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Editorial

OK Boomers, it's happened. The 2021 Census of Population and Housing reports that the Millennials (or Gen Ys) have overtaken the Baby Boomers as the largest generational group in Australia. Each generation has over 5.4 million people, but over the last decade, Millennials have increased from 20.4% to 21.5% of the population, while Baby Boomers have decreased from 25.4% to 21.5%. In 1966, 38.5% were Boomers. Generation Z is at 18.2%. The Census has been conducted every five years since 1961, and less frequently since 1911. Here are the Census definitions. Yikes, the youngest Boomer is 55!

Generation	Age	Year of Birth	Percentage*
Generation Alpha	0-9 years	2011 - 2021	12%
Generation Z	10–24 years	1996 - 2010	18.2%
Millennials (Gen Y)	25-39 years	1981 - 1995	21.5%
Generation X	40-54 years	1966 - 1980	19.3%
Baby Boomers	55-74 years	1946 - 1965	21.5%
Interwar	75 and over	1945 or earlier	7.5%

** Share of population by generational cohort, Australia 2021. Source: ABS.*

Yes, Gen X and Gen Y, we know Boomers had it good for many years and whereas in 1996, 42% of homeowners had no mortgage, this was down to 31% in 2021. At least the younger generations will inherit billions in wealth in coming decades although the Boomers will live longer, even if they need care. **Dr David Gruen,** Australian Statistician, said:

"We see that an increasing number of Baby Boomers are needing assistance with core activities with 7.4% reporting a need for assistance, compared to 2.8% across the younger generations. This information will help frame policy that delivers positive outcomes for our communities."

Around one in eight, or 13%, of Baby Boomers are caring for other peoples' children (usually their grandies), and Boomers are most likely to volunteer and provide unpaid assistance. Maybe they can afford to with houses paid off, free education and access to superannuation.

Since the Baby Boomers are now 55 to 74, many are either in retirement or thinking about the date. We'd like to find out more about this experience. For those who have reached this stage of their lives, **please share the lessons in our short survey**, and we will publish your insights next week. Is retirement the golden years or a struggle?

The Census also found that 48% of Australians have a parent born overseas and 28% of people were born overseas. We rely on immigration to grow our population, and with it comes a welcome cultural diversity. The largest increase in country of birth since 2016, outside Australia, was India with 220,000, which has moved past China and New Zealand to become the third largest country of birth behind Australia and England. The number of people who used a language other than English at home has increased to over 5.5 million people. Mandarin is the most common language other than English, and the Census reported over 250 ancestries and 350 languages.

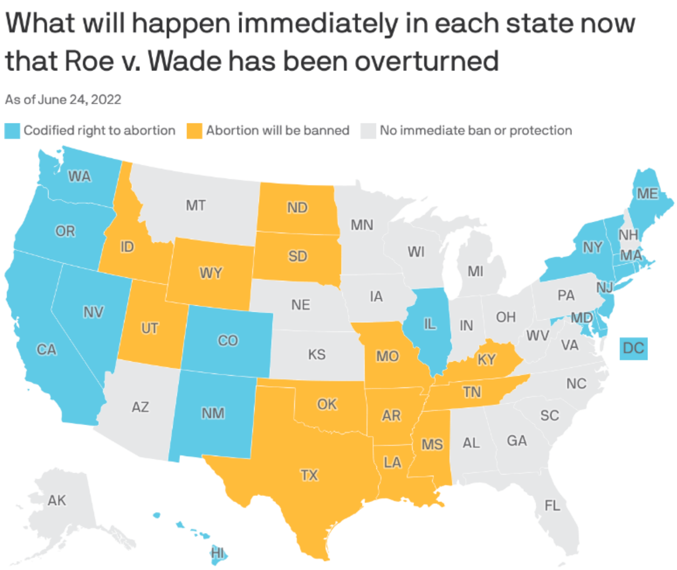
Leading demographer, **Bernard Salt**, writing on the Census this week in *The Australian*, concluded optimistically:

"The lesson for business and government is that there will be no return to normal. The lesson is to read the market, to read the electorate, to understand the drivers of modern Australian thinking. Even from yesterday's high-level data release it is evident to me at least that Australia is being reshaped not so much by individual events but by the quiet determination of the Australian people to create what they consider to be a better version of their nation for the 2020s and beyond."

Another revealing statistic is that the proportion of Australians who selected 'No religion' has risen to 39%, up significantly from 30% in 2016. It is now the second-largest group after Christians, who have fallen from 52% to 44% over the same period. Australia is increasingly secular, and there will be profound implications for our laws and regulations. A Senior Lecturer on law and religion at the University of Western Australia, **Renae Barker**, said of the Census:

"In the five years between the 2016 census and 2021 census, Australia saw a monumental shift in what might broadly be considered moral laws."

This is not an academic point. We can see how divisive moral issues can become, leading to civil rights protests and conflict as people take sides. For example, after the **Roe v Wade** decision by the **US Supreme Court** this week, abortion rights (and potentially contraception and same-sex marriage) will change in many states and the national divide is similar to the red/blue of US party politics. Many commentators are questioning the impact on US democracy of having conservative Supreme Court judges appointed for life, with three of them nominated by **Donald Trump.** He remains the first choice of Republican voters for reelection in 2024. His actions at the 6 January storming of the Capitol look increasingly dangerous and deliberate, as the blog from The New York Times describes:



Data: Axios research; Cartogram: Sara Wise and Oriana Gonzalez/Axios

"Ms. Hutchinson said Mr. Trump knew of the threat of violence by his supporters but was unconcerned by it, since they were not targeting him; and that he sympathized with them as they chanted for the execution of Vice President Mike Pence, who had refused his entreaties to overturn the election. And she testified that senior aides had tried in vain to persuade Mr. Trump to call off the mob, but he resisted for hours. Her testimony was replete with stunning revelations."

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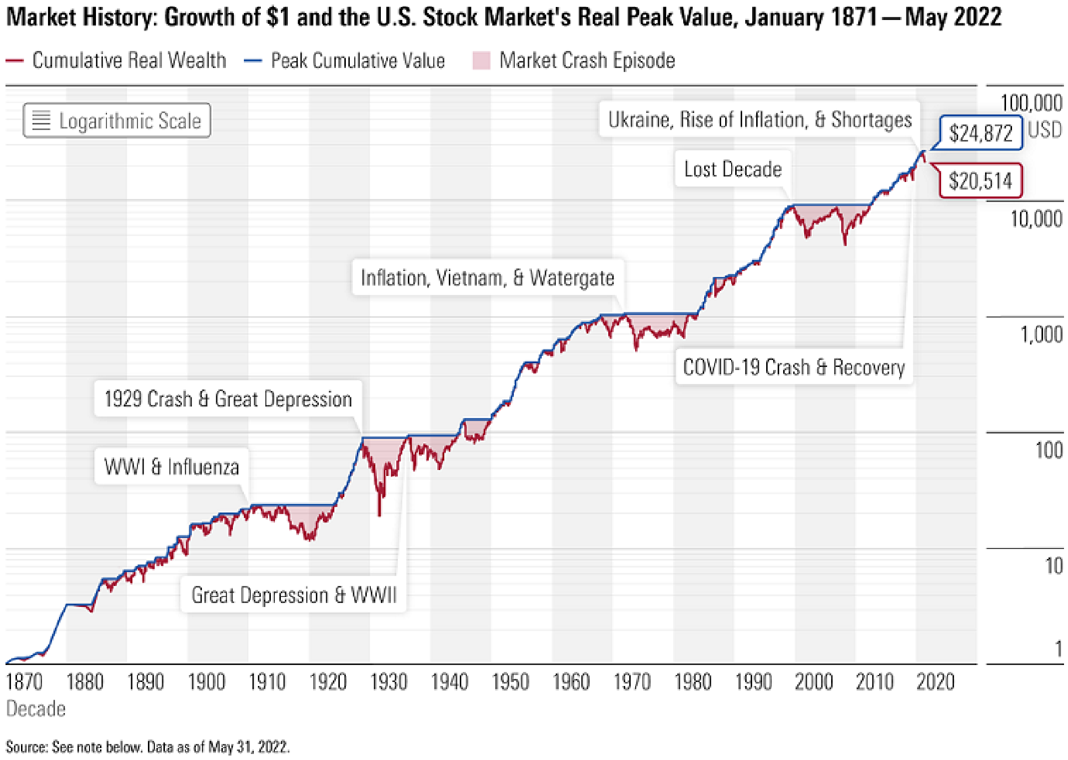
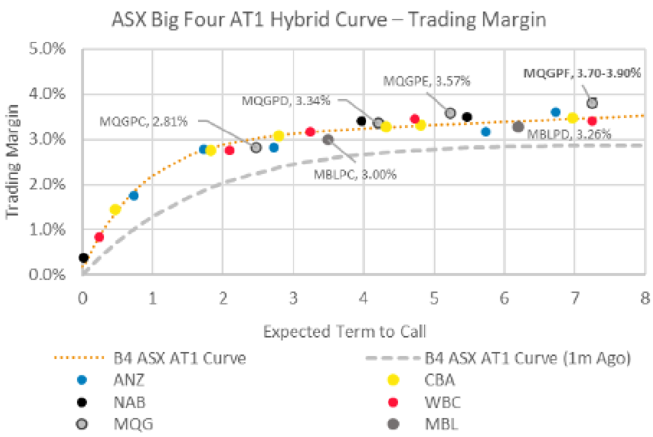
There are always reasons not to invest in shares, but there's no doubt geopolitical risk is on high alert. Optimism about the end of the Ukraine war has been shattered by Russia's attacks on Kyiv this week, and there's little prospect of shipping the desperately-needed Ukrainian agricultural products. Although equity markets, especially in the US, had a strong recovery last week, the market was down about 20% in real terms from December 2021 to mid-June 2022. It's the worst first half since 1970.

