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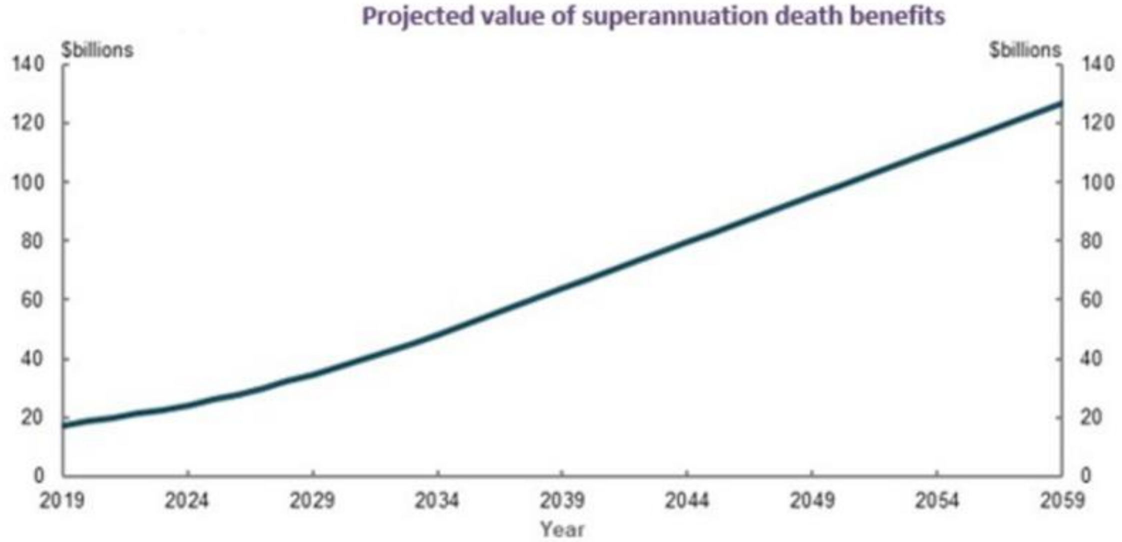
Editorial

Several Government reviews have highlighted how retirees tend to be more frugal than they need to be.

In 2020, Treasury's *Retirement Income Review* said that around 90% of retirees drew the minimum amount required and died with much of their super balances untouched. The review revealed that retirees lack the confidence and support to spend their savings, resulting in a poorer quality of life in retirement.

It suggested that the problem would become more pronounced going forward as people retire with larger superannuation balances. It also included projections that outstanding superannuation death benefits could increase from around $17 billion in 2019 to just under $130 billion in 2059, assuming there's no change in how retirees draw down their superannuation balances.



Note: In 2018-19 dollars. Superannuation death benefits include insurance payouts due to death.
Source: Analysis of Rice Warner estimates for the review.

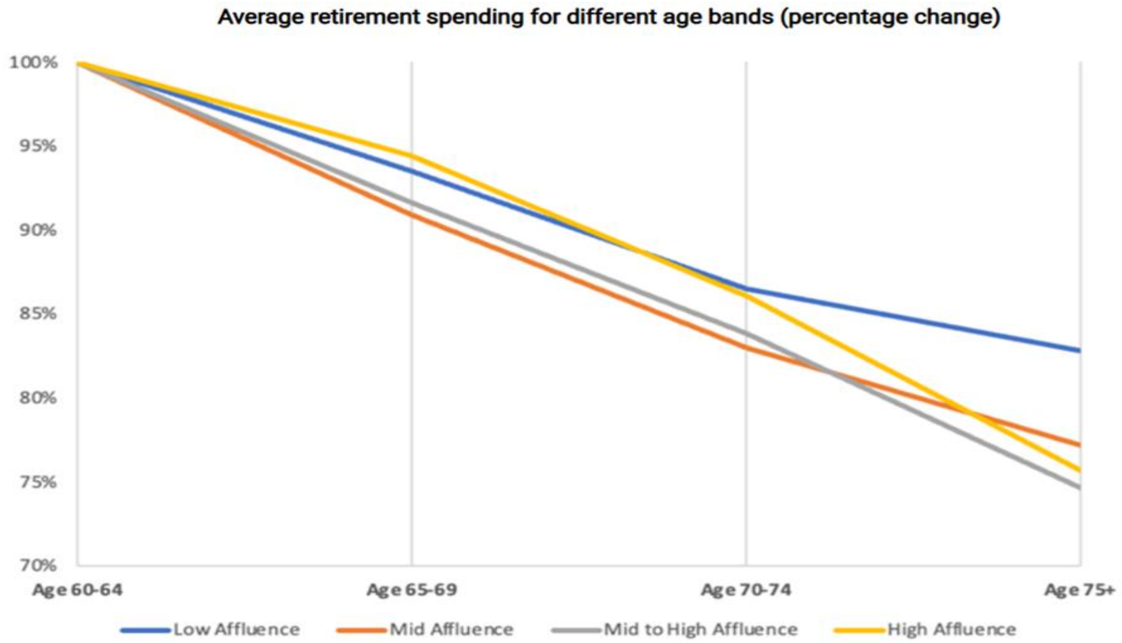
The *Intergenerational Report 2023* found that outliving one's savings is a key concern for retirees in deciding how to draw down their superannuation, and that's why many retirees draw down at the legislated minimum drawdown rates.

How retiree spending changes as we age

In an [article](#) in Firstlinks last year, actuary Ruvinda Nanayakkara outlined how spending in retirement varies for different age bands.

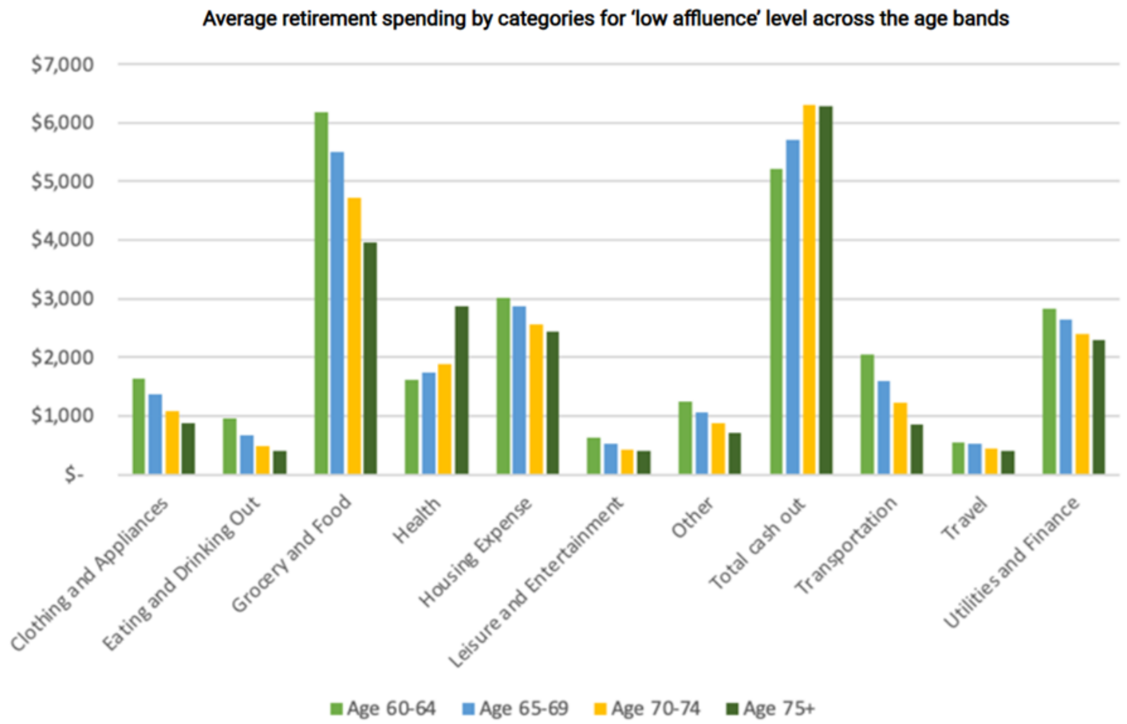
Using bank spending data, he looked at the percentage change in retirement spending, using the age 60-64 age band as the base year, and considering the relative decrease in retirement spending for older age bands.

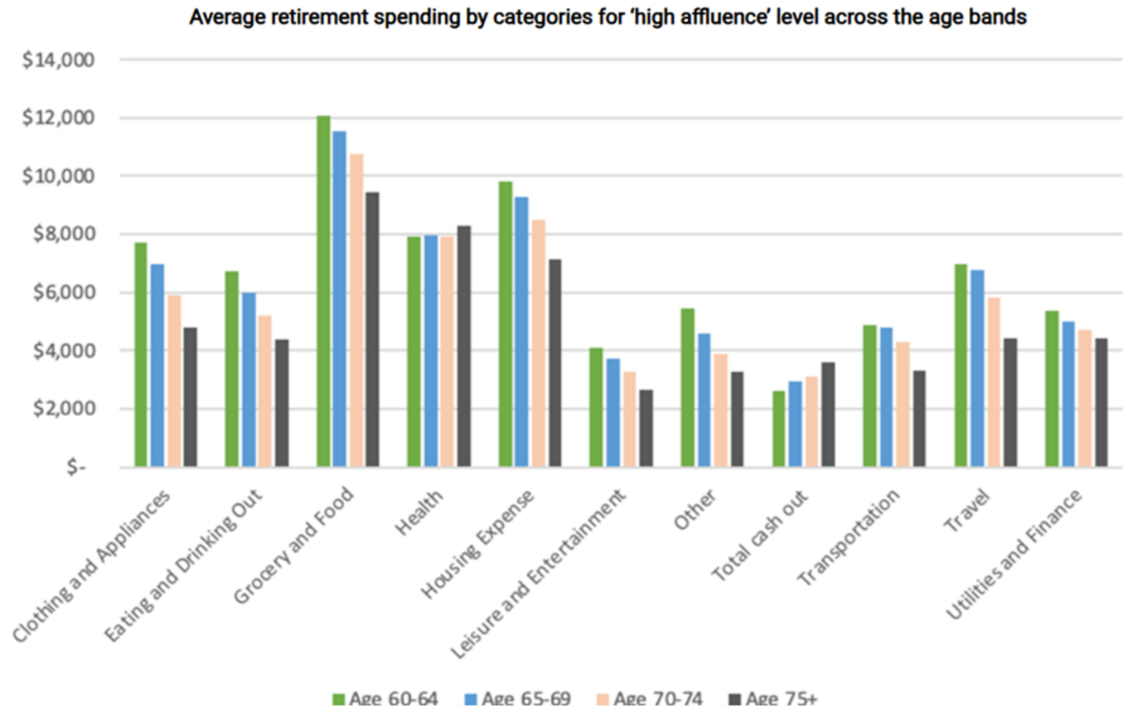
He found that for all affluence levels, there is a consistent reduction in spending across the age bands. In the *'low affluence'* group, individuals aged 75+ spent approximately 15% less than those aged 60-64. This reduction is even more pronounced for the higher affluent levels, with spending at age 75+ band reducing 20-25% of the spending levels observed at age 60-64.



Source: Spirit Super

For both 'high affluence' and *'low affluence'* groups, spending across most categories gradually decreases across the age bands, except for health-related expenses and cash withdrawals.





Source: Spirit Super

Explanations for frugality

Why aren't retirees spending more? It seems much of it stems from uncertainty about the future. That uncertainty includes longevity risk, rising healthcare costs, financial market returns, inflation, interest rates, and sequencing risk.

Another growing risk less mentioned is Government risk, with potential threats to Aged Pension funding, and further tightening of superannuation rules.

There's also the desire to leave wealth to children, especially given the cost-of-living crisis disproportionately impacting younger generations.

Other explanations

I've always thought that there may be deeper, psychological reasons for retirees underspending and recent research lends some support to this.

Scott Rick, an associate professor at the University of Michigan, suggests that there are three types of people when it comes to money: tightwads, spendthrifts, and those in between. He says tightwads and spendthrifts make up a disproportionate percentage of the population:

""Tightwads" experience too much pain when considering spending and therefore spend less than they would ideally like to spend. By contrast, "spendthrifts" experience too little pain and therefore spend more than they would ideally like to spend. Neither are happy with how they handle money."

Rick's research reveals that tightwads tend to be older than spendthrifts and that men are more likely to be tightwads. Tightwads are more highly educated and numbers oriented than spendthrifts.

Rick says that being a tightwad isn't the same as being frugal as "the highly frugal love to save, and tightwads hate to spend." And, "the highly frugal are generally much more at peace in their relationship with money than are tightwads."

Tightwads have far more in savings than spendthrifts and think in terms of opportunity costs when considering spending money. The high savings offer "no guarantee that tightwads feel financially comfortable. Subjective feelings of financial well-being are only loosely related to objective aspects of financial well-being."

On the other hand, spendthrifts are more impatient than tightwads and report a high susceptibility to shopping momentum ie. going to buy one thing and then getting carried away. And though spendthrifts have lower financial literacy on average, it isn't markedly different from the rest of the population.

One of the most fascinating findings is that as younger children, we tend to be more tightwads, this changes somewhat as we enter adulthood, but by the time that we become adults, we commonly revert to what our parents are on the tightwad-spendthrift spectrum. Put simply, our attitudes and emotions toward money as adults seem to follow those of our parents, whether we like it or not!

Possible solutions

The Federal Government is intent on getting retirees to spend more money. It wants those billions or trillions of dollars flowing in the economy, spurring GDP growth.

The Government recognizes that financial advice is one area that could help reduce the fear for retirees of running out of money. Hence, why it’s trying to reduce the cost of advice and pressuring superannuation funds to do more for its members in retirement.

The Government moves are supported by recent research from Vanguard which found that having high retirement confidence isn’t dependent on age or income, but rather on having a plan, and financial advice has a large role to play in that.

Low cost advice has obvious merit, though Scott Rick’s findings highlight how difficult it will be to change retiree spending habits. Let’s hope the Government doesn’t go overboard with any future ‘nudges’, or legislative solutions.

In my article this week, I look at the performance of major asset classes in 2024 and over longer timeframes, and the lessons that can be drawn for building an investment portfolio for the next decade.

James Gruber

Also in this week's edition...

Schroders' Duncan Lamont details the cases for and against continuing US stock market outperformance. We also have renowned market strategist, **Gerard Minack**, on the risks to the US outlook.

Negative gearing is often referred to as a tax concession. **Paul Tilley** investigates whether that's fair, and what changes Australia could make to ensure its tax system is more equitable.

Danielle Hart and Jane Koelmeyer explore the issue of untangling assets after a broken relationship. They detail the steps that people should take to protect themselves.

Australia hasn't had a bond market rebellion in a long time, but **Joshua Rout** from **Franklin Templeton** warns that upcoming state and territory bond issuance to fund record levels of Government spending could test the market in the near future.

Retirement village contracts can be complicated beasts. **Brendan Ryan** offers a primer on what to look out for before signing on the dotted line.

Lastly, in this week's whitepaper, **Fidelity International** outlines the financial needs of younger generations and what advisers and investment groups can do to cater to their preferences.

Curated by James Gruber and Leisa Bell

The perfect portfolio for the next decade

James Gruber

Let’s first review the performance of the major asset classes and sub-sectors in 2024.

