Firstlinks
a Morningstar company

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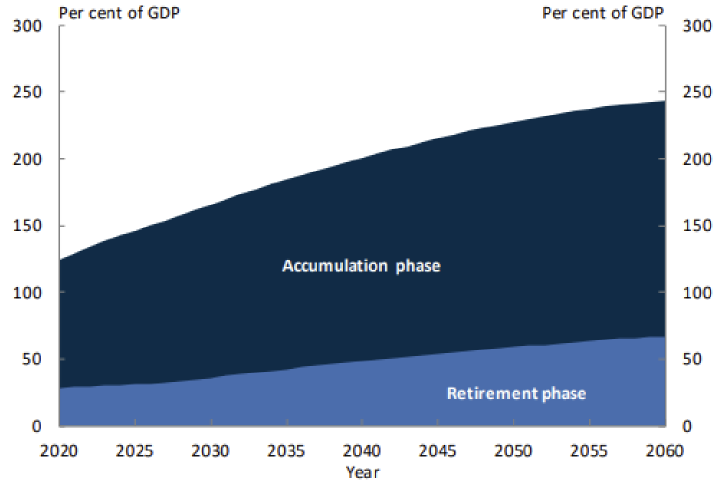
Editorial

The power of Australia’s $3.6 trillion superannuation sector has been on full display of late.

First, AustralianSuper used its influence as Origin Energy’s largest shareholder to reject a takeover offer led alternative investment titans, Brookfield. It’s not the first time that super funds have swayed the fortunes of Australian listed companies. In 2019, they were instrumental in getting Westpac CEO, Brian Hartzer, fired. In 2021, a consortium of IFM Investors, QSuper, and Global Infrastructure Partners, backed by AustralianSuper, acquired Sydney Airport for $32 billion. The Origin deal collapse is another marker for the growing heft of the super funds in listed markets.

The power of Big Super is testament to the success of our superannuation system. The OECD says our system is now the fourth largest in the world. A recent report from The Thinking Institute and Pensions and Investments shows five of Australia’s super funds rank among the top 100 in the world.

Total value of superannuation assets



Source: Treasury

Forecasts from the Treasury Department and others suggest super fund assets may reach $10.5 trillion by 2040. To put that in context, residential property is currently the largest asset class in Australia and it’s valued at $10.1 trillion.

At last count, super funds had about 22% of their $3.6 trillion in assets in listed Australian stocks. That equates to close to $800 billion, or 29% of the total ASX market capitalization of $2.8 trillion.

Given the forecast trebling in super fund assets by 2040, it’s not hard to see that Big Super will increase their ownership of ASX stocks over time. And that those companies offering real, long-term assets such as Origin Energy will be prime targets for these funds.

Given the limited size of the ASX, it can also be expected that super funds will continue to diversify their holdings into international stocks and private assets.

Clime Investment Management's John Abernethy has said that super funds have almost defaulted into private assets from listed assets due to their size. There's some truth to this.

Second, the Labor Government released a discussion paper called 'The Retirement Phase of Superannuation' this week. The paper floats an idea proposed in David Murray's Financial System a decade ago, and backed by the two largest super funds, AustralianSuper and Australian Retirement Trust, of automatically rolling fund customers into pension products once they reach retirement age.

This seems another sign that super funds are pushing back against the Labor Government's wish for these funds to be all things to all people. The government has previously pushed for super funds to be more involved in 'nation building' housing and infrastructure projects, as well as offering better financial/retirement advice to their members. This discussion paper seems to pave the way for a compromise on the latter issue.

Third, super fund bosses visited Canberra this week to lobby Treasurer Jim Chalmers to overhaul the Your Future, Your Super performance testing regime. The super funds suggest the testing discourages them from investing in the long-term projects that the Labor Government wants them to pursue.

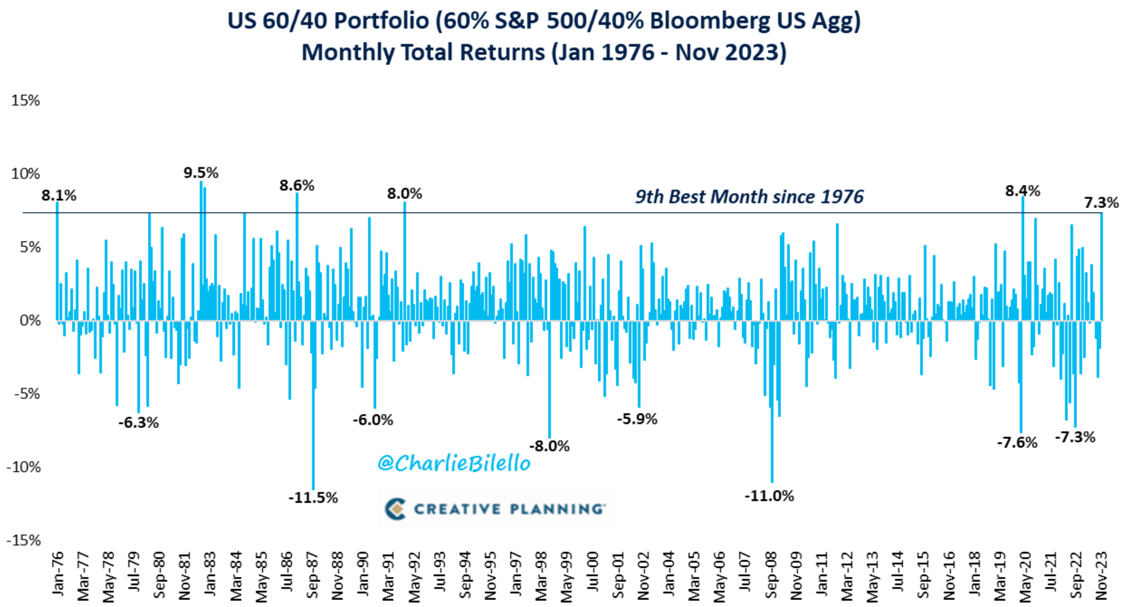
The funds have a point. Short-term performance testing doesn't align with long-term investments.

Yet, the lobbying is another indication that Big Super is trying to set boundaries with the government on what it should and shouldn't do. As super funds continue to grow, those boundaries are likely to become increasingly blurred.

Stocks, bonds, bitcoin, gold are all flying – we're back to the everything rally!

In November, the ASX 200 was up 4.52%, its best month since January. And year date, the index has risen 4.4%.

Meanwhile, the S&P 500 ripped 8.9% higher in November, it's 7th best month in the last 30 years. The US bond market gained 4.5% for the month, its best month since 1985. And a US 60/40 portfolio had its second-best month in 30 years.



90% of key asset classes in the US are in the green in 2023, with Bitcoin and the Nasdaq 100 up a cool 126% and 47% respectively.

CREATIVE PLANNING		Asset Class Total Returns Since 2011 (Data via YCharts as of 11/30/23)													@CharlieBilello	
ETF	Asset Class	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 YTD	2011-23 Cumulative	2011-23 Annualized
N/A	Bitcoin ($BTC)	1473%	186%	5507%	-58%	35%	125%	1331%	-73%	95%	301%	66%	-65.5%	**126.3%**	12471511%	148.0%
QQQ	US Nasdaq 100	3.4%	18.1%	36.6%	19.2%	9.5%	7.1%	32.7%	-0.1%	39.0%	48.6%	27.4%	-32.6%	**46.7%**	703.6%	17.5%
IWF	US Growth	2.3%	15.2%	33.1%	12.8%	5.5%	7.0%	30.0%	-1.7%	35.9%	38.3%	27.4%	-29.3%	**36.5%**	490.0%	14.7%
SPY	US Large Caps	1.9%	16.0%	32.2%	13.5%	1.2%	12.0%	21.7%	-4.5%	31.2%	18.4%	28.7%	-18.2%	**20.7%**	361.2%	12.6%
EFA	EAFE Stocks	-12.2%	18.8%	21.4%	-6.2%	-1.0%	1.4%	25.1%	-13.8%	22.0%	7.6%	11.5%	-14.4%	**12.4%**	80.9%	4.7%
GLD	Gold	9.6%	6.6%	-28.3%	-2.2%	-10.7%	8.0%	12.8%	-1.9%	17.9%	24.8%	-4.2%	-0.8%	**11.3%**	36.1%	2.4%
HYG	High Yield Bonds	6.8%	11.7%	5.8%	1.9%	-5.0%	13.4%	6.1%	-2.0%	14.1%	4.5%	3.8%	-11.0%	**8.1%**	71.1%	4.2%
CWB	Convertible Bonds	-7.7%	15.9%	20.5%	7.7%	-0.8%	10.6%	15.7%	-2.0%	22.4%	53.4%	2.2%	-20.8%	**8.0%**	183.4%	8.4%
MDY	US Mid Caps	-2.1%	17.8%	33.1%	9.4%	-2.5%	20.5%	15.9%	-11.3%	25.8%	13.5%	24.5%	-13.3%	**6.9%**	234.0%	9.8%
PFF	Preferred Stocks	-2.0%	17.8%	-1.0%	14.1%	4.3%	1.3%	8.1%	-4.7%	15.9%	7.9%	7.2%	-18.2%	**6.1%**	65.0%	4.0%
EMB	EM Bonds (USD)	7.7%	16.9%	-7.8%	6.1%	1.0%	9.3%	10.3%	-5.5%	15.5%	5.4%	-2.2%	-18.6%	**5.8%**	45.1%	2.9%
IWD	US Value	0.1%	17.5%	32.1%	13.2%	-4.0%	17.3%	13.5%	-8.5%	26.1%	2.7%	25.0%	-7.7%	**5.5%**	224.0%	9.5%
EEM	EM Stocks	-18.8%	19.1%	-3.7%	-3.9%	-16.2%	10.9%	37.3%	-15.3%	18.2%	17.0%	-3.6%	-20.6%	**5.2%**	7.8%	0.6%
BIL	US Cash	0.0%	0.0%	-0.1%	-0.1%	-0.1%	0.1%	0.7%	1.7%	2.2%	0.4%	-0.1%	1.4%	**4.5%**	10.9%	0.8%
LQD	Investment Grade Bonds	9.7%	10.6%	-2.0%	8.2%	-1.3%	6.2%	7.1%	-3.8%	17.4%	11.0%	-1.8%	-17.9%	**4.3%**	52.1%	3.3%
IWM	US Small Caps	-4.4%	16.7%	38.7%	5.0%	-4.5%	21.6%	14.6%	-11.1%	25.4%	20.0%	14.5%	-20.5%	**4.2%**	174.6%	8.1%
VNQ	US REITs	8.6%	17.6%	2.3%	30.4%	2.4%	8.6%	4.9%	-6.0%	28.9%	-4.7%	40.5%	-26.2%	**2.2%**	143.1%	7.1%
BND	US Total Bond Market	7.7%	3.9%	-2.1%	5.8%	0.6%	2.5%	3.6%	-0.1%	8.8%	7.7%	-1.9%	-13.1%	**2.0%**	26.0%	1.8%
TIP	TIPS	13.3%	6.4%	-8.5%	3.6%	-1.8%	4.7%	2.9%	-1.4%	8.3%	10.8%	5.7%	-12.2%	**1.3%**	34.6%	2.3%
DBC	Commodities	-2.6%	3.5%	-7.6%	-28.1%	-27.6%	18.6%	4.9%	-11.6%	11.8%	-7.8%	41.4%	19.3%	**-3.0%**	-10.2%	-0.8%
TLT	Long Duration Treasuries	34.0%	2.6%	-13.4%	27.3%	-1.8%	1.2%	9.2%	-1.6%	14.1%	18.2%	-4.6%	-31.2%	**-5.4%**	35.4%	2.4%
Highest Return		BTC	BTC	BTC	VNQ	BTC	BTC	BTC	BIL	BTC	BTC	BTC	DBC	BTC	BTC	BTC
Lowest Return		EEM	BIL	GLD	BTC	DBC	BIL	BIL	BTC	BIL	DBC	TLT	BTC	TLT	DBC	DBC
% of Asset Classes Positive		62%	95%	52%	71%	38%	100%	100%	5%	100%	90%	67%	10%	90%	95%	95%

What happens next? Hedge fund titan Stanley Druckenmiller once said that liquidity, not fundamentals, moves markets in the short-term.

