

Adviser portfolio trends: Learnings for 2025



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Throughout 2024, Vanguard's Portfolio Analytics and Consulting (PAC) team undertook an extensive series of comprehensive analytics and discussions with advisers, to provide them with insights on their portfolio constructs.

Over the past few years markets have exhibited resilience in the face of continued uncertainty and in the presence of high inflation, high interest rates, the US election and heightened geopolitical risk. Despite this uncertainty, the MSCI World Index generated a return of 31% for the year to 31 December 2024. The US equity market was the most significant contributor to this return despite the volatility attributed to the Magnificent 7 (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla). Bonds did not fare as well as equities, as investors could not gauge the magnitude, direction or timing of the next interest rate change.

In response to the uncertain glide path of markets over recent years, previously observed trends have continued and evolved as advisers have positioned portfolios to lessen performance variability in a world of increasing uncertainty.

This document presents the insights and trends observed from the analyses and adviser discussions held. It is intended to provide advisers with insights as to how their peers are constructing portfolios, and Vanguard's views regarding some of these trends and dynamics.

Disclaimer: The following insights are predominantly qualitative based on adviser consultations. Any quantitative insights referred to were taken from a representative sample of adviser portfolios that were aggregated into a single, average adviser model and weighted equally within the dataset. This portfolio data was taken from the period 1 January 2024 to 31 December 2024. We also supplement certain themes discussed with our own internal research where applicable.

Methodology

Vanguard's PAC team completed around 63 consultations and portfolio health checks on predominantly balanced, growth and high growth diversified portfolio constructs. We analysed all portfolios across risk profiles in aggregate. To ensure equal comparison we also focused our analysis on growth portfolios, as these were the most common risk profile analysed. Adviser portfolios were combined on an equally weighted basis into a single portfolio with metrics determined including indirect cost ratio (ICR), passive versus active

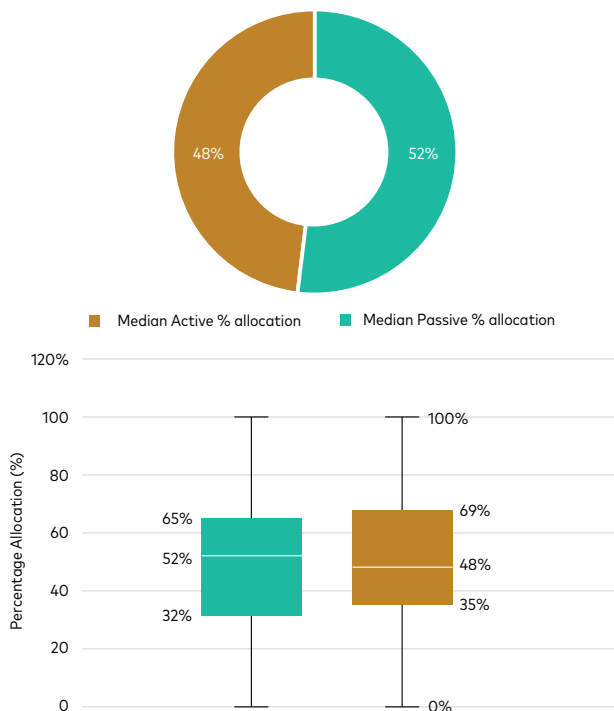
allocations, hedge ratio for the international equity sleeve and duration within the fixed income sleeve. Portfolio data is for the year ending 31 December 2024.

Any observations should be noted in the context of a philosophically aligned subset of predominantly 'core-satellite' investors which made up our sample. Furthermore, the adviser subset may change each year, potentially influencing results.

Total portfolio observations

Adviser portfolios in our sample had nearly an even active/passive split of 48% and 52%, respectively.

Figure 1. Median active/passive split and ranges



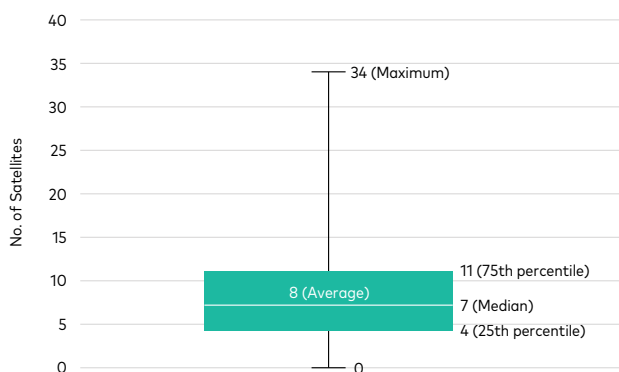
Notes: Median active/passive split data observed across portfolios in our sample. The 25th, 50th (median) and 75th percentile ranges for the active/passive split observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Portfolios in our sample tended to have seven (median) to eight (average) satellites (**Figure 2**), which were more prevalent in the equity sleeve. The PAC team believes that seven to eight satellites can help achieve adequate diversity and active coverage across asset classes. However, the range demonstrates that several portfolios in our sample exceeded this number of satellites – we view this greater number of satellites as unnecessarily excessive.

In the PAC team's experience, there is often a double up or crossover between satellite exposures and we don't believe the addition of further satellites provides additional diversification benefit or value. Significant outliers in this range usually held direct securities, which was not a common trend in our sample.

Figure 2. Number of portfolio satellites

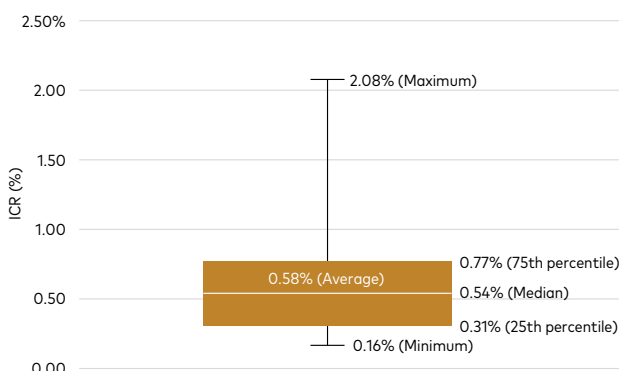


Notes: Number of satellites observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges for the number of satellites can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

The average total cost for portfolios in our sample (**Figure 3**) across all risk profiles was an Indirect Cost Ratio (ICR) of 0.58%. More expensive outliers tended to use alternatives such as private equity, which generally increases portfolio cost.

Figure 3. Portfolio ICRs

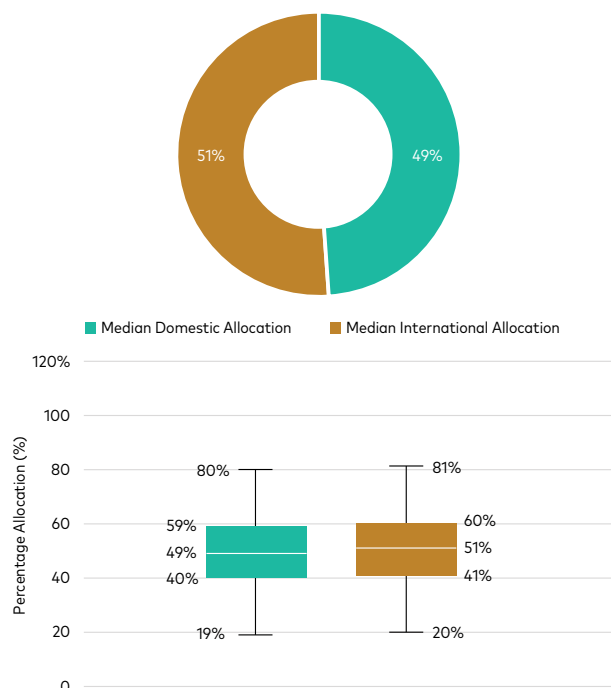


Notes: ICR data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges for portfolio cost observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Regarding the domestic versus international split, portfolios were biased towards international assets with an average 52% allocation. However, for reference the Australian average allocation of 48% is notably higher than Vanguard's Diversified Balanced and Diversified Growth portfolios which currently feature domestic allocations of 35% and 37% respectively. A large driver of this was a greater home bias in fixed income versus Vanguard, as will be shown later.