This chart (log scale, real returns adjusted for inflation) by **Morningstar** on the US market since 1871 shows the recent fall in context. The 152-year record is littered with bear markets but for the patient investor, the market eventually recovers and goes on to new highs, although sometimes it can take a decade. It's as difficult to pick a top as it is to find a good reentry level.



We wrote two weeks ago about the [fixed and floating bond opportunities]() and new bank hybrids continue to come to the market. This week, **Macquarie** is offering its sixth ASX-listed note, with an indicative range of 3.7% to 3.9% over the bank bill rate. Showing how spreads have widened, the previous hybrid in March 2021 raised $725 million at a 2.9% margin. New issues usually include a small extra premium to compensate for the pricing risk between launch and settlement. The chart below shows where this new note (ASX:MQGPF) ranks against the current trading margins of the Big Four banks and Macquarie's existing issues. There are plenty of hybrids available at these better rates listed on the ASX, but it remains annoying that the new DDO rules deny the opportunity for retail investors to participate at primary issuance stage. It achieves nothing when any retail investor can acquire the same securities on-market.



Source: BondAdvisor

Graham Hand

In our articles this week ...

Tomorrow is the 30th anniversary of the introduction of compulsory super and the Superannuation Guarantee. **Noel Whittaker** draws on his extensive memory and records to show how we ended up with a complex retirement savings system, and the [journey is revealing]().

Paul Keating is not only called the 'Father of Superannuation' but he continues to fly the flag, jumping into the debate whenever a politician tampers with his policy. We [highlight extracts]() from three articles written in Firstlinks in 2013, plus a couple of interviews with him in recent years.

As today is the last day of the financial year, remember we have published two pieces to check on tax for FY21 and changes for FY22.

Our interview this week is with **Eric Marais** from the San Francisco office of **Orbis Investments**, a $A27 billion fund manager specialising in global equities. Eric welcomes the end of companies making profitless promises but it can be a long slog looking for diamonds in the rough.

Catchy phrases like the 'death of 60/40' are easy to remember, require little explanation, and may even seem to have a ring of truth in difficult market environments. **Roger Aliaga-Diaz** writes that such statements ignore basic facts of investing, focus on short-term performance and create a dangerous disincentive for investors to remain disciplined about their long-term goals.

Arian Neiron provides Australian context while refuting the criticism that is often directed at passive investing and ETFs. Is all the talk really just much ado about nothing?

Mark Mitchell invests in investment grade bonds and he explains what has happened to credit spreads and rates and whether it's time to jump in after a bond sell off. Another source in the money markets tells me funding conditions for banks have been tight in the run up to 30 June which may have increased upward pressure on rates. However:

" ... from 1 July onwards period where tight financial conditions will ease when a flood of Federal Government budget appropriations flow and probably $30b of tax refunds drop into Australian bank accounts in the first 60 days of July/August and household savings may ratchet up from $280b to >$300b."

So he sees funding relief ahead for banks, which may temper their desire to pass rising rates to retail investors.

This week's White Paper from the **Franklin Templeton Institute** discusses the importance of casting a wider net for income generating assets in the current financial and economic environment.

Farewell **Leigh Sales** from **ABC's 7.30** after 12 years of dedicated reporting. Tonight is her final episode. Leigh and 7.30 are not only part of my nightly routine but I have seen her working in budget lockups where she was doing her own research and writing notes for hours. No doubt there has been a team supporting her but she is a talented professional journalist and presenter and I look forward to seeing her in other programmes. Well done on a top innings, Leigh, and welcome **Sarah Ferguson**.

Superannuation: a 30+ year journey but now stop fiddling

Noel Whittaker

We are now celebrating the 30th birthday of compulsory superannuation. Of course, the origins of super go back much further. When I resigned from the bank in 1964, I received a cheque for the money in my bank pension fund. It was quite a small amount, it wasn't preserved, and it was quickly spent.

Before compulsory super

Today in Australia, every employee should be a member of a superannuation scheme, but it was not always like that. Until the early 1980s, superannuation tended to be restricted to white-collar male career workers such as public servants and bank officers. In those days, few women worked after marriage and most men stayed in one job for life. However, super gradually became a significant industrial issue as unions campaigned against the disparity between blue-collar and white-collar workers and their conditions.

In addition, superannuation was used by aggressive tax planners as a tax rort. They established superannuation schemes that were designed to minimise tax rather than provide benefits to employees. Typically, the employer, usually a small business, would make a large tax-deductible contribution to his own superannuation fund and then lend the money back to the business at a tiny rate of interest. The fund suffered and in many cases was unable to pay adequate retirement benefits.

Until 1983, superannuation was an investor's paradise. There was no tax on contributions, no tax on fund earnings and they paid less than 3% lump sum tax on the end benefit. Obviously, the rules then were simple and the tax concessions gave an incentive to place money into superannuation. However, at the same time as they were legitimising superannuation, the Hawke Government raised the tax on retirement payments to 30% to bring them into line with the tax on long service leave.

But the Hawke-Keating Government did much more than simply increase the exit tax to 30%. They also introduced a concept that was unknown in Australia until 1983. To encourage retirees to hold on to their superannuation and not cash it and spend it, they brought in 'rollover funds'. If you rolled your superannuation into a fund such as an Approved Deposit Fund (ADF) or a Deferred Annuity (DA), you could defer payment of the exit tax and leave your money in what was then a zero-tax environment. Of course, this appealed to retirees and rollover funds grew at a great rate.

Raising the tax on superannuation payments tenfold from 3% to 30% may have been a good thing for government coffers but it hit one group particularly hard: airline pilots. They received high salaries and large superannuation payments. They retaliated by banning all flights in and out of Canberra until the government backed down.

A confrontation followed but finally a compromise was reached. The pilots agreed to lift their blockade if the government took away the retrospective nature of the new tax. The government said yes but, in doing so, created the first of the complications in the superannuation system.

The portion of the superannuation payment that related to pre-1983 service continued to be taxed at the old low rate. The portion that related to service after that date (called post-1983 service) was taxed at the new higher rate. This is where the terms 'pre' and 'post' come from.

In 1988, the then Treasurer Paul Keating suddenly realised that he had introduced one of the most unpopular taxes in history, and yet would receive little benefit from the higher tax as most of the money would be collected by future governments.

The move to the current system

How did Keating solve it? Simple. He chopped the 30% exit tax in half and promptly made up the loss by levying a 15% tax on contributions. The change made no difference to the final payment but it gave the government of the day a large and growing income. It also reduced the impact of separating the exit tax into pre and post 1983 components because a tax on contributions enjoyed no such concession.

It was a financial win for the government but Keating still had more revenue raising work to do. He also added a 15% tax to the income of the superannuation fund itself.

In just five years the taxes on superannuation had gone from nil on contributions, nil on earnings and less than 3% on the final payment to 15% on contributions, 15% per annum on fund earnings and 15% on the end benefit.

In 1991, the Superannuation Guarantee (SG) was introduced and legislated in 1992. The compulsory superannuation system ensured Australian employers paid their employees’ super, boosting super coverage to 80% by 1993. Super coverage continued to rise from the 1990s, and in the 2000s, Australians were able to choose their own super fund, and were given the opportunity to transition to retirement. The SG will increase to 10.5% from 1 July 2022.

Complexity creeps in

As superannuation enables people to move assets into a low tax environment, there has long been debate as to how much should be allowed. Until 1994, it was governed by a complicated formula based on your average annual salary and your length of service. It was horrendously complex and on 1 July 1994, new simplified rules were introduced which included the concept of a Reasonable Benefit limit (RBL) which governed the amount that could be held in a superannuation or a rollover fund without penalty. From that date, everybody was allowed a lump sum RBL of $400,000, and a pension RBL of $800,000. The figures were indexed to AWOTE so they grew substantially over time.

