Perpetual Asset Management

Perpetual Industrial Share Fund

Fund update

NET PERFORMANCE - periods ending 31 December 2024

	Fund	Benchmark #	Excess
1 month	-3.99	-3.03	-0.95
3 months	4.06	2.23	+1.82
1 year	22.72	21.22	+1.51
2 year p.a.	15.87	16.61	-0.75
3 year p.a.	10.33	7.74	+2.60
4 year p.a.	12.05	10.55	+1.50
5 year p.a.	9.74	8.34	+1.40
7 year p.a.	7.68	8.41	-0.73
10 year p.a.	7.54	8.38	-0.84
Since incep.	9.92	9.22	+0.70

Past performance is not indicative of future performance. Returns may differ due to different tax treatments.

Past performance is not indicative of future performance. Returns may differ due to different tax treatments.

Performance

During the month of December 2024, the Perpetual Industrial Share Fund generated a return of -4.0% (net of fees). This underperformed the benchmark (S&P/ASX 300 Industrials Accumulation Index) by 0.95%.

Over the twelve months to 31 December 2024, the fund generated a return of 22.7% (net of fees), outperforming the benchmark (S&P/ASX 300 Industrials Accumulation Index) by 1.5%. This was a pretty good year for the fund relative to the index, with the outperformance of industrials relative to resources also resulting in large outperformance of the Industrial Share Fund relative to the overall market. We won't take any credit for that as it is just the luck of the mandate, but it was a good year for our unitholders.

Over the year, key contributors to performance were our large overweight positions in Suncorp Group Ltd. and Goodman Group.

Commentary

"Consider a turkey that is fed every day. Every single feeding will firm up the bird's belief that it is the general rule of life to be fed every day by friendly members of the human race 'looking out for its best interests', as a politician would say. On the afternoon of the Wednesday before Thanksgiving, something unexpected will happen to the turkey. It will incur a revision of belief."

– Nassim Nicholas Taleb, The Black Swan

This quote serves as a metaphor for how humans (or systems) can misinterpret prolonged periods of stability as evidence of safety – making them more vulnerable to rare, high-impact events when they occur. Below, we explore areas of fragility in Australia's superannuation system (along with its financial system more broadly) given the enormous amount of concentration risk focused on one area: Australian residential property.

Superannuation funds in Australia are already a dominant force with an unprecedented portion of the overall financial system, and this is set to become more dominant over the coming decade.

We feel that they are increasingly incentivised to act like passive funds which – being pro-cyclical, given their influence, and due to all acting in unison – has the potential to be extremely destabilising. That's due to highly concentrated exposures – not just through superannuation funds' exposure to the Australian banks' capital stack, but through Australian banks' exposure to Australian residential property.

This means the fate of Australia's housing market and the members of Australian superannuation funds are inextricably linked.

We feel the pro-cyclicality of the most important pool of capital in the Australian market is the reason why a bank like CBA is currently the most expensive established bank in the world, at 25x P/E. This will not rear its head until there is a left-field risk, like a credit crunch or a prolonged housing downturn.

Given that it has been a long bull market for housing in Australia, there is complacency – just like there is complacency of the proverbial turkey before Thanksgiving.

Australia's superannuation industry

Compulsory superannuation was introduced in Australia by the Keating government in 1992 as part of the Superannuation Guarantee (SG) scheme. The idea was to encourage individuals to save some of their income for retirement.

This was in response to an ageing population and would allow individuals to fund themselves after retirement rather than be reliant on the government-funded age pension. Initially, employers were required to contribute 3% of an employee's earnings into a superannuation fund. Over the years with some tinkering, the contribution has ratcheted up and will reach 12% in 2025.

Fast forward to today, and as of June 2024, superannuation funds are managing $4 trillion in assets – a figure that's forecast to be as high as $6 trillion over the next decade, equating to just under a third of all financial system assets.

Put simply, these superannuation funds in aggregate are behemoths and are set to become an even more dominant portion of the Australian investment market over the next couple of decades.

Introduction of the Performance Test

In 2021, the Morrison Government introduced an amendment to the legislation. It was the Treasury Laws Amendment (Your Super, Your Future) Act 2021 which – among other things – introduced a performance test for the superannuation funds.

Under this test, all super funds would have to provide their annual performance (net of management costs and other fees) relative to the specific asset classes benchmark. For instance, the Australian equities component would be judged against the ASX 200 Accumulation Index.

