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Editorial

Last Friday, a faulty software update from Crowdstrike led to a glitch in millions of Microsoft Windows systems worldwide. The so-called "blue screen of death" grounded planes in Los Angeles, disrupted doctors in the UK and, for reasons I still don't understand, meant I wasn't allowed to add a tip onto my card payment at dinner on Saturday night.

The effect on my life has been minimal. In fact, I made a rather guilty gain from it all. But the situation served up a reminder of how connected our world has become. And how our world's complete and utter reliance on technology – not just one layer of it, but several interconnected layers of it – can suddenly leave us helpless.

99% of the time, the systems we have gravitated to have clear advantages. Paying with Apple Pay is easier than cash. Using Google Maps beats carrying an A-Z around or, heaven forbid, asking a stranger for directions. Storing patient records in the cloud means you don't need as many servers on site. Or as many IT staff to look after them.

It is all fantastically efficient until it isn't. What if the card terminal loses connection? What happens if your phone battery dies at a time where you really need directions? What if one of your software provider's software providers has an outage?

Tech is great. But having a low-tech backup at your disposal might also be great. Before Saturday, the concept of cash was nearing the point of being dead to me. "The Outage" has made me consider carrying a few notes in my wallet, just in case.

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Speaking of alternatives to tech, one downfall of the internet is that the algorithms delivering you content quickly latch on to what you click and spend most time reading. Once the algorithm works you out, most content you see will conform to your bias. It creates a kind of echo chamber.

Most of the macro content I consume (and see) has a bearish bias. One reason for this might be that most of my early reading was at the Benjamin Graham, Marc Faber and John Galbraith (writer of A Short History of Market Euphoria) end of the spectrum.

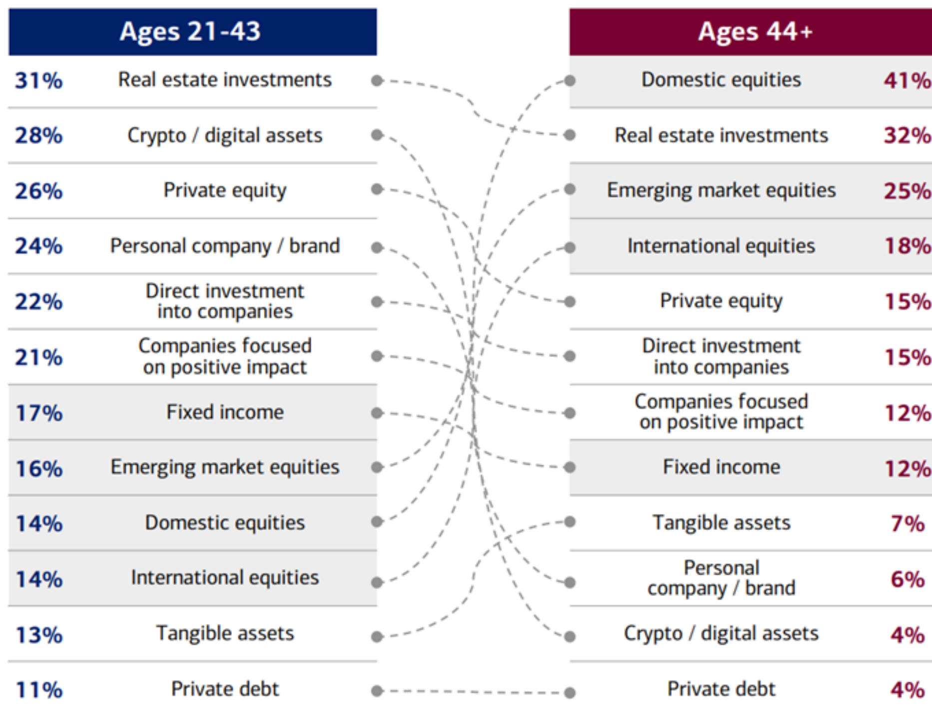
I am naturally disposed to think the next crash is coming soon and that I should act accordingly, a disposition compounded by any algorithm I influence. The problem with being bearish is that it can leave you without enough exposure to things going well. And in market history things have mostly gone well.

For that reason, getting out of the filter bubble can be useful. That requires you to make a conscious effort to read things and consult sources you might not see otherwise.

I brought up the idea of social media echo chambers because I think they could explain and sustain big shifts in the way people are investing.

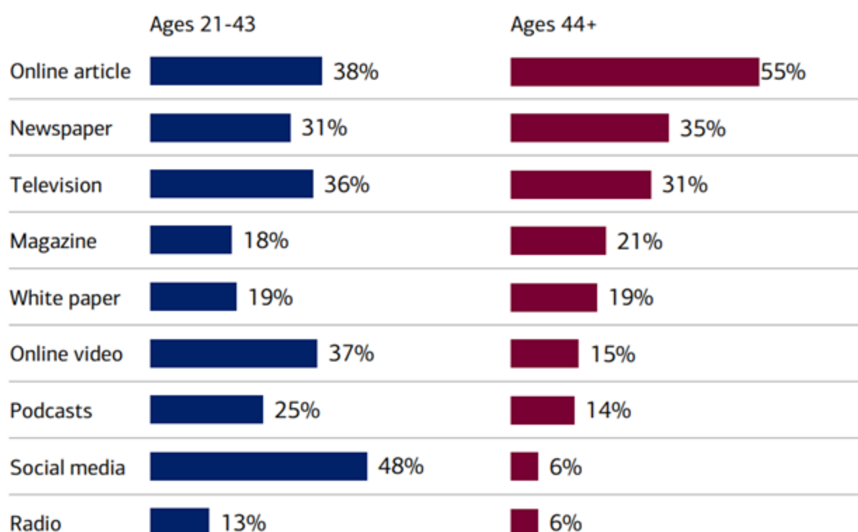
A recent report into America's wealthy and their investing habits from The Bank of America's private bank shows a big generational divide. Not only in regards to asset classes preferences, but in where different generations of investors consume financial information. I think the two are linked.

Here are the assets held by each generation (in any amount at all, not in terms of a % allocation):



Source: 2024 Bank of America Private Bank Study of Wealthy Americans

And here is where wealthy US investors prefer to get investing content:



Source: 2024 Bank of America Private Bank Study of Wealthy Americans

I will use crypto as the most obvious and extreme example.

28% of the wealthy 21–43-year-olds in BoA's study own crypto or digital assets versus 4% of the 44+ group. The latter matches with our Firstlinks customer survey, where 95% of the respondents in our latest survey were 45 or older. Less than 5% of you own cryptocurrency and over 85% of you have no intention to.

Flipping back to the American study, 48% of the BoA's 21–43-year-old respondents like getting financial content from social media compared to just 6% of the 44+ year old group of respondents. 37% of the younger group like getting financial content from online video sources (read YouTube, maybe even TikTok?) versus just 15% for the older group.

Social media and YouTube aren't just platforms where people in the crypto space are generally better at making content and making it go viral. They are also the two most algorithm-heavy, echo chamber like sources of information you could think of.

If you have been surprised by how long the crypto "fad" has endured, you might be surprised for a while longer yet. It isn't going to go away just because people on one side of the debate write articles or make videos saying that it's stupid. Those on the other side of the fence won't even see the content.

Hopefully today's edition bursts through the filter bubble and gives you a healthy dose of variety. And don't worry – I wasn't warming you up for a piece on Bitcoin.

Joseph Taylor

In today's edition of Firstlinks...

Inflation reduces the power of your savings, makes essentials more expensive and cuts the amount left over for luxuries. This makes it one of the biggest threats to a comfortable retirement. This is why most retirement products target returns above CPI – the most commonly used gauge of inflation. But does CPI provide an accurate idea of how much household costs are rising? **Harry Chemay** thinks otherwise. In this article, he explores how rising living costs really affect retirees.

Around 47% of our recent survey respondents were members of a Self-Managed Super Fund. These readers are not alone – data from the ATO shows that over 1.1 million Australians are SMSF members too. SMSF users are generally seeking greater choice and control of how they invest for retirement. But how do these advantages square up against potential downsides? **Tony Kaye** digs into the merits of a DIY approach versus investing in an APRA regulated fund.

Being diagnosed with a terminal condition often leads to worries beyond the illness itself. These will often include questions about how the patient and their family can be provided for financially, both during and after treatment. **Brooke Logan** explains options people in this situation might be able to access, including accessing super early and claiming terminal illness benefits.

