

# Investment philosophy

Strategyfirst  
FINANCIAL PLANNING

Dream | Plan | Achieve



# **Achieve** your financial dream

Dream a little to set your financial goals... and then develop a structured plan around smart financial decisions to give you the best chance of achieving your aspirations.

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# Our strategic philosophy

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## The unique human dimension

We recognise that each person is different and therefore has a different investment approach based on individual needs and objectives, whether driven rationally and/or emotionally.

Our philosophy is first to understand you as an individual investor with your unique perspective in relation to the rewards and risks of investing. We balance out the risk of not earning adequate returns over time with a structured approach to wise investment choices, to give you the best chance of meeting your financial goals.

## Strategy design

With a thorough understanding of you and your objectives in place, we use our expertise to design and structure a portfolio that is most likely to achieve your goals.

## A structural approach

We focus on the structure of your portfolio rather than on picking highs and lows in the market. We don't believe in crystal balls, nor in actively managed portfolios.

Academic research shows that over time, asset allocation has a greater impact on an investor's experience than other factors. We therefore focus on getting the structure of your portfolio balanced over appropriate asset classes to meet your objectives. This gives greater confidence in achieving strong returns over time.

## Diversification and dimension-based investing

Strategic diversification gives you the opportunity for security while also harnessing opportunities for growth. We design a structured portfolio based on both Defensive and Growth asset classes, as well as further diversifying into sub asset classes that match investment dimensions such as large, value and small companies in both domestic and global equity markets.

This approach decreases expected volatility while also positioning for exposure to growth opportunities.

## Efficiency

We take a comprehensive long-term view on managing both tax and trading costs. After all, your net return is the key measure of overall success.

## Rigour

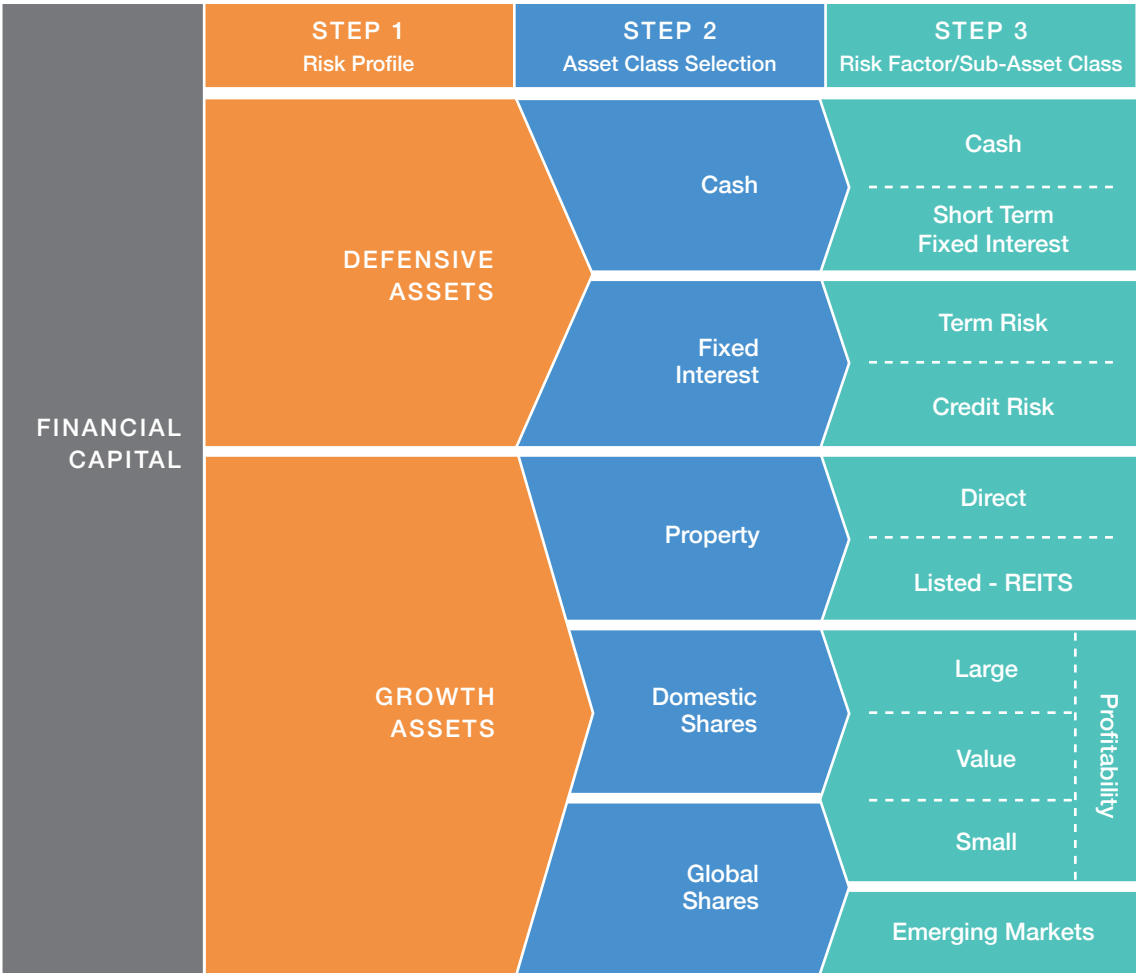
We construct your portfolio with as much rigour and reliability as we can, understanding you and your individual needs.

The following pages outline our portfolio construction process, as well as giving more detail on our investment philosophy for different asset classes.

# Portfolio construction

The process we use for portfolio construction involves three key steps.

First we establish your risk profile so that we can establish a diversified portfolio of Growth and Defensive asset classes that will meet your individual needs. Once this broad strategy is established, we further profile risk and reward factors to carefully select sub asset class allocation.



# Risk profile

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The first step in developing your investment strategy involves understanding more about your individual requirements. We consider your tolerance towards investment risks; your stage in life; your objectives and your Human Capital.

Risk Tolerance is not always the same as Risk Profile. Your tolerance towards short and long term risks are often innate, sometimes influenced by life experiences.

Your Risk Profile relates to the Investment Strategy adopted for your Financial Capital, and relates to the level of investment risk your capital will be exposed to and the risks you are seeking to manage.

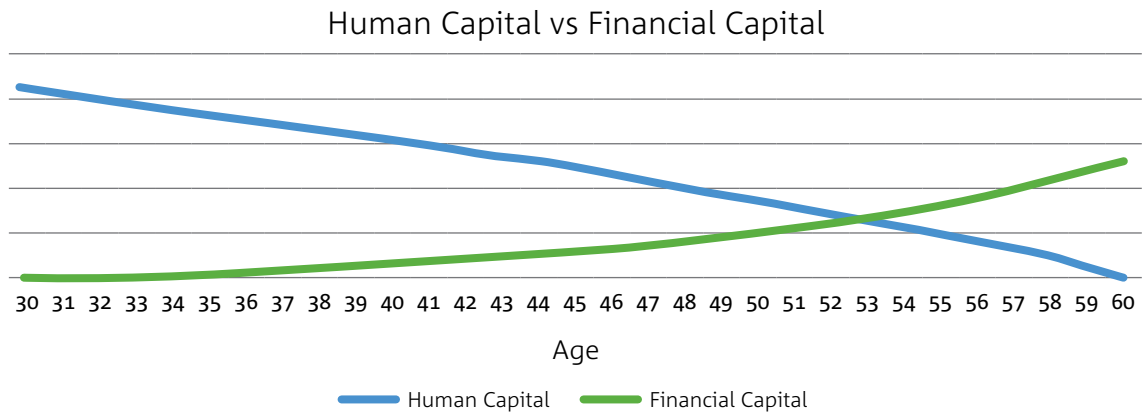
The most appropriate Risk Profile will take into account your Risk Tolerance as well as other factors such as the timeframe for the investment strategy (a short timeframe generally requires a very conservative risk profile) and your Human Capital (the higher your Human Capital, the greater your potential capacity to financially weather risk).

We define Human Capital as simply the present value of your income from your “exertion”, taking into account current income (salary, partnership drawings, etc.), expected growth in this income over your working life and a discount rate such as inflation.

Our Human Capital is often greatest when we commence our working life, simply due to time. However, our Human Capital can change over time due to other factors such as breaks in work and greater than expected increases in earnings (as a result of new skills, a change of industry/career and other factors).

