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Editorial

"Australians shouldn't expect major changes to superannuation if the government changes hands."
- **Dr Jim Chalmers**, ABC TV's Insiders, 27 March 2022

"We said that we would not have any major changes in superannuation, and that is certainly our intention. But we'll receive the review and the report into superannuation, we think that it is important that this continue, and that we do have a debate about the purposing of superannuation."
- **Prime Minister Anthony Albanese**, National Press Club, 22 February 2023

There was a lot of angst this week about the objective of superannuation but it's not the definition that will really matter. It's the legislated rules that follow. The Prime Minister and Treasurer will claim that capping superannuation is not a "major change" as it affects relatively few people, and in any case, they are wealthy and are taking advantage of the system. Jim Chalmers told Radio 2GB that he was not looking at a higher tax rate on contributions or income, but hinted at a limit on super of $3 million.

"If you think about the average balance in super is about 150 grand, I think, but for less than 1% of people in the system, they've got balances higher than $3 million. The average among that group is $5.8 million."

But a $3 million cap is a major change. Thousands of people with illiquid assets in their SMSFs will be forced into asset sales and a substantial reorganisation of their retirement planning. While the Government wants to believe that, to quote Jim Chalmers, an objective will "*end the super wars once and for all*", that's about as likely as Anthony Albanese's desire to "*end the climate wars*". Wishful thinking. The subjective words in the objective confirm that the years of arguments about superannuation are not about to cease, and the rhetoric from **Assistant Treasurer and Finance Minister Stephen Jones** is not helping.

As if someone saving for 30 years in government-encouraged superannuation makes the system "*distorted by a very small number of Australians taking advantage of a system*" like it's a dodgy Bottom-of-the Harbour scheme or Cayman Islands tax rort known only to a wealthy few. That argument is the opposite of ending the super wars, and superannuation has done fine since 1992 without *a "purpose in life".*

Then **Labor Party National President** and Chairman of **Cbus Super**, former Treasurer **Wayne Swan,** weighed in at the $3 million level, telling the [Today Show](#):

> *"But the truth is if you have $3 million in an account, you're doing pretty well and you don't need tax concessions from every other taxpayer."*

Take a look at the lively debate in Firstlinks last week with 130 comments on [the article on the super cap](#). We had everything from 'Satisfied' who wrote:

> *"Wake up folks, there is only talk of removing the tax benefits not your hard earned. You can hang on to your wealth! However, why should the tax payer continue to subsidize excessive balances beyond a reasonable 'retirement' limit?"*

And from 'Angus':

> *"It is completely UNFAIR to retrospectively cap the size of a person's funds in Superannuation or force drawdowns on them when people have foregone consumption, saved, taken risks and worked hard at their investments, all the time abiding by the rules of the day including having their Super money locked up for decades until they can access it. Any changes to Superannuation should be grandfathered at the very least."*

And everything in between. Anyone who believes the super wars will end should go back and check the comments.

Dignified. Equitable. Sustainable. Security. Wellbeing. They all mean different things to different people, and somewhere along the way in coming years, another government will make another set of changes. While savers in superannuation might set a 40-year retirement plan, governments come and go every few years, circumstances and ideologies change and so do the rules. It's not correct that defining an objective will "*make* *sure that future changes to the system are compatible with its very objective"* as Jim Chalmers claims.

Jeremy Cooper responded that a legislated objective would have "*little teeth*" to limit decisions of future governments.

> *"Super is always going to change, but for it to be tipped on its head when you're halfway through is destabilising. The proposal is not a universal panacea, things can always be justified by the circumstances."*

And what are all these social projects that superannuation is suddenly supposed to fund? The reforms would enable investment by superannuation funds in projects that: *"boost housing supply, manage climate change and spur digital transformation".*

Super funds can do that at the moment if a project meets their investment criteria, but the trustees of a super fund cannot report to their members that returns are 1% lower due to a decision to finance social housing. As the Consultation Paper acknowledges:

> *"Superannuation trustees have a legal obligation to perform their role in compliance with the best financial interests duty (BFID) under paragraphs 52(2)(c) and 52B(2)(c) of the Superannuation Industry (Supervision) Act 1993. The BFID requires that trustees are guided by the best financial interests of their members when making decisions about the fund and its investments."*

And what does 'complement' mean below?

> *"Legislating an objective of superannuation is intended to complement the long-standing legal and regulatory obligations of trustees of superannuation funds to have in place investment strategies that deliver the best outcomes for their members."*

For example, **John Pearce, the CIO of UniSuper**, deals with a vocal membership of university professors and lecturers who often hold strong beliefs about social welfare and equity, but John says UniSuper has not invested in social housing and he has yet to see a model that works:

> *"However, regardless of how worthy these projects are from a social impact perspective, the financials have to stack up. So, whether or not the conversation actually leads to real investment decisions will very much depend on our assessment as to whether it is in your best financial interests."*

The objective will make no difference to Pearce's need to generate the best returns for his members.

With words such as 'equity' and 'sustainable', there were plenty of hints that rules will change in the May 2023 Budget. The Treasury paper says bequests are inappropriate and large super holders should reconsider their retirement planning:

> *"The focus on delivering income makes clear that the purpose of superannuation is not for minimising tax on wealth accumulation or enabling retirees to leave tax-effective bequests."*

I have written more here and here. In summary, despite reassurances from the Treasurer and Prime Minister that no major changes are coming to superannuation, other statements this week suggest otherwise, as does the directness of the Consultation Paper, such as:

> *"... beyond a certain level of income, additional government support through tax concessions is not necessary or appropriate".*

Treasury and the Government will review feedback to the Consultation Paper but it's strange that the Treasurer seems to have settled on a super cap rather than increasing the super tax rates. Forcing money out of super and driving asset sales and tax on previously-unrealised capital gains will create many unintended consequences.

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While we're on the importance of words and their definitions, in business, the word 'plunge' means '*to go down in amount or value very quickly and suddenly*'. Similarly, 'plummet' means '*to fall or drop straight down at high speed*'. So when the headline on the front page of the Weekend AFR of 18 February 2023 under the tag 'Exclusive' uses these words, whatever is affected must be in serious decline. Here is an extract:

> *"New SMSF accounts **plunge** as big super fights back*

The number of new self-managed superannuation funds has fallen for the first time in four years as improved offerings from professionally managed funds and market volatility combine to take the shine off DIY super.

*Two of the nation's largest brokers, which collectively preside over about a quarter of the $865 billion SMSF market, expect the number of SMSFs established last year to **plummet** by at least 15 per cent."*

The latest data from the ATO shows SMSFs in vibrant health, with record numbers of establishments. What is the evidence that *"improved offers from professionally managed funds"* are attracting clients at the expense of SMSFs? It's index ETFs that are grabbing market share, also reaching record amounts and often held within SMSFs.

SMSF population and assets, 2017–18 to 2021–22

	2021–22	2020–21	2019–20	2018–19	2017–18
Establishments	27,713	25,787	21,694	20,309	25,311
Wind ups	2,057	15,426	17,172	17,646	25,142
Net establishments	25,656	10,361	4,522	2,663	169
Total SMSFs	603,432	577,776	567,415	562,893	560,230
Total members	1,123,430	1,075,799	1,063,486	1,055,599	1,050,448
Total assets ($m)	$868,703	$843,746	$720,531	$717,915	$683,136

There's not much plunging or plummeting there with SMSFs holding over a quarter of all superannuation. Speaking at this week's **SMSF Association** Conference, **Investment Trends Head of Research, Dr Irene Guiamatsia**, said:

"Although the average age of SMSF members remains high at around 60 years of age, SMSFs are being established at a younger age, boding well for long-term growth. The main driver for growth remains the desire for control. Early exposure of Millennials and Gen Z to digitally-delivered financial services reinforces control as an important component of their engagement with service providers. Also, Australians' well-documented bias towards direct property as an asset class, and their desire to access it, helps stoke SMSF establishments. Supply side factors, such as low-cost initial setup, greater synergies between accountants and adviser practices and a slightly softer regulatory posture also play their role."

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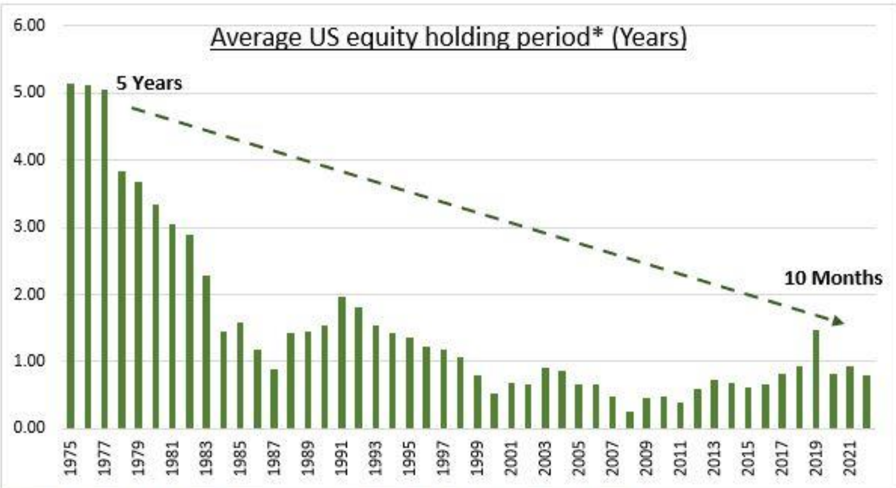
This week, I interview three global fund managers, **Orbis, MFS International and Baillie Gifford**, who are coming together to make the case for active, long-term investing in a market that can no longer be assured of simply delivering good results through the momentum of passive investing. Each explains their process and the global stocks they like for the long term. Despite the arguments in favour of investing through the cycles and allowing compounding to do its work, the average holding period for equities continues to fall, as shown here.



Source: WFE, IMF. *NYSE and NASDAQ market capitalisation divided by total turnover value

At an **Actuaries Institute** event last week, **Michelle Levy** explained the proposals in her Quality of Advice Review (QAR). Superannuation expert **Michael Rice** (previously of **Rice Warner** fame) sees the need to change the advice regime and supports many of the recommendations, but he worries about the safeguards. QAR is a start in updating financial advice rather than the final word. We also include extracts from a submission Michael made to QAR for readers who want more background.

Graham Hand

Also in this week's edition ...

It's clear the government is preparing the ground for changes to both superannuation and personal taxation. **Dr Rodney Brown** expects taxes may get a minor tweak in this year's budget, though it will lay a platform for more comprehensive reform prior to and after the next federal election.

Recently, super funds have copped flak for their valuations of illiquid private assets - is it a form of 'volatility laundering' as famously coined by quant expert, **Cliff Asness**? Perhaps, says **Simon Petris**, though Petris suggests it's important to distinguish between different segments of private markets to get a complete picture.

