portfolio construction forum

Global investing trend has much further to go

Dominic McCormick | Select Asset Management | 11 March 2014

Australian retail investors are waking up to the fact that they have not had enough global (mainly equity) exposure in recent years. SMSF investors, in particular, have had exceptionally low exposure to global equities at typically jsut a few percent of their portfolios. It seems likely this figure will increase substantially in coming years. A recent survey by Investment Trends suggested that one-in-four Australian investors intended to increase their exposure to international shares in the next month, the highest level in two and a half years.

Of course, some of this increase will likely reflect the tendency of investors to look backwards and chase past performance. After all, global equity funds generally outperformed local Australian equity funds by 10% to 20% last year - and, for reasons discussed below, this outperformance may continue. However, some of this embrace of more global exposure is secular in nature and may continue even through and beyond the next major bear market in global equities.

Indeed, that bear market could be closer than many think. It is not hard to build a case for considerable caution on many global equity markets over the next couple of years from a valuation perspective, particularly the more extended developed markets such as the US. However, the expanding role of global investments in Australian investors' portfolios will likely survive more difficult markets, particularly if investors use fund managers and structures that can exploit a diverse range of global strategies and opportunities.

Why the case for more global exposure now?

After all, fund managers have been pushing the benefits of global diversification for years with sporadic success in terms of funds inflow. I think this stubborn home bias over recent decades can be put down to four factors.

1. The strong absolute and relative performance of Australian assets (Australian equities, property and fixed interest) led to investor confidence with, and complacency about, local assets.

2. This complacency has been supplemented by the lack of a recession in Australia for 23 years, while over the last decade, Australia has been a major beneficiary of China's dramatic growth and the related mining boom.

3. Until recently the Australian Dollar had been strong (excluding 2008), weighing on the returns of global equities funds, most of which are unhedged.

4. Meanwhile, relatively high interest rates created an environment where investors could achieve acceptable returns with little risk by investing in term deposits and cash. For many such investors, there was little need to consider more risky assets like global shares.

However, these factors have already partly or fully reversed, or are in the process of doing so. The Chinese boom is slowing, the local currency has been weakening and many Australian assets have begun to underperform. Interest rates are the lowest they have been for 40 years.

While many investors are currently rushing back to residential property investment, even this boom could be relatively short-lived, in part because elevated prices may lead to poor returns particularly with limited support of constrained first home buyers, but also because of the increasing possibility of regulatory action to lessen the attractions of gearing into property especially (but not necessarily limited to) by SMSFs.

In addition, the changing economic environment is exposing a range of weaknesses in the Australian economy and sharemarket, particularly relative to the global opportunity set. One of these is the inherent high concentration with the local market in two sectors – banks and resources. Australia banks are arguably the most expensive in the world at present. Resources, while cheaper, face the headwinds of a commodity slowdown.

One common argument against a dedicated global equity exposure is that Australian investors don't need it because they already gain good global exposure via some Australian companies. While this is true to some extent, the sectoral spread of such opportunities is quite limited and, when sentiment towards Australian shares/economy sours, all shares, even those with high overseas earnings, tend to suffer.

Another argument has been the focus on franking credits from local shares. However, to the extent that this is increasingly already priced in to market prices by investors willing to pay up for franking credits, this benefit is often overstated.

The other factor driving increased global exposure in portfolios is the easier access and increased range of vehicles. A couple of decades ago, the only real options for investors were a small number of locally marketed managed funds, often run by global groups. Today, the number and types of managed funds has broadened considerably and new fund structures have also become available. Basically, the three main options for global equity exposure for retail investors today are:

1. Exchange Traded Funds (ETFs)

2. Listed Investment Companies (LICs)

3. Managed funds including passive and active, and both long-only and long-short funds.

I will expand on each of these as well as touch on some niche ways to get exposure.

ETFs are appealing for those seeking instant diversification and low cost exposure. ETFs are also useful as a way to target particular countries or regions or in dynamic asset allocation. However, in some investment environments – particularly more challenging ones – there is a question as to whether a buy and hold approach using ETFs is the best way to build global equity exposure.

LICs are currently enjoying a renaissance, especially those with a global focus. Currently, major global LICs such as Magellan Flagship and Platinum Capital are trading at substantial premiums to NTA. These high LIC premiums and recent IPOs (such as PM Capital Opportunities Fund) with more IPOs to come are demonstrating the increased appetite for active listed global funds. However, the concern is that investors paying high premiums are blind to the risks of de-ratings and lower return that often results (especially when one could access unlisted unit trusts that often hold much the same portfolio).

Unlisted managed funds continue to be the core of global market exposure for most portfolios, and are broadening in scope and strategy. Those gaining the most support have tended to be those with a local brand presence or distributor – think Platinum, Walter Scott and Magellan – although opportunities for newer boutique managers are also growing (albeit, that it's a competitive space). In a world where the larger markets and stocks are increasingly expensive, an active approach can make more sense – stock pickers are prepared to go anywhere to find value. Shorting could also be a useful strategy in coming years.

Aggressive investors could also consider investing in direct global stock holdings, although the tendency is for investors to buy only the large brand name companies, many of which may already be expensive and priced to underperform. As a more leveraged play, some investors could even consider exposure to the listed funds management companies who operate global funds. Indeed, a boom in global exposure for retail investors provides a great opportunity for locally-based managers. Unlike institutional investors who are happy to source their global equity managers from anywhere in the world (not normally requiring a local presence), retail investors heavily lean towards managers with a local presence and brand.

Technology and product innovations are increasingly allowing quick and cheap access to global equity exposure. Apart from ASX-listed ETFs and LICs, when it finally gets off the ground, the new ASX mFund service will provide enhanced access to some managed funds. One concern is that all this easier access may mean the risks of investors getting it wrong have also grown. For example, there may be a tendency for investors to overtrade or be tempted into the latest hot global sector only to sell out when it turns sour.

To the extent that current caution is unwarranted and global stock markets continue to perform strongly, the growth in global equities as part of investors' portfolios over coming years could be even more dramatic than many expect.

In any case, this trend is likely to survive even serious market weakness within the next couple of years as global assets may outperform Australian equities through such a period, and the narrowness of the Australian sharemarket will be exposed in a more difficult economic climate. A likely weaker Australian Dollar through any period of global market stress will also help cushion any fall in unhedged global equities versus local equities. Meanwhile, the opportunity set for active global stock pickers (including those with ability to short/hedge) will remain fertile given diverging performance between and within sectors and countries, both developed and emerging.

While there is some risk that investors are increasing their equities exposure at the wrong time (particularly if they are not replacing some of their Australian equities exposure with global equities), overall the move to increase global exposure is a positive trend that will result in more robust portfolios over time. This is particularly the case if managers are well selected, relative valuations across markets are considered, and more diverse strategies to gain exposure are included. Many practitioners are well placed to capitalise on this trend as most have long recommended some proportion (albeit small) of portfolios be invested in global shares – putting them one step ahead many self-directed and SMSF investors who have, at least until recently, held near zero exposure.

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