The winners in 2024

The asset with the highest return last year would surprise many: it was gold, which jumped 39% in Australian dollar terms. Other big winners were US shares, up 37%, and Australian financials, with a 34% return.

The gold price rose by 27% in US dollar terms, but higher in Australian dollars thanks to a fall the Aussie dollar against the greenback.

Asset class returns

	1yr	3yr (p.a)	5yr (p.a.)	10yr (p.a.)
Australian shares	11.4%	7.4%	8.1%	8.5%
ASX financials ex REITs	33.7%	14.7%	12.1%	7.9%
ASX resources	-14.9%	5.5%	6.8%	9.3%
ASX small caps	8.4%	-1.6%	4.0%	7.3%
A-REITs	18.5%	3.5%	5.9%	8.4%
International shares	31.2%	12.3%	14.1%	13.2%
S&P 500	37.2%	14.4%	16.9%	15.9%
Aus Govt bonds	2.3%	-1.5%	-0.7%	1.7%
Aus corp bonds	5.4%	1.6%	1.7%	3.1%
Aus cash	4.5%	3.2%	2.0%	2.0%
Physical gold	39.4%	19.3%	14.4%	11.1%

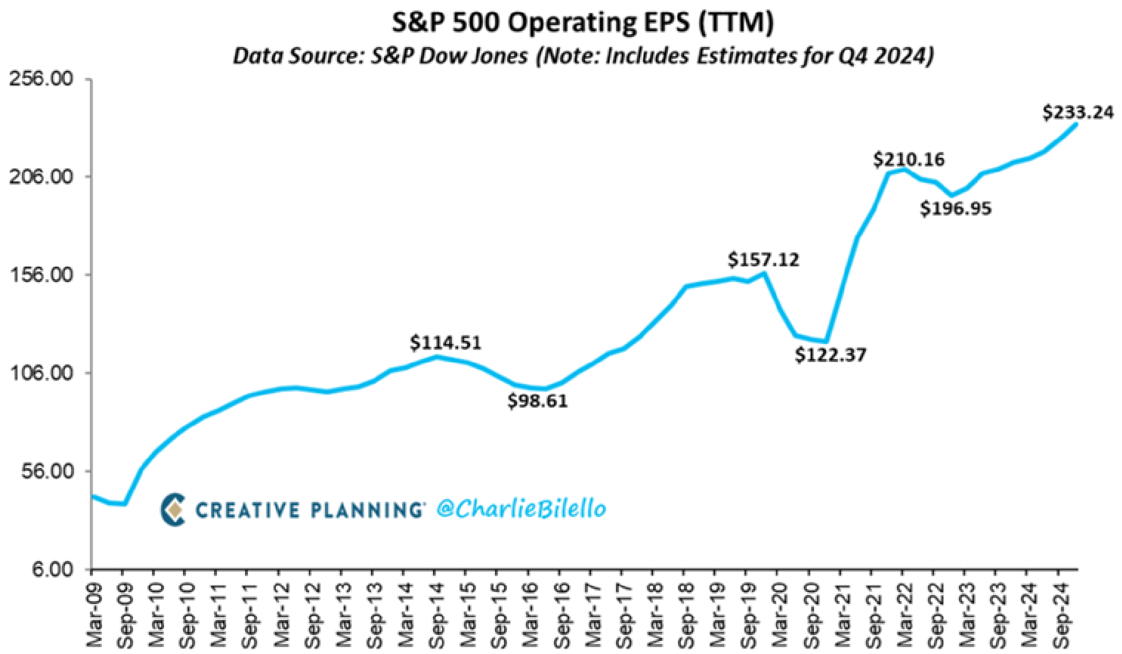
Note: All figures as at Dec 31, 2024. Aus shares = ASX 200, A-REITs = S&P/ASX 200 A-Reit Index, International shares = MSCI World ex-Aus in AUD, Aus Govt bonds = Bbg AusBond Treasury Index, Aus Corp bonds = Bbg Ausbond Credit 0+ index. Source: S&P Global, Bloomberg, Firstlinks

Why did gold go up so much? Historically, gold has tended to move inversely to the US currency – when the US dollar rises, gold often falls. But that wasn't the case in 2024.

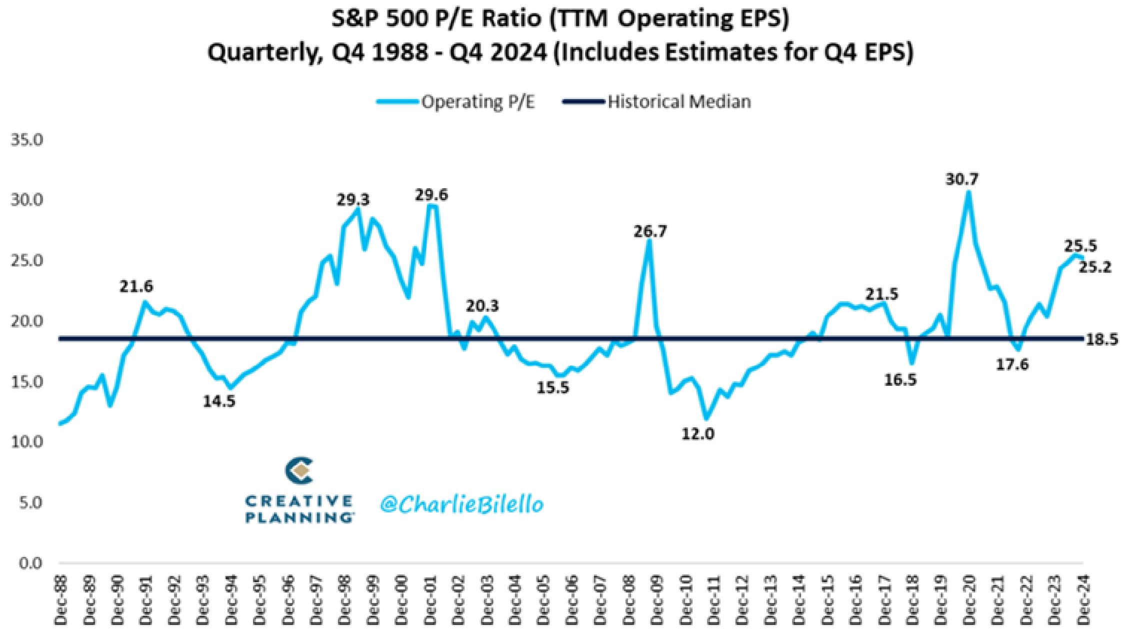
The World Gold Council's John Reade explained to Firstlinks in late October that gold has benefited from two things: central bank buying and emerging market demand. Central banks have been purchasing gold as they seek diversification following the American confiscation of Russian US dollar assets after Putin's invasion of Ukraine. Emerging markets have also been keen on the yellow metal, as the Chinese seek safety amid their economic downturn, and other countries such as India and Turkey increase their buying of jewelry and other gold-related products.

It's intriguing that Australian investors, especially institutions, generally shun gold, in spite of its recent strong performance.

US shares grabbed far more headlines than gold with its barnstorming 2024. The S&P 500 rose more than 20% for a second year in a row, driven by earnings and an increase in the valuations attached to those earnings. S&P 500 operating earnings rose 9% during the year to new record highs.

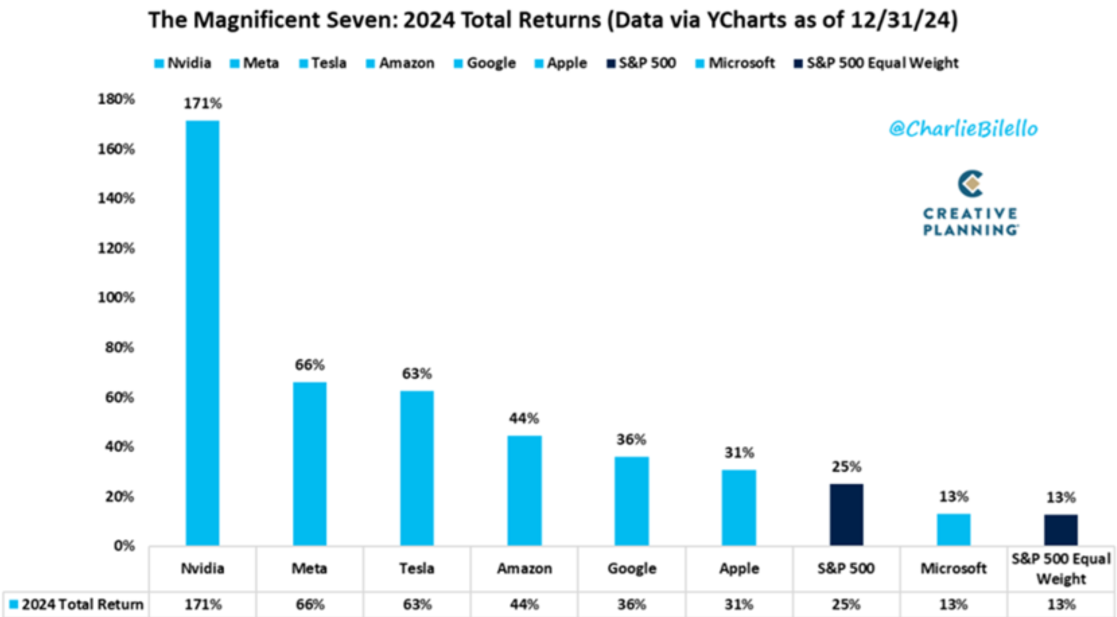


The market rise was aided by the S&P 500's price to earnings (P/E) ratio moving up to 25.2x at year-end from 22.3x at the start of the year.

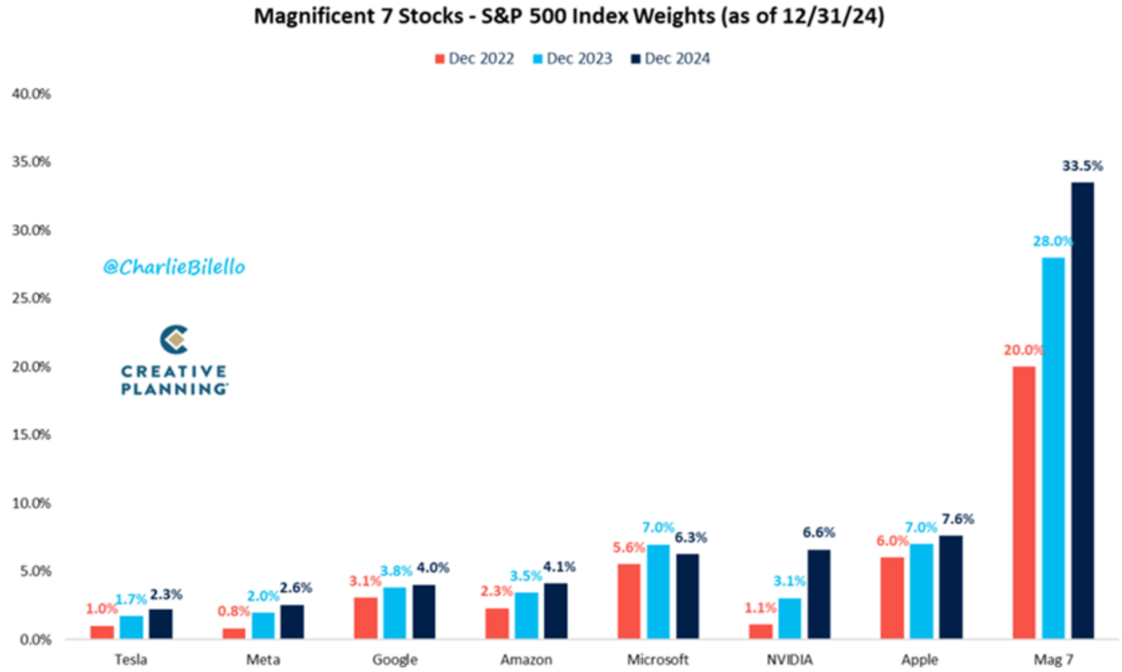


The 'Magnificent Seven' technology stocks helped the S&P 500 to new highs. They went up an average 61% in US dollar terms, compared to a 25% rise in the index (+37% in AUD terms).

Nvidia led the charge, up a stunning 171%, as expectations for AI demand soared. Following Nvidia was Meta, rising 66%, and Tesla, 63% higher. Microsoft was the laggard of the bunch.



The Magnificent Seven now accounts for 34% of the S&P 500, up from 20% just two years ago.



The other big winner from 2024 was the Aussie banks. The ASX financials sector ex-REITs leaped 34%, surprising many investors. Westpac was best, up 41%, followed by heavyweight, CBA, 37% to the better.

The amazing thing about the banks' performance was that their earnings last year went backwards, so their share price performance was entirely driven by multiple expansion. For instance, CBA is now the most expensive bank in the developed world, trading at 27x trailing earnings. That compares to America's largest bank, Bank of America, which has a price to-earnings (P/E) ratio of 16x.

The Australian banks were obviously helped by a rotation out of the miners, which suffered from China's economic slowdown. That rotation has slightly turned in 2025, with miners starting to find some love.

The other strong performer was the REITs. That may be a headscratcher for some, given the plight of the office and retail property sectors last year. However, Goodman Group accounts for almost 40% of the ASX 200 REITs index, and it rose 75% in 2024, thanks to excitement over its growing data centre portfolio.

Meanwhile, the ASX 200 increased 7% last year, and 11% including dividends. It was a decent enough year, albeit badly lagging the likes of the US. The main reason for being a laggard is that earnings barely grew in 2024 as the economy stalled.

The losers in 2024

The Australian miners were the biggest losers last year, dropping 15%. It didn't help that the price of our biggest mining export, iron ore, fell 28%. That resulted in resource majors, BHP and Rio Tinto, declining by 22% and 18% respectively.

Some of the biggest losses were in the lithium sector, as the lithium price went down a further 22% in 2024. That led to IGO, Pilbara Minerals, and Mineral Resources, sinking 43%, 45%, and 51%, respectively.

The other loser from last year was Australian Government bonds. The bonds went up 2.3% though lost money in real terms as they trailed the rate of inflation. Bonds are entering their 5th year of a bear market, with 2025 delivering more bad news so far.

The best over a decade

One year is just one year, and it's often best to zoom out to get a better picture of asset class returns.

Over the past 10 years, the standout performers have been US and international shares. The S&P 500 has returned 16% per annum in Australian dollar terms. America has had an amazing run since the financial crisis, with the index up 8.8x, and almost 10x including dividends, since bottoming in March 2009 at 666. Almost a 10-bagger over 15 years!

The US has helped international shares ex-Australia return 13% p.a. over the past decade. America now accounts for 75% of the MSCI World Index – it's now a case of where the US goes, the world goes.

Australia has trailed US and international shares badly over the past 10 years, rising 8.5% p.a. That's well below its long-run return of close to 10%. The banks have dragged on the index, despite a better 2024, due to tepid earnings growth.

Surprisingly, at least to me, is that miners have beaten the ASX 200 since 2015. That's because the resource companies had a sharp downturn from 2012 to 2014 as commodity prices swooned, but they've since somewhat recovered.

Bonds and cash over the decade have been poor investments, largely due to the low interest rates that prevailed up to 2022.

