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Contents

Editorial

All in one week. All on one subject. All buying into the same problem. Let's do a roll call. The International Monetary Fund (IMF). The Organisation for Economic Cooperation and Development (OECD). The Council of Financial Regulators (CFR). The Treasurer. The Governor and Assistant Governor of the Reserve Bank (RBA). The Australian Prudential Regulation Authority (APRA). The CEOs of ANZ and CBA ... enough abbreviations and acronyms to make us acrimonious.

What are they all fussing about? Suddenly, they've realised rapidly rising house prices might cause financial instability, generational inequity, mortgage stress and who knows ... social unrest?

And because when you don't know what to do, you call an inquiry, Treasurer, **Josh Frydenberg**, has asked the **Standing Committee on Tax and Revenue** to report on "the contribution of tax and regulation on housing affordability and supply". While it's not clear how it will discover anything not known to many previous inquiries, it keeps the problem bubbling along. Action is finally coming in the form of prudential controls, and we explore the steps that can be taken to cool a rampant market. Why is it taking so long?

Leading economist **Saul Eslake** asserts his strong views on housing affordability and the pampering to homeowners with policies that encourage house inflation. He says:

"*For all the crocodile tears which politicians of all persuasions routinely shed about the difficulties facing those wishing to get their first foot on the property ladder, deep down they know that there are far more people who already own at least one property than there are who don't, but who would like to.*"

Shane Oliver of **AMP Capital** and I recently appeared on Saturday Extra on Radio National, and Shane said:

"I think it's grossly unfair … We can't organise our property market in a way that makes it affordable for younger people without massive amounts of debt. This is a major social problem. The longer we leave it, it will lead to rising discontent and we've seen what that leads to in the US."

On to investing subjects ...

This week's guest interview is with **Jacob Mitchell**, Founder of **Antipodes** in 2015 after 14 years at **Platinum**. What big lesson would he give his 20-year-old self, and what trends and companies does he like?

Two papers on the need for caution in assuming the great market performance of the last decade will be repeated. **Joseph Davis** warns investors to prepare for a decade of returns below historical averages. And **Miles Staude** shows data from a survey of 32,000 investors in 32 countries where expected returns are extrapolating from the recent past, which is unlikely over the next five to seven years. What is more realistic?

When **Jon Kalkman** distilled the franking credit debate into a basic principle, that large refunds were due to low rates of tax in the super system, it begged the follow up question ... so are the low super tax rates fair? This is the issue that people criticising franking should focus on.

Last week, before the market worried about tapering and potential rate rises, the jitters were caused by potential defaults by Chinese giant property developer, **Evergrande. Andrew Parsons** manages a global property trust and he has been checking around his contacts for the likely impact. In a link to our earlier pieces, he also notes China and the world are struggling with housing affordability issues.

The article on the age pension assets test was a blockbuster, generating over 30,000 views, and even the survey results was opened over 10,000 times. The survey itself attracted 3,500 responses, thanks for your participation. We thought a few comments, too long to include here, were worth highlighting as adding to the debate.

In the latest edition of the podcast, **Wealth of Experience** with **Peter Warnes**, we discuss moves to control house prices, the debate on the age pension assets test, cash-up super funds chasing long-term assets and the full interview with Jacob Mitchell.

This week's white paper comes from **Capital Group** detailing 10 themes likely to drive opportunities in emerging markets in the next 10 years.

Finally, a footnote to our article on the requirement for super funds to provide a retirement income strategy, which at the time was intended to apply to SMSFs as well as large funds. The Retirement Income Covenant Exposure Draft issued this week removes the need for SMSFs to comply.

The sorry saga of housing affordability and ownership

Saul Eslake

The House of Representatives Standing Committee on Tax and Revenue is conducting an inquiry into Housing Affordability and Supply.

This is an issue about which I've written and spoken at considerable length for more than 30 years, including a submission to the Senate Economics References Committee's Inquiry into Affordable Housing in December 2013.

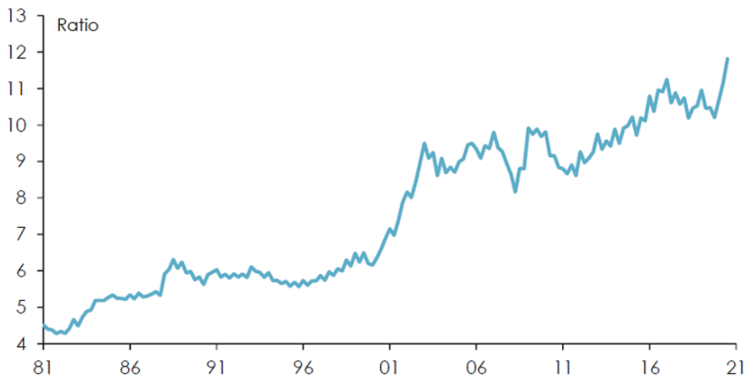
Residential prices outrunning other metrics

Between January 1991 (in the aftermath of mortgage rates rising to an all-time high of 17½% in the late 1980s) and September 2017, Australian residential property prices rose by **313.5**%, according to CoreLogic's now widely used measure. Over the same period:

- Australia's population grew by 29%
- average weekly ordinary-time earnings rose for fulltime adults rose by 171%
- the consumer price index rose by 89%, and
- Australia's economy (as measured by real GDP) grew by 128%.

As a multiple of average household disposable income per person aged 15 and over, average residential property prices rose from less than 6 times in the early 1990s to over 11 times by the end of 2017 (Chart 1).

Chart 1: Average residential property prices as a multiple of average household disposable income, 1981-2021



***Note**: 'Residential property prices' are the average of median sale prices across the eight state and territory capital cities; 'average household disposable income' is household disposable income divided by the civilian working-age (15 and over) population.*
***Sources**: CoreLogic, Home Property Value Index - Monthly Indices; ABS, Australian National Accounts: National Income, Expenditure and Product, March quarter 2021 and Labour Force, Australia, July 2021.*

For the roughly 3.2 million Australian households (out of a total of almost 4.5

million) who owned at least one property – and especially for the almost 750,000 Australians who owned at least one investment property – at the beginning of this period, this dramatic escalation in residential property prices was unambiguously a Good Thing.

For the additional 2.2 million Australian households who managed to become homeowners during this period – and again, especially for the just under 2.2 million individual Australians who by the end of it owned at least one investment property (and even more so for the 600,000 or so who owned two or more investment properties) – this huge rise in property prices undoubtedly made them financially better off.

Between the December quarter of 1990 and the September quarter of 2017, the value of household wealth held in the form of residential property rose by almost $5.7 trillion dollars – or 708%. Even after offsetting the $361 billion increase in mortgage debt over the same period, the net value of wealth in the form of residential real estate rose by some $5.3 trillion, or 680%, over this period.

Renters and young people left behind

But for the 1.1 million Australian households (almost one-quarter of the total) who were living in rented accommodation at the beginning of this period – a number which by the time of the 2016 census had risen to almost 2.6 million (or almost 31% of the total) – none of this eye-glazing increase in wealth came their way. The amount they paid in rent increased from $5.7 billion in 1990-91 to $46.4 billion in 2016-17 – an increase of 713%.

Among this almost one-third of Australian households were people who, at the beginning of this period and as it continued, would have expected to have been able to step on to this wealth escalator – only to find that they couldn't.

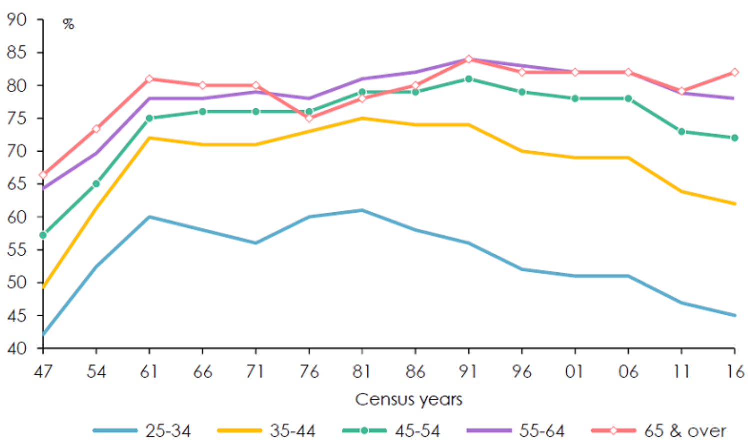
Between the 1991 and 2016 Censuses, Australia's home ownership rate fell from 68.9% to 65.5% - the lowest it has been since the Census of 1954. But for people aged between 25 and 34, the home ownership rate dropped by 11 percentage points between 1991 and 2016, to a lower level than it had been in 1954, indeed to only 3 percentage points above where it had been in 1947 (Chart 2).

For people aged between 35 and 44, the home ownership rate dropped by 12 percentage points, to a level just 1 percentage point above where it had been in 1954. Even for people aged between 45 and 54, the home ownership rate at the 2016 Census was 3 percentage points lower than it had been at the 1961 Census, and 9 percentage points lower than it had been in 1991.

Hundreds of thousands of would-be first home buyers – a group for whom politicians of all persuasions routinely profess profound concern – were effectively squeezed out of home ownership by cashed-up immigrants and, even more, by investors able to take advantage of more readily available credit and more generous tax breaks.

