

Portfolio Construction

Disclaimer

In preparing this document, *thebigpicture* Economics has not taken into account the investment objectives, financial situation or particular needs of any person. Individuals should seek the advice of a qualified investment adviser and should not rely on any information contained herein. This document is intended to outline the portfolio structuring approach recommended by *thebigpicture* Economics for use by investment advisers in framing advice for their clients based on their particular investment needs, objectives and financial circumstances.

thebigpicture portfolio analytics are based on three fundamental pillars:

- a structured approach to portfolio development
- consistent application of decision-making guideposts
- choosing companies with superior economic performance

The Investment Approach

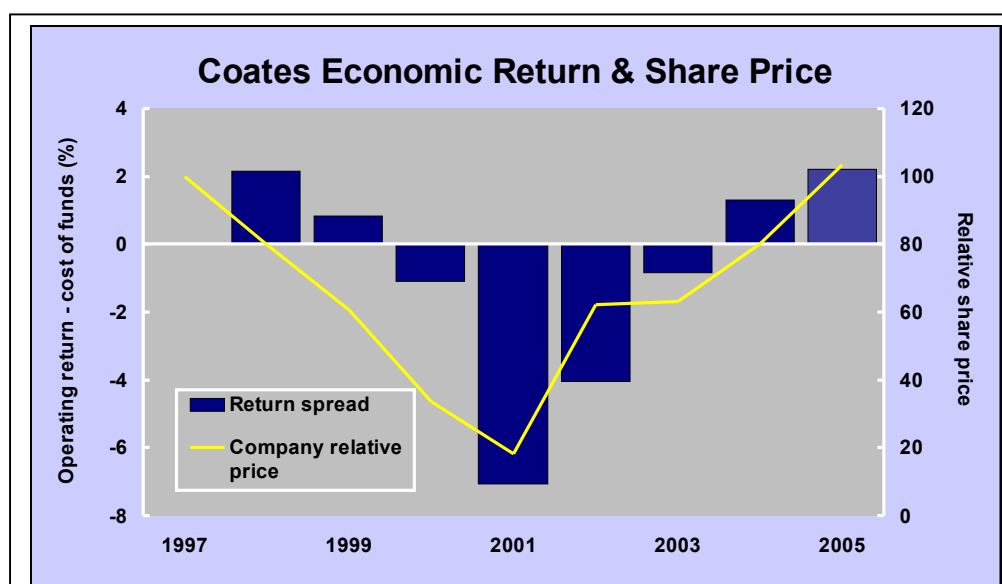
Underpinning **thebigpicture** stock selection methodology is the choice of companies with 'superior economic performance'.

'Superior economic performance' is defined as having three elements:

- **Profits higher than required rates of return.** All company returns are benchmarked against a cost of capital benchmark. It is not sufficient for a company to be profitable or growing. Even profitable companies with growing earnings might be failing to cover their costs of capital.

Many commonly used measures of financial performance ignore this fundamental measure of business performance and determinant of shareholder value. Achieving appropriate rates of return (i.e. adding value) is also a key determinant of a company's ability to sustain its dividend.

- **Improving rates of return.** Rising rates of return ('spread momentum') provide the impetus for better than average share price performance.



The chart illustrates, using Coates Limited as an example, how the underlying economic performance of a company can be reflected in its share price performance.

In this case, rising returns (including expected returns in the forecast year) have helped underpin the outperformance of the Coates share price relative to the market as a whole.

The chart helps show the potential market power from the combination of a positive return spread and the momentum which comes with positive return momentum. Not all companies can show this combination. The analytical processes of **thebigpicture** are focussed on uncovering companies with these attributes.

- **Achievable growth.** With the growth rate in western economies set to decline as population growth declines (e.g. Australia's official government forecast is for long term GDP growth of under 2% compared with the long-term historical average of 3.6% pa), it is critical that growth rates implied by share prices reflect achievable rates of growth.

