Global stock quakes: how world markets have shifted

Burnt by a decade of poor returns, Australian advisers have been reluctant adopters of international equities. But, as David Chaplin reports, the world has changed, and maybe for the better

According to rocket scientists, the massive earthquake that struck Chile this February was of such a magnitude that it wrenched the entire globe off its axis, permanently altering the length of our days.

Richard Gross, a geophysicist at the NASA Jet Propulsion Laboratory in California, told Bloomberg that following the quake: "The length of the day should have gotten shorter by 1.26 microseconds (millionths of a second).

"The axis about which the Earth's mass is balanced should have moved by 2.7 milliarcseconds (about 8 centimetres or 3 inches)."

Set against the tragic human toll the Chilean earthquake exacted, these virtually undetectable amendments to geophysical time may appear trivial, but they are also an awe-inspiring reminder of the power of natural forces; and a poignant example of the way catastrophic events resonate through time and space.

The world of finance suffered its own analogous catastrophe on September 15, 2008, when the collapse of US investment bank Lehman Brothers rocked money to its core, sending powerful shockwaves out into the real economy.

But, just as the post-earthquake planet keeps on spinning, 18 months after Lehman Brothers imploded, the world's financial markets continue to turn, albeit on a slightly different axis and a wobblier trajectory.

Share investors, in particular, might feel they are in a different orbit since the black hole left by Lehman's first pulled them down towards oblivion before slinging them up towards the stars at dizzying speed. From their peak in November 2007 to the low point in March 2009, global sharemarkets slumped by about 50-60 per cent. While Lehman's accelerated the process, equities were clearly already on a downward trend.

Since March last year, however, equity markets have bounced back in a spectacular fashion. Figures reported by Morningstar US show the broad US stock index was up by more than 73 per cent in the 12 months ending March 5, 2010.

The rest of the world rebounded nicely, too, with the MSCI All Countries (in $US terms) benchmark climbing almost 71 per cent over the same period. But it was the emerging markets sector that proved the standout performer since the trough, almost doubling in the 12 months to March 5.

According to Morningstar, the MSCI Emerging Markets ($US) index grew 99.72 per cent over that period, although the result included a fair amount of currency volatility. In local currency terms, the same index climbed 67.7 per cent over the 12-month period.

For Australian-based investors, the returns from international equities in the wake of the global financial crisis have not been quite as sweet as that offered by their home market. The Vanguard Australia online index return calculator, for example, shows that in the nine months from the beginning of April 2009 to the end of the year, investors in the ASX/S&P 200 would have experienced growth of 59.5 per cent, compared to only 18 per cent from international shares and 12 per cent from the US sharemarket.

Morningstar Australia figures for the 12 months to the end of February this year paint a similar picture. The standard Australian shares benchmark, the S&P/ASX 200, returned 44.7 per cent over the period while the MSCI (ex Australia) offered just over 9 per cent in Australian dollar terms.

However, the fully currency hedged version of the MSCI (ex Australia) index was up by more than 45 per cent, according to Morningstar. The complication of currency hedging is, of course, another reason Australian investors have eschewed global equities. Fund managers generally leave the hedging decision up to advisers, offering both hedged and unhedged versions of their global share funds. Research houses like to point out that over the long term, currency hedging is a "zero sum game".

The tempering effects of currency on short-term returns from global equities, coupled with roaring local markets and the tax advantages bestowed by franking credits, would seem to confer legitimacy on the traditional home country bias shown by Australian investors and advisers.

Indeed, as Morningstar Australia notes in

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an international equities report published last September, in the 10 years to June 30, 2009, local investors would have seen their global share portfolios shrink, assuming they matched the relevant indexes.

"But we think that there are good reasons to suggest that now is the time to be increasing, rather than decreasing, the offshore component of portfolios," the report says.

And the reasons, as always, hinge on diversification. The Australian sharemarket is, sometimes disparagingly, characterised as comprising of four banks and a few mines.

While the truth is slightly more complex - there are approximately 1000 companies listed on the ASX - resource and financial firms do dominate the Australian market. According to Morningstar, these two sectors account for close to 60 per cent of the top 300 stocks listed on the ASX. And as researchers constantly reiterate, the ASX represents only 3 per cent of the total international sharemarket.

"The options are therefore pretty narrow," Morningstar says.

"If you want exposure to a telecommunications firm, few choices exist beyond Telstra. Other sectors such as healthcare and media are dominated by only a few names.

