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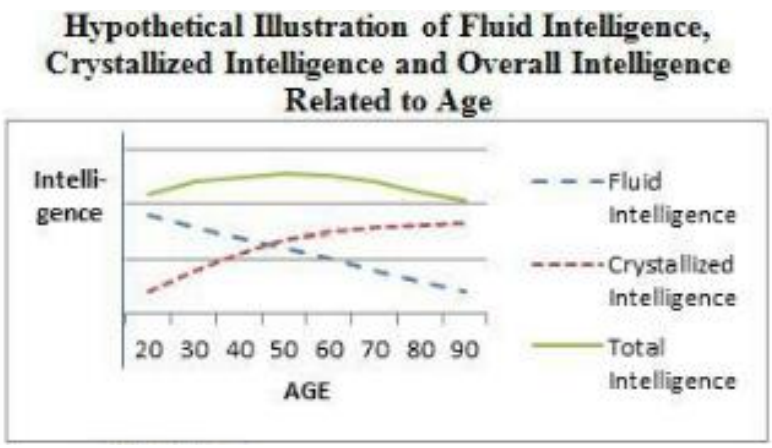
Editorial

Ageing is a horror show, right? Our mental capacities decline, health deteriorates, we have fewer friends, and eventually it all ends. It sounds depressing, and yet more scientific studies are indicating that older people are much happier than younger ones. How can this be, and what are the implications for other areas of our lives, including our financial wellbeing?

The pitfalls of ageing

I've written previously about when our cognitive abilities decline and how it impacts financial decision making. People have two types of intelligences: fluid intelligence and crystallised intelligence. Fluid intelligence is the ability to think abstractly and deal with complex information. Psychologists have long known that fluid intelligence peaks about age 20 and declines by 1% each year thereafter.

As we age, however, we also gain experience to help us make better decisions. This is called crystallised intelligence. Thus, while fluid intelligence decreases with age, crystallised intelligence increases.



Source: What to do when I get stupid: A radically safe approach to a difficult financial era, Lewis Mandell Ph.D.

When you combine the two types of intelligences and apply them to financial decisions, research indicates that we peak around age 53 and decline thereafter at a rapid rate.

Of course, it's not only cognitive abilities – including memory, language, perception, and attention - which decline with age. Our health tends to deteriorate during our 50s, though some things start much earlier. For instance, muscles and endurance start a steady decline after age 30, which speeds up after we hit 60.

It's not all bad

Yet as early as the 1980s, scientific studies started to question other aspects of ageing. Before then, it was assumed that getting older wasn't fun, and therefore older people were less happy.

The National Institute of Mental Health in the US did a study in the early 1980s that found almost every form of psychopathology - mental health problems including depression and anxiety – was less prevalent in older people than middle-aged or younger people.

This shocked the scientific community at the time. Some scientists pushed back, suggesting that these older people had lost their marbles and that's why they were reporting themselves to be happier. Others in the psychiatry profession hypothesized that they must have had a form of hidden depression.

Yet, subsequent research has confirmed the findings and expanded on them.

Why are older people happier?

Psychology Professor, Laura Carstensen, and her colleagues at Stanford University's Center on Longevity have been at the forefront of the latest research. Carstensen's studies have focused on why older people are happier.

She's found that as we age, our social networks get smaller. But rather than being a bad thing, it's a positive. Carstensen's research suggests that as we get older, we retain those in our social network who are most important in our lives. Meanwhile, more distant acquaintances fade away. It means that we focus on who and what really matters. Valuable friends and family become even more valuable.

Carstensen's studies have also revealed that how we view ourselves and our lives impacts the way we remember things. She's conducted research where positive, negative, and neutral stimuli were presented to a range of age groups. The people being studied had to sit in front of a computer screen and go through images and tell researchers which images they remembered. Younger people remembered about the same number of positive and negative images. By middle age, the preference is to remember positive images, and when older, it's overwhelmingly in favour of the positive images.

What's behind this positivity? Carstensen's more recent studies offer more clues. She's found that older people view time differently from the young. When you're young, time is essentially infinite. You're constantly thinking about the future. A brighter future. In this context, it's important when young to be curious, explore new things, travel, meet new friends, get a great job with career prospects etc.

When we age, we become more presented focused rather than future focused. That's because we're faced with our own mortality. Time becomes compressed. And that results in us becoming laser focused on what is important. Carstensen believes that laser focus and present mindedness is behind much of the happiness as we age.

As Carstensen recently told the Hidden Forces podcast:

"…younger people are rarely in a present focused mode. They're almost always thinking about the future. Older people can actually be in the present, and that tends to be very good for mental health. There are lots of meditations now, Buddhist meditations, that are intended to help people get to that present focus because living in the moment tends to take people's attention to positive aspects of the world.
… in some ways, ageing relieves us of the burden of the future. We can be in the moment."

Should we mirror the aged?

The obvious question then is: should the young become more present focused like older people to become happier? Carstensen says younger people should still focus on the future and explore the world. However, getting them to occasionally shift their focus to the present might be a good thing.

As for the aged, Carstensen says having them focus occasionally on the future may also be positive. For instance, climate change may not impact them in their lifetimes, though it would be nice if they also focused on it. In short, Carstensen thinks there needs to be a balance between time perspectives.

She's run an experiment on whether older people can change time perspectives. The experiment involved asking people to choose from among an array of social partners. It said to the participants: imagine if you got a phone call from your doctor who told you that a new medical advance means you'll live 20 years longer than expected. Which social partners would you choose? And the results showed that older people didn't just express preferences for well-known friends and family. They were curious to broaden their social circle.

The paradox of ageing

The findings on greater happiness among older people has led the scientific community to label it 'the paradox of ageing'. Ageing has negative features, as I've mentioned. And yet, we're happier as we age.

It also challenges the basis of happiness. Having lots of friends and a bright future isn't necessarily supported by the science.

Balance and money

What implications does this research have for other aspects of our lives, such as our financial wellbeing? In investing, we're taught to be predominately focused on the future. We're told to budget and save, to invest for the long-term so compounding can work its magic. Carstensen would say that there needs to be a balance – and she has a point.

For instance, I can't help thinking that the debate about retirees and 'decumulation' is one about time perspectives. The government wants the elderly to spend more so they consume and lift economic growth. Yet, the statistics show that older people are afraid to run out of money and that's why they're reluctant to spend more.

Part of the issue may be that we're taught from a young age to defer spending and save money. This can become ingrained, and it requires a mindset shift for people to change the habits they've had for a lifetime and to spend more money. If they did spend more, it mightn't just benefit the economy, but themselves. We previously written of how other scientific research shows how leisure spending can increase happiness in retirement.

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I have two articles this week. The first looks at 16 ASX-listed stocks that investors can buy and hold forever.

The second article is a transcribed interview I had with quant fund managers, **Realindex**. The company is celebrating its 15-year anniversary and has announced a name change to **RQI Investors**. I caught up with CEO **Andrew Francis** and Head of Investment **Dr. David Walsh** to discuss their latest views on markets and how passive investing may impact quantitative investing going forwards.

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Lastly, I'd like to give a shoutout to **Peter Warnes**, the long-time editor of Morningstar's *Your Money Weekly* newsletter, who's retiring. Peter started in finance in 1963, some 61 years ago. He's had a remarkable career and has been a great colleague. All the best for the future, Peter, and many thanks.

16 ASX stocks to buy and hold forever

James Gruber

In his letter to shareholders in 2022, Warren Buffett, identified two stocks that he expects Berkshire Hathaway to own forever: American Express and Coca-Cola.

In this year's letter, he elaborates on this. "When you find a truly wonderful business, stick with it," he writes. "*Patience* pays, and one wonderful business can offset the many mediocre decisions that are inevitable."

Buffett goes on to identify other businesses that he thinks Berkshire will own forever. They include Occidental Petroleum, and five large Japanese conglomerates - Itochu, Marubeni, Mitsubishi, Mitsui, and Sumitomo. Buffett likes Occidental for its vast oil and gas holdings and market-leading carbon initiatives, and the Japanese businesses for their capital allocation and management skills.

It got me thinking about which ASX stocks that investors could buy and hold forever.

The criteria

It's not an easy task. First, you must be confident that a company can last for a long time. After all, the average company in the S&P 500 has a lifespan of close to 20 years, and for the ASX, it's unlikely to be much different. It rules out a lot of companies. For instance, ones that rely on a single drug for their success, those which have mines with finite lives, and stocks that are so big already that it makes growth difficult (something which Buffett highlights about Berkshire in his letter).

Second, it's not just about longevity. You want to own stocks that will perform at least in line with or better than the indices. Otherwise, there's not much point in buying them and you may as well own a broad index ETF instead.

I've come up with the following criteria to try to identify the ASX stocks that can be held indefinitely:

1. **Part of the ASX 300.** Ideally, you want to own well-established firms that have some history of success. The smallest company in the ASX 300 has a market capitalization of under $600 million. This criterion then excludes most small caps and includes mid and large caps.
2. **Long runway of growth opportunities.** This is key. It knocks out most companies in the ASX 300. For instance, ones that are mature and focus on Australia, thereby limiting growth options. Also, those that have short-lived assets. It means leaning towards companies that have global operations, and/or large markets to operate in.
3. **Economic moats.** Moats are sustainable competitive advantages. They help companies defy the laws of capitalism, which suggest that businesses which have high returns of capital will have those returns competed away. Competitive edges can come from many things including network effects, intangible assets, cost advantages, switching costs, or efficient scale. You can find out more about moats here.
4. **Good returns on capital.** If I had to name one metric to identify a quality company, it would be return on capital. Put simply, it's the profits that a stock makes from the equity and debt that's put into the business.
5. **Sound balance sheets.** Ideally, you want to own companies that don't rely on too much debt to generate returns. Excessive debt makes companies fragile.
6. **Don't rely on exceptional managers to succeed.** Having good managers in place certainly helps. But if you're going to own a stock for a long time, it can't be reliant on one or two managers to succeed. The business needs to be so good that it doesn't need an exceptional CEO.
7. **Unlikely to be disrupted.** This overlaps with other criteria, though is worth adding. When you buy a company for the long term, you are essentially betting on things that won't change. For instance, for Buffett, he foresees that people will still be drinking Coca-Cola in 100 years, they'll still need credit cards, and they'll need energy to power their daily lives.

