Edition 533, 3 November 2023

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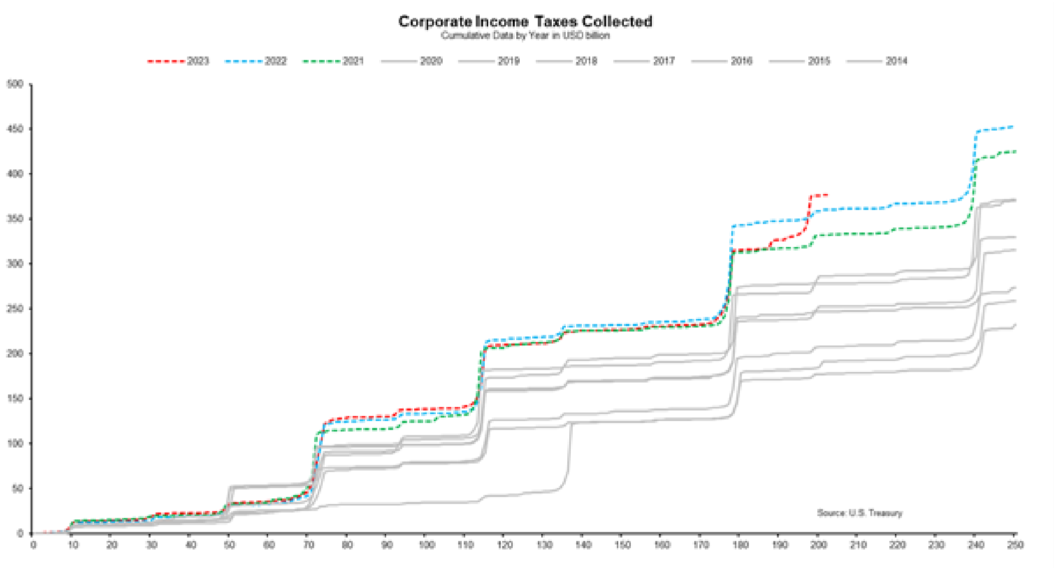
Editorial

"The best economist I know is the inside of the stock market." Stanley Druckenmiller

Economic data and stock markets are sending very different signals about the outlooks for the US and Australia.

On the face of it, the US economy is booming. A year ago, almost every economist was forecasting that the US would soon face a recession. That hasn't happened. Recent US GDP soared to 4.9% in the third quarter, the highest rate since the end of 2021 and a significant uptick from the 2.1% recorded in the second quarter.

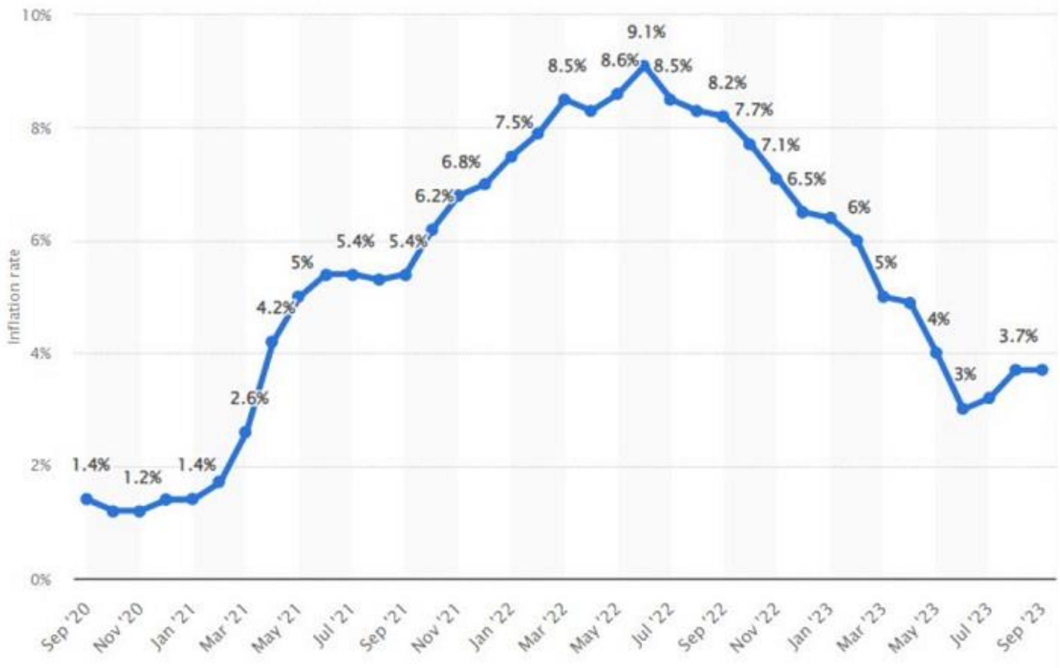
Not only that but wages growth remains strong. Private nominal wage growth is relatively steady at 4.5% year-on-year. Meanwhile, employment remains plentiful. The US employment rate of 3.8% is off the lows, yet still reflects a tight labor market. Also, tax collections are at record highs.



c/o Ray Macken, Schroders

Best of all, inflation has come down towards the Federal Reserve's target rate of 2%. The inflation rate is 3.7%, down from a peak of 9.1%.

US inflation rate



Source: Bureau of Labor Statistics

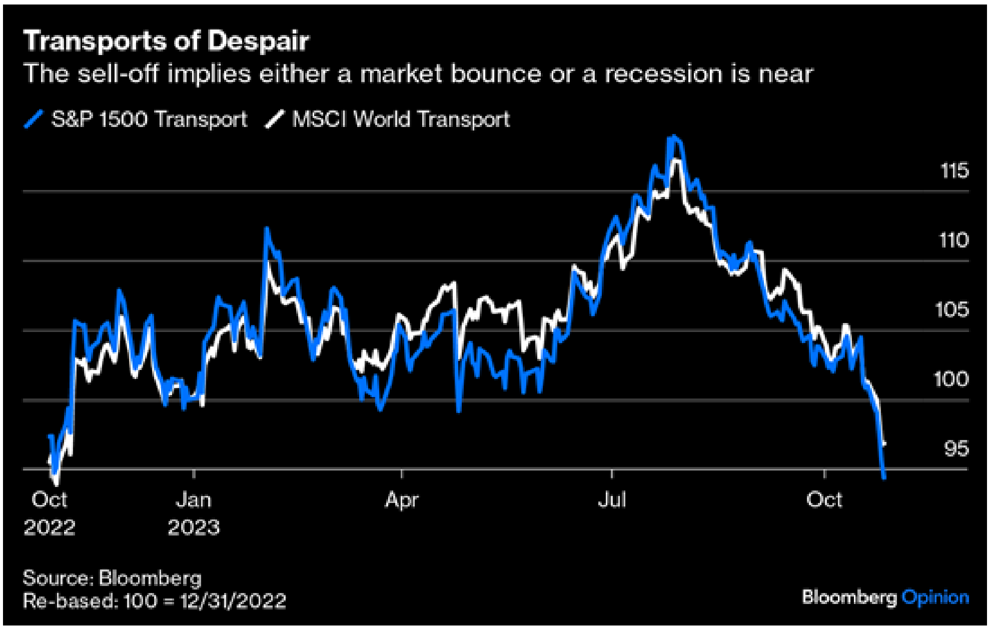
Yet, the US stock market is telling a different narrative from the economic statistics. Yes, the Nasdaq is up an extraordinary 32% this year. And the S&P 500 has risen a still healthy 11%.

These gains have been driven by what was called 'The Magnificent Seven' stocks, though should really be renamed 'The Enormous Eight' (including Netflix as the 8th). Here are the year-to-date returns for these stocks:

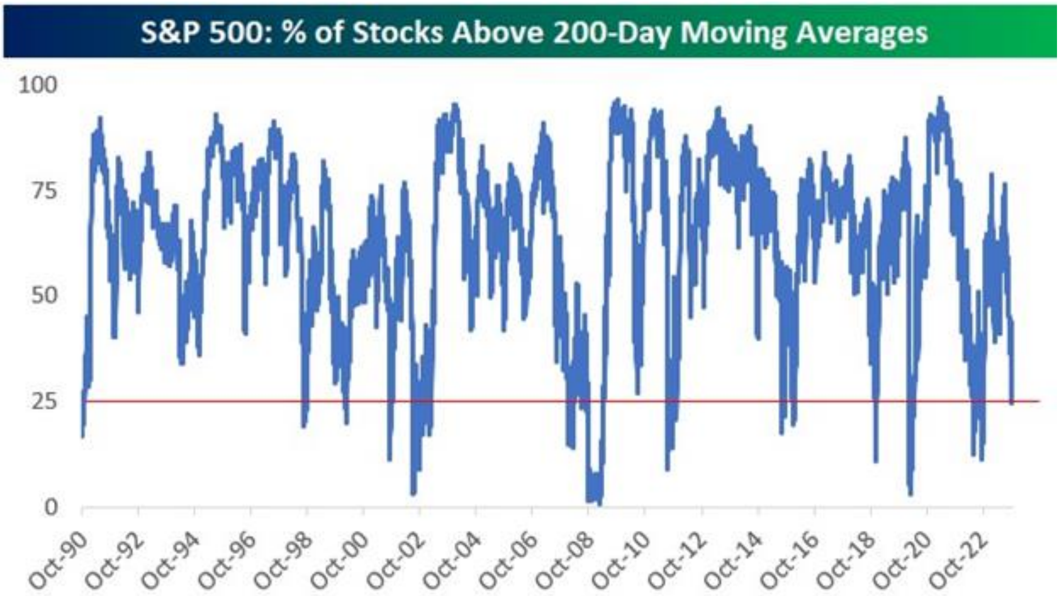
Nvidia (NVDA) +182%
Meta (META) +152%
Tesla (TSLA) +60%
Amazon (AMZN) +58%
Microsoft (MSFT) +42%
Alphabet (GOOGL) +41%
Netflix (NFLX) +39%
Apple (AAPL) +32%

Zoom in on the US market though, and the picture becomes murkier. An equal weighted index of S&P 500 stocks is down 4% this year. And US small caps are off 5% over the same period.

Economically sensitive transport stocks have tanked since July.

