CONFERENCE

25/26/27 August 2009 I Australian Technology Park, Eveleigh, Sydney

PORTFOLIOCONSTRUCTION CONFERENCE 2009

DUE DILIGENCE FORUM KEY TAKEOUTS

More than 450 portfolio construction practitioners - those who design, build and manage investment portfolios, or who have a professional responsibility to understand how leading portfolio construction practitioners do this – descended on Australian Technology Park on 25-27 August, for the 8th annual PortfolioConstruction Conference.

The 20+ hour, two-day marathon of 34 quality sessions featured 37 carefully selected, local and international portfolio experts. The program had two key components.

In this issue of Money Management, we bring you the key takeouts of one of those components – the 6-hour Due Diligence Forum program which featured 24 more international and local investment experts presenting pre-approved research papers. These summaries are written by independent research analysts from Lonsec, Standard & Poor's, van Eyk and Zenith, who were invited by PortfolioConstruction Forum to attend the DDF sessions as Researchers, to ask questions and summarise the key takeouts.

The research papers behind each session are available online at www.PortfolioConstruction.com.au for you to access, along with slides and podcasts of each session.

PortfolioConstruction Due Diligence Forum: Of Interest (Fixed Interest & Credit)
Jeff Mitchell, Director Fund Services, Standard & Poor's

Each of the four presentations that formed part of the Of Interest Due Diligence Forum provided insights into the key aspects and structures of the fixed interest and credit sectors, ranging from cash and government guaranteed loans at the most conservative end of the capital structure through to bank loans and senior secured debt, unsecured debt and its various tiers of subordination, the further subordinated high yield, hybrids and mezzanine debt, convertible bonds preference shares and, finally, ordinary shares at the bottom of the capital structure.

Roger Bridges, Head of Fixed Income with Tyndall/Suncorp Investment Management, focused on how the changes to economic conditions, mainly in Australia, but more recently in a global context, have impacted the fixed interest market as reflected by the compositional changes to the UBS Composite Bond Index.

The effective exit of the government from the bond market and the decline in economic volatility during the late 1990s and early 2000s led to a noticeable re-pricing of risk which was first illustrated by the flattening of the yield curve which resulted in duration being replaced by credit as a return driver. This created a problem, Bridges said. In the pursuit of greater returns in a low yield environment, many investors mistook the higher returns provided by credit as being achieved largely without a corresponding increase in risk. Unfortunately, as the GFC has proven, this is not the case.

In looking to the future, he observed that duration has re-emerged as a driver of bond market return as governments raise funds to support stimulus spending. As a result, term risk is displacing some credit risk. With the government guarantee still in place, most private issuance will be from the banks as non-bank borrowers are expected to find the risk premia demanded by lenders somewhat prohibitive, at least in the near term. A shortage of supply in conjunction with a demand for yield could lead to the re-emergence of higher quality structured debt issuance – in some respects, a replay of the early 1990s.

Michael Korber, Head of Credit at Perpetual, revisited the basic elements of fixed interest investments by highlighting the main characteristics of the debt securities that make fixed interest fundamentally different to equity. Key among these is the asymmetrical risk profile of the securities, that is, the expectation of a return of capital plus compensation for the risk assumed irrespective of which tier in the capital structure a particular security is positioned.

Both Korber and Mihkel Kase, Fund Manager Fixed Income at Schroders, discussed the various risks of credit investing including default, duration, liquidity and concentration of issuer, industrial sector, geography and structure.

Kase argued that traditional higher risk debt instruments that have a higher default probability which is, in turn, compensated by expected higher return, can play a role in the growth side of portfolios, along with equity, property and alternatives, as opposed to being excluded purely on the basis that they are too risky to form part of the defensive assets. He gave an example of a balanced fund portfolio construction methodology incorporating fixed interest securities from across the capital

structure to achieve a CPI plus return objective. This methodology blurred the boundary between defensive and growth asset allocations and achieved a broader diversity of assets than is generally expected in a traditional balanced fund asset allocation.

To round out the series, Bob Press, Managing Director, Trafalgar Capital Advisers, gave his insights into the debt funding structures for global Small to Medium Enterprises (SMEs) and how this segment of the debt market has characteristics more akin to equities than fixed interest, not only in the risk return profile but also in the cost and level of due diligence required to assess borrowers.

