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Nest and nest egg: 23 aspects of housing and ageing

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This article summarises research by the ARC Centre of Excellence in Population Ageing Research (CEPAR) which focusses on research in the field of population ageing. The full report is attached at the end of the article.

In Australia, the topic of housing occupies many a newspaper column, barbeque conversation and research report. Just over half (or $6.3 trillion) of Australian household wealth is stored in housing, distributed across 10.3 million residential dwellings, which are among the most expensive in the world.

The family home not only fulfils everyday needs as a shelter and a place for family and social relations but can also act as a store of value and a guarantee of financial security in retirement. It is both nest and nest egg.

Housing outcomes therefore affect financial and personal health and wellbeing over the lifecycle. And as lifespans increase and Australia's population ages, it is important to examine the interactions between demography and housing. Home ownership is often considered another pillar of the retirement income system, in addition to the age pension, and mandatory and voluntary superannuation.

Here are our major conclusions on home ownership.

1. Home ownership serves multiple purposes over the lifecycle: It acts as a home as well as a store of wealth to guarantee financial security in retirement. Its lack in old age compromises security of both tenure and finances.

2. Home ownership appears to be in decline: Depending on the measure, total home ownership in Australia currently ranges from 59% to 70%. Across all measures, home ownership is down 3-4% in the last two decades. Drops are led by young households of all incomes and middle-aged households with low incomes.

3. Much of the decline may be due to declining affordability: Over the past 20 years, house prices grew faster than household incomes. Common explanations point to cyclical as well as structural factors. These include:

(1) a surge in rental demand from new migrants (3.7 million since 2000)

(2) lower cost and greater allocation of credit to investors, supported by tax rules (negative gearing and capital discounts)

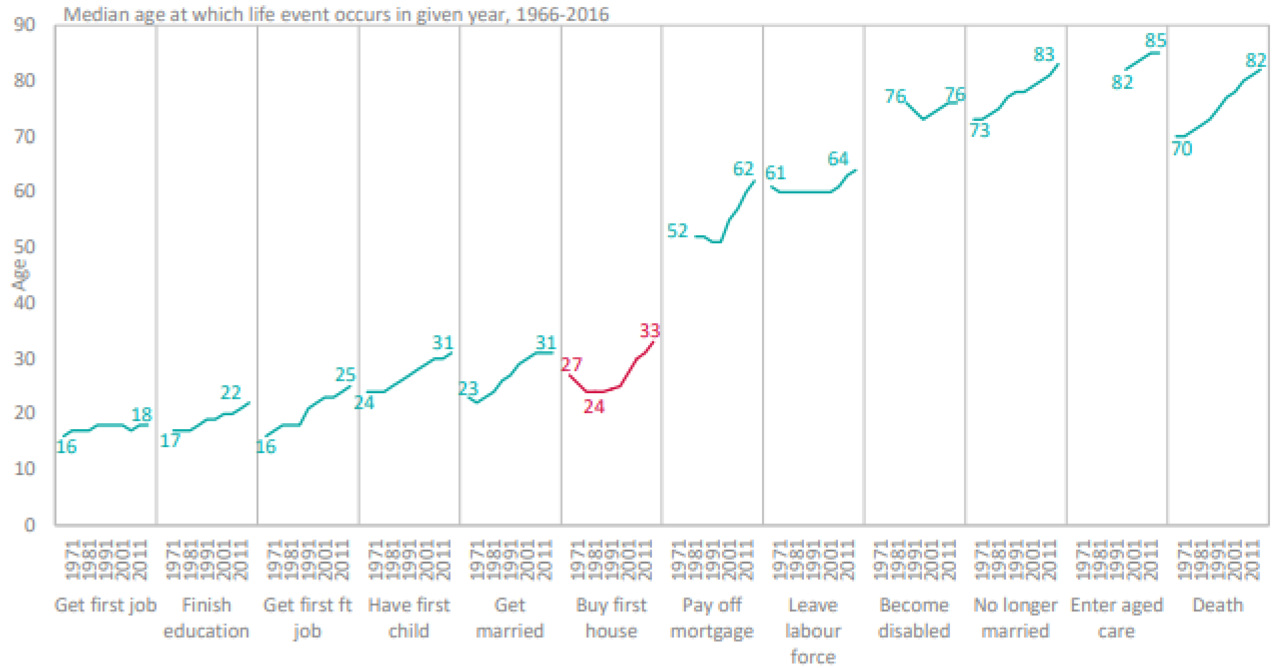
(3) a supply lag (of about 10 years between peak increase in demand and peak increase in supply, up from 3-5 years in the past).

4. Higher prices and lower borrowing costs have changed the dynamic: Across the income and house price distributions, deposit hurdles increased while borrowing costs decreased (in the past two decades, years to save for a hypothetical deposit for households with income in the second quintile buying a house in the second quintile of prices increased from 4 to 6 years, but repayments were down from 44% to 36% of income). A low initial saving hurdle in the past meant that house purchases functioned as a commitment device to save. It is less available now.

5. Declines in home ownership must be seen in a wider demographic context: The median age of first buying a house decreased in the 1960s-70s as home ownership became widespread. It has since increased by 9 years from 1981 (from age 24 to 33). But deferral in home ownership accompanies delays in all other major life events over the last half-century, as shown below.

These include a delay in the median age of getting a first job (2 years), finishing education (5 years), having a child (7 years), getting married (8 years), and dying (12 years). Deferring their first home purchase by 9 years would still probably see younger generations enjoy home ownership longer than their parents.

6A Deferred entry into homeownership is in line with deferral of other life events over the last 50 years



6. Indefinite deferral of home purchase has consequences: Lifetime home ownership rates will decline if some people defer indefinitely. Banks may be reluctant to lend past a certain age given retirement ages are increasing more slowly (by 3 years over the past 50). More people may retire with debt (36% of homeowners do so now). Some people receive help for home deposits from parents but higher gifts go to those with higher income. Modelling suggests that there is no imminent *wall* or *wave* of bequests in sight and that bequest recipients are getting older.

7. Demographic change may make things easier: In the short-term, demand for housing is expected to remain strong, so supply declines are concerning. Over the long term, base projections see a shallow deceleration in growth of demand, but the range of possible outcomes is wide. Also, cross-country variation in house prices and demographic change suggest that population ageing could weigh prices downwards.

8. In the meantime, the retirement income system is failing renters: The continued exclusion of the home from the pensions means test, undifferentiated age pension payments, and rent assistance levels that are pegged to the wrong index, result in a wide financial gap between renters and owners. The system review reporting in 2020 is an opportunity to narrow this gap. While super is important for young, low-income households, we are yet to understand how much it constrains their investment in housing. The two are complements. Super is more liquid in retirement while housing investment can be leveraged and therefore results in greater wealth accumulation when prices are rising.

9. Older renters continue to experience significant vulnerability: Often-quoted figures that old-age poverty in Australia is high, are inaccurate. But new estimates that take account of housing suggest that older Australian renters have among the highest relative poverty rates in the OECD. They also have greater rental affordability stress than other age groups. While increases in measured homelessness among older women were due to greater numbers in this age group rather than higher incidence, their increased use of homelessness services was disproportionate.

