
Home Bias in Australian Equity Allocations

Diminished Portfolio Outcomes

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Executive Summary

Home bias has several economically rational and irrational drivers. In this paper we address several of these factors to restate the case for why Australian investors should reduce their home bias further. Australian investors are potentially missing out on 1.4% p.a. based on the current allocation versus the optimal allocation we have modelled.

In recent times, the home bias in Australia has fallen from 58% in 2014 to 44% in 2024.¹ This mirrors a broader trend we have observed in the Asia region. We posit that the main rationale for this trend is the increased capacity constraints that asset owners face in their local markets and foresee it continuing as these asset owners continue to grow.

One of the more difficult decisions for Australian asset owners is what to do with the currency exposure. Given the large multi-year fluctuations of the Australian Dollar (AUD), we think that asset owners could achieve a better result from employing a dynamic currency hedging strategy that takes currency relative valuation and the costs of hedging into consideration.

Franking credits have been used to justify the home bias in Australia as they increase the return available to domestic investors. Our research has found that this benefit is about 1% p.a. Despite this increased return, our modelling shows that there is still a significant return and risk-adjusted return opportunity that increased global allocations offer Australian investors.

To conclude, in this paper we demonstrate the diversification benefits of increasing global allocations. Larger international allocations are likely to give Australian investors the ability to gain from areas and sectors that may grow faster than Australia or the sectors dominant in Australia.

Factors Influencing Home Bias

Home bias is defined as having a portfolio where the proportion invested in the domestic market is larger than the proportion that market is of the global index. Despite the many potential benefits of investing globally, institutional and retail investors tend to prefer investing closer to home. The sense of familiarity and access to information about home markets, along with a tendency to avoid international currency exposure, are powerful stimulants for this home bias.

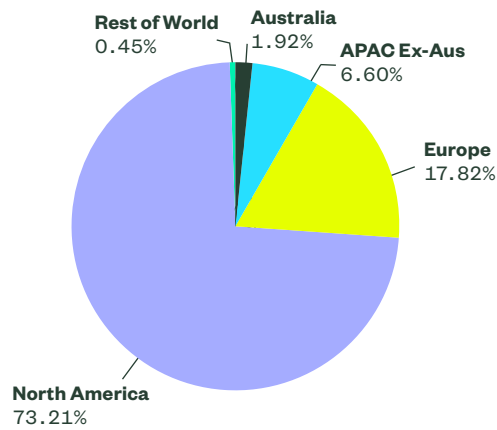
In addition, many institutional investors may have local liabilities which they are trying to hedge with their investments, so having a home bias can make it easier to match local inflation and hedge liability risk better. There is also an often overlooked motivator for home bias, and that is peer sensitivity. This is a particularly significant factor in Australia as the regulatory push to provide peer group performance comparisons and allow easier member switching has increased peer sensitivity among superannuation funds.

In Australia, franking credits offer an additional incentive to preference investing in domestic equities. The dividend imputation system results in a tax credit for Australian shareholders which boosts local equity returns. This increased domestic equity return may suggest a higher home bias in Australia.

Restating the Case for Lower Home Bias

A portfolio with no home bias would ideally be oriented towards the global market-cap index. Figure 1 shows the regional allocation for the MSCI World Index (MSCI World). The MSCI World allocation for Australia is about 1.92%, whereas the average domestic allocation for Australian superannuation funds was 44%.¹

Figure 1
Regional Breakdown of MSCI World Index

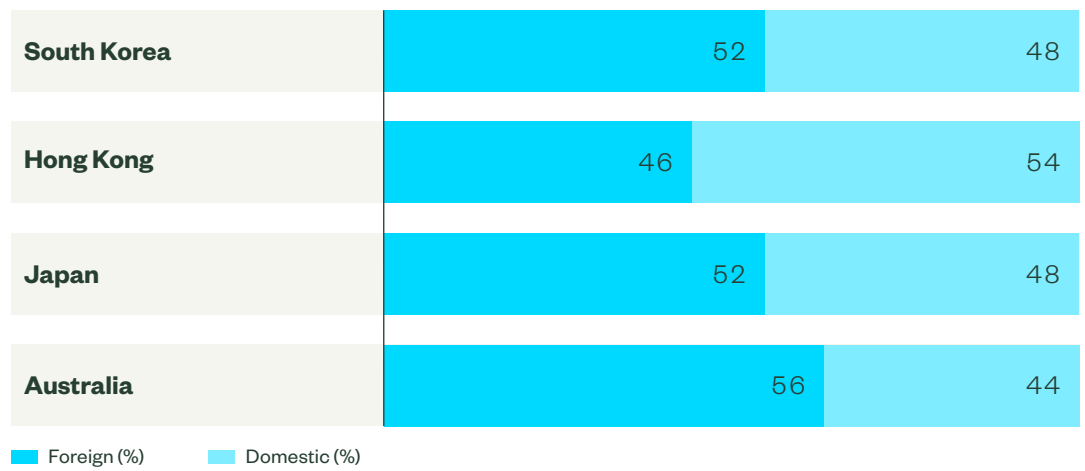


Source: FactSet, State Street Global Advisors as of 30 September 2024.

Regional Trends in Home Bias

Home bias is also apparent outside of Australia. Figure 2 highlights pension funds in South Korea, Hong Kong, and Japan have close to 50% of allocation to domestic equities. Comparatively, the Asia Pacific (APAC) allocation in MSCI World equities is just around 9%.

