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Contents

The when and why of four million Australian retirees *Graham Hand*

Questions remain on legislating the objective of superannuation *Emma Higgs*

Thornhill on shares for investment income in retirement *James Gruber with Peter Thornhill*

Three reasons why optimism pays for investors *Shane Oliver*

Podcast: lessons from a decade of patient investing *James Gruber*

Has passive investing killed small caps? *Joseph Constable*

Australia isn't ageing as quickly as the Government says *David Knox*

Editorial

There is almost universal acceptance of the need to define an objective of superannuation, and after a decade of delays, it is finally happening. The 2014 **Financial System Inquiry** (FSI) kicked off the process and the Government is again seeking comments on the draft legislation for the *Superannuation (Objective) Bill 2023.* However, there is a sting in the tail, especially for large balances.

The FSI's original wording was simple:

> "*to provide income in retirement to substitute or supplement the age pension*"

Then the 2020 **Retirement Income Review** went further, suggesting:

> "*to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way*"

This introduced greater aspiration and guidance, not only focusing on the income of the retiree, but that the system as a whole should be '*equitable, sustainable and cohesive'.*

The 2023 version continues this expansion, with several critical components open to interpretation.

> The objective of superannuation is to **preserve savings** to **deliver income** for a **dignified** retirement, alongside **government support**, in an **equitable and sustainable** way.

The words will mean different things to different people. 'Dignified' and 'equitable' should not be equated to everyone receiving the same. The role of superannuation is a deliver some smoothing to lifetime consumption, removing income from early years and adding it later. It should be replacement income for retirement years, and each person will have their own replacement rate to maintain their living standards. The more someone earns and saves in their working life, the more they will have in retirement. Equitable is not equal.

What is clear is that the Government intends the objective to guide future policies.

> *"The draft legislation ensures that future changes to the superannuation system are compatible with its objective by requiring policy-makers to assess proposed changes to super legislation for compatibility with the objective."*

The industry is hoping that this somehow means the objective will provide stability and confidence in the superannuation system, which is often criticised for its continuous changes. In fact, the objective opens doors for further amendments.

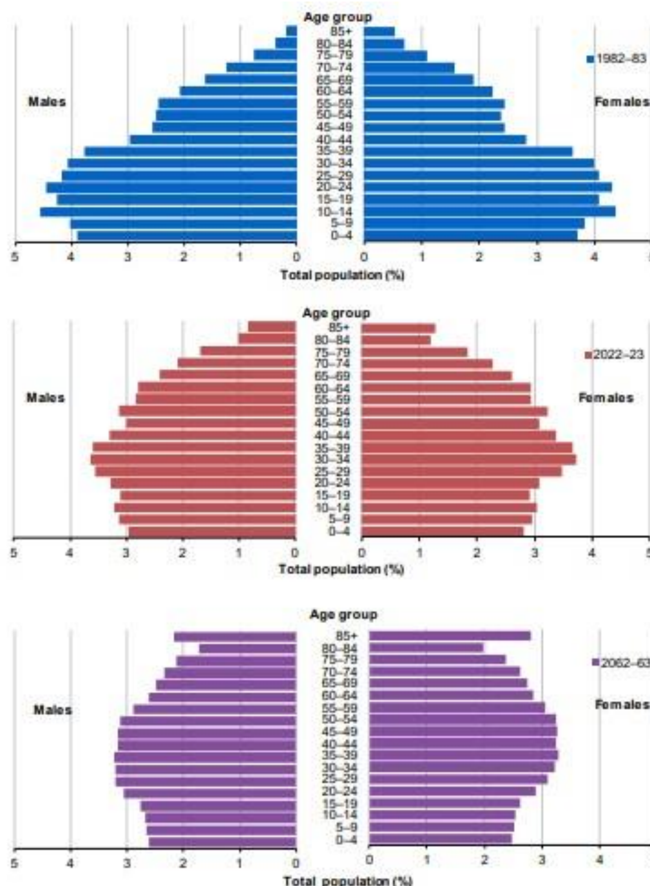
If future superannuation policies are framed by what the government of the day considers equitable and sustainable, then any treasurer can judge that a concession is no longer appropriate due to budget demands. This is recognised, for example, in **AustralianSuper**'s submission in February 2023:

> *"The proposal will increase equity in rebalancing superannuation tax concessions toward low and middle income earners. At high balance levels, it becomes appropriate to compare the tax status of superannuation accounts with the tax payable by individuals who use other investment vehicles."*

The super fund also says that the (February) discussion paper notes that an equitable superannuation system "*targets support to those most in need*".

'Sustainable' will be challenged by the needs of an ageing population and increasing demands on health, pensions and super concessions. This chart from the Intergenerational Report shows the dramatic changes in the ages of Australians, from a country with a bulge up to the age of 34 in 1983. Many of those people are now in their 60s and 70s and the bulge moves up the age groups over the years, with a significant new top of people over 85 expected in coming decades.

Australian age structures in 1983, now and 2063 (e)



Source: ABS, National, state and territory population, September 2022, 2023; Treasury.

Far from giving the superannuation system the stability and certainty that everyone seems to assume will follow from the objective, it opens the way for further measures such as the additional tax on balances over $3 million.

Retirees with large superannuation balances should not be sanguine about the objective, and large balances may drift away from the super system. Advisers report many clients are already planning for the $3 million cap, especially due to the inclusion of unrealised capital gains. Maybe that's what the Government wants.

One person who is not as enamoured with the objective of superannuation as drafted is **Emma Higgs**, a Senior Associate with law firm **Mills Oakley**. Emma asks valid questions about what the objective is supposed to achieve.

The Government and its advisers need to recognise that this focus on superannuation for retirement income fails to adequately consider savings outside super and the role of the family home. There is a looming threat to millions of future retirees who will become caught in the rental market. The **Grattan Institute** estimates the proportion of people over the age of 65 who are homeowners will fall from 76% now to 57% by 2056, and housing policy is as important as superannuation in retirement.

My article this week drills into many of the reports and reviews issued by the Government in the last month to show when and why people retire, and how they invest in retirement.

If future policy will be guided by the need to *preserve savings*, how does this sit with recent improvements in the First Home Super Saver (FHSS) Scheme, which allows access to voluntary super contributions up to $50,000 to buy a first home? And how will it influence this suggestion? ...

Superannuation and the Voice

I have no intention of giving a personal opinion here on the referendum on the creation of an **Indigenous Voice to Parliament** so I simply quote this exchange on possible implications for superannuation. **ABC Podcasts** is running a series called 'The Voice Referendum Explained' with presenters **Fran Kelly** and **Carly**

Williams. In the first full episode on 23 August 2023, there is this exchange with **Tony McAvoy SC** who specialises in native title claims and is a strong supporter of the Yes vote.

Carly Williams: But people still want to know, how would this Voice work and what kinds of issues would it be advising on?

Fran Kelly: That's right, Carly, I still want to know that. Tony McAvoy is firmly in the Yes camp but he's also Australia's first Indigenous Senior Counsel and an experienced barrister and he was on the Referendum Working Group so I thought he'd be a good person to ask about the kinds of things the Voice could advise on.

Tony McAvoy: One of the ones that I like to point people to is the superannuation legislation and the fact that it has been known for a long time that Aboriginal people do not have the life expectancy of the rest of the community. And I know personally know many people, including people in my own family, who have died before they've been able to retire and so it's a common thing in the Aboriginal community that people work all their lives and never get to retire.

And we should have in this country a conversation about whether superannuation legislation should be amended to allow us to access our superannuation earlier. The Voice cannot tell the government what to do. I cannot tell the government that must do this, but I can say let's have this discussion, and you make the decision.

Fran Kelly: That was so interesting to me, Carly. I've never thought about the shorter life expectancy of Indigenous Australians in terms of are they living long enough to enjoy their superannuation, for instance? That's a pretty straight up and down equity issue right there, isn't it? But unless it's pointed out to policymakers, it just might not occur to anyone.

Carly Williams: Absolutely. So that's the sort of thing the Voice could look at.

My only comment is to note that a leading Indigenous Barrister and Senior Counsel, when asked to identify a subject that the Voice might advise on, chooses early access to superannuation.

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Each year, the ASX carries out an Australian Investor Study, and the 2023 Report includes an intriguing finding. The stockmarket falls by 20% or more at some stage in about one-third of years, and that is the price of access to long-term gains. It is therefore reassuring that the majority if investors, probably over 80%, expect to hang on for the long run in the face of a 20% fall. The challenge is whether this reflects actual not anticipated behaviour, especially with 40% adopting a 'wait-and-see' approach.

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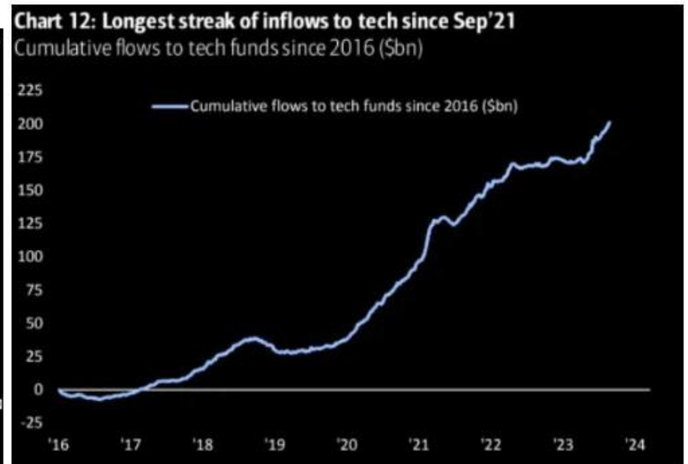
Two charts from the US show how relaxed investors are at the moment, despite rapid rises in rates and signs of more to come, and plenty of recession voices still issuing warnings. The so-called 'fear index', the VIX, is currently at its lowest level for many years.