It's an extensive list of rules, though necessary given the purpose is to find the best businesses and own them indefinitely.

Note that the criteria doesn't include valuation. The list is of quality companies that are worth buying at some point in future, though not necessarily right away.

What doesn't make the cut – banks, miners, supermarkets

I realise that the exclusions from my list are likely to be as controversial, if not more controversial, than the inclusions. Let's first go through some of what I've excluded and why:

a. **The 4 major banks.** I haven't included any of the banks in the list. There are several reasons for this. First, there are limited growth opportunities for them as they're almost exclusively focused on Australia. Second, they're reliant on credit growth, which has had a stupendous 40 years that's unlikely to be repeated in the next 40. Third, they rely on the housing market, where the future again is unlikely to be as rosy as the past. For these reasons, my view is the banks will struggle to beat indices over the long term.

b. **The major miners.** BHP and Rio Tinto don't make the list. Size is a major factor as it requires massive investments and returns just to move the needle for these behemoths. Also, mining is highly cyclical and capital intensive, which limits returns in the long term. Finally, the tailwind from Chinese infrastructure and property is over and that will make it harder going for iron ore in future.

c. **Woolworths and Coles.** Yes, these grocery retailers operate in an oligopoly, but they're in a mature market with limited growth prospects.

The list

Here is my list of ASX stocks that you could hold forever:

Company	Code	Market cap (bn)	Industry
Argo Investments	ARG	6.7	Financial services
ASX Ltd	ASX	12.6	Financial services
Auckland International Airport	AIA	11.2	Airports
Aurizon	AZJ	7.0	Railroads
Australian Foundation Investment	AFI	9.3	Financial services
Cochlear	COH	22.7	Medical devices
EQT Holdings	EQT	0.77	Asset management
James Hardie	JHX	25.9	Building materials
Medibank Private	MPL	10.1	Insurance
Propel Funeral Partners	PFP	0.76	Personal services
REA Group	REA	24.8	Internet
SkyCity Entertainment	SKC	1.4	Resorts and casinos
The Lottery Corporation	TLC	11.2	Gambling
Transurban	TCL	41.3	Infrastructure
Washington H Soul Pattinson	SOL	12.4	Capital markets
Wesfarmers	WES	75.1	Home improvement/retail

Source: Morningstar

Let’s go through them, one by one:

Argo Investments (ASX:ARG)
One of two listed investment companies (LICs) in the lineup. Argo has a long, storied investment history. It’s managed to provide healthy returns with low costs and conservative management.

ASX Ltd (ASX:ASX)
Stock exchanges are incredible businesses. They are essentially like gatekeepers to trading securities. That makes them asset light, high return businesses. There are avenues for growth via data and technology too.

Auckland International Airport (ASX:AIA)
Airports are generally fantastic businesses as they’re often monopolies with pricing power. With Sydney Airport no longer listed (a shame), Auckland International Airport is the next best thing. It relies on airport traffic and more broadly, New Zealand being a destination that people want to visit.

Aurizon (ASX:AZJ)
This one is subject to debate. I like rail assets. Rail has an enduring cost advantage over road transport for bulk commodities. The downside of the industry is that it requires huge investment, and that limits returns on capital. With Aurizon, it’s also over-reliant on coal. However, this reliance will reduce over time, and should hopefully be less of a concern.

Australian Foundation Investment Company (AFIC) (ASX:AFI)
Another LIC that’s been around for a long time. It has a proven history of decent returns with shareholder-friendly policies. The best part about LICs such as AFIC and Argo is that they pay consistent, growing dividends over time.

Cochlear (ASX:COH)
This stock is a more controversial inclusion than most would think. Healthcare companies reliant on devices or drugs are subject to potential disruption. Just ask ResMed. Cochlear’s hearing implants do seem to have greater barriers to disruption. And the company continues to invest and innovate their products to stay ahead of the game.

EQT Holdings (ASX:EQT)
EQT is one of the two big players in trustee services. The other is Perpetual, where a number of suitors are lurking, primarily attracted to its trustee business. EQT has been around for 135 years and is exceptionally well connected, with a who’s who of people who’ve served on its board. It also benefits from tailwinds of growing wealth in Australia and an ageing population. It’s a keeper.

James Hardie (ASX:JHX)
Since it pioneered the development of fiber-cement technology in the 1980s, it’s dominated the fiber-cement siding category for houses in the US and Australia. It has a long runway of growth and an economic moat based

on brand and scale that should keep competitors at bay, resulting in above average returns for decades to come.

Medibank Private (ASX:MPL)
With an ageing population, higher demand for healthcare will put pressure on the public health system. That makes private health insurers such as Medibank a no-brainer in my opinion. Yes, it operates in a heavily regulated industry where premium increases must be approved by government, but steady, growing profits seem assured, unless management does something silly.

Propel Funeral Partners (ASX:PFP)
There's a lot to like about the funeral industry (the businesses, not the services). A growing population means steady growth in deaths. And the industry remains highly fragmented, leaving plenty of room for consolidation for the likes of Propel. Consolidation of industries has historically provided some of the best returns on the ASX and elsewhere. Hopefully, Propel doesn't get acquired like InvoCare.

REA Group (ASX:REA)
Owns realestate.com.au – the premier online listing platform for Australian residential real estate. Even during the downturn in listings in 2022, it was able to substantially lift pricing – which demonstrated its immense pricing power and moat. In the top three business on the ASX, in my view.

SkyCity Entertainment Group (ASX:SKC)
How can I pick a casino operator after the recent shenanigans at Star and Crown? Well, SkyCity has long-dated and exclusive licences in Auckland and Adelaide. Unless they operate in the appalling ways of their competitors, their monopoly assets should continue to generate nice, long-term returns.

The Lottery Corporation (ASX:TLC)
The company has a near-monopoly on long-dated licences across all states and territories, except Western Australia. Though it's a mature business, it has considerable pricing power and should deliver steady and sound returns for a long time to come.

Transurban (ASX:TCL)
It owns long-term toll roads in Australia and around the world. A superb business as any car owner can attest too. Yes, the toll roads are subject to expiries, though Transurban has the scale to retain the roads and buy more. Government scrutiny and intervention are the main risks for this stock.

Washington H Soul Pattinson (ASX:SOL)
This is a family-owned conglomerate that's proven its chops over a long period. It has large stakes in Brickworks, TPG, and New Hope Corporation. And it's expanding in areas such as aged care and financial services. The company's edge comes from its investing prowess. The risk is that Robert Millner isn't getting younger and those that follow may not be as canny. However, the management team he's put in place appears capable of handling the company when he retires.

Wesfarmers (ASX:WES)
Wesfarmers is the only top 10 ASX company in the list. Warren Buffett famously dislikes owning retailers, and there are good reasons for that. They operate in very competitive industries, can be cyclical, and sometimes faddish. Wesfarmers is primarily a retailer as that's where ~80% of earnings come from. The bulk of it is from Bunnings, and it's this division that makes Wesfarmers a worthy inclusion. Bunnings has scale, an economic moat, and some growth to power Wesfarmers long into the future. Bunnings managed to see off Masters and it's difficult to imagine another competitor coming into the hardware industry at scale. The risks in owning Wesfarmers are if it gets complacent with Bunnings and lets standards slip, and more so, if management uses the cash from Bunnings to diversify into lower returning industries (the jury is out on its lithium push).

What wasn't considered

There are several things that weren't considered when compiling this list. The most notable is valuation, as noted above. Blindly buying quality companies without regards to valuation isn't the best strategy. Waiting for a hiccup to buy into such stocks is a better course of action.

For instance, James Hardie was hammered in 2022 when there were fears about a US recession and the impact that might have on the housing market. That proved a buying opportunity as there was nothing wrong with the company, it was the economic environment that was driving a steep fall in price. The stock has since bounced back hard as recession fears abated.

The list above also doesn't consider an investor's personal circumstances and portfolios. If you want a portfolio for dividend income, then that would require different criteria and an alternative list of companies.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au.

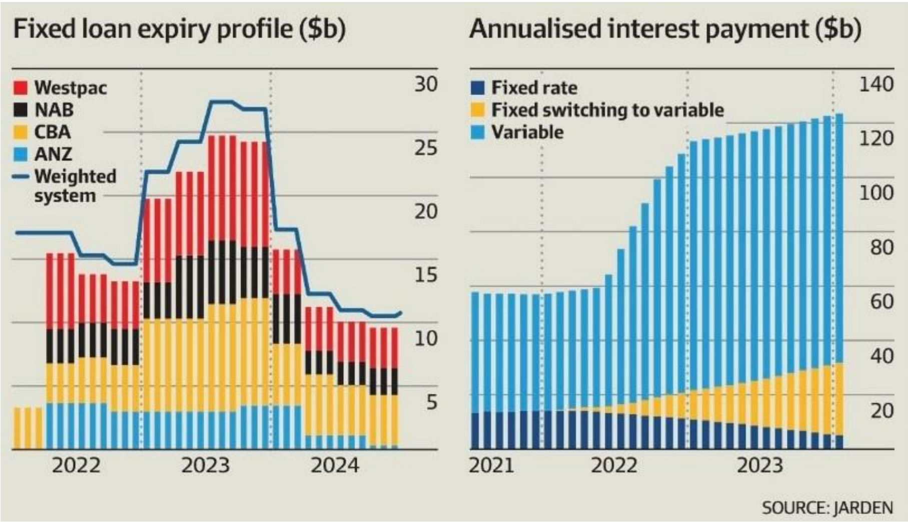
Clime time: 10 charts on the outlook for major asset classes

John Abernethy

The role of an asset allocator is to draw on macro indicators to understand trends, draw conclusions and then suggest the appropriate exposure to different assets based on the investor's needs or risk profile.

