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Private View

June 2014

Investment Strategy

Where Is Your Real Global Equity Exposure?

Classifications are meant to help investors work out their underlying investment exposures. With particular respect to global equities, the exposure is not always exactly what it seems.

Over the past couple of years, we have witnessed Australian investors increase their level of investment in overseas assets, particularly equities. With overseas markets having favourable macro-economic conditions, a strong Australian Dollar, a relatively fully-valued local share market that is very concentrated and relatively small, investors have looked offshore in search of better returns.

Some investors have sought an indirect exposure through locally-listed companies that have overseas operations: such as Twenty First Century FOX, CSL, James Hardie, Henderson Group, Westfield, Computershare, QBE and Resmed amongst others. These carry some leverage to improving macro conditions offshore and / or a weaker Australian Dollar.

However, most individual investors have focussed on a more direct exposure through specialist managed funds and the fast-growing range of listed Exchange-Traded Funds (ETFs) and Listed Investment Companies (LICs). Direct ownership of international shares has also been growing, with local trading platforms gradually becoming more sophisticated.

When making their first few forays into global equities, many investors have targeted specific country or regional investments, or large global brands / companies. Given the sheer depth of global markets and the increasing global nature of commerce today, the underlying economic exposures (i.e. where profits are generated) typically extends far beyond local borders.

Let's take the United States and Europe as an example, the two strongest performing regions over the last couple of years for unhedged Australian investors. Investors have been attracted to the improving macro backdrop for both regions and while managed funds have certainly noticed a big uptick in investment inflows, a lot of money has flowed into passive strategies i.e. index funds and ETFs. Those investors may be surprised to look at the tables on the right, highlighting where the companies listed in those markets actually generate their revenues.

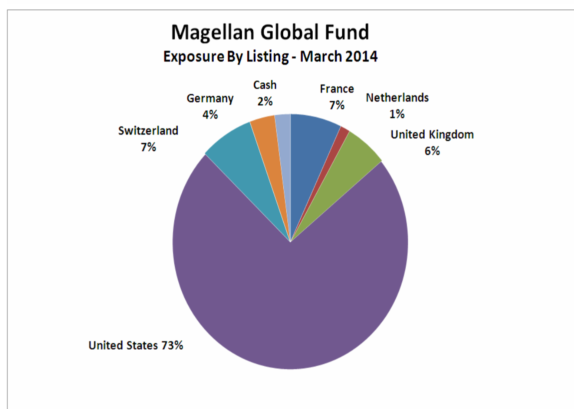
Investors buying a passive European exposure through the STOXX 600 index may be surprised that nearly half of the revenue generated by some of the largest companies listed in Europe, actually lies outside of the region itself! The same story could be applied to the US – the locally listed ETF which tracks the performance of the S&P 500 Index (ticker: IVV) has been a popular investment in recent years, but again, just over half the revenue generated by businesses listed there actually comes from within the country itself. The exposure is further skewed within the energy, material, technology and industrial sectors.

Investors in global managed funds should also be aware of this when reviewing their portfolio positioning. The Magellan Global Fund, managed by Hamish Douglass and his team in Sydney, has generated a lot of interest from local and global

European Indices Sales Exposure

Index	Domestic	Europe (ex Domestic)	Americas	Emerging Markets	Asia	Others
FTSE 100 (UK)	21%	26%	22%	15%	10%	7%
FTSE 250 (UK)	46%	15%	13%	7%	11%	8%
CAC40 (France)	28%	33%	13%	8%	8%	9%
DAX (Germany)	27%	30%	19%	4%	14%	6%
MDAX (Germany)	28%	33%	11%	10%	12%	5%
MIB (Italy)	26%	30%	23%	10%	5%	7%
IBEX (Spain)	23%	33%	12%	22%	4%	6%
SMI (Switzerland)	0%	30%	31%	5%	27%	8%
OMX (Sweden)	8%	40%	21%	10%	15%	6%
AEX (Netherlands)	7%	37%	29%	22%	3%	2%
OBX (Norway)	24%	32%	11%	12%	16%	5%
STOXX 600 (Europe)	NM	53%	18%	8%	11%	11%

Source: Worldscope via Datastream, Goldman Sachs Global Investment Research.



