Explore a new world of income

A practical guide to help you protect and grow your retirement income today

Trust is earned.

'Explore a new world of income' is an informative guide designed to share the experience and insights of Perpetual Private's team of investment experts and private client advisers – experts who have advised our clients through the biggest market events of the past three decades, including the GFC, the long post-GFC sharemarket rally and COVID-19.

It's the essential guide for those seeking to protect and grow their wealth in retirement.

For more information on Perpetual Private and our approach to investing see Chapters Eight and Nine.

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Foreword

Over the last few decades, some of the biggest investment market events have seen retirees and those approaching retirement worry about their wealth, how to grow it and how to protect it. From the Tech Bubble in the 1990s and the Global Financial Crisis in the 2000s to the economic fallout from COVID-19, retirees are asking 'Will this impact my retirement income and the vision I have for the future?'. While there is no single answer that fits all, we do know that investment markets move in cycles, sharemarkets tend to recover strongly after these big events, and that those who stay the course and adjust their retirement plan along the way are often better positioned for the future.

In the current environment, those approaching retirement are facing their own set of challenges including a sustained, record low interest rate environment. That's why choosing the right financial and investment partner is crucial – one who understands your needs and has a high level of expertise and competency to help you throughout your retirement journey. A Perpetual Private financial adviser can help you achieve your goals and realise your vision at whatever stage of retirement you're at. With a team of investment specialists behind them, they can help you navigate investment market cycles as well as through the changes that life brings with it. That includes developing a sound plan that is tailored to your individual circumstances, providing flexibility as you need it and a choice of investments and services to suit your needs.

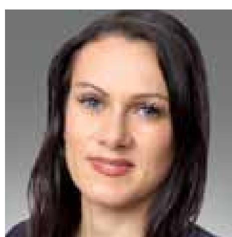
Most importantly, they will get to know you and seek to earn your trust, building a partnership to help set you up for success.

Thinking about retirement and how to best manage and grow your wealth can seem daunting, but it doesn't need to be with the right partner, tailored advice and a wealth of information at your fingertips. That is why we have created this eBook as your starting point – providing specialist insights on income generation, domestic and international investment options, and tax-effective investing. We believe it provides the foundation from which you can chart your new course.
I hope you enjoy reading it.

MARK SMITH
Group Executive, Perpetual Private

Chapter one

A fresh perspective on risk



MALISSA TOBIAS
Associate Partner – Private Clients VIC
Perpetual Private

What sets many affluent individuals apart from other investors is a greater focus on protecting – and then growing – their wealth. They understand that achieving the retirement they dream about isn't always just about selecting the highest returning investment, but also avoiding the risks that can cause permanent loss of capital.

If 2020 has reminded us of anything, it's that the future is uncertain. There is always a risk that your investments will fall in value, however risk is also a driver for growing wealth and being able to accept risk can lead to investment returns over the long-term.

The key to investment selection and portfolio management is optimising 'risk efficiency' by choosing the right mix of assets to give you the maximum return for the level of risk you're able to accept.

How much risk is right for you?

"Understanding your risk tolerance will help you find a mix of assets that have enough risk to grow your portfolio, but not so much risk that you can't sleep at night or leads you to sell at exactly the wrong time," says Malissa Tobias, Associate Partner with Perpetual Private in Victoria.

"After all, you won't see the full benefit of your long-term investment strategy if you can't stay invested during challenging times," Malissa added.

Your ability to accept risk changes as you move through life. When you start working, you're using your earnings to build a nest egg. At this stage, time is on your side as you can ride out market fluctuations with more time to grow your portfolio.

As you approach retirement, you have fewer years of earnings to save and invest and may soon need to draw down on your retirement savings. This shorter time horizon limits your ability to overcome a market downturn. As a result, how much investment risk you can take is vastly different.

If you're nearing retirement or are in your retirement years, the following questions can help you gauge your appetite for risk.

What is my financial capacity to take risk?
What is my need to take risk?
What is my desire to take risk?

"Your answers will help you and your adviser select a portfolio of investments that balance the risk you're comfortable taking, with the risk you need to take to reach your goals," says Malissa.

Asset classes

When it comes to investment selection, many investors blend various types of investments – most likely Australian and international equities, cash (or fixed income investments like bonds) and maybe an investment property. Each asset class has a unique role in your portfolio, whether that's the income derived from your investment or growth in the value of real assets or equities.

Increasingly, successful investors are including 'non-traditional' asset classes in their portfolios, as they search for new sources of income, growth and diversification.

Around 25% of Australians who have a financial adviser have an investment property at retirement – though this drops to around 10% shortly after, suggesting that the investment property is often the first investment sold when you retire.

Lembit, G., (2020) 'What do you care about', Perpetual Client Insights and Analytics, 24 August 2020

Table 1A and 1B cover the traditional, and not so traditional, asset classes:

TABLE 1A: TRADITIONAL ASSET CLASSES

ASSET CLASS	WHAT THEY MAY PROVIDE	CONSIDER THIS...
CASH (INCLUDING TERM DEPOSITS)	• Defence against a market downturn • Liquidity to take advantage of new opportunities as they emerge	In the current environment of ultra-low interest rates, interest on cash is less than inflation, meaning your capital is dwindling in real terms. Keep in mind the risk of holding too much cash and talk to your adviser about how much you need in your portfolio. Outside of super, income earned from cash is taxed at your full marginal rate.
BONDS	• Steady income • Portfolio defence from volatility in share markets	We're now entering a phase where bond yields are so low, it costs money in real (after inflation) terms to hold these traditional safe-haven investments. You may increase your returns within bonds by moving up the risk spectrum. See page 14 for more information on credit risk. Again, outside super, income from bonds is taxed at your full marginal rate.
SHARES (EQUITIES)	• Potential capital growth • Income through dividends	Shares offer the potential for higher returns and the income they pay may be tax effective due to franking credits (for Australian equities). However, shares are significantly more volatile than cash and bonds. For a deeper look at equities, see Chapter Five.
PROPERTY	• Income • Tax advantages • Potential capital growth • Tangibility	Residential property is not the only way to invest in property. Listed Real Estate Investment Trusts (REITs) give investors access to other types of property assets, such as office buildings and shopping malls. Commercial and residential investment properties may offer tax advantages where there is the ability for them to be negatively geared. Upon disposal, the availability of a capital gains tax discount could prove useful from a tax perspective.

TABLE 1B: NON-TRADITIONAL ASSET CLASSES

ASSET CLASS	WHAT THEY MAY PROVIDE	CONSIDER THIS...
ALTERNATIVE INVESTMENTS Including: Private credit and loans Private equity Hedge funds & trading strategies Currencies Commodities Infrastructure	• Income • Tax advantages • Potential capital growth • Tangibility	Generally, Alternative investments are more complex than traditional investments. They can be more illiquid and trade in less efficient markets, making them more difficult to value on a regular basis or exit quickly. However, skilled investment managers can potentially generate higher returns that are not necessarily linked to equities or bonds – hence their name 'Alternative'. See Chapter Six for our guide to Alternative investments.

ANDREW GARRETT
National Investment Specialist
Perpetual Private

Portfolio diversification

During COVID-19, the very different ways entire sectors of the share market have responded to changing spending patterns and economic uncertainty is a good reminder of a key principle of intelligent investing – diversification.

As Table 2 shows, over the past 10 years the best performing asset class one year may perform poorly in the next.

Picking next year's winner with any certainty is impossible. The good news is that in a portfolio that's well-diversified across different asset classes, you don't need to.

"Diversification helps smooth returns across different economic conditions," Perpetual Private National Investment Specialist Andrew Garrett said.

"This is because different asset classes can have low or even negative correlation. That is, if one asset class falls in value in response to an economic event, another may rise."

"As you can see in Table 2 there is an enormous range of outcomes between each year's winners and losers. The dark blue squares represent the balanced portfolio and always travel somewhere through the middle of the table, with a narrower range of returns. A balanced portfolio can provide more reliable expected returns, leading to more reliable plans for clients – which is what we're ultimately trying to achieve."

