Firstlinks
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Contents

The tortoise wins in investing *James Gruber*

A licensing regime can get super funds moving on retirement *David Bell, Geoff Warren*

Are Australian banks headed for a fall? *Hugh Dive*

Why allocating more to fixed income now makes sense *Benoit Anne*

What to do about the growing chorus of market correction warnings? *Roger Montgomery*

Small companies, big opportunities *Arian Neiron*

Editorial

It's nice to be back after a month-long bout of pneumonia. The infection landed me in hospital for a week, hooked up to a ventilation machine 24/7. It was humbling to go from being a fit and healthy person to one struggling to breathe after walking up a set of stairs.

It's great to see that I didn't miss much - only the assassination attempt on Donald Trump, Biden rolling over and Harris seemingly set to take on the Democratic nomination for President, and in markets, the Magnificent Seven entering correction territory …

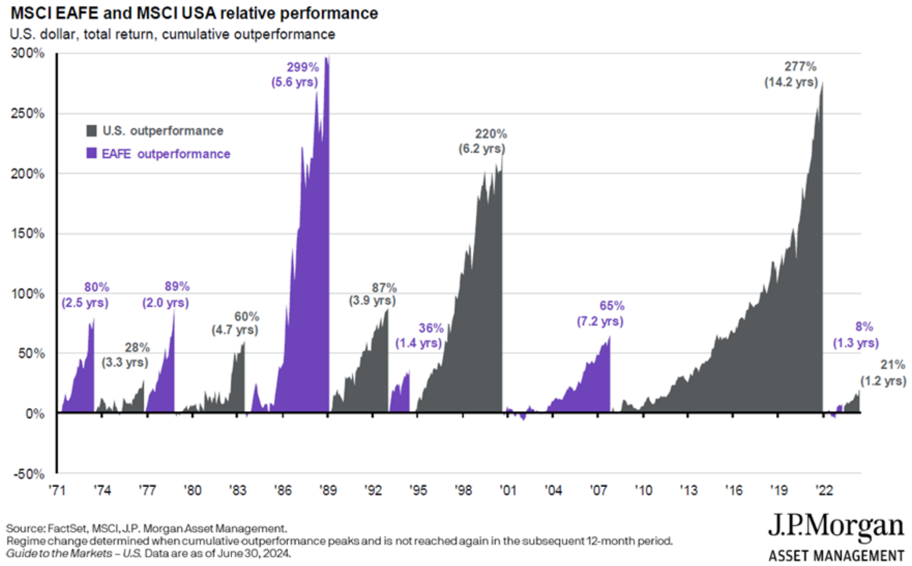
A big thank you to Joseph Taylor, Mark LaMonica, Shani Jayamanne and Leisa Bell for their tremendous work with Firstlinks in my absence.

Being in hospital can give perspective beyond the day-to-day noise of the news. And it seems to me that there are some obvious market trends right now:

1. US tech stocks are incredibly over-owned, overhyped and overvalued. If you add Alphabet, Meta, Amazon, Tesla and Netflix back into the tech sector of the S&P 500 index, tech equals 45% of the index. That means every passive investor, including many Australians, owns a major chunk of US tech – much more than they realise. And the hype around tech stocks is predicated on AI where returns from the enormous investments being made now are years away, as Alphabet admitted in a recent earnings conference call.
2. US stocks more generally are significantly overvalued. On every major valuation metrics, US shares are trading 1-2 standard deviations above their historical averages.
3. It's true that part of the reason for money flowing into US stocks has been earnings growth, especially among the Magnificent Seven. It's evident that overseas governments have invested their foreign exchange reserves not in US bonds as they once did, but in US stocks. That's not only propelled these stocks higher but also put a bid under the US dollar, which has concurrently had a long bull market.
4. Passive ETFs have poured fuel on the fire. They've filtered money into the biggest momentum stocks, namely US tech.
5. The recent correction has led to a small unwinding of these trends. US small caps have benefited at the expense of US large caps. Depressed currencies such as the Yen have bounced hard against the US dollar.
6. Is this the start of a larger correction? No one knows. However, the investor push into US stocks, especially tech, has reached such extreme levels that a more significant rotation out of them would seem inevitable at some point. A matter of when, not if.
7. Who could be the winners? Non-US equities, value stocks, and to a lesser extent, small caps stand to benefit. They're all under-owned and undervalued.

One chart that tells the story

For me, this first chart sums up much of the story.



The MSCI EAFE index includes large and mid-cap stocks from 21 developed markets in Europe, Australasia, and the Far East. The chart shows the performance of this index compared to the MSCI USA index over the past 50 years or so.

As you can see, the relative performance of the two indices ebbs and flows, with one ascendant from anywhere from one to 14 years.

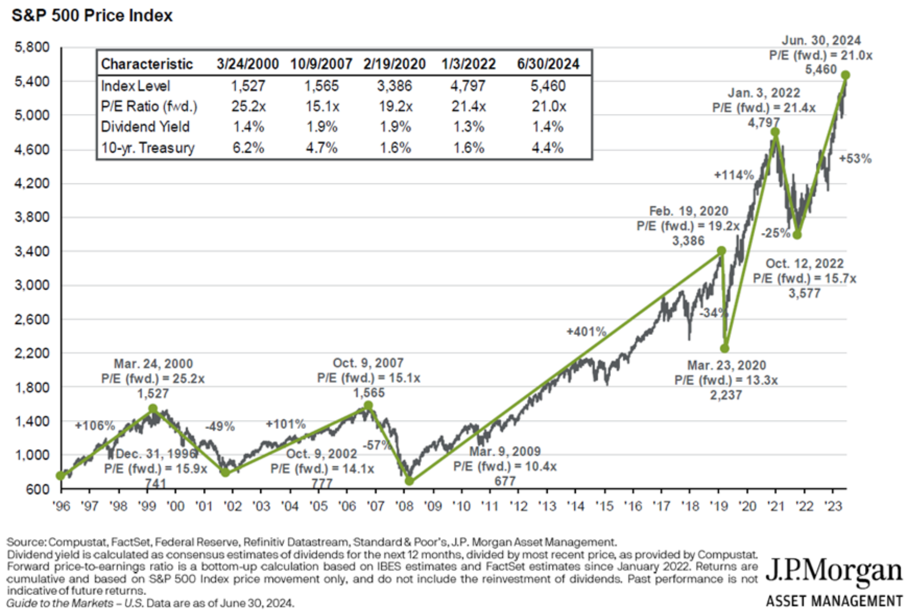
The thing that stands out is the recent outperformance of the US. From 2007-2021, American shares trounced the rest of the world. And after a minor reversal in 2022, US outperformance has returned.

There are two ways to read the chart. If you believe in mean reversion and cycles as I do, then recent US outperformance looks primed to reverse, potentially a lot, and for a length of time.

An alternative view would be that recent American outperformance has only just restarted and may go for longer.

US stocks: overhyped, over-owned, and overvalued

Here's why I don't think the alternative view will play out. First, US stocks look overvalued on every important valuation metric.



This chart reveals that at 21x forward price-to-earnings ratio, the S&P 500 is close to its peak valuation reached in 2022. The big difference between now and then, though, is that interest rates are much higher currently, as are 10-year Treasury yields. Traditionally, higher rates and bond yields equate to lower equity valuations, but that hasn't happened this time around.

Turning to the next chart, and on almost every valuation measure, the S&P 500 is 1-2 standard deviations above historical norms.

Second, the crowding into US large cap stocks, especially the Magnificent Seven, has reached extreme levels. The weighting of the top 10 stocks in the S&P 500 is 37%, more than double just a decade ago.

As mentioned previously, tech stocks now account for around 45% of the index. To put that into perspective, energy stocks after their roaring bull market of the 1970s accounted for just under 30% of the S&P 500 index at their peak.

Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	21.01x	16.69x	1.33
CAPE	Shiller's P/E	35.22x	27.80x	1.21
Div. Yield	Dividend yield	1.41%	1.99%	1.67
P/B	Price to book	4.32x	3.15x	1.46
P/CF	Price to cash flow	16.08x	11.23x	2.12
EY Spread	EY minus Baa yield	-1.08%	0.04%	0.61

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since March 1994 and by FactSet since January 2022. Average P/E and standard deviations are calculated using 30 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 30 years for each measure. *Averages and standard deviations for dividend yield and P/CF are since November 1995 due to data availability.
Guide to the Markets – U.S. Data are as of June 30, 2024.

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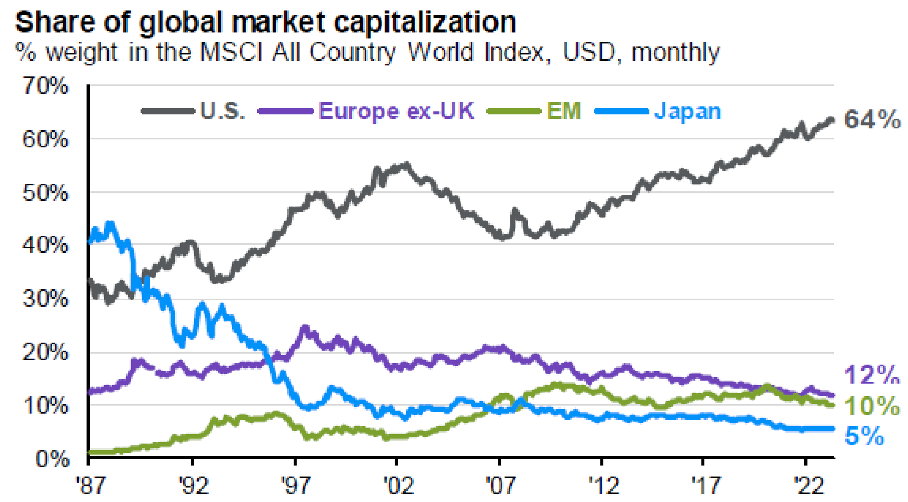
	Current	Average	% of avg.
Top 10	30.3x	20.4x	148%
Remaining stocks	17.6x	15.7x	112%
S&P 500	21.0x	16.6x	127%

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. As of 6/30/2024, the top 10 companies in the index were MSFT (7.0%), AAPL (6.3%), NVDA (6.1%), AMZN (3.6%), META (2.3%), GOOGL (2.3%), GOOG (1.9%), BRK.B (1.7%), LLY (1.5%), JPM (1.3%) and AVGO (1.3%). The remaining stocks represent the rest of the 492 companies in the S&P 500.
Guide to the Markets – U.S. Data are as of June 30, 2024.

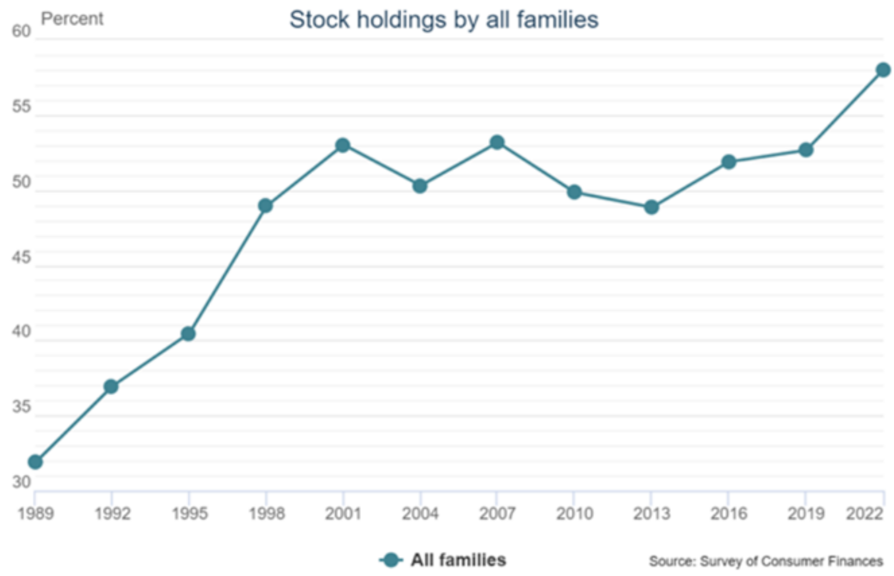
J.P.Morgan
ASSET MANAGEMENT

Third, the US share of global market capitalization has reached unprecedented levels. 15 years ago, the US weighting in the World index was close to 40%. Today, it's 64%. Anyone buying a passive global stock ETF is essentially buying America.

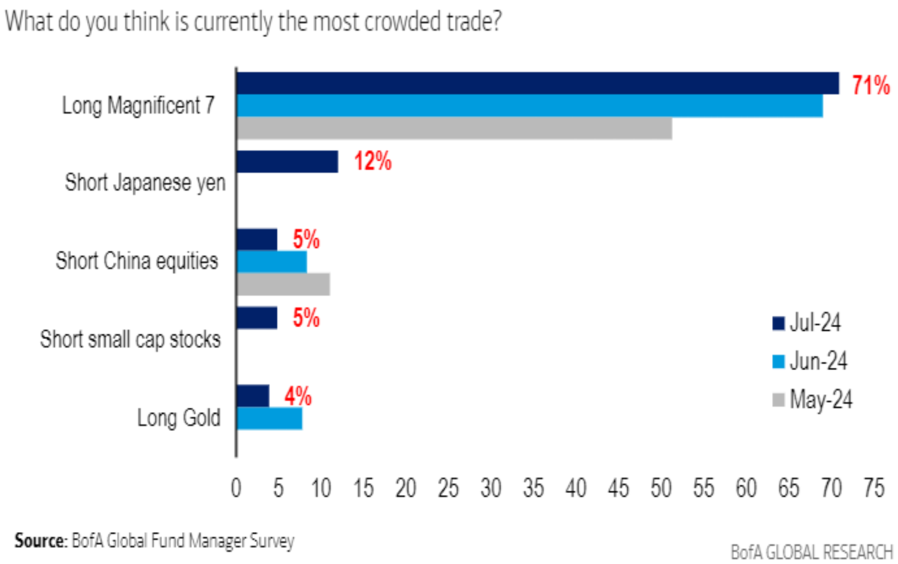


Source: JPM

Fourth, US and international investors have never owned as many American stocks as they do today, which makes them over-owned in my view. US household ownership of stocks has grown from 15.6% in 1982 of Federal Reserve Board Z-1 Household Assets to 47% today. And 58% of all American families own stocks, up from 32% in 1989.