Therefore, Human Capital is often greatest when we have the least amount of Financial Capital. Financial Capital includes those assets we accumulate that will generally provide an income stream to augment or replace our Human Capital. It includes investments, superannuation, business interests and even the expected proceeds from downsizing homes in the future.

The chart below depicts the interaction between Human Capital and Financial Capital:



Where the ratio of Human Capital to Financial Capital is greatest (often when you are younger), your capacity to take investment risk is relatively high. The impact of a significant market downturn on your total capital (Human Capital + Financial Capital) is relatively insignificant.

Approaching retirement, when you have a few years of Human Capital left, the smart financial decisions you have made should see you accumulating a high level of Financial Capital. At this point, a significant negative market event can impact your ability to achieve your dreams and goals. In this case, dialling down the level of financial risk you take may be prudent.

Again, this will depend on your financial capacity to take risk as well as your underlying risk tolerance.

### Risk profile

The amount of exposure your portfolio has to each asset class is determined by your risk profile. After ascertaining your risk profile, we can determine how much of your portfolio will be exposed to Defensive assets (cash and fixed interest) and Growth assets (shares and property).

We then match this to various alternative portfolios – Defensive, Conservative, Balanced, Growth or High Growth. Each has a different exposure to Growth and Defensive assets and, consequently, a different expectation of risk and return.

There are very few certainties in the investment world, however, we know that markets will rise and fall and interest rates will fluctuate. As a result, returns can turn out much better or worse than expected.

The higher the returns we try to achieve, the higher the risk something may not go to plan. Therefore, it is important we match your risk profile to an appropriate asset allocation. This will ensure you are comfortable with the risk/reward trade-off and investment experience.

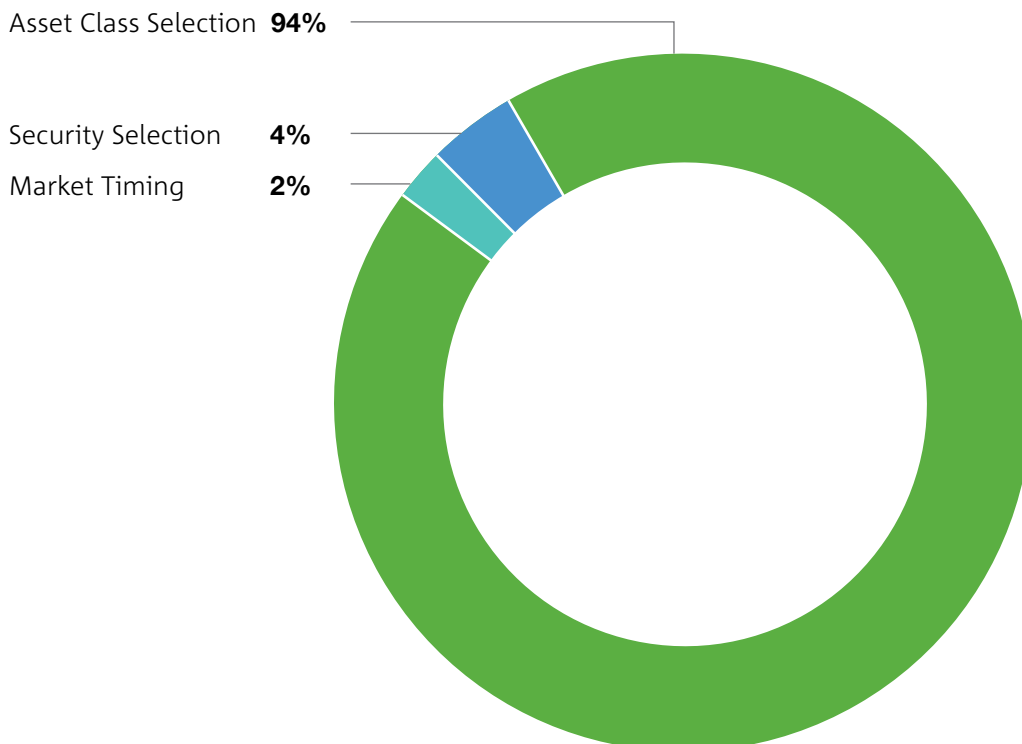
# Asset allocation

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Asset allocation is the process of allocating your investment capital and future cashflow to the main asset classes. These include Australian and international shares, property, fixed interest and cash.

Strategy First believes Asset Allocation is the key driver of investment returns, which is based on landmark research by Brinson, Hood and Beebower (outlined in the chart below). This research concluded the vast majority of a portfolio's returns are determined by asset allocation, with only a small portion determined by market timing and security selection.

The research confirmed how you allocate capital to a portfolio is far more important in determining your experience than market timing (i.e. shifting in and out of asset classes and/or securities within an asset class) or security selection (i.e. the actual selection of individual shares, property and bonds).



**Source:** Study of 91 large pension plans over 10 year period. Gary P Brinson, L Randolph Hood and Gilbert L Beebower, "Determinants of Portfolio Performance", Financial Analysts Journal, July-Aug 1986, pp 39-44; and Gary P Brinson, Brian D Singer and Gilbert L Beebower, "Revisiting Determinants of Portfolio Performance: An update", 1990, Working paper.



## Difficulty of market timing

To highlight just how difficult market timing or forecasting is, even for asset classes, the chart below shows the annual performance of different asset classes over 14 years to 31 December 2015.

Year ending 31 December

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Highest Return	11.57%	32.29%	31.30%	43.20%	34.21%	25.15%	9.23%	57.43%	13.05%	10.51%	21.64%	53.62%	32.87%	12.13%
	4.77%	17.92%	27.99%	23.65%	27.90%	17.05%	7.60%	40.86%	10.66%	5.00%	21.00%	47.00%	14.72%	11.99%
	-3.53%	16.45%	26.84%	22.79%	24.27%	16.12%	-24.92%	38.38%	9.28%	0.60%	20.85%	46.94%	13.36%	11.50%
	-3.67%	13.76%	26.64%	21.67%	23.43%	10.28%	-25.33%	36.19%	7.11%	-5.55%	16.74%	24.54%	11.40%	10.16%
	-8.63%	11.20%	20.68%	19.59%	22.98%	6.73%	-26.80%	11.73%	4.66%	-5.63%	16.08%	21.54%	10.37%	7.05%
	-9.12%	6.59%	19.48%	17.07%	16.41%	6.63%	-31.60%	8.03%	4.30%	-9.08%	14.38%	18.06%	6.97%	3.35%
	-14.70%	4.90%	13.91%	17.00%	11.74%	-2.12%	-37.21%	3.47%	1.69%	-9.82%	14.06%	13.03%	6.93%	2.33%
	-23.65%	3.23%	10.26%	16.62%	9.07%	-7.18%	-41.23%	2.11%	0.83%	-9.94%	9.66%	2.87%	6.13%	2.14%
	-27.17%	2.12%	8.92%	6.62%	6.02%	-9.53%	-41.23%	0.77%	-1.94%	-18.44%	6.58%	2.27%	2.69%	0.51%
Lowest Return	-27.22%	-0.52%	5.62%	5.74%	4.41%	-20.87%	-53.17%	-1.80%	-4.35%	-21.43%	3.97%	-0.76%	-3.81%	-4.30%

