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ASX LISTED PRODUCT ACCREDITATION COURSE

Direct Equities – Implementing Core and Satellite for SMSF and HNW Investors

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EDITORIAL

As we approach the 2nd anniversary of the nadir of the GFC – the failure of Lehman Brothers – the world is torn between the forces of massive reduction in Government and personal debt, and continuing debt funded liquidity injections in the US. Predictions of slower global growth and economic uncertainty are becoming the reality – leading to lower returns from equity markets and massive gyrations in sharemarkets around the world. After the massive wipe out of personal wealth in the GFC, the pressure on investors has never been higher. Financial advisers face the reality that they must adapt to cope with the new reality, or suffer the prospect of practice failure.

Prosperity in retirement is what your clients pay you to help them achieve. This doesn't have to mean an endless (and maybe pointless) search for the "best" investments. The thousands of planners that have participated in our LPAC training since we began in 2003 have understood that – even before the GFC - there are three big trends afoot in financial planning:

1. Many progressive advisers have learnt how to offer a credible SMSF program to their suitable clients, often within a "fee for service" offering;
2. There is an almost total overlap between SMSF equipped advisers and those that also provide direct equities advice to their clients (often these advisers include direct equities as part of a portfolio including the best performing managed funds – the latter ideal for sectors that direct equities don't provide an easy solution for, eg international, small cap, specific styles etc);
3. Those same advisers tend to a judicious use of SMSF gearing eg ASX listed instalments over the same shares that have been selected for direct investing, with portfolios also including hybrid securities for the enhanced fixed income component, and maybe geared and/or protected investments for accumulators.

In our last edition of LPAC Essentials we saw that ETFs are increasingly being used as part of the "core" of the investment portfolio, with direct equities sitting neatly in the "satellite" component. In this Special Edition of "Essentials" we focus on how to deploy direct equities to optimize the "core and satellite" approach, to deliver powerful benefits to clients and to your practice. In doing so we look at the perennial question: are shares really suitable for long term wealth creation?

The S&P/ASX 200 index is used as the basis for ETFs and also provides the benchmark for traditional fund managers. In contrast, smaller, concentrated portfolios of direct equities, typically with far lower turnover than highly diversified managed funds, have demonstrated their propensity to add investment "alpha," with the better performing concentrated portfolio managers showing good returns over the last decade or more. That is a powerful testimonial, as the last 10 years have been characterized by the Tech Wreck, the terrible terrorist events on September 11 and later, the 2nd Gulf War – and the GFC.

In this LPAC Essentials we examine the "case for equities" – why it's critical for every investor to own high quality Australian shares, as a key vehicle for long term wealth creation. We then look closely at how concentrated share portfolios add value as a core component of HNW and SMSF portfolios. This approach to "alpha" generation is ideal to cope with lower returns and higher volatility. It empowers what the many, many well trained and professional financial advisers that are thinking ahead of the curve know – keeping your clients happy and comfortable now includes attending to the performance of the investment portfolio. And in this regard, a good financial planner using direct equities will be very well equipped to deliver exactly what their client's want, and need.

Any adviser that succumbs to the mantra of the large institutions ("investing is too complex" – "leave it to the professionals" – "planners should spend less time thinking about investing and more time cultivating new and existing clients to build a profitable business" etc etc) is ultimately destined to fail in their pursuit of a large and profitable business with quality clients and recurring revenues. The market is moving too quickly, and retail clients are becoming too well informed, to hide behind these orthodoxies any longer.

What we have seen over the last decade is the rapid recognition by many quality advisers that they have to re-think the way they do business, and that this extends to the investment portfolio and its construction. At the same time, for lots of reasons (some good, some less so) the mantra of "scaleability" is still a key concept for advisers – and in the era of modern business systems, it does seem sensible to ensure that the investment process is scaleable and efficient to administer.

In this Special Edition of ESSENTIALS we focus on the tools that progressive advisers are implementing in their practices: the use of a "core and satellite" approach to investing – and in the satellite component, increasingly advisers are using scaleable model portfolios of direct equities to generate sustainable "alpha", as well as to enhance the efficiency of the planner's practice. The data showing the relevance of concentrated, low turnover share portfolios as "alpha" generators just keeps on improving.

The "core and satellite" approach offers several benefits. Clients can get real focus on "alpha" generation, at the same time as keeping their beta generators running efficiently. The "core and satellite" approach allows advisers to implement the latest buzz word in investment management – by rotating between alpha generators, clients can benefit from DIY "portable alpha" in their portfolios. This means that the core of the portfolio can remain relatively unchanged for lengthy periods – with the risk budget, as well as the adviser's time and management budget – being diverted to what the client will really value them for – the generation of outperformance. This meets the test of scaleability, and once you have made the transition, seems to be easy for many of our planning clients to implement without significant change to the way their business runs.

2010 has ushered in a sense of despair for some, but quality advisers around the country are responding by ramping up the roll out of a sophisticated value proposition to their client base. If you haven't already done so, now is the time to think about how you can re-boot your practice and your clients' portfolios. Direct equity investing will be part of that approach; but don't forget that if you are going to the trouble to change the way you do business, tell your clients what the benefits for them will be. As to those benefits, we are sure that you will find a few in the pages of this Special Edition of ESSENTIALS.

