

THE CASE FOR INTERNATIONAL INVESTING

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The Australian sharemarket makes up approximately 2% of the world's market capitalisation, yet accounts for over 60% of the overall equity allocation for the “typical” Australian balanced strategy. To put this bias into perspective, the median Australian institutional balanced portfolio had the same allocation to the four largest shares in Australia as to the entire US sharemarket as at 31 December 2007.

This home bias within equity portfolios is by no means unique to Australia, with most global investors having a significant bias towards their domestic sharemarkets; far beyond what might be optimal or rational. The magnitude of the Australian bias is however much greater than many other countries, since our sharemarket represents such a small proportion of global market capitalisation.

With this in mind, there are many reasons why Australian investors should further explore the world of investment opportunities available outside Australia. This paper discusses some of them.

BASIC PORTFOLIO THEORY

Most investments are added to a portfolio in the expectation that they will enhance returns and/or reduce portfolio volatility. Broadening the investment universe by including an allocation to international share markets can potentially meet both these criteria. There is the potential for enhanced returns from overseas markets and the diversification benefits of exposure to different geographic, economic, industrial, currency and political environments, which may reduce the portfolio's overall exposure to risk.

A “TYPICAL” AUSTRALIAN PORTFOLIO

In January 1998, the median Australian balanced fund¹ had a Strategic Asset Allocation (SAA) of 45% to Australian equities and 18% to international equities. Whilst these allocations had moved to 43% and 27% respectively by December 2007, there still exists a very significant “home bias” within the median Australian institutional portfolio. The Australian sharemarket makes up around just 2% of the world's market capitalisation, yet accounts for over 60% of the overall equity allocation for the “typical” Australian balanced strategy.

To put this bias into perspective, as at 31 December 2007² the median balanced portfolio had the same allocation to the four largest shares in Australia as to the entire US sharemarket.

Most Australian investors gain exposure to international equities via a fund benchmarked only to developed international markets, with little or zero exposure to developing (or “emerging”) equity markets, many of which have had very strong recent economic growth, accompanied by stellar equity market returns over recent years.

Therefore, not only does the median balanced fund have a significant home equity bias, but within its international portfolio there is generally also a bias towards developed markets, at the expense of emerging markets.

HOME EQUITY BIAS – IS IT OPTIMAL / RATIONAL?

This home bias within equity portfolios is by no means unique to Australia, with investors across the world favouring domestic shares to overseas markets without exception. The effect of the bias is however magnified within Australia, since our sharemarket represents such a small proportion of global market capitalisation.

Modern portfolio theory would suggest that investing 60% of the overall equity portfolio in a market which represents just 2% of the overall investable universe (assuming access to all global markets is available) would not be an optimal investment solution.

There are several factors however, which lend support to maintaining some degree of home bias for Australian investors, despite portfolio theory suggesting otherwise:

- Local investors may have more familiarity with domestic companies and hence access to better information and the ability to pick “winning” shares.
- The cost of investing domestically may be lower than the cost of investing offshore.
- The degree of company control may be greater as a domestic shareholder.
- Investing in local equities may have taxation benefits – e.g. franking of dividends.
- If most liabilities (i.e. expenditures) are in Australia, investing locally will allow assets to grow in line with liabilities, effectively hedging consumption.

1 Source: Mercer Asset Allocation survey, December 2007 (Aust equity allocation includes LPTs)

2 This assumes an Australian equity portfolio benchmarked to the S&P/ASX 300 Accumulation Index and international exposure to the MSCI World ex Australia Index^(SM) (unhedged in Australian dollars, net dividends reinvested)

There are also reasons why this level of home bias may be sub-optimal within a global framework:

- Many goods are not Australian dollar originated (Colgate, Shell, Toyota, Philips, Sony etc) and Australian demand for imported goods has risen at 9% p.a. over the last decade.
- The cost of investing in offshore equities is becoming similar to the cost of investing in domestic equities.
- The expected returns of domestic equities cannot be greater than the expected returns for foreign securities for all countries.

The New Zealand Superannuation Fund recognises the inefficiency of this home bias and accordingly allocates 84% of their equity allocation in foreign markets and just 16% to domestic (NZ) equities. This approach however is quite unique; with most global investors having a significant bias towards their domestic sharemarkets; far beyond what might be optimal or rational.

