Investor Insights: Searching for growth outside of Australian equities

A collaboration between Colonial First State Global Asset Management and the University of Western Australia Business School

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Contents

An explanation of the Equity Preference Index

In June 2012 we launched the first edition of Investor Insights, a report which analyses the Equity Preference Index (EPI). The EPI is a joint collaboration between Colonial First State Global Asset Management (CFSGAM) and the University of Western Australia Business School and dates back to its inception in December 2005, meaning that we now have nine years of data.

The EPI is a proprietary measure of investor sentiment, calculated using Colonial First State managed fund flow data for non-advised investors. It looks at investors' overall moves in and out of equity-based managed funds and switches between asset classes. The focus on non-advised clients allows the clearest exposure to discretionary decisions by investors based on their view of the market and how confident they feel about future returns.

The EPI is an accurate measure of investor behaviour and sentiment compared to existing survey-based measures that are frequently referred to when discussing investor sentiment. Investor sentiment has always thought to be a key driver of equity market performance and has frequently been studied by academics. Investor sentiment has been underutilised as a market tool, but can provide us with an accurate measure of behaviour and what this could mean for equity returns going forward.

We sought to develop an independent tool to allow us to understand how investors were behaving at different points in the market cycle. This might also help us determine when investors' preference for equities may turn around; especially post the Global Financial Crisis. At that time – and frequently thereafter – one of the most common questions we are asked is 'when can we expect to see money flow back in to equities'?

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Disclaimer

Summary

- In this edition of Investor Insights, our research shows that even in a rising market, investors have reduced exposure to Australian equities in recent months.
- This contrasts to increased exposure to equities over 2013 and occurred despite very low deposit rates and the compelling income and growth attractiveness that Australian equities can provide.
- Despite weak equity preference for Australian equities, investors do appear to be willing to take on risk in their search for growth; particularly through exposure to investment property and global equities.
- There is also a shift in terms of how investors are saving and investing in growth assets – with further increases in self managed super fund (SMSF) balances amongst younger investors and a preference for owning shares and property directly.
- However despite these subtle moves, overall the EPI does indicate that investors aged between 35 and 49 years of age do have a low preference for equities and remain most at risk of not meeting retirement objectives unless changes are made. Women in this age group are most vulnerable due to low super balances and the gender pay gap.
- On a state basis, there has been a clear unwinding of holdings in equities in Western Australia (WA), which would be largely attributed to the fall in the iron ore price, job cuts and loss of confidence in the outlook.
- New South Wales (NSW) and Victoria (VIC) over the whole of 2014 experienced a sharp fall in equity preference with a clear link between this and strong house price appreciation.
- In this report there is a special breakdown in equity preference between Australian and global equities. This shows that when the Australian dollar fell below parity against the US dollar in 2013, across all age groups there was a clear and strong increase in allocation to global equities which has largely been maintained into 2015.

The investor backdrop – equity market performance and the global economy

This edition of Investor Insights analyses the EPI data from 1 June 2014 to 31 March 2015.

This nine months period was positive for Australian shares, with the S&P/ASX200 Accumulation Index increasing by an impressive 13.1%, though the price only measure was up 9.2%, demonstrating the income benefit of Australian shares. Volatility increased sharply over the period, with sharp falls in the months of September (-5.4%/mth) and November 2014 (-3.3%/mth) and then gains in January (+3.3%/mth) and February (+6.9%/mth). These moves were driven by a range of factors including the end of quantitative easing in the US, geopolitical concerns, inconsistent Australian economic data and sharp commodity price falls, particularly in oil and iron ore.

Global equity markets, as measured by the MSCI World Index, outperformed in Australian dollar terms, driven by falls in the Australian dollar (AUD). The index returned 4.8% in USD terms over the nine-months period, and rose 22.8% in AUD terms. The US market was a clear standout, with the S&P 500 returning 14.7% in USD terms and 34.5% in AUD terms. The US economy performed well in 2014, although slowed in 2015 due to a range of factors. Earnings results were positive and the equity market continued to be supported by zero interest rate policy by the Federal Reserve (Fed) and the global search for yield led by excess savings and low investment.