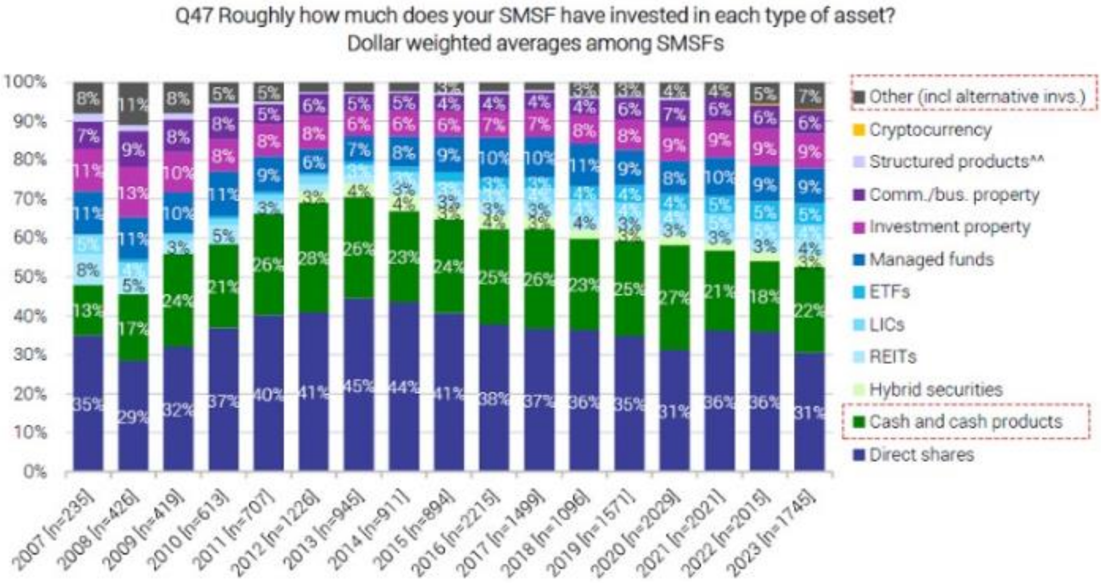
If right, we could see more money flowing from cash into stocks and bonds. In the US, it's already happening, with net inflows of US$77 billion into equities in November.

Exhibit 2: November Flows Across Morningstar Broad Category Groups

Global Broad Category Group	Net Assets ($Bil)	Market Share (%)	Estimated Nov Net Flows ($Bil)	Estimated YTD Net Flows ($Bil)
Equity	5,914.9	77.1%	77.0	280.1
Fixed Income	1,474.1	19.2%	30.7	183.9
Commodities	131.8	1.7%	0.2	-8.9
Miscellaneous	88.6	1.2%	0.4	3.7
Alternative	44.9	0.6%	1.8	12.5
Allocation	15.4	0.2%	0.0	-2.4
Convertibles	5.1	0.1%	0.0	-1.4
Money Market	0.1	0.0%	0.1	0.0
	7,674.9		110.1	467.6

Source: Morningstar Direct. Data as of 11/30/2023.

That could happen in Australia too. In the first half of the year, money poured into cash after the stock market's dismal 2022. For instance, SMSFs interviewed by Vanguard in June had increased cash and bond allocations at the expense of stocks.



Fundamentals also look reasonable for the ASX. Schroders' Head of Multi-Asset in Australia, Sebastian Mullins, says Australia looks inexpensive compared to overseas markets:

"The US is trading at 17x forward earnings, expecting 12% earnings growth. Australia is trading at 15x earnings, expecting -1.2% earnings. So, there's a potential for a surprise to the upside in Australia, relative to other countries."

James Gruber

In this week's edition...

How should investors position their portfolios for 2024? **Clime Investment's John Abernethy** suggests tilting towards income assets, before switching more to equities in 2025. He likes bonds, especially investment grade corporate bonds, over the next 12 months. Long-term, stocks remain a good bet given Australia's favourable economic and demographic outlook.

Orbis Investments' Shane Woldendorp, Eric Marais and Rob Perrone are also thinking about the long-term. They believe investors are dangerously overexposed to recent market winners such large cap, growth stocks. They say these stocks are very expensive and investors to need switch tack if they're to outperform in the decade ahead.

Vanguard's Asia-Pacific CIO, Duncan Burns, looks at the best way to blend passive and active assets into a portfolio. He thinks investors should start with a diversified index core holding and add low-cost active satellite holdings where they have conviction, unique needs, or access to a talented active manager.

We've all heard about how younger people are being priced out of the housing market. But a new survey by National Seniors Australia reveals housing affordability concerns two-thirds of older Australians too, and more than half are living in homes unsuitable for later life because they need modifications, security of tenure, or assistance. **Diane Hosking** and **Linda Orthia** have the details.

It's happy birthday to the floating of the Aussie dollar. 40 years ago, the Hawke Labor Government made the momentous decision to float the dollar. **Selwyn Cornish** and **John Hawkins** look at the history behind the decision and how it's served the country well since.

India has overtaken China as the world's most populous nation and under a reformist Prime Minister, it's growing faster than most other emerging markets. What's often underestimated is how many well-run, global companies they have. **Rajiv Jain** and his team at **GQG Partners** think India is worth a closer look for global investors.

Morningstar's Annika Bradley peeks under the hoods of the investment businesses of UniSuper and AustralianSuper. She investigates the growing trend of funds bringing investment management back in-house, and the advantages and disadvantages of doing so.

Two extra articles from **Morningstar** for the weekend. Shaun Ler says Washington H. Soul Pattinson's takeover bid for Perpetual is a lowball offer, while Jon Mills assesses ASX gold miners after a recent surge in the price of the yellow metal.

Lastly, in this week's whitepaper, **Vanguard** examines the growth of the ETF industry in Australia.

Clime time: Income assets set for bumper 2024

John Abernethy

The post-Covid period for asset markets is well advanced. This period has featured both higher inflation and higher interest rates compared to the pre-Covid period. Rising bond yields have pushed down bond prices and compressed equity market price earnings ratios (PERs). Property capitalization rates have increased and checked property valuations. Cash flows from leveraged assets have decreased due to debt facilities being re-negotiated to higher rates.

However, the era of asset price compression will continue for a short period before petering out in 2024. Whilst higher risk-free rates have caused an adjustment to the intrinsic values of all assets, it is now mainly behind us because inflation is clearly declining – and investment grade interest rates for investors will surely follow. In particular the risk-free rate of return (the ten-year bond rate) looks well anchored below 5%.

Balanced returns look good in 2024

With both inflation (already) and cash rates peaking (over the next 3 months) Australian asset markets are resetting and investors can take comfort that balanced portfolio returns stand on firmer ground. Inside a balanced portfolio lower risk yield can replace higher risk yield because investments such as corporate debt and/or asset backed securities now generate appropriate yields that are above inflation. For risk adverse investors, two and three government bonds are now generating a reasonable yield.

The strategic positioning of portfolios toward income-oriented investments, especially for investors reliant on higher pensions, has an aspect of urgency. This is because asset allocators (at large pension funds) will soon see that "real interest rates" (i.e. rates above inflation) are now clear to observe in corporate debt markets. Whilst corporate bond yields have risen, they are now enhanced by readings of lower inflation. The attractiveness of quality corporate debt that yields higher than projected inflation will become increasingly obvious.

The amount of money that will flow towards these "real" interest rate offers will be significant. Importantly the current corporate debt yields (and thus returns) are similar to the higher risk returns expected from equities, and that will not last.

This suggests that investment returns for balanced portfolios will not be greatly challenged in 2024. Indeed, positive returns for portfolios will be generated from the stronger income that will flow from fixed income asset classes (debt and credit). A balanced portfolio that invests across growth and income assets should be appropriately tilted towards income and more so as if an investor is mature and required to withdraw higher pensions.

Allocations to growth assets that generate dividends or rental streams should be maintained because economic growth will reward these asset classes post 2024. Investors need to rebalance portfolios with an eye focused on income and the other eye on the assets that will perform when the interest rate cycle plateaus during 2024. This is because Australia's economic growth post 2024 seems assured as demand flows across the economy from a surge in population.

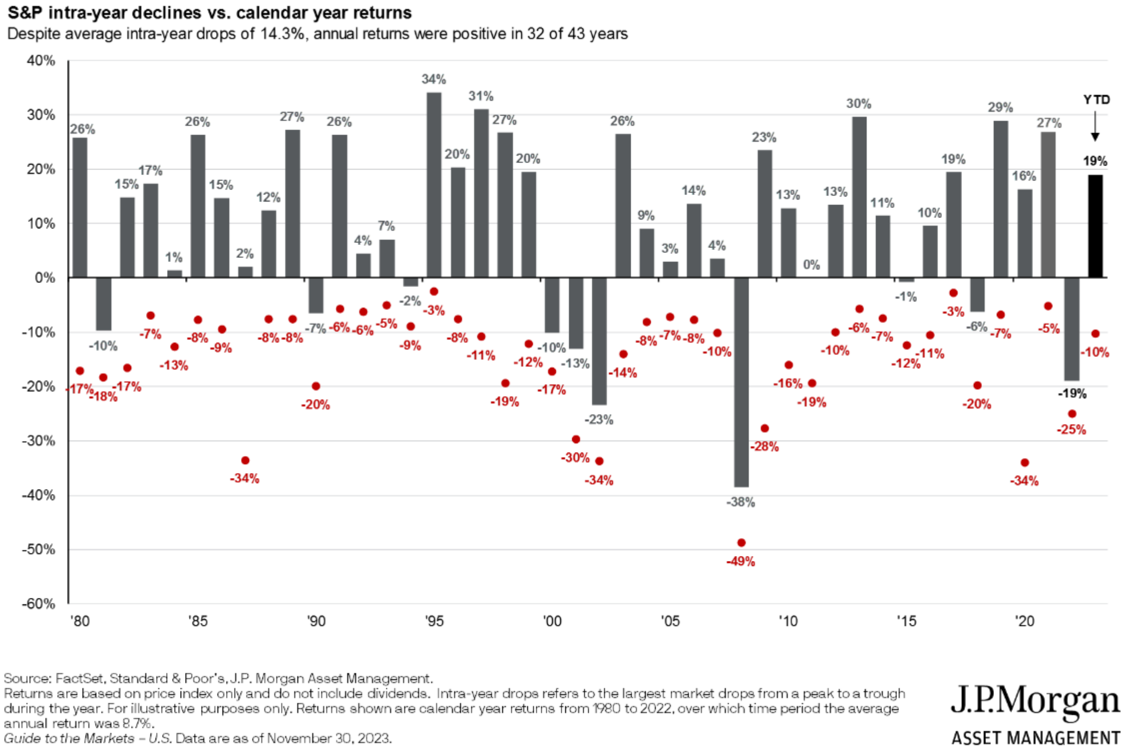
Higher bond yields have impacted the risk asset valuations

Higher ten-year bond yields (and substantially lower bond prices) are now set, and we can observe that yields are 3% to 4% above pre-Covid levels. These higher yields ("risk free rate of return") are contesting intrinsic valuations of other assets based on their cashflow generation.

