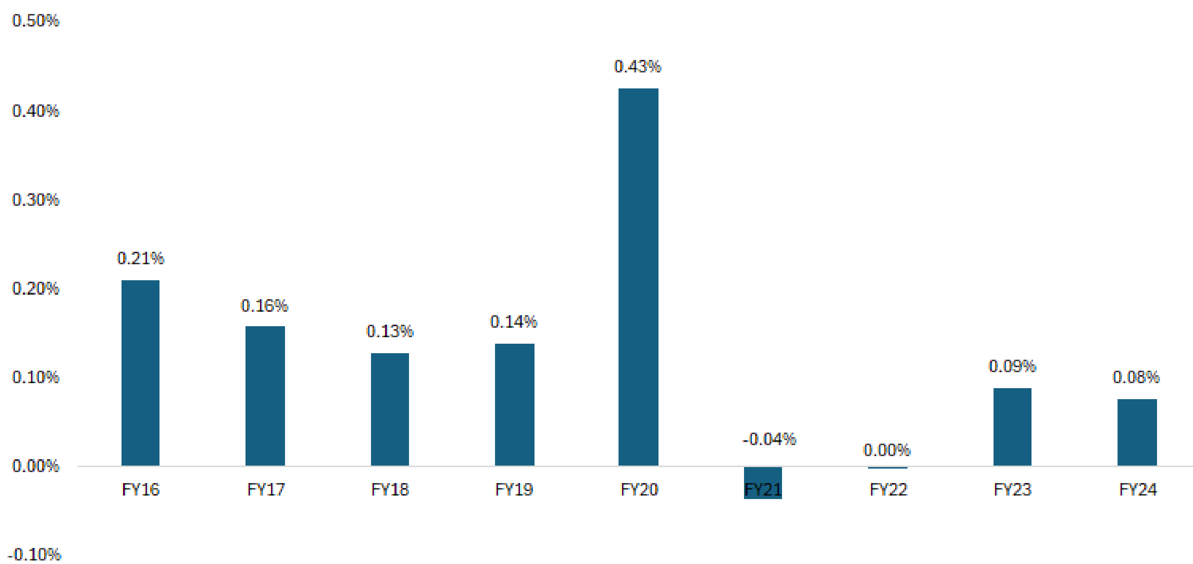
3. Shift towards lower-risk lending. Some argue that historical bad debt levels aren't as relevant today because banks now focus more on residential mortgages rather than riskier business lending, which traditionally had higher default rates.

The real risk: Are banks underestimating future loan losses?

While bad debts are currently low, history suggests this won't last forever. Since current bank earnings are inflated by unusually low bad debt expenses, it's reasonable to assume:

- Future earnings may be overstated at today's valuations.
- A normalisation of bad debts could reduce bank profitability more than expected.

