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Contents

Charlie Munger on Buffett, gambling, Apple, and China   James Gruber

Does Barrenjoey hold the key to Magellan's fortunes?   Andrew Brown

Former RBA Governor on why interest rates won't come down soon   Macfarlane, ONeill

Meg on SMSFs: Is a binding death benefit nomination worth it?   Meg Heffron

Why avoiding losers is the key to successful investing   Daniel Moore

Podcast: Matt Williams, digital gold, Warnes on investor complacency   James Gruber

The best active and passive REIT funds   Steven Le

Editorial

> *"There are these two young fish swimming along and they happen to meet an older fish swimming the other way, who nods at them and says, "Morning, boys. How's the water?"*
> *And the two young fish swim on for a bit, and then eventually one of them looks over at the other and goes, "What the hell is water?""*

The late, great US novelist, David Foster Wallace, included this parable in a speech entitled, 'This is water' at a US college commencement address in 2005. It went viral as much for its poetry as its brutal honesty.

The point of the parable is that the most important and obvious realities are often the hardest ones to see.

Markets are missing the obvious

There's a parallel to financial markets today as I see an obvious reality that the US tech sector is back in bubble territory again, yet few others are talking about it.

It's odd how this has come about. Last year, everyone seemed to have recognized that the prices of many assets had become ludicrous and that their subsequent pummelling was long overdue. However, a number of these same assets have come roaring back to life this year and there's been barely a peep.

Bitcoin hasn't not nearly got the same attention and it's rocketed 135% in 2023. Tech stocks in the US aren't far behind. Tech bellwether, the NASDAQ, is up a blistering 45% year-to-date. Of the S&P 500, seven stocks aka 'The Magnificent Seven' have risen 68% this year, while the remaining 493 stocks in the index are just 2.5% higher.

Here are 'The Magnificent Seven' total returns this year:

- Nvidia (NVDA) +230%
- Microsoft (MSFT) +55%
- Apple (AAPL) +44%
- Meta (META) +171%
- Alphabet (GOOGL) +50%
- Amazon (AMZN) +70%
- Tesla (TSLA) +74%

At first glance, what's staggering is how much the prices of these mega-cap companies have moved in one year. Apple and Microsoft are worth US$2.9 trillion and US2.7 trillion, and they're up 44% and 55% respectively this year. For Microsoft, the market believes that the company is worth around US$950 billion more now than it was at the start of the year. Even with the hype around artificial intelligence, business values moving around this much are difficult to fathom.

Though, perhaps not. Let's look at the trailing price-to-earnings (PER) multiples of the seven stocks, based on Morningstar estimates:

- Nvidia 117x
- Microsoft 36x
- Apple 30x
- Meta 29x
- Alphabet 25x
- Amazon 75x
- Tesla 72x
- **Simple average 55x**

The simple average multiple of 55x compares to the S&P 500's 24x, a premium of 129%.

Of course, some of the stocks above are set for stellar growth over the next few years. Nvidia, riding the AI boom, is a standout here.

Yet other stocks with high multiples attached are struggling to grow. Apple is one. Another is Tesla where Morningstar expects earnings to shrink this year as competition heats up in the electric vehicle space. And Alphabet faces a serious structural threat to its dominant search engine business from AI.

Have earnings driven stellar tech returns?

I thought it would be a worthwhile exercise to look at how much earnings growth has contributed to the rise in share prices for some of these stocks. For instance, Microsoft's stock has risen by 861% over the past decade. That's excluding dividends. Including those, and the stock has compounded at 26% per annum. A stellar performance.

How much of that performance was driven by earnings? Well, earnings per share over that period increased at a compound annual growth rate (CAGR) of 14% on revenue which grew at an 11% CAGR clip. In simple terms, earnings accounted for a little over 50% of the Microsoft's price rise over the 10 years. The remaining 50% or so came from expansion in the multiple attached to the stock.

Back in 2013, Microsoft was considered a stodgy dinosaur and it was valued as such, bottoming with a trailing PER of 13x. How times have changed.

Source: Morningstar

Apple is another case study. Over the past 10 years, the stock is up 896%. Including dividends, it's compounded at 26% per annum, the same as Microsoft.

Earnings per share over that period have compounded at 15.8% per annum. A big chunk of that return has come from share buybacks as operating earnings were up only 8.8% a year over the decade.

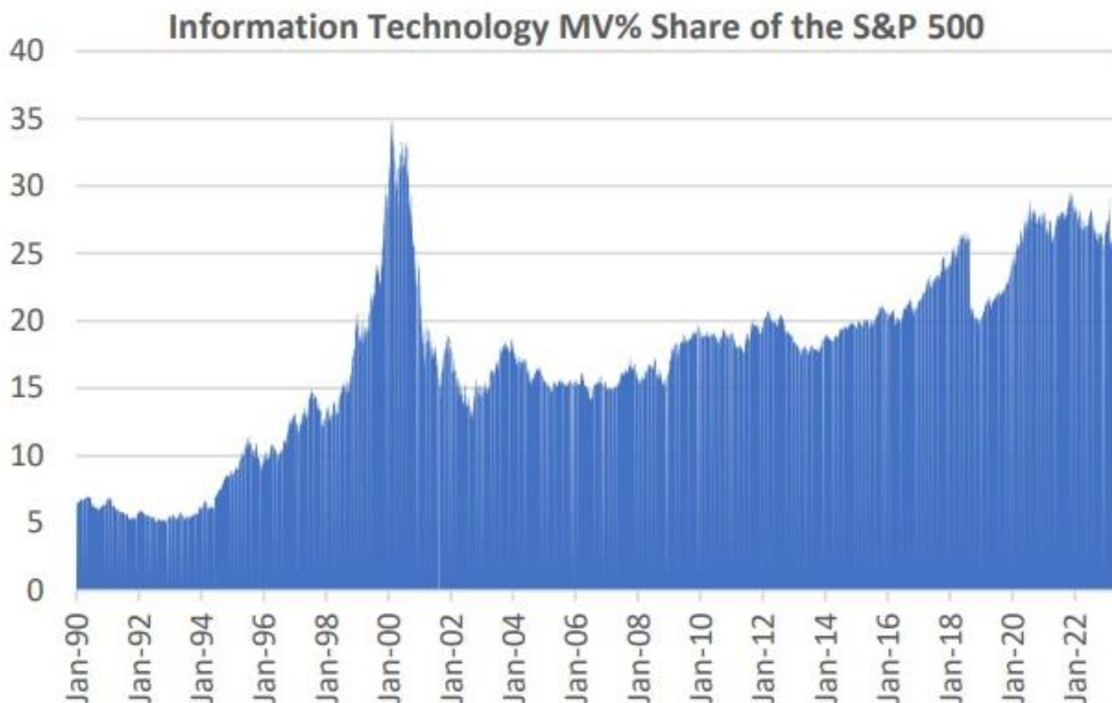
Earnings accounted for around 61% of the total return over 10 years, with the remainder attributable to an increase in the earnings multiple applied to the stock.

Source: Morningstar

S&P 500 tech weighting also flashes warning sign

It's not only the prices of large cap tech stocks that should concern investors. IT's weighting in the S&P 500 provides further evidence of irrational exuberance in the sector.

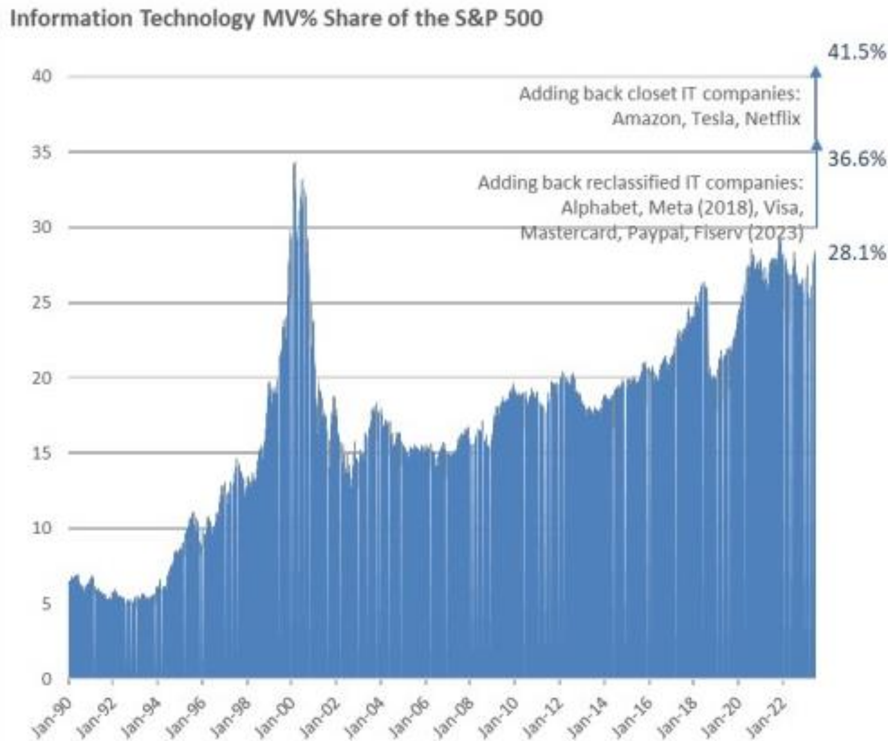
On the face of it, the tech sector's weighting of 28% in the S&P 500 looks high.



