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Editorial

In this week's edition of Firstlinks I get to put pen to paper (or more accurately fingers to keyboard) in reprising, and updating, a piece I wrote eight years ago.

There's this story about a group of US Air Force generals in World War II who try to figure out ways to protect fighter bombers (and their crew) by examining the location of bullet holes on returning planes. Mapping the location of these holes, the generals quickly come to the conclusion that the areas with the most holes should be prioritised for additional armour.

Statisticians from Columbia University were engaged to confirm these findings. Instead these outsiders pointed to a flaw in the military groupthink; the areas where the holes were weren't the most vulnerable, they were the least. The generals couldn't see the holes that were taking down their bombers, which in the returning aircraft were areas where the holes weren't. Those needed strengthening instead.

Australia's superannuation system is similarly prone to groupthink and confirmation bias, leading to systemic weaknesses. Those who live it, breathe it and work within it are often least able to see it as it truly is, warts and all. It therefore helps to have the occasional 'outsider's view'.

That's why this week I revisit the Mercer CFA Institute Global Pension Index, comparing the most recent report with one from 2013. The super system has been on quite the rollercoaster ride in the intervening years, and my piece attempts to put our system in its rightful global context.

Don Ezra then picks up the story, looking at 'decumulation', as he notes possibly the "hardest problem in finance", to provide some handy hints on how to sensibly live on your retirement nest egg when you can't possibly know in advance how long it needs to last.

The recent commencement of the 'Your Future, Your Super' rules will almost invariably result in some consolidation amongst APRA-regulated super funds. There have already been several recent high-profile announcements, a trend that's likely to escalate. There can, however, be a tension between the benefits of scale on the one hand, and sufficient competitive tension on the other.

David Gallagher and **Graham Harman** turn their attention to what consolidation might mean, in light of a current House of Reps Standing Committee on Economics inquiry into common ownership and increasing shareholder concentration by fewer, larger, superannuation funds.

World leaders might now be home, having made their appearances at the opening of the COP26 climate summit in Glasgow, but now the real work begins. Not just by their teams left behind to put a workable framework around targets for achieving net zero carbon emissions, but by stakeholders globally. Of which the investment management sector, being custodian to the current and future wealth of so many, is a critical one.

So this week features two articles on aspects of investing through an Environmental, Social and Governance (ESG) lens.

Andrew Lockhart and **Alison Chan** look at the role of ESG investing in private markets, an area with its own special challenges, given the differences in disclosure requirements between publicly listed companies and those who remain privately held.

Alison Savas then continues the ESG focus, looking at how companies are already 'decarbonising', and what this might mean for you as an investor. Interesting to see how looks can be deceiving, with the south-west region of the US already generating more than 10,000 Megawatts (MW) of electricity via utility-scale solar plants. According to the Clean Energy Council, Australian large-scale solar generation was approximately 4,000 MW during 2020 by comparison.

In the world of commercial property, the industrial and logistics segment has traditionally been seen as the unglamorous sibling to A-Grade office and high-end retail. Yet in a post-COVID world, demand for warehouse space to fulfil e-commerce sales, and demand for cold storage and food logistics, is changing the dynamics of property investing. **Steven Bennett** and **Sass J Baleh** take a look at this interesting corner of the property market from an investor's perspective.

What gets measured gets managed. This week's edition is rounded-out by a piece from Morningstar's **Ben Johnson**. Ben looks at the important, but under-appreciated, considerations that go into selecting an index against which to compare an investment strategy. Good indexes have certain characteristics that enable them to provide an effective and efficient benchmark for performance comparison, and Ben walks readers through what to look for in a suitable index.

This week's Comment of the Week comes from **Chris Darby** in response to "Trust your instinct", a conversation between Hamish Douglass of Magellan and Sir Frank Lowy AC, founder of Westfield Corporation (now Unibail-Rodamco-Westfield):

"There are some out there who need to heed the advice of the Lowy family, If you have a little, give a little, if you have a lot, give a lot, it would make this world a better place. Inspirational Sir Frank!"

This week's white paper is available to you courtesy of **MFS** on Emerging Market Debt (EMD), looking at fixed interest securities such as bonds issued by governments, quasi-governments and potentially corporates (depending on the index used) in emerging economies. The paper covers issues surrounding exchange rate risk, and how to mitigate it, in this lesser-known yet interesting asset class.

Why has Australia slipped down the global super ranks?

Harry Chemay

The recent release of the Mercer CFA Institute Global Pension Index, the 13th edition of this annual survey of the world's key pension systems, could not have been better timed. Not just because of widespread debate on differing retirement income systems, but it's an opportunity to revisit one of my earliest contributions for Firstlinks eight years down the track.

In 2013, I wrote a piece entitled *"In super the Danes are great, Australia a close third"* , based on the fifth edition of the Index. The underlying methodology for ascribing an index value to each country has remained consistent since. The final value is a weighting of three sub components; Adequacy has a 40% weight, Sustainability a 35% weight and Integrity the balancing 25%.

The latest edition covers 43 nations and around 65% of the world's population. Some 50 questions are posed of each country, the answers helping to rate each from a scale of A (a system with an index score above 80) to E (a system with an index score below 35).

In the case of Australia, only the APRA-regulated part of Australia's $3.3 trillion super system is subject to the rating process; so in effect 156 or so corporate, industry, public sector and retail funds. The SMSF sector, incorporating some 600,000 funds that collectively hold approximately $820 billion (as at 30 June 2021) is not considered.

Australia slipping in relative and absolute terms

The latest report sees Australia receive an index score of 75.0, putting it in sixth place among the 43 nations. This compares to a score of 77.8 and third place in the 2013 report.

How did Australia slip off the podium of the world's elite pension systems, and why has it been going backwards, both on a relative (position amongst peers) and absolute (falling index value) basis?

Australia's fall is partly due to the continuous addition of new countries from the original 11 of 2009. This year four new nations were added. One of them, Iceland, went straight to the gold medal position, scoring an impressive 84.2 on debut. Neither previous winner Denmark or the Netherlands cracked 84 in any prior report. That's quite an entrance.

Iceland had both the highest Adequacy and Sustainability index scores, with its retirement income system comprised of a state pension with two components (both of which are income tested according to different rules), mandatory occupational pension schemes with contributions from both employers and employees, rounded out by voluntary contributions into government-approved pension products.

Australia was also nudged out of fifth spot by a much-improved Norway, its index value climbing from 71.2 in 2020 to 75.2 this year. Israel took out the fourth spot (77.1), with Denmark third (82.0) and the Netherlands second (83.5).

The strain from Hayne

The decline in Australia's index value since 2013 is perhaps the more worrying development. After scoring 77.8 in that 2013 report, Australia peaked at 79.9 the following year, a whisker shy of attaining an 'A' rating, and with it recognition as *'a first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity'*.

