Perennial Value Wealth Defender
Australian Shares Trust

Finally, a share fund with an airbag

The Trust targets outperformance of the Australian share market while using dynamic protection strategies and cash to cushion the impact of larger market falls.

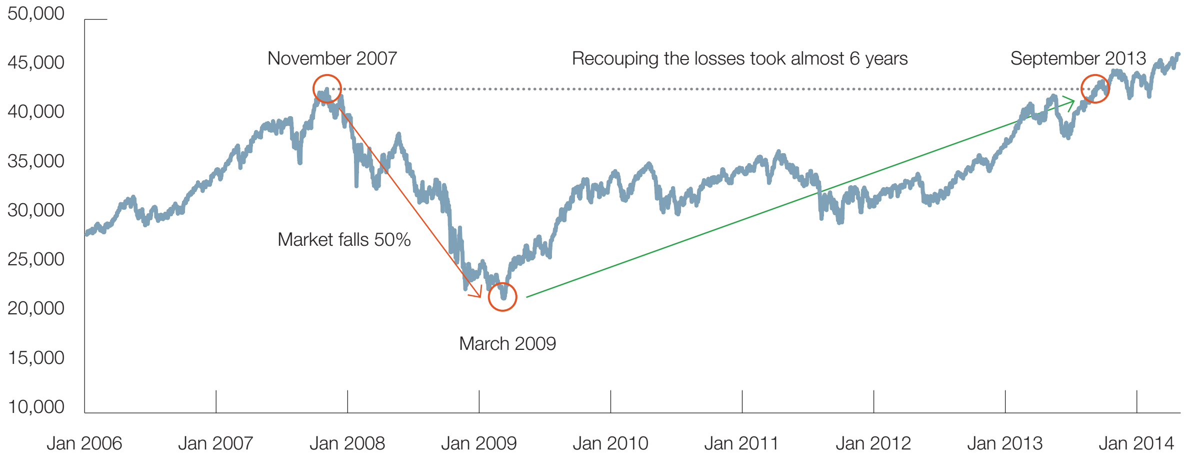
May 2015

The investor dilemma – seeking long term equity returns without all the downside

Equity investors face a constant dilemma: how can I achieve the long term returns that equities can provide, without the capital loss that accompanies market downturns? This question has become particularly pertinent following the GFC and its dramatic impact on share markets. The Australian equity market lost 50% of its value between the peak in November 2007 and March 2009 when the market bottomed, as shown in Chart 1 below.

Chart 1. Impact of GFC on Australian equities

S&P/ASX 200 Accumulation Index



Source: Perennial Value

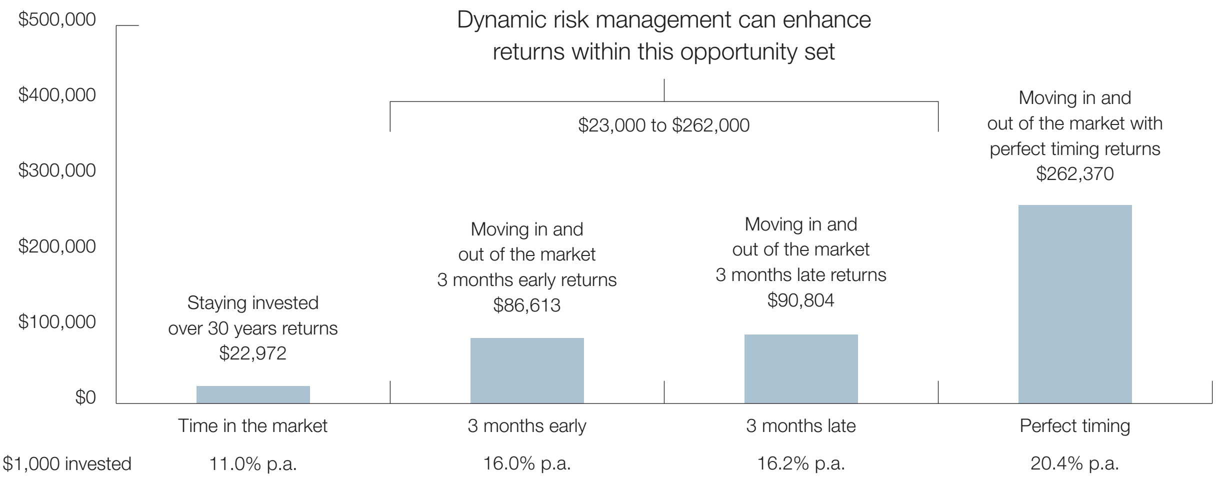
"Ouch, that hurt!"

