

### Contents

Cliff Asness: Markets are less efficient and social media is the big culprit *James Gruber*

A housing market that I'd like to see *Susan Lloyd-Hurwitz*

It isn't just the rich who will pay more for aged care *Rachel Lane*

Meg on SMSFs: At last, movement on legacy pensions *Meg Heffron*

A megatrend hiding in plain sight: defence *Arian Neiron*

The butterfly effect, index funds, and the rise of mega caps *Joachim Klement*

Options for investors who don't want to sell overpriced banks *Te Okeroa*

### Editorial

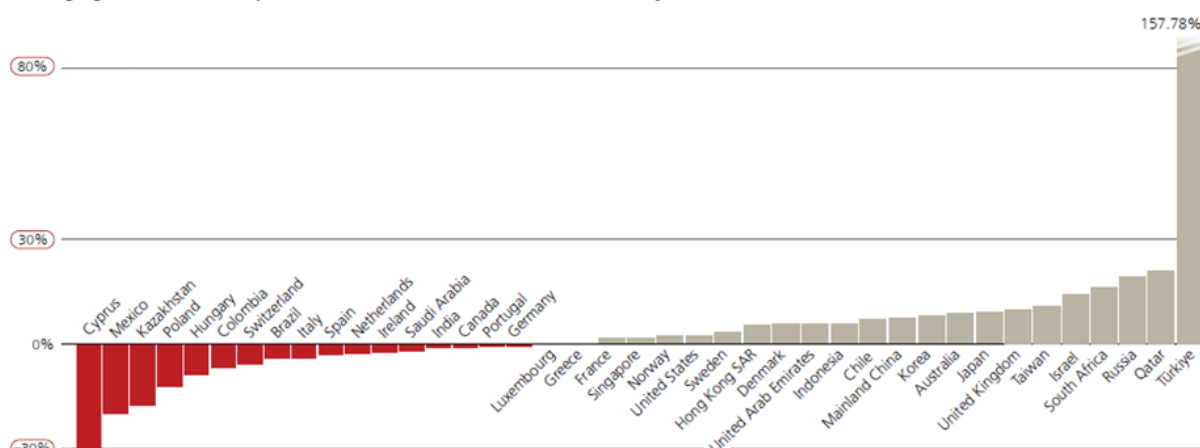
There are two new reports that shed light on wealth in Australia. The first is from UBS via its Global Wealth Report 2024.

The report says that global wealth – defined as the value of financial assets plus real assets owned by households, minus their debts – grew 4.2% last year in US dollar terms. That was a rebound from the 3% decline recorded in 2022.

The rebound was driven by Europe, the Middle East and Africa (EMEA), which saw wealth grow by 4.8%, ahead of the Asia-Pacific's 4.4%. The Americas trailed behind, with close to 3.5% growth.

Wealth in Australia grew at a faster pace, up almost 9% year-on-year, helped by the continued rise in residential property prices and the snapback in the local share market last year.

Average growth in wealth per adult from 2022 to 2023, in local currency



Source: UBS Global Wealth Report 2024

Globally, there are 58 million people, or 1.5% of the world's population, with wealth greater than US\$1 million. At the other end of the spectrum, there are 1.49 billion people with wealth of under US\$10,000.

### Australia remains the lucky country

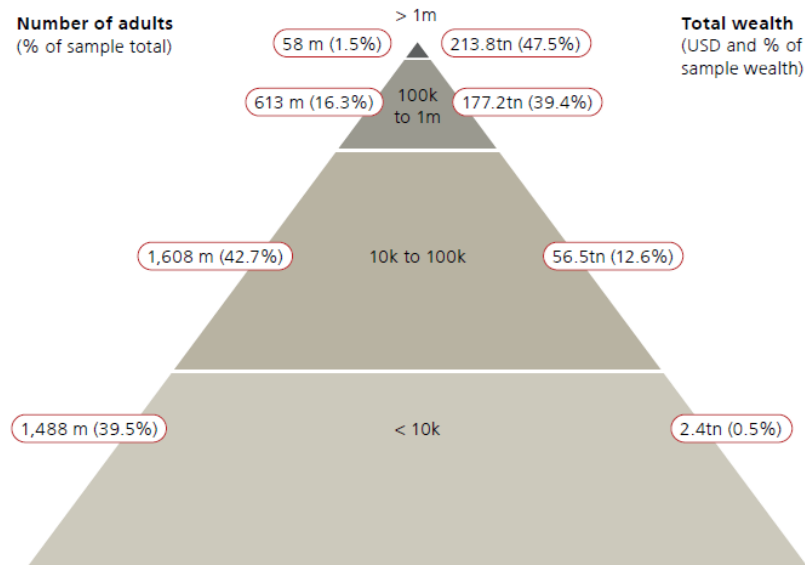
Australia remains one of the world's richest countries. We're ranked second in the world when it comes to median wealth per adult, well ahead of the likes of Switzerland, the UK, and the US.

On an average wealth per adult basis, Australia ranks fifth. According to the report, the average Australia has US\$546,184 in wealth, or A\$810,000.

Zooming out, the report suggests that growth in global wealth has slowed in recent years, including in Australia. Global wealth has cooled from average annual growth of 7% from 2000 to 2010 to 4.5% from 2010 to 2023. The report says that demographics have played a role in the slowdown, with shrinking populations in the likes of Japan and Italy resulting in slower economic activity. Other factors include a stronger US dollar, the sovereign debt crisis in Europe in the early 2010s, and the maturation of economies in Asia and Latin America.

### The global wealth pyramid 2023

Split by wealth band in USD



### All data in USD, as of 2023 (per adult)

#### Top 25 in average wealth

Switzerland	709,612	1st
Luxembourg	607,524	2nd
Hong Kong SAR	582,000	3rd
United States	564,862	4th
Australia	546,184	5th
Denmark	448,802	6th
New Zealand	408,231	7th
Singapore	397,708	8th
Norway	382,575	9th
Canada	375,800	10th
Belgium	362,408	11th
Netherlands	361,759	12th
United Kingdom	350,264	13th
France	329,122	14th
Sweden	319,289	15th
Taiwan	302,551	16th
Germany	264,789	17th
Israel	260,567	18th
Austria	255,689	19th
Ireland	249,918	20th
Korea	245,298	21st
Spain	225,675	22nd
Japan	220,371	23rd
Italy	220,216	24th
Qatar	199,430	25th

#### Top 25 in median wealth

Luxembourg	372,258
Australia	261,805
Belgium	256,185
Hong Kong SAR	206,859
New Zealand	202,525
Denmark	193,669
Switzerland	171,035
United Kingdom	163,515
Norway	152,233
Canada	142,587
France	140,593
Netherlands	116,948
Italy	113,754
United States	112,157
Spain	111,270
Taiwan	110,521
Japan	106,999
Singapore	104,959
Malta	102,451
Korea	95,872
Ireland	95,459
Qatar	92,789
Finland	87,878
Sweden	82,864
Slovenia	81,195

Source: UBS Global Wealth Report 2024

The growth in Australian wealth has also slowed since 2010. The sharp pullback in commodities from 2011-2012 has arguably been a big factor in this.

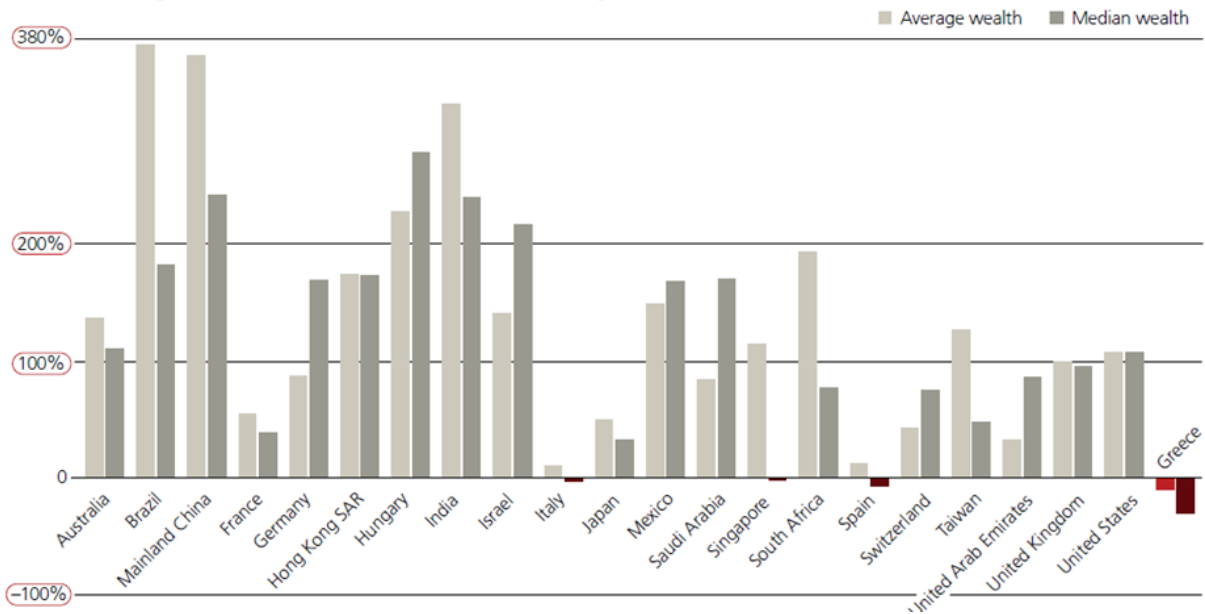
### Comparison of wealth growth rates over time, selected markets

	2000–2010		2010–2023	
	Evolution (%)	Compound annual growth rate	Evolution (%)	Compound annual growth rate
Kazakhstan	676%	20%	190%	9%
Mainland China	588%	19%	185%	8%
Qatar	983%	24%	157%	8%
Israel	114%	7%	140%	7%
India	339%	14%	133%	7%
Hong Kong SAR	82%	6%	127%	7%
Indonesia	274%	13%	125%	6%
United States	49%	4%	121%	6%
Czechia	222%	11%	113%	6%
Hungary	169%	9%	109%	6%
Taiwan	83%	6%	108%	6%
Singapore	186%	10%	106%	6%
Saudi Arabia	104%	7%	95%	5%
Mexico	173%	10%	91%	5%
Thailand	240%	12%	79%	5%
United Arab Emirates	401%	16%	69%	4%
Sweden	212%	11%	66%	4%
Australia	344%	15%	66%	4%
Switzerland	127%	8%	65%	4%
Canada	162%	9%	64%	4%
Russia	631%	20%	58%	4%
United Kingdom	71%	5%	57%	4%
Brazil	384%	15%	55%	3%
Germany	94%	6%	51%	3%
Portugal	127%	8%	48%	3%
Chile	191%	10%	48%	3%
South Africa	270%	13%	30%	2%
Belgium	131%	8%	28%	2%
France	188%	10%	22%	2%
Türkiye	227%	11%	11%	1%
Spain	248%	12%	-1%	-0%
Italy	109%	7%	-4%	-0%
Greece	103%	7%	-20%	-2%
Japan	48%	4%	-23%	-2%

Note: all values measured in US dollars.

