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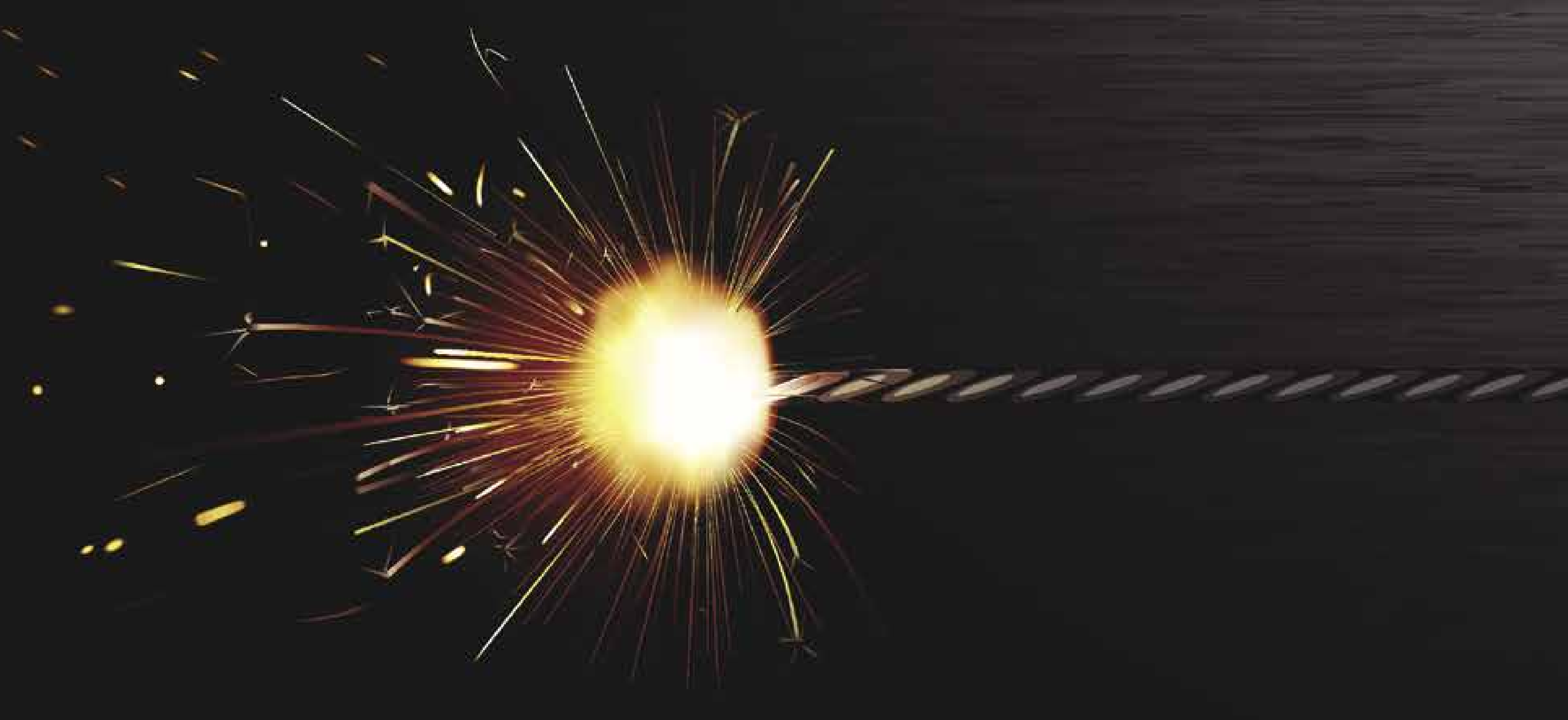
SPARKING GLOBAL INTEREST

Despite the headwinds Australian equities face, offshore investors are showing greater interest and increasingly boosting their allocations. But for how long? **Karren Vergara** writes.



01:
Anton Tagliaferro
investment director
Investors Mutual

02:
Leanne Pan
portfolio manager
Prime Value Asset Management

03:
Randal Jenneke
head of Australian equities
T. Rowe Price

Last October, an article in *The Economist* named Australia as the country with the most successful economy in the developed world.

Australia, it said, has been growing for 27 years without a recession – a record for a rich country – thanks to unfettered economic growth, rising incomes, low public debt and government policies.

Part of it also stems from luck, with Australia being blessed with an abundance of iron ore and natural gas. Its proximity to China also helps "hoover up such things."