If, over an eight-year test period, the net returns were more than 0.5% per annum less than the benchmark, then the super fund would have to write a letter to all its members pointing this out and giving guidance on where they could compare the returns to other funds on the YourSuper comparison website. If there is underperformance for two years in a row, that superannuation fund is then no longer able to accept new members. Being cut off from new members would, for all intents and purposes, likely result in the fund being shut down or forced into merging with another superannuation fund.

The intent of this legislation is completely logical. Superannuation funds should not be able to hide behind persistent underperformance. The members who have been forced to send their money to a superannuation fund should be alerted if their funds are being mis-managed. This amendment was passed without too much opposition and was not controversial.

We, however, believe there is an unintended consequence resulting from the introduction of these performance tests. There is an asymmetry of incentives for the decisionmakers at superannuation funds. While outperformance relative to a benchmark is good from a pride perspective, it is far outweighed by the downside if one underperforms. If a superannuation fund underperforms for two years in a row, it will more than likely shut down while the manager loses their job. Hence, there is no incentive for the manager to stick their neck out and stray too far from the respective benchmark.

Systems, but financial systems more specifically, require cognitive diversity – different parties within that system acting with independent thought in order for that system to have long-term stability. There will be a difference in opinions on valuation and, over time, the true underlying valuation is found. When a stock is sold by one fund, another fund might start to see value, thus creating a stabilising factor.

The problem when every participant is heavily incentivised to stay close to the average is that participants tend to all do the same thing at the same time. Any fund wanting to track the index will buy what has already gone up (and hence a larger market weight) and sell what has already gone down (smaller market weight) – no matter what the valuation fundamentals of the underlying asset is. This behaviour is pro-cyclical and, given the weight of money all doing the same thing at the same time, is extremely destabilising.

When it comes to the strategic Australian equities allocation of these superannuation funds, the biggest decision that these funds need to make is around banks. While the big four banks are slightly different beasts, they have very similar risks and very high correlation. Therefore, the 22.5% of the index that represents the big four banks is – for all intents and purposes – just one big company.

Given the incentive not to underperform under the new legislation, it would take an extremely brave superannuation fund manager to be materially over or underweight the banking sector. Therefore, in our view, an unintended consequence of the introduction of the performance test is that the super funds' holdings in the bank sector are increasingly likely to be "passive" holdings.

Issue 1: Financial stability

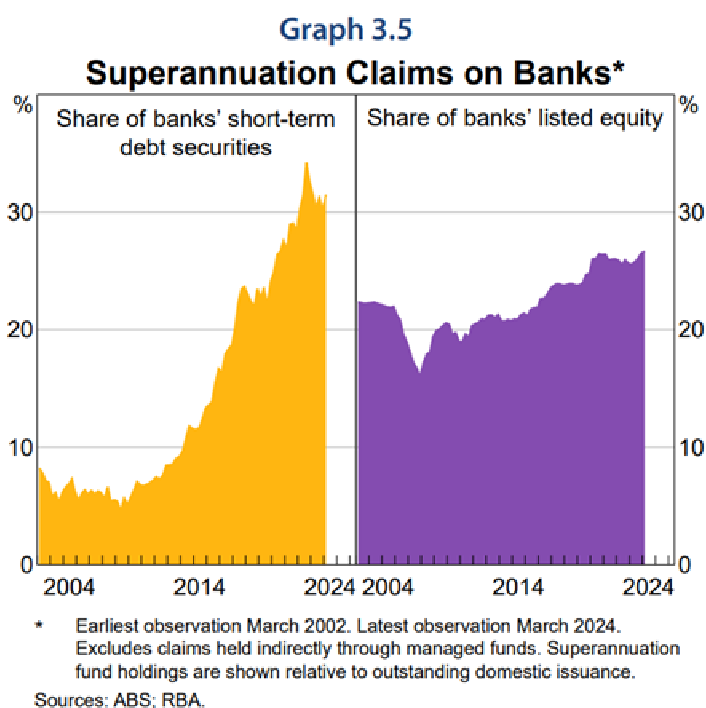
Given their size, superannuation funds are now 28% of the banks' share register on a direct basis.

If one adds indirect holdings through their managed funds, the size of their holdings is materially higher. Therefore, in equities alone, superannuation funds directly and indirectly own around a third of the register, or around $200 billion.

However, this is not where it ends. Banks issue a lot of short-term paper to fund operations. Given their size, superannuation funds own (on behalf of their members) 31% of banks short-term debt securities. This is up materially from 8% of the banks' short-term debt holdings in the Global Financial Crisis.

