



FULL REPORT // JULY 2013

# Long-term Investing Report

Taking a long-term view of the  
historical investment landscape.





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# Executive summary

## Looking back: A giant slide in bond yields, and an Australian triple treat

Two key themes dominated investment returns for the last 10 and 20 years to 31 December 2012:

- » Falling bond yields in Australia and globally
- » Strong economic growth in Australia, driven by the resources sector

### 1. Falling bond yields

Bond yields followed a long downward trajectory over the last two decades, as interest rates and inflation fell from nearly double-digit peaks in 1994 to current lows. As local and global bond markets rallied, bond investors benefited from consistently higher returns over the last 10 and 20 years.

### 2. Strong economic growth has helped Australian assets

Investors exposed to a number of Australian assets have enjoyed a 'triple treat' from investment returns relative to offshore assets, especially over the last 10 years.

#### a) Australian share market

The domestic share market has not been immune from the risk-on risk-off volatility affecting share markets since the global financial crisis. However, Australia has experienced less extreme share market fluctuations in the lead up to and recovery from the crisis – compared to our counterparts in the Northern Hemisphere – as strong resource sector activity offset weaker domestic growth.

#### b) Australian currency and interest rate markets

The Australian dollar doubled in value over the past decade, as the boom in commodity prices and global risk appetites took the domestic currency from being very undervalued to very overvalued, with significant volatility along the way. The dramatic currency appreciation protected hedged returns from offshore assets, while unhedged investments suffered.

Australia has also enjoyed a relatively stable interest rate environment compared to the multiple liquidity injections and debt crisis management that the US Federal Reserve and the European Central Bank have had to face in recent years. Australian cash rates have averaged between 3–5% over the past few years, reflecting a healthy economy, in contrast to the decline of rates to near zero levels in other developed markets.

This higher interest rate differential supported domestic currency appreciation and hence, relatively higher returns from hedged assets.

#### c) Australian residential investment property

Australians' love affair with bricks and mortar has seen housing prices increase persistently over most of the last two decades. However, following the housing collapses in Ireland, Spain and the US – which saw property values fall by 20–50% from their peaks in 2007 – the domestic market has cooled. The two-speed domestic economy driven by mining activities has slowed to a single pedestrian-speed growth outlook.

#### Highlights of the 2013 update include:

- › Australian shares outperformed hedged overseas shares in six of the past 10 years. Additionally, Australian shares outperformed *unhedged* overseas shares in eight of the past 10 years.
- › Thus, currency hedging helped boost returns from offshore assets, with hedged overseas shares outperforming unhedged overseas shares in 9 out of the past 10 years.
- › The stronger equity markets of 2012 have significantly boosted 10-year returns for domestic and global equities, and domestic and global listed property. Combined with strong bond returns, this has resulted in higher returns for diversified managed funds overall, especially funds with higher growth-asset exposures and higher hedged overseas shares.
- › The impact of tax continues to be lower for Australian shares and Australian residential investment property relative to global assets and defensive assets, due to dividend imputation and the tax deductibility of expenses respectively.

# Analysis of the 2013 update

## Results: 10 years to 31 December 2012

The domestic triple treat was reflected in strong performance from Australian dollar-denominated assets for the 10 years to 31 December 2012.

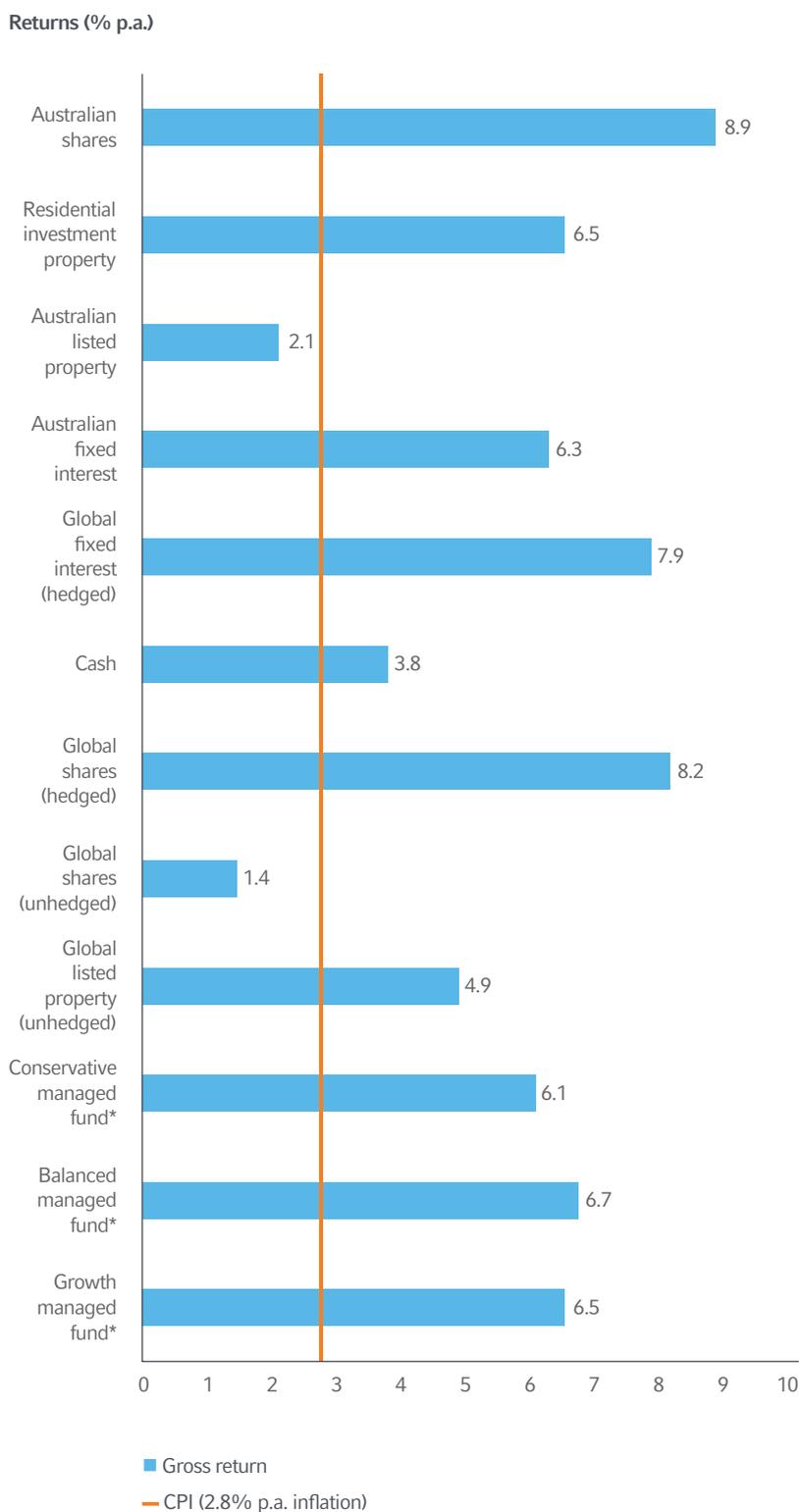
Falling bond yields also supported fixed interest returns during this period.

