A Clear Direction Financial Planning

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Investment Portfolio Basics

Ensuring you understand how we invest your money is extremely important to us. This brochure provides the basic details of that process. It should be read in conjunction with our 'Investment Philosophy' document to give a full picture of what we do.

The basis of our portfolio construction process is that it must be consistent, reliable and based on the latest academic research into the building of effective long term investment portfolios.

Step 1 – Defining Your Most Appropriate Asset Allocation

When we look to build an investment portfolio, there are various 'asset classes' into which we can invest your money. These include cash investments (like bank accounts), Australian share investments (which is an investment in Australian companies), property investments and international share investments (which is investing in overseas companies in the United States, Europe and Asia). There are even obscure asset classes like 'taxi licenses', 'wines' and 'art' – although we steer clear of these.

The first and most important stage of the process is to carefully consider what mix of assets is best for your portfolio. This will be different for every person, ***and research shows that this mix of asset classes is the number 1 determinant of investment returns***. That's why we focus on getting it right.

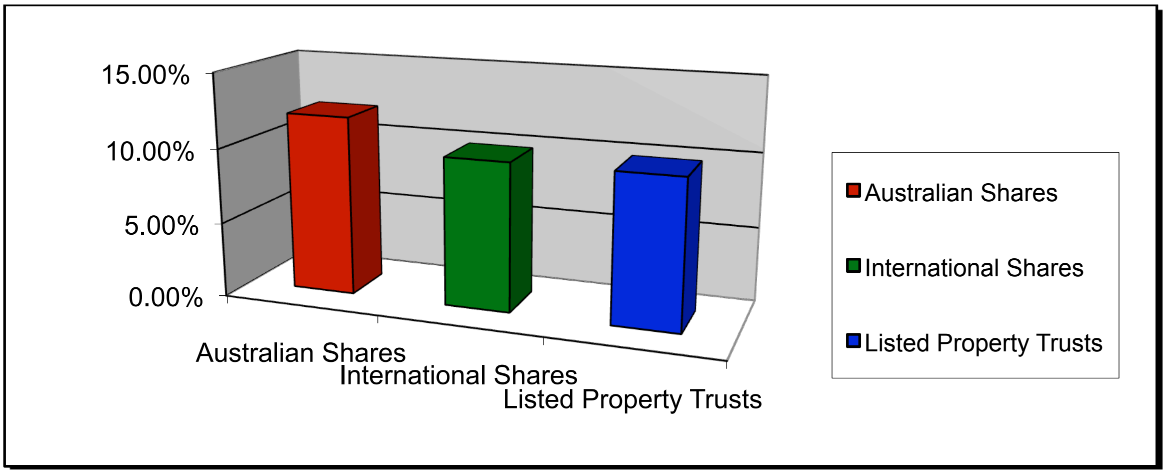
To get this mix right we very keenly focus on what income you need to draw from your portfolio, the time frame you intend to invest for and your investment experience. We also take into account our assessment of your attitude towards investment volatility (the ups and downs likely to be experienced by your investment portfolio) and your desire for investment profits.

We categorise all of the investments that are available into two general categories – **defensive assets** and **growth assets**.

Defensive assets are generally cash and fixed interest investments. Cash investments are bank account investments. The fixed interest investments we use are similar to bank term deposits. These investments provide a steady income stream, with the safety that the money invested in these asset classes is secure. You might say that these are the low risk, low return investments that will help you to sleep soundly at night.