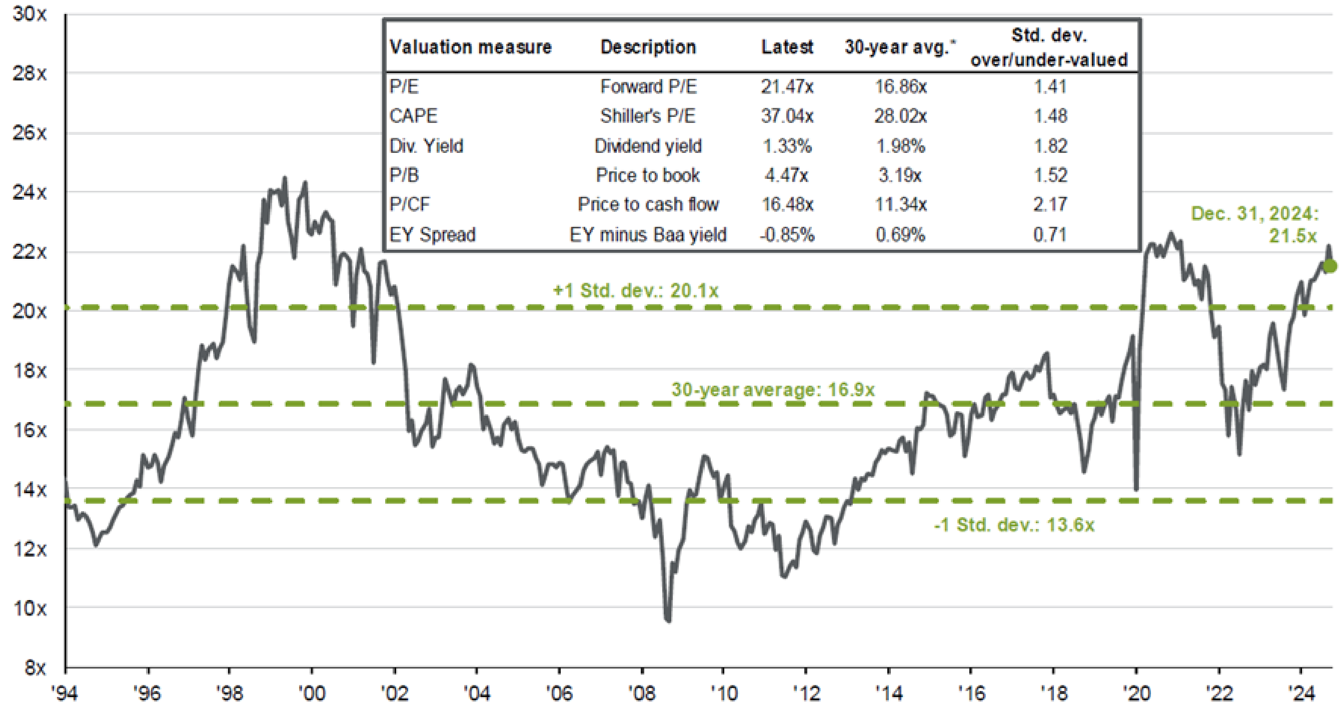
Meanwhile, gold has not only been a solid short-term performer, but a longer term one too. It's returned 11% p.a. during the past decade. That's better than Australian shares over the period.

What do past returns tell us about the future?

Unfortunately, the asset class returns of the past year and decade don't tell us a lot about what will happen during the next 10 years. They can give little clues, though.

US shares have clearly had an extraordinary run and look expensive, at 1-2 standard deviations above historical norms on most valuation metrics.

S&P 500 Index: Forward P/E ratio



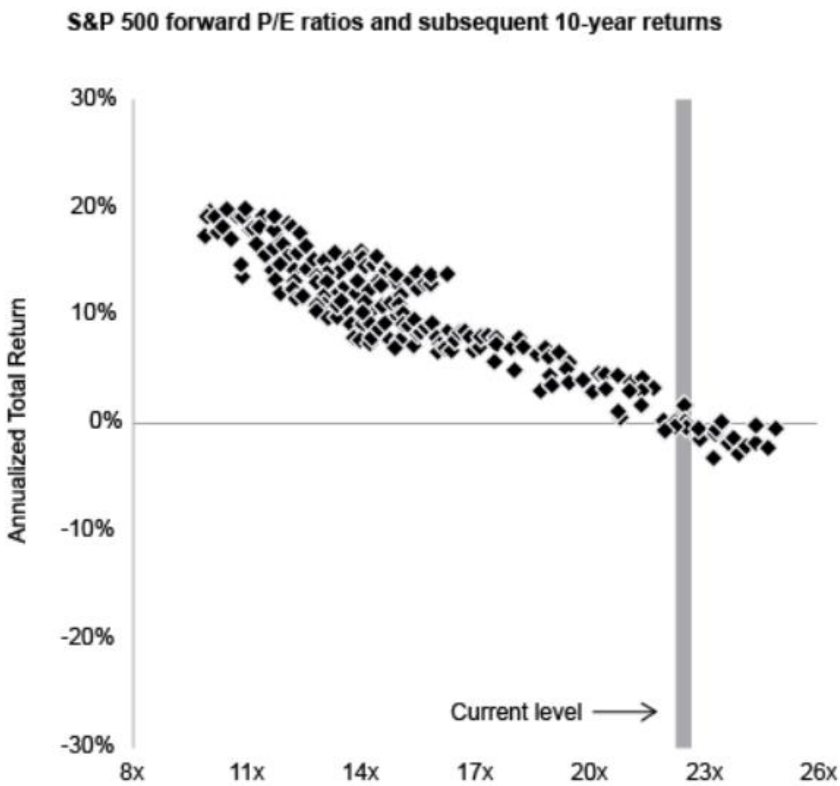
Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	21.47x	16.86x	1.41
CAPE	Shiller's P/E	37.04x	28.02x	1.48
Div. Yield	Dividend yield	1.33%	1.98%	1.82
P/B	Price to book	4.47x	3.19x	1.52
P/CF	Price to cash flow	16.48x	11.34x	2.17
EY Spread	EY minus Baa yield	-0.85%	0.69%	0.71

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since March 1994 and by FactSet since January 2022. Average P/E and standard deviations are calculated using 30 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Bloomberg US corporate Baa yield since December 2008 and interpolated using the Moody's Baa seasoned corporate bond yield for values beforehand. Std. dev. over-/under-valued is calculated using the average and standard deviation over 30 years for each measure. *Averages and standard deviations for dividend yield and P/CF are since November 1995 due to data availability.
Guide to the Markets – U.S. Data are as of December 31, 2024.

J.P.Morgan
ASSET MANAGEMENT

Current valuations for American don't augur well for future returns.

Unfortunately, most other developed markets, including Australia, also trade at higher than average multiples. It would surprise if banks didn't pull back from recent highs, unless they can generate some decent earnings growth. If the Big Four don't perform, it will be up to the resource companies to pick up the slack. And that will depend on commodity prices, whose future is always difficult to predict.



Source: JP Morgan

Bonds are offering greater competition to equities, with 10-year yields approaching 5%. Those yields should result in better returns for bonds over the next decade than the paltry ones delivered in recent years.

Gold has had a great run, though given its history of boom and bust, it seems unlikely to repeat that performance over the next 10 years.

What about alternative assets? Private equity and private debt have become increasingly important in the portfolios of super funds and other institutional investors. And of late, they have delivered commendable performance. Yet, they haven't been fully tested in times of steeply rising bond yields and/or deteriorating credit quality. That said, listed and unlisted infrastructure looks more interesting.

I'm often asked about Bitcoin. I briefly wrote about it and copped some backlash from enthusiasts. None of them have rebutted my critique that Bitcoin is yet to prove useful for anything barring speculation. If it becomes useful in the real world, I might change my mind. Until then, I can't advocate it for investor portfolios.

What should investors do with their portfolios?

Given this context, what should you do with your portfolio? Probably the worst thing that you can do is overreact to the past performance of assets and make wholesale changes to your portfolio. Tinkering perhaps, but radical surgery is usually unwise.

One of the best strategies to implement is re-balancing. I talked about this in a previous article on building a portfolio.

Say you've got a 60/40 equities/bonds portfolio, with a 70/30 split between international and Australian shares. Perhaps that split is now 75/25, given the recent outperformance of international stocks. Rebalancing back to 70/30 can make sense.

Research has shown that rebalancing every year or two, or when certain assets reach a certain percentage of a portfolio, improves investment performance in the long term. The reason for this is that rebalancing is essentially a value strategy: it switches out of outperforming, and possible expensive, assets into cheaper ones.

What if you're worried about the future and expect a sharp downdrift in stocks? Again, overreacting can be a mistake. It's handy to remember that Australian shares go up about four out of every five years on average. Therefore, if you're a pessimist, the numbers are against you.

That doesn't preclude buying some more defensive shares, if you're that way inclined. Defensive ASX stocks such as Woolworths, Endeavour, and Lotteries Corp are offering better value than a lot of other Australian companies at present.

James Gruber is Editor at Firstlinks.

The case for and against US stock market exceptionalism

Duncan Lamont

It is popular to hate on the US stock market and predict an end to its extended dominance, even as inflows continue apace. But bull markets don't die of old age. There has to be a reason.

In this article, I set out five reasons why now might be the time to downgrade exposure to US stocks (specifically, large caps). However, it would be unbalanced to not also consider valid arguments in the other direction. I highlight six here.

Whichever side of the debate you sit on, you should challenge yourself by considering the other, rather than blithely discounting it. Could US stock market exceptionalism continue?

The arguments against investing in US stocks

1. US valuations are uncomfortably high

US cyclically-adjusted price-earnings multiple (CAPE)

CAPE = price divided by 10-year average earnings, in inflation-adjusted terms. Data January 1871-November 2024. Source: Robert Shiller, Schroders.

Outside the peak of the dotcom bubble, US valuations are close to their most expensive in the past 143 years.

The chart above shows the cyclically adjusted price-earnings multiple (which compares prices with average earnings over the previous 10 years) but we could have equally made the same argument using other valuation measures and over shorter time horizons.

Although not a new argument, this year's rally has propelled valuations to uncomfortably high levels.

2. US valuations are stretched to the extreme vs other stock markets

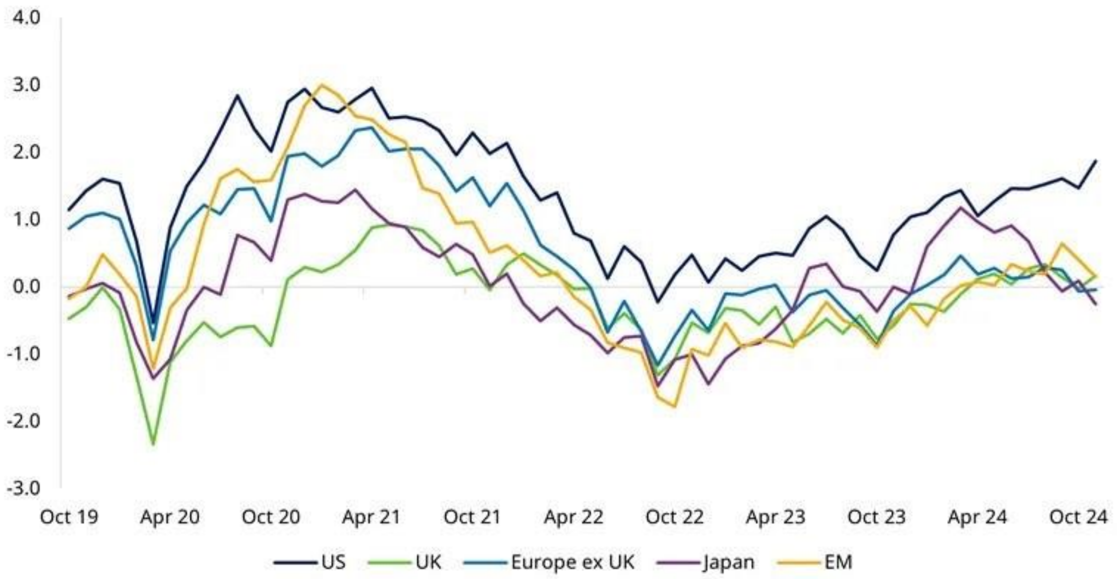
While the US is at levels which historically would have been bubble territory, valuations elsewhere are actually quite reasonable.

The chart below shows a composite valuation indicator for five major stock markets, with degrees of expensiveness/cheapness averaged across five individual measures: CAPE, trailing price/earnings, forward price/earnings, price/book, dividend yield. These are calculated on a "z-score" basis, which adjusts for differing variability of the individual measures to make them more comparable.

Outside of the US, valuations are close to fair value when compared with history. It is only the US which is extended.

Non-US valuations are reasonable, the US has become more expensive in absolute and relative terms

Composite valuation metric = Average z-score* across five valuation metrics

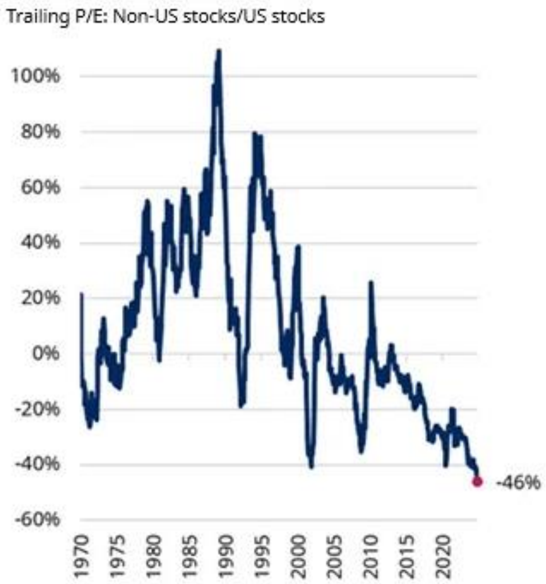


**Z-score measures the number of standard deviations above or below the average. Our assessment of expensive/cheap is relative to a 10-year rolling average of each market across five valuation metrics: cyclically-adjusted price-to-earnings, forward P/E, trailing P/E, P/B and dividend yield. Source: LSEG Datastream, MSCI and Schroders. Data to 30 November 2024.*

The consequence is that, on a relative value basis, other stock markets are valued at historically cheap levels compared with the US. The MSCI World ex US index trades at a near-50% discount to the US, in terms of trailing price/earnings multiple. Within the US, small caps have also fallen to a sizeable discount to large caps. Historically they've traded at a premium, reflecting their typically stronger expected growth rates.

This is not simply a result of US large caps having a larger allocation to the highly-rated technology sector. Almost every industry group among international stocks trades at a significant discount to the US. The median discount is 27%.