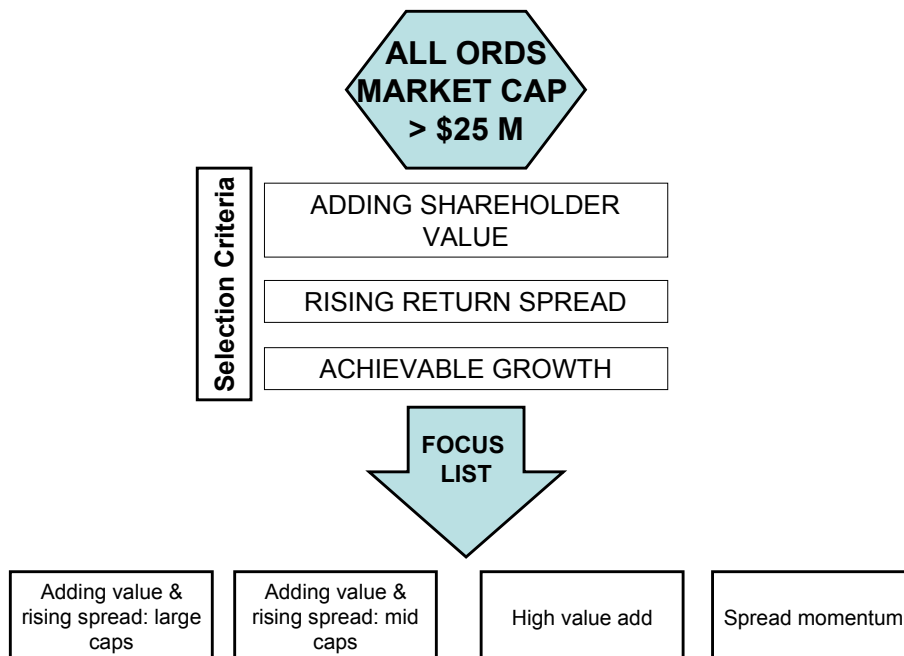
This analytical framework incorporates some of the key research findings about what drives business value. The approach is consistent with ideas of economic value added which are widely used internationally among fund managers and by some of the most successful companies in framing their corporate strategies.

This approach immediately excludes a large number of companies from consideration. For example, loss making companies or even profitable companies with a record of being unable to generate an adequate return on funds employed would not be acceptable investments. Similarly, strongly growing companies might not be attractive if the growth is failing to add value for shareholders.

Such companies may perform well for brief periods and may catch a few headlines but are unsuitable investments for longer term, value oriented investors seeking to manage their market risk.

The framework permits selection of a group of focus companies from among the listed universe of Australian stocks. The focus stocks are divided into four groups.

- **Large cap core:** companies with a market capitalization higher than \$1 billion which are adding value with a rate of return higher than their cost of capital and where the rate of return has risen in the last reported period and is expected to rise again in the first forecast period
- **Mid cap core:** companies with a market capitalization lower than \$1 billion which are adding value with a rate of return higher than their cost of capital and where the rate of return has risen in the last reported period and is expected to rise again in the first forecast period
- **Consistent value:** companies which do not display a rising trend in their return spreads but which show superior economic performance by consistently delivering a rate of return in excess of their cost of capital
- **New momentum:** companies which might have a history of failing to deliver superior economic performance but which have undergone a significant change in strategic direction (usually associated with a management change) and which are expected to change from being a value destroyer to adding value within a two year time-frame



From each of these four groups a limited number of portfolio stocks are chosen based on their ranking by the relevant criteria.