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DIRECT EQUITIES:

IMPLEMENTING CORE AND SATELLITE INVESTING FOR SMSF AND HNW CLIENTS

Core and satellite portfolio construction has to be thought of as more than just another way to blend traditional managed funds. It reflects the very different style of investing to achieve general market returns ("beta") compared to investing to generate outperformance above the general market ("alpha"). Because of these differences, it is vital to separate the equity portfolio into two components, differently managed to align with the very different objectives of each component. In doing so, not only are the overall portfolio returns capable of being enhanced, tax efficiency and risk management are improved. Financial planners adopting the "core and satellite" approach provide a strong and differentiated service proposition to their clients, ideally suited to SMSF and HNW clients. Index tracking "exchange traded funds" are ideal for the core portfolio, and low turnover "concentrated" direct equity portfolios (or managed funds that adopt this approach) are ideal for the satellite portfolio.

I. The case for equities as an efficient vehicle for long term wealth creation

Australian shares are an excellent form of investment for long term wealth creation. They continue to generate returns superior to all other asset classes over a 20 year period. But that is too easily overlooked by investors and advisers in this period of profound post GFC market volatility. To overcome the GFC invoked fear about shares we need to refocus on three key aspects of investing – your practice and clients will prosper this year and beyond if you truly master these concepts:

- Why there is an equity risk premium and what it means for investors when the equity risk premium rises (especially in market panics);
- Why shares are like investment properties, in their capacity to deliver growing streams of income over time irrespective of short term fluctuations in their price;
- Why investors and advisers should consider shares just like any other asset – we should buy them when they are cheap and sell them (if needed) only when they are overpriced.

Market panics have occurred at least three times this decade: the "Tech Wreck;" after September 11; and during and after the GFC. Our sharemarket is range trading at the moment – with falls being prompted by mini panics like the worry about the "PIGS." At the height of each panic, as the market nose dives, investors flee for the comfort of cash or other assets.

But – as CNBC anchor Joe Kiernan said recently, if these were any other assets, we'd be buying as many shares as we could when they are cheap. The reality is that most planners and clients are in hiding, fearing that buying shares now may be a sucker trap for the unwary. So what is the case for equities?

Aussie equities provide the best longer term return of any Aussie financial asset class – this is consistently borne out by the ASX/Frank Russell "Long Term Investing" reports which show that over a 20 year period, shares beat even residential property as the best performing asset: the 2010 report showed that Australian shares generated the best return of any asset with 9.9% pa and 8.7% pa after tax returns at the lowest and highest marginal tax rates. In comparison, residential investment property returned 8.8% pa and 7.2% pa at the lowest and highest marginal tax rates. The returns on bonds, international shares and cash were lower than shares and property over that 20 year period.[1]

Equity Risk Premium

Understanding the true use of equities to generate wealth is one of the hardest, yet most basic, concepts in investing. It requires an appreciation of the equity risk premium and its near relative, the concept of the "payback" period. When these concepts are understood it becomes apparent that buying shares can be seen a lot like how a landlord buys and holds investment properties as a source of growing yield – and where capital appreciation is normally a secondary factor.

One of my favourite articles was written by Arun Abey in 2003 and its opening sentence is still relevant today: "Few things in this bear market have caused more confusion than the equity risk premium, and the research community itself is split three ways." The article gives us a very clear message about why we should buy shares, even when they are trading at depressed prices:

In a market based society, wealth is generated through the company structure. Apart from building your own business, owning shares is the only meaningful way to participate in the long term growth in companies and the economy.... in a market based society, companies that are expected to produce lower returns than risk free bank deposits eventually fail...Only quality companies survive for the very long term...

> Because this "creative destruction" directs funds to companies that make money, investors can be pretty sure that an equity risk premium will be there over the very long term in a successful market based society...
>
> Over the average investor's lifetime, the equity risk premium will almost certainly be there and should be generous. Only those who invest in equities consistently will capture the full reward with any reliability.[2]

Shares should be treated like investment properties – yield first, capital growth second.

When I deliver training to planners we have the opportunity to reflect on successful property investors – most of us know landlords who are living off the rent of properties purchased many years ago. It's the same for shares – the yield on NAB shares purchased in 1990 is, in today's terms, approaching 50% pa based on the initial cost of those shares. There is nothing more certain than the gratitude a client will show you for setting them up with assets that yield them these levels in their retirement. Even if dividends are under pressure in the near term, they can and will grow over time (for quality stocks that is, remember that we do advocate some level of active management so that you can get rid of bad performers over time).

In Figure 1 and 2 below we show how buying investment properties for the long term generation of strong yield – based on the initial investment cost – is very similar to the returns from a long term, "buy and hold" approach to share investing.

In Figure 1, the patient landlord enjoys access to a steadily growing stream of rental income, with the yield on the original investment cost rising above 50% after 30 years. Even though the capital value of the investment fluctuates over that period, the investor is practically insulated from that volatility because they don't need (or want) to sell the property during that period. Of course, as the investor enters pension phase they may need to sell the property to meet lifestyle requirements; in the best case they can afford to live off the earnings instead.