In this article, I present a range of macro charts and draw conclusions from these for different asset classes. Specifically, I review the outlook for bonds and explain why that market is in a state of flux and how central banks are manipulating the bond market. I will conclude with my outlook for cash rates under the direction of central banks across the world.

Bank profitability and dividends look secure



My first charts provide an insight into the analytical process for the Australian banking sector. These charts, created 2 years ago, anticipated the expiry of fixed loan mortgages and the projected increase in interest payments on mortgages through 2023.

Through 2023, the charts were presented as a primary reason why investors needed to be cautious when investing in banks. Many fixed rate mortgage loans were written for 2-3-year terms at yields of 2-3% during the Covid period, and a 'mortgage cliff' loomed ahead. These loans were set at low rates because the RBA had given forward guidance of near zero interest rate settings through to 2024 (now) and provided loans (funding) to the banks at virtually no cost. The RBA also undertook Australia's largest quantitative easing (QE) program (about $300 billion) as it drove down interest rates.

Today, most of the 2020 to 2022 fixed rate mortgage loans have been rolled into much higher interest rates. Whilst this has caused immense pressure for borrowed households, the Australian and the world economy has avoided recession, job markets have stayed strong, and loans remain well serviced. The worst of the debt rollover is over but pain for the borrowed household sector persists (I'll return to this later).

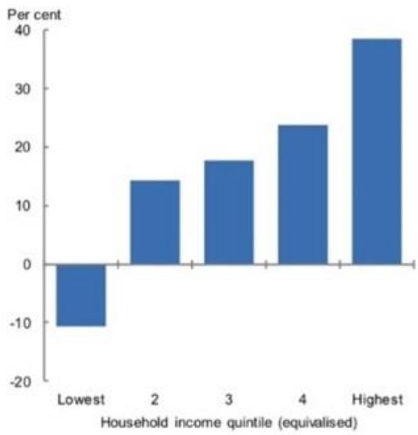
Importantly, the 'share of market' chart of fixed loan mortgages (above on right) gave banking analysts and investors an important insight. The chart shows that Westpac and the Commonwealth Bank were the most exposed to the reset of fixed rate mortgages. Indeed, given their relative sizes, Westpac had the biggest relative market exposure - suggesting that it had been aggressive in writing fixed rate loans during the Covid period.

The chart helps explain why Westpac was marked down relative to its peers over 2023 and why it has (now) bounced back strongly (relatively outperformed) in recent months. The market perceived excessive risk in the Westpac balance sheet (loan book) that has now subsided. Indeed, the whole banking sector has come through the fixed loan reset relatively unscathed. Westpac shareholders can breathe with a sense of relief.

The next charts are related to the above because they show the effects of the pandemic, inflation and rising mortgage rates on Australia's savings ratio.

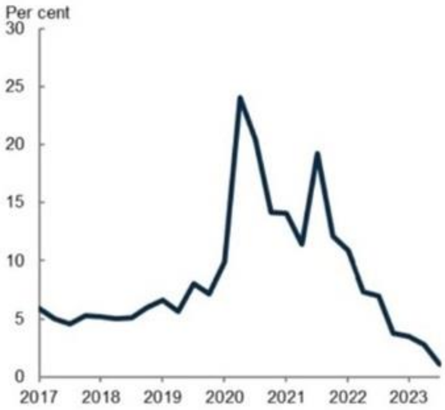
During the lockdown, savings ballooned because consumption was curtailed, and government cash payments flowed. Australia's savings ratio reached historic highs in 2020 but is now racing towards historic lows. Over the long term, Australia's savings rate has averaged around 5%.

Chart 2: Saving as a share of disposable income, 2021–22



Source: ABS National Accounts: Distribution of Household Income, Consumption and Wealth.

Chart 3: Household savings ratio



Note: Seasonally adjusted.
Source: ABS National Accounts: National Income, Expenditure and Product.

The effect of inflation (mainly cost price driven) and higher interest rates is captured in the next chart. It shows that Australia's real wages declined over the last two years following a sustained 10-year period (ex GFC) of real wage growth.

The decline in real wages, higher borrowing costs and cost push inflation (think power and petrol) has driven down the average household's real income and therefore consumed most of their discretionary consumption.

Real gross household disposable income per capita

Index, March 2007 = 100

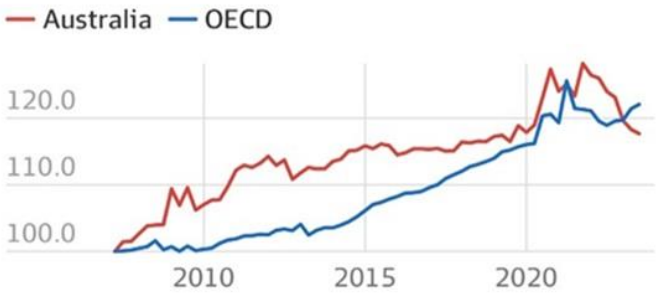
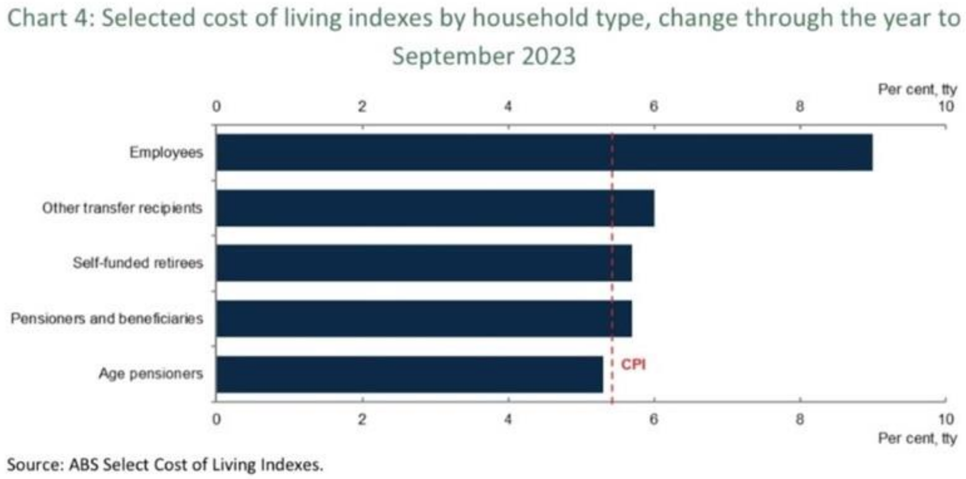


Chart: Michael Read • Source: OECD; Financial Review

The points I draw from the above are these:

1. Interest rates cannot rise much further (if at all) from current levels because the average household with a mortgage has a high level of financial stress.
2. The above charts present the total position and are not segmented. Therefore, those with savings (self-funded retirees) are generally better off and those with borrowings worse off.
3. The poor regulation of banks in the provision of mortgages – for instance, low deposit ratios and high loan to value lending – added to the housing price bubble. The government and regulators are now faced with a growing affordability problem caused by poor policy decisions.
4. The real downturn in available discretionary expenditure has been offset by the immigration of about 800,000 people and returning students and tourists over the last two years.
5. Banks will start to lend more to households with personal credit facilities (watch for a rise in credit card debt) that will increase margins so long as the borrowers remain employed.

The bank sector benefits from growth in lending assets and more so in higher interest rate categories such as personal lending. Importantly, the adjustment to stage 3 tax cuts is directly targeted at that cohort of worker, which is either in, or moving towards, financial stress. The table below shows that it is the worker who has been most affected by cost-of-living increases.

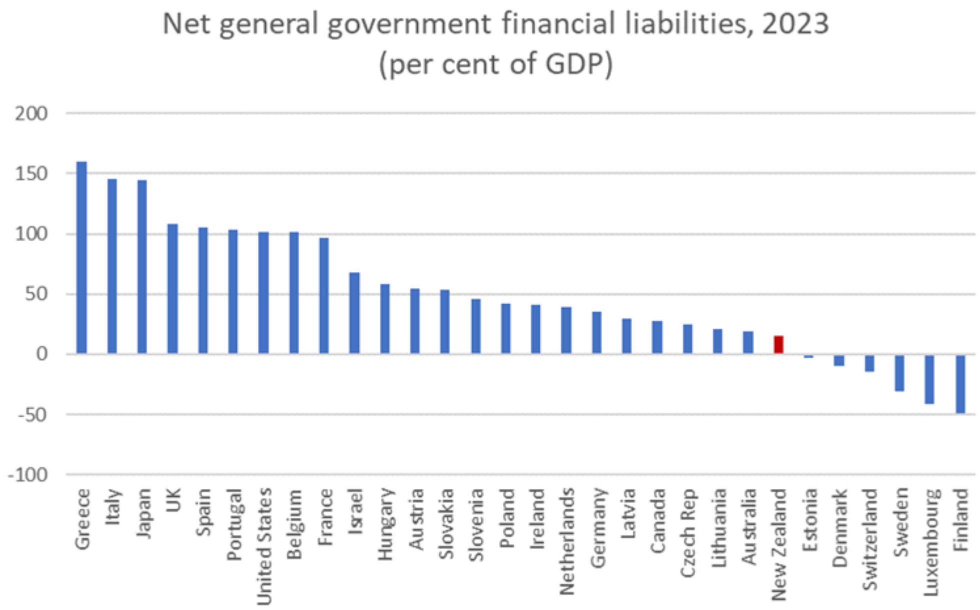


The tax cuts are supportive of the banking sector although that is not the stated objective. In the main, the banks lend to working households; tax relief to them will help them draw and repay debt. Thus, bank profitability and dividends look secure and justify retention inside equity or income portfolios. Further, as noted above, Australian interest rates are very unlikely to be raised by the RBA and so fixed income investors can lock in rates.

