GUIDED INVESTOR
INVEST | GROW | REST

PORTFOLIO METHODOLOGY

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Contents

Introduction 3

The Relationship between Risk & Return 4

What is Investment Risk? 4

Growth and Defensive Asset Classes 4

What are the types of risk? 5

How do you cope with Risk? 5

What are the different asset classes? 6

Cash 6

Fixed Interest 6

Property 7

Shares 7

Summary 8

Investment Committee 10

The CORE + SATELLITE approach to investing 14

"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." - *Paul Samuelson*

Introduction

Our portfolios are a series of diversified investments that utilise both passive and active investment framework to offer a broad market exposure with the potential to outperform, whether that be protecting capital in down markets or gaining more alpha in a rising market.

Key benefits of our portfolios include:

- Actively managed by our investment committee with a structured and robust investment process;
- Broad diversification across holdings, sectors, asset classes, asset structures and managers;
- High levels of liquidity at all times;
- A mixture of investment styles and managers to ensure a level of anti-correlation in your portfolio;
- Ongoing monitoring of portfolio asset allocation and constituents;
- Portfolios are adjusted according to the macro-economic environment;
- Adherence to long-term strategic asset allocation settings within a reasonable tolerance range; and
- Differing portfolios for accumulators seeking total return, retirees seeking income and ethical investors seeking to do good with their money.

This document details:

- An overview of investment risk and explanation of the different asset classes;
- An overview of our investment committee processes, rules and governance;
- The creation of diversified model portfolios using the core + satellite approach to investing; and
- The objectives, time horizons and investment universes of our portfolios.

Portfolio construction is a key component in wealth creation and wealth protection. Therefore, it is important you understand how your portfolio is invested and are comfortable with our investment approach. By the end of this document, you should have a clearer understanding of both.

The Relationship between Risk & Return

It is important to understand the risks associated with the investments that are chosen as part of an investment portfolio.

Risk and return are closely related. In general, the higher the degree of risk associated with an investment, the higher the return required by investors if they are to accept the risk. **There is no such thing as an investment with a low risk, high return!**

What is Investment Risk?

Investment risk is the chance that an investment's actual return will be different than expected. Investing is not risk free - every investment carries a degree of risk! When making an investment you aim to make a return. The risk of making money is the chance that you could lose money, or not make as much as expected.

Most investors expect that the higher the risks they adopt, the higher returns will be achieved. In general, cash is considered a low-risk investment because investment returns are relatively stable. However, cash is not risk-free either. Over the medium to long term you run the risk that your cash may not generate a sufficient return to meet your objectives. In a very low interest rate environment, there is the risk that inflation will erode the value of your capital.

By contrast, shares and property are considered to be higher risk because investment returns frequently move up and down and investors are less certain of the return they will receive.

Risk and uncertainty cannot be eliminated. However, they can be managed within your portfolio. The key is to determine the appropriate level of risk for you. Taking on greater uncertainty and short-term risk may be necessary for you to gain the long-term returns needed to achieve your lifestyle goals and objectives. To smooth out the volatility of market value returns on higher risk investments, a longer time horizon is recommended.

Growth and Defensive Asset Classes

Broadly speaking, we classify asset classes into two broad categories; Defensive assets and Growth assets.

Defensive assets are less volatile than Growth assets and in general their primary focus is on preserving your capital while generating a relatively small income return. Defensive assets are typically considered to be cash, bonds and deposits.

Whilst defensive assets focus on capital preservation, they are rarely capital guaranteed, so whilst they may be less volatile in nature, gains and losses of capital can still occur.

Growth assets are more aggressive and purchased with the intention to grow your wealth. This includes asset classes such as Australian shares, international shares, property, infrastructure and alternatives. When you purchase a growth asset you should expect that there will be fluctuations in the capital value of your investment.

All portfolios are made up of a blend of Defensive and Growth assets. The longer your time horizon and the higher your appetite to risk, the more Growth assets you may hold in your portfolio.

What are the types of risk?

