

The Perpetual Times

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MONEY MAGAZINE FUND MANAGER OF THE YEAR

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Seeing the forest for the trees

Richard Brandweiner, Group Executive Income & Multi Sector

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How much of your clients' total risk and return comes from asset allocation compared to stock selection?

Asset allocation vs stock selection?

- Asset allocation **accounts for over 90%** of the variance on performance – Brinson et al (1986)
- BUT this refers to having any exposure to the market (watch those term deposits)
- The importance of asset allocation decisions has been shown to be **from equal to twice** as important as stock selection – Ibbotson et al (2010)

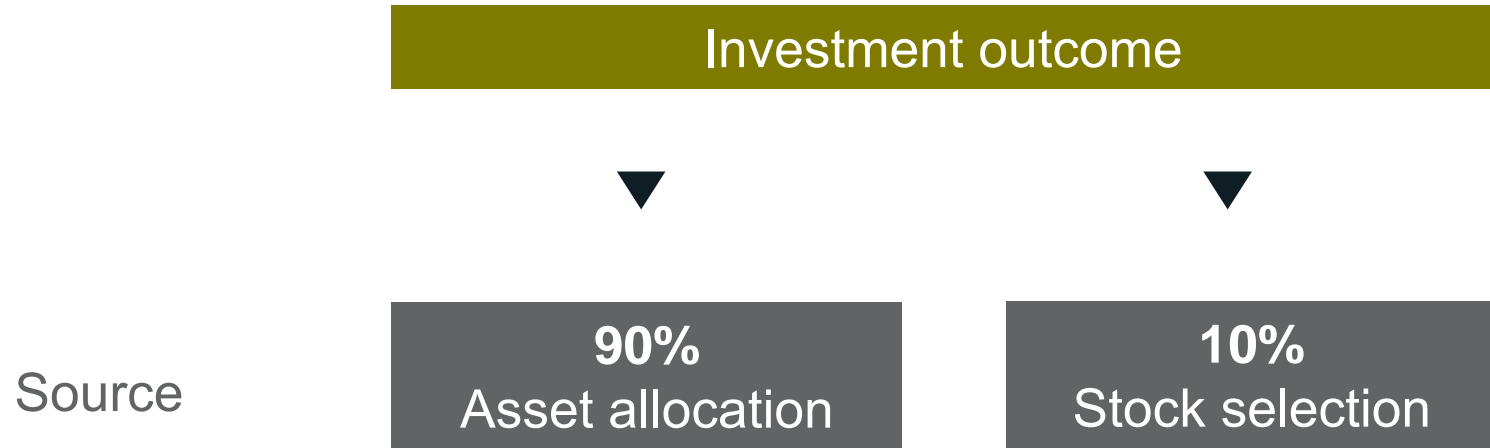
Here's another way to look at it...

40% Strategic allocation to Australian Shares	Absolute returns	Contribution to portfolio
10 year returns	8.5%	3.4%
Vary strategic allocation by +/- 10%		+/- 0.8%
Difference between 1st and 3rd quartile manager	1.4%	0.6%
Relative importance of strategic decision		138.0%

20% Strategic Allocation to Overseas Shares (\$A)	Absolute Returns	Contribution to Portfolio
10 year returns	-3.6%	-0.7%
Vary strategic allocation by +/- 10%		+/- 0.6%
Difference between 1st and 3rd quartile manager	2.2%	0.4%
Relative importance of strategic decision		140.0%