"A global share fund manager's opportunity set, on the other hand, is vast. [International] fund managers can pick the best names from each sector globally, widening their potential investment options."

Stuart James, Sydney-based associate director at Aberdeen Asset Management, says despite the strong arguments for investing offshore, Australia's home-town favouritism is still stubbornly adhered to by local investors and advisers.

"If anything, I'm seeing people slightly more sceptical about investing offshore; there's probably even more home-country bias at the moment from Australian investors," James says.

Brenda Reed

And, based on the rather dismal returns from international shares over the past decade, he says, "you can't really blame them".

However, James says investors should also be aware that by favouring the Australian market they are concentrating their risk.

"Australia's a bit like an emerging market - not in terms of living here, but the stockmarket has very emerging market characteristics in that it's dominated by resource stocks," he says.

"So the Australian market has had a very similar return profile to emerging markets over the last four or five years because China's grown strongly and the resource sector has done extremely well."

While it has been a successful strategy, James warns that "playing the resources" story via the ASX offers only a very narrow channel of returns, and remains vulnerable to a single factor - namely a slow-down in Chinese growth.

"If China wobbles, Australia will hurt," he says. "While I believe the long-term Chinese growth story, there will be speed humps along the way. So investors do need to diversify offshore."

'While I believe the long-term Chinese growth story, there will be speed humps along the way'

James says, for instance, that the focus on Australian shares will see local investors being significantly under-exposed to the industrial sector.

James cites the world's biggest manufacturer of Robotics, the Japan-based FANUC, and the French firm Schneider Electric, as examples of top-end industrial stocks not available in the Australian market.

"You're also missing out on IT - Apple, Samsung, they're all based offshore," he says.

"And I don't think you can really leverage the true story in emerging markets [via the ASX]."

James says while Australian resource stocks benefit from growing emerging market demand, truly global investors can also reap the rewards more directly.

"There's also a domestic demand story within emerging markets. Owning an emerging market bank is a really good proxy for that growth story, as indeed are retailers," he says.

Tim Dunbar, head of equities for the US-based Principal Global Investors, agrees Australian investors need to be wary of putting all their bets on the home market.

Dunbar, recently on tour in Australia with Principal, says while home investment bias is a factor in most countries, investors in some juris-

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dictions have been turning their gaze outwards.

"We had been seeing a trend that was occurring before the crisis - and is starting to pick up again - for investors to move beyond their home-country bias. They are looking to diversify a bit," Dunbar says.

"It depends a little bit on the country. It certainly has been the case in the US where we're seeing some of the more sophisticated clients looking to weightings that more mirror the global index."

He says while the trend can partly be explained by investors becoming more savvy about where they invest, the inexorable globalisation of markets has prompted the shift of emphasis.

"A lot of companies are global companies now," Dunbar says. "[US investors] have also seen a fair bit of change in currency, which hasn't been a positive thing for the US investor. Those assets that have been outside the US have certainly acted as a diversifier in several different ways."

Morningstar's Douglas says the firm has been pushing the international equities angle for some time and is currently advising clients to go underweight Australian shares relative to international stocks. Like James, however, Douglas admits this message is a "hard sell".

"We're growing more confident global equities will be the place to be over the next few years," he says.

"We're saying to advisers, 'don't look back on the last 10 years to pick what's going to happen next [in global equities] - things change."

If the collapse of Lehman Brothers could be described as a seismic jolt that shook the world to its financial foundations, it was against a background of slower-moving tectonic forces.

Even before the GFC shock, the continental drift of financial power from the developed West to the emerging East was a fully-formed theory. It's difficult to say if the crisis has accelerated that trend; it certainly hasn't halted it.

Aberdeen's James says the US market as a proportion of the commonly-used global equities benchmark, the MSCI All Countries, now sits at about 46 per cent of the index, down from 52 per cent a couple of years ago.

"The [MSCI All Countries] index has roughly 13 per cent in emerging markets these days, which is slowly increasing," he says.

The shift East, though, has hardly been a smooth process, and the GFC put paid to one popular hypothesis that was gaining ground before the crisis hit.

> 'We're saying don't look back on the last 10 years to pick what's going to happen next'

Justine Gorman, Standard and Poor's (S&P) fund analyst, says the advent of the crisis proved that the theory that the East was "decoupling" from the West was "blown out of the water".