And despite the rapid rise in the price of tech stocks, funds that offer tech exposure continue to receive strong investor flows, with the longest run of monthly net inflows since the heady days of liquidity-inspired and low rates in 2021. Yes, this is chasing recent winners, and US$200 billion into tech funds has done its fair share in pushing the market up further.

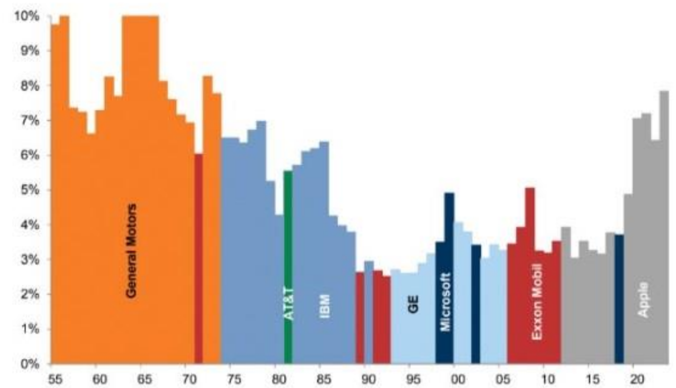
VIX: Lowest weekly close since 2019...

Source: Bloomberg



Source: BofA

It will not always be thus. This chart of the largest company in the S&P500 and its percentage share of the index shows how the sector determines the dominant company, and how it changes over time.



Source: Fortune 500, Datastream, Data compiled by Goldman Sachs Global Investment Research

Graham Hand

Also this week ...

It's the dream of many investors is to be able to live off the dividend income from their shares. Investment author and speaker, **Peter Thornhill**, offers a way to be able to achieve that, though it requires staying invested through down markets - something that's easier said than done.

It's a theme that **Ophir Asset Management's Andrew Mitchell** elaborates on in this week's ***Wealth of Experience*** podcast. Ophir is celebrating the 10-year anniversary of its Opportunities Fund and Andrew says a key lesson is that staying the course and not trying to time markets bring rich rewards. Also in the podcast, **Graham Hand** speaks about possible targets to address intergenerational inequity, and **Peter Warnes** gives a reporting season wrap.

AMP's Shane Oliver bemoans the pervasive negativity that surrounds investment commentary nowadays. He investigates why pessimism has such an allure and how investors need to resist it to be successful in markets.

It's no secret that large caps have trounced small caps over the past decade. **H&G's Joseph Constable** says passive investing has played a part, with surging investment flows into large caps regardless of price or value. He says it's only a matter of time before that turns around and small caps bounce back.

The Federal Government's Intergenerational Report says Australia is rapidly ageing and we need to be worried about what changes that may bring. **Mercer's David Knox** disagrees and believes the report used an outdated method to calculate our ageing population. Using a more realistic approach, he suggests that we have less to be concerned about, albeit reform is still needed.

Lastly, in this week's White Paper, **Pinnacle** affiliate, **Firetrail**, is also bullish on ASX small caps, and singles out some stocks that it likes.

Curated by James Gruber and Leisa Bell

The when and why of four million Australian retirees

Graham Hand

Older Australians might be feeling their creaky knees, stiff backs and failing eyesight, but one thing they should not feel is neglected by government departments and agencies studying their potential financial futures. The many reports and reviews issued recently are giving greater understanding about retirement and attempting to improve the outcomes for Australians living on their savings.

Over the next five years, according to the Australian Bureau of Statistics (ABS), 670,000 Australian intend to retire, taking the total number retired to almost five million. A check of how often the word 'retirement' is searched for on Google over the last 10 years shows a recent and sustained spike.

Australia is not alone in focussing on its ageing population. The World Health Organisation reports that by 2030, 1 in 6 people in the world will be aged 60 and over, a formidable 1.4 billion people or an increase of 400 million in 10 years. The number will exceed 2 billion by 2050, including 425 million aged 80 and over. We will live in a world where 100th birthdays are common.

The strong focus on retirement

For most of the time since the introduction of compulsory superannuation for more workers in 1992, and increasingly as retirement has become a major social and political issue, the focus has been on accumulation. The demographic shift underway has forced a rethink towards the retirement phase and decumulation.

In addition to the recent Intergenerational Report and Legislating the Objective of Superannuation, regulators ASIC and APRA completed a joint review of the implementation of the Retirement Income Covenant, issued in 2020. Registerable Superannuation Entities (RSE) need to develop strategies to assist their members to know how much they can spend in retirement, confirming that many people die with the bulk of the wealth they held at retirement intact. The regulators were highly critical:

"Overall, there was a lack of progress and insufficient urgency from RSE licensees in embracing the retirement income covenant to improve members' retirement outcomes."

So with this bombardment of insights and guidelines on how governments and the financial sector are supposed to meet the needs of retirees, we should know who they are and why they retired.

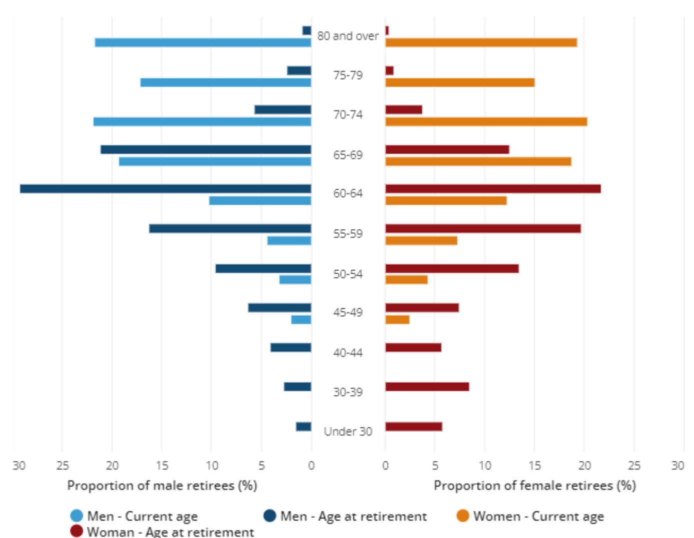
For this we turn to the ABS which has issued a new report on Retirement and Retirement Intentions, based on FY21 data.

When are Australians retiring?

The ABS estimates there are already 4.1 million retirees in Australia. In 2020, 140,000 people retired, with an average age of 64.3 years. The age pension remains the primary source of income for most retirees.

Graph 1 shows the age when people retired from the labour force (that is, ceased working or looking for work).

The chart shows the current age versus age at retirement of retirees. For example, there are far more retirees over the age of 70 than people retiring at that age. People are still alive but they retired



earlier. But in the age group 60 to 64, there are far more people retiring at that age. The average age at retirement is 65.4 for men and 63.7 for women.

Why are Australians retiring?

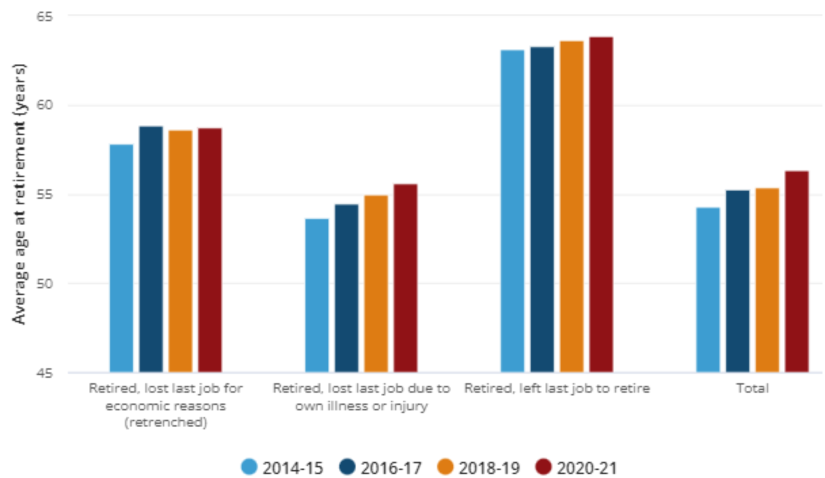
Retirement is a major change, giving up or losing regular income from work and relying on savings or a pension, but about 2,700 Australians a week take this step. The top three reasons for ceasing work are:

- Reached retirement age or eligible for superannuation (28%)
- Own sickness, injury or disability (13%)
- Retrenched, dismissed or no work available (7%).

Women were more likely to retire to care for a person than men (4% versus 2%).

Not surprisingly, the age of retirement of people retrenched, dismissed or injured is much lower than people who voluntarily retire. It shows thousands of people in their 50s 'retire' each year against their own choice. One-third of retired women rely on their partner's income after retirement, compared with only 7% of men.