In 1996, the Coalition went to went to the polls guaranteeing no changes to superannuation, but within weeks of winning government, Howard split his promises into 'core’ and 'non core' thus giving a whole new dimension to politicians’ promises.

It didn’t stop there. Just one day before the August 1996 Budget, Treasurer Peter Costello appeared on national television repeating the promise that there would be no changes to superannuation. Next day he announced a 15% surcharge on contributions, and justified it on the grounds that the well off should make a contribution to solving the nation’s problems. The result was a loss of confidence in the integrity of the superannuation system. It was a most unpopular measure and after pressure from all sides, it was reduced to 12.5% in 2003 and abolished on 1 July 2005.

Capping contributions to manage benefits

Far-reaching changes were announced in the May 2006 Budget. Non-concessional contributions went from being limitless to limited, Reasonable Benefit Limits were abolished, exit taxes for the over 60s were abolished (except for members of unfunded funds), and there was no longer a requirement that you start withdrawing your money from super at age 65. Tax deductible contributions were limited to $50,000 a year with some transitional measures. Those who could pass the work test were allowed to make tax deductible contributions till age 75. It made superannuation an even more attractive vehicle, but it did prove that change is always with us.

The concept of super had changed. Instead of limiting end benefits, rules were brought in to cap contributions.

As superannuation funds grew, some claimed it was unfair that wealthy individuals could have $5 million or more in a zero or low tax environment. Various solutions were bandied about, but in 2017, the Turnbull Government bit the bullet and announced that the maximum amount that could be transferred to the zero tax pension environment would be $1.6 million. It was known as the Transfer Balance Cap (TBC). Many people were confused about the concept, and there was wide belief that $1.6 million was the most anybody could hold in pension mode. That was wrong - it was the most that could be transferred to it - the balance could grow provided the mandatory annual pension withdrawals were made.

Large balances paid out of super on death

Those worrying about large balances should take into account that most people with large balances are older retirees who have been investing through superannuation for a long time. As they die, their balances can only be paid in cash, or in some cases their pension will revert to a spouse or a dependant. As the pension amount is limited by the TBC (less any drawdowns), a huge amount of money will leave the superannuation system over the next 10 years.

Continual change has been part of our superannuation system and many of these changes have been reasonable and have improved the system. We have tighter limits on contributions that will restrict the future growth of very large superannuation balances but we also have many layers of complexity that most people do not understand. The challenge now for all parties is to preserve the status quo and to refrain from further major changes. Australia needs everybody to trust the integrity of the superannuation system.

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. See www.noelwhittaker.com.au or email noel@noelwhittaker.com.au. This article is general information and does not consider the circumstances of any individual.

Survey: share your retirement experiences

Firstlinks

About 700 Australians retire every day. How will they spend their time? Does retirement meet their expectations? How much income do they need? Did they transition away from full-time work? Do they have any tips for someone thinking about retiring?

A few weeks ago, a reader, Alex wrote a comment on an article about retirement:

"Some day, I'd like to hear more about what people actually do in retirement. What replaces 10 hours a day of work?"

We received several responses, such as Mark:

"You can play 3 rounds of golf or more, swimming, walking, dine out, rowing on local lakes, travel for $2 anywhere on govt transport after 60, travel overseas, cruising, meeting friends, cycling, donate time for charity work, etc. Many things to do Alex. Especially after working from the age of 15 it is my free time now to enjoy."

We thought we should learn more, especially at the time of the 2021 Census released this week and the end of the financial year, when many people retire.

As every retirement is different, it is not easy to frame the questions to apply to each person, so some generalisations are needed. For example, we ask about couples when many people live alone in retirement.

But with these limitations, if you are retired, please take a moment to complete our short survey, and perhaps guide others into what to expect in retirement. Results published next week.

Complete the survey via this web link

Time for value as 'promise generators' fail to deliver

Graham Hand

Eric Marais, CFA, is an Investment Specialist at Orbis investments. He joined Orbis in 2013 and is a member of the institutional client servicing team and retains portfolio responsibilities in the investment team. He spoke to Firstlinks from his San Francisco office. The Orbis Global Fund started in 2005 and holds A$28 billion including $2.5 billion in Australia.

GH: The strong growth market between 2018 and 2021 didn't suit the Orbis style but relative performance has improved in 2022. How do you read the current market conditions for your Global Equity Fund?

EM: Yes, it's definitely better. We've seen some recovery of value shares versus growth. What is less talked about is that over the last 10 years, most of the returns in the global index have come from the US. And we've been underweight US for some time because we found better value outside of the US as bottom-up stock pickers. So, in addition to value, the other thing that's changed recently is the US underperformed a little.

(Editor's note: 'Value' investors typically look for shares trading below their estimated intrinsic value, or companies which look inexpensive on metrics such as low multiples of their profits or assets).

GH: It's been amazing to watch many US companies that did so well in those years up to 2021 are now down so much. About 300 of the Russell 3000 companies are down 80%, not just 20% or 30%, well-known names such as DocuSign and Rivian. And Amazon is off 30%, Meta 50%. Are you seeing any value in the tech or disruptor space now they have fallen so much?

EM: Yes, in technology broadly defined. With some stocks you simply can't argue that they are expensive anymore – a company like Alphabet that's very profitable, very cash generative, growing much faster than the market, yet trades at a P/E multiple slightly above market level. On the other hand, the Rivians of the world have unproven businesses that received funding.

GH: And despite building hardly any vehicles …

EM: Exactly. The last decade, with its ultralow interest rates, was a perfect funding environment for speculative business models. Many of the stocks that are down by as much as 90% have never generated $1 of free cash flow. It's hard to argue they are cheap despite the sell off. Who knows how those business models will pan out? I'm sure there will be a handful of great stocks in there but the average or median stock will not be great.

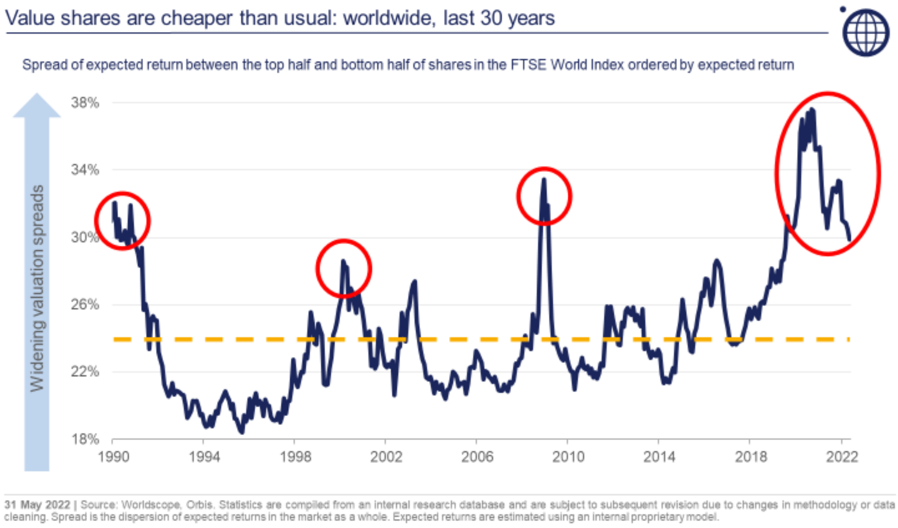
We distinguish between 'promise generators' like the Rivians of the world versus 'cash generators' which are real cash-generating tech companies that trade on reasonable multiples today. They're starting to look more attractive. We constantly compare them to the rest of the investible universe but less so the unproven 'promise generators'.

GH: Your Global Fund allows up to 25% in emerging markets. It's a sector that always seems to have potential but rarely delivers. Has it been a disappointing experience for Orbis?

EM: Lately, yes, but if we take a step back, while buy-and-hold hasn't done well in emerging markets, the returns during recoveries from global crises have been better. We don't buy regions as a whole - just a handful of stocks.

However, our Chinese shares have suffered in the last year from China's 'common prosperity' move. One of those, our investment in Naspers, gave us discounted exposure to Tencent so you can see the appeal for a value-oriented contrarian manager. However, that discount has gone even wider in the last year to well over 60%. We're still excited about its valuation, we still own it, and it's recovered in recent weeks but we needed to balance the bottom-up view against China country risks. We reduced the position size over the last year to reflect that, which is the most painful thing a contrarian manager can do.

GH: How do you balance such big macro themes, like China, with the merits of individual companies?



EM: We invest bottom up so we almost always start with the specific company first, and look at what has done poorly. Allan Gray, our founder, said that when looking for stock ideas, you should forget about the best-performing half of the market and focus on the worst-performing half over the last five plus years. That's where our contrarian approach comes from, where we've seen something going wrong. Then we marry that with macro in our risk process because we know big macro risks can impact the whole portfolio.

Value shares still look cheap to us, although they were probably cheapest this time last year. One of our internal measures tells us that it's still on par with every extreme except the height of Covid.