Many people retiring today were working long before the Super Guarantee came into place. As a result, today's retirees may rely more on assets outside of super than future generations. For many, the family home is by far their biggest asset. **Andrew Boal** encourages policymakers and retirees to rethink the role it plays in retirement planning.

The performance of a few mega-cap stocks in the US has made it nigh on impossible for active managers there to beat the index. It's also emboldened and created a new generation of passive investors, not only in the US but across the world. When it comes to Australia, though, a feature of our major indexes could give active investors the upper hand. **Tim Carleton** explains why.

Private credit funds have attracted a lot of attention recently and investors are still getting to grips with the asset class. **Nehemiah Richardson** explains some differences between global and Australian private credit. He also highlights that growing demand has led to more complex and riskier private credit securities coming to market. He says a focus on quality and diversification looks crucial.

Human beings aren't the logical machines that most economic models suggest we are. In fact, we are prone to making seemingly illogical decisions – especially when there is a potential loss or gain on the table. This has obvious implication for investing. In this extract from his recent research, **David Walsh** explores the potential for a trading strategy to exploit these biases in the stock market.

This week's Sponsor White Paper comes from **Franklin Templeton**. **Stephen Dover** shares how Franklin Templeton are thinking about the next three years. This includes a look at global growth and inflation, a comparison of today's stock markets to past periods and potential opportunities in government bonds.

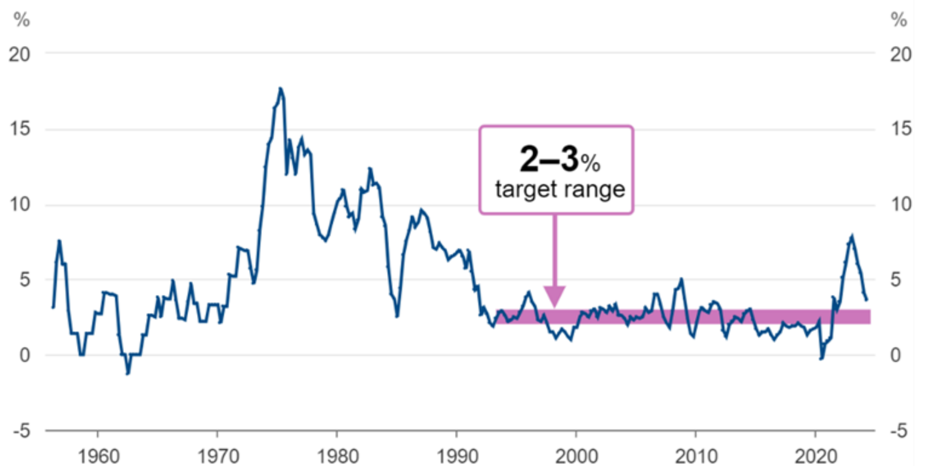
CPI may understate the rising costs of retirement

Harry Chemay

The post-lockdown resurgence of the Australian economy between 2021 and 2023 brought with it a confluence of inflation-inducing effects.

Consumer inflation, as measure by the Consumer Price Index (CPI), started to trend up in early 2021, rose past the RBA's target band of 2% – 3% p.a. by mid-year, and would go on to register an astonishing 7.8% for calendar year 2022.

The RBA responded to the inflationary threat by lifting interest rates 13 times between May 2022 and November 2023, resulting in the current cash rate of 4.35%.



If CPI is used as a measure of inflation policy success, this intervention appears to have worked, with the latest CPI coming in at 3.6% year-on-year for the March 2024 quarter, almost back within the RBA's target band, as the below chart indicates.

But what if CPI isn't the most appropriate measure of how Australians actually experience cost-of-living pressures, given their personal consumption patterns?

CPI – a blunt measure of cost-of-living

The CPI has been measured by the Australian Bureau of Statistics (ABS) using the same basic methodology back to at least 1960.

It aims to measure changes in the price of a fixed quantity (basket) of goods and services acquired by consumers in metropolitan private households (what the ABS terms 'the CPI population group').

Prices are tracked across thousands of items that are aggregated into one of 11 groups, (see table).

The weightings in the CPI basket above are meant to be representative of the consumption pattern of the 'typical' Australian household.

Except it's a big ask for one basket of good and services to accurately reflect the consumption preferences of disparate households that may differ by geography, age, income and, importantly for retirees, connection to work (sources of income).

Consumer Price Index (CPI) Groups	Current Weighting (%)
Food & non-alcoholic beverages	17.15
Alcohol and tobacco	6.98
Clothing and footwear	3.40
Housing	21.74
Furnishings, household equipment and services	8.43
Health	6.43
Transport	11.42
Communication	2.14
Recreation & culture	12.55
Education	4.34
Insurance & financial services	5.43

Source: ABS, Consumer Price Index, Weighting Pattern, 2024

In truth the CPI is not a measure of the changing purchasing power of households with differing consumption patterns. The ABS itself concedes the point, noting that:

"At the end of the day, the CPI is most useful as an indicator of price movements, whether it be for specific items, a particular city, or the economy as a whole. The CPI is not a precise measure of individual household price experiences."

Thankfully, the ABS has other inflation gauges that are better at assessing cost-of-living changes across differing household types.

Selected Living Cost Indices

To overcome the known limitations of the CPI in measuring household purchasing power, the ABS progressively introduced a series of Living Cost Indexes from 2000 onwards.

Whereas the CPI measures the change in price of a fixed basket of good and services, these cost-of-living indexes measure the change in the minimum expenditure needed to maintain a certain standard of living.

The ABS publishes four distinct 'Analytical Living Cost Indexes' (ALCIs) based on household type that, in aggregate, account for 90% of Australian households, these being:

- employee households (income principally from wages and salaries);
- age pensioner households (income principally from the age pension or veterans affairs pension);
- other government transfer recipient households (income principally from a government pension or benefit other than the age pension or veterans affairs pension); and
- self-funded retiree households (income principally from superannuation or property, and where the defined reference person is 'retired').

In addition, a Pensioner and Beneficiary Living Cost Index (PBLCI) is also maintained, this index effectively blending the middle two above, to cover households whose principal source of income is from government pensions and benefits.

According to the ABS, these five indexes are *"specifically designed to measure changes in living costs for selected population sub-groups and are particularly suited for assessing whether or not the disposable incomes of households have kept pace with price changes".*

How do LCIs track cost-of-living changes?

The CPI and LCIs share the same overall design and calculation methodology, both tracking price changes across the same 11 groups.

The key difference between the two relates to the cost of housing. The LCIs include interest charges on mortgages but exclude new house purchases. The CPI includes the cost of new house purchases (i.e. new builds) but does not include interest charges on mortgages.

That, as it turns out, causes the CPI and LCIs to diverge in dynamic interest rate environments (as was the case between mid-2022 and the end of 2023).

While headline CPI rose 3.6% for the year to 31 March 2024, the equivalent household inflation for the different household types is provided in the table below.

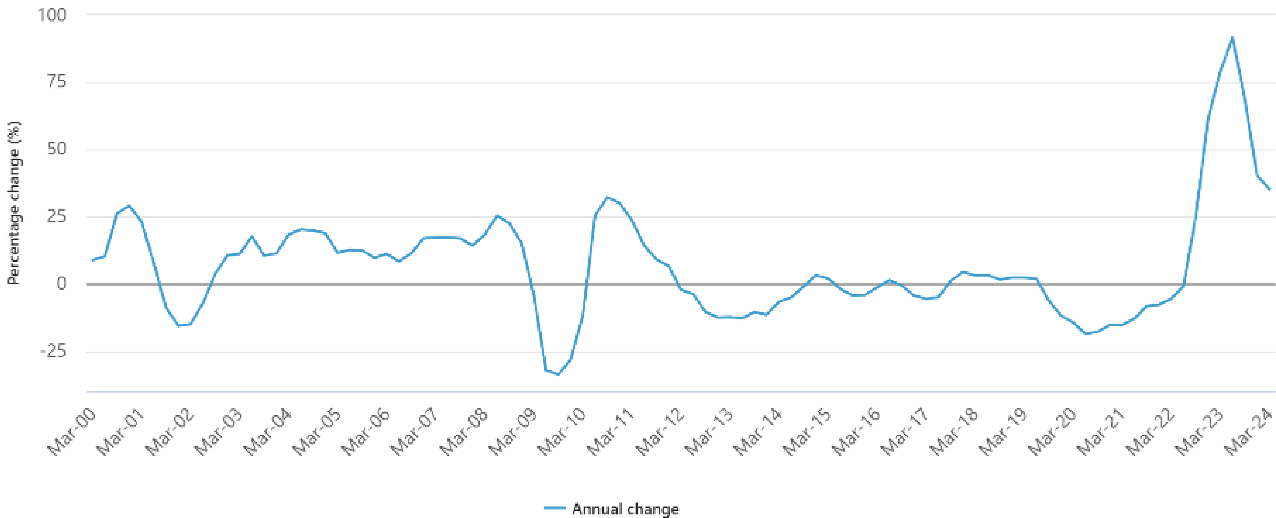
	Change from previous quarter (%)	Annual change (%)
Pensioner and beneficiary LCI (PBLCI)	1.3	3.9
Employee LCI	1.7	6.5
Age pensioner LCI	1.1	3.3
Other government transfer recipient LCI	1.4	4.4
Self-funded retiree LCI	0.7	3.4
Consumer Price Index (CPI)	1.0	3.6

