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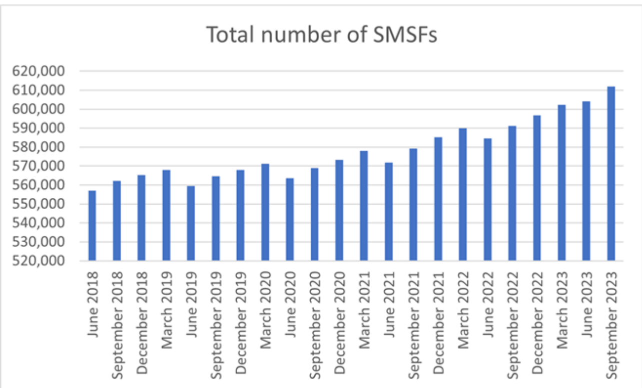
Editorial

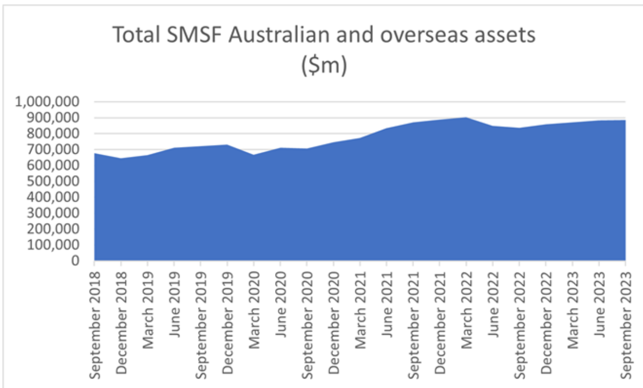
The latest data from regulators APRA and the ATO show SMSFs are continuing to thrive:

1. There are almost 612,000 SMSFs, as of September last year. That’s a 3.5% increase on the previous year and a 9% rise over the past five years.

And the number of SMSF members has reached 1.12 million.

2. The total assets held by SMSFs has increased to $885 billion. That’s up 5.6% over the year to September 2023, and 31% over the prior five years.





Source: ATO, Firstlinks

3. The average SMSF has nearly $1.5 million in assets. Almost 45% of SMSFs have funds from $200,000 to $1 million. And 47% have funds between $1 million and $5 million.

The proportion of funds under $1 million has steadily declined from 65% in 2018 to 58%.

4. SMSFs favour listed shares, cash, unlisted trusts and non-residential property. Stocks are 28% of funds, cash and term deposits are 17%, while unlisted trusts 13%.

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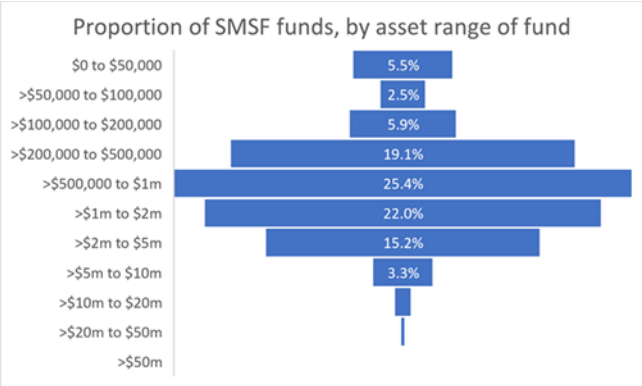
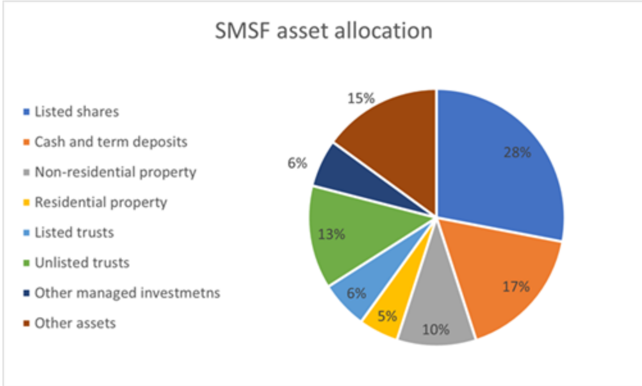




Source: ATO, Firstlinks

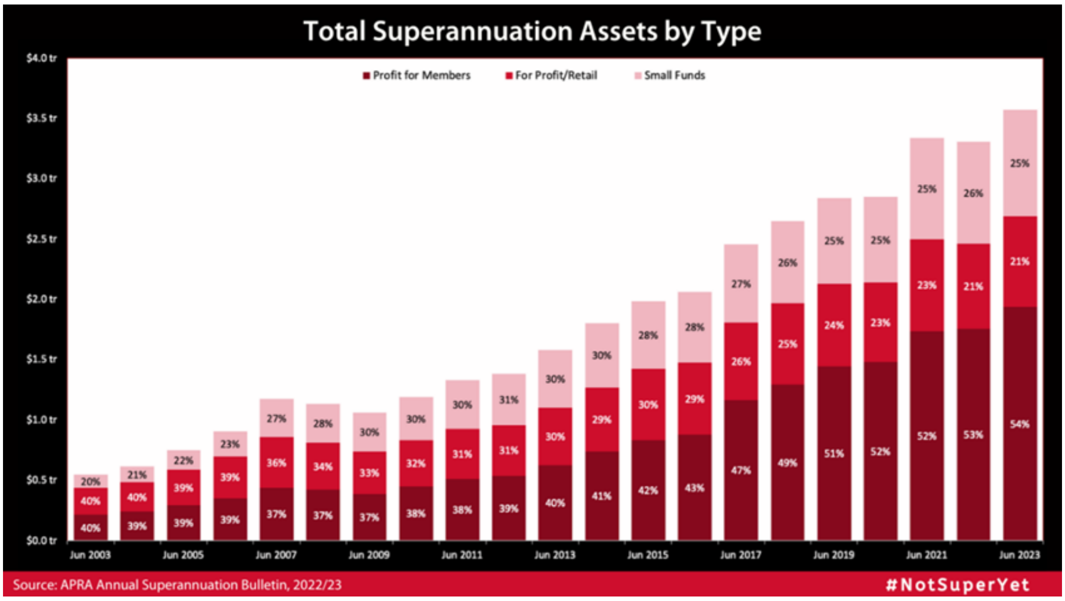
Unfortunately, the ATO only has a breakdown of SMSF asset allocation by fund size up to the 2022 financial year. Yet this data is fascinating as it shows that the greater the fund size, the less money is allocated to cash. For example, SMSFs with less than $50,000 in funds had 45% invested in cash and term deposits, compared to just 12.5% for those with $50 million or more.

Wealthy SMSFs have more money in listed shares, non-residential property, and unlisted trusts. No doubt, the latter two are due to them having more access to these asset classes.

5. The median age of SMSF members of newly established funds was 46. Meanwhile, the median age of all SMSF members was 62.

6. 65% of SMSFs have existed for more than 10 years.

7. SMSFs' share of total superannuation assets dropped from 26% to 25% in the year to June 2023, according to the latest annual superannuation bulletin from APRA. But it's held firm around 25% for the past five years.



The APRA report says total super assets increased to $3.6 trillion in the year to June 30, 2023. To put it into perspective, that figure compares to the total value of the ASX of $3 trillion, though it still trails the largest asset pool in Australia, namely residential property, valued at $10.3 trillion.

Profit for member funds, which include industry funds, public sector funds, and corporate funds, have been the largest gainers over the past year and decade. In 2013, these funds were 40% of total super assets; now they are 54%. Retail funds have been the big losers. They now comprise just 21% of total super assets, down from 30% a decade ago.

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At a conference hosted by Firstlinks' sponsor Pinnacle this week, David Allen from Plato Investment Management opened his presentation with this slide.

Source: Dr David Allen, Plato Investment Management

David Allen went on to suggest that if investors had behaved like George Constanza in that famous Seinfeld episode where he does the opposite of his every instinct, then they would have had a great 2023.