The Intrinsic Value Portfolio

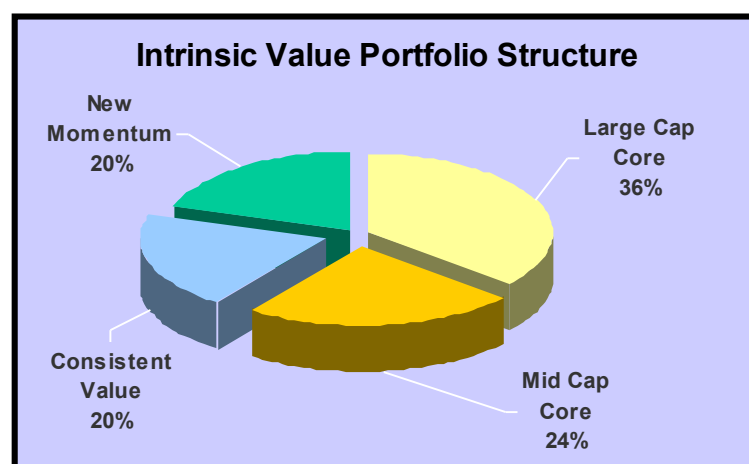
• Large Cap Core	Large cap (>\$1 billion) stocks adding value with positive spread momentum	8-12 companies
• Mid Cap Core	Smaller cap stocks adding value with positive spread momentum	3-7 companies
• Consistent value	High sustainable return stocks (without necessarily having a positive spread momentum)	5 companies
• New Momentum	Stocks on a recovery path with positive spread momentum and expected to begin delivering value within two years	5 companies

In each case, only stocks with prices consistent with achievable growth rates are selected for *thebigpicture* Intrinsic Value portfolio.

Sell disciplines are critically important. A formal monthly review takes account of price movements which might have made stocks too expensive relative to others which might be outside the portfolio.

As soon as companies fail to meet the criteria which led to them being included in the portfolio, they are removed.

The portfolio is limited in size to 25 stocks to provide adequate diversification with discipline.



Maintaining a firm discipline on the number of stocks to be included is an important element of the investment process. No additional stocks can be bought until they can be shown to be superior according to the specified criteria.

The structure of the portfolio is designed to improve on the risk/return profile provided by the market as a whole. By concentrating the portfolio on higher return lower risk companies, a relatively small number of turnaround situations (i.e. companies with a positive spread momentum) with stronger than average expected capital gains can be brought into the portfolio while, at the same time, keeping expected returns above the average for the market and risk no higher than for the market as a whole.

At any point in time, stocks can fall into an exclusion list based on certain pre-defined events:

- governance failure involving a material unanticipated investment loss or a director's unexplained resignation
- strategy failure shown by a material loss from a new business acquisition

These pre-defined events are regarded as raising the risk profile to such an extent that they constitute grounds for immediate exclusion.

The Australian resources industry represents a part of the Australian economy which could grow faster than average for the foreseeable future because its customer base is outside Australia and spending on its products is not tied to the state of the Australian economy.

The Greenshoot Resources portfolio is one way investors are able to tap this source of above average growth through an investment in Australian equities.

A Greenshoot Resources portfolio will include up to 12-15 listed resources companies which are embarking on development projects expected to add significant value over a two to three year time horizon.

Management of the Greenshoot Resources portfolio recognises that there are special skills required in selecting resource companies in which to invest. Geology, metallurgy, engineering and commodity market analysis are some of the specialised skills required for successfully investing in resource companies.

thebigpicture Economics works jointly with specialist resources sector fund manager, EIM Investment Management to provide advice on the construction and management of resources sector equity portfolios.

