Firstlinks
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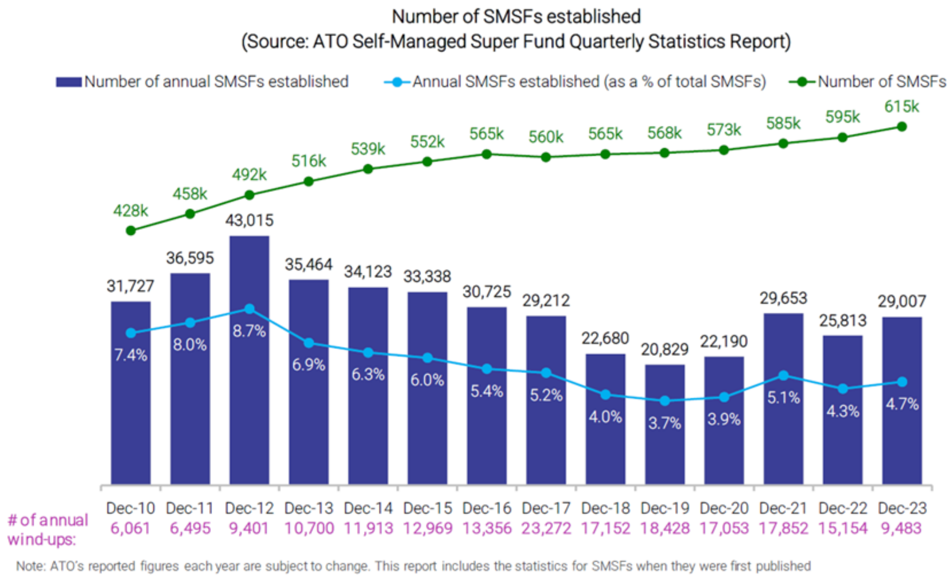
## Editorial

Vanguard and consultant, Investment Trends, have released their 11th annual SMSF Trustee report, and it gives a comprehensive snapshot of the latest trends in the sector.

Let’s go through them:

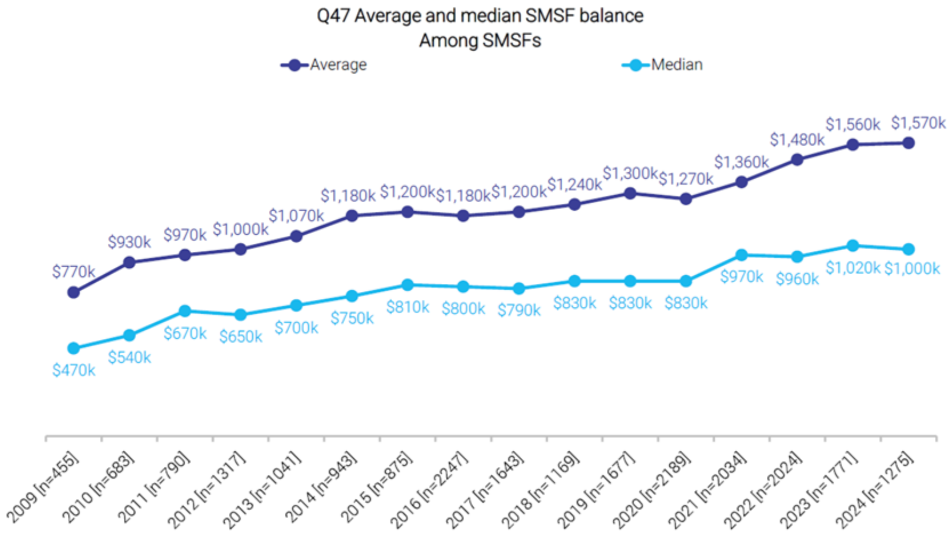
**By the numbers**

The overall number of SMSFs continues to rise. There are 615,000 SMSFs, after the establishment of more than 29,000 SMSFs in 2023, and only 9,483 closures.

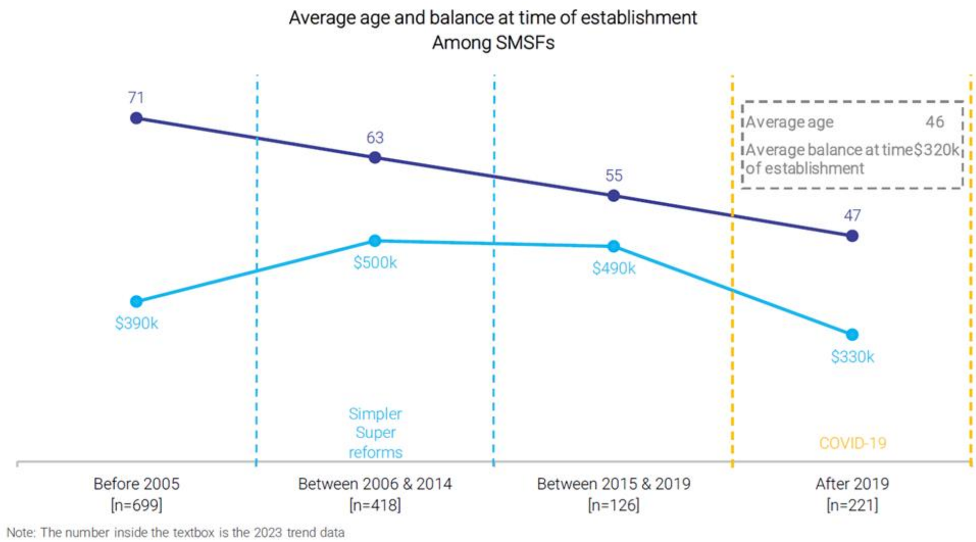



*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

SMSF average balances are at their highest levels at over $1.5 million, almost double what they were 15 years ago. The median balance is $1 million. Of those establishing new funds, they are 47 years old on average, with a balance of $330,000.

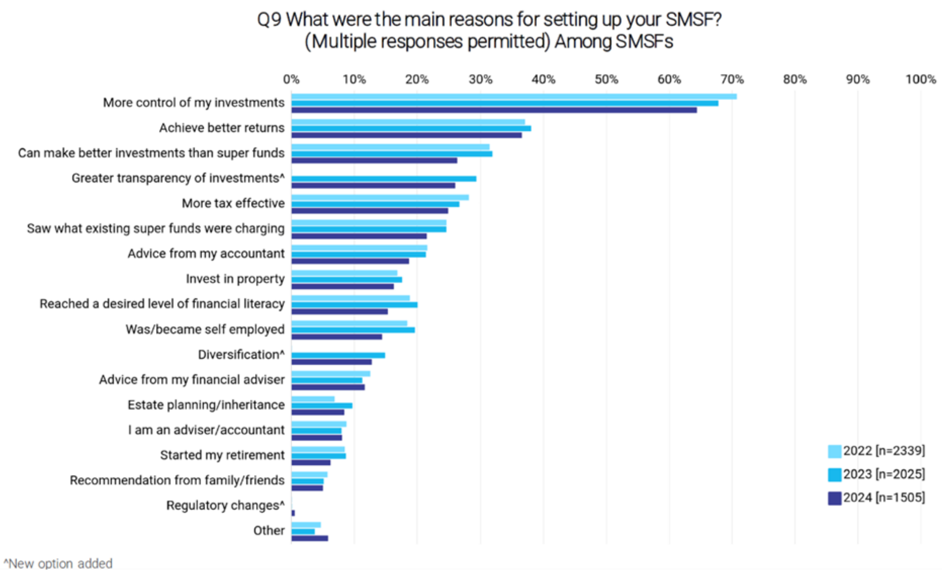



*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*




*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

The desire for control over investments continues to be the primary reason for establishing an SMSF.

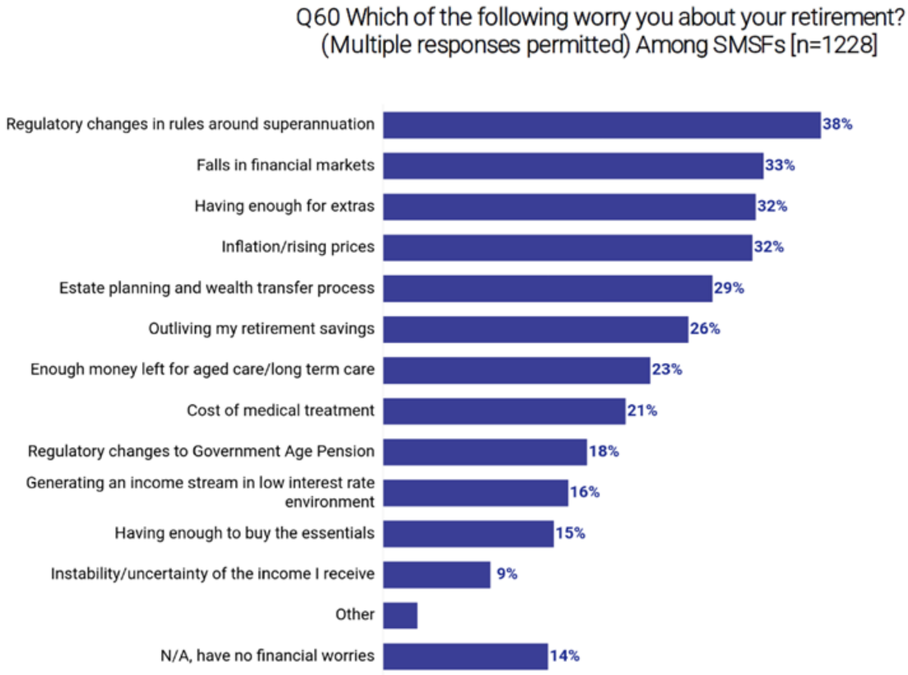



*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

Of the SMSFs surveyed, 36% intend to retire before they reach 60 years of age.

**Confidence in retirement**

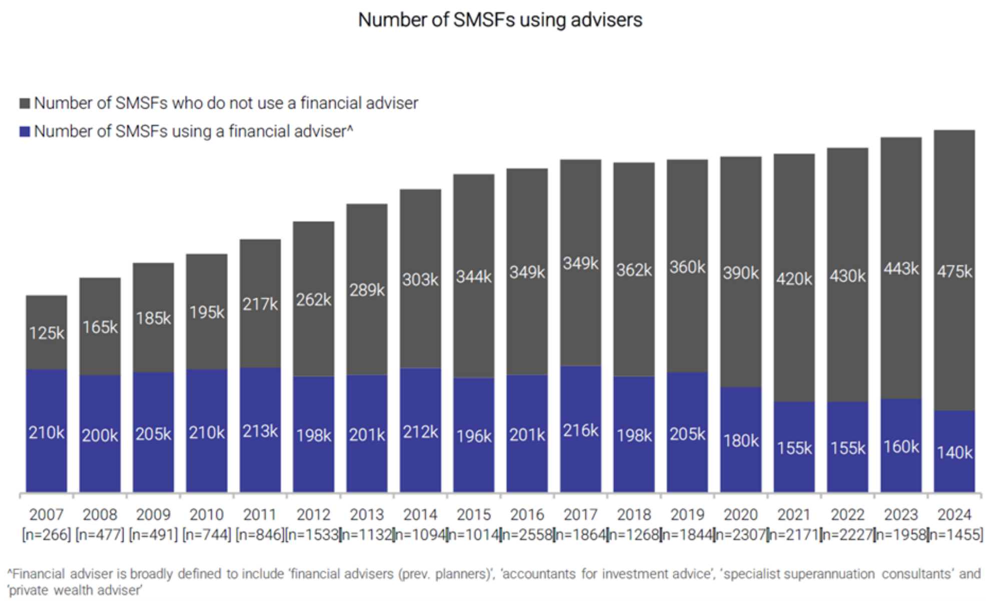
The report finds that SMSF members are far less concerned than those in super funds about the possibility of outliving their retirement savings. In fact, 34% of individuals in SMSFs are not concerned about this at all. Of SMSFs who are already retired, there's even less concern (47% of retirees vs 24% of non-retirees are not at all concerned). Instead, the biggest worries for SMSFs about retirement are regulatory changes in super rules, falls in markets, inflation, and having enough money for extra expenses.