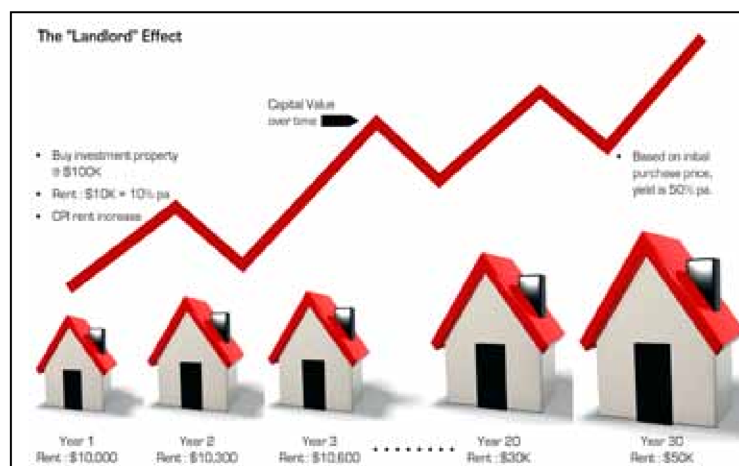

Figure 1: The wealth creation effect of investment properties

In Figure 2 we show the same phenomenon as it applies to shares. In this case we use the real example of NAB, with the yield as a function of the initial investment price having risen to well above 50% in less than 20 years. Of course, we advocate a diversified share portfolio, the single stock example is used simply to illustrate the long term wealth creation opportunities using the patient "buy and hold" approach.

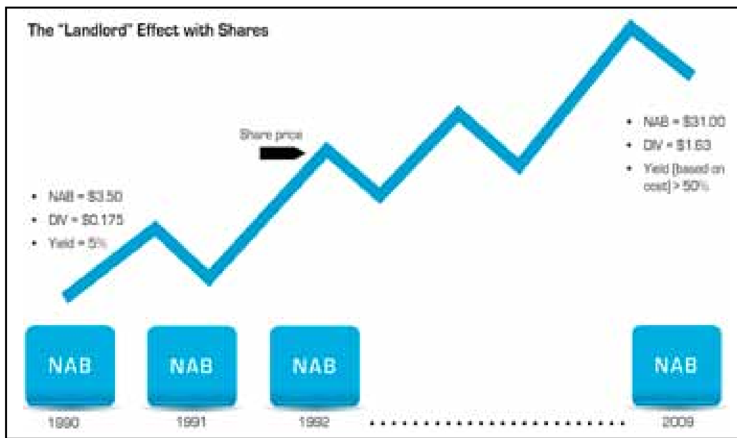

Figure 2: the wealth creation effect of share investing

The Landlord Effect as it applies to shares can be expressed another way. It is simply a product of the excess return above the risk free rate, which quality shares normally generate. For example, if a share is valued at a price/earnings ratio of (say) 13 times, this implies that if the company's earnings remain constant, the share will pay for itself after 13 years. That means that the investor's initial capital outlay will be recouped after 13 years – such that further earnings are pure profit to the investor. This profit is the equity risk premium at work – the investor is compensated for taking the risk of buying the share in the first place by the payback period covering the initial cost of outlay. And since the earnings on quality shares typically rise over time, the payback period is normally (and ought be) faster than implied by current year P/E multiples.

In contrast, buying and selling the same shares frequently exposes the investor to paying potentially a higher price for shares every time they buy them. On that approach, the Landlord Effect can never be allowed to work for high turnover share investors. Every time the share is bought, the higher price drags the yield back. It's no wonder that high turnover investments do not provide the same retirement benefits that low turnover direct equity portfolios can deliver.

So this throws into question the broker calls recently to sell a stock like CBA, on the basis that (even after another record profit) CBA profit *growth* may fall next year and that dividend growth may also decline. If we understand the power of dividend income and growth we can use good quality shares as a long term vehicle for wealth creation. Even if the rate of growth fluctuates, dividends in quality stocks do still grow over time – just like rental returns increase over time. Think about this – it means that you get paid to wait by buying and holding good shares while the company's fortunes improve. Buying quality shares at lower than usual price levels is a classic example of letting the equity risk premium work for you.

Why can't we think about shares like other assets? Maybe because of the liquidity and daily price movements, coupled with (to many) the apparent inexplicability of the share market gyrations. We need to understand and react to share value fundamentals. We have to learn to ignore the broker recommendations to sell stocks for short term profit – unlike the Cockney "barrow boys" of the London stock jobbing market, we should buy and hold shares for as long as their fortunes permit. So we have to remove sentiment from our investing mindset, and to realise how we can prosper by buying shares in times of weakness, and using their growing income streams to underpin life in retirement.

II. Generating "alpha" using direct equities

Using a concentrated, low turnover portfolio of direct equities to generate alpha typically means holding those shares in the satellite component. The core and satellite approach to portfolio construction does not ignore traditional approaches. Instead it focuses on matching the portfolio to the client's true tolerance to investment risk and volatility. By managing the allocation between the core (generating beta) and the satellites (generating alpha), the client's expectations can be managed efficiently.

