

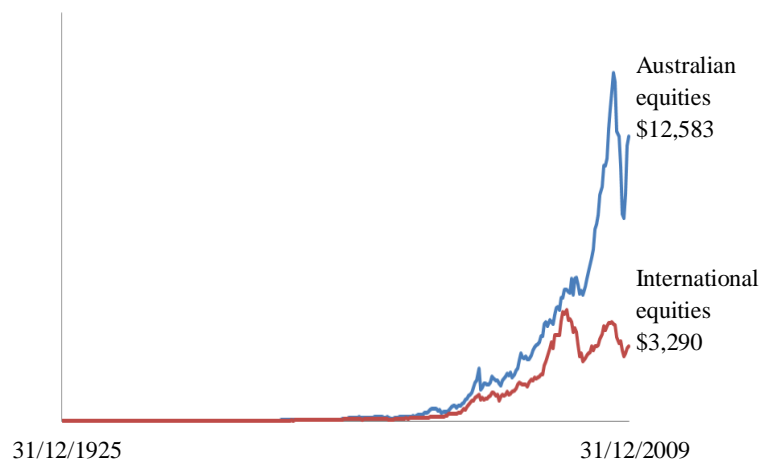
Are we really the “lucky country”?

Michael Fitzsimmons and Paul Kerin

Historically, Australians have been much better off investing in Australian equities than in international equities. But did this reflect luck, risk or superior performance? And will our luck run out?

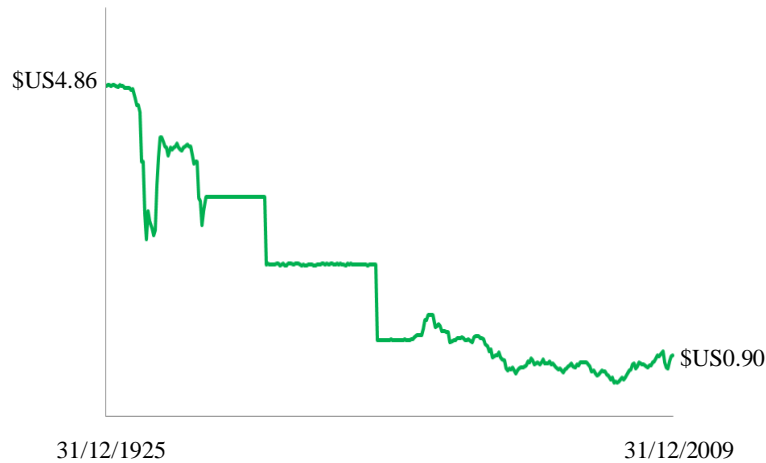
Long-run (1925-2009) total returns to shareholders – dividends, capital gains and franking credits – on Australian equities have averaged 11.9 percent. That’s 1.8 percent more than the Australian-dollar TRS on international shares. Given the magic of compounding, that’s a big difference: \$A1.00 invested in Australian equities in 1925 would have accumulated to \$A12,583 by the end of 2009, but to only \$A3,290 if invested in international equities (Chart 1).

CHART 1: VALUE OF \$A1 INVESTED IN EQUITIES IN 1925



Australian equities’ superior returns came despite relative *bad* luck: the \$A’s long-term depreciation (Chart 2) which, despite its recent upturn, boosted international equities’ \$A average TRS by 1.4 percent.

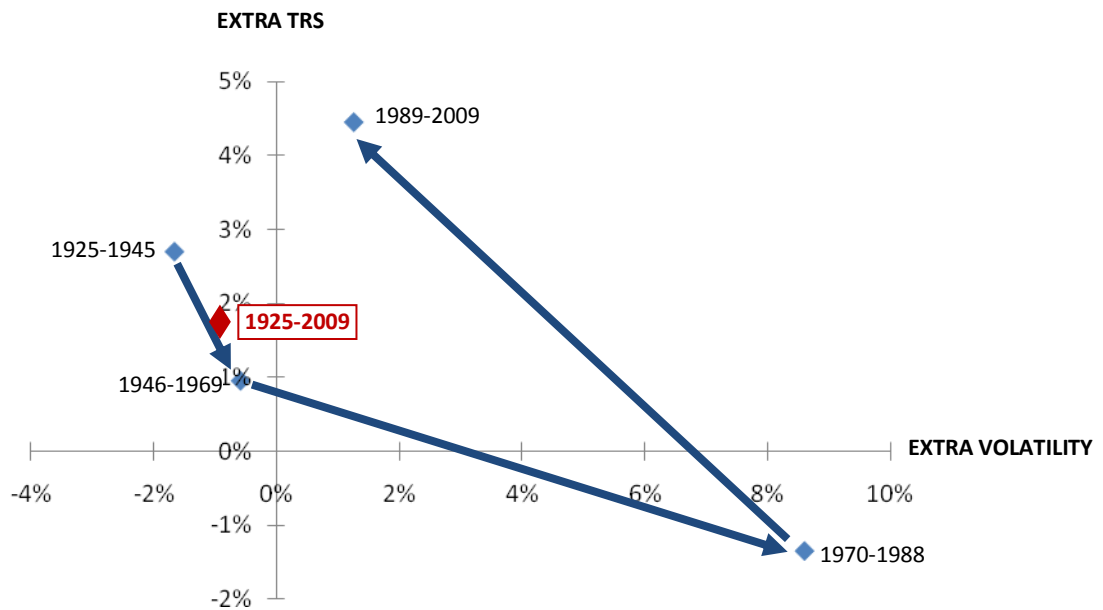
CHART 2: EXCHANGE RATE
\$US per \$A1.00



Investors require extra returns to compensate for greater expected risk (return volatility). International equities do offer greater risk-diversification opportunities. However, while *ex post* returns volatility doesn't necessarily reflect *ex ante* risk expectations, Australian equities' returns were less volatile: their standard deviation was 16.3 percent, 1.0 percent below that of international equities.

