Edition 553, 29 March 2024

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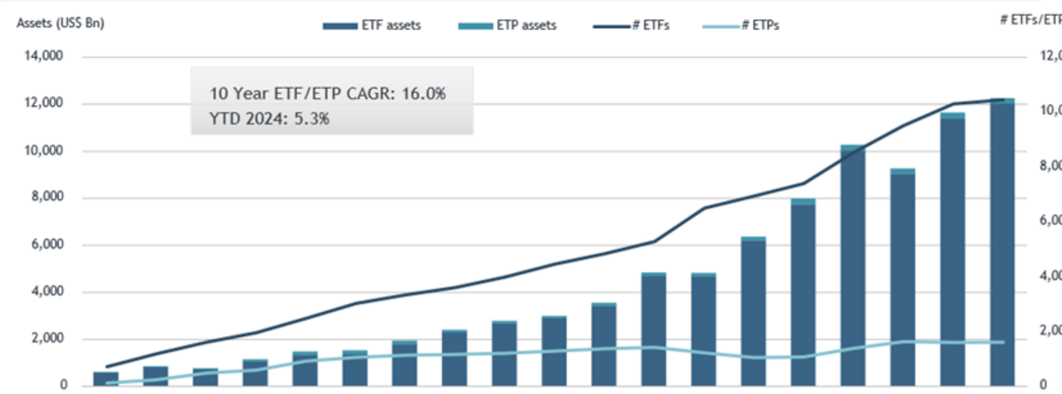
Editorial

Market bulls are firmly in command. New data from research and consulting company, ETFGI, shows that exchanged traded fund (ETF) assets worldwide reached a record US$12.25 trillion last month. Global ETF assets saw US$116.3 billion in net inflows in February, the 57th straight month of net inflows.



Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Feb-24
# ETFs	729	1,194	1,617	1,969	2,491	3,035	3,348	3,613	3,993	4,465	4,841	5,288	6,497	6,947	7,403	8,534	9,515	10,296	10,452
# ETFs/ETPs	830	1,425	2,092	2,550	3,405	4,093	4,483	4,777	5,195	5,750	6,208	6,712	7,711	7,988	8,470	9,916	11,148	11,904	12,063
ETF assets	579	806	716	1,041	1,313	1,355	1,771	2,284	2,674	2,898	3,423	4,690	4,682	6,192	7,731	10,014	9,029	11,390	12,006
ETF/ETP assets	603	856	774	1,157	1,478	1,526	1,951	2,402	2,787	2,997	3,552	4,838	4,815	6,361	7,986	10,262	9,260	11,634	12,247

Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources and data generated in-house.Note: This report is based on the most recent data available at the time of publication. Asset and flow data may change slightly as additional data becomes available.

Equities are the big winners. Equity ETFs reported net inflows of $80.4 billion during February, bring year-to-date net inflows to US$141.4 billion, close to 7x the amount recorded from the same period last year.

And where's the money flowing into equities? It's primarily the US market, and the technology sector. For instance, the Vanguard Information Technology ETF (NYSE: VGT) increased its assets by almost 10% in February alone – quite something for a fund with almost US$70 billion in assets.

It's not only equities benefiting. Bitcoin is getting plenty of investor attention too. The iShares Bitcoin Trust (NASDAQ: IBIT) now has US$10 billion in assets under management, up from close to US$5 billion in January.

The bullish sentiment is a boon for the ETF industry. There are now more than 12,000 ETF products worldwide, up from 5,000 just five years ago. As Grant's Interest Rate Observer notes, 3,000 global ETF products have launched over the past 15 months, nearly matching the 3,700 companies listed on US exchanges.

Record equity inflows

The ETF data mirrors broader market money flows. EPFR Global data reveals that investors tipped US$56 billion into US equities in one week through mid-March, besting the previous record set in March 2021. Of those weekly inflows, US$22 billion went to technology stocks, or 39% of the total.

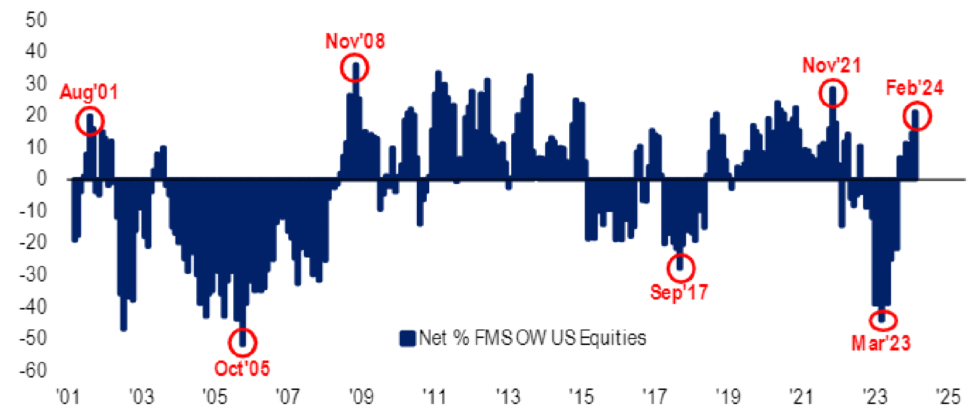
Fund manager sentiment at two-year highs

The positive market sentiment is echoed by fund managers. According to Bank of America's latest survey of global fund managers, sentiment is the most bullish since the heady days of November 2021.

Percentile rank of FMS growth expectations,

Meanwhile, US stock allocations are also the highest since November 2021.

Net % FMS overweight US equities

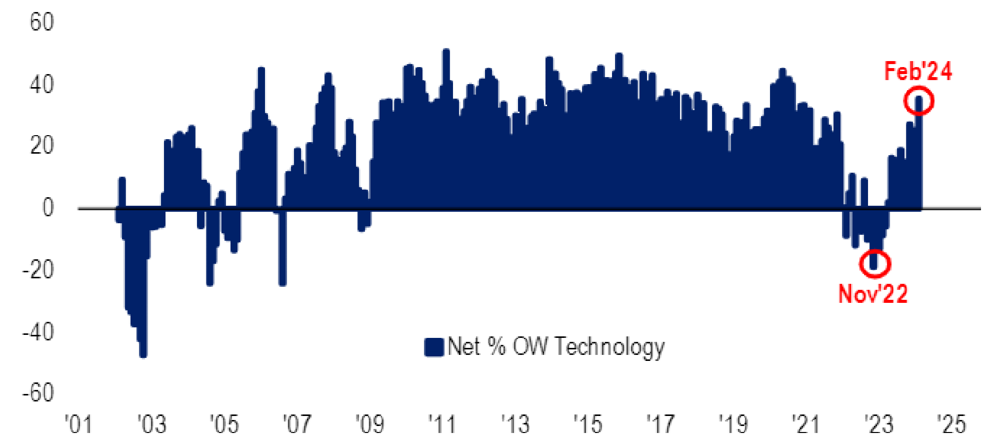


Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

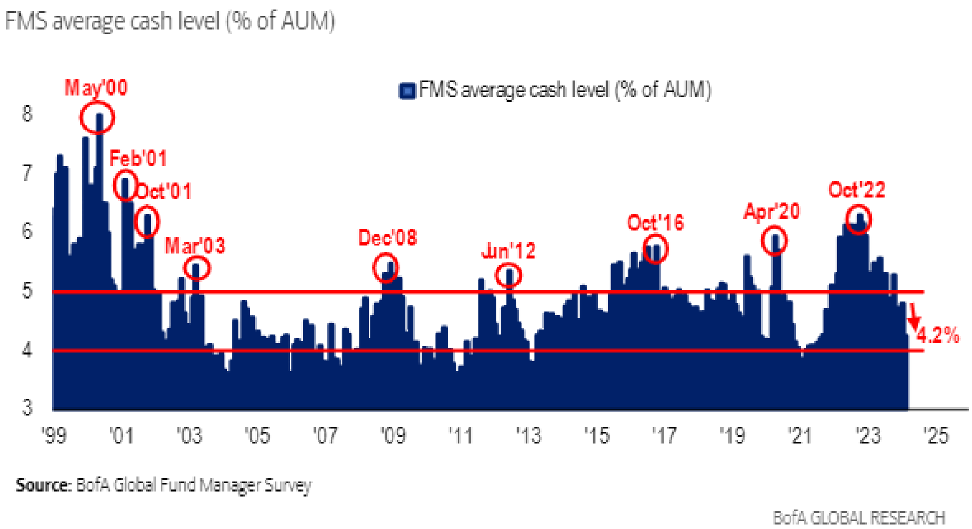
US tech allocations are the highest since August 2020.

Net % overweight technology



Source: BofA Global Fund Manager Survey

And fund managers have cut their cash levels to 4.2%. Bank of America says large cuts to cash allocations are typically positive on a three-month view, though if they dip to 4% or below, then it's a 'sell signal'.