If the cash flows from low-risk assets increases, then so too must the required cash flows from higher risk assets. These cash flows don't just suddenly appear from business operations or rental streams. Rather, the market yield rises as the market price for these assets is forced lower. That explains the asset deflation cycle that we have been in, but the good news is that we are well through this cycle.

Remember the excesses of the pre-Covid era

While asset price "down cycles" are not uncommon (and they generally last short periods), it is clear that the post GFC, pre-pandemic periods and during the pandemic itself, were dominated by ridiculously low interest rate settings, and these created an immense speculative asset inflation cycle. The chart below tracks the US S&P 500 index returns and illustrates that low rates propelled the index higher in most years. The correction of 2022 (negative 19%) was well overdue.



Thus, excessive asset prices are adjusting in this post-Covid era. The extent of this price adjustment will result from the interplay of higher required returns (the rising risk-free rate) against observations of and predictions for growth.

Understanding the interplay of interest rates on market prices of assets allows investors to understand the scenarios that flow from higher interest rates. It assists investors to look at past market behavior and understand what the driving influences were. It informs investors how extreme market behaviour or pricing can be suddenly checked or reversed. Importantly, it puts into context the past when compared to the present and guides investors in their decision making.

Can today's interest rates lead to a market crash like 1987?

To this question, the following table (published early October 2023) informs us that today's markets are nowhere near the extremes seen before the 1987 crash. For instance, whilst today's PERs are comparable to 1987, back then bond yields were significantly higher. Further, the surge in Australian stock prices over 1 and 4 years prior to the 1987 crash were extraordinary. Analysis of our current market makes clear that we are not in a speculative bubble with the Australian equity market paddling sideways.

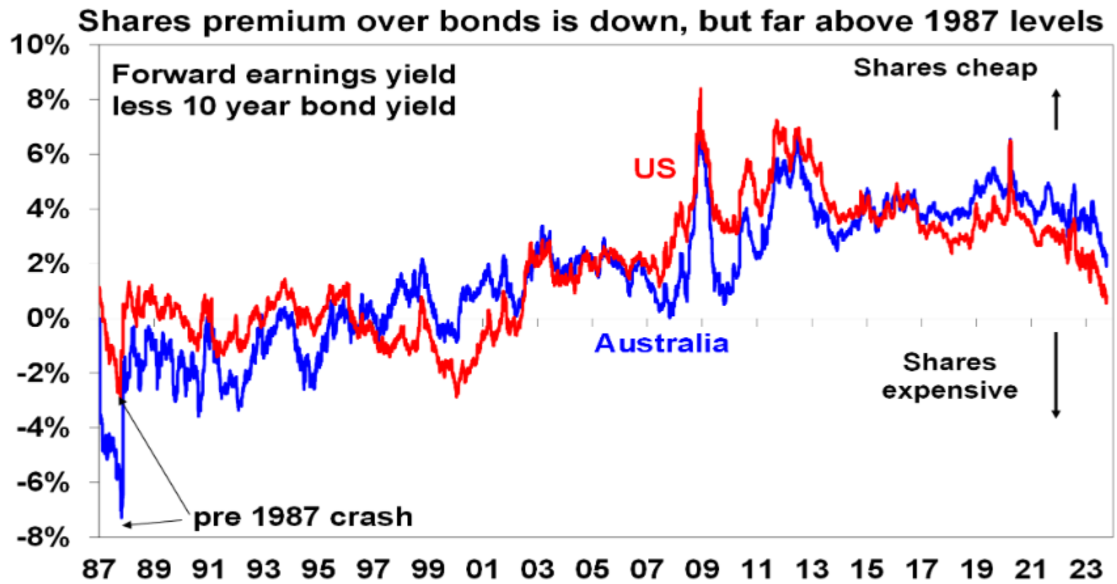
US & Australian shares – 1987 v now

	US at Aug 87 peak	US now	Aust at Sept 87 peak	Aust now
Prior 12 mth share gain, %	36.4	19.6	88.4	8.5
Prior 4 yr price gain, % pa	20.3	7.4	34.0	1.6
Forward PE, times *	14.8	18.0	14.3	14.6
10 yr avg fwd PE, times	11.4	18.0	NA	15.5
Inflation, %	4.1	3.6	8.5	5.2
10 year bond yld, %	8.8	4.8	12.4	4.5
Forward earnings yield less bond yield, %	-2.0	0.7	-5.3	2.3
Dividend yield, %	2.6	1.5	2.5	4.3
Dividend yield less infl, %	-1.5	-2.1	-6.0	-0.9

** The forward PE is based on 12 mth ahead consensus earnings expectations. The forward earnings yield is the forward PE inverted. Source: Reuters, AMP*

The earnings yield of a company is the inverse of the PER. Therefore, as bond yields rise, then the market will force earnings yields to rise and PERs fall. If PERs don't fall in relation to rising bond yields, then shares become less attractive. Investors that are offered higher yields will adjust their allocations within their multi-asset portfolio.

Australian shares might not be particularly cheap, but neither are they particularly expensive. Indeed, the chart below shows that shares on a relative basis, in the face of rising bond yields, have merely become somewhat less attractive. Axiomatically, as bond yields move lower with inflation expectations then shares will become more attractive.



Source: Reuters, AMP

Higher interest rates support a rebalance to income assets

The key points I want to emphasise from the analysis above are these:

1. Whilst Government bond yields have risen, they are still below inflation and arguably still not producing adequate returns. However, the rise in bond yields and particularly in corporate debt, do now offer investors solid income out to 3 years in duration;
2. While property assets have devalued (market values) with higher interest rates, they will begin to recover as income grows from rental flows benefiting from inflation. Leveraged property has been hardest hit, but the tailwinds for economic growth suggest property will continue to be a good long term investment – expect a recovery in 2024;
3. International equities have been highly volatile over 2022 and 2023 as higher bond yields challenged valuations. Australian investors have been protected by a weak currency and should stay alert to the risk of an AUD revaluation in 2024 that could arise once our cash rates rise above inflation;
4. Australian equities continue to generate high franked income but with limited capital growth opportunity. The equity index remains dominated by resource and financial companies and their performance will continue to dictate the trajectory of equity market returns. However, the outlook for emerging companies outside the ASX 200 has become increasingly attractive after 2 years of underperformance. Look for a sharp recovery in small company indices through 2024.

While 2024 promises to deliver positive returns across all asset classes, the returns from income asset classes have become increasingly attractive. Balanced portfolios should continue to deploy both cash and cash flows to Australian corporate debt paper and target a 7% return with less volatility and more stability in portfolio values. If 7% does not seem adequate, then it is worth reflecting that bond markets have lost about 30% of their value over recent years. Steady returns are far better than volatile returns that detract from the benefits of compounding – which is an investor's best friend.

John Abernethy is Founder and Chairman of [Clime Investment Management Limited](), a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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Blending active and passive into a winning portfolio

Duncan Burns

When you look at the long-term equity index charts moving up and to the right, it's easy to forget the individual stocks underpinning the indices don't move up and around as a unified block.

This has important implications for how you try to extract returns from the equity markets and the approach you take to building a quality portfolio.

Beating the performance of the broader share market in any one year isn't an easy task and, when you look at the data and the facts, the truth is it's way harder than most people think.

And, as you would expect, it's even more difficult to beat the market's performance over multiple years, let's say over five, 10 and 15 years.

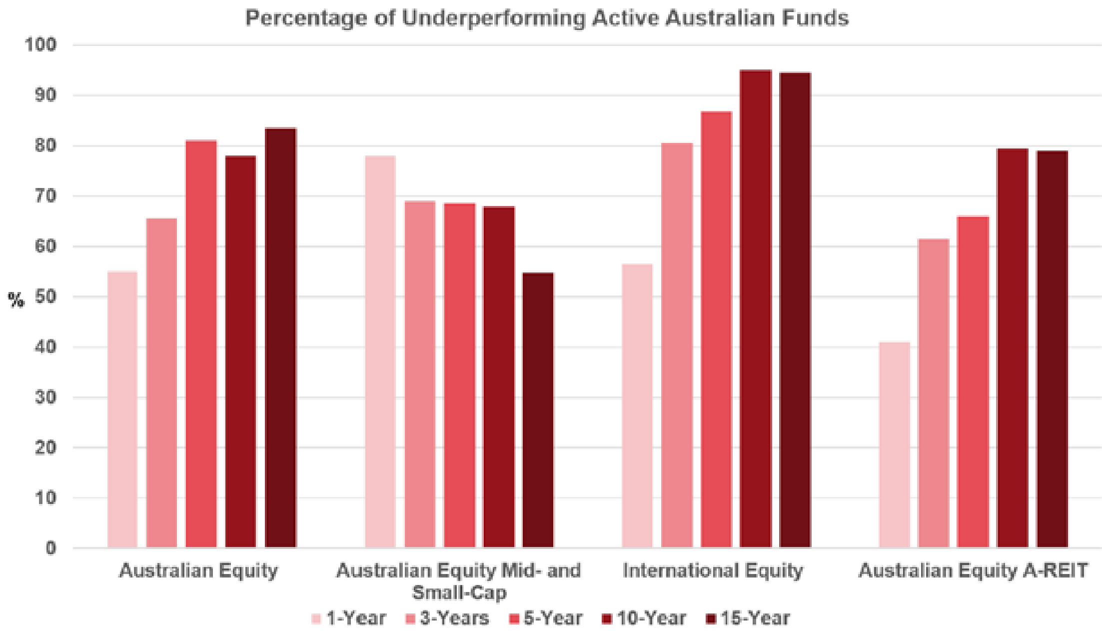
In essence, that's the Herculean task faced by all active investment managers – whether they be professionals running large portfolios or individual investors with a small portfolio of hand-picked stocks. That is, if you're investing actively, your whole modus operandi is to beat the broad market averages like the S&P/ASX 300.