Table 1: Due Diligence Forum Research Papers – Of Interest (Fixed Interest & Credit)

Author	**Research Paper title**
Schroders	Investing across the capital structure
Tyndall Investments	The changing nature of fixed interest funds
Perpetual	Old lessons re-learned for income investors
Trafalgar Capital Advisors	Global income opportunities in the listed small cap sector

To access these papers, go to www.PortfolioConstruction.com.au

PortfolioConstruction Due Diligence Forum: Getting Real (Property)
Kevin Prosser, Head of Property/Infrastructure, Lonsec

The first sector under the microscope in this stream was global listed infrastructure. Peter Meany, Head of Global Infrastructure Securities with Colonial First State Global Asset Management pointed to the many attractive characteristics, include unique market positions; pricing power; a hedge against inflation; and stable income at the asset level. He said the return from global infrastructure securities should be equal to or better than general equities at around CPI plus 4%-5%, with lower volatility. At the investment vehicle level, the main risk factors are the management (including governance issues) and high debt or financial engineering.

Andrew Parsons, MD & Senior Portfolio Manager, Resolution Capital argued that the global property securities sector is still offering value below long-term normal levels and replacement cost. He estimated that returns through the cycle at CPI plus 3% to 4%. Another of its attractions is its liquidity, he argued, contrasting it against the unlisted property sector.

Tony Mount, CIO of Becton Funds Management, argued the value proposition of Australian unlisted property. While returns from unlisted property syndicates/trusts have fallen, albeit in a lagged manner to the significant declines of the listed sector, at the underlying asset level the outlook for rentals and tenant vacancies is much more positive than the last property downturn of the early 1990s, he argued. Mount attributes this to the Australian economy holding up demand, while supply has been limited by the absence of speculative building. He argued that longer-term total returns for unlisted property should be in the low to mid teens, led by relatively attractive income distributions. Capital growth in the near future is likely to be subdued, however, he warned.

Finally, Jason Isherwood, Director of Ironstone Funds, focused on the value of residential property in a portfolio, noting that it's the largest asset class in Australia, but the least used in portfolios. Overseas, he said, there are many property funds focussed on the residential sector, and argued the case for a professionally managed fund comprised of 'buy and hold' residential property, noting a fund manager can exploit the many inefficiencies of the market and that a fund of assets provides greater diversification over a DIY approach, with lower gearing.

Our view

Infrastructure deserves to be recognised as a stand-alone sector. However, investors may already have an exposure to mainly Australian infrastructure via an equities managed fund or a direct share portfolio.

Listed property securities are still an equity exposure and investors face additional risks to those that characterise the underlying assets. It may be prudent to gain an exposure to more traditional income-producing property trusts for conservative clients and an exposure to growth-orientated property companies for clients with a longer time frame. Global property securities are a better fit with the latter and currency exposure can be substantially hedged.

Finally, we have seen very few workable models of a professionally managed buy and hold residential property fund in Australia. Investors have a long history of successfully investing in residential property and a D-I-Y approach remains a tax effective avenue for many investors. There are of course, headaches like bad tenants and recourse lending.

Table 2: Due Diligence Forum Research Papers – Getting Real (Property)

Author	Research Paper title
Colonial First State	Global listed infrastructure - the best defence is a good offence
Resolution Capital / Pinnacle	What the future holds for listed property
Becton Funds Management	Does unlisted property still have a role in a well diversified investment portfolio?
Ironstone Funds	Australian residential property - investing on solid ground

To access these papers, go to www.PortfolioConstruction.com.au

PortfolioConstruction Due Diligence Forum: Taking Stock (Equities - Country/Region)
Deirdre Keown, Managing Editor, PortfolioConstruction Forum

This stream started with an examination of the advantages of using conservative options strategies to enhance the income from equity funds. Patrick Noble, Investment Specialist, Zurich Financial Services argued that the market landscape has changed, but what hasn't changed is investors' need for reliable income streams. However, the attraction of cash has diminished following a rapid series of interest rate cuts and, after suffering share price declines, many companies are now cutting their dividends in an effort to preserve capital. He offered as an alternative, equity income funds that use conservative options strategies, arguing they can target a specified running yield, pay a regular income stream, and provide daily liquidity.

The next presenter, Robert Hook, Portfolio Manager, SG Hiscock & Co, warned that massive government intervention in markets in 2008/2009 will have far reaching implications for global markets, and by extension, Australian equities.

