Investment Philosophy Statement

An Investment Philosophy is a set of core investment principles and beliefs that guides a person's investment decision making processes. Its application in practice is reflected in the way investment portfolios are constructed and managed.

We have set out in this document a detailed exposition of the 12 Core Investment Beliefs which underlie and together comprise Retirewell's Investment Philosophy. It is a substantial document, befitting the gravity and importance we place on the role of managing our clients' investment monies. It is a role in which we believe we have excelled - refer to the **Appendix**, an 8 page document showing historical performance graphs and comparisons of Retirewell's 6 Model Portfolios since inception (2009). The time-poor need only read the next three pages, being the one page Summary followed by the two page Executive Summary.

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Executive Summary – Page 3 and 4

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Investment Philosophy Statement

Retirewell Financial Planning Pty Ltd

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What is an Investment Philosophy?

An Investment Philosophy is a set of core investment principles and beliefs that guides a person's investment decision making processes. Its application in practice is reflected in the way investment portfolios are constructed and managed.

Summary of our 12 Core Investment Beliefs

In this document, we set out an Executive Summary (2 pages) then outline a detailed explanation of each of our 12 Core Investment Beliefs. The Appendix shows the results.

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Executive Summary

Core Investment Belief 1: Investment decision-making involves a conscious trade-off between risk and return (Modern Portfolio Theory)

Modern Portfolio Theory (MPT) is based upon the works of Harry Markowitz and William Sharpe, dating back to the 1950s. It introduced the concept of the *risk-return trade off* and showed that diversification of risk by spreading investment across different investment asset classes was the key to maximising returns while minimising risk. MPT laid the intellectual foundation for subsequent decades of research. Markowitz and Sharpe won the Nobel Prize for their work in 1990.

Core Investment Belief 2: Effective diversification is essential for maximising return within agreed parameters of risk.

The fundamental concept underlying asset allocation is diversification, which is investing in multiple assets that have different risk/reward characteristics. Over 90% of the differences in returns, is due to the asset allocation decision. Genuine diversification can only occur when implemented at a number of levels – *across* all major asset classes, *within* each asset class and finally, across different investment managers. However, there is a limit to the protection provided by diversification. Other strategies must also be used to manage downside risk.

Core Investment Belief 3: Investment markets are not efficient, in that price does not equal value and thus assets are often overvalued or undervalued.

One of the original fundamental tenet of MPT, the **Efficient Market Hypothesis**, said that asset markets are “efficient” in the sense that all information is reflected in the price. Subsequent research has shown that markets are not efficient – at least not all the time and some markets are more efficient than others. This inefficiency in markets provides significant investment opportunities for an active manager to add value through exploiting inefficiencies and identifying mis-pricings in the market.

Core Investment Belief 4: Professionally managed funds provide more efficient and effective diversification than direct investment portfolios.

Professionally managed funds are usually well diversified, spreading investment risk across a wide range of securities and usually offer high liquidity. Individual securities or direct investments carry a much higher level of concentration risk, may be illiquid and are more difficult to manage/administer.

Core Investment Belief 5: Actively managed funds can generally add more value and can provide higher net returns than passively managed or index funds.

Actively managed funds aim to outperform a particular index e.g. the S&P/ASX All Ordinaries Index. This outperformance above the index (or benchmark) return, is referred to as “alpha”. We chase alpha and are strong proponents of the use of actively managed funds. An Index fund – which is passively managed, simply to mirror the components of an index – has cheaper fees, but no chance of achieving returns above the index it tracks. We have been able to add significant net-after-cost returns above both Index and market average returns through our active investment management process.

Core Investment Belief 6: Actively managed, concentrated, high conviction portfolios are likely to outperform larger, index-like portfolios.

Academic research and historical results show that across all market caps and in both domestic and international equities, high conviction active managers have consistently outperformed both their benchmark indexes and other actively managed funds. They hold more concentrated portfolios with longer holding periods, with portfolios that bear little relationship to their market index, with better risk adjusted returns. We actively seek out these managers – they are more likely to be found in the boutique space.

<u>Core Investment Belief 7</u> We believe in the 4 stage fund life-cycle theory. Significant value-add can result from identifying talented emerging managers and investing with them in their Emerging and Growth stages.

The fund life-cycle theory holds that funds go through 4 life-cycle stages – Emerging, Growth, Maturity and Decline, followed by closure or revitalisation. The optimum time to invest in the fund is from its mid- to- late Emerging stage to its early Maturity stage. Emerging managers comprise between 20% and 30% of the funds we use in our Model Portfolios

<u>Core Investment Belief 8</u>: Investors are not rational, but are influenced by emotions and inherent biases.

Human emotions affect markets and decision-making. Emotional and psychological influences can impact financial decisions and result in irrational behaviour. Human beings are not rational investors and human judgement is subject to many behavioural biases. Based on behavioural finance, investment is 80% psychology. Specific strategies which recognise this risk must be employed.

<u>Core Investment Belief 9</u>: Use of non-traditional assets and strategies (alternative assets and strategies) improves risk-adjusted portfolio returns.

A way to reduce the effect of higher correlation of returns between traditional asset classes (shares, property and fixed interest) and to reduce overall portfolio risk, is to allocate a portion of the portfolio to a relatively new class of investments known as "alternative assets and alternative strategies". They provide a pattern of returns which are uncorrelated or negatively correlated to the pattern of returns from traditional asset classes. We have been early adopters of the use of Alternatives in portfolio construction. A major positive benefit is the lower level of portfolio risk (as measured by volatility) in our Model Portfolios.

<u>Core Investment Belief 10</u>: Management of downside risk is critical, particularly equity market risk

Research has shown that equity market risk represents the major downside risk in most portfolios. One way of managing this risk is in the use of Alternatives – see above. .Another way is through the use of funds which are managed according to an "absolute return" approach. Although they use a variety of investment strategies and risk control processes, their common shared characteristic is that they attempt to protect capital. Currently, more than 1 in 3 of the funds we use is managed on an absolute return basis. A further strategy we can use is through the use of a Dynamic Asset Allocation overlay, by reallocating capital when an asset class moves outside its long-term fair value range.

<u>Core Investment Belief 11</u>: The use of a range of Strategic Asset Allocation (SAA) models is the most efficient way to provide diversification.

The use of a range of SAA Models also provides a logical, progressive risk framework to suit the wide range of personal investment risk tolerance profiles. For ease of understanding and comparison, we have adopted the broadly accepted industry standard of 5 Risk Profiles, in order of ascending risk, from low risk to high risk. See Page 24 for the SAA Table which outlines our Strategic Asset Allocation (SAA) models for each of the 5 standard Investor Risk (Asset Allocation) Profiles, along with other important information on each SAA model.

<u>Core Investment Belief 12</u>: We live in an Age of Specialisation – we focus on our strengths in Investment Management and Financial Planning and outsource the rest.

We focus on our strengths in Investment Management and Financial Planning and outsource many other specialist roles and tasks to other specialists. We believe we are good Investment Managers as shown by many years of results from the 6 main Retirewell Model Portfolios, which show significant and consistent outperformance against peers. Our bespoke, active, specialised approach to efficient portfolio construction and ongoing management of multi-asset portfolios, has provided a very different client experience to that of the large, vertically integrated institutions, whose primary purpose is to "place product".

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WEALTH MANAGEMENT SOLUTIONS

Investment Philosophy Statement

Retirewell Financial Planning Pty Ltd

AFSL No. 247062 ACL No. 247062

Introduction

"Risk comes from not knowing what you're doing" - Warren Buffet

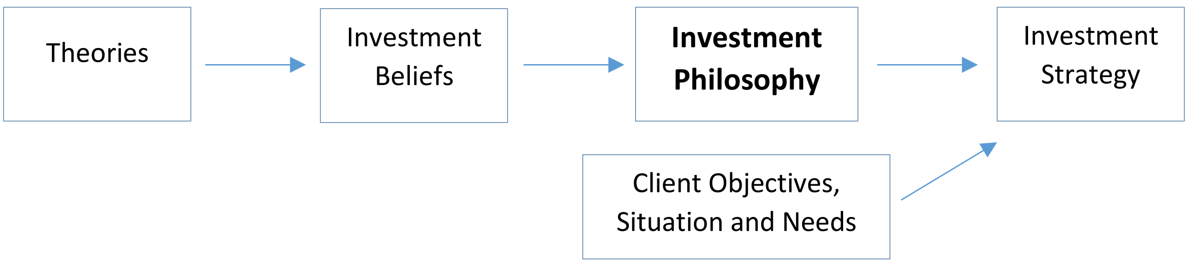
The world's leading investors will tell you that nothing is more important to long term investment success than a clear investment philosophy.

An Investment Philosophy is a set of core investment principles and beliefs that guides a person's investment decision making processes. Its application in practice is reflected in the way investment portfolios are constructed and managed.

Developing an Investment Philosophy involves articulating your beliefs in 4 areas:

- Financial markets (efficiency of markets, risk premiums, time horizons)
- Investment Process (decisions about risk management, investment styles, costs)
- Organisational (role of investment management, outsourcing or insourcing, experience)
- Transactional (managed funds vs direct, Platform choice, ownership structure)

Diagrammatically, the development process looks like this:



A clearly articulated Investment Philosophy provides the roadmap to help stay on track towards long-term goals, particularly when confronted with major market upheavals. It helps to control negative emotions such as fear and greed, which override logic and reason. It helps to shut out noise and to promote patience and discipline, to focus on the things that really matter over the long-term.

We believe that the next decade (and probably longer) will be characterised by continuing high volatility in investment markets, lower growth and lower overall returns, compared to the experience of the last 30 years – in other words, a much more challenging environment. Higher volatility with lower returns will be the "new normal" for the next decade.

Based on many years of experience, education, academic research and practical application, we have developed a philosophy on investment management and a set of **Core Investment Beliefs** that we believe provide us with a significant long-term advantage, for the benefit of our clients.

We set out in more detail in the following pages, the rationale underlying each of our 12 Core Investment Beliefs.

Core Investment Belief 1: Investment decision-making involves a conscious trade-off between risk and return (Modern Portfolio Theory)

Professional investment management focuses on minimising **risk** and maximising **returns**. Its purpose is to minimise the level of risk within individual asset classes and across the whole portfolio, whilst striving to deliver net returns which will satisfy the client's Objectives. We have a strong focus on delivery of absolute returns – or positive returns, which ensure the value of the investor's capital is maintained. Ultimately, success requires the disciplined application of a sound Investment Philosophy, implemented through a set of Core Investment Beliefs.

What is "risk"? There are 3 ways to define risk. First, in the broadest sense, risk may be defined as "the chance of not meeting your desired objectives". Second, to the layman, risk simply means the chance of potential loss of some or all of your capital. Third, from a professional investment manager's viewpoint, risk is defined in terms of *volatility of returns*, measured by standard deviation of returns away from the mean – the more volatile the returns, the riskier the investment.

Maximising Return and Minimising Risk

Risk (defined as volatility) and return are related. In general, investments with higher volatility (e.g. shares) are expected to have higher returns – an extra return (or risk premium) for accepting the greater level of fluctuations – whereas lower volatility investments (such as Government bonds, or cash deposits) are expected to offer lower returns, reflecting their greater stability.

This is called *the risk-return trade off*, which says that potential return rises with an increase in risk. So, diversification of risk through asset allocation across different asset classes is important. Because of the protection it offers, asset allocation is the key to maximising returns while minimising risk – this is expanded further in *Core Investment Belief 2*. Since each asset class has varying levels of return and risk, investors need to consider their risk tolerance, as well as their investment objectives, time horizon, current/future available capital and their financial and emotional capacity for taking on risk.

Modern Portfolio Theory

Harry M Markowitz laid the intellectual foundation for **Modern Portfolio Theory (MPT)**, with his seminal paper *Portfolio Selection* in 1952 in the Journal of Finance, followed in 1959 with his book *Portfolio Selection: Efficient Diversification of Investments*. Markowitz set out a mathematical formulation of the concept of diversification in investing, which seeks to maximise expected return for a given level of risk (or minimise risk for the same level of return), by combining different asset classes that are not perfectly correlated. (Correlation simply describes how two investments move in relation to each other, how tightly they are linked or opposed). MPT does this by the allocation of monies (diversifying) across various different investment assets which show uncorrelated returns - cash, bonds (fixed interest), shares, property and infrastructure, and more recently, alternative assets and strategies. In other words, MPT seeks to take advantage of the different patterns of returns produced by different asset classes. Markowitz also introduced the concept of the Efficient Frontier, which shows the best portfolio combinations that produce the greatest return for a given level of risk (measured as standard deviation).