10. Income and house prices: Modelling shows that an extra dollar of income increases house prices in NSW by more than a dollar and that price sensitivity increased with proximity to Sydney.

11. Deferral of home ownership: Research found little indication that home ownership fell for Generation X. Later rates of marriage were a key driver of home ownership delay. Analysis of trade-offs between renting and buying shows that initially renters do tend to consume more than owners, but that this reverses.

12. Migration and housing: Recent and temporary migrants tend to rent apartments (about 75% of long-term temporary arrivals rent). Increases in migration are likely to therefore overstate home ownership declines.

13. Demography and house prices: Higher house prices were observed in countries and periods where shares of prime-age workers were higher. An estimated 7% of the increase in real house prices in Australia between 1970 and 2015 was due to changes in age structure. Projections suggest a reversal in the future.

14. Housing bubbles and macroeconomic risks: Studying the bursting of the US housing bubble shows that a key contagion channel was the reappraisal of risk rather than the wealth effect on home owner balance sheets.

15. Supply response: NSW regions have higher housing supply responses than Sydney but are still relatively low given fewer land constraints. Councils appear inhibited by State rules.

16. Treatment of assets in the means test: It's possible to combine age pension means tests by having them separate but applied consistently. Exempting the home in the test is shown to inhibit downsizing, but effect is small.

17. House purchase triggers re-evaluation of retirement finances: Super contribution behaviour changes around the time of taking out a mortgage. Owner-occupier mortgagors appear to increase super contributions while investors rebalance toward property. Buying a house also increases interactions with super.

18. Wealth accumulation in an ageing society: Ageing alongside greater age pension means testing can result in greater private asset accumulations and lower pension spending, driven by longer-lived high-income groups.

19. Downsizing: People over 55 downsized:
(1) because the house or yard was too big
(2) to be closer to family
(3) for lifestyle
(4) to alleviate financial stress.

Older people are less likely to regret their decision to move to a smaller place compared with those who downsized at younger ages. Half of older women are choosing to age in place, but many live alone. Changes are often due to health concerns.

20. Retirement products: A reverse mortgage on a CBD house is riskier and should attract a higher risk premium. Lump-sum reverse mortgages are more profitable and less risky to providers than income stream products, explaining why the former dominates most markets. Explaining reverse mortgages well can raise interest in them. The more wealth is in one's home, the more optimal it is to annuitise the remaining wealth since home equity acts as a form of precautionary savings to cover healthcare expenditure and as a bequest.

21. Bequests: Property made up 70% of assets of those dying aged 65-84. Research confirms that bequests are being delayed as life expectancy increases. Pensioners hold on to assets rather than spending them to maximise pension income.

22. Adapting housing and neighbourhoods: The housing stock is ill-equipped to meet older people's needs with respect to safety and accessibility measures. Key modifications would prevent falls at home if discharges from hospital involved an occupational therapist home visit, and simple exercises also help. Mental health and venturing beyond the home (e.g. by being able to drive) were positively correlated.

23. Who can expect financial hardship in old age, and for how long? Single older women with low education who rent their home could expect to live 7.7 years of retirement in financial hardship (e.g. unable to heat the home, missing meals, or pawning items). Hardship *expectancy* for women with similar characteristics but who owned their home was half that. Older renters are likely to have less family support and more depression.

Rafal Chomik is a Senior Research Fellow at CEPAR and responsible for the Centre's research translation program. Sophie Yan is a Research Fellow at CEPAR.

The full research paper

This brief for this research was in three parts.

It **first** tackles the dynamics of the housing purchase in working life, describing the patterns of housing tenure across generations, demographic and market dynamics, the likely future effects of demography on housing demand, and the policies that can affect home purchase outcomes, particularly taxes.

In part **two**, the brief considers housing consumption in old age, discussing the retirement income context, the value and distribution of housing wealth, the preference of older people for remaining in their community, and how older people bequeath or can make better use of the equity in their home in retirement.

Finally, part **three** tackles housing lack in old age, describing the implications and vulnerabilities that arise from renting in retirement. Overall, the brief provides a broad stocktake of research that touches on many different areas of housing-related policy.

Download the full research brief here.

House prices are rising again, but will brakes be applied?

Diana Mousina

The Australian housing market has steadily reaccelerated since the middle of this year. House prices across most capital cities had been falling for 21 consecutive months, but finally bottomed out in around May 2019 and are now rising again.

Just last month, house prices rose at their fastest rate in more than four years and have already regained a third of the past two years' losses.

There are three main contributing factors to the recent turnaround:

First, the RBA has cut interest rates three times since May, lowering the cost of borrowing for households.

Second, the coalition government's success at the Federal election in May removed some of the perceived risks to the capital gains discount and negative gearing, locking in these favourable housing policies for investors.

Third, the Australian Prudential Regulation Authority (APRA) reduced the interest rate serviceability measure that banks are required to use when assessing home loan applications. This relaxation of lending standards led to an increase in successful applications.

Ultimately, these factors have all contributed to more buyers entering the national property market, however the number of new listings of properties for sale is much lower than a year ago and this is compounding price increases.

Capital city prices recover quickly

Whilst overall the outlook is positive for property investors, the turnaround is not consistent across the country. Around 40% of Australia's population lives in Sydney and Melbourne and price rises there have been much higher than in the rest of Australia.

Residential property prices have increased by around 5% in Sydney since May, and in Melbourne by around 6%. That's a significantly steep jump in just a few months. Gains in Brisbane have been about 1.1% in the three months to October, while Adelaide's movement is minimal. Perth remains out of sync with the rest of the country and house prices are still falling, down more than 21% since their peak.

It's not unusual that house prices in Sydney and Melbourne have bounced back more strongly. The population in both cities continues to grow (2.1% in Melbourne and 1.6% in Sydney), and despite healthy home construction rates over the last few years, there's still an issue of undersupply.

According to CoreLogic, we can expect to see prices accelerate even further next year, with Melbourne hitting a new peak as early as January, Sydney in the first half of the year and Brisbane is on track to recover to previous highs. The smaller housing markets in Canberra and Hobart have already reached new record levels.

We anticipate that residential property prices will rise another 5% after this initial bounce has run its course.

Implications for macroprudential policy

Monetary and fiscal policy are the two main levers used by policymakers to influence the economy. But, macroprudential policy has also been gaining popularity as an additional policy tool to offset some of the risks created by low interest rates.