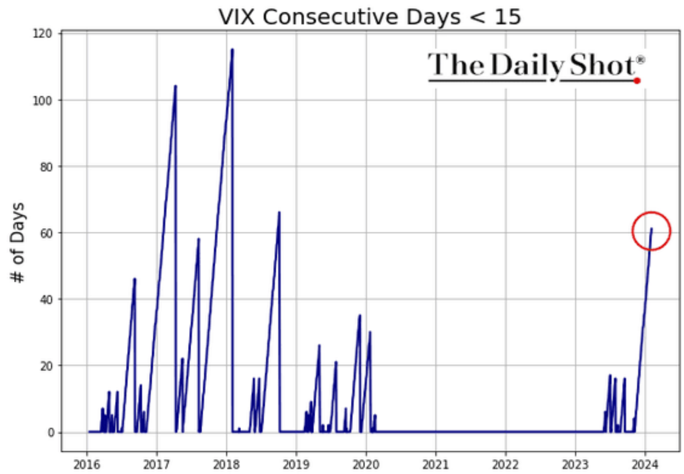
That strategy doesn't always work, of course, though it's perhaps worth pondering what the main consensus narratives are for 2024. Here are my suggestions:

- Inflation will head back towards central bank targets.
- Interest rates will fall, first in the US, then Australia, and probably more than the central banks are currently forecasting.
- There'll be no recession in the US, or Australia.
- A goldilocks economic environment will be positive for both stock and bond returns.
- China may be headed for a multi-year downturn, unless the government stimulates the economy in a big way.
- Lithium and nickel are oversupplied, and those markets will take some time to work through that.
- Australian consumers will have a tougher time but muddle through, as will the housing market.
- Geopolitics is the key area of potential risk, whether it be in the Middle East, Ukraine, or elsewhere.

These consensus narratives for 2024 are already being reflected in markets. In early February, the S&P 500 closed above 5,000 for the first time. It took 757 days for the index to go from 4,800 to 4,900 and just 15 days to go from 4,900 to 5,000.

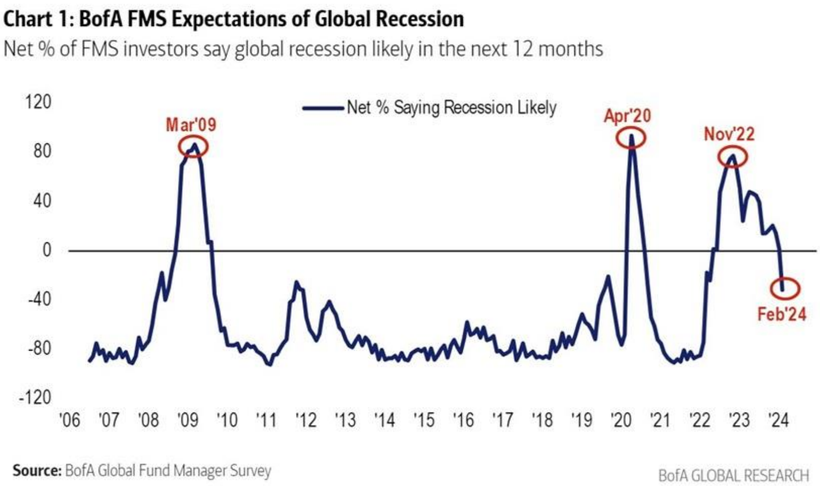
In the week ending February 9, the S&P 500 had risen in 14 of the previous 15 weeks – a run last seen in 1972.

That's resulted in the VIX – a key measure of US market volatility – being below 15 for 60 straight days, something that hasn't happened since 2018.

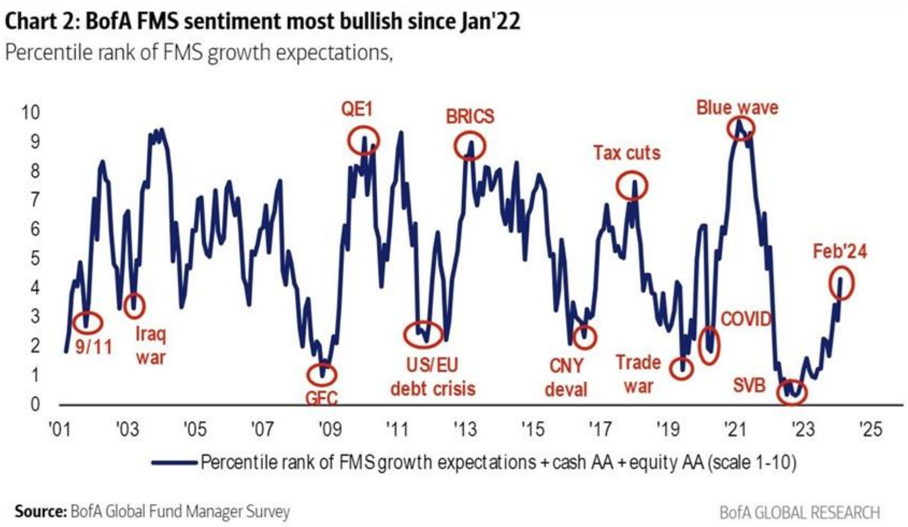


Source: The Daily Shot (February 2024)

Rising markets have lifted the spirits of fund managers. Not many of them predict a recession over the next 12 months.



In fact, fund manager sentiment is the most bullish in more than two years. Admittedly though, the bullishness isn't at extreme levels.



The big question is whether the consensus narratives which have been driving markets higher will prove wrong again this year? Time will tell.

Yet, professional investors aren't paid to wait; they're paid to take a view. UniSuper's Chief Investment Officer, John Pearce, thinks markets are getting it right and that they remain in a good spot. He outlines his positive thesis in an article for Firstlinks this week.

Meanwhile, nabtrade's Gemma Dale strikes a more cautious note, given the unprecedented rally of seven stocks in the S&P 500. She says history shows narrow market leadership doesn't usually end well.

James Gruber

Also in this week's edition...

Andrew Fleming from **Schroders** thinks management guru Peter Drucker's axiom "culture eats strategy for breakfast" continues to ring true on the ASX. If culture is the sophisticated word for execution, he says building materials company Boral has been a standout over the past 12 months, while its peer Fletcher Building still has a lot of work to do.

Labor's stage 3 tax cuts generated considerable debate among Firstlinks' readers last week. This week, we have a different take on the issue. **Tony Dillon** argues that if the government was serious about addressing the issue of bracket creep, it would index tax thresholds to inflation.

SMSF expert **Meg Heffron** expresses her surprise at how rarely she sees 'spouse contribution splitting' in SMSFs. This type of splitting is a special rule that effectively allows someone to 'give' some of their super contributions to their spouse. Meg looks at how it works in practice, and who it's best suited for.

Lawrence Lam is back with part two of his feature story on Graham Turner's entrepreneurial journey with Flight Centre. Turner tells Lawrence some great tales about how Flight Centre went global, what he's learned from key mistakes, the way he uses psychology to build the right teams, and his criteria for making acquisitions.

Private equity firms aren't shy about touting their superior risk-adjusted returns versus public markets. Empirical research casts doubt on their claims. **Larry Swedroe** says complexity, capital calls, and illiquidity are among the challenges investors face to reap potential rewards from private equity.

Lastly, in this week's whitepaper, **Neuberger Berman** investigates the rise of private credit and what the future may hold for this burgeoning asset class.

UniSuper's CIO on why the market rally could continue

John Pearce

Editor's note: This is an edited transcript of UniSuper's latest investment update with CIO, John Pearce, in which he discusses what's behind the recent market rally, and whether it's on solid ground. The full video and transcript can be viewed here.

In non-technical terms, the market has been ripping. Since the lows in October last year, the Aussie market's up about 14% and the US market is up about 18%. Why? Well, before I dive into the answer, I'd like to show you this graph. I'm sure some of you will remember as I presented it in November last year - it shows the performance of the Australian stock market over the course of 2023, and the graph depicts the rollercoaster ride that the market found itself on. And I said Mr. Market was in his usual mood swings and there were four distinct phases. We got off to a very good start for the year when the mood was very positive with the prospect of immaculate disinflation.