### Comparison across asset classes on a before-tax basis: 10 years

- › The majority of Australian assets outperformed their global counterparts, with Australian shares topping the report card at 8.9% p.a. on a before-tax, after-fees basis.
- › This was followed by hedged global shares at 8.2% p.a. and hedged global bonds at 7.9% p.a., which both benefited dramatically from the strong Australian dollar. Hedging added more than 6% p.a. to the returns from global shares, accounting for more than 80% of total performance.
- › Continuing the domestic run, Australian residential investment property and Australian bonds added 6.5% p.a. and 6.3% p.a. respectively.
- › The exception to the domestic success is Australian listed property which only returned 2.1% p.a. due to the significant underperformance in listed property markets globally in 2007–08. Unhedged global listed property also underperformed at 4.9% p.a.<sup>1</sup>
- › In addition to Australian listed property, unhedged global shares also failed to keep pace with inflation (1.4% p.a. versus 2.8% p.a.). Cash averaged 3.8% p.a.
- › The sample managed funds benefited from the stronger equity markets in 2012.

1. 10 year returns for hedged global listed property is not available. Thus, an unhedged return series has been used in this analysis.

**Exhibit 1** Gross returns for the 10 years to December 2012



\* Only before-tax returns have been calculated

**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

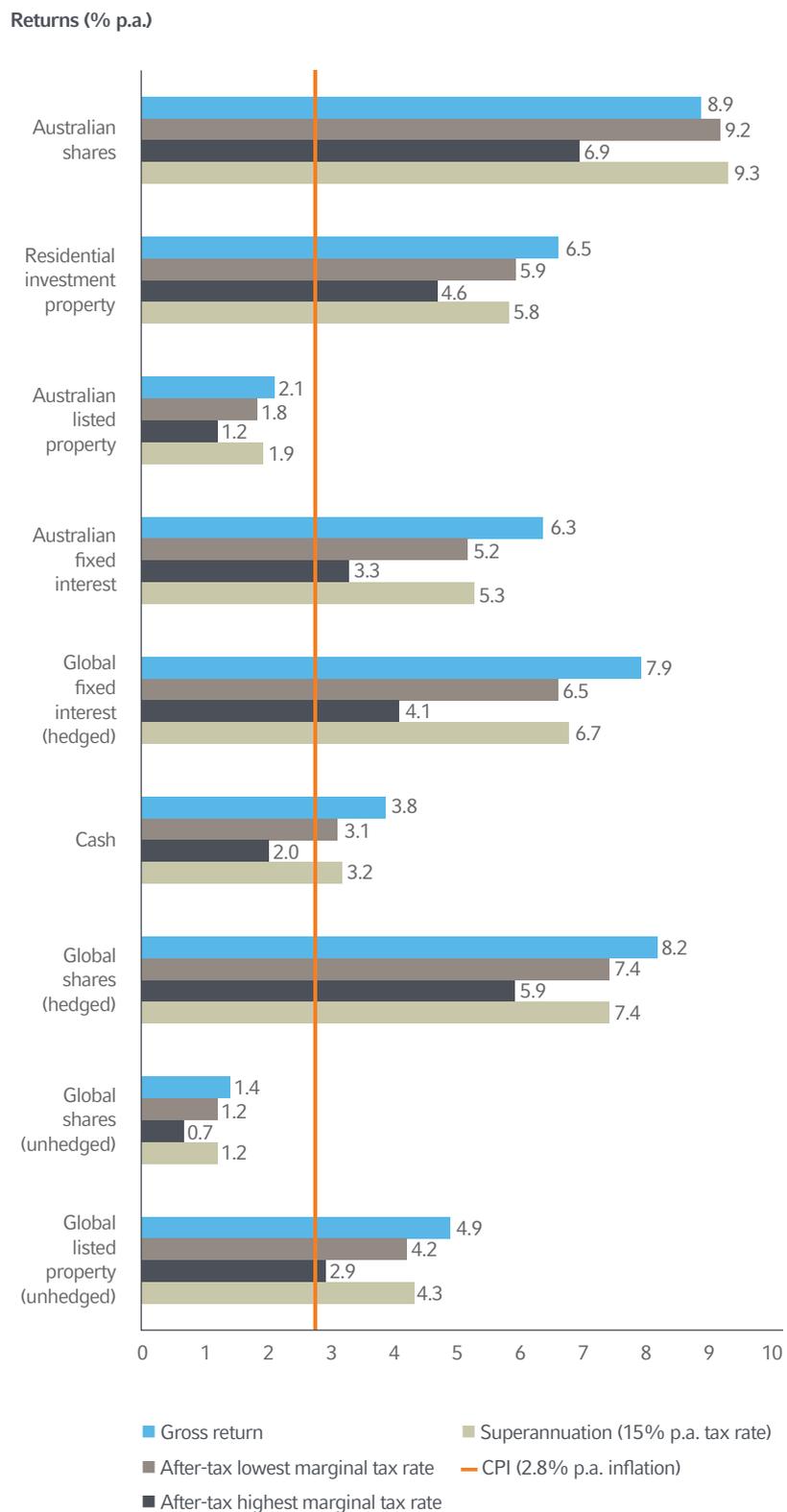
### Comparison across asset classes taking into account tax: 10 years

