Morningstar Guide to International Investing

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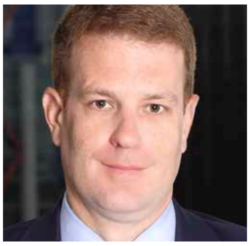


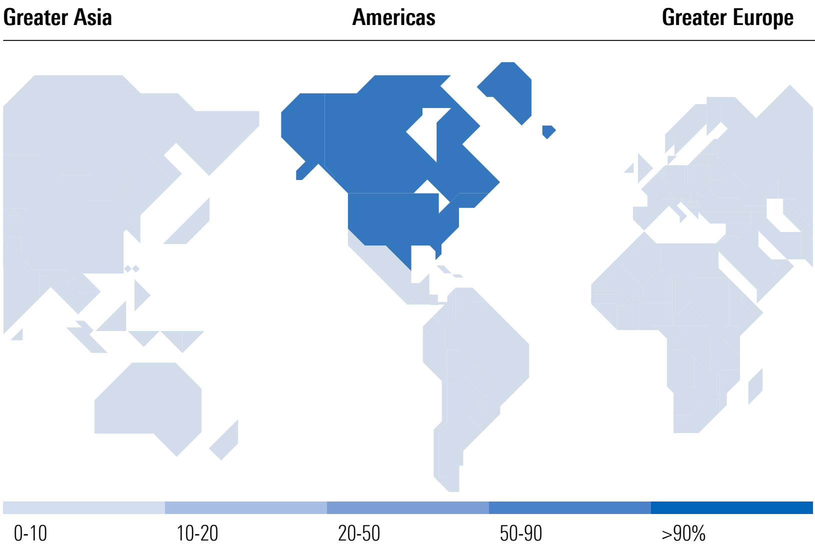
A key part of my job as the individual investor product manager here at Morningstar Australia is to know as much about our subscribers' investing habits as possible. In a little over two years at Morningstar I have been constantly surprised by the domestic bias of our subscribers—that is, their tendency to only invest in local shares. A recent survey of our Premium subscribers shows that the average allocation to international investments is 21%. And 54% of subscribers have no international exposure in their portfolio.

Context is crucial here, so I am going to use my own portfolio as an example. Not because I've done it all right—on the contrary—but because a real-life example will better show what's at stake. Like most things in life, I'm striving to become a better investor. This is a personal example, but I think it nevertheless highlights some of the crucial principles of this investing guide.

The anatomy of my portfolio

By using Morningstar's Portfolio X-Ray tool, I can establish the following global exposure of my portfolio:

As background, it is important to note that I am an American citizen who lived in the United States for the majority of my working life before moving to Australia 4½ years ago. Like many individual investors, I exhibit a high degree of home bias. Home bias is the natural tendency to invest domestically because of familiarity with local companies and economic conditions. Home bias goes beyond just individual investors. Some of the biggest names in the investment world—Warren Buffett, Jack Bogle and Peter Lynch among them—are not immune to a remarkable degree of home bias. And as they have each said, investing in what you know and products you're familiar with makes sense. So is home bias that bad? The answer is: it depends. As we will explore below, the impact of home bias depends on the size and concentration of the local market.



Total Exposure	% of Stocks
North America	73.66
Latin America	5.60
United Kingdom	5.90
Europe Developed	2.35
Europe Emerging	0.28
Africa/Middle East	0.17
Japan	0.23
Australasia	9.69
Asia Developed	0.85
Asia Emerging	1.27
Not Classified	0.00

How does my portfolio compare to the global market?

Like many of you reading this, I've ended up with a portfolio that on the surface doesn't reflect the globalised economy. The question is: how far off am I? One easy comparison to make is to look at the FTSE Global All Cap Index. This index is intended to represent the global stock market. It includes large, mid- and small-cap stocks from all the markets across developed and emerging markets. Vanguard uses it as a benchmark for their products that track the global stock market.

Compared to the FTSE Global All Cap Index, I am overweight US stocks. The index calls for a 54.1% allocation to the United States. I have a 73.66% allocation. On a percentage basis that equates to a more than 36% difference between my allocation and the suggested allocation (vs. an absolute difference of 19.56%). However, the largest discrepancy between what I own and the index is Australian shares. I have a 9.69% allocation to Australia. That turns out to be quite a bit larger than the 2.2% allocated to Australia in the index. That means that my portfolio has an allocation that is 340% larger than the portion of the global index that Australia accounts for. Consequently, if you are 100% allocated to Australia you are missing out on upwards of 97% of the global value of companies.

