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## Contents



## Editorial

Australian banks have had a great run of late, compared to both the ASX 200 and other major sectors.

Commonwealth Bank (CBA) has stood out. It was largely flat for seven months into October last year, before exploding higher in recent months. Over the past 12 months, its share price has climbed 23% versus the ASX 200's 8%.


*Source: Morgan Stanley, courtesy of Clime Asset Management*


*Source: Morningstar*

What's behind the move? It's largely on expectations of an economic 'soft landing', rates cuts, and a resilient consumer. Throughout most of last year, investors were concerned about the fixed mortgage rate cliff, how rising rates would impact consumers and their spending, and whether the economy could hold up given these headwinds. Markets seem to be suggesting that those worries were overblown and that the economic picture is more positive for 2024.

**Welcome to the most expensive major bank in the developed world**

I thought it'd be a useful exercise to compare our largest bank, CBA, to other global retail banking peers to see how it stacks up on valuations and returns. Here's a summary of the key numbers.

**Table 1:** Major global retail bank valuations and returns

| Company | Code | Market cap (USD billions) | PER (x) | PB (x) | ROA (%) | ROE (%) |
|---|---|---|---|---|---|---|
| Bank of America | NYSE: BAC | 283 | 11.60 | 1.07 | 0.80 | 9.79 |
| Wells Fargo | NYSE: WFC | 204 | 11.82 | 1.24 | 0.94 | 11.01 |
| HSBC | LON: HSBA | 143 | 6.32 | 0.85 | 0.75 | 12.03 |
| Royal Bank of Canada | TSE: RY | 141 | 12.51 | 1.74 | 0.77 | 14.43 |
| Mitsubishi UFJ | 8306: TYO | 126 | 9.56 | 1.03 | 0.53 | 11.65 |
| Citi | NYSE: C | 110 | 14.24 | 0.58 | 0.33 | 4.54 |
| Toronto-Dominion Bank | TSE: TD | 107 | 12.86 | 1.42 | 0.53 | 11.35 |
| Sumitomo Mitsui | 8316: TYO | 81 | 14.57 | 0.88 | 0.30 | 6.57 |
| Santander | BME: SAN | 69 | 11.10 | 1.69 | 1.80 | 16.08 |
| Bank of Montreal | TSE: BMO | 69 | 17.93 | 1.31 | 0.42 | 7.13 |
| U.S. Bancorp | NYSE: USB | 68 | 13.23 | 1.39 | 0.75 | 10.93 |
| *Average* | | | *12.34* | *1.20* | *0.72* | *10.50* |
| **Commonwealth Bank** | ASX: CBA | 130 | 20.41 | 2.71 | 0.77 | 13.31 |
| **CBA premium/discount (%)** | | | **65%** | **126%** | **7%** | **27%** |

*Note: PER = price to earnings ratio, trailing 12 months. PB = price to book ratio, trailing 12 months.*
*Source: Morningstar*

CBA is now the 12th largest bank in the world. In the table above, I've excluded investment banks such as JP Morgan and Morgan Stanley, which have large market capitalisations versus CBA. I've also excluded state-owned Chinese banks, which have low valuations from poor transparency and all of them are dealing with property loans going bad due to the country's deflating housing market. And I haven't included some of the Indian banks as they still operate in a developing market where growth and returns are plentiful, and valuations reflect that.

The companies left on the list are those principally in developed markets - including Europe, Japan, Canada, and the US – and are operating retail banking franchises.

What does the table tell us? CBA is arguably the most expensive retail bank in the developed world. The price-to-book (PB) ratio is the principal valuation metric used for banks, and CBA's current PB ratio of 2.71x is at a 126% premium to the global peer average. No other developed market retail bank comes close to CBA on this metric, with the Royal Bank of Canada valued the next highest at 1.74x PB.

On a price-to-earnings ratio (PER) basis, the valuation gap is less extreme though still notable. CBA's PER of 20.4x is at a 65% premium to global peers. Again, no other peer comes close to CBA, with the next highest being the Bank of Montreal at 17.93x PER.

Looking at valuation alone doesn't tell the full story, though. We need to look at the returns of CBA to see whether the premium valuation accorded it is justified.

Return on equity (ROE) is the most common metric used to evaluate a bank's returns. CBA's ROE of 13.3% is 27% better than the global peer average. There are two banks with higher ROEs, namely Santander (16.1%) and Royal Bank of Canada (14.4%).

Return on assets is likely a better indicator as it measures how effective a company is at using their assets to create value, but minus the leverage which can boost ROE figures. On this score, CBA's ROA of 0.77% is closer to the middle of the pack, at a mere 7% above the global peer average. Santander and Wells Fargo stand out on this metric.

All up, the table suggests that CBA's returns are above the average of other major retail banks, but its valuation is way above comparable peers.

**How does CBA stack up against other local banks?**

A global snapshot is useful, though a local one is necessary too. Here is the same table, though just for the major Australian retail banks (I've left out Macquarie Bank as it's an investment bank).

**Table 2:** Major Australian retail bank valuations and returns

| Company | Code | Market cap (A$ billions) | PER (x) | PB (x) | ROA (%) | ROE (%) |
|---|---|---|---|---|---|---|
| NAB | ASX: NAB | 106 | 14.72 | 1.73 | 0.70 | 12.34 |
| Westpac | ASX: WBC | 95 | 13.84 | 1.31 | 0.70 | 10.06 |
| ANZ | ASX: ANZ | 88 | 12.90 | 1.26 | 0.65 | 10.48 |
| *Average* | | | *13.82* | *1.43* | *0.68* | *10.96* |
| **Commonwealth Bank** | ASX: CBA | 130 | 20.41 | 2.71 | 0.77 | 13.31 |
| **CBA premium/discount (%)** | | | **48%** | **89%** | **13%** | **21%** |

*Note: PER = price to earnings ratio, trailing 12 months. PB = price to book ratio, trailing 12 months.*
*Source: Morningstar*

Again, CBA's premium valuations are striking. On a PB ratio basis, CBA's PB of 2.71x is at an 89% premium to the average of the other three majors. And on a PER basis, CBA's PER of 20.4x is 48% higher than the average 13.82x of the other banks. When it comes to valuations, no other Australian bank comes close to CBA.

As for returns, CBA's ROE and ROA are 21% and 13% superior to the average of the remaining three banks.

While the disparity between valuations and returns for CBA against Australian peers is less stark than against international banks, it's still significant.

**Is CBA's premium valuation justified?**

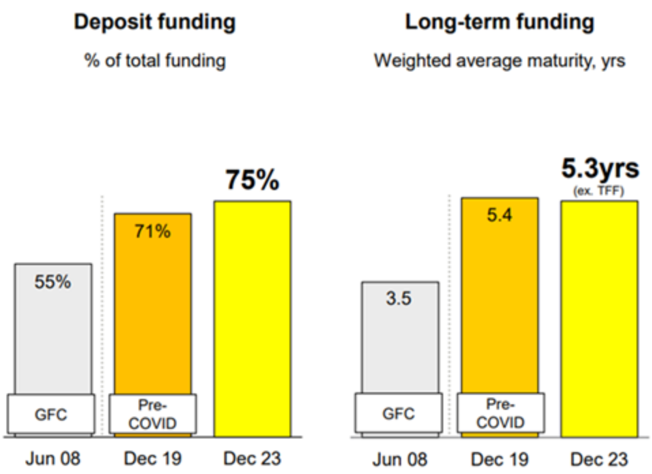
While numbers such as these are helpful, it's good to delve deeper into the reasons why CBA may or may not deserve a better valuation than other retail banks.

Let's look at the strengths of the bank:

**1. It operates in a bank oligopoly.** The structure of the banking industry in Australia is the biggest strength for all the major banks, including CBA. The 'four pillars' policy prevents any of the four major banks from taking over each other, which eliminates the prospect of competitors merging to gain scale and competitive advantages. It effectively backstops the domination of the big four banks and limits competition, which improves returns on equity.

The banking market most like Australia is probably Canada. The large retail banks there have also enjoyed decades of high returns on capital and rewarding shareholder performance.

Contrast this with the US, which has more than 4,000 commercial banks (versus 62 locally owned ones in Australia). Bank competition is much stiffer in America, and the retail bank returns are generally lower.



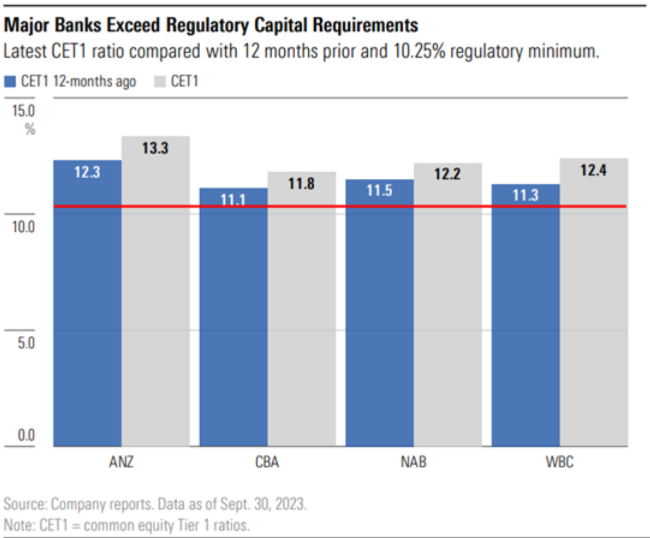

*Source: CBA*

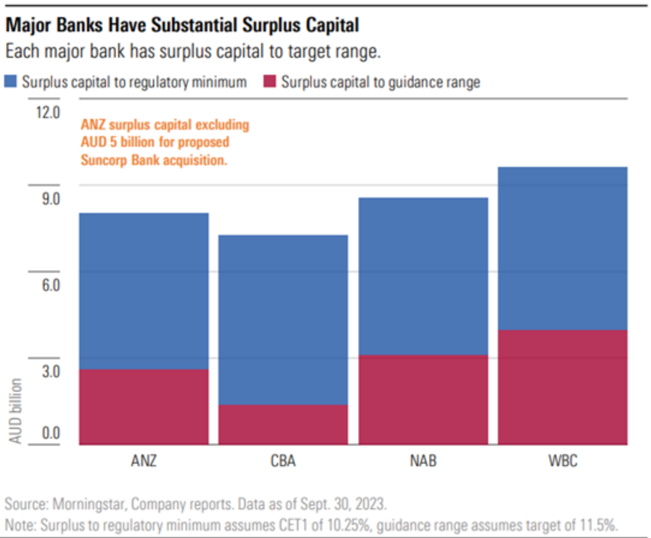
**2. CBA is the deposit king.** CBA has 16 million banking customers and 10.9 million transaction accounts, giving it the largest deposit funding pool of any Australian bank. It allows CBA to have access to cheap and sticky funding for its business. Close to 75% of total funding comes from deposits, with the rest from securitization, hybrids, and wholesale funding.

