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Contents

Editorial

Markets seem fixated on whether the US Federal Reserve will change policy and slow hikes in interest rates. Arguably, an issue that's just as important, if not more so, is when China will ease Covid lockdowns. The timing of this will have a significant bearing on the fates of commodities, inflation, and interest rates over the next 12 months.

A recent surge in China-related stocks suggests investors believe that recent Covid lockdown protests in China will force the government's hand to lift lockdown measures sooner rather than later. We think these investors will be disappointed as Xi Jinping will lose domestic credibility if he does this. Much more likely is that China cracks down on the protests, keeps the lockdown going until Covid cases decline, then gradually re-opens and stays open. This way, Xi can declare a success over Covid and ensure protests don't get out of hand and threaten social stability – which is the Communist Party's greatest fear.

If re-opening happens in the first quarter of next year, as we anticipate, then oil and industrial-related commodities are expected to soar. Energy and the likes of copper remain extremely tight markets given massive undersupply of these commodities. A reopening may also see another spike in global inflation, and interest rates could potentially rise as well.

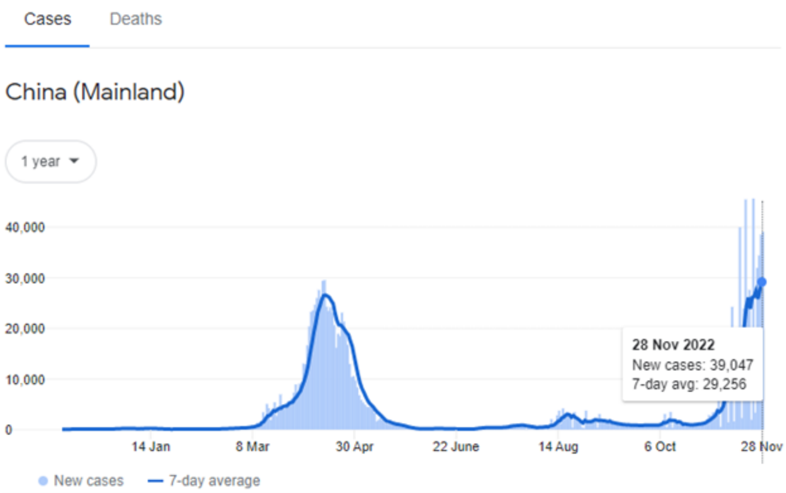
How widespread are the protests?

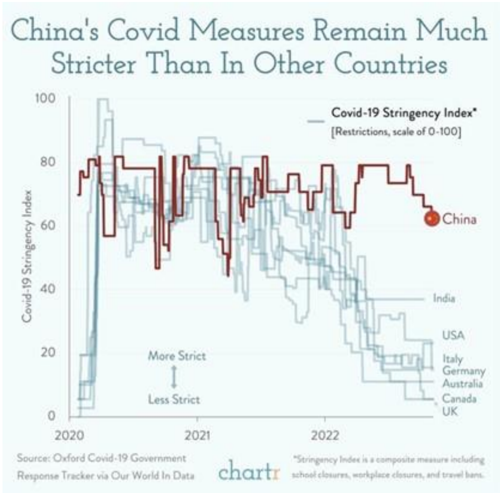
Your author lived in Asia as an investment analyst for more than four years, including in China and Hong Kong, and one thing I learned is to be sceptical of opinions on China from those outside the country (including mine perhaps!). China is a huge, diverse place and commentators often generalize and simplify the reality of what is a complex country.

That's especially the case when it comes to issues such as protests. What seems clear is that there have been several relatively small protests over Covid lockdowns across several cities in China over the past week. What is less clear is how widespread the anti-lockdown sentiment is and how much of the protests are also anti-Xi Jinping.

What's bizarre is that China remains locked down even though cases remain exceptionally low. The latest daily new case number of 39,047 is tiny for a country with a population of 1.4 billion. Keep in mind that daily cases peaked in Australia above 150,000. China's current new cases are the equivalent of 700 Australia-wide cases, when adjusted for population.

Note that from May to October of this year, China remained locked down despite daily new cases being below 2,000 for the entire period.





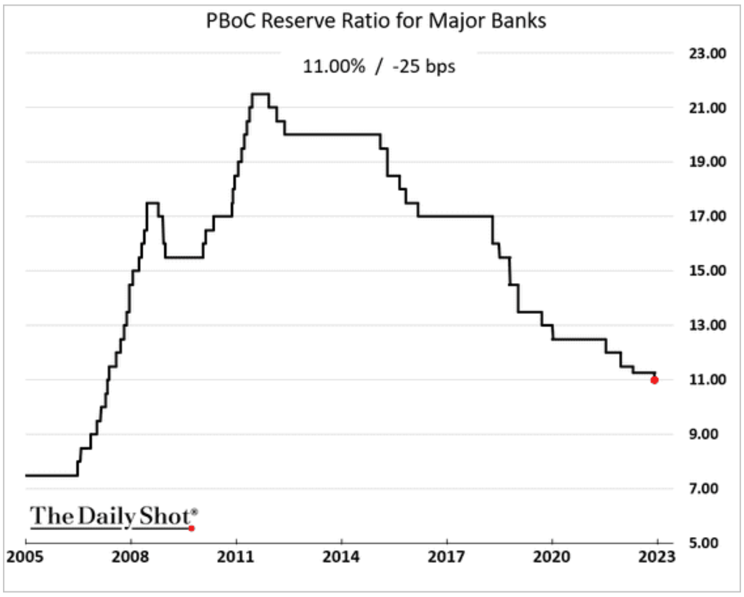
Source: Google

There's no doubt that businesses are being impacted by the Covid protests. Apple supplier Foxconn has had severe disruptions at its iPhone factory in Zhengzhou. Those livestreaming the protests say workers were beaten by police. It appears lockdowns were only part of the worker grievances, though, as claims of overdue pay emerged too.

Government support measures

The backdrop for these ongoing lockdowns is daunting. The lockdowns are causing China immense economic pain and the government is trying to spur the economy through a variety of supportive measures. The People's Bank of China has announced a 0.25% cut to the reserve requirement ratio to 7.8% and says it'll inject around 500 billion yuan (A$104 billion) in long-term liquidity.

The government has also stepped-up support for the ailing real estate sector. This includes 250 billion yuan (A$52 billion) for bond financing of private property developers and the announcement of 16 measures to support the housing market, including supporting issuance of construction loans and encouraging banks to extend mortgage repayments for home buyers.



When will China reopen?

President Xi Jinping has taken personal responsibility for China's Covid-zero policy. He lauded the country's efforts in 2020-2021 when cases remained low and pointedly referenced overseas case numbers at that time to highlight the success of his policy.

With the latest lockdown protests, there are three probable scenarios which investors need to consider:

- The lockdowns stay until Covid essentially disappears, or at least gets to very low numbers. That's likely to mean a further prolonged period of lockdowns, which have already been in place for nearly three years. China may get more vigorous in extinguishing any protests.
- Lockdowns ease immediately and the country puts up with any subsequent increase in Covid cases. The protests may be too much of a danger to social stability and that forces the move. China had started to gradually re-open over the past few months until this latest spike in cases.
- Protests are quelled, and China remains locked down until Covid cases ease somewhat. They then re-open and stay open. This way, Xi can declare victory over Covid, protests die down and the economy gets up-and-going again.

Markets seem to be betting that on scenario 2. It seems to us that the greater probability lies with scenario 3. The reason is that opening now after almost three years of Covid-zero rhetoric would dent Xi's credibility. It's a dangerous thing for a dictator to lose credibility.

Scenario 3 would appear to be a win-win for Xi and the Chinese people, who are no doubt craving freedom from being locked down for so long. First though, protests need to decline and Covid cases need to go down.

If we had to guess, we would pin reopening around Chinese New Year. However, that's purely a guess given it's dependent on both Covid cases and protests.

What happens to markets under these scenarios?

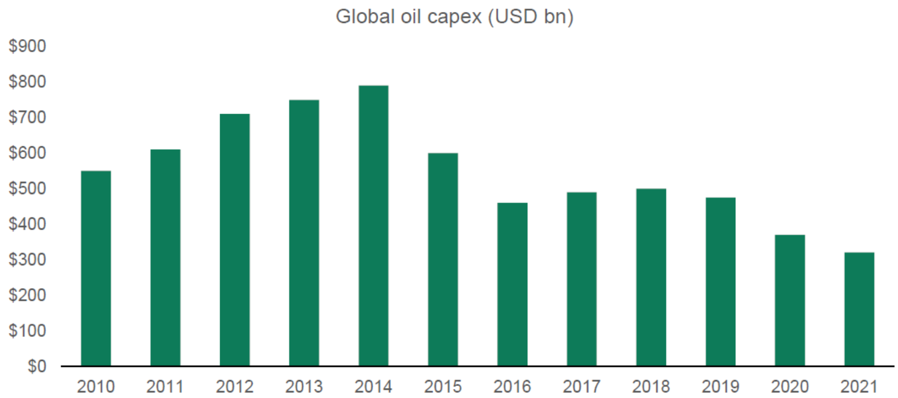
Let's look at the likely market reaction to each of the scenarios.