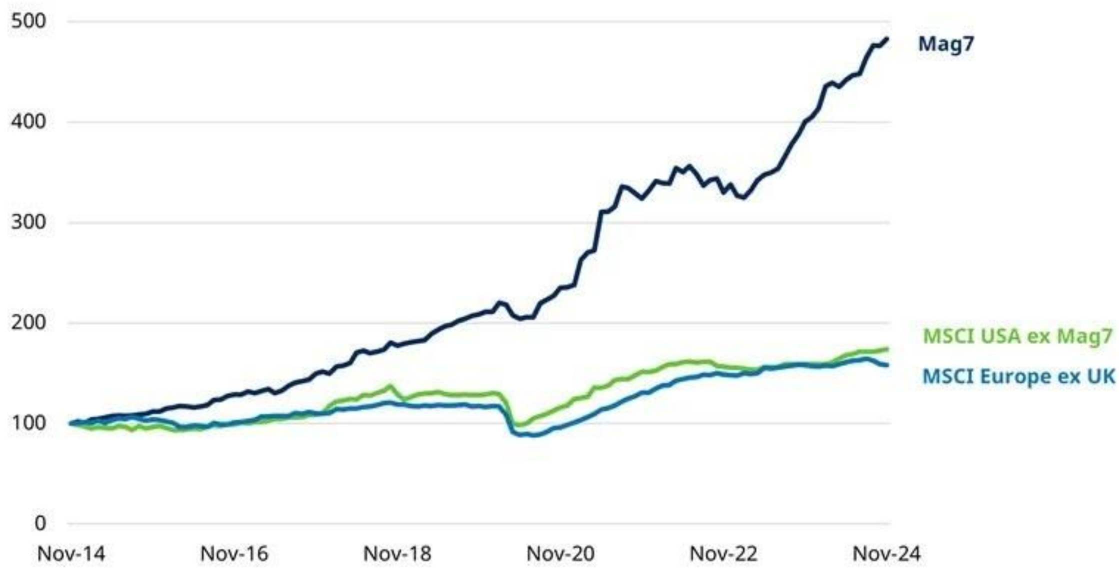
Non-US markets are historically cheap vs the US



Left hand chart: Non-US stocks are MSCI World ex-US index, US is MSCI USA; right hand chart: small caps are S&P 600 index, large caps are S&P 500. Different indices and time horizons are used in the two charts for reasons of data availability. Source: LSEG Datastream, MSCI, S&P, and Schroders. Data to 30 November 2024

3. Strip out the Magnificent-7 and European companies have been almost as good at growing earnings as US ones

Next 12-month earnings, US in USD, Europe ex UK in EUR, indexed to 100



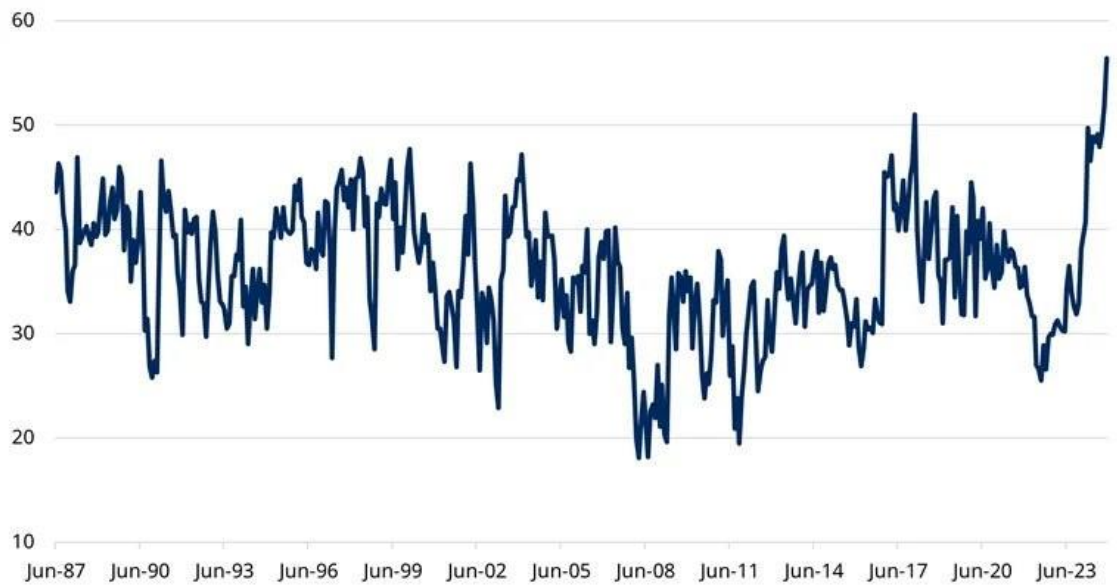
The Magnificent-7 is the name given to Amazon, Alphabet, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla. Source: LSEG Datastream and Schroders. Data covers ten years to 30 November 2024.

European companies come in for a lot of criticism compared with their US peers but, over the past decade, they've competed favourably with most US companies in generating earnings growth. The shortfall has been against the Magnificent-7 of Amazon, Alphabet, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla. They have significantly outperformed European companies, but that is not true of the rest of the US market.

So downbeat is sentiment towards non-US stocks, that you'd think the US is the only market where companies are expected to perform well. That blinkered view risks leading to missed opportunities. Around half of European and Japanese companies are forecast to deliver double digit earnings growth in the next 12 months, a slightly higher figure than in the US. The UK is not far behind on 44%.

4. US consumers are the most bullish about stock prices in at least 40 years

Conference Board survey: US consumers expecting higher stock prices in the next 12 months, %



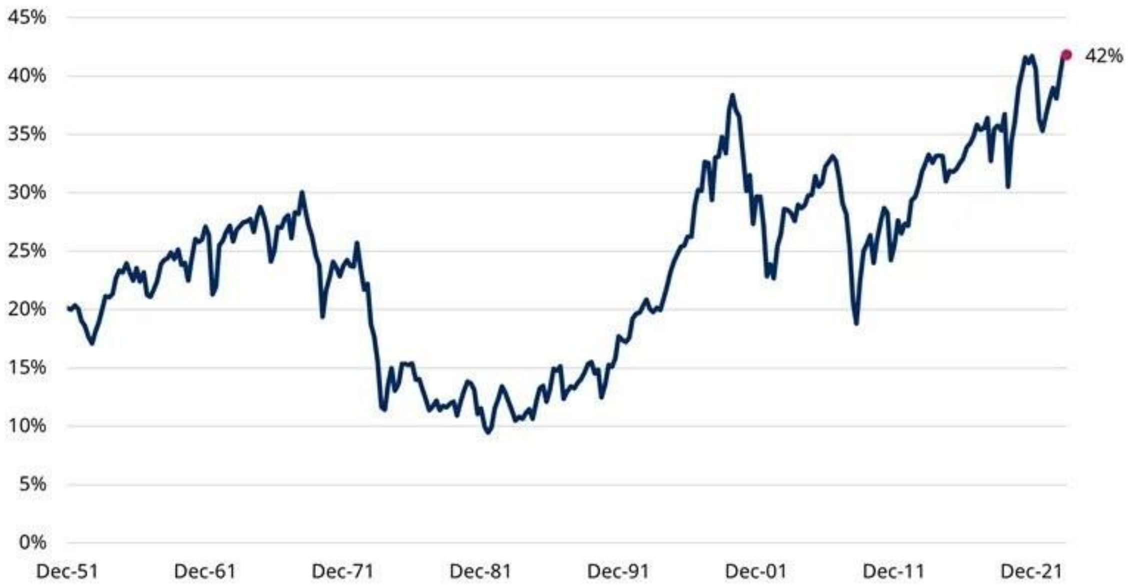
Source: The Conference Board, LSEG Datastream and Schroders. Data to November 2024.

While sentiment towards non-US stocks is pretty downbeat compared with the US, some measures of sentiment towards US stocks are exuberant. The proportion of US consumers expecting stocks to move higher is at a 40-year high, and US households have never had so much of their assets invested in stocks.

Excessively positive sentiment is often a contrarian indicator (pride before a fall).

US households' allocations to equities are also at record highs

Directly and indirectly held equities as a share of financial assets, households and non-profit organisations

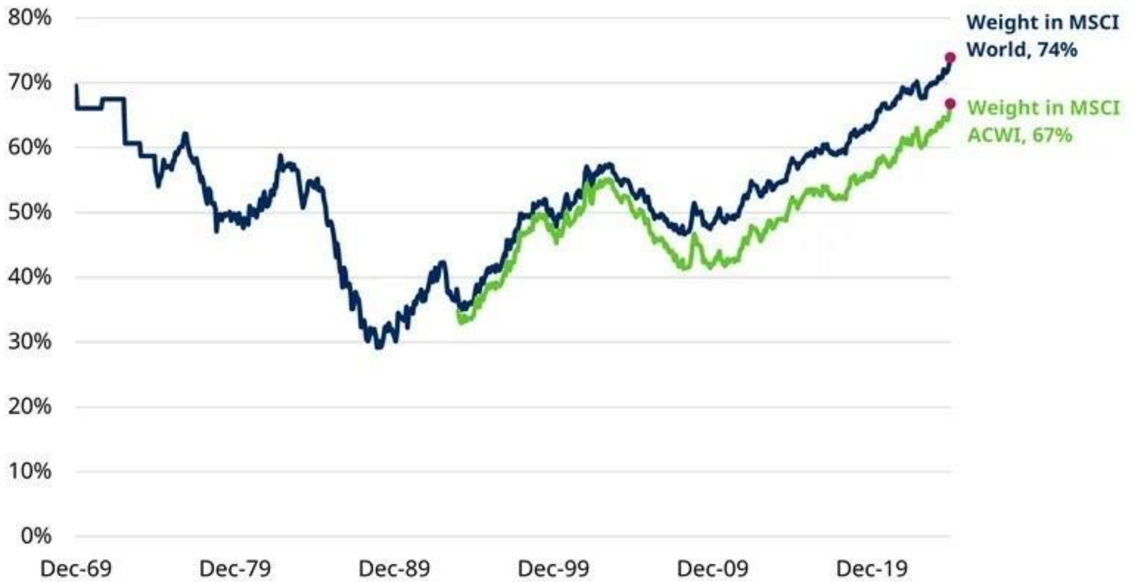


Source: Federal Reserve, LSEG Datastream and Schroders. Data to Q2 2024.

A counter argument could be made that, with so much wealth tied up in the stock market, US policymakers may have a bias towards rescuing markets from a worst-case scenario, because of the economic knock-on effects. But this would only apply in a severe downside scenario.

5. Concentration in the US market has reached a record high

MSCI USA weight in major global benchmarks



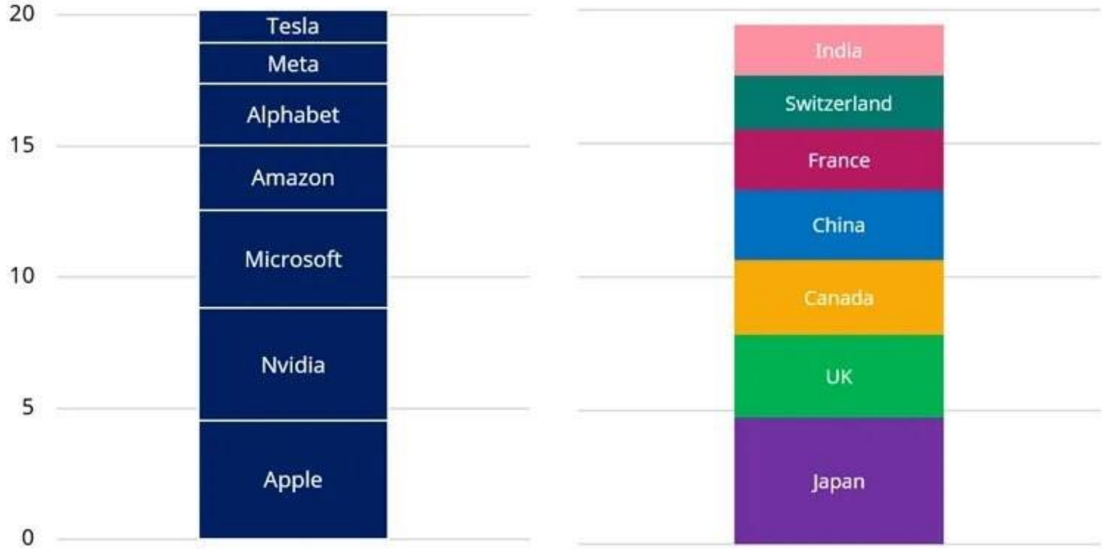
Source: LSEG Datastream, MSCI and Schroders. Data to 30 November 2024.

Even if you are optimistic about the case for US equities, there comes a point when you have to question how much you are comfortable investing to back that view. At the end of November, the weight of the US in the MSCI World index of developed market stocks had risen to 74%. In the MSCI All Country World Index (ACWI) of developed and emerging market stocks, it stood at 67%.

That is a lot of money in one country. What makes it more problematic is that the US itself is a very top-heavy market at present. The Magnificent-7 dominate. While investors might think that passively tracking the global market gives them diversified exposure to global companies, the reality is that these seven stocks make up a bigger weight in their portfolios than the next seven biggest countries combined.

Seven US companies make up a bigger weight in MSCI ACWI than the next seven biggest countries combined

Weight in MSCI ACWI, %



Data as at 30 November 2024. Source: LSEG Datastream, Schroders.

These seven stocks also make up the same weight as the 2,132 smallest companies in MSCI ACWI combined (out of a total of 2,650 constituents).

This much weight in so few stocks is worrying from a risk management perspective. It also means the wealth of investing opportunities offered around the world amount to barely a rounding error in the performance of the global market. My previous analysis has shown that, when market concentration has become extreme, investors have done better by breaking away from the confines of the index. Active approaches could prosper.

Adding some balance: the arguments in favour of investing in US stocks

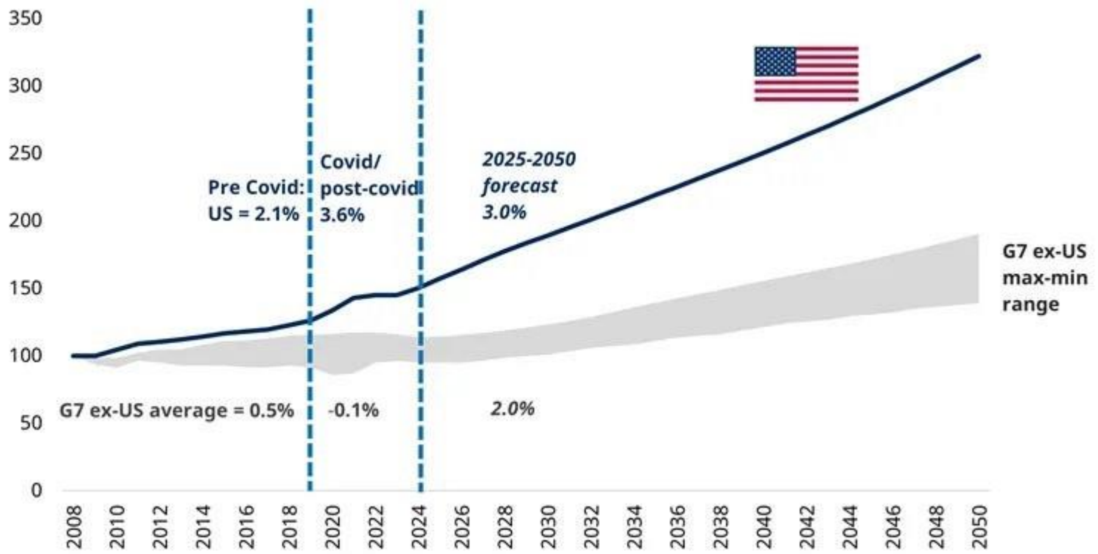
One problem with the bearish narrative painted so far is that many of the same arguments could have been made, to varying degrees, at any point in the past few years. I have made some of them myself!

The US being expensive is not a new thing, nor is the relatively high weight of the US in global markets. The extent of these, yes, but we should be humble about using them to predict its downfall.