**3. Home loan stranglehold.** Most of CBA's loans are home loans, which are considered the safest of loan types (more on that later). And it has a 25% share of the home loan market, well ahead of the second largest lender to this segment, Westpac.

**4. Sound credit quality.** The quality of loans is sound at this stage. Just 0.52% of home loans are in arrears, and CBA seems well provisioned for potential bad debts in future.

**5. Sound capital position.** CBA is well capitalized with a common equity tier 1 ratio of 11.8%, well above the regulatory minimum of 10.25%. APRA's push for greater capital to be held by banks post-GFC leaves all of them, including CBA, in a strong position.




**6. Technology lead?** Fund managers and analysts often talk of CBA's lead in technology over competitors, though my direct experience with the bank has me scratching my head on this one. It may be true, though I haven't seen it from my end.

**CBA's weaknesses**

**1. Unexciting growth prospects.** Thanks to a spectacular housing boom, loan growth for the banks has been buoyant for much of the past four decades. It's slowing now and is highly unlikely to get back to anything like the growth of the recent past. CBA housing loan growth was just 0.1% in the most recent quarter.

**2. Loan competition.** Recently, Macquarie Bank has ramped up competition in the home loan market. CBA has chosen to not match some of the aggressive pricing of Macquarie Bank and others. While it's not intense competition as some make out it to be (intense for Australia, perhaps), it is a near-term headwind for CBA.

**3. Deposit competition.** With rising rates, competition for deposits has heated up. Yet, this issue shouldn't be overstated, as deposits are traditionally sticky, and CBA has a stickier franchise than other any bank.

**4. Exposure to stretched housing market.** CBA is all in on housing, and it remains its biggest current strength, but also its largest risk. I've previously argued that housing in Australia is likely priced more expensively than any other asset in any part of the world – even more expensive than the Magnificent Seven tech stocks. Any downturn in housing would increase bad debts and hurtt profits.

**5. Commoditised products.** This isn't a CBA issue as it's common to all retail banks. That is, banks offer commoditized products with little in the way of differentiation. Commoditisation means banks have minimal pricing power, which ultimately results in lower returns on equity than other sectors which have better pricing power.

**Risk versus reward**

Assessing whether to invest in a stock, or to stay invested in a stock, is about weighing the potential reward against the potential risks. Given the tepid short- and long-term earnings outlook, the current pricing of CBA seems exorbitant both against local and global peers.

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In my first article this week, I look at hedge fund manager, Jim Simons, who perhaps has claim to being the world's greatest ever investor. His main fund has returned a breathtaking 62% annualised over the past 33 years, and yet the man himself is little known to the public. I explore how he's achieved his track record and what the average investor can learn from him.

In my second article, I sit down for an interview with Morningstar CEO **Kunal Kapoor**. Kapoor talks through a broad range of topics, including why low-cost investing wins, how artificial intelligence and ESG will bring plenty of opportunities, why 'noise' is an investor's enemy, and the implications of November's US elections for markets.

**James Gruber**

**Also in this week's edition...**

The Federal Government has finally released the Aged Care Taskforce Report which contains 23 recommendations to reform home care and residential aged care. **Louise Biti** goes through the key findings and who'll be made to pay for the increasing cost of aged care.

For those in their 20s and 30s, it's tempting to give superannuation the bare minimum of attention. Yet, **Meg Heffron** says that if you have family members in this stage, there are two quirky super benefits worth telling them about which could prove surprisingly valuable.

The world's largest car maker, Toyota, famously bet that it wasn't worth its while to go all in on electric vehicles, suggesting hybrids were a more practical way of reducing emissions. That approach is starting to pay dividends, and **Platinum's Leon Rapp** says it's time to cash in.

Since the rise of ETFs, there's been a focus on fees. However, **VanEck's Arian Neiron** thinks investors should also understand the different indices that funds are benchmarked against, as well as the ETF managers, because these too can impact investment outcomes.

Will the RBA need to cut interest rates before the US Federal Reserve? A few months ago, this looked a ridiculous proposition. With weakening economic data in Australia and correspondingly strong data in the US, **Franklin Templeton's Andrew Canobi** believes it's now a distinct possibility.

Our white paper this week is from Magellan on the structural growth tailwinds of AI and the associated risks and opportunities.

## The greatest investor you've never heard of

### James Gruber

Who is the greatest ever investor? Most of you will inevitably answer: Warren Buffett. Yet, what if I told you that there's another contender, one who has an even better track record over an extended period?

Hedge fund investor Jim Simons' flagship Medallion Fund has returned an astonishing 62% per annum over 33 years. $1,000 invested in his fund in 1988 would have grown to more than *$8 billion* by 2021.

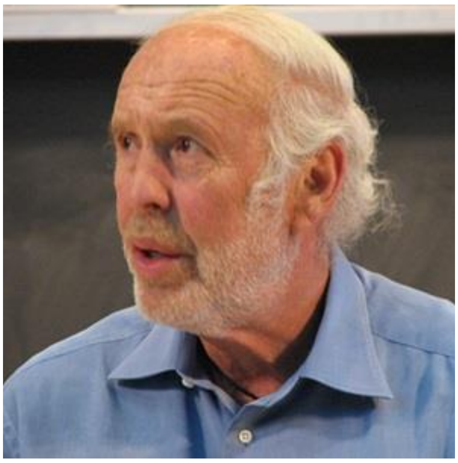
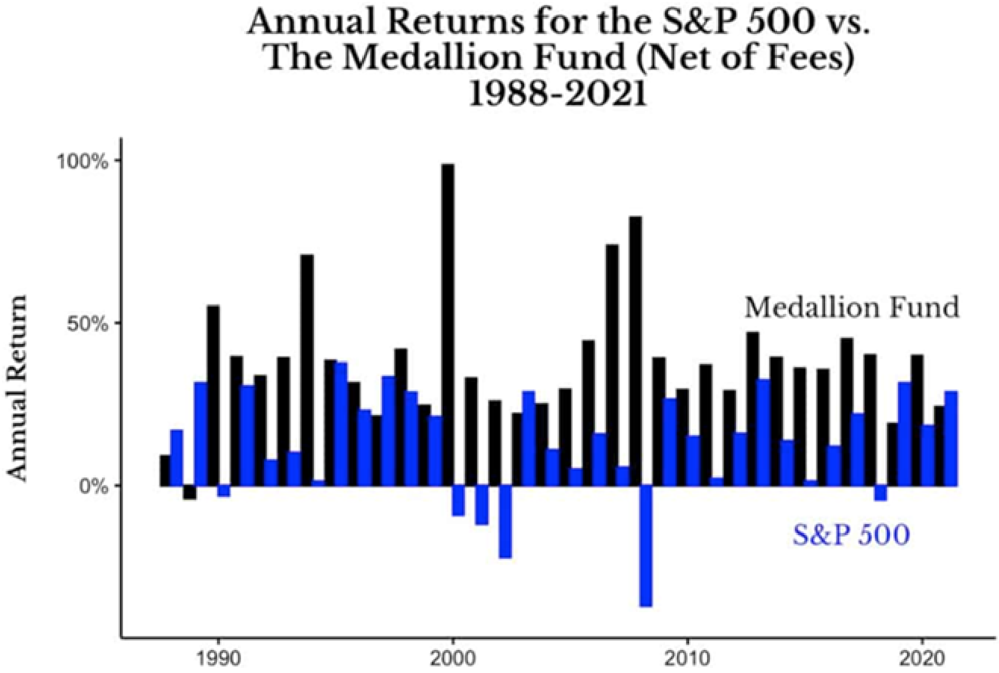


*Image by Gleuschk - Own work, CC BY-SA 3.0.*

Net of substantial fees (he's charged a 5% annual fee plus 44% performance fee, compared to the standard 2% and 20% respectively for the normal hedge fund), Simons has still generated 37% annualized returns over 33 years.

To put that in context, $1000 invested in the fund would have grown to almost $42 million, net of fees, from 1988-2021, while $1000 invested in the S&P 500 would have turned into $40,000 over the same period, and the same amount invested with Warren Buffett would have grown to $152,000.




*Source: DFA, Gregory Zuckerman*

Simons has only lost money in one year out of those 33 years. He's also made money when almost everybody else is losing it. For instance, in 2008, the Medallion Fund made 82% net of fees compared to a loss of 37% for the S&P 500.

So, how has Simons done it?

**The maths prodigy**

Let's first explore the man behind the track record. Simons is a maths prodigy who completed his PhD in mathematics at Berkeley at the slender age of 23. He went on to become a prize-winning academic who contributed to the development of string theory, which merged quantum mechanics with Albert Einstein's general theory of relativity.

During his time as an academic, he also worked with the National Security Agency (NSA) to help break codes during the Cold War.

From 1968-1978, he led the maths department at Stony Brook University in New York, which he turned into a world-class academic powerhouse through the recruitment of some of the world's leading mathematicians.