In 1964, William F Sharpe, published *Capital Asset Prices: a theory of market equilibrium under conditions of risk* - which included the Capital Assets Pricing Model (**CAPM**). The combined works of Markowitz and Sharpe provided the intellectual foundation for subsequent decades of further research. They were jointly awarded the Nobel Prize in 1990 for their work. MPT provided the intellectual basis for *Core Investment Belief 2.*

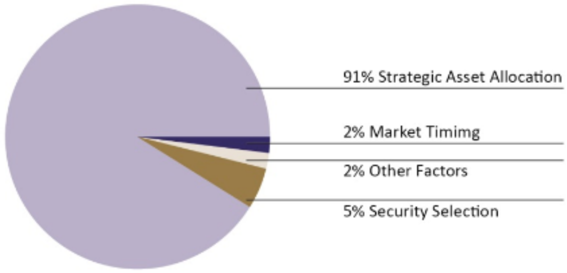
Core Investment Belief 2: Effective diversification is essential for maximising return within agreed parameters of risk

"One should always divide his wealth into three parts: a third in land, a third in merchandises, and a third ready to hand" - Rabbi Issac bar Aha, 4th century AD

There is an adage "the only free lunch in investment is diversification". We have also all heard the saying "don't keep all your eggs in the one basket". The fundamental concept underlying asset allocation is diversification, which is investing in multiple assets that have different risk/reward characteristics. Most investors should hold a diversified investment portfolio, because it is a proven way to produce reasonable returns whilst reducing risk, over time.

Asset Allocation (the Asset Class mix) is the Primary Determinant of Returns

Three academics (Brinson, Hood and Beebower in the Financial Analysts Journal, 1986) studied the performance of 91 large US pension plans between 1974 and 1983. They analysed the impact of key decisions in three areas: long-term asset allocation, stock-picking and short-term tactical changes to the asset mix. The results concluded that over 90% of risk and return in a given fund was a result of the long term asset mix with both stock-picking and short-term tactical changes having a negligible impact – see results chart below:



Sensible diversification seeks the best return for any given or accepted level of risk. Too much diversification and you will end up with mediocre or only index returns; too little and your portfolio risk level becomes too high due to concentration of risk.

Primary diversification begins with investing *across the major asset classes* – cash, fixed interest, property (including infrastructure) and shares, as well as in a newer, diverse and non-homogenous class of investments known as 'alternatives' (alternative assets and alternative strategies). Each type of investment plays a different role: cash is there for liquidity and to protect the nominal value of your capital; fixed interest securities provide security of capital with known predictable income; shares and property will provide capital growth over the medium to longer term, with regular tax-efficient but less predictable income returns; alternatives are used primarily to provide investment returns which are non-correlated with returns from traditional assets and thus to reduce overall portfolio risk.

This portfolio-level diversification is the primary tool we use to manage the risk and return in our clients' portfolios. Proper diversification also means:

- investing *within asset classes* – that is, across regions, countries and the sub-asset classes of each of the major asset classes (e.g. International fixed interest as well as Australian fixed interest).
- diversification *across investment managers*, who will have different approaches (or investment styles) and who will perform well at different times and in different circumstances to each other.

So, genuine diversification at a number of levels, can reduce portfolio risk by spreading investments across multiple asset classes, multiple investment managers and multiple securities. The result should be a much smoother pattern of returns, with greater consistency and lower volatility.

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The Impossibility of Forecasting the Future – Another Important Reason to Diversify

The table below shows the performance of various asset classes over the past 30 years. It shows that asset class performance is very unpredictable and varies significantly from year to year. Having a diversified mix of investments across multiple asset classes can help smooth out returns over time. The table also reinforces the importance of sticking to an investment strategy and focusing on the long-term.

Financial year total returns (%) for the major asset classes

Year	Australian Shares	International Shares	International Shares (Hedged)[1]	US Shares	Australian Bonds	International Bonds (Hedged)[2]	Cash	Australian Listed Property	International Listed Property[3]
1987	54.0	32.6	33.2	17.7	12.1	17.6	17.3	41.3	
1988	−8.6	−10.0	−5.3	−15.5	19.4	12.5	12.5	−2.8	
1989	3.5	18.1	18.3	26.7	3.0	16.3	15.7	−1.1	
1990	4.1	1.9	5.3	11.5	17.8	13.1	18.5	15.2	
1991	5.9	−2.0	−5.8	10.3	22.4	15.3	13.5	7.7	−15.9
1992	13.3	7.1	−3.0	16.3	22.0	15.8	9.0	14.7	6.9
1993	9.9	31.8	17.3	26.6	13.9	14.7	5.9	17.1	28.3
1994	18.5	0.0	6.7	−6.5	−1.1	2.1	4.9	9.8	8.4
1995	5.7	14.2	3.7	30.0	11.9	13.1	7.1	7.9	7.5
1996	15.8	6.7	27.7	12.9	9.5	11.2	7.8	3.6	2.4
1997	26.6	28.6	26.0	42.6	16.8	12.1	6.8	28.5	35.7
1998	1.6	42.2	22.1	58.2	10.9	11.0	5.1	10.0	25.0
1999	15.3	8.2	15.9	14.2	3.3	5.5	5.0	4.3	−6.8
2000	13.7	23.8	12.6	18.2	6.2	5.0	5.6	12.1	14.1
2001	8.8	−6.0	−16.0	0.5	7.4	9.0	6.1	14.1	38.2
2002	−4.5	−23.5	−19.3	−26.3	6.2	8.0	4.7	15.5	7.5
2003	−1.1	−18.5	−6.2	−15.2	9.8	12.2	5.0	12.1	−5.2
2004	22.4	19.4	20.2	15.4	2.3	3.5	5.3	17.2	28.7
2005	24.7	0.1	9.8	−4.1	7.8	12.3	5.6	18.1	21.2
2006	24.2	19.9	15.0	11.6	3.4	1.2	5.8	18.0	24.2
2007	30.3	7.8	21.4	5.6	4.0	5.2	6.4	25.9	3.0
2008	−12.1	−21.3	−15.7	−23.4	4.4	8.6	7.4	−36.3	−28.6
2009	−22.1	−16.3	−26.6	−12.5	10.8	11.5	5.5	−42.3	−31.2
2010	13.8	5.2	11.5	8.9	7.9	9.3	3.9	20.4	31.3
2011	12.2	2.7	22.3	3.7	5.5	5.7	5.0	5.8	9.2
2012	−7.0	−0.5	−2.1	11.1	12.4	11.9	4.7	11.0	7.5
2013	20.7	33.1	21.3	32.5	2.8	4.4	3.3	24.2	24.3
2014	17.6	20.4	21.9	22.7	6.1	7.2	2.7	11.1	11.8
2015	5.7	25.2	8.5	31.8	5.6	6.3	2.6	20.3	23.1
2016	2.0	0.4	-2.7	7.5	7.0	10.8	2.2	24.6	20.4
Average	10.5	8.4	7.9	11.1	9.0	9.8	7.0	10.9	11.2
Best	54.0 (4)	42.2 (3)	33.2 (3)	58.2 (6)	22.4 (4)	17.6 (3)	18.5 (1)	41.3 (2)	38.2 (4)
Worst	−22.1 (2)	−23.5 (3)	−26.6 (4)	−26.3 (4)	−1.1 (3)	1.2 (2)	2.2 (5)	−42.3 (3)	−31.2 (4)

Source: Andex Charts Pty Ltd - Chart courtesy of Vanguard Investments Australia Ltd

Red box denotes when the asset class was the best performing asset class

Beige box denotes when the asset class was the worst performing asset class

Note: 1. The returns for each asset class are the Financial Year returns to June 30, from the most widely used accumulation Index for each asset class. For example, the index used for Australian Shares is the S&P/ASX All Ordinaries Accumulation Index.

2. All ex-Australia asset returns have been converted to Australian Dollars at exchange rates which were current at the time the returns were made.

The table above demonstrates that asset class diversification has the effect of reducing portfolio risk by lessening the impact that the returns from any single asset class, will have on the portfolio.

Having explained the rationale for using diversification to reduce risk and increase or at least smooth returns, we have to acknowledge that as the speed of knowledge and information transfer has increased exponentially over the last 20 years, the returns from all asset classes have become more correlated – that is, they have started to move in closer synchronisation – thus the key benefit of diversification has been weakened. We have seen that during times of significant systemic shocks (such as serious economic crises or market crashes like the Global Financial Crisis) nearly all assets fall in value together – in other words, the normal pattern of non-correlated returns (where prices do not rise and fall together) is replaced with highly correlated returns. Practically all assets, except government bonds and of course cash, fall together in value at the same time.

The normal diversified asset allocation approach as described above, will be the predominant driver of risk and return during "normal" market environments – which will prevail on average, for 65% of a market cycle. In times of a higher-risk market environment – which will prevail on average for 35% of a market cycle – an investment manager will need to implement additional techniques and strategies explicitly to manage and/or minimise downside risk. We will discuss this in our exposition of *Core Investment Beliefs 9 and 10.*

Core Investment Belief 3: Investment Markets are not efficient, in that price does not equal value and thus assets are often either overvalued or undervalued

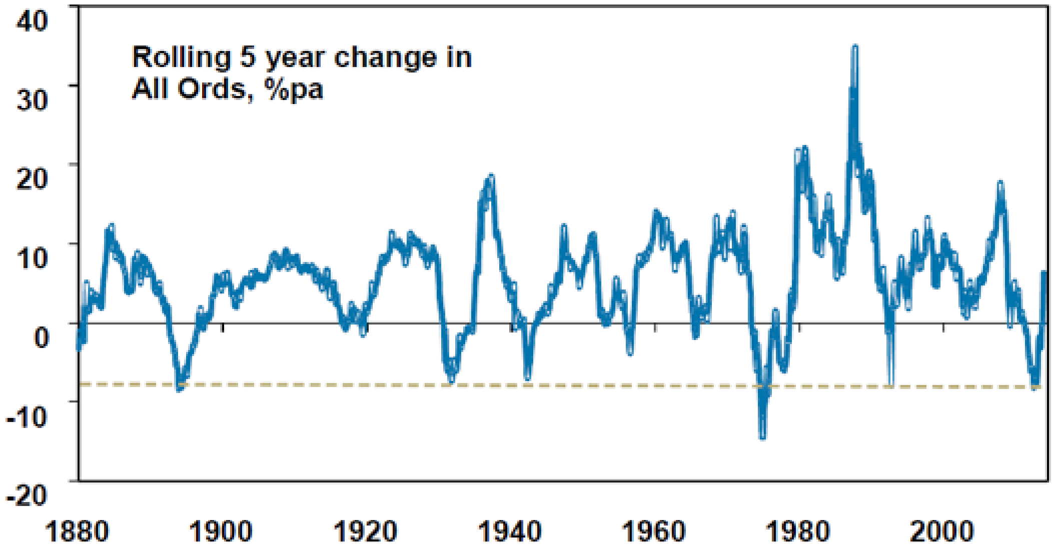
Although the central tenet of Modern Portfolio Theory is well established and accepted, i.e. that diversification across multiple asset classes with different risk/reward characteristics can increase portfolio returns and reduce portfolio risks – many investment professionals today would contend that several investment foundation theories of MPT and CAPM are probably flawed. In particular, the assumptions that investors are rational and that markets are efficient.

Recently, three other famous economists – Eugene Fama, Robert Schiller and Lars Peter Hansen were jointly awarded the Nobel Prize for Economics in 2013 for "their empirical analysis of asset prices", which included significant further research questioning the concept that markets are perfectly efficient.

A major fundamental tenet of MPT is the Efficient Market Hypothesis (EMH). **EMH says that asset markets are "efficient"** in the sense that all public information will be quickly and rationally reflected in the prices for shares, bonds, currencies, etc. This supported the contention that no one can consistently beat the market. This led to the rise of Index funds in the 1990s, championed by John Bogle, the founder of Vanguard Investments and more recently, exchange traded funds (ETFs), which are listed and traded on a stock exchange. Both types are predominantly "passive" funds which track the Index for a particular market, at low cost. Today, because of the problem of managing the huge and growing volumes of money managed by institutions, the majority of much institutional money in all asset classes, is managed on an index basis.

Starting in the 1980s, Robert Schiller and others were able to show that this fundamental tenet of MPT, the Efficient Market Hypothesis, was wrong – **markets are not efficient**, or at the very least, they are efficient for some of the time, but not all the time. Also, some markets are more efficient than others. This is shown by the mean-reverting nature of markets – meaning that markets can have years of below average returns, followed by years of above average returns – but over time, will move back to their long-term trend line. The chart below illustrates this. It shows the rolling five-year average of Australian share prices:

Mean reversion in Australian shares



Source:ASX, Bloomberg, AMP Capital

The "efficient market" claim that all publicly available information is quickly reflected in asset prices, is often wrong. Share prices move in both directions more than is justified, they move in cycles over years and end results are heavily affected by starting point valuations.

There can be no starker evidence of the failure of the EMH than the October 1987 sharemarket crash when US shares fell by 30% and Australian shares fell by 50%. Then there was the 80% fall in the tech-heavy Nasdaq index from 2000 to 2002. These dramatic moves had nothing to do with changes in the long-term outlook for profits and interest rates. So problems with the EMH were obvious long before the Global Financial Crisis (GFC).

For an active investment manager who believes that inefficiency in markets provides significant investment opportunities, this institutional focus on indexing of returns presents a major opportunity to provide significant investment "value add" for clients.

Core Investment Belief 4: Professionally managed funds provide more efficient and effective diversification than direct investment portfolios

Over many years of experience, we have found that professionally **managed funds** provide by far the best and most efficient and effective way to satisfy the need for proper diversification.

We use managed funds for investment implementation rather than portfolios of individual securities or direct investments (irrespective of the asset class) because of the difficulties of administration and the high level of concentration risk that the latter approach entails.