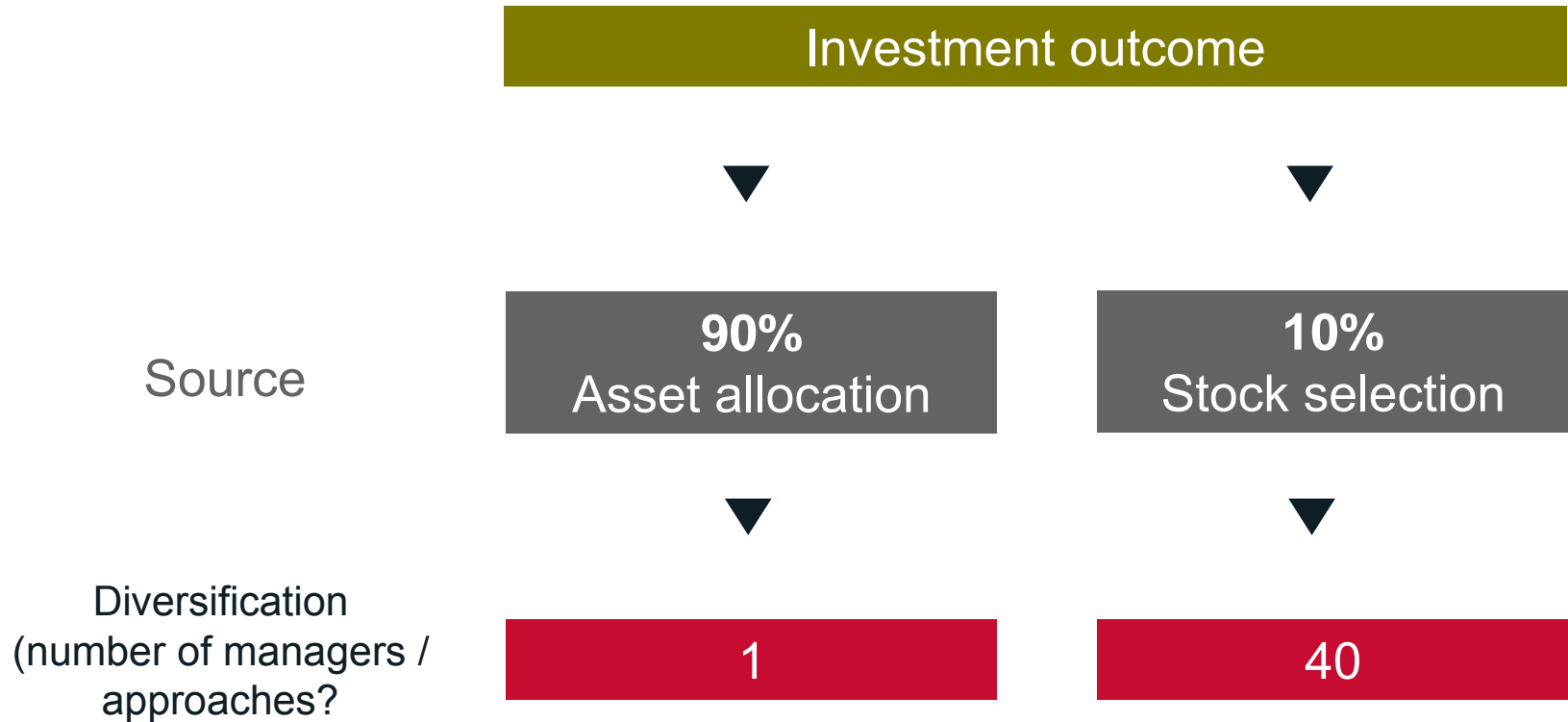
The inside story ...

Have we got the balance right?



The inside story ...

Have we got the balance right?



The inside story ...


Manager diversification – sufficient to eliminate risk?

Not enough to avoid extreme outcomes

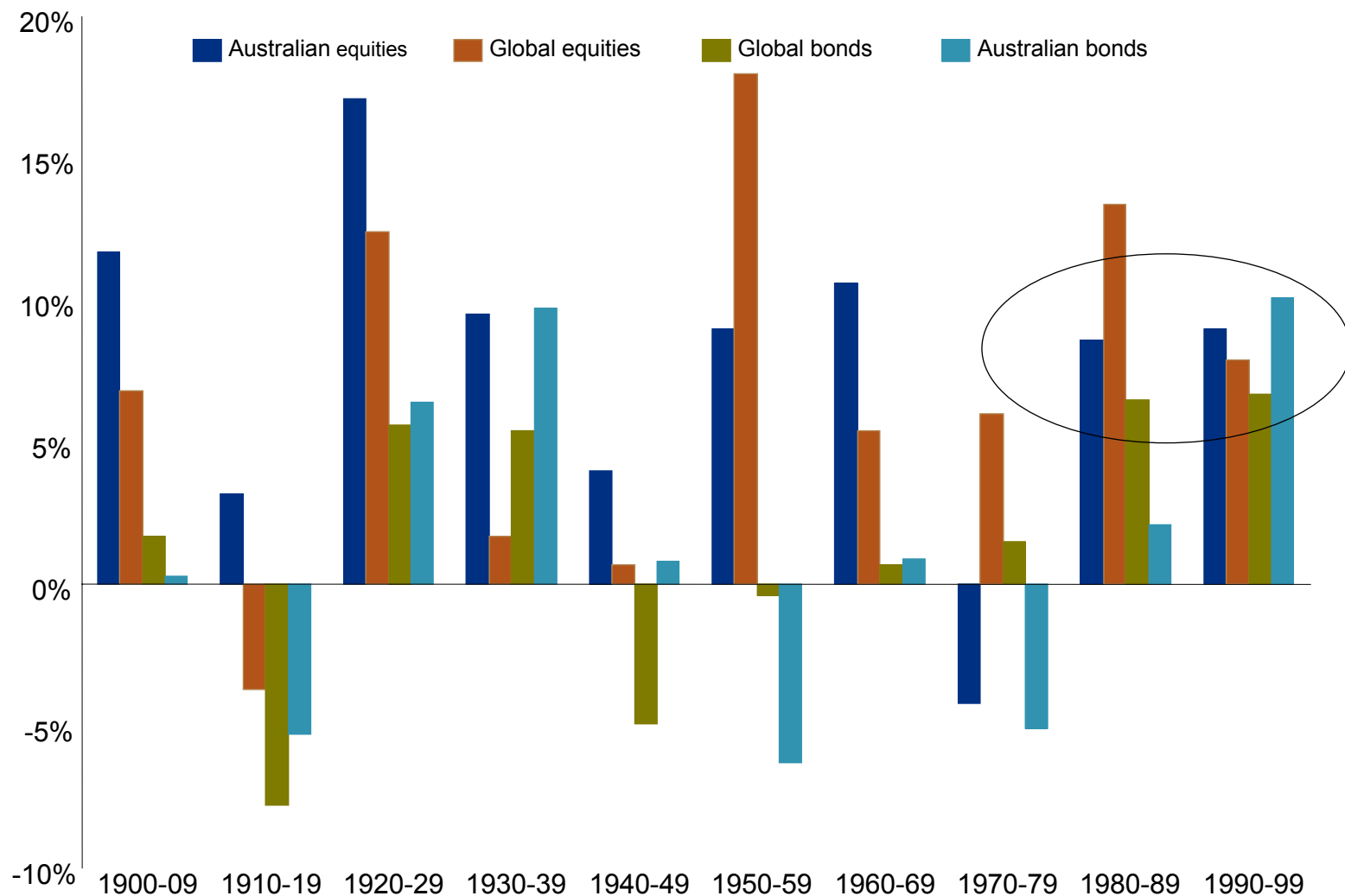
Fund	5 year return ending March 2009	5 year risk ending March 2009	Return quartile	Risk quartile
Manager A 39 managers	1.9% p.a (33/43)	10.0% p.a (5/43)	4 th	1 st
Manager B 32 managers	1.3% p.a (40/43)	11.2% p.a (2/43)	4 th	1 st
Manager C 50 managers	1.9% p.a (33/43)	9.8% p.a (12/43)	4 th	2 nd
Perpetual Balanced Growth Fund	3.5% p.a (7/43)	8.7% p.a (33/43)	1 st	4 th
Balanced Growth Index	2.4% p.a	9.2% p.a	-	-

