

*The Australian Investors
Association*

Melb 2003

Asset Allocation

The key to long term returns

Kevin Bailey CFP



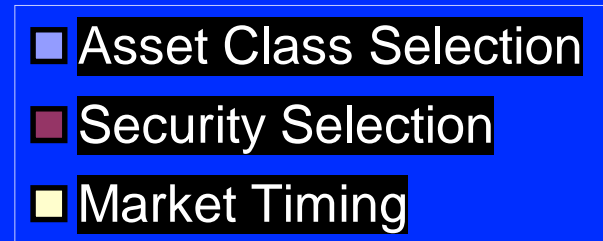
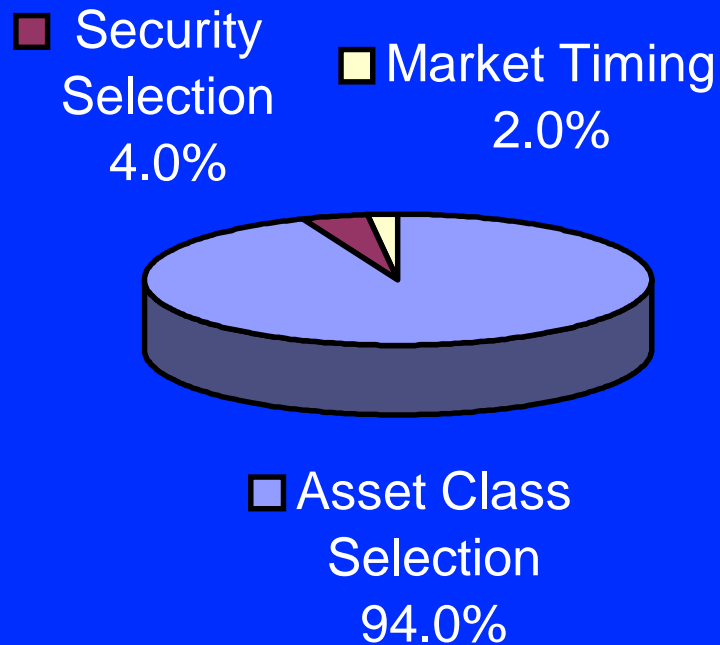
Fear & Greed

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information.

What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

(Preface by Warren Buffett in the “Intelligent Investor”, by Benjamin Graham)

Determinants of Portfolio Performance



(Study by Brinson, Hood, Beebower - Financial Analysts Journal 19 88 and 19 89)

Random Market Noise

There is a commercial imperative driven by a multi-billion dollar industry that keeps our focus on the relatively unimportant aspects of market timing, stock picking and prophesising the future

The great false hope, “searching for financial guru’s”

Investors vs Speculators

“The psychology of the speculator mitigates strongly against his success. By relation of cause and effect he is most optimistic when prices are highest and most despondent when they are at the bottom.”