“Markets can remain irrational for longer than you can remain solvent” isn’t a popular saying among investors for nothing. The next section addresses reasons why investors could justifiably feel optimistic about the prospects for US stocks compared with international peers.

1. US productivity is soaring while the rest languish

Output per worker, rebased to 100 in 2008



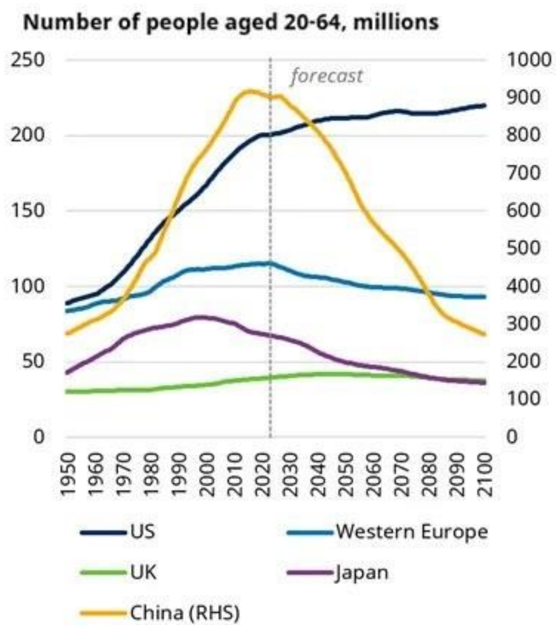
G7 covers Canada, France, Germany, Italy, Japan, the UK and the US. Source: LSEG Datastream, Oxford Economics, and Schroders. Data from 2024-2050 are forecasts.

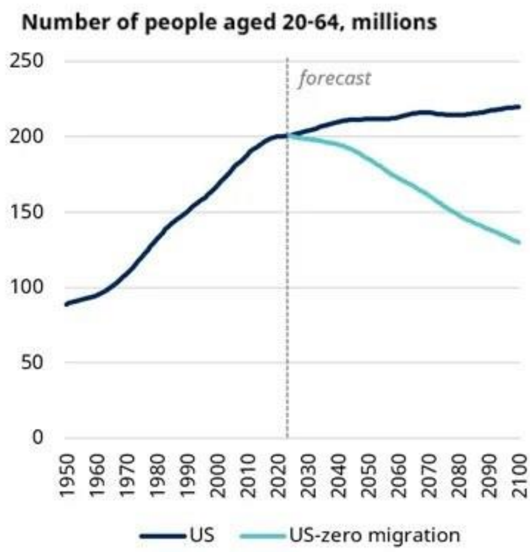
The level of productivity is a key driver of economic growth.

US productivity growth soared ahead of the rest in the years following the Great Financial Crisis and then, when Covid hit, rather than falling back to the pack, it accelerated further ahead. This gap is forecast to continue. If these forecasts come true, US economic exceptionalism is set to endure.

2. The US also has more favourable demographic projections

The US working age population is forecast to increase while others shrink, supporting *long-term* US economic growth… but this hinges on immigration. A shift to a less accommodative stance on immigration could easily remove this advantage.





1950-2023 are estimates. 2024-2100 are forecasts, medium-variant and zero migration-variant. Source: UN World Population Prospects 2024 and Schroders.

3. Economic momentum is with the US

It's not just long-term economic momentum which the US has in its favour, it is also performing better on a more cyclical level.

Economic 'surprises' have been more positive than in other regions and the Schroders Economics team have recently upgraded US growth expectations for 2025 and 2026 in response to President-elect Trump's plans. We now expect 2.5% growth next year, compared with 2.1% previously. This compares with 1.2% for the Eurozone and 1.6% for the UK. Even stronger growth of 2.7% is forecast for 2027, comfortably ahead of other developed markets. For more details, see our latest Economic and Strategy Viewpoint.

This does come a cost, however, with higher inflation also forecast. This is likely to have consequences for interest rates and borrowing costs, ultimately posing a risk to growth. Although our central case is for strong US economic performance, in a downside scenario, higher inflation and rates could push the US in a stagflationary direction.

4. A buoyant US economy will benefit US stocks more than overseas ones

US large cap stocks generate around 60% of revenues from the US, other markets are less than half that. If the US economy does power ahead, US companies stand to be the main beneficiaries.

But US small caps and value stocks are even more highly geared to domestic growth than large caps. If that is your main reason for backing US stocks, there may be better ways to do so.

Geographic revenue exposure of major global stock markets:

		Geographic source of revenues					
		US	Europe ex UK	UK	Japan	EM and frontier	Other/un-allocated
Equity index	US	59	9	2	2	24	4
	Europe ex UK	23	35	4	2	31	4
	UK	27	14	22	3	29	5
	Japan	17	7	2	46	24	4
	EM	13	4	1	2	78	3
	US small caps	77	4	1	1	10	6
	US value	69	7	2	2	16	3
	US growth	50	10	2	3	31	4

Other/unallocated includes Canada, Australia, New Zealand, Singapore. Analysis based on the most recently available data as at 19 November 2024. Note: the Russell 2500 index of US small and mid cap stocks has 76% revenue exposure to the US economy, a similar percentage as US small caps. Source: Factset, Schroders.

5. US companies are more profitable and are forecast to grow faster

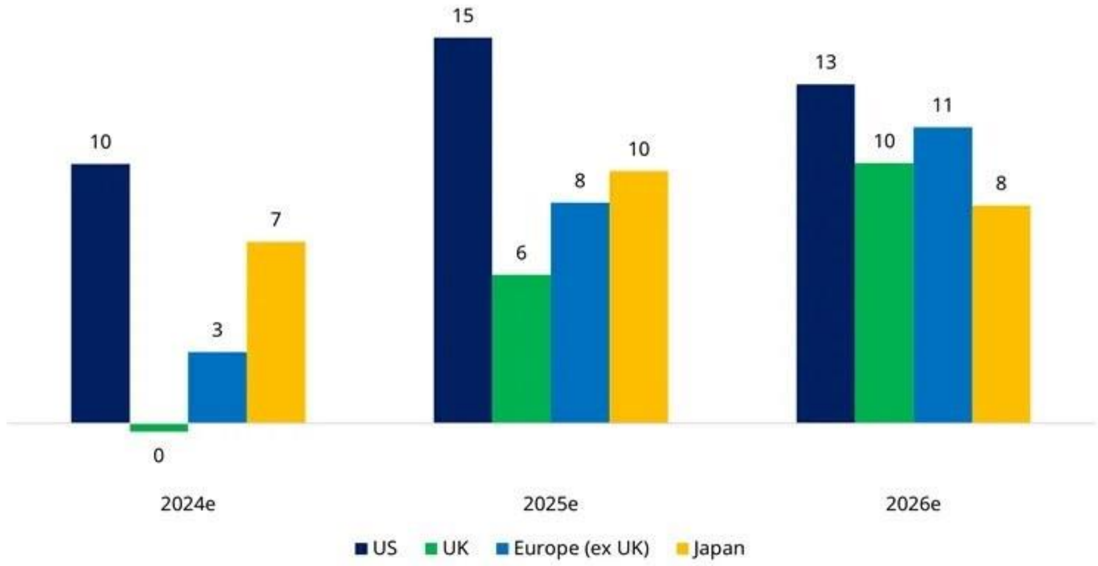
Net profit margin, %

Based on Datastream total market equity indices for each region. Source: LSEG Datastream and Schroders. Quarterly data to Q3 2024.

Although one of the earlier arguments was that, outside of the Magnificent-7, European stocks hadn't undershot US earnings growth by much, the reality is that, in aggregate, US companies have been consistently more profitable.

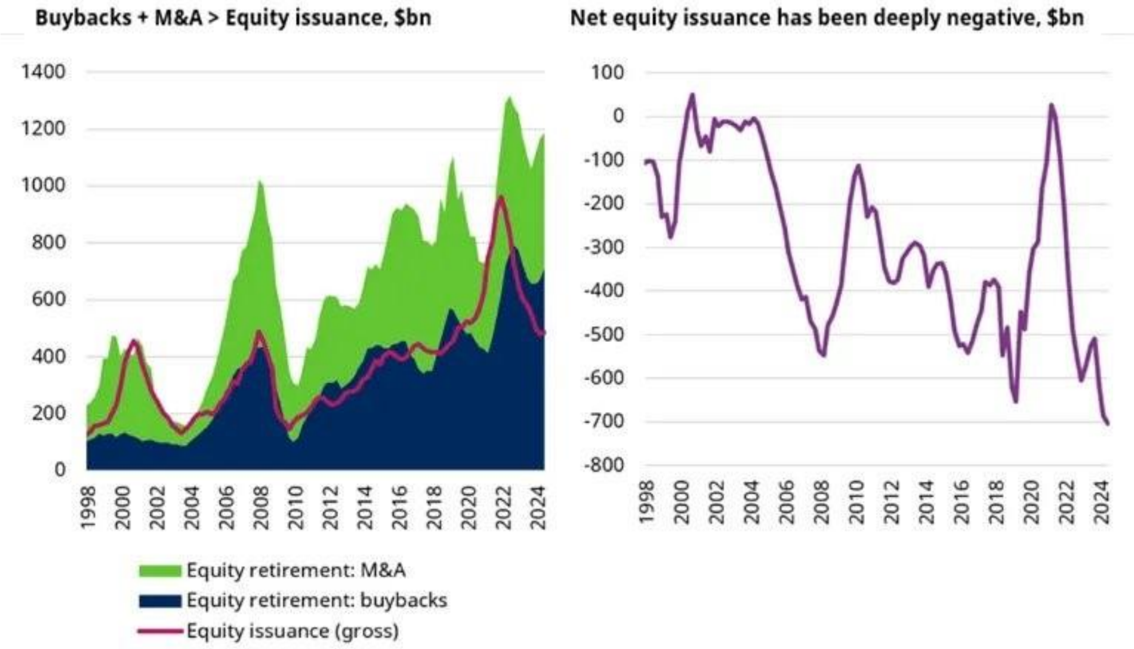
Whether this is down to sector mix or a handful of companies matters less when it comes to the earnings growth that investors benefit from when investing in the US market. Furthermore, US earnings growth is forecast to stay high through 2025 and 2026, comfortably ahead of the rest.

Corporate earnings: Consensus YoY EPS growth forecasts, %



Note: Japan EPS is 4 quarter sum until 30 June of next calendar year, e.g. 2024 = 31/03/2024 – 31/03/2025. Source: LSEG Datastream and Schroders. Data as at 30 November 2024.

6. Prices are supported by high levels of corporate buying: demand > supply



Data covers US-domiciled public and private non-financial companies. Equity issuance covers initial public offerings as well as equity issuance by existing companies. Net equity issuance = gross equity issuance - equity retirements (through buybacks and mergers and acquisitions (M&A)). Data to 30 June 2024. Source: Federal Reserve, Schroders.

Corporate buying, through share buybacks and mergers and acquisitions (M&A), provide a persistent source of demand for US stocks. This demand has exceeded the new supply of equities each year for the past 20, apart from 2021.

In summary

- US stocks are very expensive, some sentiment measures are bullish in the extreme, and you own an LOT of them
- This is problematic (and inflationary risks of Trump policies should not be discounted) but:
    - US stocks also have a lot going for them
    - other global markets have their own issues e.g. France, Germany, UK, China, Korea - hard to see a catalyst for acceleration vs the US.
- Consider diversifying to manage US risk rather than take a strongly negative view on the US:
    - small and mid-caps, and value stocks, are cheaper and geared to US domestic strength
    - international stocks are even cheaper and many individual companies outside the US are performing well
    - active approaches within large caps can beef up exposure to (relatively cheaper) smaller companies within the large cap market

Duncan Lamont, CFA is Head of Strategic Research at Schroder Investment Management Australia. This material is general information only and does not take into account your objectives, financial situation or needs. Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this material. Read the full report and important disclaimers here.

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Negative gearing: is it a tax concession?

Paul Tilley

Negative gearing is a phrase used in Australian tax policy debates regarding rental property investments. It is claimed to be a tax concession that an investor receives a tax deduction for interest expenses that contribute to a current loss on a rental property investment and can combine that with wage income for tax purposes. The deductibility of interest for tax purposes, though, is part of the general provisions of the tax act, ie that expenses incurred in earning of assessable income are deductable for tax purposes.[1] So what is the basis of the claim that this is a tax concession?

What is negative gearing?

There are two words in the phrase 'negative gearing'. The second word 'gearing' simply means that borrowing is used in the financing of the investment. The first word 'negative' means the current expenses of the investment are greater than its current income. That is, the investment is making a loss in the current financial year (with a presumed accruing capital gain). So, a negatively geared investment is one that uses debt in its financing and the current expenses are greater than the current income.

While the tax policy issues around negative gearing are relevant to any taxable investment, the negative gearing phrase is typically used for rental properties investments. The expenses consist of interest on a loan and other costs such as property maintenance, depreciation and other taxes – all deductable in the current financial year. The returns can be categorised in two parts: current income in the form of rent, which is taxable in the current financial year; and an accruing capital gain, which is taxable only upon sale of the property and generally with a 50% discount.

While a rational investor will expect to make a positive return over the life of an investment, that can be consistent with making a loss in the current financial year (current income minus current expenses), with the accruing capital gain expected to turn that into a positive overall return.

The second aspect of the negative gearing tax policy debate is that current losses on investment income are generally able to be combined with an individual taxpayer's other taxable income, eg wages. This is consistent with the general schema of the Australian tax system whereby in a progressive income tax system an assessment of a taxpayer's overall ability to pay is required.

A taxpayer's net income for the year is taken as a proxy for assessing their ability to pay tax. In the Haig-Simons[2] tradition, a comprehensive measure of net income is required to establish a good basis for assessing a taxpayer's ability to pay tax – all income, regardless of source, form or use, should be included. Combining an individual's capital income and labour income is what is required to assess their comprehensive income and ability to pay tax.

Rental property investments

Within the property market, it is important to understand the differences between the tax (and transfer system) treatment of investments in rental properties and in owner-occupied properties. For a given overall supply and demand in the private housing market, it is the split between these two that is fundamentally at stake.

Owner-occupied properties are generally treated more concessionally in the Australian tax/transfer system than rental properties. With owner-occupied properties, neither the imputed rent[3] from living in the house nor the capital gain upon sale are taxable. With rental properties, there is full taxation of rents and partial taxation of capital gains. Consequently, no tax deductions are allowed for owner-occupied property expenses while full deductions are allowed for rental properties.

Further, while purchases of both rental and owner-occupied properties are subject to stamp duty and both pay property rates, land tax applies to rental properties but not owner-occupied properties. In addition, owner-occupied properties are largely exempt from transfer system means tests.

Taxation of Rental v Owner-Occupied Properties

	Rental Property	O-O Property
Purchased out of after-tax income	Yes	Yes
Taxation of returns	Yes (CGT 50%)	No
Deductibility of expenses	Yes	No
Stamp duty	Yes	Yes
Land tax	Yes	No
Property rates	Yes	Yes
Inclusion in pension means test	Yes	Partial

Overall, the existing tax/transfer system in Australia is heavily tilted in favour of owner-occupied housing.

Is negative gearing a tax concession?

Whether something is a tax concession needs to be assessed against some benchmark of an ideal treatment. Departures from that ideal benchmark might be considered concessions (or penalties). The general benchmark for income tax in Australia is net nominal income. The *Tax Expenditures and Insights Statement* adopts a comprehensive measure of income (labour and capital) and provides for deductions for expenses incurred in earning that income.

