

Australian Equities

The Relative Risk Bubble

The Australian equity market has experienced unusually strong performance with low volatility over the past decade, influencing risk perceptions and investor behavior. This environment has heightened focus on relative returns rather than absolute risk, driven by the growth of passive funds and regulatory incentives, which we believe could be imprudent.

The September quarter saw the Australian Equity market break through the double-digit annual return barrier for the seventh time in the past decade. This is unusual in isolation, but what makes the last ten years truly remarkable is how good the bad times have been. The only two negative return years have been 2018 (-3%) and 2022 (-2%). This means that the volatility of observed annual market returns (8%) has been about half what would be typically expected.

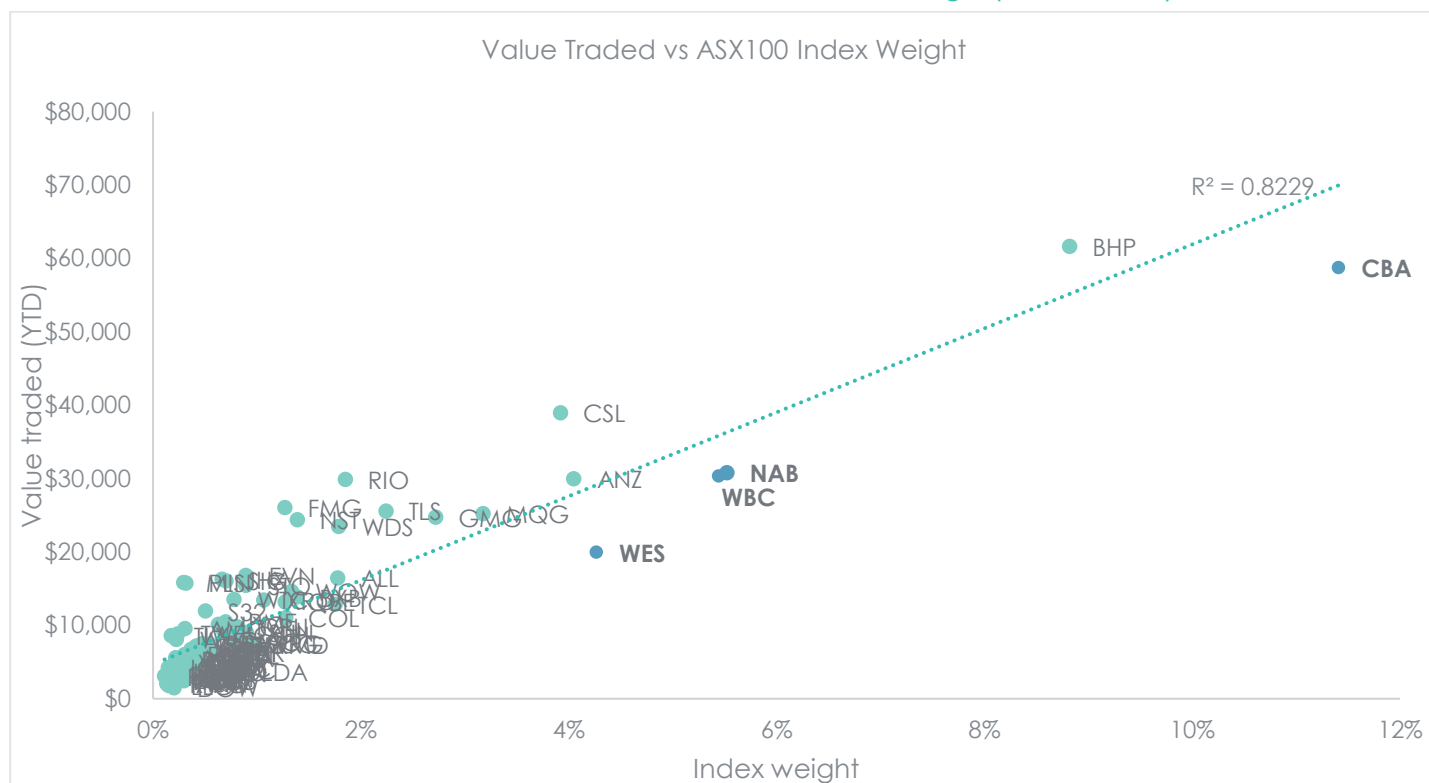
Exhibit 1: ASX300 calendar year returns (Source: FactSet)