*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

**Not keen on financial advisers**

Around 77%, or 475,000, of SMSFs do not use a financial adviser. The number using advisers peaked at 216,000 in 2017, but that's plummeted to just 140,000 today – a 35% drop over seven years. The report finds that newly established SMSFs are less likely to use advisers than established SMSFs.




*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

Furthermore, only a quarter of trustees without financial advisers are likely or very likely to seek financial advice in future.

The report says the top four reasons given for not seeking financial advice are:

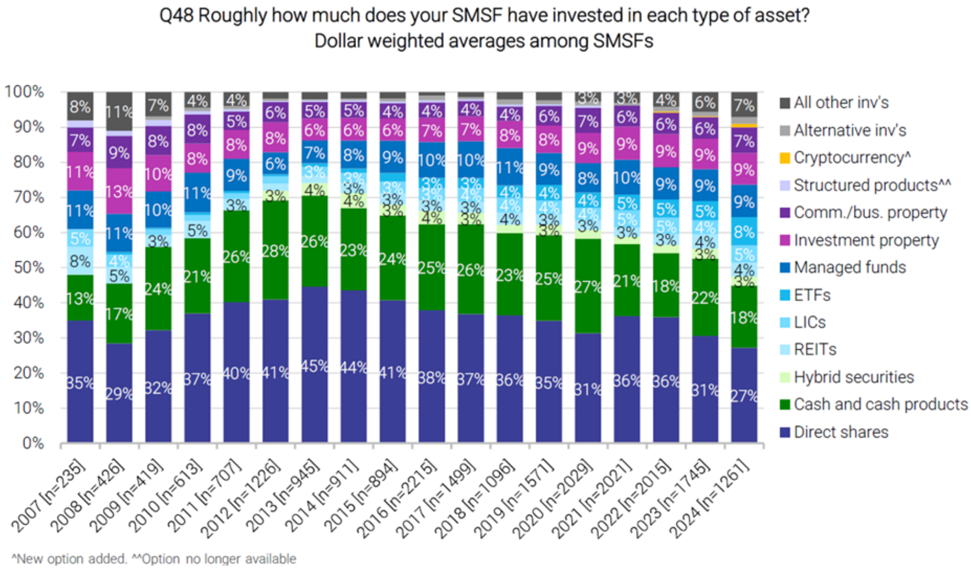
1. The ability to manage their own finances
2. The high cost of advisers
3. Not current needing advice
4. Poor previous experiences with advisers

So, where do SMSFs seek advice if they need it? Accountants remain the go-to advisers for established SMSFs. For new SMSFs, they consult with their SMSF administrators.

In terms of what advice that SMSFs would find helpful, tax and retirement strategies topped the list, followed by pension strategies and inheritance and estate planning.

**Asset allocation**

Last year, SMSFs reduced their cash and direct shareholdings and increased their use of ETFs. The percentage of cash holdings fell from 22% in 2022 down to 18% in 2023. Meanwhile, direct shareholdings decreased to 27% from 31% the prior year. ETFs as a percentage of total assets climbed from 5% to 8% in the 12 months to December last year. SMSFs now account for 13% of ETF investors.




*Source: Vanguard/Investment Trends 2024 SMSF Investor Report*

Observing longer term trends, direct share and cash holdings have fallen sharply from their peaks in 2013. They've been replaced with more ETFs, property, both residential and commercial, as well as Listed Investment Companies (LICs).

Interestingly, SMSFs seem to be using ETFs to both diversify their assets and gain greater exposure to international shares.

SMSF use of managed funds remains high at 9% of total assets. Over one-third of SMSFs have an allocation to managed funds.

**Gender differences**

For the first time, the report includes gender breakdowns. Female SMSF trustees have lower SMSF balances ($1.3 million vs $1.6 million) and annual incomes ($96,000 vs $122,000) compared to their male counterparts.

SMSF women trustees are more concerned about outliving their retirement savings – 3.3 on a scale of 10, vs 2.8 for men.

Female trustees also feel a greater need to improve their financial literacy and therefore are more likely to seek out education. To do this, they're primarily approaching accountants and SMSF administrators.

**James Gruber**

**In this week's edition...**

Two commonly asked questions are: 'How much do I need to retire' and 'How much can I afford to spend in retirement'? **Ashley Owen** says precise answers to these questions are difficult, but he provides an easy-to-understand guide to help you come up with your own numbers to suit your goals and needs.

Since the creation of compulsory superannuation in the 1990s, inflation hasn't been a notable issue, but the past two years has been a stark reminder of the impact inflation can have on the spending power of retirees. With another inflation uptick a risk, what are the best ways for retirees to protect their income from future inflation shocks? **Aaron Minney** gives his thoughts.

Bonds have had a prolonged bear market and their positive correlation to equities of late means they may not be the diversifier in portfolios that they once were. What are the alternatives to bonds, and where might there be value? **Schroders Group CIO Johanna Kyrklund** has some suggestions.

A *Firstlinks* article on April 17 on how public servants were demanding an exemption from the $3 million super tax provoked a lot of debate. It also caused some confusion, given the number of defined benefits schemes and their complexities. Today, we get a different view from **John Pauley** on how unfunded pension schemes may be treated unfairly compared to their funded counterparts under the new tax.

Investors are pouring into ETFs yet they may not be aware that there are tax advantages to these funds. **VanEck's** tax guru **Michael Brown** outlines two tax advantages to having ETF investments, plus a bonus perk if you're in a fund hedged to the Aussie dollar.

Healthcare is a niche property sector that's about to go mainstream. With ageing demographics set to boost demand for decades to come, institutions are investing a lot of money in the space. **Cromwell's Colin Mackay** identifies one specific area that is especially attractive.

On a lighter note, did you know you are far more likely to share genes with friends than non-friends? Or that the number of friends you have is correlated to the size of certain parts of your brain? These are the latest findings of psychologist, Robin Dunbar, who's most famous for inventing Dunbar's number, as **Joseph Taylor** explains.

Lastly, in this week's whitepaper, **Franklin Templeton** details recent trends in demographics around the globe and what they may mean for the future.

## How much do you need to retire comfortably?

### Ashley Owen

How do these 17 key drivers that determine how much you need to retire and how much you can afford to spend actually work, and how do they apply to you?

This guide will help you come up with your own Number that suits your needs and goals.

It is not intended to arrive at an exact number, as forecasting is never an exact science. It is intended to help readers understand the issues, assist in refining goals, trade-offs and priorities, and provide a starting point for discussions with family and professional advisers.

Let's get started …

In Part 1 - What's your Number? Part 1: 'How much do I need to retire?', 'How much can I afford to spend?' – I outlined the idea of everybody having a 'Number' to aim for, and I used some generic examples to illustrate the concept.

Part 2 outlines 17 key factors that can make a big difference in estimating what each person's own minimum required **Multiple** of Spending Budget, and their maximum **Safe Spending Rate**, given their individual circumstances.

For example, for the first factor – current age: taking two extreme examples - my 95-year-old mother needs a lot less capital (lower Multiple of her spending budget, and a higher Safe Spending Rate) than say a trust set up to support a 20-year-old disabled child for the rest of their lives, which may be many decades.

## Quick re-cap on Part 1

In Part 1, we looked at the two key questions:

- How much **capital** do I need to be able to finance a given spending budget (rising with inflation), with a good degree of confidence that I will not run out of money, ie that my money will last as long as I do, and with enough left over to satisfy my bequest goals (eg leave a financial legacy for my family and/or other causes). This is the minimum required **Multiple** of my spending budget, and

- Given the amount of capital I have (or are aiming for at retirement), how much I can safely afford to **spend** each year with a good degree of confidence that I will not run out of money, and that my money will last as long as I do, with enough left over to satisfy my bequest goals. This is maximum '**safe spending rate**' (or 'safe withdrawal rate'). The Safe Spending Rate is merely the 'reciprocal' of the required Multiple. For example, if the minimum required multiple is 20, the maximum safe spending rate = 1/20 = 5%.

- Other related questions like - '**How long** will my retirement savings last?', and '**When** can I afford to retire?' are driven by the same numbers.

## 'Retire? Me? Never!'

Even if, like me, you don't want to actually 'retire', but want the **freedom** to be able to scale back work or take an indefinite break, or donate your time to charity, or if you are prevented from working by health or family circumstances, it is useful to have an idea of how much capital will you need, and how much you can safely afford to spend given the capital you have.

NB.

'Capital' includes not just 'superannuation' fund balances, but also includes other investment assets excluding the family home, minus ALL debts, including any mortgage on the family home. You should also deduct large initial one-off expenses – like the 'big trip', or the house extension, or the 1965 Mustang you've always promised yourself.

The 'Spending Budget' can also vary over time – eg more in the early 'active' years, less in the middle 'quiet' years, then rising in the final years as medical and aged care expenses rise.

Part 1 also provided two quick tests to help readers see how far along on the journey they are now.

Those quick tests used a required multiple of 25 times the spending budget (ie a 4% 'Safe Spending Rate' on capital) because I have found over many years, and through many kinds of market conditions, that this is roughly where most people end up.

But you and I are not 'most people'!

The actual Multiple and Safe Spending Rate will be different for everyone – depending on their own circumstances, and it also depends on market conditions at the time.

## Wide range of possible outcomes

Depending on each person's individual circumstances, there can a wide range of outcomes. At one extreme, if you are happy to rely on the government age pension (currently around $28,000 per year for singles, and $22,000 each for couples), and if are sure that all of your other capital and income needs are going to be paid for by others, and/or by selling the family home, then your required capital base and multiple is Zero.

This is the most popular option in Australia. After more than 30 years of compulsory employer superannuation in Australia, the median superannuation balance of Australians aged between 60-64 is just $181,000 for males, and $139,000 for females. Up to half of all retirees use their super to pay off debts when they retire, and so two thirds of Aussie retirees just go on a government age pension!

One very popular 'retirement calculator' that is used by countless super funds on their websites is provided by the Association of Superannuation Funds of Australia (ASFA). On their numbers, a typical retired Australian couple aged 65-84 can enjoy a 'comfortable' retirement on an expense budget of $70,000 (December 2023 numbers), and they say this requires just $690,000 in capital.

That's a spending rate of **10%** (ie required capital is a multiple of 10 times spending budget). This, and almost all other online retirement calculators, assume you will be relying on the government age pension when your money runs out, and it assumes the government pension will remain in place in its current form and eligibility, and indexed, forever.