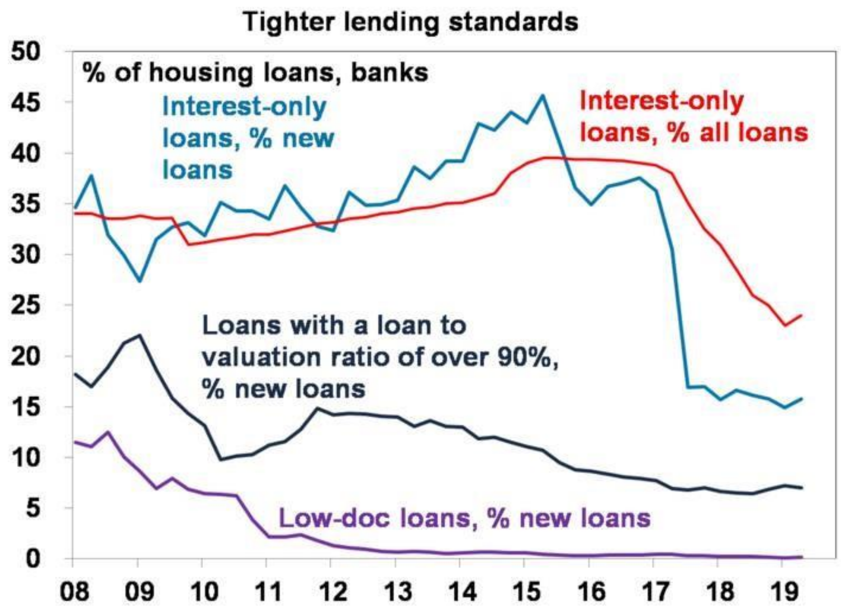
Macroprudential policy deals with managing financial stability risks which usually means limiting credit and debt growth, tightening lending standards and increasing bank regulation.

In Australia, APRA is in charge of administering macroprudential regulation, with the RBA also involved in consultations. From 2013 to 2016, interest rate cuts and housing undersupply (predominately in New South Wales and Victoria) fuelled rapid home price growth. The regulators were concerned about the huge lift in investor lending and the sharp rise in interest only loans. From late 2014 onwards, APRA introduced various macroprudential tools to combat these risks in the housing market including:

- limiting banks' investor loan growth
- introducing a minimum 7% interest rate when assessing new loan serviceability
- greater scrutiny on loan applicants expenditure based on average household expenditure and overall debt levels
- increasing capital buffer requirements for banks and limiting interest-only lending.

The progressive use and tightening of macroprudential policy over 2014-2017 was a significant contributing factor behind the slowing in housing prices and credit growth, especially for investors.

Macroprudential tightening significantly reduced the proportion of 'risky' interest only loans which fell from around 40% of total loans at their peak in 2015 to around 24%, as shown below.

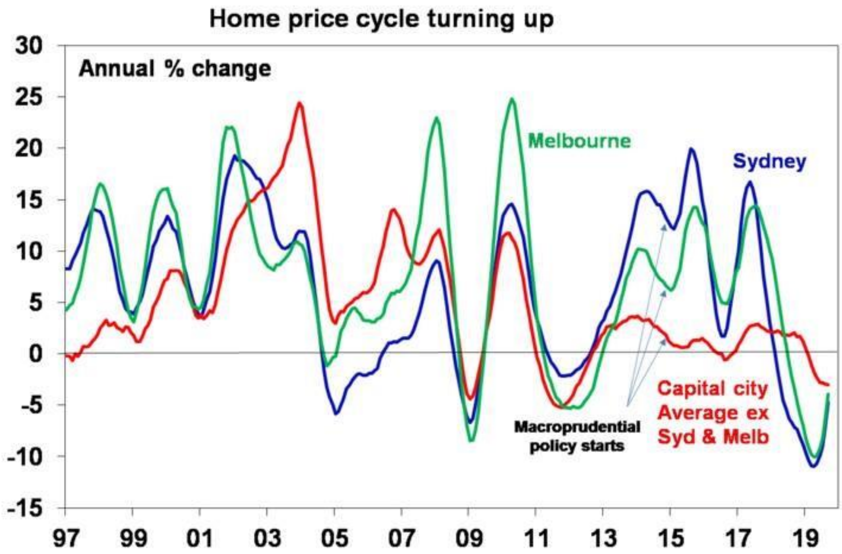


Source: ABS, AMP Capital

In 2017, APRA started to remove some of the investor lending limits and moved more towards sustainable qualitative lending controls through scrutinising household expenditure and total debt holdings. In May 2019, APRA removed the minimum interest rate serviceability measure, which increased borrowing capacity for households by ~10-15%. Despite this change, lending standards are still tighter than a few years ago.

The recent housing cycle in Australia

Home prices bottomed in June this year. The re-election of the Liberal Government removed the risks around changes to capital gains tax and negative gearing. The rapid recovery in Sydney and Melbourne (see chart below) has led to concerns of another unsustainable housing upswing and a further build-up in household debt. However, tight lending standards, low foreign demand for housing and a weaker economic environment (we expect the unemployment rate to rise) should limit home price growth.



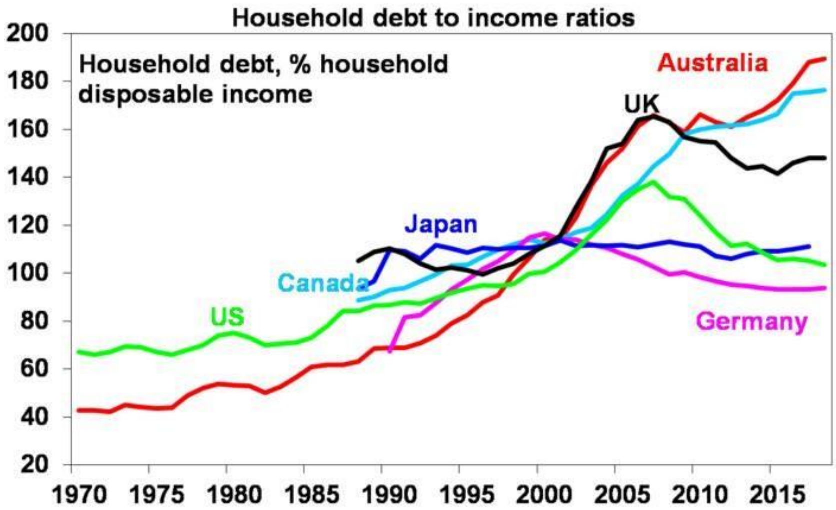
Source: CoreLogic, AMP Capital

What types of macroprudential tools could be used in future?

Investor lending is considered riskier because investors are generally more leveraged, more likely to take out interest-only loans and are more likely to exit the housing market in times of stress which can exacerbate housing downturns. However, to offset these risks, Australian housing investors generally have higher incomes and wealth positions and use interest-only loans for their tax strategies. The current upswing in home prices does not appear to be driven by investors yet.

