Firstlinks
a Morningstar company

Edition 548, 23 February 2024

Contents

Editorial

Recently, a friend of mine went for a job at an ASX 200 company. Towards the end of the interview, my friend asked about remote work, and the recruiter said that "if you want a job, you can work from home, but if you want a career, you'll go to the office."

Another story comes from my own company: Morningstar. A few weeks ago, we had a conference call and a colleague rocked up sporting a nice-looking shirt. Everyone gave him a quizzical look as he's normally dressed quite casually, and when questioned on it, he said: "Didn't you read the company email the other day about office attire?" Everyone looked blank though I did recall an email reiterating company policy for full-time employees to work three days in the office each week (office attire must have been further down the email!)

A final anecdote comes from a work client who told me that his firm had recently implemented a policy that working in the office would be factored into bonuses.

All these stories are the latest battlegrounds in the work from home debate. Two years after Covid ended, there doesn't seem to be any definite conclusions about what is best for both businesses and individuals.

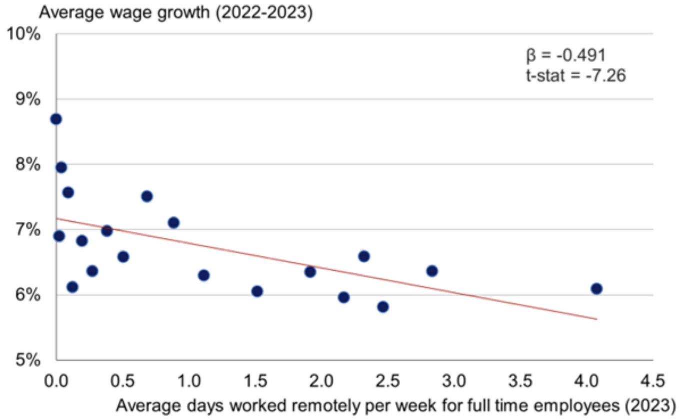
New studies are emerging though that may shed some light.

Study 1 – Work from home brings higher productivity and lower wage growth

The latest study out this month comes from the Bank of England, which teamed with universities to survey 2,500 firms in the UK. It found that businesses with higher numbers of employees working from home had lower wage growth. For every extra day of remote work, there's 0.5% lower growth.

The obvious question is why this has happened. One theory is that remote work expands the potential labor pool, which puts pressure on wages.

Average wage growth between 2022-2023 and number of working days done remotely



Source: Decision Maker Panel

The study also found that there's a link between work from home and higher productivity. The research suggests that for every extra day that an employee works outside the office, their productivity increases by £15,000 a year.

The study reveals 8% of UK employees are fully remote working, 30% are doing hybrid work, while 62% are in the office. Of the bosses surveyed, most believe these numbers won't change over the next five years.

Study 2: Return to office doesn't result in better profitability or market value

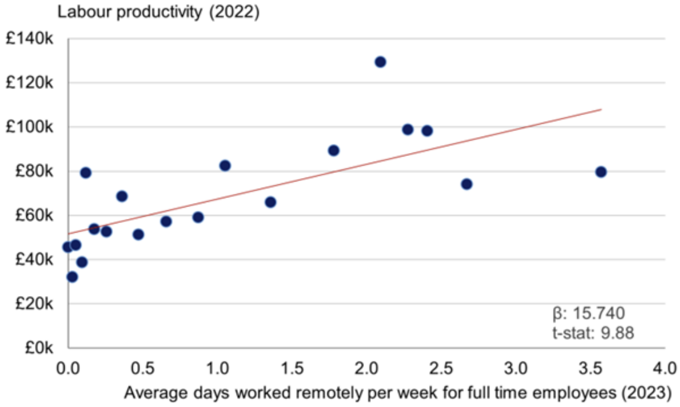
Last month, University of Pittsburgh researchers released a study which looked at return-to-office policies in S&P 500 companies. The researchers analysed the change in employee job satisfaction, company performance, and share market valuation at 137 companies from the S&P 500 that introduced return-to-office mandates. It then compared the changes to those experienced at other S&P 500 firms.

The study found that return-to-office orders had almost no impact on company profitability or market value. However, these orders did result in a significant drop in worker satisfaction.

The study also found companies were more likely to introduce a return-to-office policy if their CEO was male or they'd suffered a prior period of poor share market performance.

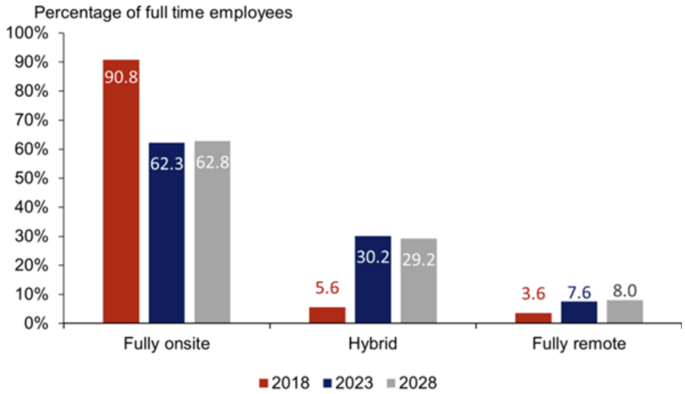
Study 3: Remote work may increase short-term productivity but reduce long-term output

Firm productivity and the number of working days done remotely



Source: Decision Maker Panel

Proportion of full-time employees based fully onsite, hybrid or fully remote in 2018, 2023 and expected in 2028



Source: Decision Maker Panel

A further study came out late last year from the National Bureau of Economic Research in the US. Researchers there studied software engineers at a Fortune 500 firm. They found that working from home increases productivity in the short term, because experienced staff spend more time producing their own work and less time reviewing the work of junior employees. However, the study also suggests that less collaboration and mentorship between senior and junior staff due to remote work may reduce productivity in the long term.

Research takeaways

Though the studies point to the benefits of working from home outweighing the costs, it's too soon to draw conclusions. The research looks over relatively short time frames. Further research is needed on the impact of remote work in the long term.

The studies also have some obvious drawbacks. For instance, the third study focuses on software engineers at one firm in the US. These engineers are hardly representative of the broader workforce, and making broad generalisations from that study is questionable.

But there is one, definite takeaway from the studies: most workers prefer the flexibility of being able to work from home. If that's right, businesses which insist on employees being in the office at all times are likely to lose out on hiring and keeping talented workers. All things being equal, if the choice is between a company offering flexibility and one that's not, workers will likely go for the former over the latter.

The irony of the current debate

It's important to step back from the minutiae of the debate and look at the long-term forces that are driving the remote work trend.

Management guru, Charles Handy, nailed many of the changes taking place today, more than 30 years ago. In his book, The Age of Unreason, published in 1989, Handy recognized a shift in the structure of workplaces. He identified the rise of what he called 'shamrock' organisations. Essentially, these were businesses based around a core group of executives and workers, supported by outside contractors and part-time help. These types of organizations had existed before, in the form of builders and newspapers, but it was being adopted by more and more businesses.

What was behind the change? Handy said it was growing because it was cheaper:

"Organisations have realised that while it may be convenient to have everyone around all the time, with their time at your command because you have bought all their time, it is a luxurious way of marshalling the necessary resources. It is cheaper to keep them outside the organization, employed by themselves or by specialist contractors, and to buy their services when you need them.

This is a sensible strategy when labor is plentiful, when you can pick and choose between suppliers. It is a sensible strategy when your work ebbs and flows as it tends to do in service industries. When you are manufacturing things any surplus resources of people or equipment can always be turned to good advantage by producing things for stock for the weeks of peak demand, but the service industries cannot, or at least should not, stockpile their customers, and therefore must flex their workforce."

In the book, Handy said the age of workers staying in the one job for a long time was over. In later works, he urged people to develop 'portfolio careers' that comprise a variety of roles rather than one job at a single firm. He realised that because of the way that businesses were moving, people would need to develop portable skillsets to meet the needs of the modern workplace.

Handy foresaw many of today's trends including the gig economy. I'd argue that remote work too is an extension of his theories.

How so? Since Handy first published his thoughts, the advent of technology and specifically the Internet has accelerated the changes to the workplace that he identified. It's allowed more individuals to have so-called portfolio careers.

I'd argue the other big change that's driven the push for greater remote work is the higher cost of living. That's resulted in more families where both parents are having to work. For example, in Australia, the proportion of parents both working has risen from 40% in 1991 to around 60% now. Consequently, having flexible work has become more important.

It's ironic that the challenges many businesses face from remote work today were brought about by changes that businesses themselves made more than 30 years ago.

The broad, long-term forces driving remote work seem unstoppable and businesses enforcing strict back-to-office mandates may be fighting a losing battle.

***

My article this week looks at recent comments from renowned investor **David Einhorn** that passive investing has broken markets, and how he's changed his investing style to stay in business. I investigate Einhorn's claims, how passive investing has transformed markets, and what happens next.

For those interested, I was interviewed for Morningstar's *Investing Compass* podcast this week, and talked about how to set up a lazy, 3 ETF portfolio. You can catch it here.

James Gruber

Also in this week's edition...