Under scenario 1, China's economy would continue to slow, and it would dampen demand for goods and inflation globally. Commodity prices might fall. That would help worldwide inflation to ease, perhaps a lot. And that would be supportive of the US Federal Reserve slowing interest rates hikes.

The concern might become one of slowing economic growth rather than inflation. Continued lockdowns would hurt exporters such as Australia and European countries such as Germany.

While stocks might bounce initially, any hints of a slowdown would cap any upside. Bonds would likely be the largest beneficiary. Commodities would be in the doldrums for some time to come.

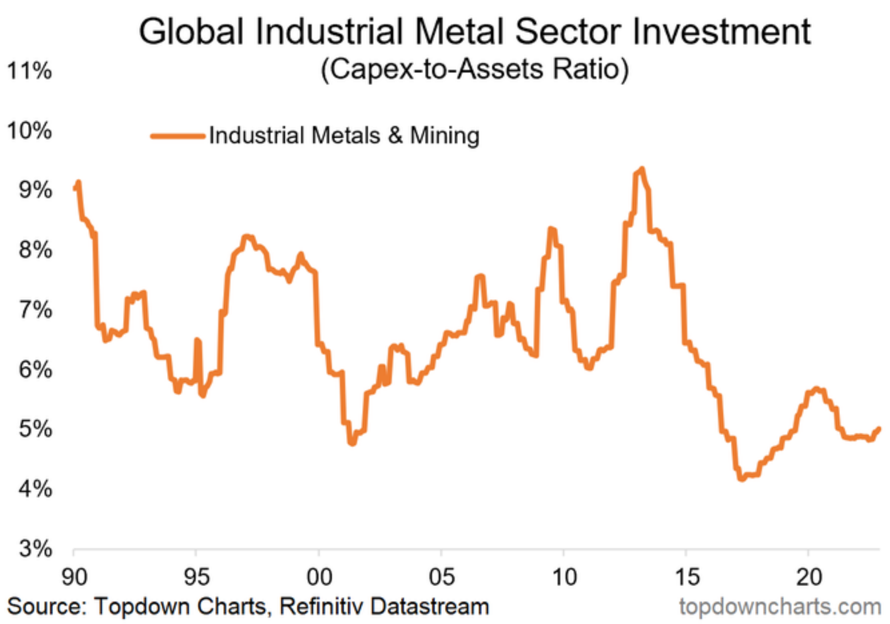
Under scenario 2, there would be a significant and near immediate spike in Chinese holidaymakers and spending on goods such as luxury goods would boom. Demand for energy and commodities would re-accelerate as the economy surges.



Source: International Journal of Energy Research

Your author remains positive on the likes of oil and copper as both are significantly undersupplied and any pickup in Chinese demand may send prices higher, potentially a lot higher.

Scenario 2 would be positive for commodities prices, emerging markets' stocks and currencies. It would be bearish for interest rates and bonds, and for countries with indebted consumers.



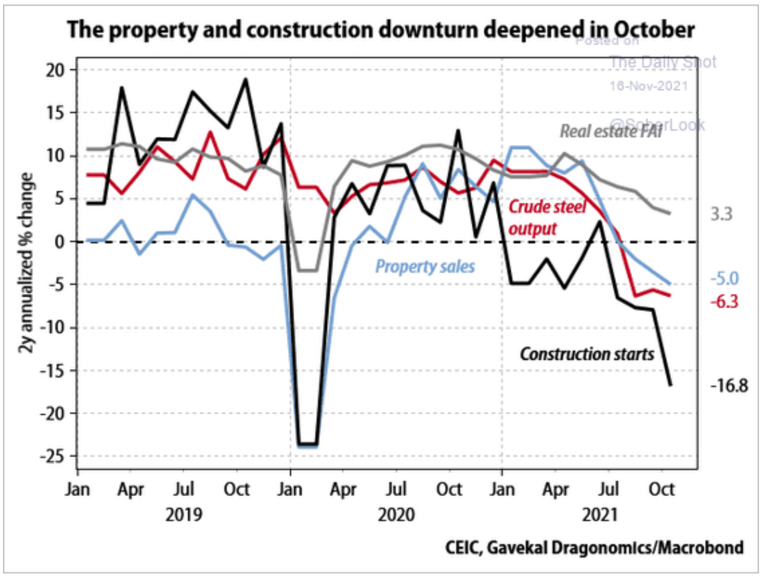
While Australia would appreciate the higher commodity prices, higher inflation and higher interest rates would weight down the consumer and, of course, the housing sector.

Under scenario 3, it would be the same as scenario 2 except with a time delay. We are guessing the first quarter of 2023 might be the time, though there are many variables which will determine that.

China's long-term problems

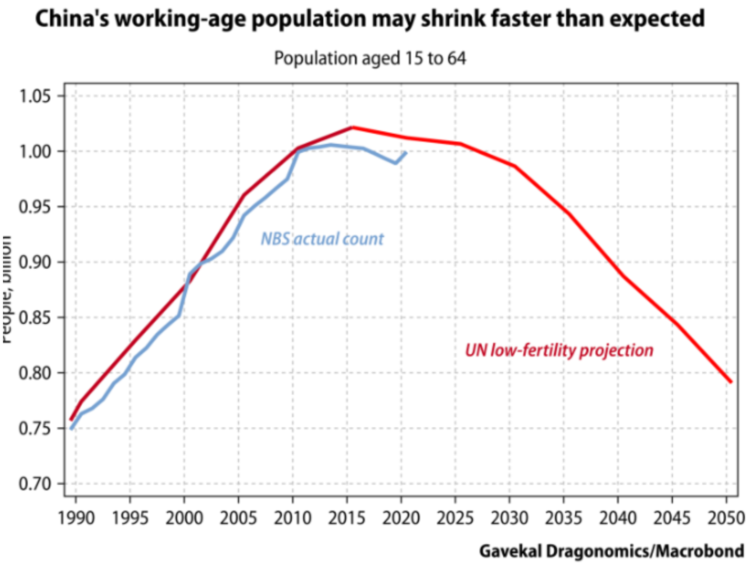
We've talked about scenarios for China over the next 12 months, but the long-term picture for the country remains problematic. There are three main issues:

- A prolonged real estate slowdown, not unlike Japan in the 1990s. For far too long, China stimulated real estate and infrastructure to pump up economic activity and GDP. The effectiveness of that stimulus has waned, slowing economic growth, and resulting in falling residential and commercial property prices. Homes in so-called 3rd and 4th tier cities have seen price declines of up to 20% since 2020. Kenneth Rogoff, Professor of Economics and Public Policy at Harvard University, suggests these cities account for more than 60% of China's GDP so any slowdown there will have broader implications. He also notes the real estate sector accounts for roughly 23% of China production and 26% of final economic demand.



- Demographics also bode poorly for China's long-term economic growth prospects. The UN estimates that China's working age population may decline by two-thirds by the end of this century. China's long-time one-child policy is mostly to blame.

  The importance of a shrinking working age population is that it weighs on economic demand. After all, GDP (gross domestic product) equals the population growth rate plus GDP per capita. A paper by [Rand Corporation] found that a 10% increase in the fraction of the population aged +60 decreases the growth rate of GDP per capita by 5.5%. "Two-thirds of that reduction is due to slower growth in labor productivity of workers across the age distribution, while one-third arises from slower labor force growth", according to the paper.



- China's 20th Party Congress in October clearly emphasized security and stability as priorities and deemphasized the economy. The focus on security is understandable given the US has effectively declared a tech war through its restrictions on semiconductors, initially implemented against Huawei and extending them to include all Chinese corporations (a recent article in *Firstlinks* provides more detail on this). But it doesn't bode well for the private sector. Internet companies have already gone through a regulatory assault aimed at purging "bad habits" associated with online gaming, live-streaming, music, and private tutoring. There's no sign of government incursions into the private sector letting up any time soon.

In this week's edition ...