"When we saw the banks in the West starting to collapse, and the US markets collapse too, we saw emerging markets go down with a thud," Gorman says.

"People were thinking they had to pull their money out of emerging markets because they were higher risk.

"There was a lot of money heading into those regions before the crisis, but now investors have a clearer picture of the future in different regions they're a lot more comfortable heading back into emerging markets."

As investors have cottoned on to the fact that the East remains connected to the West, they have also become more lateral in how they approach investing in it. The popularity of emerging market funds over the past couple of years has prompted many analysts to label the sector fully-valued, or even over-valued, at present.

And while opportunities undoubtedly remain buried in stockmarkets from the BRIC economies and beyond, Morningstar's Douglas says many international fund managers are now telling the research house they see better value in buying the emerging market story through developed country exchanges.

Brenda Reed, London-based portfolio manager of the Fidelity Global Equities Fund, says this reverse strategy makes sense, as huge flows into emerging markets have distorted stock prices. Reed says she is a "big believer in the idea that the economic centre of the world is shifting East" and, in one way or another, her fund has played out that theme over the years.

"However, one thing I keep telling people is that there is a big difference between where a company is domiciled versus what drives the company's earnings," she says.

"We can buy emerging markets exposure through buying a company that is domiciled in a developed market.

"I have some of those in the portfolio because they're really cheap."

According to James, investors in global shares can no longer rely - if they ever could - on labels.

"You've got to strip the labels off and see what's underneath," he says.

An example of this, James says, is the traditional view that Western banks are sound while emerging market financial institutions are rubbish. The recent banking crisis in the West, which precipitated the broader economic melt-

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down, has exposed the fallacy of that argument, he says.

James says while many US, UK and European banks were leveraging up their balance sheets into dangerous territory, in the East the savings rates have generally been higher and lending more sober.

The outcome has been good old-fashioned banking margins - pay depositers at 5 per cent, lend at 10 per cent.

"To me that's exactly what a bank should be doing," James says.

"Compare that to a developed market bank: trading its own proprietary book; it's making a lot of its income from fees; lending money to people who couldn't pay it back. That, to me, is riskier."

Even so, there may be few emerging market banks that meet an investor's criteria, which is where the global stock-picker's skill comes into its own, James says.

Like Aberdeen, Reed's Fidelity global shares fund takes a bottom-up approach to stock-picking. Macro-investment themes, if they exist, appear only after the fact, Reed says.

"I'm just looking for 100 good ideas," she says, out of the many thousands of listed opportunities.

According to the World Federation of Exchanges website, more than 46,000 companies are currently listed across the 52 bourses on its database. Most international share managers whittle that number down quickly; but there is a generally-accepted universe of about 12,000 to 13,000 companies that might make the first cut.

Researching the entire universe might be impractical, but Reed says Fidelity's team of 700 or so professionals scattered around the world sift through a fair proportion. And gems can appear in places outside the mainstream, she says. For example, Reed is bullish about Aspen Pharmacare - a pharmaceuticals company listed on the South African exchange.

"Aspen is the largest generic drug company based in South Africa," she says. "[Aspen] is looking to improve healthcare in a cost-efficient manner. They're good at what they do and they're great at distribution. They've just done a deal with [drug giant] GlaxoSmithKline to distribute their products through Africa.

'Even so, there may be few emerging market banks that meet an investor's criteria'

"And the stock is still cheap considering its growth rate."

As emerging markets mature, similar stories are sure to appear out of Africa and other regions currently neglected by Australian investors. Nigel Wilken-Smith, van Eyk's head of strategic research, says the group has tried for several years to encourage Australian advisers to broaden their international exposure - particularly to emerging markets and the global small-caps sectors.

Wilken-Smith says in van Eyk's 2007 strategic asset allocation review it recommended advisers shift domestic exposure - which included all asset classes - down to 50 per cent, from the prevailing rates of about 70 per cent. Interestingly, van Eyk has recently reduced its recommended weighting to international equities, shifting the emphasis to alternatives, although it remains committed to convincing advisers to invest more offshore.

However, Wilken-Smith admits the resistance remains strong.

"Australian financial planners have seen returns from traditional international shares that look pretty anaemic," he says.

"And they're suspicious of emerging markets because they're concerned about governance issues, such as lack of transparency or corruption."

But Wilken-Smith says Australian investors still need exposure to emerging markets, pointing out that governance in the sector has improved markedly over the years.

