Firstlinks
a Morningstar company

Edition 529, 6 October 2023

Contents

Editorial

Among many behavioural tendencies that impair decisions is confirmation bias, where we interpret and look for information that is consistent with our preferences or beliefs. It may prevent opposing views entering deliberations. A property fund manager will find data which shows rentals rising and high occupancy rates. A fixed interest bond manager will read commentary to justify lower interest rates and falling defaults. A private equity manager will point to the volatility of listed equities and better values of private assets. And so on.

The theory is that there are three types of confirmation bias: selective search, selective interpretation and selective recall. Politicians use all three, as well as simply choosing facts to suit an argument. **Treasurer Jim Chalmers** is finding data points to justify the new tax on super balances over $3 million that are irrelevant to that threshold. This week, Chalmers introduced a short consultation period on the Exposure Draft.

In announcing the legislation, Chalmers previously said:

"The average superannuation balance is about $150,000 and the few people with balances above $3 million hold an average of almost $6 million in their accounts. As the Prime Minister said, 17 people have gotten over $100 million and one person's got over $400 million. And think about this example: a $100 million fund earning a 5% return receives a tax break upwards of one and a half million dollars a year compared to a return outside of superannuation taxed at the marginal rate. So it takes 100 average wage earners paying the average amount of tax to pay the tax break for that single super account every year."

Let's consider the selective bias in this statement:

1. The new tax is on balances over $3 million so quoting the impact of a few people over $100 million and one over $400 million is hyperbole.

2. Measuring the impact against marginal tax rates disregards how people will respond. They will not withdraw from super to pay tax at 45%. They will either leave money in super and pay the extra 15% tax or use another investment structure such as a company, or even buy a bigger home and pay no tax.

3. The '17 people hold over $100 million' is a great headline but for all the effort and compliance work involved, the tax will raise only $2 billion a year, even assuming no change in behaviour. It's hardly meaningful tax reform although the Treasurer likes to call it that. In the Tax Expenditure & Insights Statement, Capital Gains Tax (CGT) exemptions total $72 billion and the family home exemption alone is worth $48 billion. Where are the stories about people with homes worth over $10 million making tax-free capital gains? No way, sacred cow.

4. Chalmers is ignoring the main objection to the tax. It is not so much the amount but the way it imposed, taxing unrealised capital gains. Most people in the industry accept the need to cap super benefits but this calculation method is a radical departure from normal tax policy and introduces anomalies.

***

Misinformation comes in many forms. There is so much misleading information in the media that it's difficult to know what to believe, as we cannot be expert in most subjects. As **Morgan Housel** wrote recently:

"Most fields have only a few laws. Lots of theories, hunches, observations, ideas, trends, and rules. But laws – things that are always true, all the time – are rare ... The strongest-held beliefs are usually on topics with the most uncertainty. No one is as passionate about geometry as they are about religion."

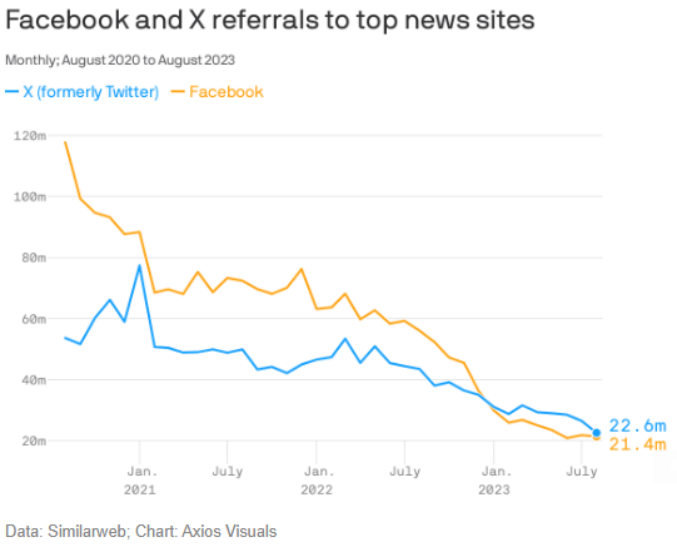
Australia's **Department of Home Affairs** has established a 'Strengthening Democracy Taskforce' because, they say, our democracy is a national asset that should be protected.

"Democracies around the world are under threat from a range of anti-democratising forces, including foreign interference, rising disinformation and discord online, populism and polarisation, and declining reserves of public trust."

General Angus Campbell, Chief of the **Australian Defence Force**, recently told the **Australian Strategic Policy Institute** that:

"This tech future may accelerate truth decay, greatly challenging the quality of what we call public 'common sense', seriously damaging public confidence in elected officials and undermining the trust that binds us."

Social media platforms **X (formerly Twitter) and Facebook** are withdrawing from news content and focussing more on entertainment and viral trends. This chart shows how traffic referrals to news sites have slumped. It compromises the ability of voters to receive accurate information as fewer people can source reliable news on social media platforms.



Consider a social issue regularly in the news, the problem of rising inequality, and some recently-released charts on Australia. Most people accept that rich people should pay proportionally more tax than poor people, but what's the right level? The Australian Taxation Office reports:

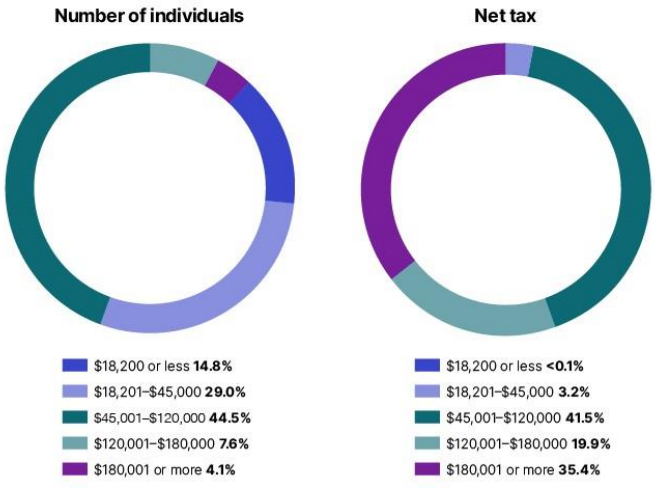
- At the bottom end, 43.8% of adults pay 3.2% of net tax.
- At the top end, 11.7% of adults pay 55.3% of net tax, of which 4.1% pay 35.4%.

If asked the question, how much of net tax should the Top 10% of income earnings pay, how many people would say much more than 50%?

So that's one picture of tax addressing inequality.

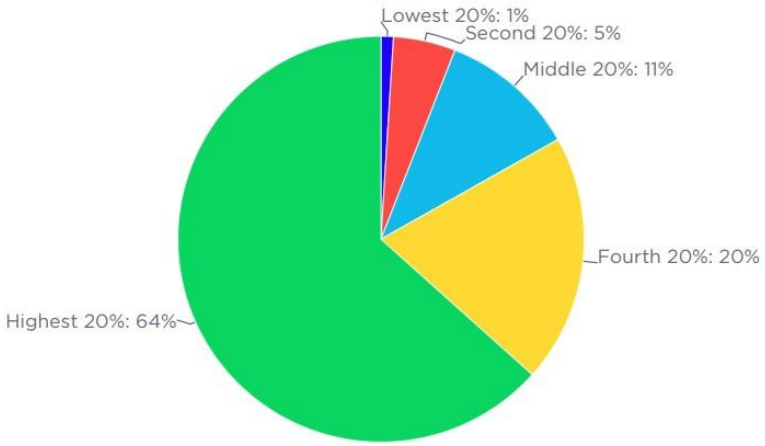
Then last week, the **Australian Council of Social Service** (ACOSS) and **University of NSW**, as part of its Poverty and Inequality Partnership, produced an Inequality in Australia 2023 Overview. It paints a picture less of the wealthy supporting the poor but more like a country where the rich get richer.

"Australia's wealth gap has continued to grow over the past two decades, with superannuation and property investment driving inequality across the country."



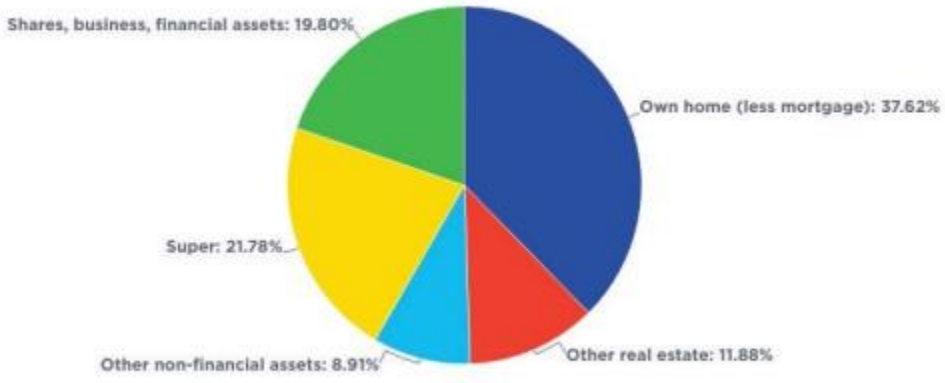
Here are three slides from the Report.

First, the share of all wealth held by each wealth group divided into quintiles. The top 20% holds 64% of wealth, while the bottom 40% holds about 6%.



Second, the two largest components of household wealth are own home (net of mortgage) at 38% and superannuation (22%). Australia is a country where home ownership and superannuation primarily determines where someone stands in the wealth stakes.

Figure 19: Composition of household wealth (% of all wealth in 2019-20)



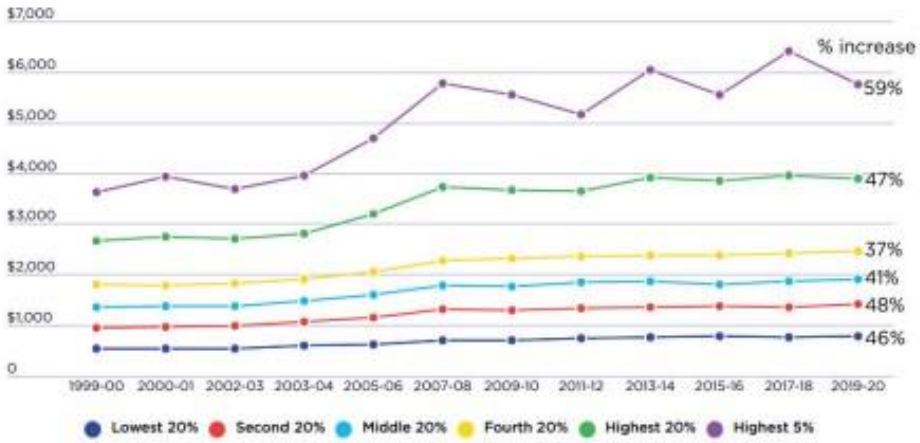
Note: Wealth is adjusted for associated debt. An equivalence scale is not applied to adjust wealth for household size.

Third, between 1999 and 2019, the wealthiest 5% experienced the largest percentage increases in after-tax income, despite what the ATO tax tables show. But the lowest 40% increased their after-tax income by the same percentage as the highest 20%, and it is in the middle tiers - from 41% to 80% - that have experienced the smallest increases.

As the ACOSS/UNSW Report says,

"Since wealth begets more wealth, wealth inequality rises more persistently than inequality of income."