Source: Mercer, as at 31 March 2009.

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Two decades of consistent returns across asset classes



Source: ABN Amro Global Investment Returns Yearbook, as at 31 December 1999.


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What will change going forward?

- Availability of new types of investments


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What will change going forward?

- Availability of new types of investments
- The secular macro-economic outlook

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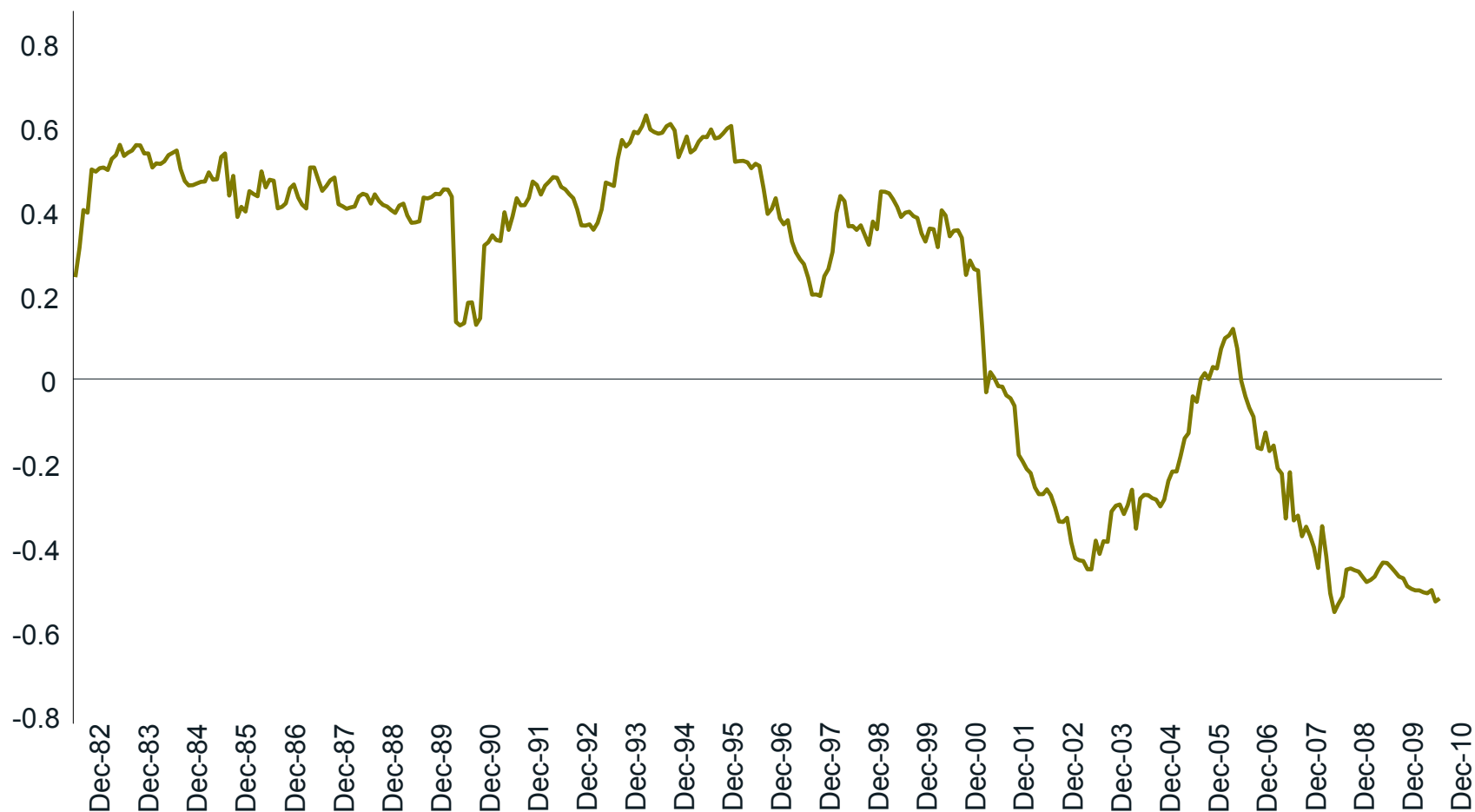
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What will change going forward?

