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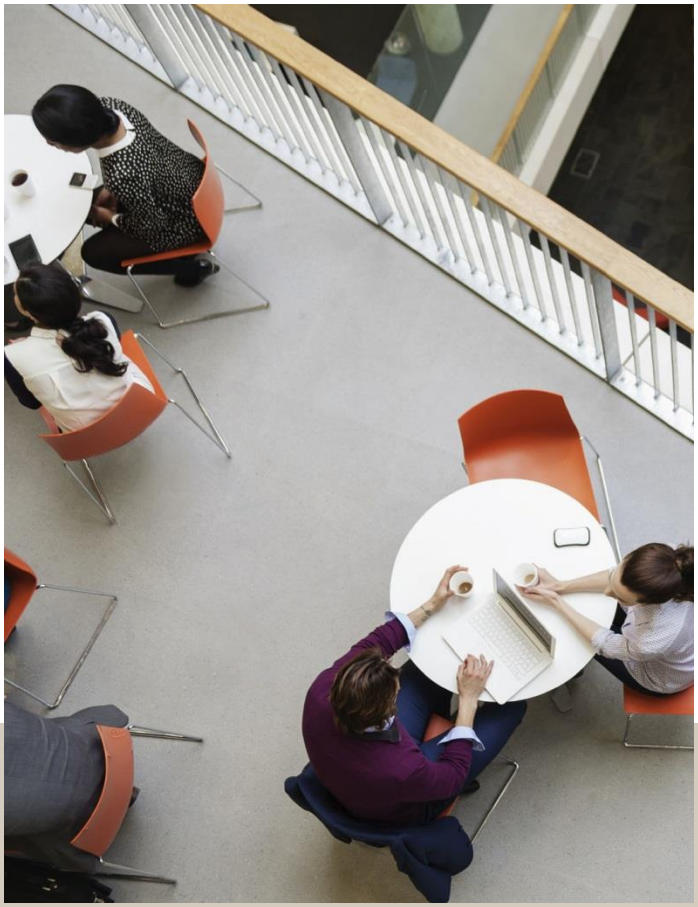

# UNDERSTANDING **INVESTMENT AND RISK**

## A GUIDE FOR CLIENTS

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# INTRODUCTION AND PURPOSE OF THE GUIDE

‘Understanding Investment and Risk’ has been developed to provide background information explaining our method for constructing investment portfolios, providing explanations of key investment concepts and informing you on risk and how we intend to manage it.

## Definitions

Risk Tolerance

Risk tolerance is the degree of variability in investment returns that an investor is willing to withstand. It is the measure of how emotionally comfortable a person is with taking financial risk. For example, how much a person is willing for their portfolio to diminish for a chance to make bigger returns.

Risk Capacity

Risk capacity, unlike tolerance, is the amount of risk that an investor "must" take in order to reach financial goals. The rate of return necessary to reach these goals can be estimated by examining time frames and income requirements. Then the rate of return information can be used to help decide upon the types of investments to engage in and the level of risk to take on.

Risk Profile

This is the agreed level of risk which an investor is willing to accept after taking both risk tolerance and risk capacity into account.

## The Process

‘Risk Profiling’ is a term given to the process where you explore your financial capacity and willingness to accept risk and then adopt planning and investment strategies to match this with the amount you need to save to meet your goals. Historically, the main focus of Risk Profiling has been to better determine your comfort with different levels of volatility (Risk) and then a portfolio of assets is created to match this.

We believe a more evolved approach is to understand your Life Plan with regards to your financial needs and objectives (your ‘financial goals’) and then use this to create an appropriate financial strategy. Our process is to ensure you understand the following concepts which will help you become empowered to make decisions on the level of risk you need to adopt to achieve your goals.

- Uncover the goals that make up your Life Plan, estimate the return needed for you to achieve this and determine what level of risk you can take.
- Explain key investment concepts to ensure you have a thorough understanding of the risks of investing.
- Determine the level of risk needed to achieve this Life Plan and assess how this fits with your comfort levels / tolerance.
- Consider the various risks that could prevent this strategy coming to fruition.


## CONSIDER YOUR FINANCIAL GOALS

To help you choose an appropriate manner to invest your assets, our first step is to understand where you are now and where you want to go. We do this by considering the time frame for each goal and the following needs and objectives:

- your financial goals,
- your income needs now and/or in the future, such as in retirement,
- any other lump sums you may need to access in the future to meet your short term goals, and
- how much you need to accumulate in savings either within the superannuation environment or outside of super for each goal.

In this sense, all your goals form a future obligation on the amount you have saved. Some examples of these goals would be to have sufficient cash to cover your cost of living, paying debt or setting up a charitable foundation.

Timeframes are important as we need to set aside adequate money for short term goals so that these assets can be accessed easily and not be overly subject to short term fluctuations in value. This could mean that you are less exposed to significant market risks for this portion of your portfolio. The remainder of your assets can then be invested in more growth oriented assets that generally require a longer investment timeframe. As well a building real wealth, this also helps to protect the value of your funds against the effect of inflation.

Once we know what your goals are, we use this information to assess the target return that is needed to fund your Life Plan. As risks to your Life Plan do not happen in an even or consistent manner throughout your investment lifecycle, we may need to adjust this target return so we can manage risk effectively at different times.

### The importance of time frames

As well as understanding how much you need to accumulate to achieve each of your goals, it is also critical that we know when you want to achieve these goals.

Annual returns from growth assets (such as shares and property) can fluctuate significantly in value over a short time frame. However, over the longer term the fluctuations may be smoothed. Our process is to set aside funds to meet your short term goals in secure investments that are not subject to wide market fluctuations so that you have peace of mind knowing that the money will be there when you need it. For the remaining assets that you do not plan to access in the short term (under 7 years), you may be able to take a higher level of risk by investing in areas that will provide more growth.

## HOW MUCH RISK ARE YOU ABLE TO TAKE?

Once we have considered how much risk you need to take to meet the objectives of your Life Plan, we need to understand how much risk you are able to take – both from an emotional sense and a practical sense. This assessment must focus on two key areas:

- Risk tolerance – how you emotionally withstand risk i.e. do you have difficulty sleeping at night when your investments are subjected to risk?
- Risk capacity – your financial capacity to take on risk i.e. can you afford the risk or will your financial security be impacted if markets drop?

Risk tolerance relates to the level of risk you can emotionally handle. We know this can be influenced by recent experience with investments and markets. For example if investment markets have had large increases, then people are typically more comfortable with taking risks. Conversely, if markets have recently been performing poorly, clients are more risk averse or unwilling to take on risk. This can lead people to make decisions based on their recent past experiences rather than their Life Plans or future expectations of markets. We see our role as making sure you hold your nerve during these times.

Your financial capacity to take on risk is something that we can calculate. This risk is impacted by the timing and amount of cash you need from your portfolio and also your ability to financially recover from any shortfall. When we calculate this, we need to consider both the amount of money that we expect to come into your portfolio and the time you have to recover from market down turns. If you have limited ability to 'top up' your portfolio, for example if you have already retired, then your risk capacity is typically lower.

## TYPES OF RISK TO YOUR LIFE PLAN AND HOW TO HELP MANAGE IT

It is impossible to avoid risk entirely and risk is not necessarily a bad thing. You are taking some form of risk no matter how you invest. Taking appropriate and calculated risks should result in higher returns over time provided they are matched to your requirements. This could be achieved by taking on market risk which means exposing your investments to growth assets like equities (shares) or property.

Alternatively, by accepting shortfall risk - which means that your portfolio is invested in more secure assets like Cash and Bonds, your investments are less likely to keep pace with inflation and therefore may not grow large enough to achieve your objectives. Our goal is to help you manage your investments to a level of risk you are comfortable accepting, while still achieving your goals and objectives over your chosen time frame.

We know that to achieve a higher return, we typically need to select investments that are growth oriented and these are more likely to be more volatile such as shares and property. Generally, we think of market risk as short-term in nature and shortfall risk as a longer-term issue. The key is for us to help you balance these two competing risks given your unique circumstances, goals, and objectives.