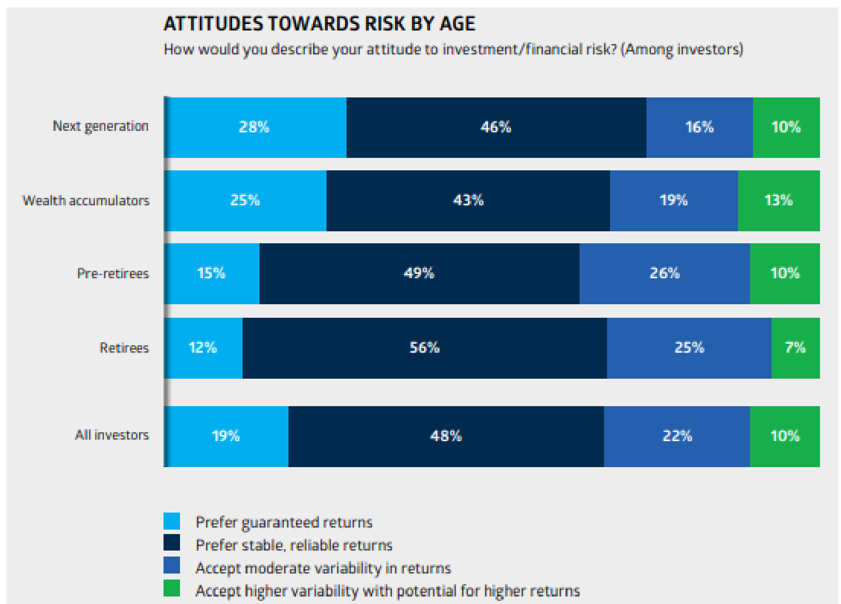
Graph 6 - Average age at retirement by reason ceased last job



- Lost last job for economic reasons (retrenched) includes people who were dismissed.
- Left last job to retire includes people who left their last job to coincide with their partner's retirement.

Investment risk by generation

Turning to another recent report, the Australian Securities Exchange (ASX) releases an annual Australian Investor Study. The 2023 Report says that 10.2 million people or 51% of the adult population hold investments outside their home and superannuation. Over the years, the ASX has increasingly focussed on generational differences, especially as more younger investors start their journey with listed securities.



As should be expected, the 2023 Report shows retirees are highest for seeking 'stable, reliable returns' and lowest for 'higher variability with potential for higher returns'. Retirees are also more likely than younger generations to hold a diversified portfolio.

SMSF members by age

A final check on SMSF usage by age from the latest ATO statistics (data for March 2023 is extrapolated from FY21). There were 606,000 SMSFs with 1,136,000 members, holding $890 billion.

Although there is much media coverage about younger generations opening SMSFs, only 3.1% of members are 34 years and under, although a strong 19.2% are aged 35 to 49. Which leaves 77.7% aged 50 and over, with high representation in all older age groups including 17.2% over the age of 75 and 11.9% between 70 and 74. It's clear that SMSFs are a popular superannuation vehicle for older Australians.

Table 6: Members, by gender and age range

Age ranges	Male	Female	Total
< 25	0.5%	0.5%	0.5%
25–34	2.6%	2.6%	2.6%
35–44	10.1%	10.7%	10.4%
45–49	8.6%	9.1%	8.8%
50–54	11.0%	11.8%	11.4%
55–59	11.7%	12.3%	12.0%
60–64	12.7%	13.2%	12.9%
65–69	12.0%	12.7%	12.3%
70–74	11.9%	11.9%	11.9%
75–84	15.3%	13.0%	14.2%
85+	3.7%	2.3%	3.0%
Total	100%	100%	100%
All ages	52.9%	47.1%	100%

The policy implications of these changes are profound, from the impact on government revenues, the demand for housing, the impending wealth transfer from baby boomers to their children, and the design of financial products for decumulation. Investors should factor demographic changes into assessing the future of any company.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information.

Questions remain on legislating the objective of superannuation

Emma Higgs

In February 2023, the Government released a consultation paper initiating public consultation on the proposal to enshrine the objective of superannuation into legislation. There is now a follow up on the Exposure Draft Legislation.

The Government considers that:

"*the objective of superannuation is to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way"*

and this should be embedded in legislation to:

"*provide stability and confidence… that changes to superannuation policy will be aligned with the purpose of the superannuation system*".

Assistant Treasurer and Minister for Financial Services, Stephen Jones MP, had previously indicated that legislating the objective of superannuation would be a precursor to consideration of the concessional tax treatment of superannuation from a budgetary perspective. Indeed, on 28 February 2023, he, together with Treasurer Jim Chalmers MP, announced plans to scale back tax concessions, in a proposal to introduce an additional 15% tax on earnings on superannuation balances over $3 million.

That proposal was supported by the release, on the same day, of the *Tax Expenditures and Insights Statement*, which estimated that the combined aggregate tax revenue forgone from concessions on superannuation for the year 2023-24 will be $49 billion, with 30-40% going to those in the top income decile. Concessional tax treatment is more favourable for those with higher balances and higher marginal income tax rates. APRA statistics reveal that 292,449 accounts with balances over $500,000 are held by women, and 511,974 by men, revealing a clear gender inequity within the system.

The *Australia Institute* reported in February 2023 that tax concessions for superannuation were estimated at $52.6 billion, just shy of the cost of the Age Pension, at $55.3 billion.[1] Generous tax concessions on 'high balance' superannuation accounts seem not to fit within the Government's articulation of the objective of superannuation, although the notion of what constitutes a 'high balance' will inevitably change with time.

This raises the question of whether a legislated objective of superannuation would ever be able to constrain political tinkering with the system to achieve one or other policy objective on the basis it could be justified, one way or another, within the framework of its legislated objective.

Struggle for consensus

Public debate on the objective of superannuation has revealed that while the basic concept of the superannuation system may seem straightforward, an individual's experience with their own superannuation, and the expectations they have of it, is unique to their personal circumstances, and puts in doubt whether political consensus is achievable.

Former Prime Minister Paul Keating, influential in the design and implementation of Australia's compulsory superannuation system, has previously described it as "*a system designed to augment the age pension for income in retirement*"[2]. This factual description leaves little room for subjectivity. However, the subsequent *Retirement Income Review* recommended that the objective of the superannuation system should be "*to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way*", reflecting a somewhat more aspirational element and introducing the concepts of adequacy, equity and sustainability.

The question of adequacy is highly subjective. ASIC's *Money Smart* website says that "*if you own your own home, you will need two-thirds (67%) of your pre-retirement income to maintain the same standard of living in retirement*". The Association of Superannuation Funds of Australia (ASFA) has devised its own "ASFA Retirement Standard", ranging from an annual cost of $30,063 to cater to a 'modest' single person's needs to $66,725 for a 'comfortable' retirement for a couple.

All estimates assume home ownership, and all estimates exceed the current rate of the age pension ($26,689 for a single person and $40,238 for a couple, plus rent assistance for those who do not own their own home).

The latest proposal builds on earlier formulations of the supposed objective of superannuation, elevating it to an aspiration for a 'dignified' retirement and introducing the concept of preservation, in an apparent reaction to concerns of ad-hoc early release of superannuation that was permitted during the COVID pandemic. It was a clear shot across the bow at those who consider that superannuation should be accessible to financially assist those facing financial pressures pre-retirement that prevent many Australians from building their personal wealth outside the superannuation system, for example by purchasing their own home, or recovering from financial detriment caused by domestic violence.

The three pillars of the retirement income system

Superannuation is one of three pillars of the retirement income system in Australia.

The **first** is the age pension, which can best be described as a 'safety net' that prevents retirees from descending into abject poverty (with women more likely than men to require this support).

The **second** is compulsory superannuation, which requires workers to set aside part of their salary and preserve it for their retirement years, which was introduced as the product of wage bargaining negotiations to constrain wages at a time of high unemployment and inflation, and to support productivity growth.

The **third** pillar is personal equity, which comes in the form of individual savings, voluntary superannuation contributions and property ownership.

The superannuation system should therefore not be viewed in isolation from its place in the retirement income system as a whole. This is precisely the issue that trustees of superannuation funds have been grappling with since the introduction of the Retirement Income Covenant[3] on 1 July 2022.

In recognition of the demographic shift of Australians moving from the accumulation phase of their superannuation to the retirement phase, and living longer post-retirement, superannuation trustees are now subject to the fiduciary obligation to develop a specific retirement income strategy for their members. Trustees must determine the meaning of retirement income, having regard to income from the age pension, and potentially the income 'from any other source'.

This has raised clear challenges for trustees as to how they are to determine the correct strategy for various cohorts of their membership, when each individual member, with their own life trajectory, is bound to experience their individual retirement needs, objectives, and income, differently.

Impact of the proposal

Enshrining a secondary, or subsidiary, set of objectives or principles in legislation (as the Financial System Inquiry originally suggested) is not a part of this current proposal. However, introducing a legislated objective does have the potential to add another layer of complexity to a trustee's decision making, despite the lack of clarity as to how such an obligation could be enforced.

For example, how does it intersect with the sole purpose test which contemplates benefits pre-retirement when a member ceases working due to ill-health. Does it impact how a trustee should meet the insurance covenant to only offer insurance "*if the cost of insurance does not inappropriately erode the retirement income of beneficiaries*"?

The proposed wording of the single objective reflects the following concepts:

- **preserve savings**: restricting access to superannuation for retirement only
- **deliver income**: emphasising the principle that superannuation is to provide income
- **dignified retirement**: denoting worthy of respect
- **Government support**: highlighting interaction with the age pension pillar, and
- **equitable and sustainable**: fair and able to be maintained.

It is not clear that these concepts are compatible with each other, and if there are competing elements, which one takes priority? Structural inequity already exists in the superannuation system – the gender pay gap and other social inequalities continue into retirement, longevity risks (and how these are estimated) impact the income that an individual might achieve from their preserved savings, and investment and inflation risk can threaten sustainability. The level of access an individual has to each of the three pillars of the retirement income system is dependent on that individual's personal circumstances and heavily influences their retirement outcomes.

The retirement income system will evolve

The macroeconomic circumstances that affect workers and retirees will change over time, with shifting demographics, and the superannuation system should evolve with it. The current cohort of retirees generally will live longer than those before them and benefit from relatively high rates of home ownership, and less personal debt.