Investors Mutual investment director Anton Tagliaferro[01] agrees Australia is a great place to invest in because of its natural resources, low unemployment and booming economy supported by population growth.

Figures from the Australian Bureau of Statistics show about 45% of the local share market is made up of foreign investors, while institutional investors comprise roughly 42%.

By 2030, Tagliaferro says superannuation will reach $8 trillion. (See Figure 1)

The bad news, he warns, is the local share market will not have the capacity to cope with that growth over the next 10 to 15 years. For this reason, more money will end up overseas.

There are currently some risks in the Australian market that may keep some international investors on the sidelines, according to Leanne Pan[02], a portfolio manager at Prime Value Asset Management.

The global investors' appetite depends on how they perceive the ASX as being dominated by resources and financials; the value of the Australian dollar also plays a role, she says.

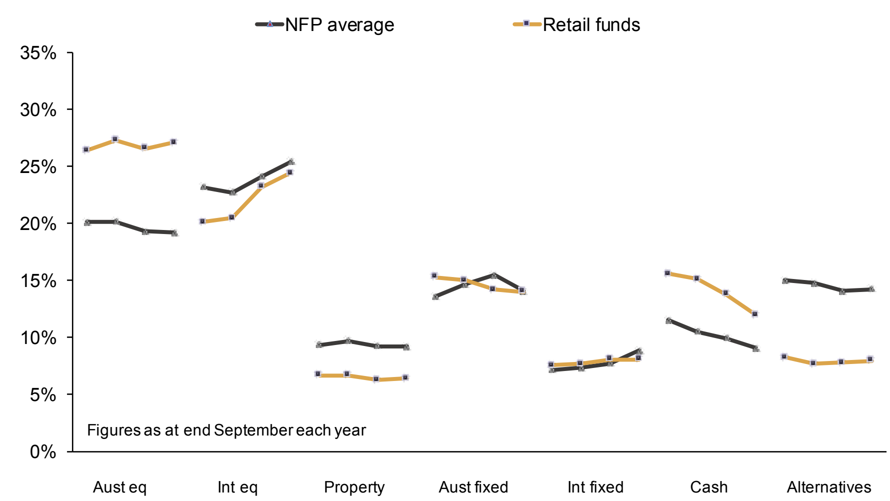
With the current political uncertainty and regulatory risk, investment risk is perceived as "high" for Australia, Pan adds.

Adding to this, the world's gaze will be on Australia when it elects its new Prime Minister by May 18. By that time, it would have its sixth Prime Minister in the last 12 years.

There will be a lot more attention paid by international investors on the upcoming Federal election, Randal Jenneke[03], head of Australian equities at T. Rowe Price says.

"Domestic investors live and breathe the domestic market and are on top of what is happening locally; foreign investors don't focus on it until it happens," he says.

Figure 1. Superannuation asset mix across funds and investment options



Rainmaker Information and APRA September 2018

> *In getting the asset class decision right, the underlying investments themselves are the secondary factor that influences final outcomes for clients.*
> **Julia Schortinghuis**

Starting out

Lighthouse Capital director and Certified Financial Planner Julia Schortinghuis[04] says Australian equities are an important source of income in portfolios, particularly now when interest rates globally are low.

"Trying to generate sufficient income from bonds and traditional fixed income sources is very difficult. So Australian shares are more important than ever as part of the solution for retirees to be able to generate reliable income streams."

Australia pays the highest average dividends among the largest economies, yielding 4.2% at the end of June 2017, according to Siblis Research. Italy, Portugal, Spain and UK pay about 3.5%.

Investors in late accumulation and retirement phase rely on regular income from their investments, Ausbil portfolio manager Michael Price[05] says.

Because the cash rates are so low (and have been for a long time) and equity yields are significantly higher, it makes sense that investors are increasingly looking at dividend-paying companies as income investments, he says.

"As our population ages further, the hunt for yield will only increase."

These two types of investors face two major risks that impact retirement savings: longevity and inflation.

"Equities, being businesses, can typically adjust for inflation in their business models by changing their prices.

"Moreover, in the long term, equities typically provide a higher level of return that can help offset the long-term wealth impact of inflation," Price says.

One aspect of investing in Australian equities Schortinghuis wants to emphasise is how to gain access.

She says as an adviser, it's important to consider clients' preferences to Aussie equities: are they seeking transparency or direct ownership?