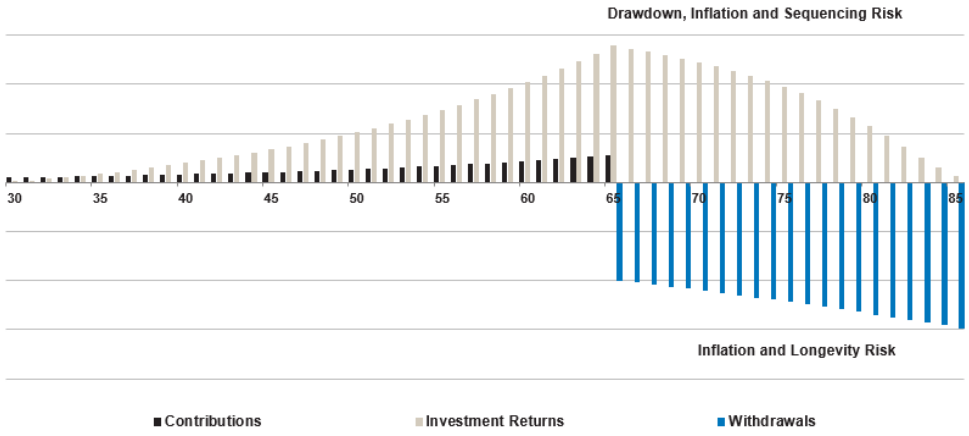
Some other risks that are important to consider are described below and shown in the following diagram:

- Funding Risk – you make lower contributions to your portfolio than you had planned.
- Shortfall Risk – your actual return is less than your required return.
- Liquidity Risk – you are unable to access your investments when you need them. (To reduce the impact of this risk, it is important to have shorter term financial needs catered for by cash and other liquid investments)
- Longevity Risk – you will live longer than you expected.
- Inflation Risk – increased inflation will erode your capital and means your money will run out faster.
- Sequencing Risk – you receive lower or negative returns early in a period when withdrawals are made from the underlying investments (see further explanation below).

The following chart shows how each of these risks relate to each other. Draw down risk happens after retirement as you start taking money from your portfolio. It can occur if you deduct more money from your portfolio than you had anticipated. Funding risk occurs when you make less contributions than you anticipated. This means you don't accumulate what you had planned.

Both inflation risk and sequencing risk can occur at all times, however, the impact of those risks is far more prominent post retirement. Longevity risk relates to the risk of living longer than you had anticipated.

Chart 1




Most people feel that reducing risk in a portfolio becomes more important the closer they get to the end of their life. In actual fact, there is a much larger impact on your total long term wealth if there is a large market downturn in the early part of your retirement or just before. This is because your account balance is at its peak in dollar terms. A large fall in asset values at this point will have the biggest negative influence. In addition, if you have just retired, you will have a reduced ability to contribute cash back into the portfolio. This is compounded by the fact that you have a longer period of time for your capital to last as well as a reduced ability to add to the balance. This is what we mean by Sequencing Risk.

## UNDERSTANDING RISK IN A PORTFOLIO

Some of our clients choose not to undertake a Life Plan as they want to engage us to manage their investments only. However, at a minimum we need to determine what level of risk is appropriate for these investment funds. To do this we will refer to the key investment concepts and needs of those investment funds.

To help you understand some of the risks in a portfolio we have provided the tables below which are designed to provide you with a guide as to the expected return and risk that you might expect to achieve over the long term. You will be able to see the historical experience of different investing styles in the portfolios. One way this table can be used is to match your target or desired return with a corresponding portfolio in the table. Then, you can note the largest drawdowns that have happened historically and look at the average volatility to begin to understand how you may feel at times throughout the term of your investment.

Note that this is based on historical information and there is no certainty that these investments will perform in this manner in the future.

### Selecting a suitable Risk Profile

Once you are familiar with the concept of risk and return and how it works, and we understand your comfort levels and financial goals it becomes easier to create an investment strategy to match your needs. This can be referred to as your 'risk profile'.

Understanding this risk profile helps us to construct an investment portfolio that suits your individual requirements. Your Risk Profile is based on a range of factors, but largely should reflect your level of comfort with risk in your portfolio.

Typically, (but not always), the higher the risk an investor may be willing to accept, the higher return they should expect to receive for taking on that extra risk.

A widely accepted definition of risk (or volatility) is the difference between the returns you expect to receive and the returns you actually receive – this can be both positive or negative. The greater the variation in the investment value, the more volatile the investment is seen to be. This means the investor needs to take a longer-term view (investment timeframe). The most important item to be comfortable accepting is the volatility number, which is a way of measuring the degree of fluctuation in yearly returns.

There are five Risk Profiles typically used in the industry – Conservative, Moderately Conservative, Balanced, Growth and High Growth. Each of these will have different Asset Allocation mix.

A typical asset allocation is outlined in the table below. This provides you with a guide as to how your capital might be allocated across a range of different growth and defensive assets.

In a traditional portfolio, volatility is typically managed by spreading a range of investments over the asset classes. The percentage allocated to each of the different types of assets determines the expected level of risk the portfolio is exposed to (and therefore the level of growth you would expect).

- Shares and property – to provide growth, and
- Cash and fixed interest – to provide stability.

**Table 1**

| | Conservative | Moderately Conservative | Balanced | Growth | High Growth |
|---|---|---|---|---|---|
| Cash | 25% | 10% | 5% | 2% | 0% |
| Domestic Fixed Interest | 23% | 22% | 15% | 8% | 0% |
| International Fixed Interest | 22% | 21% | 14% | 7% | 0% |
| Property and Infrastructure | 4% | 8% | 11% | 12% | 12% |
| Australian Shares | 7% | 13% | 19% | 24% | 31% |
| International Shares | 7% | 14% | 19% | 28% | 38% |
| Alternatives | 12% | 12% | 17% | 19% | 19% |
| Total | 100% | 100% | 100% | 100% | 100% |

The information shown here is not necessarily the asset allocation recommended by your adviser. It is shown to highlight the way in which a typical diversified portfolio might be constructed.

Below we highlight the return and risk that could typically be expected over the long term across each of these portfolios, as well as the percentage of the portfolio allocated toward growth and defensive assets and the estimated proportion of return attributable to income and growth. Whilst this time period shows the type of return or risk that could be expected, you should be aware that this is not a guarantee and should be used as a guide only.

Please see below under Forecast Returns where it sets out the information used to arrive at these numbers.

**Table 2**

| | Conservative | Moderately Conservative | Balanced | Growth | High Growth |
|---|---|---|---|---|---|
| Estimated long-term returns | 3.2% | 4.1% | 5.1% | 6.1% | 7.1% |
| Estimated long term volatility | 2.3% | 3.9% | 5.4% | 7.0% | 8.8% |
| Minimum Investment Timeframe | 2 to 3 years | 3 to 4 years | 5 years or more | 6 years or more | 7 years or more |

All returns are estimated before fees and taxes

Table 3

| | Conservative | Moderately Conservative | Balanced | Growth | High Growth |
|---|---|---|---|---|---|
| Growth Assets | 20% | 40% | 60% | 80% | 100% |
| Defensive Assets | 80% | 60% | 40% | 20% | 0% |

Table 4

| | Conservative | Moderately Conservative | Balanced | Growth | High Growth |
|---|---|---|---|---|---|
| Proportion of return as Income | 75% | 65% | 60% | 50% | 45% |
| Proportion of return as Growth | 25% | 35% | 40% | 50% | 55% |

The table below also provides the actual historical return that has been achieved over the long term and gives you a guide as to what risk has been over this period. We also highlight the worst negative return over the period.

Table 5

| | Conservative | Moderately Conservative | Balanced | Growth | High Growth |
|---|---|---|---|---|---|
| Average Return | 5.2% | 5.8% | 6.5% | 6.8% | 7.2% |
| Average Volatility | 2.6% | 4.0% | 6.0% | 7.6% | 9.6% |
| Largest decline * | -5.9% | -15.0% | -25.4% | -33.3% | -41.6% |
| Months to Recover | 5 | 18 | 41 | 47 | 54 |

* The largest decline can be described as the largest fall in returns over the period covered for the risk profile. It is the biggest peak to trough fall in the portfolio's value over that period.