TABLE 2: THE ANNUAL RETURNS FOR DIFFERENT ASSET CLASSES RANKED FROM HIGHEST TO LOWEST

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	10 YR AVERAGE
Aus. FI 11.4%	A-REITs 32.8%	DM Eq. 47.0%	A-REITs 26.8%	A-REITs 14.4%	A-REITs 13.2%	EM Eq. 27.1%	G-REITs 4.8%	DM Eq. 27.9%	EM Eq. 7.8%	DM Eq. 13.0%
Global FI 10.5%	G-REITs 26.1%	Int. Eq. 42.5%	G-REITs 25.7%	G-REITs 11.6%	Aust. Eq. 11.8%	Int. Eq. 14.8%	Aus. FI 4.5%	Int. Eq. 26.8%	Int. Eq. 5.9%	Int Eq. 12.3%
Cash 5.0%	Aust Eq. 19.7%	G-REITs 20.3%	DM Eq. 14.7%	DM Eq. 11.5%	EM Eq. 11.7%	DM Eq. 13.3%	A-REITs 3.3%	Aust Eq. 23.8%	DM Eq. 5.6%	A-REITS 11.3%
Port - 1.5%	EM Eq. 16.7%	Aust Eq. 19.7%	Int. Eq. 13.9%	Int. Eq. 9.8%	Int. Eq. 8.4%	Aust. Eq. 11.9%	Cash 1.9%	G-REITs 22.1%	Global FI 5.1%	G-REITs 8.5%
A-REITs - 1.6%	Int. Eq. 14.7%	Port 16.7%	Global FI 10.3%	Port 5.3%	DM Eq. 8.0%	Port 8.8%	Global FI 1.6%	A-REITs 19.6%	Aus. FI 4.5%	Port 8.0%
DM Eq. 5.6%	Port 14.5%	EM Eq. 13.0%	Aus. FI 9.8%	Global FI 3.3%	Port 7.6%	A-REITs 6.4%	DM Eq. 1.4%	EM Eq. 18.6%	Port 3.0%	Aust. Eq. 7.7%
G-REITs - 6.5%	DM Eq. 14.4%	A-REITs 7.3%	Port 9.6%	Aust Eq. 2.8%	Global FI 5.2%	Global FI 3.7%	Int. Eq. 0.6%	Port 17.2%	Aust. Eq. 1.7%	EM Eq. 6.6%
Int. Eq. - 7.4%	Global FI 9.7%	Cash 2.9%	EM Eq. 6.9%	Aus. FI 2.6%	G-REITs 4.6%	Aus. FI 3.7%	Port 0.6%	Aus. FI 7.3%	Cash 0.4%	Global FI 5.9%
Aust Eq. - 11.0%	Aus. FI 7.7%	Global FI 2.3%	Aust Eq. 5.3%	Cash 2.3%	Aus. FI 2.9%	G-REITs 2.2%	Aust Eq. - 3.1%	Global FI 7.2%	A-REITs - 4.0%	Aus. FI 5.6%
EM Eq. - 18.4%	Cash 4.0%	Aus. FI 2.0%	Cash 2.7%	EM Eq. - 4.3%	Cash 2.1%	Cash 1.7%	EM Eq. - 5.1%	Cash 1.5%	G-REITs - 17.1%	Cash 2.4%

- Aus. FI – Australian Fixed Income
- Global FI – Global Fixed Income
- Cash - Cash
- Port - Balanced Portfolio
- A-REITs – Australian Real Estate Investment Trusts
- DM Eq. - Developed Market Equities
- G-REITs – Global Real Estate Investment Trusts
- Int. Eq. – International equities
- Aust. Eq. – Australian equities
- EM Eq. – Emerging market equities

Source: FactSet Dec 2020

Performance by design

"In today's globalised world, retirees or those nearing retirement have an abundance of investment choices," says Andrew Garrett.

"Paradoxically it's often challenging to decide on the right mix of asset classes for the risk you're comfortable with. The good news is, you don't have to do it alone and it doesn't have to be difficult."

Creating a plan with a suitable investment portfolio that matches your long-term financial goals and risk tolerance is at the core of what a Perpetual Private adviser provides.

CAUTION AHEAD:

Risks to your retirement

In the years around retirement, there are two risks that make careful and appropriate portfolio construction essential – sequencing risk and longevity risk.

Sequencing risk is the risk that a market downturn occurs right before, or soon after, you retire. If you are forced to withdraw from your portfolio during market losses, you will crystallise those losses before markets have a chance to recover. This can have a large and lasting financial impact on your retirement and greatly increase longevity risk, which is the risk that you will outlive your investments in retirement.

The path, or sequence, of returns (the order in which you sell different assets in retirement) is very important. Having too much money in growth assets as you retire, just as a market downturn occurs, may mean your retirement lifestyle needs to be significantly downgraded or retirement postponed in order to ride out the market fall.

Likewise, avoiding growth assets like shares and property altogether in retirement may not be as safe as it sounds, particularly now with cash rates near zero and bonds delivering negative returns after inflation. In this case, you are effectively locking in a decline in the real value of your portfolio and increasing your longevity risk.

An appropriate balance of cash that can be drawn upon during a market downturn, together with growth assets, such as shares, in your portfolio will ultimately help you avoid both sequencing and longevity risk.

Chapter two

Rethinking retirement income

ROBERT WOODFORD
Partner – Private Clients NSW
Perpetual Private

For many retirees, earning enough income to fund their retirement has been the defining investment challenge of the past decade.

Dividends from shares have taken on greater importance for income deprived investors. However, by focusing only on the highest yielding shares, are you missing an opportunity to invest in companies that could create more income in dollar terms – and a better lifestyle – in the long run?

Income investing

Along with many other lessons, 2020 reminded us that dividends are not guaranteed. During the pandemic, many companies paid little or no dividends as they sought to protect and repair their balance sheets.

Notably, the 'big four' Australian banks were also restricted from paying full dividends by the Government. As a result, investors who had adopted an income focused strategy were impacted. These investors consciously construct a portfolio of stocks with the highest dividend yielding companies.

"Income investing is an appealing strategy for retirees," says Robert Woodford, a Partner with Perpetual Private in New South Wales. "It avoids touching the principal and, in theory, is a strategy that can last forever."

"However, prioritising income generating investments can lead to a portfolio with poor diversification," says Robert.

"Investors can be overexposed to interest rate risk, changes to legislation or systemic shocks like the pandemic that reduced company dividends."

"It's important that your portfolio is prepared for times when the income you receive falls below what you need to support your lifestyle."

STELLA MCMULLEN
Senior Research Analyst – Direct Equities
Perpetual Private

Think about your total returns

Total return is the foundation of 'Modern Portfolio Theory', which underpins most modern investment thinking. It considers the total return generated by an asset, regardless of whether that return comes in the form of capital growth, interest or dividends.

This allows for the inclusion of companies with strong growth prospects, even if they pay little or no dividends.

In times when there is not enough cash from interest or dividends to cover your income needs, you can benefit from the capital growth of your investments by prudently selling shares for extra cash flow. With advice from your financial adviser or accountant you could do that without incurring excessive capital gains tax.

Perpetual Private's Senior Research Analyst, Stella McMullen believes that portfolios focused on total returns, as opposed to highest dividend yield, should deliver a better outcome than simply owning so-called income stocks, like banks and utilities.

"Growth companies with lower dividends re-invest a greater proportion of their profits back into their business in order to grow. Providing the company has a successful strategy, this will ultimately lead to a larger potential dividend and greater company value," says Stella.

How does it work?

Let’s compare two Australian companies at opposite ends of the dividend spectrum over a ten-year period – Commonwealth Bank (CBA) and CSL Limited (CSL), a world-leading biotechnology firm. Chart 1 shows the stark difference between these companies.

CBA is one of the best-known brands in Australia. Like most of our banks, CBA usually has a generous dividend yield – around 3.8% as at December 2020. Crucially, over the past 10 years only 74% of its 178% total return can be attributed to a rising share price. The remaining 104% of the returns have come from dividends.

Conversely, CSL currently yields just 1%. However, in the past 10 years, CSL has delivered a total return of over 820%. Of this return only 53% came from dividends.

While the yield on CSL is still lower than CBA, if you had invested $10,000 in 2010 you would be receiving comparable levels of income today. But while the CBA income is still slightly higher, the capital value of the CSL investment is three times higher.

Diversify your income strategy

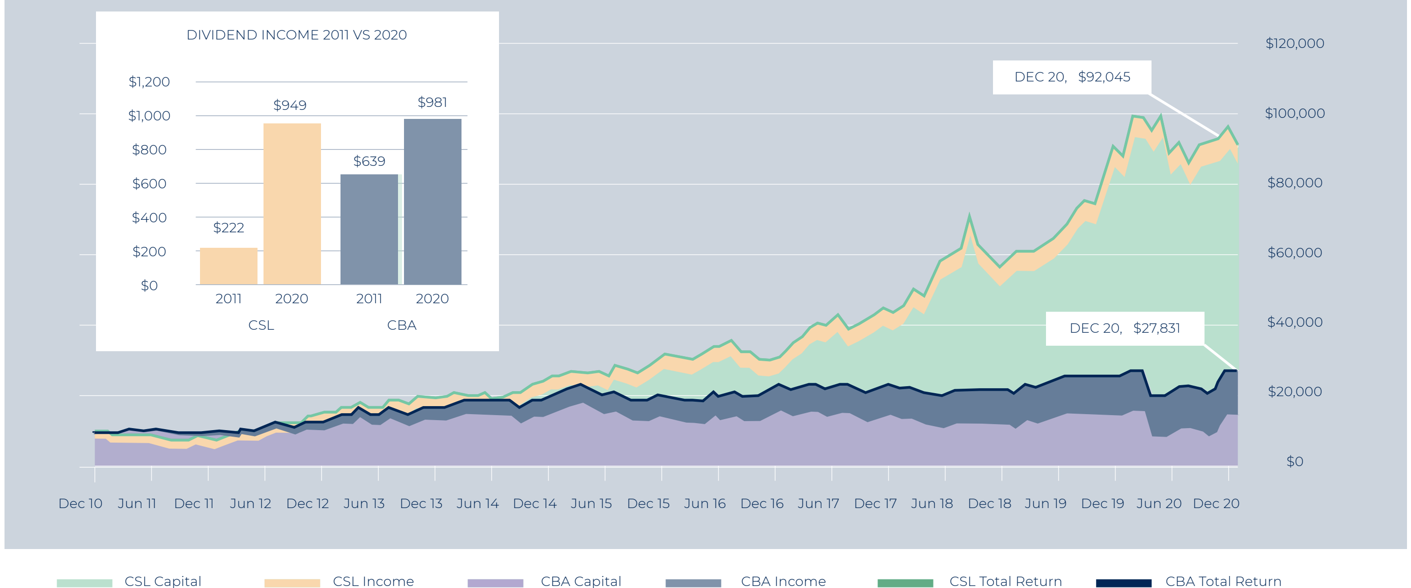
Comparing CBA and CSL illustrates the real benefits of a total return strategy. In this case, your investment in CSL will eventually lead to higher income in dollar terms than CBA, even though the dividend yield from CSL will always be foreseeably much less.