Figure 14: Trends in real average weekly after-tax income from 1999 to 2019 (in 2019 dollars)



Note: Average weekly household disposable incomes for different income groups, after taking inflation into account.

My overall conclusion from the Report is that inequality increases when asset prices rise fastest, and with most wealth in houses and super, inequality rose in the period to 2007 before the GFC, and probably since 2019 with equity and property markets doing well. Our surging property market and strong jobs markets are the main reasons Australians in general are among the wealthiest people in the world. For the main part, whether Australia looks like it is moving to become a more or less egalitarian society reflects market values of assets.

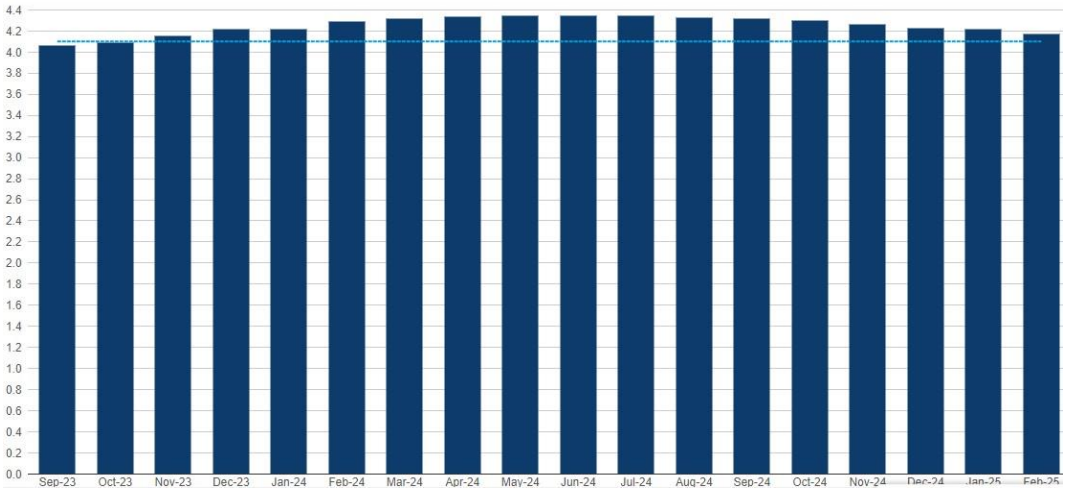
Over the long term, expect superannuation and residential property to perform well and become more of a target for governments seeking to address budget deficits and inequality. Confirmation bias will continue to justify policy decisions.

This week, **David Knox** runs the numbers on whether government revenues are worse due to superannuation benefits, or do the savings in the Age Pension justify the tax breaks. We can be sure we have not seen the end of superannuation changes even if Treasurer Chalmers says the $3 million tax is the only one for this term of government.

***

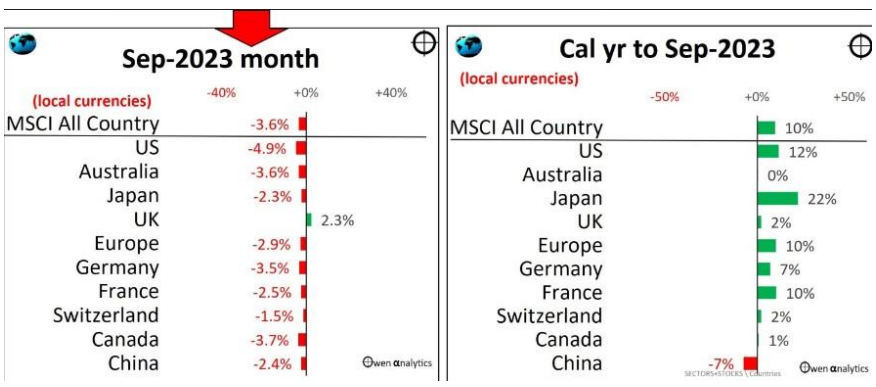
Which all makes the Stage 3 tax cuts an even bigger political issue, although discussion has dropped away in recent months. They are legislated to begin on 1 July 2024, now only nine months away, and taxpayers in the $45,000 to $200,000 bracket will pay a marginal tax rate of 30%. Economist **Chris Richardson** estimates they are the economic equivalent of three interest rate cuts, suggesting this will temper any official reductions in cash rates. The best guess from here is a cash rate at around the current level for at least 18 months.

ASX 30 Day Interbank Cash Rate Futures Implied Yield Curve (as at 28 Sept 2023)



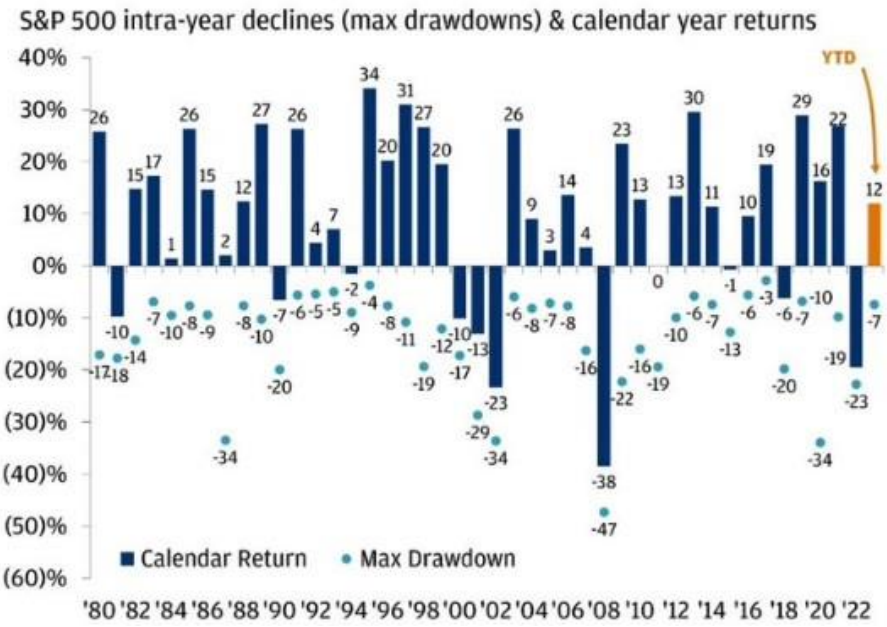
There has been a change in market sentiment in the last month or so, now believing inflation will remain elevated with the robust economy preventing rate falls. Oil prices are higher than expected and the new **Reserve Bank Governor, Michele Bullock**, is already warning about further rate increases.

The S&P/ASX200 is close to a one-year low and bond yields are at a 10-year high as we move into the last quarter of calendar 2023. September 2023 gave away earlier modest gains in Australia and the index is down another 2.5% in October to date. If you feel your portfolio has gone nowhere, combined with losses in bond funds, you're not alone. Those with more US exposure, especially to tech, have done better, but have also given some back recently.

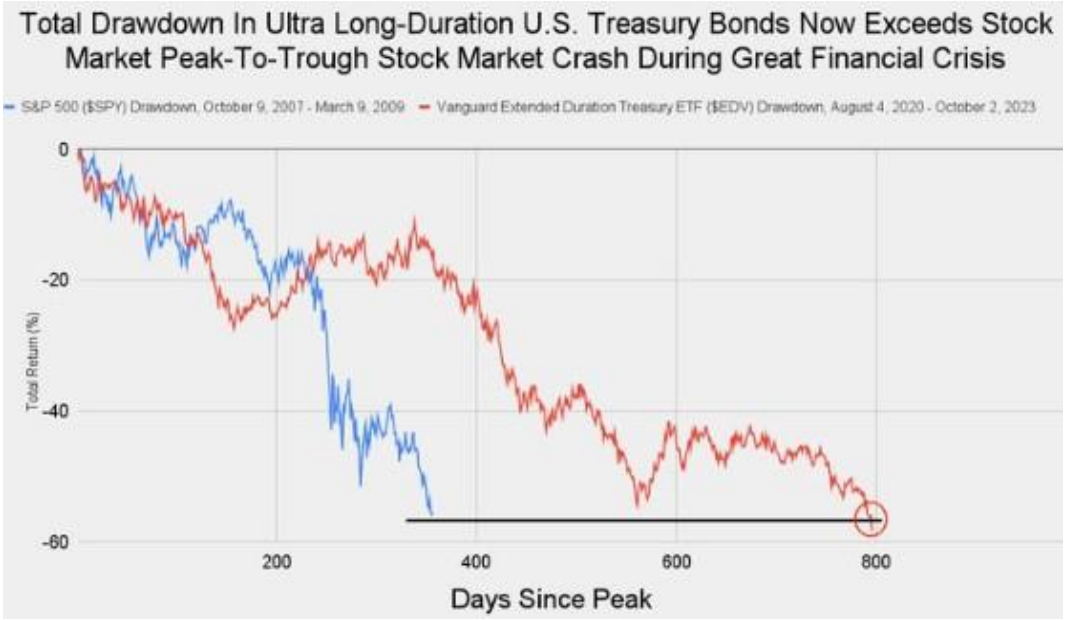


(Chart source, OwenAnalytics)

The challenge for investors is realising that every year, regardless of how well they perform overall, stockmarkets have a solid drawdown (market loss) at some stage of the year, as shown below for the S&P500 index. If there is a company that an investor wants to own, this period can deliver a cheaper opportunity.



For those seeking the safety of long bonds, watch out for duration risk. The rise in interest rates now means that the **Vanguard Extended Duration Treasury ETF** in the US has now experienced a larger drawdown than the S&P500 index during the GFC.



Source: Jack Farley

***

The ATO has issued a special notice to taxpayers about CGT on rental property, shares and crypto assets, saying they are seeing many mistakes in tax returns, including using a family home for income. Assistant **Commissioner Tim Loh** said the ATO receives reports on over 600 million transactions a year, including from property titles offices, revenue agencies, exchanges and share registries. He said:

"Generally, your main residence (your home) is exempt from CGT, but if you've used it to produce income, such as renting out all or part of it, including through the sharing economy, like through Airbnb or Stayz, or running a business from home, then you may have to pay CGT ... If you think you can slide under the radar and avoid reporting a capital gain, think again."

***

In my article this week, I look at how SMSF trustees invest based on three different data sources, then dive deeper into the most popular listed companies, managed funds and ETFs used by SMSFs. There remains a local bias, as most trustees make their own investment decisions based on what they know and understand.

Graham Hand

Also in this week's edition...

Bonds look set for their third straight year of losses, something that hasn't happened over the last 100 years. **James Gruber** analyses what's behind the carnage in bond markets and asks whether this is the start of a generational bond bear market.

More Australians are investing overseas and recent data suggests many are choosing to hedge their international exposure. **Vanguard's Duncan Burns** investigates whether hedging is worth the cost, and if so, which investors it may suit best.

Another episode of the Wealth of Experience podcast is out and this week features special guest, personal finance guru **Noel Whittaker**. Noel offers his key tips for making the most of your retirement. He discusses the mistakes that people make with SMSFs, why super remains a good vehicle for retirees, how estate planning is a 'minefield', and the financial traps to avoid with aged care. Graham looks at LICs and Peter checks in on bonds.

