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Editorial

Anyone looking for a guide to future Government policies might check two recent speeches, but it is clear which one will dominate actions. **Prime Minister Anthony Albanese** gave the keynote address at the **Labor Party** National Conference on the weekend before last, and he made it clear that policies mattered little if Labor was not in power. He used words like "*a plan for progress over the next decade*" and "*the difference between a moment of progress or a lifetime of opportunity*" and "*the difference between laying the foundation and finishing the build.*" In other words, there is a time for policy bravery but it is not now.

A speech a few days later at the **Press Club by Treasurer Jim Chalmers** was full of visionary intention but devoid of policies to support the ambition. In responding to the Intergenerational Report (IGR), he spoke of this moment in time when crucial decisions are required, such as:

> *"Moving from a younger to an older population is something we've known about for some time now. And it's true that this will put a strain on our Budget. In fact, around 40% of the projected increase in spending that's outlined in the IGR is due to us getting older. Here, at this generational fork in the road, we can shape the future on our terms. We can turn these turbulent twenties into the right kind of defining decade."*

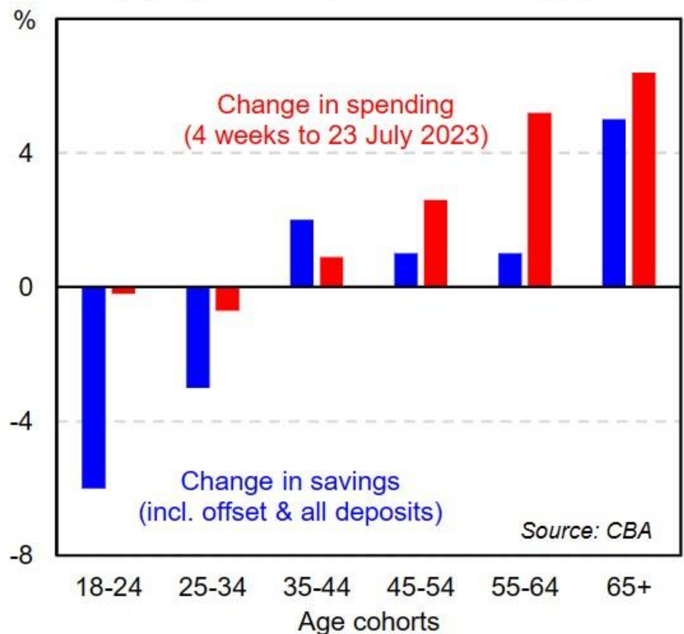
So according to Chalmers, we are at a "*generational fork in the road",* but it is 'kicking the can down the road' without policy responses. The Prime Minister made it clear that there is little room for unpopular decisions with an adverse impact on sufficient voters. For example, although the Labor Conference agreed a motion to increase social and affordable housing "*with funding from a progressive and sustainable tax system, including corporate tax reform*", there was no indication how this will be achieved. The IGR says we are heading for personal tax raising an unheard of 60% of all taxes.

In the meantime, the Government boasts of tiny incrementalism to avoid scaring the voters. The new tax on super balances over $3 million will not even raise the forecast $2 billion a year after SMSF trustees change their investments, but Chalmers cites it as reform.

According to the Australian Bureau of Statistics (ABS), there are 4.1 million retired Australians, and they have at least as many children expecting to inherit their wealth. As Labor's now-dumped election policy directed at changing franking credit treatment in 2019 proved, it is not only the older generation scared by changing tax policies. **Opposition Leader Bill Shorten** admitted after the lost election that he "*misread*" the level of anxiety caused by the policy, and Anthony Albanese is determined not to make the same mistake. There is no way Shorten would have run with the policy if he had understood the consequences, and there are many tax issues in the same bucket.

Given the outcry about the strain on future generations, what are some of the current tax settings that are compromising future affordability while at the same time making the Government scare away from major changes? We summarise 10 ways Australians can avoid paying tax, most of which are so commonly understood that every financial adviser in the country would offer them to their clients without blinking. They are all legal and popular ways to manage tax which makes changing them difficult.

The intergenerational consequences are already evident. This revealing chart from CBA shows the change in saving and spending by age groups over the last 12 months, and it is older people sustaining economic activity. They are earning more on their deposits and are not burdened by high mortgages.



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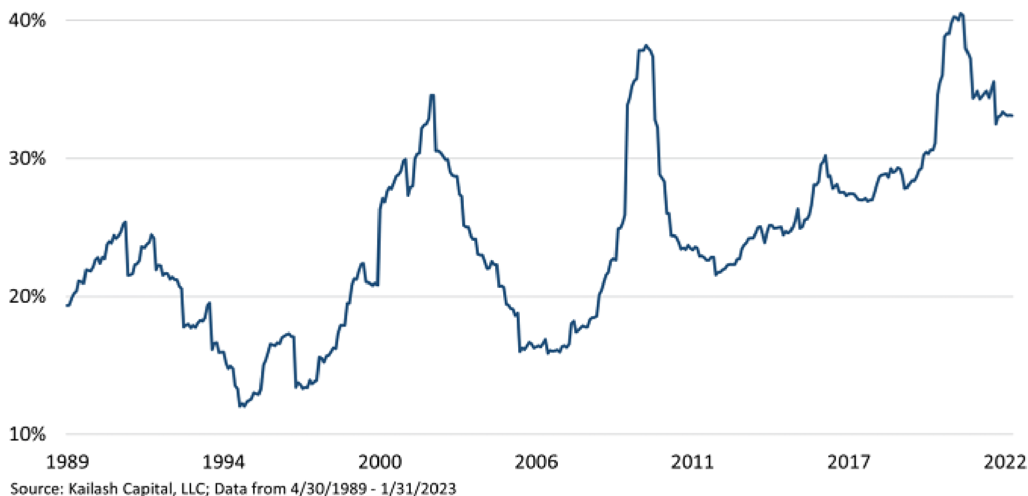
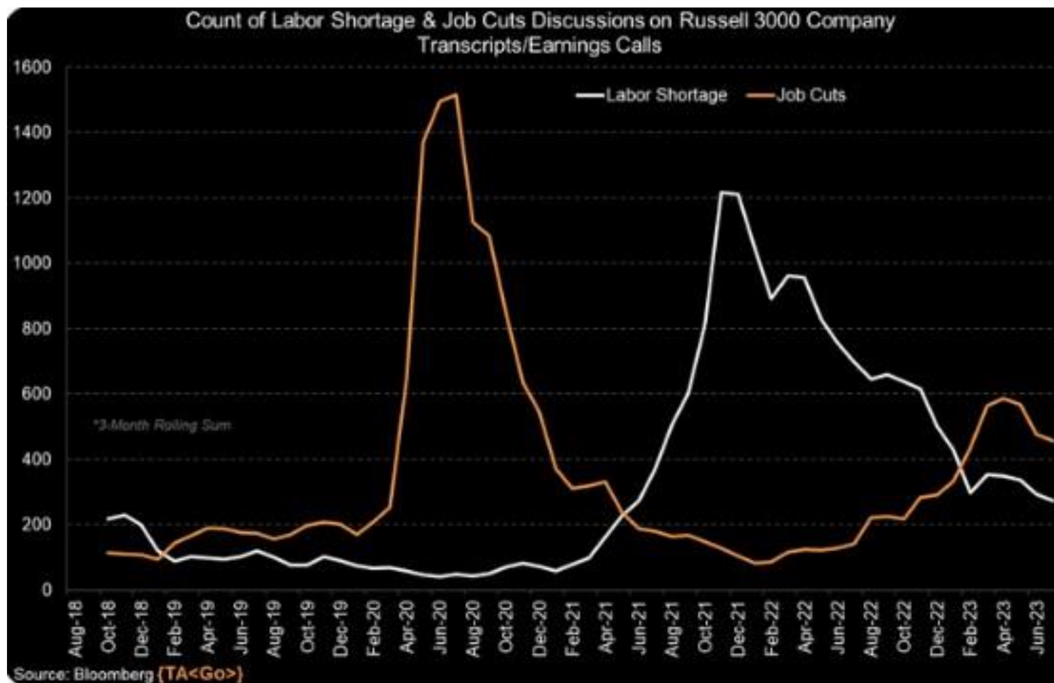
The most-commonly quoted index of the US stockmarket is the S&P500. As an index of the biggest companies, it covers about 80% of overall US market capitalisation. A better measure of the entire market is the Russell 3000, which measures the 3,000 largest listed companies and covers about 97% of the total market value, capturing small and mid-cap stocks. This index is arguably more exposed to the US economic performance as investors tend to turn away from smaller companies when conditions are difficult, preferring larger companies with big balance sheets.

