Morphic
Perspectives Series

September 2016

WHY YOU NEED MORE GLOBAL EQUITIES IN YOUR SUPER FUND

Decades of Australian shares beating global markets are over. Don't let your retirement travel plans pay the price.

Change Creates Opportunity

Morphic
Asset Management

INTRODUCTION

You open the papers daily to hear about the rise of a new superpower and the collapse of old empires. Your friends talk about the opening of new markets globally and of free trade and travel. Your country is perfectly positioned to provide the food to fuel this growing demand with ample room to expand for cattle and crops. Your fellow citizens are amongst the richest in the world: five times richer than the nearest large neighbour (regarded as more of a holiday destination than a serious competitor) and 50% higher than the country from which many of your citizens originated. In short – your country is on the cusp of great things.

You could read the above and think of Australia. Indeed you'd be forgiven for thinking that: expecting the neighbour to be Indonesia and the UK to be the country of origin.

In fact the story above refers to Argentina in 1909, with Brazil and Italy being the neighbour and source country respectively.

Argentina is a sad story and a tale of blown opportunities. A country endowed with both natural resources and new population that has been stuck in the slow lane for 100 years, racked with recurrent inflation and instability.

So why is this relevant to you as a Self Managed Super Fund (SMSF) trustee? Because when it comes to protecting your wealth over the long term, there are many things that can go wrong in a manner in which you had not anticipated, such as a collapse in your home country's terms of trade coupled with a succession of poor governments.

The hidden dangers in an Argentine pension portfolio in 1909 might have come from too narrow a dependency on local assets compounded by currency risk.

In response to some questions from a number of SMSFs, we have put together these thoughts on why we think it is incredibly important for SMSFs to look offshore for their investments to protect their future retirement plans.

GLOBAL EQUITIES ARE OUTPERFORMING AUSTRALIAN EQUITIES

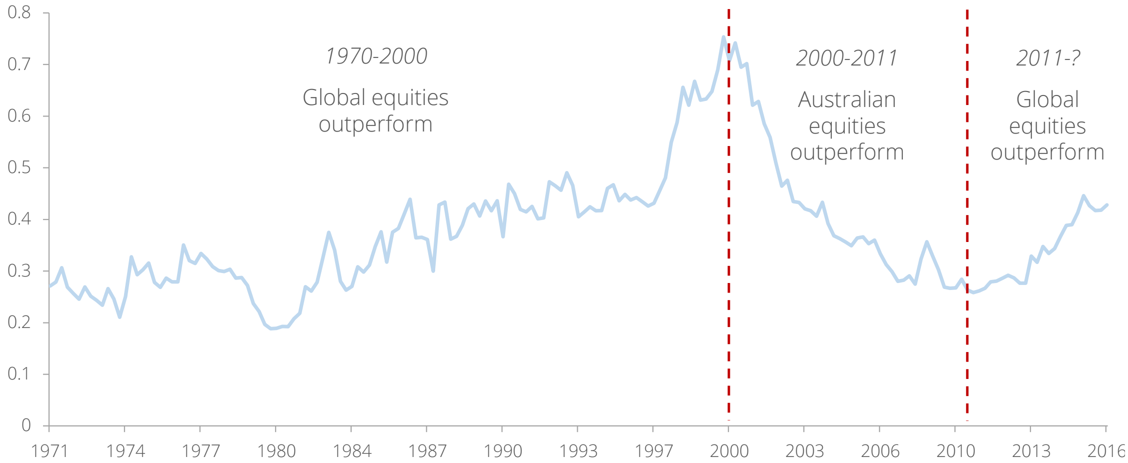
"A first-rate organizer is never in a hurry. He is never late. He always keeps up his sleeve a margin for the unexpected."

Arnold Bennett

After a decade of stunning performance by Australian shares, a clear break in the trend started in 2010 as can be seen in **Figure 1** below.