Volatility increased over the period, as measured by the Chicago Board Options Exchange SPX Volatility Index (VIX). The index averaged 15.2% over the nine-months to March 2015, compared to 13.77 in H1 14 and 14.25 in all of 2013. The increase in volatility did appear, as shown in the next section, to deter retail investors over the period from equities as an asset class. Although as detailed later in the report, this hides significant divergence between preference for Australian versus global equities as well as a move into investment property.

Major economic and market themes to emerge over this period included:

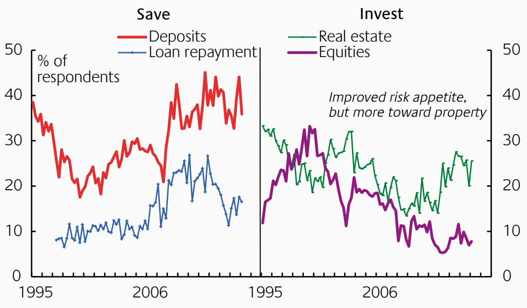
- The Reserve Bank of Australia (RBA) retained its ultra-accommodative monetary policy settings throughout the second-half of 2014 before easing the official cash rate to 2.25% in February 2015. Although outside the time period of this report, it is also worth noting that the RBA did cut rates again in May 2015 to a record low 2.0%.
- The Fed ended its quantitative easing program in October 2014, which had been in place in its current form since September 2012.
- The European Central Bank (ECB) cut its main refinancing rate to 0.05%, and its deposit rate to -0.2% and began an aggressive and expanded asset purchase program in March 2015 (announced in January 2015). Combined with the Bank of Japan's announcement in October 2014, this further highlights the excess supply of funds looking for income, pushing up asset prices.
- Government bond yields fell due to concerns about global growth, expectations of quantitative easing (QE) in Europe and a weaker inflation outlook as commodity prices fell. For some investors this raised the attractiveness of equities as the bond yield/earnings yield /dividend yield differential widened.
- The AUD fell 19% against the US dollar over the period. US dollar strength was a major theme to emerge, with the US Dollar Spot Index rising 19% over the nine-months to March 2015.

Investor Insights: what are investors thinking?

There are a number of surveys available to gauge investor sentiment, providing an indication of the preferred place for savings by investors.

The Westpac/Melbourne Institute Consumer Confidence survey continues to highlight the relative preference for property over equities and continued demand for deposits despite low deposit rates. There also remains a reasonable preference for loan repayment.

Chart 1: Consumers preferred use of savings



Source: Westpac/Melbourne Institute, Datastream, Citi Research.

A second source of investment trends can be found in comments contained in the March edition of the RBA's Financial Stability Review. The RBA noted that household finances are not really a cause for concern, with existing borrowers taking advantage of low interest rates to pay down debt more quickly than contractually required. The RBA notes "the aggregate mortgage buffer – as measured by balances in offset and redraw facilities – has risen to 16% of outstanding loan balances" (more than two years' worth of scheduled repayments at current interest rates). Households are also saving more than pre global financial crisis (GFC) levels. While this is positive in terms of the state of household finances, some of these moves could be reducing the potential to grow assets to save for retirement, especially when coupled with low cash deposit rates.

A survey, organised by the Australian Investors' Association (AIA) and FNArena, of 494 investors as at January 2015, showed that 14% of investors were bullish, 61% neutral and 25% bearish. This compared to 30%, 60% and 10% respectively as at July 2014, indicating sentiment fell. Comments contained in the survey suggested there was a cautious outlook for Australian equities driven by valuation concerns, unsustainable policies by central bankers, political uncertainty and property valuations.[1]

All three sources suggest investor sentiment remains fragile, with investors concerned primarily with income generation in a period of low deposit rates.

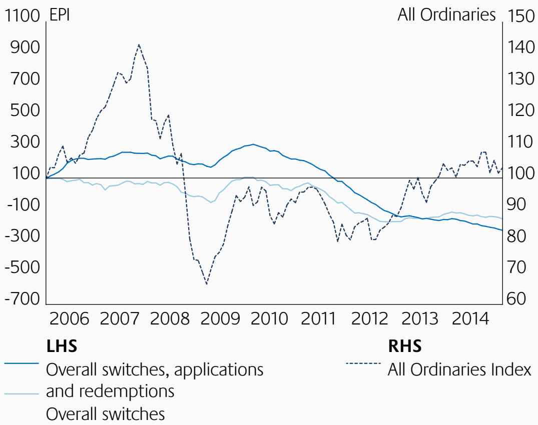
Footnote:
1. http://www.investors.asn.au/assets/media-releases/2015/MR-InvestorSentiment2015March.pdf

The EPI retreated by 40 pts to (-22%) in the December 2014 half-year and a further 11% (26 pts) in the March quarter 2015, and follows on from declining preference for equities in the June half-year.

