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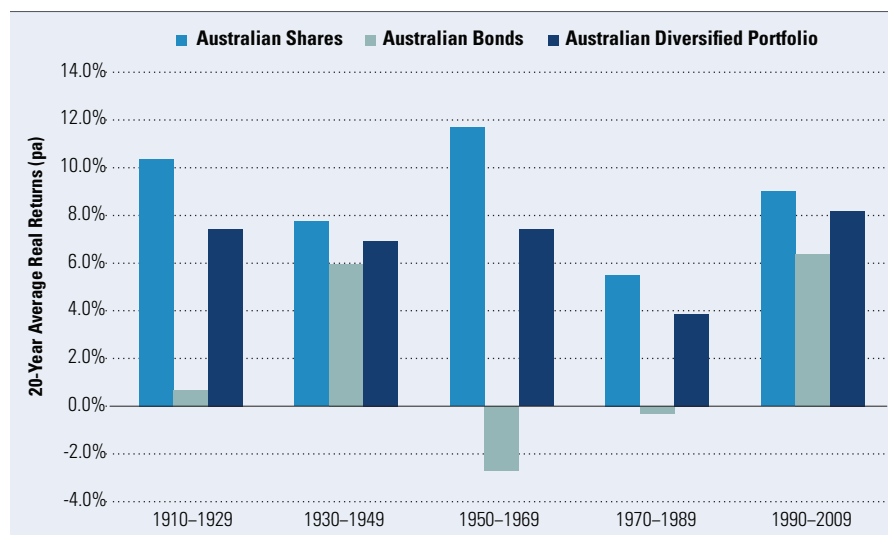
Australian investors have been spoiled by two decades of high returns, but face challenges in the decade ahead. In a recent Ibbotson Insight (*'Australia – The Lucky Country?'*), we looked at the fundamental drivers that set Australia apart from other developed economies, and concluded that these would continue for some years. In this Insight, we take a longer-term perspective and consider the implications for investment strategy of an end to the commodities boom and the twin global challenges of high debt and very low interest rates. We find that successful investing will require more focus on preserving capital and on finding diversifying assets and strategies that are less sensitive to economic growth and share prices. Core infrastructure and hedge funds are well-suited to play this role.

Australia's 'Golden Age'

Australian investors enjoyed high real returns from local shares (nine percent per annum) and bonds (6.40 percent per annum) over the past 20 years, enabling Australians to build wealth quickly. The key to these unusually high gains lies in the low valuation levels at the start of the period, when the domestic sharemarket traded on a price/earnings ratio of 12.3 and a dividend yield of 5.10 percent, while 10-year bonds traded at a 12.80 percent yield. The subsequent re-rating of both asset classes created larger than usual capital gains on top of sizeable yields. Figure 1 shows the real returns from these two asset classes and a diversified portfolio (comprising 70.0 percent Australian equities and 30.0 percent Australian bonds and cash) over 20-year periods since 1910, revealing the high returns from 1990–2009.

Investment Strategy for a Volatile, Low-Growth World

Figure 1. 20-Year Real Returns from Australian Equities, Bonds, and Diversified Portfolio, 1910–2009.



Sources: Ibbotson Associates, Global Financial Data.

Future equity gains will be more dependent on corporate earnings growth, as there is less scope for a further re-rating from today's much higher valuation levels (the S&P/ASX200 Accumulation Index traded at a price/earnings ratio of 18.3 and a dividend yield of 4.1 percent at 30 September 2010). Similarly, future bond returns are likely to be much closer to current yields (five percent for the 10-year government bond at 30 September 2010), and may be lower if there is an inflationary shock.

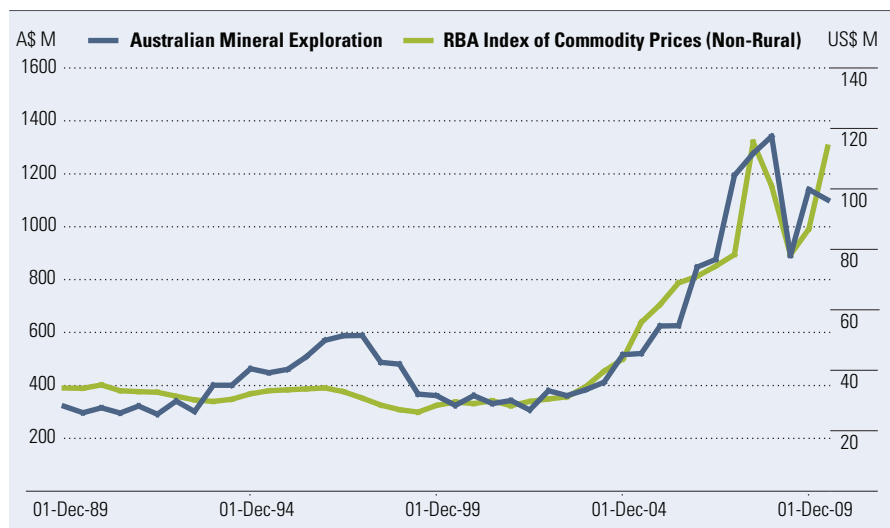
The End of the Golden Weather

The outlook for corporate earnings growth both in Australia and globally is linked closely to economic growth, which faces a major headwind. In the United States and Europe,

