Logical Thoughts

SUPERANNUATION CHANGES EFFECTIVE 1 JULY 2022

Following from previous year's budgets and suggested changes, a Bill and associated SIS regulations have been introduced to change the laws effective from 1 July 2022.

Work Test Removal

From 1 July 2022 individuals can make personal non-concessional super contributions if they are under age 75, regardless of their work status. Furthermore, individuals aged between 67 and 75 will be eligible to utilise the bring-forward rule from 1 July 2022.

Importantly, for those aged 67 to 74 to be eligible to claim a tax deduction on the personal super contributions, they will still need to satisfy the work test (or work test exemption) during the income year of contribution.

Reduced Eligibility Age For Downsizer Contributions

This has been amended to allow individuals aged 60 and above (currently age 65 and above) to make downsizer contributions to their superannuation plan from the proceeds of selling their home from 1 July 2022.

Super Guarantee

One of the current rules determining whether an employer is obligated to pay Super Guarantee (SG) payments for an employee is that the employee must earn more than $450 in a calendar month. From 1 July 2022, the $450-a-month threshold will be removed.

In accordance with previously legislated rules, the SG rate will increase to 10.5% for 2022/23.

Other rules apply to determine eligibility to make or receive super contributions such as the concessional contributions cap, non-concessional contribution cap, restrictions on total super balance etc.

2022 FEDERAL BUDGET SUMMARY

The following is a brief summary of some of the more pertinent budget announcements that we believe will affect our Logical Thoughts readers. Please note that these are proposed changes only and not yet legislated.

Superannuation

Reduced minimum pension drawdown to continue: The budget proposes to extend the minimum amount that needs to be drawn from account-based income streams. This means the minimums for the 2022/23 financial year are proposed to continue at 50% of the ordinary minimum drawdown rates.

The government stated that there is still significant volatility in financial markets due to the ongoing impacts of Coronavirus and the war in Ukraine.

Personal taxation

Cost of living tax offset: The Low and Middle Income Tax Offset (LMITO) will increase to a maximum of $1,500, providing an additional $420 to reduce tax payable for eligible taxpayers in the 2021/22 financial year. This offset is non-refundable and available to those earning up to $126,000 per annum. LMITO was not extended to future financial years.

Halving of fuel excise: The excise on fuel and petroleum-based products will be halved, resulting in the excise on fuel and diesel to reduce to 22.1 cents per litre. The expectation is this should result in lower fuel prices during this period. Whilst the reduction in fuel excise applies from 30 March 2022 and last for a planned 6 month period only, it will likely take several weeks for existing fuel stocks to be depleted and new stocks purchased at the lower excise.

Indexation of the Medicare Levy thresholds: The Medicare Levy low-income thresholds are indexed each year. From 1 July 2021, the thresholds are expected to be as follows - For singles $23,365 (increased from $23,226) - For families $39,402 (increased from $39,167) plus $3,619 per dependent (increased from $3,597) - For single seniors and pensioners $36,925 (increased from $36,705) - For family seniors and pensioners $51,401 (increased from $51,094) plus $3,619 per dependent (increased from $3,597).

Home ownership

Affordable housing measures: The First Home Loan Deposit Scheme and Family Home Guarantee allow eligible individuals to purchase a home with a smaller deposit, and the Government will guarantee the loan, removing the need for lenders mortgage insurance. Currently, guarantees are limited to 10,000 per year. Under the expanded Home Guarantee Scheme, the government will make available:

- 35,000 guarantees each year (up from the current 10,000) from 1 July 2022 under the First Home Guarantee. This supports eligible first homebuyers to purchase a new or existing home with a deposit as low as 5%.
- 10,000 guarantees each year from 1 October 2022 to 30 June 2025 under a new Regional Home Guarantee. This supports eligible homebuyers, including non-first home buyers and permanent residents, to purchase or construct a new home in regional areas.
- 5,000 guarantees each year from 1 July 2022 to 30 June 2025 to expand the Family Home Guarantee announced in last year’s Budget. This scheme assists eligible single parents with children to either buy their first home or re-enter the housing market with a deposit as little as 2%.

Social Security

Cost of living payment: Eligible recipients will receive a one-off $250 payment in April 2022. Eligible recipients include Australian residents currently receiving the Age Pension, Disability Support Pension, Carer Payment and Allowance, JobSeeker Payment (and equivalent DVA payments), as well as individuals holding a Pensioner Concession Card or Commonwealth Seniors Health Card. The payments will be tax-free and not means tested. Individuals will only be able to receive one payment of $250. Payments are to be made automatically in April 2022.