Figure 2
Equity Allocation of Pension Funds in Asia Pacific

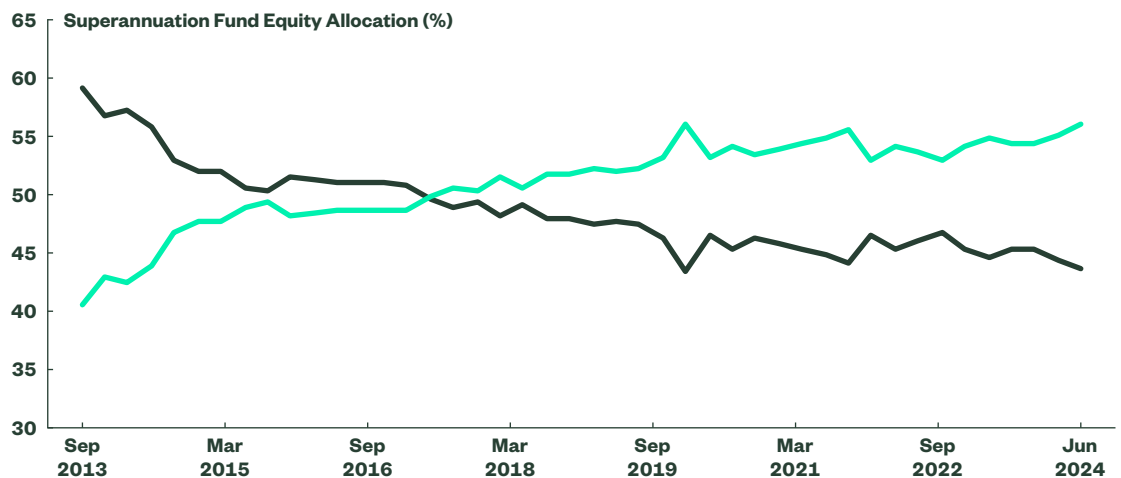


Source: Mercer Asset Allocation Insights and My Super Statistics as of 2023 and 2024, respectively.

However, it is important to note that the amount of home bias present in Asia has been decreasing with international equity allocations growing from just 36% in 2014 to 48% in 2022² with South Korea, Taiwan and Thailand being the main drivers. In Australia, there has been a similar trend with international equity allocations growing from 42% in 2014 to 56% as of June 2024.

Figure 3
Trend in Home Bias for Australian Superannuation Funds

■ Australia
■ International



Source: APRA Quarterly Superannuation Performance Statistics March 2024. Data from 30 September 2013 to 30 June 2024.

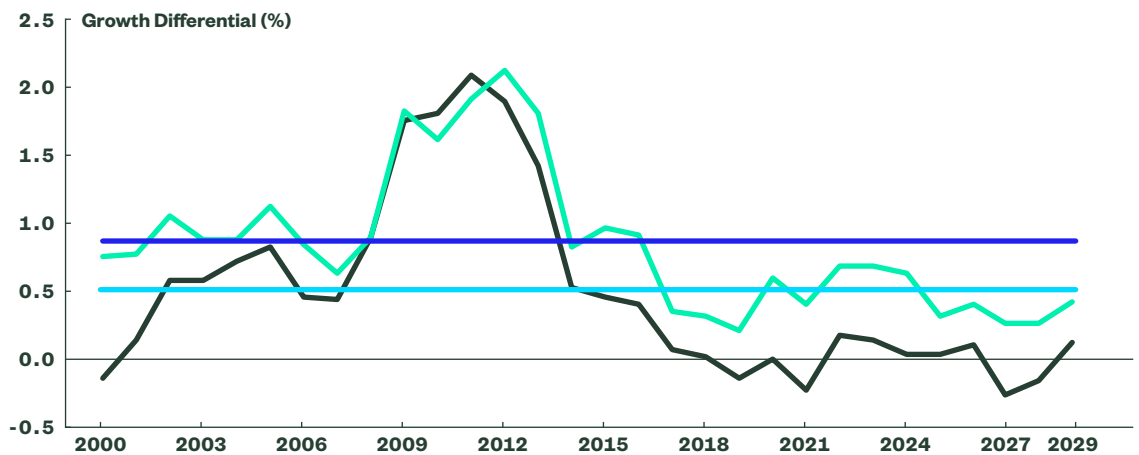
Sovereign wealth funds have been on the forefront of this trend to reducing home bias. Some prominent global examples such as GIC, ADIA and Government Pension Fund of Norway all have equity portfolios that are global and exhibit no home bias at all. Here in Australia, the Future Fund does not quite have that level of international diversification; but, at 72% international equity exposure it has a substantially lower home bias than the superannuation funds. Of course sovereign wealth funds have a strong risk rationale for investing more overseas — avoiding contagion and offering an offset if the local economy collapses. Another factor which has driven this more global orientation for these large investors is their relative size compared to the domestic market. This has led to concerns about capacity within the home market potentially impacting portfolio returns and liquidity and the natural response to reducing that risk is to diversify internationally. As Australian superannuation funds continue to consolidate and grow in size, capacity concerns are starting to become a significant issue for them as well. Here at State Street Global Advisors we have been speaking to clients about this issue and we recommend that superannuation funds continue to diversify their portfolios internationally or face the prospect of diminished portfolio outcomes.

Historical Performance and Efficient Frontier

The historical analysis we have performed is over the 15 years since the Global Financial Crisis and largely leaves out the China-driven resources boom from 2004–2011. The resources boom distorted Australia’s terms of trade and caused a material, but temporary, deviation of growth relative to the US and the developed world. This deviation is shown in Figure 4 which also shows that the growth differential between Australia and developed market peers is likely to remain subdued in the medium term.

Figure 4
**GDP Growth Differentials
 Australia vs. Developed
 Markets (DM) Peers**