The additional equity market volatility experienced over the period added to the weakness in preference for equities. The worst two months for equity preference were November and December, and follows sharp falls in the equity market in September and November. This also coincided with a time of additional volatility as commodity prices fell heavily and global growth concerns peaked. What is surprising is that preference for equities did not improve despite stronger returns from equities in the first quarter of 2015.

Overall there is clear evidence of a definite increase in risk aversion across all investors. This is manifesting itself through a number of ways: low bond yields, the creation of large cash stockpiles by both investors and companies and a marked preference for dividend yield.

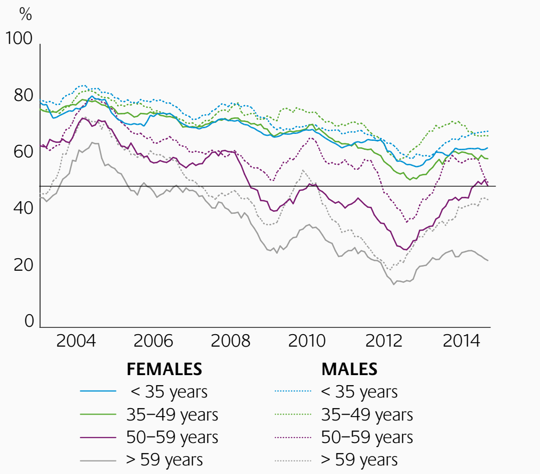
Chart 2: Equity Preference Index Aggregate and switches



Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 March 2015. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

By definition, the aggregate EPI considers the equity components of: (i) new inflows (applications); (ii) outflows (redemptions); and (iii) the net equity component of existing flows in and out of investment options (switches) derived from Colonial First State data for non-advised investors. These historical outcomes from the inception of the Index back in December 2005 are depicted in chart 2.

Chart 3: Equity preferences in new applications



Source: UWA's Business School and CFSGAM as at 31 December 2014.

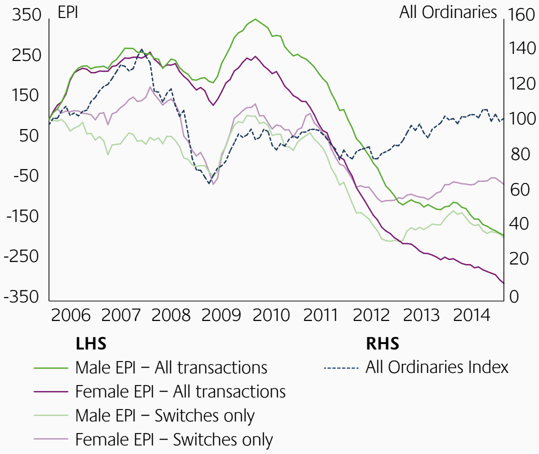
While overall equity preference has been weak in 2014, the choices of new investors can be instructive to gain a gauge of overall investor sentiment. The chart above presents the proportion invested in equity of every dollar of new money (applications) from December 2005 through to December 2014. The lines show a 12 month rolling average.

For new applications, as per existing investors, equity preference is positive for under-35 year olds, driven in this instance by males. New investors in the 35–49 year old age group had marginally negative equity preference for the six months to December 2014, driven by both genders. For those aged 50–59 years old, new funds devoted to equities fell, driven by males while female preference rose. In the oldest age group, 59 years and older equity preference fell, with negative preference of females outweighing positive preference amongst males.

Equity Preference Index by gender

As part of our research, we also split the EPI by gender. This analysis continues to reveal differences between males and females in terms of overall equity preference. These outcomes are shown in chart 4.