Global index provider Standard & Poor's measures the performance of active fund managers over time. The 2022 S&P Index Versus Active scorecard, widely known in investment circles as SPIVA, showed 57% of actively managed large-cap Australian equity funds (funds that invest in a selection of the largest Australian companies chosen by an investment team) underperformed the S&P/ASX 300 Index last year.

The SPIVA report also shows that active underperformance rates over the longer term were even more dismal.

Over five, 10 and 15-year time horizons actively managed large-cap Australian equity funds underperformed the S&P/ASX 300 Index by 81%, 72% and 83.5%, respectively.

The takeaway here is, when investors go active, they are more likely to be in the long-term majority of the distribution that underperforms rather than the smaller percentage that outperforms. This isn't just an Aussie thing. We see similar results in equity markets all around the world.



Source: Standard & Poor's

Costs are a headwind to active

All investors are subject to the costs of participating in the market.

These costs include management fees, bid-ask spreads, administrative costs, commissions, market impact and, where applicable, taxes. These costs can be high and reduce investor returns over time.

And costs create a hurdle that must be overcome to beat the market averages.

Because the average costs of active management are typically much higher than those of index funds, this is a strong headwind that diminishes the chances of successful active outperformance.

The equity market is 'skewed'

Before I got into index investing, I assumed that half of all stocks outperformed a market index and the other half underperformed in a given year.

Successful active stock picking meant selecting from the top half, avoiding the bottom half, and making massive amounts of money, or "alpha" as the pros call it.

Unfortunately, that's not the way equity markets really work. In reality, there are huge tails when you look at the extreme over- and under-performers in the market. This asymmetry is what we call the 'skewness' of equity returns.

As shown in the chart below, a positively skewed distribution has a tail which is more pronounced on the right side (positive) than it is on the left (negative).

In a positively skewed distribution, there are a few really large data points way out in the tail that pull the average up. That is, the mean (average) is greater than the median (middle), with the most extreme values on the right side.

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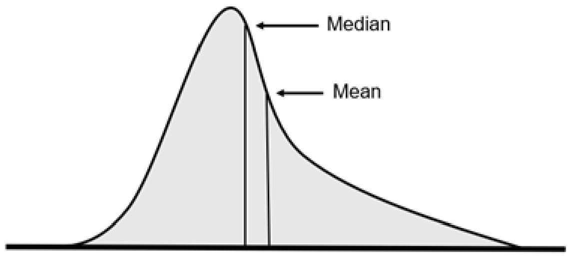
Skewness of Equity Returns

Positively Skewed Distribution (mean > median)....this is reality for equites



Source: Vanguard

When thinking more deeply about equities, we might intuitively suspect there is a natural tendency towards a right skew—after all, a stock can only go down by 100%, while it can appreciate by way more than that. A handful of stocks go up by 200%, 300%, 500% or 1,000%, and that's where the bulk of equity index returns really come from.

What this means for investors with a well-diversified portfolio is they typically experience frequent small losses from the majority of stocks, but a few exceptionally large gains from a subset of their holdings.

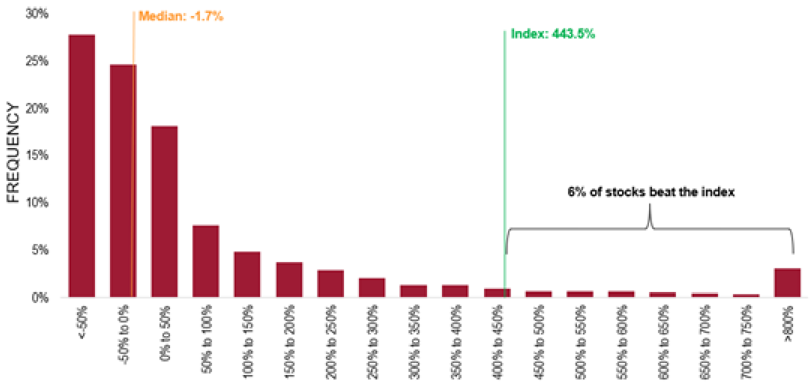
In 2022, roughly a third (33%) of the top 300 companies outperformed the return from the S&P/ASX 300 Index. So, to outperform the market, an active investor needed to be concentrated in that 33% of outperforming companies.

The 10-year period from the start of 2012 to the end of 2022 shows only 17% of the companies in the S&P/ASX 300 Index beat the performance of the broader market average over that time. Furthermore, the top three ASX stocks (Commonwealth Bank, CSL and BHP) accounted for 24% of the total index return.

This skewness becomes even more pronounced over the 20 years from the start of 2002 to the end of 2022. Only 6% of the companies in the S&P/ASX 300 Index beat the performance of the broader market over this time, with the top three stocks (BHP, Commonwealth Bank and Westpac) accounting for almost one-third of the total index return.

Put another way, if an active investor didn't have those three particular stocks in their portfolio they would have missed out on a fair chunk of the market's return.

Skewness of Equity Returns – S&P/ASX300, 2002-2022



Source: Standard & Poor's

Striking a balance: Index + Active

So, how can investors position their portfolio to take advantage of this skewness of equity returns?

If there is one takeaway, it's that index managed funds and exchange traded funds should be a consequential piece of a core equity portfolio.

Think of broad-based index funds as a way to 'tame the skewness' of equity markets because they capture the upside of those extreme winners and tilt the odds in an investor's favour. It's simply the most efficient way to capture long-term equity market returns.

Now you know why the search for winning active fund managers is a tough and ultimately unrewarding one for most investors. So, consider dialling back your active exposure and dialling up your index exposure.

The core/satellite approach to building a portfolio is a great framework for blending both index and active. Start with a broadly diversified index core holding. Then add some small low-cost active satellite holdings around the margins where you have conviction, unique needs, or access to a truly talented active manager to round it out.

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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Preparing for next decade's market winners

Eric Marais, Rob Perrone, Shane Woldendorp

The lesson from history is that passive exposure leads to concentrations in expensive areas just before those areas suffer. That is alarming if we consider how passive portfolios have evolved since the Global Financial Crisis.

In 2009, a passive investor in the MSCI World Index had a 50% exposure to the US, 1/3 of their portfolio in giant companies, and a 10% exposure to tech. Over the subsequent years, that portfolio has grown more American, more dominated by giants, and more tech heavy. Stockmarkets are now heavily concentrated in the US (70%), giant companies (2/3), and in technology shares (25%). The magnificent seven alone account for close to 20% of global passive portfolios.

Figure 1: Equity markets are concentrated in the US

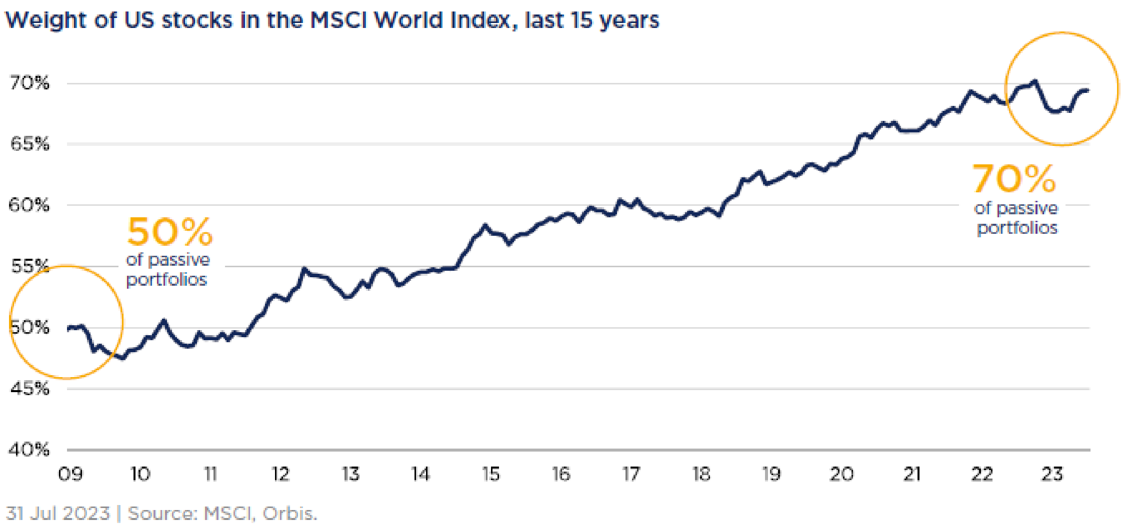


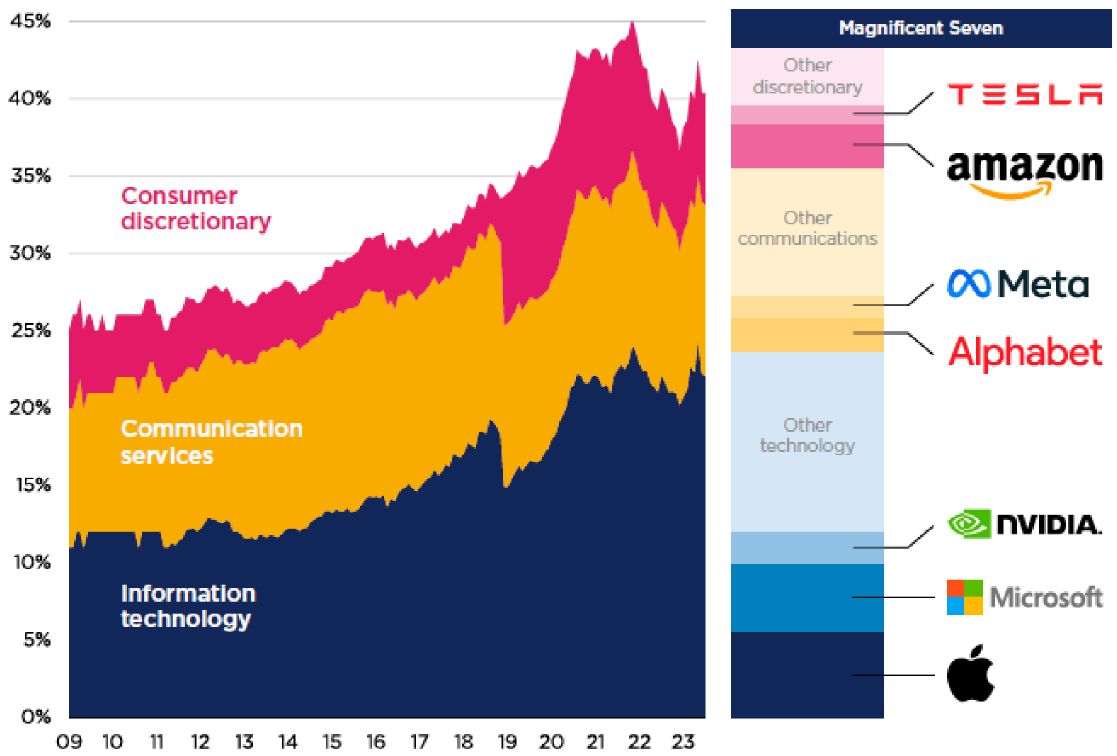
Figure 2: Equity markets are concentrated in giant companies

Weight of mega-cap stocks in the MSCI World Index, last 15 years

31 Jul 2023 | Source: MSCI, Orbis. Mega-cap stocks are defined as those with market capitalisations above $50 billion.

Figure 3: Equity markets are concentrated in tech shares

Weight of sectors and top stocks in the MSCI World Index, last 15 years



31 Jul 2023 | Source: MSCI, Orbis. The Magnificent Seven are the seven largest companies in the MSCI World Index by market capitalisation.