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>Australian Large</b>	-8.63%	13.76%	27.99%	22.79%	23.43%	16.12%	-37.21%	36.19%	0.83%	-9.82%	21.00%	21.54%	6.13%	2.14%
<b>Australian Small</b>	-9.12%	32.29%	26.64%	19.59%	34.21%	17.05%	-53.17%	57.43%	13.05%	-21.43%	6.58%	-0.76%	-3.81%	10.16%
<b>Australian Value</b>	-3.53%	11.20%	31.30%	21.67%	24.27%	10.28%	-41.23%	40.86%	1.69%	-9.94%	21.64%	24.54%	6.97%	0.51%
<b>Global Large</b>	-27.17%	-0.52%	10.26%	17.00%	11.74%	-2.12%	-25.33%	0.77%	-1.94%	-5.55%	14.38%	47.00%	14.72%	11.50%
<b>Global Small</b>	-23.65%	17.92%	19.48%	23.65%	9.07%	-9.53%	-26.80%	11.73%	10.66%	-9.08%	16.08%	53.62%	11.40%	12.13%
<b>Global Value</b>	-27.22%	3.23%	13.91%	17.07%	16.41%	-7.18%	-24.92%	-1.80%	-4.35%	-5.63%	14.06%	46.94%	13.36%	7.05%
<b>Emerging Markets</b>	-14.70%	16.45%	20.68%	43.20%	22.98%	25.15%	-41.23%	38.38%	4.30%	-18.44%	16.74%	13.03%	6.93%	-4.30%
<b>Property</b>	-3.67%	2.12%	26.84%	16.62%	27.90%	-20.87%	-31.60%	2.11%	7.11%	0.60%	20.85%	18.06%	32.87%	11.99%
<b>Cash</b>	4.77%	4.90%	5.62%	5.74%	6.02%	6.73%	7.60%	3.47%	4.66%	5.00%	3.97%	2.87%	2.69%	2.33%
<b>Fixed Interest</b>	11.57%	6.59%	8.92%	6.62%	4.41%	6.63%	9.23%	8.03%	9.28%	10.51%	9.66%	2.27%	10.37%	3.35%

Data is the annual return to 31 December, 2015. Data used for each asset class is as follows: Australian Large: S&P/ASX100 Index, Australian Small: S&P/ASX Small Ordinaries Index, Australian Value: S&P Australia BMI Value Index (gross div. AUD), Global Large: MSCI World Index, (net div. AUD) Global Small: MSCI World Small Cap Index (net div. AUD), Global Value: MSCI World Value Index (net div., AUD), Emerging Markets: MSCI Emerging Markets Index (net div. AUD), Property: S&P Global REIT Index (net div.), Cash: Bloomberg AusBond Bank Bill Index, Fixed Interest: Barclays Global Aggregate Bond Index (hedged to AUD). S&P/ASX data reproduced with the permission of S&P Index Services Australia. MSCI data copyright MSCI 2016, all rights reserved. Securities and commodities data provided by Bloomberg. Barclays indices copyright Barclays 2016. The S&P data are provided by Standard & Poor's Index Services Group. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

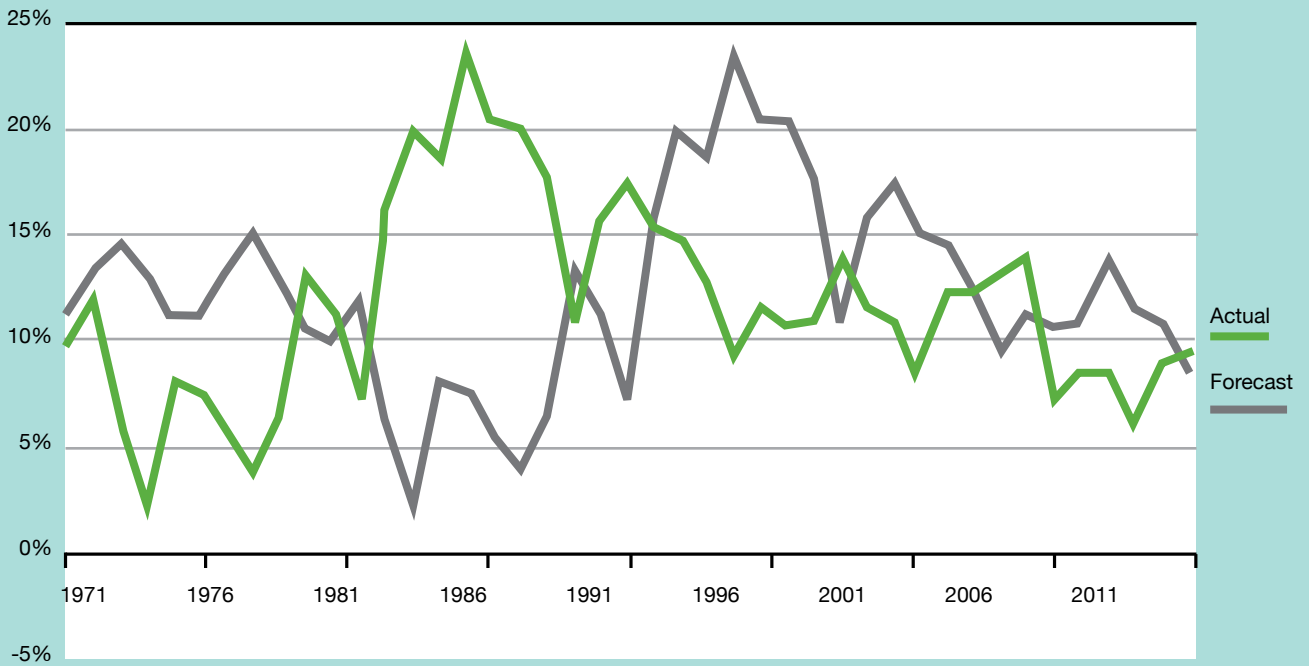
As the chart shows, trying to anticipate what will be the best performing asset class is nearly impossible and certainly not repeatable.

### How do we determine our asset allocation?

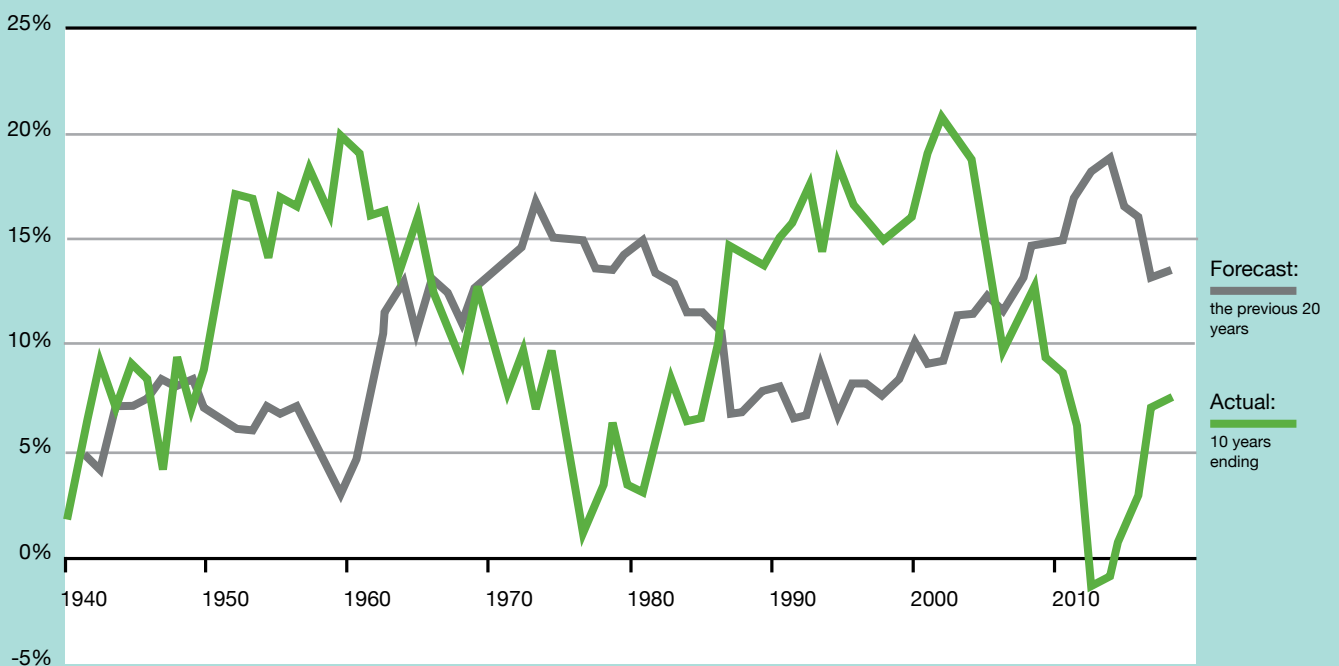
Strategy First believes using past performance as a guide to setting an asset allocation is often misleading. In fact, if you use past performance as a guide, the opposite will often occur (i.e. good performance is generally followed by poor performance and vice-versa).

This is demonstrated by the following charts, which use the average performance of Australian and US shares (on a rolling basis) over the preceding 10 years to forecast the next 10 years.

