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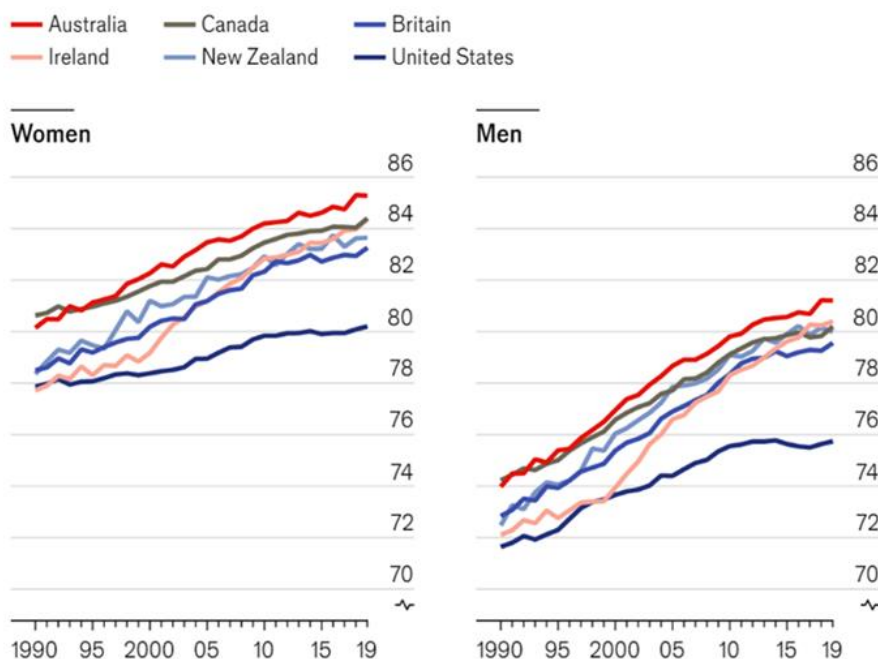
### Editorial

A new paper from medical journal, *BMJ Open*, has found that Australians far outlive people in other English-speaking countries. The gap is four years compared to the average American and two years to the average Briton.

The research reveals Australia trailed Canada's life expectancy in the early 1990s but has since overtaken it, and we've extended the lead over Ireland, New Zealand, the UK and the US.

The average Australian today can expect to live to 83 years of age, with life expectancy for women at 85, and for men at 81.

Anglophone countries, life expectancy at birth, years



Source: "Life expectancy and geographic variation in mortality: an observational comparison study of six high-income Anglophone countries", by R. Wilkie and J. Ho, *BMJ Open*, 2024

The study shows that the US has been the worst performer since 2001. Life expectancy in America at age 65, especially, has deteriorated. And as the chart above attests, the situation for both men and women in the US has stagnated over the past 20 years.

Meanwhile, the UK has had the second lowest life expectancy for much of the past decade. And more recently, Ireland and New Zealand have almost caught up to second-placed Canada.

The research suggests the gaps in life expectancy at birth between the best and worst-performing Anglophone countries have widened over time. The gaps for men and women were 2.4 years and 2.9 years respectively in 1990, and they now stand at 4.8 years and 3.8 years.

### Why Australians are better off

The big question is: why do we stand out compared to our English-speaking peers?

For a start, we're healthier. Our young suffer fewer complications from pregnancies and births than other countries. This cohort is also less likely to die from drug overdoses, especially compared to the likes of the UK and US.

Our older people are less likely to die from chronic diseases such as heart disease and circulatory issues. And cancer mortality rates are generally lower here.

The authors also point to lower tobacco use in Australia as a contributor. Australia had a less severe smoking epidemic than other nations, and since the 1980s, tobacco-related deaths have shown more rapid declines here for both men and women. This has led to fewer deaths from respiratory diseases, cancers and circulatory diseases.

The paper reckons our health care system has helped too. Australia spends less on health care as a percentage of GDP (10.5%) than Canada, Britain or America, yet we have vastly lower rates of avoidable deaths than other Anglophone countries.

Another contributor to us living longer is having fewer road deaths than our English-speaking counterparts.

Fascinatingly, the study also raises the possibility of immigration being part of the reason for our better life expectancy numbers. Australia has the highest foreign-born share of population among its peers, at close to 30%. That's about double the share of America and Britain. And prior studies have found that immigrants tend to have higher life expectancies than the native born. The paper admits that the role of immigration in Australia's growing lead in life expectancy isn't clear and needs further research.

### It's not all dandy

Though Australia heads the pack, the study says we still have work to do. We have the second-highest obesity rate, which impacts health and life expectancy.

Though Australia has the lowest disparities in life expectancy across the population compared to others, the gap between indigenous and non-indigenous people remains large. People in the Northern Territory, where Aboriginal and Torres Strait Islanders make up 31% of the population, live 6.2 years and 5 years less for men and women respectively, than the national average. A previous study found the gap in life expectancy between indigenous and non-indigenous people in the Northern Territory was 17 years.

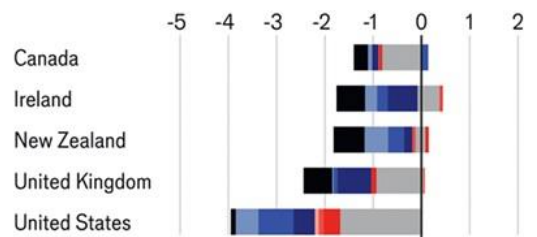
Lastly, our life expectancy feats are less impressive when compared to the non-English speaking world. The paper says that we rank fourth for men and sixth for women versus other high-income countries. Japan, Switzerland, and Spain head the list.

**Australia, difference in life expectancy at birth, 2019, years**

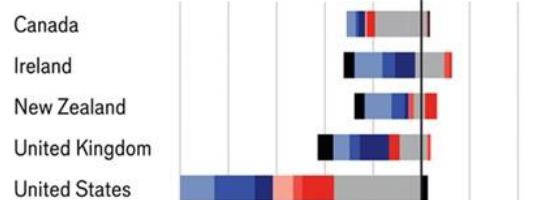
#### By cause of death

- Cancers
- Heart disease
- Circulatory disease
- Respiratory disease
- Firearm related
- Road accidents
- Drugs & alcohol
- Other\*

#### Women



#### Men



\*Includes mental disorders, nervous system diseases, residual, perinatal conditions, congenital anomalies and other external causes

Source: "Life expectancy and geographic variation in mortality: an observational comparison study of six high-income Anglophone countries",

by R. Wilkie and J. Ho, *BMJ Open*, 2024

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## A common misunderstanding

It's worth noting a common misunderstanding when it comes to life expectancy figures. The average life expectancy of 83 is for an Australian at birth, not for an 83-year-old now. A person born in Australia in 1992 had a life expectancy of 74 years for men and 80 for women. In other words, the statistics quoted in the BMJ Open study overlook people who are already living and old.

## The implications of living longer

While Australia's increasing longevity is welcome, it has enormous implications for our health system, and indeed our financial system. Those implications aren't covered in this study.

For instance, Firstlinks has published many articles on our ageing population and the need to design a better superannuation system. As Graham Hand wrote recently:

*"There are an estimated five million Australians in or approaching retirement and drawing down their pensions...*

*While many large super funds such as REST and Hostplus can be confident their members will continue as net investors through all their years, other funds will remain in net outflow. Funds need to know the characteristics of their members, especially as many will switch to cheaper ETFs as their balances build.*

*Despite millions of members, most large super funds do not know their clients. They certainly don't know the needs of their partners and families, and the problem becomes more acute the older the member. These funds need to understand the potential for longevity, plus know the correct legal treatment when their members die at the age of 65 to 75 and beyond."*

Our featured [white paper](#) this week from the Franklin Templeton Institute addresses this issue of what longer life expectancies will mean for financial services.

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Meanwhile, my article this week looks at how investors often overestimate the risks in owning shares when the real risk is not owning enough of them to [build real wealth](#) in the long term.

## James Gruber

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

**Ashley Owen** says that Australia has more listed companies per capita than any other country and we're also the world's best gamblers. The question is, whether there's a [connection between the two](#).

It's common to assume that once a member decides to wind up their SMSF, it should happen as quickly as possible. But **Meg Heffron** suggests that sometimes slowing down can be important, particularly [if there are pensions involved](#).

Apart from "what will home prices do?" and "where are the best places to buy a property?" the main debate around the Australian housing market has been about poor housing affordability, occasionally interspersed with a scare that home prices will crash. But how serious should we take [forecasts for a crash](#)? And more fundamentally, how do we fix affordability? **Shane Oliver** has some answers.

Passive investing is all the rage, yet **Emma Davidson** believes there are signs that it's struggling to keep up in a world that's rapidly passing it by. With the rise and rise of private equity, the average retail investor isn't getting a [representative slice of the economy](#) through passive investing anymore, and they risk missing out on superior returns as a result.

US market concentration in large technology companies has captured investor attention. But [how does this concentration compare to history](#) and what typically follows periods of extreme concentration? **MFS' Benjamin R. Nastou and colleagues** investigate.

Think US stocks and the Magnificent Seven are headed for a fall? Think again, says **Franklin Templeton's Stephen Dover**. He argues that macroeconomic conditions and secular trends are [likely to play in their favour](#).