Source: Bloomberg

But that doesn't tell the full story. There are companies that should be part of the tech sector but aren't. For example, Amazon and Tesla are classified as consumer discretionary when they're arguably not. Amazon's cloud business generates 107% of operating profits, which should make it an IT company. In case you're wondering, Amazon's online retail business doesn't make any money (those deliveries are loss makers, after all). Netflix, Alphabet, and Meta are classified as communication companies when they clearly shouldn't be.

If you include these companies in the tech sector, the true weighting of IT in the S&P 500 is closer to 41%, which is well above the peak of 35% reached in 2000.



Source: Bloomberg

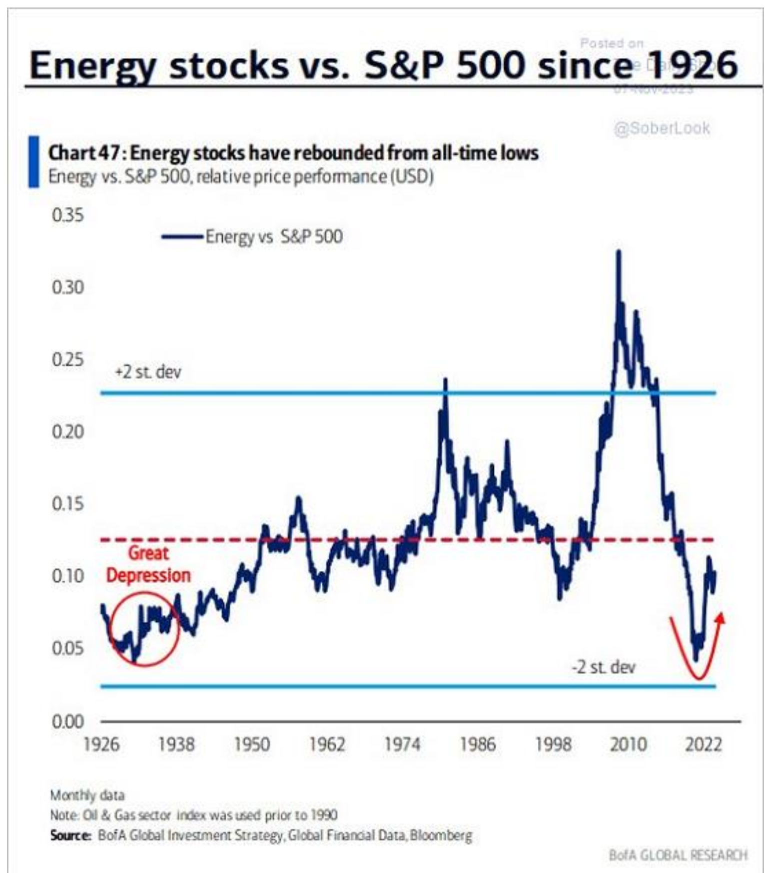
Crowding into tech has created opportunities in other sectors

Like in 2000, an extraordinary amount of money has found its way into the tech sector at the expense of the rest of the market, leaving some sectors looking cheap. And like back then, these sectors may perform well even if tech stocks pull back hard.

The energy sector appears the standout in this regard. In the US, the sector is down 2% versus the S&P 500's 18% gain this year. And energy looks inexpensive on almost every valuation metric.

Energy stocks have the potential to be what tobacco stocks were over the past century. The tobacco sector in the US outperformed all other sectors over the past century. On the face of it, this seems strange. After all, tobacco has been a dying industry for decades. That's only been part of the story, though.

Increased regulations, tax hikes, and numerous lawsuits have driven companies out of the sector, leaving only a few large players left. With this consolidation has come immense pricing power for those companies which remain. Increased tobacco pricing has been able to offset reduced product demand.



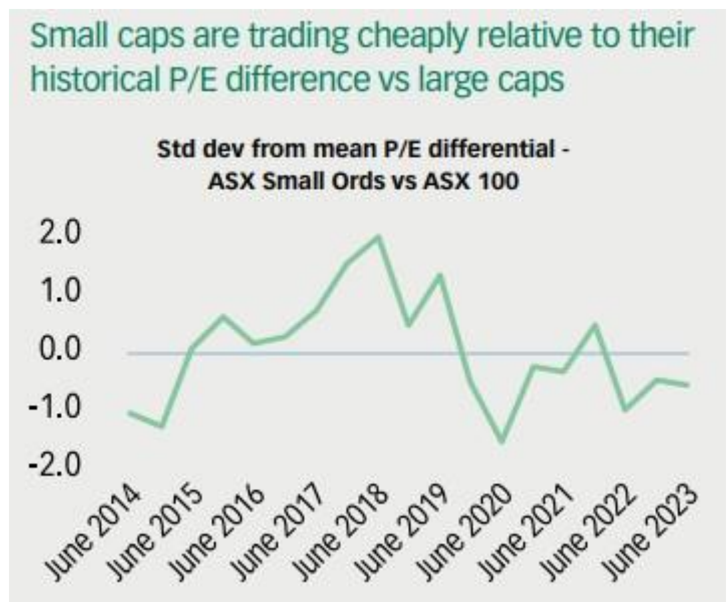
Throw in almost perpetually low valuations for the tobacco sector providing opportunities to buy back stock at cheap prices, and that's led to incredible long-term returns for shareholders.

The energy sector has similar dynamics to the tobacco sector. Oil and coal demand will likely decline in coming decades. That's led to large cuts in investment, which is reducing supply. The question is whether supply cuts will outrun demand cuts, and I suspect they will.

There's also pressure on investors to not invest in oil and coal stocks. Many of these investors are essentially forced sellers of these stocks. That's making many shares in the sector cheap. Yes, they could be forever cheap, though like tobacco, that paves the way for stock buybacks at inexpensive prices.

The other opportunity may be in small caps. In the US, small caps are at their lowest level compared to large caps since December 2000.

It's similar in Australia.



If the US tech sector does stumble at some stage, these types of opportunities may finally get some love from investors.

James Gruber

In this week's edition...

Charlie Munger is best known as Warren Buffett's sidekick though he's a formidable investor and thinker in his own right. In a rare interview, Munger sheds light on what makes Buffett a great investor, why Costco is the world's best retailer, and the reasons behind Berkshire Hathaway's investments in Apple, Japan, and China. **James Gruber** reports.

Magellan Financial Group has been under the pump of late with investors exiting funds and a management reshuffle resulting in further falls in the share price. That's made it potential takeover fodder. **East 72's Andrew Brown** says it would be wrong to sell the company now and there's still significant value outside of the funds management business, especially with Magellan's stake in investment bank, Barrenjoey.

Former RBA Governor **Ian Macfarlane** says Australia's economy has held up incredibly well given the sharp spike in interest rates. Yet he thinks that economic strength plus high inflation mean rates are more likely to go higher than lower in 2024.

Meg Heffron is back, this time to address the issue of whether binding death benefit nominations make sense for SMSFs. She describes her own journey in deciding on the issue after weighing up the pros and cons.

Novak Djokovic is widely regarded as the greatest tennis player of all time and the secret to his success isn't so much from the winners he hits, but from how few mistakes he makes compared to his opponents. **Investors Mutual's Daniel Moore** thinks it's like investing - that avoiding losers is as important as making gains. And he goes through how to best protect the downside on investments.

In the *Wealth of Experience* podcast this week, special guest Matt Williams from Airlie Funds Management talks through recent investments in 'fallen angels' such ResMed and Orora. Our other special guest, Joe Cavatoni from the World Gold Council, explains the key drivers behind gold prices and the rise of digital gold. Meanwhile, Morningstar's Peter Warnes suggests investors are complacent and possibly 'in fairyland' given current market risks.

Morningstar's Steven Le investigates the performance of passive and active funds in A-REITs and G-REITs. He finds that though passive outperforms, it's not by much, especially in A-REITs. He runs through his best picks for both active and passive REIT funds.

Finally, in this week's whitepaper, **Epoch**, a **GSFM** affilate, looks at what AI means for work, the economy, and markets.

Curated by James Gruber and Leisa Bell

Charlie Munger on Buffett, gambling, Apple, and China

James Gruber

Charlie Munger is best known as Warren Buffett's sidekick though he's a formidable investor and investment thinker in his own right.

Munger first met Buffett in 1959 through a mutual friend. A doctor in their hometown of Omaha, Dr. Edwin Davis, told Buffett in 1957 that he trusted him to manage money because Buffett reminded him of someone called Charlie Munger. "Well, I don't know who Charlie Munger is, but I like him," Buffett responded to Davis. Two years later, Davis arranged for the pair to meet, and they hit it off right away.

Munger was originally a lawyer by trade. He started his own investment firm in 1962 and went on to crush the market over the following 13 years, compounding his portfolio at 19.8% per annum compared to the Dow Jones Industrial Average's 5%.

In 1978, Munger became Vice Chairman of Berkshire Hathaway, a position he still holds today. Munger is credited for helping change Buffett's investment approach from buying cheap, often low-quality companies, to purchasing great companies at reasonable prices.

Munger is 99 years of age yet retains a sharp mind and wit. Recently, he gave a rare interview to the Acquired podcast and offered some great insights on a range of investment topics.