**Australian Equities** Using the past to forecast the future



**US Equities** Using the past to forecast the future



As the charts clearly show, using the past returns of an asset class as a guide to future returns is misleading and very unrewarding.

To counter this, the asset allocation process used by Strategy First is derived using a robust analytical process that forecasts the returns of individual asset classes over a 10 year period. This process of valuation is based on research completed by John Bogle (the founder of Vanguard Investments - the world's second largest fund manager) and updated by Farrelly's Consulting.

This method has proven very accurate, especially over longer periods of time (like 10 years). Over this timeframe, earnings per share (EPS) growth rates become more stable and Price/Earnings (PE) Ratios and other valuation metrics tend to revert to the mean.

This approach breaks market returns into three main drivers:

1. Income.
2. Growth in income.
3. Effect of changing valuation ratios.

The three elements can be added together to produce a reliable 10 year return forecast.

$$\text{Returns} = \text{Income} + \text{Growth in income} + \text{Effect of changing valuation ratios}$$
$$[R = Y + G + V]$$

**Y** is the **current investment yield**, which is known and requires no forecasting.

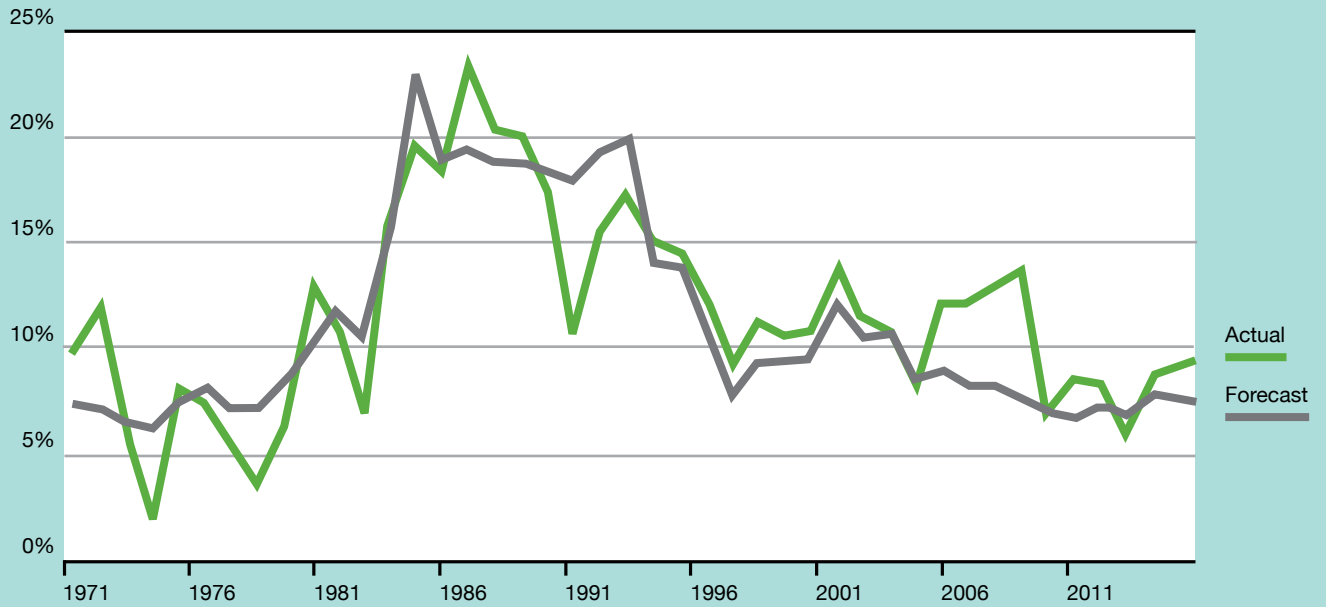
**G** is the **annualised growth in income or earnings** for the asset class, such as rent for property and dividends for shares. Fixed interest is zero by definition.

**V** is the **valuation effect**, which is the compound effect of an increase or decrease in PE ratios or yields on the value of the asset.

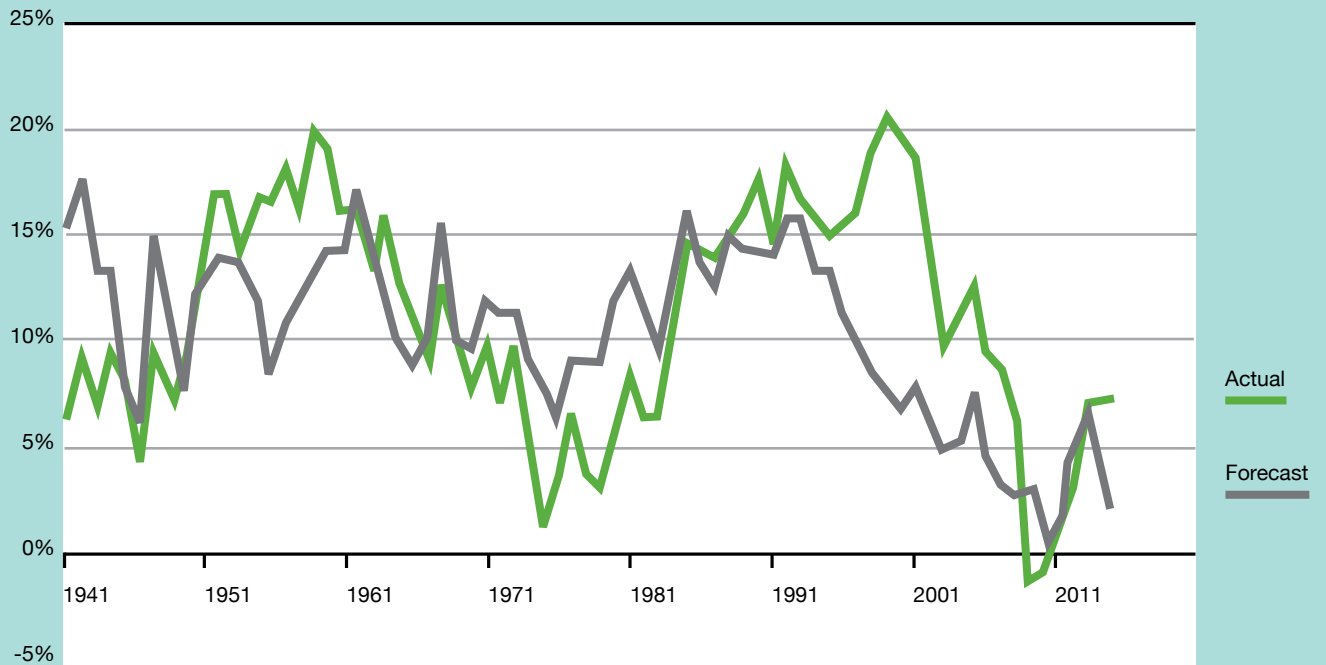
[See further explanation at Appendix A on page 25](#)

Using this methodology to again forecast the returns for Australian and US Shares, we receive the following results:

### Australian Equities. Actual v Forecast, 10 Years Ending



### US Equity Returns. Actual v Forecast, 10 Years Ending



As the results show, the methodology is a vast improvement compared to using past performance as a guide to the future.

# Implementation

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The primary aim of implementation is to ensure your portfolio delivers a successful investment experience. To achieve this, Strategy First believes:

- The most important investment return is an after-tax return.
- 'Asset Class' investing is the most efficient and effective way to invest.
- Diversification is used to reduce risk and enhance returns.
- Minimising fees and transaction costs is important.
- How we spend your 'risk budget' is critical.

**To practically implement the key tenants of our investment philosophy, we:**

- Recommend managed funds over direct stock portfolios to maximise diversification.
- Focus on low cost fund managers that are low turnover and 'tax aware', to minimise unnecessary transaction costs and maximise after-tax returns.
- Do not recommend 'active' investment management as it generally underperforms, delivers unrewarded risk and has higher fees. (Of the 5 major asset classes measured, only Australian mid and small company funds showed a propensity to beat the index. In the other asset classes, the index beats the clear majority of actively managed funds over 5 years).\*
- To achieve long term returns in excess of an index portfolio we include, in the equity component of our portfolios, an exposure to the three additional dimensions of returns above 'Large Companies'. These are: Value, Small and Profitability factors.

