Vanguard®

Asset allocation report

September quarter 2020

Contents

Budget timing leaves rates on hold

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The release of the historic big-spending federal budget overshadowed another key piece of economic news on the same day: the Reserve Bank's monthly statement on monetary policy.

There had been some speculation leading up to the RBA's statement that Australia's official cash interest rate would be cut from 0.25 per cent (where it has been since March).

Doing so would have dropped Australian rates below those of the United States, Canada and New Zealand (all also at 0.25 per cent), and Singapore (at 0.21 percent).

Dropping rates to 0.1 per cent would place us on the same rung as the United Kingdom, Poland and Israel. Taking an even greater step down to zero per cent would put Australia in line with a host of other countries around the world.

In any event, a rate cut didn't happen. But another decrease is certainly not off the RBA's policy agenda either.

The federal government's budget measures, including investment incentives, wage subsidies and tax breaks for businesses, have largely been designed around creating one million jobs to short-circuit the large spike in unemployment caused by COVID-19.

In his statement, RBA governor Philip Lowe noted the central bank's board remains committed to doing what it can to support jobs, incomes and businesses in Australia.

And he said the bank's board would maintain "highly accommodative policy settings as long as is required".

The rates view for investors

What that means is that the RBA will not increase the cash rate target until progress is being made towards full employment and the board is confident inflation will be sustainably within its 2–3 per cent target band.

"The board continues to consider how additional monetary easing could support jobs as the economy opens up further," Dr Lowe said.

Additional monetary easing translates to even lower interest rates for investors, including those borrowing capital for investment purposes.

Of course, what happens at the policy level hasn't in any way stifled activity at the retail level across banks and other financial institutions.

Even though Australia's official interest has now been on hold for over six months, there has been considerable rate movement activity at the retail level.

This has included further cuts to bank term deposit rates, to investment property mortgage rates, and to other loan product rates.

Data from financial products comparison website Canstar shows the current peak one-year rate on bank term deposits is 1.41 per cent, with the bulk of rates at or below 1 per cent. This compares with the top 12-month interest rate in June of 1.7 per cent.

Locking away cash out to three years can currently attract returns between 1.1 per cent and 1.55 per cent. Back in June, some rate returns on two or three-year term deposit accounts were above 2 per cent.

On a borrowing level, rates on the bulk of variable and fixed investor property loans are now below 3 per cent. Many are hovering in the mid 2 per cent range.

In terms of fixed interest securities, bond yields are still around record lows.

Early in September, the RBA bought a further $2 billion of Australian government securities in support of its three-year yield target, bringing total purchases of government securities since March to $63 billion.

Over the past couple of weeks, 3-year bond yields have fallen to around 18 basis points as markets have priced in the probability of further monetary policy easing (a rate cut).

How low can rates go?

In a speech late last month, RBA deputy governor Guy Debelle also gave some further insight into the bank's current thinking on interest rates.

He spoke of the RBA having multiple options, including lowering rates further and even using negative interest rates to spur increased lending from banks to businesses and consumers in order to boost spending across the economy.

Germany, France and 20 other European countries currently have zero interest rates, with Japan, Denmark and Switzerland each having negative rates.

There's no clear picture on what the RBA will do next.

As at 7 October, the day after the federal budget, the ASX 30 Day Interbank Cash Rate Futures November 2020 contract was trading at 99.925, indicating a 78 per cent expectation of an interest rate decrease to zero per cent at the November RBA board meeting.

The future path for official interest rates in Australia is very much wedded to the stimulus measures unveiled in the latest federal budget.

Many of the government's announced jobs-growth measures will take a fair bit of time to filter through the macro economy, so the next move on rates comes down to how long the RBA board is willing to wait.

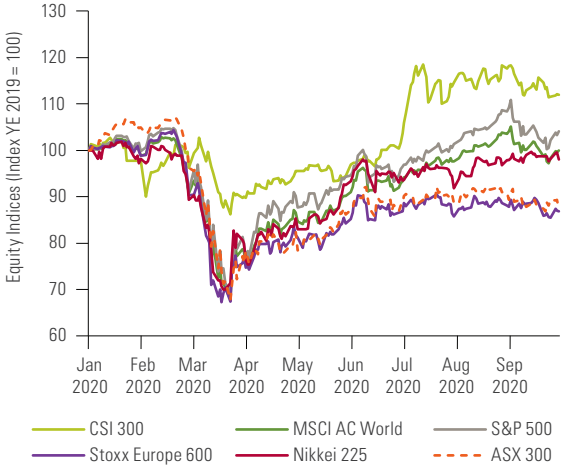
An iteration of this article was first published in *The Australian Financial Review* on 1 July 2020.

Hypothesising a post-COVID world

Quarter in review

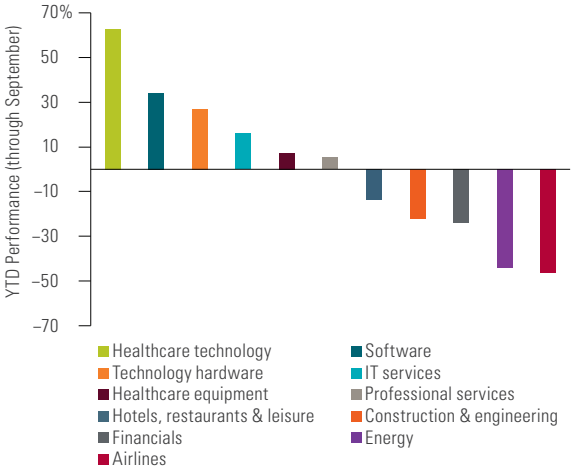
Markets oscillated between risk-on, risk-off mode in Q3, with investors whipsawed by policy announcements, economic data and changing COVID-19 case counts. The picture across regions (**Figure 1a**) was mixed, with China outperforming the rest of the world owing to its first-in-first-out (FIFO) experience with the pandemic, and the U.S. dwarfing most developed markets on the strength of gains in tech-heavy indices, which benefitted from favourable network effects during the pandemic. Australia, on the other hand, appeared to lag most markets given the renewed surge in new COVID-19 cases and stringent re-imposition of lockdowns in Victoria, which accounts for around a quarter of national GDP.