4x leveraged stock ETNs flying

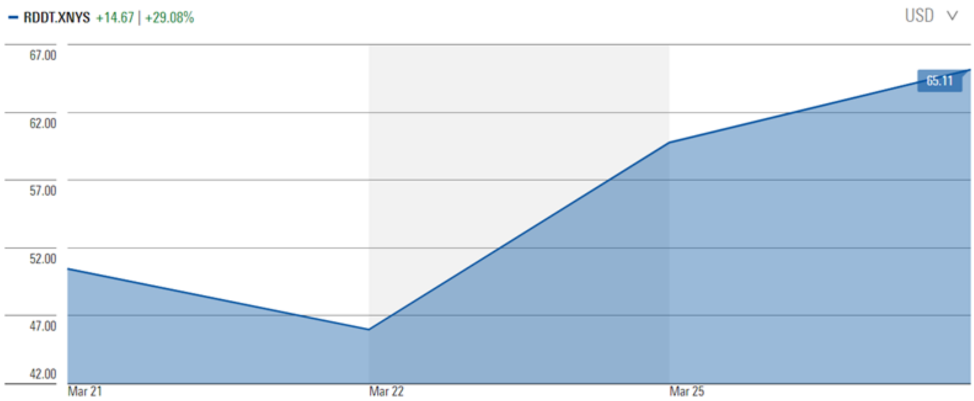
The optimism has worked wonders for the MAX S&P 500 4x Leveraged Exchanged Note (NYSE:XXXX), launched by Bank of Montreal in December last year. The exchange-traded product allows massively leveraged bets on the S&P 500. The ETN is up a cool 31% this year, bringing its market capitalization to US$106 million.

That the leveraged ETN was allowed to launch raised eyebrows initially, as it came after two 4x leveraged products proposed by ForceShares were blocked by the Securities and Exchange Commission back in 2017.

The IPO market rising from the dead

Meantime, the IPO market is getting a jump-start after being moribund for the best part of 18 months. Reddit (NYSE: RDDT) went public on March 21, the first social media company to IPO since 2019. Its IPO price of $34 valued the company at US$6.5 billion, 35% below its highest private market valuation of US$10 billion in 2021.

The stock jumped 48% on debut, is now up 91% since listing. The market cap of US10.35 billion eclipses that of the 2021 private market valuation.



Source: Morningstar.com

Not bad for a company that's never made a profit since being founded 20 years ago. Last year, it reported US$801 million in revenue but had a net loss of US$91 million. At least it was better than the year before, where the net loss came in at US$159 million.

Reddit now sports quite the valuation, trading at a 12.9x price/sales ratio. That compares to the likes of Meta (NASDAQ: META) at 9.8x and Pinterest (NYSE: PINS) at 8.9x. To put it into context, Reddit has 73 million daily users, compared to Facebook's 2 billion.

And just this week, Donald Trump's company, Trump Media & Technology Group (NASDAQ: TMPTG) debuted on the Nasdaq, and rose intra-day 60% on day one before finishing up 16%. It came more than two years after its merger with a blank-cheque firm was announced. Trump's stake in the company is valued at US$5.4 billion, meaning the Republican Presidential nominee may not go bankrupt after all.

Unsurprisingly, other companies are expected to line-up to IPO. Investors expect US listings from payments provider, Stripe, last valued at US$50 billion, and 'buy now payment later' operator Klarna, sometime in 2024.

Insiders selling

While investor go all-in on markets, corporate insiders appear to be heading for the exits. According to Verity LLC, the ratio of corporate insider selling to insider buying is at the highest level since the first quarter of 2021.

Some of the biggest sales have come from tech executives. Amazon founder, Jeff Bezos, sold shares worth US$8.5 billion in February. That's noteworthy as Bezos has timed share sales well previously, especially in 2020-2021.

Meta CEO, Mark Zuckerberg, sold US$135 million worth of shares in early February, while Palantir co-founder, Peter Thiel, offloaded US$175 million of stock this month.

Is the bull market bubbly or maturing?

Investors love to see things in black and white, yet most are grey. One person's market bubble can be another's bull market.

While it's beginning to feel like 2021, we're probably not there yet. There are plenty of signs of froth in certain areas of markets - namely in US stocks, technology, Bitcoin, AI – yet that has filtered through to other areas. Whether it will or not remains to be seen.

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There are a couple of related articles this week. **Shane Woldendorp** from **Orbis** looks at whether valuations for the Magnificent Seven stocks are realistic. He drills down into the numbers to reveal what history says about companies with high multiples and how they've subsequently performed.

And, **Michael Howell** investigates what's behind the surge in Bitcoin and gold prices. He suggests that US bank balance sheets are expanding again, driving increasing money supply that is finding its way into markets, including into Bitcoin and gold. He says that greater money supply will mean inflation remains higher for longer.

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In my article this week, I suggest that Listed Investment Companies (LICs) could be close to bottoming. Investor disgust, consolidation, de-listings, price discounts, activist investors entering, are typically what happens at business cycle troughs, and it's happening to LICs now. That may present a potential opportunity.

James Gruber

Also in this week's edition...

The ATO has released the superannuation rates and thresholds that will apply from 1 July 2024, and **Julie Steed** outlines what's changing and what's not, as well as some key considerations and opportunities in the lead up to 30 June and beyond.

VanEck's Russel Chesler runs through the pros and cons of borrowing to invest in the share market. He says gearing provides greater exposure to the share market and its potential gains or losses, as well as more associated franking credits. Yet, there are additional risks and costs to consider too.

What is factor investing and can it help investors deliver better returns? **Blackrock's Andrew Ang** says investors often express their current views on markets by tilting their portfolios towards certain sectors, in hopes of generating excess returns. But what they may actually be looking for are companies with specific characteristics – or factors - that add portfolio resilience.

ESG is a much-maligned topic in investing circles, yet fund managers have been using such tools to screen for quality companies for some time. **UniSuper's Lou Capparelli** says ESG can deliver portfolios that are aligned with investor values as well as better returns, and shows us how.

In this week's whitepaper, the **World Gold Council** goes through the key factors behind gold's recent rise and why investors should consider an allocation to gold in their portfolios.

Why LICs may be close to bottoming

James Gruber

It's hard to think of a segment of the market that is more hated by retail investors than Listed Investment Companies (LICs). Hate may be too strong a word as LICs were hated a year or two ago, but now they're mainly ignored.

Yet, institutions are getting increasingly busy in the sector, including:

- VGI Partners Global Investments' (ASX:VG1) trading volume has recently shot up as speculation mounts that Regal may consider merging the $561 million LIC with the $826 million PM Capital Global Opportunities Fund (ASX:PGF). That comes after Regal acquiring both PM Capital and VGI Partners.
- Saba Capital, a US$4.4 billion global hedge fund known for pressuring funds to act to close discounts to asset values, has taken an almost 10% stake in Hearts and Minds Investments (ASX:HM1), the charity investment vehicle. Saba owns shares in several other LICs including MFF Capital Investments (ASX:MFF), Platinum Capital (ASX:PMC), and WAM Global (ASX:WGB).
- Wilson Asset Management has entered into a scheme of arrangement to merge with QV Equities (ASX:QVE) to create an almost $2 billion vehicle.
- Early this year, the board of small caps LIC, Spheria Emerging Companies (ASX:SEC), gave the manager a deadline of one year to close its discount to net tangible assets (NTA), or the LIC will be delisted.

The corporate activity follows a swathe of funds including Magellan, Bennelong, Antipodes Partners, Monash, Partners Group, Forager and others, who've pulled or intend to pull listed funds.

The comments from some of these funds has been instructive. When Forager announced its intention to delist the ~$145 million Australian Share Fund from the ASX in October last year, it stated that the fund had tried and failed to narrow the share price discount to Net Asset Vale (NAV):

"Investor apathy towards close-ended investment vehicles has become entrenched and … smaller, less liquid vehicles like FOR are unlikely to trade at NAV for the foreseeable future."

It went on to suggest that it wasn't fair for investors who wanted to redeem money that they'd have to do it at a +15% discount to NAV.

And, in August last year, unitholders voted to remove the $465 million Partners Group Global Income Fund from its ASX listing. Partners Group, a global fund manager, cited several reasons for the delisting:

1. The lack of liquidity led to the fund trading at an NTA discount about 90% of the time.
2. Unitholders had continued to give negative feedback on the discount and pushed the company to address it.
3. Buy-backs were an unlikely panacea as while they might boost the share price in the near-term, they were unlikely to in the longer term.
4. A change to an open-ended unit trust structure would give investors to ability to realise an investment at NTA and also give Partners Group the opportunity to increase the fund's size.

How do we make sense of the retail investor apathy and de-listings on the one hand, and the hive of corporate activity on the other?

A $51 billion pool of money

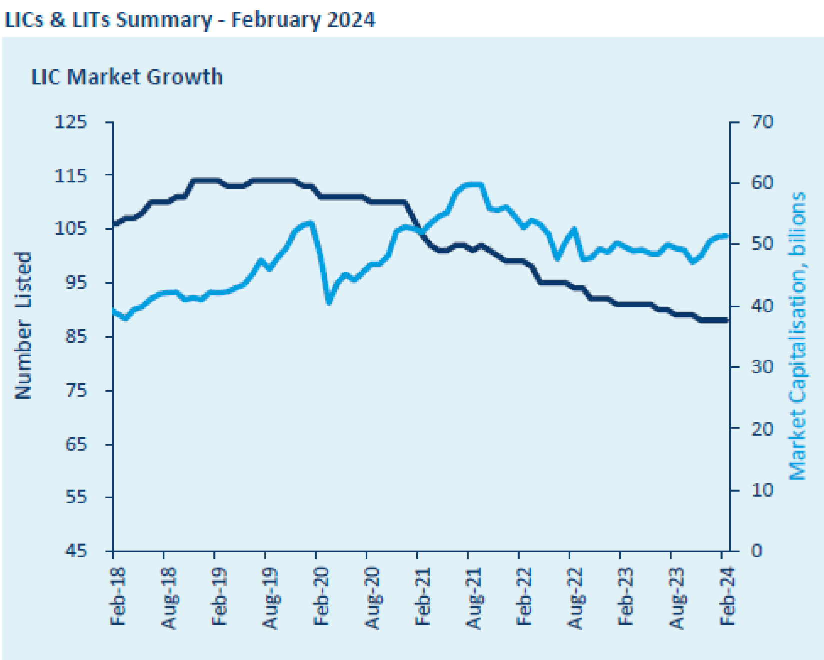
Before getting to that, let's first look at what LICs are and aren't, and how they compare to listed investment trusts (LITs), and exchanged traded funds (ETFs). LICs are investments funds where money is pooled to buy assets. While LICs are companies that issue shares, LITs are trusts that issue units. This article will refer to LICs for both, for simplicity's sake.

