Australian National University

ANU Student Managed Fund

Emerging markets position finalisation and rebalancing recommendation

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Contents

Notes:
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Glossary

AA – Asset Allocation
AAA – Betashares Australian High Interest Cash ETF
AC – Australian cash
AAE – Active Australian Equities
AE – Australian equities
AFI – Australian fixed income
ANU – The Australian National University
CBE – ANU College of Business and Economics
CIO – Chief Investment Officer
CMT – BT Cash Management Trust
CRO – Chief Risk Officer
EM – Emerging markets equities
DM – Developed markets equities
DM,U – Developed markets equities (unhedged)
FEMX – Fidelity Global Emerging Markets ETF
ESG – Environmental, Social and Governance
IAC – Investment Advisory Committee
IEM – iShares MSCI Emerging Markets ETF
IOZ – iShares Core S&P/ASX200 ETF
IPS – Investment Policy Statement
IOZ – iShares Core S&P/ASX 200 ETF
PE – Price-to-earnings ratio
R&C – Risk and Compliance
ROE – Return on equity
RSFAS – Research School of Finance, Actuarial Studies and Statistics
RT – Relationship Team
SMF – ANU Student Managed Fund
SRI – Socially responsible investment
TLS – Telstra Corporation Limited
VGB - Vanguard Australian Government Bond Index
VGE – Vanguard FTSE Emerging Markets Shares ETF
VGS – Vanguard MSCI Index International Shares ETF

Emerging markets finalisation and rebalancing recommendation

The Student Managed Fund (SMF) proposes combining the second tranche of investment in emerging market equities (EM) with a broader rebalancing of the SMF portfolio. We seek endorsement from the Investment Advisory Committee (IAC) for the trades set out below, noting that some trades do not fully align with the rebalancing procedure as the 3% rebalancing threshold has not been formally triggered. The proposed trades achieve three effects:

(a) Implementing the 10% position in EM as endorsed by the IAC on 11th October 2021;
(b) Rebalancing the growth/defensive mix back to the target 80/20;
(c) Rebalancing the defensive components of the portfolio back to target weights, thus addressing the current –1.71% underweight position in Australian fixed income (AFI) versus its target weight of 7.5% (which sits -7.5% below the reference weights).

Proposed trades:

1. Purchase sufficient iShares MSCI Emerging Markets AUD ETF (IEM) to achieve the target weight of 10% in EM;
2. Purchase sufficient Vanguard Australian Government Bond Index ETF (VGB) to achieve the target weight of 7.5% in Australian fixed income (AFI);
3. Reduce holdings in the BT Cash Management Trust (CMT) to align the growth/defensive weight with the 80%/20% target versus the current 79.21%/20.79%, and return AFI to target weight;
4. Sell sufficient Vanguard MSCI Index International Shares ETF (VGS) to achieve the 5% target weight in developed markets (unhedged) (DM,U);
5. Fund the balance by reducing Australian equities (AE) via sales of the iShares Core S&P/ASX200 ETF (IOZ), including selling all remaining IOZ holdings within the Asset Allocation (AA) component of the portfolio, with the residual from IOZ holdings within the Active Australian Equities (AAE) portfolio.

The following should be noted with respect to the IOZ holdings within the AAE component:

- The trades should leave Australian equities (AE) modestly overweight (estimated +0.11% at the date of writing), matched by an equivalent underweight in developed markets (hedged) (DM(H));
- Implementation is designed to minimise the required trades and disruption to the existing active holdings within the AAE portfolio;
- The effect is to reduce existing underweights versus target weights for three of the stocks held in the AAE portfolio, along with a modest estimated increase in the overweighting in Telstra Corporation (TLS) from 9.17% to 9.46% versus the endorsed target weight of 9%;

The proposed trades also have the effect of reducing the CMT component within Australian cash (AC), which is desirable given its relatively low return. Portfolio weights both prior to and after the proposed trades are provided in the table over, based on portfolio weights on Friday 29th March 2022.