Figure 4. Domestic vs international median allocation and ranges

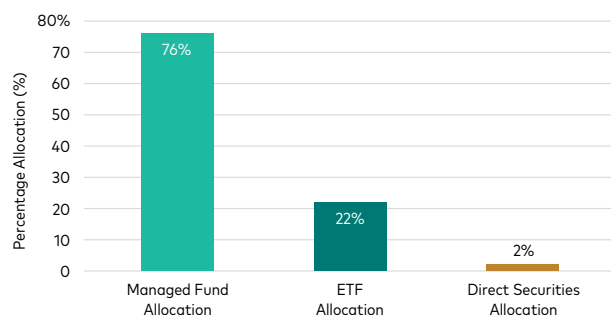


Notes: Median domestic vs international split data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges for domestic vs international (median) allocation observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Finally, managed funds are still the preferred investment vehicle with an average portfolio allocation of 76% followed by ETFs at 22%.

Figure 5. Investment vehicle weighted average allocation



Notes: Weighted average investment vehicle allocations observed across portfolios in our sample.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

In later sections we consider the equity and fixed income sleeves of the portfolio samples we observed. In addition to our growth portfolio analysis later, we present some high-level findings for the total portfolio across all risk profiles.

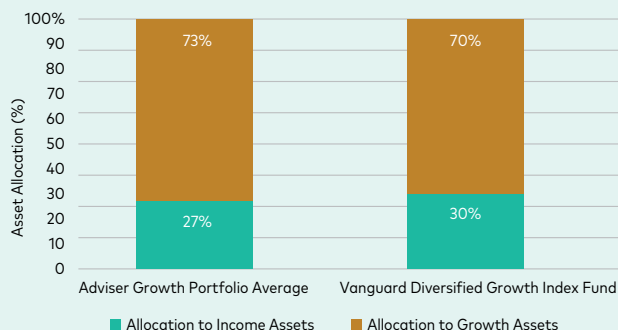
The adviser growth portfolio

We previously noted that the PAC team carried out approximately 63 consultations and portfolio health assessments on balanced, growth and high growth diversified portfolio constructs. However, to obtain greater information utility and uniformity with respect to asset allocation and portfolio construction, we focused our analysis on growth portfolios as they were the most common risk profile analysed. We define a growth portfolio as having an allocation to growth assets of between 61% and 80% (inclusive). Adviser portfolios were combined on an equally weighted basis into a single portfolio to conduct this analysis.

Figure 6 shows the allocation to income assets and growth assets for the average adviser growth portfolio, compared to the Vanguard Growth Index Fund. There is a small variance between the average adviser growth portfolio of -3% for income assets and +3% for growth assets relative to the Vanguard Growth Index Fund.

Asset class analysis of the average adviser growth portfolio relative to the Vanguard Growth Index Fund reveals greater variances. The outcome of this analysis comes as no surprise. Asset classes which may be captured at market cap weight in the Vanguard Growth Index Fund (such as Australian and global listed real estate investment trusts, global

Figure 6. Adviser vs Vanguard growth/defensive ratio for growth risk profile



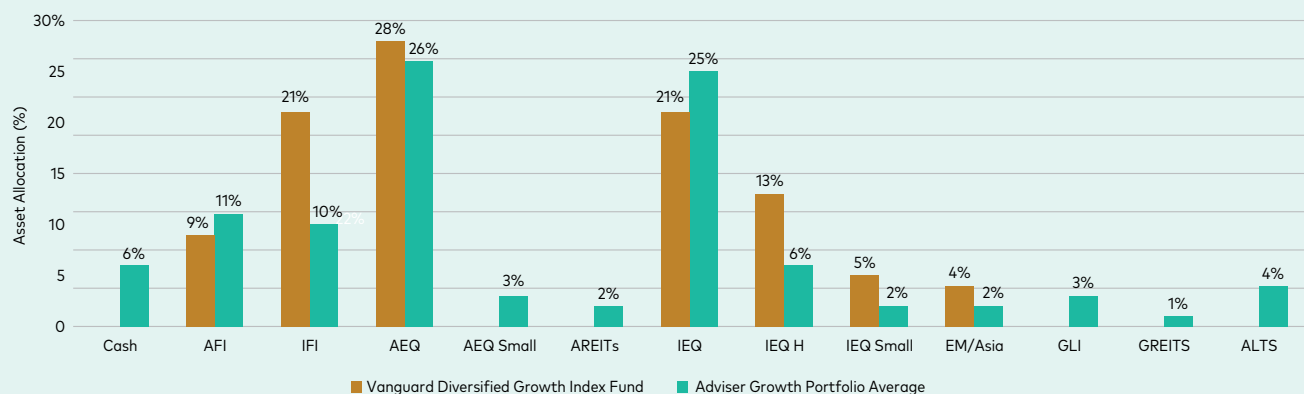
Notes: Average growth/defensive ratio allocations observed across portfolios in our sample.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

listed infrastructure and Australian small caps) are often discrete allocations held at a higher weights in adviser portfolios. Also, many alternative assets and direct property are not represented in Vanguard Growth Index Fund.

Figure 7 illustrates the notable differences in the average asset allocation for the adviser growth portfolio and the strategic asset allocation of the Vanguard Growth Index Fund. We recognise that advisers structure portfolios to achieve investment objectives that are specific to their clients. To this extent, we are unsurprised by the divergence between adviser growth portfolios in our sample to the Vanguard Growth Index Fund.

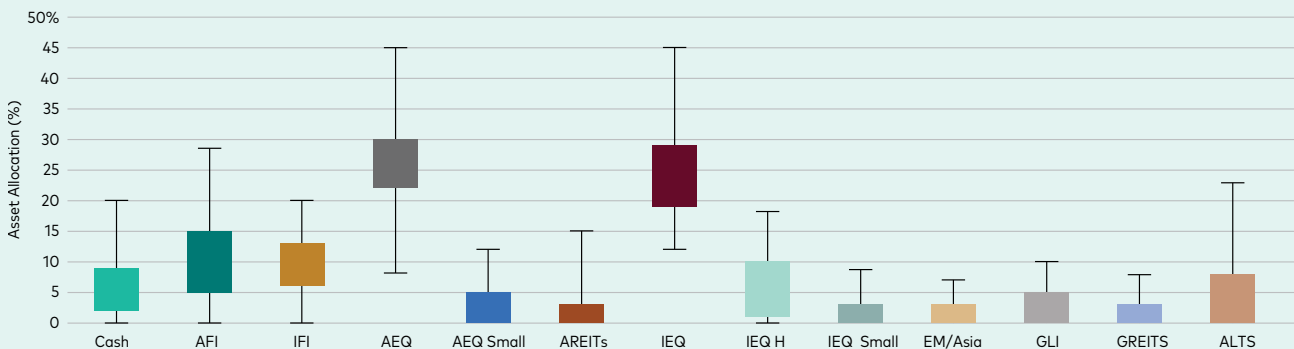
Figure 7. Adviser vs Vanguard asset allocation for growth risk profile



Notes: Average Growth risk profile asset allocation observed across portfolios in our sample. May not add exactly to 100 due to rounding.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Figure 8. Sample portfolio asset allocation ranges for growth risk profile



Notes: Growth risk profile asset allocation ranges observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of growth portfolio asset allocation observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Figure 8 shows the 25th, 50th and 75th percentile ranges with respect to the asset allocation for the growth risk profile for portfolios in our sample.