Consistent with this, the Income Tax Act states "your assessable income includes the ordinary income you derived directly or indirectly from all sources"[4] and that you can deduct from that, expenses "incurred in gaining or producing your assessable income".[5] That is, the benchmark for the general schema of the Australian income tax law is net nominal income.

To assess the tax treatment of negatively geared investments in rental properties against this benchmark, we can first examine the expense and income sides of the transaction separately, then consider any asymmetry between them.

On the expense side, there is nothing unusual about the tax treatment of investments in rental properties. Expenses incurred in earning assessable income are deductable under the general provisions of the income tax act and this is the treatment applied to expenses for investments in rental properties.

On the income side, though, there are two components: rent and capital gains. Rent is treated like other current income; it is included in the taxpayer's assessable income for that financial year. Capital gains, however, are treated differently. While an ability-to-pay approach in the Haig-Simons tradition would call for the accruing capital gain to be included in each year's assessable income, akin to how depreciation on assets is allowed as a tax deduction annually, the general practice is to only apply capital gains tax upon sale of the asset. Further, only half the nominal capital gain is included in assessable income for that year.

It can be seen, then, that there is an asymmetry in the tax treatment of the expense and income sides of rental properties investments. The expense side of the transaction is consistent with the nominal income benchmark. The income side of the transaction, though, is not. From a benchmark perspective, then, to the extent there is a tax concession associated with investments in rental properties, it has nothing to do with the deduction of interest (negative gearing), it is about the income side of the transaction and the tax treatment of capital gains. **Importantly, this is the case whether the property is negatively geared or not.**

It can be argued, then, that the capital gains tax treatment of investments in rental properties, as with other appreciating assets, is concessional. As such, any reform of the tax treatment of rental properties is best considered in the broader context of reform of Australia's general approach to the taxation of capital income.

Second best?

Reforming capital gains tax, though, is a difficult task. With the 50% discount, it can be argued that this is a (generous) proxy for an inflation adjustment. With the deferral of the taxing point to sale, it is claimed an accruals approach presents valuation and cash flow difficulties.

So, if capital gains tax reform is not possible, a 'second best' argument might be made for an offsetting distortion on the expense side of the transaction. That is, some restriction on the tax deductibility of expenses such as interest could act as an offsetting distortion to the under-taxation of capital gains.

This approach would achieve greater symmetry between the tax treatment of the income and expense sides of rental property investments. A better approach, though, would be to address the under-taxation of capital gains directly.

Consequences of increasing taxation of investments in rental properties

While assessed against the standard income tax benchmark, negative gearing is not a tax concession, it is worth examining what the consequences would be of an increase in the taxation of investments in rental properties if that step was taken.

Such an increase in the taxation of rental properties investments would add to investors' costs, tilting the balance further in favour of owner-occupier purchasers. For a given overall supply of housing, an increase in the taxation of rental property investments would likely mean there would be more owner-occupier properties and less rental properties - at the margin some renters would become owner-occupiers.

While the tax increase on rental property investments falls initially on investors, they will seek to pass that through to tenants in higher rents. There is a distinction between the legal and economic incidence of taxes – the rental property investor has the legal incidence of the tax increase, but they will seek to pass the actual economic incidence of that tax increase onto the tenants.

The extent to which they can do that will depend on the relative market power of the landlord and the tenant. The lower their market power, the greater will be their share of the tax increase. In a tight rental market, tenants have limited alternative accommodation options, and it is likely they will have relatively low market power. Keeping in mind this is a tax increase on just one asset class, investors have other investment opportunities to achieve their required after-tax rate of return.

The consequence of a policy action to increase the taxation of rental property investments would be a reduction in the quantity of rental properties and likely some increase in rents. Conversely, there would be an increase in the quantity of owner-occupier properties. The magnitude of these changes would depend on the size of the tax increase and the realities of investor/tenant market powers.

Policy lessons

There are some major problems in the Australian tax system, including ones that impact on the housing market, that are sorely in need of reform efforts. The taxation of capital income generally is a mess, with investments in properties, shares, superannuation and bank accounts taxed in markedly different ways. Further, the use of structures such as companies and trusts to minimise tax obligations is compromising the integrity of the Australian tax system.

Increasing taxes on housing is not the way to increase supply. In the housing market, the most obvious tax reform initiative is at the state and territory level with a transition away from stamp duty (a transaction tax) to a broad-based land tax (a recurrent tax).

The negative gearing discussion is an unfortunate distraction from more genuine tax reform priorities.

[1] Contrary to some public perceptions, there is no 'negative gearing' provision in the tax law.
[2] American economists who developed a measure of income for tax purposes.
[3] The equivalent of the actual rent paid by a tenant in a rental property. This was part of Australian income tax law from 1915 to 1923, and still applies in some OECD countries.
[4] Income Tax Assessment Act 1997, s6-5(2).
[5] Income Tax Assessment Act 1997, s.8-1(1)(a).

Paul Tilley is the author of Mixed Fortunes: A History of Tax Reform in Australia. He is a Visiting Fellow at the Australian National University's Tax and Transfer Policy Institute, and a Senior Fellow at the Melbourne Law School.

How can you not be bullish the US?

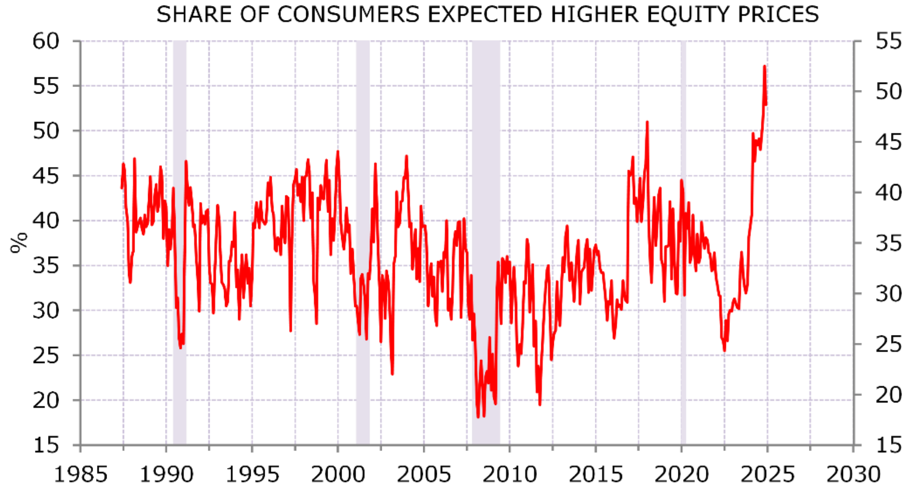
How can you not be bullish the US?

Gerard Minack

Great question. (Wish I had asked it 5, 10 or 15 years ago.) Near-term – say, to pick a random date, until 20 January 2025 – momentum may stay with the US trade. But beyond that US equities look rich, their EPS advantage may narrow, rising bond yields may crimp returns, and the next cycle – which isn't here yet – should favour other markets. I'm not convinced Trump can offset these headwinds.

Who's not bullish the US? Exhibit 1 – nicked from [Torsten Slok](#) – shows the share of US consumers expecting higher equity prices is now at an all-time high. The AAII survey is also high (not at a record). So is Mike Hartnett's BoA fund manager survey. I don't know when this will peak. The bulls can project their hopes and dreams on the President-elect until inauguration day (20 January 2025).

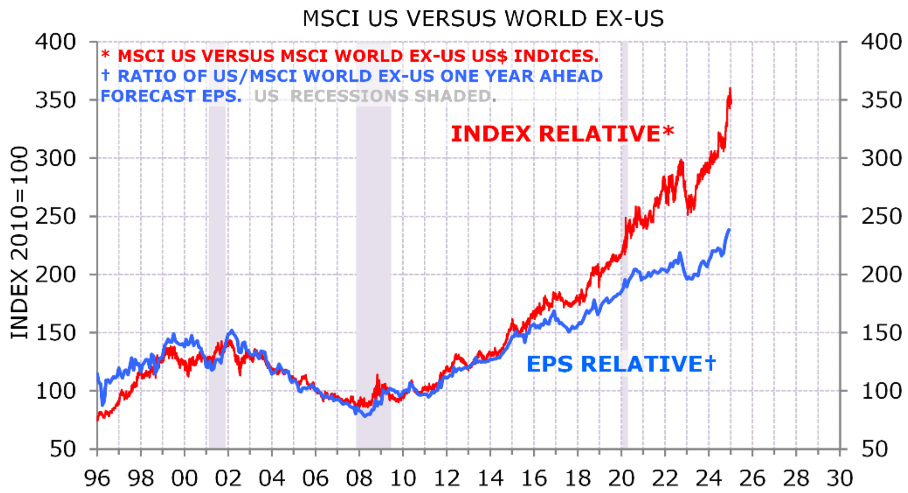
Exhibit 1: Everyone (almost) expects higher equity prices



Source: Conference Board, NBER; Minack Advisors (thanks [Torsten Slok](#))

The key to US exceptionalism has been earnings out-performance. Since 2016 EPS-driven out-performance has been enhanced by the US market rerating versus other markets (Exhibit 2).

Exhibit 2: Earnings drove most (not all) US exceptionalism

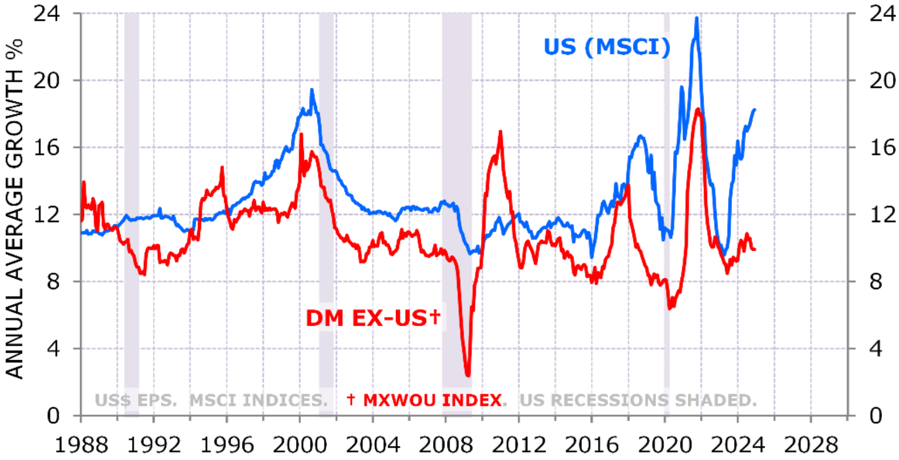


Source: MSCI, IBES/DataStream, NBER; Minack Advisors

That rerating coincided with a widening gap between US and non-US long-run EPS forecasts. The gap between expected US and non-US long-run EPS growth is now at 8%, a record, excluding 4 months in the GFC (Exhibit 3).

Exhibit 3: US exceptionalism is for the long run

CONSENSUS LONG TERM EPS FORECASTS

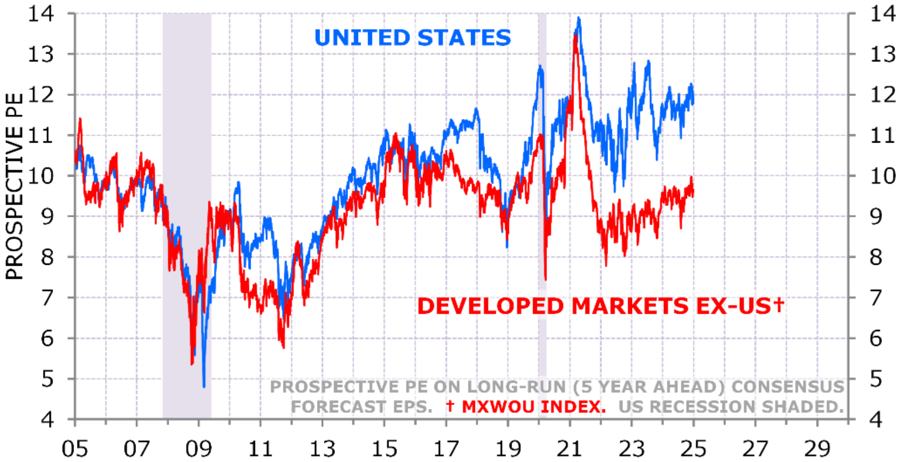


Source: MSCI, IBES/DataStream, NBER; Minack Advisors

I doubt that US EPS growth will outpace the rest of the world's by that much. Even if it does, that superior EPS growth is now in the price. Exhibit 4 shows prospective PE ratios based on long-run (5 years ahead) EPS level. The US market has re-rated relative to other developed markets even after taking into account its faster long-run EPS growth.

Exhibit 4: US is expensive even with exceptional EPS

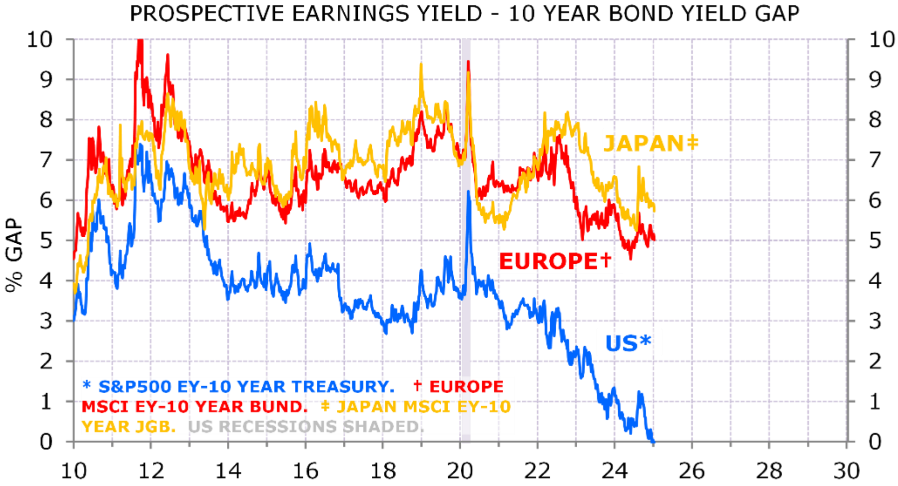
PROSPECTIVE PE BASED ON LONG-RUN FORECAST EPS



Source: MSCI, IBES/DataStream, NBER; Minack Advisors

The US market is expensive relative to its own history, relative to other markets and relative to other assets. The prospective earnings yield is now in line with the 10-year Treasury yield (Exhibit 5). I expect 10-year yields to breach 5% in 2025. At some stage rising long-end yields will be a headwind for equity valuations in the US.