Figure 1a. Significant dispersion across countries...



Notes: Index returns are stated in local currency.
Source: Vanguard, using data from Bloomberg.

Figure 1b. ...and across sectors



Notes: Inter-industry performance for MSCI AC World Index in local currency
Source: Vanguard, using data from Bloomberg

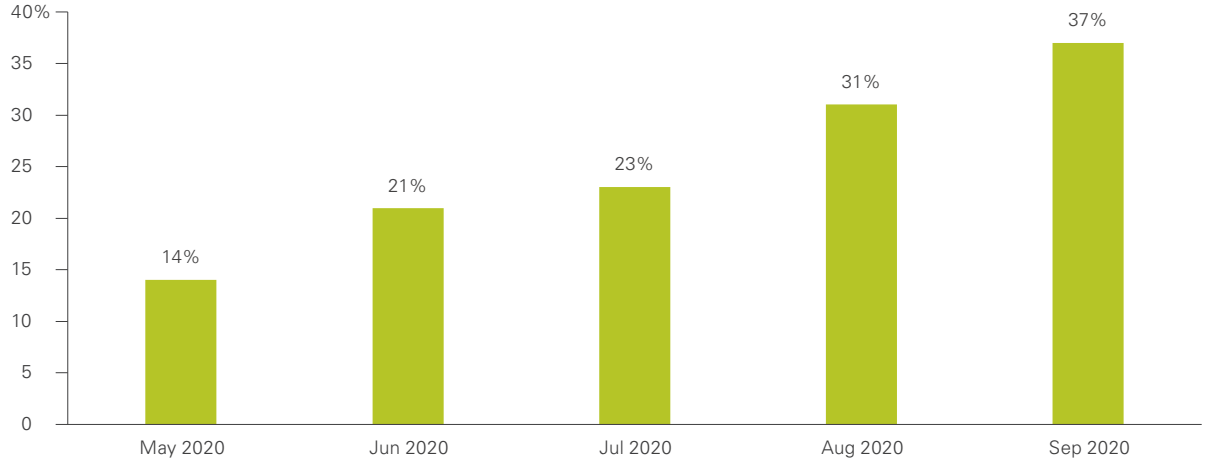
As **Figure 2** illustrates, high frequency indicators used to track activity locally have experienced a pullback over the past two months, with most retail, labour and recreation mobility indicators falling below the levels seen in June. With the extension of direct fiscal support and bank payment holidays until March, 2021 is positive for Australian businesses and households. The lack of a meaningful economic reopening in Victoria until later in Q4 may increase the likelihood of more permanent job and business losses in the state. In the U.S., the negative effects of having the economy in hibernation for a prolonged period of time are evident, with the proportion of temporary unemployed workers permanently losing their jobs steadily increasing over the course of the last quarter (**Figure 3**).

Figure 2. Real time tracking shows stalling recovery in recent months given VIC lockdowns

Source: Vanguard, using data from OpenTable, CityMapper, Apple, Google, Box Office Mojo, OAG and ANZ.

As past crises have taught us, a high proportion of permanent unemployment could prove detrimental to the shape and strength of the recovery, given its spillover effects on consumer confidence and spending. With the labour market unlikely to be as tight as it had been before 2021, and consumer sentiment weighing on face-to-face (F2F) consumption, we do not expect global output to return to its pre-pandemic levels in the very near-term, and quite possibly beyond, should permanent scarring effects intensify.

Figure 3. Increasing percentage of unemployed not on temporary layoffs



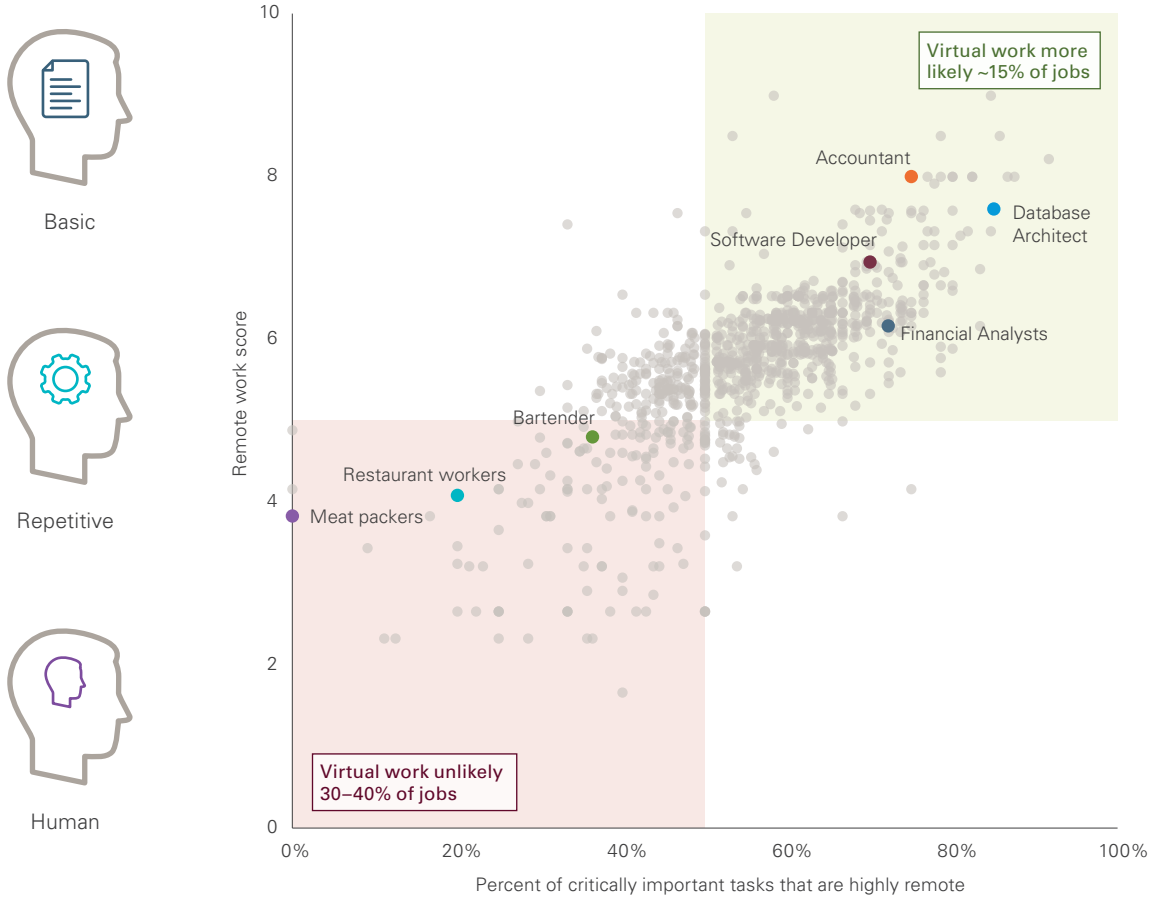
Source: Vanguard, using data from the U.S. Bureau of Labor Statistics