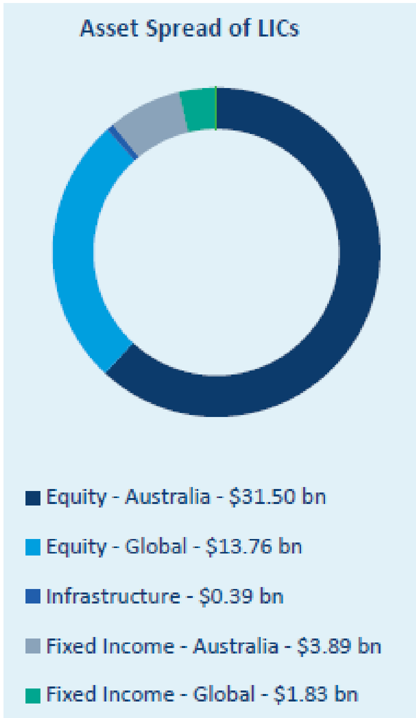
LICs are 'close-ended' as there are a fixed number of shares on issue. ETFs are 'open-ended', meaning they can issue new shares, or retire them.

As Graham Hand has previously mentioned in this newsletter, the strength of LICs is also their fundamental weakness. The strength is the committed, or permanent, capital means portfolio managers aren't forced to sell assets to meet redemptions. The weakness is that without these managers providing liquidity, it must come from the market. If demand for buying is less than the supply of selling, then LIC prices fall and can trade at discounts to NTAs.

Putting the sector in context, LICs are small, though still significant. The market capitalisation of the sector stands at more than $51 billion. The number of LICs listed on the ASX peaked at 115 almost six years ago and is down to 88 now.

About 62% of LIC assets are in domestic equities and 27% in global equities.

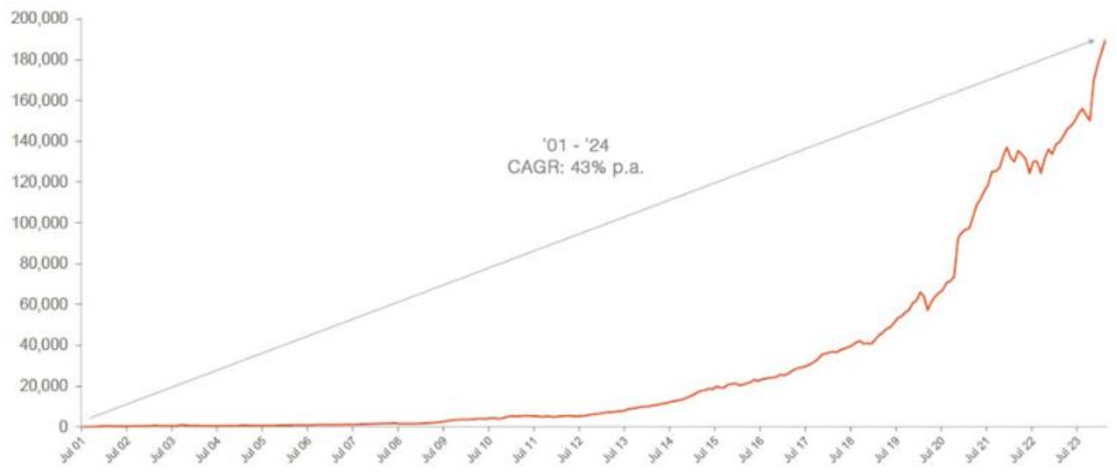




Source: ASX

The LICs sector is dwarfed by ETFs and managed funds. ETF assets under management in Australia reached $189 billion last month.

Australian ETF Industry AuM: July 2001 – February 2024



CAGR: Compound Annual Growth Rate. Source: ASX, CBOE

Despite ETFs getting most of the press coverage, they are still small fry when compared with managed funds (including super, unlisted funds, life insurance funds), which have $4.8 trillion of funds under management, as at the end of last year.

Why the fuss over LICs, then, given their relatively small size? For fund managers, there's the obvious attraction of having permanent capital and the associated management and performance fees that come with it. This can result in managers choosing to keep LICs listed even if a NTA discount persists, because they want or need the fees, among other reasons.

For investors, LICs can give them access to quality managers, with the ease of trading them on the stock exchange. Right now, they can also get these managers at potentially large discounts to NTAs. LICs can also be useful for income investors as they have the ability to smooth dividend payments via their profit reserves.

LICs struggling with large discounts

Currently, LICs are trading at some of their steepest NTA discounts on record. Whereas some segments of the sector have usually traded at premiums or close to NTA, now all of them are at discounts.

Premium/discount by investment mandate (market cap weighted)

Source: IRESS, Company Data, Bell Potter Estimates

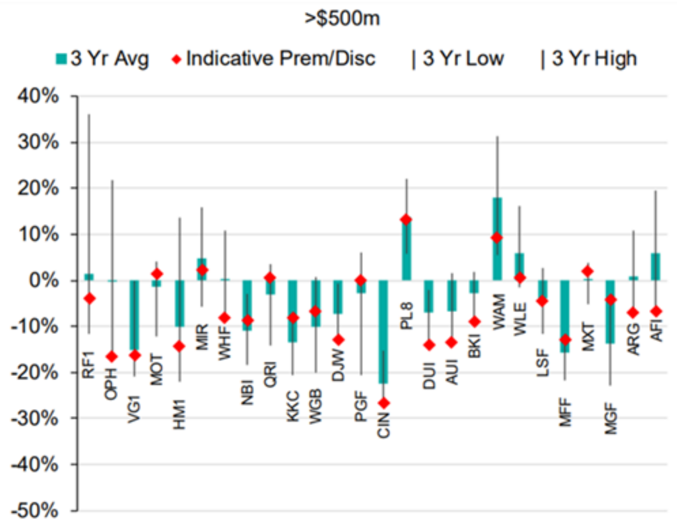
The chart above shows that large cap LIC have traditionally traded at or above NTA, yet they are currently at discounts. The mid and small cap segment is in the doldrums, and has been for some time, reflecting their benchmark's underperformance versus large caps. Private equity funds trade at the largest discount, perhaps indicating scepticism around valuations for their assets. Meanwhile, fixed income funds seem to be back in vogue.

Breaking it down by market cap, the smaller the LIC, the greater the NTA discount.

Premium/discount by market capitalisation band (market cap weighted)

Source: IRESS, Company Data, Bell Potter Estimates

But even among large cap LICs, the current discounts appear extreme. The biggest LICs such as Australian Foundation Investment (ASX:AFI) and Argo Investments (ASX:ARG) are trading close to their widest discounts over the past three years.



Source: Bell Potter

Reasons for the discounts

Why are LICs trading at such large discounts? There are many reasons, some of them self-inflicted, such as:

Underperformance. Many LICs have underperformed their benchmarks in recent years. Their jobs haven't been made easy by the concentration of market gains in large caps. Yet, that's not an excuse as good managers will find a way to outperform over an investment cycle.

High fees. A number of LICs still charge high fees even when they consistently underperform. A little-known fact is that LICs charge the fees against NTA not their market value.

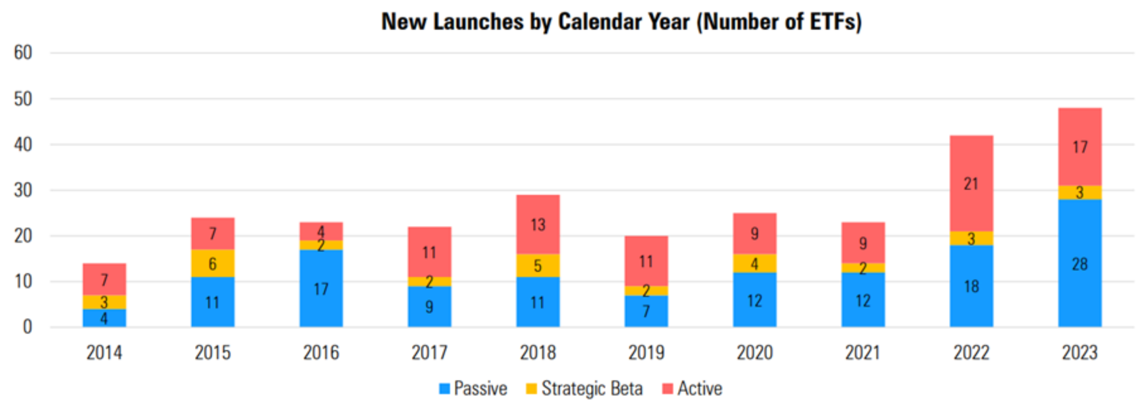
Lack of scale. Among the 88 LICs, there are a lot under the $200 million market cap mark that lack scale. Scale brings marketing power, and potentially lower management expense ratios.