Australian investors can readily access fund managers who specialise in global small and mid-caps, and over the two decades (2003–2022), global small and mid-cap stocks outperformed larger companies. This has since reversed with the dramatic surge in the values of the largest companies in 2023. While opportunities abound in the small and mid-cap space, it's also more volatile. This chart shows that about one-third of all companies in the Russell 3000 are not profitable or cannot meet their interest expenses, and this is despite many locking in lower rates of interest on their debt. Good stock picking will be essential as debt rolls into higher interest rates, creating more zombie companies.



It's also fascinating to see how quickly companies in the US have adjusted to changes in the labour market in recent years. In their earnings calls, they have gone from cutting jobs in the pandemic to labour shortages a year later, to not mentioning labour shortages to rising job cuts. They seem to have reached a levelling where both cuts and shortages are common.



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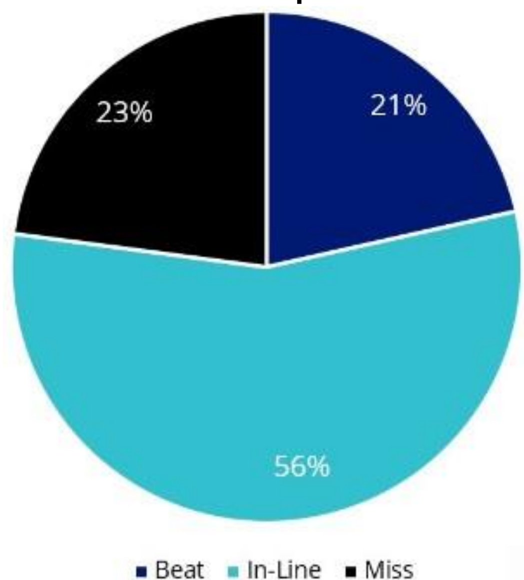
Back at home during results season, even analysts who follow companies closely are often surprised in half-yearly results. Although companies are scrutinised each day by brokers and fund managers, the market reacts surprisingly strongly to variations from expectations. Watching a feed from CommSec for a couple of days, these jumped out:

> *Smartgroup (ASX:SIQ) down 16%, Telix (ASX:TLX) up 12%, Core Lithium (ASX:CXO) up 7%, Tabcorp (ASX:TAH) up 9%, Costa (ASX:CGC) down 18%, Eagers (ASX:APE) down 7%, Ramsay (ASX:RHC) down 8%, Judo Capital (ASX:JDO) down 16%, Insignia (ASX:IFL) down 14%, Battery Age (ASX:BM8) down 13%.*

The overall results show most companies reported in line with expectations but there's a lot of money made and lost on the others.

S&P/ASX 200 August 2023 earnings result split



Source: Bloomberg, Index Weighted, as at 25 August 2023, ±5% range for beat/miss

Also checking my emails a few days ago gave another reason why it is difficult to select active managers. It's not only their ability to pick stocks, but their overall outlook for the market. Within an hour, I received these two views.

From **Schroders**:

> *"Register now to hear from Martin Conlon, the Head of Australian Equities, and senior members of his team as they unpack:*
> - *Why they believe this market bullishness can't last*
> - *How caution is driving their portfolio positioning"*

From **Bell**:

> *"While it might seem somewhat counterintuitive to adopt a bullish tone when markets are where they are, however, we find ourselves in a situation where we see quite material upside in specific areas of the market."*

Top down or bottom up. Should an investor only allocate to an active manager who agrees with their overall market view, or trust their stock picking?

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The latest inflation numbers increase the likelihood that the final meeting of **Philip Lowe** as Reserve Bank Governor next week will not result in another cash rate increase. The Governor is probably glad of that. The ABS reported:

> *"This month's annual increase of 4.9% is down from 5.4% in June. Annual price rises continue to ease from the peak of 8.4% in December 2022. The most significant contributors to the July annual increase were Housing (+7.3%) and Food and non-alcoholic beverages (+5.6%). Reducing the July increase were price falls for Automotive fuel (-7.6%) and Fruit and vegetables (-5.4%) ... When excluding these volatile items, the decline in annual inflation is more modest at 5.8% in July, compared to 6.1% in June."*

Fuel, fruit and vegetables down? Not where I spend.

Graham Hand

Also in this week's edition ...

People love new things, and investors are no different. Yet there's something to be said for valuing things which have endured. Because the longer something's lasted, the longer it's likely to last. **James Gruber** takes a look at nine ASX stocks that have stood the test of time with proven formulas for success.

On a related topic, **Joachim Klement** asks the question: how would you invest if you could live forever? Endowment funds and others such as Bridgewater's All-Weather portfolio have tried to address this question. Klement has a different take on how individual investors can build a portfolio that lasts generations.

There are two articles on income investing this week. The traditional approach to income is buying high-yield, dividend-paying stocks. **First Sentier's Rudi Minbatiwala** doesn't believe this is the best approach and explains why. Meanwhile, **Shane Woldendorp** of **Orbis Investments** suggests that in a market enamoured with growth stocks, he's finding good value in dividend-yielding shares.

What does the recently-released Intergenerational Report mean for the aged care sector? **Assyat David** of **Aged Care Steps** does a deep-dive into the report and suggests that the trends highlighted reinforce the need for Australians to consider their aged care needs now rather than wait for a crisis.

Private markets are all the rage among institutional funds yet they've been slower to catch on with individual investors. **Patrizia's John O'Brien** says private markets make better returns than public markets on average, and he advises on the ways that individuals can build their own private markets portfolio.

And in this week's White Paper, the **World Gold Council** reports on gold demand trends and how central bank buying reached record levels in the first half of the year.

Curated by James Gruber and Leisa Bell

Who needs the Caymans? 10 ways to avoid paying tax

Graham Hand

For much of my career in the 1980s, I specialised in global capital markets, arranging transactions worth billions of dollars on behalf of my employers, the Commonwealth Bank and State Bank of NSW. It was great fun, travelling the world at a time when Australian borrowers started using a wide range of offshore funding markets for the first time, and the Australian dollar became desirable for overseas investors.

But the Eurobonds we issued helped rich global investors to evade tax by hiding their wealth from tax authorities.

An excellent book called *Moneyland* by investigative journalist Oliver Bullough examines how global bankers developed ways for wealthy people to hide their investments, entering the world of oligarchs and thieves and corrupt governments. He demonstrates how powerful bankers and government officials in places like the Caymans, Channel Islands, Jersey, Ukraine, Russia and Luxembourg facilitated money laundering and hid billions on behalf of the world's wealthy, making the bankers rich in the process.

The Eurobond market started in London when bankers developed a brilliant idea that created a financing and investment bonanza. Says Bullough:

> *"The idea of an asset being legally outside the jurisdiction that it is physically present in, is absolutely central to our story. Without it, Moneyland would not exist."*

The pivotal genius of the design was the use of bearer bonds. Whoever possessed the bonds, owned them. There was no register of ownership and no record of the investment. The bonds could be carried anywhere and sold, and the coupons snipped off to collect interest. This grand scheme was not only favoured by wealthy people, but the ordinary folk such as the legendary 'Belgian dentists' with a few thousand dollars to invest could buy bearer bonds at a local bank.

Most Australians have little need for dodgy schemes

Reading the book made me think about the use of such schemes in Australia. Few people would expect to go to a financial adviser in Australia and hear about dodgy schemes to evade tax. There's a good reason for this. We have plenty of ways to avoid paying tax that are completely legal and commonly used.

But it raises the question of where tax revenue will come from in future. The 2023 Intergenerational Report (IGR) has triggered a debate (again) about the future reliance on personal income tax to fund budget expenditures, and the burden this will place on future workers. Former Treasury Secretary Ken Henry called it an '*intergenerational tragedy*', adding in an ABC Radio interview:

> *"It's the young people who are going to be the workers of the future. People who are weighed down with HECS debt, who are going to have to repay a mountain of public debt, who are dealing with the consequences of climate change … who are facing diminishing prospects of ever being able to afford a home of their own. These poor buggers are also going to be the ones who are facing ever-increasing average rates of income tax."*

According to the Australian Bureau of Statistics (ABS), there are 4.1 million retired Australians, and they have at least as many children expecting to inherit their wealth. That's millions of voters with a vested interest in the current system. A recent speech at the Press Club by Treasurer Jim Chalmers shows he recognises the problem although he avoids any meaningful policies to support his ambition.

> *"In fact, around 40% of the projected increase in spending that's outlined in the IGR is due to us getting older. Here, at this generational fork in the road, we can shape the future on our terms. We can turn these turbulent twenties into the right kind of defining decade."*

Given the outcry about the strain on future generations, what are some common ways Australians avoid tax which might demonstrate why the Government is reluctant to make major changes?