## Why I'm a perma-bull on stocks

James Gruber

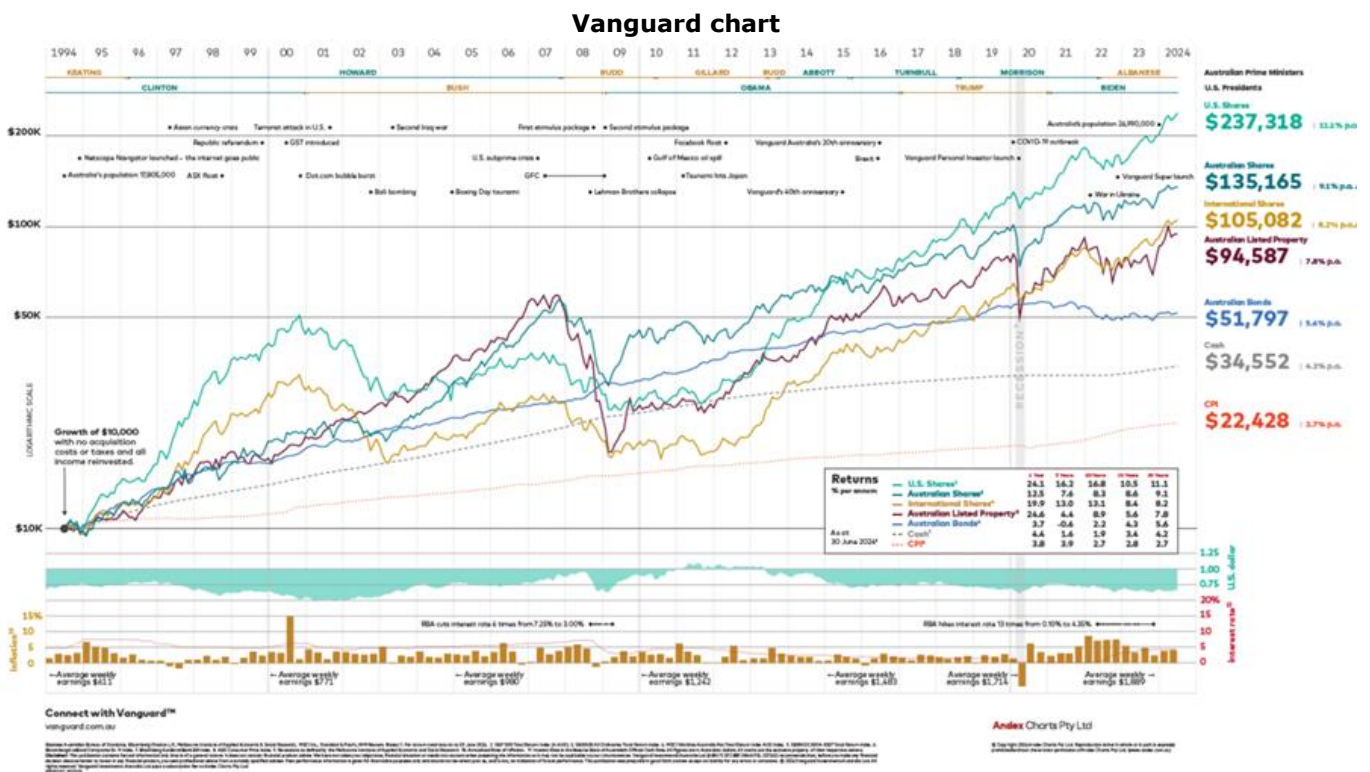
Like many older people, my mother's attitude to money and investing is simple. Save up cash, buy a house, upgrade to a better house in her case, put spare money into the bank, and use that savings plus the age pension to see out your remaining days.

My mother has always been suspicious of the share market. For her, it's a quasi-form of gambling. Far too volatile for her to part with her bank savings.

### The risks in not taking risk

While I've inherited some of her conservative ways, I've learned through my investing career that people like my mother overestimate the risk of owning stocks and underestimate the risk of not owning them in the long-term.

This chart illustrates it well.



The chart shows the how a starting balance of \$10,000 would have changed in value after being invested into six asset classes over the past 30 years. The top performer has been US stocks, where \$10,000 investment in the leading 500 US companies in 1994 would have grown to \$237,318 now. At an average total annual return of 11.1%, an investor would have made about 23x their money, assuming no additional investments and the reinvestment of all income distributions.

Australian shares have been the second-best performer, with a 9.1% per annum average annual return for the All Ordinaries Index over the 30-year period. Notice how much a 2% difference in annual returns between Australian and US stocks makes to total cumulative returns. An Australian share investor made more than \$100,000 less!

International shares returned a little less, with an 8.2% annual return.

Fourth place goes to Australian listed property, measured by the S&P/ASX 200 A-REIT Total Return Index, where a \$10,000 initial investment would have grown to \$94,587, an average annual return of 7.8%.

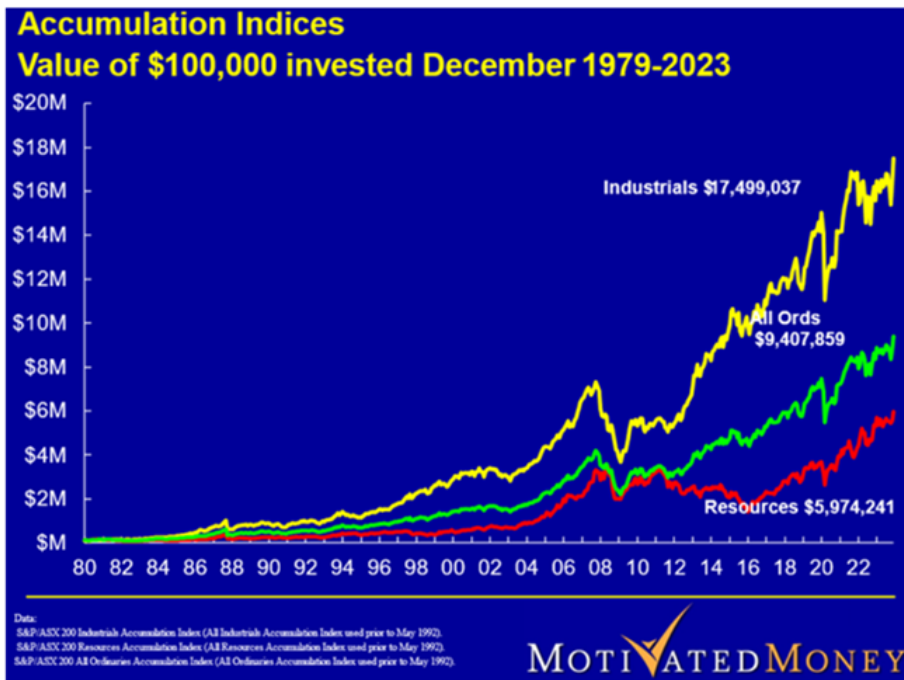
Australian bonds are next, returning 5.6% per annum, and cash trails the pack with an average annual return of 4.2%.

Notice how much a small difference in average annual returns makes to the total cumulative returns of the different asset classes. For instance, 2% difference in annual returns between Australian and US stocks results in a \$100,000 difference in total return. A 3.5% difference in annual returns means Australian stocks made \$83,000 more than Australian bonds over the 30 year period.

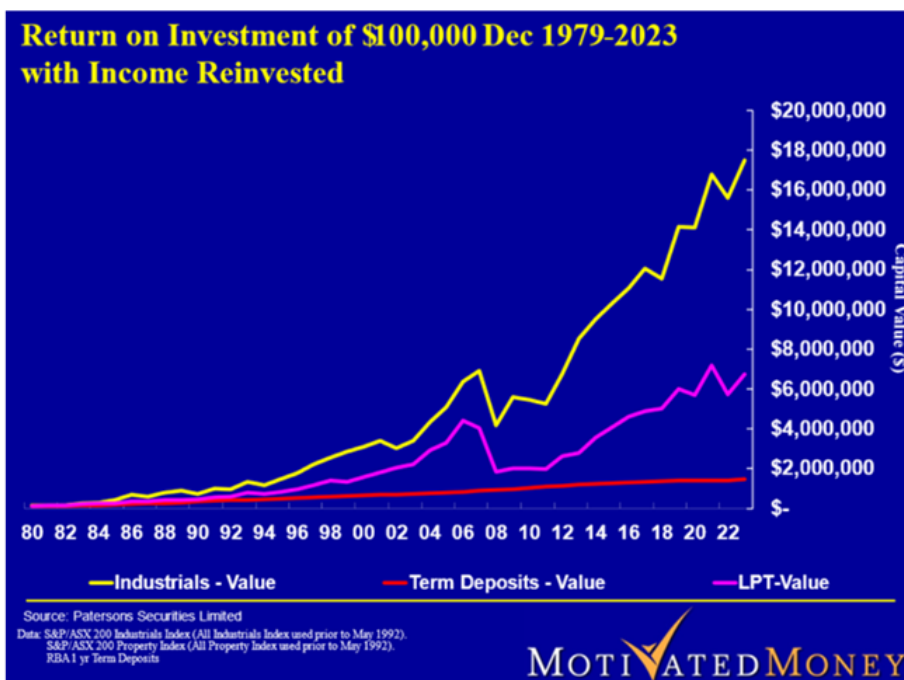
**Peter Thornhill’s tweak**

Well-known financial author and friend of Firstlinks, Peter Thornhill, makes a similar case for the power of owning shares in the long run, but with a twist. He advocates holding a particular part of the Australian share market, namely industrials.

In his eyes, buying and holding industrial shares is superior to owning the All Ordinaries. It’s also better than holding resources and property stocks, which have underperformed in the long term, primarily due to their capital intensive operations.



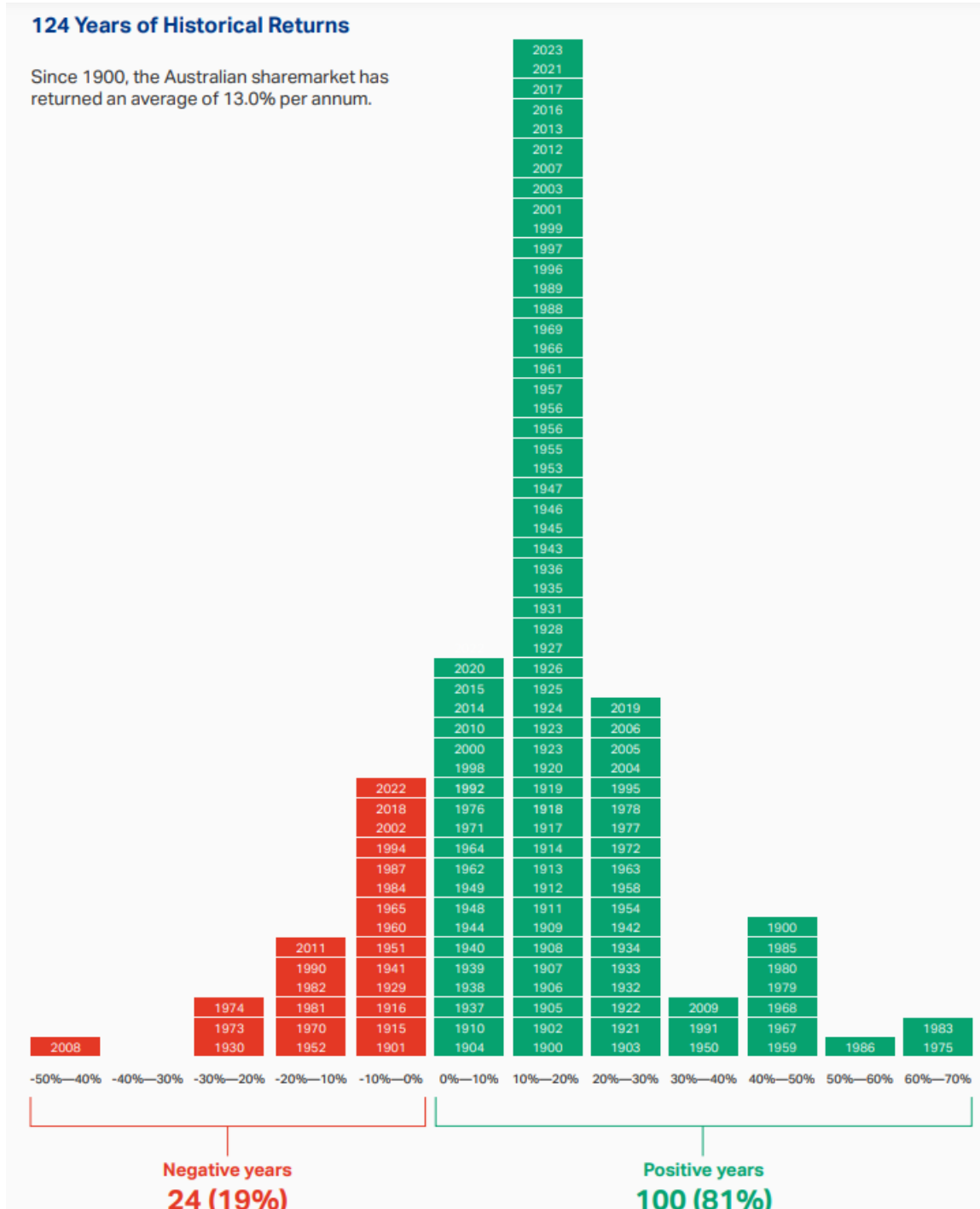
Thornhill says the opportunity cost of not owning stocks is too large to ignore.



