

Towards Smarter Investment Portfolios Why Clients Need a Smoother Ride

Dominic McCormick, CIO
Select Asset Management



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Agenda

- why investor behaviour makes smarter portfolios necessary?
- conventional portfolios – issues and problems
- an alternative “absolute return” approach
- the “building blocks” for smarter portfolios
- investments to emphasise/avoid looking forward
- what smarter portfolios might really look like?
- what investment role should planners really have?



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“We sold dreams and delivered nightmares”

anonymous comment to a UK survey of fund managers quoted in Financial Times 25 June 2003 “Fund Managers Suffer a crisis of confidence”



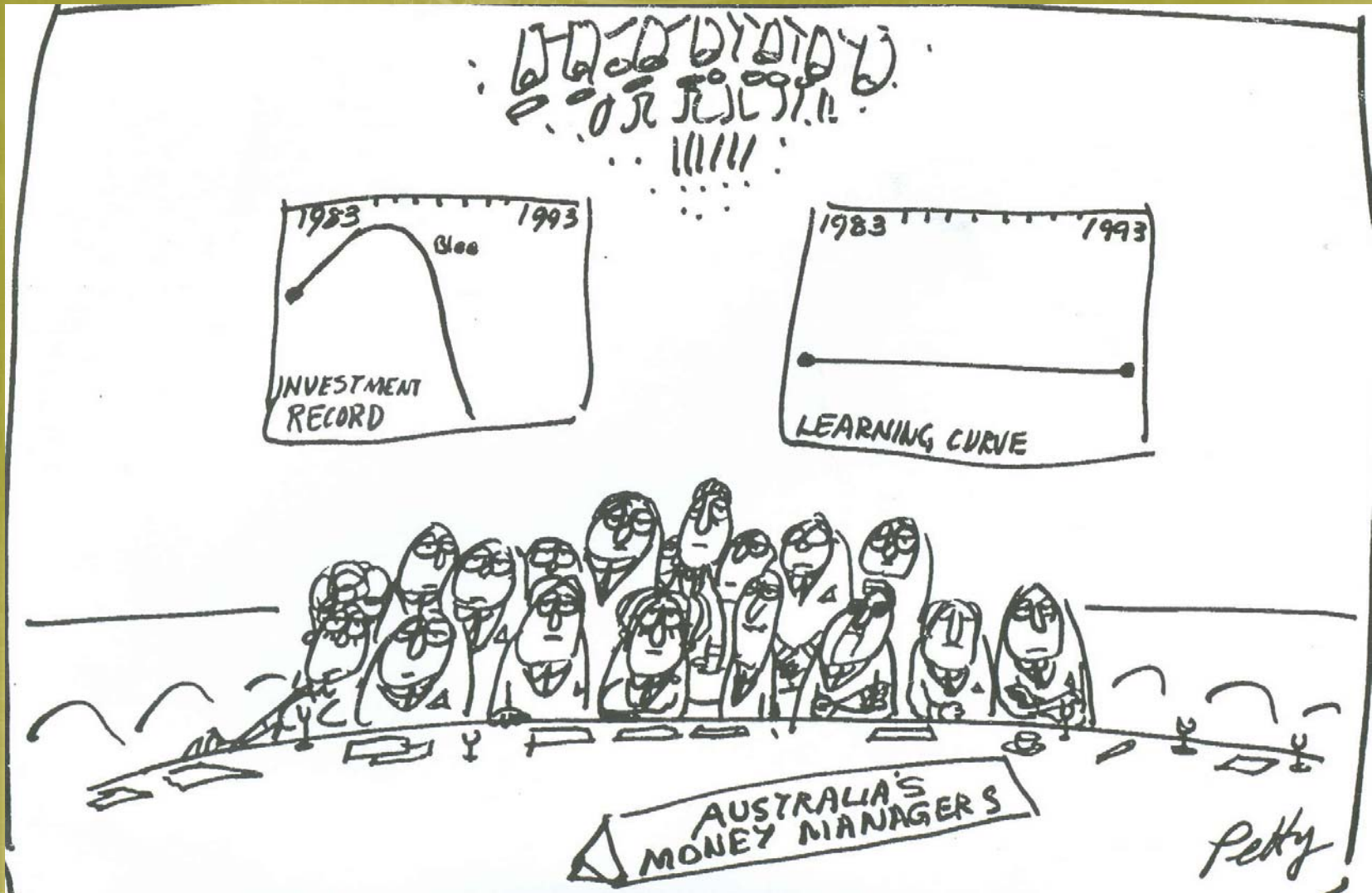
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Times have not changed much!



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Retail multi-asset/multi-manager diversified funds returns to 31 July 2003 (% p.a.)

| Fund | 1 yr | 3yrs | 5yrs | 7yrs | 10yr |
|----------------------------|-------|------|------|------|------|
| Advance Income | - 2.5 | -1.5 | 2.4 | 5.1 | 5.9 |
| Advance Income & Growth | 3.0 | 2.7 | 3.9 | 5.5 | 5.9 |
| MLC Balanced | 4.2 | -0.7 | 3.3 | 6.3 | 6.8 |
| MLC Growth | 2.6 | -3.1 | 2.1 | 5.6 | 6.5 |
| State Super Bal | 5.5 | -0.4 | 3.2 | 6.4 | 6.5 |
| State Super Growth | 3.5 | -5.3 | 1.2 | na | na |
| Morningstar CMT index | 3.9 | 4.2 | 4.2 | 4.4 | 4.7 |
| Morningstar Mortgage Index | 5.1 | 5.3 | 5.4 | 5.7 | 6.1 |



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Source: van Eyk irate/Morningstar

Client returns are even worse!

- Dalbar US study bond/equity funds 19 years to 2002

| | Bonds | Equities |
|-------------------------|---------|----------|
| Market Return | 11.7%pa | 12.2%pa |
| Average Investor Return | 4.2%pa | 2.6%pa |
| Average Holding Period | 3 years | 2 years |

“deliberate market-timing strategies cannot be doing this.. Investors who haphazardly manage their active fund managers are more to blame”



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Dalbar study of Investor Behaviour 2003

Why we need to rethink portfolios?

- conventional/MPT based portfolios have not, and may not, deliver for investors
- in any case many investors cannot handle the risks involved
- planners' businesses are too exposed to “market risk”
- new approaches and “building blocks” for smarter portfolios are more easily available
- clients are more sophisticated and have DIY options



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The industry persists on giving investors too much risk

- 1987 (equities)
- 1989 (unlisted property)
- 1994 (bonds, equities)
- 2001-2 (overseas equities)
- 2003? (bonds/LPT's)

“Rule No 1: Never lose money. Rule No. 2: Never forget Rule No 1” - Warren Buffet



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Investment risk is not a static concept

- if longer term risk is chance of not meeting a certain level of return, and
- current valuation matter in determining future returns
- then, risk of any asset class/sector cannot be constant
- thus a static asset allocation will give you varying levels of risk over time
- *therefore managing asset allocation is necessary to manage client investment risk*



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Behavioural finance shows that investors..