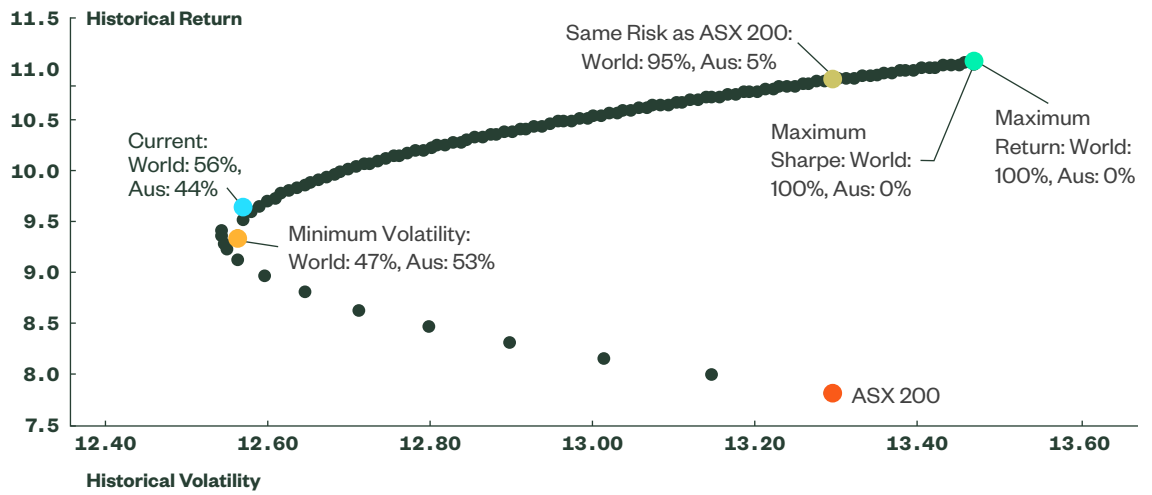
- AU Less US GDP Growth (5yr Avg)
- AU Less DM GDP Growth (5yr Avg)
- LT Avg AU less DM
- LT Avg AU less US



Source: International Monetary Fund. *World Economic Outlook*. April 2024. Estimates after 2023.

Figure 5 shows historical risk and return of portfolios consisting of two indices in various proportions: MSCI World ex-Australia Index (MSCI World ex-Australia) and S&P/ASX 200 Index (ASX 200). In this analysis, the worst performance recorded was a 100% allocation to Australian equities. On the other hand a similar risk portfolio on the efficient frontier which includes 95% World and 5% Australia, returned 3% p.a. higher. The maximum Sharpe portfolio on the efficient frontier had an allocation of 0% to Australia and 100% to global equities. This result is markedly different from the current allocation in Figure 2 showing that the average Australian investor was invested as high as 44% in domestic equities.

Figure 5
**Efficient Frontier MSCI
 World Ex-Australia and
 ASX 200**



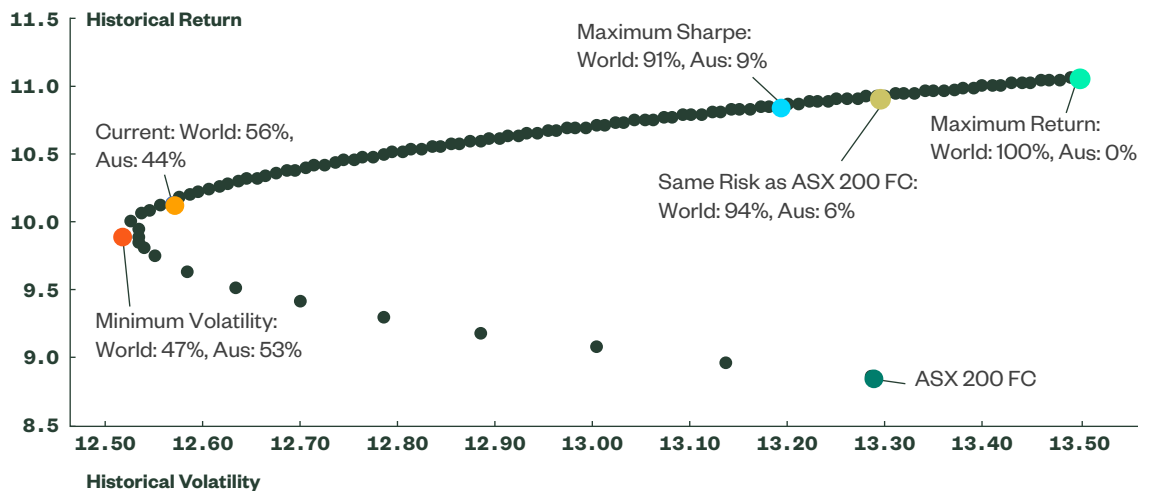
Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia and S&P/ASX 200 indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

We concede that considering franking credits on Australian equities, the ideal allocation will lean more towards domestic equities. Next, we explore the impact of franking credits on the allocation.

Franking Credits

Franking credits, also known as imputation credits, are tax rebates that companies pay to their shareholders along with dividend payouts to avoid double taxation of shareholder income. For Australian residents, this credit can be up to 30%. We estimate that franking credits can improve returns to domestic investors by about 1% p.a. This improved return can lead to a higher allocation to Australian equities being appropriate. To test this theory, we reconstructed the previous portfolio combinations with the additional return impact of franking credits for Australian equities. Figure 6 shows the historical risk and return of portfolios consisting of two assets in various proportions: MSCI World ex-Australia and ASX 200 Adjusted for Franking Credits — Superannuation Index.

Figure 6
Efficient Frontier MSCI World Ex-Australia and ASX 200 Franking Credits Adjusted Superannuation Index



Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia and S&P/ASX 200 Franking Credits Adjusted Superannuation indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

We have chosen the superannuation franking credits adjusted index given that many Australians invest in the equity market through their superannuation - the earnings in these funds get taxed at 15%. We have plotted the efficient frontier by assuming this benefit so some investors may get a different net result. Compared to the previous plot, the added benefit of franking credits tilts the maximum Sharpe portfolio a little more towards domestic equities. This is because the return for domestic equities is improved by 0.9% p.a. over the 15 year history of our analysis. This overall maximum Sharpe allocation is still invested more in global equities than the current institutional allocation observed (91% vs 56%). Once again, the portfolio allocation that had an equivalent amount of risk boosted returns by 2.1% p.a. with an allocation to global equities of 94%.