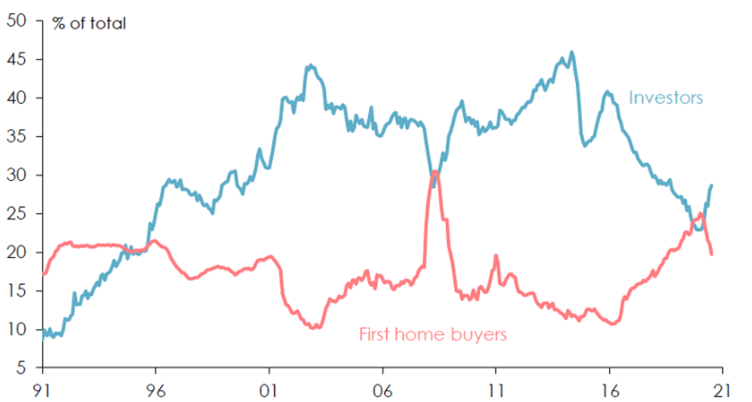
The share of housing finance going to first home-buyers fell from over 20% in the mid-1990s to just over 10% by 2003, and then, following a brief recovery during and after

Chart 2: Home ownership rates by age group at Censuses, 1947-2016



Sources: ABS, [Census of Population and Housing: General Community Profile, Australia, 2016] and [Historical Census Data]; Judith Yates, "[Explainer: what's really keeping young and first home buyers out of the housing market]", The Conversation, 12th August 2015, and personal communication.

Chart 3: First-home buyers' and investors' shares of total housing finance commitments



Sources: ABS, [Lending Indicators], June 2021, and [Housing Finance, Australia], November 2018.

the global financial crisis, fell back down to less than 11% again by the first half of 2017. Meanwhile the share of housing finance going to investors climbed from less than 10% in the early 1990s to over 40% in 2003, and was again back over 40% between mid-2013 and mid-2015, and in the latter part of 2016 (Chart 3).

Prices can fall when policies change

Then, after a series of steps by the financial system regulator APRA to curb some of the more egregiously risky forms of lending to investors that had mushroomed in the first half of the past decade, stricter enforcement of rules pertaining to foreign investment in established properties, and perhaps also in response to expectations that the tax preferences enjoyed by residential property investors would be scaled back in the event of a Labor victory at the federal election due in 2019, residential property prices began falling in Sydney, Melbourne and to a lesser extent Brisbane.

Between September 2017 and May 2019, residential property prices fell by an average of 8.6% across Australia. They fell by almost 15% in Sydney, and by more than 10% in Melbourne – more than they had (in nominal terms) in either city in the recessions of the early 1990s.

Those declines were ruthlessly exploited by the Coalition parties, and by property interests, as 'evidence' of what would occur if Labor were to win the 2019 election, and implement its commitments (which it had also made at the 2016 election) to scrap 'negative gearing' for all but newly-built investment properties and to reduce the capital gains tax discount – something the Government could do knowing that the number of voters who believed that they benefited from continually rising property prices greatly exceeded the number of voters who saw themselves as 'missing out', or losing.

And after a brief revival in the aftermath of the Coalition's largely unexpected victory at the 2019 election, the onset of Covid-19 in March last year initially prompted a renewed decline in property prices, and widespread speculation (including by all of the major banks) that double-digit percentage declines could be in the offing.

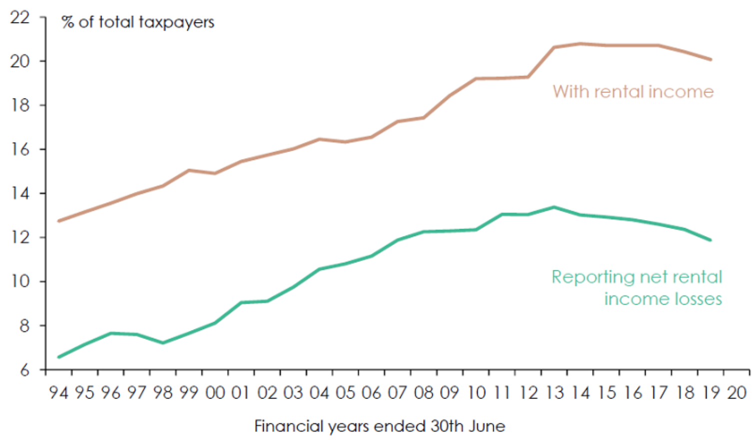
As always happens in Australia whenever it is feared that property prices might fall, governments at all levels and of both major political persuasions moved heaven and earth to ensure that they didn't. State Governments committed at least $2 billion over two years, and the Federal Government $680 million, to expanded schemes of cash grants or stamp duty concessions to first time buyers. And (admittedly for reasons other than propping up property prices), the Reserve Bank slashed interest rates to new record lows.

Governments to the rescue

And as it always does, it worked. Generous cash grants and tax breaks for first-time buyers 'brought forward' demand, funneling it into a relatively short period and allowing those who were able to get to the front of the 'queue' to pay more for the homes they bought than they otherwise would – the value ending up in the pockets of vendors or the profit margins of builders and developers. Strongly rising prices then attracted the attention of investors, who could then capitalise on the eagerness of banks and others to lend at record-low interest rates.

Although 'negative gearing' isn't as attractive a strategy as it once was – given the decline in interest rates – the most recent data from the Australian Taxation Office shows that over 1.3 million individual taxpayers (12% of the total) were still doing it in 2018-19 (Chart 4). They, moreover, are disproportionately high-income earners: 22% of all taxpayers in the top tax bracket (that is, those with taxable incomes in excess of $180,000) were negatively-geared property investors, compared with just 8.6% of those with taxable incomes of $180,000 or less.

Chart 4: Taxpayers with rental income, and reporting net rental income losses



Source: Australian Taxation Office, Taxation Statistics, 2018-19.

And data from the banking regulator APRA suggests that mortgage lending standards are again beginning to decline – albeit not yet as egregiously as they had done before 2015. The proportion of new loans being made on interest-only terms has crept up from less than 16% in the last quarter of 2018 to 19¼% in the first quarter of this year.

The proportion of new loans being made at loan-to-valuation (LVR) ratios of 80% or more has more than doubled, from less than 14% in the first half of 2018 to over 31% in the first quarter of this year.

Some of that can be explained by the increased proportion of loans going to first-home buyers, who typically have smaller deposits than those borrowing for the second or subsequent home – but not all of it. The proportion of new mortgages being written with LVRs of 90% or more has risen from 6½% in the middle of 2018 to 10½% in the first quarter of this year.

Australia is by no means alone in experiencing an unexpected resurgence in residential property prices in the aftermath of the pandemic.

It's happening almost everywhere around the world – including in countries which hadn't seen rapid growth in property prices over the previous two decades, such as Germany. Property prices have more than twice as fast in New Zealand over the past 12 months than they have done on this side of the Tasman – in part because the New Zealand subsidiaries of the Australian banks relaxed their lending standards much more (in response to very strong demand from investors) than they have thus far done here. That's prompted a strong regulatory response from the Reserve Bank of New Zealand – and a much more dramatic curtailment of tax preferences for property investors than the Labor Party had contemplated for Australia.

The increase in home ownership rates which was achieved over the first two decades of the post-war era – culminating in a peak of 72.5% at the 1966 Census – occurred despite Australia's population (and in particular the populations of its largest cities) growing at a much faster percentage rate than they have done over the past two decades.

Boosting demand rather than supply

That was possible because, throughout that period, the housing policies of the Commonwealth, state and local governments focussed on boosting the supply of housing – both by building a lot of housing themselves, and by facilitating the construction of housing by the private sector. As a result, despite the strong growth in the 'underlying' demand for housing, the ratio of house prices to average incomes remained relatively steady at around three times.

But, starting from 1963, when John Howard (as President of the New South Wales Young Liberals) managed to persuade Sir Robert Menzies to promise cash grants to first home buyers at that year's federal election, the emphasis of government housing policies has gradually shifted away from boosting the supply of housing, instead to inflating the demand for it.

The (almost inevitable) results of this shift in housing policy have been that house prices have risen to, typically, six or seven times annual disposable incomes; that it now typically requires two incomes to accumulate a deposit and service the mortgage required to buy an average-priced home; and that (as noted earlier) the home ownership rate is now lower than at any time since the mid-1950s (and possibly earlier).

Indeed, it is hard to think of any area of widespread public concern where the same policies have been pursued for so long, in the face of such incontrovertible evidence that they have failed to achieve their ostensible objectives.

Far more votes from property owners

For all the crocodile tears which politicians of all persuasions routinely shed about the difficulties facing those wishing to get their first foot on the property ladder, deep down they know that there are far more people who already own at least one property (and who therefore have a very strong interest in policies which result in continued property price inflation) than there are who don't, but who would like to (and who would prefer, at least until they succeed in their aspiration, policies which would restrain the rate of property price inflation).

And, sadly, there's no reason to think that political calculus is going to change. Nor, therefore, are the housing policies which have resulted in created the housing system which Australia has today.

Saul Eslake is an Economist and Principal of Corinna Economic Advisory. This paper was a submission to the House of Representatives Standing Committee on Tax and Revenue's inquiry into Housing Affordability and Supply, 25 August 2021. Republished with permission.

It's coming: 10 ways to cool rampant housing prices

Graham Hand

It’s finally coming. After watching house prices surge around 20% in a year in many parts of Australia (and Sydney 23%), Treasurer Josh Frydenberg has signalled action to control rampaging prices and potential financial instability threats.

Although prices are rising around the world, when it comes to citing a prime example, even *The Wall Street Journal* turns to Sydney. On 27 September 2021, it reported:

“In cities from Austin to Dublin to Seoul, more families are finding it impossible to pay higher prices unleashed by a global property boom. Sydney house prices leapt by nearly $870 a day in the second quarter of the year, said real-estate firm Ray White. In the U.K., first-time buyers are paying on average 32% more than 12 months ago, according to Benham and Reeves, a real estate agency.”

Australia’s regulators, notably the Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA), have been slow to respond. Both deny responsibility. Governor Phillip Lowe recently said higher house prices are "*outside the domain of monetary policy and the central bank*", although Assistant Governor Michele Bullock later said: "*developments in the housing market (including prices) provide information on the emergence of financial stability risks*".

It’s time to act, not only for financial stability reasons and because borrowers are taking on too much debt, but a generation of Australian families are increasingly priced out of the home market.

