

# Lonsec Direct Equity Model Portfolios





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## About Lonsec

Lonsec Limited (Lonsec) is a specialist investment research and stockbroking house that has been working in partnership with financial advisers for more than 17 years.

Lonsec has developed a range of quality stockbroking, research, consulting and portfolio services tailored to provide investment solutions to the intermediary market.



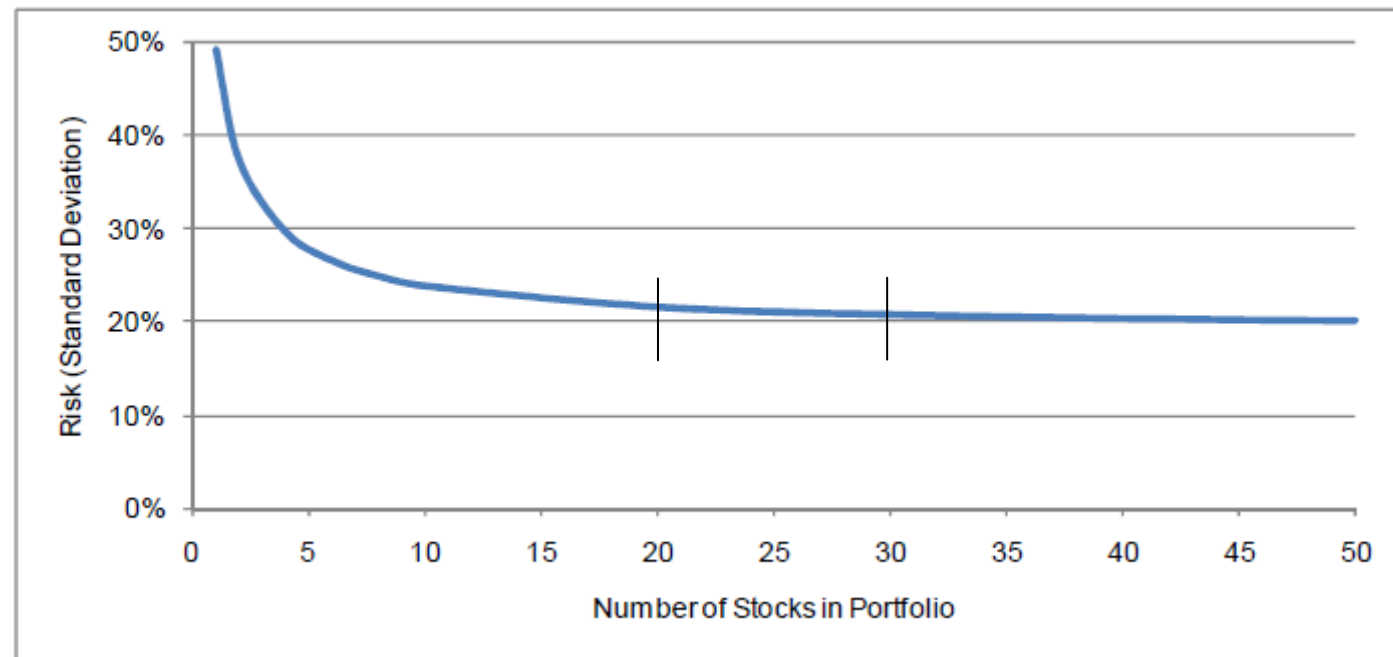
# Lonsec Australian Equity Research

<p><b>MARCUS TUCK</b> General Manager Stockbroking</p>		<p>25 years investment experience - Bachelor of Economics, F Fin          Joined Lonsec in April 2010 as Head of Equities Research          LINWAR Securities, Founding Director &amp; initial Head of Research – 7 years          BNP Paribas Equities, Strategist &amp; Quantitative Analyst – 3 years          HSBC Securities, Strategist &amp; Chief Economist – 5 years</p>
<p><b>BILL KEENAN</b> Senior Equity Strategist</p>		<p>17 years investment experience - Bachelor of Bus. (Accounting), Grad. Dip. Finance &amp; Investment          Lonsec, Snr Equity Strategist – 4 years, responsible for invest. strategy and direct model portfolios          TOWER Trust, Investment Manager, Snr Investment Analyst – 8 years          IOOF Trustees, Investments Supervisor – 2 years</p>
<p><b>BASIL BURMEISTER</b> Senior Resource Analyst</p>		<p>40 years investment experience - Bachelor of Science (Geology) and Master of Geoscience (Mineral Economics)          A geologist by training, Basil gained 15 years experience in the mining industry in Southern Africa and Australia, specialising in gold and precious metals. He has spent the past 25 years in equities research and institutional banking. He joined Lonsec in August 2007 and is responsible for resources research.</p>
<p><b>PETER GREEN</b> Senior Property and Infrastructure Analyst</p>		<p>12 years industry/investment experience (Australia, UK) – Bachelor Comm, Bach. Arts, ICAA          Lonsec, Snr Investment Analyst , listed/unlisted property, infrastructure – 3 yrs          Centro Properties Group, retail dev't/acct – 3.5 yrs          Andersen/EY, external audit – 3.5 yrs</p>
<p><b>DANIAL MORADI</b> Industrial Analyst</p>		<p>9 years investment experience - Bachelor of Electrical and Computer Systems Engineering and Graduate Diploma in Applied Finance and Investment          Lonsec Industrial Analyst – 3 years, responsible for Income Journal and industrial equities          Professional Trader – 4 years</p>
