Firstlinks
a Morningstar company

Edition 677, 28 August 2026

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Editorial

Few issues generate as much heat in Australia as housing. The focus tends to revolve around *who* possesses the assets and what one generation *owes* the next.

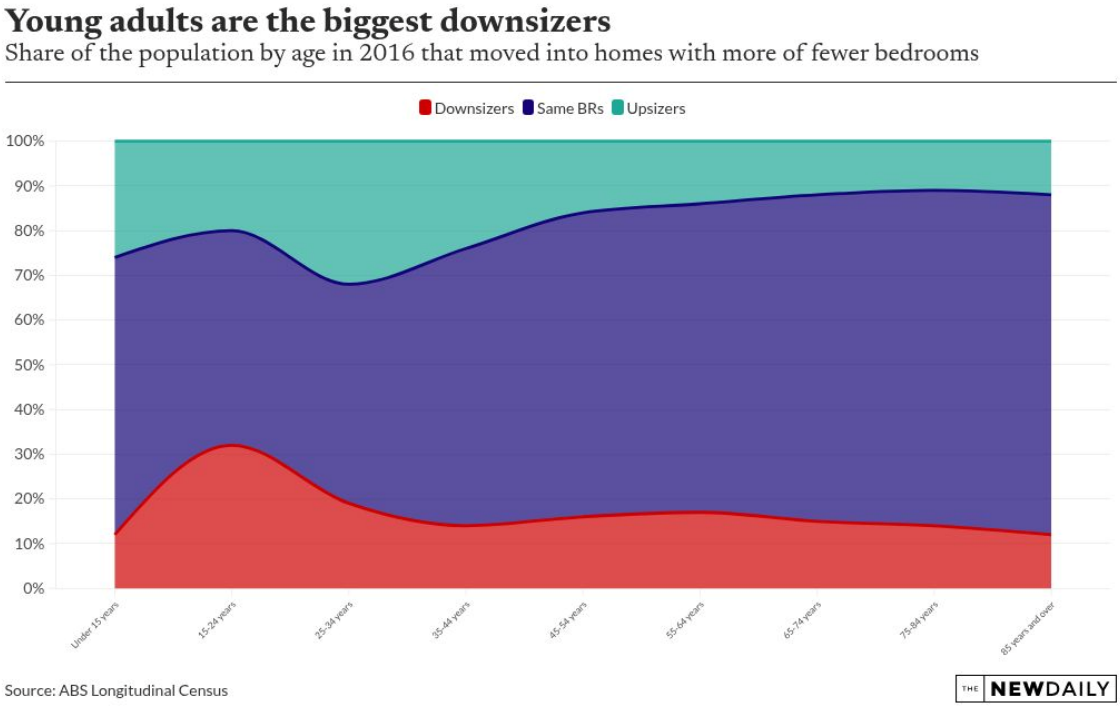
Earlier this year, we published an article titled '13 million spare bedrooms: Rethinking Australia's housing shortfall'. The piece challenged conventional thinking about housing affordability, suggesting that the issue is not simply a shortage of dwellings but the way existing housing is distributed.

The assertion is based on 2021 Census data which shows millions of rooms sit unused across the country, largely in homes occupied by older Australians. If housing is scarce and spare capacity exists, the argument naturally follows that perhaps better utilisation of existing housing stock should form part of the solution.

Should people take in boarders? Should vacant dwellings be brought back into the market? In practice, the debate almost always circles back to one group and one idea - downsizing.

For years, policymakers and property developers have anticipated a great downsizing wave. The expectation was that as baby boomers moved into retirement, they would gradually trade large family homes for smaller properties, freeing up housing stock in the process.

A recent finding suggests the downsizing wave may be far smaller than many expected. Most older Australians appear remarkably attached to where they live. Rather than embarking on a mass migration to apartments and townhouses, many are choosing to remain in the homes they've occupied for decades.



This doesn't surprise me. I think the downsizing argument raises a deeper question. At what point does a person's home cease to be simply their home and become a public policy asset?

We don't often lament over the size of people's gardens, nor do we question whether someone is driving a vehicle larger than necessary. Yet housing has become different because of its scarcity. The existence of millions of underutilised bedrooms has led some to view older homeowners as custodians of a resource that should be allocated more efficiently.

Viewed purely through an economic lens, perhaps the argument has merit. But this is only part of the story. Behavioural finance tells us that people rarely assess such decisions objectively. We become overly attached to what we own and feel losses more acutely than equivalent gains. Some forms of value cannot be easily quantified.

In this sense, economists, policymakers and homeowners are talking about entirely different things. The economist sees an asset. The policymaker sees housing stock. The homeowner sees something else altogether.

Besides the financial and administrative burden of downsizing, the family home (no matter the size) carries an extraordinary amount of emotional capital. Perhaps that is why the debate feels so fraught. It asks one generation to surrender something deeply personal in order to solve a problem created by forces much larger than itself. Perhaps that is why the great downsizing wave remains more theory than reality.

Simonelle Mody

Also in this week's edition...

Reversionary pensions have long been a staple of SMSF estate planning, **Meg Heffron** is back to discuss whether they are still the best option.

Rising age dependency is frequently treated as a warning sign for economies, but **Cameron Murray** argues the ageing crisis will not happen.

The 4% rule has long been retirement's gold standard. **Amy Arnott** suggests a more conservative approach.

Most Australians gear into property but ignore shares. **Alex Cousley** from Russell Investments explains how a moderate level of gearing can support retirement goals.

Matt Reynolds from Capital Group shares four charts that expose market concentration risk.

Australia has just hit $1 trillion in debt. **Ashley Owen** evaluates whether this may create challenges.

For decades, GDP has been the benchmark for economic success. **Tony Dillion** asks whether this has made us materially happier?

Curated by Simonelle Mody and Leisa Bell

Meg on SMSFs: What do we think about reversionary pensions these days?

Meg Heffron

This is a blatant (if informal) opinion poll masquerading as an article on an issue I've been musing about recently. Firstlinks readers clearly think a lot about super strategies so I'm banking on some useful feedback in the comments.

Should pensions be reversionary (continuing automatically to a spouse when you die) or not?

I'll declare a bias – I used to be a big fan of reversionary pensions in an SMSF 30 years ago. The tax settings were very different back then. Does anyone remember Reasonable Benefit Limits (RBLs)? Back then, your super was checked against your RBL when you started a pension and, if you died, it could continue to your spouse (ie a reversionary pension) with no check against *their* RBL (which was a good thing). But if the pension *wasn't* reversionary, it was checked against the spouse's RBL if they used the money to start a pension. Such a big difference in treatment made the case for reversionary pensions really easy.

But I have to confess I've fallen out of love with them in recent years and, if I was setting up a pension today, I think – reluctantly – I'd make it non reversionary.

It would be a bittersweet decision, because there are still some benefits.

Certainty

I like certainty in life – so if I wanted to make sure a spouse could take my super as a pension, I would quite like the idea of setting things up that way in the beginning. A reversionary pension is a neat way to do this.

But there are some caveats.

First – if you have a binding death benefit nomination that contradicts the reversionary pension (eg it requires all super to be paid to your estate) someone will need to read the trust deed carefully, and

possibly get legal advice, to work out which one takes priority. And if it's the binding death benefit nomination, that certainty you felt you had never really existed in the first place.

Second – there are downsides to certainty. It might seem like common sense that if there's a surviving spouse, as much of your super as possible should continue to them as a pension. Maybe. But what if they're 90 when you die and in fact it would be better to get the money to them via your estate? By continuing the pension, you've missed that chance. The spouse can certainly commute the pension and withdraw the money but they can't fenagle it into your estate.

Transfer balance cap delays

I still love this one: if a spouse inherits your reversionary pension, they get to keep the pension running (with all the great benefits that brings) and nothing gets added to their transfer balance account for that pension for another 12 months. Even better, when the pension is eventually added in, the value that's used is whatever the pension was worth when you died – not what it's worth 12 months on.

Another nice little bit of certainty.

I don't have a counter to this one – I think it's a strong benefit of a reversionary pension.

Simplicity

It can be nice not to have to think about switching off pension payments when you're mourning the death of a spouse. If the pension is reversionary, everything can just keep going. While the pension payments are technically now coming to the spouse not the deceased, many couples have pensions paid into a joint bank account anyway so there's nothing to change.

But this too can backfire. It means there's a minimum pension payment to make in the year of death. I've seen plenty of clients miss that one – thinking they only have to worry about meeting the minimum requirements for their own pension, not their deceased partner's.

So what specifics do I have *against* reversionary pensions?

We don't need them any more

There was a time when some of the important benefits of a pension potentially stopped if the pensioner died and the pension didn't continue.

For example, multiple pensions for one person are all kept separate (which means they can be dealt with separately). This can have some valuable tax benefits that will help the spouse who inherits the super in their own estate planning. Similarly, pensions are special in that when they start, their 'tax free component' (the part that can go to adult children tax free) is locked in as a percentage of the balance. The percentage stays the same for as long as that pension exists. It's very valuable because it means future growth also grows the tax-free component (whereas normally, growth from the fund's investments all flows through to the taxable component).

But these days, the tax legislation specifically makes sure these features of pensions continue even after someone dies. That happens whether there is a reversionary beneficiary or not.

Total super balance considerations

Lots of us care about our total super balance because it's used to work out if we can take advantage of particular rules. For example, only people with a total super balance of less than $2.1 million at 30 June 2026 can make non-concessional contributions during 2026/27. It's even more important these days for people facing Division 296 tax. This tax is paid based on the proportion of your total super balance that exceeds $3 million.

