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Top Quote:
"Technology is all pervasive, and investors want not only to own the latest iPhone, but to invest in its producers as well."

Worth a read because:
Articles on portfolio diversification are a dime a dozen but this one is a gem. The author presented his case very well, drawing a line between fake diversification and real diversification. A must-read for any financial adviser looking to work with an international equities specialist.

** Earn CPD Points by answering the short quiz at the end of this article.*

RETHINKING INTERNATIONAL SHARE PORTFOLIOS

Sam Stobart

The prevailing advice for Australian investors looking for investment opportunities in recent years has been to look offshore. Home country bias is particularly prevalent in Australia; self-managed superannuation funds (SMSFs), according to the ATO, hold over a third of their assets in Australian equities and less than 1% in direct international shares. Given the dominance of domestic banks and resources, this creates enormous sector concentration risk which the advice to diversify internationally should surely counteract; and yet the traditional approach may create as many problems as it solves. The question arises then: not should Australian investors invest offshore, but how?

The case for global equities - Diversification

One of the fundamental principles of sound portfolio construction is diversification; used primarily to spread the multiple risks in volatile assets. Yet despite the rise of inexpensive diversified products and increased financial education, domestic portfolio construction, particularly at the retail level, remains highly concentrated.

According to Willis Towers Watson, of the world's seven largest pension markets, only the US has a higher home country bias than Australia. (Given that the two US exchanges comprise more than 60% of the worlds' developed markets, this is more understandable than for Australia, which comprises approximately 3% of MSCI).

According to the ATO's quarterly superannuation statistics, the average SMSF portfolio (with over 570,000 funds and a million trustees holding an average fund balance of $1m, this is a good proxy for the 'average' Mum and Dad investor) holds:

- A cash balance of approximately 27%.
- Direct Australian equities of 30% (and closer to 35% when taking into account allocations to other listed securities including trusts)
- Direct property, primarily commercial, a further 18%.
- Managed Funds (including domestic, global, fixed income and diversified <5%

Listed international securities comprise 0.3% of total assets and global managed funds are a third of this figure.

Digging a little deeper, it should come as no surprise that Australian banks and resources dominate domestic portfolios with a particular concentration in the top 20 securities. According to Commsec, which holds over 50% of retail investor trading accounts, ANZ, CBA, NAB and Westpac alone comprised 32% of their SMSF client holdings and represent a quarter of all SMSF trading turnover. For non SMSF clients, these four securities alone accounted for 18% of turnover. At nabtrade, NAB's online trading platform, the top 10 stocks on the ASX comprise more than 60% of client accounts.

Portfolios managed by investment professionals (such as large super funds) and by financial planners tend to have higher allocations to global equities, however the bias to domestic shares remains strong. For non-superannuation investors (generally self-directed but often also advised), domestic residential property still remains the largest asset class.

The simple case for diversification, combined with these statistics, makes the decision to invest internationally clear; global equities are woefully under-represented in the average investor's portfolio and exposure can be increased substantially without introducing any material new risk.

In order to achieve these outcomes, the current approach is generally to invest via a managed fund (either actively managed, or a passive strategy), or an exchange traded fund (ETF). While these structures may be comprised of different markets and sectors, have different fee models and be accessed via different channels, they both offer considerable inherent diversification.

Growth ptotential

Diversification for its own sake has little benefit to the investor if there are obvious risks to be avoided or benefits to be gained by some other method. The Global Financial Crisis made apparent the redundancy of diversification if assets are highly correlated across different markets, or there is significant inherent risk in a particular sector (for example, the global banking sector in 2007).

Investing offshore must therefore offer compelling long term uncorrelated returns relative to other asset classes in order to justify the risk and cost of gaining this exposure.

The case for global equities, then, is that great global companies offer investment opportunities not currently available in Australia; that they offer a hedge against sector concentration risk and diversify the standard Australian investor's portfolio. The rise and rise of US tech giants such as Apple, Facebook and Alphabet has illustrated the opportunity of investing offshore for many; while the ASX 200 has generated a meagre 6% price return over the last 3 years, the NASDAQ has delivered over 39% (to 30 June 2017)