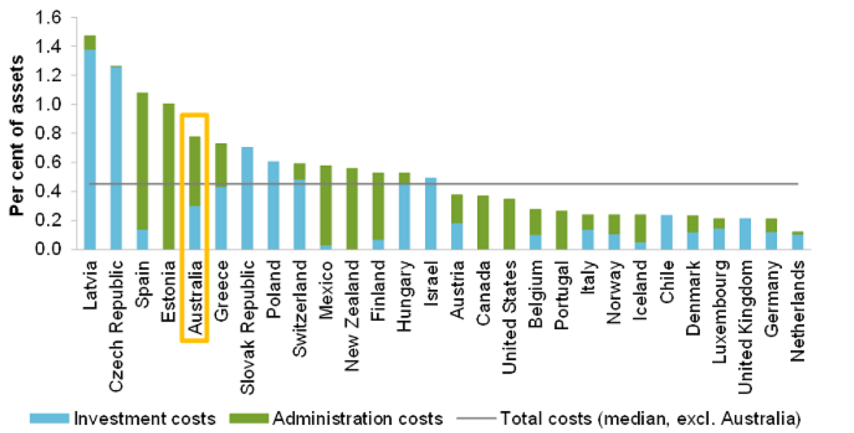
Australia then trended downward, before a significant fall in 2018 to 72.6, losing its coveted B+ grade for the first time. 2018 was, of course, the year during which the Hayne Royal Commission sat, and much of the evidence surfaced therein was damaging to the super sector, some of it brutally excoriating.

A system in need of a reboot

In addition, the Productivity Commission's inquiry into the sector, delivered a few short months before Commissioner Hayne's final report, painted an unflattering picture of superannuation as an "unlucky lottery", prone to frictions created by unintended multiple accounts, and serial underperformance experienced by far too many superannuation members.

Data collected by the Productivity Commission showed that superannuation fees and costs were at the upper end of global comparators, and significantly higher than pension top dogs, Denmark and the Netherlands, as the this chart from the final report illustrates.

Fees and Costs as a Percentage of Assets, 2016



[a] Based on the OECD measure of 'operating expenses', which comprises costs arising from investment management and administration. The median for total costs is for those countries who have non-zero reported costs for *both* administration and investment costs. [b] Administration and investment cost data are not collected for all countries.
Source: OECD (2017a, figure 8.9).

Part of the reason for this imbalance does, to be fair, lie in Australia's heavy tilt toward Defined Contribution plans, where the administration burden at the individual member level (contributions, switches, partial commutations, pension payments) tends to be resistant to scale benefits that more readily accrue to other aspects of superannuation management (such as investments).

New headwinds of scale

The super landscape looks very different today than it did when Commissioner Hayne presided over those 2018 hearings. Many financial conglomerates, and most of the big four banks, have exited retail superannuation altogether, if not substantially.

Chief amongst these changes is the recently enacted 'Your Future, Your Super' package which has just seen the commencement of account stapling, so that one super account follows an individual through any number of employment changes, and a new annual investment performance test, the first of which saw 13 MySuper products fail to come within -0.5% p.a. of their respective risk-adjusted benchmarks.

And then there is the new Best Financial Interests Duty (BFID), which places a statutory obligation on super fund trustees to do all things necessary to ensure that spending is best directed to the advancement of member outcomes. The days of profligacy in certain parts of the super sector now appear numbered.

The message being sent to the superannuation industry is as clear as it is stark: cost matters in providing appropriate member outcomes. If you can't meet that challenge through scale, you should consider your position.

The reason is simple enough, as the Mercer CFA Institute Global Pension Index report states:

"it is likely that as funds increase in size, their costs as a proportion of assets will reduce and some (or all) of these benefits will be passed onto members."

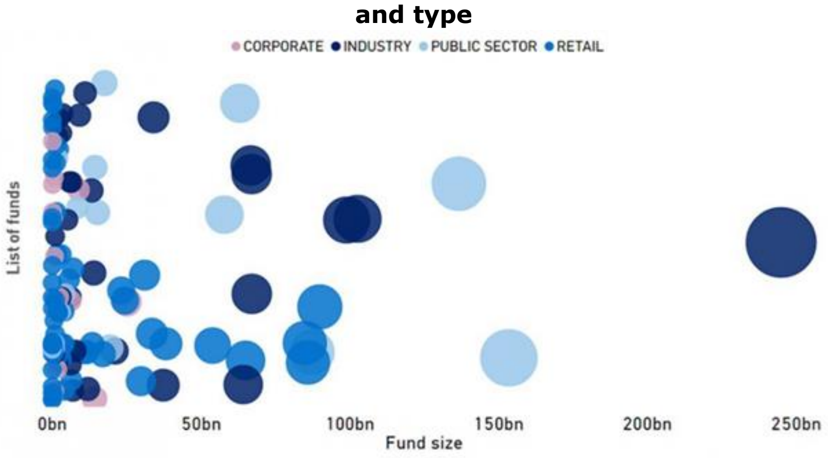
Australia: big system, small funds

It is remarkable that, as a nation of some 20 million adults, Australia has the fourth largest pension pool, after the US, the UK and Canada. OECD data put our super system at 3.8% of total OECD pension assets (as at the end of 2019). But by global standards, with a few exceptions, our pension funds lack the scale needed to push costs down significantly.

Margaret Cole, APRA's new board member in charge of superannuation (British by birth and a veteran of pension regulation within that system) left little doubt of APRA's thinking at a recent speech. She pointed out that, as at 30 June this year, of the current 156 APRA-regulated funds, only four manage assets in excess of $100 billion. Another 13 managed assets between $50 and $100 billion. In short, 11% of funds currently manage 70% of all APRA-regulated super assets.

To make her point crystal clear she produced this chart showing the dispersion of funds by size:

Breakdown of APRA-regulated superannuation funds by size and type



Source: APRA

The Australian system is characterised by a handful of funds that have meaningful scale, and a large tail of funds that don't, and who must now be considering Ms Cole's warning:

"[f]or all funds, but especially for the vast majority managing assets of less than $10 billion, that [the members' best interests] needs to include urgent, focused consideration of finding a compatible merger partner, or consolidating products, to gain economies of scale, cut costs and lift returns".

Consider the latest Pensions & Investments list of the world's largest pension funds, provided in US dollars as at the end of 2020.

The largest Australian pension fund, AustralianSuper, ranks 22nd, with some USD $156 billion. The next largest is Aware Super at 39th (USD $107 billion). No other Australian pension fund makes the Top 50.

Compare that to the largest pension fund in the world, Japan's Government Pension Investment Fund (GPIF). It had USD $1.7 trillion in assets under management at year end, 11 times the size of Australia's largest fund. With that size and buying power, GPIF now has an investment fee of under 0.05% per annum.

That is a stark reminder of the scale discrepancy currently in existence in Australia, and the dilemma in which many smaller super funds now find themselves.

Decumulation - super's final frontier

Another curious artefact of Australia's modern super system, barely 20 years old, is that the emphasis so far has been on 'accumulation' (growing member balances during their working lives) rather than 'decumulation' (converting those balances to a sustainable income in retirement).

In the closing section of my 2013 piece I noted that *"[p]ension systems exist to provide benefits in retirement, and the best systems deliver that goal to the greatest number by the most robust means possible"*.