Professionally managed funds help us to minimise risk. These funds are usually well diversified, spreading investment risk across a wide range of securities in the particular asset class. There are two distinct types of funds that are available to investors – actively managed funds and passively managed funds. In the explanation for another of our core investment beliefs, we explain the difference between Active and Passive investment.

In summary, the use of professionally managed funds allows better and far more efficient and effective diversification, with easier and more efficient ongoing management.

Core Investment Belief 5: Actively managed funds can add more value and can provide higher net returns than passively managed or index funds

We actively seek out managers who can provide reliable alpha. **Alpha** is a measure of the excess return added by the portfolio manager through active management, relative to the return of the fund's benchmark index. It is the return on an investment that is not a result of general movement in the greater market. An alpha of 3 would indicate that the portfolio manager has added 3% in additional return above the index.

What is Active Investing?

Most actively managed funds aim to outperform a particular index. For example, an Australian equities fund might aim to outperform the S&P/ASX 300 Accumulation Index (ASX 300). This Index captures the total return of the top 300 shares (by size of market capitalisation) on the Australian Stock Exchange, including the accumulated value of reinvested dividends.

In their efforts to beat or outperform the index, the active fund manager will research all the companies and/or securities that are constituents of the particular index. Professional managers typically have the resources required to undertake detailed analysis on companies and skilled managers can identify those likely to perform better than the market average over time. These professional investment managers have access to information, research and robust investment processes that are not readily available to individuals.

Following this analysis, active fund managers will construct a portfolio designed to produce returns for investors, greater than the index. They will buy securities that are expected to perform better than the broader market, sell winning securities following a period of favourable performance, and avoid those that are expected to underperform.

The intention is that the actively managed portfolio of securities will perform better than the relevant index, usually referred to as the "benchmark". Of course there is also a risk that an active fund will underperform the relevant index if the selected securities do not do as well as the manager anticipates.

The performance of an active manager is typically measured against the relevant benchmark index, which they try to outperform by a given margin. Active management enables a skilful manager to exploit inefficiencies and mispricings in the market. As a general rule, the bigger the investment universe (the number of securities from which to choose), the greater the opportunity set for an active manager to outperform the benchmark. The extent to which returns vary from those of the benchmark index is a fair indication of the manager's skill.

What is Passive Investing?

A passive investment manager tries to replicate an index (e.g. a sharemarket index, such as the ASX 300), by owning shares in each constituent of the index. The quantity of each security (stock) held is determined by the stock's weight in the index. If BHP Billiton accounts for 4.6% of the ASX 300, for example, a passive Index fund manager will invest 4.6% of the fund's assets in that stock, and so on, for every stock in the index. Consequently, the challenge for index funds is that, by definition, they are over-exposed to overvalued securities and under-exposed to undervalued securities.

Cost is another differentiator of the two styles. Actively managed funds typically charge a higher management fee (and sometimes a performance fee) to cover research costs and to pay for the large teams of experienced analysts that are typically employed in the management of the fund. In contrast, because no attempt is made to outperform a benchmark index through research or stock selection, management fees for passive funds tend to be much lower than for actively managed funds. However, cost should not be the main factor in picking a fund - *net after cost returns to the investor is what matters.* Ask yourself this question – if you are making an important purchase, is cost (price) the only criterion upon which you base your choice? We are happy to pay a 20% performance fee to a skilled manager, for returns above the fund's relevant index, given we are still getting the other 80% of the return above the index.

We believe it is penny-wise and pound foolish to chase a 0.5% saving in lower management fees in an index fund and miss out on (say) 3% net after costs better returns from an actively managed fund in the same asset class.

Here is a summary of some of the key advantages and disadvantages of active and passive funds:

	Advantages	**Disadvantages**
Active	-Opportunity for the fund manager to research and select securities that are expected to outperform the market average over time -Potential to outperform a benchmark index and maximise returns for investors	-Potential to underperform the benchmark if the selected securities do not do as well as expected -Higher fees -Potentially wider dispersion of returns
Passive	-Very low risk of the fund underperforming a benchmark index by more than cost of fees -Lower fees	-No opportunity for fund managers to actively select securities that are expected to outperform -Managed only to match, not out-perform a benchmark index

Why do We Favour the Use of Active Managers?

The active versus passive debate cannot be reduced to a one-size-fits-all response. The best approach should be considered in the context of the asset class. In Australian equities for example, we'd never invest in a passive or index fund, since just 10 stocks comprise over half the value of the most widely used index, the ASX 200 Index. But we may consider indexing in parts of the fixed interest asset class, because of the difficulty in being able to consistently add sufficient value above the index – even for the new style of "unconstrained" manager in this sector.

We prefer to use active managers because of our belief that markets are not efficient – and at times will exhibit highly irrational behaviour. This provides opportunities for the skilful active manager to take advantage of market inefficiencies and mispricings.

To put our view a little more strongly, we believe that Index investing, in particular when it is directed to capitalisation-weighted equity indices, is dumb investing.

Critics of active management (who will support the low cost index fund approach to investment management) will point to many studies which show that it is very difficult for active managers to outperform their benchmark index over the long term.

We Acknowledge That the "Average" Manager will Under-perform the Index

We accept and agree that the "average manager" – in fact 75% of active managers – is/are not able to outperform their relevant index, over the long term (say 5 years +) after fees and expenses. This is mainly because many so-called "active" managers could be described as "closet" index managers – they charge higher active management fees but "hug the index" in their portfolio holdings. This is particularly so in the institutional space, where managers are obsessed with benchmark risk and competitor risk. They are simply not game to run their portfolios too far from index weights, through fear of underperformance in the next quarterly fund performance rankings – and also through "career risk" fear that as a consequence, they could actually lose their jobs! We owe this outcome to the tyranny of short-term performance rankings. It also explains the bunching up of results around the index. As evidence of the fact that many active managers are closet index huggers, over the 5-year period ending May 2016, only 22% of funds in the Morningstar universe of 299 Large Cap Australian Equity funds, had a tracking error (ie portfolio holdings variance from the Index) higher than 3% p.a.

However, it is a fact that a <u>significant minority</u> of active managers **can** and **do** add value. It requires a lot of active research, experience and detailed analysis to identify excellent managers in this small minority, from the many hundreds of choices available. This is beyond the reach of most individuals – it is also where we "earn our keep". It requires continual research and surveillance to ensure that our shortlist (around 30 funds) is always populated with those managers and funds we believe to be the best available in their specialist area.

Good active managers often will be found in smaller funds, run by "boutique" fund managers, with a high degree of independence of approach and the ability to be innovative and genuinely invest away from the crowd - see *Core Investment Beliefs 6 and 7*, which explain our belief in high conviction fund management and the four stage Fund Life-Cycle theory

The Importance of Manager Selection

The selection of the best active managers is crucially important and a primary consideration is our confidence in an active funds management company, to achieve their investment objectives. Whilst Compliance requires us to say things like "Past performance is no guide to future performance", we believe it's the best guide to showing what a manager is really like over a long period – so past performance is extremely important, with some qualifications. Most investors will consider a manager's long-term performance track record before making an investment. We also will focus on selecting managers who demonstrate characteristics in line with our Core Investment Beliefs: a long-term history of adding alpha (outperformance), absolute return focused, properly diversified, with downside risk management as a clear stated objective.

Only Long-Term Results Are Relevant

Even successful, truly active managers will not outperform consistently every month, quarter or even year. In fact in a study of one such international equities manager, over the last 25 years there were 7 periods where the fund underperformed by more than 10%, with the average time to recover being 6.5 months. Warren Buffett once commented the sharemarket is a mechanism that transfers wealth from the impatient to the patient. The point is that even a better-than-average manager will occasionally experience periods of meaningful under-performance during which investors must exercise patience – otherwise we are unlikely to receive the benefit of the long term outperformance achieved by the manager. In using active managers, we <u>know and accept that they will go through periods of underperformance</u>. They are being paid to invest differently to their benchmark index – and no one can get their portfolio choices and positioning right, all of the time. So investors should refrain from using short term results as a primary criterion for investing in (or selling) an actively managed fund. Short-term underperformance can still accompany long-term outperformance.

To be successful in following a philosophy of using active management, it is important that we be willing to recognise that every actively managed fund will endure periods during which the performance of the fund will lag its benchmark. For this reason – apart from the many other benefits of diversification - it is important to use a selection of managers/funds in each of the major asset classes, so that if a particular active manager is going through a poor patch, other active managers in the same sector might still be achieving above benchmark returns.

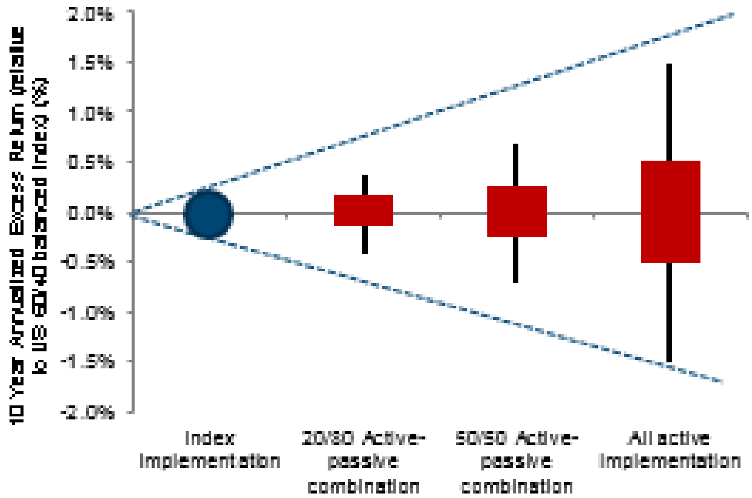
It is this lack of performance persistence among top-performing managers, which makes it difficult for the nonprofessional (who does not have access to multiple sources of research, the right analytical tools, the experience, or – dare we say it – the passion) to run an actively-managed portfolio comprised almost wholly of actively-managed funds.

Core and Satellite Approach - The difficulty of consistently selecting the right combination of actively managed funds, is the main reason for the popularity of the “core and satellite” portfolio construction approach, used by many. By the way, there is nothing too wrong with this approach, in which the majority of the money invested in a particular asset class, is invested in an index fund for that asset class, with a number of actively managed ‘satellite’ funds around the asset class index investment core, to try to lift the average return from that asset class, somewhat above the index. However – if 50% to 80% of the money is invested in index funds, it is difficult to achieve much by way of additional performance above the index - particularly if a couple of the active ‘satellite’ funds underperform.

Acceptance of Wider Dispersion of Outcomes from Active Management

One of the strongest proponents of passive or index management, is the Vanguard Group, which is the largest manager of Index funds in the world. We acknowledge the source of the diagram below to Vanguard, which shows the 10 year annualised excess return % (relative to the US 60/40 Balanced index) on the vertical (left hand) axis. Along the horizontal (bottom) axis, you can see as you move from portfolio implementation via 100% market index funds (the solid blue circle), through progressively higher exposures to active management, that the potential range of outcomes (the length of the black vertical line) becomes much greater. The potential is there for greater returns – but also for greater losses.

ACTIVE STRATEGIES COME WITH GREATER DISPERSION OF OUTCOMES



Source of Diagram: Vanguard Investments Australia Limited

We believe this diagram provides a fair visual representation of actual outcomes. When you think about it, the outcome it represents is quite logical. After all, active managers are being paid for their expertise and judgement in taking portfolio positions away from the index. However, they are only human and will sometimes "get it wrong" or perhaps be right, but be right far too early. In doing so, we acknowledge that a whole portfolio of actively managed funds can – occasionally, in toto - go through periods of underperformance (relative to index results), on those rare occasions when the majority of the selection of actively managed funds, underperform their respective indexes. Has this happened to us? Yes it has, but notably only over relatively short periods of 6 – 9 months, from which (after making some portfolio adjustments) results have bounced back. Our long term results against our peers (the *real* market – the results others are actually achieving) can be seen in the performance graphs at the end of this document. This is what moderately active management of an investment portfolio of actively managed funds, is all about - this is what we do.
*The actively managed funds we use have generally been able to add additional net-after-cost returns above the benchmark Index of between **1% and 20%** per annum over rolling three-year periods, depending upon the asset class. This is reflected in the composite results of our Model Portfolios (see graphs at the end of this document) versus the market average. Independent rankings against Index returns are readily available and can be supplied upon request*

Core Investment Belief 6: Actively managed, concentrated, high conviction portfolios are likely to outperform larger, index-like portfolios.

The pursuit of alpha – The outlook for lower asset class returns has caused investors to focus more heavily on the ability of managers to generate returns in excess of the benchmark or index (alpha). The extra return delivered by managers in the form of alpha becomes more important when the overall equity market seems likely to deliver only single digit returns of 7% to 9% per annum.

