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Contents

Editorial

Legendary US basketball star, **Wilt Chamberlain**, died in 1999 but he is remembered for scoring 100 points in a single game and other individual records which still stand today. His intimidating physical stature at over seven feet tall and weighing 250 pounds and his aggressive approach to playing and living meant he was generally disliked across the NBA league, but he came up with the famous quote:

"Everybody pulls for David, nobody roots for Goliath."

There's a strange '*nobody roots for Goliath*' in Australian funds management, as these numbers show:

- In the March 2023 quarter, the total managed funds industry in Australia rose $137 billion to **$4,545 billion** (ABS release 1 June 2023)
- On 31 May 2023, the total in Exchange Traded Funds (ETFs) was **$143 billion** (ASX and Cboe releases).

That's right. Goliath, or managed funds, rose almost as much in three months as the entire size of David, the ETF market. At $143 billion versus $4,545 billion, David is **3.1%** of Goliath. Yet *everybody pulls for David,* and the greater coverage of ETFs gives the impression that it is the dominant structure capturing market flows. Put it down to the greater marketing commitment by ETF providers who not only promote their own funds but ETFs (or ETPs) in general, and their listed status gives them more exposure. The ease of investment in ETFs augurs well for their future growth.

Look at the table and chart from the ASX, and there's the story at the moment.

Investment Product Summary - May 2023

ETPs	Last 12 months ($bn)			Last month	
	May-22	May-23	% change	Apr-23	%change
Equity - Australia	36.24	38.57	6.4%	39.12	-1.4%
Equity - Global	61.19	67.72	10.7%	66.17	2.3%
Fixed Income	15.61	21.33	36.6%	20.84	2.3%
Property	7.48	7.32	-2.1%	7.49	-2.3%
Commodities	4.19	4.51	7.6%	4.50	0.2%
Currency	0.18	0.17	-6.7%	0.16	2.9%
Mixed	3.52	3.92	11.2%	3.92	0.0%

more info www.asx.com.au/etf-and-other-etp.htm

Global equites and fixed interest both up about $6 billion in a year, which while good for ETFs, is small for managed funds. The skilled ETF marketers give enthusiastic reporters (including from *Firstlinks*) the numbers and the story angles, while Goliath sleeps in the background with nobody cheering him on.

For example, in last week's *Weekend AFR*, in its *Smart Investor* section, the lead story was *'The Income Option'*. It started:

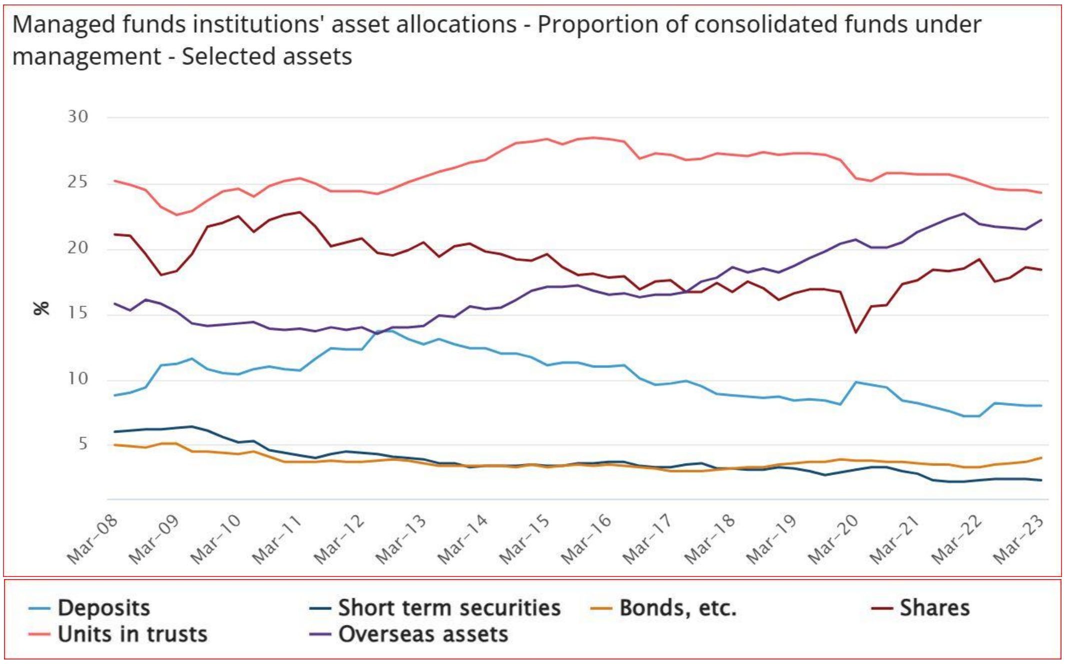
"Some exchange-traded funds are bringing the 'covered call' strategy normally used by institutional investors to everyday portfolios ..."

ETFs are credited with an innovation which the managed fund industry has offered **to retail investors** for 15 to 20 years. I wrote about it a couple of weeks ago, yet every example in the AFR article is an ETF.

Then two pages further on, the heading - which was also on the front page - was '*11 ETF strategies for income investors*', advising the many types of ETFs with an income focus "*if you know where to look".* It included a table of 20 high-yielding ETFs.

It would be easy for investors to read these articles and think the investment choices are covered, but there are far more in the managed fund space. Many of Australia's best fund managers have chosen not to operate in the listed space. And while ETFs quickly introduce thematic and trend funds and generate much excited commentary (here comes robotics! invest in crypto! launch of cloud computing!), the money attracted to these special sectors is tiny and often flames out after an initial flurry.

So what's happening with Goliath? The **ABS** data shows these movements in asset allocations:



Most of the big flows are into large superannuation funds. Deposits and (domestic) directly-held shares have fallen over the last 15 years while the winners are overseas assets and unit trusts. The ABS reports:

> *"Total unconsolidated assets of superannuation funds rose $120.9b (3.5%) to $3,546.6b during the March quarter. Key movements were as follows:*
>
> - *assets overseas rose $44.3b (6.7%)*
> - *units in trusts rose $35.9b (3.0%)*
> - *bonds, etc. rose $13.5b (15.6%)*
> - *shares rose $13.4b (2.3%)*
> - *deposits rose $10.9b (4.2%)."*

(The ABS defines managed funds as institutions - superannuation funds, unit trusts, etc - which buy assets on their own account, plus fund managers which provide professional investment services, less any cross investment between fund managers).

The largest industry fund, **AustralianSuper,** alone holds twice the assets of the entire ETF industry and it's heading for half a trillion, according to its CIO, **Mark Delaney.** The net growth into large super funds in the year to March 2023 was $83 billion from many types of flows.

Funds with more than six members

March quarter 2023	$ million
Employer DB contributions	4,521
SG contributions	23,627
Salary sacrifice	1,930
Personal contributions	6,946
Net rollovers to SMSFs	1,233
Lump sum benefits	13,962
Pensions	10,339
Contributions taxes	4,042
Earnings tax	4,405
Operating expenses	1,839
Net earnings	77,223
Net growth	83,125

Source: APRA Statistics – March quarter 2023.

And yes, to mangle history, the slings (and rocks) of outrageous fortune helped David to slay Goliath, according to the bible, and the Philistines fled the battleground. It may be a case of the winners writing the history books, but it will be a long time before David's ETFs reach anywhere near Goliath's managed funds.

While on this numbers game, it's sobering to realise the largest fund manager in the world, **BlackRock**, holds $13 trillion (yes, thousand billion) and **Vanguard** is at $10 trillion. That's where the real power over companies and markets lies.

So this week, we have articles on managed funds, platforms and SMSFs. From the recent **Morningstar Investor Conference**, **Peter Labrie from Colonial First State and Jason Entwistle from HUB24** describe recent developments with platforms. They continue to grow strongly, especially supported by financial advisers, but do not receive much media attention.

It was also notable that **Westpac** has decided to retain its **BT Platforms** business after trying for years to sell it, repositioning to assist financial advisers to run their practices. It holds $131 billion in funds under management.

Then we check the latest SMSF data, despite esteemed publications such as the *The Australian Financial Review* predicting their demise talking about the *"improved offerings from professionally managed funds and market volatility combine to take the shine off DIY super"* and *"... there was probably a little while where we all drank the SMSF Kool-Aid".* We check whether this prediction of the fall of SMSFs carries much weight, and why people use them and the role of financial advisers.

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Does it feel like your portfolio is going nowhere while the news talks of a bull market, regaining 20% from its October 2022 low? Here's how **CNN Business** started this week:

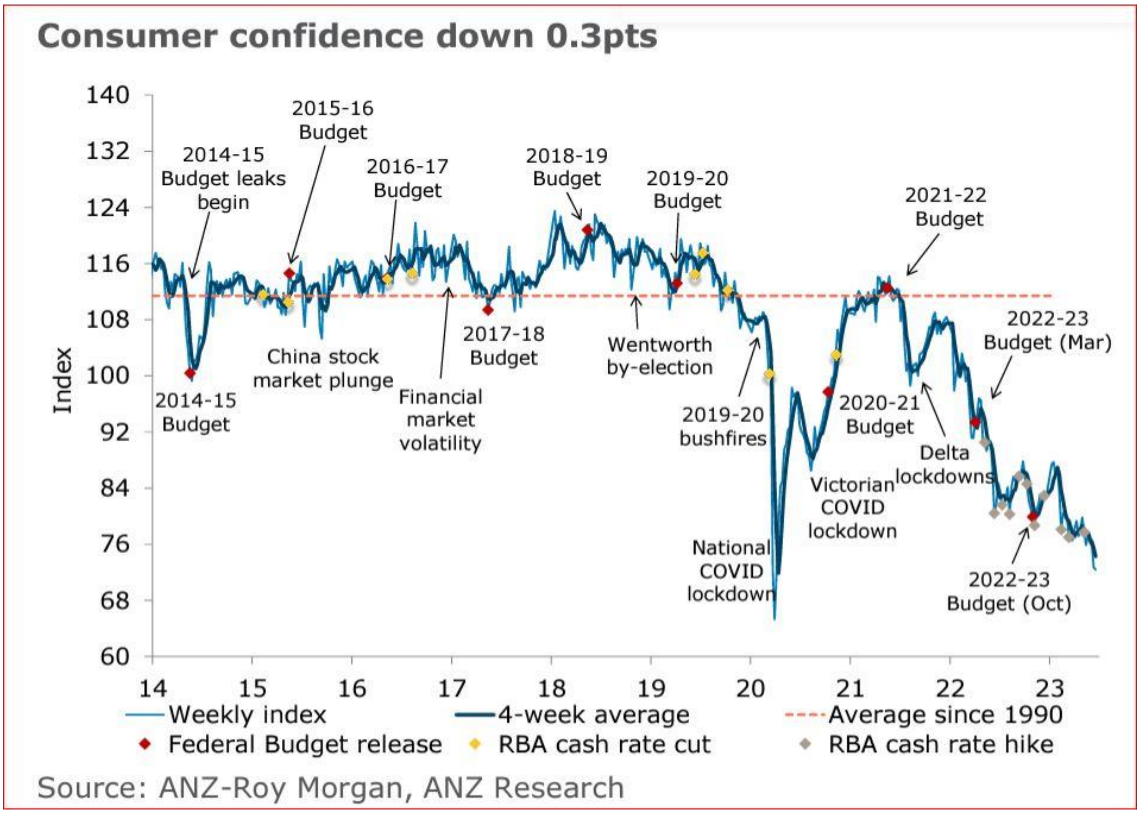
> *"The stock market has made incredible strides since its downturn last year, so much so, it's difficult to believe the economy could be on the verge of recession. At the market's close on June 16, 2022, the S&P 500 index was at about 3,666.77, beaten down by persistent inflation, the Federal Reserve's interest rate hikes and geopolitical tensions. The broad-based index is at 4,409.59 as of the close on June 16, 2023, marking a roughly 20% gain from a year earlier despite collapses of regional banks, an only narrowly avoided debt default and the Fed's continued battle against inflation.*
>
> *Mega-cap tech stocks that were battered by rising interest rates in 2022 have also seen a huge boost this year. Shares of Apple notched an all-time high close of $186.01 last Thursday, compared to*

$135.43 a year before. For the year, the S&P 500 is up roughly 15%, the Dow has gained 3.5% and the Nasdaq Composite has risen 30.8%."

There's a good reason you feel you are missing out, as both the All Ords and S&P/ASX200 price indexes are down over the last 12 months without the tech stock dominance of the US markets where the bull headlines originate.

The local outlook is not great when **Roy Morgan Research** reports:

"Notably, confidence about 'current financial conditions' fell to a new low, after declining 10.6pts in the past four weeks. This is the third consecutive week with 'future financial conditions' below 90, the longest it has been this low on record. 'Future economic conditions' is at its lowest since early April 2020, as is confidence among outright homeowners, which fell for a fifth straight week. Confidence declined among renters to its recent all-time low from mid-May, while it rose for those paying off their homes."