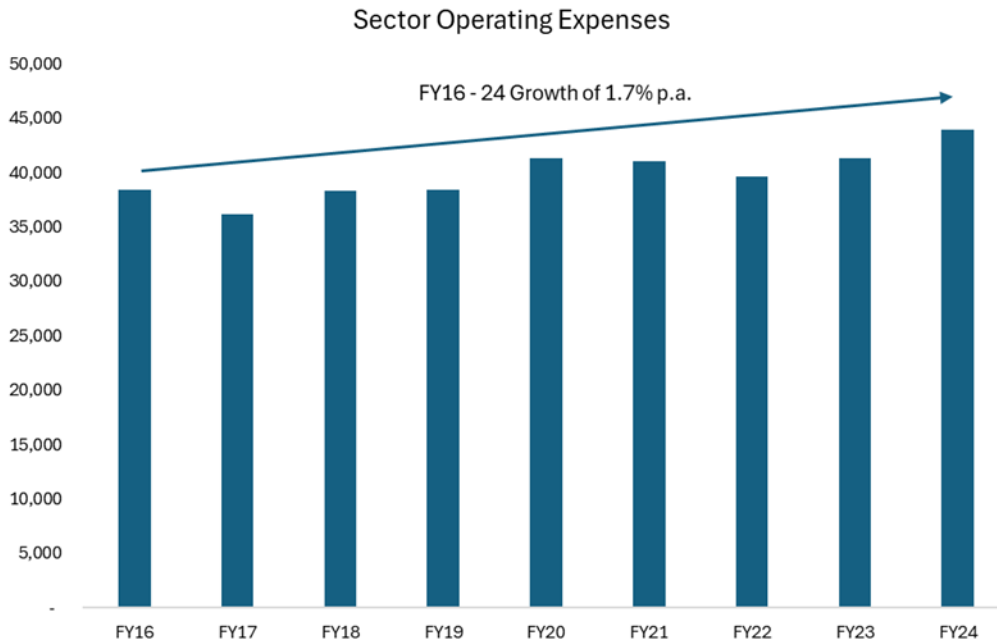
Bottom line? The current low levels of bad debts make bank earnings look better than they likely are in the long run, suggesting investors should be cautious about assuming today's profits are sustainable. To pick on ANZ as an example – and we chose ANZ because it has the lowest level of provisioning for bad debts – if the bad debts expense were to normalise to ~0.20% of gross loans and acceptances (the pre-covid FY16-19 average) from 0.05% in FY24, its EPS would have been ~13% lower.



Expenses

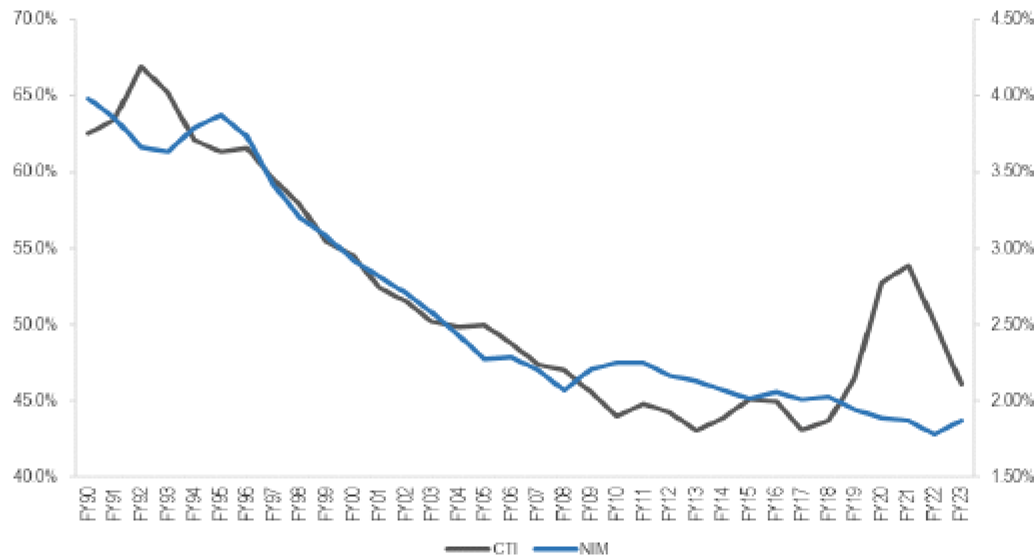
One area where banks could justify a higher valuation is through improved efficiency. However, the track record here is mixed. While banks have closed physical branches and pushed digital banking, these savings have been offset by rising IT spending, cybersecurity costs and regulatory compliance. Additionally, employee expenses account for ~70% of a bank's cost base and wage pressures remain high. The net result? Banking cost bases have proven resilient, making it difficult for them to structurally improve profitability through expense reduction.

Since FY16, bank expenses have grown at ~1.7% p.a. compared to income growth of just 0.9% p.a.



This means that despite cost-cutting efforts, banks struggle to convert these savings into higher profits because any efficiency gains are competed away in lower prices for customers. As a result, cost-cutting alone is unlikely to drive meaningful margin expansion at the sector level.

