

# Morningstar Balanced Real Return Fund

# Q3 2018

## Quarterly Performance Update

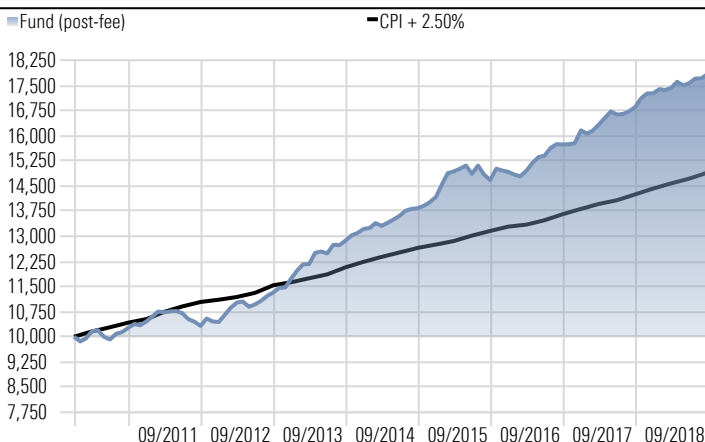
All data and information as at Portfolio Date: 30/09/2018

**Inception:** 1 January 2010\*  
**Size \$m:** 207.4  
**Unit pricing:** Daily  
**Distributions:** Quarterly  
**Management Costs:** Up to 0.79% (effective from 30 September 2018)  
**Buy/Sell Spread:** 0.10%/0.10%  
**Minimum investment:** \$10,000

Management Costs include Morningstar's management fee of 0.51% as well as our reasonable estimate of indirect costs which include performance-related fees charged by underlying managers.

### What's the purpose of this fund?

The fund aims to earn a rate of return that exceeds the Consumer Price index by at least 2.5% pa over a rolling 5 year periods.

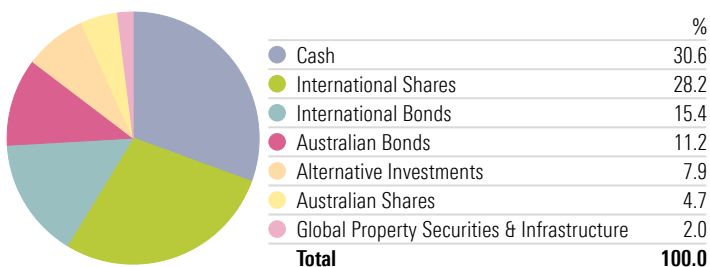


Past performance is not a reliable indicator of future performance. Returns over 12 months are annualised.

### How the investment portfolio has performed

	7yr (% p.a.)	5yr (% p.a.)	3yr (% p.a.)	1yr (%)	3mth (%)	Since inception (% p.a.)
Fund (post-fee)	8.13	6.75	6.72	5.83	1.53	6.84
CPI + 2.50%	4.38	4.30	4.23	4.58	1.24	4.66

### Quarter-end Asset Allocation



*"Investors should favor strategies, managers and approaches that emphasize limiting losses in declines above ensuring full participation in gains. You simply can't have it both ways".*

- Howard Marks

### Key points:

- The escalation of trade tensions continues to see divergent sentiment toward key share and bond markets, while Brexit and the upward path of U.S. interest rates pose potential challenges for investors looking forward
- Recent weakness in Emerging Market shares and bonds sees them stand out in a world of few opportunities

As we march through 2018, we look back on the continuation of what has been a strong period for equity markets, particularly the U.S. This is perhaps a surprising outcome when you consider how overvalued a number of share and bond markets were at the start of the year, which raised the likelihood of lower future returns. However, periods of strong investment returns in an environment that otherwise looks challenging are not unprecedented. Indeed, expensive assets can become even more so in the short term as sentiment drives markets well beyond what we might rationally expect, and what fundamentals reasonably support.

This can happen in reverse too – i.e. investors become too negative in the face of fear and uncertainty. In fact, what we typically see is that sentiment leads investors to overshoot at both market extremes. They become euphoric in buying those assets that feel good to buy (which usually means that it feels like everyone else is doing it too) ... or they sell, amid overwhelming pessimism, those assets that feel uncomfortable to own (and where it feels lonely to hold the investment). While this is understandable human behaviour, it consistently leads to poorer longer term investment outcomes because investors lose sight of what the asset is truly worth, in their efforts to buy (or sell) to satisfy their emotional needs. It is these poor behavioural decisions by others that we seek to exploit as contrarian investors, buying and selling only when valuations compel us to do so.

