Warringal
Financial Services

Warringal Financial Services

Investment Philosophy Document

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Investors should, before acting on this information, consider the appropriateness of this information having regard to their own circumstances.

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Introduction

This document details the approach we use when we construct your Personal Investment Portfolio (PIP) in order to achieve your goals and objectives.

The document details our investment beliefs and the philosophy behind the approach we use in building our recommendations. Overall, our purpose is to outline how we aim to achieve your goals with the greatest certainty and lowest risks.

Your goals and objectives we are aiming to achieve will be outlined in your Statement of Advice (SoA).

We will continue to use this investment philosophy as we review your portfolio and we assess the progress towards your goals and objectives.

It is important to realise that this document does not take into account your individual circumstances, requirements and objectives – it is a generic outline of our approach, beliefs and considerations when we consider the investment portfolio appropriate for your individual circumstances. To understand the investment portfolio we have recommended for your individual circumstances, you should refer to your Statement of Advice.

Our Investment Beliefs

When we build and review your investment portfolio, we base our recommendations on a number of investment beliefs, which are fundamental to the way we operate our business.

We believe:

- One of the best ways to grow wealth is to use **exceptional investment managers** which apply their **skills, resources and research** to build portfolios of individual investments.
- **Deep research** is the only reliable way to identify exceptional investment managers. Brand and past performance are unreliable predictors of future performance.
- **Diversification** is one way to provide more consistent investment outcomes.
- A **long-term approach** should be used if your financial goals are long-term
- **Efficient implementation** reduces the costs of running a portfolio.
- **Responsible investment,** investing for good, is understanding the extent to which portfolios are contributing to, or detracting from the key environmental and social challenges facing society and the environment

As these beliefs are central to our recommendations, they are regularly referred to throughout this document as we outline our approach to creating your investment portfolio.

Constructing Investment Portfolios

We use a 2 stage process when we build investment portfolios:

- **Stage 1** involves identifying an appropriate asset allocation for your goals, timeframe and risk tolerance.

History and research has shown that asset allocation is responsible for over 90% in the variation in returns between portfolios, and is therefore one of the most important decisions we make for your portfolio[1].

We aim to select an asset allocation that is likely to achieve the ***aspirational returns*** required to achieve your desired goals, with the lowest amount of volatility possible.

- **Stage 2** involves constructing your portfolio, or deciding how to invest the different allocations to each asset class, in order to apply our investment beliefs.

This process helps to maximise the returns and manage the risks associated with investing in each individual asset class that is appropriate for your goals, timeframe and risk tolerance.

Determining an Appropriate Asset Allocation

The most important decision for your investment portfolio is your recommended asset allocation. This is because studies have shown that your chosen asset allocation is responsible for more than 90% in the variability of returns between portfolios.

The diagram below illustrates the process we go through to determine the asset allocation for your investment portfolio:

[1] Brinson et al, *Determinants of Portfolio Performance II*, Financial Analysts Journal, Jan/Feb 1995

Potential Asset Allocations

Once we have identified your investment timeframe and your required rate of return, we can determine which potential risk profile or asset allocation may be appropriate to achieve your lifestyle goals and objectives.

The typical risk profiles or asset allocations that we use for clients are outlined below:

Risk Profile / Asset Allocation	Description
0% Defensive, 100% Growth	This profile may be appropriate for investors with an investment horizon of at least five to seven years and a high risk tolerance. The full exposure to growth assets means that the portfolio will have greater fluctuations in value than portfolios with allocations to defensive assets. This strategy suits investors aiming to achieve capital growth over a long term timeframe and are comfortable with a share portfolio dominated by Global shares. Given the 100% exposure in growth assets, investors will experience a high level of volatility from this type of portfolio.
15% Defensive, 85% Growth	This profile may be appropriate for investors with an investment horizon of at least five to seven years and a moderate to high risk tolerance, seeking a high exposure to growth assets. The bias to growth assets means that the portfolio will have greater short term fluctuations in value than portfolios with greater allocations to defensive assets. This strategy suits investors aiming to achieve capital growth over a long term timeframe and who want slightly lower volatility than that provided by a 100% growth asset mix. Given the 85% exposure to growth assets, investors will experience a moderate to high level of volatility from this type of portfolio.
30% Defensive, 70% Growth	This profile may be appropriate for investors with an investment horizon of at least five years and a moderate risk tolerance. The bias to growth assets means that the portfolio will have greater short term fluctuations in value than portfolios with greater allocations to defensive assets. This strategy suits investors aiming to achieve capital growth over a medium to long term timeframe and who want lower volatility than that provided by a 100% growth asset mix. Given the 70% exposure to growth assets, investors will experience a moderate level of volatility from this type of portfolio.
50% Defensive, 50% Growth	This profile may be appropriate for investors with an investment horizon of at least three years and a low to moderate risk tolerance. A balanced split between growth and defensive assets means that the portfolio is expected to deliver relatively consistent returns over time. This strategy suits investors aiming to achieve capital growth over a medium term timeframe and who want lower volatility than portfolios with a higher allocation to growth assets. Given the 50% exposure to growth assets, investors will experience a low to moderate level of volatility from this type of portfolio.

Risk Profile / Asset Allocation	Description
70% Defensive, 30% Growth	This profile may be appropriate for investors with an investment horizon of at least three years and a low to moderate risk tolerance. The bias towards defensive assets means that the portfolio is expected to deliver relatively stable returns over time. This strategy suits investors seeking regular income with an opportunity for some growth over a medium term timeframe and who want lower volatility than portfolios with a higher allocation to growth assets. Given the 30% exposure to growth assets, investors will experience a low to moderate level of volatility from this type of portfolio.
100% Defensive, 0% Growth	This profile may be appropriate for investors with an investment horizon of at least three years and a low to moderate risk tolerance. The bias towards defensive assets means that the portfolio is expected to deliver relatively stable returns over time. This strategy suits investors seeking higher than cash returns over the medium term with a low to moderate level of volatility.

