Regions going in and out of style

China and Greece seemingly created some shaky ground for international equities. **Jassmyn Goh** finds out how funds are allocating global shares in their portfolios and which regions have gained and lost popularity.

When the financial year ended most superannuation funds found themselves with double-digit returns for the sixth year in a row despite a bumpy end.

Despite the last minute global share market slump all asset sectors managed to deliver positive returns with unhedged international shares claiming the top spot as the strongest performing asset sector, according to Chant West.

This was thanks to strong growth in overseas share markets and the decline in the Australian dollar, Investment Trends said in a report.

Chant West's report found unhedged international shares returned an average 24.2 per cent for the 2014/2015 financial year, with Australian listed property coming in second at 20.2 per cent.

While hedged international shares came in at 8.5 per cent, Australian shares returned the lowest in terms of equities at 5.6 per cent.

For the most part, most super funds have opted to follow the international equity growth with their fund allocation tilting towards global shares rather than domestic.

Investment consultants Mercer said their clients had modest overweight positions in global equities and were all aggressive funds.

"This is from a strategic perspective and current market outlook perspective," Mercer dynamic asset allocation head, David Stuart, said.

"We're trying and keeping hedging levels pretty low at the moment because we do expect further weakness on the Australian dollar against the US dollar and that will likely lead to higher returns for unhedged global equities rather than hedged gloabl equities."

Stuart said for an average portfolio fund allocation international equities would account for around 30 to 35 per cent, Australian equities 25 per cent, and the rest in unlisted and alternative growth assets.

"During the commodity boom Australia was really rated. But it's over and Australia needs to return to more normal relative valuation against the world," he said

"Australia is not slowing but in a period of sluggish growth that will be quite prolonged. In particular, Australia has yet to really go through a deleveraging phase which many of the advanced economies have already done."

Agreeing, NGS Super chief executive, Anthony Rodwell-Ball, said his fund's allocation to international equities was roughly 32 per cent.

"There is a tilt away from Aussie towards international, about 29 to 30 per cent of the fund is in international and a couple of per cent less in Australian. If you went back a couple of years those relationships would be inverted," he said.

For asset consultants JANA Investment Advisers over the past four years their weightings have shifted from an Australian bias to an overseas bias.

JANA's executive director, John Coombe, said they follow a seven year view and believe the overseas market growth will be better due to share growth.

"The stock markets in the longer term are driven by earnings growth and we don't think Australia is going to have great earnings after the mining boom," he said.

Anthony Rodwell-Ball

However, not following trend is Frontier Advisors which still has higher allocations to Australian equities than offshore.

Senior consultant for equities, Fraser Murray, said their main reason was due to the dividend imputation system.

The system implemented in 1987 allows income tax paid by the company to be passed on to shareholders, avoiding double taxation for shareholders.

"Investing in Australian equities is certainly advantageous to funds and super funds to get a franking credit for all that prepaid company credit," Murray said.

"Certainly in the last 20 years we've seen slowly increasing allocations to international equities. The existence of the imputation dividend system almost put a cap on that."

Murray noted leading up to this years' budget there was conjecture on the potential of dismantling the system.

He said if it were the case it would be a trigger for an increase in allocation

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– John Coombe

into international equities as the system favours Australian funds over international equities.

"In all markets around the world everyone has a home bias. We're no different here and we tend to invest more money in companies that exist in Australia and major employers in Australia," Murray said.

For Frontier, their fund allocation across a super fund had international equities sitting at 25 per cent, and Australian equities at 30 to 35 per cent.

Greece for all that it is

Leading up to the end of the financial 2014/2015 year saw share volatility on the back of the Greek crisis and China's falling economy.

While the world sat on the edge of their seats wondering what the Greeks would choose, or if they would exit the European Union, investors barely battered an eye.

"No one cares about Greece. Greece is a total distraction," Coombe said.

"The only people that care about the Greeks are the Greeks. I feel sorry for them but it's a minuscule part of the market. Greek is irrelevant, it's a distraction. The sooner it is out of the EU the better we'd all be because it's a total distraction."

