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Editorial

Previously I've written of studies suggesting that our capacity to make financial decisions peaks around the age of 53, and declines thereafter at a rapid rate. Decisions related to borrowing and debt peak at around age 53 while investment skills peak around age 70, with the difference likely due to the varying ages at which we get experience in borrowing and investment.

The risks to our cognitive functioning seem to be increasing given the rise of dementia-related conditions. Recently, I relayed how dementia is about to overtake heart disease as the leading cause of death in Australia. Dementia, including Alzheimer's disease, contributed to just 0.2% of deaths in 1968, yet that's now risen to 9.1%. It's already the leading cause of death for women due to their longer life expectancies increasing the risk of developing dementia.

The latest research on cognitive decline in financial matters

New research appears to confirm that cognitive decline is evident in financial affairs often long before any illness is officially diagnosed. A paper from the Federal Reserve Bank of New York reveals that credit scores among Americans who later develop dementia start falling well before their disease is formally identified. 12 months before diagnosis, these people were 17% more likely to be delinquent on their mortgage payments than before the onset of the disease, and 34% more likely to be delinquent on their credit card payments. The paper suggests the problems can develop early, with the probability of delinquency among credit card holders being consistently worse up to five years before diagnosis, and for mortgage holders is worse in the three years prior to diagnosis.

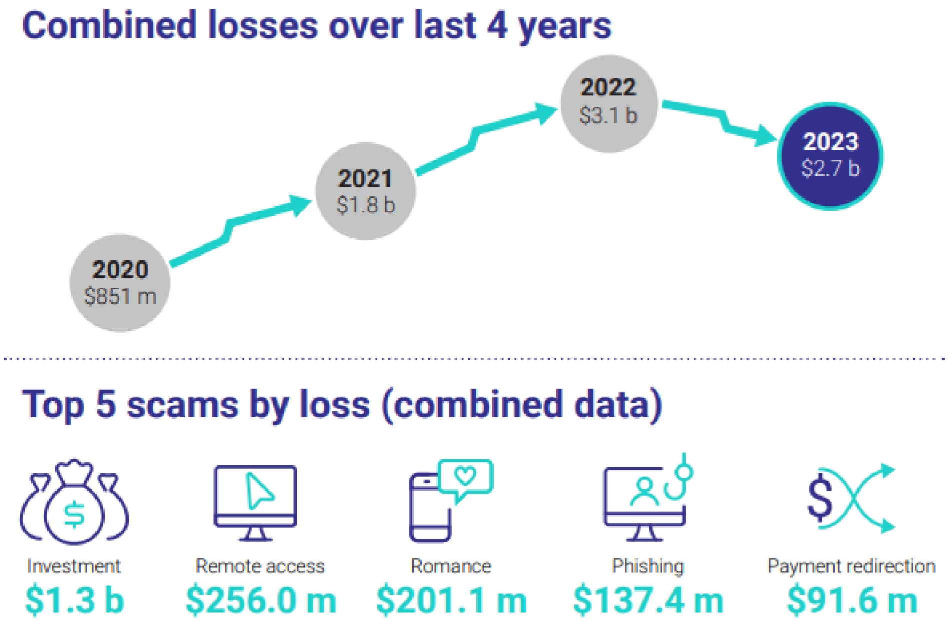
Another study published in the *Journal of Political Economy* has found that falling cognition not only impacts decision making when it comes to debt, but also investments too.

"First, we show that older people tend to underestimate their cognitive decline. We then show that those experiencing a severe decline but unaware of it are more likely to suffer wealth losses. These losses largely reflect decreases in financial wealth and are mainly experienced by wealthier people who were previously active on the stock market. Our findings support the view that financial losses among older people unaware of their cognitive decline are the result of bad financial decisions, not of rational disinvestment strategies."

Increased susceptibility to financial scams

Cognitive decline not only effects our decision making on investment and debt matters but also makes us more vulnerable to scams and fraud. Previous studies have shown that older age and lower levels of cognitive function are two key markers for susceptibility to falling victim to financial scams (the other two markers being lower psychological wellbeing and lower literacy).

Last year, there were more than 600,000 cases of scams in Australia, with losses of more than $2.7 billion.



Source: Report of the National Anti-Scam Centre on scams activity 2023

As noted by Clime's John Abernethy in a Firstlinks article a few weeks ago:

"From a livelihood and welfare perspective, a scammer can create havoc for an unwitting target. Whether the target loses their life savings, their superannuation, or a deposit for a house, the devastation is the same. Money that is scammed is stolen and lost. It can change lives unless there is recompense."

Sadly, the research shows that financial fraud among the elderly often comes from those closest to the victim, including family members, caregivers and friends.

But it can also come from strangers and there are certain types of deception which are more effective than others. Email phishing that relies on reciprocation – the tendency to repay what another person has provided them – is more effective on the elderly.

There's also evidence that as we age, we have greater difficulty detecting the "wolf in sheep's clothing": someone who appears trustworthy but is not acting in a trustworthy way.

The best defences against cognitive decline

Like it or not, your financial cognition will decline over time. That makes it imperative to have legal and financial guardrails in place to protect your wealth. A financial adviser can be a useful gatekeeper for elderly clients with diminishing cognitive function. Also, having a Power of Attorney is a must, along with an updated Will.

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In my article this week, Berkshire Hathaway's third quarter earnings update revealed Warren Buffett aggressively sold down stocks including Apple, halted company share buybacks, and built record cash reserves. These moves indicate Buffett is seeing little value in the current stock market. I look at his track record in calling market tops and whether you should follow his lead and reduce risk in your portfolio.

James Gruber

Also in this week's edition...

Donald Trump has been elected US President (again) in a decisive result. **Shane Oliver** looks beyond the short-term noise to the longer term implications of the election for investors and Australia.

Harry Chemay says fewer people are owning a home in retirement and those that do are carrying more debt than ever before. He believes retirement planning assumptions haven't kept pace with these latest developments and that could result in future income projections that ultimately disappoint retirees.

We hear a lot about megatrends these days and there is always scepticism about how much of their positive attributes are already reflected in share prices. **Magellan's Alan Pullen** and **Elisa Di Marco** say that scepticism may explain why most megatrends are underplayed at first. Not only that, but they may also provide clues as to why these trends tend to last longer than initial estimates. And in a twist, they suggest that not all megatrends are positive, with some being downright risky for investors in the long term.

If there is an industry Australia needs confidence in right now, it's the residential construction sector. Yet, at a time of unprecedented need to build, construction companies are collapsing like houses of cards, leaving consumers with lost deposits and half-finished homes. **Drs Bradley Hastings** and **Peter Swan** propose some solutions to fix the growing problem.

MFS President, **Carol Geremia**, was recently in Australia and sat down with *Firstlinks* to discuss her views on the investment environment. She believes investors have significantly dialled up portfolio risk in recent decades by reducing their stock holding periods and including a greater share of equities and other risk assets. That's had a cascading effect not only on investors but investment firms and ultimately the companies they invest in. And much of it hasn't been healthy, in her view.

Arian Neiron of **Van Eck** offers a fantastic exploration of the history of indexing. He says equity indices have evolved over time, led by step-changes in our ability to manipulate data, yet they weren't initially meant to be investment tools.

Lastly, in this week's whitepaper, **Schroders** provides its latest Global Investor Insights Survey.

Warren Buffett is preparing for a bear market. Should you?

James Gruber

Warren Buffett was born in Omaha, Nebraska, during the depths of the Great Depression in 1930. At an early age, he showed an aptitude for maths and business, and he eventually went to the prestigious Wharton business school at the University of Pennsylvania, and later to Columbia University, where he was taught by investing legend, Ben Graham. He would go to work for Graham for a few years during the early 1950s.

Aged just 25, Buffett went home to Omaha from New York to set up his own investment firm. He raised US$105,000 from six investors and began managing it out of a small study in his rented home.

USA White House, Public domain, via Wikimedia Commons

Over the next 12 years, Buffett pursued a Ben Graham-style of deep value investing that achieved extraordinary results: returning 31.6% per annum before fees. By the end of 1968, he was managing US$105 million on behalf of more than 300 investors. He'd grown rich in the process.

And, then, he quit. In a letter to investors, he explained why he was shutting down the fund:

1. Opportunities for his style of investing had dried up.
2. The market had grown overexuberant and detached from fundamentals.
3. His fund had grown too large for small cap investing
4. He needed a break.

Buffett liquidated his fund and returned to investors both cash and stock in two illiquid holdings he controlled – Diversified Retail Company and Berkshire Hathaway.

The fund's closure proved well timed. From December 1968 to May 1970, the S&P 500 fell 36%. Later, from January 1973, it would fall a further 48% over the ensuing 21 months.

Buffett wasn't out of the game long. By the end of 1970, he built a 36% stake in Berkshire Hathway, giving him a vehicle for the 'permanent capital' he craved. The downturn of 1973-74 allowed Buffett to go on a spending spree and amass some of his most famous stock purchases, including Washington Post, and later, GEICO, Buffalo Evening News, and Capital Cities/ABC.

The question remains whether Buffett was a little lucky in closing his fund just before the big bear markets of the late 1960s and early 1970s.

Fast forward a quarter of a century later to May 1999, and Buffett released an unusually pointed annual shareholder letter. In it, he criticized many of his fellow CEOs for manipulating earnings to keep their company share prices high.