By 1978, Simons thought his pattern recognition skills could be applied to the world of investing.

**Renaissance Technologies**

He partnered with a former colleague Leonard Baum to form an initial fund, but it didn't go accordingly to plan. They made a lot of money until the market crash of 1984 where their investments lost 40% of their value. The partnership dissolved soon after, and Simons is quoted as saying that Leonard had mastered the "buy low" technique but hadn't perfected the "sell high" part.

Simons set about refining his techniques. He sifted through huge amounts of data from primary documentary sources, as well as electronic data. He then hired world-class mathematicians and data scientists. He got his employees to study correlations and patterns that could be traded in large volumes and numerous securities.

Yet, the initial years weren't easy. In its first year, the Medallion Fund returned 9% net of fees versus the S&P 500 which was up 16%. It's second year was much worse, as the fund returned -4% net of fees compared to the S&P 500's gain of 30%.

One of the initial partners then left the firm and Simons brought in a game theorist named Elwyn Berlekamp, who revamped Renaissance's trading systems. The changes worked and the following year, the fund returned 55%, and in subsequent years, it obliterated the indices.

**The fund's secret sauce**

Simons was a pioneer in quantitative investing. That is, finding patterns and asymmetries in data to make small profits, and magnify those profits through leverage.

As Gregory Zuckerman notes in his biography of Simons:

*"Early on, Simons made a decision to dig through mountains of data, employ advanced mathematics, and develop cutting-edge computer models. While others were still relying on intuition, instinct, and old fashioned research for their predictions. Simons inspired a revolution that has since swept the investing world."*

Simons tries to keep human emotions and judgments out of his investing.

*"Simons and his colleagues hadn't spent too much time wondering why their growing collection of algorithms predicted prices so presciently. They were scientists and mathematicians, not analysts or economists. If certain signals produced results that were statistically significant, that was enough to include them in the trading model".*

And he sides with his computer models even if they don't make complete sense:

*"More than half of the trading signals Simons' team was discovering were non-intuitive, or those they couldn't fully understand. Most quant firms ignore signals if they can't develop a reasonable hypothesis to explain them, but Simons and his colleagues never liked spending too much time searching for the causes of market phenomena. If their signals met various measures of statistical strength, they were comfortable wagering on them."*

However, Simons isn't a robot and there have been instances where he's overridden his models. On at last one occasion, he's traded counter to his models with panicked selling of investments. In 2018, he also temporarily lost faith in his trading systems.

**His detractors**

You don't become rich and famous without having detractors, and Simons is no different. Notably, Charlie Munger in one of his final interviews said he was uncomfortable with investors who principally used algorithms like Renaissance Technologies. He said these funds essentially front run investors. And Munger believed that they were making smaller profits with more volume, and the only way that they were still making good returns was through using greater and greater leverage, "which I would not run myself".

Meanwhile, notable investment author, William Bernstein, questions the purpose of hedge funds like Renaissance:

*"Clearly, the quant hedge fund business has little to do with the primary societal purpose of capital markets – the efficient allocation of capital to productive enterprises. Rather, it is a zero-sum game that transfers wealth from those endowed with skill and luck to those less well endowed with them…*

*… Were quantitative hedge fund managers to suddenly disappear, would they be missed? Or might the world be a better place without them?"*

**Lessons from Simons**

Quantitative trading may be foreign to most investors, yet there are still lessons to learn from the likes of Simons, including:

**1. You're not Jim Simons.** The greatest investors including Simons, Buffett, and Soros are maths geniuses. You can't hope to emulate them. Accept that, and instead formulate an investment strategy that best suits you.

**2. Don't compete with the best and brightest.** Quant trading is for experts. If you're trying to make day trades based on technical analysis and other techniques, you need to be aware that you're most likely competing with computers and the world's brightest maths minds.

**3. Find your edge.** You need to find your edge in markets. It could mean being a long-term investor, a deep value one, focusing on a certain sector that you are familiar with, or other approaches. Whatever it is, it needs to fit with your strengths and goals.

**4. Wherever possible, remove emotions from investing.** Investing is a hyper-rational endeavour, yet every investor is prone to emotions and biases. Even Jim Simons is. The trick is to find ways to minimize the instances of emotions override rational thinking.

Some fund managers go to radical lengths to achieve this. For example, Guy Spier in his book 'Education of a Value Investor' says he deliberately removed having Bloomberg screens in his office so he couldn't constantly check stock prices. He even ended up moving away from the 'noise' of Wall Street to a quiet village outside Zurich to ply his trade:

*"Following my move to Zurich, I focused energy on this task of creating the ideal environment in which to invest – one in which I'd be able to act slightly more rationally. The goal isn't to be smarter. It's to construct an environment in which my brain is not subjected to quite such an extreme barrage of distraction and disturbing forces that can exacerbate my irrationality."*

**5. Find a smart partner.** Perhaps Simons greatest achievement has been creating a world-class team. He recognized early that he needed to hire the best minds to make his fund work.

You probably don't have the luxury of hiring others, though it doesn't stop you from finding other like-minded and smart investors to bounce ideas off. Investing doesn't have to be a solo sport and collaboration can make for better returns.

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

## Taskforce recommendations to shake up aged care

### Louise Biti

It was late on Monday night (11th March) when the Government released the much-anticipated report from the Aged Care Taskforce, discussing how to fund aged care services to ensure sustainability and what it is likely to cost us to access the care we need.

The Royal Commission into Aged Care found that improvements are needed for the aged care system to ensure higher standards and quality of care, but achieving this raises two significant challenges:

1. How to support people's desire to age at home
2. Where the money comes from to ensure aged care providers can afford to meet people's increasing demand and expectations, particularly with an expected increase in the number of older Australians.

Older Australians want greater choice and more control, but they are also worried about how much care costs and whether they can afford the care they need. Care providers are worried about the cost of delivering care and whether they can afford to meet people's expectations. The Government is worried about the projected increases in aged care expenditure and how to ensure a system that works for us all.

The Taskforce's report focusses on all of these challenges with some key principles that should form the basis for government policy. It tries to navigate a path that ensures a fair and equitable system that delivers quality care.

While the report gives us some clues on what changes we might expect, it is important to note that the Government has not yet commented on their policy position. So, we do not yet know what changes the Government might accept and put forward as legislative change. All eyes will now be on the May Federal Budget.

**Aged care needs more money**

The Federal Government is the major funder of aged care - both home care and residential care. However, there is a limit to their ability to support the increase in costs needed in the future. Government spending on aged care as a proportion of gross domestic product (GDP) is projected to grow from 1.1% in 2021–22 to 2.5% by 2062–63.

To make care sustainable we need to inject more money and the Government has ruled out imposing a specific levy or increasing taxes to fund aged care. Therefore, the additional money will need to come from either Government (using current taxpayer funding) or from the people who access care services (fees and co-contributions). Efficiencies and better business models for care providers may also help to direct more of the available money into better care services.

An overriding principle adopted throughout the report is that we should have one aged care system. At entry a person should have their needs assessed and then they can choose where they want to live and how to access this care. This will create greater alignment and equity across government subsidies for home care and residential care.

It is also clear that the portion of costs paid by people accessing care will be higher. Currently the people accessing care only pay (on average) 25% of the ongoing costs of residential care and 6% of home care costs.

**What to expect for home care**

Home care is a cashflow conversation. People accessing home care have sorted out their own accommodation and funded those costs. Home care is about what support you need and who pays the costs.

The Taskforce's report divides these costs into three groups, with principles around what people should pay for:

- Clinical (medical) care – it is suggested that this should be fully or mostly paid by government.
- Support to facilitate independence and safety – this is where most of the money is currently spent and includes services such as allied health and social supports. It is suggested that this should have a compulsory contribution by people accessing the care but still be heavily subsidised by government.
- Everyday living expenses – these are the normal expenses associated with living in a home such as cleaning, laundry and maintenance and it is suggested that they should be mostly (or totally) funded by the person.

This model will require clear guidance from government on what services can be subsidised and which ones cannot and is likely to result in people needing to fund more costs on their own.

The suggestions also aim to address the problem with many people not spending all of their available package (unspent funds) and freeing up these amounts to fund care for a greater number of people.

If the changes are implemented, people will need a lot more support and guidance with managing cashflow and will need to focus on what services will help them to improve and maintain their quality of life, personal safety and healthcare management.

**What to expect for residential care**

A similar model to categorise services is suggested for residential care, but residential care has the added complexity of funding accommodation.

The cost of accommodation and daily care expenses (eg food, electricity, laundry etc) is suggested to be considered as personal expenses. The government should only subsidise these costs for a person who is determined to have low financial capacity.

The cost of accommodation is one of the biggest concerns for residents with costs that amount to hundreds of thousands of dollars. This may be made more affordable through the person's choice to pay this cost as a daily fee (rent) or a lump sum – with each option having different financial outcomes. The report suggests moving away from the lump sum option to a rent only option, but this needs to be done slowly to give providers confidence to invest and increase the supply of aged care beds and ensure a rental only option is sustainable. It is proposed that lump sum refundable accommodation deposits (RADs) could be fully phased out by 2035.

In the interim, we need to ensure providers can have confidence to build more residential care homes and upgrade the existing rooms. Some of the suggestions in the report may see the cost of rooms increase, with changes to make it easier for providers to charge higher RADs and the ability for providers to keep a portion of any RAD paid (the suggestion is up to 15% over a 5-year period). A safety net for low-means residents is still a key measure under these suggestions.

The ongoing daily fees and split into two components: care and daily living needs. it is suggested that the care needs that are directly related to health and impairment should continue to be fully (or mostly) funded by government, potentially removing the currently costly and expensive system of means-testing these fees.

Some of the costs currently allocated as "care costs" may also be transferred into the category of daily living costs. The category of daily living needs is suggested to be a personal expense which would need to be fully funded by the person living in care. This includes the cost of food, electricity, laundry etc. Most of this cost is already paid by the person living in care, with some Government subsidy. However, providers are not recovering the cost of providing these services – they are making a loss on this area.