Source: ABS, Selected Living Cost Indexes, Australia (March 2024)

Self-funded retiree households experienced an increase in their cost-of-living, but slightly below the headline CPI rate, as did age pensioner households.

Other government transfer recipient households (typically of working age) and employee households fared worse than CPI, with the latter seeing their cost-of-living surpass CPI by 2.9% over the year.

The main driver of this divergence has been interest charges. The current weighting for this expenditure is almost 12.5% for employee households, as compared to just over 1% for self-funded retiree households and 1.6% for age pensioner households.



Source: ABS, Selected Living Cost Indexes, Australia (March 2024)

With mortgage interest charges rising 35.3% during the past year (easing from a peak of 91.6% during the June 2023 quarter compared to a year earlier), the current cost-of-living crisis for many home-owning Australians, particularly those in their thirties and forties, could perhaps be better described as a 'cost-of-mortgage crisis'.

Current sources of cost-of-living stress for retirees

Below is a selection of spending categories from the age pensioner and self-funded retiree LCIs, displaying the percentage change in index values over two years, from the start of 2022 to the end of 2023.

Employee households are included, indicating how working-age households have fared in comparison to retiree households.

The two retiree groups within the LCI may have had broadly similar overall cost-of-living experiences over the past two years, but with distinct differences across specific expenditure items.

Change in Living Costs 2022-2023 (%)	Employee Households	Age pensioner Households	Self-funded retiree Households
Food & non-alcoholic beverages	11.0	10.7	10.5
Housing	13.8	9.4	13.8
Health	7.8	2.7	5.7
Transport	7.4	7.4	7.4
Recreation & culture	8.9	10.5	9.9
Insurance & financial services	72.7	26.8	26.1
All groups	**14.8**	**9.5**	**9.9**

Source: ABS, Selected Living Cost Indexes, Australia (March 2024, Table 2)

The main ones being insurance premiums and mortgage interest charges.

Self-funded retiree households tend to hold more, and higher premium, insurance products. Insurance premiums have soared across house, home and contents, landlord and motor vehicle insurance over the past year, some at the highest rates since the LCIs were first introduced.

Age pensioner households, by contrast, have been more impacted by the sharp rise in interest charges since mid-2022, particularly those still servicing mortgages, but also credit cards and personal loans.

Should CPI be used in retirement planning?

Inflation is central to any conversation on retirement, because its pernicious effects erode purchasing power over time and, with it, one's standard of living.

So central is inflation risk to retirement that it makes its presence felt right across the superannuation sector, from investment return objective setting (CPI plus targets) to retirement income forecasting (inflation-adjusting projected balances for 'today's dollars').

The Retirement Income Covenant, a requirement for all APRA-regulated super funds since July 2022, also explicitly names inflation as one of three key risks that members face in retirement, and that trustees must address in building retirement solutions.

But it's patently clear that the CPI is not best placed to be a measure of inflation as experienced by households, especially once in retirement. A lot of that is due to the CPI no longer measuring mortgage interest charges.

Some 14% of homeowners aged 65 and above now still carry a mortgage. Australians may therefore increasingly be subject to mortgage rate shocks, of the kind experienced during 2022 and 2023, well into retirement.

Add to that the sharp rises in private market rental over the past 12 months and, for the 18% of those over 70 who don't own the roof over their heads, rent inflation can impact far more than its weighting in the CPI might indicate.

The changing, increasingly tenuous, nature of housing in retirement therefore warrants a rethink of CPI as the best measure of retiree cost-of-living pressures.

In fact, the base rate of Age Pension (itself indexed to Male Total Average Weekly Earnings) already indexes its half-yearly increases to the higher of CPI and the PBLCI.

A case can therefore be made for self-funded retiree and age pensioner retiree households to have the relevant ABS living-cost-indexes applied to their circumstances in other areas, such as inflation indexation for retirement income products.

As the saying goes: 'what gets measured gets managed'.

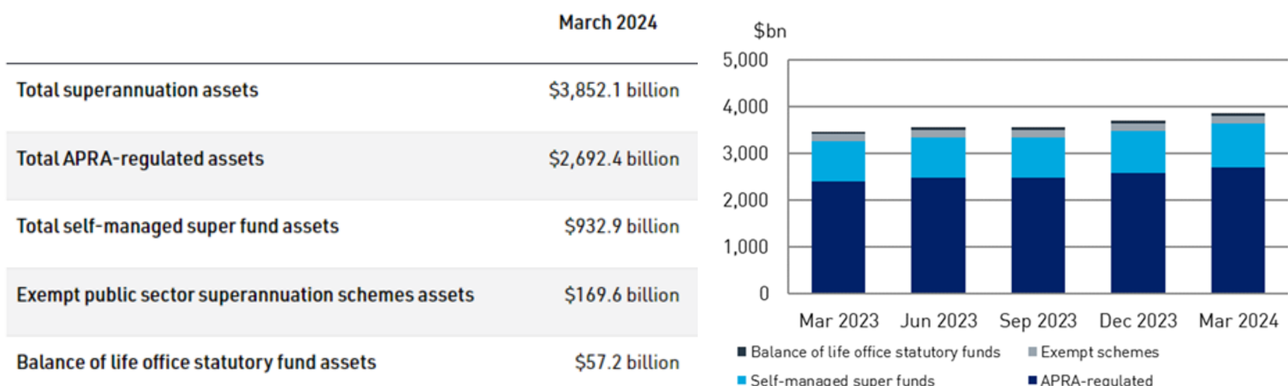
With the CPI we're not measuring what truly counts in retirement; maintaining a dignified standard of living irrespective of the specific cost-of-living pressures we may encounter along the way.

Harry Chemay has over 26 years of experience in both wealth management and institutional asset consulting. Initially a private client adviser with an SMSF focus, he has since consulted across wealth management, FinTech and superannuation, with a focus on improving post-retirement outcomes.

The pros and cons of taking the DIY super route

Tony Kaye

The number of Australians choosing to manage their own superannuation investments – both before and during retirement – has been progressively increasing over time. Current data from the Australian Tax Office (ATO) shows around 1.15 million people are now members of self-managed super funds (SMSFs), with their SMSF trustees collectively managing more than $900 billion of net assets.



	March 2024
Total superannuation assets	$3,852.1 billion
Total APRA-regulated assets	$2,692.4 billion
Total self-managed super fund assets	$932.9 billion
Exempt public sector superannuation schemes assets	$169.6 billion
Balance of life office statutory fund assets	$57.2 billion

Source: apra.gov.au

It’s a very sizeable amount, and it begs some obvious questions. Why are many Australians preferring to take the do-it-yourself (DIY) route instead of placing their super with a fund regulated by APRA (the Australian Prudential Regulation Authority) and into the hands of professional investment managers?

Are SMSF trustees generally better investors and fund super managers than the professionals, or are other factors coming into play?

Ultimately, choosing between an APRA-regulated fund and an SMSF depends on individual preferences, financial situations, and the level of involvement one wishes to have in managing their retirement savings. Each option has its own set of benefits and considerations.