Table 1: Portfolio weights and proposed trades

As at 29th March 2022

Total SMF portfolio	Current portfolio weights	Revised target weights	Deviation from target	Proposed trades	Proposed portfolio weights	Proposed deviation from target
Growth assets						
Australian equities						
AAE portfolio*	56.82%	50.00%	6.82%	-1.71%	55.11%	5.11%
AA portfolio holdings	0.89%	5.00%	-4.11%	-0.89%	0.00%	-5.00%
Total Australian equities	57.71%	55.0%	2.71%	-2.60%	55.12%	0.11%
International equities						
Emerging market equities	4.49%	10.00%	-5.51%	5.51%	10.00%	0.00%
Developed market equities, hedged	9.89%	10.00%	-0.11%	0.00%	9.89%	-0.11%
Developed market equities, unhedged	7.11%	5.00%	2.12%	-2.12%	5.00%	0.00%
Total international equities	21.50%	25.0%	-3.50%	3.39%	24.74%	-0.11%
Total growth	***79.21%***	***80.0%***	***-1.01%***	***0.79%***	***80.00%***	***0.00%***
Defensive assets						
Australian fixed income	5.79%	7.50%	-1.71%	1.71%	7.50%	0.00%
Australian cash & accruals	15.00%	12.50%	2.50%	-2.50%	12.50%	0.00%
Total defensive	***20.79%***	***20.00%***	***0.79%***	***-0.79%***	***20.00%***	***0.00%***
Total SMF portfolio	**100%**	**100%**	**0%**	**0%**	**100%**	**0%**

AAE portfolio*	Current portfolio weights	Target weights	Deviation from target	AAE weighting change	Proposed portfolio weights	Proposed deviation from target
iShares Core S&P/ASX 200 ETF**	63.96%	61.00%	2.96%	-1.13%	62.83%	1.83%
Brambles Limited	8.84%	10.00%	-1.16%	0.27%	9.11%	-0.89%
Inghams Group Limited	9.17%	10.00%	-0.83%	0.29%	9.46%	-0.54%
Telstra Corporation Limited	9.17%	9.00%	0.17%	0.29%	9.46%	0.46%
Westpac Banking Corporation	8.86%	10.00%	-1.14%	0.28%	9.11%	-0.87%
Total AAE portfolio	**100.00%**	**100.00%**	**0.00%**	**0.00%**	**100.00%**	**0.00%**

* AAE portfolio part of the table shows the implications of selling a portion the IOZ, assuming no other trades.

** Proposed trade is implemented by selling IOZ holdings contained within the AAE portfolio.

Background

On the 11th of October 2021, the AA team received majority endorsement from the IAC to change the target asset weights within the SMF portfolio by adding +10% in EM, funded by a -5% decrease in AE and a -5% decrease in DM,U. However, the IAC requested that the position be executed in two equal tranches, with one occurring immediately and the remainder in Semester 1, 2022. The intent was to enable the AA team to smooth the entry given near-term uncertainties such as the Evergrande debt crisis, and to confirm IEM as the best candidate for representing EM within the SMF portfolio. The trades for the first tranche were completed on the 11th of October 2021.

After further examination, the AA team confirms that it is appropriate to proceed with the second tranche purchase of IEM. The reasons for this decision are outlined in the 'Emerging market second tranche' section below.

In addition, the AA portfolio weights have moved away from target due to market movements. As at the 29th of March 2022, the SMF portfolio was overweight AC by +2.50% and overweight defensive assets by +0.79% versus target, with AFI underweight by -1.71%. These deviations can be attributed to the underperformance of both AFI and equities. While the purchase of IEM was initially anticipated to be funded entirely through decreasing holdings in AE and DM,U, the AA team wishes to take this opportunity to rebalance the asset weights in conjunction with finalising the EM position. This entails partially funding the IEM purchase by reducing AC, as discussed in the 'Reasons for rebalancing' section.

Emerging markets second tranche

The addition of EM in two tranches was endorsed by IAC to allow for uncertainty over the near-term outlook, particularly in China due to the Evergrande crisis, as well as to allow the AA team to assess alternative ETFs to IEM. The AA team confirms that the original investment thesis for EM remains valid, after having examined some additional factors not originally considered and assessing the risk of further significant market movements due to Evergrande. The AA team also confirms that IEM is the most appropriate vehicle after considering alternatives.