Then of course, we had the regional bank crisis in the US. You remember Silicon Valley Bank. Then, we had the market being gripped by euphoria around artificial intelligence (AI). And then Mr. Market got into a bit of a swoon because the bond market crashed.

Let's roll the clock forward to 31 January this year, and what do we see? Another sharp rally.

Figure 1: The 'rollercoaster' performance of the Australian stock market over the course of 2023

Once again, I put it down to the prospect of immaculate disinflation.

Is this justifiable? Well, firstly, let's define exactly what immaculate disinflation is. Disinflation is simply a fall in the rate of inflation, and the market is pretty confident that we're going to trend towards that magical 2.5%, 3% level that central banks are typically targeting. What's immaculate about this? It's all going to happen without having to crash the economy.

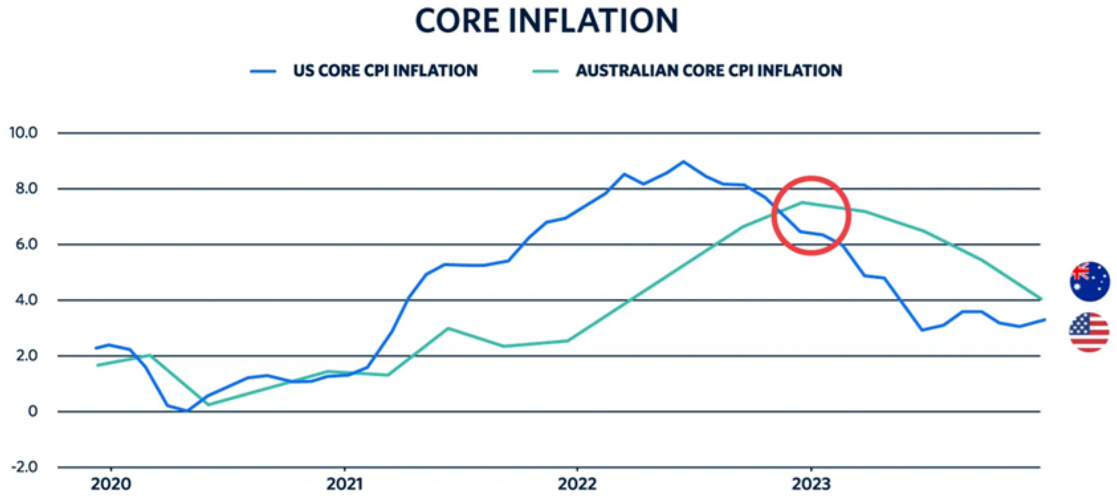
Central banks are not having to tighten to the point where we're forcing the economies into a recession. If you think about this combination, strong economies, low inflation - that is utopia for company profits and share prices.

Is the market rally justified?

So let's get back to that question: is the market rally on solid ground or are we experiencing just another bout of irrational exuberance?

Market commentators love being pessimistic and negative about things, but let me give you three reasons why I think the market could indeed be on solid ground. Firstly, the concept of disinflation is real. Take a look at this graph showing core inflation in both Australia and the US. It's all heading down. Contrast where we are today to where we were in January last year when we experienced this bout of euphoria. Inflation in the US was around 6.5%, it's now closer to 3% - inflation in Australia was around 7.6%, it's now getting closer to 4%, so all very much heading in the right direction.

Figure 3: Core inflation in Australia and the US from 2020 to 2024



Point number two, and this is really important - the Federal Reserve, the most important central bank in the world, really important for other developed countries as well - look at the pivot that the central bank in the US has undertaken.

And to give you an idea of the speed of the so-called Fed pivot, I'd like to refer to the comments made by Jerome Powell, the all-important chair of the Fed Reserve. It was not that long ago, in November of last year, that the chair was basically saying, "Hey, we're still going with these rate hikes- watch out, market". Then in December, "Hmm, we believe that is room for a pause". Then in January, two months after November, he's basically saying, "There are grounds for rate cuts this year, but March is probably too early". Wow. That's a hell of a pivot in a very short period of time. I would have ruled out any possibility of rate cuts if you asked me in November last year.

So they're three reasons why the market could indeed be on solid footing.

Risks for the market

Of course, what could go wrong? And once again, there's no shortage of risk factors that people will allude to. Let me talk about the three most common risks that commentators like to talk about.

First, geopolitical conflict. Now, I've been around long enough to beware of fund managers parading as geopolitical experts, and what I can say in my four decades or so of working in markets, I can't recall a time when the world was totally at peace, when there was no conflict, and frankly, I don't see much difference today. And what's more, when there is an outbreak of hostilities, historically, it tends to be a good buying opportunity. Second, the prospect of a hard landing. Now we can have an exogenous shock such as a pandemic, we can't stop that from happening. But hard landings are typically driven by policy, and given the current posturing of central banks, I don't think a hard landing is a high probability.

The one that I am concerned about is the possibility of reacceleration of inflation. So the market at the moment is saying that inflation indeed will trend down to that 2.5%, 2% mark and we're going to get rate cuts.

And if we don't get that, well, the market could get into a bit of a tailspin. I'm not so sure. Firstly, I'm not sure what's so magical about a 2% inflation rate versus a 3% or 3.5% inflation rate. Also, I don't believe that we necessarily need rate cuts to sustain the current market rally. However, it does change if we get a reacceleration in the rate of inflation.

Could that happen? It could, but I won't be blaming central banks if it does, I'll be blaming governments. To me, economies are really strong at the moment. Governments around the world should be printing large surpluses. They are not - many governments are still printing large deficits. It's imprudent, and I hope that they will become more prudent. What about the prospect of a Trump victory? Well, the election happens in November, there's plenty of time before then so we'll leave that for another day.

As we sit today, if you ask me what do I think about the current state of the economic and financial world, I say it feels about normal and that's not a bad place to be.

John Pearce is Chief Investment Officer at [UniSuper](), a sponsor of Firstlinks. This article provides general information and may include general advice. It doesn't take into account your financial situation, needs or objectives. Consider your situation before making financial decisions, because we haven't, as well as the PDS and TMD relevant to you at unisuper.com.au/pds, and whether to consult a qualified financial adviser. Past performance isn't an indicator of future performance.

For more articles and papers from UniSuper, click here.

A case study in good business culture versus bad

Andrew Fleming

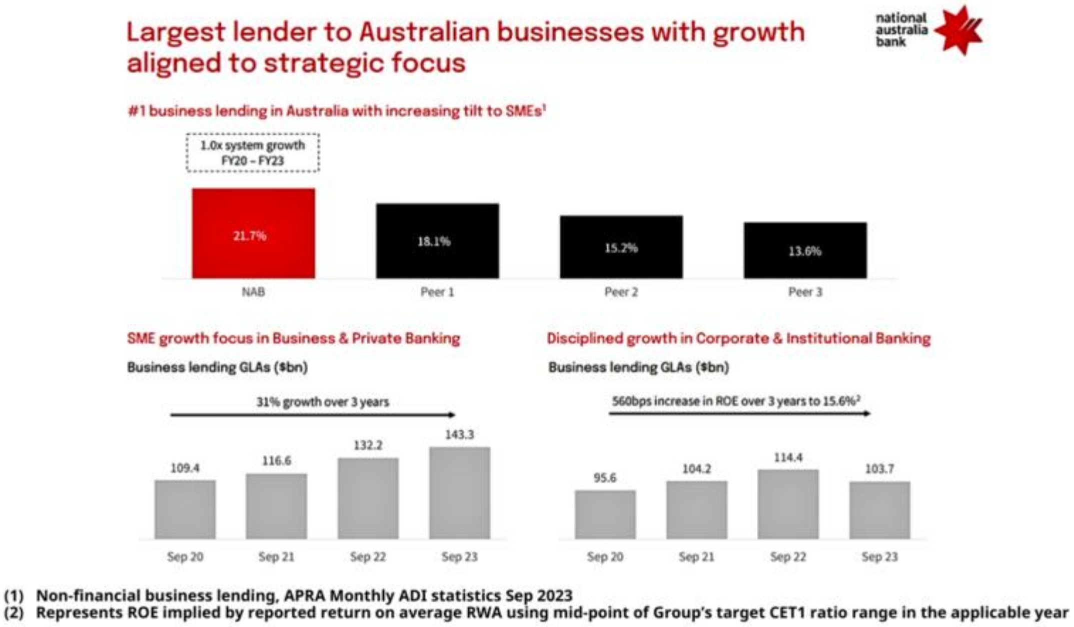
(Editor's note: as this article went to air, Fletcher Building announced that their CEO and Chair would leave the company this year).