Source: UBS Global Wealth Report 2024

Growth in average and median wealth, 2008-2023, in local currency, selected markets



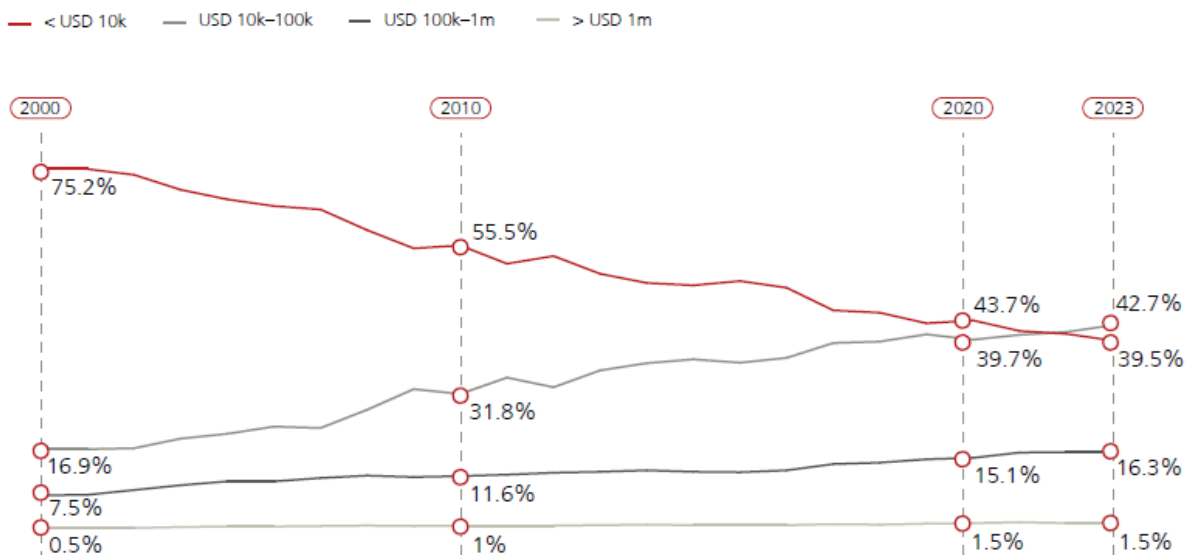
Source: UBS Global Wealth Report 2024

### Wealth inequality

There's been progress with inequality. The only wealth band that's been in constant decline over the past 15 years is the lowest one. Adults with less than US\$10,000 have nearly halved from more than 75% in 2000 to below 40% in 2023. All other wealth brackets have been steadily expanding.

Inequality has tended to increase in fast-growing markets and decline in many developed economies. Despite all the negative headlines, wealth inequality has fallen in the US of late. Inequality in Australia has risen marginally, though remains low compared to other developed countries.

Percentage of adults by wealth band in our sample of markets, 2000–2023



Source: UBS Global Wealth Report 2024

	Wealth inequality*		Change
	2008	2023	2008–2023
South Africa	70	82	17.7%
Brazil	70	81	16.8%
United Arab Emirates	88	77	–12.4%
Saudi Arabia	89	77	–13.3%
Sweden	74	75	1.3%
United States	76	75	–2.4%
India	62	73	16.2%
Mexico	68	72	6.5%
Singapore	57	70	22.9%
Indonesia	59	68	15.1%
Germany	72	68	–5.4%
Switzerland	70	67	–4.6%
Austria	69	65	–5.0%
Netherlands	67	64	–3.6%
Finland	53	64	21.0%
Israel	72	64	–12.2%
Hong Kong SAR	66	63	–5.9%
Denmark	56	62	11.3%
United Kingdom	57	61	7.5%
Taiwan	55	61	10.5%
Mainland China	55	60	7.4%
France	56	59	4.7%
Italy	50	57	14.9%
Korea	62	57	–8.1%
Spain	47	57	19.8%
Japan	50	54	9.4%
Australia	51	54	5.4%
Qatar	43	48	12.5%
Belgium	51	46	–10.7%

\*Measured by the Gini index: a higher score indicates higher inequality, a lower score indicates a more equal distribution of wealth.

Source: UBS Global Wealth Report 2024

### The great horizontal wealth transfer

UBS says wealth is more mobile than static, and that applies across the globe. If you're wealthy, there's no guarantee you'll stay that way, and vice versa.

The report also touches on the intergenerational wealth transfer that's about to take place. Globally, US\$83 trillion is expected to be passed on within the next 25 years. Given that people over the age of 75 hold nearly 20% of the world's wealth, and the average life expectancy for 75-year-olds ranges between 82-86 across most of the world, a large chunk of assets are expected to be transferred within the next ten years.

UBS also points out that before being transferred from one generation to another, wealth is frequently passed on within the same generation between spouses. Life expectancy varies between men and women, and couples can have age gaps, and the inheriting spouse will typically own and hold onto the wealth for an average of four years before passing it on. UBS calls this 'the great horizontal wealth transfer' and suggests around US\$9 trillion of wealth will soon be transferred between spouses.

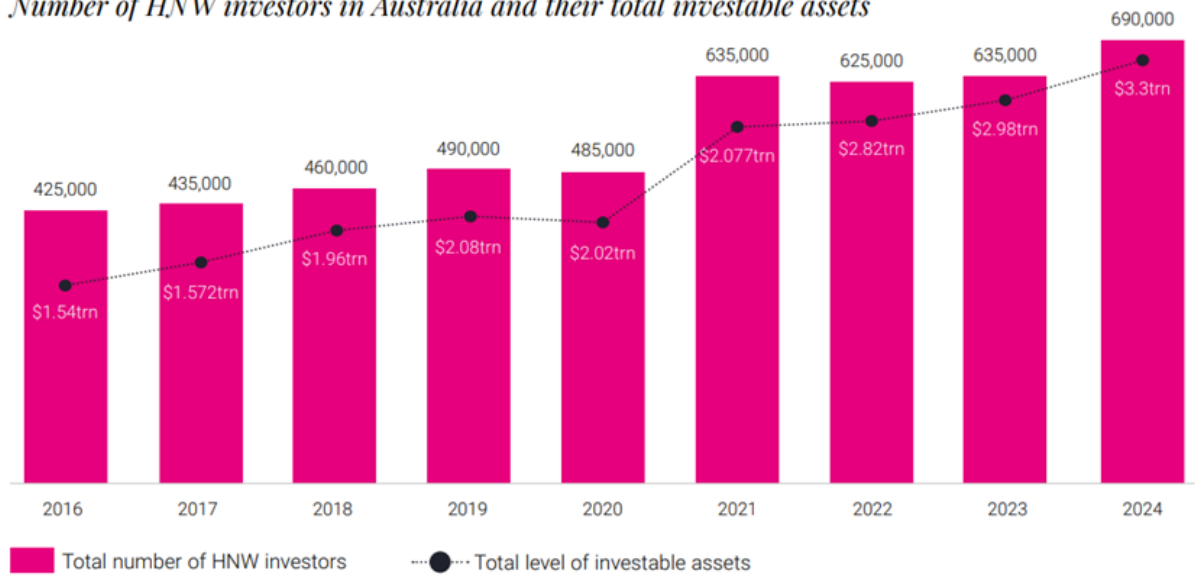
### How Australia's high net worth individuals are faring

A separate report from Praemium and Investment Trends has looked at how Australia's high-net-worth individuals (HNWIs) are faring. Pretty well, it turns out.

As of June this year, there are 690,000 high-net-worth investors in Australia, up 8.7% year-on-year. These investors are defined as those who have at least \$1 million in investable assets – net wealth clear of debt,

excluding their own home, business, and super (but including SMSF assets). They now control \$3.3 trillion in assets, up from under \$3 trillion in 2023.

*Number of HNW investors in Australia and their total investable assets*



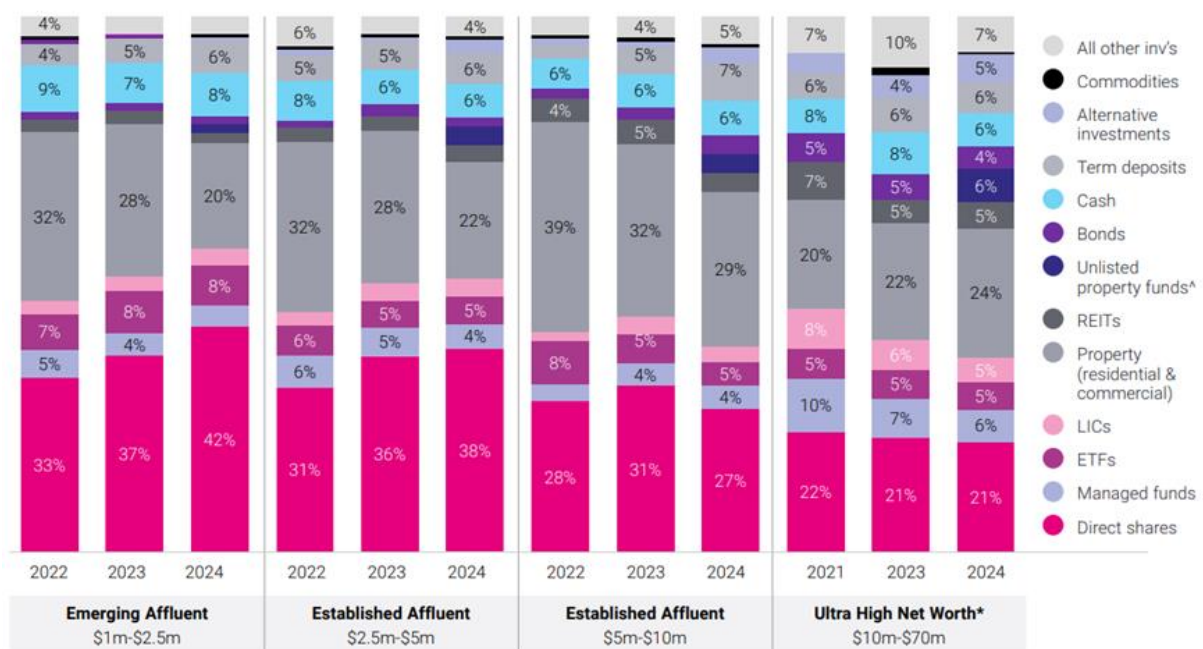
Source: Praemium and Investment Trends

It seems the wealthy are getting wealthy. The report reveals a surge in wealth among ultra-HNWIs – those with investable assets of \$10 million or more. Their assets saw an 11.6% increase in value in 2024, versus an 8.6% rise in 2023.

**How the wealthy are investing their money**

The breakdown of how HNWIs are investing their money makes for fascinating reading. The so-called 'emerging affluent' – those with \$1-2.5 million in investable assets – are putting a lot more money into direct shares, compared to other asset classes such as property. Those wealthier than this hold much less in direct shares. Across the board, managed funds and listed investment companies are waning in popularity, while holdings in cash, term deposits, and bonds are relatively small. And alternative assets are gathering more funds, albeit off a small base.

*Investment allocation – by wealth*



Note: Trend data unavailable. \*Note: '2022 – \$10m to 70m' is not displayed due to small sample size. Source: Praemium and Investment Trends

The report also notes that HNWI's continue to retain a preference for getting financial advice from time-to-time. The number identifying themselves as validators – who seek advice to validate their own opinions – remains high, yet unchanged, at 58% (at least they're honest!). Those who describe themselves as self-directed investors stands at 35%. For those using an adviser, around 38% of their wealth is under the stewardship of an adviser while the remaining 62% is self-managed.

----

In my article this week - despite an explosion in data, investment legend Cliff Asness believes markets have become less efficient, not more, over his 34-year career. In a new paper, he explains why social media is mostly to blame for this, and how investors can [take advantage of the market distortions](#).

## James Gruber

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

**Susan Lloyd-Hurwitz** is one of the best female leaders in Australia. The former CEO of Mirvac now heads a Government housing council looking into solutions to the housing crisis. In a speech, she outlines [the housing market that she'd like to see](#), and how we get there.

Prime Minister Anthony Albanese has described recent changes to aged care as "once in a generation". He's right, and though much of the media coverage has been on how the wealthy will have to pay up, **Rachel Lane** says [everyone will be forced to fork out more](#).

Draft regulations released this week finally provide the framework for unwinding legacy pensions. **Meg Heffron's** reaction: About bloody time! Meg details the [ins and outs of the regulations](#), as well as some caveats.

Global defence spending is increasing as geopolitical tensions rise. **VanEck's Arian Neiron** believes it's a [megatrend hiding in plain sight](#) and he looks at the best ways to profit from the theme.

[Index fund flows into the US market](#) are relatively tiny. Yet a new research paper argues that they've distorted the size of the market's largest stocks to a surprising degree, as **Joachim Klement** explains.

After the extraordinary runup in the share prices of banks, many investors are wondering [if it's time to sell, or to hang onto them](#) for dear life. **Te Okeroa** says those aren't the only options for investors, and it may be time to think more creatively.