- **value avoiding losses about twice as much as they value gain (Prospect Theory)**
- **are short term focused even when they have a long term investment horizon**
- **see their benchmark return as cash**
- **see risk as “losing money”**

Unfortunately conventional portfolios are not built with these considerations in mind



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Much of the industry just doesn't get it!

- Retail investors are primarily concerned with:
 1. absolute returns (compared with cash)
 2. preservation of capital (i.e. not losing money)

Implications:

- tracking error is an irrelevant measure of risk
- traditional growth/balanced portfolios are usually too risky



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Possible solutions

- better education?
- more defensive conventional portfolios?
- lower cost passive portfolios?
- *more diversified, absolute return focused portfolios*



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Myths that inhibit better portfolios

- SAA determines 90% of return
- any attempt at active asset allocation will fail
- equities always outperform
- skewing towards certain sectors is always “risky”
- no investment “style” will outperform long term
- it’s impossible to find managers that can consistently outperform
- all hedge funds are risky
- lower investment management fees are the best way to get better returns



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The MPT/Conventional Approach

- **passive/SAA focus**
- **conventional/mainstream assets only**
- **broadly sector neutral**
- **broadly style neutral**
- **long only**
- **low tracking error/index management**
- **focus on larger/brand name managers**
- **no direct/listed investments**

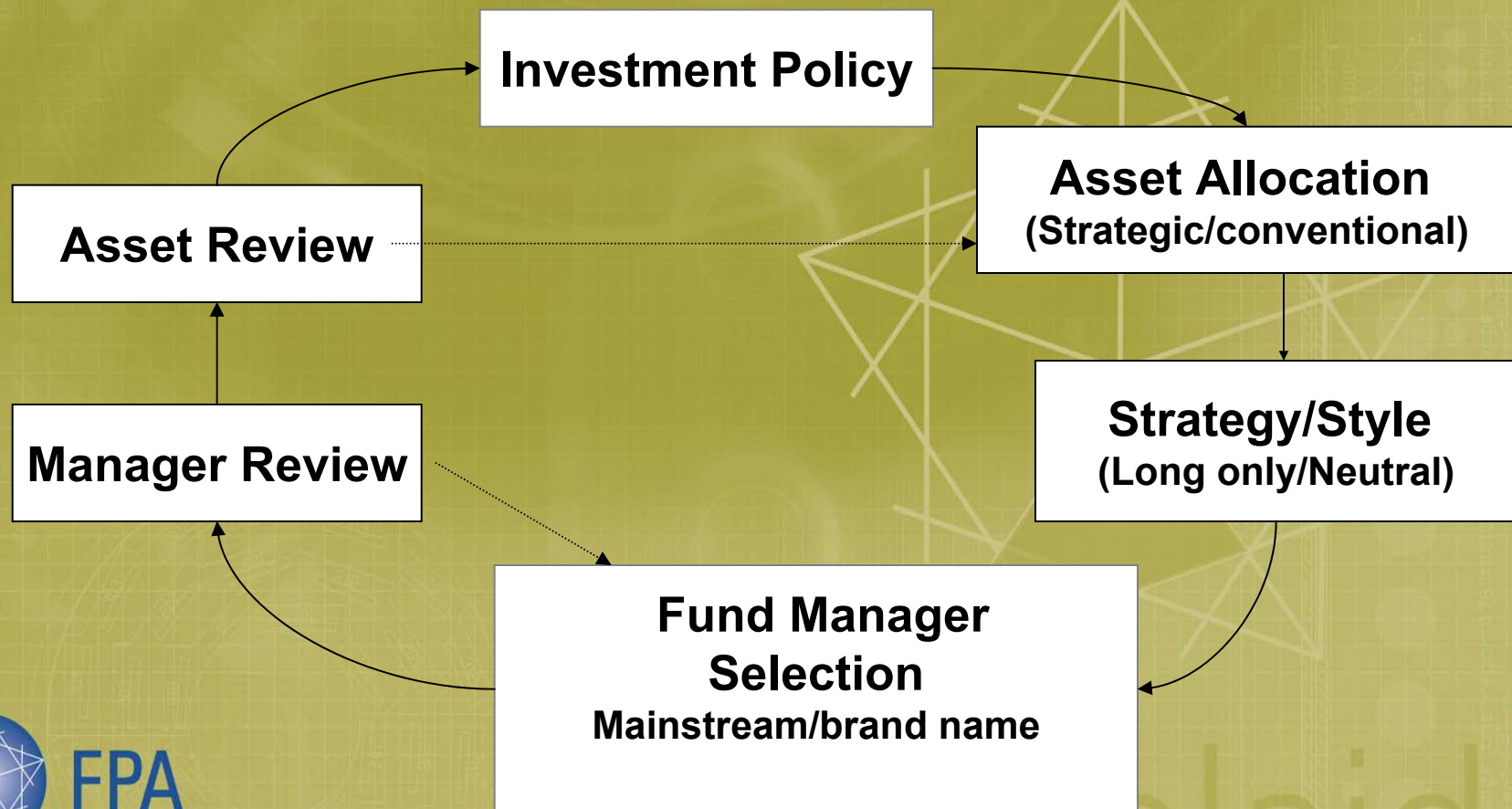


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THE CONVENTIONAL APPROACH TO PORTFOLIO CONSTRUCTION



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A conventional balanced/growth portfolio

| | |
|---|------------|
| Australian Equities (4-5 mgrs – mix of styles) | 40% |
| Overseas Equities (3-4 mgrs – mix of styles) | 25% |
| Listed Property (1-2 mgrs – indexed?) | 10% |
| Australian Fixed Interest (1 mgr – indexed) | 15% |
| Global Fixed Interest (1 mgr – indexed) | 5% |
| Cash | 5% |



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Problems with conventional approach

- long term returns, volatility and correlations across assets and sectors are not stable
- valuations matter in determining future returns (and they do not suggest great returns going forward)
- evidence of major inefficiencies (asset bubbles/busts)
- therefore there is no “set and forget” SAA that will definitely meet client objectives over time
- risk profiling that directs clients to a set asset allocation is dangerous
- resistant to innovation (e.g. new asset classes/strategies)



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Practical limitations of traditional approach

- **heavily dependent on equity out-performance**
- **vulnerable to high weighting to overvalued assets (index weightings)**
- **cannot significantly overweight attractive sectors (concern about tracking error)**
- **style neutrality may increase absolute risk and limit returns (insufficient small/value)**
- **cannot take advantage of short/hedged opportunities**
- **may suffer from inflexibility of larger managers**
- **no risk/return benefits from alternatives**



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stocks do not always outperform!

“The public is said to have learned that stocks must always outperform other investments, such as bonds over the long run, and so long run investors will always do better in stocks. We have seen evidence that they do largely think this. But again they have gotten their facts wrong. *Stocks have not always outperformed other investments over decades long intervals and there is certainly no reason to think they must in the future*”

Robert Schiller

Irrational Exuberance (2000)



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Does investing in an unhedged world index fund make sense today?