Your tolerance for risk

While we believe that the achievement of your lifestyle goals and objectives is of the utmost importance, an asset allocation that only reflects these goals and objectives may expose you to an uncomfortable level of investment risk and may lead to a short term loss of capital. For this reason, the final aspect that we undertake is to identify a risk profile (and associated asset allocation) that reflects your investment risk tolerance alone and see whether this is consistent with the proposed asset allocation.

To determine your attitude to risk we have used a series of assumptions and a mathematical model in conjunction with the information provided by you when you complete Your Attitude to Investment Risk questionnaire. In this questionnaire your attitude to risk is graded on a scale of 1-7, where 1 is the most risk averse and 7 the most risk accepting investor. You should note that the questionnaire is not a scientific or definitive reflection of your attitude to investment risk. However, it is an indication of your current attitude and/or tolerance towards investment risk.

Determining your final asset allocation

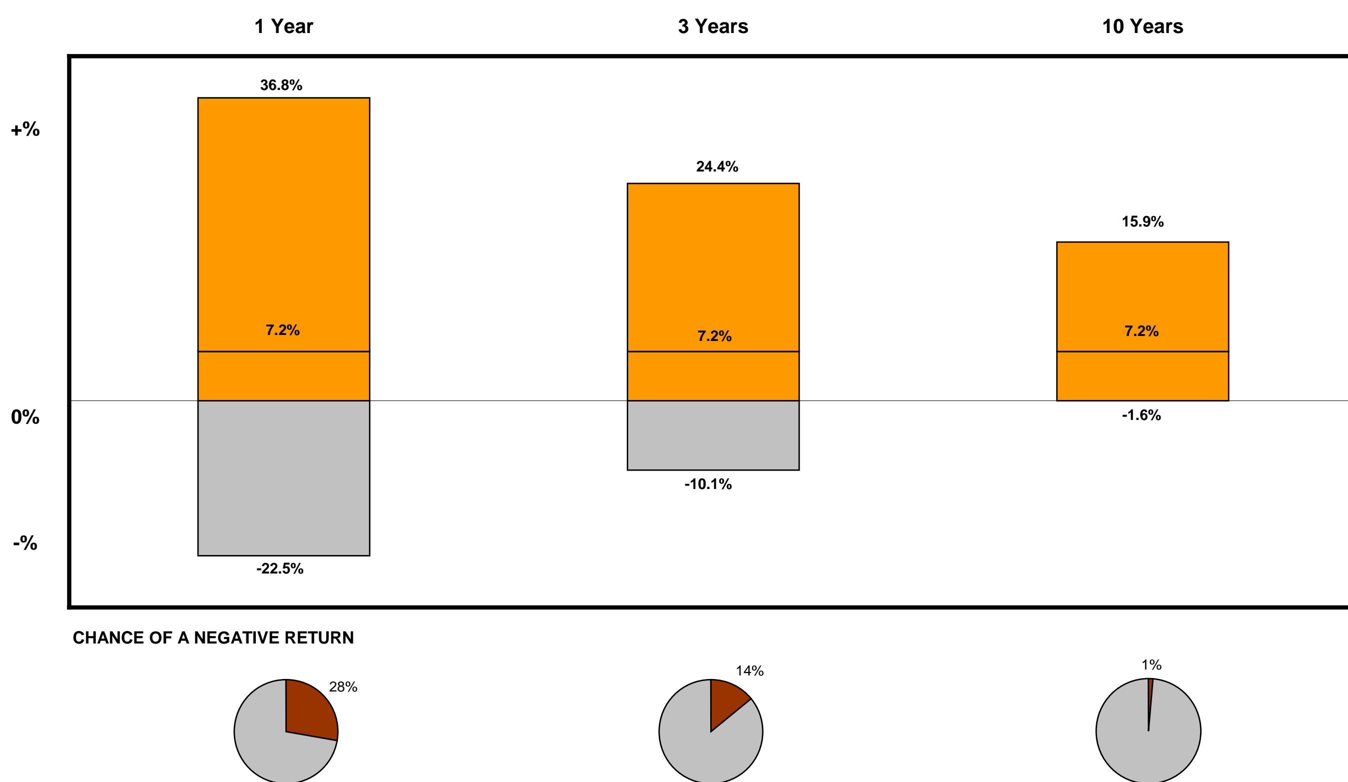
The asset allocation that is appropriate for your risk tolerance may or may not be consistent with the asset allocation we have determined is appropriate for your return requirement and investment timeframe.

If it is consistent, then we can construct your investment portfolio with the appropriate asset allocation.

However, if it is not consistent, we need to review your risk tolerance, required rate of return based on your goals and objectives, and/or your investment timeframe to determine the most appropriate course of action for you and your individual circumstances to achieve a final asset allocation for your portfolio. This discussion will be outlined in your Statement of Advice.