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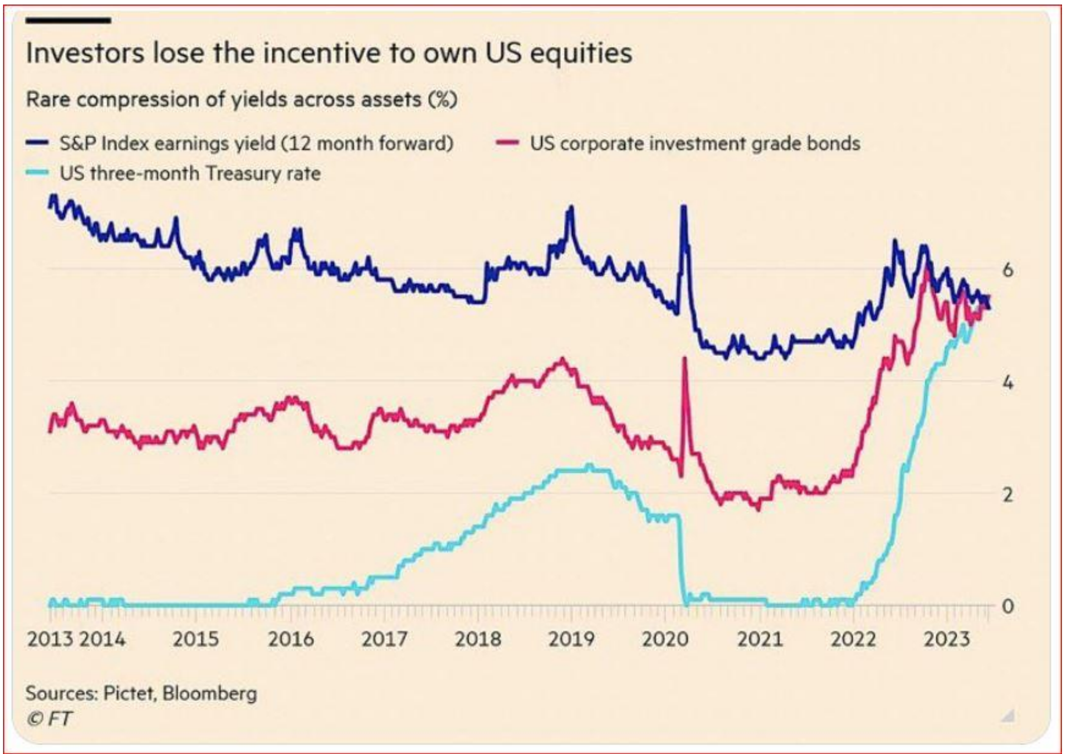
Before we leave overseas markets, check this chart of yields across the big asset classes of US cash, S&P earnings and corporate bonds. For the first time ever, they are all the same. While cash rates have risen, equity yields have fallen, removing some of the incentive to own equities with implications for portfolio balancing. Cash is now a legitimate investment in its own right, adding protection and optionality to a portfolio.



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Former financial adviser, author and retirement expert **Noel Whittaker** rang me last week after reading a couple of my articles on discount capital gains and the $3 million super tax (also the subject of [last week's podcast](#) where I spend a few minutes explaining part of the calculation many are missing). Noel wanted to make the point that with the Stage 3 tax cuts, the 30% bracket will extend all the way to personal incomes of $200,000, with implications for the new $3 million tax super tax.

Stage 3 tax rates

Index	Taxable income	Cumulative tax liability	Marginal tax rate
1	$0	-	0%
2	$18,200	-	19%
3	$45,000	$5,092	30.00%
4	$200,000	$51,592	45%

While it is incorrect to call the new tax a '30% tax' because the extra 15% is calculated in a different way to the usual 15% tax, the imposition of the tax on unrealised gains means many more people will prefer to invest in their own name. The dual impact of lower personal tax and higher super tax will have profound implications for large balances in super.

Graham Hand

Also in this week's edition ...

Given the hype around ETFs as mentioned above, everyone has heard of indexing, but what is direct indexing? It is growing swiftly, especially among those working with an adviser in a separately managed account. **Morningstar's Karen Wallace** explains what direct indexing is, and explores its benefits and drawbacks.

With some markets near their highs, fund managers are expressing caution. **Platinum Asset's Clay Smolinski** says interest rates are now in restrictive territory and a number of economic indicators suggest that there may be trouble ahead. Despite this, he thinks there are areas of opportunity for contrarian investors, including in China and select European stocks.

Ophir's Andrew Mitchell isn't as bearish yet he believes it is a good time to 'wargame' a possible US recession. He gives us seven lessons about what investors can expect from a recession, including the prospects of timing the bottom and how Ophir is positioning its portfolio for a possible US downturn.

Meanwhile, **Duncan Burns** of **Vanguard** acknowledges that the rapid market dip of last year and the subsequent rip this year has scared off many investors. He offers five reasons for investors to hold their nerve and stay invested, including that while market losses can sting, recoveries normally follow, and balanced portfolios have proven resilient through time.

And, **Ned Bell** of **Bell Asset Management** suggests that while growth stocks have reigned supreme since the GFC, now is the time for quality stocks to shine. He goes through the reasons why he thinks quality stocks will outperform both growth and value over the short and medium term.

Finally, in this week's White Paper, steel is one of the largest contributors to global carbon emissions and **Franklin Templeton** looks at the prospects of green steel from zero-emission hydrogen to help with the problem.

Curated by James Gruber and Leisa Bell

Reports of the demise of SMSFs are unfounded

Graham Hand

The Mark Twain quotation that "*The report of my death has been grossly exaggerated*" has become embellished over many years, but let's run with it as an analogy for SMSFs. The headlines react to small variations in SMSF establishments, only for the sector to recover the next year.

Superannuation in Australia is a multi-trillion-dollar arms race. Not only has the total amount in super reached $3.5 trillion, but each year, new contributions are nearly $40 billion. While over time, withdrawals will increase as more people reach pension age, the two big winners in recent years are industry funds, now at $1.1 trillion, and SMSFs, at $891 billion. Both have overwhelmed retail funds. SMSFs are called 'Funds with less than 7 members' in the ASFA table below.

Overview

Type of fund	Total assets ($billion)	No. of funds	No. of accts (June 2022)
Corporate	57	10	0.2 million
Industry	1,157	26	12.5 million
Public sector	658	31	2.9 million
Retail	680	76	6.6 million
Funds with less than 7 members	891	607,592	1.1 million
Balance of statutory funds	51		
Total	**3,494**		**23.4 million**

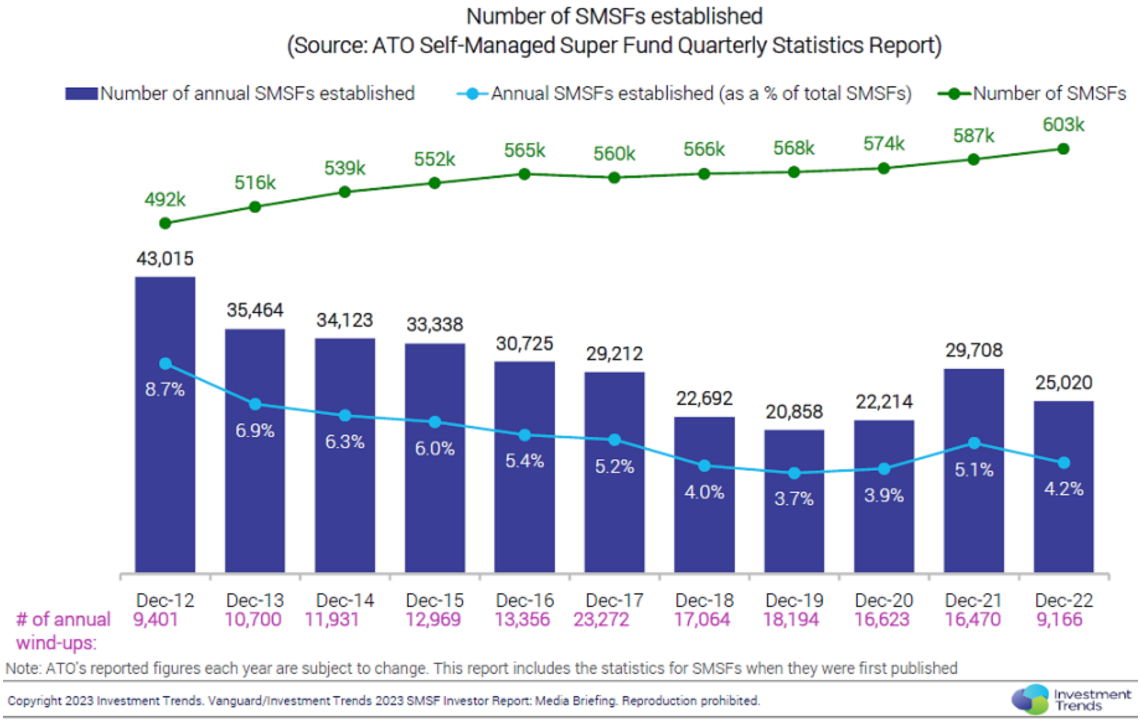
Source: APRA Statistics – March quarter 2023

While recent headlines suggest SMSFs are declining in importance, in the 12 months to March 2023, net rollovers from large funds into SMSFs were $1.2 billion, suggesting many people still want the control and flexibility that personal funds deliver, even transferring money from industry funds.

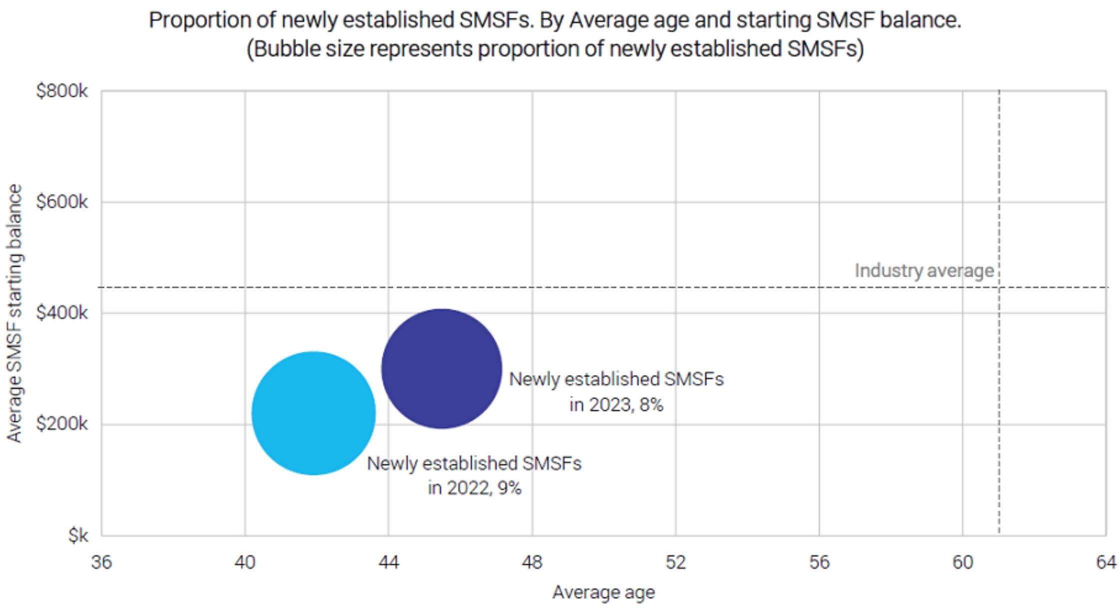
As recently as February 2023, *The Australian Financial Review* reported the expected '*plunge*' in SMSF accounts, and how brokers were seeing the number of SMSF accounts '*plummet*'. It was argued that SMSF establishments were brought forward in 2020 and 2021 as new investors engaged with their own investments during the pandemic, but this boost is over. The latest statistics indicate otherwise.

SMSFs are thriving

While large funds continue to evolve and give investors much of what they need, more SMSFs were established in the 12 months to December 2022 than in the calendar years of 2018, 2019 and 2020, as shown below. Yes, 2021 was exceptional, driven by the freedom to acquire new assets such as Bitcoin which are not offered in managed funds, but the total number of SMSFs is now over 600,000 for the first time. Indeed, the data below drawn by Investment Trends from ATO sources shows a significant fall in wind-ups, although this is a notoriously volatile series subject to updating.



