SAFAA MONTHLY

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SUPER SNIPPETS

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Stockbrokers and Financial Advisers Association

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BY **KEVIN DICIURCIO,** Vanguard

Why we believe value stocks are poised to outperform growth

Brighter days are ahead for value stocks.

This might seem a relatively safe prediction. After all, looking at the U.S.—the primary driver of global equity market trends—shares in companies with relatively low valuations and high dividend yields have outperformed their growth counterparts so far this year[1]. Our research shows that the coming reversal of fortunes would restore the decades-long performance edge that academic researchers have ascribed to value stocks.

Investors, younger ones especially, may be sceptical. Powered by a relentless rise in technology share prices, growth stocks have handily outpaced value—the province of financial, utility, energy, and basic materials companies, among others—since the 2008 global financial crisis.

Taking a global view, the U.S. trend is reflected in the performance of the MSCI World Value and Growth indexes. Value outperformed sharply in the period prior to the GFC, but the decade following saw value's fortunes slide.

The story is far from over, but there are reasons to believe value will again prove to be the winner over the coming decade.

What drives the relative performance of value and growth stocks?

To better understand past results and provide estimates of future returns, Vanguard's Investment Strategy Group (ISG) identified fundamental forces—some secular,

Until recently, a long-running performance premium for value

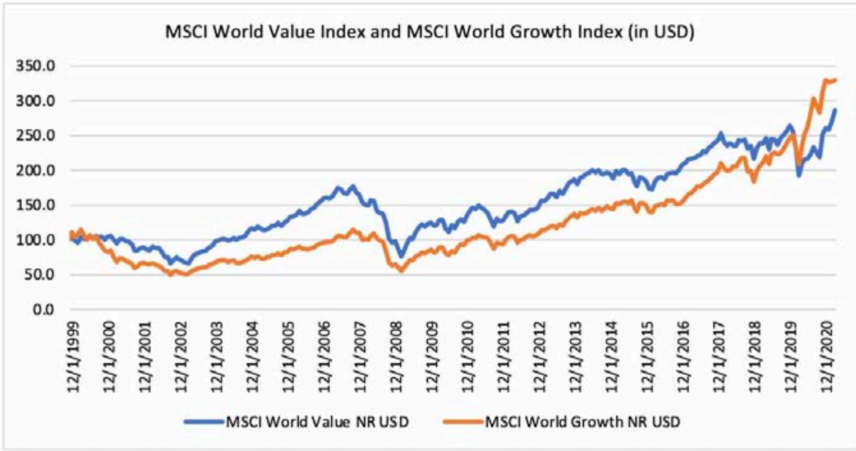
Notes: The chart displays monthly observations of ten-year annualized total returns for the U.S. market, for periods from June 1936 through January 2021 of a hypothetical long-short value versus growth portfolio constructed using Fama-French methodology, available at https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/f-f_5_factors_2x3.html. Past performance is no guarantee of future returns.

Source: Fama-French research returns, outlined at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research.

others cyclical—that drive changes in the value-growth relationship and constructed a related fair-value model. ISG's model suggests that value stocks' underperformance in recent years owes mainly to fundamental drivers, particularly low inflation rates, which boost the relative attractiveness of growth stocks' more-distant cash flows. But investor behaviour has played a role as well.

We expect value to outperform growth over the next ten years by five to seven percentage points, annualised, and perhaps by an even wider margin over the next five years.

Growth has dominated in the post-GFC period

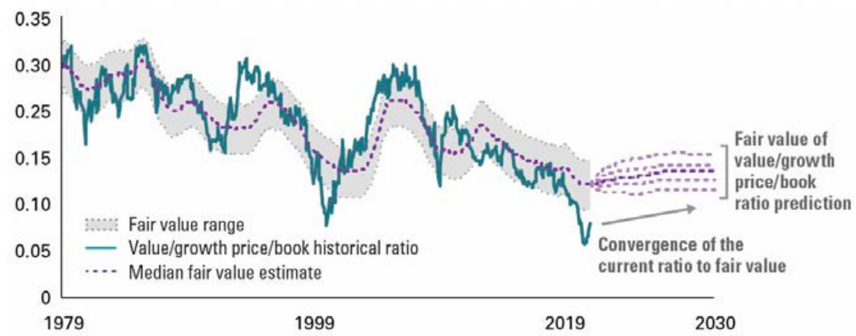


Source: Morningstar, MSCI and Vanguard March 2021. Past performance is not a reliable indicator of future results.