Two months later, he gave a speech to tech and media tycoons at the famous Allen Sun Valley Conference. Alice Schroeder's book, *The Snowball*, describes what happened next:

"He put up a slide to illustrate how, for several years the market's valuation had outstripped the economy's growth by an enormous degree. This meant, Buffett said, that the next seventeen years might not look much better than that long stretch from 1964 to 1981 when the Dow had gone exactly nowhere—that is, unless the market plummeted. "If I had to pick the most probable return over that period, he said, "it would probably be six (6%) percent. Yet a recent Paine-WebberGallup poll had shown that investors expected stocks to return thirteen to twenty-two percent.

He walked over to the screen, waggling his bushy eyebrows, he gestured at the cartoon of a naked man and woman, taken from the legendary book on the stock market, Where Are The Customers' Yachts? "The man said to the woman, 'There are certain things that cannot be adequately explained to a virgin either by words or pictures.'"

The audience took his point, which was that people who bought Internet stocks were about to get screwed. They sat in stony silence. Nobody laughed. Nobody chuckled or snickered or guffawed."

Buffett's warnings became more public in November of that year when journalist and sometimes Buffett ghost writer Carol Loomis summarized two of his speeches, including the Sun Valley one, in an article in *Fortune* magazine.

Buffett was widely mocked for his warnings. After all, they followed a decade of stellar returns and the advent of an Internet boom. Between 1995 and 2000, the Nasdaq Composite stock market index rose 400%. In 1999 alone, shares in Qualcomm increased by 26x and 12 other large-cap stocks each climbed over 1,000%. The Nasdaq Composite leaped 85.6% higher and the S&P 500 also rose 19.5% in 1999.

Yet, after peaking in March 2000, the Nasdaq subsequently fell 78% in one of the biggest crashes in history.

Fast forward eight-and-a-half years, and there was an even larger crisis. This time, Buffett gave few warnings about what was to come, however he did express some misgivings about the housing market in the years prior.

There was one tell-tale sign that Buffett was getting defensive, though: Berkshire had raised its cash levels to the highest ever in 2005 and though they came down, they remained high going into 2008.

That cash allowed him to purchase some extraordinary bargains when the financial system imploded in October 2008. When almost every other institution was struggling or on its knees, Buffett was able to provide much-needed money to a host of firms, including Goldman Sachs, Bank of America, and Dow Chemical. He ended up making a mint.

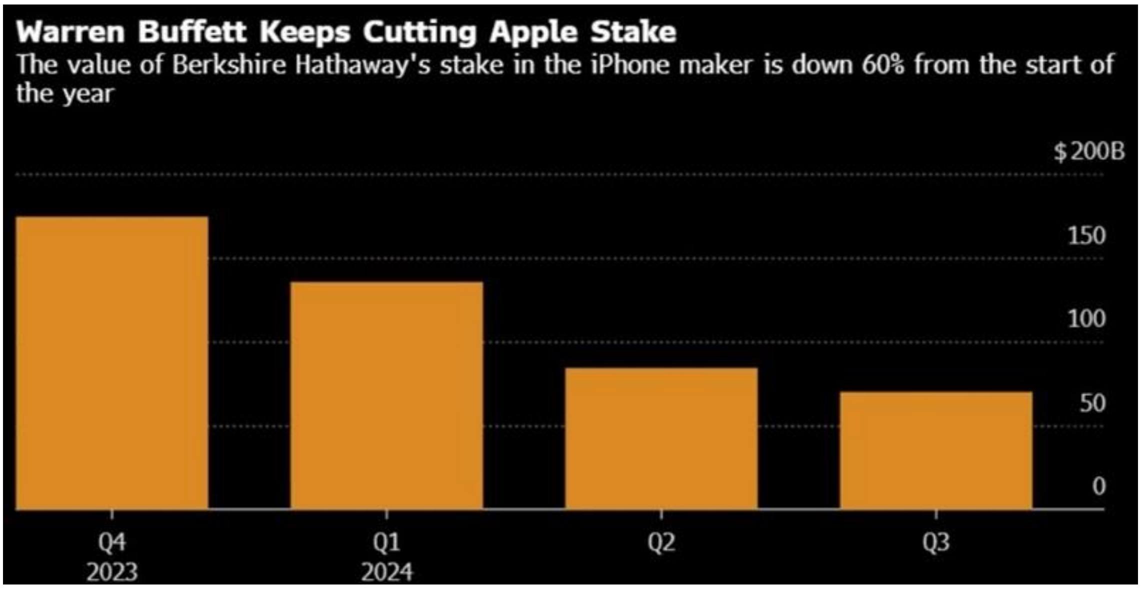
On October 16, 2008, Buffett penned an opinion article for the New York Times titled, "Buy American. I am." It was an eloquent distillation of his famous quote: "Be fearful when others are greedy, and be greedy when others are fearful."

Since that time, markets have had an extended bull market, interrupted only briefly by a worldwide virus and the 2021-2022 downturn. After bottoming at 666 in March 2009, the S&P500 is up 8.5x, or an annualised 14.4%, excluding dividends. Meanwhile, the Nasdaq is 15.8x higher, or 18.8% annualised, ex-dividends.

Buffett's latest moves

Given this context, Berkshire Hathway's third quarter earnings released last weekend are noteworthy. They revealed:

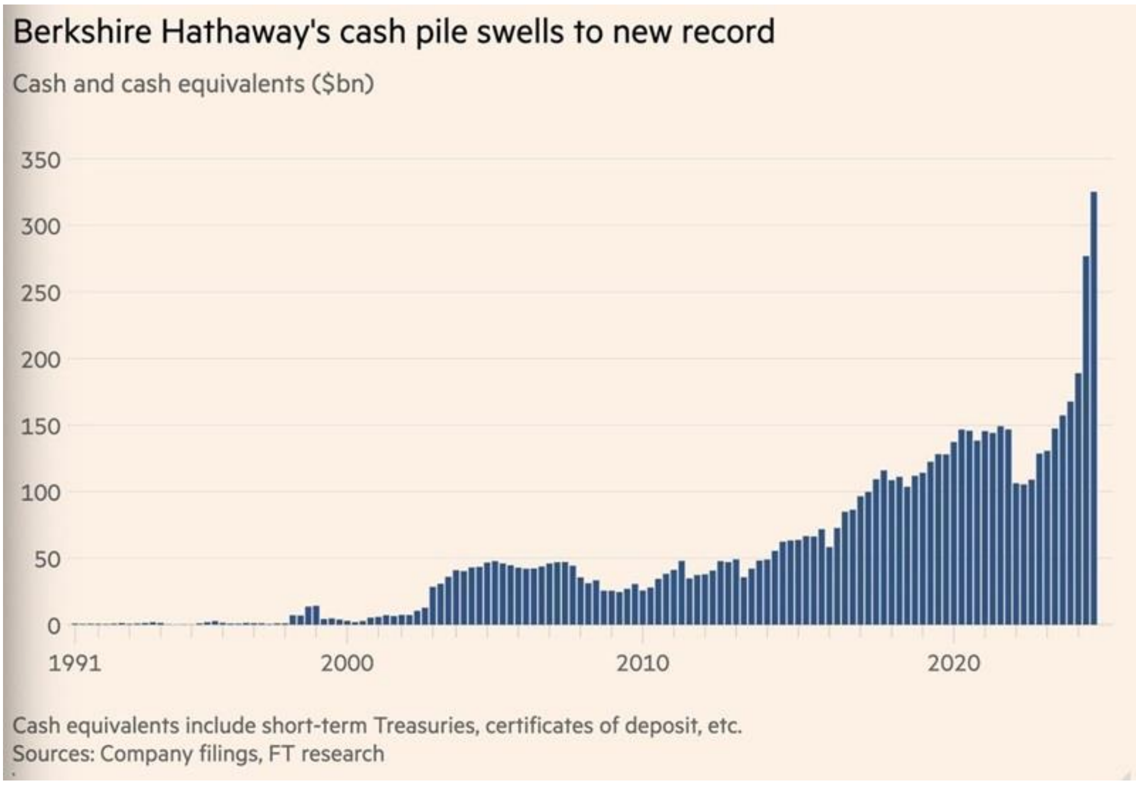
1. Buffett sold about US$100 billion in Apple (NYSE: AAPL) stock, or 25% of his stake. It means he's sold 600 million of his 900 million shares in Apple, or two-thirds, since the start of the year.