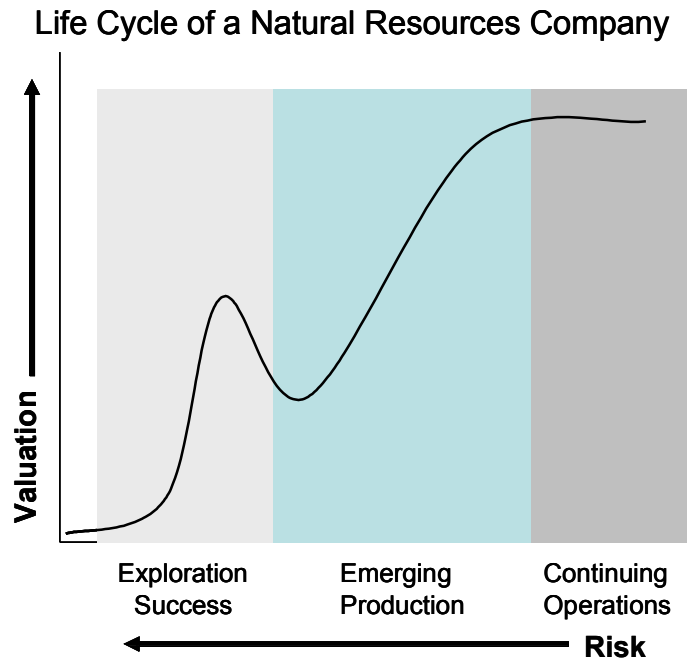
Our approach is based on a natural resources company having three phases to its corporate life cycle. Portfolio construction revolves around choice of companies in the second phase.

Phase One coincides with exploration successes which can deliver a sharp increase in value. However, reaching this phase depends on an economically viable resource base being delineated. This value increment might be highly attractive but the risk of finding the necessary resources can be very high and potential investors can often lose a substantial part of their investment on any single company in this phase of its development.

Phase Two coincides with planning and initial development of a greenfield site or substantial extension of an existing operation. It might also include redevelopment of previously abandoned operations which might have become viable over time because of changes to technology or market conditions.

This phase could take from one to three years during which time potential investors can gain greater confidence about the development outlook as more and better quality information progressively becomes available.

The key challenges for an investment manager are to test the underlying assumptions and verify that the project as outlined has an acceptably high probability of succeeding financially using fundamentally-based analytical techniques.



Phase Three is the period of continuing operations. During this phase, the potential for valuation upside from organic growth diminishes. This is the phase when expected movements in commodity prices become the greatest single influence on share price changes.

The Greenshoot Resources portfolio is not intended as a means of speculating on commodity prices or exchange rates. Nonetheless, all the companies in which investments are made will be subject to the effects of commodity price movements which add to the risk profile of this group of companies.

The Greenshoot Resources portfolio is concentrated on those stocks which are committed to a development path which implies a significant increase in value over a two to three year time horizon under a broad range of commodity price and exchange rate assumptions.

Risk will also be managed by the portfolio having a suitably broad commodity exposure.

Focusing attention on emerging producers characterized as being in the second phase of their corporate life cycles can be a particularly attractive investment strategy, provided an investor has access to the necessary skills.

There are several advantages to targeting this group of companies.

- Because of their stage of development, such companies can be valued using traditional cash flow based valuation techniques.
- Since the broader market sometimes takes time to understand the potential of such development projects, there can be potentially attractive buying opportunities for a manager suitably disciplined in his research approach.

- The “emerging production” stage is attractive as many of the key financial and technical parameters of a project are known allowing a manager to:
 - ~ critically evaluate the underlying deposit to be extracted, review the potential mine life and assess potential exploration prospectivity;
 - ~ assess the financial parameters through a detailed cost evaluation and peer project comparison; and,
 - ~ initiate an active dialogue with the emerging producer company.
- Value created in the “emerging production” stage is less risky than expected value in phase one when exploration success drives value creation and potentially less volatile than from later continuing operations which are more heavily influenced by commodity price fluctuations.

Absolute Return. This investment option allows the portfolio manager to take a position in cash. It will suit an investor who wishes to apply a more aggressive asset allocation overlay to his investment decision making processes.

In the event that the manager is unable to find sufficient stocks which meet the agreed criteria and which offer the necessary medium term returns, the investment strategy allows for the portfolio to hold cash.