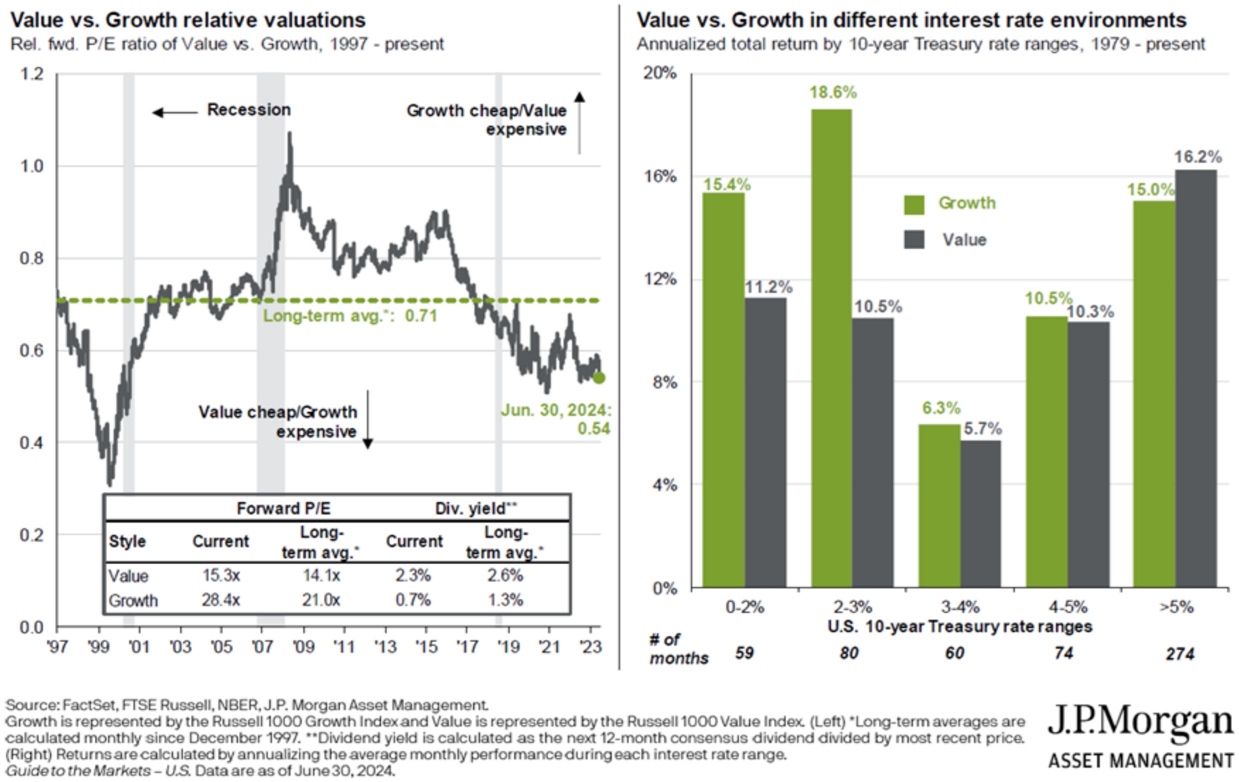


As for global institutional investors, they're all in – and then some - on the Magnificent Seven.



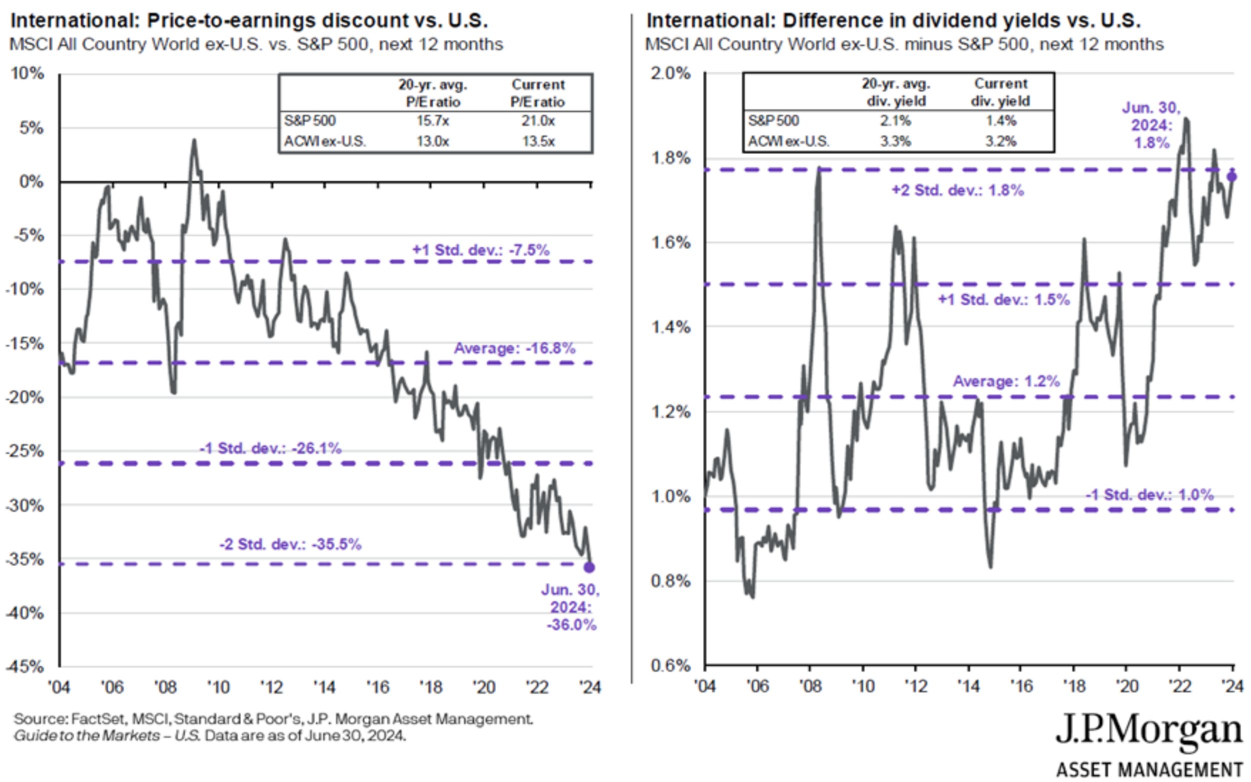
Trades for the next decade

If a long-term rotation out of US stocks, particularly tech, is near, then which assets stand to benefit? Value stocks, for one. The charts below show value versus growth stocks in the US.

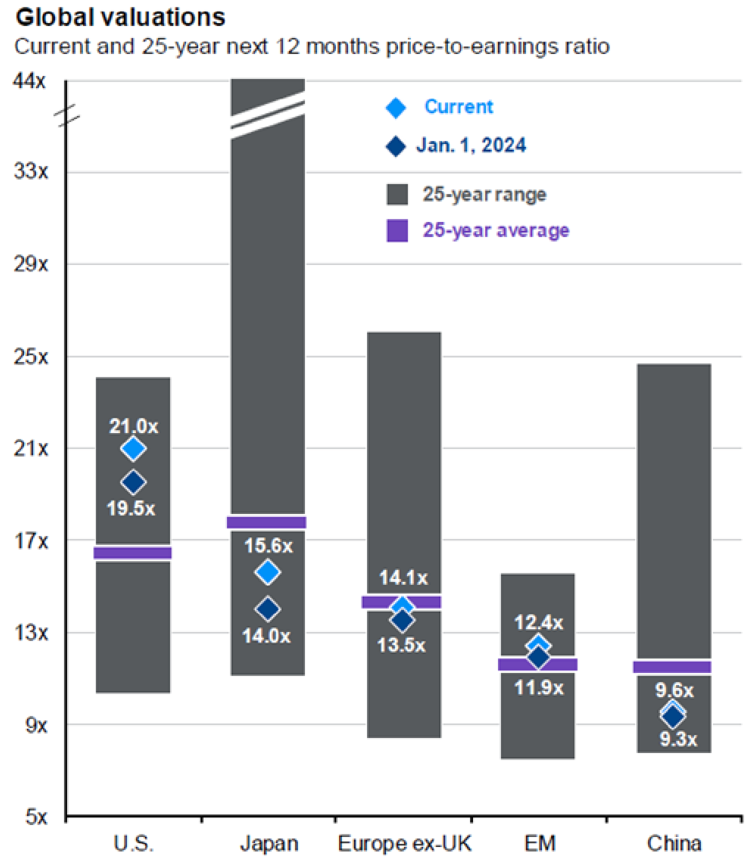


Note how value stocks are being priced at half of growth stocks on a current price-to-earnings ratio basis. And value has historically outperformed growth in higher interest rate environments.

Value stocks are even cheaper outside of the US, too.

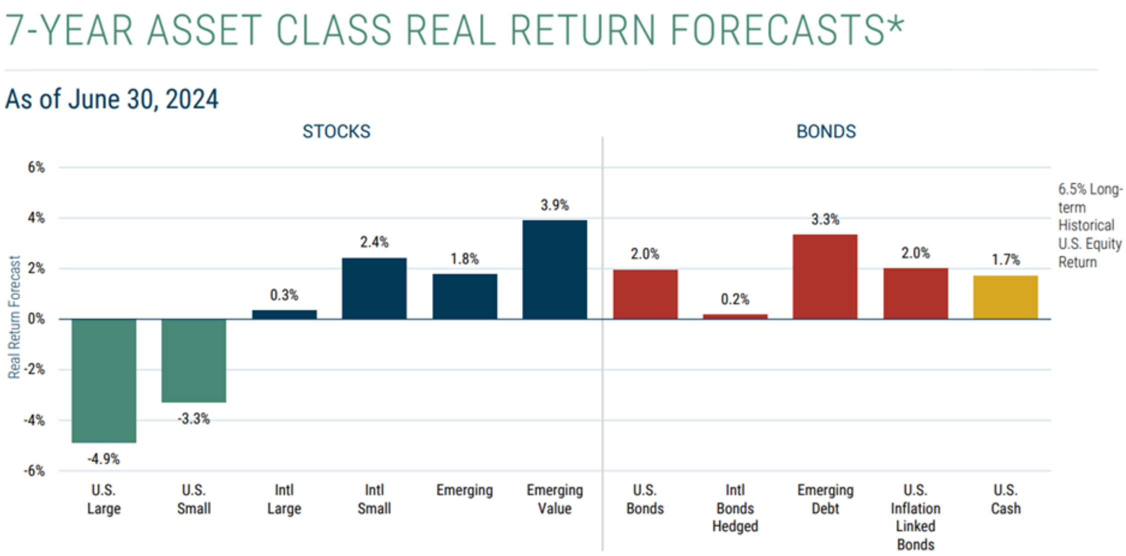


The other potentially more prospective area is in markets outside of the US. Many look cheap, especially those in emerging markets.



Source: JPM

Legendary forecasters, GMO, tend to agree, as they expect attractive real returns from markets excluding the US over the next seven years.



Source: GMO

As the GMO chart indicates, small caps, specifically outside the US, also appear attractive. That follows the rush into larger caps in recent years, aided by passive ETFs.

Triggers

So, what would be the catalyst for a long-term rotation out of US equities? If I knew that I'd be a billionaire living in the Bahamas.

More seriously, there are numerous potential triggers. However, sometimes it can be as simple as price action. Famous perma-bear Albert Edwards says bubbles often deflate purely because prices start to go down. What he means by that is when prices go down, that can trigger technical selling and impact investor psychology, and that can feed onto itself and lead to a larger downturn. It's a view of markets that closely aligns with George Soros' reflexivity theory – where positive and negative feedback loops between expectations and economic fundamentals can cause price trends that substantially and persistently deviate from equilibrium prices.

Opposing points of view

Where could my view go wrong? There's little doubt that the US has a lot going for it: a strong economy, significant private investment, cheap energy sources, a relatively young population compared to the rest of the world, and it attracts the best and brightest. That's not to mention this little thing called AI which could revolutionise business and propel economic productivity. That's the bull case for US equities to march higher.

The big question is whether any chinks may develop in this positive narrative. It could be AI being less than revolutionary or not rolling out as soon as investors expect.

And the other question is how much of the optimism is already priced in. As you might be able to tell, my view is: it's priced in a whole lot.

Key takeouts

The premise of this editorial isn't that people should rush to exit US stocks and tech. It's more that it might be prudent to lean into non-US equities and other neglected areas such as value. It may feel lonely to do so given the way investors are currently positioned. Yet it may pay dividends in the long-term.

In my article this week, I highlight recent research which suggests that less volatile, older companies have historically outperformed more speculative, newer companies. It runs counter to the current hype around tech companies and startups. It turns out the tortoise really does win in investing.

James Gruber

Also in this week's edition...

The Retirement Income Covenant mandates super funds create retirement strategies, but **David Bell** and **Geoff Warren** think progress has been uneven, leaving retirees under-served. They advocate for a retirement licensing regime that could enforce standards and improve outcomes.

Australian banks have had a roaring 12 months even though their earnings haven't improved. Are the stocks headed for a tumble? While fund managers and sell-side analysts are falling over themselves to be negative, **Hugh Dive** reckons the outlook is more nuanced.

Stocks and bonds have moved up and down together a lot in the recent years. Does this high correlation between stocks and bonds make bonds less attractive as a portfolio diversifier? **Benoit Anne** from **MFS** thinks not, because that high correlation has lifted overall portfolio risks, and the best way to lower those risks is by increasing bond allocations.

As markets retreat from record highs, more bears are making headlines. **Roger Montgomery** isn't one of them as he sees positive economic growth combining with disinflation to provide a nice backdrop for equities going forwards.

There's been a big rotation from large caps into small caps in the last month. Can it continue, and if so, what's the best way to play it? **VanEck's Arian Neiron** has some answers.

Allianz Retire+ says current retirement income options are limited, with Account Based Pensions offering flexibility but high risk; annuities providing certainty but lacking flexibility; and the Age Pension being insufficient. It outlines how new solutions are needed for retirees.

Finally, in this week's whitepaper, the **World Gold Council** gives an overview of recent supply and demand trends in gold.

