SNOWGUM
FINANCIAL SERVICES

Investment Philosophy

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Abstract

Investment Basics

This section provides an introduction to investing. It is appropriate to all levels of financial literacy. Key investment themes are introduced which provide a foundation for the following sections of this document. Not necessary reading for experienced investors.

Investment Concepts

We incorporate up to date academic research and theory development to explore some of the most important considerations for investing and portfolio construction.

Investment Philosophy

Utilsing the findings in our theory development from the previous sections of this document, we outline our approach to capital management throughout your life. We outline the far more important qualitative approach to wealth accumulation before delving into our approach to portfolio construction and investing.

Basics

RISK & RETURN

The parameters governing any investment decision are that of risk and return. A low investment risk usually means a lower investment return. As investment risk increases, an investor justifies this additional risk with the expectation of a greater return. The diagram below demonstrates the relationship of risk and return for the most common types of investments.

DIVERSIFICATION

The adage, "don't put all your eggs in one basket" reflects the wisdom of diversification. It is the simple principle of spreading investments over a number of types or classes and even within each class. This lessens the possible losses that could arise if one class of investment performs poorly and all of one's funds were invested in that class or individual investment.

ASSET CLASSES

Asset classes are defined as investments that behave similarly, exhibit similar characteristics and are subject to the same laws and regulations. The most common asset classes are:

- Domestic Cash,
- Domestic Equity,
- International Equity,
- Domestic Fixed Interest,
- International Fixed Interest,
- Property & Infrastructure,

Asset classes like property, international shares and Australian shares generally display higher risk and investment return and are considered growth asset classes.

Conversely, cash, domestic fixed Interest and international fixed interest are considered defensive asset classes as they typically display lower expected return and risk. Investing within an asset class can be undertaken via 'passive' or 'active' investment management, where active management encompasses a broad array of investment styles.

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PASSIVE INVESTMENT MANAGEMENT

Passive investing is an investment style that targets a benchmark index. Passive investing is often associated with a 'set and forget' investment strategy and is popular with 'hands-off' and non-active investors. An example of a passive investment strategy is an investor who wants their investment portfolio (or a portion of it) to reliably receive the same return as the S&P/ASX 200 index. To achieve this an investor would need to invest in each of those 200 companies, in appropriate weightings. Or more realistically, they would invest in an index managed fund or exchange traded fund (ETF) which would make that spread of investments within their fund on their behalf, for a small fee.

Pros and Cons

Passive investing provides broad diversification (depending on the index it tracks) at low investment management costs. A downside of this investment style is the inability for a portfolio to outperform its chosen benchmark.

Basics

ACTIVE MANAGEMENT

Active management is a style of investing that seeks to generate additional returns above a benchmark index or targets a different investment mandate. When an investor makes an investment decision based on a conviction or belief with a view to profit beyond normal market movements, they are 'actively managing' their investment.

The principle behind active management is that skilled investors should be able to outperform their chosen benchmark indices. Professional investors, like fund managers, do this for a living with the aim of providing their investors a net benefit once investment fees are deducted.

Should an investor attain a net benefit (after fees) above the benchmark then they have generated what professional investors call 'alpha'. Their portfolio return represents the sum of the benchmark market component (Beta) and additional value added through active management (alpha).

Pros and Cons

Active management, if engaged through an investment professional can be expensive with no guarantee of performance. The key advantage of this investment approach is the ability to generate returns above a benchmark index or invest in a manner that targets an investment goal completely removed from that of an index.

INVESTMENT TIME FRAME

Your investment time frame refers to the length of time you intend to maintain your investment portfolio. This plays a significant role in influencing the selection of investments.

For short to medium term investment time frames, there is insufficient time for long term market trends to override or 'iron out' short term volatility cycles which can significantly affect your return. If you need to sell your investment at a specific time you could find yourself selling out' short term volatility cycles which can significantly affect your return. If you need to sell your investment at a specific time you could find yourself selling when the investment is at the bottom of one of those cycles.

