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Investment Portfolio Philosophy

The performance of your investment portfolio and the way it contributes to your lifestyle goals is always our prime concern. Our portfolio construction process for all of our clients must be consistent, and based on the latest academic research available today.

Matching Your Financial & Lifestyle Needs with Your Portfolio Asset Allocation

During initial construction and when reviewing your individual portfolio, we consider very carefully how to match the strategic asset allocation of your portfolio (the mix of defensive assets and growth assets) with your individual income and capital needs.

Your strategic asset allocation should also initially be based on our assessment of your Investment Risk Profile. ie: your attitude towards investment risk and your desire for investment profits.

Accordingly, the strategic asset allocation of your investment portfolio towards shares & property versus the allocation to cash & fixed interest securities is intended to address your specific income and capital needs as well as your preference for investment risk & reward.

Fundamental Beliefs

When reconsidering our investment portfolio construction philosophies, we arrived at the conclusion that there are very few investment fundamentals that you can consistently rely upon to achieve a successful investment experience. They are:

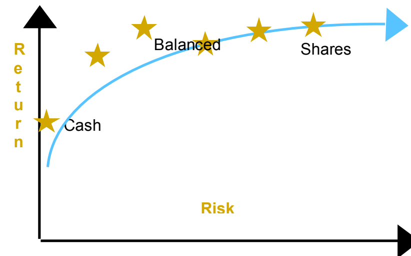
- **Discipline is Essential** – when faced with adversity, many investors panic. This results in the sale of poorly performing asset classes and/or managed investments and then buying recent strongly performing asset classes or "winning managers". Then almost inevitably, markets change and the best performing asset classes or managers deliver poor results. History is littered with examples of this destructive behavior by investors.

- **Markets are Efficient** – in our electronic world, information flows so quickly that no investor or even professional fund manager can consistently gain a reliable advantage over all of the other market participants. Asset prices quickly and fully reflect the knowledge and expectations of investors. ie. stock selection and market timing provide little value.

- **Risk and Reward are Always Linked** – when Harry Markowitz won the Nobel Prize for Economics, his work was acclaimed principally for this concept. He asserted that there was no such thing as a low risk high return investment.

- **Diversification Reduces Portfolio Volatility** – Markowitz also suggested that if you diversify sufficiently different asset types your portfolio volatility will reduce in the longer-term.

Markowitz was the first to suggest the concept of the efficient investment frontier illustrated in the chart opposite.



- **Fixed Interest Securities are Used to Reduce Portfolio Volatility** – based on the history of the major financial markets throughout the 20th century, fixed interest and cash assets will under-perform property and shares over the longer-term. They help smooth your portfolio's results but they will not enhance your long-term returns.

In our opinion, there is little academic research to confirm any other reliable investment fundamentals that are not derived from the above. It is our further belief that most other concepts are based either on opinion, speculation or are yet to be proven in the longer-term.

Different Portfolio Construction Methods Considered

When analyzing the various investment approaches that you could utilize for your portfolio, we believe there are essentially three approaches that warrant consideration.

A. *Traditional Active Management*

Traditional Active Management generally involves the implementation of investment strategies that are designed to achieve improved returns through active stock selection and market timing.

This is the approach most frequently used to manage investment portfolios. That is, each of the managers adopted within a portfolio are trying to achieve excess returns through the active selection of assets that they believe will provide higher returns over time. This active selection of assets is usually implemented as a result of forecasting future asset prices and future economic events.

B. *Passive (or Index) Management*

Passive or Index Management is where the funds under management are designed to closely track the returns of an index, typically of one specific asset type.

Which of these is best?

The question of whether to adopt an 'active' versus 'passive' approach to investment is a highly controversial issue. Indeed, each style of management has attracted a great level of criticism from the other side over the years.

We believe that all financial decisions should be made objectively and should be based on common sense and empirical research. On this basis, we provide a number of important considerations that we believe are relevant to the question of whether to implement or retain an active versus passive management approach to your investments:

Weaknesses of the Active Management Investment Process

Research overwhelmingly shows that:

- Active investment managers do not consistently outperform the index. In fact the majority of active managers often under-perform the index managers over time.
- Attempting to select fund managers that will produce above average returns in future has little scientific or academic basis, as such it is at best unreliable.
- Index funds, with low management fees and low turnover costs, always rank high in long-term performance studies.
- Managers with good past track records are no more likely to have good track records in the future than are managers with poor returns – in fact, research shows that managers with good track records are more likely to have poor future returns than are other funds in the future.