As we’ve seen, diversification is key to minimising investment risk. This includes your sources of income.

A total return approach can draw on multiple sources of return, and when income from assets is low, you can also look to sell assets that have appreciated in value to supplement the income to a level that is needed.

For more information on Perpetual Private's methodical, rules-based approach to constructing client portfolios, see Chapter Eight.

CHART 1: TOTAL RETURN OF $10,000 OVER 10 YEARS – CBA VS CSL



Source: Factset, IRESS Dec 2020. Chart 1 assumes the reinvestment of dividends.

CASE STUDY: BONDS

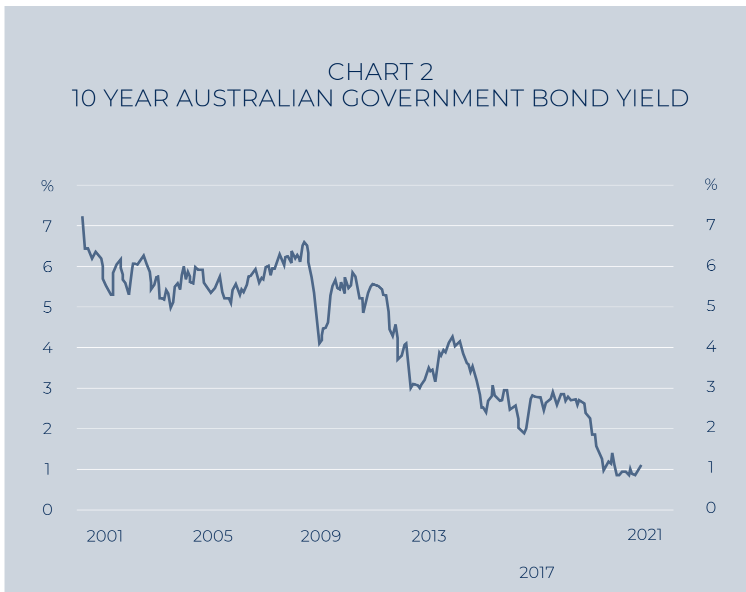
Chasing yield

Bonds are an important way for governments and companies to raise money. They also represent investment opportunities in diversified portfolios. A bond is essentially a loan, whereby the government or company pays interest usually at a fixed interval, before repaying the full amount at the end of the bond's maturity.

Government bonds, especially Australian Government bonds, are often thought of as the most predictable of investments. After all, what can be more predictable than lending money to the Australian Government.

But the current low interest rate environment means we're now in a phase where Australian Government bond yields are so low, it costs money in real terms to hold these traditionally safe-haven investments.

As Chart 2 shows, the yield on 10-year Australian Government bonds in early 2021 is around 1% – that's below the level of inflation.[1]



Sources: RBA, Yieldbroker

1. The Australian Economy and Financial Markets Chart Pack. February 2021 Reserve Bank of Australia

In early 2021, some countries such as Germany and France had negative bond yields, meaning investors actually paid for the privilege of owning them rather than earning interest.

Do bonds still have a role to play in a diversified portfolio?

It's a question investors may ask in a time when current income yield is below inflation. In a well-diversified portfolio, the answer is "yes".

Bonds still pay income and provide stability over the longer term by diversifying equity risk. For investors who are near retirement, or in retirement, bonds are also a sensible protection against sequencing risk.

As with any asset class, not all bonds are the same. Government or semi-government bonds – particularly those of strong economies, such as Australia, are considered very low risk. With minimal risk, however, they provide minimal returns.

Corporate bonds

You may have options to increase your returns while still moving some money away from shares, by investing in corporate bonds (sometimes called credit). Most companies in the ASX/200 issue bonds of varying types and duration.

As a bond is in effect a loan, your return is based on the company's ability to pay. The financial strength of the company will affect its perceived risk and the return it needs to pay to attract investors. By buying the bonds of riskier companies you can generally expect to receive a higher return for the price you pay.

Importantly though, credit does not have the same diversification characteristic as government bonds. When equity prices fall, so too do the price of corporate bonds, albeit usually to a far lesser degree than equities, depending on the type of corporate bond and riskiness of the company. The regular income (known as coupons) from credit – subject to no default – can still provide a stabilising effect but shouldn't be used as a complete substitute for government bonds.

Consider a credit fund

Knowing which company's credit securities to hold isn't easy. Much the same as managed funds for equities, credit funds hold a portfolio of credit and fixed income assets diversified by country, asset type, credit quality, loan maturity and issuer.

Diversification across a broad range of company securities is very important. Even the best returns from credit funds, although distinctly advantageous to Australian Government or semi-government bonds, are unlikely to match equity returns.

Chapter three

Tax-effective investing

CATHERINE CHIVERS
Senior Manager - Strategic Advice
Perpetual Private

KYLE LIDBURY
Head of Investment Research,
Perpetual Private

While there's the tax you should pay, many people pay more than they need to. Every excess dollar paid in tax is a dollar you can't use to support your lifestyle or invest to pay for future needs (like medical services or aged care).

There are 36,000 registered tax[2] specialists in Australia – a reminder that tax management is not really a do-it-yourself hobby. But there are some broad principles that can help you invest more tax effectively.

1. Superannuation is still the most tax-effective investment

Superannuation can offer you tax benefits:

- when you contribute
- when you earn money on your contributions, and
- when you withdraw money (especially after age 60).

According to Catherine Chivers, Senior Manager, Strategic Advice at Perpetual Private, "Super can be a very tax-effective structure, but for affluent investors the issue can be that contribution limits prevent them putting more money into super."

2. Growth assets can be more tax effective

In Chapter Five we talk about the tax benefits of investing in shares. Investing in other growth assets, such as property can also offer significant tax benefits. Whether you're investing via a Real Estate Investment Trust (REIT) or in an investment property, you may be entitled to receive relief on capital gains tax (CGT) if you hold the asset for more than a year. The income you receive may also be considered tax-deferred income or entitled to depreciation allowances.

In short, capital gains on assets are often treated more favourably for tax purposes than income from cash, term deposits or bonds which is fully taxable at marginal rates and where capital growth is either minimal or zero. Further, CGT is generally only paid when the asset is sold.

When selling assets such as shares or units in managed funds, investors can choose to sell specific holdings to minimise capital gains and/or only sell the assets that qualify for CGT discounts. A financial adviser can help ensure your portfolio is effectively managed from both a tax and investment strategy perspective.

3. Negative gearing

Most Australians are familiar with the tax outcome of negatively gearing into property, whereby if your investment expenses, including interest, are greater than the rental income received, this 'loss' is claimable as a tax deduction. The power of negative gearing lies in any capital gain that may occur over the investment period. What many are less familiar with is that borrowing to invest in shares essentially is a similar concept.

But while borrowing to invest in growth assets like shares and property can be tax-effective, there are two caveats.

Firstly, our low-rate environment is likely to persist for some years. According to Kyle Lidbury, Perpetual Private's Head of Investment Research, "The Reserve Bank recently said it's unlikely to raise rates until inflation, unemployment and wage growth are where they want them and it doesn't expect that to happen until 2024."[3]

This low-rate environment reduces the costs of your borrowing and the costs you can claim as a tax deduction. With rates so low, it's harder to negatively gear your investments.

Secondly, negative gearing increases your risk – anything that involves debt generally does. If you're seeking a better return and more tax-effective income by investing in shares or property and perhaps borrowing to buy those assets, you are moving up the risk curve (see also Chapter Four).

2. ATO, Commissioner of Taxation Annual Report, 2019-20

3. RBA: Statement on Monetary Policy – February 2021

TONY MASTROMANNO
Associate Partner – Private Clients VIC
Perpetual Private

Tax-effective investment structures

"Tax-effective investing is more than just looking at the underlying investment," says Tony Mastromanno, a Perpetual Private Associate Partner from Melbourne. "It's important to also look at the tax-effectiveness of the ownership structure. This is because you want to make sure you're holding those investments through the optimal structure."

Table 3 looks at the advantages and disadvantages of the three main structures investors use to tax-effectively hold investment assets.

According to Perpetual Private's strategic advice and investment teams, optimising the use of tax-effective investment structures involves:

- Strategic thinking at key financial turning points, such as receiving an inheritance, a windfall from a business sale or when your income rises significantly. The optimal financial structure could be a company, a family trust or an SMSF – or none of those, which is why financial advice is so important.
- Unwinding tax-effective investment structures you no longer need. The right planning can save you money and stress in the long run by putting in place the right structures at the beginning, whether that's for a blended family, running a business or looking after multiple generations.