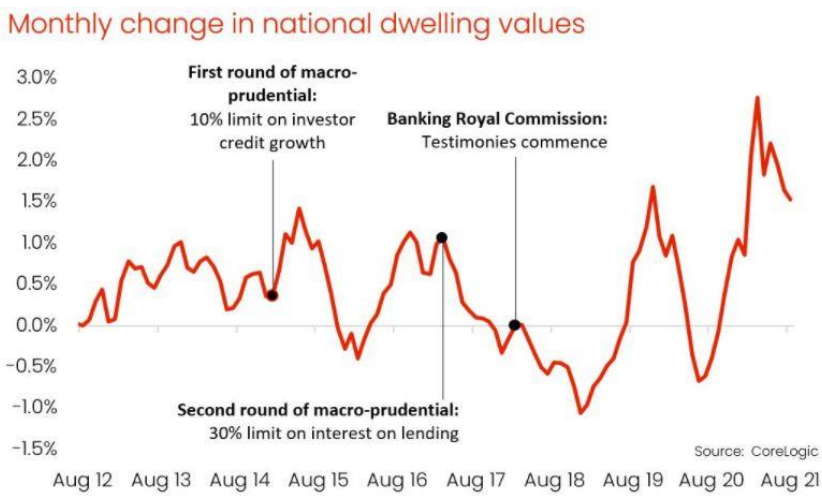
Shane Oliver of AMP Capital and I recently appeared on Saturday Extra on Radio National, and Shane addressed the intergenerational social tensions:

“I think it’s grossly unfair … We can’t organise our property market in a way that makes it affordable for younger people without massive amounts of debt. This is a major social problem. The longer we leave it, it will lead to rising discontent and we’ve seen what that leads to in the US.”

There are plenty of policy choices capable of taking the steam out of the market. Clearly some of these are politically difficult but that does not mean they should be ignored.

1. Introduce macroprudential controls

Australian banks are more generous than their peers in other countries on standards for housing lending. A recent Macquarie Research Report said Australian banks are willing to lend at about seven times a borrower’s gross income (and up to nine times with senior approval) versus around four or five in places like the UK, Canada, the US and Sweden. In Australia, 22% of loans have a debt-to-income ratio of six and over according to APRA, a rapid rise in the last year. Macquarie also reported that about 38% of borrowers (on a weighted average basis) took on debt at their maximum capacity in FY21.



This chart from CoreLogic shows macroprudential limits can reduce housing prices, such as when the Hayne Royal Commission supported strong responsible lending laws and when limits were placed on interest-only loans.

Josh Frydenberg finally accepted the need to tighten the reins, telling The Australian Financial Review:

“... it is important to continually assess the appropriateness of our macroprudential settings. We must be mindful of the balance between credit and income growth to prevent the build-up of future risks in the financial system. Carefully targeted and timely adjustments are sometimes necessary. There are a range of tools available to APRA to deliver this outcome.”

The [International Monetary Fund also weighed into the debate](), advocating the need for debt-to-income ratio or loan-to-value ratio caps on mortgage lending.

"Surging housing prices raise concerns about affordability and financial stability ... Macroprudential policy should be tightened and lending standards closely monitored."

The Reserve Bank of New Zealand acted along these lines as their house prices rose rapidly, also favouring debt serviceability restrictions to meet its housing price stability goals.

"Our analysis detailed that debt serviceability restrictions, such as a debt-to-income (DTI) limit, are likely to be the most effective additional tool that could be deployed by the Reserve Bank to support financial stability and house price sustainability."

So DTI is shaping up as a target. DTI is total debt divided by gross income (before tax). ANZ and NAB cap their DTI at nine, while CBA and Westpac allow above seven with special approval. What does this mean? If two people earn $100,000 each, that's $200,000 gross income before tax. With a DTI of nine, they can borrow $1.8 million. Throw in their own savings and generous assistance from the Bank of Mum and Dad, and that's why many buyers have $3 million to spend.

2. Increase the 'floor rate' or 'buffer' used to assess repayment capacity

At the moment, APRA requires banks to calculate borrower repayments at 2.5% above the interest rate charged. Alternatively, the bank can set a 'floor rate', and use whichever rate is higher. APRA previously imposed a floor rate of 7% but it was removed in 2019 as it was seen as a major limit to borrowing capacity.

Although borrowers might look at a stated lending rate of 2% and calculate for every $1 million they borrow, the repayment is only $20,000, banks use different rates to provide an affordability buffer and to cover future rate rises. CBA Managing Director, Matt Comyn, advised the Senate Economic Committee last week that his bank is increasingly concerned about the mortgage stress on its customers, and he supported 'modest' measures to control house prices. He added:

"We have put up our benchmark floor rate to 5.25% which is well above the rate customers would pay."

One reason Matt Comyn voluntarily increased the floor rate is that he considers loan-to-valuation hits first home buyers as they have not built up enough of a deposit to justify the loan size, whereas they may have the future servicing capacity to pay the loan.

3. Tighten lending standards

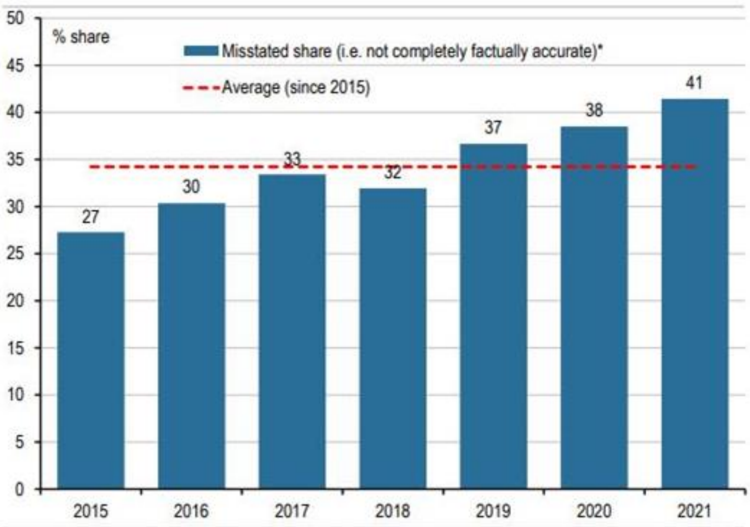
The Macquarie Research Report estimates Australian banks offer their clients between 35% and 65% more than their global peers. Adding to the concerns around high debts are doubts about the accuracy of mortgage applications.

UBS's [Evidence Lab]() surveyed 900 Australians who took out a mortgage in the last year, looking for "factually inaccurate" mortgage applications. The 2021 Report "suggests a material deterioration in lending standards" with the share of misstated applications rising to 41% from 38% in 2020 and 27% in 2015. Application errors included over-statement of income and assets and an under-statement of financial commitments and living costs.

UBS also reported the time for approval had lengthened, but this was more likely due to the record volume of loans rather than tighter lending standards.

ANZ Managing Director, Shayne Elliott, also speaking to the Senate Economics Committee, said:

Share of home loans misstated (not factually accurate)



Source: UBS Evidence Lab ([> Access Dataset]())

"We're taking more time to be careful, to ask more questions, to really assess whether people do have the capacity to take on the debt that they would like. In our case, we've lost a bit of market share … as a result of that, but it's just a time to be prudent and a bit more cautious."

4. Overhaul planning rules and land availability

The IMF also suggested Australia could improve housing supply and affordability, with new infrastructure provisions to address scepticism about new developments.

This view gained some support from Philip Lowe, who said rising housing prices should be addressed through changing the factors that influence the value of land:

"*More broadly, society-wide concerns about the level of housing prices are not best addressed through increasing interest rates and curbs on lending. While monetary policy is contributing to higher housing prices at the moment, the way to address these concerns is through the structural factors that influence the value of the land upon which our dwellings are built. The factors include: the design of our taxation and social security systems; planning and zoning restrictions; the type of dwellings that are built; and the nature of our transportation networks. These are all obviously areas outside the domain of monetary policy and the central bank."*

The Chair of the current Inquiry into Housing Affordability and Supply, Jason Falinski, has made his views clear, saying:

"the research points to limitations on land and restrictive planning laws as the major causes of shortages in supply."

However, this opinion is not universally supported, as the vast majority of sales are existing houses in major cities. How does a new land release 50 kilometres from the CBD improve affordability in the inner city?

5. Review the role of the RBA in housing policy

Australia has a complex mix of official bodies with some clear and some overlapping responsibilities. The Council of Financial Regulators (CFR) chaired by Governor Philip Lowe also includes the heads of APRA, the Australian Securities and Investments Commission and Treasury, and it meets quarterly to improve coordination and discuss policy. House prices were on the agenda last week, and under Josh Frydenberg's direction, the group has been charged with looking at policy solutions.

The above quote from Philip Lowe on "*areas outside the domain of monetary policy and the central bank"* shows he believes interest rates and curbs on lending are not the best moves to control prices, and other factors are more important.

But Michele Bullock said in an online speech:

"Sharp rises in housing prices that are not associated with fundamentals could lead to instability by raising the risk of a subsequent decline. Whether or not there is need to consider macro-prudential tools to address these risks is something we are continually assessing."

Last week, the Organisation for Economic Cooperation and Development (OECD) said the RBA had missed its key targets in recent years and its operations should be reviewed. Josh Frydenberg is open to the idea, and it should be clarified whether the RBA has any responsibility for housing prices, especially in the context of financial stability.

6. Lightly tap the interest rate brake

Interest rates are set at levels which are appropriate for the entire economy, including business borrowing, and cannot be used solely to reduce house prices. Governor Philip Lowe's recent speech set jobs growth as a far more important goal:

"I would like to address the question of housing prices, as some analysts have suggested we might lift the cash rate to cool the property market. I want to be clear that this is not on our agenda. While it is true that higher interest rates would, all else equal, see lower housing prices, they would also mean fewer jobs and lower wages growth. This is a poor trade-off in the current circumstances."

To the extent that the Fear of Missing Out drives rising property prices, there is probably no greater measure than a slight tap on the interest rate brake. A rise from the current 0.1% to 0.2% would send a signal.