1 It has been well-documented that large financial crises or deep recessions can cause productive potential to ratchet down to a trajectory below its previous trend or even that the trend growth rate will be lower; for example, productivity growth in many developed economies still has not recovered from the 2008 global financial crisis.

Longer-term consequences of the pandemic

As economic activity gradually re-emerges, attention shifts to some of the longer-term consequences of the pandemic, some of which are more evident than others. Significant trends such as the shift to new ways of working, for example, will become more entrenched as a result of the pandemic. For many companies, arrangements such as working from home and virtual business meetings that had previously been the exception have now become the rule. Similarly, e-retail and food delivery, already growing in popularity before the pandemic, have become essential to consumers worried about F2F interactions. As with office work and air travel, restaurants and retail may not overcome heightened consumer reluctance until an effective vaccine or treatment is developed—something we're not expecting before 2021. Under these circumstances, the damage on certain brick-and-mortar retailers could become permanent, and workers whose majority of tasks depend on physical interaction are also at a higher risk of not being able to resume their normal working hours in the near-term (**Figure 4**).

Figure 4. COVID and the future of virtual work



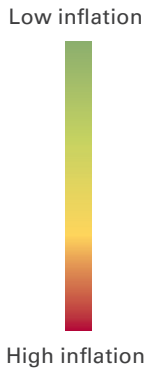
Source: Vanguard, using data from O*NET.

Interestingly, the second-order effects of remote working on commercial real estate, or at least how we invest in it, had already been occurring in plain sight even before the pandemic hit. Over the last decade, for instance, office and retail constituents have fallen from 39% to 19% of equity REIT assets, while residential, infrastructure, and data centres—sectors that are likely to benefit from the pandemic—now make up 45%[2]. The proliferation of digital technology will likely further accelerate this trend, although we expect the changes to occur gradually rather than overnight.

Meanwhile, inflation concerns have also re-surfaced against the backdrop of massive policy stimulus, supply-chain disruptions, and pent-up demand. While the effects of diminished demand imply a greater likelihood of disinflation (a slowing in the rate of inflation) in the near-term, virus-related supply shocks and increased willingness by central banks to tolerate above-target inflation could eventually push prices higher in the medium-term. In **Figure 5**, we list several cyclical and structural factors that could drive inflation outcomes, including higher inflation expectations, central bank tolerance, as well as de-globalisation.

Figure 5. The inflation machine: Factors driving inflation

Inflation Driver	Current	2022+
Demand		
Supply		
Central bank tolerance		
Inflation expectations		?
Dollar and debt		
Globalisation		
Technology		

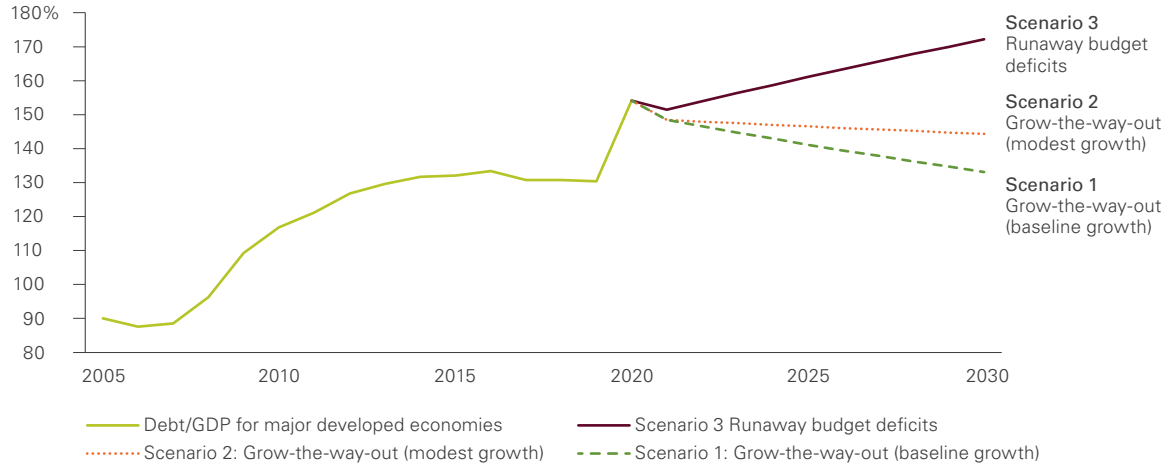


Some of these factors are more plausible than others in the near-term, such as the recovery in demand driving up consumer price inflation, particularly for goods inflation. Others, such as sustaining higher inflation expectations for an extended period of time, have proven to be more challenging, given central bank credibility in fighting inflation as well as the limited monetary ammunition to combat structural deflationary forces such as technology and globalisation. Indeed, while most central banks have a luxury of tools (such as raising policy rates) to combat higher inflation, it's on the downside where they've struggled, as interest rates have fallen toward or below zero even as the banks have implemented extraordinary measures to try to bring inflation to more reasonable levels. The adoption of the average inflation targeting (AIT) framework by the Fed in September is yet another unconventional tool used in hope of raising inflation expectations, but the not-so-successful experience of the Bank of Japan's inflation overshooting commitment in 2016 lead us to taper down our hopes for what this policy measure is able to achieve.

