Investment Insights Paper

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December 2022

Live locally, invest globally: Diversifying equity allocations beyond Australia

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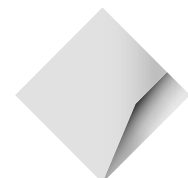
Public



‘Two sectors does not a portfolio make’

There is a phenomenon in the field of psychology called the ‘spotlight effect’, which describes the fact that people believe they are noticed by their peers, far more than what occurs in reality. The bias arises when our brain decides that since we operate at the centre of our own world, we must therefore be at the centre of other people’s world too. Easy enough to understand, yet hard to control. We can extend the concept to our national identity when travelling abroad too. How often are you surprised at how little our country is spoken of in the foreign press when overseas? Spend long enough out of Australia and it feels as though Australia doesn’t even exist!

To stretch the concept further, the author is also reminded of the ‘spotlight effect’ when it comes to investing in Australian equities. For example, whilst domestic investors and local media obsess over the performance of our ‘big four banks’ and Telstra, the average investor outside Australia pays very little to no attention to our domestic companies – even seasoned global fund managers. It is amazing to hear international fund managers struggle to even name our ‘big four banks’, let alone make an insightful comment! Besides, they have their own domestic companies and investment portfolios to keep them occupied. However, there is a catch for Aussie investors. Whilst global investors can afford to forget about Australian stocks and focus on themselves, Australian investors cannot afford to do the same. In other words, as Australian investors we must prove the ‘spotlight effect’ for our global investing peers correct – that is, we must always think of them, not us. So, let’s now shift the ‘spotlight’ away from Australia and explore why this is the case.

To illustrate the key concepts in our comparative discussion that follows, we have selected a number of indices which aggregate the largest global companies by market capitalisation by region. Notably, these indices also have domestically accessible exchange traded funds (ETFs) that closely track these indices.

Please note, the ETFs displayed in Table 1 below, as well as in other tables throughout this paper, are not intended to imply any recommendation or opinion about the named ETFs – they are displayed merely to support this fact-based discussion.

Table 1:

	Vanguard FTSE Europe Shares ETF	**Global X EURO STOXX 50® ETF**	**BetaShares FTSE 100 ETF**	**iShares S&P 500 ETF**	**iShares Asia 50 ETF**	**iShares MSCI Emerging Markets ETF**	**SPDR® S&P/ ASX 200 ETF**	**SPDR® S&P/ ASX 50 ETF** (shown for comparison)
ASX ticker	VEQ	ESTX	F100	IVV	IAA	IEM	STW	SFY
Index	FTSE Developed Europe All Cap Index	EURO STOXX 50	FTSE 100	S&P 500	S&P Asia 50	MSCI Emerging Markets	ASX 200	ASX 50
No of Stocks	1,360	50	100	500	50	1,400	200	50
Region	Developed Eurozone + UK	Eurozone + UK	United Kingdom	United States	Basket of Asian countries	24 emerging economies	Australia	Australia
% Asset in Top 10 Holdings	20	43	51	28	60	22	48	61
Average Market Cap (AUD billion)	49	113	71	255	156	48	34	59
P/E Ratio (trailing 12 months)	11	12	10	18	10	10	12	12

Source: Morningstar Direct, data per 30 September 2022. Above products are provided for illustrative and factual information purposes only.

From Table 1, we can make a few observations:

- All key global benchmarks are larger than the Australian market in terms of average company size.
- The comparative ETFs are generally less concentrated than the Australian indices, with fewer assets comprising the top 10 holdings of the ETF.

- Valuations were roughly similar on a trailing 12 months price to earnings ratio, except for the United States which was more expensive.

Table 2 now breaks down the country exposure obtained when investing in the same ETFs. Notably, not every company listed in a particular country will derive all its revenue from that country (for example, think of where Apple earns its revenue), so in **brackets** we also list the percentage of revenue derived from each country. To keep the table uncluttered, we used a minimum threshold of 5% in both cases.

