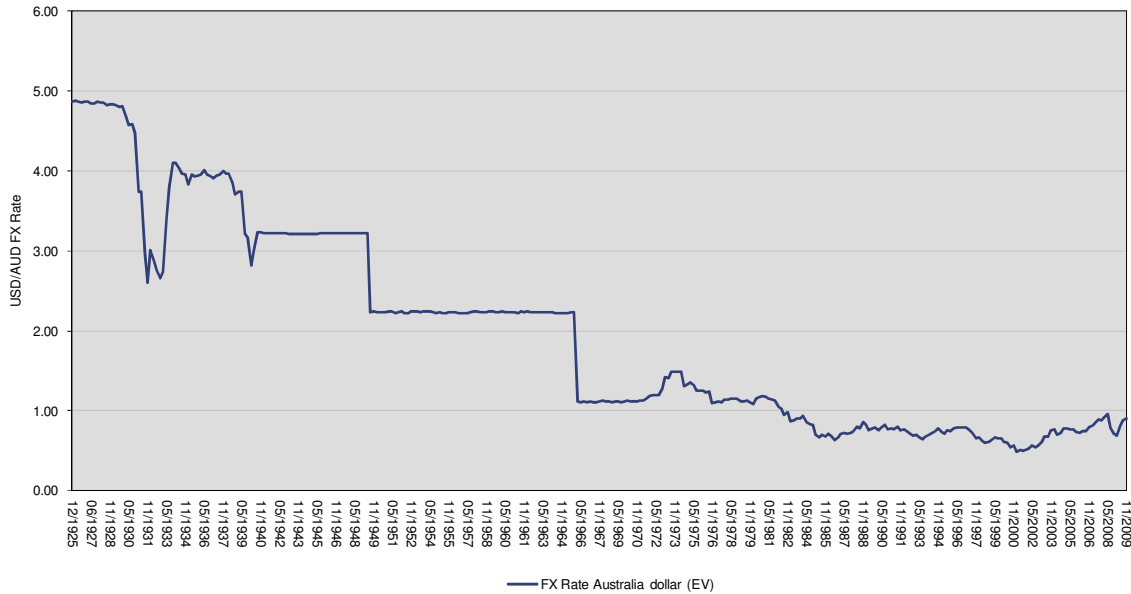


As part of our recent review of Australia's long-term equity risk premium [ERP], we considered the question: **just how lucky, has 'the lucky country' been when looking at equity market returns over the long term? And, was it so lucky in US dollar terms given the depreciation of the Australian dollar versus the US dollar over the long term?**

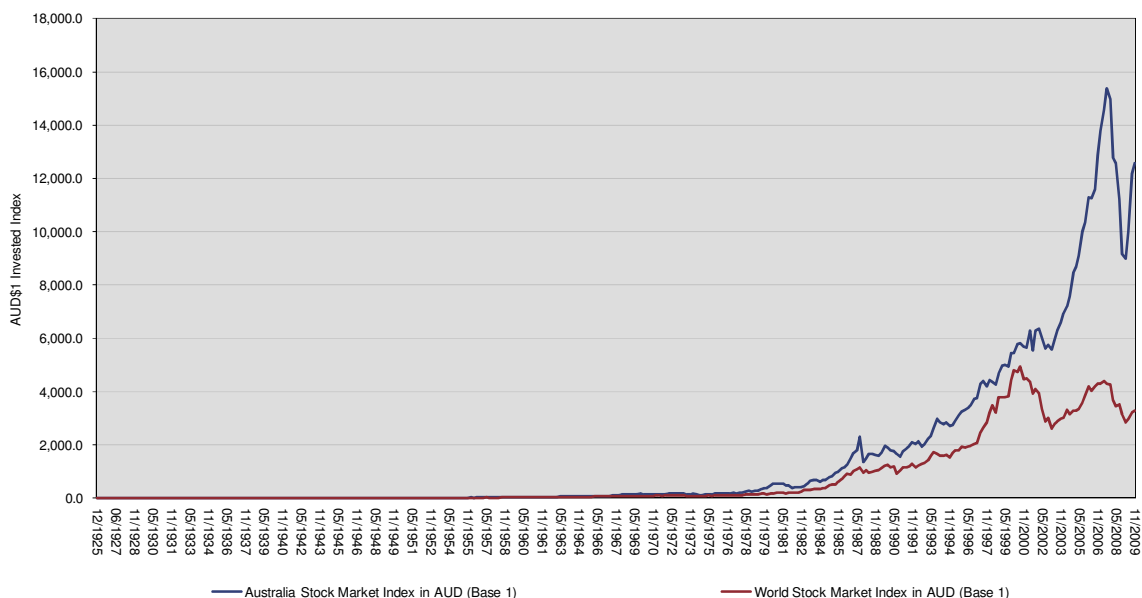
Despite this precipitous long-term fall in the Australian dollar [see chart below], in equity market returns Australia was still indeed 'the lucky country'. From the 31/12/1925 to 31/12/2009 the Australian equity market delivered a CAGR return of 11.9%pa in Australian dollars, versus the a World equity index return [also in Australian dollars] of just 10.1%pa.