- Availability of new types of investments
- The secular macro-economic outlook
- Relationships between assets and pricing variables


Correlations between equities and bonds have shifted

Correlation of monthly returns - rolling three year periods - Australian equities and bonds



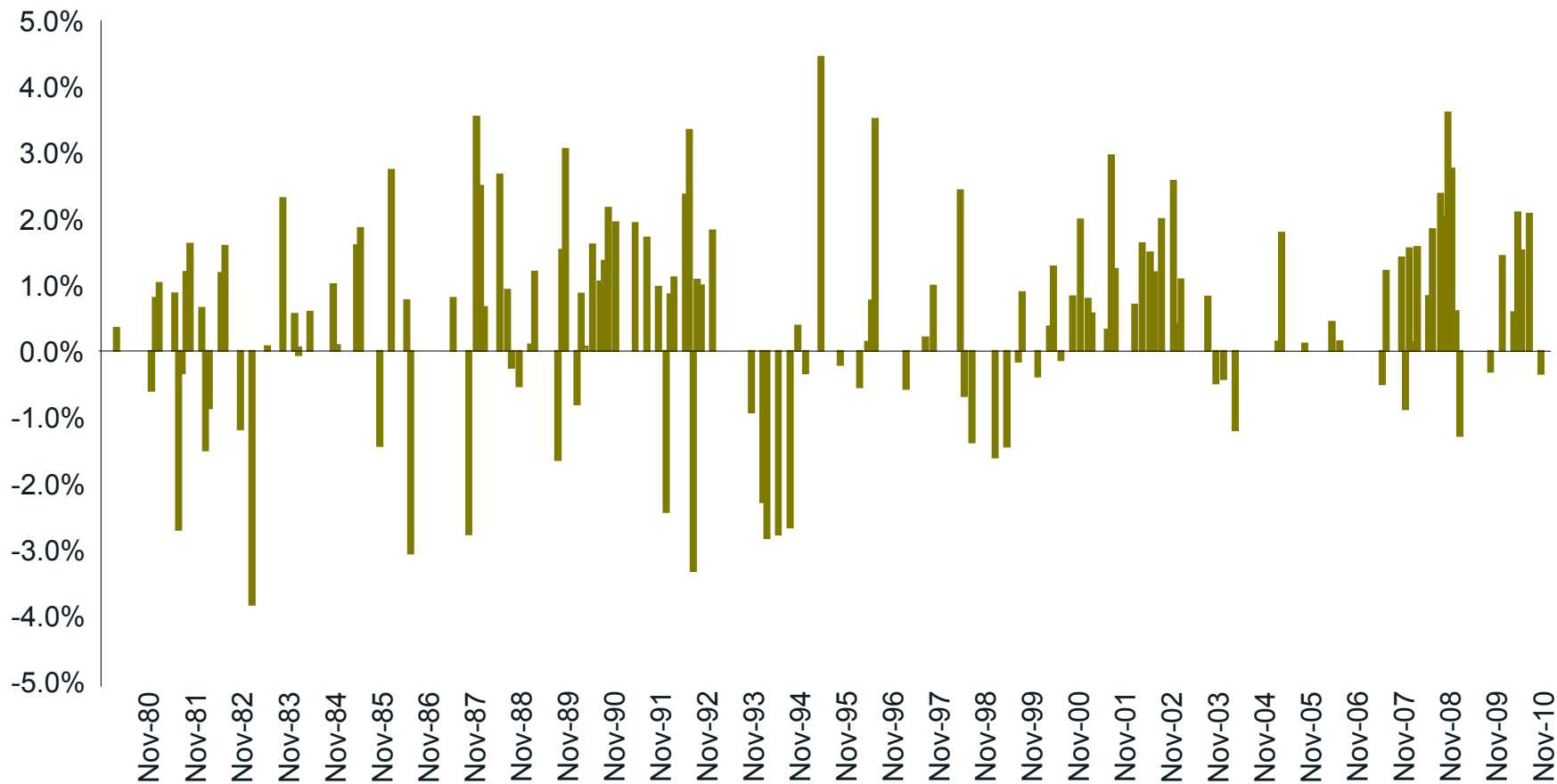
Source: Datastream, FactSet, as at 31 December 2010.