Research from the Gratton Institute indicates that most Australians can look forward to a comfortable retirement, with an average retirement income of 89% of pre-retirement income and many low-income Australians will receive more income when they retire than in their working life, because of the combination of the age pension and the income from superannuation. The picture, however, is less rosy for retirees who do not own their own home.

Younger generations are facing stagnant wage growth, higher costs of living, education related debt, higher costs of housing, the inability to own their home, the impact of climate change, rising interest rates, and rising inflation, which all put financial pressure on their ability to generate personal wealth (the third pillar of the retirement income system).

Against this backdrop, compulsory superannuation contributions are increasing from 10.5% to 12% in 2025, and the $3.5 trillion of funds under management keeps on growing. Higher superannuation contributions are predominantly borne by workers, and lead to lower wage growth and, says the Grattan Institute,

"*the trade-off between more super in retirement and lower living standards while working isn't worth it*".

The objective raises as many questions as it answers

Is the increase in compulsory contributions compatible with the proposed objective of superannuation?

It might meet the preservation requirement but is it equitable that this is at the expense of building personal wealth?

Will increasing superannuation balances preclude more Australians from accessing government support?

Is it sustainable for the funds under management in superannuation to outweigh the relative size of the economy?

How do dignity, equity and sustainability interact when it comes to addressing the gender gap in retirement?

And will changing social and economic conditions require us to revisit the legislative objective of superannuation from time to time, to ensure that it reflects those changes?

The background paper refers to the opportunity to leverage greater superannuation investment in areas where there is alignment between the best financial interests of members and national economic priorities. Although this reflects the current Government's appetite for using superannuation to support nation-building projects, it is not immediately clear how this issue is aligned with legislating the objective of superannuation as proposed.

Is it because preservation until retirement aligns with the long lead time of major infrastructure projects? Is that sufficient to 'pass the test' of meeting the objective of superannuation and implementing policy change?

There appears to be broad support for legislating an objective for superannuation. It will certainly be interesting to watch whether it will have any impact on the structural inequities inherent in the system.

[1] "Self-funded or State-funded Retirees? The cost of super tax concessions" *The Australia Institute* February 2023
[2] In his speech at the Australian Pensions and Investment Summit in 2007
[3] Section 52(8A) of the Superannuation Industry (Supervision) Act 1993 (Cth)

Emma Higgs is a Senior Associate at Mills Oakley and a member of the Victorian Committee of Women in Super. This article is general information.

Thornhill on shares for investment income in retirement

James Gruber with Peter Thornhill

This is an edited transcript of a recent interview between James Gruber and Peter Thornhill, on Morningstar's Wealth of Experience podcast.

Peter is a financial commentator, author, public speaker and Principal of Motivated Money. His investment philosophy involves owning high quality industrials and LICs, and holding them forever.

James Gruber: Peter, welcome to the Wealth of Experience podcast.

Peter Thornhill: Thank you.

Gruber: Are they [LICs] your primary investment?

Thornhill: They are now, they were not back then [before he left his employer and started his own public speaking business]. Because when I was working in the industry still working for fund managers, the likes of Peter Morgan, Anton Tagliaferro, John Murray, et cetera, I would often follow their advice, I would buy individual shares. So, I left the industry owning quite a substantial number of individual shareholdings, direct. I have been unwinding those and unwinding them faster and faster now and redirecting it all to listed investment companies.

Gruber: Okay. So, let's get into your overall philosophy. It's long-term, it's primarily industrials, it's steady dividend paying companies or LICs. You don't want volatility in those dividends, you don't want them paying out dividends in full one year and then zero the next year. What do you look for in an investment?

Thornhill: With the listed investment companies, it's quite straightforward. They have a history, a long history, and that gives me the comfort, particularly the City of London [an investment company that Peter's held from his time living in London], 162 years. How many staff changes have occurred in 162 years? But they have not been talking about their amazing bottom-up approach, their value approach, blah, blah. They have stuck strictly to a very simple investment goal, to increase the capital over time and to produce an income stream that grows over time, full stop. That's it. And clearly in 162 years the staff has changed, but that specific target has been matched every single year, decade, et cetera. And it's that consistency that I'm looking for.

Gruber: You do advocate industrials primarily. Most investors' portfolios are filled with banks and miners in Australia, given that they are a large part of the indices. Why do you say that investors should largely stay away from them?

Thornhill: The banks I've got no problem with, it's purely the resources. Digging stuff out of the ground, it's okay, but it's cheap and cheerful. I mean, to give an example, if I'd invested $100,000 in the industrial index 42 years ago, it would now be worth $2 million in price alone. The All Ords, it would have been worth $1.3 million, and the resources, it would have been $1.3 million. Now, if I reinvest the dividends over the 42 years, the $100,000 in industrials becomes $15 million. The All Ords gives me $8.3 million, and the resources gives me $5.2 million. Digging stuff out of the ground is not what I consider to be a great investment. It is the value add from the technological, the manufacturing and the intellectual inputs that occur within quality industrial companies that make all the difference.

Gruber: Do you advocate that investors hold on to their investments that they don't sell even if markets take a big tumble?

Thornhill: Well, if markets take a big tumble, the last thing you do is sell, wouldn't you? But I say that with a smile on my face, because to be honest, fear is based on ignorance. Knowledge is power. If you are frightened – and this is something that's annoyed me for decades – volatility has nothing to do with risk. Volatility is merely a function of the liquidity. Why was it during the GFC that a whole load of people sold their Commonwealth Bank shares and they went from $64 to $26? Are you telling me that Commonwealth Bank lost more than half its business? No, sorry.

Gruber: So, what should investors focus on? CBA drops, as you say. What should they focus on? Should they focus on the dividend? How do you get around that from an investor point of view? How do you stay focused?

Thornhill: It's very hard. It's almost impossible. Every day, the media has commentary on individual companies. Can you tell me how often the media talk about the dividends? They only are paid twice a year. Share prices are fluctuating every single day. So, there's a whole lot of useless information being pumped into people's faces. Turn the television off and focus on the important things in your life – your family, your career, and friends. People are becoming slaves to their money. Money is my slave. It's out in the back room doing all the work and I'm at the front of the house having all the fun.

Gruber: I imagine some people would find that difficult. They may not have the psychological makeup to do that.

Thornhill: Correct.

Gruber: Is that key in this kind of philosophy?

Thornhill: Yes, and if you don't have the willpower to be able to absorb all the media commentary, you can't switch it off mentally, then you're going to have one hell of a life. You're going to be spending an awful lot of your time worrying about something in the background when you should be focusing entirely on your family, career and friends.

Gruber: With the LICs, you've mentioned a number of them there, can you go through a just to – give us some examples of why you like them?

Thornhill: The best example is the recent COVID smash, if you like, where a lot of companies, individual companies, because of the sheer uncertainty, reduced their dividends, some companies cancelled their dividends for a period of time until sanity returned, and the fear began to drift away. But during that period, the listed investment companies were able to use their retained profits to help stabilize the dividends. And it's that element that I love. And it just – as I say, listed investment company around for 162 years, 56 years of unbroken dividend growth. I love it. It's very simple. I don't worry about a thing. In fact, I was interviewed after the Global Financial Crisis and the interviewer asked me what was on my wish list. And I said, oh, another Global Financial Crisis, please. And there was hesitation. He said, but Peter, why would you want another Global Financial Crisis? I said, I'd like to buy some more Commonwealth Bank at $26 because I didn't go hard enough the first time around.

Gruber: What would you advocate an investor do? Say, they were starting off now with a portfolio, how should they go about buying LICs on the ASX? Should they wait for discounts, average in? What would you advocate?

Thornhill: If they're uncertain, dollar cost average. So, if you've got $20,000, depending on how frightened you are, dribble it in at $2,000 every three months or something like that. That way you can congratulate yourself. When you bought up here, you keep quiet about when you bought down there, then up, then down, then up, then down, then up, then down. I mean, it's a pity that that would even be an element in their consideration. But unfortunately, as we've already discussed, different strokes for different folks and depending

on their attitude towards the market and its volatility. I've never been particularly fast. Over the decades, I can honestly say, I bought high, I bought low, I bought high, I bought low. But if you take the line of best fit between all those high lows, guess where the line has gone? Upwards, for 40 plus years.

Gruber: You've got quite the investor following, and I assume that you've been able to get through to these people your philosophy and the others have kind of fallen by the wayside, the ones that aren't psychologically adept at implementing your philosophy. Is that a fair description?

Thornhill: Absolutely. And after 30, 40 years of presenting, I can say the feedback from thousands of presentations, my best guess is 10% of the audience intuitively get it and act, 80% enjoy the presentation and do nothing, the other 10% go away absolutely devastated because I've just run the sword through whatever fancy investments their family had been put through. I've actually had people walk out. So, I'm there for the 10%. I'm sorry, but all the rest, if they're not up to it, that's cool. I'm there for the 10%.

The full interview with Peter Thornhill is available on Morningstar's Wealth of Experience podcast.

Peter Thornhill is a financial commentator, author, public speaker and Principal of Motivated Money. He runs full-day courses in the major capital cities explaining his approach to investing "in the vain hope that not everyone is frozen with fear".

This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.