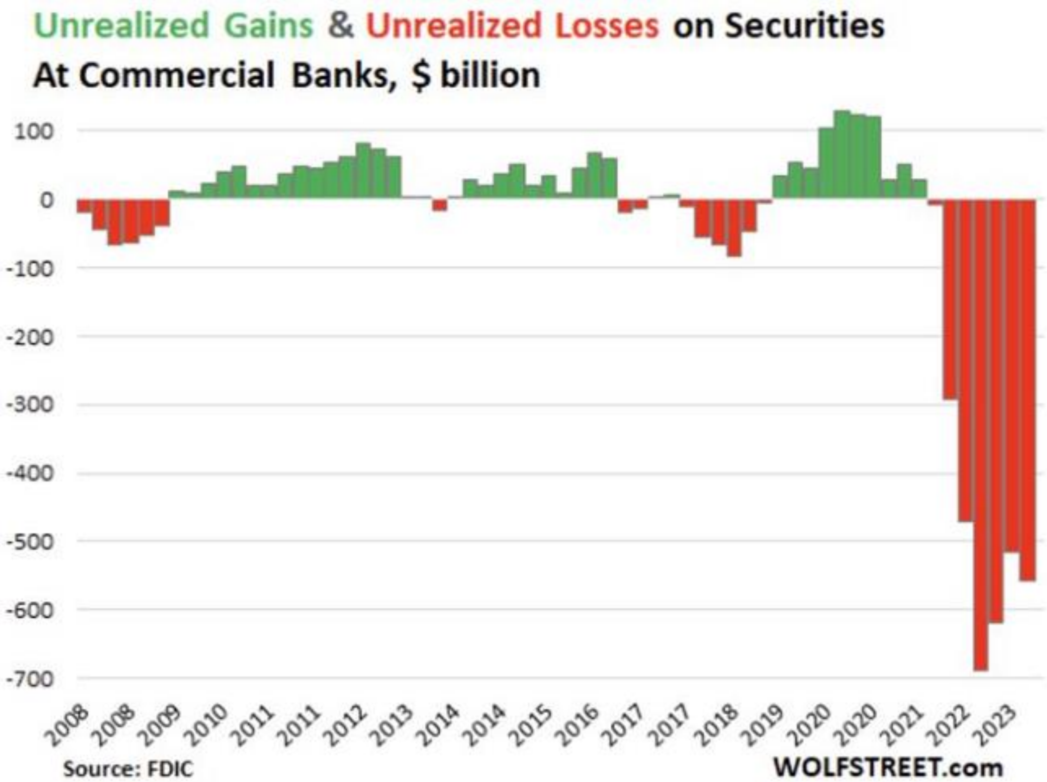


The percentage of S&P 500 stocks trading above their 200-day moving average also peaked in July at 67%, and that’s now down to just 25%.



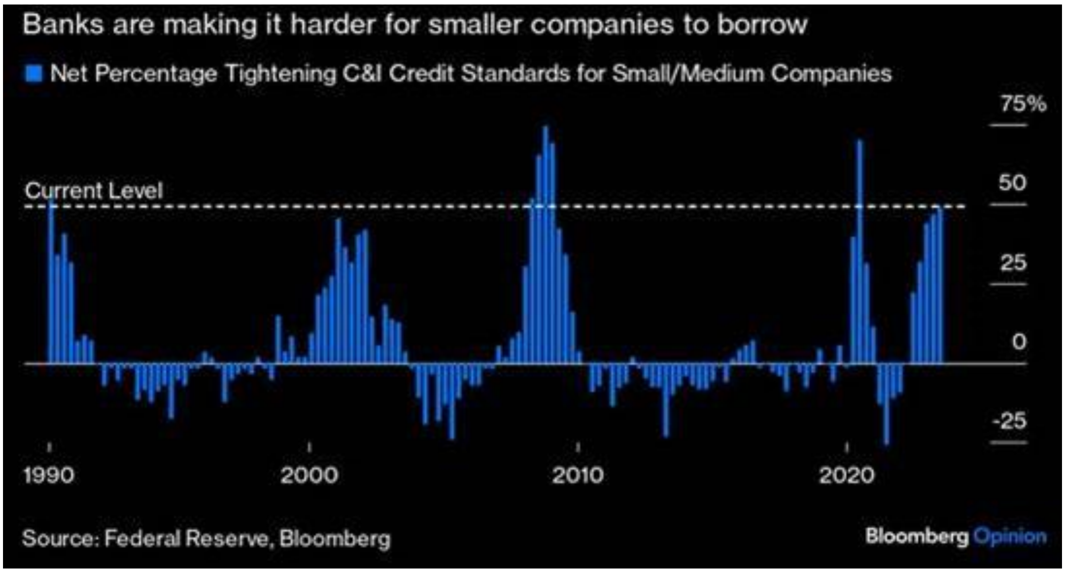
More worrying is the performance of the large US banks. They’re down 25% this year. The larger retail banks such as Citi and Bank of America are 47% off their highs reached in 2021-2022. Investment banks like Morgan Stanley and Goldman Sachs are down 17% and 12% respectively year-to-date.

The retail banks are of particular concern. Recently, Bank of America revealed that the unrealized balance sheet losses from so-called held-to-maturity securities was US$132 billion - that's 63% of the bank's US$208 billion market capitalisation. These securities are mostly bonds that the bank bought when interest rates were near zero. Now that rates are up 500 basis points, these securities are deeply underwater. Bank of America is far from the only bank sitting on losses from these bonds.



The concern isn’t that the banks will have to realise these losses any time soon. They won’t. It’s more that it’s likely to restrict banks from making loans going forward.

There are signs that this is already happening.



What are the conclusions to draw from all this? Morningstar's Peter Warnes told me on this week's [*Wealth of Experience*] that today's events remind him of 2007, before the financial crisis. Back then, there were a few bank failures in 2006-2007, and things only accelerated downhill about 12 months later. Peter sees parallels with Silicon Valley Bank and Credit Suisse's downfalls earlier this year, and the potential for further bank failures into next year.

UniSuper's Chief Investment Officer, Jon Pearce, seems to be taking the other side of that bet. He revealed to the same podcast that he'd recently bought heavily into the US banking sector.

My views sit somewhere between these two men. I tend to agree with Steve Eisman, famed for shorting the US housing bubble and featured in Michael Lewis' book, *The Big Short*, who sees American banks as uninvestable, though the financial system itself is in ok shape. Eisman says net interest margins at the banks are being squeezed as customers demand higher deposits, and yet they are earning less on long-term loans such as mortgages, which are locked in for several decades. Add in new regulations requiring the banks to hold more capital, and it doesn't paint a pretty picture.

The issue is whether the US banks further tighten credit. If that happens, an economic slowdown if not a recession, seems inevitable.

Australia is different from the US. GDP growth is nowhere not as strong, the last print at 2.2%. Like the US though, the employment market is tight, with the unemployment rate at 3.7%.

Australia inflation rate

Unlike the US, inflation remains high in Australia, at 5.4%. Sure, it's down from the peak of 7.8% in the December quarter of last year, yet it is still well above the RBA's target of 2-3%.

Spending habits appear strong. Australian retail sales in September increased 0.9% from August, well above market estimates for a 0.3% rise.

And housing seems to be as bubbly as ever. Recently, this house, located 31 kilometres west of the Sydney CBD, sold for $4.6 million, some 2.6 million above the reserve.

Source: realestate.com.au

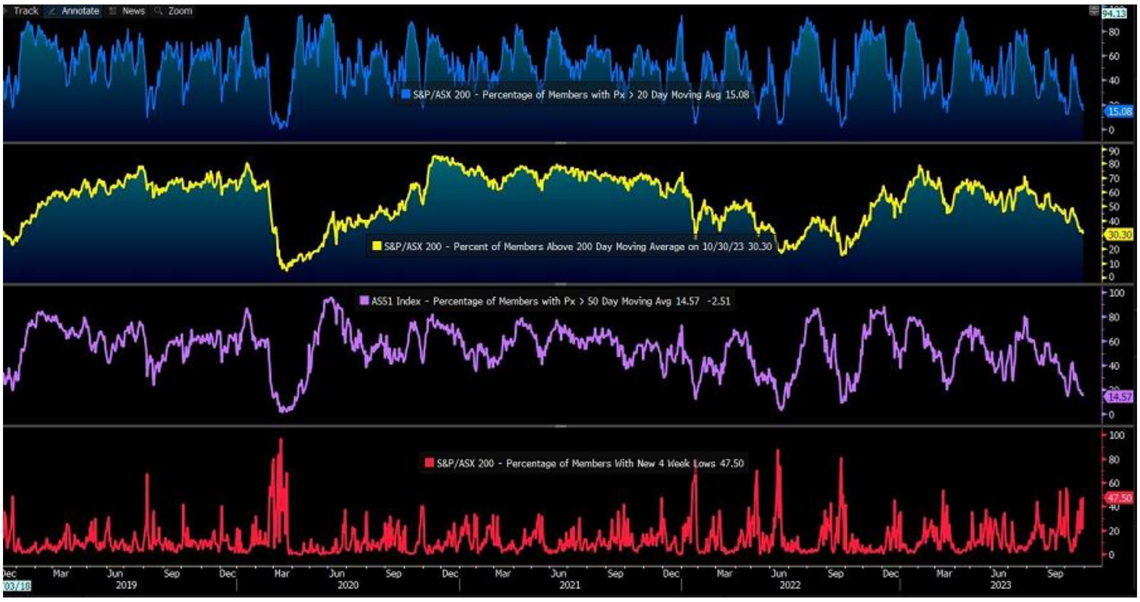
Of the sale, one of the agents told the AFR:

"If I see $2.6 million over reserve in Bondi for a $10 million waterfront property, that's expected – look at the view, the location. You wouldn't see that in the west or south-west. I can't explain it. It's something I'd see out of Seinfeld."

It seems the RBA has some work to do to slow overheated parts of the economy and bring the inflation number down.

So, what's the ASX telling us? Well, it's duller than the US and that mightn't be a bad thing. The ASX 200 is down 2% this year in price terms, banks are off a little more at 4%, and small caps have declined 7%.

More than a quarter of ASX 200 stocks are at 52-week lows, and only 30% are trading above their 200-day moving average.



Source: Bloomberg

Unlike in America, there are few red flags in Australia's stock market. However, that could change if things go south in the US.

James Gruber

Also in this week's edition...