Stage 3 tax cuts have generated a lot of debate and this week we have former Treasury Department Secretary **Ken Henry**'s thoughts on the issue. Dr. Henry suggests the tax system distortions that he's talked about for a long time are coming to the fore. He says younger workers are shouldering the burden as their taxes are essentially funding the lifestyles of older people. And he believes radical action is needed on tax, including negative gearing, to prevent an even greater intergenerational tragedy.

The Treasury Department's review of superannuation in retirement is well underway and decumulation is on the agenda. Financial advisers have been dealing with this issue for years, and **Morningstar's Annika Bradley** thinks super funds can learn a lot from how they've handled it.

Meanwhile, **Vanguard's Tony Kaye** reports on a super free kick that's about to run out. For some people, there's a concessionally taxed superannuation investment opportunity dating back to the 2018-19 financial year that will expire on 30 June this year. Tony details what you may be entitled to.

What are some of the best long-term themes in markets? **Montaka's Andrew Macken** selects five that he thinks could be big winners, including luxury goods, alternative assets, AI, and mission-critical financial firms.

It's easy to get caught up in the noise of the market and invest in a way that doesn't suit you. **Joe Wiggins** says that to have any chance of success, it's critical to avoid playing somebody else's game. He looks at the best way to do this.

The S&P 500 has become an increasingly concentrated index over the past decade, with the returns of the top seven stocks far outpacing the average stock in the index. **Ben Inker** thinks this explains a large part of why active managers have underperformed indices. If history is a guide, Inker says the next decade will see US megacaps underperforming the average index stock and active managers mounting a comeback.

Lastly, for this week's whitepaper, we have **Vanguard Australia**'s submission to the Federal Government's Superannuation in Retirement consultation.

Are markets broken?

James Gruber

Earlier this month, famed US hedge fund investor David Einhorn gave one of the more fascinating interviews I've heard in recent years. For those that don't know him, Einhorn has run Greenlight Capital since 1996 and is well-known for having shorted Lehmann Brothers prior to the 2008 bust.

In the interview with Bloomberg, Einhorn declares that passive investing has fundamentally broken markets. And that the changes wrought from passive investing have meant he's had to change his method of value investing to stay in business.

His claim that passive investing is distorting markets isn't new. Active managers have long complained about the issue. Yet Einhorn makes some important observations about how he thinks indexing is changing the structure of markets:

"There's all the machine money and algorithmic money … which doesn't have an opinion about value. It has an opinion about price. Like what is the price going to be in 15 minutes? And I want to be ahead of that or zero-day options. What is the price of the s and p or whatever stock you're doing for today, what's it going to be in the next half hour, two hours, three hours? Those are opinions about price. Those are not opinions about value. Passive investors have no opinion about value. They're going to assume everybody else's done the work, right?

And then you have all of what's left of active management and so much of it, the value industry has gotten completely annihilated. So, if you have a situation where money is moved from active to passive, when that happens, the value managers get redeemed, the value stocks go down more, it causes more redemptions of the value managers, it causes those stocks to go down more.

… And, all of a sudden, the people who are performing are the people who own the overvalued things, that are getting the flows from the indexes, that are getting you take the money out of the value, put it in the index, they're selling cheap stuff and they're buying, you know whatever the highest multiple, most overvalued things … in disproportionate weight. So, then the active managers who participate in that area of the market get flows and they buy even more of that stuff. So. what happens is instead of stocks reverting toward value, they actually diverge from value. And that's a change in the market and it's a structure that means that almost the best way to get your stock to go up is to start by being overvalued."

How Einhorn has adapted to the changes in markets is intriguing. Einhorn had a fantastic track record in the almost 20 years to 2015. Then, he had two awful years and three mediocre ones. Some of you may recall that news publications started to question his ability during this time, if not writing him off altogether.

How Einhorn came through this period is instructive. He analysed his period of underperformance and realised that he had continually bought cheap stocks and when these stocks handily beat earnings estimates, they weren't being re-rated by the market. Because they were outside of indices and not included in ETFs, there were few buyers for these stocks.

This happened often enough that it made him change his investment style:

"… what we have to do now is be even more disciplined on price. So, we're not buying things at 10 times or 11 times earnings. We're buying things at four times earnings, five times earnings, and we're buying them where they have huge buybacks, and we can't count on other long only investors to buy our things after us. We're going to have to get paid by the company. So we need 15-20% cash flow type of type of numbers. And if that cash is then being returned to us, we're going to do pretty well over time … you're literally counting on the companies to make that happen for you."

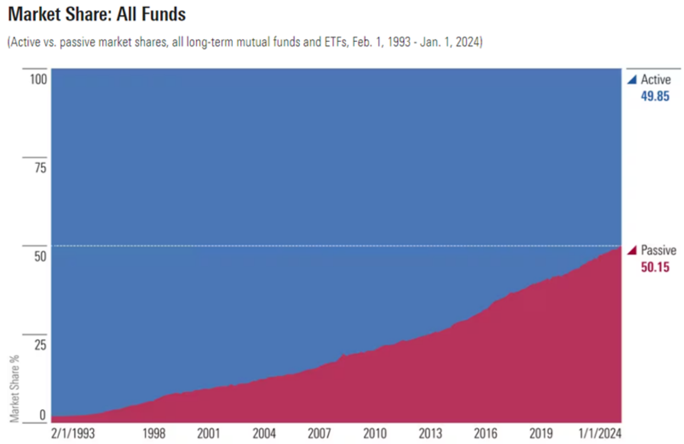
Since Einhorn has made these changes, he's gone back to handily beating the market benchmarks.

Passive a goliath in US, not so much in Australia

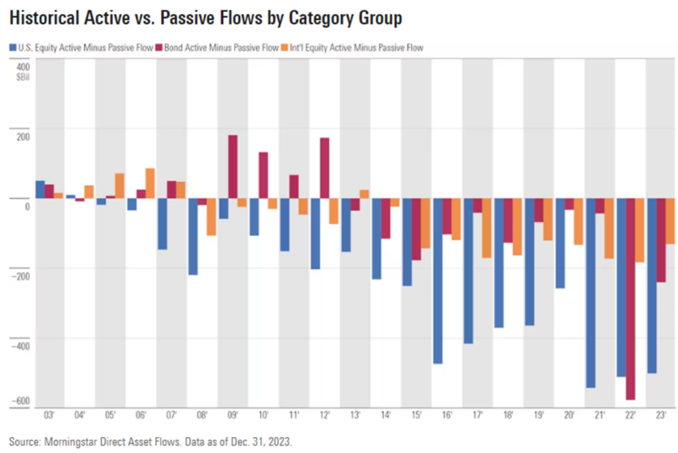
Einhorn's comments raise several important questions about today's markets.

There's little doubt that passive investing is growing quickly and taking market share from active funds. Last month, for the first time, passively managed funds in the US controlled more assets than did their actively managed competitors.

That's after passive US equity funds took in US$244 billion in 2023, while active funds had outflows of US$257 billion, continuing a long-running trend.



Source: Morningstar



The relentless growth in passive funds has resulted in the largest ETF and index providers growing into behemoths. Blackrock now has A$14.5 trillion under management, while Vanguard has A$11 trillion.

The growth in passive funds in the US has been mirrored in Australia. Last year, the ETF industry here grew 33% year-on-year to $177.4 billion in funds under management, according to BetaShares.

Yet unlike in the US, ETFs are relatively small fry still compared to active funds. The latter, which include industry funds, retail funds and other fund managers, have funds under management at close to $4.5 trillion, about 25x the size of the ETF market.

And ETF insiders suggest passive ownership of the ASX 200 is close to 10%, a far cry from the larger share it has in the US.

Yet, further growth in passive funds seems likely, with investors attracted to the simple and low-cost access that ETFs provide to markets, as well as their performance versus active funds.

The other big market trend

Along with the rise of passive funds, there's also been an increasing institutionalisation of markets. In the US, professional money managers accounted for 10% of share ownership after the Second World War. That's risen to close to 67% today. It means that in the 1940s and 1950s, active fund managers had far fewer direct competitors - their main competitors were individuals.

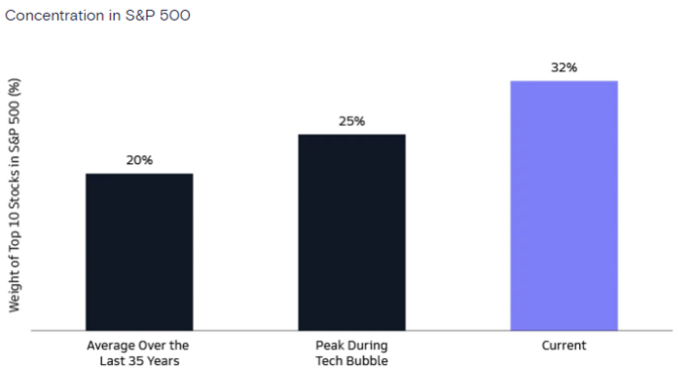
Professional fund managers are hired and fired according to how they perform compared to benchmarks. As passive funds pile into the stocks included in benchmarks, it's likely that active managers are being forced into buying into the same stocks to keep up with these benchmarks. If they're buying into the same stocks as passive funds, and charging higher fees to clients, it isn't a surprise that active funds have consistently underperformed passive ones over the past 10 years.

It's why Einhorn is complaining that passive funds are breaking markets. He's saying individual investors are fleeing into passive funds, and these funds are buying stocks included in indices, which are principally the larger companies. And they are doing that automatically, without regard to price. Also, active funds, to keep up with benchmarks and passive funds, are buying into the same stocks.