(Tax 'evasion' means concealing income or information from tax authorities whereas tax 'avoidance' is legally reducing tax).

10 common ways to avoid tax

Millions of Australians are well-practiced at avoiding tax. It's almost a national pastime. These techniques are not complex derivatives, offshore companies, special purpose vehicles or money hidden in the Cayman Islands. These are not only legal but part of every financial advisers' kitbag.

1. Invest through superannuation

According to the IGR, total superannuation balances will grow from 116% of GDP in 2022-23 to 218% by 2062-63, as shown below. Despite the ageing of the population, the vast majority of assets will continue in the accumulation phase, but assets in tax-free pensions will reach two-thirds of GDP from the current 28%, an increase of 129%. Accumulation assets will increase by a more modest 75%. That's more money paying less tax.

Mode	% of GDP 2022-23	% of GDP 2062-63	Change
Accumulation	87.4	153.0	+75.1%
Pension	28.2	64.6	+129.1%

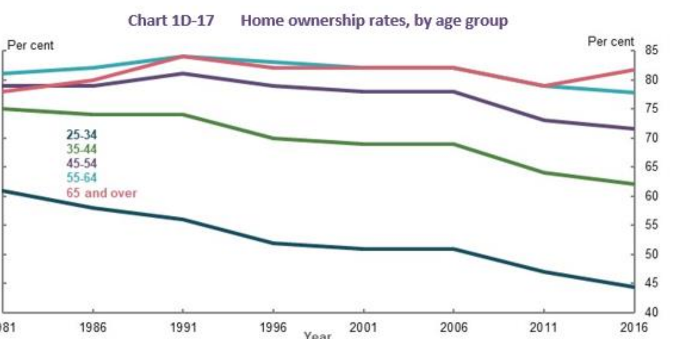
Future assets in retirement phase are significantly higher as the system matures and more Australians will have received the Superannuation Guarantee for most of their careers, rising to 12% from 1 July 2025. The proportion of people drawing a superannuation pension will increase from 8% to 19% of the population over the next 40 years.

Despite numerous rule changes, the current Transfer Balance Cap is $1.9 million per person, expected to rise to over $2 million at the next indexed increase on 1 July 2024. So a couple can soon hold over $4 million in assets in a tax-free pension. Assuming it is simply placed in term deposits at 5%, that's $200,000 a year tax free.

For people too young to be eligible for a superannuation pension, the system offers many ways to avoid or reduce tax, such as salary sacrifice, spouse and co-contributions.

2. Leverage into the family home

It's the sacred cow, the place where most Australians have accumulated their tax-free wealth through high leverage. And the older a person, the more likely they are to own their own home. The chart below from the Retirement Income Review shows home ownership for people aged 65 and over is higher now than 40 years at about 82%, while it is significantly lower for people aged 24 to 34 years.



Note: Per cent of occupied private dwellings. Age refers to age of household reference person. Excludes households with tenure type not stated. Source: (Daley, et al., 2018a).

In addition to avoiding tax on the sale of their biggest asset, the family home is excluded from social security tests such as eligibility for the age pension.

Who needs a Caribbean tax haven when they live in and own a piece of Australian residential real estate? The tax treatment is the main reason why Australians have the most expensive houses in the world after Hong Kong. According to Demographia, Sydney is the second least-affordable housing market in the world, ranking 93rd in affordability out of 94 markets.

3. Earn tax-free income outside super

The general tax-free threshold for Australian residents is $18,200. However, a combination of the Low Income Tax Offset and the Seniors and Pensioners Tax Offset pushes the effective tax-free threshold to $29,783 a person. A couple can earn $59,566 outside superannuation and pay no tax.

Many older people should consider moving their investments out of super to avoid the so-called 'death tax' payable when superannuation is inherited by a non-dependant.

4. Pass wealth to the kids

There are no inheritance or death taxes in Australia, and beneficiaries do not need to pay tax on money received as part of a will. In many other countries, inheritance taxes are major estate planning factors. Generally, capital gains tax (CGT) does not apply when a dwelling is inherited, but it may apply later when the property is sold. An inherited property may retain its principal place of residence status, but this depends on the treatment by the deceased and beneficiary. There is an exemption from CGT if a property was the main residence of the deceased and it is sold by the beneficiary within two years or acquired before September 1985. There are conditions allowing the extension of this two-year rule.

There is a super 'death tax' when the taxable component of superannuation is inherited by a non-dependant, taxed at 15% plus the Medicare levy. While a spouse is always considered a dependant, adult children are not. The obvious way to avoid this tax is to withdraw the money from superannuation tax-free before death and leave it outside the superannuation system. Some people appoint an enduring power of attorney which permits the attorney to withdraw money in cases where someone loses capacity near death.

5. Receive franking credits

There is a lot of misunderstanding about franking credits, and a longer explanation is in this article called *Franking Credits Made Easy*.

There is a key change coming in the Stage 3 tax cuts which are expected from 1 July 2024. The 30% tax rate is legislated to apply for the $45,000 to $200,000 tax bracket.

Our tax system allows tax already paid by a company to be refunded to a shareholder. For example, if a company makes a profit of $100 and pays company tax of $30 at the 30% rate (smaller companies pay at 25%), the company may fully distribute the profit after tax of $70 by declaring franked dividends to shareholders. The ATO 'imputes' or 'credits' the tax paid by the company to each shareholder.

When shareholders complete their tax returns, they add the $70 of dividend to the $30 of franking to declare the $100 of taxable income. The $100 of company profit is then subject to personal marginal income tax rates. Up to the $200,000 threshold (or lower for smaller incomes), shareholders pay tax on the $100 at 30% and claim the $30 that was already paid by the company as a tax credit. The shareholder pays no additional tax when receiving a fully franked dividend.

6. Negative gear investments

The term 'negative gearing' is not mentioned in any tax legislation, but it is familiar to millions of Australians as a technique to manage or eliminate tax. Where expenses, including interest paid on borrowings, on an investment are greater than income earned on the investment, the loss can be charged against other income, such as salaries and wages. The asset does not need to be residential property but that is the most common personal use.

The Parliamentary Budget Office (PBO) estimates that the annual cost to the budget of housing investors claiming deductions against other income will exceed $20 billion a year by 2032.

7. Top up with insurance (investment) bonds

Investment or insurance bonds are offered by life insurance companies and are subject to company tax rules. Tax is payable at the company tax rate, and if the bond is held for at least 10 years, earnings are not included in the investor's tax return. These bonds are commonly used to pay for a child's education, often purchased by grandparents, with no need to record or declare the earnings if held for 10 years. While this investment is not strictly 'tax free', the individual holder does not need to pay tax. Previous articles provide more detail including tax treatment if withdrawn prior to 10 years.

8. Distribute income using family trusts

A family trust is a discretionary trust used to hold the wealth and assets of a family. A trust is a legal structure under which the trustee holds the legal title to investments for the benefit of other people, the beneficiaries. The trustee has the discretion to distribute to the beneficiaries who are usually members of the same family. Trust income distributed is taxed at the marginal income tax rate of the beneficiary. Generally, the trustee allocates more distribution to the family member with the lower marginal income tax rate, thereby reducing the tax paid on the trust income. This might include adult children who have no other income, or are below the income-free threshold, and therefore pay no tax.

9. Use favourable capital gains treatments

CGT is only incurred when an asset such as an investment property or shares is sold, giving the taxpayer more control over the timing of a liability than on personal taxable income. Capital gains are reported in the normal income tax return and any capital losses can offset the CGT. Another asset can be sold at a loss to offset a CGT liability and a CGT discount of 50% can be claimed for assets held more than a year.

The Australia Taxation Office is also generous in allowing taxpayers with a capital gain to select a favourable purchase price using several methods, including First In First Out (FIFO), Last in First Out (LIFO) and Average Cost. This discretion can significantly reduce the CGT liability.

Care should be taken with investments to ensure a capital gain is not converted to taxable income. For example, an investment in a managed fund in June that receives a distribution in July may be converting capital to taxable income. If the unit price is say $1.00 and then a 10 cent per unit distribution is made on 30 June, the unit price will fall to 90 cents at the beginning of July. The 10 cents will be taxable income in the hands of the unit holder.

In superannuation, it is possible to avoid CGT on an asset bought during the accumulation phase but sold after a switch to pension mode where no tax is payable. There are tips to doing this correctly as explained here.

There is also a lifetime exemption from CGT of $500,000 from the sale of an active small business.