Figure 1 - Long term performance of Global vs Australian equities

MSCI World Index vs All Ordinaries Index, AUD, 1971-2016

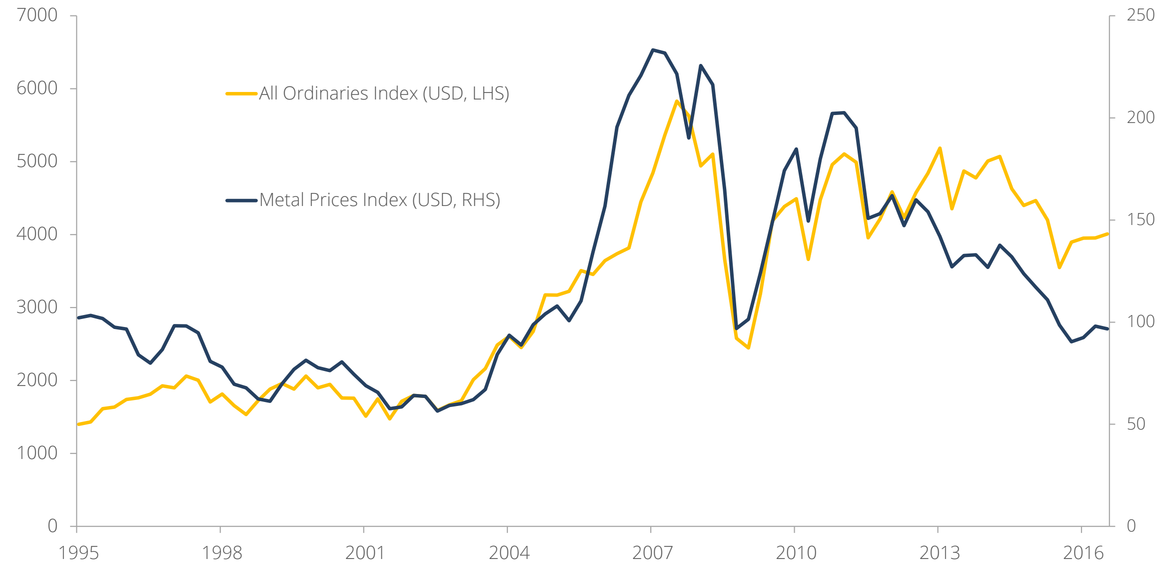


Source: Morphic Asset Management, Bloomberg

There are good macroeconomic reasons for that. Chinese booming demand for resources in the Noughties has normalised and spending on investment (in infrastructure, property and machinery) is set to decline in the next decade. (see **Figure 2 and 3** below). This is not to say the "China story" is over, just that there will be different drivers of growth. Indeed, the Morphic Global Opportunities Fund holds investments in Chinese companies set to benefit from progressive modernisation and the growing middle class.

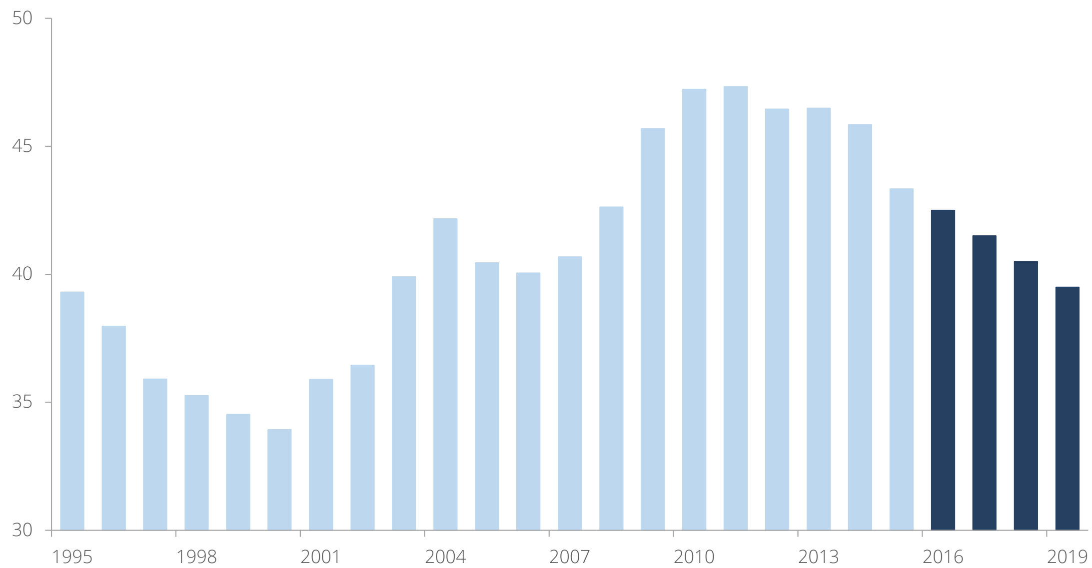
Figures 2 & 3 - Metal prices drive Australian stock market but China's demand is declining

