Colonial First State
Global Asset Management

Equity Preference Index – the first signs of a shift in investor sentiment

In collaboration with the University of Western Australia Business School

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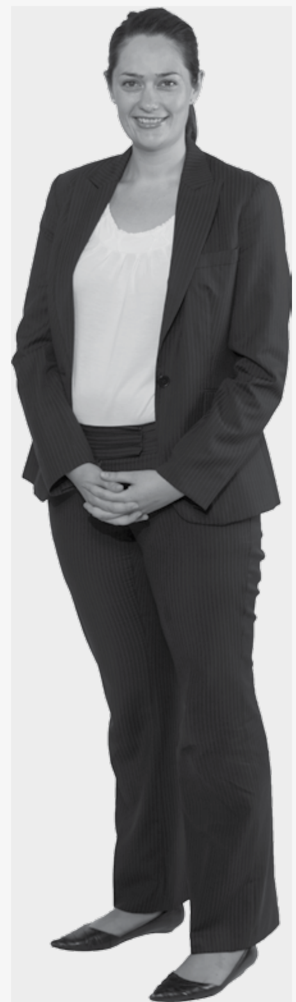
Summary

- Investor sentiment continues to play a large role in the performance of the Australian equity market; equity redemptions have been a notable feature in the period since the Global Financial Crisis
- In the second half of 2012 the macroeconomic landscape improved, term deposit rates fell and equity market returns were consistently stronger. These factors traditionally encourage allocations back into equities
- As this second edition of the Equity Preference Index shows, while there have been some signs of a neutralisation of preference for equities, it is too early to suggest sentiment has improved and that the allocation out of equities was only temporary
- At this stage sentiment has improved for under 35 year olds and 50 to 59 year olds; no broad-based trends are evident as yet
- Females and investors aged between 35 and 49 remain at most risk of not meeting retirement objectives. Saving more, accelerate saving earlier than anticipated or moving into higher returning asset classes remain the key for these investors



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An introduction to the Equity Preference Index

In June 2012 we launched the first edition of the Equity Preference Index, a collaboration between CFSGAM and the University of Western Australia Business School.

The Equity Preference Index is a proprietary measure of investor sentiment, calculated using Colonial First State managed fund flow data for non-advised investors. It looks at investors' overall moves in and out of equity-based managed funds and switches between asset classes. The focus on non-advised clients allows the clearest exposure to discretionary decisions by investors based on their view of the market and how confident they feel about future returns.

The Equity Preference Index is an accurate measure of investor behaviour and sentiment compared to existing survey-based measures that are frequently referred to when discussing investor sentiment. Investor sentiment has always thought to be a key driver of equity market performance and has frequently been studied by academics. Investor sentiment has been underutilised as a market tool, however, and can provide us with an accurate measure of behaviour and what this could mean for equity returns going forward.

We sought to develop an independent tool to allow us to understand how investors were behaving at different points in the market cycle. This might also help us determine when investors' preference for equities may turn around; especially post the Global Financial Crisis. At that time – and frequently thereafter – one of the most common questions we were asked is 'when can we expect to see money flow back in to equities'?

In the first edition of the Equity Preference Index, which included data up to 31 January 2012, it was clear that preference for equities had shown a sharp deterioration in 2010 and 2011. This period followed the worst of the Global Financial Crisis and coincided with a period when concerns over the European debt crisis and US economy were at their most intense. A clear preference for cash had developed among most investors as term deposit rates were also compelling.

In this first edition of the Equity Preference Index, preference for equity-based managed funds was the weakest among women and older investors, particularly those older than 59. Under 35 year olds had consistently retained a higher equity exposure than other age groups. This is logical, given these individuals have the longest time horizon left to invest and accumulate wealth and ride the market cycle.

One of the main themes to emerge from the first edition was that women older than 35 years old had placed themselves at high risk of not meeting retirement objectives if subdued sentiment towards equities persisted for a long period of time.

In fact many investors had been substituting risk of capital volatility for longevity risk through the accumulation phase. This was particularly prevalent in the 35 to 49 year old group, whose preference for equities was similar to 50 to 59 year olds, placing this demographic at increased risk of not saving enough for retirement.

The choices were clear – investors had to save more, accelerate savings earlier than anticipated or move back into higher growth alternatives.