In more recent times, we've seen positive sentiment toward less attractive opportunities like U.S. shares persist, with investors looking to strong corporate earnings, a flourishing U.S. economy and expectations that the U.S. stands to benefit (or lose the least?) from Trump's policies regarding trade. Such an approach appears sensible but, in our view, we think much of this is already in the price and recent prices moves have only stretched valuations further, exacerbating our already cautious stance to this market.

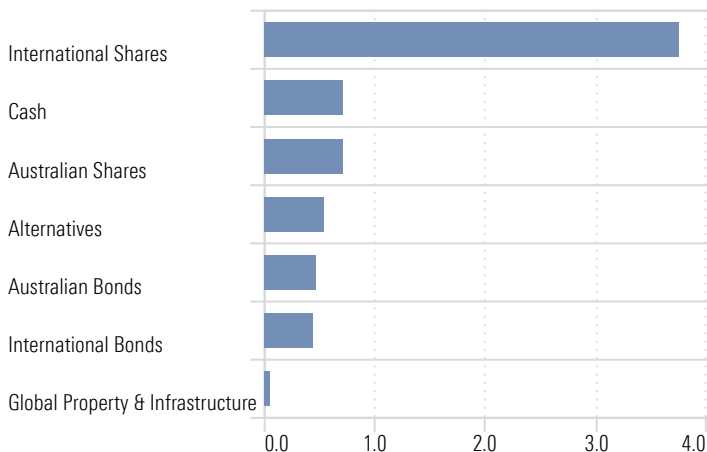
By contrast, more attractive assets, such as Emerging Market shares and bonds, have endured significant pressure. Much of this poor sentiment centres on the historical relationship between Emerging Market assets and the U.S. dollar (specifically that a stronger U.S. dollar typically has negative implications for the outlook of most Emerging Market economies). In this respect, many fear that the stronger U.S. dollar, combined with the unfolding economic trouble in Argentina and Turkey (to name a few concerns), may in fact be the start of a broader Emerging Market crisis. While this cannot be discounted, we believe Emerging Market economies and financial systems to be much more resilient than in years gone by, with current valuations compensating investors for this uncertainty, in our view. Similarly, anxiety reigns among investors in U.K. shares, as the U.K. moves toward the finalisation of its divorce from the European Union. Again, while its difficult to know how these negotiations progress, U.K. equity valuations appear favourable on a reward for risk basis.

It remains near impossible to predict the short term movements of markets, given that they can be heavily influenced by investor sentiment, which can, and often does, change rapidly. However, as long term valuation driven investors, we can assess that the risk of loss remains elevated in a number of key asset classes. While these risks have so far failed to materialise into something more significant, we continue to proceed with caution, investing when and where markets are most fairly priced for the risks we currently face.

\* The Fund's inception date used is 1 January 2010, the start of the full implementation of the Valuation Driven asset allocation process.

# Information about the portfolio's performance

## What drove portfolio performance over the past year?



Actual outcomes may differ, as the chart has been prepared using a monthly 'buy and hold' approach

This chart shows how the individual parts of the portfolio contributed to investment performance over the past year.

### International shares were the key driver of portfolio performance over the past year.

Japanese shares, Emerging Market shares and select U.K. and European sectors like energy and healthcare have been a key source of positive returns, particularly where those investments have been exposed to the falling Australian dollar. With valuations in U.S. shares generally unattractive, we continue to prefer U.K, Emerging Market and Japanese shares.

## Risk versus reward since inception



This chart shows how a number of investments have performed on average since full implementation of the Valuation Driven Asset Allocation process, which occurred on 1 January 2010.