According to Einhorn, stocks that are outside of benchmarks are being ignored by individual and professional investors. Even if these stocks are undervalued and their fundamentals are improving, there are few if any buyers for these companies in the current market.

Are Einhorn's concerns valid?

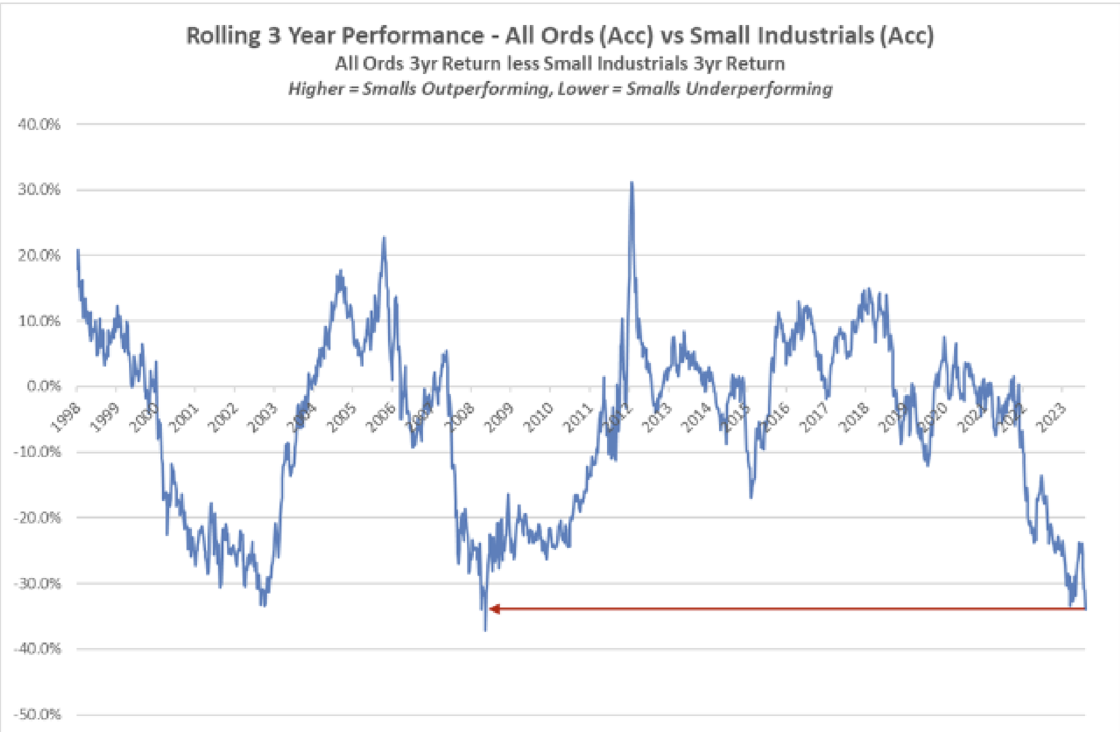
There is some anecdotal and academic evidence to support Einhorn's claims. For instance, it does seem larger cap stocks are getting more investor love than at any time in recent history. Late last year, Goldman Sachs did a study that found the S&P 500 is more concentrated than it's ever been. The average weight of top 10 stocks in the S&P 500 index has been 20% over the past 35 years. During the dot-com bubble, the combined weight of top 10 stocks peaked at 25%. Today, the figure stands at 32%.



Source: Goldman Sachs

That's led to significant outperformance from large cap stocks versus small caps. Last year, US large caps returned 26.2% compared to US small caps' 16.8%. Since 2011, large caps there have returned 382%, or 13% annualized, versus small caps' 208%, or 9% per annum.

The story of large cap outperformance has also been evident in Australia.



Source - E&P Financial Group

The largest stocks have tended to be 'growth' stocks, and growth has destroyed value over the past 15 years.

Russell 1000 Growth vs. Russell 1000 Value
(Total Returns, 1979 - 2023)

Year	Growth	Value	G-V	Year	Growth	Value	G-V	Year	Growth	Value	G-V
1979	23.9%	20.5%	3.4%	1994	2.6%	-2.0%	4.6%	2009	37.2%	19.7%	17.5%
1980	39.6%	24.4%	15.2%	1995	37.2%	38.4%	-1.2%	2010	16.7%	15.5%	1.2%
1981	-11.3%	1.3%	-12.6%	1996	23.1%	21.6%	1.5%	2011	2.6%	0.4%	2.3%
1982	20.5%	20.0%	0.4%	1997	30.5%	35.2%	-4.7%	2012	15.3%	17.5%	-2.3%
1983	16.0%	28.3%	-12.3%	1998	38.7%	15.6%	23.1%	2013	33.5%	32.5%	1.0%
1984	-1.0%	10.1%	-11.1%	1999	33.2%	7.3%	25.8%	2014	13.0%	13.5%	-0.4%
1985	32.9%	31.5%	1.3%	2000	-22.4%	7.0%	-29.4%	2015	5.7%	-3.8%	9.5%
1986	15.4%	20.0%	-4.6%	2001	-20.4%	-5.6%	-14.8%	2016	7.1%	17.3%	-10.3%
1987	5.3%	0.5%	4.8%	2002	-27.9%	-15.5%	-12.4%	2017	30.2%	13.7%	16.5%
1988	11.3%	23.2%	-11.9%	2003	29.7%	30.0%	-0.3%	2018	-1.5%	-8.3%	6.8%
1989	35.9%	25.2%	10.7%	2004	6.3%	16.5%	-10.2%	2019	36.4%	26.5%	9.8%
1990	-0.3%	-8.1%	7.8%	2005	5.3%	7.1%	-1.8%	2020	38.5%	2.8%	35.7%
1991	41.3%	24.6%	16.7%	2006	9.1%	22.2%	-13.2%	2021	27.6%	25.2%	2.4%
1992	5.0%	13.6%	-8.6%	2007	11.8%	-0.2%	12.0%	2022	-29.1%	-7.5%	-21.6%
1993	2.9%	18.1%	-15.2%	2008	-38.4%	-36.8%	-1.6%	2023	42.7%	11.5%	31.2%

CREATIVE PLANNING @CharlieBilello As of 12/31/23

There's also academic evidence that backs some of Einhorn's assertions. In a 2022 paper, 'How Competitive is the Stock Market', UCLA's Valentin Haddad and colleagues found that the rise of passive investing was distorting price signals and pushing up the volatility of the US market. The paper examined institutional investors and concluded that the rise of passive investors' share of the US market over the past two decades "*has led to substantially more inelastic aggregate demand curves for individual stocks, by 15%*". Passive investors have a demand elasticity of zero, because they automatically buy stocks without regard to whether it's cheap or not. If a stock is cheap, demand from passive investors won't increase. In theory, that should mean other investors step in to make up the demand shortfall in stocks, but the paper suggested that hadn't happened.

Counterarguments to Einhorn

The anecdotal evidence mentioned above is just that: anecdotal. The academic evidence is also relatively new and untested.

There are several potential counterarguments to Einhorn's assertions that passive investing is distorting markets and prices:

1. The influence of passive funds on market prices may be less than claimed. Passive funds typically have low turnover, of 10-20% each year. That compares to active funds of +50%. Trading sets prices, and therefore the influence of passive investing on pricing may be overstated.
2. If stock markets and price discovery are becoming less rational, that should help active investors rather than hinder them. If markets are fully rational and price stocks perfectly, there would be no role for active investors.
3. Indexing may aid price discovery rather than hinder it. For example, it increases the supply of lendable shares and thus enables short selling.

In short, there may be some truth to Einhorn's complaints though they are likely exaggerated.

The danger of passive investing for markets

Nonetheless, Einhorn is right to point out the changes that passive investing is bringing to markets. If passive investors are crowding into the large cap stocks that dominate indices, and active investors are mimicking them to keep up with performance benchmarks, it's logical that the reverse can happen too. That is, in a market downturn, there may be a rush for the exits as both passive and active investors get out of large cap stocks. This may become even more of an issue as passive funds continue to take market share from active managers.

There hasn't been a real test of this sort for passive investing. That said, markets did remain relatively orderly in 2022 when they were hit hard. A larger market downturn would be a real test for passive investing and the changes it's made to markets. Whether it leads to a shakeout in passive funds is also an open question.

Investors can learn from Einhorn

You must credit Einhorn for changing his investment style to adapt to the changes that he sees in markets. Here was a guy that was known as one of the best hedge fund investors in the world, going through an extended rough patch. He could have easily doubled down on the strategy that had brought him results and fame over the previous years. Instead, he questioned that strategy and decided to change tack.

It would have been a big risk to change investment style at that time. He was under a lot of pressure from his clients and the media. If it went wrong, he would have looked foolish, and it might have been game over for his fund. Instead, it helped him turn things around.

Investors can learn a lot from Einhorn's objective assessment of his underperformance, the reasons behind it, and changing his investment process and style to address the issues.

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

For the younger generation, we need to get real on tax

Dr. Ken Henry

This is an edited transcript of Dr. Ken Henry's radio interview with Andrew Pike on ABC's RN Drive Program recorded on 15 February 2024.

