PORTFOLIO CONSTRUCTION

The portfolio construction process involves a full understanding of your needs and objectives and matching an investment strategy with your particular circumstances to minimise the overall investment risk. This is usually achieved through establishing a diversified investment portfolio across:

- Different assets classes;
- Different investment management styles; and
- Domestic and international investment markets.

The portfolio construction process has four main aims: -

1. To control risk but with the aim of maximising the overall investment returns to you.
2. To match an investment strategy to your needs and objectives and risk profile.
3. To help establish a level of expectation for portfolio performance from the selected investment strategy.
4. To provide guidance on the expected volatility associated with the investment strategy.

To help achieve the successful design and implementation of an investment plan and its ongoing maintenance, there is an established, disciplined process to assess your attitudes to risk and return to determine in what asset sectors to invest and in what amounts.

The allocation of investment funds between different asset classes is the most critical issue in achieving an expected outcome as, without sound asset allocation strategy, an investment portfolio will not achieve a satisfactory return for the amount of risk involved.

When considering investments to make, it is important to differentiate between income producing and capital growth investments.

- Income producing investments generally offer a high level of security in respect to the maintenance of original capital (i.e. Australian cash) while offering ongoing returns (i.e. interest income). They are however disadvantaged by taxation as the income produced is usually fully taxable and the effects of inflation reduce the real purchasing power of the funds over time.

  Generally these types of investments provide no growth in capital.

- Growth investments are those that provide income as well as increases in the capital value of the investments over the longer term (i.e. shares and property). These investments are generally subject to capital gains tax (CGT), which is not payable until you sell the investment and may, at that point, be reduced by various discount provisions.

  These investments also provide income, some of which may carry tax benefits, such as fully franked dividends, which can be important in the overall investment return these types of investments provide.

A brief summary of the general asset sectors available for investment are listed below:

Australian Cash (Liquidity)

Cash investments are generally those where the investor can readily get their money back at short notice. For direct investors, the only "at call" option is a cheque/savings account with a bank, building society or credit union. While cash in the bank is very low risk, real (after inflation, but before tax) annual returns are projected to range between 0% and 3% pa over the long term. There is no growth factor involved, as the balance grows only by reinvestment of income received.

Fixed Interest

Fixed Interest is an important defensive sector of any diversified portfolio. It incorporates the use of Government and corporate bonds that offer high, long-term capital security and the potential for some limited capital growth in addition to interest income.

There are two types of issuers of bonds - government and corporate. The Australian market for corporate bonds is very limited, with larger companies often issuing bonds in the overseas markets that are larger and more active. Therefore the main bond market in Australia is for Federal, State and semi-government instruments.

International fixed interest markets however offer a much larger range of options both in the different types of interest bearing products available but also in the range of different countries and corporate entities that are in those markets.

When bonds are purchased at issue and held to maturity, there is no growth in capital and the return of interest is treated as income for tax purposes. Where a bond is purchased or sold on market during the period to maturity, it is possible for there to be a capital gains or loss, which arises due to interest rate changes.

Another category of the fixed interest sector is mortgage funds. Mortgage funds are designed to provide regular interest at variable rates, whilst maintaining capital security. Investor's funds are pooled and invested mainly in registered first mortgages secured against a spread of freehold property. Usually only 66% to 75% of valuation is lent so the risk of capital loss is controlled.

A relatively new category of fixed interest investment is what is called Hybrid debt which has some characteristics of debt and some of share capital. These are issued by corporations and carry higher income returns than you would receive as dividends on shares but they generally do not have to be repaid by the corporation, but rather once issued they are bought and sold like shares. These carry a higher risk factor than corporate bonds, as the hybrid debt ranks behind normal debt, but before shareholders capital, in the event of a liquidation of a company.

Share Investments

In nearly all cases exposure to shares is an essential part of any investment portfolio that aims to provide capital growth.

Investment in the Australian sharemarket allows you to participate in the profits and growth of the private sector of our economy. Returns from these investments can be volatile in the short term, however, over the long term, this sector has consistently outperformed all of the other major Australian investment classes.

The level of volatility and returns associated with this form of investment will vary depending upon the type and diversity of companies in which you invest.

Property Investments

Property has a number of different sub-categories. The market choices include residential, commercial, industrial, retail, rural, hospitality or tourist type properties. Property should provide the investor with capital growth over the medium to long term, which generally reflects the increased cost to replace the property and/or demand for the property. Of course, as a property ages, it may need to be maintained and updated to achieve its desired value so there is an ongoing cost not associated with other types of investment. Property investment also provides an income in the form of rents received from tenants.