- almost 60% in US stocks
- focus on more expensive large cap stocks
- 60% plus in US\$/US linked currency
- < 1% exposure to Asian and emerging markets

Is this really diversified?



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What happened to true diversification?

- correlations across mainstream assets are high and increasing
- diversification benefits of mixing equity styles in mainstream assets are vastly overrated

Investors need to consider alternative assets to get true diversification



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Correlations June 1999 - May 2003

| | Mkt. Neutral (FOF) | Managed Futures Fund | FTSE Gold Mines Index | MSCI World Index | S&P/ASX 200 Acc | S&P Listed Property Trust Acc |
|-------------------------------|--------------------|----------------------|-----------------------|------------------|-----------------|-------------------------------|
| Mkt. Neutral (FOF) | 1.00 | | | | | |
| Managed Futures fund | -0.19 | 1.00 | | | | |
| FTSE Gold Mines Index | -0.04 | -0.03 | 1.00 | | | |
| MSCI World Index | 0.27 | -0.40 | -0.26 | 1.00 | | |
| S&P/ASX 200 Acc | 0.20 | -0.47 | 0.08 | 0.47 | 1.00 | |
| S&P Listed Property Trust Acc | -0.21 | 0.02 | 0.17 | -0.05 | 0.19 | 1.00 |

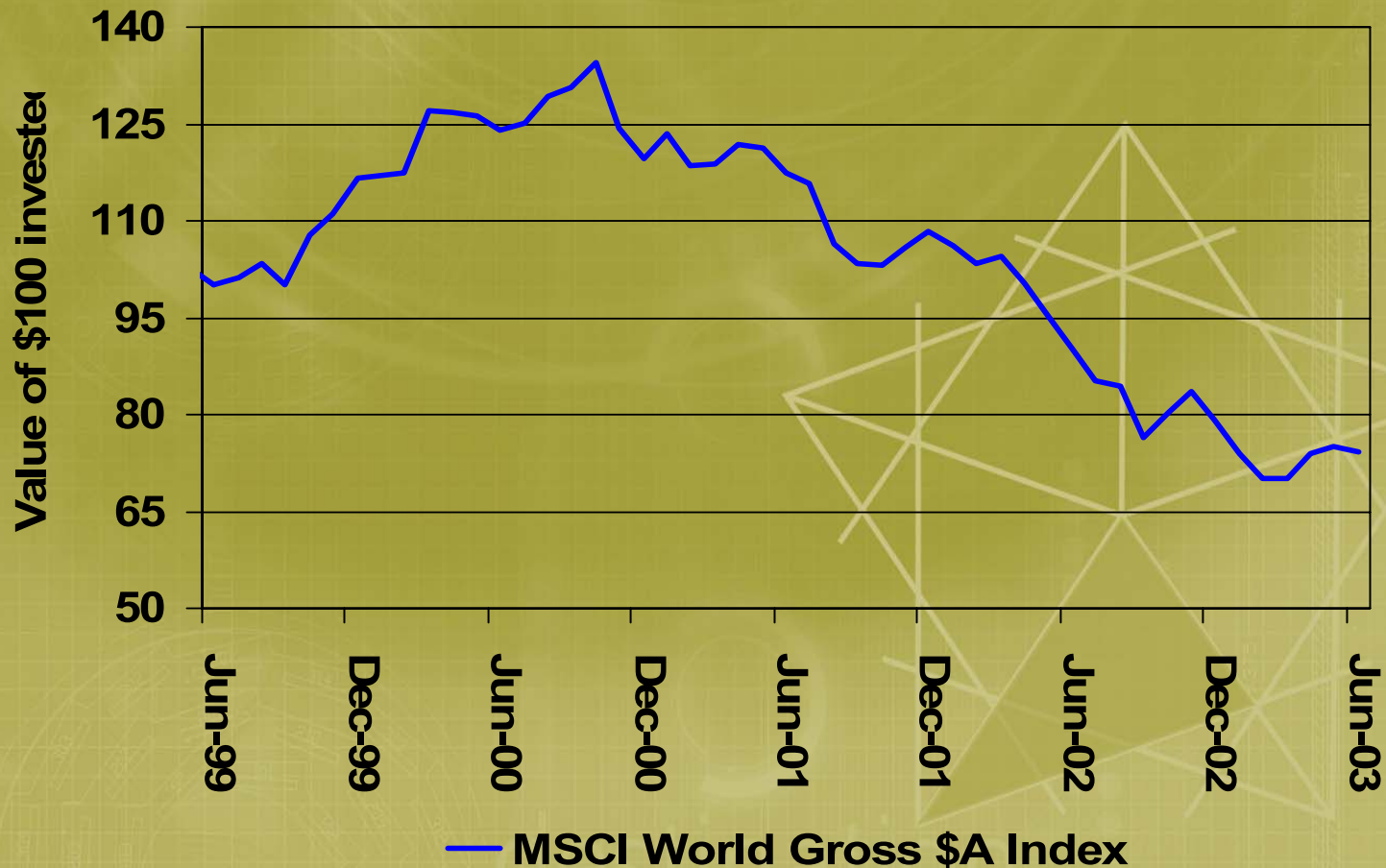


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This investment is volatile..