Peter Drucker's axiom "Culture eats strategy for breakfast" continues to apply, across industries. For investors, if culture is the sophisticated word for execution, market performance has been littered with examples of strong execution dominating market returns.

What Ross McEwan did right

Ross McEwan delivered on culture and strategy for NAB, but if culture is "what we do around here", McEwan simplified that and made accountability for execution a strong point. Do fewer things but do them well; for example, the number of internal projects being worked on was cut from 467 to 20 when McEwan assumed the role.

As with Boral, and opposed to Fletcher Building, an implicit cultural recognition arose that for any business with the financial resources that arise when profits in the billions are reported, malinvestment is the silent killer. The result was sector leading performance through McEwan's tenure, with return on equity nudging that of the long-time leader in the sector, CBA. Indeed, whilst NAB's market performance is about half of CBA's through the past five years, since McEwan's arrival and the focus upon simplification the relative performance gap with CBA has converged.



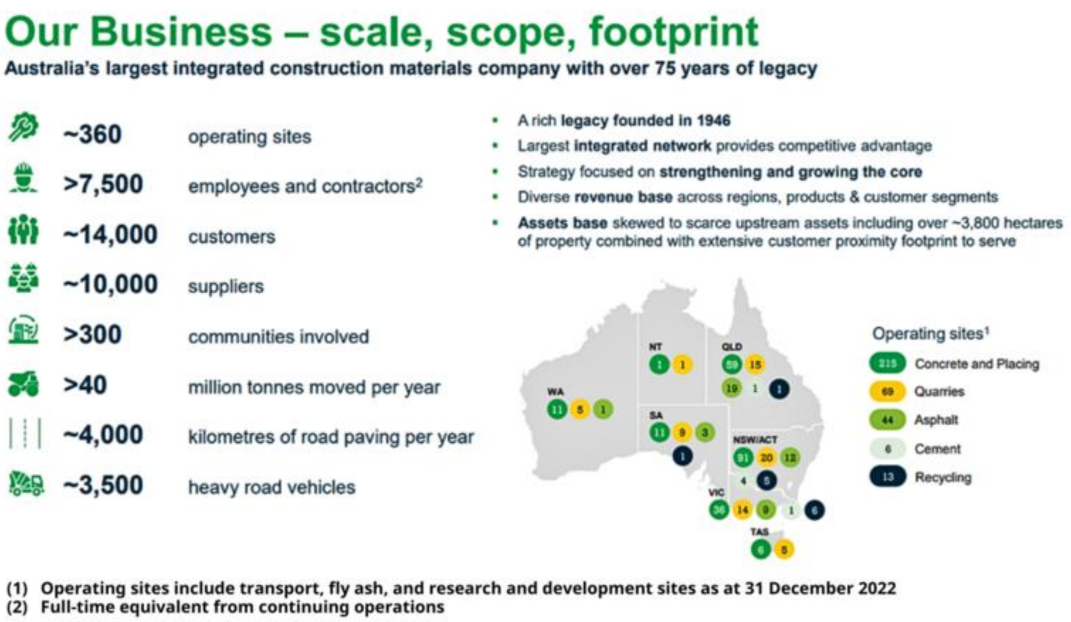
One senior NAB executive recently highlighted to us that much of the base for the work that has been done during recent years was prepared through the past decade with a complete rewiring of the internal transfer pricing mechanisms within NAB, a project led by the then CFO, albeit that data needs to be used judiciously to be turned to commercial advantage, which has been the change in culture seen through the past four years. When asked what the biggest threat was to NAB after his departure, McEwan nominated "losing focus", trumping AI, government interference, strategic resets and economic cycles.

Boral has turned things around

An exemplar of execution through the past year has been Boral. A little more than a year ago, Vik Bansal was appointed as CEO and Managing Director of Boral. In that year, fundamental financial performance changed markedly; revenues up almost 20%, EBITDA up twice that again, and operating cash flow increasing by more than 50%. Repeatedly, internally and externally, 'the Boral Way' is emphasized, speaking to purpose, values, operating model, strategic areas of focus and the pathway to execution. Needless to say, the menu is adopted by many companies, but the focus is often on the former and not the latter elements.

At Boral, since Bansal joined, the focus has been on execution, at a granular level, with the operating model seeing aggressive devolution of authority and responsibility for pricing and volumes, within guardrails, for each of Boral's 360 operating sites. The CEO spends half of every month in scheduled calls with each of the largest operating sites discussing performance and cashflow performance and requirements. Interestingly, one of the purposes of this is that it is seen as inhibiting malinvestment, especially in grand projects such as ERP systems which are usually expensive, not fit for purpose, do not produce claimed benefits and are soon orphaned vanity projects within the organization which installed them. Mr Bansal claims that managers of operating sites, who will be allocated with the implementation and ongoing costs of such systems, are vocal in opposition to such proposals unless they can see obvious benefit to their asset in terms of the system allowing them to gain market share or charge higher prices.

Indeed, when South32 spun off from BHP, one of the first actions of South32 management was to dismantle the ERP system which had only recently been foisted upon the assets when they were part of BHP, on the basis that the systems were expensive – impeding efficiency – and unduly complicated investment decisions, impeding effectiveness.



Fletcher Building has work to do

In contrast, another materials company we have held is Fletcher Building. Its performance has been as dire as Boral's has been stellar. It may be a co-incidence that in just about every observable operating model metric, Fletcher Building has been doing the exact opposite to Boral in recent years. A new ERP system is in the process of being installed across a group which straddles construction, home building, distribution, building products (manufacturing plasterboard and insulation) and concrete businesses.

The better New Zealand assets of Fletcher Building in many ways replicate the product and market positions held by Boral and CSR in the Australian market, and yet the operating performance – before we get to write downs – stands in stark contrast. Centralisation has led to a significantly worse outcome than decentralization, a theme we see persistently across industries. Those closest to the customer usually know best where capital should be allocated to meet the needs of those customers. Whilst New Zealand has had some pressures on end market volumes which have affected operating performance, Australia has had the same headwinds and yet Boral and CSR, let alone James Hardie, have used their positions more adroitly to generate value for shareholders. In sum, it's not just the whiteboard and strategy that matters (they are often very similar across competitors); it's in the way that you use it that matters for performance and shareholder return.

Note: TRIFR is 11 months ended 31 May 2023, NPS is 11 months ended 31 May 2023; EBIT margins is FY23F; CO2 Emissions is 12 months
Source: Fletcher Building Limited Investor Daily Presentation, June 2023

Of course, issues other than just sub peer operating performance have materially impacted upon Fletcher Building in recent years. Unfortunately, most of these wounds are self-inflicted.

In July 2017, Mark Adamson left as CEO of Fletcher Building, after a five-year tenure. Months later, Ralph Norris stood down as Chairman. In each case, the changes reflected losses of circa NZ$660m booked through the prior year. Upon announcing his resignation, Mr. Norris wrote that "… Our shareholders place significant faith in me to act in their best interests and expect accountability from the board for all aspects of the company's performance".

After years now of further large write offs, overwhelming those that pre-empted the departure of the prior Chair and CEO, there is now neither accountability at Fletcher Building nor murmurings suggesting the acceptance of accountability. Indeed, just through the past year alone, write offs are at NZ$450m, and significant further risk remains in the book on the company's own reckoning.