Lastly in this week's whitepaper, **Neuberger Berman** says that despite a rising tide of negative media coverage, [private debt still has tremendous potential](#) to deliver attractive risk-adjusted returns for investors.

---

## Legendary investor: markets are less efficient and social media is the big culprit

### James Gruber

Cliff Asness isn't widely known yet he's a legend in the investment industry. He joined Goldman Sachs Asset Management while doing his PhD in finance in 1990. There, he set up a quantitative research unit to build on the 'factor' models created by his academic mentor, Nobel laureate, Eugene Fama, and economist Kenneth French.

In 1995, Asness with some Goldman colleagues formed a fund to invest in the market, and three years later, he co-founded the quantitative hedge fund firm, AQR. Today, AQR has about US\$100 billion in assets under management.

Recently, Asness penned a paper called *The Less-Efficient Market Hypothesis*, which will soon appear in *The Journal of Portfolio Management*. In the paper, Asness outlines why he thinks the market has become less efficient during his 34 year career, and what investors can do about it.

### Stock prices should accurately reflect reality but often don't

Asness says it's important that stock prices accurately reflect reality. That's because a well-functioning economy needs a well-functioning capital market, and stock prices are important because they provide

incentives for how society allocates resources. If prices are too high or low, that has real-world consequences for resource allocation and ultimately productivity and the economy.

The 'efficient market hypothesis' (EMH) has been central to the debate of a well-functioning stock market. Put simply, EMH suggests that asset prices reflect all information and the market is thus very efficient.

That's long been disputed by Asness and others, and hypothesis architects such as Eugene Fama have admitted that markets are not perfectly efficient, though they're close enough.

If you accept the premise that markets aren't perfectly efficient, then the question becomes just how efficient are they? Asness believes they have gotten less efficient over his career.

It's fine for Asness to put forward this argument but can he prove it? Even he admits that tests of EMH are difficult and controversial, and tests of how much it's changed are harder still. Asness says his paper is as much an op-ed as it is quantitative research, though he "thinks it's an accurate op-ed!"

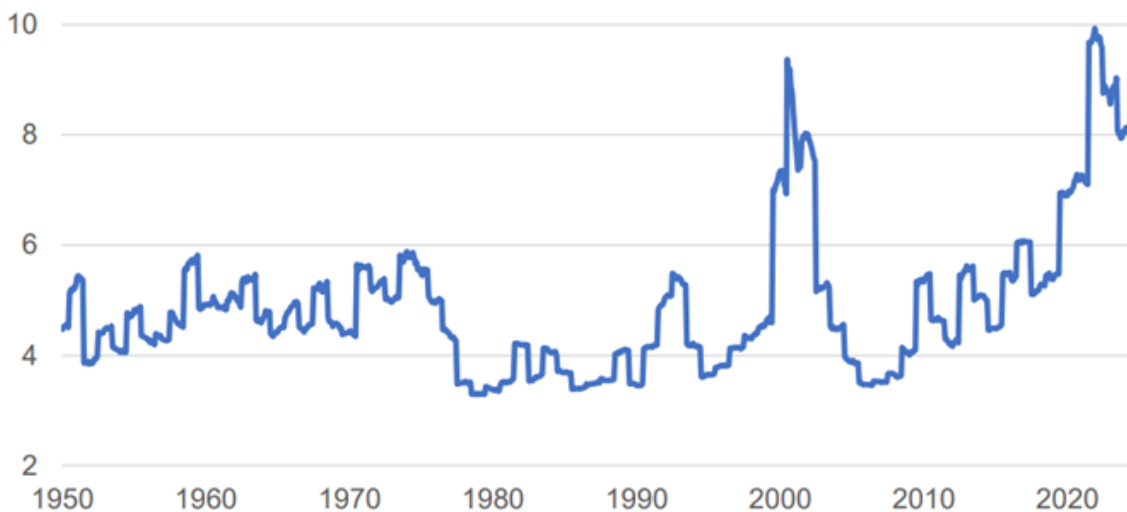
Before getting to the evidence to support his opinions, Asness puts to bed the contention that the ubiquity and speed of information has made the markets more efficient. He says it mistakes speed for accuracy. Speed doesn't imply the level of prices before or after new information becomes available is accurate or otherwise, he says.

### The evidence

To validate his theory, Asness presents three charts. The first is the ratio of the valuation of expensive stocks to cheap stocks. When it's high, investors are paying a lot for their favourite stocks compared to those they dislike, and vice versa.

The below chart is the price-to-book of the most expensive 30% of large-cap stocks divided by that of the cheap 30% of large-cap stocks.

**EXHIBIT 1: Value Spread from Fama-French**



Source: Ken French data library.

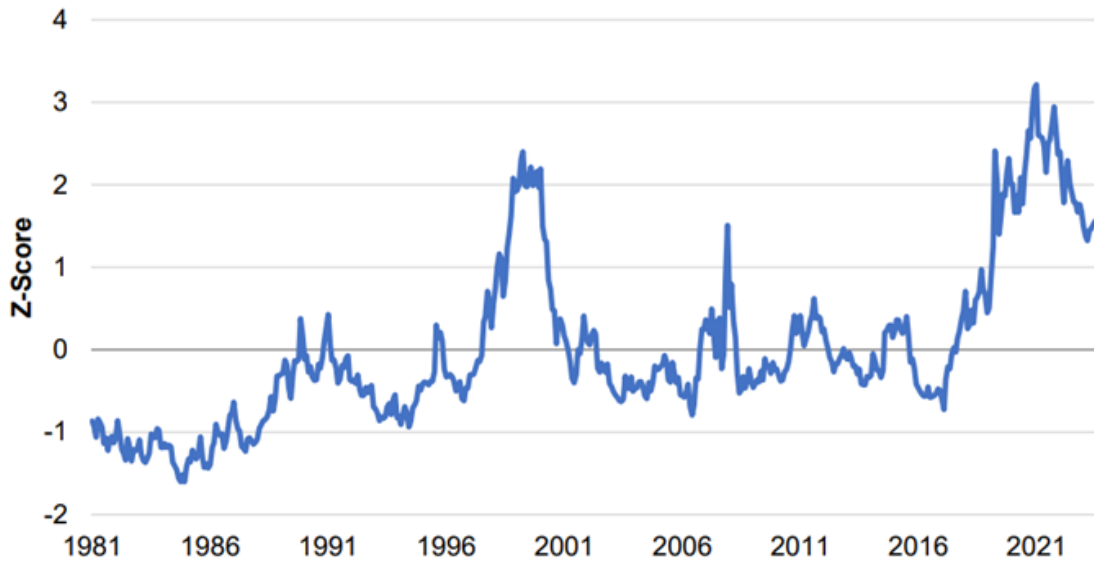
As you can see, the ratio didn't deviate a lot from 1950 to the late 1990s, ranging between 3 and 6x. Then it went bananas during the dot-com bubble before plummeting again. It got back to 2000 levels, and beyond, in 2019-2020, and now remains at relatively high levels.

Asness anticipates critics of the above chart suggesting price-to-book is just one valuation, and that it may not be an accurate one given the rise of tech stocks and the intangible assets attached to them.

So, he also provides data using five measures of value, including book-to-price, cash-flow to price, trailing earnings to price, forecasted earnings to price, and sales-to-enterprise value. Again, it plots expensive against cheap stocks.



**EXHIBIT 2: “Real Life” Value Spread (intra-industry, 5 measures)**



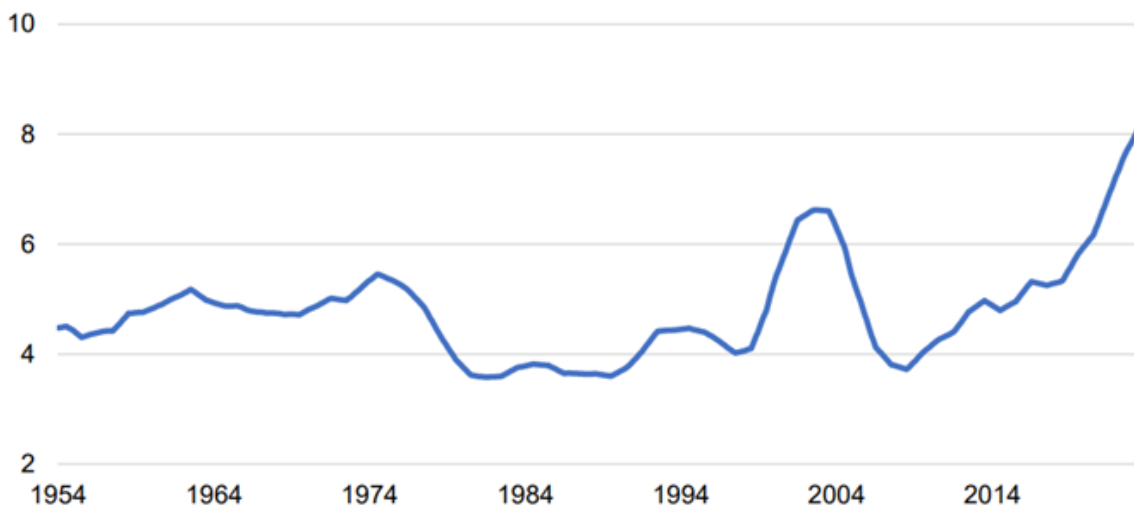
Source: AQR

It yields similar results to the first chart.

Asness acknowledges that so-called value spreads are informative, though aren’t conclusive. He looked further into why the spreads are high now. Is it because of some anomaly? Perhaps the rise of technology stocks? Nope, he ruled that out. Perhaps from more intangible assets not being included in traditional valuation metrics? No. Perhaps because of the super expensive mega cap stocks? No. Perhaps low interest rates are to blame? No again. Asness couldn’t find an anomaly to explain recent high value spreads.

In addition, he looked at the duration of these value spreads. He took the first chart and applied a five-year moving average. And he notes that other versions such as his own come up with similar results.

**EXHIBIT 3: 5-Year Moving Average of Value Spread from Fama-French**



Source: Ken French data library.

The chart shows we’ve had 10 years with spreads above the median, and for much of it at great magnitudes.

Asness’ conclusion is that if *“these very wide value spreads represent market inefficiencies, they aren’t just more extreme than in the past, but they are lasting longer when extreme”*.

The question then becomes: why?

### **Possible explanations**

Asness puts forward three possible explanations for markets becoming more disconnected from reality. He prefaces them by saying that none are conclusive and other people may have further ideas. That said, here are the potential explanations:

#### **1. Indexing has ruined the market**

Indexing has coincided with increasing inefficiencies in the market, though correlation doesn't equal causation. Asness says there is evidence and a reasonable argument that the rise of indexing has made stock prices more inelastic. That is, prices have to move more in response to changes in desired quantities (a trade moves prices more).

Asness admits there's no proof of value spreads being directly linked to indexing, and more research is needed into the issue.

#### **2. Low interest rates**

Low interest rates weren't prevalent during the dot-com period, which immediately causes a problem for this explanation. However, Asness believes that low rates do impact market valuations:

*"... it certainly feels like it could be a serious contributing factor among other conditions in making investors lose their minds (a more colloquial definition of a bubble). Sorry I can't be more formal/specific here, but I'm going to stock with "very low, even negative, real rates over long periods might drive investors to do batty things."*

Not much evidence here.

#### **3. The gamification of markets via social media**

Asness suggests this is the best of the possible explanations. His theory is that technology has hindered rather than helped market efficiency. It's done this by turning market participants who would normally act independently of each other (the wisdom of crowds) into a coordinated, often ill-informed gang:

*"... has there ever been a better vehicle for turning a wise, independent crowd into a coordinated clueless even dangerous mob than social media? Instantaneous, gamified, cheap, 24-hour trading now including "one-day funds" on your smartphone after getting all your biases reinforced by exhortations on social media from randos and grifters with vaguely not-safe-for-work (NSFW) pseudonyms filtered and delivered to you by those companies' algorithms which famously push people to further and further extremes. What could possibly go wrong?"*

### **Implications for investors**

Asness is principally a value-based quantitative investor and he looks at the issue through that lens. He thinks value strategies are the best way to take advantage of the increased market efficiencies. However, given the cycles of irrational market pricing are lengthening, these strategies will have periods of underperformance that are more severe and longer lasting. In other words, there's a lot of money to be made but investors need to take a long term view.