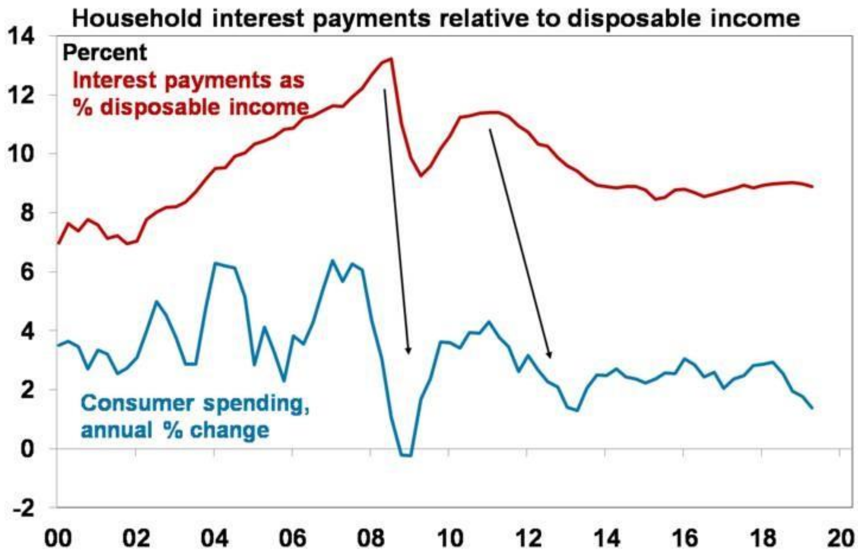
At the moment, the more worrisome part of the Australian housing market is overall high household indebtedness, mainly housing debt, currently at 190% of household disposable income, which is extremely high compared to global peers (although it has been high relative to the rest of the world for a while – see next chart).

This level of housing indebtedness has raised concerns that APRA could introduce debt-to-income (DTI) caps or even restrictions around high loan-to-value ratio (LVR) loans. The highest risk loans with debt levels six times or more above incomes make up a small amount (around 15% of new loans) while less than 10% of new loans have an LVR ratio above 90% and the proportion of these risky loans has generally been declining over the past few years.



Source: OECD, AMP Capital

We think it is unlikely that APRA will impose specific DTI or LVR caps. High household debt is an issue if home loan serviceability is unsustainable. But this is not really an issue in Australia, as shown below. Interest payments as a share of disposable income have been stable at 9% for years and are unlikely to rise while interest rates are falling.



Source: RBA, ABS, AMP Capital

Imposing restrictions for DTI or LVR levels would help to reduce housing debt levels but it would also create unnecessary distortions in the market by excluding first home buyers, single person households and buyers who are trading up. Inequality issues could also be created as borrowers with means to draw on funds get around the rules.

Tightening lending standards further (by additional analysis over borrower expenses and total debt holdings) or bringing back a minimum interest rate measure for serviceability would benefit financial stability, as much as DTI or LVR cap with less market distortions.

The risks for financial stability from here are mainly down to household serviceability and how it would react to a deterioration in the economic environment, particularly given:

- wages growth is low, at just over 2% per annum
- the unemployment rate is likely to drift a little higher (to around 5.5% over the next few months), and
- a high proportion of the labour force is still underemployed (at around 13.5%).

While housing arrears are currently low at less than 1% of all loans, they could drift up if the employment market deteriorates. APRA should focus on further strengthening lending standards when assessing individual borrower serviceability as its main macroprudential instrument.

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To hear more investment news and insights, join AMP Capital's Chief Economist Shane Oliver and Senior Economist Diana Mousina at a free webinar on 4th December discussing [2020 vision: an exclusive analysis and discussion of market conditions at home and abroad for 2020]().

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How 'residential for rent' may change Australian housing

Stephen Hayes

In many global cities, housing demand has typically outstripped supply over the past decade with strong housing price inflation affecting affordability. There are marked changes occurring within the global housing markets with a defined long-term trend from home ownership to rental accommodation.

The maturity of the Residential for Rent (RfR) market around the world varies greatly from the more established countries, such as in the United States, Germany, France, Finland and the Netherlands, to the more immature markets, such as Canada, United Kingdom and Australia. Demographic trends and the evolution of cities are playing an important role in the growth of RfR around the world.

Declining rates of home ownership

Housing affordability has become an issue for younger generations and the aspiration to own a home has waned as priorities have shifted to lifestyle and experiences. This trend is evident in the US where home ownership peaked at 69.2% in 2004 and has fallen to 64.1% in Q2 2019.

"Technology is also advancing rapidly in today's society, affecting how we live, work and play. This is particularly the case for younger generations who have more readily adopted new technologies. As a result, younger generation's behaviours and values are now vastly different to those of previous generations. Using Australia as an example, the prime renting cohort are the Millennials (born 1981-1996) who now represent 44% of the Australian work force."
Source: AlphaBeta – How millennials manage money.

Outside of the broader issues such as a shortage of housing in many countries, younger generations are adopting changing lifestyles and preferences which are driving increasing demand for rental properties. This defined social trend is changing the housing landscape within the major cities. The percentage of rental properties compared with owned residential property has been increasing and is expected to accelerate into the future.

Millennials have different life preferences, adopting a 'You Only Live Once' (YOLO) attitude to living, which has also influenced spending habits with a focus on experiences over goods.

They are also savvy spenders who are delaying home ownership. Australian home ownership rates have fallen to 66% in 2018 from 71% in the 1960's. Housing affordability is another major factor, with housing costing approximately 8 times household income compared to 5 times for baby boomers in 1970. The next cohort behind Millennials are Gen Z (born 1996 -2014) who have an even greater adoption of technology and social media and are more financially savvy and debt averse, having grown up through the GFC. They are less brand conscious and more price sensitive.

These social trends and changing behaviours are a major factor in the material changes that we expect in the housing market in Australia. Purpose-built RfR buildings will grow rapidly as experienced in other countries.

The quality of Residential for Rent

Another factor driving the greater propensity to rent is the quality of the amenities. This is particularly evident as the RfR markets mature. The evolution from Government-owned social housing and the renting of individual apartments from 'mum and dad' investors to established, purpose-built rental apartments with high amenity and services is well in train. The old adage, 'build it and they will come', is particularly relevant as RfR markets mature.

Modern RfR buildings contain greater renter amenity than typical standard residential buildings. They have gyms, are pet friendly, have well-amenitised community facilities, parcel delivery, with all services provided by on-site staff.

The standout differences to traditional residential offerings are the services offered through technological innovation. Modern RfR buildings under institutional ownership are typically highly connected, with services offered through the building's app. The resident's phone can run everything from accessing the building and the rental apartment, signing the lease, paying rent, requesting maintenance, booking a car pool and interacting with other tenants using social media services.

The buildings tend to be located in close proximity to transport nodes and this feature combining with the car-pooling services, could significantly reduce car ownership, offering extra cost benefits. Other services likely to be included are laundry and cleaning services, child care, removalists and electric bike hire.

The total RfR product offering is a game changer for the renting cohort in Australia. No longer will renters have to deal with real estate agents or individual 'Mum and Dad' investors. With extra amenities and services at the touch of button, the rental experience in Australia will be transformed.

The current Australian rental market

The Australian residential rental market is vast with 2.3 million households representing 32% of all households. It is also highly fragmented and non-institutionalised, in contrast to other countries such as the United States. Individual investors own the majority of rental properties in Australia, with 20% of Australians owning an investment property and of those, 71% own a single investment property. Even with the fragmented ownership, the rental market has remained remarkably stable, with national vacancy rates ranging between 2%-4% over the past 30 years. The current national vacancy rate sits at a low 2.5%.