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This is helping diversification

Australian bond performance in down months for Australian equities



Source: Datastream, FactSet, as at 31 January 2011.

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What will change going forward?

- Availability of new types of investments
- The secular macro-economic outlook
- Relationships between assets and pricing variables

The role of asset allocation is now even more important

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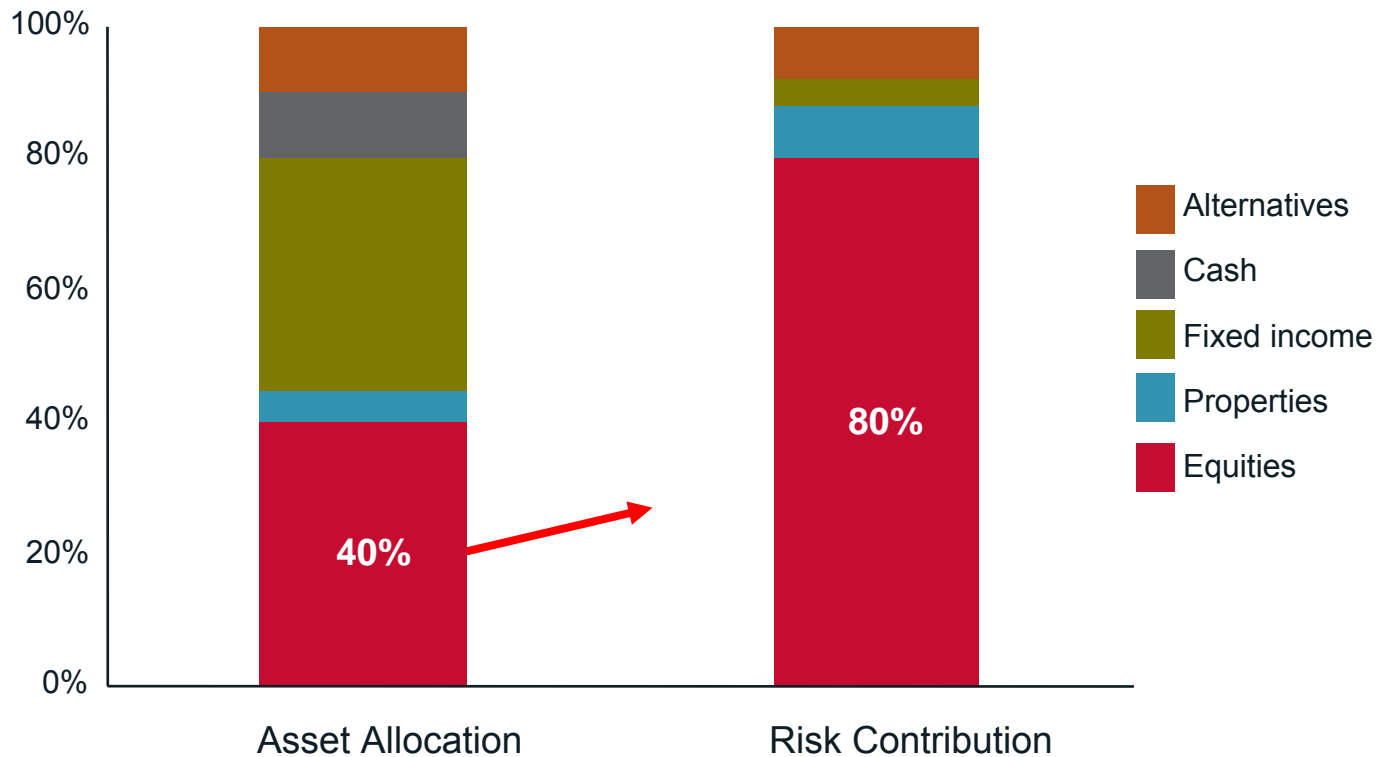
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5 questions to ask your researcher

1. How will we deal with the fact that share market volatility dominates all risk in the portfolio?
2. Generic asset class categories have lost a lot of meaning in a globalised world. What are the real drivers of risk and return in the portfolio?
3. How do we manage 'price risk'?
4. How do we cater for increasing life expectancies when clients risk tolerances have decreased?
5. Back to the beginning: are we diversifying the wrong risks?

1. Problem: share market volatility dominates balanced fund returns

Risk budget analysis shows that shares contribute disproportionately to risk and returns



The asset allocation consists of Australian Equities (20%), International Equities (20%), Listed Properties, Australian Fixed Income (17.5%), Global Fixed Income (17.5%), Cash (10%) and Alternatives (5% GAF and 5% DAF). Source: Perpetual, Towers Watson, as at 31 December 2010.