Munger and Buffett's investment approaches

Buffett got his first taste of investing as a young man at the racetrack. Munger was asked about this, and his response gives a key insight into the way that Buffett approaches the stock market:

> *"… Warren never gambled. He was only a patron of them [the racetracks]. Warren wants the odds in his favor, not somebody else. It's just so simple if you're Warren. You want to be the house, not the punter."*

There are many famous investors who started out as gamblers – Edward Thorp, Bill Gross, and Jeff Yass come to mind. Buffett is also in this bracket. He took the mindset of an expert gambler – betting when the odds are overwhelmingly in your favour - and parlayed that into investing.

On his own investment approach, Munger gave a surprising answer. Though he's known for liking stocks that earn high returns on capital over long periods, Munger acknowledged that's not the only way he invests:

> *"I only study two kinds of companies. I'm enough of a big Ben Graham follower… so if something is really cheap, even though it's a crappy company, I'm willing to consider buying it. For a while anyway. I do that occasionally. I've done it with great success a time or two, but unlike Howard Marks I've only done it once or twice in my lifetime for big gains, and that's it. It's not like I've done it a hundred times. It isn't a bit easy. A hundred times easy money is almost non-existent….*
>
> *… Great brand companies, of course, are good. Getting the right price… the whole trick is getting them on a few rare occasions when they're really cheap. Buying Costco at its present price… it may work out all right but that's… but again it's getting hard."*

Buffett's big Costco error

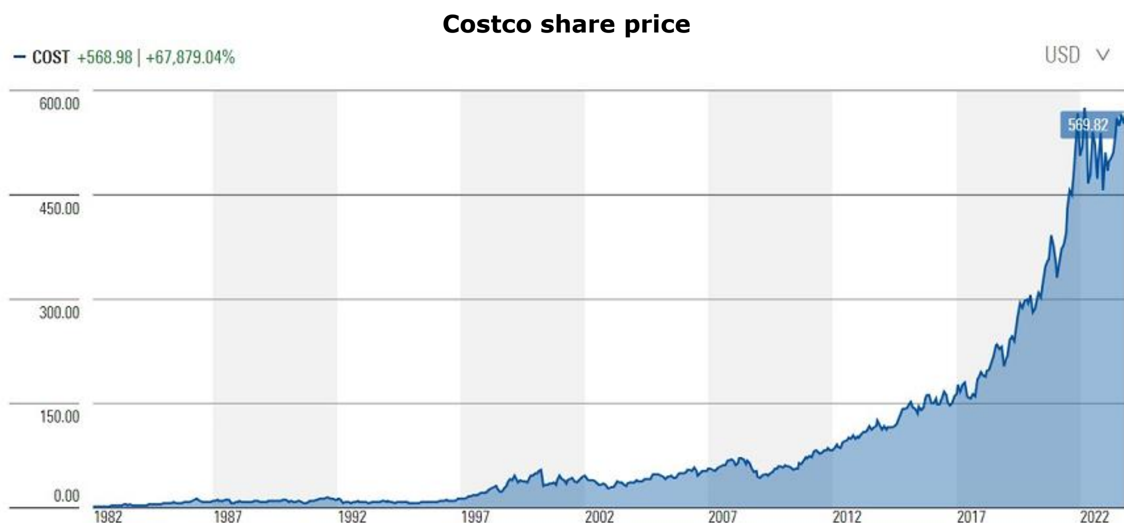
In 1997, Costco (NYSE: COST) offered Buffett a seat on the board, which he declined. Buffett suggested Costco ask Munger instead, and Munger accepted. He's been on the board ever since.

Munger tried to convince Buffett to invest in Costco early, though it didn't work. The reason: "Warren doesn't like retailing". Apparently, Buffett had seen many retailers come and go, including big department stores that once dominated, and thought it a difficult business to make money from.

Munger thought differently, and recognized early on that Costco had an incredible business model:

> *"They really did sell cheaper than anybody else in America and they did it in big, efficient stores. The parking spaces were 10 feet wide instead of eight or nine feet or whatever they normally are. They did it all right and they had a lot of parking spaces. They kept out of their stores. All these people didn't do big volumes, and they gave special benefits to the people who did come to the stores in the way of reward points."*

Costco share price



Source: Morningstar

What makes a great retailer

Munger says Home Depot took the Costco business model and applied it to home improvements: "They copied everything".

Munger believes there's a more modern Costco imitator in a smaller company called Floor & Décor (NYSE: FND). As the name suggests, the business sells flooring, offering a huge selection via large warehouses, and with cheap prices to boot.

Floor & Décor share price

Source: Morningstar

Munger was asked about whether he'd ever looked at Nike as a business, and he said he had, though he rejected it because it's a 'style company'. Munger didn't elaborate on this though I suspect what he's alluding to is that with 'style companies', future prospects and earnings are difficult to forecast and that is not the type of business that he likes to invest in.

Munger prefers capital-light retailers with predictable earnings and pricing power:

> *"… we were lucky enough to buy See's candy for $20 million as our first acquisition. We found out fairly quickly that we could raise the price every year 10%, and nobody cared. We didn't make the volumes go up or anything like that. Just made the profits go up. We've been raising the price by 10% a year for all these 40 years or so. It's been a very satisfactory company.*
>
> *It didn't require any new capital. That's what was good about it: very little new capital. It had two big kitchens and a bunch of rental stores when we bought it, and now it's got two big kitchens and a bunch of rental stores."*

Berkshire's investment in Apple

Buffett's most high-profile recent investment has been in Apple (NASDAQ: AAPL). He first purchased a stake in 2016 and it's since been a home run. Berkshire now owns 5.8% of Apple, worth around US$164 billion. Apple accounts for close to 50% of Berkshire's stock portfolio.

Apple share price

Source: Morningstar

Munger's take on the lessons from Berkshire's investment is intriguing:

> *"What everybody has learned is that everybody needs some significant participation in the 12 companies that do better than everybody else. You need two or three of them, at least. If you have that mindset, Apple was the logical candidate to be on the list of which you're going to select your companies. It's not very hard to come up with an idea that it may be okay."*

This seems to be a recognition that when you're a big investor like Berkshire, you must be invested in some of these great technology companies, or risk underperformance.

As for why Berkshire picked Apple, Munger says it was valuation, as the company got down to around 10x earnings when Buffett bought in.

Buffett's investment in Japan trading companies

Buffett's other recent investment success has come from the unlikely place of Japan. He started investing in Japanese trading companies in 2020 and retains stakes in five of them (Mitsubishi Corp., Mitsui & Co., Itochu, Marubeni and Sumitomo Corp).

Munger implies that there was leverage involved in the purchases. He says at the time, you could borrow in Japan at 0.5% for 10 years, and these stocks had cheap assets and dividend yields of 5%, making them "no-brainer" investments:

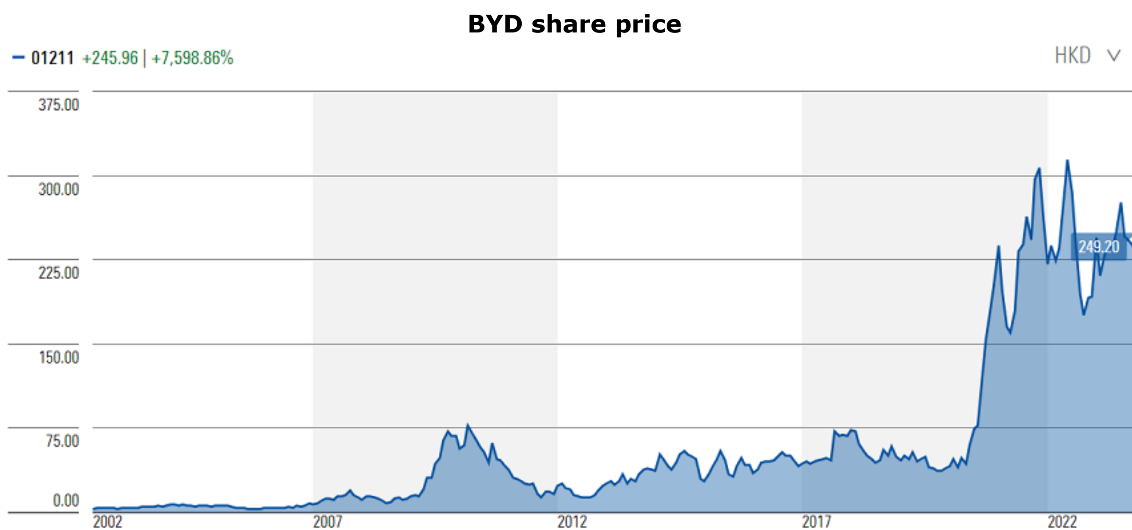
> *"It took him [Buffett] forever to get $10 billion invested. It was like God just opening a chest and just pouring money. It's awfully easy money."*

Why he likes China

Munger has been a long-time investor in China. He persuaded Buffett to invest in automaker, BYD (HKG: 1211), in 2008. Munger has since called this one of the best decisions that he's ever made.

Munger claims the BYD founder, Wang Chuanfu, is a genius, and says he's better at making things than Elon Musk.

BYD share price



Source: Morningstar

In the interview, Munger doesn't address his more recent investment in Chinese online retailer, Alibaba, which hasn't worked out so far.