You can purchase property in your own right and take responsibility for maintenance, securing tenants etc, or invest in a property managed fund that purchases and manages properties directly or invests in the securities of property investment companies or trusts that are listed on a stock exchange.

An individual has limited ability to invest in property and provide diversification due to the large amounts required to purchase an individual property. Often small investors are limited to residential property investments.

Property sector managed funds can offer much wider diversification by providing exposure to the various property sectors, such as shopping centres, office buildings, retirement villages and industrial property, that the average investor could never achieve in their own right. Any capital growth or losses and rental income are passed on to the investors and the managers of these types of funds have the responsibility for managing the properties or selecting the listed property securities in which to invest.

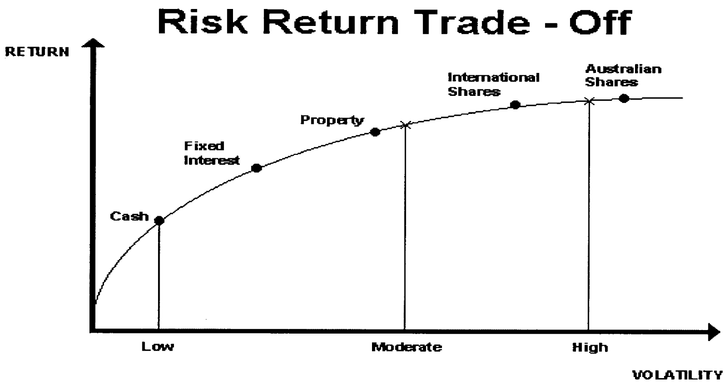
International Investments

The Australian economy and investment markets represent only a very small proportion of world wide investment opportunities. Australian investment markets represent less than 2% of global markets by value or market capitalisation.

International investment markets therefore provide a whole range of additional opportunities for investment to increase diversification and returns. Any portfolio should therefore have exposure to international markets in the fixed interest, property and sharemarket sectors.

Diversification across world economies can also help manage the volatility of your investments through exposure to economies that are at different stages of the economic cycle.

The long-term risk/return trade off between different asset classes is illustrated in the following graph.



<u>Diversification</u>

It is widely recognised that one of the best ways to reduce investment risk and the uncertainty of which asset class will perform, while increasing your chance of a better return on your money over time, is to diversify your investments. Diversification means spreading your investment across a number of investments in different market sectors (or the asset classes summarised above), and works on the principle that different asset classes perform well at different times.

Achieving a truly diversified investment portfolio however, can be a difficult task for an individual investor making direct investments, particularly those with limited investment funds that may preclude investment in say, a property.

This can be overcome by investing in managed investments, which pool investors' funds to harness the buying power of potentially millions of dollars. They allow access to a broader range of investment opportunities, such as international shares and commercial and residential property, which would be difficult for an individual investor to access.

A diversified fund, as the name suggests, invests across the entire spectrum of asset classes with the aim of reducing risk while maximising long-term return through the use of diversification.

The amount that is invested in each asset class will vary depending on the objectives of the fund and the particular the type of investors to which the fund is most applicable. As an example an investor making a long term investment who is prepared to tolerate high levels of risk to achieve higher returns, may invest in a Growth or High Growth fund, which would invest around 85% to 100% in share and property investments. These types of funds are expected to be more volatile in the short term.

A retiree, who wants to protect their capital, would adopt a Defensive portfolio that may only invest 30% to 50% in share and property investments and the balance in fixed interest and cash. These funds will be much less volatile.

The investor must be aware that all asset classes have some risk attached to them so all diversified funds, will have some risk of capital fluctuation. In the long term however diversified these funds will generally provide high investment returns than cash and fixed interest.

Over the past 10 years, most asset classes have had negative returns in some years and diversification is used to limit the effect of these negative returns on investment portfolios. Exposure to portfolios that are not diversified means there is a risk of negative returns from year to year. Research shows significant volatility in the annual returns from the main individual asset sectors over each of the past ten years but that, by diversifying, the likelihood of achieving a positive return in each year, in excess of inflation, is much stronger.

Diversification of Asset Sectors

Generally a portfolio which maintains a set allocation in each asset sector can achieve strong returns and does not require regular changes to the amount invested in each asset class. This is known as a strategic asset allocation approach and is represented by the long-term asset allocation target of investor risk profiles.

Tactical asset allocation re-weights a portfolio in line with current market fluctuations and future market expectations, trying to pick those asset sectors that will next outperform other assets sectors. This carries more risk than the strategic asset allocation approach in that there is no certainty that those picks will be correct.

As noted above diversification of asset sector investment can be achieved by investing in managed funds that invest across all asset sectors within the one fund usually managed by the one manager.