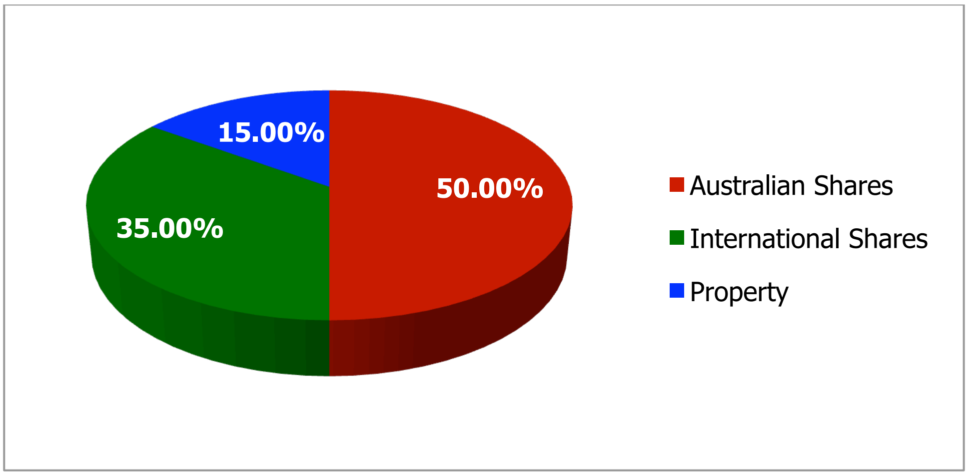
Growth assets classes include Listed Property, Australian shares and International shares. Listed property investments are listed on the stock exchange, with the underlying assets being office buildings, retail shops and industrial sites (for example Westfield Shopping Centres). Owning Australian shares means that you are a part owner of a business, or portfolio of businesses listed on the Australian stock exchange (businesses like BHP and Telstra). Owning international shares means that you are owning businesses listed all over the world – the US, Europe and Asia. In owning all of these assets you would expect to experience significant fluctuations (volatility) in asset values. In some years they will rise sharply in value, other years they will fall in value. Importantly, the average return from these asset classes have been higher than the returns you get from investing in cash and fixed interest investments.

Actually, within these growth assets the returns from the three major classes, (Property, Australian shares & International shares) have been comparable in the longer term, averaging about 10% to 12% a year over the past 30 years. *(Source :Vanguard, 2012)*



Therefore, for the sake of diversification we use all three growth asset classes in our portfolios. *(NB - These figures are higher than we would expect from them in the future)*

Australian shares provide an extra benefit through the provision of tax benefits on most dividend payments through the application of franking credits. As a result we build the growth asset component of a portfolio with a slight over weighting towards Australian shares. A normal allocation of the growth assets in a portfolio would be as follows:



 # The Australian share investments that we incorporate in out portfolio also include some listed property trusts.

Now, to get the balance of your portfolio right between the 'defensive' investments and the 'growth' investments, we take into account your specific income and capital needs, your investment timeframe and your acceptance of investment volatility. (The more growth assets in a portfolio, the higher expected return BUT the greater volatility).

Step 2 – Which Growth Assets? - Using Index Funds as the Basis for Investing

The next step is to select the actual growth investments within each asset class. That is, how do we expose the portfolio to Australian shares, International shares and listed property trusts?

What exactly is an Index?

An index is the collection of all the investments in a particular investment universe. For example, the ASX 200 is the collection of the largest 200 companies on the Australian stock exchange (ASX).

Indices were developed as a method of measuring the performance of a market over time. What people did was to measure the change in performance of all of the companies in the index over time. For example, you often hear on the news that the 'ASX200' has risen by 1%. That means that on average the top 200 companies have risen in value by 1%. The biggest six companies in the ASX 200 index at the moment are BHP, the big 4 banks and Westfield.

Given that indices are used to measure performance, many investment managers measure their returns against the index. The results have been really significant – very few active investment managers managed to perform better than the index. This led, in the 1970's, to the start of a new way of investing, the 'Index Fund'.

What is an Index Fund?

An index fund is a managed fund investment that owns all of the investments that are in an index, in the same proportion as they exist in the index. For example, as we said previously the largest 6 companies in the ASX200 index are BHP, the big 4 banks and Westfield. These are then the biggest 6 companies in an index fund. ***An index fund simply mirrors the companies that make up the index.***

Why do index funds work?