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

- Investment market risk is the possibility that all investments in a market sector, (eg. shares) will be affected by an event.
- Investment specific risk is the possibility that a particular investment may underperform the market or its competitors.
- Inflation risk is the possibility that your investment return is below the inflation rate, which reduces the spending power of your money.
- Credit risk is the potential failure of a debtor to make payments on amounts they have borrowed.
- Interest rate risk is the possibility that your investment will be adversely impacted by a fall or rise in interest rates.
- Legislative risk is the possibility that a change in legislation will impact the appropriateness of certain investments for you.
- Liquidity risk relates to the ease with which you can sell or liquidate your investments. Some investments impose exit fees or have limitations on your withdrawals. Other investments may be difficult to sell due to a lack of buyers.
- Currency risk is possibility that an investment's value will be affected by changes in exchange rates.
- Longevity risk is the possibility you will live longer than your invested capital can support you.

How do you cope with Risk?

In considering an investment strategy, you need to understand the risks that you may be exposed to and how they will impact your personal situation. Assessing risk and potential investment returns should be in the context of your goals and the time that you have to achieve your objectives.

It is important to recognise the high level of volatility associated with the high growth asset classes. Although they all outperform cash over the long term, growth investors significantly underperformed cash over shorter periods in some years (the Global Financial Crisis in the 2007/2008 years and the Coronavirus in 2020 are examples of this). This highlights the importance of treating growth asset classes as long-term investments. Periods of at least 5 years are needed to accommodate growth asset classes.

There are benefits of both defensive asset classes and growth asset classes. Growth asset classes can assist you to receive a better than average cash return over the long-term and, can help guard against inflation. Couple this with an exposure to defensive assets and you can create a portfolio that benefits from market fluctuations when times are good but are less likely to savage your portfolios in negative markets.

Everyone has different investment objectives and investment timeframes. However, for most medium to long-term investors, there needs to be some risk taking if objectives are to be met. By learning more about the different asset classes, you will gain a better understanding of how to set, manage and cope with the risks in your portfolio.

What are the different asset classes?

Cash

Cash represents funds held at call. The main advantage of cash is its liquidity. It can be accessed at very short notice and does not fluctuate in value. Cash offers the lowest expected long term returns because it is the safest investment over a short time period. The main risk with cash is that the returns derived rarely exceed inflation, especially taking tax into account.

Fixed Interest

Fixed interest investments (eg bonds, debentures and term deposits) involve the lending of funds to others in exchange for interest. The returns on fixed interest investments are generally higher than that of cash. On the downside, funds are generally unavailable for a specified term. Generally, the longer term of the fixed interest investment, the higher the return. This higher return compensates investors for the risk that they might need the funds when they do not have access to them.

A common misconception is that fixed interest investments do not fluctuate in value. Many fixed interest investments do in fact fluctuate in value, yet people do not realise that losses can occur. An existing fixed interest investment might fall in value for example if official interest rates increase. This is because the interest rate on an existing investment is less desirable compared to new investments that are offered at the new, higher interest rate.

Whilst Fixed Interest and Cash based investment income returns vary and fluctuate with interest rate markets, they generally do not provide a rising income stream over time.

Property

Property investing involves the purchase of an asset (typically land and buildings although cars, artwork and collectibles are also examples of property) and then leasing or renting that asset out.

The advantage of this approach is that returns are generally higher than for cash or fixed interest and you are investing in a tangible asset that you can see and touch. The downside is that there may be prolonged periods where you cannot rent or lease your property out, your property is exposed to the prospect of damage and there are often many factors outside of your control such as nearby developments which increase the supply of property in your area or reduce the desirability of your location.

Whilst property is a sought-after asset class due to its tangible nature, property investments can often be illiquid, limiting the ability for you to access your capital in short time frames. Property assets are also often hard to divide (i.e. you often can't sell part of a property) and care needs to be taken in comparing some property investments to other asset classes, as the capital expenses and costs are often not recorded in net valuations.

The main benefit of property investments is there are often increases in the value of the property, particularly over longer periods (in excess of 5 years), although losses can occur, particularly over shorter periods. Many property assets provide a rising income stream over time through increased rents.