This all comes within two years of Fletcher Building spending NZ$273.5m on a share buyback, completed at an average price per share circa 50% above the current share price. At a current enterprise value less than ten times earnings, the value case for Fletcher Building is clear; albeit a steep discount assuming a continuation of reckless operating and financial performance needs to be maintained so long as the current board and management are in place.

Notwithstanding the current malaise, assuming the current board and management will not endogenously or exogenously change in the face of enduring poor performance is stubborn. And at the time of that change, the Boral and CSR lesson is instructive: privileged assets with long lives, managed well, can readily be afforded a multiple circa two to three times Fletcher Building's. As with many other serial underperformers, it's time for the company board to lose their religion and try a different choir, even with the same lyrics.

*Andrew Fleming is Deputy Head of Australian Equities at [Schroders](), a sponsor of Firstlinks. This document is issued by Schroder Investment Management Australia Limited (ABN 22 000 443 274, AFSL 226473) (**Schroders**). This document does not contain and should not be taken as containing any financial product* *advice or financial product recommendations. It does not take into consideration your objectives, financial situation or needs. For more articles and papers from Schroders, [click here](#).*

Indexing tax thresholds to address bracket creep

Tony Dillon

The Labor Party stage 3 tax cuts expected to pass through the parliament are welcome cost-of-living relief for lower income taxpayers. But payback to higher income earners for the effects of wage inflation induced bracket creep is less than that intended under the Coalition's stage 3 version.

What bracket creep really is

Bracket creep is a function of a progressive tax system, constructed by setting higher marginal tax rates at higher income bands. It is both a scourge on taxpayers and an ally of governments.

As well as having the potential to push wage earners into higher tax brackets, it increases the average tax rate within brackets. Because as the portion of salary taxed at the higher marginal rate grows, the total tax paid as a percentage of income increases. 'Tax creep' is probably a more apt description of this process.

In general, the more income tax brackets, and the wider the spread of marginal tax rates, the more progressive the tax system. And the more progressive the tax system, the greater the impact of bracket creep.

We clearly have a progressive income tax scale in Australia, with for example, the top 10% of salary earners paying about half of all income tax.

To negate bracket creep, the thresholds at which marginal tax rates change should be indexed to inflation. The problem is the government of the day does not index tax thresholds. Rather, it legislates ad-hoc tax cuts to address bracket creep, and usually announces them with lots of fanfare as if it was doing some great deed. But the cuts are basically payback for a silent tax that creeps up on wage earners like a librarian.

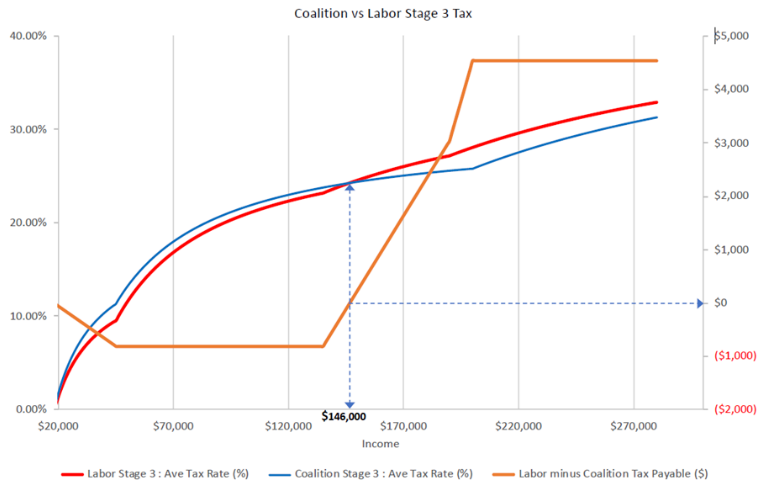
Indexing thresholds would also incentivise governments to exercise budgetary discipline, with no bracket creep to fall back on. And fiscal discipline may even lead to significant tax reform, with less reliance on personal income tax.

Labor's proposed changes

The Coalition stage 3 tax scale had only three tax brackets, with a super-sized bracket of income between $45,000 and $200,000 taxed at a marginal rate of 30%. It would have been a virtual flat-tax regime for around 94% of Australian taxpayers in that tax bracket. The marginal rate beyond $200,000 being 45%.

The soon to be legislated Labor stage 3 tax scale has an additional tax bracket, with a marginal rate of 37% for income between $135,000 and $190,000, after which the top marginal rate of 45% cuts in. And the lowest marginal rate is at 16% compared to the Coalition's 19%. Both scales have the same tax-free threshold of $18,200.

In the chart, we compare the average tax rates for the two tax scales, with increasing income levels.



The chart shows a more progressive Labor tax regime, with average tax rates lower under Labor at lower income levels, and higher further up the income scale. The crossover point being $146,000 income, where average rates and tax payable are equal. Beyond that, bracket creep takes hold at a more rapid rate under Labor, with a sharper increase in average tax rates and tax paid.

Note under both scenarios, average rates of tax increase more sharply at lower income levels before flattening out at higher income levels. So that under a progressive tax system, bracket creep is actually regressive.

The key factor behind the accelerating Labor Party bracket creep is the 37% tax bracket. It puts wage earners' average tax rate on a steeper trajectory compared to the Coalition's, when it arrives at $135,000. Which explains Treasury's advice that Labor's reworked tax scale is expected to raise an extra $28 billion in tax over the next decade.

While the 37% marginal rate heightens bracket creep, it also incentivises tax minimisation. Removing alignment of the marginal tax rate with the 30% corporate tax rate for earnings between $135,000 and $200,000, means that the shuffling of income between different tax structures will persist. A golden opportunity to remove inefficiencies in the tax system has been lost.

Should tax cuts be separate from cost-of-living relief

Meanwhile, arguments for the Coalition stage 3 tax structure were compelling. Not only would its flatter tax structure dampen the ability for future governments to increase tax take by stealth, but it also would encourage initiative and ambition to a greater extent, stimulating labour supply and exposure to taxation. Overall, it would encourage lower wage earners to earn more, and higher wage earners not to earn less.

Recognising that cost-of-living support for lower income earners is appropriate, the intention of the Coalition's stage 3 tax cuts, and indeed of stages 1 and 2 before it, was to return bracket creep to all taxpayers. However, Labor argued that its revised tax position was in response to cost-of-living pressures brought about by changed economic circumstances. Which is a broad argument and doesn't really hold up when the economy is constantly changing.

Cutting personal income tax should be about reversing bracket creep and should not be conflated with other issues. In this instance, provision of cost-of-living relief could have been dealt with independently of stage 3 tax cuts, via targeted support.

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

Meg on SMSFs: Is contribution splitting a forgotten strategy?

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues on managing your SMSF.

It often surprises me how rarely we see 'spouse contribution splitting' in SMSFs. Perhaps it's more common in large APRA funds but it's certainly not so in SMSFs.

Spouse contribution splitting is that special rule that effectively allows someone to 'give' some of their super contributions to their spouse. There's a process – more on that later. Don't confuse it with the super splitting that happens when couples separate/divorce – this particular form of splitting is all about sharing growth in super while you're together.

It's only possible for concessional contributions so it's limited to the contributions counting against the smaller cap of $27,500 (such as employer contributions, personal contributions where a tax deduction is claimed). Perhaps that's why it's not done much – it feels quite small fry as strategies go, not something that will set the world on fire.

But my own experience is that it can really add up – my husband and I did this for years and I'll explain why shortly. But first a brief run down on the process.

There are broadly four steps and – of course - rules.

1. The contributing spouse's concessional contribution

First, contributions are made for the 'contributing spouse' (I'll use that term even though often we're splitting employer contributions, so they weren't actually contributed by that spouse). As mentioned earlier, concessional contributions can be up to $27,500 per year.

Because these contributions get taxed at 15% in the fund, the maximum amount that can be split is 85% of the contribution (say $23,375 for someone who's had contributions of $27,500). It's worth knowing, though, that sometimes the contributing spouse might be allowed extra concessional contributions because they're eligible to use rules that let them look back over the last 5 years and use up any concessional contribution caps they didn't use back then. If they can use those rules to contribute (say) $100,000 this year, then $85,000 (85%) can be split to their spouse. (They could also choose to split less – there's no rule saying that if you want to use the splitting rules you have to give all your concessional contributions away.)