- Index funds firstly have significantly lower fees compared to 'active' managed funds. This is because index funds don't have to complete in-depth research what investments to buy nor when to buy them. Research suggests index funds are about 1/3 of the cost of normal managed funds.

- Index funds tend to have lower levels of trading. They are not buying and selling shares all the time, rather they hold the same portfolio of shares. There are two advantages of this. Firstly, you don't have the trading costs of buying and selling investments all the time and secondly, in the Australian tax environment, it is far more tax effective to buy and hold investments rather than trading all the time. Trading frequently leads to more capital gains tax having to be paid.

- Markets are efficient - in our electronic world, information flows so quickly that no investor or professional fund manager can consistently gain a reliable advantage over all of the other market participants. Share prices of a company quickly and fully reflect the knowledge and expectations of investors – so paying high fees for the research of a normal fund manager provides no advantage.

- Diversification across all of the market reduces the volatility of the fund – and the risk of any one business failure impacting on your investment wealth. (Remember, if you hold an index fund based on the ASX200 there are 200 underlying investments in the portfolio!).

Here is an important point. The market index is a measure of the average market return. Therefore if you invest in an index fund you get the market return, less the relatively low index fund costs. The average return of all the other investors, then, must be the average market return (index return) less their higher active investment costs. **Investing in an index fund actually guarantees you a higher return than most investors receive!**

What are the index funds we use?

We use two main providers of index funds – Dimensional Fund Advisors (DFA) Australia and Vanguard Investments – as a basis for our portfolios. The Australian shares component of our portfolios is based on the **Dimensional Large Company Trust** or **Vanguard Australian Shares Index Fund** or **SSgA Australian Equities Index Trust**, the International shares component of our portfolios is based on the **Dimensional International Large Company Trust** and our Listed property investments include the **Vanguard Property Securities Index Fund** (Australian listed property trust investments) and **Vanguard Hedged International Property Securities Index Fund** (international listed property trust investments).

On the defensive side of things, our core fixed interest investment is the Dimensional 5 Year Diversified Fixed Interest Trust. The '5 year' part of the title refers to the fact that it does not hold any fixed interest investments with more than a 5 year term. This is the first part of the strategy to keep this trust low risk for investors. The second part is to only invest in very high quality fixed interest investments, which rating agencies have rated 'AA' or better. This rating means that these are the highest quality fixed interest investments available – including Government bonds and bank bonds.

Step 3 – Determining Asset Allocations within the Growth Asset Components

Even though Index funds work very well there is still more to the story. Academic researchers in the USA have identified two sources of additional return beyond just the average market return (the index return). This research was conducted and published in the early 1990's by University of Chicago Professors Gene Fama and Ken French, and their results are known as the '3 Factor Model' of investing. Importantly, Fama and French's research has been consistently repeated in markets around the world and shows that two factors – **company size** and **value** (or company health) are sources of above market average returns.

- ***The Company Size effect*** identified that small company shares have higher expected returns than large company shares. This is not entirely new to Fama and French's research, it had been proposed for some time. An example of a small company would be the Bank of Queensland – much smaller than the Commonwealth Bank which is amongst the 5 biggest companies listed on the Australian stock exchange.

- ***The Value Effect*** identifies that financially pressured or out of favour 'value' companies have higher expected returns than healthy and popular companies. This does not seem to make sense at first glance. One way to think about it is this, when a company is out of favour or under financial pressure everyone sells their shares. The price of the company falls, and it is only once it has fallen a long way that people become interested in buying it again – only once they are attracted to the company by the higher expected returns that come about because its share price has fallen so far.

All that is good in theory; however what we need is a 'show me the money' test. How have these index style small and value company funds performed.

Australian Shares:
The following tables represent the Australian share returns in two ways. Firstly is the average annual return over 10 years followed by the growth of $10,000 invested over 10 years. All returns are after Dimensional fees, and returns are to the end of June 2012. As you can see the performance of the actual funds show that small companies and value companies, invested in a strategic way, provide a higher return than just the index return (with the Dimensional Australian Large Company Trust reflecting the index return).