An explanation of our methodology

The Fama-French data have the virtue of a long history, dating to the Great Depression. But few investors are able to implement the academic definition of value, which includes holding the cheapest stocks while selling short the most expensive stocks[2]. To assess the performance of investable value and growth portfolios, ISG constructed market-capitalisation-weighted indexes of companies in the bottom and top thirds of the Russell 1000 Index, sorted by price/book ratios and reconstituted monthly.

In our view, a stock thought to represent a style factor should, for analytical purposes at least, represent only one style. In our model, a company can be deemed only value or growth in any given month, though its classification may vary from month to month.



Notes: The valuation ratio is projected based on a Vector Error Correction Model (VECM) describing the statistical relationship between cointegrated time series. The VECM is a dynamic model of the first differences of the variables used in the cointegrating regression that includes a disequilibrium term to correct deviations from the long-term equilibrium.

Sources: Vanguard calculations, based on data from FactSet.

Why value stocks are poised to top growth stocks

It's well-known that asset prices can stray meaningfully from perceived fair values for extended periods. So why should investors expect value to outpace growth in the years ahead? For one, we believe the growth trade is overdone.

ISG's research found that deviations from fair value and future relative returns share an inverse and statistically significant relationship over five- and ten-year periods. The relationship is an affirmation that, ultimately, valuations matter—the price we pay influences our return. That's intuitive, right? So, too, is the imperfection of our model: While it reveals a relationship between fair-value deviations and future results, its predictions for relative performance are imprecise. That's consistent with investment risk enabling but not guaranteeing potential returns. Put another way, if valuations perfectly presaged performance, there'd be no risk. Fortunately, that's not how markets work.

Asset bubbles and the investment road ahead

The large current deviation of growth-stock valuations relative to our fair-value estimates also helps make our case. The size of the deviation is similar to the one at the height of the dot-com bubble. When the bubble popped, value proceeded to outperform growth by 16%, annualised, over the next five years. We can't be certain that growth stocks represent a bubble, but Vanguard's global chief economist, Joe Davis, recently noted that low-quality growth stocks have been driving much of the recent growth rally.

We believe that cyclical value-growth rotations are founded in investor behaviour and that investors become more price-conscious when profit growth is abundant. Since 2008, corporate profit growth has been insufficient to sustain value stocks.

Vanguard expects inflation to normalise and eventually exceed the Federal Reserve's 2% target this year and next. Corporate profits should strengthen amid economic recovery from the pandemic. Still, their impact on the "fair value of value" may be modest. The ultimate driver of the coming rotation to value stocks, then, is apt to be a change in investors' appetite for risk.

For investors with sufficient risk tolerance, time horizons, and patience, an overweight to value stocks could help offset the lower broad-market returns we expect over the next decade.

Industrial strength value exposure

The Vanguard Global Value Fund offers significant and consistent exposure to the value factor, which has been shown to be a component of long-run stock market returns. It utilises a long-only, broadly diversified investment strategy that invests in developed market equities and seeks to provide long-term capital appreciation. Through active implementation and a transparent rules-based process, investors can gain industrial strength exposure to the value factor. ■

TO FIND OUT MORE VISIT
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Kevin DiCiurcio CFA is the Head of the Vanguard Capital Markets Model® research team.

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1 For example, as of April 27, 2021, the Russell 1000 Value Index had returned 15.51% year-to-date, while the Russell 1000 Growth Index returned 8.65%.

2 A short sale occurs when an investor borrows and then sells a stock in anticipation of its price declining. If the price does decline, the investor can repurchase the shares to return them to the lender at a lower price, thereby profiting. If the price rises, however, losses ensue. Regulations limit short sales.

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GET READY: Managed portfolio customisation technology is coming

BY ANDREW VARLAMOS
CEO / Co-founder, OpenInvest

The traditional strength of the stockbroker's value proposition was that they would personally advise their clients so that each client had their own personal share portfolio, reflecting who they were and what they wanted — as filtered and interpreted by their stockbroker. It was, and is, by its nature high-touch, relationship-based and, therefore, expensive.