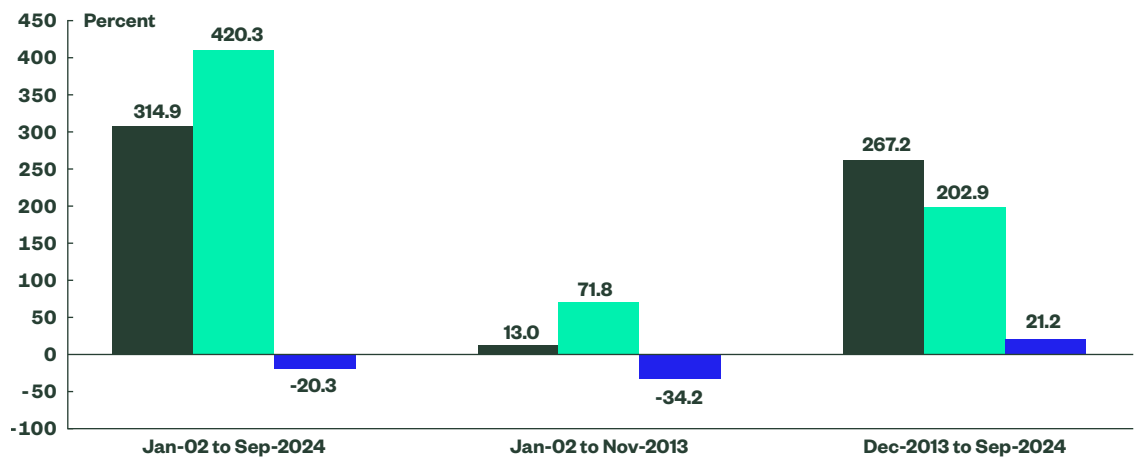
Recent changes to the Australian franking credit regime have impacted the attractiveness of harvesting franking credits, particularly through off-market buybacks. The government has tightened rules around these buybacks, limiting the ability for investors (especially superannuation funds) to maximize franking credit benefits. This and the stock selection challenges of dividend run-up strategies have made such strategies less appealing. Additionally, the rise in foreign ownership of Australian shares (from just under 25% to 33% since 2010³) has diluted the demand for franking credits, as foreign investors cannot benefit from these credits. The increased turnover and transaction costs associated with franking credit harvesting have also diminished the strategy's appeal as super funds and institutional investors have become more fee and capacity constrained. What is left as a viable strategy for sophisticated investors then is index-level franking credits. Even then there is a case to say that the Australian equity market does not provide a higher overall return — it just merely has a greater proportion of returns coming from income (dividends) than capital.

The MSCI World ex-Australia return and risk metrics for the efficient frontiers presented above were based on unhedged returns in line with our observations of most client portfolios. We have repeated the analysis above, this time applying hedged international equity returns — these results are presented in Appendix 1. The overall conclusion remains that there is a benefit to international allocation with both hedged and unhedged currency exposure. We explore currency risk in our next section.

Currency Risk

The historical performance for an Australian investor in MSCI World ex-Australia is presented in Figure 7. There is a notable difference in performance based on currency; between January 2002 and September 2024, the local return on the investment was reduced by 20.3% when translated in Australian dollars as AUD strengthened over this period. However, currency returns were not tilted in one direction throughout our study period, as shown with breaking down this history into two sub-periods.

Figure 7
Local, AUD and Cumulative FX Total Returns for an Australian Investor in MSCI World Ex-Australia

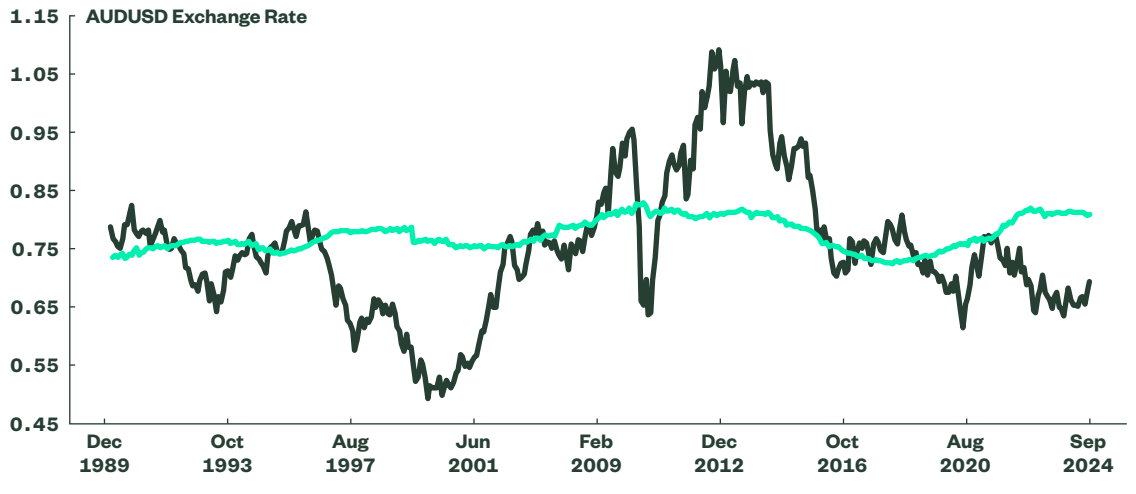


Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 December 2001 to 30 September 2024. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. It should not be assumed that they represent the performance of any particular investment.

This loss on currency translation was worse for the sub-period of January 2002 to November 2013. However, for December 2013 to September 2024 the international currency exposure would have added value to the return for an Australian investor as AUD weakened over this period. This makes it difficult to have a fixed preference when it comes to the choice between hedging the international currency exposure or leaving it unhedged.

