Chant West

Research Paper

December 2022

Limiting the damage – how diversification beyond traditional asset sectors saved the day in 2022

Investment markets delivered some unusual outcomes in 2022. It is quite rare for bond markets to deliver a negative return over a full year, and rarer still for them to do so at the same time as equity markets, but that was what happened both globally and locally in calendar 2022. Australia's major super funds were up to the challenge, however, managing to minimise the losses for their members mainly through diversification beyond traditional liquid asset classes.

In 2022, super funds were confronted with the toughest investment environment in recent history because all of the traditional listed asset sectors in which they invest – shares, property and bonds – delivered negative returns. Table 1 shows that the Australian share market got off the lightest, losing just 1.8%. International shares fared much worse, losing 12.5% in unhedged terms and 16.4% when hedged back into Australian dollars. Listed property performed worse still, with Australian REITs down 20% and global REITs losing as much as 24.1%.

What really made life difficult, however, was that bond markets, which fall relatively infrequently and generally provide diversification benefits during periods of share market weakness, also fell substantially over the year. Yields rose and capital values fell because of rising inflation and the response of central banks worldwide, which was to embark on a steady round of interest rates increases. So rather than act as a buffer to falling equity markets, bonds themselves delivered negative returns, with Australian bonds losing 9.7% and global bonds 12.3%.

It is worth noting that this was only the second time in the past 50 years that international shares and bonds have both fallen over a full calendar year (the last time was in 1994). In the case of Australian shares and bonds, 2022 was only the second time both have fallen in the 30 calendar years of compulsory superannuation and only the third in the past 50 years.

Super fund members, faced with the knowledge of those substantial falls in public markets, could be forgiven for fearing the worst when they come to look at their funds' annual returns. Happily, the outcome is a lot better than many would have expected, with the median growth fund falling just 4.6% over the year. That is largely due to the degree of diversification built into most funds' investment portfolios, which typically have meaningful exposures to physical assets such as property and infrastructure as well as other unlisted or alternative assets including private equity and hedge funds.

Looking at the one-year returns in Table 1 (on page 2) based on median performance for a small group of major super funds, it is clear how those exposures to unlisted and alternative asset sectors helped to counter the negative returns from the traditional listed sectors. Returns of 9.1% from unlisted property and 10% from unlisted infrastructure were solid. Private equity posted a small median return of 0.9% but some funds' private equity returns were slightly in the red as we've seen some downwards valuations over the past six months.

Looking at the longer-term data, the benefits of diversification are again evident from the table. Asset sectors do not all move in the same direction at the same time, and no sector consistently performs best. It is only by combining and balancing them judiciously that funds can control downside risk and capture enough of the upside to drive positive returns over time.

Table 1: Asset Sector Performance (Results to 31 December 2022)

Asset Sector	1 Yr (%)	3 Yrs (% pa)	5 Yrs (% pa)	7 Yrs (% pa)	10 Yrs (% pa)	15 Yrs (% pa)
Australian Shares	-1.8	5.5	7.1	8.4	8.6	5.0
International Shares (Hedged)	-16.4	5.7	6.9	8.8	10.1	6.1
International Shares (Unhedged)	-12.5	6.2	9.3	9.6	13.7	7.3
Private Equity	0.9	16.7	13.7	13.4	13.7	-
Australian Listed Property	-20.0	-0.8	3.8	5.5	8.5	2.4
Global Listed Property	-24.1	-5.6	-0.4	1.7	4.6	3.1
Unlisted Property	9.1	6.9	8.5	8.9	10.1	-
Global Listed Infrastructure (Hedged)	-4.2	1.1	4.7	7.2	9.2	-
Unlisted Infrastructure	10.0	8.7	9.7	11.3	11.0	-
Australian Bonds	-9.7	-2.9	0.5	1.3	2.3	4.3
International Bonds (Hedged)	-12.3	-3.2	-0.2	1.1	2.3	4.6
Cash	1.3	0.5	1.0	1.3	1.7	2.7

Note:

Market indices are shown other than for private equity, unlisted property and unlisted infrastructure where we use the median returns of a small group of major superannuation funds. For these unlisted sectors performance is shown net of fees whereas for other sectors no fees are taken out.