10. Make donations to charity

Of course, nobody is proposing a change to the tax deduction of charitable giving, but no list of ways to reduce or avoid tax should overlook the most altruistic. A tax-deductible donation to an Australian Deductible Gift Recipient (DGR) is a simple way to reduce tax. Public and Private Ancillary Funds are structures that generate an immediate tax deduction with the donations made later. It requires a tax invoice and the correct status of the charity can be checked on the Australian Business Register here.

Keep it legal

In Australia, there are plenty of ways to avoid tax without incurring the wrath of the ATO or hiding money in a Caribbean island. However, given the revenue needs outlined in the IGR, and Treasurer Jim Chalmers' desire to "*shape the future on our terms*" and *"turn these turbulent twenties into the right kind of defining decade",* then at some point, tough decisions will be needed on many of the ways tax is collected and more importantly, not collected.

But for now, anyone using these opportunities should ensure every step is taken with full knowledge of the correct tax treatment or penalties may be imposed. The tax treatments outlined in this article are common but there are procedures to follow, and guidance from a tax professional is always beneficial.

Graham Hand is Editor-At-large for Firstlinks. This article is general information, not taxation or personal advice, and is based on an understanding of relevant legislation. Individuals should seek advice from a financial advisers or tax accountant before embarking on any of the strategies outlined in this article.

ASX stocks that have stood the test of time

James Gruber

People love new things, and investors are no different. Currently, investors are fixated on artificial intelligence. Before that it was electric vehicles. Further back it was cryptocurrency. And prior to that, it was software. New technologies are fast moving and grab media attention.

Less talked about are older technologies. These are slower moving, though have stood the test of time. Think of air conditioning or water filtration.

There's something to be said for valuing things which have endured. Because the longer something's lasted, the longer it's likely to last. It's proven that people know the product or service, and often depend on it.

For this reason, I like older businesses. These are businesses that have done something right to have lasted. They've proven stronger than competitors. They've probably applied a certain formula for years and decades. And they'll probably continue to apply that formula in future.

The Lindy effect

There's a term for the above and it's called the Lindy effect. The theory is that how long an idea or technology may last is correlated with how long it has already lasted. Put a different way, old things have better odds of getting older still than newer things.

The term was first invented by a media columnist before being taken on by statisticians, including Nassim Taleb, who popularized it. In his book, *Antifragile*, Taleb, said of the Lindy effect:

If a book has been in print for forty years, I can expect it to be in print for another forty years. But, and that is the main difference, if it survives another decade, then it will be expected to be in print another fifty years. This, simply, as a rule, tells you why things that have been around for a long time are not "aging" like persons, but "aging" in reverse. Every year that passes without extinction doubles the additional life expectancy. This is an indicator of some robustness. The robustness of an item is proportional to its life!"

Taleb elaborated further in his later book, *Skin in the Game*, where he linked the Lindy effect to fragility. For Taleb, "time is equivalent to disorder, and resistance to the ravages of time, that is, what we gloriously call

survival, is the ability to handle disorder". And "things that have survived are hinting to us *ex post* that they have some robustness".

Market application

On this point, I remember getting an odd request when I was an equities analyst at a stockbroker in Asia. One of the more successful funds in the region at that time, First State, was a large client of my firm, and they requested analysts provide them with annual write-ups on the histories of 20 nominated companies.

First State didn't just want things you could get from Google. It wanted anecdotes, background on leaders past and present, and insights into company culture.

First State may have heard of the Lindy effect because they were one of the few investment firms that valued the history of companies, and wanted to learn what made them tick over long periods of time.

Some of the oldest companies on the ASX

In the spirit of valuing enduring businesses, here's a list of some of the oldest companies listed on the ASX. Note that the youngest company on the list is 95 years old, and the oldest has lasted 206 years.

AGL (ASX:AGL)

This company was formed in 1837 to light up the town of Sydney via gas. It was the second company to list on the Sydney Stock Exchange, initially as the Australian Gas Light Company in 1871.

Now it's the largest generator and seller of electricity. There's been plenty of change of late after merging with Alinta and then demerging to create separate retail and infrastructure companies.

The company has had recent challenges with the moves toward net-zero climate emissions, though it remains a premier energy provider and it's likely to remain that way for a long time to come.

Washington H. Soul Pattison (ASX:SOL)

This investment company began life as a pharmacy in 1872. It's then that Caleb Soul opened the chemist in Pitt Street, Sydney. In 1886, Lewy Pattinson opened a pharmacy in Balmain. Caleb and Lewy became friends and in 1902, Washington Soul bought out Pattinson and a year later, listed on the Sydney Stock Exchange.

Today, the company has a diverse portfolio of assets across many industries. Amazingly, it's managed to pay a dividend in every year since listing. And SOL has rewarded patient shareholders handsomely for many decades.

ANZ (ASX:ANZ)

The Australia and New Zealand Banking Group Limited (ANZ) dates back to 1835. Its current corporate structure was set up in 1970 when ANZ merged with the English, Scottish and Australian Bank (ES&A). It was the largest bank merger in Australia's history at that time. ANZ itself was formed in 1951 as the result of a merger of the Bank of Australasia and the Union Bank of Australia – and these banks' histories go back to 1835 and 1837 respectively.

ANZ is now the second largest Australian bank by assets.

Australian Foundation Investment Company (ASX:AFI)

AFIC dates back to 1928. The company is now the largest Listed Investment Company (LIC) in Australia. It's attracted a large group of investors due to its conservative investment approach and ability to consistently grow income and dividends.

Westpac (ASX:WBC)

Westpac calls itself Australia's oldest bank. It started as the Bank of New South Wales in 1817. In 1956, it was granted a license to operate as a retail bank, meaning it could pay interest on savings deposits. In 1982, it merged with the Commercial Bank of Australia. And in that year, the company changed its name to Westpac. A decade later in 1992, Westpac lost $2 billion and was raided by Kerry Packer as it fought for survival.

Today, the bank is comfortably ensconced in the banking oligopoly which is unlikely to change in the decades ahead.

BHP (ASX:BHP)

It's hard to believe but BHP began life as Broken Hill Proprietary in 1885. It owned a single silver, zinc, and lead mine in the outback. BHP merged with Billiton in 2001. Billiton began with a tin mine in what's now Indonesia in 1851.

In 2015, the company decided to spin off assets mostly belonging to Billiton into South 32. And the Billiton part of the name was dropped two years later.

Today, BHP is the world's largest mining company by market capitalization.

Equity Trustees (ASX:EQT)

This company is embedded in the Melbourne establishment. The walls of its headquarters are decorated with portraits of former Prime Ministers, Premiers, and Governors-General who've served on its board. Former Prime Ministers Robert Menzies and Stanley Bruce were once on the board.

Throughout much of its history, Equity Trustees has offered estate planning services to the wealthy. Yet that's changed of late as the company has become a leading player in the superannuation trusteeship sector. It now has more than $150 billion in funds under management, administration, and supervision.

Whitefield (ASX:WHF)

This company is an LIC with a difference. It only invests in industrial companies, therefore stays away from resources.

Initially, the company invested in mortgages, taking advantage of a resurgent housing market during the 1920s. But with the Great Depression, and then price controls on house prices and rents during World War Two, Whitefield pivoted to investing in companies that would benefit from growth in the broad industrial economy. That's how the investment strategy evolved towards owning a diversified portfolio of Australian share for long-term wealth creation.

Rio Tinto (ASX:RIO)

The company was founded in 1873 when a group of investors bought a mine on the Rio Tinto, in Huelva, Spain from the Spanish Government. It's grown through a long history of mergers and acquisitions. Today, it's the world's second largest materials company and not only focuses on mining but refining, especially iron ore and bauxite. It's dual listed on both the London Stock Exchange and ASX.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au. This article is general information.

Investing for generations

Joachim Klement

Some time ago, a reader suggested I should do a post on investing for immortals. This was triggered by the prediction of one futurist that by 2030, nanobots will help humans become immortal. I doubt that humans will become immortal by then, but the question is an interesting one to ponder. So here we go.

The investment community has thought about ultra-long-term investing for a long time. Endowments and Sovereign Wealth Funds have an expected life of hundreds of years, so for them, intergenerational investing is a real issue. And the solutions we have come up with are things like the Endowment Portfolio that makes use of the risk premia achievable in alternative and illiquid asset classes. Other famous approaches are Harry Browne's Permanent Portfolio and the All-Weather Portfolio of Bridgewater.

Constructing a portfolio for immortals

But let's assume I was immortal. How would I go about constructing an investment portfolio?

Most importantly, I would go back to first principles wherever possible. And the most important one of them is to not make forecasts, or to make only very limited forecasts.