<p><b>TOM BOURNE</b> Industrial Analyst</p>		<p>3 years investment experience - Bachelor of Agricultural Science and currently completing a Master of Professional Accounting          Tom initially joined Lonsec as an Agribusiness Analyst, reviewing primarily direct agribusiness assets and investments. In 2008 Tom's focus expanded to Natural Resources Managed Funds (Resources, Renewable energy, Carbon, and Commodities) and more recently agricultural equities.</p>

# What is a diversified portfolio?

An academic analysis<sup>1</sup> of a universe of 3,290 stocks listed in the US found that an equally weighted diversified portfolio of 20 stocks had only a slightly higher standard deviation (21.7%) than the whole universe (19.2%).

**Average Standard Deviation of Annual Portfolio Returns**



Further, each additional stock added to the portfolio of 20 stocks delivered a diminishing benefit in terms of reducing risk. There was little diversification benefit after 30 stocks.

<sup>1</sup> EJ Elton and MJ Gruber, *Risk Reduction and Portfolio Size: An Analytic Solution*, Journal of Business, October 1977

# The case for concentrated portfolios

A study<sup>2</sup> of 12,000 randomly selected portfolios in the 1990's showed how returns and outperformance are linked to what the author of the study termed "focused investing".

## 10 year period 1987-1996

	Minimum RoR	Maximum RoR
15 Stock Portfolios	4.41%	26.59%
50 Stock Portfolios	8.62%	19.17%
100 Stock Portfolios	10.02%	18.32%
250 Stock Portfolios	11.47%	16.00%

Source: LPAC Online

Hagstrom's study showed a 15 stock portfolio generated the highest returns but also the lowest returns. However, after further analysis he found that:

- out of 3,000 15 stock portfolios, 808 beat the market;
- out of 3,000 50 stock portfolios, 549 beat the market;
- out of 3,000 100 stock portfolios, 337 beat the market; and
- out of 3,000 250 stock portfolios, 63 beat the market.

Hagstrom submitted the above results as convincing evidence that the probabilities of beating the market, goes up as the number of stocks in a portfolio goes down.

<sup>2</sup> Robert Hagstrom: *The Warren Buffett Portfolio* (J Wiley & Sons 1999)

## Investment Philosophy

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Lonsec focuses on generating absolute returns, over the medium to long term, through concentrated, low-turnover portfolios.

## Investment Process

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## Lonsec Australian Equity Model Portfolios

- **Lonsec Core Model Portfolio**

Benchmark – S&P/ASX 100 Accumulation Index

Inception: April 2000

- **Lonsec Income Model Portfolio**

Benchmark – S&P/ASX 100 Industrials Accumulation Index

Inception: August 2002

## Objective

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The Core Model Portfolio aims to deliver absolute returns and tax-effective income, over the medium to long term, from an Australian equity portfolio.