Warren Buffet, in his most recent annual report, tells us that it doesn't matter how good the underlying investment is, if your investment time frame limits the time the investment can be held; then market volatility, not the quality of the investment strategy, will dictate your returns.

"For those investors who plan to sell within a year or two after their purchase, I can offer no assurances, whatever the entry price. Movements of the general stock market during such abbreviated periods will likely be far more important in determining your results than the concomitant change in the intrinsic value of your shares" [1] (Buffet, 2014).

Take for example an individual in their early 30's who accumulates wealth in both a personal investment account and a mandated superannuation fund. This individual plans on utilising their personally held investment funds within the next two years to fund the purchase of their first home. Conversely, the individuals superannuation investments will, most likely, only become accessible when the individual is in their 60's, in over 30 year's time. These two investment accounts require very different investment strategies, irrespective of the investors defined risk tolerance.

The personally held investments require greater capital security than the superannuation fund investments as these personal funds need to be realised within a set time frame meaning the investor cannot wait for the investment cycle to rise again before selling. Whereas the superannuation funds, which have a long term investment time frame, can pass through a number of cycles and benefit from the long term positive market trend.

1. Buffet, W. E. (2014). Berkshire - Past, Present and Future. Omaha: Berkshire Hathaway Inc.

Concepts

ASSET ALLOCATION STRATEGY

Definition

Asset allocation strategy is the diversification of investment capital amongst asset classes to better align an investment portfolios risk and return characteristics to an investor's needs.

Strategic asset allocation (SAA)

Strategic asset allocation is the utilisation of benchmark asset class weightings in the portfolio construction process to target an investor's risk appetite to the portfolios risk and return characteristics.

The justification for targeting benchmarks allocations reflects the high level of volatility attribution associated with different capital allocations between asset classes.

Tactical asset allocation (TAA)

Tactical asset allocation is the deviation of capital allocations about a SAA to take advantage of perceived miss-pricing between asset classes. It is primarily a tool for enhancing the return attribution of a portfolios investment decisions.

Asset allocation & volatility

In 1986 Brinson, Hood and Beebower[2] (BHB) published research outlining that 93.6% of a portfolios variation in returns was due to asset allocation strategies. This research has become a centerpiece for modern portfolio construction risk management, which places strategic asset allocation formation as the key mechanism to address portfolio risk.

Asset Allocation & Returns

BHB's seminal research also led to the misconception by investors (professional and otherwise), who mistakenly attribute portfolio returns (not the volatility inthese returns) to asset allocation.

BHB's research results did not provide specific guidance of asset allocation attribution to portfolio return levels. Furthermore, their analysis did not isolate market movement from asset allocation correlations.

Upon isolation of market movements, the correlation that (both tactical and strategic) asset allocation decisions have on portfolio returns becomes greatly dependent on the degree of active management in the portfolios underlying investments.

For instance, analysing the return attribution from any asset allocation strategy on a purely passively managed portfolio becomes quite a trivial exercise given that passive investing is designed to mirror market movements.

"On average, the passive asset allocation policy determines 100 percent of the return before costs and somewhat more than 100 percent of the return after costs" [3] (Ibbotson, 2010).

Subsequent academic analysis on asset allocation strategy, looking to ascertain the importance of tactical asset allocation in return attribution was discussed in a paper titled The Equal Importance of Asset Allocation and Active Management [4] (Xiong, Ibbotson, Idzorek, & Chen, 2010)

Although the paper title probably gives it away, this paper demonstrated, through cross sectional regression (removing the effect of market movement on a portfolio) that once the overwhelming impact of market returns was accounted for, tactical asset allocation and active management are equally important in influencing return deviations.

What does it all mean?

Asset allocations return attribution, once we isolate market factors, has been grossly overstated in actively managed portfolios.

2. Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. 1986. "Determinants of Portfolio Performance." Financial Analysts Journal, vol. 42, no. 4 (July/August):39–44.