\* **Source:** S&P Dow Jones Indices, SPIVA Australia Scorecard Year-End 2015

The following sections highlight our philosophical position on each asset class.

# Fixed interest philosophy

For fixed interest investments, Strategy First believes:

Fixed interest investments, together with cash, form the defensive part of an investment portfolio that is designed to serve three core purposes:

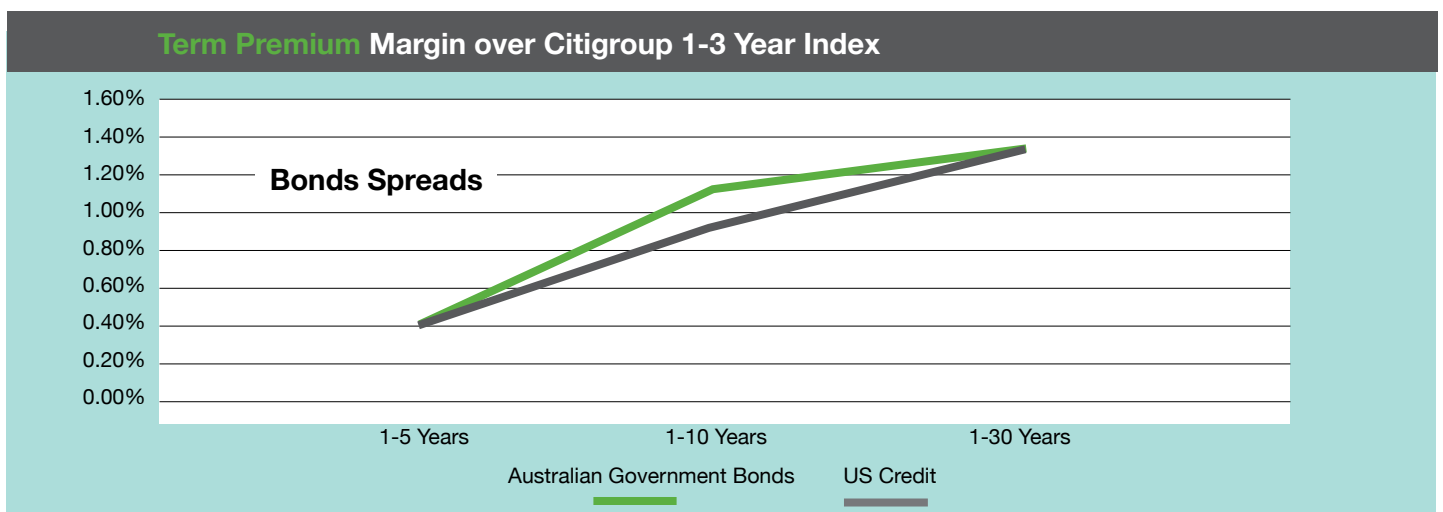
- Provide a source of secure liquidity to fund cashflow needs.
- Provide a source of liquid capital to take advantage of weakness in equity markets.
- Take advantage of term and credit premiums within fixed interest markets.

The risk premium associated with equities is more reliable than very long dated or very low credit quality fixed interest investments.

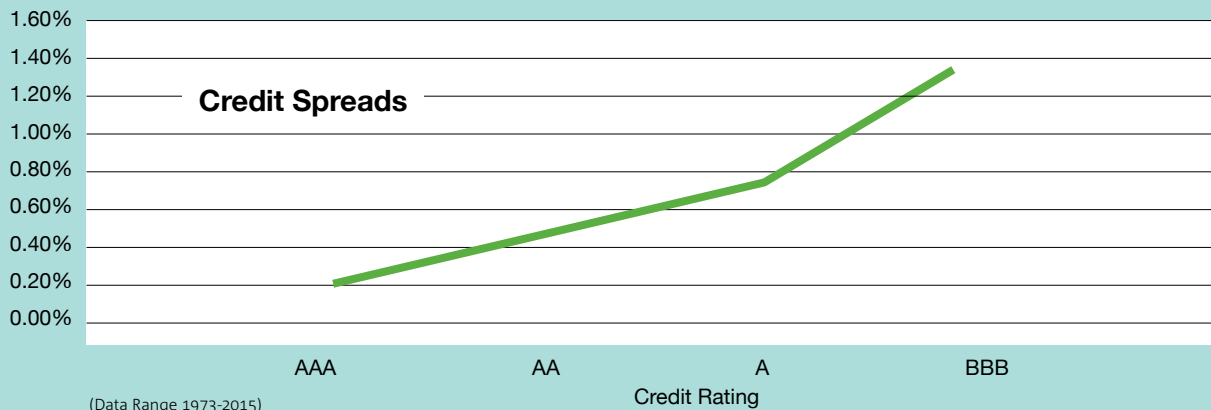
However, risk premiums are available from taking on both term and credit risk, within a risk constrained framework. For example, longer dated bonds tend to generate higher risk and expected returns than cash (Term Premium).

In simple terms, we understand when we may need to access fixed interest capital and how quickly to determine how secure and liquid the investments may be. We also know that additional returns may be available from holding longer dated bonds with credit quality lower than government bonds, without investing in 'junk' bonds.

The chart below and on the following page show the historical term and credit premiums that have been achieved in major bond markets over the last 30-40 years.



## Credit Premium Margin over Barclays US Government Bond Index



To implement our investment philosophy for this part of your portfolio, we primarily invest in managed funds to maximise diversification. Where term deposits provide an expected margin over similar dated government bonds, we may hold them within the portfolio, provided they meet the objectives outlined above.

### Fixed income risk in your portfolio

Investment strategy should drive fixed income decisions. Investors may hold fixed income securities for a variety of reasons—for example, to reduce portfolio volatility, generate income, maintain liquidity, pursue higher returns than cash, or meet a future funding obligation. Each objective may involve a different portfolio approach, or a combination of strategies to manage tradeoffs.

### Defensive Component

In a low interest rate environment, the structure of your Defensive portfolio becomes even more critical. We believe it is very important to consider the role these assets play in the overall portfolio construction.

When recommending the suitable investments for this part of your portfolio, we essentially break the Defensive assets into three separate components, as illustrated in the table on the

following page, where each component is designed to meet a different client objective:

### Defensive Structure

	Cash Flow Reserve	Asset Allocation Reserve	Long-Term Reserve
<b>Purpose</b>	Provide liquidity to cover cashflow needs (such as pensions, insurance premiums and other costs)	Provide security to purchase Growth Assets, should they sharply fall in value, to rebalance the portfolio	Maximise returns in the Defensive component of the portfolio
<b>Investment Characteristics</b>	Cash and short-dated Fixed Interest securities (maturity of less than 2 years)	Highly liquid Fixed Interest securities, with the inclusion of longer-dated maturities than in the Cash Flow Reserve	Fixed Interest securities with longer-dated maturities (3 years or longer) including a partial exposure to Investment Grade (BBB- or greater) Corporate Debt
<b>Amount Allocated</b>	2 years' worth of cash flow needs	Enough to replenish Growth Assets after a fall of, say, 20% (Based on the 1 in 20 chance of the worst case 1-year downturn in the Growth component of your portfolio)	Remainder of the Defensive portfolio

According to Dimensional Fund Advisors, regardless of your approach, you should know the difference between controlling risk and avoiding it. You cannot eliminate risk, but you can manage your exposure by diversifying across maturities, industries, countries, and currencies to reduce the impact of interest rates, inflation, currency fluctuations, and other risks.

Many factors influence the direction of interest rates and performance in the bond markets, and these are too complex to predict. Rather than placing your faith in the experts or reacting to economic news, manage your fixed income component from a portfolio perspective.

Your strategy should reflect your overall investment goals, risk tolerance, and other personal financial considerations. This is a solid approach to managing your portfolio in an uncertain interest rate market.

[See Appendix B on page 25 For full article.](#)



# Property philosophy

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## Listed Property Securities (REITs)

To gain exposure to Property Securities, Strategy First believes the most efficient and effective way to benefit from the asset class is via low cost domestic and global index funds.

This maximises diversification and minimises costs and tax, by focusing on funds that minimise trading.