Table 2:

Country of listing / (Revenue Exposure)	Vanguard FTSE Europe Shares ETF	Global X EURO STOXX 50® ETF	BetaShares FTSE 100 ETF	iShares S&P 500 ETF	iShares Asia 50 ETF	iShares MSCI Emerging Markets ETF	SPDR® S&P/ ASX 200 ETF
Australia							93% **(51%)**
China	**(9%)**	**(11%)**	**(13%)**	**(9%)**	41% **(47%)**	31% **(32%)**	**(12%)**
France	14% **(5%)**	40% **(7%)**					
Germany	12 **(7%)**	25% **(9%)**					
Hong Kong					12% **(6%)**		
India						16% **(12%)**	
Netherlands	6%	13%					
South Korea					21% **(7%)**	11% **(5%)**	
Switzerland	16%						
Taiwan					22% **(5%)**	14%	
United Kingdom	26% **(9%)**	**(5%)**	97% **(20%)**				
United States	**(22%)**	5% **(22%)**	**(27%)**	100% **(61%)**	**(16%)**	**(11%)**	**(11%)**

Source: Morningstar Direct, data per 30 September 2022. Above products are provided for illustrative and factual information purposes only.

From Table 2, we conclude that one must look beyond the country of listing when assessing key geographic exposures. The most obvious example of this is the S&P 500, where only 61% of revenue of constituent companies is derived in the United States. Similarly in Australia, only 51% of revenue of Australian domiciled companies comes from Australia! Nonetheless, the bottom line is we can see that earnings by geography becomes far more diverse once we diversify beyond Australia.

Another perspective to examine the diversification benefits of global ETFs is by breaking down the sector exposure. Before we begin, to show just how concentrated the Australian market is, Table 3 below shows the top 10 holdings of the ASX 200.

Please note, the companies displayed in Table 3 below are not intended to imply any recommendation or opinion about holdings in the named companies – they are displayed merely to support this fact-based discussion.

Table 3:

	Sector	Weight
BHP Group Limited	Materials	9.60%
Commonwealth Bank	Financials	8.40%
CSL Limited	Health Care	6.40%
National Aust. Bank	Financials	4.90%
Westpac Banking Corp	Financials	4.00%
ANZ Banking Group Limited	Financials	3.60%
Woodside Energy Group	Energy	3.30%
Macquarie Group Limited	Financials	2.90%
Wesfarmers Limited	Consumer Discretionary	2.40%
Telstra Corporation	Telecommunication Services	2.10%
TOTAL		**48%**

Source: Morningstar Direct, data per 30 September 2022. Above is provided for illustrative and factual information purposes only.

We can see that an investor in the ASX 200 will primarily be exposed to Financials, Materials and to a lesser extent Healthcare. In addition, we can see the Financials sector accounts for almost 50% of the top 10.

Now contrast this outcome with the sector breakdown of our ETFs in Table 4.

Table 4:

Sector exposure (%)	Vanguard FTSE Europe Shares ETF	Global X EURO STOXX 50® ETF	BetaShares FTSE 100 ETF	iShares S&P 500 ETF	iShares Asia 50 ETF	iShares MSCI Emerging Markets ETF	SPDR® S&P/ ASX 200 ETF
Energy	7	6	14	5	0	6	7
Materials	6	11	12	3	3	9	23
Industrials	16	13	10	8	2	6	6
Consumer Discretionary	12	18	6	11	19	13	6
Consumer Staples	12	8	21	7	0	6	5
Healthcare	16	7	12	15	2	4	10
Financials	16	16	16	11	25	23	30
Information Technology	7	14	1	26	32	18	3
Communication Services	3	2	4	8	16	9	4
Utilities	4	3	4	3	1	3	1
Real Estate	2	1	1	3	2	2	6

Source: Morningstar Direct, data per 30 September 2022. Above products are provided for illustrative and factual information purposes only.

Table 4 reveals that the aggregate ASX 200 has a 30% exposure to Financials and a 23% exposure to Materials. By contrast, only Emerging Markets and the Asia 50 come close to Australia in terms of percentage contribution in Financials. No other market is close to the contribution of Materials. In addition, in the sectors where Australia has minimal exposure such as Consumer Discretionary, Information Technology and Industrials, we observe meaningful sector weights in the global ETFs. Coupled with the fact that Australia has one of the lowest average market capitalisation's (per Table 1), we can see that the average ASX 200-only investor is missing out on access to many leading global companies and taking significant sector risk with respect to the demand drivers for Materials (i.e. commodities) and Financials (the health of Australia's 'big four banks').