Chart 4: Equity Preference Index by gender Aggregate and switches

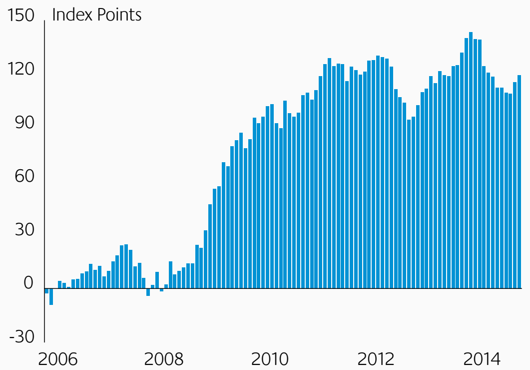


Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2014. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

In the December half-year 2014, the aggregate EPI, which includes both applications and redemptions, fell for both males (-27%) and females (-20%). It was a weak half-year for equity preference across the board with both males and females behaving in a similar way.

However there remains a large differential between overall equity preference between males and females, which commenced during the GFC and has been maintained since. It seems that females' attitude to equities was permanently altered during the heavy losses and volatility of the GFC and has not recovered despite improved returns and low deposit rates over recent years. Chart 5 demonstrates the growing differential between male and female equity preference and suggests behavioural biases have increased since the GFC.

Chart 5: Gap between male and female equity preference index

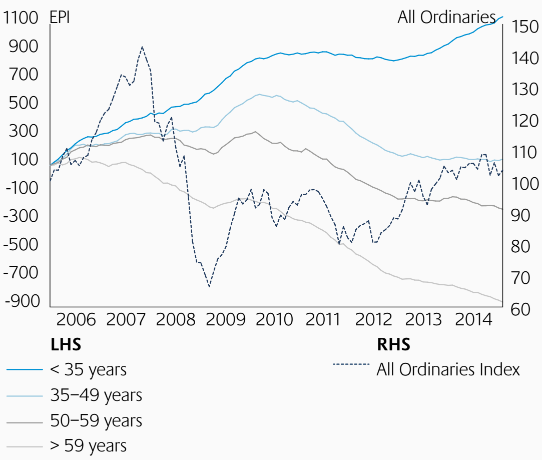


Source: University of Western Australia, CFSGAM. Data to 31 December 2014.

By age

The remarkably strong impact of age on appetite for investing in equities has been noted in previous EPI updates. Across the age groups, we continue to see divergences between the four sub-sectors as depicted in chart 6.

Chart 6: Equity Preference Index by age
Aggregate



Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2014. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

Since 31 December 2005, the EPI for investors younger than 35 years old has consistently remained positive or neutral at worst, and has continued to reach new highs, finishing December 2014 at 1051pts, up 8% over the six months to December 2014 and 17% over 12 months.

However this is where the rising preference for equities over the period finishes. In the three older age groups, preference for equities was negative across both six and 12 months and was particularly prevalent in the 50–59 year old age group. In this age group, preference for equities fell 24% over the six months to December 2014, and fell a sharp 73% over the 12 months to December 2014. This investor group must be seeking alternative growth and income returns elsewhere because according to our data, it has not moved into low risk cash options.

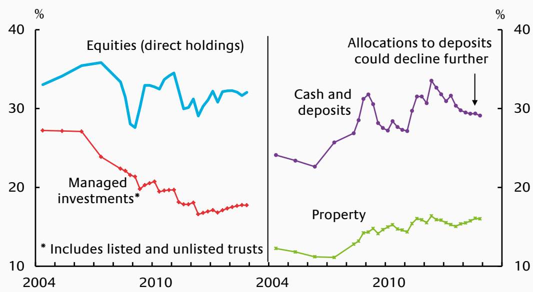
A high-level analysis of SMSF data from the Australian Tax Office reveals the possible answer. SMSF holders are becoming younger. At the end of December 2014, 29% of SMSF holders were aged between 35–44 years of age, versus just 11.2% two years earlier. While in the 45–54 year old age groups, it is now 32.5% compared to 22.8% two years earlier, and in the 55–64 year age group it is just 20.4% versus 33.4% two years earlier.

This could help explain the lower equity preference. Within the SMSF data provided by the ATO, over the two years to December 2014, the largest increase in holdings has been in listed shares (+28%), residential real estate (+25%) and overseas shares (+42%).