Vanguard founder, John Bogle, famously advocated US-based investors need just two funds in their portfolio: one covering the entire US stock market and the other the bond market. Recently, **James Gruber** tried to create an Australian version of the Bogle portfolio and he found that what seems like a simple task can quickly turn complicated. He describes the [journey and the lessons learned].

Zac Gross from **Monash University** takes issue with an ASX tool to gauge market predictions for the RBA cash rate. It's a tool widely used by news outlets and RBA watchers, though Zac believes it's flawed. He says adjustments are needed to ensure a more accurate barometer for interest rate expectations.

James Gruber reviews a charming book by Roger Rosenblatt called *Rules for Ageing*. James chooses the top 18 rules from the book for ageing well including, 'the unexamined life lasts longer', 'change no more than one-eighth of your life at a time', 'nobody is thinking about you', and 'pursue virtue but don't sweat it'.

Textbooks tell us there are two main ways to allocate assets: via strategic asset allocation (SAA) and tactical asset allocation (TAA). The first is largely a set-and-forget allocation while the latter is about taking more active positions. **Vanguard's Maziar Nikpour** explains why he thinks TAA is fraught with danger.

Many investors have a perennial fear of market crashes. Yet how likely are they? There's new academic research on the issue and **Larry Swedroe** puts it into plain English for us.

There's a lot of red ink among Australian listed property companies or A-REITs this year. The question that everyone seems to be asking is whether now is the time to buy or add to them. **Charter Hall's Mark Ferguson** thinks sector fundamentals remain solid and the sell down in A-REITs offers opportunities for the astute investor.

And lastly in this week's whitepaper, **Montaka** outlines the three pillars of active management outperformance.

Curated by James Gruber and Leisa Bell

The challenges of building a lazy portfolio

James Gruber

Legendary Vanguard founder John Bogle was famous for advocating that US-based investors need just two funds in their portfolio: a total US stock market index fund and a total US bond market index fund. And that they could split those funds according to how much risk they were willing to take. Bogle's theory was that investors could capture the performance of both markets at low cost via such funds.

Recently, I've tried to create a Bogle-like portfolio with exchange-traded funds (ETFs) and found that what it seems like a simple task can quickly turn complicated. Should I have just Australian stocks or go global? If I go global, how much do I want of US stocks versus non-US? Do I want exposure to emerging markets, and with that, China? For bonds, do I take on non-government bonds to potentially increase returns?

Beyond these questions, I've discovered that ETF labels sometimes don't reflect the portfolios underlying them. That makes me suspect that other investors may not fully understand what they're invested in when they buy ETFs.

The following is my journey for building an ETF-based portfolio and the lessons learned.

Full disclosure: I'll be discussing several ETF providers and three of them, Vanguard, Blackrock (iShares) and Van Eck, are Firstlinks' sponsors. Also, this article is based on my views and shouldn't be taken as personal financial advice.

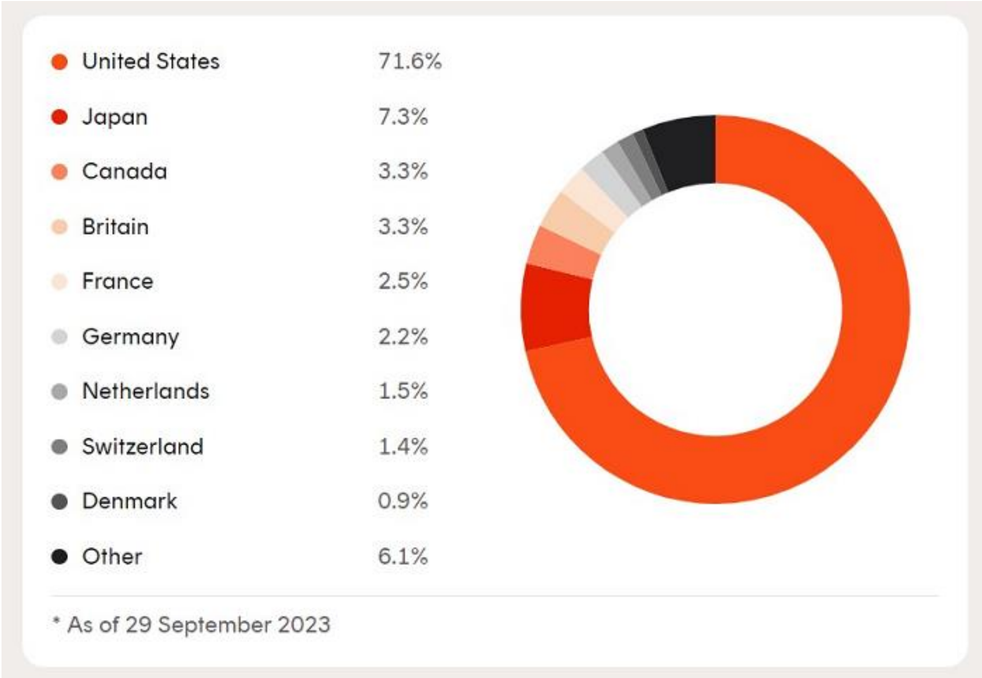
The equities conundrum

Recently, I built up excess savings and set out on a mission: to create a simple, low-cost ETF-based portfolio for the long term. My preference was for a mix of 80% equities and 20% bonds. The equities portion principally in global stocks. I figured that Australia is a relative minnow – with 0.33% of the world's population and 1.9% of global stock market capitalization – and my portfolio should reflect that.

Getting a global equities ETF is easy enough. For instance, Betashares has recently released a global stocks ETF (ASX:BGBL) with management costs of just 0.08% a year. On the face of it, that seems attractive.

Yet, there's a wrinkle: with any global stock ETF, it's mostly buying America. With the Betashares ETF, US stocks are 71% of the total portfolio and the top 10 holdings are all American.

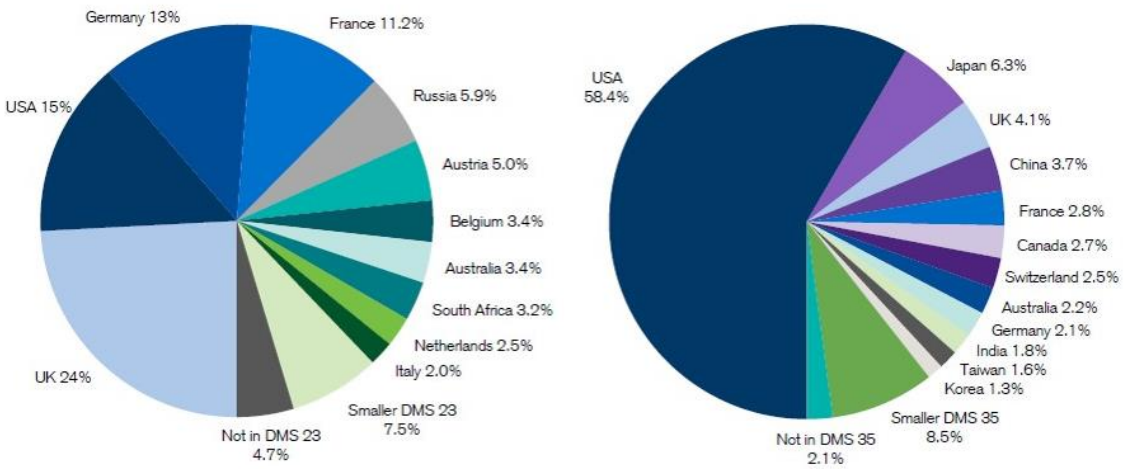
Betashares Global Shares ETF - country allocation



Source: Betashares

My problem with this is that the US market looks expensive compared to the rest of the world. And I'm not sure that the US will command such a large share of world equities in the long term.

Figure 2: Relative sizes of world stock markets, end-1899 (left) versus start-2023 (right)



Source: Credit Suisse

This chart above shows how dramatically a country's share of world stock markets can change over time. At the start of the 20th century, the US was just 15% of global stocks. Now, it's 58%, reflecting its rise as a world superpower over the past 123 years. Meanwhile, the UK has gone from superpower to a middling country over that same period, and its share of world stock markets has shrunk from 24% to 4%. This chart is in the back of my mind when I look at a global stock ETF with overwhelming US exposure.

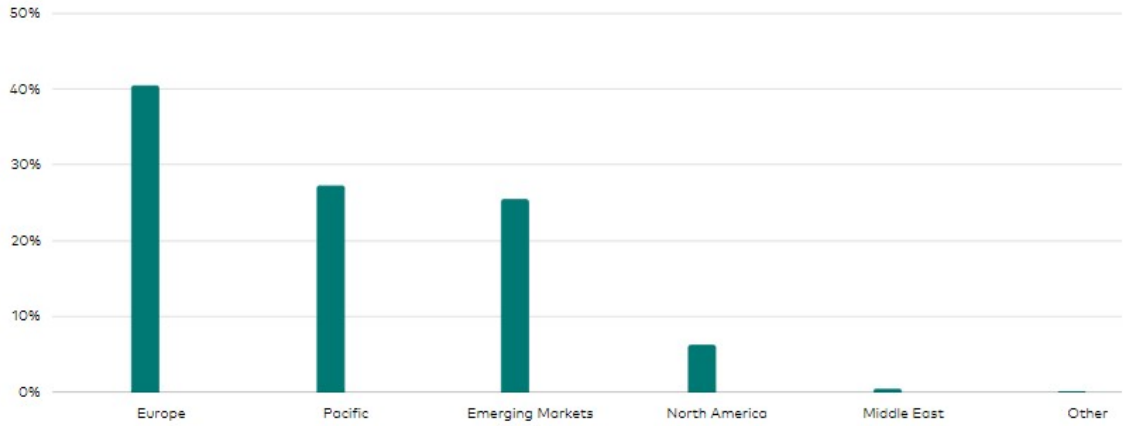
How to work around this issue, then? The simplest solution is to split a US stock ETF and a world ex-US stock ETF. It could be a 50/50 split or even 25/75. Either way, it'd have the globe covered, hopefully at minimal cost.

Getting a US stock ETF at low cost is straightforward. Vanguard offers a US total market shares index ETF (ASX:VTS) at 0.03% annual fees, and iShares has an S&P 500 ETF (ASX:IVV) at 0.04% annual fees. Note that one covers the whole US market while the other has the top 500 stocks.