Australia's sector concentration in both Materials and Financials also means that generally speaking our market will be relatively more cyclical than peers. Commodities and financials both tend to be procyclical, doing better when economic activity is high (e.g. higher construction, more credit being issued) and underperforming when economic growth is weaker. This naturally offers limited diversification to varying economic conditions.

Finally, the dispersion of sector weights in most global ETFs are far more evenly weighted than the ASX 200 Australia. For instance, Vanguard Europe's largest sector contribution is 16% and has five sectors with a weight greater than 10%. Similarly, the FTSE 100 has six sectors over a 10% weight. Australia has three sectors over 10%. Thus, not only does an investor get access to different sector exposures by moving offshore, but they are taking less concentration risk sector-wise in almost every other market.

How does performance compare?

Table 5:

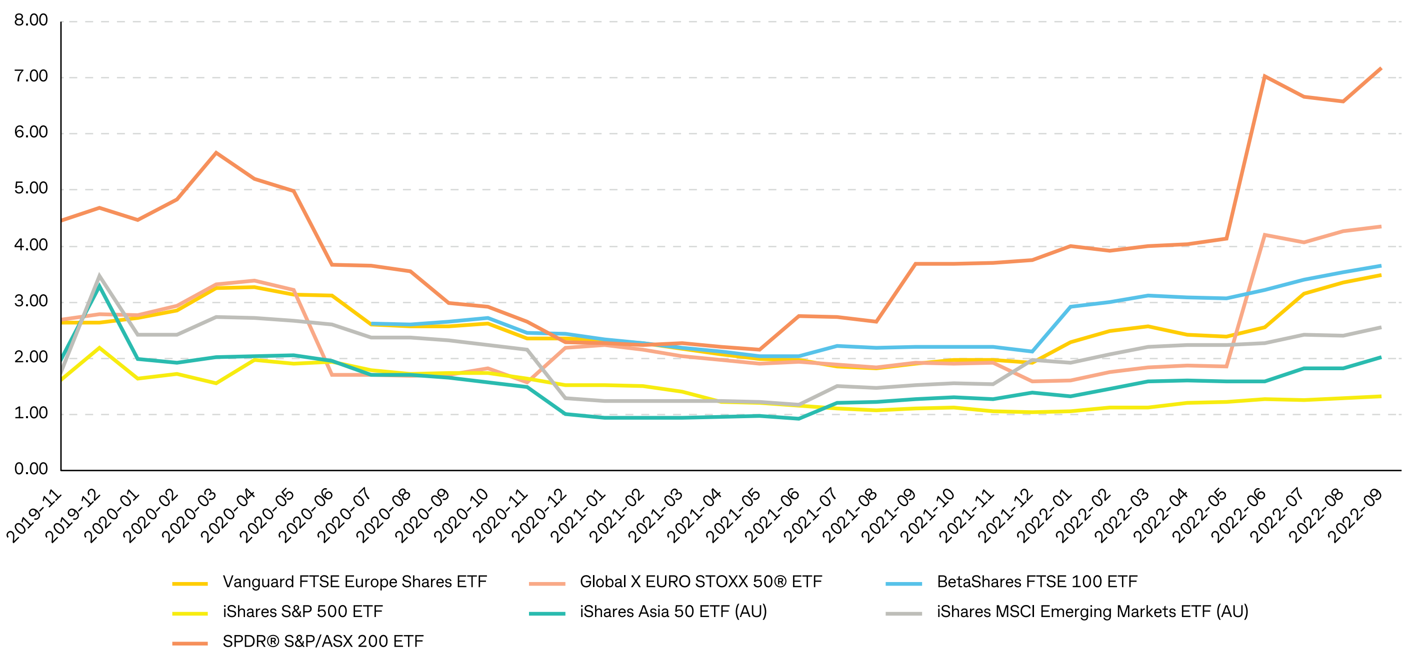
Performance (%) and volatility (%) to 30/09/22 in AUD	Vanguard FTSE Europe Shares ETF	Global X EURO STOXX 50® ETF	BetaShares FTSE 100 ETF	iShares S&P 500 ETF	iShares Asia 50 ETF	iShares MSCI Emerging Markets ETF	SPDR® S&P/ ASX 200 ETF
1 Year Return	-18	-20	-6	-5	-27	-21	-8
3 Year Return	-1	-2	-1	10	-2	-2	3
5 Year Return	2	1	Not available	13	2	1	7
Volatility 1 Yr	13	13	11	14	16	11	17
Volatility 3 Yr	15	17	13	13	15	12	19
Volatility 5 Yr	13	15	Not available	13	15	12	16