On China itself, Munger remains a believer:

> *"My position in China has been that: (1) the Chinese economy has better future prospects over the next 20 years than almost any other big economy. That's number one. (2) The leading companies of China are stronger and better than practically any other leading companies anywhere, and they're available at a much cheaper price.*
>
> *So naturally, I'm willing to have some China risk in the Munger portfolio. How much China risk? Well, that's not a scientific subject, but I don't mind whatever it is, 18% or something."*

Choice words for John Malone and Jim Simmons

Munger is known for his blunt manner, and he doesn't hold back on a few subjects. One is US billionaire, John Malone, who owns Formula One and the Atlanta Braves baseball team, among other things. Malone is credited with the rise of Ebitda (Earnings before interest, tax, depreciation, and amortization) as a financial term used by corporates, one that Munger has long abhorred. Munger says he's never liked Malone's "extreme manipulations", including his famous methods of minimizing tax at his listed companies.

Munger also says he's uncomfortable with investors who principally use algorithms like the famous hedge fund, Renaissance Technologies. He says these funds essentially front run investors. And Munger believes that they're making smaller profits with more volume, and the only way that they're still making good returns is through using greater and greater leverage, "which I would not run myself".

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

Does Barrenjoey hold the key to Magellan's fortunes?

Andrew Brown

If you want attention in the global investment scene, write a lengthy – and preferably extreme - piece about Tesla and place it on socials. You'll discover friends you never thought you had.

In Australia, it's astonishing that a mere $1.3 billion company attracts proportionally similar interest amongst commentators. That is instructive as to how wide a network that Magellan created for itself in its boom years from 2009-2021, how people embraced Australia's second home-grown global equity manager, and now how disappointed they are in its difficulties.

Turning around an underperforming funds management business is not easy. I have been involved in a couple of reasonably successful efforts, and there is simply no substitute for meeting the clients face to face, let them vent if need be, and understand these are the folks whose livelihoods you are looking after. It's even harder in the institutional world since once a gatekeeper has removed you from the list, there's very little upside for them to speculate on putting you back on as a potential or actual turnaround.

The attraction to investors in holding successful funds management stocks is the four-way asset light investment leverage. A fixed cost business that gives you profit growth simply from upward trending markets, which then attracts natural inflow. Add in performance fees – which are not always relative to benchmark – and then if the manager is especially successful, the shares re-rate, sometimes dramatically. Remember Magellan Financial Group (ASX: MFG) traded at >38x forward P/E and 12.7% of funds under management (FuM) at one stage. The operating leverage doesn't always work symmetrically on the downside; retail clients take a long time to leave, and the manager can still earn significant cash flows even from a dwindling pool of managed assets.

That, of course, is where we are in new territory for Australia's first two global asset managers, Platinum and Magellan. Just to prove you should never put an asset manager on a board, neither company currently has a proper CEO/Managing Director and seem to be just existing in the ether, in a fashion they would criticise remorselessly should it be an investee company of their funds.

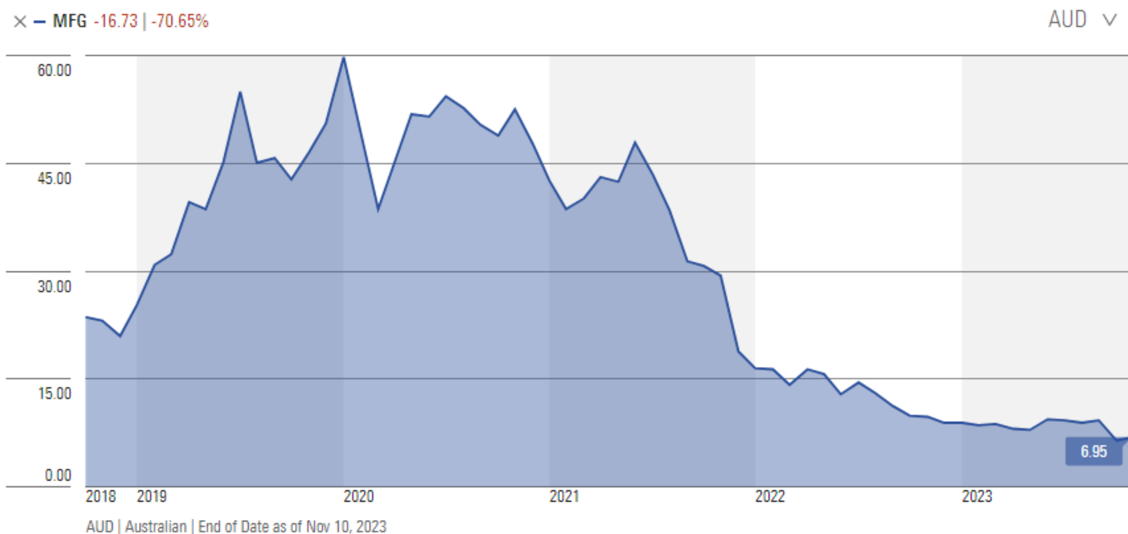
In the evening after Magellan's AGM on 8 November, I posted up an 'X' thread discussing the company. Given that 12,000 folks have checked it out – when I barely participate in Australian markets these days – there's clearly a desire to see Magellan win again, or do something to bring about a share price recovery.

MFG is more than funds management

The issue for MFG shares, as opposed to the funds management business, is that the two are not 100% aligned. On my estimates, the funds business, having had its global equity institutional funds reduced to virtually nil (and Airlie's nearly halved since John Sevior retired) represents only around 35% of the value of the listed company. This situation has grown appreciably worse over the course of 2023 as other people have picked up on it – most publicly Sandon Capital and UBS Investment analyst Shreyas Patel.

The reconstituted board of Magellan have the real capacity to continue messing up by adopting a conventional 'clear the desks' strategy, with some vested interest financial market players hoping they do so. The board must think outside the square, understand what they have, and be less opaque with shareholders about the value of the other assets in the company. The financial media's obsession with 'the manager' as opposed to the value within the listed Magellan Financial Group entity is disconcerting.

In my opinion, MFG shares can be reasonably valued at over $8.50/share, against a prevailing price of ~$7 assuming a stabilisation in the funds management business – which should be more likely given, assuming the infrastructure equities component doesn't haemorrhage. The listed company has ~$300 million cash ($1.67/share) after the dividend payouts and assuming there isn't a need to fund the closed end fund option exercise discount. In addition, at end June 2023, the company held $420 million in seed assets of its own funds and initiatives ($2.33/share). So that's $4.00 a share in 'liquidity' leaving you paying, at prevailing prices, around $3/share for the ailing funds manager and the stakes in Finclear (small) and Barrenjoey – replete with options.



Source: Morningstar

Earlier in 2022, I valued the funds management business at $979 million, when it had over $45 billion of FuM. That's far too high given FuM is now ~$34 billion (but will rebound in November given markets), the brand continues to suffer with adverse publicity and whilst expenses have been lowered, this is still a fixed cost business. Based on both earnings estimates at a lower level of FuM than currently managed, cross checked against more asset-based parameters, I believe the funds management business to be worth around $550 million ($3.05/share) – below 10x equivalent P/E or 1.6% of current FuM.

What beautiful symmetry! My valuation of cash, seeds and funds management, equates to the current share price around $7. Which leaves the two equity accounted investments, made in the days of Hamish Douglass, to decide how much your MFG shares are worth.

MFG carry these two investments on an equity accounted basis. Equity accounted values are taken at MFG's entry cost less their subsequent proportional share of losses and bear no resemblance whatsoever to reality. MFG's board and audit committee should stand up to the auditors and ditch this – they have no effective 'control' up to the level of economic interest. Then they can value the stakes appropriately – with justification - in the books.

Finclear is small in the scheme of things with MFG paying $20 million for a 17% stake in November 2020; the investment is carried in the books at just above $25 million (14c/share).

Barrenjoey, however, is where MFG's management and board are going to earn their money. I recommend the piece by Aaron Weinman in the AFR of 30 October 2023 ('Inside the Country's most talked about investment bank'). Apart from the fact Aaron falls for the equity accounting 'scam', it details just how successful Barrenjoey has been albeit with the benefit of significant financial banking from Barclays facilitating the operating losses from build out. Barclays has an 18% economic interest at a cost of $120 million; so why is MFG's 36% interest valued at $124 million, which in turn is over $30 million below the September 2020 entry price of $156 million (albeit only $90 million was in cash)?

MFG is now of limited use to Barrenjoey. It could even be argued they are a hindrance, providing limited to no support. But this is a very substantial asset for MFG shareholders, which could easily be worth far above the entry cost as Barrenjoey has now established itself. The problem is that investment banking is in a slump with limited IPO's or other ECM activity; Barrenjoey is getting more than its share, that's for sure.

Do MFG's management become impatient and sell 'at the bottom' in the wake of approaches from some of the smartest investment banking executives in Australia who have an intensely competitive streak? Shareholders in MFG must be alert to this and ensure management find a way to retain the stake for shareholder benefit until the investment bank further matures. A spin-off would be excellent, but I assume pre-emption/confidentiality conditions preclude this. Bluntly, MFG will be leaving significant money - $100 million+ in my opinion over a few years – on the table should they sell now.

Add in a more realistic valuation of Barrenjoey plus the small Finclear stake is where I get my extra $1.50 a share from to bring the valuation up to $8.50.