The original investment thesis identified EM as offering relatively high expected returns across the 10-year investment horizon due to trading inexpensively, as signalled by a low forward price-to-earnings (PE) ratio. The current EM forward PE of 11.65x remains at a significant discount to the 17.48x and 15.49x of DM and AE, respectively. Further, the original investment thesis noted that EM's moderately higher return on equity (ROE) and low levels of leverage indicate that the PE discount is not due to lower profitability or higher gearing. The latest data shows ROE for EM of 14.55%, tracking above AE at 12.98% and close to that of DM of 14.97%, with no indication that the debt structure of EM has changed. The AA team thus confirms its view that the PE discount for EM appears to relate to risk premia that the SMF is able to bear given its long horizon and objectives. **Appendix figure 1** presents updated output from the AA modelling, which suggests EM currently offers forecasted 10-year real returns of 6.59% compared to 4.27% for AE and 3.70% for DM. The AA team therefore maintains the original investment thesis underpinning the purchase of a second tranche of EM remains intact.

Noting the relatively high weighting of IEM in China of ~32%, one newly noted area for concern is recent regulatory action aimed at de-monopolizing markets and addressing rising unease over potential privacy breaches amongst technology stocks in China. This regulatory reform has contributed to further declines in forward PE for Chinese equities and has cast some doubts over long-term profitability. The AA team recognises this risk, but also takes the view that the impacts of the regulatory action are adequately compensated for in the forward PE discount. Further, 2021 has provided a supportive environment for harsh regulatory action due to strong economic growth in China. As economic growth becomes more challenging, regulatory reform is likely to slow as growth moves to the forefront of policy decision making (Macquarie, 2021). With the EU implementing similar anti-monopolistic and privacy and data breach regulatory reform, and the US slowly following, the heavy price discount placed on Chinese equities is partially a result of relative over-concern amongst investors (Goldman Sachs, 2021). Shorter-term factors such as uncertainty of China's role in the Russia-Ukrainian conflict are also influencing the markets. The

AA team view is that Chinese equities have been overly discounted for these concerns, and that this provides an opportunity to purchase EM at an even more attractive price.

The Evergrande crisis was an area of concern in the final quarter of 2021, and a key reason for implementing the EM position in two tranches. The AA team concludes that residual risk has subsided. Since the company's official default in December, the Chinese central government has taken a prominent role in supporting Evergrande's restructuring and management of the crisis. There has been ringfencing of Evergrande's debt obligations. and the establishment of a new government-backed risk management committee. The AA team therefore concludes that the Evergrande crisis is unlikely to significantly affect the long-term horizon returns of EM, at least to the extent that the second tranche should not proceed.

Following concerns raised by IAC members over IEM's exposure to China, two alternatives for the second tranche of EM were assessed: Vanguard FTSE Emerging Markets Shares ETF (VGE), and Fidelity Global Emerging Markets ETF (FEMX). The two key factors considered were the funds' comparative exposures to China, and management fees. Despite VGE's attractive management fee of 0.48% p.a., compared to 0.68% p.a. of IEM, its underlying market allocation towards China and Taiwan were higher. VGE has 34.1% and 19.6% exposure to China and Taiwan respectively, compared to IEM exposures of 29.8% and 16.37%. In comparison, FEMX's market allocation to China and Taiwan are lower at 26.0% and 18.9%. However, the management fee of 1% p.a. is significantly higher than IEM. The AA team found FEMX's greater management fee difficult to justify, and noting that both ETFs track the index closely, it is our view that FEMX and IEM should realise similar returns in the long run. The AA team views neither of these alternative ETFs as clearly superior to IEM.

The AA team concludes that the original investment thesis underpinning the recommendation to buy EM remains valid, and that recent regulatory tightening in China has if anything provided an inexpensive entry point to purchase the second tranche of EM. Further, the sheltered default of Evergrande and Chinese central government support has mitigated many short-term risks associated with the high exposure to China of EM. The AA team recommends that the second tranche of IEM is purchased as initially endorsed by the IAC.

Reasons for rebalancing via partially funding IEM by reducing AC

The AA team sees it as appropriate to partially fund the second IEM tranche through reducing AC. This facilitates bringing AC closer to target weighting, while restoring the growth/defensive mix back to the 80/20% target weights consistent with the reference portfolio. The AA team also concludes that it is appropriate to further reduce AC in order to purchase AFI and hence rebalance the defensive portion of the SMF portfolio back to target weights.