Does it matter where a company is headquartered?

The Portfolio X-ray shows me that my top 5 holdings are Intel, 3M, ADP, Diageo and Cisco. They are all large-cap companies, and with the exception of Diageo, are all based in the US.

In a globalised economy with large multinational companies, the location of a company's headquarters matters little. Take Diageo for example. Is it a British company because it is based in London? Looking at their 2018 annual report, I can see that revenue from Great Britain isn't even part of the reporting breakdown. The company makes 24% of its revenue from a combined Europe and Turkey category. North America leads the way with 34% of revenue.

Conversely, many of my American holdings earn large percentages of their revenue outside of the United States. In 2018, more than 60% of 3M's revenue came from outside of the United States. Intel makes ~80% of its revenue outside of the United States.

In Australia there are certainly examples of companies that get the majority of their revenue from outside the country. However, the percentage of domestic revenue for the ASX 200 is higher than many other indexes. More than 60% of ASX 200 revenue comes from Australia while for the S&P500 in the US, the corresponding figure is about 40%. And it's about 30% for the FTSE 100 in the UK. Many of the largest Australian companies and most popular holdings for our subscribers have a domestic focus. Examples of this include the big four banks and Telstra.

Global allocation: how much is enough?

The obvious answer is that it depends on your personal situation. It is safe to say that for the vast majority of people it isn't the 0% that 54% of our subscribers allocate to global shares, nor is it the 2.2% that the index allocates to Australian shares. The Morningstar Portfolio Construction Guide contains five different defensive/growth asset class combinations related to five different levels of risk:

- Conservative
- Cautious
- Balanced
- Growth
- Aggressive

The recommended allocations to Australian assets range from 36% in the Conservative portfolio to 49% in the Aggressive portfolio. That is in stark contrast to many of our subscribers' portfolios. Not to mention my own.

What are the impediments to international investing?

The purpose of this guide is to examine the reasons why our subscribers don't invest internationally. The reasons make complete sense and echo some of my own experiences in trying to increase my global allocation.

The rationale that our subscribers gave for not having a higher global allocation:

- 29% said they don't know enough about overseas markets
- 20% said they are concerned about currency risk
- 10% said they don't know what to invest in
- 7% said they don't know how to access investments in overseas markets

At Morningstar, our mission is to empower you to make sound investing decisions. We believe that being better informed about global investing is a means to that end. Along with the information contained in this guide we are happy to announce that we've expanded our stock coverage to include global data and research. Where we previously covered 200 companies from Australia and New Zealand, we're now adding research on 1300 additional global companies from North America, Europe and Asia.

We hope you will find this guide useful.
Happy investing.

Mark LaMonica, CFA
Individual Investor Product Manager

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Introduction

> I wanted real adventures to happen to myself, but real adventures, I reflected, do not happen to people who remain at home: they must be sought abroad.
>
> **James Joyce**

The Australian Stock Exchange makes up just 2% of global sharemarkets. That's a whopping 98% of the world's sharemarkets that remain untapped if your portfolio only includes Australian investments.

Within the ASX, 60% of companies belong to the banking and resources sectors. This consequently means limited asset class diversification and little exposure to emerging industries. Investing overseas, however, can mitigate concentration risk while providing exposure to a great mix of stocks that are otherwise underrepresented in Australia, such as technology. By spreading your investments and risks strategically you insulate yourself against the potentially nasty side-effects of one market falling.

In this guide, we examine the benefits, risks and idiosyncrasies of international investing — and how to make it work for you.

Why should you invest overseas?

> A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.
>
> **Winston Churchill**

Diversification

Diversification is a straightforward concept that is commonly misapplied and misunderstood. The goal of building a diversified portfolio is to lower risk without affecting the level of returns. The key question is: What is the risk that you are trying to diversify away from? At Morningstar, we think about risk differently than most of the financial industry, who use terms such as "price volatility" and "standard deviation". Traditional views of diversification prioritise the correlation between different assets classes and focus on creating a portfolio that contains asset classes that show little correlation. In other words, the portfolio contains some asset classes that are supposed to go up when other asset classes go down. That way there is less short-term volatility in the overall account value.