Benjamin Graham
Security Analysis 1934 p12

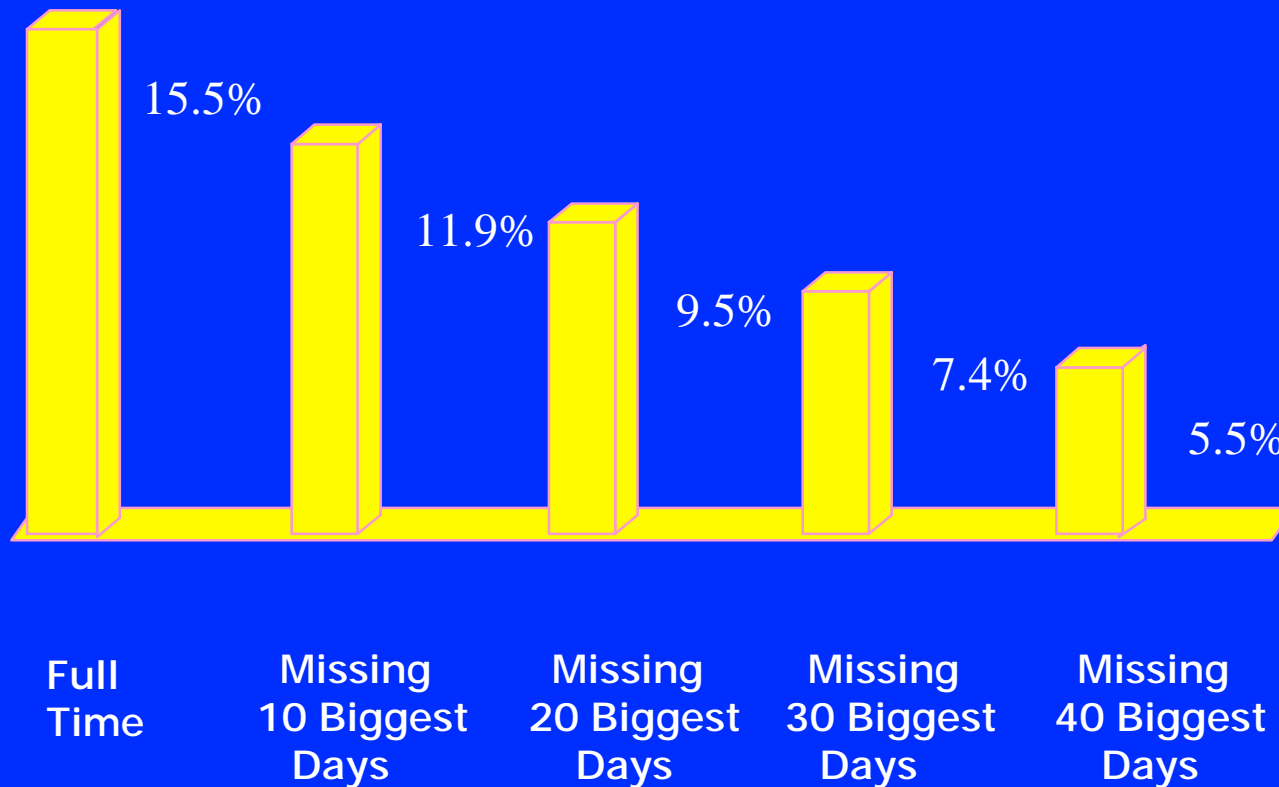


Successful Investing - counter intuitive

- Most people don't believe the stock and property markets discount all available information
- Most people fail to buy low and sell high
- 90% of decisions are made on the basis of emotions rather than intellectual decisions
- Big Money moves in secrecy
- Markets destroy the average investor

Time in not timing the Market

Returns on the US Sharemarket 1980 to 1993



(Source: Sanford Bernstein)

Sticking to the Strategy

- **US Study (1984 - 2002)**

S&P 500 index generated a return of 12.9% pa

Average return of all US equity funds was 9.6% pa

Average investor only achieved 2.7% pa

Survey conducted by Dalbar (US Mutual Fund Research Firm)

- **US Morningstar Research**

Average returns from Diversified funds 12.2% pa over 5 years, but investors earned -2.2% pa

- **Australian Study by IFR:**

Average returns from Diversified funds 10.4% pa over 5 years, but investors earned +2.4% pa

Investor Irrationality

- Too much emphasis on the latest news
- Chase the latest hot action
- Ignore long term trends
- Trade too often

- Imagine patterns that don't exist
- Confuse luck with skill
- Place too high a value on certainty of outcome
- Emotional Value of Loss (Regret)
= 2 to 3 times the monetary value of Gain



Index Management

- Accepts the average of the total market return
- Allows commercial benchmarks to define strategy
- Sacrifices transaction costs and turnover in favour of tracking

Active Management

- Undermines asset class exposure to keep up with the most “promising” securities
- Generates higher fees, trading costs and taxes due to increased turnover
- Attempts to beat the capital market return through forecasting



Is Your Adviser Independent?

1997 ASC Policy Statement on Investment Advice

To be called Independent a practice must:

- * avoid any commissions, trailing commissions, soft dollar arrangements and benefits from product providers
- * operate free from any direct or indirect restrictions relating to securities recommended
- * operate without any conflict of interest created by ownership links to product providers.

Developing a Financial Plan

The Key elements of a plan are:

- Understanding the Psychology
- Minimising Costs
- Managing Tax
- Managing Risk of Investing



Principles & Beliefs

Capital Markets Work and Are Efficient

For investment purposes, assets are fairly priced

Risk & Return Are Related

Priced risk factors determine expected return

Diversification Is Essential

Diversification is the antidote to uncertainty. Concentrated investments add risk with no additional expected return

Structure Explains Performance

Asset Allocation principally determines results in a broadly diversified portfolio

Portfolio Construction

- Ensure portfolio is grounded in efficiency of capital markets
- Ensure you capture the specific dimensions of risk identified by academic research
- Minimise transaction costs
- Enhance returns through minimising trading costs



