INTERNATIONAL INVESTMENT
OUTLOOK FOR 1985

An Address by

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The following paper was the introductory address at a seminar on foreign investment, International Investment — Outlook for 1985, presented by The Securities Institute of Australia, Victorian Division, February 18, 1985.

BACKGROUND

Overseas investment by Australian based investors was first allowed in September 1972 to a limited extent when the Reserve Bank of Australia permitted investors to make an annaul investment overseas in equities or property at the rate of $10,000 per annum, per individual, and $1 million per annum, per institution. The authorities increased these limits to $250,000 per annum, per individual and $2.5 million per annum, per institution in 1980. In December 1983, all restrictions on overseas investment were lifted concurrent with the deregulation of exchange controls and the floating of the Australian dollar. This, therefore, allowed the inclusion for the first time of long and short term, fixed interest securities in addition to equities and property to an unlimited extent with no approvals being required.

Necessarily then, the approach to overseas investment by Australian investors and institutions has been "evolutionary" in that due to the limitations prevailing between 1972 and 1983 it was logical to look at investing in mutual funds managed in various overseas markets, particularly Japan, as it was not worthwhile establishing expertise here in Australia to look after such a small proportion of the institution's fund.

This evolutionary process has now taken the Australian perception of international investment from a limited "interesting" diversion of investing in a few mutual funds to a position where currently "the world is one's oyster".

Nevertheless, it is interesting now after 12 years to look at:

1. The reasons for investing overseas.
2. The experience to date of international investment performance from an Australian dollar perspective.
3. Performance of domestic managers in domestic markets compared with "trying to do it from afar".
4. The future capacity for Australia to be able to afford unlimited investment abroad.

1. The reasons most usually cited for overseas investment are various and are listed below:
   - Diversification of risk
   - Investment in stocks/sectors not available in Australia
   - Higher liquidity
   - Out-of-phase cycle tends to reduce total volatility of portfolio
   - 98 per cent of market cap is outside Australia
   - Diversify out of currency which is inherently weak
   - Short to medium term opportunities at times in cycle when ours is dull
   - Participation in an economy growing faster than ours
   - The Australian market, being resource dominated, performs better during worldwide inflationary climates. This may no longer be the case.

Reasons to invest overseas do generally vary from time to time depending on the domestic economic and political outlook but in the long term the only valid reason must be in order to get a better return than that perceived to be available from the domestic markets.

2. What has been the experience to date?

We measured performance of most of our long standing overseas investments over the five year period dated June 1979 to June 1984, and whilst
these were in only four inhouse mutual funds, the
evidence shows:

<table>
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<th>TABLE I</th>
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<tr>
<td>RELATIVE PERFORMANCE OF ROTHCHILD’S</td>
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<td>OVERSEAS INVESTMENTS</td>
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<td>(All returns calculated in $A Terms)</td>
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<tr>
<th></th>
<th>5 years to June 84</th>
<th>9 years to June 84</th>
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<tbody>
<tr>
<td>Five Arrows Fund</td>
<td>16.3</td>
<td>13.3</td>
</tr>
<tr>
<td>Leveraged capital holdings</td>
<td>29.2</td>
<td>25.8</td>
</tr>
<tr>
<td>Tokyo Pacific Holdings</td>
<td>20.3</td>
<td>22.9</td>
</tr>
<tr>
<td>Old Court America</td>
<td>26.8</td>
<td>NA</td>
</tr>
<tr>
<td>House ordinary shares</td>
<td>20.6</td>
<td>20.4</td>
</tr>
<tr>
<td>IMS average ordinary shares</td>
<td>19.6</td>
<td>18.9</td>
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PERFORMANCE OF INDICES AND CURRENCY FOR COMPARISON

| Australian All Ordinaries | 11.6 | 11.3 |
| Dow Jones Industrials     | 6.1  | 2.9  |
| Toyko New                 | 12.2 | 10.8 |
| $US/$A                    | -5.8 | -4.0 |

To the extent that the United States Pension Funds have invested overseas away from their domestic market, the evidence also shows a superior performance from their international investments as compared with the domestic return.


Further, in the United States, the Erisa Legislation is interpreted now to suggest that the trustees of pension funds would be imprudent not to diversify some part of their assets outside the United States. If the United States’ stock market represents 53.4 per cent of the total world market capitalisation then it follows that in Australia with only 1.6 per cent of the world market capitalisation, trustees of domestic Australian pension funds would be even more imprudent not to diversify away from the local, narrow domestic market.