Should central banks finally achieve it, however, higher inflation could prove to be beneficial, especially against the backdrop of elevated debt levels taken on to fight against the monumental threat of the COVID-19 pandemic. In just two months after the initial shock, major developed economies saw their debt-to-GDP ratio surge by more than 20 percentage points, as policymakers spent trillions in spending, loans, and loan guarantees. In comparison, a similar increase in global debt in response to the 2008 global financial crisis took two years to play out.

2 Based on the FTSE Nareit All REITs Index. Data from 2010 are as of December 31, 2010, and data from 2020 are as of July 31, 2020. In 2010, residential, infrastructure, and data centers made up 14%, 0%, and 0% of the index, respectively.

Figure 6. The fiscal math behind debt sustainability



Notes: Countries included in the calculation are Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States.
Scenario 1 represents 4% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit.
Scenario 2 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 2% budget deficit.
Scenario 3 represents 3% nominal GDP growth, an average 10-year yield of 1.2%, and a 5% budget deficit.
Source: Vanguard calculations based on data from Thomson Reuters Datastream.

Under normal conditions, higher inflation doesn't help with debt reduction because bond markets eventually catch up through higher interest rates. But in rare circumstances like wartime spending or disaster responses, such as in this COVID-19 crisis, higher inflation can potentially erode the value of one-off debt. In addition, most policymakers and market participants understand that debt sustainability—the cost of servicing debt compared with economic growth—is far more important than the cold, hard headline number. In that respect, although the health shock led to unprecedented emergency spending, the low-interest-rate environment offers a favorable backdrop.

With growth rates also likely to rebound in coming years, as economies bounce back from pandemic-induced contractions, we could see developed economies "grow out" of their newfound debt. In scenario 1 of **Figure 6**, we suggest that an average nominal growth rate of 4% will be sufficient for debt in these major developed economies to return to pre-COVID levels by the end of the decade. Even more muted growth assumptions, as per scenario 2, are still enough to put debt on a sustainable downward trajectory, thanks to the sub-1% 10-year yields at which governments are issuing their debt. Of course, these scenarios are ultimately contingent on the shape of the initial recovery. A sooner-than-expected development of a vaccine or indications that we've achieved herd immunity would help accelerate recoveries and place us on a better path for debt sustainability. On the other hand, a second wave of infection that requires another round of national lockdowns is less likely but nonetheless a non-negligible risk—from both health and economic standpoints—that we unfortunately can't rule out.

Given the high degree of uncertainty associated with both the near-term and medium-term outlook, we think investors will be well-advised, as always, to maintain appropriately diversified portfolios appropriate to their goals. Attempting to time the market is tempting but rarely profitable.

Market outlook

With equities continuing to rise in Q3, albeit at a more moderate pace, some investors have questioned the attractiveness of this asset class given current valuations. Although Australian equity valuations have risen by 20-per cent so far this year by traditional metrics, we maintain the view that Australian equity markets appear fairly valued. This is owing to the significant correction in valuations early in 2020, from which the market continues to recover, as well as the support of historically low interest rates. Looking abroad, the divergence in valuations persists, with the rapid rebounds from the U.S.'s tech-driven rally and China's first-in-first-out experience now slowing, but appearing to hold steady. This is in contrast to the U.K. and EU which have struggled to regain ground amidst uncertainty over the trajectory of the virus.

Our outlook remains similar to our midyear economic update, with expected returns of 5.8–7.8% for local equity and 5.4–7.4% for international equity annualised over the next 10 years for AUD investors. Central banks' positions on monetary policy look to continue to dampen fixed income yields with forecasts of 0.5-1.5% for domestic bonds and 0.9–1.9% for international.

The benefits of holding a globally diversified portfolio, with exposure to a variety of asset classes, sectors and regions, are likely to remain. The demonstrated unpredictability of markets and their varied paths towards recovery, as well as the role of high-quality bonds as ballast, reinforce the importance of not only a diversified portfolio that is aligned to your investment objectives, but also the discipline to stick to your plan and stay the course.

Figure 7a. Australian equity fairly valued

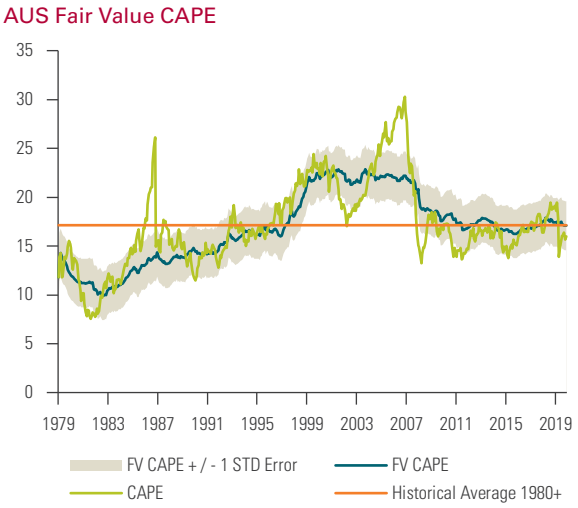
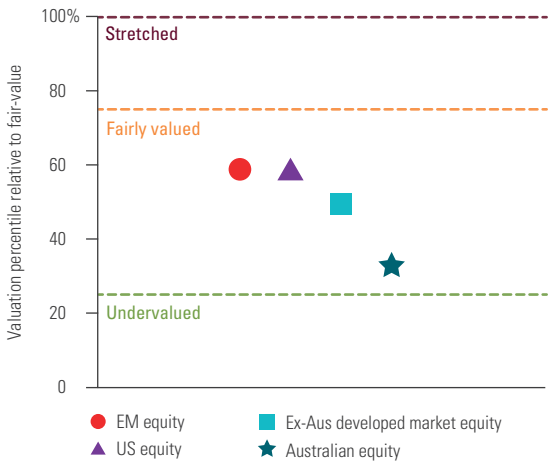