Three Factors of Risk

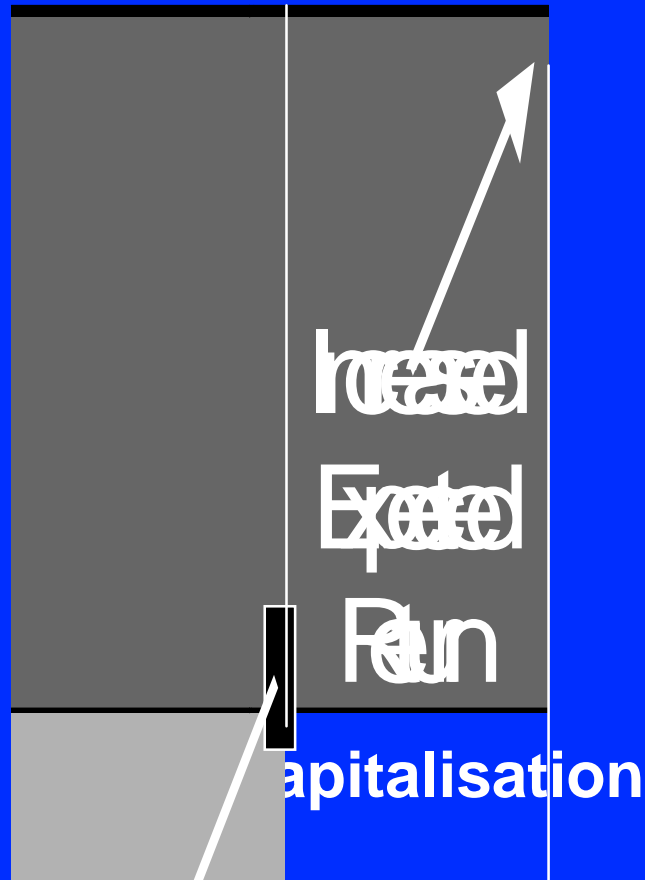
- **Market Factor** (complete value weighted universe of shares)
Shares have higher expected returns than fixed interest
- **Company Size Effect** (measured by market capitalisation)
Small company shares have higher cost of capital and higher expected returns than large company shares
- **Value Effect** (measured by ratio of 'book' value to 'market' equity value)
Relatively distressed "value" company shares have higher cost of capital and higher expected returns

Managing Asset Class Risk

Small Capitalisation

Growth
(Low BtM ratio)

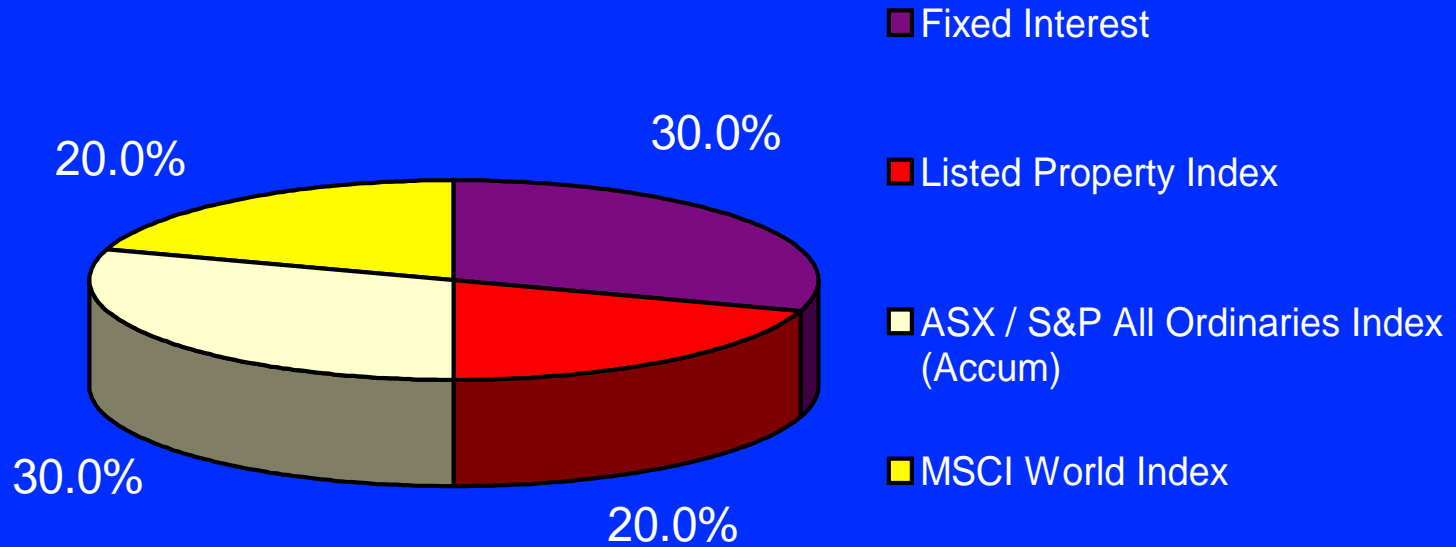
Value
(High BtM ratio)