Figure 2 - Industrial Metals Index vs All Ordinaries Index
1995 - 2016



Source: Morphic Asset Management, Bloomberg

Figure 3 - China Investment % GDP
1995 - 2019



Source: Morphic Asset Management, Bloomberg

GLOBAL EQUITIES ARE A GOOD DIVERSIFIER FOR AUSTRALIAN STOCKS

"In investing, what is comfortable is rarely profitable."

Robert Arnott

Part of successful portfolio construction is to diversify your risks. Most investors see this in terms of having some equities along with cash, bonds and property. Yet it would seem that the SMSF community hasn't taken the next step of looking at currency risks.

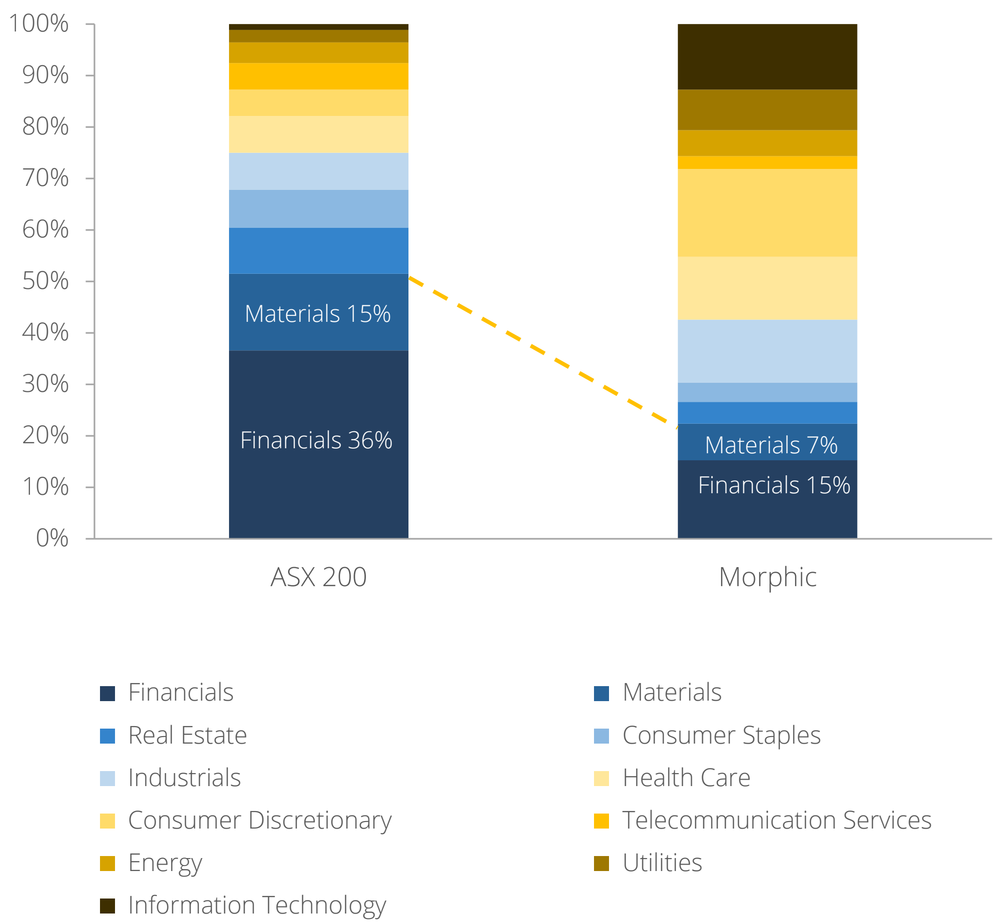
By adding some international funds to your SMSF, you can also gain exposure to sectors which are under-represented in Australia. The Australian stock market essentially represents an exposure to banks and resource companies, with this combination representing almost 2/3 of the Index (see **Figure 4** below).