TABLE 3: TAX-EFFECTIVE INVESTMENT STRUCTURES

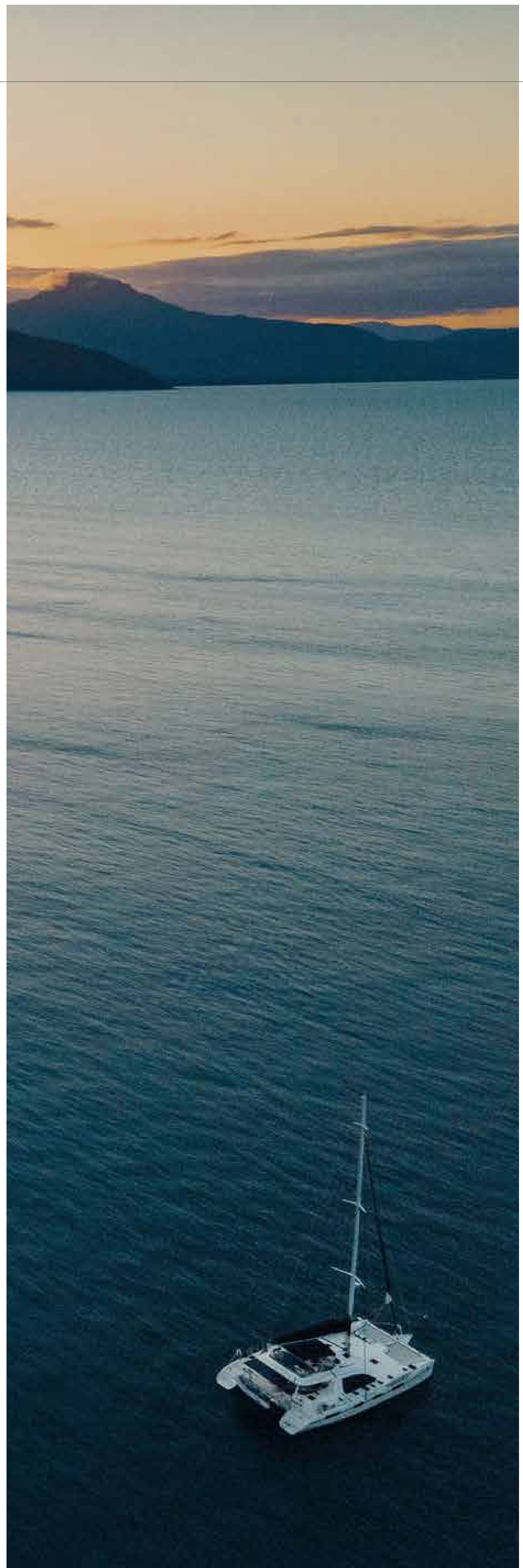
TAX-EFFECTIVE INVESTMENT STRUCTURE	ADVANTAGES	DISADVANTAGES
SELF-MANAGED SUPER FUNDS	• Personal control over your investment choices • A wide range of potential asset class choices, including your business premises • Asset protection benefits	• As trustee you have personal responsibility for all compliance with tax and super law • Can be costly
TRUSTS	• Distribute income and capital gains tax effectively because income is taxed at the beneficiaries' marginal tax rate and CGT discounts apply • Asset protection benefits • Can help keep assets in the family	• May be complicated and expensive to establish • Trust deeds need to be well drafted to provide protection, ensure compliance and allow flexibility • Have a limited lifespan of up to 80 years (except in South Australia where they can exist in perpetuity)
COMPANIES	• Can exist in perpetuity • Flexibility; can be used for business purposes or to hold investment assets (using the same company for both purposes may be inadvisable from an asset protection perspective) • Can be a tax-effective way to distribute income for those on a tax rate of less than 30% (otherwise top-up tax may be payable on income received) • Shareholdings can be a useful way of managing control over assets, especially where you're thinking about transferring wealth across generations • Net capital gains are taxed at 30%	• Can complicate estate planning • Winding up a company is complex

Three top tax tips (that are not about tax)

1. Think family. If you're making investment and tax decisions that involve family members – whether about family trusts, educations funds, estate planning, inheritance – bring those family members into the room with your adviser/s. Good communication makes for better decisions.

2. Check the time. When setting up your tax affairs, align your strategies with your time frame, which may be for generations rather than years. As Catherine Chivers says, "trusts will die, except in South Australia, but companies can live forever."

3. Leverage a team approach. To become a truly tax-effective investor you might need help from accountants, investment specialists, estate planning experts, solicitors and insurance advisers. You're the owner of that team – but who is the manager? Who makes sure all that expert transaction advice blends into an overall strategy? Your financial adviser may be best placed to help you run your team.



Chapter four

How interest rates affect investing

AMANDA MACDONALD
Investment Specialist
Perpetual Private

If you're retired or preparing to retire, there's a good chance you've paid off your home. When you were making your mortgage repayments you wished interest rates were lower. Now, as you rely on savings and term deposits for income, you wish they were higher.

In retirement, you'd like the returns on your assets to replace your work income. Unfortunately, record low interest rates has made this harder than ever.

In this chapter we'll take a look at how you can respond to a low-rate world – the investment choices and advice you need to live more comfortably.

Why cash crashed

Perpetual Private's Investment Specialist, Amanda MacDonald says: "The origin of the income challenge for retirees is rooted in the Global Financial Crisis. To restart battered economies, governments and central banks did everything they could to push down interest rates."

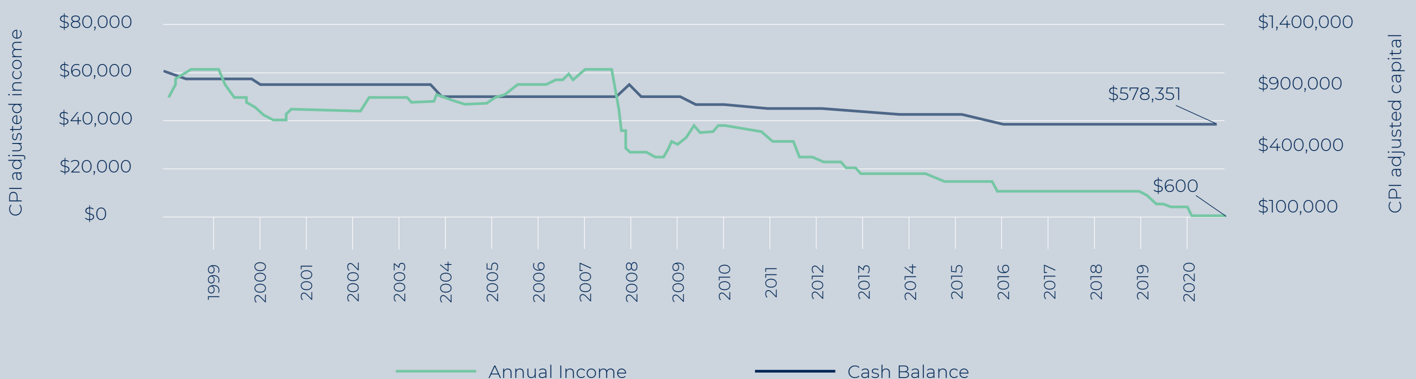
"With lower interest rates, conventional wisdom says that people should borrow more, spend more and invest more – spurring the economy and increasing employment."

"COVID-19 has made the situation worse and extended it. Central Bank governors globally have promised to keep rates low till lockdown-induced unemployment has recovered to pre-pandemic levels – something the Reserve Bank of Australia has said could take several years," Amanda added.

Since 2007 – just before the Global Financial Crisis – overall returns from a $1 million cash portfolio have fallen dramatically. As Chart 3 shows, the income you could expect has dropped precipitously and thanks to inflation, the real value of your capital has also fallen.

CHART 3: $1M INVESTED IN CASH IN 1999 – INCOME AND CAPITAL

Indexed to 1999 Consumner Price Index
Income has reduced 99%, Capital had decreased 42% due to sinking cash rates and inflation.



Source: Factset December 2020

ANDREW PARKER
Partner – Private Clients SA

Adapting to a low-rate reality

Investment professionals have a saying: 'You can't fight the Fed'. While this saying refers to the US Federal Reserve, a similar sentiment could apply to our central bank, the Reserve Bank of Australia (RBA). Betting on an outcome counter to the stated goals of the RBA is a risky endeavour given the tools and powers the RBA has available to influence markets.

Today's income-seeking investors shouldn't expect rates to rise when the world's central banks continue to be focused on keeping them low.

If you've been living off the interest on term deposits, generating returns in today's low-rate environment requires a change in strategy.

Strategy changes

Move your assets

For most people, replacing income lost to low interest rates means a change of asset allocation – changes in where they invest.

"Every investor is different," says Andrew Parker, a Perpetual Private Partner in Adelaide, "but many income-focused investors will need to move at least some of their money out of cash accounts and term deposits into other assets such as credit funds, shares, alternative assets in order to maintain their required returns."

This asset allocation shift should increase your ability to generate income. It's important to note that this shift will also 'move you up the risk curve', because credit and equity investments run the risk of capital loss, unlike cash and term deposits.

Manage the extra risk

If seeking extra income requires more risk, what can you do to manage the risk you're adding?

1. Invest in quality

Choosing profitable companies with good management, strong balance sheets and proven business models will offset some of your extra risk.