However, Lowe is looking to other members of CFR to do the housing price work. Confirming other steps are coming:

"That is not to say that there aren't public policy issues to be addressed here. On the financial side, the issue is the sustainability of trends in household borrowing. We are continuing to watch this closely, with the Council of Financial Regulators discussing possible regulatory steps if lending standards deteriorate or credit growth accelerates too much."

7. Maintain responsible lending rules

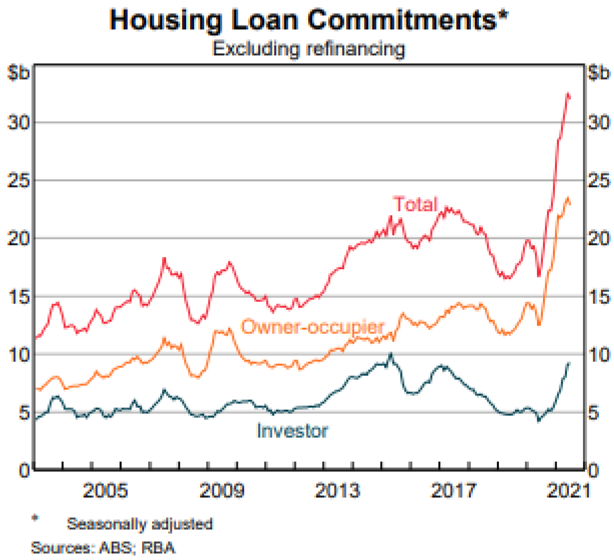
Josh Frydenberg has flipped around on responsible lending rules. The Hayne Royal Commission made the retention of these laws its first recommendation after much evidence that banks had engaged in predatory lending, making loans to people who had no chance of repaying. ASIC mounted the so-called 'wagyu and shiraz' action against Westpac in 2017 to prove it had ignored responsible lending laws prior to 2015 but the lawsuit was unsuccessful.

The Treasurer initially supported the Hayne recommendations strongly, but he later argued access to credit had become restrictive and was compromising economic activity. He said:

"What began as responsible lending principles has translated into a practice that has become imbalanced between a lender and its customer, leading to the undesirable consequence of unduly restricting lending."

He introduced legislation to repeal the responsible lending laws in September 2020 but they did not pass through the Senate.

There's not much evidence that lending has been restricted. All the signs are the opposite, that access to mortgage credit is relaxed and lending is surging, as shown here from the RBA Chart Pack. Housing loan commitments have surged in the last year.



8. Examine a wide range of tax and welfare rules that benefit property

Australia's tax and social security system strongly favours home ownership and investing in residential property. Many of these policies are sacred ground for homeowners and investors, and there are plenty of Australian politicians with investment property on their personal interests register.

Much good policy is politically difficult, which is why small policy targets have become smart politics. The Labor Party proposal to reduce the capital gains tax discount taken to the last election has now been abandoned.

Without elaborating in detail, consider:

1. Exemption of Principal Place of Residence (PPR) from capital gains tax.
2. Exemption of PPR from age pension asset test (a subject discussed extensively recently with an unprecedented response, including an article viewed over 30,000 times).
3. Negative gearing allows losses from investment property to offset other income, whereas losses from business must be carried forward.
4. Where a PPR is passed to the next generation, there is no capital gains tax if the asset is sold within two years.

New Zealand passed laws in March 2021 to curb price increases including the removal of tax deductions for interest payments on investment property loans.

9. Talk it down

For all the controls and changes the regulators and governments could bring to housing policy, it is the mood and perception of buyers and sellers that drives panic buying. I have written previously about attending inspections and auctions recently where price guides are smashed by half a million on houses that need a lot of money spent on them. Supply is at record lows during lockdowns, and in the current market, few people want to sell before they buy in a fear of missing out.

In a FOMO market, signalling from the Treasurer and Government officials that they would prefer to see price stability and avoid future stress might release some pressure.

There is too much complacency by borrowers taking massive debts. Digital Finance Analytics claims half of borrowers hold too much debt for their income, and their modelling suggests a 0.5% rise in interest rates would increase the number of households facing mortgage stress by 220,000 to 1.7 million families. Interest rate will rise at some time, and it's better to issue warnings now than face rising foreclosures in the future.

10. Move quickly

The CFR issued a statement following its 24 September 2021 meeting. It confirmed action is coming on macroprudential controls but with little immediate policy change:

"The Council is mindful that a period of credit growth materially outpacing growth in household income would add to the medium-term risks facing the economy ... Over the next couple of months, APRA also plans to publish an information paper on its framework for implementing macroprudential policy."

But it's a mystery why APRA needs another two months. In March 2021, six months ago, the Chair of APRA, Wayne Byers, told a Parliamentary Committee that it was watching key metrics while deciding if macroprudential intervention is required. But then he added:

"It's not our job to solve house prices and it's not our job to solve house pricing affordability."

If it's not the responsibility of the RBA or APRA, whose is it? Given substantial support for greater controls, even among banks themselves, the delay brings further dangers. Already, buyers' agents are encouraging clients to rush into the market before APRA strikes. This will make the indebtedness and financial vulnerability worse while APRA thinks about it.

Even when all the ducks are in a line, nobody wants to pull the trigger.

Graham Hand is Managing Editor of Firstlinks.

Antipodes' Jacob Mitchell on his biggest investing lessons

Graham Hand

Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, managing over $8 billion and part of the Pinnacle Group. Jacob spent 14 years at Platinum Asset Management before starting Antipodes in 2015.

GH: What attracted you into this business at the start?

JM: Even in high school, I was interested in understanding linkages between business, the world economy and politics, and looking up the stock pages - what it meant and why share prices react. It became a lifelong pursuit, and I was fortunate to start my career with a fundamental approach to company analysis and (at?) an early quantamental shop. That put me on a journey to global equities at Platinum and then to starting Antipodes in 2015.

GH: And if after all this time, you could go back and give your 20-year-old self one lesson which you didn't fully appreciate at the time, what would that be?

JM: As we've gone through each cycle, policy responses have become more and more dramatic, and we've now gone way beyond cutting interest rates to extraordinarily imaginative policies with QE and central banks socialising credit risk. The key lesson is don't underestimate how pragmatic central banks will be in the face of weakening economies.

And western central banks, especially, are committed to protecting asset prices as the key transmission to the real economy. They talk about targeting inflation but really, they're targeting and supporting the economy via higher asset prices – understanding, in my earlier years, how extreme this would become would have been helpful.

GH: Yes, it has been extraordinary how much support the central banks keep giving. You specialise in global equities and we have seen more Australian investors allocating to global whereas in the past the home bias dominated. What do you tell investors are the main reasons to hold global equities?

JM: The great opportunity is to diversify from a relatively-concentrated Australian stock market, especially away from financial and resources, and also domestic economic risk. Australia is a concentrated play on the health of the local economy and the health of China.

And the other opportunity is exposure to sectors that are not represented in the local stock market, such as semiconductors, critical enabling technology where the leading companies are American, Japanese, Taiwanese, Korean and European but not Australian. If you want to participate in certain parts of the market, you have to go offshore.

GH: We've had a great run in the market since the GFC and it recovered quickly from COVID. As purchase prices drive future returns, do you think it will be difficult for equities to perform as well over the next 10 years as they have over the last 10?

JM: Most definitely, yes. The best predictor of future returns is the starting multiple and that is elevated. It is very high in the US and the US represents roughly 60% of the global benchmark. So we struggle with the valuations for US equities, which are roughly 65% more expensive than the rest of the world, close to all-time highs. And then the other 40% is quite cheap in an absolute sense, certainly allowing for interest rates, and in a relative sense, as cheap as it's ever been.

GH: Compared with the US?

JM: You've got this bifurcation in potential outcomes, I think similar to 2000. There is P/E dispersion everywhere, even in the US and the US represents our largest exposure. Yes, we're underweight the benchmark significantly, but it's still a large exposure for our portfolio.

GH: It's very difficult to ignore the US in a global portfolio. What percentage of your book is in the US?

JM: In our long exposure, it's roughly 40% versus a benchmark of 60%. The average P/E valuation is hiding some very expensive stocks and some very cheap stocks, so we still think there are great stock picking opportunities and we do see different investment cycles starting to emerge, such as decarbonisation.

GH: Are there any big market trends you're backing at the moment and a couple of companies in this trend?

JM: Yes, we see reopenings emerge at a different pace around the world. One sweet spot in the next 18 months will be a return to cross border travel. Europe as an economy will do quite well and it has underperformed the US because it's so much more dependent on international tourism. So we broadly want to be exposed to Europe domestics, whether it's financials, specific travel exposures like Airbus and GE.

Then on the consumer side of travel, a company like Ctrip. It's the leading online travel portal in China with a high share of outbound bookings and a dominant position. It's a part of the market that's not experienced a proper recovery so stocks are quite cheap. It's a structural opportunity. We are constructive on the emergence of the Chinese middle class, and the aspirational premium consumers that we may have forgotten. But they will come back to travel. They love spending on luxury and that spending hasn't gone away.

The theme with deep implications is decarbonisation.

Investors often play conceptual stocks as opposed to thinking about what it really means, and it means a lot for power infrastructure. It will take years. It changes the fundamental underlying composition of capital spending towards power infrastructure.

It's a little bit like cloud computing. In the early days of the emergence of cloud computing and the evolution of SAAS software models, you really needed to work out what the longer-term implications were because it was a trend that will be around for a while.

GH: It will play out over decades. Are you seeing some winners in that space or is it too early?

JM: We like three themes. A utility company with sound regulatory protections that we like is Fortis, which will connect renewable energy to load centres. Then there's the 'picks and shovel' stocks like Siemens, which is well exposed to this capex cycle of reengineering the industrial base and reinforcing the grid. And third, companies in the materials space that need to decarbonise or build that power infrastructure. Switching the auto fleet to EVs changes the demand profile for copper. Also, aluminium has an excellent supply story as China has stopped adding capacity, and it has a great demand story as a lightweight metal. So those three buckets are all interesting.