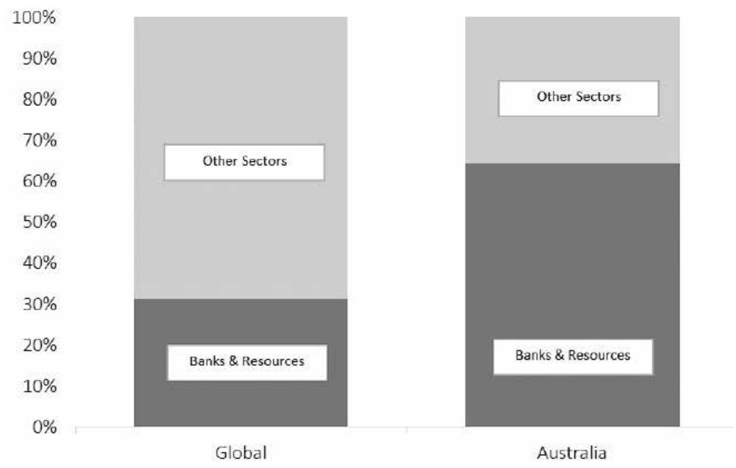
The proliferation of consumer technology has also helped to demonstrate the global nature of investing; a single device, designed in the USA and made in China, using raw materials and components from all over the globe, sold in almost every country, can give an individual access to an almost infinite universe of ideas, music, video, consumer products and more. Restricting one's portfolio choices to singularly-focussed domestic operations in this environment precludes the opportunity to benefit from the extraordinary growth of these opportunities.

Many investors therefore, have, or are considering reducing their allocations to cash and diversifying their portfolios into global equities. The most recent evidence from the ASX illustrates this; over $AUD1bn was traded in Australian-based global ETFs in July 2017 on the ASX alone (source: ASX 14 August 2017).

Diversifying globally – from a uniquely Australian perspective

It is worth pausing to challenge the notion that 'diversification is achieved simply by investing globally' and

Figure 1: Industry Exposure: Australia vs Global



Source: Bloomberg 31 December 2016

consider whether in fact we are doing it all wrong? Have investors, both professional and self-directed, properly addressed Australian sector concentration risks when investing globally? At Arnhem, we do not believe so.

Large bank and resource sector weightings in Australia are well known and now represent more than 60% of ASX market capitalisation (31 Dec 2016). Investors are well aware that any variable affecting these two sectors can materially move the market and therefore their equity portfolios. The proposed introduction of the bank levy in the 2017 Federal budget is a recent example.

Banks and resources represent circa 30% of global market capitalisation as illustrated by figure 1, using the MSCI World ex Australia index. Many investors fail to consider however, that these same variables can significantly impact their global portfolios also.

Deeper analysis on the performance characteristics of these two sectors, both domestically and globally, clearly demonstrates the extent to which traditional global investing further compounds the challenge of sector concentration risk for investors.

From June 2009 to June 2016, (figure 2), Australian banks; CBA, WBC, NAB, ANZ when compared to global banks (MSCI World ex Aus Banks) reveal two key points:

- over the past 7 year period Australian banks have materially outperformed their global peers, and
- the monthly rolling correlation between these two baskets of equities is as high as 64%.

Over the same period, when we compare BHP, RIO and S32 to their global peers (in this case MSCI World ex Aus Metals and Mining companies), the results are stark:

- over the past 7 year period domestic resource companies have materially outperformed their global peers, and
- the monthly rolling correlation between these two baskets of equities is alarmingly high at 83%

This correlation research should come as no surprise. At the beginning of the GFC in 2008 for example, the

The quote

The question arises then: not should Australian investors invest offshore, but how?

The quote

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Rio Tinto share price in May was $115 AUD and by December 2008 it was languishing at $29. Its global competitor, Brazilian based Vale, over this same time period fell from a high of $58 BRL to $21 BRL.

By following the traditional path and adding an index or benchmark aware global strategy to an existing domestic equity portfolio and funding this from cash –not from selling equities, investors are actually increasing their exposure to highly correlated assets, thereby increasing the risk in their portfolios. This not only fails to deliver the benefits of diversification, but reduces the funds available for investment in true growth opportunities to which the investor has little or no exposure to on the Australian stock exchange.

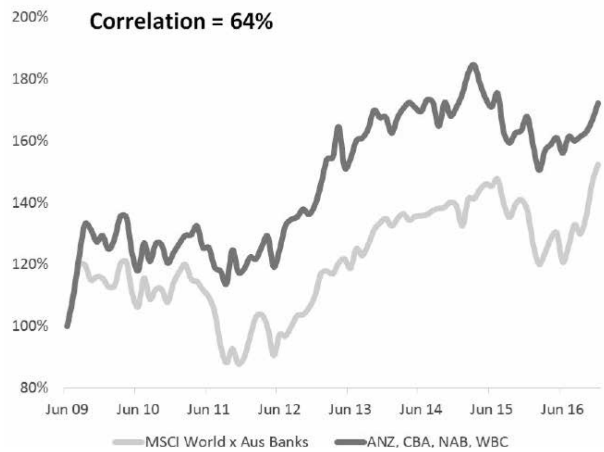
Proponents for the existing approach will argue that the significant presence of banks and resource companies in global benchmarks is a good reminder that Australia does not have a franchise on high quality companies in these sectors, and that perhaps the 'best in class' bank or miner actually resides in London or Geneva or New York.