Only now, some seven years and numerous consultations, white papers, green papers, roundtables and conferences later, has a legislative framework been implemented to bring the David Murray-led Financial System Inquiry 'Comprehensive Income Products for Retirement' (CIPR) vision to life, at least partially.

As from 1 July 2022, super fund trustees will be required to have a Retirement Income Covenant in place for members; essentially a document that details how they propose to create retirement income products to cater for their retiring members. Retirement income strategies can either be developed to treat all retiring members equally, or to separate members into cohorts based on characteristics the trustee deems most relevant.

In some ways, APRA-regulated super funds are playing catch-up with the SMSF sector which has long had a focus on the decumulation phase. Lessons learned in SMSF pensions may well, somewhat ironically, find their way to the APRA-regulated space.

Shooting for an 'A' grade?

Despite the unexpected fall in Australia's standing as a Top 3 super system, with the new legislative impetus, our system can turn the corner and regain its former glory.

With industry consolidation and scale, Australia might not just recapture its previous Bronze medal podium place, but has every chance of pushing for an index score north of 80, and thus an 'A' rating.

The APRA-regulated super sector might look significantly different from today when it does, but that will be to the good of all Australians who rely on the super system to help make our retirement years our golden years.

Harry Chemay has more than two decades of experience across both wealth management and institutional asset consulting. An active participant within the wealth and superannuation space, Harry is a regular contributor to investment websites in Australia and overseas, writing on investing and financial planning.

He has also been appointed an Australian ambassador to the Transparency Task Force, a UK-led global initiative to bring greater transparency and accountability to financial services.

How to help people with retirement spending decisions

Don Ezra

It is becoming routine to quote Nobel Prize Winner Bill Sharpe in saying that *decumulation* (determining how much you can regularly and sustainably withdraw from your pension assets) is "the hardest, nastiest problem in finance."

From a finance perspective, decumulation is so difficult because there are two huge and separate uncertainties involved: how long you will live, and what return you will earn on your retirement assets. Each causes great uncertainty; and yet we have to cope with both. To the mix add the negative psychological effects of all that uncertainty; like confusion, stress and fear of running out of money, and we can easily find the whole prospect too daunting to deal with.

On the positive side, the finance sector has found a reasonable approach to helping people with *accumulating* retirement assets; that is, setting aside money and deciding how to invest it. It's a much simpler issue to deal with than decumulation.

There's still the uncertainty of what exactly investment returns will turn out to be during the accumulation phase. But the time horizon is more forgiving in its impact. Not only do we typically have some ability to control the end date (retirement), but if we postpone it the money tends to continue growing anyway. And we can even keep the investments going after we retire, so all in all, the impact isn't determined by a single date or event.

Gliding to retirement

One reasonable solution to the decumulation dilemma is to create what has become known as an *investment glide path*, for which the goal is to give growth-seeking investments time to grow (and time also to overcome temporary setbacks), reducing the growth exposure as we draw nearer to the prospective retirement date (after which there is still usually sufficient time available for the hoped-for recovery if the risk of a sudden investment decline eventuates).

This approach has become so popular that it is frequently offered as the default option with many super accumulation plans, and worldwide roughly 90% of participants go with this default. It saves people who may not feel confident enough (or possess sufficient financial literacy) to make an investment selection from having to do so.

Now compare that with the issues involved in the retirement, or decumulation, phase. While the time horizon for accumulation is known within perhaps a few years, the time horizon for decumulation has a much larger margin of uncertainty – it might be very near or it might be more than 30 years away. This magnifies the effect of investment uncertainty.

Little wonder an unfortunate rule of thumb has developed that the only way to ensure a pension pot doesn't expire before you do is to never 'eat capital' at all – the idealised outcome being to only live on the income produced.

Framing retirement choices appropriately

As with the rest of the world, Australian Baby Boomers started to reach age 65 some 10 years ago and are now retiring in very large numbers. But, by and large, they have no idea what to do with their accrued superannuation benefits. The Australian government is commendably taking a lead on assisting new retirees and is planning to make trustees of super funds offer guidance to retiring members via the Retirement Income Covenant requirement that commences on 1 July 2022.

Problem solved? Not quite! That's because, as I understand it, the government appears to be emphasizing member choice over default options. Given that default options are not only the norm, but indeed a popular norm, for accumulation, surely the case for default options in decumulation is even more compelling.

I'm not saying that creating default options will be easy – far from it, it will be much more difficult than for accumulation, – but telling members "we're giving you choices, but beyond that you're on your own, and we wish you the best of luck" hardly seems constructive.

What sorts of choices would be useful? Well, choices are needed at two levels.

The first and most basic level has nothing to do with the financial technicalities; it simply deals with a member's attitude. As I expressed the choices in Walk 2 of my Life Two book, this might be:

- Do it for me; in other words, assign a default option to me.
- Do it with me; in other words, help me to combine my own knowledge (of my situation and my goals) with your technical expertise. In turn, this could involve another choice:
  - Once you know more about me, assign an option to me.
  - Once you explain the options to me, I'll make the choice myself.
- I'll do it myself. And in turn that could mean either of these:
  - Refer me to a financial planner.
  - I'm capable of doing everything on my own.

I understand that in Australia there are also members who are totally disengaged, and do not respond to anything related to their superannuation assets – special provisions will need to apply to them.

Horses for courses

That's the first level of choices. The second level is the more technical one of actually having explicit default options.

Why do I suggest options (using the plural) rather than a single option? Because it isn't possible for a single approach to suit everyone – otherwise "the hardest, nastiest problem in finance" would have been solved by now.

What are the complexities that make this so difficult? Partly it's because, as aforementioned, there are those two separate issues to deal with; uncertain investment returns and uncertain longevity. But there's another fundamental dimension, and that is to accommodate multiple goals that members probably have.

What's more, members' superannuation assets are usually only one part of their total assets. They may have a home, other physical assets, other investments, bank accounts, and so on. It's a plan for the aggregate assets that's really needed, and what to do with the super assets needs to fit in with the overall plan. That plan may need to be for the member alone, or for the member and partner as a couple, in which case two sets of assets and joint assets need to be included.

Those multiple goals I referred to could include, for example:

- How do your plans for your own lifestyle interact with your bequest motives?
- How much of your super do you need to finance your own lifestyle?
- Are there certain aspects of your lifestyle that you absolutely want to lock in for as long as you live, with total certainty, to enable you to sleep at night?

There are other relevant questions, as you can imagine, but these are enough to illustrate that there isn't likely to be a one-size-fits-all solution.

Toward a smoother landing in retirement

To conclude: it's not enough to identify products and services (and financial planners) and then list them. It is also not enough if these lists are given to members with insufficient explanation and context about how to use them.

It is *absolutely essential* to ask members about their attitudes, per the first set of bullet points above. And to have a default option specified for each of the various combinations of sets of answers to questions in the (possibly extended) second set of bullets, so that those members who say "Do it for me" can be assigned to the relevant default option. Given the discussion earlier, I'm certain that many retirees will want a default either to be assigned to them or to be guided towards.

I have no doubt that we'll learn from experience and see which attitudes and sets of circumstances dominate, and which new products and services become available, so that trustees can refine the choices they offer. That's inevitable, and all to the good. But default options are an essential part of the solution.