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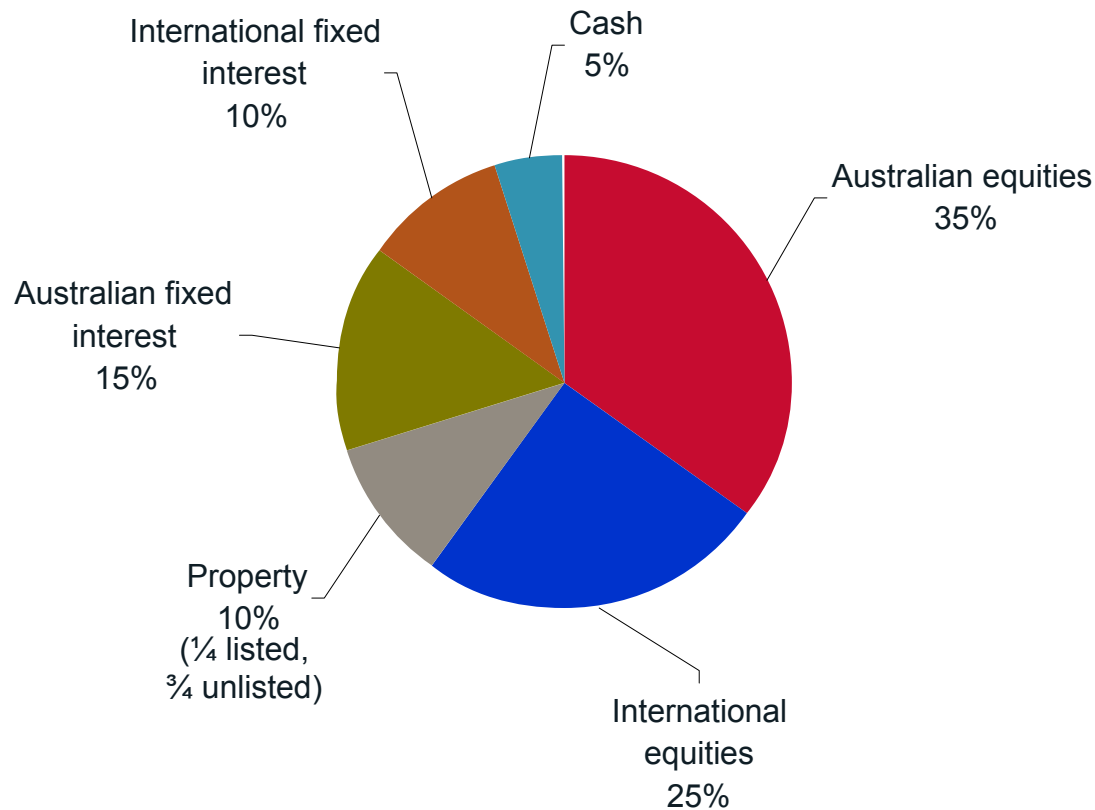
Solution:

- The right exposures in your underlying fund managers can actually reduce absolute risk
 - Quality and value risk premia that performs well in down markets

- Look for other sources of diversification
 - Alternatives such as
 - Hedge funds
 - Infrastructure
 - High risk credit
 - Long weighted lives
 - Sub-investment grade
 - Hybrid / subordinated debt

2. Problem: Asset classes don't mean too much

- Overseas shares vs Australian shares
- Overseas fixed interest vs Australian fixed interest



Source: Perpetual, as at 31 January 2011.

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Solution: Think about the underlying drivers of return in asset allocation

- What is your clients' exposure to underlying risk premiums?
 - equity risk premium
 - small cap risk premium
 - value risk premium
 - emerging markets risk premium
 - credit risk premium
 - interest rate risk premium
 - illiquidity risk premium
 - currency exposure
- These are far more important considerations than, say, how much global fixed interest vs domestic fixed interest.


3. Problem: Price risk does matter, even over the longer term

US equities – long term returns, valuations and earnings growth

10 yrs ended	Real return*	Met objective of CPI + 5%?	Starting PE	Ending PE	GDP growth (real)	Average real earnings growth (pa)	Inflation
30/06/1920	-2.9%	✗	13.0	5.0		0.4%	7.8%
30/06/1930	18.5%	✓	5.0	21.9	2.8%	-2.2%	-2.2%
30/06/1940	0.1%	✗	21.9	12.8	2.7%	-0.3%	-1.7%
30/06/1950	6.5%	✓	12.8	11.6	5.6%	2.0%	5.4%
30/06/1960	15.4%	✓	11.6	17.8	3.7%	4.5%	2.2%
30/06/1970	3.0%	✗	17.8	13.8	4.2%	2.6%	2.7%
30/06/1980	1.2%	✗	13.8	8.5	3.1%	1.5%	7.8%
30/06/1990	11.7%	✓	8.5	17.8	3.4%	-0.3%	4.6%
30/06/2000	14.5%	✓	17.8	42.8	3.4%	2.5%	2.9%
30/06/2010	-3.8%	✗	42.8	19.8	1.6%	2.4%	2.3%