An alternative is to look at an equal weighted US stock ETF, like the Betashares S&P 500 Equal Weight ETF (ASX: QUS). Equal weighted means that the stocks are weighted equally rather than by their size. If you're concerned about tech valuations and tech stocks being a large part of the index, then an equal weighted ETF can address that risk. There are also several studies suggesting that equal weighted indexes can outperform weighted ones over the long term.

For a non-US stock ETF, Vanguard offers the All-World ex-US Shares Index ETF (ASX:VEU) with investment management costs of 0.08% per annum. One thing to be aware of is that any ex-US stock ETF has large exposure to Europe. For instance, European markets are more than 40% of Vanguard's product. Some people are comfortable with this, while others may not be.

VEU region allocation



Source: Vanguard

Wanting less European stock exposure and perhaps more emerging stock holdings comes with complications and increased costs. Vanguard and iShares have emerging market ETFs with management costs of 0.56% and 0.68% per annum respectively. Note that Chinese stocks make up around 30% of these ETFs. I know that institutions in the US are now offering emerging market ex-China stock products, though I'm not aware of any available in Australia.

For more Australian exposure than a world ex-US stock ETF can give, there are a lot of options. An ASX 200 ETF is the go-to for many investors. Note that the ASX is banks and commodities-heavy, with these two sectors making up almost 60% of the ASX 200 index.

I looked at the different options, weighing up a lot of factors, but I opted for the simplest equities portfolio for my needs: 50% in a US stock ETF and the other 50% in a non-US stock ETF.

Bonds: the ballast of a portfolio

I confess that I am an equities guy and bonds are not my specialty. That said, my view is that bonds can serve as a ballast to an investment portfolio. When stocks take a large tumble, as they invariably do at times, bonds can help to mitigate the fall in equities. That didn't happen last year when both equities and bonds fell, and the 60/40 stock/bonds portfolio has been questioned ever since. The questioning seems exaggerated to me given bonds before 2022 were priced at ludicrous levels rarely seen in history. That's not the case now, and I'm comfortable with bonds being part of my portfolio.

I found that it's easy to get bond exposure through ETFs by buying an Australian government bond ETF or a composite bond ETF. The former is essentially medium-term loans to governments, while the latter involves medium-term loans to governments as well as some to corporates. Lending to governments comes with limited credit risk as governments tend to repay their loans. And medium-term loans reduce exposure to movements to interest rates. These ETFs are low-risk bond options. Some products on offer include Vanguard's Australian Government Bond ETF (VGB) and iShares Core Composite Bond ETF (IAF).

A few options crossed my mind. Should I explore corporate bonds? I dismissed this because I didn't think it'd offer enough diversification from the equities portion of my portfolio.

What about high yield bonds? I am zero expertise in this area and quickly banished this idea.

The other question was whether it would be worth getting a mix of short and long duration bonds for diversification purposes? For instance, I looked at the new Van Eck ETF, the 1-5 year Australian Government Bond ETF (ASX:1GOV). I didn't think it was worth complicating the portfolio and rejected this option.

The last question was whether I needed to venture overseas to get bond exposure. For instance, I looked at Vanguard's Global Aggregate Bond Index (Hedged) ETF (ASX:VBND). Unlike with equities, I didn't think global bonds would provide enough reward versus risk, compared to Australian bonds.

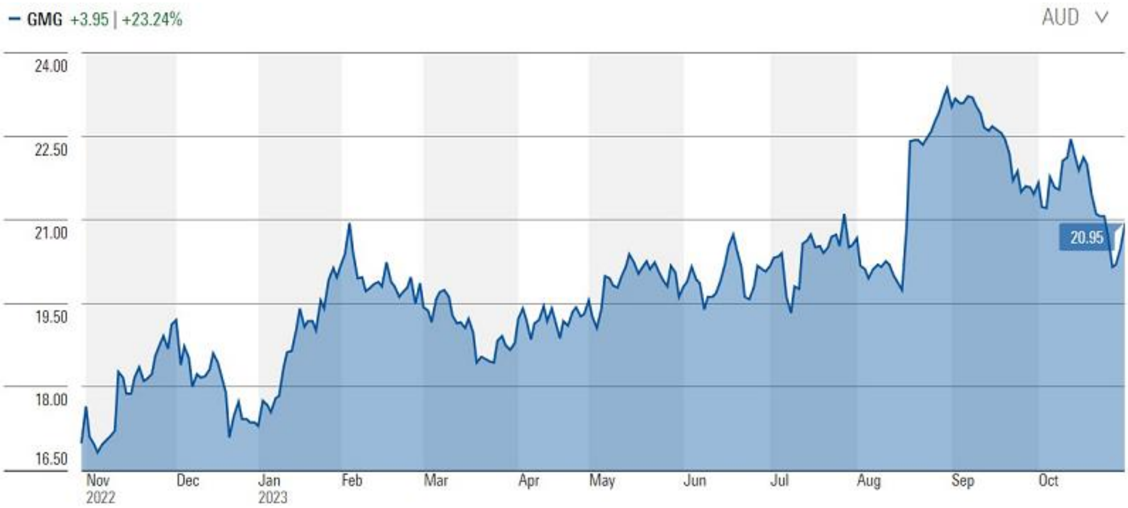
In the end, I went with an Australian government bond ETF.

Moving beyond stocks and bonds

I did explore whether it was worth buying other assets besides stocks and bonds to diversify the risks of the portfolio.

I have some sympathy for investment titan Ray Dalio's view that an investment portfolio should include a small percentage in commodities. There are several things to be aware of with commodities. First, they are cyclical and volatile. Second, you can buy physical commodities or commodity stocks. With physical commodities, many ETFs track the so-called CRB Index, which has 39% exposure to energy and 41% exposure to agriculture. It has much less allocated to industrial and precious metal commodities. It's also worth noting that the performance of commodity stocks can diverge from the commodities themselves, sometimes by a wide margin. I seriously considered adding commodities to the mix, though chose not to as I didn't want to complicate the portfolio.

I also looked at real estate as another option to diversify the portfolio. I thought that there could be a contrarian opportunity in property stocks given the poor recent performance of many A-REITs. Caveat emptor though: I found the A-REIT index is dominated by one stock – Goodman Group (ASX:GMG). Goodman comprises more than 30% of the A-REIT 300 index. You might be surprised to learn that despite the carnage in property, the A-REIT 300 index is largely flat over the past year, and that's thanks to the 23% rise in Goodman's share price over the period.



Source: Morningstar

I chose not to include real estate, primarily because I wasn't convinced that it would do enough to diversify the risks of my portfolio.

The final decision

In the end, I've opted for a 3-ETF portfolio: 80% in equities with 50% of that in a US stock ETF and the other 50% in a world ex-US stock ETF, and 20% in an Australian government bond ETF. It suits my needs for a core portfolio.

One of the biggest lessons that I've taken away from this exercise is that it's difficult to resist the allure of adding more to an investment portfolio. There's almost a deep psychological need to add complexity.

I'm no investing saint though. My next project is to consolidate my stock portfolio into a smaller, 'satellite' equities portfolio to hold alongside this core portfolio.

John Bogle would rightly be rolling his eyes.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au

ASX tool for interest rates bets needs an overhaul

Zac Gross

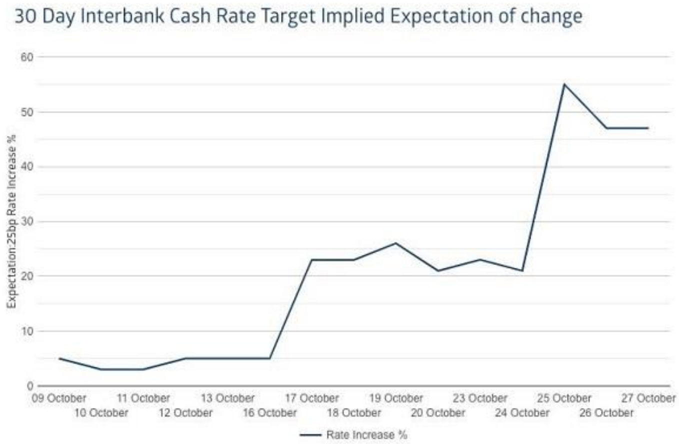
In the quest to decipher the how the RBA might adjust interest rates, the ASX's RBA Rate Tracker is a handy tool. Developed by the ASX, the page translates the price of the interbank cash rate futures into a straightforward probability regarding the RBA's potential movements in the interest rate. Essentially it publishes the financial market predictions for the RBA’s cash rate.

At present, the futures market suggests an even split in the probability of the RBA either raising interest rates in November or maintaining them at their current level.

Market expectations of an interest rate increase at the next RBA Board meeting in recent days.

This calculation is predicated based on ASX Rate Indicator calculation

TRADING DAY	NO CHANGE	INCREASE TO 4.35%
16 October	95%	5%
17 October	77%	23%
18 October	77%	23%
19 October	74%	26%
20 October	79%	21%
23 October	77%	23%
24 October	79%	21%
25 October	45%	55%
26 October	53%	47%
27 October	53%	47%



However, divergence emerges when one consults betting platforms like Betfair or Sportsbet. These platforms, which also provide odds on interest rate movements, indicate a more than 60% likelihood of a rate hike (accounting for their profit margin).

What could be the root of this discrepancy?

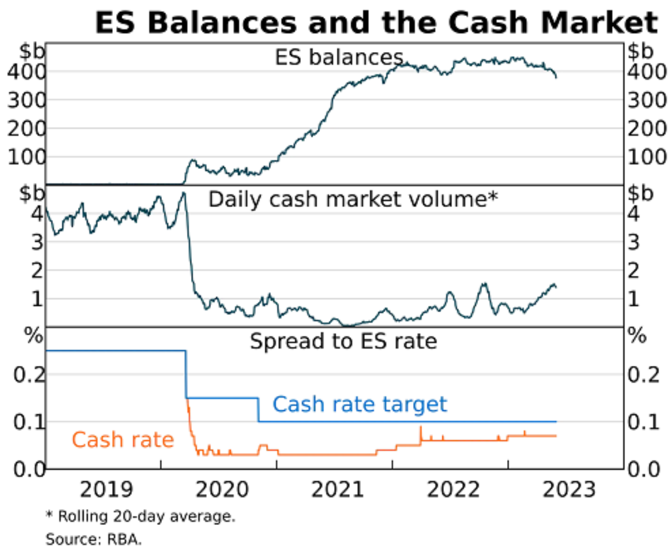
You might be inclined to question the integrity or liquidity of the small-scale betting platforms, hypothesizing that their implied probabilities might be unreliable. That would be a reasonable guess as they are dwarfed by the size of the interbank cash rate futures market. However it is the ASX rate tracker which is at fault.