### **What are most investors doing about it? Not much...**

Asness says most investors aren't doing anything to take advantage of increased market inefficiencies. Instead, they're crowding into indexing. Asness doesn't criticize those doing this, as it makes sense if you don't want to play the game of 'taking on the market to beat it'.

The other thing that investors are doing is flooding into private assets. Asness has long been a critic of private investing, especially of its transparency and valuation practices. He coined the term 'volatility laundering' to describe those that don't properly mark-to-market their valuations and essentially 'hide' from the volatility of public markets.

### **What investors should be doing**

Here's the disappointing part: Asness doesn't offer much concrete advice about how to take advantage of opportunities from increasing market inefficiency. Given the longer duration of pricing cycles, he says that investors should lengthen their time horizons – which isn't very helpful.

A better point he makes is that investors should think carefully about matching their portfolios to their time horizons. All the research indicates that momentum and trend following strategies are strongest over 6-12 month periods. At a 3-5 year horizon, being a mild contrarian works best.

Unfortunately, that doesn't really tie back to his original premise of markets becoming less rational and creating more opportunities.

### **My two cents**

What do I make of Asness' theories? I think efficiency of market pricing happens in cycles – sometimes they're more efficient, sometimes less. Right now, we appear to have the latter. Some of his reasons for current market valuations seem plausible, albeit inconclusive.

There are parts of the market which appear to have been left for dead by the momentum-driven, trend following, and gamified investors of today. Value stocks, international markets outside of the US, and small caps come to mind. I'll speak more to these neglected areas of the market in another article soon.

*James Gruber is the Editor of Firstlinks.*

## **A housing market that I'd like to see**

Susan Lloyd-Hurwitz

*This is an edited extract from an address given to the National Press Club by Susan Lloyd-Hurwitz, chair of the National Housing Supply and Affordability Council on September 4 2024.*

Our housing system is simply not working. Prices and rents are growing significantly faster than wages, 170,000 households are on public housing waiting lists and over 120,000 people are experiencing homelessness.

The pressure on households is considerable. Since January 2020, house prices have risen by over 30% in capital cities and over 50% in regional areas. The median house price has reached 7.7 times median household income, close to historic highs. Since interest rates started to rise, repayments for borrowers have increased by as much as 60%.

Home ownership rates are falling, particularly for younger households. In 2001, the year my daughter was born, 51% of 24-to-35-year-olds owned their home. Today, just 43% do. She's now 24 and we can clearly see the challenges presented to her generation in terms of accessing home ownership where there isn't housing wealth to pass on.

Renting is no easier. Renters in the private market have experienced a sharp rise in rents of almost 40% since January 2020. Paying the rent now consumes a record 32% of household income on average. Imagine the stress, maybe you're experiencing it yourself, of coping with the rising cost of living and wondering where the rent is going to come from.

Housing is important to everyone, to our families and our children. It is clear that the community, including government, now recognises that this is one of the most important issues of our time and that we all have a role to play. It is puzzling to me why, given the acute situation we are in, that we don't prioritise the housing system more than we do.

Let's unpack some of the causes of this crisis, the outlook for the next five years, and explore five areas that can take us forward.

### **Causes of the current crisis**

The Council recently released our first [State of the Housing System Report](#), and as you would expect, it paints a grim picture, driven by long term structural and cyclical factors. Beneath the ebbs and flows of cyclical challenges there are numerous entrenched structural constraints that limit housing supply and reduce affordability. I'm going to briefly call out just seven.

There is a limited supply of suitable land for housing. Where land is available, sites can be highly fragmented or have limited enabling infrastructure, such as water, sewerage, power, roads and rail connections, or suffer from restrictions that limit the optimal use of land.

Our planning approval systems are too complex and too slow. Arrangements vary across states and territories and across the more than 500 local governments that provide planning consent authority. The frameworks and processes that dictate what gets built, and where, are hugely biased against change.

We have under invested in social housing. Social housing as a proportion of all housing has fallen over recent decades, while demand has soared – wait lists for greatest need households are up 52% since 2018. Given Australia’s remarkable and unparalleled record of 31 years of economic growth with only one short COVID induced recession, how can that be a fair and just outcome for our country?

How we finance new homes is a major constraint. We rely on households to provide financing for new homes through off-the-plan pre-sales, or committed construction contracts, and we put plenty of barriers in the way of foreign investment. Both of these serve to reduce the sector’s capacity to respond quickly with supply to meet demand.

Various features of our housing system, notably stamp duty, mean that we don’t use the housing stock we already have as efficiently as possible. Almost 4 million dwellings had 2 or more spare bedrooms on the night of the 2021 Census. And the growth of the short-term rental market through platforms such as Airbnb and Stayz has removed existing stock from the long-term rental market.

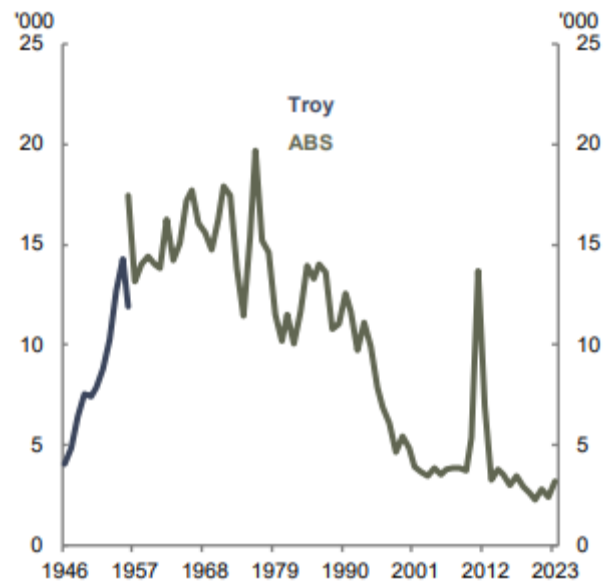
We’ve had decades of weak or even negative productivity growth in the construction sector, reflecting the fragmented nature of the sector and low levels of innovation. The ABS estimates that Australia’s construction labour productivity rose by just 0.2% per annum in the 30 years to 2023, compared to 1.3 per cent in manufacturing. Since 2014, construction productivity has been on a downwards trend.

Even if we solved all the other problems, we don’t have enough construction capacity to deliver the homes we need. Cost increases have led to an elevated level of insolvencies in the sector. The construction workforce is ageing, and of those that do enter apprenticeship training, only half complete their course. There is also significant competition for labour coming from major infrastructure builds in New South Wales and Victoria, and from the resources sector in Western Australia and Queensland.

Put all those factors together, and the stage is set for housing affordability to deteriorate further over the next few years, and this from already challenging levels. Under current policy settings, we are likely to fall 260,000 dwellings short of the target of 1.2 million new homes within five years. Both rents and house prices are forecast to continue to outpace inflation over the next several years.

The median income household now needs around 10 years to save the deposit for the median home. More alarmingly, even those median income households who can raise a 20% deposit could only afford 13% of the homes sold in 2022–23 due to mortgage serviceability. Lowest income households could afford only one per cent of homes sold.

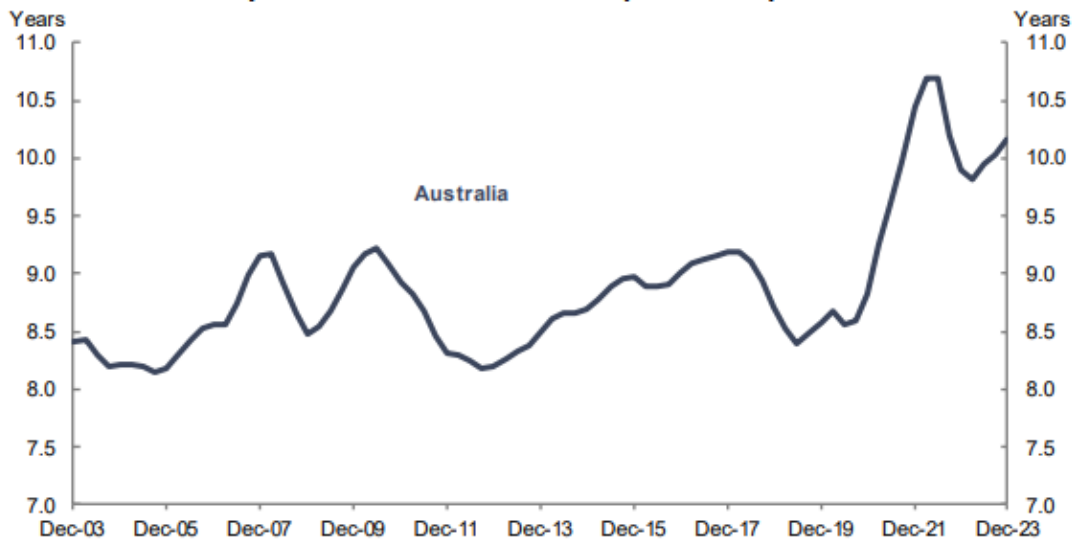
**Chart 2.12 Public housing completions**



Sources: Troy (2012) for 1946–1955, ABS Building Activity 2023.

Source: National Housing Supply and Affordability Council

**Chart 5.8 Number of years it takes to save for a 20 per cent deposit**



Note: Measured as the years it would take to save for a 20 per cent deposit, assuming 15 per cent gross median household income is saved annually.

Source: ANZ and CoreLogic 2024.

Source: National Housing Supply and Affordability Council

Australia deserves a better housing system. It’s an economic and social imperative in so many ways. Given the significance of the challenges we’ve been discussing today, it would be easy to despair, but I prefer to think of it as a call to action that requires bold measures and innovative solutions.

Let me highlight five areas that require immediate focus to move us towards that better housing system.

**Five areas that require immediate focus**

Firstly, we need to have adequate investment in social housing. Investing in social and affordable housing, whether that’s by government directly, or by the for purpose and private sectors, makes good economic sense, especially where it offers good access to employment and amenity.

It alleviates the insecurity associated with private rental housing. It reduces homelessness and the incidence of poverty, which in turn generates savings for all taxpayers. In fact, SGS economics estimates that for every dollar invested to bring about the supply of social and affordable housing, the Australian community saves \$2.

Ongoing and predictable investment in social and affordable housing also provides a stable base level of construction activity, which reduces the challenges that arise from an inherently cyclical sector.

Secondly, we must commit to best practice zoning and planning systems across the country. We need to remove politics from the assessment process, digitise our systems, and move towards performance-based systems and away from open discretion.

Thirdly, we need to build more capacity in the construction sector. The key to this is encouraging more workers into the sector including through support for training, and skilled migration channels. Government can partner with industry to promote trade careers and attract more people from under-represented demographics, including women and migrant workers.

We should focus on upskilling the construction industry in advanced technologies and processes. This could be supported by increased use of advanced manufacturing techniques in social housing projects and other government procurement and accommodating innovation in building codes and regulations.

Fourthly, we need a better system for renters. More than 30% of Australians rent their home. The number of renters is increasing, and those who are renting are doing so for longer. Renting is the only viable option for an increasing share of the population.

But in many ways our system does not work for renters. Housing quality and maintenance are variable – ranging from excellent to utterly inadequate. Security of tenure can be fragile. We need regulatory frameworks that better support renters.

This could include things such as having a nationally consistent policy regarding reasonable grounds for eviction, no more than one rent increase per year and requiring minimum standards for rental property. The Council does not support rent freezes. They only serve to inhibit supply – the very thing we are trying to have more of.

More institutional investment in housing – known as build-to-rent – would benefit both investors and tenants. Institutional investors need long-term assets with stable income streams, particularly if those assets are less well correlated with other large, well established asset classes.

Institutional investment can drive innovation in design and construction, as well as efficiencies in energy consumption and maintenance. For renters, build-to-rent could improve affordability through increased supply, improve security of tenure, the quality of rental housing and the provision of services.