The tortoise wins in investing

James Gruber

There aren't too many must-reads in the investment world, but UBS' Global Investment Returns Yearbook (formerly Credit Suisse) is among them. In it, a trio of academics – Ellroy Dimson, Paul Marsh, and Mike Staunton - dig deep into historical data and uncover key long-term trends, often at odds with current investment thinking. The latest publication, out earlier this year, hasn't received the attention it should as it ties in with other, just-released research, that debunks the long-held notion that taking greater risks in markets equates to higher returns. If right, it has ramifications for how investors should allocate assets for their portfolios.

Questioning Markowitz's Modern Portfolio Theory

In 1952, Harry Markowitz put forward a theory that would revolutionise finance. His Modern Portfolio Theory (MPT) said that taking more risk would reward you with a higher expected return. Markowitz later won a Nobel Prize for MPT, and it's framed how financial advisers and investment managers put portfolios together to this day.

There's now enough evidence to show that it's wrong. There's been plenty of research questioning the theory, though the UBS Yearbook should prove the exclamation mark that puts MPT to bed.

Specifically, the Yearbook looks at volatility across US stocks since 1963 and UK stocks since 1984. Volatility is the rate at which the price of a stock increases or decreases over a period. If the price of a stock fluctuates wildly in a short period, hitting new highs and lows, it's said to have high volatility. If the stock price moves higher or lower slowly, or stays relatively stable, it's said to have low volatility. Higher stock price volatility often means higher risk and helps an investor to estimate the fluctuations that may happen in the future. The UBS Yearbook orders the US and UK stocks by volatility and calculates how shares with low, medium and high volatility performed.

The study reveals that for low and medium volatility shares, returns are clustered. That means volatility is shown to have little effect on returns. For high volatility stocks, the results are more striking. They reveal that these stocks dramatically unperformed the rest. In other words, investors haven't been rewarded for putting money into stocks with high volatility; they've been punished.

Old and boring industries beat the new and shiny

The latest UBS research builds on their earlier, better-known work on whether it's better to invest in new industries, often characterized by higher volatility and risk, or older, more seasoned sectors. Its 2015 study examined the rise and fall of industries in the US and UK since 1900.

It found that though new industries and companies have transformed the world, they've often been disappointing investments. Why? Because, historically, there's been a tendency for the market to overvalue new industries and technologies. Part of the issue is that new industries are often born on a wave of IPO activity. And numerous studies show that the post-IPO performance of stocks around the world is poor.

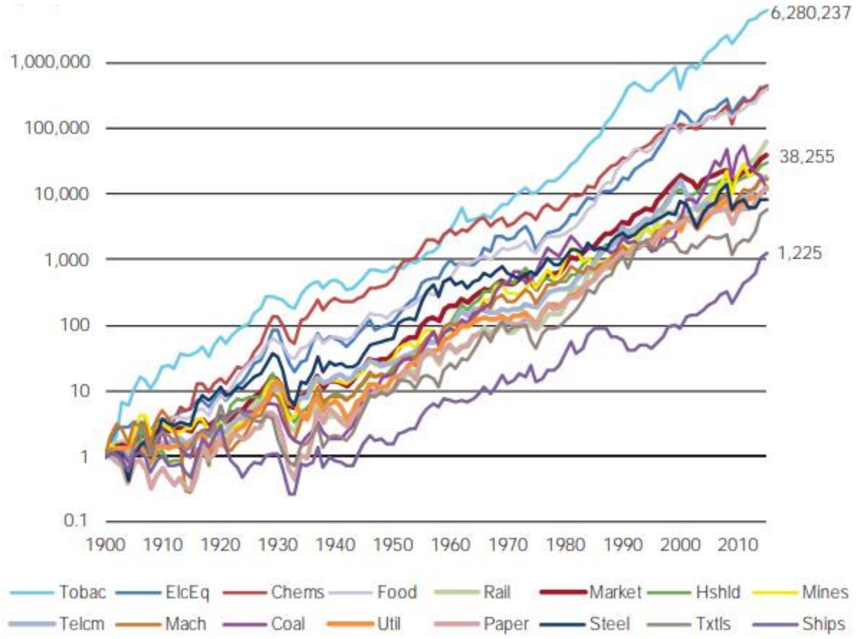
On the flip side, markets have tended to undervalue older industries, and that's resulted in superior performance over time, as the chart (right) attests.

It might surprise some that tobacco is the best performing industry in the US since 1900. US$1 invested in the sector back then turned into US$6.28 million in 2015. Not bad for an industry where volumes peaked in the 1960s.

Other unglamorous sectors such as electrical equipment, food and rail have also handily beaten the market. Rail is also a fascinating case study given it was the new technology of the late 19th century and had a prolonged decline soon after, though the last 30 years has seen a resurgence in the sector.

Long-run performance of industries in the USA

Cumulative value of USD 1 invested in US industries at the start of 1900



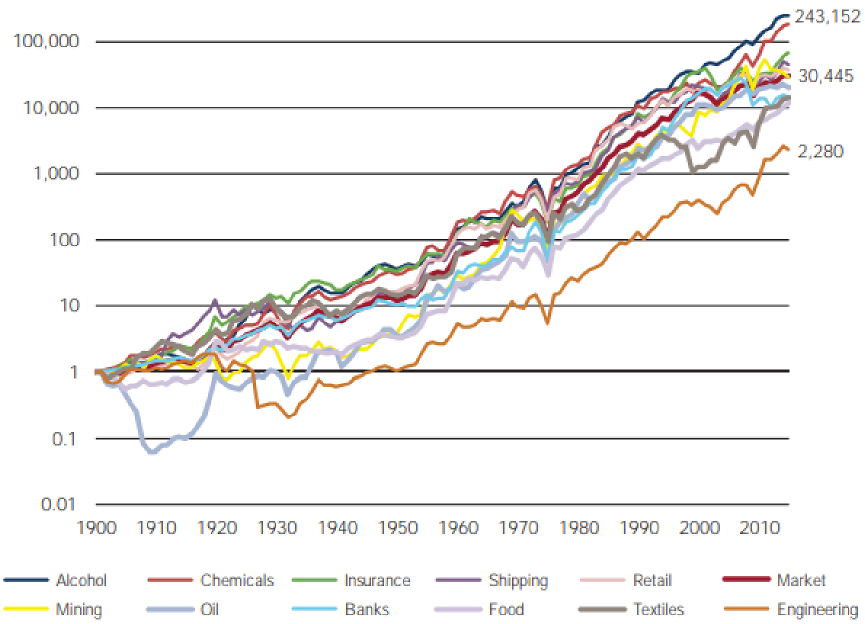
Source: Elroy Dimson, Paul Marsh and Mike Staunton; Cowles (1938), Ken French industry data; DMS USA Index.

The UK has different sectors at the top of the performance rankings than the US.

Notice how alcohol, part of the 'sin' industries including tobacco, is the best performing sector in the UK since 1900. It's followed by chemicals, insurance, and, surprisingly, shipping.

Long-run performance of industries in the UK

Cumulative value of GBP 1 invested in UK industries at the start of 1900

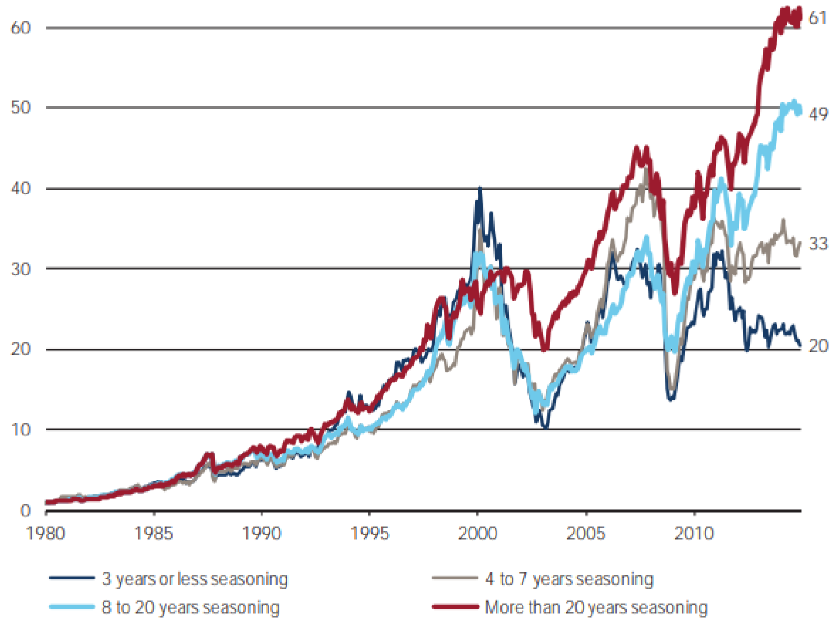


Source: Elroy Dimson, Paul Marsh and Mike Staunton; Top 100 database; FTSE International; DMS UK Index.

The 2015 study also outlines the performance of stocks based on their degree of so-called 'seasoning' – the length of time they've been listed since their IPO. It found that over a 35-year period, terminal wealth was almost 3x higher for the most seasoned stocks over the least seasoned. In other words, older stocks on average substantially outperformed newer ones.

Impact of seasoning on UK stock returns, 1980-2014

Cumulative value of £1 invested in UK stocks at the start of 1980



Source: Elroy Dimson, Paul Marsh and Mike Staunton.

Finally, the research tested value and momentum investment strategies that leaned into older industries and stocks against newer ones and found that they would have historically delivered superior returns.

Bessembinder's best stocks ever

The UBS findings tie into just-released work from renowned finance academic, Hendrik Bessembinder. Bessembinder has become famous, at least in investing circles, for his pioneering work into how very few stocks have historically accounted for the overwhelming majority of market returns.

"Focusing on aggregate shareholder outcomes, we find that the top-performing 2.4% of firms account for all of the $US75.7 trillion in net global stock market wealth creation from 1990 to December 2020. Outside the US, 1.41% of firms account for the $US30.7 trillion in net wealth creation."
- Hendrik Bessembinder and colleagues, Financial Analysts Journal, revised March 2023.

In his latest work, Bessembinder drills down into which specific stocks have performed best in the long-term. Can you take a guess as to which stock has had the highest cumulative returns in the US since 1925? You may have got a clue from the UBS study because the answer is Altria, the tobacco company. US$1 invested in Altria in 1925 turned into US$2.66 million by the end of last year. That's a compound annual growth rate of 16.29%.

Other stocks with impressive returns include Vulcan Materials (construction materials) Kansas City Southern (rail) General Dynamics (aerospace, defence), and Boeing (aerospace).

Table 2: CRSP Common Stocks with the Highest Cumulative Returns						
Company Name (Most Recent)	First Return Date	Last Return Date	Years	Cumulative Gross Wealth Per Dollar	Cumulative Compound Return (%)	Annualized Compound Return (%)
ALTRIA GROUP INC	31-Dec-25	29-Dec-23	98.00	2,655,290	265528900.62%	16.29%
VULCAN MATERIALS CO	31-Dec-25	29-Dec-23	98.00	393,492	39349084.13%	14.05%
KANSAS CITY SOUTHERN	31-Dec-25	13-Dec-21	95.95	361,757	36175578.11%	14.27%
GENERAL DYNAMICS CORP	28-Jan-26	29-Dec-23	97.92	220,850	22084880.36%	13.39%
BOEING CO	5-Sep-34	29-Dec-23	89.32	212,206	21220526.33%	14.72%
INTERNATIONAL BUSINESS MACHS COR	31-Dec-25	29-Dec-23	98.00	175,437	17543644.18%	13.11%
EATON CORP PLC	31-Dec-25	29-Dec-23	98.00	151,173	15117167.57%	12.94%
S & P GLOBAL INC	14-Feb-29	29-Dec-23	94.87	128,787	12878643.34%	13.20%
COCA COLA CO	31-Dec-25	29-Dec-23	98.00	123,724	12372265.06%	12.71%
PEPSICO INC	31-Dec-25	29-Dec-23	98.00	86,360	8635937.80%	12.30%
ABBOTT LABORATORIES	1-Mar-37	29-Dec-23	86.83	78,038	7803730.36%	13.85%
UNIVERSAL CORP	11-Nov-27	29-Dec-23	96.13	70,318	7031700.72%	12.31%
DEERE & CO	29-Jun-33	29-Dec-23	90.50	69,886	6988538.63%	13.12%
HERSHEY CO	1-Dec-27	29-Dec-23	96.08	69,099	6909822.15%	12.30%
WYETH	29-Apr-26	15-Oct-09	83.47	57,024	5702341.59%	14.02%
JOHNSON & JOHNSON	25-Sep-44	29-Dec-23	79.26	54,281	5427968.94%	14.75%
ARCHER DANIELS MIDLAND CO	31-Dec-25	29-Dec-23	98.00	51,811	5181049.17%	11.71%
C V S HEALTH CORP	27-Sep-28	29-Dec-23	95.26	46,939	4693845.60%	11.95%
U S T INC	31-Dec-25	5-Jan-09	83.02	43,963	4396203.50%	13.74%
EXXON MOBIL CORP	31-Dec-25	29-Dec-23	98.00	40,273	4027183.13%	11.43%
NORTHROP GRUMMAN CORP	10-Dec-51	29-Dec-23	72.05	39,495	3949426.66%	15.82%
TRANE TECHNOLOGIES PLC	31-Dec-25	29-Dec-23	98.00	39,238	3923693.49%	11.40%
F M C CORP	22-Apr-31	29-Dec-23	92.69	37,001	3699995.48%	12.02%
CATERPILLAR INC	2-Dec-29	29-Dec-23	94.08	36,903	3690210.17%	11.83%
BRISTOL MYERS SQUIBB CO	8-Sep-33	29-Dec-23	90.31	34,867	3486607.85%	12.28%
TOOTSIE ROLL INDS INC	31-Dec-25	29-Dec-23	98.00	34,401	3440011.10%	11.25%
PFIZER INC	17-Jan-44	29-Dec-23	79.95	28,990	2898900.69%	13.71%
KROGER CO	26-Jan-28	29-Dec-23	95.93	28,345	2834362.61%	11.28%
WALGREENS BOOTS ALLIANCE INC	15-Feb-34	29-Dec-23	89.87	27,053	2705196.76%	12.03%
EMERSON ELECTRIC CO	5-Sep-44	29-Dec-23	79.32	24,098	2409682.63%	13.57%

Source: Henrick Bessembinder, 'Which US stocks generated the highest long-term returns'

The top five best performing stocks aren't exactly in sexy industries. Does that mean the mundane beats the new? Bessembinder says yes and no. His study goes on to list the stocks more than 20 years old which have delivered the best annual returns, as opposed to cumulative returns. Topping this list is none other than the hottest company of the moment, Nvidia, closely followed by other technology companies such as Netflix and Amazon.