Paid parental leave changes: Parental leave pay is proposed to be combined with Dad and Partner Pay resulting in a single scheme of up to 20 weeks leave which can be shared between parents as they see fit. This leave can be taken at any time within two years of birth or adoption. The new payment is proposed to be subject to an additional household income test designed to increase eligibility. Single parents are also expected to be able to access an additional two weeks of leave.

Lowering the Pharmaceutical Benefits Scheme (PBS) safety net: From 1 July 2022, the Government proposes the PBS safety net to come into effect earlier, with 12 fewer scripts being required for concessional patients and 2 fewer scripts for general patients each calendar year before the safety net activates. Once within the safety net, concessional patients do not pay for PBS medicines whilst general patients only pay the concessional co-payment rate (currently $6.80 per script).

WHAT IS HAPPENING TO EQUITY MARKETS?

Key Take Outs

- The Australian, International and US markets were in negative territory over six months to the end of February 2022, however since early March equity markets have bounced strongly.
- There has been a large discrepancy between the performance of value and growth investment styles. Recent market movements have shown the pitfalls of significant exposure to any single holding and the benefits of diversification.
- We have seen both equities and bonds sell off at the same time, making asset allocation decisions difficult. We have now officially lived through the worst bond market selloff ever, and there is no certainty we are any closer to a turning point.
- Allocations to investments that are protected against rising inflation may provide some protection against further equity and bond market volatility.

After a strong performance by equity markets in 2021, we've seen a dramatic change in the investment landscape in the first few months of 2022. The prospect of higher inflation and the potential for an interest-rate-tightening cycle has caused anxiety for investment markets, leading to a sharp sell-off in equities. The sell-off gathered pace with the start of the war in Ukraine and the markets concern around stagflation (higher inflation and stagnant economy).

As table 1 illustrates, the Australian, International and US markets were in negative territory over six months to the end of February 2022, most of which was attributable to year-to-date performance.

Table 1: Australian, international & US equities total return (1, 3 & 6 months & 1, 3 years p.a.)

End of February 2022	1 Month	2 Months	3 Months	6 Months	1 Year	3 Years (p.a.)
Australian Equities TR*	2.52%	-4.34%	-1.05%	-3.43%	10.58%	9.05%
International Equities TR**	-5.52%	-7.19%	-6.05%	-3.98%	18.33%	13.82%
NASDAQ	-7.32%	-12.48%	-13.63%	-7.67%	18.49%	26.36%
S&P 500 TR Index AUD	-5.81%	-7.84%	-6.09%	-1.92%	24.18%	17.47%

*S&P/ASX 200 TR AUD
**MSCI World ex Aust NR

However, since early March overseas equity markets have bounced strongly (table 2) despite the increasingly hawkish comments from the US Federal Reserve, sharp increases in the ten-year US bond yields, surging oil prices and the continued uncertainty in Ukraine.

As table 2 highlights, at the bottom (14th March 2022) the NASDAQ had fallen -21.8% but after 11 trading days had rallied +18.2% (29th Mar 2022). The broader US market (S&P 500) fell 13% by the 8th of March but has since rallied +11.1% (29th March 2022).

Table 2: Australian & US Share Market Price Performance (Peak, Low & High)

	Peak	Date	Low	Date	High	Date
ASX 200 Price	7,589	4 Jan 2022	6,838 (-9.90%)	27 Jan 2022	7,517 (+9.92%)	30 Mar 2022
S&P 500 Price	4,796	3 Jan 2022	4,170 (-13%)	8 Mar 2022	4,631 (+11.1%)	29 Mar 2022
Nasdaq Price	16,488	28 Dec 2021	12,896 (-21.8%)	14 Mar 2022	15,239 (+18.2%)	29 Mar 2022

Potential reasons for the rally, include the following:

- Sentiment and positioning being too negative, leading to a technical bounce;
- A poor outlook for bonds, driving rotation to equities. Investors must understand that we have now officially lived through the worst bond market selloff ever. The Bloomberg Barclays Global Aggregate Index rolling 12-month return is the lowest in history – negative 7.3%;
- Equity inflows remaining positive despite softer investor sentiment indicators;
- Economic growth supporting earnings, underpinning a view that the market can de-rate without a bigger correction;
- A belief that the pre-requisites for economic slowdown are being put in place and rates will not need to rise as far as the Fed is saying;
- In Australia, the market has been driven by foreign demand for our market. Aussie equity markets seem reasonably priced compared to other markets but currently benefit from the strongest profit and dividend momentum in the world. Our dividend yields are seen as an important buffer against surging bond yields.