The problem with reversionary pensions is that they are added to the surviving spouse's total super balance immediately (no 12-month delay here).

For example, Anita and Greg both have $2 million balances in their SMSF, and both are providing reversionary pensions. If Greg dies in May 2027, and Anita doesn't change anything, Anita's total super balance at 30 June 2027 will be $4 million and she'll be subject to Division 296 tax for 2026/27. In contrast, if the pension wasn't reversionary, Anita might not start a pension with Greg's super until the following financial year – meaning Division 296 tax wouldn't be relevant until 2027/28.

I'm not suggesting Division 296 tax can be avoided entirely – just that Anita can put it off for a bit if the pension isn't reversionary.

So what's the verdict? I think I'm still on the "no reversionary pension" bandwagon but I know views vary.

Which way are you leaning?

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.

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The ageing 'crisis' has not and will not happen

Cameron Murray

I have written many times about why fears about ageing are misplaced.

For starters, we have panicked about it for a century.

Also, the reality is that we aren't adding extra old years at the end of life. Instead, we are stretching out our entire lives. We work to older ages, but start work later, too. Women work a larger share of their lives. Here's my take on this important but misunderstood pattern of stretched-out lives.

It is a little strange that few people notice this. It should be obvious. It is extremely clear in the data. I can only surmise that ageing is something that can be transformed into a crisis and promoted to justify self-interested policy positions.

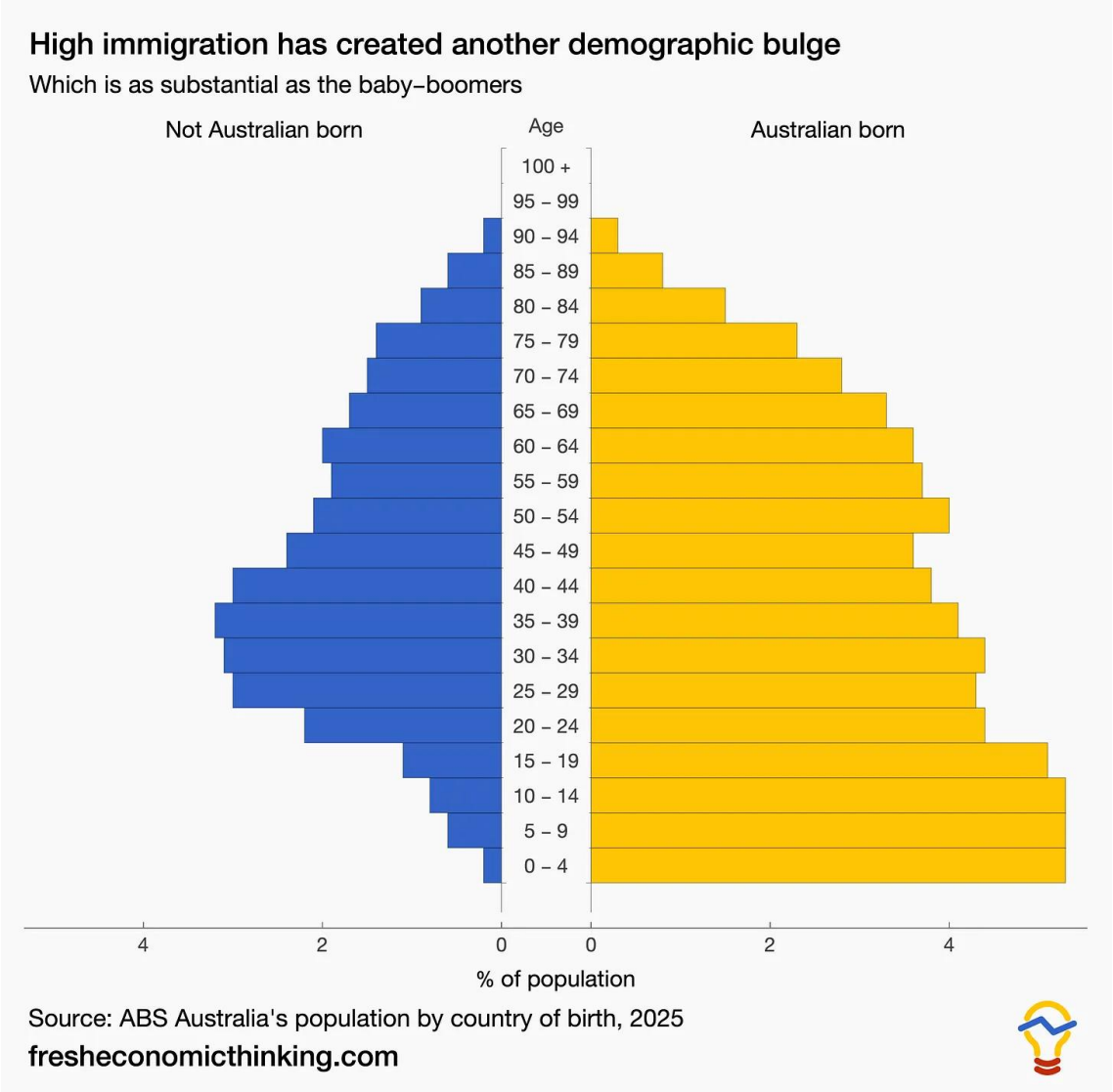
Which is weird when you think about it.

We have spent the past century devoting a huge amount of social resources to the science of medicine with the intention of making people live longer. That is what ageing is, after all. And I never hear that we should curtail medical investment and innovation because of the cost of ageing it creates.

Another part of ageing is the baby-boomer bulge.

The odd thing about the boomers is that we know their demographic bulge is temporary and their ageing inevitable, and there is essentially nothing that can be done about it. Many people like to argue that immigration will solve it, but this is simply not true. Immigrants age at the same rate as the rest of us, and now we have a bulge in the age profile where most immigrants arrive, creating the same "pig in the python" bulge that will age just like the baby boomers.

That is clear from the image below.



The mistaken ageing crisis script goes like this.

Look at changes to the population age structure and *simply assume* that it is bad and creates more non-working dependents who rely on others for their income, either from others in their household, or the state via pensions.

Take a look at the chart below.

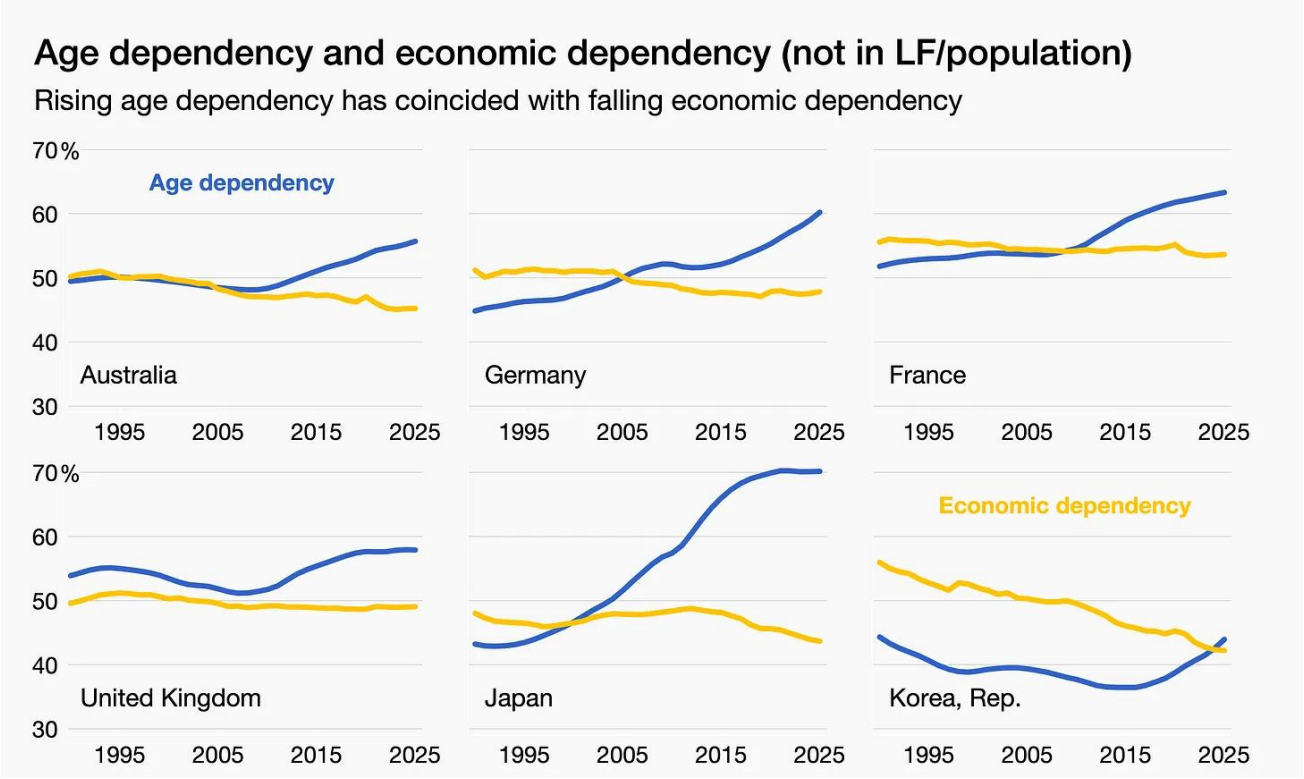
In it, I compare the trends for the past 35 years of two measures.