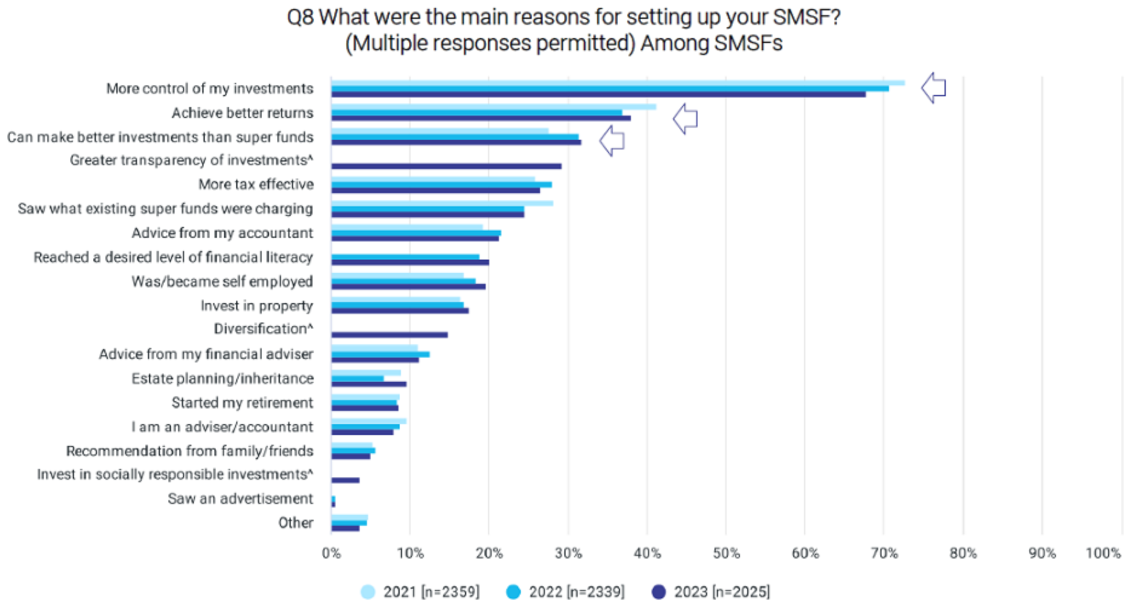
It's also popularly believed that the age of new SMSF trustees is falling, but recent data shows the reverse. In the chart below, where 'newly established' means set up in the preceding two years, the average age has increased by a couple of years and average set up balance risen from $220,000 to $300,000. This tends to support the claim that younger people set up SMSFs in 2021 to participate in pandemic fads which have since faded.



Source: ATO and Investment Trends

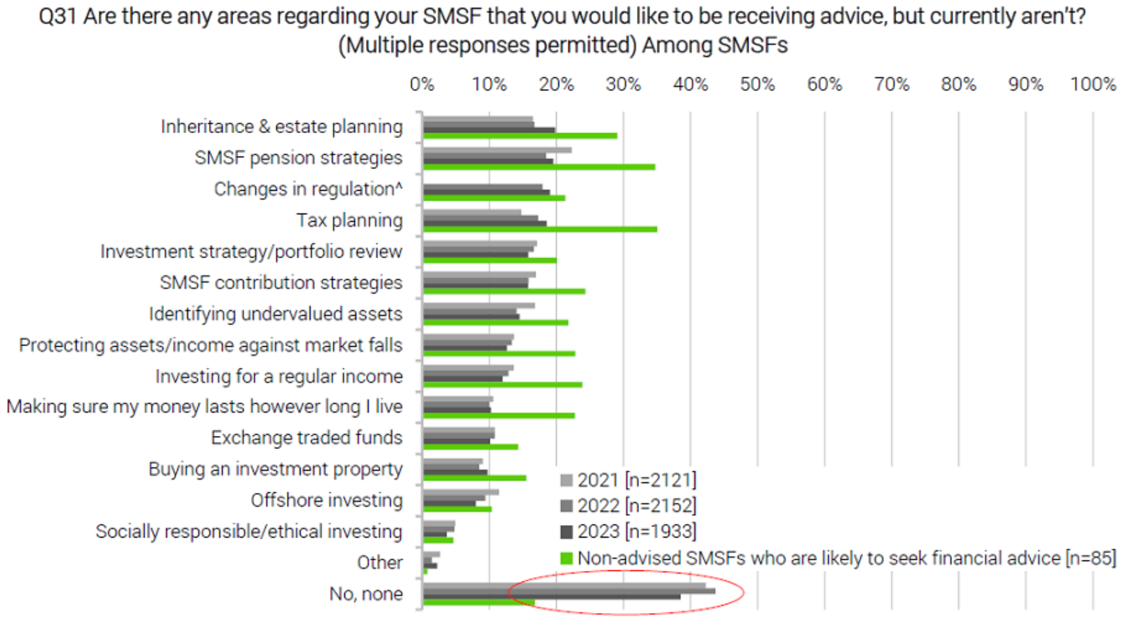
Why do people set up an SMSF?

The dominant reason for establishing an SMSF remains 'control', given the flexibility to invest in almost anything. But it is common for new trustees to think they can perform better than professional investors, with 'achieve better returns', 'can make better investments than super funds' and 'saw what existing super funds were charging' high on the list. A recommendation from accountants and advisers to set up an SMSF still makes up a healthy 30%.



This confidence in personal expertise is confirmed in the reasons most SMSFs do not use a financial adviser, where 'can manage my own financial affairs' is the top reason, followed by cost, lack of confidence in advisers and difficulty finding an adviser.

However, SMSF trustees do nominate areas where they need assistance, and the most popular are not the advice on investment selections traditionally thought of as the role of an adviser. Rather, inheritance and estate planning, pensions strategies, tax planning, impact of regulations and contribution strategies are vital parts of the advice experience.



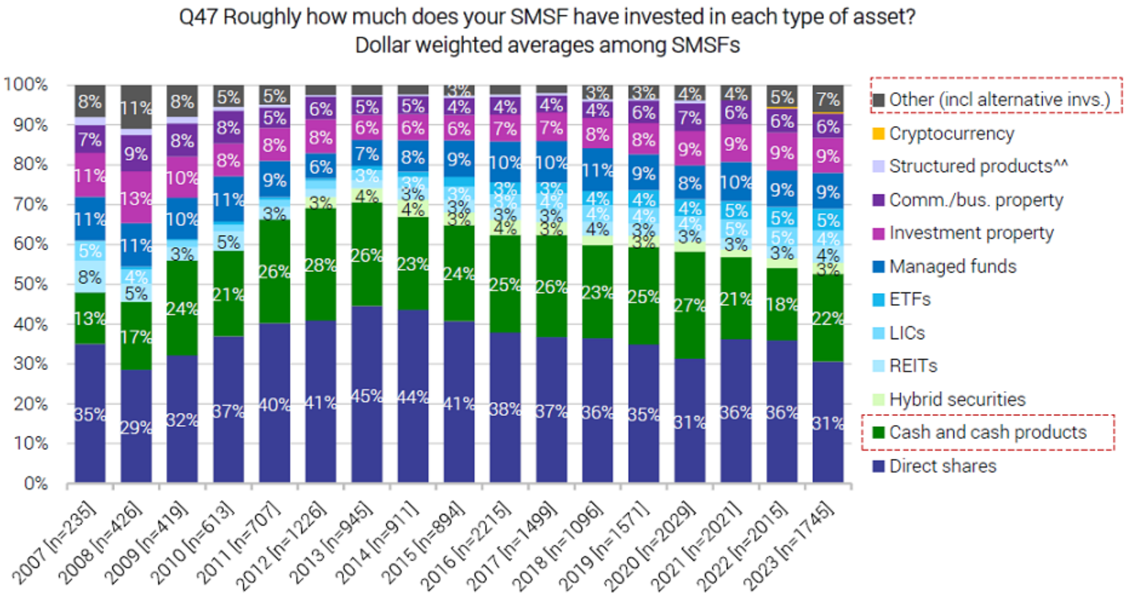
Investment Trends concludes from looking at the data on financial advice:

> *"SMSFs' use of financial advisers has stagnated, while unmet advice needs continue to accumulate. Two key segments in particular – female investors and those in Transition To Retirement phase – would be particularly receptive."*

How are SMSFs investing?

While data is produced by the ATO showing asset allocation by SMSFs, the categories obscure trends by grouping global and Australian equities into one number. The Investment Trends Survey asks trustees directly and generally shows a move back to cash, up to 22%, and a decline in direct shares, down to 31% (but still by far the highest).

This may coincide with caution about the equity markets and better rates on cash, although the latter has always received a surprisingly high allocation among SMSFs. Alternatives also received a decent jump in the last year. ETFs have retained a small but steady allocation of 5%, while managed funds occupy 9%. Property remains popular at 15%.



On the new $3 million super tax, the Survey suggests far more changes to investments are likely in response. Although the Government and Treasury estimate that only 80,000 people will be affected, representing 0.5% of members, it is a significant issue with SMSF trustees, where large balances are usually held. Nearly half, at 46%, of surveyed trustees think the tax is a 'bad idea', while only 24% say it's a 'good idea'. The rest are neutral or want more detail. Surprisingly, given the $3 million threshold, a high 25% say they are 'very likely' to be affected, with a further 22% saying 'somewhat likely'.

In summary, SMSFs remain a vibrant and growing part of the superannuation landscape, and with decent investment markets, will also push through the $1 trillion barrier in the next few years.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information. All charts are copyright Investment Trends and are sourced with permission from the Vanguard/Investment Trends 2023 SMSF Report.

The seeds of a downturn, and opportunity

Clay Smolinski

There is a long-held pattern in markets:

1. Consumers and businesses become accustomed to prevailing interest rate conditions.
2. The situation changes, and then rates rise rapidly.
3. Interest rates hit a level that becomes restrictive, high enough to slow activity. Two signals that become restrictive are:
    a. Activity in interest-rate-sensitive industries, such as housing and used car sales, contracts.
    b. The yield curve (the difference between 10-year and six-month interest rates) turns negative.
4. From that point, when interest rates become restrictive, 12-18 months later, activity starts to contract, company profits start falling, layoffs rise, and stock prices tend to fall.

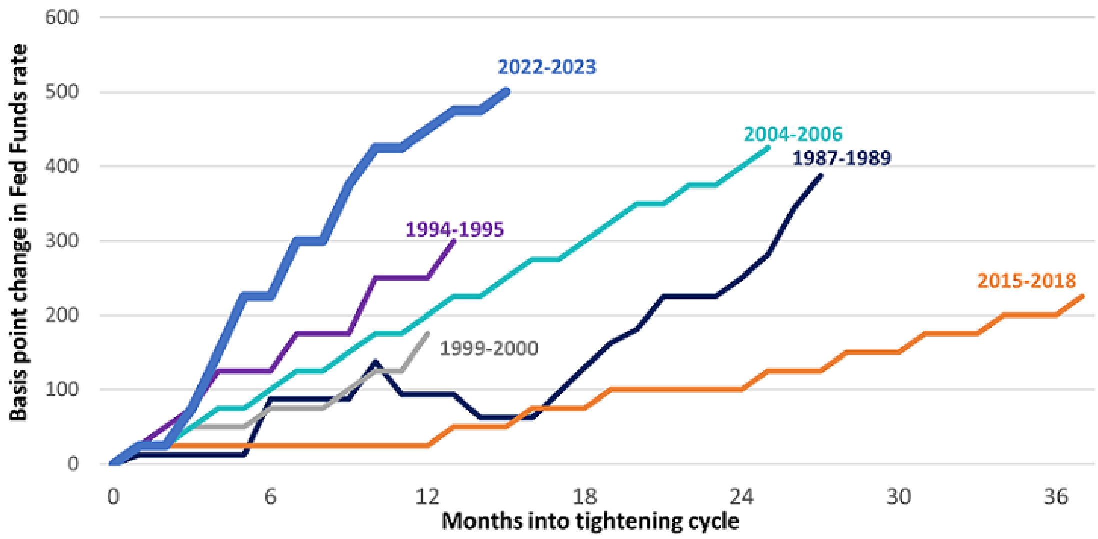
Historically, it has been worthwhile paying attention to when this interest rate pattern started unfolding - and we are seeing this same pattern unfolding today.

Reasons for caution

For over a decade, we have lived in a world of **record-low interest rates**, which we all became very accustomed to.

The factor that changed was **inflation**. Central banks globally have responded by increasing interest rates very quickly to combat rising inflation. This has been the sharpest increase in US interest rates in 40 years, as illustrated in Fig. 1.

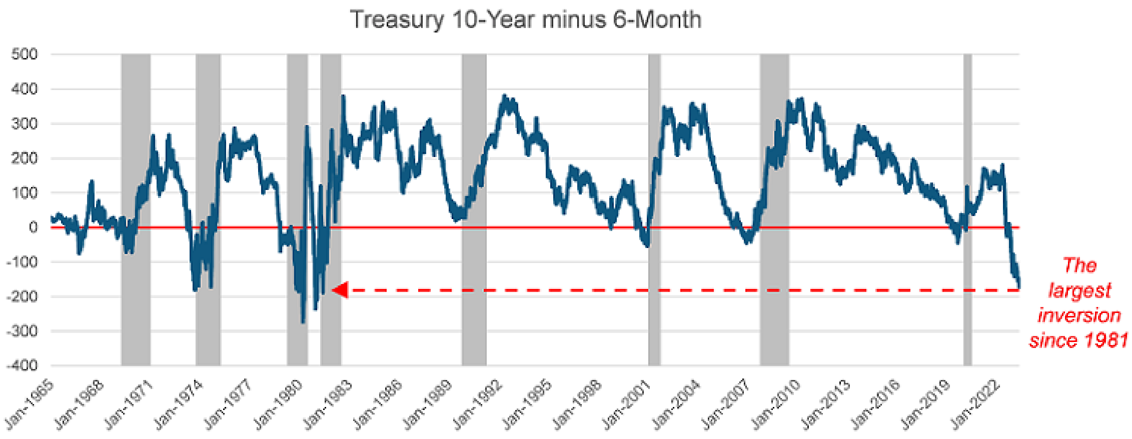
Fig. 1: Rates have gone up very fast, but the impact lag is 12-18 months



Source: Evercore ISI Research, as at 12 May 2023.