On the other hand, there are many cases where the minimum Multiple of spending budget is 30 or more, ie a maximum Safe Spending Rate of 3% or less.

**Table of 17 key factors**

Today's table (next page) outlines 17 important factors that can make a big difference in estimating 'How much do I need to retire?' (minimum required Multiple of Sending Budget), and 'How much can I afford to spend?' (maximum Safe Spending Rate), for each person given their individual circumstances.

For each factor, readers can select where they are on a scale from 1 to 5, with a mid-point of 3. Some are relatively easy (eg factor 1: Current Age), but other can be quite difficult to assess.

Some factors appear straightforward (eg Factor 12: Importance of not 'eating into capital'), but often requires a major re-think about goals and priorities once people realise how much more capital it requires in practice.

*Green and pink zones*

The green column describes the conditions that would require a **lower Multiple** of the spending budget and allows a **higher Safe Spending Rate** on capital. These apply to scores of 1 or 2 for the given factor.

The pink column describes the conditions that would require a **higher Multiple** of the spending budget, and a **lower Safe Spending Rate** on capital. These apply to scores of 4 or 5 for the given factor.

*Mid-point '3' on the scale*

Our starting point or 'base case' with a mid-point score of '3' is for a 65-year-old requiring a Multiple of spending budget of 25, ie a maximum Safe Spending Rate (or 'safe withdrawal rate') of 4% of capital.

Remember, this is just the starting point. Everybody will end up with a different Multiple and Safe Spending Rate depending on their scores on each factor (and everyone has a different Spending Budget to start with).

The aim of this exercise is not to arrive at an exact number for the Multiple and the Safe Spending Rate. There is no such thing as an exact number.

The aim is merely to outline the main factors that influence the outcome and provide users with a broad sense of whether they are likely to need more or less capital given their spending budget. It is intended as a starting point for discussions with family and professional advisers.

**Example - Factor 1: current age**

Starting with the easiest one - If you are currently 55 years old and you wish (or fear) never having to work for money ever again, you would circle '5' for this factor. (Life expectancy is dealt with in Factor 2).

A score of 5 is on the pink side of the table, indicating that your required minimum Multiple of your spending budget is probably going to be **higher** than 25 – ie your maximum Safe Spending Rate is probably going to be **lower** than 4% of capital. (Alternatively, you may need to re-assess your desired spending budget).

On the other hand, if you are currently 75 years old, you would circle '1' for this factor.

This is on the green side of the table, indicating that your required minimum Multiple of your spending budget is probably going to be **lower** than 25 – ie your maximum Safe Spending Rate is probably going to be **higher** than 4%.

How much higher or lower will depend very much on how you score on the other factors.

**Factor 2: likely life span**

Here you assess whether you are likely to live longer or shorter than actuarial life expectancy tables.

For example, if you are 65 years old now, you are projected to live to 85 (males) and 88 (females) according to official actuarial tables in Australia. We look at this in a separate story, but it worth noting here that if you think you are heathier, fitter, and more genetically blessed than average, you might give yourself a score of 4 or 5. In that case, your capital may need to last a lot longer than the life tables suggest.

## 17 Key Factors that drive the Multiple of spending budget, and Safe Spending Rate:

| Owen αnalytics® **Factor** ↓ | Need **LESS** capital for given spending budget / can spend **MORE** on current capital: ie - LOWER Multiple - HIGHER Safe Spending Rate | **1 – 5 scale** 3 = mid-point – use: 25 Multiple, 4% Safe Spending Rate | Need **MORE** capital for given spending budget / can spend **LESS** on current capital: ie - HIGHER Multiple - LOWER Safe Spending Rate |
|---|---|---|---|
| 1) Age now (or age of planned retirement) | 75 | 1 2 3 4 5 | 55 |
| 2) Likely life span | Likely to die earlier than median life tables – due to poor health, diet, fitness, genetics, lifestyle, dangerous hobbies | 1 2 3 4 5 | Likely to live longer than median life tables – due to good health, diet, fitness, genetics, lifestyle |
| 3) Willingness and ability to downsize family home or use equity in family home, or other assets to boost funds | Willing and able to downsize, sell equity, or reverse mortgage to free up capital | 1 2 3 4 5 | Not willing or not able to downsize, sell equity, or reverse mortgage to free up capital. |
| 4) Flexibility of Income – ability to increase income from other sources when required and for as long as necessary | High flexibility of income – can increase income from other sources when I need to (for many years if needed) | 1 2 3 4 5 | Low flexibility of income – cannot increase income from any other sources |
| 5) Flexibility of spending – ability to reduce, delay, or defer expenses when investment income is low | High flexibility – large part of spending budget is 'discretionary' items. I am willing and able to reduce, delay, or defer large portion of spending budget if I need to | 1 2 3 4 5 | Low flexibility – spending is mainly on essentials. Cannot reduce, delay, or defer much of the spending budget without hardship |
| 6) Irregular one-off spending, capital outflows (voluntary and involuntary, eg house repairs, replacement car, appliances, medical operations, etc) | Nil – I am certain I will have no irregular or unexpected spending or capital outflows (or certain they will be met by other assets / income sources) | 1 2 3 4 5 | Likely to have (or allows for) irregular or unexpected spending or capital outflows |
| 7) Withdrawal pattern per year | Withdrawals are a set **percentage** of the fund balance each year (eg 'min withdrawal rates', or some other specified % of fund) | 1 2 3 4 5 | Withdrawals are a set **$amount** each year (eg $spending budget) , rising for inflation, or rising by a specified margin each year |
| 8) Fees/cost drag on investments eg fund fees, platforms, portfolio admin, audit, accounting, valuations, ASIC, subscriptions, etc | Low fees – eg total fees below 0.20% of assets pa, eg with non-complex ETF-based portfolios, minimal advice & admin costs | 1 2 3 4 5 | High fees - eg total fees above 1% of assets pa, complex portfolios with complex products, high advice & admin costs |
| 9) Tax drag – on investment returns and income, based on what assets are held in what entities | Low-nil tax drag – tax-free investment returns and income eg Super 'pension' phase, discretionary trusts with tax-free beneficiaries | 1 2 3 4 5 | High tax drag – in company name, individual name, super 'Accumulation' phase |
| 10) Importance of leaving an estate eg family, society | Low importance – happy to run down capital + leave nothing for estate (for next generation or society) | 1 2 3 4 5 | High importance – want to maintain significant portion of assets for my estate (for next generation, society) |
| 11) Dependents and others are relying on your financial support | Nobody relying on your financial support, now or in the future | 1 2 3 4 5 | Have dependents or others relying on your financial support |
| 12) Importance of not 'eating into capital' (not selling down assets) to fund withdrawals | Low importance – happy to sell down assets to fund withdrawals. Assets easily divisible (eg no large 'lumpy' assets that can't be partly sold) | 1 2 3 4 5 | High importance – don't want to 'eat into capital' (sell down any assets), or have 'lumpy' assets that can't be partially sold (eg real estate) |
| 13) Importance of not having to rely on government age pension, government services – ie relying on the goodwill of future tax-payers and future governments | Low importance – happy to rely on government age pension and government services (two thirds of Aussies retirees are on gov age pension for life) | 1 2 3 4 5 | High importance – don't want to have to rely on government age pension and government services forever |
| 14) Risk Tolerance (tolerance of market volatility) – ability to sleep at night / completely ignore market volatility, turmoil, crashes, FOMO | High tolerance to volatility & turmoil – can relax and completely ignore scary headlines, never lured into FOMO fads | 1 2 3 4 5 | Low tolerance to volatility & turmoil – prone to panic sell in crashes, and/or chase high returns in bubbles, FOMO |
| 15) Your personal expense inflation (above or below CPI) | Expenses skewed toward items that rise by less than CPI | 1 2 3 4 5 | Expenses skewed toward items that rise by more than CPI |
| 16) Future inflationary environment over next decade or so | Low inflation - ie up to 2% pa. Future real returns on financial assets likely to be above historical average | 1 2 3 4 5 | High inflation – ie above 4% average. Future real returns on financial assets likely to be below historical average |
| 17) Current market pricing / valuations of financial asset markets | Low current pricing of markets- Future returns are likely to be above historical average | 1 2 3 4 5 | High current pricing of markets - Future returns are likely to be below historical average |

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It's a cruel curse, but your minimum Multiple of spending budget will be higher, and your maximum Safe Spending Rate will be lower. On the other hand, your good health may allow you to work longer and build up your capital base. You'll need it if you're going to live to 110!

Some of the factors require more detailed explanation and require a lot more modelling to demonstrate the impact on capital needs and spending rates.

We will look at each of the main factors in separate stories in this series, to assist in in self-assessment, and to assist in discussions with your family and your adviser.

**Two factors are already locked in**

Two of the factors are related to the market environment and apply to everybody, regardless of their individual circumstances. These are:

**Factor 16: Future inflation environment**

I would give this a score of 4 at the moment, and it applies to everybody. We are probably heading into an era of above average inflation for the next decade or so, and certainly higher average inflation than we have had over the recent couple of decades.

If this is the case, it will mean that it is highly likely that future real returns on financial assets (shares, bonds, real estate) are going to be below historical averages, and therefore the Multiples will be higher and the Safe Spending Rates will be lower.

**Factor 17: Current market pricing / valuations of financial asset markets**

This is the second market-related factor that is already locked in for everybody, regardless of their individual circumstances.

High current levels of pricing of financial asset markets (shares, bonds, real estate) mean that future real returns are also likely to be below historical averages. Therefore, this is another reason that Multiples will be higher and the Safe Spending Rates will be lower.

How does current market over-pricing affect how much capital I need?

If share markets are currently priced at say 50% above their underlying, fundamental, 'fair values' (measured by pricing relative to profits, dividends, book values, and a host of other valuation techniques), it means that, when you look at your index fund balance of say $500,000, you need to realise that it is not really 'worth' $500,000.

The underlying sustainable fair value is actually more like $333,000 ($500,000 / 1.5), and the over-pricing will soon evaporate – it always does. In fact, when over-priced market booms collapse, as they always do, they always swing too far, into cheap territory, when you can buy assets below fair value if you have the nerve.

So, it works both ways: in over-priced booms (like now), your fund statement **over**-states the actual underlying fundamental value of the assets you own, so if you are going to use the boom-time portfolio statements that over-state you actual net 'worth', you will need a **higher multiple** of your spending budget, and your Safe Spending Rate is going to be lower.

On the other hand, after a major market correction when assets fall below their fair values, your fund statements will **under**-state the actual underlying fundamental value of the assets you own, so you will need a **lower multiple** of your spending budget, and your Safe Spending Rate is going to be higher.

**Wrap-up**

Once you have assessed yourself against the 15 factors (Factors 16 and 17 are already locked in), you can form an opinion about whether your overall score is likely to be higher or lower than the mid-point score of 3 on our 1-5 scale, ie whether your multiple of spending budget is going to be higher or lower than our reference point of 25.

You can take your estimated Spending Budget and go back to our two back-of-the-envelope tests in Part 1 to see how you're going on your journey to reach your required capital base.

You can also see how much you can safely afford to spend/withdraw given your current capital base.