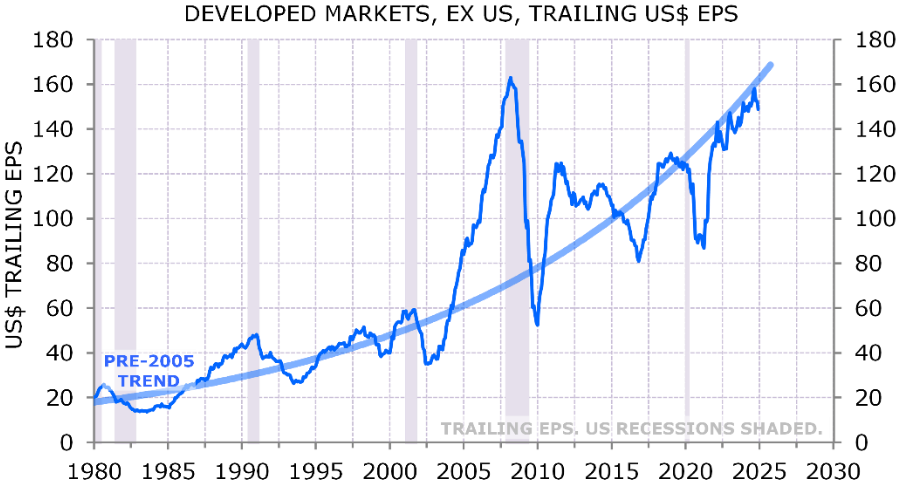
Exhibit 5: Exceptional valuation at risk from bond yields



Source: MSCI, IBES/DataStream, Bloomberg, NBER; Minack Advisors

The post-GFC cycle saw unusually strong US EPS growth and unusually weak EPS growth outside the US. Why will that change? The principal reason why ex-US EPS has been so weak since the GFC is that earnings had ballooned to unsustainable levels before the GFC. EPS in US$ terms quadrupled between 2002 and 2008. That EPS bubble bursting kept EPS weak for several years. However, rest of world EPS is now back on its pre-bubble trend and has resumed normal growth through the past few years (Exhibit 6).

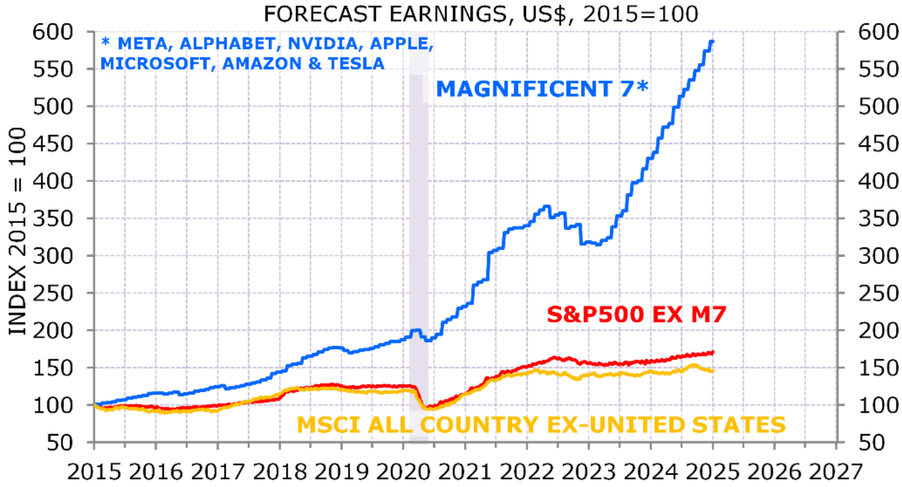
Exhibit 6: The rest of the world back on EPS growth trend



Source: MSCI, NBER; Minack Advisors

US EPS has grown at an above-average pace since the GFC: 4% real over the past decade versus a long run average of 1.75%. Most of that exceptional growth – and most of the recent US EPS out-performance versus other markets – is due to the Magnificent 7 (Exhibit 7). I don't analyse single names, so I don't have a strong view on how long the Magnificent 7 can maintain EPS growth at recent rates. At some stage the law of large numbers will have to kick in. But several clients have commented that 2025 will be the 'show me the money' year where investors will want companies to show the payoff for the massive investment in artificial intelligence. If the returns aren't there, valuations could fall.

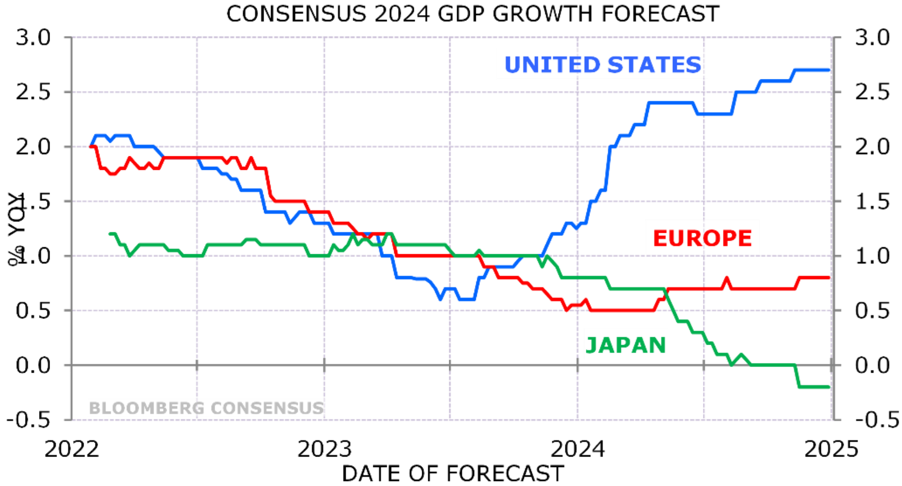
Exhibit 7: Mag 7 explains most of US EPS exceptionalism



Source: Bloomberg, IBES/DataStream, MSCI, NBER; Minack Advisors

Much of the recent EPS out-performance of the S&P493 versus the rest of the world has been driven by diverging macro growth rates (Exhibit 8). However, I expect the growth gap between the US and the rest of the world to narrow in 2025.

Exhibit 8: This was not the year for RoW recovery



Source: Bloomberg, NBER; Minack Advisors

Mr Trump's election has turbocharged US outperformance. While there may be a few sectors that benefit from specific policies, it's not clear to me that Trump locks in sustained US equity outperformance. The cycle gap between the US and non-US markets should narrow next year. The prospect of higher long-end yields is a greater threat to the expensive US market. Mag 7 performance will be tested if AI underwhelms. And everyone is so bullish the US, who's not already in?

Gerard Minack founded Minack Advisors in 2013 and has a wealth of experience as a macro strategist.

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Navigating broken relationships and untangling assets

Danielle Hart, Jane Koelmeyer

Relationship breakdowns can be emotionally challenging, particularly during the holiday season. As an accounting partner and a family law specialist, we've both seen when emotions can cloud judgment and make it difficult to approach asset protection, and if required, a division. The holiday season can make this harder, but it's a sad fact that for many couples, this is the period when it's finally time to let go and separate your lives and assets.

So here are some pointers on how to do just that, calmly and rationally through a separation process.

The most difficult aspect: letting go

Shared possessions often carry memories—both good and bad—which can make it hard to lose, or even keep, certain items. People can make decisions which make no financial sense. The cost of settling some disputes is disproportionate to the value of the issue or asset, so advice about when to let go can save you angst and cost.

Important decisions have to be made at this time. Approaching this task with your accountant helps to ensure that the overall impact of your decisions is clear to you: they can help 'light up' options to deal with these issues and help you understand what each might mean for you.

The first step

To begin the process, a comprehensive inventory of everything acquired during the relationship (including assets and debts) must be taken. This includes:

1. **Physical assets:** Real estate, vehicles, furniture, and personal belongings.
2. **Financial assets:** Bank accounts, investments, and superannuation accounts.
3. **Intangible assets**: business interests.

This helps provide a clearer picture of the 'asset pool' i.e. what needs to be kept or divided – and it's a critical step. Some people are very clear on what assets they have; others aren't. But couples have a legal duty to exchange financial information, so transparency during this process is crucial and mandatory. Hidden assets can lead to complications, delays, protracted disputes and cost orders against parties who fail to honour their duty – even if it is an oversight.

This is why it's important to maintain thorough records of all individual and shared financial dealings including assets, income, expenses and debts. These can be vital in ensuring a fair division and may be relied on if disputes arise.

Involving your accountant here is also important. They can help you provide information quickly and effectively. They can clarify ownership where different structures are involved and may already have structure charts that identify your financial assets. A shared early understanding of your assets saves you time and cost.

And it's critical to consider the difference between the market value of assets versus the emotional value. The costs involved in 'winning' assets with great emotional value can be considerable, so some perspective is important. Accountants can help clients to make this assessment.

Have a strategy around dividing assets

Sometimes, the traditional division of assets may not be practical, and people need to consider alternatives such as trading assets or cash settlements. This is where a financial strategy meeting with your advisors can be hugely valuable. They can provide advice about which assets you actually do need for your lifestyle and future financial needs and recommend the most favourable pathway to minimise the impost of tax and other fees to your family and you.

Think through your legal position

When assets are involved, consulting a legal professional is necessary. Laws regarding asset division in Australia are applied with considerable discretion.

Understanding your rights after a relationship is crucial and you should get specialist advice early, so you know where you stand. Family law also looks at businesses, trusts and partnerships, as well as personal and other interests.

Couples and their families are unique and so you need to get advice about your particular circumstances. Further, the Commonwealth Parliament has just passed new laws for property settlement which come into effect from 10 June 2025.

A lawyer can help mitigate emotional stress by providing objective guidance before, during and at negotiations.

Consider mediation

Discussions about finances can be tricky if it's already hard to talk. Trust your judgement. If you feel conversations might be become contentious or unproductive, consider involving a mediator sooner rather than later. This can help ensure everyone stays on track, respectful and heard. It's important that everyone remembers the intention is to find a resolution through a respectful conversation that allows both parties to move on. An accredited mediator can provide structure and help both parties reach an amicable agreement.

Protect yourself in other ways

Family law property settlements often occur in an emotional context. It's important to recognise that the parties to a separation are making big financial decisions in the midst of emotional upheaval. It's essential to make fully informed decisions, rather than decisions based on emotion alone.

Feelings of anxiety, distress or just being overwhelmed are commonplace, but that does not make them easier to manage or safe to ignore. If you are feeling overwhelmed by the separation, then talk a health professional, like your doctor. It is difficult to make wise choices and decisions if you are unwell. Take care of your health at this time when you are making big decisions.

Danielle Hart, CPA is an Associate Director at Marin Accountants, and Jane Koelmeyer, BA LLB is Principal of Jane Koelmeyer Family Law & Mediation. This article is for general information only. It does not consider any of your personal objectives, financial situation or needs. Before taking any action, you should seek appropriate professional advice.

Beware the bond vigilantes in Australia

Joshua Rout

In September 2022, the UK government released a budget update and economic plan. By mid-October 2022, both the Prime Minister and the Chancellor of the Exchequer had resigned due to the significant increase in borrowing required to fund the new fiscal policies, which led to a substantial sell-off of UK government bonds and skyrocketing yields.

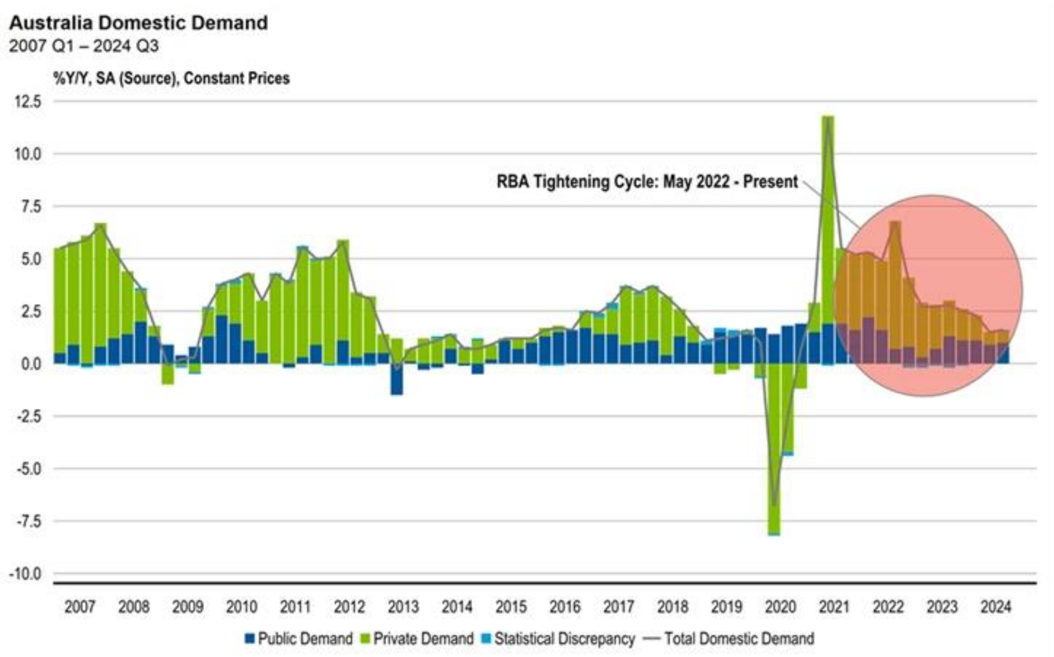
More recently, following the outcome of the US Presidential election, there has been close monitoring of US fiscal policy and its implications for bond issuance in 2025 and beyond. However, one market that hasn't seen as much focus is Australia. Could this be about to change?

Elevated Government spending

The RBA Governor, Michelle Bullock, mentioned the higher-than-expected growth in government spending in Australia in a recent press conference. In fact, the RBA has highlighted the high level of government spending several times over the past few months.

Exhibit 1 below shows Australian domestic demand by sector. The private sector is reducing its spending in response to higher interest rates, which is helping to rebalance the economy. The economy was growing at an above-trend rate for several quarters, and this triggered the most severe bout of inflation seen in decades. But while the private sector is adjusting, the combined government sector continues to spend at elevated levels.

Exhibit 1: Australian Domestic Demand by Sector, 2007 Q1 – 2024 Q2



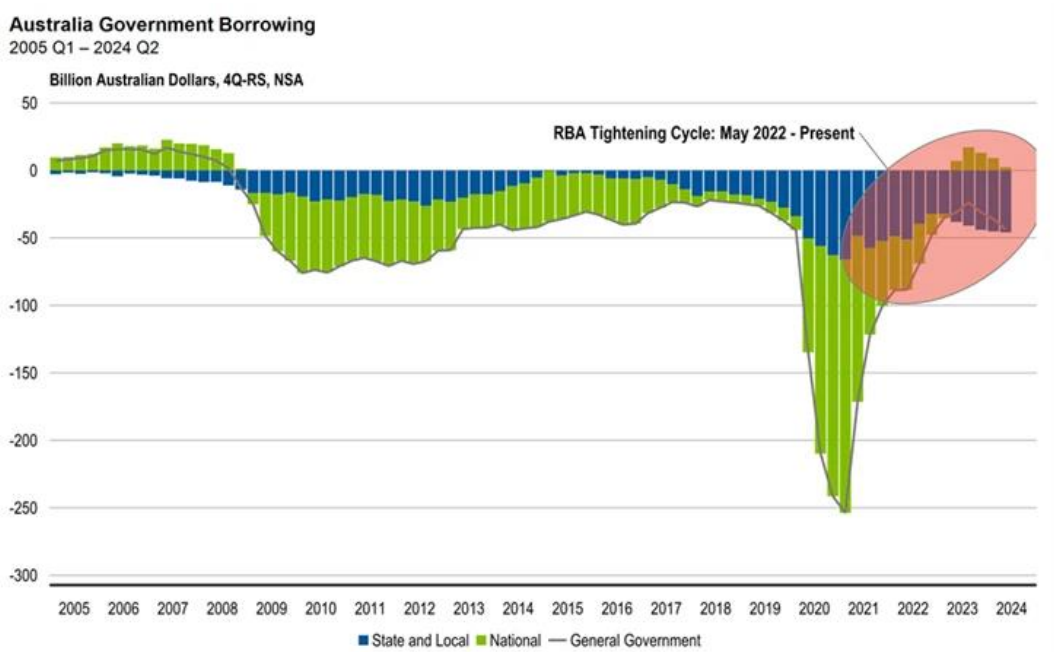
Source: Franklin Templeton, Australian Bureau of Statistics, Macrobond.