GH: And you talk about the market "irrational extrapolating". What's a good example of that?

JM: Well, look at what's happening in China with tech regulation. We think the market is extrapolating in a somewhat irrational manner. We acknowledge the uncertainty but in some ways, China is catching up to the rest of the world in terms of anti-monopoly, consumer data protection, cyber security. We don't think this is a move by the Chinese Government to stamp out these companies in their provision of consumer and ecommerce services. They still want to encourage basic consumer services and successful businesses.

Look at patents which originate in China. There is a critical dependency and that innovation is coming out of the private sector, it's not the state-owned enterprises. I think the Government wants to coexist with the private sector and as investors, we should be able to navigate that uncertainty and use it to our advantage because I think it will reduce over time.

The strongest, largest and most dominant companies are in the best position to face that regulation, as we've seen with Facebook and the dominant tech companies in the world. When uncertainty has come to the fore, it's typically an opportunity to buy the company cheaply. And then, as uncertainties dissipate, it's typically those larger companies that have the financial and business capabilities to implement the change. Ironically, the regulations have reinforced their dominance because they have the resources to deal with the issues.

GH: Let's look at your listed vehicles, the closed-end LIC (ASX:APL) and your plan to give investors the choice to switch into your open-ended active ETF (ASX:AGX1). Can you give some insight into why the Board chose this approach when other methods have been tried in the past, such as a tender offer structure, as the best way to remove any discount in the share price to Net Tangible Assets (NTA).

JM: AGX1, as an exchange-traded active ETF, solves permanently the NTA discount. So while we took a path to get there - buybacks, tender offer - it is the best outcome. It's the same approach, but within a long only rather than long-short strategy, same investment philosophy, same investment team. And combining the two gives better scale and solves permanently the NTA issue.

GH: Is there any concern on your part that whereas previously, you had locked-in capital, investors can now redeem from an active ETF, that maybe there will be some loss of funds?

JM: Retention of FUM is a function of communication and performance, and we think the future is active ETFs. If we do our job, we'll retain our investors but ultimately it's their choice, but we thought this was an elegant solution to the discount problem.

GH: A final question. Is there a stock in your portfolio that you're confident you will still hold 10 years from now?

JM: Well, repeating based on the great long-term opportunity, Siemens will reengineer industrial supply chains and power. If you think of the businesses that Siemens is in - supply chain solutions, manufacturing solutions, infrastructure, fortifying the grid, reducing emissions – we've never seen anything like this, and Siemens is going to be the stock. These are long-term capex growth exposures, and the growth rate will accelerate over the next couple of decades, and the market is significantly underestimating the long-term value of the company.

The stock I've owned the longest is Microsoft. It can be decades before the market efficiently prices the asset. Microsoft is getting there, Siemens hasn't even started.

Engineers, designers, once they're trained on these Siemens tools, it becomes similar to the Microsoft suite. It's easy to keep using it.

Graham Hand is Managing Editor of Firstlinks. Jacob Mitchell is Founder and Chief Investment Officer of Antipodes Partners, managing over $8 billion and part of the Pinnacle Group, a sponsor of Firstlinks. This article is an edited transcript and the general information does not consider the circumstances of any investor.

Move on from franking: Is tax-free retirement fair?

Jon Kalkman

Superannuation funds receive franking credit refunds simply because their marginal tax rates are low, and for no other reason. This point seems to be lost on many people in the debate about whether franking credit refunds are fair.

Franking credits are fair because they transfer all company profits (not just the dividend) to the personal tax system which are then subject to progressive marginal tax rates. Taxpayers with the highest income not only pay more tax, they pay a greater proportion of their income in tax.

The super fund is the taxpayer

It is the super fund, not the member, that is the shareholder and taxpayer and the recipient of any franking credit refund. The fund member never owns the shares and never receives a franking credit refund, not in SMSFs, nor as members of industry funds even where they invest in a Direct Invest or Member Direct Option.

But many people question the fairness of a tax-free retirement, for which they blame Howard/Costello in 2007.

Before 2007, fund members paid some tax when they withdrew money in retirement. Costello made all member withdrawals from super for both pensions and lump sums, tax-exempt after the age of 60 but left the tax on superfunds unchanged. There is a pervasive view that Costello forfeited a lot of tax through that decision. I think that is a myth, as I explained in this earlier Firstlinks article.

In summary, that tax on withdrawals only applied to the taxable portion of the fund and the member was also entitled to a 15% tax rebate in compensation for the taxes applied earlier to contributions and investment earnings. That tax arrangement is still in place for taxes on death benefits. By definition, large funds had small taxable portions because they became large only from large non-concessional contributions. For smaller funds, the rebate eliminated most of the tax payable.

Restrictions on large contributions

Costello's other change was more important than people realise. He stopped unlimited contributions of after-tax money into super. It is no longer possible for to accumulate several million dollars in super (barring an investment windfall).

Previously, these large accumulation funds became very large tax-free pension funds, entitled to very large associated franking credit refunds. Some of these large funds still exist. The Retirement Income Review identified 11,000 people with more than $5 million in their super and some funds are much larger than this. According to James Kirby, *The Australian*, 10 September 2021, we are now at a point where a tiny number of mega funds, linked with less than 100 people, control more than $10 billion. These funds are clearly not required for a comfortable retirement, but they do make a very favourable estate planning tool.

The changes introduced in 2017 closed that favourable tax treatment. Tax-free pension funds are now limited by the Transfer Balance Cap of $1.7 million, and the excess is moved to an accumulation fund which is subject to tax. It is also no longer possible to make after-tax contributions once you reach your Total Super Balance Cap.

All contributions are taxed

Super became compulsory in 1992 with the complex tax rules we now have. All contributions are now taxed before they are invested, and all investment earnings are taxed while in accumulation mode. A super fund paying a pension in retirement has been tax-free since 1992 and since 2007, those withdrawals from the fund are also tax-exempt.

The original plan was to allow all contributions and investment earnings to be tax-free inside super and then to tax retirement benefits at 30%. Aside from the fact that a 30% tax rate would mean no franking credit refunds, this method would have had two distinct advantages.

First, superannuants would accumulate larger nest eggs as compounding over 30-40 years would be applied to total investments rather than the after-tax (85%) portion.

Second, this would avoid the inter-generational envy caused by the favorable tax treatment for retirees. This method was not adopted because the government was not prepared to wait 30-40 years to collect any tax from super, but that system is difficult to change now.

There remain many critics of the tax-free status of pension funds. Let us consider this favourable tax treatment.

The main reason for the super tax concessions is to ease the pressure on the age pension as retirees live longer. Changes to the downsizer contributions and the work test have the same effect. Similarly, franking credit refunds extend the life of a super fund's capacity to pay a pension and thereby delay a retiree's dependence on the age pension.

For the government, the cost of tax concessions in retirement needs to be offset against age pension costs. Valid comparisons are difficult because super tax concessions represent tax foregone but the projected tax that might be collected if this money was invested elsewhere is only a guess because it would involve different costs and benefits for taxpayers. Moreover, the super system is not yet mature as retirees today did not benefit from super all their working lives and then only at low levels at the beginning.

Nevertheless, the Retirement Income Review shows that super in retirement is already reducing the cost of the age pension.

For individuals, a tax-free pension is not cost free

By design, the more super you accumulate by retirement age, the less age pension you are entitled to. A couple will have their age pension reduced when their assets exceed $405,000. They become ineligible for any age pension once their assets exceed $891,500. Note that the family home is not assessed in this calculation. If they have $1 million in a super pension and earn $50,000 tax-free, they may cost the government $4,500 in forfeited income tax but they save the government $37,923 in age pension that they cannot claim.

Some age pensioners may question the wisdom of saving so diligently.

On the other hand, age pensioners enjoy a risk-free, tax-free, lifetime annuity that requires no personal effort. They could enjoy this annuity for more than 25 years, so the cost to the taxpayer can be very high.

A tax-free super pension is the incentive and reward for locking money away in a super fund for up to 40 years but it comes with a huge opportunity cost. Absent a pandemic, there is no access to this money for other purposes such as housing, education or travel. You must also trust successive governments to not change the rules. This explains why many young people do not contribute more than the minimum required.

In addition to these constraints, super pensions also have mandatory cash withdrawals that increase with age. At age 90 the mandated withdrawal is 11%. Failure to meet this requirement means the loss of the fund's tax-free status. The purpose and effect of this requirement is to progressively remove capital from super that it is then subject to normal tax. This reduces any concessional money left in the estate. Super balances at death may also be subject to a death tax.

A tax-free super pension represents a social contract. A breach of faith would cause alarm to those who have accepted these conditions for the last 30 years.

There are undoubted benefits associated with a tax-free retirement, which is available to all. The fact that the government needs to compel Australians to save for their own retirement through the Super Guarantee, though, suggests that many people remain unconvinced of those uncertain future benefits.

The zero-tax rate applies to all super pension funds. That tax rate could be changed by an act of parliament, but such a change would impact the retirement benefits of all Australians.

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.

Never Evergrande

Andrew Parsons

The failing financial position of China Evergrande Group, one of China's largest residential property developers, has captured the world's attention for fears of a broader economic and social fall-out. Property investment and related construction and appliance activity is a substantial contributor to China's GDP, up to 25% by some estimates. Hence, the risk of a sudden collapse of Evergrande could threaten capital providers and home buyer sentiment leading to a downturn in property investment and the Chinese economy.

This could have far-reaching implications for the regional and global economy. The challenge is to understand the depth of the issues facing Evergrande, its industry competitors and the Chinese residential market.

Our global REIT portfolio has no direct exposure to the Chinese property developers, including Evergrande. We have long doubted the quality of the earnings and the strength of their balance sheets.