2. Invest in value

Even high-quality assets can become too expensive. Buying assets that are over-priced reduces your chance of a good return in the medium term and increases risk in the short term. Simply put: an expensive investment has less room to move up in price – and a lot more room to fall.

3. Diversify

By spreading your money across different asset classes, regions and individual securities (and via investment managers with different specialties) you reduce the risk. Spreading money widely also gives you access to different types of return – which we'll talk more about in the alternatives section (Chapter Six) of this eBook.

The value of advice

More and more, evidence shows that investors are better off, financially and emotionally, when they receive financial advice[4].

Perpetual's own research suggests retirees are calmer in the face of challenges when they have an adviser. According to that research, the percentage of advised investors who 'don't mind a challenge' – even in their 70s – is 10% higher than it is for non-advised Australians[5].

Similar research, like The Financial Services Council's Future of Advice research[6], has calculated the extra returns gained by advised investors versus unadvised investors. While some of that extra return comes from better investment choices, there's also a layer of extra return that accrues because working with an adviser helps you invest with more discipline – to be less bold when markets are flying and less fearful when markets are falling.

"The very few clients who panicked and cashed out of their portfolios when markets fell in March 2020 missed the V-Shaped recovery that unfolded over the rest of the year. Now, these same clients face a more difficult decision about when to buy back in," says Andrew Parker.

4. The Financial Services Council's Future of Advice research conducted by Rice Warner, 6 August 2020

5. Lembit, G., (2020) 'What do you care about?', Perpetual Client Insights and Analytics, 24 August 2020

6. The Financial Services Council's Future of Advice research

Chapter five

Shares – the foundation of investment portfolios

STEPHEN KENCH
Head of Direct Equities
Perpetual Private

ROXANNE GORMAN
Senior Financial Adviser - NSW
Perpetual Private

For most investors, including retirees looking for income, shares are a staple in their investment portfolios.

"Even clients who have a conservative attitude to risk can benefit from holding shares," says Perpetual Private's Head of Direct Equities, Stephen Kench, "as they're a crucial hedge against inflation and a good way to generate a growing income stream."

Widely shared

Notwithstanding our property obsession, Australians enjoy an understated love affair with shares.

A 2020 ASX survey says nine million Australians invest outside their home and compulsory super. Some 74% of them – over 6.5 million people – own shares.

The ASX research highlighted that nearly 30% of retiree investors will buy shares in search of a sustainable income stream in the next year.[7]

Long-term, Australian share investors have been well rewarded. Since 1900 Australia's share market is ranked second best in the world with an annual average return nearing 7% per annum, in Australian dollars.[8]

The tax benefits of share investing

Franking credits. When you receive a dividend they often come with franking credits, which represent the tax already paid by the company. Depending on your personal tax rate that can make your dividend income tax-free – or at least cut the tax you pay on that income.

Capital Gains Tax (CGT). Hold a share or managed fund for longer than a year and you can discount any gain by 50% and therefore reduce CGT (if you're an Australian resident for tax purposes and own the asset as an individual or via a partnership or trust).

Within super. The tax treatment of share income and capital gains within a super fund can further reduce the already concessional tax rate (15%) on returns in super.

Share market volatility and the retiring investor

The big issue for investors in, or close to retirement is risk. The 2020 COVID-19 share sell-off and subsequent recovery highlight how quickly share prices can move.

According to NSW Perpetual Private Senior Financial Adviser, Roxanne Gorman, it's a question of balance.

"The client's risk profile is crucial," Roxanne says, "but so is the amount of income they require, their tax situation, even their health."

"Many retirees will live for decades after retirement, so they need inflation-beating returns over a long period. Retirees often benefit from the comparatively high returns from shares because they still have time to ride out the risk."

7. ASX Australian Investor Study 2020
8. Credit Suisse Global Investment Returns Yearbook 2020

Which shares?

As with selecting investments in any asset class, the question is: which shares? Table 4 shows the alternatives to investing in Australian shares only, and what to consider with different regions around the world.

TABLE 4: INVESTING IN SHARES BY REGION AND COMPANY SIZE

SHARE INVESTMENT	UPSIDE	CONSIDER THIS...
AUSTRALIAN SHARES	• Relatively high dividend payouts • Potential for tax-effective income	• Australia only represents around 2% of world share markets • Our market is heavily skewed to resources and financials
GLOBAL SHARES	• Diversification • Lower dividends often offset by higher growth • Currency can work in your favour (when the dollar falls, your global shares are worth more)	• Broader access to high-growth industries – including biotech and technology • The wider you spread your share investing the less you are affected by volatility or an economic decline in any one economy • Withholding tax
DEVELOPED MARKETS (Europe, Japan, North America, Australia/NZ)	• Large liquid markets – you can buy and sell easily • Typically high standards of regulation and corporate governance	• While similar in some ways, developed markets still offer diversification. For example, the UK is a major finance hub, while Japan is a leader in auto production and consumer appliances
EMERGING MARKETS (Developing Asia, Eastern Europe, Africa, South America)	• Fast growing economies. In developed markets expected 2021 GDP growth averages 4.3%. In India it's 11.5%[9] • Emerging economies become developed ones (e.g. Japan)	• Weaker regulation and corporate governance can increase risk • Emerging markets (EMs) do offer access to large and fast-growing companies e.g. Alibaba (China), Reliance Industries and Infosys (India) • EMs can be accessed through developed markets stocks and/or exchanges (i.e. via dual listed companies) • Currency hedging in EMs is often expensive or impractical
BLUE CHIPS (e.g. BHP, ANZ, NAB, CSL)	• Well understood by investors and the market • Relatively predictable income • Easy to buy and sell	• Blue chips may have less room to grow than smaller stocks and less incentive to innovate • Just because a stock is big and well-known doesn't mean it is guaranteed future success • May be paying out cash (in higher dividends) because their ability to find new growth opportunities is limited
SMALLER COMPANIES	• Opportunity for growth • Often innovative – can develop popular new products and grow new markets • All big companies were once small companies (Microsoft, Google and Apple were all launched from a garage) • Low liquidity, prices can move when you try to transact large volumes	• Economic shocks or market dislocations can have a bigger effect on smaller companies as they have less capital and are typically less diversified than larger companies • Smaller companies are often less well understood by the market so the potential for surprises (positive and negative) is higher • Historically generate higher returns, with more risk, than their bigger counterparts • Quality can be more difficult to find so stock selection is important

9. IMF: World Economic Outlook Update, January 2021

Your choice – active or passive?

The other major decision advisers work through with retiree clients is whether they want to take an active or passive approach to investing.

Active investing means buying and selling shares based on a view on the prospects of specific companies. Passive is investing via funds that effectively replicate major share market indices (e.g. the S&P500, the ASX/300 or the Nasdaq) or other types of markets, including bonds, real estate investment trusts and other more niche exposures.

"Index funds provide cost effective share market exposure with lots of diversification and have less need for ongoing research," says Roxanne. "For many investors, they are an easy way to gain a broad exposure to a wide array of stock markets, without the risk of potentially choosing an underperforming fund manager."

Care should be taken to understand the index and market that the passive fund is tracking. While major markets are straight forward, index funds tied to fixed income markets, emerging markets, certain commodities or funds that employ leverage can have more tracking error (may not actually track the index as closely) and can also have pricing issues in times of market stress.

An active approach doesn't just potentially increase returns above the benchmark but can also reduce risks by selectively excluding companies that don't meet certain quality criteria or other environmental, social or governance issues. Conversely index funds are required to invest in all companies if they're included in the index they track.

As the fund manager has little or no decision-making responsibilities, during market crises, passive funds will follow the market lower with no inherent protection built in. An active approach can potentially take risk off the table by selling or buying shares in different companies for the benefit of investors. The following case study gives a real-life example of how Perpetual Private's Direct Equities team navigated the challenging market environment in 2020.

The financial health benefits of staying active in 2020

COVID-19 tested Perpetual Private's active investment approach. Perpetual Private's Head of Direct Equities, Stephen Kench, talks us through the turning points.

Caution First. When the effect of COVID-19 on society and the economy became clear in early 2020, we immediately sought to reduce the effect on client's capital. In early March we cut economically sensitive financials such as Macquarie Bank and Westpac and added Coles and Amcor. Even in a recession people still need to eat and buy essentials.

Focus on fundamentals. With the market falling 35% in 22 days we saw opportunities in many sectors. So in April and May 2020 we bought back into quality stocks such as NAB and ANZ. Given the regulator had told banks to cut dividends, we added to our BHP holding. The iron giant was cash-rich thanks to a soaring ore price so BHP provided an income surrogate for our investors.

Build confidence around market direction. Between June and October 2020 we were increasingly confident; vaccine development was moving at a pace never seen before and while lockdowns and border closures continued, we saw a developing investment opportunity. That saw us buy into Aristocrat and James Hardie – both in cyclical industries primed for recovery. We also closed out holdings in defensive companies like Coles.

*Based on our flagship Core 100 model Australian Equities portfolio, we estimate that between 1 January 2020 and 31 December 2020 our active approach added an additional 2-3% of gross return above a 'do nothing' approach. On an average client portfolio of $1m with one-third invested in Australian shares, this would have generated an additional return of $5,000 to $10,000.**

*Performance numbers are based on our flagship Core 100 model Australian Equities portfolio, using end of day stock prices for trade and returns calculated in Factset, inclusive and assuming reinvestment of dividends, before tax and before fees. They do not reflect actual client portfolios and are not intended to provide you with advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable for your circumstances. The information is believed to be accurate at the time of compilation and is provided by PTCo in good faith.