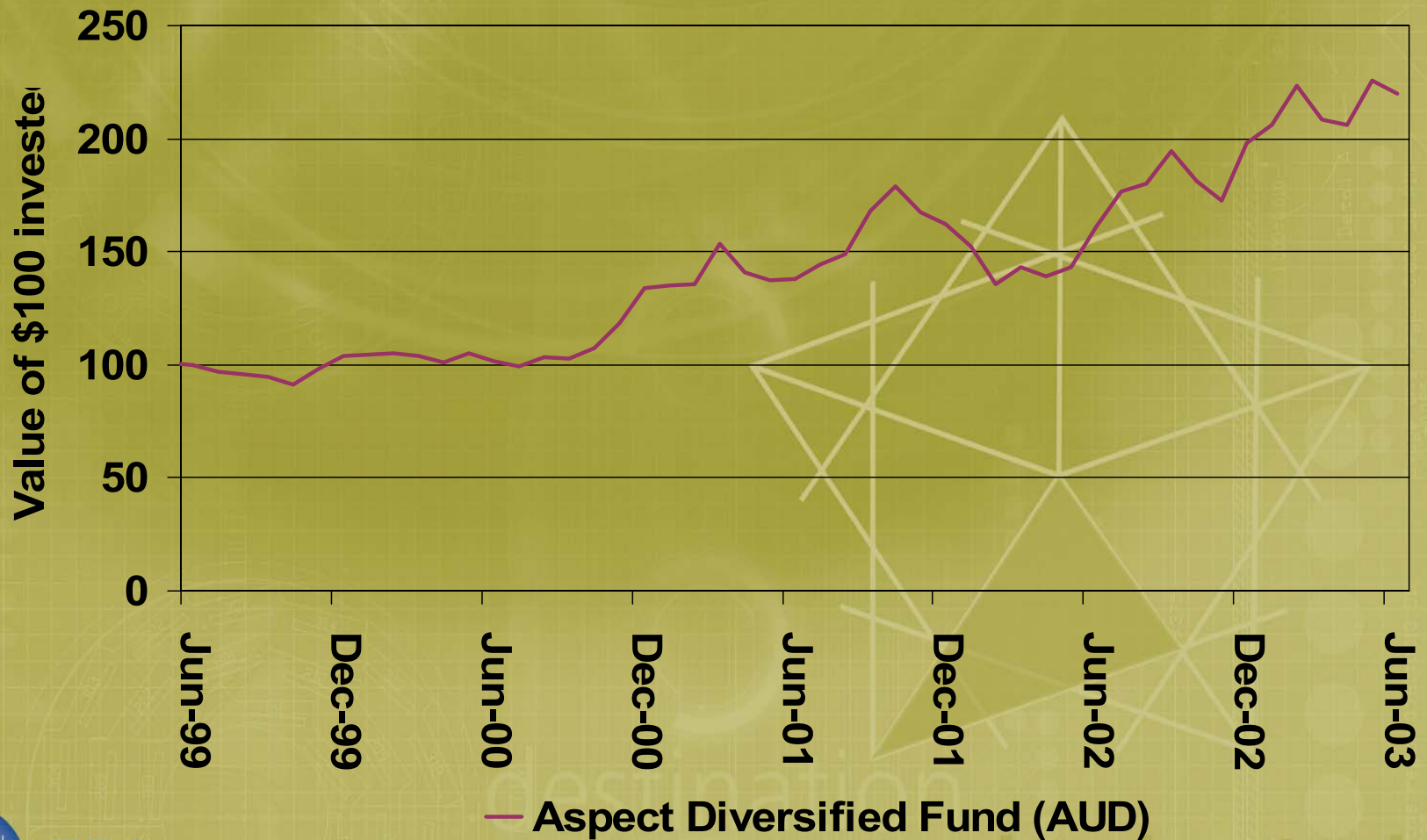


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and so is this one..

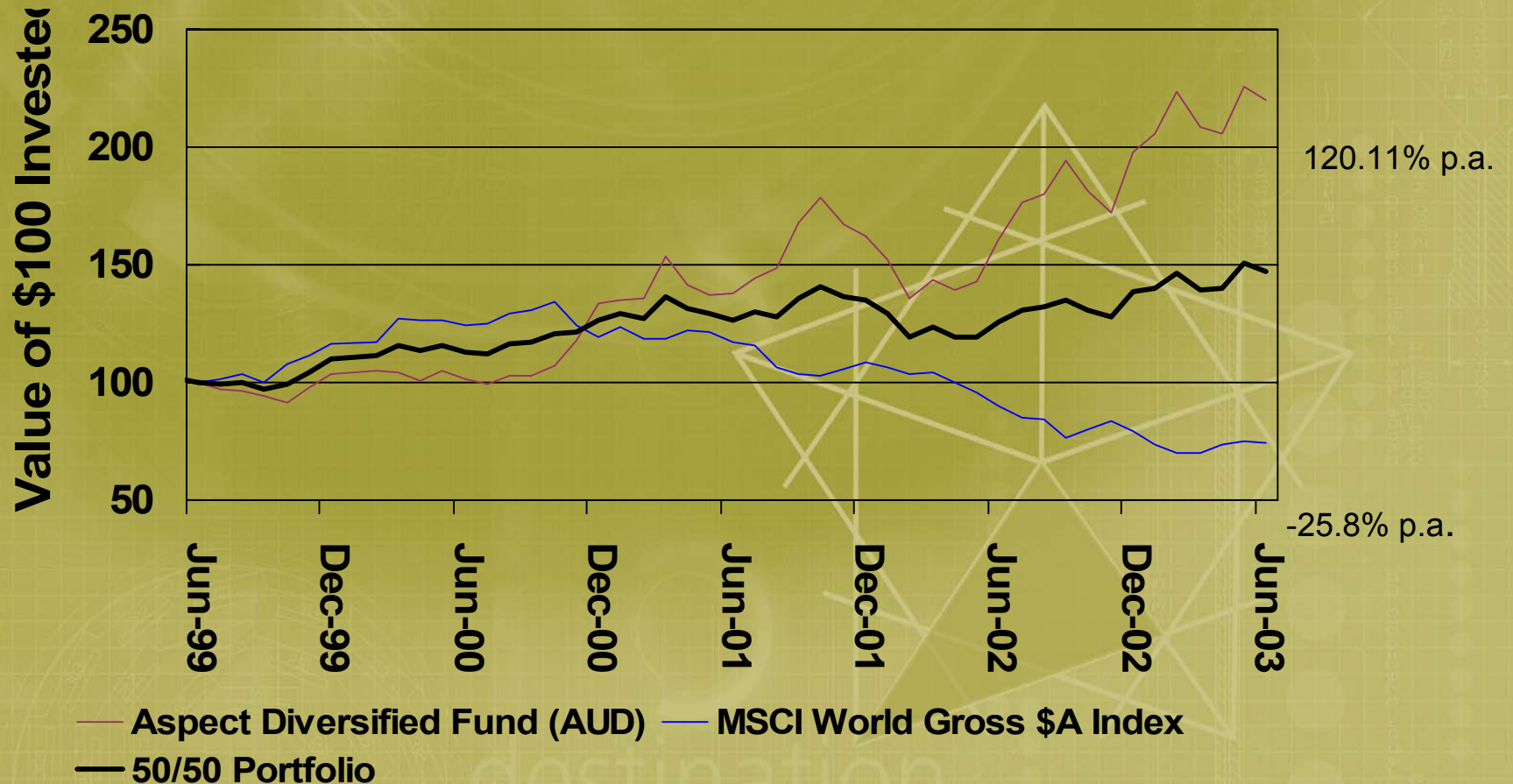


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But together they look like this



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Mixing equity styles does not necessarily reduce risk