Source: Morningstar Direct, to quarter end 30 September 2022. Above products are provided for illustrative and factual information purposes only.

With a maximum of five years, the performance time horizon in Table 5 is relatively short and does not include a full economic cycle. However, the key point is to highlight the significant difference in both returns and volatility. Undoubtedly geographic and sector diversity has an impact!

Do dividends and franking credits make a difference for Australian investors?

Chart 1 below depicts the oft-mentioned benefit that the ASX 200 generates a greater income than its global counterparts. For many, income generation is an important investment objective. Nonetheless, it should not be an overriding input into the decision making process of where to invest. Consider how much of the superior yield in the ASX 200 is derived from the economic fortunes of our banks and mining companies. The ride has been great for a while as mining profits have boomed and defaults across banks have been low, but can one rely on that continuing forever?



Source: Morningstar Direct, data to 30 September 2022

The other benefit often called out is franking credits, which are credits for tax already paid by Australian companies on earnings that are then paid out as dividends. Franking credits ensure shareholders are not taxed twice on these same company earnings. Everyone eventually pays tax on the 'grossed-up earnings' at their marginal rate. This system is especially appealing to those on tax rates below the corporate tax rate, such as superannuation investors.

Taking an approximate average from Chart 1 above, assume the average ASX 200 dividend yield is 4%. We can gross up the dividend yield of the Australian market (4% divided by 0.7, assuming a 30% company tax rate) to 5.7% and state that franking provides a 1.7% uplift. However whilst an additional 1.7% might be attractive, markets are far more efficient than many expect. Research from a 2012 Vanguard paper suggests the following:

> *"Investors place a higher value on dividends paid by companies that have imputation [franking] credits attached. This is evident in the domestic market place. Usually after a company's dividend is paid, the share price drops further than the cash payment of the dividend due to the added value placed on the imputation credit. Our analysis of the dividend payments from one of the largest companies by market cap in the Australian market, National Australia Bank (ASX Code: NAB), found that out of 64 dividend payments since 1987, when dividend imputation was introduced, the ex-dividend price fell by more than the cash dividend 69% of the time. Of the declines, nearly half were of an amount greater than the grossed-up dividend, the other half being an amount slightly less than the grossed-up amount. Similar results were obtained from analysis of other major Australian companies paying dividends that have an imputation component."*
>
> Source: "The role of Australian equities and the impact of home country equity bias", Vanguard, December 2012

What this passage suggests is that franking credits are largely 'priced-in' to Australian companies; that is, investors realise there is a benefit to franking credits and adjust the share price accordingly, whereby it falls more than the declared dividend. Thus, it is highly likely that even though 1.7% looks significant, the market will adjust for this uplift. In addition, given all Australian companies do not pay fully franked dividends, the 1.7% benefit would be much lower in reality.

Accordingly an investor should question whether the additional yield and franking credit benefit justifies taking the geographic, sector and volatility risk we have discussed above.