Debt is a global problem – What does it mean for bonds as an asset class?

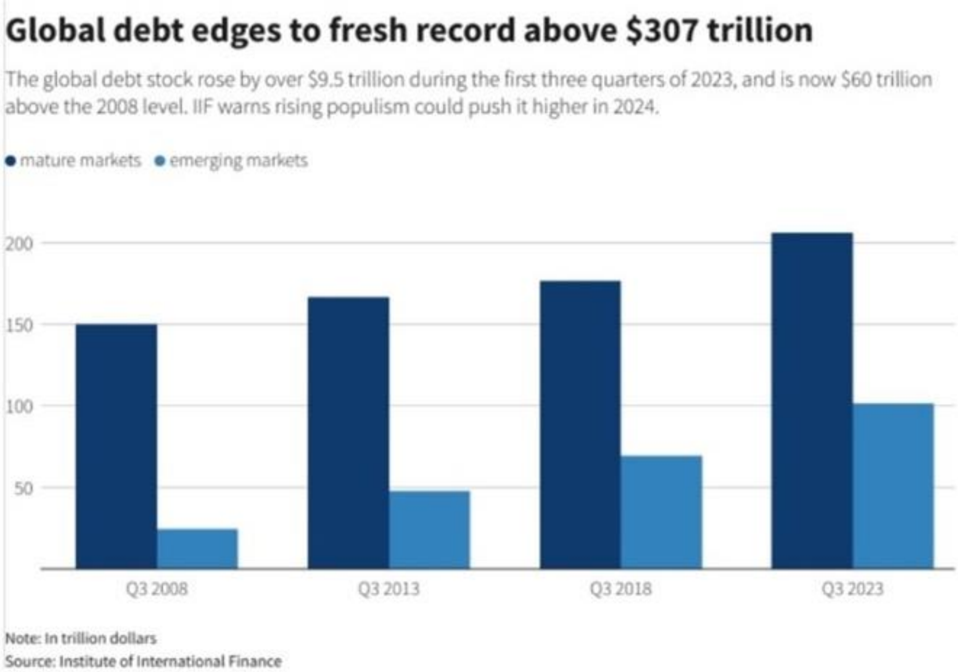
Whilst Australia has a significant household debt problem, the rest of the developed world has a significant government debt problem. This observation would normally lead to the view that bond interest rates should either rise or remain elevated based on the excessive supply of bonds over potential demand.

The next chart shows the level of government debt across the developed world, but it leaves out Japan whose net government debt exceeds 250% of GDP.



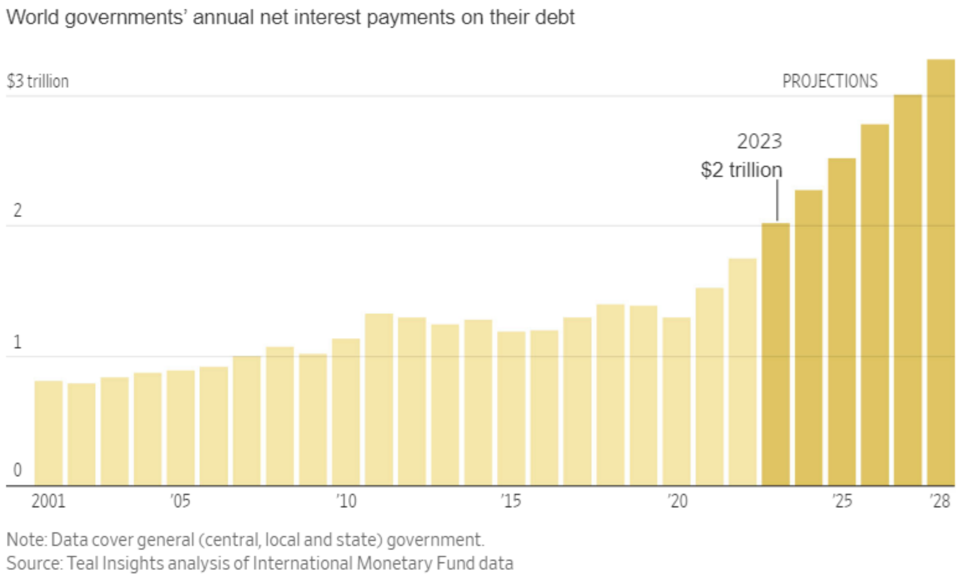
Source: Croaking Cassandra

Note that the level of government debt and the 'credit rating' of that debt appears to have no relationship to the cost (the interest rate) of that debt. Further, the burgeoning supply of debt (chart below) also appears to have no effect on the interest rates demanded by bond investors. Global debt (including private debt) has risen to 300% of world GDP (US$100 trillion).



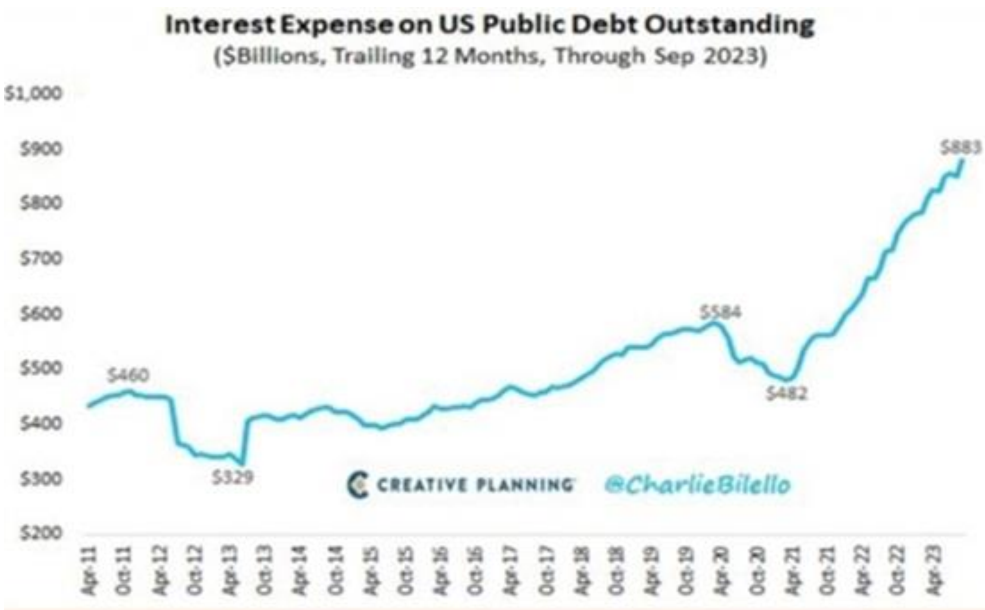
World government debt is estimated at about US$100 trillion, and the cost of that debt presents as remarkably low. This must be understood by investors investing across asset classes: a perversely low bond yield (the "risk-free" rate) affects the valuation and market prices of all assets.

The chart below suggests that the interest cost of global government debt is a mere $2 trillion (or 2%), but it will dramatically increase by over 50% in the next 4 years as low coupon debt (set in the years before and during the pandemic) is rolled over. It looks very similar to the Australian household debt situation which I presented above.



Most of the low coupon bond debt resides in the US (approximately US$30 trillion), Japan ($10 trillion) and Europe ($15 trillion). Importantly, both Japan (aggressively) and Europe (less aggressively) maintain QE programs that hold down bond yields. Today, a Japanese 10-year bond yields just 0.7% pa and cash rates are set at negative 0.1%.

Meanwhile the US Federal Reserve (the Fed) has lifted cash rates to 5.5% and modestly reversed its QE program to quantitative tightening (QT) as it attempts to deflate its massive $7 trillion balance sheet. As the Fed undertakes this, US bond yields have adjusted upwards and are driving up interest costs to the US government as shown below.



Source: Charlie Biello

In passing, note that Australia's 10-year bond yield – which is AAA rated – is currently 4.2% whilst Italy's is 3.8% (rated BBB) and Greece is 3.35% (rated BBB-). A famous physicist named Julius Sumner Miller would have asked (like you should too) – Why is it so? The answer lies in the manipulation of bond yields caused by QE.

This leads me to the following conclusions for investors and asset allocators:

1. Bond yields continue to be disengaged from the historic forces that determined the "risk-free" rate of return.
2. Inflation, credit rating, currency risk and default risk have a weak connection with the market yield of bonds at present.
3. Bond yields have been manipulated by central banks for over a decade and in Japan for near 25 years. Bond managers struggle to determine a fair value or yield with constant central bank intervention.
4. Therefore, bond yields now have a poor forecasting capacity for the outlook for economies. That is, negative yield curves that historically forecast recession no longer do so.
5. The experience of Japan is incisive because it shows that money printing (QE) does not necessarily cause either inflation, severe devaluation or economic calamity. Indeed, it suggests that QE is a viable (but not yet well-understood) economic tool.
6. QE will therefore remain in the central bank toolkit. It will not and cannot disappear as the level of global government debt is simply too high.

Understanding macro forces is important, but it is also essential for that analysis to understand the effect of monetary manipulation.

Whilst all of us need to be concerned about the level of debt across the world, I would suggest the greater concern, indeed risk, would be if the world central banks resolved to ***not*** intervene in bond markets.

In a perverse way, it is high government debt that is protecting asset markets. High government debt continues to support the need for monetary intervention and manipulation. Investors need to understand the economic environment and monitor the monetary policy settings. Importantly investors need to stay fully invested across asset classes.