## Portfolio Construction Rules

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Investment universe	ASX 150 excluding A-REITs
Benchmark	S&P/ASX 100 Accumulation Index
Sector diversification	Minimum 8 GICS industry sectors
Min/Max stocks	12-20
Individual stock limit	15%
Stocks weighted at 10%+ must be selected from ASX 50	
At least 80% of the portfolio must be invested in ASX 100	
Cash weighting	Nil (fully invested model portfolio)
No A-REITs	(refer Property asset allocation)
Average portfolio turnover	20-30% pa



## Core Model Portfolio

### Portfolio Profile

Typical no. of stocks	15 – 5 x 10%; 10 x 5%
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Cash weighting	0%
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Top 3 Industry exposures	Banks 25%
	Metals and Mining 15%
	Energy 15%

ASX 50 exposure	90%
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ASX 100 exposure	100%
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Current portfolio cash yield	4.6% (90% franked)
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Inception date	17/04/2000
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# Core Model Portfolio Performance

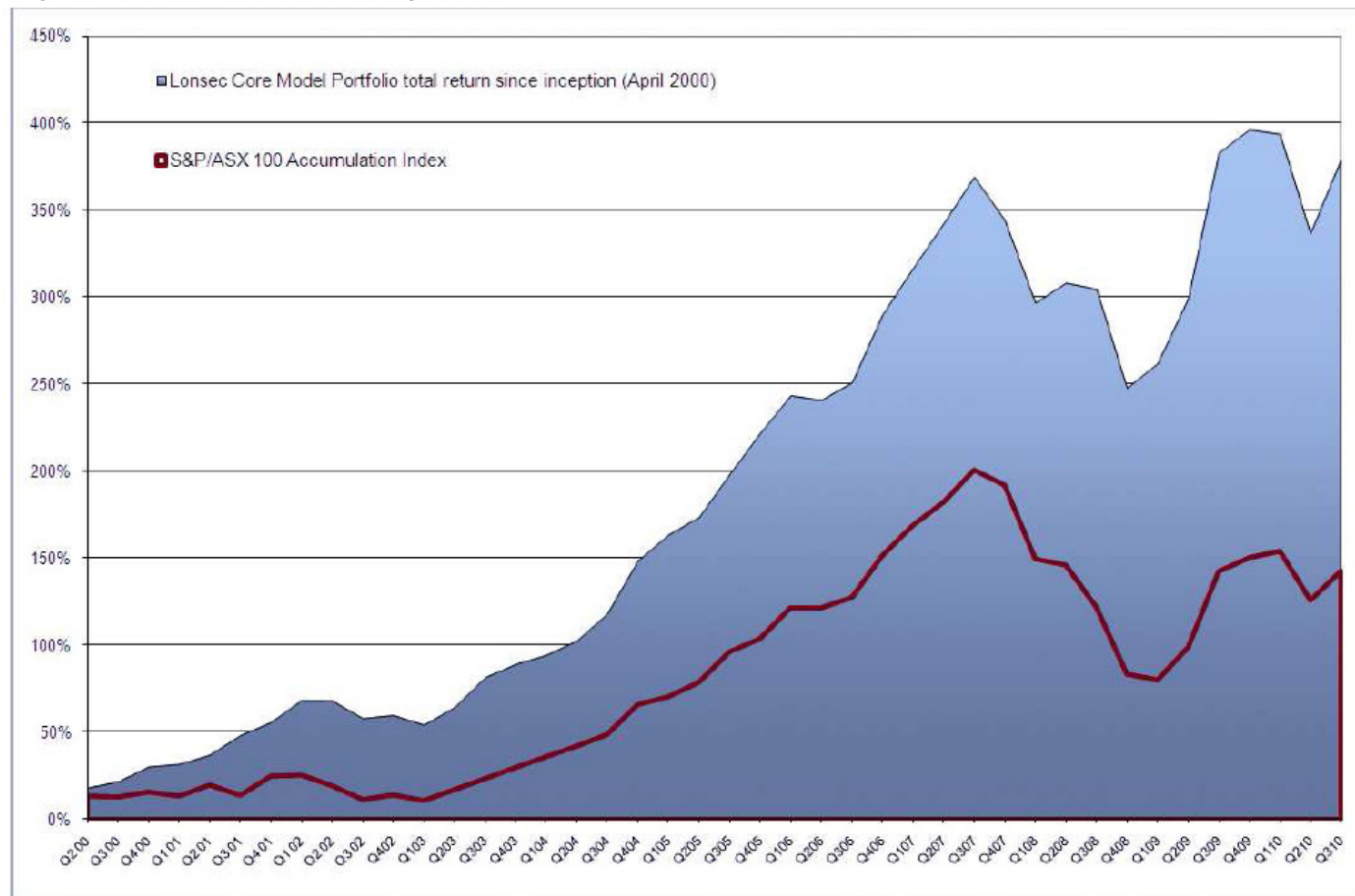
## INVESTMENT PERFORMANCE

Period ending	30 September 2010	Month	Qtr	Six Mths	Year	2 Yrs <sup>1</sup>	3 Yrs <sup>1</sup>	4 Yrs <sup>1</sup>	5 Yrs <sup>1</sup>	10 Yrs <sup>1</sup>	Since Inception <sup>1</sup>	Since Inception <sup>2</sup>
<b>Lonsec Core Model Total Return<sup>3</sup> (%)</b>		<b>5.3</b>	<b>9.7</b>	<b>-3.0</b>	<b>-0.9</b>	<b>8.7</b>	<b>0.6</b>	<b>8.1</b>	<b>9.9</b>	<b>14.7</b>	<b>16.2</b>	<b>378.9</b>
S&P/ASX 100 Accumulation Index (%)		4.4	7.5	-4.5	0.1	4.6	-6.9	1.6	4.3	8.0	8.8	142.7
Out/Under Performance (%)		0.9	2.2	1.5	-1.0	4.1	7.5	6.4	5.6	6.7	7.3	236.2

<sup>1</sup> % per annum <sup>2</sup> Total return since inception date 17 April 2000

<sup>3</sup> Investment Performance is calculated before fees, brokerage and taxes. Dividends are reinvested at the end of each month. The Lonsec Australian Equity Core Model Portfolio is a fully invested model portfolio that is rebalanced monthly. Physical portfolio results will differ depending on cash levels, start date, brokerage, fees, taxes and rebalancing policy.

**Past performance is not a reliable indicator of future performance.**



## Summary

- **Investment Philosophy** - active, focused on absolute returns, concentrated portfolios, low turnover.
- **Investment Process** – five key components:
  1. Top-down
  2. High Conviction
  3. Quality companies at a reasonable price
  4. Low turnover
  5. Risk management
- **Two model portfolios** – Core and Income
- **Core has delivered strong growth**
- **Income has delivered high fully franked income**

# Market update

## Positives

- The Australian economy is expected to grow by 3.0% in 2010 and 3.5% in 2011 - its 20<sup>th</sup> consecutive year of growth
- The Banking system is in good financial shape
- The Government is in a relatively strong financial position
- The Superannuation pool is \$1.2 trillion and growing
- Corporations have recapitalised
- Financial markets have improved
- Housing market has been resilient
- Reasonable population growth
- Asia (our main export destination) seems to be in good economic shape
- Exports prices (coal and iron ore) have generally held up well
- Employment has also been surprisingly resilient (unemployment rate 5.1%)
- Underlying inflation has slowed to 2.7%
- A strong AUD helps reduce inflation

## Negatives

- US, Europe and Japan are all dealing with post GFC issues including:  
fragile banking systems; large budget deficits; high public and private sector debt levels; regulatory reform; political change and currency volatility
- Private sector deleveraging leading to falling credit growth and money supply
- Public sector trying to reflate via expansionary fiscal and monetary policy
- Australian economy tied to Asia, any hiccup in China would affect our exports
- Australian financial markets still tied to the US and European markets
- Aust. private sector debt levels are high (160% of GDP), with A\$650bn borrowed offshore, therefore highly sensitive to global debt markets
- Bank loan rates may have further to rise, outside of the RBA
- Capacity constraints limit productivity gains and pressure inflation
- Govt policy is moving to the left - increasing risk for the private sector
- A persistently strong AUD hurts our export competitiveness over the long term

- Developing world (about 45% of global GDP) growing strongly
- Developed world growing more slowly but likely to avoid double-dip recession and interest rates to stay low
- Australia well positioned
- Company profits & balance sheets OK
- Equity valuations supportive
- High cash levels

- Banks (ANZ added)
- Metals & Mining (RIO added)
- Energy (AGK added)
- Chemicals (ORI weight increased)
- Healthcare (COH added)

# Lonsec Direct Equity Model Portfolios