A high return, low volatility backdrop over a sustained period has a profound influence on risk perception. If absolute risk is perceived to be negligible, returns compared to the benchmark (i.e. relative risk) becomes the primary consideration. This tendency has been accelerated in the Australian market by the growth of passive funds (a global trend) and the uniquely local impact of the Your Future Your Super (YFYS) performance test. This test specifically incentivises regulated super funds to prioritise the minimisation of benchmark underperformance (an existential threat under the current regime) over the inherent risk of their members' capital destruction. As a consequence of the YFYS test, regulated super funds are perversely better off losing half their members' balances in a downturn (if the market did the same) than they would be by underperforming peer returns in a bull market.

Myopic focus on relative risk over absolute risk and returns has built to a crescendo in the Australian equity market. Precise data on flows and balances into passive, and passive like, strategies is difficult to measure with precision. However, a useful shorthand approach to assessing this is to compare market turnover (value traded) in individual stocks to their market size, as measured by index weight, as shown in Exhibit 2 below. Stocks with above average turnover for their size are typically those actively traded by market participants seeking alpha opportunities. Stocks with low turnover compared to their size are those where the views of traders and investors are swamped by the sheer scale of passive flows.

Exhibit 2: Value traded of ASX100 Index constituents versus their Index weight (Source: IRESS)



Year to date, there are four stocks that stand out as having a low value traded compared to their size – three of the four major banks (namely Commonwealth Bank, NAB and Westpac) plus Wesfarmers. On the above measure, these stocks have been 'over bought' by around \$30 billion in the calendar year to date alone. Comparing current market prices for these companies to their own long term (10-year average) trading ranges relative to the market on a price to earnings basis (PER) is revealing, as shown in Exhibit 3.

Exhibit 3: Market pricing for 'over bought' companies (Source: CLSA, IRESS, at 30 September 2025)

	Long run PER	Current PER	Current share price	Share price at long run PER	Downside from current share price	YTD Return 2025
Commonwealth Bank	0.82x	1.15x	\$164.88	\$117.29	-29%	12%
NAB	0.62x	0.82x	\$43.64	\$33.08	-24%	22%
Wesfarmers	1.06x	1.60x	\$92.13	\$61.2	-34%	32%
Westpac	0.62x	0.82x	\$38.17	\$28.66	-25%	24%

All four stocks have outperformed the market this year and are trading well above their long-term average level compared to the broader market (in the range of 25% - 35% expensive), despite very modest expected earnings growth in each case. The evidence is circumstantial but crystal clear – these four stocks, collectively representing more than 25% of the ASX100 Index by weight, have become expensive due to the amount of money flowing into the index. Relative return preference is in bubble territory!

So, what is the right response? Equity markets have provided exceptional long-term returns, and limiting exposure deprives investors from the incredible benefits of compounding. However, ignoring absolute risk is in our view imprudent, particularly at a time when passive flows have pushed several large index weight companies to unsustainably high valuations. Our view has been consistent over the 20 years of our existence – preferencing high quality companies at reasonable valuations provides participation in up markets but significant protection in periods of distress. The absence of these events in the market's collective psyche has pushed the concept of absolute risk to the background. This is all the more reason to remain alert to its existence.

Northcape Capital

Sydney

Level 24, 45 Clarence
Street Sydney NSW 2000
Australia

P: +61 2 8234 3600

Melbourne

Level 18, 90 Collins Street
Melbourne VIC 3000
Australia

P: +61 3 8626 8000

ABN: 53 106 390 247

AFSL: 281767

www.northcape.com.au

For further enquiries:

Katie Orsini

Client Director

p: +61 2 8234 3629
e: katie.orsini@northcape.com.au

Wendy Hammond

Client Manager

p: +61 2 2 8234 3638
e: wendy.hammond@northcape.com.au

Eliza Clarke

Client Manager

p: +61 2 2 8234 3606
e: eliza.clarke@northcape.com.au

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