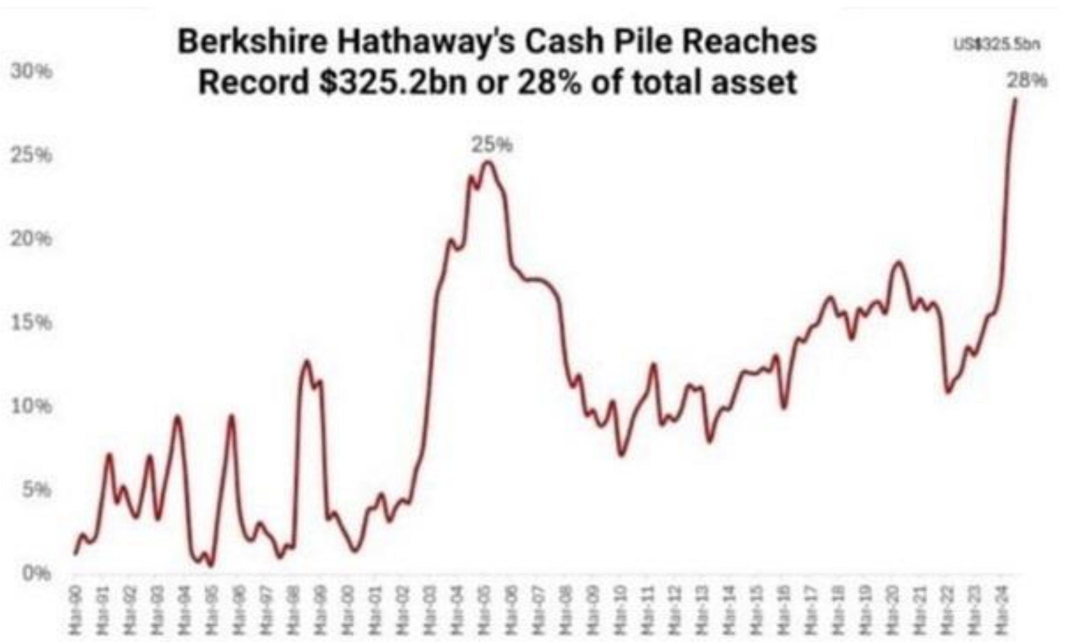


Source: Bloomberg

2. He also sold other stocks including Bank of America (NYSE: BAC) and only made US$1.5 billion in new stock purchases.

3. The stock sales and profits from his operating businesses grew Berkshire's cash pile to US$325 billion. That cash is larger than the company's listed portfolio investments. Cash levels have almost doubled this year and trebled over the past two years. They are at their highest ever level as a percentage of Berkshire's assets. Berkshire's cash pile is now greater than the market capitalisation of 477 out of 500 companies in the S&P 500.

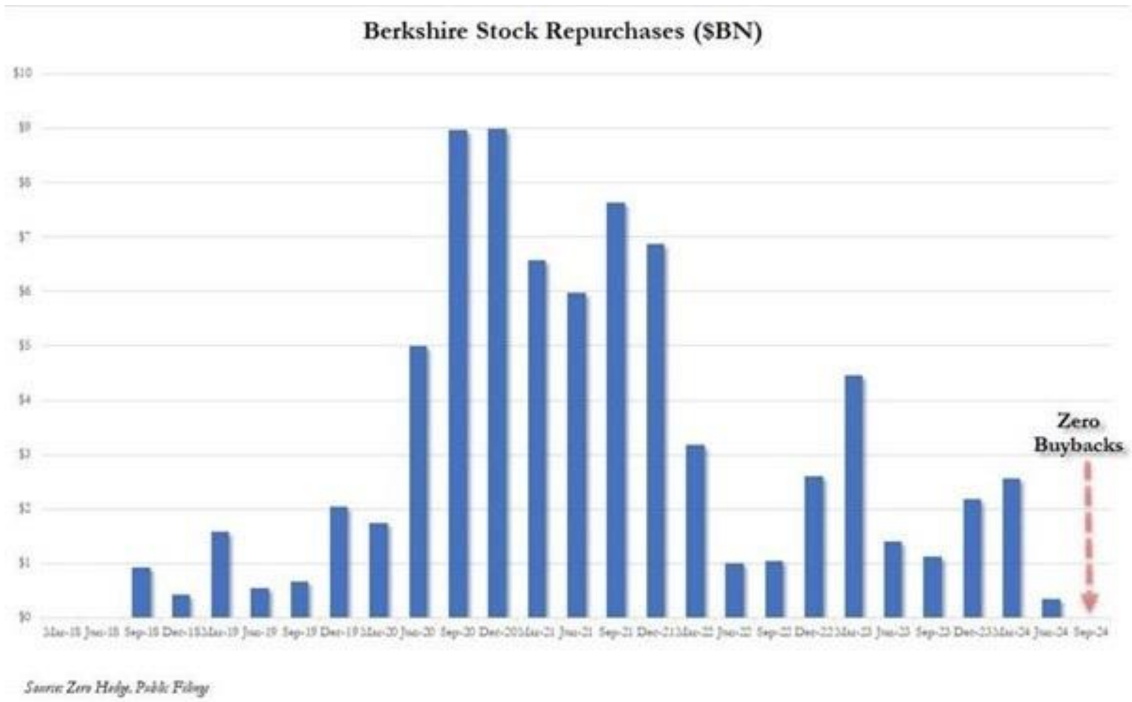




Source: Yahoo!

4. Buffett has continued to plough the cash into short-term Treasuries. He holds a record US$288 billion of US Treasury bills, US$93 billion more than the US Federal Reserve!

5. Berkshire didn't buy back any of its own stock in the third quarter – the first quarter that it didn't do buybacks since 2018.



Buffett is preparing for a bear market

One theory for Buffett's latest moves is that the growing cash pile is to ensure Berkshire Hathaway can buy out Buffett's stake in the company in future. While fascinating, this seems unlikely.

Much more likely is that Buffett is preparing for the next bear market. He sees that valuations for companies are getting expensive and he's holding cash in anticipation that valuations will make more sense at some point.

Is Buffett calling for an imminent market downturn? I doubt it, but he wants to be prepared with 'dry powder' to take advantage of opportunities when they arise.

The situation with Apple may be more nuanced. In August, I wrote of four probable factors behind Buffett's decision to sell down his Apple stock:

1. Apple is expensive.
2. It has no growth.
3. He's lost faith in management.
4. He believes his money is safer in Treasuries.

I think those points are as valid now as they were then. The third point is controversial, though crucial, as I outlined in August:

"One reason for Buffett selling that I haven't seen in any commentary is that he may have lost faith in Apple's CEO. Buffett has said that he looks closely at leaders and how they allocate capital. Previously, he's lambasted CEOs who've bought back company stock when the shares were expensive.

While Buffett has applauded Apple's large buybacks in the past, he's probably less happy with continued buybacks now. Why? Because buying back shares when the company was cheap made sense. With the company now expensive, it makes much less sense."

Is it time to bunker down like Buffett?

Buffett is arguably one of the greatest-ever investors and he's got a history of detecting both opportunities and dangers in markets. His recent earnings updates suggest that he thinks it's now best to play defence rather than offence.

The question is whether you should follow suit. That really depends on your time horizon, risk tolerance, and circumstances.

That said, like Buffett, I'm pretty sure of four things:

1. Valuations are expensive, especially in large caps in the US and Australia.
2. Those valuations mean returns over the next decade are unlikely to match the last decade.
3. Cash is often derided though can be an asset when it's in short supply, especially during a market downdraft.
4. Waiting for a 'fat pitch' requires patience and isn't for everyone, though can be worth it.

James Gruber is editor of Firstlinks and Morningstar.

US election implications for investors and Australia

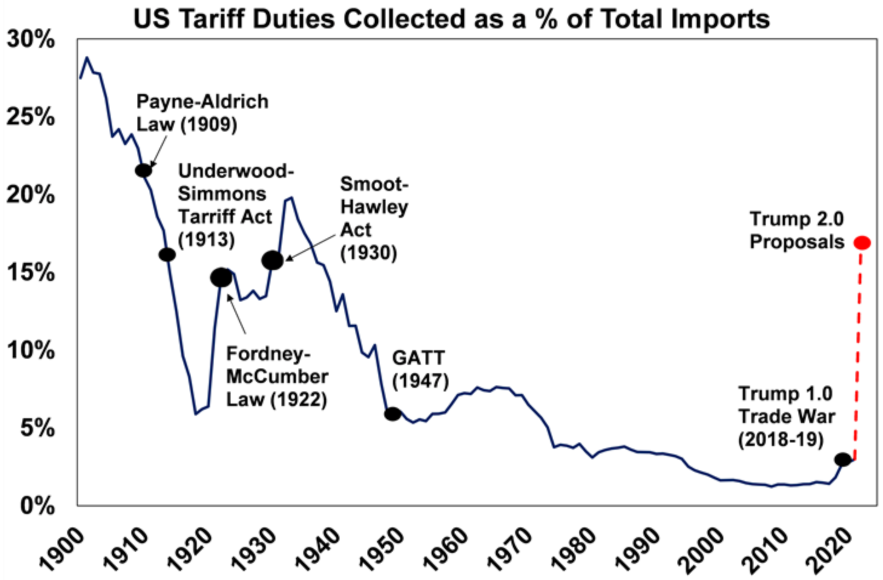
Shane Oliver

Contrary to what would normally be suggested by the solid US economy, low unemployment, falling inflation and strong share market, Donald Trump has been re-elected President of the US. Clearly some combination of the cost-of-living surge, the immigration blow out and too much 'wokeness' along with various other things weighed against Kamala Harris. Counting is continuing but Trump looks to have secured at least 270 of the 538 electoral college votes and won the popular vote. The Republicans are also on track to regain control of the Senate &, although its close, look like retaining the House, resulting in a Red Sweep. Trump's victory portends a ramping up of trade wars and increased economic policy uncertainty with the high risk of weakening of US institutions, democracy & global alliances.