Of course, for a long time, this was generally the only way the retail investor could invest, and as a result, stockbrokers and their partnerships, were extremely lucrative and valuable (aka: the Good Old Days).

Even after the end of fixed rate commissions in 1984, the launch of online broking in 1997, and the dramatic rise in market share of the (unholy[1]) trinity of wrap platforms, managed funds and financial planners, stockbrokers could claim their service offering had the advantage of providing their High Net Worth clients with their own personalised and unique portfolio of shares.

And this is largely still valid today, a decade after financial planners started the shift – gradually at first, and then en masse – to using Separately Managed Account (SMA) platforms as a means of delivering to their retail clients, first, ASX-listed share portfolios, and then, multi-asset class diversified portfolios. Its truth is not obscured by the fact that many stockbrokers now also run SMA programs as a means of servicing mass affluent clients, as part of the shift to a broader 'wealth management' value proposition.

'Well yes, these SMA platforms can deliver a reasonable outcome… so long as you're happy to have the same portfolio as everyone else', might be the refrain, 'however, if you want your own portfolio of shares to reflect your personal preferences, you need to talk to a stockbroker.'

The game is afoot

If you've been following the international financial services press, you'll know this is all about to change. Because the largest financial services companies in the world have gone through a whirlwind two years, with each buying up what are generally referred to as 'direct indexing' technology platforms.

Before I explain what these technologies do, let me list those who've made strategic bets in this area in this two-year period: BlackRock, JPMorgan, Morgan Stanley, Fidelity, Goldman Sachs, Schwab, and as of a few weeks ago, Vanguard (interestingly, its Vanguard's first acquisition in its 50 year history).[2] As Sherlock Holmes would say: the game is afoot!

So, what do these direct indexing platforms do? Well, instead of owning an interest in a managed fund or ETF structure, you can own all (or most) of the securities in a relevant index, or indices – hence, the nomenclature. Three things flow from this.

First, why would you want to? Well, by owning the actual underlying securities the investor can better optimise their tax position, harvesting tax losses via intelligent algorithms for instance, while staying almost-perfectly aligned to the index. The individual can also customise their portfolio based on specific preferences, perhaps ESG-related, or by not investing in assets or asset classes to which they already have exposure, for example, by virtue of their industry of employment.

Second, one might conclude immediately it's surely only of interest to those with incredibly large portfolios. That the amount required to get exposure to the securities in an index, let alone trading costs, render it esoterically, but not practically, interesting. Well, Yes, but then No: it becomes very practical in an environment in which fractionalisation of shares becomes available and share trading costs heads towards zero – which is the case in the US.

> The threat is obvious: powerful global brands reaching out to aspirational consumers with sophisticated yet easy-to-use technology.

The third implication is the most interesting. If the technology will manage any number of client portfolios based on selected indices overlayed with the individual's personal preferences, surely it's just as possible to do so based on a portfolio manager's model portfolios.

Highly customisable SMA portfolios

Or to put it another way, SMA portfolios, but with customisations by each individual retail investor to express their personal preferences – relating to tax, ESG priorities, factors, and/or career-related risk management – that add up to giving each their own personalised portfolio, managed at scale. (For this reason, you might also see the term 'Custom Indexing' being used.)

Here's an example of what might be possible. Say an individual has $10,000 to invest. In applying for a portfolio online from their chosen asset manager (or stockbroker), they rank in order of importance to them ten ESG issues: perhaps climate change is number one, followed by companies that ensure safe working conditions throughout their supply chains, then gender equality, then animal welfare, and so on.

As a result, they obtain their own personal investment portfolio consisting of (fractions of) shares listed across eight different exchanges, managed by their chosen asset manager (or stockbroker), who also keeps them up to date with their thinking on those stocks.

Brokerage might be zero, but the investor happily pays a management fee for the right to obtain their own managed portfolio, that they have customised via a simple online ranking of issues to reflect their personal beliefs. Yes, stockbrokers have always delivered such 'customisation', but by getting the technology to do the heavy lifting, now everyone is a potential customer, not just the wealthiest.

Actually, such a solution is essentially possible today – albeit currently only for larger portfolio balances. However, with the involvement of the largest financial services in the world, this functionality is inevitably going mass market.