Figure 8
Evolution of AUDUSD Exchange Rate

■ SPOT — AUDUSD
 ■ Fair Value — AUD

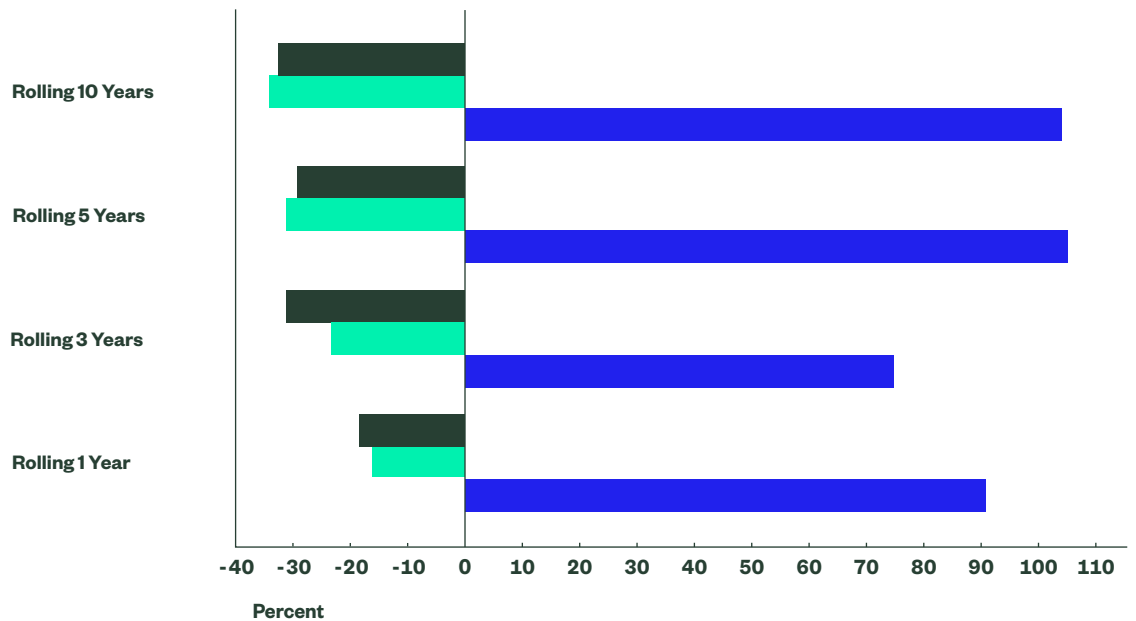


Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 December 1989 to 30 September 2024.

As Figure 8 shows, currency can have very large swings up to +/-50% even if the fair value (as measured by Purchasing Power Parity) does not fluctuate nearly as much. The chart shows that AUD is 14% cheap relative to fair value as of 30 September 2024. These fluctuations in the AUD can have a large impact on the risk profile of an international equity allocation. Figure 9 shows that currency risk can be as large, or larger, than equity risk.

Figure 9
95% Value-at-Risk (VaR) for MSCI World Ex-Australia (AUD)

■ Equity 95% VaR
 ■ Currency 95% VaR
 ■ Ratio Currency Risk to Equity Risk



Source: MSCI Inc, State Street Global Advisors. Data from 31 January 1990 to 30 September 2024.

The currency impact does seem to wash out over the long run but the shorter-term impact is too large to ignore. A prudent approach would be to manage the currency risk at an overall portfolio level to navigate the large swings that happen periodically.

This entails applying a dynamic currency hedging policy that takes currency relative valuation and the costs of hedging into consideration. At State Street Global Advisors, we generally recommend managing currency risk using the Dynamic Strategic Hedging program (DSH). Rather than choosing to be unhedged, choosing a fixed hedge ratio or fully hedged, the DSH program adjusts the hedge ratio for each currency in the portfolio according to our medium to long term assessment of that currency's economic value relative to the Australian dollar.

Benefits of Global Diversification and Sector Biases

Home bias leads investors to forgo the benefits of geographical diversification. A large exposure to one country can make the portfolio vulnerable to volatility of one market, which in Australia's case is a relatively small and concentrated market. In contrast, a portfolio diversified over world markets has exposure to return-efficient market risk that reduces idiosyncratic standalone risks, including stock specific risk.

Figure 10
Relative Annualised Performance of Country Indices against MSCI World (Corresponding Currency)

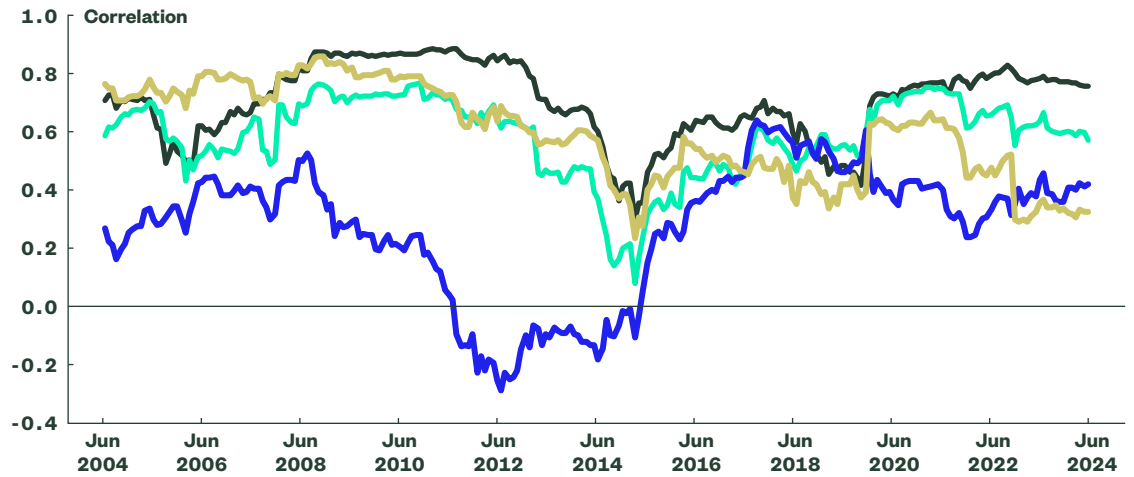
Relative to MSCI World	S&P 500 Index	MSCI Europe Index	MSCI Japan Index	ASX 200
1 Year Performance (%)	3.92	-6.85	-10.34	-1.44
3 Years Performance (% p.a.)	2.83	-2.43	-7.04	-2.30
5 Years Performance (% p.a.)	2.93	-4.15	-6.23	-4.29
10 Years Performance (% p.a.)	3.30	-4.55	-3.81	-3.99
15 Years Performance (% p.a.)	3.81	-4.41	-4.41	-4.20
15 Years Risk/Return (p.a.)	0.27	-0.39	-0.22	-0.53

Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment. Performance returns are calculated in local currency.

