



Why should you invest in international equities?

Global sharemarkets have rallied strongly since March this year, but for many investors the gains in global equities have been less than the gains in Australian equities. In this Point of View, AXA's Chief Investment Officer Mark Dutton looks at the reasons behind this occurrence and outlines the case for investing in global assets.

In brief

- The global sharemarket has rallied strongly since March this year and has experienced less volatility than the Australian sharemarket
- While the Australian dollar has detracted from recent gains, it cushioned the preceding fall
- Global and domestic markets have different risk and return characteristics, and also act as good diversifiers between themselves

The recent global sharemarket rally

A common perception is that the Australian sharemarket has outperformed global markets during the recent recovery. We frequently hear that our domestic economy has been one of the strongest in the western world, so it may seem logical that our sharemarket should also be stronger.

But there are two problems with this perception.

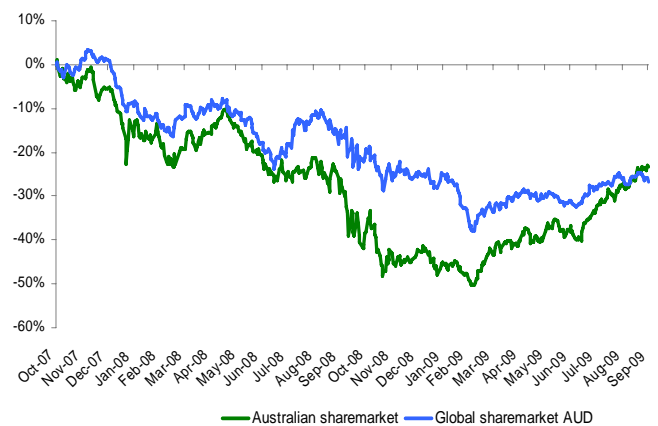
Firstly, it is factually wrong. All major markets around the world have experienced strong share price gains. On average, these gains have been very similar in magnitude to the rise in Australian market.

For example, from early March 2009 to the end of September 2009, the US market is up 55 per cent, the Euro markets by 58 per cent and Hong Kong by 76 per cent. The Japanese market has lagged but is still up by 41 per cent.

Secondly, if we consider the whole period of market disruption and recovery – approximately November 2007 to the present – the returns for Australian investors in Australian shares and in global shares have been almost the same, but the global sharemarket has actually been less volatile.

In other words, Australian investors in global sharemarkets achieved similar returns, but with lower risk, as shown by figure 1 below

Figure 1: The Australian sharemarket and global sharemarket total returns



Source: Bloomberg, AXA. ASX S&P 300 Accumulation Index, MSCI World Index ex Australia net dividends re-invested in AUD. Data from 31 Oct 2007 to 30 Sept 2009.

Currency

A question many investors in global share funds may be asking is, why they haven't seen gains of similar magnitude in their portfolios?

The reason is largely due to exchange rates. The recent market recovery has corresponded with a period of very strong rises in the value of the Australian dollar compared with most major currencies.

Looked at from an Australian investors perspective, foreign currencies have fallen in value by approximately 30 per cent since March this year.

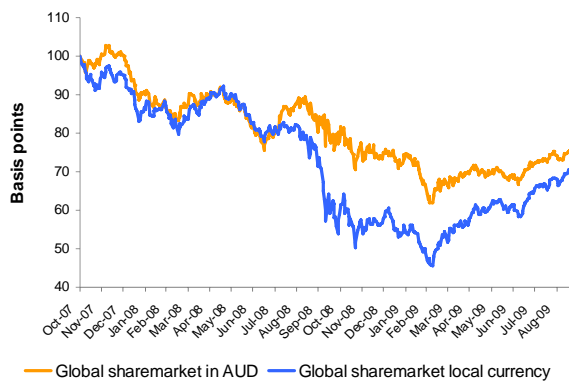
But despite this recent negative impact, currency diversification has benefited overseas investors in overseas markets during the crisis period.



For example, figure 2 below shows the fall in the global sharemarket leading up to and during the crisis was not nearly as severe in Australian dollar terms compared to local currency.

In other words, during this period the Australian dollar helped cushion the effect of the large fall and contributed to diversification benefits.

Figure 2: Global sharemarket in local currency and Australian dollars



Source: Datastream, AXA. MSCI World Index ex Australia net dividends reinvested local currency and MSCI World Index ex Australia net dividends reinvested AUD. Data rebased to 100 from 31 Oct 2007 to 22 Sept 2009.

Fund managers

In addition to currency effects, the actual performance of individual fund managers has deviated from market indices markedly over this cycle.

During the downturn, market prices became distorted, and many investment manager returns fell further than the markets.

Our own experience with AXA's Wholesale Global Equity - Value Fund mirrored this outcome, with the portfolio falling in value by more than the market until March this year.

Since March, the portfolio return is up by 17.3 per cent compared with a market return of 10.4 per cent.

The forces driving this outperformance (outlined in the August 2009 Point of View 'Time for active management') are still very positive.

Why should you invest in global assets?

Key reasons for considering global shares in diversified portfolios include taking advantage of the broader range of investment opportunities and diversification benefits.

Over the crisis period, global sharemarkets experienced less volatility than Australian markets.

But this is not a surprising result.

Global sharemarket indices typically comprise nearly 1600 stocks and offer the potential to choose from thousands of additional stocks, including emerging markets and smaller company shares not included in the main index.

Critically, this diversity enables global portfolios to typically hold around 100 to 150 stocks compared with less diversified Australian share portfolios.

This enables global portfolios to be well diversified across industry sectors, economic cycles, countries and regions.

In contrast, Australian sharemarket concentration increased during the financial crisis.

Stocks in the financials sector now comprise more than 40 per cent of the Australian market capitalisation. Stocks in materials (resources) and energy sectors make up an additional 30 per cent of the market.

These two groups of stocks drive the Australian market returns.

Meaningful investment in important growth sectors such as information technology and healthcare can only be achieved in global markets, where they collectively comprise more than 20 per cent of market capitalisation.



In Australia, they are small, with the information technology sector being less than 1 per cent of the market – in a market which is 12 per cent of the world.

What this means for investors

Global investing provides valuable diversification. A somewhat surprising observation, as shown by figure 3 below, is that the longer-term Australian sharemarket rarely tracks the international sharemarket.

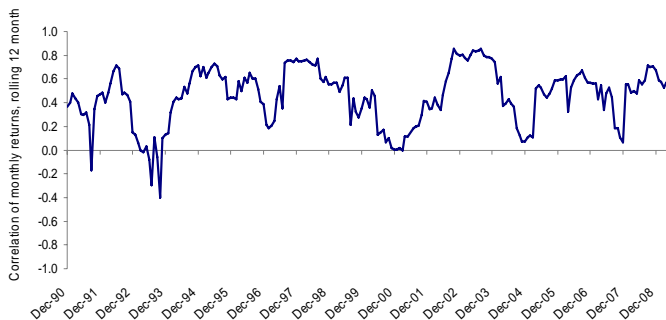
With correlations rarely exceeding 0.6 and ranging down to zero, the split between global and Australian equities is a powerful diversifier over the longer-term.

Investors in global markets are able to diversify their growth portfolios and access opportunities which aren't available in the local Australian market.

Over time, this diversification can help manage risk. And the experience of the past two years shows this does not need to mean lower returns.

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Figure 3: Global versus Australian equities (Asset class return correlations)



Source: Datastream. MSCI World Index ex Australia net dividends re-invested AUD, S&P ASX 300 Accumulation Index. Data from 31 December 1990 to 31 December 2008

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