GH: Last time I spoke to Orbis, in August last year, the only Australian company in the Global Fund was Newcrest. Why does Australia rank so low?

EM: We now own Woodside as well. We have about 3% of the Fund in Australia, or a little more than the global index. The simple answer is that we have a wide opportunity set of about 5,000 companies we can invest in, and we find stocks that are more appealing to us. For example, we also own Shell but an Australian investor might only consider Woodside.

GH: You've been underweight US stocks, do you expect that to change in future?

EM: It is a significant underweight of about 20% or so versus the weighting in the global index. Another way to look at it is that we're underweight technology shares which make up much of the US weight in the global index. So our view is more about the companies than the country and where we find value.

GH: When you talk to clients, how do you explain your contrarian style? Isn't an emphasis on unpopular companies a difficult story to tell, with the cyclical underperformance that comes from it?

EM: We're not contrarian for its own sake. We believe that to outperform the market requires a meaningfully different portfolio from the market by doing something different. Adam Karr (President and Head of Investment Team) likes to say "*It works because it hurts*". We think this is the way to outperform, but it can be challenging to an individual investor's psyche and not everyone can do it. The firm also needs the right structural elements that allow us to execute the investment philosophy. For example, we are privately held and employ refundable performance-based fees. Our clients are well-aligned and understand our approach.

GH: So do you need a certain type of personality to be an Orbis Portfolio Manager?

EM: I think so, yes. They need to think independently and be willing to look wrong for extended periods of time. Investing our way will go against you, and if you start to feel uncomfortable, that will affect your decision making. A huge amount of our value add comes from sizing up during times when stocks have performed poorly so you want to be in a mental position to lean into things that have done poorly to maximise the benefit when they recover.

GH: A mix of humility and resilience.

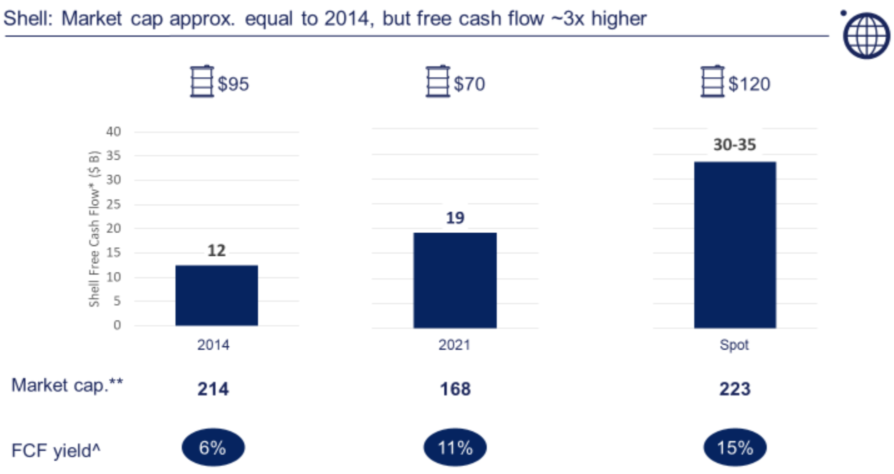
EM: That's a good way to put it.

GH: Is there a stock in your portfolio that you're so confident about that you would expect to own for say 10 years?

EM: 10 years is a big commitment. Outside of marriage and children, I'm not sure I'd go that far. NetEase is an example that we've owned continuously for maybe 12 or 13 years. Another longstanding holding is XPO Logistics, which spun off GXO in 2021 and we continue to own both companies. A major reason is that they are run by owner-operators, such as William Ding at NetEase and Brad Jacobs at XPO. XPO is Brad's third public company. We'll watch it carefully if he goes for number four.

GH: Final question, is there a theme where you're seeing good opportunities?

EM: Although energy prices such as oil and natural gas are high, we don't think company share prices are valued highly enough relative to normal energy prices, and certainly not relative to spot energy prices. For both Woodside and Shell, we estimate they are trading in the ballpark of seven or eight times free cash flow. That looks very attractive compared with their growth prospects which could justify a low teens multiple of free cash flow. We can have a debate about the sustainability of spot prices, but the free cash flow of around 15% is being returned to shareholders, not reinvested in the ground to increase supply. It's a good setup for shareholders, even if spot prices are not maintained forever.



31 May 2022 | Source: S&P Capital IQ, Orbis. *Defined as Cash Flow from Operations less Cash Flow from Investing, excluding asset sales, in USD billions. **Market capitalization, as of last day of indicated year, in USD billions. Spot is 31 May 2022. ^Defined as stated free cash flow divided by stated market capitalization. Oil prices shown are approximate averages over last 12 months for indicated years (aside from spot), using brent crude prices in USD.

Graham Hand is Editor-At-Large for Firstlinks. Eric Marais is an Investment Specialist at Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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Paul Keating's long-term plans for super and imputation

PJ Keating

It is 30 years tomorrow since the introduction of the Superannuation Guarantee which entrenched retirement saving into the plans of the majority of Australians. The $3.4 trillion pool is expected to increase to $10 trillion by 2040, or around 200% of GDP.

In 2013, we published three articles by former Treasurer and Prime Minister, Paul Keating, considered the principal architect of compulsory super. It is a valuable record of Keating's thoughts, and we have selected highlights from the articles plus two recent interviews.

We're living longer and so should our superannuation

7 February 2013

Our retirement income system is built on three pillars:

- the means and asset tested age pension
- compulsory superannuation
- tax-assisted voluntary superannuation.

The big leap forward came with occupational superannuation which morphed into compulsory superannuation with the introduction of the Superannuation Guarantee Charge (SGC) in 1991 and its extension to universality in 1992. That change was a defining one for Australia because few democracies can encourage their workforce to save at least 9% of their wages and even more on top of that voluntarily. But Australia did.

But it is now clear that the current system does not provide enough because people are living longer now than when my Government created the scheme for them. We built something that took people from age 55 to 75, but these days, if you reach 60, you have a reasonable likelihood of getting to 85. And the numbers continue to change materially with every decade that passes.

So, we have two groups in retirement – a 60 to 80 group and an 80 to 100 group. The 60 to 80 group is all about retirement living and lifestyle, which I think the current superannuation system adequately caters for. But the 80 to 100 (which is technically, the period of life beyond the previous life expectancy) is more about maintenance and disability and less about lifestyle.

I don’t believe the current system caters for this. The policy promise of a good retirement cannot be fulfilled with such longevity, and so, the promise has to change.

While I believe that private enterprise has been the appropriate outlet to provide for products and services for our country’s compulsory superannuation system (and I have never been in favour of government mega-funds of the European variety), I do think deferred annuity structures are a different kettle of fish.

A government-administered, universal, compulsory deferred annuity scheme would be a fully-funded scheme, with the capital provided by the annuitant from a portion of their lump sum superannuation benefit. This would mean that if there was any shortfall in the actual assets set aside and the liability due to the annuitant, the government would fund the gap. However, careful asset management with a long term horizon should ensure that any such shortfall should, over time, be insignificant.

I am still of the view that the compulsory superannuation component should increase further beyond the 12% level. If the compulsory superannuation charge was increased from 12% to 15%, it would provide more options to adequately provide for the final phase in life, rather than relying on the age pension.

Where did SMSFs come from, and where are they going?

15 February 2013

When we laid the foundations for the current superannuation system in the 1991 Budget, I never expected Self Managed Super Funds (SMSFs) to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes.

Employer contributions to superannuation rose from 4% of salaries in 1992-93 to 9% by 2002-2003. I wanted to reduce the future reliance on the age pension, and over time, give ordinary people a better retirement. Back in the 1980s, only wealthy people were in the stock market, but I felt mums and dads should be able to share in the bounty of the wealth of the nation. Owning a home was fine but they needed more. And through superannuation funds, everyone is now in it, and it’s been good for both investors and the nation.

The wealth would address the growing economic problem of an ageing workforce, and realign the mix between capital and labour through labour contribution to real capital growth. Very few countries have developed an adequate retirement income system with no ‘false promise’ in such a universal way, leaving the age pension – an income and asset tested pension – as an anti-destitution payment, which ceases when the recipient dies.

So the SGC was not introduced as a welfare measure to supplement the incomes of the low paid. It was principally designed for Middle Australia, those earning $65,000 to $130,000 a year, or one to two times average weekly ordinary time earnings (AWOTE). This is not to say that those on 50% or 75% of AWOTE should not benefit equitably from the superannuation provisions. They should. But for Middle Australia, the SGC and salary sacrifice was and is the way forward.

At an SGC of 12% and tax arrangements as now, someone on one to two times AWOTE plus adequate salary sacrifice limits should be able to secure a replacement rate in retirement income of around 70% over a 35 year working life.