Morningstar uses a simpler and more practical definition. We define risk as losing money that can't be made back. For investors, that's the risk of not having enough money in time to retire or having to change your lifestyle so that your savings last throughout retirement. Take some time to think about your own view of risk and how fluctuations in your portfolio would affect your life. If you are investing for the long term and can adequately cover any short-term cash outlays with an emergency fund, then perhaps your definition of risk is the same as ours. The less value that an investor puts on the correlation of returns of different asset classes, the more attention can be paid to building a portfolio of global investments that are trading at attractive prices compared to intrinsic value.

Given our definition of diversification, we see two main benefits of international investing. First, we think that investing globally can boost your chances of unearthing attractive investment opportunities. There is an opportunity cost to limiting your investments to the Australian market. As we mentioned, the ASX comprises just 2% of global sharemarkets. Investors who limit themselves to domestic companies risk overlooking whole industries with potential for returns. Technology is a perfect example. Overseas, the dominant names are Apple, Microsoft, Samsung,

Vanguard International Shares Index vs the S&P/ASX 100 TR

	Portfolio (% of stocks)	S&P/ASX 100 TR (%)
Cyclical	**36.49**	**66.36**
Basic Materials	4.27	17.58
Consumer Cyclical	11.88	6.64
Financial Services	17.41	35.05
Real Estate	2.94	7.09
Sensitive	**38.67**	**18.54**
Communication Services	3.77	2.64
Energy	6.11	5.50
Industrials	11.41	7.53
Technology	17.39	2.87
Defensive	**24.84**	**15.10**
Consumer Defensive	8.83	4.18
Healthcare	12.67	8.74
Utilities	3.34	2.19

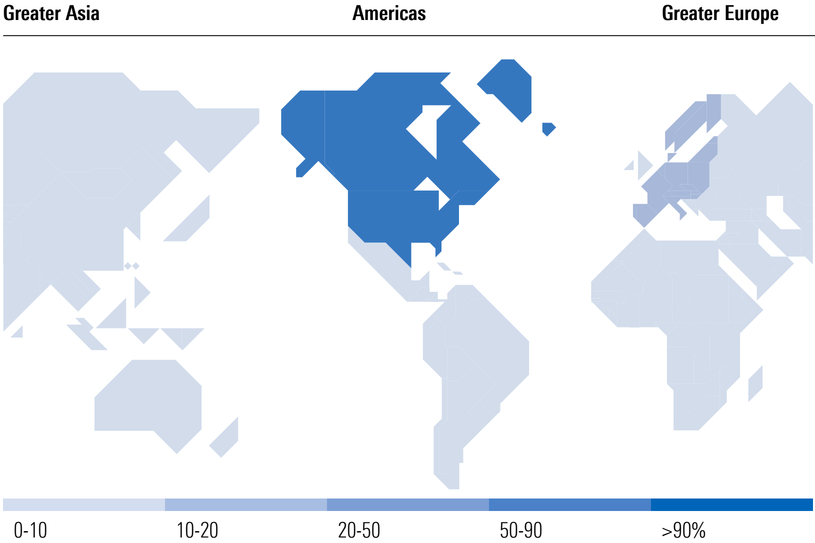
Source: Morningstar

Amazon, Alphabet and Alibaba (some of which fall under the snappy acronym we now know as the FAANGs). Innovation and entrepreneurship are still catching on here, and we struggle to find a foothold in pharmaceuticals, telecoms and cars as well. In short, there are innovative areas the Australian market simply isn't large enough to cover.

The second benefit of international investing is related to losing money that can't be made back. For most people, working and living in a country means the local economy can play a big role in determining your financial well-being. A downturn in the local economy can lead to (or be caused by) depressed prices in housing and the sharemarket. At the same time, your livelihood could suffer as economic upheaval often leads to wage cuts and job losses. And if you're on the eve of retirement it could dramatically alter your circumstances.

This effect may be amplified for a country like Australia that makes up a smaller percentage of the global economy. As we learned during the 2008 global financial crisis, the Australian stock market is not immune to economic shocks on the other side of the world. The local economy held up well and Australia avoided a recession. However, the Australian stock market still experienced similar losses to the US, which was the epicentre of the crisis. However, it is hard to imagine a homegrown recession in Australia—caused by say a slump in housing or commodity prices—making much of an impact on major markets in North America, Europe or Asia.