Maintaining long-term strategic asset allocation

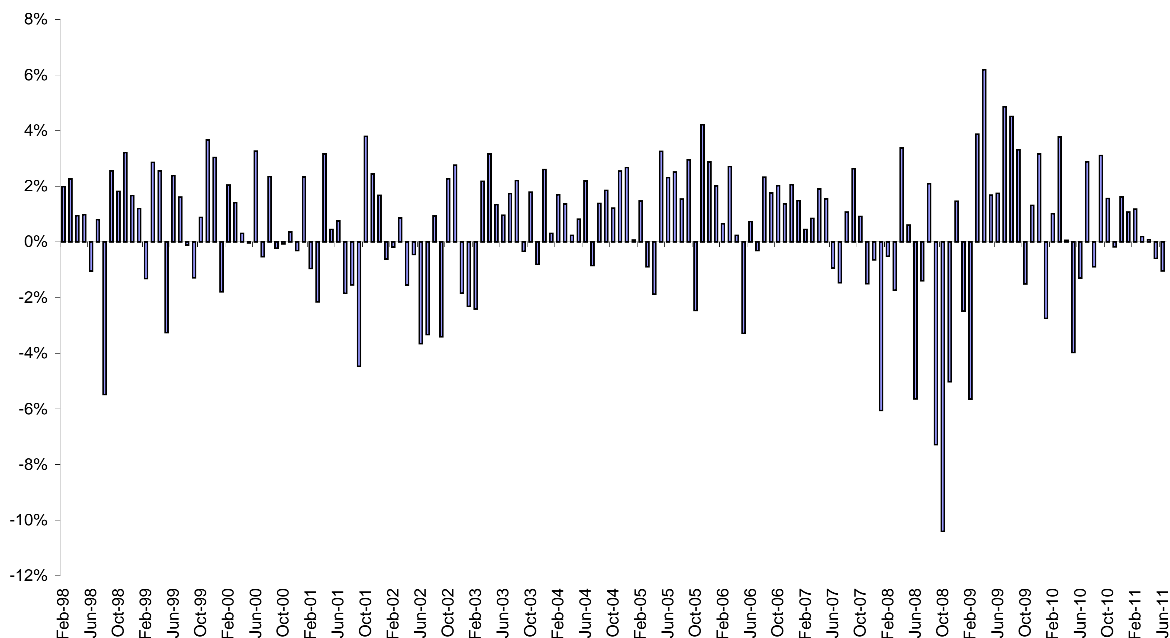
Unless your circumstances significantly change, it will be important to maintain this asset allocation over the long-term, despite short-term investment market movements. As can be seen in the graph below, the range of return and chance of a negative return for a representative 70/30 portfolio should reduce over time.



Source: 360 Research, assumptions are for a 70/30 diversified portfolio managed passively and are gross of fees and tax.

Don't forget about the short-term volatility of returns

This graph is an example of monthly returns of a representative 70/30 portfolio and highlights the volatility associated with short term performance.



Source: 360 Research

Returns are based on a representative 70/30 "Balanced portfolio" (non-super). They are calculated on an annualised, compound basis using end of month redemption prices and are net of management fees, charges, expenses and do not allow for initial/exit fees or policy charges. Returns are calculated in accordance with IFSA Standard No. 6. Performance over different durations, and for different periods, than shown may vary considerably. Past performance is not indicative of future performance. The value of an investment may rise or fall with changes in the market.

Constructing your Portfolio in line with our beliefs

Once we have determined an appropriate strategy and structure together with your asset allocation for your portfolio (based on your risk tolerance, investment timeframe and return requirement), we then consider how we should construct your portfolio in line with our investment beliefs, including each of the underlying asset sectors.

One of the best ways to grow wealth is to use exceptional investment managers

An exceptional investment manager will have a clear, sound set of investment beliefs.

We believe that deep and disciplined research of individual securities can generate superior outcomes. For this reason we focus on investment managers that have a ‘bottom-up’ philosophy that involves constructing investment portfolios out of securities that are anticipated to perform well.

We generally do not utilise investment managers which focus on:

- passive indexing that merely mimics index returns
- price momentum investing based on buying into an asset with rising prices with the hope that they will be able to sell later for a higher price, or
- pure ‘top-down’ approaches that assess broad economic trends to identify groups of investments, but do not take the effort to identify the best individual investments within those groups.

Using specialists

Skilful investing involves knowing what you are good at, and sticking to it. You don’t have to be the best at everything, just find and use what you believe are the best.

This typically results in the appointment of managers who specialise in a particular asset class – rather than managers who try to cover all asset classes. The theory behind this is quite simple – it’s easier to be good at one discipline than a range of them.

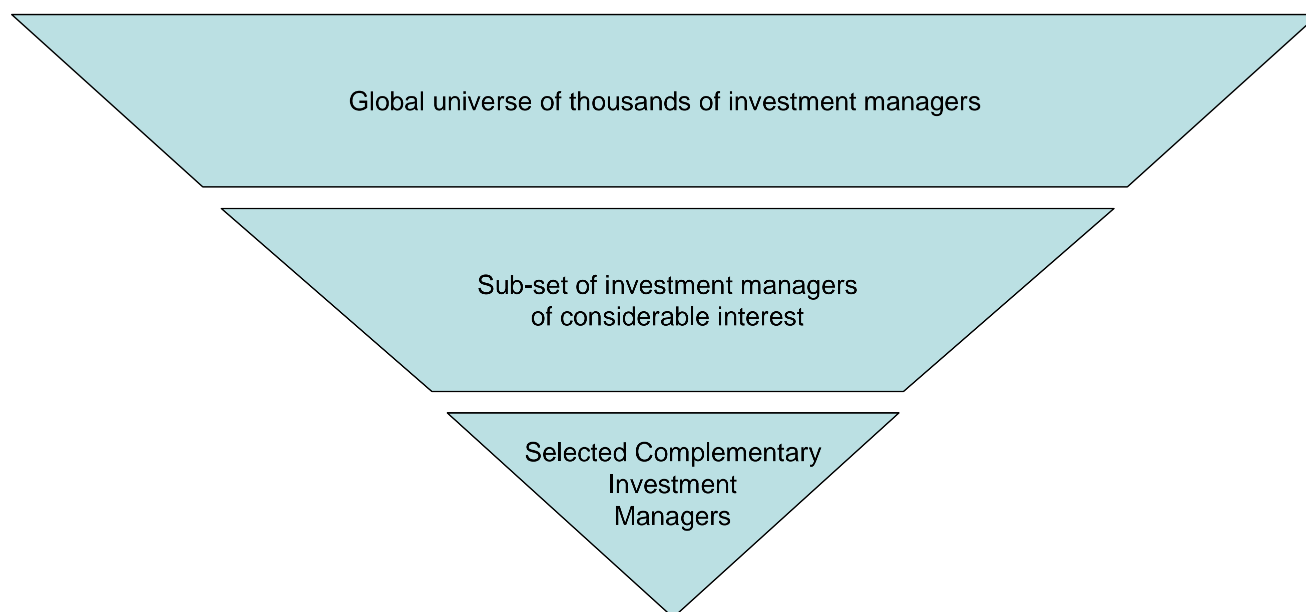
Deep research is one reliable way to identify exceptional investment managers

No single investment manager will be the best performer in a single asset class at all times across different economic and market environments. In fact, there are actually very few firms in any asset class that are skilled investment managers and have a real and sustainable competitive edge. There is ample academic evidence[2], in addition to our experience, that clearly shows brand and past performance are not helpful in identifying investment skill.

