Fact Sheet

Portfolio Management

The purpose of this fact sheet is to help you understand investment concepts that relate to a personal financial plan.

This includes:

- ⇒ Risk and return
- ⇒ Types of risk
- ⇒ Asset allocation and types of investments
- ⇒ Diversification
- ⇒ Direct vs managed investments
- ⇒ Investment manager selection
- ⇒ Investment portfolio review
- ⇒ Dollar cost averaging

Risk and return

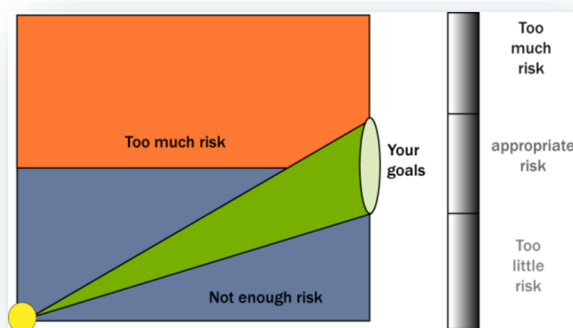
What is risk?

There are several definitions of risk. For a financial plan, this could mean:

- ⇒ loss of capital due to a poor decision or market movements.
- ⇒ insufficient income produced to meet needs.
- ⇒ variability (or volatility) of overall returns.
- ⇒ failure to meet objectives or goals.

Investment risk is crucial to achieving higher investment returns over the long term. It is also important to remember that you should only take as much risk as you need to achieve your goals.

If you can achieve your goals by taking on a low level of risk, then why risk your money and your goal by taking on a higher level of risk?



The relationship between risk and return

Generally, the higher the degree of risk associated with an investment, the higher the return required by investors to accept this risk. This is sometimes referred to as the risk/return trade-off.

All investments and asset classes have different levels of risks and anticipated returns. High risk investments generally offer the potential of a higher return over the long term. However, they are also likely to be more volatile in the short term. Conversely, low risk investments such as cash are low in risk and returns are also therefore likely to be low.

Types of risk

There are a number of risks to be considered when constructing your portfolio such as:

Investment market risk - The possibility all investments in a market sector will be impacted by an event.

Investment specific risk - The possibility a particular investment may underperform the market or its competitors.

Market timing risk - The possibility that an investment may need to be *sold* at a time when the sale price is at a low-point or *purchased* when the sale price is at a high-point.

Inflation risk - The possibility that an investment return is below the inflation rate which reduces spending power.

Credit risk - The potential failure of a debtor to make payments on amounts they have borrowed.

Interest rate risk - The possibility an investment will be adversely impacted by a fall or rise in interest rates.

Legislative risk - The possibility a change in legislation will impact the suitability of an investment.

Liquidity risk - The ease with which an investment may be liquidated. Some investments impose exit fees or have limitations on withdrawals. Other investments may be difficult to sell due to a lack of buyers.

Hedging risk - A technique designed to reduce the risk from part of an investment portfolio often by using derivatives. While hedging can reduce losses, it also has a cost and therefore can reduce profits.

Currency risk - Relates to global investments and is a form of risk that arises from the change in price of one currency against another.

Derivatives risk - Risks associated with derivatives can include; the value of the derivative declining to zero; the value of the derivative not moving in line with the underlying asset and, the derivative may be difficult or costly to reverse.

Opportunity cost - The investment return forgone from an asset as a result of investing in another asset. There is the risk that the asset purchased may not return more than the alternative investment.

Returns

Returns from the overall market, rather than the actual investment, will determine the majority of the returns within an investment portfolio. This is known as the market return.

Additional returns come from the ability of the manager to add value relative to the market return. They must do this so the investor is compensated for any extra risk the manager takes in the portfolio on an after fees basis.

Let's assume you need to receive an average a return of 5% per year over five years to meet your goals. It is important that you understand the difference between an 'average' return after five years, and actually receiving a 5 per cent return every year.

It is very unlikely that you will receive a return of 5% every year. Some years it will be higher and some years lower, but when averaged over a minimum of five years,
this return is possible.

Choosing your investment strategy

Choosing your investment strategy is the most important investment decision. We use portfolio theory in the development of our investment strategies and construction of the investment portfolios. They take into account:

- The expected return of the individual asset classes.
- Diversification benefits of each asset class.
- Business risk (what are competitors doing?).
- Implementation costs. Can it be put together so that costs do not outweigh benefits?

