THINKING
OUTSIDE THE SQUARE

The typical Australian equities portfolio is concentrated in a very small number of industries, increasing the associated risk. **David Prescott** explains why it may be prudent for SMSF investors to diversify their portfolio exposure to include companies outside the top 100.

The Australian equity market consists of around 2000 companies, with a current total market capitalisation of about $1.4 trillion.

The top 100 companies, as characterised by the S&P/ASX 100 Index, account for over 80 per cent of this total capitalisation, but do not represent a diverse cross-section of industry. The two largest sectors, financials and materials, denote a whopping 63.7 per cent of this index. Of the total capitalisation of the Australian market, financials companies make up $426 billion (of which $260 billion of this is the four major banks alone) and materials companies make up a further $286 billion.

Yet outside of the S&P/ASX 100, there are over 1900 companies, with a combined market capitalisation of nearly $200 billion, to consider as potential investment candidates in an Australian equity portfolio.

Importance of looking outside the top 100

But what does this actually mean to an SMSF investor who, according to the latest

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Australian Taxation Office statistics, has on average 33 per cent of their portfolio invested in direct Australian shares and a further 9 per cent in managed funds?

SMSFs invest in the Australian equities market either by buying or selling shares directly or by investing through a managed fund. In direct equities portfolios, many SMSF investors gravitate to the perceived safety of large capitalisation stocks. Additionally, most fund managers in Australia pursue an 'index relative' strategy, which means their portfolio closely resembles the underlying composition of the index and rarely strays from the larger companies.

It follows, therefore, that given the underlying index composition, SMSF investors have on average 60 per cent of their Australian share portfolio invested in financials and materials companies. The returns many investors will receive from their Australian equities portfolio will by virtue largely be driven by the performance of the companies that comprise these two sectors. SMSF investors may be underestimating the risks of such a strategy.

Avoiding loss and generating attractive absolute returns should be the primary goal of any considered SMSF investment strategy. Given the risks evident in the two largest sectors of the Australian equities market, it is only prudent SMSF investors consider the whole landscape of Australian companies, big and small, to effectively diversify their equity exposure away from these dominant industries.

Banking and materials

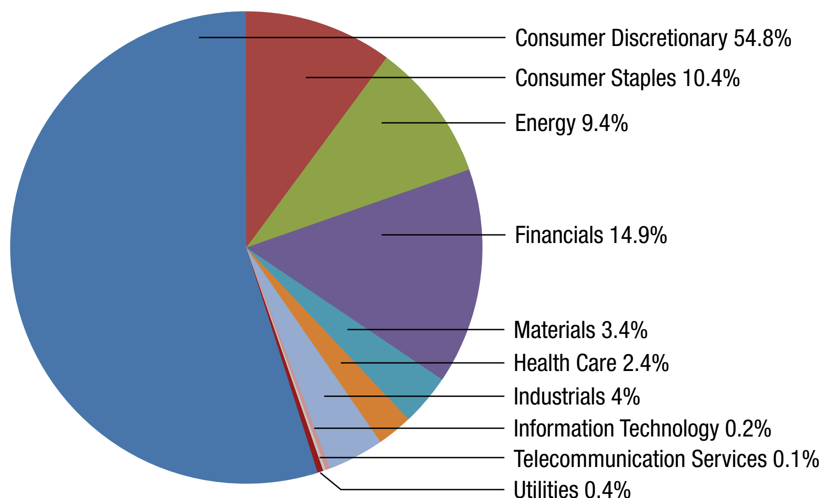
Over the past 20 years, banks and resource companies have generated very strong returns for shareholders.

The financials sector predominantly consists of shares in Australian banks, with the four major banks alone representing over 26 per cent of the S&P/ASX 100 Index. Over the past 20 years, the Australian banks have benefited from an explosion in customer appetite for credit, resulting in very strong lending growth. The earnings of Australia's major banks have also been assisted by the stable and orderly market structure, with limited competition between the banks, customer inertia and inexpensive and abundant availability of funding. This period has also been characterised by a very low level of loan defaults, due mainly to a rapidly and consistently appreciating housing market.

As a result of this powerful combination, this sector of the market had been a wonderful place to invest as the major banks were strong beneficiaries of these industry conditions and delivered strong profit and dividend growth. The four major banks each posted compound growth in earnings per share of over 10 per cent over this period.

Banking is, however, at its core, a highly leveraged and risky industry. The outlook for the industry is not nearly as favourable as it was 20 years ago. Banks now have to contend with a consumer deleveraging cycle, higher funding costs, a deteriorating housing market and increasing competition for market share.

Figure 1 – Composition of the ASX 100



In our opinion, given this landscape, it is highly unlikely the Australian banks will post the same level of earnings growth and returns to investors over the coming decade.