While this may be true, it requires considerable research and a stock picker's analysis to determine; it also ignores the not insignificant benefits of franking and the undeniably higher dividend yields in Australia.

Additionally, it also ignores the reality that very few Australian investors are likely to divest their long-held and much loved CBA and BHP shares for a recently disgraced Wells Fargo (until recently, a market darling touted to be 'best in class', and a good reminder that conduct risk is a global challenge).

Despite the logic of this theory, neither professional nor retail investors employ this methodology, preferring to construct their domestic and global portfolios as discrete and independent strategies.

Figure 2: Australian Banks Correlation



Source: Bloomberg 31 December 2016

The solution to this problem

How then to construct a global portfolio that offers the true benefits of diversification? At Arnhem, we believe diversification is about offering the investor genuine investment opportunities that cannot be accessed on the Australian market. This may sound trite, but it is clearly not a solution currently offered through the traditional portfolio construction methods. Growth industries such as semiconductors, renewables, internet security, luxury branded goods and biotechnology offer a world of new and exciting opportunities, and are increasingly the sorts of investment opportunities investors are demanding.

While financial planners are aware of the trend toward newer sector exposures, it is direct investors who are driving the change. Direct investors are increasingly aware of investment opportunities that are not available on the ASX. Technology is all pervasive, and investors want not only to own the latest iPhone, but to invest in its producers as well. One cannot fear the impact of Amazon's impending arrival on listed local retailers without considering that Amazon itself might represent an interesting investment proposition. As the world gets smaller and technology allows us to learn and share, the lure of high-growth, ground-breaking global companies become stronger and stronger.

So investors want access to these current and future global leaders, but they do not need to expose themselves further to the sectors which they hold so dear in Australia. In order to gain access to the former, and not gain more of the latter, they will need to eschew portfolios (both active and passive) that are built around the traditional benchmarks, and seek out specific sectors in order to balance their exposure.

At Arnhem, we believe in screening out entire sectors which are heavily overweight on the ASX (currently financials, resources and AREITs), and then undertaking a traditional bottom up stock analysis, looking for standout global companies in high growth sectors not available in Australia. We invest in these companies via a separately managed account model; a lower cost solution with complete transparency for the end investor. It has the added benefit of avoiding unanticipated tax consequences for the end investor, one of the less attractive features of a traditional unit trust.

In today's world, investors are seeking exciting investment opportunities, and look to financial planners to offer value over and above what they believe they can generate for themselves. The traditional portfolio construction method used by individuals and offered by financial planners carries much inherent and unidentified risk in the form of sector concentration, and prevents investors from deploying their funds in pursuit of other, more exciting opportunities. **FS**

Figure 3: Australian Resources Correlation

Source: Bloomberg 31 December 2016

This paper was written by Sam Stobart, head of distribution for Arnhem Investment Management.

Arnhem Investment Management is a boutique fund manager focused on delivering value through in-depth industry structure analysis and company research.

The quote

Despite the logic of this theory, neither professional nor retail investors employ this methodology, preferring to construct their domestic and global portfolios as discrete and independent strategies.

CPD Questions

1. **Listed international securities made up what proportion of the average SMSF portfolio, according to ATO superannuation statistics?**
   a) 27% b) 18% c) 5% d) 0.3%

2. **At end-2016, banks and resource companies represented approximately what percentage of the global market capitalisation in the MSCI World ex Australia index?**
   a) 64% b) 60% c) 30% d) 27%

3. **Which of the following statements is in line with the author's view regarding sector concentration and correlation when diversifying in global markets?**
   a) Investments in global equity that have high correlation to existing domestic equity should be funded from cash
   b) Investments in global equity should be funded from proceeds of correlated domestic equities
   c) High correlation leads to reduced risk
   d) Any investment in global equity is sufficient diversification

4. **Which of the following is an industry that the author believes will offer the true benefits of diversification when investing globally?**
   a) Semiconductors b) Biotechnology
   c) Renewables d) All of the above

5. **Of the Australian companies discussed, banks demonstrated a higher correlation to their global counterparts than resource companies.**
   a) True b) False

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