Some of us are still feeling the pain. Numerous studies have shown that the pain of losing money is greater than the joy of making it. But emotions aside, the loss of capital is a serious matter. It took almost six (long) years for the market to return to its previous high on an accumulation basis.

Some investors believe that timing is the solution to protecting their capital. “I will just pull my money out of shares and put it into cash, then put it back into shares when the market turns”, right?

Wrong. Perfect timing is practically impossible to achieve without the benefit of hindsight. Chart 2 below shows the impact that timing can have on returns.

Chart 2. $1,000 invested over 30 years



Time period: 30 years (1982 – 2012)

Source: Perennial Value. Based on S&P/ASX All Ordinaries Accumulation Index return.
Assumptions: 1. Does not include tax free threshold. 2. Assumes highest marginal tax rate including Medicare levy (46.5%). 3. CGT Free Asset does not apply. 4. Assumes 50% CGT discount method. 5. No CGT in periods where funds were invested in cash. Only Individual tax applies (46.5%). 6. Assumes cash rate of 5.0%. 7. Losses are not taxed but carried forward. 8. Interest is not earned if prior period was a loss.

An investment of $1,000 in the share market over the last 30 years would have grown to be worth almost $23,000 (after tax at the highest marginal rate) as shown above. The bar on the right shows that with perfect hindsight, moving in and out of the market at exactly the right time (which of course is all but impossible to do) would have produced more than $260,000; over 10 times the amount achieved by just staying invested in the market. Realistically, the numbers for perfect hindsight are unachievable. What we can learn from the above is that the market provides significant opportunity to improve our long term returns if we as investors can better manage the risk of losing capital during periods of significant market downturn.

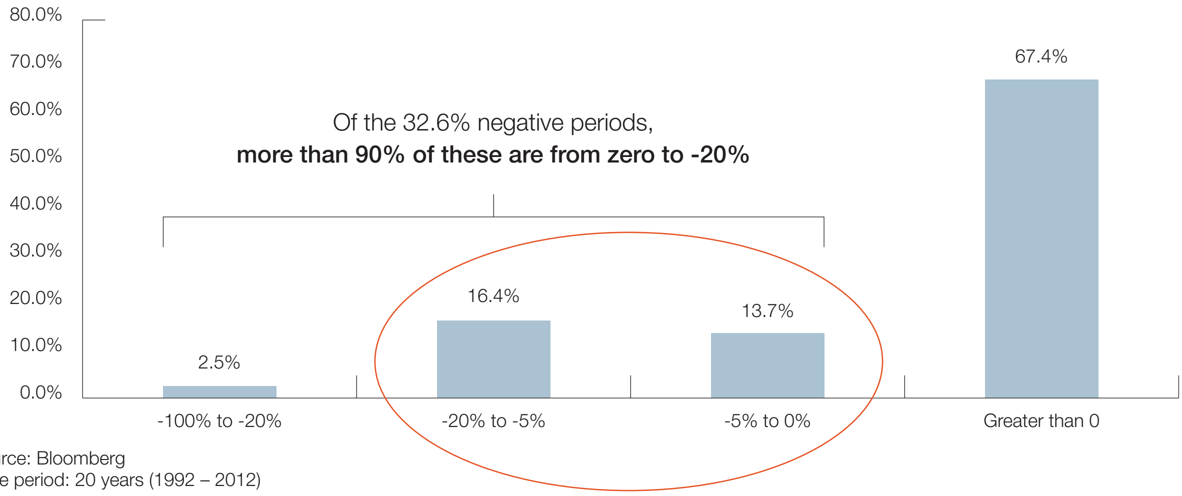
The important lesson here is that timing affects your market participation, and you need to maintain good market participation in order to maximise future returns. In this example, the opportunity set that arises by better managing the capital risk of your portfolio lies between $23,000 and $262,000. It is within this opportunity set that dynamic protection can help enhance returns.

While most investors appreciate the impact of the loss of capital, they tend to overlook the secondary impact; they now earn future returns on a reduced amount of capital. Over time this can have a significant impact on investment outcomes.