Global equities provide greater diversification across all other sectors, with important investing opportunities in information technology, healthcare, industrials, consumer discretionary and to other currencies.

Global equities are also good for "de-risking" a typical portfolio of Australian stocks. One way to look at this, is to examine the returns of Global equities when Australian shares lose in value. Since inception (August 2012), Morphic Global Opportunities Fund, for example, has outperformed the All Ordinaries Index in all of the ten worst months for the Australian stock market (see **Figure 5** next page).

Figure 4 - Global equities are more diversified than Australian shares

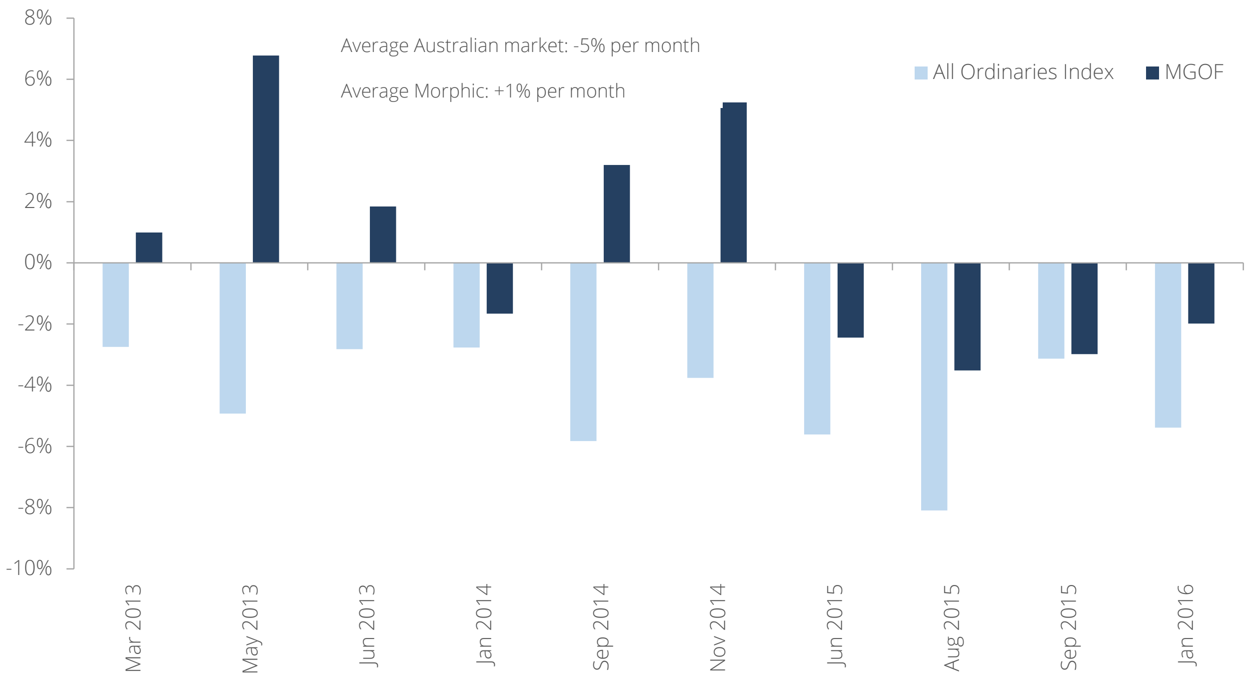
All Ordinaries Index sector diversification vs Morphic Global Opportunities Fund, 2016



Source: Morphic Asset Management, Bloomberg

Figure 5 - Morphic outperforms Australian shares when market goes down

Morphic Global Opportunities Fund vs. All Ordinaries, Ten worst local market months since August 2012