We are getting the signal that **rates are now firmly in restrictive territory**. We can see that in the deeply inverted yield curve – it is now the most inverted yield curve since the early 1980s, after inverting in August 2022. At the same time, we started to see a recession in housing, and used car prices started to fall.

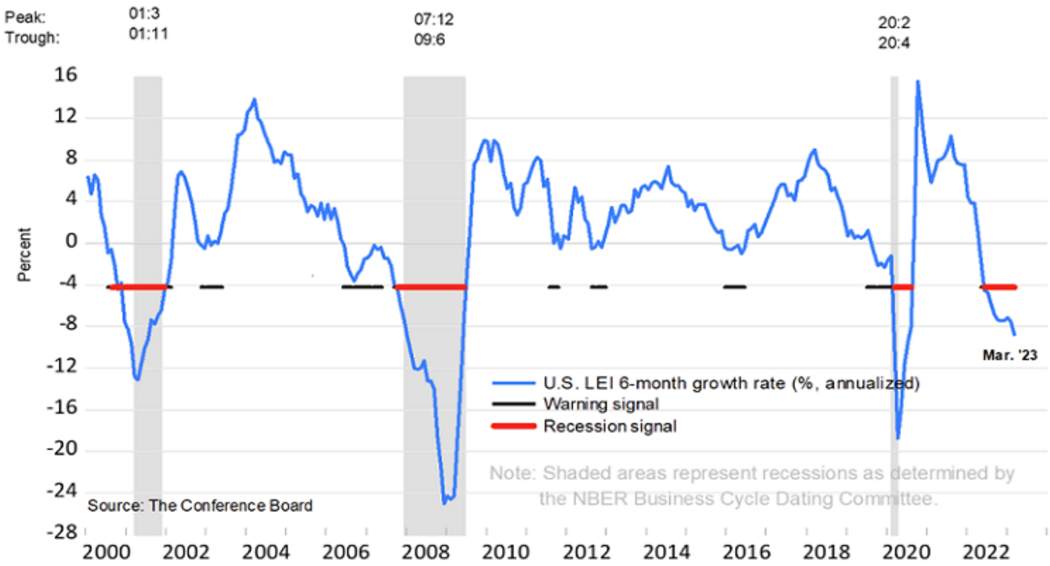
Fig. 2: US yield curve is the most deeply inverted since the early 1980s



Source: FactSet Research Systems, as at 15 May 2023. Note: Grey-shaded areas indicate GDP-based recession.

The number of leading economic indicators flashing recession continues to build. The Conference Board Leading Economic Indicator (LEI), a composite measure that combines a number of leading indicators such as manufacturing orders, freight volumes, business confidence, and bank lending, is signalling a recession over the next 12 months. We are also seeing a significant number of layoffs in the tech sector,[1] problems in commercial property with office vacancy rates rising to all-time highs (with WFH a contributing factor) and asset values falling, and four major banks collapsing.

Fig. 3: The US LEI signals a recession over the next 12 months

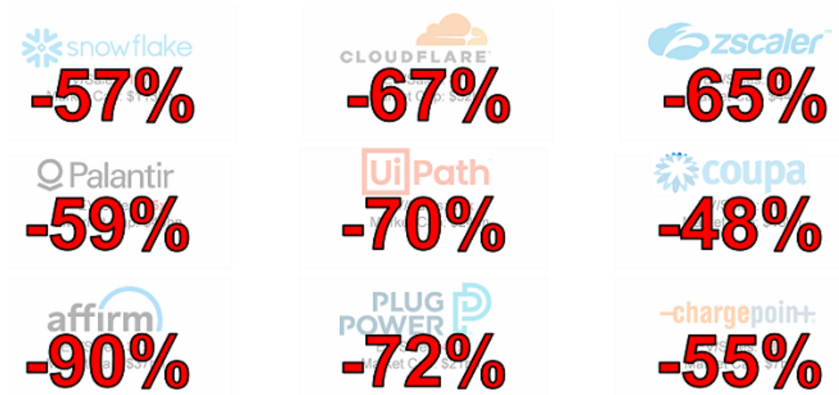


Source: The Conference Board, as at 11 May 2023.

So, this long-held historical pattern is playing out in front of our eyes. Our simple response is that it calls for caution.

We also need to keep in mind that one of the all-time great 'super bubbles' in the last 100 years has now burst. Favourite stocks of the day, many of which were loss-making businesses trading on astronomical valuations in 2021, have seen their prices plummet. The post-COVID bubble of 2020-2021 was truly enormous, and we will most likely look back on that period like we do with the 2000 tech bubble. It has all the same ingredients.

Fig. 4: The air pressure test: Valuation of software as a service (SaaS)/disruptors



Source: FactSet Research Systems, as at 12 December 2021.
EV: Enterprise Value. Sales data is the latest completed period figure.

Jeremy Grantham, the co-founder of GMO, has specialised in studying the great super bubbles of history. His work showed that the super bubbles were in a class of their own and given the sheer excess required to generate the bubble, the hangovers tended to be very different from the usual stock market downturn.

In 2021, we had some wild excesses: zero interest rates, record stimulus and incredible speculation in things like cryptocurrencies. There have been seven super bubbles in the last 100 years (1929, 1972, 1989, 2000, 2007, 2008, 2021).[2]

Following the bursting of these super bubbles, on every occasion we experienced:

- A decent recession
- A fall of at least ~50% in the broad stock market from peak to trough.[3]

Now, history doesn't have to repeat itself, but when we combine that precedent with the business conditions outlined earlier, we feel there is a need for caution and to avoid the eye of the bubble.

Reasons for optimism

Whenever you're looking at the big picture, you need to maintain a balanced view, and there are positive factors that are also in play.

China is in a completely different economic phase from the other major countries. China has just experienced its worst recession in 20 years, and its economy went through the COVID experience without fiscal or monetary stimulus, resulting in a 50% fall in housing sales and a decline in retail sales,[4] whereas in the West they boomed due to stimulus cheques. However, the about-face on its zero-COVID policy should see the economy recover. We are seeing the first signs of that recovery coming through, and the government is very clear they want to boost domestic consumption.

What does that mean for the rest of the world? The old adage was that when the US economy sneezes, the rest of the world catches a cold. This was because the US economy and capital market were so much larger than every other country.

The difference today is that the Chinese economy is only ~20% smaller than the US, which is the closest single country to rival the US in size since Japan in the 1980s, but even then, the Japanese economy was about 40% smaller.[5]

So, we have two big economic engines; one is sputtering, and we expect the other to grow, and for certain goods and industries, the Chinese economy is likely large enough to offset some of that recessionary pulse out of the US.

The other positive is **employment**. To date, in both Europe and the US, employment has been considerably stronger than many expected. Europe managed to shake off a major energy crisis and unemployment did not weaken, while in the US, we are only just seeing the first hint of a pick-up in unemployment claims.[6] Compared to history, the labour market is still incredibly strong in both economies. We would also add that the Australian consumer has remained incredibly resilient in the face of higher mortgage rates. So, we need to respect that resilience.

The third positive factor is cautious **investor sentiment**. While investors are certainly not panicked, there is an undercurrent of concern, and this means investors are generally more mentally prepared for tougher times ahead. Once investors have had time to digest the prospect of problems, they are more likely to look through them.

We also need to note that last year, the broad US and European stock markets fell around 25%. After accounting for inflation, in real terms, the fall was more like 35%, which historically is a pretty decent fall.[7]

Opportunities

While we are cautious about how the business cycle is developing in the US, as investors, we need to keep our eyes wide open to what is happening and opportunities.

China has been in one of the all-time great bear markets. The Hang Seng China Enterprises Index (HSCEI), comprising prominent mainland Chinese companies listed in Hong Kong, fell 60% from its most recent peak in February 2021 to October 2022 and is still down 44%.[8]

Fig. 5: Hang Seng China Enterprises Index – Still well below its 2021 highs

Source: FactSet Research Systems, as at 15 May 2023.

The market fall was driven by the zero-COVID policy-induced recession plus extreme fears over geopolitics. So, we are starting from a position of deep investor negativity, with an economic recovery on the horizon being a large positive, as mentioned above.

One of our holdings in China is **AK Medical**, the country's largest domestic manufacturer of orthopaedic products (mainly hip and knee). AK has been the most R&D focused of the domestic players, building a 20% market share and being the first to gain approvals for a number of its 3D-printed/more innovative implants.[9]

Mispricing opportunity: The stock was heavily sold down due to the short-term impact of winning the new volume-based procurement (VBP) system on their profits. In winning the contract, AK is providing the health system with a low-priced line of five standard hip and knee implants, that will be sold in high volume.

What are positives looking forward?

- **Significant expansion of surgeon relationships.** In orthopaedic implants, the buying decision is made by the surgeon, and companies go to great lengths to familiarise surgeons with their products. Post winning the VBP, AK's medical implants will be used by 90% of Chinese hospitals, and AK is building relationships with thousands of new surgeons, who can be introduced to AK's higher-priced products in time.

- **Chinese government's push for self-reliance**. After the US government's semiconductor chip bans, the Chinese government has been encouraging domestic companies to make higher-end goods, including medical products. To date, the Chinese implant market has been dominated by foreigners, with around 50% of the market held by US companies like Johnson & Johnson and Stryker.[10] The Chinese government is reimbursing surgeons who use domestically made implants. This has seen companies like AK Medical win share from foreigners.

- **A relatively small and nascent orthopaedic implant market**. Implants per 1,000 head of population are five times higher in Japan and Korea and ten times higher in Europe and the US than they are in China. Orthopaedic procedure rates are strongly correlated with the standard of living, and as the middle-income group grows, we believe the orthopaedic market in China has the potential to double or triple from current levels.

In Europe, we have a holding in **Infineon Technologies**, the leading supplier of high-end power semiconductors for automotive and industrial customers. These chips are critical in converting and managing power from, say, an electric vehicle battery to the required voltages of all the components. Infineon also produces a range of automotive-specific microcontrollers that benefit from the growing electrical complexity of cars.

Mispricing opportunity: Last year, you could buy Infineon on 12x earnings as investors were worried about a downturn in the semiconductor cycle and a recession in Europe due to gas shortages. Ultimately, we believe this company has a nice growth runway ahead, and we felt that the market was undervaluing this potential, so we started building a position in the stock over the course of 2022.

Three key growth drivers:

- **Shift to electric vehicles**. EVs have six times the power semiconductor content of internal combustion vehicles.
- **Shift to advanced driver assistance**. Cars are getting more and more computation power, which further increases the power semiconductor content.
- **Bias to electrify (heating, etc).** Heat pumps and solar inverters require more power semiconductors.[11]

Summary

The environment sounds daunting; however, we believe we must keep in mind the incredible buying opportunities and long-term wealth that can be built if you are willing to invest in these environments. These cycles are nothing new; we just need to understand them and take advantage of them.

In that regard, we will continue to invest in companies that can still grow in this environment or have already priced in their recession, all the while remaining disciplined on valuation and what we are paying.

1. Source: Evercore ISI Research.
2. Source: 1929 bubble: Dow Jones -87%; 1972 Nifty Fifty bubble: S&P 500 -48%; 1989 Japan bubble: Nikkei -63%; 2000

1st Tech bubble: S&P 500 -48%; 2007 Chinese stock bubble: SSE -71%; 2008 US housing bubble: S&P 500 -56%; 2021 Tech, 'Disruption' and COVID spending bubble: S&P 500 -25%. Source: FactSet Research Systems.
3. Source: FactSet Research Systems.
4. Source: citi.
5. Source: IMF.
6. Source: Europe: FactSet Research Systems; US: Federal Reserve Bank of St. Louis.
7. Source: FactSet Research Systems.
8. Source: FactSet Research Systems.
9. Source: Company reports, Bloomberg.
10. Source: GlobalData.
11. To hear more about Infineon Technologies see our video: https://www.platinum.com.au/Insights-Tools/The-Journal/Power-Semiconductors-Powering-Our-Lives

Clay Smolinski is Co-Chief Investment Officer and Portfolio Manager at Platinum Asset Management, a sponsor of Firstlinks. For more articles and papers by Platinum click here.

Investment execution and how platforms are evolving

Graham Hand

At the 2023 Morningstar Investor Conference, Morningstar's Director of Research and Investment Products, Rick Di Cristoforo, hosted a panel with leading platform providers, Jason Entwistle, Executive Director of Strategic Development at HUB24 and Peter Labrie Executive Director at Colonial First State's FirstChoice. This is an edited transcript of sections of the discussion.