A few observations can be made from the above data. Adviser portfolios tend to hold more cash than the Vanguard Growth Index Fund. Some portfolios had a meaningful allocation to term deposits with maturities mostly around 12 months, taking advantage of higher rates on offer relative to cash and fixed interest, and seeking a haven from recent bond volatility. Vanguard views cash as a source of liquidity rather than a source of long term investment returns and prefers to not take as much reinvestment risk by holding so much cash. The Vanguard Diversified portfolios take advantage of the diversification benefit that fixed rate bonds offer as well as benefiting from the term premium of longer dated bonds, which history shows outperforms cash consistently over the long term.

Adviser growth portfolio allocations to Australian fixed interest averaged an 11% weight relative to 9% for Vanguard, with 61% of growth portfolios having an allocation of 9% or greater. As we will later see, this was driven by biases favouring Australian credit products in our sample. The larger than expected 28% maximum observed in the range was driven by a greater home bias and the inclusion of direct hybrids which are not viewed by Vanguard as fixed interest given they (by definition) have characteristics spanning equities and bonds.

International fixed interest exhibited an adviser average of 10% (range between 0% and 20%)

in our sample compared to 21% for Vanguard. The lower exposure is in part explained by the preference for Australian fixed interest, hybrids, term deposits, diversified credit and private credit products. This is especially so, given longer duration fixed interest has experienced significant declines over the past few years. Many parts of the Australian credit market have higher exposures to floating rate structures and advisers in our sample seemed to have preferred to take on floating rate credit risk rather than interest rate risk on sovereign and high-grade securities, which dominate the available global fixed income product set.

We note that the fixed interest allocation for Vanguard is 30%, whereas the average adviser fixed income allocation in our sample of growth portfolios was 22%. The variance may be explained by advisers being overweight cash and, in some instances, considering private credit as part of their fixed income allocation, which is often best classified as an 'alternative'.

On average the allocation to Australian equities was 26% versus 28% for Vanguard. If we combine the allocation to Australian equity small caps this rises to 29%. We did observe a minimum and maximum allocation of 8% to 45%, respectively, with only 37% of portfolios having an allocation greater than or equal to Vanguard's 28%. Portfolios with a greater than 28% allocation were generally positioned to generate income and take advantage of franking credits. We often observe income focussed clients having a greater home equity bias, as post-franking yields are much more attractive than offshore.

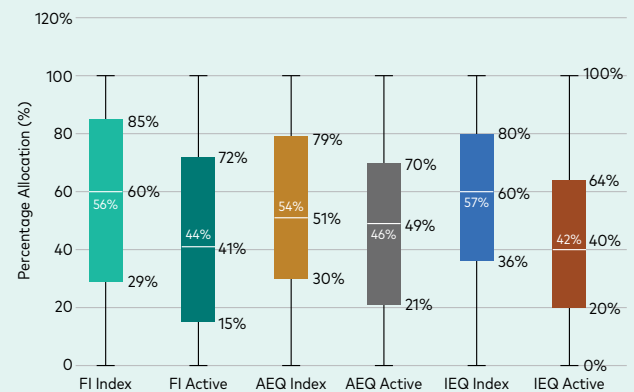
The average adviser growth portfolio had a total international equity allocation of 39% versus a greater allocation for the Vanguard Growth Index Fund at 42%. Advisers held greater amounts of unhedged developed market large caps compared to Vanguard. However, Vanguard held more across hedged developed market equities, international small caps and emerging market equities. Adviser growth portfolios in our sample preferred global real estate and infrastructure, which on a look-through basis are held at market cap weight within international equities in the Vanguard diversified portfolios.

There was a minimum and maximum allocation of 0% and 23% to alternatives, with an average of 4%. More than half (55%) of portfolios had no allocation to alternatives, highlighting that many core-satellite portfolios prefer daily liquidity as they have a retiree and retail investor base in mind. Only 37% in our growth sample had an allocation greater than or equal to 4%. Allocations to alternatives typically included exposures to gold, private equity and private credit.

Since 1988, the average five-year annualised excess return of unhedged global equities has been just 0.4%. Therefore, we expect the effect of currency hedging to be minimal over the very long term. For Vanguard, FX hedging of equities is primarily a risk consideration to help smooth any currency effects. Furthermore, the Australian dollar tends to be positively correlated to global equities. Whilst this relationship varies through time, this suggests that Australian investors do warrant foreign currency exposure. Balancing all of this, Vanguard maintains a static 30% hedge ratio on international developed market equities in the diversified portfolios.

Regarding active/passive split, **Figure 9** shows there were similar levels of indexing across all three major sleeves of growth portfolios in our sample:

Figure 9. Active/passive split ranges across asset class sleeves

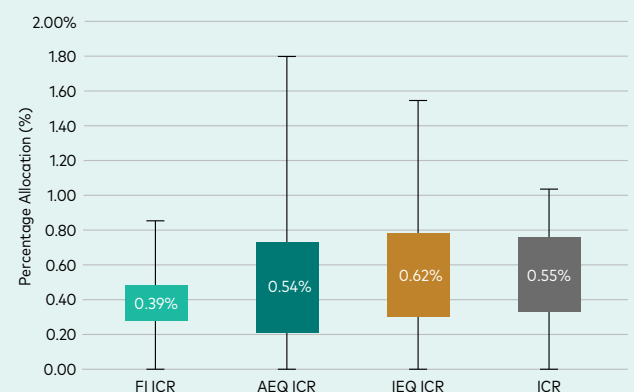


Notes: Active/Passive split ranges observed for growth portfolios in our sample. The 25th, 50th and 75th percentile ranges of growth portfolio active/passive splits can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Finally, with respect to growth portfolio costs, **Figure 10** shows average sleeve costs for the growth portfolios in our sample. The average total portfolio cost for growth portfolios in our sample was 0.55%. This compares to a total portfolio cost of 0.29% for the Vanguard Growth Index Fund.

Figure 10. Average sleeve costs for sample growth portfolios and ranges



Notes: Average growth portfolio sleeve costs observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of growth portfolio sleeve cost observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Equity observations

International equity markets, as measured by the MSCI World ex Australia Index, generated a return of 31.18% in 2024. For the purposes of comparison, **Figure 11** illustrates the returns from the seven MSCI factor indices, MSCI World ex Australia Index and the Vanguard International Shares Index Fund for 2022, 2023 and 2024.

Value's relative outperformance in 2022 may in part be attributed to interest rate increases over this period, however, value's return was short lived. In 2023, growth outperformed value as the market anticipated a declining interest rate environment. Growth stocks which have projected cash flows further into the future are therefore more sensitive to changes in discount rates compared to value stocks and perform better in such an environment. In 2024 we saw a continuation of the performance of growth, as technology stocks, specifically those that were expected to benefit from artificial intelligence (AI), performed well.

By virtue of a strong performance environment in 2023 and 2024, advisers were questioning how long the strong performance of growth would continue given extended valuations. Therefore, the international equity sleeve in adviser portfolios exhibited a substantial allocation to a Vanguard passive core to provide some style agnosticism and mitigate the volatility in factor leadership of the last few years. However, this was often complemented with a quality or growth style strategy.

Australian equities have exhibited a similar return profile to their global counterparts. **Figure 12** illustrates the returns from MSCI Australia factor indices, MSCI Australia Index, the Vanguard Australian Shares Index Fund and the S&P/ASX 300 Total Return Index.

MSCI Australia Value outperformed MSCI Australia Growth in 2022, however there was a rotation from value to growth in 2023, and a significant return dispersion in 2024 where growth generated a return of 19.52% compared to value returning 3.52%.