Don Ezra, now happily retired, is the former Co-Chairman of global consulting for Russell Investments worldwide, and the author of "Life Two: how to get to and enjoy what used to be called retirement". This article is general information and does not consider the circumstances of any investor.

[Guest Editor's Note: It should be noted that under the proposed Retirement Income Covenant requirement that commences on 1 July 2022, super fund trustees will be required to develop retirement income strategies for their members, whether one for all members, or differentiated strategies for different retiree member cohorts.

A recent Treasury consultation paper on the issue suggests that where a cohort approach is adopted, trustees might look to factors such as super balance, expected entitlement to the Age Pension, partner status, home-ownership status and the expected age of drawdown commencement.]

Competition and concentration issues in Australian investment markets

David Gallagher, Graham Harman

It's been disparaged as 'political theatre' and as 'a solution in search of a problem', but in our view The House of Representatives Standing Committee on Economics is dealing with some meaty issues at present. The task in hand is to "inquire into and report on the implications of common ownership and capital concentration in Australia." This is motivated in large part due to the burgeoning $3.3 trillion superannuation industry growing significantly, and being forecast to dwarf the domestic equity market in decades to come.

The Terms of Reference also call for an examination of "the changing influence between individual investors and small funds, compared to larger funds." Disquiet about proxy advisory firms still lingers; and there are reservations about concerted or 'organised' action. "This inquiry will ensure that we empower citizens, not organised capital… [as] common ownership risks bypassing democracy", says Committee Chair Tim Wilson.

Hopefully the Committee will provide a thoughtful 'compare and contrast' of participatory capitalism versus, say, participatory justice or participatory politics. Members of juries and voters in Federal elections need no qualifications, no documentation (yet), and no reasons for their votes. There is no cap on membership of a 'party organisation'. You're allowed to advise people how to vote. And acting in concert is encouraged, with both hung juries and hung parliaments seen as failure.

Agency problems and misaligned incentives

Governance and agency risks also call for careful consideration. If progressive, university-educated super fund executives vote a social-conscience agenda that's in tune with urban, pink-collar, worker-member-shareholders, well, that's not 'agency risk', it's 'commendable alignment'.

But what if conservative, cigar-smoking company management are of one mind with conservative, cigarette-smoking blue-collar worker-member-shareholders, perhaps in logging or coal-mining industries? What if super fund executives usurp those preferences by managing portfolios, and voting, in line with their own personal (say, anti-tobacco or anti-logging) predilections?

To Wilson's concern that "a handful of 'mega-funds' make all the decisions, and ordinary investors are locked out and higher costs are paid by Australians", we would have thought that, rather than attempting to restrain the 'mega-funds' from fulfilling their responsibilities, the Committee would be better employed in encouraging, if not requiring, the 'ordinary investors' to fulfil theirs.

That's analogous to compulsory jury duty and compulsory political voting. No-one is 'locked out'. It's quite the opposite. 'Ordinary investors' are entitled to vote as they see fit. Likewise, ordinary super fund members are entitled to exercise choice of fund; and it so happens that many do not.

There may be value, also, in the Committee examining safeguards as to the conduct of company elections. As Joseph Stalin allegedly commented: "Those who cast the votes decide nothing. Those who count the votes decide everything".

Tensions between scale and competition

Turning from processes to outcomes, Australia's relatively small, affluent population of 25.6 million is, on the face of it, susceptible to excessive concentration and oligopolistic behaviour. A paper by Sasan Bakhtiari (2019) at the Australian Department of Industry finds concentration is increasing, especially for industries that are already heavily concentrated.

By far the worst examples are in utility-type industries, given economies of scale and high price regulation. In other Australian-focused research, a study published by Gallagher, Ignatieva and McCulloch (2015) found that dominant companies operating in concentrated industries generated significant risk-adjusted excess returns compared to firms in more competitive markets. Interestingly, this experience is the opposite of that found in the United States.

Balancing stakeholder interests

The hinterland, where micro-economics borders macro-economics, is a lawless and turbulent frontier. When an undifferentiated, commodity product such as nickel abruptly triples in price, it's not because enterprising fossickers in the Kimberley have been texting their counterparts in Sulawesi and Norilsk, in a collusive scheme that channels their inner OPEC. It's because the global economy has hit its straps.

Even if one were to assume that corporate owners and managers possess more than an illusion of control, and even if their power and concentration is indeed increasing, they are still beholden to the Rule of Law. It will be for the Committee to establish whether the rules of the corporate playing field are adequate, and whether the umpires are adequately resourced.

ACCC Chairs, present and past, have recently been conducting a robust debate on that question. It also needs to be remembered that powerful vested interests have been undermining start-ups ever since Tiberius destroyed the formula for flexible glass. It's not illegal to invent an innovation, and then not to use it.

Working in tandem with the Rule of Law, to keep corporate and super fund power in check, is the Law of the Jungle. Innovation, consumer caprice, technological change, complacency, and hubris all work tirelessly to undercut the most muscular of corporate behemoths. As a result of these forces, industry concentration is a lot like a lava lamp – an endless cycle of mergers, acquisitions, spin-offs, break-ups and oblivion.

Finally, it's well-known that economists love paradoxes, and we'd highlight three to the Committee.

First, the Committee will need to decide whether the problem is too much bad intent – "collusion", in the words of the Chair; or too little good intent – "blunted incentives", in the words of the Deputy Chair.

Second, it's hard to blame super funds for asset growth when it's fuelled by Government-mandated super contributions; or for increasing concentration when the Government regulator, APRA, is pressuring funds to merge.

Third, you can't criticise the ACCC for allowing a situation where "higher costs are paid by Australians", when it's the Government that legislates exorbitant fees for privatised services, in its attempts to maximise the enterprise value it extracts from other companies, private equity and super funds.

David R. Gallagher and Graham Harman are with the RoZetta Institute – a university-owned commercial organisation focused on solving industry problems.

The role of sustainability in private markets

Alison Chan, Andrew Lockhart

Investor focus on sustainability and ESG (environmental, social, governance) factors has reached unprecedented levels and its impact on choosing where to invest is accelerating. COVID-19 turned the spotlight on sustainability by highlighting social and business challenges, while international agreements on CO2 emissions and the release of the 'Code Red for Humanity' report from the Inter-Governmental Panel on Climate Change have added urgency to the challenge of addressing global warming by reducing carbon emissions.

The Responsible Investment Association Australia's (RIAA) *Responsible Investment Benchmark Report Australia 2021* highlights the growing pace at which capital is shifting towards funds demonstrating leading responsible investment practices. Australian Responsible Investment assets under management rose by $298 billion to $1,281 billion in 2020. The proportion of Responsible Investment AUM to Total Managed Funds was 40% in 2020, up from 31% in 2019.

The challenge of addressing sustainability falls squarely on the shoulders of fund managers who are the medium between the asset owners and the companies who must adapt their businesses. With the growing volume of investor capital has come increasingly diverse asset classes that can address those challenges.