The second edition of the Equity Preference Index

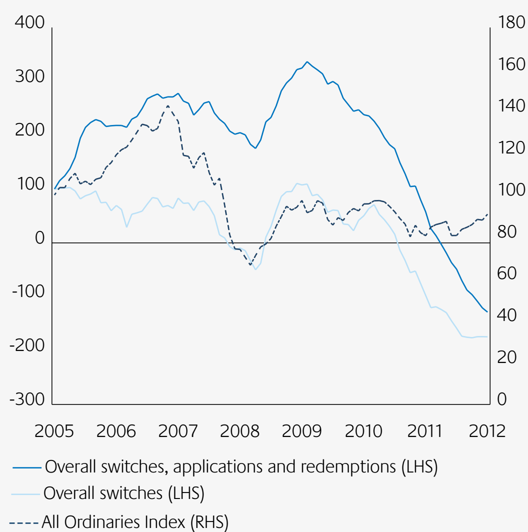
In this second edition of the Equity Preference Index, and the first regular quarterly update, data has been updated to 31 December 2012. Over this period of time there have been several significant events from the Australian investor's perspective that could have prompted a change in sentiment and a renewed preference for equity-based managed funds:

- The Australian equity market has returned just over 14% since 31 January 2012 (on a total return basis).
- The global macroeconomic landscape has improved and the perceived risk of extreme adverse outcomes has declined. This was prompted first in Europe from comments made by European Central Bank President Mario Draghi that he would do 'whatever it takes' to preserve the euro. There were also more optimistic signs of a US economic recovery and a commitment by the Federal Reserve to engage in open-ended Quantitative Easing. In addition, the economic outlook improved in China and there was a smooth leadership transition. Overall, investors appeared to develop greater confidence that policy makers would announce further actions to prevent a worst case outcome as and when deemed necessary.
- Term deposit rates in Australia fell on average from 4.20% in January 2012 to 3.55% in December 2012. These moves were based on the Reserve Bank of Australia easing the official interest rate from 4.25% to 3% over the same period.

The chart to the right outlines the overall Equity Preference Index updated to 31 December 2012. We include both an aggregate measure, including applications, redemptions and switches, as well as a switches only measure. This chart shows that the preference away from equity allocations in managed fund products shows signs of correcting.

Notable signs of a change in equity preference emerged from June 2012; when switches in to and out of equity managed funds appeared to neutralise. Indeed, switches in to and out of equities have largely offset one another since July 2012. The aggregate measure, however, which captures applications and redemptions, continues to show deterioration in equity preference. Investors seem more content reallocating existing funds to equity-based managed funds than committing new money to the asset class.

Equity Preference Index: Aggregate and switches



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

Equity preference by gender

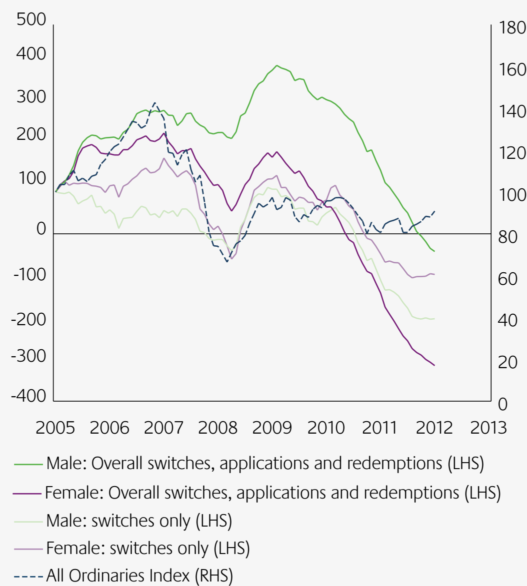
As part of our research, we also split the Equity Preference Index by gender.

This analysis continues to reveal a stark difference between males and females in terms of overall equity preference. Overall, females continue to have a much lower preference for equities then males. Indeed this trend appears to have increased post the Global Financial Crisis.

Encouragingly, the data to 31 December 2012 suggests switches into equity-based managed funds have increased for females since July 2012. Equity preference for females in the switches only measure has risen more than 7% since July 2012. Switches for males have been broadly unchanged over the same period.

Our first edition of Equity Preference Index highlighted that females tend to track the market with switches into equities, while males are more circumspect. These latest results support this original observation, given the rising equity market.