Figure 7b. International equities valuations are a mixed bag

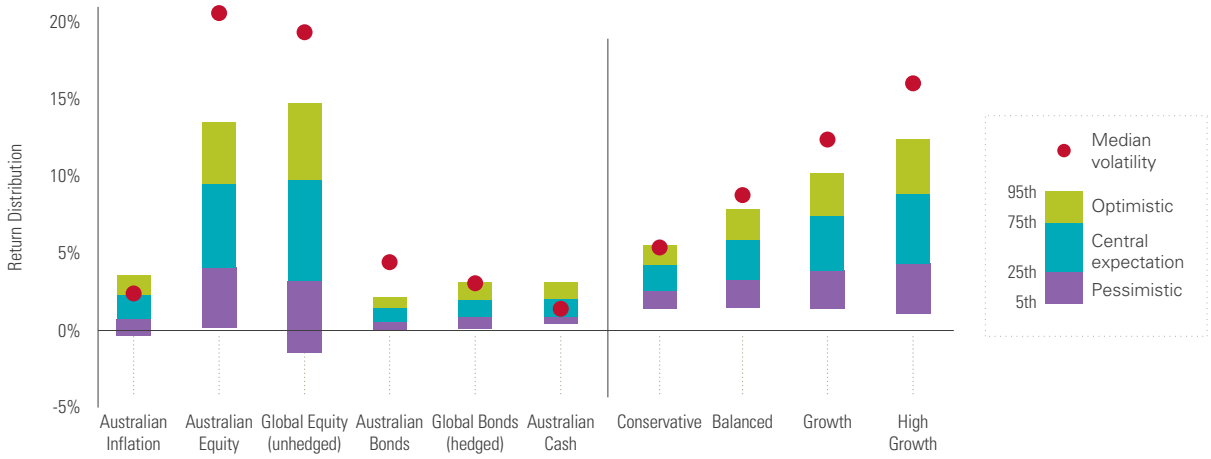


Notes: "Fair-value CAPE" is based on a statistical model that corrects CAPE measures for the level of inflation expectations and for lower interest rates. The statistical model specification is a vector error correction (VEC), including equity-earnings yields, ten-year trailing inflation, and ten-year Govt. bond yields, and equity and bond volatility. Estimated over the period January 1970–October 2020.
Source: Vanguard calculations, based on data from the Reserve Bank of Australia and Thomson Reuters Datastream

Long-term market outlook

The chart below shows the Vanguard Capital Markets Model (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds.

Figure 8a. Projected 10-year nominal return outlook



Source: Vanguard, 30 June 2020 VCMM Simulation.

It shows two concepts: the range of annualised 10-year nominal returns and the median volatility experienced.

The bars show the range of return outcomes over a 10-year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The red circles show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10-year period. The chart shows that equities are expected to produce a higher return over a 10-year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

Figure 8b. Projected 10-year nominal return outlook

	Return percentile					
	5th	25th	Median	75th	95th	Median Vol.
Australian Inflation	–0.4%	0.8%	1.5%	2.3%	3.5%	2.4%
Australian Equity	0.2%	4.1%	6.8%	9.5%	13.5%	20.6%
Global Equity (unhedged)	–1.5%	3.2%	6.4%	9.8%	14.7%	19.3%
Australian Bonds	0.0%	0.6%	1.0%	1.5%	2.2%	4.4%
Global Agg Bonds (hedged)	0.1%	0.9%	1.4%	2.0%	3.1%	3.0%
Australian Cash	0.4%	0.9%	1.4%	2.0%	3.1%	1.4%
Conservative	1.4%	2.6%	3.4%	4.3%	5.6%	5.4%
Balanced	1.5%	3.3%	4.6%	5.9%	7.9%	8.8%
Growth	1.4%	3.9%	5.6%	7.4%	10.2%	12.4%
High Growth	1.1%	4.3%	6.6%	8.9%	12.4%	16.0%

Source: Vanguard, 30 June 2020 VCMM Simulation

The next two charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way.

Figure 9. Probability of achieving real return target

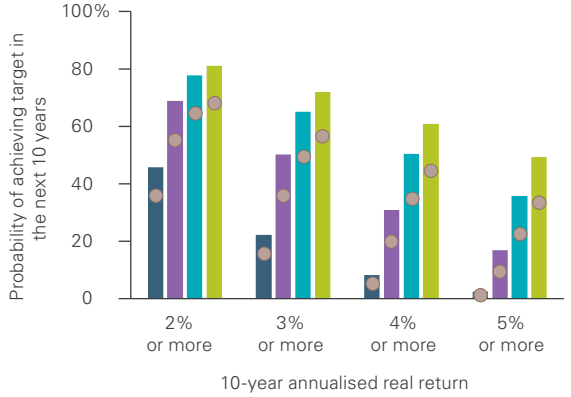
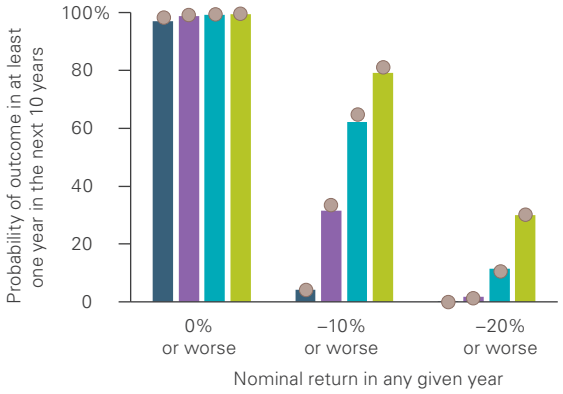


Figure 10. Downside risks



Conservative | Balanced | Growth | High Growth | December 2019

Note: The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modelled asset class in AUD. Results from the model may vary with each use and over time.

Source: Vanguard, 30 June 2020 and 31 December 2019 VCMM Simulations.