Liquidity. Lack of scale can also bring liquidity issues, especially for institutions wanting to buy and sell.

However, there are other reasons, little mentioned, that are likely behind the LIC underperformance too:

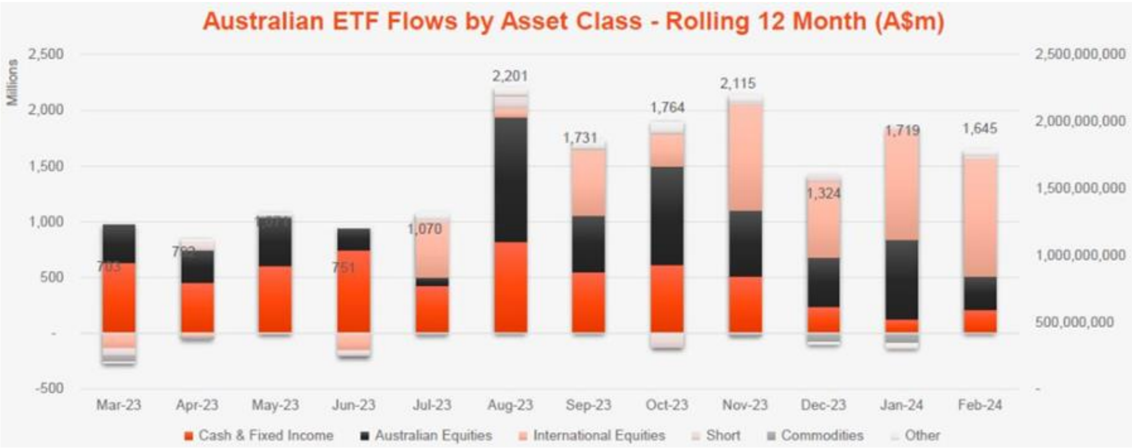
LICs typically underperform during stock bull markets. As markets run up, investors are more willing to trade out of LICs to play the market directly.

ETFs have acted as an accelerant to this trend. The inflows into ETFs in Australia over the past six months has been extraordinary. It's led to 11 ETF products hitting the market in February alone, after a record for new ETFs in 2023.



Source: Morningstar

The ETF money has been flowing into the hottest areas of the market. Where once retail investors didn't want to invest overseas, they are now piling in.



Source: Betashares

While ETFs have much going for them, including low costs, the above charts suggest that there is a lot of momentum trading happening as well.

LICs may offer value in a valueless world

What's happening with LICs is akin to a normal business cycle of boom and bust. LICs were hot in the mid-2010s. In each of 2014, 2015, 2017, and 2018, there were 10 or more LIC IPOs. Many of the funds now delisting, or being taken over, were part of this wave.

Yet, like many industries, success brought oversupply and increased competition. The competition not only came from other LICs but 'disruptors' such as ETFs. That's meant LICs have had to increase marketing and lower fees and costs, which have hit the small-scale funds especially hard.

We are now at the point in the cycle where savvy investors see value and are pushing for changes. That's leading to increasing consolidation in the sector. From a business cycle perspective, these types of things typically happen at the bottom of cycles. It's not unlike what's starting to happen in the lithium and nickel sectors, though LICs are likely further along in the cycle.

There's undoubtedly value in the sector. That's why Geoff Wilson, Saba Capital, and Regal are diving into LICs. As retail investors chase momentum and growth stocks, LICs perhaps represent one of the few pockets of value left in the market.

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

2024/25 super thresholds – key changes and implications

Julie Steed

The ATO has released all the superannuation rates and thresholds that will apply from 1 July 2024. This article outlines what's changing and what's not. It also explains some key considerations and opportunities in the lead up to 30 June and beyond.

Transfer balance cap

The transfer balance cap limits the amount of superannuation that can be used to start a pension, where the investment returns are generally tax free. The transfer balance cap was introduced from 1 July 2017 at $1.6 million and is indexed periodically to the consumer price index (CPI) in $100,000 increments. From 1 July 2021, it increased to $1.7 million and to $1.9 million from 1 July 2023. The transfer balance cap will remain at $1.9 million from 1 July 2024.

Contributions

Some key thresholds that impact contribution planning will increase from 1 July 2024, while others will be unchanged.

Total super balance

The value of the general transfer balance cap is used to determine the total super balance threshold which impacts eligibility for making non-concessional contributions and spouse contributions, as well as receiving Government co-contributions. This will remain at $1.9 million from 1 July 2024.

When determining eligibility for contributions, the total super balance is measured at the previous 30 June, not at the time a contribution is made.

Concessional contributions

The concessional contributions cap is indexed to average weekly ordinary times earnings (AWOTE) in $2,500 increments. The concessional contributions cap will be indexed from $27,500 to $30,000 from 1 July 2024.

This also impacts the concessional contributions that can be made under the five-year carry forward rules by individuals who have a total super balance at the previous 30 June of less than $500,000. The five-year carry forward total super balance threshold is not indexed.

Individuals who have a total super balance at 30 June 2024 below $500,000 will have a concessional contribution cap of up to $135,000 in 2024/25. This includes a maximum of $25,000 for 2019/20 and 2020/21, as well as $27,500 for 2021/22 and 2022/23.

Based on the five-year carry forward rules, from 1 July 2024, any unused concessional contributions from 2018/19 will no longer be available to use. This means that 2023/24 is the last year that individuals can use any unused concessional contribution cap from 2018/19.

Non-concessional contributions

The non-concessional contributions cap is calculated as four times the concessional contributions cap. So from 1 July 2024 the non-concessional contributions cap will be $120,000.

The two- and three-year bring forward limit will also increase to $240,000 and $360,000 respectively from 1 July 2024.

The total super balance thresholds for determining eligibility to make non-concessional contributions will change, as outlined in the table below:

2023/24		2024/25	
TSB on 30 June 2023	NCC cap	TSB on 30 June 2024	NCC cap
$1.79m to < $1.9m	$110,000	$1.78m to < $1.9m	$120,000
$1.68m to <$1.79m	$220,000	$1.66m to <$1.78m	$240,000
< $1.68m	$330,000	< $1.66m	$360,000

Importantly the three-year bring forward maximum contribution is based on the non-concessional contributions cap at the time the three year bring forward is triggered. There is no benefit from indexation for individuals who have triggered a bring forward prior to 1 July 2024.

Example

Shamal triggered the three-year bring forward in 2023/24 by making a $150,000 non-concessional contribution. Shamal can contribute a further $180,000 prior to 30 June 2026; they don't benefit from indexation of the non-concessional contributions cap during this time.

Thresholds not indexed

In addition to the threshold for accessing the five-year concessional contributions carry forward, the $300,000 total super balance threshold for determining eligibility for the work test exemption is not indexed.

Summary of rates and thresholds

The table below summarises the key rates and thresholds recently released by the ATO:

Item	2023/24	2024/25
Untaxed plan cap (for lump sums paid from untaxed schemes)	$1,705,000	$1,780,000
Defined benefit income cap	$118,750	$118,750
CGT cap (lifetime limit for eligible business owners)	$1,705,000	$1,780,000
Government co-contributions		
Lower income threshold	$43,445	$45,400
Upper income threshold	$58,445	$60,400
Superannuation guarantee		
Maximum contribution base (per quarter)	$62,270	$65,070
Contribution rate	11.00%	11.50%
General transfer balance cap	$1,900,000	$1,900,000
Concessional contributions cap	$27,500	$30,000
Non-concessional contributions cap	$110,000	$120,000
Total super balance limits		
Catch-up CCs	$500,000	$500,000
Work test exemption	$300,000	$300,000
Government co-contribution	$1,900,000	$1,900,000
Total super balance for NCCs		
$360,000 over 3 years	<$1.68m	<$1.66m
$240,000 over 2 years	$1.68m to < $1.79m	$1.66m to <$1.78m
$120,000 over 1 year	$1.79m to < $1.9m	$1.78m to <$1.9m

Superannuation guarantee contributions

Although not subject to indexation, from 1 July 2024 the superannuation guarantee rate is increasing from 11% to 11.5%. Individuals who make personal concessional contributions or have salary sacrifice contributions made by their employer may need to factor the increase into their arrangements.

Preservation age

From 1 July 2024, the preservation age will be age 60. This means that all individuals who are eligible to commence a pension or take a lump sum payment will not pay PAYG tax on their benefits.

Summary

The superannuation rules changed dramatically in 2017 and introduced a variety of thresholds that determine eligibility for certain tax concessions and the ability to make contributions. The indexation of the thresholds adds an additional layer of complexity from 1 July 2024. Understanding the additional complexities will assist individuals to maximise the opportunities available within super in both 2023/24 and 2024/25.

Julie Steed a Senior Technical Services Manager at Insignia Financial.

Are expectations for the Magnificent Seven too high?

Shane Woldendorp

Investing is hard. Seeing stocks that you own fall in price and resisting the urge to sell takes a strong stomach. Seeing stocks that you find expensive soar without you is no fun, either. It takes discipline to tame the fear of missing out. That emotional rollercoaster means that in investing, knowledge is cyclical, not cumulative. We learn the same things over and over again. It's rare to see something truly new.