Equity Preference Index by gender: Aggregate and switches



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

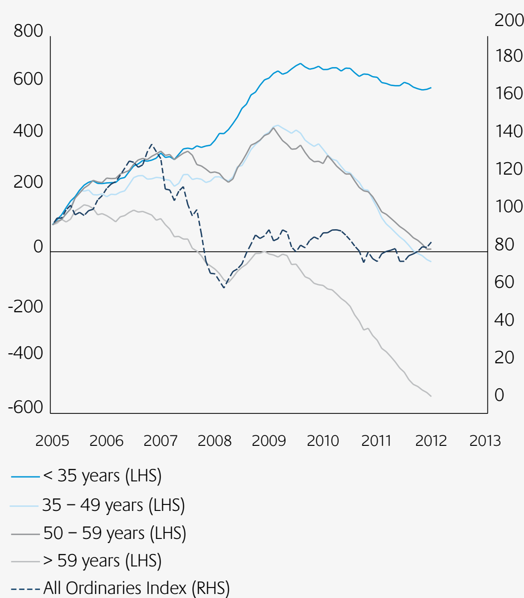
Both aggregate measures for males and females, which take into account applications, redemptions and switches continued to see preference for equities fall.

These latest results continue to highlight that the cautious behaviour of females – in particular their much lower overall preference for equities – must be seen with rising concerns in the context of lower female superannuation balances. Unless there is an increase in saving or a reallocation into higher returning asset classes, there appears to be a growing risk that some females will not meet their retirement objectives.

Equity preference by age

Across the age groups, we continue to see large divergences between the four subsectors. The results also highlight some differences compared to our broad expectations of behaviour.

Equity Preference Index by age: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

In this second edition of our Equity Preference Index, under 35 year olds still have the strongest preference for equities. Indeed the last quarter of 2012 showed an improved preference for equities of 1.5%, as seen in the chart above. As mentioned above, this is likely attributable to the improved investment landscape and favourable market returns in the second half of the year.

Our next oldest age group, 35 to 49 year olds, is not showing any signs of neutralising their preference for equities. In fact, preference for equities is still declining and this age group now has an overall lower level of preference for equities than 50 to 59 year olds. This is a real surprise given 35 to 49 year olds are in their peak accumulation phase. This trend could expose the 35 to 49 year group to greater longevity concerns if preference for growth assets does not return over time.

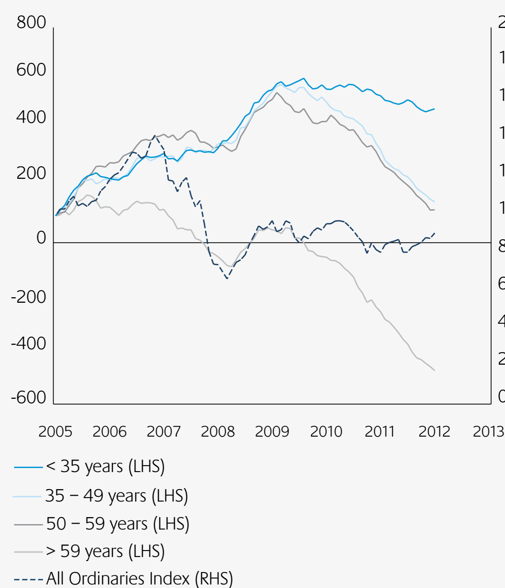
Lifestyle choices and a change in family circumstances could be partly attributable to the relatively low equity preference. In addition, low interest rates are encouraging mortgage and other debt repayments. However, the superannuation section later in this report suggests that investor behaviour in this age bracket is consistent also with behaviour inside super accounts. This suggests other factors are at play for this age group in terms of an overall low preference for equities.

The next oldest age group, the 50 to 59 year olds, who previously had been reducing their preference for equities are now neutralising – if not increasing. Over 59 year olds continue to have a declining preference for equities. In the first edition of the Equity Preference Index, we raised the possibility that 50 to 59 year olds were dormant equity investors – they liked the concept of equities, and were waiting for improvements in the investment landscape before re-entering the market. We believe this thesis continues to have merit.

Equity preference by gender and age

The next two charts provide more in-depth analysis of equity preference by gender and age, to help determine whether any group has begun to neutralise its preference for equities.