The report suggests increasing the fees for daily living to ensure providers are adequately reimbursed (with a margin). If this becomes a fully personal expense, it could see people paying an additional $15-20 per day. it is likely that pensioners and other vulnerable groups could still be partly subsidised for some of this increase.

Providers and residents would also be able to negotiate additional services for higher standards of living and additional services. Hopefully this moves us away from the current system of compulsory additional services packages that have no connection to resident choice or values.

**Getting financial help**

Overall, we hope to see changes working to ensure financial sustainability for providers, with a large and fair share of the costs continuing to be paid by Government but older people may need to fund more of the costs.

While we are still waiting to see the Government response and get a clear direction on what will change and what it means for us planning our future care needs, it is clear that advice is important, and a greater understanding of the care system is needed.

Good regulation will be important, but so is a better understanding by us all. This includes a better understanding of the costs and a better understanding of how we can arrange our own finances to meet our needs and expectations, including better using our homes and superannuation savings to meet all of our retirement needs, including care.

The report flags the need for people to start this financial planning journey early in their retirement, not just when the crisis hits. From our experience it is important to get this advice from a financial planner who is licensed by ASIC (you can check your planner's details at https://moneysmart.gov.au/financial-advice/financial-advisers-register) and is also experienced in aged care advice.

*Louise Biti is a Director of Aged Care Steps, supporting advice professionals to give advice on aged care. Support is provided to older people through Aged Care Personal Advice. The information in this article is general and does not take into account your particular circumstances. We recommend specific financial tax or legal advice be sought before any action is taken to apply the rules to your specific circumstances. Refer to the relevant Product Disclosure Statement before investing in any product. Aged Care Steps ABN 42 156 656 843 is holder of AFSL 486723. Current as at 13 March 2024.*

## Meg on SMSFs: Super concepts to explain to your kids (or grandchildren)

### Meg Heffron

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

For those of us of a certain age, super is an obvious place to save. It's beneficially taxed, there are lots of investment options (particularly in an SMSF), and we don't have too long to wait before we can take it all back out again if we want to.

But the same is definitely not true for those in their 20s and 30s. At that time of life, it's tempting to give super the bare minimum in terms of both money and attention.

If you have family members in this stage, I completely understand their position. But there are two quirky super benefits it might be worth telling them about which could be surprisingly valuable.

**Free government money**

The first is Government co-contributions. And let's not be ageist about this; it's available up until age 71 so it's not just for the youngsters.

I like to describe this to my own children as "free money from the Government". The deal is this: you put up to $1,000 of your own money into super (a non-concessional contribution) and the Government will put another 50% of this amount (so up to $500) into your super account for nothing. The Government's contribution is known as a "Government co-contribution".

There are a few catches. It's only possible for people who are working (at least 10% of their income must come from a salary or running a business) and it's means tested based on income. The maximum Government co-contribution of $500 is only available to people whose income is less than around $43,000 and people with income of around $58,000 or more don't get this at all. Anyone who is somewhere in between can still get a government co-contribution, but the maximum amount is lower than $500.

Of course, the person must also be allowed to make their own (non-concessional) contribution to super in order to get the Government co-contribution. But these days, almost everyone from 0 up to 75 can do this – they can be a child, retiree or anywhere in between (just remember the rule above about having to earn at least 10% from working to get the co-contribution). Some people can technically make non-concessional contributions but their legal cap on these is $nil (in other words, they could make contributions, but extra taxes would apply). In 2023/24, for example, this would apply to anyone with $1.9 million or more in super at 30 June 2023. Those people are specifically ruled out of the Government co-contributions but then again, they're probably not too fussed about the bonus $500 either!

The young people in your life might not be super keen on locking up $1,000 of their own money just to get $500 that they can't get back for another 30-40 years. But it is a pretty good rate of return for those who can. (Or those whose generous parents, grandparents are prepared to give them the money to make the contribution.) And there are many life situations where it could apply – young people who are working part time and still studying (even under 18), those working part time while raising a family or those working full time in the early stages of their career.

**The First Home Super Savers Scheme**

The second super benefit worth discussing for those who wouldn't ordinarily be keen on super (yet) is the First Home Super Savers Scheme (FHSSS). This is a rule that essentially allows ***some*** people to tap into their historical super contributions to buy their first home. Of course, there are lots of rules, but this could be a handy boost for a home deposit.

It's only available for a first home – so anyone who has ever owned property in Australia before is ruled out (even if that wasn't a property they lived in). It has to be a home (not an investment property) and there are deadlines about how quickly the money has to be used once it's released from super. One very important feature of the rules at the moment is that the application to release the money has to be made ***before signing a contract*** to buy or build the property (this is to be moved to settlement date from September 2024, but current applications are still based on contract date).

Unfortunately, only certain 'voluntary' contributions can be released. This includes, for example, personal contributions or salary sacrifice contributions. But it doesn't include compulsory employer contributions (Super Guarantee). It could even include (say) the $1,000 contributed to secure the Government co-contribution but **not** the $500 co-contribution itself. It also doesn't include contributions made by a spouse.

Effectively, the law is allowing people to save "extra" in their super fund for their home deposit but not tap into their compulsory retirement savings. This is probably one of the reasons people don't use this scheme as much as might be expected – those saving for a home are not usually topping up their super at the same time.

The maximum amount that can be released is a bit complicated.

First, it's only 85% of any "concessional" contributions (salary sacrifice contributions from an employer or personal contributions that have been claimed as a tax deduction). That makes sense –these contributions were taxed at 15% when they were paid into the fund so only 85% is left. In contrast (logically) it's 100% of any "non-concessional" contributions. Both of these amounts are increased by some notional investment earnings (currently around 7% pa).

But then there are further limits.

The maximum amount of contributions to be taken into account for release is $50,000. So, if all of the contributions were salary sacrifice contributions (over many years), the maximum amount the member could actually get out would only be $42,500 (85% of this amount), plus earnings. And then there's tax – more on this below. If all of the contributions were non-concessional contributions, the maximum amount would be $50,000 (plus earnings).

And only $15,000 from any one year can count. (getting the maximum would require multiple years of voluntary super savings before buying the home.)

Fortunately, when someone applies to the Tax Office to use this scheme (which can be done via myGov), the Tax Office works all this out and lets them know the maximum that can be released and how it's broken down between the different types of contribution.

Finally, when the money is actually released, the bit that comes from earnings and concessional contributions (but not non-concessional contributions) is taxed. The tax rate is the member's normal marginal tax rate less a 30% tax offset.

The net result is that as a general rule, someone on a marginal rate of income tax that's higher than 30% can actually **save tax** by making salary sacrifice contributions and using this scheme to get them back for a house deposit. Someone on a lower tax rate can potentially also save tax but only if they have enough personal income to "use up" the 30% tax offset.

There's nothing to stop the young people in your life using both the FHSSS and Government co-contributions. Imagine helping them to make non-concessional contributions of $1,000 pa for the next 10 years. They'll have built up $10,000 (plus earnings) towards their home deposit in their super fund. At the same time, the Government will have given them up to $5,000 in Government co-contributions. While they can't take the co-contributions back out for their home deposit, they have at least boosted their super without locking up their spare cash for years to do it.

*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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## Toyota: How the hybrid engine regeared the investment case

### Leon Rapp

The world's biggest car company is reaping the rewards for a multi-pronged approach to reducing $CO_2$. Here's why that's good news for investors.

Toyota has been a long-term holding for us, and it's been a relatively easy decision to own it. After all, Toyota is:

- the world's largest car maker [1]
- the world's 6th most valuable brand [2]
- the company that in many ways redefined modern manufacturing through just-in-time delivery and its kaizen and kanban production practices.

In late 2023 we began to positively reassess our Toyota position as we discerned some key trends in the battery electric vehicle (BEV) market.

**EVs and a range of anxieties**

Over the past few years, growth in Electric Vehicle (EV) sales has been staggering. Global sales doubled in 2021. They grew by 60% in 2022 and were up around 30% in 2023.[3] But in late 2023 the pace of growth in EV demand began to slow (especially in Europe and the US, much less so in China). More cost-conscious mainstream buyers baulked at high sticker prices, soaring insurance and repair costs, problematic resale values and range anxiety due to inadequate charging infrastructure.

Meanwhile, regulatory backing for EVs became less of a one-way street. In some countries, subsidies have been reduced. In the US, unions and car dealers are pressuring the Biden government to wind back policies that push rapid BEV adoption.

**Toyota says "not yet"**

The slowdown in EV growth had some interesting implications for Toyota.

While US giants like Ford and GM and European car makers like Volkswagen had made early commitments to a BEV future, Toyota maintained that hybrid vehicles (a technology they invented with the Prius in the late 1990s) offered the most practical pathway to lower emissions.

Chairman and former CEO, Akio Toyoda said one billion people around the world live in areas without electricity. In the case of Toyota, they also supply vehicles to these regions, so a single battery-electric vehicle option cannot provide transportation for everyone and that's why they are trying to have a variety of options.

Strategically that's turned into an astute decision.  Demand for hybrids is soaring.

- In the first nine months of FY2024, Toyota and Lexus retail sales rose 9.7% Year-on-Year (YoY).
- Sales of their electrified vehicles - mostly hybrids – accelerated 41% YoY) over that period. They now account for 36% of total sales.
- In Europe, over 60% of Toyota and Lexus sales in FY2023 were hybrids.

Toyota's shift to hybrids is good for profitability as well as volume. Partly that's a function of increasing demand. But its famed engineering excellence also means Toyota can now make the more complex hybrid drivetrains much more efficiently.  They now make as much profit on hybrids as on Internal Combustion Engine cars.