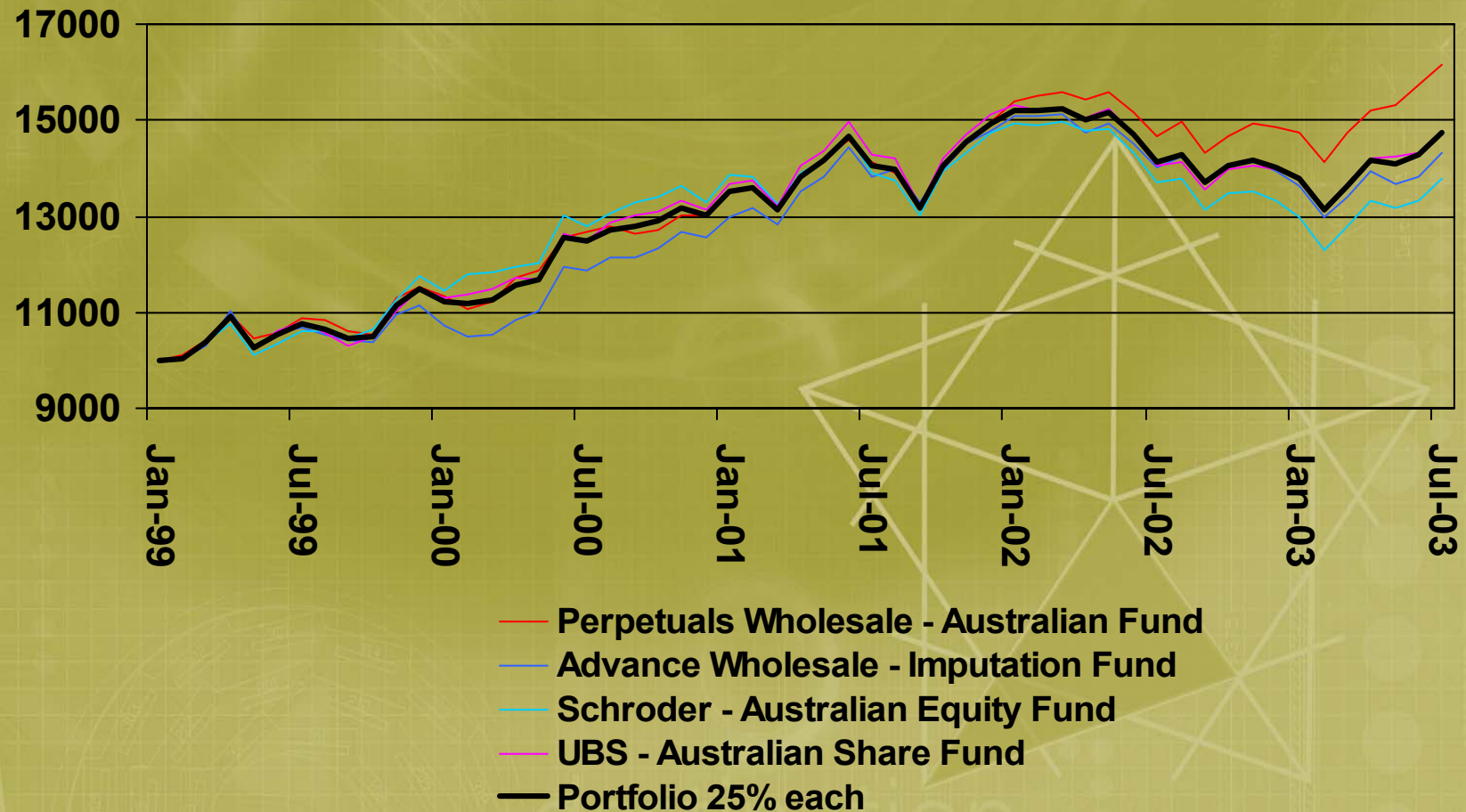
- mixing styles is mainly about reducing “relative risk” i.e. tracking error
- diversification benefits of mixing styles are overrated
- in many cases it actually increases absolute risk
- strong evidence that value and small do outperform in the long term
- but need to reduce bias when valuation advantage shrinks



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Is this really diversification?



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The constraints on large managers

- lack of flexibility in some asset classes
- bureaucratic/groupthink decision making
- excessive focus on business risk
- marketing not investment focus
- loss of key investment people



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Boutiques make sense but..

- greater key person risk
- difficulty of discerning good managers
- some boutiques get too big
- some managers get complacent

Problem – it takes good performance to attract funds but only mediocre performance to keep it.

Solution – *if using boutiques need ongoing research/assessment – not a permanent “buy and hold” proposition*



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Are hedge funds and other alternatives investments risky?

- alternatives offer wide choice across risk/return spectrum
- some alternatives offer much lower absolute risk than traditional investments
- even volatile alternatives can lower portfolio risk because of low/negative correlation



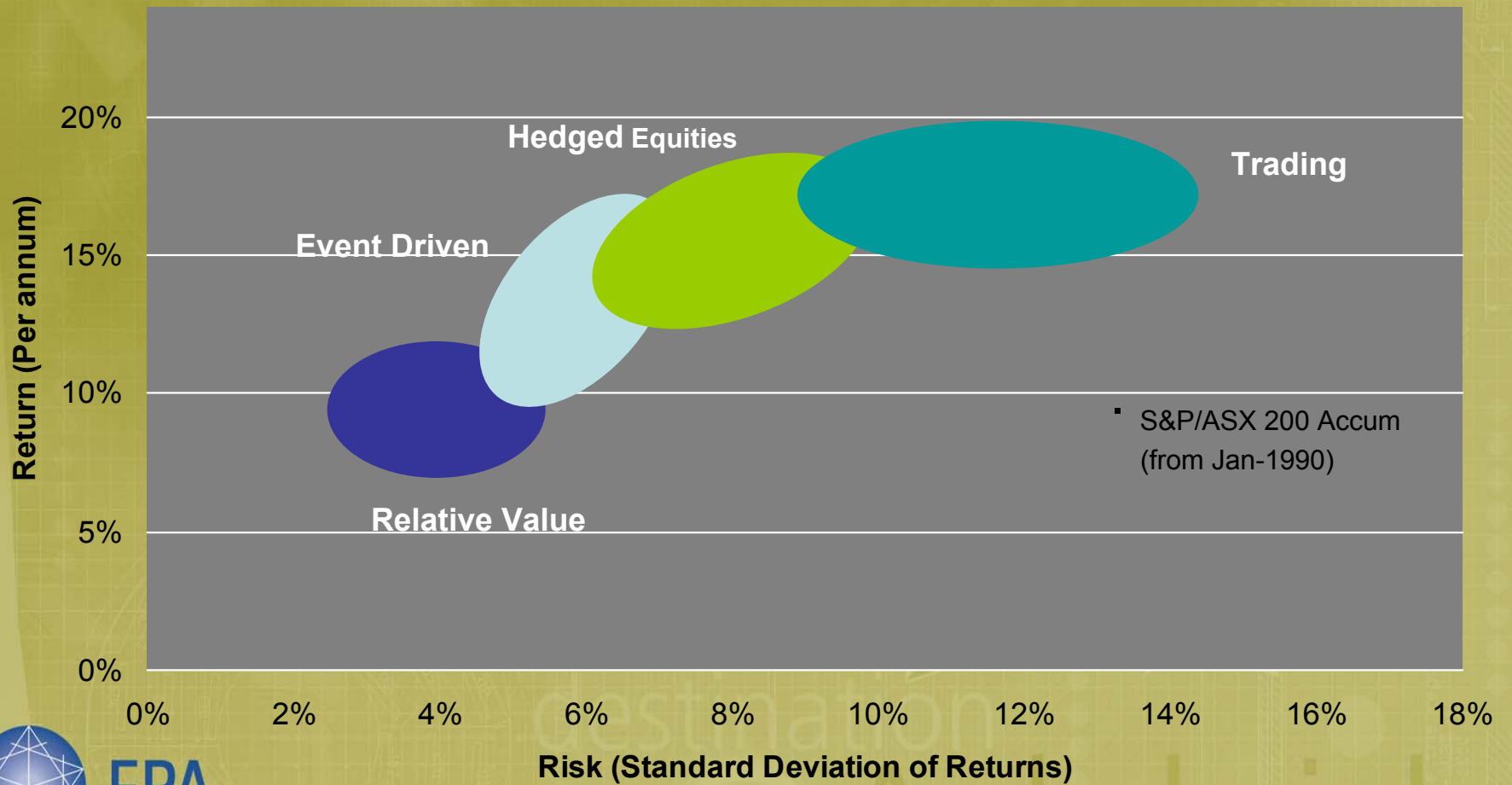
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Hedge Fund Strategies



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Is there a smarter way?