governments are being forced to raise taxes and cut spending to prevent debt levels growing beyond their capacity to repay. This is a long-term and substantial adjustment which will take many years to play out given the very large amount of debt involved. Households are also repaying debt, spurred on by high unemployment, falls in house prices, and large amounts of debt relative to incomes.

For Australia, the outlook for commodity prices will be a key driver of economic growth and corporate profits, as the mining sector now represents 25.0 percent of the sharemarket by value while coal, iron ore, and gold represent over 60.0 percent of our export revenues.

Figure 2. Commodity Prices and Australian Mining Investment, 1989–2010.



Sources: Ibbotson Associates, Reserve Bank of Australia.

When and how this commodity boom ends depends on the demand and supply responses to the current high level of prices. Historically, high prices have attracted capital to the mining industry and related infrastructure, resulting in increased supply. The rise in both prices and mining investment already dwarfs those of Australia's previous booms, as Figure 2 shows. Higher prices also affect demand, creating incentives for consumers to find substitutes, as happened with oil in the 1970s and 1980s. Demand from the dominant consuming economies, especially China, will also depend on their success at managing their own growth.

Increased supply means that further rises in commodity prices are likely to be smaller than they were in the past five years in percentage terms. The eventual waning of the boom will remove a major stimulus for the domestic economy and corporate earnings. According to International Monetary Fund research, economic growth has averaged two percent per annum more during commodity booms than after, based on 40 years of commodity booms in over 150 countries. Lower growth is in store for the Australian economy and corporate profits.

The Path Back From Policy Extremes

Market volatility has been highest in the past when economic imbalances were at extremes and a wide range of growth and inflationary outcomes were plausible, for example periods such as the 1930s and 1970s for the US.

These conditions are in place today because of the very high debt levels and extreme monetary policy settings.

This once-in-a-century build-up of debt has left policy settings so extreme that the path back to 'normal' levels will have far-reaching and long-lasting effects on growth and inflation. Fiscal policy will swing from a big stimulus to a big drag on growth if governments reduce debt back to sustainable levels. Whether this happens quickly or slowly, and whether from tax hikes or spending cuts, is unclear, yet these different options have very different effects for the path of both growth and inflation. Defaults or inflating away the real value of the debt is another option. Similarly, a diverse range of economic outcomes is possible depending on how quickly central banks raise interest rates from record lows, withdraw quantitative easing, and sell their financial assets. For example, the rapid 2.50 percent US interest rate rise in 1994 triggered a major bond market selloff and bankruptcies, while the gradual 4.50 percent rise from 2004–06 led to a large build-up in debt which boosted economic growth initially but led ultimately to the 2008 financial crisis.

The Impact of High Volatility

Not only are there multiple scenarios for fiscal and monetary policy, but each scenario has different economic effects that are both far-reaching and long-lasting. Large swings in

asset prices are consistent with this wide range of plausible outcomes, keeping market volatility higher than we have been used to over the past 20 years.