Potential changes to superannuation remain a hot topic. This week, we have **Jon Kalkman** as our guide on how the super system was originally designed and how we ended with the system we have now. He says the numerous changes to super over the years have complicated a system which was flawed from the outset.

Meanwhile the equity or inequity of super tax breaks for retirees has provoked intense debate among Firstlinks' readers. Some view these breaks as a travesty while others believe they're fair. We try to shed more light on the issue by collating the views of a number of our readers.

Shane Woldendorp of Orbis Investments suggests investors face a difficult decision when choosing a fund manager. He outlines four principles for choosing the right active manager which can help make a difference to investor portfolios.

After a dismal year, could bonds be set for a comeback? **Tim Dowling** of Aquasia thinks the pullback has opened up opportunities in asset-backed securities and RMBS, especially for those investors looking to maximise returns from investment grade assets while also reducing their exposure to interest rate risk.

Australian small caps have also been hammered this year and **Simon Brown** from Tribeca Investment Partners is hunting for value. He thinks tech, consumer discretionary and building materials look interesting. And stocks benefitting from the renewable energy push are also attractive.

Andrew Mitchell says investors who abandon fund managers because of the recent market downturn are making an error. He provides compelling evidence that even if you have the 'perfect portfolio', large drawdowns are inevitable.

We also look at how cryptocurrency advocates seem to be in total denial that their war against fiat currency has ended. FTX's downfall should prove the final straw as the world is moving on from crypto mania and it'll be better off for it.

This week's White Paper comes from Pinnacle Investment Management affiliate, **Hyperion Asset Management**, reflecting on recent portfolio performance and the importance of keeping a long-term view.

Finally, we recently did an article on the need for company directors to get director identification numbers (director ids) by 30 November this year. The ATO has announced it won't penalise around 700,000 company directors who have yet to apply for director IDs if they do so by 14 December.

Super is about equity and fairness

Jon Kalkman

Imagine a world in which all contributions to super during your working life were tax-free and imagine that the fund that invested these contributions was also free of taxes on their investment returns. Now imagine a world in which all withdrawals from that super fund in retirement, including income streams and lump sums, were taxed as income at normal progressive marginal tax rates.

Imagine how much higher those investment returns would have grown before retirement if the compounding over a working life of 30-40 years had operated on 100% of investments rather than the 85% remaining after a 15% tax.

Paul Keating's original design for our super scheme in 1992 was almost this ideal system. Originally, contributions and earnings would be tax-free and retirement benefits would be taxed at 30% in recognition that this money is locked away for half a lifetime. But Keating was not prepared to wait 30-40 years before any tax was collected and so we ended up with a system whose design faults require frequent correction so that it encourages people to save for their own retirement through tax concessions, but also limits those concessions to curb the budgetary cost.

Since the system is now 30 years old, many people do not know or remember the history of this complex system.

How super works

There are two ways to contribute money to super. Contributions on which tax has not previously been paid include employers' super guarantee (SG), salary sacrifice and tax-deductible contributions. These contributions are then taxed within the super fund at 15%. But for high income earners the contribution tax is 30%. Previously people over the age of 50, could contribute $100,000 of their pre-tax salary to boost their super balance prior to retirement but because of the cost to tax revenue, these limits have been progressively reduced. Today this type of pre-tax contribution is limited to $27,500 per year for everyone.

The other type of contribution has tax paid prior to transfer to super. These contributions include the proceeds of sale of investments, businesses or personal savings. These after-tax contributions are not taxed within the super fund. Both types of contributions are invested in an accumulation fund. The income earned by the fund is then taxed at 15% until the money is withdrawn, but not before retirement.

Tax rates for superannuation

Activity	Tax Rate	
Employer contributions	15%	If you earn less than $37,001 per year, up to $500 of the tax paid on your concessional super contributions will be refunded into your super account.
Salary sacrifice and other super contributions you've claimed a tax deduction on	15%	
Voluntary after-tax contributions	Not taxed	These contributions are not taxed because it is from your after-tax earnings or take-home pay.
Government co-contributions	Not taxed	
Transferring or consolidating your super	Not taxed	
Super fund investment earnings	15%	
Exceeding $250,000 income and super contributions per year	30%	
Withdrawing money from your super fund at 60 or above	Not taxed	

Source: Industry Super Australia

In retirement, the accumulated super balance can be transferred to a super pension fund where the fund's income and capital gains are tax-exempt. Super pension funds have been tax-exempt since 1992 because tax has already been collected on contributions and accumulation earnings over many years. Accumulation and pension funds are two distinct types of super funds because of their different tax treatments.

The changes under Costello

Before 2007 there was no upper limit on after-tax contributions. People with sufficient resources were well advised to maximise these contributions because, when they retired, their super pension fund paid no tax on investment earnings. Those pre-2007 rules explain why we still have a few SMSFs with more than $100 million.

In 2007, Treasurer Costello introduced strict limits on these after-tax contributions. Initially the annual limit was $150,000 but in response to the howls of protest, he allowed a $1 million contribution for one more year. That was later indexed to $180,000 per year. These contribution caps have also been progressively reduced since that time and are now limited to $110,000 per year.

Costello also eliminated the tax that members paid previously on drawing their money out of a super fund. All withdrawals, including lump sums, from a super fund are now tax-exempt after age 60. That appears to be a generous concession but in fact members paid very little tax before these changes as explained here.

Until 2017, these large funds were held in pension phase in retirement to take advantage of its tax-exempt status. The pension fund paid no tax on investment earnings and the fund member paid no tax when they withdrew their pension. Their only obligation was to draw a mandatory pension determined by their age. For someone between the ages of 65 and 75, that minimum pension is 5%. For a fund of $10 million, that would have provided a tax-free pension of $500,000 per year which had to be removed from super, but it would then be exposed to normal tax rates.

The changes under Morrison

In 2017, Treasurer Morrison introduced the Transfer Balance Cap which limited the amount that could be transferred to a tax-free pension fund. It was set at $1.6 million and looks likely to increase to $1.9 million in 2023 due to inflation. Any excess money was required to be either removed from super altogether or transferred to an accumulation fund. Most chose the accumulation fund for the concessional tax rate.

For the government it meant increased taxation revenue from accumulation funds. For an SMSF of $10 million it meant a mandatory pension was then 5% of $1.6 million in the pension fund, or $80,000. The remainder ($8.4 million) was held in an accumulation fund and is still concessionally taxed (at 15%) with no obligation to make any withdrawals, although tax-free withdrawals of any size can be made after age 60. Unsurprisingly, the ATO reports that these large funds just continue to grow.

These large funds remain a legacy of an earlier time and eventually they will disappear because death is a cashed-out event but until then, they are perfectly legal and make ideal estate planning vehicles. Worse, they continue to distort the whole debate around tax concessions flowing to super.

Morrison also introduced the Total Super Balance Cap. Once a member's super balance reaches this cap (presently $1.7 million), the fund cannot accept any more after-tax contributions. There will be no more extremely large funds in future but arguably this is an inter-generational equity issue. Older retirees had access to very generous tax concessions but for younger people it is now simply not possible to accumulate those large super balances, regardless of their circumstances.

The current government proposals

The present government is now mulling a total cap on super across both types of funds to limit the tax concessions flowing to these very large accumulation funds in retirement. Reports suggest that if the limit was set at $5 million, it would affect 16,000 people. If the limit was set at $2 million, it would affect 80,000 people.

These people were not pleased with the changes in 2017 which introduced tax on some of their super for the first time. Given that these people followed the rules as existed at the time, they would not be thrilled with further legislation that forced them to remove any excess money from super altogether, especially as the government promised before the election to make no changes to super.

Misplaced envy about retiree tax benefits

A tax-free retirement is the result of Keating's tax concessions provided to super funds which have existed since 1992, and not the Costello tax concessions flowing to individuals. Some would argue the whole point of compulsory saving inside a super fund that cannot be accessed for 30-40 years, IS a tax-free retirement. It actually represents a social contract. Unfortunately, it has led to considerable intergenerational envy about the tax benefits flowing to retirees, from people who do not understand how super savings are taxed. That envy would not exist if super funds had been structured differently in the first place.

If we wanted to design a better super system, we wouldn't start from here, given the complicated patches that have been needed to fix a complex system. In any case, knowing what we know now, who would trust a government that promised tax arrangements on retirement savings to be delivered by some future government in 30 years' time?

Jon Kalkman is a former director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor. This article is based on an understanding of the rules at the time of writing.