3. Ibbotson, Roger G. 2010. "The importance of Asset Allocation". The financial analyst's journal, vol 66. No. 2

4. Xiong, James X. Ibbotson, Roger G. Idzorek, Thomas M. Chen, Peng. 2010. "The Equal Importance of Asset Allocation and Active Management". Financial Analysts Journal, vol 66, no. 2

Concepts

"After removing this common market factor, on average for typical funds about half of the return variations comes from detailed [tactical] asset-allocation decisions in excess of the market movement and about half of the return variations comes from active management" [5] (Idzorek, 2010).

These findings in no-way undermine asset allocation strategies importance, it simply encourages us to more equitably consider the role of active management in portfolio construction when pursuing alpha.

In Summary

Asset allocation strategy is the foundation building block in developing a holistic investment strategy. Empirical evidence demonstrates that general market movements are the primary driver in a portfolios return attribution. Strategic asset allocation, associated with aligning an investment portfolio to an investor benchmark risk tolerance, dictates the level of exposure to these market factors.

As such, strategic asset allocation maintains its dominance as the key consideration in portfolio construction for an investor.

In pursuit of above benchmark returns, at varying risk tolerances, it is the role of the investment professional to equally consider the merits of both relative mispricing's between asset classes (tactical asset allocation) and the effective use of active management. Should opportunities not exist in either area, then a passive investment strategy, with a focus in minimising investment costs, should be pursued.

ANOTHER WORD ON ACTIVE MANAGEMENT

Active management, undertaken primarily by professional and institutional investors, makes up the vast majority of market volume.

The goal of active management is to outperform a benchmark index. A benchmark index's return is the aggregate mean performance of all the index's underlying securities, proportionately weighted to their market capitalisation.

As the index return is a mean aggregate of underlying investment performance, then for every outperformance of the index, there must be an opposing underperformance of the index.

Given that active management makes up the vast majority of market volume[6], it is an empirical certainty that not all active managers will outperform their benchmark.

Standard and Poor's Index Versus Active (SPIVA) Australia scorecard provides annual updates on active management performance. For the financial year ending 2014

"The majority (66.1%) of Australian large-cap equity funds underperformed the S&P/ASX 200 Accumulation Index in the one-year period, which has been consistent for the past three- and five-year periods (65.6% and 74.9%, respectively)". [7] (Standard and Poors, 2014)

Active management performed best when performance measurements were isolated to small-caps stocks.

In the US, active management underperformance is consistently worse with 80.1% of active managers returning less than the index. [7] (Standard and Poors, 2014)

Australian fund managers have consistently outperformed their peers. High levels of outperformance actually rely upon a greater pool of

5. (Thomas M. Idzorek. 2010. "Asset Allocation is King". Ibbotson Associates.
6. Market Volume is a measure of the flow of funds in an out of investment markets
7. Standard and Poors. 2014. Standard and Poors Index Versus Active (SPIVA).

"'Non-institutional, individual investors [who] must be foolish enough to pay the added costs of the institutions' active management via inferior performance" [8] (Sharpe, 1991)

This performance variation between active managers in the US and Australia is likely a reflection of the greater pool of less-sophisticated retail investors participating in the Australia market. We suspect that this reflects the profound influence that Australia's mandated superannuation savings has had on financial markets.

What does it all mean?

Very few fund managers consistently provided alpha. Active management, as an investment sector, has not being value adding to the investor and on balance provides a return below its relative benchmark[9]. Where there is no strong conviction for active investment management, we revert our portfolio position to a more passive exposure.

OVER DIVERSIFICATION AMONGST FUND MANAGERS

With the above understanding of the pitfalls of active management, we should then consider the implications of diversifying amongst active managers.

Applying similar principles to those which Markowitz introduced in his seminal work on portfolio theory. By diversifying amongst active managers, each additional manager we select will almost certainly result in a reduction in the tracking error[10] of the actively managed portfolio subset. This means that with every additional active manager we select, we progressively revertback to the index, less active fees. i.e. underperform a passively managed investment portfolio.