We do not use active management as it largely underperforms after fees and taxes. For example, 85% of 'Active' Australian Listed Property (A-REIT) fund managers underperformed the S&P/ASX 200 A-REIT index after fees over the 5 years to 31 December 2015.\*

\* **Source:** S&P Dow Jones Indices, SPIVA Australia Scorecard Year-End 2015

## Direct Property

Our focus is to invest via trusts that invest directly into commercial property to provide the following experience:

- An investment return directly correlated to the performance of the underlying properties, rather than the manager's development activities or market induced premiums/discounts to net asset value.
- A largely unleveraged exposure to reduce volatility and the risk of lenders taking control of the property portfolio during periods of market weakness. This may occur where banking covenants are at risk due to property revaluations.
- Diversification across sector (industrial, retail and office), geography and tenant. We prefer structures in which there is not a very high exposure to a key tenant.
- An appropriate weighted average lease expiry.
- Suitable liquidity to provide ease of investment and redemption during 'normal' market cycles.

# Equities

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Strategy First believes the most efficient way to maximise returns and minimise risk from equity markets is to:

- Have a core exposure to the share market combined with strategic tilts towards 'value' and 'small' companies, with a 'profitability' overlay.
- Focus on after-tax returns by targeting low cost managers that minimise trading.
- Maximise diversification domestically and globally to manage risk.
- Avoid active management as it generally underperforms after fees and taxes and cannot be relied upon to maintain style bias.

There has been an enormous amount of academic research and analysis to determine what drives equity market returns. Whilst the initial research dates back to the 1950s, there was a ground breaking study released in 1992. This was from two well known economists, Professors Eugene Fama Snr from the University of Chicago Graduate School of Business and Professor Ken French from Dartmouth College, who drew on over 75 years of previous share price analysis.

Fama and French tested a range of variables to search for traits that explained differences in share portfolio returns over the period 1963-1990. Of the large number tested, two variables stood out as being reliably more profitable - a company's size (measured by its market capitalisation) and a company's relative price (measured by the ratio of a company's market equity to book value - commonly referred to as Price-to-Book ratio).

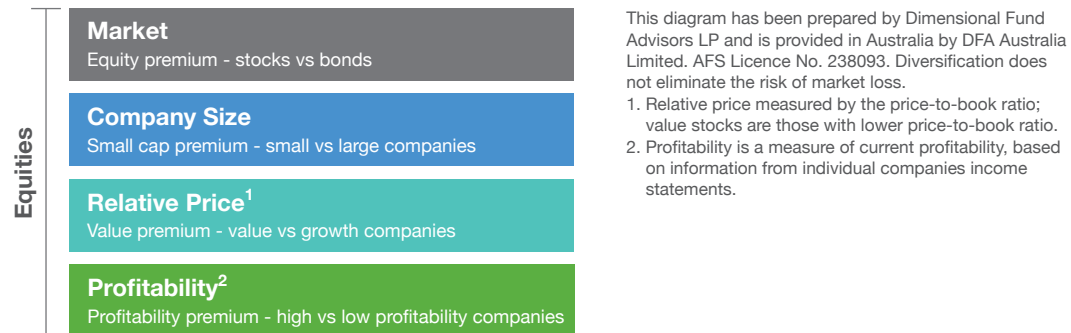
**The key findings of their research were:**

1. The share market has a higher expected return than bonds.
2. Small company stocks have higher expected returns than large company stocks.
3. Lower priced 'value' stocks (i.e. lower Price-to-Book ratio) have higher expected returns than higher priced 'growth' stocks (i.e. higher Price-to-Book ratio).
4. The degree of exposure to these three factors reliably explains over 90% of all portfolio performance.
5. Controlling for other dimensions of expected returns, such as relative price and market capitalisation, more profitable firms should have higher expected returns than less profitable firms.

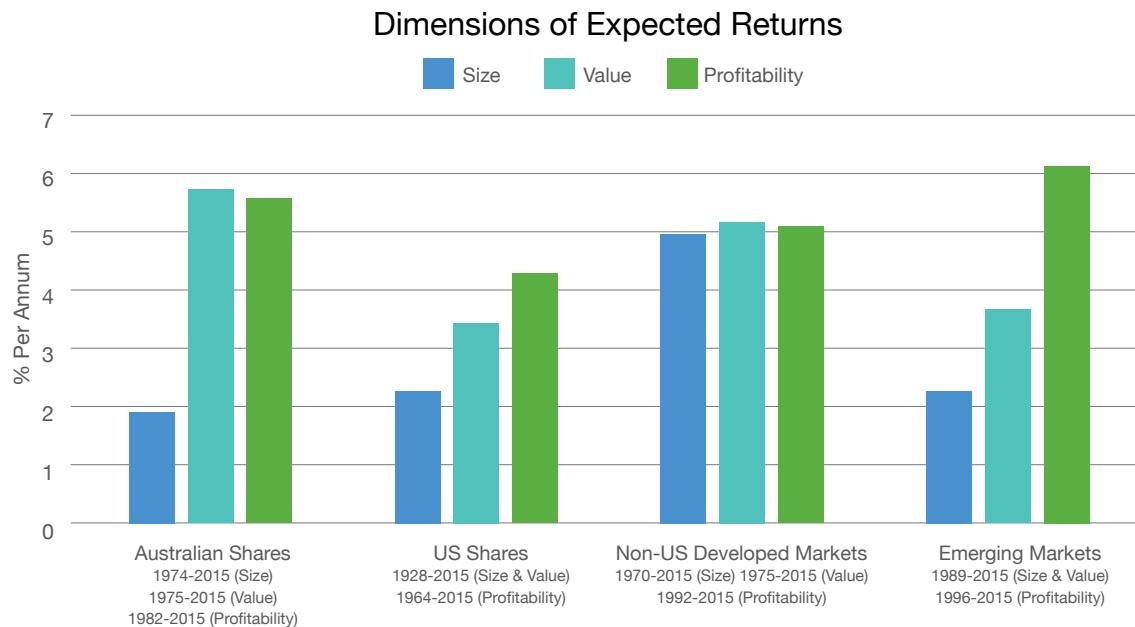
## Dimensions of expected returns

Expected returns are driven by prices investors pay and cash flows they expect to receive. To be considered a dimension of expected return, a premium must be:

- Sensible
- Persistent across time periods
- Pervasive across markets
- Robust to alternative specifications
- Cost-effective to capture in well-diversified portfolios.



Independent academic studies over different times and regions have rigorously tested these theories and have come to the same conclusions - the size and value effects are real and have been observed over several decades in the U.S. and in all countries (developed as well as emerging economies).



\* **Source:** DFA Australia Limited.

Historically the long-term premiums available by tilting the equity component of your portfolio to small and value are:

	Australian	US	Developed (ex-US)
Size Premium	1.96%	2.28%	5.03%
Value Premium	5.76%	3.44%	5.23%
Profitability Premium	5.59%	4.35%	5.18%

\* **Source:** DFA Australia Limited

It is important to note the above premiums manifest themselves differently, that is:

- The value effect happens more consistently over time.
- The small effect happens less frequently with greater volatility.

With these premiums being so prevalent in both Australian and International shares in the past, it may be tempting to try to pick when these premiums will occur next. The difficulty is that these market premiums occur in a random manner and picking them consistently is almost impossible, particularly if we take into consideration transaction costs and tax.

We recommend long-term core holdings to these known risk factors that exist in the market - value, small and profitability.

**See Appendix C on page 28 Constructing a long term equity market forecast.**

# Diversification

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As mentioned earlier, the higher returns you target, the higher the risk of loss you need to accept.

Investors can reduce their potential for loss through diversification. The concept is simple: holding only one share in your portfolio makes you directly susceptible to its price changes. If its price plummets, so does your entire portfolio. Hold two shares instead and if one share falls sharply, the portfolio in total has fallen by only 50% of the drop. The key to diversification is the old adage, “don’t put all of your eggs in one basket”.

Diversification can be considered across the following lines:

- Defensive and growth assets.
- Global and domestic assets.
- Government and corporate debt.
- Large, value and small companies.
- Number of security holdings.