*Ashley Owen, CFA is Founder and Principal of OwenAnalytics. Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. You can subscribe to OwenAnalytics Newsletter here. Original article is here: What's your Number? Part 2: 17 key factors driving 'How much do I need' & 'How much can I spend?'*

## Protecting retirement income from inflation shocks

### Aaron Minney

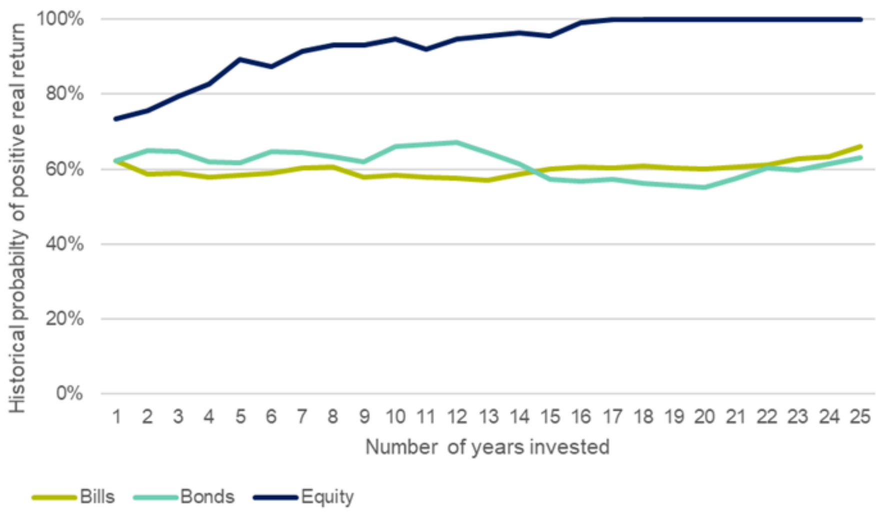
Since the creation of compulsory superannuation in the 1990's, inflation hasn't been a notable issue, but the past two years has been a stark reminder of the impact inflation can have on the spending power of retirees. Inflation spikes are less of an issue in the accumulation phase as there is time for investments to recover, but retirement is different. In retirement, regular income must be protected and maintained to give retirees confidence to spend on essentials, while ensuring maximum enjoyment of their golden years.

**Are equities the answer?**

A commonly held perception is that the best way to account for inflation is maintaining exposure to equity markets. The assumption is market returns will solve for the issue of inflation. However, looking back at historical performance across all asset classes, the reality is markets can take more than a decade to recoup the lost income in retirement.

Analysing historical real returns generated by equities, bonds, and cash, what always matters is the long-term. Analysing returns from 1900 through to 2023, we see that equity markets have proven to deliver returns that outstrip inflation in 81 years – or 73% of the time. Bonds and cash provided a positive real return only 62% of the time over the same period.

**Figure 1** Historical probability of positive real returns, 1900-2023



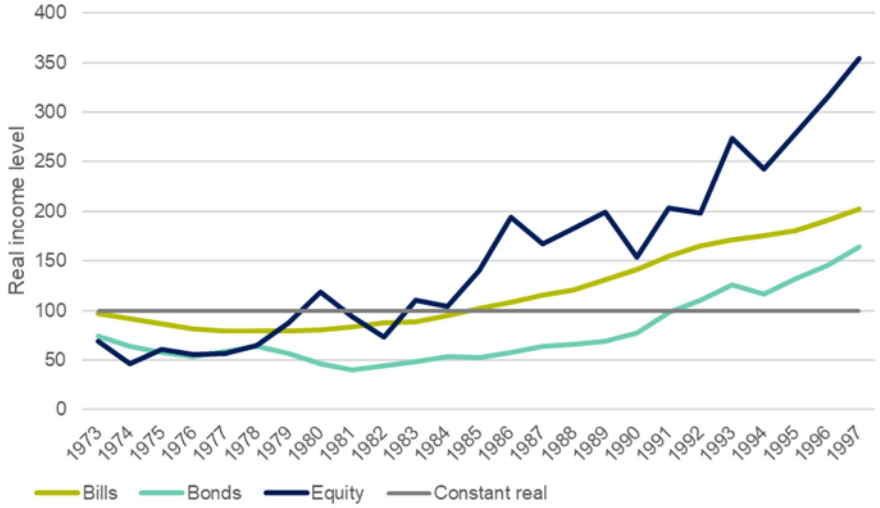

*Source: Calculations, based on data from Morningstar, S&P, Bloomberg and ABS*

Historically, all investment horizons of 16 years (and longer) have provided a positive real return for Australian equity investors. By contrast, a diversified portfolio showed a 70/30 fund (70% equities and 30% bonds) needed 20 years to ensure a positive real return, while a 50/50 balanced fund needed 25 years.

So, while waiting for long-term returns to overcome any near-term short falls is a tried and tested approach in the accumulation phase, it needs to be considered differently in and approaching retirement. The impact is not just the length of time to recover the real capital value, but the income that is lost over that period.

The last time we saw anything like the recent inflation spike was in the 1970s. A retiree who started drawing their income linked to the equity markets in 1973 would have seen their income fall by 30.7% and take nine years, through to 1983, to return to their initial level of income. Cash would have taken until 1985 to recover and bonds until 1992 (see figure 2 below). While history does not provide a guarantee of future performance, a person who started drawing an income linked to markets in 2023 could very well be facing a similar proposition.

**Figure 2** Investment-linked income example




*Source: Calculations, based on data from Morningstar, S&P, Bloomberg and ABS*

With history showing that market-linked investments don't necessarily protect an income stream from inflation over the short to medium term, the question becomes how do retirees maintain their lifestyle in the face of cost-of-living increases?

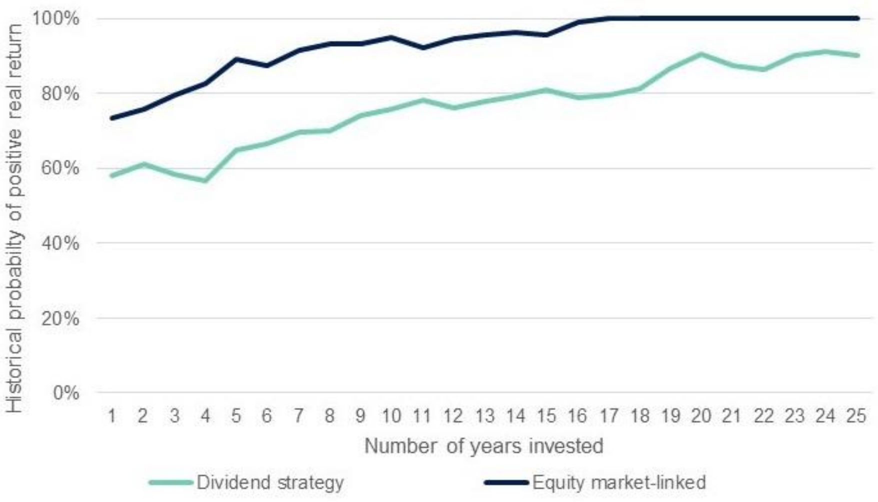
**A different strategy needed in retirement**

There are three common approaches to addressing this very real and present challenge.

The Age Pension represents an income stream that is indexed to inflation and it is a good safety net for some retirees.  However, those who desire a lifestyle goal beyond the Aged Pension need additional inflation protection.

Living off dividend income is another approach that is particularly popular with retirees. Dividend yields tend to be counter-cyclical so are not as volatile as share prices. Historically dividend growth over 25 years was below inflation in 10% of the scenarios. However, the bigger challenge is the level of under spending by retirees taking this approach. By not drawing down on their capital, retirees experience a lower level of lifestyle than would have otherwise been possible.

**Figure 3** Inflation protection of a dividend strategy




*Source: Challenger calculations, based on data from Morningstar, S&P, BHM, Bloomberg and ABS*

Alternatively, by consuming capital in retirement, retirees can generate increased income. A CPI-linked lifetime income stream, for example, sustains the lifestyle of the retiree by adjusting their payments with changes in the cost-of-living.

**Protecting your nest egg in retirement**

Protecting an investment portfolio from inflation can be an important concern for any investor. In retirement, the challenge increases as a retiree needs to protect their income stream to be able to sustain their lifestyle.

We know retirees are seeking an increased level of certainty in retirement. Recent research by YouGov, commissioned by Challenger, found that 2 in 3 Australians over 60 said cost-of-living impacted their confidence they would have enough money for retirement, while more than 70 per cent believe a guaranteed income in retirement would significantly boost happiness.

Inflation risk has a different impact on a portfolio in the retirement phase. It requires a unique investment approach to mitigate risks, while providing retirees with the confidence to safely spend. When investments in growth assets have returns below inflation (or negative), the only option for retirees is to reduce their lifestyle or run down their capital early. This inflation risk can have serious flow-on consequences for longevity and sequencing risk in a portfolio in the decumulation stage. There is more at stake for retirees – they do not have the luxury of time and are at heightened risk to the impacts of inflation, requiring a hedge in their retirement portfolio that can protect income and maintain lifestyle.

While the fall in inflation from multi-decade highs is good news for our economy, many retirees continue to struggle with cost-of-living because of the cumulative impact inflation has had on their financial position. Retirees need to consider how they can maintain their lifestyle in the face of inflation and cost-of-living pressures. There is a misguided perception that equity market exposure will be sufficient to achieve this, but the data shows retirement requires an investment strategy that will guarantee lifestyle regardless of market returns or inflation spikes. An inflation-protected income-strategy is vital to this, and while the Age Pension does deliver some income, it often falls short of meeting the financial needs and lifestyle expectations of many retirees.

As we continue to navigate a volatile market and geopolitical landscape, retirees need a portfolio with protection from inflation risks so that they don't experience another cost-of-living crisis when inflation has another upturn. With more than 2.5 million Australians, 10% of our population, set to retire in the coming decade, retirement is a top priority for government, industry, and aging Australians. We, as an industry, have a responsibility to empower confidence to spend in retirement, provide assurance that income will keep pace with inflation, and protect from the swings in market-linked investments.

*Aaron Minney is Head of Retirement Income Research at Challenger Limited. This article is for general educational purposes and does not consider the specific circumstances of any individual.*

## Where to find value in a multi-asset portfolio

### Dan Kemp with Johanna Kyrklund

*Introduction: Johanna Kyrklund is Group Chief Investment Officer (CIO) and Global Head of Multi-Asset Investments at Schroders.*

*Kyrklund was recently interviewed by Morningstar's Chief Research and Investment Officer Dan Kemp for the digital day of the Morningstar Investment Conference. The following is an edited extract from that interview.*

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**Dan Kemp:** Bonds have had a tough couple of years having had a really good period for a long time. So how are Schroders thinking about not just what bonds are going to do, but their role in a multi-asset portfolio? I think that's what people are struggling with.

**Johanna Kyrklund:** Well, this comes back to the benefit of having some kind of strategic roadmap on a one to three-year time horizon. We came to the conclusion that we were going to see a deterioration, that rates weren't going back to where they were before, and that bonds therefore are not going to be offering that negative correlation with equities. That's been our core view.

And I think it's been very interesting. If you think about it, just over the last two years, you've had three attempts by the market to price in a major Fed pivot. Three times they've tried it. I think that's the market participants getting used to the fact that we are in a new regime. But it takes a very long time.