Over time cost efficiencies (lower cost-to-income (CTI) ratio) have been reinvested back in the customer



Source: JP Morgan

Are bank valuations justified?

The 2024 banking rally may suggest a thriving sector, but the fundamentals tell a different story:

- Net interest margins remain under pressure as mortgage brokers dominate the market and Macquarie intensifies competition.
- Bad debt expenses are at historic lows, but history suggests they will normalise over time, reducing earnings.
- Cost-cutting has failed to translate into sustained profitability, with banks reinvesting savings into lower prices to stay competitive.
- Volume growth will remain moderate, given Australia has one of the highest household debt-to-GDP ratios globally.

Given these challenges, the current high bank valuations appear disconnected from long-term earnings potential.

Jack McNally is an Equities Analyst at Magellan-owned, Airlie Funds Management. Magellan Asset Management is a sponsor of Firstlinks. This article has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not consider your investment objectives, financial situation or particular needs.

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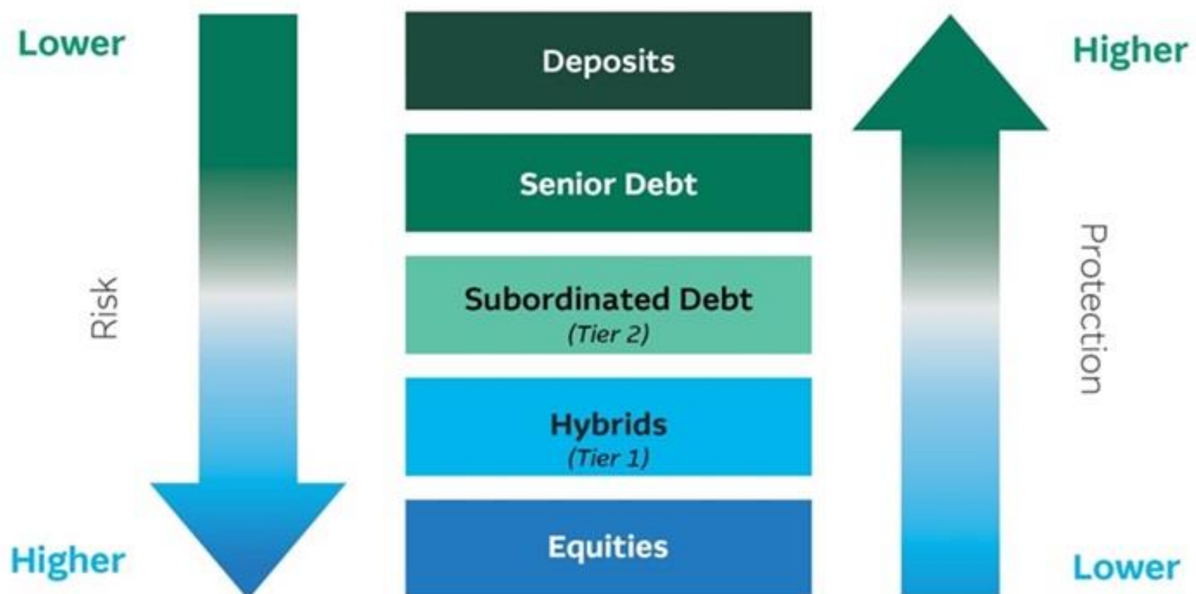
The useful role that subordinated debt can play in your portfolio

Blair Hannon

Also known as Tier 2 capital, subordinated debt securities rank below senior debt in terms of repayment priority in the event of insolvency of a company. However, subordinated debt generally takes priority claim of cash flows and assets over hybrid securities and equities in the event of a default.

To determine the potential risk or return of any security investment, it's important to understand where the security sits within the issuer's capital structure. The higher a security ranks in the capital structure, the lower the risk of a default event and the higher the level of protection compared to other securities further down the capital structure.