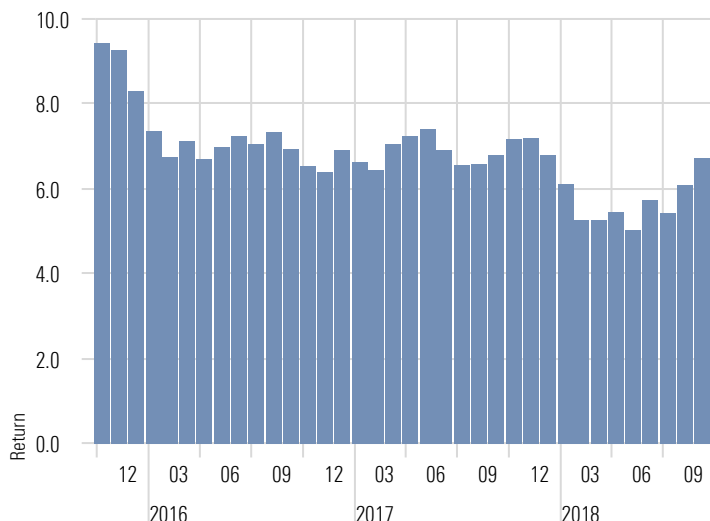
Returns alone are not the full picture. You cannot generate returns without taking on a level of risk. The chart shows the 'riskiness' of each investment relative to its average return.

You want to be as close to the top right corner of the chart as possible, as this indicates high returns achieved with less risk. You would expect cash to be towards the bottom right of the chart, with little to no risk and consequently, low returns.

It's important to note that past performance is not a reliable indicator of future performance and **riskiness of investments may far exceed what has occurred in the past.**

\*Risk is measured as the maximum loss from a peak to a trough for that investment during the period.

## How stable have returns been? (Rolling 3 year returns)

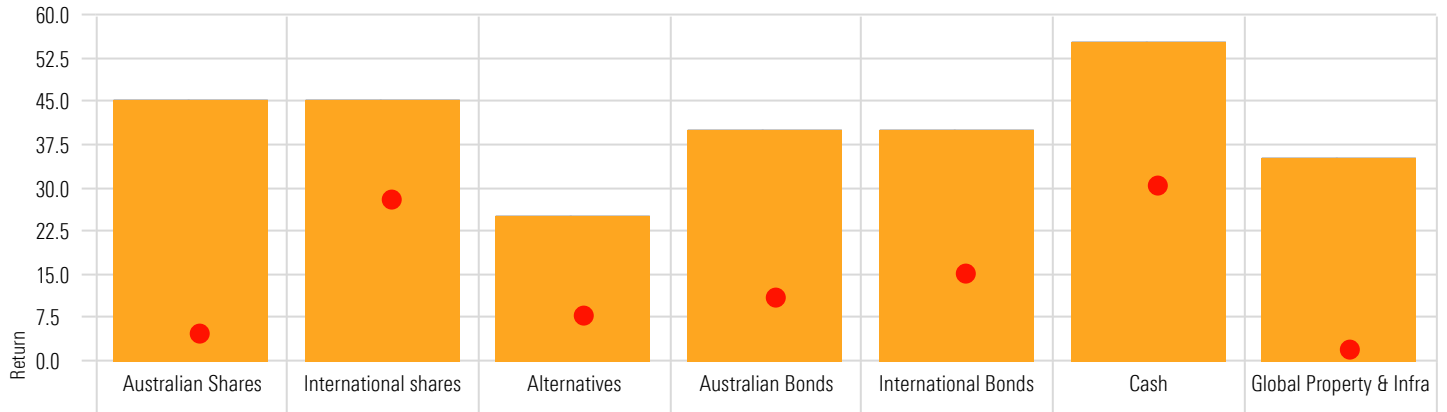


This chart shows the annual performance of the portfolio over rolling 3 year periods – e.g. your average annual return for each of the three years for any given month. In other words, this chart shows that the portfolio has delivered consistent positive returns over longer-term periods.

**Long-term investing helps you ride out the market's ups and downs.** It also lets you take advantage of opportunities that arise due to other investors making short-term, emotion-led investment decisions (e.g. irrationally selling investments at the first sign of fear and uncertainty).