Diversify Risk Factors

Annual Returns Yrs	MSCI World Index A\$ %	Global Value A\$ %	Global Small A\$ %
Dec-82	26.24	33.56	28.47
Dec-83	32.84	40.27	43.59
Dec-84	13.98	21.14	13.08
Dec-85	70.19	76.76	80.36
Dec-86	45.63	49.47	35.84
Dec-87	6.92	10.42	23.88
Dec-88	4.23	10.64	6.71
Dec-89	26.16	36.03	35.17
Dec-90	-15.16	-13.21	-14.79
Dec-91	20.09	20.37	25.27
Dec-92	4.42	17.06	6.30
Dec-93	24.63	38.47	28.78
Dec-94	-8.13	-8.77	-5.97
Dec-95	25.90	27.34	17.18
Dec-96	6.23	6.34	2.09
Dec-97	41.06	35.67	13.06
Dec-98	32.01	21.16	9.89
Dec-99	17.27	4.45	15.81
Dec-00	2.28	24.35	16.44
Dec-01	-9.62	2.34	8.37
Dec-02	-27.21	-19.05	-15.46
Annualised	14.10%	18.74%	16.11%

Basic Index Portfolio



Monthly data: Jan 89 - Aug 03

Annualised Return(%)

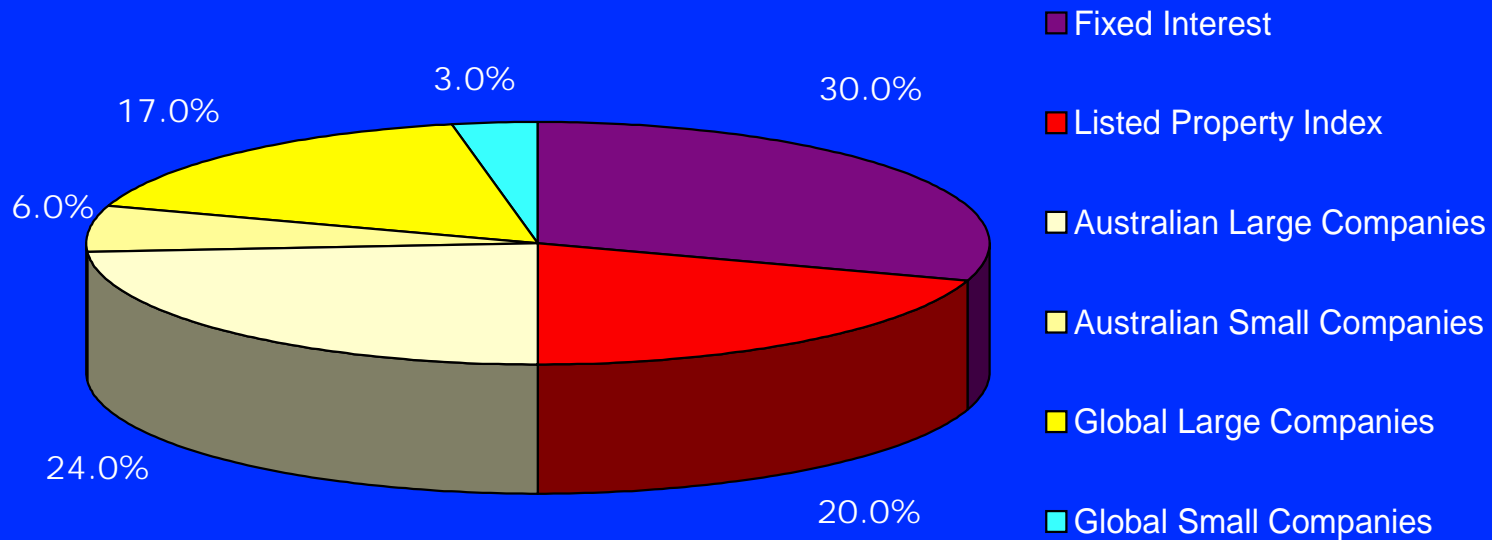
Standard Deviation (%)

Basic Portfolio

9.74%

7.34%

Size Effect



Monthly data: Jan 89 - Aug 03

Annualised Return(%)

Standard Deviation (%)