Therefore, when selecting managers, we want to look beyond past performance. As markets move in cycles, certain market conditions will suit certain types of managers. Even the best managers are likely to experience short-term underperformance if market conditions don't suit their investment strategy.

We believe the fundamentals of an investment manager (such as its investment philosophy, investment approach, people and ownership structure) are much better indicators of a manager's skill than past performance.

We use a research provider to select skilled investment managers from around the world:



[2] For example, see Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor, by John C. Bogle (2000)

Diversification can lead to more consistent investment outcomes

Diversification is a genuine way of reducing uncertainty without compromising expected future returns.

Diversification involves spreading your investment amongst asset classes, investment managers and securities in order to reduce risk and the impact that any single one of these can have on your portfolio.

While most people understand the basic concept of diversification, many still don't fully diversify their portfolio. For example, just holding several stocks is not good diversification, especially if they have similar risk factors by belonging to similar industry group, asset classes, or even selected by investment managers using a similar investment process.

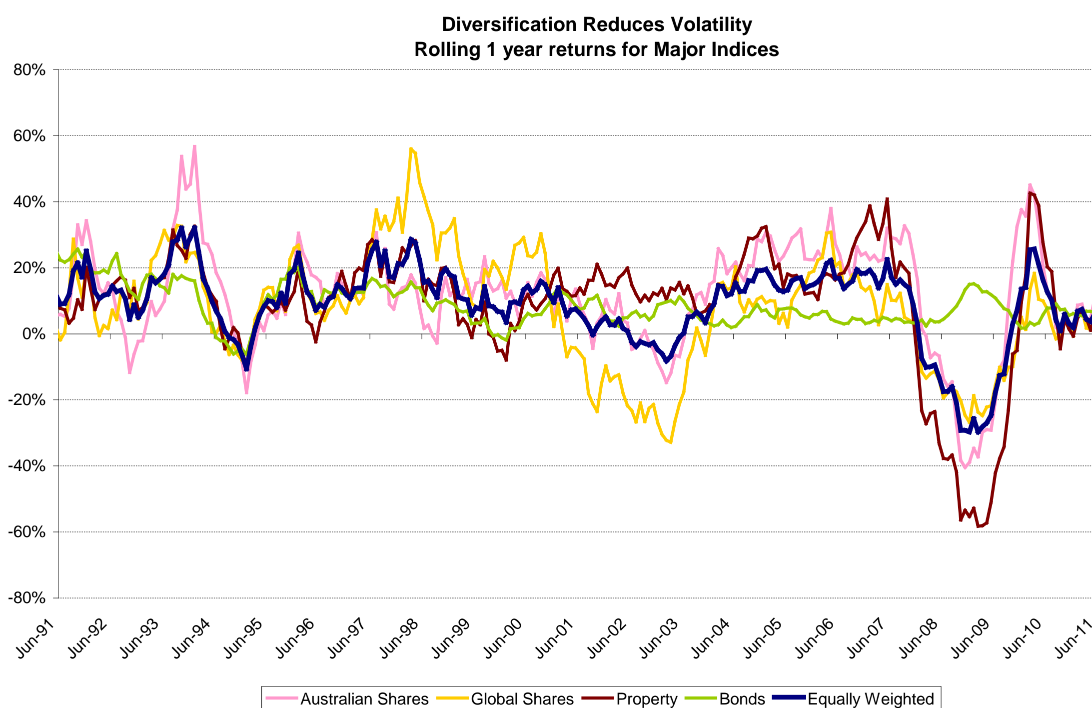
To fully utilise the benefit of diversification, we construct your portfolios so that it is diversified in three ways (each of which is described further below):

- across asset classes
- within asset classes
- across investment managers.

Diversification across Asset Classes

As different asset classes (eg shares, property, bonds and cash) perform differently under different economic and market conditions, diversifying across asset classes reduces the impact of downward fluctuations in any one asset class over the short-term, yet still capture the benefits of potentially higher returns of growth assets.

The benefit of diversifying across asset classes is illustrated in the diagram below – you can see that an equally weighted allocation to each of the asset classes produces a more consistent return over time, without compromising the benefit of being exposed to those asset classes (generally growth assets, such as shares and property) that will provide the highest long-term returns.



Source data based upon the following: Australian shares: S&P/ASX 300 Accumulation Index, Global shares: MSCI World ex-Australia Index ($A), Property: S&P/ASX 300 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Bonds: UBS Australian Composite Bond Index (All Mats);

When we recommend your asset allocation in your Statement of Advice, we ensure it is diversified across asset classes that are appropriate for your return objective, investment time horizon and risk profile.