However, Rodwell-Ball said if the Greece did exit the Euro zone there would have a potential ripple effect. He also said there was a lot of emotion and hysteria about China where people were forgetting China's capacity and reserve to control turbulence.

"There's a massive correction, but a lot of rubbish being reported in Western media. A lot of hysteria going on in those areas."

Commenting on the issue, principal at Tempo Asset Management, Joe Bracken said the reaction to the crisis was nowhere near the reaction to the 2011 and 2012 Greek crisis. This was mainly due to the fact that people realised the Greek economy accounted for less than two per cent of the EU economy, he said.

"Even if Greece exited the Euro the affect would be very, very small," Bracken said.

He said unlike in 2011 and 2012, most of the peripheral markets like Spain have been ring fenced by the European Central Bank (ECB).

"So you not only have the ECB quantitative easing (QE) program where they are buying Italian debt, and Spanish debt, but also the outright monetary transaction program which is also a back stop program where they agree to buy debt of countries that get into trouble," Bracken said.

"Those two programs have really boosted the perception to investors that Italy, Spain, and other peripheral countries are kind of now beyond some kind of contagion effect."

Has the US seen its day?

Tempo, an investment manager for Fidante, the boutique arm of Challenger, has a global only focus and said they rated what they call "core Europe" consisting of Germany, France, and the Netherlands as their favourite region.

"We think those markets are undervalued, and with the ending of the Greek crisis they have already bounced back considerably and we expect more price appreciation going forward," Bracken said.

Within Asia, Bracken said Japan was their top choice on the back of the government doing everything to stimulate the economy.

"Japan was one of the first ones to launch a QE program that's ongoing, and have large pension funds further supporting the equity markets. You have two different forces coming together to help the Japanese stock market and the Japanese economy," he said.

Bracken noted although they liked the US it was now not so popular due to the high US dollar hurting exports and earnings, and the Federal Reserve talks about raising interest rates.

Similarly, JANA started to move out of the US about a year and a half ago for the same reasons.

"Remember 40 per cent of earnings of the SP500 come from offshore and if you have a rise in the US dollar like we've had in the last two years that's a negative translation back into the US dollars of those earnings," Coombe said.

"You've got the currency against earnings growth in a lot of companies just on a translation basis."

Stuart said despite the US being the lowest risk market and the EU and Japan having some question marks over economic recovery, they still preferred non-US over US stocks.

Going against the grain were both NGS Super and Frontier that rated the US as their top region

"In part due to the indices having the US as their largest constituent but also there's a very large significant market of good companies in the US," Murray said.

He noted many of the companies were part of the large technology industry and healthcare industry.

Both Rodwell-Ball and Coombe noted consumer based stocks were popular on the back of the affluence of the middle class, especially in Asia.

"In Asia, anything consumer. The middle class growth is thematic, so it can be banking, insurance, health, building related. Europe is more about industrials and banks," Coombe said.

Outlook

With the country's superannuation assets totalling $2.05 trillion at the end of March this year, according to the Australian Superannuation Fund Association, it is clear fund allocation is a key point for driving returns.

Equities often make up half of a portfolio and fund managers are struggling to see eye-to-eye on whether domestic or international shares should dominate.

"In this country we manage over $2 trillion and you can only invest so much domestically, the economy is not big enough to absorb all this cash that is being generated by superannuation members," Rodwell-Ball said.

"So you've got to look outside. There's no question the home bias may be well intended but the market can't absorb all the capital."

Bracken said investors needed to look into markets in Asia and Europe that are not over valued and have currencies against the US that are quite weak, and have QE programs like Japan, and potentially later on China.

"Really the theme we started on this year which is about the US economy has kind of seen its day and there are better places to invest," he said.

With the seeming switch from a home bias to an international one by most, Stuart said it also reflected the fact that it is a lot easier to invest in overseas equities than it was 20 years ago and that costs were now lower.

Stuart said the information investors are able to obtain on overseas markets and stocks are much more easily available.

However, on topic of easy information Murray pointed out that despite this ease there is a much greater difficulty in getting an information advantage over competitors than ever before.

"The successful managers require an analytical advantage over their competitors as it's so much harder to get information that is advantageous," he said. SR