The house always wins

The crux of the issue lies in the contractual language of the interbank cash rate futures, the foundation of the ASX's published probabilities. The cash rate futures pay out according to the value of the cash rate averaged over the calendar month - not what the RBA actually targets the cash rate to be.

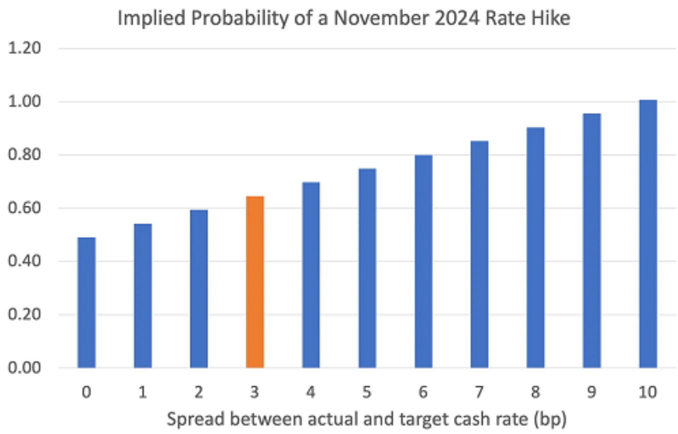
Historically the actual cash rate has tracked the target closely. For instance, if the RBA aims for a cash rate of 4.10%, the monthly average cash rate would typically aligned almost exactly with that 4.10% target. But the introduction of quantitative easing has disrupted this close surefire aim.

The gap between the target cash rate and its actual average opened up during Covid as show in the bottom panel of this chart.



The RBA's recent note on this issue highlights that this gap has reduced to an average of 3 basis points and predicts it will eventually revert to zero once quantitative tightening is fully implemented.

This seemingly minor gap of 3 basis points can significantly alter the probabilities when determining the likelihood of a 25 basis point movement in the cash rate, a standard unit for an interest rate adjustment. Incorporating this spread into the ASX's calculations, the probability shifts from an even 50-50 implied probability to a 65% likelihood of a rate hike. It thus appears that betting markets like Betfair have adeptly factored in this statistical bias! Chalk up another win for the efficient markets hypothesis.



Considering the prolonged timeline anticipated for the completion of quantitative tightening and the widespread reliance on the ASX's figures by RBA watchers, including journalists, it would be prudent for the ASX to recalibrate its formula to reflect the evolving monetary policy landscape. Until such adjustments are made the unconventional realm of online betting will offer a more accurate barometer for interest rate expectations than the ASX's implied odds!

Dr Isaac (Zac) Gross is a lecturer in economics at Monash University. This article was first published via Zac's blog, Gross National Product, and is reproduced with permission.

18 rules for ageing well

James Gruber

I recently happened upon a practical and often humorous book about how to age successfully. It's called *Rules For Ageing* by Roger Rosenblatt, a literary overachiever who's had success as a Harvard lecturer, newspaper editor and columnist, and is the author of 21 books and six plays. I first came across Rosenblatt on the PBS Newshour show years ago, where he regularly presented essays on an array of topics.

His book has 58 rules for ageing, of which I've picked the best 18. Here they are:

1. It doesn't matter

"Whatever you think matters – doesn't. Follow this rule, and it will add decades to your life. It does not matter if you are late, or early; if you are here, or if you are there; if you said it, or did not say it; if you were clever, or if you were stupid; if you are having a bad hair day, or a no hair day; if your boss looks at you cockeyed; if your girlfriend or boyfriend looks at you cockeyed; if you are cockeyed; if you don't get that promotion, or prize, or house, or if you do. It doesn't matter."

I can relate to a few of these examples. For instance, I've been a stickler for time for most of my life. It probably came from my parents. Over time, I've changed my ways. I'm never deliberately late, it's just that I don't have a panic attack if I'm not.

Taken to the extreme, Rosenblatt's rule is nihilistic. Though it's a good reminder to keep things in perspective.

2. Nobody is thinking about you

"Yes, I know, you are certain that your friends are becoming your enemies, that your grocer, garbageman, clergyman, sister-in-law, and your dog are all of the opinion that your have put on weight, that you have lost your touch, that you have lost your mind; furthermore, you are convinced that everyone spends two-thirds of every day commenting on your disintegration, denigrating your work, plotting your assassination. I promise you: Nobody is thinking about you. They are thinking about themselves – just like you."

It's funny how we're one of eight billion people in this world, yet in our own minds, we're at the centre of the universe. And everyone else thinks the same way.

I've tried to explain this to one of my children, without success. This rule comes with maturity.

3. Yes you did

"If you have the slightest question as to whether or not you are responsible for a wrongdoing, you are. As soon as you think, "I really didn't do it" – you did. Come to this conclusion early, act to correct it, and live a lot longer. Don't come to it at all, never act to correct it, and … how are you feeling?"

Too true. Psychiatrist Scott Peck in his book, *The Road Less Traveled*, suggests the meaning of life comes from solving problems. If you don't solve them, they can compound and get worse. That speaks to this rule.

4. After the age of 30, it is unseemly to blame one's parents for one's life

"Make that 25."

Guilty as charged. You may have noticed that I blamed my parents in response to rule no. 1 above. As Rosenblatt says: stop.

5. Swine rules

"A swine is not a swan. Over a lifetime, one will encounter several swine – true lowlifes – and one is sometimes tempted to treat them kindly under the theory that, if shown kindness, they will be less swine-like and, perhaps, even reform … this is the sort of optimism that ought to be criminalized. A swine is a swine is a swine."

I admit to still struggling with this one. I was taught to 'always see the good in people', yet life has taught me that this is hard, as Rosenblatt suggests.

6. Pursue virtue but don't sweat it

"The pursuit alone is sufficient to establish your qualities, and if you fail once in a while, your guilt will remind you of the right path you didn't take."

I like this rule. It suggests trying to do the right thing and if you don't on occasion, then it's ok because no one is perfect.

7. Do not go to your left

"*Going to one's left – or working on going to one's left – is a basketball term for strengthening one's weaknesses. A right-handed player will improve his game considerably if he learns to dribble and shoot with his left hand and to move to his left on the court. What is true of basketball, however, is not true for living. In life, if you attempt to compensate for a weakness, you will usually grow weaker. If, on the other hand, (the right one), you keep playing to your strength, people will not notice that you have weaknesses. Of course, you probably do not believe this. You will want to take singing lessons."*

It's probably my favourite rule. Who hasn't wanted to be the well-rounded renaissance person who's good at many things? It usually doesn't end well. Though it may not stop me from taking those singing lessons…

8. Male and female compatibility rules

"a. She's right. b. He's really thinking about nothing. Really."

As Charlie Munger is famous for saying at Berkshire Hathaway's annual shareholder meetings: *"I have nothing to add"*.

9. Do not keep company with people who speak of careers

"Not only are such people uninteresting in themselves; they also have no interest in anything. They often form cliques, putatively for social pleasure, actually for self-advancement and self-protection."

When younger, I remember going to a party with a friend, and it just happened that he was an Oxford University graduate and so were most of the people at this soiree. One came up to me early on and asked the standard: "So what do you do, then?" When I started to talk about my job, he stopped me and said: "No, not boring things like work, I want to know what you do for *fun*".

The lesson - that work should never define you - has stuck with me.

10. Envy no one – ever

As Charlie Munger similarly said: *"Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun. Why would you want to get on that trolley?"*

My experience is that this is a hard rule to stick by.

11. Believe everyone – always

"I realise that this rule seems to contradict the spirit of so many others. But when one gets down to it, life's basic choice is either to live cynically or innocently. I would choose innocence."

As would I. A related theme is whether to live life with optimism, pessimism, or realism. Many would choose realism, though that can easily veer into pessimism. I'd rather lean into optimism.

12. The unexamined life lasts longer

"A certain amount of self-examination is useful, but even that should be directed toward what to do in a given situation and not at who you are. However full your nights are with self-recrimination, you are probably all right as person (most people are)."

It was Socrates who once said that the unexamined life isn't worth living. As someone who has made introspection an art form, I tend to side with Rosenblatt over Socrates on this one.

13. No they don't – and so what?

Rosenblatt creates this rule for people who are over 50, now working for younger bosses, and don't feel they are getting the respect that they deserve: "Don't they realize how very special you are, how gifted, how distinguished?" And Rosenblatt's answer is, "No, they don't – and so what?" He says while that may bruise your ego, it could be what you need to produce even better work.

14. Abjure fame but avoid obscurity

"If, instead of seeking fame, you are more interested in simply meriting the approval of peers, the chances are better than you will accomplish this by drawing attention to the things you do rather than to some shimmering persona that you have manufactured for public inspection."

15. Fast and steady wins the race

"Steady excellence is one of the hardest things for Americans [and Australians] to recognize because it is the antithesis of newness, revolution, and excitement. Yet those who achieve steady excellence lead contented lives, which are in fact a lot more appreciated than they may know. Excitement is a reasonable standard only for the young, who know what to do with it."

This rule hit home. I think steadiness with everything in life is a good credo to live by.

16. Change no more than one-eighth of your life at a time

"The trouble with most people is that when they do decide to change their lives, they tend to think of changing everything all at once. Even if this were possible – it isn't – it would lead to disaster. When you are certain that it is time to become the novelist, sculptor, or watercolorist, change your shoes. See how the new pair fits … That's plenty for the moment. In a few years, change your glasses."

I feel seen. Meanwhile, I'm going to change that pair of shoes.

17. Never do it for the money

"I mean it."

18. The game is played away from the ball

"I used to teach this idea to journalism students to make the point that the more interesting things in the news occur without making a big noise."

I remember being taught in journalism such things as "if it bleeds, it leads", and "in news, one Australian dying is equivalent to [insert number] Chinese [or any other people living overseas] lives". Sad, but true.

This rule extends to markets too. High growth companies whose share prices skyrocket and then crash make all the headlines, though often the best stocks are the ones that are slow and steady achievers.