In the following table and charts, we have demonstrated the benefit of diversification, not only by higher expected returns but also via a reduction in the volatility of the returns.\*

The asset allocations we have used are based on our Growth Portfolio, using the following process:

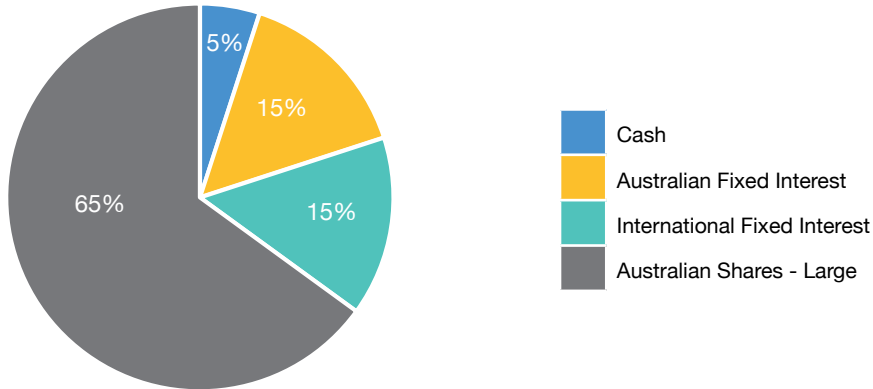
- **Step 1** - Defensive/Growth asset mix of 35%/65% (using a basic level of diversification within the Defensive Component between bonds and cash).
- **Step 2** - broader diversification incorporating global shares and property trusts.
- **Step 3** - asset class investing, incorporating an exposure to large, value and small companies in both domestic and global shares.

The volatility is measured by the standard deviation of the returns.

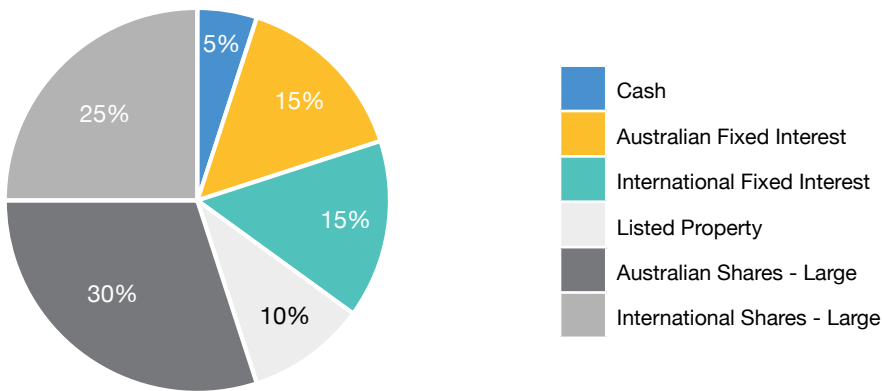
\* **Source:** Dimensional Fund Advisers Returns Program, data from 1994-2016.

Portfolio	Annualised Compound Return	Annualised Volatility
Basic Portfolio	8.31%	8.39%
Traditional Portfolio	7.75%	7.00%
Strategy First FP Portfolio	8.61%	7.05%

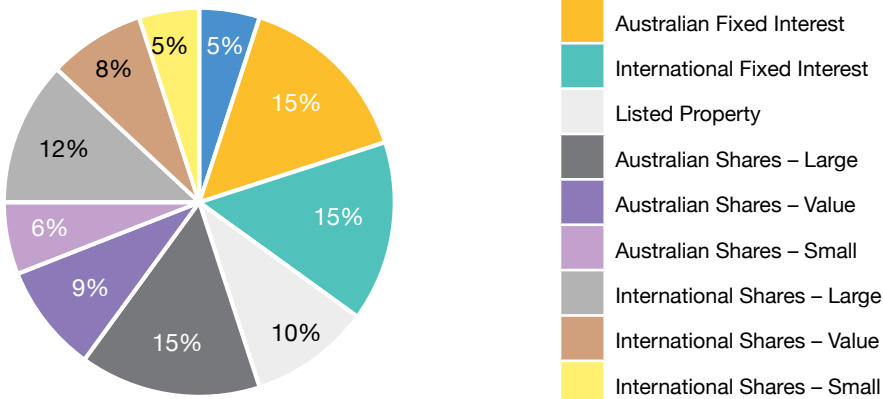
**Basic Portfolio**



**Traditional Portfolio**



**Strategy First Portfolio**



# Tax management

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A core component of Strategy First's philosophy is to maximise after-tax returns. We do this by selecting funds that have low turnover and focus on minimising tax liabilities.

We also achieve this via funds which operate under rules designed to increase the tax efficiency of the investment return. For example, stocks will generally be held for at least 12 months to qualify for the discounted capital gains tax concessions.

Where a capital gain is realised, the managers will generally sell sufficient stocks in the portfolio which are trading at a capital loss to offset the capital gains.

In terms of Australian shares, the managers will hold stocks for at least 45 days to be eligible for franking credits.

# Summary

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This document is to help our clients understand the Strategy First Investment Process. It is a process that is built from the bottom up, which means we start with the needs of our clients, including:

1. Protection of capital.
2. Long-term capital growth.
3. Generation of tax effective income.

As a result of these needs, we have developed an Investment Philosophy that delivers a consistent and repeatable process that focuses on:

- Asset Allocation and Asset Class Investing.
- Diversification as a tool to reduce risk and enhance returns.
- Using Fixed Interest to manage risk and provide liquidity.
- Investment Managers that strategically maintain an exposure to the risk premiums of 'market', 'value' and 'small' for shares.
- Minimising fees and transaction costs.
- After-tax returns.



# Appendices

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## Appendix A: How do we determine your asset allocation?

Returns = Income + Growth in income + Effect of changing valuation ratios [ $R = Y+G+V$ ]

**Y** is the current investment yield, which is known and requires no forecasting.

**G** is the annualised growth in income or earnings for the asset class, such as rent for property and dividends for shares. Fixed interest is zero by definition.

**V** is the valuation effect, which is the compound effect of an increase or decrease in PE ratios or yields on the value of the asset.

So for shares over a one year period:  $V = (\text{PE at end of period} / \text{PE now}) - 1$

For example, if PEs rose from 10 to 12 then:  $V = 12/10 - 1 = 0.2$  or a 20% increase.

For longer time periods [T] we use the compound growth rate:  $V = (\text{PE at end of period} / \text{PE now})^{(1/T)} - 1$

Using the same example over 10 years:  $V = (12/10)^{(1/10)} - 1 = 1.0183 - 1 = 1.83\%$  pa.

## Appendix B: Fixed income risk in your portfolio

With interest rates near historical lows, some investors may be anxious about a possible rate climb and its potential impact on their fixed income investments. Rising interest rates typically cause existing bonds to lose value. While investors might hold short-term instruments to manage this risk, an interest rate decline could spoil this strategy by forcing investors to reinvest in lower yields when their short-term instruments mature.

Rate movements in either direction affect portfolio returns. This is true in any market environment, regardless of the current rate level. The larger question is how to manage the risk. As you read the financial headlines and evaluate your current fixed income exposure, it may be helpful to consider these principles about fixed income investing:

### Interest rate movements are unpredictable

Academic research offers strong evidence that the bond market is efficient, and that bond prices and interest rates are not predictable over the short term.<sup>1</sup> This uncertainty is reflected in the often-contradictory interest rate forecasts offered by economists, analysts, and other market watchers.<sup>2</sup>

Even when the experts share similar views on the direction of the economy and credit markets, reality often proves them wrong. A Wall Street Journal forecasting survey offers an example.<sup>3</sup> Among fifty economic forecasters surveyed in 2009, forty-three expected the ten-year US Treasury note yield to move higher over the next year, with an average estimate of a 4.13% yield. Only two respondents predicted rates to fall below 3.00%. The ten-year Treasury yield slumped to 2.95% on June 30, 2010, and rates on thirty-year mortgages fell to their lowest level since Fannie Mae began tracking them in 1971.

Today's bond prices already reflect expectations for tomorrow's business conditions and inflation, and these expectations can change quickly in response to new information. This new information is unknowable. Investors who accept market efficiency should not be surprised when the credit markets foil the experts. If prices were easy to forecast, you should find a host of fixed income managers with market-beating returns. But most of them underperform their respective benchmarks over longer time periods.<sup>4</sup>

Since no one has a reliable method for determining whether interest rates will rise or fall in the near future, investors should avoid making fixed income decisions based on a forecast, media coverage, or their own hunches.