From the 31/12/1945 the CAGR for Australia was 12.5%pa versus 11.0%pa for the World, and from 31/12/1969 the CAGR for Australia was 11.5% versus 9.7% for the World.

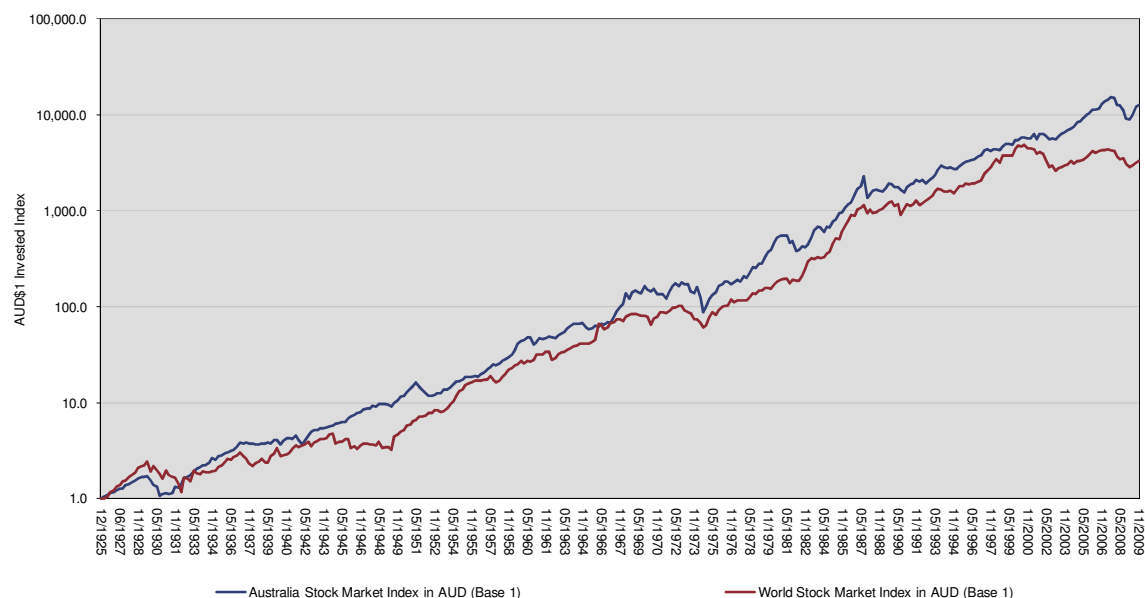
Note that the Australian CAGR figures include franking credits valued at 50% from 31/12/1988 to 30/06/2000, and 63% from 30/06/2000 to 31/12/2009 [i.e. 'market value' based on JFCP's dividend drop-off analysis]. For investors that could have fully utilised the franking credits, they gained an 'extra' 1.0%pa from 31/12/1988 to 30/06/2000, and 0.6%pa from 30/06/2000 to 31/12/2009.

The chart below shows the cumulative effect of the Australian dollar return from the Australia equity market [excluding the 'extra' franking credit value referred to above] versus the Australian dollar return from the World equity index from 31/12/1925 to 31/12/2009.



For the Australian equity market, one Australian dollar invested on 31/12/1925 has grown to AUD\$12,584, versus one Australian dollar invested in the World equity index which has grown to only AUD\$3,290.

The next chart shows the same figures but instead using a log scale base 10.



**So was this luck, or was it just compensation for extra risk in the Australian equity market versus the World equity index [i.e. given the much greater diversification benefits of investing in the World index]?**

Surprisingly the answer is no, at least not over the long-term [i.e. back to 31/12/1925]. That is, despite the diversification benefits, the World equity index [in Australian dollars] has been a far riskier investment over the longer term.

From the 31/12/1925 to 31/12/2009 the Australian equity market had an annualised risk [i.e. standard deviation] of 16.3% [in Australian dollars] versus the World equity index return of 17.3% [also in Australian dollars].

Therefore, despite its greater diversity, in the long term the World equity market has historically been a very risky place for investors relative to the Australian equity market [i.e. over the last 85 years – it's had more wars, revolutions, hyper-inflation episodes, etc., etc. to contend with]. For example, “four of the fifteen largest stock markets in the world in 1900 suffered total loss of capital, a -100% return, at some point in the past century: China, Russia Argentina and Egypt. Two others came close: Germany (twice) and Japan.”<sup>1</sup>

However, over the shorter time frames, the Australian equity market has been somewhat riskier. From the 31/12/1945 the risk for the Australian equity market was 17.4% [in Australian dollars] versus 16.4% for the World [also in Australian dollars], and from 31/12/1969 the risk for Australia was materially higher at 19.5% versus 16.4% for the World.