Other options to extract value

There are alternatives – could MFG merge with Barrenjoey, rather than just pursue buying up funds management businesses at significant goodwill to retiring executives? Or, of course, put MFG up for sale. Anyone acquiring MFG will recoup around half their outlays from liquidating seeds and the cash in the business. To make the 'sum of the parts' valuations more transparent, Sandon Capital's push to have significant funds returned to shareholders makes a great deal of sense.

There's simply no expectation that MFG's board will spend the money wisely. Should they sell the Barrenjoey stake at just above book value and reinvest proceeds in a funds management acquisition at above 1.7% of FuM, shareholders would be justified in making next year's AGM a far more volatile affair.

With corporate activity being the equity management theme and story of the past twelve months, and with Magellan Asset Management yet to really start its recovery, it remains at a genuine crossroads, But nothing like the complex junction in front of its parent company board, a feature that local financial media continually underplay.

Andrew Brown is the Principal of [East 72 Management Pty Limited](), and manager of East 72 Dynasty Trust. East 72 Dynasty Trust holds shares in Magellan Financial Group. This article contains general information only; it does not purport to provide recommendations or advice or opinions in relation to specific investments or securities. It has been prepared without taking account of any person's objectives, financial situation or needs and because of that, any person should take relevant advice before acting on the commentary.

Former RBA Governor on why interest rates won't come down soon

Ian Macfarlane, Vincent ONeill

This is an edited transcript of an interview between Stanford Brown CEO Vincent O'Neill and former RBA Governor and Stanford Brown Investment Committee member Ian Macfarlane on 6 November, 2023.

Vincent O'Neill: Ian, we've met on this podcast a few times over the last 18 months or so and I'd like to start today if we can, given the significant interest rate increases that we have seen in the past 18 months, where do you now see that we're at in the cycle?

Macfarlane: Well, the economy has slowed as you would expect but it hasn't slowed as much as most people would have expected. I mean there are some puzzles out there. I think a year ago, if you had been told that interest rates would be raised by 400 basis points, you wouldn't expect the unemployment rate to still be at multiple decade lows. And I think the other thing you wouldn't expect, you wouldn't expect to see house prices having risen for the last six months.

So, why has there not been a bigger contraction? Well, the first thing I think is even though the change from 0% to 4% is a big change, the level of interest rates at 4%, that's not a very high level of interest rates. That's actually below average.

O'Neill: In terms of the historical long term.

Macfarlane: Yeah, absolutely. And the economy can operate perfectly well with a level of interest rates – the risk-free rate, the overnight cash rate at 4%. It never got down to 4% in the 10 years that I was a governor.

Australia interest rates

O'Neill: Do you think that's a surprise to many people that we've been able to wear the increase that we have to-date with that more significant economic fallout?

Macfarlane: Yeah, I think it has been a surprise to everyone. So, that's the first thing. You've got to sometimes think in terms of level, not just changes. The second thing is although monetary policy has a number of effects, in Australia its biggest single effect is actually through the mortgage market and through indebted households, and there's no doubt that a lot of those have been squeezed. But that's only part of the economy. There's a lot of other parts that are just soldiering on as normal. The corporate sector in Australia is not highly geared. They've felt a bit of a pinch but not much. The resource sector is doing well. Agriculture is doing well. And if you try and book an upmarket restaurant midweek, you'll discover that there's an awful lot of people out there who are still living very comfortably.

O'Neill: And spending.

Macfarlane: And spending, yes. So, the bottom end of town has been squeezed and the top end of town has not been squeezed very much at all. And finally, the other thing that is new which had to be factored in, we hadn't seen it before, which is this huge increase in population. 450,000 over the last recorded 12-month period, we think the next 12 when we move ahead a quarter it's going to be 500,000. That's a huge amount. I mean, typically, it was 200,000 a year and at an extreme 300,000 but never had 500,000. The other amazing thing is this huge increase in population and they're all finding jobs. So, I don't want to give the impression that the economy is so resilient that nothing is going to happen. I think there will be further contraction. And we also got to remember that over the last two completed quarters although GDP grew, it grew less than population and that's very unusual.

O'Neill: So, people describe the per capita recession potentially.

Macfarlane: Yeah, I haven't heard that used before, but it is unusual.

O'Neill: And probably – you haven't heard it much before because you probably haven't had that degree of immigration in such a short timeframe given I guess the post-COVID catch-up that we've had. Now I'm conscious as we record this morning, we're just over 24 hours out from the next RBA meeting and the decision there. I'm not going to ask you to make a call on that one, but I would ask what is your broader outlook for rates given the rate of increase, how far we've come, but the resilience that we're still seeing in the economy?

Macfarlane: Well, I think you just made the case in your question for the position that is far more likely to be increases than for it to be steady over the next year and certainly far more likely to be increases or steady than for it to fall.

O'Neill: What's your views in terms of what you see in the inflation picture?

Macfarlane: Well, the thing that will really determine the outcome is what's happening to inflation. We had some comprehensive figures on inflation came out a couple of weeks ago. There's no such thing as the official inflation rate. You have to actually look at all the different measures over all the different time periods – monthly, quarterly, six monthly, 12 months ended. You have to look at headline inflation. You have to look at core inflation. My reading of all those numbers is really whatever you do with a rate of inflation still got a 5 in front of it. So, it's come down a bit as some of the transitory factors have washed out but still are about 5. It's probably got further to come down, but I wouldn't be holding my breath. I think it will happen slowly. The Reserve Bank forecast, I wouldn't call it a forecast, I'd call it an assumption, is that it won't get to below 3 until the second half of 2025. I think that's a reasonable assumption whether it happens or not, I don't know. But it's a reasonable assumption at this point, in which case, you wouldn't be expecting interest rates to come down if that's the outlook.

Australia inflation rates

O'Neill: Anytime soon. But you say that, and we've got the money market still forecasting a reduction in the cash rate potentially even in the second half of next year. How do you balance those two factors?

Macfarlane: Well, the money market always does that. I mean, you can work out what the money market is expecting for the cash rate from this thing called the short-term yield curve and it's constantly expecting in a very short-term an increase and then within a year interest rates to start coming down again. In other words, they're expecting the anti-inflation job to be completed within a year.

O'Neill: To have almost instantaneous impact of those increases.

Macfarlane: Yeah. And of course, they've been wrong every time, and I think they're still wrong. I mean, the only way I could conceive of that eventuality of interest rates coming down within the year would be if inflation got down to below 3% within a year. I don't think that's going to happen. I don't think anybody thinks that's going to happen. Or if there was going to be a sharp recession with a big jump in unemployment, and I don't think that's going to happen either.

O'Neill: Again, the economy is showing a lot more resilience. It would have to be a big correction for that to play out. So, you look at those outcomes and you expect monetary policy essentially to play out in slow motion.

Macfarlane: Yes, I think so.

O'Neill: I'd like to talk, if we can, about the transitioning governor from Phil Lowe to Michele Bullock. From your seat, given your experience, should we expect anything different?

Macfarlane: I don't think the change in personalities will make a big difference. I know both of them well. They both worked for me for a long time. But what could make a very big difference is if the proposals in the review of the Reserve Bank are carried out, that will make a very big difference, and it will lead to a much inferior monetary policy than we've had over the previous 30 years.

O'Neill: You're talking about an environment there where it's much tougher for Michelle Bullock to potentially operate than the environment under which you operated?

Macfarlane: Yeah, I think Michelle Bullock will have a much harder job than any of her predecessors and any of her peer governors in other countries if these proposals go through.

O'Neill: For the benefit of the listeners who are less familiar with the proposed changes, do you mind setting out the most substantive element of what has been discussed?

Macfarlane: Well, the main change will be to reduce the power of the governor and transfer that power to the part-time members of the board. Now, the Reserve Bank Board has nine members. Reserve Bank represents two of those and seven of them are outside the Reserve Bank. And it's operated, I think, reasonably well because it is operated as an advisory board or like a corporate board. But the proposals are to turn it from being like that type of board into a decision-making board where at each meeting the decision has to be voted on, has to be recorded, and has to be published. So, what this means is that the outsiders or the part-timers on the Reserve Bank Board will have the majority of the voting power.

O'Neill: Will have the balance of power.

Macfarlane: They'll have more. They'll have – they've seven out of nine, one of whom is the Secretary of the Treasury and six are part-timers who are supposed to work one day a week. But they will have two-thirds of the voting power on monetary policy. So, that's what's going to make the governor's position very difficult.

This is an edited transcript of an interview between Stanford Brown CEO Vincent O'Neill and former RBA Governor and Stanford Brown Investment Committee member Ian Macfarlane on 6 November, 2023.

Meg on SMSFs: Is a binding death benefit nomination worth it?

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues on managing your SMSF.

I'm visiting an estate planning lawyer this week to finally update my will.

I hate to admit it but this is the first time I've had it reviewed in 20 years. Back when my current will was drafted, my youngest child was a newborn, I was married and my husband and I had pretty much no assets other than our home and shares in our fledgling business.

As I race through my 50s, life looks different. So it's definitely time.

I know one of the issues that will come up is whether or not I should have a binding death benefit nomination for my super so that's something I've been thinking about in advance.

Will it make a difference?

Let me start by saying that if I belonged to an APRA fund, I would ***absolutely*** have a binding death benefit nomination. The idea of complete strangers needing to pour over my affairs to work out where my super should go (and delay delay delay) sends shivers down my spine.