Taking more risk means that an investor increases the probability that they will achieve their target over 10 years.

Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.

About Vanguard's Investment Strategy Group

Vanguard's Investment Strategy Group is a global team of economists and investment and portfolio construction strategists with a wide variety of specialties, ranging from monetary policy to index construction to market trends. Their research serves as the basis for Vanguard's investment principles and methodology, guides Vanguard's global leadership and influences decisions about our investment offerings and portfolio construction.

Research-based investment approach

As part of Vanguard's broader Investment Management Group, ISG plays an essential role in developing Vanguard's investment methodology, which is carried through in the implicit and explicit advice solutions available to our clients. Our global chief economist and head of ISG reports directly to Vanguard's global chief investment officer. We work closely with Vanguard's in-house portfolio managers. Notably, our global chief economist is integrated into Vanguard Fixed Income Group through our portfolio management process. Through that process, ISG advises our fixed income investment managers on the macroeconomic outlook, expected monetary policy and other factors to support day-today portfolio management. Vanguard's investors around the world benefit from our collaborative approach to investment management, research and thought leadership.

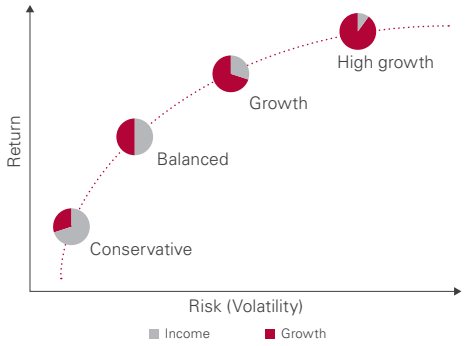
Vanguard Capital Markets Model

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based. The Vanguard Capital Markets Model® (VCMM) is a proprietary financial simulator developed and maintained by Vanguard's Investment Strategy Group. It is a long-term tool that takes into account current macroeconomic conditions and equity and bond valuations to forecasts distributions of future returns for a wide range of asset classes and portfolios. The primary value of the VCMM is in its application to analysing potential client portfolios. VCMM asset-class forecasts—comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk-return trade-offs, and diversification benefits of various asset classes.

Asset allocation

Vanguard's approach to asset allocation is to provide long-term returns that match investors' desired level of risk. The broad allocations to defensive (fixed income) and growth (equities) are the main factors influencing the risk/return profiles of our asset allocation strategies.

Our asset allocation approach is designed with a medium to long-term investor in mind (a time horizon of at least five years), reflecting the reality that the majority of Australian investors need to accept some market risk in order to reach their investment goals.



Why diversification matters

We believe that a successful investment strategy starts with an asset allocation suitable for its objective. In practice, diversification is a rigorously tested application of common sense: Markets will often behave differently from each other—sometimes marginally, sometimes greatly—at any given time.

Owning a portfolio with at least some exposure to many or all key market components ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas.

Many investors lack the time, interest, or skills, and can become overwhelmed by the choice of investment options, asset classes, and other implementation hurdles such as choosing between index and active management. Investors also face behavioural risks in adhering to their investment plan over time due to the temptation of performance chasing or overreacting to market events.

Vanguard Diversified Funds provide professionally managed portfolio solutions designed to help medium to long-term investors achieve their goals and overcome these challenges.

Understanding Vanguard's SAA process

For multi-asset funds, such as Vanguard Australia's Diversified Funds, Vanguard's Investment Strategy Group (ISG) conducts an annual review of the strategic asset allocation (SAA) of the funds. The team considers new asset classes, currency exposure, home bias, regulatory and tax impact, investment costs, investor behaviours, and implementation factors amongst others. The ISG team presents a recommendation to maintain or change the SAA to Vanguard's global Strategic Asset Allocation Committee (SAAC), which oversees all of Vanguard's multi-asset funds. The SAAC is comprised of senior leaders from the Investment Management Group and Vanguard's advice businesses and is co-chaired by Vanguard's global global chief economist. Upon approval of a change to the SAA, Vanguard assesses the feasibility, tax impact, and costs of the recommended changes and presents to the Board of Vanguard Australia for approval prior to implementing the changes.

Risk and return overview

Vanguard diversified funds peer group comparison

30 September 2020

The shaded boxes display the total return percentile rank of the Vanguard fund within its peer group*, as shown by the colour code, with the number reflecting the Vanguard fund return in excess of the peer group median return (%). The numbers below the shaded boxes indicate the number of funds in the peer groups across each time period.

Vanguard fund Asset weighted peer group MER (% p.a.)	3 mths	6 mths	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Conservative 0.66	0.24 47	1.11 47	2.44 47	2.07 43	1.66 40	1.71 39	1.33 35
Balanced 0.80	0.30 55	1.22 54	2.70 54	2.37 50	1.45 44	1.80 40	1.40 33
Growth 0.79	0.27 72	1.58 71	3.09 70	2.45 66	1.61 60	1.76 58	1.48 53
High Growth 0.84	0.47 75	2.02 75	2.96 74	2.18 69	1.67 61	1.61 58	1.46 47

Peer group percentile
- Top 5%
- 1st quartile
- 2nd quartile
- 3rd quartile
- 4th quartile

Sources: Vanguard calculations using data from Morningstar Inc. Past performance is not an indication of future performance. All returns are net of fees and assume reinvestment of income distributions. Returns greater than 12 months are annualised. There has been no adjustment for survivorship bias.
* The peer groups were constructed by first sourcing a universe of funds from Morningstar having the same category as the Vanguard Funds, but excluding Vanguard strategies.
An automated filter was then applied to these original peer groups with the aim of removing identified duplicate investment strategies and retain unique strategies.