So over the long run, Australian equity investors have enjoyed the best of both worlds: higher \$A returns *and* lower volatility. Nevertheless, they've had their ups and downs (Chart 3). Higher returns coincided with lower volatility during the decades preceding the end of World War II and this persisted for some time post-war. That's not surprising. Four of the world's 15 biggest share markets in 1900 subsequently lost their entire market capitalisations (Argentina, China, Egypt, Russia), while Germany (twice) and Japan almost did too. Australian companies didn't have to cope with invasions, revolutions or hyper-inflations.

**CHART 3: RETURN & VOLATILITY DIFFERENTIALS
AUSTRALIAN VERSUS INTERNATIONAL EQUITIES**



Australian equities endured the worst of both worlds during the seventies and eighties. While they've displayed lower volatility since then, they were still slightly more volatile than internationals; however, their particularly strong returns more than compensated for that. The 1987 introduction of dividend imputation system helped raise equity returns. Our TRS calculations include franking credits, valued at 50 percent of face value to mid-2000 and 63 percent since then, consistent with research evidence (see "Investors frankly deserve more credit", 29/1/10). Investors who could fully utilise franking credits also enjoyed up to a further 1.0 percent annual return.

What does all this mean for investors' portfolio allocation decisions? That depends on how well history serves as a guide to the future – and which history is the best guide.

The further back in history we look, the more information we have. But if the underlying drivers of equity returns change fundamentally, history pre-dating those changes may be useless, even downright misleading.

However, as market participants often think the world has changed when it really hasn't, they may base decisions on overly-short historic timeframes. Former U.S. Federal Reserve Chairman Alan Greenspan told Congress in 2008 that securities held by financial houses were over-valued pre-GFC because: "The data inputted into the pricing models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic

periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today”.

To illustrate the difference that the historical lens we peer through makes, we’ve estimated optimum portfolio allocations using four different timeframes, assuming that returns and volatility within these time-frames are good indicators of future expected returns and risk (Table 1). These portfolios maximise expected returns per unit of risk suit investors with average risk appetites.

TABLE 1: OPTIMUM EQUITY PORTFOLIO ALLOCATIONS BY TIMEFRAME

Timeframe	Years	Optimum Australian equities weight %
Long	1925-2009	79
Medium	1946-2009	62
Short	1969-2009	100
Very short	1989-2009	100

The longest timeframe (1925-2009) suggests that an optimum equity portfolio would comprise 79 percent Australian shares and 21 percent internationals. While this portfolio’s expected return (11.5 percent) is 0.2 percent under Australian equities’ long-run average TRS, its expected risk (standard deviation) is 1.1 percent below their long-run average volatility. The significantly lower risk more than compensates for slightly lower expected returns.

If we think that equity returns prior to war’s end are irrelevant and therefore employ the medium timeframe, Australian equities’ optimum share drops to 62 percent. That’s because we’ve ignored a 20-year period when Australian equities enjoyed relatively high returns and low volatility.

Using the “short” 40-year time-frame, we’d hold no international shares in the optimum portfolio. That’s because Australian equities’ 2.8 percent extra average annual return (over internationals) during that time was large relative to their additional volatility.

Using the very short time-frame makes the case for an all-Australian equities portfolio even stronger – particularly for investors who can fully-utilise franking credits.

Whichever historic lens we use, the case for a large home country bias is compelling.

But are returns in these historical timeframes good guides to the future? The long timeframe provides a good starting point, but should be adjusted if there are good reasons to do so.

Some strong arguments suggest that Australia will be just as lucky, or even luckier, in future – at least for some years. A huge commodities boom and our proximity to high-growth markets, particularly China and India, which (history tells us) were amongst the world's biggest economies – and they're making rapid headway towards regaining that status. We'll probably remain relatively attractive to foreign investors, given our political stability and sound institutional frameworks. Many nations won't catch us on those fronts and some may go backwards. How stable will the EU be? How will China's political system evolve? Will Japan and the US stagger under their debt mountains?

But Australia also faces risks. As some are common to other nations (for example, the potential implications of growing household debt), they may not affect our relative risk. But others may hit Australia relatively hard. We're more exposed to possible consequences of growing inflationary pressures in China, and China's ability and willingness to deal with them remain unclear. Soaring inflation may damage China's economy and/or political stability – arguably, inflationary pressures helped foment the 1989 Tiananmen Square protests.

But even if Australia will be more/less lucky in future, that doesn't mean Australian equities will be. If the Australian equities market has already fully priced the implications of Australia's future luck into equity returns, it won't be luckier than in the past.

We think the market has probably over-priced the short-term positives and under-priced both medium-term risks and the longer-term positives. However, the potential value of longer-term upsides probably outweighs the downside risks of short/medium-term price corrections.

On balance, equity portfolio allocations should probably retain a strong – but not absolute – home country bias. To not do so would fly in the face of history. Franking credits and potential longer-term upsides further justify being biased.

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