But all my super is in my SMSF. Does that make a difference?

I think it makes all the difference in the world.

For a start, I have two levels at which I can control what happens with my super after my death – both a binding death benefit nomination ***and*** who controls my SMSF after I die.

Let's think about control first.

I currently own all the shares in the trustee company for my SMSF and I'm the sole director. That means if I die, control of those shares initially passes to whoever I nominate as my executor(s). They would be able to use their power as shareholders to appoint themselves as directors of the corporate trustee. And that would be useful because the SMSF would be pretty rudderless until someone else was appointed as a director. Until then, my fund couldn't even lodge returns or make changes to its investments. On this front, it's worth noting that while the SMSF rules **allow** executors to be trustees of SMSFs on the death of a member, it usually doesn't

happen automatically. They still need to formally take on the role (and in my case, become directors of the trustee company) before they can do anything.

(As an aside, my will could leave control of those shares to someone else. That might make sense if, for example, I decided that my two sons were too young to take on the role of executor and instead asked someone else to do that job for me. I could still leave the shares themselves to the boys. While that would give them the ability to hire and fire directors eventually, that wouldn't happen until the executor(s) actually distributed that particular estate asset to them. By then, my death benefit might have been dealt with and the shares effectively useless.)

The key, though, is that this ability to choose a specific person or people to take charge of my SMSF once I die, means I can make sure the 'right' person is in the driver's seat when it comes to making decisions about my super – not a faceless trustee of a large public super fund.

If I've got that covered, would I ***also*** put a binding death benefit nomination in place?

Remember a binding death benefit nomination is a document that binds the trustee and requires them to do specific things with my death benefit. In an SMSF, this document can last indefinitely if the trust deed allows for that (it wouldn't need to automatically expire every three years like it would in a public fund). It can also be far more precise than binding nominations for public funds. It could, for example, give different instructions for different parts of my super (my pension could be treated differently to my accumulation account), set instructions that depend on other events – for example "if my youngest son is still considered a dependant, give it all to him", stipulate that particular assets are to go to particular beneficiaries and more.

Flexibility is an issue

The thing that makes me nervous about binding death benefit nominations is that they take away some of the flexibility for the people left in charge – who are often also the beneficiaries.

My late husband didn't have a binding death benefit nomination and that was deliberate. It left me (his executor and primary beneficiary under his will) with a lot of flexibility to arrange things the way I wanted based on whatever my own super, his super and the tax rules looked like at the time.

If he'd had a binding nomination directing all his super to his estate, for example, I couldn't have kept some of it in our SMSF to start a pension.

If he'd had one that nominated me as his sole beneficiary, I couldn't have had any paid to his estate.

And in either case, I couldn't have entertained the idea of paying some of his super as pensions to our (then dependent) sons. (OK – let's be honest, this was only a very brief consideration. I'd like to think I'm a generous parent but I'm not crazy.)

Of course, a binding death benefit nomination that considered every possibility could have accommodated all of the above. But that would take a lot more careful consideration than just filling in a standard form available from my accountant or adviser.

It wasn't relevant in our case but I've seen plenty of clients with binding nominations that effectively require a deceased's pension to automatically continue to the surviving spouse. That might be great for some people but it does mean that the surviving spouse misses out on some valuable choices.

For a start, the deceased's pension balance immediately becomes part of the surviving spouse's 'total super balance'.

For some couples that will make all the difference when it comes to whether or not the surviving spouse can make further super contributions one last time. For example, someone with $1 million in super themselves who inherited their spouse's $1 million pension in May 2024 would have a total super balance of $2 million at 30 June 2024. That means no more non-concessional contributions in 2024/25. In contrast, the ability to delay the start of any new pensions until 1 July 2024 would mean non-concessional contributions could continue in 2024/25.

The proposed new tax on people with more than $3 million in super will, if introduced as planned, also depend heavily on the survivor's total super balance at 30 June. For example, someone with $4 million in super who inherits a spouse's $2 million pension automatically in May 2026 would have $6 million in super at 30 June 2026. This could result in much more tax being paid than necessary for the 2025/26 financial year.

So what am I going to do?

I think the situation is slightly different once you've reached the point where the strategic planning options have diminished. In my case, for example, chances are my two sons won't be eligible to receive my super as a pension (this stops when they turn 25 even if they are still – heaven forbid – dependent on me at the time). That means my super will definitely have to come out of the SMSF on my death. In that case, the downsides of a binding death benefit nomination aren't so significant. I could comfortably have a binding nomination that required the balance to go to my estate knowing that it's the most tax effective option anyway (it means no Medicare Levy).

I guess there's always the chance that I remarry. Doing so will mean my new will is invalid (unless I update it again in contemplation of the marriage). But the same wouldn't apply for a binding death benefit nomination, it would remain in place. That might mean the supposedly 'safe' option actually becomes the very worst thing I could do – my super would no longer be guaranteed to end up with my children.

Perhaps the most important thing I need to do at this stage is make sure I don't leave it another 20 years to update my will if anything significant happens in the meantime.

Meg Heffron is the Managing Director of Heffron SMSF Solutions, a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

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

Why avoiding losers is the key to successful investing

Daniel Moore

Novak Djokovic is, probably, the GOAT of tennis (Greatest Of All Time). Does he hit more winners than other top players? No, not particularly. But he makes fewer mistakes. While playing in Australia in early 2023 he hit 374 winners, while his opponents, cumulatively, hit 314 winners. This is a winner ratio of around 20% better than his opponents. What is more striking, however, is the difference in error count. Novak made 576 unforced errors in the same timeframe while his opponents, made 802 errors – they made around 40% more errors!

Novak's low error count is a key part of his incredible, enduring success. It might not make him popular, but it makes him a winner. It's the same in golf, or football, or rugby, or any other sport. Don Bradman, the GOAT of cricket, only hit 6 sixes throughout his storied career – if you don't hit it in the air, you can't get caught out.

Avoiding more errors than your opponents is the key to winning. And it's the same in investing. Avoiding losers is just as important as picking winners. Unfortunately, this is not the approach that most investors follow.

Why? It's mostly down to human nature.

Psychologically, we get more enjoyment out of winning, as opposed to avoiding losses. It's more interesting and exciting to focus on how much your investments have increased in value, rather than talking about the poor performing companies you decided NOT to buy, or the companies you sold after they dropped 10%, but ***before*** they dropped 40-50%.

However, our experience shows that a more balanced approach to investing delivers much better long-term outcomes. An approach that considers, and carefully weighs, upside potential with downside risks is more likely to deliver better returns. To maximise long-term returns investors should give equal weight to what they could lose if things don't turn out well, as well as what they could gain if things do go well.

You should only invest if the risk and reward is in your favour

This approach has been a hallmark of the IML process for more than 25 years, we have an equally vigorous approach to both upside analysis and downside protection. We do this because avoiding large losses in your portfolio can have a dramatic effect on your long-term returns.

There are three main reasons why:

1. It's simple maths.

If you avoid big losses, your portfolio doesn't have to rise as much to deliver good returns.

Shares, particularly smaller companies, can drop by 10% relatively regularly. It's not too hard for them to rise 11% to make up the loss. But the further shares fall, the harder it becomes for them to make up that lost ground as this table shows.

Portfolio loss %	Return needed to recoup
10%	11%
20%	25%
30%	43%
50%	100%

Source: IML

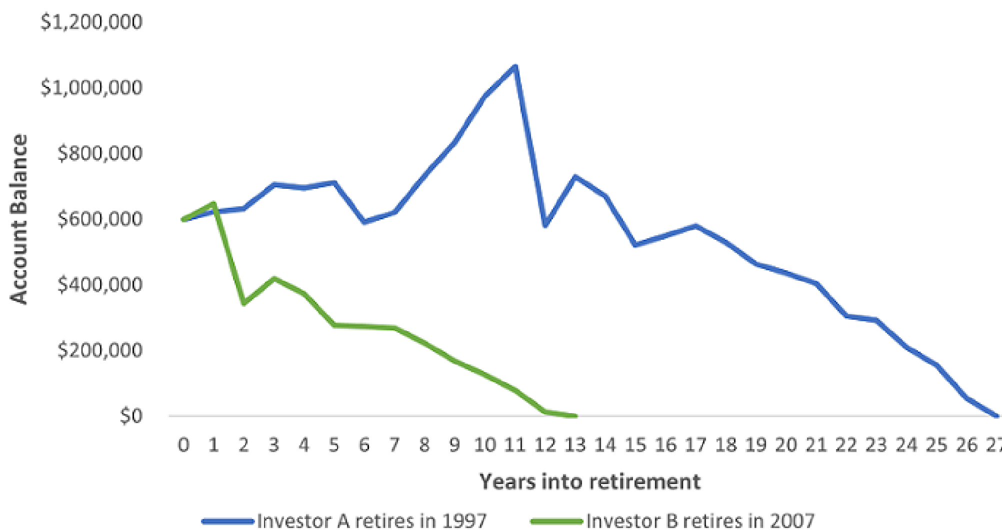
2. It's critical for investors in, or close to, retirement

The technical term for this is sequencing risk – the risk that the 'sequence' of returns has a negative impact on an investor's total savings.

