

CENTREPOINT RESEARCH INVESTMENT PHILOSOPHY

(Adviser Use Only)

1. EXECUTIVE SUMMARY

The purpose of this paper is to bolster the existing Investment Philosophy by elaborating on the Centrepoint Research teams' views around asset classes and portfolio construction. The Research team hopes that this will provide further transparency over our process to achieve more meaningful discussions with the advisers and their end clients.

2. OBJECTIVE

The model portfolios are designed to give advisers portfolios that will deliver CPI+ objective over a range of medium to long term timeframes.

The portfolios are designed across a range of risk profiles to be chosen for the client by the adviser. The Portfolio Construction is designed to optimise the chance of the portfolio to deliver the investment objectives from a risk adjusted return perspective. We also seek to minimize volatility and give strong downside protection during market crisis periods.

The Centrepoint Research team believes that where an active return net of fees is feasibly achieved, we should seek to access that return via active managers to deliver a better outcome to clients.

Where excess return is not feasible or cost effective, or where a low-cost exposure is sought, we may use passive components in sections of the portfolio. Given underlying brokerage for listed assets can increase costs for some platforms, we will prefer using managed fund versions where possible. Examples of environments where a passive approach might perform well would be in very low inflation environments or market regimes where there are persistent low levels of cross-sectional volatility.

3. STRATEGIC ASSET ALLOCATION

The philosophy is based on setting long term strategic weights to asset classes based on optimising the trade-offs between long term (20 year) expected return, expected risk and asset class correlations. Ranges around these strategic weights are also defined. These strategic settings will be reviewed each year, with a full refresh every three years. After a full refresh, the Research team would not expect these strategic settings to materially change each year.

The core elements of our thinking on expected return for an asset class are yield, growth in yield and valuation. The Research team seeks to quantify what each asset class can reasonably expect to achieve in those three areas. The sum of these will give the asset class an expected return. We will use our asset consultant to help calculate the expected returns on an ongoing SAA review cycle, making sure we are comfortable with the calculations and process.

4. VOLATILITY MANAGEMENT

The Research team will monitor market volatility on a quarterly basis at both the asset class level and overall portfolio level. Research feels this is important to monitor as a risk monitoring tool but also to help compare volatility to our long-term expectations for an asset class when we conduct sector reviews each quarter.

5. MANAGER SELECTION

The Centrepoint Research team employs a multi-manager approach to the construction of the Model Portfolios. This is based on the notion that active return can be enhanced through considered and skilful selection of investment managers whose processes enable them to outperform the benchmark return of their respective asset classes over different market conditions.

Consistent with this, the manager research and selection process employed by the Centrepoint Research team is driven by the objective of identifying high quality managers with a demonstrable skill of adding value in a risk-controlled manner. While it is important that the manager can consistently add value over time in its own right, the Model Portfolios blend several high calibre managers who provide a range of complementary investment styles and processes. This seeks to enhance and reduce the variance of returns for clients. Manager research and selection is informed by the Centrepoint Research team.

It is important to note that while the elements of a manager's prior performance play an important role in the selection process, the Model Portfolio philosophy is predicated on the notion that past performance is by no means an accurate indicator of future performance. Central to this is also the belief that whilst performance can at times be fleeting, skill tends to be more likely to be identified over the market cycle. The focus of the Centrepoint Research team is to analyse both qualitative and quantitative factors to help determine a manager's competitive advantage and skill relative to their peers. The Centrepoint Research team meets regularly with model manager for ongoing monitoring.

6. ASSET SELECTION

Within an asset class, we are then faced with the decision on how to populate the asset class to deliver the risk adjusted return expectation of the asset class.

6.1.1 Equities

The team will take a balanced approach to different styles of investments within an asset class, to harness proven "risk premia" or "factors" that are proven to outperform passive benchmarks over time.

Examples of these factors in equities are:

- the market risk premia (i.e. the index return – not expected to outperform but a powerful return driver),
- the value risk premia (buying undervalued stocks),
- the size risk premia (buying smaller cap stocks), and
- the profitability risk premia (buying stocks with high returns on capital).

We do not seek to harness the momentum risk premia (buying stocks that have recently gone up) as it is not practical in a model portfolio context. However, we note its academically proven merit and may harness this factor by employing fund managers that incorporate that risk premia into their process.

The Centrepoint Research team seeks to balance the above factors within the equities asset classes by providing a blended style neutral exposure. All equity managers provide access to the market risk premia to the

extent they are fully invested. That said, for risk reduction we may exclude higher risk managers from the more conservative risk profiles, e.g. small cap managers and emerging markets (in international equities). How we would break up a portfolio is by making sure we have the following investment styles

- core / quality / growth manager
- value manager
- small cap manager
- variable beta manager (low volatility manager)

6.1.2 Property and Infrastructure

Arguably listed property (REITs) and listed Infrastructure securities are a subset of the broader equities asset class. With regard to asset allocation, we model their expected return and risk characteristics separately to the equities asset class.

These asset classes can be used as levers to accentuate tilts toward inflation protection, or where the valuation of real assets looks particularly attractive. Passive exposure can be utilised for highly fee sensitive portfolios, but we prefer active in this space.