Based on our own experiences, we acknowledge that:

- Active managers are more expensive than passive managers – this is reflected in higher Management Expense Ratios (MERs) of actively managed funds.
- There are many cases of an apparent disregard for ‘after-tax’ returns for the investors in actively managed investment funds. Many managers pursue pre-tax returns that involve a higher level of turnover and subsequent realization of taxable capital gains.

We also acknowledge common criticisms of index management

- There is no procedure to eradicate financially unsound securities from index funds.
- Index funds do not consider liquidity factors and market cycles.
- The index represents a relatively narrow and concentrated group of companies and does not reflect the greater number of companies and/or investment opportunities available. That is, companies which are not part of the ASX200 Index or MSCI International Index, for example.
- Indices are chosen randomly – for example, why the ASX200 and not the 250 largest stocks (by market capitalization).

If the disadvantages of Index Management could be overcome, we would strongly prefer Index or Passive Management above Active Management, given our concerns with Active Management. However, the criticisms of Index Management are also compelling.

Fortunately, there is another process of investment management – Asset Class Investing, which we believe captures the advantages of Index Management over Active Management, whilst also overcoming the main disadvantages of Index Management.

C. Asset Class Investing

Asset Class Investing is a form of investing that involves the purchase of specific asset classes, combined with active macro-economic condition filters, in order to enhance the returns on the index.

This also involves the targeting of companies within the equity component of your portfolio that may improve long-term returns, such as small companies or companies that are clearly suffering financial distress. (This concept is explained in detail later within this document.)

While Asset Class Investing is by no means a 'new' concept or style of management, its application to the management of individual investor's funds has not been readily accessible until relatively recently. In the past, such strategies were usually reserved for the large corporate superannuation funds.

Structuring an Efficient Asset Class Portfolio

Investment Portfolio Fundamentals

A. The Relationship Between Risk and Return

The most certain of financial concepts is that risk and return are related. Systematic differences in long-term returns must relate to differences in risk. After all, who would invest in shares or property if they expected the same return from a secure cash investment?

Investors expect markets to compensate them for increased uncertainty of returns and/or increased volatility in capital invested. Economists all over the world are unable to document any reliable way to add to returns without taking additional risk.

B. Portfolio Construction Process

We now believe that there are some essential criteria to consider when constructing an investment portfolio. These criteria can be summarized as follows:

- Broad investment diversification across a range of asset classes.
- Control over the asset allocation decision within your portfolio.
- Access to asset class returns that traditional portfolios often neglect.
- Tax efficient investment returns with a focus on your net of tax investment return.
- Cost effective investment approach.
- Ensuring that your portfolio structure matches your desired financial & lifestyle objectives and also your attitude to risk and reward.

Whilst these criteria form part of our overriding investment portfolio construction process, we then need to consider the most effective method of achieving these objectives. This involves a three-layered decision making process:

(i) *Determine the allocation between growth oriented assets such as shares & property and interest bearing or defensive assets*

- this asset allocation decision is the major determinant of the return you can expect to achieve. Academic research from the USA proves that 96% of the return that you achieve over time will be a direct result of the asset allocation you have invested in. As noted on page 1, this allocation must consider your income and capital needs as well as your risk profile.

(ii) *Allocation between domestic assets and international assets*

- this is a major diversification decision as different markets will perform differently at any given point in time.

(iii) *Allocation across large, value, small shares*

- this is where we have the opportunity to increase your expected return on your share portfolio by diversifying the portfolio away from the return of the 'broader' market.

Why Utilize an Asset Class Investment Approach

A. The Evidence

Before the mid-1960s, there was neither a generally accepted way to calculate a total return, nor a way to compare the returns of different funds. However, from the mid-1960s onwards, investors could calculate returns on a consistent basis and compare returns with those achieved elsewhere.

There is now over thirty years of research into fund performance, and the research is clear. In every time period examined, active management has lower average returns than would be expected from index funds (in other words, less than the broad market).

The results are the same for all equity styles and are also compelling with other asset classes such as fixed interest and property securities.
Upon hearing these findings, investors often respond that they are not concerned with the results of the average manager. Investors plan on hiring the above-average managers.

However, the research is clear again, managers with good track records are no more likely to have good records in the future than are managers with poor track records. Whilst not endorsing a pure index approach, index funds with low management fees and low turnover costs always seem to rank highly in long term performance studies.

Research in Australia, published in the Journal of the Securities Institute of Australia (JASSA Issue 4 - Summer 2000), provides evidence that Australian investment managers are unable to add value above passive strategies. These findings are consistent with previous studies conducted in Australia and also in the US, UK, and Japan. The research findings in all these

countries send a clear message: Active management has lower returns than would be expected from passive management.