Source: Chant West

Passive options miss out on diversification benefits

Cost-conscious investors are often attracted to passively managed investment options because of their lower fees, and some funds have responded to that demand by offering diversified options that use an indexed approach to investment management.

While the fees may indeed be lower, the downside of that approach is that it limits the range of investments to those that can be replicated by a market index. That rules out exposure to unlisted property, unlisted infrastructure, private equity and other alternative assets which, as we have seen, produced positive returns in calendar 2022 that helped to offset the losses in listed markets. As a consequence, members invested in those indexed options suffered much heavier losses than their counterparts in actively-managed options.

To demonstrate that, we can look at the returns of the funds in our universe that offer both active and indexed growth options. Table 2 shows the median returns for those options over the past 1, 3, 5 and 10 years. Over calendar 2022, 10 of the 11 funds recorded a better return for their active option than their indexed option. Most tellingly, the median return for the active options was a full 3% better than the median indexed option.

Table 2: Active Growth vs Indexed Growth Options – Periods to Dec 2022 (% p.a.)

	1 year (10 funds)	3 years (9 funds)	5 years (6 funds)	10 years (6 funds)
Active Growth	-4.4	4.2	5.7	7.9
Indexed Growth	-7.4	3.2	5.1	7.3
Active Outperformance	3.0	1.0	0.6	0.6

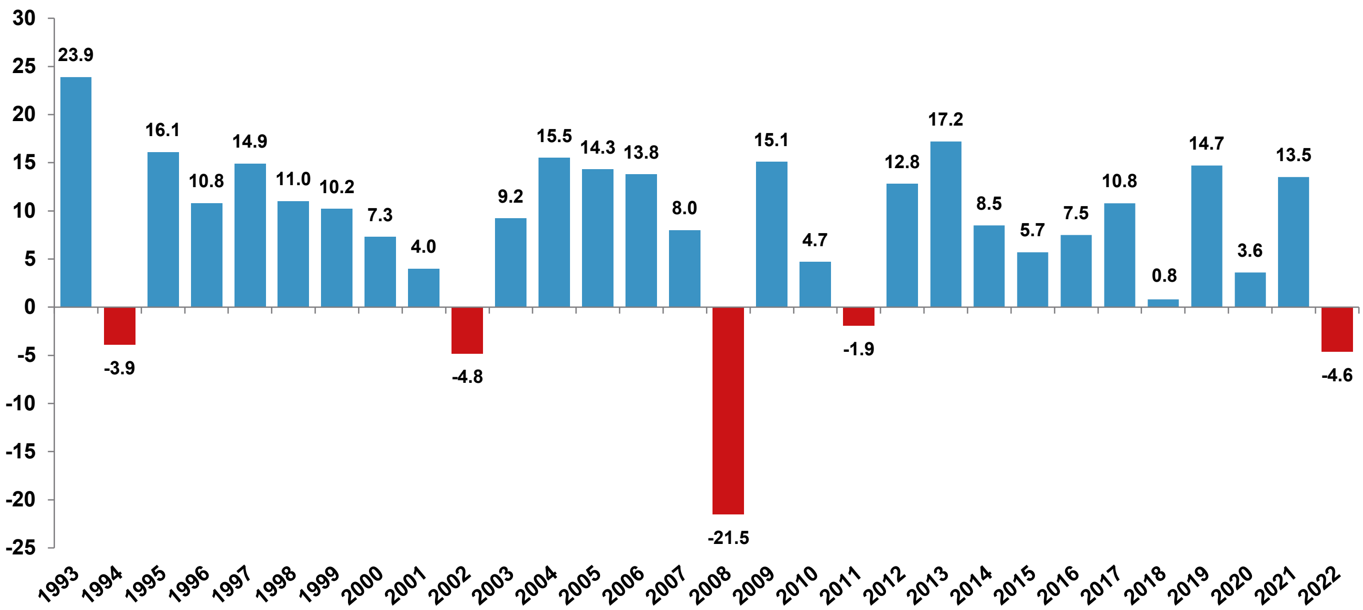
Source: Chant West

We can observe the same pattern over longer periods. While the degree of outperformance is lower, the active options nevertheless returned up to 1% per annum more than their passive equivalents over 3, 5 and 10 years – this is even after taking off tax and the higher fees payable in active investment options. Ultimately, net benefit to members is what's most important.