Importantly, it doesn’t necessarily have to be one way or the other. Many SMSF members are also members of APRA funds. I’ll explain why later.

The desire for control

Broadly speaking, most SMSF trustees have one thing in common – their desire for total control over their superannuation investments.

This was one of the key findings from the 2024 *Vanguard/Investment Trends SMSF Report.*

Control incorporates having full choice over investment products, control over asset allocation, and total flexibility (within the strict parameters defined in the Superannuation Industry (Supervision) Act).

Just like APRA funds, SMSFs provide their members with the ability to make investment decisions tailored to their personal circumstances, risk tolerance, and retirement goals.

But SMSFs can invest in many things that APRA funds can’t, or don’t. This includes the ability to invest beyond mainstream assets such as Australian and international shares, fixed income, and cash.

For example, many SMSFs invest in direct property, including residential properties and privately controlled commercial property assets. Some hold collectible assets such as artworks and luxury vehicles.

Tax management is an extension of the control aspect for many SMSFs because they can provide opportunities for strategic tax planning, such as timing the sale of investments to minimise capital gains tax and utilising dividend imputation credits.

Cost effectiveness can also come into play for DIY funds. For those with larger balances, the per-member cost of running an SMSF can be lower than traditional super funds, making it a potentially economical choice. Also, in terms of pooling resources, SMSFs can have up to six members, which can be beneficial for families looking to combine their resources for investment purposes.

On the other hand, the costs associated with setting up and maintaining an SMSF, including audit fees, administration fees, and legal fees, can be disproportionately high for smaller fund balances.

Managing an SMSF requires a significant amount of time, financial literacy, and compliance with complex legal regulations. There are major risks associated with non-compliance. SMSFs are subject to strict regulatory requirements, and failing to comply can result in significant penalties.

How APRA funds compare

Contrasting with SMSFs, members of APRA-regulated funds have far less control over making specific investment decisions, which may not align perfectly with their personal investment strategies.

APRA funds do typically offer a range of options, mainly diversified investment products offering different weightings to equities, fixed income and cash that are usually labelled as conservative, balanced, growth, and high growth. Many also offer lifecycle products that automatically adjust members’ weightings to asset classes based on their age.

Some also offer access to quasi-DIY options, such as the ability to invest in Australian and international equities, which are generally underpinned by exchange traded funds (ETF).

There’s a degree of comfort for many people knowing that APRA funds are managed by investment professionals, which is ideal for individuals who lack the time or expertise to manage their own investments.

The cost of participating in an APRA-regulated fund can be more favourable than having a SMSF, particularly for people with smaller super balances.

That's because larger APRA-regulated funds benefit from economies of scale, which can lead to lower fees per member and potentially higher investment returns due to more significant investment opportunities and bargaining power.

But a major advantage for people joining an APRA-regulated fund is that the process is generally much simpler, and potentially much cheaper, than setting up and maintaining an SMSF. This can be particularly appealing for those who prefer a straightforward approach to their super.

Overarching this is the fact that APRA fund members are not responsible for the day-to-day management and compliance, reducing their administrative burden. APRA funds are subject to strict oversight, ensuring adherence to legal standards and reducing the risk of mismanagement.

Which way is better?

In summary, choosing between an SMSF and an APRA-regulated fund largely depends on individual circumstances, including financial goals, investment knowledge, and the desired level of involvement in managing retirement savings.

Many Australians actually choose to have both. They may use an SMSF to hold certain assets that are not available through an APRA fund, such as direct property, and an APRA fund that invests in mainstream assets such as equities and fixed income for their employer contributions.

Another advantage is that most APRA funds offer life and disability insurance at competitive rates with automatic acceptance up to certain levels. This can be more convenient and sometimes cheaper than obtaining similar insurance as an individual.

When deciding between managing a SMSF and using an APRA-regulated superannuation fund, it's essential to consider the advantages and disadvantages of each, based on individual financial situations, expertise, and personal preferences.

SMSFs do offer more control and flexibility but require significant commitment and responsibility. In contrast, APRA-regulated funds provide professional management and simplicity but at the cost of personal control over investment choices.

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

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Terminal illness and your super

Brooke Logan

In the face of a terminal illness diagnosis, financial stability and support for the person impacted (and their family) is an important consideration.

Someone who is diagnosed with a terminal medical condition may be able to access their superannuation early, and if they have insurance within their superannuation fund, they may be able to claim a terminal illness benefit.

Early access to super

The eligibility requirements to access super under terminal illness require that:

- Two registered medical practitioners have certified that the person suffers from an illness or an injury that is likely to result in the death of the person within 24 months; and
- At least one of the registered medical practitioners is a specialist practising in an area related to the illness or injury suffered by the person.

There are no limits on the amount someone can withdraw from their super, subject to fund rules. When accessing super due to terminal illness during the 24 months following the medical certification, any lump sum payment is tax-free and does not need to be included on your tax return.

Balances remaining after the 24-month certification period ends can still be accessed but may not be tax-free as benefits that accrue after the certification period are not covered by the original terminal medical condition of release.

Terminal illness benefit

Whilst the requirements to claim terminal illness insurance are generally like those needed to access your super, it is important to note it is a separate process.

Policies may vary, but usually terminal illness cover is included with your life insurance policy and can be claimed when a doctor certifies you have between 12 and 24 months of life remaining.

If the insurance claim is accepted, the terminal illness benefit will generally be paid into the person's super account.

There are different ways to access your super

Depending on the fund rules, a person who is terminally ill may have the option to take a pension, a lump sum payment or leave the funds in accumulation. The optimal decision will depend on their individual circumstances and financial needs including tax, social security and estate planning implications. Let's look at the three options.

Taking a lump sum

A lump sum withdrawn during the certification period provides immediate and tax-free access to funds which may be needed prior to death, such as for medical expenses or renovations, a family holiday, or for repayment of debt.

Lump sum withdrawals are not assessable for Centrelink or Department of Veteran Affairs (DVA) means testing, although unspent proceeds may be assessable if maintained, for example, in a bank account. Any unspent funds held outside super also attract tax on earnings at the person's marginal rate, which may be higher than the super maximum tax rate of 15%.

For estate planning purposes, there is no option for beneficiaries such as a spouse or child to commence a pension once the funds are removed from super. Once funds are withdrawn and invested personally, on death the amount will be included as an estate asset, and subject to the terms of the deceased's Will.

Withdrawing funds from super does create the possibility of intergenerational wealth transfer prior to death and removes any tax payable on super death benefits.

Retain in accumulation

Retaining funds in accumulation means the person can maximise social security entitlements whilst below Age Pension age, as these funds are not assessable by Centrelink or DVA. They also maintain access to ad hoc tax-free lump sum withdrawals as required to meet expenditure needs. Earnings are taxed at a maximum of 15%.

On death, eligible beneficiaries may have the option to commence a death benefit pension within super. However, any lump sum payments to non-dependant beneficiaries may attract tax.

Commence a pension

Using super to commence a pension can provide regular income to fund expenses. Whilst there is no tax on earnings within the pension, pension income is subject to standard tax rates:

- Tax free if the person is age 60 or older
- Taxed at marginal rate if they are under age 60 (some special situations can apply, eg, a disability superannuation benefit)

Funds used to commence a pension are assessed under both the assets and income test for Social Security and could reduce any benefits received. Note pensions can be beneficial for estate planning, as they allow for reversionary or death benefit pensions for eligible dependants, such as a spouse or minor child.

Beware – rolling over during the certification period

Whilst super benefits can be cashed under terminal illness, there is restriction on rolling over benefits to another fund. Where such a benefit is transferred between super funds during the certification period, the transfer is treated as having been cashed out as a lump sum and then recontributed as a non-concessional contribution for tax and contribution cap purposes. A rollover could therefore inadvertently breach a contribution cap and trigger an excess contribution.

Claiming permanent incapacity instead

Once any claimable insurance proceeds have been paid into the super fund, the trustee can be informed of which condition of release the person wishes to apply for. In some situations, a person may be eligible to access super under either terminal illness or permanent incapacity. The implications of accessing under both options differ.

The permanent incapacity condition of release may be suitable for a terminally ill individual if they

- are under age 60 and wish to commence a pension, where they will be entitled to a 15% tax offset on the taxable component of income payments, or
- wish to rollover their benefit to another super fund, where they may also have access to a tax-free uplift that is applied to the entire rolled over amount.