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

Why it's best to resist tactical asset allocation

Maziar Nikpour

Making knee-jerk changes to an investment portfolio's asset allocations based on the current market conditions isn't an ideal strategy - as a general rule. But we're seeing a lot of reactive behaviour by investors right around the world at the moment. It's mostly in response to the prevailing economic conditions and unsettling geopolitical events, which are triggering large capital movements between equities, fixed income, cash, and other asset classes.

For example, monthly exchange traded funds (ETFs) data released by the Australian Securities Exchange (ASX) shows investors seeking to capitalise on higher yields have been moving record amounts of capital into ETFs that invest in bonds. Some are doing this by selling down their equity positions.

Separately, there's been a surge in cash inflows from investors into bank term deposit accounts that are paying relatively attractive returns now because of the sharp rise in interest rates.

This is not to say that all the investments into these categories are in response to the prevailing market conditions. But the evidence, especially in the context of the impact of higher interest rates on shorter-term investment returns, suggests many investors are making tactical asset allocation moves.

Making tactical adjustments to a portfolio based on what's happening in investment markets at any point in time, particularly when there's a high level of turbulence, may seem logical.

The terms 'flight to quality' and 'flight to safety' are often widely used to describe the tendency of investors to quickly move their capital out of higher-risk assets such as equities into so-called safer havens during periods of volatility.

But tactically adjusting long-term portfolios in a bid to minimise short-term risks and enhance returns is high risk. It's difficult to get right, even for professional active portfolio managers. In fact, research has repeatedly shown that a 'market timing' approach is often counterproductive to investment returns over time.

Strategic versus tactical asset allocation

At the most basic level, asset allocation is about spreading investment capital across different investment assets.

As discussed above, tactical asset allocation involves making adjustments to a portfolio's asset mix based on short-term circumstances.

By contrast, strategic asset allocation involves setting target allocations across various asset classes and rebalancing the portfolio regularly to ensure it stays closely aligned to the assigned allocation through all market conditions.

Vanguard employs a strategic allocation approach across its diversified products range (managed funds and ETFs) to maintain set exposures to international equities and bonds irrespective of market conditions.

Our research has consistently shown that the mix of assets in broadly diversified portfolios as a result of strategic asset allocation is by far the greatest determinant of both total returns and return variability over the long term.

Conversely, short-term tactical investment decisions made by active portfolio managers, such as market-timing and security selection, have relatively little impact on return variability over longer time frames.

The main reasons for this are twofold. Firstly, active portfolio managers need to ensure they're making the right choices in relation to the prevailing market conditions. Timing markets is extremely difficult.

Secondly, for an active portfolio manager to add value over time, a tactical approach needs to mitigate the investment costs of making regular portfolio adjustments.

These costs include management fees, bid-ask spreads, administrative costs, commissions, market impact, and, where applicable, taxes. These costs can be high and reduce investor returns over time.

Active versus passive

Global index provider Standard & Poor's regularly measures the performance of active funds against passive benchmarks. The results paint a strong case for index funds, because a high percentage of active managers underperform passive index benchmarks most of the time.

For example, the S&P Indices versus Active scorecard for 2022, or SPIVA as it's known, shows that 57.6% of actively managed large-cap Australian equity funds – that is, funds that invest in a selection of the largest Australian companies chosen by an investment team – underperformed the Australian share market.

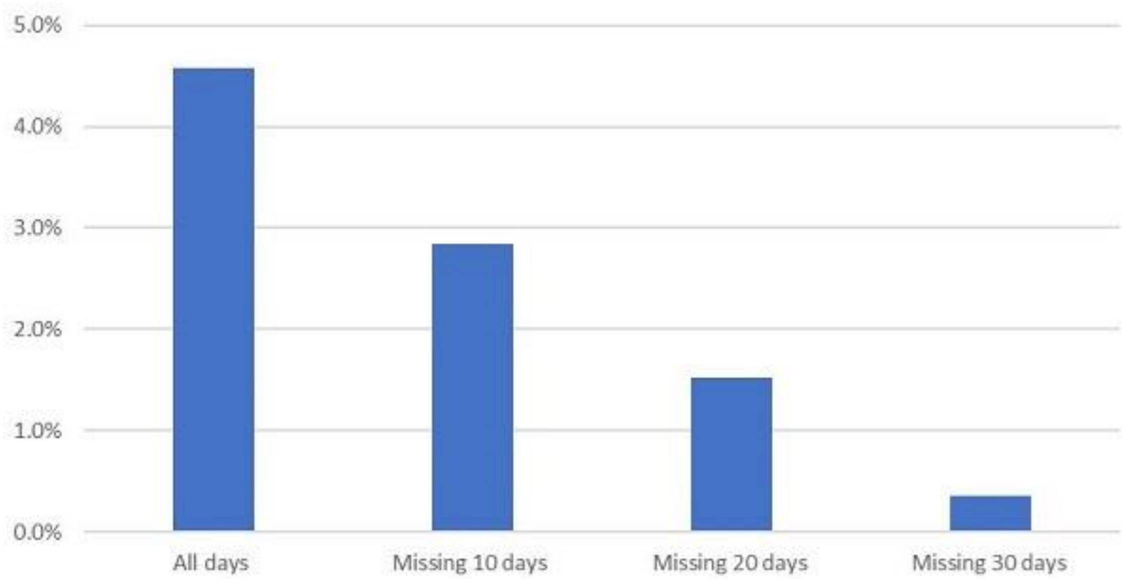
The SPIVA report found that underperformance rates over the longer term were even higher, with 81.2%, 78.2% and 83.6% of actively managed large-cap Australian equity funds underperforming the S&P/ASX 200 Index over the 5-, 10- and 15-year horizons, respectively.

Making active, tactical adjustments to portfolios based on short-term events can have far reaching consequences over the long term.

Let's look at this based on investors who made tactical decisions around buying and selling shares and missed out on the 30 best trading days on the Australian stock market between June 1992 and October 2023. By missing those specific best days, they would have achieved only a fraction of the returns achieved by investors who had been invested for the whole period.

Furthermore, the best and worst return days on markets are often very close together.

Annualised returns of Australian stock market from 1992 to 2023



Notes: *Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance. Returns are based on the daily price return of the S&P/ASX 300 Index from June 1992 to 18 October 2023. The returns do not include reinvested dividends, which would make the figures higher for all bars.*
Sources: *Vanguard calculations, using data from Bloomberg as of 20 October, 2023.*

For tactical portfolio adjustments to be successful an investor needs to identify a reliable indicator of short-term future market returns, then time their exit from an asset class or the market and re-entry precisely, to the day. They also need to decide on the size of the allocation and how to fund the trade, and execute the trade at a cost that's less than the expected benefit.

A tactical approach can offer the chance to outperform. However, based on Vanguard's extensive research, using a strategic asset allocation approach has proved to be a much more reliable driver for long-term returns because it's based on evidence of what has performed well over time.

It's also important to note that strategic asset allocation is not a 'lazy' approach, as some may perceive. Rather, coming up with a strategic asset allocation through a research-driven process is generally more laborious and difficult than a tactical approach.

Vanguard reviews its asset allocations regularly, although the bar for making changes is high. This is in contrast to what often takes place in tactical asset allocation, where the focus is on short-term performance.

Rather than making tactical changes, investors who stay aligned to their goals, who are well diversified, who minimise their costs, and who have the discipline to stay invested, even during periods of heightened volatility, have the best chance of investment success over the long term.

Maziar Nikpour is a Senior Manager, Investment Strategy Group at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only. It does not take your objectives, financial situation or needs into account so it may not be applicable to the particular situation you are considering.

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Podcast: UniSuper's John Pearce, today's GFC similarities, LIC news

James Gruber

Season 2, Episode 11

Special guest John Pearce, Chief Investment Officer at UniSuper, explains why the 60/40 portfolio is far from dead, that governments not central banks are to blame for the recent inflationary spiral, why history is a dangerous guide to the future, and how UniSuper has recently invested heavily in the downtrodden US banking sector.

Morningstar's Peter Warnes tells us why events today remind him of 2007, a year before the financial crisis hit.

And Firstlinks' Managing Editor, Graham Hand, gives an update on developments in listed investment companies and listed investment trusts, including planned delistings from Neuberger Berman and Forager, the ongoing battle over Magellan Financial's Global Fund, and Wilson Asset Management's latest offering.

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

Please share with friends and colleagues, and a favourable rating would help spread the word. We welcome questions and suggestions at firstlinks@morningstar.com.

Grab a cuppa and settle in for our chat.

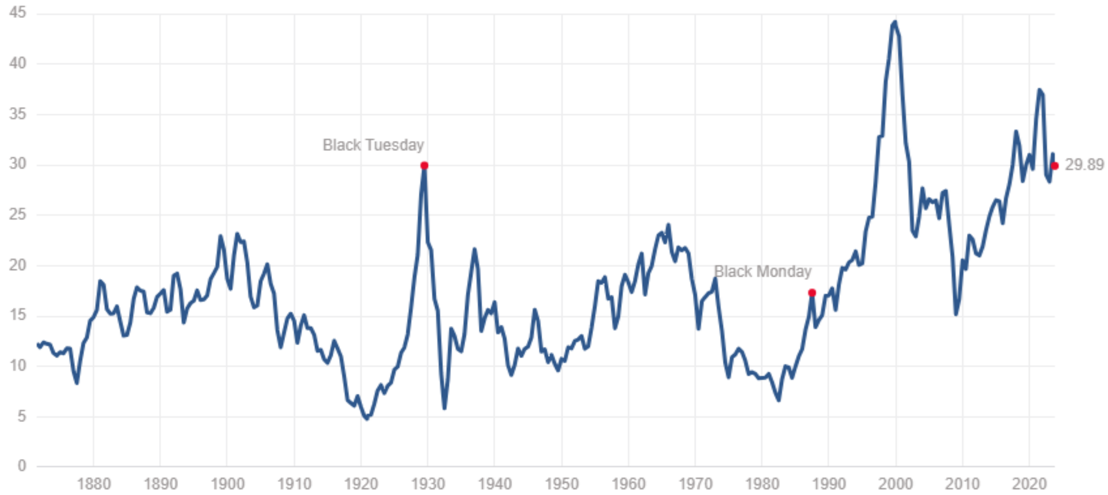
How likely are market crashes?