Basic Portfolio

9.74%

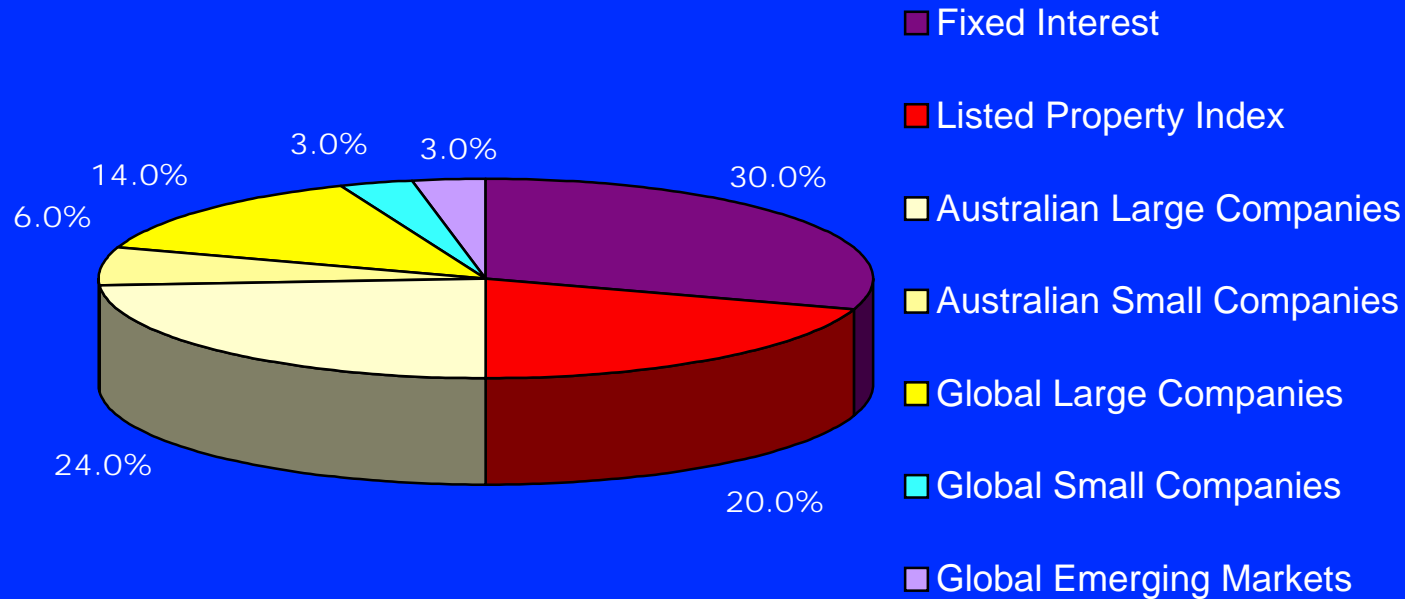
7.34%

Size Effect

10.00%

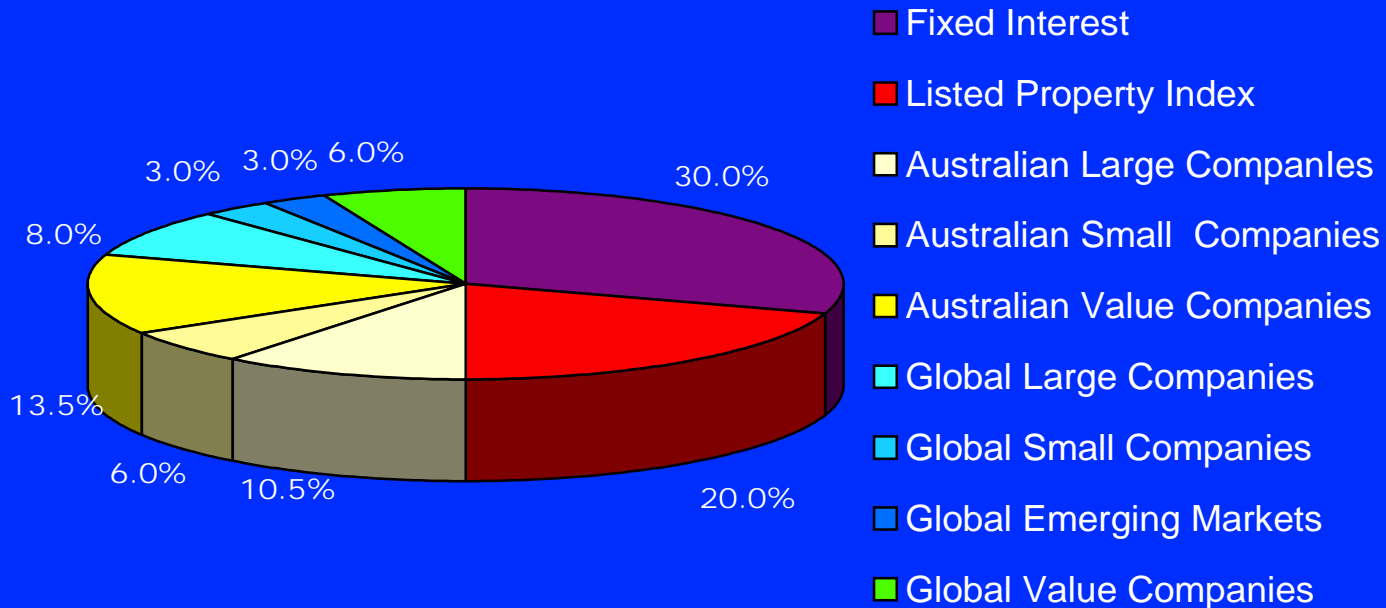
7.18%

Emerging Market Diversification



Monthly data: Jan 89 - Aug 03	<u>Annualised Return(%)</u>	<u>Standard Deviation (%)</u>
Basic Portfolio	9.74%	7.34%
Size Effect	10.00%	7.18%
Emerging Market	10.30%	7.24%

Value Effect (Book to Market BtM)