Equity Preference Index by age: Male: Aggregate



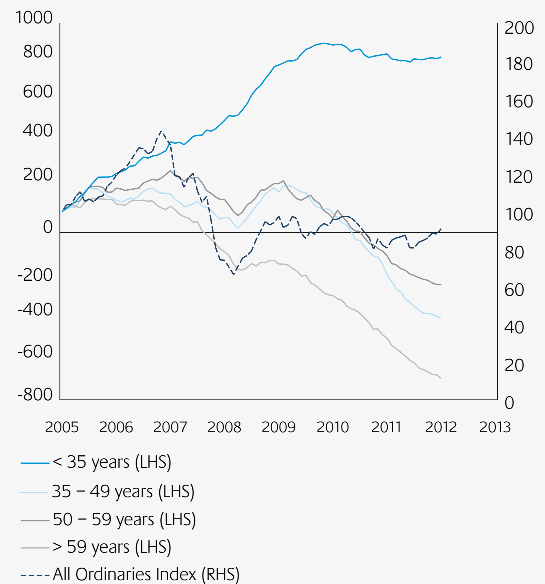
Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

As the chart above left shows, males under the age of 35 have begun to increase their preference for equities since October 2012; the Equity Preference Index for this group rose 2.3% in the final three months of the year. There are also tentative signs that males aged between 50 and 59 could be starting to increase their preference for equities.

Breaking down the data for females by age once again highlights the different dynamics that are at play within the female cohort. As the chart above right shows, females under 35 continue to maintain a higher preference for equities compared to other female age groups. Indeed equity preference in females under 35 is even higher than their male counterparts.

The second edition of our Equity Preference Index shows a continued deterioration in preference for equities within the other female age groups. Like their male counterparts, however, there are tentative signs that sentiment is beginning to neutralise in the 50 to 59 year old segment. The most significant trend continues to be the behaviour of 35 to 49 year old women, whose preference away from equities has increased at a faster rate than their older counterparts since January 2011.

Equity Preference Index by age: Female: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

Women aged between 35 and 49 years old remain at the highest risk of not meeting their retirement objectives. There are a number of possible reasons behind this decision making:

- Women overall rate themselves as having lower financial literacy then men. Lower financial literacy typically results in a lower appetite for risk.
- There have been studies, however, which show that younger women, particularly Generation Y (versus Generation X, which is predominantly the 35 to 49 year old group being discussed here), have a higher level of financial literacy then the older female age group. Generation Y appears more focused on its financial situation then previous generations. In part, this could be attributable to Generation Y being more technology savvy, making it easier to be engaged with personal wealth management.
- 35 to 49 year olds have also embraced home ownership at a higher level than the under 35 year old age group and have a higher level of debt. As a consequence, this group arguably has a higher preference for property as a way to build wealth.

- 35 to 49 year olds tend to have a greater memory of the early 1990s recession. Indeed many would have started their careers during this period, which could promote a more conservative attitude then generations either side.
- Women rate family financial matters more highly then men according to survey data. This trend would likely be magnified in this age group due to time taken out to raise families.

Further analysis and research will be required to assess the reasoning behind the decision making of this age group if these trends continue.

Equity preference by state

New to the second edition of the Equity Preference Index, we have broken down the data on a state by state basis.

Overall the results are broadly in line with expectations. Note: Data is not included for Tasmania, NT and ACT due to the higher volatility given a smaller sample size of the data set, although results are available on request.

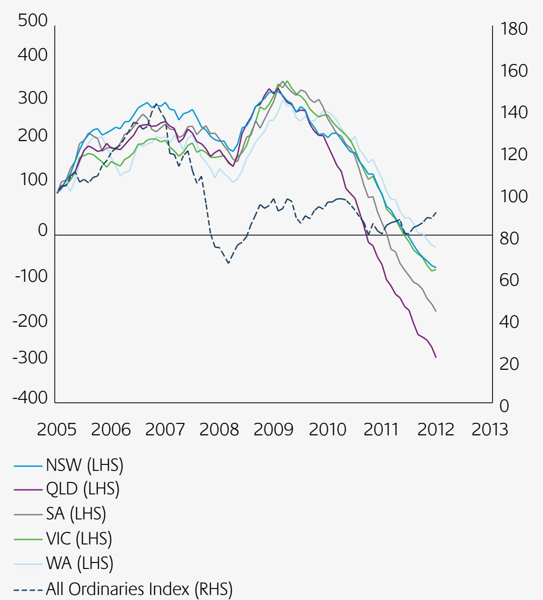
The fastest growing state on economic growth terms, WA, has the highest preference for equities among the major states. Notwithstanding this, overall preference for equities in WA has been falling using our aggregate measure including new net flows and switches.