A static investment strategy has not led to static exposures, but increased concentrations in the winners of the last decade. That has been rewarding for investors as momentum has persisted. But as 2022 showed, it carries risks. Each of those three areas is more richly valued than its opposite. The US market trades at 22 times earnings, versus 14 times for shares elsewhere. Giant stocks trade at 20 times earnings, while the median global stocks trades at 17 times. Tech shares are valued at 30 times expected earnings, while other industries are valued at just 16 times in aggregate. Passive exposure to global stockmarkets has led to heavy concentrations in the most richly valued parts of the market.

Investors are concentrated in recent winning styles

That would be alarming enough, as close to 70% of the assets in Australia's 10 biggest retail global equity funds are in passive strategies. But investors have also actively allocated to styles best suited to the day that is now approaching dusk. If we look just at the 10 biggest active retail global equity funds in Australia, Figure 4 shows that 66% of active assets are in growth strategies— those that generally pay higher prices for companies expected to grow more quickly. Only 10% of assets are in value strategies. Concentration in growth has worked fantastically well over the past 15 years. The largest active fund which has a growth style, trounced the broader market and a blend of the three biggest active global equity funds, which all have a growth style, beat the broader market over the same period.

That is not just down to luck. While we prefer to focus on valuations, managers with a sound growth philosophy and the structure to stick with it over the long term can deliver very healthy returns.

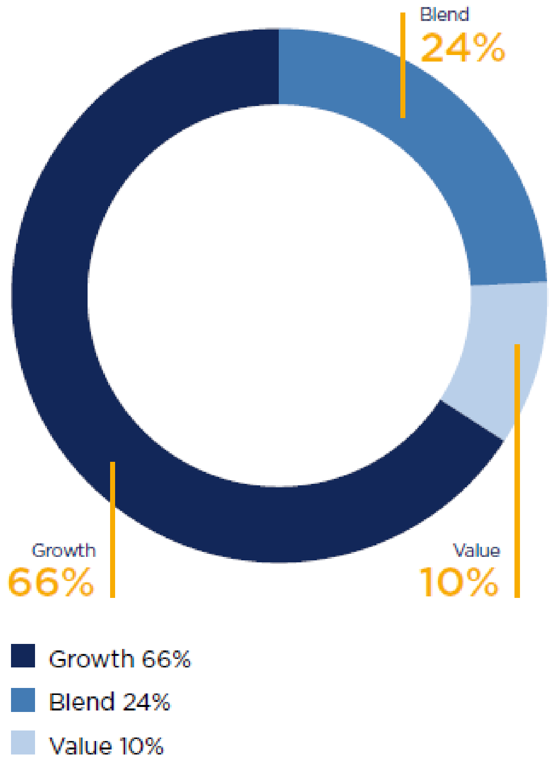
The trouble is what happens when that falls out of favour. If investors hold multiple active funds to get diversification, but those active funds invest in very similar things, investors can end up being diversified in name only. But as Figure 6 shows, being diversified only in name is painful when trends change.

In 2022 the broader global equity market fell around 16%, and after a bit of a recovery this year, it is still down around 4%. The largest active retail global equity fund, which has a growth style, fell slightly more with a decline of 18%. Attempting to diversify by holding the two other largest active retail global equity funds did not help at all because they also have a growth style. Investors in that mix of funds saw declines of 21%, and are still underwater today.

Yet investors remain concentrated, with the bulk of their active assets in growth-style funds, and their passive assets concentrated in giant US technology shares. With valuations where they are today, that worries us. If they do not adjust their portfolios, they will need to adjust their expectations.

Figure 4: Investors are highly concentrated in growth funds

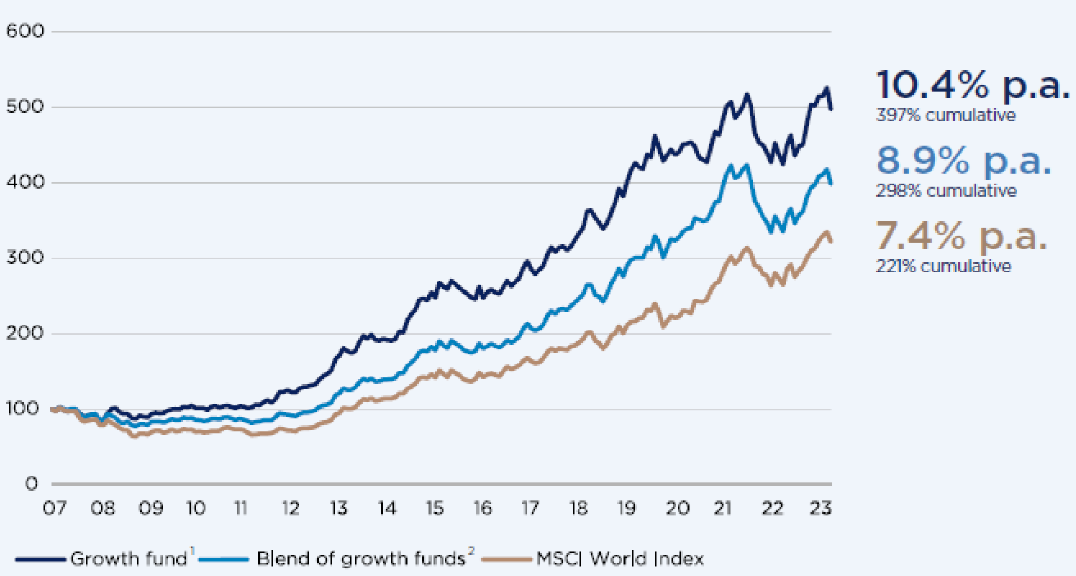
Equity style split for Australia's 10 largest active retail global equity funds[1]



Source: Zenith Investment Partners, Morningstar, Orbis. [1]The 10 biggest active retail global equity funds is based on retail unit trust size, sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. The style for each fund has been categorised using the Morningstar Style Box, which is based on the latest available portfolio holdings for each fund.

Figure 5: It has been a great environment for growth-style funds

Total returns (in AUD, rebased to 100 at 30 June 2007)

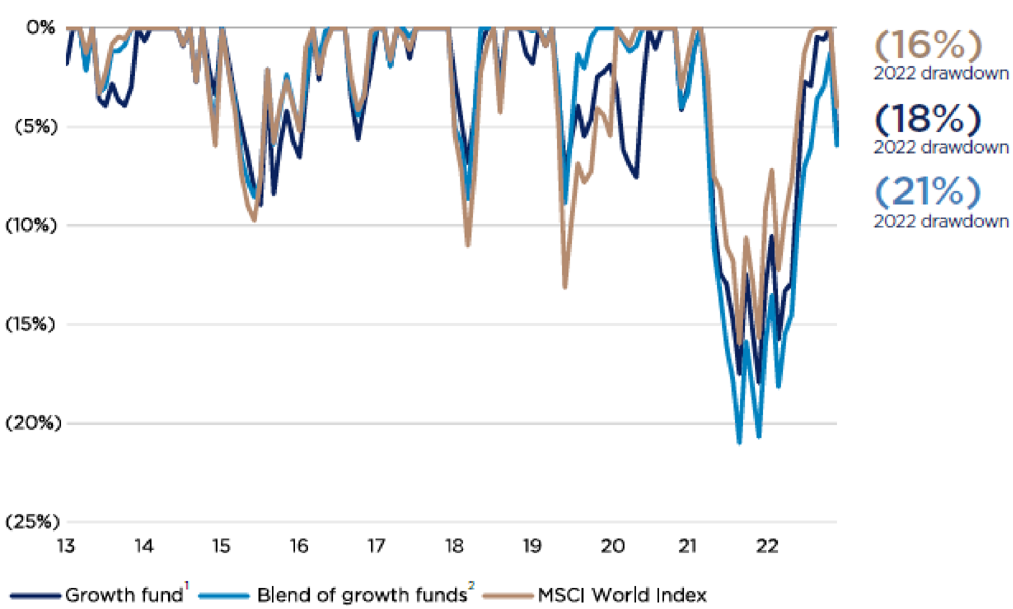


Past performance is not a reliable indicator of future results.

30 Sep 2023 | Source: Zenith Investment Partners, Morningstar, Orbis. Blends assume monthly rebalancing. The largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. [1]The largest active retail global equity fund, net of fees. This fund has a growth equity style. [2]An equal-weighted blend of the three largest active retail global equity funds, net of fees. Each of these funds has a growth equity style. The common inception date for the three largest active retail global equity funds is 30 Jun 2007.

Figure 6: Holding similar funds is risky when that style falls from favour

Drawdowns (from peak, using monthly total returns in AUD)



Past performance is not a reliable indicator of future results.

30 Sep 2023 | Source: Zenith Investment Partners, Morningstar, Orbis. Blends assume monthly rebalancing. The largest active retail global equity funds is based on retail unit trust size sourced from the 2022 Zenith Investment Partners International Shares Sector Report, November 2022. Active is defined as all long-only funds excluding those in the index categories. Hedged vehicles have also been excluded to avoid the duplication of funds. [1]The largest active retail global equity fund, net of fees. This fund has a growth equity style. [2]An equal-weighted blend of the three largest active retail global equity funds, net of fees. Each of these funds has a growth equity style. The drawdowns for the last 10 years is shown.