Diversification within Asset Classes

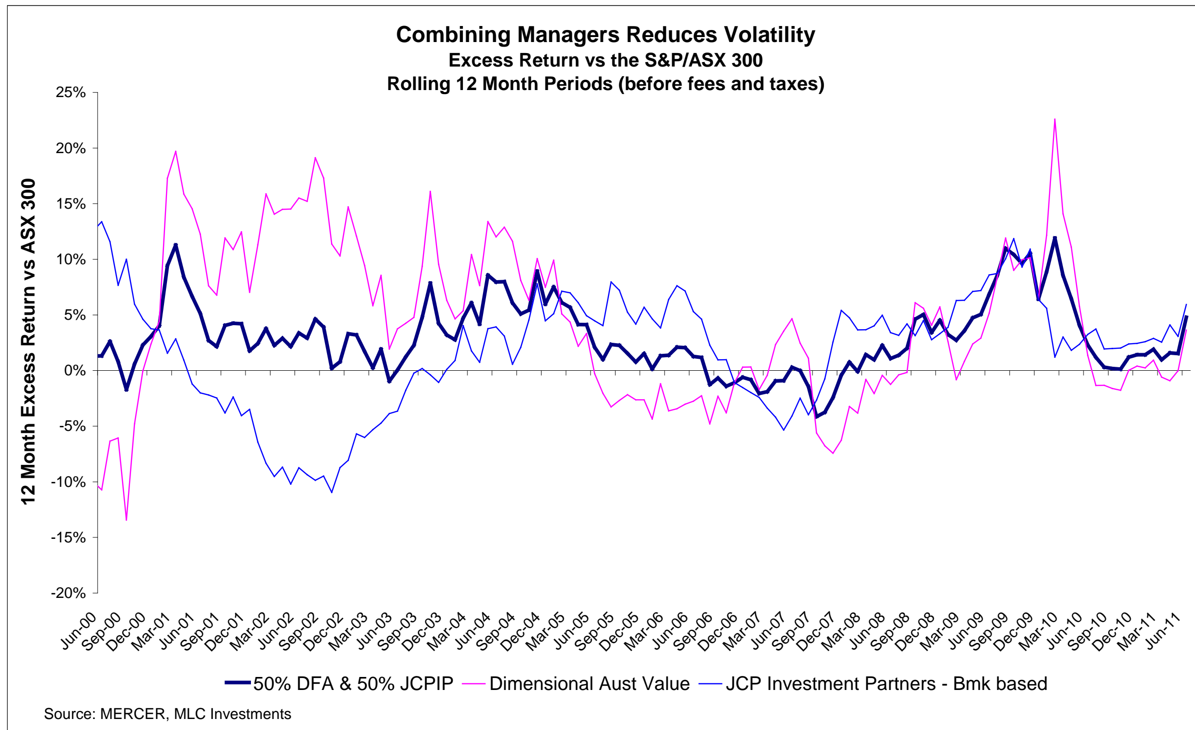
Within each asset class you are investing in, we want to ensure your portfolio is diversified across regions, countries, industries and currencies. This approach to investing ensures that your portfolio is not concentrated in a particular region or industry, which helps to reduce the impact of a regional or industry downturn.

Each asset class has its own form of diversification that we consider. The section below outlines the diversification available within the Personal Investment Portfolios.

This only provides an indication of how we consider diversification within asset classes, it does not indicate the diversification available within your particular portfolio that will be outlined in your Statement of Advice.

Diversification across Investment Managers

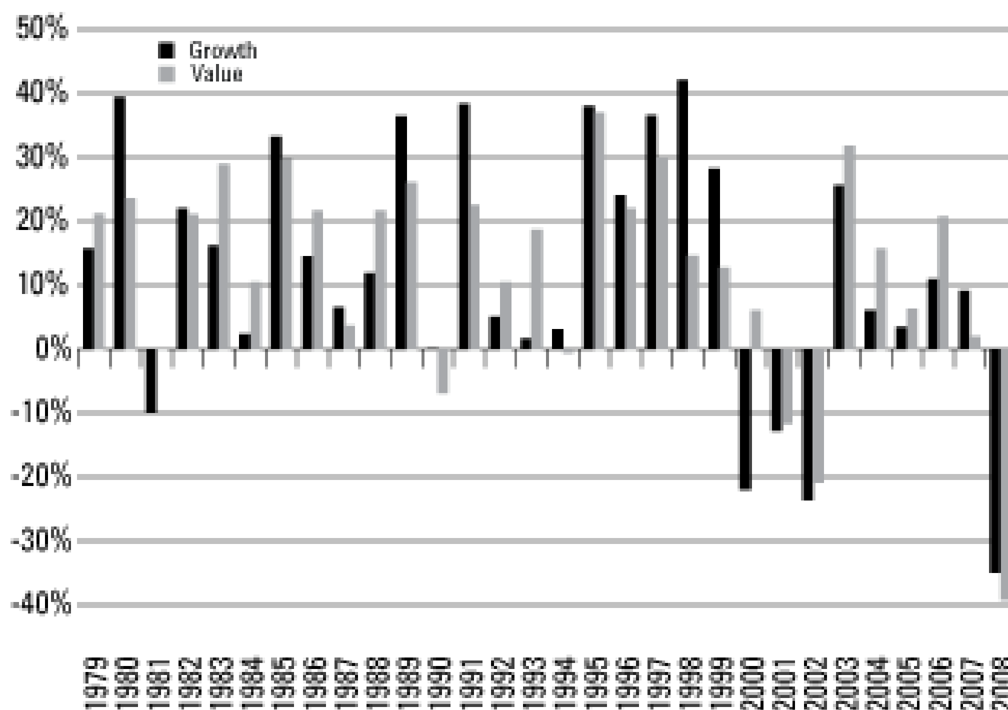
Different investment styles excel at different times under different economic and market conditions. By combining managers with different, but complementary, investment styles, your portfolio is likely to have a more consistent return than is possible with a single investment manager.



We diversify portfolios across many managers within each asset sector. This reduces the extreme hi-lo impacts of tilting a particular style such as value vs growth, or large vs small cap.

A 2009 study conducted by US/Canadian broker Toronto Dominion (TD) Ameritrade, looked at the relative performance of S&P500 Value and Growth indices (see chart below). Over a 30 year period (1979-2008), they found that Growth outperformed Value 50% of the time, and vice versa.

Also, in the 10 year period (1979-1988) Value and Growth alternated as the leading performer almost every second year, while the periods of outperformance extended to 6-7 years in the 90's and 2000's (Growth outperformed for 6 years straight in 1994-99, and Value for 7 years straight in 2000-06). Growth then returned to the preferred style bias since 2007.



Source: Russell

This study highlights the dangers in constructing long term portfolios with an underlying or built-in style bias. For example, having a value-style bias at the heart of your long term strategic portfolio can lead to extended periods of underperformance when economic and market conditions are favourable to growth investing (and vice versa). For this reason, we advocate a style-neutral approach to the construction of client portfolios.

A long-term approach should be used

We believe that successful investing is a long-term process. Instead of trying to outguess the market (eg by trading in and out of asset classes and investment managers on a short-term basis) we look to set a target weighting to each asset class and manager based on our long-term expectations. We then maintain these weightings via a disciplined rebalancing process.