Figure 11. Vanguard diversified funds return contributions for the quarter

30 September 2020

Fund	3 Month Gross Return (%)	3 Month Return Contribution (%)			
		VCIF	VBIF	VGIF	VHIF
Vanguard Cash Plus Fund*	0.20	0.0	0.0	0.0	0.0
Vanguard Australian Fixed Interest Index Fund	1.04	0.2	0.2	0.1	0.0
Vanguard Australian Shares Index Fund	–0.04	0.0	0.0	0.0	0.0
Vanguard International Shares Index Fund	3.83	0.3	0.6	0.8	1.0
Vanguard International Small Companies Index Fund	3.16	0.1	0.1	0.2	0.2
Vanguard Emerging Markets Shares Index Fund	5.18	0.1	0.2	0.2	0.3
Vanguard International Shares Index Fund (Hedged) – AU Class	6.47	0.4	0.6	0.8	1.0
Vanguard Global Aggregate Bond Index Fund (Hedged)	0.90	0.4	0.3	0.2	0.1
Total Return Contribution (%)		**1.4**	**1.9**	**2.2**	**2.6**

*Figures in the return contribution table are calculated as the product of the monthly gross return and the corresponding actual asset allocation.

* From 1 October 2020, the Vanguard Cash Plus Fund was renamed as the Vanguard Short Term Fixed Interest Fund.

Underlying fund asset allocation

The strategic asset allocation (SAA) is provided in the table below. The diversified funds leverage Vanguard's international expertise in investment research and utilise a global investment methodology. This approach starts with market capitalisation weightings. Local market factors are then also considered.

Figure 12. Target asset allocations effective from July 2017

	Asset Allocation (%)			
Fund	Conservative	Balanced	Growth	High Growth
Asset Classes				
Vanguard Cash Plus Fund*	10.0	0.0	0.0	0.0
Vanguard Australian Fixed Interest Index Fund	18.0	15.0	9.0	3.0
Vanguard Global Aggregate Bond Index Fund (Hedged)	42.0	35.0	21.0	7.0
Total income	**70.0**	**50.0**	**30.0**	**10.0**
Asset Classes				
Vanguard Australian Shares Index Fund	12.0	20.0	28.0	36.0
Vanguard International Shares Index Fund	8.5	14.5	20.5	26.5
Vanguard International Shares Index Fund (Hedged)	5.5	9.0	12.0	16.0
Vanguard International Small Companies Index Fund	2.0	3.5	5.0	6.5
Vanguard Emerging Markets Shares Index Fund	2.0	3.0	4.0	5.0
Total growth	**30.0**	**50.0**	**70.0**	**90.0**

* From 1 October 2020, the Vanguard Cash Plus Fund was renamed as the Vanguard Short Term Fixed Interest Fund.

ESG: Putting it all together and making decisions

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We already know there are a growing number of socially focused investors pushing for more choice and control over their investments.

Interest in ESG (environmental, social, governance) in Australia is healthy and growing, even as measured against global trends (of $30 trillion invested in ESG globally, $980 billion is allocated in Australia) and the events of 2020 have only compounded those preferences.

The bushfires over the Australian summer followed shortly after by the COVID-19 pandemic have sparked a renewed interest in ESG issues.

With more and more public companies now disclosing their ESG indicators, investors are getting the benefit of ESG-related data moving from the margins to the mainstream.

The upshot of that has meant socially minded investors now have a much wider choice of ESG investment choices, both active and index, and asset managers are now integrating a wider field of ESG indicators into investment options.

The increased availability of ESG data has enabled index providers like Vanguard to construct and offer a wider set of screened indexes capable of meeting different preferences for different socially-minded investors.

How to make sense of increasing choice

With the choices for ESG investors increasing what—if anything—should investors do about integrating ESG into their portfolio and how should they approach narrowing the field of choice?

Promoting good governance practices, protecting the environment and engaging in climate risk mitigation are top-of-mind for an increasing number of investors. Even so, it can be particularly hard to make a call on how to select investments reflecting those concerns if you're making choices on behalf of clients or beneficiaries.

Deciding a course of action when there are multiple parties or stakeholders involved, as with investment committees, can be complicated.

Many ESG investing approaches are available, and deciding which tool, or set of tools, to use—if any—depends on a variety of factors.

To assist in making informed ESG investment choices that reflect an investor or investors' socially-minded goals, Vanguard has developed a framework to help focus the search:

Figure 13. Key steps to making a prudent ESG investment decision[1]

Source: Vanguard

Just as with the principles for long-term investing success, the framework asks investors to first define the goals of your ESG investing activity. From there, evaluating your options and choices are key before deciding on a course of action. A prudent approach to ESG investing also asks investors to periodically monitor and review their decisions to ensure they stay relevant and on-target towards their original goals.

1. Define goals

What ESG issues matter?

First establish what you aim to achieve through ESG investing. Investors list of potential ESG-related issues is typically as diverse as it is long; animal testing; weapons; board diversity; human rights standards; opioids, tobacco, privacy—the list goes on.

Fossil fuels is one of many issues that demonstrates how caring about an ESG issue does not necessarily easily or directly translate into a clear choice of companies or investments.

Investors who want to adopt a screening approach to fossil fuels—wanting to screen out companies that exhibit that undesired ESG behaviour—may become confused about at which point to 'draw-the-line' on their beliefs when it applies across the whole supply chain: is it at the point of initial exploration? What about end consumers and activities like aviation and driving? Determining the boundaries of an ESG issue can be a complex, involved process.

Questions inevitably arise in a more detailed discussion of beliefs of what an investor screens in or out. Ideally, it would be as clear as possible about what they will or won't tolerate as part of their goal-setting. Objectives are important in defining these goals.

Determine objectives

It's common for investors to have one or more of the following reasons or objectives for deciding to invest in ESG. Whether to:

- Satisfy values preferences;
- Generate financial benefit such as risk-adjusted return;
- Effect meaningful change on an issue that concerns them;
- Meet legal requirement. For instance, a regulatory change may require a pension fund to exclude investment in companies that conduct certain activities.

1. Source: '*ESG, SRI, and impact investing: a primer for decision-making,*' Vanguard Research, Douglas M. Grim and Daniel B. Berkowitz, August, 2018, Figure 8 on p. 8 of 27.