For example, here's a typical capital structure of a financial institution. Most banks and insurers are required to hold a certain amount of capital, which they do through a combination of equities, debt, and deposit holdings.



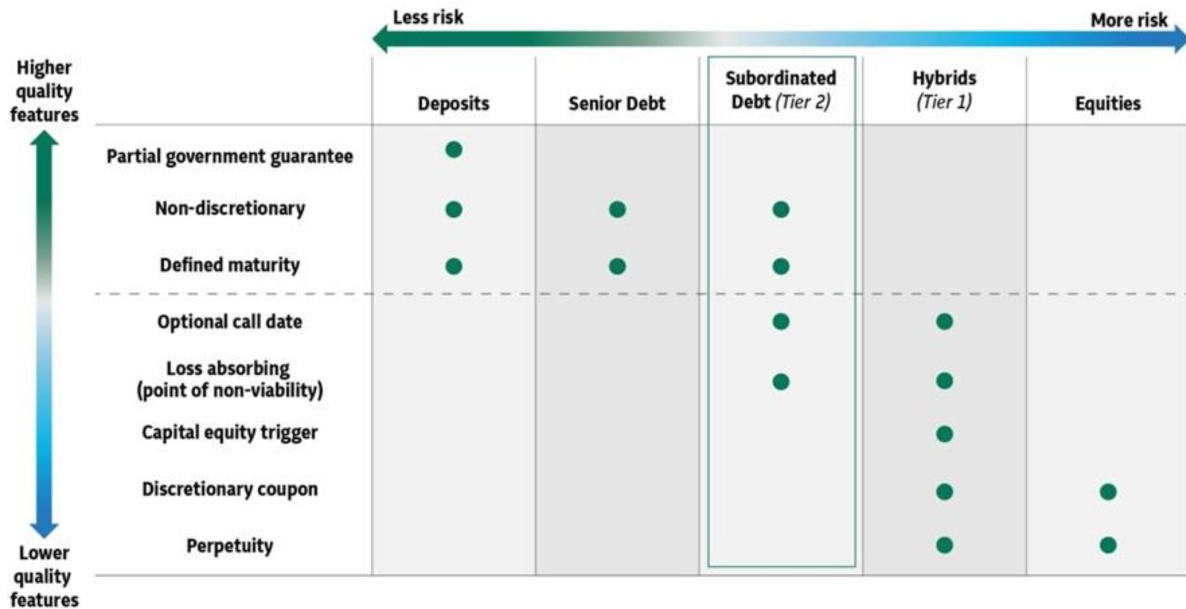
Subordinated bonds are typically unsecured, meaning they are not backed by specific assets. Their value is tied to the overall creditworthiness of the bond issuer.

What differentiates subordinated debt?

Let's take a closer look at the different securities making up a financial institution's capital structure.

Subordinated debt vs. senior debt

The claims of subordinated debt holders rank below that of senior bondholders or depositors. That means if the issuer were to default, subordinated bondholders will only be paid after all obligations to higher ranking creditors are paid. As a result, subordinated bonds generally pay higher interest than senior bonds.



Despite ranking lower on the capital structure hierarchy, subordinated debt has many of the same higher-quality features as senior bonds. They both offer non-discretionary coupons, so interest payments must be made, and have a clearly defined maturity date at which principal must be repaid.

What differentiates subordinated bonds is their 'loss absorbing' feature. Subordinated bonds form part of the regulatory capital that banks are required to hold to protect depositors and policyholders from unexpected losses. This means in the event of severe crisis, which the regulator deems a bank to no longer be viable, interest and capital payments owing to subordinated bondholders can be delayed, converted to equity potentially at a significantly lower value than the principal amount or in the worst case written off. To compensate for this risk, subordinated debt can offer a higher yield than senior debt and deposits.