Don't react to short-term performance

Some markets, managers or securities may not perform as well as others (and may even go down) from time to time. Successful investors know this is just market noise, and more often than not making changes in response to this noise is likely to destroy value.

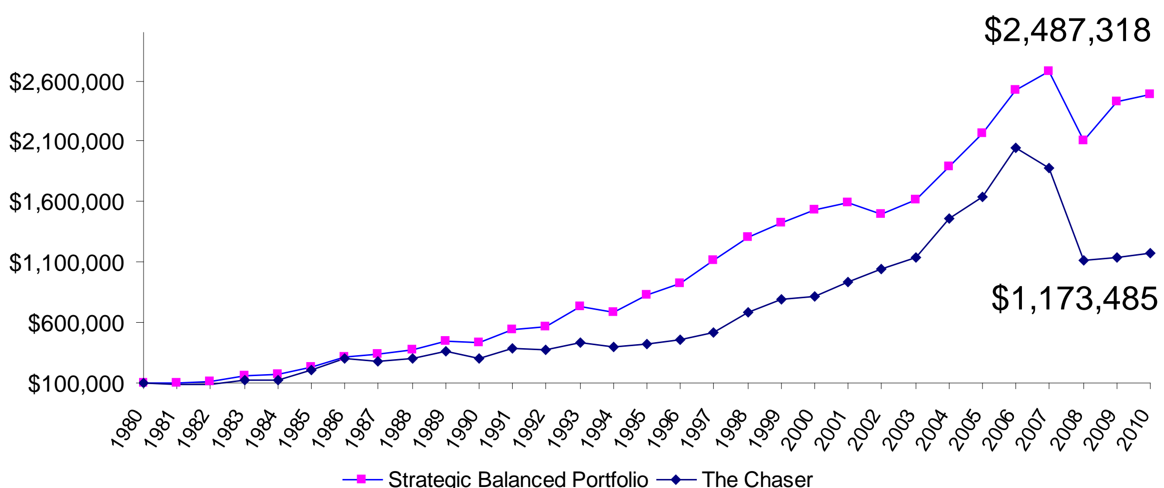
In times of negative returns, there is a natural temptation to chase the perceived higher returns from other investment options. Studies show that investors who switch funds to the best performing asset class of the previous year, chasing higher returns, are often worse off than investors who maintain their investment in a balanced portfolio. Say you invested $100,000 at the end of 1980:

- If you chased the best performing asset class from the previous year, your investment at the end of December 2010 would be valued at $1,173,485. A compound return of 8.3% p.a.
- But if you stay invested in a balanced portfolio, your investment would instead be worth $2,487,318. A compound return of 10.9% p.a.

Simply by chasing returns, you would have generated a lower return on your original investment of over $1,200,000, and this does not even incorporate the additional costs incurred (both fees and taxes) of switching between products.

We often create more volatility in investments by switching course and trying to catch the best performing asset class.

Value of $100,000 Since December 1980



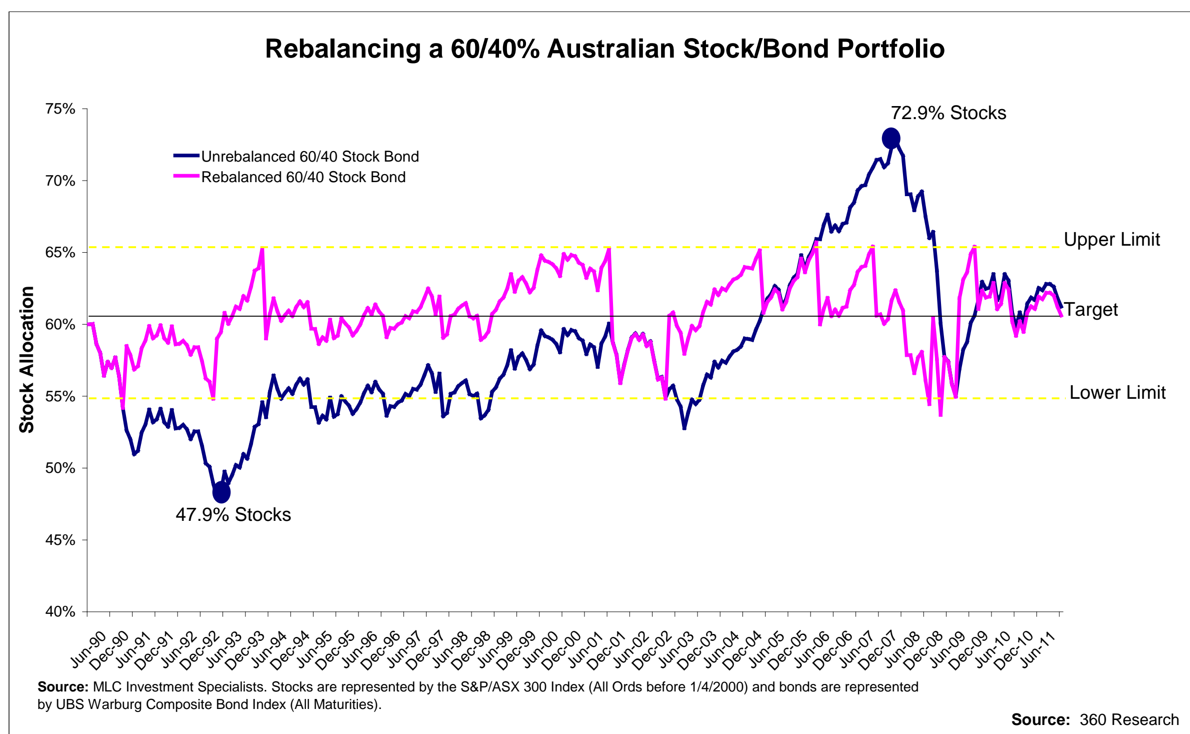
Source: 360 Research.

However, this doesn't just apply to asset classes, but also applies to investment managers and even securities. Short-term fluctuations in returns are not a reason to change your portfolio – you need to apply discipline and reaffirm your belief that your portfolio is appropriate for your circumstances.