Larry Swedroe

It is well known that equities are subject to both booms and busts, testing the discipline of most investors and leading legendary investor Warren Buffett to conclude: "Investing is simple, but not easy." Perhaps the best example of the boom-and-bust nature of equity markets is the late 1990s. From January 1995 through February 2000, the S&P 500 boomed, returning 25.8% per year. By the end of the period, the Shiller CAPE 10 had reached 42.2, producing an earnings yield of just 2.4%. The CAPE 10 earnings yield has been as good a predictor as we have of future equity returns. At the time, the yield on 10-year Treasury Inflation-Protected Securities was in excess of 4%. In other words, the expected real return to equities was almost 2 percentage points less than the riskless real return on TIPS. If anything is a sign of a bubble, that is the leading candidate. Then, from March 2000 through September 2002, the S&P 500 "busted," producing a cumulative loss of 38.3%.

Another boom and bust was experienced from October 2002 through October 2007 when the S&P 500 returned 15.5% per year. That boom, which pushed the CAPE 10 to 27.3, producing an earnings yield of 3.6% (just 1.5 percentage points above that of the yield on 10-year TIPS), ended in a bust that saw the S&P 500 lose a total of 51.0% from November 2007 through February 2009.

The next boom and bust occurred a decade later. After returning 26.1% a year from 2019 through 2021, producing a total return of just over 100% in three years—a boom that pushed the CAPE 10 to 38.3 (an earnings yield of just 2.6%)—from January through September 2022, the S&P 500 lost 23.9%.



Source: https://www.multpl.com/shiller-pe. As of Oct 16 2023.

The historical data demonstrates that extremes in the right tail of the return distribution (caused by rising valuations) can portend sharp reversals and painful performance downturns.

Empirical research

Academic research has found some useful metrics in terms of predicting markets. For example, it has found that credit growth is a relevant predictor of financial crises and that a bull equity market, combined with strong credit growth, indicates a higher likelihood of a banking crisis. Research has also found that acceleration in price momentum leads to greater instability in future prices and that market crashes are typically preceded by a bubble phase, characterized by a rapid acceleration in asset prices. And finally, in their famous 1988 paper "Stock Prices, Earnings and Expected Dividends," Robert Shiller and John Campbell established that future equity market returns are negatively related to the cyclically adjusted price/earnings ratio (the CAPE 10), providing a basis for equity market valuation as a predictor of future returns.

New research

Steve Sapra, Josh Davis, German Ramirez, and Marc-Antoine Loo contribute to the literature with their study "Equity Fragility," published in the July 2023 issue of *The Journal of Portfolio Management*, in which they developed a framework for assessing the likelihood of large equity market drawdowns. They built a regression model based on macroeconomic variables (yield curve slope using the 10-year yield minus the three-month yield, year-over-year inflation percentage change and three-year credit growth); a technical metric (the 12-month Sharpe ratio for equities); and a valuation metric (the equity dividend yield) for both the United States and a cohort of four additional developed markets (Australia, Germany, Japan, and the United Kingdom). Their sample covered the period from March 31, 1951, through Aug. 31, 2022. Here is a summary of their key findings:

- Across the five markets, drawdowns of up to 5% occurred in 38.3% of the months, with 8.2% of the drawdowns occurring during recessions. Drawdowns of 5% to 10% occurred in 18.3% of the months, with 13.4% of the drawdowns occurring during recessions. Drawdowns of 10% to 20% occurred in 19.3% of the months, with 21.8% of the drawdowns occurring during recessions. And drawdowns of more than 20%

occurred in 11.9% of the months, with 38.9% of the drawdowns occurring during recessions. The pattern makes clear that while the more-severe drawdowns are more likely to occur during recessions, most do not—the likely explanation is that the market is a leading economic indicator, tending to fall in anticipation of recessions.

- Large equity market drawdowns were generally more explainable than small drawdowns. However, as the drawdown size increased, the number of factors that met the threshold of statistical significance increased, as did the R-squared value—it is difficult to predict small equity market declines relative to their larger counterparts.
- Since 1951 global markets had returned, on average, 7.6% over cash and experienced an average drawdown of 15.0% over a one-year horizon. However, on average, when the drawdown probability was above 30%, global markets performed poorly over the following year, with an excess return of negative 1.7% and an average drawdown of 22%. For probabilities below 30%, the average excess market return and drawdown were 11.4% and 12.2%, respectively.
- Market crashes historically have been associated with a set of factors centered around valuation (particularly dividend yield), technical (the 12-month Sharpe ratio), and macroeconomic (inflation and credit growth) indicators.
- Their model showed a likelihood of a crash of more than 80% prior to the crashes in 1973 and 2000, and more than 60% prior to the crash that began in late 2007. In 2021 the likelihood of a crash was less than 20% but by August 2022 had risen to above 80%.
- Their framework was effective for both recessionary and non-recessionary drawdowns.
- Valuation was the only factor that showed a high degree of statistical significance across all markets except Japan (for which no factor was statistically significant). However, by pooling data (and excluding Japan) almost all factors were statistically significant, with inflation being the most significant (t-stat = 5.34), followed by valuation (t-stat = negative 4.88).
- While the U.S. was a fundamental driver of "market fragility" globally—the incremental effect of a U.S. drawdown was 0.31, implying a 31% increase in each country's conditional drawdown probability if the U.S. equity market were impaired—country-specific factors were still relevant for predicting the likelihood of large equity market drawdowns.

The finding that valuations play an important role in forecasting future equity returns and the risk of large market drawdowns is consistent with prior literature, including the 2012 study "An Old Friend: The Stock Market's Shiller P/E," the 2022 study "Equity Risk Premiums (ERP): Determinants, Estimation, and Implications," and the 2023 study "The Continued Forecasting Effectiveness of a Real Earnings Model of the Equity Premium."

With that said, the research also shows that starting valuations clearly matter, and they matter a lot. Higher starting values mean that not only are future expected returns lower (and vice versa), but the best outcomes are lower and the worst outcomes worse. However, a wide dispersion of potential outcomes, for which we must prepare when developing an investment plan, still exists—high (low) starting valuations don't necessarily result in poor (good) outcomes.

Investor takeaways

Sapra, Davis, Ramirez, and Loo demonstrated that global equity drawdowns have generally been associated with a common set of characteristics centered around valuation, macroeconomic, and technical variables. They also demonstrated that a drawdown in the U.S. is highly indicative that a non-U.S. market is also in a drawdown—the U.S. acts as a fundamental driver of global equity market fragility. However, country-specific factors (such as valuation, yield curve slope, and inflation) contain information beyond just the impact of the U.S.—although the U.S. matters a lot, it isn't everything. Perhaps most importantly, they showed that expensive markets are not only predictive of lower future returns but also of increased fragility.

Turning to conditions today, the strong performance of the S&P 500 in 2023 pushed the CAPE 10 to 28.9 on Oct. 3, producing an earnings yield of just 3.5%. Assuming valuations don't revert toward their historical mean (in which case realized returns would likely be lower), investors in the stocks of the S&P 500 should expect to earn a real return over the next decade of just 3.5%, half its long-term historical average compound real return of 7%. Adding the current spread between 10-year Treasuries and 10-year TIPS (providing an estimate of inflation) of about 2.4% provides a forecast nominal return of 5.9%, about 60% of the S&P 500's historical nominal return of about 10%.

This provides two warnings for investors. First, valuations are historically high, and high valuations are correlated with the increasing risk of a crash. Second, investors who build plans using historical returns to both stocks and bonds (bond yields are still well below historical averages) are likely to be disappointed, increasing the risk of failing to achieve financial goals.

What can investors do to address these issues?

One way to reduce both risks is to increase allocations to international equities. Using Morningstar data, Vanguard Total Stock Market Index Fund VTSMX had a current P/E ratio of 18.4 and Vanguard 500 Index Fund VFINX had an even higher P/E of 19.5, but Vanguard Developed Markets Index Admiral Fund VTMGX had a P/E of just 13.0, while the Vanguard Emerging Markets Index Fund VEIEX had an even lower P/E of 13.2. The much lower P/Es not only project higher expected returns, but they also reduce crash risk. We see similar results with the CAPE 10 (as of June 30) for the S&P 500, the MSCI EAFE Index, and the MSCI Emerging Markets Index: 3.2%, 5.6%, and 7.3%, respectively.

Another way to address the risks of high valuations is to increase allocations to small-value stocks.

The evidence makes clear that estimating future equity returns isn't a simple task. It's why trying to time markets based on short-term forecasts has proved so difficult, and why legendary investors such as Warren Buffett ("The stock market serves as a relocation center at which money is moved from the active to the patient") and Peter Lynch ("Far more money has been lost by investors trying to anticipate corrections than has been lost in all the corrections combined") advised against it.

With that said, because financial plans are developed without the benefit of a clear crystal ball, the best tools available should be used. However, when using these tools, the evidence demonstrates that healthy skepticism about the accuracy of forecasts is needed. Be careful not to treat outcomes from models in a "deterministic" fashion. Instead, treat them only as the mean of a very wide potential dispersion of possible outcomes.

Larry Swedroe is head of financial and economic research with Buckingham Strategic Wealth. The views expressed here are the author's. For informational and educational purposes only and should not be construed as specific investment, accounting, legal, or tax advice. The author own shares in one or more securities mentioned in this article.

A-REITs: what the market gloom is missing

Mark Ferguson

Historically, investors have looked to Australian Real Estate Investment Trusts (A-REITs) as a medium-to-long term property investment option, providing a sound base of distribution yield, capital growth and with the added benefit of liquidity. The A-REIT market offers retail investors an opportunity to invest in some of the highest quality real estate in Australia with strong lease covenants, such as ASX listed corporates, Governments, multinationals, and national tenants. Strong lease covenants ensure contractual rent commitments flow-on to investors in the form of distributions. The large scale of A-REIT property portfolios and consequent tenant diversification ensures that a single tenant expiry is unlikely to negatively impact investors distributions.

A-REITs can diversify your investment portfolio by exposure to the core property sub-sectors of industrial, retail, office and to the emerging alternate sectors of seniors living, affordable residential rentals, self-storage, healthcare, data centres and the build-to-rent residential sector. Many of these nascent high growth alternate property sub-sectors will capture the convergence of societal megatrends, such as urbanisation and technology, affordable housing and ageing demographics, to cite just a few.