Age range	Dec–14	Dec–13	Dec–12
< 25	1.40%	1.10%	1.00%
25–34	11.30%	4.00%	3.40%
35–44	29.00%	12.70%	11.20%
45–54	32.50%	23.90%	22.80%
55–64	20.40%	32.30%	33.40%
>64	5.50%	25.90%	28.10%

This analysis confirms some of the changes we have identified in the EPI; equity allocation has been falling, but it suggests that these funds are being redeployed into residential and commercial property.

Chart 7: SMSF allocations



Source: ATO; Citi Research.

Incidentally, in exit surveys conducted by Colonial First State, the most common reasons cited for withdrawals are personal reasons such as buying a home or investment property and a move to a SMSF.

Other results from the EPI indicate the 35–49 year old age group showed a slight decline in preference for equities, falling 1% over the six months period, and a 3% fall over the 12 months to December 2014. This age group continues to exhibit very cautious behaviour towards equities. The GFC appears to have had a strong impact on their investment behaviour, due to the erosion of their savings and likely earnings potential in their prime wealth-building years. This result, however, masks the gender bias evident when we break down male versus female equity preference in the next section.

The oldest group, over 59 years of age, as expected, showed a fall of 9% in preference for equities which continues to be explained by redemptions that outweigh applications and switches for this cohort. The "generation gap" in attitude to risk remains, as evidenced by the 16% decline in equity preference by the oldest age group over the 12 months to December 2014. However with life expectancy on the rise and people working later in life, we may observe some changes to the equity bias in this age group over time.

By gender and age

The dominant influence of behaviour is clearly evident when we look at the EPI by gender and age. The rankings and the degree of differences between the age groups have largely been the same historically when we review males and females separately.

However, over the past 12 months we are seeing curious results between females aged between 35 and 49 and males of the same age group and the preference for equities in males aged between 50 and 59 years of age.

Charts 8 and 9 provide more in-depth analysis of equity preference by gender and age.

Males

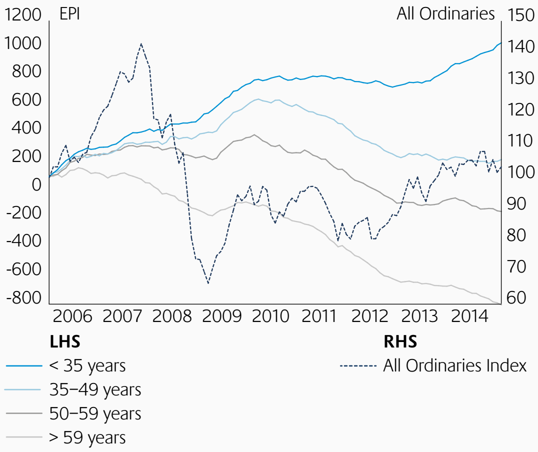
As chart 7 indicates, males under-35 years of age have continued to increase their preference for equities after bottoming in October 2012. The EPI for this group rose by a further 10% in the six months to December 2014 and is now up 43% from its trough in October 2012.

The 35–49 year old age group EPI showed a positive preference for equities in the six months to December 2014, after a falling preference over the start of 2014. Preference for equities rose 4% in the half, but was still negative over the whole of 2014, falling 5%.

The sharpest change in equity preference was in the 50-59 year old male age group, with preference falling 32% over the six months to December 2014 and an outsized 158% for the 12 months to December 2014. As discussed above, there has been an increase in this age group moving to SMSFs, as well as purchasing investment property, with a focus on Sydney and Melbourne. Over the six months to December 2014, lending for investment property rose 16%, compared to loans for owner-occupiers which rose just 1.7%. This is discussed further in the state-based section.

Males aged over 59, saw equity preference fall 11% in the six months to December 2014 as is roughly expected for this age group currently and consistent with moves post-GFC.

Chart 8: Equity Preference Index by age
Male: Aggregate



Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2014. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

Females

Breaking down the data for females by age once again highlights the different dynamics that are at play within this cohort.

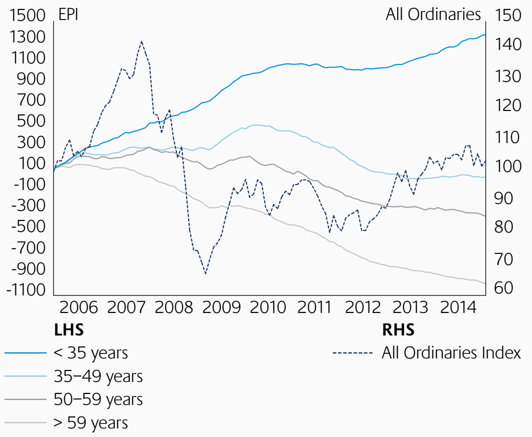
As chart 9 illustrates, females under-35 years of age (+5%/half-year) have continued to maintain a significantly higher and gradually increasing preference for equities compared to older females. This trend has been consistent since the GFC.