Imagine having a rental home where you could inspect the property when it suits you rather than in the company of 20 other people in the 15 minutes that the real estate agent allows. Imagine you can live there as long as you like, the concierge knows your name and your pet's name, you can paint the walls, and repairs are done by the onsite team with no inconvenience to you.

This doesn't need to just be confined to the medium and high-end segments of the market. Vibrant, mature and at scale build-to-rent markets exist in other countries, notably the US, UK and Japan. But in Australia, the vast majority of rental housing is supplied by individual landlords.

In July last year, the Council released a report on *Barriers to Institutional Investment in Housing*. Why is it that our institutions invest in this asset class internationally, but not here? It's largely a nascency problem.

Because there is virtually no market and no track record, institutions, rightly or wrongly, require a significant risk premium which makes the economics challenging. And because there is no market in which to buy and sell, institutions need to create these assets through development, bringing a whole different level of complexity, and an increase in time and capability required.

Fifthly, we need to work towards policy settings that are well coordinated across all levels of government. One of the challenges in our housing system is just how many parts of government are critical to the provision of housing – Commonwealth, states and territories and local governments. And within these levels of government, multiple departments and agencies.

### ***"An Australia I'd really like to see in my lifetime"***

As former RBA Governor Phil Lowe noted in his farewell address 'the reason that Australia has some of the highest housing prices in the world is the outcome of the choices we have made as a society: choices about where we live, how we design our cities, and zone and regulate urban land, how we invest in and design transport systems and how we tax land and housing investment'.

I've tried to imagine a world in which we have done all the things we need to do to create a healthy housing market. An Australia in which adequate housing can be accessed by households on all budgets, where there is frictionless transition to appropriate housing that suits the different stages of life. Renting would no longer be a stressful and insecure experience. Generations of families would be able to find appropriate housing near each other, and lifelong community connections could be preserved.

Our health budgets could be spent on preventing poor outcomes rather than remedying the effects of housing insecurity. Our housing system would no longer fail many First Nations people. Those who work in our stores, educate our children, serve our coffee, protect us and look after us when we are sick could afford to live in the suburbs where they work, and our cities would be devoid of excessive commutes.

That's an Australia that I would really like to see, and I'd really like to see it in my lifetime.

*Susan Lloyd-Hurwitz chairs the National Housing Supply and Affordability Council. The Council's "State of the Housing System 2024" report can be accessed [here](#).*

## It isn't just the rich who will pay more for aged care

Rachel Lane

Last week, the Government introduced the new Aged Care Act into Parliament and provided its response to the Aged Care Taskforce. Combined they represent the biggest changes to aged care in almost 30 years. The changes, which Prime Minister Anthony Albanese described as "once in a generation", will redefine aged care and who pays for it.

At its heart, the reform package will see the Government pay for all of your care, regardless of your means, with care recipients needing to pay more towards their other services based on their assets and income. The million-dollar question is "What is care?". While the reform package will invest \$5.6 billion into aged care services, the net impact of the changes is a \$930 million spend over four years and a \$12.6 billion saving over the next 11 years.

Quietly, the government have decided to define care as clinical care services, such as nursing, occupational therapy and physiotherapy. This means the list of non-care services is extensive and will include things many people think of as care – such as help with medications, having a shower and getting dressed. As well as services that people cannot do due to their care needs such as help with shopping, preparing meals and gardening.

How much you will contribute towards your non-care services will depend on whether you receive your care in your own home or in an aged care home.

### Home care

Demand for Home Care has tripled over the last five years with current wait times for some home care packages exceeding 12 months. With more people wanting to age at home, the lion's share (\$4.3 billion of out of \$5.6 billion) of funds in the reform package are aimed at the new "Support at Home" programme.

Support At Home will bring the current home care package and short-term restorative care programmes together and add two new programmes: the Assistive Technology and Home Modifications Scheme and the End of Life Pathway.

The Assistive Technology and Home Modifications Scheme will give people access to home modifications and assistive technologies up to a value of \$15,000 without the need to wait for funds to accumulate in their package. The End of Life Pathway will provide up to \$25,000 for funding palliative care in the home in the last three months of life.

The current four levels of Home Care Package will be increased to eight, with the maximum funding increasing from around \$61,400 per year to \$78,000 per year and the services within your Support at Home package designated as either clinical care, independence or everyday living.

The government will pay for all of your clinical care, and you will pay towards your independence and everyday living services based on your assets and income.

	Clinical Care	Independence	Everyday Living
	Nursing and therapists	Showering, getting dressed, medications	Cleaning, gardening, meal preparation, shopping
<b>Full pensioner</b>	0	5%	17.5%
<b>Part pensioner and CSHCC holder</b>	0	5%-50% based on assets and income	17.5%-80% based on assets and income
<b>Self-funded</b>	0	50%	80%

### Case studies – Support at home (based on a Level 5 package) (provided by Government)

Bill, a full pensioner with \$10,000 of assets will pay \$2,467 per year for his Support at Home Package. The Government will pay \$37,107 per year.

Marco, a part pensioner with \$65,000 p.a of income and \$200,000 of assets, will pay \$11,464 per year for his Support at Home Package. The Government will pay \$28,110 per year.

Harry, a self-funded retiree with \$100,000 p.a of income and \$500,000 of assets, will pay \$16,615 per year for his Support at Home Package . The Government will pay \$22,959 per year.

### Aged care homes

The changes to what you will pay for an aged care home span both the cost of your accommodation and the cost of your ongoing services.

#### Accommodation costs

##### Market Price Cap increasing to \$750,000

From 1 January 2025, the market price cap on Refundable Accommodation Deposits (RADs) will increase from \$550,000 to \$750,000. The cap sets the price beyond which an aged care home requires government approval. While there are plenty of examples of prices above and below this price, the effect of the cap is that we see a clustering of prices around the cap.

The reforms don't change who is classified as a Market Price payer. If you have assets above \$206,039, you need to pay the market price. This perverse assessment currently creates a gap that I often refer to as "aged care no man's land", where people with \$300,000 or \$400,000 need to pay substantially more than they can afford. If most prices go up to \$750,000, there will be a \$500,000 gap between what some people need to pay and what they can actually afford for their accommodation.

##### Exit fee of up to 10% on RADs

From 1 July 2025 aged care homes will charge an exit fee of 2% of your RAD per year for up to 5 years. Which means if your RAD is \$750,000 and you stay for 5 years (or more) then \$75,000 will be deducted when you leave. There will also be a change from the current fixed rate that applies to people who pay towards their accommodation by daily payment. From 1 July 2025, Daily Accommodation Payments (DAPs) will be indexed twice a year at CPI.

##### The cost of ongoing services

When it comes to the ongoing cost of your aged care, you will pay the Basic Daily Fee, which is set at 85% of the Age Pension. Beyond this, you will pay a hotelling supplement and a Non-Clinical Care Contribution based on your assets and income, as well as a higher everyday living fee if you choose to get 'extras'. The Government will pay for all of your clinical care.

What an Aged Care Home will cost you					
Accommodation	Basic Daily Fee	Hotelling Supplement	Clinical Care	Non-Clinical Care Contribution	Higher Everyday Living Fee
Market price cap \$750,000 2% per year up to 10% cap deducted from RAD	Paid by everyone regardless of means	7.8% of assets above \$238,000 50c per dollar of income above \$95,400 p.a	Paid by Government	7.8% of assets above \$502,981 50 cents per dollar of income above \$131,279	User pays services such as Hairdressing, Beer/Wine with meals
	\$64 /day	Up to \$13 /day	\$0 /day	Up to \$101 /day	
	\$23,200 p.a	\$4,600 p.a	\$0	\$36,923 p.a	
				Capped at 4 years and \$130,000	

##### No change to the treatment of the family home

There is no change to the assessment of the family home for aged care means testing. Your home will be included in your aged care assets up to a capped value of \$206,039 unless a protected person lives there in which case, it is exempt.



A protected person includes your spouse or dependant child, a carer who has been living in the home for at least two years and is eligible for an Australian Income Support Payment, or a close relative who has been living in the home for at least five years and is eligible for an Australian Income Support Payment.

### **'No Worse Off Principle' for people already receiving aged care**

The no worse off principle is designed to protect people already receiving aged care or waiting for a home care package. If you are receiving a home care package or have been assessed as eligible then the no worse off principle will mean that your costs will be the same or less after the reforms.

If you move from home care to an aged care home after 1 July 2025, the changes to accommodation payments will apply but you will have the choice of staying on the existing contribution arrangements or moving to the new ones. If you are already living in an aged care home or move in before 1 July 2025 your contributions will not change while you live there.

### **Case studies – Residential aged care (provided by Government)**

Hannah is a full pensioner who owns her home and has \$150,000 of other assets. Under the new rules she will pay \$28,800 per year (the Government will pay \$111,300 per year). Under the current rules Hannah would pay \$24,700 per year.

George is a part pensioner who owns his home and has \$500,000 in other assets. He will pay \$47,700 per year (the Government will pay \$92,400 per year). Under the current rules George would pay \$34,300 per year.

Heather is a self-funded retiree who owns her home, she has \$500,000 in other assets and receives \$70,000 p.a of income. She will pay \$62,800 per year (the Government will pay \$77,400 per year). Under the current rules Heather would pay \$49,400 per year.

The government estimates that 3 in 10 full pensioners and 3 in 4 part-pensioners will pay more. When you consider these case studies, it's easy to see why. While the message has been that "wealthy Australians will pay more for aged care", it seems that in reality most Australians will pay more. In some cases, much more.

*Rachel Lane is the Principal of [Aged Care Gurus](#) where she oversees a national network of advisers dedicated to providing quality advice on retirement living and aged care. She is also the co-author of a number of books with Noel Whittaker including best-seller 'Aged Care, Who Cares?' and '[Downsizing Made Simple](#)'.*

For further information see: [The Final Report of the Aged Care Taskforce \(2024\)](#), and the [Aged Care Legislated Review \(Tune Review, 2017\)](#).

## **Meg on SMSFs: At last, movement on legacy pensions**

Meg Heffron

About. Bloody. Time.

Draft regulations released this week provide – finally – the framework for unwinding legacy pensions cleanly and simply for members who choose to do so. It seems amazing that a mere six pages (plus one line) of legislation took this long to come about but...at least we have something to consult about now.

'Legacy pensions' is the generic term used for certain old-style pensions that are generally no longer available in SMSFs. Some of these are market linked, lifetime complying or life expectancy complying pensions which carry strict restrictions.

One of these restrictions is that they can't be commuted and simply cashed out or turned into account-based pensions at will. Instead, they can only be commuted if the money is used to acquire another legacy pension or if the ATO forces the commutation (more on this later).

For years now, successive governments have promised to make life simpler for members who locked into these pensions back at the turn of the century when tax rules were very different. Yesterday's draft regulations provide new rules which would allow that to happen, essentially removing the requirement that a commuted legacy pension must be turned into another legacy pension.

(If you're wondering why flexi pensions aren't mentioned, it's because they don't need extra rules – they can already be commuted at any time, for any reason and the member can do anything with the commutation

amount. Their particular challenge is that they generally release a lot of reserves which create other problems. Fortunately the Government is also proposing changes there – read our separate article [here](#).)

### The catches

There are of course some catches:

- there is a limited window to use this new opportunity - 5 years from when the Regulations come into force, and
- it only removes the requirement to keep the commuted amount in the “legacy pension family” if the pension is commuted in full.

In other words, even these new changes wouldn’t allow someone to keep half of their market linked pension in place and turn half of it into an account-based pension.

Why the time limit? Who knows. It seems odd that something so long in the making would have a deadline. And it will definitely create a class of people who “miss out” by not getting the right advice quickly enough to act on it. But at least this opens up some new opportunities for a lot of people.

Of course, commuting any pension and starting a new one has implications for the member’s transfer balance cap. Commuting a pension effectively adds back some or all of the amount of the transfer balance cap that’s been used in the past, and starting a new one causes a new amount to be checked against the transfer balance cap.