Example

Claire, age 49, has a terminal illness. Her super fund has confirmed she is eligible to access her benefits via either the terminal illness or permanent incapacity condition of release. In either case she has the option to take a lump sum or start a pension.

Claire's financial adviser explains the differences:

	Access benefits under terminal illness	**Access benefits under permanent incapacity**
Lump sum	Has flexibility to withdraw lump sums at any time tax-free during the certification period.	Will pay tax on the taxable component of any lump sum withdrawal up to 22%, there will be an increased tax-free component due to the tax-free uplift applied to a disability benefit.
Pension	The taxable component of each income payment would be included in her assessable income and taxed at her marginal rate.	The taxable portion of the income payments would be taxable at marginal rate but attract a 15% rebate.

Given that everyone's circumstances are different there is no right or wrong answer.

As always, one should seek financial advice before accessing superannuation due to terminal illness. A financial adviser can help you understand:

- the most appropriate condition of release under which to access your benefits;
- the difference between taking a pension, lump sum or leaving funds in accumulation; and
- the tax, estate planning and social security implications.

Brooke Logan leads the Member and Advice team at UniSuper, a sponsor of Firstlinks. Please note that past performance isn't an indicator of future performance. The information in this article is of a general nature and may include general advice. It doesn't take into account your personal financial situation, needs or objectives. Before making any investment decision, you should consider your circumstances, the PDS and TMD relevant to you, and whether to consult a qualified financial adviser.

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Rethinking how retirees view the family home

Andrew Boal

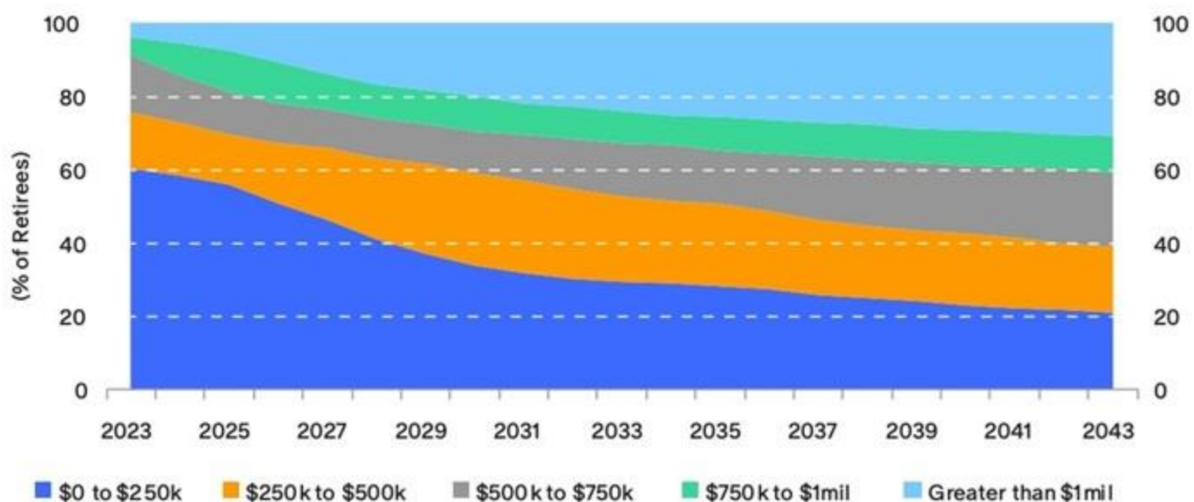
While the Australian superannuation system is one of the most successful in the world, it is still maturing.

After all, the Super Guarantee only commenced in 1992 at 3% of a person's earnings (or 4% for employers with an annual payroll above $1 million), increased to 9% from 1 July 2002 and is scheduled to reach 12% from 1 July 2025. It will take another decade or two before most employees retire having only experienced superannuation contributions of 9% or more for all of their working lives.

As the system matures, a growing number of Australians will be less reliant on the Age Pension and, as a result, will enjoy a better retirement funded wholly or in part by their superannuation.

While around 60% of current retirees have less than $250,000 in superannuation 'at retirement', this percentage is expected to decrease to around 20% over the next 20 years as the compulsory superannuation system matures (Boal & Somerville, 2023).

Figure 1: Proportion of superannuation balance ranges at retirement



This is what Treasurer Jim Chalmers calls "the intergenerational genius of super" (Ransley, 2023). But if we look at our ageing population and 'retirement' from an intergenerational perspective, we see there are many challenges.

In particular, government-funded health and aged care costs are on the rise while the superannuation system is still immature.

More than just a roof

An important part of voluntary private savings is the family home, with more than 80% of people currently aged 65 to 74 living in their own home (AIHW, 2023).

The property price boom of the past few decades means that even more modest properties have appreciated in value significantly, now accounting for a significant portion of the average homeowner's wealth. Yet it is also true that many 'asset rich, cash poor' retirees live more frugally than they need to.

For these retirees who own their home but have insufficient superannuation or other liquid savings, perhaps the home should be treated and used more like any other financial asset to help fund their desired lifestyle, as long as there are appropriate consumer safeguards in place.

Given these trends, it is reasonable to now ask how we should treat the family home in retirement, in a fair way that supports the sustainability and equity of the retirement system both today and into the future, for homeowners and renters alike.

Key areas of reform to focus on in relation to the retirement phase include:

- changing the narrative, so that it is more acceptable to access and spend part of the equity that has been built up in the home;
- improving financial literacy, especially in relation to retirement and longevity, so that retirees understand how they could use their accumulated assets to live a better life in retirement while still managing the various risks;
- ensuring we have strong disclosure requirements and consumer protections for the range of home equity release and related products, including "debt type" products, to improve the level of community understanding and expectations for these products;
- improving equity in the system for renters to make renting more affordable, especially in retirement;
- addressing the financial disincentives to access part of the wealth stored in the home, such as removing or refunding some of the frictional costs associated with downsizing and changing the means test treatment of the proceeds from sale

We must also do more to narrow the gap in retirement outcomes between homeowners and renters.

Gradually including the value of the home above a reasonable threshold into the Age Pension means test, for example, could improve equity in the system and encourage retirees to access some of this wealth. This continues to be a politically sensitive issue. But that doesn't mean we should fear having a conversation about it.

Given the amount of wealth stored in home equity in Australia, one could reasonably argue that the home is just as important as superannuation and the Age Pension when considering retirement outcomes. As policy makers bed down the legislated objective of superannuation and attention continues to shift to the retirement phase, we must take this opportunity to review our policies.

Andrew Boal is a Partner in Deloitte's Superannuation & Investment Specialists Practice and Chair of the Actuaries Institute's Retirement Strategy Group. This article is an edited extract from the Institute's new dialogue paper "More Than Just a Roof: Changing the Narrative on the Role of the Home".

ASX200 'handbrake' means passive investors could miss out

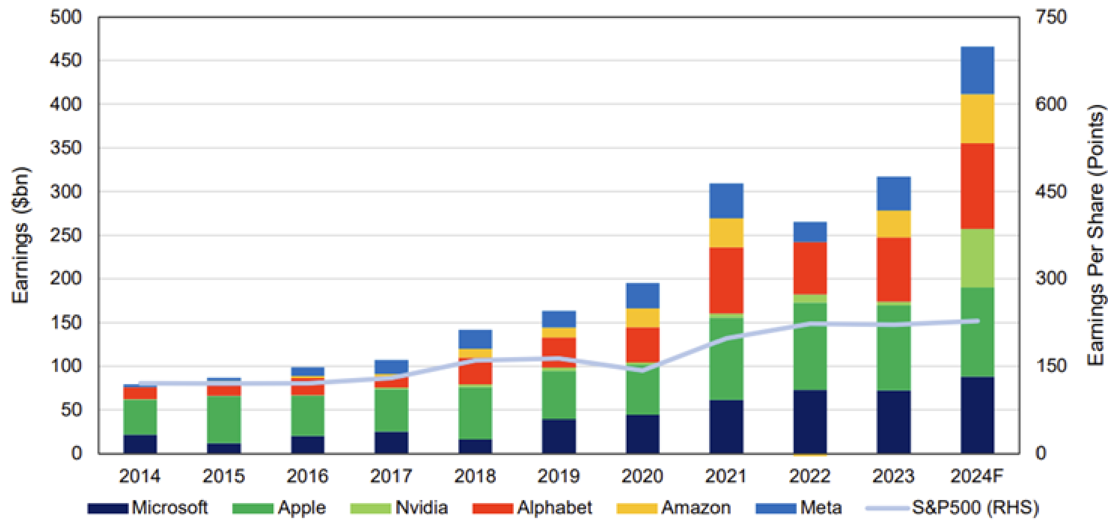
Tim Carleton

Passive investing is currently all the rage. This is in large part due to the strong performance of the US stockmarket, which very few active managers have outperformed in recent years.