In fact, I believe that it will be difficult to achieve the returns from investment in Australian shares that we have been used to during the second half of the inflationary 1970s when the resources market provided sensational price gains inordinately above those available from other investments. The 1980s will not witness a repeat performance and Australian pension fund managers will have to turn increasingly to overseas investment in order to achieve comparable returns. In many ways, the domestic Australian pension fund investing in the narrow Australian sharemarket, half of which is represented by the highly volatile and recently poor performance resources sector, is in a similar position to that of the domestic Hong Kong pension fund in its highly volatile Hong Kong market, i.e. diversification away from the domestic market will be increasingly sought in order to improve both returns and lessen volatility. Of approximately 50 per cent currently in equities, we at Rothschild Australia already carry 30 per cent of those overseas.

3. Domestic Managers for Domestic Funds

International investment has traditionally been conducted from London in all international markets. Evidence shows that domestic managers in domestic markets tend to perform better than those from outside. In many ways this trend is a crystallisation of the next stage beyond the “Gee Whiz” syndrome and in Australia we now have the benefit of the experience of others. For example:

a. Investment management in Japan is best done with managers based on the ground in Japan. It is interesting to note that all of the organisations represented here today each have Japanese fund managers based in Toyko. Rothschild found that when it established its Tokyo Pacific Fund some years ago, the international manager for Japan was based in London for the first two years and the performance of the fund at that time was the poorest it has ever been — subsequently, the manager was relocated to Toyko and since then performance improved significantly. The reasons for this are usually a range of minor items — right down to the simple fact of the inability to obtain the morning newspapers from Toyko in London at an appropriate time!

b. New York City investment managers have had legendary difficulties in trying to manage Japanese securities from the United States due to the persistent “selling” techniques of the Japanese brokers.

c. London and Hong Kong based investment managers dealing in the Australian market have recently tended to under-perform the Australian index and leading upper quartile domestic managers due to their inordinately high emphasis on the volatile resource sector — “viva la difference!”
d. The smaller companies’ trusts currently being made available for investment in the E.E.C. cannot be adequately monitored other than from the ground nearby, e.g. London.

It is interesting to note that each of the speakers here today are also “on the ground” experts in their own markets. I believe that the future trend in international management may be towards the selection of specialist regional managers rather than the global approach.

**Future outlook for the capacity of an Australian investor to continue to invest overseas in an unlimited manner.**

From 1980-84 Australia’s Net Foreign Debt has grown from $7.1BN to $29.3BN and as a percentage of gross national product (GNP), has increased from 6.0 per cent to 16.0 per cent the cost of this debt servicing as a percentage of exports of goods and services has increased from 4.5 per cent to 12.2 per cent including principal repayments 7.9 per cent to 27.9 per cent over the same period! In the meantime, our balance of payments continues to deteriorate with the present outlook for Australian exports still remaining bleak.

Against this background all controls on Australian investment abroad have been lifted whilst those on overseas investors making equity investments into Australia are still severely limited by the Foreign Investment Review Board. We, therefore, go on building up overseas debt which has to be serviced and ultimately repaid whilst we continue to discourage certain equity investment from overseas.

**TABLE 2**

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<th>Year to June</th>
<th>Debt as % of net new Foreign Investment</th>
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<tbody>
<tr>
<td>1980</td>
<td>63</td>
</tr>
<tr>
<td>1981</td>
<td>45</td>
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<tr>
<td>1982</td>
<td>86</td>
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<td>1983</td>
<td>83</td>
</tr>
<tr>
<td>1984</td>
<td>91</td>
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Worse still, the figures show that of all overseas investment into Australia, the rate of debt to equity has increased from 63 per cent debt/equity in 1980 to 91 per cent debt/equity in June 1984, a most concerning trend that, if continued, will lead to ever greater debt servicing and repayment problems and an ever declining currency. This ultimately leads to the reintroduction of some form of exchange controls as in certain South American countries (and the U.K.?), thus creating the possibility of an external Australian dollar pool not unlike that of the pounds sterling in the United Kingdom in the early 1970s.