I mention this to provide context commentary on the rapid growth of SMSFs. As a general statement, I believe people's expectations as to rates of fund returns are too high. The Australian superannuation system is both large in world terms and large in absolute terms. It is simply too large in aggregate to consistently return high single or double digit returns.

I am certain expectations as to returns and the search for yield have done two things:

- managers have adopted a higher risk profile in portfolios, and
- lower returns than expected have soured expectations, encouraging more people to take the initiative and manage their own assets, including taking on the trustee role when setting up an SMSF.

I believe returns expectations are inflated and those expectations lead to incentives to drive higher fees for managers, but at much higher risks, as was the case between 2002 and 2011. We only have to look at asset allocations. At December 2011, total Australian super assets were weighted:

- 50% to equities
- 18% to fixed income
- 24% to cash and term deposits
- and the rest across other asset classes including property.

By contrast, the average weighting of OECD country pension assets was:

- 18% to equities
- 55% to fixed income
- 11% to cash and term deposits
- and the rest to other asset classes including property.

So, Australia is 2.5 times more heavily weighted into equities and relatively underweight in other asset classes. We are disproportionately weighted into the most volatile and unstable asset class.

The question is – how does this weighting work to deliver the key objective of the system? 60% of total superannuation assets are held by investors over the age of 50. A large proportion of these assets should be moving towards less risky, more stable asset classes, protecting capital ahead of the retirement phase. When we reach the point where outflows are increasingly matching inflows, the weighting to equities needs to be rectified.

How many SMSF investors are competent in matters of asset allocation and general investment savvy? This becomes a real problem for the SMSF system and its deliverability as it occupies an increasingly higher proportion of overall system assets.

For systemic prudential reasons, investment in stable asset classes, such as government bonds or higher rated corporate bonds, could be desirable for SMSFs. That is, perhaps some form of minimum investment will be required which is mandated to mitigate downside risks. As the system reaches the tipping point, where inflows are increasingly being matched by outflows, it will need to be monitored for capital adequacy risk.

Dividend imputation and superannuation are worth fighting for

22 February 2013

Before I became Treasurer, company income in Australia was taxed twice: once at the company rate, at the time 46%, and then the dividends were taxed at the top personal rate of 60%. On $100 of company income, this left only $21 in the hands of the taxpayer!

In 1985, I changed the system completely and removed the double taxation of company income by introducing full dividend imputation. This meant that company income would only be taxed once. And this concession was reserved for Australian taxpayers.

People should understand that for Australian taxpayers, the company tax is broadly a withholding tax. The government collects it at the 30% rate on company income – and temporarily hangs onto it – before returning it to shareholders (including local superannuation funds) in the form of imputed credits.

In other words, when a company issues its dividends on a fully franked basis, it hands back the company tax paid earlier and staples it to the dividend.

This is my point. If the company tax rate is reduced from 30%, the principal beneficiaries will be foreigners, those who do not qualify for imputation credits. A reduction in the 30% rate, to say 25%, will diminish the value of dividends paid to superannuation funds and self-funded retirees. Such a move would effectively increase the rates of tax applying to superannuation.

Dividend imputation revolutionised capital formation in Australia. The Treasury was uncomfortable with it because of its cost to revenue, and about every seven years it promotes a debate to remove it.

Superannuation is about de-risking the future. In the system I set up, people were encouraged to salary sacrifice in later life, when mortgages had been paid off and they had discretionary income. Under that policy, people could salary sacrifice up to $100,000 a year when over 50 years of age. I believe the current limit of only $25,000 is too low, certainly for those over 50.

This is where long term vision is important. While the government and the Treasury would see an increase in permissible voluntary contributions as a cost to the Budget in revenue forgone due to reduced tax revenues today, such increased limits would provide the government with certainty in the later years by reducing its future funding obligations. This was one of the original intentions when the foundations for the current superannuation system were laid over 20 years ago.

Interview with Leigh Sales following the release of the Retirement Income Review

23 November 2020

LS: What would you say to an Australian who said to you, "I get what you're saying about needing money for my retirement, but I need money right now because I've got rent to pay, I've got kids and it's my money. Why shouldn't I have it now if I want it and let later worry about later?"

PK: The Report gave the answer. It said for every $10,000 allowed out in the early release programme for someone in their 30s, it costs them $100,000 later. It's a tenfold increase leaving it in because of the compounding. So, we're talking about a half a percent, on 1 July it goes from 9.5% to 10%, the half a percent is eight dollars a week, two cups of coffee. For two cups of coffee, people are supposed to walk away from their future.

And of course the other thing the Libs are up to is in the Report. I'll just read this to you. "If the SG rate remained at 9.5% and people made more efficient use of their retirement savings, many would have higher replacement rates than they would have under the SG at 12%." And what they mean by that is accessing home equity. So, the idea is this. You can do better than 9.5 but you got to eat your house by reverse mortgaging your house.

LS: People now tend to live off their investments and when they die they have their house and they have most of their super which they then pass on to their kids. Doesn't it bake in inequality because if you are rich then you've got an asset to pass on your kids but if you're poor and you actually have to run down your savings, then your kids get nothing.

PK: Well, you can't blame the system, poor people have all sorts of choices. But the idea that a Report endorsed by the Government is putting about is that you don't pay more than 9.5% but you should start reverse mortgaging your house. In other words, give the kids nothing, eat the house, and then you don't have to go above 9.5%. Now, just remember this. There's been no increase in real wages for eight years now. There's been a 10% improvement in labor productivity and the legislation for the super is passed. People have earned the superannuation, they've earned that 2.5%, the employers are going to pay it. And today the stock market was 6,500 on the index because the wage share of GDP is falling and the profit share is rocketing. So that's why.

[Conference run by Industry Super Australia](#)

4 August 2020

"It is a breach of the preservation rules to just let anyone take out their money willy-nilly. There has been no scrutiny whatsoever ... The whole point of superannuation was a great public bargain with the community: defer consumption for your working life and you will get a very low rate of tax."

Keating argued that much of the money was probably spent on discretionary items such as cars, boats and motorcycles, and the long-term savings of young Australians are now compromised. As others have argued, the people who needed money could have been protected by the right fiscal policy:

"Every dollar which came out of young peoples' super balances could have been funded by one press of the computer button at the Reserve Bank."

Hon Paul Keating was Treasurer of Australia between 1983 and 1991 and Prime Minister between 1991 and 1996. This article is general information.

On interest rates and credit, do you feel the need for speed?

Mark Mitchell

There are many apt analogies explaining the ways central banks supported financial markets all the way back to the GFC until last year and how that process is reversing. We can choose from removing the punchbowl, hitting the brakes or taking the wind out of the market's sails, but I'll go with a reference to one of the best series of all time and say winter is coming (if not already here).

There have not been many safe havens in the traditional asset classes over the last 12 months, but where does that leave us today? Is the worst behind us or is there more to come?

What are credit spreads?

As an unconstrained investment grade bond fund manager, most of the risk in our portfolios is driven by the change in the general level of credit spreads. Credit assets (ie non-government) trade at a margin above the risk-free (government) rate. This margin compensates investors for the increased risk associated with lending to an institution with greater default risk than the government. The difference between government risk pricing and corporate risk pricing is referred to as the credit spread. Generally speaking, the riskier the borrower the wider the spread demanded over the risk-free rate. For example, in the current market five-year A-rated assets are trading around 1.50% above the government bond curve while BBB-rated assets are trading about 2.10% higher (or 0.6% more).

From an investment perspective, when markets get nervous or more pessimistic about the outlook, the credit spread or risk premium demanded tends to increase. This is similar to equity markets selling off to compensate for lower expected earnings or a reduction in the multiple investors are willing to pay for a dollar of earnings.

These wider credit spreads in bond markets push down prices and can result in short-term losses. However, there is a critical difference between a correction in the bond market and those in the equity markets. Bonds are a contractual obligation to pay money back at a certain time at an agreed price. Equities have no such contractual obligation, so when equity markets go down there is no guarantee you will recover those losses. However, any near-term loss in performance of fixed income assets is contractually guaranteed to be recovered as long as the issuer doesn't default.

The following table provides an example of this. A near-term selloff results in short-term losses but then a higher forward expected return over the life of the bond. This example applies to bond funds as well. For example, the Daintree Core Income Fund has had multiple negative monthly returns due to the credit spread widening. However, if we were to reset the portfolio to normal risk-on positioning today the forward expected return on the fund would be much higher.

In this example, a five-year bond is bought at issue for 100 with a 3% annual coupon. At the end of the first year, rates have risen to 4% and the price has fallen to 96.34. The price loss is 3.64% less the 3% coupon to give an annualised return of -0.64%. But importantly from that point forward, the expected return of the bond is much higher resulting in an attractive entry level. Over the life of the bond, rates and prices change but the bond delivers the expected return (compounded to reflect the semi-annual coupon).