Think about how bad our forecasts are for the near future. Now think about how badly wrong we are going to be in the long run if these small mistakes don't cancel out but accumulate and reinforce them. Think back 100

or 1,000 years and the world people lived in then. For them, our world today would have been completely unfathomable. Similarly, it is impossible to forecast how our world will look like in 100 or 1,000 years. Whatever forecast we make is going to be way off, which is why I have made it a habit to ignore futurists and their predictions.

Yet, the task we have is to figure out how to invest for that time frame.

And this is where the Copernican Principle comes in. I have written a post explaining this important but not well-known concept in some detail. But the short version is that if you want to know how long something will be around before it ceases to exist, a good starting point is to assume that you are witnessing it at a random point in time. You are much less likely to encounter something at the beginning of your life or at the end of your life than somewhere in the middle. In other words, you are not special in the sense that right now, right here, you witness the beginning of a new era (say with cryptocurrencies as a new form of money that will replace all other forms of money in the future) or the end of an era (say with the end of economic progress and the beginning of a no growth world).

If you think through all that (and in the article linked above I do just that) you find that things that have been around for a very long time are much more likely to be around for much longer into the distant future than things that only have been around for a few years or decades.

Key guidelines for the portfolio

Combining the Copernican Principle with only very defensive forecasts leads me to the following guiding principles for my investments:

1. Bet on humans being humans. Any investment that exploits behavioural biases and mental shortcuts is likely to work not just today and tomorrow but as long as humans are around. Yes, it is possible that technologies will make us more rational over time or eliminate the influence of human biases but even with AI, it seems that it is exhibiting similar biases as humans do.

The two investment techniques that I think are almost entirely based on exploiting human biases to their advantage are momentum investing and value investing. Coincidentally, these are also the two investment styles that seem to be much more robust against data mining than all the other factors that have been described. Yes, there is increasing evidence that value investing does not work in a low interest rate world or has stopped working for some other reason, but because I want to be very defensive, I will give value the benefit of the doubt and use value and momentum as my two ways to manage the portfolio. I think momentum is going to work because people will always be greedy and try to jump onto investments that have gone up in the past, hoping that they will continue to go up in the future. And value is going to work because when assets have been dropping in value a lot, most people will be fearful of these assets, providing opportunities to investors willing to pick up good investments at bargain prices.

2. I will rely on the forecast that technological progress will never stop. No matter what problem we face, humans will find a solution. That, in my view, is a pretty easy forecast to make because if we ever encounter an existential problem that we can't solve then – well – so much for immortality. Thus, I am not going to invest for a world after the nuclear holocaust or a world where we won't find a way to cope with climate change, or where AI kills us all. That would be pointless. Instead, I assume that being immortal implies that I am not going to die of natural causes, but it is still possible to kill me by shooting me with a gun.

But if I believe in technological progress to continue, then I want to invest in human creativity which is the driving force behind technological progress. And the simplest (and in my view best) way to do that is to invest in businesses. Hence, I do want to invest in listed equity and private equity. This way, I become a part owner of the business and benefit from the ingenuity of the people who work at these businesses and solve the challenges of the day.

3. I want to invest in stuff that I can use as a medium of exchange that is liquid and relatively safe. Being immortal does not mean that I will be alone. I will always have to rely on other people to get food, shelter, and other stuff. So, I need 'money' and liquid assets I can tap into whenever there is an unexpected need for cash.

This one is where the Copernican Principle helps a lot. The longest existing forms of 'money' are gold and cash issued by governments. So, I want to hold a diversified collection of gold and a variety of cash in different currencies. But because I have no idea if the Dollar or gold will survive or the Chinese Renminbi, etc. I will simply make no forecast on any specific form of money and hold each in equal measure.

And I think that's about it.

In the end, it seems I would essentially invest in listed equity, private equity, and 'cash'. And because I cannot predict which one is going to perform better or worse, I would put the same amount of money in each of these three buckets.

Within equities, I would probably split it 50/50 into a value and a momentum portfolio and within each of these portfolios, I would hold equal amounts in each stock. Within private equity, I would invest in as many different businesses as I can and put the same amount of money in each investment, just like I would put the same amount of money into each currency and gold.

But some investments would not be part of my portfolio for immortals: bonds, real estate, hedge funds, art, crypto, etc.

The reason for all of these is pretty much the same. I don't know if they will still be around in a couple of hundred or thousand years. We might no longer need houses or buildings to live in and all forms of bonds and loans may long have been eaten by inflation or abolished in favour of other forms of financing. And crypto? Well, come back in a couple of thousand years to discuss that.

Joachim Klement is an investment strategist based in London. This article contains the opinion of the author. As such, it should not be construed as investment advice, nor do the opinions expressed necessarily reflect the views of the author's employer. Republished with permission from Klement on Investing.

A different approach to equity income investing

Graham Hand with Rudi Minbatiwala

Rudi Minbatiwala has managed the Equity Income Fund at First Sentier Investors since its inception in 2005. With his team, Rudi has developed a novel way to generate income from Australian equities.

Graham Hand (GH): You've spent a couple of decades developing your Equity Income strategy. How would you describe it?

Rudi Minbatiwala (RM): We use the label 'objectives-based' to address the needs and challenges of income-seeking investors. This group is the typical pre-retirees or retirees, and their objectives are not only maximising returns. They're thinking about a mix of good returns, with lower volatility and of course, income. There are multiple objectives and a conflict between objectives.

Our belief is that maximising income from Australian shares requires investing in companies that can grow earnings and dividends over the long term. But income is not viewed with a long-term lens, it's a here-and-now problem. So we need to address the income and lower volatility needs as well. And our approach is selectively using call options to generate a greater proportion of the return as income. This equity income approach is called a 'buy-write' or a 'covered call' strategy.

GH: Can you explain how your approach differs from other equity income funds?

RM: The traditional approach tilts to buying high-yield, dividend-paying stocks. But I come from a fundamental analysis background which requires a broad range of inputs as part of comprehensive stock research. I struggled with investing based on one factor which throws out all the value from the research effort. And in the last 18 or so years, equity income and the better ways of doing it have become my life.

GH: Let's make sure everyone understands 'buy-write' or 'covered call', which I describe as selling call options over an existing portfolio. And a call option is giving someone the right to buy a stock at a set price and your fund sells call options to generate income.

RM: So the starting point is building the underlying stock portfolio, but in all the years of our Equity Income Fund, there's only been one month where our portfolio's dividend yield - ignoring the options premiums received - has been higher than the market. Think about that for an equity income fund.

GH: Yeah, that's unusual.

RM: It's about building the best ideas portfolio. We think the usual approach is misleading. The dividend yield is a short-term metric. It compares the current dividend to the current share price without thinking about how they change over time. We want exposure to future earnings growth of the best companies.

GH: Not just the highest-yielding companies.

RM: And the benefits come back to us over time in the form of (hopefully) growing dividends and some eventual reflection in a growing share price. The percentage yield can look low for years, but the dollar value of income can be growing really healthily. It requires a long-term perspective to income. And this is where the buy-write strategy comes in. We can't just say to our investors, think about income with a long-term lens. They need the income here and now. And so, the role of the options is to provide a bridge that allows us to focus on the best stock ideas. If it's got yield, great. If it doesn't, it doesn't matter either. The options provide the additional level of income and a downside cushion of lower volatility. And that's how we go back to achieving that mix of objectives mentioned at the start.

GH: I want to make sure that people understand the selling call options part. Can you give a stock example?

RM: Here’s a recent one. James Hardie (ASX:JHX) is a stock with attractive investment opportunities but it's decided to keep capital and reinvest it in the business. So, now it's a non-dividend paying stock. Typical equity income investors would just push that one to the side, but we like the upside potential. When its results came out recently, the stock responded, and then we thought the stock was more fully valued. We still like James Hardie, so we want to keep a position in that stock, but there's an opportunity to cap some of the potential upside in return for income.

Let me bring this example to life with some numbers. James Hardie was trading at $46.57 on 8 August when we agreed to sell a JHX Call Option with a strike price of $51.22 and expiry date of 11 October on a proportion of our JHX shares (at this time, 26% of our holding). In our assessment, capping the *potential* share price upside to 10% over the next 64 days was attractive given we were compensated with a *certain* upfront option premium income of 56 cents per share (annualised yield 6.9%pa). And that income is generated if the share price stays flat, goes up a little bit or even goes down. That's the balancing act.

GH: Whether that example plays out remains to be seen. Have you got an example of something that you did maybe 10 years ago, which was a low-yielding stock, not traditionally held by equity income funds, but you liked the capital gain potential of it?

RM: A great example is Realestate.com. Again, it's a stock that has been ignored by most equity income investors because it's only ever had a yield in the 1% to 2% range for a 14-year period. But it offered a 2% yield 14 years ago on a share price of $10 or $15, and then it became a 2% yield on a stock trading at $20 to $40, and now it's a 2% yield trading on a price of $140.