We had a generation, particularly of bond investors who – if you were a bond bear, I don't think you survived the last 15 years, right? You wouldn't be employed anymore. So, in some senses, we have bond investors biased to wanting to buy their market, always worried that they might miss out. There's a bit of FOMO in bonds. And generally, also for allocators hooked on that negative correlation between bonds and equities, attempting to pile in and constantly positioning for a bond bull market.

We have said constantly that there is a role for fixed income, but it's as a source of yield rather than a source of diversification. So that means that you need to recalibrate the yields at which you will buy it. When it was highly diversified, you could buy at very low yields. But actually, in an environment where you can't rely on that negative correlation, it's there to generate income. Of course this is the old-fashioned reason people used to own bonds, and there's actually nothing wrong with that. There's a case for them, but you just need to recalibrate the yields. Again, that strategic mindset has helped us.

While I'm on this, there is a debate out there that says 60/40 is dead because bonds are no longer negatively correlated with equities. I would say that I don't think that's right, because when 60/40 was first invented decades ago, you had a positive correlation between bonds and equities. Bonds were owned for income; equities were owned for growth. The negative correlation was something that came in the last 15 years. It was not the original premise for that model.

**Kemp:** I think that's absolutely right. At the same time, where that negative correlation tends to let you down is when you've had rising real yields. That's been where the bonds haven't really provided that hedge, and real yields are a lot higher than they were. So that's a much better starting point.

**Kyrklund:** I'd much rather have a yield on bonds than be where we were before with 0.6% on the US Treasury. And then there's a role for commodity-related investments. So, the other side of this equation is, if you're worried about more geopolitically tense environment in a world where commodity supplies are disrupted by the path to decarbonisation, because it's skewing investment patterns, there's a role for commodities in the portfolio that you didn't have in the last decade. So, generally, we've also been favouring commodity-related investments for diversification now, which of course is good for Australia.

**Kemp:** Absolutely. I'm fascinated by that because when we think about the role of commodities, we can think about it as a hedge for demand, there's some inflationary hedge. But how do you think about the forecasting of the returns of commodities compared to bonds and equities? And again, going back to your earlier comments about getting really deep into individual asset classes, how do you bring commodities into the equation?

**Kyrklund:** Over the long term, commodities don't have a risk premium. So, it does come to the real yield. Ideally, you want to have a positive real yield if you're buying commodities. That's step one. I generally don't like a negative carry situation if I can avoid it. And interestingly, of course, US Treasuries are still negative carry versus cash. But anyway, that's another story. Generally, we tend to favour physical commodities when we can get a positive real yield. That's where we tend to think about it, and when we can see an environment where they offer diversification.

So in the 2010s, the main issue [was] we were in a deflationary environment where commodities were not diversified because we kept getting growth shocks and our equities would fall and commodities would fall at the same time. But that's why generally they're making it into our portfolio more. We can't do it based on traditional valuation because there isn't a risk premium. But if you get a positive real yield and it's diversifying, then it typically earns its place. And we don't necessarily do it just through physical commodities. It might be through the stocks as well or the currencies.

**Kemp: J**ust in case people aren't familiar firstly with the idea of carry investments - can you unpick that a little bit for us?

**Kyrklund:** Positive carry is when you're earning a return over cash.

**Kemp:** So you can borrow in cash, then invest and you get a positive return on that.

**Kyrklund:** Yes. Exactly. And if you have a negative real yield in commodities, it means your starting point is you're losing money. And right now, because the shape of the yield curve in the United States, if nothing happens, you're losing money versus cash if you're in the US 10-year. You actually need rate cut expectations to come in to move that.

**Kemp:** And that's because shorter-term rates are higher than longer-term rates.

**Kyrklund:** Yes. Thank you. I should nick that explanation. But I always think you want to stack the odds in your favour. You typically want to try and own stuff that gives you a positive yield. Generally, that's a good idea.

**Kemp:** Yeah. And the really interesting thing there is that often people underestimate the benefit of that positive carry, that kind of keep accumulating over time.

**Kyrklund:** Yes, the compounding of return.

**Kemp:** Exactly right. So, let's talk about credit because, again, typically a positive carry type investment, we're seeing spreads quite narrow at the moment. How are you thinking about that?

**Kyrklund:** Again, in the context of owning fixed income for yield, generally we'll own fixed income if it gives us a return above cash, we have been favouring credit over the last couple of years. Things are getting a little bit more challenging in some markets, particularly US investment grade debt because the US investment grade curve is actually inverted now. So, you don't earn a premium over cash in the US anymore.

**Kemp:** Yes. So even when you're lending money to companies rather than government, you're still not getting that positive carry.

**Kyrklund:** Yes. That, I would say, is starting to look a bit expensive now. And, we're steering away from that. The corporate fundamentals are still strong. But ultimately, that's why we favour equities to generate return right now is because we're not getting necessarily the same payoff that we were getting before in credit. But we still like investment grade debt, for example, in Europe.

**Kemp:** Interesting. Is that more of an interest rate view? Is it more of a corporate fundamental view or this value spreads?

**Kyrklund:** Yeah, positive yield over cash. And then as an index, [it's] pretty high quality.

**Kemp:** You mentioned commodities. You mentioned not using bonds so much for diversification. Do you have other things in the portfolio that you're looking to diversify the equity exposure?

**Kyrklund:** For a long time, everybody had [interest] rates at zero, which made it very difficult to see divergence between different economies. I think now we're in an environment of a much greater divergence. That's creating opportunities across different equity markets. This is where – as I said, we put this thesis together a couple of years ago, a number of things have played out. The one that hasn't played out was the ongoing outperformance of the US, because I would have expected that potentially with a higher rate environment, some of the more value-oriented markets would have been outperforming the United States. The Magnificent Seven came in and essentially overwhelmed that. The Magnificent Seven have been so cash generative, they're in some sense almost cash plays because they're probably earning a return on cash. That's been the big surprise. But if you look under the surface of the US market, what you find is the broader market has underperformed quite significantly. Actually, its performance has been much more similar to markets outside the US. But I would expect more opportunities in value generally.

*Johanna Kyrklund is Group Chief Investment Officer (CIO) and Global Head of Multi-Asset Investments at Schroders.*

## How the $3 million super tax impacts unfunded pension schemes

### John Pauley

A Senate Committee reported back last week with a majority recommendation to pass the $3 million super tax unaltered. It would appear that the Committee was swayed in its conclusions by the evidence from Treasury which "*observed that the draft regulations for defined benefit interests reflect the need to ensure that the changes apply equally to all different types of superannuation interests.*"

Furthermore, the Committee's report states that "*Mr Hawkins [Treasury's Adrian Hawkins] reiterated that the calculation of an interest under the changes has been designed to ensure that the approach is consistent across defined benefit members and accumulation members.*"

The objective of these proposed Bills, and the associated regulations, is to ensure the better targeting of superannuation tax concessions which apply to superannuation assets accumulated under the Superannuation Guarantee arrangements. The proposed changes will increase the maximum headline marginal tax rate on superannuation fund earnings from 15% to 30% for earnings corresponding to the proportion of an individual's Total Superannuation Balance (TSB) that is greater than $3 million. The reforms introduce a new Division 296 into the *Income Tax Assessment Act 1997*. Earnings from superannuation assets below the $3 million threshold will continue to be taxed at just 15% or exempt from income tax if held in a retirement pension account.

**Unfunded super schemes are being unfairly treated**

While funded superannuation has benefited from these open-ended tax concessions, superannuation payments from unfunded sources, such as those applying to many Commonwealth and State employees, are taxed as normal income and do not receive these tax concessions. Governments did not put aside funds to meet these superannuation obligations to their employees and made conscious decisions to fund the obligations as they fell due following an employee's retirement.

Much of the discussion around the Better Targeting of Superannuation Tax Concessions, including the comments from Treasury to the Committee, conveniently ignore this important difference in how superannuation is taxed.

The draft legislation for this reform did not fully outline how unfunded superannuation would be treated and left the special rules for the modified treatment of unfunded superannuation and some retirement phase interests, including the valuation of such interests, to be addressed through specific provisions in subsequent regulations.

The draft regulations were finally made public on 15 March 2024. They detail how unfunded superannuation will be valued and Division 296 tax subsequently determined. They take no account of the current taxation arrangements currently applying to unfunded superannuation.

As a result, the inclusion of unfunded superannuation in Division 296 tax proposals is neither equitable, or just.

Under the proposed regulations an individual in receipt of an unfunded superannuation payment of $300,000 per annum will be subject to a Division 296 tax assessment of around $7,000. A number of factors affect this assessment including the individual's age, their sex and the CPI. In this example the individual is assumed to be a 67-year-old male, and the CPI was assumed to be 3%. Application of the regulations using these assumptions would ascribe this individual a total superannuation balance of around $3,555,000, with earnings for the year of around $297,000 or 8.36%.

The Division 296 tax assessment is in addition to the normal income tax of around $105,000 which the individual would pay.

In contrast, an individual who has the equivalent superannuation assets, around $3,555,000, earning a similar amount, around $297,000, and drawing the same total income of $300,000, would be subject to a total tax bill of just $27,700.

While the application of the Division 296 tax may be consistent across these two individuals, in that they both would pay the same $7,000 Division 296 tax, it is clear that the latter benefits significantly from the superannuation tax concessions which are not available to those in receipt of unfunded superannuation.

Were the individual in receipt of the unfunded superannuation payment of $300,000 a woman the Division 296 tax assessment would increase significantly to around $12,000. This is hardly treating defined benefit members and accumulation members in a consistent manner as stated by Treasury.

**Other areas of inconsistency**

There are many other areas where the proposed legislation does not treat individuals in a consistent manner as asserted by Treasury. These include the following:

- Those holding in excess of $3 million in a superannuation fund will be able to readily escape the full impost of Division 296 tax by moving some of their superannuation assets to other tax effective places. Individuals receiving unfunded superannuation are unable to access any of the unfunded asset that will be ascribed to them in the Division 296 regulations and cannot take any actions to limit the impact of a Division 296 tax impost;
- In retirement mode, the earnings of the first $1.9 million of an individual's superannuation asset will remain tax exempt. In contrast the full amount of an unfunded superannuation pension will continue to contribute to an individual's personal income tax assessment with normal marginal income tax rates applied impacting them as shown in the example above;
- Earnings from an individual's superannuation asset valued between $1.9 million and $3.0 million will continue to be taxed at only 15%. On the other hand, unfunded superannuation which is ascribed under the proposed regulations to be derived from a fund valued towards the top of this range, is likely to be exposed to the top personal marginal income tax rate of 45 percent; and
- Earnings from an individual's superannuation asset in excess of $3.0 million will attract the Division 296 tax loading of 15% taking the marginal tax rate to 30%. Unfunded superannuation pensions, assessed under the Regulations to incur the Division 296 loading of 15%, will have that loading applied on top of the existing 45% marginal personal tax rate that will almost certainly apply to that pension.

It is unfortunate that some commentators are muddying the waters in respect of the taxation arrangements applying to unfunded superannuation. These commentators confuse the taxation arrangements applying to funded and unfunded superannuation and frequently make reference to retirees receiving up to $118,750 tax free.