Composition of global sharemarket



Total Exposure	% of Stocks
North America	57.62
Latin America	1.49
United Kingdom	5.51
Europe Developed	13.61
Europe Emerging	0.72
Africa/Middle East	1.12
Japan	7.86
Australasia	1.88
Asia Developed	4.59
Asia Emerging	5.61
Not Classified	0.00

Risks of overseas investments

> Most people talk about fear of the unknown, but if there is anything to fear, it is the known.
> **Deepak Chopra**

International investing presents a list of advantages but also a unique set of risks. How you negotiate these risks will again depend on your personal circumstances and risk appetite. In addition to garden-variety investing risks, you must also be aware of currency risk and political, economic and regulatory risk.

Currency risk

Currency risk means that you're vulnerable to changes in exchange rates. Obviously, as any income or capital gains/losses generated overseas will need to be converted to Australian dollars, you'll be at the mercy of the dollar's performance against its overseas counterparts. Currency movements are notoriously difficult to predict. Fluctuations can be caused by the comparative performance of national economics, shifts in global trade, geopolitical risk and the perceived safety of one currency vis a vis another.

Currency movements can have a devasting impact on investors with shorter time horizons. For investors approaching, or already in, retirement who are relying on income or capital gains from their portfolios for day-to-day expenses a prolonged rise in the Australian dollar and a high allocation to global investments can be a troublesome combination.

All investment decisions should take careful consideration of your personal circumstances. Global investing and your approach to currency risk is no different. Remember that the point of investing is to achieve your financial goals and enable you to maintain your desired lifestyle. Sometimes chasing the highest return is appropriate, but this is seldom the case. Your success at investing often comes down to your ability to realistically assess what enables your lifestyle and what puts it at risk. Only then can you develop a portfolio that reflects your own circumstances. It takes some time to determine what can affect your income and where you spend your money. If either is influenced by global economic performance and exchange rates, then you might have a different perspective on currency risk. For instance, a retiree with 100% of their portfolio allocated to Australian shares who spends 20% of their income on international travel can be extremely vulnerable to falls in the Australian dollar.

One way to address currency risk is to hedge your global investments. A currency hedge involves using a financial instrument to eliminate currency risk. In theory you could do this yourself, but another approach is to purchase an exchange-traded fund that is hedged against currency risk. One example is the Vanguard MSCI Index International Shares (Hedged) ETF (VGAD), which receives a Morningstar Medallist rating of Silver as of April 2019. This particular security gives you exposure to the MSCI World index ex-Australia, which includes 1,578 stocks from around the world. The fact that it is hedged means that the net asset value of the ETF is unaffected by fluctuations between the Australian dollar and all the currencies of the holdings. Currency hedging does entail a cost and the fees will be higher. In this case, we can see the exact hedging cost by looking at the Vanguard MSCI Index International Shares ETF (VGS). This ETF also receives a Morningstar Medallist Rating of Silver and follows the same index but is un-hedged – meaning that the returns will be affected by currency fluctuations. Whereas the hedged fund charges an annual management fee of 0.21% the un-hedged version charges a fee of 0.18%. In this case, the hedging cost is .03% per year.

Political, economic and regulatory risks

Political, economic and regulatory risks can affect your investment portfolio no matter where you invest. Investors naturally feel more comfortable with such risks when investing in their home country. In most cases, this comfort is based on the illusion that you have more control in your home country than you would elsewhere. Technically, you have more control over your own country's government because you have the right to vote. However, there are many cases when there is substantial opposition to a tax policy from which you benefit or a company or industry that you hold. To see this in action, look no further than the political and societal opposition to franking credit rebates and the banking and mining industry.

When investing overseas there are a couple key factors you should consider. Does the country in which you are investing respect the rule of law? Are there strong property rights? Is there a stable political system? Often overlooked are the country's corporate governance practices. Does management operate to enrich themselves or large shareholders (who may be government entities) or are they good stewards of shareholder capital? One good way to asses this is the Morningstar Stewardship Rating for stocks. Our equity analysts assign one of three stewardship ratings: "exemplary", "standard", and "poor" based on management's stewardship of shareholder capital. If you are investing in countries that have a history of poor corporate governance the Morningstar Stewardship rating can be a useful guide to how individual companies stack up.

How do you invest globally?

> Risk comes from not knowing what you're doing.
>
> Warren Buffett

The traditional way to get exposure to global markets was to purchase an actively managed fund or listed investment company (LIC) that specialises in global investing. In the past 15 years, however, the advent of the exchange-traded fund, or ETF, has expanded the options available investors. Between the three investment vehicles—actively managed funds, LICs and ETFS—investors have a wide number of strategies to choose from. Morningstar alone rates 101 global equity strategies. You can use an online brokerage account to buy units in LICs and ETFs. Managed funds can either be purchased through your online broker or directly through the fund manager by completing an application, which can usually be found at the back of the fund's product disclosure statement or on the fund's website.