There is no strict requirement to rebalance AC at current weights, as it remains within the +3% rebalancing threshold as set out in the Investment Policy Statement (IPS). However, funding part of the second tranche investment in IEM through the sale of AC takes advantage of recent equity market weakness to top up the growth asset exposure, as well as limiting the realised losses of crystallising recent downward movements in AE and DM,U. Evidence suggests that these downwards movements have resulted in these markets falling to more attractive levels. Since January 2022 the forward PE ratios for AE and DM,U have fallen 12.57% and 12.78% respectively. **Appendix figures 2 and 3** show that these markets are no longer relatively expensive compared to historical levels**.** With Australian and other developed market earnings having recovered strongly, the outlook for slowing earnings growth suggests some reduction in PEs are appropriate. Higher inflation also suggests there is scope for lower PEs. Nevertheless, some of the PE reduction seems attributable to lower prices that in turn imply higher expected returns, to some extent due to increased risk premia following heighted uncertainty surrounding aspects such as the Russia-Ukrainian war.

Selling AC to partially fund the purchase of IEM also mitigates the extent of adjustments required to the active positions within the AAE portfolio, while facilitating moving the growth/defensive mix back to the 80%/20% weights. Funding the IEM trade from within the equities component would necessitate additional sales from the AAE portfolio, which in turn would require making some small trades of active stocks.[1] Table 1 outlined the active position weights relative to target before and after the proposed trades. The proposed trades move TLS further overweight by +0.29%, which is a marginal change. Further, the AAE team has expressed comfort with a modest increase in the TLS holding to an active position that remains below 10%. Meanwhile, the proposed trades act to reduce the underweight position in all other active stock positions. The SMF team considers this approach as preferable to making small trades at high brokerage costs.

The AA team has also elected to go a step further in reducing AC to fund the purchase of AFI, thus bringing the defensive portfolio back to target weights. This involves maintaining the current target weights for AFI and AC noting that these target weights are underweight AFI and overweight AC relative to the reference portfolio. The decision to maintain these deviations vs the reference portfolio is underpinned by the lower expected real horizon returns for AFI of -2.11% compared to -0.70% for AC (**Appendix figure 1**). The low AFI returns relative to AC are largely due to a combination of still low real bond yields and the AA team's skew to higher inflation scenarios. However, Australian 7-year bond yields have risen significantly from 0.82% to 2.78% since the underweight AFI position was adopted on the 6th of October 2020. This upwards movement in bond yields has meant that - under AA modelling - AFI now outperforms AC in the low inflation and crisis scenarios (scenarios 7,8,9 and 11 in **Appendix figure 1**), which have a combined probability weighting of 14.5%. When the decision to move underweight AFI was originally endorsed, AC had higher expected real horizon returns across all scenarios, and the shift away from this indicates that the case for an underweight AFI vs AC position has weakened slightly. The AA team is therefore averse to remaining further underweight AFI than target weights. Hence, the AA team recommends increasing AFI and reducing AC to their current target weights, given that the already underweight AFI vs AC position incorporates AC outperformance of AFI in AA modelling.

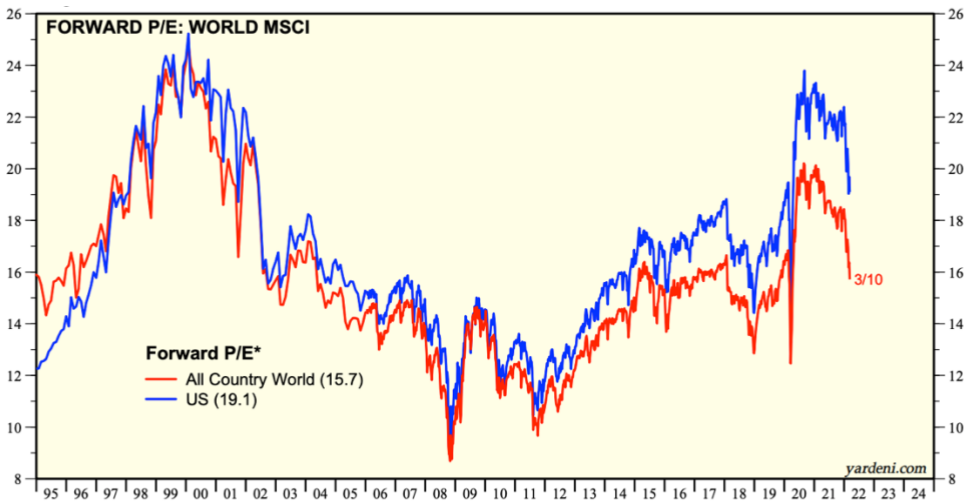
[1] This arises under the Rebalancing Procedure sections of the SMF IPS, where rebalancing trades are "subject to the requirement that no trades have the effect of moving the portfolio weights further away from target weights". Selling a larger portion of the IOZ holdings within the AAE portfolio potentially pushes active stock holdings other than TLS from underweight to overweight.

