# Australian Shares Income Managed Account Portfolio

Q42016

## Quarterly Performance Update

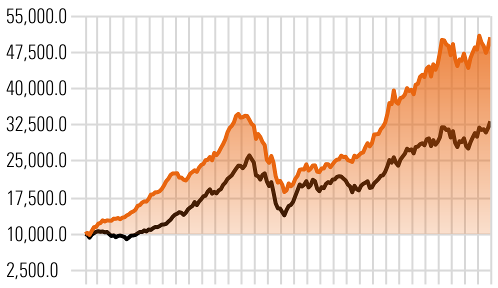
All data and information as at Portfolio Date: 31/12/2016

### Top Holdings

| | Weighting % |
|---|---|
| Telstra Corp Ltd | 8.5 |
| Cash Account | 6.0 |
| Wesfarmers Ltd | 5.2 |
| Australia and New Zealand Banking Group Ltd | 4.6 |
| QBE Insurance Group Ltd | 4.3 |
| National Australia Bank Ltd | 4.2 |
| Commonwealth Bank of Australia | 4.1 |
| Westpac Banking Corp | 3.9 |
| Vicinity Centres | 3.8 |
| Carsales.com Ltd | 3.8 |

### Investment Growth of $10,000

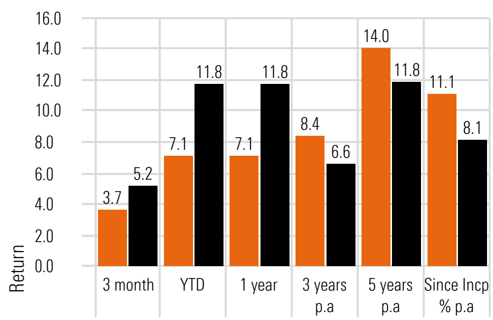
Time Period: 01/08/2001 to 31/12/2016




Australian Shares Income    S&P/ASX 200 TR AUD

### Returns Relative to Benchmark

As of Date: 31/12/2016




Australian Shares Income    S&P/ASX 200 TR AUD

### Market Commentary

A wild year it was. Markets started 2016 with fear, exited with euphoria, and along the way it seemed like the unthinkable became the norm. A renaissance in most commodity prices helped drive a 43% rise in the basic materials sector, partly lifted by China's credit-fuelled economic growth - central planning allows imbalances to persist longer than economics and history predict. And then of course, there was politics. The UK voted to walk alone and Hillary – the candidate that couldn't lose – lost, so Donald "Tweeter" Trump will be sworn into office soon.

How has our investment process changed to accommodate these historic events? If there was a year to test resolve and make one question previously held truths, 2016 was it. But we haven't altered our approach. That's not to say the status quo shouldn't be challenged at times. Expanding economic inequality and self-serving politicians deserve renewed scrutiny. To remain relevant, businesses must innovate to varying degrees or risk losing to competition. But intrinsic-value investing, buying pieces of cash flow streams at a discount and holding them for the long-term should be an immutable investing truth through the unexpected. While there's no guarantee that our strategy will be successful every year, we believe it to be the most rational and consistent approach to deliver long term results. The challenge when uncertainty hits is to not be drawn into newly crafted caveats or "this time is different" thinking.

### How the Portfolio Performed

After fees and before franking credits, the Income Portfolio total return for the year was 7.1% (including 4.3% in income) compared to 11.8% for the S&P/ASX 200. Dexus Property, BHP Billiton, and QBE Insurance were noteworthy contributors, while Platinum Asset Management, AMP, and Telstra detracted. Over the last three years, our 8.4% annualised mark is ahead of the benchmark's 6.6%, and over five years we've generated 14% annually versus the benchmark's 11.8%. At December month-end, the portfolio's net dividend yield was 4.9% and gross about 6.3%, representing attractive income in a low return world.

It's worth repeating part of our third quarter commentary. Investment strategies perform better or worse in different market environments and are highly dependent on the process followed and expertise applied. Honest and self-aware portfolio managers can readily describe markets where they tend to excel and those they tend to lag. Strong capital appreciation derived disproportionately from the materials sector (low quality, low yield, high uncertainty) is not a sweet spot for an income strategy.