AUSTRALIA IS NOT A COMPLETE INVESTMENT UNIVERSE

Australia is the 15th ranked equity market in the world³ by size (in terms of market value of publicly traded shares), representing only around 2% of global equity markets by market capitalisation. The remaining 98% of listed investment opportunities therefore exist in international sharemarkets. With such a massive proportion of global markets based outside Australia, strong investment opportunities will undoubtedly exist in other international equity markets, which cannot be ignored by Australian investors.

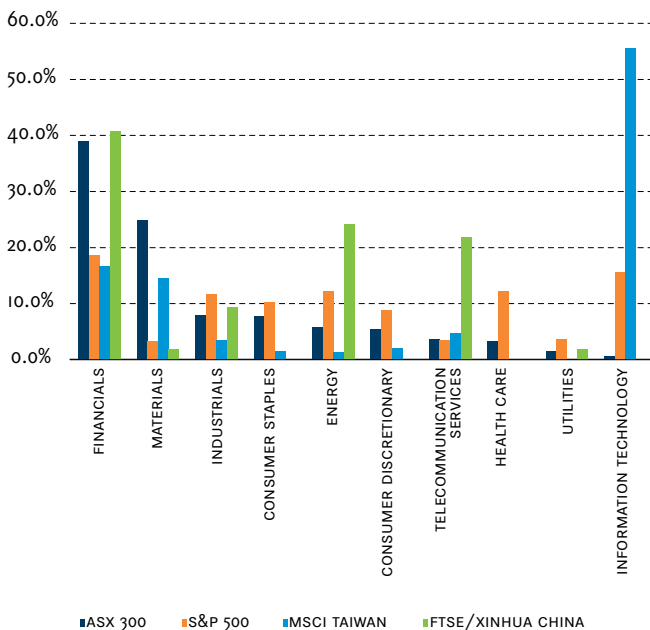
Whilst these international markets are still concentrated across a few large developed regions (US, UK, Japan and Europe), the liquidity and significance of the less developed, or “emerging”, markets has increased dramatically over recent years. Brazil, Russia, India and China (commonly referred to as “BRIC”) now account for almost 20% of global publicly traded shares. Although a large proportion of the shares issued in these countries are still not directly investable for foreign investors, they are becoming increasingly more accessible over time and thus the significance of the emerging markets is likely to increase in the foreseeable future.

As global markets and economies have become increasingly integrated, cross border trade has increased and countries have become more specialised in certain industries and sectors. As such, industrial mixes now differ greatly across different countries, with sector and industry exposures now becoming as important as specific country exposures to international equity portfolios. Figure 1 illustrates the very different sector allocations of three international iShares ETFs versus the S&P/ASX 300 Index. While the chart speaks for itself, let us note a few specifics:

- Australia (S&P/ASX 300 Index) is heavily tilted towards the Financials (39%) and Materials (25%) sectors
- China (FTSE/Xinhua China 25 Index) has very high exposure to Financials (41%), Telecoms (22%) and Energy (24%)
- Taiwan (MSCI Taiwan Index) is heavily skewed towards the IT (56%) sector
- The US (S&P 500 Index) has much higher exposure to Healthcare (12%) than other markets

This confirms the intuition that the Australian sharemarket does not capture the world's industrial mix. In fact, even if Australia did have similar sector weights as offshore economies, the specific companies will differ and thus superior companies will exist offshore in certain sectors. In other words, Australian sector portfolios will not be as well diversified as global sector portfolios.

Figure 1 – Sector exposures of international equity markets (as at 31 Jan 2008)



OPPORTUNITIES FOR STRONG ECONOMIC GROWTH AND PRODUCTIVITY OFFSHORE

As at December 2007, Australia accounted for just 1.2% of world GDP⁴, with the USA and Europe each making up over 20% of global economic output. Outside the developed economies, Brazil, Russia, India and China combined represent 33% of total global economic output.

Not only do the emerging economies now make up a significant portion of global GDP, but they have also been growing much faster recently on average than the developed economies. For example, GDP in Europe and the USA grew by 3.0% and 2.2% respectively during 2007, compared to 11.4% and 8.5% for China and India. Australian GDP grew by 4.2% during the same period.

Along with the recent rapid growth of many of the “emerging” economies, their equity markets are also rapidly becoming more sizable and have experienced accelerated growth over recent years accompanied by improved market liquidity, breadth and accessibility. Not surprisingly, these emerging markets have therefore been subject to much discussion regarding their potential to deliver strong future investment returns. While the four largest countries (Brazil, Russia, India and China) have attracted much investor attention recently, there are also opportunities in many other less prominent emerging markets, such as Egypt, Mexico, Poland, South Africa, South Korea and Turkey.