Appendix

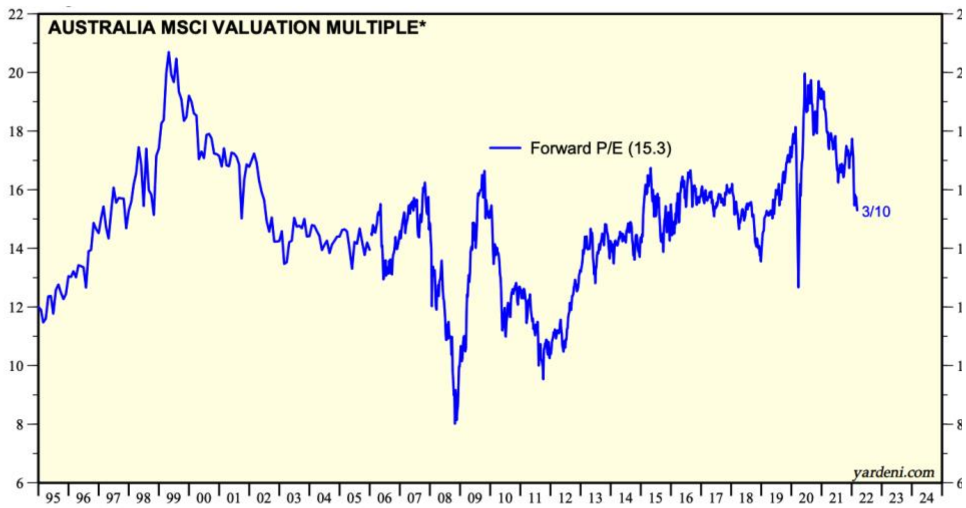
Appendix figure 1: Forecasted year 10 real horizon returns of asset classes

Scenarios				Year 10 real horizon return under 11 scenarios				
No.	**Inflation**	**Growth / Potential**	**Weight**	**AE**	**DM**	**EM**	**AFI**	**AC**
1	High	High	7%	5.58%	4.95%	7.37%	-2.41%	0.26%
2	High	Medium	17%	3.35%	2.33%	4.33%	-2.60%	-0.42%
3	High	Low	14%	-0.20%	-0.27%	2.69%	-3.22%	-0.97%
4	Medium	High	9%	7.44%	7.11%	10.58%	-1.34%	-0.22%
5	Medium	Medium	22%	5.28%	4.99%	8.30%	-1.81%	-0.68%
6	Medium	Low	13%	4.21%	3.12%	6.60%	-2.03%	-1.13%
7	Low	High	4%	9.41%	8.53%	10.81%	-0.45%	-0.92%
8	Low	Medium	6%	6.35%	5.77%	8.76%	-0.95%	-1.24%
9	Low	Low	4%	3.52%	2.96%	5.56%	-1.26%	-1.56%
10	Stagflation	Stagflation	3.5%	-4.55%	-5.16%	-1.43%	-3.58%	-0.70%
11	Crisis	Crisis	0.5%	-2.03%	-1.32%	-2.09%	-0.92%	-1.40%
Probability-weighted			**100%**	**4.27%**	**3.70%**	**6.59%**	**-2.11%**	**-0.70%**

Appendix figure 2: MSCI World PE multiple



Appendix figure 3: MSCI Australia PE multiple



* Price divided by forward consensus expected earnings per share. Monthly data through December 2005, weekly thereafter.
Source: I/B/E/S data by Refinitiv.

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Contact details

SMF email: smf.rsfas@anu.edu.au

SMF website: https://www.rsfas.anu.edu.au/rsfas-education/student-managed-fund/

SMF Facebook page: https://www.facebook.com/smfANU/

SMF LinkedIn page: https://www.linkedin.com/company/anu-smf

Research School of Finance, Actuarial Studies and Statistics

College of Business and Economics

+61 2 6125 4626

The Australian National University

Canberra ACT 2600 Australia

www.anu.edu.au

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