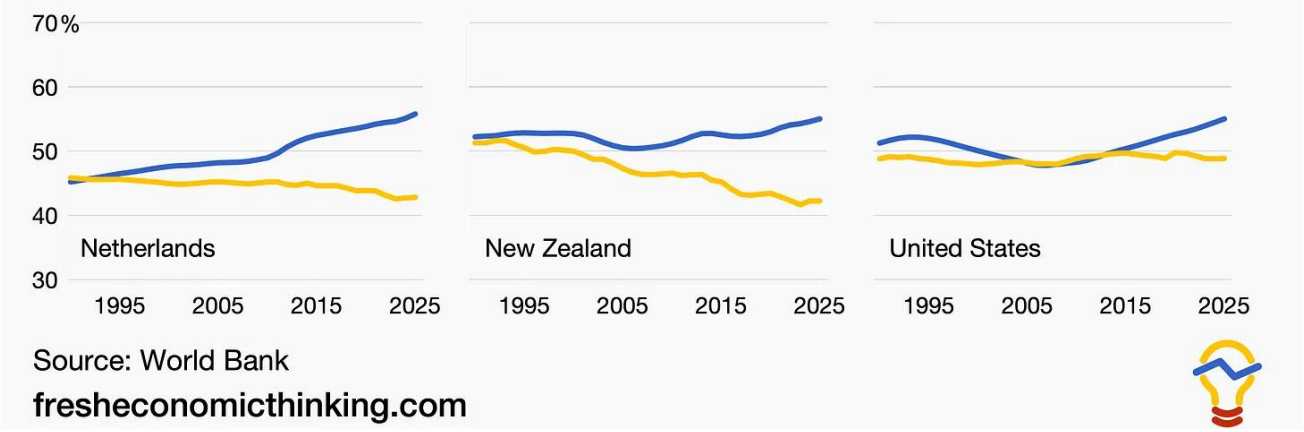
First, *age dependency,* which is a characteristic of the age profile of the nation. Nothing more. Nothing about who is working or how much, nor who is dependent on whom.

There are many ways to measure it, but here *age dependency* is the number of people aged 14 and below plus those aged 65 and above, divided by the population aged 15-64. So when the measure is 50%, it means there are two people aged 15-64 for every one person outside that age range. When it is 70%, like it has been in Japan recently, it means there are only 1.42 people in the 15-64 range for every one person outside that range. At 100%, it would mean one person aged 15-64 for every one person aged outside this range.

The second measure is *economic dependency.* This is the actual workforce divided by the population (including both full- and part-time workers). There are no age limits on working, so why not look at who is actually working?

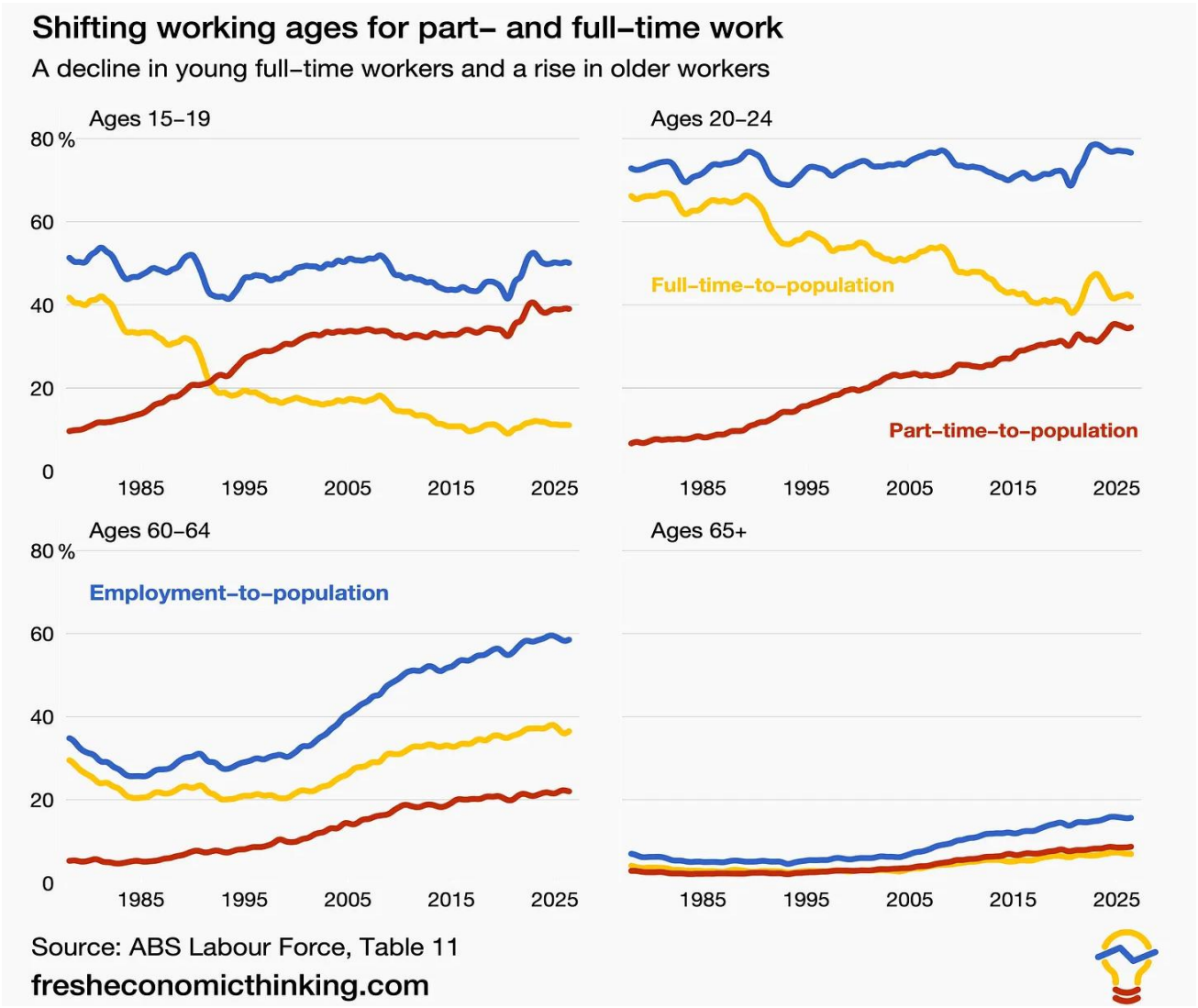
Here, I have measured *economic dependency* as the total number of non-workers (the population minus the labour force) divided by the population. So when the measure is 50%, it means that there is one worker for every one non-worker. When it is 40%, it means that there is one worker for every 0.67 non-workers.





Notice that in all of these countries, *age dependency* has been rising, especially in the past 10-20 years. But in all of them, *economic dependency* is falling. Often quite substantially. This is true even in countries like Japan, which have both an ageing and declining population.

This pattern of declining *economic dependency* despite rising *age dependency* is because of our stretched-out lives. We work later but longer. Looking at ratios of people in fixed age brackets was always silly. The *working later but longer* pattern is evident in Australia in the charts below, which include a breakdown of the full- and part-time share of the population for key age groups.



Across the top are the 15-19 and 20-24 age groups. Notice that although total workforce participation remains stable, there has been a major switch from full-time to part-time work. This is generally associated with people studying longer rather than commencing full-time work in their late teens. So overall, less work from the young.

But look at the bottom two charts.

Since the 1990s, the share of 60-64 year olds working has doubled, from 30% to 60%. Meanwhile, the share of the population at this age has increased from 4.2% to 5.6% since 2000. This older age group is working much more and growing as a proportion of the population.

Back in the 1980s, people aged 20-24 worked full-time at triple the rate of those aged 60-64 (66% compared to 22%). Now, both age groups see about 40% of people working full-time, while the younger group has higher overall participation via more casual and part-time work.

Looking older still, the share of those over 65 working has tripled from 5% to 15% over the same period. Their share of the population has grown from 11% to 14% since 2000.

We are the oldest we have ever been on average.

Has the sky fallen?

Nope.

Ageing has been a huge success. We live longer, healthier lives, and we spend them becoming more educated and working later but longer.

Any claim that is backed by the need to "do something" about the ageing crisis should be carefully scrutinised, because there is no such thing.

Dr Cameron K. Murray is Chief Economist at Fresh Economic Thinking. The original article can be found here. Subscribe to his written work at Fresheconomicthinking.substack.com or YouTube channel @fresheconomicthinking. This article is for general information.

How does the 4% rule stack up?

Amy C. Arnott

How much can retirees safely withdraw from their portfolios?

That's one of the issues we've been addressing in our annual The State of Retirement Income report since November 2021. The study differs from some other widely used research on safe withdrawal rates in that it relies on forward-looking estimates for future market returns, as opposed to testing the numbers based on historical data.

How the research differs from the 4% rule

William Bengen's landmark research in 1994, for example, found that a static withdrawal rate of 4% of the initial portfolio balance with the dollar amount adjusted each year for inflation would have never failed over any 30-year period going back to 1926.

But because future market returns may or may not be in line with the past, we incorporate forward-looking return and inflation forecasts to estimate how much retirees can safely spend going forward.

For each hypothetical withdrawal percentage, we calculate the probability of success based on simulated results for 1,000 potential return scenarios over a 30-year period. The goal is to find the highest withdrawal percentage that ends up with a positive portfolio balance in at least 90% of these return paths. We test a variety of flexible spending methods, along with a "base case" that assumes retirees keep annual withdrawals constant in dollar terms by adjusting each year's withdrawal amount for inflation.

The resulting recommended withdrawal rate is meant to be a general guideline, not a strict edict. People willing to use a more flexible approach or a lower probability of success can safely withdraw larger amounts (and in fact, a more flexible approach to withdrawals would probably be the best practice for the majority of retirees). But for new retirees who followed the suggested baseline amount for retirement withdrawals starting in 2022, our initial research has worked out well so far.