As we've seen, the market's current obsession is with artificial intelligence (or AI) and the 'Magnificent Seven': Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla. As a group, they represented 70% of the S&P 500's 2023 return. Standout winner Nvidia closed the year up 239%, while Apple, the relative laggard, returned 48%. Today, those seven companies command as much market value as the 'Foreign Five' (China, Japan, India, France, and UK) – the largest developed stockmarkets outside the US by market value.

While these tech giants have dominated the headlines in recent years, this phenomenon is nothing new. Before our recent market darlings, we had the FANG quartet (Facebook, Amazon, Netflix, and Google). Go back even further and you'll find the BUNCH companies—Burroughs, Univac, NCR, Control Data and Honeywell—the forgotten darlings of the mainframe computing era. After soaring to dizzying heights for many years, they too eventually came back down to earth.

So, what lessons can we learn from history and are there any markers that can help navigate the current zeitgeist?

Valuations vs expectations

The key is in valuations and expectations. Stocks go up when results are better than investors anticipated. So, you make money by owning businesses as their outlook brightens. Sometimes that means buying the business when others think the outlook is dim. The higher the valuation, the higher the expectations, and the greater the scope for potential disappointment.

Today, the valuations of some of the mega-cap giants are incredibly high. That sets a high bar. For some of them, expectations are so high that they must deliver blindingly fast growth simply to justify their current prices.

Take Microsoft, for example. While Microsoft may make $101 billion in operating profit, the market then expects it to grow at 10-15% a year – so it needs to grow profits by $10-15 billion a year, compounded over time. That's like growing a brand-new Coca Cola in 2024, and then another in 2025, and so on.

Even the growth expectations for Nvidia are astounding. In 2023, as a whole, Nvidia presented revenues of almost $61 billion, up 126% from a year ago. Having beat market expectations in the fourth quarter, Wall Street expects Nvidia to grow by 35% per annum for at least half a decade. Even for the best companies in the world, such growth rates are really hard to sustain.

The trouble is that growth potential is clear to everybody. So those expectations are already reflected in the stock's price. Today, that price is high. Nvidia trades at 20 times estimates for next year's sales. That's 20 times the top line, before any expenses. It's not impossible for a business to deliver the sort of growth now expected of Nvidia. It's just exceedingly rare.

The sobering reality

We decided to see how rare. Since 1990, just 230 stocks in the FTSE World Index have ever sustained 30% revenue growth for more than five years. That's just 7% of the 3,400 relevant stocks in the Index. The feat is even rarer for large companies. Just 45 businesses have ever delivered that kind of growth after cracking the top 200 of the Index.

The hit rate is higher for huge expensive companies, suggesting that markets do have some signal. 23% of huge companies trading for more than 10 times sales have gone on to sustain 30% revenue growth. But that is less encouraging than it first appears. The flip side is that three-quarters of the time, it doesn't play out. Three-quarters of the time, huge expensive companies don't deliver the blazing growth now expected of Nvidia.

Valuations reflect expectations and in the investing world, high expectations can often lead to disappointment. If we take a long view of history, that's often the pattern and valuations are often highest just after a company has burned brightest.

Beyond the Magnificent Seven

Fortunately, there is an alternative to chasing the leading lights. Look beyond the Magnificent Seven, and there are thousands of companies out there—many of which will have brighter futures than the market now expects. In 2023 alone, many good-sized companies returned more than Apple's 48% return.

But the spotlight doesn't shine on these businesses. It's hard to tame the fear of missing out, especially when the companies leading the way continue to beat expectations quarter after quarter. But rather than crowding into giant companies that must continue to shine brightly just to hold their prices, we much prefer to invest in companies that trade at discounted valuations and are trying to clear a lower bar. It is more rewarding to be there before their time to shine.

The important thing is that with such an uncertain backdrop, now is a critical time for investors to be open-minded and adaptive—as continuing to stick with past winners is no guarantee of success, especially when the valuations trend of the Magnificent Seven begin to strongly resemble the Nifty Fifty of the 1970s.

Shane Woldendorp is an Investment Counsellor at Orbis Investments, a sponsor of Firstlinks. This article contains general information at a point in time and not personal financial or investment advice. It should not be used as a guide to invest or trade and does not take into account the specific investment objectives or financial situation of any particular person. The Orbis Funds may take a different view depending on facts and circumstances.

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The potential and perils of increasing franking credits

Russel Chesler

We have all borrowed to fund large purchases, and, sometimes, not so large. We are told that debt is bad. We try and pay back our loans and credit cards as quickly as possible. But not all debt should be considered bad. With careful planning, debt has the potential to be 'good'.

In Australia, investors who borrow to buy property benefit from a tax regime that allows them to reduce their taxable income by losses they incur from interest payments and other investment costs for the property they have borrowed to invest in. This tax benefit has been in the news recently, as it always seems to be following a change to tax laws or whenever there is an election.

Like these property investors, Australian equity investors can also borrow to invest. This gearing combines the investors' funds with borrowed funds making the amount available for investing larger, so thereby magnifying returns (in both directions). Gearing is not suitable for everyone, and we recommend you speak with your financial adviser. Below we provide two potential benefits of gearing as well as introducing a simple and convenient way to gear Australian equities.

But first let's understand gearing and its impact on an Australian equity portfolio.

The modelled table below illustrates how gearing can affect investment gains and losses in comparison to a fund that is not geared.

Table 1: Modelled performance of a geared and ungeared fund

	Geared	Ungeared
Initial investment	$5,000	$5,000
Fund gearing level	50%	Nil
Amount borrowed by Fund	$5,000	Nil
Amount invested in market	$10,000	$5,000
If the value of the Fund's assets rises by 10%		
Rise in value of the Fund's assets	$1,000	$500
Value of Fund assets	$11,000	$5,500
Outstanding loan	$5,000	Nil
Value of investment	$6,000	$5,500
Gain on investment	$1,000	$500
Return	+20%	+10%
If the value of the Fund's assets falls by 10%		
Fall in value of Fund's assets	-$1,000	-$500
Value of Fund assets	$9,000	$4,500
Outstanding loan	$5,000	Nil
Value of investment	$4,000	$4,500
Loss on investment	-$1,000	-$500
Return	-20%	-10%

The table above considers gains and losses in the value of the underlying assets. It does not consider income or associated franking credits. The table assumes that the loan is not increased or decreased as the asset values change.

If you also consider income, you can see another potential benefit of gearing Australian equities. Because you have increased the amount invested, you also increase the amount of dividends you receive, thereby increasing your franking credits.

Table 2: Modelled dividends of a geared and ungeared fund

$$\text{*Franking Credit} = \frac{\text{Company Tax Rate}}{\text{1-Company Tax Rate}} \times \text{Dividend Amount}$$

	Geared	Ungeared
Initial investment	$5,000	$5,000
Fund gearing level	50%	Nil
Amount borrowed by Fund	$5,000	Nil
Amount invested in market	$10,000	$5,000
Assume a dividend of 4% with 70% 'franking' attached		
Dividend	$200	$100
70% franking credit*	$60	$30
Grossed up distribution	$260	$130

Now, if we consider the costs of borrowing, which the simple examples above do not, when gearing the dividends are used for interest payments associated with the costs of borrowing. It is important to note that for tax purposes these costs are deducted from the dividends received and do not impact the associated franking credits. The franking credits associated with the dividends received remain. In the example above, irrespective of the borrowing costs, the franking credit would still be $60. In the example above, if the borrowing costs were $150. The taxable dividend would be reduced to $50, but the franking credit would still be $60, making the grossed-up dividend $110.

These are simple examples. Gearing is complex, but you can see the potential benefits it can provide, albeit with additional costs and an increased risk of losing money.

We think there are two ways investors can use gearing and fund managers are helping all types of investors including SMSFs increase their exposure to Australian equities.

Potential benefit 1 – Wealth accumulation strategy

You can see above in Table 1 that gearing provides greater exposure to the share market and thus potential increased gains or losses compared to an ungeared portfolio. Additionally, geared Australian equity investors receive more associated franking credits than if they were not geared. There is no doubt gearing is riskier and has additional costs, so it is not for everyone, but with careful planning, it can be used as a part of an overall portfolio solution.

Potential benefit 2 - As a portfolio diversification tool

By gearing your Australian equities exposure, capital may be freed up to invest in other asset classes.

Think about an investor with $10,000. Putting all your eggs in one 'asset' basket may not be prudent risk management. Gearing allows investors to put a portion of their funds in one asset class, enhancing that exposure to the asset class, meaning they can use the leftover funds to invest in other asset classes.

In the table below, investor A retains their $10,000 allocation to Australian equities, but because they have geared, they have spare capital to allocate elsewhere.

Before gearing		After gearing	
Investment	**Amount invested**	**Investment**	**Amount invested**
Australian shares	$10,000	Australian shares	$5,000 investment plus $5,000 gearing
		International Equities	$2,000
		Bonds	$2,000
		Term deposit	$1,000
Total investment exposure	**$10,000**	**Total investment exposure**	**$15,000**

For Illustration only. Assumes gearing ratio of 50%. This is not a recommendation for any particular asset class, or product, or approach. Please speak to a financial adviser to discuss whether gearing is right for you.

Gearing can be difficult, but some fund managers do the work for you, creating 'geared' versions of their Australian equity funds. These funds combine investors' funds and borrow funds to invest in an underlying Australian equities strategy.