**The investment case**

Toyota could be entering a period of 'breakout profitability'. In the short-term, the BEV market is crowded and slowing so there's lots of pressure on BEV companies outside China to cut costs – a trend that's already hitting Tesla. Positioned as it is, Toyota avoids getting caught up in a margin-cutting BEV price war while at the same time capturing all the benefits of a growing hybrid market through higher volumes, more pricing power and stronger earnings.

While hybrids have been viewed as a 'transition' technology, the Toyota view is that many consumers now prefer hybrids – and may continue to do so. As we write, Toyota is trading on a P/E ratio of 10x, only slightly above its long-term averages. Yet it looks poised for sustained growth.

*New technologies - and more chargers - could end 'range anxiety' and take EVs mainstream. Image Source: Adobe*

**The future is still bright for electric**

It's crucial to note that Toyota is not writing off the BEV market. Even with the recent blip in Europe and America, the case for electric vehicles remains strong. The driver experience is different – and many say better. New European emissions standards due in 2025 may add impetus to European demand.

Perhaps most importantly, car makers are increasingly focused on making more affordable EVs that can appeal to the mainstream driver. BYD in China, for example, is a leader in this effort but other makers are also adapting their approach to both the underlying technologies and the cost profiles of their BEVs.

Toyota is also focused on developing a range of technologies that will make it even more competitive in a world focused on low-carbon transportation.

They aim to produce around 3.5 million BEVs by 2030 but these will be powered by newly-developed bipolar and solid-state battery technology that promise longer range and faster charging. To deliver those new technologies, it is spending the equivalent of US$60bn on electrification through 2030. Toyota is also unwinding its cross shareholdings of other companies and plans to invest the proceeds in electrification.[4]

For us, the investment case for Toyota now has further improved:

- It passed the BEV-trend test by sticking to its strengths (hybrids) in a way that met customer needs whilst boosting the bottom line.
- It's investing heavily in R&D to make it competitive in a low-carbon world.
- In its recent third quarter results the company committed to better shareholder returns through higher dividends and buybacks.
- Its valuation remains reasonable.

Toyota also has an outstanding competitive position. It's a quality business with strong brand equity. Their cars are highly rated for reliability and have outstanding resale value. That represents good value for the people driving the world's Camrys and RAV4s. High demand for hybrids also means limited inventories and Toyota pays out lower incentives than the industry average. So it's good for investors too.


*Source: Morningstar.com. End of Date as of Mar 8, 2024.*

*As at February 2024, Toyota is a holding in the Platinum International Fund and the Platinum Japan Fund.*

*[1] It sold over 9.5 million vehicles in 2023*
*[2] Source: Interbrand Best Global Brands, 2023*
*[3] Source: Benchmark Minerals*
*[4] For more on a new shareholder-friendly culture in Japan see our recent article: Japan's reform. New dawn or same old story.*

*Leon Rapp is Co-Portfolio Manager, Japan Strategies at Platinum. This information is commentary only (i.e. our general thoughts). It is not intended to be, nor should it be construed as, investment advice. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Before making any investment decision you need to consider (with your financial adviser) your particular investment needs, objectives and circumstances.*

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# It pays to look under the hood of ETFs

## Arian Neiron

Since the rise of ETFs (Exchange Traded Funds), there has been a focus on fees. The first casualties were active managers who started to see their market share being eroded by these low-cost, transparent funds. Many active managers dropped their fees.

As ETFs gained traction, more asset management businesses started offering more ETFs. Often the differences in these ETFs are difficult to ascertain. Sometimes these differences appear to be just the fees, but it's important to check if the indices are different, too. It's also worth considering the asset manager offering the ETF.

Fees are easy to understand. This is seen as the price of the ETF. In the consumer world, the price of a good is seen by consumers as a signal of quality, and while the most expensive is not always the best quality, the cheapest rarely is.

Investments, like consumer goods, should be assessed on the outcome they offer, therefore it is useful for investors to understand different indices and the ETF manager because they can impact the investment outcome.

So, let's unpack indices first.

**Indices: Beta**

In financial jargon, beta is the term used for the market benchmark. In Australia, the S&P/ASX 200 Index is the market 'beta'. There are ETFs that track market beta indices for a range of asset classes including Australian equities, international equities, bonds and infrastructure.

Beta is the starting point, and asset owners who allocate to beta expect to get exactly that: 'true' beta.

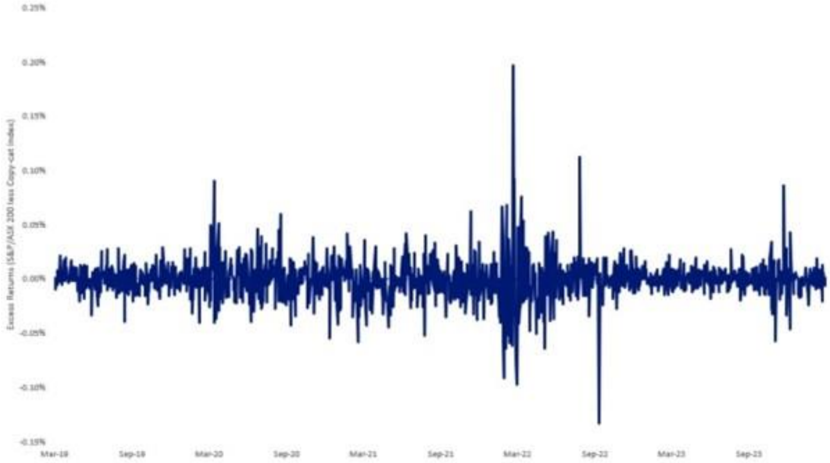
However, some funds track indices that appear to be like the market beta but are not. Often the ETFs that track these indices are a cheaper alternative than the ETFs that track the market beta. When you use these beta-like indices, your outcome will be distorted and because of compounding, you could have a butterfly effect.

The historic basis for the 'true' market beta, is derived from Modern Portfolio Theory (MPT) and its underlying principles that have been used by industry professionals for decades to help investors understand risks and returns.

A simple example would be two Australian equity indices, the S&P/ASX 200 index (the 'true' beta) and another index provider's Australia 200 (beta-like). In this instance, over the past five years, the 'true' beta has underperformed the copy-cat index. While, on the surface, this could be a great outcome, the reality is it is also a risk.

The subtle differences in the index could easily mean that performance could go the other way. To give you an idea of how different the returns can be on any given day, the below chart shows the excess returns of the copy index each day.

**Chart 1:** Five-year daily excess returns: Australian equity betas




*Source: VanEck, Bloomberg. You cannot invest in an index. Past performance is not a reliable indicator of future performance.*

There is an example in which performance has gone the other way. For Australian investors, the 'true' beta for international equities is the MSCI World ex Australia Index. Over the past five years, a similar copycat index has underperformed the true beta. And like chart 1 above, its variation to the 'beta' on any day could be wildly different from the true beta.

For investors who are aiming to achieve market returns, beware of the copycat indices. It is a risk that you should be aware.

**Chart 2:** Five-year daily excess returns: International equity betas


*Source: VanEck, Bloomberg. You cannot invest in an index. Past performance is not a reliable indicator of future performance.*

Remember, when you invest for market returns you should be getting 'true' index returns (minus fees) without the fear of additional risks. You should be able to construct the rest of your portfolio confident in the level of risk in your equity bucket. A different beta will be exactly that: different.

**Indices (continued): The misfits**

So, we have 'true' beta being the market capitalisation indices that have become the standard measure for the market return and we have beta-like indices which are copy-cats of these. There is another type of index to understand and that is 'smart beta'. Smart beta is any index construction methodology that is different from market capitalisation. An example of a smart beta index is the MSCI World ex Australia Quality Index, which focuses on the world's highest-quality companies based on key fundamentals.

Again though, the beginning or starting point, or the 'true' beta is a crucial first step in the process of offering an investment product that tracks a smart beta index.

Investors that start with the wrong benchmark may create a divergence and thus not achieve true exposure to the investment outcome they are targeting. According to a research paper from MSCI, Benchmark Misfit Risk: Identifying the Risk Contribution Arising from Differences in Manager and Policy Benchmarks, this discrepancy between the manager's beta and the wrong starting point is known as benchmark misfit.

From an investor's point of view, 'benchmark misfit' introduces two basic investment problems. First, it creates inconsistency in risk reporting. Many risks are relative to the benchmark index, or beta. From a different starting point, the risk and return attributes may capture new and different idiosyncrasies. Second, it introduces uncertainty in how and where the actual risk budget is being spent. Performance and risk are likely to be more idiosyncratic, thus harder to explain or match the expectation.

The returns of these copycat smart beta 'misfits' may differ from your intended investment outcome.

Again, the cheapest may not always be the best.

**The asset manager: Skill**

There are two important ways the asset manager offering the ETF can impact the investment outcome: their skill and their income management.

In regards to skill, the goal of an ETF is to track the performance of its index. It is important to investigate how good the ETF issuer is at tracking its index when adjusted for the fees associated with the ETF which are not incurred by the index.

The difference in performance should usually be small, in the range of one per cent. However, various factors can sometimes conspire to open a gap of several percentage points. To avoid such an unwelcome surprise, investors should seek ETF issuers that have a history of tracking their respective indices closely, which means tracking within just a few basis points of the index after adjusting for fees.

You would expect an ETF issuer to report this information on their website. Performance tables should include the performance of the ETF and the performance of the index they are tracking. If they don't, alarm bells should ring.

**The asset manager: Income (if it's important to you)**

For many ETF investors, income is an important investment outcome they are aiming to achieve. Here are two good examples that we think may help investors consider assessing the different income outcomes between similar ETFs.

First, above we spoke about two different Australian equity indices, the S&P/ASX 200 and a copy-cat 200 index. ETFs track both of these indices and while you would expect the income outcome would be similar, it is not. VanEck's analysis found that the dividend yield for the ETF that tracked the S&P/ASX 200 was 0.30% higher than the copy-cat ETF (as of 31 December 2023). Furthermore, the franking credits received by investors were different too.