In previous editions, we have highlighted females aged 35–49 are the most at risk of not meeting their retirement objectives. This age cohort experienced sharp falls in equity preference post the GFC, but this appears to have troughed in July 2013 and since then, has risen, albeit not in a straight line but a fragile and volatile one. Since mid-2013, preference for equities has surged, rising 781% to December 2014. While these gains are impressive, the overall level of equity preference is extremely low and will need to move higher to assist females close the savings gap compared to their male counterparts.

This lower appetite for risk is important when placed in the context of lower super balances and the gender pay gap, which has risen post-GFC, and lower financial literacy, in general, compared to males.

There is hope though. Females aged under-35 are showing very similar risk appetites to males, assisted by exposure to compulsory superannuation since starting work and improving financial literacy through the use of technology and smart phones.

Chart 9: Equity Preference Index by age
Female: Aggregate



Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2014. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

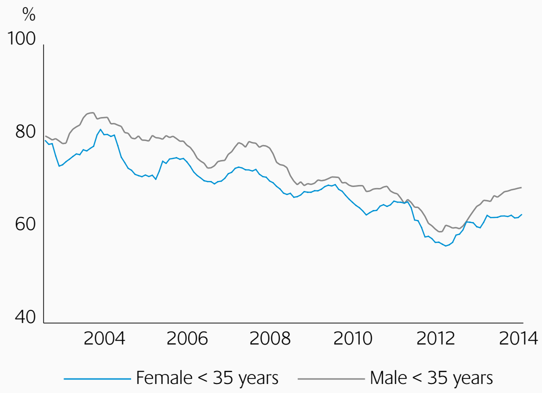
A focus on younger investors – has equity preference permanently changed?

When we isolate equity preference for the youngest investor group, under-35 years old, a decade long trend of decreasing equity allocation is evident.

In June 2004, male equity allocation peaked at 85% and bottomed at 59% in December 2012 and has since risen to 69% at end December 2014. For females, a similar trend emerges as seen in chart 10; peaking at 82% in October 2004, falling to 56% in February 2013 before rising steadily to 63% in December 2014.

What has changed this preference for equities? Some of it could be attributed to alternative investment options outside equity based managed funds, part of it is likely to have been driven by falling housing affordability and links to first home owner share of housing finance and housing affordability.

Chart 10: Equity allocation for under 35 year olds



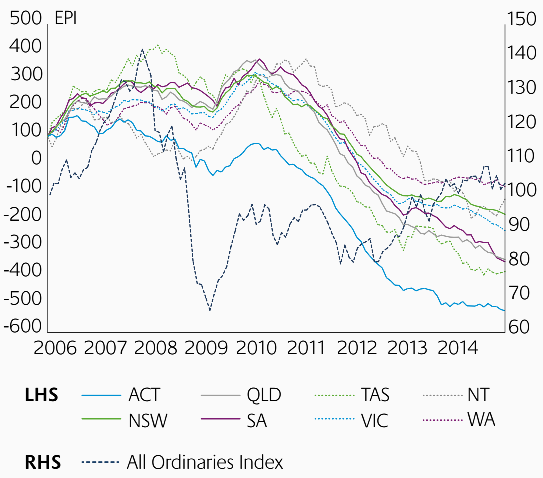
Source: University of Western Australia, CFSGAM.
Data to 31 December 2014

By state

An examination of equity preference by Australian state and territory, as shown by chart 11, reveals weakening equity preference across the major states.

The Northern Territory was the clear standout, with equity preference rising 19% in the second-half of 2014 after strong weakness in the first-half of 2014, albeit from a small fund base.

Chart 11: Equity Preference Index by state
Aggregate measure



Source: UWA's Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2014. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments. Note:

What is most striking out of the state based results was the performance of equity preference in WA. While WA still has the highest relative equity preference amongst states, it did fall 57% in the six months to December 2014 as investors became more conservative. This could have been driven by a number of mine closures, job losses and the sharp fall in the iron ore price over the period.