Why we started with 3.3%

In the first report published in 2021, it was recommended that new retirees take a conservative approach to retirement income by using a **starting withdrawal rate of 3.3%**. The 3.3% figure was based on cautious estimates for future asset-class returns, which increase the likelihood that portfolio balances will run out before the end of an assumed 30-year retirement period.

The report's 3.3% recommendation raised a few eyebrows. If a 4% withdrawal rate has always worked historically, people wondered, why use a number that's so much lower? Assuming a $1 million starting portfolio balance, retirees withdrawing 3.3% per year would end up with a first-year withdrawal amount of just $33,000, versus $40,000 based on a 4.0% withdrawal rate. Depending on a retiree's other sources of income, that difference could mean a lot of belt-tightening or forgoing some travel plans during the first year of retirement—exactly when it might be nice to spend a little more lavishly.

How 3.3% retirees have fared so far

But taking a more cautious approach to retirement spending turned out to be a wise move for people who started retirement at the beginning of 2022. By the end of the year, both stocks and bonds had suffered double-digit losses, leading to a 15% loss for the 50/50 portfolio I tested for this article. (The portfolio I tested is based on a 40% weighting in US stocks, 10% in international stocks, 32% in US core bonds, 8% in global core bonds, and 10% in cash, rebalanced annually.) Inflation would have been a double whammy, as it rose to about 6.5% in 2022 and remained above average in the following years. That means retirees would have had to withdraw more each year just to keep inflation-adjusted spending flat, which also cut into portfolio values.

For retirees who adopted an initial withdrawal rate of 3.3%, the portfolio would have dropped as low as about $786,000 after withdrawals made at the beginning of 2023 but bounced back to just over $1 million by the end of 2025. At the same time, the inflation-adjusted withdrawal amount would have risen to about $38,400 by the beginning of 2026, which is 3.66% of the balance.

I ran these numbers through the same Monte Carlo simulation used in our other research (using the same capital market assumptions we used in the most recent edition of the paper) and found that 966

out of 1,000 trials (96.6%) would have ended up with a positive balance over the remaining 26 years in the test period.

That's a pretty high probability of success and safely clears the 90% hurdle we set for our initial recommendation. In fact, these odds are high enough that retirees who followed our conservative approach starting in 2022 can probably afford to bump up their annual spending to about $40,800 and still clear the 90% hurdle, based on our most recent return estimates.

What happened to those using the 4% rule?

Retirees who followed the standard 4% rule would have enjoyed less favorable results thus far, as a more aggressive approach to spending exacerbated the impact of poor market performance plus above-average inflation. The portfolio value would have dropped as low as about $773,000 by the beginning of 2023 but bounced back to slightly above $1 million by the end of 2025.

That's only about $38,000 lower than the year-end balance for a retiree who started out with a 3.3% withdrawal rate. But because of the ripple effects of inflation on annual spending amounts, retirees who started out with a $40,000 withdrawal amount would now be spending more than $46,000 per year - a withdrawal rate of 4.6% based on the portfolio balance at the end of 2025.

What retirees should do now

The probability of success over the next 26 years looks significantly lower based on these numbers, dropping to 85.2%. Some retirees might be fine with those odds, but people who prefer a greater level of certainty may want to pull back slightly on spending. Cutting annual spending (ideally to about $39,400) would improve the odds of success.

While the initial results for retirees following our recommendations have been positive, it's worth noting that we won't get it right every year. Estimating future market returns is notoriously difficult, particularly over a 30-year period. Inflation is another major question mark. The model used in our most recent paper assumes a 2.42% inflation rate, but if actual inflation turns out to be higher going forward, retirement spending will be less sustainable. Even so, the initial results from our first foray into withdrawal rate research underscore the value of a conservative approach.

Amy C. Arnott, CFA, is a portfolio strategist for Morningstar. This article does not consider the circumstances of any investor. Minor changes have been made to the original US version for an Australian audience.

Four charts that expose market concentration risk

Matt Reynolds

Since ChatGPT launched in 2022, some AI-related stocks have soared to record highs despite elevated inflation, sweeping tariffs and war in the Middle East. A small group of companies now make up an outsized share of the US market, pushing concentration to levels not seen in decades.

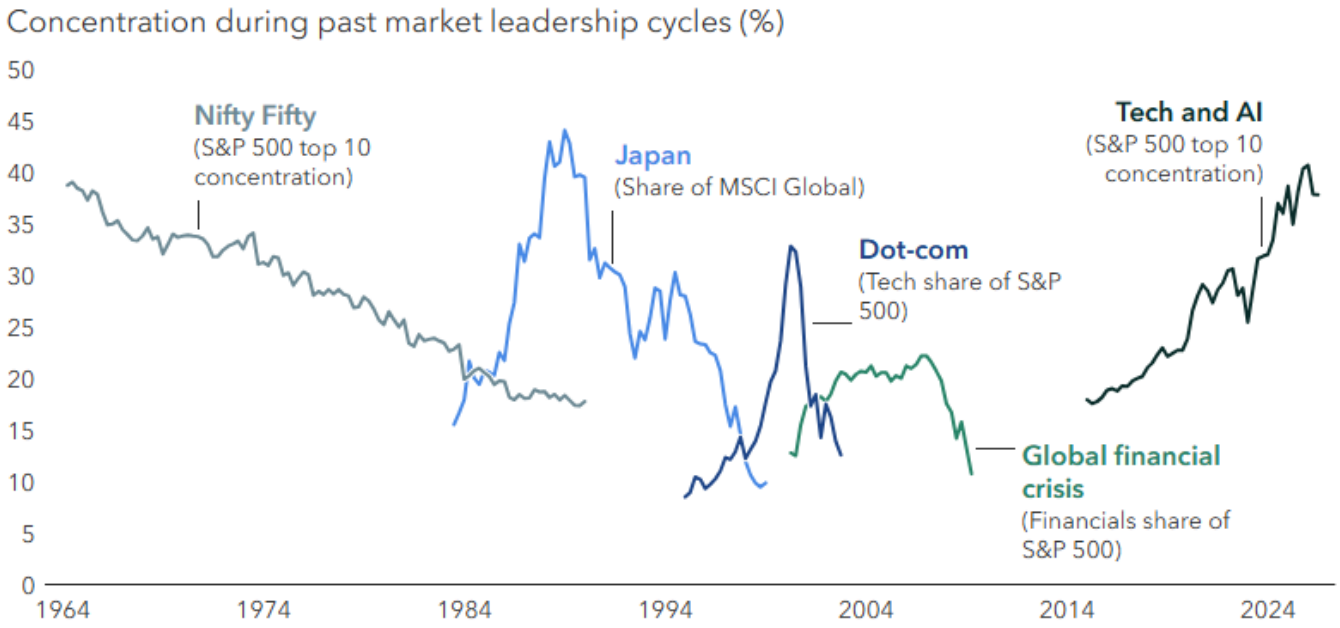
That means investors in some index funds may be holding unintended risks in their portfolios, since market capitalisation-weighted funds, which weight companies based on their market value, are not as broadly diversified as many expect.

1. Today's market is among the most concentrated in history

It is undeniable that we are living through an extraordinary market environment. Today's market concentration stands out, with the top 10 companies approaching 40% of the S&P 500 Index.

However, we have seen this before. Similar levels of concentration emerged in Japan's 1980s boom and the US Nifty Fifty era. Specifically, in 1964, the top 10 stocks reached 39% of the S&P 500 Index. The largest holdings included AT&T, General Motors, ExxonMobil, IBM and Texaco — diverse businesses from a range of sectors.

Markets have long rallied around compelling investment themes



Sources: Capital Group, FactSet, MSCI, RIMES, S&P Global. Data shown is quarterly from 31 March 1964, to 30 June 2026. Data prior to 1964 is unavailable, so the full Nifty Fifty concentration cycle is not shown. Japan represented by the MSCI Japan Index. Top 10 concentration is defined as the share of index market capitalisation represented by the 10 largest index constituents. Share represents the specified sector's percentage weight in the index.

Today's concentration differs from the 1960s because many of the largest companies, including NVIDIA, Microsoft, Amazon and Micron Technology, are tied to a single theme: AI investment. As a result, semiconductor stocks, for example, could decline in tandem if demand for chips drops.

This is precisely what we saw during the early July pullbacks in the market, which were led by companies such as SK Hynix and Sandisk.