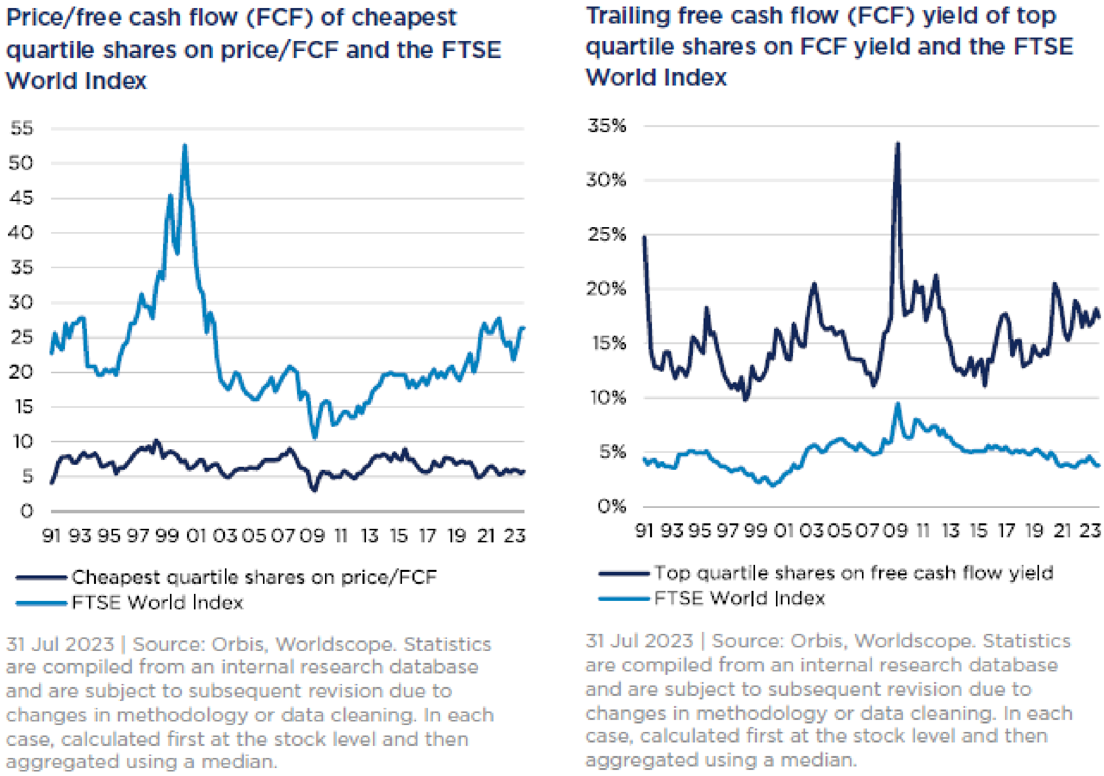
Value stocks are still attractive

Value has suffered a long, dark night. Having thrived for nearly a century, value has lagged since the Global Financial Crisis, suffering the deepest and longest drawdown in its history. That underperformance has left value stocks trading at exceptionally attractive prices, even after a good year in 2022. In a still-expensive market that has grown ever-more concentrated in richly priced US, mega-cap, and tech shares, value stocks offer both a refuge and a source of opportunity.

But as fundamental, long-term, contrarian investors, we look at companies like business owners, and as business owners, the single most important metric is free cash flow. If you own a business outright, free cash flow is your money—to reinvest in profitable projects, buy a competitor, pay down debt, pay out dividends, or buy out your partners. It is the single measure that best captures the true worth of a business. And if we look at the free cash flow valuations of the most neglected companies, we see reasons for excitement.

That is not true for the market as a whole, as Figure 7 shows. On a price-to-free-cashflow basis, we see the same pattern as for the other measures. In the years since the global financial crisis, markets in aggregate have got more expensive, and are currently near their richest levels since the original Tech bubble in 2000.

Figures 7-8: Free cash flow



The pullback of 2022 barely made a dent. The typical global stock trades at over 25 times free cash flow. If you owned it outright, it would take 25 years of current cash flow to get your money back. Investors are hoping for rapid growth. In fact, the market's valuation is so stretched that the multiple of the neglected shares is barely discernible.

We can change that by inverting the ratio, and looking at free cash flow yield, or free cash flow divided by price. This reveals a more promising picture.

While the overall market is expensive, the most neglected quarter of shares offer free cash flow yields of 17%. If you bought one of these businesses outright, and assuming cash flows stay flat, you would reap an ongoing return of 17% per year. You could get your entire investment back in about six years—and could still own a profitable business at the end of that period.

This excites us, as it suggests a wider opportunity. Cash flow is underappreciated at a time when investors desperately need the diversifying benefits of value stocks.

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

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Housing is a major issue for older people too

Diane Hosking, Linda Orthia

The Australian welfare system, including the Age Pension, was designed on the assumption that older people own their home and can age there. But the latest National Seniors Australia research has shown this to be far from true for many of us.

This year, the 11th National Seniors Social Survey, or NSSS-11, asked more than 5,300 people aged 50 and over about their housing situation.

It revealed housing affordability concerns plague two-thirds of us, and more than half are living in homes unsuitable for later life because they need modifications, security of tenure, or assistance to manage their size.

The findings are consistent with concerns across the country about rental and mortgage crises, showing they affect older people as well as the young.

However, they also ring a new alarm bell by suggesting that the current trend towards home-based aged care will not be sustainable.

Housing is increasingly unaffordable

Survey respondents were asked if they were concerned about their ability to afford suitable housing during the 12 months following the survey, and during the rest of their lives.

One third (34%) were concerned for the short term, with the level of concern ranging from "only slightly" (20%) to "quite" (9%) to "acutely concerned" (5%).

The figure almost doubled to two-thirds (65%) when respondents were thinking about the remainder of their life.

Unsurprisingly, people who rented were nine times more likely than everyone else to be "quite concerned" or "acutely concerned". Those with a mortgage were four times more likely to feel that way.

Having higher savings or being in an older age group provided some protection against concern.

In written comments, people elaborated on the sources of worry about affordability.

These included:

- The cost of buying housing, especially housing they wanted or that was accessible and age friendly.
- High rent levels and interest rates.
- Costs associated with retirement villages and aged care.
- Costs of buying, selling, and moving.
- Ongoing housing costs such as council rates, body corporate fees, and utilities.

As one person said, "*House prices are going up and the cost of any renovations/adjustments are also going up quickly.*"

Housing is not secure for all

Housing security remains a pressing problem for renters. Commenters mentioned having been forced to move multiple times in the past few years, with one writing, "*Landlords too greedy, never know if we will be asked to move, in our seventies and frail. Need more security*".

Comments also revealed that long public housing waitlists and a scarcity of retirement living options for renters contribute to the problem.

Obstacles facing older renters who want to buy, such as an inability to secure a home loan because of their age, have left people stuck in precarious rental conditions in later life.

The high costs of housing and changing life circumstances such as later-life divorce, have also left some homeowners without housing security.

Ageing in place is impossible for many

Around half the survey respondents said their current home is unsuitable for ageing in place, with only 44% saying their home is suitable as is.

But options to move to age-friendly housing are stymied by multiple factors.

About a quarter (26%) said their home would be suitable with modifications. But some respondents discussed difficulties affording any renovations and problems finding tradespeople to do the work.

A tenth (10%) said they were unable to make modifications, in some cases because they were renting. A further tenth (11%) were unsure if their home was suitable.

When asked what they would like to change about their housing, the most common theme was a desire to move to a home that was smaller or more manageable in terms of housework, yard work, maintenance, and accessibility.

Alternatively, people desired paid home support to help them stay in their current home. One commenter spoke for many when they wrote, "*More support with property/yard maintenance to allow us to stay in our own home*".

For 19% of homeowners, the scarcity of age-friendly housing stock and other retirement options was a major barrier to making a move.

In particular, many people identified problems finding appropriate housing in the area where they currently lived. They were concerned that they would have to move elsewhere, to areas they did not know and lacked the support and services they had come to rely upon. Having to leave their current area was a barrier to moving for 29% of people.

Some homeowners faced the related problem of owning a low-value home. For 19% of respondents this meant that if they sold their home, they could not afford to buy one they would want.

Stamp duty adds to costs and was a barrier for a third of respondents (32%), while the hassle of buying, selling, and moving was a barrier for half (50%). Some commenters remarked on the physical, mental, and/or emotional difficulties presented by moving.

Yet staying in place may not be a viable option either, with commenters noting the scarcity of homecare workers, even for people who already had an aged-care package approved.

One respondent commented, "*If only there were enough service providers available to provide the services I have codes for with MyAgedCare.*"

This tricky situation is a crisis waiting to happen and requires urgent national action on housing in conjunction with aged care that recognises the realities of older people's living circumstances today.

Diane Hosking, PhD, is Head of Research, and Lindy Orthia, PhD, is a Senior Research Officer at National Seniors Australia.

The Aussie dollar was floated 40 years ago

Selwyn Cornish and John Hawkins

These days, we take for granted that the value of the Australian dollar fluctuates against other currencies, changing thousands of times a day and at times jumping or falling quite a lot in the space of a week.

But for most of Australia's history, the value of the Australian dollar – and the earlier Australian pound – was 'pegged' to either gold, pound sterling, the US dollar or to a value of a basket of currencies.

The momentous decision to float the dollar was taken on Friday December 9 1983 by the Hawke Labor Government, which was elected nine months earlier.

As they approached the cabinet room at what is now Old Parliament House, Treasurer Paul Keating asked Reserve Bank Governor Bob Johnston to write him a letter to say the bank recommended floating.

The letter, dated December 9, referred to the bank's concern about the "volume of foreign exchange purchases and its belief that if these flows are to be brought under control we shall need to face up without delay either to less Reserve Bank participation in the exchange market or capital controls".

By "less Reserve Bank participation", Johnston meant a managed float. Direct controls were to be considered "as a last resort".

The bank had long maintained a 'war book', bearing the intriguing label 'Secret Matter', outlining the procedures to be followed in the event of a decision to float.

An updated version was handed to the treasurer the day before the decision.

The US and the UK floated their currencies in the early 1970s. Since the early 1980s the value of the dollar had been set via a 'crawling peg' – meaning its value was pegged to other currencies each week, and later each day, by a committee of officials who announced the values at 9.30 each morning.

If too much or too little money came into the country as a result of the rate the authorities had set, they adjusted it the next day, sometimes losing money to speculators who had bet they wouldn't be able to hold the rate they had set.

Keating had Johnston accompany him to the December 9 press conference instead of Treasury Secretary John Stone, who had argued against the float in the cabinet room, putting the case for direct controls on capital inflows instead.

Johnston's presence was meant to make clear that at least the central bank supported floating the dollar.