Gearing Australian equities may not be suitable for all investors. While it can have benefits, including the tax benefits associated with franking credits, undertaking a gearing and the potential associated benefits will also depend upon your attitude to risks and your personal situation.

Recently, VanEck launched the VanEck Geared Australian Equal Weight Fund (Hedge Fund) (ASX: GMVW) on the ASX.

Russel Chesler is Head of Investments and Capital Markets at VanEck, a sponsor of Firstlinks. Russel is responsible for managing VanEck's Australian ETFs. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.

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What's behind the surge in Bitcoin and gold?

What's behind the surge in Bitcoin and gold?

Demetri Kofinas with Michael Howell

This is an edited transcript of Michael Howell's podcast interview with Hidden Forces' Demetri Kofinas.

Michael Howell is Managing Director of CrossBorder Capital, a London-based independent investment research company. He's also the author of 'Capital Wars'.

Demetri Kofinas: What are the risks that are introduced to the economy, to financial markets, with [US] yield curve suppression?

Michael Howell: If they're starting to fund a lot of government spending through short-term bills which is the reality of what's happening, and let's say that the money funds or the banks start to buy that debt, this is pure monetization.

And this goes back to something that Stan Druckenmiller said six months ago when he was being interviewed. There was a well-known interview on YouTube that he expressed these fears where he said, if you look at the numbers that are coming out of the Treasury in terms of the quarterly refinancing statement, those numbers were the numbers that you would have seen in Latin America not in the USA.

This is a warning sign, this is bad, and if the Treasury keeps funding at the short end, and they start issuing more debt to banks, so the banks are holding Treasuries, what you're getting is this pure monetization of the deficit.

Look at U.S. money supply data now. Money supply, broad money supply in America, is beginning to tick up. Everyone says, well, that's great news. Well, let's look beyond that headline figure and drill down into why it's picking up. It's not picking up because banks are lending to the private sector. Their hands are tied many ways because of regulation. It's because they're effectively de facto lending to the public sector. They're starting to fund these big deficits, and this is bad news for the long-term health of the U.S. economy...

... What you're now hearing is debate going on between the lines which is basically saying why don't we allow the banks or encourage the banks to own more Treasuries? Well, lo and behold, guess what happened in World War II or in the British case in World War I? What you saw was the banks owned lots of Treasury Securities and that's war finance.

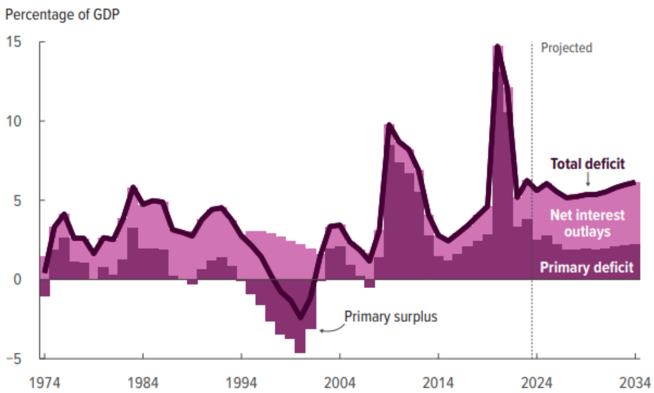
Kofinas: What are the consequences to the real economy of this kind of suppression continuing? In other words, having this kind of distortion and duration, because interest rates on government bonds have an important influence on interest rates across the economy.

Howell: Correct. And I think the danger is – I mean, we can go back in history and look at why there is the obsession among the economics profession for interest rates. And my view is that that's wrong. There's too much fixation on interest rates, so much so that the Federal Reserve gets in a lather about the dot plot and everyone in the market tends to focus an awful lot on the dot plot diagram, about what the FOMC are thinking rates are going to be…

… But look, over the last 18 months, what you've seen is liquidity expanding, the markets gone up through that period, policy rate expectations have flip flopped from one side to the other. That hasn't really affected the market. What's driven the market is the flow of liquidity.

The reality is that what's happening in America is that fiscal policy is so loose, with a budget deficit running on close to 8% of GDP. It's a huge, huge fillip to the domestic economy. And that's what you're seeing.

US Budget surplus/deficit



Source: US Congressional Budget Office

Kofinas: How much is also that a lot of business, small businesses, consumers have long duration loans at lower interest rates, and they really haven't had the need to refinance? And is that a concern that if interest rates remain high long enough that eventually it's going to impact the economy because a lot of people are going to have to refinance at higher rates?

Howell: I've got sympathy with that view, Demetri. I think that that's quite feasible. The problem is, is that the longer you have interest rates at high levels, the more you hit the small to medium-sized business sector, and that matters a lot for U.S. productivity in the longer term.

But at some stage, we've got to address this point about debt, about trying to disincentivize debt. But I think the reality is what you can't see is interest rates coming down a lot from here. Certainly, that would be my view. I think they stay higher for much longer.

Kofinas: Where do we go from here in terms of financing the deficit?

Howell: There's an old saying in Ireland is that – for the lost travelers, if you want to get to Dublin, don't start from here. And that's the reality that most Western governments have got a face. Now, I'm not picking on the U.S. because the U.S. is the cleanest shirt in the laundry by far. A lot of other countries are in far worse shape.

The reason that the U.S. is maybe easy to pick on is that the U.S. is very transparent in terms of its future finances. The Congressional Budget Office does a brilliant job in actually projecting debt out to 2050 and in detail over the next 10 years. So, you pretty much know what's coming. You're looking at deficits, 8%, 9% of GDP going out into the foreseeable future. And that is something that if you look back, if you go back, as I say, 20 years ago, if you said that, people thought you're crazy to project those sorts of numbers. But that's the reality we face.

Kofinas: I think you fall within the camp of people who view QE as actually a policy that raises term premia counterintuitively for people, because most people think QE actually lowers rates. But the arguments of people like you fall in the camp of those who believe that QE actually raises interest rates because it creates a risk-on environment. But how does that square with the government monetizing its debt? I mean, doesn't the government just become the larger purchaser of government debt and yields are therefore kept low?

Howell: Yeah, but we sort of go back to an Alice in Wonderland world where Alice said to the Red Queen, you've got to run faster just to stand still. And I think that's the reality is that if the Fed starts to purchase Treasuries, by definition, if it's taking Treasury supply out of the system, it must by demanding Treasuries be pushing their prices up and capping their yields.

But at the same time, it's issuing liquidity into the system. And as more liquidity goes into the system, investors don't want to take risk, and they don't have any demand for safe assets. So, their demand for safe assets crumbles. And if you look at all these studies that are done by the Federal Reserve, by academic economists and whatever else, what they're looking at purely is the supply impact of central bank purchases of Treasuries on term premia. They're not looking at the second-round effects that come through as the private sector says, well, we've got no need for these safe assets now.

Kofinas: We'd rather have Bitcoin.

Howell: Exactly. Well, wouldn't you?

Kofinas: Yes, at the limit. The last thing I want to own is U.S. government debt. So, is this another way of saying that this is the Japanification of the U.S. bond market that we're seeing in the United States, what we saw roughly in Japan just in several decades earlier?

Howell: Yes. But there's a very important point that comes with that observation, which is the critical one. And this is what I guess Treasury officials or Fed officials have woken up to. Did it matter?

Kofinas: Did what matter?

Howell: Did the Japanification matter for Japan? You end up with the Bank of Japan owning most of the debt. Okay, fine. But what's the cost to Japanese economy? Now, I would argue the cost is that the Japanese economy is a slow growth economy that's going to be very difficult for it to pick up because you've got this huge burden of debt to fund, and the government is monetizing that. But in terms of the implications for there's been no recession, inflation hasn't picked up materially, interest rates remain pretty benign, the economy just rolls on. I mean, it's not a disastrous scenario. And this is the fact that if the U.S. starts to monetize debt, which we're arguing it is, you're not going to go to a hyperinflation state or deep recession. What you're going to do is the can is kicked down the road, you got a higher level of inflation. And ultimately, as my friend and your friend Russell Napier says, this is financial repression. So basically, people who are debt holders lose out over the over the longer term.

Kofinas: Well, in any case, I mean, that's sort of the intention there. But the demographics are very different in Japan. We have tons of immigration here. So, I wonder if we can actually accomplish that without much higher levels of inflation in the United States.

Howell: It's quite possible. I'm not in the camp that says that you get very high inflation. I think you'll get some seepage of this liquidity. It will spill over. Monetary inflation is a component of 'high street' inflation. It's not the only factor. 'High street' inflation is a hybrid cocktail of both monetary inflation, which is devaluing paper money and cost factors. So, if you get oil prices suddenly collapsing, or you get a big productivity shock, or the Chinese help us out by cutting their prices, then you're going to see cost deflation in the 'high street'. And that basically means high street inflation is not so badly affected. But equally, it can go the other way. So, what we're saying to our clients is, what you want in this environment are monetary inflation hedges. So, what you want are things like gold, which is a long-standing monetary inflation hedge or Bitcoin, which seems to be actually acting like exponential gold, it's sort of becoming a monetary inflation hedge par excellence.

Gold Spot Price USD/oz

Data as of 25 March, 2024

Sources: FastMarkets, ICE Benchmark Administration, Thomson Reuters, World Gold Council; Disclaimer https://www.gold.org/terms-and-conditions#proprietary-rights

Bitcoin (BTC) price per day from June 30, 2021 to March 25, 2024 (USD)

Kofinas: Is it just me, or is the Fed collaborating with the treasury more than it has at least in the last 40 years?