The second largest sector in the Australian market is the materials or resources sector, representing nearly 25 per cent of the capitalisation of the ASX 100. Here the outlook is also challenging. Over the past 10 years, the Australian economy has been a major beneficiary of economic growth and industrialisation in Asia, notably in China and India, which has led to rapid growth in their demand for our commodities, namely iron ore and coal. The associated sharp rise in the prices of these commodities has largely underpinned Australia's economic growth, with exports of these commodities now accounting for more than one-third of Australia's total export value.

In recent years, China's fixed investment has extraordinarily reached almost 50 per cent of its gross domestic product. This has fuelled strong demand for iron ore and coal as China has built more and more infrastructure, including bridges, roads and a number of yet to be inhabited cities. It is our expectation that while economic growth in China may continue to be strong, the composition of that growth will move away from investment or fixed capital formation. This will lead to a, perhaps significant, reduction in the volume of commodities demanded by China.

Even though this is not a widely accepted view, it appears the imminent demand-side pressures are starting to become more broadly understood. Indeed, a senior executive at BHP very recently confirmed that demand for iron ore from China is "flattening out". This is happening at a time when many resource companies are experiencing significant labour cost pressures as substantial further supply is coming on line. Over recent years, many large investment projects have been initiated in response to the increase in global demand and strong pricing. These new projects will result in a significant boost to production capacity over the next five years.

This combination of falling demand and increased supply does not auger well for commodity prices. As a 'price taker', the earnings of some of our major resource companies could come under pressure. Again, this does not bode well for investor returns from this sector of the market.

FIGURE 2 – PERFORMANCE OF LARGE CAP VS ALL ORDINARIES

	20 YEARS RETURN (ACCUMULATION)	20 YEARS STANDARD DEVIATION
S&P/ASX ALL ORDINARIES	10.3%	18.0%
S&P/ASX 100	9.0%	17.1%

Source: IRESS

That does not mean there will not be selective investment opportunities in either of these two sectors, but we feel there now exist many challenges and substantial downside risks, some of which perhaps were not evident 10 years ago.

Outside the top 100

The investment universe of ex-100 companies is both large and diverse, with over 1900 companies representing nearly $200 billion in market capitalisation.

This area of the market covers a broader range of industries, is less widely researched and offers greater opportunity for finding bargains.

Another feature of the smaller company area of the market is its ongoing evolution. As small companies get taken over, grow to become big companies, or as new companies and initial public offerings enter the market, this results in this universe being an evergreen source of investment opportunities.

The smaller company universe typically displays marginally higher volatility than the larger end of the market. This volatility in share prices, often in the absence of fundamental developments, can create opportunity for patient, long-term investors.

In addition to this increased diversity and the volume of companies available, the smaller company space has also been known for its above-average, long-term investment results. Figure 2 shows the All Ordinaries Index has produced higher returns than the top 100, with slightly higher volatility, over the past 20 years.

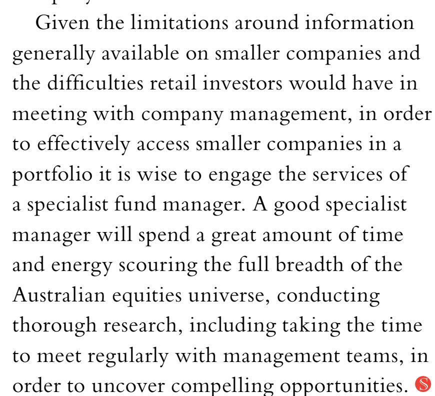
SMSF investing in ex-100 Australian equities

SMSF investors typically target both the preservation of capital and generation of attractive long-term returns. Given the dominance of the financials and materials industries and the current risks in the large end of the Australian market as a result of this concentration, staring ahead it might be difficult for the average SMSF equities portfolio to fulfill these objectives. It is important, therefore, for SMSF investors to consider their Australian equities investment in a broader context, bearing in mind many of the larger traditional fund managers are often constrained to the top end of the market, due to the size of assets they manage and/or inability to deviate from their benchmark.

Aside from the issue of sector dominance, there are several key factors that support a contention to consider the broad landscape of companies available to an equity investor.

Large companies in Australia are heavily researched by stockbroking analysts and fund managers. They also receive significant media attention. In contrast, smaller companies in Australia are less widely analysed with little, if any, published financial research available. Smaller companies also receive less media exposure and scrutiny. This lack of research and analysis can lead to mispricing and opportunity for those prepared to devote the time and effort to do the work.

Additionally, the management of smaller companies will often have a greater influence on company performance when compared to the management of a larger, more established company.



Given the limitations around information generally available on smaller companies and the difficulties retail investors would have in meeting with company management, in order to effectively access smaller companies in a portfolio it is wise to engage the services of a specialist fund manager. A good specialist manager will spend a great amount of time and energy scouring the full breadth of the Australian equities universe, conducting thorough research, including taking the time to meet regularly with management teams, in order to uncover compelling opportunities.

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