S&P 500 Revenues by Geography (Mkt Wgt)	U.S.	Europe	Asia	Other
Energy	38%	18%	7%	38%
Materials	42%	24%	12%	22%
Info Tech	44%	14%	19%	23%
Industrials	57%	17%	14%	12%
Health Care	60%	17%	6%	16%
Cons Staples	63%	7%	3%	28%
Cons Disc	73%	10%	3%	14%
Financials	80%	8%	7%	5%
Utilities	96%	0%	1%	3%
Telecom	100%	0%	0%	0%
S&P 500	**55%**	**13%**	**8%**	**24%**

Source: RBC Capital Markets Research, Capital IQ

investors due not just to its robust performance over the last 5 years, but also the fact that it carries a very large exposure to U.S equities (~73%). However, when analysed

Investment Strategy

Where Is Your Real Global Equity Exposure? (continued)

from the perspective of where its underlying investments generate their revenue – the story is very different, as the charts show. Holdings may be predominantly US listed, but revenue is far more global.

Many investors in index funds and ETF investments may not be fully aware of the underlying exposure of the indices they seek to replicate. Reporting remains at a basic level from many passive and active investment products. Investors in actively-managed strategies should gain comfort from the fact, however, that they have teams of analysts and portfolio managers who can identify, analyse, manage and exploit these opportunities or risks.

In switching our focus to industry sectors, while sector exposures superficially tend to capture the economic sensitivity of companies a lot better than simple regional / country measures, again the devil can be in the detail. Let's take a quick look at the most universally adopted system of industry classification on a global basis - the Global Industry Classification Standard (GICS).

Many investors will be aware of the GICS 10 main sector groups - financials, energy, materials, industrials, consumer staples, consumer discretionary, healthcare, technology, utilities and telecommunications. Sitting beneath these 10 level one groups (GICS1), however, are 24 industry groups (GICS2), 67 industries (GICS3) and 147 sub-industries (GICS4).

The dynamics of companies listed within the same GICS1 categories can be very different. For example, capital intensive industries such as aerospace and industrial machinery production will perform independently of professional services firms, yet both are labelled as 'industrial' companies. The consumer discretionary sector includes industries as diverse as car manufacturers, clothing retailers and restaurants. Many examples like this can be made within each of the GICS1 sectors.

Confusion can also lie on businesses such as Mastercard and VISA – are they financial companies or technological platforms? GICS classify them as financial. In a world that is becoming increasing reliant on digitisation and technology, where will the line be drawn in the future? Does this have implications for indices or benchmark-aware fund managers?

Unfortunately, too much focus from investors is reflected only on whether a portfolio is overweight or underweight that broad sector level, rather than looking at more in-depth measures such as the industry groups found at the GICS2 level.

Fund managers and ETF providers vary in their ability to articulate their detailed positioning to their investors, with some providing very little granularity. There are exceptions however: Magellan classify businesses under their own industry headings, as per the chart on the right.

Having discussed considerations around regional and industry mix, what implications or impact does this have on a portfolio? Is it important?

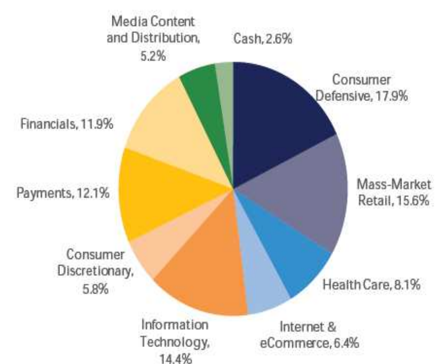
In the short term, investors may well gloss over some of the finer details of an investment in an attempt to chase price momentum and generate quick profits, an environment where more fundamentally-biased managers may lag in terms of performance. Examples include the rally in US and European equities (despite no statistical correlation that links short-term economic growth with share market appreciation**). Index funds or ETFs tracking countries and sectors can be popular, cheap and relatively efficient investments for short-term trading opportunities like this.

Over the long term, investment performance is far more likely to be tied to stock selection, based on fundamental investment building blocks such as profitability, solvency, valuation and cash flow generation.

A thorough assessment on the underlying economic drivers of any investment is crucial in this regard, although short term performance is not always correlated to this approach, as performance of some global markets have proved in recent times! Active managers biased to this approach tend to be better positioned than index funds.

By JBWere

Industry Exposure by Source of Revenues[5]



** '*Reports of the death of equities have been greatly exaggerated: explaining equity returns'*, Ben Inker, GMO LLC, Published 8 October 2012

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