This is why we don't change our portfolio to try and take advantage of short-term trends – it puts your money at risk and will often go unrewarded. Instead, we set a strategic allocation and then continually rebalance to your target allocation in a disciplined manner.

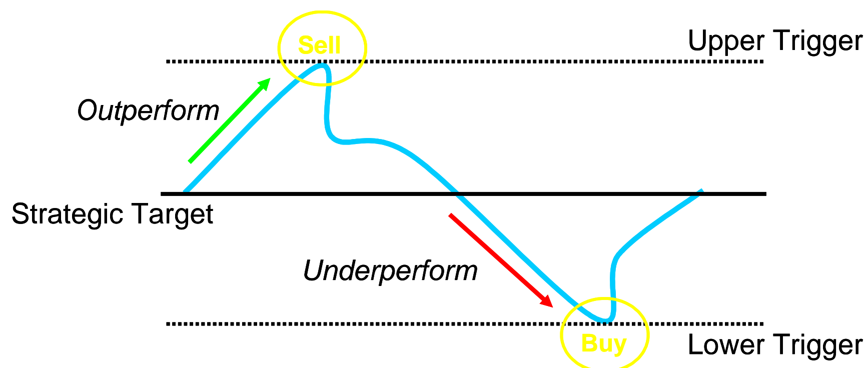
Rebalance portfolios to their target allocation

Over time, asset classes and investment managers will perform differently at different periods – this different performance means portfolios become "unbalanced", or no longer in line with your original asset class and investment manager weightings. For example, if shares perform better than other assets in the portfolio, the actual allocation to shares will increase above the target allocation. This is illustrated in the diagram below.



In order to make sure the portfolio continues to be appropriate for your circumstances, we generally undertake a process of 'rebalancing'. Effectively, this means reducing your allocation to the better performing asset classes and/or investment managers (selling 'high) and increasing your allocation to the poorer performing asset classes and/or investment managers (buying 'low').

While intuitively this is what you want to do when investing, without this discipline many people don't and they end up destroying some of their hard earned wealth.



With disciplined rebalancing, you can manage the drift in your asset and manager mix, and keep it consistent with your desired target allocation. This means you are not exposed to risks or different performance characteristics you did not agree to when you first invested.

The disciplined rebalancing ranges applied to your portfolio will be +/- 2% around the target asset allocation. The Strategic Overlay (SO) component of the asset allocation process may set a target allocation that differs from the neutral allocation within the specified SO ranges for your portfolio. For example, should the SO set the target of the 30% Defensive/70% Growth portfolio at 35% debt asset and 65% shares, the rebalancing range will be 37-33% debt assets and 63-67% shares. Your exposure to growth assets could therefore range from 63-77% of your portfolio. Remember that the SO has been designed to better manage portfolio risks.

Efficient implementation reduces the costs of running a portfolio

Great investment ideas can only result in great outcomes if they are efficiently implemented.

After spending considerable time and effort in constructing your portfolio, we don't want to find that you have lost valuable returns through implementation leakages. Some common implementation leakages include:

- Inefficient structuring of investment vehicles, incurring extra transaction costs and taxes when running, trading and transitioning the portfolio.
- Inefficient cash flow management resulting in more buying and selling than should be required to keep the portfolio in line with its strategic targets.
- Inefficient transition management when changing managers or asset classes, incurring extra transaction costs, taxes and market impacts.

When we select how to implement your portfolio, we look to ensure that these potential costs are all carefully managed so you don't lose valuable returns, which means you end up with more in your pocket at the end of the day.

Responsible investment, investing for good,

Understanding the extent to which portfolios are contributing to, or detracting from the key environmental and social challenges facing society and the environment

We utilises our key research partner (Lonsec's) Sustainability Score which is a quantitative estimate of the net 'goodness' in a portfolio.

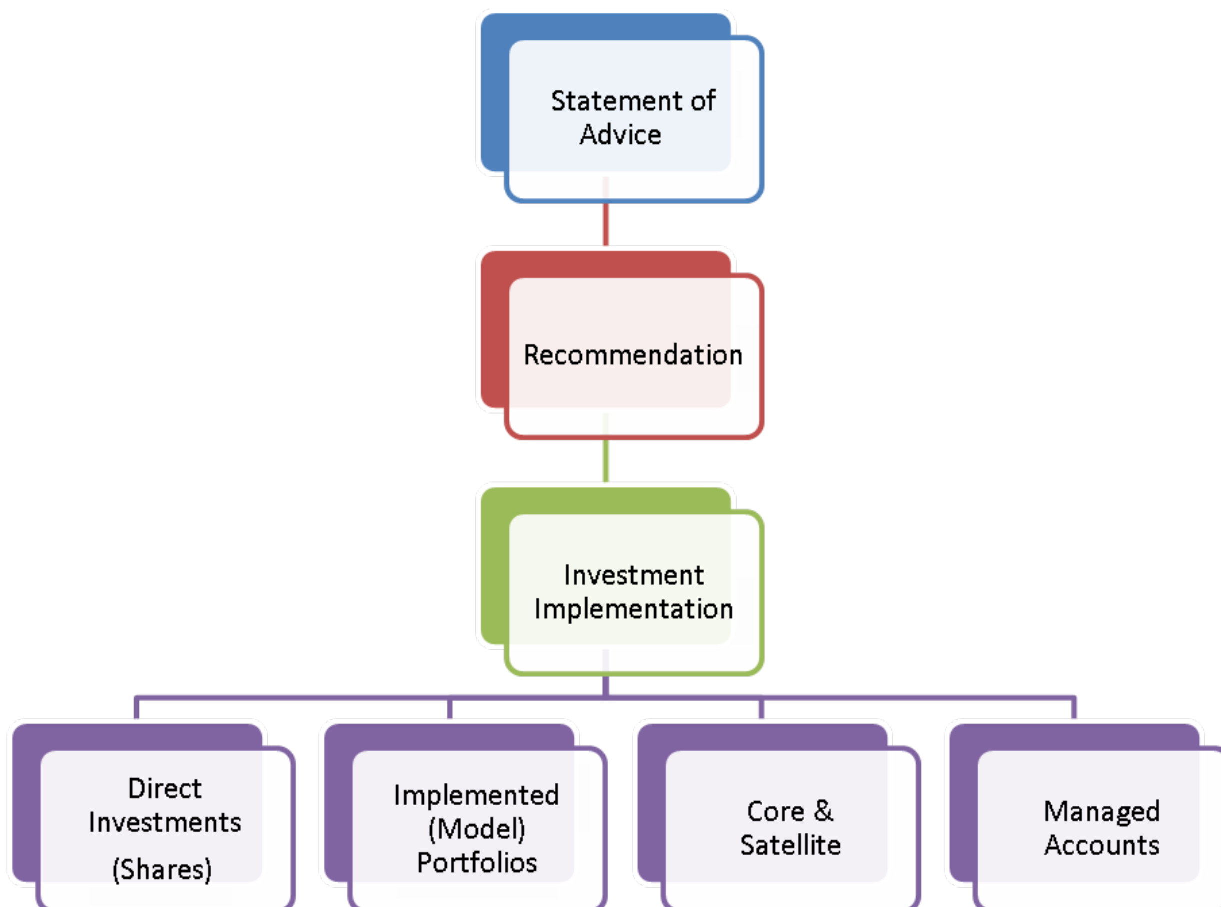
The Score nets the positive contributions to the 17 UN Sustainable Developmemt Goals (SGDs) against the negative impact of exposures to controversial industries from the activities of the companies held in a fund's portfolio.