In October last year, **Annika Bradley** wrote of the impending arrival of **Vanguard** into superannuation in Australia. Today, she assesses how the Vanguard offering stacks up against local juggernaut, **Australian Super**.

The tech sector was obliterated last year, though it's made some of that back in 2023. Montaka Global Investments' **Andrew Macken** remains an undaunted bull on the sector. He says tech is entering a new phase of growth and dominance, fuelled by innovation and AI, and highlights some compelling ways to play this theme.

David Booth thinks that the past three years are representative of the history of stock returns: two steps forward and one step back. And it provides important lessons about how you should best prepare your investment portfolio for future market outcomes.

In this week's White Paper, **MFS** says that soaring interest rates have made cash a competitive asset again, prompting an overdue de-rating of risk assets. But just because yields are higher, that doesn't mean risk is lower.

Curated by James Gruber and Leisa Bell

Lesson 1: focus on the long term, Lesson 2: see Lesson 1

Graham Hand

At the forthcoming Active Advantage 2023 conference, open to institutional and wholesale investors, joint hosts Orbis, MFS and Baillie Gifford will present on the long-term value of an active approach for investment portfolios. It will examine local and global research into the critical factors underpinning good investing.

In preparation for the event, I spoke to Rosemary Shannon, Client Service Director, Baillie Gifford; Marian Poirier, Senior Managing Director, Head of Australia and New Zealand, MFS Investment Management; and Jason Ciccolallo, Managing Director, Orbis Australia.

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GH: Rosemary, you're in Edinburgh now where it's cold and early so let's start with you. We've seen major changes in markets in the last 12 months. Do you feel the favorable investment conditions of low inflation, falling rates, globalisation and cheap energy are in the past and what does this mean for the future of asset allocation?

RS: The past 12-18 months have been uncomfortable, and we have seen significant volatility driven by the war in Ukraine, rising inflation and rates. This has been challenging for performance. The continual review of our portfolio holdings allows us to check the investment thesis and its resilience through such an environment. However, we're focused more on the long-term, transformational shifts in society rather than the macroeconomic conditions of the last 18 months or so. It's too easy to become myopic and miss the big but slow-moving changes.

We think we're seeing the biggest long-term shifts since the Industrial Revolution, due mainly to advances in technology. And that really provides a fantastic opportunity for long-term active investors. There's never been a better time to hunt out, in our case, growth companies. Our eyes are tuned into the transition to clean energy, the future of sustainable agriculture, the electrification of transport, breakthroughs in biology. For example, we're looking ahead to cures for cancers and other diseases.

GH: Marian, coming to you, what is the impact on asset allocation of the market changes we've seen recently?

MP: We also focus long term but on overall asset allocation, cash now has a return, fixed interest has a return, so there are more tools in the toolkit. The changes you highlighted, inflation and higher rates, are 100% of concern to us. Higher volatility, scarcer access to capital and higher rates will likely lead to decreasing profit margins for some companies. I agree with Rosemary that active management or stock selection will be key to differentiate between winners and losers in a more difficult environment.

GH: Jason, has your thinking changed over the last 12 months?

JC: We think there have been decades of undisciplined capital allocation, with decisions which resulted in huge valuations for certain companies which led to big valuation dispersions. At the margins of the different asset classes, there have been some changes … for example, 'bond-like equities' such as Nestle and Coca-Cola became popular when rates were zero, however, as rates have risen, those same stocks have more competition today from the asset they were trying to replace: actual bonds.

Where we think there have been much deeper shifts is below the surface of each market. There's a much bigger difference – a lot more value to be found - between European and Asian bank stocks, and US tech stocks, for example, than there is between Nestle, and corporate bonds.

GH: Many people who read this are retail investors learning about investing. What is the most important lesson they can learn from professional investors?

JC: To focus on the correct time horizon for their investments and not react to short-term market sentiments. We are long-term, contrarian value managers so there are a lot of the 'Buffettisms' that are hard to go past, and one often quoted is "be greedy when others are fearful and fearful when others are greedy". It has served investors well by staying away from things that look inflated. It was only three years ago, on the precipice of COVID, when everyone thought the world was ending and that was a chance to avoid the perils of running with the crowd. The crowd also jumped into the glitz and glamour of crypto and meme stocks and SPACs and NFT's. I mean, those things were so hot then but now you go back and wonder, what were those people thinking?

GH: Yes, what was that all about?

JC: The advice not to run with the crowd applies all the time, at market lows or highs. There will always be times when investors have given up and are running away and believe the world's going to end in a particular market or sub sector. It sounds simple but investing is hard to execute in practice because you need to control your emotions, especially as a contrarian investor.

MP: Two points I would make here. First, nobody has an information advantage anymore, everyone has access to the same information. But you do have a time advantage if you can cut through the short-term noise. The second critical thing is resilience, which requires investors to do the homework, do the research, know what they're investing in. This also applies for clients. Do the research into managers and don't just go with last year's best performers, and then stick with them through the cycle.

GH: That's the challenge for clients, retail or wholesale. They have to tough it out because fund managers may go years where their numbers are not great. What are conversations with clients like in those times?

MP: I always go back to the time period we are looking at. We should be measured through the cycle, not say a three-year period. It doesn't mean 'set-and-forget' and not monitoring what the managers are doing. Everyone needs signposts along the way. One of the best questions we get asked prior to an appointment is, "When are you likely to underperform?" Ideally, clients will remember when you come to that underperforming period. Another good question is, "What happened? We didn't expect you to outperform in this period." Again, it's about knowing your manager, understanding what they do and when they're likely to perform and when they're not. And it makes for easier conversations.

GH: Jason, the three firms here are running joint seminars in Sydney and Melbourne making the case for active investing. Can you elaborate on why you think conditions are especially good at the moment?

JC: If someone had invested passively for the last decade in the broad US market, they would have returned around 11% per annum real after inflation. It was a time when people could invest in almost anything and make money. But the world has changed, as you said up front, with inflation, rising interest rates, geopolitical tensions, all those things are at play. What was the winning bid for the last decade isn't going to be the winning bid for the future.

The case is stronger than ever to use skilled managers to navigate this turbulent environment. That's why we three managers have come together for this active message. We are differentiated in our style but unified in the way we approach investing, which is to be active and invest from a long-term perspective for our clients.

GH: That need to focus on the long term is the biggest single challenge for retail investors because the media bombards everyone with scary headlines. We've all seen redemptions rise when markets fall and applications increase when markets rise and it's frustrating.

Rosemary, can you identify something in your investment process that you think has delivered consistently good results?

RS: Our process has remained consistent through time and it's important not to change just because the short-term environment is different. But the inputs into that process are critical and one key input for us is the information that often comes from academia. In order to identify outlier companies, we need to understand the big changes I was talking about earlier and speaking to academics who share that long-term time horizon helps us to understand what's happening. They have access to cutting-edge knowledge about technological advances and long-term social and environmental shifts that could affect investments.

For example, we have a longstanding relationship with Hendrik Bessembinder. He's the author of the famous study which shows all the wealth creation in the US market comes from just 4% of listed companies. We commissioned him to look at global equity markets and the 4% quoted for the US is even more concentrated globally. Only 1.3% of companies are really delivering the return and he helped us to identify them. That's one example but we have 30 or so leading academics around the world. We do work in Edinburgh with the Genomics Institute and the Low Carbon School. We have a relationship with a farm in northern Scotland which is testing various elements of sustainable farming. It's hugely varied, from the ethics of AI to genome research to sustainable farming.

GH: Jason, what part of your investment process consistently delivers?

JC: Contrarianism. It allows us to produce good returns because we focus on the mistakes other investors make. Many investors panic when things go badly and get excited when things go well, and there is a dispersion in behaviour. We look at the stocks that are out of favour, and some people think that's brave because it goes against the crowd, but we research the long-term value of the company and we're assisted because investors are increasingly short term. We don't forecast the overall market as we don't think anyone can do it. Our managers need to be independently minded and have the courage of their convictions, but the research is intensely peer reviewed as if it's a PhD thesis to make sure we haven't missed something.

GH: Rosemary, back on Hendrik Bessembinder, whose research we have featured a few times in Firstlinks, if only 1.3% of global companies deliver all the outperformance, how do you find them?

RS: That's the challenge. Hendrik has looked at company's outcomes decade by decade to find the patterns over long-time horizons. The evidence suggests that returns follow fundamentals. There are four standout factors with statistical significance: strong cash accumulation, rapid organic asset growth, higher R&D spend and larger drawdowns in the prior period. You need active managers who are looking for these key characteristics and traits, often in outlier companies. So you should be expecting price volatility in that subset of companies.

GH: If I could clarify, as you saying that the best performers have a large prior period share price fall?

RS: Yes, from peak to trough of maybe 50% or more in the prior decade, but they subsequently perform exceptionally well. So patience and deep research can pay off if those other traits have been identified, which is where active management comes in again. Amazon, for example, is among this small cohort. It's not a tech company as some people might label it, it is a tech-enabled retail company.

GH: Can I ask each of you to identify one company in your portfolios that best meets your investment and that you're likely to hold for a long time like a decade.

MP: I'll give you a sector and a specific stock. US railroads don't sound hyper-exciting and hyper-techie, but they have long-term potential growth fueled by pricing power. There's a strong ESG angle as rail is still the most energy efficient way to transport goods across North America. And on a stock, Schneider Electric, a

European-based multinational is focusing on digital automation and energy efficiency in homes and offices, again with pricing power and long run growth. They help with the efficiency automation process, for example, most buildings leave too many lights on at night.

JC: Although we think long term, we probably don't plan to hold anything for a decade because we want to buy things at a significant discount to their intrinsic value until the market recognises the potential and we're happy to bank that profit and move on. One example is XPO, a US logistics and trucking company which has changed a lot in the last decade. We don't know how much longer we'll hold it but today it offers a wide discount to our estimate of intrinsic value.

RS: Unlike Jason, we're intending to hold many companies for 10 years or longer based on our average holding period in the past. So we could pick almost any company in our portfolios, but I'll highlight a few. Moderna brings transformational change to our healthcare systems and how we treat disease and maybe prevent disease going forward. I mentioned Amazon already. Plus Mercado Libre which is the largest ecommerce platform in Latin America and a sort of emerging fintech provider. Maybe we hold that for 20 years. Companies such as Orsted which transitioned from oil and gas to become the largest offshore wind producer globally. And more unusual is John Deere, which is the world's largest agricultural equipment manufacturer, rapidly improving the sustainability of farming.

GH: What happens if one of those companies goes on a good run with an excellent gain. There must be a temptation to sell.