Three reasons why optimism pays for investors

Shane Oliver

"More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other to total extinction. Let us pray we have the wisdom to choose." – Woody Allen

The 'news' as presented to us has always had a negative bent, but one could be forgiven for thinking that it's become even more negative with constant stories of disasters, conflict, wrongdoing, grievance and loss. This was an issue prior to coronavirus – with trade wars, social polarisation, tensions with China, worries about job loss from automation and ever-present predictions of a new financial crisis. Since the pandemic higher public debt, inflation, geopolitical tensions and rising alarm about climate change have added to the worries.

These risks can't be ignored yet when it comes to investing, the historical track record shows that succumbing to pessimism doesn't pay.

Three reasons why worries might seem more worrying

Some might argue that since the GFC the world has become a more negative place and so gloominess or pessimism is justifiable. But given the events of the last century – ranging from far more deadly pandemics, the Great Depression, several major wars and revolutions, numerous recessions with high unemployment and financial panics – it's doubtful that this is really the case viewed in the long-term sweep of history.

There is no denying there are things to worry about at present – notably inflation, political polarisation, less rational policy making and geopolitical tensions - and that these may result in more constrained investment returns. But there is a psychological aspect to this combined with greater access to information and the rise of social media to magnify perceptions around worries. All of which may be adding to a sense of pessimism.

Firstly, our brains are wired in a way that makes us natural receptors of bad news. Humans tend to suffer from a behavioural trait known as 'loss aversion' in that a loss in financial wealth is felt much more negatively than the positive impact of the same sized gain. This probably reflects the evolution of the human brain in the Pleistocene age when the key was to avoid being eaten by a sabre-toothed tiger or squashed by a wholly mammoth. This left the human brain hard wired to be on guard against threats and naturally risk averse. So, we are more predisposed to bad news stories as opposed to good. Consequently, bad news and doom and gloom find a more ready market than good news or balanced commentary as it appeals to our instinct to look for risks. Hence the old saying "*bad news and pessimism sells*".

This is particularly true as bad news shows up as more dramatic whereas good news tends to be incremental. Reports of a plane (or a share market) crash will be far more newsworthy (generating more clicks) than reports of less plane crashes this decade (or a gradual rise in the share market) ever will. As a result, prognosticators of gloom are more likely to be revered as deep thinkers than optimists.

Secondly, we are now exposed to more information on everything, including our investments. We can now check facts, analyse things, sound informed easier than ever. But for the most part we have no way of weighing such information and no time to do so. So, it's often noise. As Frank Zappa noted "*Information is not knowledge, knowledge is not wisdom*."

This comes with a cost for investors. If we don't have a process to filter it and focus on what matters, we can suffer from information overload. This can be bad for investors as when faced with more (and often bad) news we can freeze up and make the wrong decisions with our investments. Our natural 'loss aversion' can combine with what is called the 'recency bias' – that sees people give more weight to recent events in assessing the future – to see investors project recent bad news into the future and so sell after a fall.

Thirdly, there has been an explosion in media competing for attention. We are now bombarded with economic and financial news and opinions with 24/7 coverage by multiple web sites, subscription services, finance updates, dedicated TV and online channels, chat rooms and social media. This has been magnified as everything is now measured with clicks - stories (and reporters) that generate less clicks don't get a good look in. To get our attention news needs to be entertaining and following from our aversion to loss, in competing for our attention, dramatic bad news trumps incremental good news and balanced commentary. So naturally it seems the bad news is 'badder' and the worries more worrying than ever which adds to a sense of gloom. The political environment has added to this with politicians more polarised and more willing to scare voters.

Google the words "the coming financial crisis" and it's teeming with references – 270 million search results at present – and as you might expect many of the titles are alarming:

- "A recession worse than 2008? How to survive and thrive."
- "Could working from home cause the next financial crisis?"
- "Economic crash is inevitable."
- "Three men predicted the last financial crisis – what they're warning of now is terrifying."
- "How China's debt problem could trigger a financial crisis."

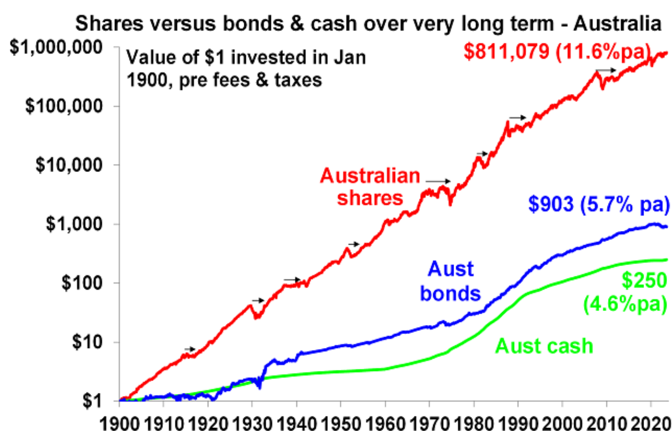
The danger is that the combination of the ramp up in information and opinion, combined with our natural inclination to zoom in on negative news, is making us worse investors: more distracted, pessimistic, jittery and focused on the short-term.

Three reasons to be optimistic as an investor

There are three good reasons to err on the side of optimism as an investor.

Firstly, without a degree of optimism there is not much point in investing. If you don't believe the bank will look after your deposits, that most borrowers will pay back their debts, that most companies will see rising profits over time supporting a return to investors, that properties will earn rents, etc, then there is no point investing. To be a successful investor you need to have a reasonably favourable view about the future.

Secondly, the history of share markets (and other growth assets like property) in developed well managed countries with a firm commitment to the rule of law has been one of the triumph of optimists. Sure, share markets go through bear markets and often lengthy periods of weakness – where pessimists get their time in the sun - but the long-term trend has been up, underpinned by the desire of humans to find better ways of doing things resulting in a real growth in living standards. This is indicated in the next chart which tracks the value of $1 invested in Australian shares, bonds and cash since 1900 with dividends and interest

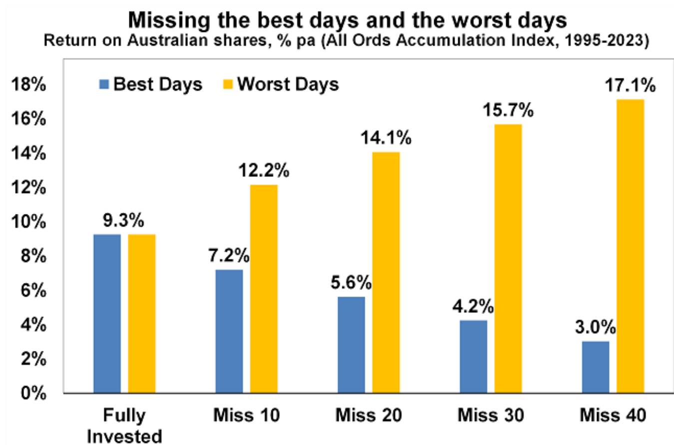


Source: ASX, Bloomberg, RBA, AMP

reinvested along the way. Cash is safe and so fine if you are pessimistic but has low returns and that $1 will have only grown to $250 today. Bonds are better and that $1 will have grown to $903. Shares are volatile (and so have rough periods – see the arrows) but if you can look through that they will grow your wealth and that $1 will have grown to $811,079.

This does not mean blind optimism where you get sucked in with the crowd when it becomes euphoric or into every new whiz bang investment obsession that comes along (like bitcoin or the dot com stocks of the 1990s). If an investment looks too good to be true and the crowd is piling in, then it probably is - particularly if the main reason you are buying in is because of huge recent gains. So, the key is cautious, not blind, optimism.

Finally, even when it might pay to be pessimistic and hence out of the market in corrections and bear markets, trying to get the timing right can be very hard. In hindsight many downswings in markets like the GFC look inevitable and hence forecastable and so it's natural to think you can anticipate downswings going forward. But trying to time the market – in terms of both getting out ahead of the fall and back in for the recovery - is difficult. A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 9.3%pa (with dividends but not allowing for franking credits, tax and fees).



Covers Jan 1995 to March 2023. Source: Bloomberg, AMP

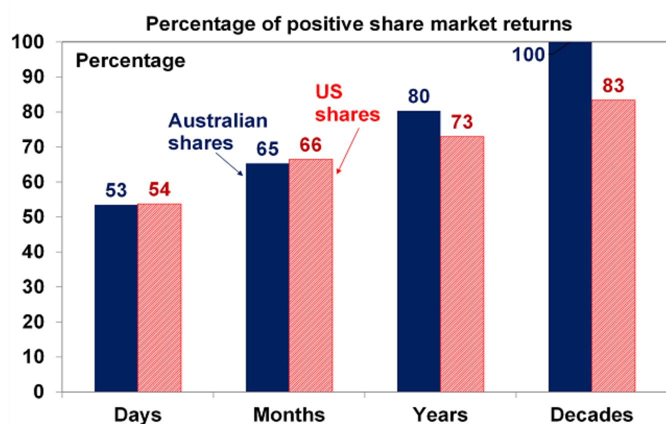
If you were pessimistic about the outlook and managed to avoid the 10 worst days (yellow bars), you would have boosted your return to 12.2%pa. And if you avoided the 40 worst days, it would have been boosted to 17.1%pa! But this is very hard, and many investors only get really pessimistic and get out after the bad returns have occurred, just in time to miss some of the best days. For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 7.2%pa. If you miss the 40 best days, it drops to just 3%pa.

As famed investor Peter Lynch has pointed out "*More money has been lost trying to anticipate and protect from corrections than actually in them*."

On a day-to-day basis it's around 50/50 as to whether shares will be up or down, but since 1900 shares in the US have had positive returns around seven years out of ten and in Australia it's around eight years out of ten.