Not only has Alpha become more important, it has become more elusive. The more that professional fund managers trawl global markets seeking excess returns, the more efficient markets will become, making alpha more difficult to extract. In the pursuit of increasingly scarce alpha, we are seeing a proliferation of long-short, concentrated, absolute return and benchmark unaware funds. All are different variants of what is here termed **high conviction.**

What is 'High Conviction'? High conviction investing typically means holding fewer securities, taking larger positions relative to the benchmark and with a lower-turnover investment approach, than traditional funds. Holding a smaller, more concentrated portfolio intuitively would seem to increase the level of risk; however returns are typically higher on a risk-adjusted basis – in other words they produce higher returns without proportionately higher risk. In a high conviction fund, it is not unusual to see up to 50% of the portfolio invested in the top 10 securities held – which can lead to a more volatile result. This potentially higher volatility factor can be mitigated somewhat through careful fund manager selection and manager diversification.

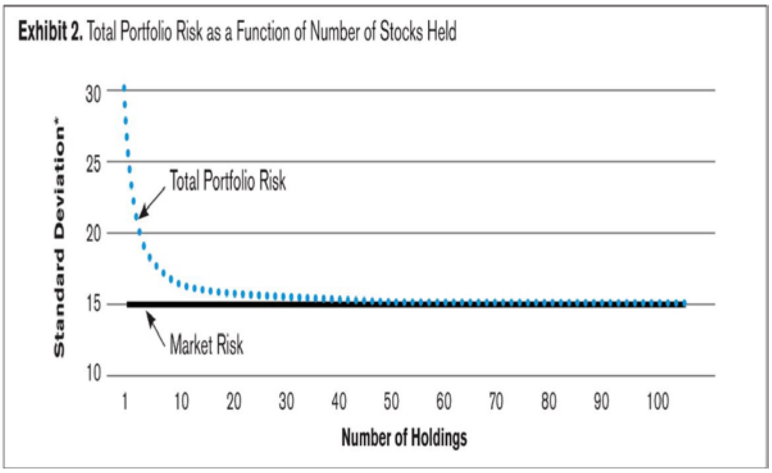
How many stocks? Just what "high conviction" (in terms of portfolio size) means in practice, depends upon the asset class in question – in International equities for example, a concentrated portfolio is likely to hold between 30 and 60 stocks – compared to the MSCI World Index of around 1640 stocks. In an Australian sharemarket context, a broad cap portfolio would hold typically hold a portfolio of between 20 and 35 stocks, compared to the S&P/ASX All Ordinaries Index of around 500 stocks. In the Australian Small Cap Area, a concentrated portfolio would hold 20 to 30 stocks, compared to the Small Ordinaries Index of 200 stocks (S&P/ASX 300 minus S&P/ASX 100).

Academic Research Supports High Conviction Approach

There is a significant body of empirical evidence which supports the use of high conviction approaches. Because of its huge market size, most of this research is based on US markets:

1. *Kacperczyk, Sialm and Zheng (2005*) analysed a database of US mutual funds and found that more concentrated funds performed better after controlling for risk and style differences.
2. In Australia, *Brands, Brown and Gallagher (2004*) used a virtually identical approach and arrived at similar conclusions, using Australian data.
   Both studies focused on risk-adjusted returns – both showed that high conviction managers produced significantly higher returns than traditional managers.
3. *Baks, Busse, Green in "Fund Managers Who Take Big Bets," (2006)* from Atlanta, Georgia's Emory University Goizueta Business School, analysed a universe of over 2000 funds over the period 1976 – 2003. They found that high conviction managers, defined as those who take large stakes in fewer stocks, outperformed more diversified funds by approximately 30 basis points per month or 4% annualised
4. *Cohen, Polk, Silli in "Best Ideas," (2010)* researchers at Harvard Business School, London School of Economics and Goldman Sachs Group analysed stock returns and quarterly fund holdings for US equity mutual funds over the period 1991 – 2005. The authors found that active Equity fund managers highest-conviction investments outperformed the broader US Stock Market, as well as other stocks held by those funds, by 1% to 4% per quarter.

High Conviction and Risk - High conviction strategies have at times been viewed as inadequately diversified due to their more concentrated nature. However, Modern Portfolio Theory suggests that portfolio risk, as measured by standard deviation, may be minimised by investing in as few as 20 holdings, as shown in the chart below:



Historical Returns and Risk Profile of High Conviction Active Managers

Across all market caps (large capitalization stocks, medium capitalisation stocks and small capitalisation stocks) and in both domestic and international equities, research and historical data shows that:

– over the last 20 years, high conviction funds have consistently outperformed both their benchmark indexes and other actively managed funds and

– these high conviction managers have generated higher risk-adjusted returns – as measured by Information Ratios, which measure unit of return for unit of risk taken – than both active peers and benchmark indexes. Information Ratios are often used to gauge the skill of managers – a higher Information Ratio implies higher active return, given the amount of risk taken.

Identifying High Conviction Managers - The Role of Active Share

There are three key inputs that define the high conviction approach: <u>concentration of holdings</u>, <u>longer holding periods</u> (meaning lower portfolio turnover) and <u>active share</u>.

With respect to holding periods, it is interesting to note that the average holding period of an equity security on the New York Stock Exchange has fallen from 97 months in 1953, to an average of 25 months in 1990, down to just 7 months in 2010. This simply reflects the growing effect of “short-termism” in investment thinking and management over the last 60 years.

A key indicator of active management conviction is **active share**, a measure that calculates the proportion of a manager’s portfolio that does not overlap with the benchmark index. (If a portfolio holds none of the index stocks, the active share will equal 100.0%; an index portfolio with holdings identical to the benchmark will have an active share of 0.0%.)

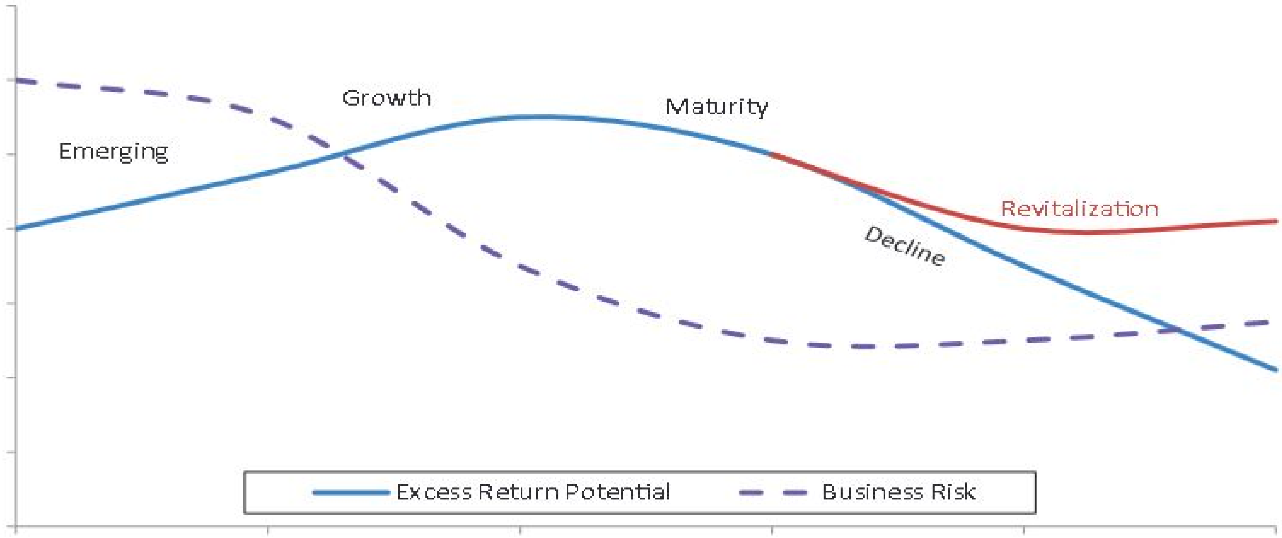
In a 2010 study, *“Active Share and Mutual Fund Performance”* Antti Petajisto of the NYU Stern School of Business published data on more than 2,500 U.S. retail mutual funds over a 24-year period, and revealed that managers with an active share of greater than 80.0% who were diversified across holdings and sectors, outperformed their respective benchmarks by roughly 1.14% per year after fees. These managers employed a high-conviction approach, holding fewer stocks for longer periods of time, standing in stark contrast to a "closet indexer" (defined as one with an active share of less than 60.0%) whose holdings closely mirrored the benchmark.

High conviction management is a primary characteristic we look for, in selecting the funds for use in our Model Portfolios.

Core Investment Belief 7: There is strong evidence to support the 4 stage fund life-cycle theory. Significant value-add can result from identifying talented emerging managers and investing with them in their Emerging and Growth stages.

The Fund Life-Cycle Theory holds that funds go through four life cycle stages: (a) Emerging (b) Growth (c) Maturity and (d) Decline (leading to Closure or Revitalisation). Each underlying stage can be analysed and compared using such characteristics as size (of both funds under management and size of investment team), age, infrastructure, process, uniqueness and investor base. The length of each stage is not fixed in duration and does not necessarily follow in sequence – for example, some funds move directly from Emerging to the Maturity/Decline stage and hardly experience a Growth stage.

The life-cycle of a fund can be represented diagrammatically as follows:



The changing characteristics of the Fund over its life cycle are described in the table below:

	Emerging	Growth	Maturity	Decline
Size	Small →			Mega
Age	New →			Mature
Infrastructure	Simple →			Complex
Process	Entrepreneurial →			Bureaucratic
Uniqueness	Distinctive →			Groupthink
Investor Base	Early Adopters →			Laggards

The "Sweet Spot" for Investment – As an emerging fund increases in size and generates more consistent returns and a longer term track record, the late Emerging, Growth and early Maturity stages of a fund's life represent the "sweet spot" for investing. An analysis of the historical returns for many funds, shows that this sweet spot is when the manager is most likely to generate solid, consistent excess returns and has developed a sustainable business and stable operational infrastructure.

The fund life-cycle theory suggests that the *optimum* time to invest in a fund is in its Emerging phase, when it has low assets under management and less years of track record. So we believe life-cycle timing is definitely an important issue, in choosing when to enter and exit a fund.

Comfort with Maturity – Because of the emotional comfort factor, many people feel happier investing in a fund when it has a long track record and large assets under management (AUM). In reality, however, these funds are likely to have reached their Maturity phase and their best returns are usually behind them – when they were younger, smaller, more nimble, more entrepreneurial and less bureaucratic.

Bigger is not always better in the funds management business. Academic and industry research has suggested that size is very relevant in predicting fund performance and persistence of performance. Getmansky (2005) noted a "positive and concave relationship between fund size and performance, which suggests funds have an optimal size and that exceeding that size has a negative impact on performance". Similar conclusions were reached regarding the persistence of performance. Boyson (2008) noted that "performance persistence is strongest among small, young funds. A portfolio of these funds with prior good performance outperformed a portfolio of large mature funds with poor performance by 9.6 percentage points per year."

Big, Mature Fund Domination will Continue – Despite the research however, very large funds continue to attract the biggest share of assets. This trend is unlikely to change, for many reasons – investor ignorance and complacency, perceived safety in larger funds, cost and due diligence efficiencies in large size, the herding instinct (see Investor biases in *Core Investment Belief 8*) and career risk concerns on the part of many institutional fund managers. Big funds are also likely to have bigger "sales and distribution" teams.

Other factors related to increasing fund size can also impact negatively on investment performance, such as the size of the investment team, the number of key decision-makers and the number of funds managed under the fund manager's umbrella.

Life-Cycle Awareness Helps Returns - For all the reasons outlined above, we firmly believe that identifying the stage of where a manager lies in their life-cycle can improve manager selection. The trend towards big funds getting even bigger provides an opportunity for active portfolio managers (such as Retirewell) to add value through seeking out managers and funds in the late Emerging/early Growth stage of their development. We usually find these managers to be highly motivated with significantly more upside return potential than their monolithic peers.

While many professionals and investors may be aware of it, we believe that only a few are actually managing their investment portfolios with a conscious bias towards actively seeking out and using talented emerging managers. At any time, emerging managers will comprise between 20% and 30% of the funds we use in our Model Portfolios.

Sifting the Wheat from the Chaff - By incorporating life-cycle analysis into the manager selection process, we can significantly improve the likelihood of superior performance, over a selection process based solely on historical performance. Of course, the main challenge we face is to identify the potential rising stars among the new kids on the block, since smaller, newer funds are not without risk. Determining where a manager lies in its life cycle, is a combination of art (qualitative, based on experience) and science (quantitative, based on research). We are happy to stand upon our record in this regard.

Core Investment Belief 8: Investors are not rational, but are influenced by emotions and inherent biases

The second fundamental tenet of MPT is **the Rational Man Theory** - which states that *individuals will act rationally, in their own best interest.*

The evidence shows otherwise, as proven by behavioural economics. As Benjamin Graham liked to say, "*The worst enemy of the investor is most likely himself*". Emotional and psychological influences can impact financial decisions and result in irrational behaviour. Human beings are not rational investors and human judgement is subject to well-documented behavioural biases. Humans are fallible, impatient, suffer from lapses in logic, overrate their abilities and are subject to bouts of greed and fear. These all result in irrational investment decisions, which result in inefficiencies at the market level and which sometimes lead to investment manias, with booms and busts, which significantly affect asset prices.

Behavioral finance is a fairly new and novel topic that has gained prominence since the early 1990s. Amos Tversky and Daniel Kahneman, winners of the 2002 Nobel Memorial Prize in Economic Sciences, helped popularise the topic with their development of Prospect Theory.