We stress that pontificating on the broader implications for Chinese central planning policy and the consequent outcomes of Evergrande's collapse is a fool's errand. Recall few experts predicted the U.S. subprime crisis, and countless pundits have been predicting the demise of the Chinese residential market for a decade. Notwithstanding, we have reached out to a broad range of interested parties to get a balanced perspective.

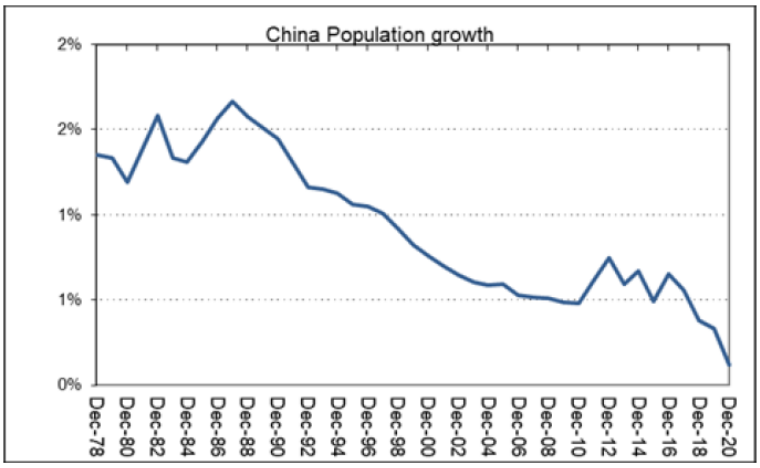
Chinese housing boom is over

Our channel checks support the view that the housing boom in mainland China is largely over. Having maintained a high-risk capital structure reliant on continued if not accelerated home price dynamics, Evergrande is a high-profile casualty of a changed dynamic and there will likely be others albeit likely not on its scale.

Evergrande is one of China largest property developers and ranked 4th in terms annual housing production. Whilst by itself Evergrande is not too big to fail, the broader consequences on the housing market, financial institutions and the economy are meaningful, particularly if it leads to the rapid collapse of many other highly leveraged players in the market.

Direct stakeholders include purchasers of unfinished homes, construction workers and building materials suppliers as well as its debt and equity investors. Equity investors and offshore bond holders should prepare for the worst, but they should not be shocked given Evergrande's precarious financial position has been evident for some time.

The Chinese Communist Party (CCP) has warned in the past 2-3 years that it is seeking to address some imbalances in the economy. Whilst part of the motive of the CCP is to curb the influence of large private enterprise and high-profile individuals, there also appears to be a deliberate policy to reign in escalating education and housing costs in an attempt to address low birth rates and stagnating population growth.



Source: Bloomberg

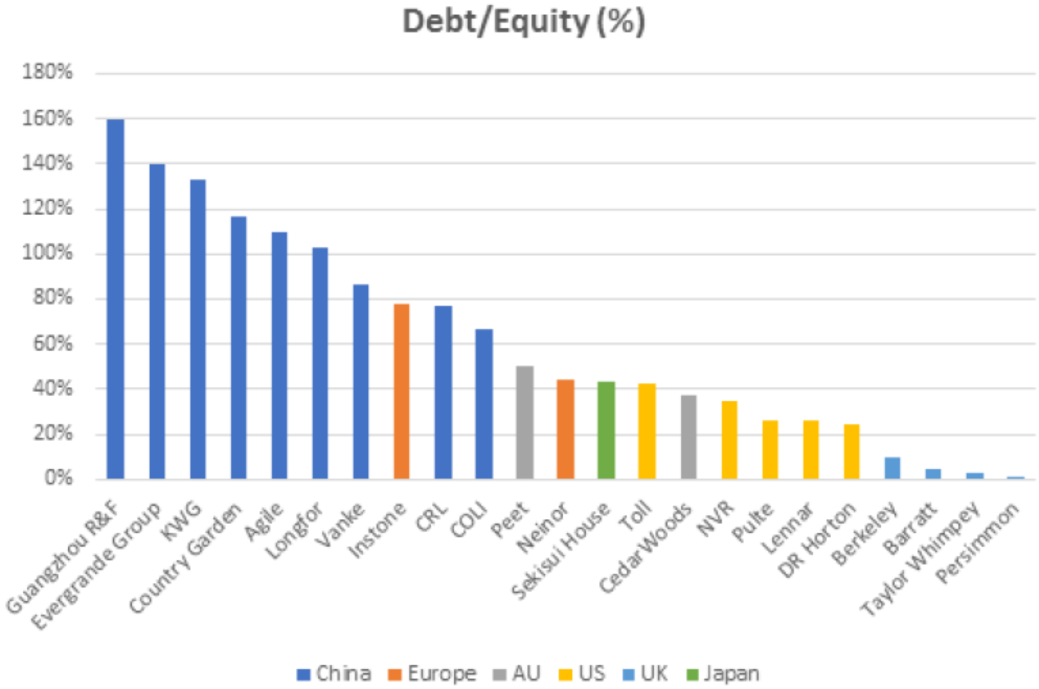
Specific to the residential property sector, President Xi Jinping is often quoted saying "houses are built to be inhabited, not for speculation".

Buoyed by seemingly ever-rising land prices and a constantly growing economy, as highlighted in the chart below, Chinese residential developers have maintained higher financial leverage then their global peers.

Concerned about this dynamic, from a policy perspective, the Chinese Government had been tightening lending conditions for developers for some time – most recently initiating the 'three-red-lines' policy[1] introduced in August 2020 which imposes three specific leverage metrics targets on property developers. This tightening of lending conditions has been well telegraphed.

Indeed, policy tightening is a major contributing factor to the timing of Evergrande's troubles, but principally because it was already in a self-inflicted precarious financial position as the graph below illustrates.

Global snapshot sample – Publicly-listed residential property development companies



Source: S&P Capital IQ

Not in the Lehman league

We do not believe the challenges facing Chinese developers and their lenders is likely to be a crisis on the magnitude of Lehmans. Whilst there are 'shadowy' recesses in the financial system, there is limited evidence of low doc NINJA (No Income No Job Applicants) loans that riddled the US banking system ahead of the GFC.

Indeed, the Government has deliberately put in measures to forestall such a crisis. Stress testing conducted by sell-side banking analysts generally concurs that the Chinese banking sector should be able to manage various default scenarios for both Evergrande and the Chinese property sector more broadly. The Chinese banking regulator is directing banks to maintain liquidity to other property developers to avoid a broader loss of buyer confidence in developers' ability to deliver.

Nevertheless, we acknowledge the CCP's efforts to balance the economy could fail and wider contagion impacts depend on whether Chinese homebuyer confidence diminishes more broadly. This is accentuated by the way in which off-the-plan home buyers make progress payments throughout the construction phase in China, putting more risk on the home buyer when developers fail and are unable to deliver the completed project.

We will not be surprised to see the liquidation or significant restructure of Evergrande's affairs but do expect it to be executed in an orderly manner, potentially with State-Owned-Enterprises called upon to assume responsibility for completing major works in progress.

Access to foreign capital is likely to be curtailed for some time so much depends on the Chinese banking system's ability to fill any voids in order to reduce the extent of a housing slow down.

Crucially, the CCP has no motive to undermine the housing market, the populace has most of its wealth invested in residential and, as mentioned at the outset, it is a significant driver of the economy. Hence, we expect the Government will pull levers necessary to stabilise the market.

Residential affordability a global problem

The challenges facing China's residential market in relation to demographics and affordability are by no means isolated. The collapse of Evergrande places pressure on Chinese policy makers to underpin property values whilst addressing affordability issues. We stress this is a challenge not confined to China as governments and societies around the world also face the challenge of how to manage residential affordability.

In terms of the broader global REIT sector, financial leverage is moderate, debt sources are diversified and debt maturities are well laddered. We see limited risk of a repeat of the GFC liquidity crisis which impacted the REIT sector. Our portfolio remains skewed towards exposures which have sound balance sheets, prudent management teams and healthy operating conditions where landlords continue to have pricing power.

Andrew Parsons is a Co-Founder and Chief Investment Officer at Resolution Capital, and affiliate manager of Pinnacle Investment Management. Pinnacle is a sponsor of Firstlinks. This article is for general information purposes only and does not consider any person's objectives, financial situation or needs, and because of that, reliance should not be placed on this information as the basis for making an investment, financial or other decision. For more articles and papers from Pinnacle Investment Management and affiliate managers, click here.

Why market forecasts matter to long-term investors

Joseph H. Davis

Why should long-term investors care about market forecasts? Vanguard, after all, has long counselled investors to set a strategy based on their investment goals and to stick to it, tuning out the noise along the way.

The answer is that market conditions change, sometimes in ways with long-term implications. Tuning out the noise - the day-to-day market chatter that can lead to impulsive, suboptimal decisions - remains important. But so does occasionally reassessing investment strategies to ensure that they rest upon reasonable expectations.

It wouldn't be reasonable, for example, for an investor to expect a 5% annual return from a bond portfolio, around the historical average, in our current low-rate environment. As the late Vanguard Founder John 'Jack' Bogle wrote:

"Treat history with the respect it deserves. Neither too much nor too little."[1]

In fact, the Vanguard Capital Markets Model® (VCMM) suggests that investors should prepare for a decade of returns below historical averages for both stocks and bonds.