So getting too hung up in pessimism on the next crisis that will, on the basis of history, drive the market down in two or three years out of ten may mean that you end up missing out on the seven or eight years out of ten when the share market rises. Here's one final quote to end on:

"No pessimist ever discovered the secrets of the stars, or sailed to an uncharted land, or opened a new heaven to the human spirit." – Helen Keller



Daily & mthly data from 1995, data for years & decades from 1900. Source: ASX, Bloomberg, AMP

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP and AMP Capital. This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

Podcast: lessons from a decade of patient investing

James Gruber

Season 2, Episode 7

In this week's episode, we welcome special guest, Ophir Asset Management Founder and Senior Portfolio Manager, Andrew Mitchell. Recently, Ophir celebrated the 10-year anniversary of its Opportunities Fund, which has returned more than 21% since inception. Andrew shares the lessons learned running the fund, the key rules of investing, some of the fund's winners and losers, as well as where to find value now.

As usual, Firstlinks' Managing Editor, Graham Hand, also joins us, this time to go the Intergenerational Report and possible targets to address intergenerational equity. And our other regular guest, Peter Warnes gives us a wrap up of the ASX reporting season, including the big winners and losers.

The podcast is also available via our dedicated website page, Google Podcasts, Apple Podcasts, Spotify, and BuzzSprout.

Has passive investing killed small caps?

Joseph Constable

The S&P/ASX Emerging Companies Index has underperformed the S&P/ASX 200 Index by 12% over the last 12 months. What does this say about the future of active investment in small companies?

"Past performance is not always indicative of future performance"

Historical performance can often act as a double-edged sword. While the outperformance of large cap indices has drawn investors *en masse*, the past is not always indicative of the future. What works today, driven by a confluence of factors—be it economic conditions, regulatory environments, or global events—might not necessarily hold its ground tomorrow.

Strong performances by the major, large cap-focused equities indices have outdone active small cap investors for a number of years and lulled passive investors into the false security that their hands-off approach is not only easier but superior.

Average % price change over last 12 months (to Aug 18, 2023)

Market Cap	Sub-$50m	$50m-$100m	$100m-$300m	$300m-$1b	$1b-$5b	$5b+
Communication Services	-35%	-29%	-27%	-11%	-10%	6%
Consumer Discretionary	-24%	-30%	-11%	30%	2%	9%
Consumer Staples	-41%	-37%	-5%	-2%	-10%	-15%
Energy	-17%	-12%	8%	28%	5%	15%
Financials	-22%	-16%	-15%	-5%	1%	4%
Health Care	-35%	-10%	9%	21%	11%	-4%
Industrials	-20%	-11%	42%	9%	-11%	23%
Information Technology	-22%	0%	8%	-3%	17%	41%
Materials	-28%	-7%	85%	48%	9%	17%
Real Estate	-9%	-34%	-12%	-8%	-10%	-6%
Utilities	-16%	-34%	-27%		34%	47%

Source: Koyfin, H&G Investment Management Limited

Concentration

Passive investing in the index was originally pitched as a simple diversification strategy but thanks to its own success, is now shaping up as a form of concentration risk itself.

Index-tracking investors are placing all their eggs in one large cap 'basket' that has no fundamental reason to outperform other portfolios in the long-run and is currently priced with far less margin for error than many alternatives - and with more concentration in a small number of securities.

In theory, the passive index should not outperform in the long run. The differences between the index and the average portfolio performance should be limited to fees and other costs.

Does anyone believe that the committee at Standard & Poor's that selects stocks based on their 'free float' has a special and sustainable edge over other investors?

If not, the conclusion that follows is that these large indexes are outperforming because, in their respective markets, a disproportionate amount of capital has been flowing to the index portfolio only.

Passive index investing has become momentum investing - buying equity in businesses without reference to fundamentals and buying more of a stock at higher prices simply because it has already experienced demand that outstrips supply.

When momentum is working for the investor, it makes markets look simple. But when momentum crashes it can get ugly. If a large percentage of investments in the market concentrate on an index, the entire market becomes vulnerable to systemic shocks.

Two strategies to de-risk from the index are: (1) to weight a pool of investments differently to the index; and/or (2) selectively invest in smaller companies that don't have material (if any) index weightings.

Buying better

Today we look at the Australian equities market and see the market cap weighted average Price/Earnings (PE) ratio of the top 200 stocks is just under 22x earnings reported for the last 12 months.

Unless investors are willing to accept low returns, these companies need to have growth baked in for investors to justify buying 'the market' index rather than sticking to the safety of government bonds.

The current ten-year government bond yield of about 4.3% has been closing in on the ASX 200 Index's market cap-weighted earnings yield, which is the PE ratio inverted, and equates to 4.6%.

While the S&P data on mainstream equities funds has been disheartening for active investors, the evidence does suggest that investors have found greater success relative to the large indexes when focusing on smaller companies.

This market-cap weighted PE multiple for large caps is currently a 24% premium to the median for micro-to-mid caps of 17.5x (excluding the resources sector). If we look at EV/EBITDA multiples, which take into account the total capital structure, the premium is 32%.

Another way of seeing the current opportunity for small caps relative to large caps is the historical relationship between their valuations. The S&P/ASX Small Ordinaries Index, which consists of the companies ranked between 100 and 300, has historically traded on a PE multiple 12% lower than the S&P/ASX 100 heavyweights, looking back to June 2002.

Before COVID-19 hit in early 2020, smaller stocks were actually trading on a premium PE multiple to the top 100. Today that discount is hovering at 26%.

One thing the historical data shows us is that when these extreme valuation gaps emerge, they are always closed again within several years.

There are a number of reasons why such gaps emerge. Small firms are neglected by analysts and investors, leading to a lack of awareness and information flow. Their shares are generally less liquid, meaning investors do not have the luxury of being able to change their minds and sell stocks on a whim. They can suffer from a lack of resources or poor governance.

Neglect

There are nearly 1,800 ASX listings with market caps below $1 billion - and only ~240 valued above that level. Most of the latter make up the S&P/ASX 200 Index.

Analyst coverage is focused on the larger stocks. Around 340 stocks are covered by at least three analysts. Another 260-odd have at least one analyst setting a price target (often from an obscure firm or with the conflict of receiving fees from the researched company). The majority are left with no formal research, adding another barrier for investors who do not have the time or ability to do the work themselves.

Media coverage follows a similar pattern, with a focus on the big end of town and very little insightful or investigative coverage of smaller listed companies.

Yet the great juxtaposition is that studies have shown less researched stocks deliver greater risk-adjusted returns than stocks receiving greater focus from analysts.

Liquidity and exits

The lack of liquidity may be one explanation of the greater risk-adjusted returns from under researched stocks. It is harder to buy meaningful positions in these companies and once a position has been accumulated a decision to sell could be difficult to execute without driving down the price.

To H&G High Conviction Limited (HCF), illiquidity represents opportunity. As managers of permanent capital, there is no pressure to realise investments at a time that doesn't suit.

A feature of smaller companies is that they don't necessarily have to rely on increasing investor interest to convert their operating performance into market value. In time, if investors do not appreciate the value creation, larger corporates and financial buyers (like private equity) will seize the opportunity for themselves.

We have seen this play out time and time again - most recently with Ensurance (ASX:ENA), a small ASX-listed insurance agency. Last month, Ensurance agreed to be acquired by leading insurance broker PSC Insurance for ~$25 million and at a 40% premium to the previous closing share price.

A patient, long-term view is necessary to be able to see an investment through from its purchase to the optimal exit. Our investment approach takes that a step further though - we actively work to solicit such opportunities to maximise value.

Active engagement

HCF has found that rolling up our sleeves and working constructively with shareholders, boards and management teams can help maximise shareholder value. This is possible by sitting on company boards directly, sharing previous business experience, identifying stand-out talent, and helping to deploy capital management strategies and M&A.

Successful investment in small companies requires intensive due diligence and active engagement with companies. At HCF, we believe the recent sell-off means there is considerable value in this segment of the market for diligent, long-term investors.

Joseph Constable is the Portfolio Manager of H&G High Conviction Limited (HCF) and an executive director of Hancock & Gore Limited (H&G). H&G is the investment manager of and owns shares in HCF. This article is general information and does not consider the circumstances of any investor.

Australia isn't ageing as quickly as the Government says

David Knox

The 2023 Intergenerational Report (IGR) helps us understand the consequences of Australia's ageing population. Therefore, how we measure our ageing population is really important.

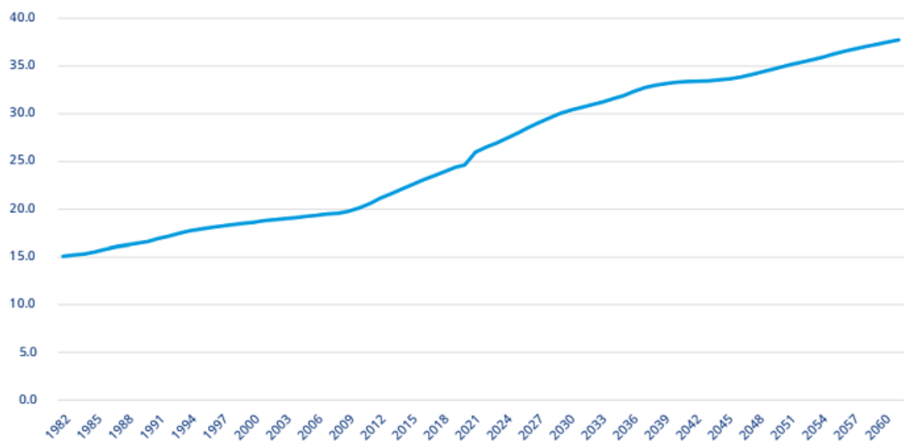
Traditionally, we have used the old-age dependency ratio which compares the population aged 65 and over with the so-called working age population, the people aged 15-64. The IGR continues to publish this ratio, but this approach is outdated and can lead to unnecessary fear and even unhelpful policies.