The state with the lowest preference for equities, Queensland, also has the highest proportion of retirees, particularly concentrated around the harder hit area of South East Queensland. The Equity Preference Index for Queensland continues to deteriorate.

NSW and Victoria have performed alike, reflecting the similar nature of their populations and economies. South Australia, generally a lower growth state, has a weaker preference for equities when compared to NSW and Victoria.

On a state by state basis only Victoria has showed any sign of increased preference for equities, with a pickup in the last two months of 2012. WA, on the switches only measure, has also showed a modestly increased appetite for equities in recent months.

Equity Preference Index by state: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

A closer look at superannuation

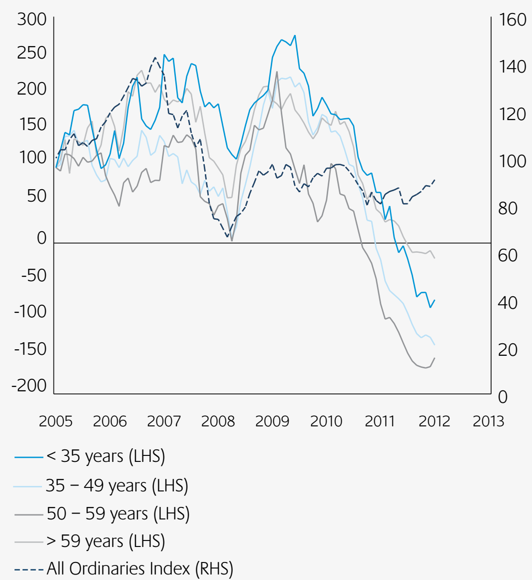
Isolating behaviour within superannuation accounts highlights some age variations in equity preference, reflected in switches into and out of equities.

Overall, investors are more conservative within their superannuation accounts. Whilst each group show signs of more neutral positioning, it is once again the under 35 year old age group which is most volatile (albeit preference for equities did improve towards the end of 2012).

The 50 to 59 year old age group shows the next most consistent signs of positive preference to equities. This appears consistent with the conclusions we drew from the broader Equity Preference Index. This segment appears to include dormant equity investors, who were waiting for improved conditions before returning to the share market.

Similar to their behaviour in all investment accounts, 35 to 49 year olds within their superannuation accounts show the least consistent sign of positive equity preference. Indeed this segment appears to remain more pessimistic than its age group would suggest. Given this behaviour is occurring both within superannuation and outside superannuation, there does seem to be an inherent theme that this age group is reducing its preference for equities. This theme will be examined further over time.

Equity Preference Index: Superannuation accounts by age



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice Personal Super (wholesale and retail).

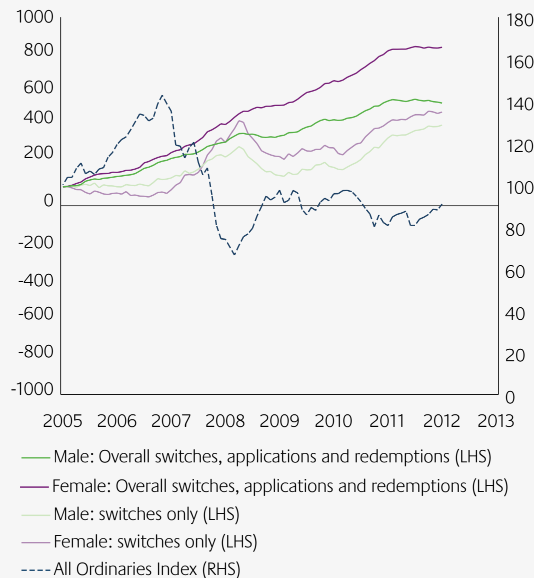
The Cash Preference Index

In this second edition of the Equity Preference Index we also introduce the Cash Preference Index.

This allows us to determine whether cash preference has peaked and what this could mean for flows into other asset classes, including equities.

The neutral to positive movement towards equities has been matched by a neutral to negative swing in the Cash Preference Index. On the whole, we observe that females continue to hold a higher preference for cash then males, who, at the margin, have a slightly negative cash preference. The Cash Preference Index for males peaked in June 2012 and has since fallen 3.6%. The Cash Preference Index among women also peaked in June 2012, but has since fallen only 0.5%. As the Equity Preference Index showed, females appear to have used this lower cash preference to begin reallocating back into equities. Based on the Equity Preference Index and the Cash Preference Index, however, it appears that males may be diversifying any reallocations across a number of different asset classes.

