CIO MONTHLY NOTE

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Local and global equities – getting the blend right

The long-term outlooks for both global and domestic equity markets remain positive, following the very strong rally of the past six months. The market has priced in improved global economic conditions and higher commodity prices, along with the subsequent increase in earnings.

While global growth will continue to increase steadily over the next few years, markets have already priced in further earnings upgrades for the short term. Given the recent strong performance of equity markets some consolidation is also expected.

It's also important to reflect that forecasts for the emerging market and developing economies will continue to outpace advanced economies with China's structural growth story continuing for the decade ahead.

At a domestic level, Australian market valuations are not cheap compared to historical levels as, after a very positive half-year reporting season, the market is now pricing in the well anticipated earnings recovery.

It's a similar story in the US, with equity market valuations also above long-run historical benchmarks, thanks to anticipated stimulus and improved economic conditions. The US reporting period currently underway will be a good indication of the momentum of US earnings.

It's important to consider the different but complimentary aspects of both local and global equities. While Australian equities receive consistently higher dividends, global equity markets provide investors with access to growth opportunities that are under-represented in the local market, and have less concentration in certain sectors.

One of most obvious examples is the IT sector, which makes up just 1.3% of the Australian market but 16.1% of the MSCI All Countries World Index. The growing middle classes in many emerging economies will continue to drive growth for healthcare, technology and consumer staples, which will make them a larger component of the global investment universe in years to come.

The benchmark index for Australia – the ASX/S&P 300 – comprises just 300 companies, compared to the 2500 companies in the MSCI All Countries World Index.

Thus, the local large cap equity market offers investors a good consistent dividend stream, more so than global equities – yet those global equities offer lower yields but more growth opportunities in different sectors. The key point is that global and domestic equities are complimentary, and offer opportunities to blend and diversify portfolios.

Comparing a typical domestic equity growth fund and a global growth fund the differences in outcomes become even starker.

The Australian share fund delivers a dividend yield around 4.5% net (5.8% grossed up), compared to 1.5-2.0% yield for a global growth fund. In contrast, the global growth fund targets more growth and has earnings (EPS) growth of 15.5% 1 year forward compared to 4.5% for the Australian share fund.

And let's not forget that it's all about the long run, with domestic equities averaging a return of 13.9% per annum since 1959. So, hold on tight for a possible rocky ride ahead, and remember - you're in it for the long haul.

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