Each investment strategy has a specific investment objective which it is expected to meet with a reasonable degree of certainty and a minimum time frame that you should hold them for. The investment strategies we typically select from are:

Strategy	Australian shares	International shares	Property	Australian Fixed interest	International Fixed interest	Cash
30% Growth	13%	13%	4%	32%	32%	6%
50% Growth	22%	22%	6%	22%	22%	6%
70% Growth	31%	31%	8%	12%	12%	6%
85% Growth	37%	38%	10%	6%	7%	2%

Asset allocation and types of investments

Asset allocation is the proportion of your portfolio spread across a number of asset classes, markets and regions.

The aim is to achieve a return for an acceptable level of risk by combining asset classes in a calculated way. This also helps smooth the ups and downs of each asset class returns.

There are several approaches to asset allocation in common use. They all have their advantages and disadvantages so it is important to understand the basic differences.

⇒ **Strategic asset allocation (SAA)** is the process of setting and maintaining the long term structure of the portfolio. It reflects expectations about assets over the long term and is designed to reflect your long term objectives and appetite for risk.

⇒ **Tactical asset allocation (TAA)** refers to short term changes to asset allocation to take advantage of short-term views of the markets.

⇒ **Dynamic asset allocation (DAA)** is in between strategic and tactical asset allocation. It's an active approach to altering a portfolio's asset allocation over the medium term. DAA recognises markets will constantly move around from what is considered 'fair value'. It provides a level of flexibility to alter the asset mix of the portfolio to take opportunities as they arise or to help preserve wealth if markets fall.

Asset class characteristics

On the following page is a brief description of the main types of defensive and growth asset classes including distinct features such as expected returns and volatility.

⇒ Defensive asset classes

Defensive assets have a lower potential rate of return over the long-term but are also generally less volatile and have less potential to lose value than growth assets. Cash and fixed interest investments are defensive assets.

⇒ Growth asset classes

Growth assets have the potential to earn a higher rate of return over the long-term but are also generally more volatile than defensive assets

There are five different **asset classes** in which you can invest:

<table>
<tr><th colspan="2">Types of investments</th></tr>
<tr><td>Cash</td><td>
Cash is the most secure investment. The return you receive will depend on interest rates at the time.
While cash is very low risk, the increasing cost of living (known as inflation) can decrease the buying value of your money. Tax on the returns should also be considered when working out the real, after tax, return of a cash investment.
Cash investment can usually be accessed immediately ("at call"). However, if invested in superannuation and pension accounts, legislative restrictions must also be considered. Cash investment offers no growth.
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<tr><td>Fixed interest</td><td>
Fixed interest investments arise from loans. An investor lends money to a borrower who must then repay the loan as well as interest.
Fixed interest investments differ due to:
The type of loan issuer,
The security/asset that backs the debt,
The loan timeframe, and interest rate.

Generally, the longer the loan timeframe and the less secure the lender, the higher the interest rate.
Typical fixed interest investments include:
Term deposits that provide a regular income at a fixed rate for a set timeframe.
Mortgage trusts provide regular interest income at variable rates and a high level of capital security. Investors' funds are pooled and invested mainly in registered first mortgages secured against a spread of freehold property. Usually only 66% to 75% of the property's value is lent.
Bond trusts provide regular interest income through pooled investment in Government and corporate bonds. These funds offer high long-term capital security and the potential for some capital growth in addition to interest income.

Generally you can only access money from fixed interest investment at maturity. Again, when investing in superannuation and pension accounts, legislative restrictions must be considered.
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Types of investments	
Australian shares	• Australian shares are investments in companies listed on the Australian Stock Exchange. • As a shareholder you become a partial owner of the company and therefore benefit from the profit and capital growth the company achieves. • Investment returns are paid in the form of dividends (a distribution of the companies' profit) and capital growth (reflecting the increased value of the company over time). • The upside of growth and profits comes with the risks associated with owning any business, cost increases, regulation changes and increases in competitor presence.
International shares	• International shares allow you to become a partial owner of an international company, the same as you would in an Australian company. • This can offer opportunities that are not available within the Australian share market and provide further diversification to your portfolio as different countries' economies grow at different rates. • The Australian share market only represents about 1% to 2% of the world share markets. • Returns on international shares are affected by changes in currency exchange rates. • While the purchase and sale of Australian shares is relatively easy and the cost to buy Australian shares is relatively low, investing directly into International shares is difficult for the general investor. Most investors have exposure to international shares through pooled investment structures, such as super and managed funds.