B. Defining Where Returns Come From for Equities and Fixed Interest Securities

There has been a tremendous amount of research and analysis performed on the issue of what drives stock returns. Whilst the initial research dates back to the 1950s, there was a ground breaking study released in 1992 from two well known economists, Professors Eugene Fama Snr from the University of Chicago Graduate School of Business and Professor Kenneth French from Dartmouth College, that drew on over 75 years of previous stock price analysis.

Fama and French tested many variables to search for traits that explained differences in share portfolio returns. Two variables stood out in this analysis, portfolios consisting of small companies and those with relatively high book-to-market (BtM) ratios have delivered superior rates of return. This lead to the development of the three-factor model, which found that three factors very reliably explain virtually all portfolio performance.

- ***The Market***: any share portfolio will generally rise and fall in value in line with the same general direction as the whole market.

- ***Company Size***: small company shares have higher expected returns than large company shares - the 'size effect'.

- ***Value or Company Health***: relatively distressed, unhealthy or 'value' company shares have higher expected returns than healthy 'growth' company shares - the 'value effect'.

The results of Professors Fama and French extensive research suggests that performance of a share portfolio, as compared to the overall market, depends almost entirely on the amount of small companies and/or high BtM (value or unhealthy) companies that you hold. These two dimensions of stock returns rightfully appear in all of the stock markets around the world.

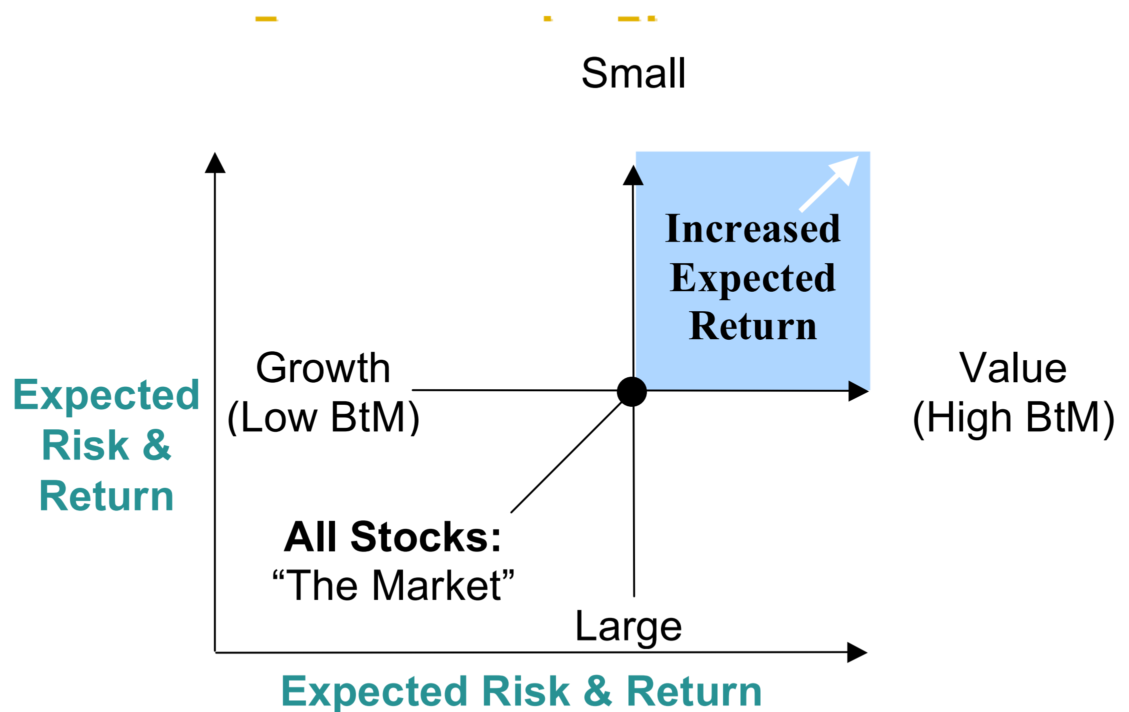
Whilst most people agree that small stocks are 'riskier' than large stocks (and hence the expected return from small stocks should be greater than large stocks), the notion that high book-to-market stocks are 'riskier' and have greater returns than low book-to-market stocks is tougher to accept.

However, the key to book-to-market lies in the denominator, the market price. High book-to-market stocks are lower priced stocks due to distressed earnings, other commercial risks or the like. Therefore, again we focus on the relationship between risk and return and these distressed companies have illustrated superior returns for investors over time due to their 'riskier' nature.

