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PORTFOLIO CONSTRUCTION AND MANAGER SELECTION IN A FULLY VALUED ENVIRONMENT

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UPCOMING EVENTS

Fintech Cocktail evening – 29th August

Responsible Manager Masterclass – 17th September

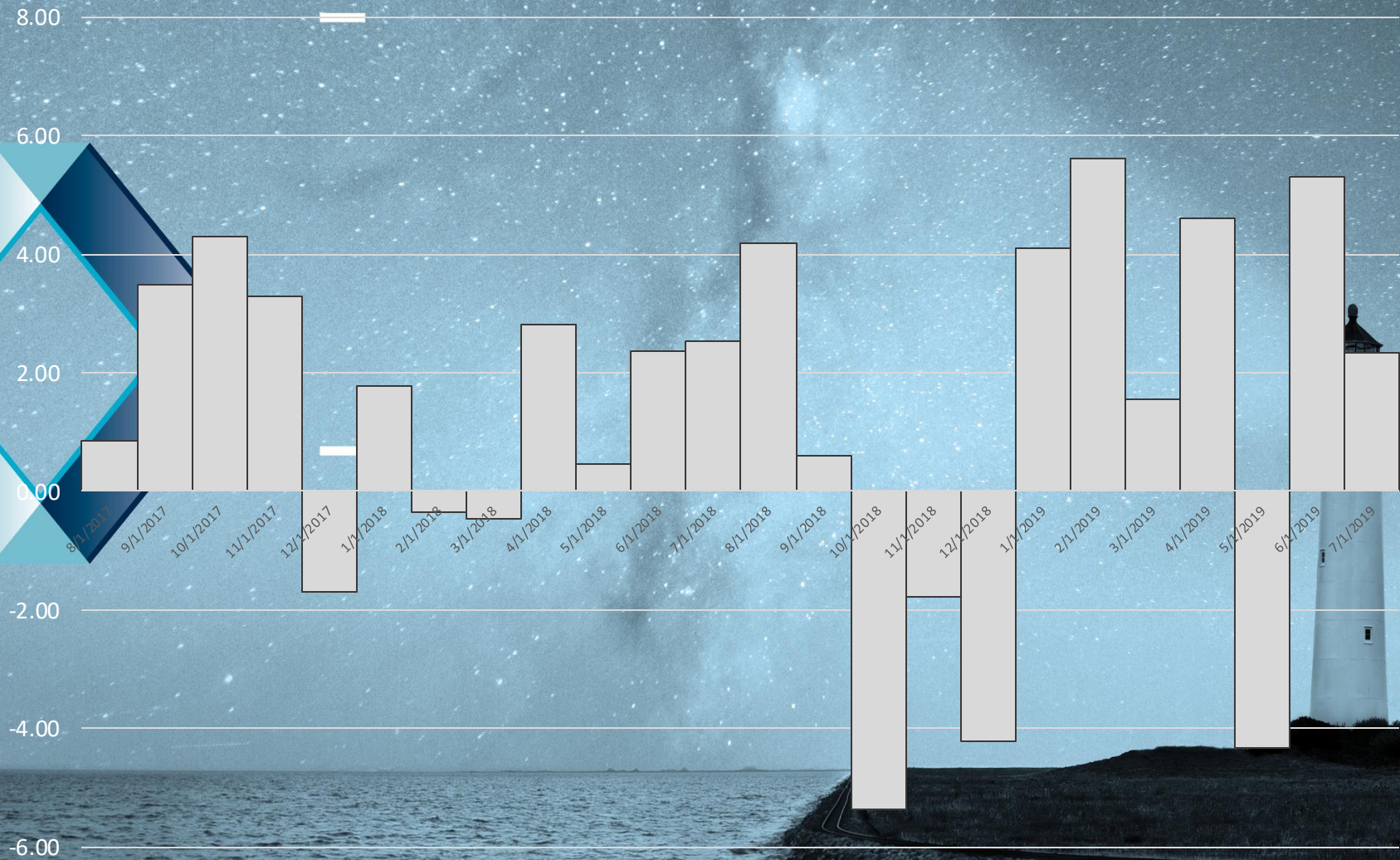
Portfolio Management Conference Melbourne – 22nd October