Trump's key policies

Taxation: Trump would make the 2017 personal tax cuts (which took the top marginal tax rate to 37%) permanent (as they expire next year) and cut the corporate tax rate to 20% with 15% for domestic profits.

Trade: Trump is threatening a big ramp up in protectionism with a 10-20% tariff on all goods imports and a 50-60% tariff on goods from China. This would take the average US tariff rate on imports from around 2.5% to at least around 17%, a level last seen in the 1930s, and it was a disaster then!



Source: US ITC, Evercore ISI, AMP. Trump 2.0 assumes 10% general tariff and 50% on China.

Immigration: Trump will aggressively curtail immigration and is threatening mass deportation of between 15-20 million undocumented people.

Fed independence: Trump would seek to replace Jerome Powell, and his supporters are looking at ways to roll back the Fed's independence.

Climate policy: Trump will likely reverse the US' net zero commitments and support fossil fuels ("drill baby drill"). Subsidies for green manufacturing are likely to be replaced with wider support for domestic manufacturing (such as a 15% corporate tax rate on domestic profits and tariffs).

Regulation: Trump is likely to slash energy and financial regulation.

Budget deficit: The deficit – already huge at 6.5% of GDP - would likely get bigger under Trump by around 2-3 percentage points of GDP.

Key implications, risks and uncertainties

First, there will be less checks and balances this time around - Trump's second term as President arguably faces less constraints than seen in his first term as: there are less anti-Trump Republicans in Congress; there is likely to be less "adults in the room" amongst his staff and advisers this time around; and being unable to run for a third term he lacks the political constraints of his first term. Working partly the other way though he is still likely to regard the share market as a barometer of his success and would prefer to see it go up. So this may provide a partial constraint on him.

Second, expect another ramp up in trade wars and further deglobalisation – in practice Trump is likely to target countries with a trade surplus with the US (notably China, Europe and Japan) and rewrite of the trade deal with Canada and Mexico. The tariffs may not get as high as he has been talking about and it may be part of a "maximum pressure" campaign to bring production, including by Chinese manufacturers, back to the US. The latter may be the case, but we could go through a lot of disruption as Trump initially ramps up the pressure resulting in a much bigger impact on share markets than seen in 2018 (where Trump's trade wars contributed to an almost 20% fall in shares). This time around the proposed tariffs are much bigger (first chart) & he only backed away in 2019 out of a desire to get re-elected which is not an issue this time around. In any case Trump has long been a protectionist suggesting his tariff threats may be an end in themselves. And tariff hikes this time around will likely be made worse as impacted countries hike tariffs on US imports in retaliation (with reports Europe is planning to hit back quickly). The net impact will be a further reversal in global trade and globalisation.

Third, expect increased policy uncertainty – this was a key feature of his first term and flows from Trump's own erratic approach to policy making. Back to watching the US President's social media posts!

Fourth, the US is likely to become more polarised, including around how to deal with economic challenges – this was a feature of Trump's first term and arguably continued under Biden (albeit more mildly).

Trump is likely to treat his win as a vindication of his policies and may double down. This could make it harder for the US to reach compromises to solve economic challenges and lead to increased social unrest threatening US democracy.

Fourth, increased geopolitical uncertainty - Trump's re-election may further weaken global institutions and cooperation, resulting in a further deterioration in multilateral cooperation and increased geopolitical uncertainty. For example, his policy to negotiate an end to the war in Ukraine (which could be a short term positive globally) would almost certainly involve Ukraine ceding territory to Russia which could embolden Russia particularly if Trump weakens or withdraws from NATO.

Finally, the sequencing of policies may have a big impact on investment markets – if he focusses initially on tax cuts and deregulation then US (and hence global) shares could rally further in response as we saw in 2017. But if he goes early and hard on tariffs then any near-term rally in shares could be brief. His inability to have a third term suggests a high risk of the latter.

Specific economic impact of Trump's victory

While a Harris victory would have meant a continuation of Biden's policies, Trump is far from the status quo. Put simply Trump's policies taken together are ambiguous for US growth, negative for global growth and would likely add to inflation.

His policies on tax cuts and deregulation could help boost the supply side of the US economy via increased investment in the US resulting in a boost to productivity. However, on balance Trump's policies – with higher tariffs resulting in higher import prices and less competition (which is bad for productivity), deportation and lower immigration resulting in lower labour force growth (which will lower potential economic growth) and potential moves to weaken the Fed's credibility – risk adding to inflation and being negative for US growth. His trade policies with a likely global trade war would be negative for global growth.

There is also a risk that an even higher US budget deficit when US public debt is already very high (at 125% of GDP), will cause a market backlash resulting in much higher bond yields.

As noted in the previous section, much will depend on sequencing. If he runs with tax cuts and deregulation first (as in 2017) it could boost shares and the economy in say 2025, but if he runs first with sharp tariff hikes and immigration cuts it could be taken more negatively early on.

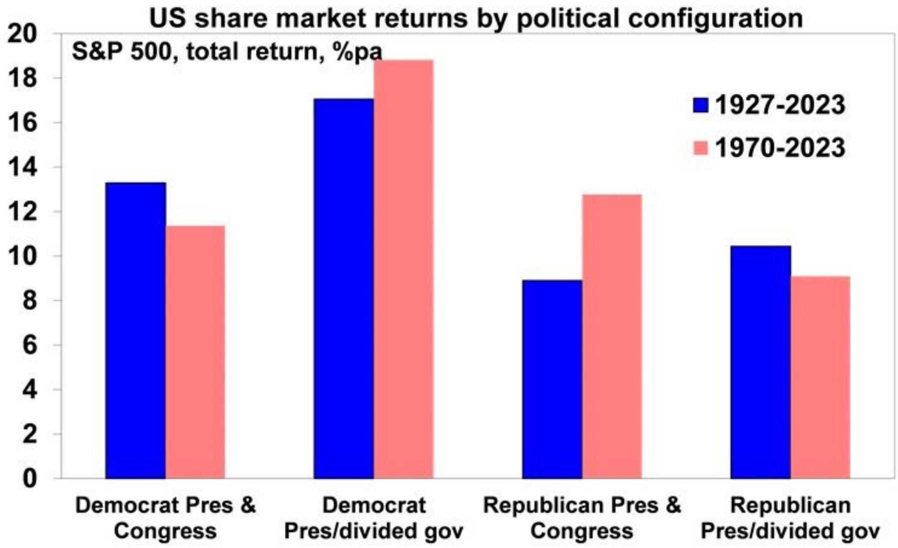
Likely investment market implications

Put simply Trump's policies point to:

- upwards pressure on US bond yields - via a bigger budget deficit and higher inflation and less rate cuts from the Fed;
- upwards pressure on the value of the $US – via higher tariffs, higher than otherwise Fed interest rates and increased global uncertainty;
- upwards pressure on Bitcoin and other cryptos as Trump is seen as more favourable towards crypto;
- ambiguity for the US share market with tax cuts and deregulation being positive (driving a short term boost), but trade wars and higher bond yields being negative (on a cyclical view);
- US shares outperforming global shares reflecting the tariffs and increased global uncertainty;
- upwards pressure on US financial and energy shares (less regulation) relative to clean energy shares (as climate measures are reversed);
- upwards pressure on US small caps relative to large caps including tech stocks (as small caps will benefit most from the lower corporate tax rate on domestic profits and large caps are vulnerable to a trade war).

Some of these moves had already started prior to the election – with bond yields, the $US and Bitcoin all up over the last month - as a Trump victory started to be anticipated and they have gathered pace in the immediate aftermath (with Bitcoin at a record high). It's likely that they have further to go in the short term but note that this win for Trump is very different to 2016 where his win surprised markets resulting in big market moves. At the time of Trump's victory in 2016 shares were relatively undervalued and soared 38% into January 2018 as the focus in his first year was on business-friendly tax cuts and deregulation but they fell in 2018 as the focus shifted to trade wars. This time around shares are already expensive so the upside may be more limited. That said shares may still see further post-election gains on relief that it's out of the way and hope that he focusses more on tax cuts and deregulation, but this could be reversed if he starts focussing on tariffs and as higher bond yields are bad news for shares.

Historically US shares have done best under Democrat presidents with an average return of 14.4% pa since 1927 compared to an average return under Republican presidents of 10% pa. Fortunately, the Republican sweep scenario has been the second-best outcome for shares since 1970. If the Republican's lose control of the House though, Trump will struggle to cut taxes, and this could see less upwards pressure on bond yields but be bad for shares as Trump could still do the tariff hikes.



Source: Bloomberg, AMP

Australia is vulnerable to a new Trump trade war

Polls show that only around 30% of Australians would have voted for Trump so many here will be disappointed. And from an economic point of view, Australians have some reason to be concerned. Exports to the US are only 4% of Australia's total exports and may be spared from Trump's tariffs as Australia has a trade deficit with the US. However, as an open economy with high trade exposure to China, Australia is vulnerable to an intensification of global trade wars under Trump, particularly if it weighs on demand for Chinese exports. An OECD study showed that Australia could suffer a 1.2% reduction in GDP as a result of a 10% reduction in global trade between major countries. Resources shares would be most at risk and the $A would likely fall (and we have already seen a bit of that). Of course, similar fears existed during the last Trump trade war, and it didn't turn out so bad (although the $A fell 10% in 2018 with US tariff hikes and Fed rate hikes). And there would still be demand for iron ore somewhere – it just may switch from China to elsewhere. Much will depend on how other countries respond and how hard Trump goes.