- › Absolute returns changed materially when tax was incorporated into the analysis, because the impact of tax differed across different asset classes and geographies.
- › Tax had less impact on Australian shares and Australian residential investment property compared to defensive assets like bonds and cash. In particular, dividend imputation created an additional source of returns for those investing in Australian shares through franking credits, while tax deferral and capital gains also helped. The tax deductibility of expenses against income from residential investment property lowered the effective tax rate for this asset class. In contrast, returns from defensive assets were primarily taxed as income without concessions.
- › This also meant the impact of tax on Australian shares and Australian residential investment property was lower than the tax rate applicable to global assets.
- › In addition, the difference in after-tax returns between types of investors in the same asset class highlighted opportunities to choose the right investment structure. For example, the value of investing in Australian equities via a superannuation vehicle rather than directly was an additional 2.4% in returns to high marginal tax rate investors over 10 years.

The 0.5% Medicare levy increase from 1 July 2013 and the prospect of higher personal tax rates more generally in future years will make it even more attractive to invest via super rather than directly.

- › However, due to the greater differences between asset classes for the 10-year period, the order of asset class returns remains unchanged from the gross results, even after taking into account taxation for superannuation investors, and the lowest and highest marginal tax rates.

**Exhibit 2** Before-tax and after-tax returns for the 10 years to December 2012

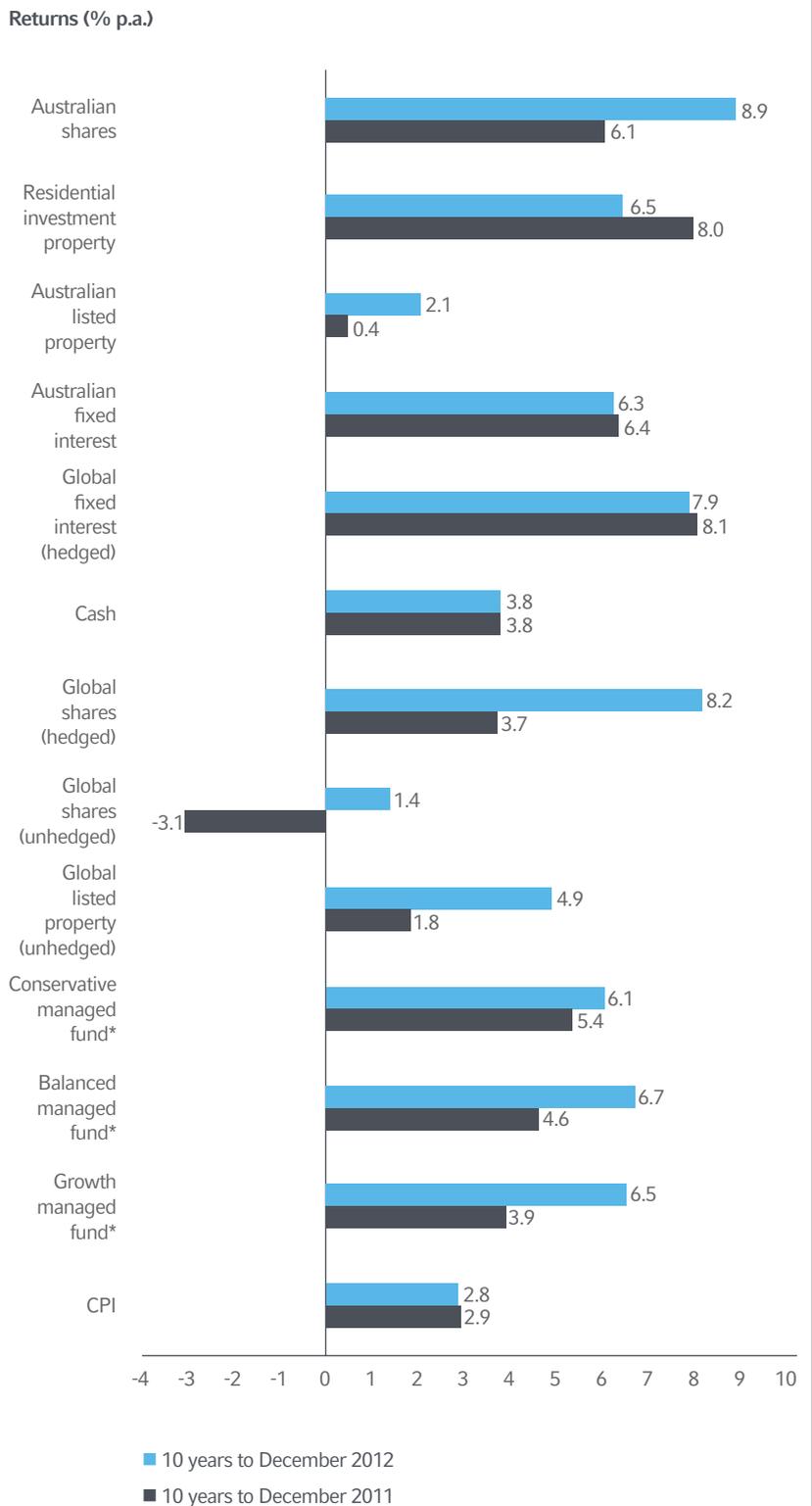


**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

### Comparison with last year's gross results: 10 years

- › Comparing the 10-year results to 31 December 2011 and to 31 December 2012 on a gross basis, last year's winner – hedged global bonds – slipped two spots to third place, as yields became less attractive relative to growth assets. The runner-up from last year – Australian residential property – came fifth this year.
- › Australian shares and hedged global shares took first and second places this year, driven by the strong equity market rally – especially in the second half of 2012 – as risk appetites rebounded. This also brought unhedged global shares returns into the black, beating last year's results by 4.5% p.a.
- › Returns from growth assets (domestic and global shares and listed property) were dramatically higher due to stronger markets for risk assets last year. The only exception was residential property, which posted a modest 2.6% return in 2012. On the other hand, returns for defensive assets (domestic and global bonds and cash) were largely unchanged from last year. This helped reverse the return patterns from last year, making them more 'conventional' – the sample Balanced and Growth managed funds generally posted higher returns than the sample Conservative fund modeled. However, the sample Balanced managed fund remained slightly ahead of the sample Growth fund for the 10 years to 31 December 2012, primarily due to the significant underperformance of unhedged global shares over their hedged counterparts.
- › Overall, returns for the three sample managed funds modeled also increased significantly (between 0.7% to 2.6%) for the 10-year period to December 2012 compared to results for 2011, due to last year's improved risk appetites.