InvestTech – 13th November

Data Standards Working Group



MSCI Monthly Returns 8/2019 - 7/2019



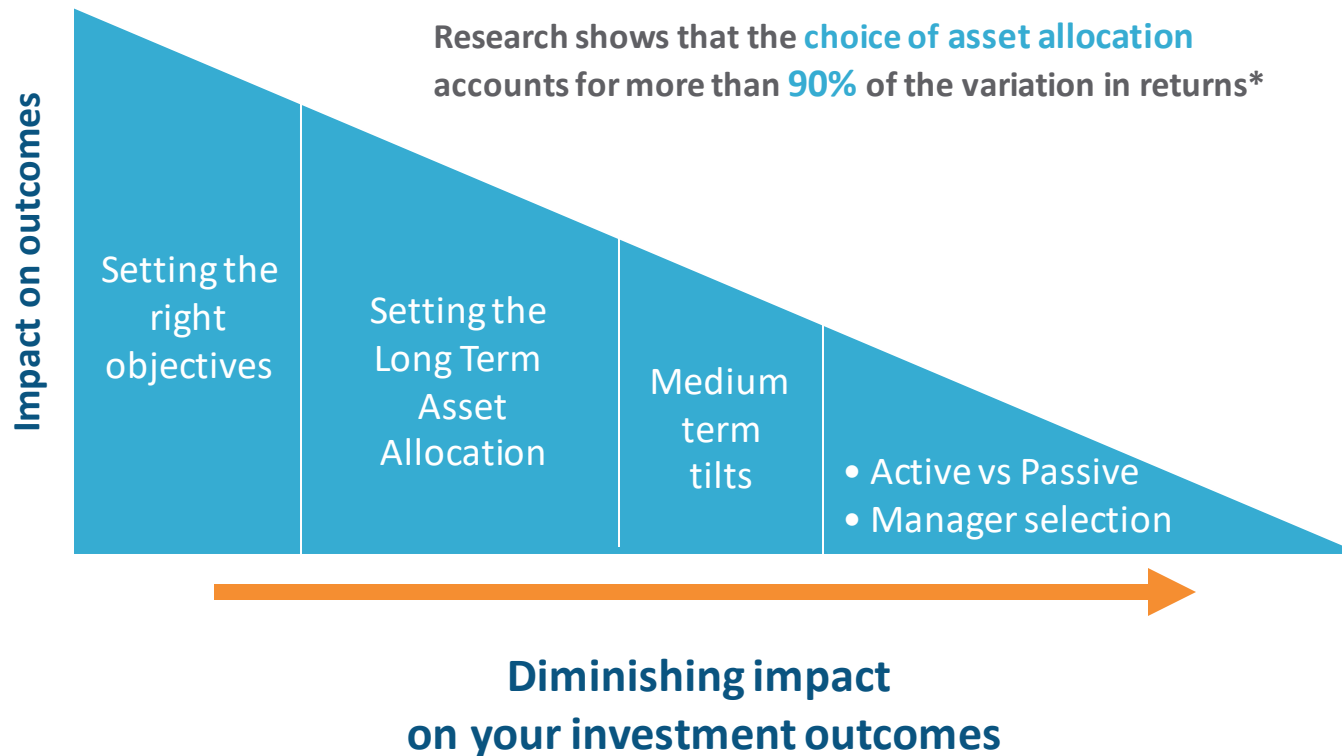


IMAP Webinar

Portfolio construction and the use of passive & alternative strategies

August 2019

What matters most...



Passive vs Active strategies

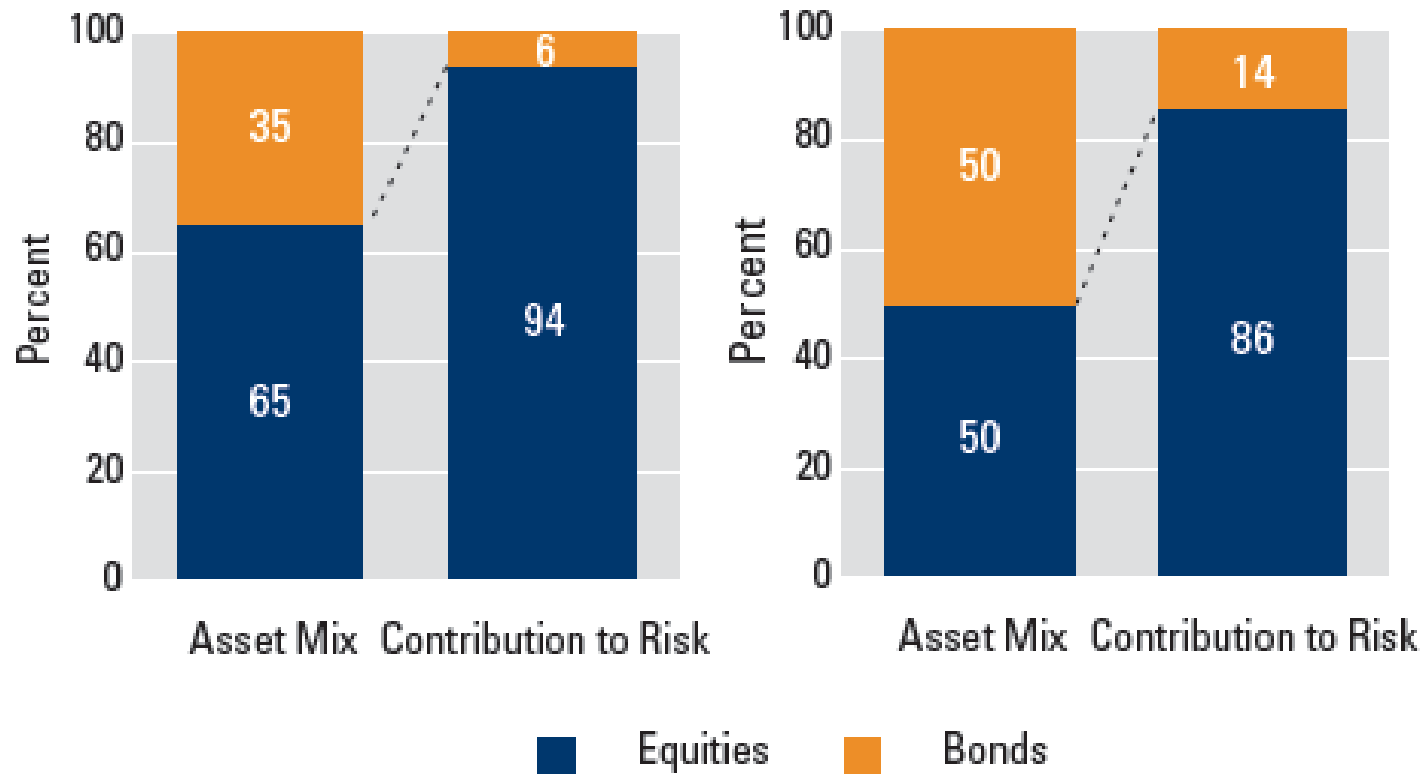


Passive is a great way of getting access to cheap beta – it can reduce the cost of portfolio management considerably

However, at the **late stage of an investment cycle excessive use of particularly cheap equity beta can be an increasingly risky approach to portfolio construction**

Why ? Equity risk generally dominates portfolios – passive equity strategies are dominated by capitalisation weighted indices. At the end of an investment cycle this is necessarily over-exposing portfolios to past performing stocks at the expense of better value or more defensive exposures which have underperformed

Equity risk dominates portfolio volatility



Source: Wellington Management

Solutions to this ?