# Information about what the portfolio is invested in

## How asset allocation is positioned vs the allowable ranges



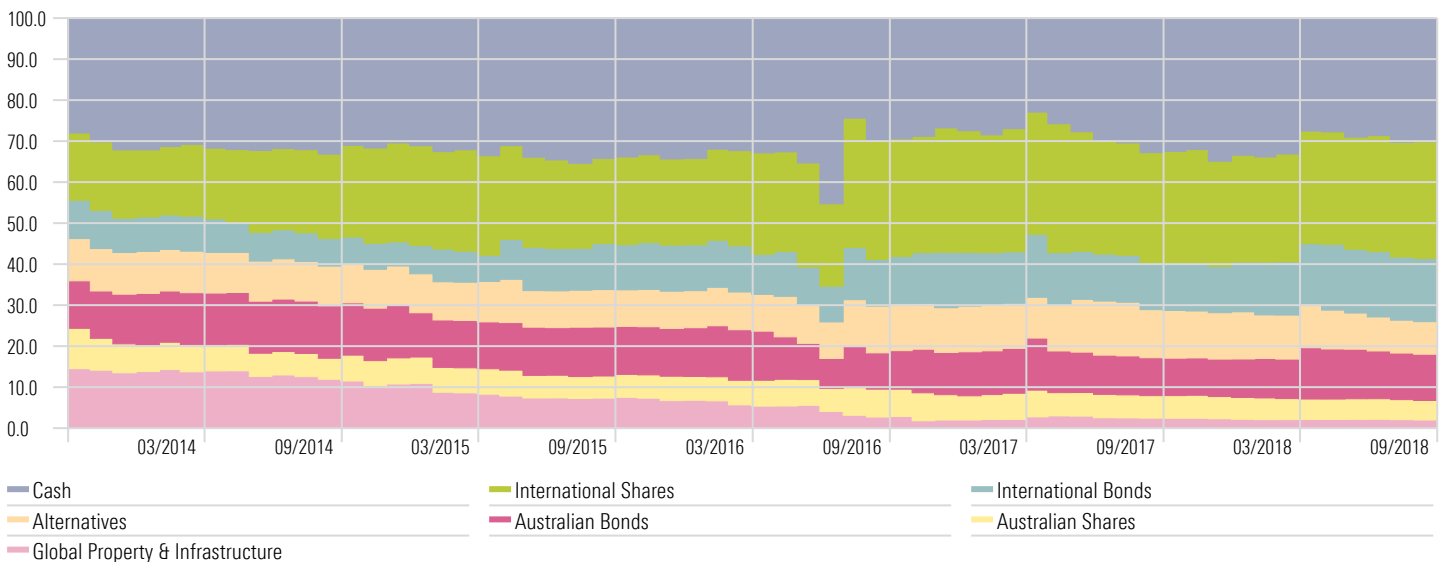
● Actual

The above chart shows the current breakdown of how the portfolio is invested.

We prefer international shares over Australian shares, particularly those from Emerging Markets, Japan and Western Europe. We further favour Australian bonds over international bonds, given superior valuations. The portfolio continues to hold high levels of cash as we wait for more compelling investment opportunities.

## Asset Allocation over 5 years %

Time Period: 1/10/2013 to 30/09/2018

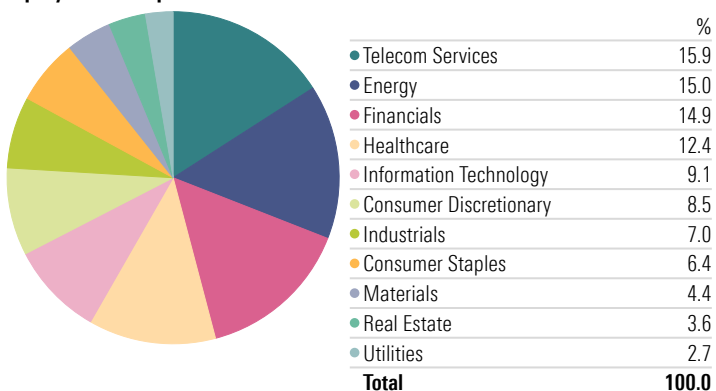


This chart shows how the portfolio positioning has changed over time in accordance with our valuation driven asset allocation process.

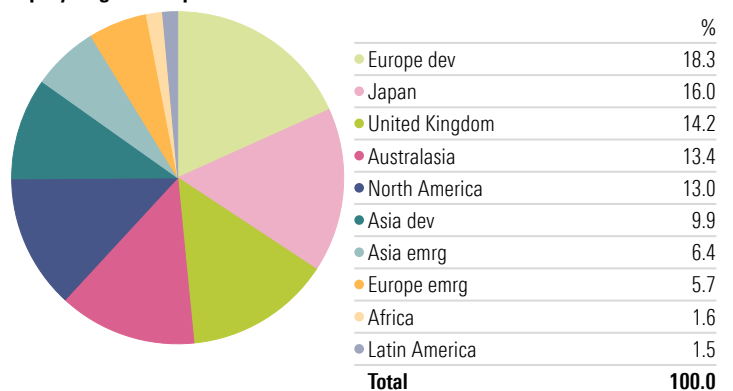
The portfolio has the flexibility to move towards opportunities that offer the best reward for risk (and away from those that we deem to be less attractive).