Australia is likely to follow global demographic trends, with the average household size expected to shrink below the current 2.7 person per household, while average dwelling sizes are expected to fall below the current 3.2 beds per household. We believe the home ownership rate will continue to fall, creating excess demand for more rental accommodation.

Residential for Rent as an asset class

From a comparative total return perspective and on a risk-adjusted basis, the investment case is compelling. RfR cash flows have proved stable through economic cycles, with occupancy levels typically remaining high through periods of economic slowdowns. Rents are correlated to employment and wages growth, demographic trends and supply levels.

During economic slowdowns, new development slows and with the lower job security, renters are typically hesitant to purchase a residence and will likely continue renting. US apartment revenues have grown on average by +4.0% p.a since 2010, with an average increase of 660,000 new renter households per annum during this time.

There are some risks, particularly with regard to regulatory risk. Given the social nature of housing, regulators and governments can act irrationally. While rare, governments responding to popular public opinion can overregulate rental markets through policies such as rent controls. This may result in a shortage of housing, poor quality rental stock, lower jobs growth, higher carbon emissions and a greater reliance on taxpayers to fund affordable housing.

The Australian market is in its infancy, with just 10 mainstream RfR developments that have been publicly announced, or are under development, totalling approximately 3,500 units.

The major developers are the Mirvac Group, Grocon, Salta Properties, Sentinel Property Group, Gurner and Meriton. Developments are typically higher density multi-unit buildings in inner city and middle suburbs well served by public transport.

In Australia, RfR is typically being developed to a 4.5% - 5.0% stabilised yield, depending on the location, but land tax and council rates contribute approximately 30%-40% to total expenses. Also, GST treatment disadvantages RfR, as there is no GST credit on development and operational inputs. This is in contrast to commercial buildings (such as student accommodation) and residential developments where GST inputs can be claimed.

More mature RfR markets have demonstrated stable growing cash flows through a cycle and we expect Australia will be no different. Over time as the market becomes more established, we expect RfR allocations in superannuation funds to become standard.

The future looks strong

With urbanisation driving the population growth of major global cities, demographic and social changes, city housing markets are a going through a defined change. Rapid advancements in technology are influencing lifestyle changes with society’s values now very different from the past. This has led to accelerating demand for rental housing, with institutionally-owned modern RfR buildings being the clear winner.

The supply of purpose-built rental accommodation has failed to keep up with vacancy rates that are low in most global cities. From an institutional investment perspective, the returns are competitive and the investment case is compelling. While Australia has been a laggard, mainly due to unintended taxation policies, the landscape is now changing, which is setting the RfR sector up for rapid growth.

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Disclosure: At the time of publishing, the Global Listed Property team of First Sentier Investors held investments related to RfR in Equity Residential, Kojamo Oyi and Mirvac Group in a range of the portfolios it manages.

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What is quant investing and why is it different?

Max Cappetta

The essence of a quantitative investment approach is straight-forward: it is the utilisation of rational economic and fundamental investment insights in a disciplined and consistent fashion.

Of course, all investment managers use quantitative tools in various ways. Many use simple screens to help focus their detailed research on a smaller set of companies. This is especially important when managing global portfolios. The detailed research element often includes modelling a company's financial statements and company visits to gain a deep stock specific perspective. The final step is then to incorporate the research insight into portfolios to meet both risk and return objectives.

Investment styles move in and out of favour

One problem with this traditional approach is that no one investment style or theme is consistently rewarded. A better approach is to research and use a range of disciplines to determine which stocks to own or not. These range from longer-horizon, financial statements-based disciplines such as valuation, quality, sustainability and growth through to shorter-horizon strategies that aim to capture investor sentiment, company news and market events. Applying this breadth of insight is where a systematic quantitative approach is different to managers who take a fundamental focus on one dominant theme or philosophy.

Another key difference is a fundamental manager will examine the absolute depths of specific companies and industries, whereas a quantitative manager will work across a broader range of individual stocks and industries.

Quantitative managers undertake fundamental research upfront to formulate various investment ideas. These ideas are then tested with complex mathematical and statistical modelling to ensure that they are supported across different markets and investment environments.

Both are legitimate and credible means through which to approach investing and can have varying degrees of success depending on the point in the cycle.

Quant working alongside other investment styles

A quantitative approach can effectively work in tandem with other investing approaches in the one portfolio. A diversified quantitative approach can act as a scalable core exposure assisting with both capacity constraints and cost in other styles or managers.

The fact that the quantitative portfolio utilises a range of investment insights can also lead to improved after-tax outcomes. As the value manager sells his winners (realising a taxable gain) some of them may have become attractive to the growth manager. Inside the diversified quantitative portfolio, the same position simply transfers from the 'value' allocation to the 'growth' allocation without the need to realise the position.

While 'off the shelf' systematic strategies are growing in number, investors need to be careful to avoid inadvertently investing into potentially crowded trades or poorly-structured exposures with large unintended risk exposures. Using last year's earnings relative to today's price can often be a poor proxy for company valuation. A quantitative approach will model the financial statements of listed companies to derive a forecast of future earnings. This will include specific handling of accounting anomalies, country and industry effects.

Risk control is also critical as stock selection insight can often be drowned out by unintended portfolio bets caused by naïve approaches to portfolio construction, signal rebalancing and trading.

Quantitative managers are also well-equipped to manage the increasingly important area of sustainable investing, including a direct incorporation of ESG metrics. For some active managers, having an investor ask to invest in certain stocks or to avoid certain stocks while remaining tied to the benchmark can be problematic, but is less of an issue for quantitative managers with a view on every stock in the investment universe. They can make effective risk and return trade-offs even when required to exclude specific companies from their investment universe.

Valuations and performance

As with all investment disciplines, the performance of systematic quantitative investment strategies is largely influenced by the market and economic environment.

The post-GFC investment landscape has been dominated by central banks doing all in their power to meet growth and inflation targets. This monetary stimulus has fuelled risk appetite to the point where both equity and bond market valuations are stretched.

Price volatility has fallen as investor confidence has responded to the implicit view that monetary stimulus will always be applied by policy makers to mitigate downside events. This skewing of markets has been a difficult environment for active managers to outperform in.

In our experience, increases in uncertainty and volatility across financial markets makes the investor focus more on the fundamentals of the company they're buying. This is usually when traditional active and active quantitative-style management is in a better position to outperform and offer investors the best possible return.

Outlook and examples

Diversification in investment insights is key. An investor focus on one particular style may not pay off. A robust quantitative approach can aggregate multiple investment disciplines in the one portfolio.

Looking ahead, there are opportunities for a valuation discipline to be rewarded but it's skewed towards avoiding stocks that are expensive. Within the current economic cycle, there's not a lot of cheap valuation opportunities available.