This means that with continued diversification amongst active managers we create a 'mean reversion' in portfolio performance back to the index return (less the active management fee).

Even if passive investors begin to make up vastly more of the market, the majority of market volume will still be attributable to active investors.

I.e Should passive investors make up 50% of market exposures, as passive investors do not actively trade on perceived pricing inefficiencies, they have minimal influence on market volume. Therefore it is unlikely that we will ever see a scenario where active managers will operate outside of a zero sum game.

Given the pitfalls of using too many active managers, we accept that passive management may form a large part of our portfolio considerations.

HOME COUNTRY BIAS

Home country bias is the fondness for investors to have a significantly overweight exposure to domestic investment opportunities relative to their domestic markets global footprint.

It is particularly pronounced in Australia due to the attraction of franked dividends and perceived difficulties associated with accessing overseas markets.

The Australian investment market represents less than 4% of the world economy. A typical Australian equity investor has approximately 74% of their portfolio weighted to domestic equities.[11] (Christopher B. Phillips, 2012).

8. William F. Sharpe. (1991) "The Arithmetic of Active Management". The financial analyst's journal, vol 47. No. 1

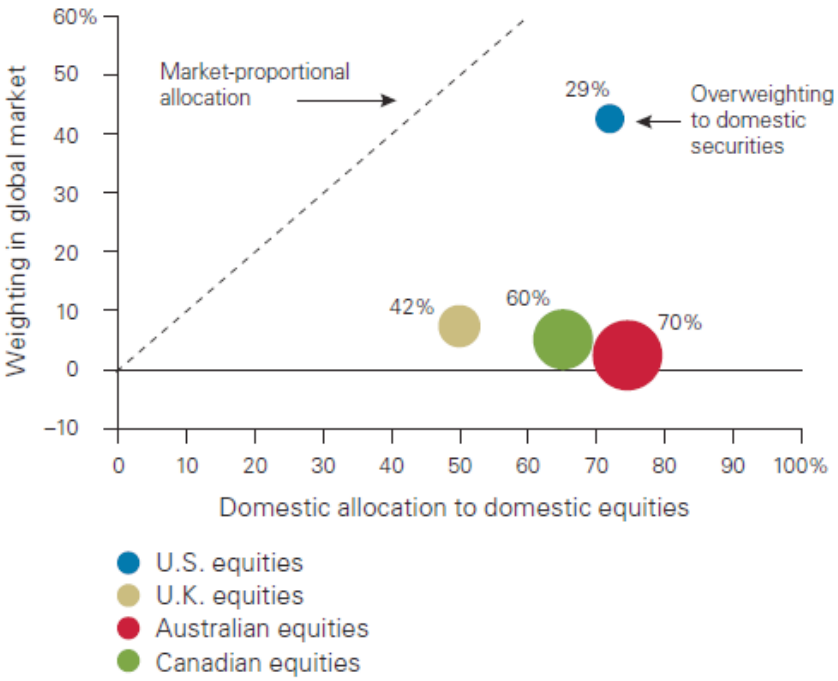
9. An aside - active management provides an economic benefit through its role in assessing fair value in markets. Retail investors do not commit the necessary resources to do this themselves. Accurately representing 'fair' value makes markets more efficient. This results in better resource and capital allocations. "Therefore, although the contest between active managers may be a zero-sum game, active management as a whole is definitely not: By making markets more efficient, active management improves capital allocation—and thus economic efficiency and growth—resulting in greater aggregate wealth for society as a whole". (Jones & Wermers, 2011)

10. Tracking error is the percentage of the fund's portfolio that differs from the fund's benchmark index.

11. Phillips et al. (2012). "The role of home bias in global asset allocation decisions". Vanguard Research

This is significantly at odds with our understanding of diversification and what we would expect from modern portfolio theorem.

The graph below demonstrates how far the typical Australian investor is from their market proportional allocation.



Sources: International Monetary Fund's Coordinated Portfolio Investment Survey (2011), Barclays Capital, and Thomson Reuters Datastream. All data as of December 31, 2010.