**Exhibit 3** 10 years to December 2012 vs 10 years to December 2011



\* Only the before-tax returns have been calculated

**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

### Comparison with and without gearing: 10 years

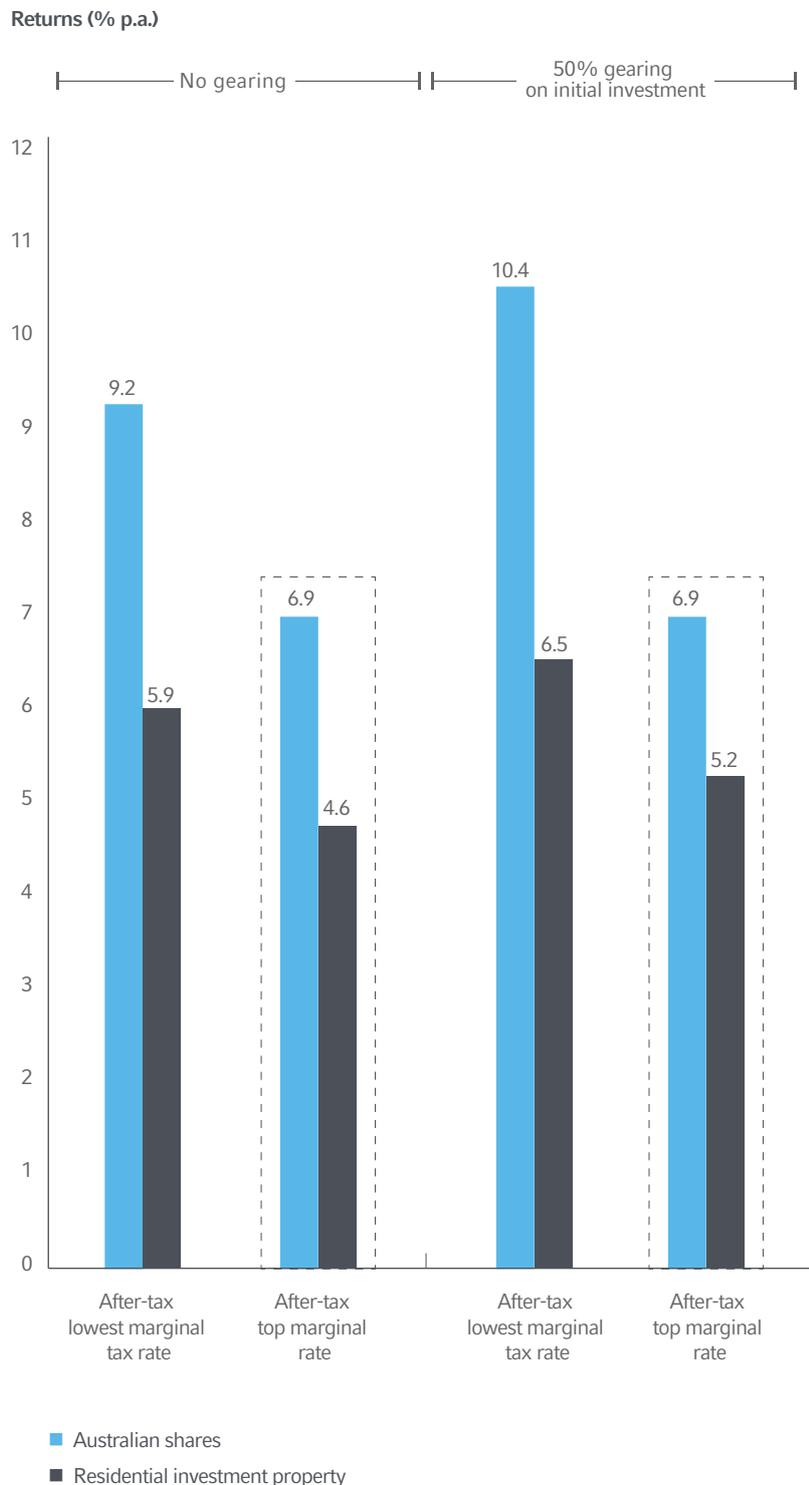
- › Incorporating borrowed funds – or gearing – into the analysis, enhanced residential investment property returns for investors at the lowest and highest marginal tax rates.
- › For investors in Australian shares, gearing benefited low-tax rate investors but not high-tax rate investors.

The low interest rate environment has kept borrowing costs low, and meant that gearing-related tax deductions were modest.

Both sets of investors benefited from receiving a higher amount of franking credits on the geared portfolio. However, this merely helped to neutralise the costs of gearing for high-tax rate investors. However, low-tax rate investors were significantly overcompensated for the additional costs of gearing the portfolio, by the extra franking credits received as a proportion of the capital outlay.

- › Australian shares continued to outperform residential property for the lowest and the top marginal tax rates after gearing was taken into account.