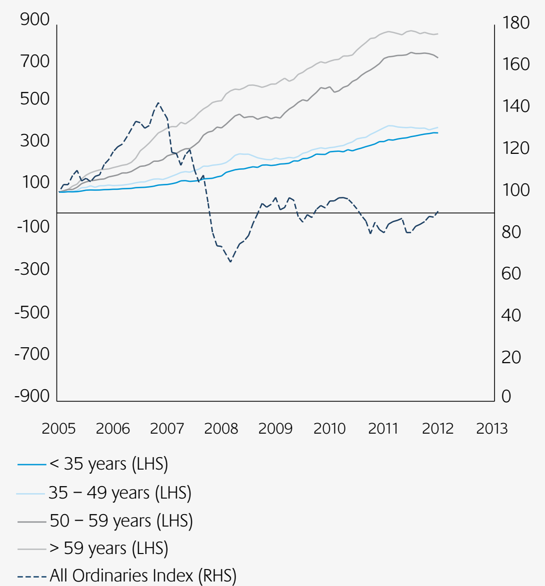
Cash Preference Index by gender: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

We can also isolate the Cash Preference Index by age. As expected, under 35 year olds have the lowest preference for cash. Where the surprise lies is in the 35 to 49 year old group, which also exhibits a relatively low cash preference. The results from the Equity Preference Index for this age group and the Cash Preference Index do not match up. It appears that this age cohort is placing its money elsewhere, perhaps through a lower allocation to investment funds, or through an increased level of mortgage and other debt repayments.

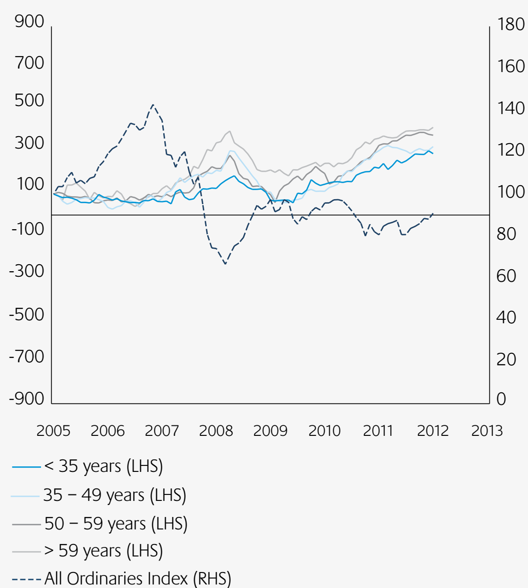
Cash preference Index by age: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice (Investments, Personal Super both Retail and Wholesale) & Managed Investments.

In terms of the Cash Preference Index within superannuation accounts, the above chart shows that for all but the oldest age group, over 59 year olds, cash preference is now lower than its peak. Again, falling term deposit rates, an improved macroeconomic landscape and higher equity market returns are likely to be the leading causes. However, as the chart shows, the Cash Preference Index remains at elevated levels for all age groups, even when compared to the height of the Global Financial Crisis in 2008 and 2009.

Cash preference Index in superannuation accounts by age: Aggregate



Source: UWA Business School and CFSGAM. Each series scaled to 100 as at 31 December 2005. Data to 31 December 2012. Equity Preference Index includes First Choice Personal Super (wholesale and retail).

Conclusion

Overall this second edition of our Equity Preference Index shows some early signs that equity preference is returning.

It is too early, however, to suggest that risk appetite has improved significantly or be confident that a sustained improvement in demand for equities is in place.

In our first edition of the Equity Preference Index, we concluded that it remains open to debate about whether this lower preference for equities is temporary or permanent. While we saw some neutralisation in preference during 2012, there is not yet sufficient evidence to change this view.

If we continue to see consistent positive equity market performance, lower term deposit rates and further elimination of downside risks in the global economy, the improvement in equity preference is likely to accelerate.

Concurrently, we could continue to see a reduction in risk tolerance, which will present further longevity risks, particularly among women and investors still in the accumulation phase. The 35 to 49 year old group remains most at risk.

Our overall view remains that investors have three choices in order to safeguard their retirement – save more, begin their saving phase at an earlier age or invest in asset classes with higher long-term growth characteristics.

Further information

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