In essence, risk is related to distress in a very intuitively appealing way. Financially distressed companies have higher costs of capital than financially healthy companies. When they borrow from a bank, they pay higher interest rates. When they issue new shares, they receive lower prices. A firm's cost of capital is very similar to an investor's expected return.

The chart that appears below reflects the different return and risk characteristics of the three factors identified by Professors Fama and French.

Returns are Determined by



In relation to fixed interest assets, the two dimensions of risk appear to be maturity (term of investment) and quality. Low quality debt obligations have higher returns than high quality debt obligations.

To some, the difference is so great that they invest in high-yield strategies. The maturity dimension is somewhat more complicated. Longer-term debt obligations do not have reliably higher average returns than shorter-term debt obligations, even though their prices fluctuate more.

Generally, investors concerned about return volatility from fixed interest investments should avoid long-term debt obligations.

Ultimately, you should want to hold broadly diversified portfolios in order to capture the true factors in returns and to minimize the impact of individual asset returns. That is, you should want to avoid a portfolio of randomly selected assets, as this approach will not provide true diversification or exposure to the different sources of higher expected returns.

How to Implement Your Recommended Asset Class Portfolio

As we discussed above, expected portfolio returns are shaped by how much is invested in growth oriented assets (shares, property etc) versus fixed interest assets, the fixed interest expected return is largely a function of the maturity and quality decisions.

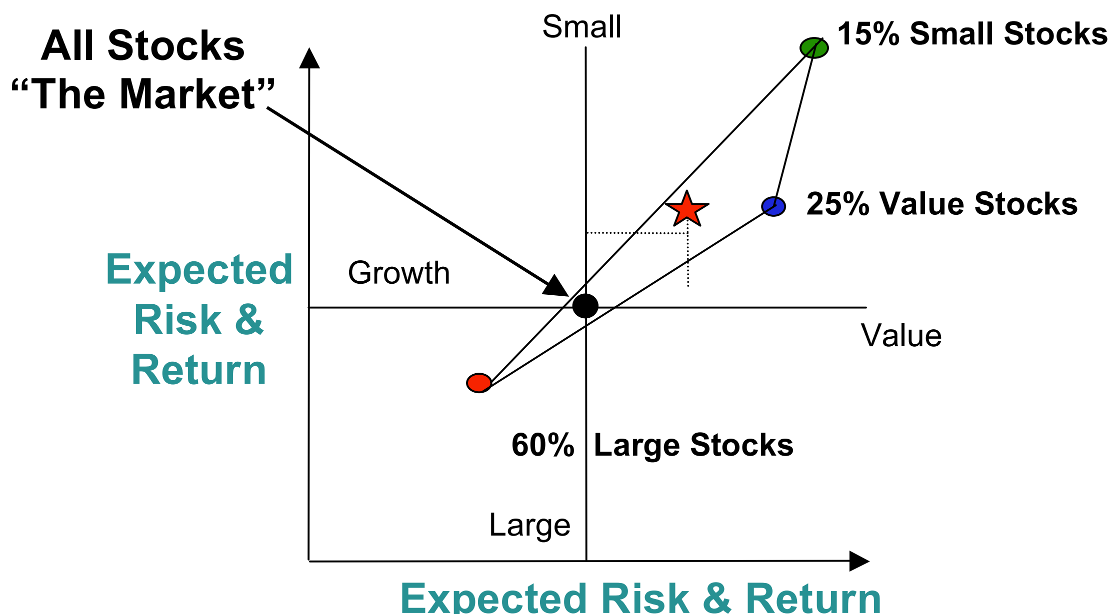
The stock portfolio expected return depends on the proportions invested in international versus domestic stocks, in value versus growth stocks, and in small cap versus large cap stocks.

Once we have agreed on the most suitable and appropriate asset mix for you, there should be no second-guessing of the manager, because a structured passive fund always provides the return of an asset class. There is no anxiety about market forecasting, because the proportion of the portfolio invested in each asset class remains the same (i.e. true to label).

In summary, logic and sound academic research overwhelmingly favours an investment approach based on passive funds.

- The returns over the long term are higher and the fees are lower.
- The returns of an asset class are more assured (i.e. there is no style drift across various investment styles).
- The discipline keeps the portfolio fully invested, thereby avoiding the adverse timing pitfall inherent in investment committees and active managers.