**Another perspective on returns**

People like my mother will look at the above and think that’s all well and good, but what about the potential to lose a lot of money on stocks in the short term, or even medium-term.

Here’s a breakdown of ASX All Ordinaries Index returns over the past 124 years.

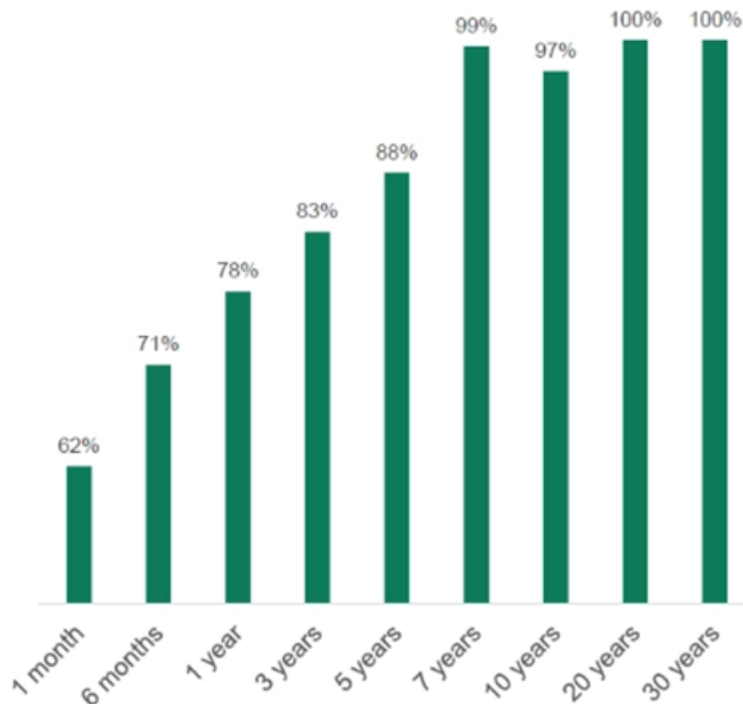


Source: ASX

The ASX All Ords has returned 13% per annum since 1900. 100 of the 124 years have resulted in positive returns – that’s 81%, or four out of every five years.

Also, if you hold shares for a period of seven years or longer, the chances of getting positive returns in Australia and internationally is almost 100%.

## % of positive MSCI World Net Total Return obs



Source: Firetrail

### Stock returns aren't magic

The returns from stocks don't come out of nowhere; they're driven by earnings. Though these earnings can go up and down, they've consistently gone up in the long term.

Legendary stock picker, Peter Lynch, highlighted this in a speech in 1994:

*"Some event will come out of left field, and the market will go down, or the market will go up. Volatility will occur. Markets will continue to have these ups and downs. ... Basic corporate profits have grown about 8% a year historically. So, corporate profits double about every nine years. The stock market ought to double about every nine years. So I think — the market is about 3,800 today, or 3,700 — I'm pretty convinced the next 3,800 points will be up; it won't be down. The next 500 points, the next 600 points — I don't know which way they'll go. So, the market ought to double in the next eight or nine years. They'll double again in eight or nine years after that. Because profits go up 8% a year, and stocks will follow. That's all there is to it."*

Essentially, Lynch is saying; buy stocks, hold them, and ignore everything else.

Funnily enough, the Dow Jones Industrial Average has compounded at 8% per annum in the 28 years since Lynch made that speech, while earnings compounded at a marginally lower rate.

### Buying shares is easy, holding onto them is harder

Through the years, I've learned that investing is probably 20% maths and 80% psychology. It's one thing to understand the power of owning stocks and compounding, it's quite another to be able to stick with shares during tough times.

Respected investment author, William Bernstein, suggests many investors can't handle volatility and their portfolios need to reflect that.

*"... yes, compounding is magic, but you have to observe Charlie Munger's prime directive of compounding, which is never to interrupt it. So, you have to design your portfolio not with the normal 98% of the world and 90% of the time in mind. You have to design your portfolio with the worst 2% of the time in mind so that you don't interrupt compounding, which basically translated into plain English means that you probably should have more safe assets than you think you should have. In other words, a suboptimal portfolio that you can execute is better than a stock-heavy optimal one that you cannot execute."*

Bernstein has a point though I have a different take. Yes, switching portfolios at the wrong time can lead to terrible results. However, implementing a suboptimal portfolio also comes with a huge opportunity cost. It can mean leaving tens of thousands, or maybe a lot more, on the table. It can mean the difference between an ok outcome and building real wealth.

### **Which stocks?**

You might be like my mother reading this (at least I hope she is) and thinking, "Alright, I'll buy some stocks, or buy more stocks as the case may be, but which stocks should I buy?"

I've looked at how to build a lazy portfolio in a [previous article](#).

The easy and low cost way to buy stocks is via ETFs which cover the entire market. For example, Vanguard's Australian Shares Index ETF (ASX: VAS) tracks the ASX 300, which comprises most of the listed stocks. For international exposure, Vanguard's MSCI Index International Shares ETF (ASX: VGS) covers the world ex-Australia stocks.

If you want to own stocks directly, I've written of [16 ASX stocks to buy and hold forever](#), and [20 US stocks to own indefinitely](#).

If you're after income from companies, I've also written of [11 dividend stocks](#) worth holding for the long term.

Finally, if Peter Thornhill's ideas piqued your interest, there's a well-run listed investment company (LIC) that invests solely in ASX industrial shares – Whitefield Ltd (ASX: WHF).

### **Final word**

My argument that there's only one place invest to build wealth for the long term depends on investors having the right risk capacity and investment horizon. Please seek advice if you need it.

*James Gruber is the Editor of Firstlinks.*

## **Australia: Most listed stocks per capita and biggest gamblers in the world**

### **Ashley Owen**

Australia has more listed companies per head of population than just about any other country on earth – and many times more than the US. Why?

Is it because we have many times more viable businesses opportunities to pursue? Or is it because we have the wildest stock promoters and spruikers, and we are the biggest gamblers in the world?

Actually, it is both!

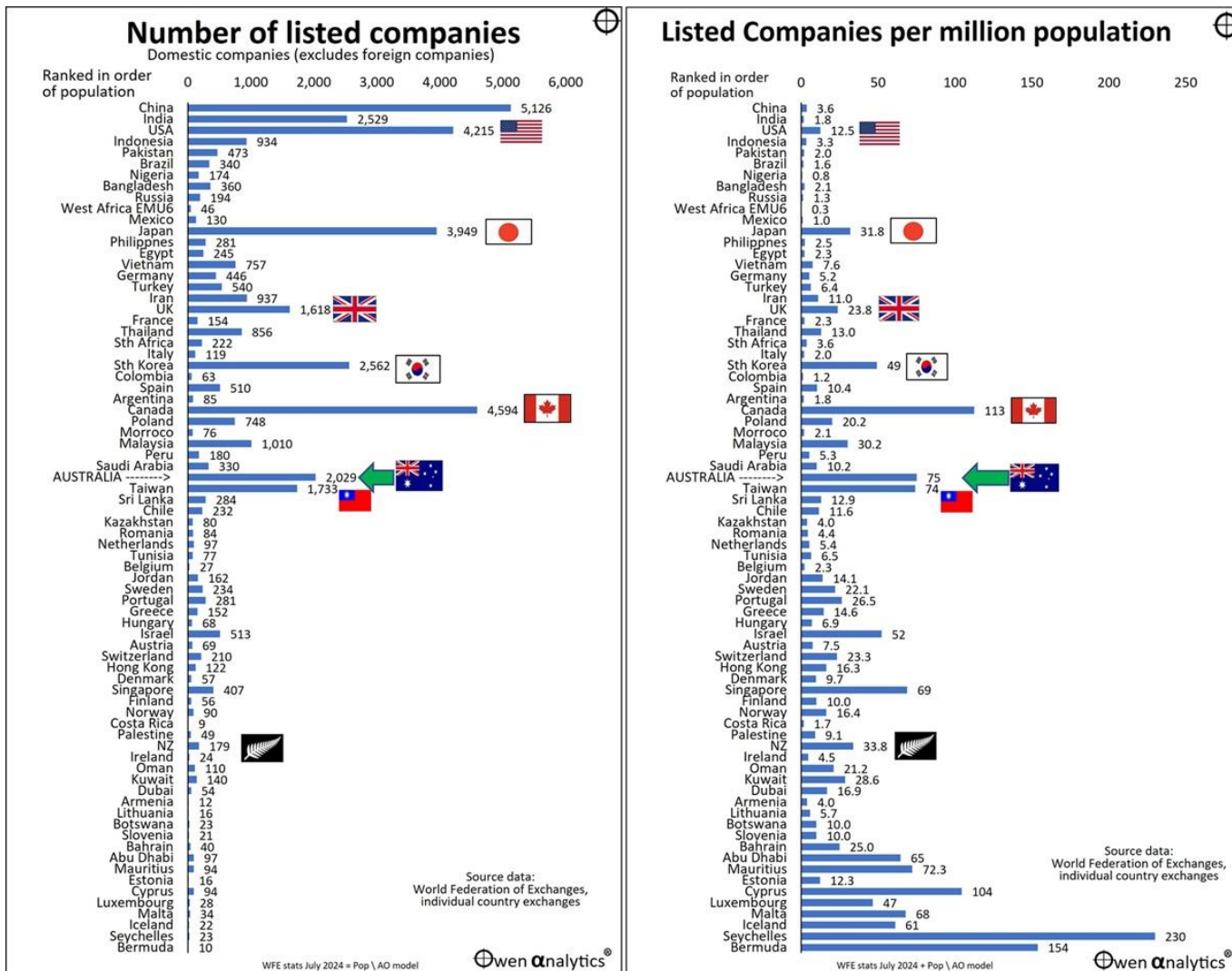
### **Aussies leading the world**

Australia has 0.3% of the world's population, and 1.5% of the world's land surface area, but it has 4.5% of the world's stock exchange listed companies. This is some 13x the world average number of listed companies per head of population, and five times more than the USA.