Chapter six

There is an alternative

DAVID BLUNT
Senior Research Analyst
Perpetual Private

Traditionally investors have looked to shares, bonds or cash, or residential property to invest and grow their money. In a time of low interest rates and share market volatility, investors are increasingly looking for alternative investments as another income source or to add an additional layer of diversification to their portfolio.

Another reason alternatives are now increasingly found in the portfolios of wealthy investors is the growth in private markets as a source of capital. In the US the number of publicly listed companies has decreased by around 50% in just the last 20 years. With fewer companies listing on the public markets and more companies being taken private, investors are looking at other means to invest their capital.[10]

There are a wide range of alternative investments to choose from, including private equity, hedge funds and private debt. Each has their own distinct characteristics, such as liquidity and risk. In this section, we look at what they are, their benefits and drawbacks and how Perpetual Private manages them.

What are the alternatives?

"To understand alternatives, you need to think about how the returns are generated," says David Blunt, Senior Research Analyst at Perpetual Private.

"With traditional asset classes such as shares, property and cash, the underlying market drives a large portion of the overall return. In alternatives, illiquidity and manager skill can make a big difference to overall returns."

For skill-based strategies the expertise of the money managers is often more important than the performance of the underlying asset class.

"One example is 'shorting' stocks," says David. "That's where a fund manager uses financial market techniques to invest in – and profit from – a fall in the value of a share. It means you can make money even in a falling market."

10. www.investors.com/news/publicly-traded-companies-fewer-winners-huge-despite-stock-market-trend/

MARISA SENESE
Senior Financial Adviser - QLD
Perpetual Private

Taking the road less travelled

The shorting example sums up one of the key benefits of alternative investing. Because the return is derived mostly from skill and less from the asset class, investing in alternatives gives you excellent diversification.

"Traditional asset classes are more correlated than you think as they can derive their value from the same underlying company or asset," says Marisa Senese, a Perpetual Private Senior Financial Adviser in Brisbane.

"Take investing in high yield corporate bonds and investing in shares. They look very different, the kind of return they pay is very different. But the health of the underlying companies is a major factor for both. So for diversification we cast the net wider."

That net can be cast very wide. Alternative assets can include everything from private equity to infrastructure investing, currencies, commodities and a whole range of specialist fields where experienced money managers find unique ways to capture returns.

Table 5 shows four of the most common types of alternative investments and what they do.

TABLE 5: ALTERNATIVE ASSETS AND WHAT THEY DO

ALTERNATIVE ASSET	WHAT THEY DO	CONSIDER THIS...
INFRASTRUCTURE INVESTING	Specialist infrastructure managers invest in roads, bridges, airports, energy grids and more. As the return is often based on agreements with governments (e.g. toll roads) income returns can be predictable and pegged to beat inflation.	Infrastructure typically requires a lot of money and is often highly illiquid so you should be prepared to lock your money away.
PRIVATE DEBT	Unlike bonds or credit securities, private debt assets aren't traded in public markets. Private debt covers a wide range of ways to lend money to fund business or real estate, often with the underlying asset securing the loan.	Unlike public credit or government bonds, it can be difficult to sell private debt instruments, which means they are often held to maturity.
DISTRESSED DEBT, SPECIAL SITUATIONS, LEVERAGED BUY OUT	Just some of a wide range of specialist strategies based around a manager's unique ability to find opportunities – including buying businesses, debt or equity assets that are misunderstood by the market and thus offer high returns to those who have the patience, skill and capital to pick the direction of returns.	Requires higher level of financial knowledge than other investment types.
PRIVATE EQUITY (PE)	Private equity investors typically buy large chunks of a business (often using debt) and exert some management control. Crucially, returns from PE are often about the manager's ability to change the business through cost cuts, divestment and operational improvement, rather than simply picking an undervalued business.	While investors often anticipate higher returns than public market investments, the risks can be higher and it can be difficult to withdraw invested money. PE can also require higher levels of involvement than other investments.

Different shaped returns

Diversification is much more than a risk-management tool. Alternative assets also offer a different return profile. Instead of relying on income from shares, property and government securities, an investor can enjoy both income returns from toll roads, airports or capital appreciation from the sale of privately owned companies.

Returns can also be made by trading currencies, commodities or distressed loans that can be bought at a discount and worked out for profit. There are also different risks associated with alternatives, such as illiquidity, greater complexity and less transparency.

Private markets and private goods

"In many alternative asset strategies, the assets aren't traded on public exchanges like the ASX," says David Blunt.

"There are pros and cons. Public markets provide liquidity meaning you can get in and out of investments more easily and you have lots of price information."

"In private markets there's less trading so you have less price information and less liquidity – you may have to lock your money away," says Marisa Senese. "The payoff is that in private markets, skill gets rewarded more – and that's where expert managers can do a great job for investors. In return for those benefits they may have to accept locking their money away and higher fees of managing skills-based strategies."

Perpetual Private's alternative approach

"Alternative asset investing is highly reliant on skill, so manager selection is crucial," says David. "We have a dedicated team whose job it is to stay attuned to who the good managers are in each asset class, make sure they are still at the top of their game and then to create portfolios which hold the right mix of alternative assets to suit market conditions and the needs of our clients."

Award winning alternatives

To meet the different needs of income and growth investors, Perpetual developed the Perpetual Income Opportunities fund and the Perpetual Growth Opportunities Fund. Together, the two funds hold more than $1billion worth of assets accrued over ten years.

In 2019, Perpetual was recognised as Best Alternative Investment Manager of the Year at the Hedge Funds Rock Awards (2018-2019).

The Perpetual Income Opportunities Fund won Best Multi Strategy Fund two years running at the Hedge Funds Rock Awards (2018-2019).

The PDS for the Perpetual Growth Opportunities Fund and the Perpetual Income Opportunities Fund, issued by PIML should be considered before deciding whether to acquire of hold units in the funds. The PDS can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

Chapter seven

ESG – investing with a conscience

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Research Analyst
Perpetual Private

JANE MAGOR
National Manager –
Philanthropy and Non Profit
Services, Perpetual Private

Most Australians care deeply about sustainability and environmental issues. That's the findings of a Perpetual study, which surveyed 3,000 Australians. Water quality and nature were their top concerns. Australians also cared about recycling (58%) while sustainability was a priority for 51% of people.

When it comes to investing in companies which reflect these values and concerns, 30% of retirees with a financial adviser prefer responsible investments in their portfolio. Perhaps surprisingly therefore, 86% of Australians are unfamiliar with the term 'ESG investing'. [11]

Understanding what ESG covers gives a clearer picture of what ESG analysts and fund managers look for when constructing a portfolio that generates social or environmental, as well as financial, returns:

Environmental – climate change, pollution, natural resources, waste

Social – human rights, diversity, equal opportunity, community impact, product impact

Governance – corporate responsibility, board remuneration

When investors do know about ESG, it makes a big difference to their investments. According to Perpetual's research, 56% of investors who have heard of ESG investing prefer to invest in companies that satisfy ESG criteria. Just 17% of investors who are unfamiliar with ESG investing would do the same.

The growth of ESG

The growing appetite to invest in ethical and sustainable ways saw funds managed under responsible investment approaches in Australia increase 17% in 2019 to $1.15 trillion. That's 37% of total professionally managed Assets Under Management, according to the most recent Responsible Investment Association Australasia's (RIAA) 2020 Benchmark report.[12]

"Whether it's the environment, health or human rights, socially responsible investors can invest in companies with values that reflect their own," says Sarah Fox, Research Analyst at Perpetual Private.

"As people become more aware of the social good they can do, they're turning that awareness into action," Sarah added. "It's no surprise that socially responsible investing is growing so fast."

Debunking the performance myth

"A question we sometimes hear from investors is - it's a great idea, but how much do we have to give up for ESG investing?" says Jane Magor, National Manager, Philanthropy & Non-Profit Services, for Perpetual Private.

"Historically, that may have been the case, but as ESG funds have grown in sophistication investors no longer need to sacrifice returns."

An often-quoted 2015 report by the Journal of Sustainable Finance and Investment summarised the results of more than 2,000 studies and found that overall ESG performance is comparable to, or better than, non-ESG funds[13].

It's a finding supported by RIAA's 2020 Benchmark report which, based on Morningstar research, found that multi-sector responsible investment funds outperformed mainstream funds over most time horizons in the last decade, as shown in Table 6 on the following page.