There is also the risk that if Trump's policies boost US inflation there could be a global flow on, including to Australia, resulting in higher than otherwise RBA interest rates. This is a risk, but I suspect it would be offset by the growth dampening impact of an intensified global trade war.

From a policy point of view, if Trump cuts the US corporate tax rate to 15% on domestic profits it could renew pressure on Australia to cut its corporate tax rate. Trump's reversal of US climate policies will again add to confusion and may increase pressure for Australia to slow its net zero commitment.

Concluding comment

Finally, it's worth noting that while the US Presidential election is important, many other things impact investment markets and investors should aim to remain focused on adhering to their financial objectives, ensuring that their portfolios are well diversified across asset classes and geographies and are continuing to take a long-term view. For now, we continue to see central banks cutting interest rates as inflation falls and this will help share markets.

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.

The rising tension between housing debt and retirement balances

Harry Chemay

Strongly rising residential property prices have increased the wealth of home-owning households significantly over the past two decades, resulting in Australia now sitting comfortably in the top three nations globally for median household wealth.

This national bias toward holding wealth in bricks and mortar may, however, have consequences for those approaching retirement in the form of growing mortgage debt levels being carried into later life.

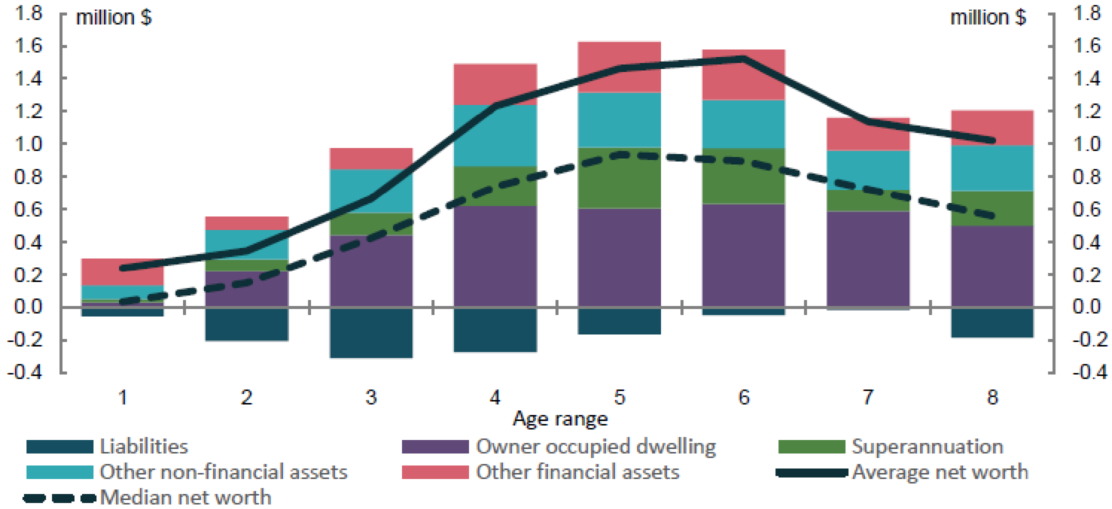
At the end of the 2024 financial year, the value of 'land and dwellings' on household balance sheets stood at $11.2 trillion, according to the Australian Bureau of Statistics (ABS).

The superannuation system was $3.9 trillion at the same point, made up of some $2.7 trillion in APRA-regulated funds and $990 billion in self-managed superannuation funds (SMSFs), with the balancing $225 billion held in exempt public sector super schemes and life office statutory assets.

Elsewhere, the combined valued of all companies listed on the Australian Securities Exchange (the market capitalisation of the ASX) totalled some $2.9 trillion at the time.

In essence, the value of residential land and housing is 2.9 times greater than the entire super system at present, and 3.9 times greater than the stock market. That in turn shapes how the composition of household wealth shifts with age, as the Retirement Income Review illustrated in 2020 below.

Figure 1: Composition of Household Balance Sheets by Age Cohort



Source: ABS 2019a, cat. no. 6523.0.

The key takeout is that from the 30s onwards, owner-occupied dwellings (the purple segment above) dominate the median (middle) household balance sheet over other asset types, and by a clear margin.

A median national dwelling price of some $800,000 will have that effect.

The growing debt burden

As at June 2024, the total amount of long-term loans sitting on household balance sheets (primarily mortgage debt) was around $2.9 trillion, identical in size to the ASX market cap and some $200 billion more than the assets held in APRA-regulated super funds.

The final Retirement Income Review report acknowledged housing's importance in Australia's retirement income system, noting that *"outright home ownership supports retirement by reducing ongoing expenses and acts as a store of wealth that can be accessed in retirement."*

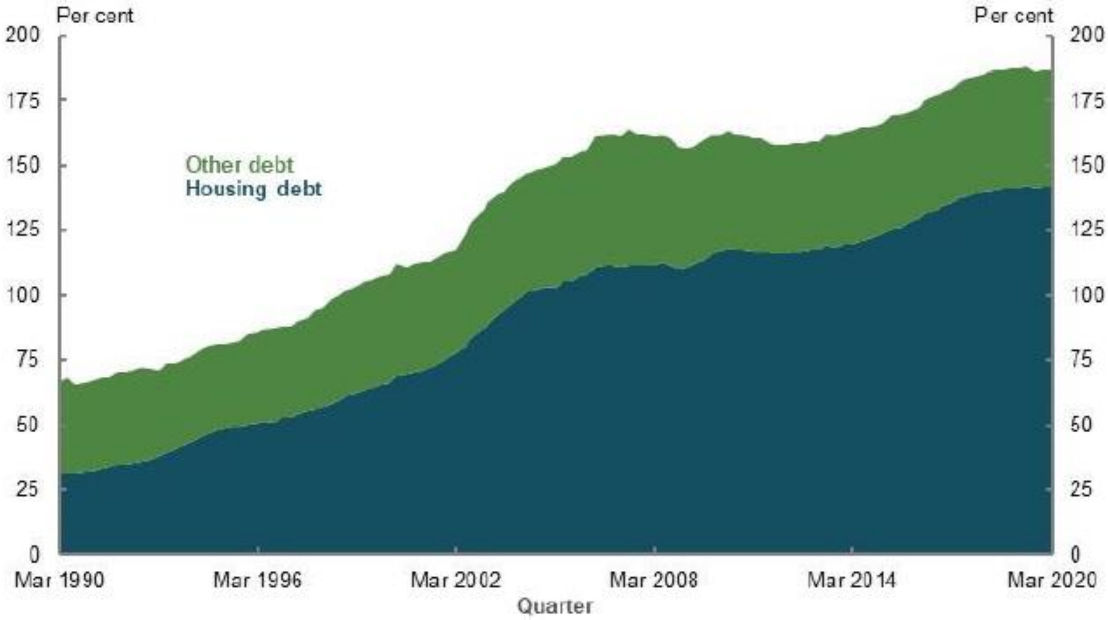
The difficulty, increasingly, is in attaining 'outright ownership' unencumbered by mortgage debt prior to retirement. The evidence points instead to more Australians entering their pre-retirement years (broadly 55 to 64) significantly mortgaged.

For example, the ABS Survey of Income and Housing (SIH) shows that for this age group, the percentage of homeowners with a mortgage has risen, from a low of under 20% in 1996, to sit at 54% in the (latest) 2019 iteration. The average mortgage then held by the typical homeowning 55 to 64-year-old was around $230,000.

In short, more than half of all pre-retiree homeowners (around 77%, the remainder are renters) are now still dealing with non-trivial mortgage debt as retirement approaches.

According to SIH data, the mortgage debt-to-income ratio for mortgagors aged 55 to 64 years rose from 72% to 138% between 1990 and 2020, while aggregate household debt has also ballooned, as the below chart illustrates.

Figure 2: Household debt as a percentage of disposable income



Source: Treasury, Retirement Income Review, 2020

The upshot of all this, as noted in the Retirement Income Review, is that:

"Increasing mortgage commitments have coincided with more owner-occupier households holding a mortgage at older ages. The median age for paying off a mortgage increased from 52 in 1981 to 62 in 2016."

Or in layperson's terms; half of owner-occupiers aged 62 or older still had a mortgage in 2016. The median age of mortgage extinguishment is only likely to have increased since then.

Lump sum withdrawals – the joker in the retirement income pack?

Households approaching retirement with material mortgage debt outstanding have three main choices: extend their time in the workforce in a bid to reduce/extinguish that debt; accept they can't and aim to service it in retirement; find a source of capital to extinguish it at or prior to retirement.

There is a growing pool of evidence that many retirees are choosing the third option and using their super to do so.

The survey of retirement and retirement intentions conducted by the ABS provides insights into the retirement plans for people aged 45 and over, and shows a clearly accelerating trend of Australians withdrawing their super to meet property related expenses.

In 2013 around 25% of lump sum super withdrawals were used to pay off a mortgage, acquire a new home or renovate an existing one. By 2017, that had increased to 29%.

The latest survey data shows the main uses of super lump sums, across all participants surveyed, as follows.