Based on the above and in conclusion I present my view on cash rates in 2024:

1. Interest rates are too low in Japan but will stay low for the foreseeable future.
2. Interest rates in Europe are low but will sit at this level until cost pressures flow out of inflation readings.
3. Australian cash rates are appropriate and will remain at current levels until the US Fed cuts.
4. US interest rates are too high and need to be adjusted down in the next few months (probably by June). The debt load of the US government suggests that QE will return at some point and so the Fed will be keen to flatten the yield curve below 4%.

John Abernethy is Founder and Chairman of [Clime Investment Management Limited](), a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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Phasing out cheques, and what will happen to cash?

Noel Whittaker

Cheques and bank service, or the lack of, were major topics when I addressed a seniors' group recently. The word had got out that the government was phasing out cheques, and many of the members of the audience were feeling abandoned.

On cheques

One person told me he was shocked to receive a letter from his bank telling him the Federal Government would be phasing out cheques. He said: "For years I have used cheques for donations to charities and sending family members a gift of money. Sending cash in the mail is not secure, and I have always found cheques to be a reliable and safe way to send money. How can I send a surprise gift of cash to family and friends once the cheque option is no longer available?"

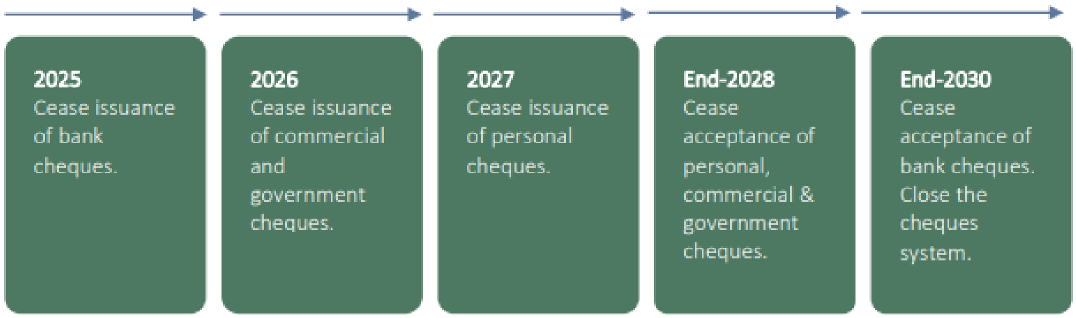
I must confess it caught me by surprise. It's been years since I've sent or received a cheque, and I have never given them much thought. They are one of the most inefficient methods of payment around. To send someone a cheque you have to write the check out in legible handwriting, find their address and write that on an envelope, also legibly, add a postage stamp and then take the letter to a post box. If you receive a cheque, you've got the hassle of finding a bank branch that's still open, making out a deposit form, standing in line for the teller, and then waiting a week for the funds to be cleared.

I spoke to the Reserve Bank, who told me that cheque use has declined drastically in recent decades. At its peak in the 1980s, cheque payments accounted for 85% of all non-cash payments. Today, cheques are used for just 0.01% of total payments. One of the main reasons is how easy the system is to defraud. The bank tells me that common cheque frauds include:

- counterfeit cheques (false copies of cheques previously issued),
- materially altered cheques (the payee or amount has been altered) and
- lost or stolen cheques (sometimes a whole chequebook has been stolen).

The government has a timetable for phasing out cheques. Next year will see the end of bank cheques, 2026 will be the end of commercial and government cheques, and by 2027 there will be no more personal cheques. By the end of 2030, the entire cheque system should be over and done with.

Figure 1: Potential staged transition plan for cheques system



Source: [treasury.gov.au]()

The reality is that there are now much better methods payment available. For domestic transfers I love [Osko]() ,which appears on many transfers I make through St George bank. Once you press the confirm button a message comes up that the payment has been successfully received by the payee. It's instantaneous. And of course, you get an immediate receipt. Almost all my bills now come by email, and I just make an electronic payment through the bank account, print off a confirmation receipt, and staple that to the bill itself.

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Not all the audience were convinced. One pointed out that there are elderly people who have never learnt to do internet banking, and plenty of people in the bush have no access to the internet if they knew how to use it. Very good points, and I had no solution for them.

Box 3: Alternate payment methods – personal cheque use

Most activities that consumers commonly use cheques for already have alternative payment methods that are reliable, faster and more cost-effective. However, it is important to note that many of these alternatives are digital or require access to the internet.

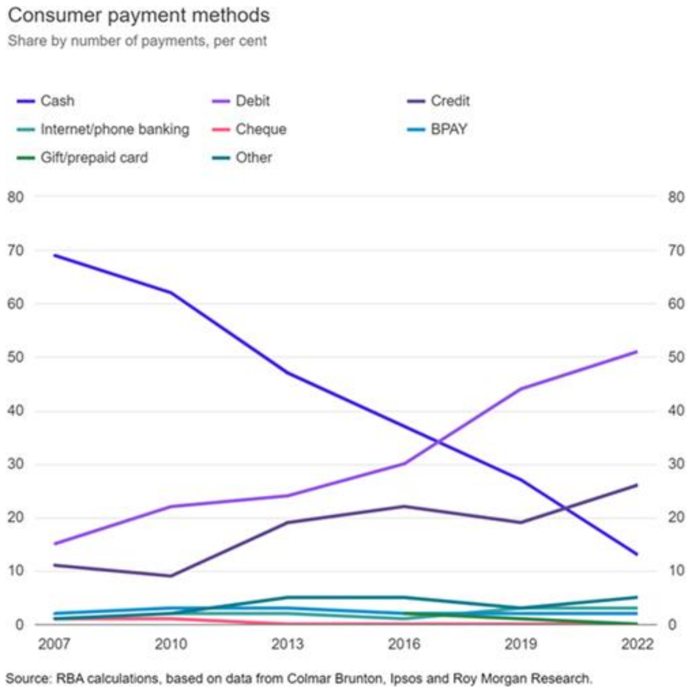
Activity	Alternative payment methods
Pay a bill	BPAY, Debit/Credit card via in store EFTPOS terminals or online/over the phone, Electronic Funds Transfer (EFT), Fast payment using New Payments Platform (NPP), Money order.
Donating to charities	Payment methods vary between organisations but most offer options such as EFT, Direct debit, Cash, Debit/Credit card online, via tap-and-go, or over the phone, Money order.
Pay a friend/send a gift	Fast payment using NPP, EFT, Gift Card, Cash, Money order.
Send money overseas	International Money Transfer (IMT), Travel Card.
Pay in instalments	Direct debit agreements, scheduled payments, Buy Now Pay Later (BNPL), PayTo.
Make a payment at auction or private sale	Pre-approved transfer (can be subjected to first time hold/daily withdrawal limit), Cash (noting security risk of holding large quantities), Fast Payment using NPP (for private sale) and Money order.

Source: treasury.gov.au

Bye bye to cash

A more contentious issue is the phasing out of cash. The main functions of cash are as a means of exchange (to buy things), and as a store of value (you can safely tuck away a few $100 notes knowing that they will retain value into the future as legal tender).

The Reserve Bank's sixth triennial Consumer Payments Survey found that most in-person payments are now made by tapping cards or mobile devices, even for small purchases. This means the share of in-person transactions made with cash halved — from 32% to 16% —over the three years to 2022. The demographic groups that traditionally used cash more frequently for payments, including the elderly, people on lower incomes, and regional residents, had the largest declines in cash use. Cash usage has generally been replaced with card payments. While Australians are aware of and use a range of other newer payment methods, such as digital wallets and buy now pay later services, they still make up a small share of payments.



When things get risky, like during the pandemic, people tuck $100 notes away as a risk management strategy. So, people now use cash less often as a means of exchange, but still value it highly as a store of value. And the numbers are big. It's estimated there are now $60 billion worth of bank notes in circulation — that's about $2600 a person. There must be somebody with plenty – there are none at my place.

The lack of bank service

The next issue was the refusal of banks to accept overseas cheques. One woman said her SMSF owns several properties in the USA and last year received two cheques for insurance claims on those properties. Both St George and Westpac refused to accept the cheques as, like almost every other Australian Bank, they no longer accept cheques in overseas currencies.

The Australian Bankers Association say the remedy is to ask the overseas institution to use the SWIFT (Society for Worldwide Interbank Financial Telecommunication) system which facilitates secure and swift international payments between financial institutions worldwide. It ensures efficient transfer of funds, enabling businesses and individuals to conduct cross-border transactions seamlessly. SWIFT is utilized by over 11,000 financial institutions across more than 200 countries and territories globally.

However, there is a glimmer of hope. Both HSBC bank and Heritage Bank tell me that they will accept cheques in US dollars on behalf of customers. Maybe it's worthwhile opening an account with them.

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. This article is general information. See noelwhittaker.com.au.

What financial risks do retirees face?

Harry Chemay

The recently completed Treasury consultation into the retirement phase of superannuation is making waves in retirement income circles, as a result of the wide range of issues for which views were sought, and the divergent responses in submissions made public so far.

A particular focus of the consultation was on how APRA-regulated super funds are delivering on their obligations under the Retirement Income Covenant (RIC). This requires fund trustees, from 1 July 2022 onwards, to formulate, record, implement, make available and regularly review a retirement income strategy to assist their members in balancing three objectives in retirement, these being:

- to maximise member expected retirement income;
- to manage expected risks to the sustainability and stability of member retirement income; and
- for members to have flexible access to expected funds during retirement.

The RIC identifies three specific risks to retirement income that trustees must consider: longevity risks, investment risks and inflation risks. In addition, trustees must have regard to *"any other risks to the sustainability and stability of retirement income"*.

What exactly might these risks be? In my submission to the consultation, I included an appendix with a list of the key financial risks to an individual's standard of living in retirement. The following is an exposition of these risks, taken from my submission (with additional detail where needed for context), and presented in alphabetical order.

Budgetary risk

Expenditure patterns can vary considerably during the ***active*** (broadly one's 60s to early 70s), ***passive*** (early 70s to early 80s) and ***frail*** (early 80s onwards) stages of retirement. As individuals might move through these stages differently, budgeting for expenditure needed across an entire retirement is a considerable challenge.