"If it's the latter, what is the overall size of the portfolio that is being invested and therefore is it large enough from a portfolio construction perspective to manage the risk-adjusted returns in the portfolio? That's quite important."

Her practice generally operates a portion of portfolios in Australian shares under a managed antares

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04:
Julia Schortinghuis
director
Lighthouse Capital

05:
Michael Price
portfolio manager
Ausbil

06:
Richard Dixon
senior investment
manager
Antares

discretionary account, which she says is necessary to make adjustments that come from the investment committee and respond to corporate actions in a timely manner.

"Where direct ownership is not appropriate, we utilise other ways and means to get exposure, that's where we would use things like SMAs, exchange-traded funds, managed funds and the like."

Clients are typically mum and dad and their children. Intergenerational wealth, she says, is a strong feature of the practice.

When it comes to working with the children, there might be greater emphasis on other areas of their financial life such as paying off their mortgage and ensuring they having adequate insurance cover.

"We're not prescriptive. It's about delving into the client's preferences; what is their tolerance for risk; and finding the appropriate solution. It some cases, it could be an industry fund if that is appropriate," she says.

Depending on the client, actively managed Australian equities, ETFs, or managed funds or a combination could be suitable.

ETFs are a good way to manage tactical asset allocation, she says, particularly if going overweight in an asset class. "It's a good way to get a broad and reasonably priced exposure in the asset class to dial up or down."

Index concentration

Once upon a time, the ASX had a thriving food and beverage sector.

Lion Nathan was acquired by Japanese brewer Kirin, while Fosters folded into SABMiller, which was eventually taken over by Belgian firm Anheuser-Busch InBev.

The likes of Arnott's, Goodman Fielder and George Weston have also been acquired by foreign conglomerates, and whatever footprint these once Australian-owned companies left on the ASX now exist mainly in the past tense.

The overly concentrated Australian market is a function of growing banks and resource companies, as well as sectors disappearing, Tagliaferro says.

In the last 15 years, Australia has become a much more competitive place to do business, and earnings growth is much harder to find, he adds. "In the old days, when the economy grew so did profits, that's no longer the case."

He attributes high dividend yields and strong balance sheets to limited growth prospects Australian firms face.

"It's challenging for companies to grow and there are not many opportunities to use retained capital at the moment, which instead is paid out to shareholders."

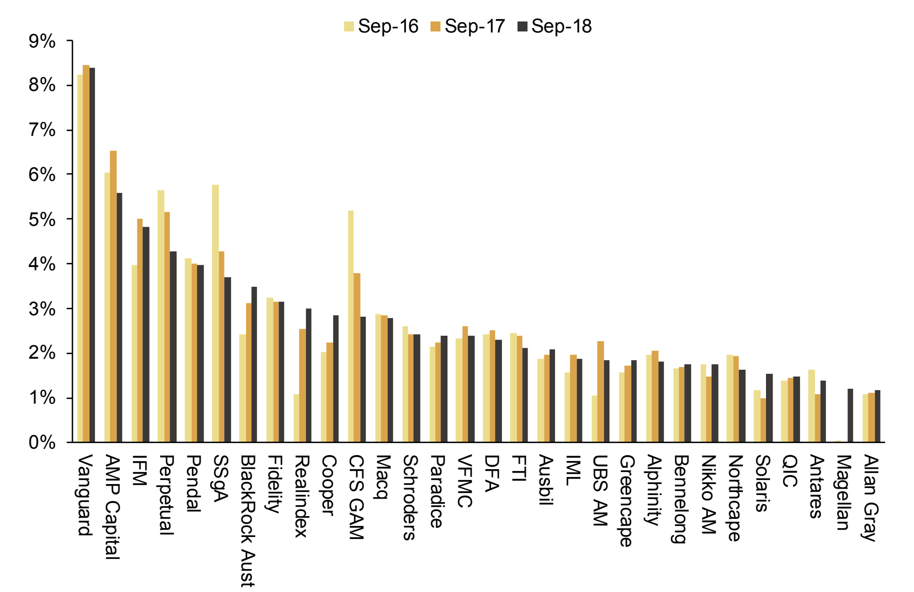
For an Australian company to be able to grow it has to either do one or a combination of the following: acquire, cut costs, win market share or expand offshore.

Tagliaferro names Aussie companies Brambles, Amcor, CSL, Sonic Health and Transurban as overseas success stories.