Monthly data: Jan 89 - Aug 03	<u>Annualised Return(%)</u>	<u>Standard Deviation (%)</u>
Basic Portfolio	9.74%	7.34%
Size Effect	10.00%	7.18%
Emerging Market	10.30%	7.24%
Value Effect	11.08%	7.35%

Model Portfolio - Structure

ASSET CLASS / INVESTMENT	80% Bonds	60% Bonds	50% Bonds	40% Bonds	20% Bonds
	20% Equity	40% Equity	50% Equity	60% Equity	80% Equity
<u>Australian Shares</u>	6.0%	18.0%	24.0%	30.0%	42.0%
Australian Large Company	2.4%	6.3%	8.4%	10.5%	14.7%
Australian Small Company	0.0%	3.6%	4.8%	6.0%	8.4%
Australian Value	3.6%	8.1%	10.8%	13.5%	18.9%
<u>International Shares</u>	4.0%	12.0%	16.0%	20.0%	28.0%
Global Large Company	4.0%	4.8%	6.4%	8.0%	8.4%
Global Small Company	0.0%	3.6%	4.8%	6.0%	5.6%
Emerging Markets	0.0%	0.0%	0.0%	0.0%	5.6%
Global Value	0.0%	3.6%	4.8%	6.0%	8.4%
<u>Listed Property Securities</u>	20.0%	20.0%	20.0%	20.0%	20.0%
Australian Property	12.0%	12.0%	12.0%	12.0%	12.0%
Property Securities Index	8.0%	8.0%	8.0%	8.0%	8.0%
<u>Fixed Interest</u>	50.0%	40.0%	30.0%	20.0%	8.0%
Global Diversified Fixed Interest	50.0%	40.0%	30.0%	20.0%	8.0%
<u>Cash Securities</u>	20.0%	10.0%	10.0%	10.0%	2.0%
Short Term Bonds	16.00%	8.00%	8.00%	0.0%	0.0%
Cash at Call	4.00%	2.00%	2.00%	10.0%	2.00%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%

	80% Bonds 20% Equity	60% Bonds 40% Equity	50% Bonds 50% Equity	40% Bonds 60% Equity	20% Bonds 80% Equity
ONE YEAR TOTAL RETURN (%) ENDING 30/6/03	8.02	5.56	4.02	2.93	-0.35
THREE YEARS ANNUALISED RETURN (%) ENDING 30/6/03	7.65	6.7	5.78	5.15	3.66
FIVE YEARS ANNUALISED RETURN (%) ENDING 30/6/03	7.37	7.44	7.29	7.27	6.90
TEN YEARS ANNUALISED RETURN (%) ENDING 30/6/03	8.46	9.09	9.27	9.58	10.05
ANNUALISED RETURN (%) 1989-2003	9.67	10.34	10.54	10.85	11.21
ANNUALISED STANDARD DEVIATION (%) 1989-2003	3.34	5.22	6.26	7.40	9.62
LOWEST ONE YEAR RETURN (%)	-2.36	-6.16	-7.72	-9.82	-12.92
	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)
LOWEST ANNUALISED THREE YEAR RETURN (%)	6.37	6.17	5.18	4.41	3.01
	(4/98-3/01)	(3/00-2/03)	(3/00-2/03)	(3/00-2/03)	(3/00-2/03)
HIGHEST ONE YEAR RETURN(%)	17.88	28.02	32.49	37.58	46.31
	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)
HIGHEST ANNUALISED THREE YEAR RETURN (%)	14.03	18.02	19.64	21.68	25.04
	(1/91-12/94)	(1/91-12/94)	(1/91-12/94)	(2/91-1/94)	(2/91-1/94)
NEGATIVE QUARTERS 1989 - 2003					
Total = 172 (ie Jan - Mar, Feb - Apr)	7	21	30	32	40

	80% Bonds 20% Equity	60% Bonds 40% Equity	50% Bonds 50% Equity	40% Bonds 60% Equity	20% Bonds 80% Equity
ONE YEAR TOTAL RETURN (%) ENDING 31/08/03	6.77	7.34	7.38	7.43	7.63
THREE YEARS ANNUALISED RETURN (%) ENDING 31/08/03	7.22	6.69	6.17	5.65	4.79
FIVE YEARS ANNUALISED RETURN (%) ENDING 31/08/03	7.33	8.26	8.56	8.86	9.52
TEN YEARS ANNUALISED RETURN (%) ENDING 31/08/03	7.88	8.53	8.78	9.03	9.61
ANNUALISED RETURN (%) 1989-2003	9.59	10.37	10.65	10.91	11.48
ANNUALISED STANDARD DEVIATION (%) 1989-2003	3.34	5.19	6.22	7.30	9.57
LOWEST ONE YEAR RETURN (%)	-2.36	-6.13	-7.65	-9.17	-12.63
	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)	(2/94-1/95)
LOWEST ANNUALISED THREE YEAR RETURN* (%)	6.38	6.12	5.27	4.43	2.91
	(4/98-3/01)	(3/00-2/03)	(3/00-2/03)	(3/00-2/03)	(4/00-3/03)
HIGHEST ONE YEAR RETURN*(%)	17.87	27.82	32.28	36.73	46.02
	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)	(2/93-1/94)
HIGHEST ANNUALISED THREE YEAR RETURN*(%)	14.02	17.87	19.47	21.09	24.76
	(1/91-12/94)	(1/91-12/94)	(1/91-12/94)	(2/91-1/94)	(2/91-1/94)
NO OF NEGATIVE QUARTERS (1989-2003) (Total of 174 individual rolling quarters)	8	22	29	32	40