Types of investments	
Property	**Residential** • For many Australians, property is their first and most significant investment. Generally property is purchased to meet housing needs, not as an investment to make a profit. • Some people may also buy a rental investment property. The risks of direct property include interest rate changes, tenant vacancy and property damage. • Property is an all or nothing investment – you cannot sell a room if you need some cash, you have to sell the whole asset. **Commercial** • Commercial and industrial properties generally generate higher rental incomes, however, most people cannot afford to invest directly i.e. buy a whole office building. • An easy way for Australians to invest in commercial property is through pooled investments such as a managed fund or listed property trusts. • Property is a valuable inclusion in most people investment portfolios because property values tend to move independently of share prices. Including property in your portfolio can smooth out the overall return on your investments.
Alternative Assets	• Alternative assets cover a wide range of investments that are not considered traditional assets like those already described. Some examples include hedge funds, infrastructure and gold. • These types of investments are generally included in portfolios to increase diversification and provide returns that aren't strongly linked with the performance of traditional assets.

Diversification

One of the most effective means of reducing the effect of risk is to diversify your portfolio. This means not putting all your eggs in the one basket.

No one type of security, asset class or investment manager provides the best performance over all time periods. So a range of investments should reduce the risk of each of the investments within a portfolio experiencing drops in performance at the same time.

This is simply because one asset class or manager may perform well to counter the poor performance of another.

Diversification can be implemented in three distinct ways by investing:

- ### Across asset classes

  Asset classes perform differently under different market conditions. By investing across a variety of asset classes you may be able to reduce the volatility of your portfolio return.

- ### Across markets and regions

  Spreading your exposure within each asset class across a wide range of countries, currencies, industries and stocks ensures your investment is not narrowly concentrated in a particular region or industry. This reduces the impact of a region or industry downturn, and

- ### Across investment management styles

  Different investment management styles tend to excel under different economic and market conditions. By combining a range of investment managers with complementary investment styles you may be able to reduce reliance on any one style in each asset class.

Direct vs managed investments

You can choose to invest directly in the financial markets or via a managed fund.

Direct investments vs managed funds	
Direct investments	• Made directly into the market such as the share market or property. • Generally requires large amounts of money, a degree of market knowledge, and the time and skill to regularly monitor market trends and relevant tax and legislative changes.
Managed fund	• Allows you to pool your money with that of other investors. • Let the experts manage your investment, monitor economic and legislative changes that affect your money. • The fund manager can look after most of the administrative requirements associated with your investment.

What makes managed funds so attractive?

You can start small

To invest in a managed fund, you need a smaller amount of money (as little as $1,000) to gain exposure to the various sectors of the market and dozens of individual stocks.

One of the keys to investing successfully is investing on a regular basis. Setting aside as little as $100 a month can add up to a substantial sum when you invest it regularly for longer periods of time. You can choose small monthly or weekly amounts and transfer your payments on the day you get paid.

It is an easy way to diversify your investments

The beauty of managed funds is that you can access different asset classes, companies, industries, sectors and countries with a relatively small amount of money. Investing directly requires large sums of money to gain this range of exposure.

It is a cost effective way to invest

Investing directly into shares or property comes at a cost. Expenses such as brokerage, stamp duty and agents fees can have a significant effect on the value of your investment.

Managed funds allow you to access certain investments at a fraction of the usual cost. This is because you share these costs with other members of the fund, rather than having to pay the minimum investment fee on your own.

Experts manage your money

Your investment will be managed by professionals who have the education and skill to make appropriate investment decisions. These experts have access to investment research and information not easily available to individual investors.

You don't need to sell an entire house to access your money

You can generally access your money within five to ten days after making a request. Accessing capital in direct investments, particularly property, can be very difficult, costly and time consuming. Managed funds have a major advantage over direct property investments, in that you don't have to sell the whole investment to access some capital.

