

More and more Australians are recognising the importance of having a saving plan to help fund their retirement. Encouraged by the Government's recent superannuation initiatives, Australians are implementing strategies to maximise their contributions to superannuation.

While this is good news, many Australians are overly reliant on Australian assets. Their portfolio strategy is dominated by Australian shares, property, bonds and infrastructure, which accentuates a "home country bias". What is more concerning is that many investors (and their financial advisers) are unaware of this bias and its consequences until it is too late.

The home country bias, that most of us have, has many contributors. Our employment prospects, job security and the value of our homes (and investment properties) are already hooked into Australia's fortunes. When we travel overseas, the cost of travel, the quality of the hotels we stay at and the restaurants where we dine is largely dependent on the strength or weakness of the Australian dollar. And when we go to purchase the latest plasma screen TV or imported car, the price (and affordability) is inevitably linked to the currency. Therefore, accentuating these biases further by having an investment portfolio with a strong dependence on Australian economic and market conditions is inadvisable.

So, why is it an issue? A home bias in our investment arrangements means we are very reliant on the performance of assets domiciled in Australia for the returns we need to achieve our retirement income goals. Also, a bias to Australian assets can create an overly concentrated portfolio and result in adverse return consequences in some market and economic environments, which a better diversified portfolio containing more non-Australian assets could help avoid.

A lot of people might ask, so what if my investments are biased to Australia? We've enjoyed fifteen years of continuous economic growth and Australian assets have delivered great returns; why do we need to diversify away from Australia? Well, based on the experience in the early 1990s, 'the recession we had to have', Australians shouldn't be too complacent about a home country bias. In 1991, Australia's Gross Domestic Product fell by 1.2% and in the three years to December 1992, the Australian share-market return was barely positive, increasing by only 2.7% per annum.

Still not convinced? Consider this: it's not a question of "if", it's more a question of "when" Australia will experience another period of subdued economic (and market) circumstances. While it is hard to imagine that occurring, as we ride another resources wave (thankyou China!), it will happen. Given that it is always difficult to correctly predict the timing, severity and length of the next economic and market downturn, Australians should think ahead about how they can insulate their portfolio from this scenario. Building a portfolio that is more globally diversified than their present strategy is a good place to start.

Many Australians are saving for their retirement via managed investment schemes. It could be argued that these schemes are better placed to build portfolios that reduce this home country bias by holding a range of non-Australian asset classes. However, the April 2007 Mercer Pooled Fund Asset Allocation survey shows that the average Balanced fund allocation to Australian assets was at least 55%, including an allocation of 36.4% to Australian shares. Approximately half of the average Growth fund's assets are also Australian, including a 40.3% allocation to Australian shares.

Understandably, Australian investors often find comfort in assets they are familiar with but whether it is appropriate from an investment perspective is questionable. Let's use Australian shares to illustrate this point.

The Australian share market is a concentrated market. The five largest companies account for approximately 27% of the market's value. BHP Billiton is the largest, accounting for 9% of market value while the remaining four companies in the top five are all banks (ANZ, Commonwealth, National and Westpac).

If the average Growth fund is invested in all five stocks, with portfolio allocations equivalent to each company's weighting in the market index, an investor in that Growth fund would therefore have 3.5% of their "diversified" portfolio in BHP Billiton and 7.5% in the four banks. In other words, 11% of their investment portfolio will be in just five Australian companies (and two industry sectors – Materials and Financials), which is probably substantially more than their entire exposure to the Japanese and European share markets. While these companies are well managed, profitable and have all stood the test of time, it's debatable whether allocating so much to so few companies is advisable.

The decision by many Australians to directly invest in Australian companies compounds this home country bias and further concentrates wealth outcomes on too few companies and industries. The 2006 Australian Share Ownership Study prepared by the Australian Securities Exchange found an estimated 38% of Australians owned Australian shares directly (as opposed to indirectly via their super funds). The Study suggested the typical direct shareowner has a very concentrated portfolio, averaging just nine companies, with an estimated 42% invested in just three companies or less. The Study also found evidence of considerable industry concentration within direct shareowners' portfolios with 60% exposed to three or less sectors. Not surprisingly, the three most popular sectors were Financial Services (e.g. the banks, AMP among others), Mining (e.g. BHP Billiton) and Telecommunications (e.g. Telstra).

The strategy of many Australians to enhance their wealth via direct share ownership in Australian companies is admirable, and after a number of years of positive returns by the Australian share market, direct share owners are no doubt better off for their decision to invest (except maybe T2 investors). However, their actions are probably accentuating the bias that a typical superannuation fund gives to Australian assets. Ultimately, the average investor has too much invested in too few Australian assets, sectors and companies.

A willingness to diversify by investing offshore where there is substantial investment choice can help Australian investors reduce their home country bias, with potentially better investment outcomes. To illustrate this, consider Australian investors who want to invest in airline companies because they believe the airline industry has a strong growth outlook. By limiting their investment perspective to just the Australian share market, they have only two airlines to choose (Qantas and Virgin Blue). Had the recent bid for Qantas succeeded, their choice would have been limited to just Virgin Blue. However, if investors were prepared to look outside Australia for airline stocks to invest in, the choice they face is far greater. For instance, there are thirteen airline companies in the MSCI global index, including well known companies such as British Airways, Cathay Pacific, Singapore Airlines and Ryanair. In short, more choice, better diversification, less home country bias and potentially better return outcomes.

The same could be said for listed property. What would you prefer - an Australian centric strategy with choice limited to around twenty four listed property trusts (and portfolio dominance by Westfield which accounts for 29% of the sector), or a global strategy where you can choose from over 320 trusts? You could also choose from multiple categories of property that are not available in Australia and, if desired, from a gamut of exposure to the property cycles of eighteen countries.

There are many contributors to our home country bias that are hard to avoid. However, we do have choice in the way we structure our investment arrangements. A willingness to reduce the home country bias within our investment portfolio means we have a greater choice of securities to invest in, better portfolio diversification and greater protection from adverse market and economic circumstances in Australia.

So, how biased is your portfolio?

John Owen
Investment Analyst