Figure 10 illustrates the relative performance of country indices against MSCI World since July 2009. We have compared each domestic index with the domestic currency version of MSCI World. Over the long term, barring the S&P 500, all regional indices have underperformed the MSCI World. The ASX 200 has underperformed the global benchmark across all the time periods. Based on this observed historical performance, global diversification would have enhanced performance for Australian investors.

We also examine the correlation between the domestic market and regional indices in Figure 11. The figure shows pockets of very low correlations between domestic and other regional indices (in AUD). This is especially true for ASX 200 against the MSCI Japan Index and MSCI Emerging Markets Index. A domestic investor would benefit from the low correlation between domestic and global markets in AUD terms. The low correlations is also found among local currency returns. We present the results of that analysis in the Appendix.

Figure 11
**ASX 200 3-Year
Rolling Correlation
vs. Corresponding
Regional Indices**



Source: Bloomberg Finance L.P. Data from 30 June 2004 to 30 September 2024. Data calculated in Australian dollars. Past performance is not a reliable indicator of future performance.

A domestic tilt will also lead to significant sector exposure differences relative to the MSCI World. Figure 12 highlights the sector differences between MSCI World and regional indices. The ASX 200 has a significant negative exposure to the Information Technology sector, which has been a major driver of prior underperformance relative to the global index and also leaves future performance at risk from a lower ability to benefit from emerging trends and innovation in this sector. Additionally, it has large over-weights to Materials and Financials sectors against the MSCI World. Moreover, the variance of sector weights is higher for Australian equities than it is for other regions. The standard deviation of sector weights is 10.5 for Australian equities compared to 2.6 for US equities, 5.8 for Japan, and 6.3 for European equities as of 30 September 2024. Australian investors, via their concentration in the domestic market, are more prone to sector specific drawdowns and diversification away to global markets would provide a better balanced spread of sector weights.

Figure 12
**Sector Weight Variation vs.
MSCI World Index (%)**

	ASX 200	S&P 500 Index	MSCI Japan Index	MSCI Europe Index
Communication Services	-3.8	1.5	-0.4	-4.2
Consumer Discretionary	-2.5	0.2	7.9	0.1
Consumer Staples	-2.6	-0.7	-1.2	4.3
Energy	0.0	-0.8	-3.2	1.0
Financials	16.3	-2.6	-1.3	3.3
Health Care	-2.8	-0.7	-3.5	4.8
Industrials	-4.0	-2.5	11.9	5.5
Information Technology	-21.5	7.0	-9.8	-17.1
Materials	17.5	-1.4	0.6	2.5
Real Estate	4.7	0.1	0.5	-1.4
Utilities	-1.2	-0.1	-1.5	1.4

Source: FactSet as of 30 September 2024. Sector weights are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

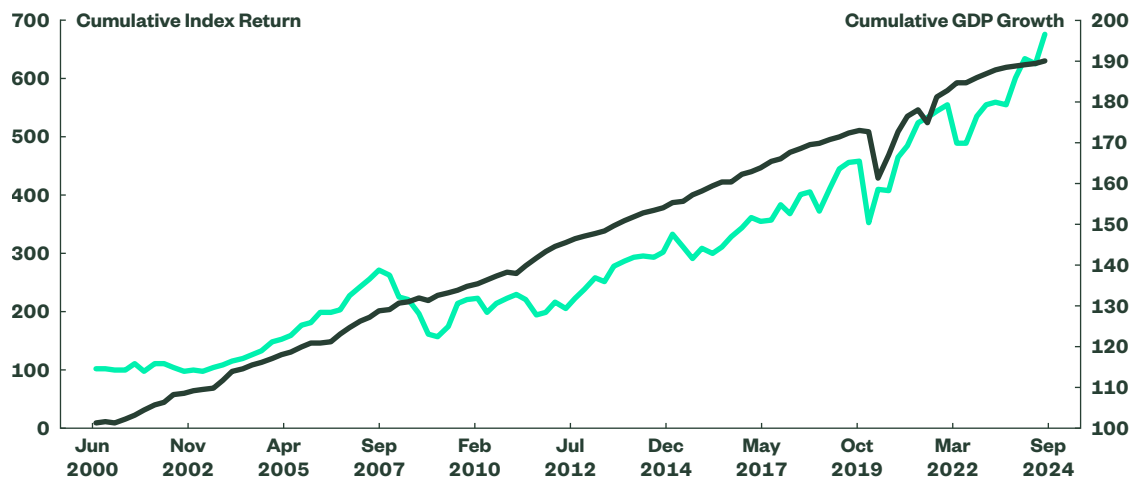
Economic Risks to Domestic Concentration

A strong bias to domestic equities can expose investors to the risk of contagion during domestic economic downturns. Figure 13 draws the relationship between Australian GDP growth and domestic market growth over the last 23 years. We see a close, but not direct, relationship between the two metrics so an investor can simultaneously be exposed to weak economic prospects and downside on their investments.

Conversely, robust economic growth can fuel upside in stock markets. However, Australia's growth rate has been slowing and its forecasted medium-term growth is not expected to significantly exceed the advanced economy average as has been the case over the last 20 years (see Figure 4). This provides another potential benefit for Australian investors to diversify globally in faster growing markets.

Figure 13
Cumulative Annual Growth — Australia GDP and ASX 200

■ Aus GDP Growth (RHS)
 ■ ASX 200 Net TR



Source: Bloomberg Finance L.P. Data from 31 December 2000 to 30 September 2024. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment. Performance returns are calculated in Australian dollars.

Conclusion

Despite a reduction in recent years, there remains a significant home bias for Australian investors including superannuation funds. We have shown that a large standalone exposure to the Australian market can lead to lower risk adjusted returns relative to a larger allocation to global equities.

We have also investigated one of the oft-cited reasons for the home bias in Australian equity allocations — franking credits. We found that even accounting for the positive return impact of franking credits, increased global allocations would have led to better risk-adjusted returns.