2. Evaluate options

Social impact bonds. Green bonds. Norms-based screening. ESG Integration. Impact Investing. There are a wide variety of terms and approaches. And just as much as the terminology has proliferated so too has investor confusion. For investors grappling with whether they should do anything about ESG within their portfolios, Vanguard believes investors need to address the ESG-related goal or set of goals.

Vanguard's ESG funds primarily employ an index investing approach. These index funds use exclusionary investing strategies, which means they avoid investing in companies that engage in certain business activities, such as the production of fossil fuels, weapons, or tobacco. These funds may also exclude the stocks of companies that fail to meet certain standards for environmental, labour, human rights, diversity, or anticorruption practices.

3. Decide on action

While there can be no singular "best" ESG strategy, the field of choice can be better tailored to investors' preferences by following the previous steps.

Begin by setting goals, review and identify the field of potential investment options available and then deciding on a course of action.

For those serving as fiduciaries, it's important at this point that the decision-making process is clearly documented.

This means engaging in some procedural due diligence to ensure that stakeholders—whether client, legal counsel or regulator—have a clear view of any decision-making. If a stakeholder later requests information about a decision, ideally there would be documentation in which the goals and expectations of a course of action are clear.

4. Reassess periodically

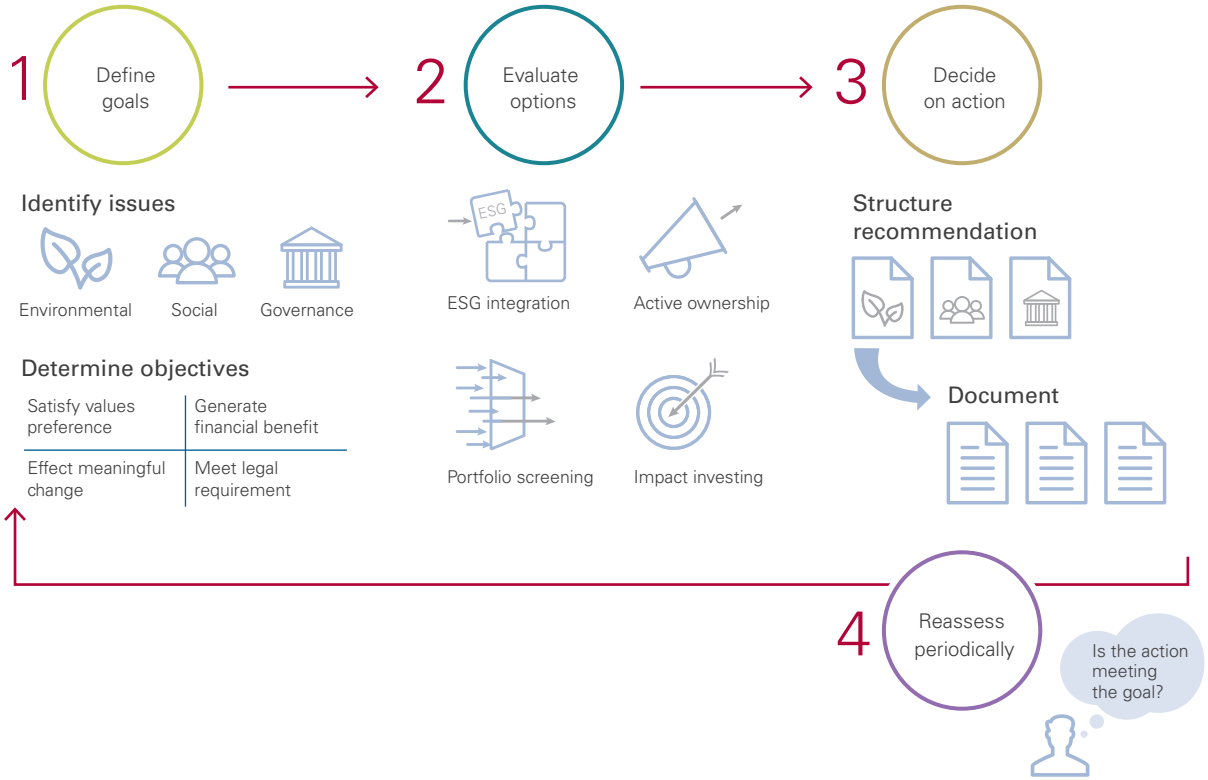
As with any investment decision, the last step to rounding out a prudent investment decision is to periodically monitor and reassess whether it's tracking to your objectives.

For institutional investors, this step may require some form of legal document, with varying levels of detail to ensure that proper assessments and stakeholder reporting become a standard practice. If action was taken, the evaluation should be linked to the goals and the criteria used, along with any metrics to be tracked or tasks to be done to measure success.

Putting it all together

Figure 14 presents a more detailed summary of the four primary steps to making an informed decision about ESG investing. The aim of using this framework to assess ESG investing is that investors will have identified their goals, assessed an array of potential courses of action, and made a choice supported by thoughtful evaluation of important considerations and trade-offs tied to their preferences, beliefs, expertise and circumstances.

Figure 14: Making informed decisions on ESG investing actions[2].



Source: Vanguard

2. Source: '*ESG, SRI, and impact investing: a primer for decision-making,*' Vanguard Research, Douglas M. Grim and Daniel B. Berkowitz, August, 2018, Figure 8 on p. 18 of 27.

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Vanguard Capital Markets Model

IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.

The Vanguard Capital Markets Model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include Australian and international equity markets, several maturities of the Australian Treasury and corporate fixed income markets, international fixed income markets, money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

Although central tendencies are generated in any return distribution, Vanguard stresses that focusing on the full range of potential outcomes for the assets considered, such as the data presented in this paper, is the most effective way to use VCMM output.

The VCMM seeks to represent the uncertainty in the forecast by generating a wide range of potential outcomes. It is important to recognise that the VCMM does not impose "normality" on the return distributions, but rather is influenced by the so-called fat tails and skewness in the empirical distribution of modelled asset class returns. Within the range of outcomes, individual experiences can be quite different, underscoring the varied nature of potential future paths. Indeed, this is a key reason why we approach asset-return outlooks in a distributional framework.

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