Not everyone will value it, and managed funds and ETFs aren't going to disappear anytime soon. But when you consider the relative global growth of ETFs compared to managed funds in the past 20 years, it's clear that changing consumer preferences do have major industry impacts.

Shiny, but peripheral? Or mainstream?

To go back to my example above, does it matter if someone with fancy tech wins over the kids who have $10,000 to invest?

My answer is that as people of all ages continue to seek increasing personalisation of the goods and services they acquire, as ESG becomes increasingly mainstream and as younger generations grow their wealth, both by personal labours and via the largest intergenerational wealth transfer in history, direct indexing (or my preferred term: customised managed portfolios) is at the perfect intersection of these trends.

Threat or opportunity?

In my article in last month's edition ('How stockbrokers can reach the next generation of clients by embracing digital'), I framed the key issue in terms of threats and opportunities, and I think it's logical to do the same again.

The threat is obvious: powerful global brands reaching out to aspirational consumers with sophisticated yet easy-to-use technology. However, the opportunity for Australian stockbrokers is immense: stockbrokers have always recommended and traded listed shares; it's in the DNA of their brands. If this step-change in technology has the effect of shifting focus away from managed funds and ETFs towards listed shares, who better to use that same technology infrastructure to reassert their primacy and grow their businesses?

Australians have always preferred to invest directly in shares – and our tax system encourages it. The ASX Investor Study 2020 highlighted that nine million Australians have investments outside of their super and primary dwelling, and the online trading boom of the past 18 months has only increased that number and consumer interest in investing, generally.

A new golden era awaits. ■

Andrew.varlamos@openinvest.com.au

OpenInvest configures and deploys white label digital investing solutions for its partners, allowing them to offer their own portfolios and associated content, in their branding, to their audience, in their way. You can find out more about the OpenInvest digital platform at https://www.openinvest.com.au/for-advisers/.

1 Yes, I'm being tongue-in-cheek here, but older readers will know what I mean.

2 To be completely accurate, Fidelity's foray is via an investment and partnership, not outright acquisition.

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DDO – What's next?

Wednesday 11 August from 1.00 to 2.00pm

Corey McHattan, a Partner with Ashurst, will provide an update on the Design and Distribution Obligations coming into effect on 5 October. Following a recap of what products are in and out of scope of DDO and the important dates, Corey will then focus on distribution obligations of brokers in particular: reasonable steps obligations and the personal advice carve out; what issuers are looking for; significant dealings and complaints reporting.

FASEA CPD: 1.00 hour Regulatory Compliance and Consumer Protection
RG146: 1.00 Generic Knowledge

Electronic execution of documents

Wednesday 25 August from 1.00 to 2.00pm

There has never been a more important time for firms to be able to collect client signatures digitally. However, there has been a lot of change recently to laws surrounding electronic execution of documents as well as proposed reforms that are not yet enacted which have left many confused. We are delighted to have Paul Derham return to address these concerns. He will outline policies that ensure clients can execute documents in a legally binding manner that is consistent and digital.

FASEA CPD: 0.5 hour Regulatory Compliance and Consumer Protection | 0.5 hour Client Care and Practice
RG146: 1.00 Generic Knowledge

Single Disciplinary Body

Wednesday 8 September from 1.00 to 2.00pm

The bill implementing the Single Disciplinary Body for financial advisers is currently before Parliament and is expected to come into effect on 1 January 2022. SAFAA CEO, Judith Fox and Policy Manager, Michelle Huckel will provide an overview of how the key aspects of the new regime will impact on advisers and licensees.


Judith Fox


Michelle Huckel

FASEA CPD: 1.00 hour Professionalism and Ethics
RG146: 1.00 Generic Knowledge

Private wealth management: global trends & future predictions

Wednesday 22 September from 1.00 to 2.00pm

Disruption is a term that gets thrown around a little too often these days, and yet it can't be denied that the past decade has seen significant technological change. Much of this change will have far-reaching impacts on private wealth and investment management. Join Michael Blomfield from Iress as he explores the top four global trends and future predictions for the private wealth industry.