Fierce debate among Firstlinks' readers over 'super inequities'

James Gruber

In last week's *Firstlinks* newsletter, we featured an interview that the ABC's Geraldine Doogue did with Jeremy Cooper, a former ASIC deputy chair and former chairman of retirement income at Challenger, on potential changes to the superannuation system. In the interview, Cooper outlined super's purpose as a consumption smoothing mechanism and how that purpose had been distorted as the system had become more complicated. He described his caution about super possibly being used for national development projects such as infrastructure and housing. And he said no changes to super should be urgent given their long-term implications.

It was Cooper's comments on the inequities of super tax breaks for retirees which provoked the greatest reaction among Firstlinks' readers and we thought it was worth sharing some of these comments to shed further light on the debate.

First, let's look at what Cooper said on the issue. He broadly agreed with Doogue that the tax concessions to retirees cannot last:

"...it's not about the budget for me. It's about basically equity and fairness. So, just consider somebody – let's just assume that I'm nearing retirement. I could go into retirement soon, and I could be earning, let's just say, several hundred thousand dollars a year upon which I would pay absolutely no tax and even better than that for me personally, but not so much for society, I would actually probably receive franking credit rebates as well, possibly in the tens of thousands of dollars. Let's just think I've got two kids who are 30 somethings. They're carrying HECS debts. They're trying to buy a house in Sydney at the moment. They're on relatively modest incomes upon which they're paying more tax than I would be...

...I'd be interested in who could explain to me why that's an equitable setting. It's embarrassing. I sort of choke having just said that. It's just unequal and illogical and frankly, dangerous. I mean, when you set up parts of a society in different age groups and on different income bands, that's just so unequal, it's just not good policy. Now, of course, that's easy for me to say. I'm not a politician going out there and actually rendering that change. I mean, once you've given – particularly retirees, once you've given somebody a state of affairs, winding it back, it's very difficult. But that's not to say that we shouldn't be having the conversations. People have picked a figure of $5 million. If you've got $5 million in super, the excess above that should be treated as effectively being in the ordinary economy, not being in super, and should be taxed appropriately."

Firstlinks reader, Brian, says he agrees with Cooper, as super was never designed as a tax shelter for high-net-worth individuals:

"There should be an upper limit to how much can be held in super not an open opportunity to minimise tax. If the current status is retained, then advisors and tax agents will only be doing their job for their clients if they utilise super to minimise tax."

However, another reader, Jack, thinks it's silly to compare retirees with a younger generation:

"…by definition, retirees have had a working life of asset accumulation. A more valid comparison would look at the standard of living of young families today, with the retired cohort 40 years ago. We could talk mortgage rates and childcare and home prices etc. but young families always do it tough, and retirees are always more comfortable because the kids have left home, and the mortgage is paid off or very nearly. Therefore, Jeremy's argument fails at the first hurdle.

Then we could talk about why super is tax-free in retirement because, as Jeremy admits, this is still a source of great confusion."

Reader, Ian, suggests people can have opinions though there's little doubt that changes to super are coming:

"A tax on super balances over $5m is coming for sure. Maybe the cut-off will be less than 5. Grattan suggests 2. That will encourage even more money to be redirected to investment in the tax-free family home (of both the superannuants or their kids/grandkids). Happy kids."

Meanwhile, another reader, James, thinks super was flawed from the get-go and changes now will remove the incentive to lock away money in super:

"Keating decided to tax the input and the earnings. Overseas, usually input and earnings are untaxed (maximum compounding ability), and drawdown is taxed. This is arguably as it should be. To tax a superannuation pension now breaks the governments compact with the people that incentivises locking away your money in superannuation…

…Take away the incentive to save in superannuation and people will choose to live it up and spend almost all of it. Hit 67 and draw a full single or couple's pension indexed for life, and aim to have only the maximum allowable in assessable assets (home owner singles $280,000, couples $419,000) to supplement the pension. Which is preferable, richer retirees spending more in the economy (paying more GST, stamp duties, fuel excise etc) or poorer retirees who are welfare dependent who will consume and spend less?"

Reader, Jon Kalkman, says Cooper has made a more fundamental mistake in his analysis:

"Jeremy has made the classic mistake of confusing his super fund's assets with his own. The hundreds of thousands of dollars he mentioned, are earned by his super fund, not by him. A super fund is a separate entity, much like a company, with its own assets, rules and tax return. As a shareholder of CBA, it's $10 billion profit has no impact on me until I get a distribution from those profits. I certainly wouldn't count the company's profit as my income.

We need to differentiate between the tax paid by the super fund as a separate entity, from the tax paid by a member when they receive a distribution from that fund. You may control the entity as director or trustee, but you cannot mix its assets with your own.

Super funds in accumulation phase pay 15% tax on concessional contributions and investment earnings. Super funds in pension phase are tax exempt. These tax arrangements have remained unchanged since the start of compulsory super in 1992."

Regular reader and past *Firstlinks'* contributor, Warren Bird, sought to unpack the question of capital versus income in pension payments from super:

"If I put $10,000 in a term deposit for 3 years at 4% per annum interest, then after 3 years I leave $5,000 in the bank and withdraw the rest am I taxed on the $6,200 that I've taken out? No. I'm taxed on the $1,200 that was interest income. It's similar with super. When you withdraw money from your super account, if the amount you take is more than the income you earned then that means some of it was taking out capital. In super ... you have ALREADY PAID TAX on that. You don't get taxed when you take money out of your bank account and you shouldn't be taxed when you take capital out of your super.

When you take income out of super, well if that income was earned on $1.7mn that's in a pension phase account, it's currently tax free. I argue that this is absolutely fair and reasonable…But what would be totally unfair would be for people to fail to distinguish between capital withdrawals and income, resulting in taxing that person twice."

And Warren Bird also takes issue with Cooper and other readers' suggestions that having $1.7 million in a pension phase account can generate several hundreds of thousands of dollars in income:

$1.7 million in a pension phase account cannot generate $200k a year in income. That would be a yield of 12% and that's not going to happen in a sensible portfolio. So the cap on the size of the fund that can generate the tax free retirement income also limits the income that is generated. More like $80-100k is what you should be thinking.

The comparison then becomes with someone earning $80k on which they'd pay $16,000 in tax.

Second, you need to take into account that the reason society, through successive governments, has encouraged people to save for their own retirement is that the person with $1.7 million in pension account does not now get the old age pension. That effectively means that they ARE being 'taxed' on their earnings, to the tune of $27k a year. That's more than the person paying $16k in income tax.

Look at the big picture and you'll see that there's a very fair base to our retirement income system. What would be unfair would be to not only deny the retired person the old age pension, but to tax the income they've earned on the funds they've put away for decades to get into that position."

We hope this article has amplified and clarified some of Jeremy Cooper's comments. *Firstlinks* appreciates all of the reader feedback on the issue.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

Four principles for choosing the right active manager

Shane Woldendorp

Most investors now realise their portfolio can, and probably should, be made up of a diversified set of investments that balance lower-cost and usually lower-return passive funds with those that are actively managed with a higher fee but usually higher returns in the long-term.

However, that is easier said than done. For passive options there are many things to consider, but the key question remains price. Meanwhile, with active managers, the dilemma for investors is in identifying skilled managers for the long-term. And when data suggests the majority (around 75%) of active fund managers underperform their benchmarks, that may raise the question whether it's worth it at all.

That statistic, however, shouldn't come as a surprise. Like a seesaw or a set of balancing scales, in the investment markets there is always a buyer and a seller and if one makes a profit, the other has to make a loss.

Therefore, not everyone can outperform the market – it's just simple maths!

Making the right choice

Of course, that doesn't mean that investors should give up and just stuff their money under the mattress. It's just that instead of striving for the impossible – perfect – performance they should understand that even a modest outperformance can make a big difference to their portfolios over the longer term.

But to do that, investors need to identify managers that have a particular set of skills - they should be unique, transparent and have a sustainable long-term advantage that is difficult to replicate.

We believe there are four principles that can be helpful in narrowing down the field, that are typically overlooked by investors in general.

1. Understand the incentives

This is another way of asking whether their interests are aligned with yours, as incentives are strong drivers of human behaviour.

One example of this in the investment world is often described as 'herding' or 'momentum' where investors tend to follow the crowd. This can sometimes be driven by fears of career risk, where fund managers might prefer to play it safe and stay in line with their peers to protect their job, rather than take a different position and potentially risk underperformance and standing out from the crowd.

Key things to look for that show a manager is more aligned with their clients' interests:

The ownership structure – Is fund management a key focus for the business, or a side hustle? Is it privately owned, or are there thousands of external shareholders driving behaviour and requesting shorter-term results rather than thinking long-term?

Co-investment – According to Morningstar, only half of all US mutual fund managers invest their own money in their funds. Does your manager put their money where their mouth is?