The 10 controversial industries are: fossil fuels, gambling, alcohol, tobacco, deforestation, defence, nuclear, opioids, genetically modified organisms (GMO) and adult industries.

The Score is a peer relative assessment of a fund at a point in time

Implementing Your Portfolio

There are four main options we have available in implementing your investment portfolio. The following graphic illustrates the process required to arrive at the decision point of the four options:



Purchase direct investments

This would involve buying many individual shares through the Australian and global sharemarkets, fixed-interest products through various financial institutions and then continuously monitoring these individual securities and ensuring your portfolio is re-balanced to align with your strategic asset allocation.

Of course, selecting which of the millions of securities around the world are most likely to meet your goals is extremely difficult. Care must be taken to ensure direct portfolios maintain a strategic discipline, and remain consistent with the required return and risk detailed in your SoA to ensure your goals are achieved.

Implemented (Model) Portfolios

This would involve selecting and purchasing a range of specialist managed funds and blending them into a tailored portfolio and continuously monitoring and rebalancing these funds to ensure your portfolio remains in line with your strategic asset allocation.

However, choosing investment managers is also a complicated and involved process, and it is next to impossible for any individual to replicate the depth of resources available to research houses. It can also result in an expensive outcome.

Use a 'core and satellite' portfolio approach

This involves selecting a fund to be the core of your portfolio, and using a range of specialist funds as 'satellites' to tailor the portfolio to your needs and circumstances.

Generally, we use a model portfolio core where our nominated research provider reviews and invests the large portion of your portfolio.

We then focus our resources and energy on the satellite options to ensure that your portfolio is tailored to your unique objectives and requirements.

This approach means the bulk of the portfolio is an efficient, cost effective structure, and the rest can be allocated to investments that will potentially increase the return, reduce the risk, invest in less liquid options, or tilt the portfolio to a particular preference (e.g. geographic, investment style, thematic, etc).

This may mean there are fewer specialist funds or direct investments, however still requires additional rebalancing to ensure it remains appropriate.

Use a specialised 'managed accounts' investment service

This would involve appointing a specialised facility which researchers and invests on your behalf in what it believes is the most appropriate assets and investment managers.

Often known as Managed Accounts, this also rebalances your investments between asset classes and investment managers, so that your portfolio remains in line with your strategic asset allocation.

This is a highly efficient and practical approach, which employs the skills of research houses, who provide fund ratings for underlying investments held within the over portfolio (managed account) for all types of risk/return profiles.

Cost comparison of implementation options

Cost is a valuable consideration to any portfolio construction.

All costs for any agreed portfolio will be outlined as per the recommendations in your Statement of Advice and form the foundation component of your total wealth portfolio, as it provides clear cost and efficiency focus (together with risk controls) that may add significantly to your wealth when compounded over time.

Our focus is to ensure we have selected the most appropriate strategy and portfolio to achieve your goals, and allows full-time professionals to focus on managing your underlying investments.

Ongoing Performance & Review

We will review your portfolio's performance at our regular reviews, to ensure it continues to be relevant for your circumstances, and the most appropriate to achieve your goals and objectives. When we review the portfolio's performance, we consider:

- Changes to your circumstances, goals or objectives that require an adjustment to your recommended portfolio.
- The economic and market environment impact on:
  - Different asset class performance compared to our long-term expectations.
  - Investment Manager performance in absolute and benchmark relative returns, and future expectations.

  We review this performance in light of the investment beliefs and the approach we use to constructing your portfolio outlined in this document.

  For example, we understand that markets and investment managers are often cyclical in nature, and may go through periods of poor, or even, negative returns (in either an absolute or benchmark relative sense). We do not make changes to your portfolio based purely on past performance. Instead, we only make changes to provide an improved likelihood of achieving your goals and objectives, with greater certainty or lower risk.

  In particular, given we use various research providers to support our investment advice for our multi-manager investment solutions, they undertake a considerable amount of research and monitoring of investment managers. We therefore review their research and monitoring to ensure they continue to do an appropriate job for our clients' portfolios.
- Any rebalancing we need to undertake to adjust your portfolio back to our agreed allocations.

We do not make adjustments to your investment portfolio based on a period of poor peer relative, or even negative, returns as this often results in wealth destruction. We will assess each asset class, investment manager and investment against its future expectations to determine whether we believe your investment portfolio remains the most appropriate portfolio to achieve your desired goals and objectives.