Fidelity's James Abela compares mid-cap stocks to a middle child: both tend to be overlooked and underappreciated. He explains why mid caps offer potentially more growth than large caps and less risk and volatility than small and micro-caps.

Clime's Will Riggall says while bond yields are more attractive than they were a year or two ago, they're still not high enough to compensate for the risks of persistent inflation. Will suggests equities offer the best prospects for income oriented investors.

Lastly, in this week's White Paper, **Franklin Templeton** explains why it no longer expects a technical recession in the US and that central banks will keep interest rates higher for longer.

Which shares and funds do SMSFs invest in?

Graham Hand

SMSF trustees are a heterogeneous group, choosing the vehicle for their superannuation because it offers control and flexibility. Although SMSFs account for 25% of all super balances, only 1.1 million people are SMSF trustees while over 17 million people have a super account. While almost any investment is allowed in an SMSF, a top-level picture can be drawn showing what SMSF trustees invest in, despite variances in data sources.

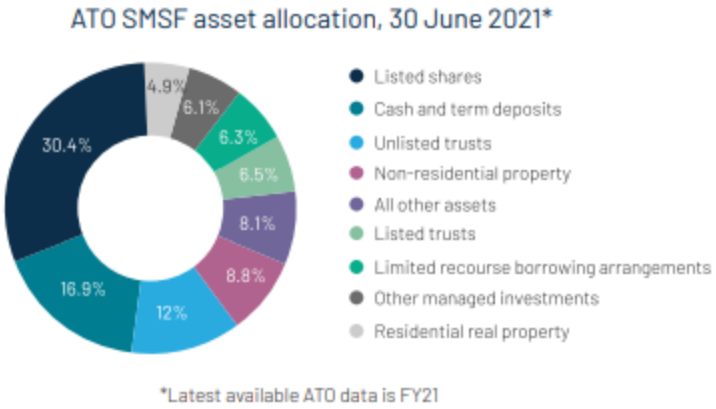
For the most part, SMSFs are genuinely 'self-managed' because the majority of trustees make their own investment decisions. Where guided by advisers, use of platforms and managed funds is higher because advisers use these structures to facilitate their own administration, giving a consistent back-office experience.

Similar but important differences in SMSF data sources

There are three main sources for top-level SMSF data:

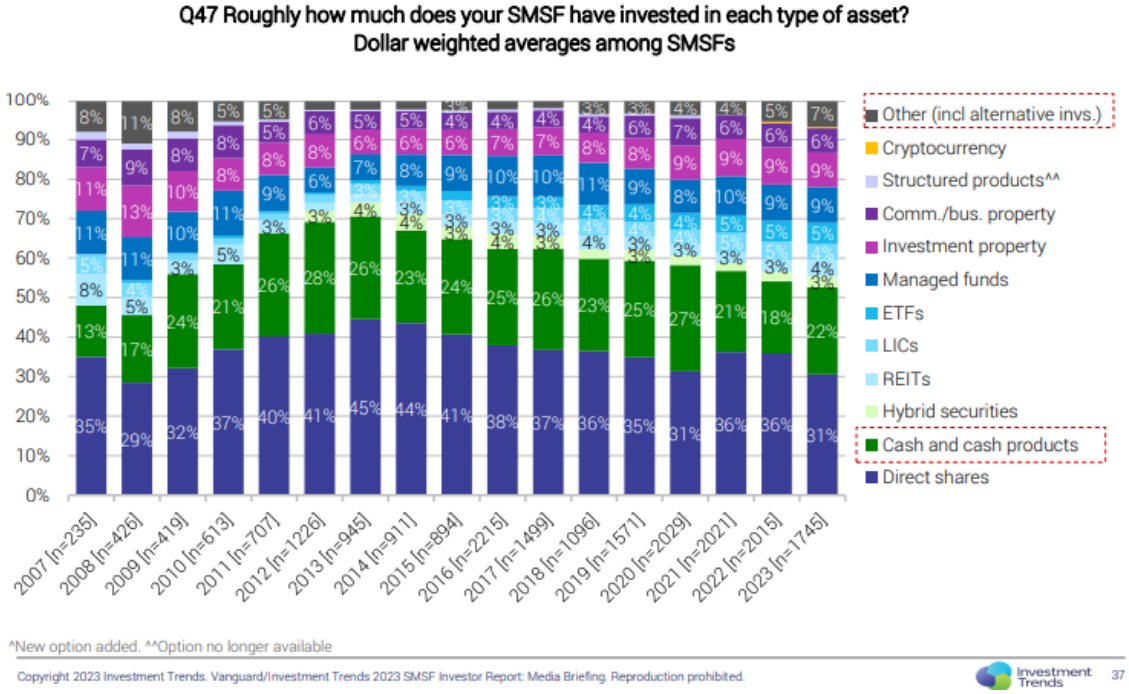
1. Australian Taxation Office (ATO)

The ATO is the regulator for the SMSF sector and collects data on asset allocation, as shown below. As SMSFs lodge returns with considerable delays, the data is often a couple of years old, and some categories are highly aggregated. For example, it is impossible to know how much SMSFs invest in global equities based on ATO data because 'unlisted trusts', 'listed trusts' and 'other managed investments' are lumped together. Nevertheless, 'listed shares' is easily the top category at 30.4%, followed by 'cash and term deposits' at 16.9%.



2. Investment Trends

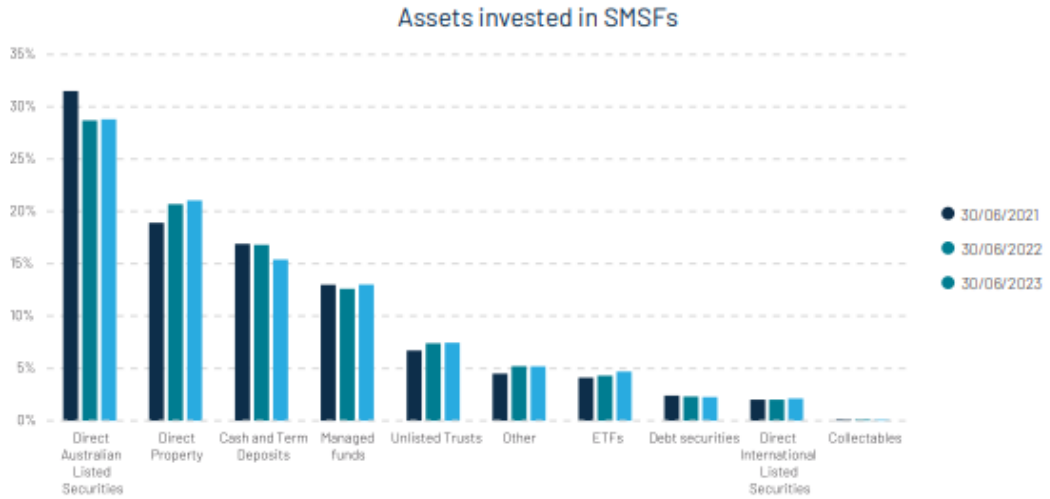
Research firm Investment Trends dives into the data at source by asking online a large sample of SMSF trustees about their portfolio. In the 2023 SMSF Investor Report, 'direct shares' are also the largest asset class followed by cash, and a combination of structures such as managed funds, ETFs and LICs make up the third category.



3. Class Benchmark Report

Class is a software provider to SMSF administrators, and of the $875 billion in SMSFs, Class covers about $310 billion across 185,000 SMSFs and 350,000 members. There is therefore a good sample reflected in its annual Benchmark Report, but it is probably the top end. Their average SMSF holds $1.7 million in assets with an average of $900,000 per member.

Class data shows about 28% of SMSF assets are in Australian listed shares but unlike the other sources, the second largest asset class is direct property, pushing cash and term deposits as low as 15% in third place. Then come the group of managed funds, ETFs and unlisted trusts.

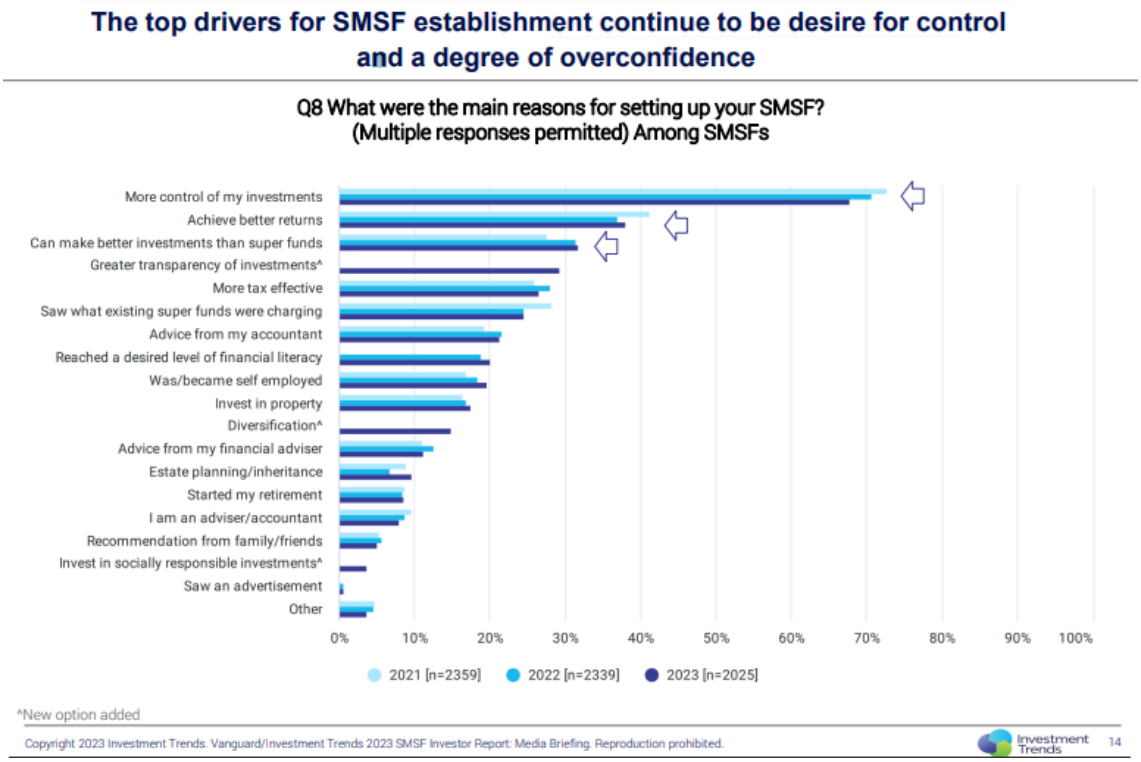


What does the data tell us?

According to Investment Trends, only 27% of SMSF trustees use an investment adviser. The main reasons given are that trustees want to control their own investments, they lack trust in advisers and want to avoid the

cost. In every survey on why SMSFs are established, control tops the list, and other strong factors include confidence in achieving returns, transparency of investments and tax efficiency.

In other words, most SMSF trustees are comfortable in their own ability and financial literacy and prefer to avoid the cost of an investment adviser.



The end result is that SMSF trustees buy Australian shares and funds they are familiar with, and leave a decent amount in cash and term deposits for conservative investment allocation and liquidity access reasons. They know, for example, that in pension phase, they are obliged to pay minimum pensions which require some level of access to cash.

What shares do SMSF trustee Invest in?