Since the earliest days of organised stock exchanges in Australia's fledgling coastal cities and scattered across a host of remote, dusty mining towns, Australians have always led the world in investing their hard-earned cash in speculative mining ventures. To this day, Australia (along with that other wild west mining frontier land, Canada) continues to have the largest number of listed companies per head of population in the world, many times more than the US, UK and other 'developed' or 'rich' countries.

The left chart shows the number of domestic listed companies in the 80-odd countries in the world with recognised stock exchanges. Countries are ranked in order of population – from China at the top, to Bermuda at the bottom.





For this purpose I exclude foreign listed companies in order to eliminate double-counting (eg ASX-listed NZ-based companies like Xero, a2Milk, Fisher & Paykel Healthcare are included in the numbers for their home exchange in NZ, but not Australia). Likewise for foreign listings on other exchanges.

In total, there are more than 55,000 companies listed on stock exchanges around the world, but only around 50,000 companies excluding multiple foreign listings. Also excluded are listed funds (unit trusts) and ETFs.

### Listed companies per capita

The right chart shows the number of domestic listed companies per million population in each country. Aside from some small tax havens down near the bottom of the chart, Canada is the leader, with 113 listed companies per million population. Australia is not far behind with 75 listed companies per million people.

Other countries with relatively high numbers of listed companies per capita are technology hubs Taiwan, South Korea, Japan, and Israel.

The **US** market has a wide diversity of industries and has been the dominant technology and innovation hub of the world for the past century, but it has only a fraction of the number of listed companies per capita than Canada or Australia. The number of US listed companies has been declining in recent decades, despite the huge tech booms in the 1990s and 2000s.

The number of listed companies per capita in **Australia** have been relatively stable, and several times US levels, especially since the late 1960s mining boom. In **Europe** the numbers of listed companies per capita are very low indeed, probably because of the heavy state involvement and regulation of business across Europe.

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## **Mining speculators' paradise**

Australia and Canada are the stars – but why? They are not technology innovation hubs – in fact, the exact opposite. The stock markets of both countries lack the broad diversity of industries of the US market. Australian and Canadian stock markets are both dominated by a very small number of large banks and miners.

In the case of Australia and Canada, although each has more than 2,000 and 4,000 listed companies respectively, the vast majority of these are tiny revenue-less, profitless, wannabe mining explorers with little more than a map, a compass, and the promoters' (mostly unjustified) dream of striking it rich. This has been the case since the earliest days of share trading in remote mining settlements.

The vast majority of tiny explorers will disappear worthless when they run out of money before finding anything useful to dig up. They will be replaced by the next round of tiny explorers that will also disappear worthless when they, too, run of money. There is always a next round of starry-eyed investors willing to throw money at dreams of hitting the jackpot in some faraway patch of dirt just waiting to be discovered.

## **More companies, not higher returns**

It should be noted that simply having more listed companies to invest in does not lead or contribute to higher share market returns. Australia and Canada are similar to the US and all other stock markets in that the vast bulk of wealth created by the share market as a whole has come from a tiny handful of companies.

One of the main downsides for Aussie and Canadian investors has been that the huge number of cashless, profitless, speculative ventures tend to divert investors' attention from the real generators of wealth.

It is very hard to resist the lure of hitting the jackpot by discovering the next Challis Mining or Pilbara Minerals or Lynas.

## **Vast unexplored territories**

There are probably two main reasons for Australia and Canada having much higher numbers of listed companies per capita than the rest of the world. The first is that both countries are vast, sparsely populated, frontier territories filled with an extraordinarily wide range of mineral resources just waiting to be explored and exploited.

Mining requires capital.

Aside from the initial alluvial gold fields that were exhausted quickly by hand at minimal cost, exploration and development of mines requires large pools of capital that generally require the collection of money from hundreds or thousands of willing investors. This requires corporate structures to protect investor rights, and processes to enable the secondary buying and selling of shares, which in turn requires brokers, lawyers, accountants, auditors, and recordkeepers – ie stock exchanges.

## **Highest income and wealth per capita**

A second likely reason for the large numbers of speculative mining ventures in Australia and Canada, is that the combination of high-value resource exports plus sparse populations, has produced very high levels of individual wealth and incomes in both countries.

In many or most resource-rich countries (like Venezuela, Nigeria and dozens of other countries), much or most of the wealth has been, and still is, siphoned off by the rulers and their cronies, resulting in very low incomes and wealth for the great bulk of the population. In contrast, Australia and Canada have had relatively stable, representative political systems, and relatively low levels of inequality of incomes and wealth.

As a result of speculative mining riches (as well as from wool during the first 150 years), Australians have enjoyed the highest or near highest median income and wealth per capita in the world since the late-1800s, much higher than the US. This is still the case today.

## **Chronic gamblers**

Australians have long been the biggest gamblers in the world per capita (eg see [Productivity Commission report](#)). This may be one of the reasons for our love of speculative mining stocks. Or is it the other way around? Are we a nation of mad gamblers today because of our history of speculative mining riches?

Meanwhile, time to get back to finding the next winner!

Ashley Owen, CFA is Founder and Principal of [OwenAnalytics](#). Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. You can subscribe to OwenAnalytics Newsletter [here](#). Original article is here: [Australia: Most listed stocks per capita, and biggest gamblers in the world - Is there a link?](#)

## Meg on SMSFs: Winding up SMSFs paying a pension requires care

Meg Heffron

It's common to assume that once a member decides to wind up their SMSF, it should happen as quickly as possible. After all, everyone likes to avoid unnecessary costs and each additional year means another year of accounting and audit fees, not to mention the ATO's supervisory levy.

But sometimes slowing down can be important, particularly if there are pensions involved.

Let's look at a case where the money is being moved to a public fund rather than taken out of super entirely.

Usually the pattern is to rollover 'most of the money' first and then make a final payment once the fund's final tax refund has been received. If the decision is made to wind up in (say) February 2025, the trustee might hope to make that first transfer in April or May 2025, leaving only a few thousand dollars in the fund at 30 June 2025. While the fund technically stays 'alive' until the tax refund is received, bank account closed etc, it can be possible to ensure that at least the accounting and audit fees stop with the 2024/25 return rather than continuing another year.

In a fund paying a pension, the pension technically has to be commuted so the rollover can take place (only lump sums can be rolled over so the pension firstly needs to be turned into a lump sum). There are two ways this could be approached – and to highlight the difference between the two let's assume that the fund only has one member, one pension and no accumulation accounts.

### Fully commuting the pension

Firstly, the pension could be **fully** commuted and as much as possible rolled over. The final payment in 2025/26 would then be made from a small accumulation account.

Remember that as soon as the pension is fully commuted, it stops for tax purposes. That means the fund stops claiming a tax exemption on its investment income (this tax-exempt income is often referred to as "exempt current pension income" or ECPI). So this exposes the fund to a very real risk that only income (and capital gains) received *before* the trustee formally commutes the pension is exempt. If the rollover is happening in specie (ie, the member is transferring their SMSF assets to their new fund rather than cashing them out first), then by definition all of the capital gains realised as a result of the transfer will be realised *after* the commutation. That means they would normally be **taxable**.

These days, fortunately, we have a solution. The trustee can elect to claim ECPI using a different method (often called the 'actuarial certificate method' because it requires an actuarial certificate to do it). This method doesn't actually look at precisely when capital gains were realised, or income received. Instead, the actuary looks at the fund over the whole year and works out (on average) what proportion or percentage of the fund was in pension accounts. If that's (say) 70%, the actuary certifies that 70% of the fund's investment income is exempt from tax no matter when it was actually received (before or after the commutation).

**But the key here is to actually make the election and ensure the tax return is prepared on that basis.**

The fund's accountant/tax agent should do this proactively but legally, the 'default' for many funds in this position is that it's not.

### Partially commuting the pension

The second approach would be to **partially** commute the pension and just rollover the partial commutation.

The great thing about that option would be the pension continues and so does ECPI. The capital gains would be realised at a time when the whole fund was still in pension phase – so there's no need for the trustee to make the election etc.

But there's also a downside. The minimum pension payment set at the start of the year continues to apply until the pension is fully commuted. So if a little bit of pension account remains for the whole year, you'll need to take the full minimum pension.

That might be fine in some cases but in others it could mean much more than expected comes out of super. And remember that if the amount moved to a new fund is converted to a new pension in that new fund, a minimum pension amount has to come out of that fund too. (Effectively the combined minimum will double count your super.)

### **What if there were accumulation accounts?**

In that case, the actuarial certificate method would almost certainly be used to work out ECPI.

But this is where really understanding how the percentage is calculated can be invaluable in controlling tax. And it also might encourage you to slow down.

Take a fund where approximately 40% is in pension accounts and 60% is in accumulation accounts. In the normal course of events, the actuary will probably calculate 40% for their certificate.

That means, if a lot of assets are sold realising capital gains, they will be partially taxed.

But the SMSF trustee can get a better result if they're willing to wait a bit. Let's say the wind up is being initiated in May 2025.

They could look to transfer all the accumulation balances in the first year (2024/25). Ideally this would draw on as much cash or assets with low capital gains as possible. During that year, the actuarial % would be around 40%.

Early in the following year, the trustee would sell the rest of the assets and make a second large transfer (most of the fund). In that year, remember, all that remains is pension accounts. So the capital gain would be realised at a time when the actuarial % is more like 100% - potentially reducing the tax paid enormously.

This might make going slowly well worth it, even if it results in another year of accounting and audit fees.

### **And what if the money is coming out of super?**

For many people, winding up their SMSF means taking all their money out of super entirely.

There are plenty of good drivers here – for example, a 90-year-old widow whose beneficiaries are adult children might want to avoid death benefit taxes. Some people find their balances decline over time and the SMSF is no longer worthwhile from a cost perspective. And others just decide to simplify their affairs.

All of these could see money moved out of superannuation.

There are things to watch here.

#### *Commonwealth Seniors Health Card*

Don't forget that eligibility for this card is based mostly on taxable income, say from investments outside super. And often, money that's in super is ignored entirely. For example, if you started your super pensions before 1 January 2015, you can ignore all your super for this card. Those who have a lot of their super in an accumulation account can ignore this as well. Even if your pension started on or after 1 January 2015, you only have to take a "deemed" amount of income into account for the income test on this card.