- **Consider increasing active management in portfolios later in investment cycles** – avoid the passive overweights
 - **Smart beta strategies** - systematic investment in alternative benchmarks (e.g. equal weight, factor weighted or minimum variance strategies)
 - **Increased exposure to alternative investments** can also be a useful late cycle diversification strategy
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The case for Alternatives



Getting the allocation to the available range of asset classes right is generally more important than which managers are managing an asset class – beta (or market) risk will account for the majority of outcomes in asset classes such as Australian and global shares

Alternatives are the exception where the nature of the strategy and manager style often dominates the outcome

“idiosyncratic manager or strategy risk” – manager skill (or luck) can dominate returns

Look at Alternatives more as a “class of investments” rather than an “asset class”

Common characteristics



Alternative assets need to deliver either:

A return premium for illiquidity (can be a problem for managed account strategies)

OR

Diversification of returns away from traditional investments

“Alternatives” covers a variety of investments



Private Equity

Infrastructure

Hedge Funds

Commodities

Timberland

Distressed Debt

Opportunistic Debt

Insurance Related Investments

Each of these strategies can have quite diverse investments and managers

e.g. PE, commodities, hedge funds

We recommend open-minded scepticism



Issues to be mindful of when investing in alternatives:

- How attractive after fees and after tax?
- Bias to expensive assets
- Capital inflows can erode opportunities
- Transparency
- Skill or luck?
- Beta dressed up as alpha?
- How much illiquidity can you afford?

Well worth exploring but a detailed understanding of the strategy and strong fund manager research is essential to avoiding mis-steps

Final thoughts ?



Portfolio construction in an extended bull market is pretty straight forward

- “The rising tide lifts all boats”
- Buy cheap beta
- Manager alpha is nice but not essential
- Why bother with risk management or insurance ?
- Keep it simple and cheap

Portfolio construction in late cycle markets is much trickier

- Overvaluation means that markets tend to become more volatile
 - Aggregate returns tend to decline – beta is less rewarded
 - Undiversified beta can be dangerous
 - Risk management (i.e. diversification & insurance) may be more relevant
 - Quality strategies and managers are likely to make a difference
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Questions

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WHO WE ARE



CORE FUND

AIMS:

CONSISTENTLY MAKE MONEY

MINIMISE LOSSES & VOLATILITY

HOW WE DO IT

PORTFOLIO CONSTRUCTION	ACTIVE MANAGEMENT
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PORTFOLIO CONSTRUCTION

How we pick stocks



**POSITIVE
TAILWINDS**



**GOOD
MANAGEMENT**



**UNLIKELY
TO BLOW UP**



**CASH
GENERATION**



**REASONABLE
VALUATION**



GROWING

LOGICAL AND COMMONSENSE

PORTFOLIO SEGMENTATION

CORE	CYCLICAL	OPPORTUNISTIC
<ul style="list-style-type: none">✓ 60 – 80% of Fund✓ 15 – 30 stocks✓ 5 – 15% growth✓ Stable and growing companies with favourable tailwinds✓ Position size: 1-5%	<ul style="list-style-type: none">✓ 0 – 30% of Fund✓ 0 – 15 stocks✓ >10% growth✓ Operate in cyclical industries poised for an upturn✓ Stop losses✓ Position size: 1-3%	<ul style="list-style-type: none">✓ 0 – 20% of Fund✓ 0 – 10 stocks✓ Company specific situations with attractive potential upside✓ Stop losses✓ Position size: 1-3%