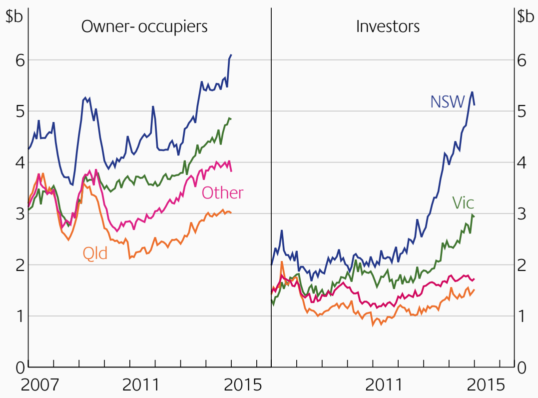
Interestingly, the states with the strongest capital house price appreciation over recent years – NSW and VIC – continue to experience weak preference for equities, as seen in chart 11. Equity preference in the second-half 2014, fell in NSW by 18% and Victoria by 31%. This took the annual moves to -65% and -62% respectively. This continues to suggest that funds were diverted into investment property and out of equities.

Elsewhere Queensland equity preference fell 17% over the half-year and 30% over 2014, while South Australia was also negative down 26% for the half and 59% for the full year. ACT and Tasmania were less impacted, possibly due to weaker housing markets than Sydney and Melbourne. Equity preference in the ACT fell 5% in the December half-year while Tasmania was down 4% over the same period. See table below for details.

EPI performance	Six months to December 2014	12 months to December 2014
ACT	−5%	−6%
NSW	−18%	−65%
NT	19%	−29%
QLD	−17%	−30%
SA	−26%	−59%
TAS	−4%	−26%
VIC	−31%	−62%
WA	−57%	−59%

Chart 12 shows the sharp increase in housing loan approvals particularly in NSW, with investor housing approvals increasing by almost 150% over the past three years and now account for almost half the value of all housing loan approvals.

Chart 12: Housing loan approvals by state

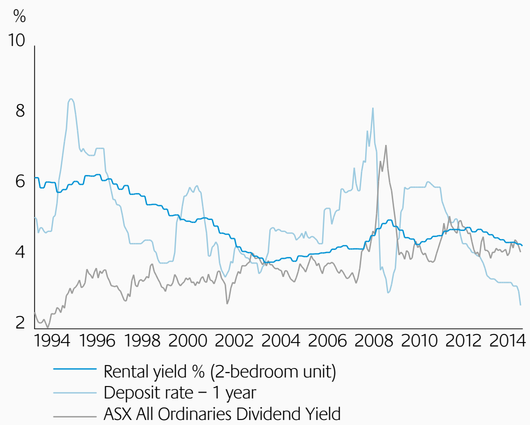


Source: ABS; RBA

The risk for investors is that the future potential return for these assets may not match expectations and meet the need to provide both income and capital growth to investors to achieve retirement goals. Chart 13 compares the yield that investors can earn on three investment options – a rental yield on a two bedroom unit, a one year term deposit rate at a bank and the dividend yield on the ASX All Ordinaries Index.

Deposit rates have fallen sharply due to lowering of the official cash rate in recent years. As at December 2014 the deposit rate was 3.2%, the rental yield was 4.4% and the dividend yield (excluding franking) was 4.5%. The relatively high rental yield and recent capital growth has attracted investors into the property market, with the RBA citing in its March Financial Stability Review that low interest rates and heavy competitions amongst lenders has spurred demand. The RBA has warned that "the heightened level of investor activity and borrowing could amplify the housing price cycle and increase the risk of significant falls later." The Australian Prudential and Regulatory Authority have been monitoring the situation but it is too early to see any impact since the measures were announced in late 2014. The rental yield has steadily retreated over the past few years, driven by rising prices and some increase in vacancy rates.

Chart 13: Yield comparisons by asset class



Source: UBS, RBA and Bloomberg. Data to March 2015

A special focus: reducing risk or chasing returns?

The EPI aggregates domestic and international equities into one equity preference. In this section we disaggregate the traditional EPI into preference for Australian equities versus global equities.

The two charts (charts 14 and 15) below demonstrate preference for Australian equities and global equities in new applications.