Data used within the tables and charts below is drawn from the Morningstar Multi-Asset Indices from Oct 1991 to June 2020.

## How is risk measured?

Risk, when applied to financial investment, is defined as the difference between expected returns and the return achieved. This is the volatility of the return.

Risk can be quantified by standard deviation. This measures the amount of variation from the average expected return. The larger the standard deviation, the greater the volatility experienced.

## What level of risk is acceptable?

The first step of investing is to determine a risk profile for the investor. This is a long-standing practice of classifying an investor based on their risk acceptance level into one of the five standard risk profile categories outlined above.

Once the risk profile has been determined, this then leads to a portfolio being selected which contains a pre-determined level of growth and defensive assets. This allocation is further broken down into specific assets and / or securities, for example the portion into Australian and international shares.

This approach produces a generic split between growth and defensive assets, but does not necessarily link to the risk an investor is comfortable with. It is often termed as a traditional or Strategic Asset Allocation (SAA) approach to identifying risk and the resulting investment portfolio.

An issue with this approach is that the risk in traditional SAA portfolios will vary with market conditions. More specifically the actual risk an investor is willing to take may not align with the portfolio selected. It should be noted that many investors have a greater acceptance of risk on the upside than they do on the downside, and a SAA portfolio is unable to manage a portfolio with consideration of this human trait.

An alternative approach to SAA is a Risk Targeted Approach. The Risk Targeted Approach seeks to cap volatility, and this in turn aims to provide greater market downside protection. It is interesting to contrast the SAA approach, which results in the market determining what the return and risk (or volatility) experience is for the investor, with the Risk Targeted Approach. The Risk Targeted Approach uses a “Risk Budget” or “Risk Target” as the basis of building and managing a portfolio of investment assets, which have both return and risk (volatility) characteristics, and which when combined are within the Risk Target.

There is no universal standard on how to assess an investors risk profile or appetite for risk. This is because there are many different types of risks, different investor experiences and awareness of risk, and also the unknown of how an investor will react or behave in different financial situations. Education and communication, including looking at trade-offs or competing priorities, is the best method to assess and document a risk profile. Once a risk profile is determined it is possible to select either a traditional SAA portfolio which aligns with the risk profile or an equivalent Risk or Volatility Target if using a Risk Targeted portfolio. Note that it is not possible to perfectly align a risk profile to a particular style of investment approach or portfolio, as portfolio characteristics will vary with market movements and an investor may also experience different feelings about market risk over time and in specific situations. Fitzpatricks has determined an equivalent “Risk Target” for each traditional risk profile as outlined below.

The Risk Target is the approximate volatility for each traditional risk profile. The Risk Target or volatility assists to explain the possible range of returns that may be achieved. The Risk Target enables investment portfolios to be built and managed which align with a specific risk profile.

| Risk Profile | Risk Target |
|---|---|
| Conservative | 3% |
| Moderately Conservative | 5% |
| Balanced | 7% |
| Growth | 9% |
| High Growth | 11% |

Please note the volatility risk targets are long term targets and portfolios may in fact be higher or lower than the target at any point in time. It is likely that in a bull or rising equity market, that a traditional SAA portfolio will produce better returns than a “Risk Targeted” portfolio. Conversely in a bear or falling equity market, a “Risk Targeted” portfolio is likely to have better relative performance than a traditional SAA portfolio.

Another point to note is that not all of the portfolios outlined above may be available in a particular investment structure or product, hence often products have to be combined to achieve the equivalent of these risk objectives.

It is not as simple as stating a SAA portfolio approach is superior or inferior to a Risk Targeted portfolio approach. A Risk Target objective may be very important to one investor but potentially less relevant to another. A key point is to understand risk and ensure that the focus is not just on return. Furthermore, there are different types of risks as noted above, and also the time period we measure risk and return over should be relevant to the timeframe of our needs and objectives.

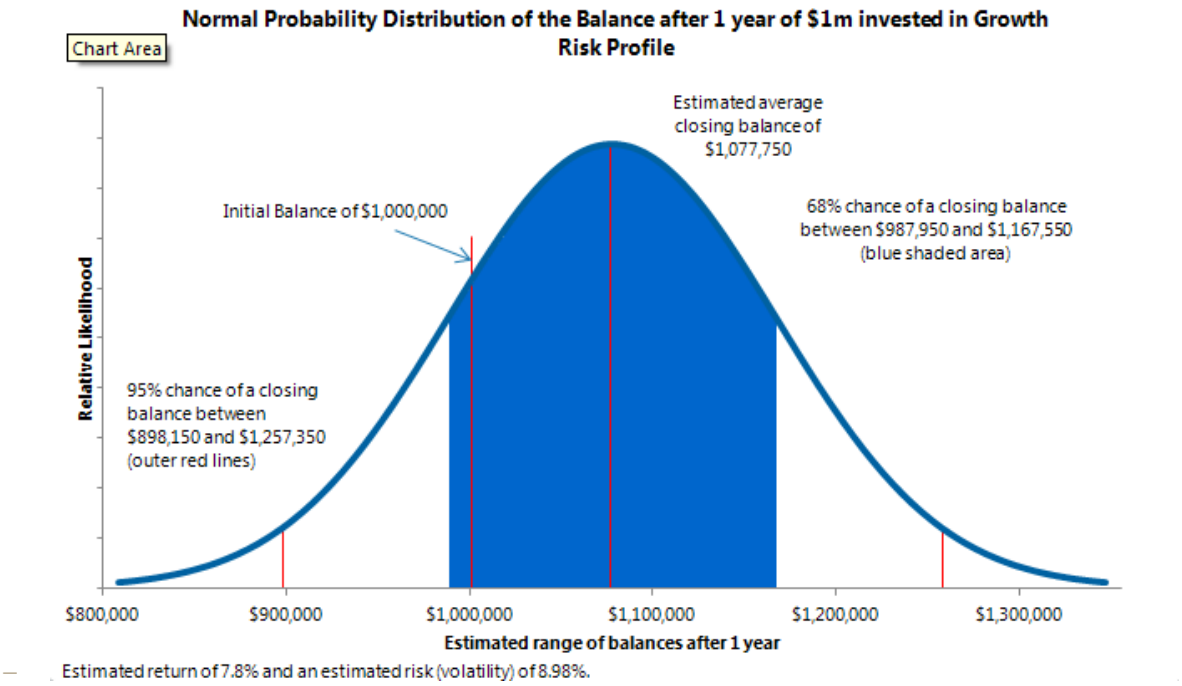
## Example: Growth Risk Profile

We feel that using a risk target percentage is more meaningful as the potential range of returns can be calculated by multiplying the risk target by the amount invested. This risk target is measured by a statistical measure called ‘standard deviation’.

The chart below shows an example portfolio. The opening balance of the portfolio is $1,000,000, invested with an estimated average return of 7.8% per annum and a risk target (or standard deviation) of 8.98% per annum. Thus the expected return of the portfolio over one year is $78,000, leading to an expected portfolio value after one year of $1,078,000. To calculate the ‘standard deviation’ we multiply the risk target of 8.98% by $1,000,000, which equals $89,800.

This means for every 1 standard deviation there is a risk of +/- $89,800 to the expected return of the investment. The chart below shows:

- 68% of the time returns are expected to be within 1 standard deviation of the expected return (shaded section of the chart) i.e. between $987,950 and $1,167,550
- 95% of the time we expect returns to be within 2 standard deviations of the expected return i.e. between $898,150 and $1,257,350.




Standard deviation is a mathematical equation to quantify risk based on the historical returns achieved from investment assets, markets and investment portfolios. It is a measure of the statistical probability of the range of returns.