This challenge is further complicated by health issues that tend to be correlated with the ageing process, such as dementia. Some of the precautionary savings behaviour exhibited by retirees may be a measure of self-insurance against health care costs associated with such potential advanced aged concerns.

Counterparty risk

Most financial products involve an exchange of money by one party for a set of financial claims on another party (typically a financial entity). The nature of the claim might be as simple as interest, in the case of a basic savings account, or as complex as margining requirements for derivatives such as futures.

In each case there is counterparty risk; the risk that the party you, the investor, are relying on to deliver on your financial claims, possibly decades into the future, is unable to do so as and when required. Whilst strong prudential regulation can mitigate counterparty risk, it can never fully remove it.

Inflation risk

Expenditure in retirement is subject to inflation in broadly the same way it is prior to retirement, although the composition of retiree consumption baskets may differ depending on household type.

Any increase in the retirement cost of living, if not accompanied by an equivalent increase in cashflow, results in a loss of purchasing power and thus a decline in one's retirement standard of living.

Investment risk

During the accumulation years, members don't know what their final retirement benefit will be, subject as it is to the vagaries of financial markets, over which neither an individual member nor their super fund exerts any control.

Things are no less complicated once in retirement, with investment returns playing an outsized part in maintaining purchasing power in retirement, where account-based pensions with exposure to growth assets are used. Negative investment returns can, despite the ameliorating effect of diversification, accelerate capital depletion, thus impacting one's living standard in retirement.

Legislative risk

A member's retirement may span two or more decades, during which time it is possible that legislative changes may occur that negatively alter one's financial outcomes.

Whilst some disadvantageous changes may be 'grandfathered' and their impact thus mitigated, legislative risk still represents a long-term risk to retirees.

The proposed measure to apply a new 15% tax on earnings to individuals with total superannuation balances in excess of $3 million dollars (currently being reviewed by the Senate Economics Legislation Committee) is a clear and present example of legislative risk.

Liquidity risk

Retirees may require rapid access to lump sums of capital at short notice to meet unplanned expenditure. Liquidity risk arises where there is a mismatch between the assets backing a retiree's pension product and the ability to redeem it for cash, at short notice, with no discernible impact on value.

While liquidity risk is considered as part of the third RIC objective for members of APRA-regulated funds, this risk within SMSFs in pension phase requires careful management, particularly where large illiquid assets, such as real property, make up a non-trivial component of a retired member's benefit.

Longevity risk

Longevity risk can be thought of as the risk of living beyond actuarial life expectancy, and in so doing exhausting one's ***private financial resources*** before death, consequently experiencing a fall in living standards below that which is then desired.

It is important to make the distinction between private financial resources and those that might be accessible via social security; specifically, the longevity risk hedge of the Age Pension, payable as it is for life (subject to meeting the qualifying criteria and thereafter the assets and incomes tests).

Longevity risk complicates the budgetary process, often resulting in members drawing the minimum prescribed pension amount (where an account-based pension is used) to self-insure against prematurely exhausting their capital base.

As a result, the consultation explored a number of options to help trustees mitigate longevity risk for identified groups of retirees who may be subject to it, including through the use of lifetime income products where appropriate.

Management & agency risk

When deciding on a super fund (or an investment option therein) an individual cannot know whether their selected fund will thereafter perform well relative to its peers and investment objectives. In a sense a super fund's offering can be viewed as *a bundle of promises about the future with no guarantees attached, the veracity of which cannot be confirmed before the fact*.

This risk arises as trust placed in the competent stewardship of retirement savings with a super fund (or an adviser) may not be repaid, either through poor management, a misalignment of interests or ineffectual governance.

Issues that produce sub-optimal results in the accumulation phase are exacerbated in retirement, where every dollar lost to agency risk is one less dollar of retirement income.

Sequencing risk

Where an account-based pension has exposure to investment risk, a member's account balance (and by extension, pension income) is 'path dependent' on the sequence of returns achieved by the investment strategy, particularly at and into the early years of retirement.

A poor early sequence of returns in an account-based pension can accelerate capital exhaustion faster than might have been expected. Sequencing risk is a function of investment volatility, which in retirement creates a tension between the desire for high investment returns (to help manage inflation risk) on the one hand, and the desire to avoid being forced to sell into a falling market, just to make pension payments, on the other.

Harry Chemay has over 26 years of experience in both wealth management and institutional asset consulting. Initially a private client adviser with an SMSF focus, he has since consulted across wealth management, FinTech and superannuation, with a focus on improving post-retirement outcomes. Harry was also a co-founder of the online investment platform, Clover.com.au, subsequently acquired by wealthtech entity SuperEd.

Recession surprise may be in store for the US stock market

Chad Padowitz

Financial markets are full of warnings about past performance not being an indicator of future performance. But past precedent can be invaluable in helping prepare for the future.

Most people currently investing in stock markets, or advising clients on how to manage their finances, have never experienced more than one interest-rate tightening cycle, and perhaps not lived through the global financial crisis (GFC). As a result, few people today can draw on their personal experiences to help them navigate the latest rate tightening cycle and its aftermath, so learning about the past might be the only way to appreciate what is happening now and could arise in the future.

Indeed, history is especially important in markets today with such elevated valuations for stocks. For investment managers, the brutal truth is that we are playing a game, albeit a very serious one. We are making decisions on behalf of investors in an environment of uncertainty, considering the probabilities of certain events such as recessions or debt defaults happening.

At the moment, the 'higher for longer' interest rate scenario and the expectation of recession have largely been priced out of markets. US stock markets are pricing in cuts in interest rates this year alongside a double-digit reacceleration in corporate profits. Falling bond yields have allowed multiples to expand and stocks to rise. But this situation is against the odds.

We believe that many investors and commentators are being excessively optimistic and not giving enough credence to a less rosy outcome. The potential end of the rate tightening cycle has prompted relief rallies in stocks before, but that does not change our assessment that the probability this rally could well end in tears are not insignificant.

US equities now yield less than sovereign bonds, investment grade bonds and cash. This is confusing for anyone used to the idea of an equity risk premium. There are ways to rationalise this inversion of the usual position including a tech-related new paradigm encompassing AI. But the simplest explanation is that US stocks are now very expensive, and those valuations can't be sustained. They have been driven up by tailwinds such as low wage costs, rates of taxation and interest rates. These tailwinds are now reversing, and stock prices are vulnerable to a correction.

What does history tell us about the present? Focusing on the largest and most important economy, the US, one can draw on a few useful indicators that suggest stock markets could turn.

Earnings likely to fall

First and foremost, history suggests that US earnings and GDP recessions are more likely than not following an interest rate tightening cycle. In all the 13 tightening cycles since 1954, the ISM manufacturing index (which is a leading indicator of where the economy is going) fell below 50, which is where it currently sits. In 12 out of 13 cases there was an earnings-per-share (EPS) recession and in 10 out of 13 cases this was followed by a GDP recession.

The year that bucked the EPS trend was 1994, but that was a time when real earnings were well below the historical average, and unemployment was high (pent up demand) which is not the case now. Instead, we believe that EPS and the S&P 500 are most likely unable to durably sustain today's levels, and that income, value and low beta stocks should outperform.

The table shows that following a cyclical peak in the US Fed Funds Rate, the median decline in the S&P 500 has been 26% over the following 14 months. Typically, there is a gap between the peak in interest rates and the peak in the market, but then comes the fall in stock prices as corporate profits decline.

Peak Fed Funds rate and subsequent change in S&P 500 price

Cycle Peak FFR	SPX Peak	SPX Peak to Trough	Months from peak FFR to bottom of SPX
Aug-57	Sep-57	-14%	2
Sep-59	Jan-60	-13%	14
Nov-66	Nov-66	0%	1
Aug-69	Aug-69	-28%	10
Aug-73	Oct-73	-44%	13
May-74	Jun-74	-33%	5
Dec-80	Jan-81	-26%	21
Aug-84	Sep-84	-4%	2
Feb-89	Oct-89	-18%	20
Feb-95	Feb-95	0%	0
May-00	Sep-00	-49%	29
Jun-06	Oct-07	-57%	33
Dec-18	Feb-20	-34%	15
Jul-23	???		
	Median	-26%	14
	Hit rate	85%	

Source: Bloomberg

While the US Q4 earnings season has overall been good, looking beneath the surface suggests that all the growth has been due to the mega-cap technology companies, the so-called 'Magnificent Seven.

These stocks grew earnings 50% year on year in the 4th quarter while so far, the remaining 493 companies in aggregate have delivered negative 10%. In addition, more companies in the S&P have lowered earnings estimates for 2024 than increased them. There is a big question mark over how much longer the magnificent seven can continue to carry the rest of the market.

A bigger concern is forward guidance. The S&P 500 is anticipating around 25% EPS growth over next two years. Given we are seeing signs of late cycle weakness and a lowering of inflation (as expected due to the lagged impact of monetary policy), these expectations appear overly optimistic, which then creates the risk of investor disappointment.

Toppy prices too

This is further compounded by high valuations against these expected earnings. It's notable that the Shiller PE, the inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio, in the US is 33.6 compared to 26.5 since 1990 and merely 15 over the long term. This is not a market priced for disappointing earnings delivery.

Looking ahead we suspect that growth is a factor to avoid. This is because in anticipating slowing GDP growth, investors have bid up the stocks of companies they perceive to have structural or resilient growth. From here the path to outperformance for these equities in a post-peak rate world is narrow. This is especially the case because growth after all is cyclical too.

We also believe that the strong equity market performance at the end of 2023 and so far in 2024 has misled investors and analysts, who are now embracing what has been called an 'immaculate slowdown', where interest rates decline but corporate profitability grows. History tells us that a downturn in earnings is inevitable, and this will puncture the latest rally.