	Senior Debt	Subordinated Debt (Tier 2)	Hybrids (Tier 1)
Seniority (ranking)	Above subordinated debt, hybrids and equities	Above hybrids and equities	Above equities
Payment discretion	No discretion - coupons must be paid	No discretion - coupons must be paid	Banks *have* discretion in making coupon payments
Maturity date	Fixed maturity date	Fixed maturity date	No maturity date
Franking	No	No	Yes
Missed coupon payments	Accumulate as debt	Accumulate as debt	Do not accumulate as debt
Common equity trigger event	Will not be converted or written off	Will not be converted or written off	May be converted or written off
Non-viability trigger event	Will not be converted or written off	May be converted or written off	May be converted or written off

Subordinated debt vs. hybrids

As subordinated bonds rank higher in the capital structure, they provide more protection and lower capital risk than hybrids and equities. They are more akin to debt: interest payments must be met, and the principal repaid at maturity.

Investors have used hybrid securities for decades as a way to access regular floating rate income payments and franking credits.

Both subordinated debt and hybrids have a 'loss absorbing' feature as describe above, however in addition to this, hybrid securities also have a capital trigger. This trigger defines a minimum capital threshold of the bond issuer below which these instruments will be immediately written down or converted to equity, resulting in greater capital risk.

Hybrid securities are also listed, making them more accessible for advised and retail investors. However, this doesn't always translate into greater liquidity, as few institutional players invest in hybrid markets.

With APRA's requirement to phase out the new issuance of hybrids (or additional tier 1 instruments) by January 2027, banks and issuers are likely to replace hybrids with other forms of capital – like subordinated debt.

Subordinated debt is a liquid investment, but has been harder to access for most investors, outside of institutional investors. Now, investors can gain easier exposure to actively managed subordinated debt via exchange traded funds on stock exchanges, like the ASX.

Why do banks issue subordinated debt?

APRA requires major Australian banks to hold a certain amount of regulatory capital to protect depositors from unforeseen losses. This also limits the potential need for taxpayer money to bail out a failing institution, as we saw in the US and Europe during the global financial crisis. Subordinated debt acts as this buffer. It can absorb potential losses in the event of financial stress, by converting to equities and thereby lowering the debt burden of the company.

Recent regulatory changes requiring hybrids to be phased out will see subordinated debt form an increasingly significant part of the Australian fixed income universe. While it generally offers a higher yield than senior debt or cash, it will become the lowest ranked debt instrument in the capital structure.

So… why invest in subordinated debt?

For investors with holdings of cash, deposits and senior bonds who are willing to take more credit risk, subordinated debt issued by well-known and well capitalised Australian financial institutions can provide access to potentially higher yielding opportunities.

On the other hand, for investors with holdings in high-yielding hybrids or shares who are seeking to *reduce* credit risk, subordinated debt can play an important defensive role in a diversified portfolio.

Blair Hannon is Head of ETFs, ANZ at Macquarie Asset Management, a sponsor of Firstlinks. This is general information only and does not take account of investment objectives, financial situation or needs of any person and before acting on this information, you should consider whether this information is appropriate for you.

Macquarie offers a Subordinated Debt Active ETF (ASX: MQSD). You can learn more about it here.

*Glossary

Common equity trigger: A minimum capital threshold of an issuer, below which the relevant tier 1 instrument is required to be written down or converted to shares at a value potentially significantly below the principal amount.

Cumulative coupon: A coupon payment that, if not paid by the issuer, will accumulate and must be paid in the future.

Defined maturity: A predefined date when the principal amount of a bond becomes due and is payable to bondholders.

Discretionary coupon: Coupon payments made at the issuer's discretion.

Loss absorbing (point of non-viability): Power granted to the prudential regulator to cause the instrument to be written down or converted to shares at a value potentially significantly below the principal amount. This only occurs in the event of a severe crisis where the regulator deems the bank or issuer no longer viable.

Non-cumulative coupon: Coupon that will not accumulate to be paid in future distributions.

Non-discretionary coupon: A coupon that, if unpaid, would constitute a default event.