Rick Di Cristoforo: Jason, what are the key trends in portfolio management that platforms are seeing and how are you responding?

Jason Entwistle: The key trend in portfolio management is advisers are doing less of it. In the past, there was a big focus for advisers on research and portfolio construction and the trading tools platforms provided. We're increasingly seeing advisers engaging longer with their clients on broader strategies and financial advice, and leaving the implementation, portfolio construction and rebalancing of investments to the automated tools platforms offer.

Rick Di Cristoforo: Peter, what are you seeing?

Peter Labrie: Very similar. There are more asset consultants implementing across portfolios, and we're also seeing an increased focus on a core and satellite investment approach. It's about getting the best out of the fee budget that people spend on investments, with indexing for some parts of the portfolio and then using that fee budget for more of the alpha-generating-type assets, such as private equity, private debt, concentrated equities, those sorts of things. And in a rising interest rate environment, a lot more focus on fixed interest funds, and platforms have a really good selection of those type of assets.

Jason Entwistle: At HUB, about 45% of our Funds Under Administration (FUA) is in managed accounts and probably 60% of new monies. Something like 80% of our advisers are using managed accounts in some way for efficient implementation of investment strategies.

There's a much broader question about platform business models. In my 30-something years in platforms, I've seen a 1 to 2 basis point drop in margins pretty much every year on average. Sometimes you get to a cliff, sometimes a plateau, but it's a scale game, and parts of the platform are a commodity.

Peter Labrie: Platform offerings depend on a scale perspective. We're in the process of launching a new Edge platform, and we've partnered with FNZ for cost and efficiency, and they're a platform provider that manages over $2 trillion in assets. So, it's massive scale using their underlying technology. Obviously, FirstChoice from our side has been a long and strong master fund, and there's a $400 million investment over the next four years to reinvigorate our core technology as well. We see that that focus on efficiency is super important from a platform perspective, and every basis point matters.

Jason Entwistle: Back 30 years ago, trustee services cost 10 to 20 basis points, and we pay less than 1 now for that same service. These things do become commodities. Platforms are focused on delivering a solution for clients, but we're not really solving the adviser's problem when we just focus on certain clients, because the adviser has two or three platforms and clients with other assets. So, if we're really going to solve the advice problem and help advisers to be more efficient and deliver a great experience, we have to solve more of the problem. And that means more technology. That's where it will go, and that's not so much a commodity business, that's about experience, that's about service, and it will really help advice businesses.

Rick Di Cristoforo: So to what extent are platforms digging into the actual advice delivery and process itself?

Jason Entwistle: There's a holy grail of the platform technology and the advice technology being the one and the same, and it all just works. It's not even an integration, it's the same thing. But I don't see it and I've tried to make it happen. But the reality is, Xplan, the leading tool in our market, with 20 years of development and a really broad feature set that is just so hard to replicate, and I can't see platforms going there. We will make it more efficient, integrate better, make the ecosystem work much better, but I can't see us building those tools.

Peter Labrie: The secondary platform used by advisers is increasing in importance, driven by the best interest duty and that one platform will not suit every client's needs. We also know that advice practices use something like 14 different pieces of technology, and then none of those advice practices all do it the same way. You can't become a one-stop shop, you need a very open architecture and integrate out into various software providers. The platform is an enabler, to enable advisers to do their job more efficiently and more effectively. We're connecting with Xplan, AdviserLogic, Myprosperity, all those sorts of groups to minimise the time that an adviser spends on integration.

Rick Di Cristoforo: What do you see from an opportunity and potentially risk perspective that are on the horizon from the Quality of Advice Review?

Peter Labrie: We've seen the number of advisers in the industry decrease probably 40% over the last couple of years. We also know the cost of advice is going up because of the increased compliance. So, that's not a good environment when you think about mass Australia getting advice. If we continue on the current policy settings, only about a third of Australians will get retirement advice over the next 10 years. Now, retirement advice is incredibly complex. It's difficult to get a handle on across all of the things that are going on. We had one of my colleagues run a session with our extended leadership team the other day asking us difficult questions about retirement. And I tell you, for a room of experts, we didn't do very well. So we do have this advice gap, and QAR is a key component to simplify that advice process.

Jason Entwistle: Yeah, it's a sad state of affairs when something like 10% of Australians are able to get full service advice and afford advice, when every survey says that advice is a community good, ultimately people end up with better financial futures, and we have less reliance on the age pension. So, it is incumbent on us all to help solve that advice gap problem. QAR looks like a great step forward.

Rick Di Cristoforo: Do you think there's opportunity for platforms such as yourselves engaging with those sorts of entities that have, in the case of banks, been out of the market for five years, let's say, and in the case of industry funds have barely dipped a toe in to basically deliver into their work? So, could we help them?

Jason Entwistle: Yeah, possibly. They haven't rung lately, mate. I'm waiting for the call.

Peter Labrie: The industry funds are focused on this market, it's front and center when they're thinking about their clients going into retirement. Banks is a different proposition. We'll see how that changes over time.

Rick Di Cristoforo: Jason, how do you see platforms evolving to meet changes over time?

Jason Entwistle: In the past, we started from the backend, custody, execution, registry and investment books of record, all that stuff, and worked forwards towards the adviser and ultimately the end client. If we were starting today, you would start at the client and come down. The technology is so different now, and the clients expect digital engagement, you have to start there and work backwards. But we are where we are. The platforms we have today all started from the ground up. We are looking at how do you start to fashion the platform from the client experience backwards, supported by their adviser.

Rick Di Cristoforo: Jason, there's been a lot of developments in the asset space outside of the listed space or managed investment schemes, particularly unlisted assets or special assets. And it was an area that needed some work at the beginning of platforms. How are you handling it, and what are the trends you're seeing from the users?

Jason Entwistle: The last thing we want is advisers unable or unwilling to recommend an asset that is in the client's best interest but it's just hard and they can't make it work for their own business, their processes, because their platform doesn't support it. We need to be able to deal with any asset, anywhere, anytime, no matter how it's held. There's a lot we can do in custody, and platforms in the last few years have expanded the list, but we'll always get to the point where an asset doesn't suit being held in a pooled custody environment. Some of these assets, the ones with calls, for instance, they put the pool at risk. We've got to deliver that money. The client may not give it to us, and we can't put the rest of the pool at risk. So, there has to be an alternative model where if the adviser wants it, we can deliver the experience, the access, we do all the work, but it may not be held in custody on the core custody platform. It's essentially reporting, transacting, but not held in custody.

Rick Di Cristoforo: A key selling point for a platform is the size of the menu. What trends are you seeing on inclusions of products and how do you make those decisions?

Peter Labrie: For a start, there's a lot of regulation in this space, trustee requirements around what can and can't go on investment menus, particularly in the superannuation space. We go through that process before we add a fund to an investment menu. Then there’s ratings, support from advisers, understanding the portfolio management team, how long they've been there, the tenure, independent researchers such as Morningstar. Then it's really our engagement with the adviser. Where do they see the demand, how much support will it receive? It's finding that right balance between the cost in adding assets to the menu versus the demand that's coming through.

Rick Di Cristoforo: The focus has been on the basis point fee levels for platforms, and over time, there's been additional ways that platforms have been able to earn an income. Is it all still about the basis points?

Jason Entwistle: Rick, it's never been all about the basis points, but ultimately like any supplier/partner relationship, there is a fee, and we want to provide the service at the lowest cost we can. And our clients want to buy it at the lowest cost they can get it at. But ultimately, if you want a healthy partner, you want a healthy supplier, and you want us to keep investing in the service, in the technology for the long term, not just, let's invest for three years, squeeze the lemon and get out. You want this to be a business that's around for the long term. So we've got to have really mature conversations about fees. We've been able to share fantastic fee benefits with clients as we scale up and that will continue, but it’s also about the service, the ability to invest and delight our clients while giving us a reasonable margin so we can continue to do that.

Peter Labrie: Ultimately, it's about value for the services that you're providing, not necessarily the cheapest. Some people will opt for the cheapest service but we need a sustainable industry and it's not always going to be the cheapest provider that will prevail here.

Graham Hand is Editor-At-Large for Firstlinks. This edited transcript does not take account of the personal circumstances of any investor.

Seven lessons on how investors should prepare for a recession

Andrew Mitchell

You know that scene. The one where the hero is dying of thirst, crawling on their hands and knees across the scorching desert sand. They spot an oasis on the horizon … with a life-giving water hole. They keep crawling, but the oasis never gets any closer.

It's a mirage.

Well, that's what it's felt like with a US recession this cycle. Economists have been calling it for ages, but like the oasis it never seems to arrive. And, of course, like a mirage, it still may never arrive.

But consensus from economists puts a recession at a 65% probability (Bloomberg) over the next year. That's as close to a sure thing as economists would ever call. Investors need to be prepared for the mirage to suddenly become material.

So now is a good time to look at what investors should expect if a recession does arrive in the next year in the US.

What, if anything, should share market investors do about it?

Below, we look at seven 'truths' and insights for investors, including who will be to blame for a recession, the prospects of timing the bottom, and how we are positioning our own portfolios for a possible US economic downturn.

1. It's the Fed who will likely cause a recession

Since World War 2, on average, there has been about one U.S. recession every 6-7 years (12 in total). On average they have lasted a little less than a year (10 months).

What causes them?

Well, the ultimate cause (if there is ultimately just one) is hotly debated amongst economists (though I'm not sure big crowds are turning up for the debate!), but the proximate cause is usually a central bank increasing interest rates to cool an overheating economy.

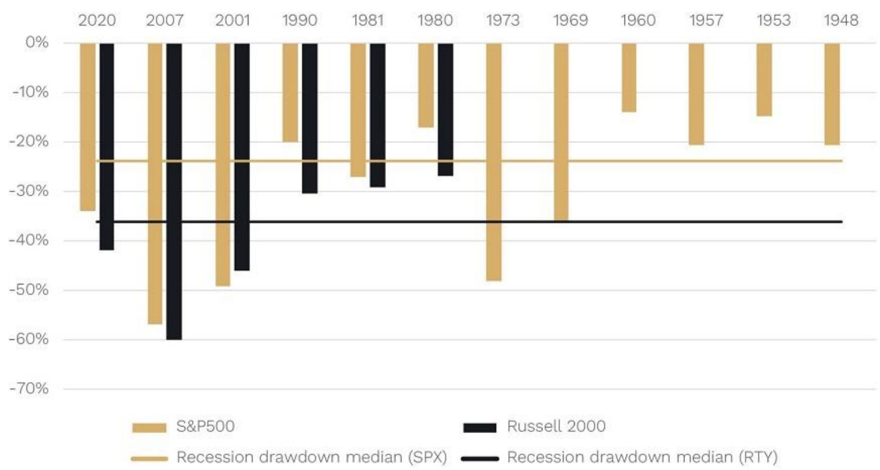
US recessions tend to line up nicely around the end of the US Federal Reserve's rate hiking cycles. The key exception in modern times is the 1995 rate cycle, which resulted in a soft landing and no recession.

2. Small caps get hurt the most in recessions

So, when recession has hit in the past, what has been the share market fallout?

Below, we show the drawdowns (peak to trough falls) for both US large caps (S&P500) and US small caps (Russell 2000).

The share market hit



Source: Factset.

The median drawdown for large caps has been -24% and for small caps -36% (though the available data doesn't go back as far for small caps).

What you can also see is that outside the 2001 dot com bursting episode and the associated recession, small caps have fallen farthest. This is generally expected in a recession because:

- Investor generally seek the greater liquidity and higher and more certain dividends of more mature large caps; and
- Small caps tend to be less diversified businesses with on average weaker balance sheets than large caps.

3. Small and big cap stocks have *already* recorded recession-like falls

How does this stack up to the current maximum drawdowns experienced so far for US large and small caps?

At writing, large caps have fallen -25% to their lows in October 2022, while small caps have fallen -32% to their lows in June 2022 (both since have partially rebounded).

So, while a recession has not occurred this cycle in the US (at least so far), during the most recent sell off starting in 2021/2022, both US large and small caps have already fallen by a similar amount to their recession averages.

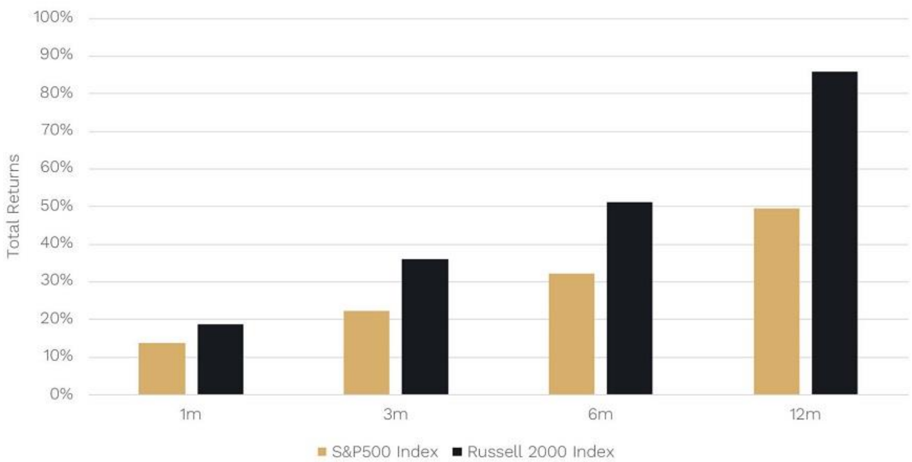
This gives some hope that even if a recession does eventuate, the downside may be more limited from here.