Protecting the downside… efficiently

Managing the downside in equity portfolios can be the difference between staying in front, or falling behind, perhaps forever. Perennial Value has developed a risk management strategy that allows investors to benefit from the superior long term return of shares, while having a dynamic protection strategy in place to help reduce the impact of market drawdowns. To do this we focus on the **most likely** loss range of a portfolio. To determine the most likely loss range, in Chart 3 below we look at six monthly Australian equity returns over a 20 year period. Approximately two thirds of returns are positive and almost one third of the returns are negative. Importantly, of these negative returns, 90% fall between zero and -20%.

Chart 3. Frequency and magnitude of negative equity market returns
S&P/ASX 200 Index – 6 monthly rolling returns

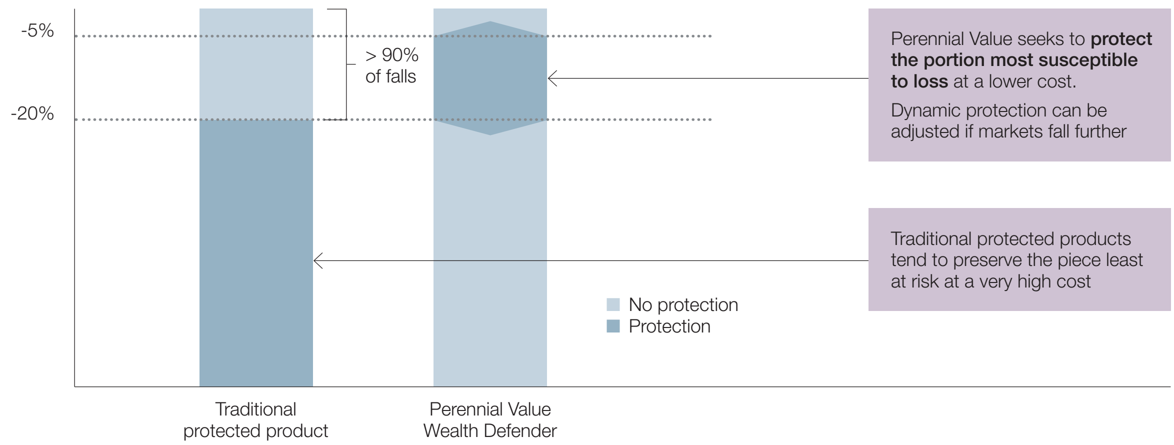


Source: Bloomberg
Time period: 20 years (1992 – 2012)

It makes sense to focus on the capital losses that are most likely to occur. The diagram below shows how Perennial Value's dynamic protection differs significantly in its approach to protection versus many other protected products. Traditional protected products tend to preserve the portion of the portfolio down to a zero return, sometimes at a very high cost. If you think about this in practical terms, this is the portion least at risk. For example, it is hard to imagine that 100% of the shares in the S&P/ASX 200 suddenly all become worthless overnight. Furthermore, traditional protected products can end up cashing out in a major market correction, and inevitably when the market does recover, the investor does not get to participate in the upside.

Perennial Value's unique approach seeks to initially protect the piece **most susceptible to loss**, at a lower cost, as shown in Chart 4 below. As markets fall, Perennial Value manages the dynamic protection and/or increases cash to protect investor capital.

Chart 4. Protection where it matters most



Note: Perennial Value will employ dynamic protection strategies meaning the level and type of strategy will vary at Perennial Value's discretion.

The solution:
Perennial Value Wealth Defender Australian Shares Trust

The Perennial Value Wealth Defender Australian Shares Trust (the Trust) targets outperformance of the Australian share market by investing in a diversified portfolio of Australian shares, and has strategies in place to cost effectively and dynamically cushion the portfolio from major market falls.

Chart 5 below shows conceptually how dynamic protection can help improve returns by focusing on one of the most likely loss ranges, in this case market falls in the range of 5 to 20%.

Chart 5. The impact of dynamic protection on returns

Source: Perennial Value. For illustrative purposes only. The protection strategy in place may not protect the portfolio to the same extent.

By maintaining market participation, and having in place protection strategies that will provide a pay off if the market falls by a specified percentage, capital can be better preserved in the long run. The additional benefit of dynamic protection is that by reducing the impact of falls in your equity investments, you have a higher level from which your capital can grow, all thanks to the effects of compounding. High school economics taught us that compounding is a wonderful phenomenon. If capital appreciates over time, money grows exponentially. In the above example, the blue line shows that over time, your investment could be worth significantly more than what would otherwise have been achieved by the market, thanks to dynamic protection strategies. As can be seen in the chart, the portfolio will still have some volatility in its returns, however overall the dips are expected to be shallower (thanks to protection strategies), and the peaks higher (thanks to compounding), relative to the market.