The point here is that superannuation funds own an unprecedented amount of the banks' capital stack and this is likely to increase materially over time.

See the chart below:



At this point in time, it's worth highlighting a few points:

We have a system where the banks have never been more reliant on one source of funding (superannuation funds) from an equity and debt perspective.

Perpetual

We think because of the introduction of performance test, these superannuation funds are incentivised to hug the index and act in unison.

They are likely going to be pro-cyclical in their investing given the nature of passive investing. That is, they will sell after the shares fall and buy after the shares go up (as they're doing now).

As we saw during COVID, in periods of stress, liquidity dries up and superannuation funds will disproportionately sell what they can to meet liquidity requirements – thus shares and short-term fixed interest assets would bear the brunt of any liquidity crunch.

Scenario

To illustrate why we see this as a potential issue in the future, let's consider a hypothetical scenario where we experience a credit crunch or house price collapse.

In this scenario, the share market would fall, liquidity would dry up, and banks will underperform the market. As the banks underperform the index, superannuation funds that would be at least a third of the banks' register would more than likely disproportionately sell their position to maintain market weights – with the selling pressure bringing about more selling pressure.

There is no obvious stabilising influence. This will likely be a liquidity crisis, with heavy demand from members to shift to defensive portfolios. Combined with the inability to liquidate assets across unlisted property, private equity and private credit, these superannuation funds would then be forced to liquidate their shares and short-term credit. We observed this reaction through a short window in March 2020 after the shock of Covid.

A repeat of this with higher starting ownership levels would be an extremely bad cocktail for bank equities.

We think that the opposite of this is happening currently in slow motion.

As more money piles into superannuation funds and as banks become a bigger part of the index, the weight of money will continue to buy banks no matter their valuations. This explains why CBA is trading at 25x P/E, making it the most expensive bank in the world.

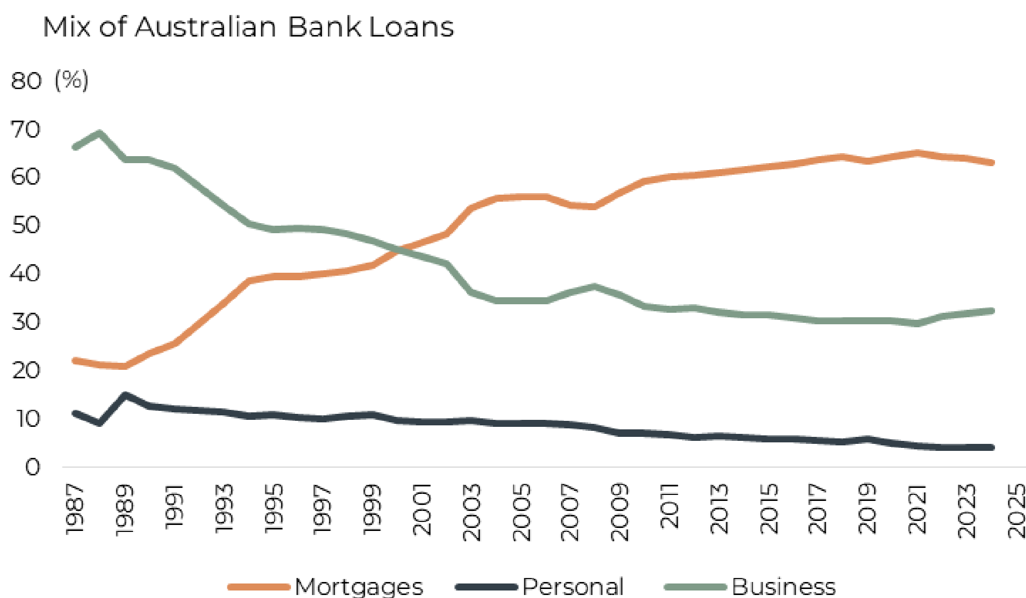
We don't see this trend reversing any time soon, but when it does, it will be vicious.

Issue 2: Concentration risk to the power of two

Turning to the banks themselves, how have they changed over the last decade or so?

While bank fundamentals look pretty good at this time, with decent credit growth, margin expansion and extremely low bad debts, there is one issue that needs to be addressed: that is, yet again, concentration risk.

Over the past few years thanks to shareholder, regulatory and public perception, banks have de-diversified away from international businesses and local wealth management, insurance and other financial businesses.