The 1970s and 1980s were particularly risky periods for Australia investors versus the World equity index. Over these two decades the risk of the Australian equity market was 23.9% versus 16.9% for the World equity index.

**What impact did the Australian dollar have on the risk of World equity returns for Australian investors?**

The Australian dollar decreased the volatility of World equity returns in Australian dollars from 31/12/1969 [i.e. 16.4% versus 17.2%] but not over longer time periods. From 31/12/1945 the volatility of the World index returns [in Australian dollars] was 16.4%, whereas in US dollars it was 15.4%. From 31/12/1925 the volatility of the World index returns [in Australian dollars] was 16.4%, whereas in US dollar it was 15.4%.

**What was the optimal portfolio combination of World equities and Australian equities over these different time periods?** The optimal combination using returns for the period from 31/12/1925 to 31/12/2009 was 79% Australian equities and 11% World equities [i.e. a Sharpe ratio of 0.352x]. The optimal combination using returns for the period from 31/12/1945 to 31/12/2009 was 62% Australian equities and 38% World equities [i.e. a Sharpe ratio of 0.339x]. Note that the optimal combination using returns for the period from 31/12/1969 to 31/12/2009

<sup>1</sup> R. D. Arnott, P. L. Bernstein, “What Risk Premium Is “Normal”, (2002, Financial Analysts Journal). Note not all the equity market disasters are in the World index data series.

was 100% Australian equities based on historic return and risk figures [that's why these figures are the same as the 100% Australian equities row in the summary table below].

All the figures referred to above are summarised in the table below [note the optimal combinations are shown in the rows shaded blue].

Time Frame		Portfolio Weights		Return		Risk		Sharpe Ratio	
From	To	Australian	World	AUD	USD	AUD	USD	AUD	USD
31/12/1926	31/12/2009	100%	0%	11.9%		16.3%		0.350x	
		0%	100%	10.1%	8.7%	17.3%	17.1%	0.270x	0.267x
		79%	21%	11.7%		15.2%		0.352x	
31/12/1945	31/12/2009	100%	0%	12.5%		17.4%		0.333x	
		0%	100%	11.0%	9.7%	16.4%	15.4%	0.275x	0.293x
		62%	38%	12.2%		15.3%		0.339x	
31/12/1969	31/12/2009	100%	0%	11.5%		19.5%		0.208x	
		0%	100%	9.7%	9.5%	16.4%	17.2%	0.117x	0.189x
		100%	0%	11.5%		19.5%		0.208x	

**Assuming these ex-post returns hold true in the future** [and that is a big if], **then there is a very compelling case for a large home country bias**, made even more compelling for a tax-payer who can gain from the incremental franking not currently valued by the market [i.e. 0.61%pa] which are not included in the figures above.

**All this is interesting, but what about the thing that really matters – the future! Will Australia be as lucky in the next 5, 10, 20, or 50 years as it has been over the last 85 years? And if it is, how much of this is discounted into current equity prices?**

On the first question, if you believe the rhetoric coming from the Australian Treasury and the RBA over the last 6 months, Australia will indeed be 'the lucky country' going forward. Our geographic proximity to the fastest growing region in the world, and our hard and soft commodities which are, or will be, in great demand, by two of the world's historically largest economies [China and India] emerging from more than a century 'in the economic wilderness'.

Also there is the attractiveness of the Australian economy to foreign investment capital given Australia's political stability and sound institutional frameworks, relative to the rest of the World [e.g. the European Monetary Union? the Chinese political system? the Japanese and US fiscal positions? etc., etc.].

But for mine there are also a number of risks for Australia's equity market, not least the level of debt in the household sector which has largely been accumulated to bid-up established house prices, and the resultant foreign debt that has made Australia's banking system heavily dependent on foreign savings to fund this largely unproductive 'investment' [or should I say speculation!].

The negative catalyst risk to bring this un-stuck is the inflation pressures that our building in China [and will ultimately pose a risk in the rest of the world as well] and the ability [and/or willingness] of the Chinese Communist Party to deal with this potential inflation in the future.

If China takes a big economic step backwards because of a serious inflation problem [the Tiananmen Square protests of 1989 arguably had their roots in inflation pressures that were building prior to the protests], then the attractiveness of Australia to foreign capital could cause some real problems for Australia's banking system and therefore Australia's economy.

On the second question, it is always difficult to say. I think the market has probably over-priced the short-term positives, under-priced the medium-term risks, and largely under-price the long-term positives [e.g. economic ties to China, India and the rest of Asia]. So on balance the answer to this question is, probably no.

Therefore, if I were allocation assets, I would have a pretty heavy home country bias [talking my own book here!]. Despite the additional diversification benefits of not doing so, you are 'flying in the face' of history, ignoring the franking credits still not fully valued by the market, and missing the compounding effects of the positive 'tail risks' that are probably a greater chance of happening than the medium-term negative tail risks [e.g. Chinese inflation and its economic implications for Australia].

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