Diversification can also be achieved by investing in individual managed funds that specialise in a particular asset sector or type of investment. Usually portfolios built up using sector specific funds require larger investment amounts to be cost effective.

Diversification of Fund Managers

For those sectors where it is difficult to add value (cash, fixed interest, listed property) one or two managers in each sector within a portfolio is generally sufficient. However where active styles are used, such as in Australian and international shares, volatility can be reduced significantly by using around three to four managers in each sector. These managers should offer a range of different styles in order to achieve the best diversification benefits.

To get the better results, portfolios should include a range of different investment “styles” in the sectors where volatility is high. For example an equity portfolio could use the following:

- a growth style manager, and
- a value style manager, and
- a neutral or growth-at-reasonable-prices (GARP) manager, and
- a highly aggressive specialist fund –such as a small company fund.

Such a portfolio will offer strong diversification across styles, countries (in the case of international equity funds) and even currency management. A description of the main styles of investment management exhibited by equity fund managers follows.

Growth Seek out companies that will provide strong expected earnings growth going forward. Growth managers tend to pay a premium for these stocks as the market has already priced in some of the good news about the company. Typically a growth manager invests in companies that have:

- consistent earnings streams
- lower dividend yields
- high price to earnings ratios

Growth managers tend to outperform in a bull run when interest rates are lower and earnings growth is slowing.

Value Markets and/or assets move from being under priced to over priced over time and a value manager searches for those that are relatively under priced while reducing exposure to those it considers overpriced. Typically equities a value manager tends to invest in companies that have:

- low price to earnings ratios
- higher dividend yields
- low price to book ratios

Value managers tend to invest in stocks when the bad news is factored into the market and the price may be languishing (looking for turnaround stories). Value managers tend to outperform in the early stages of a recovery in the market (counter cyclical style) i.e. when earnings are starting to improve and interest rates are rising.

Neutral Neutral or “Growth at a Reasonable Price" (GARP). Generally a GARP manager aims to take the best elements of both value and growth and put them together i.e. looking for stocks with strong expected earnings growth going forward but are not prepared to pay 'any price' for the stock – ie looking for relatively cheap prices

Index A passive index manager seeks to replicate the performance of the chosen market index. An enhanced index manager seeks to provide performance at a slight premium to the chosen index through enhancement activities, such as dividend reinvestment plans and Offerings.

Fund Manager Selection Process

The objective of the fund manager selection process is to use qualitative and quantitative techniques to seek out fund managers that are likely to offer investors high levels of financial strength and superior risk adjusted returns. The fund manager selection process ensures that clients have access to a range of investment products that include many of the most highly regarded fund managers in the market place.

Financial Strength

The first step is a consideration of financial strength with a strong preference for large, experienced fund managers with strong, long-term credit ratings. Where a fund manager does not have this record, focus on the market capitalisation or the credit rating of the parent company can provide some comfort.

Although most investments are held through a trust structure, we believe that financial strength is important in assessing a fund manager’s ability to withstand adverse events. By focusing on financial strength we can avoid a number of unnecessary risks, without compromising potential returns. Clearly this offers an additional layer of comfort for investors.

Notwithstanding this there are occasions where investment through small specialist “boutique” fund managers is warranted for small amounts of a portfolio to provide further diversification and exposure to growth opportunities.

Quantitative Analysis

Quantitative analysis is used to assess a fund manager’s historical performance and volatility characteristics. The aim is to establish whether a fund manager has shown the ability to outperform the relevant benchmark at an acceptable level of risk. This analysis is used as a filter to consider which fund managers are worthy of further investigation.

While short-term historical performance is of little use, there is solid evidence to suggest however that longer-term historical performance can be a useful indicator, although this is no guarantee of future performance.

Fund managers offering an excellent process and top quality employees should be expected to add value consistently over time. Placing a high level of importance on risk control is important so managers that have shown the ability to produce solid returns without excessive risk are favoured. Using standard deviation as a proxy for risk, risk relative to a benchmark or as a comparison between a number of fund managers can be measured to also help in the selection process.

Qualitative Analysis

The qualitative aspect of the fund manager review process is regarded as critical and involves an assessment of the fund manager’s process and people. Specifically the investment process needs to be logical and well articulated, while the investment management personnel should be highly experienced and have worked together for an extended period.

Given the link between these qualitative factors (process and people) and fund performance a detailed review is considered essential.

Independent Research

There are a number of companies that provide research into managed funds and conduct extensive quantitative and qualitative reviews of individual managers and funds. These in depth reviews include regular face to face meetings with the fund managers and continual monitoring of personnel changes, changes in ownership and a range of other factors that may impact on the manager’s ability to provide consistent investment returns.

This research forms an important part of the selection of the managed funds to structure portfolios.