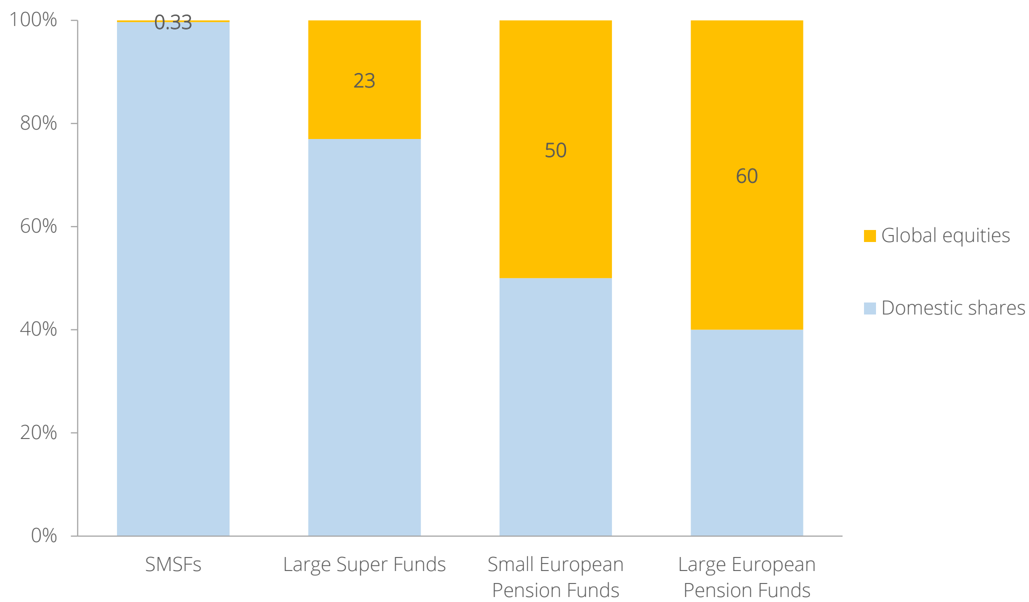


Source: Morphic Asset Management, Bloomberg

Perhaps the most startling thing about SMSFs' currency allocation strategies is that they don't seem to have any! ATO figures below in **Figure 6** put average international equity holdings at just 0.3% of SMSF asset allocations. To say that the SMSF sector is taking a large bet on Australia and the continuation of the current trends in China, would be an understatement.

Figure 6 - Pension funds allocations to Domestic vs. Global Equities

2013 or latest available



Source: Morphic Asset Management, ATO, Mercer

A recent international survey of retirement plans suggests that SMSFs need to increase the investment in Global Equities to about 14% of their portfolio just to match the average of international savers.

INTERNATIONAL ASSETS ARE A GOOD MATCH FOR FUTURE EXPENSES

"Paris is always a good idea."

Audrey Hepburn

We're not sure about you, but one of our aims in retirement is to spend time travelling to parts of the world that we had always wanted to visit, but never had the time – what with four weeks annual leave and then the trips with the kids that came after that.

Australia over the last 10 years has enjoyed one of the highest exchange rates in real terms, since either 1950 or 1890 depending on how it is measured. As such most people have become accustomed to travelling with their Australian Dollars buying a good holiday. We would just point out that this period has been the exception, rather than the norm over the last 50 years.