Speculators now speculate against themselves

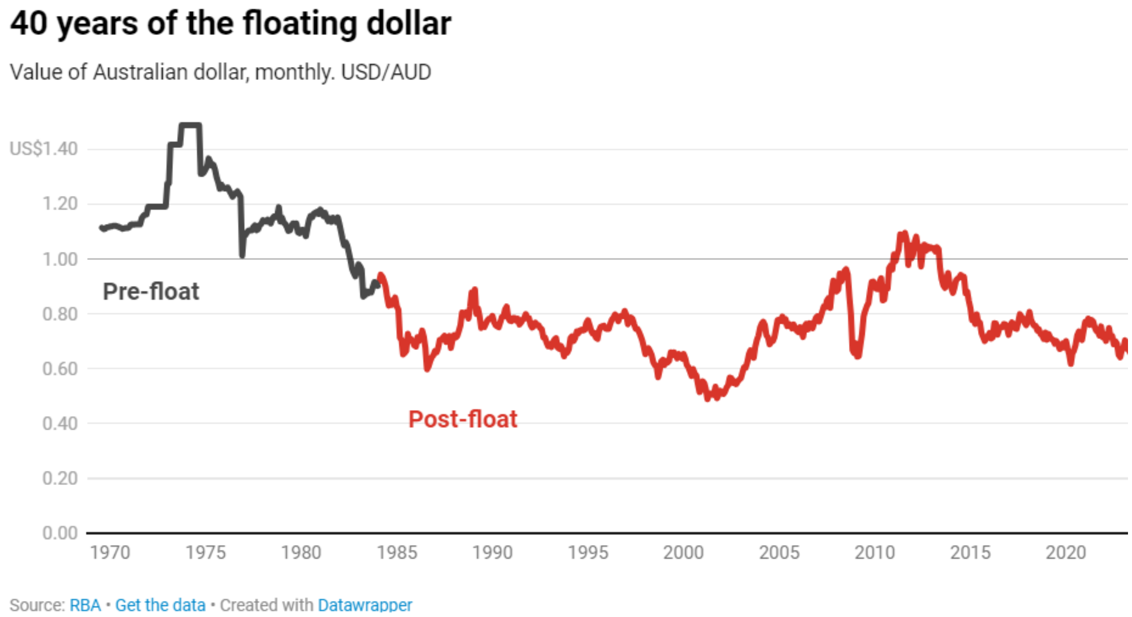
Keating told the press conference the float meant the speculators would be "speculating against themselves", rather than against the authorities.

One banker quoted that night confessed to being "absolutely staggered". "I'm not sure they know what they have done," the banker said.

The following Monday on ABC's AM program, presenter Red Harrison heralded "a brave new world for the Australian dollar". He said, "from today the dollar must take its chance, subject to the supply and demand of the international marketplace, and there are suggestions that foreign exchange dealers expect a nervous start to trading when the first quotes are posted this morning".

At the time, the Australian dollar was worth 90 US cents. At first it rose, before settling back.

Since then, the Australian dollar has fluctuated from a low of 47.75 US cents in April 2001 to a high of US$1.10 in July 2011.



The long road to the float

The idea first took hold in Australia when Commonwealth Bank Governor "Nugget" Coombs visited Canada in 1953, at a time when it was one of the few countries with a floating exchange rate.

On his return, Coombs wrote the bank should consider Canada's experience.

A strong advocate from the mid-1960s was the bank's economist Austin Holmes. Among those he mentored at what by then was called the Reserve Bank were Bob Johnston, Don Sanders, and John Phillips.

All three were in the cabinet room when the decision was taken.

Backed by Cairns, opposed by Abbott

An unlikely advocate in the 1970s was the left-wing Labor Treasurer Jim Cairns.

But asked in 1979 whether he was in favour of a float, the then Reserve Bank governor Harry Knight responded by quoting Saint Augustine, saying "God make me pure, but not yet". An oil shock was making markets turbulent at the time.

In 1981, the Campbell inquiry into the Australian financial system delivered a landmark report to Treasurer John Howard, recommending a float. The idea was backed by neither the Treasury nor Prime Minister Malcolm Fraser.

Two years later, Howard watched from Opposition as Labor did what he could not.

The Liberal Party generally backed Labor's move, with one notable exception – the later Prime Minister, Tony Abbott, who in 1994 wrote that, "changing the price of the dollar moment by moment in response to each transaction makes no more sense than altering the price of cornflakes every time a buyer takes a packet off the supermarket shelves".

A success by any measure

The floating exchange rate has served Australia well.

When the Australian economy has slowed or contracted – in the early 1990s, the Asian financial crisis, the global financial crisis and in the COVID recession – the Australian dollar has fallen, making Australian exports cheaper in foreign markets.

When mining booms have sucked money into the country, the Australian dollar has climbed, spreading the benefit and fighting inflation by increasing the buying power of Australian dollars.

It's why these days, hardly anyone wants to return to a pegged rate.

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Is India the world's best growth story?

Rajiv Jain and team

There's a strong case to be made for investing in Emerging Markets (EMs). For example, when you adjust the GDP of the E7 (the seven largest EMs), for purchasing power parity (PPP), their output is greater than that of the G7 (the seven largest developed nations). In addition, as these nations are growing at a much faster rate than developed countries, their economic significance is increasing.

Within EMs, India is particularly attractive as an investment destination and as the world's most populous nation it is simply too large for investors to ignore. Once labelled as one of the 'Fragile Five', India has roared to life through strong leadership and a stable government that has implemented positive economic reforms, improved infrastructure, and stimulated private enterprise.

India's demographics are also favourable. Its middle class is quickly growing in size, and its population is relatively young – much younger than China's – which has been boosting consumer spending.

India's favourable economic outlook

In our view, India's economic growth prospects are more attractive than many other EM and developed nations, including China's. The World Bank recently said that India's economy is showing resilience in a challenging global environment. India has been one of the fastest-growing major economies in FY2022-23, expanding by 7.2% and India's growth rate was the second highest among G20 countries and almost twice the average for EM economies. The World Bank forecasts India's GDP growth for FY2023-24 to be 6.3%, with the expected moderation mainly due to challenging external conditions and waning pent-up demand after the passing of the COVID-19 pandemic. However, service sector activity is expected to remain strong with growth of 7.4% and investment growth is also projected to remain robust at 8.9%.

India's economic resilience has been underpinned by robust domestic demand, strong public infrastructure investment, and a strengthening financial sector. Over the longer term, we believe this may support economic growth in the nation led by Prime Minister Narendra Modi, who has prioritised economic development.

In contrast to India's strong growth prospects and democratic government, economic growth in China has been much weaker. China is dealing with ongoing economic challenges such as government interference in private and state businesses, high debt levels, and instability in the real estate sector. Structural factors too, such as an aging population, are weighing on economic growth in China. China's economic growth was forecast by the World Bank this month to slow to 4.4% in 2024, down from a forecast 5.1% in 2023.

Other things favour India too

There are other factors we believe favour investment in India over China and other EMs. The nation's stock market capitalisation is large and diverse – it is bigger than the UK or the German market (as the table below shows). India's economy and listed companies have benefited from a stable government over the last decade, and that has encouraged growth in its stock market. India's government has invested significantly on roads and rail and related infrastructure – that has had a multiplier effect on the economy and listed companies are benefitting from the uptick in spending in these areas.

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DIVERGENT MACRO

Emerging Markets Appear Much Better than Developed Markets

Ranking of Ten Largest Economies Using Nominal GDP

	FORECASTED CALENDAR YEAR 2023				
COUNTRY/REGION	NOMINAL GDP ($B)	CONSUMER PRICE INFLATION (%)	10 YEAR RATE (%)	REAL RATES (%)	MARKET CAPITALIZATION ($T)
USA	26,750.8	4.37	3.35	(1.02)	43.7
China	19,309.8	2.28	2.88	0.60	11.1
Germany	4,455.3	6.31	2.26	(4.05)	2.5
Japan	4,334.1	2.63	0.41	(2.22)	5.6
India	3,696.1	5.24	7.30	2.06	3.2
United Kingdom	3,203.7	5.64	3.58	(2.06)	3.1
France	2,994.4	4.90	2.77	(2.13)	3.3
Italy	2,214.0	6.42	4.12	(2.30)	0.7
Canada	2,119.3	3.81	2.78	(1.03)	2.8
Brazil	2,007.6	4.57	12.21	7.64	0.8

Source: Capital IQ. Estimates for calendar year 2023. Actual results may differ from any projections illustrated above.

Importantly, India's equity market offers more breadth and diversity than its EM peers; it is significantly less concentrated than Chinese and Latin American equity markets in the largest three sectors, as the table below shows.

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INDIA'S EQUITY MARKET HAS MORE BREADTH

Relative to Many of its Emerging Market Peers

	MSCI INDIA	MSCI CHINA	MSCI EM LATIN AMERICA	MSCI EM
% OF MSCI EM INDEX	**14.6%**	**25.6%**	**9.2%**	**100.0%**
Communication Services	3.0%	19.76%	7.1%	10.1%
Consumer Discretionary	10.0%	28.68%	1.8%	12.8%
Consumer Staples	10.0%	5.76%	16.7%	6.6%
Energy	12.4%	3.03%	9.9%	5.0%
Financials	26.3%	16.31%	25.1%	22.2%
Health Care	4.6%	5.54%	1.5%	3.9%
Industrials	5.7%	5.60%	9.1%	6.4%
Information Technology	13.9%	6.23%	0.5%	19.6%
Materials	9.3%	3.35%	21.4%	8.8%
Real Estate	0.6%	3.14%	0.8%	1.9%
Utilities	4.3%	2.61%	6.3%	2.7%
Top 3 Sectors	**52.6%**	**63.2%**	**63.2%**	**54.6%**

Source: Source: S&P Capital IQ, MSCI. Data as of June 30, 2023. You cannot invest directly in an index. Past performance may not be an indicator of future results.

In addition, India's stock market arguably offers higher quality investment options than other EMs including China, as its listed companies typically offer a greater return on equity (ROE) than that offered by Chinese companies (as the charts below show). Indian companies offer relatively high ROE as its companies have been relatively capital starved and hence those business that survived and grew tend to be more efficient. We believe active management is, however, needed to identify the most promising investment prospects and help minimise investment risks.

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INDIA HAS WELL-RUN BUSINESSES IN MANY INDUSTRIES

India has a High Return on Equity (ROE) Across Most Sectors

	MSCI INDIA	MSCI CHINA	MSCI EM LATIN AMERICA	MSCI EM
TOTALS/AVERAGES (ROE)	**19.2%**	**12.0%**	**25.2%**	**17.3%**
Communication Services	21.2%	18.7%	18.7%	17.5%
Consumer Discretionary	14.9%	5.6%	6.1%	10.5%
Consumer Staples	31.5%	20.8%	23.8%	24.3%
Energy	11.3%	17.7%	41.2%	23.2%
Financials	13.6%	11.5%	20.2%	14.0%
Health Care	12.8%	2.1%	6.6%	7.3%
Industrials	24.5%	14.1%	33.8%	19.7%
Information Technology	33.5%	14.3%	12.2%	23.6%
Materials	18.5%	19.4%	31.1%	17.7%
Real Estate	4.1%	11.1%	15.1%	10.7%
Utilities	18.0%	11.7%	12.2%	12.1%

Source: Source: S&P Capital IQ, MSCI. N/A indicates zero sector exposure in that MSCI index. ROE is calculated using the trailing twelve-month period as of June 30, 2023. You cannot invest directly in an index. Past performance may not be an indicator of future results.

There are other positives to investing in India. Structural changes over the past decade have made India more competitive. India has built up its foreign exchange reserves which has given the nation an economic buffer and war chest to handle economic turbulence, such as that resulting from higher interest rates and inflation. Notably, on 14 July 2023, India's Forex reserves stood at US$609.02 billion, a 15-month high, though they have dipped since then.

Compared to China, India is well placed to grow in these challenging economic times and investors should consider an equity allocation to the world's most populous nation.