Chasing Performance

	Index 60% equity/ 40% Bond	Asset Class Portfolio 60/40	Mercer survey Bal Median	Best Manager	Worst Manager
1 Year Std Dev	5.69% 6.83%	7.34% 5.19%	4.4%	9.4% BGI	1.7% Advance Tower
5 Year Std Dev	6.75% 5.97%	7.27% 6.20%	5.4%	8.0% Maple Brown	3.4% BT
10 Year Std Dev	8.22% 7.22%	9.58% 7.21%			
15 Year Std Dev	9.86% 7.47%	10.88% 7.46%			

Failure of Active Managers

Source: Mercer Pooled Funds Survey, Period ending August 2003

Balanced Funds	1 Year	Return
Best	Barclays Diversified	+9.40 %
Worst	Advance PST & Tower	+1.70 %
Median		+4.40 %
Asset Class		+7.34 %

Failure of Active Managers

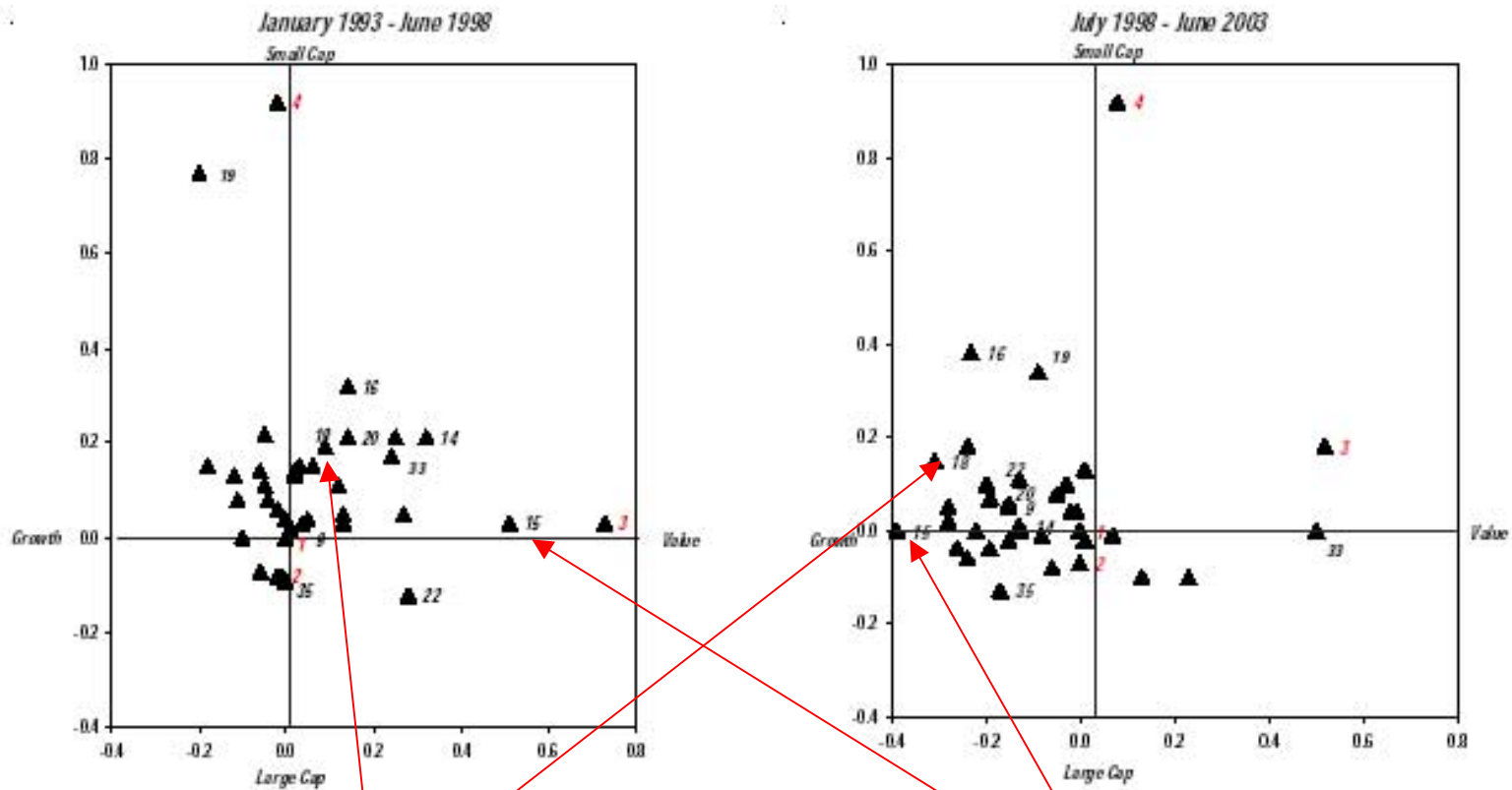
Source: Mercer Pooled Funds Survey, Period ending August 2003