Chart 14: 12 month rolling average net Australian equity/total dollar value – application

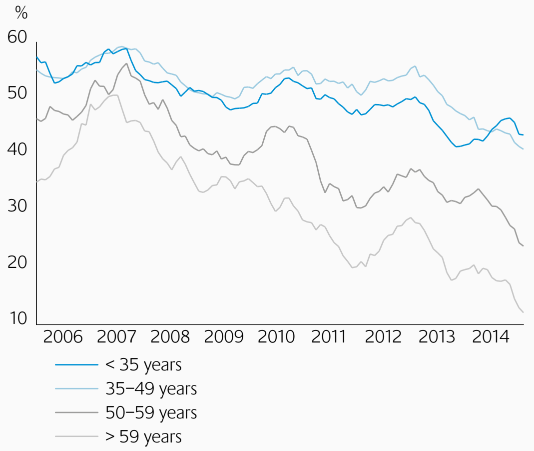
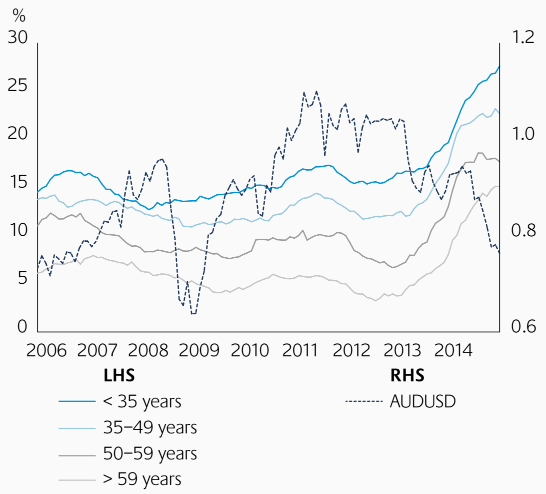


Chart 15: 12 month rolling average net global equity/total dollar value – applications



The trend for new applications into Australian equities has largely followed a negative trend for every age group since the peak in the market in 2007. The three youngest age groups did return to Australian equities from mid-2009 until mid-2010, taking advantage of the rebound in the market from its lows before retreating til end-2014, apart from a pick-up in August 2011 to October 2012 for all age groups. Not surprisingly, the two youngest age groups, under 35 year olds and 35–49 year olds, did maintain a higher flow into Australian equities than the two older age groups.

When looking at global equities, the difference in equity preference is clear. With preference for Australian equities falling, there has been a clear and consistent uptick in applications for global equities, across all age groups. What is remarkable is that even over 59 year olds, who typically are in or close to drawdown phase have been investing new funds in to global equities, which is in direct contrast to expectations and the overall equity preference index presented at the start of the report. The data would suggest that preference for global equities is directly related to moves in the Australian dollar, with applications picking up when the Australian dollar moved below parity against the US dollar and have accelerated since mid-2013 and throughout 2014.

Historically Australian investors have been under allocated to global equities, with a significant 'home bias' to the Australian sharemarket. With good returns offered from global equities and an improved understanding of the sector biases within the Australian market, a greater move to invest offshore is likely.

Long-term trends evident

In previous editions of this report we have spent considerable time discussing the consequences of some of the trends we are witnessing within the EPI.

While less focus was paid to these in this report, below is a brief summary which outlines the key longer-term trends:

- Investors aged between 35–49 years of age, particularly females, through low and falling equity preference, are not adequately protected from longevity risk. These investors need to continue to have exposure to growth assets to build their savings pool, as well as saving more and saving at an earlier age.
- Women in particular, given their weaker starting position in terms of superannuation balances (half that of men), need to think about how to build their wealth and utilise financial literacy programs and tailored advice to help them to save earlier, save more and explore growth opportunities. The infographic highlights the key statistics for this long-term issue.
- Falling equity preference has seen investors allocate heavily into both commercial and residential property, in search for yield and capital appreciation. It is worth noting that the RBA has been warning against the growing risks in this asset class.
- For the industry, this research continues to suggest ongoing need for products focused on retirement solutions. This is starting to occur in the most important transition to retirement phase. The report also highlights the need for the industry to focus on investors well before retirement age to assist in refining any behavioural biases that have emerged. This is particularly relevant in the female 35–49 age group.

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