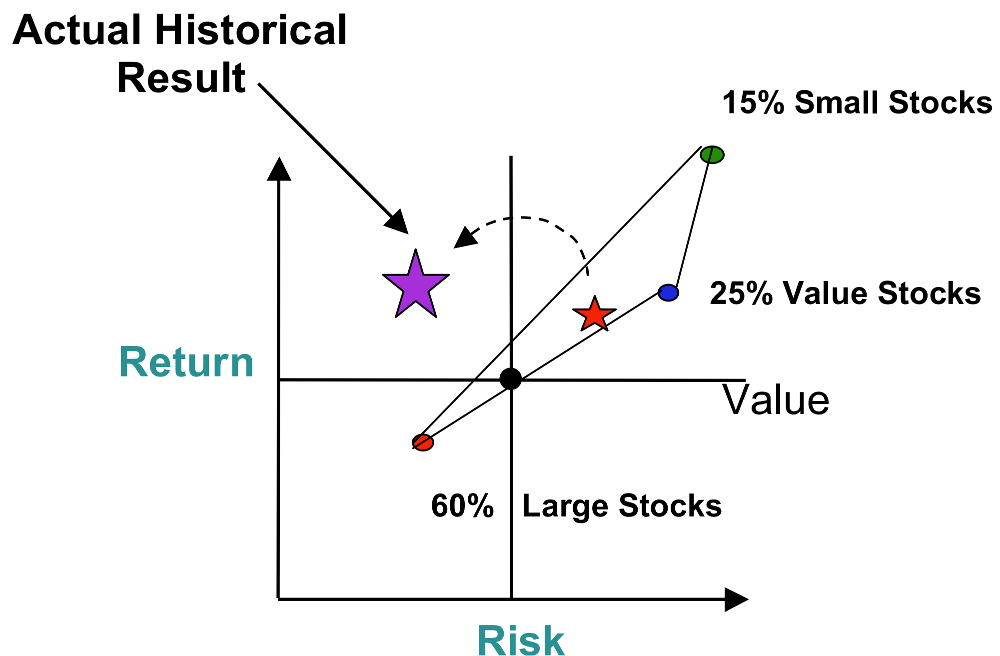
Our preferred benchmark for constructing a managed share portfolio and its expected results looks as follows:



Whilst your share portfolio's expected return intuitively looks like it ought to occur as shown by the star point in the above chart, if you remember the fourth of our fundamental beliefs from page 2, and the second feature of Harry Markowitz's Nobel Prize winning work, history has actually shown the results conclude as shown over the page.

The work of Professors Fama and French has clearly demonstrated that over time large cap shares, small cap shares and value or unhealthy shares have such different return characteristics that they actually provide a volatility reducing diversification benefit within a managed share portfolio.

Structured Equity Portfolios



Thus by building an asset class portfolio it is possible to deliberately and consistently pursue above market returns with below average risk. History and sound academic research have shown that this process has been consistently successful.

Equally, it is possible to pursue even higher returns by increasing exposure to small and value stocks, however, this may increase the portfolio risk above that expected from the overall market.

Summary

The experience of 2001 – 2002 highlights the importance of discipline and diversification in order to avoid the greed and fear that drives the markets over the short-term. Clearly each

asset class will have good years and bad years….we just don't know when these years will occur.

We now believe that it is critical that your portfolio is always positioned to take advantage of higher returns from riskier asset classes when they do occur, as over long periods they will improve your total investment returns. However, it must be understood that there will also be periods of underperformance that will be extended and certainly painful…these inevitably will come to an end just as periods of excessive returns eventually conclude.

In summary, there are some powerful benefits in utilizing our new asset class and fee based approach:

- ***Increased Diversification –*** structured diversification is a proven way to reduce the possibility of a loss within the overall portfolio. By reducing the possibility of loss, this adds to your investment return. One by-product of the asset class approach is an indirect ownership of thousands of individual assets. Therefore our objective is to acquire many companies in various asset classes in order to widely diversify your portfolio and capture the asset class return.

- ***Access to different dimensions of risk*** – in order to add to your returns you generally need to take additional risk. Portfolios including small companies and/or those with relatively high book-to-market ratios (value shares) have superior rates of return over time.

- ***Tax Management*** – compared to the high turnover characteristics of active managers, asset class investing is relatively passive in the trading sense and hence keeps trading costs down to a minimum but more importantly provides for more competitive after-tax returns.

- ***Cost Effectiveness & Fee Transparency*** – each of the different asset classes can be accessed on a low cost basis that adds to your bottom line investment result and in future you will understand more clearly your portfolio costs and why those costs are incurred.

We acknowledge that the above explanation is not necessarily straight forward. We do however believe that it should be the foundation of every portfolio we manage for our clients.

Quite simply we want you to enjoy a more reliable and successful investment experience into the future.

For further information, please contact Adam Passwell, on 02 4455 5333.