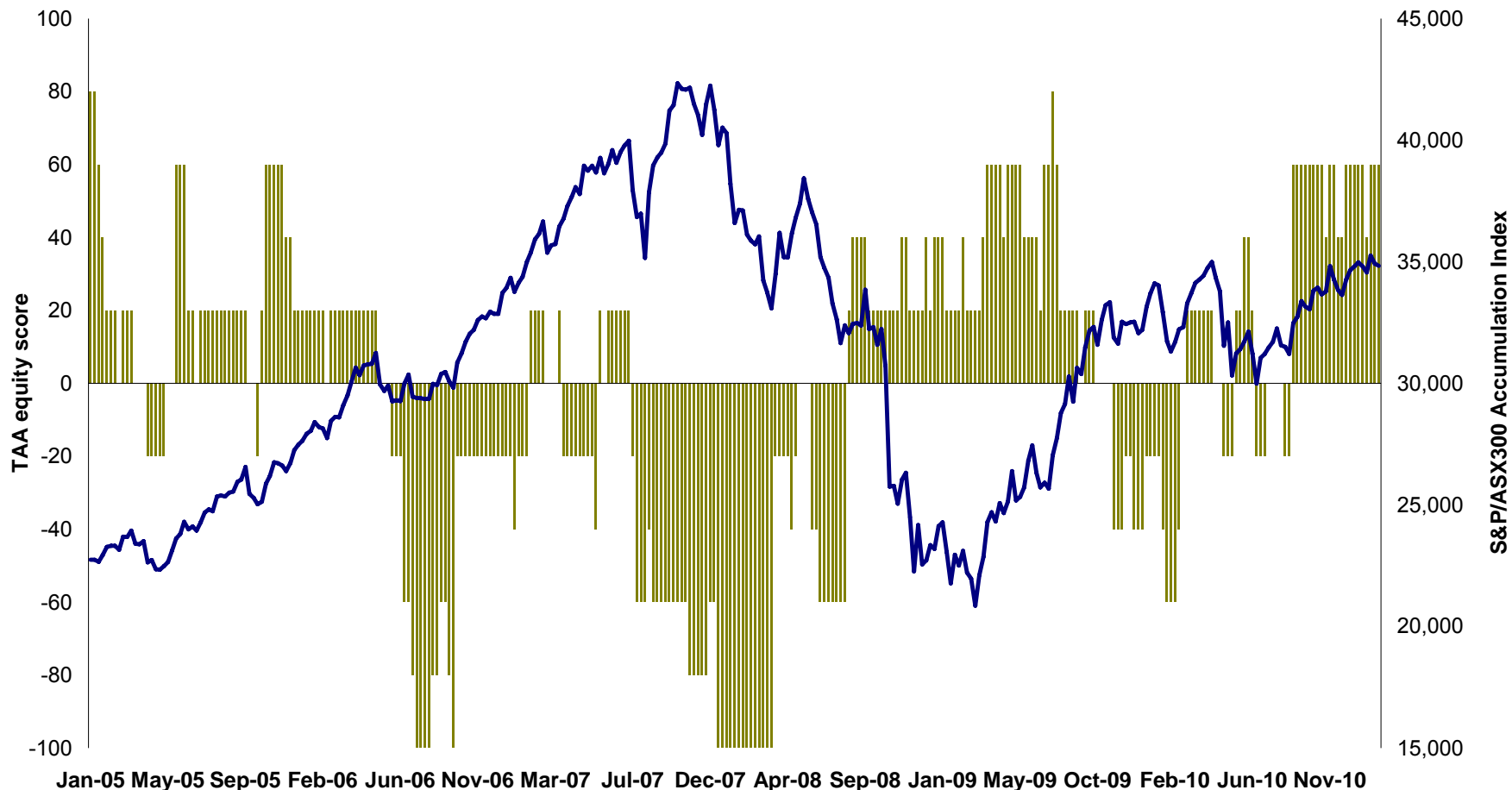
*S&P 500 Price Index. Source: Perpetual, Datastream, Shiller, as at 30 June 2010.

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Solution: Need to think about more active asset allocation

S&P/ASX300 Accumulation Index and TAA equity model scores over the past five years



Source: Perpetual, as at 31 January 2011.

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4. Problem: How do we cater for increasing life expectancies when clients' risk tolerances have decreased?