Rajiv Jain, Chairman and Chief Investment Officer, alongside Brian Kersmanc and Sudarshan Murthy are at the helm of the Investment Management Team serving as Portfolio Managers for the GQG Partners portfolios. This article contains general information only, does not contain any personal advice and does not consider any prospective investor's objectives, financial situation or needs.

A closer look at UniSuper and AustralianSuper

Annika Bradley

Increasingly, industry superfund members also need quality advice, and advisers need detailed information as to what's under the hood of the large industry superannuation funds.

In response, Morningstar is gradually expanding its research coverage and, in 2023, added UniSuper to our multi-asset options coverage. Its level of internalisation is high relative to its peers. But Tim Wong, Director of Manager Research, concluded that: "UniSuper's clever handling of a major internalisation program has seen it build a capable team while taking care to avoid overextending its reach." Adding UniSuper to our coverage lineup of large superannuation funds highlighted that there are different ways internalisation can be approached. And it reinforced the benefit of looking under the hood.

UniSuper versus AustralianSuper—Different approaches to internalisation

All three of UniSuper's assessment pillars (Parent, People, and Process) were awarded Above Average with an overall rating of Bronze. This puts it on par with AustraliaSuper's overall rating of Bronze. As far as internalisation goes, both funds have a high proportion of assets managed internally, but the overall team size differs meaningfully as does the investment teams' global footprints.

Exhibit 1 A Snapshot—UniSuper and AustralianSuper

	UniSuper	AustralianSuper
Funds under management	$124 billion	$299 billion
Percentage of assets managed by internal teams	70%	58%
Number of "internal" investment professionals	74	335
Investment team office locations	Melbourne	Melbourne, London, New York

Data as of June 30, 2023. Sources: AustralianSuper and UniSuper Annual Reports and fund data provided.

In our "Is Your Industry Super Fund Too Illiquid?" paper, we took a look at the level of illiquid assets held at the fund and option levels of five large superannuation funds. AustralianSuper has a much higher proportion of illiquid assets compared with UniSuper (refer to Exhibit 2) and has built a large internal team to manage these assets.

Exhibit 2 Fund- and Option-Level Illiquid Allocations at Dec. 31, 2022, as Reported by the Funds

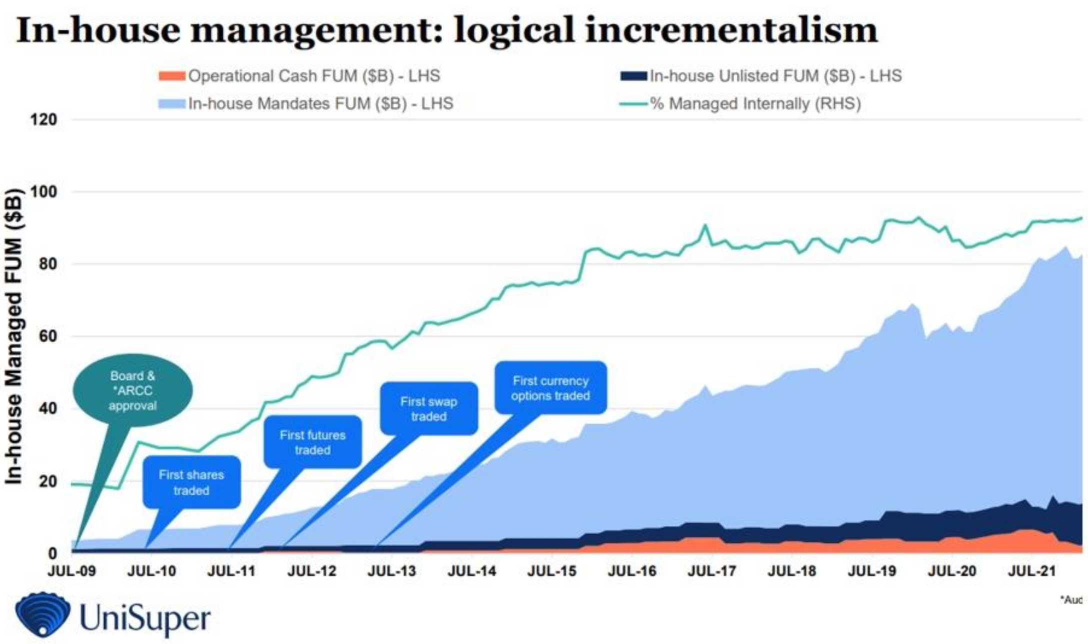
	Fund level	Option level
Australian Retirement Trust	29%	34%
AustralianSuper	27%	30%
Aware Super	27%	24%
CBUS	26%	28%
Unisuper	12%	13%

Source: Fund responses.

Typically the management of private assets is more resource-intensive, which partially explains the stark difference in the number of internal investment professionals. In the AustralianSuper research report, we commented that "Phenomenal asset growth has seen AustralianSuper evolve continuously. Its suite of capabilities has expanded considerably, with private assets, illiquid credit, and global bonds priorities, alongside beefed-up operational and risk groups. To be clear, this isn't costless, and breakneck hiring needs to be balanced against becoming too bureaucratic."

UniSuper has taken a more incremental approach to internalisation and to hiring. Its internalisation program started in 2009, and the first share was traded in 2010. Morningstar's assessment is that "further internalisation is likely to be incremental rather than revolutionary." See Exhibit 3.

Exhibit 3 UniSuper's Internalisation Journey—an Incremental Approach



Source: UniSuper.

UniSuper has also elected more of a partnership approach for their private asset mandates. Let's take the Direct Property asset class by way of example. UniSuper holds $4 billion of directly owned property assets that have been managed under a unique mandate arrangement for over 20 years. The partnership leverages the expertise of the external specialist property manager while enabling the internal team to maintain full control over all aspects of the portfolio.

The bottom line here is that internalisation can be executed in various ways across different funds and have meaningfully different outcomes when it comes to the number of investment professionals and the level of complexity inherent in a fund.

People: A key ingredient

The number of internal investment team members is one thing; attracting quality people and retaining them is another. People are a vital pillar to any successful investment management business. And achieving equivalent levels of competence with external managers is a key ingredient to a successful internalisation program. There's no point in internalising assets if the returns are subpar compared with an external manager. Therefore a deep dive into the quality of the investment team, its retention levels, the superfund's culture and overarching governance bodies is necessary to determine whether the fund stands a chance of delivering equivalent returns to an external manager.

UniSuper and AustralianSuper are not immune to the challenges of assembling and retaining a quality investment team. Both funds have had their fair share of high-profile departures. At UniSuper, Simon Hudson and Mark Himpoo departed the high-performing equities team in 2021-22. AustralianSuper saw disruption in its property team with Bevan Towning departing in April 2023, and John Longo and Neil Harvey leaving in late 2019. And then there were the high-profile departures of AustralianSuper's Head of Equities Innes McKeand, who left in early 2021, followed by Justin Pascoe in early 2023. The point is that attracting and retaining quality people is a challenge, as is shaping the right organisational structure to accommodate bright, ambitious investment people. Growing pains should be expected given the rapid rate of growth these funds have experienced.

AustralianSuper is tackling the additional complexity of locating their investment teams globally. They have strategically inserted "head office" staff members into their global offices to ensure that the homegrown culture permeates these global offices.

Then there are the Chief Investment Officers, or CIOs. UniSuper's John Pearce "would (also) be a hard act to follow" according to our research report. And "CIO Mark Delaney has overseen sound development of internal teams" as well as AustralianSuper's investment success since the start. Culture starts at the top—so how long these two leaders stick around and how the organizations look to handle their eventual succession are definitely watchpoints.

The governance structures and trustees overseeing these investment teams should not be underestimated, and it is worth considering as part of the due diligence. Tim Wong notes that "UniSuper has assembled a credible board and investment committee, suggesting a sensible decision can be made on succession."

Alignment to members is also important. One of the big selling points of working for a large, profit-for-member fund is the sense of purpose that an investment team enjoys from serving members. And the Morningstar report comments that, "Alignment with members is credible: Performance pay for senior investment staff is largely tied to the Balanced fund, and investment staff superannuation is defaulted into the AustralianSuper fund."

The key point to note here is that an internalised investment function is a complex investment management business that should be scrutinized accordingly. There's no point internalising if the fund is unable to build a high-quality investment team that is set up to deliver quality outcomes for members. Hiring and retaining quality people and putting the right governance and incentive frameworks in place are key to successful delivery.

The runs on the board

So, have these internal investment teams delivered for members compared with an outsourced model? That's a very difficult question to definitively answer, but both UniSuper and AustralianSuper's Balanced Options have posted very strong long-term returns relative to both the Morningstar Australia Growth Target Allocation NR AUD Index (a tough hurdle!) and their category peers. Investors eat net returns, and it is pleasing to see that the internalisation programs at both funds have delivered solid outcomes for their members.

Exhibit 4 Performance as of Sept. 30, 2023—UniSuper Balanced and AustralianSuper Balanced Options

	1 year (% p.a.)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UniSuper Balanced Option	10.1	6.1	6.1	7.7
AustralianSuper Balanced Option	8.5	7.1	6.2	8.1
Category Index*	11.1	5.9	5.2	7.0
Category Average^	9.1	5.9	4.6	5.9

Source: Morningstar Investor as of Sept. 30, 2023. * Morningstar AUS Growth Tgt Alloc NR AUD. Category: Multisector Growth. The AustralianSuper and UniSuper Options' performance returns are subject to the impact of taxes and franking credits inside the superannuation environment.

What's the cost?

One of the key drivers of internalising investment management is to keep fees and costs low. Net returns should be the measure of success, however, given how heavily fees and costs are scrutinised in this market, it's worth taking a look at them. Both funds have managed investment-related fees and costs as well, as shown in Exhibit 5. Unlisted and private assets are typically more expensive and might explain some of the differential between the two.

Exhibit 5 Investment Fees and Costs—UniSuper Balanced Option and AustralianSuper Balanced Option

	UniSuper Balanced Option	AustralianSuper Balanced Option
Investment management fees and costs (% per year)	0.38	0.40
Performance fees (% per year)	0.03	0.10
Total investment management fees and costs (excluding transaction costs) (% per year)	0.41	0.50

Source: Morningstar Investor as of Sept. 30, 2023. *Morningstar AUS Growth Tgt Alloc NR AUD. Category: Multisector Growth. The AustralianSuper and UniSuper Options' performance returns are subject to the impact of taxes and franking credits inside the superannuation environment.

Approaches to internalisation—Take a close look

UniSuper and AustralianSuper have both attained Morningstar Medalist status for a reason—their investment people and investment process are high quality. But as these large superannuation funds grow and evolve, there's no one-size-fits-all model to success. Managing large pools of capital can be approached in different ways—and no one way is more right or effective than the other. What is clear is that these funds are now large, complex investment businesses, and it's worth taking a look under the hood before making an investment decision.

Annika Bradley is Morningstar Australasia's Director of Manager Research ratings. Firstlinks is owned by [Morningstar](). This article is general information and does not consider the circumstances of any investor. This article was originally published by Morningstar.