PORTFOLIO



30 – 50 STOCKS



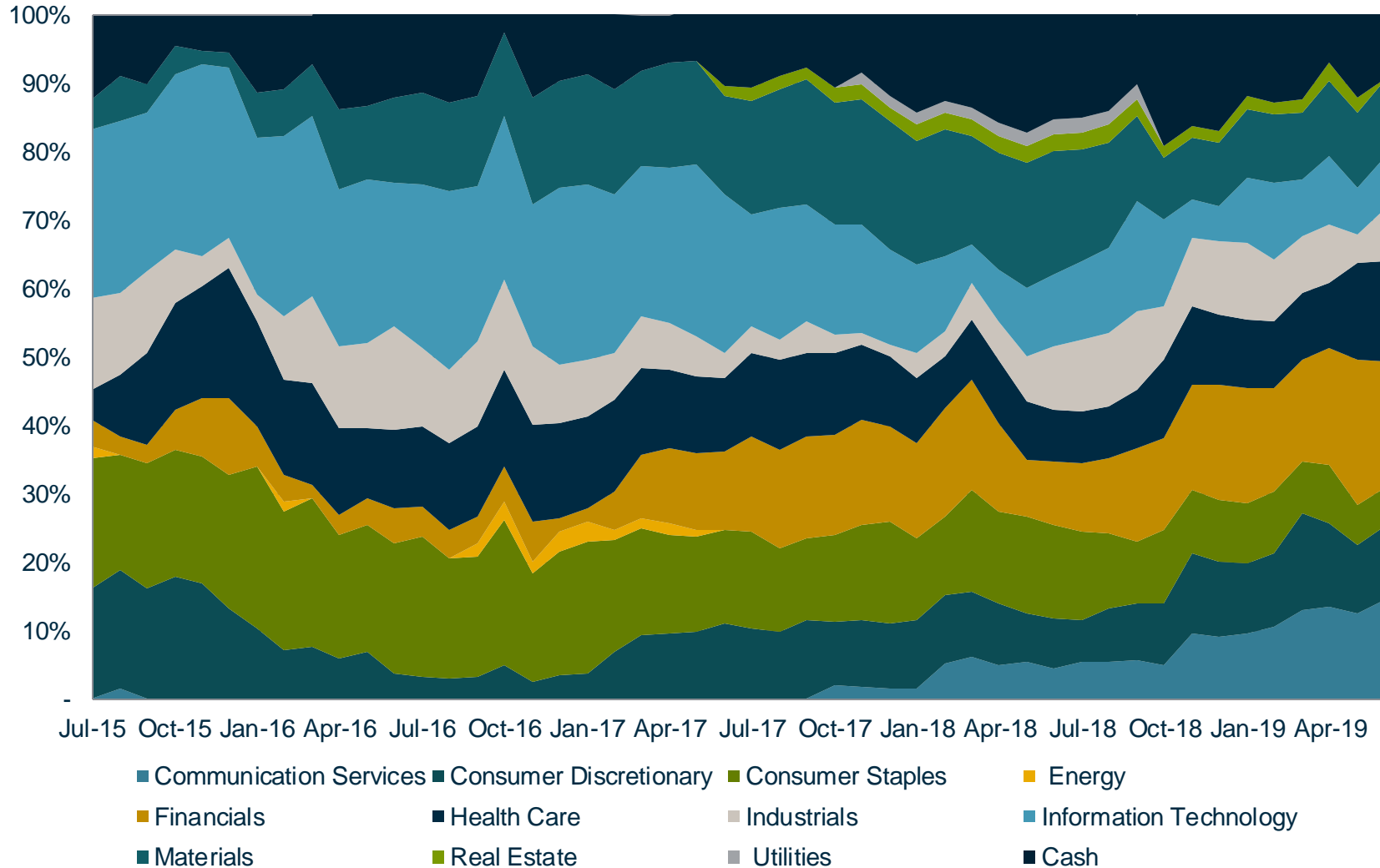
> 5% GROWTH



FCF YIELD > RFR + 3%

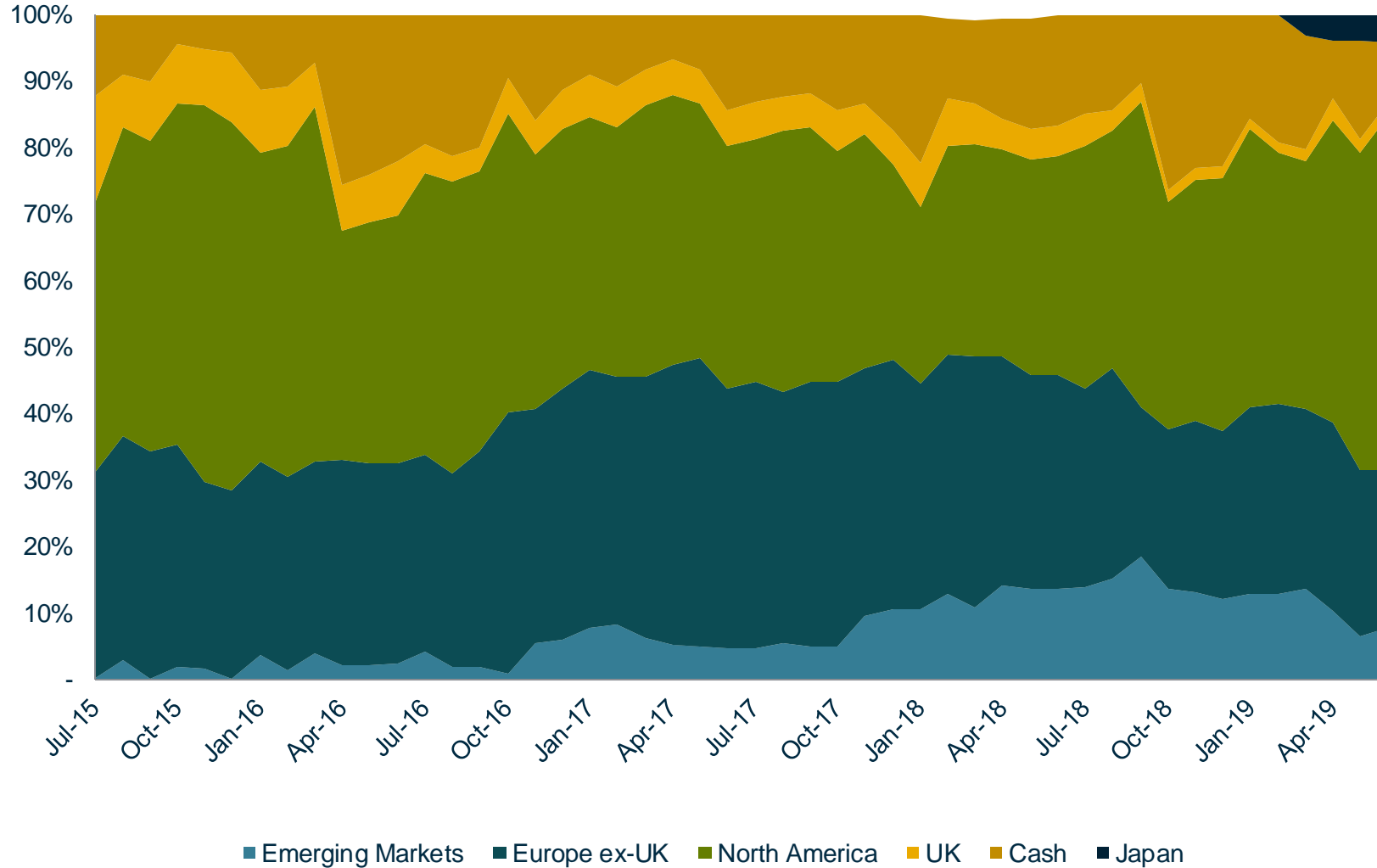
ACTIVE MANAGEMENT

Industry exposure



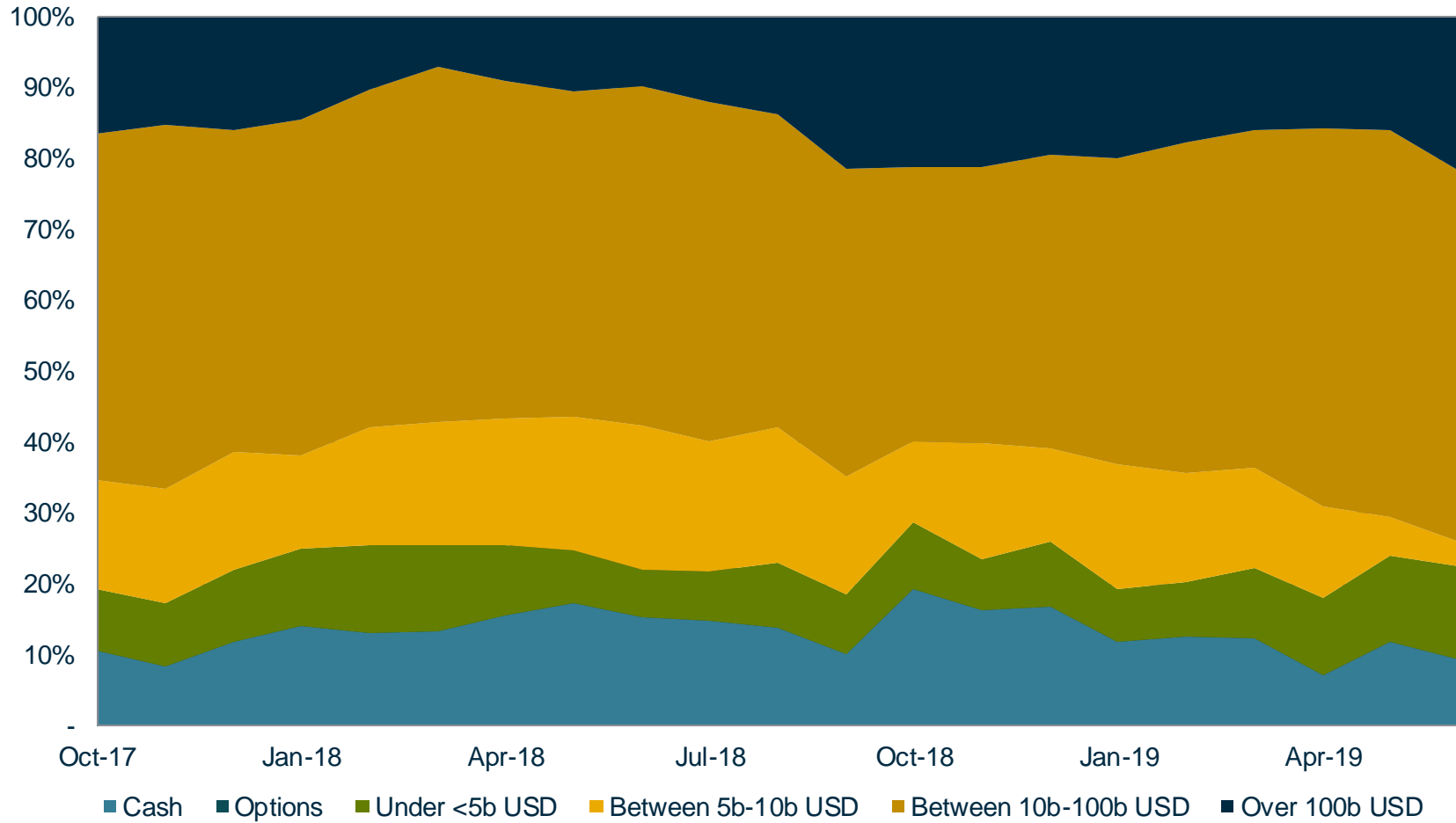
ACTIVE MANAGEMENT

Geographic exposure



























ACTIVE MANAGEMENT

Company-size exposure



EXAMPLES OF PORTFOLIO POSITIONS

	Core	Cyclical	Opportunistic
Finance	  		 
Consumer Services			
Consumer Staples	 		
Communications			
Real Estate			
Electronic Technology			 
Commercial Services	 		
Agriculture			
Health Technology	  		
Industrials			
Technology Services	 		 

PERFORMANCE – DIFFERENTIATION

Fund Inception to 30th June 2019

- ✓ Overweight Europe, underweight US
- ✓ Overweight Materials and Consumer Staples, underweight IT and Financials
- ✓ Overweight Mid-cap, underweight Mega-cap

	Portfolio average weight	Index* average weight	Portfolio return**	Index return**
Region				
Europe ex UK	28.5%	14.9%	12.0%	5.4%
US	43.4%	56.8%	12.5%	11.1%
Sector				
Consumer Staples	14.6%	8.9%	12.5%	8.2%
Materials	12.4%	5.0%	11.8%	7.4%
IT	11.9%	13.5%	17.7%	17.6%
Financials	10.1%	18.0%	19.9%	6.0%
Market Cap				
USD 5bn - 10bn	13.7%	8.5%	11.8%	-0.4%
>100bn USD	22.1%	33.4%	10.9%	14.7%