On the plus side, the strength in stock markets offers an opportunity to rebalance into our recommended factors of value, short duration, high income as a component of return, low leverage and low beta assets. All broad equity classes are more expensive than they were five years ago, but the return profiles have changed significantly.

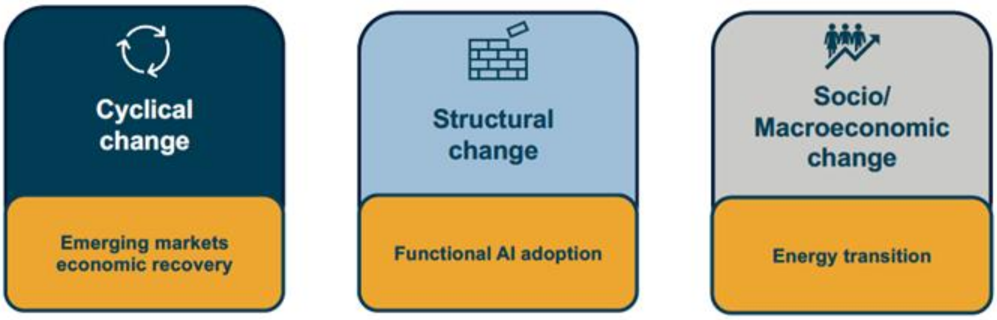
Chad Padowitz is Co-Chief Investment Officer of [Talaria Capital](). Talaria's listed funds are Global Equity [(TLRA)]() and Global Equity Currency Hedged ([TLRH)](). This article is general information and does not consider the circumstances of any investor.

3 under the radar investment opportunities

Vihari Ross

There is a lot of noise in markets. What's going to happen with Donald Trump? Is he going to win the next election? What's going to happen with interest rates, inflation, geopolitical conflict? Part of our job is to cut through that noise to try and understand what true tangible changes are taking place in industries, sectors and markets that we can take advantage of as investors. Let's have a look at three examples.

Take advantage of opportunities by change



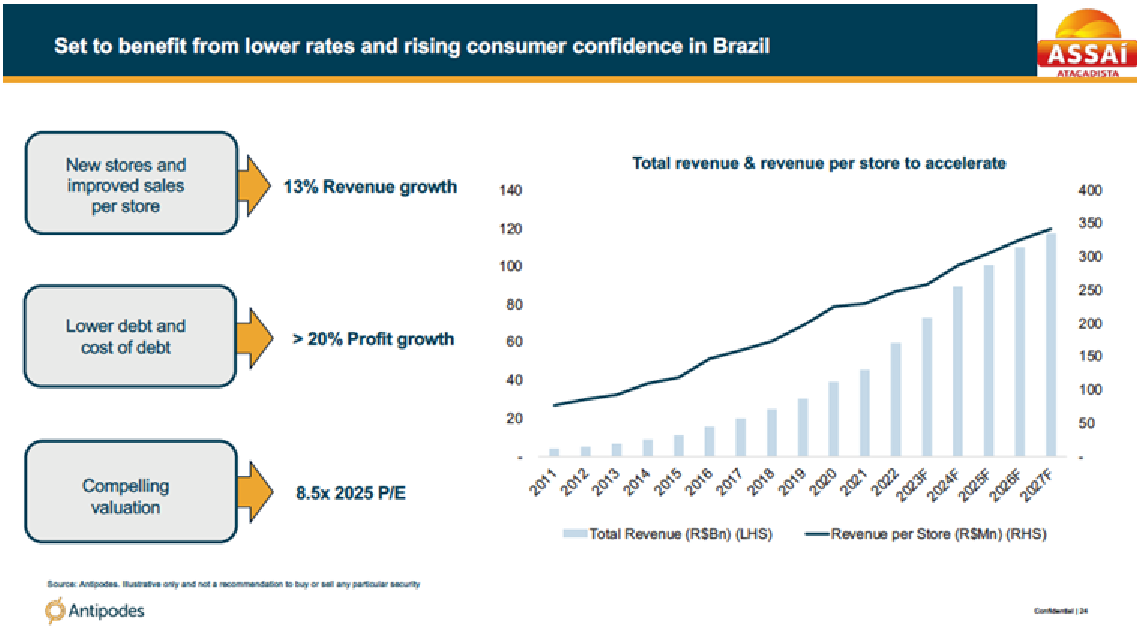
Source: Antipodes

Cyclical change – Coming out ahead at the grocery store

We have 18% exposure to emerging markets in our global portfolios. This includes Brazil, which has had a volatile economy, and been through all sorts of cyclical ups and downs. Yet, interest rates are starting to come down, consumer confidence is rising, unemployment is declining, while people's ability to borrow is increasing. That's leading to a real consumer recovery in Brazil. It's a cyclical change we want to be a part of, and we are taking advantage of that through Sendas Distribudora (BVMF:ASAI3).

This is a Brazilian cash and carry grocery store that's popular among the well off. This business bought one of its competitors at an unfortunate time, when interest rates really started to accelerate, and they took on debt. Now what they're doing is rolling out stores at a rapid pace. They're refurbishing those stores that they bought and opening them at three times the rate of sales that they had before. So you're getting this really nice double digit revenue growth rate. Then you've got the cashflow coming out of these new stores and you've got interest rates coming down.

That means that they're now growing earnings at 20% per annum. And yet this grocery retailer is trading at just eight and a half times PE. We can compare that to a developed market equivalent of Costco, but to buy Costco, it will cost you a 40x earnings multiple.

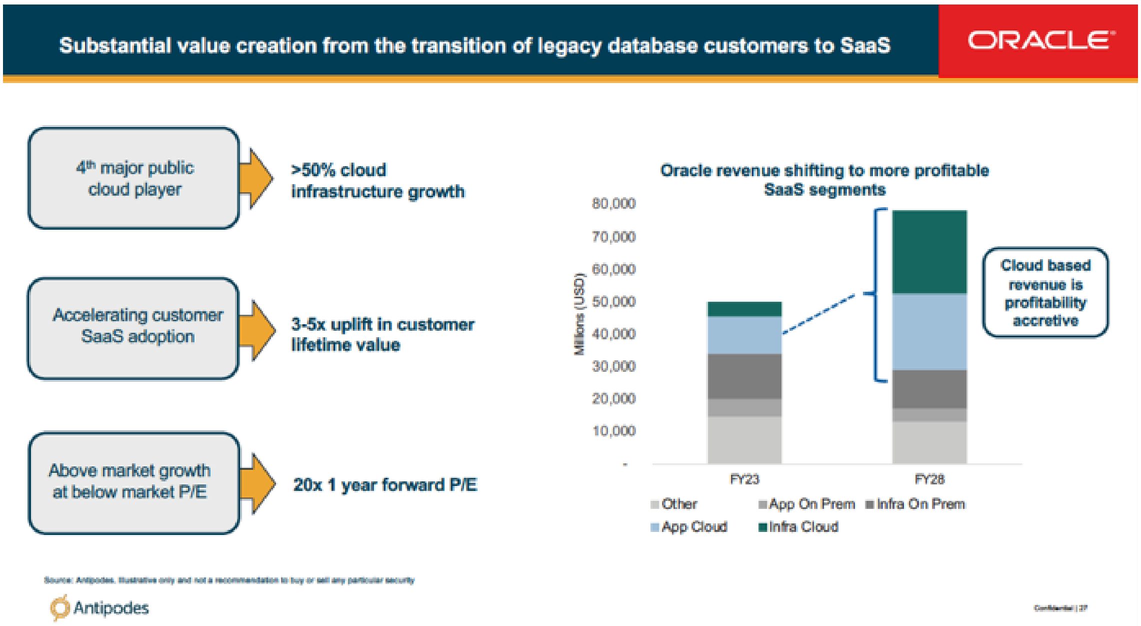


Structural change – AI, but the boring bits

A lot of the structural shift that's taken place with AI has been on the consumer facing side. With the likes of Netflix, Apple Music, Microsoft apps on the cloud etc.

A big shift is about to happen on the less exciting end of things, with back-office databases and the infrastructure as a service element of this cloud transition. And as that shift takes place, we are going to continue to have 15 to 20% organic migration growth coming from that growth in the usage of cloud. It'll come from new products, and AI will be a real way for this growth to be augmented over time.

And the pragmatic value way that we are playing that trend is through Oracle (NYSE:ORCL). This is a business that was written off by the market about 10 years ago. The CEO famously said that he thought cloud was a fad. Therefore, the company was slow to move on the 'fad' and paid the price. Now, it's a different story.

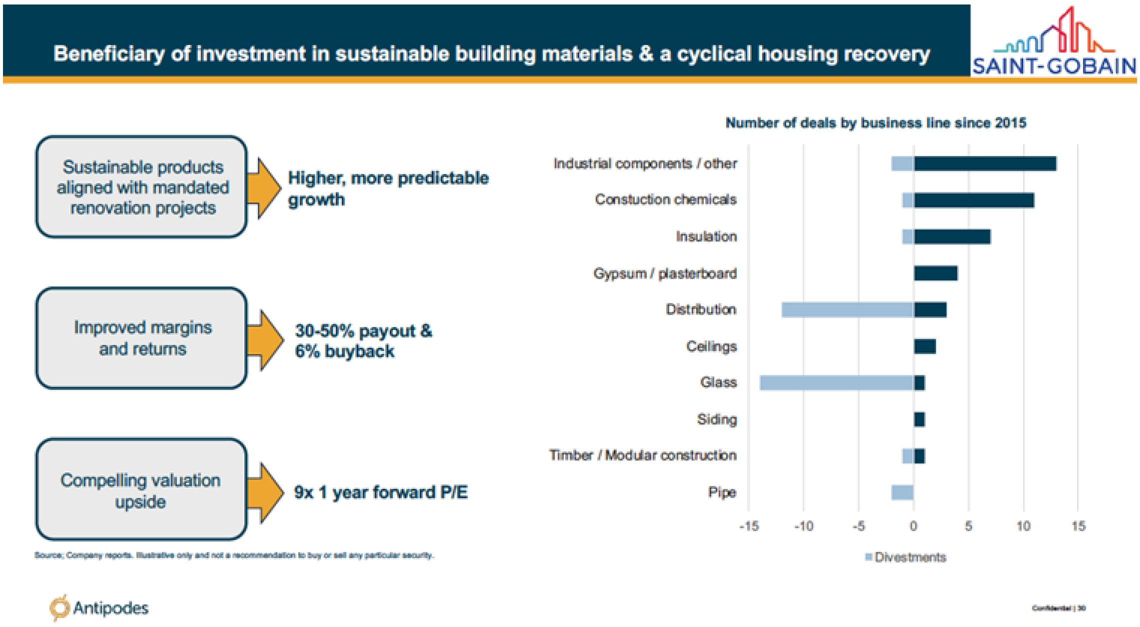


You can see that with those gray bars, Oracle's on-premise ERP stuff is declining. It's being replaced by cloud infrastructure revenue that is growing at 50% per annum. And as they augment that infrastructure as a service with platform and with software, they're actually getting three to five times the customer value out of those business.