4. Stocks surge back after recession falls

The other good news is that even if a recession does eventuate, the subsequent returns from the associated market lows over the next 6-12 months tend to be very healthy.

Below we show the average returns in both US large and small caps in the 1, 3, 6 and 12 months post their recessionary lows.

The share market recovery from recessions



Source: Factset

While, as mentioned, small caps tend to fall farthest, they also tend to recover the strongest on the other side. In fact, the average six-month returns for US small caps are over 50% … and a whopping 85% over 12 months.

As a small-cap manager this is one of the reasons we must be prepared for what is usually a very sharp share market recovery on the other side, should a recession eventuate.

5. Trying to time the bottom? It's a fool's errand

The natural question to then ask is: if a US recession looks quite likely and US share markets tend to fall heavily in a recession, shouldn't I just sell out now and buy back in when it looks like the market is staging what is usually a big recovery on the other side?

While superficially this may seem appealing (and believe me if it were possible, we would certainly do it), it is highly unlikely to be consistently and successfully achievable by an investor for two key reasons:

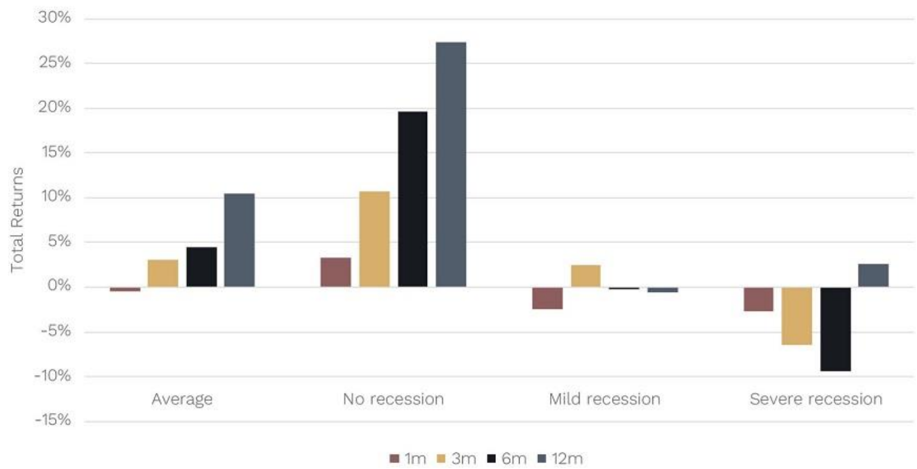
Firstly, a recession is not assured.

While, as we noted above, the consensus probability of a recession in the next year according to Bloomberg is 65%, of the 60 economic forecasters surveyed, their probabilities currently range from 30% to 100%.

Bottom line, a recession is no sure thing.

Take, for example, the chart below which shows the S&P500 return outcomes over the next 12 months after the last Federal Reserve hike depending on whether no recession, a mild recession or a severe recession occurred.

Why market timing around recessions is a fool's errand



Source: Factset

As you can see, if no recession does eventuate then history suggests it is 'off to the races' for the share market.

That's not something you'd want to miss if you sold out of the market preparing for a recession. This is particularly relevant now as commentators debate whether we have already seen the last rate hike this business cycle.

Secondly, timing market bottoms during a recession is virtually impossible.

History suggests that if a recession does eventuate, out of the 12 US recessions since World War 2, **the share market has never bottomed before the recession has started.**

When has it tended to bottom in these recessionary periods?

With the exception of the 2001 dot com crash, where the U.S. share market bottomed after the end of the associated recession, it has always bottomed after the recession start, **but before the recession end**.

On average, in fact, if we remove the 2001 dot com crash, of the 11 other post-WW2 recessions, the share market has bottomed on average 47% (or almost exactly half) of the way through the recession.

But before those recession absolutists think of using that as a market timing tool, the range in those 11 recessions has been a bottom as early as 15% of the way through the recession, to as late as 79% of the way through.

Given history suggests the market recovery can start at wildly different points during the recession, and the recovery itself, as highlighted earlier, is generally very swift, the odds of getting it wrong by trying to market time are high.

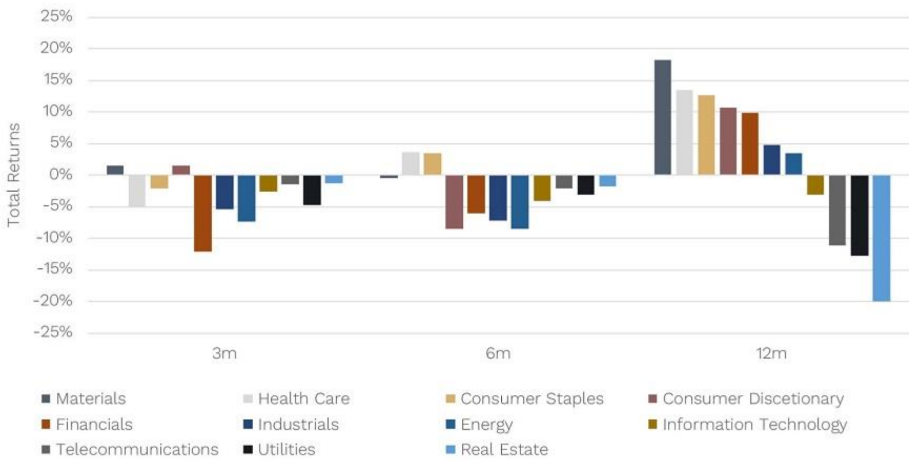
So, staying largely invested seems to us to be the most sensible course of action.

But are there any types of areas of the market investors could benefit from skewing to given a heightened recession probability?

6. Some sectors will lead a recession recovery

Enter the chart below. It shows historically which US sectors have performed the best 3, 6 and 12 months after a recession has started.

Where to invest instead



Source: Factset

What you can see is it tends to be the most resilient, less macroeconomically sensitive consumer staples and healthcare sectors that fare the best, holding their ground.

This makes sense because, while consumer spending pulls back in a recession, they tend to pull back less on things like groceries or medical costs.

By the 12-month mark, returns in most sectors tend to be positive ,with more cyclical sectors such as materials and consumer discretionary joining in and helping lead the rally as the market looks forward to the economic recovery ahead.

Again, this makes sense. Usually by this stage the recession is over or nearing its end and forward-looking share markets seek out those businesses that will benefit from a recovery in demand which tends to boost commodity prices and discretionary expenditure.

7. We are cautious, but not overly so

In sum, at Ophir, we still remain incrementally cautiously positioned in our funds given heightened recession risks, but not overly so.

We are remaining largely invested, with only slightly higher-than-usual levels of cash.

Most importantly, though, our largest positions are in those companies that we believe have strong growth prospects, but where that growth is less reliant on strong economic growth.

Usually, that is because the company's goods or services are seen as more of a necessity by their customers, or they have unique attributes versus their competitors which is allowing it take market share, or both.

An example of this in our Australian equity funds is AUB Group, one of Australia's leading insurance brokers to businesses. It operates in an industry that has proved itself resilient to economic contractions in the past as businesses seek to hold on to their policies in a heightened risk environment.

Hopefully this article has shed some more light on when and if a recession might occur near term and some lessons from history on what to expect if it does. And, perhaps most importantly, how we are thinking about portfolio positioning as a result.

Andrew Mitchell is Director and Senior Portfolio Manager at [Ophir Asset Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Read more articles and papers from Ophir [here]().

What is direct indexing?

Karen Wallace

Index funds are passive investments. They track an index with the goal of replicating the performance of that index, minus expenses. They're a popular investment choice for good reason—they're often cheap, diversified, and uncomplicated portfolio building blocks. Active funds, meanwhile, are led by managers who choose particular securities in an effort to outperform an index.

What is an index fund?

When you own shares of an index fund, you own the stocks in the index fund indirectly, in the same proportion as the index.

For example: Let's say you invested $100,000 in an index fund that tracks the S&P 500.

Because the S&P 500 is tilted toward the largest companies in the market, you have some pretty sizable stakes in some of these big blue chips—nearly $6,000 in Apple (AAPL); over $5,000 in Microsoft (MSFT); $4,000 in Amazon.com (AMZN), and so on.

What does it mean to own stocks indirectly?

Indirect ownership means that even though you are exposed to the companies' fortunes and failures, you don't have the benefits of direct ownership.

For instance, even though you may have thousands of dollars committed to these companies, an invitation to the shareholders' meeting will not be forthcoming. Nor do you have a say in board member elections—the portfolio manager that runs the index fund votes in shareholder elections on your behalf.

You also can't buy and sell the underlying securities or trim any of the positions in the index fund for any reason. What if you thought Apple was overvalued and wanted to reduce your position? You're out of luck as an index fundholder. What if Meta's (META) data privacy and security issues give you pause, and you want to remove it from your portfolio? As an index fund investor, you are stuck holding the stock as long as it's in the index.

How does direct indexing work?

Direct indexing means you own the stocks in the index directly. It's a pretty straightforward idea, but most people don't do it, and those who do are usually working with an advisor in a separately managed account.

For one thing, some indexes track areas of the market that aren't as 'liquid', meaning the component securities can be thinly traded and priced inefficiently. Funds that track such indexes often use a sampling or optimisation method to mimic the performance of an index.

But even the S&P 500, which is a relatively compact index comprising very liquid (easily tradable) stocks, isn't that easy to replicate.

One barrier to doing this, traditionally, is that you can't buy every stock in the index if you don't have a lot of money to invest. This is essentially why managed funds were created; they allow investors to pool their money with other investors, so they could buy hundreds or even thousands of securities and build diversified portfolios.

Two things that have made direct indexing a more viable option for more investors in recent years are the rise of commission-free trading, and fractional-share stock investing, which allows investors to purchase fractional shares in a certain dollar amount. Because stock prices vary so widely, having the ability to invest fractionally makes it much easier to match the index's proportions.

What are the benefits of direct indexing?

When you own the stocks directly, you are ultimately the portfolio manager.

That means you can customise the index if you want to. Are there securities in the index that don't align with your values, from an environmental, social, and governance perspective perhaps? Direct indexing allows you to sell or avoid them.

One thing to be aware of: If your version of the index starts to look a lot different from the 'real' index in terms of sector weightings and so on, the performance won't match up, either. This is called tracking error.

What are the drawbacks of direct indexing?

Direct indexing really only makes sense for people who have a considerable amount to invest in a taxable account and want a level of customisation they couldn't otherwise obtain through a portfolio of funds or individual securities.

In addition, portfolio customisation can get really complicated, really quickly. The idea of being able to customise your portfolio from an ESG or factor exposure perspective may be appealing, but keeping track of all the moving data points on 500 separate securities can be daunting.

You would also have to keep tabs on changes in the index—rebalances and reconstitutions—to make sure you know which securities are added and removed from the index.

Traditional index funds and exchange-traded funds do this for you for a (typically reasonable) annual fee.

And finally—and this is the big one, in my mind—watch out for expenses. Not only do you pay asset-based fees for the direct-indexing account, but these fees may be a multiple of what you'd pay for a diversified portfolio of ETFs or index funds, says Ben Johnson, head of client solutions for Morningstar.

Also, Johnson says, there may be frictional costs - such as brokerage commissions, bid-ask spreads, and market impact - things that you don't really see or are difficult to measure that are involved with direct indexing.

Bear in mind that S&P 500 index trackers are low-turnover strategies, meaning they don't buy and sell too many stocks (the portfolio turnover rate is around 4%).

The more you start trading and customising positions in a direct-indexing portfolio, the more possibilities you have to encounter transaction costs, which will ultimately eat into your return.

Is direct indexing right for you?

Direct indexing allows investors and advisors to build a portfolio that is quite different from the broad market or a broad-based index fund, Johnson explains.

Over time that may result in better risk-adjusted returns, but for many active managers, it results in worse returns. Johnson says:

"[Direct indexing] makes a large number of investors effectively active managers,"

"And what we know about active management, about being different from the market, is that sometimes it's going to look right and feel good, and sometimes it's going to look wrong and feel bad."

In Johnson's opinion, this is a risk, or opportunity cost, of constructing your portfolio using direct indexing versus using traditional mutual funds or ETFs.

"There could be circumstances where [investors] would probably be better served—they would have gotten greater returns with less risk—by simply owning broad-based index mutual funds or discretionary active funds."

Karen Wallace is a senior editor with morningstar.com. Firstlinks is owned by [Morningstar](). This article is general information and does not consider the circumstances of any investor. Originally published by Morningstar and edited slightly to suit an Australian audience.