Performance fees – Do they benefit the manager no matter whether they under or outperform or are they dependent on actual results?

Activism – Does the manager make use of opportunities to potentially influence companies towards shareholder best interests. This could include things like engaging on remuneration, and corporate governance.

2. Focus on the long-term

Investors should remind themselves that when buying shares, they are investing in a business. This is sometimes ignored, as is evident by the fact that the average holding period for shares listed on the New York Stock Exchange is about 5.5 months. Is your manager making decisions based on the long-term fundamentals, or on short-term noise? Or a combination of both?

3. Be sceptical of overconfidence – especially about the future

The future is more uncertain than people believe, and many investors are prone to overconfidence in their assumptions and their ability to interpret information.

Though it is tempting to think that we can accurately predict the future, history tells us a different story. The key is to accept no-one can predict the future, but even modest outperformance compounded over time can make a big difference.

4. Embrace creativity

This is not opposing consensus for the sake of it, but rather being independent thinkers and looking at the counter view to the more popular one. As mentioned above, humans like to stick with the herd and look at what other people have done and say that's probably the right thing to do. But there are exceptions, and investing is one of them.

This is because share prices don't move based on the outcome of some event. They move based on the difference between the outcome and what people expected the outcome to be. So, for contrarian investors it comes down to finding opportunities where the outcomes are likely to be better than the expectations.

Thinking differently

The more successful investors over the years are those that look at the wider picture, and many active managers have evolved to do just that.

We try to only invest in a company once we have a strong view of what it's worth (its intrinsic value) and aim to buy its shares at a price that is below that. But you have to understand the reasons why the seller is selling at a lower value.

We also tend to try and let other people take it off our hands once the share goes past our estimate of fair value. We can then invest those proceeds into something that we think is unfairly priced.

Sometimes people say that contrarian investing, opposing the consensus, comes with more risk. But our view is that it's actually a risk averse approach as you're seeking to avoid overpaying for shares that are very overpriced.

While we may not get it right all the time, as we've discussed, no-one can do that, but to create modest outperformance consistently over the long-term is a goal that we are proud to pursue.

Shane Woldendorp, Investment Specialist, Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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Hunting for value in fixed income

Tim Dowling

As 2022 has proven, the direction of financial markets is determined by the continuous colliding of two highly reactive elements: expectations and realities.

Fixed income, often taking a back seat to the allure of equity markets, has this year been the focal point for financial pundits around the world. And with this excitement comes real opportunity for investors who can identify market sectors providing compelling relative value.

Expectation versus reality

Expectation: The Reserve Bank of Australia would continue to aggressively raise interest rates. Reality: A more measured 25 basis point increase in the cash rate for both October and November. The result was a rebound in asset prices through October and November and a renewed sense of optimism in the state of the economy.

However, while it may have helped to reverse some of the Australian share market's[1] September slide, the fifth-worst single month of market performance over the last decade, it did little to alleviate the overall pain investors have felt since the start of the year.

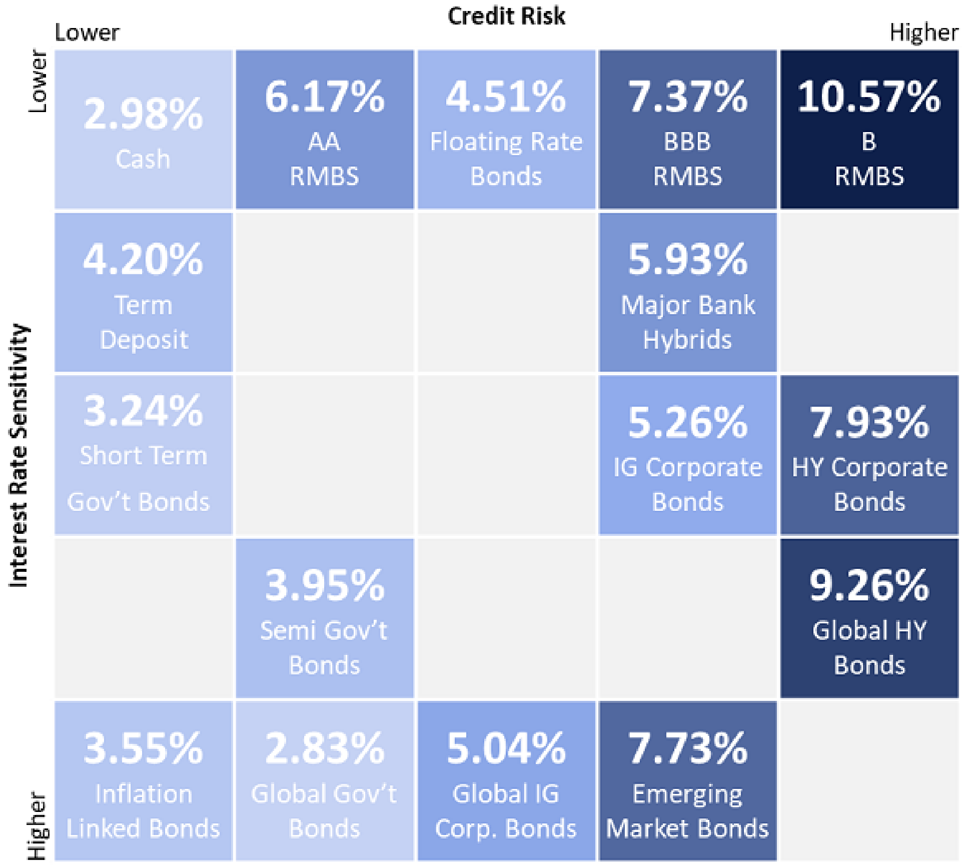
A balanced 60/40 portfolio of shares and bonds is down 8.56%, calendar year to date[2]. This has been driven by a fall in equity valuations, as well as the downward repricing of interest rate sensitive assets. Nonetheless, with future interest rate rises expected and the possibilities of a global recession looming, the composition of investors' fixed income allocations has never been more important.

The periodic table of bonds

For professional money managers and individual investors alike, the question remains the same: which fixed income securities offer the best risk and return potential on a forward-looking basis?

Below is the periodic table of bonds; a range of bond market sectors, mapped by credit quality and interest rate sensitivity. The location of each bond sector represents its relative risk exposures, while the number is what the sector is currently yielding. It's a novel way to provide a reading on the current climate of the fixed income market.

Figure 1: The Periodic Table of Bonds



Source: Bloomberg, Aquasia. Interest rate sensitivity measure is modified duration and CPI is assumed to remain unchanged. Credit risk measure is the credit quality of the index or underlying securities. Bloomberg AusBond Bank Bill Index (Cash), published 12 month term deposit of major bank (Term Deposit), Bloomberg AusBond Treasury 0-5 Yr Index (Short Term Gov't Bonds), Bloomberg AusBond Treasury 5+ Yr Index (Long Term Gov't Bonds), Bloomberg AusBond Infl 0+ Yr Index (Inflation Linked Bonds), Bloomberg AusBond Semi Govt 0+ Yr Index (Semi Gov't Bonds), Bloomberg Global Agg Treasuries Index (Global Gov't Bonds), Bloomberg AusBond Credit FRN 0+ Yr Index (Floating Rate Bonds), Bloomberg Global Agg Corporate Index (Global IG Corp. Bonds), S&P Australia Investment Grade Corporate Bond Index (IG Corporate Bonds), Bloomberg EM Aggregate Index (Emerging Market Bonds), S&P Australia High Yield Corporate Bond Index (HY Corporate Bonds), Bloomberg Global High Yield Index (Global HY Bonds). All Hybrid and RMBS data is based on recent primary issuance. All data as at 25 November, 2022.

Cash has the backing of the Australian government, in the form of the Financial Claims Scheme, for deposits of up to $250,000. The mark to market value of cash is also relatively immune to changes in interest rates - that's to say it has extremely low duration. The combination of these two things means cash is located at the top left-hand corner of the table. Using the Australian AusBond Bank Bill Index as a proxy for cash, we can calculate that the yield on cash is currently 2.98%.

Moving down the table we find securities with greater levels of duration and therefore greater sensitivity to interest rate changes. An increase in interest rates will cause the value of a long-term government bond to fall by more than a short-term government bond, all else remaining equal. Importantly, they are both backed by the AAA credit rating of the Australian government, one of only a handful of countries currently awarded the highest possible rating.

Moving to the right represents an increase in the credit risk of the underlying securities. The Bloomberg Global Aggregate Treasuries Index, a representative index for global government bonds, will inherently have a lower credit rating than Australia, as it includes government bonds issued by countries that have a lower credit rating than AAA.