One additional benefit of Class knowing the exact investments of its hundreds of thousands of users is that data is available by stock and fund, which the other providers do not offer. In this snapshot, we divide investments into four categories: a) direct domestic, b) direct global equities, c) all managed funds and d) all ETFs.

(The following charts are sourced from the Class Benchmark Report 2023).

a) Direct holdings of domestic equities

About two-thirds of all SMSFs in the sample hold some allocation to the Top 20 domestic shares listed below as at 30 June 2023. BHP and Woodside are the most popular, followed by the four major banks, Telstra, Wesfarmers, CSL and Macquarie. Note this is popularity by number but the right-hand column shows the dollar amount invested, with CBA at number 1 and CSL rising to number 3.

Rank	Security code	Description	% Of funds with domestic shares that hold this security	% of total SMSF domestic share investments
1	BHP	BHP Group Limited	48.0%	5.0%
2	WDS	Woodside Energy Group Ltd	45.6%	2.3%
3	WBC	Westpac Banking Corporation	40.9%	3.4%
4	CBA	Commonwealth Bank of Australia	39.1%	6.0%
5	NAB	National Australia Bank Limited	38.9%	3.6%
6	ANZ	Australia And New Zealand Banking Group Limited	37.9%	3.0%
7	TLS	Telstra Corporation Limited	37.4%	2.4%

8	WES	Wesfarmers Limited	32.2%	2.5%
9	CSL	CSL Limited	31.8%	4.3%
10	MQG	Macquarie Group Limited	28.3%	3.1%
11	WOW	Woolworths Group Limited	23.1%	1.5%
12	COL	Coles Group Ltd	20.1%	0.8%
13	RIO	Rio Tinto Limited	19.0%	1.5%
14	TCL	Transurban Group – Ordinary Shares/Units Fully Paid Triple Stapled	17.9%	1.3%
15	EDV	Endeavour Group Ltd	17.8%	0.3%
16	S32	South32 Limited	15.1%	0.4%
17	STO	Santos Limited	15.0%	0.7%
18	AMC	AMCOR PLC/IDR UNRESTR	13.6%	0.5%
19	SHL	Sonic Healthcare Limited	12.9%	0.7%
20	RHC	Ramsay Health Care Limited	12.7%	0.5%
Total *(percentage that the top 20 make up of total SMSF investments in direct domestic shares)*				**43.8%**

b) Direct holdings of global equities

Direct holding of global shares is much less common, comprising only 2.2% of SMSF assets and held by only 10% of funds. This number is often misunderstood because it does not show the extent of SMSF investment in global equities, as trustees normally invest indirectly through ETFs and managed funds.

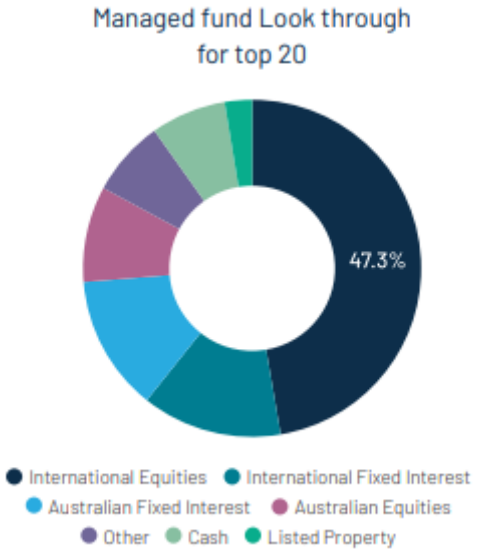
But taking care to read these numbers correctly as direct holdings only, not via funds (and the percentages are 'of international funds', not 'of total assets'), it is no surprise to see the tech giants of Microsoft, Alphabet, Amazon and Apple at the top. These stocks have performed strongly in 2023 delivering astute rewards for many SMSFs.

Rank	Security code	Exchange	Description	% of funds with international shares that hold this security'	% of total SMSF international share investments
1	MSFT	NASDAQ	Microsoft Corp	25.7%	5.5%
2	GOOG(L)	NASDAQ	Alphabet Inc - Class C (A) Shares combined	23.6%	2.6%
3	AMZN	NASDAQ	Amazon.com Inc	20.7%	2.8%
4	AAPL	NASDAQ	Apple Inc	18.6%	7.8%
5	V	NYSE	Visa Inc	10.9%	1.6%
6	PYPL	NASDAQ	PayPal Holdings Inc	8.3%	0.4%
7	TSLA	NASDAQ	Tesla Inc	7.7%	1.8%
8	BRK.A/B	NYSE	Berkshire Hathaway Inc. Classes A & B combined	7.7%	2.9%
9	NVDA	NASDAQ	NVIDIA Corporation	7.7%	1.8%
10	JNJ	NYSE	Johnson & Johnson	7.3%	0.6%
11	DIS	NYSE	Walt Disney Company	7.0%	0.6%
12	ASML	NASDAQ	ASML Holding NV	6.8%	0.5%
13	BABA	NYSE	Alibaba Grp Shs Sponsored American Deposit Share Repr 1 Sh	6.6%	0.4%
14	JPM	NYSE	JPMorgan Chase & Co	5.9%	0.8%
15	MA	NYSE	MasterCard Inc	5.6%	0.8%
16	MC	NYSE	Moelis & Co	5.0%	0.8%
17	COST	NASDAQ	Costco Wholesale Corporation	5.0%	0.4%
18	NKE	NYSE	Nike Inc	4.6%	0.4%
19	TSM	NYSE	Taiwan Semiconductor Mfg. Co. Ltd.	4.4%	0.3%
20	CRM	NYSE	salesforce.com, inc.	4.2%	0.3%
Total *(percentage that the top 20 make up of total SMSF investments in direct international shares)*					**33.3%**

c) Managed funds

Although ETFs receive a higher profile, managed funds occupy a significantly larger proportion of SMSF assets (12.9%) than ETFs (4.7%). And confirming the point made above that Australians use funds rather than direct investments, almost half of managed funds are international equities.

Showing how it established an early lead under the high-profile Kerr Neilson, Platinum remains the most common managed fund in SMSF portfolios. The Ardea and Janus Henderson funds may not be as well known to many SMSF trustees but are favoured by financial advisers for their broad market exposures, with a PIMCO bond fund and the large Magellan Global Fund (non-listed version) rounding out the Top 5. Note again that the right-hand column shows dollar amounts in managed funds, not all assets.



Rank	Security code	Description	% of funds with managed funds that hold this security	% of total SMSF managed fund investments
1	PLA0002AU	Platinum International Fund	10.9%	1.7%
2	HOW0098AU	Ardea Real Outcome Fund	10.0%	1.1%
3	IOF0145AU	Janus Henderson Tactical Income Fund	9.0%	1.1%
4	ETL0018AU	PIMCO Global Bond Fund – Wholesale Class	8.8%	0.8%
5	MGE0001AU	Magellan Global Fund	8.5%	1.1%
6	ETL0276AU	Partners Group Global Value Wholesale	6.9%	1.2%
7	CSA0038AU	Bentham Global Income Fund	6.1%	0.6%
8	FID0008AU	Fidelity Australian Equities Fund	5.9%	0.9%
9	MAQ0277AU	Macquarie Income Opportunities Fund	5.8%	0.6%
10	BFL0004AU	Bennelong ex-20 Australian Equities Fund	5.8%	0.5%
11	MGE0002AU	Magellan Infrastructure Fund	5.4%	0.5%
12	ETL0071AU	T. Rowe Price Global Equity	5.3%	0.7%
13	PLA0004AU	Platinum Asia Fund	5.1%	0.7%
14	MAQ0410AU	Walter Scott Global Equity Fund	5.1%	1.0%
15	VAN0003AU	Vanguard Wholesale International Shares Index Fund	5.0%	1.2%
16	LAZ0014AU	Lazard Global Listed Infrastructure	4.7%	0.4%
17	VAN0004AU	Vanguard Australian Property Securities Index Fund	4.7%	0.4%
18	ETL0016AU	PIMCO Diversified Fixed Interest Fund – Wholesale Class	4.6%	0.6%
19	MIA0001AU	MFS Global Equity Trust	4.4%	0.6%
20	MGL0004AU	Ironbark Royal London Concentrated Global Share Fund	4.3%	0.5%
Total *(percentage that the top 20 make up of total SMSF investments in managed funds)*				**16.2%**

d) Exchange Traded Funds (ETFs)

Fast-growing as a sector with now almost $160 billion under management, ETFs are still the new kids on the block compared with other asset categories, but again, almost half represent global exposures.

Most popular among SMSFs that use ETFs are two Vanguard funds, Australian Shares (ASX:VAS) and Australia Property (ASX:VAP) but the major ETF providers – Vanguard, iShares, VanEck, BetaShares and Magellan - are all in the Top 10. Notable exceptions from the broad-cap market indexes are VanEck's Global Quality (ASX:QUAL), BetaShares NASDAQ 100 (ASX:NDQ), Magellan Infrastructure (ASX:MICH) and BetaShares Cash (ASX:AAA). Most of the Top 10 popular funds are international.

Rank	Security code	Description	International / domestic	% of funds with ETFs that hold this security	% of total SMSF ETF investments
1	VAS	Vanguard Australian Shares Index ETF - Exchange Traded Fund Units Fully Paid	D	12.6%	5.5%
2	VAP	Vanguard Australian Property Securities Index ETF - Exchange Traded Fund Units Fully Paid	D	12.5%	2.6%
3	IVV	Ishares S&P 500 ETF - Exchange Traded Fund Units Fully Paid	I	11.5%	2.8%
4	VEU	Vanguard All-World Ex-Us Shares Index ETF - Chess Depositary Interests 1:1	I	10.6%	7.8%
5	VGS	Vanguard MSCI Index International Shares ETF - Exchange Traded Fund Units Fully Paid	I	9.7%	1.6%
6	QUAL	VanEck Vectors MSCI World ex Australia Quality ETF - Exchange Traded Fund Units Fully Paid	I	9.0%	0.4%
7	MGOC	Magellan Global Fund (Open Class)	I	8.7%	1.8%
8	IOO	Ishares Global 100 ETF - Exchange Traded Fund Units Fully Paid	I	8.5%	2.9%
9	VTS	Vanguard Us Total Market Shares Index ETF - Chess Depositary Interests 1:1	I	8.5%	1.8%
10	NDQ	Betashares Nasdaq 100 ETF - Exchange Traded Fund Units Fully Paid	I	7.4%	0.6%
11	MICH	Magellan Infrastructure Fund	I	7.4%	0.6%
12	AAA	Betashares Australian High Interest Cash ETF - Exchange Traded Fund Units Fully Paid	D	7.1%	0.5%
13	VGAD	Vanguard MSCI Index International Shares (Hedged)	I	7.0%	0.4%
14	STW	SPDR S&P/ASX 200 Fund - Exchange Traded Fund Units Fully Paid	D	6.8%	0.8%
15	HBRD	Betashares Active Australian Hybrids Fund (Manged Funds)	D	6.5%	0.8%
16	MVW	Vaneck Vectors Australian Equal Weight ETF - Exchange Traded Fund Units Fully Paid	D	6.3%	0.8%
17	VHY	Vanguard Australian Shares High Yield ETF - Exchange Traded Fund Units Fully Paid	D	6.3%	0.4%
18	A200	BetaShares Australia 200 ETF	D	6.0%	0.4%
19	IXJ	Ishares Global Healthcare ETF - Exchange Traded Fund Units Fully Paid	I	6.0%	0.3%
20	VAF	Vanguard Australian Fixed Interest Index ETF - Exchange Traded Fund Units Fully Paid	D	5.7%	0.3%
Total *(percentage that the top 20 make up of total SMSF investments in exchange-traded funds)*					**50.8%**

SMSF trustees doing their own thing

Trustees select SMSFs for the high degree of control and they can hold almost anything that looks like an 'investment', such as collectibles, wine, art and cars. A report by SuperConcepts in 2019 showed its SMSFs held weird investments such as frozen semen, ATMs, vending machines, water rights, cattle and taxi plates.