With markets generally expensive, the portfolio is cautiously positioned with a focus on the best value opportunities.

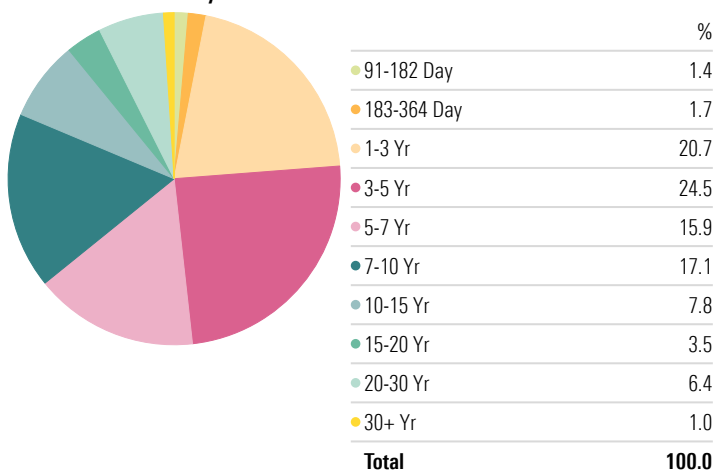
## Equity Sector Exposure



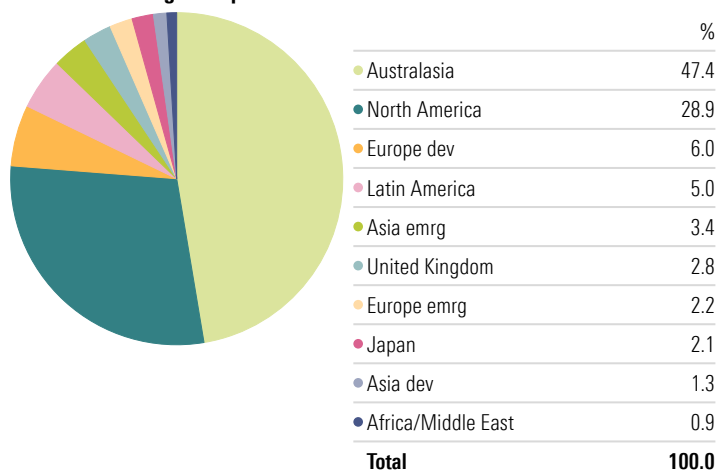
## Equity Regional Exposure



### Fixed-Income Maturity



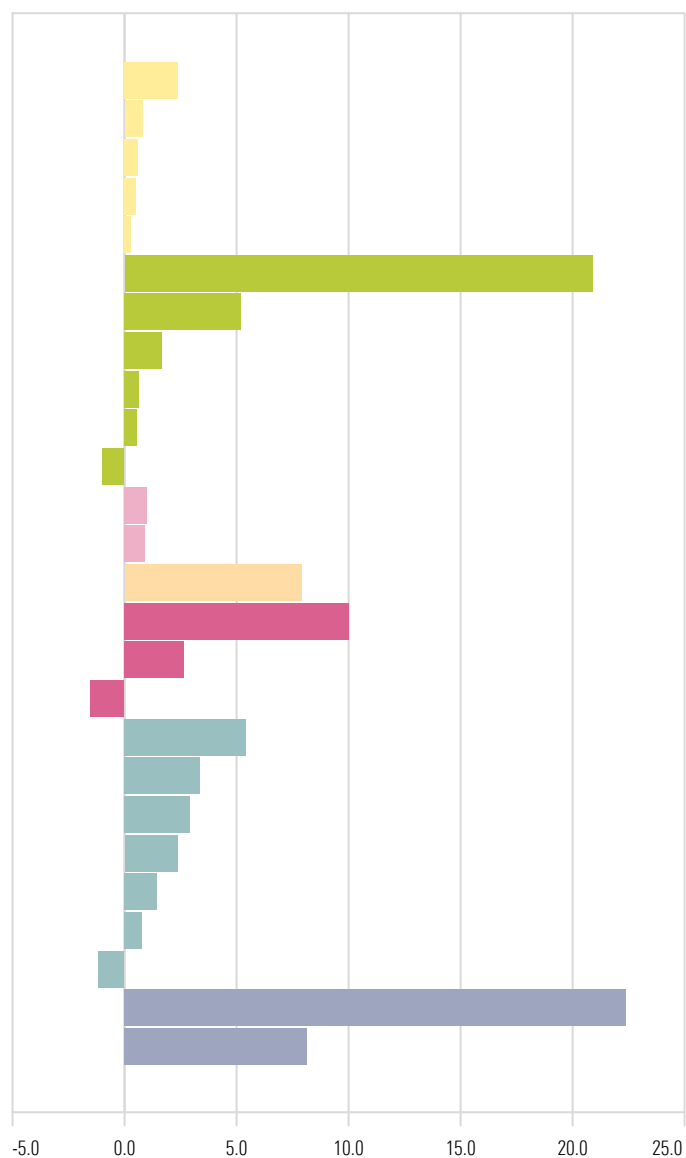
### Fixed-Income Region Exposure



## Information about who manages the fund

### Fund Holdings

Fund Holding	%
Australian Shares - Morningstar	2.4
Australian Shares - Vinva	0.8
Australian Shares - JCP Investment Partners	0.6
Australian Shares - Allan Gray Australia	0.5
Australian Shares - Platypus	0.3
International Shares - Morningstar	20.9
International Shares - Marathon	5.2
International Shares - Vanguard (ETF)	1.7
International Shares - Sands Capital	0.7
International Shares - iShares (ETF)	0.6
International Shares - Others	-0.9
Global Property & Infrastructure - Omega	1.0
Global Property & Infrastructure - Morningstar	1.0
Alternative Investments - Alpha Strategies Fund	7.9
Australian Bonds - Omega	10.0
Australian Bonds - Metrics	2.7
Australian Bonds - Others	-1.5
International Bonds - Omega	5.4
International Bonds - Colchester	3.4
International Bonds - Ashmore	3.0