Average Annual Returns:

	10 Year Annual Return to End June 2012
Dimensional – Australian Large Company Trust	6.91%
Dimensional – Australian Value Trust	8.19%
Dimensional – Australian Small Company Trust	9.13%

Growth of $10,000 Invested:

	10 Year Annual Return to End June 2012
Dimensional – Australian Large Company Trust	$19,506
Dimensional – Australian Value Trust	$21,972
Dimensional – Australian Small Company Trust	$23,957

International Shares:
Within International shares these same sources of return premiums from value and small companies can be found.

There is also an extra sub-category to add to this mix – companies in **Emerging Markets**. Emerging Markets are those that are not yet developed but have significant potential for growth. Consequently they also are riskier and therefore can provide an extra risk premium for an investor who is comfortable to take on this extra risk. Our preferred fund, **Dimensional Emerging Markets Trust**, holds shares in companies listed in Argentina, Brazil, Chile, China, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Philippines, Poland, South Africa, South Korea, Taiwan, Thailand, and Turkey.

Average Annual Returns:

	10 Year Annual Return to End June 2012
Dimensional - Global Large	-1.20%
Dimensional - Global Value	-0.58%
Dimensional - Global Small	1.91%
Dimensional - Emerging Markets	6.84%

Growth of $10,000 Invested:

	10 Year Annual Return to End June 2012
Dimensional - Global Large	$8,862
Dimensional - Global Value	$9,434
Dimensional - Global Small	$12,082
Dimensional - Emerging Markets	$19,379

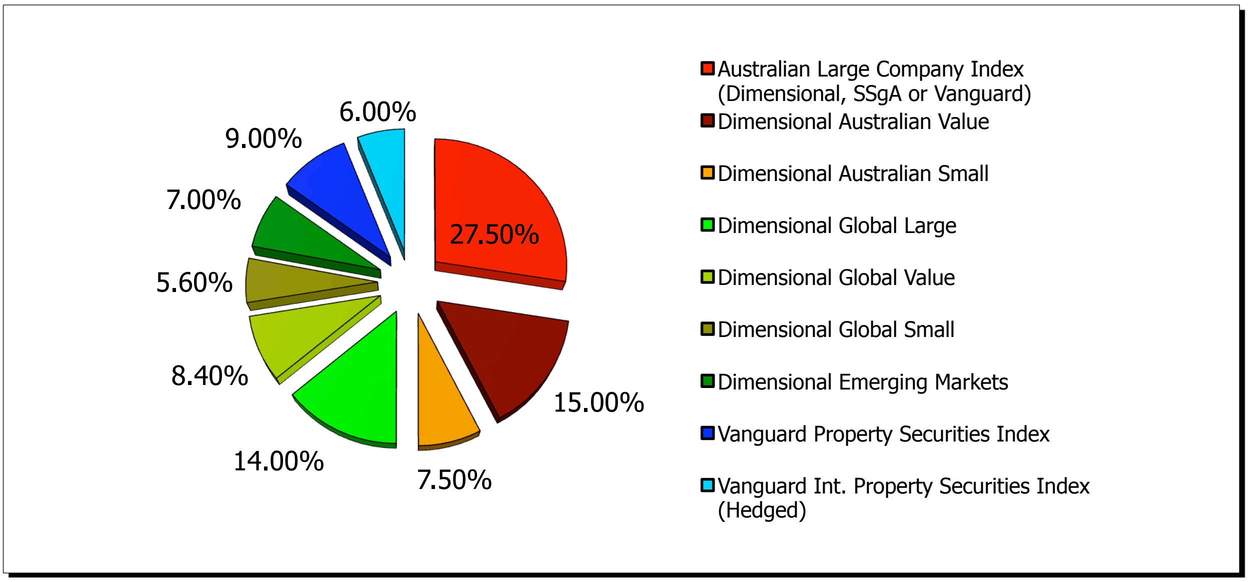
How do we Build Portfolios from these Australian Funds and International Funds?