Dr. Ken Henry is an economist and public servant who served as the Secretary of the Department of the Treasury from 2001 to 2011. He chaired the Future Tax System Review, known as the Henry Tax Review, in 2010. Dr. Henry was also Chair of National Australia Bank from 2015 to 2019.

Andrew Pike: How often do you find yourself warning somebody that something bad is going to happen if they don't act, and then you have to sit back and rather painfully watch it play out just as you suspected it would? That's unfortunately been the experience of one of Australia's top economists, who's now warning that the state of the tax system has deteriorated to the point that Australia's social compact is at risk of falling apart. Dr. Ken Henry was the Treasury Secretary for a decade until 2011. He famously conducted the comprehensive, routine branch examination of the tax system known as the Henry Review. That report made 138 recommendations and specifically warned about possible tax distortions created from negative gearing.

Dr. Henry, great to have you.

Dr. Ken Henry: It's good to be with you.

Pike: 138 recommendations. How many of those recommendations were adopted? Do you know?

Dr. Henry: No, I don't. Very little actually. And some of those that were adopted were subsequently reversed. So, for example, we proposed a new taxation system for Australia's natural resources to tax the very large profits that mining companies, multinational mining companies especially, were making out of the extraction of Australia's natural resources.

Pike: The RSPT, yeah.

Dr. Henry: The RSPT. At that time, the Rudd government endorsed that recommendation, but of course it didn't survive the parliament. Another of the recommendations, you remember at that time the government was designing what became called the Carbon Pollution Reduction Scheme, which was the emissions trading scheme, the economy-wide emissions trading scheme for dealing with climate change or carbon abatement. That was in due course implemented, and then of course, that was abolished when the Abbott government came into power. So, we have gone backwards. We're in a much worse position today than we were 15 years ago when we were working on that review.

Pike: I think a lot of people in voter land right now have seen the Stage 3 tax cut changes and vaguely believe that there is some more equality in the tax system. You say that Australia's social compact is at risk of falling apart due to the state of the tax system. What do you mean?

Dr. Henry: So, what I mean is that – and actually your reference to the restructuring of the personal income tax scales is highly appropriate, because the discussion that we in Australia have been having about the design of the personal income tax scales over the past 12 months or so has been a conversation about fairness, about equity, about who should get tax cuts. The tax cuts are going to be provided. Who should get them, high-income earners or low-income earners? And not surprisingly, the community consensus is that those tax cuts should be skewed to lower and middle-income earners.

Now that's consistent with a basic principle of tax reform, which is that if you think about the features of the tax system in terms of efficiency effects, basically what impact does the tax system have on the performance of the economy; the equity effect, which is all about fairness; and the simplicity of the tax system. If you think about those three buckets, the one that trumps, always trumps, is equity. But here's the point. Because we have lost interest in economic efficiency as a guiding principle, and also to some extent in simplicity, the tax system has now become so distorted that it is underpinning the greatest inequity of all, at least the greatest inequity that I've seen in my lifetime, which seems to me to be an intergenerational tragedy.

So, the point is that we now have, because of this intense focus on equity at every point in time, we have a system which has been designed to be fair to the baby boomers, people like me. The consequence of it is that people like me are sitting on large, untaxed capital gains in houses that young working-age families will never be able to afford to buy, and in fact, increasingly, are not being able to afford to even rent. And we're sitting there either as investors getting very lowly taxed capital gains and interest deductions, or we're sitting there on tax-free capital gains, and we have priced out the working-age generation. We've just priced them out of access to the Australian property market.

That's just one example of the way that through this intense focus on equity, equity, equity for every tax issue, we have managed to produce a situation in which we have created a tragic intergenerational inequity. We've lost sight of the main game. The main game should be making a better country for future generations.

Pike: So, if you don't disagree with the Albanese government's changes to the Stage 3 tax cuts, you say that they ultimately go to that point of equity, which is largely a good thing, what more can the Labor government do to address this equity to get middle Australians and working-age Australians into the position that their parents enjoyed?

Dr. Henry: Well, get serious about tax reform.

Pike: Negative gearing?

Dr. Henry: Well, of course, that has to be part of the discussion. We have to talk about negative gearing. We have to talk about the capital gains tax concession, the fact that only 50% of nominal capital gains are included in a taxpayer's income, whilst they get full interest deductions. That's what negative gearing is all about. We have to get serious about that. We have to think about the way the capital income is taxed, in the way the capital deductions are allowed in our system. But that's only one of the things we have to think about.

I mean, my generation, the baby boomers, at the same time as we're sitting on those tax-free capital gains and our wealth is not taxed, we are paying the smallest rate of consumption tax in the industrialized world. We've got to think about consumption tax in this country. The whole GST debate from 1975, when Kenneth Asprey published his report, The Asprey Review in 1975, right through until 2000, the debate was all about the so-called tax mix switch, putting more reliance on taxation of consumption and less reliance on the personal income tax system.

Pike: Is that the Scandinavian tax model? You've sort of raised this idea.

Dr. Henry: No, the Scandinavian tax model is really about how you apply similar taxation treatment to different forms of capital income, whether it'd be interest, rent, dividends, capital gains, trying to tax those in a uniform manner so as to reduce the distortions in the economy. That model does do a lot to address the distortions created by negative gearing. And that is one of the distortions that we do have to address.

But the other one that I was talking about just then is that we have to go back to thinking about the appropriate balance between taxes on income, taxes on wealth, and taxes on consumption. Because the source of the intergenerational inequity that I've been talking about is that the workers who are the ones that are paying the personal income tax, they are having to shoulder the burden of supporting a Commonwealth budget that delivers benefits not just to aged people, but predominantly to aged people or increasingly to aged people, I should say, who are themselves contributing very little. Because they're not paying tax on their superannuation, they're not paying tax on their capital gains, and they're paying a very, very low rate of consumption tax. So, we've got to ask ourselves, is this really fair? Is it really fair that the young working people who are the ones who are paying all the tax, they're not able to afford a house? They're the ones who are going to have to pay off the massive public debt that has been accumulated both in the Global Financial Crisis and more recently in the pandemic. Many of them have huge HECS bills. I mean, for goodness sake, how can anybody think this is fair?

Pike: I mean, you're almost directly talking to my generation in my early 40s. A lot of my friends are exactly in this position.

Dr. Henry: Right.

Pike: So, let me ask you then, who do we blame? I mean, do you put blame at the feet of the Rudd-Gillard government, which was in power at the time of your review, because it was arguably their lack of action, which allowed subsequent governments like Liberal and Labor governments to sort of sit on their hands?

Dr. Henry: I mean, of course, I would wish that they had been more successful. But they had a go. I don't blame them. Actually, I blame all of Australia. I think as a country, we've got to get real about where the country is going and the policy changes that we need to improve the way that the country is going. Many commentators will tell you that the Australian economy is really, really strong. What they mean is that the mining sector is doing well. That's what they mean. The mining sector, let me tell you, employs less than 1.5% of the Australian labor force, right? And yet, that's what's driving the great optimism amongst the economic commentators in Australia and including politicians in Australia. Oh, well, the economy must be doing well, but they're really talking about is mining is doing well, right? We've got to start worrying about the rest of the economy. We've got to start worrying about the other 98.5% of the labor force and what's happening to their real wages growth? Well, negative. And why negative? Because we don't have policies that are making the labor force more productive year after year after year.

Pike: So, on that, we heard yesterday, a treatise from Professor Ross Garnaut, who basically believes it's time for Australia to revisit a carbon tax. He calls it a carbon solutions levy, or CSL, get prepared to hear that quite a lot over the next few months until the next election. I mean, essentially, this is to incorporate the climate impacts of fossil fuels into the economic system also to open up our export industries to European standards, who are also implementing these kinds of taxes. What did you think of this vision, this idea of a CSL?

Dr. Henry: What do I think about it? Yeah, I think it's a great idea. By the way, I don't see it happening anytime soon, but I do think that that's exactly the sort of tax change – tax changes of that magnitude that we need to be having a discussion about. And we have avoided those discussions for many, many years now. We published the Intergenerational Report in 2002, which pointed to some of the looming intergenerational challenges that you and I have been talking about this afternoon. And we have, in the 20 years since studiously avoided talking about these big policy changes that are going to be required. And a policy change of that sort is exactly the sort of thing that we should be talking about.

Pike: It was Julia Gillard that said when she was PM, we think an abolition of negative gearing would cause distortions to the property market we don't want to see. I mean, this is sort of part of the problem, isn't it, that politicians are too afraid to tackle this head on?

Dr. Henry: Too afraid, yeah. I do remember when I was posted to the OECD in Paris, which was a lovely posting, I've got to say, but the analysts in Paris used to say that Australia was top of the class when it came to dealing with adversity. But whenever Australia thought that the good times were rolling, policy was just crap. And for most of the time, we think the good times are rolling, and so policy is just crap.

What can super funds learn from advisers?

Annika Bradley

The industry’s focus on delivering Australians income for a dignified retirement is heartening. Treasury [recently sought industry feedback] on the opportunities, barriers, and challenges to improving retirement for Australians. This follows last year’s thematic review from ASIC and APRA on the [Retirement Income Covenant]. When it comes to decumulation we know there are no silver bullets, but advisers have been grappling with many of these issues for years. So, what could superannuation funds learn from advisers?