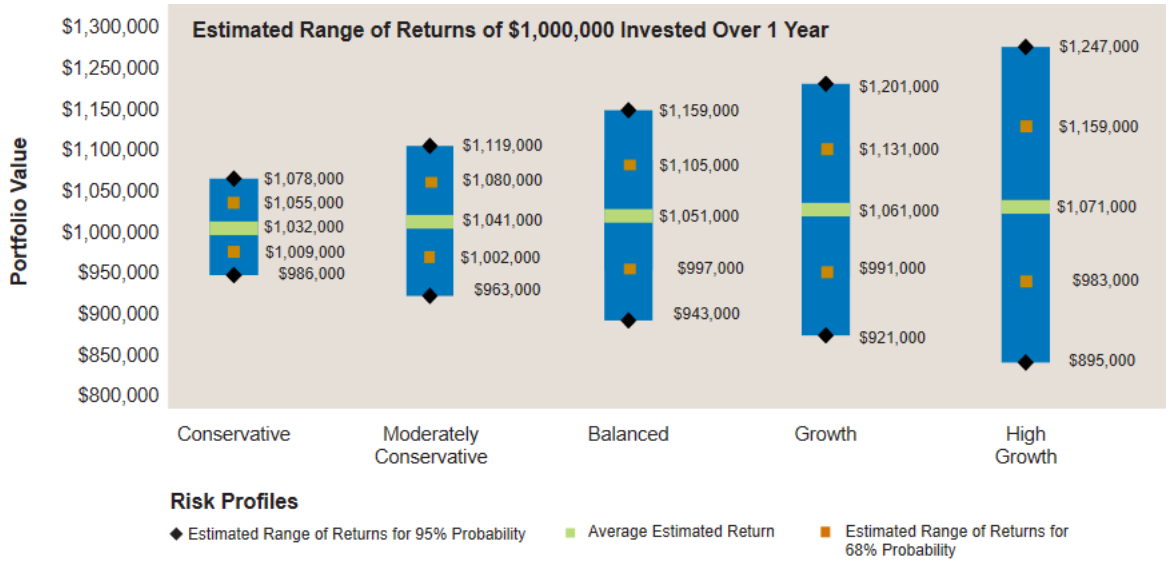
The graph shown is an example to illustrate the link between return and volatility (or risk) and the range of outcomes. The input number for estimated return and estimated risk (volatility) are hypothetical and noted for reference to demonstrate the link between these important variables.

With all statistical tools there are limitations to the use of standard deviations, especially when looking for a high degree of certainty. This is because it is based on a 'normal distribution'. A 'normal distribution' presumes the returns are symmetrical i.e. an equal upside and down side surprise and based over an exceptionally long time frame. This "normal distribution" of events does not always eventuate as statistical mathematical modelling would suggest it should occur, hence some degree of caution is suggested so as to not over rely on these concepts.

## UNDERSTANDING WHAT THE VOLATILITY NUMBER MEANS

To help you visualise the impact of the volatility number, the following chart shows the range of estimated returns based on the various traditional SAA risk profiles in any one year outlined in the table earlier. The profiles on the right with the larger range of returns are the ones that have a higher degree of volatility (i.e. higher risk). As you can see there is a greater chance of a higher return, but also potentially larger negative returns.

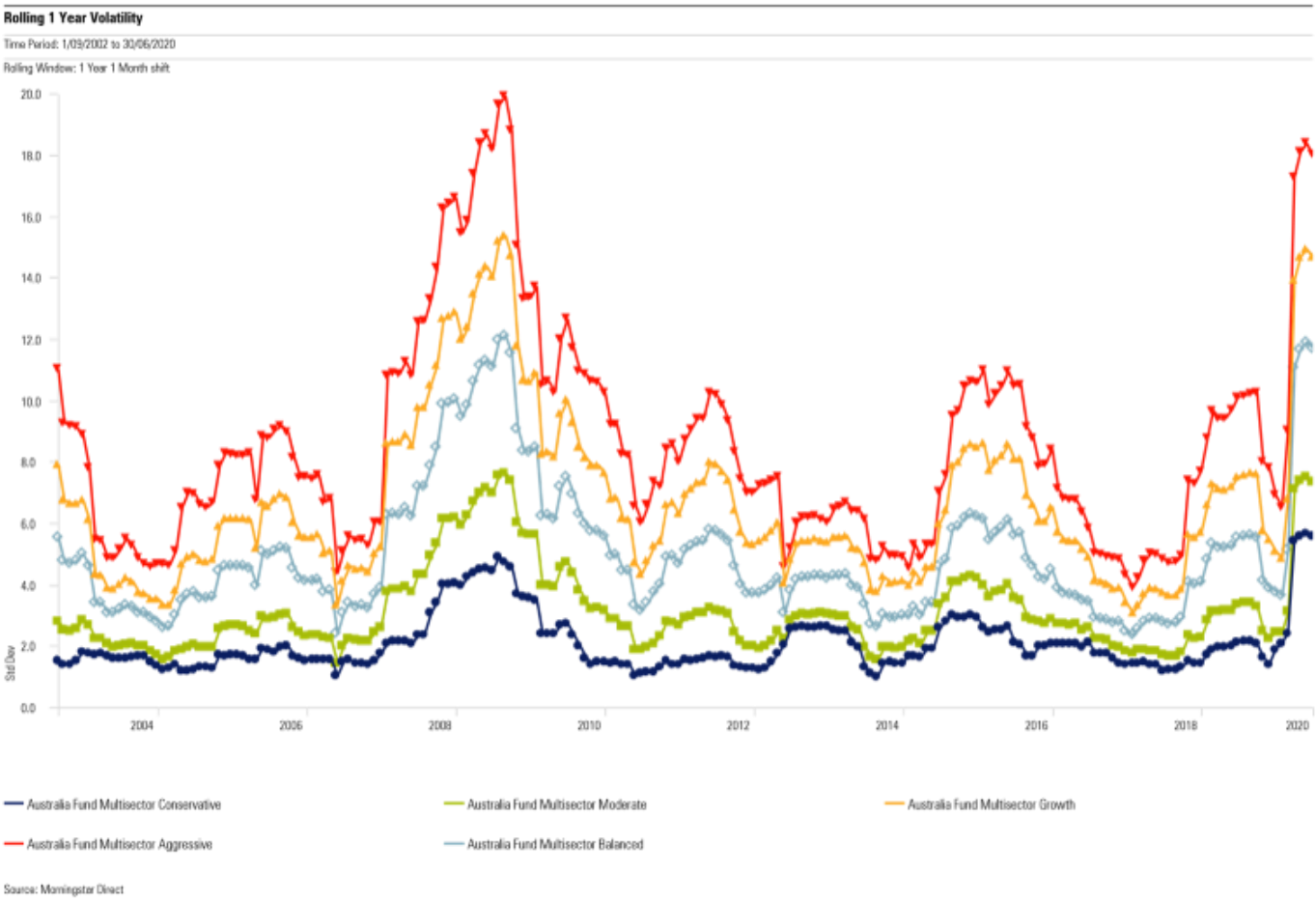
**Chart 2**




Source: Fitzpatricks

## Chart 3 – Illustrating the journey of investors at different return expectations

The following chart shows the degree of fluctuation (or volatility) of returns for some typical multi asset portfolios. Over time, there will be fluctuations in returns, with the portfolios that have a greater percentage of growth assets typically experiencing larger fluctuations compared with lower growth portfolios.



## WHY THE SEQUENCE OF RETURNS IS IMPORTANT

Managing volatility is critical as the timing and magnitude of annual changes to your investment performance can have a material impact on the long-term value of your portfolio, even when average returns are the same.

The example below shows why the sequence of investment returns can be critical to the total return achieved in a portfolio and ultimately, the longevity of your retirement savings. Keeping volatility as consistent as possible is important especially in those parts of the investment lifecycle where sequencing risk is mostly apparent.