However, Logical remains wary in the near term. The Fed needs financial conditions to tighten and have signalled that they may bring forward their rate rises – rising equities works against this objective. It is possible that markets may consolidate and tread water for a few months as we gauge central bank ability to contain inflation. This would be consistent with the history of US bull markets, which shows that the third year is often lacklustre — particularly if the first two are very strong.

What's driving equity markets – Investment Style and Sector

Volatility has returned to equity markets, but what is striking is the discrepancy between value and growth investment styles. Looking at the decline in the most recent six-month period, the global value benchmark is just in positive territory with a small +0.09% total return. This contrasts with the global growth benchmark with a significant -13.29% decline, reaching the definition of a market correction.

It's clear that value has been more sought after by investors recently, bucking the great run growth had for some time. Over the past 2-3 years real (inflation adjusted) bond yields have fallen and as a result growth stocks (e.g., technology and healthcare stocks) have looked more attractive relative to value stocks.

However, as Central banks around the world start raising official interest rates combined with geopolitical conflict, it will likely create more headwinds for expensive or speculative growth stocks, commonly trading on high price to earnings ratios. In this type of environment, defensive and value stocks will likely perform better as highlighted in table 3 and 4 below.

Table 3: Australian Equities – Large Value vs Large Growth Investment Style Total Return (1, 3 & 6 months & 1, 3 years p.a.)

End of February 2022	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)
Australian Large Value	+2.61%	+2.11	-0.52%	13.42%	7.52%
Australian Large Growth	-0.48%	-6.79%	-8.44%	6.88%	9.74%
Difference	*+3.09%*	*+8.90%*	*+7.92%*	*+6.54%*	*-2.22%*

Table 4: International Equities – Large Value vs Large Growth Investment Style Total Return (1, 3 & 6 months & 1, 3 years p.a.)

End of February 2022	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)
Equity World Large Value	-3.74	1.07	0.09	17.59	9.25
Equity World Large Growth	-6.57	-13.20	-13.29	4.69	13.28
Difference	*+2.83%*	*+14.27%*	*+13.38%*	*+12.9%*	*-4.03%*

It's worth digging a little deeper to explain the underperformance of growth investment and outperformance of value investment. The recent fortunes of the technology and energy and materials sectors stand out for opposing reasons.

After technology pushed the market higher for many years, increasing inflation concerns and the threat of rising interest rates have taken the shine off this sector, with investors seemingly no longer willing to pay high multiples for long-duration growth.

Table 5 and chart 1, highlight that the technology (growth) sector, which represented less than 3% of the ASX 200 (Australian share market), fell 23.82 % since the beginning of the year, while Healthcare (growth) which represents approximately 10% of the market, fell

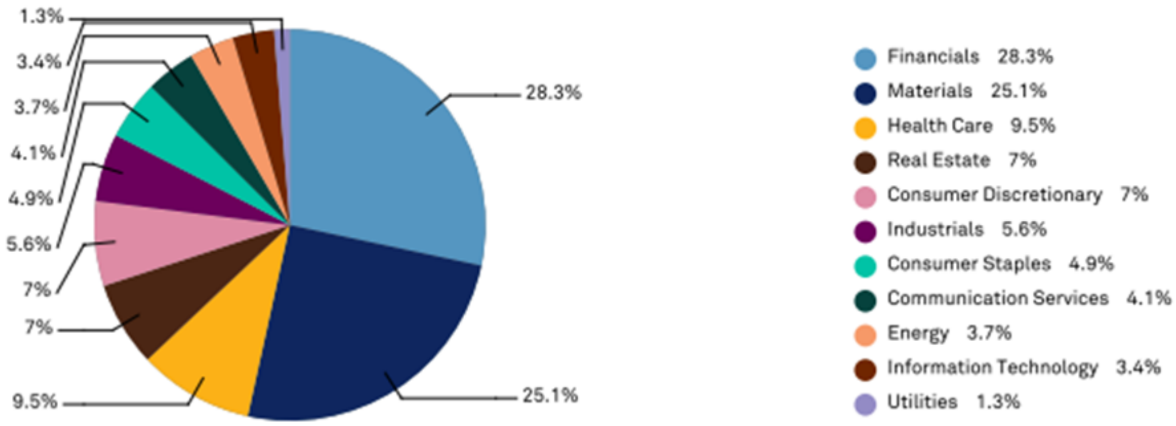
12.27%. Offsetting some of this pain, were the energy (value) (only 3.7% of the market) and material (value) (25.1% of the market) sector which jumped year to date 17.13% and 5.99%, respectively.