Investors can also buy direct equities in overseas markets through brokerage accounts. All major brokers offer global investing with varying fee levels and exchanges. Brokerage fees have always been an impediment to purchasing direct equities but as investor demand has increased some brokers have dramatically lowered costs. For instance, transaction costs for trading on US markets range from US$1 to US$59.95, according to a report on international share trading ratings by financial comparison site Canstar published in November 2018.

We have gone through the why and how of international investing. The biggest question that investors typically have is what to buy. That is where Morningstar can help. Our global coverage uses the same consistent research framework in every region where our 270 analysts are evaluating investments. We offer independent research on more than 1500 global equities spanning markets in Europe, North America, Asia and Australia. We also offer research on more than 450 managed products, including a number of LICs, ETFs and managed funds that provide global exposure.

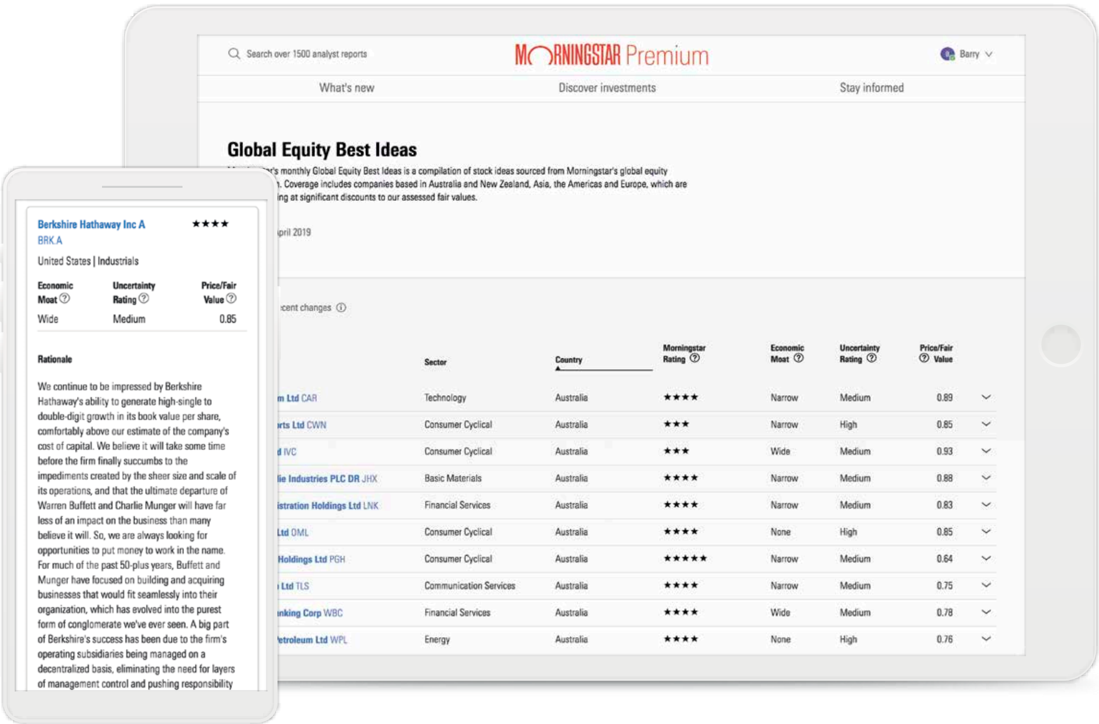
Below are some of the ways that Morningstar Premium can help you invest globally:

Morningstar Portfolio Construction Guide

The Morningstar Portfolio Construction Guide offers suggestions on global asset allocation and the portfolio construction process.