RS: We don't have price targets because the environment and the markets are changing constantly, and an opportunity might be opening up to them. We bought Amazon before the iPhone existed and now you can buy anything on Amazon Prime using your iPhone. It was a bookseller and now it has a cloud business and a streaming business. So investors need to constantly review and understand the upside potential. Just because something has made five-fold increase to date doesn't mean it can't make another five-fold from here.

GH: Can we talk about the other side of investing, coping with setbacks.

MP: A few things come to mind for us. Our team always focuses on the downside risk and we ask a lot of questions around what can go wrong. If an investment doesn't work, we recheck the long-term thesis, and if it's no longer intact, we look at the valuation and work out our exit strategy. What has not changed is the strong management support when things go wrong. A lot of investments can take years to play out and if performance isn't delivering in the short term, portfolio managers need management support, as long as the thesis remains sound.

RS: If I can jump in, we're focusing more on the upside and the 'blue sky' potential, but I think that illustrates that we're a group of three managers who have deep respect for each other's processes but we're different. We're often seen all together in one institutional client's portfolio at the same time. It's complimentary as success does not come in a straight line, especially when you're investing in transformational growth companies. And so really, that's why that patience is required. Finding a few small but big winners will deliver outsized returns but it's over a prolonged period of time.

GH: Jason, the process around setbacks?

JC: It's inevitable with our style that we'll hold stocks that go against us. For example with XPO, we may retest the thesis by getting a fresh set of eyes on it, or bringing it back to what we call the Review Policy Group to check if anything is fundamentally broken with the company, or if it's an even better buying opportunity. The portfolio managers do reviews every day using portfolio management risk tools.

GH: You must have some tough conversations with clients who ask why you're holding some of this stuff?

JC: We often say some of our best stocks are the ones we even hate because they make us feel uncomfortable. But it generates great conversations with our clients because they read all the negative comments in the press. It's our job to explain what normalised earnings will look like for that company and why risk/reward will pay off.

GH: Marian, can we come back to non-traditional research sources. We hear about quirky things like placing cameras in supermarket car parks to see how busy they are. What does MFS do?

MP: It's not leading-edge use of tech, but we're doing a lot more collaboration between the equity and fixed income teams. It allows us to look at companies from different angles, and it paid off in COVID when we needed to have greater focus on company cash burn and work out which companies would survive or win in a major downturn. More recently, as market fragility increases and as capital becomes harder to access, it is important to identify those companies with stronger balance sheets who can undertake capex. It will help to identify survivors and winners.

GH: Are the fixed interest fund managers feeling better now that they do not need to justify negative interest rates? That must have been a tough sell.

MP: There's definitely a better buzz around fixed interest and we have some of the team are coming to Australia soon.

JC: On the non-traditional resources side, we hire some unusual people from different backgrounds. For example, we've developed an AI-based screening system that looks over our stock selection history going back 33 years and identifies patterns in the past and possible opportunities today. We use decision analytics to look at investor behaviour and biases displayed in particular stocks. We've used traffic data to assess how quickly distressed businesses were recovering post COVID, and we look at demographic analysis for the context in which companies operate.

RS: I know everyone talks about culture of the people and the organisation but it starts with the types of people we hire. When hiring graduates, for example, we look for curiosity and cognitive diversity, and that might be an historian, an astrophysicist or a musician, a ballet dancer or a geographer as much as the traditional economics or accountancy graduates. That kind of diversity of thought often does take us down different roads.

I'll make a final comment that the reason we are running the Active Advantage seminars is the respect we have for each other and complementary styles which work well in a client portfolio. We're trying to have a collaborative and collegiate discussion on issues we feel are becoming lost in the short-term noise.

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Michael Rice: Quality of Advice Review is only a start

Michael Rice

Editor's introduction

The Quality of Advice Review (QAR) Final Report is a proposals paper prepared by lawyer Michelle Levy and Treasury. It correctly observes that the current regulatory framework is a major impediment for many Australians to benefit from accessing financial advice. The Report gives 22 recommendations to address advice complexity, and it has received broad support within the financial services industry.

Briefly, 'personal advice' would be broadened with an obligation to provide 'good advice', the 'general advice' definition would be scrapped, and disclosure documents such as SOAs and FSGs would no longer be required.

Advice will be considered as 'personal advice' if the financial advice provider holds information on the client's circumstances, but crucially, not where the advice provider simply *considers* the client's circumstances. This will allow superannuation funds to provide personal advice to their members, which is one reason why the major industry funds are big supporters.

It is also a major point in Michael Rice's criticism below.

A provider of financial advice would need to provide 'good advice' but the law would not regulate or define the inputs to that advice. It must be 'fit for purpose' when designed by a financial adviser who knows a client's personal circumstances. The fiduciary duty is enough to protect the client and a separate 'best interests duty' is not required. SOAs would be replaced by maintaining records of advice.

'Good advice' is advice that would be reasonably likely to benefit the client, having regard to the information that is available to the provider at the time the advice is provided.

The Report states:

"A duty to give good advice does place a different kind of responsibility on providers than laws which prescribe process. It also creates the opportunity to remove many of the regulatory requirements relating to disclosure and some relating to conduct. This will allow providers to decide what they need to do to ensure their advice is in fact good advice. It will relieve providers of obligations to comply with requirements that are unnecessary or do not respond to the circumstances and needs of their customers."

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Michael Rice is a leading actuary who with a lengthy career as a consultant and researcher in superannuation, life insurance and investments. He was a founder of Rice Warner where he consulted widely to the financial services industry and headed the firm's public policy work. Rice Warner produced reports on financial advice and provided services to superannuation funds and governments on a wide range of financial matters.

The attached article is in two parts. The first part is Michael's presentation to the Actuaries' Institute in February 2023 following the release of the QAR, and the second part is extract from his previous papers to the QAR in June 2022. The original is over 50 pages on how advice should be structured and is further background to the complexities faced.

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Part 1: A good beginning but weak on safeguards

Most people are financially illiterate - not because they are stupid, but rather because insurance, investment and superannuation are all unnecessarily complex and the guidance consumers need to navigate these uncertain areas is largely unavailable (partly due to legislative barriers).

Everyone agrees that good financial advice is beneficial and indeed essential at certain times, such as when entering retirement. However, the laws of financial advice are incomprehensible and poorly structured. Further, a layperson would find it difficult to seek advice, and most would find the cost of buying it is beyond their budget.

Clearly, we need a catalyst for change and the *Quality of Advice Review* provides a very good beginning.

The Review aims to increase the amount of advice provided to consumers and one theme is to allow those with large customer bases to provide advice on a single subject at a point of time. This recognizes that many consumers who currently get no advice do need simple types of advice periodically during their life. We could call this 'event-based advice'.

Superannuation funds already provide similar advice under their intra-fund advice structures, but the take-up rate for this is low. Broadening the base of this type of advice would open the market to other suppliers (including retail financial advisers), many of which would use technology to bring down the cost of delivery.

The proposed changes to the intra-fund advice rules fits in with the government's Retirement Income Covenant requiring funds to have a strategy for those members entering retirement and maintained for them during the retirement years. This would allow funds to collect information on the member's full personal financial circumstances (including their spouse) and eligibility for the Age Pension. Effectively, it would allow funds to offer comprehensive advice leading into retirement without any of the current restrictions.

Opening the market in the way proposed makes sense. However, the Review is surprisingly weak on some consumer safeguards. In my opinion, financial advice legislation should be tailored to the risk of harm for consumers. The proposal does not differentiate between a simple piece of harmless advice and a complicated risky strategy. The former could easily be provided by superannuation funds, banks, and others with large customer bases. However, many forms of advice are complex and risky - and the legislation needs to reflect that.

Consequently, the bar for Good Advice appears to be set too low. It is not a requirement to provide "best advice", but simply to provide advice that is likely to benefit the client. Consumers can still be put in expensive or risky products when better strategies might be available.

Take retirement as an example

Superannuation funds are likely to put members into cohorts when forming their Retirement Income Strategies. They may well use entitlement to a full or part Age Pension as one of the criteria for allocating members into a cohort. Giving members guidance as to the default structures for these cohorts is sensible.

However, there remain some conflicts which the review glosses over.

70% of members will be married when they enter retirement – and their spouse will usually not be in the same fund unless they have an SMSF. They will need to know whether to stay in separate funds or whether a new fund might be more suitable for both.

They will be offered a longevity product, but is this suitable if they are a homeowner? They might prefer to wait until later in life and buy a reverse mortgage to supplement their income rather than allocate money to a longevity product with an uncertain outcome (noting that the values of future benefits could depend on the longevity of all members).

They cannot get these answers from their own fund which is conflicted.

As you can see, some areas do need to be revisited before we make final changes to the system.

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Part 2: Submission to Quality of Advice Review, June 2022

While there is now much improved consumer protection, the heavily bureaucratic legislation pertaining to financial advice together with the ultra-cautious approach of the regulators is a severe hindrance to the industry delivering sound financial advice at a fair price for most Australians.

Without material change, we will soon reach a situation where financial advice will be delivered largely to wealthy Australians. Few ordinary Australians can afford to purchase the financial advice they need and, for many of those who do obtain it, the advice they receive is not optimal. This is a major problem for the significant number of Australians moving into retirement. They need advice if they are to optimise their retirement incomes – which will be highly valuable for them as well as being to the benefit of the Australian economy.

The Rice Warner Report also described many of the weaknesses in the current regime and suggested a new model. We suggested any changes should be measured against five key attributes:

- Simplification
- Affordability
- Accessibility
- Consistency
- Quality of advice.

It expands these ideas to present a new paradigm for delivering financial advice, namely:

that legislation on financial advice should be tailored to the potential risk of any harm to consumers.

Further, consumers are no better off as most find advice in its current format to be too expensive. The FSC White Paper included research by KPMG showing a financial plan currently costs more than $5,000 to produce. It suggested some administrative changes to reduce this cost significantly. However, the projected savings of $2,000 do not bring the cost of a financial plan down to levels that most consumers find palatable, so more fundamental change is needed.

Several surveys have shown that most consumers will not pay more than a few hundred dollars for each piece of advice. Conversely, wealthier Australians have substantial assets to protect or have high income which will generate future savings. In these cases, they value financial advice and will pay a sizable fee for it.

Consequently, to broaden the uptake of financial advice in the community, this submission considers that:

We need a system where people can get simple advice for one-off amounts under $500 for Simple Advice, and some forms of comprehensive advice for less than (say) $1,500.

Any changes to the system will need to address the following issues:

- Most financial needs can be met with relatively low-risk strategies which require Simple Advice. This should be the default position for most consumers.
- Most consumers do not need to take high risks. It is suitable for them to be in strong default products such as MySuper.