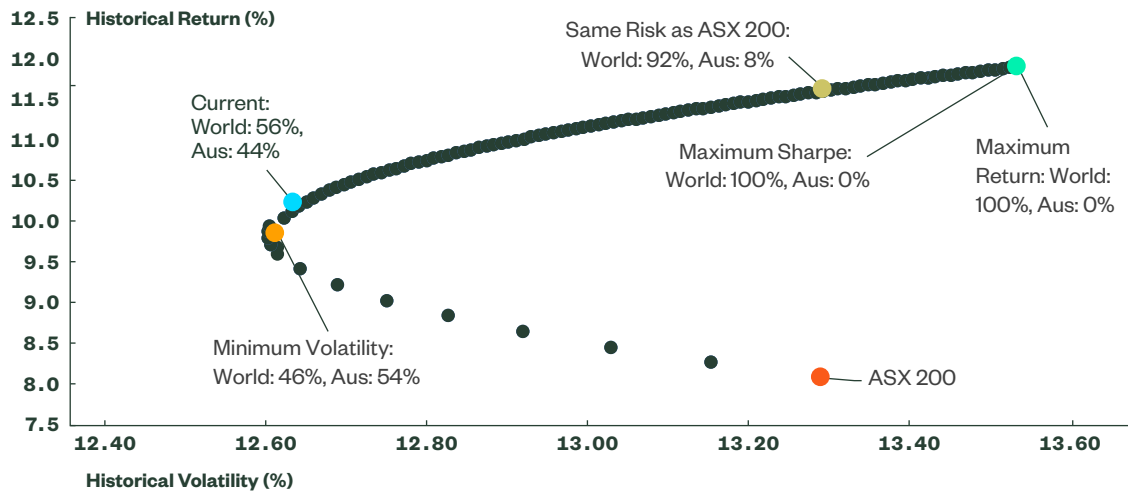
While relatively well known, we presented the higher sector weight deviations that the Australian market has against the MSCI World (and compared to other markets). It is an easy case to make that an increased allocation to global equities offers a more diversified market opportunity set helping reduce the idiosyncratic risk of standalone domestic markets.

However, there are material risks in investing globally, particularly currency risk. Our discussion showed how the currency impact can be managed by Australian based investors to provide long-term value to global allocations.

Overall, the case for increasing global equity allocations is compelling from multiple angles. Looking ahead, as Australian superannuation funds continue to grow, capacity constraints in the Australian equity market will increasingly affect the efficiency of their equity portfolios. We therefore recommend that superannuation funds continue to diversify their portfolios internationally or face the prospect of diminished portfolio outcomes.

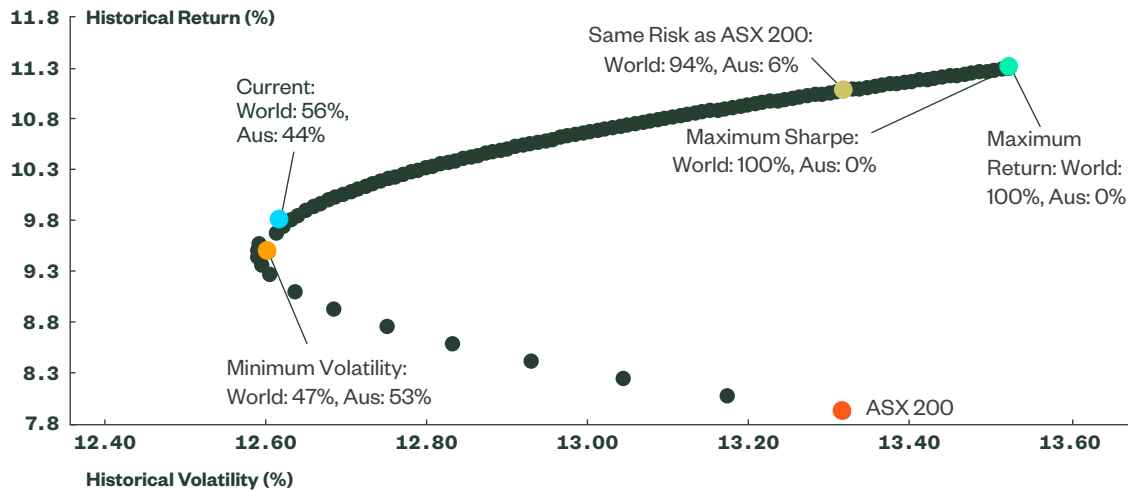
Appendix 1

Figure 14
**Efficient Frontier MSCI
 World Ex-Australia 100%
 Hedged and ASX 200**



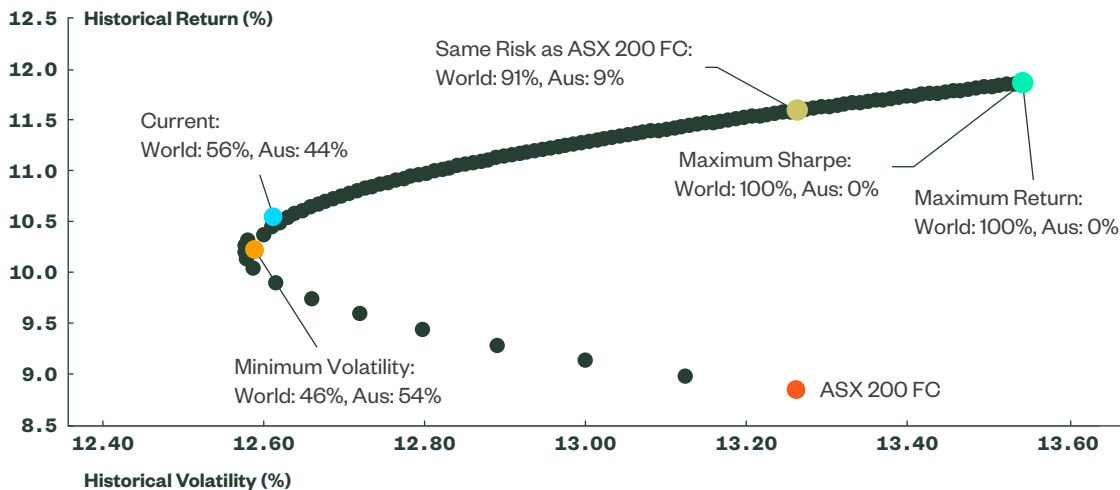
Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia 100% Hedged and S&P/ASX 200 indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

