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The difference between international shares and international currencies

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Most investors think about investing in global equity markets and global currencies as the same thing. Are you in, or are you out? Prefer local Australian assets, or prefer the added diversification of larger markets and reserve currencies? What is the right currency hedging strategy?

Instead, currencies and global equity markets should be considered differently. We believe that holding a portfolio of assets that satisfies our Quality and Value screens produces more sustainable returns.

- Quality in company earnings means cash earnings through the cycle with little use of leverage. Morningstar Equity Research refers to these companies as having an economic moat.
- Quality in currency means investing in countries where the economics are going the right way – expansionary growth in a low inflation world.

Today in 2015, economies are diverging after a long period of central bank-inspired monetary stimulus. Japan and Europe still have the monetary policy accelerator firmly pressed down, while the United States and United Kingdom are preparing to apply the brake.

Challenge 1: The US equity market makes up over 50% of world indices, so in buying global equity products, investors generally automatically receive a high weighting to US companies.

When building portfolios, Ibbotson has followed a long-term valuation framework to achieve sustainable returns. We believe that the US equity market is overvalued, and that the potential for long-delayed wage growth will affect company profitability in all but the highest-quality companies. On the other hand, Japanese equities appear relatively cheap on a long-term valuation basis, the addition of microeconomic reform from 'Abenomics' increasing the attractiveness of some Japanese companies. We don't paint with a broad brush, though – it's important to use country-specific tools such as listed ETFs or specialist investment managers to gain exposure to those areas which present good value and robust investment opportunities to achieve the outcome you want.

Outcome: Significant value added through low US equity exposure and high Japanese equity exposure.

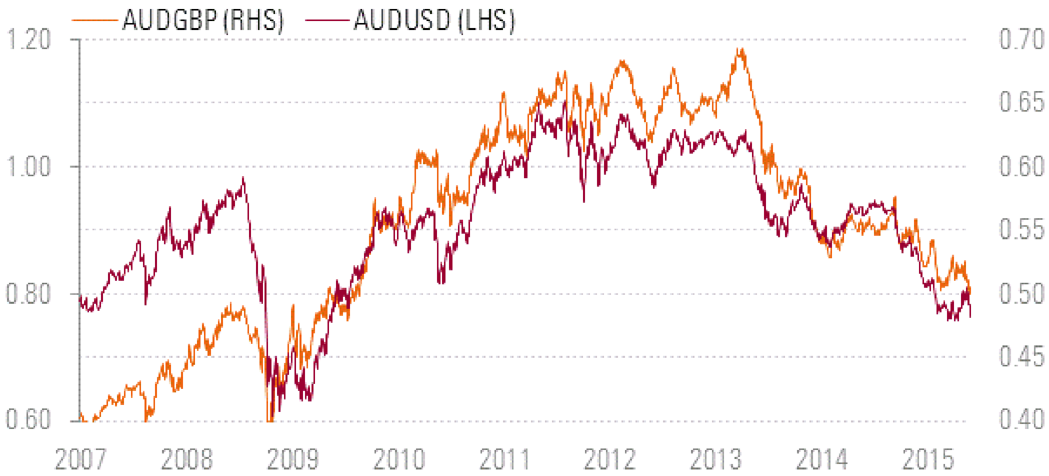
Challenge 2: For Australians, the US dollar and UK pound sterling are currencies that offer significant appeal. On the other hand, we believe that the Euro is being devalued, and our current strategy is to avoid this currency. In many global equity products, the European equity market represents around a quarter of the portfolio, while the UK equity market is less than 10%.

We all know that memories can be short-term. An investing condition called 'anchoring' means that we all use recent experience and extrapolate this into the future. Who can remember how much the Australian dollar was worth pre-GFC? One Australian dollar bought around US 80 cents and 48 UK pence even as the great commodity boom fired up.

Track forward to nine months ago, and while the commodity fires were fizzling out, one Australian dollar bought 89 US cents. BUY! Track forward further to April 2015, and in the midst of uncertainty over the result of the UK election and fears of deflation, one Australian dollar bought 53 pence. BUY!

More recently, the extraordinarily low Australian capital expenditure numbers signal that the commodity cycle has well and truly slowed down, political uncertainties in the UK have abated with David Cameron's majority, while the ongoing uncertainties about Greece's place within the European Union continue to impact our view of the Euro.

Outcome: Significant value added through dynamic positioning in the US dollar, pound sterling, and Euro not linked to global equity market positions.



Summary:

1. Holding foreign currency in Australian portfolios helps smooth portfolio volatility at critical phases of the investment cycle

2. The attractions of specific country currencies and equity markets are different

3. Use specialist ETFs and derivative instruments to pick out the currencies and direct securities that meet strict quality and value based criteria

4. Ibbotson's multi-asset portfolios have contributed over 20% of their objective-relative outperformance in the last nine months, through an ASX-listed US dollar ETF purchased in October

2014, and then swapped for a UK pound sterling ETF in April 2015 in the midst of pre-election uncertainty.

"It is impossible to produce superior performance unless you do something different from the majority." Sir John Templeton