Why is this the case?

There are advantages in maintaining an overweight position to domestic investments. These stem from insulation to foreign exchange risk, straightforward investment access as well as tax efficiencies associated with imputation credits and tax deductibility of investment expenses.

Additionally, many of Australia's large listed companies provide an indirect exposure to international markets through the global scale of their operations. However, these advantages do not justify the disproportionate weighting that so many Australians have to their domestic market. As seen in the previous graph, home country bias is not isolated to Australia. Many investors, especially retail investors draw comfort in investing in companies that they know and these are typically companies traded domestically.

Major drawbacks associated with Australian investors home country bias is a lack of industry diversification. Australia's large exposure to mining and financial service sectors means that investors without international exposures will have minimal exposure to FMCG, Information Technology, health care and multinational franchise businesses.

Australian investors also forego their ability to gain meaningful exposures to geographic themes (like the continued economic development in Asia).

By accessing a broader array of industries, geographic sectors and global thematic's, the Australian investor can achieve a greater risk rated return on their investment portfolio. As such we advocate a more balanced exposure between domestic and international investments. their domestic market. As seen in the previous graph, home country bias is not isolated to Australia. Many investors, especially retail investors draw comfort in investing in companies that they know and these are typically companies traded domestically.

Philosophy

WEALTH ACCUMULATION

Before you are in a position to consider how best to accumulate wealth, it is worth considering what key drivers influence your wealth accumulation capacity.

Generating wealth in our opinion is more than clever tax structuring or shrewd investing, it is the long term and patient build of up personal retained income. Simply put, it is the year on year accumulation of excess income above lifestyle expenses.

The best way to improve your capacity to generate wealth is by increasing your income earning potential, whilst maintaining a disciplined savings regimen.

A savings regimen can involve a self-directed budget, for those with good discipline, or it might involve regular bank sweeps to move funds into a savings/investment structure out of arms reach.

Savings measures are relatively straight forward in principle (although they can require behavioral moderation), it is how we increase the earnings side of the wealth accumulation equation that is far less straight forward.

PERSONAL INVESTMENT

It is Snowgum Financial Services strongest view that through first investing in yourself, do you stand the best chance of enriching your personal value proposition. We view this as the answer to the difficult question of how to enhance your earning capacity?

Personal investment might mean pursuing further education, developing a new skill set, establishing your own medical/dental practice, buying a stake in an established business, putting up capital for partnership or following your entrepreneurial instincts.

We are strong advocates for continued investment in yourself and/or any business that is an extension of your personal exertion.

Conversely, we believe great care should be taken and often discourage investing in any non-market regulated business that does not rely on your personal exertion.

Worked examples

For medical professionals there is no better investment than buying into or setting up your own practice.

For talented creatives this might mean forming your own agency and for legal eagles, this could mean buying into a partnership or starting your own firm.
For management professionals, this might involve undertaking an MBA or business degree allowing you to transition to senior management and for service providers this could mean establishing your own shop front.

STRATEGY FIRST

Once you have the capacity to generate surplus income, you need to ensure that this is being done in a tax effective manner. The best investment advice will not compensate an unnecessary 15% tax obligation. We can advise you on the appropriate investment structure and/or engage collaboratively with your accountant.

Once you have established an appropriate tax structure(s) for your wealth accumulation needs, you then need to consider how to most appropriately utilise your investment capital.

PORTFOLIO CONSTRUCTION

Once we understand the mechanisms of wealth generation and are comfortable with the structural arrangements in place, we are now in a position to formulate an investment plan.

Our first consideration is understanding the holding capacity of your investment capital. This is known as your investment time horizon, (discussed in detail within the investment basics section of this

document). Your investment time horizon is a primary driver in influencing what volatility parameters we allow your portfolio to be exposed too.

We can break down capital allocation according to their funding purpose as required.

Once we understand your investment time frame, we are in a position to undertake an analysis of your investment risk appetite. Your risk appetite allows us to establish how much or little volatility (risk) your capital can be exposed too. We can then benchmark your risk appetite against strategic asset allocation (SAA) benchmarks.