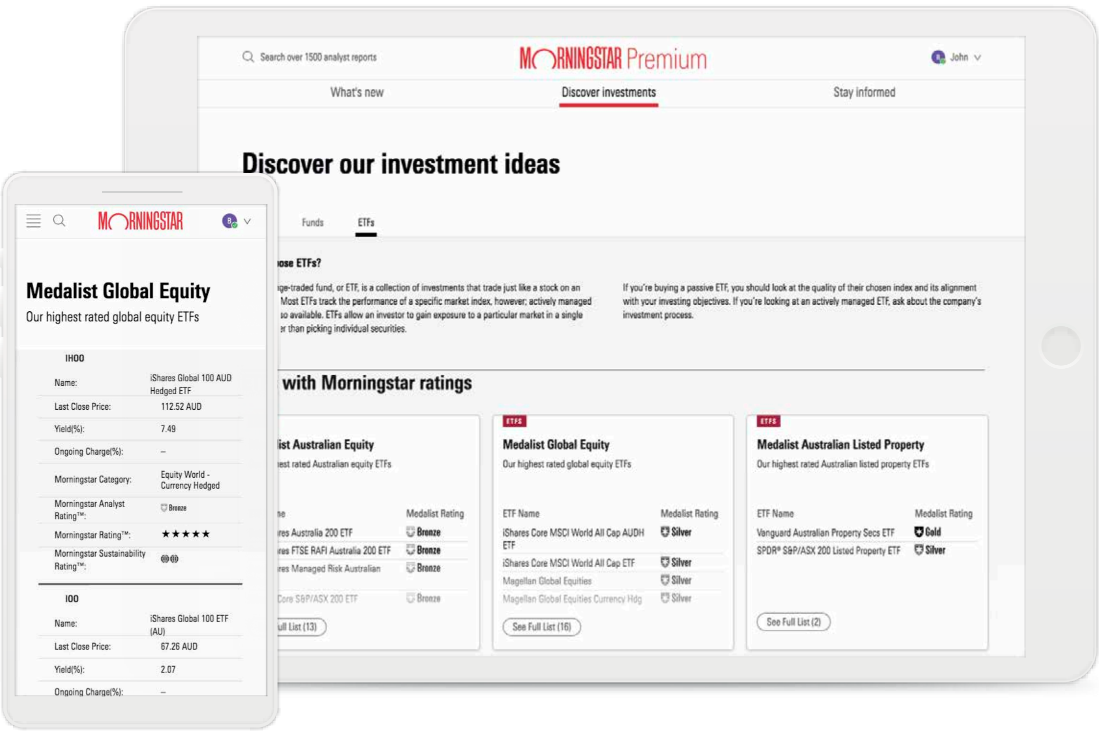
Global Equity Best Ideas

Morningstar's monthly Global Equity Best Ideas is a compilation of stock ideas sourced from Morningstar's global equity research team. Coverage includes companies based in Australia & New Zealand, Asia, the Americas and Europe, which are currently trading at significant discounts to our assessed fair values.