Along the way, like any active manager, we'll take some profits to reflect our fundamental views. Perhaps we sell an option to cap some of the future potential upside as we go along, convert that into income, and our job is to change the degree to which we use options on each stock.

GH: You've also said that your equity income fund can replicate the market risk characteristics of a traditional 70-30 portfolio. Now that's a big call for an equity income fund. How do you justify that?

RM: The 70-30 concept, 70% equities-30% cash, is often used to de-risk away from 100% allocation to equities. But the problem is that the de-risking also delivers a similar reduction in expected returns. It potentially addresses a risk objective but at the expense of achieving the other two objectives of long-term returns and income. We use the options to reduce the short-term exposure to the market by around 30%. It hovers over time at 20% to 40%, but on average, it's in that ballpark of around 30%. So our Equity Income Fund lags in rising markets and cushions a falling markets, similar to a 70-30 portfolio.

GH: That’s because you sold call options. If the market runs strongly, the counterparty exercises the call option, their right to buy, and your fund loses something off the top.

RM: Yes. But in other times, if the markets were weak, flat, or just going up a little bit, we've earned that premium. The big difference is our equity income approach remains fully invested in shares, like a long-only portfolio, which means that over the full market cycle, we expect full capture of what is called the equity return. What comes off in a strong market is made back on the other side. The value add is delivering similar returns to the market but with less risk. And that’s what pre-retirees and retirees want, rather than just higher fund returns than the benchmark, which is more of an accumulation-centric mindset.

GH: Why does the more traditional approach of chasing high-yielding stocks dominate equity income investing?

RM: I can understand why individual investors do the high-yield concept themselves. The strategy I'm talking about is a lot more challenging to implement. Individual investors don't receive the same over-the-counter pricing benefits that we do as a large investor. And the media is attracted to simple stories. We acknowledge our approach is more complex, but that's only because the things that retirees are looking to achieve, a balance of different objectives, different timeframes, conflict between objectives, that's more complex too.

GH: Another way we tend to talk about market performance for simplicity reasons is before-tax returns without factoring in tax benefits, such as franking credits.

RM: We think about after-tax returns with the combination of capital growth, dividends, as well as the franking credit benefits. Franking credits are valuable, but they need to be considered as just one of the components towards maximising after-tax returns. After-tax returns are not simply about maximising franking credits. We value franking credits, we capture them, but they don't become the sole basis upon which we buy stocks.

Let me come back to selling an option above the current share price. It reflects our view on a value of the stock. And if it goes up, well, that's where we are comfortable to reduce some of our positioning at that price. So it's no different to any other active investor thinking about managing their sell discipline. And we also avoid those companies who keep paying a dividend even if they raise new capital to afford it.

GH: Are your investors puzzled by an equity income fund holding stocks with a yield lower than the overall market?

RM: We own Realestate.com, James Hardie, Xero, Wisetech - all the names not usually in an equity income fund, but the combination of stock and options delivers a lower volatility with the aim of delivering a higher income yield after the addition of the option premium income. I'm not telling a 65-year-old to change their ways, to take on more risk. It goes back to the start of our discussion. How do we best balance a combination of needs? It's not just to de-risk to manage more conservative needs. It's not just to throw everything into generating income. Most investors still need to think about longevity and inflation risk, or estate planning considerations that make an investment time horizon longer. Equities should remain a part of that thought process.

Graham Hand is Editor-At-Large for Firstlinks. Rudi Minbatiwala is Head of Equity Income at First Sentier Investors, a sponsor of Firstlinks. This article is intended for general information only and does not consider the circumstances of any investor. It is an edited transcript of a full discussion on the Wealth of Experience podcast published soon.

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Is there still value in high dividend-yielding companies?

Shane Woldendorp

Investment returns can be roughly broken down into the sum of two components: growth and yield. When a business generates cash flow, it can be reinvested to produce future growth, paid out to shareholders, used to pay down debt, or some combination of the three.

The growth component can be extremely valuable if management allocates capital sensibly on behalf of shareholders. The downside is that future growth is inherently unpredictable and therefore difficult to value. The yield component, the hard cash in hand today, is more predictable and easier to measure relative to the price you pay for it (e.g. dividend or free cash flow yield). The disadvantage with yield is that shareholders need to be able to reinvest the cash wisely.

In 'normal' market environments, we tend to find mispriced investments across the spectrum—from businesses that reinvest close to 100% of their cash flow in an effort to grow, to those that have lower growth opportunities and therefore release more profits. Yet the current environment is somewhat unusual in that we have found more opportunities toward companies in the latter camp—those with high yields on excess cash, or more simply higher dividend yields.

High yield stocks appear to be attractive

We do not control the investment environment; we are price takers. We seek to own mispriced equities, and we are not dogmatic in our search for them. Terms like 'growth', 'value', or 'quality' are all just different fundamental characteristics that can be more or less attractive at a given price.

That said, we do find today's environment to be both fruitful for stock selection and perhaps even comforting in the sense that it comes with a relatively high degree of certainty, to the extent such a thing exists in investing.

Firstly, if a company is able to pay a high dividend that is well-covered by its free cash flow generation and able to keep pace with inflation over the long term, an investor doesn't need to do much forecasting in order to earn an attractive return.

Shares that offer well-covered 5-7% real dividend yields are not typically common, but we have found more than a few of them in today's environment. To put this in perspective, international equities have returned just over 6% per annum (in US dollars) since 1990, a return stream that has been accompanied by considerably greater risk and uncertainty.

Secondly, there has historically been a strong tailwind behind shares of businesses with above average dividend yields. If you invested $100 in an equal-weighted basket of international stocks in 1990, you'd have about $700 today. But if you only invested in the half of shares with the highest dividend yields, you'd have about $1,800! *A bird in the hand has been someway better than two in the bush*, and this has been especially true following periods in which 'yield' was on sale, as is the case today.

Emerging markets offer selected opportunities

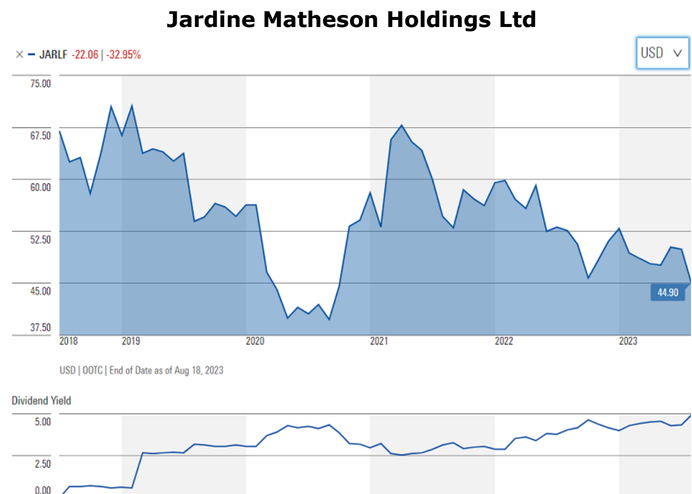
Whilst we have found yield opportunities across the globe, a few of our emerging market (EM) equities are worthy of discussion. Somewhat akin to the 'AI' moniker today, 'BRIC' economies (Brazil, Russia, India, China) were the darlings of the 2000s. The narrative turned out to be absolutely correct—economic growth rates were indeed impressive—but the rampant influx of capital from growth-hungry investors pushed BRIC valuations to extremes and set the stage for disappointing longer-term returns. Exciting narratives and satisfying investment results tend not to be happy bedfellows. Growth is fabulous only if you pay the right price for it.

Fast forward to today, and we would argue that the longer-term growth story in much of the developing world has not meaningfully changed. Countries like Indonesia have growing populations, growing productivity, and plenty of room for further development over the next few decades. Yet investor sentiment and capital flows have changed substantially. EM equities are now characterised by depressed valuation multiples and little interest from the large pools of global investment capital.

Investor apathy has a profound impact not only on the valuation multiples applied to EM equities, but also on the fundamentals of the businesses themselves. When valuations are low, it can be a signal to management teams that it's time to pay ample excess cash back to shareholders rather than reinvest aggressively in future growth. In EMs, one can still find a constructive blend of low valuations, high cash yields, and modest amounts of capital investing behind potentially solid and enduring growth opportunities. This is often a great setup for robust future investment returns.

A good illustration is Jardine Matheson (JM), a Hong Kong-based industrial conglomerate with holdings across Asia in property, autos, retail, finance, construction, restaurants, transport, hotels, and industrial equipment. Given JM's footprint in the region, the business carries substantial and diversified exposure to the continued growth and development of emerging Asia.