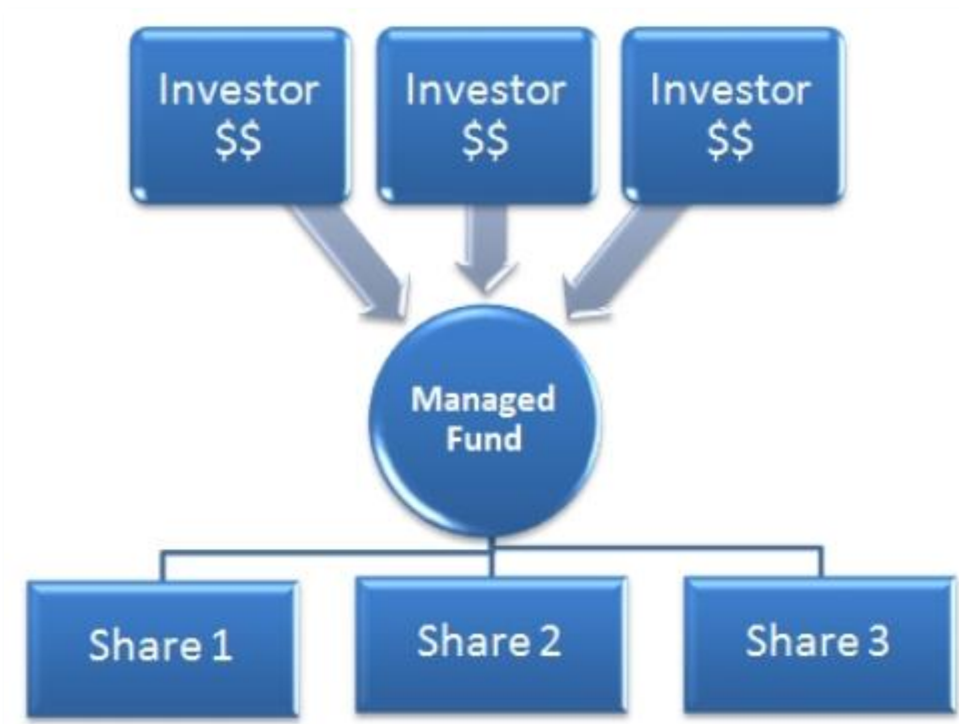
Tax advantages

Income distributions may be tax advantaged through imputation credits for investments with underlying Australian share assets.

What types of managed funds are available?

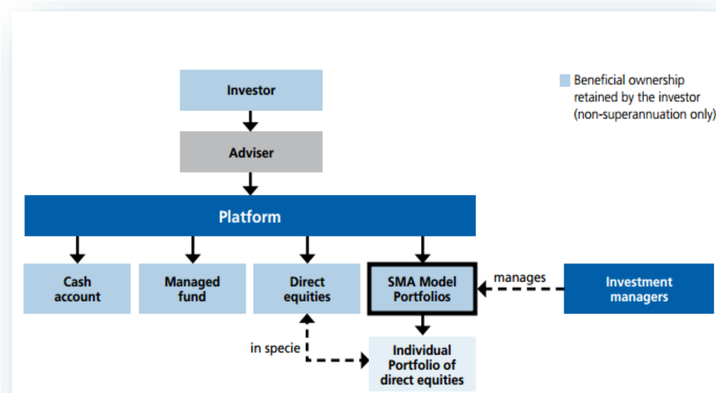
Types of managed funds	
Capital guaranteed	• This type of fund guarantees that the capital you have invested will not fall in value. • These funds tend to be heavily weighted in cash and fixed interest type investments. • Investors will generally pay a fee or premium for the guarantee over their investment.
Cash and fixed interest	• These funds usually invest in securities (i.e. bills and bonds) issued by financial institutions including banks, Government and semi-Government authorities. • Cash funds are suitable for short-term liquidity requirements and emergency needs, while fixed interest funds are good as a source of regular interest income. • These funds focus on generating an income stream with lower risk of capital loss. • They are sometimes known as 'defensive' funds.
Capital stable funds	• The majority of the money in a capital stable fund is invested via cash and fixed interest. A smaller proportion is usually held in shares and property to provide some growth within the fund.

Types of managed funds	
Balanced funds	• Invest across the entire spectrum of asset classes, usually weighted towards growth assets. • These funds are generally subject to a higher level of volatility than defensive funds yet long-term performance is expected to be higher.
Growth funds	• These funds focus on long term capital growth rather than income and are generally suited to people who don't need to access their money for at least five years.
Sector specific funds	• These funds generally invest in only one asset class, with a small holding of cash to meet liquidity requirements. • As these funds allow an investor to be 'overweight' in an asset class there is the potential to achieve a higher level of return and in-turn, experience a higher level of volatility.



Separately Managed Account (SMA)

The SMA is a registered managed investment scheme that allows you to access a number of professionally constructed and managed investment portfolios (model portfolios) comprising Australian listed shares and cash in which beneficial ownership is retained by you (or the trustee in the case of a superannuation investment). The SMA can only be accessed via an eligible platform (for both investment and superannuation).