As the economic development of the emerging countries continues, their sharemarkets will become increasingly attractive as part of a diversified international equity portfolio.

REGIONAL RETURNS & CORRELATIONS

Over recent years, the Australian sharemarket has enjoyed a prolonged period of stellar returns, whilst developed international equity markets have languished in comparison. This performance disparity has been enhanced by a rallying Australian dollar since 2001, which has detracted from Australian dollar returns of unhedged international strategies.

As seen in the following two graphs, whilst the S&P/ASX 300 Index has strongly outperformed the MSCI World ex Australia Index since January 2001 (Figure 2a), the story was very different for the preceding seven years, with international equities strongly outperforming the domestic market (Figure 2b). It should also be noted that these graphs show returns for developed markets only, ignoring the recent strong performance of emerging markets. Emerging markets have performed very much in line with the strong domestic market since 2001, despite the rallying Australian dollar.

Figure 2a – Performance of Australian and international sharemarkets from Jan 2001 to Jan 2008

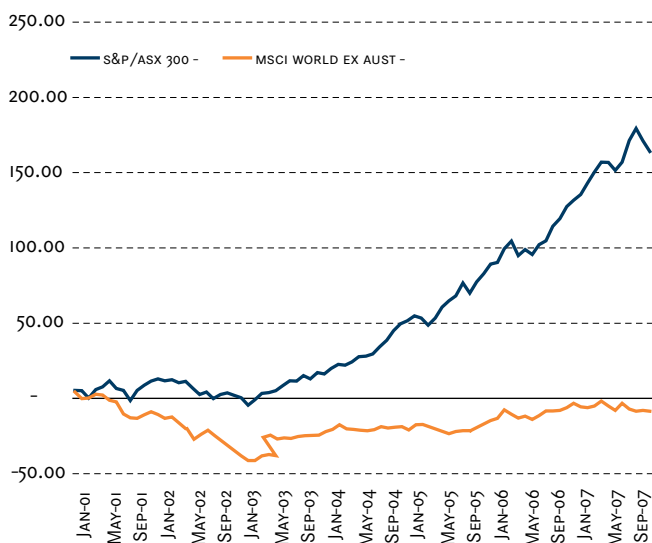
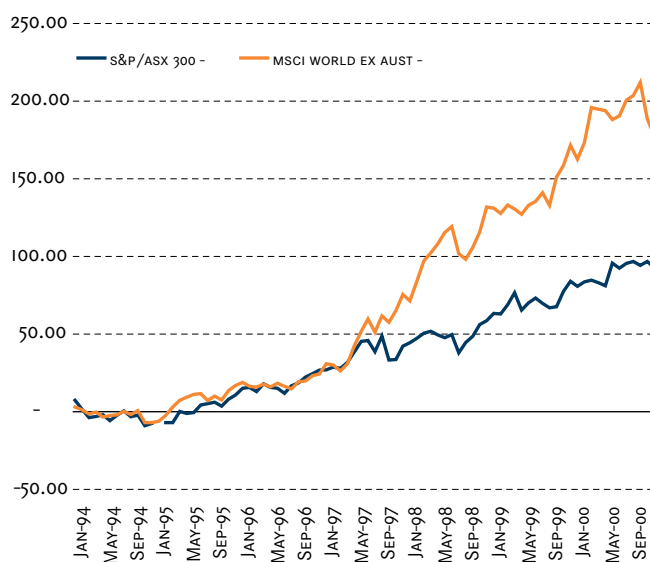


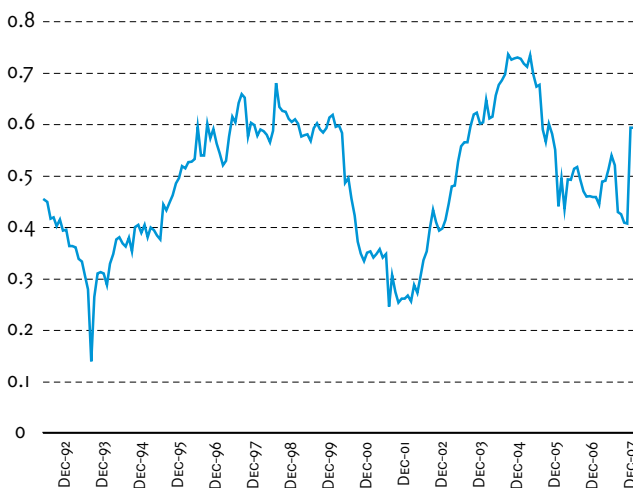
Figure 2b – Performance of Australian & international sharemarkets from Jan 1994 to Jan 2001



This recent performance differential between Australian and international developed markets has likely been a short-term effect, rather than a long-run trend and should not necessarily be expected to continue for the mid to long-term future. Investors should be very careful not to base their long-run forward looking return expectations on what has happened in the short term past. The period 1994–2000, shown in Figure 2b, depicts a very different story to the past six years.