Optional call date: A date prior to maturity when the issuer has the option to repay the debt early.

Partial Government Guarantee: The Australian government guarantees up to $250,000 deposited with Australian incorporated authorised deposit-taking institutions.

Europe is back and small caps there offer significant opportunities

Francisco de Juan, Jacobo Llanza, James Gruber

This is an edited transcript of an interview that Firstlinks' James Gruber did with Francisco de Juan, CIO of Alantra's EQMC Fund, and Jacobo Llanza, Chairman of Alantra Asset Management, on 14 March in Sydney.

James Gruber: One of the fascinating aspects of this year has been the turnaround in European equities. Have you been surprised by this, and do you think it can continue?

Francisco de Juan: Two things. A lot of pessimism was built into Europe. It was built because of the subdued growth that Europe had been delivering, the geopolitical issues around Ukraine, and the tariff situation. And there was even more pessimism in small caps, which we can expand on later.

Are we surprised? Well, Trump is creating a situation where Europe needs to react. I was reading an article the other day that asked, Is Trump making Europe great again? That is a nice question, in the sense that Europe understands that, in different moments in history, it needs to react.

Now, Europe is talking about joint defence, using its balance sheets, and we are seeing the UK and Europe talking again more than ever.

You could claim that what is going now could fundamentally be a step forward for Europe. It's not only just [investor] flows, looking for where to park money outside of the US, but it could be that there's a fundamental change within Europe.

With Trump, the uncertainty he's creating with tariffs is bad for everybody. We think it is temporary. But some of the things he's doing, like ending the war in Ukraine, that could also entail some very positive news for Europe.

JG: Are opportunities opening up for you that maybe weren't there six months ago due to some of these changes?

FDJ: Over the last two or three years in the small cap space, we've seen the opportunity improve for the wrong reasons, in the sense that the [valuation] discounts of the small caps have been expanding. We've seen a period where the uncertainty and rates going up have stopped M&A (mergers and acquisitions). What that has created in Europe, and particularly in small caps, is that the price to value gap has widened.

We've been running our fund for 15 years, and today we are flooded with opportunities. The next thing is our business model in this environment has to move also, not only to spot ideas and execute ideas, but to make sure that we spot assets where you might find sort of crystallization of value. We've seen M&A activity subdued in the course of the last few years. As long as we see inflation under control, geopolitics steady or improving, we might also see M&A picking up. The opportunity will then get even more attractive.

JG: Forgive my ignorance, but larger caps in Europe have turned quickly, but have the small caps followed suit yet?

FDJ: Over the last 40 months, there has been strong relative underperformance in Europe of small caps to large caps. Small caps used to trade at a 15% premium to large caps on a price-to-earnings (PE) basis – historically they traded for 15-16x PE, but now they are around 12x. And today, we have one of the biggest spreads of small cap to large cap discounts: 10%. In the last 25 to 30 years, we have not seen such an extreme period of underperformance.

JG: Can you describe your approach? I know that you also take an activist role in your investing.

FDJ: You know we get very upset when people call us activist [laughter]. We think we are a gentle, and constructive, active owner. Our approach is about being engaged in a positive way with companies. We seek to own 20% ownership in a given company. We seek to eventually join the board or have an influence with that board. We don't control companies, but we try to help companies. And what we try to achieve is help a small cap company typically with a billion, one-and-a-half billion Euros market cap, and we try to help them to become a mid-cap. We typically underwrite five-to-seven-year investment cycles, and we try to be a constructive, positive accelerator of value creation. And this is typically something that the boards like.

The companies need to expand earnings growth and compound and sometimes for that, you need to refocus parts of the business. And if you get that right, the company can turn into a two or three billion market cap company, and then it can get included in indices, ETFs, and liquidity improves.

JG: Can you give an example of a company that you guided and turned into a mid-cap?

Jacobo Llanza: CIE Automotive (CIE:MCE) is a business we underwrote 13 years ago. It was a 625 million euro market cap company. Now it's 2.7 billion. It's in a very basic industry, making components for cars.