Such comments are irrelevant in the case of an individual in receipt of an unfunded superannuation pension that may be subject to Division 296 tax. These individuals are not in receipt of this tax benefit, and as stated above, and shown in the example, are almost certainly already paying a marginal tax rate of 45% on any income ascribed to them under a Division 296 assessment applied to that unfunded superannuation.

The stated purpose of the Government's Division 296 measures is to ensure **the better targeting of superannuation tax concessions.**

As ACPSRO and others have demonstrated, unfunded superannuation does not attract these concessions and should not be included within the Division 296 tax arrangements. The application of Division 296 tax to an individual's unfunded superannuation will amount to the double taxation of that superannuation and impose an effective marginal tax rate which is likely double that proposed under the government's reforms.

*John Pauley is President of the [Australian Council of Public Sector Retiree Organisations](#).*

## Two overlooked tax advantages of investing in ETFs

### Michael Brown

Many of us don't think about taxes until it's too late. This mindset is so pervasive that it's even crossed over to fictional universes like The Simpsons. During the ninth season of The Simpsons, Homer was on the couch watching the TV news. Channel 6 news anchor, Kent Brockman was reporting a rush of people mailing their tax returns before the deadline.

"Will you look at these morons?" Homer laughed. "I paid my taxes over a year ago."

After Lisa pointed out Homer's problem, Homer rushed to complete his return, "Okay, Marge, if anybody asks, you require 24-hour nursing care, Lisa's a clergyman, Maggie is seven people and Bart was wounded in Vietnam."

The good news about ETFs is that telling porkies to the ATO isn't required.

Here are two benefits to having ETF investments, plus a bonus perk if you're in a fund hedged to AUD.

**ETF tax benefit 1: streaming**

In periods of volatility, many investors flee the funds they are in, waiting for calmer days. We're sure you're aware of the perils of such a strategy, but it is worth understanding that in unlisted managed funds, your tax liability goes up as other investors desert the fund. ETFs, being listed on ASX, have a mechanism to mitigate this risk.

In unlisted managed funds, investors who redeem from the fund leave behind their share of the tax liabilities on any capital gains realised. In an unlisted managed fund, these tax liabilities are then attributed to the remaining investors. This does not happen in an ETF. Investors sell their units on the exchange to other investors or the market maker. A market maker ensures there are units available for investors to buy or sell, and they may redeem their units in the ETF. The good news is that when they do, they take the capital gains caused by the redemption with them. ETFs, therefore, protect investors from the impact of redemptions by other investors.

Those who have had a bad tax experience with an unlisted managed fund will understand. An ETF won't hit you with a large taxable distribution the way an unlisted actively managed fund can do due to client redemptions.

This tax efficiency is often an overlooked benefit of investing in ETFs.

**ETF tax benefit 2: passive management**

Passive ETFs hold a portfolio of shares or other assets that track an index. As a passive ETF's portfolio is automatically determined by the rules of the index, its portfolio only changes when the index changes. The contrast to this is 'actively managed' funds, where the fund manager picks the shares that they think are going to perform the best. The tax problem with the active management process is that it causes a lot of shares to be sold each year, whereas the index fund process generally does not.

The more shares sold by the active fund manager in a year, the higher the investor's capital gains tax liability for that year. This brings forward capital gains. In passive ETFs with low turnover, these would otherwise not be payable until the ETF units are sold.

The advantage is in the time value of money. The longer the investor holds the ETF, the more this advantage compounds.

In a nutshell:

1. ETFs are generally a tax-efficient investment vehicle because they minimise exposure to capital gains tax when other investors redeem.
2. As passive funds, ETFs typically have lower turnover and therefore generate lower levels of capital gains tax compared to actively managed funds.

**Bonus benefit for those in funds hedged to the AUD**

If you've experienced a massive dividend from a global fund that is 'AUD hedged', this is for you.

Over the past decade, the government has implemented a series of changes that are intended to benefit investors in these AUD currency-hedged funds. However, the changes are proving not so easy to implement. So much so that the industry has been lobbying to make these rules simpler.

Until there are more changes, only a few fund managers have the skill and processes to implement the newer tax rules.

The tax rules we refer to are called the 'Taxation of Financial Arrangement', also known as 'ToFA' (pronounced like 'tofu' but ending in an 'a').

It is important to note any AUD currency-hedged managed fund can adopt these. There are no restrictions, so if your fund manager says they are unable to avail themselves of the ToFA hedging election, the problem is with them, not the legislative framework.

The first hurdle in ToFA hedging is that the tax rules can only be adopted after complex auditing rules found in the accounting standards. Managed funds have no reason to do this apart from ToFA, but to adopt the rules, the fund manager will need to reconstruct their financial reporting process and satisfy their financial auditors that they are complying with all of the rules in the accounting standards.

If the accounting rules can be satisfied, the next hurdle is to install a process to produce, what we will call for simplicity, 'an adequate document trail'. This is potentially subject to an Australian Tax Office audit. Processes like this require the fund's tax department and the fund's portfolio management team to work closely together. These are two teams that usually have little to do with each other, and who think quite differently, so the new process is a challenge. You can imagine that in some big fund managers, these parts of the business will not know one another, and potentially sit on a different floor or in a different office.

The last hurdle is the hardest: the calculations. Among the challenges, in an AUD currency-hedged managed fund, there isn't always a one-to-one relationship between the hedging instruments and the hedged assets. These also change daily, as do the underlying securities bought and sold. Again, these may not match when currency hedging positions are opened and closed out.

There is no software available to do these calculations, so fund managers have had to develop their own processes and intellectual property.

We think fund managers that properly implement ToFA have a competitive advantage over those that do not.

Without the ToFA overlay, currency hedging can lead to tax shocks for investors. This was precisely the experience for a large number of advisers/investors who were invested in two currency AUD hedged global equity products in 2021. See below the historical cents per unit (CPU) declared for these two funds.

**Table 1: Example of a fund manager that had not properly implemented ToFA**

| | US equity currency hedged ETF CPU (Annual dividends) | Global equity currency hedged ETF CPU (Annual dividends) |
|---|---|---|
| **FY 2023** | 57.66 | 212.42 |
| **FY 2022** | 553.12 | 201.83 |
| **FY 2021** | 9,198.75 | 2,405.21 |
| **FY 2020** | 725.00 | 350.16 |
| **FY 2019** | 0.00 | 290.24 |

*Source: ASX*

For context, the net asset value (NAV) for each of these on 30 June 2021 was $512.44 for the US equity ETF and $155.13 for the global equity ETF. That means the distribution represented 17.95% and 15.50% of the total assets in the funds. The reason for this would be hedging gains in the fund from the rise of the Australian dollar in that financial year.

Our currency-hedged international quality equity ETF (QHAL) utilises the currency hedging ToFA rules and it has not been subject to these types of huge surprises.

**Table 2: Example of a VanEck ToFA implementation**

| | QHAL CPU (Annual dividends) | QHAL distribution as a percentage of total assets in the ETF |
|---|---|---|
| **FY 2023** | 43.50 | 1.11% |
| **FY 2022** | 37.00 | 1.13% |
| **FY 2021** | 37.00 | 0.94% |
| **FY 2020** | 32.00 | 1.08% |
| **FY 2019** | 40.00 | 1.49% |

*Source: VanEck. QHAL dividend payment history is not a guarantee of future dividends payable from QHAL.*

Further, we think this is a particularly important consideration for those investors utilising AUD currency-hedged global strategies for income such as global infrastructure and global property securities.

As an example of the effort we have put into our systems to ensure investors don't get tax-time shocks in these AUD currency-hedged income ETFs, our global infrastructure ETF (IFRA) has a demonstrable track record of not giving investors nasty high dividends.

**Table 3: Infrastructure example of a VanEck ToFA implementation**

| | IFRA CPU (quarterly dividends) | IFRA 12-month dividend yield, 30 June |
|---|---|---|
| **FY 2024** | 17, 17, 17 | |
| **FY 2023** | 16, 16, 16, 17 | 3.05% |
| **FY 2022** | 16, 16, 16, 16 | 3.12% |
| **FY 2021** | 16, 16, 17, 16 | 3.70% |
| **FY 2020** | 16, 16, 16, 17 | 3.26% |

*Source: VanEck. IFRA dividend payment history is not a guarantee of future dividends payable from IFRA.*

*Michael Brown is Head of Finance, Legal and Regulatory Affairs at VanEck Australia, a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.*

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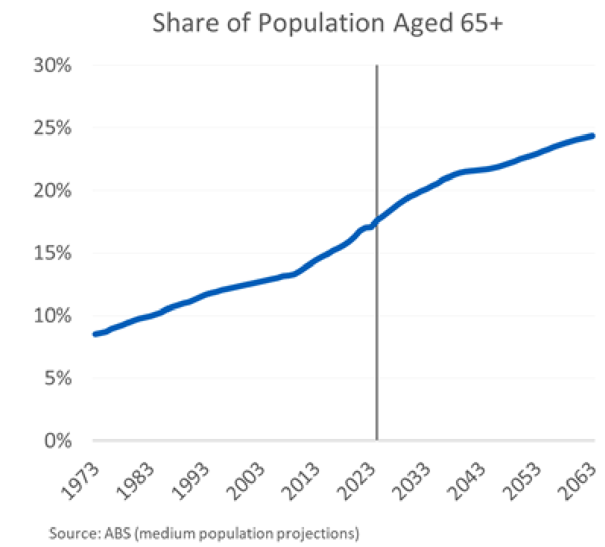
## Why healthcare is a compelling property niche

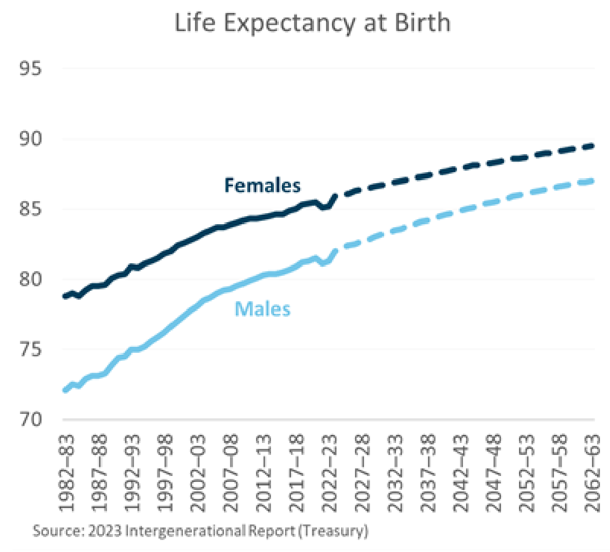
### Colin Mackay

The healthcare and social assistance sector is an essential and growing industry, accounting for 8% of the Australian economy[1]. It is expected to see the biggest increase in share of government funding from 2022-23 to 2062-63, with government health spending per capita forecast to grow by 2.0% p.a. on an inflation-adjusted basis[2]. However, it's not all smooth sailing, as evidenced by recent news of private hospital closures[3]. This article outlines the tailwinds and characteristics which continue to underpin healthcare's compelling investment proposition and explains why we believe medical centres are the specific property exposure investors should prioritise.