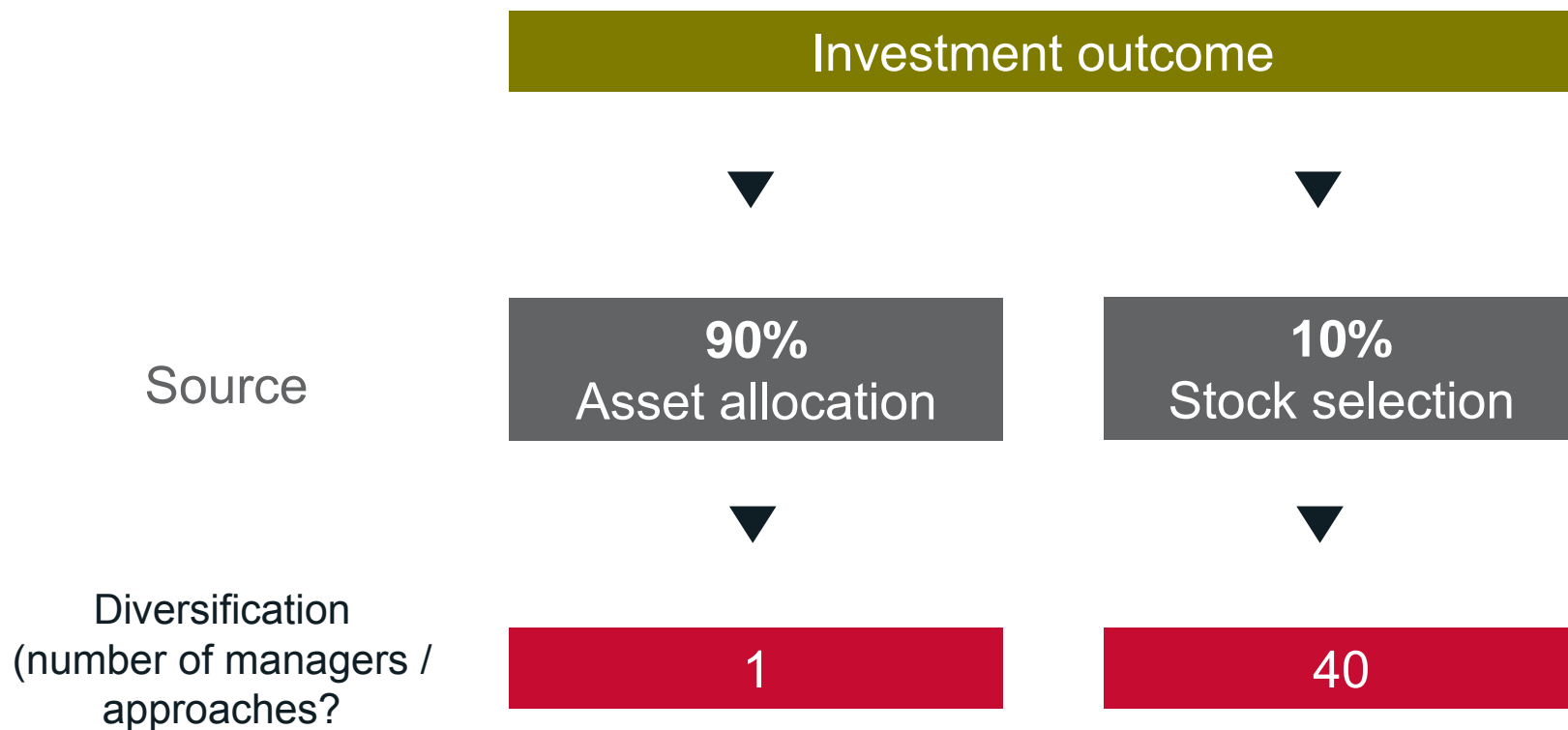
We know:

- Tolerance for risk has decreased: increased cash holdings, reduced margin lending etc
- Investors are living longer. A 65 year old male today has a 50% chance of living to 100
- Clients probably need more equities exposure

Solution:

- Not enough to strategically set an asset allocation which is based on historical relationships when:
 - we know these relationships change
 - market is prone to bubbles and price risk
- Asset allocation needs to be active and risk aware, allowing for:
 - greater outright risk to be taken
 - better managing price risk and volatility

5. Original problem: Diversifying the wrong risks



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Solution: How to think about diversifying your approach to asset allocation

- Identify managers or research sources with skill in asset allocation
- Combine different approaches
- Ensure access to ongoing research into new investment opportunities

Current asset allocation in the diversified funds

	Balanced	Diversified	Conservative
Australian equities	28%	21%	11.5%
International equities	24%	18%	10%
Emerging markets	4%	3%	1.5%
Property	5%	5%	5%
Infrastructure	4%	-	-
Mezzanine debt	5%	5%	5%
Inflation linked bonds	5%	6%	8%
Fixed income (nominal)	5%	14%	22%
Diversified real return	7%	5%	3%
Cash and enhanced cash	13%	23%	34%
Total	100	100	100

Active Asset Allocation Overlay

The inside story ...

Why diversified funds?

- Lower monitoring burden
- Specialist asset allocation skills
- Active management of price risk
- Ability to look through the portfolio

Why are we in a position to talk about this?

- Highly experienced asset allocation team
- Diversified range of unique assets
- 14 year track record of successfully managing risk
- Long and stable approach

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Important note

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