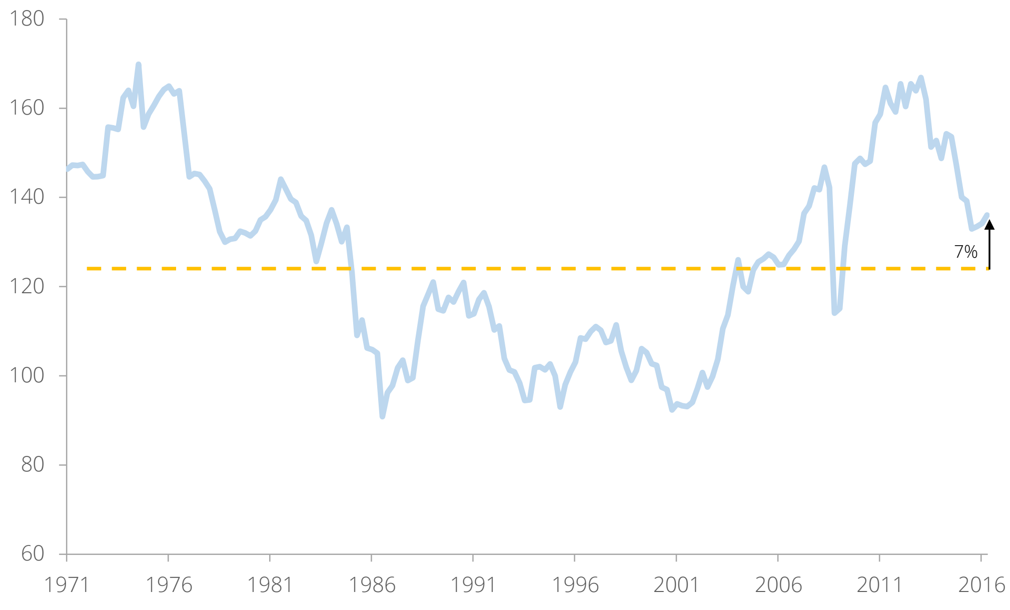
We believe it is entirely possible that the next 10 to 20 years could see the Australian dollar fall by 30 to 40% against the standard basket of Australia's trading partners, which is represented by the so called "Trade Weighted Index" or TWI charted below (**Figure 7**). Investors who only have Australian assets will need these to appreciate by at least this amount to just match the currency fall. Historically, times when the Australian dollar is weak have also often been times when the Australian stock market gives lacklustre returns.

By looking offshore, if SMSF investors find one day the outlook at home less rosy, they will be safe in the knowledge that their global purchasing power for those overseas trips they always planned in their retirement hasn't ended in tears!

SMSF trustees should also consider how much money they spend each year on imports. The most obvious example is imported cars. Then they should think how their lifestyle would be effected if the Australian dollar falls sharply and they have no offsetting foreign assets and income to pay for these things.

Figure 7 - Australian dollar is at least 7% overvalued by historical standards

Australian Dollar Trade Weighted Index, 1971 - 2016



Source: Morphic Asset Management, Minack Advisors, Bloomberg

HOW TO GO ABOUT INVESTING OVERSEAS

"When preparing to travel, lay out all your clothes and all your money. Then take half the clothes and twice the money."

Susan Heller

If SMSFs are to overcome their home bias and change their asset allocation strategy, they will have to choose whether to invest direct in a few stocks or choose a managed fund or the Exchange Traded Fund (ETF) route.

Even the biggest Australian Super Funds mostly outsource the investment process to specialist fund managers.

Many SMSFs take a direct investing stance when it comes to Australian equities and probably feel qualified to pick on a few big international stocks, like Microsoft, Coke and Apple, and feel this might meet risk and return challenges.

But this would ignore a number of investing rules. This is more oriented towards investing based solely on a company's past reputation without necessarily delving very deeply into its future prospects. Nor does it take into account some of the macroeconomic risks, like which are the best economies and sectors to be investing in at any given time, microeconomic risks like comparative stock performances and differing individual currency trends.

If SMSFs do recognise the risks of stock picking themselves they will need to take the managed fund route.

ABOUT THE AUTHORS

JACK LOWENSTEIN

Managing Director & Joint CIO, Morphic Asset Management

Before founding Morphic Asset Management in 2012, Jack was previously Deputy Chief Investment Officer at Sydney based global equity manager Hunter Hall with responsibility for risk management and portfolio construction. As a stock picker Jack has invested in a variety of markets and sectors, but developed in-depth knowledge of markets in Asia-Pacific region as well as global finance and resources sectors.

CHAD SLATER, CFA

Joint CIO, Morphic Asset Management

Chad co-founded Morphic Asset Management in 2012. He was previously a Portfolio Manager and Head of Currency and Macroeconomics at Hunter Hall for five years. He has worked at BT Investment Management, Putnam and the Federal Treasury over his 15 year career.