11. Lembit, G., (2020) 'What do you care about?', Perpetual Client Insights and Analytics, released 24 August 2020

12. Source: responsibleinvestment.org/wp-content/uploads/2020/09/RIAA-RI-Benchmark-Report-Australia-2020.pdf

13. 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Journal of Sustainable Finance and Investment, Gunnar Friede, Timo Busch, Alexander Bassen, 2015

TABLE 6: PERFORMANCE OF RESPONSIBLE INVESTMENT AGAINST MAINSTREAM FUNDS

(weighted average performance net of fees over 10 years)

Australian Share Funds	1 Year %	3 Year %	5 Year %	10 Year %
Average responsible investment fund (between 17 and 38 funds sampled depending on time period)	24.7	11.3	10.1	9.0
Morningstar: Australia Fund Equity Large Blend*	22.3	9.0	7.8	6.8
S&P/ASX 300 Total Return	23.8	10.3	9.1	7.8
International Share Funds	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Average responsible investment fund (between 13 and 50 funds sampled depending on time period)	22.5	13.7	11.0	11.9
Morningstar: Equity World Large Blend*	25.2	12.6	10.8	10.9
Multi-Sector Growth Funds	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Responsible investment fund (between 13 and 39 funds sampled depending on time period)	19.48	11.26	8.73	8.24
Morningstar: Australian Fund Multisector Growth*	16.22	7.56	6.52	6.88

*Source: Morningstar Direct™

Outperformed by the average RI fund

Underperformed by the average RI fund

"With growing evidence that investors can generate financial and social returns in tandem, it's clear that integrating ESG investments into a portfolio isn't a costly but ethical 'nice-to-have'," Jane Magor adds.

What's driving ESG fund performance?

Many large ESG screened funds have benefited by investing in large tech stocks that performed well over the past decade. In the short term, ESG screened funds are also less exposed to fossil fuel investments, particularly oil and gas, which suffered from a plunge in prices in April 2020 as well as the more gradual shift to renewable energy.

More and more companies generate revenue from intangible assets such as innovation and brand recognition. ESG screened funds are more focused on identifying and managing these non-financial assets, which over time is reflected in a superior market valuation.

As with any investment, past performance of ESG funds is no indicator of future performance and there are risks. Among these is less investment diversity or the exclusion of heavyweight market incumbents, such as Australia's big miners, which may affect performance at different stages of the market cycle.

While the industry matures, there is also a lack of consistency and transparency in exactly what qualifies an investment to be an 'ESG' investment.

"Ethics are personal, and not all ethical investing is the same," Sarah says. "That's why it's important to discuss your ESG investing needs with your financial adviser, so you understand where you're investing and ensure it's aligned with your broader investment objectives."

Jane adds that this is particularly relevant to philanthropists.

"It's becoming increasingly important for philanthropists to have alignment between the charitable purpose of their foundation and the underlying investments."

Three ways to invest sustainably

As ESG investing moves from the realm of institutional investors, more innovative and high-quality products will become available for retail investors. Whether you build a portfolio of individual companies or invest through a managed fund, there are three main ways to construct an ESG portfolio:

1

Negative screening

The most common and the simplest to implement negative screening excludes investments which don't align with your values, for example gambling or tobacco stocks.

2

Positive screening

This actively seeks to include investments which align with your values, for example, energy companies that focus on renewables, such as wind or solar, or manufacturers with a low-carbon footprint.

3

Impact investing

This takes positive screening to the next level. Investments are required to have a measurable positive impact – usually, these investments are off-market, tailored and likely illiquid. Impact investing is an emerging field in Australia and covers the development of areas like solar farms, water rights, low carbon investing, clean energy, social housing and other similar initiatives. Usually driven by institutional investors, impact investing is now increasingly being adopted by wealthy investors.

Getting started with ESG investing

Talk to your adviser

Many of your investments may already be in companies that are aligned to your values. Before you make any changes, your adviser can help break down for you exactly where you are – or aren't – invested.

Decide where you want to make a difference

Do you want to focus on renewable energy advancement to reduce climate change, support companies that reduce deforestation or support the development of ethically sourced products? There are many ways to make a difference – and usually a fund that works towards that goal. Spend some time thinking about what's meaningful to you.

Choose your investments

The options for ESG investing are growing. At Perpetual Private, we've been running a socially responsible direct Australian equities portfolio for over five years and ESG investments are becoming a larger part of many of our client portfolios.

While choice is always good, finding the optimal return within your universe of ethical options can be complex and time consuming. Your adviser can help you find a fund to suit your values.

Chapter eight

How to construct your portfolio

CHRIS MARSHALL
Partner – Private Clients WA
Perpetual Private

Constructing an investment portfolio is about building a collection of assets to meet the investor's specific return objectives and lifestyle goals with as much certainty as possible.

It requires blending asset classes together to ensure that:

- risks are minimised
- you're diversifying across markets, investment styles, geographies and industries
- there is exposure to a broad range of return drivers, and
- you've created a resilient portfolio that will perform well in a variety of market conditions.

But you've also got to consider the human element – your own feelings.

"The emotional challenges for investors in the past few years have been pretty striking," says Chris Marshall, Partner at Perpetual Private. "We've had the ongoing decline in returns from traditional income sources, booming equity markets, then the COVID-19 crisis and an amazing recovery."

"Constructing a portfolio can be easily influenced by being overly optimistic or fearful. It's only natural, but making emotional decisions can do a lot of damage in the long run," Chris added. "That's where a financial adviser can help."

In this eBook we have written about different investment types, asset classes and strategies you can use to manage and grow your wealth. But how does it all come together in an investment portfolio?

Perpetual Private's approach to portfolio construction

Our advisers take a methodical, rules-based approach to cut the emotion out of portfolio construction and help our clients succeed in the long term. Here are the principles we follow:

1. Define your investment objective

The first step in building your investment portfolio is to know what type of investor you are. Understanding your appetite for risk, what you want your investments to achieve, your timeframe and when money will be required to fund purchases or lifestyle decisions – in essence, it's planning out your financial future. This determines the investment strategy and asset allocation of your portfolio.

2. Asset allocation

Asset allocation is arguably the single most important factor that will determine your long-term investment outcomes.

Ultimately, your investment decisions aren't a choice between growth or defensive assets – it's how much of each you need in a diversified portfolio.

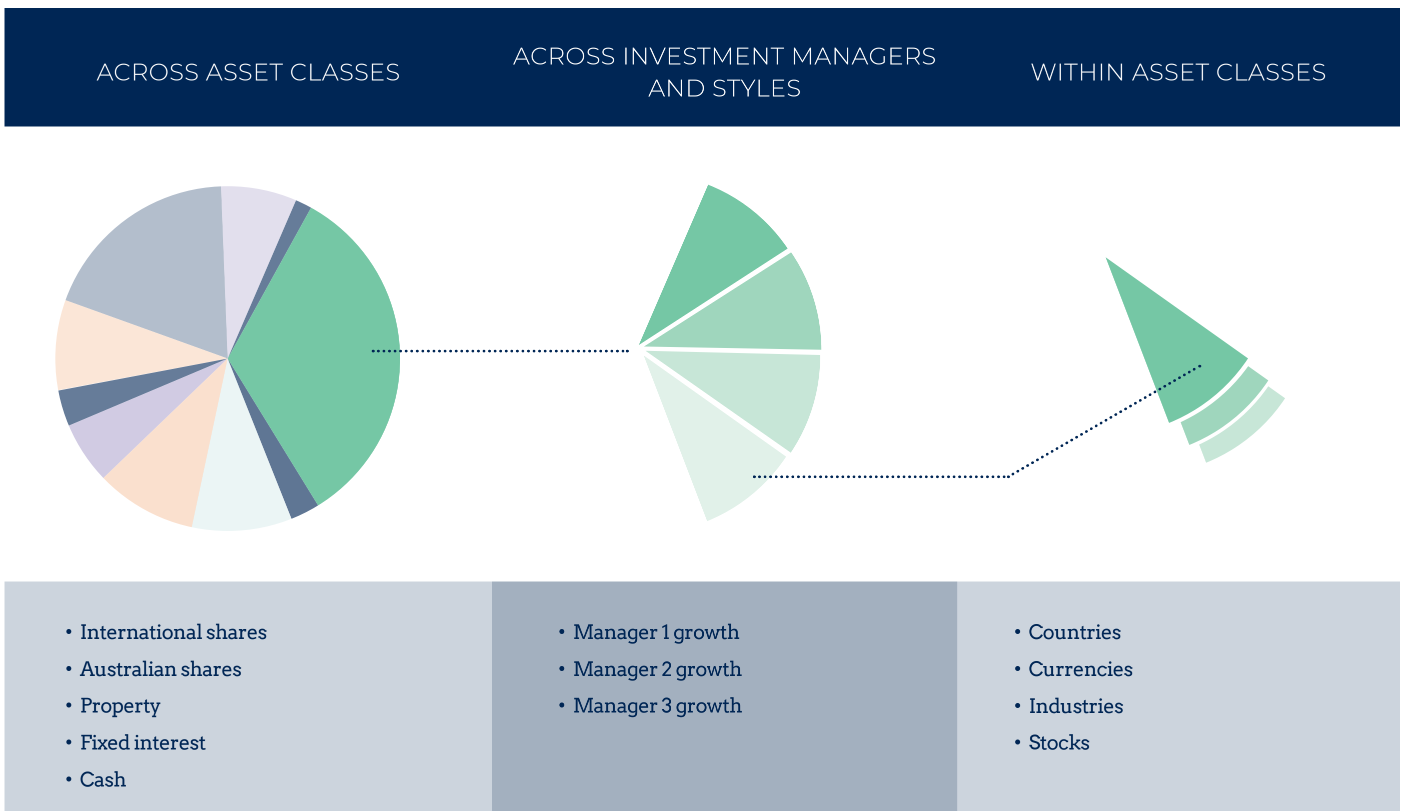
"Diversification isn't about selecting two banks, a miner and a consumer staple," says Kyle Lidbury, Head of Investment Research at Perpetual Private.