Oracle is trading at 20x earnings and growing at 10-15% per annum. So it's growing faster than the market and it's trading at a cheaper multiple.

Energy transition as socio/macroeconomic change

Socio/macroeconomic change is now achievable and in lots of different ways. One of the least exciting is through efficiency. That means things like using insulation, reusing materials, having more energy efficient air conditioning in your home. Efficiency is quite a broad-based investment opportunity within this broader circle of socio/macro change and the way that we're participating in this is through French multinational building materials company Saint-Gobain (EPA: SGO). This is a business that has really re-engineered itself towards sustainability.



75% of the products and services that they sell now are sustainability focused. This is leading to higher and more predictable growth. To give you an example of Europe, 90% of buildings actually need to be retrofitted with things like insulation. It's going to triple the renovation rate in Europe. So this is a business that's getting higher growth than it used to. It's getting better profitability, it's getting better return on its capital employed and it's getting better cashflow.

They've actually increased their dividend. They're paying back 6% of their stock. And this is a business that's trading on a single digit multiple. This is a multiple that is at a 10 to 15 year low for a business that has better forward-looking economics than in the past. And the reason for that is because people are worried about the mortgage cycle and they're worried about what's going to happen with new builds, when the reality is this is a story that is about sustainability and the market is missing the point when it comes to the future of this business.

Vihari Ross is a Portfolio Manager at Antipodes Partners, an affiliate manager of [Pinnacle Investment Management](). Pinnacle is a sponsor of Firstlinks. This article is for general information purposes only and does not consider any person's objectives, financial situation or needs, and because of that, reliance should not be placed on this information as the basis for making an investment, financial or other decision.

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Why a quant approach can thrive in the age of passive investing

Andrew Francis, Dr. David Walsh, James Gruber

Celebrating its 15-year anniversary, Realindex Investments has changed its name to RQI Investors. RQI manages close to $30 billion through active, quantitative strategies. Here, Firstlinks' James Gruber interviews RQI Investors' Chief Executive Andrew Francis and Head of Investment Dr. David Walsh about how the firm is meeting today's market challenges.

James Gruber: How would you describe your approach to investing as a firm?

Andrew Francis: Our approach to investing is quantitative. That means that we're very systematic in our approach to research, portfolio construction, our processes are very quantitative in nature. But we don't believe the market is perfectly efficient and we think that by generating quantitative insights, we can outperform the marketplace.

Gruber: Has passive investing changed the way you invest across time? For instance, with value, has it increased the opportunities or decreased them?

Francis: I think the duration of some cycles is longer than it might have been in the past. The weight of money going into some parts of the market can mean that that mispricing might stay mispriced for slightly longer than it might have in prior years. But there's still long-term mean reversion.

Take for example, BHP. In 2010, BHP was 'stronger for longer'. It was perceived as a resource super-cycle with China going to the moon and back in terms of growth. But the cap weighted index was putting more and more money into BHP at that point of time. I think it got up to $45 or $50, representing 12% to 14% of the Aussie market.

And everyone would say, but you're underweight BHP. And I said, yes, we are underweight BHP. And they said, well, you will never be overweight BHP. And I said, well, I don't know. And that was the truth.

But you know what? It wasn't a resource super cycle. China wasn't stronger for longer. And we saw BHP share price go from that $45 down to $15.

Source: Morningstar

And you know what happens at $15? Charlie Munger says that the share market is the only market on the earth that no one wants to buy when it's on sale. And the point is: you had a maximum amount of money, if you're invested in a cap weighted index, in BHP at the peak of the market. And when it's down at $15 and it's cheap, no one wants to buy it. And it's half the index weight.

Well, you know what? When you're weighting by fundamentals, our weight didn't change considerably. So, we were very underweight BHP when it was at $45. And we were rebalancing back to company fundamentals and then when it was down at $15, our weight hadn't changed significantly, but the market cap weight had changed significantly. So, all of a sudden, we're very overweight BHP and we've benefited from the mean reversion on the way down to $15 and on the way up as well. This example highlights the value process in that one name. And we can give countless examples as well.

Gruber: We'll get David in here. Systematic investing, it looks for edges in things or asymmetries in data and markets. Do you find that those asymmetries persist, or do they evolve, and you have to change into other asymmetries over time?

David Walsh: A lot of good ideas can be arbitraged out over time. This is well-known in the market - that certain things come on and they're researched, and then there's more and more people tending to chase those ideas which can be arbitraged out. We do see that.

But the question you have to ask in the first place is: why do these inefficiencies exist? And we believe there are some three central reasons why they do that.

1. There are limits to arbitrage including not being able to act fast enough, and costs in terms of opportunity sets.
2. There are behavioural biases: people behave in a certain way that means they're underreacting to news, they tend to oversell, don't sell at the right times, or buy at wrong times.
3. And information complexity which includes the vast amount of information flowing at the moment.

So those underpin a lot of the inefficiencies in the market, they're not changing, but getting worse in a lot of ways.

The question then is not 'does a particular insight get arbitraged out?', it's 'can you exploit one of those three ideas in a way in which you can generate alpha'? It might be that one particular idea gets arbitraged out, but an idea which replaces it, which has a bigger barrier to entry, is more complex, remains. The trick is in your research and the way you build models to capture those ideas in a more efficient way. The fact that these ideas can be arbitraged out is more a mechanism of the way in which the market prices it. It could be the data that's available becomes more commoditized, it could be that the research becomes more popular in academic publications, those sort of things cause it. But the underlying fundamentals to why markets are inefficient don't really change.

Gruber: Do you rely 100% on your models or is there some human judgment that comes into play?

Walsh: All our best ideas should be in the models. We don't override the models once they're in the portfolios, unless there are extreme circumstances. The human part comes in the research and generating the ideas in the first place. The idea has to be generated by insight and really at the core of what we do is better insight. We need to be very good at building the right team, having the right environment and the right culture to foster insight development. Now when you're doing that, you're involved in a lot of discussion with the team, a lot of research, sometimes subjective decisions, sometimes not. You spend a lot of time researching your ideas and building better tools so you understand what's going on. When you build the model and put it in place, you're confident it is going to work. At that level, the subjectivity is gone. In some sense subjectivity comes in when you're doing the research in the first place and how you go about choosing it and what the ideas might be.

Gruber: ESG has copped a fair bit of flak of late. It's always been part of what you do. Has that changed your view on ESG at all and how you do things?

Walsh: We've got a philosophy around ESG we think is consistent and hasn't changed. The consistent idea is ESG should fall into one of, we think, four pillars of ideas – exclusions, company engagements, risk controls and alpha sources. Exclusions are stocks you don't want to own at all, which are usually based on client mandates. And from time to time, we'll put in exclusions ourselves based on our own principles, for example, tobacco and controversial weapons won't be included.

We also do an engagement process with companies over time, which is significant. Being a quant manager, we own a lot of stocks, so it can be hard to engage with all companies. We've got to be very selective who we engage with.

But when it comes down to it, the key issues we see in ESG are firstly risk controls, controlling what we perceive to be an ESG risk; carbon exposure being a good example of that.

And secondly is around alpha sources. Now ESG as an alpha source, it's something of an anathema with quant managers because they don't necessarily see it that way. But we would say that ESG is a reflection of a good quality company. A company which has good ESG policies, implements efficient ESG in what it does is a better quality company. So, it gives you a lens on how a company operates. In a sense, ESG alphas are a way of thinking of quality within a stock.

Francis: I might just add one thing on the ESG alpha side. Likewise, if we didn't have comfort on those signals, they wouldn't make their way into the portfolio. They've got to stand up on their own right. They're not there because they're ESG. They're there because we think they've got a competitive advantage versus other signals and they're complementary. But if, for example, we lost confidence in any of those signals, they wouldn't make up part of the portfolio.

Gruber: And how are you going about that with AI and trying to implement that in your firm going forward?

Walsh: We have a really strong team that understands a lot of this work in terms of natural language processing or other various machine learning applications, but we're really very hesitant to put something in unless the insight is right. So, the insight needs to be there. The machine learning, AI, natural language processing is not the insight. That's not the idea. It's a tool to apply a certain level of insight. And maybe you can have insights or see things going on the data you can't see normally without applying some kind of other tool like a machine learning or natural language processing, deep learning tool of some sort that will give you those. So, we have approaches which use natural language processing and text processing for alphas. We use machine learning in a way that we think of selecting peers between groups, so how does momentum work between peers, how do you choose a peer group? Those sorts of things require machine learning tools. But the idea is what comes first.

Andrew Francis is the Chief Executive and Dr. David Walsh is Head of Investment at RQI Investors, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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