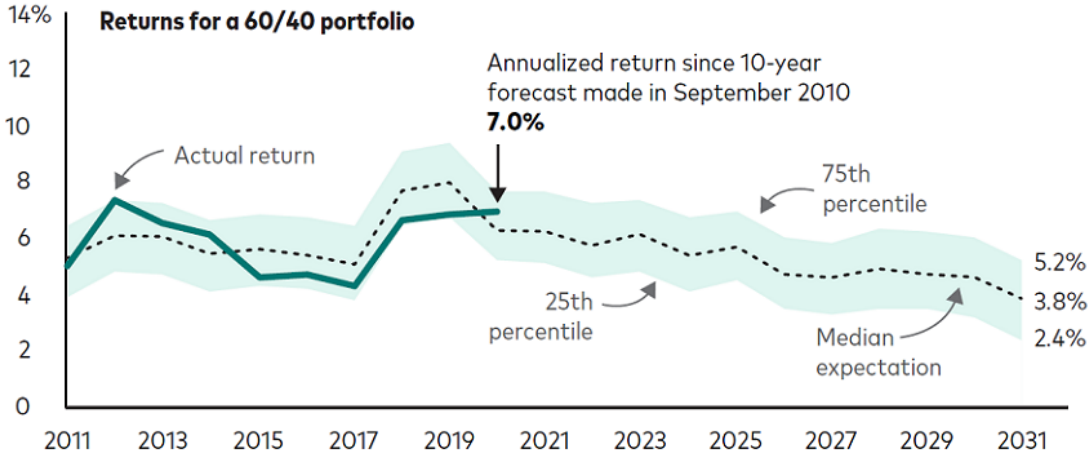
The value of market forecasts rests on reasonable expectations

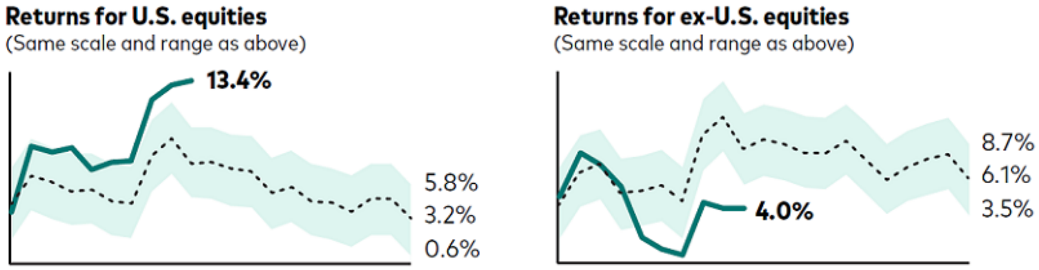
The role of a forecast is to set reasonable expectations for uncertain outcomes upon which current decisions depend. Our forecasts inform our active managers' allocations and the longer-term allocation decisions in our multi-asset and advice offers.

Being right more frequently than others is certainly a goal. But short of such a silver bullet, we believe that a good forecast objectively considers the broadest range of possible outcomes, clearly accounts for uncertainty, and complements a rigorous framework that allows for our views to be updated as facts bear out.

So how have our market forecasts fared, and what lessons do they offer?

Some errors in our forecasts and the lessons they offer





Source: Vanguard calculations, using data from MSCI, Bloomberg. See endnotes for more detail on the benchmarks used.

The illustration shows that 10-year annualised returns for a 60% stock/40% bond portfolio over the last decade largely fell within our set of expectations. Returns for U.S. equities surpassed our expectations, while returns for ex-U.S. equities were lower than we had expected.

The data reinforce our belief in balance and diversification, as discussed in *Vanguard's Principles for Investing Success*. We believe that investors should hold a mix of stocks and bonds appropriate for their goals and should diversify these assets broadly, including globally.

You may notice that our long-run forecasts for a diversified 60/40 portfolio haven't been constant over the last decade, nor have the 60/40 market returns. Both rose toward the end of the decade, or 10 years after markets reached their depths as the GFC was unfolding. Our framework recognised that although economic and financial conditions were poor during the crisis, future returns could be *stronger* than average. In that sense, our forecasts were appropriate in putting aside the trying emotional strains of the period and focusing on what was reasonable to expect. Our outlook then was one of cautious optimism, a forecast that proved fairly accurate.

Today, financial conditions are quite loose - some might even say exuberant. Our framework forecasts softer returns based on today's ultralow interest rates and elevated U.S. stock market valuations. That can have important implications for how much we save and what we expect to earn on our investments.

Why today's valuation expansion limits future U.S. equity returns

Valuation expansion has accounted for much of U.S. equities' greater-than-expected returns over a decade characterised by low growth and low interest rates. That is, investors have been willing, especially in the last few years, to buy a future dollar of U.S. company earnings at higher prices than they'd pay for those of ex-U.S. companies.

Today's high valuations suggest a far more difficult climb in the decade ahead. The big gains of recent years make similar gains tomorrow that much harder to come by unless fundamentals also change. U.S. companies will need to realise rich earnings in the years ahead for recent investor optimism to be similarly rewarded.

More likely, according to our VCMM forecast, stocks in companies outside the United States will strongly outpace U.S. equities - in the neighborhood of 3% a year - over the next decade.

We encourage investors to look beyond the median, to a broader set between the 25th and 75th percentiles of potential outcomes produced by our model. At the lower end of that scale, annualised U.S. equity returns would be minuscule compared with the lofty double-digit annual returns of recent years.

What to expect in the decade ahead

This brings me back to the value of forecasting.

Our forecasts today tell us that investors shouldn't expect the next decade to look like the last, and they'll need to plan strategically to overcome a low-return environment.

Knowing this, they may plan to:

- save more
- reduce expenses
- delay goals (perhaps including retirement), and
- take on some active risk where appropriate.

And they may be wise to recall something else Jack Bogle said:
"Through all history, investments have been subject to a sort of Law of Gravity: What goes up must go down, and, oddly enough, what goes down must go up."[2]

[1] Bogle, John C., 2015. *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor*. [2] Jenks, Philip, and Stephen Eckett, 2002. *The Global-Investor Book of Investing Rules: Invaluable Advice from 150 Master Investors.*

Notes to chart: The figures show the forecast and realised 10-year annualised returns for a 60% stock/40% bond portfolio, for U.S. equities, and for ex-U.S. equities (all U.S. dollar-denominated). On each figure, the last point on the darker line is the actual annualized return from the 10 years beginning October 1, 2010, and ended September 30, 2020, and covers the same period as the Vanguard Capital Markets Model (VCMM) forecast as of September 30, 2010. The last points on the dashed line and the surrounding shaded area are our forecasts for annualized returns at the 25th, 50th (median), and 75th percentiles of VCMM distributions as of July 31, 2021, for the 10 years ending July 31, 2031. VCMM simulations use the MSCI US Broad Market Index for U.S. equities, the MSCI All Country World ex USA Index for global ex-U.S. equities, the Bloomberg U.S. Aggregate Bond Index for U.S. bonds, and the Bloomberg Global Aggregate ex-USD Index for ex-U.S. bonds. The 60/40 portfolio consists of 36% U.S. equities, 24% global ex-U.S. equities, 28% U.S. bonds, and 12% ex-U.S. bonds.

Joseph H. Davis, Ph.D., is the Global Chief Economist of Vanguard, a sponsor of Firstlinks. Past performance is no guarantee of future returns. This article is for general information and does not consider the circumstances of any individual. The author thanks Ian Kresnak, CFA, for his invaluable contributions to this commentary.

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***IMPORTANT:** The projections and other information generated by the Vanguard Capital Markets Model® (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. The distribution of return outcomes from the VCMM is derived from 10,000 simulations for each modeled asset class. Simulations for previous forecasts were as of September 30, 2010. Simulations for current forecasts are as of July 31, 2021. Results from the model may vary with each use and over time. For more information, refer to Vanguard's original publication linked here.*

What do you expect from your portfolio today?

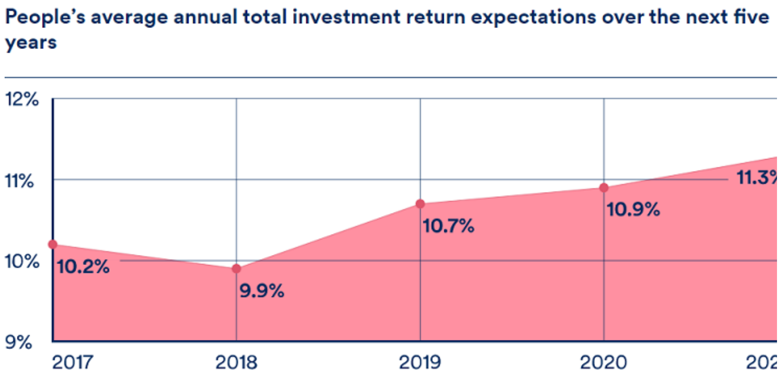
Miles Staude

One of the big challenges we see for investors today is the disconnect between the investment returns that have been realised over the past few years, and the likely investment returns that await us in the years ahead.

At face value this disconnect is easily understood. Recent history has been spectacularly good for most asset classes. Stock, bond, and property markets - three investment classes that dominate most portfolios - have all delivered recent returns that are well above their long-run averages. It has been quite some time since the average long-term investor has suffered any real financial pain.

While it is true that the pandemic caused a severe market correction, global equity markets had recovered to their all-time high within six months of this event. That feat took three years following the GFC, or five years following the 'dot-com' crash.

With returns plentiful and perception of risks low, it is understandable that investors' expectations have been steadily rising. The 2021 'Global Investors Study' of over 23,000 investors in 32 locations by Schroders highlighted that its respondents expected average annual investment return of 11.3% over the next five years, a figure that has increased in each of the past three years Schroders has run this survey. Perhaps unsurprisingly, the study shows that people's return expectations are at their highest in the countries that have enjoyed the strongest local market gains in recent years.



Source: Schroders Global Investor Study 2021

Try as we might, we are all emotional actors. Recent investment returns are not a particularly robust platform to base future return expectations on. Worse, the driving force behind these recent stellar returns has been a been a period of relentless falls in interest rates all around the world. This has provided a one-time boost to most asset classes, as lower discount rates have reset asset valuations higher.

Lower interest rates mean higher asset prices

It is a truism that as the cost of money falls, the value of assets simultaneously rises. For example, lower mortgage rates provide home buyers with the ability to pay higher prices for houses. This same principle applies across all asset classes. Long duration (or length) assets benefit from this the most, as they have the greatest sensitivity to the cost of money.