Valuation in some financial services stocks, such as the local major banks, is attractive, but whether earnings will contract from here, or exactly how they can grow earnings in the future, is unclear. The risk is though they are relatively cheap, they may be cheap for good reason. Any sensible investment approach must seek to discern between the value opportunity and the value trap.

A recent case in point is the turmoil which has engulfed AMP Limited (ASX:AMP). Since the start of 2018, the share price has more than halved from over $5 to below $2. Making sense of the company's financial position has required a detailed investigation of a range of events and data. Our quantitative assessment was that AMP was unattractive on valuation grounds when trading at $5. The company's interim and financial reports through 2018 and 2019 raised a number of flags, determining that the stock remained a value trap rather than an opportunity as its share price fell. Our analysis flagged events such as increases in cashflow volatility, uncertainty across the financial statements and analyst estimates.

Taking a simplistic approach such as a focus on reported earnings or past dividends paid could have led investors to view the stock as attractive as the share price fell. However, a quantitative approach can include complex and detailed rules with the added benefit of being unemotive in decision-making.

Another sector with a question mark is local discretionary retailers, who appear to be trading below reasonable valuations. Again, the risk for such firms is that if there's any dislocation, such as any impediment to consumer spending, then they may be at risk of underperformance.

Overall, the combination of investment insight, risk-managed portfolio construction and manager oversight afforded by many quantitative managers serves to mitigate these uncertainties.

Max Cappetta is Chief Executive Officer and Senior Portfolio Manager at Redpoint Investment Management. This information is of a general nature only and is not financial product advice. Opinions constitute our judgement at the time of issue and are subject to change, and do not consider the circumstances of any investor.

Why emerging markets are difficult for index funds

Conrad Saldanha

The highly variable and diverse nature of the emerging markets equity asset class makes it well-suited to active management. By remaining benchmark-aware without being benchmark-guided, active managers are free to enhance value by investing in attractive regions, industries and individual companies.

The popularity of ETFs in emerging markets equity

Despite the benefits of active management, investments in emerging markets equity often flow by default to Exchange Traded Funds (ETFs) and other passive vehicles. Over the last five years, passive strategies have attracted almost 2.5 times more capital flows than active strategies into US-domiciled funds, as shown in Figure 1.

Figure 1. Five-year cumulative flows to US-listed active and passive emerging market equity

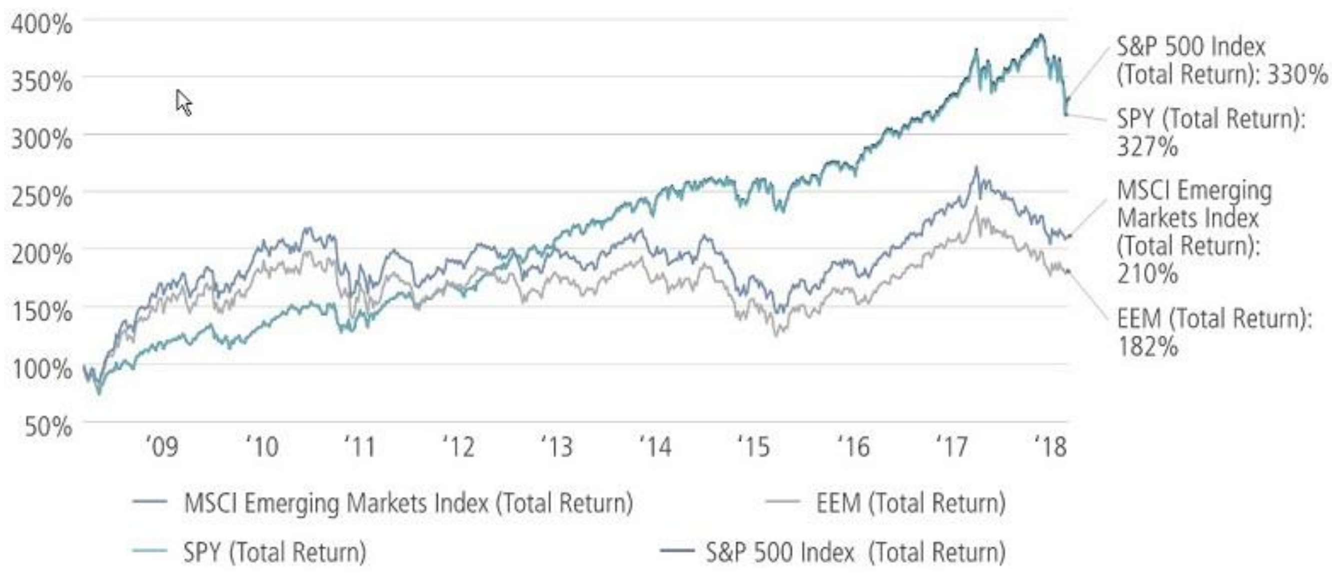
Emerging markets equity ETFs lagging their benchmarks

In the broader capital markets, the rising popularity of ETFs sometimes may reflect an increased focus on fees. However, ETFs for emerging markets equities are far less capable of delivering benchmark returns than ETFs tracking large capitalisation U.S. equities.

As shown in Figure 2 below, the largest US equity ETF (SPY) has managed to track the S&P 500 over the last 10 years. The two lines replicate each other almost exactly.

However, the median emerging market passive ETF has underperformed the MSCI Emerging Markets benchmark. The following example shows the iShares emerging markets ETFs, and the same is true for Vanguard. They have trailed their benchmarks by a substantial margin since their respective inception dates.

Figure 2. iShares MSCI Emerging Markets ETF has lagged its benchmark since inception



Source: Bloomberg.

Over the last 10 years, iShares MSCI Emerging Markets ETF (EEM) and Vanguard FTSE Emerging Markets ETF (VWO) have finished in the 79th and 58th percentile respectively among all U.S.-listed emerging markets equity funds. (The variance in performance between the two is a function of iShares targeting the MSCI benchmark while Vanguard is based on the FTSE Russell, which excludes Korea.)

Why is this happening?

The sources of physical ETF tracking error

ETFs attempt to track their target indexes by holding all, or a representative sample, of the underlying securities that make up the index. Generally, higher tracking error in physical ETFs tied to the MSCI Emerging Markets index stems from a combination of factors, including:

Transaction pricing: Due to a lack of liquidity in certain securities, the stock price observed in the calculation of the index is not available to a tracking portfolio. Supply-demand dynamics can push the actual price at which a tracking portfolio can transact to buy or sell to a less favourable level.

Optimised sampling: Physical emerging markets ETFs typically use optimised sampling techniques, whereby they hold a basket of securities designed to match the characteristics of the benchmark, but not exactly the same securities, in the same weightings. Optimised sampling is typically employed where the index has fairly illiquid constituents, a large number of index members or where there exist legal and regulatory barriers to owning certain securities. The nature of the sampling technique is imprecise, which can lead to higher tracking error. The same holds true for ETFs aiming to replicate the MSCI World index, which have lagged that index by 19 basis points (0.19%) on average, relative to synthetic, derivative-based counterparts.