Point in time	Yield to Maturity	Bond Price	Coupon	Price Return	Total Return	Cumulative Annualised Return
At issue	3.00%	100.00	3.00%	-	-	-
First year	4.00%	96.34	3.00%	-3.64%	-0.64%	-0.64%
Second year	3.75%	97.89	3.00%	1.64%	4.76%	2.02%
Third year	3.50%	99.04	3.00%	1.20%	4.27%	2.76%
Fourth year	3.25%	99.76	3.00%	0.75%	3.78%	3.02%
Maturity year	3.00%	100.00	3.00%	0.27%	3.28%	3.07%

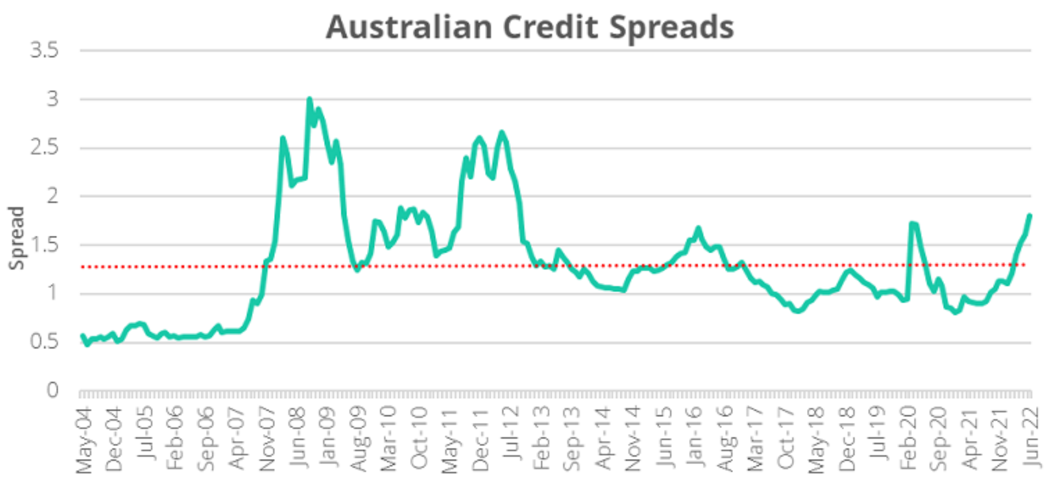
Source: Daintree. Modelled price and returns of a five-year semi-annual coupon bond through its life. Coupons are re-invested at the average of the yield at the start of the period and the yield at the end of the period.

Where are credit spreads likely to peak?

There are lots of academic studies which show that humans are usually terrible at forecasting. We suffer from all sorts of biases and are often overconfident in our conclusions when we have a little bit of knowledge or experience. At Daintree, we remain humble about our ability to forecast. The future is unknowable, but at the same time we must make investment decisions today with imperfect and incomplete information. Therefore, we need to have a view but also allow for a wide margin of error.

Consider the chart below which looks at the average Australian investment grade credit spread going back to 2004:

1. While spreads have widened over the past 16 months, they are only modestly wider than the average level over this period.
2. Spreads are still well below the levels reached during the GFC crisis in 2008-2009 and the European sovereign debt crisis in 2011-2012.
3. Spreads are now just slightly above the levels seen during 2015-2016 commodity weakness as well as the COVID crisis in March 2020.



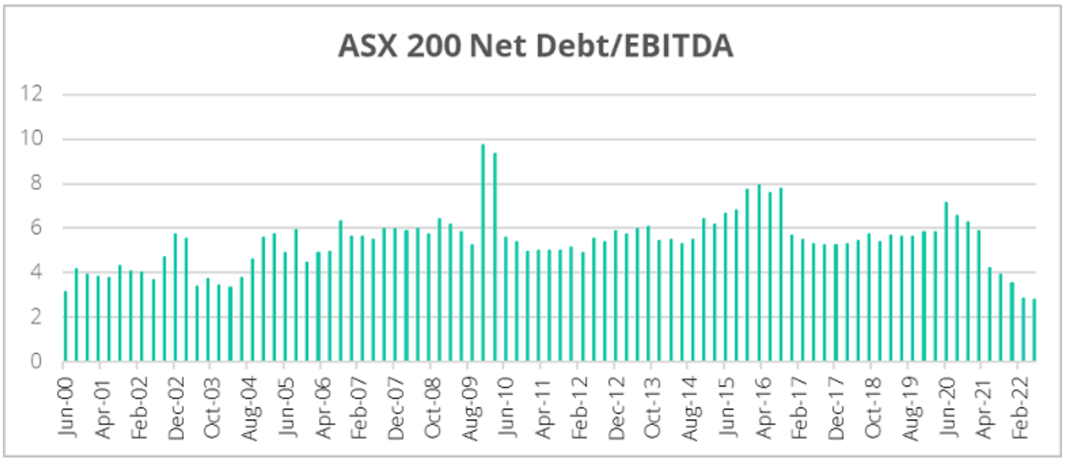
Source: Bloomberg

So, this begs the question, how much further could they widen? It seems reasonable to conclude that short of a large tail event (such as Russia expanding its aggression into Europe) that spreads are not likely to reach the wide levels seen in the GFC or the European sovereign debt crisis.

Our justification for this view is based in-part on increased financial system resilience and improvements in corporate balance sheets:

- Despite the fact that monetary accommodation is being reduced, global central banks remain much more supportive of financial stability than during the GFC. Structurally, liquidity in credit markets is significantly better than it was then and banks are much better capitalized

- Australian corporations in general have done a good job improving their financial position over the last few years. The chart below shows a material improvement in the average amount of net debt of companies in the ASX200 index relative to cashflow (approximated by EBITDA).



Source: Bloomberg

On the flip side, markets have not had to contend with the extraordinary levels of inflation we are now seeing for many decades. There will be pain as central banks begin to remove accommodation and work to reduce inflation. We have been expecting a correction in Australian credit spreads toward a range of 1.75% to 2.25%. The market is currently around the low end of our estimated range, and therefore on balance we believe there could be more spread widening to come but we do feel the vast majority of the repricing has already occurred.

What about interest rates?

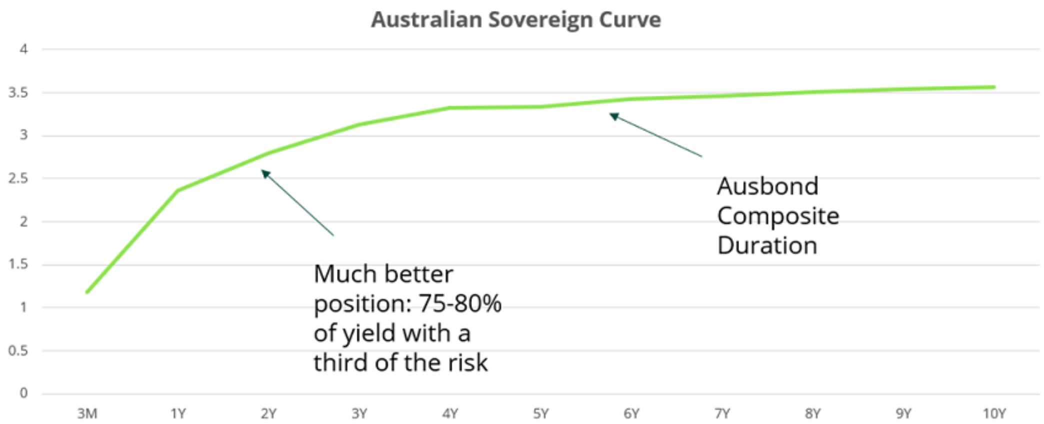
Most people in the market have been telling us they have been underweight interest rate duration (that is, not investing in long-term fixed rate bonds) for a long period of time and given the increase in government bond yields, they are now wondering if this a good opportunity to start adding duration back into their portfolios.

There are three things to consider.

First, in a high-inflation environment, historically the correlation between government bonds and equities has tended to be positive, meaning they sell off at the same time. Adding government duration to hedge out modest equity corrections may lead to disappointing results.

Second, adding long duration government bonds purely as a hedge against significant tail events (such a world war) does make sense in our view. Our suggestion would be to find the cheapest long duration government bond index fund for a portion of a diversified portfolio.

However, **thirdly,** if fixed income is viewed purely as a defensive allocation which earns a modest income and minimises capital volatility, allocating to a fund that mirrors a simple index such as the Ausbond Composite index is sub-optimal. To illustrate why, consider the chart below which shows the shape of the Australian government bond curve.



Source: Bloomberg

By buying longer-dated assets, expected returns are increased but there is no free lunch. These assets come with greater interest rate risk, meaning changes in underlying interest rates result in larger changes in bond prices. We believe a focus on the 1.5-2.0-year part of the curve makes more sense. Investors can pick up about 75-80% of the yield available while only taking on about a third of the interest rate risk embedded in traditional Ausbond Index-type products. Investors should either target shorter-duration funds or choose funds that have flexible mandates to increase interest rate duration in a more optimal way when it makes sense to do so.