Figure 3: Main uses of super lump sums, 2022-23

Source: Author's calculations from ABS Cat 6238.0 (Retirement and Retirement Intentions) – Table 8

Of the individuals surveyed, around 63% had taken some amount of super as a lump sum withdrawal during 2022-23. As before, paying off a mortgage or acquiring/renovating a home was the most cited use of super withdrawals.

A thorny issue for super funds

To be clear, mortgage debt approaching retirement is unlikely to concern the top 20% of near-retirees by wealth and income. Particularly so SMSF members aged 60 – 64 with, according to the most recent Australian Taxation Office (ATO) data, combined couple median balances close to $1.8 million.

But for median homeowning 60 – 64-year-old couples in APRA-regulated funds, with combined super balances closer to $400,000, material mortgage debt at retirement will increasingly be the norm, not the exception.

As the Treasury noted in its 2023 Intergeneration Report, the fact that a non-trivial amount of this combined super appears to be extinguishing/reducing mortgage debt clearly *"impact[s] patterns of how superannuation is drawn down"*.

It is very likely that many APRA-regulated superannuation funds will, depending on the sociographic nature of their membership base, increasingly be impacted by Australia's growing mortgage indebtedness.

Super funds would do well to revisit the long-held industry presumption of unencumbered home ownership at the point of retirement and adjust their retirement solutions accordingly. They should also be looking at ways to obtain, estimate, forecast or otherwise establish the home ownership status/equity of their members.

Factors such as whether a property is likely to be owned outright or with a mortgage at the point of retirement, or whether a member is more likely to be renting, are insights that forward-thinking funds should be developing as part of their retirement income covenant obligations.

Armed with this data, funds might be able to forecast a ***'Net Pension Generating Super'*** (NPGS) value for members; that being the total forecast accrued super at the point of retirement less any likely property-related withdrawals, ideally at the household level.

That's a more pragmatic starting balance from which to make retirement income projections for most fund members today.

Housing equity will continue to dominate household wealth into the future, with super narrowing the gap as the system reaches full maturity over the next few decades. We need to stay vigilant to the interplay between the two; ensuring that mortgage debt doesn't negate super's retirement income enhancing ability for everyday Australians.

Harry Chemay has over 27 years of experience in both wealth management and institutional asset consulting. Initially a private client adviser with an SMSF focus, he has since consulted across wealth management, FinTech and superannuation, with a focus on improving post-retirement outcomes. This article broadly encapsulates the key themes of a presentation delivered at the recent 2024 IBR Post-Retirement Conference entitled 'Housing and Retirement: In Search of a Unified Approach'.

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Why megatrends can deliver big upside (and downside)

Alan Pullen, Elisa Di Marco

Megatrends are long-term structural changes that affect the world we live in. Importantly, they shape communities, but they also create investment opportunities and risks.

What we have learned from historical megatrends is:
1) they often solve a problem through innovation;
2) the scope of the megatrend can initially be underestimated;
3) the duration of a megatrend is typically longer than anticipated

There are numerous megatrends likely to influence markets that investors should consider: the shift to the cloud and generative AI, the ageing population, rising geopolitical tensions and so on. Today we highlight just some of the megatrends we are monitoring.

The continued growth in 'winners take all' dynamics

A megatrend that continues to play out is growth in “winner take all” or at least “winner takes most” dynamics in the global economy. Reduced cross-border frictions, the growth in digital goods and distribution channels, and the increasing importance of scale and network effects have allowed companies to scale to a size almost unimaginable in the past.

The rise of the so-called 'magnificent seven', the group of leading US technology companies, is a good example of these forces playing out. This group now accounts for a higher share of global markets than the leading companies of the tech bubble era of the early 2000s. However, unlike that time, their size today has predominantly been fuelled by enormous growth in revenues and profitability, albeit some speculative elements may have played a part more recently.

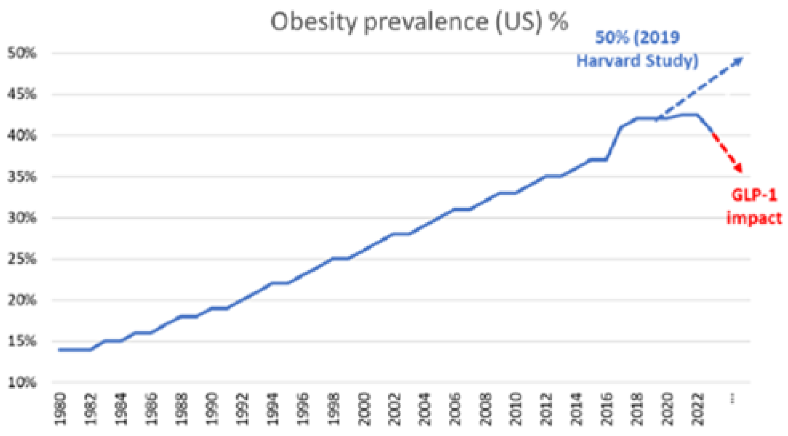
A key risk for some of these businesses is antitrust. Microsoft, Apple and Alphabet have recently attracted the attention of the antitrust authorities, with increased competition the primary motive. We see a low probability that regulators break-up these businesses meaning the underlying economic forces will continue to allow successful businesses to scale far more quickly and to far larger sizes than historically was the case. This presents a significant opportunity for global investors, as these companies can deliver outsized returns. On the other hand, these trends also increase disruption risks to legacy businesses and industries.

To benefit from the former and guard against the latter, investors should focus on quality companies that have strong and enduring competitive advantages. These advantages typically include scale, pricing power, brand strength, network effects, and intellectual property.

GLP-1s and solving obesity

One of the biggest health issues facing developed countries is obesity. The development of the GLP-1 class of weight loss drugs such as Ozempic promises to transform the treatment of obesity and significantly improve health outcomes for societies. GLP-1s stimulate the brain to reduce hunger and act on the stomach to delay emptying, so you feel fuller for longer, have a lower calorie intake and lose weight.

Take-up is likely to be strong over coming years as supply constraints ease and continued innovation delivers a more convenient oral pill and mitigates potential side effects such as nausea. Growing clinical evidence of health benefits, such as lower risk of heart problems, will also encourage governments and insurers to cover the cost of the drugs. These developments have dramatically changed the outlook for obesity, with the US recording its first fall in obesity rates since at least the 1970s, a dramatic turnaround from predictions of just a few years ago.

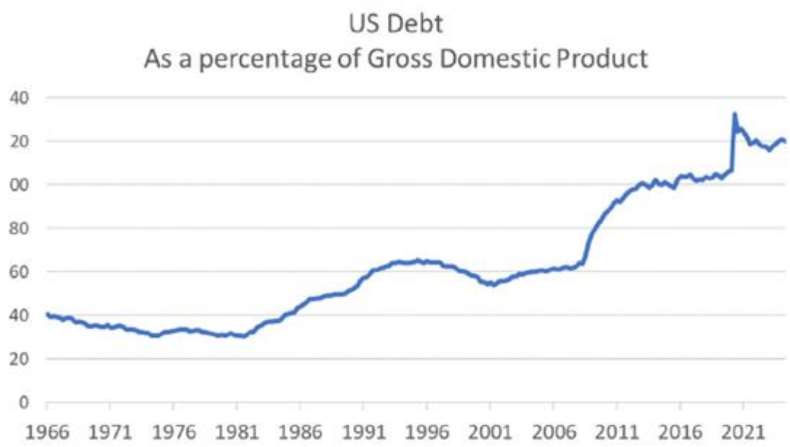


Source: CDC, OECD, WHO, IHME, Harvard

The development also has some significant investment implications. Most obvious are the potential investment opportunities in the drug manufacturers, although given high expectations we need to carefully monitor scientific developments and the pricing environment. There are also several investment risks to consider, with the potential for lower demand for certain medical device companies, food manufacturers and quick service restaurants.

The unrelenting rise in sovereign debt

Not all megatrends are positive for investors; one megatrend to be wary of is rising sovereign debt. In many parts of the world fiscal responsibility is no longer a priority as governments focus on more immediate issues and winning elections. In the US, the national debt has been rising since the 1980s. In 2010, following the government's response to the Global Financial Crisis, it first exceeded 90% as a percentage of GDP – the level identified by academics Reinhart and Rogoff as associated with a worsening in growth outcomes. A further spending binge during the 2020 covid pandemic has resulted in the US national debt rising to more than 120% of GDP.



Source: Federal Reserve Economic Data

With the US Federal budget deficit expected to hit $1.8 trillion in 2024 and the new President promising billions more in spending, debt is likely to continue to build. US national debt has not been a major issue for markets to date, but the risk of a debt crisis, accompanied by rising bond yields and volatile markets, increases as debt levels continue to rise. Many other countries are in a similar position, with debt to GDP exceeding 100% in the UK, France, Spain, Italy and Japan. Australia is relatively well placed with the national debt at 38% of GDP.

What does this mean for investors? Governments have three ways to "solve" excessive national debt: (1) austerity – cutting spending and raising taxes; (2) default; or (3) financial repression – printing money to inflate the problem away. The first is politically unpalatable and appears unlikely, the second would be an outright disaster and can be avoided by countries that issue debt in their own currency such as the US. Thus, the most likely outcome is money printing, or central bank financing of budget deficits in more technical terms, resulting in a period of structurally higher inflation.