6.1.3 Fixed Income (Bonds)

In the bond section of the portfolio, we are seeking to harness risk premia in excess of the risk-free rate. These are;

- The Maturity or Duration Risk Premium (compensation on longer term bonds for value fluctuations in response to interest rate changes).
- The Liquidity Risk Premium (compensation for a bond that cannot be quickly converted into cash at a fair market value)
- The Default Risk Premium (compensation for risk that a government or corporate will default on its payment obligations)
- The Inflation Risk Premium (compensation for inflation risks)

The key return drivers for bonds are their yield and their valuation normalisation. Fixed income securities do not have any growth in yield. We consider this combined return in concert with the expected volatility of the asset class when considering portfolio strategic allocations.

Currently in our SAA, Fixed income encapsulates both traditional fixed income and defensive alternatives. Research will continue to differentiate these two due to their differing characteristics at a portfolio level only.

The APL at Centrepont Alliance buckets Growth Alternatives in the “Diversified Alternatives” space, whereby most Defensive Alternatives are bucketed into Fixed Income. For this purpose, we will characterise all managers (at the portfolio level) by an CPI objective, so a manager with a ‘CPI plus 4 and above’ would be considered as a Growth Alternative, and those in fixed income with an objective of ‘CPI plus 3 and below’ as Defensive Alternatives at Centrepont Research discretion. Even though the SAA characterises diversified alternatives as 50% Growth and 50% Defensive. This is not a hard rule – we seek to make this distinction to advisers for educational purposes in portfolio construction.

6.1.3.1 Defensive Alternatives (Ideal Classification) – for managers with Low Duration and CPI plus 3 and below objective.

The purpose of defensive alternatives is to provide a substitute allocation to fixed income markets within the defensive component of a diversified portfolio. These are typically fixed income strategies that are more unconstrained and absolute return in nature having flexible investment guidelines to invest broadly within fixed income markets. For example, they may have wide variation in their duration exposure vs the benchmark and in some cases, they may have negative duration.

- **Absolute Return Bond Funds:** These funds seek to be able to deliver a modest return even in rising interest rate environments when traditional fixed income should struggle. They do so by capturing long / short factor returns from different asset classes such as corporate government debt, currencies, and a manager's view (which might be quite different to the long only fixed income benchmark) on duration. Managers may even hold negative, or short duration exposures.
- **Multi Asset Absolute and Real Return Funds:** These seek to harness a range of risk premia from different asset classes. They seek to deliver differentiated and diversified return with low drawdown experience via skilful dynamic asset allocation. Often their constituent investments are not hugely varied from traditional asset classes, but they may allocate in a quite dynamic fashion along with taking short positions to try to deliver an inflation plus type return. Arguably the excess return they may deliver from this dynamic positioning is uncorrelated with bond and equity markets.

6.1.4 Diversified Alternatives

The Alternatives Asset Class is used for two main reasons.

The first is to provide an alternative approach to generating a return when the equities and bonds asset classes may find this challenging due to the stage of the economic cycle or due to expected return concerns, usually due to valuation.

The second is to broadly diversify as part of the portfolio construction process, and harvest returns that provide a similar quantum of risk adjusted return to equities and bonds, whilst doing so in a lowly correlated fashion.

But for this second reason, there is no need to complicate portfolios beyond using equities, property and infrastructure for portfolio growth and income, or high-quality sovereign and corporate bonds for defensive exposure and income. However, where alternative assets deliver the same risk and return characteristics with low correlation, we should exploit that to the level of our conviction in those alternatives delivering those outcomes, so that we access the portfolio correlation benefits and a more efficient asset mix.

6.1.4.1 Growth Alternatives (Ideal Classification) – for managers with a CPI plus 4 and above objective

The purpose of growth alternatives is to provide a substitute to listed equity markets within the growth component of a diversified portfolio. This category will include strategies such as managed futures, multi-strategy hedge funds and global macro funds.

Funds will typically have an objective of cash + 4% or higher with volatility up to an equity like volatility level.

These funds capture a range of risk premia in diversified ways – e.g. hedge funds may capture risk premia such as the equity risk premium, credit (default) risk premium and the small cap equity risk premium, along with hedge fund manager skill (alpha).

6.1.5 Currency

Currency is not considered an asset class within portfolios but can be thought about in this way when managing the risk and return that currency exposure brings to a portfolio.

There are genuine benefits from having overseas currency exposure on a look through basis in a portfolio.

1. It provides diversification benefits. This can reduce risk if exposures are not too extreme.
2. It may enable a pool of assets to match the future liability stream (goals and objectives) more exactly. If a client has a future goal of travelling overseas in retirement, it is prudent to hold investments that will go up in value with the value of that future expense.
3. It enables investors to access investments in higher performing regions.

A neutral hedging approach to judge a currency hedging program against would be 50% of all growth assets which have a foreign currency exposure hedged back into Australian Dollars. A risk profile may deviate from this level at any point in time, however, we will maintain a 50/50 hedging ratio dependent on the recommendations from our asset consultant. We will consider fixed income and defensive assets as fully hedged.

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