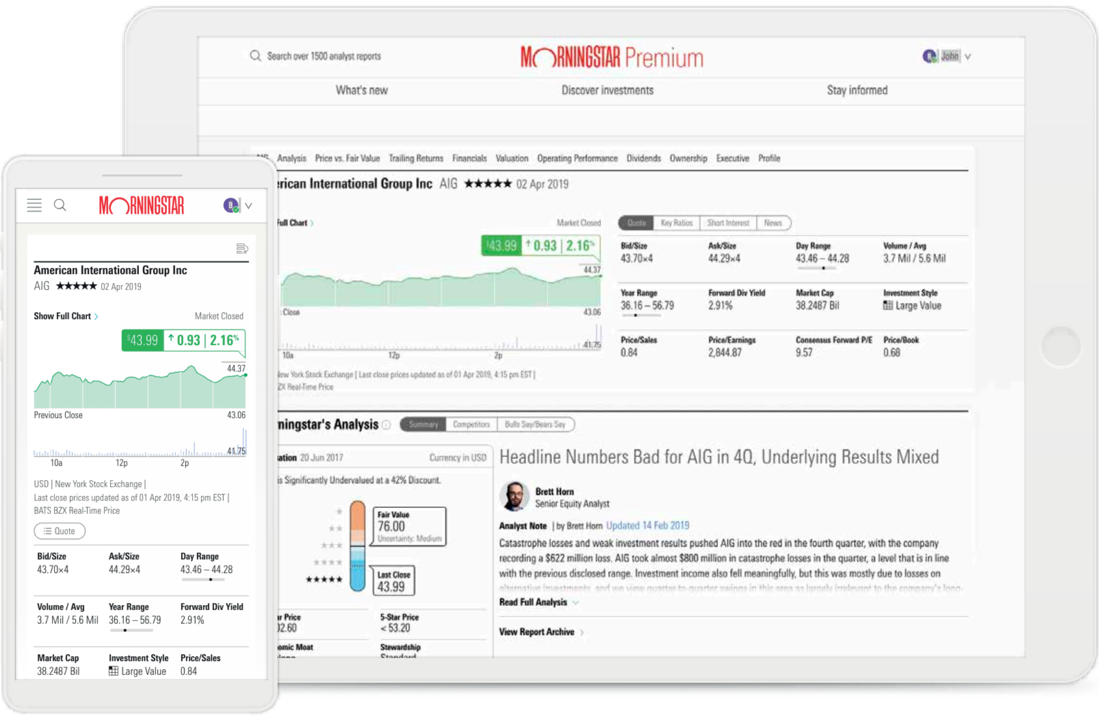
Discover investments

Our Discover investments features provide a summary of investment ideas that have received ratings from our Equity and Manager research team. See our 5-star and Moat-rated equity ratings from the US, Europe and Asia and our Gold-, Silver- and Bronze-rated ETFs and Funds.



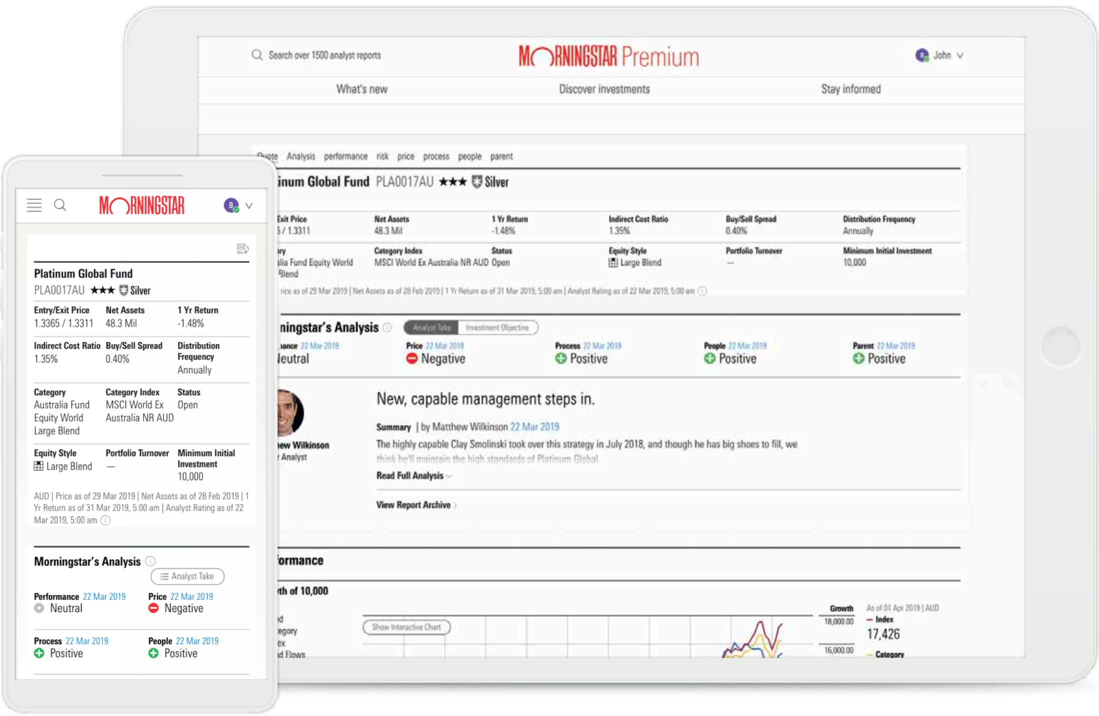
Morningstar Equity Research Reports

Morningstar's Equity Research Reports contain a comprehensive view of each security that we cover. We provide an overall recommendation based on our calculated intrinsic value compared to the current price of the security. The key to our evaluation of each security is our assessment of the four key components of our fundamental analysis: the fair value estimate, uncertainty rating, economic moat, and stewardship rating. Our analyst report also includes our full investment thesis and comments on the valuation and risk of the security.



Morningstar Manager Research Reports

Morningstar's Manager Research covers LICs, ETFs and Managed Funds. We provide our forward-looking qualitative Morningstar Analyst Rating along with detailed research reports. Our full analyst report includes our view of the role that the fund or ETF can play in a diversified portfolio as well as our assessment of the investment team, investment process and the various fees that investors are likely to incur. M



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