Change began with listed equities, where there is a large amount of public data and benchmarks against which companies can be measured. It is now however becoming a whole of portfolio issue as investors press to ensure that ESG factors are integrated into all asset classes, including private debt and private equity.

It is therefore an opportune time to look at what investors need to consider when choosing a private debt manager who can help them achieve their sustainability goals.

Practice makes perfect

Private debt managers face greater challenges in gathering and measuring information on ESG practices and performance because the companies to which they lend are not public, and therefore not subject to the same disclosure obligations. Even if a private company has well established disclosure practices, there can be difficulties in benchmarking that performance because their peer group are also private companies.

This has led private debt providers to devote more resources to understanding the ESG performance of borrowers. Fortunately, established due diligence practices can be readily adapted and the heightened focus on ESG allows lenders like Metrics Credit Partners to engage even more deeply with borrowers to understand the risks and opportunities their businesses face. It is the start of a conversation with management about key issues that continues throughout the life of the transaction and allows challenges to be addressed as they arise.

Building blocks

Established due diligence practices are a good start. But to have a meaningful role in helping borrowers transition to long-term sustainability goals, and deliver for investors, requires a whole-of-organisation commitment from the lender.

- It starts with the Board, which sets the policies and strategic direction that must be delivered by management, the investment committee and dedicated teams supporting the business units to integrate ESG factors into the investment process.
- Having a robust ESG policy to guide the firm is vital. It directs action and provides transparency and accountability for investors, customers and employees alike.
- International commitments can play a similar role. For example, Metrics recently became the first non-bank asset manager in Australia to join the Climate Bonds Initiative which develops the standard used to help investors identify investments that are consistent with the goal of the Paris Climate Agreement to limit global warming to under 2°C.
- In-house practices aimed at reducing the managers' own carbon footprint are also a worthwhile contribution to the challenges of climate change. By embracing the recommendations of the Task Force on Climate-related Financial Disclosures, firms send an important signal to the broader market.

Scale is an important consideration in being able to deliver sustainability goals. Larger private debt providers have the resources in-house to engage specialist skills, develop policies and practices that can be used to help assess lending opportunities against sustainability criteria and to assist existing borrowers as they make the transition. That scale also allows the manager to effect change through its own policies and practices across a bigger and more diverse portfolio of industries and companies, and apply the lessons from one borrower to another.

From risk to opportunity

Sustainability is quickly coming to be at the heart of private debt markets, and perhaps most importantly is now being framed not just in terms of risk, but increasingly as an opportunity for anyone concerned with the best long-term interests of their investors.

A Deloitte survey in late 2020 found that if climate change goes unchecked, Australia's economy will be 6% smaller and have 880,000 fewer jobs by 2070. That's a $3.4 trillion lost opportunity over the next half a century. However, there is a $680 billion dividend that is ours for the taking if we do rise to this environmental challenge, along with 250,000 more jobs, the study argued.

More recently the Business Council of Australia has thrown its weight behind more ambitious targets for carbon reduction. It advocated raising the 2030 emissions reduction target from 26%-28% below 2005 levels, to between 46% and 50%, arguing there would be an $890 billion boost to economic activity and 195,000 jobs created over the next 50 years from such a move. [*Editor: at the recent COP26 summit, Australia maintained its 26-28% 2030 target, despite being on track to achieve a 35% cut in emissions.*]

Private debt providers' approach to sustainability is evolving with developments in regulation, climate change and societal expectations. Systems and processes are being upgraded to collect high-quality data that will help measure progress and deliver transparent sustainability reporting for all stakeholders. Investors should expect to see more detailed and better organised information about how private debt managers and borrowers are working toward the achievement of those goals in the near future.

Beyond the environment

Environmental issues have been a major driver of the growing investor tide in favour of ESG, both because of the immediacy of the issues that need to be addressed and the availability of data to measure progress in addressing it. That said, the COVID-19 pandemic has highlighted social issues that need to be addressed and are increasingly on the radar of investors, including the disproportionate effects of lockdowns on young people and on workers whose jobs could not be done from home.

Addressing those concerns is becoming a mainstream project for companies who want to better reflect the wishes of their customers, investors, employees and partners for a fair, equitable and sustainable society.

By articulating and demonstrating a commitment to sustainability, private debt providers can show leadership, increase the impact of what they do to address these challenges and provide transparency to their stakeholders.

Andrew Lockhart is Managing Partner and cofounder of [Metrics Credit Partners](#) (MCP), an Australian debt-specialist fund manager, and sponsor of Firstlinks. Alison Chan is Metrics' Investment Director, Sustainable Finance. This article is general information and does not consider the circumstances of any investor.

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Decarbonisation should already be in your portfolio

Alison Savas

Here in Australia, and around the world, the United Nations Climate Change Conference in Glasgow (COP26) has brought decarbonisation to the forefront of today's news agenda.

The event was the biggest Summit ever held in the UK, with world leaders, dignitaries, scientists and, the business community all discussing one primary question – how to address the challenges posed by climate change?

While the conference does have a set of predetermined goals, these events most often conclude with ambiguous outcomes. COP26 reinforces the relevance of decarbonisation, but for investors it is important to focus on the areas where real tangible action is taking place.

Decarbonisation, we believe, is a multi-decade investment super-cycle in power infrastructure and one of the most significant investment themes in global markets right now. To keep global warming to 1.5 – 2°C above pre-industrial levels, greenhouse gases need to be halved by 2050 and eliminated by 2100.

Another way to think about global warming is that 75% of greenhouses gases are related to the combustion of fossil fuels, and most of that is in carbon dioxide and methane. Fuel is combusted for kinetic energy (to create motion e.g., driving a car) or for heating and cooling.

In most cases we can replace fossil fuels with electricity from non-fossil sources like hydro, solar and wind, and nuclear. This technology already exists today, but investment is required to increase scale.

Unfortunately for Australian investors, while COP26 has thrust decarbonisation firmly into the national political agenda, it is a challenge to get exposure to this investment super-cycle via ASX-listed equities. Global equities, however, can provide real and material portfolio exposure.

Decarbonisation and the three major economic blocks

Decarbonisation is a central pillar of policy in Europe, China and the US.

Europe has some of the most aggressive ambitions as it is a net importer of fossil fuels, spending around €120 billion per annum on importing energy – decarbonisation is thus positive for Europe's GDP.

The European Union has a legally binding target to reduce emissions by 55% by 2030 versus 1990 levels, and to be carbon neutral by 2050. To help achieve this, Europe has its European Green Deal, a €4 trillion commitment over the next decade to help achieve this target - which is equivalent to incremental investment of more than 2% of GDP p.a. This is significant relative to Europe's economic growth and could create 20 million jobs.

At the core of the European Green Deal is Europe's Emission Trading scheme, which has put a price on the cost of reducing carbon emissions. The scheme, in existence since 2005, targets the power sector and other large industrial emitters. Power producers are required to purchase certificates to offset their carbon emissions. As the number of certificates available for purchase falls each year, the scheme is designed to force the power sector to switch to renewables. Further, the €40 – €60 billion generated each year from the sale of certificates is used to subsidise a reduction in fossil fuels elsewhere, such as subsidising EVs or replacing gas with green electricity to heat and cool buildings.