After managing the Antares High Growth Shares Fund for about 17 years, senior investment manager Richard Dixon[06] says deploying a long-short strategy is relevant in an over-concentrated Australian equities market.

This is because the local market is two to three times more concentrated at a size level than its global peers, meaning the top 10% of the stocks in the ASX make up half the market, he says.

Figure 2. Market share of Australian equities investment managers



Rainmaker Information September 2018

8% p.a.

Aussie equity returns over 20 years pre-gross up for franking credits.
Richard Dixon

The structure and concentration of the sectors makes it difficult to hedge sector exposures.

Dixon says for long-only managers overweight to a stock, it is hard to obtain a material hedge to a sector theme (see Figure 2).

"With the ability to go short, we can actively manage any sector, macro or style tilts in the portfolio. There are definite diversification and risk management benefits to it."

Shorting in basic terms, he explains, is having a $100 fund that invests in $100 worth of stocks.

"I can short sell up to $25 of stocks we don't own or we think will underperform or fall in value."

If the stock price moves sideways, proceeds can be used to invest in stocks that may rise.

"We've effectively broadened our opportunity set and magnified our view because it allows us to buy more of the stocks that we like."

This is typically called the 130-30 strategy, but Dixon's ratio is more in the 125-25 range.

That's investing 125% long and 25% short to net out to 100%, effectively coming to the same exposure as a long-only fund.

But realistically, the fund's short position varies between 10% and 20% on average, and diversified across 20 to 30 stocks, he says.

"There's a different risk profile to shorting and it needs greater risk management.

"If a fund manager gets a short call wrong, that exposure to that bad call is rising. If you get a long call wrong, that exposure is falling," he notes.

Instos and Aussie equities

Consolidation across sectors and incidentally the formation of oligopolies are a challenge for Australia, Equipsuper executive officer of investments Troy Rieck[07] says.

An active fund manager would want more choice between stocks, while consumers tend to lose in the long run because of oligopolies, he adds.

The $15 billion fund has mandates with six Australian equity fund managers, whose strategies range from low active risk management to very active.

In Australian equities, Rieck says the benchmark concentration plays a role in how he and his team think about mandate design.

"By having an active strategy, we think it's an asset class we can add value to compared to a pure index exposure."

Equip's merger with Rio Tinto, which finalised in June 2018, prompted it to reassess its investment model.

It now outsources all of its investment management function, though for some time about 35% was managed in-house.

Outsourcing day-to-day management allowed the team to focus on the top-down issues, such as asset allocation, portfolio construction and investment strategy, he says.

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07:
Troy Rieck
executive officer of investments
Equipsuper

08:
Daniel Young
head of equity distribution for Australia
Citi

Rieck says this is somewhat contrarian to what other funds are doing. "The fact that it's different to other funds is less important than the fact that it's fit for purpose for Equip members."

Equip also moved to 100% active in Australian equities.

There's a broad trend in the market to increase allocation to passive or index strategies, he says.

"We don't have a philosophical problem with passive strategies, but we are looking for higher returns and with Australian equities we can achieve that."

Rainmaker September 2018 figures show the local exchange-traded product market stood at $38.9 billion, comprising mainly of international equity (46%), then Australian equity (38%) strategies.

The Australian equity ETF market is dominated by wealth and retail investors, with a "smattering" of offshore ownership, according to Daniel Young[08], head of equity distribution for Australia at Citi.

A global investor interested in the Australian ETF market would want to gain exposure in a sector that isn't available in their geography or home country. For example, they might not have exposure to banking and resources.

While it is growing and continues to see inflows, it is still in its infancy compared to the US, Young says.

The truth about buybacks

Lately, there has been more off-market share buyback activity than usual in anticipation of the potential franking credit refund policy changes, says Pan.

Companies such as BHP, Rio Tinto and Caltex have recently undertaken off-market buy backs, whereby shares are typically bought back at a large discount of about 14%.

"Off-market buybacks generally occur through a tender process and allows the company to distribute surplus franking credits to shareholders," Pan says.

It is attractive to shareholders and beneficial for those who can utilise the franking credit, she adds.

On-market buybacks, which are conducted via a broker that purchases the shares on behalf of the company, also benefit shareholders, she says, due to the reduction in issued capital that improves earnings-per-share.

While the practice is not new, there is currently a wave of share buybacks engulfing public US corporations.