While van Eyk, Morningstar and S&P might all emphasise different aspects of the international investment story - as well as holding competing views on asset allocation and manager selection - they have a broad agreement that Australian advisers should peek out further from their national borders.

Clearly, risks remain in global markets - chiefly, a slow-down in China and brewing sovereign debt problems, of which Greece is the current exemplar. International share managers are also divided on the short-term outlook.

Both Aberdeen's James and Principal's Dunbar, for example, are "cautiously optimistic" a sustainable recovery is underway.

Reed, on the other hand, is stridently upbeat, letting her on-the-ground contact with real businesses inform the argument about what shape the post-crisis world will assume.

"I talk to companies around the world all the time and from everything I hear it's a V-shaped recovery," she says.

Factories, Reed says, are firing up again; manufacturing orders are coming through; the world is spinning a little faster.

"It's amazing to say, but this is just a normal economic cycle," she says.

"It was a little scary on the downside, but we're having the rebound now." ■

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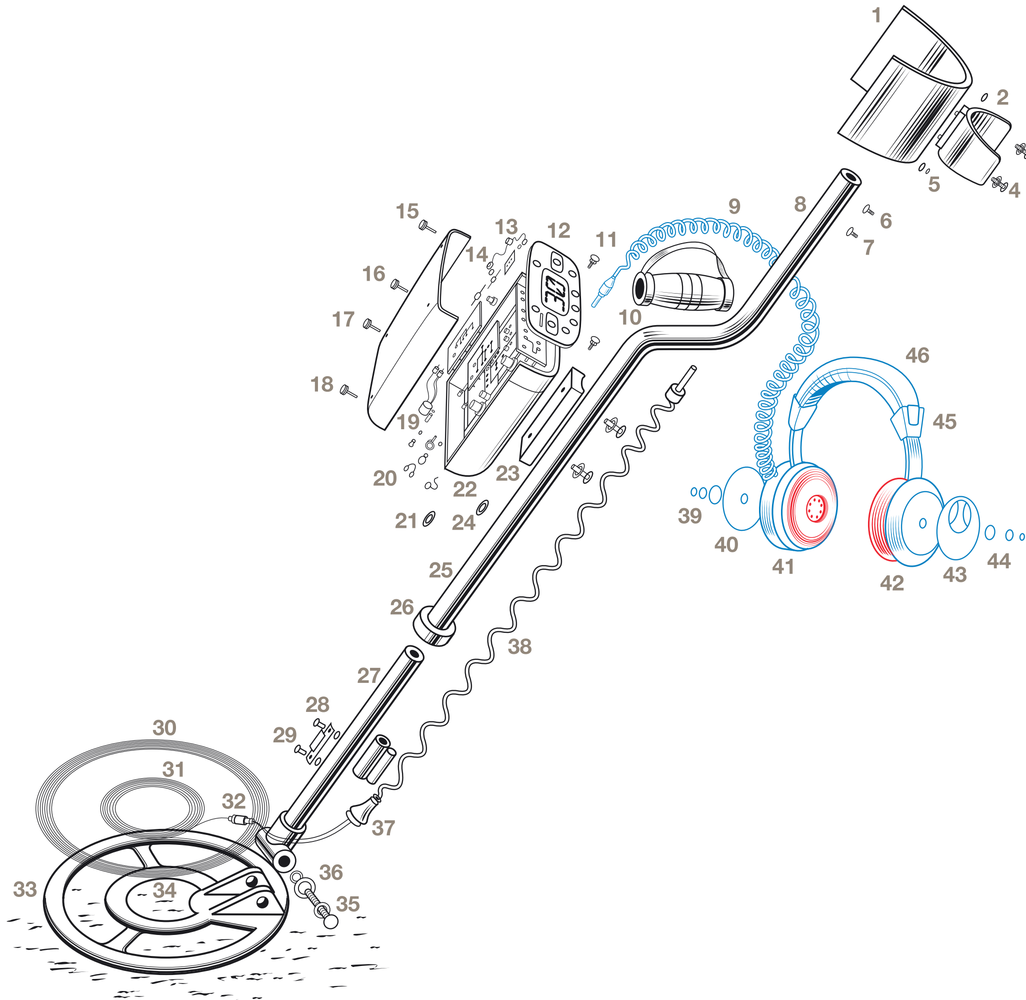

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