Income for a dignified retirement goes beyond investments

Solid investment returns in accumulation are essential, but it's not the main game in retirement. A key finding of the thematic review was that super funds need to better understand members' needs and address fundamental data gaps to deliver useful assistance to members in retirement.

advisers know that delivering a sustainable retirement income comes from truly understanding their clients. It requires a more complete picture about members—their goals, preferences, risk tolerance, assets outside of super funds, pension eligibility, home equity, spending habits, and so on. The role of the modern financial planner extends well beyond simple investment advice. Strategic advice plays an important role, such as optimizing tax strategy, adjusting strategic asset-allocation settings over time, and managing behavioral factors such as the ability to stay invested during market ups and downs.

Many super funds have done a good job of playing the role of the simple investment adviser by delivering strong net returns for members. But to play the role of a strategic adviser, the clear barrier is the provision of member information. To provide a personalized retirement solution at scale, super funds need more member data and engagement. Unless the provision of data is mandated or unless super funds can integrate with government systems, including the Australian Tax Office portal and Centrelink, forming a holistic picture of a member to provide adequate income in retirement will be difficult.

Better managing longevity risk

Running out of money before you die is often cited as a key concern by Australians. Finding the optimal withdrawal amount each year to mitigate this risk is tough. Treasury is clearly aware of this and has dedicated a whole section of its discussion paper to tackling longevity and mortality risk.

How do advisers manage longevity risk and drawdown levels? Annuities are sometimes used. But more typically, advised clients attend annual check-ins to see how their assets and income are tracking, how their spending habits have evolved, and take the opportunity to reassess any future goals or preferences. This iterative process can result in more flexible withdrawal rates, which could potentially lead to higher withdrawal rates compared with other strategies, such as a fixed withdrawal rate. It has been acknowledged that a more-flexible approach works best when the investor can receive this personalized guidance. However, many Australians aren't in the privileged position of meeting with an adviser each year.

Nonetheless, longevity risk could be better managed across advised clients through to defaulted members. After all, it's the nastiest, hardest problem in finance according to Nobel laureate, William Sharpe. Back in 2013, Paul Keating acknowledged that the super system adequately caters for the 60- 80-year-old cohort, but the 80- to 100-year-old cohort old is not well served and that *"a government-administered, universal, compulsory deferred annuity scheme, that would be fully-funded with the capital provided by the annuitant from a portion of their lump sum superannuation benefit"* is required. Let's see what feedback surfaces from the Treasury paper.

Measurement metrics must evolve

The thematic review also highlighted that super funds lacked adequate metrics to assess the retirement outcomes provided to members—specifically, the changes in drawdown rates and member confidence levels in meeting their retirement goals.

In accumulation, oversight and measurement is focused on maximizing net returns for a given risk capacity, but come retirement, the mindset shifts to the amount of income hitting the bank account and whether retirement savings "will last."

Let's think of how an adviser operates. When it comes to the investment products that underpin their clients' retirement strategies, the adviser definitely wants to measure the investment return. But in overseeing and measuring the success of a holistic strategy, the conversation isn't just about an investment return; it's about income and spending. That is, what income levels are required; what's available from the pension or an annuity; what was last year's spending; and what are the potential changes to future circumstances such as bequest motives? Then there's the assessment of a client's residual asset balance and whether it is still adequate to fund future needs and wants. This requires a very different framework to the annual "Your Future, Your Super Performance" Test.

Unfortunately, there are some elements of successful retirement outcomes that are very difficult to measure. A good example is behavioral management. Ensuring clients stay the course through market downturns can have a significant impact on their retirement outcomes. A member's money-weight return relative to an appropriate reference portfolio could be illuminating here, but likely won't catch everything. And some things are simply unquantifiable – such as a trusted relationship that helps you sleep at night. However, lots of retirement-related outcomes are measurable, and we must evolve the thinking to cater for retirement. Of course, a big challenge is doing it at scale.

Personalization at scale

Another key finding from the thematic review is that trustees should tailor assistance to cater to diverse member needs and preferences. It doesn't take too much imagination to think of a technology platform whereby individual goals, preferences, and circumstances are recorded, a personalized strategy recommended, and the outcome overseen in accordance with the strategy set. Adjustments could be made iteratively through time. However, the technology stack required to support this is significant (even in a world of artificial intelligence and big data). Not to mention how this "personalized advice" would be dealt with under the Levy reforms.

But there are plenty of retail platforms that have been producing individualized performance return reporting (both time and money-weighted, mind you) for decades. And with the advent of managed accounts, some of the more progressive platforms are implementing and overseeing personalized investment solutions at scale. advisers can log in and see how clients are tracking against their personalized investment mandate. These systems are typically investment-focused, though not necessarily extending to a holistic strategy that's more focused on annual incomes and residual balances as the yardstick, but we can't be far off, can we?

Super funds would need a 'chief adviser' to oversee cohorts of members with similar characteristics. Sophisticated systems and exceptions reporting would be required to ensure trustees meet obligations, and automatic nudges and member prompts would need to be developed. This level of personalization at scale would meet the thematic review's desire for funds to better understand their member needs, would oversee strategy implementation, and would go a long way to providing "fit-for-purpose" assistance. The problem will come when a member has a major life event (think death of a spouse or divorce) and they simply want to pick up the phone and chat with a human about it. No amount of technology can replace the value of a trusted relationship.

Solving the retirement income puzzle

Delivering a dignified retirement for Australians is edging closer. The government's focus on longevity and mortality risk is a welcome development. The framework for retirement offered by the advice industry is worth closer examination. Strategically focused advisers who tailor personalized, holistic strategies know that successful outcomes are complex, interdependent on a web of factors that go well beyond investment products and returns. Complex challenges are seldom solved with a single, silver bullet. We need to tackle this holistically, not as individual parts. And many retirees and advisers have already laid some solid foundations for us to learn from and build upon.

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.

Clock is ticking on a super free kick

Tony Kaye

The early part of each year is often a good time to review your investing strategy for the calendar year ahead and beyond. And, with less than six months to go before 30 June, it's also a good time to consider shorter-term opportunities. Sometimes it can be a case of use them or lose them.

Take this financial year, for example. For some Australians, there's a concessionally taxed superannuation investment opportunity specifically hinged to the 2018-19 financial year that will expire on 30 June this year. By 1 July it will be gone.

The catch-up opportunity

Working Australians are allowed to contribute a maximum of $27,500 into their super each financial year at a concessionally taxed rate of 15%.

It's a capped amount that includes the mandated super payments made by your employer plus any additional personal super contributions you choose to make to your super fund. However, in any given financial year, many people are unable to take advantage of the full $27,500 concessionally taxed contributions limit.

Back in 2016-17 the then federal government announced that from the start of the 2018-19 financial year it would allow eligible Australians to carry forward any unused annual concessional contribution amounts they have for up to five financial years.

As such, the deadline for taking advantage of any unused concessionally taxed entitlements from the 2018-19 financial year is the end of 2023-24.

In many respects it's a super free kick that's there for the taking, at least for those Australians who are legally and financially able to do so.

Income year	Date	Your age at this date	Your concessional contribution cap
2023–24	N/A	All ages	$27,500
2022–23	N/A	All ages	$27,500
2021–22	N/A	All ages	$27,500
2020–21	N/A	All ages	$25,000
2019–20	N/A	All ages	$25,000
2018–19	N/A	All ages	$25,000

Source: ATO

Eligibility requirements

There are eligibility requirements for being able to take advantage of carry forward contributions from previous financial years.

To be eligible, you must:

- have a total super balance of less than $500,000 at 30 June of the previous financial year.
- have unused concessional contributions cap amounts available.

The good news is that if you are eligible, there's nothing you really need to do. If you have the ability to make extra super contributions this financial year above the concessionally taxed $27,500 annual limit, any carry forward concessional cap amounts from previous financial years will be automatically applied by the Australian Tax Office (ATO).

If you haven't used them already, the ATO will first apply any amounts from the 2018-19 financial year. It will then progressively apply any unused amounts from subsequent financial years.

A carry forward example

Let's say you are still under the $500,000 total super balance and have some accumulated savings you're willing to put into your super fund. Maybe you've recently sold an asset and now have some extra cash in the bank.

In the 2018-19 financial year you made $15,000 in concessional super contributions. Because the annual concessional contributions limit back then was $25,000, you would therefore have a $10,000 unused amount from that financial year. The annual concessional contributions limit wasn't lifted to $27,500 until the start of 2021-22.

In each subsequent financial year you made $20,000 in concessional contributions, so you also have $10,000 from both 2019-20 and 2020-21, and $7,500 from both 2021-22 and 2022-23.

That gives you a grand total of $45,000 in unused concessionally taxed contributions spanning five financial years plus this financial year's $27,500 limit.

If you were to exceed this financial year's $27,500 by between $1 and $10,000, the extra contributions would be deducted from your 2018-19 carry forward amount. Any amounts over $10,000 would be deducted from 2019-20, and so on.

How do I find out if I have unused amounts?

You can easily check if you have unused concessional contribution amounts online via your myGov account by linking to the ATO.

After logging in, select **Super - Information - Carry forward concessional contributions**, and your unused balances by financial year should be viewable.

The caveats are that you must not have made concessional contributions in the financial year that exceeded your general concessional contributions cap and, as noted, your total super balance must be below $500,000 as at 30 June of the previous financial year.