Last February, US senators Chuck Schumer and Bernie Sanders wrote an op-ed in the New York Times denouncing the "corporate self-indulgence" of buybacks.

Between 2008 and 2017, 466 of the S&P 500 companies spent about US$4 trillion on stock buybacks, equal to 53% of profits, they wrote.

"When a company purchases its own stock back, it reduces the number of publicly traded shares, boosting the value of the stock to the benefit of shareholders and corporate leadership," they said.

Both plan to introduce new legislation to prohibit a company from buying back its own stock unless it invests in workers and communities first, meaning they would like firms to pay workers at least US$15 an hour and provide seven days of paid sick leave.

Pan points out that share buybacks are not guaranteed to drive stock prices higher.

"Sometimes we might see an early impact from a buy back but the share price ultimately depends on the company's growth outlook, earnings and many other factors.

"We have seen companies engage on-market buybacks at what were considered attractive prices, only to see the share price collapse on different reasons – Alumina and AMP are two examples," she says.

Thematics at play

T. Rowe Price's Jenneke says the interim December 2018 reporting season was interesting and disappointing at the same time because only one sector saw an upgrade to earnings – resources.

"In many ways, it was perhaps the worst reporting season since the GFC."

Most funds performed well until September and faced an even tougher December quarter.

"While we didn't have a great December quarter like many of our peers, the fundamentals in terms of positions we hold are still attractive.

"Because we're active managers, we took advantage of the selloffs during the quarter to top up existing holdings and bring new strategies," he says.

That said the market was up 10% by early March.

The market bounce, Jenneke says, had little to do with reporting season rather concerns about rising interest rates here and overseas that have neutralized. Meanwhile fears that growth will decelerate are expected to stabilise.

One positive outcome from last reporting season is the increased dividend payouts and focus on capital management, he says, which is partly driven by potential excess franking credit changes.

Even though earnings were weaker than expected, dividends were an upside, he adds.

Dixon agrees that dividends were a key theme from the last reporting season, along with off market buybacks.

One long-term thematic for Antares that has been fruitful and generated alpha, Dixon says, are demergers.

One example is Treasury Wine Estate, which demerged from Fosters.

"In the packaging sector, we own Amcor and Orora, [which] was demerged from Amcor a few years ago."

Dixon says Australian equities have been a very strong asset class and consistent performer with about 8% returns per annum over 20 years.

This 8% is pre-gross up of franking credit benefits and a very attractive long-term return – not many markets have been able to deliver that, he notes.

The All Ords however, has yet to reach its pre-GFC peak of about 6760 compared to other countries such as the UK and US. The S&P 500 for instance, is trading nearly twice its pre-GFC level of about 2800 points.

Pan says it's important to note that Australia does not have a big IT sector.

"Consider how the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) have been driving performance – Australia doesn't have these stocks."

There are even parallels between the current tech push and the dotcom era where valuations were based heavily on 'eyeballs,' while the old economy stocks with solid earnings are left behind.

She says another influence is de-gearing among corporates in Australia.

During the GFC, REITs in particular were highly geared but it has been wound down. Now the household sector is highly geared and may put some brakes on the economy, she explains.

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> **Troy Rieck**

Uniqueness factor

Expert advisers and investors urge not to look at the Aussie equity market in isolation.

"We look across all of the asset classes," Schortinghuis says. "What we're seeing is increased volatility across the board even in the bond market where we normally don't see this level of volatility."

Focusing on which asset classes to overweight or underweight is key.

Schortinghuis stresses this investing principle with clients because she says the majority of return outcomes come from such decisions.

"In getting the asset class decision right, the underlying investments themselves are the secondary factor that influences final outcomes for clients."

If Equip's Rieck puts himself in the shoes of US, Japanese Chinese d European investors, one burning question they would ask is: what is unique in the Australian share market that cannot be bought anywhere else?

CSL for example, is a "once-in-a-generation firm" – but most companies can be replicated anywhere else in the world.

"That's a challenge we have here," Rieck says.

Local investors meanwhile will continue to be swayed by large dividend payouts and pocket franking credits and imputation credit refunds – double taxation benefits foreign investors aren't entitled to.

Somehow, this isn't deterring global inflows in Australian shares, given nearly half (45%) of the ASX is made up of foreign investors.

Even with these drawbacks, there's something about Australia that keeps pulling them in. **FS**