However, Class data shows a concentration of over 85% of SMSF assets in five categories: Australian listed shares, direct property, cash and term deposits, managed funds and unlisted trusts. SMSFs show a home bias due to familiarity with the investments and the franking credits regime.

The data indicates that of the 1.1 million trustees with 610,000 funds, the majority are doing their own thing, if not picking the shares directly, then identifying the active or index investments to look after their retirement savings.

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

Rethinking super tax concessions for the future

David Knox

Superannuation tax concessions have been the subject of considerable public debate in recent times. The debate is likely to be fuelled again by this week's release of draft legislation for a new tax on investment earnings for total superannuation balances above $3 million.

The legislation and commentary around it suggest that the current tax arrangements for superannuation are unfair and/or unsustainable.

This article tackles this issue from a different perspective. That is, are there long-term financial benefits from the tax concessions for individuals and the government?

But let's begin with an analogy.

It's not super versus Age Pension

Many Australians own an investment property. The annual expenses relating to this investment include borrowing costs, maintenance, land tax, council rates and insurance which may exceed the income received from their tenants. However, their investment is for the long term and any short-term negative cashflow is an investment for the longer-term benefit.

Superannuation tax concessions should be considered in a similar way. That is, taxpayers (through government policies) are investing for the longer term, in line with two broad government objectives. The first is to enable Australians to have a dignified retirement and the second is to reduce future Age Pension costs.

Hence, we'll look to address the following question:

Does the government's investment in superannuation provide a fair outcome for individuals and improve the government's future fiscal position?

This longer-term holistic approach also highlights the inappropriateness of comparing today's Age Pension costs with the level of superannuation tax concessions for future retirees. These two forms of government support are given to different generations for different purposes. There is no reason why one should be higher or lower than the other.

The base case: a median income earner

Consider an individual on the current median income of $65,000 and subject to a marginal income tax rate of 34.5%, including the Medicare levy.

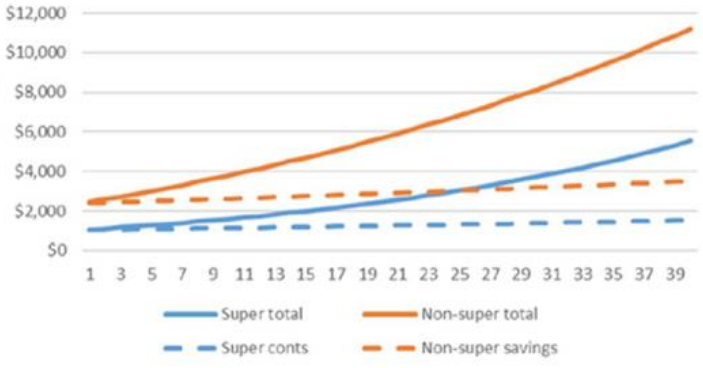
Assume this worker receives an SG contribution of 12% throughout their career of 40 years and will have a retirement period of 25 years from the age of 67. We will also assume that at retirement, the individual will convert their accumulated superannuation benefit into an account-based pension, which represents the most popular retirement product in Australia today. We will also assume that the retiree withdraws money from their account-based pension using the minimum drawdown rules which apply from 30 June 2023. Again, this represents the behaviour of many retirees who have a reasonable superannuation benefit.

We will compare this superannuation scenario with a non-super counterfactual. That is, the government continues to require a savings rate of 12% but provides no taxation concessions so that these savings are taxed at the individual's marginal tax rate. The resulting investment income would also be taxed but at a slightly lower rate to allow for the capital gains discount and franking credits. During retirement, the retiree would again withdraw money based on the minimum drawdown rules.

Under both scenarios, the retiree may receive a part or full Age Pension, subject to the current income and assets tests, with the thresholds indexed to CPI.

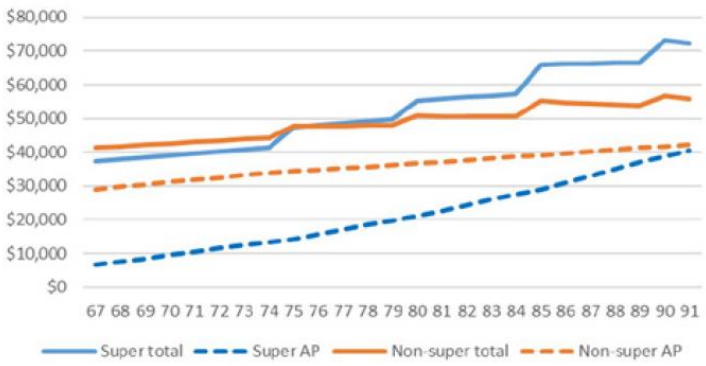
Figure 1 shows the actual tax paid during the 40 years of active employment, from both the superannuation and non-super scenarios. The numbers have been deflated by CPI to express them in today's dollars. The top solid lines in Figure 1 represent the total tax paid each year while the lower dashed lines show the tax paid on the super contributions and the saved income respectively. The difference between the solid and dashed lines represents tax paid on the investment earnings which naturally increases as the balances grow over time.

Figure 1: The real value of tax paid each year



Now let's turn to the retirement years. Figure 2 shows the total income and Age Pension received each year, again deflated by CPI, to express it in today's dollars (AP=Age Pension).

Figure 2: Real income during retirement



Several observations are worth making.

- The Age Pension (AP) paid under the non-super scenario is higher than under the superannuation scenario due to the lower level of financial assets.
- The Age Pension payments increase materially during retirement under the superannuation scenario as the superannuation balance is gradually reduced. This outcome highlights the impact of the assets test on the Age Pension.
- Due to the impact of the assets test, the total income in the super scenario begins below the income in the non-super scenario but overtakes it at age 75 due to the impact of the increasing Age Pension.
- The total income received is jagged under both scenarios due to the impact of the minimum drawdown rules.

Finally, and not shown in the graph, is the capital available at age 92 under the two scenarios. In today's dollars, the balances are $274,150 and $162,822 for the super and non-super scenarios respectively.

The real value of all the future income in retirement plus the remaining capital at age 92 under the superannuation scenario is 23.1% higher than the real value of the future income and remaining capital under the non-super scenario. This represents a good outcome for the individual with superannuation.

But what about the cost to the Budget?

However, the question remains: How much did this positive outcome for the retiree with superannuation cost the government?

The costs to the government include the superannuation tax concessions shown in Figure 1 as well as the limited income tax during the retirement years, in contrast to the income tax that would be paid under the non-super scenario. However, these concessions must be offset against the extra Age Pension payments paid under the non-super scenario shown in Figure 2.

Table 1 shows the government finances under both the super and non-super scenarios allowing for future Age Pension payments and the tax received during both the pre-retirement and retirement years. These future cash flows have been deflated in Table 1 at both the assumed CPI rate of 2.5% and the assumed long term bond rate of 5%.[1]

Table 1: The net present value of future cash flows between the government and the individual

Deflator	2.5% (CPI)		5% (bond rate)	
	Super	Non-super	Super	Non-super
Taxes in active years	$111,589	$226,088	$62,033	$127,948
Taxes during retirement	$3,151	$102,123	$676	$29,082
Age Pension costs	-$530,950	-$867,450	-$137,945	-$239,475
Net revenue to government	**-$416,210**	**-$539,240**	**-$75,237**	**-$82,446**
Net gain under super scenario	**$123,030**		**$7,209**	

These figures highlight:

- The most significant cost to the government relating to the provision of retirement income for a median income earner is the Age Pension.
- This cost is significantly reduced by the presence of superannuation.
- There is a net gain to the long-term government finances under the superannuation scenario, both in real terms and when the bond rate is used as the deflator.
- The income tax paid during retirement is higher under the non-super scenario as both the investment earnings and the Age Pension are subject to tax.
- As expected, the present value figures are much lower when a higher deflator is used.

In sum, the superannuation scenario provides a better long term financial outcome for both the individual and the government than the non-super counter-factual.

Of course, there are many different scenarios for different income levels, though most of them also show a similarly favourable outcome for the superannuation scenario for both individuals and the government. These scenarios and their assumptions can be found in the full report here.

Tax concession improvements

Many government reports, including the Henry Tax Review and the Retirement Income Review, make the case that superannuation should be supported by the government through tax concessions and not be taxed in the same way as other forms of saving. However, that is not to say the current arrangements are fair or appropriate.

Our recommendations for improvement include:

- reducing the taper rate of the assets test of the Age Pension from $3 per fortnight to $2 per fortnight.
- increasing the current minimum drawdown rates for pension products by 2% to increase the level of drawdown during retirement.
- maintaining the current concessional contributions cap, as it should be no less than the required SG contribution rate on the maximum super contribution base.
- halving the current non-concessional contribution cap or introducing a lifetime cap for non-concessional contributions.
- reducing the threshold for the Division 293 tax from $250,000 to $225,000 (or 20% above the top marginal income tax rate).
- introducing the additional tax on investment earnings for balances above $3 million while ensuring that this cap is always greater than or equal to the indexed transfer balance cap.

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. Mercer's full report "Rethinking super tax concessions" can be downloaded here.

Is this the start of a generational bear market in bonds?

James Gruber

At the start of this year, fund managers and individual investors piled back into bonds. Suddenly, bonds had a decent yield. And they'd just endured their worst annual performance on record, which surely meant reversion to the mean would see them bounce back.

Yet that hasn't happened. Bonds are possibly heading for a third straight year of losses, which is unprecedented over the past 100 years.

What's surprising is that investors are so surprised by these events. After all, what happened before this period was itself unprecedented, with bond yields turning negative in many countries, something that has rarely happened. A snapback from these extraordinarily low yields was inevitable.

And if you zoom out from the current noise, bond market cycles tend to last 30-40 years. Bond yields came down for 39 years from 1981 to 2020. 2020 likely marked the beginning of a long cycle of rising yields. Commentators now talk about yields and rates being 'higher for longer', meaning perhaps higher for another 12 months. What they should really be saying is that yields could be going higher for *a lot* longer, if history is any guide.

It's a bond bloodbath

If you thought bond were due for better times this year, you weren't alone. Fund manager expectations for lower bond yields hit 20-year highs in April this year, and still hover near those highs.