Moving money outside super could have a big impact on whether or not you're eligible for the card.

#### *Estate planning*

For many people, all the money is going to the same place (the estate) whether it's currently in super or invested in their own name. So moving large amounts outside the super system won't disrupt any plans.

But if you've carefully arranged to have your super go to one beneficiary but other assets go elsewhere, you need to act with care. These types of arrangement are completely disrupted if the money is moved around during your lifetime. Ideally, you'd fix your Will before taking the money out of super.

*Where should the money or assets go?*

It's one thing to say "I'll take all my money out of super" but it might be quite another to decide where to hold it.

Let's imagine your SMSF owned a property. The decision has been made to pay it out of the fund in specie (ie by transferring it rather than selling it to someone else). For a start, remember that only lump sums (not pension payments) can be paid in specie. So once again, it would be necessary to fully or partially commute your pension.

But the next step is also important. What if you actually want the property to go to your family trust, or another family member or an investment company? While the benefit has to be paid "to the member", that doesn't mean the property has to be transferred to you first and then transferred again (with more stamp duty) somewhere else. You can ask the trustee to transfer the property directly to the right place. It pays to think about this before making the move – and getting the right paperwork in place.

All in all, there are plenty of reasons to think carefully before acting when it comes to winding up an SMSF, particularly where pensions are involved.

*Meg Heffron is the Managing Director of [Heffron SMSF Solutions](#), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.*

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**Will house prices crash?**

Shane Oliver

Apart from "what will home prices do?" and "where are the best places to buy a property?" the main debate around the Australian housing market has been about poor housing affordability, occasionally interspersed with a scare that home prices will crash. The most recent example of the latter was on 60 Minutes last week with a call by US demographer and economist Harry S Dent that Australian house prices could fall "as much as 50% in the coming years". But how serious should we take forecasts for a crash? And more fundamentally, how do we fix affordability?

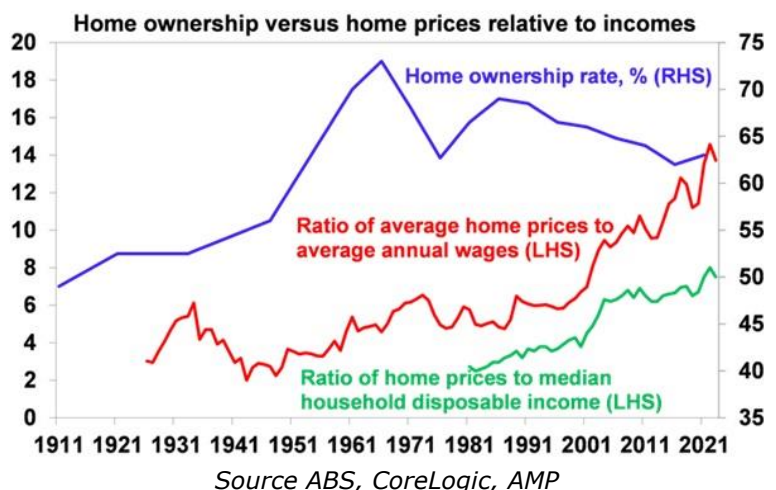
**Basic facts on the Australian property market**

The basic facts regarding the Australian housing market are well known:

First, after strong gains in home prices over many years, it's expensive relative to income, rents and its long-term trend and by global standards.

Second, flowing from this, housing affordability is poor:

- The ratio of average dwelling prices to average wages (red line in the chart, right) & household income (green line) has doubled since 2000.
- The time taken to save for a deposit has roughly doubled over the last 30 years from five years to more than 10 years (chart, next page).
- The portion of income needed to service a mortgage has hit an all-time high, thanks to the combination of the high price to income ratio and the sharp rise in mortgage rates starting in 2022.



Source ABS, CoreLogic, AMP

Third, the surge in prices has seen our household debt to income ratio rise to the high end of OECD countries, which exposes Australia to financial instability on the back of high rates and or unemployment.

These things arguably make calls for some sort of crash seem plausible.

**Crash calls for Australian property are nothing new**

US commentator Harry S Dent’s forecast for an up to 50% fall in property prices is nothing new. Calls for an Australian property crash – say a 30% or more fall - have been trotted out regularly over the last two decades.



Source: ABS, AMP

- In 2004, The Economist magazine described Australia as “America’s ugly sister” thanks in part to a “borrowing binge” and soaring property prices. At the time, the OECD estimated Australian housing was 51.8% overvalued.
- Property crash calls were wheeled out repeatedly after the GFC with one commentator losing a high-profile bet that prices could fall up to 40% & having to walk to the summit of Mount Kosciuszko as a result.
- In 2010, a US newspaper, The Philadelphia Trumpet, warned: “Pay close attention Australia. Los Angelification (referring to a 40% slump in LA home prices) is coming to a city near you.” At the same time, a US fund manager was labelling Australian housing as a “time bomb”.
- Similar calls were made in 2016 by a hedge fund: “The Australian property market is on the verge of blowing up on a spectacular scale...The feed-through effects will be immense... the economy will go into recession”.
- Over the years, these crash calls have periodically made it on to Four Corners and 60 Minutes. The latter aired a program called “Bricks and slaughter” in 2018 with some predicting falls of as much as 40%.
- And Harry S Dent was regularly predicting Australian property price crashes last decade that didn’t occur.

**Why a crash is unlikely?**

Of course, a crash can’t be ruled out, but as I have learned over the last two decades the Australia property market is a lot more complicated than many “perma property bears” allow for.

First, the property market is not just a speculative bubble fuelled by easy money and low interest rates. Sure low rates allowed us to pay each other more for homes but the key factor keeping them elevated relative to incomes has been that the supply of new dwellings has not kept up with demand due to strong population growth since the mid-2000s and more recently with record population growth resulting in an accumulated shortfall of around 200,000 dwellings at least but possibly as high as 300,000 if the reduction in average household size that occurred through the pandemic is allowed for. This partly explains why property prices have not collapsed despite the threefold rise in mortgage rates since May 2022.



Source: ABS, AMP

Second, the property market is highly diverse as evident now with strength in

previously underperforming cities like Perth, Adelaide and Brisbane but weak conditions in Melbourne, Hobart and Darwin.

Thirdly, Australian households with a mortgage have proven far more resilient than many including myself would have expected in the face of the rate hikes in 2022 and 2023. This is evident in still relatively low mortgage arrears (of around 1% of total loans). This may reflect a combination of savings buffers built up through the pandemic including in mortgage pre-payments and offset accounts, access to support from the 'bank of mum and dad', the still strong jobs market allowing people to work extra hours and an ability to cut discretionary spending (suggesting definitions of what constitutes mortgage stress may be overstating things). Of course, arrears are starting to rise as these supports recede, so the continuation of this resilience should not be taken for granted.

Finally, the conditions for a crash are not in place. This would probably require a sharp further rise in interest rates and/or much higher unemployment. Sharply higher interest rates from the RBA are unlikely as global inflationary pressure is easing and global central banks are now cutting. Our inflation and rates went up with a lag versus other countries and are likely to follow on the way down. Higher unemployment – with jobs leading indicators pointing to less jobs growth – is the biggest risk though.

So, a property price crash is a risk, but would likely require a deep recession. Our base case for average home prices remains for modest growth ahead of a pick-up after rates start to fall.

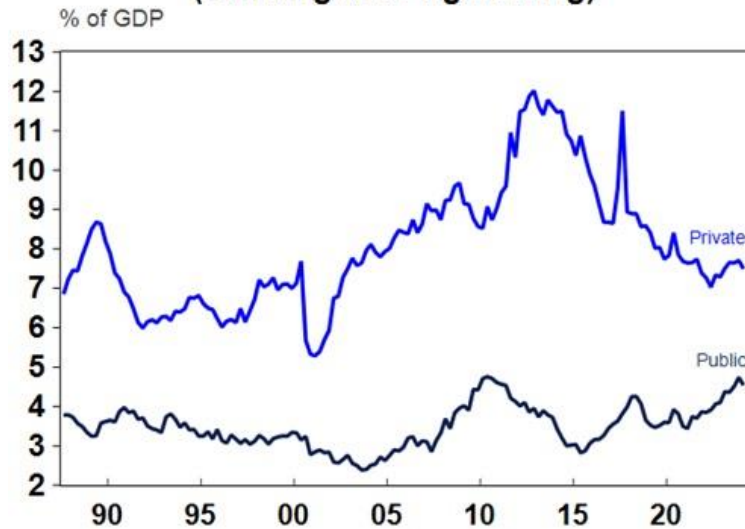
### **What can be done to boost housing affordability?**

Of course, a house price crash would improve housing affordability – but it's also a case of "be careful of what you wish for" because a crash would likely also come with a deep recession and sharply higher unemployment which could see many lose their homes along with a hit to incomes. However, improving housing affordability is critical as its long-term deterioration is driving excessive debt levels and increased mortgage stress and contributing to a fall in home ownership (the blue line in the first chart). Of course, other factors have also driven falling home ownership since the 1960s including people starting work and family later in life, a decline in perceptions that owning a home is necessary for security and growth in other forms of saving beyond housing. But worsening affordability is likely a big contributor and falling home ownership due to this is something we should be concerned about as its contributing to increasing inequality and if it persists it could threaten social cohesion.

So, beyond crashing home prices, what can be done to boost housing affordability? My shopping list includes the following:

- **Build more homes** - relaxing land use rules, releasing land faster and speeding up approval processes, encourage build to rent affordable housing and greater public involvement in provision of social housing. The commitment by Australian governments to build 1.2 million homes – backed up by incentives and strong moves by at least NSW and Victoria over five years starting from this financial year is a welcome and big move down the path to boost supply. So far though approvals and commencements running at around 160,000 to 170,000 homes annually are well below the implied 240,000 target.
- **Refocus on building more units** – we will need more units (which are lower cost) than houses in the mix. The only time we consistently built more than 200,000 homes per annum was in the unit building boom of the 2015-19 period. Back then unit approvals were around 50% of total approvals whereas they are now about one third.
- **Slow down infrastructure spending** – home builders are now regularly complaining about the difficulty in building apartments. Apart from issues around approvals, much of this relates to cost blow outs and labour shortages and beyond the disruption caused by the pandemic an ongoing driver is the competition for resources from booming public sector infrastructure projects.

### Australia Total Construction (Building and Engineering)



Source: Macrobond, AMP

- **Match the level of immigration to the ability of the property market to supply housing** - we have clearly failed to do this since the mid-2000s and particularly following the reopening from the pandemic, and this is evident in the ongoing supply shortfalls. Of course, we need to be careful to not over-react with the crackdown on student visas and numbers risking a lasting negative impact on our education sector which is our biggest export earner after iron ore and energy.
- **Encouraging greater decentralisation to regional Australia** – this should be helped along with appropriate infrastructure and of course measures to boost regional housing supply.
- **Tax reform** - including replacing stamp duty with land tax (to make it easier for empty nesters to downsize) and reducing the capital gains tax discount (to remove a distortion in favour of speculation).