Interestingly, the new regulations don’t propose any change to how the transfer balance cap works for unwinding legacy pensions. In practice, that means someone with (say) a market linked pension won’t be able to simply turn it into an account-based pension.

In fact, if the market linked pension is large enough, they will find if they commute the whole market linked pension they won’t be able to put even a single dollar back into an account-based pension. It will be a big decision. But for many people looking for more flexibility, or concerned about the estate planning implications of remaining locked into their legacy pension, it will be the right choice.

We have yet to see what changes the Government will make to the Social Security rules. This will be vital for anyone who started one of these pensions to allow some or all of their pension to be excluded from the assets test for the age pension.

Significant consequences apply for people who commute these pensions without complying with all the rules (which, among other things, include moving the money to a new legacy pension). We assume the Government will also address this – it will be an essential extra step before anyone concerned about the age pension makes a change.

### What to do

There is a lot more to unpack here in terms of what members with legacy pensions should **actually** do.

People with large legacy pensions already have a mechanism to unwind them. For some time now, they’ve been able to do so as long as they’re willing to deliberately change their pensions to trigger an excess relative to their transfer balance cap.

Taking that step effectively meant the ATO **directed** them to unwind their legacy pension – one of the few times it was possible to commute the pension without any restrictions on what the member did with the money. All this latest announcement will do for people in this position, assuming it’s enacted, is shorten the process and make it cheaper (they won’t have the tax cost of creating their temporary transfer balance cap excess).

For those potentially impacted by the proposed \$3 million cap, stopping their complying lifetime or life expectancy pension after 1 July 2025 could have adverse tax implications. Hopefully the draft Regulations will be finalised quickly so appropriate action can be taken in time. And as mentioned earlier, those impacted by the age pension still need some further change.

But for others – whose legacy pension wasn’t large enough to enable them to create an excess relative to their transfer balance cap – this will provide a brand-new opportunity to end their legacy pension. All of this requires only a few lines of legislation.

The rest of the proposed regulations make extra changes to the way in which reserves are handled. Since reserves are often released when **defined benefit** pensions are commuted or simply end, making these changes at the same time makes sense.

The changes proposed actually do a whole lot more than just help unwind complying lifetime and complying life expectancy pensions – they are even relevant for the other type of legacy pension (flexi pensions) and even people whose pensions have simply ended rather than being formally commuted. We’ve got a whole separate article on that – [click here](#) to read it.

*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.*

*Looking for more information on this topic? Come along to next week's [Quarterly Technical Webinar](#) where Leigh Mansell and Lyn Formica will talk through the proposed changes.*

*For more articles and papers from Heffron, [please click here](#).*

## A megatrend hiding in plain sight: defence

Arian Neiron

Information technology is not the only sector holding up share markets. There is another industry. We all rely on it, but the opportunity on ASX is scant. It’s a global sector hiding in plain sight.

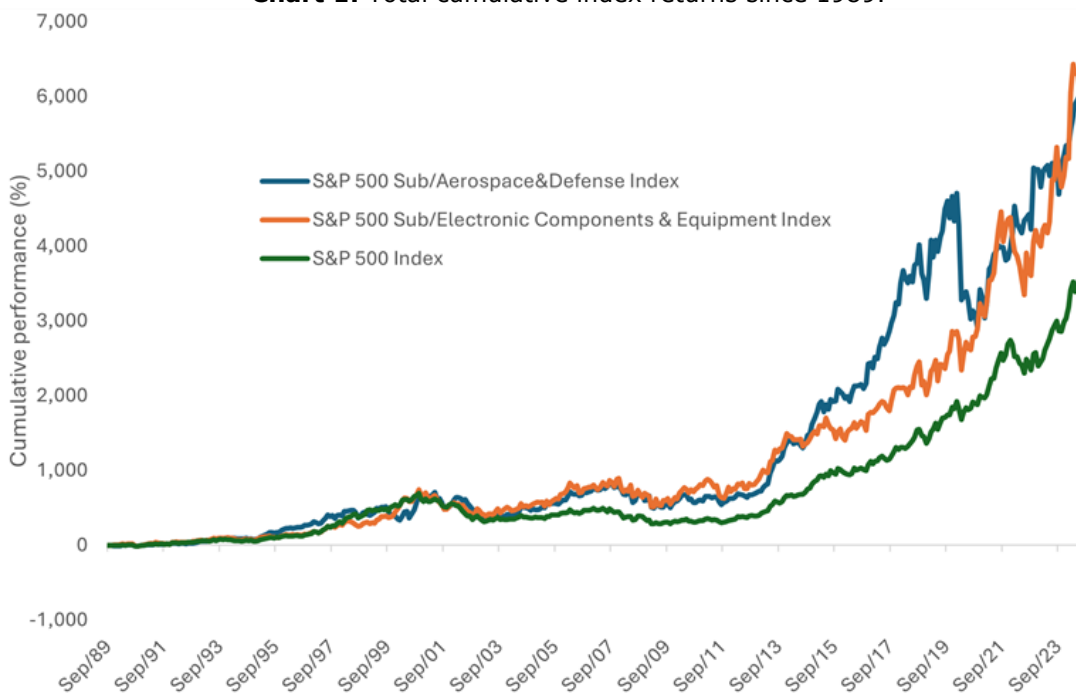
Protecting its citizens and keeping them safe is the responsibility of governments. Since ancient times civilisations have grappled with this, and the changing technologies and material demands of protecting borders and populations are complex. More recently the cyber world has become a battleground, and the defence industry is again at the forefront of technology.

But when we read stories about defence spending, we do not normally associate this with investing. The reality is that governments are spending more than ever on defence, and much of the budget is being directed toward listed companies that are leaders in their fields. These companies operate in diverse [sub-industries](#) including aerospace & defence, and electronic equipment & instruments.

These sectors are typically under-represented in broad market benchmarks. The S&P/ASX 200 index has zero exposure to these military and defence industries, while the S&P 500 and MSCI World ex Australia indices have 1.95% and 1.98% exposure respectively.

For long-term investors, these sectors have historically outperformed the broader market.

**Chart 1:** Total cumulative index returns since 1989.



Source: Morningstar Direct 1989 to 31 August 2024. Past performance is not a reliable indicator of future performance. You cannot invest in an index.

Unhappily, the world has changed from countries celebrating the peace dividend, a term used to describe the economic benefits of a decrease in defence spending. Instead, countries are ramping up military expenditure.

We think there are three key reasons for investors to consider a defence allocation within a diversified equities portfolio.

**1 – Spending by governments toward the sector is increasing**

Although Australia is far removed from troubles plaguing other parts of the world, it is not immune from the flow over effects from uncertain times. In 2023, defence expenditure hit a record high and accounted for 1.92% of GDP and 5.06% of total government expenditure in Australia – a 6% increase from the previous year. Australia’s defence spending is set to increase further with the Government committed to spending 2.4% of GDP to this sector by 2033-34, which is roughly \$100 billion.

It is a similar story for other NATO (North Atlantic Treaty Organisation) and NATO-friendly countries. NATO was founded in 1949 following WWII by Canada, United States and several Western European nations. This Alliance was created to provide political integration and collective security across the regions and now includes 32 countries. In 2014, NATO governments agreed to commit 2% of their national GDP to defence spending to help ensure the Alliance’s continued military readiness.

Compared to other parts of the world, the post-Cold War period has seen significant underinvestment in the defence sector by European nations. As a result, defence capability has suffered in many nations. This has begun to shift in recent years, with Germany a prime example.

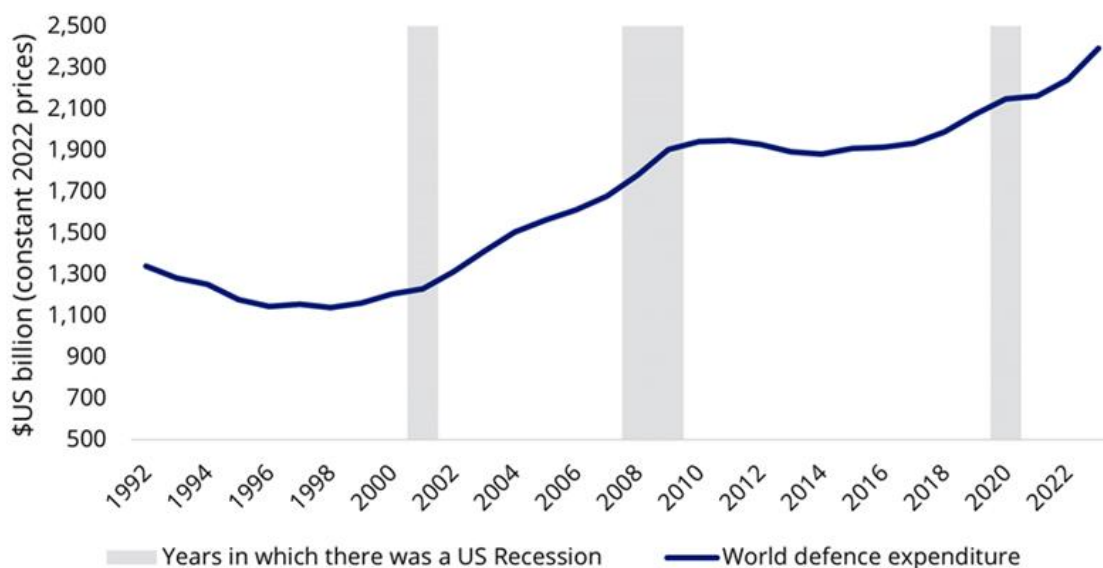
A leaked Inspector General report on the state of the German army in 2022 highlighted poor results for functional weapons. It further implied the situation was even more dire in the other parts of the army. As a result, the German government passed a bill allocating €100 billion to a special defence fund and also announced intentions to increase its yearly defence spending.

Elsewhere, The Netherlands shifted policy and approved an additional €5 billion in defence investments and the UK announced that it would increase defence spending to 2.5% of GDP by 2030. This will inject an additional £75 billion over six years and retain the UK’s place as the second largest defence spender in NATO.

This year, 23 NATO allies are expected to meet or exceed the defence spending target, compared to only three Allies in 2014. This represents a significant increase in collective investment to the industry. NATO Allies have also agreed that at least 20% of defence expenditure should be devoted to major new equipment. This includes associated research and development, perceived as a crucial indicator for the scale and pace of modernisation.

Globally, data released by the Stockholm International Peace Research Institute (Sipri) for 2023 showed that global military expenditure grew 7% to US\$2.43 trillion, the steepest annual rise since 2009 as international peace and security deteriorated.

**Chart 2:** World defence expenditure: 1992 to 2023



Source: Sipri, VanEck, figures are represented in constant 2022 US dollars.

---

## **2 – Demand for the sector’s products and services has not historically correlated to the economic cycle.**

It is important to note that defence expenditure has historically been agnostic of the economic climate. Looking at chart 2 above, defence spending rose during the last three US recessions (the grey shaded area).

## **3 – The defence industry has historically been at the forefront of technological development and advancement**

Military and defence sector companies generally invest heavily in research and development to create new technologies, inventions and products.

This can often lead to technological development and advancements that spill over into areas beyond military use to everyday life. Some everyday products and innovations that have deep roots in the military sector include the internet, GPS satellite navigation, microwave ovens and super glue.

Additionally, in the modern world, defence strategies must consider a broad range of factors, beyond military and weapons, to effectively protect a country’s security and prepare for potential threats.

Cyber security, satellites and communications, analytics and event response software, and training services are now included in defence budgets and represent further growth opportunities for defence firms.

## **Australia’s first defence ETF, the VanEck Global Defence ETF (ASX: DFND) launched earlier this month on ASX.**

Key risks: An investment in our defence ETF carries risks associated with: ASX trading time differences, financial markets generally, individual company management, industry sectors, foreign currency, country or sector concentration, political, regulatory and tax risks, fund operations, liquidity and tracking an index. Once available, see the PDS and TMD for more details.

*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.*

For more articles and papers from VanEck, [click here](#).