How can this trend be reversed? Apart from effectively and efficiently increasing Australian exports, one of the few alternatives is to have an unfettered two way flow of equity or else all we are doing is borrowing more and more from outside simply to satisfy our xenophobic fears of foreign equity. This is what happened in Canada ... either you have controls both ways or free the controls completely.

**The Foreign Investment Review Board and the Canadian experience**

After many years of over-borrowing and declining currency, the recently elected Canadian Government has taken the only move it could in the circumstances and that is to dismantle controls on foreign investment in Canada. The Mulrohney Government is, at the eleventh hour, reversing the protective xenophobic policies previously in place in order to correct Canada’s untenable external position.

I believe that similar action is now urgently required in Australia rather than awaiting years of erosion which will follow a continuance of the “protection” afforded by the current policies of the Foreign Investment Review Board.

Except in the case where it is unequivocally not in the “national interest”, foreign investments should be allowed and equity injected into a fully deregulated market, thereby reversing and balancing the flow of equity into Australian industry, resources and property.

Let us not do what the Canadians did.

A further thought; it seems that we are currently “setting down the road” to “Canadianise” or “Australianise” existing foreign corporations here.

It is interesting to look at the performance of recently listed “Australianised” companies such as Caltex, Thorn EMI and EPT.

In Canada, foreign companies were obliged to “Canadianise” in the same manner as is being suggested here by the Foreign Investment Review Board. What has been the experience? — nobody wants it; it does not serve the management; it has been proven to be a poor investment for local institutions in...
that the “Canadianised” stocks are similar to the few we have in Australia. These companies:
1. Suffer from the narrow vicissitudes of the domestic economy
2. Do not fully participate in the transfer payments usually involved in such multi-internationals.

The only equity security that is generally wanted is that of the ultimate parent holding company so that the domestic investor can, therefore, participate in the total earnings of the worldwide group (including all transfer payments, royalties, etc.) and avoid the narrow volatile domestic cycle in the domestic business.

Therefore, should we call on the Foreign Investment Review Board to allow a listing of the ultimate parent holding companies on the stock exchanges in Australia in return for development equity and even the acquisition of domestic companies’ assets or divisions? For example, it seems unfortunate that Unilever was unable to consummate its proposed transactions with Elders IXL. It should have been allowed and Unilever should then have been obliged to place Unilever NV shares in the hands of the Australian vendors (and ultimately Australian institutions) as consideration for the purchase.

The advantages of such a change in policy would be:
1. The companies achieve their legitimate commercial objectives.
2. International “Competitive Breezes” would result in Australian vendors obtaining the best possible price in world competition, e.g. Nicholas Kiwi.
3. Australian institutions would obtain excellent investment in the ultimate parent company rather than a local hybrid.
4. The international companies would add significant Australian investors and thus broaden their share registers.
5. The Australian economy would benefit from a unfettered, two way flow of equity, i.e. Australian investors investing abroad whilst foreign investors invest in Australia.
6. The ever increasing Australian indebtedness to the rest of the world would be reversed as debt would be replaced in part by new equity investments.
7. The Foreign Investment Review Board could be dismantled and replaced as an executive branch of treasury with broad guidelines centred around the “national interest”.
8. We would have certainty in investing overseas in an unlimited capacity indefinitely. The present situation, in my view, will lead to a painful reintroduction of exchange controls, probably after it is too late.

I would wish this to occur in 1985.

BOOK REVIEW

PETROLEUM — THE NEXT 15 YEARS
Published by
Australian Mineral Economics Pty. Ltd.

A variant to Murphy’s Law states that “the only certainty about any forecast is that it will prove to be wrong”.

In spite of the foregoing foreboding, the 235-page study, Petroleum — The Next 15 Years, published in January, 1985, by the Sydney-based resources consulting group, Australian Mineral Economics Pty. Ltd., is a comprehensive and useful analysis of the world’s petroleum market scene from the 1970’s to now, with various forecast scenarios of the world’s supply/demand for petroleum resources through to the year 2000.

The volume offers a comprehensive evaluation of the world demand for energy; the world’s petroleum resources, supply/demand and pricing trends; international trade in petroleum; and has a useful summary, albeit somewhat sketchy, on the Australian oil and gas industry. The study also has a very convenient and wide-ranging collection of tables, graphs and appendices in relation to the various topics covered, and these alone make it a handy reference volume.

There are a few glaring errors or omissions. For example, there is a map showing the world’s giant oil and gas fields, including those gas fields in the Cooper