**Exhibit 4** Returns with and without gearing for the 10 years to December 2012



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

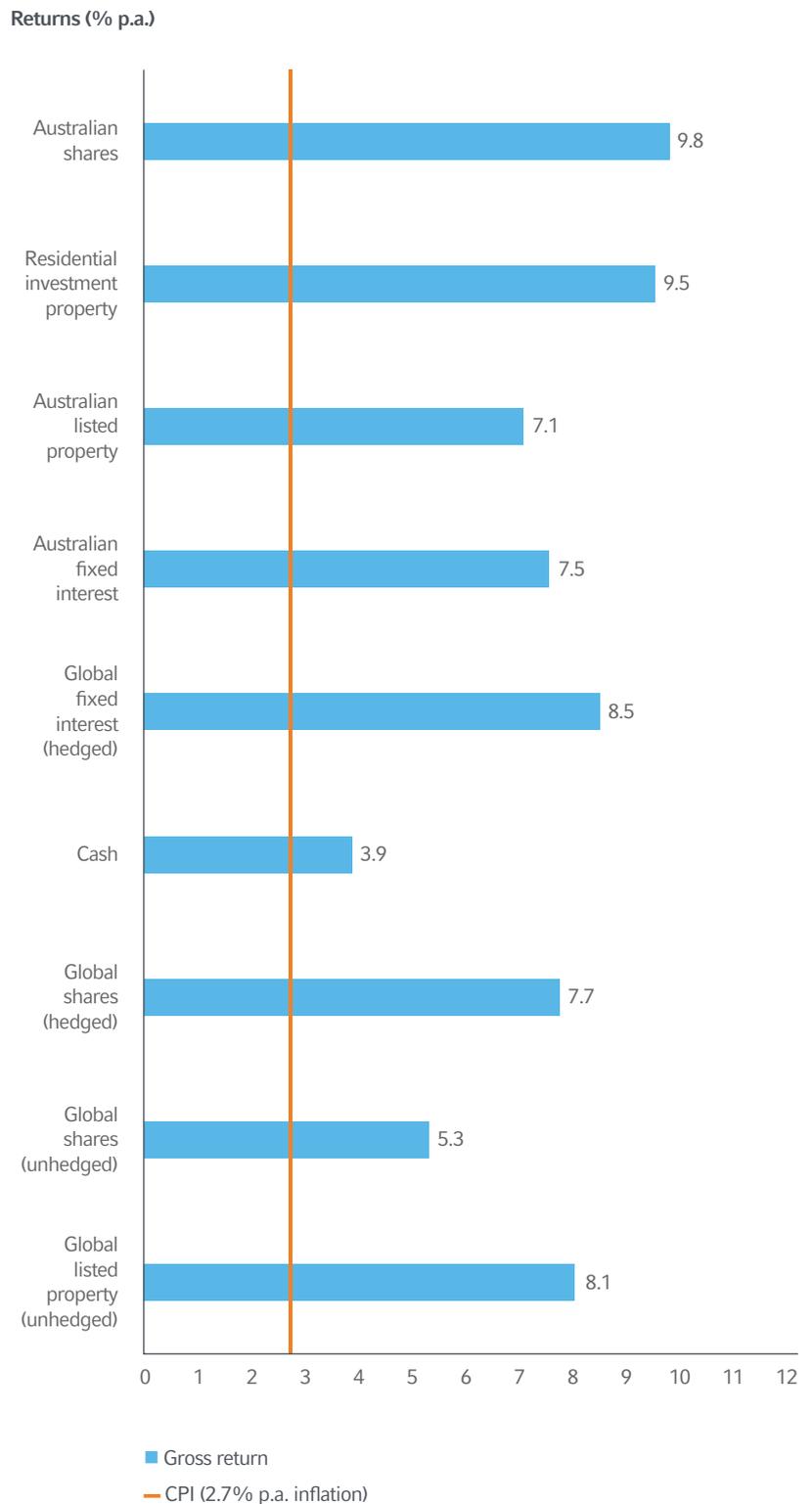
## Results: 20 years to 31 December 2012

For the longer 20-year period to 31 December 2012, the themes of falling bond yields and robust domestic economic growth also resulted in strong bond returns, and a triple treat of investment returns from Australian denominated assets.

### Comparison across asset classes on a before-tax basis: 20 years

- › The majority of Australian assets also outperformed global counterparts over the longer timeframe. Australian shares were again leading at 9.8% p.a., followed by Australian residential property, which returned 9.5% p.a.
- › Hedged international bonds added 8.5% p.a. while hedged overseas shares returned 7.7% p.a., as favourable currency movements helped add more than 2% p.a. to underlying returns from offshore assets.
- › Unhedged global listed property then followed with 8.1% p.a., Australian bonds at 7.5% p.a. and Australian listed property at 7.1% p.a. The laggards were unhedged overseas shares at 5.3% p.a. and cash at 3.9% p.a.
- › All asset classes beat inflation, which rose 2.7% p.a. over the 20 years to 31 December 2012.

