The ASX200 is too concentrated - reduce weights!

Tim Farrelly | farrelly's | 19 September 2017

This one has being enjoying something of a resurgence from a range of commentators in recent times… The story goes that Australian Equities are too concentrated in a handful of sectors and stocks and, as a result, Australian investors should reduce weights to reduce risk.

There is more logic in this contention than most of the issues we highlight in Crockpot. There really is too much concentration in the ASX 200 – and the All Ordinaries for that matter. Financials make up 37% of the ASX 200 index. Resources and REITs make up a further 21% and 8% respectively. The top 10 stocks in the index make up fully 47% of the index.

One way to avoid this concentration risk is, indeed, to reduce weights. For Australian investors, this also means ignoring imputation credits and, from time to time, superior valuations. It is a trade-off – but only if we accept the index as immutable. We consider the high weights to resources and banks as an accident of history and geography. There is no good reason why Australian investors' portfolios should slavishly follow the index. In fact, as the detractors rightly point out, there are good reasons not to be slaves to the index. Last year, we suggested resources weights should make up 10% or less of Australian Equity portfolios. In this quarter's Editorial, we suggest that investors set a limit on their exposure to Australian banks based on their own tolerance for risk. These two measures alone can substantially reduce this concentration risk.

Another sensible approach is to make greater use of Australian mid-cap and small-cap managers. Not only does this greatly reduce concentration risk, it does so in a way that has historically produced substantial alpha. The average small to mid cap manager has out-performed the indices by 2% and 3.5% per annum respectively over the past five and 10 years, according to the December 2016 SPIVA report.

Direct equity investors have no problems implementing a more sensible mix than the index. Even those preferring passive approaches can find passive options that reduce the concentration risk without turning their back on the valuation and taxation advantages.

The importance of imputation to Australian investors can be seen in the different asset allocations to Australian Equities recommended by farrelly's for Australian versus New Zealand investors. The target recommendations for a Target 3 portfolio are 24% for Australians and 16% for Kiwis. (And, the Kiwi investors have some NZ stocks in that

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allocation which carry NZ imputation credits.) Imputation really makes a major difference to returns and, therefore, the allocation investors should give to home country stocks.

Sensible weighting of Australian Equity portfolios can both reduce concentration risk while gaining the benefits of imputation credits and the current favourable valuations.

Simply observing the concentration inherent in the index and reducing Australian Equity weights is throwing the proverbial baby out with the bathwater.

It's nuts and you can clearly see it's nuts.

Tim Farrelly is principal of specialist asset allocation research house, farelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.