- Regulations based on complex, high risk advice are unnecessary, inappropriate, and too expensive for simple low-risk advice. In most cases, they do not reduce the risks around providing advice on simple topics - instead they increase risks for consumers by making this advice largely unavailable! Rules for simple low-risk advice should be simplified to ensure the delivery can be done at low cost. This specifically applies to those providing low-risk simple advice via online tools.
- Financial advice should be focused on strategies, with less emphasis on products. The legislation needs to recognise this separation.
- Advisers only need to know and consider their client's full financial affairs if they are placing them in medium- to high-risk strategies/products (as defined later in this submission) or are providing advice on a range of needs. Most consumers have relatively homogenous financial needs, and these can be determined quickly.
- Ad-valorem (asset-based) fees are not appropriate on low-risk strategies where the advice provided can be commoditised. There should be a shift to fixed-dollar fees for these cases.
- The distribution of life insurance should be expanded to replicate the ways people buy Private Health Insurance and general insurance products.
- Financial decisions not currently within the advice legislation should be included. This would include savings, budgeting, and mortgage broking. As these activities are generally low-risk and beneficial for consumers, the legal requirements should be simple.
- High-risk activities will be defined and will continue to require strict standards and strong regulator monitoring. However, many advisers will shift their emphasis to low-risk strategies for many clients.
- Some high-risk strategies may need closer attention. These include:
  - Areas with a conflict of interest such as investing in related-party investments without appropriate management of potential conflicts. This should be done to avoid past failures such as Storm Financial and Dixon Advisory.
  - Investing in geared investments (including investment properties).
  - Investing directly in shares (perhaps with a reasonable financial threshold of $25,000 to allow some exposure without being considered high-risk).
  - Any risky strategy such as Contracts for Differences, unlisted assets, and some forms of foreign investments (which include currency risks).
  - Cryptocurrency products, many of which are distributed outside the reach of financial services regulation.

Many of the leading financial institutions were required to pay large amounts of compensation and fines. The stigma coupled with low returns on the capital placed in these businesses led directly to the four large banks exiting the financial advice segment.

An unforeseen response to FOFA was the rapid shift in client bases of advisers towards wealthier Australians. When commission was being received on low-activity accounts, advisers had kept these clients on their books. However, there was now a minimum cost of engaging with clients. Even simple needs could not be met under fees of $3,000 to $5,000 a year, so clients with smaller balances have been jettisoned. The minimum fees have also deterred an increasing number of Australians from obtaining advice.

The evolving legislation and regulation have contributed to most Australians not receiving financial advice. This act of omission is a major societal risk as unadvised people are more likely to make poor decisions. These include investing in speculative schemes or products, poor savings habits, and underinsurance. Arguably the risks of omission of advice are greater than the commission of receiving poor advice (due to the scale of omission within society).

Example of problem with intrafund advice, specific limitation

Intra-fund advice has been carved out of the law to allow superannuation funds to offer specific advice relevant to their fund membership. Even this has some grey areas. For example, most funds offer intra-fund advice when moving a member into a pension under the same fund. However, it is critical to discuss retirement with the member's partner to know the family's full financial circumstances. If the fund's adviser recommends putting the partner into the fund, it is no longer intra-fund advice – and they should have an Approved Product List for these contingencies!

Superannuation funds are specifically prohibited from giving personal financial advice relating to the Covenant to their members and can only provide strategic guidance. However, trustees need to consider how to assist groups of members understanding investment, inflation and longevity risks.

Intra-fund advice in its current form is not suitable as a vehicle to provide members with retirement advice since any sensible advice on retirement income requires consideration of financial interests outside the specific superannuation fund. Consequently, there is a problem with the interaction of the financial advice legislation and the Covenant. The current financial advice legislation and regulations effectively prevent funds from giving proper and adequate effect to the Covenant.

Some suggest that it is reasonable to extend intra-fund advice to deal with this set of circumstances. However, it is difficult to provide people with advice on retirement within the current framework for intra-fund advice given the need to advise on matters outside the fund such as the Age Pension or their spouse's circumstances and options.

At retirement

Fund members need advice which will include:

- What Age Pension can I receive and when does it commence? (This considers family assets including those of a spouse).
- What income do I need to live on in (say) the first ten years of retirement? Should I draw more than the minimum regulated pension amount?
- For homeowners, how can I use my equity in the family home? For example, can I spend all my super over 20 years, knowing that the home is a nest egg for good longevity or to provide for the costs of Aged Care later in life?
- Should I join the Retirement product provided by my super fund and should I vary it in any way (eg take less of the longevity component as I have high equity in my family home).
- Should I vary the asset allocation of my product? Can I afford to take on a higher investment risk to provide higher expected returns to fund my retirement?
- How should I use my cash and investments outside superannuation?

These questions do require financial advice at a level which is currently defined as Comprehensive. The consequence is that although most members require advice on these issues, few of them will seek it because the fees charged for Comprehensive Advice are too high.

There needs to be a better, risk based, approach to regulate this advice as Simple Advice. If the fund has a strong default product (utilising the Retirement Income Covenant to set up a sensible structure for groups of members), the retirement income strategies become one of tailoring this product to the member's personal circumstances.

Michael Rice's professional work at Rice Warner relating to financial advice included the Report prepared for the Financial Planning Association on the Value of Advice; set up and maintenance of the VicSuper financial advice structure, Report on Financial Advice Within Superannuation Funds and original research for the Financial Services Council on the Future of Financial Advice. This article is general information and does not consider the circumstances of any person.

The super wars revisited: Vanguard vs AustralianSuper

Annika Bradley

Vanguard has thrown down the gauntlet to the superannuation industry by launching its Super SaveSmart accumulation offering. This launch gives it the ability to go head-to-head with the large superannuation funds, but will it really be able to compete with the likes of AustralianSuper? Vanguard is a global monolith with over

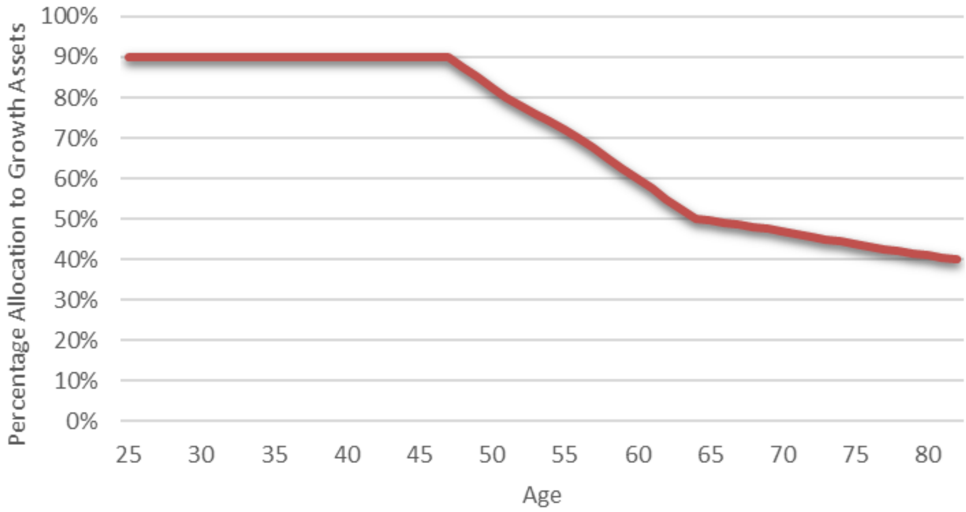
$10 trillion of assets globally, but homegrown AustralianSuper is pretty sizable on the global stage with over $250 billion in assets. Let's take a closer look at Vanguard's super offering and how it stacks up.

Vanguard's Super SaveSmart investment offering

Vanguard's offering provides a range of investment options—a Lifecycle investment option, five diversified investment options, and six single-sector options. Let's focus on its MySuper (or default) option, which is a Lifecycle investment option. Lifecycle investing automatically adjusts investors according to their age—there are 36 Lifecycle stages. (See Exhibit 1.)

Basically, if you're 47 years old or under, you will be invested in an option that has 90% of its investments in shares and property—that is, "growth assets". Beyond this age, Vanguard starts to ratchet down the allocation to growth assets and increases defensive assets. A lower allocation to growth assets generally means fewer market ups and downs but also lower returns. By age 56, the growth exposure is down to 70% and the defensive exposure at 30%. At 64 years old, investors hold an even mix of growth and defensive assets. Finally, the last milestone is 82 years or older—at which point growth assets are down to 40%. Between these age milestones, Vanguard is making incremental adjustments for you - for example, at age 52, 78% is in growth assets.

Exhibit 1: Vanguard lifecycle—percentage allocation to growth assets by investor age



Source: Morningstar.

Why lifecycle?

In typical lifecycle investing, an initial investment is made, based on investor age, into a well-diversified mix of investments. The investment mix gradually transitions into lower risk investments as one ages—as shown in Exhibit 1. It is generally accepted as a good approach for investors who are more "hands-off" and would like a professional to monitor and adjust the investment mix over time. This approach is certainly not new. At the end of 2022 in the United States, Vanguard managed around US$1.1 trillion of this style of product, and the overall market there is more than US$3 trillion. Also, in Australia, Aware Super, AMP, and Australian Retirement Trust (to name a few) offer lifecycle-style products.

But retirement is a personal experience, and adjusting investments based only on age is simplistic compared with working with a financial planner, who generally considers many more factors such as your total wealth (and your spouse's), homeownership status, age pension eligibility, risk capacity and risk tolerance, future liabilities, spending patterns, and more.

Having said that, personalised advice can be expensive. Setting your initial asset allocation and then adjusting it based on age is normally a much better option than selecting an investment with a limited understanding of what you're buying and never making any adjustments to it.

Vanguard's lifecycle approach—adjusting the asset mix

Vanguard's Lifecycle product has been designed to make reasonably gradual adjustments to the mix of investments, as shown in Exhibit 1. The adjustment to the investment mix ranges from 0.5% to 2.50% in any given year. No one knows exactly when markets are going to turn. More gradual, smaller adjustments over time are generally recommended over larger, arbitrary ones (such as annually on your birthday); as this minimises the risk of making a large change to an asset allocation at the worst possible time. Every month, Vanguard rebalances each investor's portfolio back to the targeted mix of growth and defensive assets, if this mix has fallen outside of reasonably generous tolerances ranges. It also uses any new investments made by an investor into their option to align the mix. Sensible tolerance ranges and the use of cash flows help minimise outsize changes and unnecessary transaction costs including taxes.

Then, on the business day after the investor's birthday (once older than 47 years), Vanguard adjusts the portfolio in line with the 'new' mix of investments. The monthly rebalancing mechanism could see an investor buying shares a month before their birthday and then selling shares a month later. But Vanguard is the largest provider of index solutions in the world, so 'trading' a portfolio effectively and minimising transaction costs to investors should be well within its skill set.