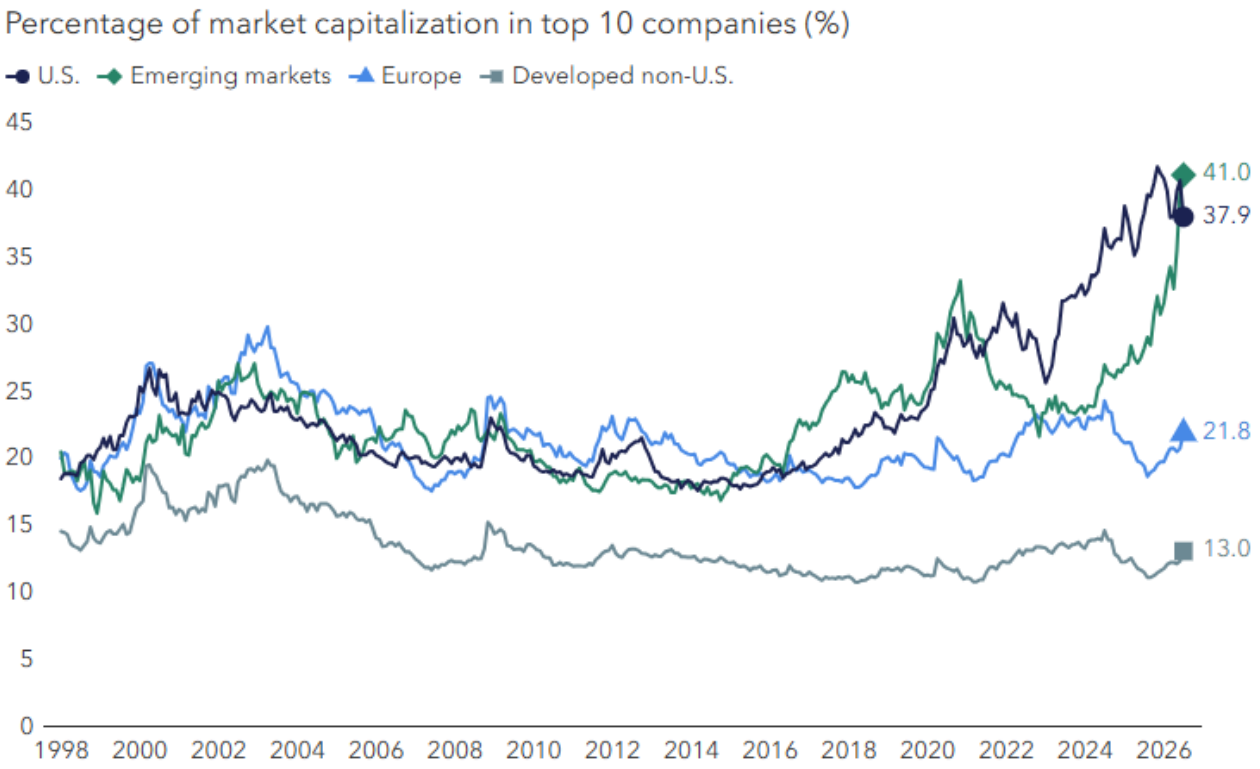
Prior episodes of intense concentration eventually broke down, often painfully, before returning to more balanced levels. That does not mean a market crash is imminent, nor are we predicting one. Concentration is not a timing tool, but it is a reminder that trees don't grow to the sky.

As investors crowd into AI-related stocks, some high-quality businesses have been left behind. These are companies with growing profits, strong dividends and durable franchises. Many are trading at discounts to their historical valuations of 20% or more. Examples include Royal Caribbean, Procter & Gamble and Citigroup.

2. AI concentration is a global phenomenon

Market concentration is not limited to the US. The seemingly insatiable demand for specialised chips has catapulted technology companies in South Korea and Taiwan to new highs. The top 10 firms in the MSCI Emerging Markets Index account for 41% of its total market capitalisation, with just three — SK hynix, Samsung Electronics and TSMC — making up 29%.

Worldwide demand for computer chips has fueled market concentration



Sources: Capital Group, FactSet, MSCI, S&P Global. Figures represent the index concentration of the top 10 companies by market capitalization across the MSCI Emerging Markets Index (Emerging markets), S&P 500 Index (US), MSCI World ex USA (Developed non-US) and MSCI Europe Index (Europe). Data shown is monthly, from 31 January 1998 through 30 June 2026.

Meanwhile, global markets continue to offer other attractive opportunities, particularly in Europe and parts of Asia, where valuations remain compelling. Such examples include UK-based drug giant AstraZeneca and China-based Tencent, the largest gaming company in the world.

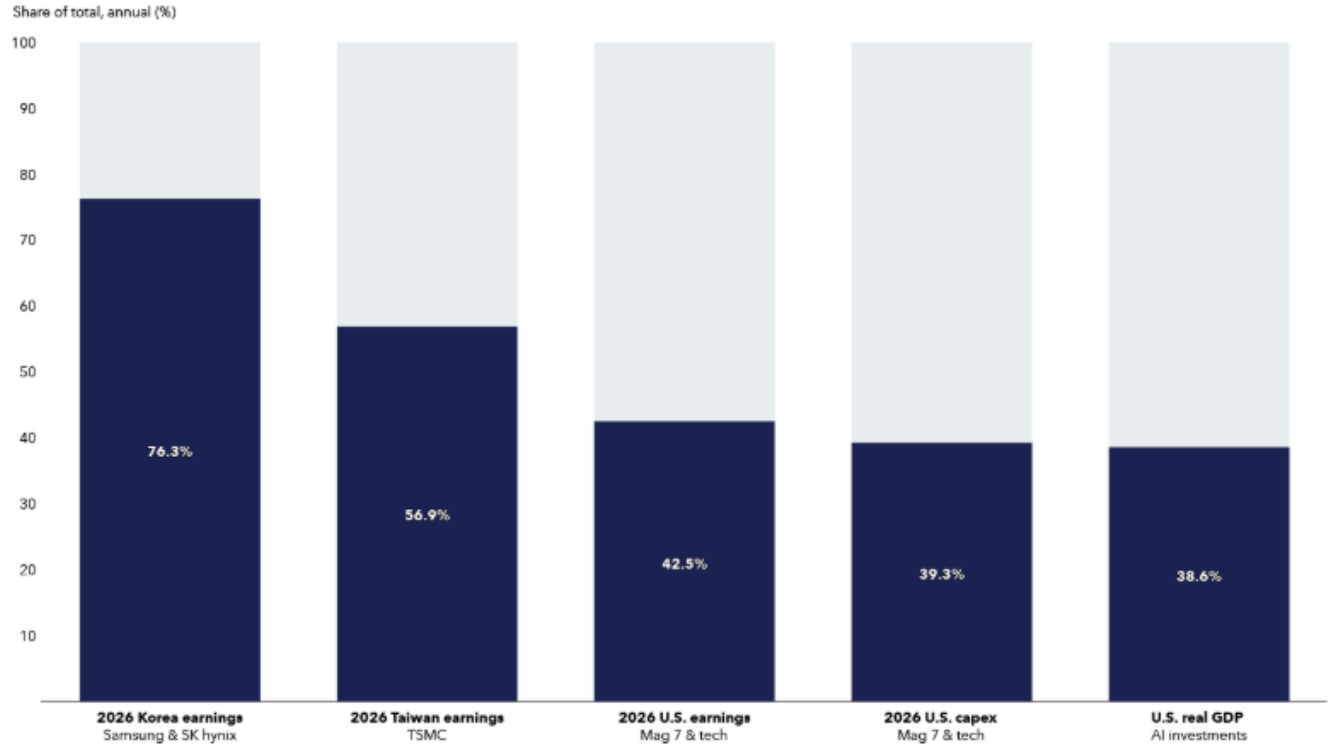
Similarly, there may be opportunities to be found by sifting through the artificial intelligence wreckage for companies that may have been unfairly hit by fears that easy-to-use AI applications will impair their business. These include large software companies like Germany's SAP, as well as companies in the online travel space, including China's Trip.com and Spain's Amadeus IT Group.

3. US GDP heavily relies on AI spending

Concentration risk extends beyond the top 10 stocks in the US index to the broader economy. The data centre build-out has supported US growth, with AI-related investments contributing nearly 1% to real GDP in the first nine months of 2025, or 39% of overall growth during that period, according to the St. Louis Federal Reserve.

Thus, company earnings and the broader economy may be more vulnerable to an AI-induced slowdown. The growing profit pools are all driven by the same physical build-out of data centres. Chipmakers have grown the most because roughly 50% of data centre-related costs are tied to semiconductors, but companies that provide heating and air conditioning, electricity, water treatment and transformers are also enjoying strong tailwinds.

AI drives large parts of the global economy



Sources: Capital Group, FactSet, MSCI, S&P Global, Hannah Rubinton and Bontu Ankit Patro, "Tracking AI's Contribution to GDP Growth," St. Louis Fed *On the Economy*, 12 January 2026. Estimates as of 30 June 2026. Earnings and capital expenditure (capex) estimates for 2026 represent the mean industry analyst consensus for the year ending December 2026. Korea is represented by the MSCI Korea Index, Taiwan by the MSCI Taiwan Index and the US by the S&P 500 Index. The Magnificent Seven (Mag 7) refers to Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla. Share of US real GDP represent Federal Reserve economists' estimates of AI investment's contribution to economic growth during the first nine months of 2025.