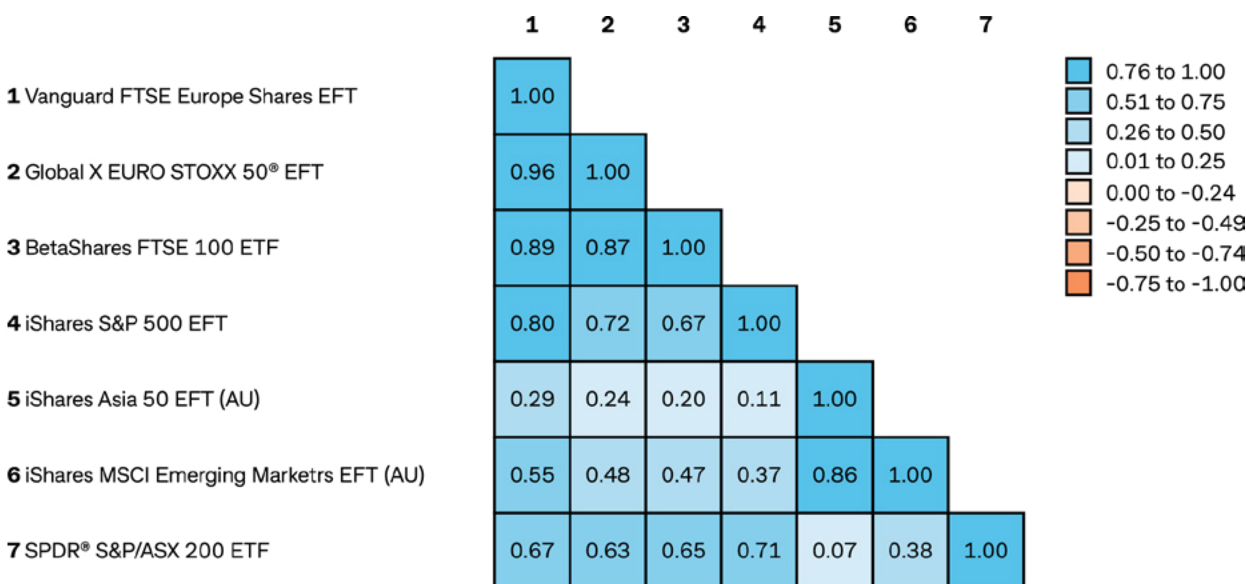
In summary

In this paper, we have seen that diversifying beyond the ASX 200 can have numerous advantages. Namely, we found offshore markets offer greater relative diversity to a larger cohort of companies, both by number and market capitalisation, and better diversity across sectors and domiciles. By contrast, Australia's benchmark offers a narrower investment exposure with particular exposure to the Financials and Materials sectors. In addition, whilst the dividend yield and franking credits are of some benefit, any such advantages should be weighed against the aforementioned factors. Indeed this paper is certainly not suggesting to have zero exposure to Australian equities, and we see many self-managed superannuation fund investors with high allocations to cash and Australian Equities. However while a reasonable allocation to Australian Equities does make sense for Australians with a high proportion of their expenses in Australia, as we have explored above, there are clearly benefits from a diversification and risk basis to consider when allocating to international equities.

In closing, Table 6 below observes the correlations between the different ETFs over the last three years, where a correlation of one means the assets move in lockstep and a correlation of zero means there is no relationship between the markets. Here we see Australia has the lowest correlation to the Asia 50 (0.07) and the largest to the S&P 500 (0.71). Whilst correlations change through time and across different time periods, it is most pertinent to observe that the correlations between the ETFs vary widely, where lower correlations are beneficial for diversification purposes overall.

Table 6:

Correlations for the 3 years to 30 September 2022



	1	2	3	4	5	6	7
1 Vanguard FTSE Europe Shares EFT	1.00						
2 Global X EURO STOXX 50® EFT	0.96	1.00					
3 BetaShares FTSE 100 ETF	0.89	0.87	1.00				
4 iShares S&P 500 EFT	0.80	0.72	0.67	1.00			
5 iShares Asia 50 EFT (AU)	0.29	0.24	0.20	0.11	1.00		
6 iShares MSCI Emerging Marketrs EFT (AU)	0.55	0.48	0.47	0.37	0.86	1.00	
7 SPDR® S&P/ASX 200 ETF	0.67	0.63	0.65	0.71	0.07	0.38	1.00

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