FASEA CPD: 1.00 hour Technical Competence
RG146: 1.00 Generic Knowledge

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BY JAMES DUNN, ShareCafe

Farming, Food and Fertiliser: **Sulphate of Potash bringing a revolution in all three**

A new chapter is opening in Australia's rich history of mineral endowment, as an emerging group of producers bring onstream deposits of sulphate of potash (SoP), a premium fertiliser product.

The Western Australian producers are tapping into potassium-rich brines formed by rainfall over millions of years, carried through palaeo-channels below what is now desert, that have formed under old salt lakes. These large brine resources suit perfectly the SoP product, which – although it represents only about 10 per cent of the potassium fertiliser market, is definitely at the premium end.

"Every plant product that you buy in the fresh-food section of the supermarket, or the deli – the leafy green vegetables, the tomatoes, avocados, berries, tree nuts, coffee, cocoa, even cut flowers – is a plant that cannot tolerate chlorine," says Keren Paterson, managing director of SoP project developer Trigg Mining. "Most of the market is muriate of potash (MoP), which is cheaper, but it is half chlorine, and can't be used where the chlorine could burn the foliage or the roots of the plants."

Australia's major broadacre crops – like wheat, barley, oats, rye – will likely continue to use muriate, but "all the high-nutrient produce" cannot, says Paterson. "All the flavoursome things – your smashed avocado on toast at breakfast, your coffee, salad for lunch, your glass of wine at the end of the day – they need SoP."

Australia currently imports all of its SoP requirement, about 63,000 tonnes a year, but the nation's food producers are "demanding" a local supply, Paterson says.

"There's a couple of things happening here. One, the whole 'Master Chef generation' is just so much better educated now about high-quality food, where it comes from and how it is produced. It is not too much of a stretch to envisage discerning consumers wanting to know how it's been fertilised. And this is where our product comes into its own," she says.

Potash is an essential nutrient used in high-quality fertilisers that protect food crops from disease and pests, and improve water retention, yield, taste and appearance. But because supply of natural sulphates of potash is limited, most of the SoP product used in the world is derived from a secondary chemical process, called the Mannheim process, in which muriate of potash is combined with sulphuric acid and heated to 800 degrees Celsius in a furnace, to create a manufactured version of sulphate of potash, potassium sulphate, with a by-product of hydrochloric acid.

"There's about 1.2 tonnes of hydrochloric acid created for every tonne of SoP. And that's a highly corrosive acid, it can't be stored, and it doesn't have much of a market, especially compared to the sulphuric acid market," says Paterson. "So, you need to build it either near a consumer of hydrochloric acid, or near a limestone quarry, for you to neutralise it, and then manage it environmentally. But it's environmentally taxing both from an energy perspective and then from a waste product perspective, being hydrochloric acid. The Mannheim process is also an energy-intensive process and that means it is emissions-intensive, too."

As both food consumers and the agriculture sector become much more aware of the need to map the provenance of the food, it is "naïve to think that where the fertilisers are coming from" will not be part of that," Paterson says. "Do you really want to be giving consumers a choice of a chemical SoP made from the Manheim process in China or Morocco, or of totally natural and sustainable Australian Outback solar-evaporated SoP?"

Consumers "increasingly understand that false choice," and are "actively looking for sustainable solutions that help to decarbonise agriculture," she says. "Commercially, you would look at the Australian sulphate of potash story as an import replacement story, first, and then a potential export story. And it certainly stacks up on those grounds. But a lot of consumers – and farmers – are far more conscious of the carbon impact of the production of food. Imported fertiliser immediately creates a very large carbon footprint for food, before it is produced – even if it's grown in Australia."

These considerations are part of the "thematic drivers" into which SoP taps. A growing world population, a consequent global reduction in arable land, and the rising use of fertiliser are huge tailwinds.

"To feed that growing population, a lot of food is going to be produced in increasingly intensive agricultural applications, through hydroponics (growing crops without soil, by using mineral nutrient solutions placed in the water supply) and 'fertigation,' or fertilisation delivered through the irrigation system," says Paterson. "Instead of a row of tomato plants out in the paddock, it could be row of tomato plants in a food factory, quite possibly in the city. It could be vertical farming. This type of food production is going to grow massively in use, and SoP is the perfect match for it," she says.

