

thebigpicture

guideposts for the private investor

Week Commencing 3 May 2004

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to *thebigpicture* premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

◆◆◆◆◆◆◆◆◆◆

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

INTERNATIONAL INVESTMENT: HOW MUCH?

Fund managers encourage people to invest in international equities. The argument that they are going to be better off if they go offshore is an enticing one but is not as clear-cut as the marketers suggest and some important questions need to be asked to clarify why the decision is being taken.

One prominent Australian fund manager with an international equities product encourages investors to buy offshore equities with the following argument in its marketing material:

- “Historically, international shares have produced stronger performance than Australian shares over the long term.”
- “By combining a portfolio of Australian shares with a cross section of international shares, you can lower your investment risk and potentially improve performance.”
- “A mix of 60% international and 40% Australian shares is considered optimal.”

Portfolio theory does suggest that splitting investment funds between asset classes (in this case, Australian equities and international equities) can lower risk while maintaining the same level of return. Alternatively, if returns are lower from diversifying into a n-other asset class, risks might also be lower by more than enough to compensate.

The potential for gain will change with conditions. In particular, the lower the correlation between returns from the two asset classes the greater the chance of gains from diversification. In the extreme, if the price of one asset rises at precisely the same time as another falls and by the same amount, risk can be entirely eliminated by holding a 50/50 combination of the two assets.

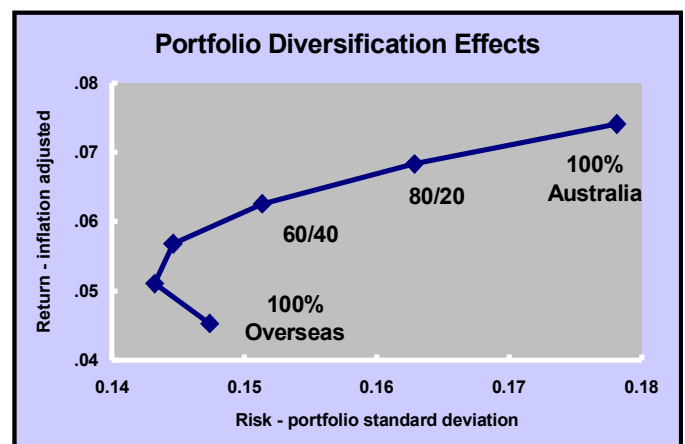
In the other extreme, when the price of one asset moves in identical fashion with the price of the other asset, there are no gains from diversification.

From a practical standpoint, the size of the diversification benefit suggested by portfolio theory will depend on returns being less than perfectly correlated and how close they are to being perfectly uncorrelated with one another. A conclusion about the value of diversification is entirely dependent on making a judgement on this point.

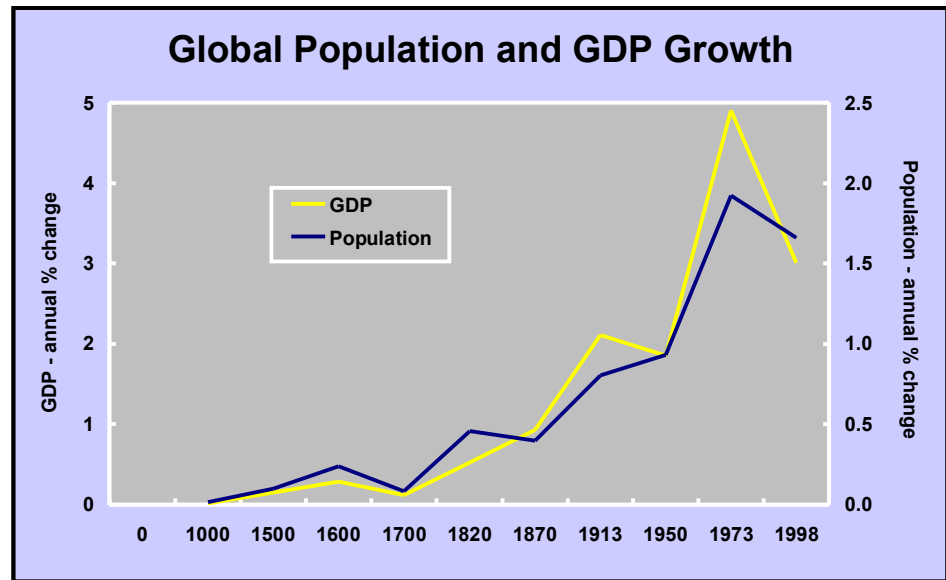
For this, fund managers typically turn to history, as did the fund manager referred to above. Its quoted “history” to justify its contention that there should be a 60/40 split in investment funds between international and Australian equities was from between 1980 and 2001 for the Australian and international share markets.

These data supported the notion that there would have been benefits from investing

(Continued on page 2)



THE WEEKLY CHART SPOT



Source: The World Economy: a Millennial Perspective

The chart represents a two thousand year view of population growth and economic activity from data compiled by economic historian Angus Maddison, author of 'The World Economy: a Millennial Perspective', published by the OECD.