Most sharemarket investors know that drops in the market happen, but they also know that over time markets tend to go up more than they go down, so this makes up for the losses. The main risk for sharemarket investors is that if one of these drops happens shortly before they are due to retire it can delay their retirement plans for years. And if it happens shortly *after* they retire it can significantly reduce the amount of money they have to live on in retirement.

To demonstrate this point, the chart below shows two people with very similar retirement plans who retire at 67 in line with the Association of Superannuation Funds of Australia (ASFA)'s current guidance on what they will need for a 'comfortable retirement':

- They both retire with a balance of $600,000 and invest the full amount in the ASX 300.
- They both withdraw $50,000 in the first year for living expenses and increase their withdrawal amount each year in line with inflation.
- The only difference is that Investor A retires in 1997 and Investor B retires in 2007.



Source: IML, as at 23 October 2023

Investor A's funds stayed above their initial starting point for more than 10 years, only dipping below as the global financial crisis (GFC) hits. From there they decline reasonably steadily, but still last 27 years to the age of 94, well past average life expectancy.

Investor B has the bad luck to retire around a year before the GFC, so their funds dip below their initial starting point reasonably quickly and never recover. Investor B's savings run out in less than half the time, in 13 years, when Investor B is 80.

The outcome is so stark because making withdrawals from your savings at low points during the market means that you don't have enough capital to make up lost ground when the market bounces. So, investment strategies which include greater levels of downside protection are particularly valuable for investors in, or approaching, retirement.

3. It helps investors stay invested through the cycle

It's an investment truism that you shouldn't sell out after a major sharemarket correction, because you lock in your losses and miss the inevitable recovery. But while it might be well known, it's not necessarily well followed. Many sharemarket investors, especially new investors, give up on markets after they see their savings drop significantly. It's just as hard to pick the bottom as it is to pick the top.

And it *is* true that when markets *do* bottom, the bounce back is often swift. If you miss the rally you can severely damage your long-term returns. The S&P 500 posted a median return of 15% for the month following the bottom of the eight bear markets over the past 40 years.

If investors' portfolios drop less, they are less likely to sell out, and less likely to miss the bounce after markets bottom. A study by the Vanguard Group in 2016, "Downside Protection Strategies: A Review of the Evidence", found that investors who used downside protection strategies were more likely to stay invested during market downturns than those who did not.

How do you analyse the potential downside of an equity investment?

Just like there are many ways of estimating the upside potential of an equity investment, there are also multiple ways of analysing the downside potential.

Here are the main things IML looks at for Australian companies:

- Cyclicality of earnings. Are earnings at a peak, on the way up, down or mid cycle?
- Balance sheet. Can a company withstand a downturn in the economy or might it need to raise equity and so dilute the investments of current shareholders?
- Management track record. Has management won or lost market share consistently? Has their capital allocation historically been sound, or are they likely to do value destroying acquisitions? How has management performed during difficult periods for the company or economy?
- Financial accounts. Are they transparent or not? Are there any concerning issues buried deep in the accounts?
- Is there regulatory risk or not? Does the company operate in an industry where the government is likely to change regulations? E.g. gambling, heavy-emitting industry etc
- Does the valuation of the business look attractive relative to its long-term history, the quality of the business, its growth prospects and its peers?

Investing is emotional as well as analytical

Great investors are often just as good at controlling their emotions and biases as they are at analysing companies and markets. Whether you're a hardened professional investor, or a first-time retail investor, it's never easy to control your emotions and make rational decisions under pressure - yet this is what we need to do to be successful. A lot of avoiding big losses is ensuring that you are in control of your own emotions, that you don't get caught up in the hype. That you don't fall for fads or FOMO.

When the world looks like a bleak place it's hard to focus on the opportunity, but that's when investors most need to. It's the time when you could get the opportunity to buy a brilliant company at a bargain price. Similarly, when markets are running hot and delivering outsize returns, it's hard to focus on risk – but that's often the time when risks are at their sharpest.

The key is to have a consistent, risk-adjusted approach to investing through all the different stages of the market cycle. This might not give you a bagful of great after-dinner anecdotes, but it's likely to make you more money in the long run.

Daniel Moore is a Portfolio Manager at Australian equities fund manager Investors Mutual Limited. This information is general in nature and does not take into account your personal objectives, financial situation or needs. You should consider, and consult with your professional adviser, whether the information is suitable for your circumstances. Past performance is not a reliable indicator of future performance.

Podcast: Matt Williams, digital gold, Warnes on investor complacency

James Gruber

Season 2, Episode 12

Special guest Matt Williams, Head of Australian Equities at Airlie Funds Management, explains the investment approach that's resulted in his firm having market-leading returns. And he details recent investments, including in two 'fallen angels', ResMed and Orora.

Our other special guest is Joe Cavatoni, Market Strategist at the World Gold Council. Joe describes they key drivers for gold, its future prospects, as well as the rise of digital gold and its potential to transform the industry.

Finally, regular guest Peter Warnes from Your Money Weekly looks at why rates will remain higher for longer, and investors are complacent about the risks that brings to markets.

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.

The best active and passive REIT funds

Steven Le

Deciding whether to use an active or passive vehicle for the different allocations within an investment portfolio is an important decision for investors. It can have a significant impact on a portfolio's risk/return profile and on the long-term investment outcomes from an absolute and relative standpoint. While the active/passive issue has been covered across many asset classes, this article will explore the topic specifically for listed real estate funds, both Australian, or AREITs, and global, or GREITs, focused strategies.

What does empirical data tell investors about active and passive REIT performance?

Exhibit 1 below is a snapshot from Morningstar's Active Passive Barometer. It shows that the average total return of both active AREIT and GREIT managers was less than passive strategies on a trailing 10-year time frame to June 2023. Many active managers across both categories failed to outperform the average total return of passive strategies over the same period, with survivorship and merged funds considered. It's important to note that the sample size of both categories is relatively small: AREITs had 27 active and seven passive strategies, while GREITs had 16 active and five passive strategies.

Exhibit 1 Morningstar Active Passive Barometer Annualized 10-Year Trailing Return

Category	Active Strategies Average Return (%)	Passive Strategies Average Return (%)	Excess Return (%)	# of Active Strategies	# of Passive Strategies	Total
Australia Real Estate	7.0	7.3	-0.3	27	7	34
Global Real Estate	4.6	4.8	-0.2	16	5	21

Source: Morningstar. Data as of June 30, 2023.

On the surface, the average underperformance of active strategies relative to passive strategies in both categories is a disappointing result for investors. Particularly given that they are paying active management fees and expect some level of outperformance over a reference index or passive strategy that aims to track a benchmark in the long term. But as we delve deeper into these simple average figures, we see that it's not all bad news.

Looking beyond the simple average

Exhibit 2 below shows the number and percent of active strategies that have outperformed the average total return of passive strategies in their respective category over the last decade to June 2023.

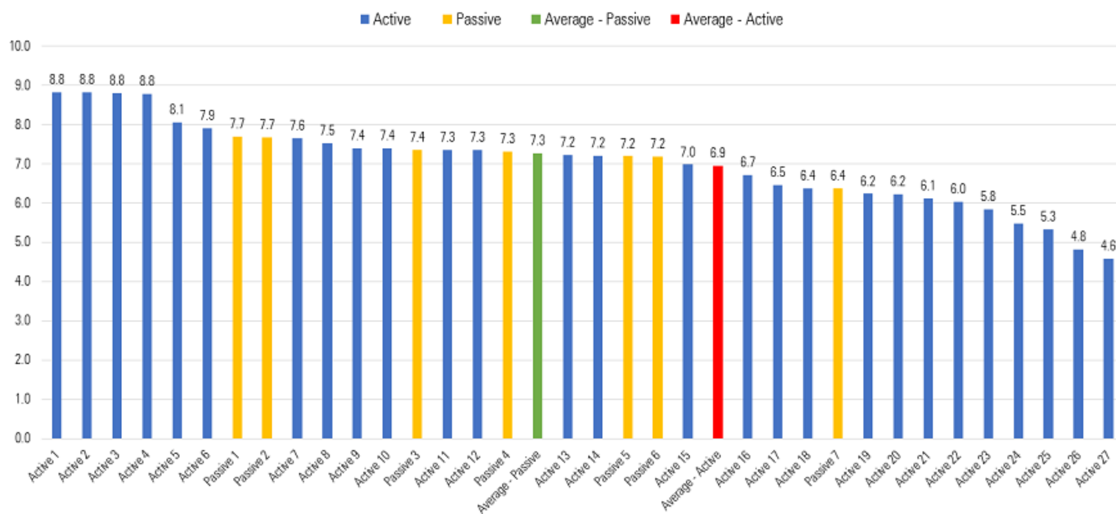
Exhibit 2 Morningstar Active Passive Barometer Over 10 Years

Category	# of Active Strategies with Positive Excess Return	# of Active Strategies	Active Success (%)	Passive Strategies Average Return (%)
Australia Real Estate	12	27	44%	7.3
Global Real Estate	4	16	25%	4.8

Source: Morningstar. Data as of June 30, 2023.