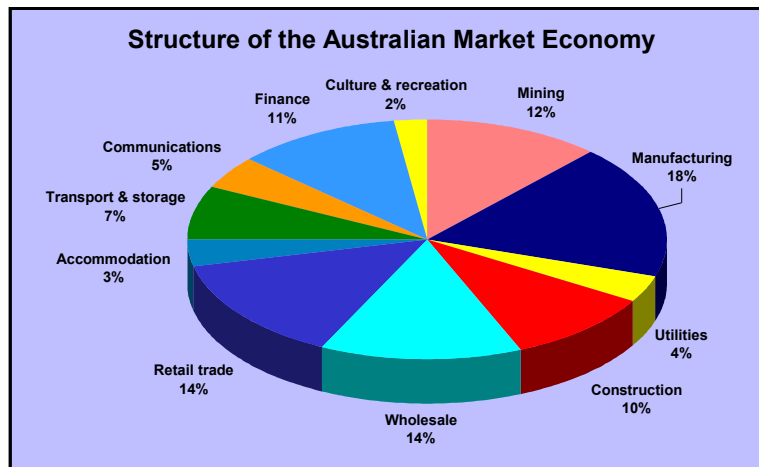
The absolute return option is managed in conjunction with the Tailored risk option.

Value Plus. This offers the greatest investment flexibility. It allows for any combination from among the investment options including use of the Greenshoot Resources option to better reflect risk preferences and investment goals.

Because portfolios can be tailored to personal circumstances, investment performance will reflect the differences in the funds allocation within each investment portfolio.

thebigpicture portfolios do not normally attempt to replicate the performance of ASX indexes. Nor are stocks in a portfolio intended to reflect the structure of the ASX indexes. This is a deliberate choice to provide investors with an alternative investment product.

The composition of the ASX indexes does not reflect the make-up of the Australian economy. The Australian equity market is heavily biased toward the financial services sector, for example. The market capitalisation of companies in this grouping is equivalent to 35% of the market capitalisation of the companies included in the ASX 200 index. According to the Australian Bureau of Statistics, however, the financial services sector accounts for only 7% of the Australian economy (or 11% of the non-agricultural market sectors of the economy).



Using the ASX 200 as an investment benchmark implicitly assumes that financial services will provide superior investment returns to those generated from the economy as a whole. Alternatively, using the ASX 200 as the relevant benchmark suggests that an investor does not care whether his investment portfolio takes advantage of relatively strong segments of the Australian economy as long as its performance matches that of the ASX 200.

The financial services sector of the economy performed strongly through the 1990s. The ABS has estimated that financial services operating surplus grew at an average annual rate of 19% compared with economy-wide growth in corporate (non-financial) operating surplus of 10% a year over the same period.

Extrapolating such performance indefinitely adds inappropriate risks to a portfolio. *thebigpicture* investment processes continually reviews the pricing of stocks in the market to choose companies likely to produce superior economic returns irrespective of the sector of the economy in which they operate and the weighting of the company in any ASX index based on the established criteria.

Philosophically, ***thebigpicture*** approach aims to deliver returns consistent with the returns which are available from the economy as a whole.

There are general risks associated with any investment in the stock market.

There are risks from global and local macroeconomic conditions reflected in growth, price inflation, interest rates and exchange rates all of which can affect company profitability and the valuation the market might place on any given level of financial performance.

Global political events can affect markets generally as well as the valuation of individual companies with particular exposures to events and conditions which might be difficult to predict.

Sector risk is associated with exposure to particular products or services which might be affected by commodity prices, changes in consumption patterns, product life cycles and demographic changes among other influences.

Government policies can affect the earnings of companies in which investments are made as well as the returns which flow to investors through tax treatment and other regulatory changes.

Company management will influence business outcomes. While considerable efforts are made to assess the competence of management in choosing individual companies in which to invest, management can change without notice or might fail to perform in a way which is consistent with their foreshadowed performance.

The research used in selecting investments for a portfolio is based on the approaches and opinions of thebigpicture Economics as well as external analysts and investment managers. While every effort is made to ensure accuracy and high standards in analysis, investment outcomes cannot be guaranteed.