But higher asset prices also mean lower long-term returns.

Finance theory says that the return from an investment should be anchored to the return received from holding the current 'risk-free' rate such as a term deposit account - essentially zero return today. With more risk, we should expect to earn an additional margin of return to compensate for this.

Thus, the interest rate received from owning high quality bonds (loans) today is around 2% pa in the US and Australia. While that provides a 2% margin over the risk-free rate of return, it is a figure that has fallen considerably from the c.3.5% for making the same loan five years ago, or the 5% earned 10 years ago.

Further along the risk curve are high-yield bonds, essentially loans that are made to companies where there is a reasonable chance the borrower may default. This risk of borrower default is why high-yield bonds are also sometimes referred to as 'junk bonds'. Today, the yield on these loans is 3.75%. This offers an additional return margin of 1.75% over high-quality bonds, but, again, is still considerably lower than the 5% interest rate on these loans five years ago or the 8% on offer 10 years ago.

High-yield bonds are not really high yield

The investment proposition with high-yield loans today provides a helpful framework to think about investing even further out along the risk curve, notably into asset classes like the sharemarket.

Earning an interest rate of 3.75% from lending to risky borrowers can hardly be thought of as a 'high-yield' proposition. Yet, while the interest rate has plummeted, the risks from holding these loans are largely unchanged. 'Junk' remains apt. We are bearing a high level of investment risk while expecting a low investment return.

If the academic textbooks are right, this same framework should apply to the highest risk asset classes, like the sharemarket, which also have been the places that investors have received the strongest gains in recent years.

Over the long run, global sharemarkets have generated annualised returns of **7.6% a year** (MSCI All Country World net return index in $US terms, 31 December 1987 to 30 June 2021). However, over the past five years, this figure has been 14.5%. We would argue the disconnect between these two numbers has led to the steadily increasing future return expectations we see in many investors today, as illustrated in the Schroders study.

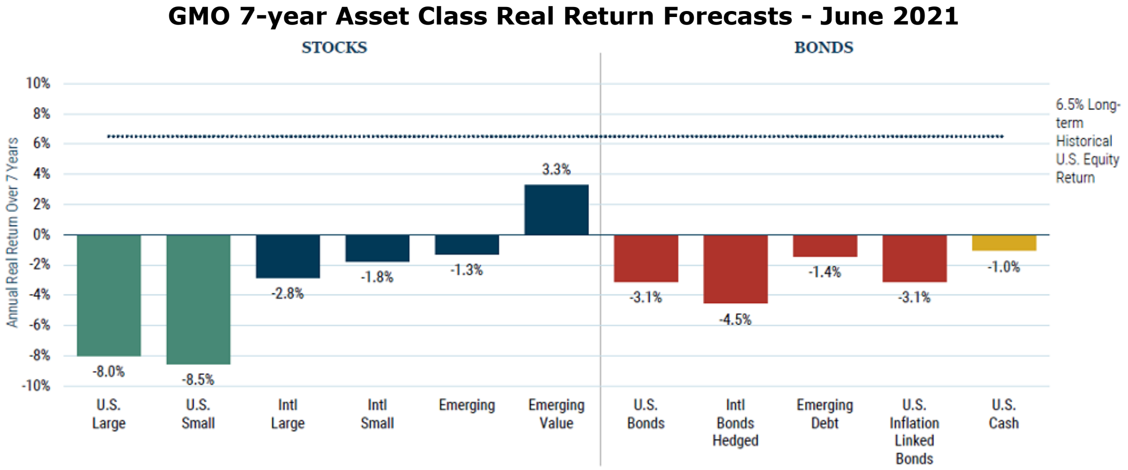
Unfortunately, forecasting longer-term sharemarket returns is not just a case of dragging our expectations back down to previous long-term averages. Market valuations are so much richer today than they have been historically, an attempt to forecast future returns based on fundamentals suggests we are in store for a period of returns that are much lower than this. And we are still left bearing the high risks that come with investing in this asset class.

The long and short of it

Looking out over the long run (typically five to 10 years) allows reasonable assumptions about things like asset class valuations, or sustainable rates of earnings growth, to play out.

As an institutional investor we are privy to many of these forecasts, and it is common for us today to see low-single digit return assumptions attached to sharemarket expectations. GMO is one high-profile forecaster that generously publishes all of its forecasts for everybody to see (and hold them to).

Using a set of assumptions that would be common for most professional investors, they project annualised global equity market returns of *minus* 2.8% over the next seven years.



Source: [GMO 7-Year Asset Class Forecast, 20 July 2021]

Professional forecasters, of course, have an embarrassing proclivity for getting things wrong. However, the colossal gap between fundamentally-based forecasts and investors' current expectations is worthy of reflection. Particularly since the basis for many investors' current high expectations is simply that recent returns have been unusually strong.

The common disclaimer that 'past performance is not indicative of future results' may never have been more apt.

Miles Staude of Staude Capital Limited in London is the Portfolio Manager at the Global Value Fund (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

Three good comments from the pension asset test article

Graham Hand

Comments on including part of the value of a family home in the assets pension test, as discussed here.

I've got relatives and the biggest difference in their stories isn't gender, or even the recession we had to have. Its geography, and differing house price increases. All buying similar valued homes around 1970, all working hard, and all suffering setbacks, most working into their 70's. The relatives living in Sydney get a par or full pension, and have home equity of around $2m. Those living in large regional centres get a part or full age pension but have homes worth in the $300k range.

The current system has the children of all these people paying more taxes (or we have less services or build up more debt for generations to come), to fund the age pension for the older generation. Obviously that's fine. The problem is the children of the Sydney relatives have the system protecting their $2m inheritance (say $700k for each of 3 kids), while those with the same story except for where their parents live have a system protecting $100k each inheritance. The goal of the policy proposal is to have the system so it just protects say $1.5m of inheritance per family. So for your situation, if your home is worth $1m, a $1.5m threshold won't affect you. If your home is worth $2m, then $500k would count towards your age pension assets. Once you've borrowed $500k of this to support your retirement you're back to having none of your home value count.

The idea isn't about penalising people for working hard, hurting people with no asset value, and nothing to do with gender. Its about recognising that people with your exact same story except for where they live are treated as little less unequally. If it helps, my parents are in the crowd of people getting a part age pension and living in a $2m house, so I'm benefiting from the current policy, and would lose by any change.

My parents worked until age 72 and 75. I can see the inequity very clearly though with relatives in regional centres. Did I read you withdrew super to help your children buy a house? As a taxpayer I'm against me paying more taxes to pay benefits to people who would have been fine but gave their money away. Effectively I'm paying taxes to give a handout to people buying a house, but only to those with parents who have both the assets and make the choice to give their kids money. Amongst other things, my relatives in regional NSW don't have the assets to be able to do this.

Comment by GG shows complexity of individual circumstances.

In light of all the comments made, please consider the below:
• Female – on her own- just hit 70 – worked full-time whole life apart from approx. 9 mths off for each of 3 children
• Hoping to retire finally next year at 71!
• Small nest egg built up in Super (since females included in Voluntary Super) – then had to cash in Super (when it was still allowed) for deposit on home – to give children security of a "roof over their heads"
• Have just in last month paid off my home – 1st time mortgage free in 47 years - Finally hopefully will be able to live in retirement knowing have roof over my head (only way achieved was by using all of the proceeds from sale of my own business – so none left over to boost my Super)
• Sacrificed lifestyle – worked 60-70 hours week most of the last 25 years - to enable security in retirement throughout my working life – still won't make it BUT will be just over the threshold for any pension entitlement
• Live and have lived frugally all my life so children could have the best opportunity / education to give them a fair start in their adult lives
• Assets will preclude from pension BUT at the same time will be "Income Poor" -Super will last approximately 10 / maybe 12 years BUT life expectancy - that is the totally unknown factor!
• If have to sell / remortgage home and downsize to enable "to be able to live" will this leave sufficient backup if have to enter aged care? Cost for a reasonable environment can be anywhere from a very conservative $500k - $unknown at the age it may be required
• Never received government assistance for anything in life –definitely not for any child care – paid from own income for over 25 years (10 yr gap -oldest to youngest child)
• Goal to save and invest to have the means to live out the rest of life – not as "wealthy' but comfortable – ie not having to worry to meet the necessary expenses & hopefully have a "buffer" for the contingencies
• Maintained private health insurance since age 20 –to cover if have to contend with serious / costly illness
My question to ALL – please consider those who are:
- on their own; female; worked hard and paid their taxes
- in the Super balance disparity cohort (eg female compared to male)
- never taken nor received ANY assistance from the government
AND
- Have just entered or are about to enter retirement - knowing full well it will not be an easy road financially to fund themselves within the current Superannuation / Pension environment let alone making it tougher for cohorts such as this
There are a myriad of other stories similar to this one.
It is just one example that highlights the complexity of this discussion and in particular the difficulty in determining the best answer to:
At what point (or asset value) is it fair and reasonable to draw the line?

And Jack illustrates the inequity of the current policy.

Take this example. My wife an I understood the problem Boomers presented in retirement. We invested in superannuation to be self-reliant in our old age. We have a modest house worth $400,000 (obviously not in Sydney) and $1.6 million (together) in super. We do not get the age pension but we have a very comfortable income. Bill Shorten wanted to demonise us as the "top end of town".

My sister and her husband invested instead in the family home. They have a family home of $1.6 million and super of $400,000. They are the classic asset rich but income poor, pensioners. As the family home is not an assessable asset, they are regarded as so needy that they deserve the "welfare" of the full age pension at a cost to the taxpayer of $38,000 per year or about $800,000 over their lifetime, which is what my wife and I are saving the taxpayer by taking responsibility for our own retirement.

At death, both estates are worth $2 million. My children pay tax on my super death benefit, my niece pays no tax because the family home is also capital gains tax free. How is this equitable?

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