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* Lonsec Core 16.1% pa v S&P/ASX 100 Accumulation Index 8.7% pa, as at 31 July 2010. Model portfolio investment performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month. Physical portfolio results will differ depending on cash levels, start date, fees, taxes and rebalancing policy. **Past performance is not a reliable indicator of future performance.**

High conviction. Low turnover. Transparent. Long-term wealth solution.

CONCENTRATED LOW TURNOVER INVESTING: THE LONSEC APPROACH

Lonsec has successfully been providing equity model portfolios since 2000. Lonsec has identified that the key drivers of alpha are:

1. Asset allocation
2. Security selection
3. Turnover
4. Liquidity
5. Costs

Generally, to generate strong performance, in both absolute and relative terms, it is important to get asset allocation right, select outperforming securities, minimise turnover, maximise liquidity and minimise management costs. Get all these right and you will maximise your net performance after tax.

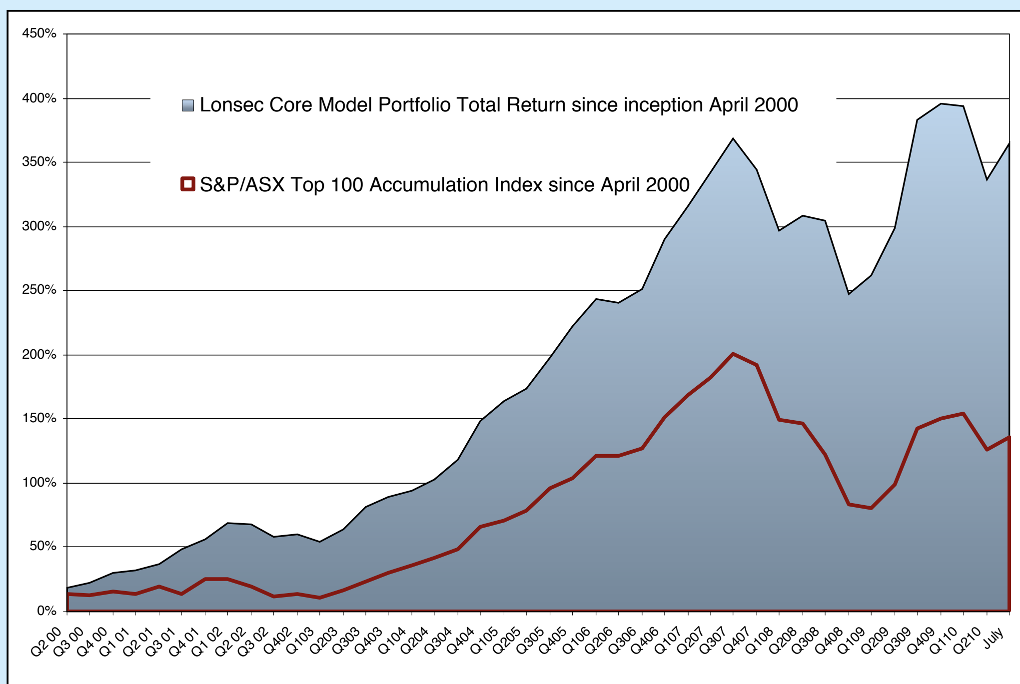
Lonsec provides advice on asset allocation via strategic and tactical recommendations. In regards to the remaining factors, Lonsec offers a range of low cost, low turnover, liquid model portfolios. The flagship Lonsec Australian Equity Core model portfolio has been operating for over 10 years and has generated 16.1% p.a. versus the S&P/ASX100 Accumulation Index return of 8.7% p.a. – an excess return or alpha of 7.4% p.a. (to the end of July 2010).

The philosophy and process behind the Core model portfolio differs from many mainstream fund managers. Lonsec adopts a top-down, high conviction approach to investing. Top-down means macro-economic and industry fundamentals are given greater weight than bottom-up company numbers. Both are important, but Lonsec believes it's more important to find the best industries before you find the best companies.

Lonsec's portfolio manager, William Keenan says, "We are after the best companies in the best industries, but only at a reasonable price. We don't necessarily go for the most popular stocks nor do we go for the ugly ducklings; we are looking for the right balance between growth and value."

Keenan continues, "Lonsec only holds the best one or two companies per preferred industry sector, so the portfolio is concentrated at only 12 stocks – although we are working on expanding the portfolio to 15 stocks in the near future to slightly increase diversification and reduce portfolio risk without losing the alpha potential."

The portfolio is not changed often, with recent turnover as low as 17% p.a. Turnover generally averages around 20-30% p.a. which is still relatively low.



Risk is mitigated by the decision making process, portfolio construction rules and stock selection criteria. Over the past ten years, the volatility of the portfolio has been similar to the market (standard deviation of 14) with high tracking error around 6.5 (i.e. the portfolio does not track closely with the benchmark) which one would expect for a high conviction approach.