An absolute return/risk approach

- absolute return focus
- real concepts of risk (ignore tracking error)
- diversification that makes sense
- medium/long term focus but beyond “set and forget”
- exploit inefficiencies in markets
- value/contrary focus
- look forward not backwards



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Absolute Return Approach

“Selecting a diversified portfolio of investments based on their ability to make money and preserve capital over the medium to long term, not on their historical return, their weighting in any index or their weighting in other investors portfolios.”



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Comparative Overview

| Views on | Conventional | Absolute |
|------------------------------------|---------------------------------|---|
| Market Efficiency | Markets mostly efficient | Markets can be grossly inefficient |
| Asset Allocation | Passive / rebalancing | Active medium to long term, value / risk focus |
| Sector Selection | Largely sector neutral | Contrarian / value (look for catalyst) |
| Style Selection | Style neutral | Small / value bias but flexible |
| Strategy Selection | Buy and hold – long only | Innovative / what will work (including shorts) |
| Fund Manager Selection | Passive / mainstream | Boutique / absolute return focused |
| Direct / Listed Investments | Not considered | Opportunistic / value |



Absolute return approach is not about

- **avoiding growth assets**
- **investing all in hedge funds**
- **aggressive market timing**
- **neglecting diversification**
- **chasing past performance**
- **ignoring risk management**



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Portfolio construction process



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Asset class parameters – an absolute return approach

| | <i>Defensive</i> | <i>Growth</i> |
|--------------------------|------------------|---------------|
| Cash/Fixed Income | 25-75% | 5-50% |
| Property | 5-25% | 5-25% |
| Equities | 10-50% | 50-90% |
| Alternatives | 5-25% | 5-25% |



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Asset class parameters

- no strategic asset allocation benchmarks
- broad asset ranges
- no top down local/overseas allocation
- equities include hedged strategies
- allocation heavily driven from bottom up
- high weighting to non correlated alternatives



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Looking Forward not backwards!

US Equities (S&P 500) - 10 yr projected returns

| | |
|---|-----------|
| At future PE of 20 (same as 29,87 peaks) | 4.8% p.a. |
| At future PE of 14 (average 1950 - present) | 1.2% p.a. |
| At future PE of 11 (historical median) | -1.2%p.a. |
| At future PE of 7 (74,82 troughs) | -5.5%p.a. |

assumes historical average EPS growth of 6% pa



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The need to think “contrary”

“investment success generally stems from contrarian impulses. Winners should be viewed suspiciously, with consideration given to reducing or even eliminating previously successful strategies. Losers should be eyed hopefully, seen as potential sources of future gains for the portfolio. Contrarian, long-term investing poses extraordinary challenges under the best of circumstances”



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David F Swensen

Yale Chief Investment Officer

Pioneering Portfolio Management 2000

Some investments that should be considered for portfolios today

- market neutral hedge funds
- systematic trading strategies
- gold/gold stocks
- commodities/resource exposure
- Asia/Japan
- smallcap/microcap/private equity
- listed investment companies at discounts



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Investments that should be avoided/less heavily weighted in portfolios today

- Australian large cap industrials (esp. banks)
- residential property
- listed property trusts
- index/near index international share funds
- long term bonds
- high interest debentures



