The role of Australian equities and the impact of home country equity bias

Australian investors have a stronger home country bias than many other developed countries. This bias equates to an overweighting of around 70% relative to Australia's market capitalisation, which only represents around 3.5% of the global equity market.¹

While the tax and performance benefits associated with our dividend imputation system are two distinct advantages of holding a high Australian equity holding, Vanguard’s mean-variance analysis highlights some of risks and diversification issues inherent in this strategy.

Why do Australians have such a high home country equity bias?

There are a number of factors that contribute to Australia’s home country bias. Some, like better return expectations, familiarity, currency concerns and lower investment costs, are consistent across other markets. Others like dividend imputation and superannuation are unique to Australia.²

Dividend imputation

Australian investors place a higher value on companies that pay dividends with imputation credits attached to them. This can be witnessed by investors’ behaviour following the payment of dividends, when share prices typically drop more than the cash value of the dividend.

Dividend imputation credits can provide a significant boost to performance for Australian investors. Franking credits currently add around 1.4% to Australian share yields, based on the current dividend yield of 4.4% for the S&P/ASX 300, which rises to 5.8% when grossed up.³

¹ MSCI World Index in Australian dollars.
² Hathaway, Neville, Bob Officer, 2004 "The Value of Imputation Tax Imputation Credits", Capital Research.
³ Australian Financial Review, ASX data feed as at 31 October 2012.
Growth in superannuation

Australia’s superannuation market has grown rapidly since the introduction of the Superannuation Guarantee in 1992 and now represents the fourth largest market in the world. Self-managed super funds comprise around one-third of Australia’s AUD1.3 trillion in superannuation assets as at 31 March 2012.

Growth in superannuation and our ageing population are contributing to the increasing importance of taxation status in the investment decision making process. Tax can make a big difference to the net returns an investor receives.

Franking credits are particularly attractive to superannuation investors as they can increase the value of the dividend due to the lower tax rate on superannuation investments. The difference between the investor’s tax rate and the company tax rate of 30% can result in a tax refund or reduced amount of tax payable.

For example, SMSFs in the pension phase with a 0% tax rate would receive a full refund on any franking credits. A dollar paid as a franked dividend is worth more, as the investor receives not only the dividend, but a full cash fund of the franking credit as well.

It’s important to remember that a company’s level of franking can be reduced for offshore earnings where Australian company tax does not apply.

Other factors

Past research studies highlight some other reasons for home country equity bias, including:

- Investors are typically more optimistic about their own economies and markets.
- Investors generally feel more comfortable with their home market.
- Corporate governance practices and investors’ perceptions of companies’ accountability.
- Investors feel that they achieve sufficient global diversification by investing in multinational companies. This is contrary to historical evidence, which suggests that a company’s performance is more highly correlated to its domestic market than the geographical location of its operations.
- Perceptions of higher risk due to currency fluctuations.

Magnitude of home country equity bias

Figure 1 shows the percentage weighting of domestic investment in domestic securities to the percentage weighting of domestic investment in global securities for Australia, the US, Canada and the UK - the larger the size of the bubble, the higher the overweighting to domestic equities relative to global equities.

As you can see, Australia has a much higher home country bias than other countries, particularly in terms of its relatively small market cap weighting in the global market.

Figure 1
Relative magnitude of home country equity bias

Notes: The IMF’s Coordinated Portfolio Investment Survey was used in conjunction with market-cap information to determine domestic and foreign investment. The MSCI All Country World Index (ACWI) was used to represent the world equity-market portfolio. Country weights for domestic equities were represented by the MSCI USA Investable Market Index (IMI), the MSCI UK Investable Market Index, the MSCI Australia Investable Market Index, and the MSCI Canada Investable Market Index.

Sources: Vanguard Investments Australia Ltd analysis based on International Monetary Fund’s (IMF) Coordinated Portfolio Investment Survey (2011), Barclays Capital, and Thomson Reuters Datastream as at 31 July 2012.

5 Australian Bureau of Statistics (ABS).
How much exposure to Australian equities?

While a market cap weighted approach suggests an allocation of 3.5% to Australian equities, local investors are unlikely to invest most of their equity portfolio in global markets due to the inherent benefits of the local market.

Vanguard analysed four portfolios with different weightings to equities and fixed income using historical minimum-variance analysis. The results are shown in Figure 2 below.

Over the full period between January 1990 to June 2012, a 100% equity portfolio containing 52% Australian equities and 48% global equities would reduce portfolio volatility by 2%. Over the 10 years ended June 2002, optimum results (reduction of portfolio volatility by 1.9%) were achieved with a 48% weighting to Australian equities and 52% weighting to global equities. While for the 10 year period to June 2012, the historical minimum-variance reduced portfolio volatility by only 0.8% and suggested a split of 36%/64% for Australian and global equities.

While the mean variation portfolio approach is backward looking and is very dependent on the time period selected, the analysis suggests a much higher weighting to Australian equities than a market cap approach across all periods surveyed.

Correlations, diversification and volatility

Diversifying across global markets offers different risks and rewards. Australian equities have typically exhibited positive correlations with both global equities and Australian listed property. However, the degree of correlation changes over time.

Figure 3 shows the correlation between Australian equities, global equities (hedged and unhedged), global fixed income and Australian listed property. Correlations between Australian and global equities have increased since 2008 due to the higher volatility, which has impacted most asset classes following the global financial crisis. More recently, correlations have fallen highlighting the positive benefits of diversification.
The volatility of international equities (unhedged in Australian dollars) has been lower than Australian shares. Hedged international shares have been more closely correlated to Australian equities due to their higher volatility. Previous studies have found that the hedge impact, or relative return, has been positive for Australian investors, producing a higher average annual return but with higher volatility.

**Investment costs and liquidity**
Investing in global equities typically has higher costs than investing in Australian equities. There are higher expenses associated with investing offshore such as implementation costs, currency management, taxes and market-impact costs.

**In summary**
- The tax and performance benefits associated with the dividend imputation system are the major factors supporting Australia’s home country equity bias.
- Mean variance analysis suggests Australians are exposing themselves to more risk than they should. Results support a 52% weighting to Australian shares over 20 year periods and 36% over 10 year periods.
- Diversification across both country and sector is still relevant. The volatility of global equities (unhedged in Australian dollars) has been lower than Australian equities.

This paper includes general information and is intended to assist you. The volatility of asset classes – rolling 36 months

Sources: S&P, MSCI and UBS. Correlations are 3 year rolling volatility. Data covers the period 30 June 1992 to 30 June 2012.

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