A passive index exposure is going to be a great investment when the biggest companies in that index are growing their earnings faster than most other companies in the index.

If we look at the US's S&P 500 Index, its largest weights are currently Microsoft (7.2%), Apple (7.0%), Nvidia (6.7%), Alphabet (4.3%), Amazon (3.8%) and Meta (2.4%). These 6 companies account for 31.4% of the S&P 500 Index. They are also companies that are growing earnings a lot faster than the broader market, and in fact faster than most of the other companies in the Index.

This can be seen in the chart below.



Over the last decade the 6 current largest companies in the S&P 500 have compounded their earnings at 19.4% per annum. This compares to the Index, which includes these companies, which has seen compound earnings growth of 6.6%, implying the compound earnings growth of the other 494 companies has collectively been even lower than this.

The result is that a passive US index exposure in recent years has given investors a low-cost overweight exposure to a group of companies with significant earnings growth. So significant is the earnings growth and corresponding stock market performance of these six largest companies in the US that less than 25% of individual companies are outperforming the S&P 500 Index, a record low number over at least the last forty years.

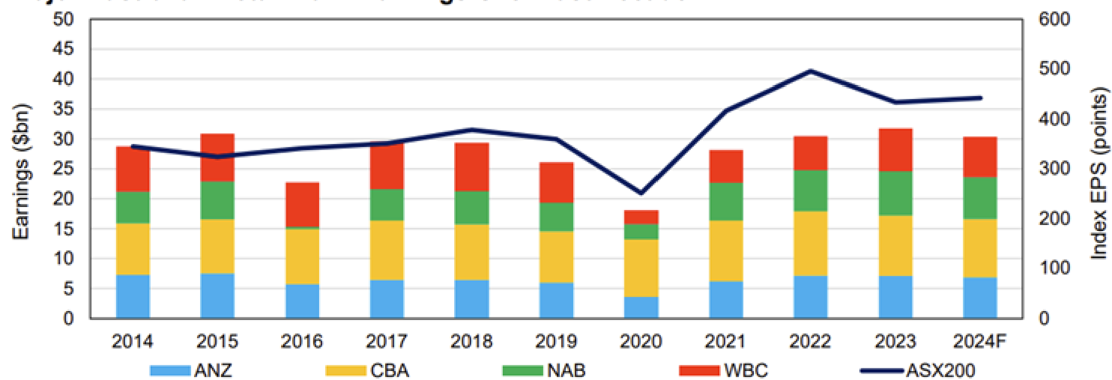
In such an environment, a passive index approach is very difficult to beat as an active manager. On the other hand, we suggest that there are also certain conditions that make an ideal environment for active investing.

These conditions include an index that is materially overweight large companies that are likely to exhibit low, or even negative, earnings growth over future periods. This is particularly the case when the market has plenty of other companies that should see strong earnings growth over time.

The argument for active management in Australia appears to us to be as strong as the argument for passive investment has been in the US.

Australia does not have large technology companies dominating the domestic stockmarket. The largest weights in the ASX200 are the Commonwealth Bank of Australia (9.3%), BHP (9.3%), CSL (6.3%), National Australia Bank (4.8%), Westpac (4.1%) and ANZ (3.8%).

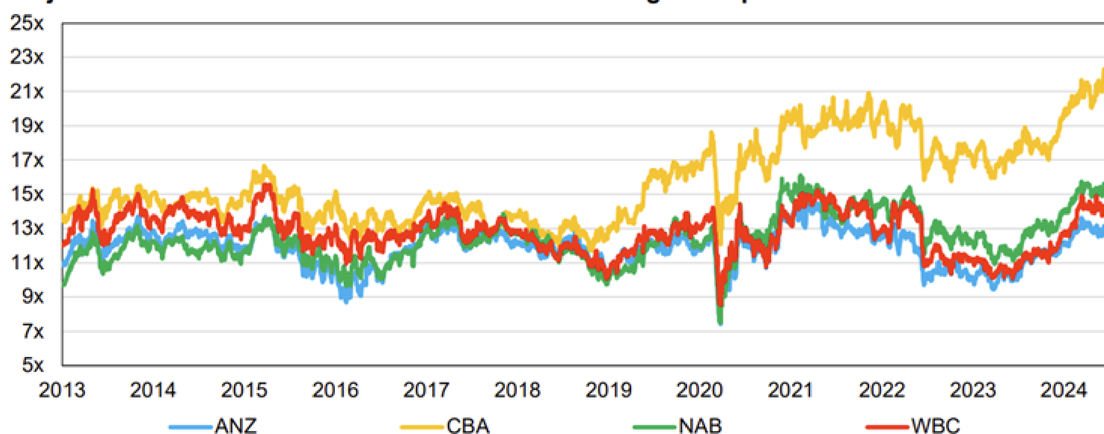
Australia's largest six companies, four of which are the large banks, account for 37.6% of the ASX200. If we focus on the four retail banks, collectively they account for 22% of the Index, yet they have failed to grow earnings meaningfully over the last decade.



Source: Bloomberg, Auscap

With the large banks continuing to display a more risk averse approach to lending, facing increasing competition in residential mortgages and business lending with the emergence of private credit providers, and having to deal with rising cyber security, information technology, compliance and employee costs, we struggle to see tailwinds for material earnings growth in the future.

All four banks have recently experienced strong share price appreciation, but this largely appears to be a function of the market paying a higher multiple of earnings for these companies than representative of a lift in their earnings growth. In fact, analyst forecasts suggest the market expects anaemic earnings growth for the big four banks over the next five years.



Source: Factset, Auscap

BHP, RIO and Fortescue account for a further 12.8% of the ASX200 Index. Their largest commodity exposure is iron ore. Yet it would appear that China's steel consumption, and hence iron ore consumption, peaked in 2020. This is extremely significant. In 2023 China accounted for 53.9% of the world's steel production and 50.8% of the world's steel consumption.

There is also political pressure on the margins for the large supermarkets, Woolworths and Coles (2.7% collectively of the ASX200 Index), and energy transition issues facing Australia's large energy companies, Woodside and Santos (3.2% collectively of the Index).

All of these stocks are in the largest 20 companies in the Index. So in contrast to the US market, we think there is a strong argument for relatively anaemic growth out of many of the largest weights in the domestic Index. But that is not true of all constituents within the Index.

Our caution around the outlook for earnings growth in the biggest domestic companies stands in contrast to our view on the attraction of investing in the Australian stockmarket.

Australian equities have returned 13.0% per annum from 1900 to 2023. This compares favourably with US equities, which have returned 9.9% per annum over the same time period. We are firmly of the view that the Australian economy is well placed to experience growth as strong as any developed economy on a go forward basis.

This is likely to be driven by structural advantages which include: strong population growth; an abundance of natural resources that will continue to be in demand globally through the energy transition; proximity to the growth of the emerging nations in Asia; a sound democracy with an established rule of law and firm private property ownership protection; a solid Government fiscal position; an educated population and a business culture with a track record of innovation and entrepreneurship.

We continue to believe that the domestic economy will present great opportunities for investment over time. Indeed there are currently many companies in the mid cap universe that are significant in scale with strong competitive advantages, have high return on capital metrics and plentiful opportunities for organic growth. This should lead to these companies experiencing strong earnings growth over time.

What does this mean? We think investors should expect their long-term return from investing in equities to approximate the sum of the earnings growth and dividend yield delivered over time. A passive investment in an Australian index appears to us to be overweight many companies that will struggle to grow earnings at attractive rates.

Such a market is one in which active management should outperform over time, if that active management is based on identifying businesses that are reasonably priced that will grow their earnings at healthy rates by reinvesting capital into attractive opportunities. We see many such opportunities in the domestic Index, particularly in the mid-cap space.