Shares

Shares are an intangible asset which represent a share in the ownership of a business, giving you access to certain rights. Typically, these shares are listed on the stock exchange although there are a number of unlisted shares such as those in a private company.

As you would expect, shares are one of the 'riskiest' asset classes because their price fluctuates the most. However, shares offer the highest expected returns over longer periods and therefore can be one of the most appropriate asset classes when taking into consideration inflation and longevity risks.

Investing in international shares offers an added aspect of risk as you may be exposed to fluctuating exchange rates on top of fluctuating share prices. Not only that, but it can also often be difficult to predict market movements in a country in which you are not exposed firsthand to market conditions.

Australian shares offer the added benefit of dividend imputation. This is a tax credit system where investors receive a credit to the extent that Australian company tax has been paid on the profits of the business in addition to the cash dividend payment. These are known as franking credits.

Some shares are considered relatively safer than others, depending upon the industry and activities of the business as well as its size, balance sheet strength, management quality and strategy. Blue Chip shares are generally larger companies with high cash flow. They are considered relatively lower risk than smaller companies with plans for high growth in the future.

The main benefit of quality share investments is that over long periods (in excess of 5 years) there can be increases on capital value of the shares. Many share-based investments can provide a rising income stream over time through increased dividends payments.

Summary

Each asset class has its own unique set of pros and cons and will perform differently in different market cycles. Given the variability, we recommend all investors have exposure to all asset classes. The amount of exposure to each asset class is going to depend on your investment timeframe and tolerance for risk.

Generally, investment portfolios are not capital guaranteed, and from time-to-time losses will be incurred. On the chart on the following page you will see how the different asset classes have performed over time.

1993 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18 19 20 21 22 2023

KEATING HOWARD RUDD GILLARD RUDD ABBOTT TURNBULL MORRISON ALBANESE — Australian Prime Ministers

CLINTON BUSH OBAMA TRUMP BIDEN — U.S. Presidents

$200K

$100K

$50K

$10K

LOGARITHMIC SCALE

- Australia's population 17,635,000
- Netscape Navigator launched – the internet goes public
- Asian currency crisis
- Republic referendum
- ASX float
- Terrorist attack in U.S.
- GST introduced
- Dot.com bubble burst
- Bali bombing
- Second Iraq war
- Boxing Day tsunami
- U.S. subprime crisis
- RBA cuts interest rate 6 times from 7.25% to 3.00%
- First stimulus package
- Second stimulus package
- GFC
- Lehman Brothers collapse
- Gulf of Mexico oil spill
- Facebook float
- Tsunami hits Japan
- Vanguard Australia's 20th anniversary
- Vanguard's 40th anniversary
- Brexit
- Vanguard Personal Investor launch
- COVID-19
- Australia's population 25,770,000
- War in Ukraine
- Vanguard Super launch

RECESSION[9]

Growth of $10,000 with no acquisition costs or taxes and all income reinvested.

U.S. Shares **$176,155** 10.0% p.a.

Australian Shares **$138,778** 9.2% p.a.

International Shares **$87,584** 7.5% p.a.

Australian Listed Property **$83,326** 7.3% p.a.

Australian Bonds **$49,394** 5.5% p.a.

Cash **$34,737** 4.2% p.a.

CPI **$21,979** 2.7% p.a.

Returns

% per annum

As at 30 June 2023[1]

	1 Year	5 Years	10 Years	20 Years	30 Years
U.S. Shares[2]	23.5	14.7	16.5	10.1	10.0
Australian Shares[3]	14.8	7.3	8.8	9.0	9.2
International Shares[4]	22.6	11.5	13.2	8.4	7.5
Australian Listed Property[5]	8.1	3.5	7.7	5.2	7.3
Australian Bonds[6]	1.2	0.5	2.4	4.2	5.5
Cash[7]	2.9	1.2	1.7	3.5	4.2
CPI[8]	6.0	3.4	2.7	2.7	2.7