Depositary receipts: many physical ETFs tracking the emerging markets index trade American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs), instead of buying and selling the underlying local securities. Listed on large U.S. or European exchanges, ADRs and GDRs are designed to mirror the ownership of a company's domestic stock listing. Deviations between these proxies and their local parents contributes to tracking error in ETFs.

Fees: ETFs, like traditional mutual funds, charge management fees that detract from the products' net asset value and, in many instances, prevent an ETF from matching the performance of the index it tracks. ETFs also incur shareholder transaction costs through brokerage commissions and bid-ask spreads, which are costs that take away from an investor's actual return even if not captured in an ETF's reported performance.

Benchmark inefficiencies provide active opportunities

Setting aside the tracking issues confronting emerging markets equity ETFs, we believe the MSCI emerging markets benchmark itself remains inefficient for the following reasons:

- Weighting by market capitalisation implies a backward-looking bias toward stocks that have performed well in the past
- Holdings of state-owned enterprises, whose interests are not necessarily aligned with minority shareholders, can lead to unproductive capital allocation decisions
- Minimal exposure to small capitalisation stocks hampers access to some of the fastest growing companies in emerging markets
- Lack of a financial viability requirement for entry of indices may detract from performance
- The MSCI benchmark is also limited to 1,193 constituents, when there are over 10,000 public companies in the broader emerging markets universe.

Active opportunities in emerging markets

By focusing on company profitability and taking a broader view of the emerging markets stock universe, active managers have the potential to positively differentiate their returns relative to passive strategies and their index benchmarks.

Emerging markets equity is a particularly supportive asset class for active management. The ETFs designed to track emerging markets equity indexes are challenged by illiquidity and sampling issues, while the indexes themselves can be inefficient due to the inclusion of less attractive companies and state-run enterprises, for example. Investors should carefully consider their investment options in order to maximise the capital appreciation potential of this growth asset class.

Conrad Saldanha is a Senior Portfolio Manager at Neuberger Berman, a sponsor of Firstlinks. This material is provided for information purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. It does not consider the circumstances of any investor.

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Voting your shares: why it's worth the effort

Fiona Balzer

Retail investors are rarely the most powerful voice in the room when they attend an Annual General Meeting (AGM) with institutional investors like super funds or managed funds holding many more shares. But where we lack power as individual shareholders, aggregating proxies can increase the leverage to bargain for what we want from a company. And when the big shareholders disagree about a resolution, retail shareholders can tip the vote and take it from 'for' to 'against'.

Retail shareholder power

This is not an over-exaggeration of retail shareholder power. The most recent ASX Australian Investor Study released in 2017 found that 37% of the adult population holds exchanged traded investments. This number is likely to grow if current taxation structures remain in place. Research published in the RBA's Quarterly Bulletin indicates that Australian taxation currently favours higher dividend payments to shareholders. The Australian Investor Study also indicates that the numbers of younger shareholders have almost doubled since previously measured.

Many retail shareholder investors who are not represented by institutional investment organisations. This is an important factor in how corporate governance is shaping the many concerns people have about the world they live in. Studies (linked here and here) conducted by the Australia Securities and Investment Commission (ASIC) have consistently identified higher shareholder engagement as a hallmark of the last two AGM seasons.

Increased engagement has also led to better results. According to the ASIC reports cited, gender diversity within corporate boards was a major shareholder engagement issue in 2017. In 2018, this engagement reduced the number of boards without any women on them significantly. This is not to suggest that the issue of diversity has been resolved but it does provide a metric to measure the difference shareholder engagement makes when managed correctly.

Examples of shareholder action

Retail shareholder proxies have made a difference in many circumstances already. At its 2018 AGM, National Australia Bank saw 46% of their shareholdings or 1,267 million shares out of 2,734 million shares vote on its remuneration report with 957 million voting against and 189 million abstaining. Usually, an abstention vote includes protest votes that do not oppose a resolution but indicate their lack of support for it.

This engagement made a difference as it indicated in no uncertain terms what shareholders thought of the remuneration policy.

This was also the case with the Commonwealth Bank of Australia. Out of their 830,307 shareholders and 1,770 million shares, in response to the changes they made to their remuneration structure and culture, 45% of shares voted on the remuneration report with 733 million voting for, 58 million voting against and 4 million abstaining. It was a significant improvement from the previous year's strike which signalled that the bank was regaining consumer trust.

Proxy voting arrangements

Reading these votes, interpreting them and ensuring that shareholder interests are significantly represented are why proxy voting arrangements are important. While there are several proxy organisations available to people, it is also worthwhile to understand what your proxy supports and does not support.

For institutional investors, proxy advisors often enable important decision-making that carry large resolutions. For retail shareholders, choices can be limited to maintaining a list of guidelines, having trained proxy representatives attend the meetings and ensuring nothing falls through the cracks.

While it is possible to lobby with proxy advisors and with institutional investors through a level of direct engagement, there are fewer organisations that provide retail shareholders with the ability to direct their proxies. What retail shareholders can look for in a proxy advisor is transparency. Knowing why votes are being cast enables a shareholder to see what their vote stands for.

While this may not be a guarantee with every organisation, a not-for-profit with a clear vision of advocating for retail shareholders, such as the Australian Shareholders' Association, is a good one to bet on.

An established organisation with a history that can be verified as well as a voice that can ideally help amplify the retail shareholders' voice can be significant in ensuring shareholder interests are represented at AGMs. For a well-established organisation, proxies can enable them to equate holdings that are among the top 20 in the company's shareholder lists making it highly relevant for the company to engage with.

However, it is key to remember that all of this can only be done through proxies that are actively voted. Enabling a strong, well-governed corporate sector is within the power of retail shareholders but how they can amplify their voice is something they need to decide.

You can appoint ASA as a proxy by inserting 'Australian Shareholders' Association' on the proxy form where it asks for the name of your proxy if you receive a paper notice for an AGM. The form needs to be returned to the share registry at least 48 hours prior to the AGM. If you want to know more about how you can appoint ASA as *a proxy and what that might mean, you can read their FAQ here. Find out more on how you can appoint ASA as your proxy here.*

Fiona Balzer is the Policy & Advocacy Manager at The Australian Shareholders Association, an alliance partner of Firstlinks and an independent, not-for-profit association for retail investors with its mission to both represent and educate investors. For more information www.australianshareholders.com.au.

Media worth consuming - November 2019

Jonathan Rochford

A monthly look at dozens of global media articles that often do not receive mainstream coverage in Australia.

Finance

Freight volumes continue to point to miserly global economic growth ahead. Global business sentiment is at its lowest since the financial crisis. US margin debt has dropped but stocks are at a record high. Australian insolvency firms are seeing higher demand for their services.

The Vatican Bank has been raided by police and kicked out of the global network for financial intelligence. The FBI warned Bank of America that it was about to lend money to a company engaged in widespread fraud, the bank went ahead anyway and the borrower is now bankrupt. 13 bankers have been hit with jail terms for helping Monte Dei Paschi hide losses. A professor who wrote the book on money laundering has been charged with it. Investment banks are engaging in bait and switch behaviours on bond marketing.