The free market system has come under attack, he noted, pointing to measures introduced or about to be introduced including greater financial regulation, tightening of information viz-a-viz all movements of money and more government regulation over industry. Additionally, large amounts of borrowings by governments will act to crowd out legitimate borrowers. This would normally drive up interest rates and act as a brake on the economy, he said, however, central bank balance sheets have been expanded in order to prevent interest rates from being driven higher and a nascent recovery in the economy becoming stifled. It is this soft option that will eventually lead to higher prices for most commodities and hard assets, along with a Pandoras box of economic consequences, he warned.

"Why invest in Asia?" would have been seen as an odd question just a few years back. But post GFC, the question has again become heard, according to Presenter Catherine Yeung, Associate Director, Asia Pacific ex-Japan Equities with Fidelity International.

She argued that secular trends and structural factors in Asia provide solid ground for regional economic growth to sustain in the long run. The region's stock markets are developed and share prices are being driven by a number of key factors including improving macro economic news flow, healthy earnings growth, buoyancy of takeovers, industry consolidation, and a dynamic supply of liquidity in the market. However, equities in Asia Pacific ex Japan are likely to remain volatile in the near term, she warned, as they continue to be driven by global financial markets troubles and exports are under pressure.

The final session looked at the effects of the Global Financial Crisis on short selling – or active extension. Partial bans on various forms of short selling in September 2008 were in many cases extended on into 2009, causing uncertainty about the strategy, according to Sean Fenton, Portfolio Manager with Tribeca Investment Partners. He argued that, historically, intervention of this type tends to be temporary in nature as short selling provides benefits in increasing market liquidity and pricing efficiency, both viewed as being beneficial in driving capital efficiency in a market economy.

Adding to the uncertainty, evidence of outperformance from the strategy has been rather mixed to date. This is a result of the impact of the highly volatile market and economic environment which has pressured pure quantitative strategies that are over-represented in the market, Fenton argued.

Table 3: Due Diligence Forum Research Papers – Taking Stock (Country/Region)

Author	Research Paper title
Denning Pryce / Zurich	Equity investing for regular, high income with low volatility
SG Hiscock / EQT	Alternative strategies within Australian equities
Fidelity International	Why invest in Asia?
Grant Samuel Tribeca	The future role of active extension in Australia

To access these papers, go to www.PortfolioConstruction.com.au

PortfolioConstruction Due Diligence Forum: Taking Stock (Equities - Global Diversified)
Dr. Caitlin Ruddock, Investment Analyst, van Eyk

The first key takeout from this stream was the importance of sticking to the simple fundamentals of investing. Despite the GFC, there is no need to change ones investment approach. The 60% decline in the MSCI World Index from peak (Q4, 2007) to trough (Q1, 2009) was dramatic but does not spell the end of capitalism. Investors should continue to focus on the basics of investing: undertake independent research; stick to what they know or at the very least understand; and, invest for the long term. Just as this is true for global equities managers, it is true for building client portfolios.

Secondly, despite the recent rally in global equities, the 10-year average returns to global equities are well below their historical averages. This infers that there is still good value in global equities even allowing for global growth to return to a lower level which, many managers estimated as likely to be between 2% to 3% per annum. The secular trends in emerging markets are strong. Papers cited emerging markets' favourable demographics, growth in wealth and savings, and the relative balance sheet strength as contributing factors. However, investors should not expect the double-digit returns witnessed over the first six months of 2009 to continue. In addition, certain segments of emerging markets, such as Asia, seem relatively expensive.

Deleveraging of Western consumers (and governments) was touched on in multiple sessions. Japan and Germany gave a clear snapshot of some of the likely consequences of deleveraging. While between 1992 and 2007, economies such as the USA, UK, Spain and Australia grew rapidly on the back of debt-financed consumers, the Japanese and German consumers de-levered and increased their savings rates. The result was a notable difference between growth in house prices and GDP growth rates. Relative to their levered, developed peers, house prices in Japan and Germany over the period were at best flat and both countries experienced notably lower economic growth. Thus, as credit growth slows and consumers de-lever in the US, UK, etc, it is reasonable to expect lower global economic growth which in turn will lead to lower global benchmark returns.

Our view
Current market conditions are well suited for active global equities management. We expect stock and sector volatility (often used as a proxy for active managers' opportunity set) to remain elevated as the global economic conditions remain challenging which in turn leads to uncertainty in corporate earnings. As such, investing with highly skilled fund managers that are likely to outperform the benchmark may be critical for achieving investment objectives.