Funds still surpassing their targets for return and risk

Notwithstanding the negative year, funds are still delivering on their promises to members over the long term. Chart 1 plots the year-by-year performance of the median growth fund since the introduction of compulsory super more than 30 years ago. The average return over that very long timeframe is 7.8% p.a. Over the same period inflation has average about 2.6% p.a. The typical long-term return objective that funds convey to members is to beat inflation by 3.5% p.a., so that translates to 6.1% p.a. So over 30+ years funds are 1.7% a year ahead of what they tell members to expect.

Chart 1: Growth Funds – Calendar Year Returns (%)



Source: Chant West

Of course, investing for long-term growth does mean taking on some risk, so members should expect a negative return from time to time as a natural result of investment market cycles. The typical long-term risk objective for growth funds is to have no more than one negative return in every five years, which over 30+ years amounts to six negative years. Since there have been five negative years including this last one, once again funds show that they are bettering expectations.

Different risk profiles produce different outcomes

Our analysis tends to focus on growth funds, since that is the risk category where the majority of members have their investments. There are of course other risk categories and the most popular are High Growth, which has a higher allocation to equities and other higher-risk assets and is often preferred by younger members, and Conservative, which is favoured by more risk-averse members and those with shorter investment timeframes. Indeed, the number of members in High Growth portfolios has increased since the introduction of MySuper lifecycle strategies with younger members up-risked. Our data for these categories only goes back 27 full calendar years, so that is the timeframe for the long-term performance figures in Table 3.

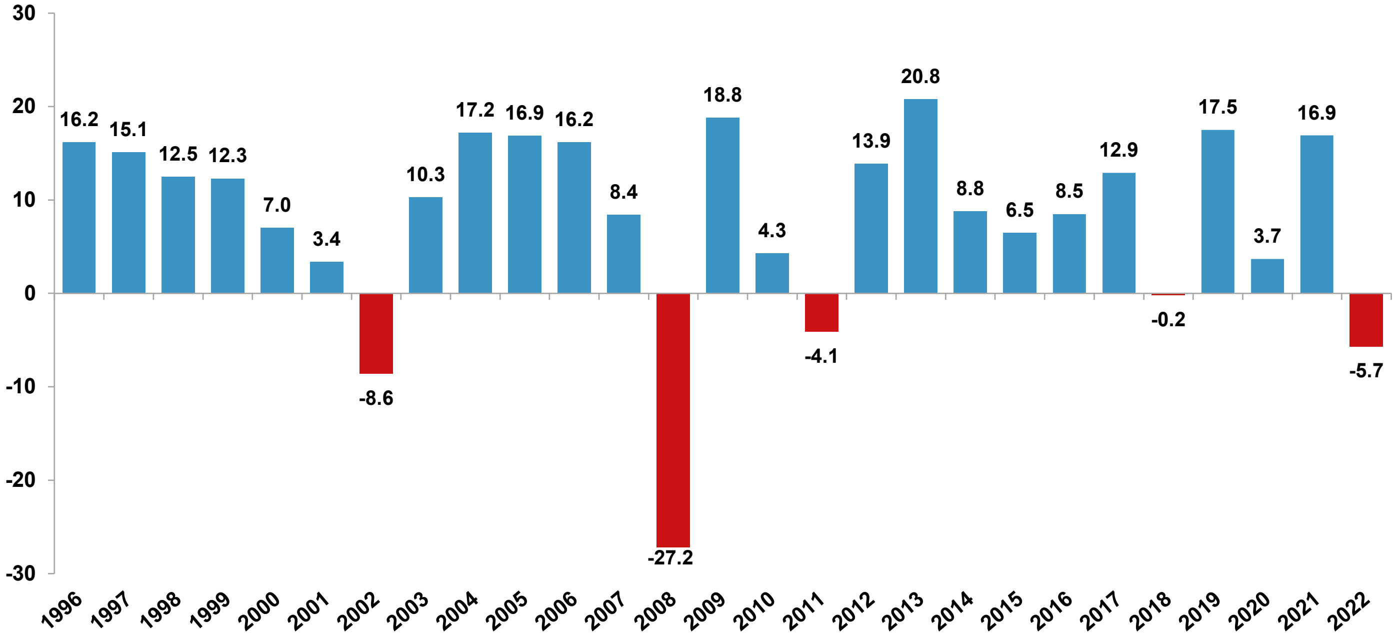
Table 3: Long-term Returns for Selected Fund Categories

