Markets Summit 2015 Great Debate - intl vs Au equities

Angela Ashton | PortfolioConstruction Forum | 19 February 2015

The Markets Summit Great Debate, a concept introduced at last year's program, is fast becoming the favourite, not-to-be-missed session of a not-to-be-missed program.

> **Background to the Great Debate**
> The session takes the form of a simulated Investment Advisory Board meeting. The Investment Advisory Board consists of investment experts – the Markets Summit 2015 Faculty of speakers – who bring their individual knowledge and expertise. The IAB advises the CIO of a large private client wealth management firm that runs individually managed portfolios for its clients, each with between $500,000 and $10,000,000 in investible assets. Typically, clients are seen on a six-monthly basis. The firm has a two- to three-year investment time horizon and clients expect insights on this basis, although the portfolios are designed to meet longer term outcomes.
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> The IAB is therefore mandated to provide high-conviction guidance to the CIO on the basis of forward-looking macro-economic conditions, and likely two- to three-year moves in markets. Each member must give rationale and justification for the basis of their vote (rather than seeking consensus). The role of CIO is played by each Markets Summit delegate.
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> **Motions at this IAB meeting:**
> Motion 1: overweight international equities, underweight Australian equities
> Motion 2: overweight bond funds, underweight cash.
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> Motion 1 was debated and voted on during the onstage Markets Summit 2015 programme. Motion 2 will be debated and voted on online over the coming weeks.

Motion 1: overweight international equities, underweight Australian equities

As an introduction, Tim Farrelly, Principal of asset allocation house, farrelly's, stepped into the role of CIO, and broadly outlined the case for both sides of this motion – in effect, presenting the competing arguments the CIO has heard on the issue in recent times.

In favour of overweighting international equities, the CIO explained the arguments put to him (using US equities as the proxy for international equities) were that the US economy is growing and is the bright spot in a slowing word. While interest rates are likely to rise, the

Fed will be careful not to derail nascent growth. The US dollar is likely to remain strong, which will not help exporters in a market where exports are a large part of earnings, however valuations are already high, yields are low and earnings growth is likely to slow.

In favour of overweighting Australian equities, the CIO explained the arguments put to him were that, while the Australian economy is weak, Australian equities yields and valuations are comparatively low; the Australian dollar has weakened, which will help exporters; resource prices may have already hit their low point as well; and, monetary policy can be loosened further, as can fiscal policy, if required.

1. The case against

Overall, few on the IAB argued that overweighting Australian equities was a better choice – but there were three who took up the cudgels.

Kate Howitt, Sydney-based Australian equities Portfolio Manager with Fidelity Worldwide Investments, argued that although Australia's economy will suffer from the loss of income from resources as China moved to a consumption-led economy, Australia's education and tourism sectors are likely to benefit. Thomas Poullaouec, MD and Head of Strategy and Research Asia Pacific with State Street Global Advisors, joined the pro Australian equities camp, noting that Australia's low valuations and high yields are supportive of the case for overweighting Australian equities. Of course, the value of franking credits was discussed. Kate pointed out that because Australia's franking regime forces companies to pay out at least 60% of earnings, Australian stocks are usually yield stocks – and, in today's low growth world, yield is very valuable which is broadly supportive of the Australian equity market. Rob Mead, Head of Portfolio Management Australia with PIMCO, noted that the Reserve Bank of Australia's ability to continue to cut interest rates if needed will also help to act as a floor for Australian equity assets.

Arguing against overweighting Australian equities, New-York based Ron Temple, Portfolio Manager with Lazard Asset Management, countered that the Australian economy had not had a recession in 24 years and that when it does, it is likely to be very unpleasant, so the risks in the banking and housing sectors are not insignificant.

Tai Hui, Chief Market Strategist Asia with JP Morgan Asset Management in Hong Kong, chimed in, noting that the Australian equity market has traditionally shown volatility levels akin to emerging market equities (partly because of our geographic location), with returns akin to those of developed markets. On a risk-return basis, therefore, Australian equities are not particularly attractive proposition in his view, with better value available elsewhere. Jeremy Lawson, Chief Economist with Standard Life Investments based in Edinburgh (but actually an Australian native) agreed that the risk associated with Australian equities was higher than in international equity markets. If China underwent a shock, a likely lower Australian dollar would not be enough to cushion our equity market, he argued. He also pointed out that there has not been any significant structural reform in Australia for at least 10 years and no private sector deleveraging, and it is not clear that there will be any soon.