This article shows that by using a realistic approach, Australia's population is ageing at less than half the rate commonly quoted.

Ageing population ratios

The world's population is ageing as we live longer and have fewer babies. This is a fact and will affect every country and every economy during the next two, three or four decades. In many countries, the retirement of the baby boomer generation from the workforce is highlighting the issue. The consequences can be many with reducing populations, a smaller labour force and increased costs for pensions, health services and aged care.

The most used calculation to measure the ageing population is the old-age dependency ratio, as defined above. Figure 1 shows this percentage ratio for Australia from 1982 to 2061, that is, the last 40 years and the projected ratio for the next 40 years. This figure highlights the steady increase in the ratio since 1982 and the expectation that it will continue to rise in the future.



Such a ratio can be useful in comparing the demography of different countries and the sustainability of different pension systems, (e.g. as used by the Mercer CFA Institute Global Pension Index). It is also useful in highlighting the ageing population for the development of appropriate public policy, as in Treasury's 2021 IGR and the 2022 Population Statement.

However, if we are concerned with a single economy such as Australia, then this ratio with its fixed definitions becomes less helpful with the many changes that occur within the workforce and life expectancies over an 80-year period.

The history: 1982-2022

The old-age dependency ratio uses the population aged 15-64 as the denominator; that is, the population of traditional working ages. Yet many of these individuals are not in the workforce due to a range of reasons while others aged 65 or over are in the workforce. A more accurate approach would be to consider the actual labour force, rather than the potential labour force.

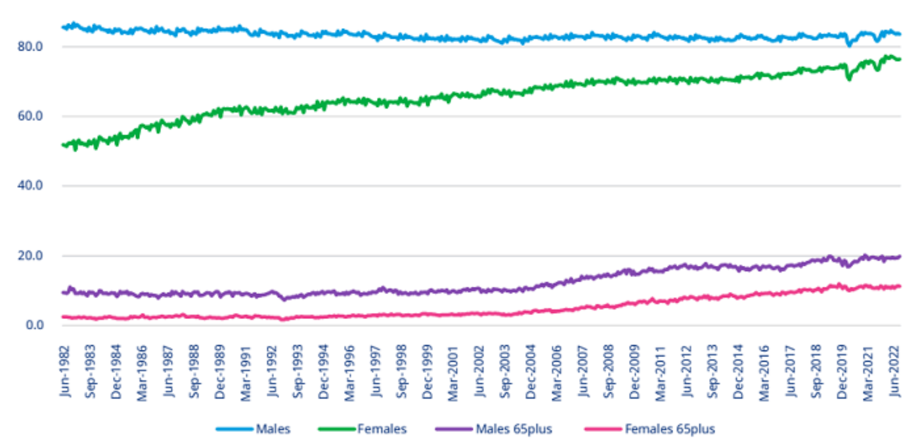
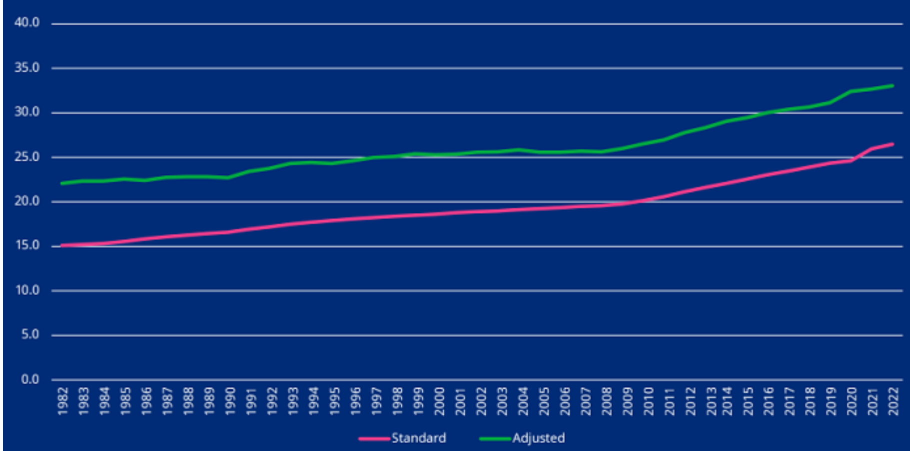


Figure 2 shows some significant changes in our labour force participation rates over the last 40 years. In particular, the female participation rate has increased significantly and, recently, more individuals over the age of 65 are in the labour force. In fact, the percentage of the labour force aged 65 and over has increased from 1.99% of the total labour force in 2006 to 4.94% in 2022. This trend is expected to continue in future years.



Hence with this changing labour force, it's important that we consider the number of people aged 65 and over per 100 people in the actual labour force rather than those within a particular age group. Figure 3 compares this adjusted ratio with the standard ratio for the last 40 years.

Two effects are evident:

- The adjusted ratio is higher than the standard ratio because the actual labour force used in the denominator is less than the population aged 15-64 as those aged 15-64 not in the workforce (and therefore now excluded) are greater than those in the workforce aged 65 and over who are now included.
- The increase in the adjusted ratio is not as significant as in the standard ratio, due to the increasing female labour force participation rate. The standard ratio shows that the number of working age persons for every person aged 65 or over decreased from 6.6 in 1982 to 3.8 in 2022 whereas the adjusted ratio shows the decrease has been from 4.5 in 1982 to 3.0 in 2022[1].

One further adjustment is required to obtain an even more accurate picture of our ageing population.

During this 40-year period, the life expectancy for a 65-year-old male increased by 6.55 years from 13.80 to 20.35 and by 4.98 years for a 65-year-old female from 18.00 to 22.98[2]. This represents an average increase of 5.77 years over 40 years, or 1.7 months every year. The eligibility age for the Age Pension is also increasing from age 65 at 30 June 2017 to age 67 from 1 July 2023. Hence, age 65 is no longer a suitable age to define an older person in Australia.

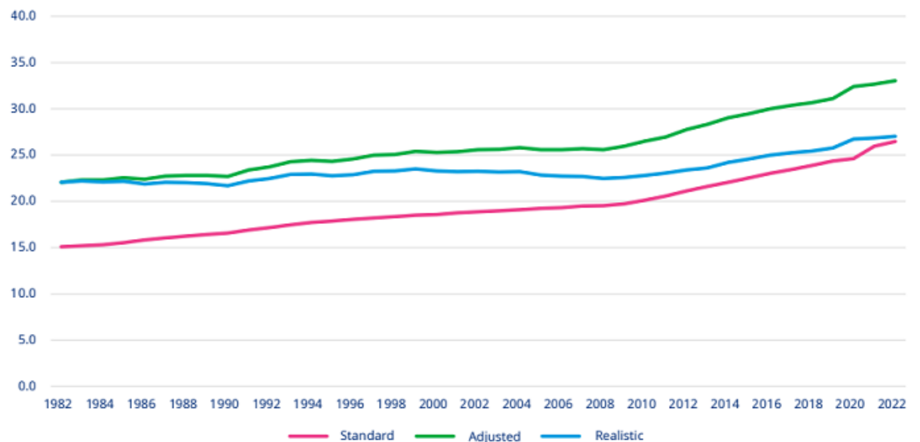
However, increases in life expectancies only represent part of the story, as it is important to understand whether people are spending more years in good health or more years living with illness. A measure known as the health-adjusted life expectancy (HALE)[3] is used to understand this difference.

The Australian Institute of Health and Welfare has shown that between 2003 and 2022, 58% of the increase in life expectancy for a 65-year-old female represented an increase in the HALE. The corresponding figure for a 65-year-old male was 76%[4]. This outcome of an increasing HALE represents one factor in leading to the increase in the labour force participation rate for those aged 65 and over.

Given that the increase in life expectancy for a 65-year-old from 1982 to 2022 was an average of 5.77 years, it is reasonable to suggest that during this period, the increase in the age to define an older person in full health could increase by 3 years or 52% of the increase in life expectancy.

Figure 4 shows the revised ratio assuming that the definition of an older person gradually increases from age 65 in 1982 to age 68 in 2022.

Figure 4: A realistic perspective



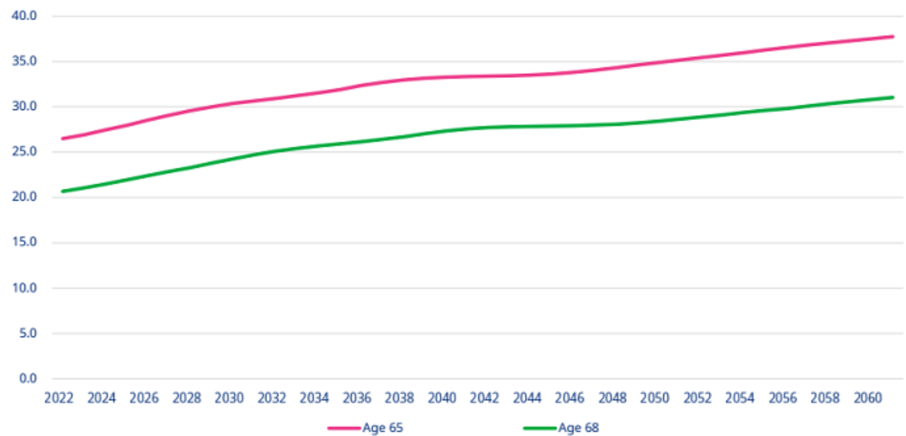
As expected, the final line using both the actual labour force and a gradual increase the age to define an older person is below the previous 'adjusted' line. There remains an increase in the ageing ratio, but it is much slower than the standard old-age dependency ratio or the adjusted line. The number of working age persons for every older person decreased from 4.5 in 1982 to 3.7 in 2022.