Note how much higher the annual returns of the likes of Nvidia are (33%) compared to Altria in the previous table (16%).

It's also worth mentioning though how many non-tech companies are in this second list too, including homebuilders (NVR), broadcasters (Lin and Time Warner), pool suppliers (Pool Corp) and healthcare companies (UnitedHealth, Express Scripts).

Table 5: Highest Annualized Returns, CRSP Common Stocks with Over Twenty Years Return Data						
Company Name (Most Recent)	First Return Date	Last Return Date	Years	Cumulative Gross Wealth Per Dollar	Cumulative Compound Return (%)	Annualized Compound Return (%)
NVIDIA CORP	22-Jan-99	29-Dec-23	24.94	1,316.00	131500%	33.38%
PLENUM PUBLISHING CORP	14-Dec-72	21-Jul-98	25.60	1,243.52	124252%	32.09%
NETFLIX INC	23-May-02	29-Dec-23	21.60	406.94	40594%	32.06%
AMAZON COM INC	15-May-97	29-Dec-23	26.63	1,551.73	155073%	31.78%
AXON ENTERPRISE INC	7-Jun-01	29-Dec-23	22.56	452.55	45155%	31.13%
SPERRY CORP OLD	3-May-33	30-Jun-55	22.16	273.82	27282%	28.82%
LIN BROADCASTING CORP	14-Dec-72	3-Oct-95	22.80	299.50	29850%	28.41%
COMPUTER DATA SYSTEMS INC	31-Jul-75	16-Dec-97	22.38	257.76	25676%	28.15%
PIONEER GROUP INC	16-Apr-79	24-Oct-00	21.53	202.40	20140%	27.98%
TIME WARNER INC NEW	19-Mar-92	14-Jun-18	26.24	541.01	54001%	27.11%
BIOMET INC	17-Dec-82	25-Sep-07	24.77	353.94	35294%	26.73%
COGNIZANT TECHNOLOGY SOLS CORP	19-Jun-98	29-Dec-23	25.53	396.11	39511%	26.40%
KEURIG GREEN MOUNTAIN INC	21-Sep-93	2-Mar-16	22.45	188.93	18793%	26.30%
MANOR CARE INC	14-Dec-72	25-Sep-98	25.78	393.08	39208%	26.08%
MICROSOFT CORP	13-Mar-86	29-Dec-23	37.80	6,225.98	622498%	26.00%
EXPRESS SCRIPTS HOLDING CO	9-Jun-92	20-Dec-18	26.53	457.25	45625%	25.97%
HOME DEPOT INC	22-Sep-81	29-Dec-23	42.27	16,627.40	1662640%	25.85%
SUNAMERICA INC	2-Jul-62	31-Dec-98	36.50	4,263.36	426236%	25.73%
POOL CORP	13-Oct-95	29-Dec-23	28.21	576.72	57572%	25.27%
NEUTROGENA CORP	17-Apr-73	30-Sep-94	21.46	123.62	12262%	25.17%
PHILIPPINE LONG DISTANCE TEL	2-Oct-62	18-Oct-94	32.05	1,299.79	129879%	25.07%
METROMEDIA INC	22-Jun-62	21-Jun-84	22.00	132.70	13170%	24.88%
N V R INC	18-Nov-93	29-Dec-23	30.11	727.32	72632%	24.46%
ECKERD JACK CORP	23-Jan-64	30-Apr-86	22.27	129.31	12831%	24.40%
INTUITIVE SURGICAL INC	13-Jun-00	29-Dec-23	23.55	168.10	16710%	24.31%
AAON INC	3-Jan-91	29-Dec-23	32.99	1,217.25	121625%	24.03%
LOGICON INC	14-Dec-72	1-Aug-97	24.63	198.55	19755%	23.96%
ADOBE INC	13-Aug-86	29-Dec-23	37.38	3,039.55	303855%	23.93%
UNITEDHEALTH GROUP INC	17-Oct-84	29-Dec-23	39.20	4,479.41	447841%	23.92%
NATIONAL COMPUTER SYSTEMS INC	14-Dec-72	19-Sep-00	27.77	361.09	36009%	23.63%

Source: Henrick Bessembinder, 'Which US stocks generated the highest long-term returns'

Key takeaways

Here are some key takeaways from these studies:

- It's time in the market rather than market timing that counts. As Altria demonstrates, compounding returns at 16% per annum generates mind-boggling wealth in the long-term, and even lower returns can still deliver satisfactory outcomes.
- The UBS study shows that investors tend to overvalue newer industries and stocks and undervalues older ones. It's not always the case, but that can pave the way for compelling investment opportunities.
- The studies neglect to mention something critical – how important industry structure is to stock returns. I don't think it's an accident that tobacco has been such a fruitful sector given the massive consolidation that's happened in the sector over the past 50 years, and the pricing power that it has given companies in the face of declining volumes. The same goes for the rail industry, where volumes have been flat for a long time, yet many companies have generated incredible returns over the past 30 years thanks to consolidation, pricing power, and streamlined cost structures. Put simply, favourable industry structures can allow some companies to bypass competitive threats and avoid the 'creative destruction' that happens to the majority of the market.

James Gruber is Editor at Firstlinks.

A licensing regime can get super funds moving on retirement

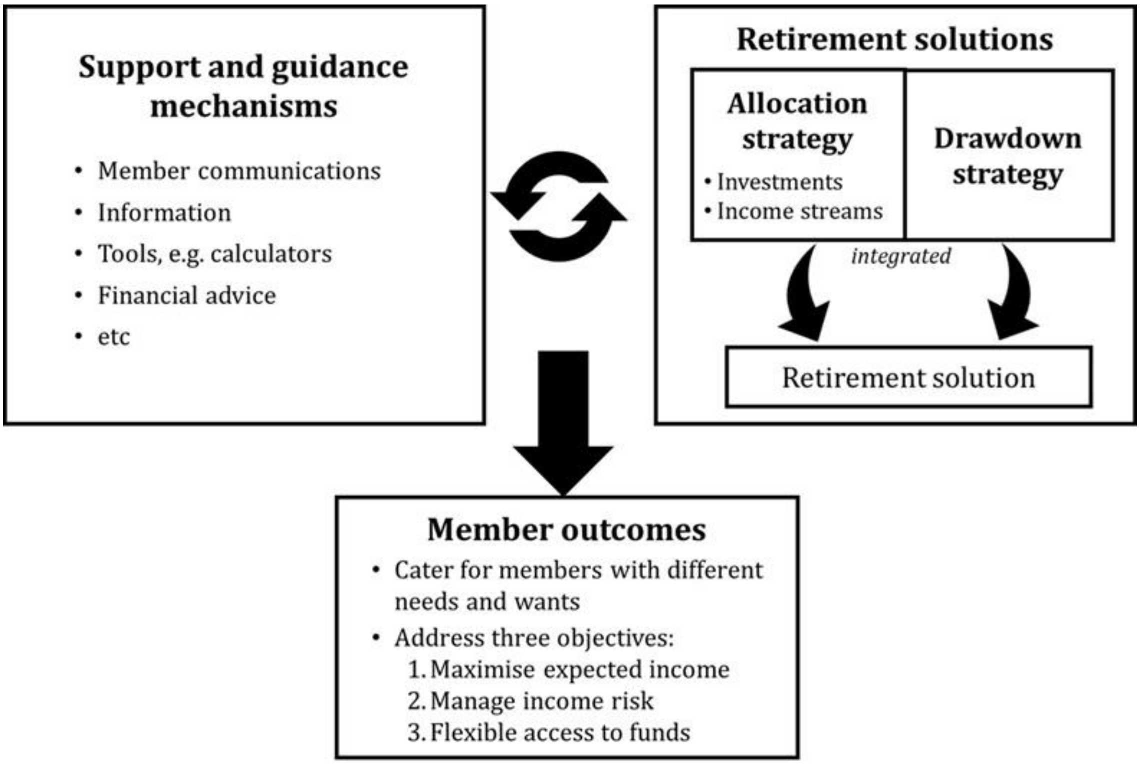
David Bell, Geoff Warren

The Retirement Income Covenant (RIC) was introduced in July 2022 and requires ***all*** super funds to develop a retirement income strategy to assist their members in meeting their retirement needs. However, progress made by funds in developing their retirement income strategies has been slow and uneven, as highlighted by two joint reviews by APRA and ASIC found here and here.

Our own discussions with super funds finds something similar. We are observing high dispersion in the progress in developing retirement offerings and the quality of those offerings across funds. Some are well-advanced, while others are lagging badly. No super fund has everything in place to assist all their members with all their retirement needs.

A super fund retirement income strategy should assist fund members through a range of retirement solutions that convert assets into income plus support and guidance mechanisms (see diagram below). However, no super fund yet has the capability to offer bundled solutions comprising investments, lifetime income products and a drawdown plan that are tailored to the needs of the member (or member cohorts). Support and guidance mechanisms are also still being built out. Members have to either seek personal financial advice on how to combine these building blocks or do it for themselves. Many fund members are left floundering as a result.

Components of retirement income strategies offered by super funds



What's going on here?

Assisting retirees is tough as their personal circumstances can differ in significant ways. Retirees vary in their available assets, access to the Age Pension, household situation, and more. They differ in how they engage with financial decisions. Both the type of retirement solution and support and guidance they need can thus vary greatly. Super funds have to develop a capacity for 'personalisation' to cater for these differences. Developing the products, processes and systems takes time and effort, and is quite costly.

However, something else is happening other than development lags. The commitment to delivering a quality retirement offering varies considerably across funds.

Some super funds have a very low portion of members and assets in the retirement phase. For example, APRA data for June 2023 reveals that 27 of the top 50 funds had less than 5% of member accounts in retirement products. And as mentioned above, retirement is costly. There is also uncertainty over how the regulations around retirement might evolve. And super funds have other pressing priorities to deal with, e.g. mergers, organic growth, cybercrime. In effect, some funds face a weak business case to commit a lot of resources to pushing ahead on retirement.

Meanwhile, the RIC only requires super funds to have a retirement income strategy, not necessarily to produce a good one. In this context, the variable progress across super funds is not all that surprising. The problem that arises is that retired or retiring members of laggard funds may be left behind.

Retirement licensing would help move the industry forward

Establishing a retirement licensing regime would help get the super industry progressing in the right direction. It is important that super funds are effective players in retirement, especially as it is unlikely that every retiree will be able to access personal advice from a financial planner. We set out our case in a 'green paper' that can be found on the Conexus Institute website here, and welcome any comments. A licensing regime would basically work as follows.

Super funds would be required to meet licensing conditions before being permitted to offer retirement solutions to their members. The licensing conditions could be based around having in place the range of ***capabilities*** needed to supply suitable retirement solutions and guidance services to their members, including meeting their individual needs. The regime would formally commence at some future date, allowing funds time to prepare.

Super funds would then face a choice. They could undertake to commit to building the required capabilities within the specified time frame. Or they could decide not to participate in the retirement market, or perhaps defer participation to a later time.

Retirement licensing can offer a number of benefits:

- Licensing would get funds that do commit to expeditiously push ahead in delivering on retirement.
- Funds that do not want to commit can opt-out. One issue with the RIC is that it requires ***all*** funds to develop a retirement income strategy regardless of whether or not it makes sense for them to do so. Giving funds a route out will reduce the risk of some funds moving forward with low-ball offerings.
- The licensing conditions could be used to establish minimum standards. This helps overcome another issue with the principles-based RIC – it is silent on required standards.
- Regulatory uncertainty over what is expected of super funds would be reduced. We envisage that the licensing conditions might be linked to how funds will be assessed by the regulators.

There are of course some issues. One is that procedures would be required for non-licensed funds to 'hand-off' members as they approach and then enter retirement. Some early comments we have received are around increased regulatory burden on the industry. While there will be cost involved in administrating the licensing regime, our view is that licensed funds will only be asked to do what they should be doing anyway, while regulatory burden is actually reduced for funds that opt-out. Finally, retirement licensing should help reduce the overhang of regulatory uncertainty.

A retirement licensing regime would be a powerful mechanism for ensuring that only super funds that are committed to delivering a retirement income strategy to a satisfactory standard are operating in the retirement market. We see this as important for ensuring that the needs of ***all*** retirees are adequately served, given that many will probably be relying on their super fund in retirement.

David Bell is the Executive Director of The Conexus Institute. Geoff Warren is a Research Fellow with the Conexus Institute, and an Honorary Associate Professor at the Australian National University.

Are Australian banks headed for a fall?

Hugh Dive

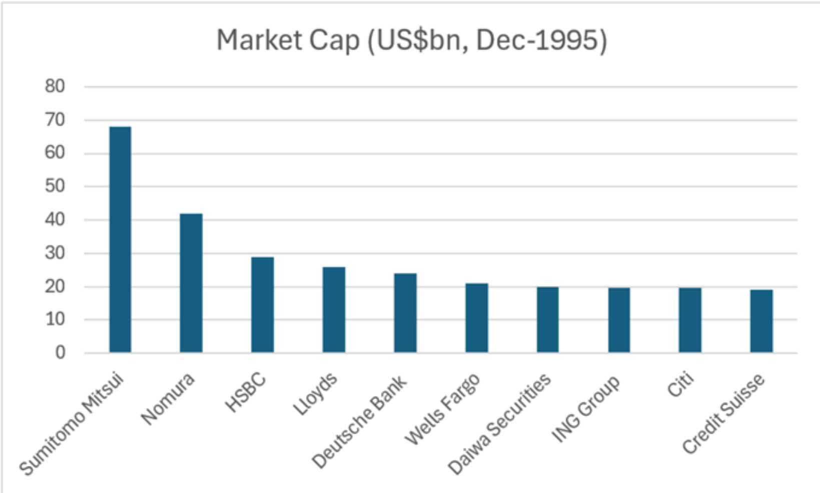
Several times in the past twelve months investors have been offered dire warnings from well-regarded bank analysts that the share prices of the major Australian bank stocks were over-valued and headed for a big fall and that prudent investors should sell all of their bank shares. These warnings were echoed in the financial press as CBA's share price pushed through $130 per share and questions why Australian banks should rank among the most valuable global banks based on market capitalization. While the current ***sell all banks call*** in 2024 is based on valuation grounds, this trading advice has been given regularly by the investment banks, most recently in 2020 (Covid-19 will see unemployment spike and house prices crash) and in 2022 (fixed interest rate cliff).