**Table 6**

| Scenario 1 | | | | |
|---|---|---|---|---|
| Year | Annual Return | Portfolio Value - with no withdrawal | Withdrawal | Portfolio Value - After Withdrawal |
| | | $ 1,000,000 | | -$ 1,000,000 |
| 1 | 7.50% | $ 1,075,000 | -$ 50,000.00 | $ 1,025,000 |
| 2 | 7.50% | $ 1,155,625 | -$ 50,000.00 | $ 1,051,875 |
| 3 | 7.50% | $ 1,242,297 | -$ 50,000.00 | $ 1,080,766 |
| 4 | 7.50% | $ 1,335,469 | -$ 50,000.00 | $ 1,111,823 |
| 5 | 7.50% | $ 1,435,629 | -$ 50,000.00 | $ 1,145,210 |
| 6 | 7.50% | $ 1,543,302 | -$ 50,000.00 | $ 1,181,101 |
| Total Withdrawals | | | | -$ 300,000.00 |
| Average Return | | | | 7.50% |
| Internal Rate of Return | | | | 7.50% |
| Ending Value | | | | $ 1,181,101 |

| Scenario 2 | | | | |
|---|---|---|---|---|
| Year | Annual Return | Portfolio Value - with no withdrawal | Withdrawal | Portfolio Value - After Withdrawal |
| | | $ 1,000,000 | | -$ 1,000,000 |
| 1 | -10% | $ 900,000 | -$ 50,000.00 | $ 850,000 |
| 2 | -5% | $ 855,000 | -$ 50,000.00 | $ 757,500 |
| 3 | 8% | $ 923,400 | -$ 50,000.00 | $ 768,100 |
| 4 | 10.00% | $ 1,015,740 | -$ 50,000.00 | $ 794,910 |
| 5 | 31% | $ 1,330,619 | -$ 50,000.00 | $ 991,332 |
| 6 | 16.00% | $ 1,543,519 | -$ 50,000.00 | $ 1,099,945 |
| Total Withdrawals | | | | -$ 300,000.00 |
| Average Return | | | | 7.50% |
| Internal Rate of Return | | | | 6.42% |
| Ending Value | | | | $ 1,099,945 |

Source: Fitzpatricks Private Wealth.

The above is a very powerful illustration of the benefits of positive compounding returns. Both scenarios have the same starting portfolio value of $1m. An amount of $50,000 is drawn out of the portfolio each year to meet living costs. The difference is that in Scenario 1 a constant (and low volatility) return of 7.5% every year is achieved, while in Scenario 2 the same simple average return of 7.5% is obtained but with a much greater fluctuation of returns each year.

Over time, even though the average return is the same, Scenario 1 has a greater portfolio value. This example shows how critical the path of returns is and why volatility is a key factor that will impact on your portfolio returns over time. Although there is always the risk that the return might be higher or lower than expected at any time, by managing volatility and smoothing out your returns, it should give you more peace of mind that your wealth has a greater chance of being preserved.

As well as having your investment portfolio managed to reduce volatility, another powerful way to manage the impact of sequencing risk is to use ‘Liquidity Reserving’. This means setting aside funds in a reserve to meet your short term goals rather than investing them in the growth portion of your portfolio. By doing so, it allows your portfolio time to recover in periods of market downturn rather than you being forced to draw money out of your investment funds. If you were to draw money out of your portfolio at this time, there would be an even greater negative impact as there would be a smaller asset base to grow when markets eventually recover. This is another reason why understanding your investment time frames is so important.

## USING DIVERSIFICATION TO MANAGE VOLATILITY

To manage volatility, we focus on making sure your portfolio is well diversified. Typically, investors think diversification means the number of shares they hold in their portfolio. While it is important for investors to be diversified within asset classes by holding many securities, it is also important for investors to be diversified among asset classes that respond differently to economic variables.

In the table below you will see how no asset class is always the top performer. Conversely you will also see how no asset class is consistently the bottom performer. What we can be sure of is that past results are no reflection of what could happen in the future and we need to be prepared for a range of economic outcomes.

**Chart 4**

**Performance Chart**

| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| 78.5% Emerging Markets | 16.9% Emerging Markets | 11.4% Australian Bonds | 32.8% Australian Listed Property | 29.2% International Shares | 26.8% Australian Listed Property | 14.4% Australian Listed Property | 13.2% Australian Listed Property | 37.3% Emerging Markets | 8.6% Direct Property | 27.4% International Shares |
| 37.0% Australian Shares | 17.4% Commodities | 10.7% International Bonds | 20.3% Australian Shares | 27.3% Absolute Return Funds | 13.8% Absolute Return Funds | 13.3% Direct Property | 12.3% Direct Property | 18.7% International Shares | 7.2% Absolute Return Funds | 23.4% Australian Shares |
| 29.0% AUDUSD | 14.0% AUDUSD | 4.7% CASH | 18.2% Emerging Markets | 20.2% Australian Shares | 10.8% International Bonds | 11.7% Absolute Return Funds | 11.8% Australian Shares | 11.8% Australian Shares | 4.5% Australian Bonds | 13.6% Australian Listed Property |
| 25.4% International Shares | 10.4% International Shares | 0.0% AUDUSD | 15.5% International Shares | 8.4% Direct Property | 10.0% International Shares | 3.8% International Bonds | 11.2% Emerging Markets | 9.0% Direct Property | 3.3% Australian Listed Property | 11.2% Emerging Markets |
| 23.5% Commodities | 8.3% International Bonds | -1.1% Direct Property | 8.3% Direct Property | 7.3% Australian Listed Property | 9.8% Australian Bonds | 2.6% Australian Bonds | 9.3% Commodities | 8.4% AUDUSD | 2.7% International Bonds | 11.75% Commodities |
| 9.6% Australian Listed Property | 6.0% Australian Bonds | -1.6% Australian Listed Property | 8.4% International Bonds | 2.7% CASH | 8.5% Direct Property | 2.6% Australian Shares | 8.9% International Shares | 6.4% Australian Listed Property | 1.5% CASH | 9.8% Absolute Return Funds |
| 4.3% International Bonds | 4.4% CASH | -2.5% Absolute Return Funds | 7.7% Australian Bonds | 2.5% International Bonds | 5.6% Australian Shares | 2.1% CASH | 5.1% International Bonds | 3.7% Australian Bonds | -2.8% Australian Shares | 8.1% Direct Property |
| 3.3% CASH | 2.7% Direct Property | -5.3% International Shares | 6.3% Absolute Return Funds | 2.0% Australian Bonds | 2.5% CASH | 2.1% International Shares | 2.9% Australian Bonds | 2.9% International Bonds | -7.5% International Shares | 7.3% Australian Bonds |
| 1.7% Australian Bonds | 1.6% Australian Shares | -8.3% Commodities | 3.7% CASH | -2.6% Emerging Markets | -2.2% Emerging Markets | -11.1% AUDUSD | 2.1% Absolute Return Funds | 1.5% CASH | -9.7% AUDUSD | 6.2% International Bonds |
| -8.1% Absolute Return Funds | -0.7% Australian Listed Property | -10.5% Australian Shares | 1.3% AUDUSD | -5.0% Commodities | -8.5% AUDUSD | -14.9% Emerging Markets | 1.7% CASH | 0.7% Commodities | -12.4% Commodities | 1.2% CASH |
| -15.6% Direct Property | -2.7% Absolute Return Funds | -18.4% Emerging Markets | -3.4% Commodities | -13.8% AUDUSD | -17.9% Commodities | -23.4% Commodities | -0.8% AUDUSD | -2.1% Absolute Return Funds | -14.6% Emerging Markets | -8.5% AUDUSD |

| Key | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| International Bonds | International Shares | Absolute Return Funds | Australian Shares | Australian Listed Property | CASH | Emerging Markets | Australian Bonds | Commodities | Direct Property | AUDUSD |
| Bloomberg Barclays Global Aggregate Government Index (Hedged AUD, TR) | MSCI World ex Australia, (Net in Local Currency) | CSFB Tremont Hedge Fund Index (AUD return) | S&P ASX 200 Accumulation Index | S&P ASX 300 Property Trusts Accumulation Index | RBA Cash Rate | MSCI Emerging Markets Index (net in USD) | Bloomberg AusBond Composite Bond Index – All Maturities (TR) | RJ CRB Core Commodity Index TR (USD) | Morningstar Australian Direct and Unlisted Property Fund Index | AUDUSD |

*Source: Fitzpatricks, IRESS, Bloomberg, Morningstar*

## APPROACHES TO CONSTRUCTING A PORTFOLIO

We acknowledge that there is more than one way to construct portfolios that could be appropriate for you. We have provided here a summary of three methods of allocation that are typically utilised in the investment industry.