It was a respectable result in the AREIT category, with 12 out of 27 (around 44%) active strategies delivering a positive excess return relative to the average total return of passive strategies. Excess return is simply calculated by subtracting the total return of an active strategy from the cumulative average total return of passive strategies in a category over a specified time frame. On an annualized basis, the top-performing active AREIT strategy returned 8.8% and the lowest returned 4.6%, while the best-performing passive strategy returned 7.7% and the worst returned 6.4%, as shown in Exhibit 3. Despite the wide range between the upper and lower bands in the category, the variability in returns was relatively low. Passive strategies in the category track the highly concentrated S&P/ASX 300 or 200 AREIT indexes. A reminder that Morningstar has written about the concentration risk associated with these indexes in the past, which remains true at the time of writing. Many active AREIT managers address this risk and the limited opportunity set by allowing a portion of their portfolio to be invested in offshore, non-index and/or smaller domestic stocks.

Exhibit 3 Annualized 10-Year Total Return (%) of Active AREIT Strategies



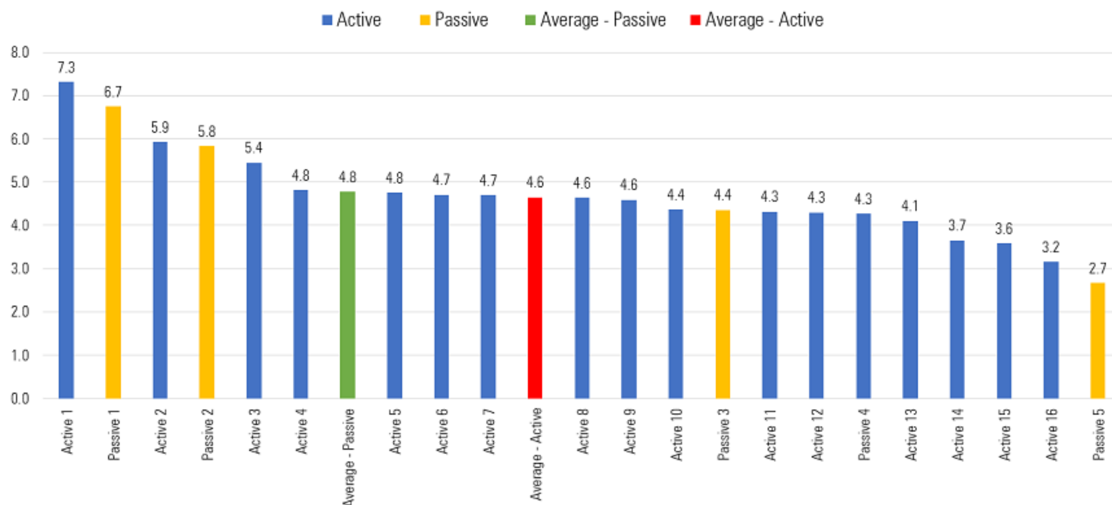
Source: Morningstar. Data as of June 30, 2023.

On the other hand, a disappointing four out of 16 (25%) active GREIT strategies only managed to beat the average total return of passive strategies. The diversity of real estate subsectors within the index has proven to be a challenge for most active managers to beat, despite U.S. domiciled REITs and stocks accounting for more than half of the FTSE EPRA Nareit Developed Index over the last decade.

On an annualized basis, the best-performing active strategy returned 7.3% and the lowest returned 3.2%, while the best-performing passive strategy returned 6.7% and the worst returned 2.7%. The variability in returns was also fairly low in the GREIT category, as seen in Exhibit 4, although the difference between the upper and lower bands was wider compared with the AREIT category.

One factor driving this and a critical point to note, is that the category consists of currency-hedged, unhedged, active, and passive vehicles because of the small number of available GREIT strategies. Foreign currency performance relative to the Australian dollar, but mainly the United States dollar, has had a sizable impact on performance over the 10-year time frame to June 2023, with the AUD depreciating relative to the USD over this period. It's also crucial to point out that not all passive GREIT strategies in the category track the FTSE EPRA Nareit Developed Hedged AUD Index, which is the benchmark assigned as the Morningstar Category Index. There are several passive strategies that track an iteration of the core index, the FTSE EPRA/NAREIT Developed ex Australia Rental Index.

Exhibit 4 Annualized 10-Year Total Return (%) of Active GREIT Strategies



Source: Morningstar. Data as of June 30, 2023.

Having said all that, it's vital for investors to be aware of the inherent risks in the real estate sector, such as interest-rate risk and susceptibility to broader economic activities, to name a few. It's also paramount to be mindful that passive strategies are generally not designed to offer downside protection when the relevant sector and/or broader markets are falling. In that type of environment, active strategies may be better designed to protect capital, like some skilled active managers demonstrated during the sector (and market) drawdowns of 2020 and 2022.

Notwithstanding the highlighted underperformance of most active strategies across both categories, Morningstar understands that some investors may still have a preference to use an active strategy over a passive one for their portfolio's listed real estate allocation.

Morningstar's Top-Performing Analyst-Rated Strategies

Exhibit 5 below lists the top-three-performing active and passive AREIT strategies over the last decade to June 2023 that have a Morningstar Medalist Rating of Bronze or above, as well as Morningstar's view on fully analyst-covered strategies.

Resolution Capital Real Assets topped the active list followed by Ironbark Paladin Property Securities and Pendal Property Investment.

In the passive space, the top three strategies from highest to lowest were Silver-rated Macquarie True Index Listed Property, Gold-rated Vanguard Australian Property Securities, and Silver-rated SPDR S&P/ASX 200 Listed Property.

Exhibit 5 Top-Three Performing Active and Passive AREIT Strategies Over the Last Decade

Strategy Name	10 Year Total Return Annualized	10 Year Tracking Error Annualized	Active or Passive	Morningstar Medalist Rating	Morningstar Medalist Rating Process Pillar	Morningstar Medalist Rating People Pillar	Morningstar Medalist Rating Parent Pillar
Resolution Capital Real Assets	8.8	2.9	Active	Gold	High^Q	High	Above Average
Ironbark Paladin Property Securities	7.9	2.0	Active	Silver	High	High	Average
Pendal Property Investment	7.6	2.2	Active	Silver	Above Average	High	Above Average
Macquarie True Index Listed Property	7.7	0.5	Passive	Silver	Above Average	Below Average^Q	Average
Vanguard Australian Property Securities	7.4	0.2	Passive	Gold	High	Above Average	High
SPDR S&P/ASX 200 Listed Property	7.3	0.7	Passive	Silver	Above Average	Above Average	Above Average

Source: Morningstar. Data as of June 30, 2023.

Exhibit 6 below shows the top-performing active hedged, active unhedged, and passive GREIT strategies over the last decade to June 2023 that have a Morningstar Medalist Rating of Bronze or above, as well as

Morningstar's view on fully analyst-covered strategies. There were only two unhedged strategies because of the criteria and size of the category. It's also worth reiterating that the global real estate category contains currency-hedged and unhedged vehicles, and not all passive strategies in the category track the AUD-hedged version of the FTSE EPRA Nareit Developed Index (the Morningstar Category Index).

Starting with hedged vehicles, Resolution Capital Global Property Securities' hedged vehicle took first position followed by UBS CBRE Global Property Securities and Principal Global Property Securities.

From an unhedged perspective, Resolution Capital Global Property Securities' unhedged vehicle claimed the top spot, while Dimensional Global Real Estate occupied second place.

In terms of passive strategies, Macquarie True Index Global Real Estate Securities' unhedged vehicle achieved top position.

Exhibit 6 Top-Performing Active Hedged, Active Unhedged, and P Over the Last Decade to June 2023

Strategy Name	10 Year Total Return Annualized	10 Year Tracking Error Annualized	Employs Currency Hedging	Active or Passive	Morningstar Medalist Rating	Morningstar Medalist Rating Process Pillar	Morningstar Medalist Rating People Pillar	Morningstar Medalist Rating Parent Pillar
Resolution Capital Global Property Securities (Hedged)	5.9	3.0	Yes	Active	Gold	High	High	Above Average
UBS CBRE Global Property Securities Fund	5.4	2.6	Yes	Active	Silver	Above Average	Above Average	Above Average
Principal Global Property Securities	4.8	2.1	Yes	Active	Bronze	Above Average	Above Average	Average
Resolution Capital Global Property Securities (Unhedged)	7.5	10.3	No	Active	Gold	High	High	Above Average
Dimensional Global Real Estate Trust	7.3	8.6	No	Active	Bronze	Average	Above Average	High
Macquarie True Index Global Real Estate Securities	6.7	8.8	No	Passive	Bronze	Above Average	Below Average^Q	Average
Vanguard International Property Securities Index (Unhedged)	5.8	9.1	No	Passive	Bronze	Average	Above Average	High
Vanguard International Property Securities Index (Hedged)	4.4	2.0	Yes	Passive	Bronze	Average	Above Average	High

Source: Morningstar. Data as of June 30, 2023.

The bottom line

Historical data based on simple average returns indicates that passive strategies have outperformed active strategies in both the AREIT and GREIT categories in the long term. At face value, this makes somewhat of a compelling case for passive strategies over active strategies within an investor's portfolio allocation to listed real estate. Regardless of this, Morningstar's Manager Research believes that certain active strategies, including the ones highlighted above, have the potential to outperform their passive counterparts. However, the allocation decision to use an active or passive strategy ultimately sits with the end investor. Given the complexity involved with this matter, investors should seek professional financial advice for assistance if required.

Steven Le is a Morningstar Manager Research Analyst. This article is general information and does not consider the circumstances of any investor. Please consult a financial adviser before making investment decisions. This article was originally published by Morningstar.

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