**Policies that won't work**, but are regularly put forward by populist politicians as solutions to poor affordability, include: grants and concessions for first home buyers (as they just add to higher prices); abolishing negative gearing (which would just inject another distortion into the tax system and would adversely affect supply), although there is a case to cap excessive use of negative gearing tax benefits; banning foreign purchases altogether (as they are a small part of total demand and may make it even harder to get new unit construction off the ground); and a large scale return to public housing (as a major constraint to more units is excessive costs and delays, and just switching to public housing won't fix this).

*Dr Shane Oliver is Head of Investment Strategy and Chief Economist at [AMP](#). This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.*

## Is the passive investing dream waning?

Emma Davidson

There's no doubt that Australians are big fans of passive investing. Over the last year, the country's ETF market [grew approximately 37%](#) to a value of \$206 billion. A mere decade ago, it totalled [just \\$12 billion](#).

According to a [recent VanEck survey](#), more than half of Australian investors claimed that ETFs are their favourite investment vehicle. To put that in perspective, only 3% chose unlisted managed funds or actively managed funds, while less than 2% selected LICs.

Overall, 84% of Australians would recommend ETFs to their fellow investors.



These figures don't come as much of a surprise to me. I've spent a large portion of my career flying the flag for passive investing. I got my first financial services job in 2000, which was around the time that ETFs began gaining momentum.

And it's not hard to see why they're so popular. Australian investors save approximately half a billion dollars a year in fees when they [choose ETFs over actively managed funds](#).

What's more, [85% of active managers](#) don't appear to provide much value for the extra fees they charge.

Armed with this damning data, you might think active management is down for the count. The evidence in support of ETFs would seem insurmountable.

However, passive investing might not be the magic bullet that everyone thinks it is. In fact, I would argue there are signs it is already struggling to keep up in a world that's rapidly passing it by.

To understand why, we need to talk about how the alternatives space - in particular, private equity - has revolutionised the investment landscape.

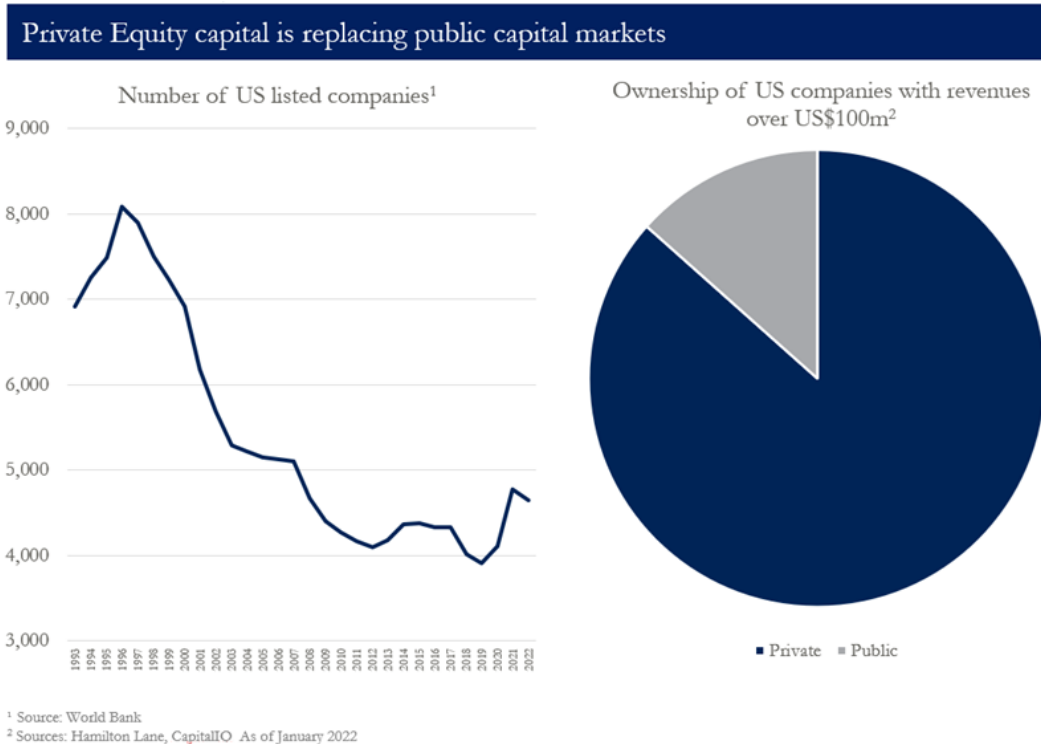
### The rise of private equity

A generation ago, public markets were the only place that companies could typically go to raise large amounts of equity capital. Fast-forward to today, however, and much of that public market capital has been replaced by the private equity industry. This has particularly been the case for new and fast-growing businesses, typically the more exciting parts of the equity investing landscape.

Take the US, for example. In 1996, there were more than 8,000 listed companies in the country, [according to the World Bank](#). This figure had almost halved to 4,600 by 2022. Over roughly the same period, the number of US companies backed by private equity firms has [increased more than five-fold](#) from 1,900 to 11,200.

Globally, participation in private markets stood at [US\\$600 billion in AUM](#) in 2000. By 2022, it had reached US\$9.7 trillion.

**Figure 1: Private Equity dominates markets today**



Clearly, private equity is booming. As a result, the lifecycle of companies is far different now to what it was at the turn of the millennium.

Many excellent businesses never make it into the public domain – they are funded, acquired and sold entirely within the private arena. Today, public markets are not only less relevant, but also less representative of the global economy.

What does all this have to do with ETFs, you may be wondering? Well, let's start by defining passive investing and what it's trying to do.

### A slice of the economy

Passive investing refers to an investment strategy that tries to track an index. When the first index ETF popped up in the mid-1970s, the thinking behind it was simple but elegant: if the [Efficient Market Hypothesis](#) holds true, then stock prices already accurately reflect all publicly available information.

So, rather than incur the costs and time of doing proprietary analysis, why not construct a portfolio that simply replicates the market?

The appeal was obvious. A precisely weighted portfolio could mimic the market and give investors a low-cost slice of the economy as a whole, with attractive returns to match. And that's certainly been the case with passive investing for many years.

But as we've seen, the business landscape and financial markets have evolved considerably over the last two decades. With private equity currently holding such a large piece of the pie, how can index trackers still claim to offer the well-diversified basket of stocks they once did?

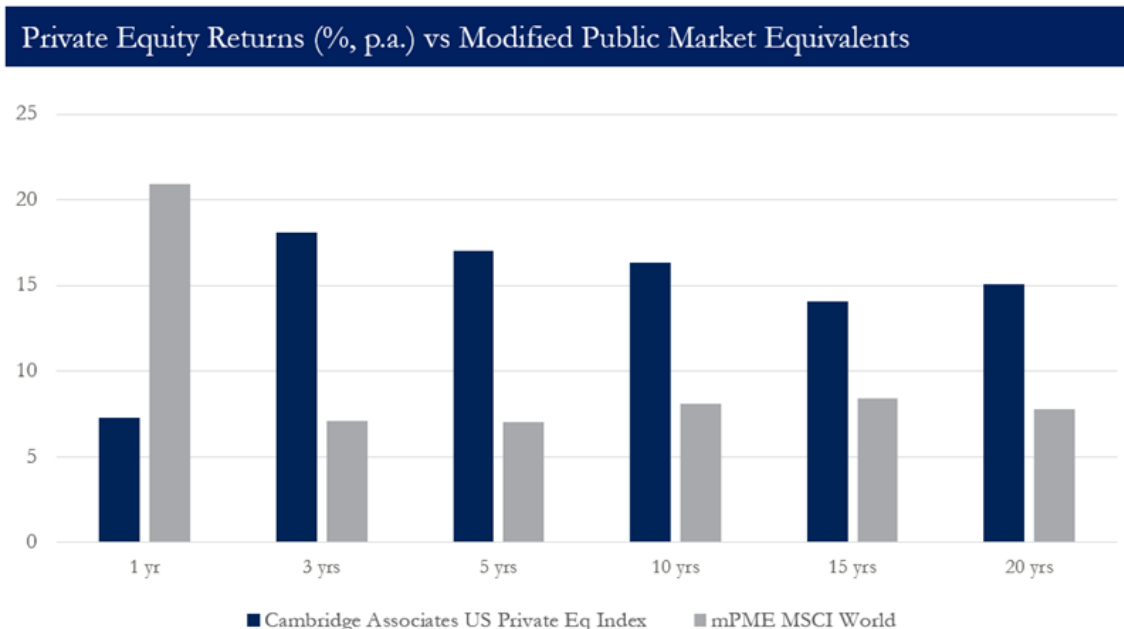
The New York Stock Exchange is a good example. The 'Magnificent Seven' tech companies – Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla – comprise [nearly a third](#) of the S&P 500's market capitalisation.

Does that seem balanced? How many financial advisers would sensibly suggest that putting a third of one's wealth into a handful of high-risk, high-return stocks is a suitable strategy for all investors?

If the current direction of travel continues, public markets will only continue to shrink and become even less relevant over time. It's likely that many of the future Microsofts, Googles and Amazons won't even make it onto the public markets in the first place.

The upshot is that the average retail investor isn't getting a representative slice of the economy through passive investing anymore, and they risk missing out on superior returns as a result. Indeed, research shows that private equity returns have significantly outperformed public markets over almost every time horizon as illustrated below:

**Figure 2: Private Equity outperforms public markets**



Cambridge Associates Modified Public Market Equivalent (mPME): The mPME calculation is a private-to-public comparison that seeks to replicate private investment performance under public market conditions. The public index's shares are purchased and sold according to the private fund cash flow schedule, with distributions calculated in the same proportion as the private fund, and the mPME NAV (the value of the shares held by the public equivalent) is a function of mPME cash flows and public index returns. The mPME attempts to evaluate what return would have been earned had the dollars been deployed in the public markets instead of in private investments while avoiding the "negative NAV" issue inherent in some PME methodologies.

<sup>2</sup> As at 30th September 2023

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## Coming full circle

The world has clearly moved on since passive investing first hit the scene, so can the industry evolve to keep up with modern markets?

Unfortunately, the academic theory that underpins traditional index funds doesn't provide much leeway for product innovation. There's only so much you can do if you're faithfully tracking an index.

This has not stopped the industry from creating a multitude of different passive investment products that focus on specific sectors, markets, themes or trends.

Thematic ETFs, for instance, have experienced steady growth in Australia over the last few years, with a total of \$5.4 billion currently invested in them, [Global X figures show](#).