The main message from the chart is how population has driven the growth in the global economy, for as long as we have information, culminating in the second half of the twentieth century when the population growth rate reached its peak.

Looking ahead, it is likely that global population growth will continue to decelerate until it reaches about 0.5% a year toward the middle of this century.

1. Dimson, Elroy, Paul Marsh, and Mike Staunton. 2002. *Triumph of the Optimists: 101 Years of Global Investment Returns*. Princeton, NJ: Princeton University Press.

———. 2003. "Global Evidence on the Equity Risk Premium." *Journal of Applied Corporate Finance*, vol. 15, no. 4 (Fall):27-38.

INTERNATIONAL INVESTMENT: HOW MUCH? CONT'D

(Continued from page 1)

internationally over that period. However, that period also had some peculiar characteristics. And, of course, any period is likely to have its own set of characteristics to make it unique. Which data might best replicate the future and be the basis for investment decision-making no-one knows for sure.

Usually, the wisest course is to use the maximum amount of data available so as to cover the widest possible range of circumstances to raise the chance that prospective conditions will be included in the data sample. Using anything less is likely to prejudice the conclusions (most frequently in a way which benefits the person analyzing the data).

So, a critical question for the private investor is whether the choice of time period actually affects judgments about whether to invest offshore and, if yes, by how much.

The short answer is that the selected time period does make a difference and there is now fresh information available to support this claim.

In the past year, three UK-based academics (DMS), sponsored by a major European-based fund manager, have published work¹ on international returns as part of a study to measure the risk premium which should be attributed to equity markets.

The data compiled for their study covers

16 markets over 102 years, including the Australian market. Their database provides the most comprehensive information on international equity returns. Everything else which is available is now only a subset of this more comprehensive data set.

DMS have argued cogently that using this broader spread of data provides a more realistic view because it covers the widest possible range of economic, political and business outcomes which might affect equity returns.

The chart on page 3 taken from their work shows the average inflation adjusted returns for 20 year periods over 100 years. The length of the bars shows the dispersion around the mean of the returns for the 16 markets studied.

Australia's 7.4% rate of return was relatively high. Risk, measured as the dispersion of returns about the mean, was also relatively low in the Australian market. In this sense, it had similar characteristics to the US market. However, other markets, such as Japan's, had a lower rate of return and a significantly wider dispersion around the mean.

Among the points DMS make is that conclusions about equity market performance have been biased by relatively short-run views most often from a US perspective. Broader geographic and chronological perspectives do not bear out some of the conclusions about rates of return. In particu-

(Continued on page 3)

INTERNATIONAL INVESTMENT: HOW MUCH? CONT'D

(Continued from page 2)

lar, they conclude that the equity risk premium – the return over the risk free rate of return – is closer to 4% than the 6% which had been assumed previously based on the more limited and US-dominated experience. This has important valuation and target return implications.

However, in the context of Australians contemplating investment in international markets, one conclusion stands out. Contrary to our anonymous fund manager quoted above, historically, international shares *have not* produced stronger performance over the long term.

To help judge the impact of the DMS data on the decision of an Australian investor to diversify, *thebigpicture* has simulated a portfolio of international equities based on the average returns across all the non-Australian markets covered by the DMS database. Implicitly, we have held an equally weighted portfolio of equities from all these markets over 102 years. The average return would have been 4.5% and the risk (measured by the standard deviation) would have been 14.7%.

The chart on page 1 illustrates the impact of diversification using this historical information. Diversification does reduce investment risk but also reduces the investment return because markets outside Australia generally offered a lower return over this time. An investor seeking to minimize risk would have a portfolio with only 20% Australian and 80% international equities. However, to achieve this risk reduction, the investor would have conceded 2.3 percentage points from the rate of return from holding only Australian shares.

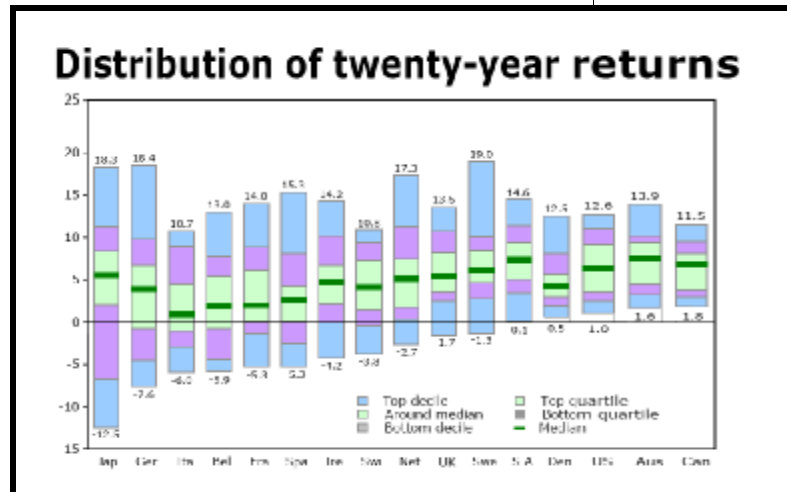
More typically, if an investor wanted to maximize his rate of return for any given level of risk, he would have had a relatively small exposure to international shares – no more than 20%.