We combine all of these funds into investment portfolios. Commonly, we would invest around 55% of a portfolios Australian share exposure to the large companies fund, 30% to the value company fund and 15% to the small company fund. This provides a conservative core using the large company fund, with a tilt to the extra returns expected from value and small company funds.

For the international shares we use the global large fund as the main holding, and the small and value funds to tilt the portfolio towards these sources of additional return. We also include some exposure to the Emerging Markets fund, around 10% to 20% of the international investments in a portfolio.

For property we again incorporate the index style of investing by using index funds to access property investments. We break this investment down into 60% Australian Listed Property and 40% International Property. We choose a higher weighting towards Australian listed property because it has a tendency to provide more tax effective income. To achieve this we use the Vanguard Property Securities Index Fund for Australian property and Vanguard International Property Securities Index Fund (Hedged) for international property. Hedging the international property exposure takes out any currency exchange rate risk that can be found with investing in international markets.

The following graph gives an overall picture of the allocation of growth assets within a normal portfolio. This shows that that the portfolio has a significant amount of diversification.



Step 4 – Better Engineering of Trusts, 'Dimensional Core' Investments

While we are confident that Dimensional are the leaders in investment solutions, they themselves acknowledge that they will always be able to improve the structure of their investments. And with the intellectual capital at their disposal, such as two Nobel prize winners on their investment board, the continuing improvement will be rooted in intellectual rigour.

One recent improvement has been the introduction of 'core' trusts, both the Dimensional Australian core trust and the Dimensional Global core trust. These trusts have a structure that mirrors using 50% Dimensional large, 30% Dimensional value and 20% Dimensional small trusts. So why is this better? Because there is a reduced amount of trading in the core fund, compared to the three component funds – and that means reduced costs and taxes for investors. For example, if an investment moves from being classified as 'small' to 'large', then usually it has to be sold out of one trust and bought back into another. However, using the core trusts the investment does not have to be sold – it just passes within the trust. The expected benefit is not large, less than half a percent a year. Our strong feeling is that every small source of additional return is worth pursuing for clients!

Step 5 – Managing the Investments

Access to the Dimensional investments is restricted. Only financial advisers approved by Dimensional are allowed to access these funds for clients. This is primarily because Dimensional want their funds to be understood by investors, and used in long term investment portfolios, rather than being traded regularly. The regular buying and selling of funds creates tax problems and trading costs for all investors. Dimensional also have a $1 million minimum investment in their funds. That means that individual investors have to work through an approved adviser and through an administration service that allows access to the Dimensional accounts.

We currently prefer Macquarie Investment Management Limited's Wrap Solutions, a division of the Macquarie Financial Services Group. Macquarie has won many industry awards for client service over the past decade. Their service standard commitments are genuinely good, their electronic portfolio administration platform uses leading edge technology, their systems are particularly secure, and they allow us access to the Dimensional and Vanguard funds from which we build effective client portfolios. We are particularly impressed by the Macquarie Wrap service's provision of online access to accounts by our clients with the ability to monitor progress and produce relevant reports such as: portfolio snapshots, valuations, performance reports to name a few. The Macquarie service also provides important records that help in the preparation of your tax returns. In the case of superannuation and pension investments, Macquarie looks after all of the tax accounting of the fund.

We also receive a significant rebate from Macquarie for using their Wrap which we pass on in full to our clients. This reduces the cost of the Macquarie fees by nearly 50%, and makes the Macquarie Wrap a very effective and cost effective solution.

This document has been prepared as a brief summary of how we develop investment portfolios. If you would like more detailed information please refer to our 'Investment Philosophy' which can be obtained through our website or by requesting a copy by email or phone. It is a publication of A Clear Direction Financial Planning. It contains general financial advice. Readers should check this advice with a professional financial adviser before acting on any of the material contained in this document.