The Core model portfolio is available via Lonsec stockbroking, the Lonsec IMA/MDA service and leading SMA platforms.

INVESTMENT PERFORMANCE									Since	Since
Period ending 31 July 2010	Month	Qtr	Six Mths	Year	2 Yrs[1]	3 Yrs[1]	4 Yrs[1]	5 Yrs[1]	Inception[1]	Inception[2]
Lonsec Core Model Total Return[3] (%)	**6.4**	**-4.1**	**-0.4**	**9.9**	**7.3**	**1.8**	**8.5**	**10.8**	**16.1**	**364.4**
S&P/ASX TOP 100 Accumulation Index (%)	4.4	-5.9	0.2	10.5	0.2	-5.1	2.0	5.2	8.7	135.7
Out/Under Performance (%)	2.0	1.7	-0.6	-0.7	7.1	6.9	6.4	5.7	7.4	228.7

[1] % per annum [2] Total return since inception date 17 April 2000

[3] Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

The Lonsec Core model portfolio is a fully invested notional portfolio that is rebalanced monthly. Physical portfolio results will differ depending on cash levels, start date, fees, taxes and rebalancing policy. Past performance is not a reliable indicator of future performance.

Research shows that over 2/3 of Australian investors are benchmark unaware, focusing instead on the absolute return of their portfolio. In fact, the traditional focus by fund managers and consultants on "risk" and "return" is a gross oversimplification. Most advisers now see clients who focus on the value added by each part of the supply chain (eg adviser, fund manager, platform and dealer group) and specifically clients who question:

- Fees, at the level of the adviser, product provider, platform and dealer group;
- Taxes triggered by the overall portfolio and individual investments;
- Liquidity;
- Risk management;
- The likely or expected return of each investment;
- The potential for excess return from each investment.

For example, by using the ETF as the core beta generator for an Australian equity portfolio, we can avoid worrying about whether the core portfolio will be able to generate excess returns – because alpha generation is now the job of the satellite investments. In addition, the ETF provides superior performance on other key attributes, such as fees and taxes. Similarly, using a concentrated, low turnover direct equity portfolio as a satellite can also help reduce fees and taxes – both of which bedevil the high turnover approach.

A number of studies have shown the high effective cost of taxes on traditional, active equity funds, which typically are characterized by very high turnover. For example, Credaro suggests that a high turnover fund (60% or more of the assets turned over every 12 months) needs to produce a return which is 1.6% higher than a fund with 20% turnover, just to break even. Since the turnover in concentrated direct equity portfolio may be around 25% per annum, that approach can deliver a far superior tax outcome than a high turnover active approach.

That data is not new, and indeed it's been reinforced by the landmark APRA paper released in June 2009 – which makes some very harsh statements regarding typical managed fund underperformance. But to really power our understanding of the core and satellite approach we need to reflect on a key point - why high levels of turnover and widely diversified portfolios cause median managed funds to underperform – which is central to understanding the real value of using a long term, "buy and hold" approach to direct share ownership as part of well constructed portfolios.

III. The case for low turnover

High turnover in the share portfolio poses several problems for long term investors. It exposes the investor to high levels of volatility, and by constantly re-setting the entry price into shares it defeats the opportunity for the landlord effect to take place. Taxes and costs are high in the actively traded portfolio, as well. Even so, typical managed funds which are benchmarked to sharemarket indices, use a high turnover approach to investing (with fund turnover often between 60% to 80% pa). What is the rationale for the high turnover approach used by typical actively managed funds?

The answer can be found by considering the manner in which actively managed funds are issued, ie as an open ended product. The drawback in the approach of traditional managed funds – and the singular cause of the high turnover associated with the benchmark aware style - is the open ended issuance process which they use. Combined with the limitations of registry and platform technology, traditional funds are managed to provide maximum liquidity for all investors, at all times (even when not needed). Clearly, an investor in the wealth accumulation phase, especially within the superannuation environment (where funds cannot be withdrawn without penalty prior to age 60) does not need the same levels of liquidity as an investor in late pension phase.

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High conviction. Low turnover. Transparent. Tax-effective.

Actively managed funds, delivered using the unit trust structure, have proliferated since the 1983 financial services de-regulation ushered in by the Campbell Committee. Prior to that de-regulation the dominant form of externally managed investments were provided either by Listed Investment Company's ("LIC's") or by insurance products. Both forms of investment suffered from inherent problems, which limited their access by many investors.

Turnover and Liquidity

Traditional LIC's have a solid and well deserved track record, with many of the early LIC's posting long periods of profits and returns well in excess of those of the general market. Traditional LIC's are closed ended and can invest in concentrated equity portfolios with low turnover – they don't have to manage with an eye to the high levels of daily liquidity which open ended managed funds are focused on. But the drawback of the closed ended LIC is that the better performers often trade above net asset value, because their supply is constrained. When a LIC trades at a premium to its fair value, it's harder to justify investing. This has a spill-over effect, beyond the limitations for DIY investors, in that it makes it difficult for the financial planning industry to build a useful business model around LIC's.