**Demographics**

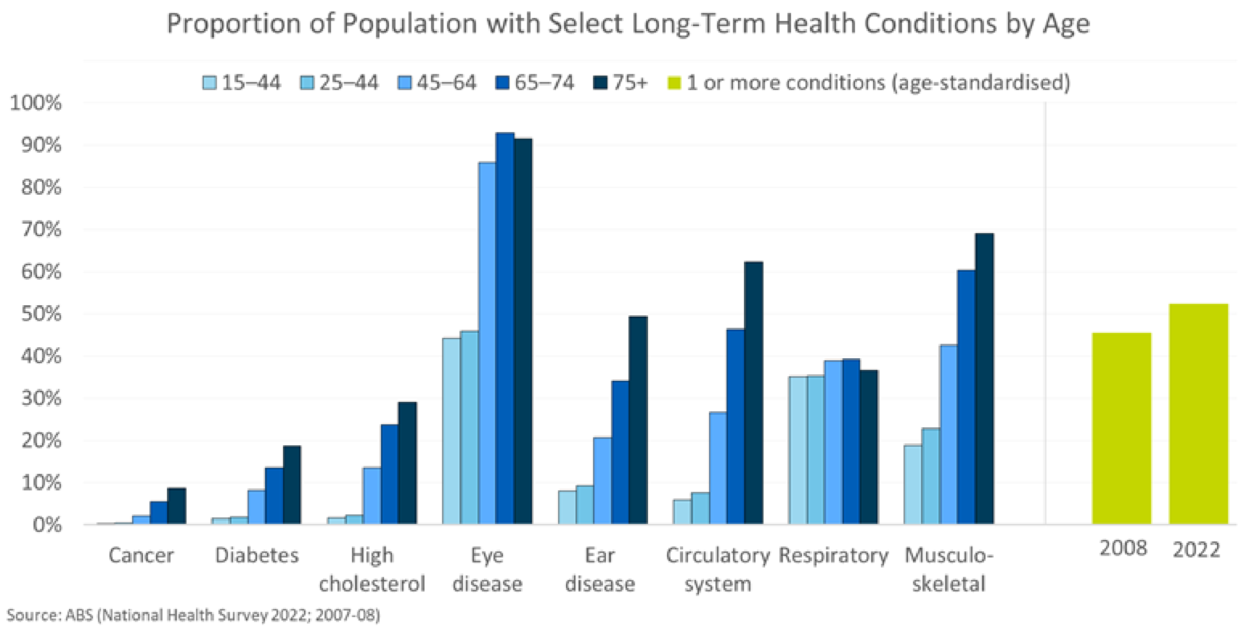
Growth in Australian healthcare is underpinned by several long-term demographic trends, which are spurring demand for care services. Firstly, Australia is forecast to experience the strongest population growth across developed economies over the next decade[4]. On top of broad-based population growth, there is an even more pronounced 'population bulge' now sitting in the 65+ age bracket due to the post-war baby boom. Life expectancy is also rising, up from 78 years (men) and 83 years (women) two decades ago to 81 and 85 today, with the rising trend expected to continue[2]. These factors mean the number of people aged 65+ will more than double and the number aged 85+ will more than triple over the next 40 years. As we live longer, the proportion of our lives lived in 'full' health is slowly declining, meaning a longer period of time where health services and care are needed per person.




**Increasing disease prevalence**

Naturally, an ageing population also means rising disease incidence and complexity. People aged 65+ currently account for 40% of government health spending despite being only 16% of the population[2], with 95% of those aged 65+ having two or more chronic health conditions, compared to 59% of those aged 15-44[5]. This is being exacerbated by lifestyle factors, such as poor diets and lack of exercise, and improved medical detection and diagnostics, which are seeing the rates of disease incidence also increase on an age-standardised basis[5].

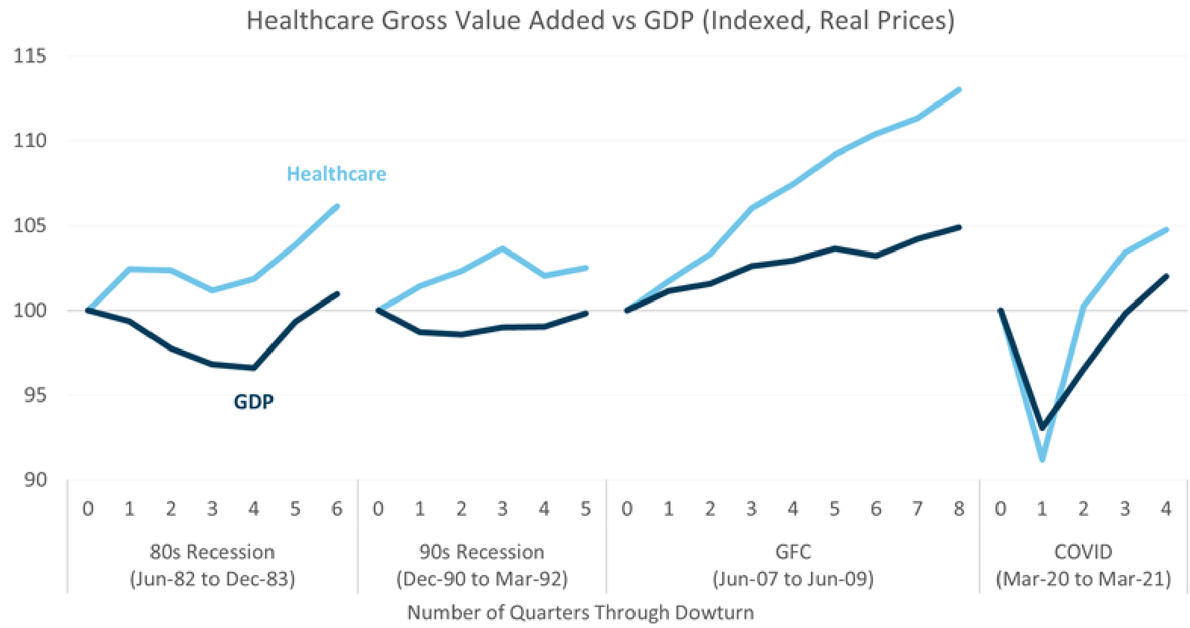



**Recession resilient**

Healthcare is a defensive, necessity service resilient to changing economic conditions. Unlike other industries that rely on consumer demand or business cycles, healthcare is driven by the constant and growing need for essential health services, meaning healthcare activity expands more consistently and experiences fewer downturns. This has historically been the case even during periods of recession or global economic disruption. In fact, the healthcare sector recorded its weakest performance during the COVID-19 pandemic when most health services were shut down, but still experienced a sharper recovery than the broader economy.

Another key factor that supports the stability and resilience of the healthcare sector is reliable government funding. The state and federal governments fund over 70% of health expenditure in Australia[6], providing a consistent primary source of funding not exposed to economic, consumer or business sector fluctuations.

The resilient and consistent nature of underlying demand and funding are in turn positive drivers of healthcare property performance.



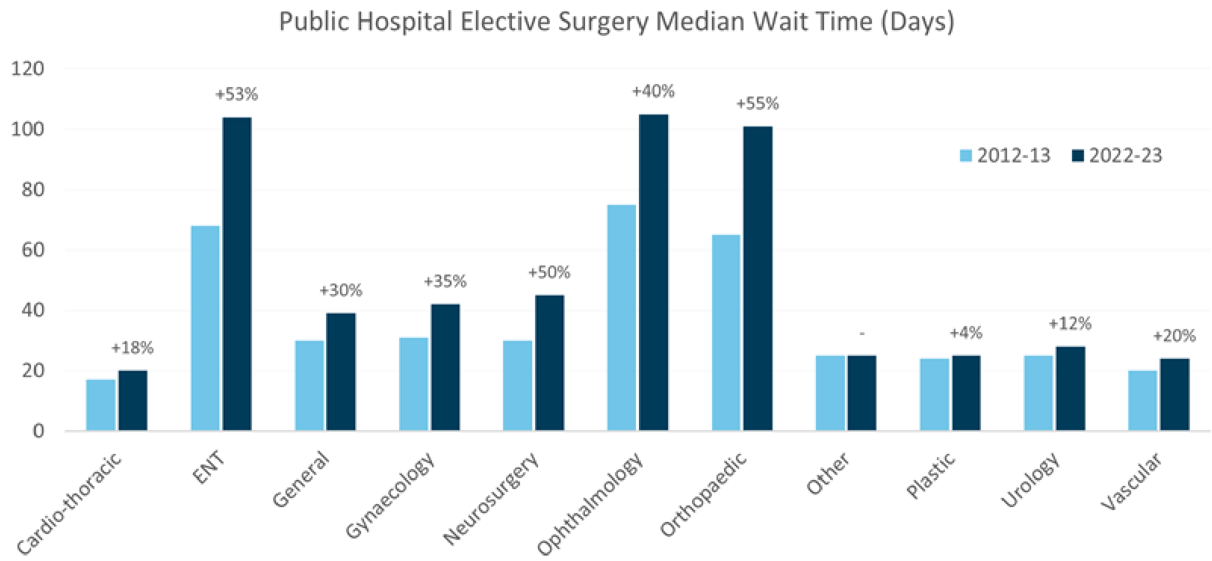

Source: National Accounts (ABS, Dec-23); Cromwell. Note: Australia didn't experience a technical recession during the GFC

**Getting the right exposure**

Healthcare property encompasses a range of asset types such as hospitals, medical centres, and aged care. While demand tailwinds are strong and the overall sector provides attractive stability and diversification benefits, the careful selection of sub-sector is still crucial. There are several reasons why we believe medical centres offer the most favourable outlook and are the optimal healthcare property exposure for investors.

**A necessary care model**

The supply of health services is struggling to keep up with demand, resulting in higher costs and longer wait times. There are inadequate financial and labour to improve care standards or wait times under the status quo – a more efficient and cost-effective system is required.

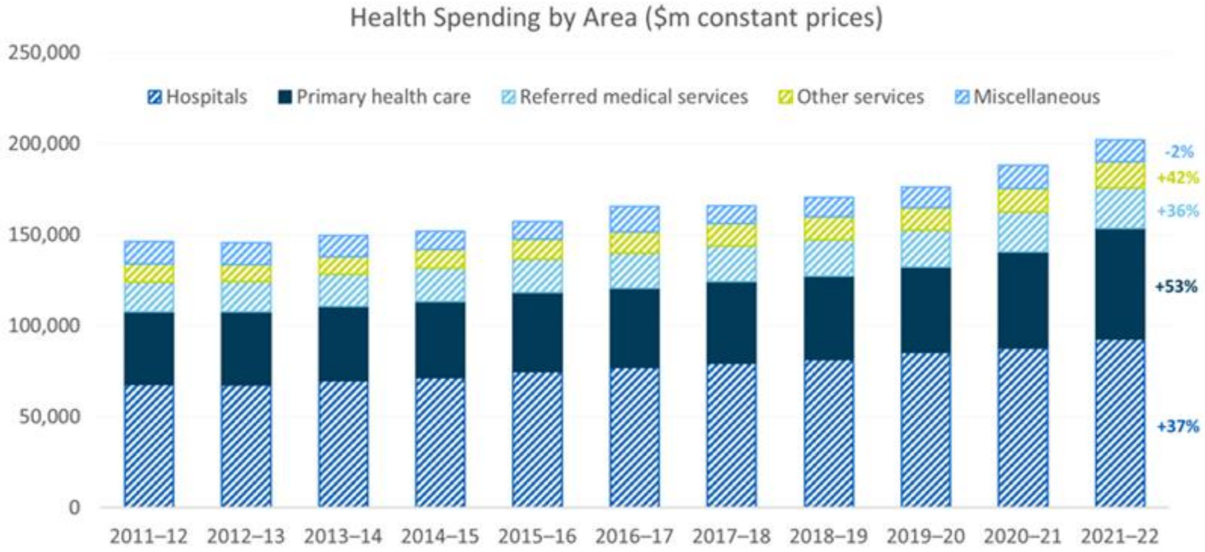



Source: Australian Institute of Health and Welfare (Jan-24)

Part of the required shift includes moving treatment out of hospitals and towards GPs and other primary or secondary care facilities. Focusing on primary and out-of-hospital care can result in better health outcomes[7], reduced risk of infection and improved patient comfort, convenience, and satisfaction[8],[9]. From a funding perspective, out-of-hospital care can be cheaper due to lower overheads compared to when a hospital bed is occupied[8].