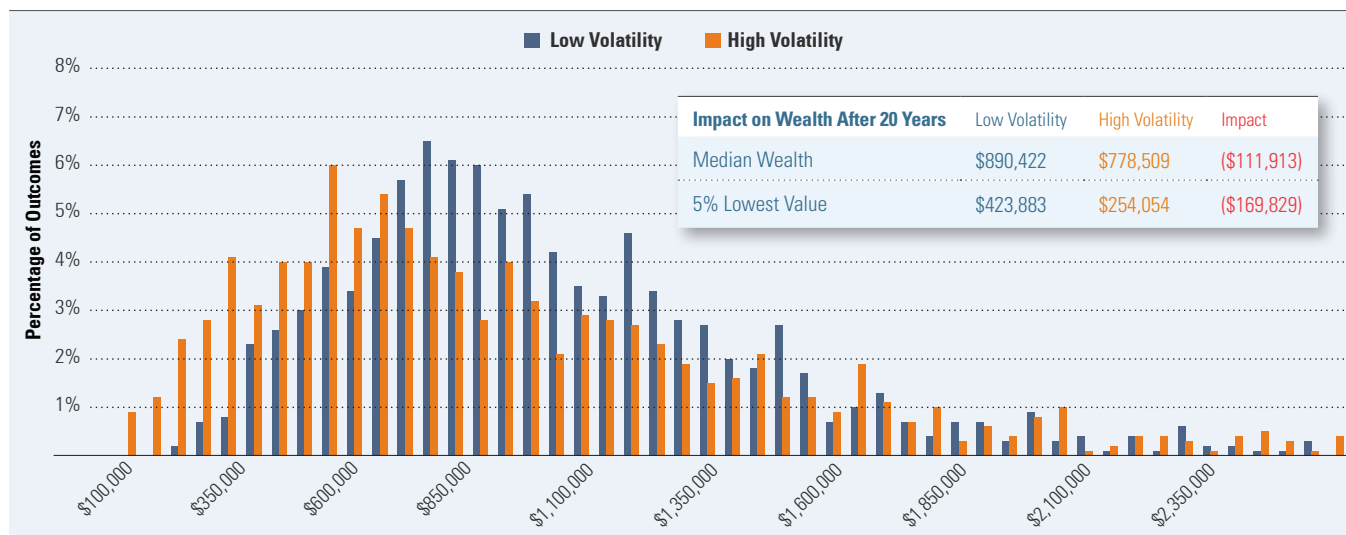
Building wealth will therefore be far more challenging over the decade ahead than it was in the past 20 years. Higher volatility means that losses occur more frequently, while lower growth makes it harder to recoup these losses. A large increase in volatility leads to less wealth in most scenarios. Figure 3 shows wealth after 20 years for an investor with an initial lump sum who makes annual contributions every year. If we increase the volatility assumption from 12.0 to 18.0 percent per annum, there is less wealth at the end of the period. The median wealth drops from \$890,422 to \$778,509, a loss of \$111,913 or 13.0 percent. Poor outcomes also occur more frequently: for example, the five percent lowest wealth outcome drops from \$423,883 to \$254,054, a loss of \$169,829 or 40.0 percent.

Capital Preservation and Diversification Strategies

Given the scenario we've outlined, investors need portfolios that can perform in the face of lower growth, economic uncertainty, and higher market volatility than we've become used to in the past 20 years. This will require a more active approach to asset allocation – reducing exposure to assets that become overpriced. Investors should also look for cheap forms of insurance to limit their downside in the event of extreme events. Successful application of these approaches requires considerable expertise, experience, discipline, and patience.

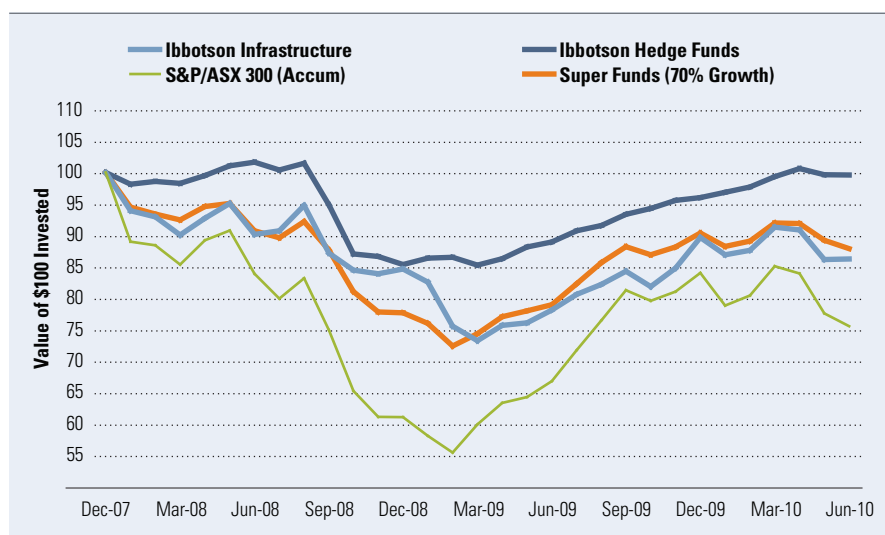
A complementary approach is to reduce exposures to equities and bonds and invest more in diversifying assets and strategies that are less sensitive to economic growth. Earlier attempts to diversify portfolios resulted in allocations that were too small to affect overall portfolio returns. Diversification benefits were also limited because of a bias to domestic assets and private equity, the latter one of the more cyclical assets with the same return drivers as equities, corporate earnings growth and the sale of businesses primarily by sharemarket listings.

Figure 3. Histogram of Wealth Outcomes at the End of 20 Years.