## **The butterfly effect, index funds, and the rise of mega caps**

Joachim Klement

What goes up must come down was the mantra of small-cap investors for decades. Yet, over the last 10 to 20 years the largest companies have become larger and larger, outperforming small caps in the process. Some new research indicates that at least in part, this might not have been the result of mega caps being operationally superior to small caps but may be due to a butterfly effect triggered by index fund flows.

Index funds have long been prime suspects in the search for reasons why large companies have grown larger over time and why the US stock market, for example, is entirely dominated by a few mega-cap tech companies. I have always been suspicious of this argument because if you buy an index tracker, you buy each stock in the index in proportion to their market cap, so investors moving from active to passive funds should not influence the relative market cap of the stocks in an index.

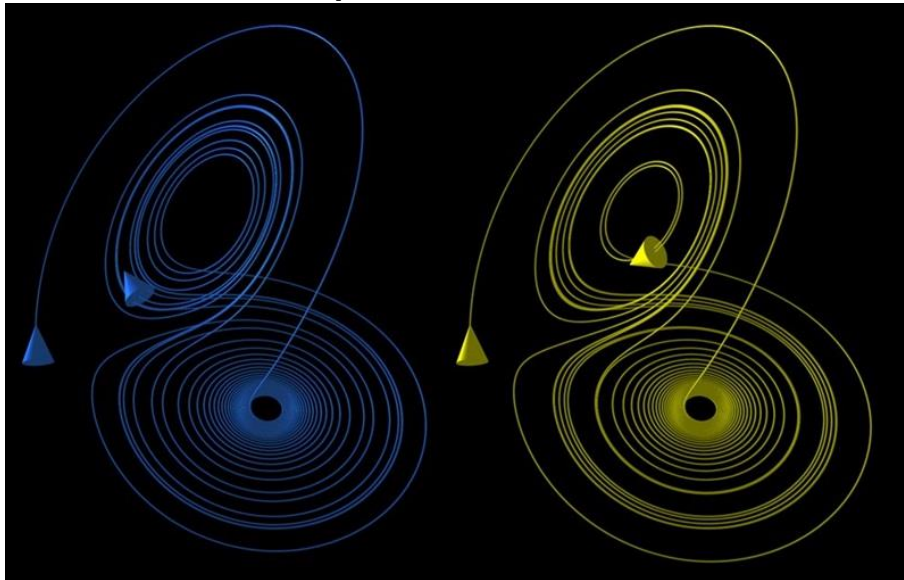
Yes, index investors don’t correct mispricing of stocks because they don’t care about valuations, but the stock market remains dominated by active investors, and the market share of index trackers is in my view way too small to explain why megacap stocks trade at much higher valuations than most of the rest of the S&P 500, for example.

But when I read a [paper by Hao Jiang, Dimitri Vayanos, and Lu Zheng](#) I was surprised to see how flows into index funds create a butterfly effect among large-cap stocks.

For the uninitiated, the butterfly effect describes the observation that in a complex nonlinear system, even the tiniest changes in starting conditions can lead to large changes in the result. This was commonly described as a butterfly flapping its wings creating a tornado somewhere else.

The butterfly effect was discovered by meteorologist Edward Lorenz who tried to run computer forecasts of the weather. Below is a visualisation of the simple computer model he ran in 1972. The blue and yellow cones are virtually in the same spot at the start of the simulation. They differ only by 0.0001 units horizontally. For the first 23 seconds, the blue and yellow trajectories are the same, but then they start to diverge wildly. The centre cone in the chart below shows the position after 30 seconds.

#### The butterfly effect in the Lorenz attractor



Source: XaoBits, Wikimedia Commons

In their research, Jiang et al. demonstrated something like a butterfly effect in US stock markets. Whenever index funds put money to work in the market, idiosyncratic volatility for larger stocks increased more than for small stocks, and excess returns over cash increased as well.

But index flows into the US stock market are tiny. Over the last 25 years, they average 0.05% of US stock market cap per quarter with a standard deviation of 0.09% per quarter. Annualised, we are talking about 0.2% of market cap shifting from active to passive management per year.

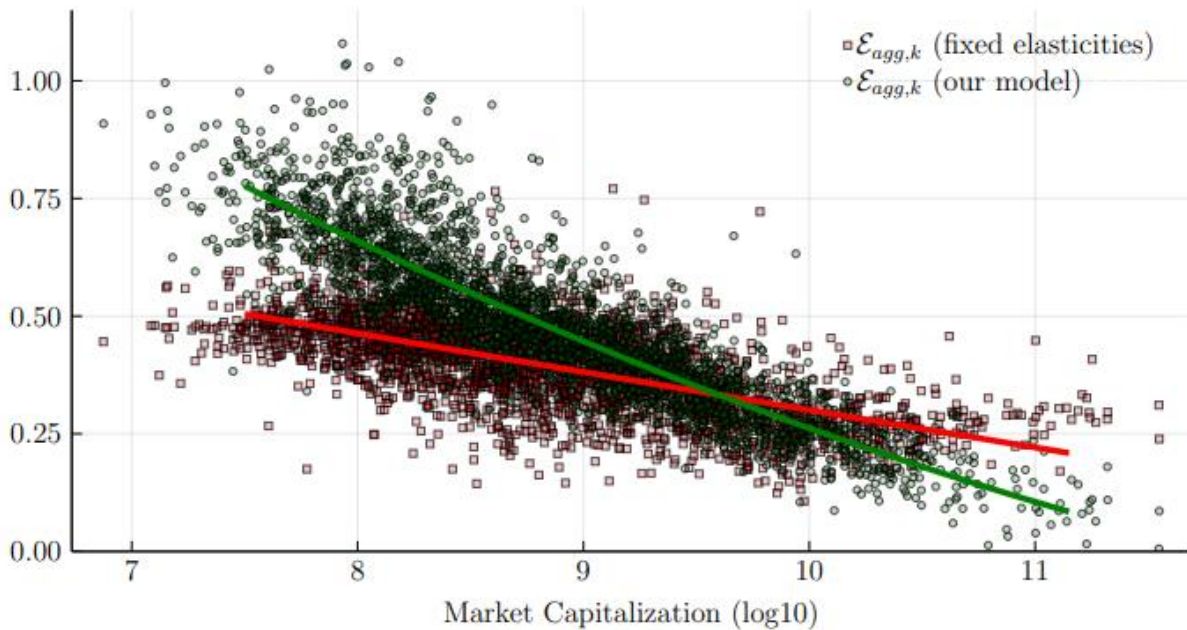
They show that while the impact on the relative market cap of the largest stocks in the US is a tiny 0.3% per quarter, this accumulates over time. After 25 years these tiny shifts in market cap between larger and smaller stocks amount to large-cap stocks being 30.25% larger than they would have been without the rise of index investments!

But why would the market cap of large stocks in an index react more than the market cap of smaller stocks? This is where [Valentin Haddad, Paul Hübner, and Erik Loualiche](#) provide a fascinating answer. They measure the price elasticity of stocks to changes in flows for each stock in the US. They find that the larger a company, the more inelastic demand becomes. But when demand is inelastic it means that a small increase in demand leads to a larger increase in price (and hence market cap).

The reason why demand becomes more inelastic for larger stocks is simply because almost every investor – whether active or passive – needs to own the largest companies in a market. If you own smaller companies, you can easily sell them when they become too expensive and in your view overvalued.

If you are an active fund manager, nobody will blame you for underperformance just because you didn't own Etsy shares. But try not owning NVIDIA or Apple shares and then underperform the market and see how your investors will react... Hence, even active investors are forced to hold at least some NVIDIA and Apple shares no matter how expensive they are. And that tiny difference in demand creates a huge benefit for the largest stocks over 25 years.

**Elasticity of demand declines for larger stocks**



Source: Haddad et al. (2024)

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

**Options for investors who don't want to sell overpriced banks**

**Te Okeroa**

The run-up in Australian bank stocks has some investors confounded: do they continue to hold them in expectation of further gains - or sell and take profits now?

As at September 13 2024, Commonwealth Bank had reached over \$230 billion in market capitalisation and recently surpassed BHP to become Australia's most valuable company. In July, the Commonwealth Bank was considered by the *Australian Financial Review* to be one of the most expensive banks in the world with a price/earnings multiple of some 24 times – 30% above its average over the past five years. It also had a price-to-book ratio approaching three times, seemingly out of line with other leading global banks.

Will it continue to do so? That question has been the focus of many conversations between investors and their financial advisers.

With the big four banks accounting for nearly 20% of the local S&P/ASX200 index, if you are invested in any index fund or exchange traded fund (ETF) you cannot easily drop the banks from a portfolio. Other investors may not want to realise the tax consequences of selling, while others may not want to lose the consistent dividend income.

**There is an option**

One way for investors to help protect their bank stock holdings is by using [options](#).

Over the first quarter of this year, AUSIEX has witnessed an increase in the put/call ratios of short-dated big four banks' options heavily weighted to calls, with around 1.6 calls open for every put and net calls materially short. Longer dated options, while more thinly held, are weighted towards puts with net puts materially long.

This suggests that some investors are already protecting the long-term value of their equity holdings – or seeking downside exposure – and funding these puts with short calls that are rolled on an ongoing basis.

Writing covered call options (a 'covered call' strategy) can also potentially provide income from the premiums received from writing these contracts, while also securing an exit price should the position expire 'in the money'.

This type of strategy consists of buying or holding stock and selling a call option on those same securities. The sale of the option contract provides the writer with a premium, which helps to lower the breakeven point on the underlying investment.

While there may be some foregone upside potential, the premium helps this strategy perform in volatile markets – while also generating income. As for risks, removing some of the upside potential can reduce gains if the stock rallies well above the option strike price.

The buyer of a put is able to secure their sell price should the stock pull back, though is required to pay the premium for the benefit. Acquisition of these contracts provides significant flexibility for fund managers, better enabling them to enter or in this case exit their positions.

Similarly, investors who may not wish to realise significant capital gains in selling bank shares, can take long puts ('long put' strategy) that will assist in offsetting losses should the underlying shares pull back.

Options can help advisers manage risk on behalf of clients. Consider a 'collar' strategy, which combines covered call and long put strategies and involves selling a covered call option and at the same time purchasing a put option. The idea is the income received from selling the covered call helps fund the purchase of the put option.

This 'collar' strategy will cap any further upside in the stock to the strike price of the sold call option. The put option provides downside 'insurance'.

There are several other ways advisers can help investors reduce volatility in their portfolios, ranging from minimum volatility exchange traded funds (ETFs), inverse ETFs and more – as highlighted below.

### Minimum volatility ETFs

There are several exchange traded funds (ETFs) listed locally that seek to reduce risk by investing in portfolios which may lose less than the overall market during downturns.

iShares' MSCI World ex Australia Minimum Volatility ETF ([ASX:WVOL](#)), for example, tracks the MSCI World ex Australia Minimum Volatility (AUD) Index. The index is designed to measure the performance of developed market equities that, in the aggregate, have lower volatility characteristics relative to developed markets as a whole.