The one thing that can't be split is any 'excess' contributions (contribution amounts over the cap, whatever that cap happens to be).

The only rule the ***contributing*** spouse has to meet is they need to have been allowed to make the contribution (and claim a tax deduction) or have their employer make it for them. Of course, that in itself comes with some rules (for example, people over 67 can't make claim for a tax deduction for their personal contributions unless they meet a work test, people over 75 often can't have contributions at all).

But as long as those rules are met, there are no other limitations based on the contributing spouse's age, whether or not they have retired, where the contribution comes from (personal, salary sacrifice, Super Guarantee) or how much they have in super.

2. Waiting until the following financial year to split

The second step is usually…. waiting.

Generally, contributions can't be split in the year they're made, they can only be split in the following year. (The idea is that you look back to see exactly how much was contributed over the whole year and then do one election to split, based on the total.) There are some exceptions – for example, a contributing spouse who moves all their super to another fund would need to do their splitting before moving (you can only split if you still have the money in the fund that received the contribution).

3. Rules for the receiving spouse

The third step is that the contributing spouse makes an application to split their contributions. This is when things get slightly trickier – the ***receiving*** spouse has to meet some extra rules. They definitely have to be under 65. And if they're over their 'preservation age' (in future, this will pretty much be age 60), they can't be retired. Fortunately, the law for contribution splitting is all about being retired 'now'. So, someone who retired in the past could 'unretire' if they wanted to use the splitting rules (and they don't have to go back to work to do this). The one thing to watch is that you can't say on the one hand you're retired (so you can access your super) but on the other hand that you're not (so you can use the contribution splitting rules) all at the same time.

These conditions have to be met at the time the application is made, not when the contribution is put into super.

4. Transferring the funds

Then lastly (fourth step), the super fund actually moves the money from the contributing spouse's account to the receiving spouse's account. This is really easy in an SMSF – just accounting entries, so the fund doesn't need to have enough cash to make a physical transfer as long as both members are in the same fund.

So, who uses this?

Often, it's used to even up super balances where it's clear one member of a couple is going to have a lot more in super than the other. For example, let's say there's one high income earner (maxing out their $27,500 cap every year with salary sacrifice contributions) and one lower income earner (with compulsory super at a much lower rate). To make sure they still build up their super roughly evenly, they could use contribution splitting to ensure that roughly the same amounts were adding to each member's account.

I used it differently. My husband reached his 'preservation age' 10 years earlier than me. So, for a long time, we 'split' all of my concessional contributions to his account knowing that it would mean 'our' super was accessible to us earlier. (And at that time, we'd even up our super balance).

Others will think about it from an age pension perspective. Super assets don't count in the assets or income test for the age pension until they're either turned into a pension, or the member reaches age pension age

(67). That means some couples might split contributions to the *younger* spouse, so their super is initially kept out of sight from means tests when the older spouse turns 67.

Or what about people who want to use those special rules I mentioned earlier about 'catching up' on old concessional contribution caps they haven't used in the past? They're only possible for people with less than $500,000 in super. Someone who is rapidly approaching $500,000 might split concessional contributions to their spouse (who is either well short of this cap or already over it) to make sure they stay under $500,000 for as long as possible. The same general principle could apply for people close to other important thresholds (for example, non-concessional contributions are only possible for people with less than $1.9 million in super).

The timing can get tricky here and it's definitely a strategy that adds value in small amounts each year rather than all at once – so something to think about early.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

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Graham Turner on lessons from 40+ years of Flight Centre Part 2

Lawrence Lam

Part 1 of Lawrence's interview with Graham Turner can be [read here]().

Going global the right way

Global expansion has traditionally been difficult for many Australian companies. It was no different for Flight Centre. The difference maker was at Flight Centre, there was a group of co-founders at the helm determined to figure out and evolve their overseas operations. They also had the ability to make quick changes without heavy bureaucracy many other organisations face.

In 1989 the business opened its first overseas shops in London and California. Despite Skroo's (the nickname that Graham goes by) extensive experience in London, the shops struggled to gain traction. Skroo puts it down to two factors: timing and leadership talent. The expansion overseas was premature because in those days Flight Centre did not yet have the level of buying power it needed to acquire the cheapest possible airfares, meaning it could not offer the competitive pricing it needed to break into a new market. Its leadership talent was also quite thin which meant decision-making was made from afar in Australia; on the ground experience was lacking. The disappointing results led to the eventual closing of the London and Californian shops in 1991.

But unlike large corporates, Skroo's operation was agile, could make quick decisions, and was determined to make the global expansion work. In 1995 they revisited the plan with a much stronger foundation. By then Flight Centre had just floated and had built up 350 shops in Australia, generating about $1 billion in revenues. With that also came a deeper talent pool of managers with greater skill and affinity to what Flight Centre was about - its corporate culture. The previous constraints which prevented a successful expansion were fixed. As Skroo puts it "this time we didn't underestimate how difficult it was to start something up like that."

Instead of hiring leaders overseas, Flight Centre sent, as Skroo put it "really good expats", from Australia with a horizon of five to ten years to lead and grow the overseas operations. This tweak worked. It highlighted the importance of corporate culture and business acumen, which took years to develop. Eventually the expat would hand over to a local manager. Even today the formula for spotting internal talent has not changed - Skroo looks for those who make the right commercial judgements, reflect the corporate culture and are willing to relocate even with young families - "it is a big commitment and people prepared to make those commitments tells you something".

It was with this approach that Skroo and his team would successfully expand into the UK and US throughout the 1990's and would set Flight Centre on the path towards a true multinational business it is today.

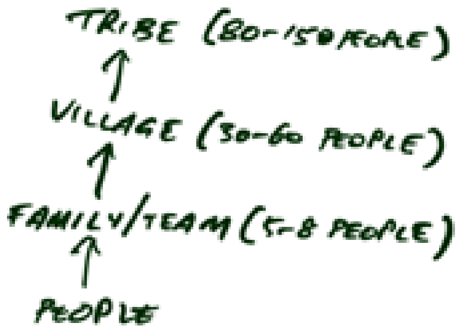
Applying evolutionary psychology to corporate culture

Conventional corporate structure is made of a hierarchical, pyramid structure which Skroo does not ascribe to. The reason is because it slows decision-making, adds bureaucratic layers and disrupts the flow of customer feedback back up to management. The secret formula Flight Centre employed during their rapid pace was based on the theory of evolutionary psychology written by Professor Nigel Nicholson from London School of Economics. The design of an organisation is centred around teams of 5 to 8 people which hark back to how our hunter gatherer ancestors liked to live and work as a family. Typically, 5 to 8 families make a village (an informal group that helps and works with each other), and 3 to 8 villages make a tribe. A tribe ideally consists of 80-150 people. Any larger unnecessary bureaucracy starts to creep in.

On organisational design: "You can take people from the Stone Age, but you can't take the Stone Age out of people" - Graham Turner

This is how Skroo designed Flight Centre's frontline teams - roughly 5 to 8 team members in any new shop, belonging to a village of 5 to 8 shops, which in turn linked to a tribe consisting of about 3 to 5 villages (15 to 25 shops). The ideal tribe had around 150 people. As Flight Centre grew beyond those limits, it had to inevitably embrace a level of bureaucracy which Skroo minimised by limiting it to a maximum of 3 or 4 levels - team level, followed by tribe level, then region level, then country level. Senior management should be a maximum of 4 or 5 levels away from frontline staff.

Organisational structure in the context of evolutionary psychology



To this day Flight Centre is structured this way and Skroo remains adamant the size of its board and senior management team should be no different than a family - a maximum of 5 to 8.

How to acquire companies

Skroo has overseen a 20-year track record of acquisitions and proudly stands by the fact he's made plenty of mistakes. He is the first to admit a success rate of "50/50" is not impressive, but the courage of continuing to take risks is part of why Flight Centre has been successful. It is the reason that has enabled its longstanding leadership team to finetune its acquisition criteria and continue learning from mistakes.