Insurance contracts were the dominant form of collective investment vehicle prior to the Campbell Committee reforms. Since insurance (appropriately) is regulated by detailed prudential and reserving requirements, this meant that "normal" investors were burdened by regulation, which was not necessarily relevant or suitable for them. The Campbell Committee recommended that simpler and better targeted investment funds should be available, without elaborate reserving and prudential requirements. This ushered in what we now refer to as the "traditional" managed fund industry.

Under the general funds management regulatory regime, non insurance products do not have the same prudential requirements as insurance products or banks (both of which rely on various forms of "reserving" to ensure investor protection) and, to be able to offer them in scaleable, open ended format, their design needs to be aware of the potential for investor loss in the event of a "run" on the fund.

The traditional unit trust registry does not provide fund managers with details regarding individual investor's expected investment timeframes, so coupled with the open ended nature of these funds, manager's have to cater for the prospect that in times of financial distress, the level of redemptions in the fund will rise dramatically.

As a result, traditional open ended equity managed funds tend to invest in the most liquid equity securities available to them; in the case of Australia this is the ASX 200 index. They do so to bolster their ability to handle high levels of withdrawals.

To add value, most managers attempt to beat the index by being slightly under or over weight specific stocks in that index (this is recognized in the 2009 APRA paper which states that "...investment managers are hired to exploit market inefficiencies to add incremental returns through market timing or tactical asset allocation and through selecting or over-weighting better-performing securities, while trying to minimize trading costs").[3]

Benchmark awareness means, in practice, that these types of funds will sell stocks when the market falls and re-purchase stocks when the market rises (in line with general market movements, adjusted as desired to allow for over- or under-weighting of specific stocks).

This leads to the high turnover experienced by some managed funds, which can reach 60% to 80% turnover per annum. The inherent and inescapable problem with high turnover is that it exposes the investment portfolio to high and uncontrollable volatility. As Figure 4 below shows, volatility is extremely high when shares are bought and sold within a 12 month period, but it tapers off as shares are held for a longer period.

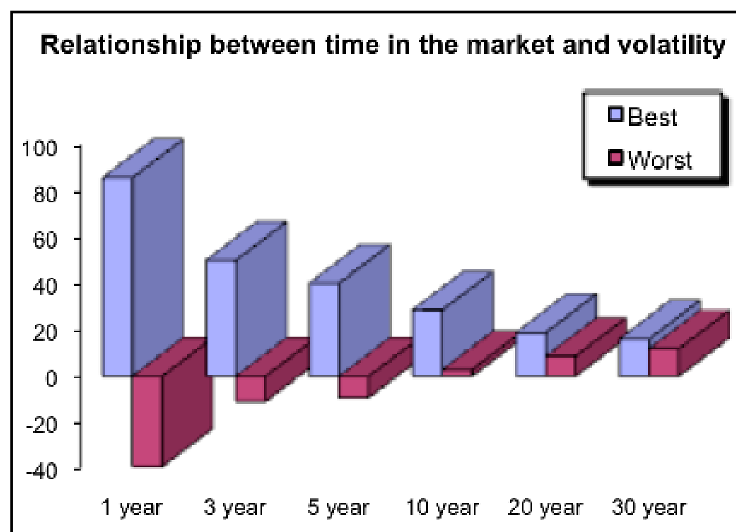

Figure 4: Volatility (dispersal of returns) for Australian shares over time
Source: ASX Limited

SMSF investor and advisers who use the SMSF to improve investment control are implicitly posing the question: why would an investment style use high levels of turnover when the underlying investor has a long-term investment time frame?

On proper reflection, it can be seen that this type of investment management is typically unnecessary, unless the investor has a high probability of needing to access their capital within a very short timeframe. Let's now look at the evidence of how investment returns are affected by high levels of turnover – typified by the traditional, actively managed fund.

Performance Analysis

Until the June 2009 APRA paper, the most accurate performance appraisal of traditional Australian actively managed equity funds has been produced using data provided by Mercer's.[4] This research shows that the median Australian active equity fund has underperformed its benchmark in 10 of the last 15 years (to the period ended 2005).

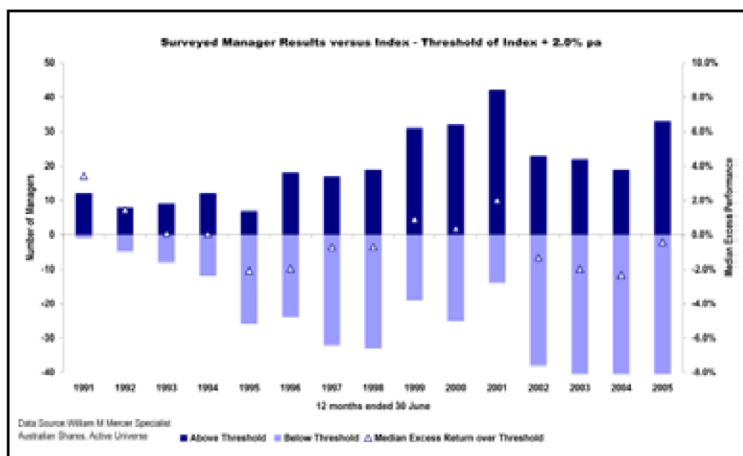

Figure 5: Performance Appraisal – Australian Active Equity Funds 1991 to 2005

In Figure 5, the benchmark is the ASX 200 index plus 2% (which is the median cost of investing in the surveyed funds, via retail or wholesale via wrap or master trust).
The irony is that these findings are not new. Asset consultants like Intech have been making similar statements for the last decade. The newly launched S&P "SPIVA" Index shows the same persistent underperformance by the majority of traditional managed funds into the current period.