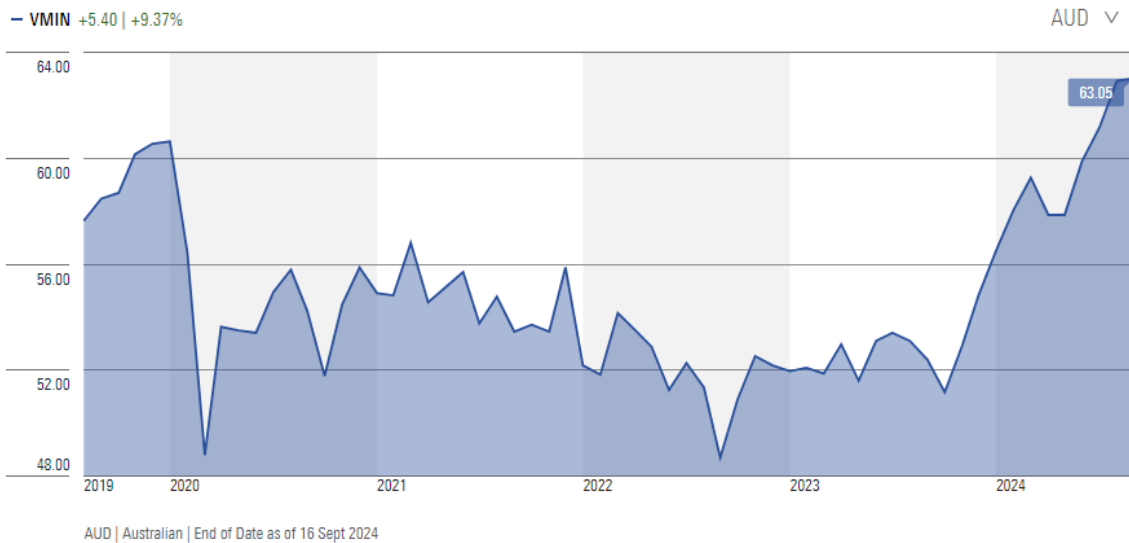
The fund's top holdings include telco T Mobile US, pharmaceutical company Johnson & Johnson, Berkshire Hathaway and health care company Merck & Co. It returned 15.66% in the year to July 31 and 6.79% in the five years to the same date.



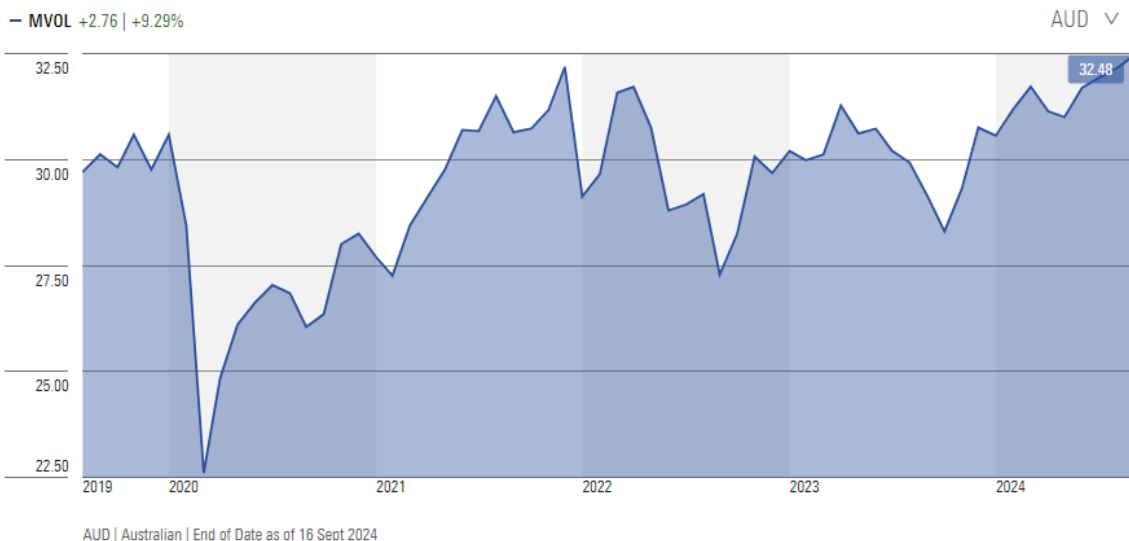
Vanguard's Global Minimum Volatility Active ETF ([ASX:VMIN](#)) instead has a portfolio of global shares that includes Australian companies. It is an active fund that aims to provide long-term capital appreciation with



lower volatility than the FTSE Global All Cap Index (AUD Hedged). Close to 60% of its holdings are in US companies, following by Japan (10.4%), the United Kingdom (6.9%) and Australia (3.6%).



Blackrock also offers the iShares Edge MSCI Australia Minimum Volatility ETF ([ASX:MVOL](#)), which tracks the MSCI Australia IMI Select Minimum Volatility (AUD) Index.

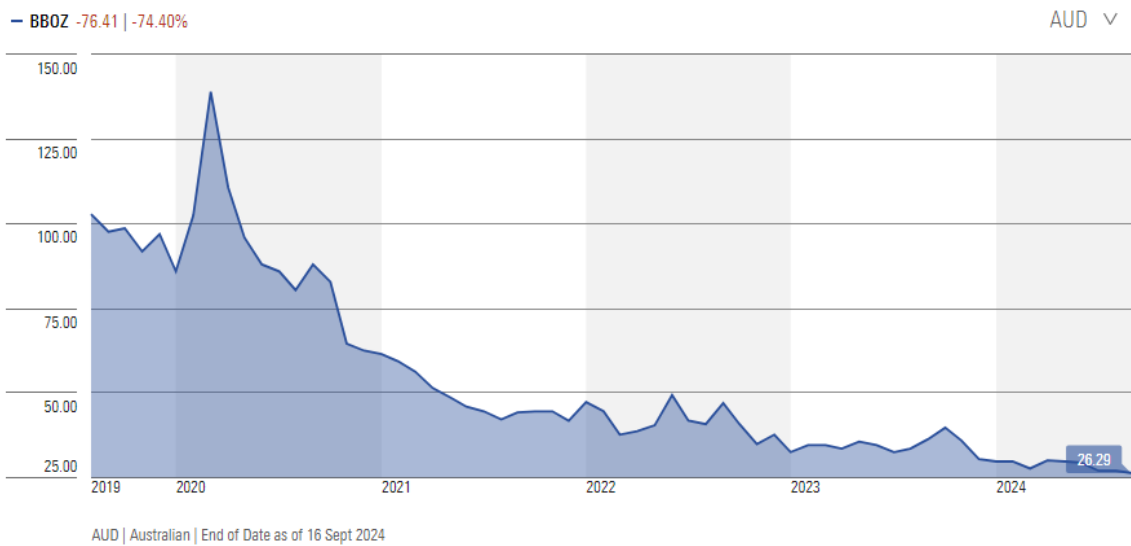
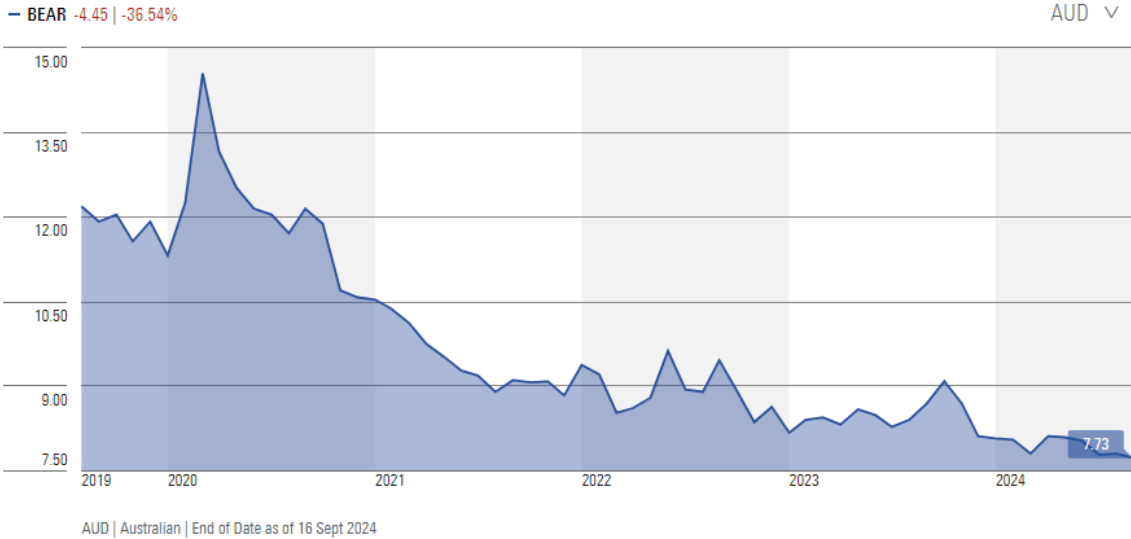


### Inverse ETFs

Advisers and investors with a particularly bearish outlook – and an understanding of short selling – might consider using inverse ETFs to profit from falling markets.

BetaShares – which operate three inverse ETFs – suggests this style of investment should be monitored daily. Its Australian Equities Bear Hedge Fund ([ASX:BEAR](#)) expects to generate a gain when the S&P/ASX200 Accumulation Index falls on a given day, and a loss when it rises. A 1% fall in the Australian sharemarket on any day can generally be expected to deliver a 0.9% to 1.1% increase in the value of the fund.

BetaShares’ Australian Equities Strong Bear Hedge Fund ([ASX:BBOZ](#)) takes a higher octane approach by offering geared short exposure to the local sharemarket. A 1% fall in the Australian sharemarket on a given day can generally be expected to deliver a 2% to 2.75% increase in the value of the fund (and a corresponding decrease in value if the local market rises).

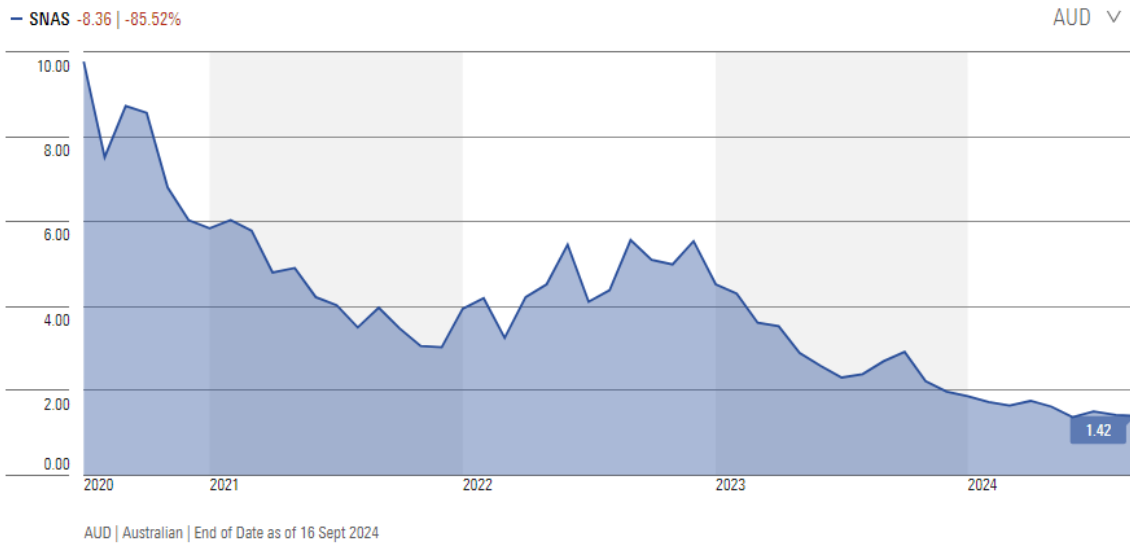


Other inverse ETFs have the potential benefit of allowing investors to protect a portfolio of US shares from market declines without having to sell shares.

The BetaShares US Equities Strong Bear Hedge Fund – Currency Hedged ([ASX:BBUS](#)), again uses gearing and is linked to the performance of the S&P500 Total Return Index.



Similarly, the Global X Ultra Short Nasdaq 100 Complex ETF ([ASX:SNAS](#)) aims to provide geared returns that are negatively related to the returns of the Nasdaq 100 index. Unsurprisingly, it hasn't had a great run in the AI boom – its total return -36.5% in the year to the year to July 31.



Overall, there are a range of options that can help advisers help their clients reduce volatility in their portfolios – and in short, using options provides options.

*Te Okeroa is Head of Sales, Trading and Customer Relationships at [AUSIEX](#). This information contains general information only and has been prepared without taking into account your objectives, financial situation or needs.*

All charts sourced from [Morningstar.com.au](#).

**Disclaimer**

*This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.*

*Any general advice has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) without reference to your financial objectives, situation or needs. For more information refer to our Financial Services Guide at [www.morningstar.com.au/s/fsg.pdf](#). You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Past performance does not necessarily indicate a financial product's future performance.*

*For complete details of this Disclaimer, see [www.firstlinks.com.au/terms-and-conditions](#). All readers of this Newsletter are subject to these Terms and Conditions.*