Even though we're now only around midway through the current financial year, it's worth considering whether you can use this super free kick before 30 June 2024.

Consider an adviser

Super and retirement planning is a complex area. Take care to understand the contribution types and limits carefully as there are significant tax penalties for exceeding the applicable contributions caps. If you're unsure about your super options before 30 June and need some advice, consider consulting a licensed financial adviser.

Tony Kaye is a Senior Personal Finance Writer at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the circumstances of any individual.

For more articles and papers from Vanguard Investments Australia, please click here.

5 exciting areas of investment opportunity

Andrew Macken

Markets are off to a good start to the year, and we still see opportunities in several exciting themes for this year and beyond:

1. Winners in alternative assets ('alts')

One of the less obvious 'fly wheels' Montaka identified several years ago was in the business models of the world's leading alternative asset managers – particularly **Blackstone** and **KKR**. We observed that, in the asset management industry, growth disproportionately favours the largest, biggest, most trusted brand names, with the longest track records. This greater scale drives advantages in talent attraction / retention, access to deal flow, geographic and product diversification, and client attraction / retention – which further drives scale, and so the flywheel continues to gather steam.

Source: Morningstar.com

Source: Morningstar.com

The alternative asset management space is undergoing a large structural transformation that we believe will result in super-normal asset growth over the coming decade – and will disproportionately favour the leading managers. The industry, at approximately US$10 trillion aggregate assets under management (AUM) today, has significant room to grow in the context of global stocks and bonds of more than US$200 trillion, and real estate an additional US$100 trillion. Growth will continue to be driven by (i) Insurance partnerships – which represent a US$30 trillion pool of assets; (ii) Retail / private wealth channels – which represent more than US$80 trillion in assets; and (iii) Asian allocations to alts – which are currently running at a penetration that is one-quarter that of North America.

While this structural transformation of the alts space remains in an early innings, it is coming – and we think it is underappreciated by the market.

2. A consumer luxury winner

LVMH owns several of the world's most prestigious and well-nurtured luxury brands, including Christian Dior and the 170-year-old Louis Vuitton. Its patient, methodical brand-nurturing over decades (not months or years) under founder, Bernard Arnault, enables the group to continue to grow strongly in a luxury market that is seeing demand for competing offerings soften.

Source: Morningstar.com

This long-term approach to value-building is less common than it should be, but refreshing, nonetheless. In recent days, Arnault reiterated that 'growth at all costs' is not the goal. And that he is very happy to deliberately slow his brands' growth to preserve and enhance long-term desirability.

In a world in which the wealthy continue to grow wealthier, LVMH's best customers have an extraordinary ability to pay almost any price for the world's most luxurious goods. Price increases – even substantial ones – are not questioned, or even noticed, by these customers. And indeed, higher prices only serve to increase the cachet and exclusivity of these brands. As a result, long-term revenue growth will likely continue to be driven by price increases to an unusually large degree.

Such a strong contribution to growth from pricing has important profit margin implications for LVMH. It means that long-term profit margins will probably end up at levels far greater than those being expected by the market today. And this is one of the important reasons we believe this extraordinary business is undervalued today.

3. Winners in AI

It will come as little surprise to regular readers that our portfolio is meaningfully exposed to those select businesses we assess as high-probability long-term winners from the AI revolution – which remains in its infancy. We see AI winners across three basic dimensions:

1. Those that can 'distribute' the benefits of AI to customers. Winners along this dimension will likely be dominated by businesses with existing large, privileged datasets, and large embedded customer bases. These include the likes of **Microsoft**, **ServiceNow**, **Salesforce**, and **Spotify**.
2. Those that can employ AI successfully in their own operations to increase productivity. Early winners along this dimension include **Meta** and **Alphabet** – though longer-term winners will span lots of non-tech industries as well.
3. Those that sell the compute, and related services, required to run the AI-infused software applications. Along this dimension, the three hyperscalers – **Amazon**, **Microsoft** and **Alphabet** – are the clear winners in the western world. (**Alibaba** and **Tencent** continue to appear to be the highest probability winners in the second largest economy in the world, China).

After some strong stock price performances in 2023, the temptation is there for some investors to perhaps wonder if the 'AI thesis' has already largely played out. We strongly caution against such a view. Indeed, our research shows that, for most large enterprise clients, early experimentation is underway, however, large-scale rollouts of AI-infused applications have not yet even begun.

4. Mission-critical financial services platforms

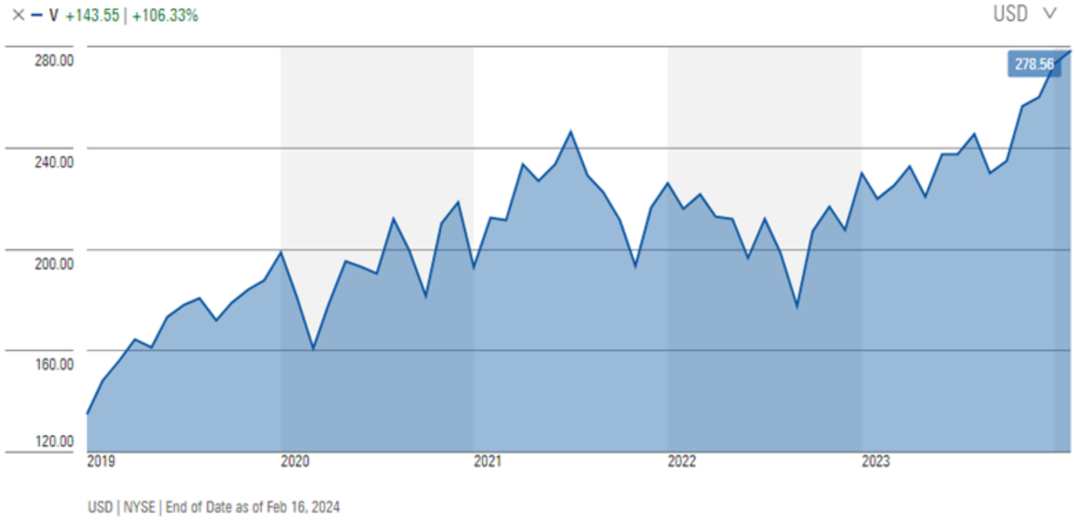
There are several financial services platforms out there today that are so mission-critical, one does not need to lose sleep over whether or not the businesses will exist over the longer term. Identifying these businesses is relatively straightforward. It is far more challenging to identify a subset of these businesses that are mispriced by the market today and materially undervalued. We believe we have currently identified two.

S&P Global owns some of the world's largest and most valuable financial datasets and has built several important businesses on top of these advantages. One of its most valuable is its Ratings business which provides credit ratings for the world's fixed income securities. Of course, this business won big from the significant bond issuance that happened when interest rates were very low during the pandemic – and demand was pulled forward. But when rates started to rise, S&P Global experienced an 'air pocket' and demand temporarily evaporated.

Source: Morningstar.com

But while Ratings earnings are currently depressed, the market is not adequately reflecting the large earnings uptick that will materialize over the coming years. Substantially all of the bonds issued over the last three years need to be refinanced. The demand for S&P's ratings is simply pent-up. It is coming. Indeed, between now and 2026, S&P Global expects that US$8 trillion in refinancings will need ratings.

Visa is the world's largest global payments network and probably needs little introduction. What is underappreciated about Visa is the long-term compounding effect of its relatively newer, smaller, but higher-growth businesses in Visa Direct and B2B / Commercial payments – and the various services that will be attached to these over time.



Source: Morningstar.com

Today, most of the market is myopically focused on Visa's large core consumer payments business, which is slowing now after a booming period fuelled by fiscal stimuli and high inflation. But the longer-term contribution from Visa's newer businesses will likely be more than the market currently expects due to the compounding effect of their relatively higher growth rates and very large addressable markets.

5. Digital marketing gatekeepers

The world's digital marketing gatekeepers – think **Meta**, **Alphabet**, **Amazon** and **Tencent** in China – continue to grow in importance for the revenue-generation of businesses, large and small, and from substantially all industries. As businesses become more sophisticated in harnessing their customer data, and the digital marketing platforms grow in sophistication with data-based targeting and measurement, buyers and sellers are increasingly connected for transactions that would otherwise have not been made. As a result, the willingness to pay for these services by advertisers continues to grow structurally.

This dynamic is best illustrated with a simple example from 2023. **L'Oreal**, the world's largest cosmetics company, has consistently grown its revenues at around 15% per annum of late, in a global cosmetics market that typically grows only around 6 or 7% per annum. The reason for this extraordinary outperformance is increasingly larger allocations to sophisticated digital marketing spend.

Source: Morningstar.com

L'Oreal spends approximately €14 billion per annum on advertising and promotions (A&P) – of which, 75% is allocated to digital media. In 2024, it will grow this spend by another 16% over and above 2023 levels. *"We are developing our own AI-powered A&P allocation tool,"* L'Oreal's CEO, Nicolas Hieronimus, said last year, *"which gives spectacular results in terms of increasing ROI both short-term and long-term."*

Through this lens, the world's digital marketing gatekeepers hold the key to unlocking new sales for businesses across a wide range of industries that otherwise would not be made. This makes them, in effect, quasi-shareholders in nearly every other business on planet earth. And we believe this continues to be underappreciated by the market.