Another Australian native, London-based Bruce Campbell, Investment Chairman of Pyrford International, agreed that China's slowing was not good for Australian equities. John Hock, Founder and CIO of Altrinsic Global Advisors, believed the Australian dollar is a lead indicator of change. Its recent fall heralds further bad times as resources and bank stocks are likely to head lower. And, supporting that argument, Sydney-based Nick Langley, Co-CEO and Co-CIO with RARE Infrastructure, believed that the lack of a good corporate debt market in Australia is hindering corporate growth here.

2. The case for

There were a myriad of views on the IAB in support of overweighting international equities, and why they may outperform Australian equities. However, there was divergence as to where in the world that outperformance may be.

Many on the IAB agreed that the US equity market was expensive. Those in favour of markets other than the US included Sydney-based Principal of Tempo Asset Management, Joe Bracken. He and Tracey McNaughton, Head of Investment Strategy with UBS Global Asset Management in Sydney, believed any equities area other than the US equities would be worth considering - including Asia, Europe and Japan. Washington-DC based Charles Dallara of Partners Group, argued that the US dollar is overvalued and that may become an issue for that equity market. John Hock agreed a de-emphasis of US equities within the international equities allocation is in order.

In favour of US equities, Ron Temple noted that the US is the international market of choice at the moment. Sydney-based Head of Income & Fixed Interest with BT Investment Management, Vimal Gor agreed that the US is more business friendly.

More broadly, Charles Dallara agreed that international equity markets were attractive, and that both public and private assets should be considered, given the medium-term view of the IAB.

Tracey McNaughton argued that central banks globally will be generally supportive of equity markets through easy policy settings. Tai Hui weighed, arguing that the improving corporate governance culture in Asia will lead to stocks in that region paying better dividends.

Scott Weiner, LA-based Managing Principal of bond house, Paydel and Rygel, thought that although Europe and Japan need structural reform that is likely to curtail equity returns in the medium term, if not undertaken, accommodative monetary policy (both conventional and unconventional) could propel those equity markets in the shorter term.

New-York based CIO of Multi-Asset Class Portfolios with Neuberger Berman, Erik Knutzen, and Neeraj Seth, BlackRock's Singapore-based Head of Asian Credit, argued that opportunities exist at the stock level rather than at a country or regional level. Market returns everywhere did not look inspiring, in Erik's view.

Rob Mead agreed that most international markets are fully priced, but preferred Europe on the grounds that the consensus outlook for Europe is so bearish, it is quite likely to be too negative.

3. The potential pitfalls

Ron Temple suggested that the highest probability risk is the US Fed tightening monetary policy too aggressively. If that happens, most of the rest of the world is likely to be affected, including Australia. Neeraj Seth dismissed the probability of the type of error. In his view, even though the US is growing, its nascent recovery is not strong so the Fed will not risk stifling it. Vimal Gor's view was that it's more likely that the US will undertake another round of Quantitative Easing, and agreed wtih Ron Tomple that if interest rates rise in the US, all risky assets – including equities everywhere – will be badly affected. Rob Mead agreed that there is some likelihood that US interest rates may continue to fall.

Of course, during the course of the debate a number of people – Vimal Gor, Rob Mead, Kate Howitt – reminded the CIO that economics does not guide markets directly. Markets often precede economics and geopolitics and technical factors are all important too. Rob Mead noted that equity markets generally performed well prior to QE being undertaken so the US and European markets are probably already fully valued as a result. Tracey MacNaughton was of the view that there was still many years of QE to go and this would be supportive of equity markets, although there will be higher volatility. John Hock disagreed – in his view, long-term QE has unknown effects on investment markets and economies and it is potentially risking deflation, hyperinflation or something awful in between. He believes central banks will try to contain the monetary experiment, adding that Australian companies were also likely to perform poorly in that case.

Charles Dallara warned that we now believe markets can handle all of our economic problems – that markets are omnipotent – and that perhaps this isn't the case.

4. The bottom line

At the end of the debate, when the formal vote was taken, just two of the 16 member Investment Advisory Board voted against the motion to underweight Australian equities. The remainder of the IAB voted in favour of overweighting international equities, albeit that there was disagreement as to which markets that overweight should favour.

The CIO (the delegates) agreed, with 61% voting that international equities should be overweighted and Australian equities underweighted in portfolios, on a two- to three-year view.