As electrification occurs in other sectors it leads to an increase in demand for electricity, which puts even more pressure on power companies to switch to renewables. On our forecasts, wind and solar could grow from around 20% of total European power generation today to 60% by 2030.

This has implications for the grid, given historical underinvestment – and we are seeing this play out in Europe's power market today. An increase in renewable generation has made the grid unstable, and more investment is required - potentially as much as €35 billion per year across transmission and distribution.

Additionally, investment in storage is essential as the sun doesn't necessarily shine or the wind blow at the same time as peak demand. Excess generation in periods of low demand need to be stored so the energy isn't lost.

Europe is not alone

Despite the often-negative portrayal of climate action in China, the nation is making real progress, particularly when you consider its starting position – a huge reliance on coal.

China's goal is to achieve peak carbon emissions by 2030 and to be carbon neutral by 2060. To meet these goals, China is prioritising reducing emissions over adding capacity in high emitting sectors like coal, steel, chemicals and aluminium.

China also has some of the highest electric vehicle (EV) targets globally, with EVs to account for 20% of new vehicle sales in 2025. With this target, China is looking to become the global leader in EVs and could account for as much as 40% of total EV sales in 2025.

China is also moving towards more renewables, as the all-in greenfield cost of solar is the same as coal, without any subsidies. China has a target to double renewable capacity to around 1,200GW by 2025, with a focus on solar.

The US is also 'going greener'

The United States' south-west region is one of the richest solar resources globally, with more than 10,000MW of utility scale solar plants.

Further, the mid-west is relatively windy through the entire year. With investment in the grid connecting the north to the south, this could result in renewables-derived electricity year-round. So, even though the US has a lot of natural gas, it increasingly makes sense to invest in renewables, given the extent of wind and solar.

We think this will accelerate further during the Biden administration.

Decarbonisation and the economic cycle

In the context of the bigger picture for the outlook for global equities, decarbonisation is more than just a 'hot theme'.

As we approach the end of 2021, growth in economic activity appears to be moderating, but moderating from an unsustainably high base given the extent of pandemic-driven fiscal stimulus. Even though growth in activity is slowing we are not looking at 2022 as a zero-growth world.

The cycle can be supported by the stimulus that's already in the system and strength of household balance sheets.

Over the longer-term our view remains that policy makers globally will be reluctant to shift to austerity too quickly and attitudes around fiscal stimulus have fundamentally shifted.

Firstlinks
a Morningstar company

Here is where a multi-decade, multi-trillion-dollar investment cycle around decarbonisation can shape market preferences in the years to come.

Along with other major investment cycles such as 5G adoption, infrastructure and catch-up spending in the health system, decarbonisation can lead to a shift away from viewing the world as in a permanently low growth, low-rate environment.

In this environment there will be low multiple stocks that could transition to secular growth winners, and this might further fuel a rotation in equity market preferences.

New investment cycles may also tighten the extreme valuation dispersion between US equities and the rest of the world; US equities are valued at a 65% premium despite very similar earnings growth through time. This premium has been driven by outsized stimulus in the US and recent investment cycles around software and the internet – which have been led by the US.

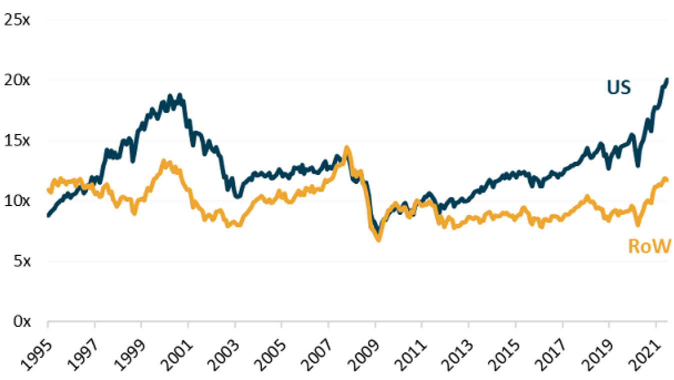
This is unlikely to be sustainable. These emerging investment cycles benefit companies *globally* and the rest of the world is not being priced for success.

The global benchmark, with its 60% exposure to US equities, is unlikely to reflect the best opportunities today.

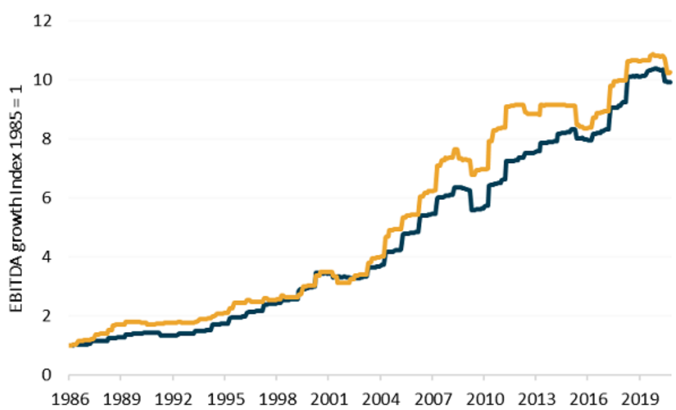
Global equity investors continue to focus on a narrow set of winners, many of which are valued at very high multiples. At the same time, there are global businesses at the forefront of a once-in-a-generation investment cycle, which are valued at highly attractive multiples.

You could be forgiven for ignoring the spectacle in Glasgow, but decarbonisation is a theme investors cannot ignore when it comes to portfolio positioning for the long term.

US priced at a 65% premium to the Rest of the World*, largest on record…



…despite similar EBITDA-growth through time



**Cyclically adjusted EV/EBITDA. Source: FactSet, Antipodes*

Alison Savas is a Client Portfolio Manager at [Antipodes Partners](). Antipodes is affiliated with [Pinnacle Investment Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Outlook for Australia's Industrial and Logistics property sector

Sass J-Baleh, Steve Bennett

The Australian Industrial and Logistics sector entered the COVID-19 pandemic with strong property fundamentals – including a low national vacancy rate (2.2%), limited speculative development activity, relatively strong occupier demand (above 2.2 million sqm p.a. average), and growing capital appetite from a number of domestic and global off-shore groups (A$50 billion looking to be deployed).

According to CBRE, these underlying fundamentals will continue to drive the resilient performance of the Industrial and Logistics sector. In particular, the global structural e-commerce tailwind is relatively immature in

Australia and is expected to further fuel the trajectory of growth. The positive outlook has translated to increased demand from investors, evidenced by the growing number of investors and advisers seeking Industrial and Logistics investments from Charter Hall.

The below are highlights from the CBRE report. If you would like to read the full report, please click here.

Capital markets

Australia's Industrial and Logistics sector has consistently delivered comparatively higher average returns than those generated overseas and has shown low volatility of returns through the current cycle relative to other commercial property sectors. The sector is primed for growth in line with increasing consumer-driven online retail demand. The asset class returns will benefit from a shortage in readily available land supply and a growing demand for logistics and last mile distribution assets.

COVID-19 has accelerated trends that were already transforming the Industrial and Logistics sector.