In the danger zone?

Where does all this leave us in the current environment? Is it time to load up on risk or sit on the sidelines? We are in the latter camp for now. While risk asset markets have corrected a fair bit, on balance it feels like there is still more to come. Central banks are still early in the process of removing accommodation and even they don't know how far they are going to have to go. If inflation proves challenging to tame and central banks err on the side of dampening inflation at the expense of growth, there could be a rough period ahead for financial markets.

Mark Mitchell is Managing Director of Daintree Capital. This article does not take into account your investment objectives, particular needs or financial situation and has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation.

Death notices for the 60/40 portfolio are premature

Roger Aliaga-Díaz

Periodically, pundits declare the death of the 60% stock/40% bond portfolio. Their voices have grown louder lately, amid sharp declines in both stock and bond prices. But we've been here before. Based on history, balanced portfolios are apt to prove the naysayers wrong, again.

Approaching the midpoint of 2022, market, economic, and geopolitical conditions all appear fraught. Inflation is hitting 40-year highs, the US Federal Reserve is sharply reversing monetary policy, the pandemic hasn't gone away, and supply chain woes have been exacerbated by COVID-19 lockdowns in China and Russia's invasion of Ukraine, with the latter putting the Western bloc the closest to a war footing in decades.

Not surprisingly, this perfect storm of negative market drivers has pushed stock and bond prices south in lockstep, impairing the normal diversification of risks in a balanced portfolio.

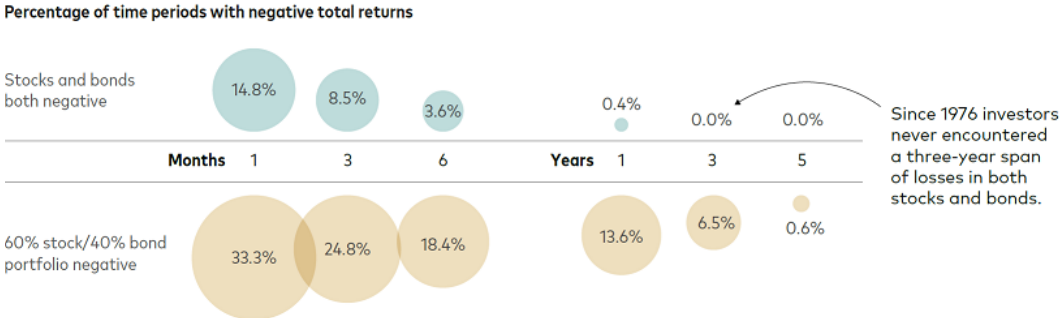
While the chart below focuses on U.S figures, the underlying theory still holds for financial markets globally.

Stock-bond diversification in historical context

Brief, simultaneous declines in stocks and bonds are not unusual, as our chart shows. Viewed monthly since early 1976, the nominal total returns of both U.S. stocks and investment-grade bonds have been negative nearly 15% of the time. That's a month of joint declines every seven months or so, on average.

Extend the time horizon, however, and joint declines have struck less frequently. Over the last 46 years, investors never encountered a three-year span of losses in both asset classes.

Historically, stock-bond diversification recovers within a few months



Source: Vanguard. Data reflect rolling period total returns for the periods shown and are based on underlying monthly total returns for the period from February 1976 through April 2022. The S&P 500 Index and the Bloomberg US Aggregate Bond Index were used as proxies for stocks and bonds.* ***Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.***

As our chart shows, drawdowns in 60% stock/40% bond portfolios have occurred more regularly than simultaneous declines in stocks and bonds. This is due to the far-higher volatility of stocks and their greater weight in that asset mix. One-month total returns were negative one-third of the time over the last 46 years. The one-year returns of such portfolios were negative about 14% of the time, or once every seven years or so, on average.

But we need to remind ourselves of the purpose of the traditional balanced portfolio.

The math behind 60/40 portfolios

Catchy phrases like the 'death of 60/40' are easy to remember, require little explanation, and may even seem to have a ring of truth in the difficult market environment we are in today. But such statements ignore basic facts of investing, focus on short-term performance, and create a dangerous disincentive for investors to remain disciplined about their long-term goals.

Keep in mind:

- **The goal of the 60/40 portfolio is to achieve long-term annualised returns of roughly 7%.** This is meant to be achieved over time and on *average*, not each and every year. The annualized return of 60% U.S. stock and 40% U.S. bond portfolio from January 1, 1926, through December 31, 2021, was 8.8%.* Going forward, based on simulations run at the end of April 2022, the Vanguard Capital Markets Model (VCMM) projects the long-term average return to be around 7% for the 60/40 portfolio. Market volatility means diversified portfolio returns will always remain uneven, comprising periods of higher or lower—and, yes, even negative—returns.
- **The average return we expect can still be achieved if periods of negative returns (like this year) follow periods of high returns.** During the three previous years (2019–2021), a 60/40 portfolio delivered an annualised 14.3% return, so losses of up to –12% for all of 2022 would just bring the four-year annualised return to 7%, back in line with historical norms.
- **On the flip side, the math of average returns suggests that periods of negative returns must be followed by years with higher-than-average returns.** Indeed, with the painful market adjustments year-to-date, the return outlook for the 60/40 portfolio has improved, not declined. Driven by lower equity valuations, the VCMM's projected 10-year returns for U.S. stocks have increased by 1.3 percentage point since year-end 2021. And with higher interest rates, the VCMM's projected 10-year U.S. bond returns have increased 1.6 percentage point from year-end 2021. Overall, the 10-year annualised average return outlook for the 60/40 is now higher by 1.3 percentage points than before the market adjustment.
- **Market timing is extremely difficult even for professional investors and is doomed to fail as a portfolio strategy**. Markets are incredibly efficient at quickly pricing unexpected news and shocks like the invasion of Ukraine or the accelerated and synchronized central bank response to global inflation. Chasing performance and reacting to headlines are doomed to fail as a timing strategy every time, since it amounts to buying high and selling low. Far from abandoning balanced portfolios, investors should keep their investment programs on track, adding to them in a disciplined way over time.

No magic in 60/40 but in balance and discipline

I've focused here on the 60/40 portfolio because of its touchstone status. In our view, 60/40 is a sound benchmark for an investment strategy designed to pursue moderate growth.

Prominent and useful as a benchmark though it is, 60/40 is not magical. And talk of its demise is ultimately a distraction from the business of investing successfully over the long term.

The broader, more important issue is the effectiveness of a diversified portfolio, balanced across asset classes, in keeping with the investor's risk tolerance and time horizon. In that sense, '60/40' is a sort of shorthand for an investor's strategic asset allocation, whatever the target mix.

For some investors with a longer time horizon, the right strategic asset allocation mix may be more aggressive, 80/20 or even 90/10. For others, closer to retirement or more conservative-minded, 30/70 may do it. The suitability of alternative investments for a portfolio depends on the investor's circumstances and preferences.

Whatever one calls a target asset mix and whatever one includes in the portfolio, successful investing over the long term demands perspective and long-term discipline. Stretches like the beginning of 2022—and some bear markets that have lasted much longer—test investors' patience.

This isn't the first time the 60/40 and the markets in general have faced difficulties—and it won't be the last. Our models suggest that further economic travails lie ahead and that market returns will still be muted. But the 60/40 portfolio and its variations are not dead. Like the phoenix, the immortal bird of Greek mythology that regenerates from the ashes of its predecessor, the balanced portfolio will be reborn from the ashes of this market and continue rewarding those investors with the patience and discipline to stick with it.

Roger Aliaga-Díaz is chief economist, Americas, and head of portfolio construction at Vanguard, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.

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**Source: Vanguard calculations using data from Standard & Poor's, Dow Jones, MSCI, CRSP, Morningstar, and Bloomberg. U.S. stock returns are represented by the S&P 90 beginning in 1926; the S&P 500 Index from March 1957 through 1971; Dow Jones U.S. Total Stock Market Index (formerly known as the Dow Jones Wilshire 5000 Index) from January 1972 through April 22, 2005; MSCI US Broad Market Index through June 2, 2013; and CRSP US Total Market Index thereafter. U.S. bond returns are represented by the Dimson-Marsh-Staunton database from Morningstar, Inc., beginning in 1926; Bloomberg U.S. Aggregate Bond Index from January 1976 through December 31, 2009; and Bloomberg U.S. Aggregate Float Adjusted Index thereafter.*

ETFs and the eight biggest worries in index investing

Arian Neiron

John Bogle is cited as the 'father of index investing' and in his last book, *Stay the Course* (2018), he acknowledged the vilification of passive investing:

"Despite the success (or perhaps because of it), in recent years index funds have come under attack on multiple fronts. Yes it seems ridiculous that an innovation that has enabled investors to earn their fair share of the returns generated in our stock and bond markets is now under fire."