The CLO whale has gotten indigestion, sending prices down. The graph that shows what it takes to break a US CLO. An example of how business development companies are the wild west of private debt. US CCC bond spreads are back above 10%. American BB bonds trade at a very small yield premium to BBB bonds. The very high level of B- rated debt today could make for a greater corporate default wave than seen in the financial crisis.

JP Morgan's $2 billion loan to WeWork was 100% cash collateralised. Japanese banks are pushing back against Softbank's request to borrow more to fund its WeWork bailout. One third of American auto trade-ins have outstanding loans that are rolled into negative equity on the subsequent loan.

Lebanon's debt yielding over 100% points to default being almost inevitable. Lebanese banks are seeing riots and citizens armed with guns demanding their money as withdrawal limits are imposed. Turkey is pushing its banks to lend more at the same time they are dealing with a spike in non-performing loans. Argentina might want to give different recovery rates to different bonds, but it would be legally tricky to do so. There's $15 billion of Asian high yield bonds maturing next year with current yields of at least 15%.

Bonds defaults are rapidly rising in China, but they're being covered up. China is fudging the statistics on SME lending growth. China's corporate credit spreads are starting to reflect credit risk, but spreads on government entities remain unchanged. The $89 billion Harbin Bank has received a government bailout. China's top two universities have debt trading at or near distressed prices. There's a growing list of Chinese skyscrapers that have halted construction when half built. China's government has ordered almost all peer to peer lenders to cease writing new business and exit the industry.

China's local governments have guaranteed $842 billion of private sector debt and are facing a wall of debt maturities in 2020. Local governments are also buying shares of and non-performing loans from small banks to prop them up. The Chinese city of Ruzhou begged healthcare workers for loans so it could build a new hospital. A Hong Kong stock dropped 98% after MSCI reversed a decision to add it to an index.

Small private equity funds deliver better returns but many capital allocators can't be bothered doing the work and only invest in large funds. Private equity managers make their best investments early in a fund's life and their worst investments when they are raising capital for the next fund. US non-core real estate strategies are underperforming with high fees a key reason. Most US debt managers underperformed their benchmarks in the year to June 30.

The call centre doing the grunt work of initial prospecting for asset managers. A summary of the book about Renaissance Technology, the greatest hedge fund in the world. Those who exit first in a run on a fund do best. Over the last decade value stocks have delivered in line with their historical return, but growth stocks have grown well above their historical return. Meal delivery companies don't scale well, expect them to have to hike prices dramatically to survive. Uber continues to lose money, especially on food deliveries.

Politics & Culture

The Trump Administration is planning to force price disclosure onto the healthcare industry but vested interests will fight hard to stop it. Democratic Presidential candidates have great plans to spend more but no plans to deal with the already large debt and deficit. America's most racist city could be Oak Park Illinois. Washington State legislators wanted to bring in racist hiring policies, but the citizens voted them down. Two Ivy League colleges are dropping admission tests claiming that tests are racist. Some Japanese corporates have banned women but not men from wearing glasses to work.

The Washington Post calls the dead Islamic State leader "an austere religious scholar" in an obituary, largely ignoring his history of torture, executions and rape. CBS fired an employee who allegedly exposed the company's suppression of evidence of Jeffrey Epstein's crimes. New Jersey has issued Uber with a $650 million tax bill after workers were wrongly classified as contractors rather than employees. A list of major brands that have grovelled to China after triggering its offense mongers. Chick-fil-A has capitulated to the small but noisy mob.

Connecticut's law against ridicule direct violates the right to free speech. Google's management is cracking down on employee dissent by narrowing the all hands meetings and allegedly retaliating against employee dissention. YouTube is giving itself the right to shutdown "commercially unprofitable content" as a backdoor way to close down opinions it doesn't like. A New York county has passed legislation that punishes behaviour that merely annoys first responders with up to a year in jail.

Denver police refuse to act against vagrants trespassing and defecating in public but are happy to fine a business owner for not cleaning up their mess. San Francisco police don't act against public defecation but arrested a man for eating a sandwich. New York City is paying homeless people to move out of the state. Baltimore is subsidising Lyft rides for residents to go to the supermarket.

Economics & Work

America has given up on free markets with industry concentration making goods and services much more expensive. Microsoft's Japan office saw a 40% increase in sales per employee after moving to a 4 day week and introducing productivity initiatives. Modest CEOs are good at outperforming expectations. Basic economics shows that marketers are wasting millions on online advertising, but they don't stop when they are shown the evidence.

Wealth taxes (excluding property tax) have never worked, but politicians keep proposing them. New York's rent controls will reduce the quality and supply of housing, as well as reducing property tax. On average, Americans paid more in taxes than they spent on food, clothing and healthcare combined. Five European countries have effective top marginal tax rates over 70%. The fall of the Berlin Wall was in large part due to the bankruptcy of the USSR. The war on terror has cost the US government $6.4 trillion, which is around one-third of its debt.

Central banks have injected so much liquidity into stock markets it is impossible to withdraw it without causing a market crash. Pensioners in the Netherlands are facing payment cuts with negative interest rates copping the blame. Germany's banks struggle to make a profit and remain solvent, negative interest rates make it much worse. As bad as it is so far, the damage from negative interest rates is only just starting. The US government deficit is MMT in all but name. The Federal Reserve is now effectively buying debt directly from the US Treasury. A 2015 study from the BIS found that goods and services deflation isn't a problem, but debt and asset price deflation following bubbles is.

Miscellaneous

Amazon is happy to sell fake, illegal and dangerous products on its website and deny all responsibility. Airbnb is happy to let scammers use their system to rip off their customers. Tesla smashed the "shatterproof" glass on its new pickup as part of the vehicle launch. An electricity company threatened a consumer with debt collection processes after she failed to pay the $0.00 owing. An Instagram account is mocking scammers who claim to be rich but aren't.

11,000 scientists have signed a declaration that there is a climate change emergency and the earth needs to reduce its population. 500 scientists have signed a declaration that calls for reasoned debate on climate change and stating that "there is no climate emergency". Air based protein is the next stage of food technology. The history of veganism and why some people hate vegans.

Deep sleep helps clear away the toxins that lead to Alzheimer's. Alcohol breath testing devices are unreliable with American courts regularly throwing out drunk driving cases. A study of loan sharks in Singapore found that they rarely cause physical damage to their clients as it would harm their prospects of getting repaid.

5 errors successful people often make. Tips from financial advisors on how to avoid or manage difficult clients. A study of tipping by Uber users found that men tip more and women drivers receive more. It's not just a hippo shaped bathtub, it's a piece of art that sold for $4.3 million. An American high school football coach was suspended after his team "won by too much". Rock band Rage Against the Machine is reuniting to rage for the machine.

Written by Jonathan Rochford of Narrow Road Capital. Comments and criticisms are welcome.

Disclosure

This article has been prepared for educational purposes and is not a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties but the accuracy of this information cannot be verified in all cases. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.