Andrew Macken is the Chief Investment Officer at [Montaka Global Investments](), a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation.

For more articles and papers from Montaka, [click here]().

Which type of investor are you?

Joe Wiggins

It is so tempting to get lost in the noise and intrigue of financial markets that we can easily forget what type of investor we are. Although the investing community can at times appear something of an amorphous blob attached to the latest in-vogue topic; groups of participants are engaged in wildly different activities that – at anything but a cursory level – are barely related. To have any chance of success it is critical to understand the realities of our own approach and avoid playing somebody else's game.

In broad terms, I think there are four investor types:

Trader

A trader operates with ultra-short time horizons (intra-day to weeks) and is typically engaged in the prediction of price movements based on historic patterns or the expected market reactions to certain events (if X happens, prices will do Y). Asset class valuations and fundamentals are largely irrelevant, and the focus is on forecasting the response function of other investors.

This is staggeringly difficult to do consistently well, which is why profits often seem to accrue to the people who teach trading to others rather than do it themselves.

Price-based investor

Almost certainly the most common active investment approach. Price-based investors have short time horizons (ranging from three months to perhaps three years) and tend to engage in one of two related activities:

1) Predicting future market / macro factors and how other investors will respond to them. "We believe that the Fed will be more accommodative than the market expects, which will support US equities."
or
2) Predicting how other investors will react to realised market / macro factors. "The Fed is far more dovish than the market expected, therefore we have increased our exposure to US equities."

The common factor in both of these closely related methods is that investors are guessing how other investors will behave. This is similar to trading, but the horizons are extended (though still what I would class as short-term). In essence it is an attempt to capture anticipated price trends.

Valuations and fundamentals matter somewhat for this group, but only insofar as they are useful for understanding the positioning and future decisions of other people like them.

This is probably the most comfortable style of investing from a behavioural perspective as it caters to plenty of our biases – our desire to be active, to be part of the herd, to tell stories. For similar reasons, it is also likely to prove the most prudent survival strategy for professional investors.

The problem is that it is incredibly challenging to get these types of calls right (or even more right than not).

Valuation-based investor

This type of investor is focused on the fundamental attributes of an asset and will look to make some assessment of expected return or fair value based on analysis of starting price and future cash flows. Given that price fluctuations dominate short-term asset class performance, a long view is essential.

It is important not to confuse a valuation-based approach with value investing, which is only a subset of it. Valuation-based investors are seeking to identify asset mispricings – these might occur because the level of growth is underappreciated, or high returns on capital will persist. The key distinction is that the focus is on the returns produced by the asset rather than how other investors might trade it.

Given that market movements over short and medium horizons often bear little relationship with the fundamental features of an asset class, a valuation-led approach is undoubtedly the most behaviourally taxing. This group will inevitably spend a great deal of time appearing out of touch and idiotic, even if they are right, and they might end up waiting years for validation that never arrives (taking a valuation-led approach doesn't mean that you will necessarily be correct in the end).

Relative to a price-based investor they are more likely to be successful in their investment decision making, but also more likely to lose their job.

Passive investor

Although there is no purely passive portfolio, this group seeks to invest in a fashion that can be considered a broadly neutral representation of the relevant asset class opportunity set (by size). While passive investors are inherently agnostic on valuation, they do care about the fundamental features of the assets in which they invest, but specifically in regard to the ultra-long run, or structural, expected risk and return.

A passive investor may not believe that markets are efficiently priced, but simply there is no reasonable and consistent way of capturing any inefficiencies (certainly relative to the effort or behavioural stress required), particularly after costs.

Although a long-term, passive approach appears simple it is not without behavioural challenges – doing nothing is tough and rarely lucrative. There will also be incessant speculation around how some profound change in asset class behaviour will soon render a passive approach defunct.

But perhaps a more credible problem is that a purely passive style requires investors to be ambivalent about extreme asset class overvaluation – passive investors are fully / increasingly exposed to equities trading at 100x PE or bonds yielding zero – even if the evidence suggests this will lead to derisory future returns. It is reasonable to suggest that this is a known cost and one which still leaves it superior to other strategies. It should not, however, be ignored.

Which one are you?

These categories are not quite as discrete as I have made out, but the overall point holds. Defining our own approach and understanding its realities and limitations is absolutely critical for any investor. This requires setting realistic expectations, knowing the information that matters and what should be ignored, and preparing for the specific behavioural issues we will encounter. Failure to do this will mean we will inevitably become part of that amorphous blob.

All investors should be asking who they are and what it means.

Joe Wiggins is Chief Investment Officer at Fundhouse (UK) and publisher of investment insights through a behavioural science lens at www.behaviouralinvestment.com. His book The Intelligent Fund Investor explores the beliefs and behaviours that lead investors astray, and shows how we can make better decisions.

History suggests the Magnificent Seven are headed for a fall

Ben Inker, John Pease

According to Morningstar, 74% of U.S. large cap blend managers underperformed the S&P 500 last year. And it wasn't just a single bad year. The decade ending in 2023 saw a stunning 90.2% of U.S. large cap blend managers underperform their benchmarks. After a brief respite for active managers in 2022, when 53% of U.S.

large cap blend managers outperformed, it seems as if 2023 may be the last straw for many clients. How can you blame them? A decade is a lifetime in the investment world. If 90.2% of managers underperformed their benchmarks in U.S. large caps over the last decade, surely that is irrefutable evidence that the market is efficient?

The reality is somewhat different, however. As we will see, the reason why the S&P 500 and other U.S. large cap equity benchmarks have been close to impossible to beat over the last year and almost as hard to beat over the last decade stems from the nature of the stocks that have outperformed.

The U.S. equity market has been growing steadily more concentrated. When the very largest stocks are the best performing ones, it is an extremely difficult environment for active managers to keep up with, let alone outperform. To outperform an index, it is necessary to look different from it. We tend to think of that difference in terms of the stocks that a manager owns, but as Cremers and Petajisto's active share measure points out, what managers choose not to own is just as important as what they do own.

In order to make space in a portfolio for the stocks a manager wants to be overweight, they by necessity must have an equal and offsetting underweight in other stocks. While active share envisions this as running a long/short portfolio on top of the benchmark, the reality is that it is a highly constrained long/short. A manager can choose to be as overweight as they would like in their favourite stocks, but the underweights for a long-only manager are constrained by the weights of those stocks in the benchmark.[1] The biggest underweight for a manager will not be their least favourite stock, but the largest stock in the benchmark that they don't like enough to have a substantial weight in. The upshot is that long-only active managers almost always have substantial bias against the very largest stocks in their benchmarks.

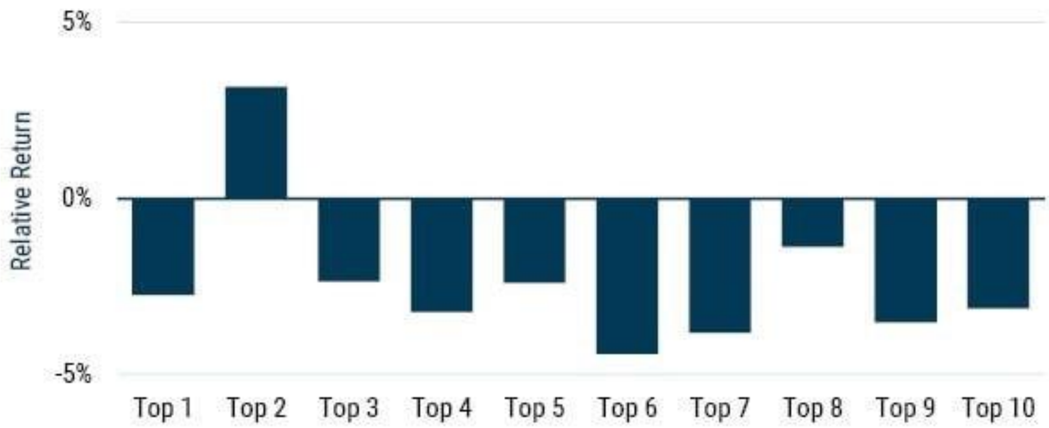
This is particularly true of the extremely high active share 'high conviction' managers beloved by endowments and foundations, who commonly have active shares in the 95% range. [If a manager has only 5% overlap with their benchmark, they definitionally have large underweights in either all or almost all stocks that have a large weight in the benchmark.] For most of history, biasing portfolios against the very largest stocks has been lucrative. But over the last decade, and particularly the last year, it has been a disaster.

A narrow decade

If you look at the 10 largest companies in the S&P 500 (or any capitalization-weighted index, for that matter), odds are that the stocks of those companies meaningfully outperformed the broad market over the *preceding* decade. The largest companies in the world either started out large and kept up with their competition, or they started out small and outperformed most everyone who was larger. This was certainly the case over the last decade.

On a forward-looking basis, however, big is generally anything but beautiful. Exhibit 1 shows the relative return of the 10 largest stocks in the S&P 500 in the year following that ranking.