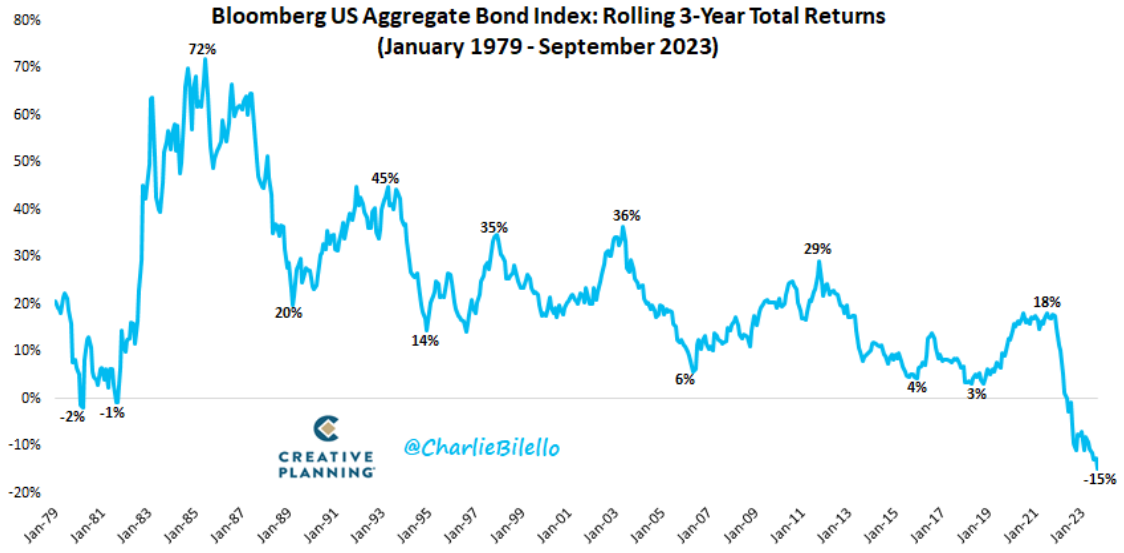
It hasn't turned out well for many of these managers with bonds again in the red this year. If the trend continues and bonds finish down again this year, it would be the third consecutive year of losses, something that hasn't happened over the past century.

And it's the worst three year stretch for US aggregate bonds on record.

US 10-Year Treasury Bond: Total Returns (1928 - 2023)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	0.8%	1948	2.0%	1968	3.3%	1988	8.2%	2008	20.1%
1929	4.2%	1949	4.7%	1969	-5.0%	1989	17.7%	2009	-11.1%
1930	4.5%	1950	0.4%	1970	16.8%	1990	6.2%	2010	8.5%
1931	-2.6%	1951	-0.3%	1971	9.8%	1991	15.0%	2011	16.0%
1932	8.8%	1952	2.3%	1972	2.8%	1992	9.4%	2012	3.0%
1933	1.9%	1953	4.1%	1973	3.7%	1993	14.2%	2013	-9.1%
1934	8.0%	1954	3.3%	1974	2.0%	1994	-8.0%	2014	10.7%
1935	4.5%	1955	-1.3%	1975	3.6%	1995	23.5%	2015	1.3%
1936	5.0%	1956	-2.3%	1976	16.0%	1996	1.4%	2016	0.7%
1937	1.4%	1957	6.8%	1977	1.3%	1997	9.9%	2017	2.8%
1938	4.2%	1958	-2.1%	1978	-0.8%	1998	14.9%	2018	0.0%
1939	4.4%	1959	-2.6%	1979	0.7%	1999	-8.3%	2019	9.6%
1940	5.4%	1960	11.6%	1980	-3.0%	2000	16.7%	2020	11.3%
1941	-2.0%	1961	2.1%	1981	8.2%	2001	5.6%	2021	-4.4%
1942	2.3%	1962	5.7%	1982	32.8%	2002	15.1%	2022	-17.8%
1943	2.5%	1963	1.7%	1983	3.2%	2003	0.4%	2023	-3.0%
1944	2.6%	1964	3.7%	1984	13.7%	2004	4.5%		
1945	3.8%	1965	0.7%	1985	25.7%	2005	2.9%		
1946	3.1%	1966	2.9%	1986	24.3%	2006	2.0%		
1947	0.9%	1967	-1.6%	1987	-5.0%	2007	10.2%		

CREATIVE PLANNING @CharlieBilello As of 9/30/23



Why are bond yields continuing to rise?

As noted in a recent article by Morningstar's Tom Lauricella, there are several factors behind the continuing rise in bond yields:

US economic strength. While America is slowing somewhat, it's nowhere near as much as economists expected 12 months ago. And the economy appears to have picked up this quarter. The Federal Reserve Bank of Atlanta's GDPNow measure—measuring the current pace of gross domestic product growth—suggests third-quarter GDP will be 4.9%, up from the 2.1% in the second quarter. If right, it would also be the strongest rate of quarterly GDP growth since the end of 2021. The US job market is especially strong, with recent initial job claims coming in at 201,000, a very low number.

Central bank expectations for fewer interest rate cuts in 2024. Given the economic strength, it's no surprise that the US Federal Reserve and other central banks are starting to talk about fewer interest rate cuts for next year. Recently released Fed forecasts show the funds rate at 5.1% at year-end 2024, which would imply a half-percentage-point cut at most.

US net debt issuance. At the end of July, bond investors were caught off-guard when the Treasury announced a significantly larger need to raise money than what they expected. The US government now expects to raise a net $1.007 trillion through bond sales in the third quarter—the largest-ever cash raise during a third quarter. With this announcement, the supply/demand dynamic of the bond market was thrown off balance as bond dealers and investors factored in the additional amount of bonds entering the market while the fundamental backdrop was worsening.

I would also add other factors:

Sticky inflation. In the US and elsewhere, inflation isn't coming down as quickly as many had expected. In fact, it's going up again in some countries, such as Australia. Here, the annual headline consumer price index climbed to 5.2% in August from 4.9% a month earlier.

Excess savings being worked through. What's continuing to be underestimated is the enduring impact from money printing by central banks during Covid. The banks printed US$8 trillion, financing roughly the same amount of government spending, and directly monetizing the largest peacetime deficits in US history. Sticky inflation is the hangover from this money printing.

A 40-year bond market cycle?

While everyone focuses on the short-term rise in bond yields, it pays to put them into context.

Source: Trading Economics

There have been three long-term bond market cycles for US government bonds over the past 100 years. The first cycle started after World War One. Bond yields peaked just above 5% in 1921. Due to deflation from the Great Depression and a cap on rates to finance World War II, yields dropped to 2.48% in 1954. That ended a 33-year bull market in bonds.

From 1954, the second cycle began. Though yields didn't really pick up until the 1960s when inflation started to rise, partly due to Lyndon Johnson's government spending on an ambitious domestic agenda and the Vietnam War. Inflation and bond yields went even higher in the 1970s before Fed Chairman Paul Volcker hiked rates above 20% to squash inflation in the early 1980s. That ended the bond bear market of 37 years.

The third cycle started in 1981 with US 10-year bond yields close to 16%. From that high point, yields fell to just 0.5% in mid-2020. A 39-year bull market for the ages, helped by deflationary forces including globalization, China's entry into the World Trade Organisation in 2001, favourable demographics, among other factors.

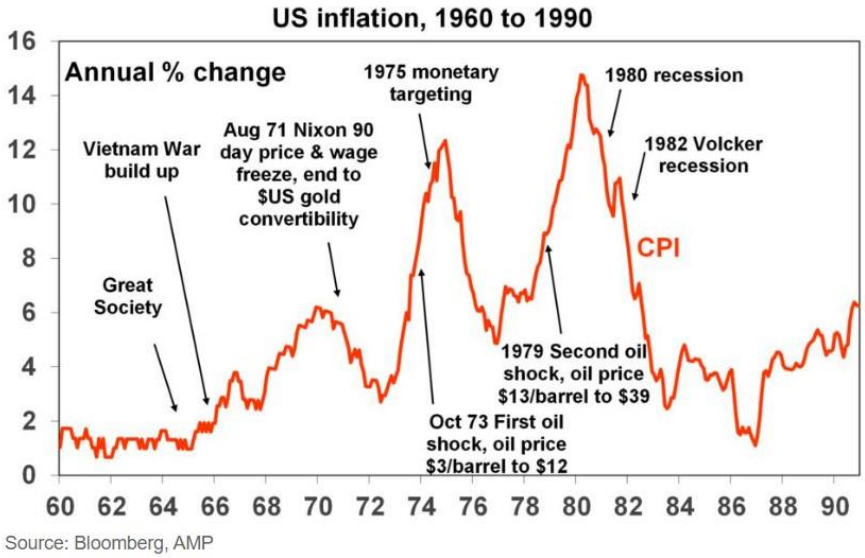
It's likely 2020 marked the start of a new bond market cycle. Whether this one is a long-lasting as those previously remains to be seen. There are no scientific laws to suggest that market cycles should last 30-40 years. Rather, they're a historical pattern that we should pay attention too.

It could be a volatile period

If we have entered another long-term cycle of rising bond yields, it doesn't mean that yields will continue to rise in a straight line. Far from it.

During the last major spike in inflation during the 1970s, there was extreme volatility in inflation, interest rates, and bond yields.

From the mid-1960s, US inflation went from below 2% to more than 6% in 1971. Then it went down again as President Nixon announced a 90-day price and wage freeze, and an end to US dollar-gold convertibility. Then in 1973, there was the first oil shock which drove oil prices from US$3 a barrel to US$12 a barrel. After monetary tightening in 1975, inflation again fell sharply, before

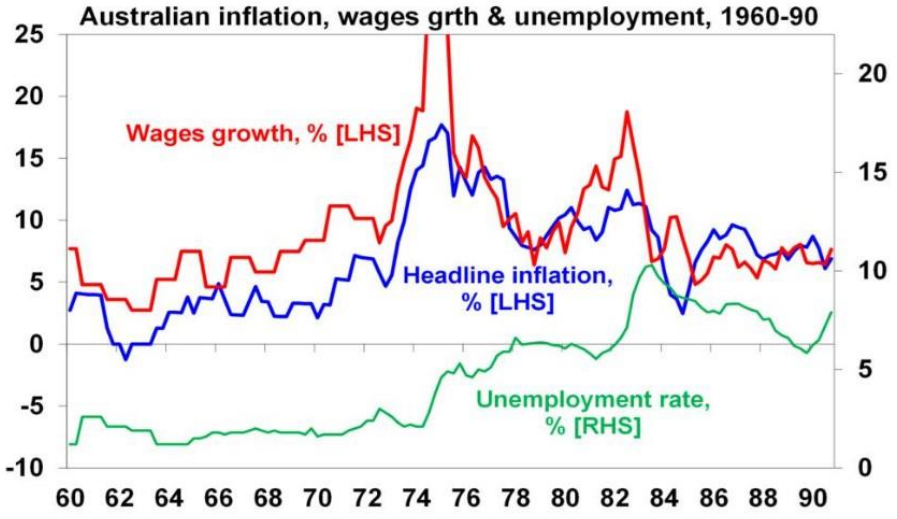


a second oil shock in 1979 sent inflation flying again.

It was a similar story in Australia.

There wasn't one inflationary cycle in the 1970s. The period saw inflation turn to deflation and back again very quickly. It was a stop-start cycle.

When inflation came sharply down, central banks dropped rates and printed money to prevent deflation. And when inflation spiked again, they slammed on the monetary brakes to bring it down again. But it took over a decade for them to get inflation under control.