Comparing funds based on asset allocations

These gradual adjustments to the investment mix over time make a comparison to other MySuper funds a little tricky. For simplicity, let's assume there are two investors: one is 40 years old, and the other is 64 years old. In Vanguard's Lifecycle options, the 40-year-old investor will be invested with a 10% allocation to defensive assets and a 90% allocation to growth assets, while the 64-year-old investor will be invested with an even mix of 50% defensive and 50% growth investments.

Unfortunately, it can be a minefield trying to compare 'like for like' across funds based on the investment mix. Due consideration should be given to the underlying asset mix, but there are a lot of nuances. At the risk of oversimplifying the issue, let's define "defensive" assets as only cash and fixed interest and the rest as growth assets. There's much debate around the classification of credit and unlisted assets, but that is another article in itself.

Under this simplified definition, the AustralianSuper options that currently correspond most closely with the Vanguard Lifecycle Age 47 And Under Option and Vanguard Lifecycle Age 64 Option are not their MySuper Option (that is, the Balanced Option) but are the AustralianSuper High Growth Option and the AustralianSuper Stable Option (see Exhibit 2). This comparison is very much 'point in time'; consideration should also be given to how investment mixes can move over time. To give a sense of this, the AustralianSuper Stable Option targeted 58% in defensive assets in 2019 and is down to less than 52% in 2022. This more-active approach to strategic asset allocations can make long-term performance comparisons challenging.

Exhibit 2: Strategic Asset Allocation comparison—as at 31 December 2022

	AustralianSuper High Growth Option	Vanguard Lifecycle Age 47 And Under Option*	AustralianSuper Stable Option	Vanguard Lifecycle Age 64 Option*
	Strategic Asset Allocation	*Strategic Asset Allocation*	*Strategic Asset Allocation*	*Strategic Asset Allocation*
Morningstar Category	*Multisector Aggressive*	*Multisector Aggressive*	*Multisector Balanced*	*Multisector Balanced*
Equity (Australian, International and Private)	73.75%	90.00%	21.50%	50.00%
Listed / Unlisted Property and Infrastructure	19.25%		18.50%	
Other*	1.00%		8.25%	
Growth Assets	**94.00%**	**90.00%**	**48.25%**	**50.00%**
Fixed Interest	2.00%	10.00%	31.25%	50.00%
Cash	4.00%		20.50%	
Defensive Assets	**6.00%**	**10.00%**	**51.75%**	**50.00%**

*Source: AustralianSuper and Vanguard. *Other – credit investments.*

Objectives – what's the difference?

Let's now consider the investment strategies' stated objectives to help understand what it is trying to achieve. Exhibit 3 compares these strategies' objectives. higher return objectives and longer minimum time horizons generally mean that there's a higher level of risk in that option. This normally means more market ups and downs. At the age of 45, though, most people have at least 20 years until retirement – so a few market ups and downs are probably worth the additional return.

Based on the underlying asset mix, the Vanguard Lifecycle Age 47 And Under Option's objective appears quite low. Interestingly, according to Vanguard, these investment objectives consider prevailing market conditions (this just means the price level of markets at a given time) and are expected to change over time. They were formulated in early 2022 (using their proprietary return forecasting tools), and if you remember, equity valuations were still quite elevated, and bond yields were low (meaning that bond prices were high) relative to where they are now. This meant that future returns forecasted at that time, and therefore the objective of the option that was set, is quite low (CPI plus 2.5% pa). This makes sense; it's often easy to lose sight of the impact an investor's starting point can have on future returns.

With global equities markets down over 12% for calendar-year 2022, the potential returns from equities compared with 12 months ago should now be more attractive. And in Vanguard's Economic and Market Outlook for 2023 (produced in December 2022), it acknowledged that globally, their 10-year equity return expectations are now 2.5% higher than they were at the same time last year. Bottom line - the objective set is low but explainable and let's see how it changes over time.

Exhibit 3: 45-year-old investor – AustralianSuper High Growth Option vs. Vanguard Lifecycle Age 47 And Under Option

	AustralianSuper High Growth Option	Vanguard Lifecycle Age 47 And Under Option
Stated objective	- To beat CPI by more than 4.5% pa over the medium to longer term. - To beat the median growth fund over the medium to longer term.	- CPI + 2.5% pa
Suggested timeframe	Minimum 12 years	Minimum 7 years

Source: AustralianSuper and Vanguard.

Exhibit 4: 64-year-old investor – AustralianSuper Stable Option vs. Vanguard Lifecycle Age 64 Option

	AustralianSuper Stable Option	Vanguard Lifecycle Age 64 Option
Stated objective	- To beat CPI by more than 1.5% pa over the medium term. - To beat the median capital stable fund over the medium term.	- CPI + 1.5% pa
Suggested timeframe	Minimum 5 years	Minimum 5 years

Source: AustralianSuper and Vanguard.

Asset allocations – listed and unlisted assets

These strategies are very different in their holdings of listed and unlisted assets. At present, Vanguard does not have an allocation to unlisted assets. On the other hand, AustralianSuper aims to have a strategic allocation to unlisted property, infrastructure, and private equity of around 20% (Exhibit 5). These assets are not listed on the Australian Securities Exchange or other global exchanges, often making it more challenging to know precisely what you are holding and at what price.

Exhibit 5: AustralianSuper Options' strategic asset allocation to private equity, unlisted infrastructure, and unlisted property as at 31 December 2022

Strategic Asset Allocations – 31 December 2022	AustralianSuper High Growth Option	AustralianSuper Stable Option
Private Equity	5.75%	1.50%
Unlisted Property	4.75%	5.75%
Unlisted Infrastructure	11%	11.75%
Total	**21.50%**	**19.00%**

Source: AustralianSuper.

Can you beat the market?

The two strategies also differ in their investment approach. Looking at the underlying investments, Vanguard's strategy is not presently designed to 'beat the market' – the underlying assets are simply trying to generate a return in line with some large indexes (think the S&P/ASX 300 Index).

AustralianSuper, on the other hand, tries to beat the market – it uses an 'active' approach. Beating the market is tough, but to date, it has been successful across a number of asset classes.

Still, at the launch of the Super product, Vanguard was on the record as saying that it wouldn't rule out adding active or unlisted strategies in the future once it has scale and liquidity. Only time will tell how Vanguard's investment strategy will evolve, and we will monitor this closely.

How much will it cost?

Fees can't be ignored – a higher fee burden makes outperformance more challenging. Exhibit 6 shows that Vanguard is true to label in delivering a low-cost investment option compared with AustralianSuper when it comes to investment fees. Fees shouldn't be viewed in isolation though – understanding the net returns delivered for the fees charged and making a judgment call as to whether that is possible in the future is key.

Administration fees and costs are the other big focus when it comes to comparing options. The value proposition can vary – members value different services, including access to particular investment options; ongoing reporting; insurance; investor education, and investor support. In the case of AustralianSuper – for an investor with $50,000, you will pay $102 each year (or 0.20% per annum) to be a member of AustralianSuper. By comparison, Vanguard Super charges the same investor $175. At this point, AustralianSuper has a significant scale advantage, and when it comes to lower administration fees, scale counts. Although, if Vanguard is true to form, it will pass these scale benefits through to investors as the product grows. Vanguard has a strong record of doing this on the investment side.

Exhibit 6: Fees and costs each year – administration and investment

	Vanguard Lifecycle Options	AustralianSuper High Growth Option	AustralianSuper Stable Option
Administration Fees*	0.30%	0.10%	0.10%
Other Administration Fees	0.05%		
Dollar-based Administrative Fees ($52 / $50,000)		0.10%	0.10%
Subtotal - administration	0.35%	0.20%	0.20%
Investment Fees and Costs	0.21%	0.36%	0.32%
Performance Fees		0.12%	0.03%
Transactions Costs	0.02%	0.16%	0.17%
Subtotal – investment-related	0.23%	0.64%	0.52%
Total – Administration and Investment Fees and Costs	**0.58%**	**0.84%**	**0.72%**
Cost of product - based on a $50,000 investment	**$290**	**$422**	**$362**

**This 0.30% administration fee is not charged on the portion of your account balance in excess of AUD 850,000. Source: Morningstar, Vanguard, AustralianSuper as at 31 December 2022.*

Performance

While Vanguard clearly states that its Lifecycle product is new and there is no performance track record available, let's use the Vanguard High Growth Index Fund and the Vanguard Balanced Index Fund as reasonable proxies – the investment mix looks very similar to the Vanguard Lifecycle Age 47 And Under Option and the Vanguard Lifecycle Age 64 Option, noting that Vanguard has included some ethical exclusions in its super offering.

We all know that past performance is not a guide to future performance, although as far as declaring 'success', long-term returns are an important yardstick. And ultimately, net returns are what are most important to investors. So, how do the options stack up? When it comes to the High Growth Options – AustralianSuper has it over Vanguard in terms of net returns over the long term. But the returns from both strategies are strong –

beating both the Morningstar benchmark and the category average over 10 years. In terms of the AustralianSuper Stable versus Vanguard Balanced, AustralianSuper has certainly recouped lost ground in the last three years, although it is still lagging Vanguard over the 10-year time frame. As highlighted earlier, AustralianSuper does move the mix of growth and defensive assets reasonably actively which will play role in its performance at any point in time.

Exhibit 7: Performance returns - 31 December 2022

	3-year return (% p.a.)	5-year return (% p.a.)	10-year return (% p.a.)
AustralianSuper High Growth Option	5.6	7.1	9.7
Vanguard High Growth Index Fund	4.3	6.5	9.5
Morningstar Benchmark* - Multisector Aggressive	4.3	6.5	9.4
Morningstar Category - Multisector Aggressive	4.8	5.9	8.2
AustralianSuper Stable Option	1.9	3.5	5.2
Vanguard Balanced Index Fund	0.8	3.5	6.3
Morningstar Benchmark^ - Multisector Balanced	1.3	3.8	6.1
Category - Multisector Balanced	2.0	3.4	5.4

*Source: Morningstar Investor. *Morningstar AUS Agg Tgt Alloc NR AUD. ^Morningstar AUS Balanced Tgt Alloc NR AUD. The AustralianSuper Options' performance returns are subject to the impact of taxes and franking credits inside the superannuation environment. There were no available Vanguard comparisons inside a superannuation taxation environment.*

Who Is winning the war?

Who's winning the super war here? AustralianSuper and Vanguard are investment powerhouses, and both offerings are compelling. The arrival of Vanguard Super feels very much 'game on' in the super wars, and we will watch with interest to see how they scale, set the standard in terms of attractive fee levels for investors, and evolve their investment strategy. What will be really interesting to watch in the next three years, though, is how these two bridge the advice and education gap for investors and offer more-holistic solutions than purely administration and investment. Ultimately, investors will be best served by not only great investment solutions but also a provider who can build a complete picture of their financial situation to help them achieve financial security in retirement. T-pension, investments outside of super, and more are taken into account. Surely these two dynamos can set the standard on this front, and hopefully, the end beneficiaries will be the investors.