While it's impossible to be precise in terms of the timing of a potential debt crisis, investors can seek to protect themselves by investing in real assets, such as property and equities, with a focus on high-quality companies with pricing power that can protect investors in times of high inflation.

These are just a few of the megatrends shaping markets today and in the future. As investors, a long-term focus and active management are key to both taking advantage of the opportunities these trends provide and avoiding risks that may arise.

Alan Pullen is a Portfolio Manager and Elisa Di Marco is an Investment Director and Portfolio Manager at [Magellan Group](), a sponsor of Firstlinks. This article has been issued by Magellan Asset Management Limited ABN 31 120 593 946 AFS Licence No. 304 301 ('Magellan') and has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not take into account your investment objectives, financial situation or particular needs.

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Fixing the construction industry house of cards

Bradley Hastings, Peter Swan

If there is an industry Australia needs confidence in right now, it's the residential construction sector. Yet, at a time of unprecedented need to build, construction companies are collapsing like houses of cards, leaving consumers with lost deposits and half-finished homes.

For consumers, embarking on building or renovating a home represents a large financial commitment, however when compared to other major investments that Australians will make in their lifetime, protection for their funds is limited. Indeed, builders can – and do – spend consumer deposits in any way that they please.

This article argues for the introduction of a regulatory mechanism that ring-fences consumer funds as a necessary element to restore confidence in the sector, improve the financial viability of homebuilders, and give hope that national home-building targets can be met.

Something's broken in the residential construction sector

Australia needs to build new homes. Driving demand is high immigration, with 2023 seeing a net migration of 518,000 immigrants, coupled with an ongoing trend for fewer habitants per home. On the supply side, building commencements are in decline, with 2024 data for new dwelling commencements at 10-year lows. Overall, the ratio of new population to new dwelling approval is the worst since data began to be recorded in 1984.

Despite this urgent need to build, residential construction companies are going into liquidation at an alarming rate. According to ASIC data, in the 2023-2024 financial year 2,832 construction companies went into insolvency, representing the greatest proportion of company collapses, and a problem that is trending worse, not better. These are not small nor newly established companies either. Several industry-revered names have gone under, including Clough Group, Probuild, and Porter Davis Homes.

Covid disruptions, including skilled labour shortages and rising raw material costs, are often blamed for the high level of insolvencies. However, as the economy begins to settle down, the building industry doesn't appear to be following suit. Warning signs have been unheeded, with a 2022 review by the Reserve Bank of Australia identifying financial pressures across the sector. This same report predicted that insolvency levels would increase – exactly what has transpired since – and the potential for the financial stress of these insolvencies to spread to consumers and the wider construction supply chain.

Going 'under the hood', Australia's homebuilding industry is characterised by low profit margins and fixed price contracts, meaning that there is little headroom nor mechanism for builders to absorb pressures such as rises in material costs and shortages of labour. Indeed, rising labour and/or material prices are a common tune when companies have entered into insolvency.

This means that many homebuilders have been operating at negative cashflows, where suppliers don't get paid, and projects are left unfinished. According to the Association of Professional Builders," the construction industry is broken and will continue to fail until it is fixed", a call that has been echoed by investigative journalists and suppliers to the sector.

Consumers left 'carrying the can'

When a residential homebuilder goes bust, consumers become unsecured creditors and are at the bottom of the food chain after a lengthy insolvency process. For many consumers, the great Australian dream of building or renovating a home has turned into a nightmare. News is replete with stories of lost consumer deposits and half-finished homes.

The only available remedy is builder's insurance, with most states (Tasmania being an exception) legislating that builders take out insurance that covers an insolvency event. However, such protection has bounds: claims cannot be initiated until five weeks after insolvency, policy limits vary between states, and in some cases, are limited to 20 per cent of the value of the build. In the case of Porter Davis Homes, this insurance wasn't taken out in the first place, leaving consumers completely in the lurch.

The fallout does not stop at consumers; subcontractors also join consumers on the unsecured creditors' lists. Often small or family-run businesses become unsecured creditors needing to cover the cost of their materials and staff if they want to continue to trade.

The asymmetric risk for consumers, compared to other largest investments

Embarking on building or renovating a home is one of the largest investments an Australian will make. Yet, in comparison to other large investments, such as superannuation, banking deposits, or payments to professional services firms, there is little regulation in the construction sector regarding how consumer funds are utilised and protected.

Across financial services, regulations protect consumer funds in the event that one of these institutions collapses. Consider consumer payments for legal services; here consumer funds must be held in a client account and only used for their intended purpose. Contrastingly, when a homeowner places a deposit with a builder, this money can be spent for any purpose. In some cases, there have been stories of builders on luxurious holidays at the same time as homes go unfinished. More often, given the cash flow pressures across the industry, consumer deposits from one project are used to complete prior commitments.

It seems nonsensical that consumer deposits can be used for purposes outside which they are intended, however builder accounts are opaque and it is very hard to know where the money goes and little incentive or need for homebuilders to spend money on the project for which it is intended.

One remedy for homebuilders' tight cash flows is to delay payments to suppliers. Another remedy is to take on more projects because these new deposits will increase cash flow in the short term. Paradoxically, this means that troubled builders put more consumers at risk, thus becoming a classic Ponzi scheme – until it falls over.

More money does not fix a broken system

The present political solution to Australia's home-building challenge is to throw a wall of money at it. Federally, there is the 1.2 million new homes target backed by the $10 billion Housing Australia Future Fund, a $3 billion New Homes Bonus, and a $2 billion Social Housing Accelerator. States are chipping in, too; one example is the New South Wales Government's $2.2 billion commitment to new infrastructure and unlocking land – all with the view to promote new dwellings.

The NSW Premier, Chris Minns, says his state is currently unable to meet its target of 75,000 new homes annually. There is very little evidence that throwing money at the problem has yet resulted in a single new home being built, but plenty of historical evidence that such large-scale stimulus will increase inflation – exactly the pressure that the residential construction sector has proved it cannot cope with.

A solution – protecting consumer deposits

Against a backdrop of stories of consumers being left in the lurch, it is hard to see confidence returning unless the industry takes a new approach. Financial services firms already provide a template for ring-fencing consumer funds and ensuring that money is spent for its intended purpose. Extending this protection to the residential construction sector would require setting up project accounts, where consumer funds reside until they are drawn down by builders and subcontractors and the work is completed to standard. In the event that the builder goes bust, this money remains in place to pay subcontractors and continue the build. A side benefit of this approach is that it may improve the robustness of the construction industry, providing homebuilders with a motive to ensure that each project stands on sound financial footing.

Stories of consumers losing their deposits are not what is needed right now. Fragile supply chains where subcontractors are unsure if they will get paid do not bode well for the sector either. The idea of ring-fenced accounts is not new. It's time for governments to fix what is broken, chiefly how money flows through the industry. Doing so might be the only way to get value for money from Australian taxpayers' investment in new homes.

Dr Bradley Hastings is an Insights Associate at the UNSW Business Insights Institute and Dr Peter Swan is a Professor in the School of Banking and Finance at UNSW Business School. To learn more, watch SBS Insight: Season 2024 Episode 23 – Buildings Blocked, which features Dr Brad Hastings.

The UNSW Business Insights Institute delivers economic and business insights, research and methods to government and business. Using a program-based approach consisting of Knowledge Hubs and Research Labs, the Institute helps industry partners solve complex challenges by providing them with access to novel research insights.

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How investor portfolios have become riskier versus history

Carol Geremia with James Gruber

[This is an extract of an interview with MFS Investment Management President and Head of Global Distribution, Carol Geremia. Recently, Ms Geremia visited Australia and spoke at the CFA Society investment conference in Melbourne.]

James Gruber: You speak of a growing disconnect between the purpose of the investment industry and real-world outcomes. Can you first define what you believe the purpose of the industry is?

Carol Geremia: Yes, and I'll just preface this by saying part of my comments in my paper is referencing the Big Shift - that's the paper that State Street wrote - and I thought they did a good job defining the purpose of the industry is. It's really to support or drive economic prosperity by allocating capital responsibly and helping investors achieve long-term financial goals. It's really this dual purpose that I think is an important distinction, not one purpose about helping investors meet financial goals. Much of it is how also we're putting their money to work.

Gruber: You talk about a disconnect between the purpose and what investors need. Can you elaborate on that?

Geremia: Yes, this growing disconnect of, we have become so short-term and one of the stats that I use is the average holding of a stock in 1950 was eight years and today it's five months. And I think that as investors, and as risk has increased dramatically, we've continued to just pile in lots and lots of money into risk areas like equities and ownership of equities, and it's having probably an unintentional effect to creating the misalignment. We say we're long-term, we say we want to allocate capital responsibly, and yet as time horizons have shortened, we've really sent different messages and incentives to the companies that we own inside the portfolio. It also incents the adviser to try and hold us accountable as active managers, which is a good thing to do, but it's in shorter periods of time. So a full market cycle has almost gotten cut in half.

Nobody gives you a full market cycle really to perform and the residual effect of that is that people are hiring and firing active managers based on past performance. It's this chasing past performance environment, and again I think is a misalignment to how we should be putting other people's money to work.