Source: ABS, AMP

The silver lining in inflation

Believe it or not, inflation can serve a purpose. It's a way to correct economic imbalances. It's a painful way but can be the only option if governments and central banks don't take action to correct unsustainable imbalances built up over many years.

Currently, governments and individuals have taken on an enormous pile of debt, and one way to reduce that debt is for interest rates to be kept below the rate of inflation for a period of time – otherwise known as financial repression. It's what happened post-World War Two and it could well be happening now.

What it means for your portfolio

Noone knows what the future holds. If history is a guide though, we could be three years into a multi-decade bear market in bonds.

What does that mean for your portfolio? It doesn't mean that bonds won't improve from here. Three down years for any asset class is rare, and when they happen, they usually result in a sharp, short-term bounce, as table 7.9 shows.

Table 7.8 Country Mean Reversion 1903–2007

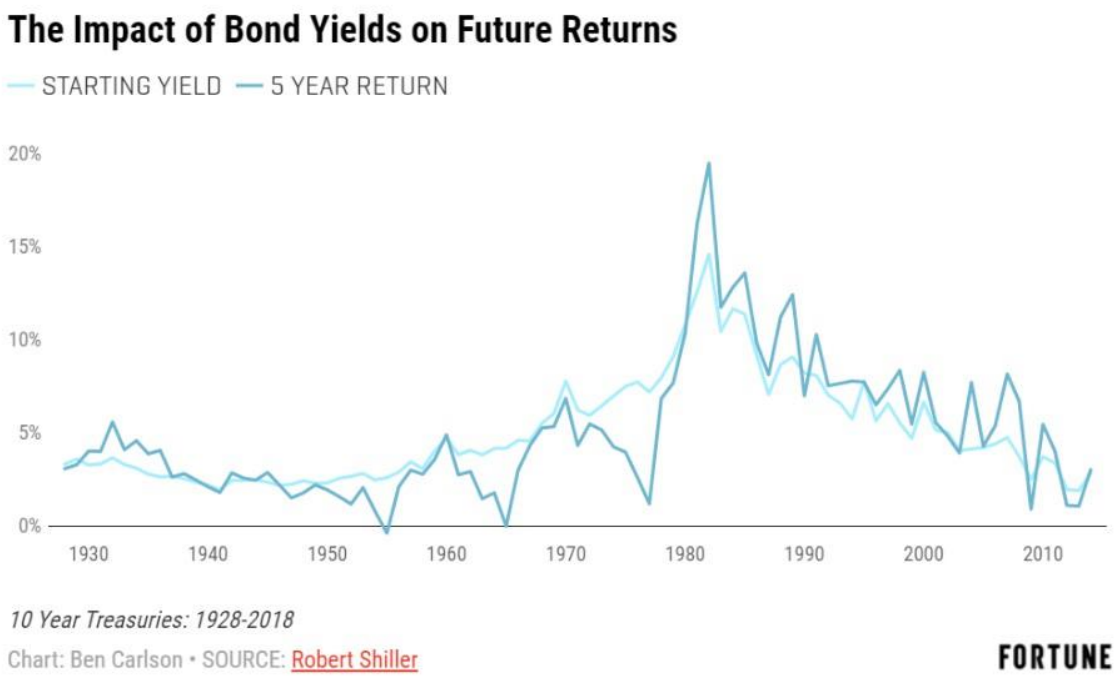
	All Years	After Two Down Years in a Row	After Three Down Years in a Row
Average Return	13.02%	19.03%	30.30%
Median Return	10.65%	14.97%	19.57%
Frequency	100%	9.26%	2.59%

Table 7.9 Asset Class Mean Reversion 1975–2007

	All Years	After Two Down Years in a Row	After Three Down Years in a Row
Average Return	12.97%	23.19%	33.93%
Median Return	12.18%	28.68%	33.93%
Frequency	100%	7.27%	1.21%

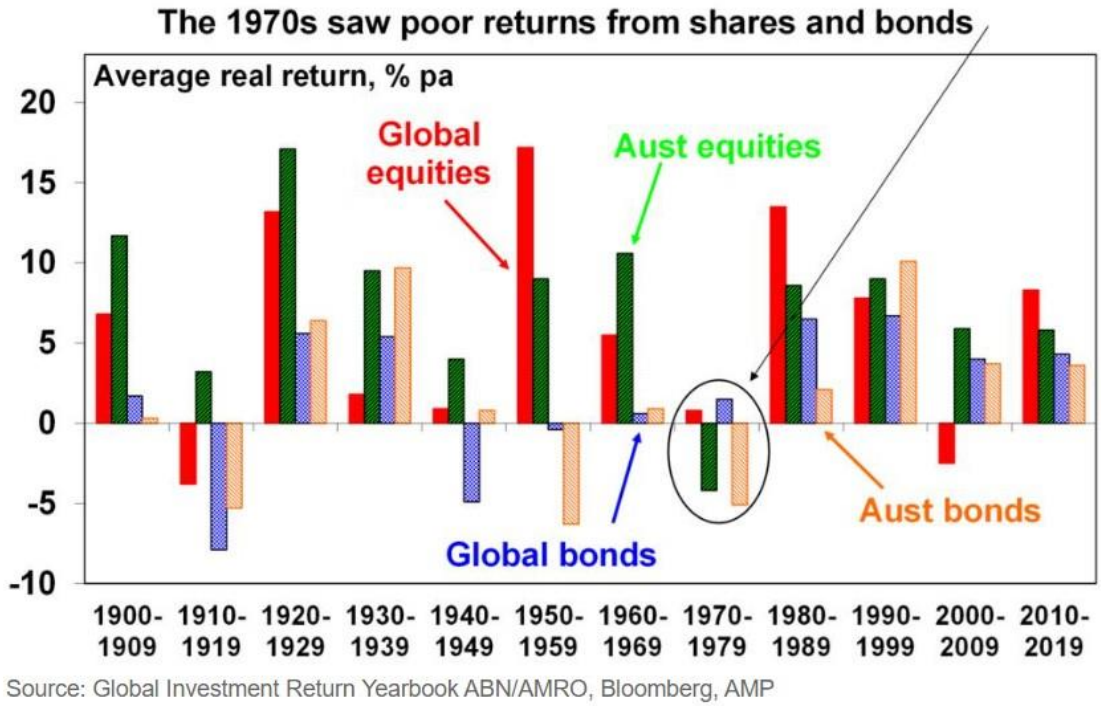
That means a comeback for bonds in the next 12 months wouldn't surprise.

The other bit of good news for bonds is that five year returns on bonds are highly correlated to their starting yield. Put simply, if you buy a 10-year bond at close to a 5% yield, that yield is likely to be your total return over a five-year period.



The problem is that this measures nominal bond returns not real returns. The difference between nominal and real returns is inflation. And inflation is a killer for bonds.

For example, during the 1970s, real bond returns in Australia were deeply negative, and they were only marginally positive for global bonds.



Given current sticky inflation and the potential for a long-term bear market, bonds may have a hard time of it from here.

From the chart above, you can see that equities don't like high inflation and bond yields either. What the chart doesn't show though is that certain types of stocks performed well during the 1970s. Namely, value stocks and real assets.

EXHIBIT 10: EQUITIES DURING THE HIGH INFLATION ERA

Source: Ken French, Global Financial Data, GMO

EXHIBIT 11: COMMODITY EQUITIES, VALUE EQUITIES, AND INFLATION

Source: Ken French, Global Financial Data, GMO

Why did value and commodity equities perform well during the 1970s? As asset manager GMO notes, you were effectively buying cheap real assets, which is a like being offered inflation insurance at a discount.

On the flip side, buying expensive growth stocks is akin to buying inflation insurance at a substantial premium. It's a warning signal for those investors currently enthused by the 'Magnificent Seven' US tech stocks, and other highly priced equities. Inflation and higher yields aren't friendly for these types of assets.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au. This article is general information.

Does currency hedging provide an edge?

Duncan Burns

A growing number of Australians are investing in global equities, largely thanks to the wide array of locally listed Exchange Traded Funds (ETFs) that make it easy to tap into offshore markets. In August 2023 for example, according to Australian Securities Exchange (ASX) data, close to $200 million flowed into ETFs in the global equity category.

Around half of those inflows were into products that are hedged (or tied) to the Australian dollar instead of to the currencies that underlie the international equities within the ETF (unhedged). In other words, the investors behind those inflows had opted to neutralise the potential impact of future foreign currency movements on their investment to remain in Australian dollars.

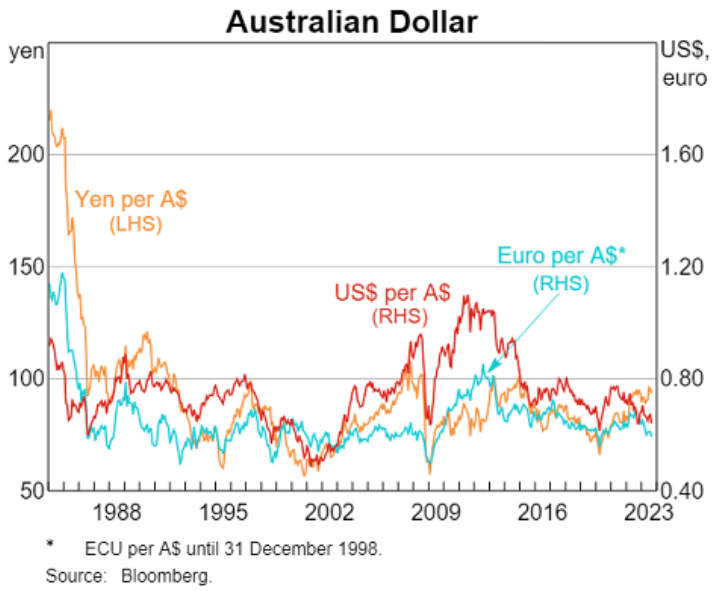
Currencies can be volatile

While sharemarkets can be highly volatile from day to day, so too can currencies in response to economic factors and geopolitical events.

Keep in mind that the Australian dollar was trading above US70 cents in late February this year and has since dropped back to its current trading level of around 64 cents. A decade ago, it was trading above parity with the US dollar, or about 30% higher than now.

It's anyone's guess whether the Australian dollar will hold its ground against other currencies, move higher based on more positive domestic economic news, or drift lower again as other world economies accelerate their own economic recovery phases.

Many global ETFs offer both hedged and unhedged versions of the same fund. There's no right or wrong choice. It comes down to personal preference, but the ongoing effect of currency movements on international assets is often overlooked by investors. And that's where currency hedging really comes into play as a strategy.



How currency hedging works

Currency hedging involves fund managers using forward exchange rate contracts to effectively lock in fixed currency rates on a rolling basis, to remove the impact of foreign currency fluctuations on the value of non-Australian dollar assets for an Australian investor.

Think of hedging as being similar to converting your Australian dollars into US dollars before you head to the United States, for example, because you want to lock in the current exchange rate in case the Australian dollar drops further in value before you take off for your holiday. It's a form of insurance policy.

Buying that insurance typically comes at a cost. Hedged investment products often have a slightly higher management fee than unhedged ones.

The cost of hedging and the risks associated with execution are small, but the impact hedging can have on your portfolio can be significant depending on the relative movements in markets and currencies.

The right strategy for you

A good framework for reviewing whether or not to hedge your currency exposure is to consider first your appetite for risk and your investment time horizon and then to understand the individual nuances of exposures to international equities and bonds.