Balanced Funds	5 Years	Return
Best	Maple Brown	+8.00%
Worst	BT	+3.40%
Median		+5.40%
Asset Class		+7.27%

Style Drift

Three-Factor Model

Australian Equities Regression Results



Colonial First State Imputation Fund

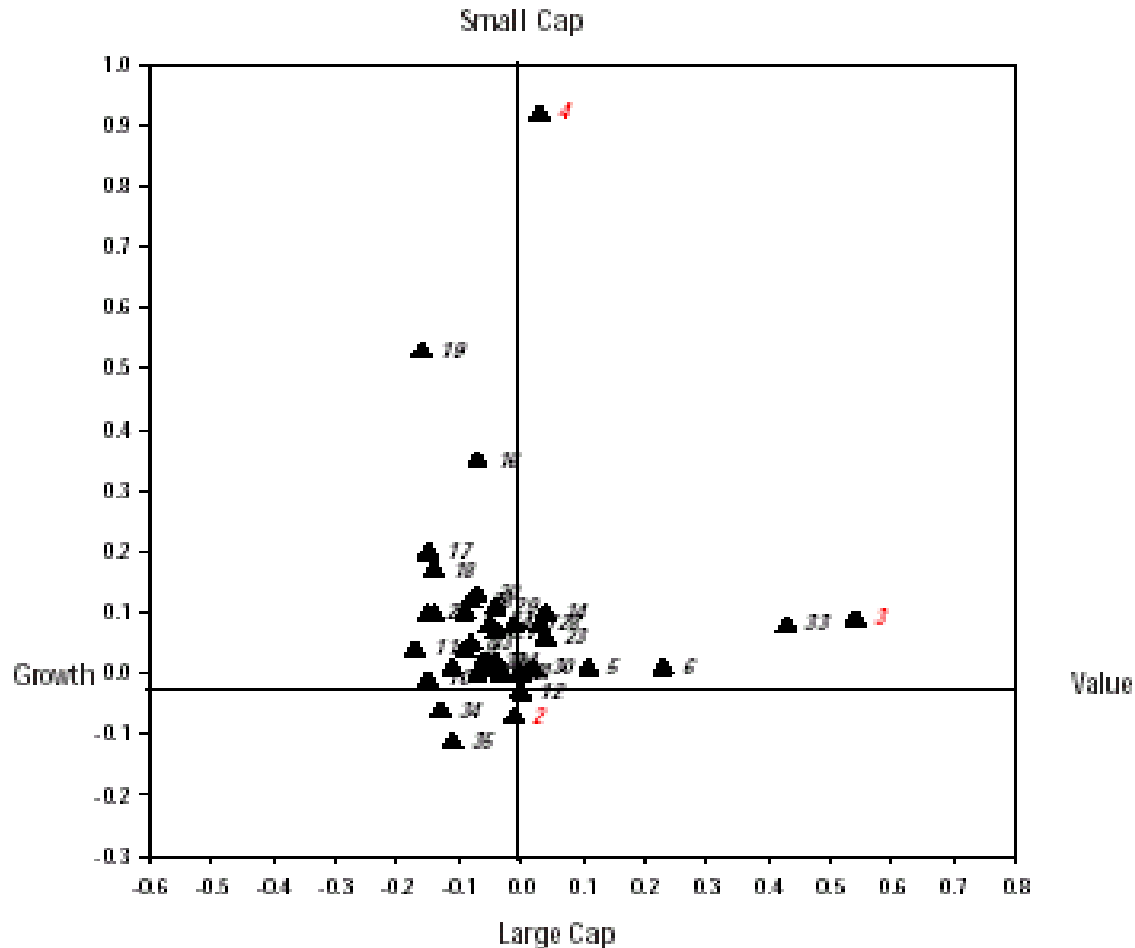
AXA Industrials Share Fund

Index Hugging

Three-Factor Model

Australian Equities Regression Results

Monthly: June 1993- June 2003



In Summary

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What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

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