Howell: I would agree 100%. I think that's absolutely right. I mean, Janet [Yellen] is one of the most political Treasury Secretaries I can remember.

The Fed is a much more political institution than it has been certainly in my estimation. So, I think we're there. But I think the reality is – and I keep coming back to this – is where we are, is we're in a monetary inflation regime. That doesn't mean to say you're going to get hyperinflation in the high street. It does probably mean you get a higher level of inflation running on. So, it's not going to be 2%, 3% that we've been used to in the last decade. It's more likely to be in the sort of 5%, maybe 6%, but that's not hyperinflation. But it does mean that if you're a debt holder, your wealth gets progressively eroded.

Now, I think you've got to extrapolate that globally and then say, well, how does America hold up in that environment? Because America basically has to sell debt, but then so do many other countries. And if the dollar is the cleanest shirt in the laundry, as I've said, against other units like the euro or the yen or sterling, pound, then the U.S. is going to fare better than these other countries. And their ability to fund is going to be compromised.

This is an edited transcript of Michael Howell's [podcast interview] with Hidden Forces' Demetri Kofinas.

How factor investing can help drive better returns

Andrew Ang

Investors often express their current views on markets by tilting their portfolios towards certain sectors, in hopes of generating excess returns. But what they may actually be looking for are companies with specific characteristics – or factors - that add portfolio resilience.

Sector classifications are useful for viewing companies in similar lines of business, but companies often have business lines that span multiple industries or sectors. For example, Amazon is one of the leading "FAANG" technology companies. It sells goods online, offers e-commerce services, streams music and video, produces media content, operates a cloud platform, has AI capabilities, sells consumer products like Kindle, Fire, Ring, Echo, and offers medical services. According to the Global Industry Standard (GICS) sector definitions, Amazon is *not* in the technology sector - it is defined as a consumer discretionary company. While sectors can provide a high-level understanding of similar businesses, sometimes these definitions are too blunt an instrument.

At the same time, economic forces can make some stocks expensive or cheap, experience winning or losing trends, and be exposed to financial stress for more highly levered companies – simultaneously affecting stocks across different sectors. Factor investing drills through broad labels to highlight what investors may care about and to help understand past performance and expected returns. These characteristics include absolute and relative price (size and value), the quality of a company's earnings, trends in company performance (momentum), and the absolute and relative risk of a company (minimum volatility).

Factor returns

The five factors of value, quality, momentum, minimum volatility, and small size are all supported by empirical data and peer-reviewed research.[1] These factors have not only shown positive excess returns or reduced risk in the initial research, but they have also survived out of sample. Historically, each of these five factors has outperformed its counterpart – large size, higher priced companies, less profitable firms, downward trending stocks, higher risk securities – over varying time periods.

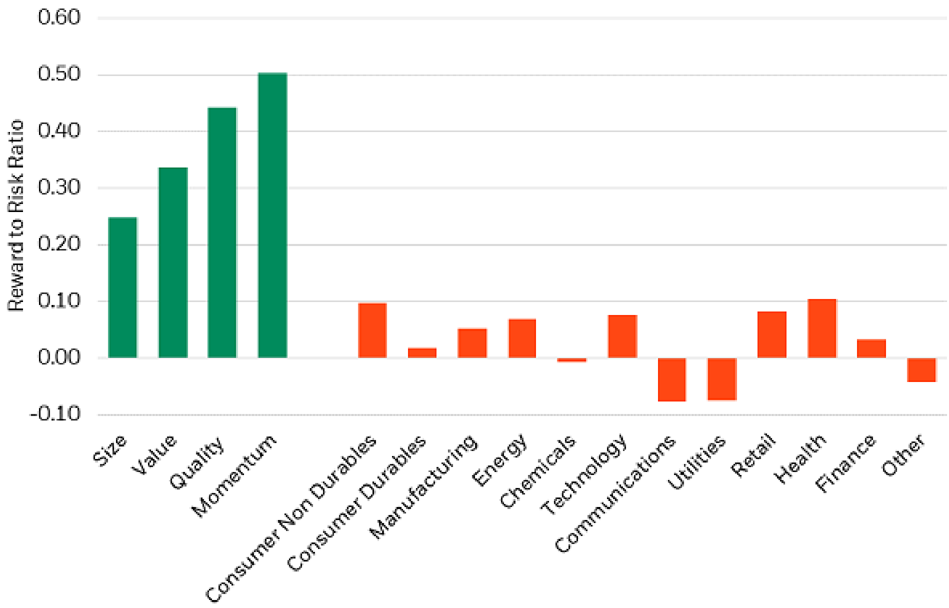
Exhibit 1: % of periods that factor outperformed counterpart[2]

Factors	Monthly Periods	Rolling 1-year Periods	Rolling 3-year Periods	Rolling 5-year Periods
Small Size	52%	56%	54%	56%
Value	54%	61%	67%	73%
Quality	56%	68%	78%	83%
Momentum	63%	75%	87%	87%
Min Vol	65%	78%	84%	92%
Broad equities	60%	71%	78%	76%

Source: Analysis by BlackRock using Ken French data library and AQR data set as of 1/31/23. Data from July 1963 through January 2023.

Investors can contrast factors with sectors or industries, which have not exhibited significant long-term excess returns above the market.[3]

Exhibit 2: Reward to risk ratio of factors compared to industries[4]



Source: Analysis by BlackRock using Ken French data library and CRSP database from July 1963 through April 2023.

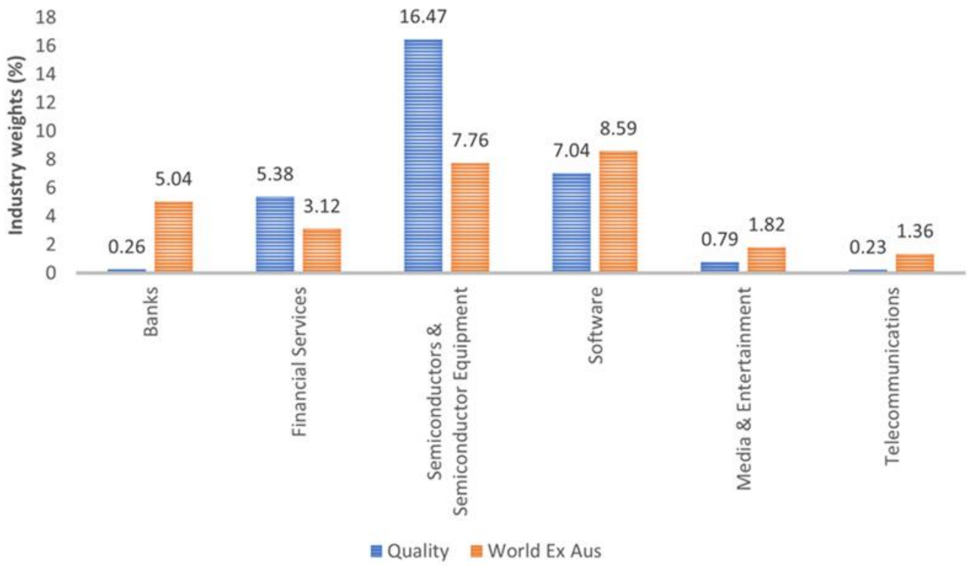
There is not much evidence to support the idea that keeping a constant, strategic allocation to sectors will result in significant returns above the market average. On the other hand, factors have the potential to provide a long-term source of returns. Additionally, by adjusting the positions of factors over time, it is possible to generate returns in a way that complements adjusting the positions of sectors over time.

Factors premiums within sectors

Investors seeking to capture factor premiums can consider whether to take a sector constrained or unconstrained approach. For factors that rely on fundamental variables, like quality and value, it may be prudent to apply sector constraints. When using balance sheet and earnings statement data, sector-specific treatment of earnings or book value in constructing factors allow more consistent comparison of companies within each sector. Investors may desire high quality and lower priced stocks across all sectors without unintended sector bets.

It's important to highlight that sector neutral does not equate to industry neutral. A focus on quality can lead to overweights within industries while still remaining sector neutral to the broad market. For example, within the financials sector, banks have often scored poorly on quality metrics due to their levered business models.