### Positioning

Over the course of 2016, we repositioned the portfolio to lessen our exposure to companies that have benefitted greatly from falling interest rates. This includes reducing utilities, telecommunications, and property, realising gains on companies like AGL Energy, APA Group, BWP Trust, Dexus Property, and Scentre Group. We shifted this capital to consumer, technology, health care, and others, such as new positions in Coca-Cola Amatil, Crown, MYOB, Medibank, QBE, and Woodside.

The portfolio's current profile aligns well with our primary objectives – attractive net yield, significant franking to benefit after-tax returns, and attractive total expected returns from replacing overvalued stocks with undervalued, using our estimates. Banks were also trimmed, partly to fund new positions but also to modestly reduce exposure to the increasingly hot property market. In short, we're protecting against the possibility that a few strong tailwinds are starting to turn. As for other simmering threats to healthy markets, our expectation is that concentrating in quality businesses across sectors at reasonable prices will keep us on track to produce attractive income through the cycle.

In 2016, we initiated twelve positions and exited five, bringing the net total number of stocks to 26. As a reminder, the Income Portfolio targets between 15 and 30 positions so we're at the upper end of the range but still much more concentrated than most Australian equity strategies. We don't see much value in having a long tail of low conviction positions in this strategy. If market prices offer opportunities on exceptional businesses, we'll happily re-concentrate our investments in the future.

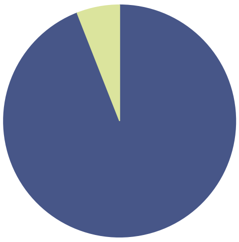
Portfolio turnover has increased due to market volatility and our desire to adjust the portfolio's composition as described. Turnover should moderate, with the obvious caveat that we're always looking for opportunity. Long-term valuation-driven investors like ourselves welcome market volatility as it often generates mispricing – a key ingredient for future performance. Nonetheless, our multi-year portfolio churn remains below industry averages, and we prefer it that way. Besides, we like our current positioning – company valuations in the portfolio are reasonable overall, and we have a nice spread of sector exposures with attractive income generated by a variety of businesses.

### Outlook

We prefer to assess the merit of individual businesses rather than speculate on the macro. But given historically subdued interest rates and inflation, and their impact on market prices, a view seems necessary. Our belief is they'll normalise to long-term averages, eventually. If nothing else, this outlook is supported by the unjustifiable market prices for interest-rate sensitive companies that have appreciated beyond what cash flows can support. When rates will normalise or exactly what that path will be, is unknowable with any precision. We simply have conviction that the next five years are likely to be less favourable to the valuation of "yield trade" securities. This area has generated noteworthy returns for us over the last few years, but that opportunity has likely passed.

### Asset Allocation

Portfolio Date: 31/12/2016



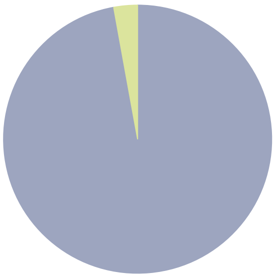
| | % |
|---|---|
| Stock | 94.0 |
| Cash | 6.0 |
| **Total** | **100.0** |

### Transactions in the Quarter

| | | |
|---|---|---|
| CWN-AU | Crown Resorts Limited | Add |
| ISD-AU | Isentia Group Limited | Add |
| VRT-AU | Virtus Health Limited | Add |
| CAR-AU | Carsales.com Limited | Increase |
| MPL-AU | Medibank Private Limited | Increase |
| AGL-AU | AGL Energy Limited | Remove |
| APA-AU | APA Group | Remove |
| BHP-AU | BHP Billiton Limited | Remove |