But if passive managers are picking and choosing specific stocks to put in their products, they are straying far from the original philosophy behind passive investing. I'd even argue they've come full circle back to being active managers.

As ever, financial markets continue to adapt and evolve – and so must we. Yes, passive investing can serve an important purpose in portfolios, but favouring it to the exclusion of everything else would be a mistake.

While many active managers don't outperform their benchmarks over the long term, it's worth remembering that the best ones do. On the other hand, all passive managers – by definition – lag the markets they track once fees are deducted.

Ultimately, it would seem to be a mistake to believe that one type of investment strategy is suitable for all people, all of the time. Sensible portfolio diversification should include not just investment diversification, but also product diversification. So don't just buy ETFs; look more widely at high-quality active funds and LICs that give you access beyond just the listed equity space.

*Emma Davidson is Head of Corporate Affairs at London-based Staude Capital, manager of the [Global Value Fund](#) (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.*

## What performs best after peaks in market concentration?

Benjamin R. Nastou, Derek W. Beane, Jonathan Perlman

Given the success of the Magnificent Seven in the US and the GRANOLAS in Europe, there has been a lot of press surrounding global pockets of market concentration. The big have gotten bigger, making up a larger representation of broad market indexes. Due to indexes like the S&P 500 being market-cap weighted, the outperformance of some of the largest stocks has buoyed the broader market, which has covered up middling performance of 'most' stocks. It has been a self-perpetuating force, to a degree, as flows to passive indexes and ETFs have grown, exacerbating the phenomenon. From a returns perspective, passive-only investors have benefited, given the support these few stocks have provided to the overall return stream. If your portfolio's exposure is predisposed to substantial amounts of large-cap core or large-cap growth (like the S&P 500 Index), you have likely done well. Anything beyond that has largely suffered in relative terms. For context, look at cumulative returns over the trailing five-year period ending December 31, 2023. From a market cap perspective, large-cap stocks returned 126% while small-cap stocks returned 61%, while from a style perspective, growth outpaced value 137% versus 67%.<sup>1,2,3,4</sup>

Given the extreme concentration in the market, the natural questions one may ask are:

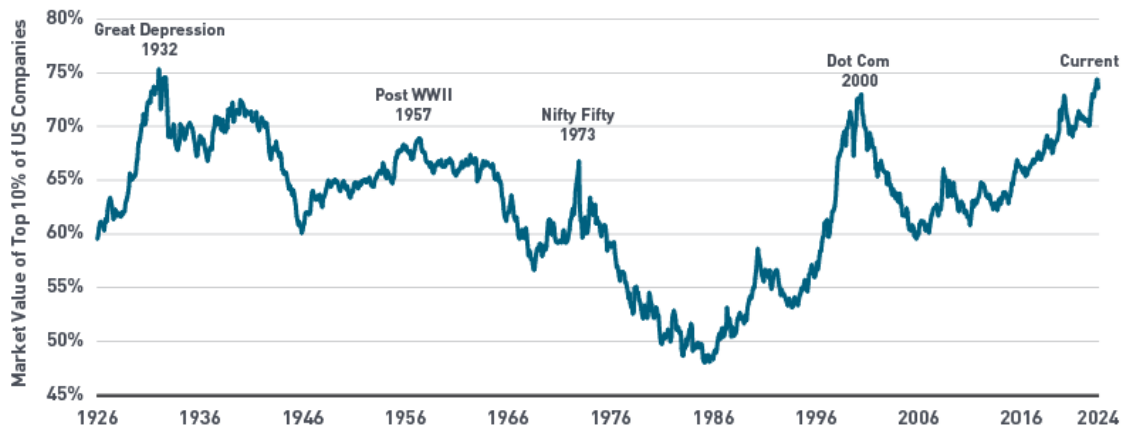
1. How does this concentration compare to history?
2. What typically follows periods of extreme concentration?

### Historical view

There are a number of ways one can assess market concentration, but they all seemingly lead to the same conclusion: Where we stand now is among the most concentrated periods in modern US history. Much of the

recent analysis in the press is focused on the S&P 500, which is fine; however, here we take a step back and look at all listed US securities for the sake of completeness.<sup>5</sup> As shown in Exhibit 1, there have been other periods of high market concentration, though we are closing in on the highest levels witnessed over the last century. This certainly doesn't mean a high degree of concentration can't continue, and we possess no crystal ball, but taking a look at historical analogies can help inform us on what may transpire when this regime shifts.

### Exhibit 1: Market Concentration



Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) [https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html#Research](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research).

It's worth noting that concentration peaks don't always occur at the same point of a market cycle. For example, some have occurred within relative proximity to market peaks as investors crowd into favoured stocks (1973, 2000) whereas some occurred near market troughs (1932, 1957).

#### What next?

Markets move in cycles. Just like value versus growth, large versus small, or US versus non-US, concentrated versus diversified is another type of cycle for investors to consider. As shown above, markets do eventually reach a concentration tipping point where they revert to broader participation. If there is some degree of willingness to accept the premise that, at some point, the regime will shift to a less concentrated and more diversified environment, how long can that unwind last, and what does that entail for various segments of the equity market?

Using the concentration peaks listed in Exhibit 1, we took a deeper dive on both sides of the peak to examine how long the run-ups preceding the peak can last and how long the ensuing unwind of these concentration cycles can take.

### Exhibit 2: Cycle Lengths

Peak	1932	1957	1973	2000	Average	Current Cycle*
Concentration Cycle (Years)	—	11.4	4.3	15.3	10.3	17.7
Diversification Cycle (Years)	13.9	11.3	12.3	5.3	10.7	—

Note: Concentration cycle indicates the period of time from the trough in market concentration to the peak. Diversification cycle indicates the period of time from the peak in market concentration to the trough. Data is unavailable for the run-up period to the 1932 peak. \*Measured through December 31, 2023.

Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) [https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html#Research](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research).

In the concentration periods, markets become more top-heavy and typically favour less diversified approaches. Conversely, post peak, market performance is historically dictated by a wider percentage of stocks and is more favourable to a diversified approach. Though lengths of the cycles favouring concentration versus diversification vary, on average these are long duration events that last about a decade. Even the shortest ones were still four to five years in length, which to many is considered a full market cycle. To put this in context to where we are

today, the 2000 diversification period lasted until April 2006. This means the current run-up of concentration is closing in on nearly 20 years, which far surpasses the average. We don't know when this will end, but we do have empirical evidence that shows us to be at an extreme in both magnitude and length.

As markets ebb and flow, and concentration comes in and out of favour, it can certainly have an impact on other underlying dimensions within the equity landscape. We have seen this over the past many years as large-cap growth has had a huge tailwind versus smaller cap and value segments of the market. Is this typical and what happens when the dynamics shift?

### Exhibit 3: Performance After Concentration Peak

	3 Years		5 Years		10 Years		Diversification Cycle	
	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative	Annualized	Cumulative
<b>Equal Wgt. - Cap Wgt.</b>	14%	50%	12%	82%	8%	125%	9%	197%
<b>Small - Large</b>	10%	36%	9%	61%	8%	114%	9%	158%
<b>Value - Growth</b>	5%	18%	7%	44%	4%	46%	7%	104%

Source: NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - Data Library (dartmouth.edu) [https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html#Research](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research).

Exhibit 3 displays the average annualized and cumulative results after the peak in concentration over various timeframes for the following: US equal-weighted index less US cap-weighted index; US small cap less US large cap; US value less US growth. The rightmost dataset indicates the average results across the entire diversification cycle, as indicated from a peak to trough in market concentration.

As shown, the better performing areas of the equity market during a diversification cycle are historically the ones that have been the laggards over the past many years — and by a wide margin. Specifically, as shown in Exhibit 3, note the following:

**Breadth:** Equal-weighted equities significantly outperformed cap-weighted equities. Following periods of excessive concentration, more diversified portfolios (i.e., equal-weighted portfolios) historically outperformed the more concentrated cap-weighted portfolios. This could bode well for active managers who are typically more diversified than the current cap-weighted indices. By definition, traditional passive portfolios carry equivalent allocations to stocks as the indexes they track. With a small subset of highly performing stocks representing a significant percentage of large-cap indices, any pressure on these stocks could subject passive portfolios to substantial downside risk. Active managers have the flexibility to prudently diversify away from the risk of excessive concentration in their benchmarks.

**Size:** Small caps outperformed large caps. Investors may be leaving returns on the table by not diversifying down the market cap spectrum. Additionally, this may bode well for some active managers given the skew of large-cap indexes as well as the potential opportunity to take active positions in an area of the market that is less covered, less efficient and may possess a greater opportunity to drive value through security selection.

**Style:** Value outperformed growth. Much like size, investors may be better served by diversifying their style exposures. Clearly growth has had a tailwind recently, but ensuring style diversification can help manage the return profile when growth eventually fades.

Of course no one can perfectly time when concentration will peak, but the encouraging element to note is that it is not critically important in our view. Our analysis showed directionally similar outcomes when measured from a starting point one and two years preceding market concentration peaks. Even if you are early, we believe the benefits of diversification can be meaningful when the cycle turns. Our conclusion here is that ensuring proper diversification is more critical than the actual timing of diversification.

### Conclusion – An argument for diversification

Given substantial market strength over the last decade, largely from just one market segment, it's easy to fall into the trap of forgetting about the benefits of diversification. The history books may describe the theme of the past decade-plus as a period of extreme market concentration and strong performance of a small segment of the investable universe. We don't know when this regime will end, but the data show evidence that when

market leadership changes, the shifts can be as dramatic and persist for just as long — historically benefiting a diversified and active approach.

#### **Endnotes**

<sup>1</sup> S&P 500 Top 50 – Gross return.

<sup>2</sup> Russell 2000® – Total Return.

<sup>3</sup> Russell 3000® Growth – Total Return.

<sup>4</sup> Russell 3000® Value – Total Return.

<sup>5</sup> NYSE, American Stock Exchange, and NASDAQ sourced from Kenneth French database Kenneth R. French - [Data Library \(dartmouth.edu\)](https://data.library.dartmouth.edu).

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## **Why investors will continue to pay up for the US market and Mag 7**

Stephen Dover

When it comes to wealth enhancement, the longer run is decisive. Many studies have shown that the strategic asset allocation decision, and adherence to it, determines the lion's share of a portfolio returns and risk over time.

It therefore makes sense to step back from current conditions and assess the medium-term outlook for growth, earnings, interest rates and valuations, and to consider secular forces likely to produce solid investment returns over time.

### **Global growth and inflation**

We begin with global growth, which pins down the equilibrium real rate of interest. Growth is determined by the supply side, which sets the speed limit for potential economic activity, as well as by the demand side, which determines whether the economy's productive capacity will be fully employed.