This is significantly lower than the 60/40 allocation recommended by the fund manager referred to at the beginning of this article.

Of course, this analysis is dependent entirely on historical information. To that extent, it is backward looking and possibly a poor reflection of conditions to come. That might be a shortcoming. However, a

greater shortcoming is to use only a subset of data to support such critical investment decisions without making a case that conditions in the selected period are likely to be typical of the future.

There are other more meretricious reasons for people to be attracted to international



investment (see boxed article on page 4) but underpinning the allocation decision is a set of performance assumptions.

In the interests of transparency, advisers should acknowledge explicitly the assumptions underlying their allocation decisions because they will reflect judgements about prospective conditions. Also, if the latter change, the adviser needs to change the recommended course of action.

None of this is intended to drive international fund managers out of business. They might be needed more than ever. A scenario which supports a high international allocation is by no means outrageous.

One scenario might be for the risk of Australian and international investments to converge to, say, 15%. However, international expected returns might be higher than in Australia because of relatively strong offshore economic activity. Assume that international returns are 7% compared to 5% from the Australian market. Assume, too, that there is a 65% correlation between returns from Australia and returns from international markets, offering the potential for some diversification benefits.

The chart on page 4 (similar to our historical diversification chart on page 1) shows the benefits from diversification in this instance. Risk can be reduced but returns

*“Contrary to our anonymous fund manager quoted above, historically, international shares **have not** produced stronger performance over the long term.”*

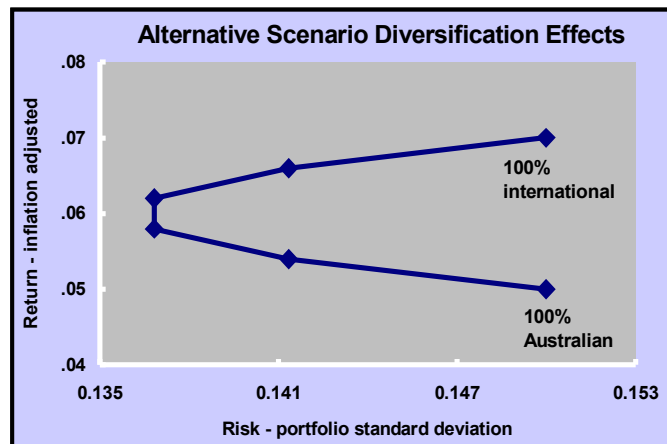
(Continued on page 4)

INTERNATIONAL INVESTMENT: HOW MUCH? CONT'D

(Continued from page 3)

are lowered as the quantity of funds allocated to international equities comes down. In this scenario, the risk adjusted expected return is highest when the international share allocation is highest. In other words, an investor could justify holding only international equities and no Australian stocks.

The actual allocation to international shares will depend on the underlying assumptions being used. Understandably, these are likely to differ among advisers according to their varying views of the world. For that reason, they should be made clear so that we can all consider when deciding where to place funds whether the big picture judge-



ments of financial advisers (even when not taken explicitly) are adding to the wealth of their clients.

The Attractions of Investing Offshore

Whether or not risk adjusted returns can be raised by opting for more international equity exposure, the marketing material of international fund managers usually cites several additional attractions from moving overseas.

- International investment gives access to a broader range of industry sectors. The relatively narrow Australian market lacks larger industrial companies operating in markets such as pharmaceuticals and technology, for example, where Australian companies tend to be at an earlier and more risky stage in their development.
- Globally recognized brand names such as Coca Cola, McDonalds and Nestles, a category that is typically unavailable in Australia, is available to international investors. While it is sometimes interesting to follow these high profile names, however, their durability has sometimes reduced their growth potential. Occasionally having to reinvent themselves to boost returns creates investment risk.
- Access to emerging markets where the most outstanding global growth prospects are likely to be found might add significantly to returns. However, these markets usually come with considerable extra risk. Investors opting for this exposure need to be risk-friendly with a longer than average investment horizon.
- Providing a hedge against a weakening Australian dollar can be a benefit of offshore investment but there is some evidence that the Australian currency could be more stable, looking ahead, than through the 1980s, for example. If so, it would make this argument redundant.
- Potentially different macroeconomic conditions outside Australia are one aspect of the diversification argument. However, with population in Europe and Japan, for example, set to contract, these markets are less likely to provide the investment attractiveness they did during the 1980s. Since the Australian economy tends to be highly correlated with US economic cycles, there is little diversification benefit, from a macroeconomic perspective, in gaining more exposure to US economic conditions.
- Greater choice might be the most compelling reason for going offshore. Even within sectors represented in the Australian market, there is usually greater variety on offer outside Australia simply because of the size of the capital pool outside Australia.

“In the interests of transparency, advisers should acknowledge explicitly the assumptions underlying their allocation decisions because they will reflect judgements about prospective conditions.”