* MSCI ACWI

** annualized total return in local currency

Source: Pengana and Bloomberg

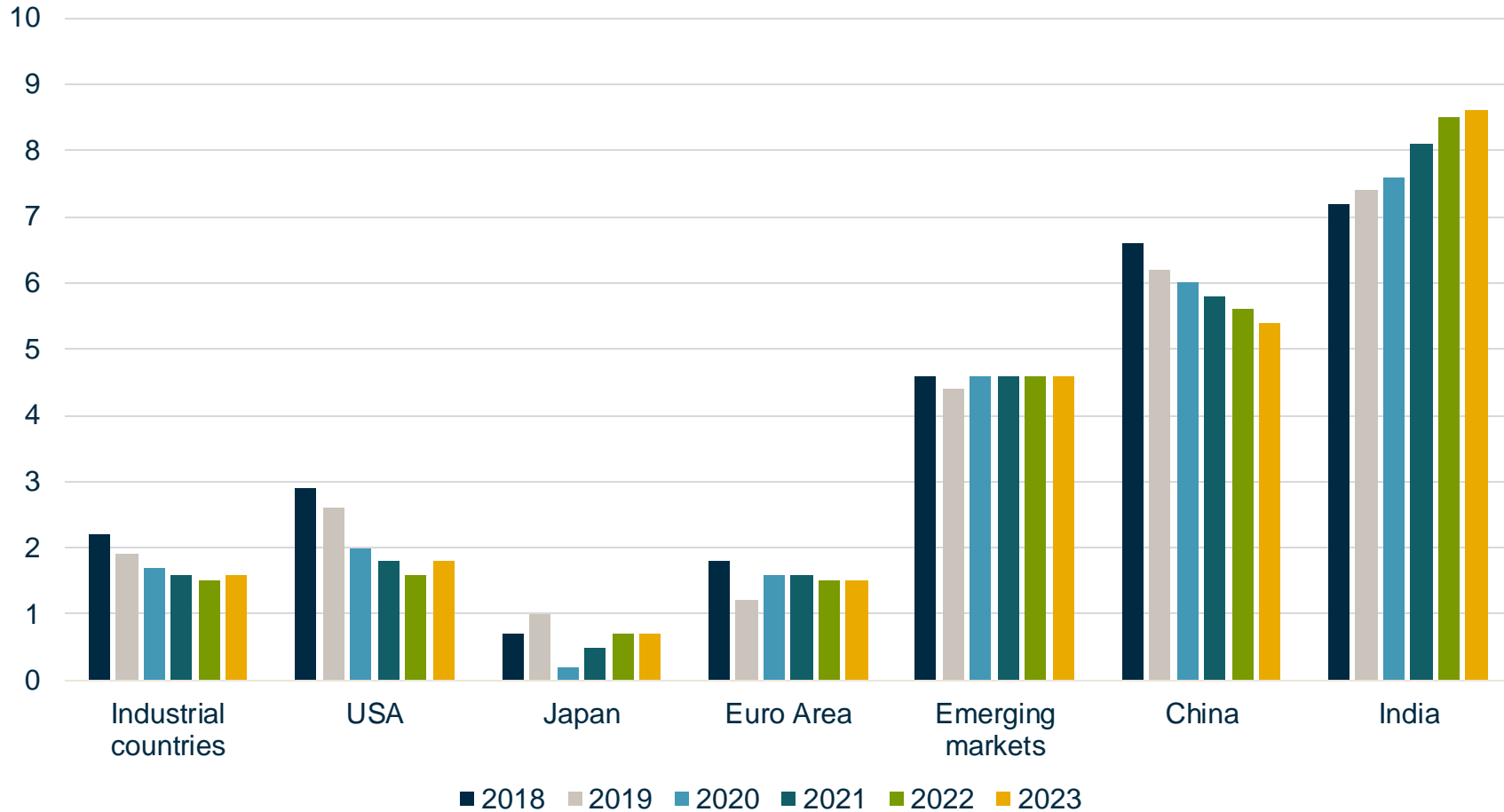
1. Net performance figures are shown after all fees and expenses, and assume reinvestment of distributions. Past performance is not a reliable indicator of future performance, the value of investments can go up and down.
2. Inception 1st July 2015.