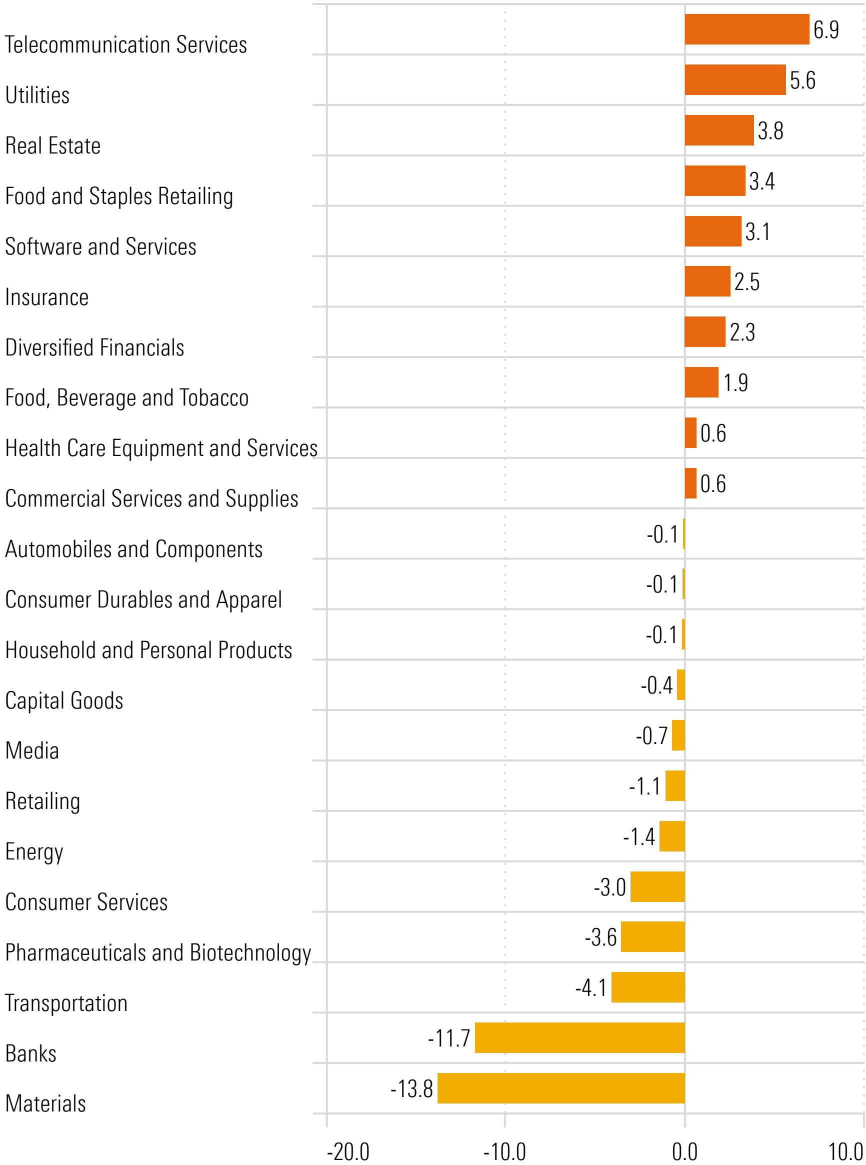
### Equity Region Exposure

Portfolio Date: 31/12/2016



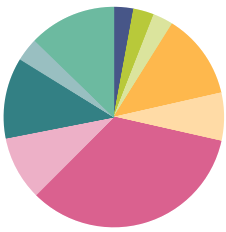
| | % |
|---|---|
| Australia | 97.1 |
| New Zealand | 2.9 |
| **Total** | **100.0** |