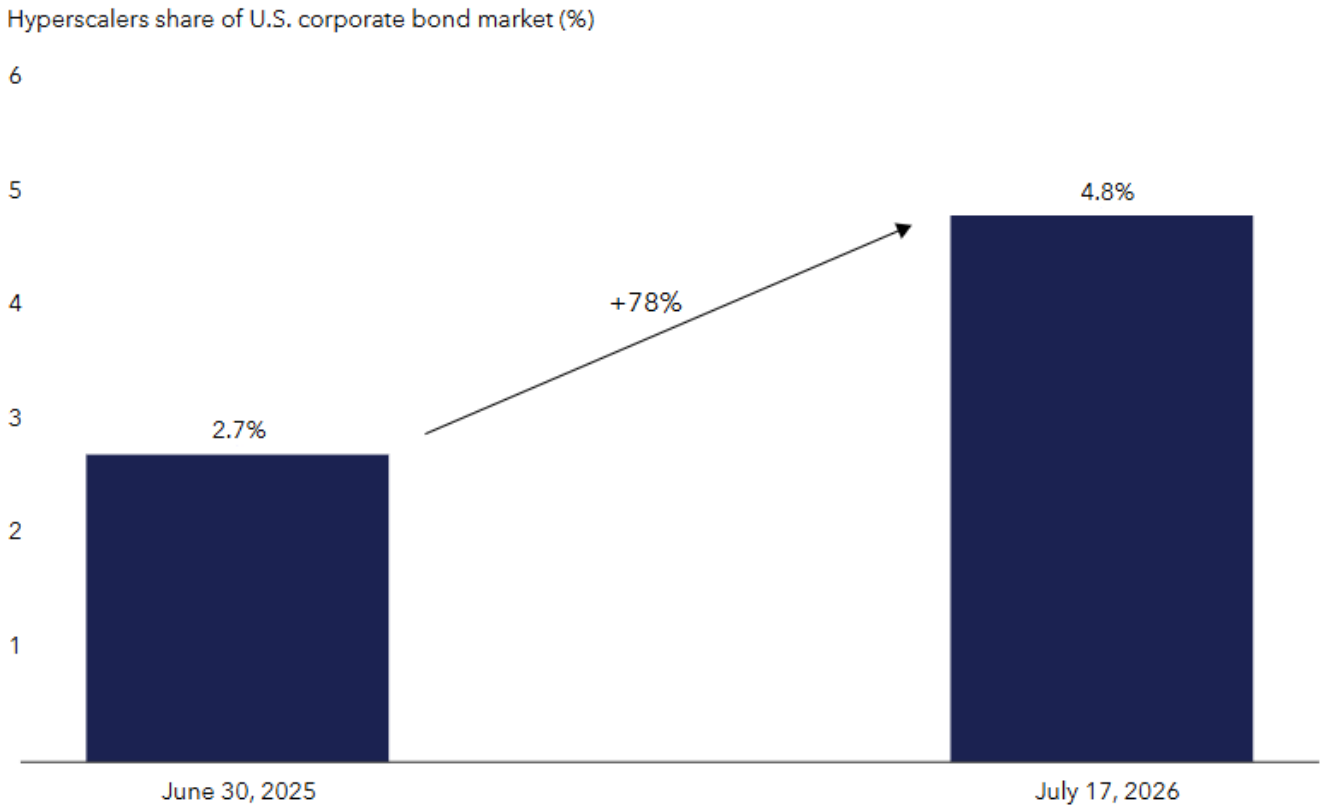
Arguably, the next chapter of the story may be about beneficiaries outside of the capex boom. These include companies that can use AI to gain a competitive advantage they haven't had historically. Within industries such as financials and healthcare, certain companies will use AI in ways that will help them grow faster or become more profitable relative to competitors.

4. AI fatigue is hitting the bond market

Another corner of the AI boom showing signs of strain is the US corporate bond market. The tsunami of bond deals has weighed on the debt prices of high-profile companies including Meta, Amazon and SpaceX.

Today, hyperscalers including Alphabet and Meta account for roughly 4.8% of the Bloomberg US Investment Grade Corporate Bond Index, an increase of 78% from a year earlier.

AI-related companies have flooded debt markets



Sources: Capital Group, Bloomberg. Hyperscalers include Alphabet, Amazon, Meta, Microsoft, Oracle and SpaceX, which are investing significantly in AI, cloud computing and data centre infrastructure to support the AI build-out. Corporate bonds are represented by the Bloomberg US Aggregate Corporate Bond Index.

The sheer volume of deals tied to AI underscores the importance of diversification in fixed income, particularly because bond prices tend to have more downside risk than upside potential. Evaluating opportunities one by one is critical. Some hyperscalers offer attractive yields relative to their strong cash flows and credit ratings, but being more selective when it comes to certain newer project financing structures is important.

Despite the surge in issuance, we remain constructive on the broader credit market.

Strong corporate earnings, healthy consumer spending and a resilient labour market provide a supportive backdrop for credit. We don't believe AI-related borrowing will derail that picture, but it reinforces the value of maintaining exposure across investment-grade and high-yield corporate bonds, securitised credit and emerging markets.

A call to rebalance and diversify

The market concentration in AI reveals some of the trade-offs tied to investing in index funds. There is a common misperception that index funds somehow are safer for most investors. Passive funds are cheaper on average. But cheaper is not the same as safer, nor does cheaper necessarily equate to better investor outcomes.

This is not an argument against owning the companies driving the artificial intelligence era. Many are extraordinary businesses with durable prospects. The point is, at today's weights and valuations, the benchmarks — and the passive strategies following them — increasingly assume one set of outcomes will dominate.

A more balanced approach calls for investors to review their risks, both intended and unintended. Arguably, the winners of this current period will need to be both bold and humble. Bold enough to own great companies when the fundamentals justify it. Humble enough to recognise that no single theme, however powerful, should dictate the shape of portfolios. Bold enough to differ from the benchmark when risk and reward call for it. Humble enough to know that being different can be uncomfortable but necessary, especially when a narrow market continues to rise.

Matt Reynolds is an Investment Director for Capital Group Australia, a sponsor of Firstlinks. Statements attributed to an individual represent the opinions of that individual as of the date published and may not necessarily reflect the view of Capital Group or its affiliates. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

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The case for gearing beyond property

Alex Cousley

The Federal Government's restriction to negative gearing for residential property investment has sparked talk that people may instead borrow money to buy shares.

That may seem like an alien concept to Australians unfamiliar with the use of "gearing" in sharemarkets, or a painful reminder to others of losses incurred during the Global Financial Crisis. However, the reality is that gearing in sharemarkets is based on the same principle as buying a property with a loan: it allows the borrower to increase their exposure to an investment to amplify potential gains.

A well-structured gearing strategy with stringent risk management may be a worthwhile component of a diversified investment portfolio for investors who have a proper understanding of how gearing works.

The geared options available to investors have changed since the late 2000s, when many people who took out direct loans to buy shares received “margin calls” when stockmarkets slumped. A margin call means a borrower must inject extra cash into a loan to restore the agreed loan-to-value ratio, or risk having their shares sold from under them by lenders.

Gearing sweet spot

Investors suited to gearing can now gain leverage by investing in managed funds with geared portfolios – instead of borrowing money themselves. The benefit is that an investor’s dollar on day one is the full amount at risk without the threat of margin calls in a market decline.

Some people may also be put off geared share investing by the volatility of stockmarkets. Property values can also fluctuate significantly, although those movements are observed less frequently than listed share prices. The difference is the ups and downs of shares are recorded on a daily basis by a stock exchange, whereas property prices are reported less frequently.

The upshot is that a diversified geared portfolio can allow thoughtful investors to gain slightly more growth assets (that is, shares) without taking on incremental risk relative to the broader sharemarket.

Our modelling suggests that investors are able to gain exposure of up to 120% of their original capital by using a combination of geared managers and diversified asset allocation, whilst taking on similar risk levels to an investment in equities alone.

This 120% exposure is the ‘sweet spot’, providing investors with the right balance between increasing expected returns and managing the volatility a portfolio is likely to experience over time.

As investors increase exposure beyond that, the incremental risk to reward ratio begins to decline. That is, the benefit of gearing starts to wane. For some investors with a very long time frame, it might still be an appropriate strategy but unlikely for everyone.

Here is the maths: combining geared equity funds with other equity exposure and real assets (to get a total growth exposure of 120%) generates an expected return of close to 10% for a diversified portfolio, with around 14% of volatility. This compares favourably to the expected volatility for Australian equities of around 15%.

With a higher gearing ratio, say 150%, our modelling shows an annual return of 11.2%, but an expected volatility of 18.6%. So, with gearing of 120%, the return-risk ratio is 0.65. For gearing of 150%, it is closer to 0.6.

Not just for young people

So, who is suited to geared equities investing? Younger people accumulating wealth are obvious prime candidates, given their long runway for capital growth and ability to recover from market dips. But early retirees can also benefit from exposure to a geared managed fund – especially because it gives them the ability to gain leverage without exposing themselves to potential margin calls.

For example, an individual entering retirement may want to generate not only sufficient income for everyday life, but also to build sufficient capital for later expenses related to old age or to leave an inheritance to chosen heirs.

A small exposure to geared equities could enable that earlier retiree with a 20-plus year investment horizon to address both needs. To illustrate this, consider an investor with a $1 million portfolio. Allocating $200,000 to a strategy with 120% equity exposure provides the economic equivalent of approximately $240,000 invested in equities. Compared with a traditional $240,000 equity allocation, the investor has effectively retained $40,000. The capital not required to achieve the desired level of equity exposure can then be allocated to income-producing, defensive or diversifying assets, depending on the investor's objectives.

A "bucketing strategy" could be used to structure their overall assets. This involves dividing retirement savings into separate 'buckets' or categories, each with its own purpose, strategy and risk profile (being the expected variation in investment returns each year).