OBSERVATIONS OF THE MARKET

A MACRO PERSPECTIVE

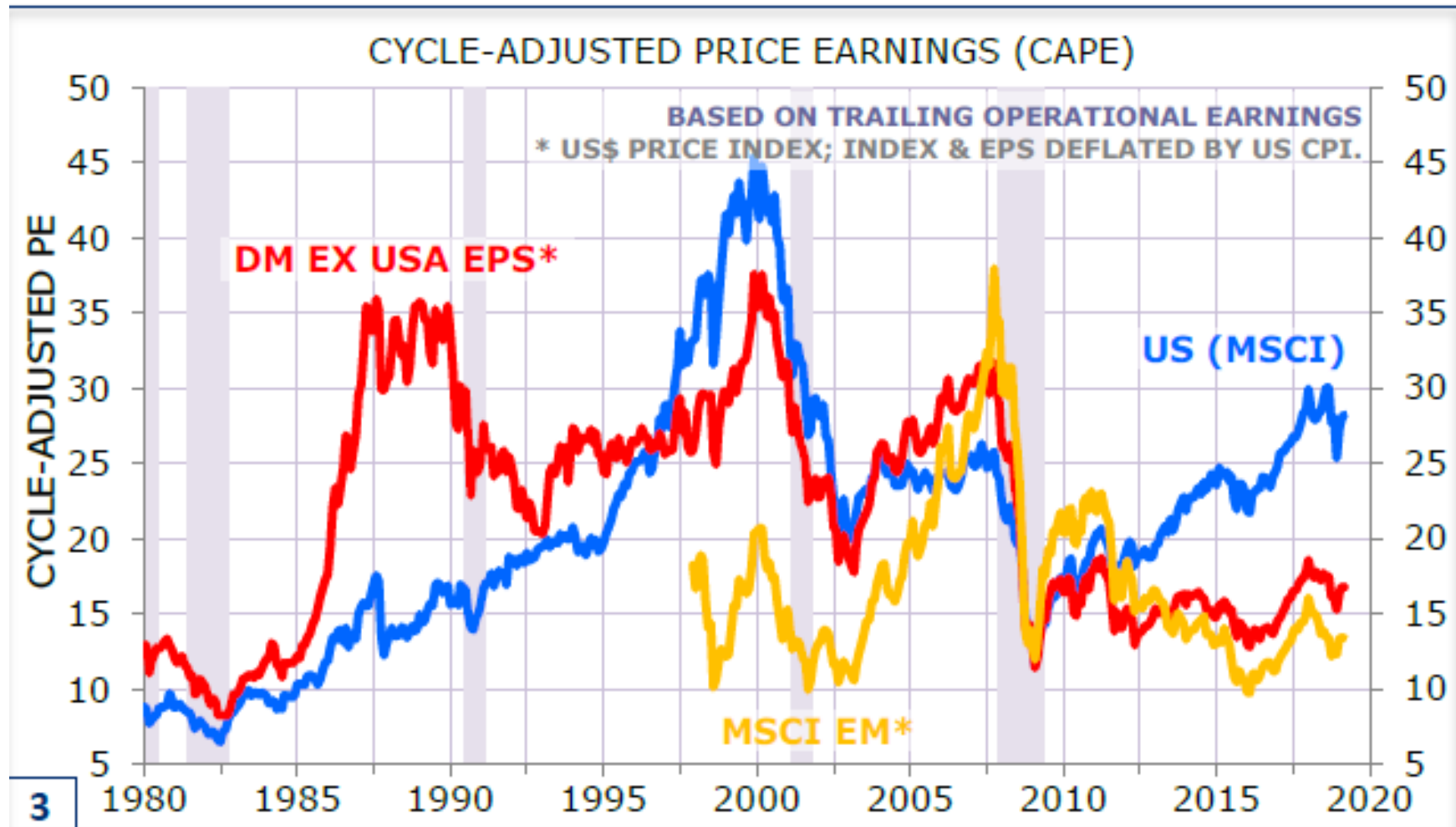
(1) Global GDP growth coming from emerging markets