**Exhibit 5** Gross returns for the 20 years to December 2012

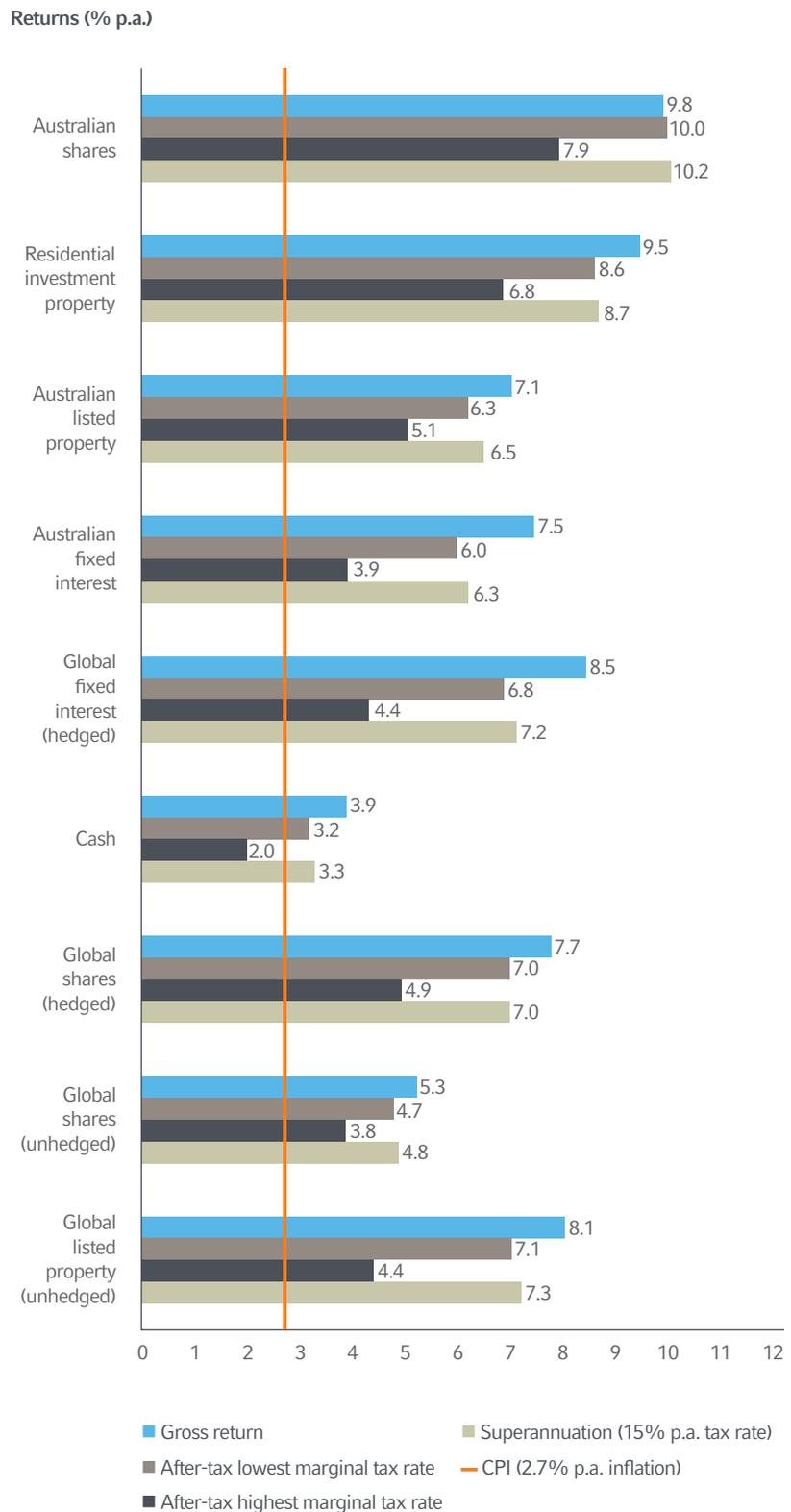


**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

### Comparison across asset classes on an after-tax basis: 20 years

- › As with the 10-year results, absolute returns changed materially after tax, particularly for the categories of investors paying a high marginal tax rate in all asset classes, and low-rate taxpayers invested in Australian equities. The differential tax treatment across different assets becomes more significant when measuring longer periods of time, due to the cumulative effects of compounding tax costs and benefits.
- › The order of asset-class returns on an after-tax basis for superannuation investors and those on the lowest marginal tax rate was the same as the gross results. Results for investors on the top marginal tax rate were similar, except Australian listed property swapped places with global listed property. This was due to the more favourable treatment of income from domestic listed property vehicles compared to global assets.