When deciding on a SAA we consider both investment time frame and the individual investor's attitude towards investment risk.

Your SAA is a key driver in managing your portfolios volatility and the primary tool in managing portfolio risk.

As an investor's SAA also dictates a portfolio's market exposure, it is an influencing factor in driving a portfolio's return attribution.

Asset allocation benchmarking

We utilise Morningstar methodologies and asset allocation research from Ibbotson and Associates to guide our SAA benchmarks.

Morningstar is a leading international provider of independent analysis in this field. We have outlined these benchmark exposures in the appendix to this Investment Philosophy document.

Tactical asset allocation

If we believe there is opportunity for relative mispricing between asset classes we are happy to alter allocations from their benchmark SAA by up to 15%. We utilise a broad array of macro-economic sources to influence these decisions in conjunction with tactical asset allocation guidance provided by asset allocation specialist Ibbotson and Associates.

Passive vs active management

Please read "Another word on Active Management" section of this document for more detailed analysis on this topic.

We will maintain a core exposure within each asset class to passively managed investments appropriate to each asset class. Depending on portfolio scale we may construct a core holding of direct Australian equities representative of quality companies that provide a broad cross-sectional exposure to the Australian market or if scale requires, engage an index investment manager.

We will utilise active investment managers to broaden your portfolio's exposure if there is appropriate conviction in the active management process. We see opportunity occurring for active management in mid to small cap exposures domestically, with a less restrictive mandate for O/S equity positions.

Where appropriate, we may incorporate long/short active managers to moderate volatility concerns.

Selecting active managers

Selecting active managers is not easy!!

Well respected financial commentator and Nobel Laureate in economics Eugene Fama's view on active management doesn't inspire hope.

"An investor doesn't have a prayer of picking a manager that can deliver true alpha. Even over a 20-year period, the past performance of an actively managed fund has a ton of random noise that makes it difficult, if not impossible, to distinguish luck from skill" [13] (Fama, 2012)

13. Fama, E. (2012). "Interview with Eugene Fama". CFA institute 65th conference.

Philosophy

As we have already discussed, the flaw with active management as a whole is the zero-sum game that it operates within.

There is some evidence that there might be scope for a greater than expected number of Australian equity small-cap fund managers to outperform the S&P/ASX Small Ordinaries index. According to the SPIVA survey

"only one in five underperformed over the five years ended June 2012" SPIVA

However this is such a small time frame that it makes it difficult to distinguish performance from market noise.

Where we look to compliment a passive exposure with an actively managed investment opportunity, we focus on fund managers that display the following attributes;

- Maintain a skilled and stable investment team which follows an investment model mandate that we understand (opaque investment strategies often end poorly)
- The fund manager must undertake their own fundamental research
- The manager's investment holding must demonstrate a nominal tracking error[13]. If the funds underlying holdings are similar to an index then we see no value in employing an active manager
- Conviction managers. This ties into the third point where we look for a strong divergence from any index.

Further considerations

We will consider alternate asset classes like infrastructure, which provide stable return profiles and opportunities for yield when market conditions warrant consideration.

Our approach to property as an asset class is tempered by the likelihood that most HNW investors already have a significant proportion of their net wealth exposed to this asset classes through their primary residence and/or directly held investment property(ies).

IMPLEMENTATION CONSIDERATIONS

We choose to utilise an investment and administration services to streamline portfolio administration, reduce your accountant's workload, provide greater transparency, pool investment transaction costs, automate cash management processes and streamline corporate actions management.

Large scale portfolios (in excess of $1million) may warrant a direct share portfolio and direct bond exposures to reduce investment costs. We will provide a proprietary data consolidation service in this instance. This will allow us to package a variety of direct and adviser managed investment holdings under a private client web portal. A level of investment scale will be necessary for this service.

13. Tracking error is the percentage of the fund's portfolio that differs from the fund's benchmark index.

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