International Bonds - Standish	2.4
International Bonds - Shenkman	1.5
International Bonds - T Rowe Price	0.8
International Bonds - Others	-1.1
Cash - Omega	22.4
Cash - Others	8.2
<b>Total</b>	<b>100.0</b>



\* Others can include futures, liquidity and transition cash, other exchange traded funds and direct stocks.

## Top equity holdings

Top 20 holdings: 9.58% Other: 90.42%

	Portfolio Weighting %	Country	Sector
<b>Stock</b>	<b>9.58</b>		
BT Group PLC	0.76	GBR	Communication Services
Royal Dutch Shell PLC B	0.68	GBR	Energy
Vodafone Group PLC	0.67	GBR	Communication Services
Telefonica SA	0.67	ESP	Communication Services
Total SA	0.63	FRA	Energy
BP PLC	0.56	GBR	Energy
Orange SA	0.50	FRA	Communication Services
Telenor ASA	0.45	NOR	Communication Services
Shire PLC	0.45	USA	Healthcare
GlaxoSmithKline PLC	0.43	GBR	Healthcare
Swisscom AG	0.42	CHE	Communication Services
Lloyds Banking Group PLC	0.41	GBR	Financial Services
Eni SpA	0.41	ITA	Energy
Barclays PLC	0.40	GBR	Financial Services
Rosneft Oil Co GDR	0.40	RUS	Energy
ConvaTec Group PLC	0.37	GBR	Healthcare
Banco Bilbao Vizcaya Argentaria SA	0.36	ESP	Financial Services
Gazprom PJSC ADR	0.36	RUS	Energy
PJSC Lukoil ADR	0.34	RUS	Energy
KBC Group SA/NV	0.33	BEL	Financial Services