For starters, he eschews "renovators" where on balance more time and capital are required than one estimates. He instead prefers ready-made targets that can already contribute immediately. The premium on acquiring these companies is worth it. Its biggest successes have come from acquisitions in adjacent markets. For example, Flight Centre was able to move into the corporate travel business through a string of acquisitions; it is now one of its largest business areas.

These days, Flight Centre has significant internal capabilities to grow by itself; it will only look to acquire where there are opportunities in niche markets where it does not already have exposure. That may be in new travel segments (such as leisure) or niche geographies where there are new growth opportunities. And this is the other key lesson Skroo has learnt - acquiring is not about empire building for the sake of organisational size; it is about building an advantage in a new niche.

The makings of a founder

To this day, Skroo remains the CEO and retains a significant shareholding. Reflecting on his own journey, I ask him the ingredients which made him a successful founder and what separated him from others. In typical Skroo fashion, he responds analytically with a sense of realism: "getting my hands dirty on an apple orchard by the age of six set a foundation for understanding small business. It's not a requirement for success, but certainly helped me learn the basics".

As he developed, it became clear he was a builder - two buses were never enough. With a dry grin he points out he was motivated to pursue life outside the family's apple orchard because "it was so boring" and of course he pays heed to a splash of luck which helped him survive the cash crisis early on. Somehow, I suspect the element of luck is less than Skroo purports.

Lawrence Lam is Managing Director and Founder of Lumenary Investment Management, a firm that specialises in investing in founder-led companies globally.

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What's unique about private equity?

Larry Swedroe

Private equity involves pooling capital to invest in private companies either in the form of providing venture capital to startups or by taking over and restructuring mature firms via leveraged buyouts. Private equity investors believe that the benefits outweigh the challenges not present in publicly traded assets—such as complexity of structure, capital calls (and the need to hold liquidity to meet them), illiquidity, higher betas than the market, high volatility of returns (the standard deviation of private equity is more than 100%), extreme skewness in returns (the median return of private equity is much lower than the mean), lack of transparency, and high costs. Other challenges for investors in direct private equity investments include performance data, which suffers from self-report bias and biased net asset values and understates the true variation in the value of private equity investments.

Empirical research on private equity performance

Unfortunately, the empirical research findings on the performance of private equity, including publicly listed private equity, have not been encouraging. In general, private equity has underperformed similarly risky public equities even before considering their use of leverage and adjusting for their lack of liquidity. But the authors of the 2005 study "Private Equity Performance: Returns, Persistence, and Capital Flows" did offer some hope. They concluded that private equity partnerships were learning—older, more experienced funds tended to have better performance—and that there was some performance persistence. Thus, they recommended that investors choose a firm with a long track record of superior performance.

The most common interpretation of persistence has been either skill in distinguishing better investments or the ability to add value after the investment (for example, providing strategic advice to their portfolio companies or helping recruit talented executives). Research by Verdad showed a lack of evidence supporting either hypothesis. But the research does offer another plausible explanation for persistence: Successful firms can charge a premium for their capital.

Reputation and the cost of capital

David Hsu, author of the 2004 study "What Do Entrepreneurs Pay for Venture Capital Affiliation?," analyzed the financing offers made by competing venture capital firms, or VCs, at the first professional round of startup funding. He found that offers made by VCs with a high reputation are 3 times more likely to be accepted, and high-reputation VCs acquire startup equity at a 10%-14% discount.

Ramana Nanda, Sampsa Samila, and Olav Sorenson provided confirmation of a reputational discount in their 2020 study, "The Persistent Effect of Initial Success: Evidence from Venture Capital." Their findings led them to conclude:

"Our investment-level analyses suggest that initial success matters for the long-run success of VC firms, but that these differences attenuate over time and converge to a long-run average across all VC firms. Although these early differences in performance appear to depend on being in the right place at the right time, they become self-reinforcing as entrepreneurs and others interpret early success as evidence of differences in quality, giving successful VC firms preferential access to and terms in investments. This fact may help to explain why persistence has been documented in private equity but not among mutual funds or hedge funds, as firms investing in public debt and equities need not compete for access to deals. It may also explain why persistence among buyout funds has declined as that niche has become more crowded."

They added: "The picture that emerges then is one where initial success gives the firms enjoying it preferential access to deals. Both entrepreneurs and other VC firms want to partner with them. Successful VC firms, therefore, get to see more deals, particularly in later stages, when it becomes easier to predict which companies might have successful outcomes." It is the access advantage that perpetuates differences in initial success over extended periods.

Robert Harris, Tim Jenkinson, Steven Kaplan, and Ruediger Stucke confirmed the prior research findings of persistence of outperformance in their November 2022 study, "Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds." However, it was only true for venture capital (not the full spectrum of private equity), as they found that there was no persistence of outperformance in buyout firms.

Latest research

In their article "The Dispersion Illusion," Brian Chingono and Dan Rasmussen of Verdad pointed out that "advocates for private equity investing often note that the dispersion of performance between top-quartile managers and bottom-quartile managers is significantly wider than the range of performance in liquid asset classes. The implication is that private markets are less efficient, that there's a larger role for skill, and that investors in private equity can take advantage of this dispersion through manager selection." However, Harris et al. found that while there was some persistence in venture capital, there was no persistence in buyout firms. Thus, at least for private equity buyout firms, the wide dispersion could not be attributable to high skill.

If skill doesn't explain the wide dispersion, what does?

Explaining the wide dispersion in performance

Chingono and Rasmussen showed that there is a simple, non-skill-based explanation for the wide dispersion of performance: It reflects the differences in portfolio composition between private equity and public funds. They explained, "Private equity portfolios are quite different from mutual fund portfolios. First, private equity portfolios tend to have about 20 firms, whereas a typical mutual fund holds about 200. Second, private equity portfolios are overwhelmingly comprised of micro-caps, while most mutual funds focus on large and mid-caps. Even the median small-cap mutual fund holds companies with market caps about 10 times the size of a typical [leveraged buyout]. Third, private equity funds hold highly leveraged companies, with the median proportion of debt financing being 49% Net Debt/EV [enterprise value] and the median leverage ratio being 4 times Net Debt/EBITDA [earnings before interest, taxes, depreciation, and amortization]."

To test that hypothesis, they created simulations of public equity portfolios that varied in concentration, company size, and timing of investment. Since private equity doesn't sample randomly, instead choosing smaller and more profitable businesses, they compared the median returns of private equity against simulated micro-cap portfolios of 20 stocks that were selected from the cheapest 5% (value companies) and the most profitable 5% (quality companies) of companies within each year. Within their micro-cap data, there were typically 30-50 stocks in the top 5% of any given year, and the factor-ranked simulations were randomly selected from this opportunity set when forming the 20-stock micro-cap portfolios over the course of three years (at a pace of six to seven investments per year).

Their simulations started by randomly selecting a vintage year between 1995 and 2017 and then included the two subsequent years to form a three-year investment period. The authors explained, "For example, if 2000 is randomly chosen as a vintage year, the investment period will comprise 2000, 2001, and 2002. Each investment within a portfolio is sold after being held for four years. This iterative process of portfolio formation and realization is repeated 10,000 times in our simulations to create a distribution of return outcomes." The following is a summary of their findings:

- Value characteristics appeared to have the biggest impact on micro-cap returns, boosting the median return from 10% in a totally random sample to 18% in a value-ranked sample of 20 stocks.
- Quality mattered, with an improvement of 4 percentage points in the median return, from 10% in a totally random sample to 14% in a profitability-ranked sample of 20 stocks.
- The dispersion was about the same, at 20.7% in private equity versus 20.4% in the micro-cap simulation; private equity's dispersion was in line with the random outcomes from volatile portfolios of leveraged, cheap micro-caps. The most notable difference was that private equity managers underperformed their simulated benchmark by 2 to 4 percentage points per year, which is easily explained by fees.