Avoidable emergency department presentations are clogging the hospital system, with an estimated 1.9 million preventable patient days per annum from those aged 65+ alone[10]. It would be more appropriate to provide this care in an efficient, fit-for-purpose medical centre environment, saving costs and freeing up hospital resources for actual emergency care and complex cases.

The shift from hospital to non-hospital care is already underway, evidenced by growth in primary healthcare spending outpacing spending on hospitals, as well as government policies putting greater emphasis on primary care and preventive health. For example, a $99 million Federal Government initiative to connect frequent hospital users with a GP to reduce the likelihood of hospital re-admission; $79 million to support the use of allied health services for multidisciplinary care in underserviced communities; and $3.5 billion to triple GP bulk billing incentives[11].



Source: AIHW; Cromwell. Includes Australian gov't, Dep't of Veterans' Affairs, state and territory gov't, and private health insurance provider spending, and health insurance premium rebates. Labels are growth from 2011-12 to 2021-22. Miscellaneous includes Research, Capital expenditure, and Medical expenses tax rebate.

**Attractive investment characteristics**

In addition to demand and funding tailwinds, medical centres offer attractive investment characteristics:

- High-quality cashflow from a reliable tenant base
- Inflation hedging, via CPI-linked or fixed rental escalations
- Long leases, sometimes on a triple net basis
- Higher rates of lease renewal compared to traditional office[12]

Compared to private hospitals, medical centres may be preferred due to deriving income from a typical commercial lease structure, rather than a percentage of operator EBITDAR. Land also typically comprises a greater proportion of asset value, which can provide downside protection and aid long-term development or change of use potential.

| | Private Hospitals | Medical Centres |
|---|---|---|
| **Lease term** | 20-30 years | 5-15 years |
| **Basis of income** | Percentage of operator EBITDAR, quoted on per bed basis | Typical commercial lease structure, quoted per sqm |
| **Tenant profile** | Single operator | One or several tenants |
| **Capital intensity** | Very high | Moderate to high |

**An increasingly important part of the healthcare landscape**

Medical centres are an increasingly important part of the essential and growing healthcare industry, representing efficient and fit-for-purpose facilities that can help alleviate the capacity constraints of hospitals and improve the sustainability of the health system.

We believe medical centres' alignment with demand trends and Government healthcare spending priorities, together with attractive investment characteristics such as CPI-linked income and defensive land holdings, puts them in a favourable position compared to other healthcare property investments.

*Colin Mackay is a Research and Investment Strategy Manager for Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.*

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## The maths of friendship

### Joseph Taylor

Did you know that the number of friends you have is correlated to the size of certain parts of your brain? That you are far more likely to share genes and neural patterns with friends than non-friends? Or that social networks in the modern world closely resemble those in Norman England?

All this comes from new research by Robin Dunbar, the world-renowned evolutionary psychologist who famously discovered Dunbar's number: how our capacity for friendship is limited to around 150 people.

Dunbar discussed his latest findings on a recent 'Invest like the Best' podcast, and here are some of the fascinating takeaways, along with context from his book, *Friends*.

***"Our entire modern world is built around this number, 150"***

Dunbar stumbled across Dunbar's number due to his studies on whether the size of an animal's brain is linked to the size of group they live in.

*"Hunter-gatherers like us live in multilayered social systems. So I was looking for a layering within their social systems that was about a 150 in size rather than, say, 2,000 or 25. And sure enough there is one. It's generally called a clan or a regional grouping or something like that. It's basically a unit that shares hunting territory as much as anything… After that, we just kept finding this number everywhere… our entire modern world is built around this number, 150."*

When I first heard Dunbar talking about seeing clusters of 150 people everywhere, I thought he was simply seeing what he wanted to see. Like spotting an elephant shaped cloud or seeing Jesus on a bit of toast. Then I read Dunbar's book. In a lot of cases, it seems that collectives of around 150 people really have popped up an awful lot – from village sizes recorded by William the Conqueror's England to agricultural cooperatives in Italy, off-grid sects and factory sizes.

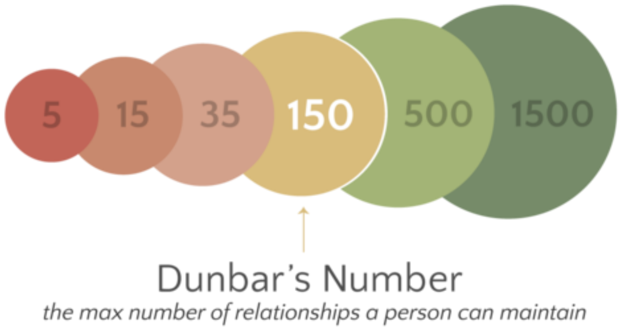
Obviously, very few of us live in villages or are part of agricultural collectives today. But Dunbar still sees complex human systems clustering around this number 150 – from the way tax is collected in Scandinavia, to the amount of people in offices and the size of trailer park neighbourhoods in Germany. Why? Because, according to Dunbar, 150 is the maximum number of meaningful relationships a person can maintain at any time.

**Dunbar's layers of friendship**

"*Your personal social network, all the family, extended family and friendships you have, looks pretty much like the ripples on a pond where you throw a stone. You have these series of layers going out from you, which increase in size but the quality of the relationship and the frequencies that you contact them gets smaller and smaller, smaller, lower and lower."*

Here's how Dunbar defines the different layers:

- 1500 faces you can recognize (including people you don't know personally)
- 500 acquaintances
- 150 meaningful relationships – your wedding or funeral attendees
- 50 friends – your wedding or funeral attendees during Covid restrictions?
- 15 people in your sympathy group, whose death would truly upset you
- 5 'cry on the shoulder' close friends




The number of people in a further out layer also includes the people in all the closer layers. So, the 1500 faces you can recognise includes the 500 people who are at least an acquaintance, plus 1000 others. Your sympathy group of 15 includes your 5 closest friends plus ten others, and so on.

**Do Dunbar's layers add up?**

For the closest layers, Dunbar's numbers seem roughly right. For a bit of context, I moved to this part of the world from Scotland about 18 months ago. Because I live 17,000 kilometres from most of my family and friends, I decided to use WhatsApp messages instead of real-life interactions to test Dunbar's theories.

Except for my partner, there are three or four people I have messaged every few days over a long period. There are a few more people I'll message once or twice a month, and a bigger group I'll message every few months – usually around their birthday or if something funny happens to their football team.

I also thought about how I share big news. I've only told a few people about my new job, and I told them in different ways. I told my partner as soon as I got the offer and I told my brother, parents and one friend the next time we spoke. I guess this reveals my inner circle, which adds perfectly to Dunbar's layer of five. Those are the people I felt would want to know and wouldn't just think I was bragging.

I struggle to see how Dunbar put a number on the further out layers. But I find it fascinating that modern research – including studies of over a million Facebook accounts and email exchanges by 30,000+ college students – tend to suggest that personal networks remain similarly sized to how they were in Norman times.

**Dunbar's most important layer**

Even though Dunbar christened 150 as his number, he sees this inner layer of 5 as the most important for human health.

*"The best predictor of your mental health and physical health well-being, and even how long you're going to live into the future from today is predicted by the number and quality of friendships you have in that layer. The five is an average. So if you only have three don't panic yet, because introverts tend to prefer to have fewer people but have stronger friendships."*

Again, I was skeptical about this. I turned to Dunbar's book for more information. As it turns out, the whole first chapter is dedicated to showing several studies that suggest the quantity and quality of social connections you have is reflected by your health. Not just your mental health, as might be expected, but your chances of avoiding and surviving physical ailments too.

Although it was interesting, I couldn't help but wonder if it's correlation rather than causation. For example, playing a sport is the best way I know to meet people as an adult. If a lot of other people find that too, wouldn't their better health be at least partly due to playing more sport?

Dunbar, though, goes all in on friendship:

*"You'll certainly do yourself a favour by eating better, taking more exercise and popping the pills they give you, but you'll do considerably better just by having some friends".*

**The 1.5 closest friends you can have**

Dunbar's 'five loved ones' is usually shown as his tightest layer of friendship, but he takes it further and says that the closest possible level of relationship are the 1.5 people found in your 'intimates' layer. Why 1.5? Because, according to Dunbar, men and women behave differently.

His and apparently several other studies suggest that most women end up with two people in the inner sanctum - their romantic partner and a 'BFF', their best friend forever. Men only have room for one. So, when they find a romantic partner, their best friend gets relegated to 'just' a close friend – hence the average of 1.5.

This rings true for me. Meeting my partner didn't stop me from talking to my closest friends on an almost daily basis. But I certainly played golf less often and no longer needed a drinking buddy – Dunbar's definition of a best friend – on Tuesday nights anymore.

**Why friendships fade**

**"***If you don't meet up once in a while face-to-face, nothing on the face of earth or Facebook is going to stop that friendship gradually becoming an acquaintanceship.***"**

Studies suggest that humans spend about 20% of their waking day in social situations. Those 3.5 hours a day need to be split between the 150 friends and family in your network. And, of course, we don't split the time evenly.

According to Dunbar, about 40% goes to closest five, 20% goes to the additional ten people who make up your 'sympathy group', and the remaining 40% is spread between the 135 other people you know.

Keeping someone at a closer friendship layer requires a bigger investment of time. If it becomes harder to make this happen – due to distance or something else – they will drift to a more distant layer. A study Dunbar mentioned on students leaving high school suggests that this can happen quite quickly for anyone who isn't family. Just six months without contact can see somebody drift out a layer, with the rate of decline slowing as time goes on.

The family immunity aspect seems right. If anything, I keep in more regular contact with my Mum, Dad and brother than before I moved Down Under, even if it isn't 'quality' time of the in-person variety. I also wonder if there's a bit of Nassim Taleb's Lindy effect going on.

The Lindy effect suggests that something's remaining lifespan is best predicted by its lifespan to date. When I look at the only friend from home still in my 'inner five', it's the one I've been friends with for longest. Unfortunately for my liver, it looks like my friend Bruce will be around for at least another 20 years – especially as he recently made the move from Scotland to Australia too.

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