## Top Fixed income security holdings

Top 20 holdings: 5.51% Other: 94.49%

	Portfolio Weighting %	Country
<b>Fixed income securities</b>	<b>5.51</b>	
Australia (Commonwealth of) 3%	0.79	AUS
Australia (Commonwealth of) 5.5%	0.49	AUS
Australia (Commonwealth of) 4.25%	0.36	AUS
Australia (Commonwealth of) 1.25%	0.33	AUS
United States Treasury Notes	0.31	USA
Australia (Commonwealth of) 3.25%	0.27	AUS
Australia (Commonwealth of) 2.5%	0.25	AUS
Australia (Commonwealth of) 4.75%	0.25	AUS
Australia (Commonwealth of) 2.75%	0.25	AUS
United States Treasury Notes 0.12%	0.24	USA
Australia (Commonwealth of) 5.75%	0.23	AUS
Australia (Commonwealth of) 4.5%	0.22	AUS
Australia (Commonwealth of) 0.75%	0.22	AUS
New South Wales Treasury Corporation 2.75%	0.21	AUS
Australia (Commonwealth of) 2%	0.20	AUS
United States Treasury Notes 0.12%	0.19	USA
United States Treasury Notes 0.12%	0.18	USA
Australia (Commonwealth of) 1%	0.18	AUS
Queensland Treasury Corporation 6%	0.18	AUS
United States Treasury Notes 0.12%	0.17	USA