GDP growth



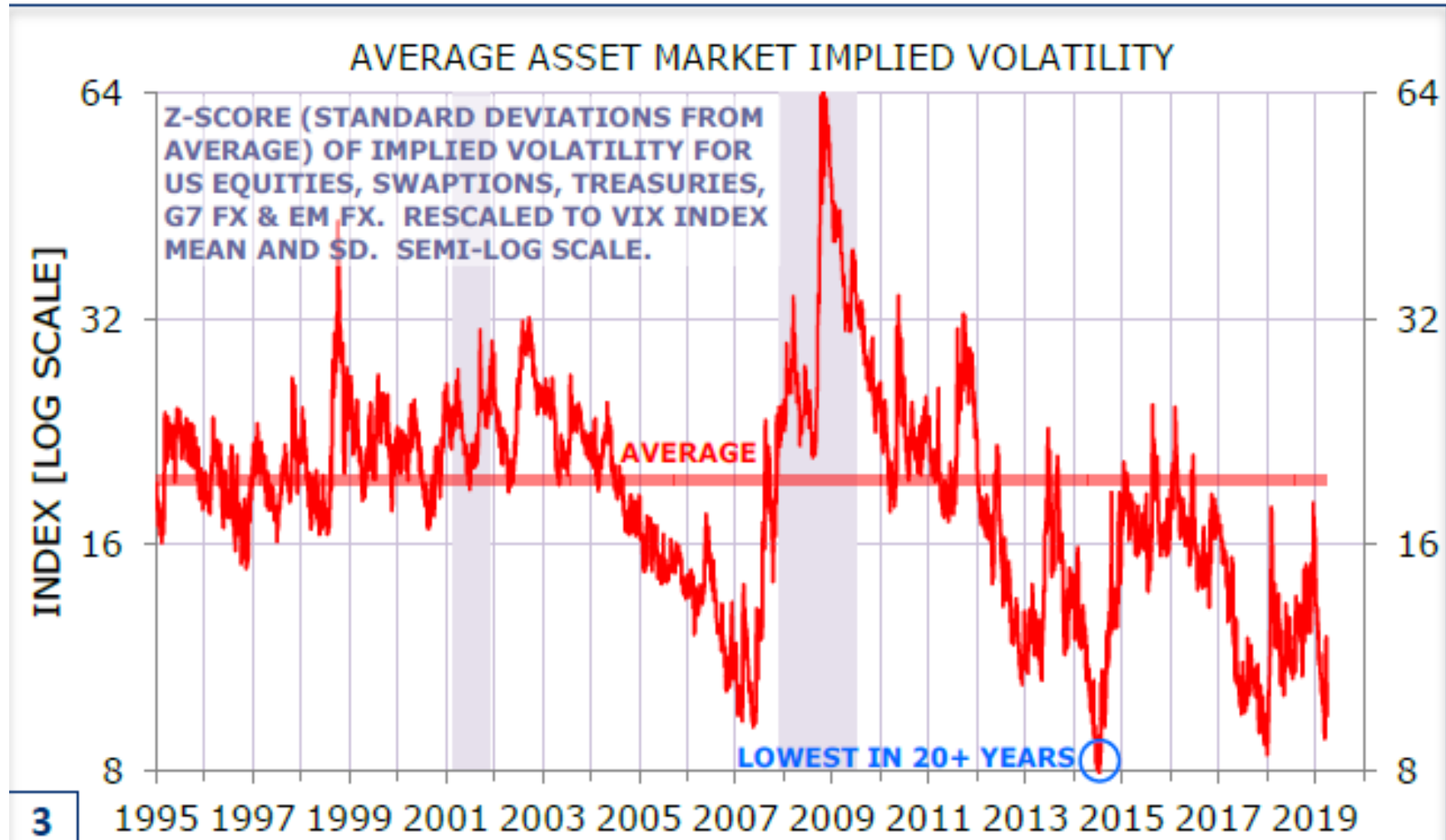
MACRO

(2) US vs EM valuation gap is at extreme levels



MACRO

(3) Volatility at multiyear lows



PERFORMANCE

Make money

Avoid losses

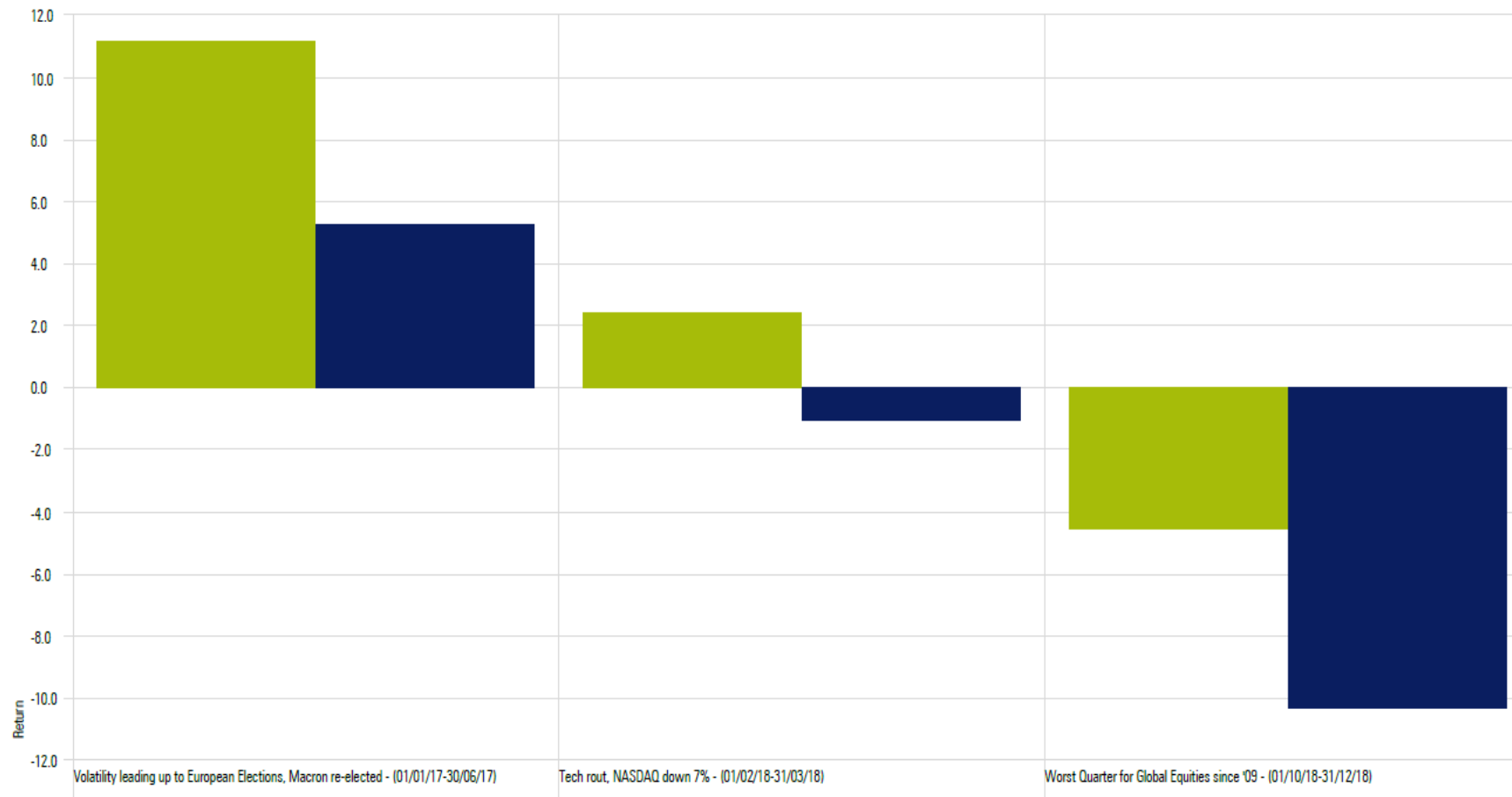
Minimise volatility

PERFORMANCE

Saving money when it counts

Returns

Calculation Benchmark: MSCI ACWI NR USD



Pengana International

MSCI ACWI NR AUD

MACRO

What we have done

Strategy – unchanged

- Invest in cash generative businesses on reasonable valuations and low debt
- Remain diversified

Regional view

- Increase exposure to Emerging Markets and gradually Europe

Sector comments

- Remain underweight Technology (especially large cap stocks)
- EM driven industries

Volatility vs low interest rates

- Increase in i/r – invest in businesses that benefit from volatility e.g. derivative exchanges
- Low and steady i/r - emerging markets benefit



FOR MORE INFORMATION

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Questions

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