## STRATEGIC ASSET ALLOCATION (SAA)

The Strategic Asset Allocation (SAA) approach is the traditional approach to investing. The approach was formed on the back of Modern Portfolio Theory (MPT) which is widely used in the financial industry as a way of maximising investment returns for a given level of risk.

This approach expects an asset's returns to be normally distributed, meaning that each asset is expected to have an equal chance of positive and negative returns and suggests that a weighted combination of assets (which are not perfectly correlated) will help minimise overall portfolio volatility and maximise returns.

The SAA approach is typically implemented via allocating your investment funds to a pre-determined set of assets, according to the risk profile of the investor. As previously mentioned, there are five Risk Profiles typically used in the industry – Conservative, Moderately Conservative, Balanced, Growth and High Growth. Each of these Risk Profiles will allocate money to a portfolio of assets utilising a different Asset Allocation mix.

The SAA approach relies on the assumption that risk is a constant. Therefore, it assumes that assets will display a level of expected return and risk. The SAA approach is available in index (or passive), or active styles, with the former being lower cost. A diversified index approach will generally have full exposure to all traditional markets based on market weight, however there is less ability for the portfolio manager to move away from a particular asset type or security based on their professional judgement. The SAA approach is an available investment option in most larger superannuation products. It is popular for reasons such as availability and ease of access, familiarity, and cost.

## ENHANCED STRATEGIC ASSET ALLOCATION (ESAA)

The Enhanced Strategic Asset Allocation approach is seen as an extension of the Strategic Asset Allocation (SAA) approach where portfolios can be expanded to include non-traditional assets, typically called 'Alternative' assets. 'Alternatives' can be assets that are uncorrelated to traditional asset classes and therefore provide further diversification to portfolios. 'Alternatives' can be broad ranges of investments from investments in commodities and trading, to strategies that focus on global macroeconomic events to derive returns on financial assets. Often alternatives include direct property, infrastructure and high yield bonds.

The Enhanced Strategic Asset Allocation approach can mean more frequent adjustments to the asset mix within the portfolio are made. This is sometimes termed Tactical Asset Allocation (TAA) or Dynamic Asset Allocation (DAA).

The ESAA approach can be considered to be an extension of the SAA approach and is more flexible in its application of investment mixes and the types of investments utilised. Products adopting an ESAA portfolio approach are becoming more common, with costs generally slightly higher than a traditional SAA approach.

## RISK TARGETED APPROACH (RTA)

The Risk Targeted Approach (RTA), also known as an 'Outcome Based' investment approach seeks to allocate assets based on the perceived level of risk, rather than simply return. It also seeks to conserve capital and provide a steady, positive return that compounds over time.

Return consistency is achieved utilising the following approaches:

1. Not being constrained by requirements to invest in sectors regardless of their investment prospects, RTA reduces the constraints to just one; the level of risk that the portfolio is exposed to. It also removes the asset class constraints typical in most portfolios and ensures the portfolio is not over-exposed to any single risk factor.

2. Providing broader diversification by investing beyond traditional asset classes. RTA typically invests in traditional assets such as equities and fixed interest, but also in alternative investments such as infrastructure, commodities, real assets, private markets and “market alpha” strategies. This approach seeks to allocate to investments which are considered strong investment opportunities on a stand-alone basis. It generally uses active asset management in preference to the cheaper passive / index management.

   In times of high market volatility, the portfolio manager will often have quite different asset allocation and security holdings relative to a traditional SAA portfolio, primarily because the portfolio manager does not wish to hold the market universe (as many passive and large active managers tend to do) as the market universe includes holding many “bad” or “overpriced” assets. RTA does not seek to match the market return and is prepared to sacrifice some returns in strongly rising markets to deliver consistency through the broader market cycle.

The Risk Targeted portfolio manager is able to incorporate all available investment instruments, techniques and thinking in targeting the highest return for a given level of risk. This approach is distinctively different to the traditional investment approach which generally includes all asset classes regardless of value. RTA looks to avoid investing in sectors that are considered over-priced or if it appears to not have good prospects at that particular point in time.

The following table is an outline of the key differences of each approach.

## Differences between the SAA, ESAA and RTA approaches

The table below highlights the differences between the SAA, ESAA and RTA approaches:

**Table 7**

| | Strategic Asset Allocation (SAA) | Enhanced Strategic Asset Allocation (ESAA) | Risk Targeted Approach (RTA) |
|---|---|---|---|
| **Overview** | Invests an amount of money in set allocations in each of the traditional asset classes depending on the selected risk profile. | Invests an amount of money in allocations that can be varied from time to time in each of the traditional asset classes and also other non-traditional asset classes (e.g. Alternatives), depending on the selected risk profile. | Invests with a focus on maximising return within an agreed level of overall portfolio risk, with wide ranges of potential investment allocations in each asset class. Usually contains exposure to non-traditional assets for benefits of diversification and volatility / portfolio risk reduction |
| **Investment approach** | Focus on return first. Allocates to assets based on return expectations. | Focus primarily on return first. Allocates to assets based on return expectations with some consideration to risk versus return expectations. | Balances the desire to maximise return while limiting level of risk. Allocates to assets based on risk vs return expectations. |
| **Asset allocation** | Invests in a long term strategic mix of traditional asset classes of equities, cash and fixed interest. Generally, does not materially change the asset mix – i.e. static. | Generally, follows a long term strategic mix of traditional asset classes, however there is some flexibility in changing the asset mix due to changing market conditions. May have a modest allocation to non-traditional asset classes e.g. alternatives, real assets, private markets, etc. | Active in asset allocation. Moves the asset mix based on expected opportunity, risk and valuation. |
| **Diversification** | Diversification of capital across a range of traditional assets. Mandated allocation constraints prevent asset allocation changes. | Diversification of capital across a range of assets, including potentially modest allocations to non-traditional asset classes. Asset allocation ranges are generally more flexible than SAA but still operate to bands around a target weight. | Diversification is based on the return opportunity and the level of perceived risk. Accordingly, the manager will generally include higher allocation to alternative, private markets and real assets, compared with a traditional approach. This results in generally higher costs. |

| | Strategic Asset Allocation (SAA) | Enhanced Strategic Asset Allocation (ESAA) | Risk Targeted Approach (RTA) |
|---|---|---|---|
| **Downside protection** | Does not target downside preservation of capital. | Some focus on downside preservation of capital given asset allocations to diversifying non-traditional asset classes. | Targets downside preservation of capital through diversification of risk across the portfolio as well as the use of specific investments to limit losses. |
| **Volatility Management** | An outcome of asset mix and not the primary objective. | Due to inclusion of some alternative assets, likely lower volatility than SAA. | Operating within a targeted portfolio volatility limit |
| **Relative Pricing** | Lowest | Mid | Highest |

We have also highlighted our views of the Pros and Cons of each approach.

| | PROS | CONS |
|---|---|---|
| **Risk Targeted Approach (RTA)** | Stronger downside protection and capital protection attributes. | May not perform as well as SAA in a strong equity market environment. |
| | Higher consistency in investment returns. | Not as well recognised or understood as the SAA approach. |
| | Allocates away from assets considered poor investments on a medium-term. | Reliant on the investment managers' ability to adjust portfolio for different market conditions. |
| | Expected to provide a better return versus risk outcome over the long-term | Higher cost than SAA |
| **Enhanced Strategic Asset Allocation (ESAA)** | Uses a broader asset mix and is more flexible in its approach than SAA. | Manager requires specialist knowledge of investments outside of traditional assets. |
| | Can exhibit slightly less volatility than pure SAA, in difficult market conditions, due to broader diversification. | Some dependency on the investment managers' ability to adjust portfolio for different market conditions. |
| **Strategic Asset Allocation (SAA)** | Has been used for a longer period. | Does not adjust asset mix based on valuation – leaving exposure to poor investments at various points in the cycle. |
| | Benefits in an environment of strong economic growth. | Low level of skill required to achieve results so may be considered poor value for money. |
| | Generally cheaper to operate – reflecting a lower investment fee. | Does not preserve capital and leaves portfolio susceptible to market volatility. |

It should be noted that all three approaches are diversified across different assets and can have a similar timeframe of investment. While a SAA approach is widely available in different products, and these are often quite similar, the other investment approaches of ESAA and RTA are not as easy to access.