Exhibit 1: Top 10 stocks vs. S&P 500



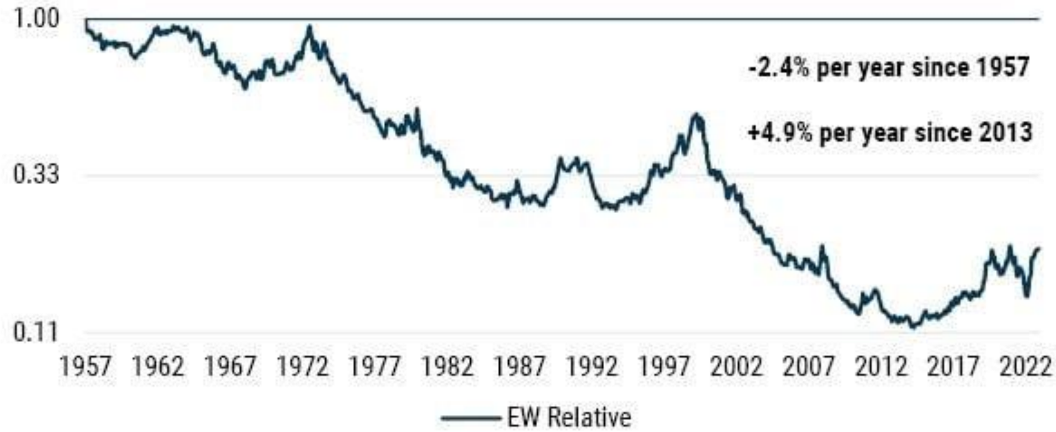
Data from 1957-2023 | Source: Compustat, Standard & Poors.

Nine of the top 10 have underperformed on average. [This isn't to say that investing in the second largest company in the index is a good idea. Prior to 2013 the second largest stock was in the throes of a 20-year drawdown relative to the S&P 500.] The historical underperformance of the top 10 comes down to the two main sources of return – valuation expansion and fundamental growth – being harder to achieve than for your average company.

The largest stocks generally become the *largest* by way of becoming expensive, and this anti-value tilt has historically been quite costly, explaining most of these companies' poor relative returns. [We can see this from a regression of returns on four important factors: market, size, value, and quality. The top seven have historically underperformed what we would expect given these characteristics.] Good returns in the face of high valuations, moreover, require exceptional earnings growth. When a company already has a substantial market and profit share of the industries in which it operates, unusual growth tends to be significantly harder than normal. It can be particularly hard if the company's growth catches the attention of anti-trust regulators.

The largest stocks certainly don't underperform all of the time, but on average, they have substantially trailed the average S&P 500 stock, as we can see in Exhibit 2.

Exhibit 2: S&P500 – Top 10 vs. 490 equal-weighted



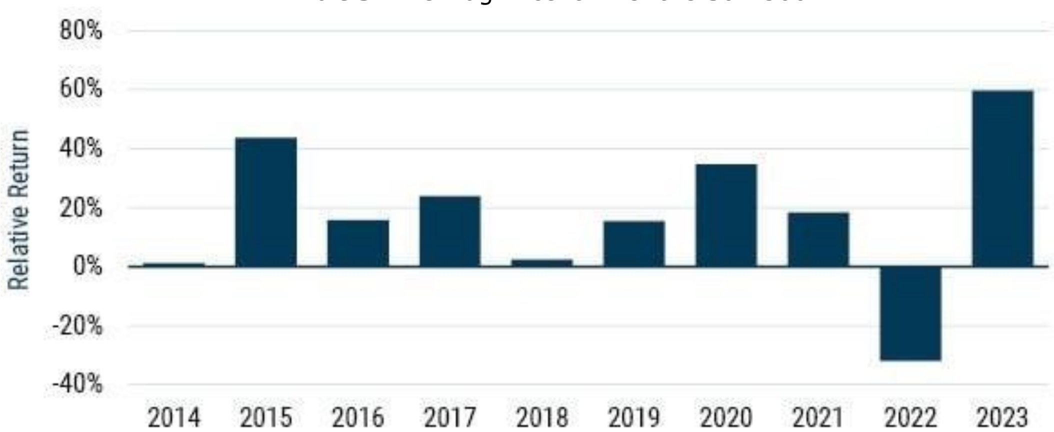
Data from 1957-2023 | Source: Compustat, Standard & Poors

Since 1957, the 10 largest stocks in the S&P 500 have underperformed an equal-weighted index of the remaining 490 stocks by 2.4% per year. But the last decade has been a very notable departure from that trend, with the largest 10 outperforming by a massive 4.9% per year on average.

Magnificent and concentrated

The break in the consistent downward trend of cap-weighted underperformance reflects the magnificence of the Magnificent Seven: Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla. As far as mega caps go, they have been practically unparalleled in their outperformance. They strung together a series of market-beating performances over the last 10 years, with 2022 being the single year in which they didn't beat the market. In 2023, as their monicker became part of the common lexicon, they outperformed the S&P 500 by an almost unimaginable 60%.

Exhibit 3: The Magnificent 7 vs. the S&P 500



Data from 2014-2023 | Source: Compustat, Standard & Poors

This performance came in part from the unusual cheapness of mega caps at the start of the decade. Apple, Microsoft, and Google, for instance, boasted a combined price-to-earnings (P/E) ratio of 15x in 2013, while the market's P/E was about 25% higher. A simple reversal of this trend was a lovely tailwind (although much more than a reversal occurred). These companies, alongside their similarly magnificent brethren, also managed to grow earnings at a breakneck pace. Microsoft and Amazon did so by reinventing themselves. Apple, Alphabet, Meta, Nvidia, and Tesla took over their primary industries. The medium-sized businesses among them became huge, and the large ones became giants.

The continued, unrelenting outperformance of very large companies has led to the S&P 500 becoming significantly more concentrated over the decade. The top seven names in the index comprise 28%, up from 13% a decade earlier. The S&P 500's total concentration, which we can measure using a Herfindahl-Hirschman Index (or HHI), is equivalent today to that of an equal-weighted, 59-stock portfolio. Ten years ago, the index was more than twice as diversified. We have never seen – over any 10-year period – a decline (or increase) in diversification of the magnitude we have just witnessed.

Exhibit 4: Effective # of names (1/HHI) in the S&P 500

Data from 1957-2023 | Source: Compustat, Standard & Poors

The active horror show

This extraordinary performance of the mega caps and the consequent concentration of the S&P 500 seems to have become conflated with markets becoming more efficient. This conflation occurs because over the same decade that appended 'Magnificent' to 'Seven', only 9.8% of U.S. large cap 'core' active managers (managers who skew neither toward value nor growth) outperformed their benchmarks. While these events are certainly connected, they in fact have very little bearing on market efficiency.

Because the vast majority of active managers are substantially underweight the largest stocks, periods when those stocks outperform are a serious headwind for active managers' relative performance. If we contrast the equal-weighted vs. cap-weighted performance of the S&P 500 with the annual percentage of U.S. large cap core active managers outperforming their benchmark from 2014 to 2022 (according to Morningstar), we find that the correlation of these (admittedly short) two series is north of 50%.

While Morningstar has not yet published its results for the full year of 2023, the equal-weighted S&P 500 trailing its cap-weighted counterpart by 11.5% (the second worst showing of all time) suggests that investment committees will have their brows furrowed when reviewing their U.S. active equity portfolios' performance vs. the S&P 500 over the last year. Some brow-*unfurrowing* might be merited. High active share managers have almost no chance in a year when the giants are dominating.

To show just how difficult an active manager following the concentrate-and-equal-weight strategy would have it, we simulate what a talented set of managers could have achieved versus the cap-weighted benchmark. These simulated managers have a consistent hit-rate of 53%; that is, each of their stock picks has a 53% chance of beating the average stock in the S&P 500 over the 12 months following their selection. This might not seem like a great deal of prescience, but it *really* is. This group of managers, by picking 20 stocks and equally weighting them, would have outperformed the S&P 500 by **3%** per annum from 1957 to the end of 2023, generating cumulatively for their investors six times the return of the index. They would have beat the index two thirds of the time. Their worse performance as a group through 2023 would have yielded them a relative return of **-13.6%** in 1998 (a year so horrible for most active investors that it is best suppressed). This is a pretty exceptional return profile.

Exhibit 5: Oracle managers vs. S&P 500

Source: GMO, Standard & Poors

The 10 years ending in 2023 were less kind to our oracular stock pickers. Despite exceptional relative returns of 8% in 2022, the group still lost to the S&P 500 by 30 bps per annum (before fees!). In 2023, only 7% of our simulated skilled managers would have beat the cap-weighted index. An investment committee that sought out fundamental managers that roughly follow our described investment process is then exceedingly unlikely to have seen its listed equity bucket shoot the lights out, and it should be comfortable with that. The reality is that these managers still had strong performance against the equal-weighted S&P 500 – and that is what they should be contrasted with in good times and in bad. If your fundamental active manager keeps lagging versus the equal-weighted S&P 500, that is suggestive of an issue; lagging the cap-weighted benchmark is, for such managers, generally uninformative.

Exhibit 6: 2023 Performance – oracle active managers

Source: GMO

[1] A big part of the charm of long/short and equity extension strategies is that managers are freed from this constraint. Once zero ceases to be the lower bound of portfolio weights, a manager can scale their active positions according to their conviction, not a company's size.

Ben Inker is co-head of GMO's Asset Allocation team, a member of the GMO Board of Directors and a partner of the firm. John Pease is a member of GMO's Asset Allocation team.

Disclaimer: *The views expressed are the views of Ben Inker and John Pease through the period ending February 2024, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.*