Annika Bradley is Morningstar Australasia's Director of Manager Research ratings. Firstlinks is owned by [Morningstar](). This article is general information and does not consider the circumstances of any investor. This article was originally published by Morningstar.

Reports of tech's death are greatly exaggerated

Andrew Macken

The launch of ChatGPT has sparked fresh interest in the massive potential of technology to continue to revolutionise our lives. The chatbot, developed by Microsoft-backed OpenAI has wowed people with its ability to use machine learning to produce human-like answers and content to questions.

After the extraordinary decline in technology stocks witnessed in 2022, many investors have been asking: is tech dead? But as ChatGPT has shown, far from dying, tech is set to enter a new era of growth, dominance, and profitability.

The 2022 downturn will lead to even higher future earnings than previously forecast because cost-cutting at tech companies will deliver higher future profit margins. Yet, perhaps most importantly, tech stocks will benefit from transformational waves of tech innovation, particularly in the field of ChatGPT-style AI.

The extraordinary price falls of many long-term-winning tech companies – including five we highlight below – mean investors can buy high-quality, reliably growing earnings streams cheaply.

How tech came to dominate the economy

The tech sector has grown more rapidly than any other sector over the past four decades as it has penetrated more and more parts of the global economy.

That growth has also come with far superior profit margins, a powerful combination that has seen tech deliver an increasing share of US corporate profits, which has flowed through to strong investment returns – even when the extraordinary stock price declines of 2022 are included.

Many of today's tech leaders continue to show faster-than-average revenue growth and higher-than-average incremental profit margins. For example, the two largest players in cloud computing, Amazon (owner of AWS) and Microsoft (owner of Azure), are growing their cloud businesses by more than 20% per annum. These rates of growth are obviously well above the average growth rate of the broader economy – and are expected to continue, albeit with some moderation in the current environment, given the early phase of cloud adoption we are in today.

Montaka estimates the incremental operating profit margin of cloud computing in Western markets to be 30-40% over the long-term. This level of profitability on future growth is also far above the average levels of profitability found in the broader economy.

And it's not just the hyperscalers.

Montaka estimates that the incremental operating profit margins of the world's leading (and entrenched) enterprise software-as-a-service businesses (SaaS), such as Salesforce and ServiceNow, are also north of 30%.

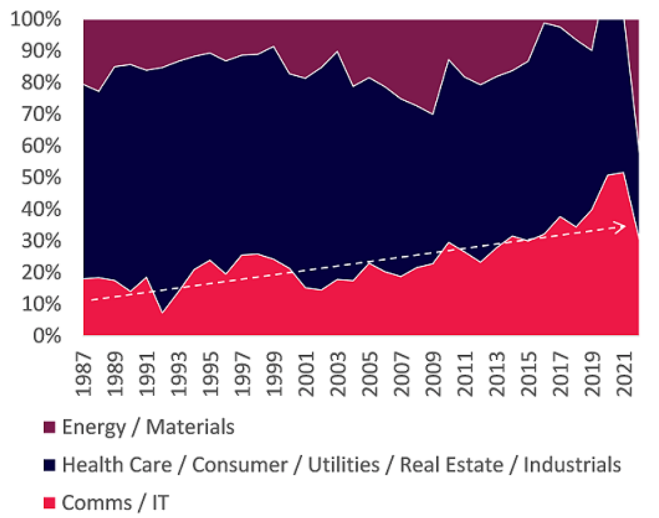
Moore's Law: Why tech's remarkable growth will endure

The aggregated tech sector is clearly growing at above-average rates of growth. And there are important reasons why this trend will continue as technology continues to expand into all walks of life.

The core enabler of this proliferation has been a powerful force: a huge increase in computing power at a rapidly declining cost. In tech circles, this dynamic is known as Moore's Law and it describes how the number of transistors on a silicon chip – that is, the fundamental building blocks of compute – increases by approximately 10x every seven years.

Share of Aggregate Operating Profits*

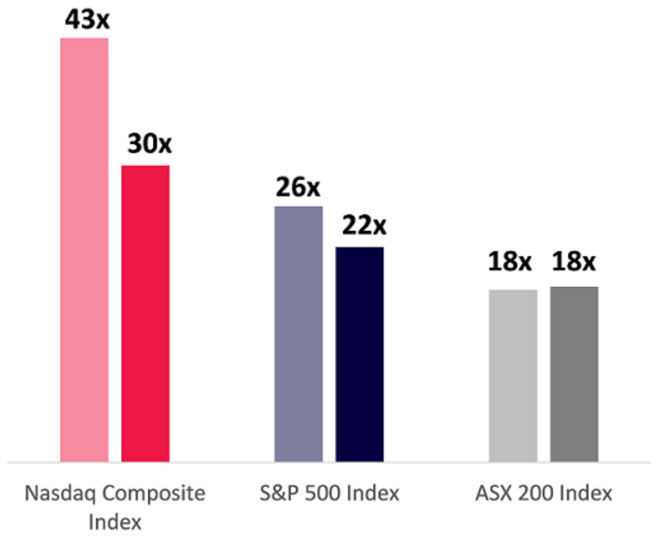
Percent



* Based on the aggregation of the largest 3k publicly-listed, US-domiciled, non-financial companies
Source: Bloomberg; Montaka Analysis

Comparison of Historical Returns (since Jan-1990)

LHS: Total Shareholder Return to **January 2022**
RHS: Total Shareholder Return to **January 2023**



Source: Bloomberg

Investing legend and Sequoia Capital Chairperson, Mike Moritz, observed in the mid-1990s that, if Moore's Law continued to hold – and computing power continued to become exponentially cheaper – then the markets that tech can penetrate should keep getting larger and larger.

And certainly, this has been the case. The investment returns from this one insight alone have been staggering.

Today, breakthroughs in chip design – from proven forms of accelerated computing to several prospective forms of unconventional computing – are paving the way for Moore's Law to continue.

At the same time, we are on the cusp of the next transformational wave that will accelerate tech proliferation even further: artificial intelligence (AI).

AI: the next transformational wave

AI will recast and refashion every aspect of life: how we consume, how we work, how we monitor industrial machines, how we deliver healthcare, how wars are won, and how we solve climate change.

Not only is software eating the world, but it is becoming a lot smarter at an accelerating rate and will continue to do so.

Why? Because of AI – and more specifically, machine learning (ML), the most common and practically applicable subset of AI today.

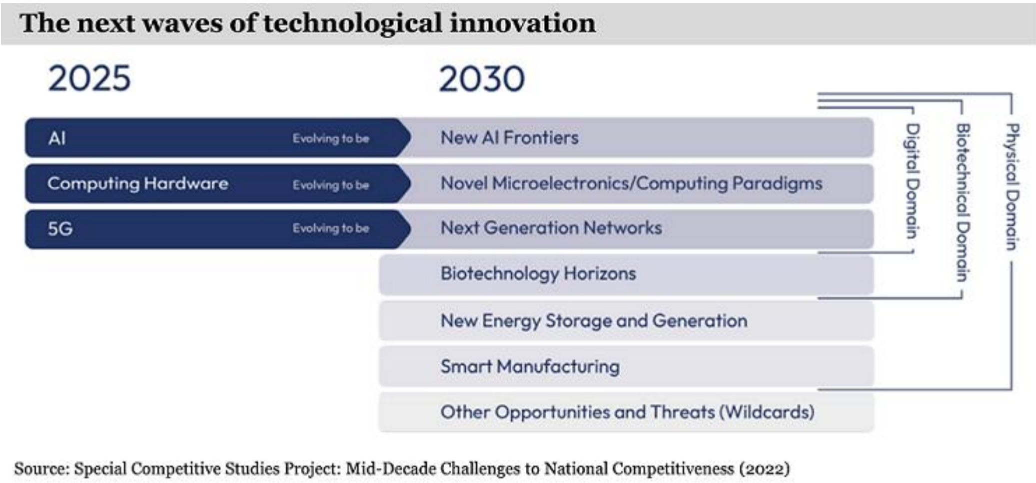
Think of Google's predictive text in Search or Gmail, or its facial recognition in Photos; Tesla's autonomous driving; or OpenAI's ChatGPT[1] natural language model, which is generating billions of words per day in human-like sentences and paragraphs.

In 2022, several text-to-image creation tools have been unveiled, such as DALL.E-2, Midjourney, and Stability AI[2], as well as extraordinary new text-to-video creation tools, from the likes of Meta.[3]

Furthermore, large language models are expected to change the way humans interact with their technology. Increasingly, users will employ natural language (everyday language) to have an ongoing 'dialogue' with their technology so they can tailor it to specific uses.

Large language models have started to unlock extraordinary new uses of technology, such as automated content generation for corporate marketing teams[4], automated document review and processing, and even search, all at very low marginal costs.

Over the coming decade, it is highly likely that AI will be the key enabler of most future waves of tech innovation. In a recent 189-page submission to the US Congress, the Special Competitive Studies Project, which is chaired by former Google CEO Eric Schmidt, identified the major areas of tech innovation, looking out to 2030.



Big investment opportunities in tech today

Far from calling the 'death' of tech, the extraordinary price drawdowns of certain long-term winning tech companies are providing investors with remarkable investment opportunities – just as they did after the 2000/01 dot-com crash and the global financial crisis (GFC) of 2008.

Of course, not all tech companies have long-term durable advantages and investors need to be selective. But when we examine leading businesses, they combine huge growth opportunities with cheap valuations.

Stock price drawdowns from prior 2-year high

	Current	GFC	Dot Com Crash
Amazon	-56%	-64%	-93%
Microsoft	-35%	-59%	-65%
Alphabet	-43%	-65%	NA
Salesforce	-59%	-70%	NA
Spotify	-77%	NA	NA

Source: Bloomberg

Short-term macro headwinds have compressed valuation 'multiples' in the year of 2022. But we know that in the long run, equity returns are dominated by earnings growth, not changes in multiples. And our analysis leads us to place a high probability on the scale and reliability of the future earnings growth of selected, advantaged tech winners.

Tech is not dead. We believe the 2022 sell off in tech represents a significant investment opportunity.

To request a copy of the whitepaper: ***Why reports of tech's death are greatly exaggerated***, click here (name and email address required).

Andrew Macken is the Chief Investment Officer at Montaka Global Investments, a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation.