Figure 11. Vanguard & MSCI World Factor Indices CY22, CY23 & CY24 returns

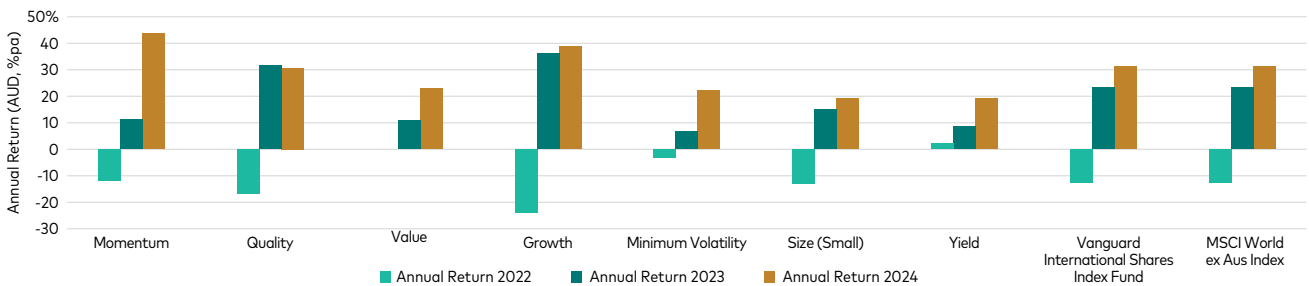
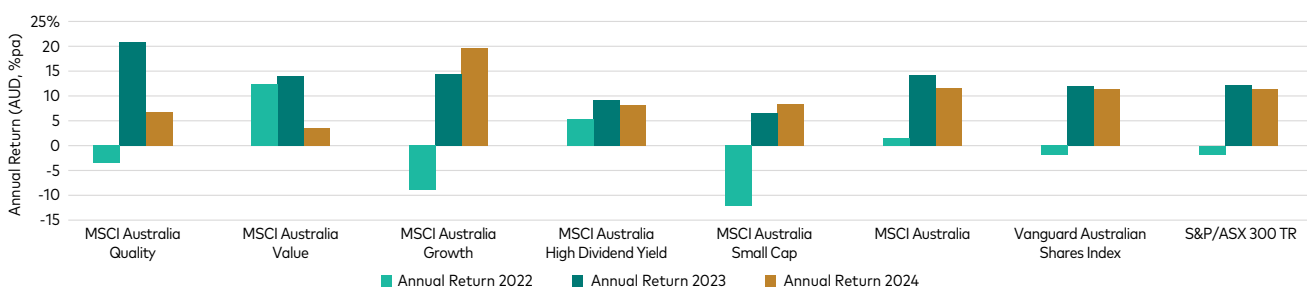


Figure 12. Vanguard & MSCI Australia Factor Indices CY22, CY23 & CY24 returns



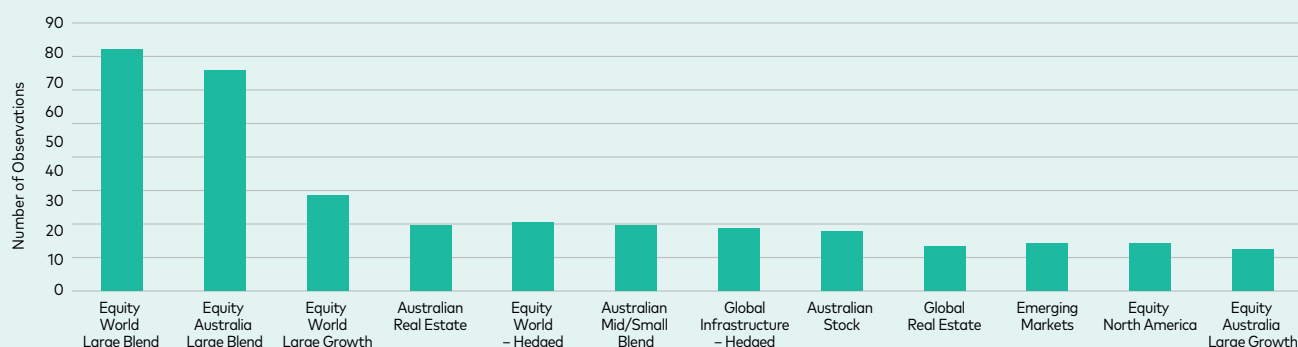
Notes: MSCI Factor Indexes returns for calendar years 2022, 2023 & 2024. The MSCI Factor Indexes are a family of benchmarks designed to represent the performance of specific factor characteristics. MSCI's factor definitions may differ from those of the investment manager. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.

Source: Morningstar Direct. MSCI Factor Indexes. Data as of 2nd January 2025.

Australian and international equity constructs

Using Morningstar's equity product categories, our analysis of all adviser portfolios showed that the most common investment strategies used by advisers in portfolios were funds from the Equity World Large Blend and Equity Australian Large Blend categories. **Figure 13** shows the number of observations for the top 12 categories. Equity World Large Blend funds invest primarily in large companies listed around the globe. The Equity Australian Large Blend funds invest primarily in large Australian companies. The blend style is assigned to portfolios where neither the growth nor value-investment styles dominate. The large number of observations in the top two categories are also attributed to the popularity of fund/ETF versions of the Vanguard International Shares Index and Vanguard Australian Shares Index investment strategies as a core allocation.

Figure 13. Most popular equity categories used



Notes: Number of observations per product category taken from observations across portfolios in our sample. Product categories adapted from Morningstar product categories.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

The analysis above demonstrates that satellite global growth style investment strategies have played a major part in adviser portfolios. What is further revealing from the analysis is that portfolios were underweight the Equity World Large Value, Equity Australia Large Growth and Equity Australia Large Value categories. The overweight to World Large Growth relative to its value counterpart is most likely explained by the relative outperformance of the growth style. Other considerations may be a deliberate tilt towards growth relative to value based on where we are in the interest rate cycle, where growth may be expected to be a beneficiary of declining interest rates. Some portfolios could have strategic growth tilts if that is the long-term view or investment philosophy of the adviser. However, the international equity sleeve retains an overall relatively style-neutral blend posture.

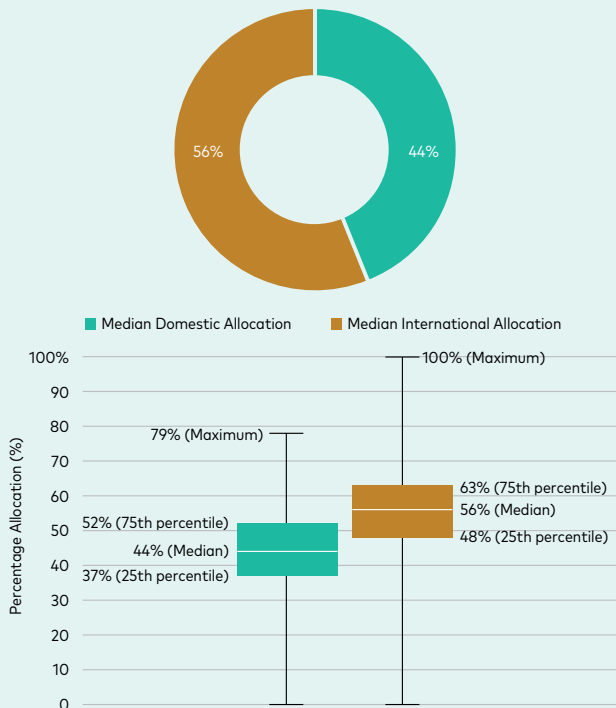
In some instances, a simply structured portfolio will include a Vanguard passive core complemented with a quality-style ETF (which is in the Equity World Large Blend category).