Table 4: Due Diligence Forum Research Papers – Taking Stock (Global Diversified)

Author	**Research Paper title**
Aberdeen Asset Management	Global equity investing – keeping it simple in a complex world
T.Rowe Price	Secular growth in emerging markets and how to access it
Magellan Asset Management	Positioning portfolios in a deleveraging world
Capital International / Pinnacle	Global investing – a paradigm shift in market leadership

To access these papers, go to www.PortfolioConstruction.com.au

PortfolioConstruction Due Diligence Forum: Alternatively (Alternative Assets)
David Wright, Founder, Zenith Investment Partners

This stream featured a diverse range of issues.

Tim Wong, CEO of AHL showed that one of the key attractions of managed futures strategies is that unlike many tradition investment approaches, the strategy is non-directional meaning that returns can be generated in both rising and falling market conditions. The best evidence of this is the strong performance of many managed futures managers through the GFC. As such, managed futures provide a very different return profile to that of traditional asset classes making the strategy a strong diversifier and therefore valuable addition to a diversified portfolio. Given the strategy is non directional, the timing of entry into a managed futures fund is less sensitive than long only investment strategies where the timing of entry (e.g. at the top of the market) can have a material impact on even the long term return experienced by the investor.

Commodities is an asset class often overlooked by Australian investors who believe they have adequate commodities exposure either through the resources stocks held in their managed funds or via direct shareholdings in BHP, RIO and other resources stocks. While this exposure is valuable, it provides exposure mainly to base and precious metals and is via equities. Jeremy McElrea, Director of Barclays Capital, showed that commodity-based equities are correlated to equity markets so don't provide the same diversification benefits as direct commodity prices which have a lower correlation to equity markets. In addition, he argued, exposure to direct commodity funds / products provides exposure to soft commodities such as grains and other agricultural commodities which are likely to enjoy increasing demand as the emerging markets standard of living improves and diet becomes more sophisticated.

The third session in this stream focused on Fund of hedge funds (FOHF), which have well and truly fallen out of favour with investors post GFC. A large part of the issue has been that they were "sold" incorrectly in the first place, promising "equity like returns with bond like volatility" and described as "market neutral", according to Michael O'Dea, Principal Alternative investment Solutions with Jana Investment Advisers. In fact, the experience has been more "bond like returns with lower volatility". Investors were also not aware that the legal structure of most FOHF (the Australian unit trust being a feeder fund into an offshore fund) was subject to Foreign Investment Fund regulations and a "bed and breakfast" sale and buy back of units on or around 30 June each year. This results in virtually all of the returns being delivered to investors as income – not attractive for those investors on high marginal tax rates. In future, O'Dea argued, the FOHFs that provide the most attractive investment options will be those that invest in a more concentrated portfolio of high quality hedge fund managers, gain access via direct mandates and negotiate more attractive fee outcomes for investors.

The final session focused on capital protection. While it has and will serve its purpose for those investors who invested in structured products in the two years leading up to the GFC, it's not much solace that they are now locked in these products for up to another five years with no prospect of a return above their initial capital.

Tony Rumble, Founder and Asset Design Consultant with Alpha Structured Investments, argued that the GFC has resulted in some positive changes in the use of capital protection with a much greater focus now on greater transparency of products and on how the capital protection mechanisms work. While the low levels of interest rates (resulting in higher bond floors) and higher levels of volatility (resulting in more expensive options) has made many structured products not feasible, the move back to real index style or stock-based structures has been a major positive.

Our view

A common question when considering alternatives for inclusion in portfolios is "where do they fit in the portfolio?" Many people confuse alternative asset classes with alternative investment strategies and therefore lump them all into the same "bucket". There are far more alternative strategies than asset classes which makes it much easier. Alternative strategies should be allocated to within the asset class they invest in (e.g. Long/short Australian equities funds should make up part of the Australian equities exposure). In the case of alternative asset classes, a logical approach is to assess the longer term volatility of the asset class which will then determine whether the asset class should be included in the growth or defensive allocations within the portfolio. The actual allocation will depend on the risk profile of the investor but needs to be meaningful (e.g. 5% of the portfolio) to make any material difference. Given that portfolio construction in Australia is very home centric with the average balanced portfolio holding 35% to 40% in Australian equities, there is plenty of scope to include an allocation to alternative asset classes and / or strategies within our portfolios.