### Average Relative Weights over the Quarter




### Equity Sectors (GICS)

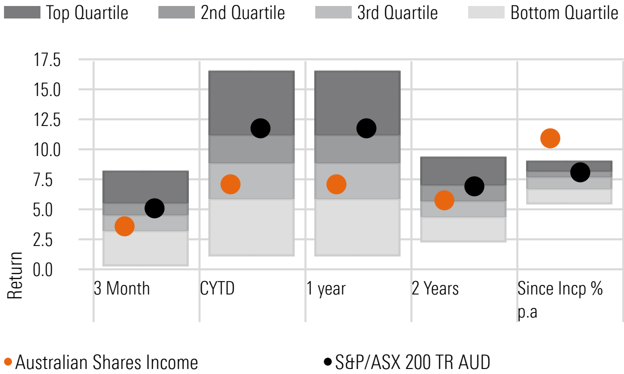
Portfolio Date: 31/12/2016



| | % |
|---|---|
| Energy | 2.9 |
| Materials | 0.0 |
| Industrials | 3.0 |
| Consumer Discretionary | 3.0 |
| Consumer Staples | 12.5 |
| Healthcare | 7.1 |
| Financials | 34.0 |
| Information Technology | 9.4 |
| Telecom Services | 11.9 |
| Utilities | 3.4 |
| Real Estate | 12.7 |
| **Total** | **100.0** |

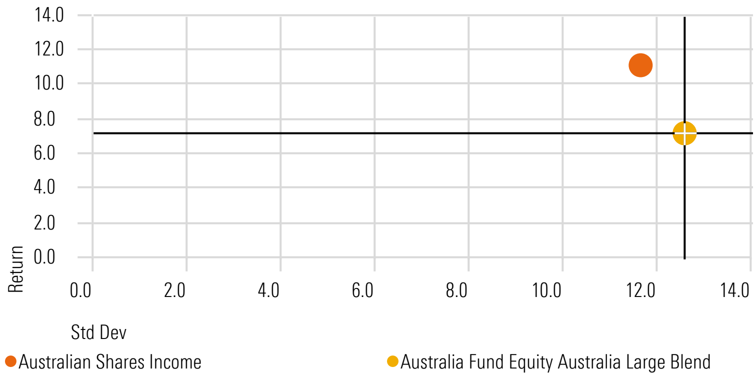
## Performance Relative to Peer Group

Peer Group (5-95%): Open End Funds - Australia - Equity Australia Large Blend




## Risk-Reward

Time Period: 01/08/2001 to 31/12/2016




## Market Performance

Time Period: Since Inception to 31/12/2016

| | Inv | Bmk1 |
|---|---|---|
| Up Period Percent | 64.32 | 62.70 |
| Down Period Percent | 35.68 | 37.30 |
| Best Month | 8.47 | 7.98 |
| Worst Month | -11.51 | -12.61 |
| Best Quarter | 17.12 | 21.50 |
| Worst Quarter | -15.78 | -18.25 |

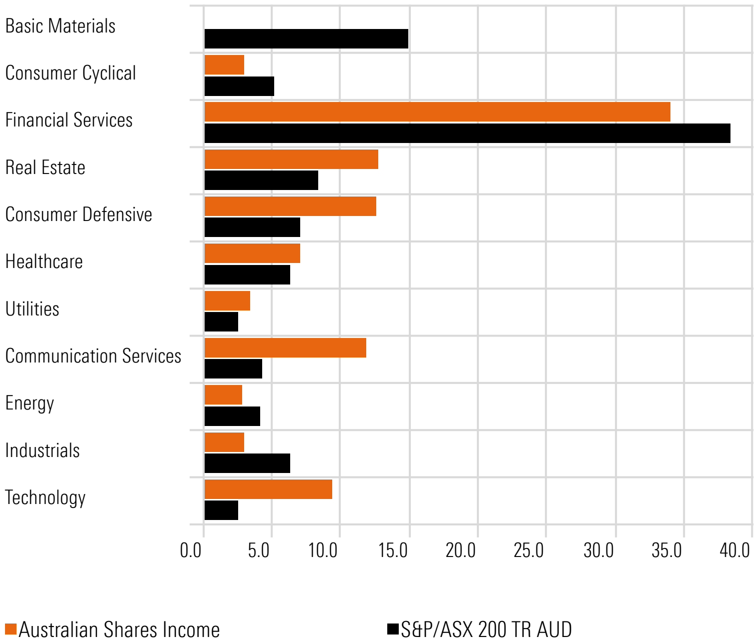
## Risk

Time Period: Since Inception to 31/12/2016

| | Inv | Bmk1 |
|---|---|---|
| Return % pa | 11.10 | 8.11 |
| Std Dev | 11.66 | 13.00 |
| Max Drawdown | -46.34 | -47.18 |