## Transactions over the quarter

Action	Security/Fund Name	Rationale
<b>Australian Equities</b>		<b>Asset Allocation Change: No Change</b>
<b>International Equities</b>		<b>Asset Allocation Change: Increase</b>
↓	Decreased Morningstar High Opportunities Fund	
<p>The Morningstar High Opportunities Fund provides diversified investments in global equities via a high conviction portfolio of managed funds, chosen in accordance with Morningstar's manager selection process that seeks to identify highly skilled managers. While we maintain our belief in this strategy, we trim our allocation as we add further to the Morningstar International Shares Fund (which was added last quarter), which we would expect to improve the overall reward for risk in the broader portfolio. Within the Morningstar High Opportunities Fund, we redeemed our investment in value manager, Altrinsic, during the quarter, with the proceeds being used to increase our allocation towards contrarian manager, Marathon, and growth manager, Sands, which we hold greater conviction in.</p>		
↓	Decreased Vanguard U.S. Healthcare ETF	
<p>The Vanguard U.S. Healthcare ETF seeks to track the results of an index composed of U.S. healthcare equities, before fees and expenses. Following the election of Donald Trump in late 2016, U.S. healthcare equities came under pressure amid expectations that Trump would repeal Obamacare and make changes to drug pricing policy that would adversely affect the earnings of leading global pharmaceutical names. This led to weakness in the sector, with investors exiting to avoid the uncertainty, thereby creating a valuation opportunity. Since that time, healthcare reform has been delayed and watered down, with previously pessimistic investors feeling more comfortable investing in this sector again. The resulting strength sees future expected returns fall, and we move to lock in profits by trimming our holding.</p>		
+	Added iShares Core MSCI Emerging Markets ETF	
<p>The iShares Core MSCI Emerging Markets ETF seeks to track the results of an index composed of equities from Emerging Market countries, before fees and expenses. Emerging Markets have borne the brunt of negative sentiment in recent months as concerns around the impact of trade tariffs as well as country-specific issues, notably in Argentina and Turkey, have led to outflows (and weakness) in these markets. While risks undoubtedly remain, we believe that investors have become overly pessimistic on the outlook for key Emerging Market assets, with current valuations providing an attractive opportunity to increase our weighting to the region.</p>		
↑	Increased Morningstar International Shares Fund	
<p>The Morningstar International Shares Fund is a diversified portfolio of international securities selected in accordance with Morningstar's disciplined investment approach to identifying undervalued quality securities. Almost 50% of the fund is invested in U.S. companies and while U.S. equities are unattractive at an index level on our analysis, the quality style (e.g. low debt levels, strong cash flow) of this portfolio is expected to deliver superior returns over time. Importantly, the fund typically performs well (relatively speaking) in down markets, consistent with our focus on the preservation of capital. As such, we anticipate that an increased allocation to this fund will further improve the overall reward for risk in the broader portfolio. Note: investors in the fund do not incur any additional underlying investment management fees when they access this fund via a Morningstar Real Return Managed Fund.</p>		
↑	Increased Morningstar European Opportunities	
<p>Morningstar's European Opportunities portfolio includes direct holdings in leading European energy, financials, telecom and healthcare companies. Throughout the quarter, we have trimmed our allocation to energy stocks, which have rallied with the soaring oil price. We have, however, added to our investments in European telecoms, including Telefonica, BT, Vodafone, Orange and Swisscom, which continue to appeal. This follows a period of price weakness relating to concerns around revenue trends, given the challenged outlook for their established businesses and the growing importance of data, a lack of industry consolidation, threat of regulation and investors moving into more growth-oriented sectors. Nonetheless, companies in this sector are typically high quality and we believe current valuations provide a reasonable margin of safety to invest. We have also added to our holdings of European financials, including companies like Barclays, Lloyds and KBC, as Brexit and uncertainty regarding the outlook for the Eurozone sees these companies becoming relatively more attractive.</p>		
↓	Decreased Japan Nikkei 400 Equity Futures	
↑	Increased Topix Bank Index Futures	
<p>Japanese equities rank among our preferred equity regions, with reasonable valuations supported by structural reform that sees corporate governance, profit margins and dividend payouts all improving. The opportunity is most pronounced within Japanese financials, which have been out of favour as a consequence of the Japanese Central Bank's ultra-accommodative stance on monetary policy. With the increasing attractiveness of this sector we have switched part of our allocation to broad-based Japanese equities into Japanese financials.</p>		
<b>Property &amp; Infrastructure</b>		<b>Asset Allocation Change: No Change</b>
<b>Australian Bonds</b>		<b>Asset Allocation Change: Decrease</b>
↓	Decreased Morningstar Australian Bonds Fund	
<p>Bond prices move in opposite directions with interest rates, all things equal. Bond prices were higher for much of the quarter as expectations of future domestic rate rises were pushed back and major banks moved to make out of cycle interest rate hikes on outstanding loans. With these gains, we trimmed our investment, notwithstanding that Australian bonds remain reasonably priced and continue to appeal relative to global peers. Indeed, at these levels, we view Australian bonds (and cash) as our preferred risk diversifiers, when compared to global bonds and inflation-linked bonds (although the extent of this has diminished more recently with improvement in valuations among global bonds, notably U.S. and Emerging Market bonds).</p>		
<b>International Bonds</b>		<b>Asset Allocation Change: Increase</b>
↑	Increased Morningstar International Bonds Fund (Hedged)	
<p>The Morningstar International Bonds Fund (Hedged) is a diversified portfolio of global fixed income securities. Approximately 30% of the fund is invested in Emerging Market debt, i.e. bonds issued by Emerging Market countries. Emerging Market debt stands out as offering one of the most attractive reward for risk profiles among our fixed interest universe. This has been particularly the case where the bonds are issued in the currency of the Emerging Market nation (as opposed to being issued in U.S. dollars) but more recent moves in hard currency (i.e. USD denominated) debt, in response to rising U.S. interest rates and uncertainty regarding the outlook for Argentinian and Turkish bonds, see valuations in this space becoming increasingly attractive. With this, we increase our allocation to the fund. Note: investors in the Morningstar International Bonds Fund do not incur any additional underlying investment management fees when the fund is accessed via an investment in a Morningstar Multi Asset Portfolio. Where that Morningstar fund uses third party managers, Morningstar absorbs the management fee charged by the investment manager.</p>		
<b>Alternatives</b>		<b>Asset Allocation Change: Decrease</b>
↓	Decreased Morningstar Alpha Strategies Fund	
<p>The Morningstar Alpha Strategies Fund is a diversified portfolio of global alternative investments. We have trimmed our holding as we repositioned some of the underlying strategies within the fund. That said, alternative investments remain a key allocation in the portfolio, given that returns from this asset class have little relationship with the performance of traditional asset classes like equities and bonds.</p>		
<b>Cash</b>		<b>Asset Allocation Change: Increase</b>
↑	Increased Morningstar Cash Fund	
<p>With equity and fixed interest markets increasingly expensive, on our analysis, we continue to hold higher levels of cash in wait for more compelling investment opportunities and to help minimise the risk of permanent impairment of capital by otherwise investing in overvalued asset classes.</p>		

## 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.



**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.



**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.



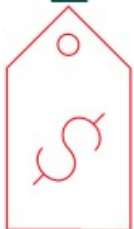
**We're valuation-driven investors.** Anchoring decisions to an investment's fair value—or what it's really worth—can lead to greater potential for returns.

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.



**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.



**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.



**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.