Jardine Matheson Holdings Ltd



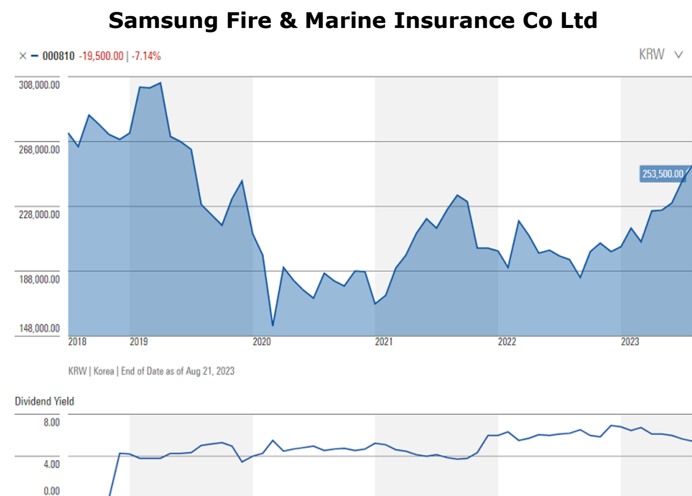
Source: Morningstar.com, as of Aug 18, 2023.

Like many Asian businesses, the company has struggled to grow over the last decade in part due to the hangover after the 2000s boom. Yet given the quality of its underlying assets, JM has still managed to grow dividends per share at a mid-single digit rate. We believe this growth rate should at least be maintained, but most likely

move higher going forward, assuming prudent capital allocation by management and continued recovery in some of its underlying markets. In addition to this growth, investors are paid a 4% dividend yield, and the shares trade at an approximately 40% discount to the underlying market value of its assets. The result is a solid and reasonable base case return with potential upside.

In South Korea, Samsung Fire & Marine Insurance (SF&M) provides another example of the possible value on offer in EMs. The company is South Korea's leading auto, property and casualty, and health insurer, but it owns a stake in Samsung Electronics that accounts for a large part of its market value. To put this in perspective, this valuation implies that its core insurance business is worth roughly the same as its #2 competitor, DB Insurance (DB), despite SF&M's superior profitability, higher underwriting quality, and more conservative accounting practices. Furthermore, SF&M's dividend has grown fourfold over the last decade, and now yields around 6%. Like most insurers globally, SF&M is starting to benefit from both a 'harder' market (i.e. the ability to charge higher premiums) and from higher reinvestment income as bond yields rise.

Samsung Fire & Marine Insurance Co Ltd



Source: Morningstar.com, as of Aug 21, 2023.

Besides generous dividend yields, a common theme uniting the examples discussed above might simply be that these companies are heavily out of favour. You're unlikely to hear much about Asian industrial conglomerates or South Korean insurance policies at a cocktail party. For value-oriented investors, that's usually an exciting setup.

Shane Woldendorp, Investment Specialist, Orbis Investments, a sponsor of Firstlinks. This article contains general information at a point in time and not personal financial or investment advice. It should not be used as a guide to invest or trade and does not take into account the specific investment objectives or financial situation of any particular person. The Orbis Funds may take a different view depending on facts and circumstances. For more articles and papers from Orbis, please click here.

Aged care and the Intergenerational Report

Assyat David

The Federal Government's 2023 Intergenerational Report features an ageing population and rising demand for aged care as key themes impacting our economy and society over the next 40 years. These trends reinforce the need for Australians to consider their aged care needs rather than wait for a crisis before becoming aware of their aged care options, how to access care, and the financial decisions that need to be made.

What the report says about aged care

The report singles out the care and support sector as one of the major growth sectors over the next 40 years. It estimates that those aged 85 years or older will triple during this time, and the care sector will need to accommodate the needs of these people.

The Government predicts that ongoing budget deficits will limit its ability to fully fund the increasing cost pressures of aged care. These increasing costs are likely to see people fund a greater portion of their care needs where they have the financial means to do so. Australians need to plan ahead for their aged care needs and consider the costs and financial decisions associated with accessing aged care support. Aged care considerations should be a key part of their retirement planning.

Australia's population is projected to grow from 26.5 million in 2022–23 to 40.5 million in 2062–63. The number of people aged 65 and over is expected to increase substantially and represent 23% of the population (around 1 in 4 people).

Longer life expectancies should result in Australians spending more years in full health. But on the flip side, we will also have an increased number of years in ill-health, which will accelerate government spending in health and aged care as well as the demand for aged care services and advice.

The average number of years that a person lives in ill-health has been steadily increasing in the last decades and this trend is expected to continue.

Chart 2.6 Male health-adjusted life expectancy at birth

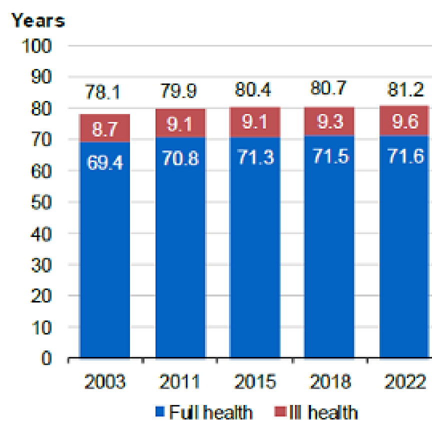
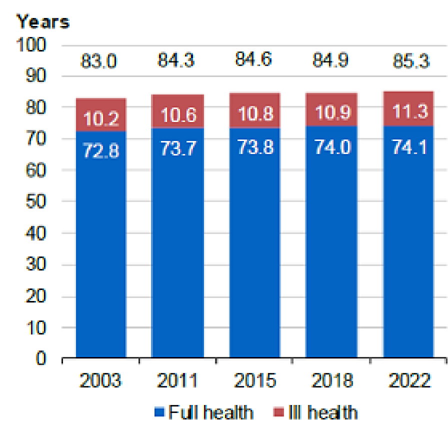


Chart 2.7 Female health-adjusted life expectancy at birth



Source: Australian Institute of Health and Welfare, Australian Burden of Disease Study 2022.

Funding for aged care

Most Australians who reach old age will need aged care services. The Australian Government provides funding for residential aged care and a range of community care – including home care – services.

The major aged care services subsidised by the Australian Government include:

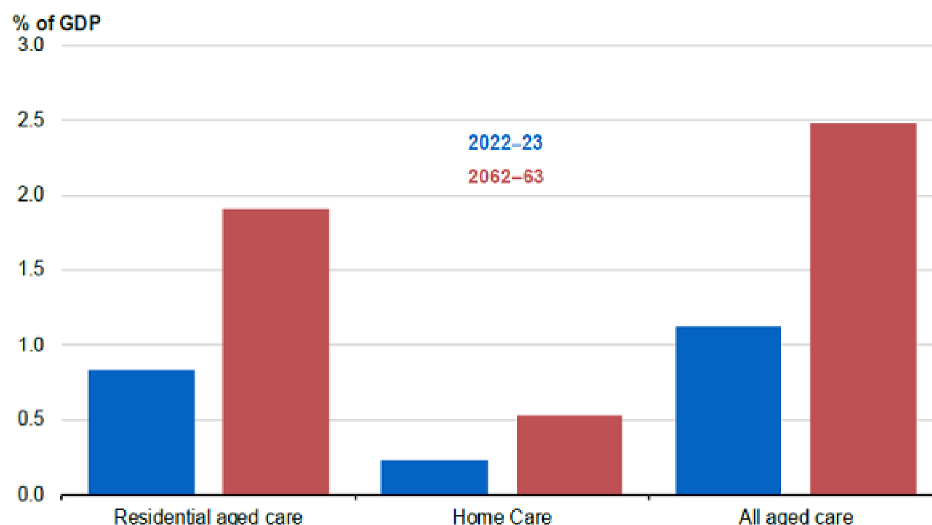
- Home support services through the Commonwealth Home Support Programme and Home Care Packages, and
- Residential aged care services that provide 24-hour care and accommodation for older people who are unable to continue living in their own home.

Currently, people aged 65 or older currently account for around 40 per cent of total Australian health expenditure, despite being about 16 per cent of the population.

Australian Government spending on aged care is projected to grow from 1.1% of GDP to 2.5% in 2062-63 with the older population accounting for around 70% of the projected increase in real spending on aged care per person.

Spending on residential aged care will increase the most although spending on community care should also rise significantly. Aged care spending per person will also increase.

Chart 7.14 Composition of Government aged care spending



Note: Residential aged care and home care are projected over the longer term based on ratio estimates based on historical data.

Source: Treasury.