At Perennial Value, we believe we have moved the goalposts by combining our mainstream long-only Australian equities capability with dynamic protection strategies. By doing this, we have created an investment capability that seeks to limit the drawdown in equity markets while retaining the ability to capture the full upside that equity markets generate over time.

Process overview

The Trust invests in a portfolio of long only positions in listed (or soon to be listed) large and small cap Australian shares using a bottom up, value-style investment process and utilises a range of asset allocation and derivative strategies to cushion the impact of market falls. From time to time, the Trust may hold investments in securities and derivatives in offshore markets. The diagram below outlines the investment process.

Stock Selection
35 to 100 stocks
Large caps & small caps

Reflection of holdings in Perennial Value's large and small cap portfolios

Dynamic protection

– Evaluate equity market for expected return and risk
– Analyse cost/benefit of insurance/protection strategies
– Adjust asset allocation: large caps versus small caps versus cash
– Implement/adjust protection strategies

Constantly monitor and adjust asset allocation and dynamic protection strategies accordingly

Perennial Value invests in companies it believes have sustainable operations and whose share prices offer good value. The cornerstone of this approach is a strong emphasis on company research. The aim is to develop a detailed understanding of each company before committing investors' funds.

The process aims to ensure that the Trust's investment decisions are focused on buying stocks offering good value and avoiding stocks offering poor value.

The Trust is permitted to hold between 35 and 100 stocks. Small capitalisation stocks are permitted to a maximum of 25% of the portfolio.

Benefits of investing

- The Trust provides investors with the return profile of Australian shares, with reduced capital risk through the use of specialist risk management and dynamic protection strategies.
- The Trust's access to dynamic protection strategies, at wholesale prices which are typically only available to institutional investors, results in a more cost efficient way of gaining downside protection.
- The Trust benefits from Perennial Value's large and highly experienced investment team of 14 investment professionals. The team has exhibited significant stability which has been evidenced by low staff turnover.
- Investors can benefit from Perennial Value's proven long term investment process spanning 14 years. The large and small cap investment processes are based upon fundamental company research undertaken by the investment team in order to identify sustainable businesses that offer good value.
- Perennial Value has a boutique business structure whereby the majority of staff own equity in the business. Staff are also investors in Perennial Value's products and we believe that this leads to a clearer alignment of interests between clients and investment managers, and can provide a better outcome for clients.

The Trust's place in a diversified portfolio

The Trust is suited to those investors:

- Wanting to maximise the opportunity set in outperforming the S&P/ASX 300 Accumulation Index
- Wary of share market risk to capital (i.e. most investors)
- Who are accumulators
- Who are close to retirement
- In retirement with pension and longevity liabilities
- Seeking the tax-effective yield of Australian shares, with reduced capital risk

The Trust targets outperformance of the S&P/ASX 300 Accumulation Index, therefore we see the Trust as a viable option within a client's Australian equities allocation.

Trust snapshot	
Suggested investment time horizon	Five years
Unit Pricing	Daily
Income distribution	Half yearly
Investment management fee	0.98% p.a.
Performance fee	15% on net returns over S&P/ASX 300 Accumulation Index. Performance fee paid monthly only if: – Returns are positive – The Trust has outperformed the benchmark after management fees for the month – Any past underperformance has been recovered
Buy/sell spread	0.30%/0.30%
Minimum investment amount	$25,000
Minimum additional investment amount	$5,000
Risk profile	High
Inception date	30 May 2014

Portfolio Management Team

John Murray
Managing Director
of Perennial Value
Perennial Value: 14 years
Industry: 29 years

Dan Bosscher
Portfolio Manager
Perennial Value: 1 year
Industry: 18 years

Grant Oshry
Senior Small Cap Portfolio
Manager/ Analyst
Perennial Value: 10 years
Industry: 15 years

Andrew Smith
Small Cap Portfolio
Manager/ Analyst
Perennial Value: 5 years
Industry: 13 years

John Murray, Dan Bosscher, Grant Oshry and Andrew Smith are the portfolio managers responsible for the investment decisions of the Trust. Each of the portfolio managers has stock selection responsibilities within the Trust. Dan Bosscher is the dedicated portfolio manager responsible for the Trust and its dynamic protection strategies.

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For up to date information of the Trust, including the latest performance and asset allocations, please visit **www.perennial.net.au/wealthdefender**

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