All of which augurs well for Trigg Mining, which wholly owns the Lake Throssell and Lake Rason SoP projects in Western Australia. Lake Throssell is a large, high-grade SoP project, at drilling has identified brine returning samples of up to 12.93 kg/cubic metre SoP, with an average grade of 10.01 kg/cubic metre SoP. The maiden resource for Lake Throssell totals 14.2 million tonnes of drainable SoP at 4,638 milligrams per litre of potassium (or 10.34 kilograms per cubic metre of SoP).

At the nearby potential satellite project, Lake Rason, the inferred mineral resource is 6 million tonnes at 5,080 mg/litre SoP equivalent. Combined, the two projects give Trigg Mining a total mineral inventory of more than 20 million tonnes of SoP – enough for a multi-decade operation – with big exploration upside to boost that figure even further. Paterson says the

As both food consumers and the agriculture sector become much more aware of the need to map the provenance of the food, it is "naïve to think that where the fertilisers are coming from" will not be part of that," Paterson says.

infrastructure endowment of the project is highly beneficial to the economics, with a nearby railhead at Leonora, a choice of port locations (Esperance, Perth or Geraldton) and the imminent upgrading of the 2,800-kilometre Outback Way into Australia's third transnational highway, running right past the company's mine-gate.

Paterson says Trigg is "only scratching the surface" at Lake Throssell, which has placed it front-and-centre of Australia's newest mining industry, SoP. But strangely enough, she says, a lot of the company's staff see SoP as more than a mining industry – she says Trigg Mining has attracted 'a lot of people who want to connect with a purpose-driven company, that's going to play an important role in Australia achieving food security.'

"This project has multiple attractions for the consumer and the investor, as a value-added product. It's sustainable production for sustainable agriculture for sustainable food supply, and nutrition. It's better for the soil on which it is used, which means it's better for our future, because we will be able to maintain those soils for longer, for production in the future. This project ticks all the boxes – I can't find one that it doesn't tick," Paterson says. ■

It's sustainable production for sustainable agriculture for sustainable food supply, and nutrition.

What's YFYS?

It stands for - *Your Future, Your Super* – to address some systemic problems in the superannuation system. Some changes will apply from 1 July 2021 with further changes coming in 2022.

The problems centred around the default system when an employee starts a new job and does not make a choice of where their SG contributions should be paid. Members ended up being in multiple funds, paying unnecessary fees and having unnecessary life insurance. On top of this, superannuation was too complicated, and members could not easily choose a fund to suit their needs and arrange the consolidation their super.

Whether members are in a *MySuper* fund or another APRA regulated fund, it is almost impossible to compare performance between funds. The default system meant many members were losers in an 'unlucky lottery'.

Some preparatory work has already occurred. The ATO has used Tax File Numbers to clean up $2.9 billion worth of small inactive accounts affecting 1.4m members.

APRA created a 'Heatmap' analysis to compare net investment returns (after fees and taxes) for multi-year periods to identify underperforming funds. Treasury concluded that 21 out of 77 *MySuper* products underperformed by more than 0.5% over the six years to 2019.

YFYS has four initiatives.

Your super follows you

Rather than being forced into a new fund, employees will have a fund 'stapled' to them. From 1 July 2021, employer's will be able to find an employee's current super fund online and use that fund rather than using a new fund. Of course, a member can choose to change their stapled fund at any time.

Empowering members

From 1 July 2021, members can compare *MySuper* funds through the *Your Super* comparison tool available via MyGov and the ATO website. This will show a member's stapled fund, its performance history and compare it to other *MySuper* products.

Your Super data will be updated quarterly based on data reported to APRA and will be extended to other APRA regulated funds from 1 July 2022.

Identifying underperforming funds

MySuper funds are now subject to an annual performance test. Funds that underperform in a year must report to their members – the first reports will go out by 1 October 2021. Funds that underperform for two consecutive years will not be allowed to accept new members until their performance improves.

Annual performance tests will apply to other APRA regulated funds from 1 July 2022.

Transparency and accountability

From 1 July 2021, superannuation funds will be treated more like companies. They must hold an AGM for members and report on the member outcomes for the year. Trustees must act in the best financial interests of the members. They must disclose remuneration of key executives, marketing and sponsorship costs, political donations, payments to industry bodies or trade associations and related party transactions.

The aim of these initiatives is to improve outcomes for members and give them control over their super. ■

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