Table 5: Australian Sector Total Return: 1 month, year to date & 1 year

End of February 2022	1 Month	Year to date	1 Year
Energy	8.57%	17.13%	13.49%
Utilities	3.41%	6.06%	26.68%
Materials	5.17%	5.99%	13.69%
Real Estate	1.67%	-8.02%	20.39%
Financials	3.01%	-3.72%	12.11%
Communication Services	-2.19%	-10.04%	16.46%
Industrials	0.39%	-7.23%	10.86%
Consumer Staples	5.57%	-4.56%	8.01%
Consumer Discretionary	-4.99%	-13.25%	6.12%
Healthcare	-0.16%	-12.27%	0.70%
Technology	-6.61%	-23.82%	-18.50%
Australian Equities*	2.14%	-4.34%	10.19%

S&P/ASX 200 TR Sector Breakdown

Chart 1: Australian Share Market breakdown by GICS sector: S&P/ASX 200 (as at end of February 2022)



Source: Standard & Poor Global (as at end of February 2022)

Implications of this style rotation for Australian and International Investment Managers

No doubt many clients would've noticed over the last few months some meaningful difference in performance numbers between investment managers they hold in their portfolio.

The Hyperion Australian Growth Companies Fund is an example of an Australian large capitalisation growth fund manager. As a growth manager the team seeks quality Australian companies that can deliver superior compounding returns and revenue growth (growth factors). As a result, the portfolio is skewed heavily towards certain sectors such as technology and healthcare (table 7 and 8).

Materials and energy stocks are typically eschewed given the unpredictable nature of their earnings and pricing power (table 7 and 8). In the last few months this is the worst sector position to hold as investors rotated out of growth into value stocks.

In contrast, a value manager like Allan Gray has held large overweight materials and energy sector positions and held no position in technology or healthcare (opposite of Hyperion) (table 8 and 9). This is reflected in performance numbers shown in table 6.

Note that both investment managers are highly regarded and well rated by the independent research houses.

Table 6: Hyperion Australian Growth Companies Fund (Growth Investment Style) & Allan Gray Australia Equity Fund Total Return (1, 3 & 6 months & 1, 3 years p.a.)

End of February 2022	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)
Hyperion Australian Growth Companies Fund (growth manager)	-4.81%	-21.53%	-22.96%	+0.33%	+15.15%
Allan Gray Australia Equity Fund (value manager)	+8.70%	+10.90%	+10.60%	+16.72	+7.20%

Table 7: Hyperion Australian Growth Companies Fund Top 10 Stock Holdings (as at 28th February 2022)

Stock	% Portfolio Weight	Sector
Xero Ltd	10.53%	Technology
Block	9.59%	Technology
ResMed	9.34%	Healthcare
CSL Ltd	9.21%	Healthcare
WiseTech Global Ltd	7.98%	Technology
Macquarie Group Ltd	6.88%	Financial Services
Fisher & Paykel Healthcare Corp Ltd	6.25%	Healthcare
James Hardie Industries	5.04%	Basic Materials
Cochlear Ltd	5.02%	Healthcare
Domino's Pizza Enterprises Ltd	3.99%	Consumer Cyclical

Table 8: Allan Gray & Hyperion Australia Equity Fund: Sector Weights for the fund and Benchmark

End of February 2022	Allan Gray Fund (%)	Hyperion Fund (%)	Benchmark (%)	Allan Gray Over/Underweight (%)	Hyperion Over/Underweight (%)
Energy	**21.84**	**0.00**	**4.53**	**Over**	**Under**
Utilities	0.00	0.00	**0.88**	Under	Under
Materials	**37.76**	**5.22**	**25.63**	**Over**	**Under**
Real Estate	4.40	0.0	**7.14**	Under	Under
Financials	27.00	11.36	**30.83**	Under	Under
Communication Services	2.93	5.18	**3.40**	Under	Over
Industrials	0.00	5.89	**6.09**	Under	Under
Consumer Staples	4.92	2.20	**4.88**	Over	Under
Consumer Discretionary	1.15	4.14	**6.00**	Under	Under
Healthcare	**0.00**	**31.75**	**9.26**	**Under**	**Over**
Technology	**0.00**	**34.26**	**1.37**	**Under**	**Over**

S&P/ASX 200 TR

Table 9: Allan Gray Australia Equity Fund Top 10 Stock Holdings (as at 28th February 2022)

Stock	% Portfolio Weight	Sector
Alumina Ltd	8.68	Materials
Woodside Petroleum Ltd	8.49	Energy
Newcrest Mining Ltd	7.62	Materials
QBE Insurance Ltd	6.36	Financials
Sims Ltd	5.57	Materials
Incitec Pivot Ltd	5.15	Materials
ANZ Ltd	4.58	Financials
Origin Energy Ltd	4.47	Energy
Santos Ltd	3.60	Energy
NAB Ltd	3.09	Financials

Implications for Clients

While concentrated growth investment portfolios have been attractive over the past few years, recent market movements have shown the pitfalls of significant exposure to any single holding.