Using a three-bucket strategy, for example, money could be split as follows:

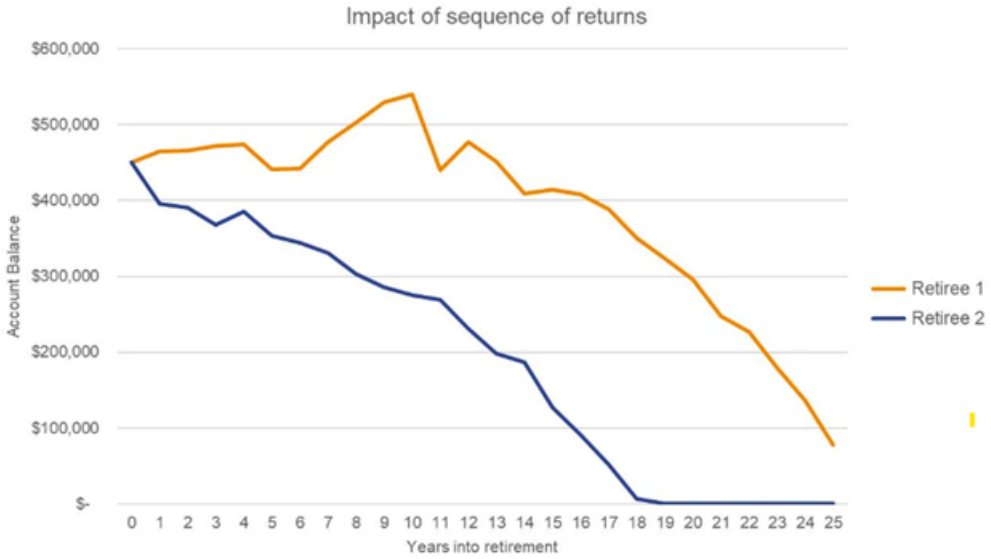
- The spending bucket (cash) – to spend over the short term, say the next 1-2 years
- The security bucket (primarily defensive assets) – to spend over the medium term, say the next 3-4 years
- The future bucket (growth assets) – to hold the balance of savings for the longer term. This final bucket could use gearing to help replenish the other buckets over time.

A bucketing strategy not only helps generate longer term gains. It can also help manage "sequencing risk" – or the risk that poor returns early in retirement mean that super savings run out earlier than expected.

For example, many retirement plans assume super will return, say, 7% on average over time. That can easily be taken to mean funds will return 7% year in, year out. But financial markets don't perform in a uniform way. Some years they rise. In others, they fall sharply or move sideways. It is the sequence of those good and bad years – not the average return over time – that often determines how long super will ultimately last after a retiree begins to draw on it.

Consider two hypothetical retirees with a $450,000 super balance who draw $30,000 annual income from it (indexed for inflation). Both can be invested in the same way, with an average return of 7% over 25 years. One runs out of super seven years earlier than the other due to the sequence of their annual returns (see graph).

A spending bucket would help the less fortunate person manage this risk by maintaining a portion of their capital in liquid assets that are not exposed to market falls. This means they could still generate income from their cash without drawing on their growth capital at a time when its value has fallen.



This example is provided for illustrative purposes only.

Source: Russell Investments. Retiree 1: Annual return/inflation from December 1997 based on indicative portfolio of 50% Australian bonds, 50% Australian Shares. Returns based on S&P/ASX 300 Accumulation Index and UBS/Bloomberg AusBond Composite 0+ Yr Index. Retiree 2: Same returns/inflation in reverse chronological order. Inflation based on Annual Consumer Price Index (CPI) sourced from ABS.

Buyer beware

Whatever their life stage, an investor considering gearing must be confident they can stomach the volatility of market falls. Gearing isn't for everyone.

Younger people wanting to increase their superannuation savings may need an investment time frame of 30 plus years to get the optimal result, and retirees should have at least 20 years ahead of them.

Both categories of investor must also understand that gearing amplifies losses as well as gains: so the outcome of selling assets in a panic can be more painful than usual. For example, the average market drawdown during a recession is around 35%. With gearing, that drawdown can be exacerbated to 50% or even higher (depending on the level of leverage used).

The longest drawdown in US equity markets since 1964 is an 89-month period between 1973 and 1980 – so young investors with a 20-30 year time horizon are likely to have the ability to recover fully from any drop in the value of sharemarkets. Early retirees may also have a sufficient investment horizon to allow them to weather bouts of volatility.

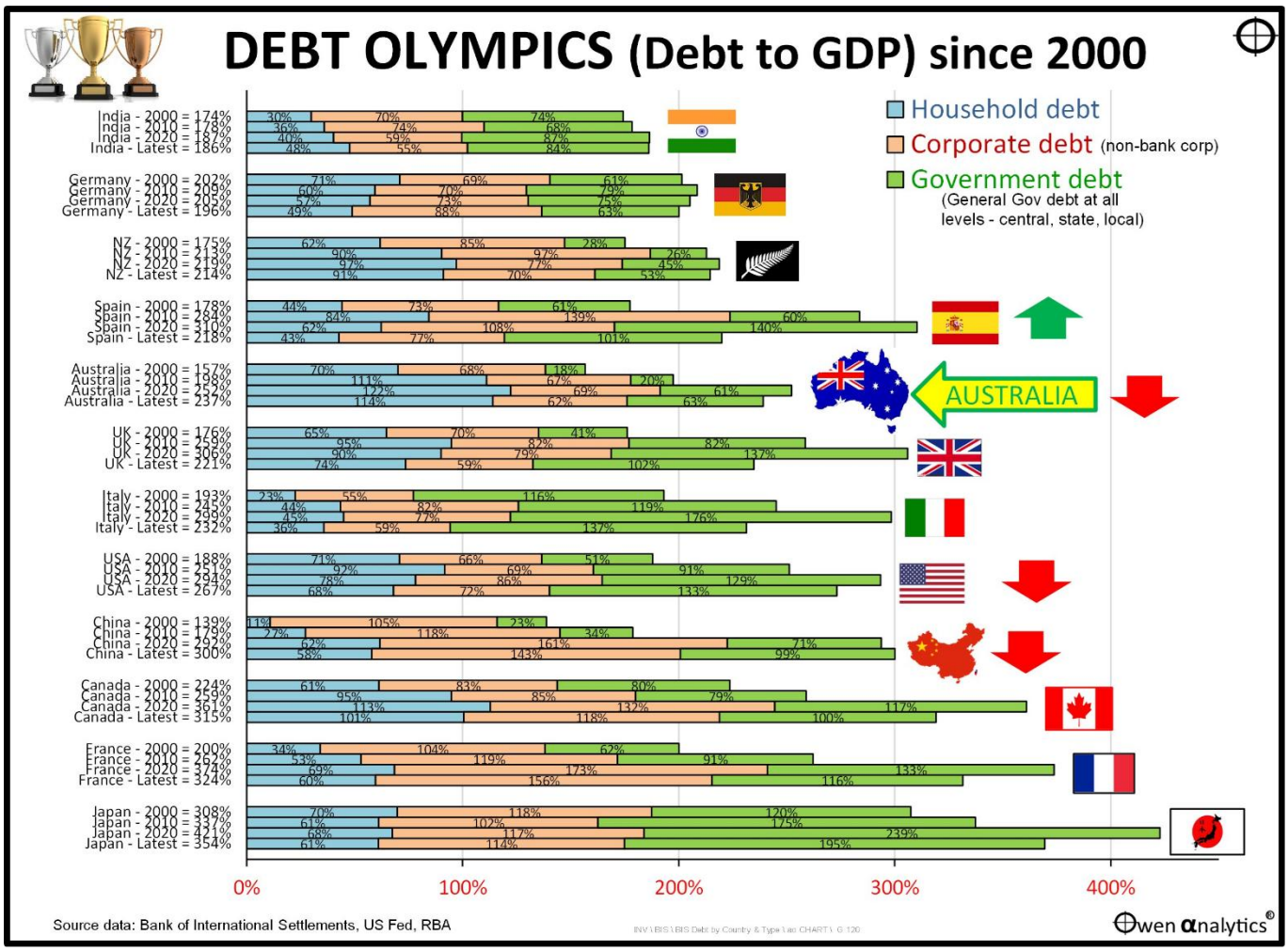
For investors who understand the risks and have a sufficiently long investment horizon, gearing need not be confined to property. Used carefully, it can be another tool for enhancing long-term portfolio outcomes. As always, it is sensible to seek professional advice to determine the most suitable investment strategies for individual needs.

Alex Cousley is a senior investment strategist at Russell Investments. These views are subject to change at any time based upon market or other conditions and are current as of the date of publication. The information, analysis, and opinions expressed herein are for general information only and are not intended to provide specific advice or recommendations for any individual or entity. This material is not an offer, solicitation or recommendation to purchase any security.

Australia's $1 trillion debt pile

Ashley Owen

Sensational headlines this week - Australian government debt hitting A$1 trillion and the US hitting $40 trillion! But how serious are they really? Here is an update of my 'Debt Olympics' chart showing all levels of debt (government, corporate, household) since 2000.



The chart shows gross debt as a percentage of national income (GDP) for a dozen major peer countries. Each country has four bars:

- The top bar is the debt levels in 2000 – at the top of the late 1990s tech boom
- 2010 – after the debt-build-up in the 2000s credit boom, and the hand-outs and bailouts in the GFC,
- 2020 – after the government deficit spending binges and bailouts in the Covid lockdown recession,
- Latest – the most recent data

Each bar has three sections representing the main types of debt:

- household debt (blue),
- non-bank corporate debt (pink), and
- government debt, including all levels of government (green).

Australia

Australia has one of the lowest overall debt burdens in the world. Of our major country peers, only India, Germany, NZ and now Spain are lower. (Also lower, but not on the chart are: Türkiye, Indonesia, Mexico, Poland, Argentina, Saudi Arabia, Hungary, Chile and Brazil.)

Although we have relatively low levels of debt overall, our ***mix of debt*** is very different to our peers and therein lie some real challenges for Australia.

Our government and corporate debt levels are relatively low, but household debt is the highest (only Switzerland is a fraction higher).

Government debt

Australia had virtually no federal government debt going into the GFC, but the government quickly racked up debt to finance the GFC deficit spending sprees. Government deficits were reduced back to zero by 2019 but soared again to fund the Covid deficit spending sprees.

Other countries everywhere also racked up debt in the GFC and Covid, but Australia's government debt levels are still the lowest in the world (even including state debts), thanks to windfall mining tax revenues in the long post-2001 mining/China boom.

Australia's Federal government gross debt of A$1 trillion is actually LOW in historical terms (it only seems BIG because of inflation). It is also relatively LOW in world terms at just 34% of GDP.