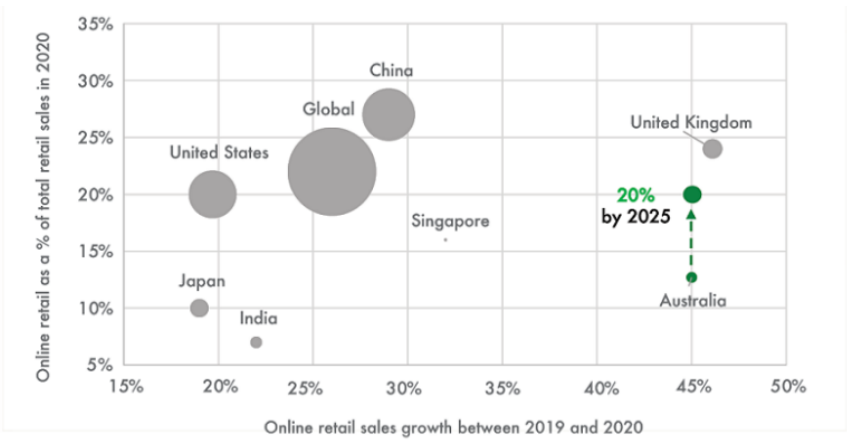
Australia's Industrial and Logistics investable universe continues to expand. It currently equates to A$137 billion and is forecast to reach A$186 billion by 2025. This will mainly be driven by higher asset values and demand-led new supply.

Long term market fundamentals

The grocery sector is a significant and stable long-term driver of growth, and demand for Industrial and Logistics space is increasingly driven by major food logistics operators.

Major supermarket retailers contributed to a record 241,500 sqm of Industrial and Logistics floorspace demand in 2020. The online grocery sector will be a supporting factor for floorspace expansion, given online grocery is expected to increase dramatically from A$8.7 billion (or 20% of online retail sales) in 2020-21 to A$14 billion (or 26% of online retail sales) by 2024-25.

E-commerce penetration rate vs. online retail total sale size and growth (2020)[1]



1. Global data may vary by source. Total sale amount represents USD $'Billions. Source is Statista, Transport Intelligence, ABS, NAB, CBRE Research.
Source: CBRE Market Outlook: Australian Industrial and Logistics - September 2021.

The Pharmaceutical Life Sciences sector growth will accelerate and contribute to demand for Industrial and Logistics property.

CBRE estimates the investable universe of the Life Science sector for commercial property currently totals A$13 billion and is forecast to almost double to A$24 billion by 2031. Australia is an appealing destination for occupiers in the life sciences space, due to an adaptive and innovative health care system, a skilled workforce, intellectual property protection, world-leading research institutions, a number of established and emerging precincts, and a range of government initiatives to bolster Australia's sovereign capability.

There will be a step change in demand as e-commerce growth will be transformational. Although COVID-19 has accelerated Australia's e-commerce penetration rate from 9% in 2019 to 13% for the 2021 year to date, the current rate lags the global average rate of 22%. CBRE forecasts Australia's e-commerce rate to reach 20% (or A$79 billion) by 2025.

Sector growth drivers

The returns being generated from the Industrial and Logistics sector continue to be compelling for a range of investors in Australia and globally. The long lease nature of the sector with fixed rental reviews, coupled with a relatively low cost of debt continue to provide attractive yield spreads. With 10-year bonds now trading at 1.50% (as at 30 September 2021), historic relative spreads are still in a healthy state and likely to continue further capitalisation rate compression.

Occupiers holding higher levels of inventory will result in greater demand for floorspace. Spurred by supply chain disruptions from the COVID-19 Pandemic, CBRE expects companies which have moved to lean supply chains with low inventory cover will seek to increase their inventory levels to hold greater buffer stock and adequately service consumer expectations.

Floorspace net demand in Australia reached record levels in 2020 (2.9 million sqm). Over calendar 2021 to date, floorspace take-up has surpassed 2 million sqm (as at 30 June) and is forecast to reach another record year of take-up. Key industry sectors driving growth are transport, postal & warehousing, retail trade and manufacturing.

The Industrial and Logistics sector is projected to deliver real rental growth. CBRE forecasts the national Gross State Product (GSP) weighted Industrial and Logistics rent index will increase by 3.0% per annum from 2022 to 2029. In a low inflation environment, the sector has the potential to deliver real (inflation-adjusted) rental growth of between 1-1.5% over the next 10 years.

Outlook

CBRE believe the outlook for the Australian Industrial and Logistics sector remains positive and the sector will continue to remain an attractive asset class for investors in the medium to long-term. Charter Hall supports this view and will continue to grow Industrial and Logistics portfolios for the benefit of investors seeking access to the asset class.

Capital allocations will increase across the sector and continue to attract a high level of demand from domestic and offshore groups, resulting in further property yield compression across the sector.

The market fundamentals and sector growth drivers across the Industrial and Logistics sector remain increasingly strong, including:

- Longer lease structures with fixed reviews across a resilient tenant base.
- Increased occupier demand from a range of sectors that are forecasted for further growth (e-commerce, food logistics and manufacturing, transport and logistic operators, pharmaceutical life sciences).
- Limited speculative development activity.
- Higher rental growth forecasted over the next decade.
- Favourable long-term economic variables for Australia, with GDP growth, low cost of debt and population growth forecasted above most other mature economies.

Steven Bennett is Direct CEO of Charter Hall Group, a sponsor of Firstlinks, and Sass J-Baleh is Head of Industrial & Logistics Research Australia and Director of NSW Research at CBRE. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.

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Decoding an ETF's DNA

Ben Johnson CFA

Index methodologies are Exchange-Traded Funds' DNA. They are the instructions that dictate how indexes—and by extension ETFs —select and weight their constituents. They impose constraints. They put in parameters for regular upkeep.

In short, index methodologies define the makeup of an ETFs portfolio, its return potential and its risk. Understanding index construction is therefore central to ETF due diligence. Here, we discuss its place in Morningstar's ratings process, share a template for decoding ETFs DNA, and list some of the traits of the best indexes.

Process, process, process

The Morningstar Analyst Rating is a forward-looking, qualitative rating. Our analysts do deep due diligence on a wide array of investment strategies (active, passive, and all things in between) and a variety of investment vehicles (managed funds, ETFs, separately managed accounts and more) to assess which ones we believe to be investment-worthy, and which we think investors should avoid. In assigning these ratings, we explicitly score the people, parent firm, and process behind each strategy.