This spending is broad-based. At the national level, the spending shows in government-related employment growth, particularly in the health care industry. However, high commodity prices over the past few years have boosted revenue and led to a national budget surplus. If only this were the whole picture…

In Australia, a significant portion of government spending occurs at the state and territory level. And this is where the numbers aren't so rosy. Some states, such as Western Australia, are reporting strong budget surpluses due to high commodity prices. Conversely, other states are reporting large deficits as soft property markets limit revenue growth and large investment pipelines boost expenditure growth. The fact that many of these projects are behind schedule and over budget exacerbates the situation.

When we examine the effective level of government borrowing, it becomes clear that the states and territories are living beyond their means at a time when the RBA is advocating for more frugality.

Exhibit 2: Australian Government Borrowing, 2005 Q1 – 2024 Q2



Source: Franklin Templeton, Australian Bureau of Statistics, Macrobond.

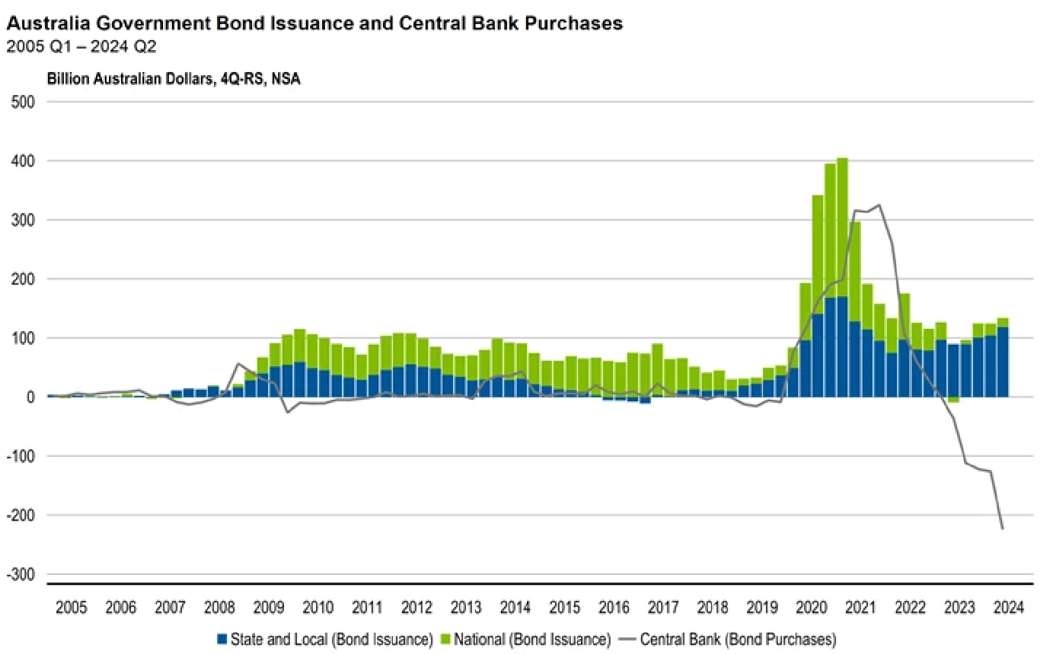
Bond issuance is key

But what does this have to do with bond vigilantes?

It is all about bond issuance. In the early stages of the pandemic, both the national and state/territory governments increased bond issuance to finance assistance packages. This was paired with the RBA purchasing government bonds as part of its response to the pandemic. Remember 'Team Australia'!

Since then, national government bond issuance has normalised. In fact, it is running below the pre-pandemic level thanks to the tailwinds noted above. In contrast, state and territory governments are issuing a significant amount of debt at a time when the RBA is transitioning from being a net buyer of bonds to a net seller. This is when bond vigilantes pay close attention.

Exhibit 3: Australian Government Bond Issuance and Central Bank Purchases, 2005 Q1 – 2024 Q2



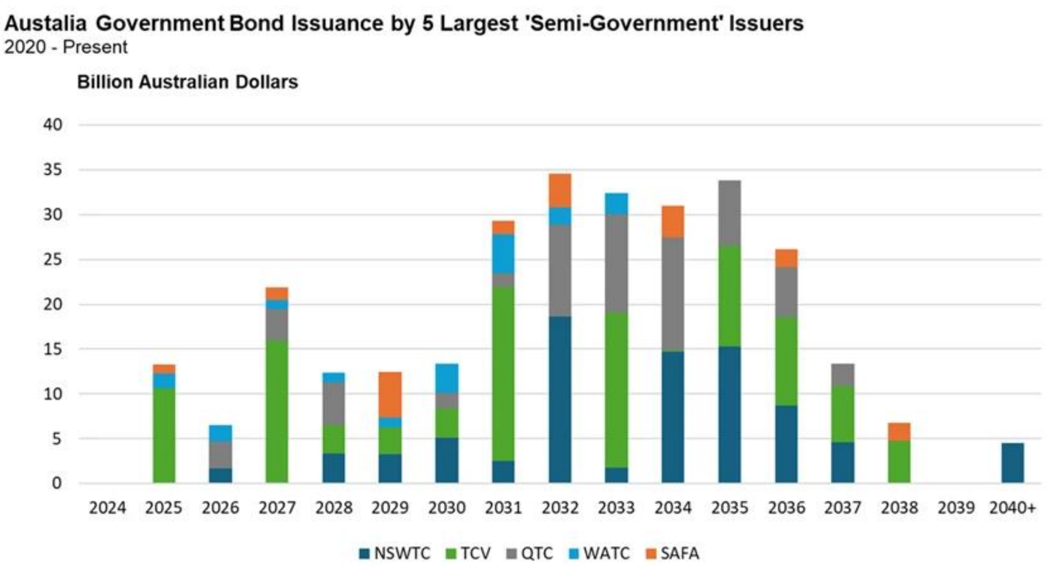
Source: Franklin Templeton, Australian Bureau of Statistics, Macrobond. Note: State and Local includes issuance by Central Borrowing Authorities.

Whilst we do not manage portfolios against a UK government bond benchmark, it is safe to assume those benchmarks performed poorly in late 2022 amidst the bond market turmoil.

When considering the outlook for Australian government bond benchmarks, specifically the AusBond Composite Index, we are particularly concerned about the level of bond issuance from the states and territories. These issuers, collectively termed the 'Semi-Government' sector, have shown a preference for issuing mid- to longer-dated bonds, i.e., 5- to 15-year maturities, as illustrated in Exhibit 4 below.

This trend does not bode well for the performance of the AusBond Composite Index and arguably goes some way to explaining its relatively poor performance, despite many central banks commencing rate-cutting cycles.

Exhibit 4: Australian Government Bond Issuance by five Largest 'Semi-Government' Issuers, 2020 – Present



Source: Franklin Templeton, Bloomberg.

Global bond markets have their fair share of headwinds at present.

The US government is issuing record amounts of debt, with neither major political party showing interest in balancing the budget. Japan might finally tighten its monetary policy, reversing a strategy that flooded the local market with liquidity and compelled Japanese investors to be net buyers of global government bonds.

Additionally, the demand for capital from the private sector is likely to increase to finance clean energy investments. All these factors suggest that interest rates will remain higher than pre-pandemic levels.

Against this backdrop, Australia's state and territory issuers need to find buyers for their bonds. The national government is also just an iron ore price drop away from needing to issue a much larger amount of bonds. Fixed income can still serve as a defensive asset class, but perhaps not in benchmark form. Beware the bond vigilantes.

Joshua Rout, CFA is a Portfolio Manager and Research Analyst at Franklin Templeton Fixed Income. Franklin Templeton is a sponsor of Firstlinks. This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

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What you need to know about retirement village contracts

Brendan Ryan

Retirement village (RV) life is great. Like living on a cruise ship, staying in a luxury resort, visiting a health spa, or driving a premium car.

But what about the costs? And what are you getting for your often multi-million-dollar investment?

The retirement village contract

A retirement village contract is a loan agreement where the borrower sets the terms. The retiree does not have title to the property they live in. In a retirement village contract you lose all control over your money - and premium retirement living means big dollars.

More than 10 retirement villages in NSW now have units that require residents to hand over more than $3.5 million to move in, and a few are asking for amounts higher than $10 million.

What are you giving up? At a minimum, you are missing out on income on the money you hand over. You could compare it to the income you may get having the money in the bank at the RBA cash rate of 4.35%.

But hang on a minute: money held by a retirement village operator is not money in the bank. You are *lending* money and the *risk* is different. As an example, the cost of money for a developer may be closer to the Maximum Permissible Interest Rate of 8.42% used in aged care. So the operator saves this amount when you loan them money for free. That’s a great deal. For them.

Or should you expect a better deal on the money handover when signing a retirement village contract, as you are lending your money to an operator, with no guarantee of repayment?

To get out of your free loan to the operator, another resident needs to take over your loan. This can take time. This is another risk.

As an example, imagine the challenge of trying to get some money back from Ardency Trebartha in Elizabeth Bay with an average time to sell a unit of 406 days, to pay a Refundable Accommodation Deposit (RAD) of $914,000 up the road at St Lukes Nursing Home. 406 days paying the interest rate of 8.42% on an unpaid RAD is $210.90 per day - that’s a cost of $85,600 incurred by having to wait for your money. Big numbers and set to get higher as Residential Aged Care costs go up from 1 July 2025.

When your children or loved ones are working out aged care options for you, what are they going to be up against to get the money? And how much money will be left after fees, charges and commissions? And how long will they wait for the money?

The takeaway here: know exactly what you are getting into.

Looking at the numbers more closely

Many residents confuse the offer of '100% Share in Capital Gain' with owning a property. The truth lies buried in the numbers.

At *Later Life Advice*, we cut through the noise by calculating an 'effective' Deferred Management Fee. This is a measure used to include *all the costs* to the resident upon leaving as one easy to understand percentage.

A '100% share in Capital Gain' is just one part of the calculation. You cannot make a profit living in a retirement village.*

Consider this contract for a $2 million retirement village unit in Sydney's north shore. This contract has complex mechanics - and also includes a '100% share of capital gain'. Taking into account all the costs, including 4.35% as 'opportunity cost' for tying up money, and a property growth rate of 2.9% as recommended by NSW Office of Fair Trading, a one-year stay would cost about $4,400 per week, and if the stay lasted 7 years, the weekly cost would reduce to about $2,700.

The 'effective' Deferred Management Fee works out about the same as less complex contracts: the resident loses 35% of their upfront loan after 7 years. This includes a '100% Share in Capital Gain'.

	Rate	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Deferred Management Fee		$102,910	$211,809	$326,960	$448,632	$577,109	$593,903	$611,186
Other Percentage Charges		$72,037	$74,133	$76,291	$78,511	$80,795	$83,146	$85,566
Non-refundable Component		$10,000	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Cumulative Recurrent Charges		$13,800	$27,945	$42,444	$57,305	$72,537	$88,151	$104,155
Cumulative Interest Cost	4.35%	$87,000	$174,000	$261,000	$348,000	$435,000	$522,000	$609,000
Costs to Resident *before share in Entry Payment Movement*		**$285,747**	**$497,888**	**$716,694**	**$942,447**	**$1,175,442**	**$1,297,200**	**$1,419,906**
Share of Entry Payment Movement to Resident	2.91%	$58,200	$118,094	$179,730	$243,160	$308,436	$375,612	$444,742
Net Cost of Living in Retirement Village		**$227,547**	**$379,794**	**$536,964**	**$699,287**	**$867,005**	**$921,588**	**$975,164**
Effective DMF on entry payment		**9.25%**	**14.80%**	**20.66%**	**26.86%**	**33.40%**	**34.35%**	**35.34%**
Weekly Cost		**$4,376**	**$3,652**	**$3,442**	**$3,362**	**$3,335**	**$2,954**	**$2,679**

The only difference between this contract with the old-style retirement village contract is the starting number. That is now in the millions of dollars.

Don't get caught by the clever terminology. It's the same old deal.

Don't rely on Government oversight

Government mandated risk disclosures ascribe no value to handing over your money.

This is a glaring omission of the Average Resident Comparison Figure, a compulsory disclosure Retirement Villages need to make about costs that is a result of a change in retirement village laws introduced in 2021.

It is no surprise that almost all of these new higher entry payment villages have been developed since these laws and disclosure regime were struck. These rules were written *before* the boom in luxury retirement villages. There is no scrutiny on what it means to get no income from your money.

Losing access to your money is something you need to **include as a cost** in these contracts. Any reasonable professional valuation would include this. Why is it different here? And don't forget to ask who has your money.

For the aged care sector, the Government has a guarantee scheme to make sure you get your money back. If an aged care home fails, the rest of the industry has to stump up and make good on the payment. This is not the case with retirement villages.

Commission-based sales teams selling complicated contracts

The 'entry payment' is just one part of a complex series of inputs that residents need to determine the cost of living in a retirement village.

The inputs to the ever more complex financial modelling that needs to be completed to understand the financial implications of entering into a contract will be found in a document known as the 'Disclosure Statement'. This document is extremely hard to get.

Basic pricing information is guarded by old school sales teams working on commission who are celebrated by the Property Council of Australia, home of the Retirement Living Council, when they crack big sales numbers.

This would be fine if they were selling real estate - they are not. They are selling complex contracts, often valued in millions of dollars, and the retirement industry's own survey last year confirms half of retirement village residents don't know what they are getting into. Commissions still get paid.

No pesky Royal Commissions, Financial Complaints agency, fee disclosure, or licensing like with financial products. Your savings in super have mandatory reporting. Your savings in a retirement village contract do not. This must be taken into account **before** you sign a contract and hand over your millions.

Know what you are signing up for

To recap: contracts are complex, salespeople are highly skilled, and Government regulation is out of date. Meanwhile, watertight contracts put the onus on you the resident to understand the deal, and an army of bankers, developers and operators are tooling up to cash in on your free money.

With NSW Clubs getting a greenlight to convert their sites to villages, Governments looking for 'seniors housing' solutions and a silver tsunami coming, billions of dollars are flowing into this sector.

By all means make the move - but do it with eyes open. And make sure you see the all-in costs as well as the benefits.

Brendan Ryan is a Director of Later Life Advice. He has more than 30 years' experience in financial analysis, modeling, and valuation, starting with his time in Macquarie Bank's research team in the 1990s. He holds a Certified Financial Planner qualification and have spent more than 20 years specialising in financial modeling for moves into residential aged care.

These are independent views informed by experience, inquiry, and feedback. They highlight critical issues facing a vulnerable demographic, as aged care costs rise and new developments seek significant financial commitments from older Australians.

Retirement Village contracts vary widely. While my observations are based on specific examples, they underscore the importance of doing thorough research and due diligence before committing. One experience doesn't define all, but the need for careful consideration applies universally.

** If you don't agree with my numbers or methodology - let's talk. Professional scrutiny of the retirement village deal for residents is woefully lacking - the more robust debate, the better.*