We previously noted that the Equity Australian Large Blend was the second largest observation in portfolios, and this was attributed to the presence of Vanguard Index Funds/ETFs as core allocations in portfolios. A-REITs (Australian Real Estate Investments Trusts) also featured prominently as a satellite holding. Vanguard does not hold a greater than market cap weight of its diversified portfolios. Additionally, the A-REITs index is concentrated, and that Australian investors tend to already have direct exposure to the domestic property market.

Whilst satellite holdings amongst our sample may exhibit a tilt towards growth and quality, we did not find that adviser equity portfolios were exhibiting unreasonable factor biases. Most equity sleeves were core and style neutral in nature. Perhaps this reflects the fact that higher amounts of factor rotation in recent years have warranted caution on not being too exposed to another violent rotation in equity factors. Vanguard applauds this approach as factors are extremely difficult to time and our market cap weighted indexed approach is style-neutral relative to the index, which we believe provides superior results over the long term.

Regarding domestic versus international equity allocation, **Figure 14** shows that on average portfolios have 56% exposure to international equity and 44% to Australian equity. This is relatively similar to the Vanguard Growth strategy's domestic versus international allocation of 40% and 60% respectively.

Figure 14. Domestic vs international equity sleeve median allocation and ranges

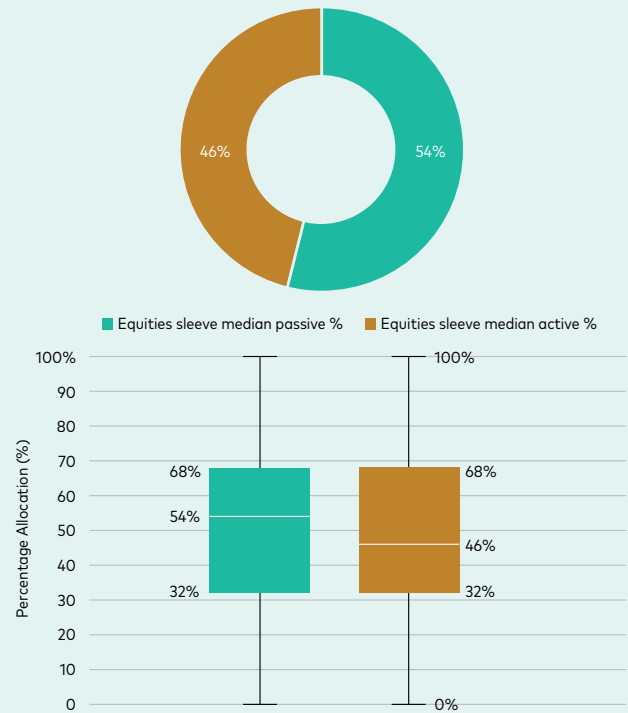


Notes: Average Domestic vs International split data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of domestic/international split observations from adviser portfolios can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct and Vanguard data. Data from January 2024 – December 2024.

With regards to the passive-active allocation, equity sleeves have demonstrated a median exposure of 54% to passive and 46% exposure to active.

Figure 15. Equities sleeve: Median active/passive split and ranges

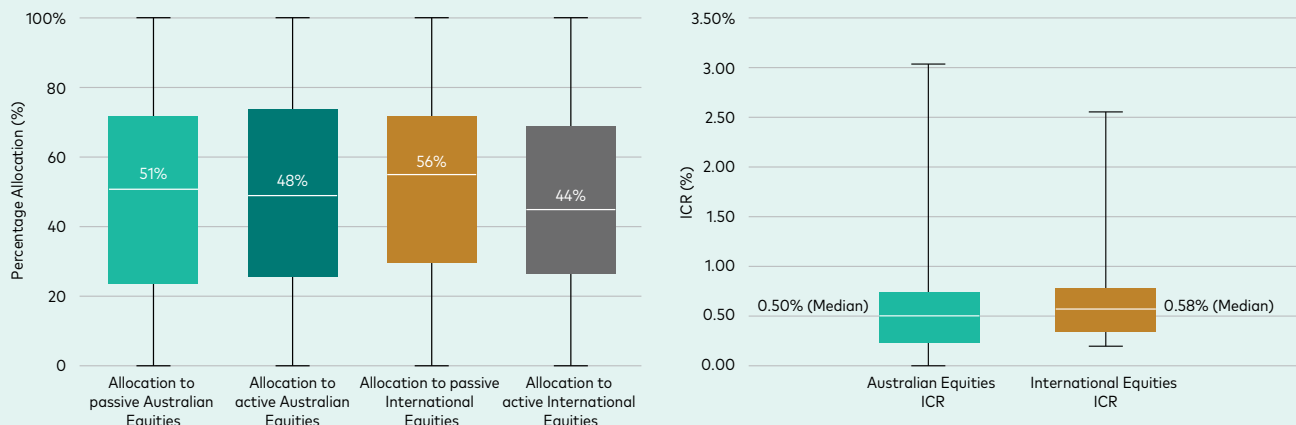


Notes: Average Active/Passive split data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of active/passive split observations from adviser portfolios can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Figure 16 shows the outcomes of our extended analysis within the Australian and international equity sleeves to determine the average passive and active allocations and costs as well as their 25th, 50th and 75th percentile ranges. Average levels of indexing for Australian and international equities are 48% and 51% respectively and average ICRs are 0.60% and 0.67%.

Figure 16. Australian and international equity sleeve active/passive splits and costs



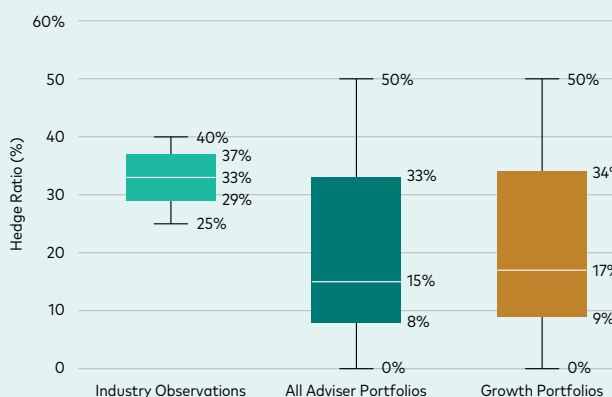
Notes: Median Active/Passive split & ICR data and ranges observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of active/passive split (left hand side) and ICR observations (right hand side) from portfolios can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

We conclude there is little variance between Australian and international equity allocations in terms of active/passive split and cost.

From industry experience, the PAC team has observed currency hedge ratios for international equity allocations ranging from 0% to 50%. However, most professionally managed diversified products we are aware of have exhibited strategic hedge ratios ranging from 25% to 40%, with an average of 33%. Across all portfolio risk profile assessments undertaken in 2024, the average hedge ratio was 15%, with a range from 0% to 50%. Specifically for the growth portfolios that average was 17%, with a range from 0% to 50%. For the growth portfolios, 26% had a hedge ratio of 0%. By way of comparison, the Vanguard Diversified Index Funds have a 30% hedge ratio in the international equity exposure. **Figure 17** illustrates this data.

Figure 17. Industry hedge ratio norms and sample portfolio hedge ratio ranges



Notes: Average hedge ratio data and ranges observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of currency hedge ratio observations can be seen in the shaded areas of the box chart.