Figure 15
**Efficient Frontier MSCI
 World Ex-Australia 50%
 Hedged and ASX 200**



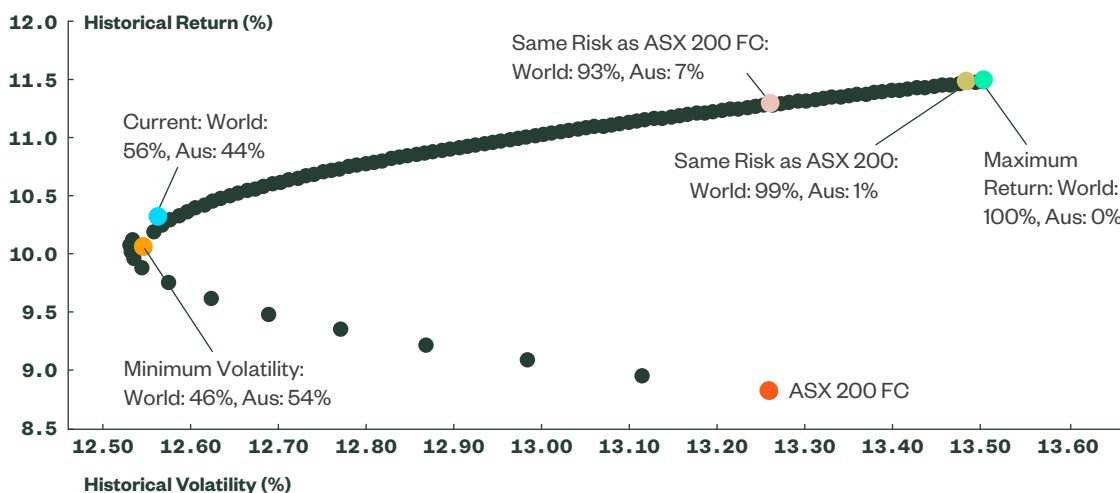
Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia 50% Hedged and S&P/ASX 200 indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

Figure 16
Efficient Frontier MSCI World Ex-Australia 100% Hedged and ASX 200 Franking Credits Adjusted Superannuation Index



Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia 100% Hedged and S&P/ASX 200 Franking Credits Adjusted Superannuation indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

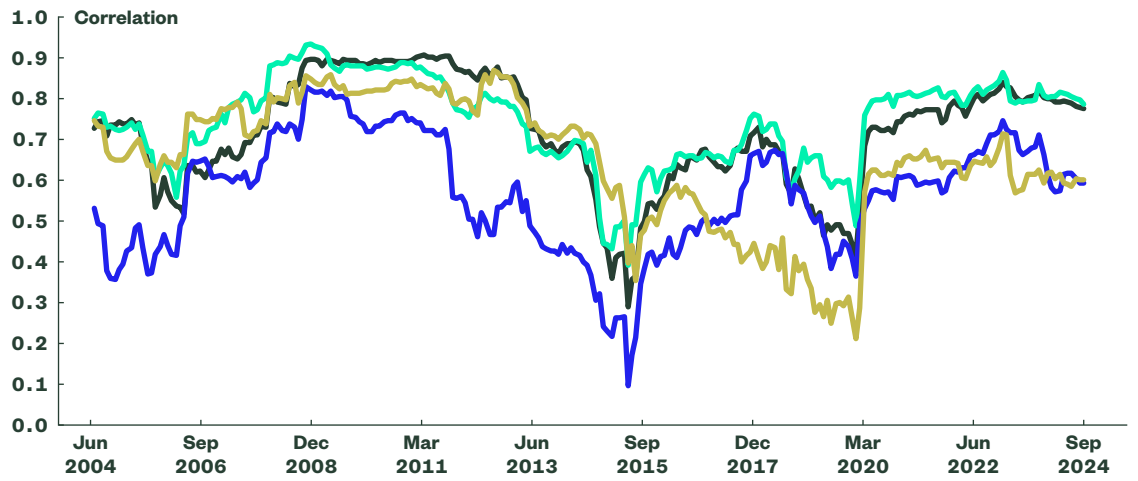
Figure 17
Efficient Frontier MSCI World Ex-Australia 50% Hedged and ASX 200 Franking Credits Adjusted Superannuation Index



Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 31 July 2009 to 30 September 2024. Returns do not represent those of an actual portfolio but were achieved by mathematically combining the actual performance data of MSCI World ex-Australia 50% Hedged and S&P/ASX 200 Franking Credits Adjusted Superannuation indices. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns are calculated in Australian dollars.

Figure 18
**ASX-200 3-Year
 Rolling Correlation
 vs. Corresponding
 Regional Indices**

- S&P 500
- MSCI Europe
- MSCI Japan
- MSCI EM



Source: Bloomberg Finance, L.P., State Street Global Advisors. Data from 30 June 2004 to 30 September 2024. Data calculated in local currency. Past performance is not a reliable indicator of future performance.

Endnotes

- 1 Source: My Super Statistics, as of June 2024.
- 2 Source: Mercer Asset Allocation Insights 2022.
- 3 Source: Australian Bureau of Statistics, May 2024.

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For four decades, State Street Global Advisors has served the world's governments, institutions, and financial advisors. With a rigorous, risk-aware approach built on research, analysis, and market-tested experience, we build from a breadth of index and active strategies to create cost-effective solutions. As pioneers in index and ETF investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US \$4.37 trillion[†] under our care.

* Pensions & Investments Research Center, as of December 31, 2023.

[†] This figure is presented as of June 30, 2024 and includes ETF AUM of \$1,393.92 billion USD of which approximately \$69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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ID2410450-7182214.11.ANZ.INST 1024
Exp. Date: 31/10/2025