Investors and their advisers should be aware of the top holdings and investment styles of their investment managers, exchange traded funds etc to ascertain any concentration risks in their portfolios. Therefore, we continue to advocate for sensible and intelligent diversification across best of breed investment managers, ETFs and direct investments.

When equities and bonds sell off at the same time, as they have this year, there are not too many places to hide. As we discussed earlier, we have now officially lived through the worst bond market selloff ever and there is no certainty we are any closer to a turning point.

At Logical we build client portfolios with the aim of meeting risk adjusted return targets and wider underlying needs and objectives. In cases, Logical may add real assets to a client's portfolio to preserve value in an inflationary or rising interest rate environment. These real assets may include unlisted direct property (e.g. Charter Hall) and unlisted diversified portfolio of directly originated corporate loans to Australian companies (e.g. Metrics).

The portfolio of unlisted direct property is hedged against inflation via annual rental increases of CPI (inflation) or 3%. While Metrics invest in predominantly floating-rate instruments, which means that the investment has a variable interest rate. Therefore, interest rates on the debt owed to Metrics will increase at an agreed rate. Thereby, hedging against inflation and interest rates.

As the US Fed raises rates it will be a headwind for growth stocks and equity markets. Whether this headwind is strong enough to trigger another fall in the equity markets due to a drag on earnings and lack of certainty is still to be seen (soft landing). The worst case we face is if there is a policy error and interest rates rise much higher and oil continues to go higher. In this case we face a recession. At this stage, the recession risk, at least for the next 12 to 18 months, looks relatively low. Strong household and corporate balance sheets leave us positive on the ability of the U.S. and global cycle to deliver significantly above-trend economic growth in 2022.

As always, we advocate taking a long term view to successful portfolio outcomes and avoid making knee jerk reactionary changes in the short term which inevitably end poorly.

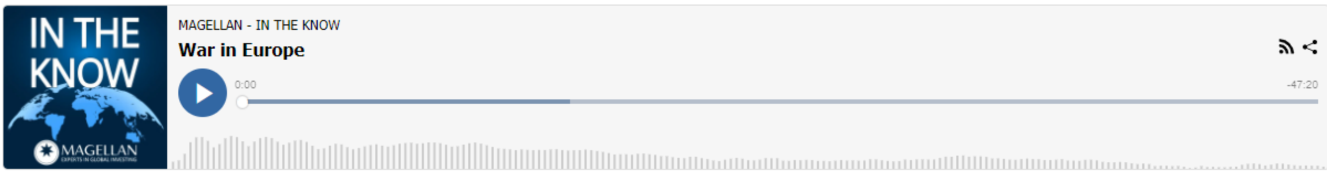
MAGELLAN - IN THE KNOW - WAR IN EUROPE

For those who want a highly insightful and knowledgeable assessment of the current Ukraine and Russia conflict, the podcast link – War in Europe, in our opinion, is well worth listening to.

The two guests with Arvid Streimann, Head of Macro & Portfolio Manager at Magellan are:

- former US Deputy Assistant Secretary of Defence for Russia, Ukraine and Eurasia - Evelyn Farkas, and
- former Deputy Director of the CIA Michael Morell

Listening time is 47 minutes. To listen to this podcast please click on the picture below.



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Kate has been in the industry for over 20 years and is a senior adviser at Logical.

She holds a Bachelor of Business (University of Technology, Sydney), Diploma of Financial Planning (Deakin University) and is a Certified Financial Planner.

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Portfolio Construction & Investment Research Manager

Gavin has been an investment specialist for more than 20 years and is the head of Investment Research at Logical.

Gavin's qualifications include a Masters of Applied Finance (Macquarie University), Bachelor of Agricultural Economic (Sydney University), Graduate Diploma of Applied Finance and Investment (Finsia) and he is currently studying a Master of Financial Planning at the University of New South Wales.

Looking for Financial Advice?

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