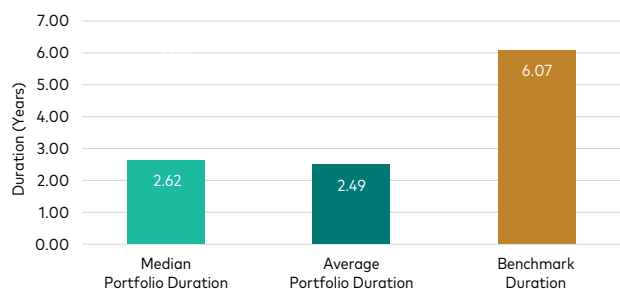
Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Fixed income trends: Why staying the course will continue to pay off

There is no doubt that in recent years bond markets have challenged investor portfolios, with 2022 being particularly tough. In 2022, Australian fixed interest as measured by the Bloomberg AusBond Composite Index declined by 9.71%, and global fixed interest as measured by the Bloomberg Global Aggregate Index (hedged to AUD) declined by 12.28%. Bond markets experienced a reversal of fortune in 2023 with Australian and global fixed interest generating returns of 5.06% and 5.31% respectively, with these returns above their 15 and 20-year averages. In 2024, the Australian and global fixed interest sectors saw rolling 1-year return highs of 7.11% and 9.11% respectively, however, they each finished the year with more modest returns of 2.93% and 2.23%. The decline from 2024 highs was due to uncertainty surrounding the glide path for interest rates.

Given the negative returns generated by bonds in 2022 and the uncertainty in the forward path of interest rates, adviser portfolios exhibited an underweight to duration. Noting that duration in the Vanguard Diversified Bond Index Fund is 6.07 years, the average duration in adviser portfolios was 2.49 years and the median was 2.77 years. **Figure 18** shows the overall levels of portfolio duration we observed as well as the ranges of observations.

Figure 18. Fixed income sleeve: Portfolio duration levels vs benchmark and portfolio duration ranges

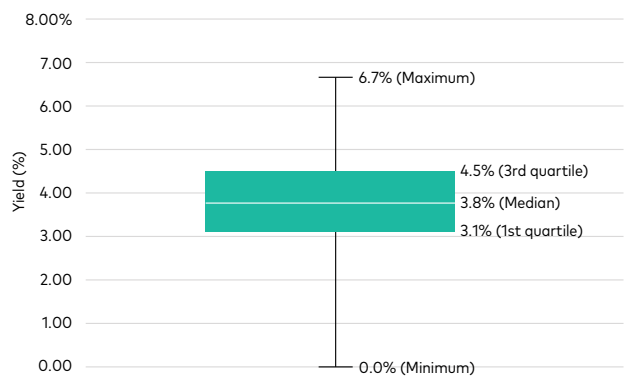


Notes: Average & median duration data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of portfolio duration observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Higher rates and the most robust real yields we've seen in nearly two decades mean that the income offered by bonds is starting to serve as a return driver in the fixed income portion of the portfolio. The trailing 12-month yield on clients' fixed income portfolios was an average of 3.93% and the median trailing 12-month yield was 3.76%. **Figure 19** below shows the ranges of these observations.

Figure 19. Fixed income sleeve yield ranges



Notes: Fixed Income Sleeve Yield data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of fixed income yield observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

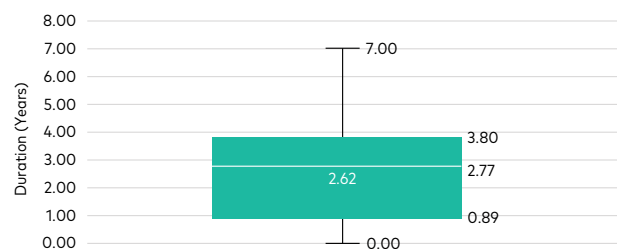
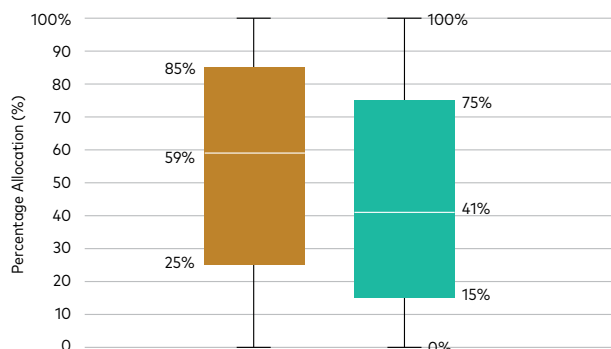
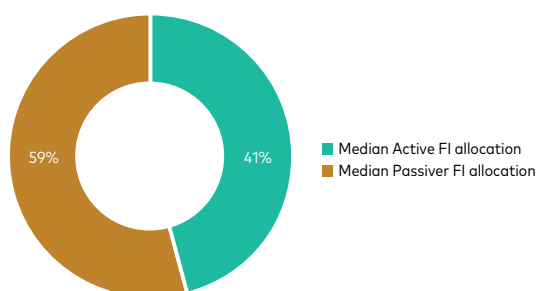


Figure 20. Fixed income sleeve: Median active/passive split and active/passive ranges



Notes: Median Active/Passive split data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of active/passive split observations can be seen in the shaded areas of the box chart.

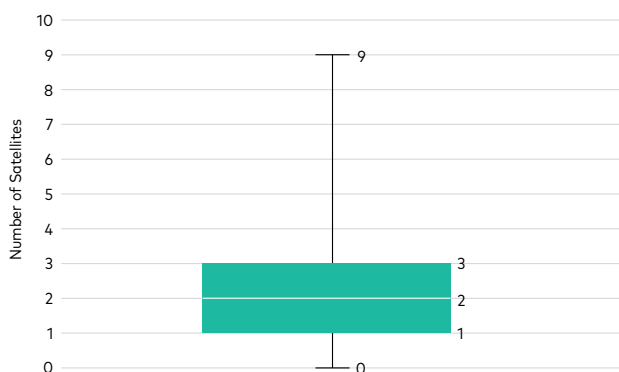
Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Analysis of the fixed income sleeve of adviser portfolios revealed a relatively even split between active versus passive products used. Passive dominated slightly, achieving an average weight of 54% versus active at 46%.

Figure 20 above shows the ranges for the average active versus passive split as well as the ranges we observed.

As is typical with core-satellite portfolios, indexed products made up the core in client portfolio construction while active, smart beta and single sector products were employed as satellites. Clients typically used two products in their satellite allocation. Worth mentioning is that the extreme outlier portfolio with nine fixed income satellites was using direct hybrids, a phenomenon we rarely observed and arguably not strictly fixed interest.

Figure 21. Fixed income sleeve: Number of satellites used in portfolio



Notes: Number of Satellites data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of number of satellites used can be seen in the shaded areas of the box chart.

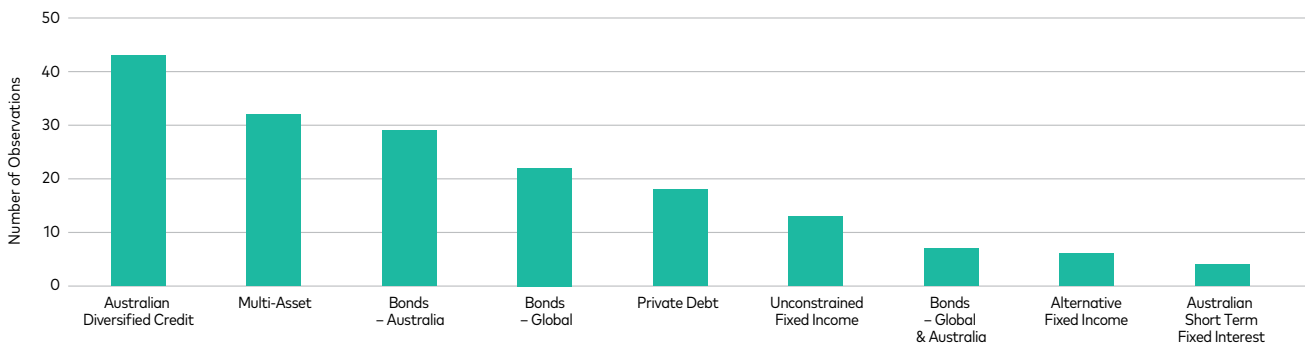
Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

The most common product types we observed in the fixed income sleeve were multi-sector diversified bond funds. These funds tend to have a duration of 0 to 3 years. They can also invest across sectors whether it be government bonds, semi-government bonds, corporate bonds, floating rate notes, hybrids, residential mortgage backed securities (RMBS) or asset backed securities (ABS). Many advisers look to active managers in their satellite to dynamically pivot the fixed income portfolio across fixed income sectors rather than doing it themselves. Private debt featured heavily. Where private debt was used it was always Australian focused amongst our sample, and predominately centred on Australian real estate finance and nonconforming mortgages.