# WHAT IS RISK TARGETED INVESTING?

## An evolution in managing risk

Risk Targeted Investing is a re-engineered process for the investment of assets. It is the next development in investment thinking for portfolio construction following the Strategic Asset Allocation (SAA) approach which was developed over 30 years ago.

SAA is based on the principle of diversification as a means to manage risk. It does this by specifying a benchmark percentage of funds to be invested in each major asset class regardless of the prevailing economic conditions at that time.

A number of constraints have become apparent using this approach. These are:

- Investment in overvalued asset classes must be maintained
- The portfolio can only generate equity returns in an increasing equity market
- High levels of correlation between traditional asset classes of equities, listed property and fixed interest in periods of high market stress;
- The high level of equity risk a portfolio may contain
- The inability to invest in assets or instruments that do not meet the definition of the traditional liquid asset classes i.e. direct property, infrastructure, commodities, and alternative “market alpha” strategies.

Risk Targeted Investing has been designed to reduce the constraints to just one, the amount of risk that the portfolio targets. This means removing the traditional constraints of asset class benchmarking and investing in any combination of assets provided the total portfolio risk meets the agreed risk target.

Risk Targeted Investing has the ability to incorporate all investment instruments, techniques and strategies available in the marketplace today including specifying percentage allocations as per SAA. It then places a risk framework over the portfolio to calculate the portfolio risk. Once the Portfolio Manager is confident the desired outcomes will be achieved and the risk framework shows the risk target is met, investments are then made.

# FITZPATRICKS’ PREFERRED APPROACH TO PORTFOLIO CONSTRUCTION

Our ultimate goal is to create a portfolio that performs well in a wide range of economic circumstances and can even generate positive returns (or reduce the negative returns) when equity markets aren’t performing. **Our preference is to outsource to investment professionals who adopt an active investment approach across a diversified range of assets and securities.**

While we can implement across various approaches including;

- Strategic Asset Allocation (SAA)
- Enhanced Strategic Asset Allocation (ESAA), which covers variations of both Dynamic and Tactical Asset Allocation (DAA / TAA)

- Risk Targeted Approach (RTA), sometimes known as Objectives Based.

Our preference is the Risk Targeted Approach where this is appropriate.

The Risk Targeted Approach (RTA) is considered a sensible approach for many clients due to the focus on managing portfolio risk, and incorporation of alternative asset classes to reduce overall portfolio volatility. RTA will often incur higher costs and may experience reduced performance over certain time periods and will not be appropriate for all investors in terms of goals, objectives and preferences. For this reason, it is important to have a strong relationship with your financial adviser who can guide you on the most appropriate investment approach for you.

Although we can implement a portfolio strategy in a number of ways, we generally recommend a platform or wrap account is used to administer your investments. This provides benefits such as consolidated reporting and easy access to online information about your investments. Platforms or wrap accounts are relatively similar in terms of functionality, however there are important differences such as the choice of investment options, service levels and prices.

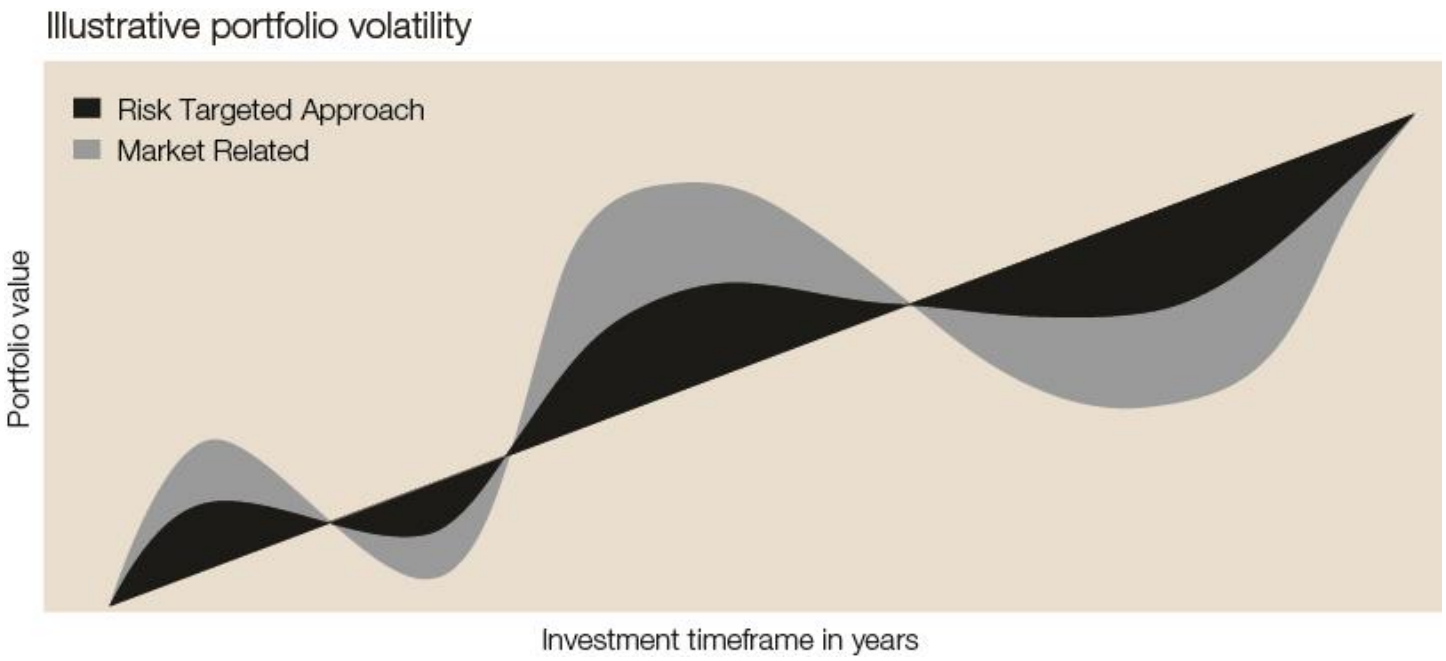
The level of transparency or visibility over your investments is a personal preference. Managed Accounts or Separately Managed Accounts (SMAs) are an ideal way to obtain portfolio visibility over some or all of your investment assets. Managed Accounts and SMAs can also offer some portability and tax management benefits which can add value for certain strategies and client situations. Managed Funds and many index options do not have these features. Please note not all platforms or wrap accounts have Managed Account or SMA functionality and/or investment options.

## Some more information about the Risk Target Approach

The Risk Targeted Approach means a focus on active management of the portfolio with the aim of controlling risk (volatility) and providing a more consistent return outcome over time. The diagram below shows the intended outcome of managing a portfolio using this approach. As shown by the grey shading, a traditional SAA portfolio will have wide fluctuations, performing well when equity markets are buoyant, but falling significantly when equity markets fall. In contrast, the RTA approach (shaded in black), aims to provide a more consistent investment return over time.

You should be aware that the RTA that Fitzpatricks prefers is not significantly different from other market participants. In fact, a number of forward-thinking advisers are changing their recommended approach toward a ‘risk’ or ‘outcome’ based approach.