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[1] WSJ: ChatGPT Creator Is Talking to Investors About Selling Shares at $29 Billion Valuation (January 2023)
[2] The Verge: Stability AI, proponent of hands-off AI image generation, gets a $1 billion valuation (October 2022)
[3] The Verge: Meta's new text-to-video AI generator is like DALL-E for video (September 2022)
[4] (TechCrunch) AI content platform Jasper raises $125M at a $1.5B valuation (October 2022)

Not all private markets are 'volatility laundering'

Simon Petris Ph D

The discrepancy between private and public market valuations has been a topic of discussion recently due to the impact of rising risk-free rates. The argument is that private assets, which are long-term and mostly illiquid, may find it challenging to maintain their high valuations as risk-free rates increase. This issue is particularly relevant to superannuation fund performance comparisons because over recent years, superannuation funds have been increasing their allocations to private assets to diversify their portfolios and potentially generate higher returns.

One of the fundamental differences between private and public markets is that there is only ever a finite amount of any private asset, and it is almost impossible to create more exposure to it synthetically via derivatives. The lack of synthetic exposure in private markets makes it impossible for traders to go short and profit from falling valuations in the future. Investors in private markets who are dissatisfied with an asset's valuation have limited options, as they can only choose not to invest and wait for another opportunity.

On the other hand, public markets offer more flexibility with the availability of index and derivative markets, as well as shorting, which is a common strategy used by hedge funds and macro traders to generate returns. However the use of shorting can lead to increased price volatility in public markets and may not effectively address the underlying issue of misaligned asset valuations.

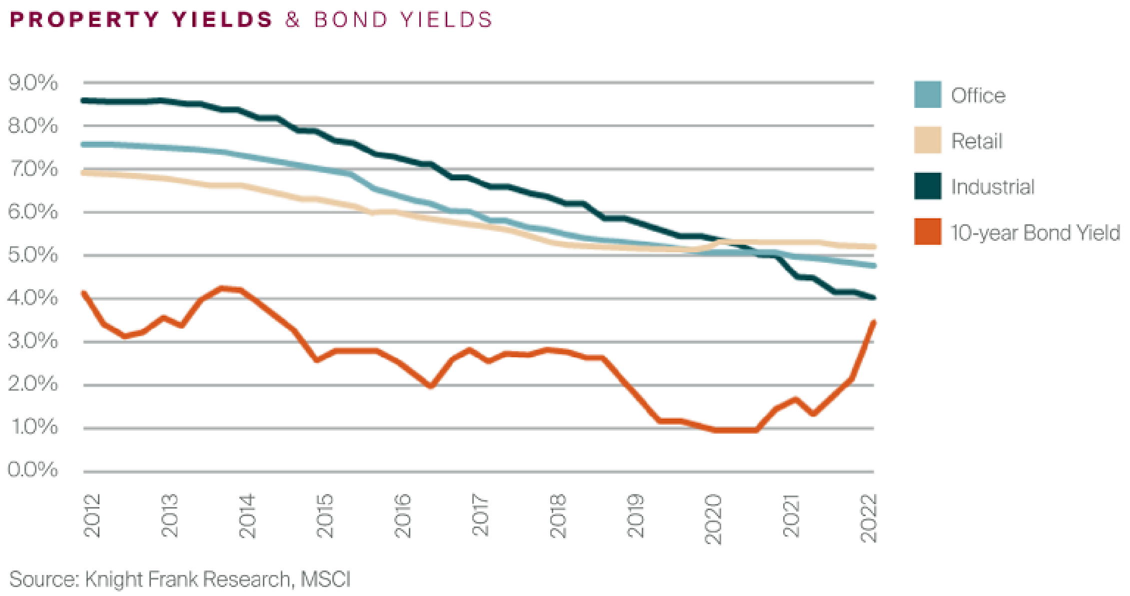
Cliff Asness, the founder of AQR, a quantitative investment firm, has been an outspoken critic of the misaligned valuations in private markets. In his article "*Why Does Private Equity Get to Play Make-Believe With Prices?*", he coined the term "volatility laundering" to describe the underestimation of risk in private equity. While there is merit to Asness' views, it is important to recognise the different impacts of rising rates on various sub-sectors within private markets. Each sub-sector may have a unique effect, and it's essential to differentiate between them for a clearer understanding of the situation.

Commercial property

Commercial property equity tends to decline in value when interest rates rise due to the use of leverage in these investments (usually between 30% to 70%). The increased cost of debt results in lower valuations or capitalisation rates. But, inflation can also lead to higher lease rates, although it is uncertain how much this will offset the impact of higher leverage costs.

In calendar year 2022, the Australian Prudential Regulation Authority (APRA) took note of commercial property valuations as there was a significant discrepancy in the performance between listed funds (~minus 20%) and unlisted funds (~positive 19%), according to data from the Property Council of Australia.

One major challenge with commercial property investments is that capitalisation rates, which are a key determinant of the asset's value, are typically only reset when a sufficient number of comparable transactions have taken place. If investors can achieve similar yields from risk free 10-year government bonds, this should not be comparable to the capitalisation rate for a real estate equity investment, as shown in the chart below. This disparity between the yields from different types of investments is currently causing concern among investors and regulators.



There is a compelling argument that, if a similar portfolio is available, investors should sell unlisted property at outdated capitalisation rates and switch to listed property.

Infrastructure equity and debt

Infrastructure equity is typically highly leveraged, which means it receives the majority of the upside from the underlying asset. The equity valuation is usually modelled based on long-term cashflows over a period of 30 years or more. However, there is often some form of inflation protection in the underlying asset, which can partially offset the impact of rising rates.

On the other hand, infrastructure debt is typically long-dated and fixed rate, which matches the underlying asset, but does not generally benefit from inflation protection in the underlying asset. The long tenors of both infrastructure equity and debt make their valuations highly sensitive to interest rates and discounting effects, which can impact their overall value.

Venture capital

Venture Capital is arguably the largest casualty of higher interest rates, because the companies in which they invest are often pre-profitability and derive much of their value from long-dated future cashflows that are less valuable due to discounting effects. In 2021, revenue multiples for venture-backed funding rounds reached as high as 100x Annual Recurring Revenue (ARR), but have since dropped to as low as 5x, in line with publicly traded peers. One of the key challenges with venture capital is that valuations are typically only adjusted after each new funding round, which means that outdated valuations can persist for long periods if a company does not need to access new capital in the short term.

Private equity

Private equity involves the acquisition of a majority stake in a privately held company that they believe to be undervalued by the public markets or the current owner. The goal of private equity firms is to improve the company's performance and profitability through restructuring, growth initiatives and value creation. Once these improvements have been made, the private equity firm can sell the company or its shares through an IPO or other exit strategy in order to realise a profit.

Given that the ultimate goal of private equity is an IPO or trade sale, the reduced valuation multiples in public markets can impact private equity investment, even if the forecast earnings growth is achieved. Private equity funds are typically ten years or longer closed-end funds, which makes it quite complicated to switch into listed equities even if the valuation gap is significant. The growth of the secondary market for private equity funds is expected to help address this issue in the future. Additionally, private equity investments are often made in undervalued and less popular companies, which usually have lower starting multiples, so the impact of multiple contraction may be lower compared to venture capital.

Private debt

Private debt has many characteristics that make it less sensitive to interest rates compared to the private markets sub-sectors discussed above. Firstly, all private debt investments have a legal final maturity date when the original principal borrowed must be repaid at par – they do not rely on the discretion of the manager to sell the investment at a future uncertain date for an uncertain valuation multiple.

Private debt is almost always floating rate in nature, which means that the absolute return increases in yield in line with higher interest rates. Private debt generally has a short credit duration, between one to three years, which means that upon rollover of the existing loans, the prevailing market credit spreads are negotiated into new loan agreements. While the credit spreads do move wider with overall risk sentiment, there is a natural margin cap where borrowing no longer makes sense for equity investors, and a natural floor below which investors will refuse to lend.

Switching between public and private debt is not a straightforward process, especially in the domestic market, as the debt structure of a privately owned company often carries higher leverage and credit margin when it is privately held, and these tend to be reduced when the company goes public. Additionally, there is limited liquidity in the secondary market for private debt investments, as they are normally held until maturity, making it necessary to build a diversified portfolio patiently over time through primary markets.

Summary

Private markets are susceptible to rising interest rates, but the impact varies depending on the specific sub-sector and the duration of the private asset. If the asset has a short duration and its value is realised by a hard-dated maturity, its overall sensitivity to higher rates is relatively low. On the other hand, if the asset has a long duration and the manager has absolute discretion over the investment timeline, its sensitivity to rates is much higher.

Not all private markets can be characterised as "volatility laundering”. The term typically refers to the practice of transferring risk from the public markets to the private markets, where regulations are less strict, and transparency is limited. While some private markets may provide more stability compared to public markets, it is not accurate to categorise all private markets as "volatility laundering”. It depends on the specific characteristics and risks associated with each private market investment.

Simon Petris Ph.D. is Executive Director and Senior Portfolio Manager at Revolution Asset Management (ACN 623 140 607 AFSL 507353), a Channel Capital partner. Channel Capital is a sponsor of Firstlinks. This information is not advice or a recommendation in relation to purchasing or selling particular assets. It does not take into account any individual's investment objectives or needs.

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Prepare for the shifting sands in personal taxation

Rodney Brown

Around this time three years ago I warned investors to brace themselves for bad news regarding potential tax and superannuation reforms as those areas were likely targets for the Government in the wake of the debt increase caused by the response to the pandemic. None of those reform options came to fruition (“thankfully” I hear you gasp!).

Since then, the Labor Party adopted a ‘policy light’ stance on tax and superannuation into the 2022 federal election probably due to its heavy defeat at the 2019 election where it sought to, among other things, implement limits on negative gearing, halve the capital gains tax discount from 50% to 25%, and eliminate the refundability of franking credits.

Furthermore, the October 2022 Budget was again light on tax reforms and changes to superannuation but, as NAB Group Economics noted:

> *"while this budget does little to address medium-term structural budget issues, it does lay the groundwork for the government to seek to address these challenges more actively in the future."*

On the back of recent developments, and the fact Treasurer Jim Chalmers is keen to stamp his mark by *"building something better, more meaningful and more inclusive"*, I think the sands may be shifting.

Potential tax changes

Last month, in its annual review of Australia, the IMF suggested comprehensive medium-term tax reform is needed to meet higher structural spending needs and to support economic efficiency and growth. The IMF recommended the government may need to:

1. Reassess the stage three tax cuts given they limit the pace of budget consolidation
2. Broaden the GST by limiting exemptions (e.g., healthcare) to rebalance from currently high direct to underutilised indirect taxes
3. Restrict the capital gains tax exemption on the sale of main residences (family home) due to this exemption costing 2.5% of GDP and to make the tax system more efficient and equitable
4. At the state and territory level, replace stamp duties with recurring property taxes to promote housing affordability and a more efficient use of the housing stock and provide a more stable tax base.

The last option is underway in some form in certain states and territories (NSW and ACT). However, while the cost in terms of revenue forgone in 2021 was about $64 billion, the third option is highly unlikely to ever be implemented in Australia. Taxing the family home is simply too controversial.