Australians need to consider the aged care options and strategies for themselves as well as their family members, particularly where they have caring responsibilities for an older family member. People who hold enduring powers of attorney for an older family member and are responsible for making financial and health decisions for them need to ensure that they have the resources and support to make informed decisions.

Chart 7.15 Australian Government aged care spending as a share of GDP

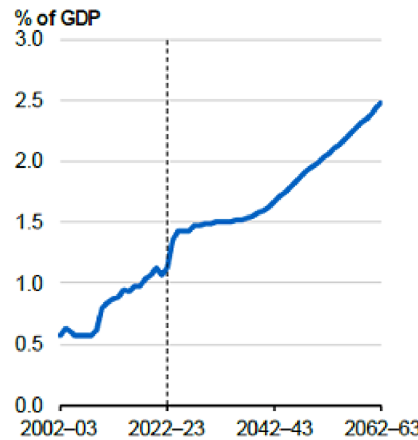
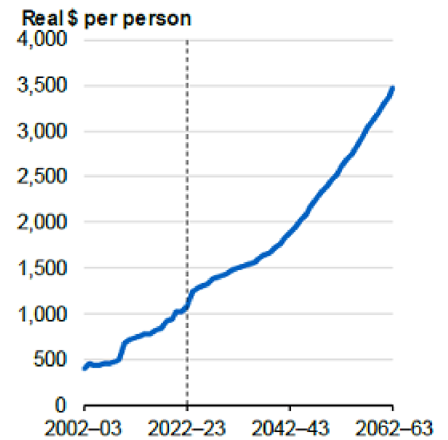


Chart 7.16 Real Australian Government aged care spending per person



Note: Real dollars per person refers to 2022–23 prices.
Source: Treasury.

Assyat David is a Director of [Aged Care Steps](). This article is based on the author's understanding of the relevant legislation at the time of writing. This information is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person.

How individuals can build a private markets portfolio

John O'Brien

It's becoming unavoidable. Private markets investors on average make more than public market investors, and the worldwide trend towards privatisation of everything makes it likely that this will continue to be the case.

The higher returns of private markets investments may be a product of private investors achieving disproportionately high returns while a company remains private, and using the public equity market to monetise these gains (at the expense of public market investors). This could lead to a future where an individual investor in public markets may find future returns increasingly squeezed downwards by private markets, whose returns are accordingly higher.

The object of this article is to develop a basic private markets portfolio plan for an individual investor, with a focus first on avoiding basic mistakes, or lemons. Because private market investments can have a fundamentally different liquidity profile from public market investments, they present more challenges. Most can be resolved using the same tools applied to public markets, but with alterations. These are shown below.

The allure of private markets funds

Table 1 shows the estimated annual returns and return ranges for the big four categories of private markets investments for Australian investors. The estimated data shows that private equity funds have the highest expected return and return range, property funds have the lowest, while private credit and unlisted infrastructure funds are in the middle.

Table 1: Expected Annual Returns and Variation in Private Markets Investments

Asset Type	Estimated Historical Return	Expected Long-Term Return (Net of Fees)	Listed Market Comparable Return	Private Market Standard Deviation	Est 1 Standard Deviation Low	Est 1 Standard Deviation High	Probability of Greater Than 8% Return
Private Equity	13.5%	12.0%	8.0%	18%	-5.0%	30.0%	59%
Private Credit	8.5%	8.0%	5.0%	11%	1.0%	19.0%	50%
Unlisted Infrastructure	10.5%	9.0%	7.0%	8%	1.0%	17.0%	55%
Unlisted Property	8.5%	8.0%	8.0%	7%	1.5%	14.5%	50%

Sources for private markets data: Click here.

The variation in private market returns is as important as the returns themselves. Table 1 also shows the return ranges based on one standard deviation from the expected return (i.e., two-thirds of the total return range), as a guide to what an investor in a limited-liquidity fund might expect. Even though the one-year return range for listed equities is much higher than for closed-end private market funds (MSCI World long-term annual volatility is 15%), the effect of private market fund volatility is more significant for a long-term investor, especially one with a limited number of investments. In simple terms, there are lemons in private markets investments, just as there are in individual stock and bond investments, but it is more difficult to avoid them in private markets.

Even a good manager may have one or more underperforming funds, and it is almost impossible to know in advance whether a fund will be a lemon.

Private markets and quasi-private markets investments

Both global and Australian private markets (where investors can buy and sell private assets off-exchange) are fast becoming a reality for individual investors. Investment in listed private market investments is one option. There are a growing number of listed investment companies and listed investment trusts that provide tradeable vehicles for private market investments. In Australia, however, these have generally tended to develop a discount to net asset value. They are also likely to have relatively high correlation with listed equity indices. Neither characteristic is ideal for a private markets investor. And while it is in theory possible that a group of investors in such listed private markets investments could seek to de-list the company and take control of the investments themselves, in most cases these are direct investments not in listed companies, but in long-term funds controlled by the investment managers themselves.

Investment selection and timing risk

Because listed private markets securities tend to develop a NAV discount over time, open or closed-end funds seem like a better option as investments. Obtaining investment access directly to funds whose actual value in most circumstances[1] corresponds with their market value is not as simple as buying a listed investment company's shares on an exchange.

Of the two options, open-ended funds are preferable for non-institutional investors due to their liquidity. Table 2 shows some anonymised sample investments that are available to wholesale investors in Australia. Each are semi-liquid, open-ended funds that provide periodic, limited liquidity to investors.

Table 2: Sample Private Markets Fund Available

Fund (Type)	Description	Minimum Investment	Expected Return (Gross)	Est Fee	Expected Return (Net)
Private Equity Fund	Fund of private equity funds*	A$25,000	11.7%	2.9%	8.8%
Private Credit Fund	Fund of private credit	A$100,000	9.5%	2.3%	7.2%
Infrastructure Fund	Fund of 4 infrastructure funds	A$20,000	10.5%	2.1%**	8.4%

**Also includes private credit, infrastructure, property, liquid strategies. **Includes estimate of underlying fund fees. Expected returns are grossed-up based on long-term net returns for each asset type.*

Ideally, a global and/or developed market fund is preferable. The funds shown in Table 2 are all global-focused funds that invest in offshore private assets. Long-term expected returns are higher than those of listed private markets funds, but have additional fee drag compared with the net returns available to institutional private market investors. Investors also give up some liquidity compared with listed private markets vehicles, with liquidity generally available only quarterly, and up to discretionary amounts.

Developing a portfolio plan

Once investment types have been selected, the next step is to choose actual investments.[2] Table 3 shows a dollar cost averaging portfolio plan for a new investor in private markets with a moderate risk tolerance. Dollar cost averaging historically has been applied to listed equity investing, but because of the illiquidity and variable fund performance of private markets, it is arguably even more applicable to private markets investing. As applied to private markets, this plan ideally means investing not only in different years, but also in different funds or instruments each year (including listed investments, if suitable open- or closed-end funds are not feasible), in order to increase diversification.

Alternatively, if an investor can identify suitable open-end funds for each strategy type, the plan could allocate to the same open-ended fund in each asset type gradually, similar to the way an active manager may incrementally allocate to specific stock investments. The portfolio plan below could have nine different investments, or it could have three investments, one of each asset type.

Table 3: A Private Markets Portfolio Plan

Type	Weight (%)	Expected Return (%)	Investment Year Allocation (Years 1-4) (20% Total)			
Private Equity	40	12	0	2	3	3
Private Credit	30	8	2	2	2	0
Infrastructure	30	9	2	2	2	0
Property	0	8	0	0	0	0
Investment Year Return (%)			8.5	9.2	9.5	9.9

Dollar cost averaging into a diversified private markets portfolio requires more planning than just making regular contributions to an equity portfolio, but it is the most sensible when faced with the multiple risks that private markets pose to ordinary investors. At its end point, a fully diversified private markets portfolio will tend towards the average return of each of its components, making it index-like. The diversification benefit more than compensates for an average return.

Horizon analysis

Because they have adverse selection risk and require fairly continuous vigilance, private markets investing is not easy: public market investing has the advantage of simplicity, and fees for most index investments continue to decline. But as most of the developed world continues to privatise with no end in sight, and more investments in private markets become available, ordinary investors should consider investing, as long as they can do so with a logical strategy. While historical and – if the privatisation trend continues – future investment returns are likely to be higher for private than public markets, return variability is also high, and in illiquid funds is a real threat to performance. With a systematic investing approach, an investor should be able to avoid, or at least significantly diminish, the risk of investing in private market lemons.

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[1] Secondary market values can also diverge from stated values, but unlike LICs or LITs they tend to close up over time, rather than expand.

[2] Again, assuming that more types of fund investments without NAV drag become available. Based on the rate of change this is likely.

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