Mainstream financial planners and dealer groups, for whom the managed fund/model portfolio/wrap platform model is the basis of their business, typically counter this critique by asserting that their manager selection processes are superior and that they avoid the median performing manager/s.

Many clients question that approach when it is noted that manager performance persistence is weak – the Mercer research also shows that managers which perform above the median don't consistently do so – nearly 2/3 of the outperformers are back below the median within 3 years.

And so, supported by hard evidence and client demand, progressive advisers are looking for a better way to manage their client investments – and the low turnover, concentrated direct equity approach has rapidly become the norm for these advisers.

APRA has weighed into the debate with its recent paper "Investment performance ranking of superannuation firms."[5]

The methodology used by APRA is set out in that paper, which leads its authors to make statements like the following, which coincide in many respects with the earlier findings of Mercer, InTech, et al:

> *"...the average (investment management) firm under-performed their net benchmark by 0.9% per year...this raises a question about the value of the active approach to risk management of investment portfolios and may support our doubt about the appropriateness of the Sharpe ratio in measuring performance...*
>
> *The net under-performance of the average firm appears more pronounced in down markets. This suggests either inactive risk management where investment managers appear to forego value adding opportunities in down markets or unsuccessful risk management in down markets perhaps due to costs...*
>
> *The empirical data suggests that superannuation firms may be less efficient at using the tax credits from capital gains and losses than we have assumed...For example, excessive share trading could forfeit capital gains tax concessions which are available after a 12 month holding period."*[6]

Although not many SMSF investors or advisers articulate the technical investment rationale for SMSFs, they do know what they hope to achieve when using the SMSF approach. Investment control is cited as the top factor driving the use of SMSFs – and an increasingly large number of SMSF investors use, concentrated portfolios of direct equities (often, to good result).

In summary, we have shown how the idea of index benchmarked, high turnover actively managed funds is a creature of the combined benefits of de-regulation (allowing for non reserve protected investment funds) and limitations of the open ended unit trust vehicle and the anachronistic unit trust registry software. High turnover triggers taxes, fees, and adverse market impact – all undermining the ability of well designed portfolios to generate positive returns.

It's no wonder that the SMSF revolution has ushered in a new focus on precise tailoring of portfolios to suit the specific needs of individual investors. The core and satellite approach is a great way to implement this precision and control.

IV. The case for concentrated portfolios

Low turnover works well in conjunction with portfolios which concentrate on holding a small number of shares in total. Diversification is important to reduce risk, however diversification must not become an end in itself. Positive absolute returns are a normal goal, so it is important that diversification be adopted for the purpose of improving returns. A number of studies have assessed the "optimal" number of shares for an efficient investment portfolio.

The results are clearly in favour of holding no more than 15 shares in the portfolio. For example, a study of 12,000 randomly selected portfolios in the 1990's showed how returns and outperformance are linked to what the author of the study termed "focus investing."[7] The study sampled portfolios randomly selected from a range of US brokerage houses, evenly divided amongst portfolios with 250, 100, 50 and 15 shares, ie:

- 3,000 portfolios containing 250 stocks;
- 3,000 portfolios containing 100 stocks;
- 3,000 portfolios containing 50 stocks; and
- 3,000 portfolios containing 15 stocks.

After calculating the average annual return for each portfolio over 10 years and 18 years the study discovered the average return for each portfolio was about the same—13.75 percent for the 15 stock portfolios rising to 13.91 percent for the 250 stock portfolios.

More importantly, the study showed the maximum and minimum returns from each of the groups. The results were as follows ("RoR" means "rate of return").

10 year period 1987–1996

	Minimum RoR	Maximum RoR
15 Stock Portfolios	4.41%	26.59%
50 Stock Portfolios	8.62%	19.17%
100 Stock Portfolios	10.02%	18.32%
250 Stock Portfolios	11.47%	16.00%

18 year period 1979–1996

	Minimum RoR	Maximum RoR
15 Stock Portfolios	8.77%	25.04%
50 Stock Portfolios	13.56%	21.80%
100 Stock Portfolios	14.71%	20.65%
250 Stock Portfolios	16.04%	19.20%

From Hagstrom's work it appears obvious that it is the 15 share portfolios that might offer the best possible returns and conversely the worst possible returns. A little further analysis however by Hagstrom helped to more accurately measure the benefits of a concentrated portfolio.

By comparing returns to the broader market and by examining the question of diversification from a probability perspective, Hagstrom found a higher incidence of outperformance in the concentrated portfolio.