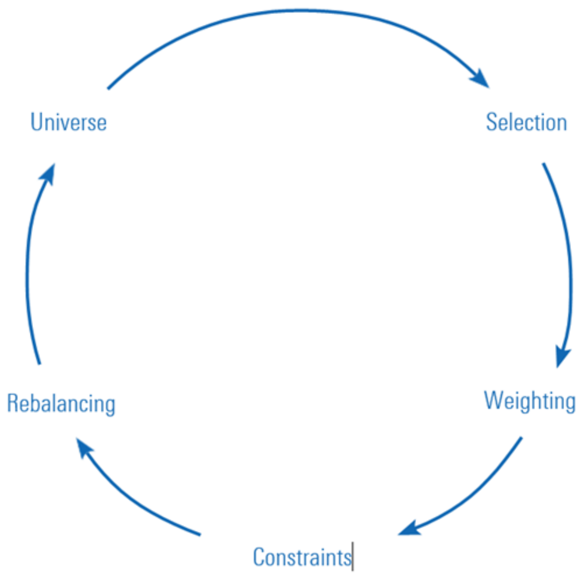
When we rate ETFs and index funds, process is paramount. Our Process ratings receive an 80% weight in calculating our overall rating for ETFs. Why? Because our assessment of index funds' processes centres around their index methodologies—their DNA. While we favour experienced, well-resourced index portfolio management teams (our People rating gets a 10% weight in our overall rating for index funds) and parent firms that align their interests with those of their investors (our Parent rating gets a 10% weighting), nurture tends to take a back seat to nature when it comes to index portfolios.

If we're primarily concerned with index construction when assigning Analyst Ratings to index funds, how do we go about putting benchmarks through their paces?

The circle of index construction

The chart below is a diagram of what I'll call the circle of index construction. It is important to remember that indexes are living things. They measure the markets but are affected by the markets just as much, and they're always evolving. The circle is meant to evoke this vitality.

Universe. All indexes draw from a specific universe of eligible constituents. An index's universe represents its investment opportunity set—its palette. A broader and more diverse palette allows an index to better represent its opportunity set and gives it more potential directions to set out on. A narrower universe equals a less vibrant palette. Global stocks represent a broad universe, Malaysian micro-caps a tiny one. The breadth, depth, and diversity of indexes' selection universes have important implications for the makeup of their portfolios.



Source: Morningstar

Selection. The next station pertains to how an index selects its constituents from its selection universe. Just how picky is the index? Broad-based, market-cap- weighted indexes are minimally selective. They'll often weed out tiny, thinly traded securities that would be costly to include in the index's portfolio. As a result, these benchmarks wind up sweeping in virtually everything available to them in their universe.

Other indexes are far choosier. Take the MSCI World ex Australia Index, for example. The index underpins iShares Core MSCI World Ex Australia ESG Leaders ETF [ASX:IWLD]. It holds around 730 stocks from a selection universe of almost 1,500. In whittling the field, it requires companies to have a minimum MSCI ESG rating, kicks out controversial businesses, and only selects the top 50% of eligible securities from each sector by ESG rankings. It is crucial to understand the criteria that indexes use to decide what's in and what's out of their portfolios.

Weighting. Once index constituents are chosen, they need to be assigned a weight in the portfolio. There are many ways these weights may be allocated. Weighting stocks and bonds on the basis of their going market value has long been the standard. But the variety of approaches has multiplied over time.

Index constituents may be weighted equally, according to their fundamentals, by their exposure to a particular factor or theme, and many, many other ways. Position weights will have a big influence on indexes' return potential and risk. Those that make bigger bets on a small handful of positions will likely be riskier than those that spread them more evenly.

Constraints. Indexes will often put constraints in place to limit concentration, tether themselves to the index that represents their selection universe, control for unwanted factor exposures, and more. These constraints can be simple, such as a 5% cap on the weight of any individual constituent.

They can also be complex, like an optimizer that controls for a range of variables from sector exposures to factor exposures. Knowing what constraints an index has in place and why they are there can help us understand their impact on the portfolio.

Rebalancing. Indexes need to be refreshed regularly. Markets change, and indexes adapt to these changes through the process of rebalancing. The need to rebalance could be driven by corporate actions. New initial public offerings might have to be added to stock indexes—assuming they are eligible. Newly issued bonds may need to be included in fixed-income benchmarks.

Other changes might be more frequent and of greater magnitude. Equal-weighted indexes regularly rebalance their constituents' share of the benchmark's value. Momentum indexes are regularly playing catch-up as they're always looking to target the market's recent top performers.

Rebalance timing luck can result in opportunity costs. And lucky or not, rebalancing always results in transaction costs. It is important to know how indexes manage their regular rebalances and the measures they have in place to mitigate these costs.

The traits of the best indexes

Now that we've taken a whirl around the circle of index construction, let's talk about the traits that typify a good index. These features are common to most of our highest ETFs and index mutual funds, which earn some of our top Process ratings on account of their benchmarks' sensible construction.

Representative. The best indexes are representative of the investment opportunity set or the style that they are trying to capture. Vanguard US Total Market Shares ETF [ASX:VTS] carries a Morningstar Analyst Rating of Gold, chiefly driven by its High Process rating, earned on account of the degree to which its index, the CRSP US Total Market Index, represents the investment opportunity set available to its peers. The benchmark captures nearly 100% of the investable market cap of the US. stock market. Few indexes are more representative than that. Casting a wide net and weighting by market cap puts the fund in a position to let its low fee shine through and give it a lasting edge versus category competitors.

Diversified. Diversification is the only free lunch in investing. In the case of index funds with zero fees, investors will find the closest thing there is to a free lunch in the realm of investing. Diversifying broadly also reduces the likelihood of errors of omission. Over the long haul, a small minority of stocks account for the bulk of the market's returns. More-inclusive indexes have greater odds of owning the market's big winners.

Investable. Investability isn't an issue for most broad stock and bond benchmarks, but it becomes one in smaller, less-liquid segments of the market like micro- cap stocks and bank loans. Index portfolio managers may have a tough time tracking benchmarks in these corners of the market. Trading can be costly, which makes index-tracking tough. The best indexes cover parts of the market that are easy to invest in, and they take additional measures to ensure investability.

Transparent. There aren't many examples of things inside or outside the realm of investing where complexity and opacity have proved superior to simplicity and transparency. The best indexes are simple and transparent. If you crack open an index methodology document and it reads like the pilot's manual to an Airbus 380, that's a red flag.

Sensible. Does the index methodology make sense? Weighting stocks by their share price might have made sense in 1896, when the Dow Jones Industrial Average was created. This approach made it easier for its publishers to calculate the index's value. But in 2021, does weighting stocks by their share price still make sense? Today we carry around more computing power in our pockets than existed on the planet at the turn of the 20th Century. We have the ability to calculate benchmarks with sensible approaches to selecting and weighting securities in real time.

Turnover-Conscious. Turnover has explicit (commissions, bid-ask spreads) and implicit (market impact) costs. The best indexes are conscious of these costs and take steps to keep them under wraps. For example, in 2018 US equity indexes based on data from the Center for Research in Security Prices (CRSP) transitioned from rebalancing on one day to spreading rebalancing over a five-day period. This was done in an effort to minimize market impact. Other indexes take measures to either slow the rate of turnover or similarly spread it out over a longer period of time—to the benefit of index fund investors.

Good genes

When it comes to doing your homework on ETFs, understanding index construction is indispensable. Knowing the progressions around the circle of index construction and seeking out the traits of a quality index at each stop will put you in a position to pick best-of-breed funds for your portfolio.

Ben Johnson, CFA is director of global exchange-traded fund research for Morningstar. This article is general information and does not consider the circumstances of any investor. It has been edited somewhat from the original US version for an Australian audience.