For an institutional investor one of the most difficult decisions, one faces is how much of the portfolio should be allocated to Australian banks. Currently, the Australian banks account for 22% of the ASX 200 or 24% when Macquarie is included, following strong profits, large share buybacks, and low bad debts across their mortgage portfolios.

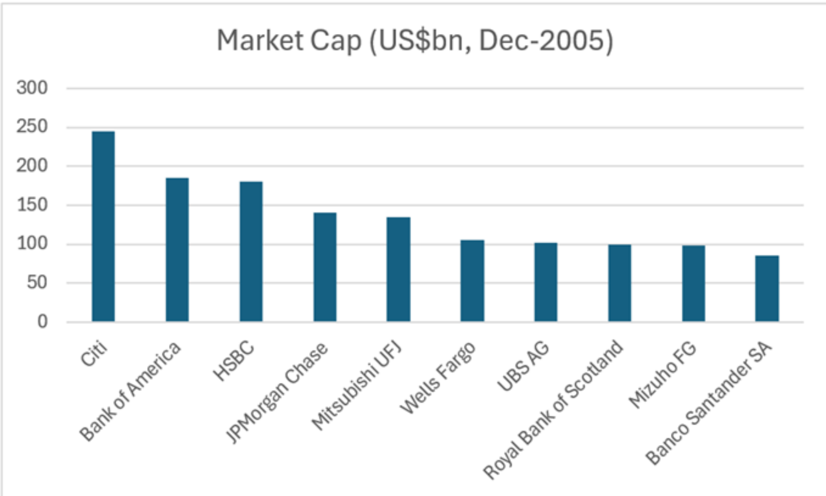
In this week's piece we are going to look at look at the change in the lists of the most valuable global banks over time. Generally appearing on these lists results in subsequent share price underperformance and raises the question whether the Australian banks are headed for a fall.

A look back in time

Looking back at the lists of the largest banks in 2015, 2005, 1995, and 1985, the banks that dominated these lists generally performed very poorly in the following decade. In the early 1980s four of the top 10 banks were French, all of which were later nationalised by the Mitterrand government.



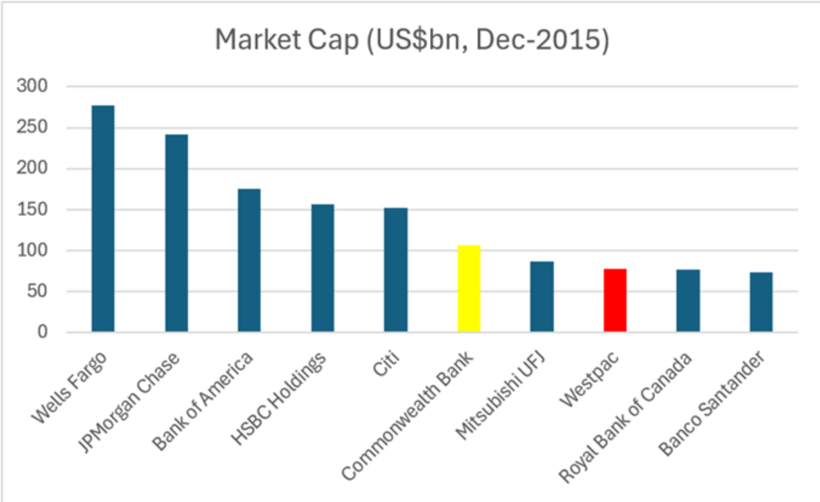
By 1995 the French banks had all fallen off the list, which was now dominated by Japanese Banks like Sumitomo Mitsui, Nomura and Daiwa. These banks were viewed at the time to be taking over the world as Japanese investors bought up assets from the Rockefeller Centre to Gold Coast apartment blocks. The bursting of the overheated Japanese asset price bubble resulted in massive non-performing loans and several Japanese banks' failure.



The next chart shows the list of the top banks by size as of December 2005. The list was dominated by US and European banks, as investors wanted exposure to innovative banks whose expertise at structuring complex financial products seemed to generate a stream of very strong profits with minimal risk. The financial crisis 2007-08 brought on by the bursting of the US housing bubble was very unkind to these banks, with the bulk of them being forced to seek state bail-out packages to ensure their solvency. Indeed, the largest bank on the list, Citibank, has a share price that currently sits -85% below what it was in December 2003, thanks to a dilutionary bail-out that saw the US taxpayer take a 36% equity stake in the bank.

The high-flying Royal Bank of Scotland's (8th largest bank in 2005) fall from grace was sharper than most with its share price falling 96% between 2007 and 2008 and was bailed out by UK taxpayers in 2008. The combination of the poor acquisitions of Dutch bank ABN Amro, £15 billion in fines and legal costs and £40bn in losses from bad lending, sees the state still owning 22% of the bank and its market capitalization 80% below what it was in 2005.

Moving on five years



In the next graph, we can see that in 2015, USA banks dominated the top five largest banks in the world, but this is where we saw a rise from the Australian Banks (Commonwealth Bank and Westpac), HSBC and a Canadian bank (Royal Bank of Canada) break into the top 10 largest banks in the world. Canadian banks operate in a similar regulatory and economic environment to Australian banks, as well as deriving a large majority of their revenues from mortgages. In Canada, six large banks (RBC, TD, Scotiabank, MBO, CIBC, NBC) control around 93% of the market similar to the Australian Big Four. The leader from 2005 Citi still remains on the list, though has shed $100 billion in market capitalization during the 10-year period.

There is an argument that in decade to 2015, HSBC along with the Australian and Canadian banks didn't grow into the top 10 banks in the world, but rather, other banks self-destructed around them or were still recovering from the global financial crisis.

What happens next?

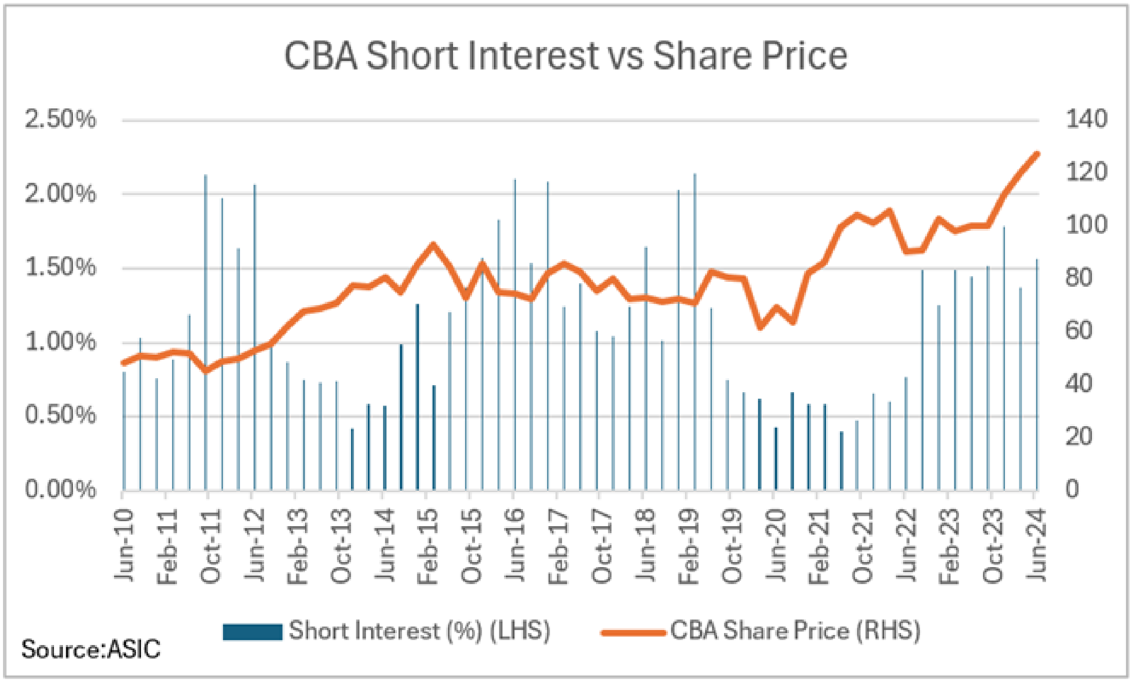
Looking back, owning the largest and most loved banks in 1985, 1995, and 2005 proved to be a poor investment decision in the following decade. However, the 2015 list has many names that remain the largest banks to 2024, but in different rankings.

Most of the biggest banks in the world are from the US, with the US banks deriving less than half of their profits from mortgages, with most coming from other arms of the banks. The remainder of the list is made up with from Canada (RBC), India (HDFC) and Australia's CBA. Interestingly none of the Australian banks are considered by the Financial Stability Board (FSB) to be globally significant banks, despite CBA (market capitalisation A$216 billion) being significantly larger and more profitable than the globally significant Deutsche Bank (market capitalisation A$44 billion). Consequently in July 2024 many investors are calling the Australian banks, especially CBA overvalued and that investors should short sell the major banks.

The Widow-Maker Trade

A '*Widow-Maker*' trade in the hedge fund world is a short-selling of an overvalued asset that may make sense intellectually, but the share price continues to rise in spite of the bearish investment thesis. As it continues to rise, the short seller is forced to post ever-increasing amounts of cash into their margin account, increasing the chance that the fund manager has a heart attack or gets fired.

US and European fund managers have been systematically shorting Australian banks based on the seductive story that they are overvalued compared to their domestic peers. International investors have historically made mistakes by thinking Australian banks operate in the same regulatory environments as their domestic banks. The basis for their thesis is that four banks from a small backwater in the financial world have little business, being amongst the largest in the world.

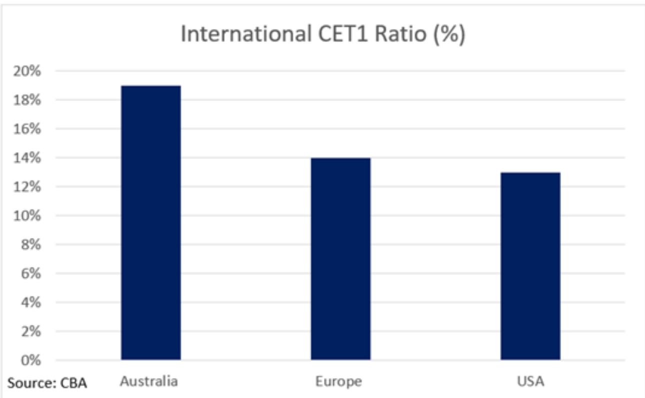


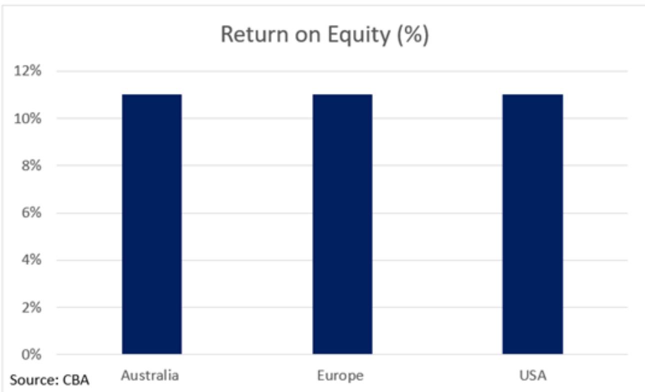
How Aussie banks are different from global banks

The big four Australian banks control around 75% of the domestic lending market and enjoy higher barriers to entry due to the high level of regulation placed on them. Conversely in the USA there are over 4,000 registered commercial banks, with the top 5 (Wells Fargo, Bank of America, U.S Bank, JP Morgan Chase and PNC Bank) having a market share of only 7%.

While the number of banks in the USA sounds like a preferable market structure to the Australian banking oligopoly, this is only due to previous regulations that precluded banks from opening branches outside their home state. This results in a large number of small and often financially precarious banks with limited geographic diversification and can lead to frequent bank collapses such as Silicon Valley Bank in 2023.Conversely the last bank collapse in Australia was the State Bank of South Australia in 1991.

Additionally, the Australian banks are regulatory made to be better capitalized leading to lower loan losses through the cycle and are more consistent profitability than their US or European peers due to low impairment and provision charges.





Betting against the buybacks

Due to strong capital ratios built up post-banking Royal Commission through COVID-19, the big four Australian banks are now well capitalized and have begun large share buyback schemes. ANZ has announced a $2 billion buyback, a $1 billion CBA buyback, a $2 billion NAB buyback and a $2 billion Westpac buyback. For investors, this will support the share price over the short term with a buyer always being in the market every day to hold up the day-to-day share price. Not only will it support the share price, but it will also reduce the amount of outstanding shares to divide next year's profit by.

The banks all normally commit to neutralizing their dividend reinvestment plans, which will see banks buy shares on the market and give them to shareholders instead of issuing new shares to shareholders. This may sound insignificant, but across the May 2024 dividend schedule, Atlas estimated $900 million worth of shares were bought to support the neutralization.

Our thoughts

The Australian banks have successfully generated record profits from their domestic franchises, which have operated in a cozy banking oligopoly over the past decade. Recently, competition from non-bank lenders has increased due to the rise of private credit funds in this higher interest rate environment. Despite this increased competition, banks' bad debts remain at all-time lows, and profits continue to be strong.

What caused the French, Japanese, and US banks to explode in the late 1980s, 1990s, and 2000s was rapid lending expansion into new areas that, in hindsight, their management teams did not fully understand. Australian banks have learnt from their previous mistakes around international expansion and are focusing on their domestic markets, in which the banks generally have a strong history of profitable business.