The relationship between risk and return is well understood by investors and the objective is to earn the highest return possible for the lowest level of risk. Therefore, increases in either interest rate sensitivity or credit risk, two key risk factors for fixed income assets, should be compensated by increases in return. Sectors in the top left corner are lower risk and lower return for investors, while those in the bottom right corner are higher risk and should provide higher returns.

Identifying relative value

In some good news for investors, fixed income securities are finally offering attractive yields, especially when compared to riskier asset classes. Only 10 months ago cash was yielding 0.05%, short-term government bonds were offering 1.03% and global government bonds were at 1.13%. Whether or not yields have found their ultimate resting place remains to be seen, but the increase will no doubt be welcomed by income seeking investors.

More importantly however, this table highlights pockets of relative value within the bond market that are worth exploring. There are currently opportunities where investors could reduce both the level of credit risk and interest rate risk and yet be rewarded with a higher yield. For example, BBB and B RMBS offer greater levels of yield with lower levels of interest rate sensitivity compared to corporate bonds of the same credit quality. They also trump major bank hybrids, whose market value has historically been more closely correlated to equities than traditional bonds. Unfortunately, a higher equity beta is not a desirable trait for a defensive asset.

Asset-backed securities, such as RMBS, are floating rate in nature, meaning that changes in interest rates flow through to the coupon payments, reducing the impact of these changes on the mark to market value of the assets. RMBS also benefit from the legal caveats unique to securitised assets, including full recourse loans, waterfall payment structures and excess spread. Much like other mark to market assets, the current yield on asset backed securities reflect all available information and risk, meaning the softening housing market and higher interest costs have created a new market implied margin from which all new deals must now be issued. As a result, these securities can deliver superior risk adjusted returns to the defensive part of an investor's portfolio.

Positioning a portfolio

Investors have already had a challenging year, as expectations have met reality in chaotic fashion. The periodic table of bonds provides more than food for thought. It is actionable analysis that highlights sectors of the fixed income market that provide the greatest level of relative value.

The reality of future interest rate changes cannot be known, but the market expectation is for further rate increases. For investors that are looking to maximise returns from investment grade assets while also reducing their exposure to interest rate risk, asset backed securities and RMBS currently provide attractive opportunities. Regardless of where you see value, the periodic table framework can be used to ensure an investment portfolio is protected from both expectations and realities.

Tim Dowling is an investment specialist at Aquasia, a boutique investment management and corporate advisory firm that specialises in fixed income and credit markets. This commentary is provided by Aquasia Pty Ltd ABN 20 136 522 051, AFSL 337872 for general information purposes and is not financial or investment advice or an offer to buy or sell any financial product. It does not take into consideration any person's objectives, financial situation or needs and should not be used as the basis for any investment or financial decision. Past performance is not a reliable indicator of future performance.

[1] Source: Bloomberg. S&P/ASX 200 Total Return Index.

[2] Source Bloomberg, Aquasia. 20% S&P/ASX300 Index, 14.5% MSCI World ex-Australia Index (with net dividends reinvested) in Australian dollars, 9% MSCI World ex-Australian Index (with net dividends reinvested) hedged into Australian dollars, 3.5% MSCI World ex-Australia Small Cap Index (with net dividends reinvested) in Australian dollars, 3% MSCI Emerging Markets Index (with net dividends reinvested) in Australian dollars, 15% Bloomberg Barclays AusBond Composite 0+ Yr Index, 35% Bloomberg Barclays Global Aggregate Float Adjusted and Scaled Index hedged into Australian dollars as at 25 November, 2022.

Where are the opportunities in small caps?

Simon Brown

The economic outlook is uncertain for all sectors of the market with rising interest rates and still high inflation. Equity markets have been volatile and come sharply off highs reached earlier this year and late last year. Small companies have not been immune and have been beaten up badly, which is often the case with market drawdowns.

Inflation does appear to be peaking but the actions of central banks around the world will depend largely on what kind of trajectory that reduction in inflation follows. The rhetoric coming from the US Federal Reserve suggests that they're not done hiking yet. And the Reserve Bank of Australia appears to be of much the same view.

The big question is 'how high will rates go and how long will they stay there?' At the moment, we're not seeing much of an impact of tighter monetary policy within some of the consumer facing sectors in the domestic economy. But it certainly feels like there is more pressure emerging in some of the other developed markets, such as the United States, where rates have gone up faster and in larger increments, and where cost-of-living pressures have been bigger.

Why small companies?

What attracts us to the small company sector is that if you are able to identify the right ones, you can get the benefits of above average earnings growth early in a company's growth phase along with possible re-rating benefits as markets become more aware of the potential of the company.

Because of this, a bottom-up investment process is important when it comes to small companies. An important stage in our investment process is the company visit. It complements our analysis of a company and the sector that it operates in, along with research of its competitors and suppliers. That analysis will have led to the belief that there is an investment opportunity. So, when we visit a company, we are trying to ascertain whether the management team and the board can deliver the outcomes that we believe are possible based on our prior analysis.

COVID-19 obviously impinged on our ability to physically visit companies but not on our ability to interact with company management, as video calls were a reasonable substitute. Physical interaction will usually lead to a much better discourse and understanding of a company, but there were some benefits to video calls as they facilitated a larger number of meetings with companies.

What sectors?

There are parts of the small cap market that have seen more material drawdowns, which are now starting to pique our interest. We put tech, consumer discretionary and building materials into these categories.

Although consumers may still be yet to feel all of the impacts of rising interest rates - as monetary policy is a lagging indicator – an important difference this time around is that balance sheets were in a pretty good position going into the downturn. Many people were able to get ahead during the pandemic and associated lockdowns as they couldn’t spend on discretionary items, such as holidays, and thus have some buffer in their budgets for the impact of higher interest rates.

Consumer discretionary make up a big chunk of the S&P/ASX Small Ordinaries Accumulation Index and we were slightly overweight the sector in October in anticipation of good quality companies with strong cost management practices being able to outperform.

Other themes we like in small caps, which are persistent across the whole market, are the long-term themes attached to energy transition and the increasingly short supply of some metals.

We believe the demand for metals - as a result of the electrification of many aspects of society is going to require - has been vastly underestimated. The companies which foresaw this and eked out opportunities for themselves are of particular interest to us.

Small cap winners

PWR Holdings Ltd (ASX:PWH)

PWR Holdings listed in 2015 and although we've not traditionally invested in too many IPOs we believed that this was a high quality business with entrepreneurial founders that led with reasonable skin in the game. We accepted that they genuinely wanted to raise money to keep growing the business.

Source: Morningstar

Originally PWR Holdings was an Australian-based radiator manufacturer, but they were able to pivot their intellectual property (IP) into advanced cooling technology that is used in cooling high performance engines in areas such as motorsport. They have continually been able to use the IP within their business to keep expanding into adjacent markets, and that has led to a very strong compound annual growth rate (CAGR) of about 25% in the nine years since it's been listed.

They been able to grow the business without jeopardising the returns that they're earning, and that is a very strong formula for market outperformance. PWR has seen a fair re-rating since it first listed and while it does trade at a 35% premium to the S&P500 aero and defence index, we feel this is justified given materially higher growth and superior returns on invested capital.

Champion Iron Ltd (ASX:CIA)

Champion Iron is another founder-led story. Back in 2016 Champion bought a high-grade iron ore mine out of administration in Quebec, Canada. A large portion of capital had been already sunk into the mine and its infrastructure, and with some incremental investment it was able to bring the mine back into production.

Source: Morningstar

That investment paid off and they are now mining high grade iron ore and looking to play into the area of 'green steel'. They are providing high grade ingredients that can help reduce emissions in blast furnaces, or which can be used as a product that's used in electric arc furnaces.

Champion understands that as steel produces approximately 7-8% of global carbon emissions, iron miners that want to continue to exist as the energy transition progresses, need to part of the decarbonisation of the steel production process.

When Champion Iron's Bloom Lake site was recommissioned in 2018 its emissions were reduced by 40%, and 65% of the company's energy consumption is supplied by renewable hydroelectric generation.

Renewable energy use also offers the company a real competitive advantage as it takes a lot of power to convert high-grade iron ore into direct reduced iron and pelletize it. It is essentially pure iron that can go into blast furnaces.

Champion also now has a long mine life and relative to other global green steel producers has a bottom quartile cost of production. But it's being put in the same boat as some of the majors - the BHPs and Rios - when it comes to valuations whereas we believe it should be trading at a material premium.

Champion is one of those commodity businesses with very attractive attributes that should be able to withstand some of the volatility underlying commodity prices.