The differences in income may be explained by the slight differences in the indices, but there are instances of ETFs tracking the same index in which the income outcome is different. In the second example, we have two ETF managers tracking the same index, but the income outcome is very different.

Infrastructure is an income-yielding asset class. A large share of its returns is traditionally income, not capital growth and its investors would expect this income to be smooth and dependable. VanEck and one of its peers track the same market beta for infrastructure, yet over the comparable period, being three quarters, there is a significant difference in the income experience. Only one fund has paid smooth income payments.

**Table 1:** Cents per unit distributions

| Date | IFRA | Infrastructure ETF A |
|---|---|---|
| 30/06/2023 | 17.000000 | 10.720008 |
| 30/09/2023 | 17.000000 | 17.485912 |
| 31/12/2023 | 17.000000 | 11.541648 |

*Source: VanEck, ASX*

Because investing in overseas markets and hedging returns back to Australian dollars can be difficult, a thorough understanding of the capital markets and tax rules means that the choice of asset manager could be paramount, especially if you seek an income-oriented investment outcome. Make sure the composition of the returns reflects your expectations.

Other ways to assess the ETF asset manager is to understand their history, how long they have been investing money and how long they have been issuing ETFs, including both here and overseas. Try to appreciate their commitment to investors and assess the quality of their product suite.

Only now after assessing different indices, investment outcomes and the investment manager are we ready to talk about fees.

**Let's talk about fees**

There is no doubt that fees are an important consideration for investors. But it is secondary to an investment outcome.

We think savvy Australian investors care more about their investment outcome than they do fees so will recognise poor quality where they see it.

Investors don't want to overpay, likewise, the cheapest may not achieve the outcome they desire.

As always, we would recommend you speak to a financial adviser or broker to determine which Australian equity investment is right for you. Their advice, we would argue, can also be value for money.

*Arian Neiron is CEO and Managing Director - Asia Pacific at [VanEck](), a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs. Investors should do their research and talk to a financial adviser about which products best suit their individual needs and investment objectives.*

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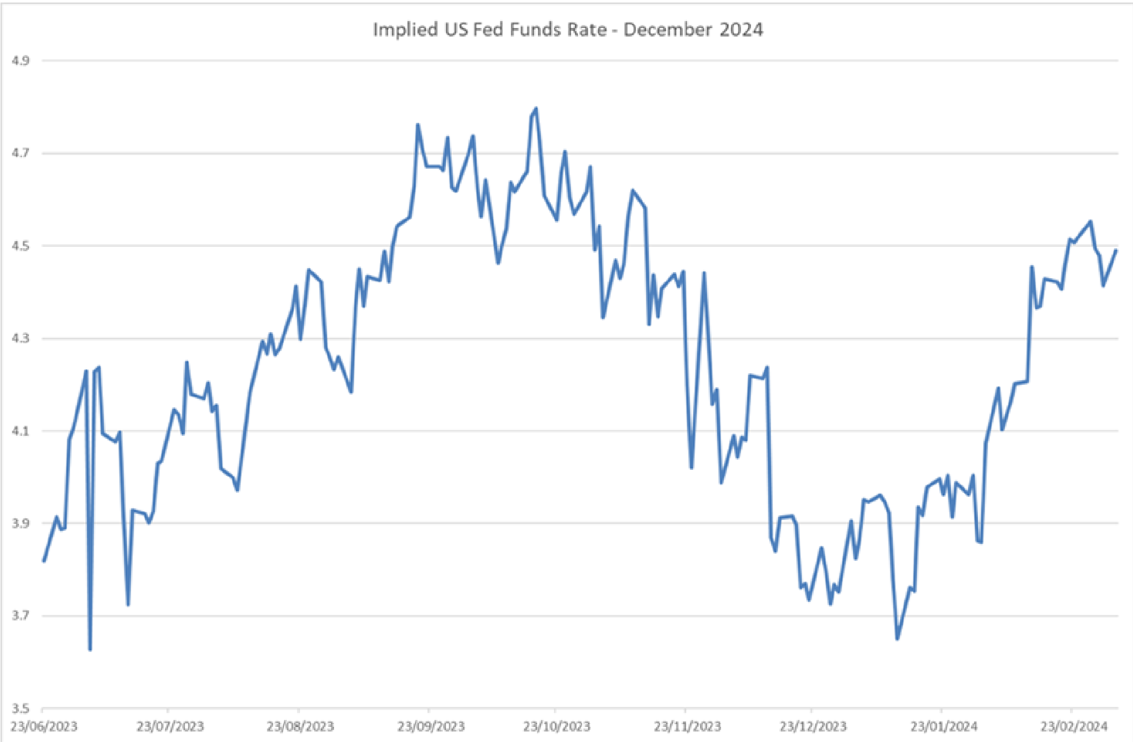
## Will the RBA cut rates before the Fed?

### Andrew Canobi

Everyone is fixated on when the US Federal Reserve will cut rates. The discussion isn't if, but when, and by how much. This is welcome news for a bond market that, so far in 2024, is treading water when one considers the year-to-date negative returns for the major benchmarks – the Bloomberg Ausbond Composite Index and Bloomberg Global Aggregate.

A big part of bond market skittishness has been the reluctance of US data to endorse a chunky easing cycle in 2024, which has seen Fed easing expectations slashed from >175bps to around 75bps for the year, as we write this. The chart below shows the roller coaster ride of markets trying to anticipate what the Fed Funds rate will be in December 2024 versus its current 5.25%. Call it ~100bps of rate cuts removed in a matter of weeks.

**Market Implied US Federal Reserve Funds Rate December 2024**




*Source: Franklin Templeton; Bloomberg Data*

Few think the RBA will cut before the Fed. That could get challenged. The Fed has the complication of a US election, which heightens sensitivity around the timing of the first cut. Commencing an easing cycle in May or June is still far enough away from the Presidential election in November to be 'arm's length'. It's unlikely to us they start in September, which is the last meeting prior to the election, if they can avoid it. The clock is ticking for the data to give the Fed permission to start the cycle comfortably ahead of a key political contest. The RBA is unlikely to face a federal election until 2025.

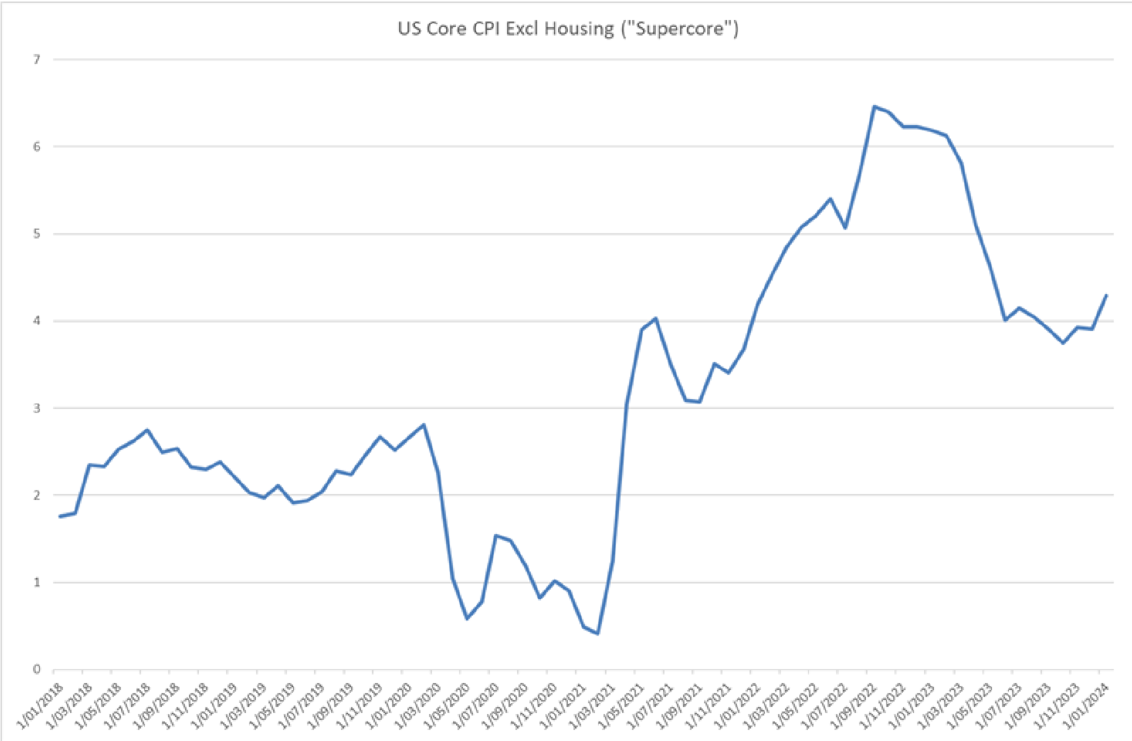
What could drive the RBA to move before the Fed?