"A diversified portfolio might include a broad mix of equities – both domestic and international – listed and unlisted real estate, infrastructure, credit, government bonds and other alternative investments."

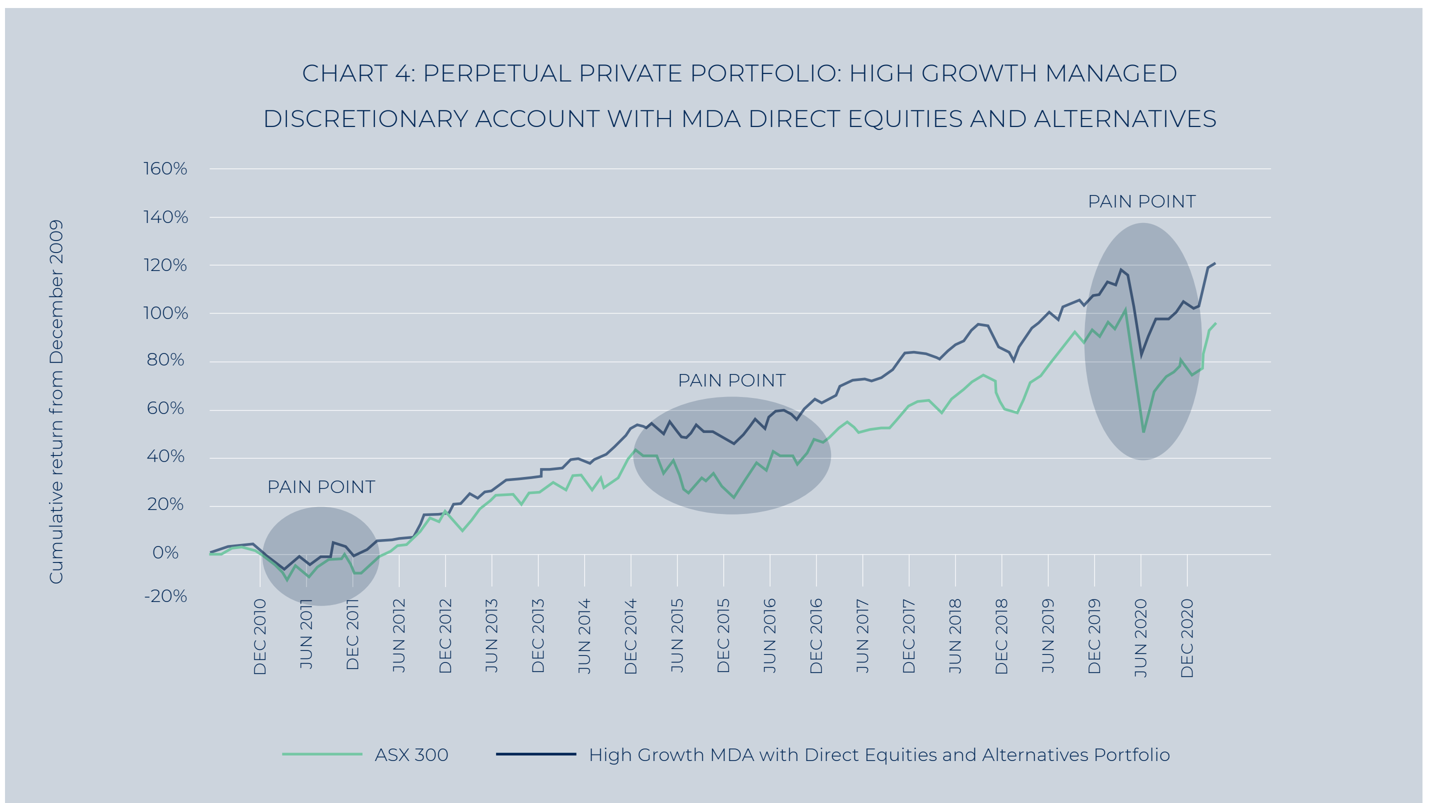
"Risk and asset allocation go hand in hand," added Chris, "that's why we make understanding a client's tolerance for risk a top priority and managing that risk at the forefront of all our decisions."

"We then work with the investment team to find that right spread of asset classes and underlying investments to meet the client's goals," Chris said.

To properly manage your risk, Perpetual Private diversifies:



As Chart 4 shows, through asset class diversification, including the addition of Alternatives, you can help reduce the impact of the market's 'severe pain points' and smooth out your returns over time.



Source: Factset, 31 December 2020. Past performance is not an indicator of future performance

3. Investment selection

The next step is to choose the investments for your portfolio. Whether you personally choose your individual investments may depend on a range of considerations, including your investing expertise, the time you have to manage your investments or the risk you want to take.

But keep in mind, there's usually a managed fund already created with a similar investment objective.

Managed funds

Managed funds are one of the simplest ways to diversify your portfolio. Built-in diversification isn't the only benefit of managed funds. Other advantages include:

- **Managed by experts:** investment decisions are made by trained professionals, acting in a methodical fashion and using a specific investment approach.
- **Pooled resources:** thanks to their scale, managed funds offer access to assets that may not usually be available to individual investors.

Managed funds can cover single or multiple asset classes, focus on income or growth or even specialise in subsets of different asset classes (e.g. funds focused on smaller companies, emerging markets or ESG investing).

A multi-manager fund is another type of managed fund; one that itself invests in different strategies, managed by multiple portfolio managers. Each of these underlying funds will have a different investment approach and style. Spreading investments between more than one fund manager increases diversification and helps to manage risk.

How do we choose our fund managers?

At Perpetual Private we select underlying managers through a rigorous vetting and monitoring process. We invest in managers that have:

1. a sound organisational structure with high standards of risk management and corporate governance
2. skilled investment teams that are appropriately resourced, and
3. a coherent, well-executed investment process that is sustainable and proven over time and different investment cycles.

Many of these managers (and therefore their skills) are not readily available to retail investors. Thanks to our scale (the size of Perpetual Private's funds under management), our investment research team can choose from the best-in-class asset managers across the globe, regardless of whether they have a managed fund available in Australia.

Perpetual Private portfolios

At Perpetual Private, we typically offer our clients two types of portfolios:

Model Portfolios: provide investors with a combination of managed investments which are professionally researched and blend various asset classes, investment managers and investment styles to achieve diversification. Our model portfolios are developed to suit a range of different investor types with common needs and objectives. Investors can track the performance of each underlying fund manager they are invested in.

Implemented Portfolios: designed to provide investors with access to core asset classes through a series of diversified managed funds, including Australian and international equities, fixed interest and property, via a multi-manager approach.

Investors can choose from four single-asset class portfolios – Australian equities, International equities, Fixed income and Real Estate.

"They're able to deliver the asset class exposure that's required to meet your long-term objectives but reduce the cost of implementation and trading you may otherwise incur by using a number of separate externally managed funds," says Kyle.

Your life, your choice

In simple terms, a portfolio is ultimately a collection of investments. But constructing your portfolio is a strategic process in that it is all about choice.

"In reality it doesn't really matter if the portfolio is built from the ground up or we use a Model or Implemented portfolio," says Chris.

"What matters is that the end result is a portfolio that will meet your specific needs and do it efficiently and at a reasonable cost."

Chapter nine

The Perpetual Private difference

At Perpetual Private, we believe the best advice comes from those who understand you.

So, whether you're retired or retiring and whatever your situation – sudden inherited wealth, the sale of a business or the culmination of long, hard years focused on professional success – we'll take the time to get to know you before we offer our advice.

And when we do offer advice it will come with qualities that make it even more valuable.

Trust

Established in 1886, Perpetual Private is one of Australia's most respected trustees and wealth managers. Our trustee heritage means we always think in terms of 'fiduciary responsibility' – a legal responsibility that has become part of our culture. It entails always putting you – our client – first.

Investment capability

Our advisers are supported by a dedicated in-house investment team of 18 experts, working across all asset classes. This is one of the largest investment teams of any private wealth management company in Australia.

We extend the depth and breadth of that expertise by constantly assessing, testing and deploying their skills, so that the team can identify and continue to employ best practice investment managers for inclusion in our clients' portfolios.

Strategy

All the technical, quantitative and qualitative investment expertise in the world is no use if it's not deployed to meet your exact needs. Whilst we pride ourselves on the quality of our investment strategies, it's our advisers' ability to tailor them to your needs that makes all the difference.

Time

A heritage of over 130 years makes us an advice firm that thinks in terms of generations, not years. Perpetual Private has several clients we've served across five generations.

So while we're constantly checking in with you to make sure your changing needs are met and that your investments are performing, we also build relationships, portfolios and strategies that can last for decades.

We're here to help you – not just to grow your wealth – but to create a better future for you and the people you care about.

To take the first step, contact us on 1800 631 681 or email: perpetual.private@perpetual.com.au
Visit perpetual.com.au/advice to learn more

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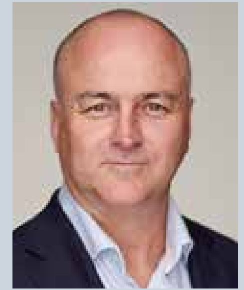

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Trust is earned.