Bogle endured these criticisms throughout his career. As we pointed out in ETF Myths Busted:

"the hysteria about ETFs was based on myths. Much of the negative focus on ETFs has been written by those who stand to lose the most."

Though most of the worries have never played out, investors do not want to be wrong so we thought we would go through them again here with a fresh approach. In *The Bogle Effect* (2022), Bloomberg's Senior ETF Analyst Eric Balchunas, successfully deconstructs popular ETF criticisms while highlighting that it:

"is a good way to learn about how index funds and ETFs fit into the broader picture of markets."

In that spirit, let's go through the eight biggest worries regarding passive investing Balchunas identified through an Australian lens.

1 – Causing stock market bubble

Critics of ETFs point to their growth, saying it will cause a 'bubble' indiscriminately pushing up prices. ETFs are growing, from around $10 billion in 2012 to be in excess of $130 billion now. So the 'bubble' theory sounds like a legitimate concern, until you add context.

Over that same time the market capitalisation of all companies listed on ASX's grew *$1.4 trillion*, from $1.2 trillion to be around is $2.6 trillion today. This dwarfs the growth of ETFs.

In addition, of the $130 billion invested in ETFs on ASX, investment in Australian equities represents only around 37%. ETFs also invest in assets like global equities, infrastructure and fixed income.

2 – Distorting the market

Going hand in hand with the 'bubble' prosecution, is the distorting the market argument. The concern is that ETFs, by just tracking an index, mindlessly drive up prices by buying stocks regardless of fundamentals and as a result companies are not being correctly priced.

Ignoring the fact that there has been example of mispricings, booms and busts since well before passive funds, there has also been a steady stream of examples when a company's price rises and falls quickly after good or bad announcements or news since the rise of passive funds, as you would expect.

Balchunas cites General Electric, once the biggest company in the S&P 500. In 2018, the company's share price plummeted 50% over ten months for fundamental reasons, namely weak profits and climbing debt, yet ETFs that included that mega-cap were growing. There have been examples in Australia too. Fund managers Perpetual (during 2017-2018) and Magellan (during the past 12 months) experienced share price falls despite flows into ETFs that held the companies. This is because other market participants, including active funds, sold them and decreased their size.

"A good way to think about it is that index funds and ETFs are in the backseat of the car that active players are driving," writes Balchunas, "Case in point: Apple and Microsoft are currently at the top of the S&P500 Index, not because passive funds are popular but because their market cap is the biggest. And the reason their market cap increased is that their price increased. The reason their price increased is that active traders like the stocks and bought them. And at some point down the road they will stop wowing active players who will sell them and then they will stop being the top two companies. The index is a dynamic, constantly changing organism thanks to active management."

3 – Never been tested

Balchunas describes this criticism as the most absurd and easiest to refute. The fact is, ETFs have been tested across multiple cycles. ETFs have not only survived stress tests, they tend to thrive in them.

In Australia ETFs saw increased volume during the GFC, the 'taper tantrum' in 2013, Brexit and the March 2020 sell-off caused by the COVID-19 lockdowns. In all ETFs have tended to be the most liquid vehicles, being used by sophisticated traders.

The track record speaks for itself.

4 – Creating a liquidity mismatch

This criticism seems to be aimed at bond ETFs. To start with, the liquidity of ETFs and the rules that they operate under are not well understood by most critics of ETFs.

The reason liquidity relates to bond ETFs is that the underlying bond assets do not trade 'on exchange'. Rather, bonds trade 'over-the-counter' and the sharpest criticism of ETFs has focused on the liquidity of these over-the-counter (OTC) markets. These same markets active bond fund managers trade in.

Banks and brokers make OTC markets possible by facilitating bond trading between institutions. Under normal market conditions, they generally carry a book of bonds on their balance sheet to assist trading and making a liquid market.

There is however a limit to how much they can hold on their balance sheets. In a market environment where there are more sellers (of bonds) than buyers, selling bonds at fair prices becomes difficult. This causes a 'liquidity crunch'.

We saw this in March 2020. Some bond ETFs experienced wider buy/sell spreads. This is because, as liquidity in the underlying OTC bond market dried up, spreads widened to reflect the lower (discounted) prices that the underlying bonds could trade for OTC. This was then reflected in the price of the ETF, as a discount to the Net Asset Value (NAV) of the fund's underlying holdings.

But as was pointed out in a Wall Street Journal article, ETFs Have Passed Their Covid-19 Stress Test, these bond ETFs were more of a reflection of where the OTC bond market was at, and that bond prices "need(ed) to catch up". Following this same point, Robin Wigglesworth in the Financial Times said, "Moreover, the discounts meant that sellers of the ETF bore the cost of instant liquidity, rather than the remaining investors in the fund.

This is a fairer outcome than what happens with traditional bond funds, which often sell their most liquid, higher-quality assets to accommodate outflows, leaving remaining investors holding an inferior portfolio."

5 – Weak hands

This is the worry that ETF investors will run for the hills at the first moment of trouble. Balchunas shoots this down by pointing out:

- Every time we've had a sell-off, the exact opposite happens;
- Many passive investors are self-directed who chose to buy the funds they are in and are thus more loyal to the fund; and
- Investors in ETFs tend to be younger and so do not need to cash out of the investments.

According to Balchunas, "for the foreseeable future, look for passive investors to be strong hands, not the weak ones."

6 – Too many indexes

There is a concern there are too many indexes and too many ETFs. According to the Financial Times, in 2018 there were more than 70 times as many stock market indices as there were quoted stocks in the world.

That maybe, but according to Morningstar, there are 3,689 Australian Investment Trusts in its Open End Funds database. All Offshore Open End Funds total 113,614. According to ASX and The World Federation of Exchanges, at the end of Q1 2022 there were 2,177 ASX listed companies and 58,200 listed companies around the world. Even though there are more funds than listed companies, we have never seen a story about that.

Balchunas, clearly an avid music fan, cleverly cites the fact there is an estimated 97 million unique songs that use just 12 notes. "Yet of all those words and songs, only 0.1 percent resonate with the public while the rest live in oblivion. The same is true of indexes. Only a microscopic number will ever be turned into investment products such as ETFs."

To give context, on ASX there are only 187 ETFs that track an index.

Too many indices is not a worry for the market.

7 – Ownership concentration

This is a little more complex. A review of the top ten companies on ASX, which represent almost 50% of the Australian equity market, reveals that the three largest passive managers globally feature. It is important to note that no passive manager owns more than 9% of an any of these companies and as a percentage of the total market capitalisation, these three passive managers own just 12% of the top 10 ASX companies. When you add up the collective ownership of active managers, it is well over 12%, it is just that active management is distributed among many managers, not three. The ownership concentration argument may be overstated.

That is not to say the rise of passive management is not a concern in this respect, especially because with ownership comes voting power.

Proxy votes are collective ballots cast on behalf of investors at company annual general meetings. Examples include proposed changes to share ownership, the structure of the board of directors, merger or acquisition approvals, and executive salary and benefits.

From VanEck's perspective, contrary to popular belief, passive ETFs which track indices do make active decisions when it comes to proxy voting elections.

At VanEck, we monitor and review all proxy votes. We also use Glass Lewis for assistance and they have developed a specific set of ESG proxy voting guidelines that closely align with our views and in our opinion satisfy the high standards expected of a fiduciary.

As an example, we recently voted against the remuneration report for listed property giant Dexus because we felt the amount of one-off bonuses was too high.

You can read more about our approach to proxy voting here and view our proxy voting reports here.

8 – Bad customer service

Critics wonder, how can a passive manager afford to provide good customer service given the low fees that they charge?

Let's qualify a few things. Passive managers track an index, so investors know what they are getting: index returns less fees and any other slippage (also known as tracking error). Furthermore, ETFs that track indices are fully transparent. Investors know what they are holding every single day.

Alternatively, active managers that persistently underperform have created an uncertain experience. Furthermore, they are not transparent, so investors do not know what is in the portfolio. Many active managers only entrust their clients with top 10 holdings, provided well after month end.

The point is, ETFs empower investors and that caters for a better service experience.

Additionally ETF issuers are hyper-committed to education. The basis for this was that, initially, ETFs were a new innovation. Therefore, ETF issuers had an impetus to educate investors about their benefits. This has transposed to education on broader investing, portfolio construction and the range of investment opportunities and strategies available.

VanEck is committed to providing the best for its customers. Our Learning Hub has, among other things, information on ETFs, assistance with trading ETFs and education about the asset classes our ETFs invest in.

In *The Bogle Effect*, Balchunas debunked much of the hysteria about ETFs.

We too, think ETF investors are strong hands, recognising the importance of looking past the positive and negative commentary and concentrating on long term goals. A financial planner or stockbroker is best placed to help more.

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