**Exhibit 6** Before-tax and after-tax returns for the 20 years to December 2012

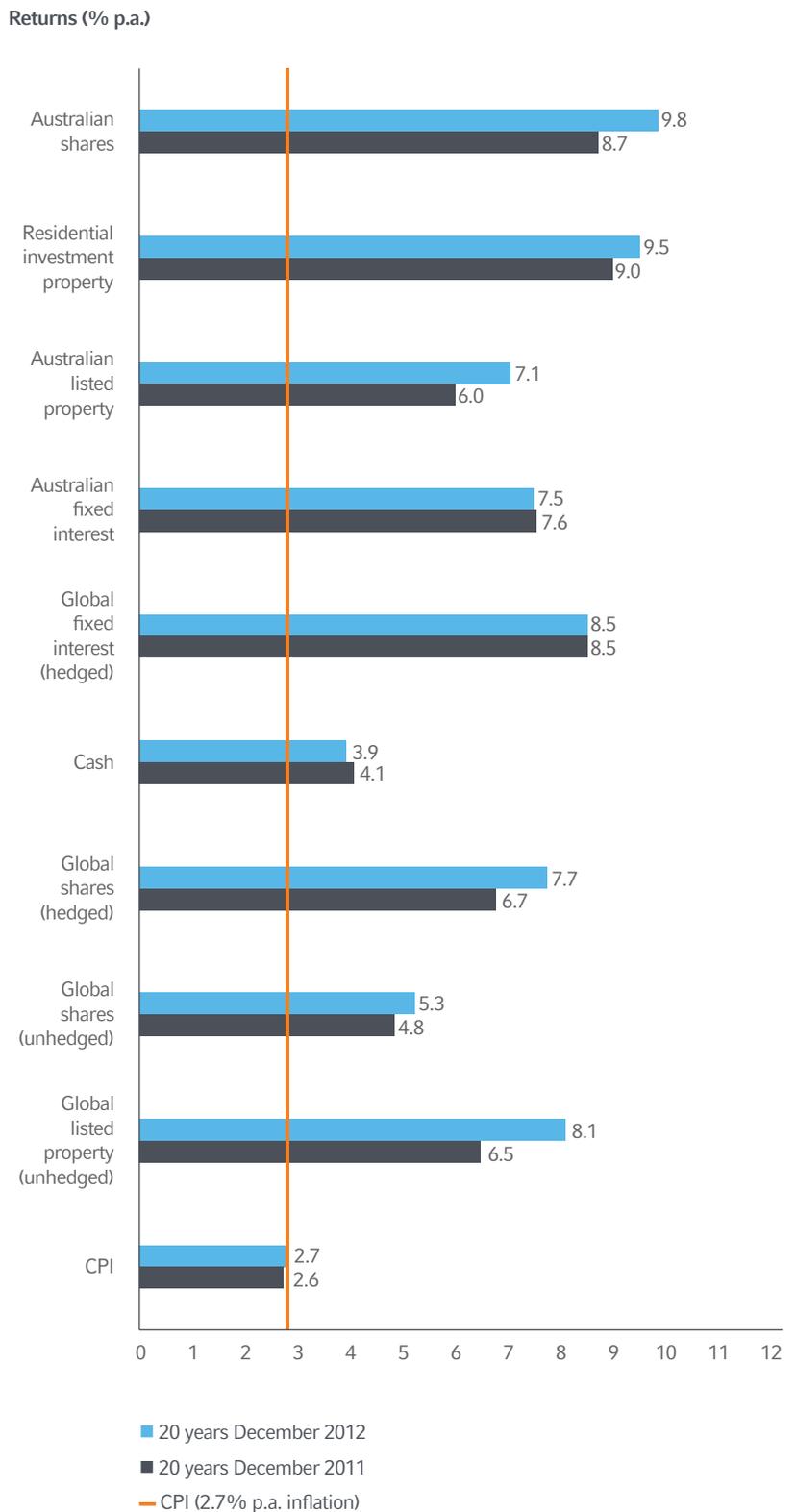


**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance. See page 10 for details of marginal tax rates.

### Comparison with last year's gross results: 20 years

- › Compared to the 20 years to 31 December 2011, last year's winner – Australian residential property – this year swapped places with last year's runner-up – Australian shares. This was driven by the strong equity market rally – especially in the second half of 2012 – as risk appetites rebounded, adding more than 1% to risk asset results across the board. Unhedged global listed property swapped places with Australian fixed interest (up from sixth to fourth place). All other asset classes maintained their positions.
- › As with the 10-year results, returns from growth assets (domestic and global shares and property) were higher due to stronger markets for risk assets in 2012. Meanwhile, returns for bonds remained largely unchanged, continuing the long downward slide in yields.

**Exhibit 7** 20 years to December 2012 vs 20 years to December 2011



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

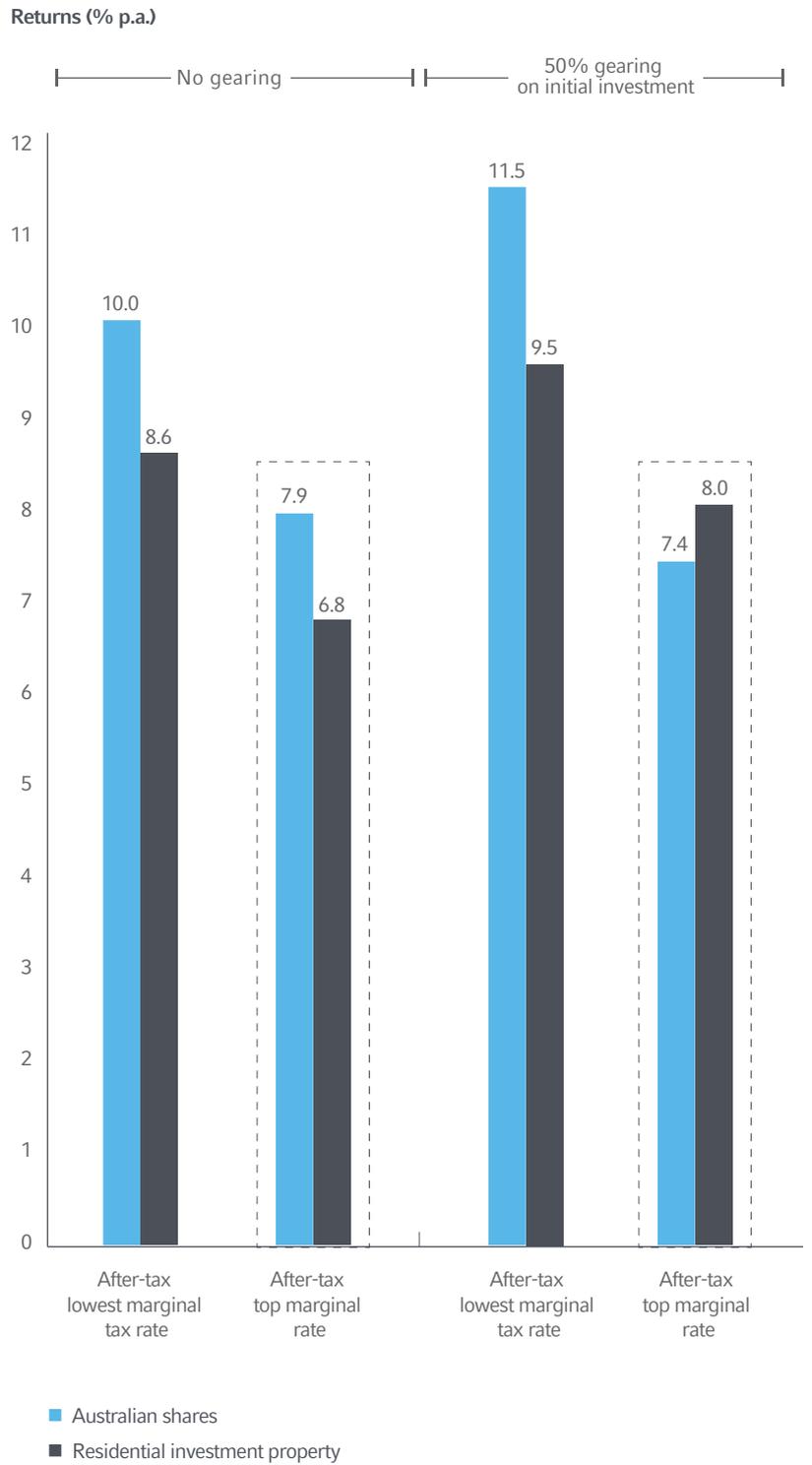
**Comparison with and without gearing: 20 years**

› Incorporating borrowed funds – or gearing – into the analysis for the longer 20-year period enhanced returns from Australian shares and residential investment property for investors at the lowest marginal tax rate. This was also the case for residential property at the highest marginal tax rate.

For Australian share investors at the highest marginal tax rate, the impact of gearing reduced returns. This was due to the effect of higher after-tax borrowing costs, and a higher tax liability on geared returns. These factors slightly outweighed the benefits of extra returns from the geared portfolio.

› For a similar reason, Australian shares continued to outperform residential property for investors paying the lowest marginal tax rate, but underperformed for those paying the top marginal tax rate.