On the supply side, most signs point toward subdued growth of the global economy's potential to produce goods and services. Across the world's largest economies, aging populations imply tepid labour force growth. Immigration has been a helpful offset in the United States in recent years, but populism is a constraint. Deglobalization is another headwind.

Hence, if the global economy's speed limit is to be raised, productivity must surge. Eventually, that may occur if the promise of new technologies in artificial intelligence (AI), robotics, genetics and elsewhere is fulfilled. But so far, those innovations are macroeconomically insignificant, with productivity growth in the United States and globally mired in a two-decade long slump.

On the demand side, the world economy benefited from a massive fiscal policy boost during the COVID-19 pandemic. But fiscal tailwinds are fading. Meanwhile, the lagged impacts of monetary policy tightening in response to surging global inflation are still working their way through the world economy. High savings, built during pandemic-era shutdowns, are being whittled away, which should slow household spending.<sup>1</sup> Lastly, China's enormous debt burdens (linked to excess real estate investment) and Beijing's unwillingness to adopt policies that could meaningfully lift consumption, suggest that China's contribution to global demand will likely also remain subdued in the years to come.

The implication is that absent an autonomous investment boom, global demand is unlikely to race ahead of global productive potential. Inflation, in other words, is more likely to fall than rise.

The key investment implications we see are that real and nominal interest rates will decline over the next few years everywhere, but particularly in the United States, where the monetary policy response to inflation has been the most forceful. As central banks respond to lower inflation and moderating growth by easing, yield curves will likely normalize (i.e., return to their customary upward sloping configuration).

How far will interest rates fall? Provided recession can be avoided, policy rates should decline toward their neutral rates that neither excessively hinder nor stimulate growth. Estimates of the neutral policy rate vary, but most reside within a range of around 2.5%-3.5% for the United States and the United Kingdom, and lower for Europe and Japan. Accordingly, over the next several years, we would expect short-term interest rates to fall about 2-3 percentage points in the United States, United Kingdom and the eurozone (in Japan and China low rates already prevail).

In response, bond yields will also likely fall, though to a lesser extent than short-term rates as yield curves normalize. Given these dynamics, we believe the return prospects in global government bond markets look attractive over the next several years.

Finally, over the medium-term, corporate profits tend to move closely with economic activity. As nominal gross domestic product (GDP) growth slows (owing to disinflation and moderating growth), total corporate profits growth should also slow. Assuming a constant share of profits in GDP (note that measure is historically high in the United States<sup>2</sup>), aggregate corporate profits should likely grow by around 5%-6% per annum over the next few years, somewhat below the postwar average of 7.4%.<sup>3</sup> In our analysis, slower corporate profit growth will likely lead to more modest equity market performance in coming years, particularly in the United States where already elevated valuations will likely constrain the scope for multiple expansion as interest rates fall.

### **Risks to the view**

Before turning to valuations, it is important to consider risks to the 'base case' outlined above.

Clearly, unforecastable shocks—war, terrorism, social strife or natural disasters—could change outcomes. But among 'known-knowns', for which we already have data and some visibility, two stand out that could be game changers.

The first is fiscal stress. As a result of the global pandemic and the 2008 global financial crisis, the fiscal position of many countries has dramatically deteriorated over the past two decades. Accordingly, investors may one day balk at absorbing government debt issuance, particularly if governments act unpredictably or irresponsibly. That was the lesson learned from the Gilt crisis during the short tenure of the ill-fated Liz Truss UK government in 2022.

But even absent policy shenanigans, we believe fiscal positions are unlikely to improve much over the next few years. Weaker growth tends to worsen the fiscal balance for well-known reasons. Some relief, however, should come through lower interest rates and as global savings rise relative to investments owing to slowing world growth.

The bottom line is that fiscal positions in the United States, United Kingdom, much of Europe and Japan are more problematic and offer less flexibility in the event of an economic or financial crisis, in our analysis. But if we assume that governments avoid significant policy errors, lower interest rates and ample world savings suggest that debt and deficit financing should nevertheless proceed without duress.

The second 'known-known' is political uncertainty. Regardless of origin, populism is intrinsically unsettling for business and financial planning.

### **Equity valuations and continuity**

There is a Wall Street adage that valuations are meaningless in the short run and are everything in the long run. Just as growth and inflation pin down the sustainable paths of interest rates and corporate profits, valuations can provide a roadmap for long-term returns. As countless studies demonstrate, excessive valuations are typically followed by periods of subdued returns, and higher returns are more likely to arise from a starting point of low valuations.

However, asset price misalignments (in either direction) are rarely the sole catalyst for market course corrections. Returns can also be persistent ('momentum'). Expensive can become more expensive, cheap can

remain cheap. To paraphrase a quote generally attributed to John Maynard Keynes, “markets can remain irrational longer than (contrarian) investors can remain solvent.”

Hence, valuations alone cannot be the only guide for investment decision-making. When considering the impact of valuations on medium-term returns, we must also consider what might (or might not) change to produce investor reassessments of worth.

Based on historical standards, high valuations do not automatically lead to underperformance in a predictable fashion. Look no further than the so-called Magnificent 7,<sup>4</sup> which trade collectively on a price-to-earnings multiple of over 50 times yet continue to lead the bull market higher.

We cannot say for certain, therefore, that over the next few years stocks with elevated multiples will underperform those with low valuations. Nor can we say that Europe’s 30%–40% valuation discount to the United States’ provides assurance that European stocks will outperform their US counterparts over the next 2-3 years.

Moreover, there is a reason why persistence of large valuation divergences exists. The Mag 7, unlike other high-priced stocks in the past, enjoy enormous profit growth driven by near-monopoly power and superior products. They fundamentally differ from stocks of earlier bubbles—the Nikkei of the 1980s, biotech stocks of the early 1990s, or dot-com stocks of the late 1990s—because of their dominant business models that, thus far, have proven durable. Instead, the Mag 7 have more in common with some of the Nifty Fifty<sup>5</sup> stocks of the late 1960s (e.g., General Electric, IBM and Xerox).

However, that observation is both instructive and sobering. Those 1960s market darlings were also innovative, at the forefront of new technologies, and had near monopoly power in their respective markets. But each eventually succumbed to competition or management failure, leading to extended periods of underperformance or even disappearance (Xerox).

The upshot is this: Relative valuations alone are unlikely to drive relative performance. Unless new competitors arise, gross mismanagement is revealed, or governments take effective action to restore competition, large-capitalization technology stocks are unlikely to underperform. Nor are other countries likely to challenge US equity return leadership.

Moreover, in a world of slower profit growth, investors will likely continue to pay up for durable profits offered by stable companies with strong business models and compelling growth opportunities. Value is unlikely to be realized without the catalyst of its own positive earnings surprises.

In short, for fundamental and valuation reasons, our key takeaway is one of equity market continuity. Barring unforecastable shocks, we believe the coming few years will likely resemble the past more than many might like to admit.

### **Fixed income valuations**

As previously noted, interest rates are presently too high relative to likely outcomes for growth and inflation. Accordingly, government bond markets, especially in the United States, offer what we consider attractive prospects for investors willing to extend the duration of their fixed income holdings.

Within credit, however, valuations are less attractive, in our analysis. Both investment-grade and high-yield markets present historically tight spreads over government bonds. Too tight, in our view, to account for some increased risk of downgrades and defaults that will likely emerge as growth continues to slow.

Yield spreads and all-in yields are considerably higher in private credit, including direct lending. That is also warranted, insofar as private credit markets have yet to prove their resilience to a more significant economic downturn or a rise in overall default risk.

Accordingly, we prefer private credit to public credit, even if private credit allocations present conservative investors with intrinsically greater risk than they may prefer.

### **Secular themes**

Most of the preceding discussion has focused on how we see major asset classes performing against a backdrop of moderating world growth, receding inflation and lower interest rates. Yet some key investment themes will emerge regardless of the business cycle, and they merit attention.



Unsurprisingly, the top secular themes reside in areas of technological innovation: AI, robotics and genetics. These are well-known trends, with readily identifiable investment opportunities (e.g., the Mag 7).

But investors should always be on the prowl for new secular opportunities. Among the candidates that we favour are investments in electricity infrastructure and digital finance.

Globally, momentum has shifted toward the adoption of alternative energy as a substitute for carbon-based sources. China (solar panels), Europe (wind) and the United States (owing to subsidies in the misnamed Inflation Reduction Act) have made considerable strides. But the production of alternative energy will also require massive investments in its distribution, principally across the electricity grid. That means more demand for copper (wiring) and other basic materials (used in batteries) as well as for software and engineering skills to develop smarter and more reliable electricity transmission systems.

In finance, the industry is poised to make the third major transition in its infrastructure (the first being human-based exchanges and the second electronic exchanges). The next generation will be based on digital finance.

The financial payments system and its platforms for buying and selling assets are ripe to be scaled more efficiently and more securely, requiring the adoption of alternative ledgers and computing systems relative to today's standards. The driving forces are both technological innovation (blockchain, faster computing) as well as economic (an "arms race" to develop hyper-efficient, scalable transaction platforms among financial institutions). Investment opportunities will likely arise among the providers of the required hardware and software, but will ultimately also manifest in lower cost, more profitable financial institutions across banking and asset management.

For both electrification and digital finance, many potential opportunities may be found in private equity and venture capital investments. Private equity, which has grown far more rapidly than public equity over the past quarter century, has become the primary vehicle for early-stage financing, driving what we consider impressive returns. Private equity is also well-suited to the longer investment horizons associated with secular themes. It is also becoming more accessible, including via secondaries that shorten payback horizons and enhance liquidity.

Finally, although some traditional areas of real estate (e.g., commercial lending or residential mortgage-backed securities) face challenges owing to excess supply (commercial) and affordability (housing), subsets of real estate remain attractive, including space devoted to multi-family housing, warehousing and life sciences. In our analysis, together with select managers in private credit, these secular drivers of returns are also less correlated with traditional asset classes (stocks and bonds), enhancing their portfolio appeal.

<sup>1</sup> Source: "Pandemic Savings Are Gone: What's Next for U.S. Consumers." Federal Reserve Bank of San Francisco. May 3, 2024.

<sup>2</sup> Source: "Shares of gross domestic income: Corporate profits with inventory valuation and capital consumption adjustments, domestic industries: Profits after tax with inventory valuation and capital consumption adjustments." Federal Reserve Bank of St. Louis. October 26, 2023.

<sup>3</sup> Source: "Corporate Profits After Tax (without IVA and CCAAdj)." Federal Reserve Bank of St. Louis. June 27, 2024.

<sup>4</sup> The Magnificent Seven (Mag 7) comprises Alphabet, Amazon, Apple, Microsoft, NVIDIA, Meta Platforms and Tesla.

<sup>5</sup> In the United States, the term Nifty Fifty was an informal designation for a group of roughly 50 large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy-and-hold growth stocks or blue-chip stocks.

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