U.S. dollar: 1.25 1.00 0.75

Inflation[10]: 15% 10 5 0

Interest rate[11]: 20% 15 10 5 0

← Average weekly earnings $518

← Average weekly earnings $648

← Average weekly earnings $779

← Average weekly earnings $994

← Average weekly earnings $1,250

← Average weekly earnings $1,483

Average weekly earnings $1,712 →

Average weekly earnings $1,875 →

Source: Vanguard Index Chart (https://www.vanguard.com.au/adviser/en/index-chart)

Investment Philosophy

Asset allocation is going to be the primary driver behind the returns in your portfolio. The Brinson, Hood and Beebower study, Determinants of Portfolio Performance (1986, 1991)[1], concludes that asset allocation accounts for 94% of the variation in returns in a portfolio, leaving market timing and security selection to account for only 6%.

The asset allocation in our portfolios is driven by two primary considerations; strategic asset allocation (SAA) determined by your risk profile and dynamic asset allocation (DAA) based on our current economic view.

SAA is constructed on the basis of long term asset class forecasts with targets to maintain a set combination of asset classes. Our portfolios will maintain a growth to defensive split within 10% of your SAA determined by your risk profile.

We will however, change weightings of individual asset classes based on current economic events. This is DAA which is an active strategy that adjusts the allocation of assets based on medium term views.

Once we have determined an appropriate asset allocation, we then select the holdings using the core + satellite approach to investing. This method incorporates both passive and active management to provide a high level of diversification with the ability to generate alpha. The core + satellite approach is detailed further in this document.

We are not stock pickers. However, we utilise some professional fund managers in the active component of our portfolio who are. They have the resources and expertise to do this better than we could and therefore we employ their specific skill set in our portfolios.

We invest in both listed and unlisted investment structures. Where appropriate we also use a mix of open and close ended funds. Investment structures we use include:

- Exchange-Traded Funds (ETFs);
- Listed Investment Companies (LICs);
- Listed Investment Trusts (LITs);
- Managed Funds; and
- mFunds.

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[1] *Determinants of Portfolio Performance*, by Gary P. Brinson, CFA, Randolph Hood, and Gilbert L. Beebower. Financial Analysts Journal, 1986 & *Determinants of Portfolio Performance II: An Update*, by Gary P. Brinson, CFA, Randolph Hood, and Gilbert L. Beebower. Financial Analysts Journal/May-June 1991

Investment Process

We start with our macro-economic outlook to determine asset allocation and filter down through individual assets using our due diligence process to arrive at our model portfolios.

Model Portfolios

We offer three categories of model portfolios. They are as follows:

- **Accumulator Portfolios** – typically suited to an accumulator, these portfolios focus on the total return outcome. We take riskier positions in this portfolio in an attempt to generate a better return over the medium to long term.

- **Retirement Portfolios** – typically suited to a retiree, these portfolios place emphasis on generating income. Where possible, we try to minimise the risk in this portfolio for capital preservation.

- **Ethical Portfolios** – these portfolios are suited to those clients who want to invest ethically. This involves avoiding harmful assets using an environment, social and governance (ESG) screening while also incorporating impact investing which actively seeks out those investments which provide a beneficial social or environmental impact alongside a financial return. These portfolios prioritise the ethics of your investment over the return and cost.

Each style of investing contains five different models to suit your risk tolerance. The models are:

Growth 80 – 100

Invests between 80 - 100% into growth assets, leaving between 0 - 20% in defensive assets.

This suits investors with a minimum ten-year timeframe or those who are willing to accept very high levels of investment value volatility to maximise potential investment performance. The 80% - 100% exposure to growth assets means that capital stability is not a consideration.

Growth 60 – 80

Invests between 60 - 80% into growth assets, leaving between 20 - 40% in defensive assets.

This suits investors with a minimum seven-year timeframe or those who are willing to accept higher levels of investment value volatility in return for higher potential investment performance. Some capital stability is still desired, but the primary concern is a higher return, hence the 60% - 80% exposure to growth assets.

Growth 40 – 60

Invests between 40 - 60% into growth assets, leaving between 40 - 60% in defensive assets.

This suits investors with a minimum five-year timeframe or those who seek both income and capital growth. This portfolio suits investors who desire a modest level of capital stability but are willing to accept moderate investment volatility in return for commensurate potential investment performance, hence the approximately equal weighting to growth and defensive assets.