## Multiple Investment Sector Exposure Chart

Portfolio Date: 31/12/2016




## Australian Shares Income - Complete List of Holdings

Portfolio Date: 31/12/2016

| Franking (%) (est): 67.3% \| Forecast Div Yield (%): 4.9% | Code | Style Box | Total Ret 3 Mo (Qtr-End) | Portfolio Weight % |
|---|---|---|---|---|
| Telstra Corp Ltd | TLS | | -1.54 | 8.5 |
| Cash Account | | | 0.44 | 6.0 |
| Wesfarmers Ltd | WES | | -4.44 | 5.2 |
| Australia and New Zealand Banking Group Ltd | ANZ | | 14.23 | 4.6 |
| QBE Insurance Group Ltd | QBE | | 33.69 | 4.3 |
| National Australia Bank Ltd | NAB | | 15.12 | 4.2 |
| Commonwealth Bank of Australia | CBA | | 13.83 | 4.1 |
| Westpac Banking Corp | WBC | | 15.02 | 3.9 |
| Vicinity Centres | VCX | | -2.93 | 3.8 |
| Carsales.com Ltd | CAR | | -5.02 | 3.8 |
| Platinum Asset Management Ltd | PTM | | 4.97 | 3.7 |
| Sonic Healthcare Ltd | SHL | | -2.77 | 3.7 |
| AMP Ltd | AMP | | -4.55 | 3.6 |
| Medibank Private Ltd | MPL | | 13.71 | 3.5 |
| Woolworths Ltd | WOW | | 3.57 | 3.4 |
| Spark Infrastructure Group | SKI | | 3.03 | 3.2 |
| Coca-Cola Amatil Ltd | CCL | | -1.27 | 3.2 |
| iSentia Group Ltd | ISD | | -25.07 | 3.1 |
| Dexus Property Group | DXS | | 7.51 | 3.1 |
| Virtus Health Ltd | VRT | | -18.96 | 3.0 |
| Spotless Group Holdings Ltd | SPO | | -7.48 | 2.9 |
| Scentre Group | SCG | | -1.28 | 2.8 |
| Crown Resorts Ltd | CWN | | -11.67 | 2.8 |
| Woodside Petroleum Ltd | WPL | | 8.87 | 2.7 |
| Spark New Zealand Ltd | SPK | | -4.36 | 2.7 |
| BWP Trust | BWP | | -4.17 | 2.2 |
| MYOB Group Ltd | MYO | | -0.40 | 2.0 |