It was a very good and profitable company, a low-cost operator, but quite exposed to the European market at the time. It had around €1.3bn revenues and €200m EBITDA in 2012. A good business and the management team had been very successful in building it up.

We backed them to do a successful international build out. They become very strong in Latin America - Brazil and Mexico – and then they entered Asia (mainly India).

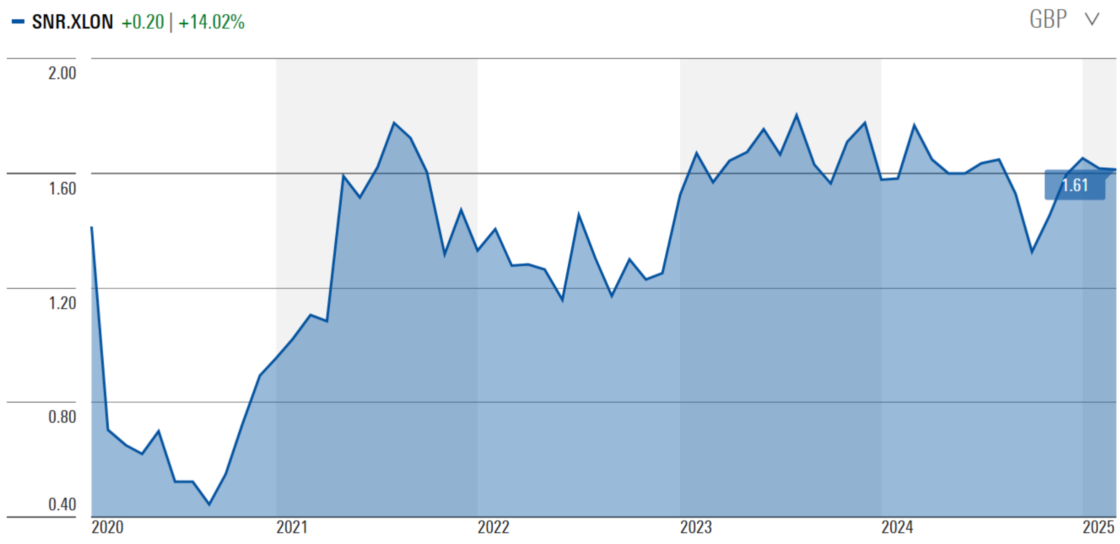
Long-story short, in 2024, the company reported 4 billion Euros in sales, and more than 720 million euro in EBITDA with margins and ROCE at the top of the industry.

We helped them in that process. We helped them simplify the shareholder structure, then with maximizing cash flow and reducing debt.

We bought an initial 5% and then we grew to 10%. When the stock hit a record, we decided to reduce part of it, getting close to 10x on that specific investment, and we still own 3% of the company.

JG: What's a stock that you are excited about now?

FDJ: One is Senior PLC (SNR:GBX). It's an aerospace supplier. We believe in the industry, with demand for planes being high, and the number of planes produced being low. In addition, the company is in the process of a strategically selling a non-core asset. That will leave the business as a pure play, fluid system business, which is a high IP [intellectual property], high margin business. So, this is a beautiful business at an inflection point in an industry that has multi-year growth.



The outcome of that may be a natural re-rating of the business, and if it doesn't re-rate, the company may be a very interesting asset for other industry players.

It's a good combination of limited downside and multiple possibilities of upside.

Alantra Asset Management is an affiliate of GSFM, a sponsor of Firstlinks. Francisco de Juan is CIO of Alantra's EQMC Fund and Jacobo Llanza is Executive Chairman of Alantra Asset Management. The information included in this article is provided for informational purposes only.