Source: Ibbotson Associates. Results shown are based on Monte Carlo simulations of initial wealth of \$100,000 and annual contributions of five percent of the initial amount for 20 years. Low and high volatility are defined as 12.0 and 18.0 percent per annum standard deviation respectively.

Figure 4. Value of \$100 Invested in Hedge Funds, Infrastructure, Australian Equities, and Australian Growth Superannuation Funds, 31 December 2007 – 30 June 2010.



Source: Ibbotson Associates. 'Ibbotson Infrastructure' refers to Ibbotson's customised global listed infrastructure strategy (SA hedged). 'Ibbotson Hedge Funds' refers to the Ibbotson Alpha Strategies Trust. 'Super Funds' refers to the median-performing option in the Morningstar Superannuation Growth Survey.

Suitable diversifiers need to be liquid enough for investors to make a large allocation, offer better returns than cash without dependence on a particular economic scenario, and have a low risk of large losses. Core infrastructure and a customised hedge fund portfolio stand out as two of the more attractive diversifiers available.

Core Infrastructure

Our definition of 'core' infrastructure is monopoly assets used to provide essential services to the

community. Prime examples include the pipelines and 'poles and wires' used for gas and electricity transmission and distribution. We exclude listed infrastructure funds, emerging market infrastructure, and 'green field' assets under construction, to reduce exposure to leverage, regulatory risk, and construction risk.

The sensitivity of core infrastructure assets' revenues to economic growth is low because of the essential nature of the services and the lack

of competition. The principal asset class risk is an adverse change in regulatory policy, which can be managed by diversifying across a range of regions and industries.

Returns over the longer term have been higher than cash and lower than equities. Figure 4 shows that during the global financial crisis, losses from core infrastructure were less than half those of equities. Overall, infrastructure offers low sensitivity to economic growth, higher returns than cash with only moderate losses, and the ability to invest in size through listed or illiquid funds. Investors can get exposure by investing in unlisted pooled funds that hold unlisted assets, or through a global portfolio of listed companies.

Customised Hedge Fund Portfolio

Hedge funds offer three attractive features that make them a natural diversifier and preserver of capital. Firstly, they're managed with the goal of generating positive returns over time, rather than outperforming equity or bond markets in the short term. Secondly, they're free to exploit a wide range of opportunities to generate returns, including shorting overvalued assets or unsustainable businesses. Thirdly, many hedge to protect their portfolios in the event of large market selloffs. Returns are therefore less sensitive to market movements, and some strategies benefit from adverse market conditions.

Table 1. Hedge Fund Total Net Returns and US Asset Class Returns, 1995–2009.

Hedge Fund Sector	Compound Annual Net Return %	Annual Alpha %	Sharpe Ratio (net)
Overall Equally-Weighted	7.63	3.01	1.16
Long/Short Equities	10.29	5.16	1.10
Global Macro	7.08	2.10	1.13
Event-Driven	8.10	3.73	1.38
US Equities	8.04	0.00	0.28
US Bonds	6.43	0.00	0.63
US Cash	3.54	0.00	0.00

Source: Ibbotson, Chen, and Zhu (2010). Based on monthly returns from January 1995 – December 2009.

Over time, hedge funds have outperformed cash after fees, providing total net returns comparable to equities with less volatility and much lower losses during equity bear markets. The 2010 study by Ibbotson, Chen, and Zhu found that “alphas from hedge funds were positive every year of the last decade, even through the recent financial crisis of 2008 and 2009”, after adjustment for fees and statistical biases in hedge fund databases. Figure 4 shows that a customised portfolio of ‘lower beta’ hedge fund strategies outperformed Australian equities and the average Australian growth superannuation fund by a large margin during the global financial crisis.

To get exposure, investors can select a fund-of-hedge funds vehicle, or invest directly in single-manager hedge funds. Selecting managers requires considerable resources to conduct investment and operational due diligence, to get access to better managers, and manage the portfolio. Hedge fund liquidity ranges from daily to multi-year redemption windows, but the vast majority of hedge fund investments can be redeemed quarterly with one to two months’ notice. Even in extreme market conditions, investors have been able to get 90.0 percent of their money back within 18 months. Overall, hedge funds offer strategies that do not rely on economic growth, are well-placed to deal with

volatility, and behave differently from equities and bonds.

Conclusion

Australian investors face many challenges in achieving their goals of preserving capital and growing wealth in the decade ahead. Returns from equities and bonds will be lower and more volatile than over the past two decades, yet these still remain the dominant assets of Australian investment and superannuation portfolios. Successful investing will therefore require greater focus on preserving capital and finding diversifying assets and strategies that are less sensitive to economic growth. Infrastructure and hedge funds are the pick of the range of alternative investments that can provide this essential diversification. **FI**

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