Tim Carleton is the Chief Investment Officer and founder of Auscap Asset Management. This article is an extract from Auscap's July 2024 letter to investors. You can see a full version of the letter here. This article contains information that is general in nature. It does not take into account the objectives, financial situation or needs of any particular person.

Don't compare apples and oranges in private credit

Nehemiah Richardson

It is little wonder more investors are interested in private credit, but as the asset class grows in profile investors need to be selective in their exposures. For success, investors must keep in mind that quality counts, and that diversification is still the best free lunch available in the asset class.

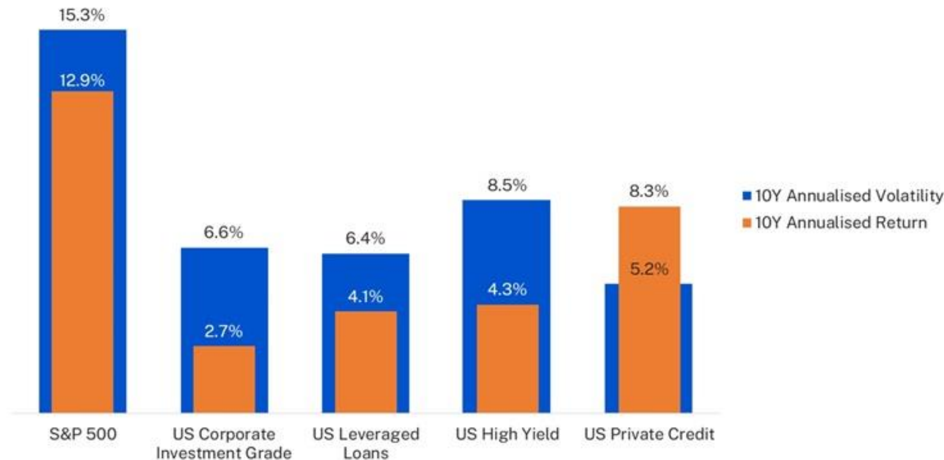
Globally, the private credit industry has surged since the GFC, having nearly tripled in value over the last 10 years to a US$1.5 trillion market size at the start of 2024. Some forecasts suggest the market could expand to US$2.8 trillion by 2028, with fund manager BlackRock predicting it will grow to US$3.5 trillion.

A good starting point for investors is understanding the difference between private credit in the Australian market and global private credit in markets such as the USA and Europe. Comparing global private credit with local private credit is like comparing apples and oranges.

Globally, the banks' withdrawal from corporate lending, combined with significant bank consolidation in the USA and Europe, created a major liquidity gap in the market. This liquidity gap is being filled by private credit managers, providing investments characterised by high risk-adjusted returns, floating rate yields, diversification, and capital stability.

Private credit is well recognised and accepted by investors and companies in the US and Europe, and plays an important role in their economies, with 85% of mid-market corporate lending done by investment managers and the balance by banks. The structural gap continues to increase, alongside growth in private equity dry powder, a key source of private credit demand.

US private credit has shown higher annual historical returns than other growth fixed income asset classes, with no significant realised increase in risk (as measured by volatility, being the Annualised Standard Deviation):



Volatility measured by Annualised Standard Deviation. Returns in USD. Source: S&P 500 Index, Bloomberg US Corporate Total Return Value Unhedged USD, Burgiss - Private Debt (North America), 10-year period from 1 July 2013 to 30 June 2023. S&P, Bloomberg and Burgiss have not provided consent to the inclusion of statements utilising their data. ***No assurance can be given that any investment will achieve its objectives or avoid losses. Past performance is not necessarily a guide to future performance.***

'Annualised Standard Deviation' is a measure of how much the price of an asset or the return of a portfolio of assets has fluctuated (both up and down) over a certain period. If an asset or portfolio of assets has a high Annualised Standard Deviation, the price of the asset or return of the portfolio of assets has historically fluctuated vigorously. If an asset or portfolio of assets has a low Annualised Standard Deviation, the price of the asset or return of the portfolio of assets has historically moved at a steady pace over a period of time.

Australian private credit is very different. It's a much smaller market with the Australian banks providing 90%+ of credit lending. The majority of loans are in areas where banks do not have credit risk appetite, for example commercial property and subordinated positions in asset-backed structured finance vehicles, which are yet to be cycle tested.

Current trends in global private credit

We're seeing several trends in private credit, including:

1. Greater accessibility for all investors

Until recently, global private credit investments have only been available to large institutional investors, such as Australia's Future Fund and industry superannuation funds.

Even high net worth investors have struggled to gain meaningful exposure because gaining entry to top rated managers with proven track records of performance was very difficult, particularly if you wanted to diversify.

But access is changing. The asset class has morphed from something impenetrable for retail investors, to something which can be accessed via the ASX or via a term account starting from $2,000.

2. An expanding borrower base

The demand for borrowing from middle market and larger companies continues unabated.

The structural liquidity gap, which occurred when banks withdrew from corporate lending, is increasing. For example, in the next 12-24 months there are about $1.5 trillion of leveraged loans which need refinancing that will not have the liquidity to do so. There is also another $1.5 trillion of commercial property to be refinanced – all at higher interest rates.

Private credit will take a large portion of this lending, whether they be direct lender or distressed managers. Many predict this will be a golden age for private credit.

But it's important to consider risk. Currently, the sweet spot for opportunity is coming from loans to middle market companies. US-based mid-market companies are relatively large by Australian standards, often having a market cap of US$1 billion-plus.

There is also opportunity from non-bank lenders with profitable pools of assets (like mortgage originators or providers of consumer or commercial finance), at sensible loan-to-value-ratios. There is a large opportunity set from these loans, which create a low risk of default and loss and attractive net returns.

3. Increase in more complex and lower quality securities

An expanding borrower base is creating more private credit product including securities of lower quality. The need to sort the wheat from the chaff will only become more important.

There is already evidence of growth in more complex loan products, along with 'covenant-lite' strategies, which may be higher risk or reduce underwriting standards.

More complexity and risk contradict the appeal of global private credit in the first place – as a relatively simple to understand investment, delivering premium fixed income returns at low-to-moderate risk. While default rates across global private credit remain very low, any strategies with complex financial engineering or high risk demands caution.

Investors will benefit from doing their homework to understand the nature of the global private credit portfolios, the managers involved, particularly their experience, track record and differentiation, and the risk being taken.

The best managers have long track records of attractive returns and low net losses, with long standing relationships and differentiated origination where they get first look at deals. While the market has strong growth dynamics, the best managers are mature with proven performance.

Key pillars for success in global private credit

The first main pillar for success is **simplicity**: Private credit is a huge, diverse asset class with strategies including distressed debt, mezzanine financing and structured debt, all of which have varying levels of complexity and risk profile.

We think the real opportunity is for simple approaches, which target quality. Global private credit can be relatively simple when built around bilateral loans, which is the most pure form of private credit investing, simply a loan between a borrower and an investor.

Well underwritten bilateral loans have strong structural protections and information rights, and modest LVRs, which result in low risk of default and loss.

These investments are relatively resilient as the loans are individually negotiated and structured – they generally have seniority and security over a borrower's cash flows and assets and have the right to force a borrower to take corrective actions to protect the value of the lender's capital if necessary.

Access to highly experienced managers with long track records of sustained performance is key to gaining the right exposures to these loans. We caution investors to beware of those claiming to have the expertise without track records extending through multiple cycles.

The second pillar is **diversification**: In global private credit, diversification is still the greatest free lunch for investors.

Diversification is key to minimising downside risk and maximising returns through economic cycles. This means diversifying across geographies, industry segments, managers, strategies and individual loans.

Even though default rates at the quality end of global private credit have been miniscule, a high level of diversification is a proven strategy for consistency of income returns, and to spread risk through a portfolio.

Nehemiah Richardson is CEO of Pengana Credit. Pengana, in association with Mercer, recently launched a listed investment trust, the Pengana Global Private Credit Trust (PCX), along with online term accounts, TermPlus, which provide fixed income from global private credit investments.

Could this flaw in human thinking be exploited for market gains?

Dr. David Walsh

Conventional economic theory assumes individuals are perfectly rational in their decision making under uncertainty. This is usually known as *expected utility theory*.

Prospect theory, on the other hand, represents more how people actually behave rather than how they are expected to behave. Its two main components are overweighting of tail probabilities and the shape of utility function.