Whilst Australian housing can be viewed as expensive globally, Atlas sees a range of factors that strongly incentivize Australian households to maintain mortgage payments. These include recourse lending, homes being exempt from capital gains tax and a very strong cultural desire to own one's own home, which means that bad debts should remain quite low. Although bad debts will remain low, banks are likely to see continued mortgage competition that will reduce their interest margins and profitability growth.

Although, CBA has diverged from its long-run price-to-earnings of 16x forward earnings to over 22 times, Atlas still believes that CBA will have a good result in August with the announcement of further on-market share buybacks. CBA is still the leader for the banks in marketing, technology, customer service, and quality of management and has the highest return on equity, but does it deserve this high of a premium?

Hugh Dive is Chief Investment Officer of [Atlas Funds Management](). This article is for general information only and does not consider the circumstances of any investor.

Why allocating more to fixed income now makes sense

Benoit Anne

The correlation between bonds and equities is very high and not likely to correct anytime soon. So what is the solution? More fixed income. A higher correlation means that overall portfolio risk has gone up, and the total risk can be managed down through a higher allocation to fixed income. Fixed income may not play out as a portfolio diversifier, but it will continue to serve its function as a volatility diversifier. The other good news is that due to elevated yields, fixed income remains attractive on a risk-adjusted basis.

Another way to risk-manage the high correlation environment is to broaden the investible opportunity set to include global markets. Establishing exposures to different currencies, markets and geographies can help diversify portfolios. This global approach is best implemented when relying on an active asset manager that can leverage potential sources of alpha.

For now, fixed income is no longer a portfolio diversifier

By historical standards, the bond-equity correlation is now very high. Based on a two-year window, the correlation stands at 0.71, the highest level since 1995 (Exhibit 1). A high bond-equity correlation means that the diversification benefits of fixed income have weakened. It also implies that total portfolio risk increases along with that correlation, making risk management an even more essential pillar of the investment process in a high-correlation world.

The bond-equity correlation is set to remain elevated in the period ahead

The sharp rise in the bond-equity correlation started in late 2021 when it became clear that a US Federal Reserve tightening cycle was imminent. The correlation corrected higher brutally, with the intensity of the Fed's rate hikes surprising global investors.

While the Fed hiking cycle may well be over, the bond-equity correlation will not necessarily adjust lower. We believe, based on our macro regime framework, that the transition under way is likely to contribute to a persistently high correlation.

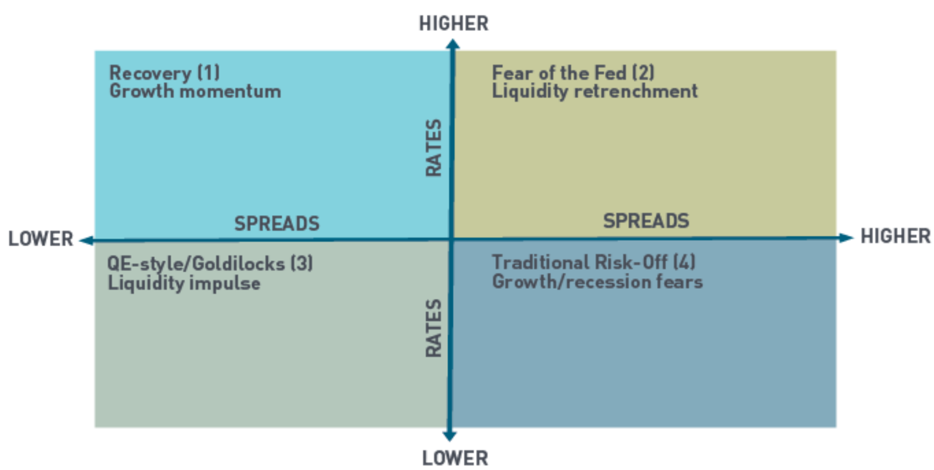
Exhibit 1: The bond-equity correlation is at an extreme level

Source: Bloomberg. S&P 500 index and Bloomberg US Treasury index. Monthly data from Oct. 1976 to June 2024 (as of 18 June).

The prevailing macro regime during the central bank hiking phase of 2022 and 2023 was the so-called the fear of the Fed (Exhibit 2). Under that regime, rates corrected higher, while credit spreads widened. Broader risky assets came under pressure, which tended to promote a high bond-equity correlation. In 2022, both bonds and equities suffered losses.

Looking ahead, we believe the prevailing regime will likely shift to a QE-style, or Goldilocks, regime, the opposite of the 2022 and 2023 pattern. Under a Goldilocks regime, rates move lower while credit spreads tighten. Risky assets also tend to perform strongly, boosted by a central bank liquidity impulse, which means that the bond-equity correlation remains elevated. This is what we have observed over the past few months, reflecting the anticipation that the Fed is going to begin its easing cycle soon. Given that the Fed cuts have yet to be delivered, the Goldilocks regime is likely to stay in place for the foreseeable future. We believe that the bond-equity correlation will normalize lower, but not until the easing cycle is close to completion, taking us to late 2025. Once the easing cycle has run its course, the macro regime will likely shift again, this time to either the growth momentum regime or perhaps to the fear of the Fed regime.

Exhibit 2: The four global macro fixed income regimes and the macro regime shift

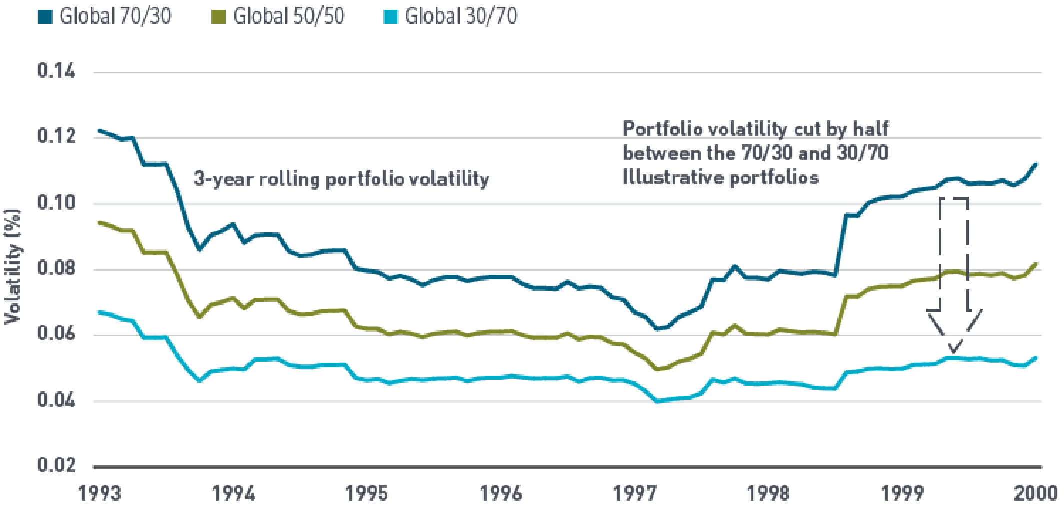


Source: MFS. For illustrative purposes only. The four regimes are defined by the direction of changes in both rates and spreads.

The need for portfolio de-risking

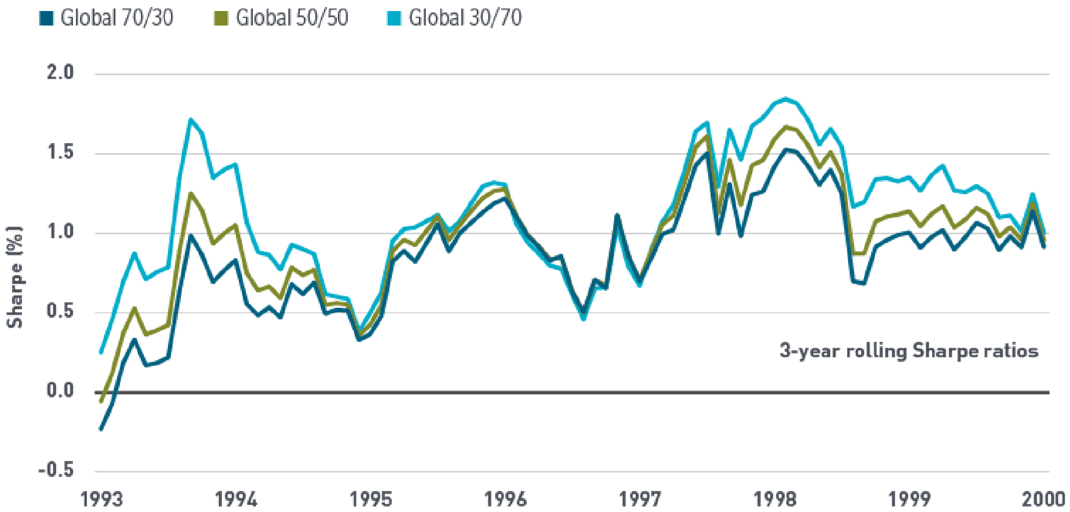
Paradoxically, the higher the bond-equity correlation, the higher the need for portfolio de-risking and therefore the higher the fixed income allocation should be, given fixed income's historical status as a de-risking asset class. In other words, fixed income may not play out as a portfolio diversifier but may nonetheless continue to serve as a volatility diversifier. Using the 1990s as an illustration, amid a persistently elevated correlation during that decade, we can observe that a higher allocation to fixed income led to both lower portfolio volatility and better risk-adjusted returns over that period (Exhibits 3 and 4).

Exhibit 3: Fixed income as a volatility mitigator



Sources: MSCI, Bloomberg, FTSE, FactSet. Monthly data from 31 January 1990 to 31 January 2000. Portfolio names reference equity and fixed income weights, respectively. Equity = MSCI World. Fixed income = Bloomberg Global Aggregate index. Returns used are gross and in USD. Fixed income returns are hedged to USD.

Exhibit 4: Risk-adjusted returns benefited from higher FI allocations

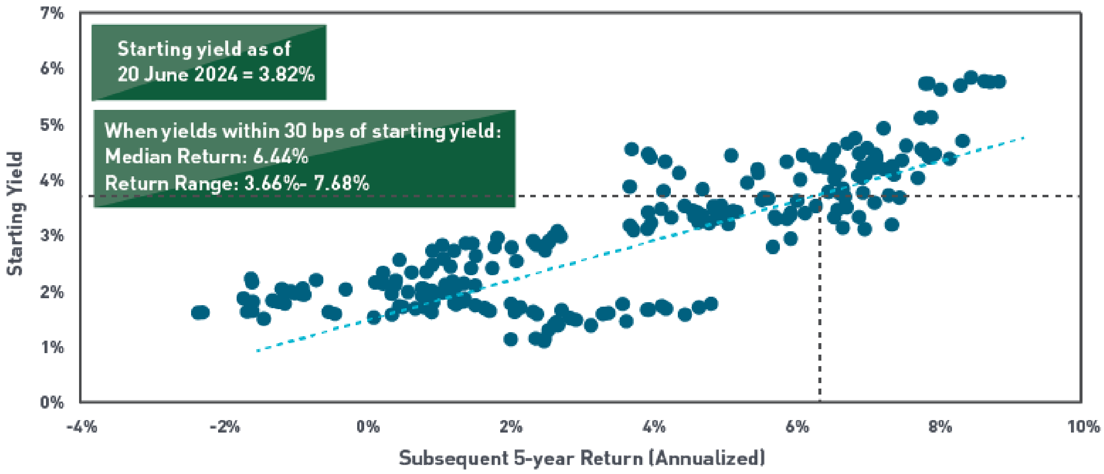


Sources: MSCI, Bloomberg, FTSE, FactSet. Monthly data from 31 January 1990 to 31 January 2000. Portfolio names reference equity and fixed income weights, respectively. Equity = MSCI World. Fixed income = Bloomberg Global Aggregate index. Returns used are gross and in USD. Fixed income returns are hedged to USD. Sharpe ratio uses the FTSE 3-Month US T-Bill Index for risk-free rate.

Fixed income is attractive on a risk-adjusted basis

The macro environment has become more supportive of fixed income, reflecting the easing biases of major central banks, the likelihood of a soft landing scenario, and the continuing disinflation process in many countries. Current yields are well above long-term returns for many of the global fixed income sub-asset classes, which means that fixed income may be well positioned to potentially deliver robust returns in the period ahead. For the strategic investor with a longer time horizon, what really matters is total yield valuation, and that is still favorable. Historically, there has been a strong relationship between starting yields and subsequent returns. Looking at the global aggregate index, which currently yields 3.82%, we can see that in the past, a similar entry yield level was associated with a subsequent five-year median annualized return of 6.44% (with a return range of 3.66%/7.68%, Exhibit 5).

Exhibit 5: Global agg – Starting yield vs. expected returns

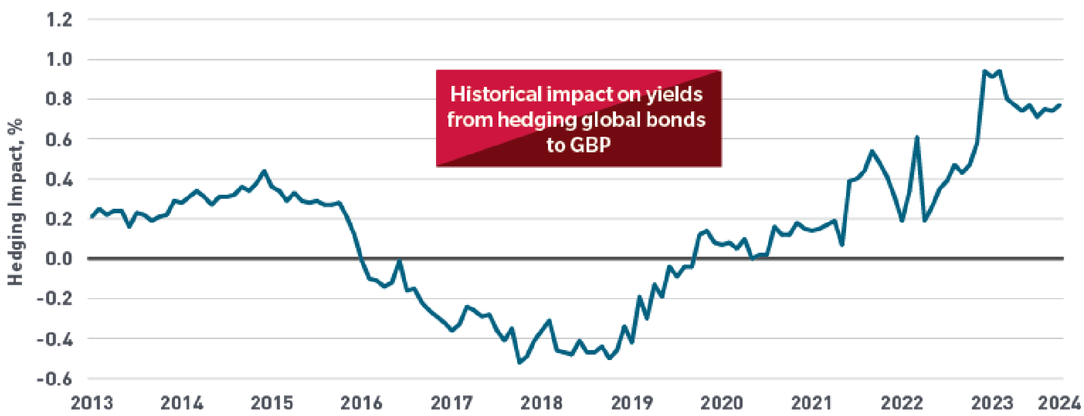


Source: Bloomberg. Bloomberg Global Aggregate index (USD). Monthly data from January 2000 through May 2024. Returns are gross and in USD. **Past performance is no guarantee of future results.**

Going global as a correlation management strategy

Investors with a strong home bias may benefit from broadening the investible opportunity set to global markets. While this does not directly address the high bond-equity correlation challenges, it may help boost a portfolio's diversification profile through the introduction of multiple region, country and currency exposures. We have observed that exposure to global bonds on a FX-hedged basis can lead to both yield enhancement and lower portfolio volatility, especially if the home market is characterized by higher interest rates as it is in the United States and the United Kingdom (Exhibit 6).