Three things stand out to us:

**1. Inflation**

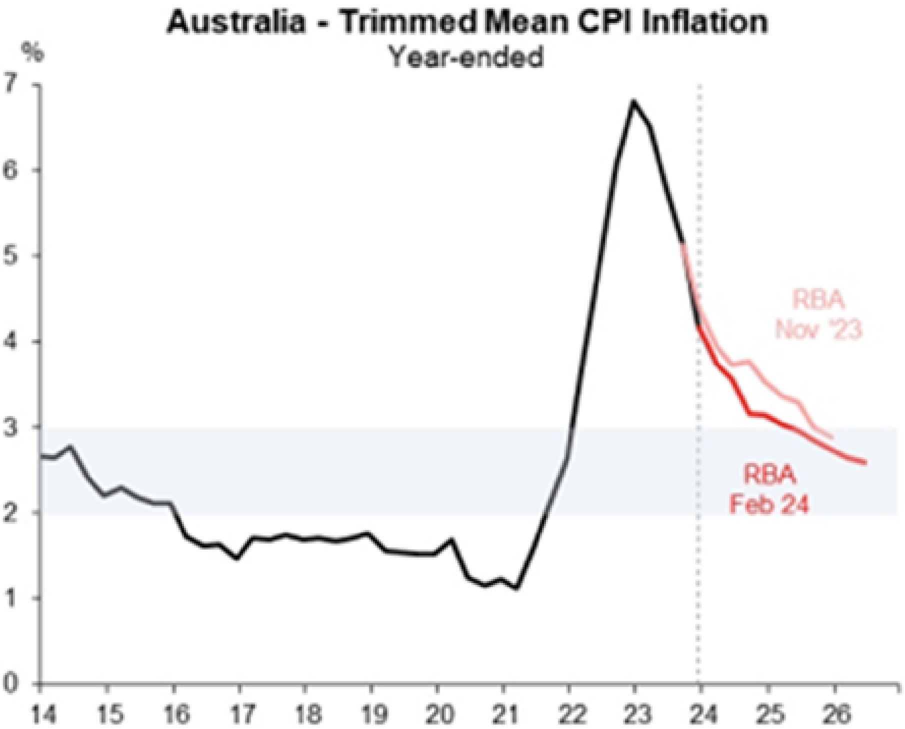
The stop start volatility in US markets reflects disappointing inflation data, which has failed to endorse the 'rate cuts are coming soon' narrative. Fed chairman Powell's favourite measure the 'super core' CPI has ticked up recently, which is likely a setback rather than the start of a reacceleration, but it's enough to keep nerves frayed. The super core is services ex-shelter inflation and a favoured measure because it is most sensitive to wages. Year-over-year it has ticked above 4%, so the next few months are key to see a decline resume.

**US Bloomberg BLS CPI Core Services Less Shelter Inflation**



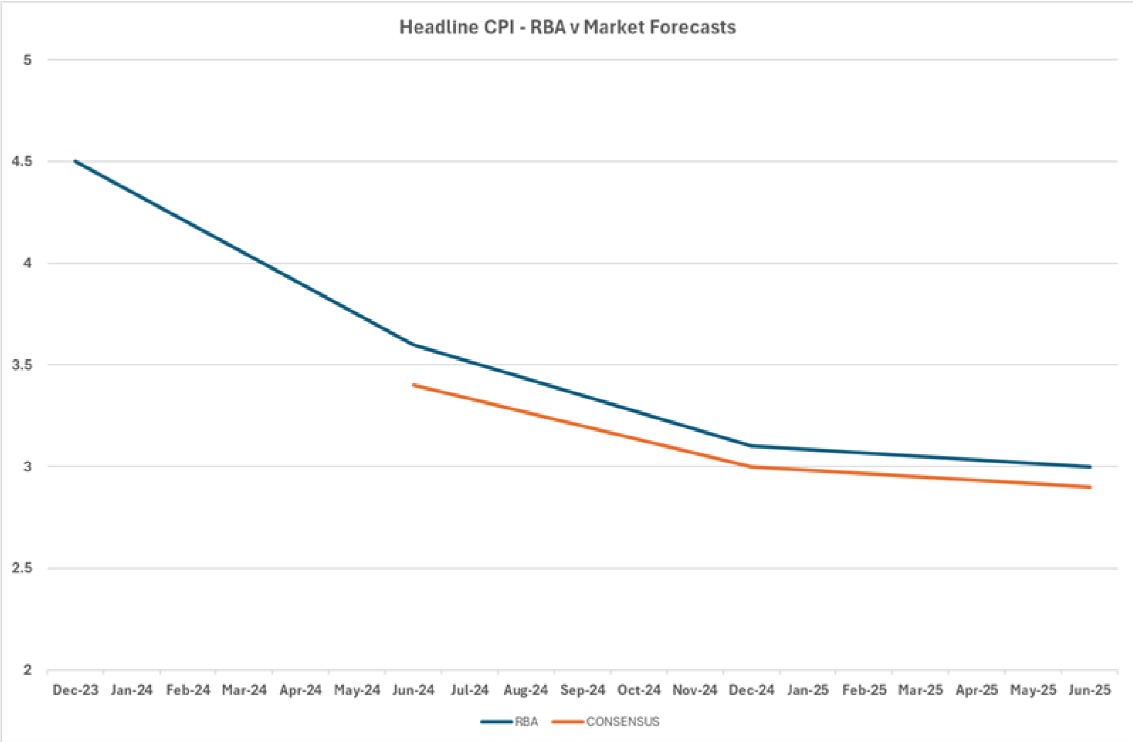

*Source: Franklin Templeton; Bloomberg Data*

Meanwhile, inflation in Australia has been falling more quickly than the RBA forecast. The chart below shows the evolution of RBA forecasts for underlying trimmed mean CPI.




*Source: Franklin Templeton; ABS; RBA; Macquarie Group*

In addition, market consensus for CPI continues to undershoot the RBA out to mid-2025. It looks like at the next update the RBA will downgrade their forecasts. One major US investment bank now sees both headline and core back in the 2-3% band by the end of 2024, well ahead of current RBA thinking.

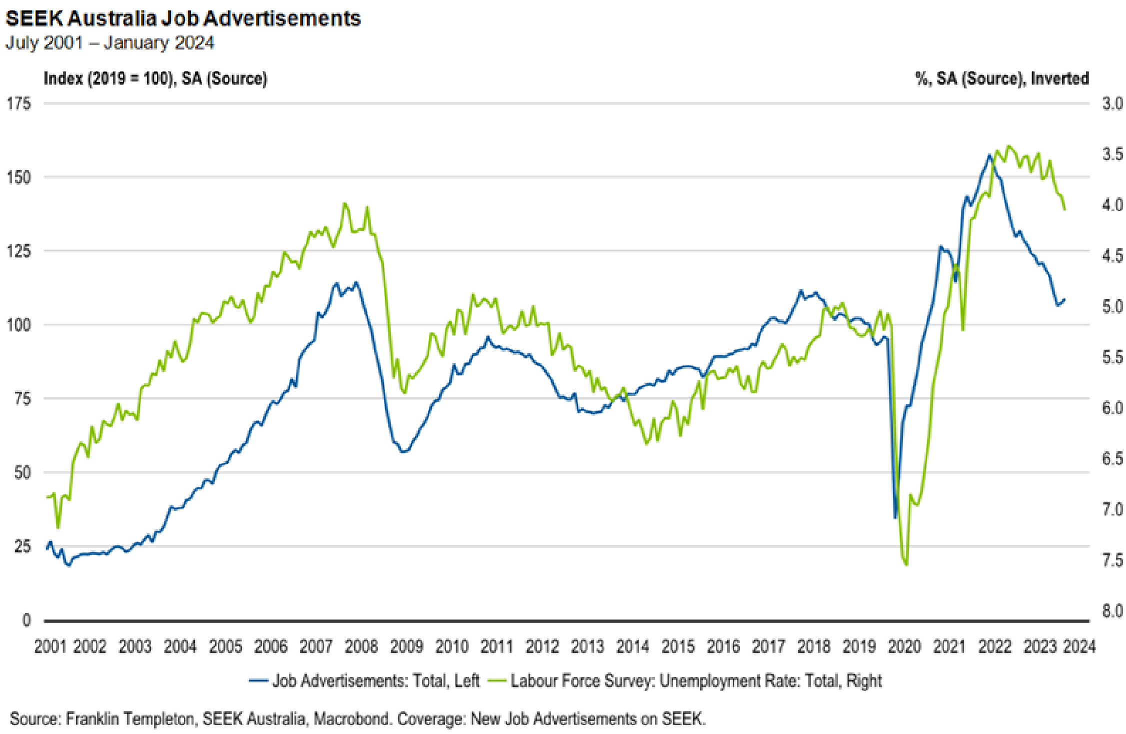



*Source: Franklin Templeton; Bloomberg*

**2. The employment market**

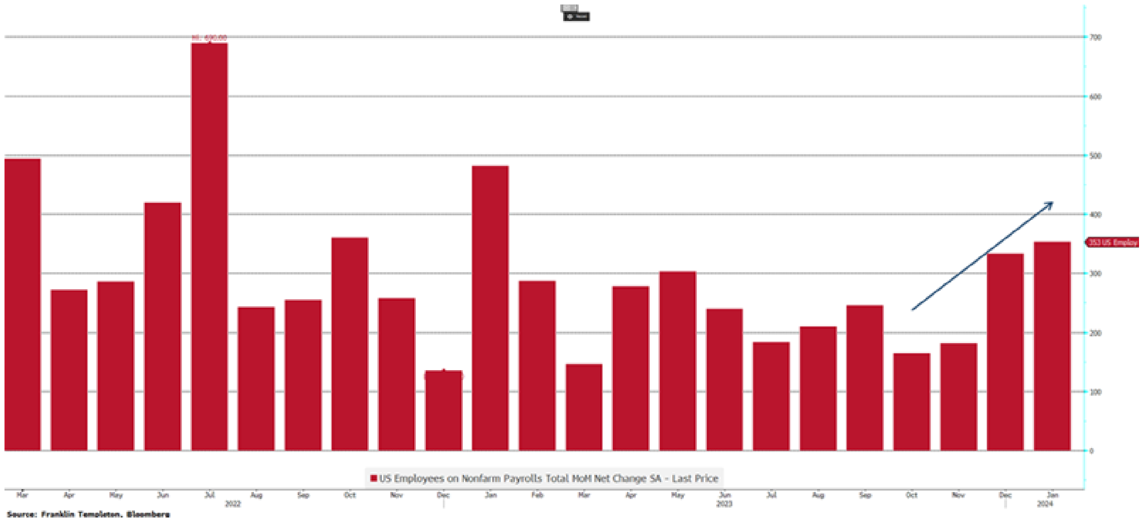
In contrast with the US, the Australian labour market looks to be softening more quickly. The RBA forecasts unemployment at 4.3% by Dec 24. We are at 4.1% now. If this moves higher in the next few months and challenges their forecasts, it's quite likely they could find an excuse to cut by mid-year.