Prospect Theory is a behavioral economic theory that describes the way people choose between probabilistic alternatives that involve risk, where the probabilities of outcomes are known. The theory states that people make decisions based on the potential value of losses and gains rather than the final outcome, and that people evaluate these losses and gains using certain heuristics. **Heuristics** are simple, efficient rules which people often use to form judgments and make decisions. They are mental shortcuts that usually involve focusing on one aspect of a complex problem and ignoring others. These rules work well under most circumstances, but they can lead to systematic deviations from logic, probability and/or rational choices. The resulting errors are called "cognitive biases." Daniel Kahneman's original 1979 paper "Prospect Theory: An Analysis of Decision under Risk" has been called a "seminal paper in behavioral economics."

So psychology plays a big part in investing. It has been said that based on behavioural finance, investment is 80% psychology. As more research is conducted into behavioural economics, new biases are discovered, researched, named and documented. Space does not permit a full explanation of each, but we have listed below 24 identified behavioural biases, with the name sometimes giving an indication as to an explanation of the particular behavioural bias:

Confirmation bias	Availability/attention bias	Home bias
Clustering	Anchoring (and adjustment)	Mental accounting
Disposition effect	Myopic loss aversion	Winner's Curse
Overconfidence bias	Hindsight bias	Certainty effect
Representativeness bias	Gambler's fallacy	Framing bias
Regret avoidance	Familiarity bias	Conservatism bias
Herding/Crowd	Cognitive Dissonance	Illusion of Knowledge

If you are keen to further study this fascinating field of behavioural economics, go to http://www.behaviouralfinance.net , where you will find a list of over 130 behavioural biases which have been identified and researched as to how they affect human decision-making.

John Maynard Keynes once said *"markets can remain irrational for longer than you can remain solvent"*. The true value for many assets can never be known with certainty, so at extremes, particularly in the face of unprecedented, unexpected or grave situations, irrational human behaviour can drive markets to highly irrational levels, either high or low.

This recognition that human emotions affect markets and decision-making, is referred to in Core Investment Belief 10, which recognises the importance of implementing specific strategies to manage downside risk.

Core Investment Belief 9: Use of non-traditional assets and strategies (alternative assets and strategies) improves risk-adjusted portfolio returns

We have mentioned in different places previously, three particular factors:

- Equity risk (measured by volatility) is proportionally larger in terms of the total downside portfolio risk, than the percentage allocation to equities in a typical portfolio. In other words, even if equities only comprise only 40% of the overall asset allocation, their contribution to potential downside risk is probably around 80%, because of their much greater volatility.
- The benefit of risk reduction through diversification has been considerably weakened over the past two decades, by increasingly correlated returns between traditional asset classes.
- The level of returns is expected to be lower and volatility higher over the next decade, from traditional asset classes.

An important way to add value by reducing the effect of higher correlation of returns between traditional asset classes, to reduce the level of equity market risk and to increase overall portfolio returns, is to add an allocation to a relatively new, diverse and non-homogenous class of investments known as “alternative assets and alternative strategies”.
These strategies often seek to generate absolute returns, or positive returns in all market conditions, over some reasonable time period.

The term **alternative assets** is used to describe something which is tangible (something you can see, touch and feel) which has a traded value, but lies outside the recognised traditional assets of property, shares and bonds. Examples would be all types of commodities including precious metals, private equity (unlisted public companies), unlisted/direct property including forestry land or even more exotic investments like art, antiques and precious stones. A common characteristic of many of these is that they are generally illiquid - which makes them unsuitable for your everyday retail investor.

Alternative strategies describes an investment approach were the return is based primarily upon investment manager skill (“alpha”) rather than passive investment market returns. Hedge funds (using many available strategies such as long/short, market neutral, trend following, global macro, relative value arbitrage, event driven and many others) and managed futures funds will comprise most of those funds which fall under the heading of Alternative Strategies. An example might be an equity market neutral fund, where the fund has an effective net zero exposure to the underlying equities market (through holding an equal value in “long” investments and “short” investments) but can still make a significant positive return if they get both their long and short calls right.

The **key characteristic** shared by both alternative asset funds and alternative strategy funds, is that they provide a pattern of returns which are **uncorrelated or negatively correlated** to the pattern of returns from the traditional asset classes of shares, property and fixed interest. However, they are often complex to understand and generally have higher management costs. Some can be relatively or very illiquid. Most alternatives have both defensive and growth characteristics, but are usually able to be clearly characterised as being either more Defensive or more Growth - oriented.

Our allocation to this diverse and growing group of alternative investments has increased significantly in recent years (to between 15% and 22%, depending upon the Model Portfolio), since we believe that alternatives provide the opportunity to improve the overall risk-adjusted outcome of portfolios across the risk spectrum and provide an opportunity to access return drivers beyond those of traditional asset classes.

We have been early adopters of the use of Alternatives in portfolio construction. A major positive benefit can be seen in the lower level of portfolio risk (as measured by volatility) in our Model Portfolios.

Core Investment Belief 10: Management of downside risk is critical, particularly equity market risk

Even in a so-called "Balanced" portfolio (in the Australian context, this was originally defined as 30% into each of shares, property and fixed interest and 10% in cash), research has shown that at least 80% of the downside risk in such a portfolio, is equity market risk. It is easy to make money in bull markets – it is much harder not to lose money in bear markets. We have explained in *Core Investment Belief 9*, that one of the major ways we act to reduce portfolio risk and volatility, is through the inclusion of alternative assets and alternative strategies in portfolio construction.

There are three other approaches we will outline here, which we incorporate under the broad heading of **Management of Downside Risk**.

10.1 Use of funds managed according to an "absolute return" approach.

Absolute return investing refers to a strategy with a return objective that is independent of a traditional benchmark – in other words, their objectives are not expressed relative to a benchmark asset class index. For our purposes, we specifically look for funds which are managed to ensure that the value of the investor's original capital is at least maintained and preferably enhanced, over some reasonable time period. Absolute return funds have a positive return target and use a variety of investment strategies and risk control processes to help ensure their objectives are met. Their common characteristic is that they all share an emphasis on downside protection.

For example, a long-only shares fund would generally be measured on a relative basis to a stock index. On a relative return basis, it would be seen as successful if when the market fell 10%, the fund only fell by 5%. In this case, it has beaten the benchmark index – but the investor's capital is still down by 5%. A similar fund run on an absolute return basis, would be seeking to ensure that the value of the investor's original capital was at least maintained. Such managers are more risk aware, more focused on avoiding capital loss and use more flexible investment strategies. This usually results in lower volatility, with lower capital drawdowns - but lagging performance in strongly rising markets.

The concept of absolute return investing can be applied to any asset class, including alternative asset or alternative strategy funds. The primary defining characteristic of an alternative fund (as distinct from an absolute return fund) is that it will provide returns which are uncorrelated with traditional assets. It is possible to have an Australian equities fund managed on an absolute return basis (which seeks to manage downside risk and provide a positive return regardless of market conditions) but which will still have a high level of correlation of returns with say the ASX 300 Index. Because of this high correlation, such a fund could not be called an alternative strategy fund.

This is a fairly new and still evolving area of funds management. The absolute return objective approach can be applied to the management of almost any type of fund, in any asset class or across a fund containing multiple asset classes. There is still not a widely agreed definition of the term "absolute return" – if it is to mean the maintenance of the value of an investor's original capital, then sensibly this must be qualified by allowing this "no capital loss" target to be met over some reasonable time period, e.g., over a rolling one-year or two year period.

Despite the newness of the absolute return concept of investment, we have actively sought out funds of this nature to enhance the overall risk/return characteristics of our portfolios – specifically we are seeking to minimise capital losses/drawdowns when markets retreat. We believe that investments with an absolute return focus are vital for retiree investors who simply cannot afford to reduce risk by just holding cash and term deposits in the current low interest rate environment.

Currently, more than one in three of the funds we use are managed on an absolute return basis, or at least with a strong downside risk management objective. Within our portfolios, they help to reduce volatility, they increase the likelihood of achieving positive returns in flat or declining markets and they allow managers to hedge unwanted risks.

10.2 Value-adding through the use of a Dynamic Asset Allocation (DAA) overlay

The Differences between Strategic, Tactical, and Dynamic Asset Allocation

SAA is the Strategic Asset Allocation, which is the long-term, neutral position for the proportional allocation of capital across different asset classes, in a portfolio constructed to optimise returns for a given level of risk. SAA assumes a static, long-term, passive approach to asset allocation with no active review of asset allocation during the investment period. It disregards fluctuations of financial markets through the business cycle. *The SAA of your portfolio will be the most important determinant of your long-term investment returns.*

In simple terms, the SAA determines the allocation of a portfolio between the broader portfolio split between Defensive assets and Growth assets. These are explained below:

Defensive Assets
– Cash
– Fixed Interest – Australian
– Fixed Interest – International*
– Defensive Alternatives

Growth Assets
– Property/Infrastructure – Australian
– Property/Infrastructure – International*
– Australian Shares
– International Shares *
– Growth Alternatives

*International investments of any sort may be fully currency hedged, fully currency unhedged, or may be managed according to an active currency hedging philosophy.

TAA (Tactical Asset Allocation) involves making smaller shifts inside or between the asset classes in the portfolio, to take advantage of perceived shorter term market opportunities. As a short term investment strategy, TAA is often considered a market timing strategy, with a fancier name. TAA can add value only if it is driven by accurate forecasting of the relative performance of asset classes over a fairly short time period. This is very difficult to do – and to do it well consistently. For this reason, we avoid the temptation to adjust portfolios using short-term, TAA - based decisions.

DAA (Dynamic Asset Allocation) describes active portfolio management from a macro, or top-down, perspective. DAA aims to generate additional returns, or reduce portfolio risks by reallocating capital when asset classes clearly move *above or below their long-term "fair value" range.* DAA enhances a portfolio's SAA which uses equilibrium assumptions to provide long-term asset allocations, by introducing a more flexible framework to increase exposure to undervalued assets while reducing exposure to overvalued assets. We believe a DAA process that adjusts expectations by incorporating new information, allows for a higher probability of achieving return expectations with better risk management. *Embedded in the use of DAA strategies is an implicit belief in mean reversion – that is, that market values will eventually return to their long-term trend line.*

Our use of DAA
Through our Model Portfolios and through the use of a limited Managed Discretionary Account authority with clients, we have the ability to implement DAA changes quickly and efficiently.
Having said that, we are very conscious of the following truths:

"The only value of stock forecasters is to make fortune tellers look good." Warren Buffet

"*Far more money has been lost by investors preparing for corrections, or in trying to anticipate corrections, than has been lost in corrections themselves."* Peter Lynch

Academics have an expression to describe the belief that you can out-guess the market*: illusory superiority.* Thus we are very wary about moving too far away from the long-term Strategic Asset Allocation, which we have determined and agreed at the outset with each client.

We acknowledge that it is almost impossible to make market timing calls correctly – whether moving out or moving into a market. This can only be seen in retrospect, sometimes years later. We will make DAA calls on a risk-driven basis – that is, when an asset class is clearly trading above its long-term value trading range and we are seeking to preserve capital through moving assets out of an overvalued asset class. Such a call will be based upon independent advice on asset class valuations, provided by one or more of our external professional asset allocation consultants and/or research firms.

We outline our Strategic Asset Allocation (SAA) models for each of the 5 standard Investor Risk (Asset Allocation) Profiles, with upper and lower DAA ranges, in Core Investment Belief 11

10.3 Use of regular portfolio rebalancing

The basic concept of portfolio rebalancing, as the name implies, is to realign the balance of investments in a portfolio, generally to stay in line with the original target weightings (SAA) for that portfolio. The conventional view of portfolio rebalancing is that it is a strategy to enhance long-term returns by periodically selling investments that are up (and overweighted) to buy those that are down (and underweighted), in the process of realigning the portfolio to its original target asset allocation.

The use of diversification and rebalancing is a valuable discipline and can be used to exploit volatility. Theoretically, rebalancing reduces concentration risk, downside risk and volatility, while increasing the long-term growth rate of the portfolio, at a lower overall level of risk. In practice, it creates a contrary in trading pattern that trades against natural investor or tendencies and takes advantages of volatility, reversals, and other return characteristics.

Rebalancing is a risk management strategy – so even if returns are lower, risk-adjusted returns may be improved if the risk is reduced by even more. And sometimes, returns really can be enhanced when rebalancing across similar-return investments, such as among sub- categories of equities.

As expected, portfolio turnover and costs increase in the rebalancing process. Unconstrained rebalancing could result in transaction costs that outweigh the rebalancing benefits. One way to reduce the frequency of rebalancing is to allow the portfolio to drift within specified bounds around the desired allocation. The second way to reduce the overall amount of trading, is to rebalance primarily at the asset sector or country level, rather than at the investment manager, industry or security level.

If a process of portfolio rebalancing is not followed, then the portfolio’s equity exposure will eventually drift too high, so that the portfolio’s exposure to growth assets becomes far greater than originally intended, with the potential for this far greater volatility than the client may be able to tolerate.

So regular portfolio rebalancing is a trade-off that is deemed necessary to manage overall portfolio risk. Rebalancing is not used in the first instance as a return enhancing strategy, but instead a risk reducing strategy that is done for risk management purposes - to reduce volatility and to enhance risk-adjusted returns.