Table 5: Due Diligence Forum Research Papers – Alternatively (Alternative Assets)

Author	**Research Paper title**
Man Investments	Why has it taken another crisis to recognise the benefits of managed futures?
Barclays Capital	Investing in commodities for a diversified portfolio
Jana / nabInvest	Overcoming the shortfalls of the traditional approach to investing in hedge funds
Alpha Structured Investments	Why does capital protection have to be so hard?

To access these papers, go to www.PortfolioConstruction.com.au

PortfolioConstruction Due Diligence Forum: The Lot (Multi-asset class)
Amanda Gillespie, Head of Investment Consulting, Lonsec

This Due Diligence Forum stream focused on broad asset and portfolio construction issues.

Select Asset Management's Dominic McCormick made the argument that there is no fixed SAA that will deliver risk/return objectives with certainty. A key take out from this session was that, at a minimum, investors should be ensuring that their SAA framework (if they follow one) is a robust one. Ideally, however, SAA should incorporate forward-looking return expectations, McCormick argued, as well as reviewed in a disciplined manner and on a regular basis (but not so regularly that it becomes tactical asset allocation), and it should consider a wide opportunity set. Investors should be realistic about the limitations of an SAA framework – it may be the starting point and 'set the scene', but it does not mean that a 'set and forget' approach should be adopted, according to McCormick.

Russell Investments' Andrew Pease added further to the SAA debate by posing that investors should vary from their SAA by Strategic Tilting, if two conditions are met: there needs to be high confidence in a view before employing a 'tilt'; and, investors should be able to cope with taking contrarian positions which may drag on performance before they pay off (if in fact they do). "If you are going to take occasional big bets, it is best to be confident that the odds are in your favour," Pease noted. Investors should only take strategic tilts away from the SAA if there is very high conviction in a view (typically predicated by a market that has reached an extreme in terms of its levels relative to long term averages). Of course, that raises the issue of identifying extremes.

Investment Science offered Strategic Risk Allocation as an alternative to SAA, arguing that it is the decision of how to allocate risk rather than assets that is important. David Toohey, CIO, contended that one whereby only a third of portfolio risk be allocated to traditional asset classes (equities, bonds, etc) and the remainder be attributed to extended/alternative assets and/or strategies.

The final session focused on the use of Exchange Traded Funds (ETFs). Anthony Chan, Senior Investment Specialist with iShares, noted the key benefits of ETFs: low cost, transparency, liquidity, accessibility and the ability to achieve diversification in a portfolio. The decision to use ETFs is not necessarily a decision about active or passive management, he noted – while ETFs adopt a passive approach, they can be used to complement active investments within a diversified portfolio such as portfolios constructed around a 'Core plus Satellite' strategy.

Our view

Overall this DDF certainly challenged the ongoing suitability of the conventional SAA approach. Investors do need to be asking whether the asset allocation framework they adopt is forward-looking, reviewed regularly and is flexible enough to accommodate structural change. One of the main principles of SAA is diversification across asset types and this is the one key point that everyone continues to agree on.

The issue that advisers face is how to put the alternatives to SAA presented into practice. These concepts are far more easily accessed via an implemented solution (buying a diversified product that

incorporates a more active approach to asset allocation). For Practitioners to implement active asset allocation consistently and in a timely manner across a broad client base certainly poses some challenges. For example, if wide flexible ranges are adopted around each asset class, what does the Practitioner use as the starting/reference point for an investor's portfolio?

Finally, the case to be active does not only apply to setting asset allocation, but also to the underlying investments within each asset class. When considering the use of passive funds, investors may need to decide on the relative importance (i.e. trade-off) of cost, liquidity and other investment objectives such as market outperformance (delivering alpha). In the challenging investment environment we face ahead, investors also need to consider whether they should be giving active managers more scope to take advantage of opportunities within certain asset classes (with wide, flexible mandates for example), or in some instances, questioning whether there is merit in paying an active fee at all.

Table 6: Due Diligence Forum Research Papers – The Lot (Multi-Asset Class)

Author	Research Paper title
Russell Investments	Strategic tilting – guidelines for use in portfolios
Investment Science	SRA - the missing piece in the puzzle
Select Asset Management	The case for a flexible approach to asset allocation
iShares / Barclays Global Investors	Exchange Traded Funds - a portfolio construction tool for the new reality

To access these papers, go to www.PortfolioConstruction.com.au