Exhibit 6: Yield optimization after going global from the UK

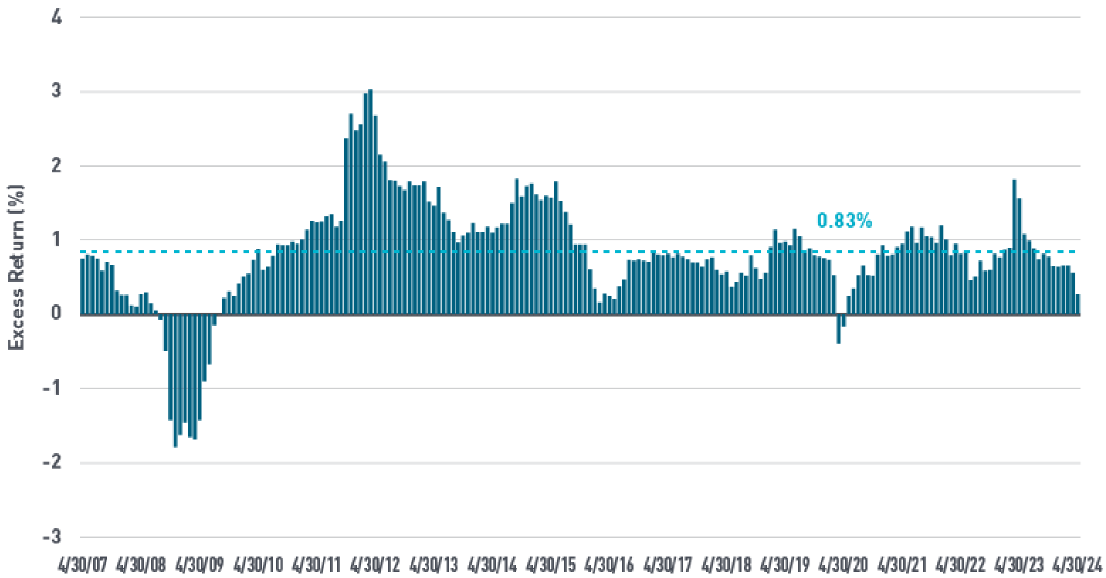


Hypothetical hedging impact provided for illustrative purposes only.
Source: Bloomberg from 31 July 2013 through 30 April 2024. Based on 3-month forward currency rates for a basket of currencies composed of 45% USD, 22.5% euros, 10% JPY, 5% GBP and 2.5% CAD, which are approximate weights of those currencies in the Bloomberg Global Aggregate Index as of 30 April 2024. (note that 15% of the index is denominated in other currencies that were not assumed to be hedged for purposes of this illustration).

The case for global, active management

In our opinion, the global fixed income opportunity set is best leveraged when relying on an active manager that can potentially tap multiple sources of alpha, ranging from currency management to duration positioning to hedging strategies to asset and sector allocation and global security selection. The historical alpha is comfortably into positive territory, averaging 83 basis points (gross of fees) over the past 20 years, illustrating that an active approach to portfolio management in global fixed income potentially adds value (Exhibit 7).

Exhibit 7: Average 3-year rolling excess return of global fixed income unhedged strategies vs. Bloomberg global aggregate



Source: eVestment Alliance, LLC. The eVestment All Global Fixed Income universe was screened for active managers using an unhedged approach and benchmarked to the Bloomberg Global Agg. The returns are gross of fee and in USD. Quarterly data from May 2004 to April 2024. Past performance is no guarantee of future results.

Overall, we believe that the high bond-equity correlation, which is currently an important feature of global markets, does not argue against allocating more to fixed income. In fact, the way to try to manage the higher portfolio risk potentially involves a higher fixed income allocation.

Benoit Anne is Managing Director, Investment Solutions Group at [MFS Investment Management](). This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. It has been prepared without taking into account any personal objectives, financial situation or needs of any specific person. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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What to do about the growing chorus of market correction warnings?

Roger Montgomery

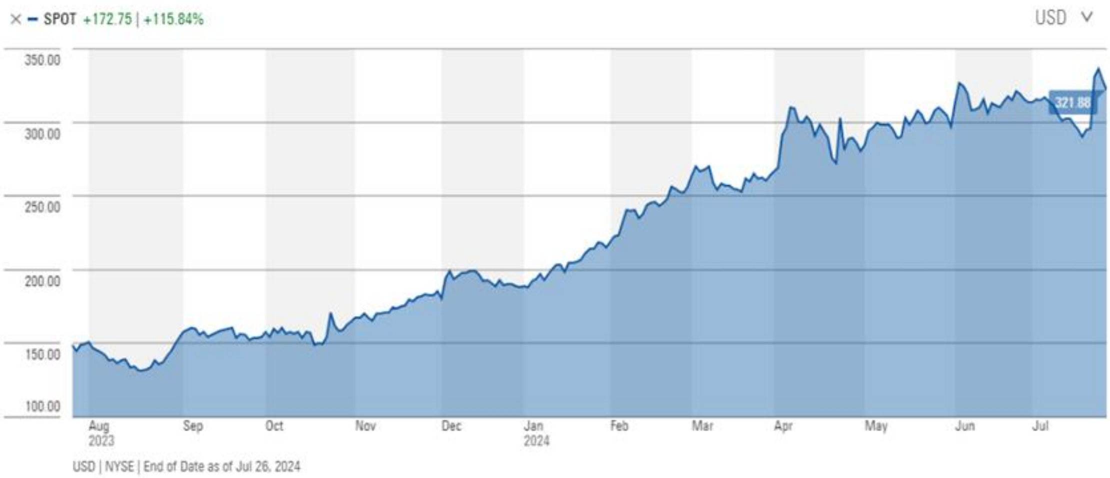
Since 2022, when the market slumped, I have repeatedly highlighted the possibility of stocks rising despite fears of a recession, which I assessed to be unfounded, and despite rising interest rates, which I believed would necessarily have to peak.

The reason for the optimism was simple; that economic growth would remain positive, albeit anaemic, and that disinflation would rule the day. As an aside, disinflation exists when prices are still rising but at consecutively lower rates of growth. The reason that combination of circumstances produced a bullish bias disposition in me was that since the 1970s, whenever positive economic growth and disinflation have joined forces, they have produced good conditions for equities, particularly the shares of innovative companies with pricing power.

Many of those innovative companies have indeed soared since 2022. I don't need to list the returns of shares in Google, Meta, Apple, Microsoft and Nvidia over the last two years, or Spotify over the last twelve months. Innovative companies that can raise their prices without a detrimental impact on unit sales volume have indeed been the beneficiaries of a desirable combination of those two economic indicators.

Nvidia

Spotify



Source: Morningstar.com

I further believe it takes a few years for the prior bearish sentiment to turn 180 degrees and become a fully-fledged boom or even a bubble. This is because the unwinding of the bearishness that pervaded 2022 needs to overcome investor inertia, an uneven distribution of information and even the reassurance of rising prices needed by many investors. By the end of the switch in the narrative from bearish to bullish, microcap stocks, cryptocurrencies and even art, wine and collectible cars could all hit unprecedented highs.

Inevitably there are bumps along the way and few reputable investors are suggesting a big bump is coming.

The bear case

Indeed, warnings from reputable investors about an impending market correction are becoming increasingly prominent. Ruffer LLP, a UK-based investment firm, has already made its largest-ever bet on cash, reflecting its growing concerns about a violent market reversal driven by shrinking US liquidity. Similarly, Mark Spitznagel, known for his multi-billion dollar wins hedging against market downturns, echoes these concerns, predicting a severe market crash. And macroeconomic research house BCA Research has most recently forecast the S&P 500 to drop to 3750 points, equating to a 33% fall from the market's mid-July high.

Ruffer LLP, managing approximately £22 billion, has allocated two-thirds of its assets to cash, a record high. The firm is funnelling the income from this cash into insurance policies, such as credit default swaps and US stock options, designed to profit from a significant decline in Wall Street.

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Back in April, while discussing the subject with Bloomberg reporters, the firm predicted the predicted market reversal could happen within the next three months due to the Federal Reserve's ongoing reduction of liquidity. That would bring us to a correction this month. Recent volatility in prices, which has seen the S&P500 fall nearly 5%, and the NASDAQ nearly 8%, could render Ruffer LLC very prescient indeed, particularly if the slide continues.

Perhaps unusually for a fund manager, Ruffer takes a highly discretionary approach to managing its portfolios and concentrates its investments in a handful of asset classes, including a very successful bet on Bitcoin in 2020. The company's approach also helped it achieve a 16% return during the 2008 financial crisis. But not every year is a success, with its funds missing out on the 2023 rally in equities, producing a 6% loss for the calendar year.

Ruffer argues that excessive optimism over potential future US interest rate cuts has left markets priced close to perfection, creating Black Monday-style liquidity risks. The firm believes that structural changes in inflation and interest rates indicate a higher trajectory for both, and as the US central bank winds down its QE-powered bond-buying program, liquidity dries up, and the risk of a market correction looms larger, with a 1987-style meltdown on the list of the firm's possible scenarios.

Another bear is Mark Spitznagel, a protégé of Nassim Taleb and head of Universa Investments. He shares a similarly bleak outlook to Ruffer LLP. Universa provides long-only equity investors with hedges against fat tail risks – low-probability but high-impact market declines. Spitznagel's credibility is bolstered by Universa's performance, which has outpaced the S&P 500 over many years, and especially during the COVID-19 sell-off.

Spitznagel has consistently warned of an impending market crash worse than the Global Financial Crisis (GFC). He describes the current market as being in "the greatest credit bubble in human history" and predicts that stocks could lose up to 50% of their value. His strategy involves taking the opposite side of complex hedging tactics like Put-Spread Collars, which he deems unnecessarily complicated and expensive.

Despite his dire predictions, Spitznagel advises investors to remain passively invested in stocks, arguing that those who continue steady contributions to a fund despite alarming headlines will fare well in the long term. He believes the market is currently in a 'Goldilocks phase', with the rally likely to continue for several months, driven by a dovish Federal Reserve and bullish market sentiment. However, he cautions that rate cuts often signal an imminent market top, followed by a reversal.

Perhaps his advice – 'stay long, but something bad is coming' – is unsurprising; his firm does sell hedges against fat tail risks to long-only fund managers.

Best to ignore the doomsayers

I would not entertain warnings from the usual crowd of Henny Pennys that the sky is falling in because their secret to being successful with their predictions is simply to forecast often. The growing chorus of warnings from reputable investors like Ruffer LLP and Mark Spitznagel however suggests we should sit up and take notice.

I believe that as long as economic growth remains positive and inflation continues to slow, the conditions are positive for innovative growth companies. Perhaps the mega-cap tech stocks give ground to small caps, where many innovators reside and whose prices have not soared to anywhere near the same levels as the mega-cap tech stocks noted earlier.

As prices rise, however, the risks of setbacks also rise. This suggests, at a minimum, a heightened awareness of potential market risks is wise. While Ruffer prioritises capital preservation in anticipation of a market correction, Spitznagel advises staying long in the market and adding to portfolios when prices sell-off. As both firms adjust their strategies to navigate any uncertainty and volatility, we should at least pause and reflect on our own approaches.

Roger Montgomery is the Chairman of Montgomery Investment Management and an author at www.RogerMontgomery.com. This article is for general information only and does not consider the circumstances of any individual.

Small companies, big opportunities

Arian Neiron

Small companies have been getting a lot of attention lately. The reason is that many investors are reassessing portfolios and preparing for the next cycle following any downturn which could be followed by a period of recovery.

In the past and during this type of cycle, small-caps have offered more upside than large caps because they had underperformed large-caps as the economy weakened.

Australian investors love small companies, but since the start of the S&P/ASX index series in 2000, the S&P/ASX Small Ordinaries have underperformed the large-cap dominated S&P/ASX 200 Index. But those backing the little companies should not despair.

Australian investors need to know where to look.

Small cap advantages

Now that the European Central Bank has eased, and it's likely the US Federal Reserve may also start to deliver rate cuts sooner rather than later, investors are considering their portfolios for the next cycle.

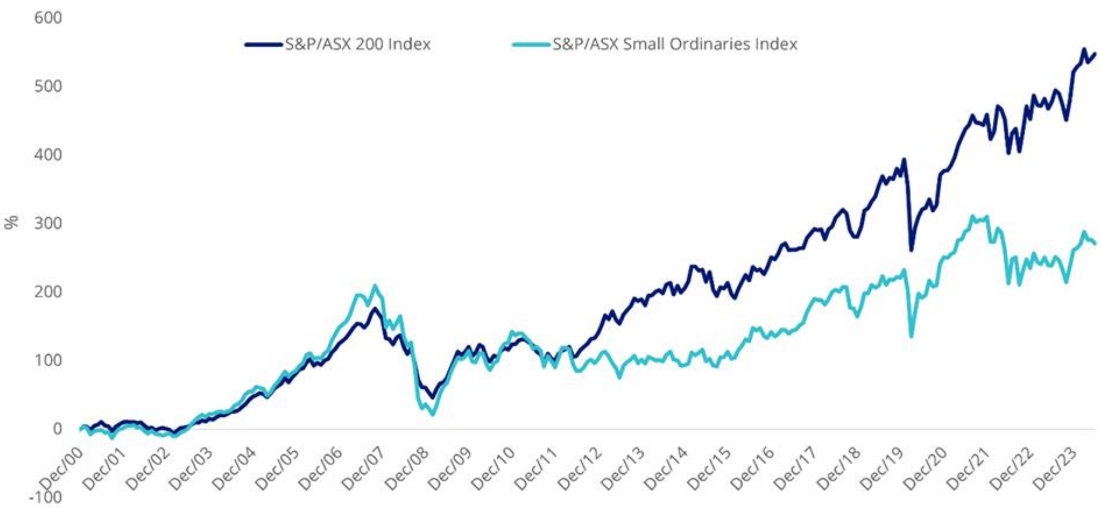
Remember though, that rate cuts are usually in response to economic weakness and thus not bullish for equities. But this is where being small and nimble has its advantages.