How regularly should rebalancing be undertaken? Although there is some difference of opinion on this, the general view is that portfolio rebalancing should occur at least annually, though some would support rebalancing on a half yearly basis. Quarterly rebalancing is unnecessary – 2 years is too long.

<u>Core Investment Belief 11</u>: The use of a range of Strategic Asset Allocation (SAA) models is the most efficient way to provide diversification.

Use of a range of SAA Models also provides a logical, progressive risk framework to suit the wide range of personal investment risk tolerance profiles.

For ease of understanding and comparison, we have adopted the broadly accepted industry standard of 5 different Risk Profiles, in order of ascending risk, from low risk to high risk. This framework of differing investor risk profiles is implemented via a range of Strategic Asset Allocation (SAA) models, with each model having a recommended strategic (long-term) allocation to each asset class, with each of these percentage allocations able to be managed within a fairly wide Dynamic Asset Allocation (DAA) range.

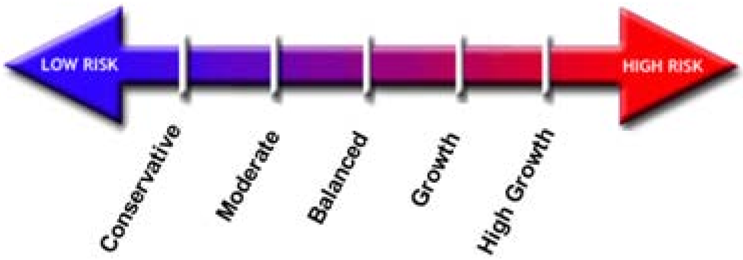
We outline below our Strategic Asset Allocation (SAA) models for each of the 5 standard Investor Risk (Asset Allocation) Profiles, with a significant amount of other important information pertaining to each Asset Allocation model.

Investment Risk Profile Name	**Conservative**		**Moderate**		**Balanced**		**Growth**		**High Growth**	
Description of Risk Profile	Willing to accept low total returns – very low growth relative to income. Low risk		Low to moderate levels of income and growth. Moderate level of risk		Moderate to high levels of income and growth. Medium level of risk		High levels of capital growth with moderate level of income. Medium to high level of risk		Very high levels of capital growth with low level of income. High level of risk	
Growth/Defensive Assets Split %	**30 / 70**		**50 / 50**		**65 / 35**		**75 / 25**		**90 / 10**	
ASSET CLASS	**SAA**	DAA Range	**SAA**	DAA Range	**SAA**	DAA Range	**SAA**	DAA Range	**SAA**	DAA Range
Australian Equities	**10%**	(0-25)	**16%**	(5-35)	**20%**	(10-40)	**25%**	(10-45)	**29%**	(15-50)
International Equities	**12%**	(0-25)	**19%**	(5-35)	**28%**	(15-45)	**33%**	(15-45)	**38%**	(20-55)
Listed Properties & Infrastructure	**8%**	(0-15)	**10%**	(0-20)	**10%**	(0-25)	**10%**	(0-30)	**12%**	(0-30)
Fixed Interest	**35%**	(25-55)	**30%**	(15-45)	**20%**	(5-35)	**12%**	(0-30)	**0%**	(0-10)
Alternative Assets	**15%**	(0-25)	**15%**	(0-30)	**17%**	(0-30)	**17%**	(0-30)	**18%**	(0-35)
Cash (or Cash-like)	**20%**	(5-45)	**10%**	(5-40)	**5%**	(0-30)	**3%**	(0-25)	**3%**	(0-20)
Min'm Recommended Investment Term	2-4 years		3-5 years		4-6 years		5-7 years		7 years +	
Performance Benchmark	CPI+2.0%		CPI+2.5%		CPI+3.0%		CPI+3.5%		CPI+4.0%	
Likelihood of negative return (1 year in ..... years)	1 year in 14-17 yrs		1 year in 8-10 yrs		1 year in 7-9 yrs		1 year in 5-7 yrs		1 year in 4-6 yrs	

Our most successful and widely used Model Portfolios are based upon the above SAA/DAA models.

Maximising Efficiency – Construction of Proprietary Model Portfolios

We have found that the best way to implement and capitalise on our specialised knowledge in the area of investment management and portfolio construction – and to make the asset allocation process easier for clients – is to create a series of proprietary Model Portfolios. Each will comprise different allocations to the various asset classes, managed by a carefully selected and monitored group of professional managers which in our view, are "the best" in their particular specialist area. Each portfolio will contain a different allocation of assets, to satisfy a particular level of investor risk tolerance.



Low Risk = Low Volatility and High Risk = High Volatility.

These Models provide solutions to a wide range of individual client needs, to suit the most conservative client, through to the client who requires some capital growth with consistent reliable income, to the client who requires a fairly aggressive, high-growth portfolio.

We would also offer the observation that our alpha driven, absolute/real return-focussed portfolios with their significant allocation to alternatives, carry a degree of sophistication and complexity which is difficult for competitors to emulate. However whilst we believe our model Portfolios have the potential to do better and have smaller drawdowns in difficult markets, they come with no guarantees.

How do our Results Compare?

We have been managing monies for our clients through the use of Model Portfolios since 1999. Morningstar Research provides the best available benchmark for comparison of actual market returns, of the performance of all Australian Multisector funds for each of the 5 industry-standard Risk Profile (Asset Allocation) models. The average of actual market returns for each category is published monthly as the Morningstar Multisector Category Averages. Note that we run 2 different Model Portfolios for 'Balanced' – Balanced (Income) and Balanced (Growth) – so although there are 5 Risk Profiles, we actually run 6 Model Portfolios. The Balanced (Income) Portfolio is designed to produce a higher level of income (relative to growth), which is normally preferred by retiree clients in Pension mode.

Each of the 6 Retirewell Model Portfolios shows significant and consistent outperformance against its peers, represented by the Morningstar Multisector Category Average (Peer Group) returns.

Detailed Comparative Performance Graphs showing our outperformance against peers, inflation and cash, back to 2009 are available in the **Appendix**, an 8 page document showing historical performance graphs and comparisons of Retirewell's 6 Model Portfolios since inception (2009).

Core Investment Belief 12: We live in an Age of Specialisation – we focus on our strengths in Investment Management and Financial Planning and outsource the rest.

Within our circle of competence, we know what we are good at in our role as Investment Managers. As broad-based, holistic Financial Planners, we also have a high level of specialist skills in a number of areas: retirement income planning, Centrelink planning, risk and estate planning, superannuation and SMSFs, Aged Care planning, taxation planning and wealth accumulation.

Outside of these core skills, we are happy to outsource the many other specialist roles and tasks to others with specialist knowledge, expertise or skills, in such areas as:

- Portfolio administration and reporting
- SMSF administration and statutory reporting
- Specialist accountancy and taxation advice
- Preparation of legal documents, such as Wills, Enduring Power of Attorneys and trust deeds
- Managed fund and ASX share research.
- Asset allocation research
- Financial planning software

We could go on, but you get the point.

Quick and Efficient Updating of Client Portfolios

In order to implement changes across many individual portfolios, within the bounds of each client's agreed "risk profile" (the agreed allocation of their portfolio across the various asset classes) we ask each client to enter into a limited Managed Discretionary Account (LMDA) Agreement, so that we may effect any required changes to their portfolio(s) rapidly, efficiently and at minimal cost.

This then allows us to buy or sell a fund within their portfolio as needed and/or rebalance their portfolio, to bring the portfolio back into line with the agreed relevant asset allocation benchmark. The client provides us with two limited discretions (to buy or sell a fund, or to rebalance the portfolio) in order for us to manage their portfolio. It allows us to streamline the portfolio management process in many ways – through improved efficiency (less cumbersome documentation), reduced risk through quicker execution of investment changes and reduced costs through applying the same investment management decisions to multiple client portfolios, according to Model Portfolio investment decisions. We could not do this without outsourcing the administration to an investment management platform.

Personal, Active Investment Management and Financial Planning Service

In the low return world of the next decade, "set and forget" won't do the job – every extra basis point counts. It is also worth noting (with a bit of tongue-in-cheek) that the natural inclination of many investors is to want *relative* returns when markets are rising and *absolute* returns when they are falling! We do our best to satisfy this need.

Our bespoke, active, specialised approach to efficient portfolio construction and ongoing investment management of multi-asset portfolios, along with our high touch client service model, makes for a very different client experience to that of the large, vertically integrated, product manufacturer institutions, whose primary purpose is to "place product".

We believe we are one of only a very small number of non-aligned, independently owned firms in Australia who can provide the specialised investment management services that investors need. Our clients have online access at all times to up-to-the-minute information on their investments and have full-time access to their own personal Adviser for queries or advice – a true personal, bespoke investment management and financial planning service.

DISCLAIMER

It has been prepared for information purposes only, for the benefit of clients and potential clients of Retirewell Financial Planning Pty Limited. It contains information, statements and opinions which are provided in good faith, based on the best advice available at the time of document preparation.

However because the particular circumstances and needs of individual investors may vary greatly, the information herein should not be used as a substitute for personalised professional advice.

Whilst every effort has been made to ensure the information herein is correct, its accuracy and completeness cannot be guaranteed. Thus Retirewell cannot be held responsible for any loss suffered by any party due to their reliance on the information or arising from any error or omission.

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APPENDIX

RETIREWELL FINANCIAL PLANNING

MODEL PORTFOLIOS

7 year Comparison Charts (Since Inception)

1 July 2009 – 30 June 2016

Explanatory Information

1. The **Top** line (**Red**) represents the **reported** Total Return from each Retirewell Model Portfolio, but does not include the value of imputation credits which is added back to these returns, each year. The **actual** Total Return will be higher than shown.

3. The **Second** line (Blue) is the **average return** of all our competitors, or Peers – that is, all Australian public offer funds as measured and published by Morningstar Research as the Morningstar Multisector Category Benchmark, for 5 Multisector Categories, as follows:

Peer Group	Percentage Allocation to Growth Assets
- Conservative	(0% – 20% in Growth assets)
- Moderate (or Moderately Conservative)	(20% – 40% in Growth assets)
- Balanced	(40% – 60% in Growth assets)
- Growth	(60% – 80% in Growth Assets)
- High Growth (or Aggressive)	(80% – 100% in Growth assets)

The difference in returns between this line and the Top line represents the additional return and 'value added' by each of Retirewell's Model Portfolios against Competitors in the same Peer Group, as a result of:

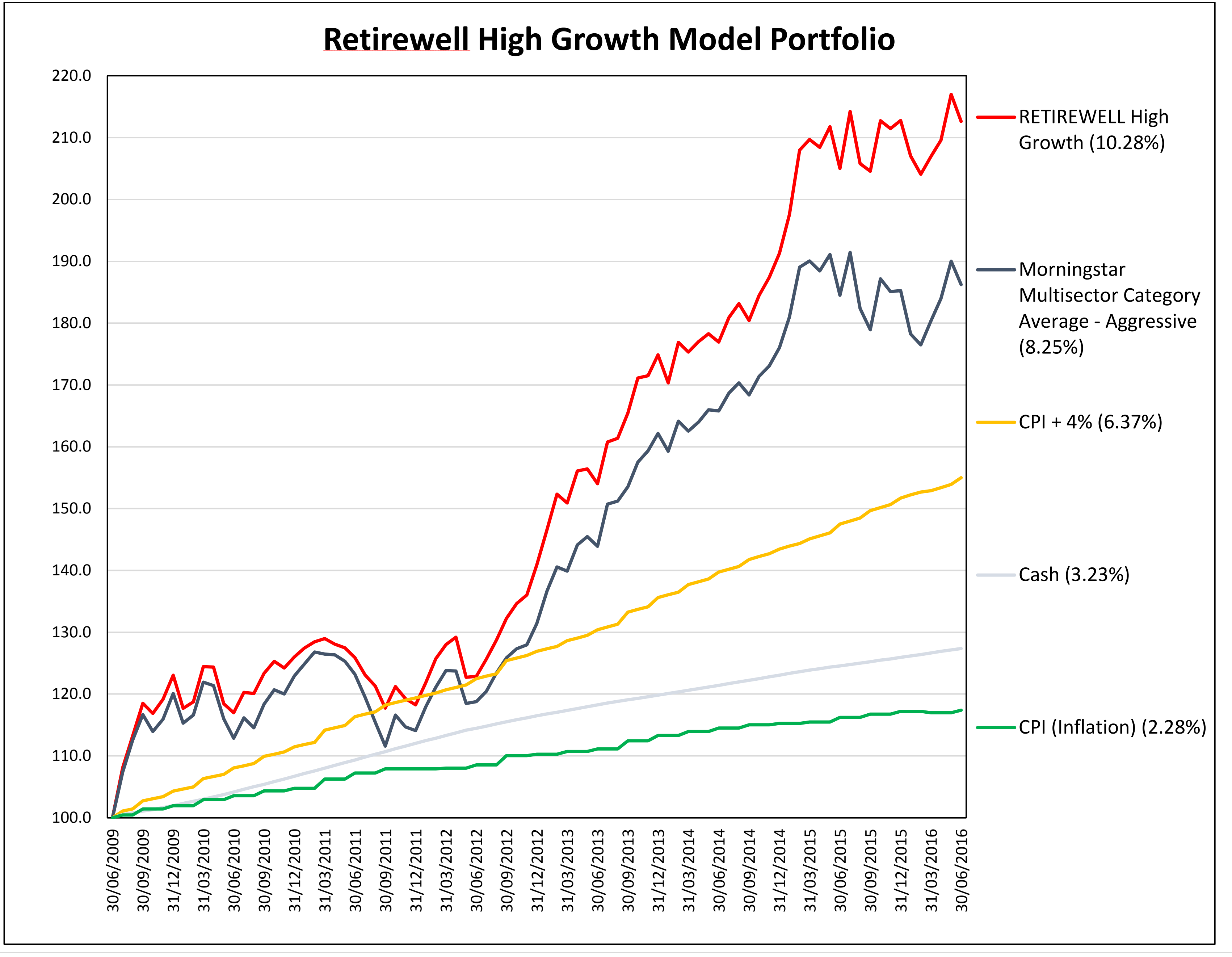
- our investment philosophy of using actively managed funds, rather than low cost passive or index funds
- our in-depth research and highly specialised fund/security selection process
- the use of our limited Managed Discretionary Account (MDA) process, which enables quick and efficient portfolio updates , and
- to some extent, our Tactical Asset Allocation decisions, aimed at reducing volatility and potential capital loss.