Our favourite indicator in Australia, the monthly SEEK Job ads index, continues to point to weakness in the official unemployment rate.




In the US, the monthly non-farm payrolls release has been reaccelerating in recent months. The official unemployment rate in the US has had a 3-handle since early 2022, and still sits at 3.7%.

**US Employees on Nonfarm Payrolls Total MoM Change**



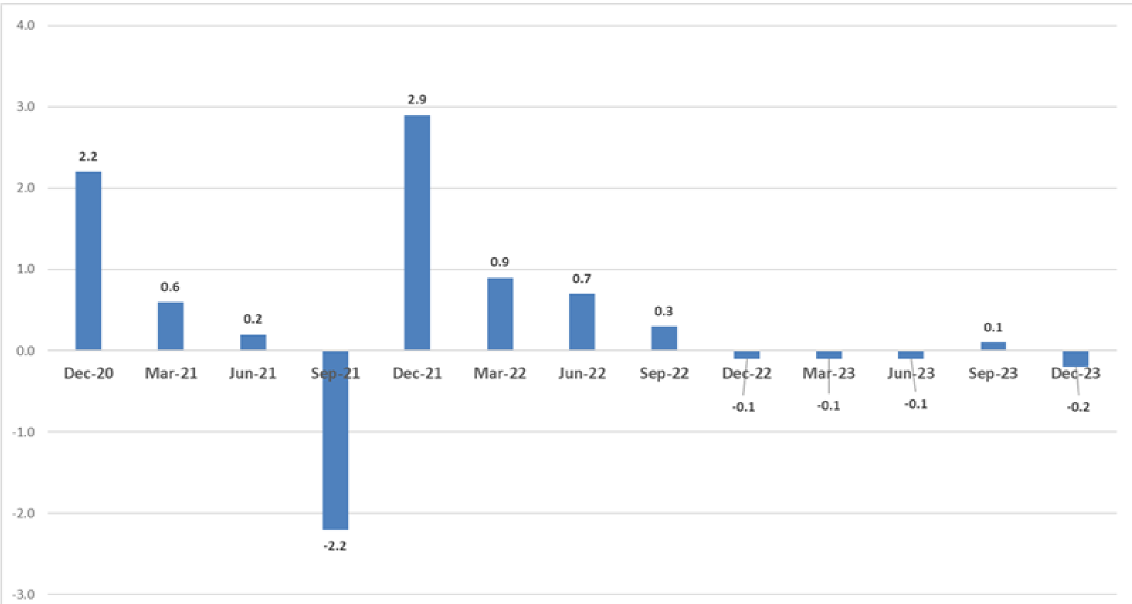

*Source: Franklin Templeton; Bloomberg*

**3. Households remain under intense pressure**

The Q4 Australia GDP data requires a microscope to find economic growth, coming in at a puny 0.2% on the quarter. In annual terms, the economy grew 1.5% for 2023, a year where population growth was ~2.4%. The ABS points out that per capita growth for the year was -1%, and that government spending and business investment were the drivers with the household barely retaining a spending pulse.

Indeed, household discretionary spending growth continues to be non-existent. Aside from a tiny +0.1% in the September quarter, every single quarter of 2023 saw discretionary consumption shrink.

**Quarterly Change in discretionary household spending (%)**




*Source: Franklin Templeton; ABS*

By contrast, US GDP grew at more than double the pace of Australia's in the year to December 2023, at ~3.2%, with personal consumption up 3%. Right now, at least, the US consumer hasn't been slugged as hard with rate hikes as the Australian consumer has.

What does it all mean? Duration looks modestly attractive in Australia but it's not a pile-in opportunity. The market has already priced approximately two 25bp cuts locally by around December but implies these will occur in the latter months of the year. On balance, we think these could be brought forward a little, and the amount of easing could be a little more than that. We like being long but absent an accident, it's hard to see the RBA, or the Fed, slashing rates in a way that would send bond yields plunging.

*Andrew Canobi, CFA is a Director within the Franklin Templeton Fixed Income team and a Portfolio Manager for the Franklin Templeton Australian Absolute Return Bond Fund (ASRN 601 662 631). Franklin Templeton is a sponsor of Firstlinks. This article is for information purposes only and does not constitute investment or financial product advice. It does not consider the individual circumstances, objectives, financial situation, or needs of any individual.*

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## Morningstar's CEO on low-cost investing, AI, and tuning out the noise

### James Gruber with Kunal Kapoor

*Introduction: Kunal Kapoor, CFA, is CEO of Morningstar. Prior to taking this role in 2017, he served as President, responsible for product development and innovation, sales and marketing, and driving strategic prioritisation. He joined Morningstar in 1997 as a data analyst and has served as Director of Mutual Fund Research and was part of the team that launched Morningstar Investment Services, Inc.*

*Kapoor recently visited Australia, and the following is an edited transcript of an interview that he did with Firstlinks' James Gruber.*

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**James Gruber:** Welcome, Kunal. What brings you to Australia?

**Kunal Kapoor:** Well, I've been accused of following Taylor Swift around, but that is definitely not the case. I'm here obviously because Morningstar has a large presence in Australia and just an opportunity to meet clients, checking on our teams, that kind of thing.

**Gruber:** You've come as markets reach record highs. Is it a time for investors to rejoice or to be cautious?

**Kapoor:** You should always be happy when your portfolio looks good, but it's certainly not a time when if you look at our coverage list, that our analysts are saying that there's a whole plethora of opportunities. And so, I'm not one to ever suggest timing the markets, but I do think it's reasonable to assume that we're not going to get the types of returns in the equity markets in particular over the next 12 to 36 months that we maybe have gotten over the past year. At least having moderate expectations is a good idea.

**Gruber:** The active versus passive investing debate seems to roll on. David Einhorn has been in the press recently. What are your thoughts on that debate?

**Kapoor:** Well, first of all, it's important to remember that not only is it a passive versus active debate, but it's a high cost versus low-cost debate. And on that score, there's no doubt that low-cost wins. So regardless of where you fall in the spectrum, make sure you're a low-cost investor. Secondly, I do think most investors can do just fine in either passive or active. The more important things you need to care about are saving appropriately, making sure when you build portfolios that you actually stick with them, and appropriately taking on risk to match the goals that you're trying to get at. But I do personally believe that active can add value. I also think it's perfectly reasonable to believe that you want to keep it simple and not worry about it and just have a passive portfolio. So, you can do things in ways that make sense for you, but keep costs low, save a lot, and stick with things for the long term as long as they line up with your goals. And those are more important facts than any debate on active passive or anything else will get you.

**Gruber:** AI is all the rage. What's your take on it?

**Kapoor:** Well, there's certainly an element of hype to it, but there's a big element of reality. And I think sometimes people get put off by the conversation because there's been so much hype, but it shouldn't take away from the fact that in reality it is here to change the way we do things. And I think in particular, if you're an investor, imagine the ways that some of the friction in how you do things could be taken away. Or even here within Morningstar, if you look at the way we've been able to expand our quantitative rating, it's on the back of machine learning and AI that we've gone from being able to cover a certain subset of securities to now large universes. And so, to me, that's exciting. The use cases are plentiful. You don't have to invent technology, but you have to use it to transform the way you're doing things and remove friction. And that's why I'm excited about it.

**Gruber:** I have to ask about this, U.S. elections. Have you got a tip?

**Kapoor:** My tip, I believe, is a good one, which is you should not care. In general, I believe the election…

**Gruber:** As an investor?

**Kapoor:** Yeah, I mean, it's a great sport to pay attention to it, but as an investor, all it does is take you off your goals. And so don't let short-term macro events have as big an impact on your portfolio as you sometimes can allow, because it's the fact that you're listening to the noise. Tune it out, stick to your goals, and congratulations whoever wins the election.

**Gruber:** Morningstar Sustainalytics is in the ESG business and ESG has copped a lot of flak recently. What do you make of that?

**Kapoor:** I think, first of all, that some of it is fair in the sense that there was some greenwashing and over-enthusiasm. It's sort of like with AI now, people just attach those letters to every sentence. Having said that, I think it also shows just a lack of understanding of the use cases around ESG. It's not just about whether you believe in investing in fossil fuel companies or not. It's much broader. It's about personalization. You and I have different preferences in our life and a portfolio is a fantastic way of expressing those preferences. And so ESG allows us to do that. You may choose to emphasize a bi-Australian portfolio. I may choose to emphasize an equal-pay portfolio. Both could be used; not controversial I think in the context of what each of us cares about. And I think importantly, through ESG data you can engage people to make those kinds of choices. So, I think a lot of what is controversial about ESG is that it's viewed as binary. You either are in or not. It's not true. You can use the data in a way that makes sense and personalize your portfolios and express your preferences. And I think that's a good thing because it leads to engagement.

**Gruber:** You've been in the investing game a long time. What's the one trait or skill that successful investors have versus those that are less successful?

**Kapoor:** I don't know about one trait, but I think an important trait is to tune out the noise. And it's so easy to get distracted. It's so easy to get caught up in the headlines. It's so easy to worry about what the elections are going to mean for your portfolio. And all of that does not matter. What matters is do you save enough? Are you investing with the right goals in mind? And then ultimately do you stick it out to see those goals come to life? Because that's what investing is about. It's about getting to the outcome, and when you get to the outcome, to feel good about what you've done. You're ultimately trying to achieve your goals. And I think keeping that lens in mind is good.

And ultimately, look, it is a little bit about practice as with all things in life. And I found personally in my own investing journey that having kind of gone through a few periods where I have not reacted or I've made a mistake, you learn from those and then reapply them. And I think that's very powerful. And so, I'd say it's okay if you make a couple of mistakes, because we all do. But the key is, you learn the lessons from them and then incorporate that and the approach that you take going forward.

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