### **Pursuing higher expected returns requires more risk taking**

The strong link between risk and return appears in all properly functioning capital markets. When investing in stocks, bonds, or other assets, investors must accept more risk to pursue a higher potential return.

In the fixed income markets, earning a return above short-term government instruments is usually a function of assuming more term and credit risk. Term risk refers to a bond's maturity, and credit risk refers to the creditworthiness or default potential of the borrower. Bonds with longer maturities and lower credit quality are usually considered riskier and have offered higher yields and returns to compensate investors for higher risk.

On the term side, investors who commit their capital for longer periods of time are exposed to the amplified effects of changing interest rates. Bond prices and interest rates move in the opposite direction: When rates rise, the value of an existing bond declines; when rates fall, bond values rise. The market adjusts the price to match the yield available on a new instrument. The longer the bond's maturity, the greater the price adjustment for a particular interest rate change. A long-term bond is more exposed to rate changes than a short-term instrument, and usually (but not always) offers a higher yield to compensate investors for the extra risk. Also, lower-coupon bonds are more affected by interest rate changes than higher-coupon bonds. For example, if rates move 1%, a bond that pays 3% will experience a greater gain or loss than one paying 5%.

On the credit risk side, the government is considered the strongest borrower in the market, so it has a lower cost of capital relative to other issuers. The most creditworthy companies are considered relatively safe, but they must still offer a higher rate than the government to compensate investors for taking more default risk. The weaker a corporate borrower's financial condition, the more it must pay in yield to attract investors. Investors seeking higher returns on the credit spectrum must bear a higher risk of default.<sup>5</sup>

## Investment strategy should drive fixed income decisions

Investors may hold fixed income securities for a variety of reasons—for example, to reduce portfolio volatility, generate income, maintain liquidity, pursue higher returns, or meet a future funding obligation. Each objective may involve a different portfolio approach, or a combination of strategies to manage tradeoffs. For example, investors who want to maximize current income may not be strongly concerned with the effects of short-term price volatility. They may extend maturity or accept slightly lower credit quality when the market offers a yield premium for doing so. On the other hand, investors seeking long-term wealth appreciation may commit most of their portfolio to equities and keep their fixed income investments short term and high quality to buffer the volatility of stocks.

Regardless of your approach, you should know the difference between controlling risk and avoiding it. You cannot eliminate risk, but you can manage your exposure by diversifying across maturities, industries, countries, and currencies to reduce the impact of rates, inflation, currency fluctuations, and other risks. Your decision to take more term and default risk may depend on the current state of the yield curve and credit spread.

Many factors influence the direction of interest rates and performance in the bond markets, and these are too complex for anyone to reliably predict. Rather than placing your faith in the experts or reacting to economic news, manage your fixed income component from a portfolio perspective. Your strategy should reflect your overall investment goals, risk tolerance, and other personal financial considerations. This is a solid approach to managing your portfolio in an uncertain interest rate market.

### Endnotes

- <sup>1</sup> Eugene F. Fama, “The Information in the Term Structure,” *Journal of Financial Economics* 13, no. 4 (December 1984): 509-528. Also: Robert R. Bliss and Eugene F. Fama, “The Information in Long Maturity Forward Rates,” *American Economic Review* 77, no. 4 (September 1987): 680-692.
- <sup>2</sup> Mark Gongloff, “Two Treasury Forecasts: a Grand Canyon-Size Gap,” *Wall Street Journal*, April 10, 2010.
- <sup>3</sup> Wall Street Journal Forecasting Survey, [www.wsj.com](http://www.wsj.com), accessed July 7, 2010.
- <sup>4</sup> Christopher R. Blake, Edwin J. Elton, and Martin J. Gruber, “The Performance of Bond Mutual Funds,” *Journal of Business* 66, no. 3 (July 1993): 371-403. Also see Standard & Poor’s Indices Versus Active (SPIVA) Scorecard for the US, Canada, Australia, and Europe (<http://www.standardandpoors.com/indices/spiva/en/us>).
- <sup>5</sup> The yield curve plots the current relationship between rates and maturity, and the credit spread plots the risk-return relationship across the range of credit qualities. The curves offer a current snapshot of how markets are pricing term and credit exposure.

### Source: Dimensional Fund Advisors

Dimensional Fund Advisors is an investment advisor registered with the Securities and Exchange Commission. This material is provided for informational and educational purposes only. It should not be considered investment advice or an offer to buy or sell securities.

## Appendix C: Constructing a long term equity market forecast

### Earnings per share growth

In assessing likely earnings growth, we compare current earnings per share (EPS) to trend EPS, as well as the growth rate of trend EPS. When earnings are above trend, we expect slower than usual future growth; when they are below trend, we expect higher than usual growth.

### Trend Earnings Per Share growth

In the very long term, company earnings grow at about the same rate as GDP. If earnings grew faster than GDP, then profits as a share of GDP would increase until, eventually, profits would become 100% of GDP.

If earnings grow at about the same rate as GDP, EPS will grow more slowly than GDP because companies tend to increase the number of shares on issue over time and this dilutes EPS growth.

As an extreme example, consider a company that did a major acquisition financed by doubling the number of shares on issue. That company would have to more than double its profit in order to increase its EPS. A mere doubling of profit would be offset by the doubling of shares so that EPS would stay the same. Thus, the issuing of new shares dilutes growth.

We assume that trend EPS growth will be equal to GDP growth less a 2.5% per annum dilution caused by new share issuance. This largely reflects the banks' need to raise capital in order to meet Basel III requirements. Banks funding capital requirements via retention of earnings will still yield lower growth, as there is less capital available for reinvestment. The net impact is slightly lower EPS growth than usual.

### Likely GDP growth

When we assess likely GDP growth over the long term, we take into account a range of factors, such as expectations relating to Asian economies, current government and private debt levels, state of play of the current banking system and housing markets as well as demographic trends. We then assess the prognosis for the global economy.

### Adjusting for cyclical peaks and troughs

In the medium term, EPS moves with the economic cycle; sometimes growing faster than trend, sometimes growing more slowly. The end result is that, at times, earnings are higher than trend and, at other times, lower than trend.

When actual EPS moves ahead of trend, it normally falls back later and, when it falls behind trend, growth is normally a little faster going ahead. In other words, this is a standard mean-reverting process. This makes sense. It is how capitalism works.

When profits grow rapidly and Return On Equity (ROE) soars, we see more investment, more competition, more substitution and, eventually, over-investment – until such time as profits fall to more normal levels. Similarly, if profitability is at low levels, we see underinvestment and reduced competition until such time as profits again rise. If it is not overinvestment, it is higher wages that eat away at profitability, or higher taxes, or the impact of depreciating currencies of offshore competitors. We don't need to know what the cause may be, just that it is likely that something will bring margins back to more normal levels.

### **How much do we have to pay for earnings?**

A good way to think about the PE ratio is to ask how much do we have to pay for a dollar of earnings.

For Australian equities, for example, the variance in the PE ratio depends on a raft of different factors including inflation, interest rates and market sentiment. In the past few years, the Australian equity market PE has varied from almost 20 in 2007 to below 10 in early 2009 while over the longer-term, the range has been even larger. Much of that range is explained by inflation. When inflation rises, PEs tend to fall and (for the most part) when inflation is under 4%, PEs are generally in the 14 to 18 range, apart from brief, sentiment-inspired breaks above and below that range. We continue to believe that a return to high inflation is unlikely both in Australia and in much of the developed world and, accordingly, that PEs are likely to remain in the 14 to 18 range.

We compare the current PE ratio to the expected PE ratio in 10 years' time to determine if we are paying more or less for earnings now than in the future. Irrespective of the rate of EPS growth (the "E" in the "PE"), PE ratios reflect the willingness of investors to pay for a dollar of EPS.

**Source:** Farrelly's June 2013 Handbook

# Strategyfirst

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**Strategy First Financial Planning Pty Ltd**

**AFSL:** 290771

**ABN:** 69 114 540 528

Grd Floor, Front Suite 55  
117 Old Pittwater Road, Brookvale NSW 2100  
PO Box 7418 Warringah Mall NSW 2100

**Tel:** 02 9091 0080

**Fax:** 02 9939 4730

**Email:** [contact@strategyfirst.com.au](mailto:contact@strategyfirst.com.au)

**Website:** [strategyfirst.com.au](http://strategyfirst.com.au)

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