Where a credit product was used it was overwhelmingly a product dominated by Australian credit. There was one global credit product that featured in the top four but it was the only dedicated global credit product that featured in the top 50 products used across the fixed income sleeves we observed. Therefore, advisers in our sample are biased towards Australian credit relative to the Vanguard Diversified Funds.

Advisers gain much of their global fixed income exposure from products benchmarked to the Bloomberg Global Aggregate, which is dominated by sovereign bonds. These products were in the top four most common fixed income products used as advisers looked to diversify their Australian-based fixed income sleeves. Term deposits and cash also played a role, with some advisers using that as a haven from the higher than usual bond market volatility we have experienced in recent years.

Figure 22. Most popular fixed income product categories used in adviser portfolios analysed



Notes: Number of observations per product category taken from observations across portfolios in our sample. Product categories adapted from Morningstar product categories.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

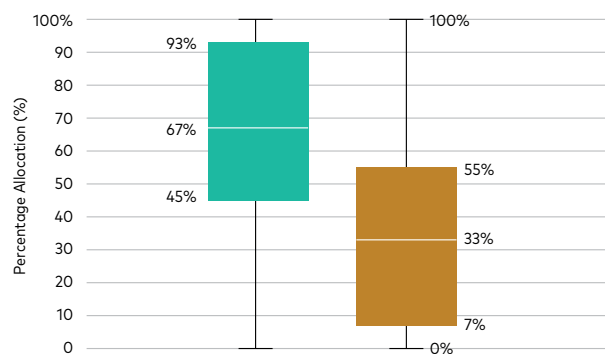
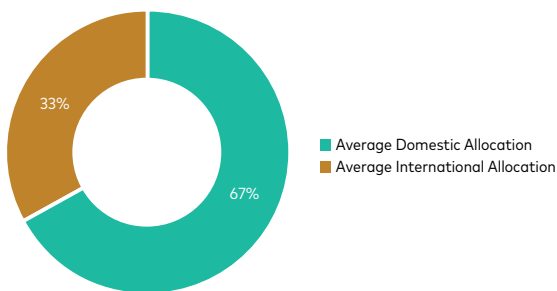
Of note, many advisers gained fixed income exposure via multi-asset funds. These multi-asset funds could either be risk profile based with a growth/defensive mix of assets set according to risk tolerance, such as balanced or growth funds, as well as real return funds which often have an inflation plus return mandate, and much greater flexibility to switch from defensive to growth and vice versa.

As one might expect due to the product selection above, fixed income portfolios in our sample exhibited a home bias. This contrasts with the Vanguard Diversified portfolios which exhibit a global bias. On average, portfolios had 67% allocated to Australian fixed income versus only 33% globally (Figure 23). And the range of observations was heavily skewed further towards a home bias in fixed income.

This is vastly at odds with Vanguard’s Diversified Growth strategy, which has a 30% allocation to domestic bonds and 70% allocation to foreign bonds.

On average, fixed income sleeve costs in our observation sample averaged 0.43% (Figure 24). There was less variance of the interquartile ranges around this than the equities sleeve. Advisers that used private debt in their portfolios resulted in higher fixed income sleeve costs in our observation sample.

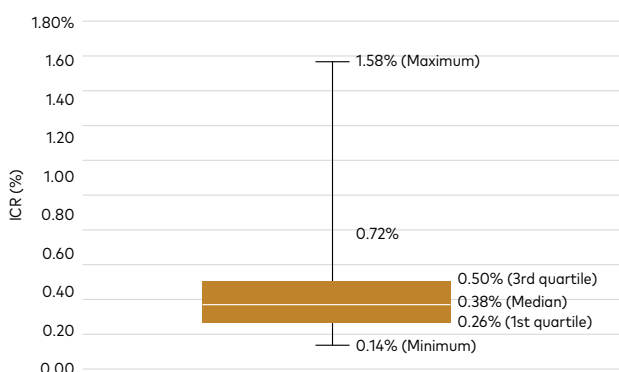
Figure 23. Domestic vs international average allocation and ranges



Notes: Average ICR data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of domestic fixed income/international fixed income split observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

Figure 24. Average fixed income sleeve ICR and ranges

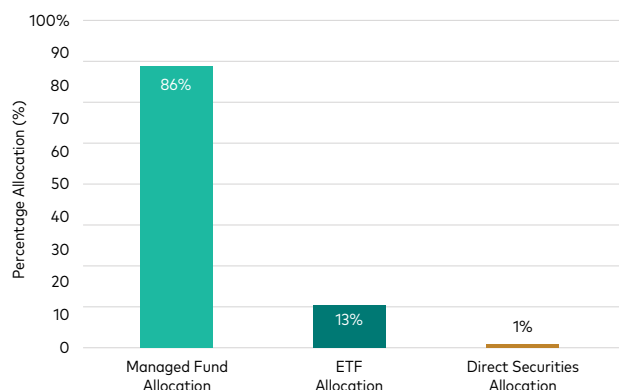


Notes: Average ICR data observed across portfolios in our sample. The 25th, 50th and 75th percentile ranges of ICR observations can be seen in the shaded areas of the box chart.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

The types of product vehicles used in our sample was dominated by managed funds with an average 85% allocation with the remainder virtually taken up by ETFs. ETFs seem somewhat more prevalent in equity sleeve portfolio implementation. Direct securities are less common in fixed income portfolios but when used are constrained to hybrids. In our observation sample, hybrid allocations were now mostly made via ETFs.

Figure 25. Investment vehicle weighted average allocation



Notes: Weighted average investment vehicle allocations observed across portfolios in our sample.

Source: Portfolios analysed by Vanguard, using Morningstar Direct & Vanguard data. Data from January 2024 – December 2024.

In general, we found adviser portfolios in our sample were overweight in credit and reinvestment risk, and underweight in duration. They were particularly more sensitive to Australian credit spreads when compared to the Vanguard Diversified portfolios. Credit and floating rate securities, which feature prominently in Australian fixed income products, have been the preferred choice for many advisers still scarred by the bond market volatility of 2022.

In our diversified portfolios, Vanguard still sees high-grade fixed rate securities as having many benefits to a multi-asset portfolio. Firstly, there is the diversification benefit bonds offer, particularly when risk assets like equities decline. Even in regimes where equities and bonds have positive correlations, these correlations tend to reduce in equity market drawdowns and bonds can serve as a defensive ballast reducing portfolio losses. Advisers in our sample who are overweight in cash and floating rate securities are susceptible to reinvestment risk where client income will reduce should interest rates fall.

Vanguard looks to harvest the term premium on offer via longer dated securities, which has been shown to consistently outperform cash over the long term. Additionally, the Vanguard Diversified portfolios look to allocate higher weights to global fixed income versus domestic as there are diversification benefits in the variety of yield curves and issuers.

Alternative strategies

Traditional asset classes such as bonds and equities have always been at the core of investment portfolios. However, in recent years the inclusion of alternative strategies has gathered momentum with the objective of increasing diversification and potentially increasing returns.