Prospect theory considers options relative to a reference point – see below – rather than in terms of absolute wealth. This is contrary to the long-accepted theory that losses and gains are felt equally. While controversial, it has been shown to appear in many human pursuits.

Here are some examples:

Insurance: Prospect theory implies that we tend to *overweight low probability events*, like a house fire or some other catastrophe. We are willing to pay insurance premiums for these highly unlikely events, effectively switching a low probability large loss for a certain smaller loss. At the same time, we are less likely to purchase insurance for higher probability lower loss events, like loss or damage to a mobile phone.[1]

Gambling: Why are gamblers willing to bet on zero or negative expected value games in casinos?[2] Think of the example of a gambler who loses $500 compared to a gambler who has won $200. The losing gambler is more likely to take on another $500 gamble ("to make up the loss") than the winning gambler. Losses matter more than gains.

Health: Prospect theory seems to apply to non-monetary rewards as well as monetary. It seems obvious but individuals who are less satisfied with their body shape and wish to lose weight tend to have higher risk seeking behaviour when it comes to weight loss or gain. That is, they equate weight loss (gain) with "psychological" gain (loss), and their aversion to weight gain is roughly twice their desire for weight loss (in the sample from the paper).[3]

In investments, a similar behaviour has been observed, which has been named *the disposition effect*.

Disposition theory was first identified and named by Shefrin and Statman (1985) [4],[5], where it was found while looking at trading patterns of individual retail investors. The name comes from the idea that:

Investors are "predisposed" to sell winners too early and to sell losers too late, and they find evidence that this exists – and it is not a tax effect.

An example: you own stock A which has risen in value. You believe that there is still upside in the stock but timing the top is difficult, and "you never go broke taking a profit". That is, you are aware that the price might go higher, but you are comfortable missing out and would repeat the action.

Or you own stock B which has fallen in value. You think the stock could fall further, and it could also rise again, but you decide to "hang on for the ride". You don't sell out because you have already absorbed the loss, and you are ok if it goes lower and would repeat the action.

The figures below come from Frazzini (2006)[6] with some additions to clarify the ideas.

Case 1: Stock falls $10 and we don't sell

In the first chart below (Figure 1), we own a stock with the Reference Point at the centre or origin. The stock then falls $10 and we want to assess whether we would sell now. For simplicity, assume the next move is equally likely to be +$10 or -$10.

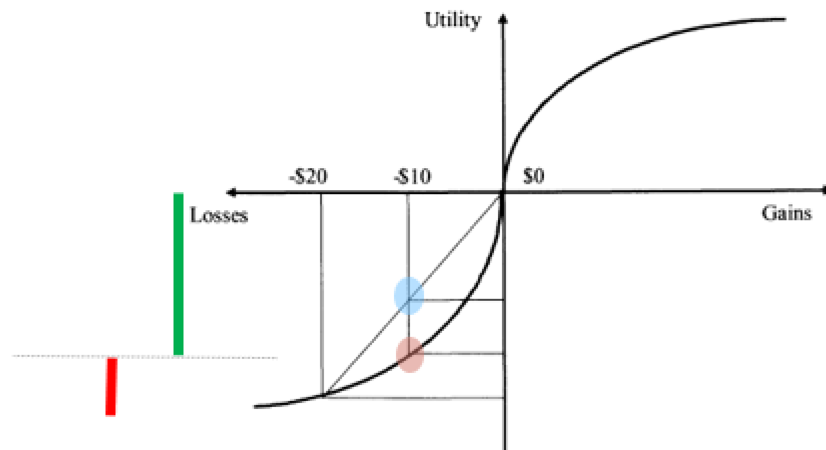
If risk neutral – blue dot – so we are indifferent to buying or selling.

However, if we use the Prospect Theory utility function - red dot - then the story is different.

If the stock recovers and we have not sold, the positive change in utility from continuing to hold the stock is the green bar. That is, there is significant upside to our utility if we don't sell and the price recovers. If the stock continues to fall and we have not sold, we lose another $10 but the reduction in utility (the red bar) is smaller than the green bar.

In other words, the $10 upside means more to us than the $10 downside. If the stock is equally likely to go up or down by $10, and we do not sell, then the expected change in utility (green bar less red bar) is positive. *So we don't sell.*

Figure 1: *The Disposition Effect with a loss – do not sell.*



Case 2: Stock rises $10 and we sell

In the second chart below (Figure 2), we own a stock with the Reference Point again at the origin. The stock then rises $10 and we want to assess whether we would sell now. For simplicity, again assume the next move is equally likely to be +$10 or -$10.

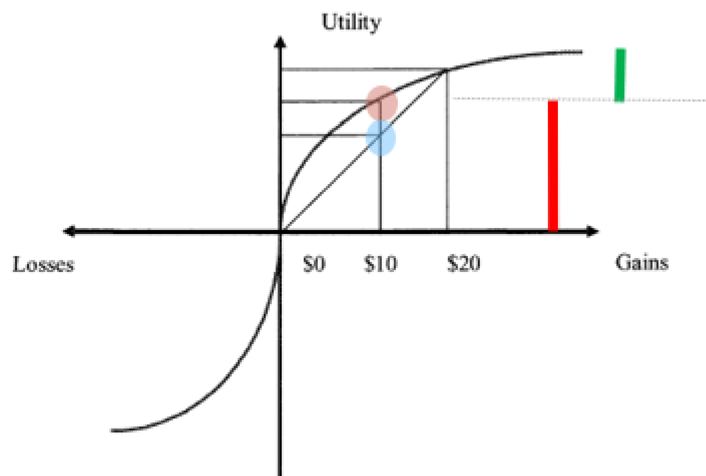
If risk neutral – blue dot – so we are indifferent to buying or selling.

However, if we use the Prospect Theory utility function - red dot - then the story is different.

If the stock falls and we have not sold, the negative change in utility from continuing to hold the stock is the red bar. That is, there is significant downside to our utility if we don't sell and the price falls. If the stock continues to rise and we have not sold, we gain another $10 but the increase in utility (the green bar) is smaller than the red bar.

In other words, the $10 upside means less to us than the $10 downside. If the stock is equally likely to go up or down by $10, and we do not sell, then the expected change in utility (green bar less red bar) is negative. *So we sell.*

Figure 2: *The Disposition Effect with a gain – sell*



To summarise, even if the probability of the next price change is equally likely to be up and down, we will choose to sell if the price has already risen but not sell if it has fallen.

Can we trade on this? Operationalising Prospect Theory

Behavioural biases push prices away from fundamentals – e.g., selling early or late in the case of the disposition effect.

Here, if prices have fallen below the individual's reference price, the individual is less likely to sell, creating an imbalance of buying over selling so future returns will be higher. On the other hand, if prices have risen above the reference price, selling has an increased likelihood, so the resulting imbalance selling over buying means future returns will be lower.

This idea might be captured by a strategy which buys stocks which have fallen and sells stocks which have risen. In other words, it may look like a price reversal/value or anti-momentum strategy. While academic research suggests that such a strategy may be additive, this remains to be seen in practice.

[1] https://thedecisionlab.com/biases/loss-aversion
[2] Barberis (2011) NBER working paper, "A Model of Casino Gambling"
[3] For example, Lim and Bruce (2015), Frontiers in Psychology: "Prospect theory and body mass: characterising psychological parameters for weight related risk attitudes and weight-gain aversion"
[4] Shefrin and Statman (1985), Journal of Finance, "The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence"
[5] There are many other examples in the literature which demonstrate the disposition effect. An early sample:
Heisler (1994), Review of Futures Markets, "Loss aversion in a futures market: An empirical test"
Weber and Camerer (1998), Journal of Economic Behaviour and Organisation, "The disposition effect in securities trading: An experimental analysis"
Odean (1998), Journal of Finance, "Are investors reluctant to realize their losses?"
Odean (1999), American Economic Review, "Do investors trade too much?"
Heath, Huddart and Lang (1999), Quarterly Journal of Economics, "Psychological Factors and Stock Option Exercise"
[6] Frazzini (2006), Journal of Finance, "The Disposition Effect and Underreaction to News"

Dr. David Walsh is Head of Investment at RQI Investors, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. You can read the full version of David's research paper on Prospect Theory and the Disposition Effect here.

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