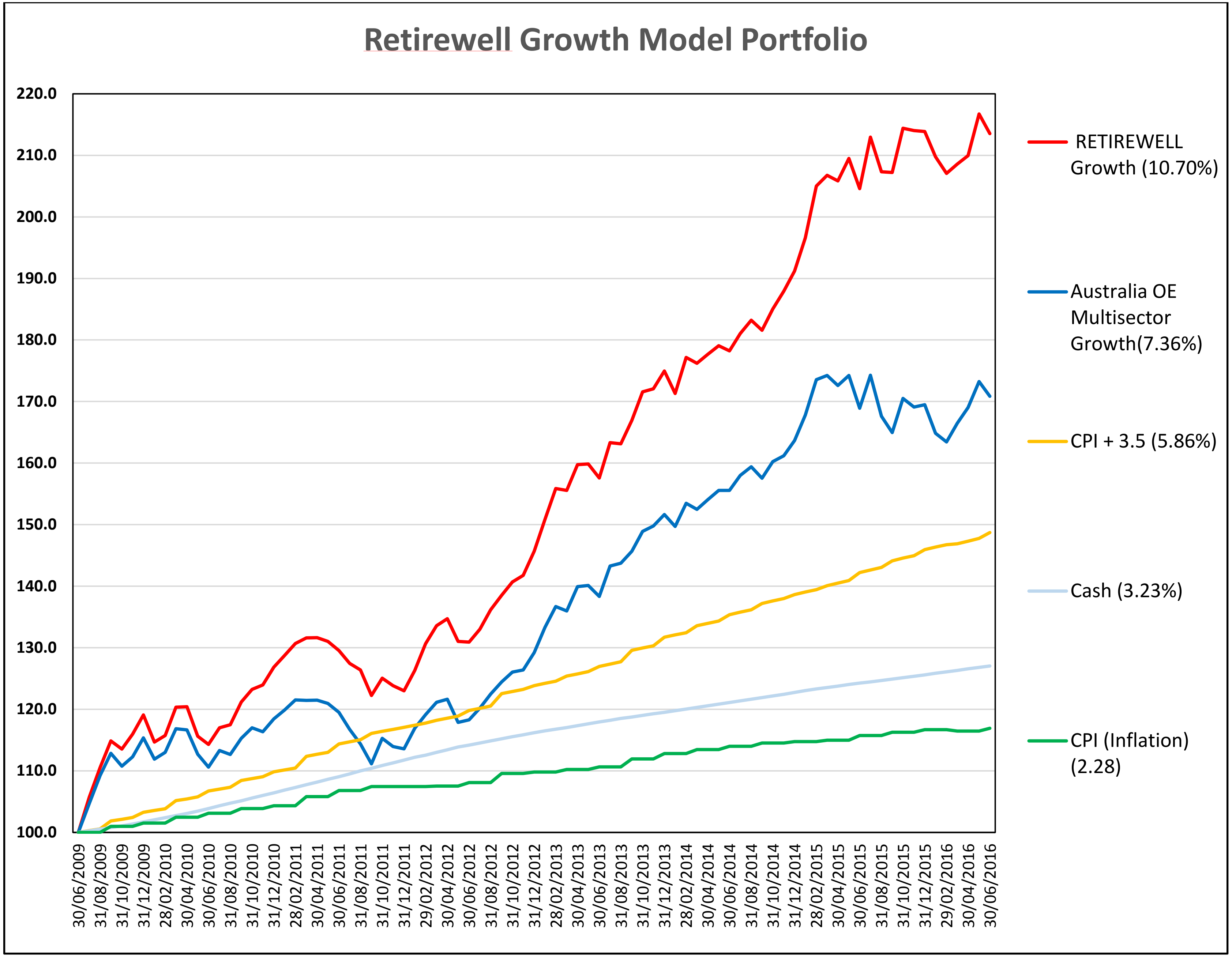
4. The **Third** line (**Yellow**) shows the expected minimum long term return above the inflation rate (CPI) - the Benchmark Return - for each particular Asset Allocation mix. The higher the asset allocation to Growth assets, the better the expected long term return above inflation.

5. The **Fourth** line (**Light Blue**) is the return from Cash – the Cash Rate, as set each month by the Reserve Bank of Australia (RBA).

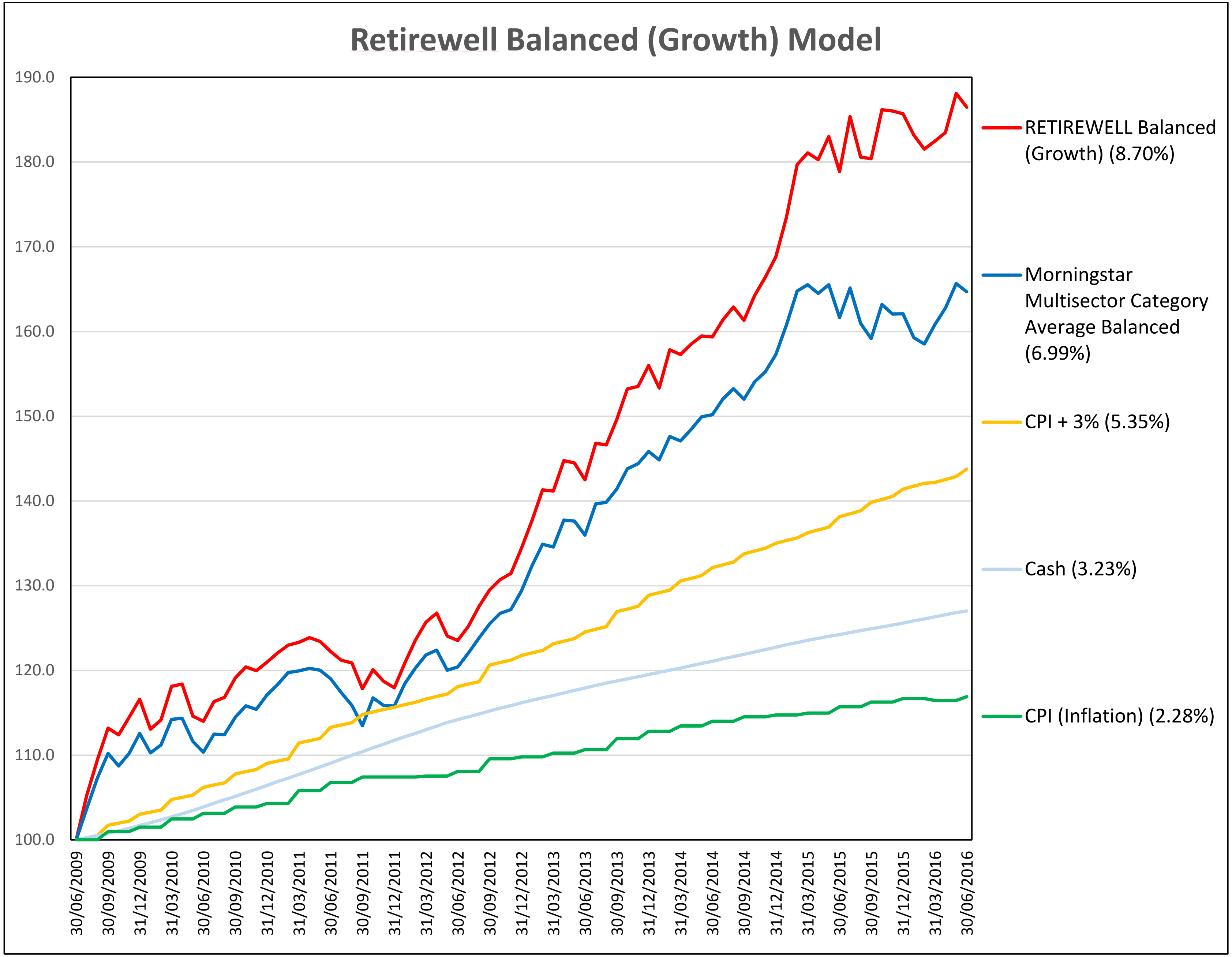
6. The **Fifth** line (**Green**) is the Australian Inflation Rate, as represented by the Consumer Price Index(CPI), which is published quarterly by the Australian Bureau of Statistics (ABS)

7. The Retirewell Model returns and the Morningstar Multisector Category benchmark returns are net of investment fees (where applicable), but exclude adviser and platform fees, which will vary. Our aim is to provide a net-of-fees return which exceeds the Peer Group average (i.e. to provide an above average return, after all fees)


Retirewell High Growth Model Portfolio
220.0
210.0
200.0
190.0
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
30/09/2009
31/12/2009
31/03/2010
30/06/2010
30/09/2010
31/12/2010
31/03/2011
30/06/2011
30/09/2011
31/12/2011
31/03/2012
30/06/2012
30/09/2012
31/12/2012
31/03/2013
30/06/2013
30/09/2013
31/12/2013
31/03/2014
30/06/2014
30/09/2014
31/12/2014
31/03/2015
30/06/2015
30/09/2015
31/12/2015
31/03/2016
30/06/2016
RETIREWELL High Growth (10.28%)
Morningstar Multisector Category Average - Aggressive (8.25%)
CPI + 4% (6.37%)
Cash (3.23%)
CPI (Inflation) (2.28%)



Retirewell Growth Model Portfolio
220.0
210.0
200.0
190.0
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
31/08/2009
31/10/2009
31/12/2009
28/02/2010
30/04/2010
30/06/2010
31/08/2010
31/10/2010
31/12/2010
28/02/2011
30/04/2011
30/06/2011
31/08/2011
31/10/2011
31/12/2011
29/02/2012
30/04/2012
30/06/2012
31/08/2012
31/10/2012
31/12/2012
28/02/2013
30/04/2013
30/06/2013
31/08/2013
31/10/2013
31/12/2013
28/02/2014
30/04/2014
30/06/2014
31/08/2014
31/10/2014
31/12/2014
28/02/2015
30/04/2015
30/06/2015
31/08/2015
31/10/2015
31/12/2015
29/02/2016
30/04/2016
30/06/2016
RETIREWELL Growth (10.70%)
Australia OE Multisector Growth(7.36%)
CPI + 3.5 (5.86%)
Cash (3.23%)
CPI (Inflation) (2.28)