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Lessons from the rise and fall of founder-led companies

Lawrence Lam

Founder-led companies often attract investors because their leaders have significant personal stakes in the business. The assumption is that these individuals will make decisions with long-term value creation in mind, aligning their interests with shareholders. Some of the world's most successful companies—Amazon, Alphabet, Meta, and Berkshire Hathaway—have thrived under their founders. But for every high-profile success, many more founder-led companies never reach the top. Founder presence alone does not guarantee success. While all companies begin with a founder, only a select few evolve into industry leaders.

For investors, board directors, and executives, the challenge isn't just identifying founder-led companies—it's determining which ones have the longevity and leadership depth to succeed over the long term.

The nuances of founder-led companies

Some founders evolve with their companies, adapting to new challenges and steering their organisations through changing market conditions. Others, however, can become their own biggest obstacles. Early success, fuelled by a founder's relentless vision and focus, can sometimes lead to rigidity and blind spots as the company scales.

Founders, like all executives, are skilled at presenting their company's strengths while downplaying its weaknesses. In fact, they may be even better at shaping narratives than most, given that many have had to do so since their earliest fundraising campaigns. When assessing these companies, it's critical to look through the polished façade to see the actual realities of the business.

Even the best founders can lose their edge. The question isn't just whether a company is founder-led, but whether the founder remains motivated, has built a strong leadership team around them, and has successfully disseminated their philosophy. What are some red flags to look for as founder-led company evolves over time?

- **Becoming institutionalised:** watch for founder-led companies that succumb to external pressure by unnecessarily bulking up their management teams and boards to unwieldly numbers for the sake of conforming to textbook corporate governance, thus losing their innate advantage: speed.
- **Changing motivation:** when the hunger for growth fades and is replaced by a focus on personal wealth maximisation or ego, the company often suffers.
- **Failure to disseminate the philosophy:** the founder's core philosophy is lost with poor organisational design or high turnover; execution becomes increasingly difficult.

These warning signs are not just theoretical. Let's examine two companies that illustrate the contrasting trajectories of founder-led firms.

In practice: Fastly vs. Cloudflare

By way of example, take Fastly (NYSE:FSLY) and Cloudflare (NYSE:NET), both pioneers in edge computing. These companies went public within months of each other but have experienced the opposite trajectory since.

Fastly, founded by Artur Bergman, focused on building a strong technical product but when Bergman stepped down from the CEO position and instead took up a CTO role very early on, the core philosophy was diluted. Did

the newly instated CEO have the final say? Or was it the CTO with a significant ownership stake? Product development stalled and the growth strategy became overly reliant on a handful of key customers. Along the way there were a few operational mishaps and Fastly has floundered since listing.

Cloudflare, on the other hand, has gone from strength to strength, embedding its founders' philosophy into the company's DNA. Co-founders Matthew Prince, Michelle Zatlyn and Lee Holloway built a decision-making structure that could operate autonomously. This approach accelerated product development cycles, allowed them to scale teams effectively, and created a governance structure that balanced founder influence with agility.

Founder-led companies, like any other, evolve and change

Founder-led companies are built with a natural edge. Their leaders are deeply invested—both financially and emotionally—in the success of the business. This alignment is reassuring, though motivations can change over time and this is why founder-led businesses must be continually monitored.

Has the founder created an enduring leadership structure, or is everything still reliant on them? Has the board and management team become too large? These are the questions that determine whether a founder-led company is on the path to sustained success or if it's heading toward stagnation. In *The Founder Effect*, I take a deep dive into the nuances of assessing the quality of management teams.

Extraordinary wealth can be generated for investors, board directors and managers involved with founder-led companies. There is one caveat though: you can only realise this value by distinguishing the exceptional from the mediocre.

Lawrence Lam is the author of The Founder Effect (Wiley $34.95), a book exploring the essential traits of successful executive teams and governance structures that drive sustainable growth. As Founder and Managing Director of Lumenary Investment Management, he brings over two decades of expertise in global equities, risk management, and advising boards. The material in this article is general information only and does not consider any individual's investment objectives. Companies mentioned have been used for illustrative purposes only and do not represent any buy or sell recommendations.

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