Exhibit 3: Sector neutral does not equal industry neutral



*Source: BlackRock data as of 21/2/2024. Quality is represented by the MSCI World ex Australia Quality Sector Capped Select Index, World ex Aus represented by MSCI World ex Australia Index. *Indexes are unmanaged and one cannot invest directly in an index.*

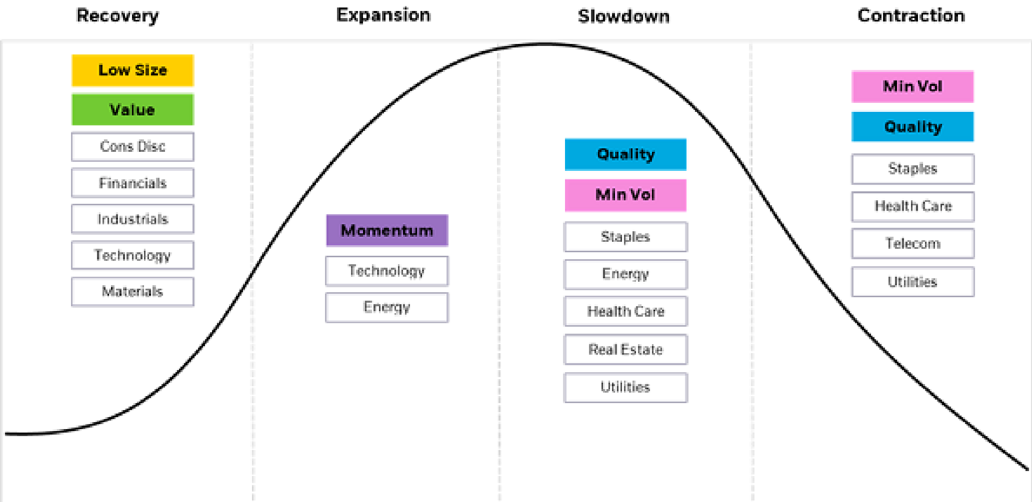
The MSCI World ex Australia Quality Sector Capped Select Index is constrained in how far it can move from the sector weightings in its parent index[5] at each rebalance. As the index methodology considers leverage as one of its three quality screens (the other two are earnings variability and return on equity), the index was able to largely avoid the regional banking crisis in the US in 2023 stemmed by the collapse of Silicon Valley Bank. This was achieved by holding minimal bank exposure, while still remaining sector neutral within the financials sector.

Factors express a complementary view

The sector-controlled or sector-neutral definitions of factors can allow investors (e.g., institutional, adviser, end investor) who dynamically allocate to factors access to a complementary source of returns compared to investors doing sector rotation.

Traditionally, many active managers, asset allocators, and individual investors have expressed tactical views by rotating across sectors in hopes of generating alpha. In some cases, they want companies perceived to be "safe havens" such as utilities or consumer staples if they believe we are headed towards an economic slowdown or recession. In many cases, what these investors are actually looking for is exposure to companies with defensive characteristics that may add resiliency to their portfolios. They want companies that are less volatile (minimum volatility) or have lower amounts of leverage and more stable earnings growth (quality).

Exhibit 4: Sector rotation vs. factor tilting



Source: BlackRock, 2023. For illustrative purposes only. 'This is not a recommendation to invest in any particular financial product.

Factors naturally align with how institutional class investors think about the market.

Investors that are able to evolve their views from traditional sector labels to factors may be able to express a complementary view in their portfolio – and more importantly, allow them to capture the underlying exposure they are seeking.

Conclusion

It's not factors versus sectors. It's factors *and* sectors.

Sector constrained implementation of factors, like value and quality, can allow investors to harvest a long-run rewarded factor return that is different from the returns of sectors. Likewise, factor rotation strategies can be used alongside sector rotation strategies as differentiating sources of returns.

In this new economic regime where inflation has been persistent and is still well above the norm across most global markets, real rates are significantly positive, geopolitical tensions are flaring, and government deficit to GDP ratios are at the same level as during World War II – investors could use all possible sources of diversification and return drivers in their portfolios. Using factors alongside traditional sector strategies can help provide additional diversification.

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[1] Fama and French, 1992, "The Cross-Section of Expected Stock Returns," Journal of Finance, vol. 47(2), pp. 427-465. Novy-Marx, 2013, "The Other Side of Value: The Gross Profitability Premium," Journal of Financial Economics, 108(1), pp. 1-28. Jegadeesh and Titman, 1993, "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency", Journal of Finance, vol. 48(1), pp. 65-91. Ang, Hodrick, Xing, and Zhang, 2006, "The Cross Section of Volatility and Expected Returns, Journal of Finance, vol. 61(1), pp. 259-299.
[2] Low size represented by SMB (small minus big). Value represented by HML (high book-to-market minus low book-to-market). Quality represented by RMW (robust minus weak). Momentum represented by MOM (high prior returns minus low prior returns). Min Vol represented by BAB (betting against beta). Counterparts for low size, value, quality, momentum, and min vol are larger firms, higher priced stocks, less profitable stocks, downward trending stocks, and higher beta securities. Broad equities represented by Mkt-Rf which takes the return of equities and subtracts out the risk-free rate.
[3] Fama and French, 1997, "Industry Costs of Equity", Journal of Financial Economics, vol. 43(2), pp. 153-193.
[4] Size represented by SMB (small minus big). Value represented by HML (high book-to-market minus low book-to-market). Quality represented by RMW (robust minus weak). Momentum represented by MOM (high prior returns minus low prior returns). Industries are represented by Consumer Non-Durables, Consumer Durables, Manufacturing, Energy, Chemicals, Technology, Communications, Utilities, Retail, Health, Finance, and Other. Industry returns are calculated as excess returns which measure the industry returns in excess of the market. Reward-to-risk ratio is calculated by taking the average return of each factor/industry and dividing by its volatility. A higher reward to risk ratio implies a higher historical return relative to volatility.
[5] The parent index is the MSCI World ex Australia index

Why ESG can still play a crucial role in investor portfolios

Lou Capparelli

ESG (environment, social and governance) has become a fixture of investing in financial markets over the last decade. It refers to a range of factors that can affect investment decisions beyond day-to-day financial impacts relevant to investors and companies. Examples include climate change and decarbonisation, workplace safety, board composition, as well as management remuneration and accountability.

As public awareness and interest in ESG issues have grown, it has created a wave of new investment options marketed as ESG focussed using various labels such as 'responsible', 'sustainable', 'socially aware' and 'ethical'. Despite being widely used, there are no standardised, generally accepted definitions of these terms and they can vary widely. Two products with the same label provided by different funds can have quite different portfolios drawn from very different investable universes. This requires a level of due diligence and research on the part of people considering investing in them.

ESG denotes quality

The use of terms like "ESG investing" and "ESG products" is somewhat grating for any sensible investor. It suggests a false choice between two different types of investing – one which incorporates consideration of ESG issues and another which doesn't. In reality, investors seeking long term returns have always had a focus on investing in assets and businesses that have quality as a core tenet, demonstrated by their capacity to generate consistent, sustainable and growing cashflows and earnings in a way that balances the needs of various stakeholders. The increasing prominence of ESG into investment processes is simply the natural evolution to a more comprehensive framework for assessing quality within an investment context.

ESG labelled funds typically invest in a restricted universe relative to more mainstream funds, with exclusions or negative screens for producers of products like tobacco, fossil fuels and weapons as well as companies involved in alcohol, gambling, human rights violations or other controversial activities. In addition, these funds may be marketed as having various positive attributes in terms of sustainability objectives or other desirable features. These restrictions and attributes inevitably raise issues for investment firms or superannuation funds, their members and regulators, around the scope of the negative screens and measurement of positive attributes claimed.

Look under the hood of ETF products

It is incumbent on the investor or super fund member to check the product is aligned with their expectations; are they aware of the scope of the exclusions and the metrics used to assess positive attributes? For example, does the negative screen for tobacco apply only to producers of tobacco or does it extend to related products? Should it apply to companies deriving revenue from tobacco sales or packaging above a certain threshold? In the case of weapons, will they be comfortable investing in a company that has incidental exposure because it produces components that go into fighter aircraft? Likewise, what are the metrics used to determine the positive attributes claimed? Will the investor be satisfied with the positive attribute of the fund based on the percentage invested in ESG "leaders" as determined by a third party ESG ratings provider – noting that different providers will apply different methodologies?

For the manager, there may be higher cost in terms of compliance checking to ensure the exclusions are applied in line with the product mandate. Higher costs can mean that these products may have higher management fees impacting net returns but it's not always so – it's wise to always check the fees and costs attached to any product you choose.

Equally important is the effect of negative screens on investment performance. Any negative screen will by definition produce investment outcomes that deviate from that of the broader market and benchmark indices. For example, the exclusion of fossil fuel companies means that these products will have a structural underweight exposure to the energy sector, with a corresponding overweight exposure to other sectors, such as the technology sector. For most of the last decade, this has been a winning trade with the global oil price sitting above US$100/bbl in 2013 and then falling precipitously to under US$20/bbl during the Covid-19 pandemic in 2020. This was coupled with technology shares performing very strongly during this period. However, the recovery in the oil price over 2021 and 2022 to back over US$120/bbl and subsequent sell-off in technology names saw significant underperformance in these products relative to their mainstream counterparts.

Another consequence of restricting the investment universe is the potential inclusion of higher risk assets. Narrowing the universe can mean going down the quality spectrum or choosing assets that may be more volatile. It's important for those considering investing in these products to get comfort with the risk they are taking.

Regulators are also weighing in and we are seeing an increase in claims of "greenwashing." While this word is relatively new, the concept it represents is the familiar one of misrepresentation or misleading and deceptive conduct. This is complicated by the lack of standardised definitions of terms like 'responsible', 'sustainable' or 'impact'. The Federal Government's initiative to develop a framework for labelling and classification should help ensure greater alignment and greater clarity for investors.

In summary, the plethora of ESG labelled products provides people with an opportunity to invest their savings in a way that is aligned with their values. However, there can be substantial differences between different products even if they have the same label and as a result products vary widely and can be difficult to compare. As with any investment, it pays to do your research and understand the investment before making any choice.

Lou Capparelli is Head of ESG at UniSuper, a sponsor of Firstlinks. Please note that past performance isn't an indicator of future performance. The information in this article is of a general nature and may include general advice. It doesn't take into account your personal financial situation, needs or objectives. Before making any investment decision, you should consider your circumstances, the PDS and TMD relevant to you, and whether to consult a qualified financial adviser.

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