The payoff

Smaller companies do of course come with higher risk. For every Champion or PWR Holding there are dozens of failures. But if you can be astute in your investment process and conduct a thorough analysis of a company, which may involve looking beyond its market valuation, it is possible to find the next Australian small company star.

Simon Brown is a Portfolio Manager at [Tribeca Investment Partners](). Tribeca is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. Tribeca may have holdings in the companies mentioned in this article. This information is general in nature and has been prepared without taking account of the objectives, financial situation or needs of individuals.

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Hold fire on your fund manager over short-term declines

Andrew Mitchell

Who hasn’t wanted to be Biff Tannen in the 1980s cult classic movie, *Back to the Future Part II*?

As an old man in 2015, Biff discovers *Grays Sports Almanac*. It shows the outcome of every sporting event from 1950 to 2000. Biff hops in the DeLorean time machine and travels back to 1955. He gives the magazine to his young self. Young Biff places bets on sporting events listed in the Almanac. He quickly builds his evil financial empire from the guaranteed profits.

This doomsday timeline is only extinguished by Marty McFly and Doc going back in time to steal the Almanac from Young Biff, masterfully aided by Marty’s hoverboard from the future. (An aside: thanks Mattel for not delivering on that promised future tech by 2015!). Marty then eventually burns the Almanac, much to the collective sigh of sports betting fans everywhere.

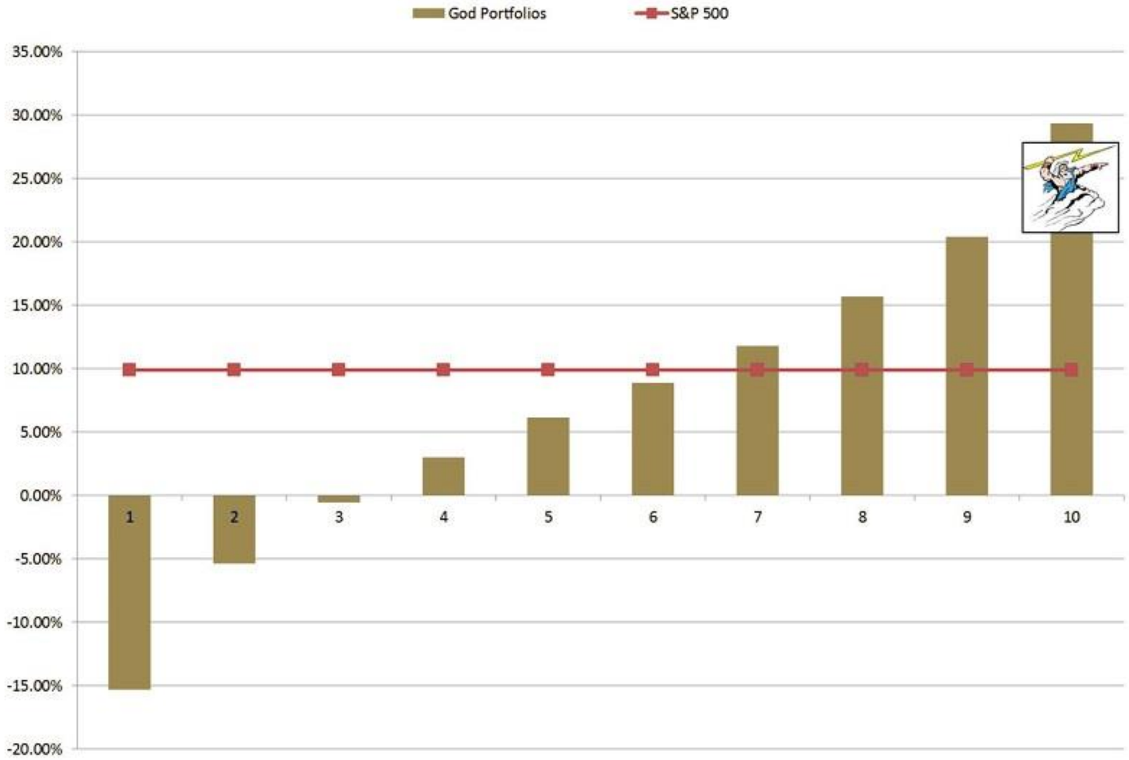
An investor’s dream

What if you had an Almanac for the share market?

That’s what US based investment group Alpha Architect took a look at a few years ago. In their study, they looked at the question: “What if you had perfect (God-like) foresight and knew exactly which stocks would be the best and worst performers over the next 5 years?”.

Their conclusion: **Even God would get fired as an active investor**.

CAGR by ranking decile (1927 to 2016)



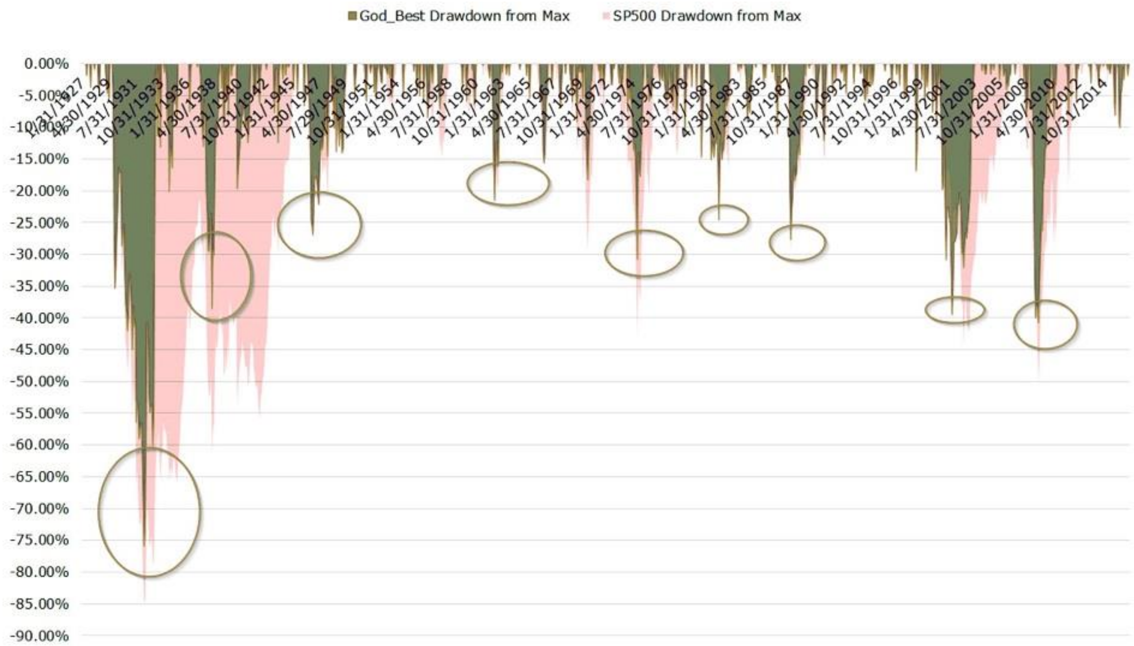
Source: Alpha Architect.

The chart above shows the outcome of having God-like skills and investing in the top-performing 10% of US stocks over every 5-year period since 1927. In terms of performance, you would have knocked it out of the park, returning just shy of 30% per annum. Eat your heart out Warren Buffett.

Dramatic drawdowns

But there is a catch.

As you can see in the chart below, to get that 30% per annum return, investors in the hypothetical 'perfect' long-term active share fund would have suffered extreme gut-wrenching drawdowns (peak-to-trough falls).



Source: Alpha Architect.