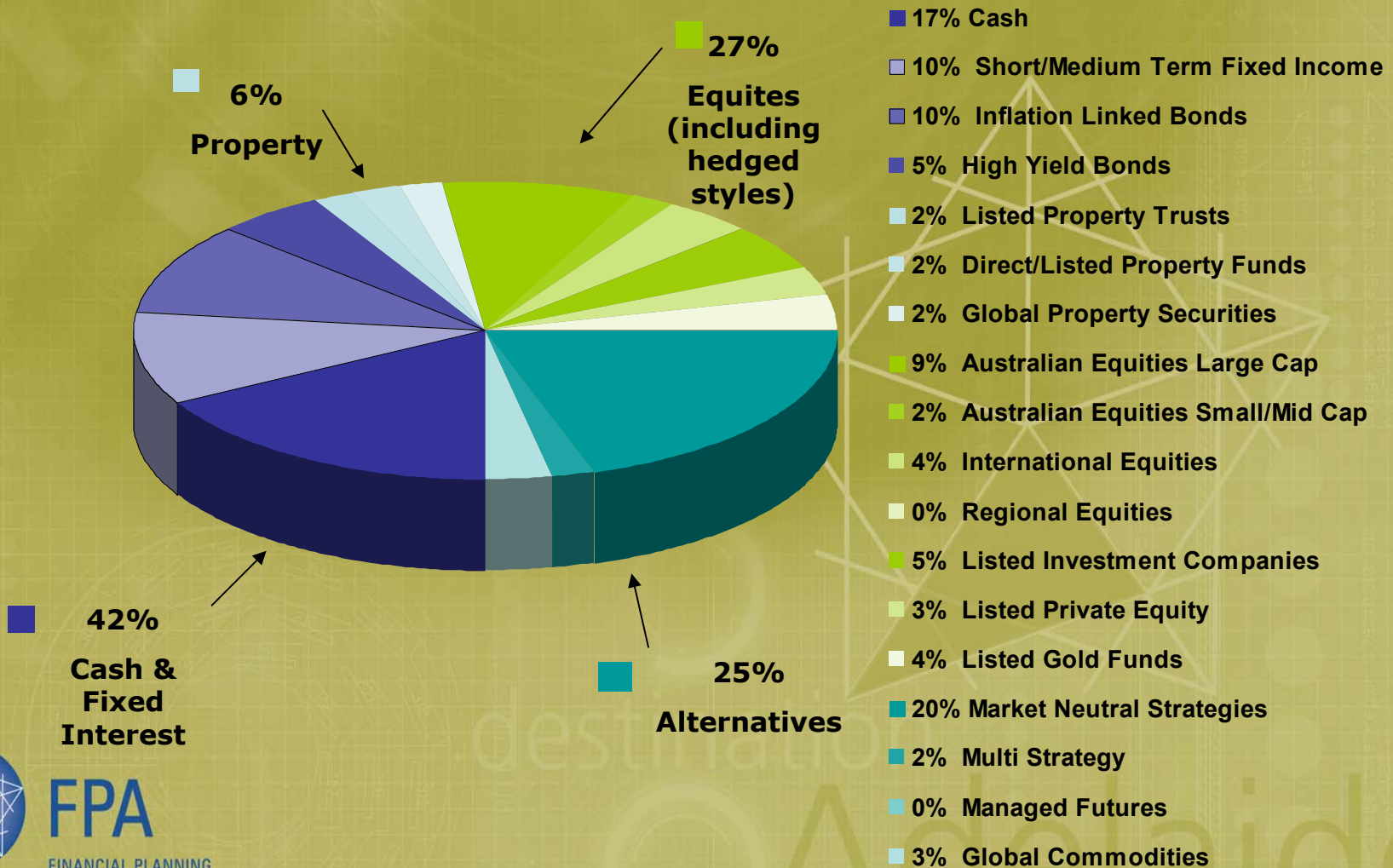
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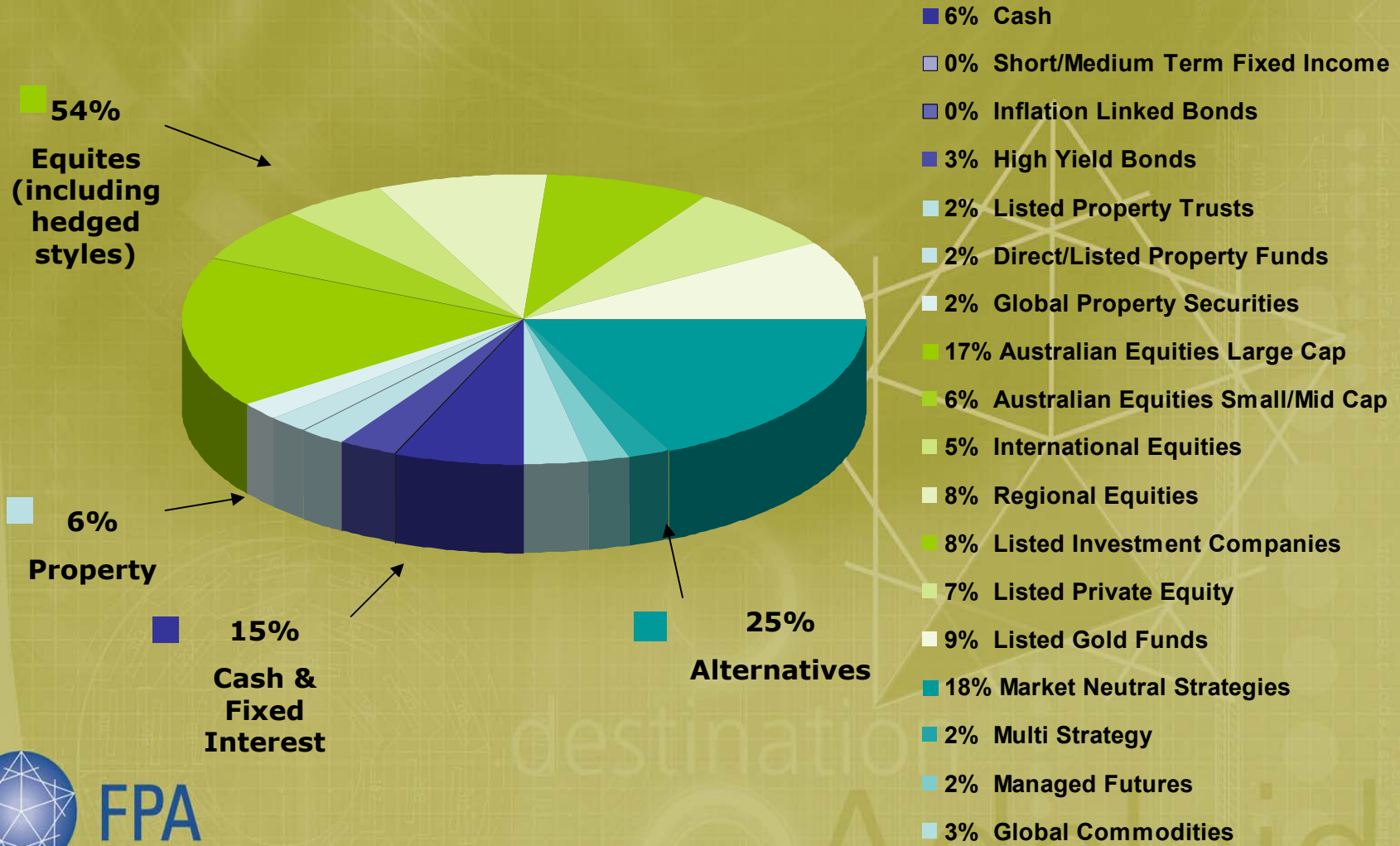
Defensive Portfolio allocation – June 2003



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Growth Portfolio allocation – June 2003



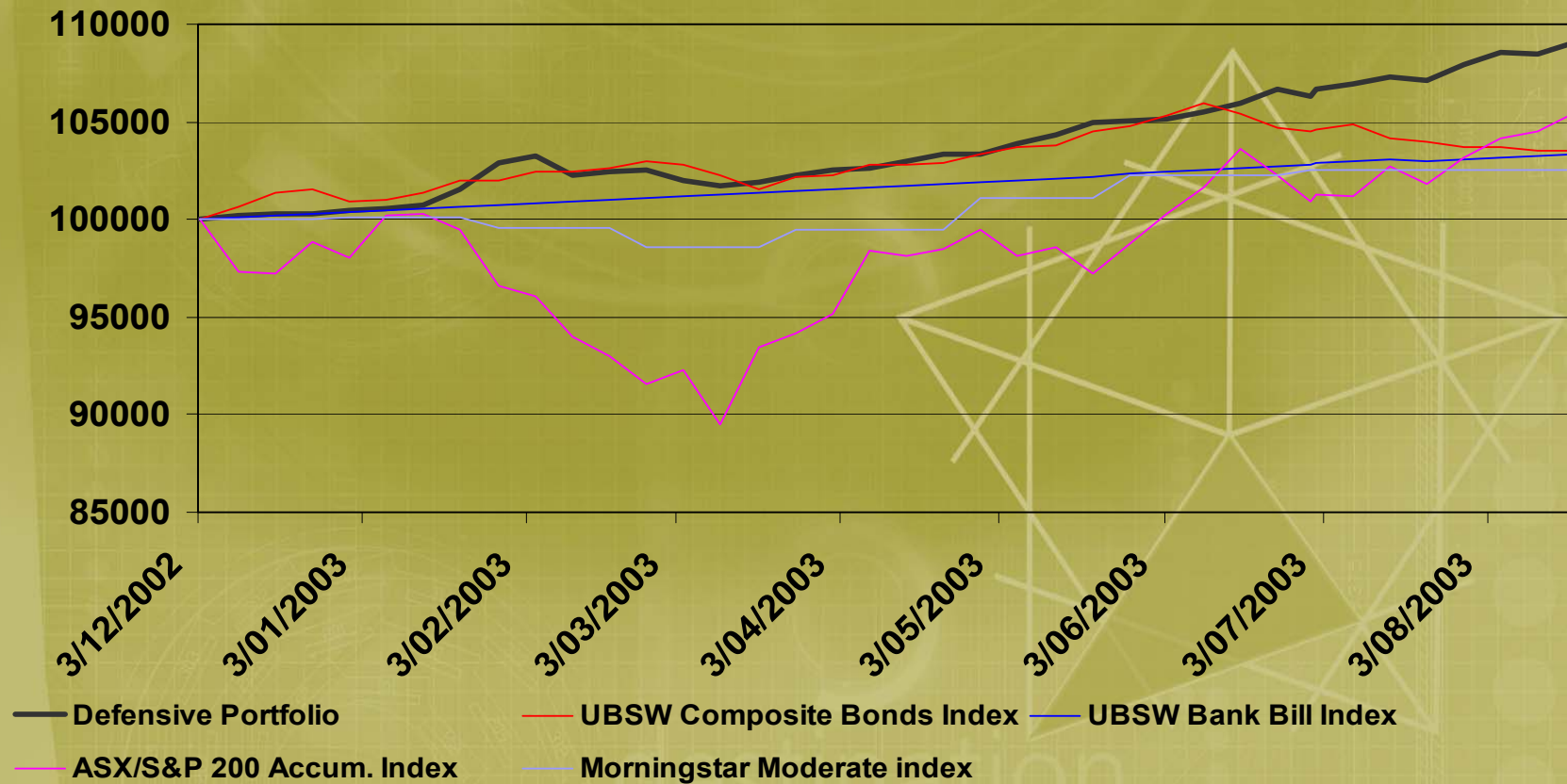
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Select Defensive Portfolio