If you have a long way to go to retirement, you may be comfortable taking on the currency risk and accept the short-term currency volatility that unhedged exposures to international shares can bring.

Vanguard research studies have shown that currency movements tend to be neutral over the longer term.

Using hedging to screen out the currency fluctuations that affect international asset prices can be beneficial for investors seeking less volatility in the asset value.

Those closer to retirement, and those who are just more risk averse than others, will likely have a greater allocation to fixed income (bonds) already. Bonds are an effective ballast against equity market declines, and international bonds are no exception.

Currency hedged gains can also result in higher taxable distributions, so investors in hedged products should expect higher than average distributions.

It is generally accepted that in order to maintain international bonds' defensive characteristics in a portfolio, they should be hedged, as their benefits could otherwise be overwhelmed by currency movements.

The decision on whether to hedge international equity exposures is not so straightforward, however.

Consider when global equity markets fall, and the Australian dollar weakens. If unhedged, you may experience smaller losses than a hedged portfolio. If the opposite scenario unfolds (markets rise and the dollar strengthens), the hedged portfolio appears 'better' than the unhedged version.

Currency movements, and how they move with equities, are difficult to predict, so investors should treat currency hedging as a way to manage risk, not to add return.

Duncan Burns is Chief Investment Officer for Asia-Pacific at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any individual.

For more articles and papers from Vanguard Investments Australia, please click here.

Podcast: Noel Whittaker's retirement tips and traps

James Gruber

Season 2, Episode 9

Special guest Noel Whittaker, best-selling author and personal finance guru, offers his key tips for making the most of your retirement. He discusses the mistakes that people make with SMSFs, why super remains a good vehicle for retirees, how estate planning is a "minefield", and the financial traps to avoid with aged care.

Firstlinks' Managing Editor, Graham Hand, also joins us to explain why more listed investment companies should close as well as the intriguing battle between Magellan and shareholder activist Nick Bolton.

And Morningstar's Peter Warnes is back from a break to talk about the carnage in bond markets and what it might mean for Australian markets.

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

Mid-caps deserve a closer look

James Abela

Like the proverbial middle child, global mid-caps tend to be overlooked and underappreciated. However, mid-caps occupy a 'sweet spot' - offering potentially more growth than large caps and potentially less risk and volatility than small and micro-caps.

This asset class offers excellent opportunities for investors looking for global equity exposure, and a dedicated allocation to mid-caps might go a long way to improving a portfolio's risk and return outcomes.

What makes mid-caps so appealing?

Diversification

One of the features of the global mid-cap universe is that it is far more diversified than the large cap MSCI World index. Today, the MSCI World index is dominated by a small number of mega cap technology stocks, known as the MANAMA stocks (Microsoft, Apple, Netflix, Amazon, Meta, Alphabet). This exposes the index to a high level of risk if any one (or more) of these stocks underperforms.

In the mid-cap universe, there is no single or group of stocks that dominate, and no stock comprises more than a small percentage of the overall market. At a sector level, the market is also more diverse. This diversification offers mid-cap investors a greater breadth of opportunity, as opposed to the large cap market which is driven by those few large tech stocks, making it harder to 'pick the winners'.

Market size

There are a number of misconceptions about the mid-cap universe and the size of the stocks that occupy it. For instance, it is commonly assumed that global mid-caps are small, illiquid, and difficult to trade. However, this is not the case.

The MSCI World Mid Cap index consists of around 900 listed companies with a market cap range of around US$1 billion to US$40 billion. Outside of this index, there are around 3000 additional listed mid-cap companies. When you compare this to the MSCI World index - which has around 1,600 listed companies in the market cap range of US$1 billion to US$2900 billion - the mid-cap market clearly offers a lot more choice.

The MSCI Mid Cap index puts the total market size of the global mid-cap universe at approximately US$8.3 trillion. Both the number of listed companies, and market size, reinforce the abundance of opportunities for investors.

Additionally, when comparing the average market cap range of the global mid-cap index to the ASX 300, the mid-cap index has a larger average market cap (see Figure 1).

Figure 1: Average market cap of different equity indices

Source: FactSet, 31 August 2023

Despite the ASX 300 holding larger companies than the global mid-cap index, the global mid-cap index is still significantly larger on an average basis across all the companies it holds. For investors, this should alleviate any concerns that global mid-caps are small, illiquid and difficult to trade.

Low stock research

Another reason the mid-cap universe is appealing, is that it is less researched than its global large cap counterparts. With fewer analysts researching these mid-cap names, it increases the likelihood of high-quality businesses flying under the radar, allowing smart investors to seize upon mispricing opportunities. Investors can also 'miss the forest for the trees', and not realise that there are well-established businesses with strong track records alongside the more obvious listings of newer companies and business models.

The significantly lower analyst coverage of stocks in the mid-cap universe compared to large caps provides excellent opportunities for active management to add value by rigorous bottom-up research.

Company leaders

Unlike large caps many mid-cap stocks are businesses that are founder-led. These companies are more likely to have management teams which are innovative, agile, and with interests that strongly align with that of shareholders.

In Fidelity's experience, the best ideas or 'future leaders' in the global mid-cap universe are typically business models that are either structural winners, technology disruptors, innovators, category killers and/or brand leaders.

A dedicated mid-cap portfolio exposure

It's common for large cap global equity managers to have some exposure to the mid-cap market in their portfolio. Data from eVestment shows that the median large cap global equity manager typically holds 20-25% of their portfolio in mid-cap stocks.

While some investors consider this exposure 'ticks the box' for mid-cap allocation, there is a strong argument that investment portfolios should include a dedicated mid-cap exposure.

With the mid-cap market less researched than the large cap market, and with many more stocks to select from, it does beg the question: are large cap managers equipped to manage mid-cap investments?

Large cap managers tend to focus their time analysing the performance of the biggest stocks in their portfolios to determine how performance compares to the benchmark large cap index. Mid-caps are not generally their focus.

An attribution analysis from eVestment (Figure 2) bears this out. It looks at the median performance of 305 global large cap equity managers and shows that over five years, large cap equity managers underperformed in the mid-cap portion of their portfolios relative to the benchmark index.

From a portfolio construction perspective, we believe global mid-caps provide excellent complementary exposure to a global large cap equity portfolio, but having a dedicated mid-cap manager is likely to be an advantage.

Figure 2: Medium performance of mid-cap element of global large cap equity managers vs index

Index	1 year (%)	2 year s (% p.a.)	3 years (% p.a.)	4 years (% p.a.)	5 years (% p.a.)
MSCI World Index	22.43	7.00	13.44	11.22	11.37
Mid cap element of median large cap manager	18.69	4.48	12.44	8.82	8.96

Source: eVestment, periods to 30 June 2023, 305 large cap global equity products

Sitting in this sweet spot, there is a compelling investment case for global mid-caps. The sector offers exposure to the broad global equity asset class, but also the opportunity for superior returns, and superior risk adjusted returns, compared to global large cap equities. And contrary to common belief, mid-caps are also on average more liquid than the Australian large cap universe.

In short, global mid-caps offer the opportunity for an excellent diversifying exposure with a greater probability of above-index performance over medium and longer time periods.

James Abela is Co-Portfolio Manager of the Fidelity Global Future Leaders Fund at Fidelity International, a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

For more articles and papers from Fidelity, please click here.

Clime time: Why stocks beat bonds for income investors

Will Riggall

Over the past 10 years, the S&P/ASX Price Index has delivered meek returns, though the picture improves when dividends are included in the Total Return Index.

The 10-year returns are:

1. The Price Index return is about 38% or 3.2% annual compound, and
2. The Accumulation (Total Return) Index is about 110% or 8% annual compound (but before franking).

Following the market correction since mid-August 2023, the capital gain of the market index from when Covid hit in March 2020 is now about zero for the last 4.5 years. The return including dividends that are fully reinvested is a healthier 30% (pre franking) over the entire period. However, this 4.5-year return of about 6.6% per annum is below both our targeted and expected long-term return of 8% per annum.

In reality, the Accumulation Index return is an appropriate measure of the equity market return for an SMSF in 'accumulation mode'. However, it is not a measure of the (longer-term) return for an investor who takes the cash dividend from the market to fund a pension.

The post-Covid investment cycle

This background leads us to consider the dramatic change in income returns across asset classes that have flowed as the world economy transitioned from post GFC, through Covid and now into a post-Covid cycle.

Projected and actual asset returns drive investment allocation that is also adjusted by the risk profile of the investor (SMSF). Returns from capital gain and income, from all asset classes, will be driven by the investment climate as measured by cash rates, bond yields and the interplay of 'risk free returns' with equity prices measured by Price/Earnings Ratios (PER) and property capitalisation rates.

The world has moved from the post-GFC cycle where the introduction of quantitative easing (QE) to fund burgeoning government debt, plus highly supportive fiscal settings, dominated. Covid checked the anticipated slowdown and the reversal of QE towards quantitative tightening (QT). Indeed, it actually reaccelerated QE, noting it was aggressively introduced in both Australia and around the world. A feature of the Covid era was that most bond yields across the world hovered well below 1% and they were deeply negative in Europe and Japan.

The post COVID era, began during 2022 when lockdowns ceased, ushered in a new investing environment. The era of near zero interest rates is over, and decades of deflation driven by globalisation and demographic changes are being replaced by an extended period of cost-based inflation.

Across asset classes, the most material change has been seen in bond markets. For instance, over the last two years, the yield on an Australian two-year bond has moved from near zero to above 4%. It has been a painful period for passive bond investors with the price of all bonds materially declining. The good news today is that the annual income that can be generated from holding a 'near risk free asset' has become more attractive in nominal terms. But are bonds attractive enough?

Preferring equities over bonds

While bonds can deliver the benefits of diversification in a balanced portfolio, the argument for their role as a key driver of portfolio returns must be framed relative to inflation. Inflation has probably peaked in Australia, yet the most recent CPI release for the June quarter was 6%, still well above the two-year bond yield. Given that government bonds are a fixed income returning assets, their ability to outperform inflation is not currently on offer.

Therefore, a pension portfolio should maintain an appropriate and meaningful allocation to the Australian equity market with the purpose to deliver a growing income stream that is enhanced by franking.

Importantly when comparing Australian equity returns to global market returns, companies here have higher dividend yields. And it is a historical fact that the Australian equity market has delivered total returns, including dividends, that are above most of the developed world. The following chart from the RBA chart book demonstrates this.

Investing in the Australian equity market, like all equity markets, is not without risk. However, with elevated inflation likely to persist well into 2024, equities will continue to play a key role in delivering on pension focussed long-term income objectives and defend against the impact of inflation.

The surging equity market during Covid was driven by bloated PERs due to excessively low bond yields. Post-Covid, PERs have declined but equity dividend payments have risen, while bonds have entered a third year of negative returns.

Will Riggall is CIO of Clime Group, a sponsor of Firstlinks, and oversees the Ralton Dividend Builder, available on several leading platforms and Clime Capital, the group's listed investment vehicle, has been constructed to deliver a high and growing tax effective dividend stream. The information contained in this article is of a general nature only and is current as at the date of publishing. It does not take into account the goals, objectives, or personal circumstances of any person.

For more articles and papers from Clime, click here.