In the PAC team's experience, alternative strategies in portfolios have included direct real estate, direct infrastructure, private credit, private equity and hedge funds. Structures for alternatives have evolved over time and liquidity terms have also improved, however the most utilised funds only offer monthly and quarterly application and redemption periods, and lengthy notice periods for clients who wish to redeem.

We have observed these structures to be somewhat suitable to wholesale investors and less suited to retail investors where daily liquidity is preferred. Advisers in our sample had mostly retail client bases and so liquidity was a key factor in mind. However, advisers in our sample still see a place for alternatives in client portfolios (depending on risk and liquidity tolerance of individual clients), albeit to a limited extent.

Of the portfolios analysed, 49% had an allocation to alternative strategies, and of those portfolios the average exposure was 5%, with a minimum and maximum of 0% and 28% respectively. Strategies that were prominent included gold, private equity, private credit and Australian equity long/short strategies.

Core-satellite portfolio constructs

Of the consults undertaken we observed that the preferred method for constructing portfolios was the core-satellite approach, this being consistent with previous years.

The most common implementation of the core exposure was by way of single-sector index funds. Others utilised a multi-sector solution such as a Vanguard Diversified Index Fund. The selection of satellites was predominantly carried out by the adviser, and in the next instance outsourced to external experts.

Advisers that utilised Vanguard's single sector index funds for the passive core noted that this method of implementation was somewhat time consuming. However, some of these advisers acknowledged that they benefitted from strategy selection, asset allocation and portfolio construction. Where an adviser was considering utilising a Vanguard Diversified Index Fund as the core to simplify the advice and implementation process, the process of a new portfolio construct and tax considerations were front of mind.

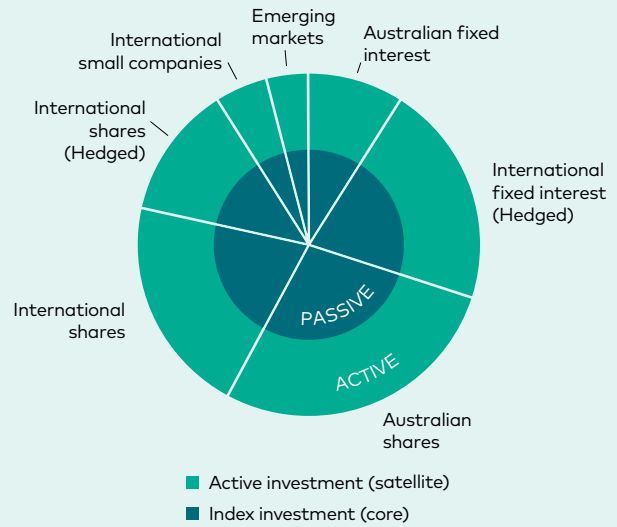
Figure 26 best illustrates the advantages of a traditional core-satellite approach from a Vanguard perspective.

Figure 26. Benefits and structure of core-satellite portfolio construct

An investment approach that seeks to combine an index "core" with active "satellites" with a view to better controlling performance.

Potential benefits of moderate allocation to active funds (50%–74% indexing)

Alpha potential:	Lower
Tracking error:	Lower
Cost:	Lower
Manager risk:	Lower
Tax and turnover:	Lower
Due diligence required:	Lower

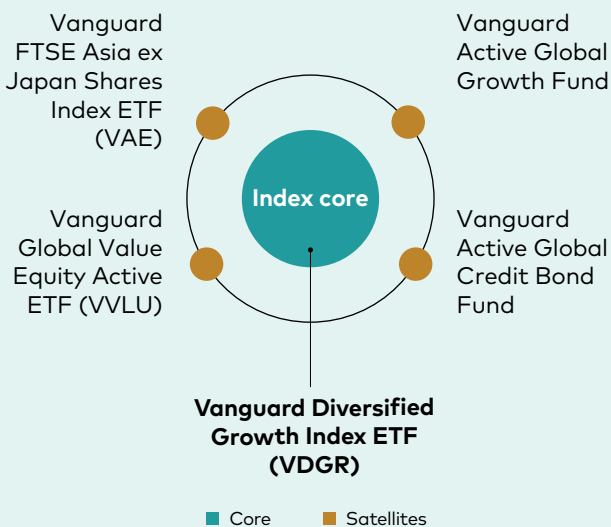


Notes: Asset allocation in this diagram are intended to be an example only and not a recommendation. This diagram and the information accompanying it are not intended as, and should not be taken to be, a guarantee that adopting this investment approach will deliver all or any of the potential benefits outlined above.

Source: Vanguard December 2022.

The combination of an index core with complementary active satellites is expected to manage performance variability.

Figure 27. Example core-satellite portfolio



Notes: Product selection in this diagram are intended to be an example only and not a recommendation. This diagram and the information accompanying it are not intended as, and should not be taken to be, a guarantee that adopting this investment approach will deliver all or any of the potential benefits outlined above.

Source: Vanguard

Key learnings from 2024

Having completed around 63 consultations and portfolio health checks on predominantly balanced, growth and high growth diversified portfolio constructs, Vanguard's PAC presents the following key learnings from 2024:

- The passive core and active satellite approach continues to demonstrate that passive and active products can complement each other, in providing a balanced and well-diversified portfolio capable of weathering different market cycles. Advisers we have spoken to acknowledge the favourable attributes of core-satellite portfolio constructs based on their own long-term positive experiences. Allocating between active and passive remains a decision, not a debate. The ideal active/passive split depends on portfolio objectives and client preferences, but consensus in our sample was that a 50% split was reasonable.
- Equity style regimes have been difficult to navigate, and advisers continue to be positioned relatively neutral as a result. Markets have and will continue to present uncertainty that makes it difficult to determine where market inflections will eventuate. The rotation in style factors that occurred a few years ago is a great example of the difficulty of any timing attempt. Therefore, advisers in our sample only had moderate style tilts if any. If a style tilt was present, it was typically towards quality or growth. But equity portfolios were generally core or style neutral in our sample. However, the difficultness of timing of markets is not specific to equity style factors, and extends to asset classes, sectors, countries and regions.
- Advisers have established clear tilts in their fixed income portfolios, being overweight Australian fixed income, particularly floating rate Australian credit. Through our conversations we suspect a good portion of this tilt is due to recency bias towards events in fixed income markets.

Vanguard's view is the diversification benefit and defensive ballast high-grade bonds offer should not be forgotten. And receiving the term premium offered by longer dated bonds consistently outperforms cash at the same time as offering this diversification benefit.

- The expected benefits of a multi-asset solution are to establish an all-weather portfolio that is consistent with client objectives. The passive core-active satellite portfolio construct is expected to provide this solution. For a low cost, the passive core involves a broad allocation to Australian and global exposures and is expected to dampen the variability in returns of the overall portfolio. The role of the active satellite components are to establish a tilt in a portfolio via investment strategies that take advantage of favourable style, sector, country and/or regional factors as well as security selection or to provide access to sectors not available in the underlying core portfolio (such as alternatives).
- In the PAC team's view, more advisers would benefit from a core multi-asset solution in their portfolio. Firstly, this provides a robust and tested strategic asset allocation, which Vanguard research has found explains 90% of returns. The time and skill required for dynamic asset allocation can be both challenging and time consuming. Secondly, a robust multi-asset solution can simplify the portfolio and the advice process, particularly in client reviews, as it is automatically rebalanced. In our sample we found many adviser portfolios are centred around seven to eight satellites. But there were many with more than this, which we believe is excessive. This can complicate the advice to the client but also often lead to overlapping exposures, which we deem unnecessary. A multi-asset core and more targeted satellites in line with the portfolio objective can simplify the portfolio and improve outcomes.

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