Key benefits of a SMA

Some of the benefits of investing in a SMA include:

⇒ **Individual accounts**

Unlike a unitised managed fund in which investors collectively have an interest in the pool of fund assets, the SMA investor has absolute beneficial ownership in the assets held in their account.

⇒ **Transparency**

The SMA allows you to view the underlying shares you hold within your chosen model portfolio.

⇒ **Portability**

If you already own Australian shares that are also included as part of a model portfolio, you can transfer them into the SMA and still retain beneficial ownership. You are able to transfer (in specie) shares out of the SMA into your platform account as well as transfer shares between model portfolios within the SMA.

⇒ **No inherited capital gains**

An individual cost base is established for you on the day the shares are bought in the SMA and this relates solely to the price of the underlying shares purchased for you at the time of your investment. There are no tax consequences for you as a result of other investors' transactions.

⇒ **Professional investment management**

The SMA provides you with access to leading experienced professional investment managers who ensure each model portfolio is continually monitored and managed, and

⇒ **Lower management costs** than most managed funds.

Fund manager selection process

When selecting fund managers we aim to determine the combination of managers that will provide the best outcome with a high degree of certainty.

It is sometimes appropriate to choose a number of fund managers to manage a single asset class within your portfolio. As a group, they will increase the likelihood of you achieving reliable strong returns.

Below is a description of the types of managers considered in the investment process.

Index manager

An index manager aims to deliver returns that are consistently in line with index returns, with a low risk of underperforming the index.

Enhanced index manager

An enhanced index manager aims to deliver returns that are consistently above index by a margin of at least the fund managers' fees, with a low risk of underperforming the index.

Core active manager

These managers do not have any material or systematic portfolio biases, and are likely to generate very consistent (albeit modest) out-performance in most market conditions. These managers have strong risk management disciplines, including processes for identifying and managing 'unintended' risks.

Specialised active manager

An active manager with specific 'style' characteristics is likely to have a higher risk of underperforming the index and to generate less consistent returns over time. However, investors should be compensated with higher long-term returns.

This type of manager needs to have strong risk management disciplines and avoid the extremes often associated with individual 'styles'.

Managing and reviewing your portfolio

Just as important as knowing what managers to put in your portfolio, is to know when their time is up.

So how does a manager get sacked?

⇒ Short-term performance is inconsistent with the manager's stated investment objectives.

⇒ Longer-term performance is inconsistent with the manager's performance objectives (usually expressed on a rolling 3 year basis).

⇒ Concern about the implementation of a manager's investment process.

⇒ The emergence of another factor (e.g. staff change) erodes the manager's competitive edge.

⇒ Identification of a compelling alternative.

Our research shows that timing in and out of markets is not a reliable source of added value over time.

Investment portfolio benefits are derived from:

⇒ Diversification across sectors, managers, and individual securities.

⇒ Disciplined re-balancing to ensure strategic asset allocations and manager allocations are enduring throughout market movements.

⇒ Active funds management.

Dollar Cost Averaging

Dollar cost averaging involves investing a set amount of money at regular intervals. By investing this way you are not attempting to pick the lows or highs of the market but rather investing a fixed dollar amount regardless of investment market trends.

The following example shows a dollar cost averaged share investment. A fixed amount of $1,000 was invested in a share each month as the market price fell and then recovered to its original value.

month	amount invested	share price	units purchased
1	$1,000	$20.00	50
2	$1,000	$15.00	66
3	$1,000	$10.00	100
4	$1,000	$15.00	66
5	$1,000	$20.00	50
total	**$5,000**		**332**

In this example, by dollar cost averaging into the market, the shares were purchased at an average cost of $15.06 ($5,000 / 332). After five months the investment was valued at $6,640 (332 shares at $20 per share), a profit of $1,640. If the shares had been purchased at the commencement of the five months (ie at $20), there would not have been any gain on the investment when the shares returned to their original value at the end of the five-month period. The $5,000 invested would still have the same value, ignoring any dividend income.

Advantages of dollar cost averaging

Some of the advantages of dollar cost averaging include:

- ⇒ By regularly investing in an investment market, you are not relying on timing strategies aimed at picking when a market has bottomed or peaked. Dollar cost averaging imposes a helpful investment discipline by completely ignoring timing issues
- ⇒ Being beneficial when markets may fall. This is because only a fraction of the total amount to be invested is exposed to declines in the market. Also, when the market price falls, your regular investment amount will purchase more investment shares or units, and
- ⇒ Providing a sound savings regime and ideal investment strategy for people with a regular income but without large sums to invest.

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