Gruber: If I put that simply, investors are thinking shorter term, therefore institutions are investing shorter term and that's increasing risks for both. Is that a fair summation?

Geremia: No, I think it's just missing one last piece … that short-term drive to meet performance pressures is also impacting the companies that we're investing in because they really see that their shareholders, their owners, are short term in committing capital to their strategy, to their underlining business … it's like a cascading effect.

Gruber: That's a good way to explain it.

Geremia: It's a cascading effect, but you did start with the right comment which is at the end of the day it does increase risks as we shorten time horizons and shorten them more and more. It's increasing the risk that you're not going to generate the long-term results that you're saying that you're going to generate.

Gruber: The other side of it, which you mentioned in your presentation, is that we've had this plethora of products that have been created over the recent decades, and most prominently, probably passive funds, you've also had private equity, venture capital, all these kind of things. The providers of these products would say they de-risk portfolios, but you seem to indicate otherwise. Would that be correct?

Geremia: Yes, I'm not even sure how they say they de-risk. I don't even know what that argument is, quite frankly, because I think there's 2.4 million indices to 43,000 companies. I'm not saying those are products, they are benchmarks. But the whole idea is that we're building portfolios to measure ourselves against all these benchmarks. And so it's created this short-term pressure to beat the benchmark when, the benchmark is a passive owner of companies they haven't looked at, haven't studied, don't know management. You don't know what you own, you're just part of the benchmark. All of that increases risk in terms of not knowing what you own.

Gruber: Sure. And the other aspect which you touched on earlier, the whole concept of shareholder value, which has been trumpeted for a long time, you're advocating something different for the industry. Why is that?

Geremia: Well, it's less an advocation, it's questioning. It's questioning whether shareholder primacy still works. And I cite Leo Strine in suggesting that it hasn't worked. I'm not saying it hasn't worked completely. I think that the point is that the pressure companies are under today are having to respond to the stakeholder versus just the shareholder. They've got to prove that they are treating their employees well today. They've got to ensure that they've got a climate transition plan. They've got to provide massive amounts of measurement data that they're on target to meet net zero. All of these things actually are going to impact returns. That in the short term, this idea of maximizing profits for just the shareholder is under a great deal of pressure because of all of these systemic risks that companies are having to answer for. My question to Leo Strine is that shareholder primacy might have been a 'win win that hasn't' but could Milton Friedman (who developed the shareholder primacy theory) ever have imagined so much passive capital in the system? If our measurement stick, our measurement benchmarks did not become investable assets or an investable portfolio, could shareholder primacy have worked?

Gruber: What do you see as some of the solutions for the investment industry to address some of these problems?

Geremia: I think there's just a lot of good opportunity to change the dialogue in what we want to hold managers accountable to do. It's one thing if it's just, hey, I have to generate the highest return for your retirement account. That's what an investor might want. But then if you tell them, well, I'm trying to make sure I'm not investing in companies that are dumping sludge in the river using third party supply chains that have human trafficking. All of these things that have become reality to our economies and the global markets, we've got to bring this story of responsible allocation and stewardship to light. And like I said, I think technology could be our friend here, but it's to demonstrate other measurement factors that show value for money. But as an industry, we should step into that as an opportunity to show a stakeholder view versus just beating a benchmark in one, three and five year periods of time.

This is an extract of an interview with MFS Investment Management President and Head of Global Distribution, Carol Geremia. Recently, Ms Geremia visited Australia and spoke at the CFA Society investment conference in Melbourne.

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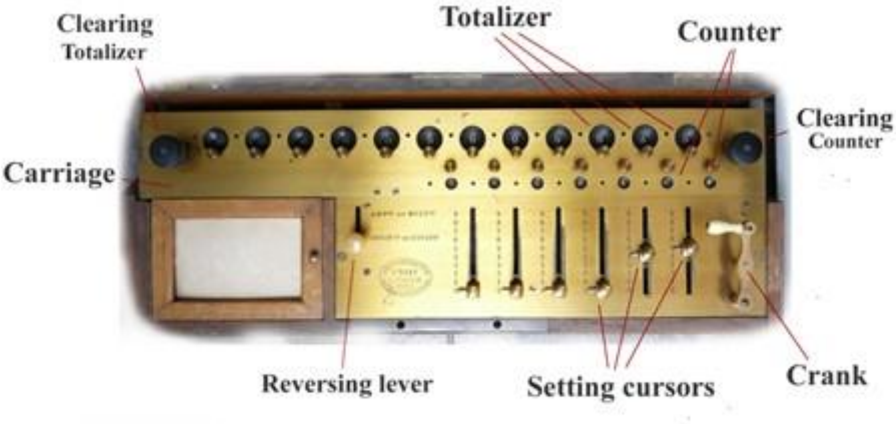
The abacus, big data and a brief history of indexing

Arian Neiron

When Charles Dow, a journalist, developed the Dow Jones Industrial Index in 1896, the abacus was still widely used to make calculations. Arithometers, which were invented by Charles Xavier Thomas de Colmar in 1820 and in commercial production by 1851, were also a common sight.



Source: arithmometre.org

Commercial production of the arithmometer ended around 1915 and abacuses are largely confined to primary schools these days. Meanwhile, the Dow Jones Index is still widely quoted. Let's start by looking at how it is constructed.

The Dow Jones is a (share) price-weighted index, which means that the stocks with the highest price have the largest weighting. This would have been the easiest way to create an index with the calculation tools available at the time.

Currently, UnitedHealth Group, which has a price of US$585 per share, has the highest weighting in the portfolio at 9.6%. By contrast, Apple is roughly six times larger than UnitedHealth in terms of market cap yet only makes up 3.5% of the Dow Jones.

The Dow Jones provides a general barometer of US equity performance. But it does not make any sense from an investment perspective because a share price could be a function of having fewer (or more) shares on issue. A share price, by itself, is not useful for making investment decisions.

After World War I and the next type of indices

At the turn of the 20th century, new mechanical calculators were usurping the arithmometer as the calculator technology of choice. The comptometer, the Burroughs adding machine and Odhner's arithmometer became the calculators of choice.

Indices evolved as they were able to embody more complex calculations. The next major innovation was 'market capitalisation', which was pioneered by Henry Varnum Poor and the Standard Statistics Co.

The result was the 1926 predecessor of the United States' S&P 500. A market capitalisation index uses the size of a company for inclusion. Therefore, in a market capitalisation index, the larger companies have bigger weights. In the S&P 500, Apple makes up around 6.7% and UnitedHealth around 1.2%.

Market capitalisation indices were considered better barometers of the market, so became the source of data quoted in finance news. Again though, the index was intended to be a market barometer, not a tool for investment.

In the 1950s, research by Harry Markowitz and William Sharpe supported market capitalisation indices as an investment tool. This is the Theory of Efficient Markets. Based on this theory, market capitalisation-weighted indices deliver the best returns for the least risk. It was thought that you cannot outperform the market unless you take on additional risk.

But there are numerous examples where the market has been wrong. There have been periods of irrational buying and selling and there have been periods during which bubbles have formed.

Consider too, the differing needs of individual investors and institutions. Each has a unique reason for buying and selling shares and could assign a different value to different aspects of the financial transaction which is often unrelated to the valuation. For example, investors sometimes trade for tax, income or even emotional reasons. As a result of these factors, the market is not efficient in reality.

By the 1970s, professional fund managers were aiming to exploit these inefficiencies, targeting returns above market capitalisation indices.

Computers, 'big data' and the next wave of indices

By now IBM had created mainframes, and the desktop computer was becoming a reality. The first handheld programable calculator, the HP-65 was released in 1974 at US$795 (Nearly US$5,000 in today's dollars).

Computers and calculators were getting faster, smaller and cheaper. Savvy active fund managers were able to use some of this technology to their advantage.

An active fund manager proactively makes decisions over which investments are bought or sold, generally with the aim of outperforming a market index. This is done via a mix of qualitative and quantitative research, personal judgement and forecasting, so computing technology and its implementation could be a competitive advantage.

When actively managed funds were first offered to investors, performance was uncertain, and the costs were high. Sometimes the returns were good, but often they were not. Many people found this a poor bargain, so preferred lower-cost passive funds which tracked market capitalisation indices. In these passive funds, returns were not high, not low, just the market average. The rise of ETFs this century has largely been driven by demand for these passive funds.

At this stage, passive funds only tracked market capitalisation indices. However, sophisticated investors in passive funds started to consider the possibility that alternate index weightings, different from market capitalisation, could give investors higher returns for the same, or even lower levels of risk.

Alternate index construction methods started to focus on grouping companies with common valuation characteristics, common balance sheet qualities and common fundamentals to screen or weight stocks, including equal weighting constituents.

These innovative index construction techniques became known as 'smart beta'. They are 'smarter' because they take a more considered approach to what goes into the index, other than just the size of the company.

These index innovations have been driven by a combination of investors seeking investment outcomes beyond benchmarks and the advent of technologies like 'big data' that enabled financial professionals to better leverage the data in financial reports, performance data points and mathematical algorithms to target these outcomes.

Unlike market capitalisation indices, these 'smarter' indices are created with an investment outcome in mind and were not created initially to represent the performance or health of the share market.

We like to say smart beta combines the best of active and passive investing: having the potential for better investment outcomes while being rules-based, transparent and cost-efficient.

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