From a political perspective, the second option, although underpinned by strong arguments on efficiency, equity and simplicity grounds, is unlikely to be implemented in the near term given successive government reluctance to change the GST.

However, momentum has gathered for the first option over the past 12 months and the fight to scrap them is heating up in parliament. Regarding this recommendation, the IMF said:

> *"Stage three of the personal income tax (PIT) reforms legislated in 2018 is projected to lower tax receipts by around 1 percent of GDP annually starting in FY2024/25, partially offset by gains from bracket creep during ensuing years." and…*

> *"The stage 3 personal income tax cuts will reduce the personal income tax burden. With the cuts taking effect from FY2024/25, there would be time, if needed, to re-assess the parameters to appropriately balance costs on the budget and benefits to the economy. Addressing bracket creep in PIT by raising the tax brackets periodically will limit distributional implications, including for low-income households and women."*

As a reminder, the stage three tax cuts will result in the following rates and thresholds from the 2024-25 income year.

Rates from 2024-25	New thresholds from 2024-25
Nil	Up to $18,200
19 per cent	$18,201 – $45,000
30 per cent	$45,001 – $200,000
45 per cent	Above $200,000

In the lead up to the October 2022 federal Budget, Jim Chalmers announced the cost of the stage three tax cuts has blown out by $11 billion to $254 billion over 10 years. So, Labor is now between a rock and a hard place since it went into the 2022 federal election promising not to change the tax cuts and did not tinker with them in the October Budget. However, commenting on the IMF's report, Jim Chalmers gave conflicting messages when he said:

> *"The point that the IMF is making is that when we've got these pressures on the budget … we need to make sure that we've got the tax system that can sustain the funding that we want to see in our areas of national priority" and…*

> *"If there are avenues for responsible tax reform into the future, like what we are doing in multinationals, then obviously those opportunities and avenues should be explored"*

Followed by:

"We listen respectfully when those kinds of suggestions are made to us, but the government's approach to the stage 3 tax cuts hasn't changed. We've got other priorities in the budget. You will see them in May."

So, the jury is out on whether the stage three tax cuts are at risk, but the IMF has effectively given the green light for the government to overhaul them.

Super changes show the need to be prepared

The announcements this week on the Government's intention to legislate an objective of superannuation is a sign of moves to come. The proposed definition is:

"to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way."

It makes clear that superannuation is not a tax minimisation vehicle or a pot for later generations, as it must:

"to provide universal savings that are then drawn down in retirement to deliver income that support retirees' standards of living. The focus on delivering income makes clear that the purpose of superannuation is not for minimising tax on wealth accumulation or enabling retirees to leave tax-effective bequests."

The Government has admitted this objective is background to introducing a cap of the amount of superannuation allowed per person.

The zeitgeist has changed and investors can expect some changes to the current taxation settings in the Budget as well. However, I suspect that, given the political cycle, they will not be significant but rather lay a platform to be followed by an in-depth holistic review of Australia's taxation systems leading to a more comprehensive platform of reform prior to the next federal election.

Dr Rodney Brown is a Senior Lecturer at the School of Accounting, Auditing & Taxation at UNSW Business School. This article is for general information only, as it does not consider the circumstances of any individual.

Two steps forward, one step back for investors

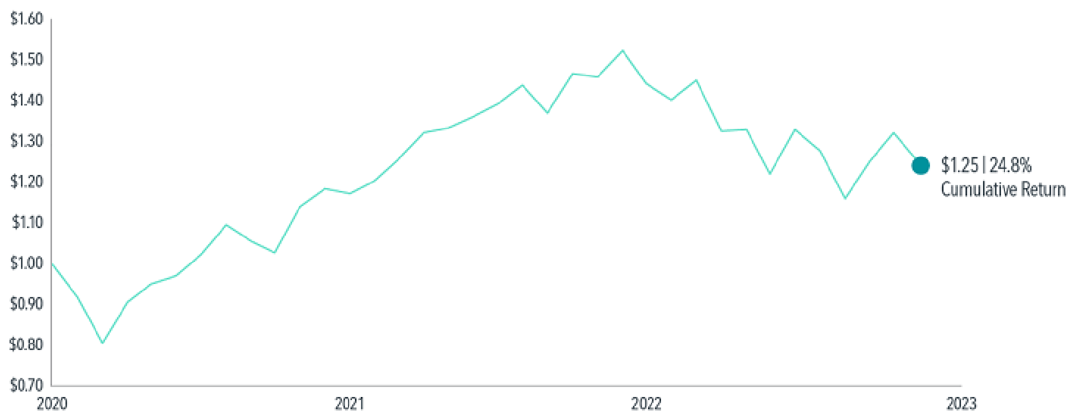
David Booth

Consider everything investors have been through in recent years: a global pandemic, rapid inflation, war in Europe, and volatile stock and bond markets. It's reasonable to feel uneasy in the face of so much uncertainty.

Now imagine it's the end of 2019 and you know what you know now. You're asked to predict market returns over the next three years. Will stocks be up 25%? Flat? Down 25%?

Exhibit 1: Big Picture

Growth of $1 invested in S&P 500, January 1, 2020–December 31, 2022



As you can see in Exhibit 1, the market was up almost 25% from 2020 through 2022.[1] That includes last year's 19% decline. Too often, people look only at year-by-year returns and don't look at the total history of returns, which can be informative.

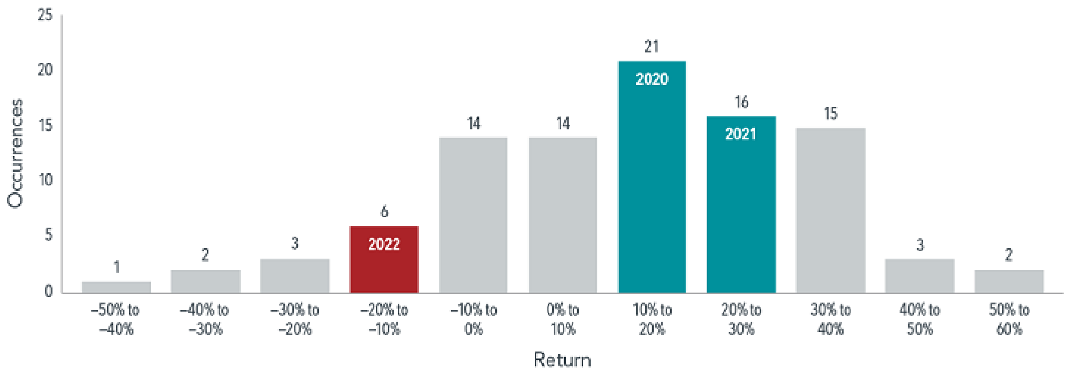
Exhibit 2: Distribution of Returns

Distribution of calendar-year S&P 500 returns, 1926–2022

We now have 97 years of research-quality data on stock returns. Exhibit 2 shows the distribution of annual returns over that time period, ranging from a year when the market lost almost 50% to two years when it gained more than 50%. The bulk of the returns are between −10% and +40%. When you look at a histogram like this, you get a sense of the distribution of returns, rather than a forecast of what any year's return will be. The best prediction of what will happen next year is a random draw from one of these 97 years.

Exhibit 3: Two Up, One Down

Distribution of calendar-year S&P 500 returns, 1926–2022



The past three years have been 'normal'

Let's look more closely at the past three years. In Exhibit 3, the returns from 2020 and 2021 were positive, with 2022 negative. These three years to me seem representative of the history of stock returns: two steps forward and one step back. Two positive years and one negative. That's about the way the world works.

But how do we explain the stock returns of these last three years, given the stress that people have felt with the pandemic? I think of it in terms of ingenuity and flexibility bailing us out. What happens when companies or individuals get hit with bad news? We don't just sit there and take it—we try to figure out how to get back on track. That's what happened here. The pandemic hit and markets dropped 20%.[2] Then human ingenuity kicked in by the end of the year. We had a vaccine and started distributing it at incredible speed. That innovation continued as businesses adjusted into the next year.

Exhibit 4: In Line with History

Annualized Returns			
	S&P 500 Index	1-Month T-Bill	Equity Risk Premium S&P 500 Index minus T-Bill
1926–2019	10.20%	3.32%	6.88%
2020–2022	7.66%	0.64%	7.02%
1926–2022	10.12%	3.24%	6.88%

Let's look at how the last three years compare with the previous 94. Exhibit 4 shows the returns on the S&P 500 index and US Treasury bills over the last 97 years. The first row is the 94-year period of 1926–2019. The S&P 500 index compounded at 10.2% per year. Treasury bills, which we think of as being the riskless asset, compounded at 3.32%.[3] We think of the difference between 10.2 and 3.32, which is 6.88 percentage points, as the reward for taking the stock market risk. So that's the equity risk premium, almost 7% a year.

The next row shows the last three years. The S&P 500 compounded at 7.66%. Treasury bills were basically flat (0.64%). The difference between those two is also about 7%—7.02 percentage points. So, for the last three years, the risk premium of 7% a year is almost precisely what it had been the previous 94, about 7% a year.

In other words, the last three years in terms of equity returns have been 'normal'.

How best to prepare for the future

How can we explain normal returns when it seemed to some people that the world was falling apart? Think of public financial markets as a giant information-processing machine. When bad news comes in, prices drop. When good news comes in, prices rise. The stock market every day is trying to set prices to induce investors to come in to invest. If the stock market had a negative expected outcome, nobody would invest. The stock market is constantly adjusting prices so that investors have a positive expected outcome.

One of the most important principles of investing is being a long-term investor with an investment plan you can stick with. The stock market will go up and down. It always has; it always will. If during this three-year period you felt like you had to bail out of stocks for some reason, then you had probably invested too much in stocks to begin with. But if you had about the right amount, for you, invested in stocks, there was a good chance that you didn't have to make any adjustments to your portfolio mix.

What will happen over the next three years? Who knows? The good news is, if you've planned for the range of outcomes, you won't have to worry about relying on a prediction.

Footnotes

[1]In US dollars. S&P 500 Index annual returns 2020–2022. S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.
[2]S&P data © 2023 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Indices are not available for direct investment. Index returns are not representative of actual portfolios and do not reflect costs and fees associated with an actual investment. Decrease of 19.6% was from Jan. 1, 2020, to March 31, 2020.
[3]One-month Treasury bill data provided by Morningstar.

David Booth is a US businessman, investor and philanthropist. He is also the Chairman and founder of global asset management firm Dimensional Fund Advisors. This article provides general information only. It does not constitute investment advice, a recommendation, or an offer of any services or products for sale and is not intended to provide a sufficient basis on which to make an investment decision. Before acting on any information in this document, you should consider whether it is appropriate for your particular circumstances and, if appropriate, seek professional advice.

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