## Glossary of Terms

| Term | Description |
|---|---|
| Active Return | A performance measure of a portfolio relative to its benchmark. |
| Allocation Effect | Refers to the portion of an investment manager's value-add attributable to the manager's decision on how much to allocate to each market sector, in other words, a manager's decision to overweight and underweight certain sectors compared with the benchmark. |
| Alpha | A measure of the difference between a portfolio's actual returns and its expected performance, given its level of risk as measured by beta. |
| Average Market Cap (mil) | Average Market Cap (mil) This is an estimation of the value of a business that is obtained by multiplying the number of shares outstanding by the current price of a share. |
| Best Month | The highest monthly return of the investment since its inception or for as long as Morningstar has data available. |
| Best Quarter | The highest quarterly (3-month) return of the investment since its inception or for as long as Morningstar has data available. |
| Beta | A measure of systematic risk with respect to a benchmark. Systematic risk is the tendency of the value of the fund and the value of benchmark to move together. Beta measures the sensitivity of the fund's excess return (total return minus the risk-free return) with respect to the benchmark's excess return that results from their systematic co-movement. |
| Debt to Capital % (TTM) | A ratio measuring a firm's financial leverage. This ratio is calculated by dividing long-term debt (excluding other liabilities) by total capitalisation (the sum of common equity plus preferred equity plus long-term debt). |
| Down Capture Ratio | Downside Capture Ratio measures manager's performance in down markets. A down-market is defined as those periods (months or quarters) in which market return is less than 0. In essence, it tells you what percentage of the down-market was captured by the manager. For example, if the ratio is 110%, the manager has captured 110% of the down-market and therefore underperformed the market on the downside. |
| Down Period Percent | Number of months below 0 divided by the total number of months. |
| Downside Deviation | This measures only deviations below a specified benchmark. |
| Moat Company Pct | Percentage of the portfolio, by market value, having a narrow or wide moat. |
| P/E Ratio (TTM) | A measure of value. It is the average price divided by latest earnings. |
| Portfolio Price/Fair Value | Ratio of the portfolio's market value to the fair value of the portfolio. |
| R2 | Reflects the percentage of a portfolio's movements that can be explained by movements in its benchmark. |
| ROA % (TTM) | Return on assets (ROA) measures a firm's performance in using assets to generate earnings independent of how the firm financed acquisition of those assets. |
| ROE % (TTM) | Return on equity (ROE) is the percentage a company earns on its total equity in a given year. ROE shows how much profit a company generates on the money shareholders have invested in the firm. |
| Selection Effect | Represents the portion of performance attributable to the manager's stock picking ability. |
| Sharpe Ratio (arith) | Is calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the fund's historical risk-adjusted performance. |
| Std Dev | A statistical measurement of dispersion about an average, which, for a mutual fund, depicts how widely the returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that are most likely for a given fund. |
| Tracking Error | A measure of the volatility of excess returns relative to a benchmark. |
| Turnover (2 Yr Avg) | Measures the portfolio manager's trading activity by taking the lesser of purchases or sales (excluding all securities with maturities of less than one year) and dividing by average monthly net assets. |
| Up Capture Ratio | Upside Capture Ratio measures a manager's performance in up markets relative to the market (benchmark) itself. It is calculated by taking the security's upside capture return and dividing it by the benchmark's upside capture return. |
| Up Period Percent | Number of months above 0 divided by the total number of months. |
| Worst Month | The lowest monthly return of the investment since its inception or for as long as Morningstar has data available. |
| Worst Quarter | The lowest quarterly (3-month) return of the investment since its inception or for as long as Morningstar has data available. |

## Morningstar's Investment Principles

**We put investors first.** We believe the firms that put investors first win in the long term because their investors win.

Since 1984, Morningstar, Inc. has been helping investors reach their financial goals. Our fiduciary duty to our principals is paramount.

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**We're independent-minded.** To deliver results, we think it's necessary to invest with conviction, even when it means standing apart from the crowd.

Our research shows that making decisions based on fundamental analysis, rather than short-term factors and sentiment, delivers better long-term investment results.

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**We invest for the long term.** Taking a patient, long-term view helps people ride out the market's ups and downs and take advantage of opportunities when they arise.

Investing with a multi decade horizon aligns with investors focus on increasing their purchasing power over their lifetimes.

The long term is the only period where fundamental, valuation driven investing works.

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**We're valuation-driven investors.** Anchoring decisions to an investment's fair value—or what it's really worth—can lead to greater potential for returns.

Valuation-driven investing through a long-term focus on the difference between price and intrinsic value enables investors to get more than they're paying for.

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**We take a fundamental approach.** Powerful research is behind each decision we hold, and we understand what drives each investment we analyse.

Fundamental investing incorporates a focus on the future earnings of an investment and not its prospective price change.

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**We strive to minimise costs.** Controlling costs helps investors build wealth by keeping more of what they earn.

Investment returns are uncertain, but costs are not.

Lower costs allow investors to keep more of their returns.

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**We build portfolios holistically.** To help manage risk and deliver better returns, truly diversified portfolios combine investments with different underlying drivers.

Portfolios should be more than the sum of their parts.

True diversification can have a powerful impact on a portfolio's risk-adjusted returns – but simply holding more investments isn't the same as true diversification.