**Exhibit 8** Returns with and without gearing for the 20 years to December 2012



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

# Appendix

This analysis has been conducted on the following basis:

## Investment comparison

- › All investment returns are determined after taking into account expenses relating to the acquisition, management and disposal of the asset. **Gross returns** are calculated before tax but after costs. **Net returns** allow for the taxation treatment of each investment over the period of the analysis. This aims to represent a realistic method of comparing the different asset classes for an investor.
- › **Compound returns** are calculated over a 10-year period from 1 January 2003 to 31 December 2012, and over a 20-year period from 1 January 1993 to 31 December 2012. The returns are equivalent to the per annum compound returns that investors would have received for an investment in the particular asset class if they invested in an equivalent portfolio over the two periods.

## Income tax

- › The lowest and highest **marginal tax rates** are currently 20.5% and 46.5% respectively. These rates have varied slightly over the 10 and 20 years due to changes in **taxation policy** and the 1.5% **Medicare levy**. These variations have been taken into account in the calculation of after-tax returns. The bottom and top marginal rates both include the **Medicare levy**.
- › These variations have been taken into account, including the impact on the calculation of franking credits, which affects after-tax returns for Australian shares.

## Capital gains

- › Generally, assets acquired on or after 20 September 1985 are subject to the capital gains tax provisions. For the calculation of 10- and 20-year returns, capital gains tax, is calculated on the initial investment and any subsequent reinvestment of income. Cash is not subject to capital gains tax as all gains are taxed as income and so are subject to marginal rates. For ease of calculation and in the absence of Australian bonds coupon and capital data, the report assumes returns from Australian bonds are treated as income.
- › Assets acquired prior to 21 September 1999 and held for longer than 12 months can be assessed for capital gains tax in one of two ways. Private

investors can choose to pay capital gains tax (at their marginal tax rate) on 100% of the capital gain (with indexation of the tax cost) or 50% of their capital gain (with no indexation). In this report, we have presented sector returns based upon the calculation method that provides the higher after-tax returns. The discounted capital gain method (as opposed to indexation) has provided the higher after-tax returns in all cases.

## Capital losses

- › **Capital losses** may be carried forward indefinitely and offset against other **capital gains** in future periods. An assumption has been made that the investor has other investments – either today or in the future – that have produced or will produce capital gains against which capital losses may be offset.

## Imputation credits

- › Since July 2000, low-tax rate investors with imputation credits remaining after offsetting all tax have been able to claim back the excess as a refund from the Australian Taxation Office. Prior to this, the excess could only be offset against income tax from other sources. An assumption has been made that before July 2000, the investor had other sources of income against which to offset this excess.

## Effective tax rates

- › This study shows that tax (and its differing effect on capital gains and income) makes a significant difference to the end return for an investor. Overall, for the 20-year period to 31 December 2012, the effective tax rate for top marginal tax payers were:

	20 yrs*
Australian shares	19%
Australian listed property	28%
Residential investment property	28%
Global shares	29%
Global shares (hedged)	36%
Global listed property	46%
Australian bonds and cash	48%
Global bonds	49%

\* To 31 December 2012.

## Gearing

- › After-tax returns with **gearing** have also been calculated for Australian shares and residential investment property over the 10-year period from 1 January 2003 to 31 December 2012, and over the 20-year period from 1 January 1993 to 31 December 2012. Half of the initial investment is assumed to be borrowed, and gearing arrangements are assumed to involve interest-only loans (that is, periodic payments do not include any repayment of principal). In addition, allowance is made for the deductibility of interest costs.
- › **Borrowing costs** are based on data from the Reserve Bank of Australia (RBA) bulletin. The borrowing costs for residential investment property are based on the standard variable rate for housing loans. The borrowing costs for Australian shares are based on the margin loans rate.

## Superannuation

- › The investment earnings of a complying superannuation fund or retirement savings account have been taxed at a rate of 15% as of 1 July 1988. Prior to this, there was no tax on superannuation earnings. The capital gains tax discount for superannuation funds is one-third of the capital gains included in a superannuation fund's assessable income. The tax that a superannuation fund pays on its assessable income (earnings and taxable contributions) can be reduced by using of imputation credits.
- › In the superannuation example, it is assumed the investor is over the age of 60 when assets are redeemed, so no tax is payable on a superannuation lump sum or income stream benefit payments.

## Investment measures

- › The **residential property** measure is a population-weighted average return calculated across major capital cities. Increases in value are based on median house prices obtained from the Real Estate Institute of Australia. Data from the Australian Bureau of Statistics is used to make adjustments for capital improvements. Net rental income allows for vacancy rates, maintenance expenses, management fees, government charges, land tax and insurance. Acquisition and disposal costs include conveyancing, stamp duty and agent's fees.
- › The **cash** measure assumes an investment of \$50,000 in cash management bank accounts, based on an average of the five largest banks' rates sourced from the RBA.
- › The **Australian shares** measure is based on investment in listed shares, with price movements and dividend reinvestment consistent with the S&P/ASX All Ordinaries Accumulation Index. Allowance is made for brokerage and stamp duty (where applicable) on acquisition and disposal. Stamp duty ceased to apply from 1 July 2001 for transfers of marketable securities quoted on the Australian Securities Exchange. Dividend franking is taken into account in determining the impact of tax on dividends.
- › The **Australian bonds** measure is based on investment in Australian Government and corporate bonds. Returns are derived from the UBS Australia Composite Bond Index. For ease of calculation and in the absence of available data, price movements and coupon payments are both deemed to be taxed as income.
- › The **Australian listed property** measure is based on the returns implied by the S&P/ASX 200 Property Trust (Accumulation) Index. Acquisition and disposal costs, such as brokerage and stamp duty (where applicable), have been factored into the return calculations. Assumptions have been made with respect to the tax treatment of listed property income, including the component of tax-free income (abolished in July 2002) and tax-deferred income.
- › The **global shares (unhedged)** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the Russell Developed Large Cap Index (unhedged) in Australian dollars from 1997, onwards and the MSCI World ex-Australia Gross Dividends Accumulation Index (unhedged) in Australian dollars prior to 1997. Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.

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  - › The **global listed property** measure is based on dividend reinvestment consistent with the FTSE EPRA/NAREIT Developed Index in Australian dollars (unhedged). Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.
  - › The **conservative managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 25–35% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to lack of data on distributions.
  - › The **balanced managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 65–75% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to lack of data on distributions.
  - › The **growth managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 75–85% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to lack of data on distributions.



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