Five reasons to hold your investment nerve

Duncan Burns

Global financial markets have been volatile in recent times, for a whole range of reasons.

They include the overhangs of high inflation and interest rates around the world and their flow-on impacts to different economies. Then there's the ongoing geopolitical tensions occurring in different parts of the world, primarily in Europe, Asia, and Africa, but also in the United States.

There's no denying that volatility can be hard for investors to stomach. It's tempting to seek shelter and turn to cash with some or all of your nest egg. When the clouds clear you'll know when to get back in, right?

Well, we've looked at the data and unfortunately, most of us that try to time the market get it wrong. History shows us that investing broadly across equities markets has been a prudent long-term strategy for many. It's discipline that seems matter most during thevolatilityse periods of market unrest.

With that in mind, here are five reasons why investors should persevere during periods of volatility.

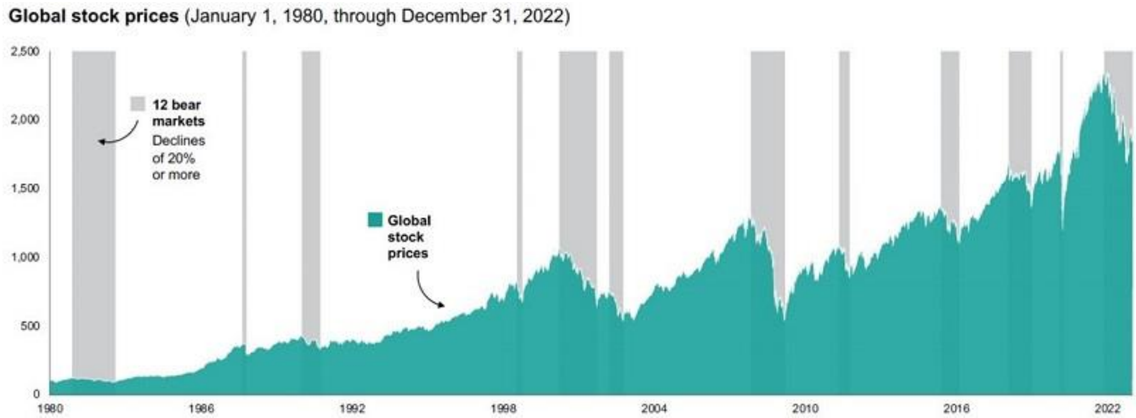
1. Market corrections, including bear markets, are a part of investing life.

Bear markets and corrections are a part of life for investors, who are best served by maintaining a long-term focus. The share market has delivered long-term average rates of return between 7-10% over long periods of time. But those returns only measure what buy and hold investors would earn by putting money in and keeping their money invested through good times and bad.

Since 1980, there have been 12 bear markets in global equities. While the current United States bear market, which began in January 2022, continues, the past shows that equities typically recover and post strong results over the long term.

It's worth noting that while the downturn that began in March 2020 at the start of the COVID-19 pandemic doesn't meet our definition of a bear market because it lasted less than two months, we are counting them as bear markets and including them in our analysis because of their historic nature and the magnitudes of their declines.

Since 1980 there have been 12 bear markets



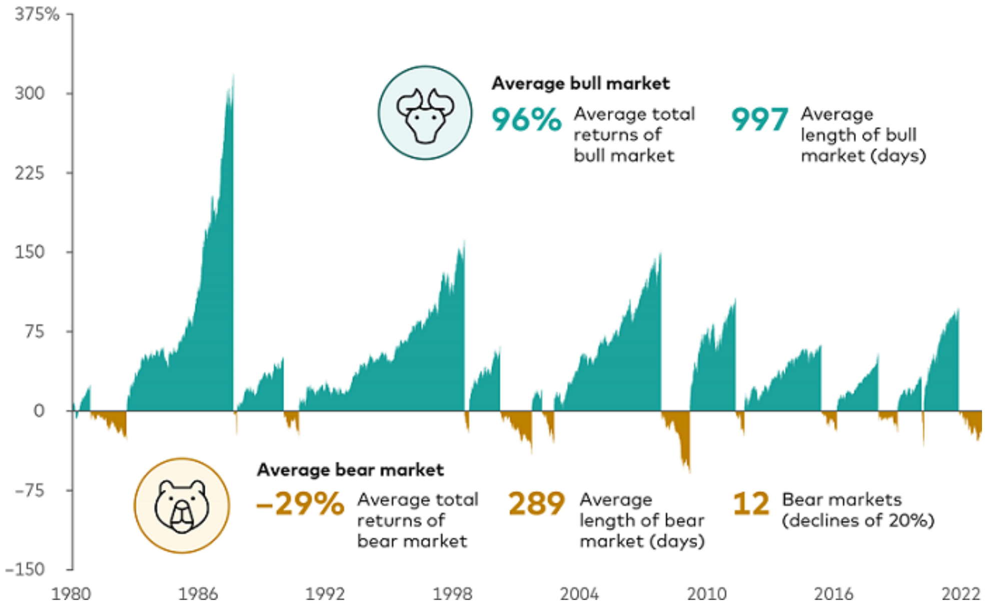
***Note:** Although the downturns that began in August 1987 (related to Black Monday) and February 2020 (related to the start of the COVID-19 pandemic) don't meet a widely accepted definition of a bear market because they lasted less than two months, we are counting them as bear markets and including them in our analysis because of their historic nature.*
***Sources:** Vanguard calculations, as of 31 December 2022. MSCI World Index from 1 January 1980, through 31 December 1987, and the MSCI ACWI thereafter.*

2. Dramatic market losses can sting. Recoveries typically follow.

While bear markets can be daunting, on average they have lasted much shorter than bull markets and have had far less of an effect on long-term performance.

From 1 January 1980 through 31 December 2022, the average length of a bull market has been nearly four times that of a bear market. Similarly, the depth of losses from a bear market has paled in comparison with the magnitude of bull-market gains. That's one reason for sticking to a well-thought-out investment plan: Losses from a bear market have typically given way to longer and stronger gains.

Bear markets are challenging, but bull markets are longer and stronger



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Sources: *Vanguard calculations, as of 31 December 2022, using the MSCI World Index from 1 January 1980 through 31 December 1987, and the MSCI ACWI thereafter. Indexed to 100 as of 31 December 1979.*

3. Timing the market is futile. The best and worst trading days often happen close together.

One reason investors shouldn't try to time the market is they run the risk of missing out on strong performance, which can seriously hamper long-term investment success.

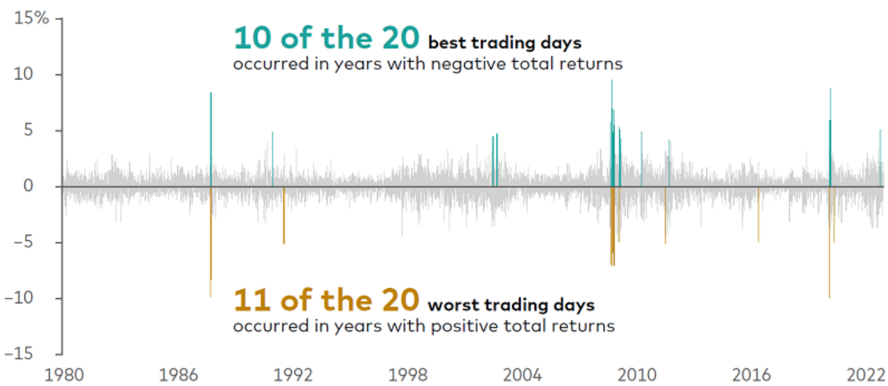
Historically, the best and worst trading days have tended to cluster in brief time periods, often during periods of heightened market uncertainty and distress, making the prospect of successful market-timing improbable.

As this chart shows, the best and worst trading days often occur within days of each other. Ten of the 20 best trading days, as measured by the MSCI World Price Index, from 1 January 1980 through 31 December 2022, occurred during years of negative total returns.

Meanwhile, 11 of the 20 worst trading days occurred in years with positive total returns—another sign of the futility of timing the market.

So practically speaking, when it comes to the market timing game, while there are a handful of experts that can do it repeatedly, for most of us it's an unrewarding experience and the only winning move is not to play.

Timing the market is futile. The best and worst trading days happen close together



Sources: *Vanguard calculations as of 31 December 2022, based on data from Refinitiv using the MSCI World Price Index. 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.*

4. Don't panic during market turmoil.

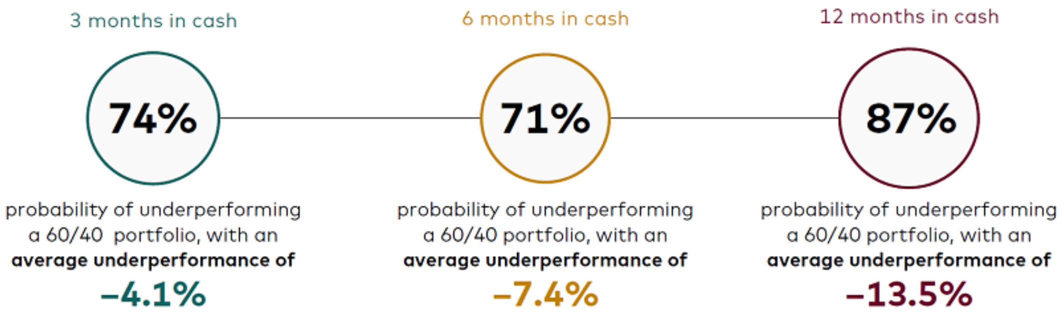
Those who have overreacted to market events by moving to cash have typically seen their portfolios underperform the markets. Long periods out of the market make matters worse and can be one of the most serious mistakes individual investors make.

Fast, significant market downturns are infrequent. When they do occur, investors may be so frightened that they move their portfolio to cash—an event made doubly challenging because investors also have to pick the right time to get back into the market. We looked at monthly stock market returns from 1 January 1980 through 31 December 2022, and found that a three-month decline of 10% or more occurred in equity markets only 6% of the time.

Because periods of such severe market stress occur so infrequently, it is easy to forget and overreact to the bad news. For example, we found that investors have a 74% probability of underperforming the market with an average underperformance of 4.1% when they have moved their balanced 60% stock/40% bond portfolios into all-cash portfolios for three months after a severe market event.

Portfolio underperformance gets even worse for those who convert their balanced portfolios to cash and hold it for longer periods of time. Converting a 60/40 portfolio to cash has led to a 71% probability of underperformance over a six-month period with an average underperformance of 7.4%. And when investors have converted their 60/40 portfolio to cash and held it for 12 months, they have an 87% probability of underperforming with an average underperformance of 13.5%.

Moving to cash in a panic rarely pays off



Notes: *Equities in the 60% equity/40% fixed income portfolio are represented by the Russell 3000 Index, and fixed income is represented by the Bloomberg U.S. Aggregate Bond Index. Cash is represented by the FTSE 3-Month Treasury Bill Index. Monthly data are from January 1980 through December 2022. Equity losses of more than 10% over three months trigger the move from a 60/40 portfolio to all cash in the illustration.*
Source: *Vanguard total return calculations, as of 31 December 2022.*

5. Balanced portfolios of stocks and bonds have proven resilient.

The longer you hold a balanced portfolio, the more likely you are to experience positive performance.

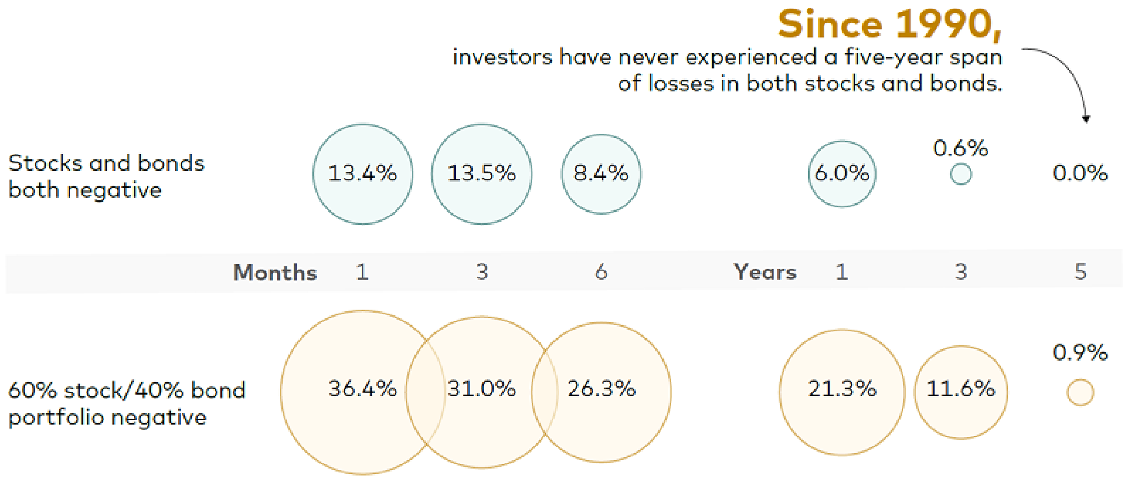
Over a 10-year holding period, a portfolio of 60% stocks and 40% bonds hasn't had a negative nominal return (not accounting for inflation) and has had significantly less likelihood for negative real returns (accounting for inflation) compared with shorter holding periods.