Growth 20 – 40

Invests between 20 – 40% into growth assets, leaving between 60 – 80% in defensive assets.

This suits investors with a minimum three-year timeframe or those who primarily seek income with some potential for capital growth. This portfolio also suits investors seeking a low level of investment volatility, and therefore willing to accept lower potential investment performance, hence the 60% - 80% exposure to income assets.

Growth 0 – 20

Invests between 0 – 20% into growth assets, leaving between 80 – 100% in defensive assets.

This suits investors with a minimum two-year timeframe or those that seek a portfolio comprising mainly of interest-bearing assets. This portfolio suits investors who give a high priority to the preservation of capital and are therefore willing to accept lower potential investment performance, hence the 80% - 100% exposure to defensive assets. Please note, with this portfolio you are exposed to high levels of interest rate and inflation risk.

Risk Profiling

In order to help you determine which model portfolio best suits your needs we will run you through a risk profiling process. This will involve you completing a series of simple questions to determine your level of risk aversion.

Once your risk profile is complete, we overlap your answers to different risk profiles to determine which profile is most appropriate for you. If we believe the outcome is not suitable for you given your age, investment time-frame, history, etc. we will suggest adjustments where needed.

It is important to remember that your risk profile is not set forever. As time moves on and your circumstances change, we need to change your risk profile in-line with this.

Notifying you of changes to your portfolio

You will be notified of any change made to your portfolio via a Record of Advice (RoA). The RoA will be sent to you via email and will contain specific information as to what is changing and why. If you ever have any additional questions regarding an RoA, you can simply respond to the email or give us a call.

The CORE + SATELLITE approach to investing

The core + satellite concept is a portfolio philosophy that combines both passive and active investment framework.

In essence, core + satellite is a common sense investment approach which combines the benefits of index funds (lower cost, broader diversification, and lower volatility) with actively managed funds or other direct investments which offer potential for outperformance.

Core + Satellite brings greater discipline and stability to an investment portfolio by:

- Reducing reliance on 'picking winners' or chasing fund manager returns
- Providing greater portfolio diversification
- Potentially improving after-tax returns by taking maximum advantage of capital gains discounts
- Reducing overall fund management and transaction costs

The importance of asset allocation in the core + satellite approach

Core + satellite is an approach that recognises the fundamental importance of asset allocation for long-term portfolio results.

Market timing and security selection may provide some short-term gains at times, however, over the long-term research studies have proven that asset allocation is far more important. Research in both Australia and overseas has consistently concluded that asset allocation is by far the greatest determinant of portfolio outcomes. Security selection and market timing only have minor influence, particularly over the long term.

Combining the benefits of index and active management

The core + satellite concept recognises the fundamental differences between index and active fund management and combines the best aspects of both approaches.

The index approach

The primary aim for an index fund is to track market performance (beta) at a low cost to an investor.

Index funds achieve this by holding a broad spread of securities within an index with an aim to track the overall performance of the index. An index fund does not require the same level of research and security analysis that active management requires (at substantial cost) and will tend to buy and hold these securities with very low

levels of portfolio turnover. Lower portfolio turnover results in lower fees to the investor and generally more favourable tax outcomes.

The active approach

The primary aim of an active fund is to seek outperformance of the index (alpha) through security selection and/ or market timing.

In contrast to index funds, active funds often hold a smaller number of securities. Active funds require more initial and ongoing analysis and rely more heavily on the skill of individual portfolio managers to pick the right stocks. Active managers come with varying styles and themes from thematic to top down, value and growth, large or small cap biases etc. Active funds as the name suggests, have a tendency to transact more often, resulting in higher portfolio turnover, which may lead to higher realised tax gains and higher costs to the investor in pursuit of expected returns.

The core + satellite approach

Core + satellite delivers the best of both worlds. Using index funds as the 'core' of your portfolio, indexing gives an investor a low cost, more tax effective and diversified portfolio, while carefully selected lowly correlated actively managed 'satellites' can complement the core by giving potential to outperform the market.