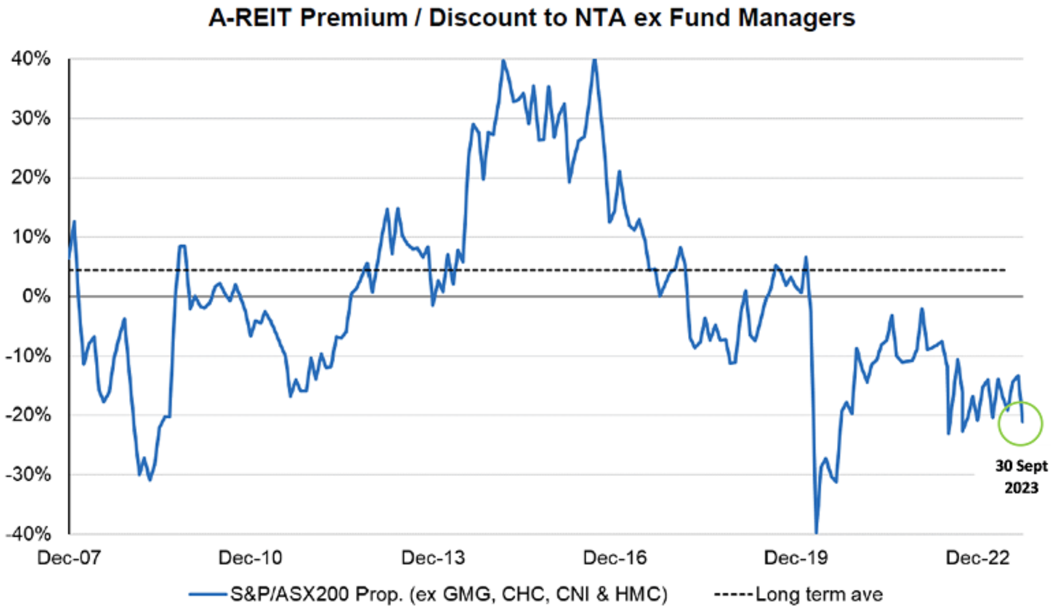
The asset quality of the A-REIT sector is best reflected by the basic property fundamentals – a weighted average lease expiry (WALE) of 5.5 years and an overall average occupancy level of 98.3%. The robust capital structure of the sector is illustrated by a look-through gearing level of 25% (debt/assets), an interest coverage ratio of 5.0x (excluding large fund managers such as GMG and CHC) and debt maturity of 4.8 years with 76% hedging.

The sector is cheap – on all metrics

The A-REIT market is one of the most interest rate sensitive parts of the Australian equity market and it has been under considerable pressure due to heightened uncertainty on the outlook for both short term cash rates and 10-year Government bond yields. Interest rate markets have been adjusting after central bank quantitative easing policies destroyed the term structure of interest rates – a normal positive shaped yield curve.

The rising cash rate has increased the cost of debt finance and reduced distributions. Meanwhile, the upward movement in 10-year bond yields is working its way through property valuations as property capitalisation rates and discount rates are adjusted higher to reflect increased risks relative to bonds.

A-REITs are now trading at 12% below pre-COVID levels compared to the broader ASX market at 13% above pre-COVID levels. The market is pricing A-REITs at a 25% discount to their Net Tangible Assets (NTAs), and the sector has only been this cheap during two other periods: the GFC and Covid-19.

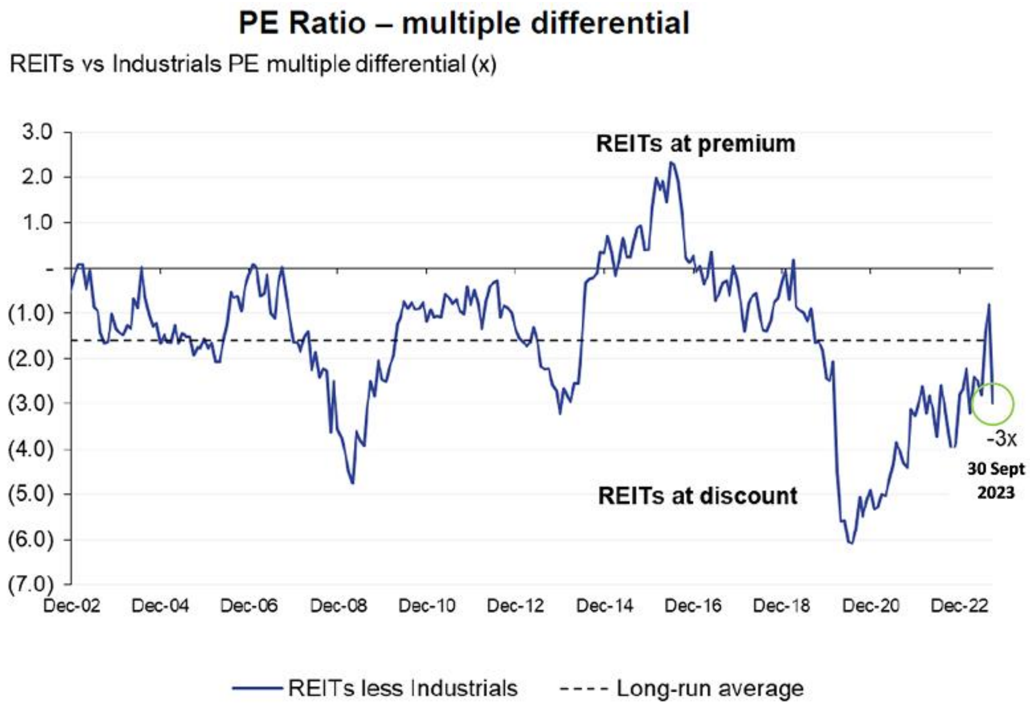


Source: UBS.

The market is pricing the sector property capitalisation rate (ex-GMG) at 6.6% or 150bps above the sector's stated capitalisation rate of 5.1%. The capitalisation rate is the rate of return on a property based on the net operating income that the property generates.

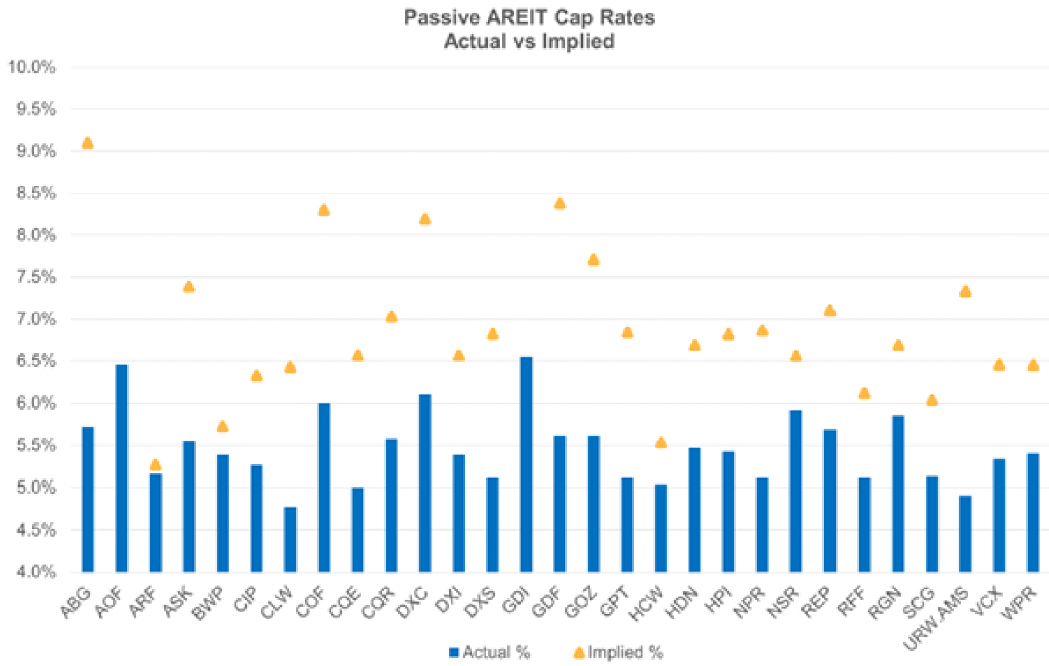
Even with the expected property devaluations to occur this financial year, we think the market is excessively pricing this in. As a result, the sector distribution yield is 5.0%, with 3.0% per annum distribution growth forecast for the next three years (ex-GMG and CHC).

On a price to earnings (PER) multiple, A-REITs also look inexpensive, trading at 14x versus the broader equity market's 17x. The PE differential of 3.0x is above the long-term average of 1.6x, as the chart below shows.



Source: Factset, Macquarie Research, September 2023

Another way to assess the value in A-REITs is through the implied pricing for the passive A-REITs or the rent collectors (non-fund managers). The A-REIT market is pricing the rent collectors for a further 20% fall in value or an implied property capitalisation rate of 7.2% versus the reported cap rate of 5.5% at June this year.



Source: Management accounts, Charter Hall

Other upside

The current environment is a chance for quality managers to showcase their capital management skills by executing buybacks or continuing to sell assets and reduce debt.

Merger and acquisition (M&A) activity is also likely. In every A-REIT cycle, M&A happens either within the sector, public to private takeouts or even foreign property groups taking advantage of cheap listed property portfolios combined with a low Australian dollar. Listed plays, Hotel Property Investments (ASX: HPI) and National Storage (ASX: NSW) have attracted suitors in the past.

We're motivated by the opportunity for capital growth driven by the dislocation between the pricing of listed securities relative to underlying asset values and strong underlying sector fundamentals. Our own A-REIT Fund enables us to offer investors a portfolio of underlying property exposures beyond the traditional core real estate sectors of office, retail and industrial. This allows us to tap into emerging real estate growth sectors, many of which are exposed to megatrends. These growth sectors include seniors housing, affordable residential rentals, data centres, self-storage, childcare, and healthcare.

Mark Ferguson is Head of Charter Hall Maxim Property Securities at Charter Hall Group, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any person. There are risks inherent in every investment. You should conduct in-depth research before deciding whether to invest, and if you are in any doubt, you should consider consulting your financial adviser, stockbroker, or other professional advisers.

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