Retirewell Balanced (Growth) Model
190.0
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
30/09/2009
31/12/2009
31/03/2010
30/06/2010
30/09/2010
31/12/2010
31/03/2011
30/06/2011
30/09/2011
31/12/2011
31/03/2012
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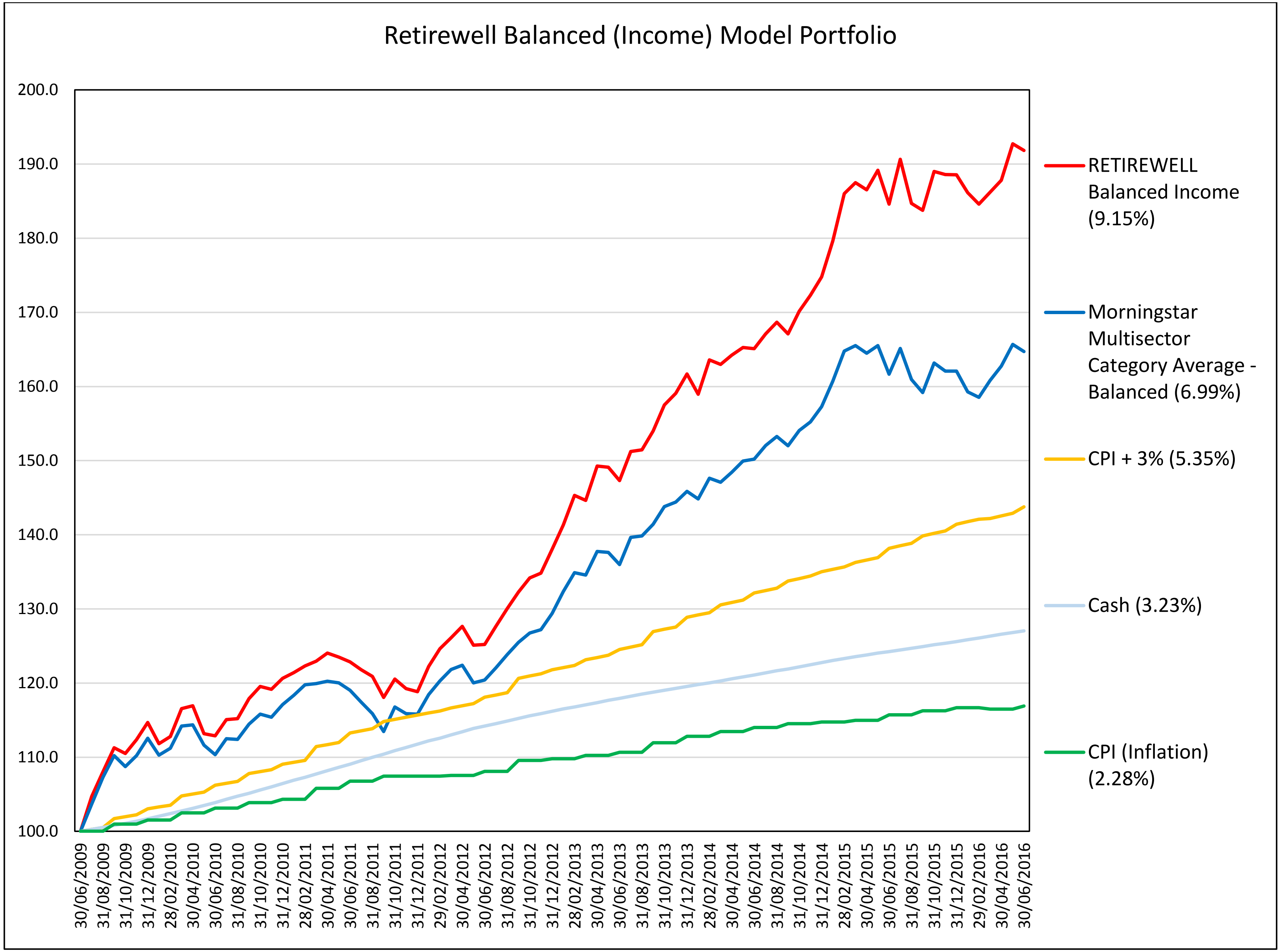
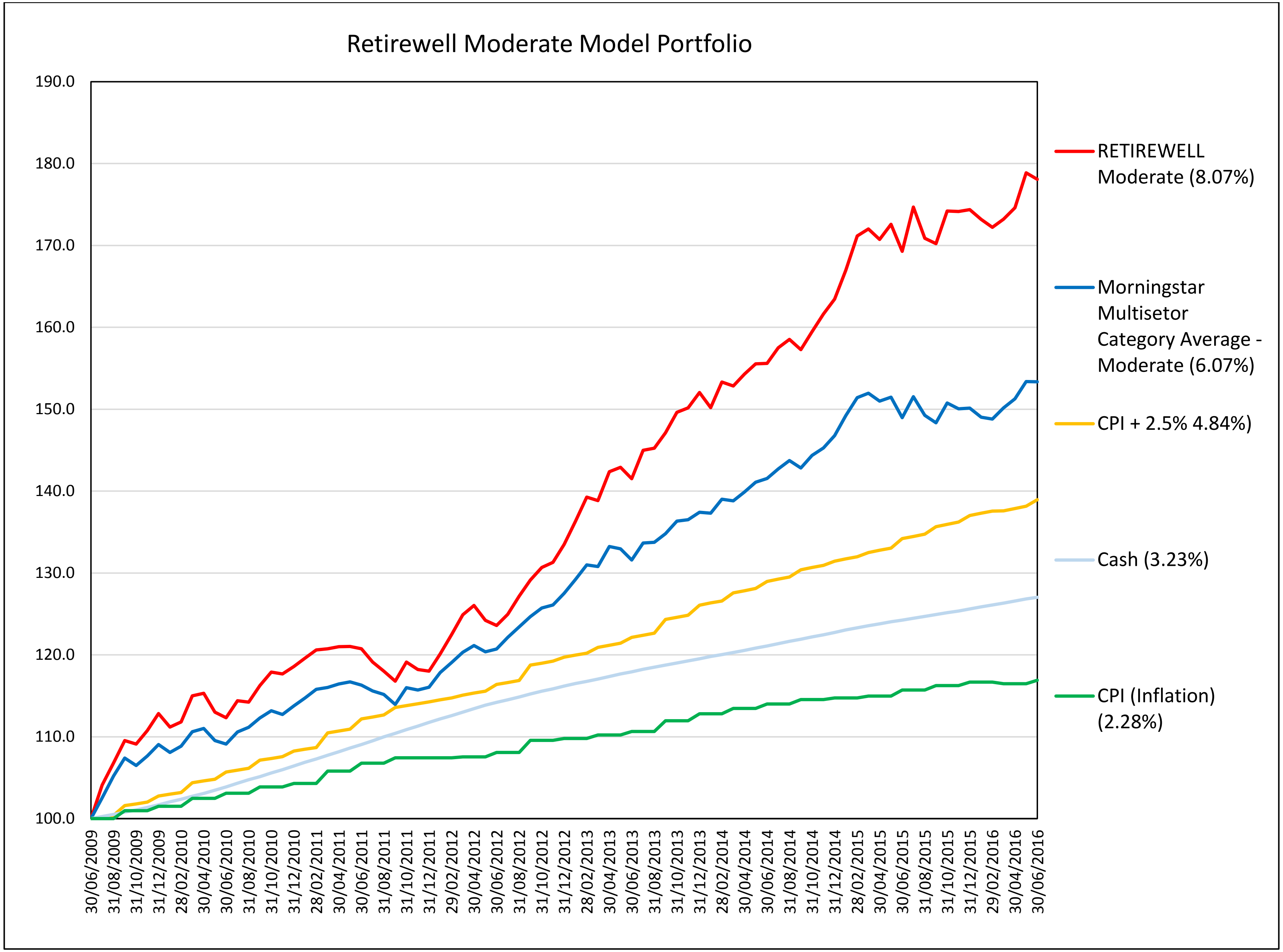
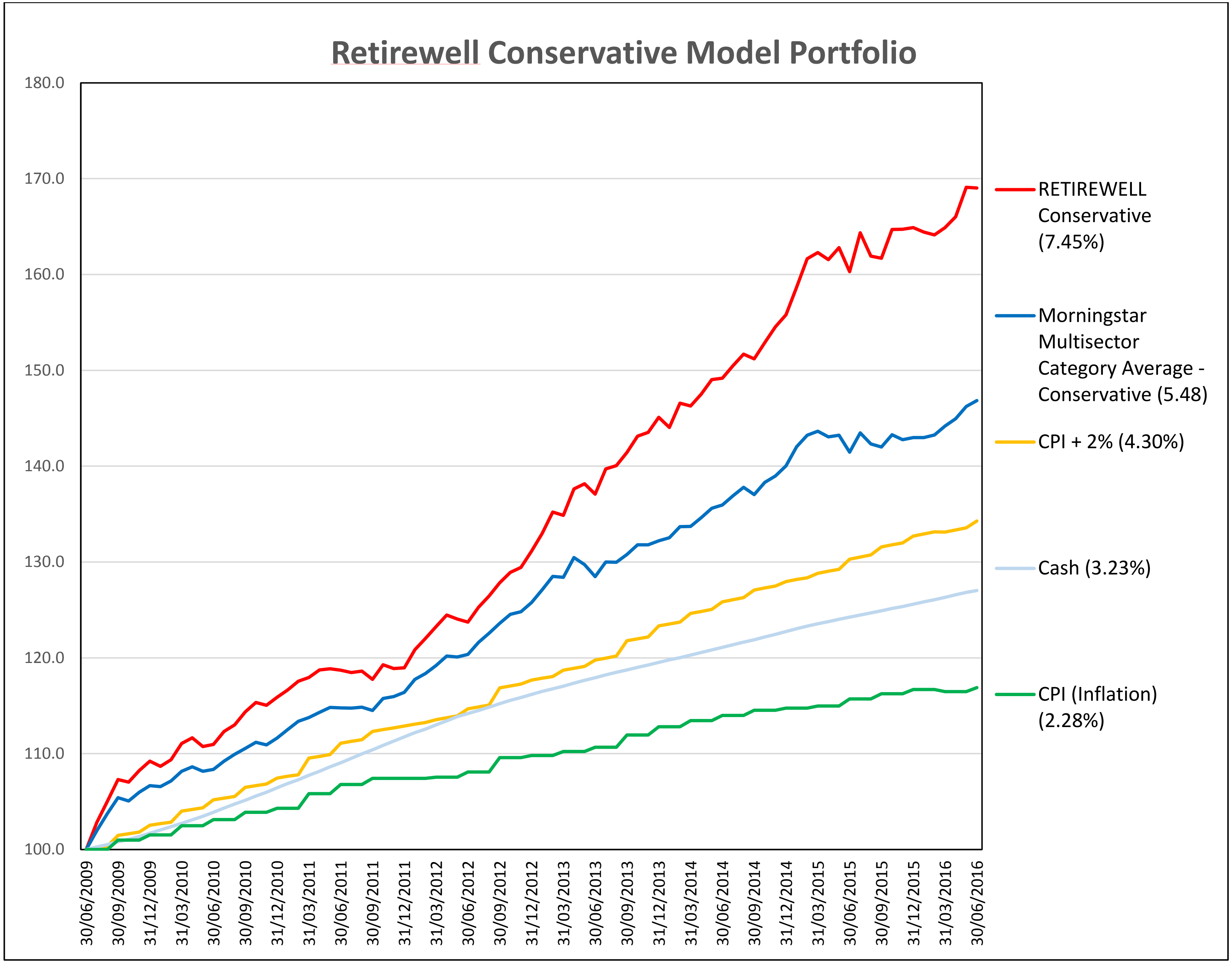
31/12/2013
31/03/2014
30/06/2014
30/09/2014
31/12/2014
31/03/2015
30/06/2015
30/09/2015
31/12/2015
31/03/2016
30/06/2016
RETIREWELL Balanced (Growth) (8.70%)
Morningstar Multisector Category Average Balanced (6.99%)
CPI + 3% (5.35%)
Cash (3.23%)
CPI (Inflation) (2.28%)


Retirewell Balanced (Income) Model Portfolio
200.0
190.0
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
31/08/2009
31/10/2009
31/12/2009
28/02/2010
30/04/2010
30/06/2010
31/08/2010
31/10/2010
31/12/2010
28/02/2011
30/04/2011
30/06/2011
31/08/2011
31/10/2011
31/12/2011
29/02/2012
30/04/2012
30/06/2012
31/08/2012
31/10/2012
31/12/2012
28/02/2013
30/04/2013
30/06/2013
31/08/2013
31/10/2013
31/12/2013
28/02/2014
30/04/2014
30/06/2014
31/08/2014
31/10/2014
31/12/2014
28/02/2015
30/04/2015
30/06/2015
31/08/2015
31/10/2015
31/12/2015
29/02/2016
30/04/2016
30/06/2016
RETIREWELL Balanced Income (9.15%)
Morningstar Multisector Category Average - Balanced (6.99%)
CPI + 3% (5.35%)
Cash (3.23%)
CPI (Inflation) (2.28%)


Retirewell Moderate Model Portfolio
190.0
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
31/08/2009
31/10/2009
31/12/2009
28/02/2010
30/04/2010
30/06/2010
31/08/2010
31/10/2010
31/12/2010
28/02/2011
30/04/2011
30/06/2011
31/08/2011
31/10/2011
31/12/2011
29/02/2012
30/04/2012
30/06/2012
31/08/2012
31/10/2012
31/12/2012
28/02/2013
30/04/2013
30/06/2013
31/08/2013
31/10/2013
31/12/2013
28/02/2014
30/04/2014
30/06/2014
31/08/2014
31/10/2014
31/12/2014
28/02/2015
30/04/2015
30/06/2015
31/08/2015
31/10/2015
31/12/2015
29/02/2016
30/04/2016
30/06/2016
RETIREWELL Moderate (8.07%)
Morningstar Multisetor Category Average - Moderate (6.07%)
CPI + 2.5% 4.84%)
Cash (3.23%)
CPI (Inflation) (2.28%)



Retirewell Conservative Model Portfolio
180.0
170.0
160.0
150.0
140.0
130.0
120.0
110.0
100.0
30/06/2009
30/09/2009
31/12/2009
31/03/2010
30/06/2010
30/09/2010
31/12/2010
31/03/2011
30/06/2011
30/09/2011
31/12/2011
31/03/2012
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30/06/2013
30/09/2013
31/12/2013
31/03/2014
30/06/2014
30/09/2014
31/12/2014
31/03/2015
30/06/2015
30/09/2015
31/12/2015
31/03/2016
30/06/2016
RETIREWELL Conservative (7.45%)
Morningstar Multisector Category Average - Conservative (5.48)
CPI + 2% (4.30%)
Cash (3.23%)
CPI (Inflation) (2.28%)