The results were:

- out of 3,000 15 stock portfolios, 808 beat the market;
- out of 3,000 50 stock portfolios, 549 beat the market;
- out of 3,000 100 stock portfolios, 337 beat the market; and
- out of 3,000 250 stock portfolios, 63 beat the market.

Hagstrom submitted the above results as 'convincing evidence' that the probabilities of beating the market, goes up as the number of stocks in a portfolio goes down. Finally Hagstrom noted that his study did not factor in transaction costs which, with a 250 share portfolio would be significantly higher than a 15 stock portfolio. These higher transaction costs would make it even more difficult for the more broadly diversified portfolios to beat the market.

That study showed similar results to research which appeared in the lauded *Journal of Finance* some years ago, where a study conducted by JL Evans and SH Archer revealed that the benefits of diversification continue to accrue as more stocks are added to a portfolio. These benefits however cease to accrue at a significant rate after 15 different companies are added to a portfolio. The costs associated with adding a 16th company in fact are higher than the additional benefit of diversification accrued by the additional company. So beyond 15 stocks it becomes uneconomical to diversify.

The more stocks you add to a portfolio, the lower the volatility. Eventually, when you own as many stocks as the index, your portfolio looks exactly like the index and so there is no volatility over and above that generated by the index itself. Importantly, however, it is essential that you understand that the more diversified your portfolio the more likely it is that you WILL NOT beat the market.

V: Blending using the core and satellite approach

As investors and advisers become more discerning, investment managers are expanding the range of investments available to allow investors and advisers to tailor portfolios to suit individual needs. One of the emerging trends in this field is the use of different products to generate investment "beta" (ie the general market performance) and "alpha" (ie the out performance over that of the market "beta"). This is easily implemented in a "core and satellite" approach:

> One of the most promising investment models is "core and tactical satellite." This model allocates a significant portion of the equity investment to a passive tax-managed core (possibly with style or class tilt). The balance of the allocation is made to satellite (investments). These satellite(s)…may be given broad mandates and the strategy may incorporate tactical changes in satellite(s). The total portfolio is managed to be dynamically efficient in a taxable client's three-dimensional investment space (return, risk and taxes). This may become the basic wealth manager investment model for the future.[8]

Investors and advisers have been using concentrated, low turnover portfolios to generate investment "alpha" for many years, often in response to client skepticism about the underperformance of median active fund managers compared to their index benchmarks.

Index proponents typically pitch their message to the cost conscious investor – pointing out that ETF's and index funds are a low cost way to obtain the general market return or "beta" that is all that many expensive managed funds deliver.

As we enter the 2nd decade of the new millennium, the investment revolution has now passed on from the "active vs index" debate: discerning investors and advisers realize that it's essential to include concentrated portfolios of direct equities to generate long term wealth for retirement. That's a great way to generate alpha: and by learning more about the essentials of alpha generation, we can also properly evaluate the use of direct equities and model equity portfolios as an efficient way to consistently generate investment alpha.

VI. Putting it all together in practice

That's why the "core and satellite" approach is so conducive to long term wealth creation. The core of the portfolio should access the general market return or "beta" for the lowest available cost. Index funds or ETFs like the StateStreet SPDRS with fees as low as 0.26% pa are an efficient way to generate market beta.

Unless you are an investor that has a need for high levels of liquidity (in which case the traditional managed fund may be ideal for your needs), an ideal way to generate market alpha is to invest in concentrated share portfolios and to hold these as satellites around the core of index tracking investments.

Structured products like ASX listed instalments can be used to optimize the risk/return profile of both the core as well as the satellite components of the portfolio. In more mature markets like the US, structured products are a mainstream part of the investment portfolio, especially for HNW investors.

If you don't have the time or inclination to select shares yourself, you can use the services of a fund manager that uses this approach, or invest in an SMA that runs portfolios selected by leading research providers (the best "model portfolio" has beaten the index by 7.4% on average every year since inception in 2001).

Using the buy and hold approach to direct share investing allows investors to access the proven potential for well managed companies to produce growing streams of earnings, which should be re-invested in accumulation phase and which can be used to fund lifestyle and expenses in retirement. The capital value of the shares will rise over time, as well – but by avoiding high turnover investors can really focus on generating solid investment alpha over the longer term.

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Footnotes:

[1]ASX Frank Russell "Long Term Investing Report" 26 May 2010, p.1.

[2]Abey A, IFA, March 2003

[3]Ibid, p.10.

[4]It is acknowledged that the APRA paper analyses the performance of balanced funds, not the norm for use by financial advisers that recommend funds for specific asset classes or sectors. However, the APRA findings are consistent with the earlier work of SSgA et al.

[5]Sy W and Liu K: "Investment performance ranking of superannuation firms" (APRA Working Paper, 23 June 2009).

[6]bid, p. 18, emphasis added.

[7]Robert Hagstrom: The Warren Buffett Portfolio (J Wiley & Sons 1999).

[8]Evensky H: "Changing Equity Premium Implications for Wealth Management Portfolio Design and Implementation" in US Journal of Financial Planning June 2002)

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"The net under-performance of the average firm appears more pronounced in down markets." APRA paper June 2009

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