One way to look at the long-term value of holding a balanced portfolio is to examine how quickly stocks and bonds recover from periods of poor performance. Using the MSCI All-Country World Index and the Bloomberg Global Aggregate Total Return Bond Index as proxies for stocks and bonds and examining these indexes' performance from January 1990 through December 2022, we found that balanced portfolios are quite resilient over longer time periods.

Stocks and bonds have both experienced negative performance in the same month 13.4% of the time, over the same three-month period 13.5% of the time, and over the same six-month period 8.4% of the time. But these two asset classes have both experienced negative total returns only 6% of the time over one-year periods.

And since 1990, investors have experienced negative returns in both asset classes only 0.6% of the time over the same three-year period and have never experienced negative returns in both asset classes over a five-year period.

Historically, diversified portfolios have recovered within a few months



Notes: *Data reflect rolling total returns for the periods shown and are based on underlying monthly total returns for the period from January 1990 through December 2022. The MSCI ACWI and the Bloomberg Global Aggregate Total Return Index Unhedged were used as proxies for stocks and bonds, respectively.*
Source: *Vanguard calculations, as of 31 December 2022.*

A similar pattern exists with a 60% stock/40% bond portfolio. A 60/40 portfolio produced negative returns in the same month 36.4% of the time. Over three- and six month intervals, this portfolio produced negative returns 31% and 26.3% of the time.

But over longer periods of time, a portfolio composed of 60% stocks and 40% bonds has proven more resilient.

Over one-year periods, it has produced negative returns 21.3% of the time. Over three- and five-year periods, it has produced negative returns just 11.6% and 0.9% of the time, respectively.

Conclusion

Most of the financial headlines we read are rightly focused on the events of the day. But when it comes to your investment portfolio, today is not that important in the context of a 20-to-40-year investment horizon. Over your lifetime, it is the asset allocation you make and stick with that will drive your investment success.

Rather, investors should focus on the things they can control, such as having clear, appropriate investment goals; developing a suitable asset allocation using broadly diversified funds; minimising investment costs; and maintaining perspective and long-term discipline. After all, you can afford not be the best investor in the world, but none of us can afford to be a bad one.

Duncan Burns is Chief Investment Officer for Asia-Pacific at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any individual.

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Now is the time to buy quality stocks

Mahesh Fonseka, Ned Bell

If there was ever a market environment when quality stocks are expected to perform, we believe it is now. 2023 has marked the 'first act' of what life looks like in a high interest rate environment.

We have had a 13-year runway of varying degrees of capital allocation that paid little attention to fundamentals and valuation. Today, the Federal Reserve ('Fed') effective fund rate is 5.06%. In essence, there has been a rapid interest rate hike – 4.98% since March 2022 – which has exposed risk in financial markets.

While the SVB, US Regional Banks & Credit Suisse stories don't require further explanation – their failures are arguably the first domino to fall in what will likely be a volatile period in markets. Leverage is everywhere in financial markets and capital markets are particularly fragile in what has become an increasingly difficult inflation battle.

Central bankers are fearful of inflation setting in and they therefore collectively seem more likely to keep interest rates higher for longer. Labour markets are structurally tighter than they have been for 20 years – and the risk that central banks overreach with rates hikes remains elevated.

What does this mean for equity markets?

Macroeconomic conditions heavily influence the performance of certain investment styles.

While Growth and Value stock approaches arguably have larger footholds in most institutional portfolios – we believe quality stocks are perfectly aligned for a sustained period of outperformance.

Our definition of Quality allows us to identify high quality businesses from across the market cap spectrum, companies with durable business models and sustainable competitive advantages, strong management teams, businesses with high ROE, stable earnings, strong balance sheets, and low financial leverage.

Over the last 40 years, the Quality investment style has performed well during periods of inflation. Since 1982, there have been 8 calendar years where US CPI has exceeded 4%. The MSCI World Quality Index has outperformed the MSCI World Index by an average of 7.4% in those years. The only two instances where the "Quality – Inflation" rule failed were in 2022 and 1988 when Quality lagged. What was interesting about that time period was the magnitude of the subsequent mean reversion. In the 3 years following 1988, Quality outperformed by an average of 17% p.a.

We expect that markets are poised to reward quality stocks for the next few years.

We view value-companies as more vulnerable to sustained earnings weakness as they tend to exhibit a combination of leverage, poor pricing power and economic sensitivity.

While growth-companies have clearly dominated in recent times, except for 2022, they are likely more susceptible to earnings multiple compression. As at the end of March 2023, the MSCI World Growth Index was trading on a forward P/E of 23.8x which represents a 45% premium to the broader market. We would also argue that the large cap growth stocks which have dominated equity market returns in recent years are far less likely to repeat their recent earnings growth performance.

Quality over the longer-term

With the expectation of slowing global growth, peaking/falling inflation and the ongoing earnings downgrades, Quality and low risk companies are expected to be rewarded over Value.

Market returns (in USD) during calendar years when US CPI exceeded 4% (last 40 years)

Calendar Years	US CPI	MSCI World	MSCI Quality	Relative
2022	8.0%	-18.1%	-22.2%	-4.1%
2021	4.7%	+22.4%	+25.7%	+3.3%
1991	4.3%	+16.0%	+35.7%	+19.7%
1990	5.4%	-18.7%	+0.3%	+19.0%
1989	4.8%	+14.8%	+27.1%	+12.3%
1988	4.1%	+21.2%	+17.9%	-3.3%
1984	4.3%	+1.8%	+5.9%	+4.1%
1982	6.2%	+5.8%	+13.8%	+7.9%
Average				+7.4%

- Quality has outperformed by an average of +7.4%
- Quality has materially outperformed in 1990 and 1991
- Quality has lagged in only 2 out of 8 years

Market returns (in USD) during the 1987-92 period of sustained inflation

Calendar Years	US CPI	MSCI World	MSCI Quality	Relative
1992	3.0%	-7.1%	+1.3%	+8.4%
1991	4.3%	+16.0%	+35.7%	+19.7%
1990	5.4%	-18.7%	+0.3%	+19.0%
1989	4.8%	+14.8%	+27.1%	+12.3%
1988	4.1%	+21.2%	+17.9%	-3.3%
1987	3.7%	+14.3%	+0.3%	-14.0%
Total		+39.3%	+107.2	+67.9
Annual		+5.7%	+12.9%	+7.2%

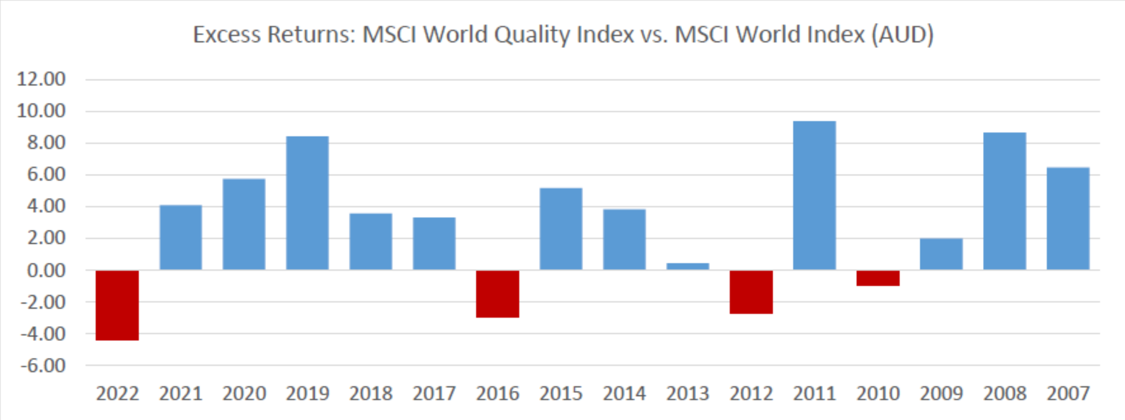
- Quality has outperformed by an average of +7.2%
- Quality has materially outperformed in the market drawdowns of 1990 and 1992

Sources: BAM, MSCI, Bloomberg Finance L.P. Indices used: MSCI World Index (MSCI World) and MSCI World Quality Net TR Index (MSCI Quality). Past performance is not an indicator of future performance.

Looking back, since the start of the global financial crisis in 2007 through to 2022, Quality has outperformed the broader index in 11 out of the last 15 calendar years. The only years of underperformance were in:

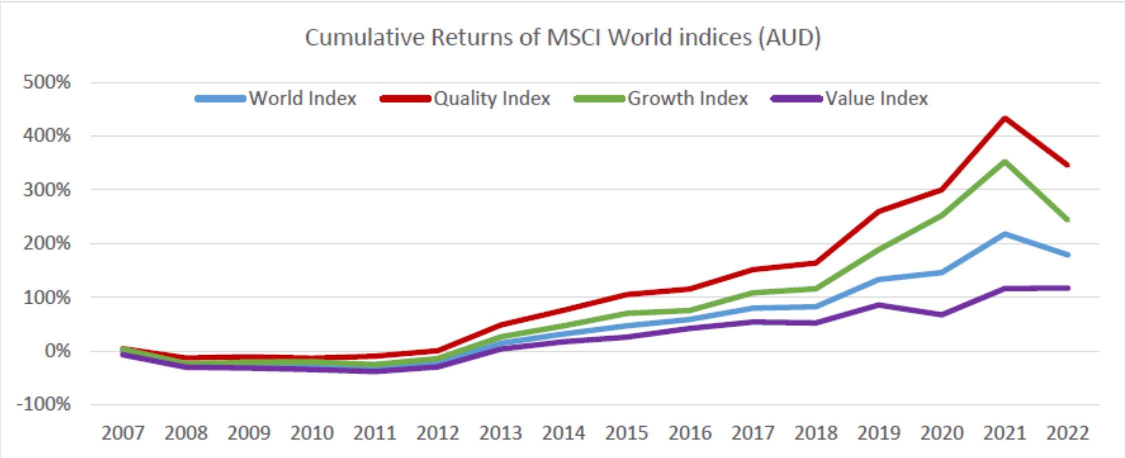
- 2010 – underperformed by 93bps
- 2012 – underperformed by 274bps
- 2016 – underperformed by 297bps
- 2022 – underperformed by 436bps

On each of the occasions, excluding 2022, quality stocks have outperformed in the subsequent year.



Source: MSCI, eVestment, Bell Asset Management, as at 31 December 2022, shown in AUD

Furthermore, 'Quality' has outperformed the broader market and the 'Growth' and 'Value' factors.



Source: MSCI, eVestment, Bell Asset Management, as at 31 December 2022, shown in AUD

One interesting point is that the recent historical earnings growth of Quality is superior to that of Growth. From 2013–2022, the 'Growth' EPS growth stood at 53% vs 'Quality' EPS growth of 87%. We believe this apparent anomaly is that "forecast growth" is a key metric that MSCI uses to categorize growth stocks. Quality stocks on the other hand are selected by MSCI based on high ROE, stable year-on-year EPS growth and low leverage.

Another way to think about this is to compare the current valuations with actual EPS growth:

MSCI World Style Index	Forward P/E (31 March 2023)	EPS Growth (2013 – 2022)	P/E vs Growth
Quality	20.3	87%	0.23
Growth	23.8	53%	0.45
Difference	*(3.5)*	*+34%*	*0.22*

Source: MSCI, Bloomberg Finance L.P., data shown in USD.

In short, our view is that paying a discount for premium growth, low leverage, and superior profitability is a compelling argument for investors to lift their quality stock exposure.

Stocks we like

Here are two stocks that we think have bright prospects:

SGS – Swiss-headquartered SGS is the world's leading testing, inspection, and certification company. We owned SGS in the portfolio many years ago and have continued to follow it closely, along with a number of peers in the space. After a recent meeting with the CEO, we gained greater conviction in the long-term outlook and believe that fears over macro impacts are well factored into the current share price and valuation after a big drawdown. Approximately two thirds of the business is driven by regulation which means that revenues should prove relatively resilient regardless of how the macro environment plays out.

Neste – Neste is a highly innovative Finnish based energy company focused on the growing renewable fuels market. It has an extensive network of feedstock suppliers from which they buy animal fats, used cooking oils and other inputs to refine into renewable diesel. Neste has recently opened new refining capacity in Singapore from where they will supply SAF (sustainable aviation fuel) to the many airlines that have signed up to use their product which will help reduce carbon emissions. Neste is a leader in this rapidly growing market, helping them achieve strong margins, plus they have a track record of disciplined capital allocation. The shares currently trade on an attractive valuation, and we see strong upside over the medium and long term.

Ned Bell is Chief Investment Officer and Portfolio Manager, and Mahesh Fonseka is Head of Investment Specialists at Bell Asset Management, a Channel Capital partner. Channel Capital is a sponsor of Firstlinks. This information is not advice or a recommendation in relation to purchasing or selling particular assets. It does not take into account particular investment objectives or needs.

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