Fund Category	27-year Return (% pa)
High Growth (81 – 95% growth assets)	7.7
Growth (61– 80% growth assets)	7.4
Conservative (21– 40% growth assets)	5.5

Source: Chant West

As we would expect over such a long timeframe, the higher the exposure to growth assets the higher the average annual return. So members in High Growth options do get a slightly higher return, albeit with increased risk. That risk is seen in Chart 2, where there have been five negative years out of the past 27 and the magnitude of those negatives has been greater than in the Growth options chart.

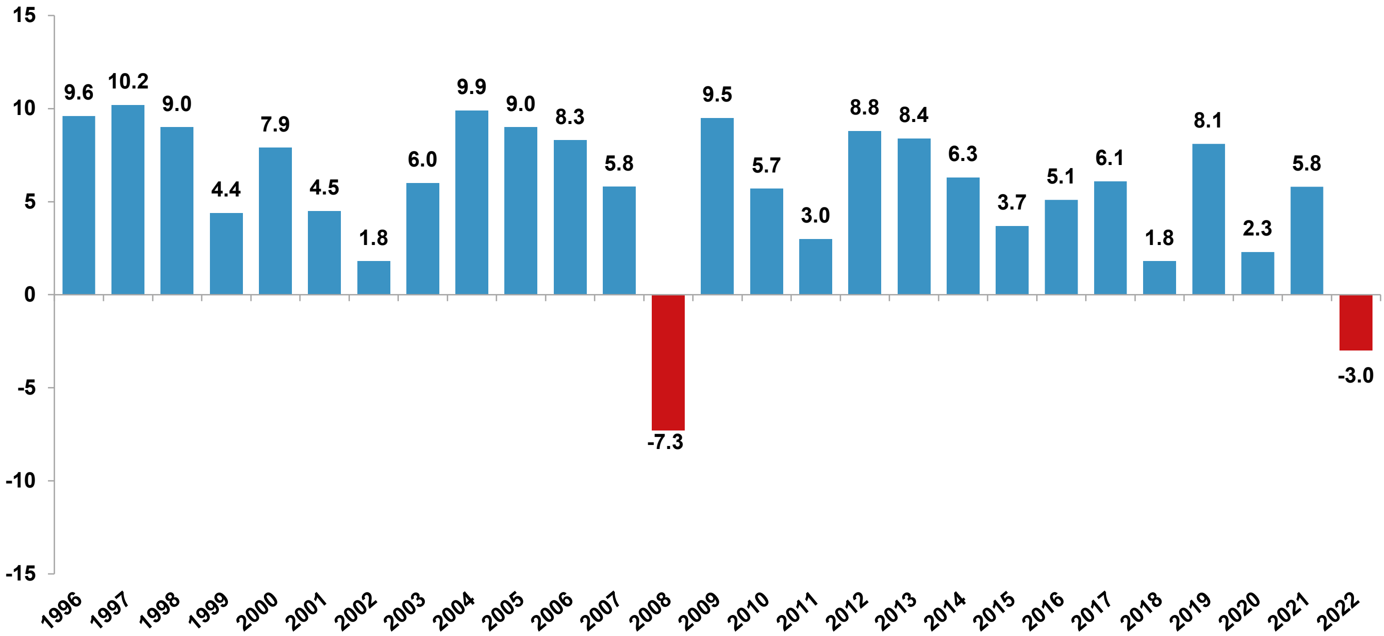
Chart 2: High Growth Funds – Calendar Year Returns (%)



Source: Chant West

The reverse is true for Conservative options, as shown in Chart 3. Here we see that there have only been two negative years in the entire 27-year period, and those losses have been relatively modest compared to the higher risk categories. The loss in 2022 can be attributed mainly to the negative returns from bonds, which form a sizeable part of these portfolios. Overall, though, these Conservative options are doing what they are designed to do, which is to protect against the worst in market downturns and to preserve the capital of members who, typically, are older and so closer to needing to access it.

Chart 3: Conservative Funds – Calendar Year Returns (%)



Source: Chant West