Their findings led Chingono and Rasmussen to conclude, "The implication of this result is that private equity's value creation is not sufficient to overcome its fees, in our opinion. While PE may create value through deleveraging and other management decisions, those benefits appear to be fully offset by fees." They added, "Our results suggest that the dispersion in private equity can be fully replicated in public markets, provided that investors focus on buying cheap, leveraged micro-caps and hold them in a concentrated portfolio, similar to the portfolio construction in PE."

Investor takeaways

There are several key takeaways for investors. First, the claims of superior risk-adjusted performance by the private equity industry are exaggerated. Given private equity's lack of liquidity, opaqueness, and greater use of leverage, it seems logical that investors should demand a roughly 3% internal rate of return premium. Yet there is no evidence that the industry overall has been able to deliver that. Second, the failure to appropriately mark-to-market investments during public market drawdowns leads investors to underestimate the risk of these investments, as the volatility is significantly understated. Third, investors should expect that much of their capital might be outstanding even well beyond a decade—and that should certainly require a risk premium.

Investors desiring exposure to the risk and potential rewards of private equity investing should recognize that the wide dispersion of potential outcomes highlights the importance of diversifying risks. This is best achieved by investing indirectly through a private equity fund rather than through direct investments in individual companies. Because most such funds typically limit their investments to a relatively small number, it is also prudent to diversify by investing in more than one fund. And finally, top-notch funds are often closed to most individual investors. They get all the capital they need from the Yales of the world. Forewarned is forearmed.

Larry Swedroe is a freelance writer and head of financial and economic research with Buckingham Strategic Wealth. The views expressed here are the author's. For informational and educational purposes only and should not be construed as specific investment, accounting, legal, or tax advice. The author does not own shares in any of the securities mentioned in this article.

Are record market highs bullish or bearish?

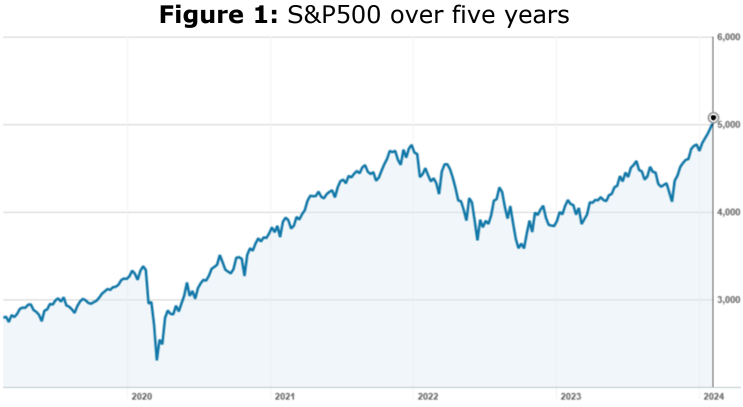
Gemma Dale

For the majority of Australian investors, the prospect of a new high for the ASX has been a long time coming, a slow grind rather than a heady and rapid climb. For those with exposure to the US, and particularly to the Magnificent Seven, however, share prices have rocketed. If you only look at your super fund returns a couple of times a year, or hold ETFs with broad market exposure, the picture is pretty rosy, but it's always interesting to see which stocks are doing the heavy lifting, and how broad the performance of your portfolio really is. A few charts below put recent returns into perspective, and may give you cause for reflection.

The S&P500 has more than doubled since its Covid lows

While new highs make sense – one would hope that companies are growing their earnings and share prices appreciate over time – the S&P500 is now 15% higher than it was when the Fed started hiking rates in March 2022. This isn't really what's 'supposed' to happen. Even more incredibly, the index has closed higher 14 out of the last 15 weeks, the first time this has happened since 1972[1].

Figure 1: S&P500 over five years



Source: nabtrade

At the same time, the concentration of shares delivering strong performance has narrowed significantly. In 2023, more than 70% of stocks in the S&P500 underperformed the index – the highest proportion, by a substantial margin, this century[2].

The Nasdaq has also doubled but is only just retouching its highs

Figure 2: Nasdaq performance over five years

Source: nabtrade

Narrowing leadership

The primary reason for the incredible resilience of the S&P500 index – which is up 5% in the first six weeks of 2024 alone – is the Magnificent Seven group of stocks, which have been driving returns over the last 12 months. This group includes sector leaders Microsoft, Amazon, Alphabet (formerly Google), Meta (formerly Facebook), Tesla, Apple and Nvidia, all of which are found in the NDQ as well as the broader index. Since Microsoft invested in ChatGPT, the Mag7 have actually delivered more than 100% of the market return[3].

The performance – and size – of these companies is incredible. Nvidia, seen as a leader in the AI mania that hit the market in 2023, has gained over 50% in the last three months; given the recent falls in Chinese stocks, it is now more valuable than the entire market capitalisation of the Chinese stock market. In one week, the stock added the entire market capitalisation of Intel. Even so, with rapid earnings upgrades, its price to earnings (PE) ratio has actually fallen, although it is far from cheap. At a market cap of more than US$3 trillion, Microsoft is now worth double the entire S&P500 Energy sector but remains a strong buy or a buy among all but 4 of 55 analysts surveyed. The remaining four have the stock as a hold.[4]

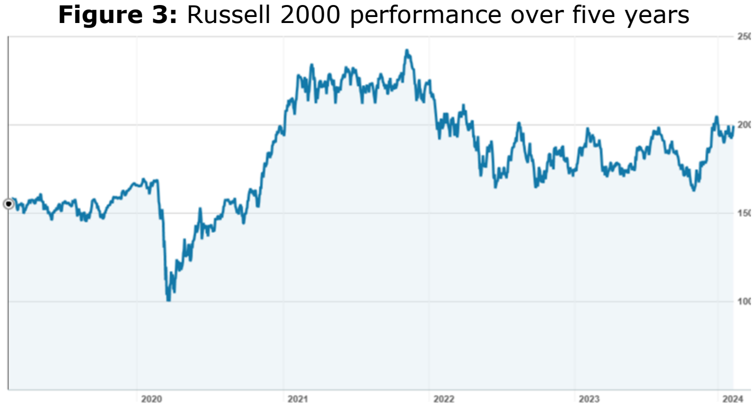
Many have argued that the astonishing rise in the Mag7, which now comprise more than 28% of the S&P500, is a largely technical rally, driven by passive funds being forced to buy in as prices keep rising. Others have pointed out that the rally in mega tech was originally driven by the commencement of an earnings upgrade cycle in late 2022, and there has been divergent performance even within the leaders based on earnings outlook – after all, Tesla has fallen 22% in 2024.

So what's going on in the rest of the market? As noted above, the S&P493 have been a significant drag on the market. According to Goldman Sachs, while the Mag7 are estimated to have added 14% year-on-year in sales for Q4, revenue growth for the remainder of the index was just 2%, while margins were contracting.

Small cap stocks in particular have failed to recover their post Covid highs. Early in US reporting season, nearly 400 small cap companies that had reported, had an aggregate Q4 earnings growth of more than -50%.[5]

The Russell 2000 has also doubled, but remains in bear market territory since 2022 highs

Figure 3: Russell 2000 performance over five years



Source: nabtrade

A note of caution

So, six stocks have been doing terribly well, and the rest have been doing poorly, on average. While this is 'just' the US market, it is worth remembering the US comprises more than 70% of the MSCI World index, the index to which your global super portfolio is probably benchmarked[6]. At the end of January, Apple and Microsoft alone comprised more than 9% of that index[7].

As an investor, you don't – necessarily – need to worry about this. Concentration in markets – and in sectors – is not uncommon, as successful businesses grow, and less successful businesses shrink or fail altogether. That said, this level of concentration is highly unusual. As noted above, less than 30% of the index is currently outperforming that index. The last time that happened was 1998-2000, after which the market fell 53%[8].

[1] Source: Standard and Poors
[2] Source: Macrobond, TheDailyShot
[3] Source: Refinitiv
[4] Source: Refinitiv
[5] Source: Refinitiv, GLJ Research
[6] Source: MSCI.com
[7] Source: MSCI.com
[8] Source: Fidelity International

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. Index charts as at 12 February 2024. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

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