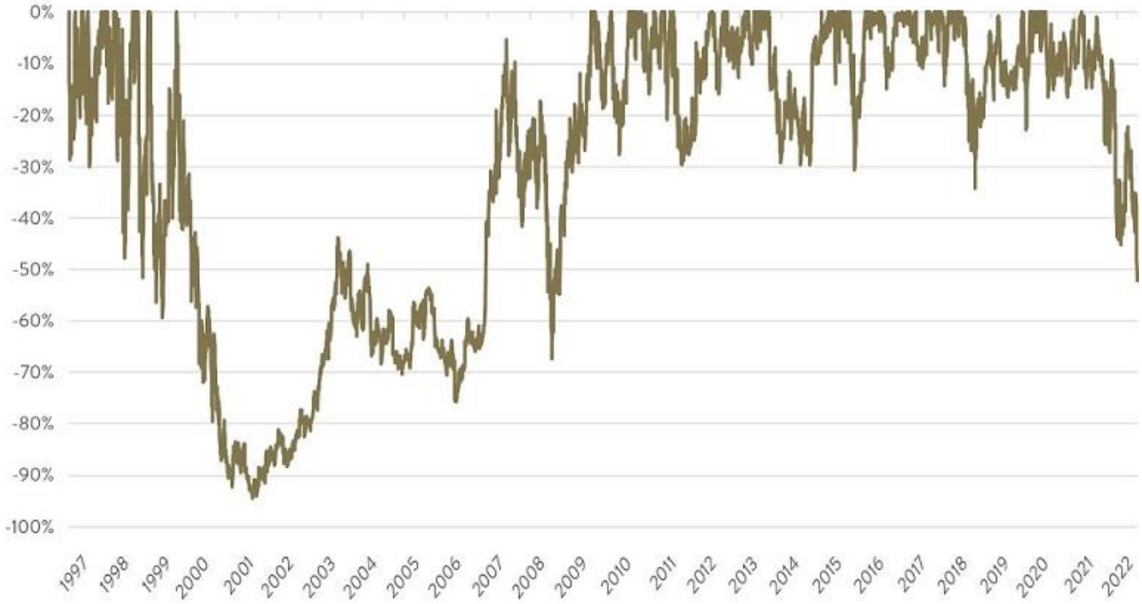
Between 1929 and 1932, the fund would have lost nearly 76% of its value before staging a recovery. Drawdowns of -20% to -40% were routine, including 40% falls during the GFC and the 2000's tech-wreck.

How does this happen? Because even the best stocks don't go up in a straight line over the long term. The share market is a volatile place, even if God is picking the stocks.

The spectacular success story of Amazon is a prime example. It has returned over +119,873%, or over 32% per annum, since listing in 1997. Yet its share price fell 94% in 2001. It took 10 years to recoup that loss. During that decade, it suffered falls of 45% in 2005, 63% in 2008, and also fell 34% in 2018. It is currently down 52%.

The lesson is that even if you possess godlike skills, you can't avoid big drawdowns.

Amazon share price drawdown



Source: Factset

The danger of focusing on short-term fund manager performance

This has serious implications for how investors judge performance. High-performing active fund managers don't post strong returns or outperformance day in, day out. Or even year in, year out. They suffer drawdowns and periods of underperformance.

Investors, therefore, need to back the long-term track record of their fund manager through the shorter-term volatility. If they don't, they risk jumping from manager to manager and missing the inevitable rebound from skilful managers – and long-term outperformance.

(For our suggestions of what to look for in a fund manager instead, please read our Investment Strategy notes on the topic here and here.)

Myopic investors can drive fund managers to focus short term

If enough investors pull their money when short performance falls, they are ultimately incentivising the fund manager to focus on short-term performance too.

Most share funds disclose that the minimum investment time horizon for their fund is 5+ years. Industry investor funds flow data, however, suggests many investors don't wait around that long for a fund manager to recover if they are suffering a significant drawdown. In that scenario, even some of the top performing fund managers can be fired. The natural consequence is managers are focussed on the short term and ensuring portfolio company results keep beating short-term expectations.

Shares, however, are a long-term asset class. They benefit from the ingenuity of businesses in raising productivity, creating new products or services, or improving existing ones. This takes time, often at least 3-5 years.

This has led to CEOs the world over lamenting how fund managers are so intently focussed on the next quarterly result, whilst they are generally focussed on setting and implementing business strategy for the next 3-5+ years. We have seen this too, many times over the years. Our response is unless investors' time horizons become longer in their decision making, then fund managers are unlikely to focus more exclusively on the long term too.

Why investors need to understand their fund's investment horizons

As we have seen, even a fund manager with perfect 'God-like' foresight would suffer major short-term falls. Investors need to accept the best-performing funds over the long-term can also post significant drawdowns.

It is terribly damaging for fund managers if lots of investors redeem during tough times. This is magnified for small caps. Fund managers have to sell less-liquid companies at fire sale prices to fund these investor withdrawals.

Sometimes, of course, investors are justified in withdrawing their capital. But short-term declines shouldn't be one of those reasons.

Investors need to understand the investment horizon for the fund, and ensure they are aligned with that horizon. Long-term investors are one of the most valuable assets a fund manager can possess. At Ophir, we deeply value ours.

Andrew Mitchell is Director and Senior Portfolio Manager at [Ophir Asset Management], a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. Read more articles and papers from Ophir [here].

Is it finally time to move on from crypto after FTX?

James Gruber

In 1974, stories filtered through of a Japanese soldier who was in the Philippines still fighting World War Two because he was convinced that the war had never ended. The stories seemed far-fetched, to say the least. The soldier had long ago been declared dead by the Japanese government. That didn't stop Norio Suzuki from wanting to find out more. Bored with his life in Japan, Suzuki set out to find the soldier in question, Lieutenant Hiroo Onoda.

Suzuki travelled to the jungles of Lubang, a tiny island in the Philippines and, incredibly, found Onoda. The problem was Onoda was preparing to shoot him on sight. Suzuki had done his background research on Onoda though and talked him down. He urged Onoda to go home, as the war had ended nearly 30 years ago. But Onoda didn't believe him and refused.

It was only after Onoda's former war commander travelled to Lubang to formally relieve him of duty by the order of the Japanese Emperor, that Onoda agreed to end his mission and travel back to Japan. It was then that details emerged of how Onoda kept fighting for nearly 30 years after World War Two had finished.

Onoda was an intelligence officer with the Imperial Japanese Army who was sent to the Philippines in late 1944 to hinder an Allied invasion expected to take place in early 1945. When the invasion came in February 1945, it didn't take long before most Japanese soldiers defending Lubang were captured, killed, or managed to escape.

As he prepared to depart the island, Onoda's commanding officer gave an order to the remaining men: fight and never surrender. "It may take three years, it may take five, but whatever happens we'll come back for you," the commander said.

When Japan surrendered the war in August 1945, Onoda refused to do so. He hid in Lubang with three other soldiers. Leaflets of the war being over were airdropped to the men, but Onoda didn't believe them. So began a decades-long campaign of guerilla warfare by the soldiers against the local police forces, various American and Filipino search parties sent to find them and the local Lubang population.

Onoda was the last surviving holdout when Norio Suzuki tracked him down.

The story is relevant to today as cryptocurrency advocates are like Hiroo Onoda post-World War Two. They're in total denial that their war against fiat currency has ended. The world is moving on and will be better off for it.

FTX's downfall may prove the final straw. Though tragic for those who have lost money, the saga will have many broader benefits, including:

- The fraudsters will go to jail. America's legal system is cracking down on white-collar fraud as seen in the recent sentencing of Theranos founder, Elizabeth Holmes. The case of FTX may be more complicated given the founder's base is in the Bahamas and the business has tentacles around the globe.
- Those who lost money in FTX will lick their wounds. The large venture capital and hedge funds will survive and learn a lesson in not speculating in gimmickry. Yes, there will be many smaller investors caught up in the fraud and that's a tragedy.
- Crypto regulation is coming. One of the biggest issues is that the crypto sector has operated with minimal oversight, thereby attracting all sorts of shady characters. Heavy regulation is now guaranteed. The Australian government has already pledged to introduce custodial and exchange legislation. It wants to safeguard crypto custody – where money or tokens are stored and who is responsible for keeping them secure. It also wants to regulate exchanges such as the one that FTX operated. An obvious step would be requiring exchanges to back customer deposits with liquid assets.
- A central bank for crypto is likely to emerge. Banks require central banks and governments to bail them out when they face liquidity crises (bank runs). Crypto will need similar help to prevent further liquidity crises undermining the sector.
- The immediate economic fallout will be negligible. There is a small caveat to this. There will be some venture capital and private equity firms who've invested heavily in crypto who may suffer further losses in the sector, and when combined with the broader tech downturn and the leverage these firms employ, that could lead to forced sell downs of holdings and a possible ricochet effect.
- It will lead to venture capital and private equity firms doing more rigorous due diligence on potential investments. That'll be a good thing for them as well as the startups who have real business models to pitch to them.
- A related point is that the hundreds of billions that have poured into crypto in recent years will be diverted to other sectors, which should be a good thing for economic productivity and society.
- The best and brightest students from some of the world's leading universities who are employed in the crypto space will move on to other, more productive sectors.

It's sad that 14 years after Bitcoin was invented, few of the grand promises of cryptocurrency have been realized. Crypto has limited uses, such as for firms paying workers in countries suffering from hyperinflation, such as Argentina. Any improvements it's made have been modest compared with more traditional forms of finance.

It's time for many crypto advocates, and us, to move on.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.