Performance to 19th August, 2003

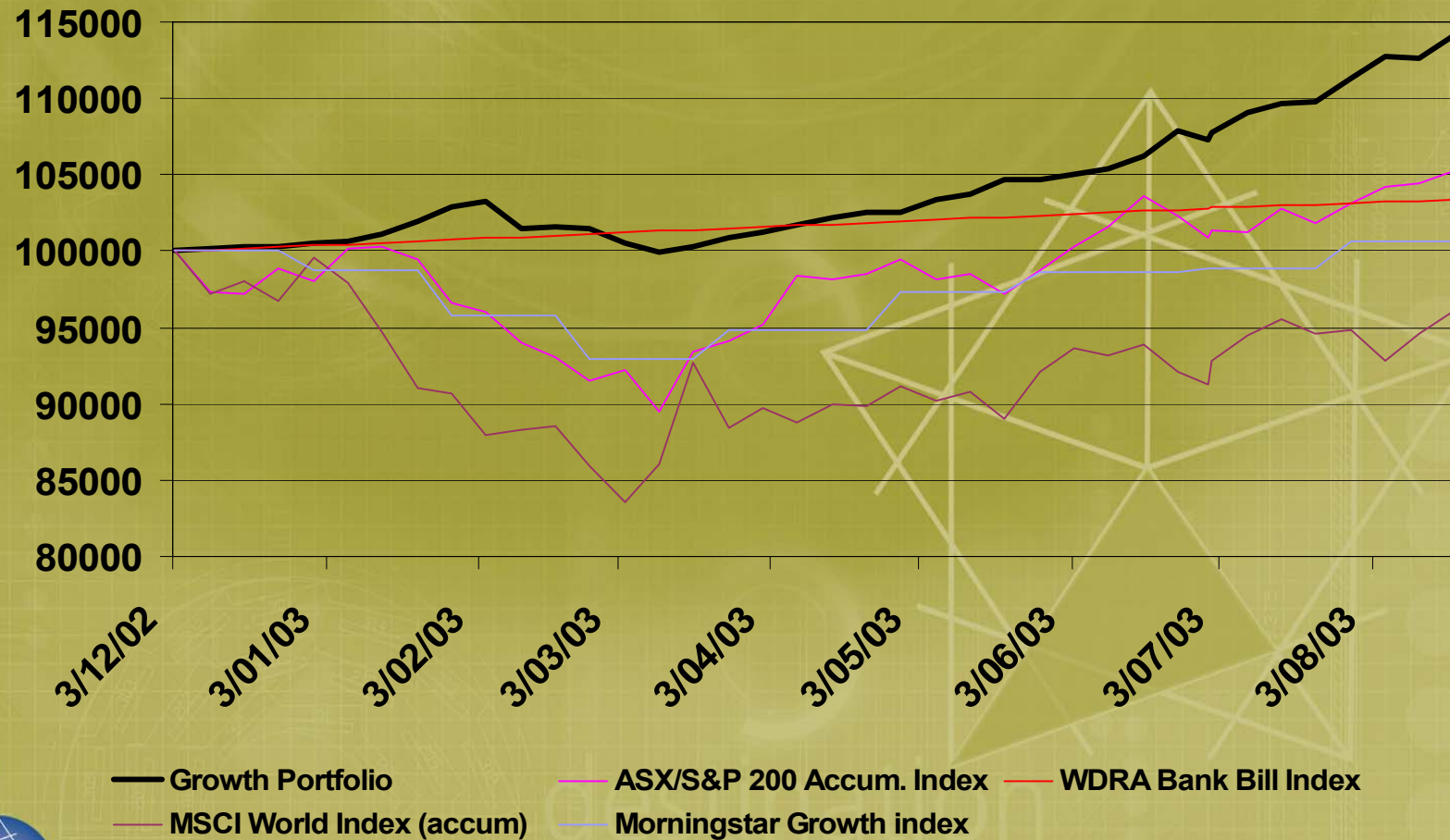


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Select Growth Portfolio

Performance to 19th August, 2003



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What investment role should planners have?

- **most financial planners are poor investors for clients**
 - not enough time
 - not enough experience/qualifications
 - implementation leakages
 - client contact inhibits tough decisions (performance chasing?)
- **to properly manage investments they need to**
 - spend more time researching and thinking about investments
 - develop an approach that they understand and are committed to
 - adopt a contrarian and value approach to investment selection
 - become very disciplined and efficient in implementing portfolios
 - understand the full range of investments and their role in portfolios

If this is not feasible planners should be outsourcing both portfolio construction and investment selection



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Investments is an art not a science!

“This framework eschews mathematical models and relies instead on deductive logic and an understanding of human nature. It is necessarily subjective, but that – whether the quasi-scientists in the economic mainstream like it or not – is reality. Ultimately, greed and fear are at the heart of most, if not all, investment decisions”

Dr Jim Walker, Chief Economist CLSA

“It is better to be approximately right than precisely wrong”

Warren Buffet



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Conclusions

- conventional/relative return portfolios have not delivered and may not in future
- even if they do most clients cannot handle their volatility
- investors need more *innovative absolute return approaches*
- planners need to *reduce the “business risk” of the current approach*



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Dominic McCormick
Chief Investment Officer
dominic.mccormick@selectfunds.com.au

Melanie Caffrey
Head of Marketing
melanie.caffrey@selectfunds.com.au

Select Asset Management

Level 29, Chifley Tower
2 Chifley Square
Sydney NSW 2000
Phone: 02 9375 2280
Fax: 02 9375 2121

Web: www.selectfunds.com.au



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Select Asset Management Limited

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