Historically, our problem with government debt has been the STATES. Currently, State and Local government debts add another $820 billion, bringing total government debts in Australia to A$1.8 trillion, or 63% of GDP. This is still among the LOWEST in the world. (Also lower than Australia but not on the chart are: Russia, Türkiye, Luxembourg, Switzerland, Denmark, Sweden, Ireland, Chile and Netherlands.)

New Zealand also remains a fraction lower than Australia. NZ has fewer levels of government, no upper house, but also has none of Australia's windfall mining revenues.

Corporate debt

Corporate debt levels in Australia have shrunk (relative to GDP) in recent years. The big banks used to specialise in business lending, but since the GFC and Hayne Royal Commission they have retreated and are now little more than bloated building societies lending mainly on housing. They much prefer mortgage lending over business lending because it requires half the capital and a fraction of half the brains.

The low level of corporate borrowing is a real policy problem for Australia. Companies are the engine room for employment, productivity, and economic growth, but the big dinosaur banks have long since lost the skill and will to lend to business.

There is a booming new industry in 'private credit' (also called 'private debt'), including direct lending by industry funds.

'Private debt/credit' is just a fancy name for 'non-bank lending'. This is being done without the equity buffer of bank balance sheets, without scrutiny or regulatory supervision, without the strict disclosure

rules that apply to banks, and without the credit management systems, collections, and work-out skills the banks used to have.

It will take decades for the new 'private credit/debt' industry to get up to the standard the big banks once had. (Spoiler alert: lending money is easy; pricing for risk and getting the money back in a recession is a lot harder! Most local funds have highly concentrated exposures to the property development / construction sector. Big losses are on the way in the next recession.)

Household debt

Australia is the perennial winner of the wooden spoon for the highest level of household debt relative to national income (only Switzerland is higher). Well before the GFC, Australia had the highest levels of household debt in the world and has increased its 'lead' even further since then.

Our high household debt levels, combined with the fact that the majority is on floating interest rates, makes Australian households (and the overall economy) more sensitive than any other country monetary policy based on short term interest rates.

Why don't we have the CHEAPEST housing and LOWEST housing debt in the world, instead of the highest?

Australia should have the most affordable land and housing in the world for three reasons:

1. We have the sparsest population in the world (ie we have the most land per person: an average of 298,000 square metres, or 74 quarter-acre blocks, per head of population). True, much of the land is uninhabitable, but Australia's habitable land ratio is the highest in the world, higher than Norway, Canada, and Japan.
2. We have an abundance of cheap building materials (dirt, rocks, timber, iron ore and coal for steel, bauxite for aluminium, silicon for glass, copper, nickel, lithium, lead, tin, etc).
3. We have giant, lazy, well-capitalised banks that do almost nothing but lend on housing! (actually, therein lies a big part of the problem).

But somehow, we have the most expensive housing in the world, propped up by the highest levels of household debt in the world.

Fortunately for highly indebted borrowers, house prices have been kept relatively high by strong demand (mainly from immigration) and by intractable supply constraints ('NIMBYs', local councils, and high taxing state governments).

A looming housing /debt crisis? Probably not yet

As long as house prices are kept relatively high (thanks to immigration, NIMBYs, and property taxes), and unemployment remains below say 10% (unemployment reached 10.4% in the early 1981-3 recession, 10.9% in the 1990-1 recession, but only 5.8% in the GFC), another widespread housing / foreclosure / bankruptcy crisis is unlikely here in the current cycle.

Property developers / builders will be hit hard (private credit funds), but banks and housing should hold up relatively well. Banks are much better capitalised now than in prior property collapses (1890s, mix-1970s, early 1980s, early 1990s, and a large majority of regular housing borrowers have relatively low Loan-to-Value ratios thanks to inflation.

Debt *per se* is NOT a problem – BUT…

Although debts in almost all countries are still well below their historical peaks, there are three big problems with the current trend for deficits and debts:

(1) First – Deficits and debts are heading toward levels in WW1&2 and the 1930s Depression, but we are not in all-out war nor depression. Economies are not even in mild recession, so there is no economic need to run deficits.

Actually, the cause-effect relationship is the reverse: economies are effectively on life support, reliant on continuing deficit spending for growth. Reining in the current deficits would probably send many economies into recession.

(2) Debt is good, but only if it builds long-term productivity capacity that generates additional revenues greater than the interest bill on the debt. However, much of the recent increases in debt are being used for current spending, subsidies, hand-outs and uneconomic political pet projects to appease populist demands and buy votes.

Australia's additional problem is our huge pile of relatively unproductive HOUSEHOLD debt from decades of failed housing policies at all levels of government.

(3) Governments have abandoned any sense of fiscal responsibility. They no longer aim to 'balance the budget' over a cycle. Instead they are resorting to 1950s-style 'financial repression' to suppress interest rates to use inflation to inflate away debts.

The US drives world markets and the race to financial repression is accelerating in real time at the moment. Rather than cut spending, Treasury Secretary Bessent is ramping up bond buying to suppress rates at the long end while Fed Chair Warsh is keeping rates low at the short end.

Inflation is not an unintended consequence of monetary and fiscal policy mis-steps. It is a deliberate policy outcome!

The biggest winners from inflation are geared-up asset owners. Trump may not know much, but that is one fact that he clearly understands, as he has been a geared-up asset owner benefiting from inflation all his life! The best way to increase inflation is to start a drawn-our war in the Middle East, so that's exactly what he did!

Ashley Owen, CFA is Founder and Principal of OwenAnalytics. Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. You can subscribe to OwenAnalytics Newsletter here and read the full article here.

Has 100 years of growth made us any happier?

Tony Dillon

Recently, I was fascinated to read that the United Arab Emirates (UAE) has a Ministry of Happiness. And I thought, “how appropriate”, when it is something we are continually striving for in life. Yet most nations, including Australia, tend to measure progress and wellbeing using proxy measures such as GDP per capita. And I couldn’t help thinking, are we barking up the wrong tree?

The UAE created the Ministry in 2016, signalling that governments should not just seek to optimise economic output, but also life satisfaction. The responsibility of the Minister of State for Happiness and Wellbeing is to “align and drive government policy to create social good and satisfaction”.

Being quantifiable and available, GDP has long been a proxy for progress and, by extension, wellbeing. But it is more a measure of production than lived experience.

Robert F. Kennedy once said in 1968 that GDP measures everything “except that which makes life worthwhile”, drawing a distinction between production and the wellbeing of citizens. And while strong GDP growth might be considered a prerequisite for happiness, in reality it can provide a basis for it, but doesn’t guarantee it.

Happiness is a subjective experience that typically involves a positive effect. It makes us feel good, content. We don’t fully understand the mechanism, but there appears to be a biological grounding, evidenced by neurochemical processes involving substances such as serotonin and endorphins, when we ‘feel’ happy.

There is also the set-point theory of happiness that suggests people have a baseline level of subjective wellbeing, influenced by genetics. Major life events may move us from our individual position on a spectrum with, say, a lottery win or a serious health setback, but we then trend back to our baseline with time. While no single ‘happiness gene’ has been identified, many genes do influence temperament which can shape long-term wellbeing.

This doesn’t mean that public policy has no role to play in influencing happiness, but rather that it must factor in biological underpinnings.

Estimates suggest that around 30% to 50% of the variation in long-term wellbeing may be attributable to genetic factors, with the remainder influenced by environment, culture, and life experiences. So there is certainly scope to lift a population up with strong economic and social institutions, even if individual variance persists due to biology.

Returning to the economic question, American economist Richard Easterlin observed in the 1970s that as countries grow richer over time, average happiness does not rise proportionally. If so, economic growth may not matter as much to average wellbeing as is often assumed. For example, in the last 100 years, GDP per capita has increased dramatically in modern economies, but I often wonder, are we as a people that much happier than we were 100 years ago?

Consider technological advances over the last century. In the 1920s, we didn't have a lot of life's luxuries of today, like air conditioning in homes, and it is easy to look back and think people of yesteryear had it so tough, they couldn't possibly be as happy as we are today. But in reality, people don't ruminate on

what has not been imagined. 100 years ago, people would have accepted heat as normal. They were probably just as content with their lives in the moment as we are today with technology that didn't exist back then. I wonder what things people in 2126 will be referring to when they say, "How did they possibly live without that back in 2026?"

That's not to say technological advances add zero to wellbeing, rather that gains may be temporary before a new normal is settled into. Technology can raise living standards, but happiness may not necessarily rise by as much. GDP is therefore not the be-all and end-all.

This is partly due to happiness depending not just on current conditions, but also future expectations. We spend much of our lives in pursuit of upgrading our existence, whether it be the next job promotion, a bigger house, or better health. Yet when we attain our goals, the hit is short-lived as we then switch focus to the next 'big thing'. Happiness is not everlasting, and in fact the relentless pursuit of it can actually make us unhappy.

This is where Buddhist teachings step into the discussion. They suggest that to break the cycle of misery, the chasing of happiness must be emptied from our minds. I often watch my little grandchildren playing and am struck by how happy they are living in the moment, oblivious to what their future might hold. Their minds are more accepting of current conditions and are far less focused on future expectations.

Therein lies a tension in the pursuit of happiness. Can we achieve better wellbeing by going down a path of an ever-expanding supply of comforts via eternal upgrades in technology, health, and wealth? Or do we subdue demand for future upgrades by emptying our minds of the pursuit of happiness? The answer probably lies somewhere in between. In that sense, GDP growth is not necessarily the wrong focus, just an incomplete one. And that the UAE is probably onto something.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.