While there are also fears that the correlation of the Australian sharemarket with developed international markets has increased slightly over recent years, investors should not assume higher correlations should persist. Figure 3 shows the rolling 36 month correlation of the S&P/ASX 300 Index with the MSCI World ex Australia Equity Index. Note that as recently as 2001, when the world was not all that different from now, the correlation was around 0.25 – less than half the current level.

Figure 3 – rolling 36 month correlation of the S&P/ASX 300 Index with the MSCI World ex Australia Index



As discussed earlier, even as international markets become more integrated, higher correlations across markets would not necessarily be expected, as different countries will specialise across industries, thus giving markets very different sector profiles from one another and hence low correlation of returns. As country specialisation continues, the diversification benefits gained from market completion by investing across a broad range of geographic locations will become increasingly important to international investors.

CURRENCY EFFECTS

As mentioned earlier, the strong Australian dollar appreciation since 2001 had a significant negative impact on the return of unhedged international investments for Australian investors. Whether this rallying will continue, or whether the Australian dollar is now becoming overvalued are the questions being asked by many international investors.

The recent rallying of the Australian dollar cannot necessarily be expected to continue for the longer term future. In fact, if the Australian dollar were to decline from its current strong position relative to other foreign currencies, this would boost the returns to unhedged international assets.

It is possible to gain exposure to international markets without the currency exposure, through a currency hedged international investment. Whilst currency hedging is a broad and complex topic (and the cost to implement may diminish overall returns), in summary, all investors holding international assets within their portfolio will be faced with the decision of whether or not to hedge the resulting foreign currency exposure resulting from holding international securities.

Optimal hedge ratios will be lower when:

- Total allocation to international assets within the overall portfolio is lower.
- Time horizon of the investment strategy is longer.
- The cost associated with implementing currency hedging is higher.
- The investor has a higher level of risk tolerance.
- Resulting tax consequences of the hedging strategy are less favourable.

Finally, remember that the decision to hedge or not to hedge should be made from the perspective of the overall portfolio, rather than considering every individual international investment in isolation. Hedging can also be implemented at the portfolio level. For example, it is possible to achieve an overall hedge ratio, of say 30%, by investing 70% of the international portfolio in unhedged assets, and allocating the remainder to a fully hedged strategy.

ACCESS TO INTERNATIONAL MARKETS

The concept of gaining “portfolio completion” by investing across a broad range of geographic locations will become a more familiar concept to Australian equity investors in the near future.

In the past, gaining exposure to international equity markets (especially those less developed), was costly and difficult (if not impossible), especially for investors with smaller portfolios. This was largely due to lack of liquidity in the underlying markets, foreign investment restrictions in certain countries, political and regulatory instability and prohibitive transaction costs.

With the recent cross-listing of iShares Exchange Traded Funds (ETFs) on the Australian Securities Exchange (ASX), investors wishing to gain quick, easy and cost-effective international diversification can do so across a range of developed and emerging markets using iShares ETFs.

CONCLUSION

There are many reasons why Australian investors should further explore the countless investment opportunities available via exposure to international equity markets:

- With Australia representing just 2% of global share market capitalisation, opportunities exist for exposure to potentially higher performing overseas markets.
- Differing sector breakdowns across regions (due to specialisation) will mean that an Australian share portfolio will never be as well diversified as a global portfolio.
- Many emerging markets have had tremendous recent growth, fuelling much discussion regarding their potential to deliver strong future sharemarket returns.
- With iShares ETFs now trading on the ASX, the access to international equity markets has never been simpler, easier or more cost effective.

With all of the above in mind, the significant home bias in many Australian investors’ equity portfolios seems difficult to justify, given the world of investment opportunities available outside Australia.

For more information

Contact your investment adviser or sharebroker

Visit our website at iShares.com.au

Call 1300-iShares (1300 474 2737)

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