Small companies tend to be domestic rather than internationally focused and more sensitive to the macro environment, historically underperforming in recessions and outperforming in expansions. Therefore, many investors are reassessing portfolios and preparing for the next cycle when rates are cut.

In the past, during this type of cycle, small caps have offered more upside potential than large caps because they have underperformed during the market downturn. But we think Australian investors should consider small companies beyond our shores because Australian small companies have not behaved the same way as small companies in other developed markets.

The S&P/ASX Small Ordinaries Index has delivered lower cumulative returns relative to the broader, large-cap dominated S&P/ASX 200 Index over the long term, and you can see in the chart below following the 2001 dotcom crash and the GFC, Australian small companies barely kept pace with their large-cap counterparts.

Chart 1: Australian small companies have underperformed Australian larger companies



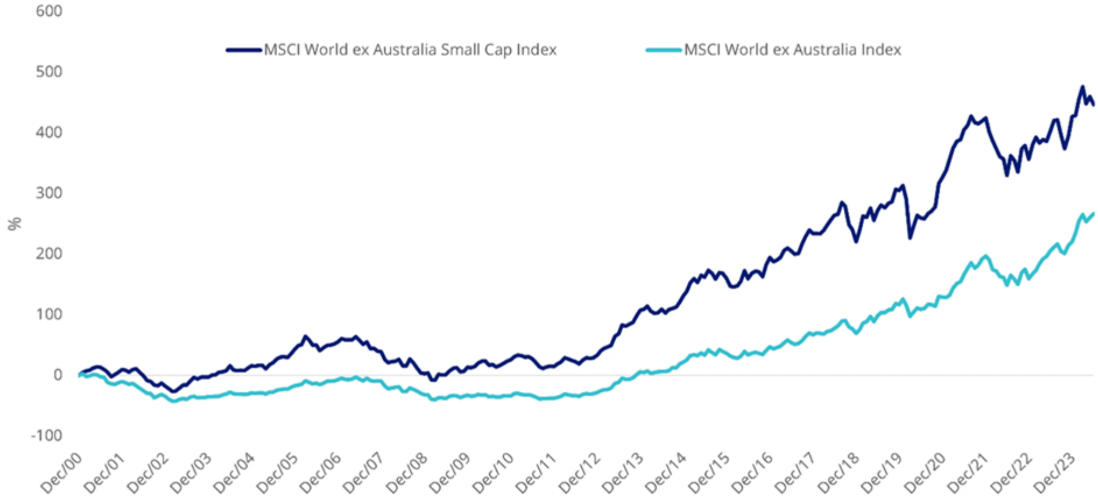
Source: Morningstar Direct, 30 December 2000 to 30 June 2024. Past performance is not indicative of future performance. You cannot invest in an index.

Look overseas

But let's not forget small companies yet. Let's look offshore.

If we consider global small companies, we can observe smaller firms, outperforming larger firms, on average. The MSCI World ex Australia Small Cap Index has outperformed the large-cap dominated MSCI World ex Australia Index over the long term.

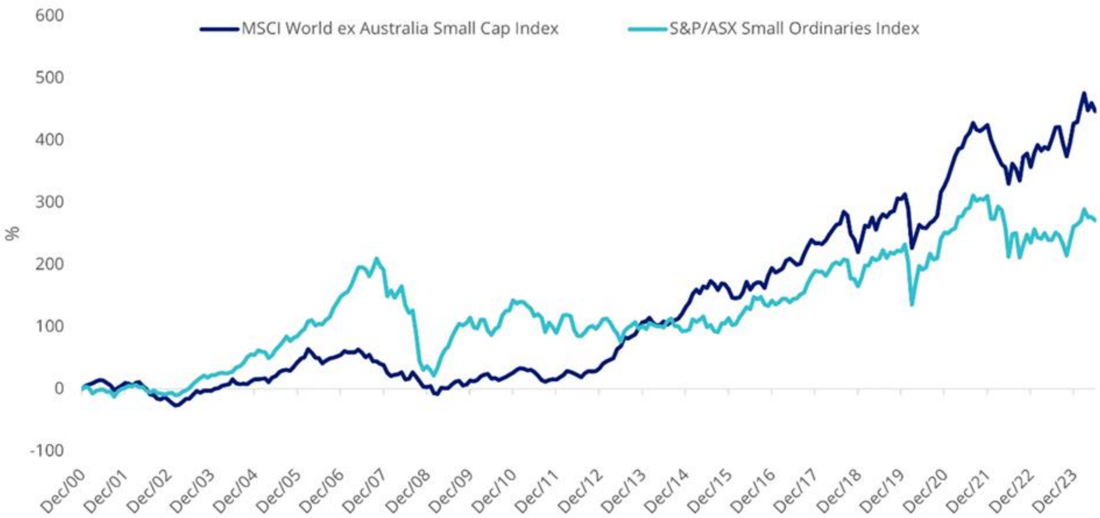
Chart 2: International small companies have outperformed international larger companies



Source: Morningstar Direct, 30 December 2000 to 30 June 2024. Past performance is not indicative of future performance. You cannot invest in an index.

And, over the long term, global small companies have outperformed Australian small companies.

Chart 3: International small companies have outperformed Australian small companies



Source: Morningstar Direct, 30 December 2000 to 30 June 2024. Past performance is not indicative of future performance. You cannot invest in an index.

But most Australian investors do not have international small companies in their portfolios. The MSCI World ex Australia Small Cap Index (the International Small Cap Index) includes over 4,500 companies and there is no way they are all desirable from an investment point of view.

In terms of approaches, many Australian investors would be aware of our international quality ETF, QUAL which tracks the MSCI World ex Australia Quality Index and targets international companies with a high return on equity (ROE), low leverage and stable earnings. VanEck also offers the VanEck MSCI International Small Companies Quality ETF, with the ticker QSML, and it tracks the MSCI World ex Australia Small Cap Quality 150 Index. We affectionately call QSML "baby QUAL" because it harvests the Quality Factor, using the same fundamentals as QUAL, but in the international Small Cap universe.

So, let’s walk through the difference between QSML and the International Small Cap Index.

QSML vs International Small Cap Index – Fundamentals

Table 1: Statistics and fundamentals

	QSML	International Small Cap Index
Index strategy	Smart beta – quality	Market capitalisation weight
Number of countries	12	22
Number of sectors	9	11
Number of holdings	149	3906
12mth trailing Dividend Yield	1.16%	2.0%
Dividend frequency	Annually	-
Return on equity (ROE) (%)	24.19	10.10
Financial leverage (debt to equity) (x)	0.43	1.47
Earnings per share (EPS) growth rate (%)	25.64	23.25

Source: VanEck, MSCI, FactSet, as at 30 June 2023. Past performance is not indicative of future results. You cannot invest directly in an index. International Small Cap Index is MSCI World ex Australia Small Cap Index.

As expected, QSML has higher ROE, lower debt to equity and a higher EPS growth rate.

QSML vs International Small Cap Index - Performance

Above we presented index data back to 2000. QSML was listed on ASX in March 2021. In that time, it has outperformed the International Small Cap Index. Based on back testing and accounting for QSML’s fees, QSML’s Index (net of QSML’s 0.59% p.a. management fee) displays long-term outperformance against the MSCI World ex-Australia Small Cap Index, as highlighted by the chart below. We always caution though past performance is not indicative of future results.

Chart 4: Modelled cumulative performance: QSML Index after fees[1] vs MSCI World ex Australia Small Cap Index

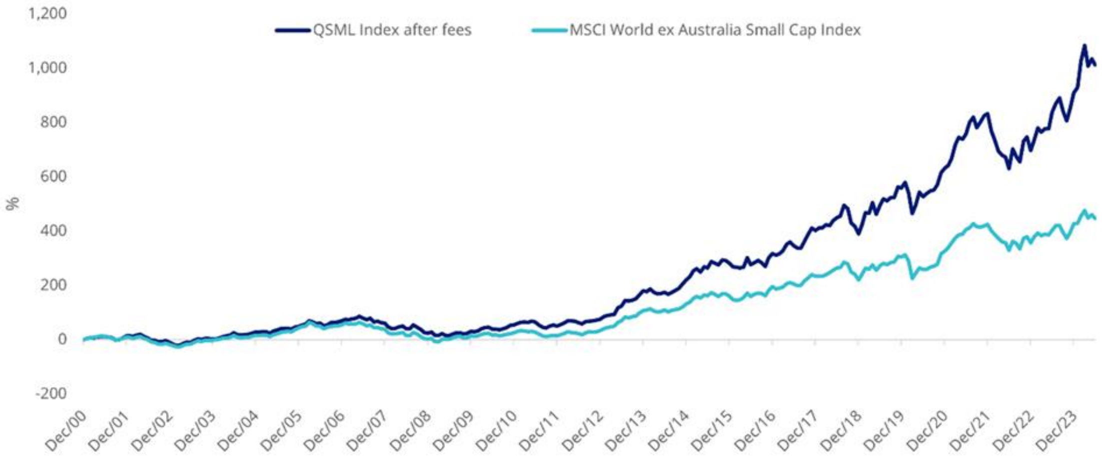


Table 2: Trailing returns: QSML, QSML Index after fees[1] vs MSCI World ex Australia Small Cap Index

	1 month (%)	3 months (%)	6 months (%)	1 Year (%)	3 Years (% p.a.)	Since QSML Inception[2] (% p.a.)	5 Years (% p.a.)	10 Years (% p.a.)	20 Years (%p.a.)
QSML	-2.07	-6.18	10.03	18.42	9.11	11.41	-	-	-
QSML Index (net of management fee)[1]	-	-	-	-	-	-	13.32	15.03	11.55
MSCI World ex Australia Small Cap Index[3]	-2.39	-5.08	3.72	8.81	2.67	5.19	7.98	10.09	8.07
Difference	**+0.32**	**-1.10**	**+6.31**	**+9.61**	**+6.44**	**+6.22**	**+5.34**	**+4.94**	**+3.48**

Chart 4 and Table 2 Source: VanEck, Morningstar, Bloomberg as at 30 June 2024. Past performance is not a reliable indicator of future performance. Results are calculated to the last business day of the month and assume immediate reinvestment of distributions. ETF results are net of management fees and costs, but before brokerage fees or bid/ask spreads incurred when investors buy/sell on the ASX. Returns for periods longer than one year are annualised.

[1]QSML Index results are net of QSML's 0.59% p.a. management fee, calculated daily but do not include brokerage costs or buy/sell spreads of investing in QSML. You cannot invest in an index. QSML's Index base date is 30 November 1998. QSML Index performance prior to its launch in February 2021 is simulated based on the current index methodology.
[2]QSML inception date is 8 March 2021 and a copy of the factsheet is here.
[3]The MSCI World ex Australia Small Cap Index (Parent Index) is shown for comparison purposes as it is the widely recognised benchmark used to measure the performance of developed market small companies, weighted by market cap. QSML Index measures the performance of 150 companies selected from the Parent Index based on MSCI quality scores. Consequently, the QSML Index has fewer companies and different country and industry allocations than the Parent Index. 'Click here for more details'.

QSML vs International Small Cap Index - Style

When looking at portfolios it is important to determine what style, e.g. value or growth and what size bias a portfolio holds, e.g. giant, large, mid or small. Below we can see QSML's. Importantly QSML skews towards mid-sized companies and it has a greater growth bias than the International Small Cap Index.

Chart 5: QSML holdings based style map

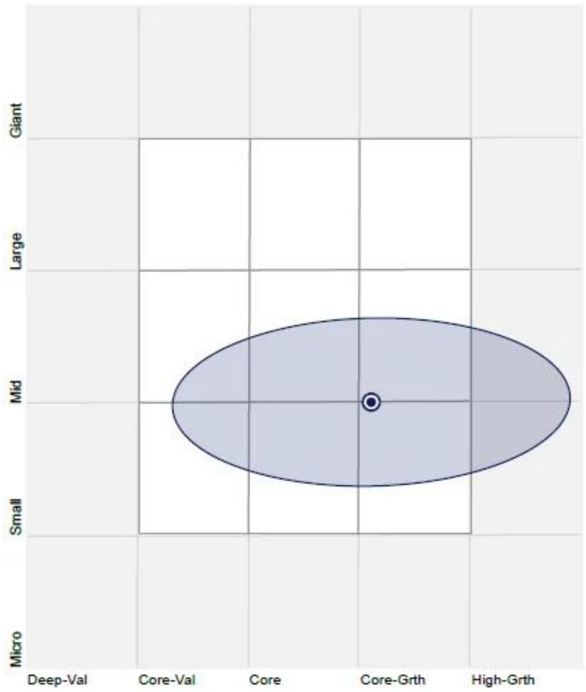
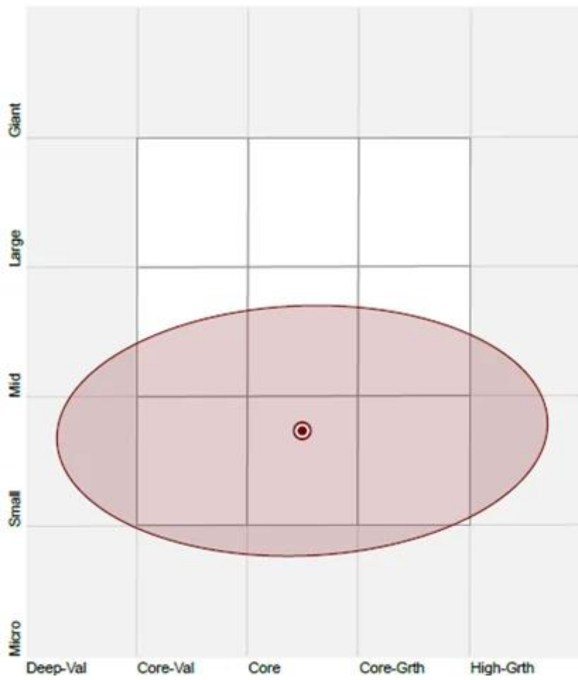


Chart 6: International Small Cap Index holdings based style map



Source: Morningstar Direct, as at 30 June 2024

While each International Small Company approach has its merit for portfolio inclusion, you should assess all the risks and consider your investment objectives.

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

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