At the same time, their lending profiles in Australia have also shifted dramatically towards residential mortgages.

Over the past three decades, residential mortgage lending has more than doubled as a percentage of bank loans and now sits at around two-thirds of a bank's balance sheet. This probably understates the true exposure to the Australian housing market, as a large proportion of the business loans to SMEs are secured by residential properties – making the true underlying exposure to Australian housing even higher.

This shift has been driven by APRA, which has engineered this outcome through a reduction in risk weightings of mortgage loans relative to unsecured personal loans and business loans.

So why is this important?

Well, at the same time as members of superannuation funds are increasing their exposure to Australian banks, these banks are increasing their exposure to Australian residential property. In addition, the type of residential loan is becoming more and more homogenous. Since the Royal Commission, banks are being pushed by APRA to lend to owner-occupiers, with high downpayments (Low LTV ratios) and full documentation. That is, they are lending to high-income earners working for big companies and reducing exposure on lower-income earners or those who run their own businesses.

As one bank CEO said last year: "Last half, our banks lent more money to borrowers earning more than $500k (top 1-2% of households) than to all households earnings less than $125k (bottom 60% of households)."

That's a huge concentration risk to high-income earning, white-collar lawyers, consultants and financial service providers.

Now to be fair, that has historically been a very good risk for banks to take. The concern with the heavy concentration in highly paid white-collar professionals is the potential for structurally increasing unemployment over the next five years, thanks to the productivity breakthroughs from Artificial Intelligence (AI).

AI tools are likely to make corporates materially more efficient at tasks, which require process-orientated and time-consuming grunt – that is, the tasks that a large portion of professionals undertake. We suspect the

"productivity gains" (which is corporate speak for "job cuts") will come in lawyers, consultants and other professional services.

Does that sound familiar? While we are not calling the end of the housing cycle, we just need to highlight that there is a long tail risk here that needs to be appreciated considering the level of concentration of exposure that the banks have to residential mortgages in Australia.

Issue 3: Concentration risk to the power of three

If you think about the underlying assets of a typical retiree, the two biggest assets would be their house and superannuation.

Given strong returns on both property and equity markets over recent decades, this has been a good risk in which to be exposed. However, as discussed previously, people's super funds are increasingly leveraged to Australian bank share prices (which are all extremely correlated) which, in turn, is highly leveraged and extremely exposed to residential mortgages.

The problem is the enormous downside correlation between someone's house and the value of bank equities.

Put simply, retirees have an enormous amount of concentration in the one asset class – Australian housing, which has been a one-way bet for many decades. We are not calling the end of this bull market just yet. But what we are saying is there is a tremendous and increasing amount of concentration risk in this asset class across ownership of one's property, allocation to Australian equities, and allocation to Australian fixed interest in one's superannuation fund.

Conclusion

Due to the historic lack of volatility in Australia, there is currently a perception that we have an extremely stable financial system.

However, we believe that there is substantial concentration risk which is being ignored because of the perceived stability of the system. As our metaphor at the beginning talks about the plight of the Thanksgiving Turkey, humans and systems can misinterpret long periods of stability as evidence of safety – making them more vulnerable to rare, high-impact events when they occur.

Could it be that our financial system, housing market and bank shares are the turkey the day before Thanksgiving? I don't think so just yet. But the longer the time before a housing cycle or financial crisis, the bigger the impact will be when it eventually comes.

This does not mean we are going out and selling all our bank shares – that may be a little premature. However, we are sensitive to the concentration risks articulated in this article. Given the increasingly passive nature of the largest source of capital in the Australian market and the pro-cyclicality and uniform nature of their investment behaviour, we believe the system is increasingly unstable.

Unfortunately, this will only become obvious when a left-field event occurs and there is a credit crisis or deep housing cycle, so it is incumbent upon us as active fund managers to manage this risk appropriately.

This information has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426. It is general information only and is not intended to provide you with financial advice or consider your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances.

To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. The information is believed to be accurate at the time of compilation and is provided in good faith. Any views expressed in this document are opinions of the author at the time of writing and do not constitute a recommendation to act.

The product disclosure statement (PDS) for the Perpetual Industrial Share Fund, issued by PIML, should be considered before deciding whether to acquire or hold units in the fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

No company in the Perpetual Group (Perpetual Limited ABN 86 000 431 827 and its subsidiaries) guarantees the performance of any fund or the return of an investor's capital. Total returns shown for the Perpetual Industrial Share Fund have been calculated using exit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.

Perpetual