This much more modest decline than is normally used is due to the increasing labour force and the recognition that the definition of an older person should not remain static over 40 years.

Hence, the consequences of the recent ageing in our population are not as severe as often suggested. However, it is in the next 40 years where the impact may become more significant, particularly with additional health and aged care costs. Let’s now consider this future period and the likely ratio between the older population and those in the workforce.

The future 2022-2061[5]

As we look to the future, let us begin with Figure 5, which shows the traditional old-age dependency ratio from Figure 1 and a revised line with an assumption that an older person in 2022 and beyond is aged 68 or over. As expected, the age 68 line is below the age 65 line.



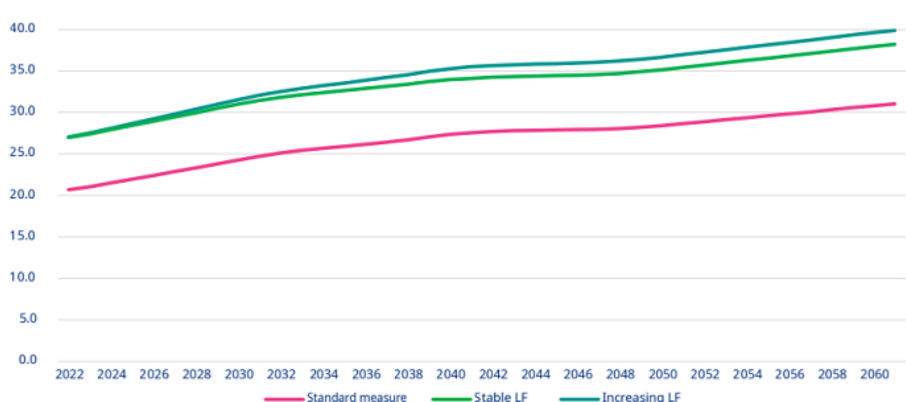
Previously, we replaced the denominator, which was the population of working age, with the actual labour force. Of course, this calculation is more difficult looking into the future. We will begin by using the latest labour force participation rates to provide an initial estimate of the future labour force. However, these latest rates may not be a good indication of the future as participation rates for those aged 55-64 and 65 & over have been increasing in recent years. This outcome is not surprising, given the ongoing increase in the health-adjusted life expectancy.

For example, the labour force participation rate for those aged 55-64 increased from 59.6% in 2010 to 68.2% in 2021. Similarly, the participation rate for those aged 65 and over increased from 12.0% in 2015 to 15.0% in 2021. These rates are likely to increase even further. For example in New Zealand, the latest rates are 79.7% and 25.1% respectively whereas in Iceland they are 83.4% and 22.3% respectively.[6]

Therefore, we will gradually increase the participation rate for those aged 55-64 from 68.2% in 2021 by 0.5% pa until it reaches 78.2% in 2041. Similarly, we will increase the participation rate for those aged 65 and over by 0.25% pa from 15.0% in 2021 to 20.0% in 2041. These projected rates are still lower than the current participation rates in NZ and Iceland.

The 2021 IGR allowed for some increase in the participation rates at older ages from 2019-20 to 2060-61 while also noting that the total participation rate has consistently outperformed the projections in past intergenerational reports.[7]

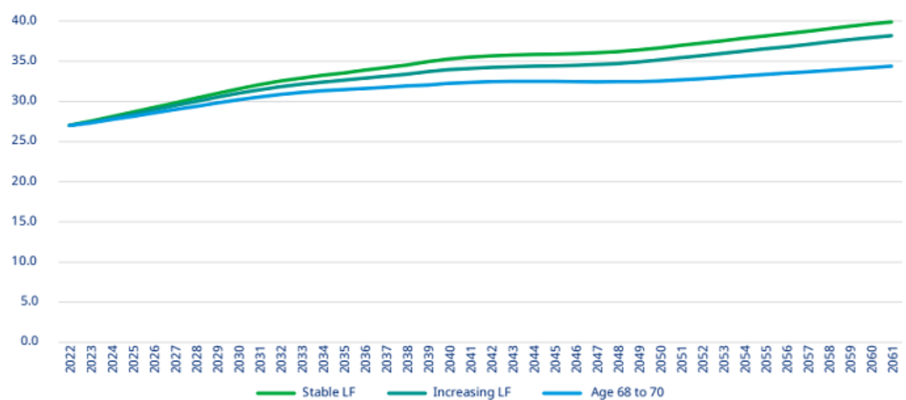
Figure 6 shows the impact of using the projected labour force instead of the working-age population as the denominator, as well as the impact of allowing for the increasing participation rates at older ages. The use of the projected labour force as the denominator means that the annual increase in the ratio is slightly less than if the projected population is used.



The next required adjustment is to recognise that life expectancies are likely to continue to increase in future years so that the definition of an older person should also increase. For example, the United Nations projects that the life expectancy for a 68 year old in Australia will increase gradually from 19.2 years in 2022 to 22.5 years in 2061 – an increase of 3.3 years.[8] Based on the recent history of the relation between HALE and population life expectancy, it is reasonable to gradually increase the age used to define an older person by 2 years over the next 40 years; that is, from age 68 to age 70. This increase is less than the rate experienced during the previous 40 years.

Figure 7 shows the effect of this change in age as well as allowing for the increasing labour force as shown in Figure 6. The impact of these two realistic adjustments is material. That is, the compound annual growth in the ratio drops from 0.94% pa to 0.56% pa.

Figure 7: Increasing labour force and age

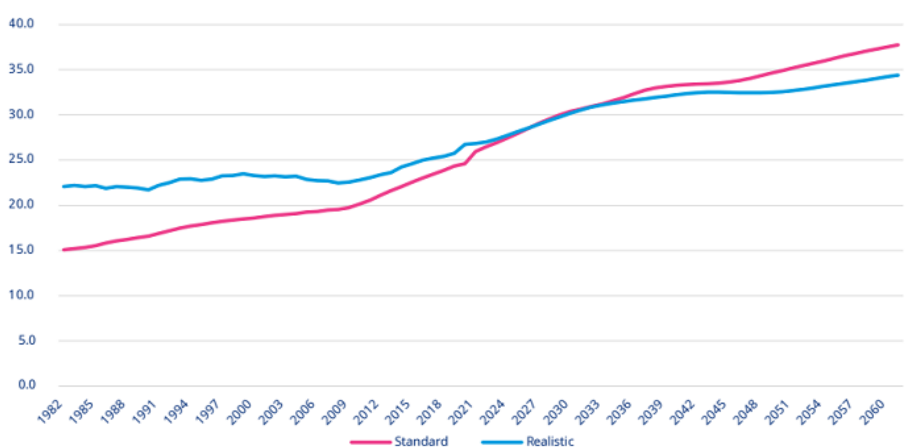


Suggested reforms

Mercer does not deny that Australia's population is ageing. That is a fact, but the consequences are not as alarming as some would suggest.

Figure 8 compares the standard old-age dependency ratio with the more realistic ratio based on the actual and projected labour force and a gradual increase in the age used to define an older person.

Figure 8: Comparing the standard and realistic ratios



The more realistic ratio increases at a much slower rate than the standard old-age dependency ratio. In fact, over the period its annual growth rate is 0.56% pa compared to 1.17% pa for the standard ratio. To express these results another way, the realistic ratio suggests that the number of workers per older person will decrease from 4.5 in 1982 to 2.9 to 2061. This compares to the figures using the old-age dependency ratio, which suggests the number of working-age persons for every person aged 65 and over will decrease from 6.6 in 1982 to 2.7 in 2061

The more realistic view of the impact of our ageing population expressed in this article does not imply that there should be no changes in government policy. Reform is needed. Mercer therefore recommends:

- Governments and employers must recognise that people aged 65 and over will form an ever-increasing percentage of the labour force. Many older individuals are healthy; have considerable expertise and experience; and wish to continue to contribute. They should be encouraged to do so.
- The measurement of our future ageing population needs to be more dynamic than the use of static ratios. It must recognise that there are likely to be ongoing changes in the labour force and life expectancies. It is also recognised that models that are more comprehensive can allow for a broader range of parameters than used in this paper.
- The means tests for the Age Pension must also encourage older persons to remain in the workforce to a much stronger extent than the current policy. Such an outcome is beneficial for the individual and to the economy.

[1] These figures represent the inverse of the ratios shown in Figure 3.
[2] These figures use the 1980-1982 Australian Life Tables from the Australian Government Actuary and the 2019-2021 Life Tables from the Australian Bureau of Statistics.
[3] Australian Institute of Health and Welfare, Health-adjusted life expectancy in Australia: expected years lived

in full health, 2011.
[4] Australian Institute of Health and Welfare, Australian Burden of Disease Study, 2022
[5] This paper uses 2061 and not 2062 as this is the final year in Treasury's latest population projections from the Centre for Population.
[6] International Labour Organisation, www.ilo.org
[7] Treasury, 2021 Intergenerational Report, p36.
[8] United Nations, World Population Prospects 2022, Medium variant
[9] Treasury, Intergenerational Report 2021, p31

Dr. David Knox is a Senior Partner and Senior Actuary at Mercer Australia. This article is general information and not investment advice, and does not consider the circumstances of any person.

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