**Chart 5**

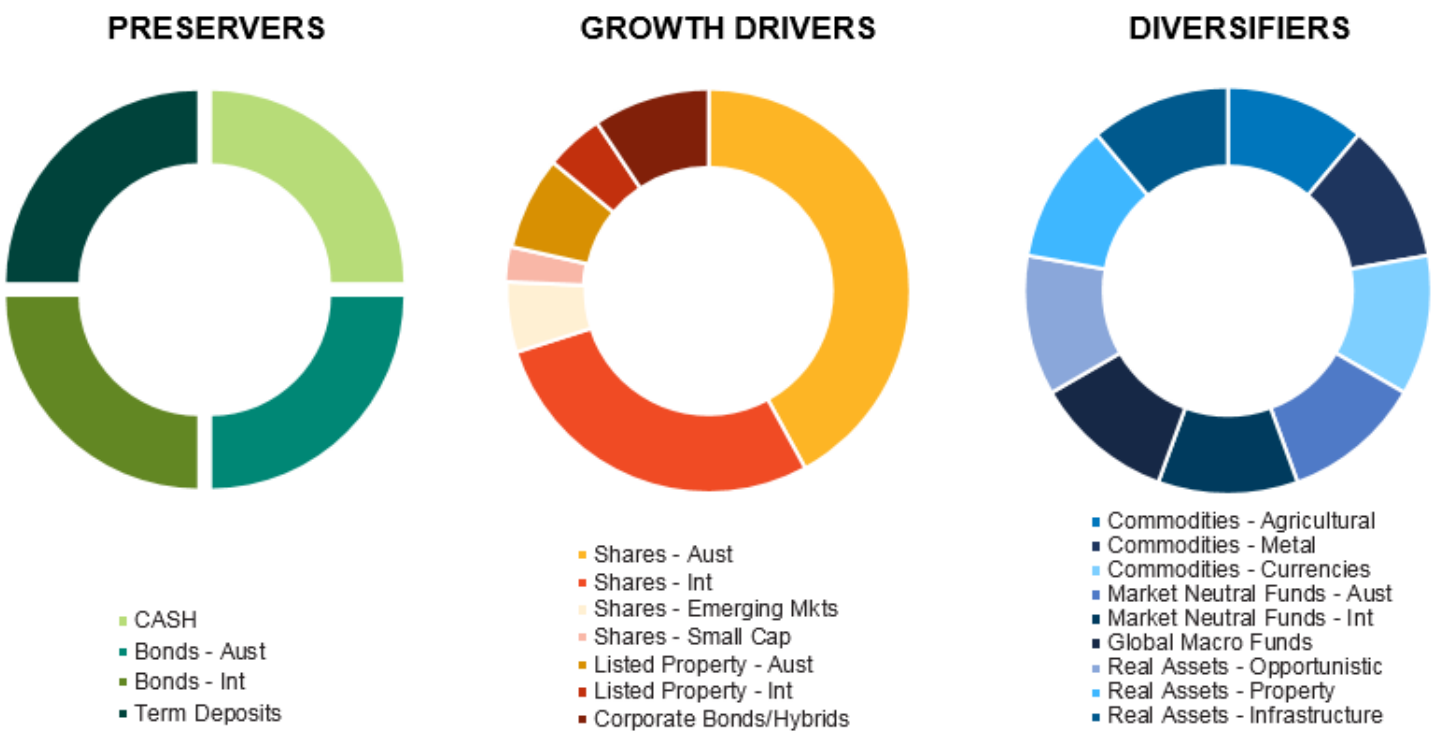



Source: Fitzpatricks Private Wealth

Fitzpatricks prefers to construct investment portfolios so they consist of three different factors, namely;

- Preservers - Assets to protect the portfolio. These are generally less volatile and more secure.
- Growth Drivers – Assets which provide growth. These are the future economic drivers of your portfolio.
- Diversifiers – Assets that still provide good avenues for growth but their performance is typically less correlated to the performance of the Growth portion of the portfolio. The diversifiers may be different types of assets or different investment strategies or a mixture of both.

Chart 6




Our view is that each factor in the portfolio matters, but we don't want any one component to matter too much.

Firstly, any money that you might need from your portfolio in the short to medium term should not be exposed to high levels of volatility, so we isolate these funds and invest them in cash or other assets that should preserve your capital. This is because you need to be sure that this money will be there for your short-term cash needs. However, an overly conservative portfolio will have a difficult time outpacing inflation. Therefore you need to have exposure to growth assets such as shares and property in your portfolio.

To overcome this concentration risk, the diversifier component in your portfolio expands the range of investments and helps your portfolio perform in different economic conditions like a declining dollar, or rising inflation. This will help provide more consistent performance.

The diversifier component of our portfolios may invest in assets such as commercial property, commodities, currencies and a range of alternative strategies where expected performance is not highly correlated to the performance of traditional shares and bonds. This means that when the returns of traditional assets are negative, the funds invested in uncorrelated asset classes have the potential to pick up the slack. Again, the idea is to make sure no single component is large enough to put the plan in jeopardy if our return expectations for that particular segment is not realised. While this 'diversifier' component looks to assist in managing portfolio volatility, it is important to understand that they are also affected by different types of risks.

## TAILORING YOUR INVESTMENTS

After testing the other risk elements, we finally need to assess how much you need to earn from your portfolio to achieve your goals. If it turns out that you could achieve your goals with a relatively low rate of return, then you have a choice to make. We need to understand if you would rather reduce the risk in your portfolio if you know you don't need high

returns, or whether you would rather keep this level of risk and try to maximize the growth of your portfolio. There is not a right or a wrong answer, it just about understanding your unique preferences.

On the other hand, if it turns out that you need a higher rate of return than what is reasonable to plan for, then you have a different set of choices to make. These choices will involve the time when you might retire, how much you can save, and how much you want to spend in retirement.

Before we finalise our instructions to construct your portfolio, we also take into account if you have any particular attachment to, or concerns with specific types of investments. Some examples may include:

- Long held investment positions that you would like to maintain;
- Directorships that may not allow you to trade readily in some listed equities; or
- How you feel about socially responsible or ethical investments.

In all circumstances your Adviser will be able to guide you through these important decisions and provide you with the information you need to make an informed choice.

## Gauging your understanding

Considering your answers to the following questions will also help us understand your experience and comfort with investing which is very important before making any recommendations. An example of the questions we will ask you to confirm your understanding of investment concepts are:

- What experience have you had with investing?
- What level of involvement in investment management, reporting and administration do you desire?
- How do you feel about accepting volatility (the amount your return and or capital might move up and down over a given period of time)?
- How important is capital stability over the short / medium term?
- Can you confirm your investment time frame?
- Do you have different time frames for different objectives such as emergency funds, regular expenses, legacy, etc. What are your liquidity needs?
- What are your income needs?
- Your preference for transparency and visibility over your investments?
- If you could achieve your financial objectives with a less volatile portfolio would you prefer this or would you rather have a portfolio that exceeded your expectations knowing the relationship between risk and return?
- Are you prepared to forego the potential for higher returns to reduce the risk of loss?
- Are you willing to pay a fund manager to actively manage your investment/s within an agreed risk budget even if this costs more that other options?
- Can you explain your understanding of the following concepts?
  - The meaning of Volatility
  - The relationships between Risk and Return
  - The different Types of Risks
  - Diversification and what the benefits are in a diversified portfolio
  - The importance of minimum time frames when investing to minimise risk
  - The differences in portfolio approaches
  - The differences in the cost of portfolio management styles

## General advice warning

This document is of a general nature only and has been provided as a guide to help explain risk concepts and our investment philosophy, therefore you should not act on this information. Your Adviser will provide you with personal advice in an eligible advice document after all of your personal and financial circumstances have been considered. All care has been taken to check that representations and statements expressed or implied in this document are made in good faith and have been derived from sources believed to be reliable and accurate.

## Forecast returns

*Past performance is not a guarantee for future performance.*

The information used in the risk profile examples and forecasts have been derived from investment sources provided to the Fitzpatricks Investment Committee as outlined in the table below. The material was produced in September 2020. The forecasts are long run forecasts (10 years) and are derived from a cash rate of 1.7% cash, inflation (CPI) of 1.8% and growth (GDP) at 2.3%. The numbers are rounded to simplify the data and to highlight the fact that forecasts or estimates are not accurate and hence being specific is not possible. During various stages in the economic cycle and over shorter time periods, these core economic indicators may be higher or lower, and this has a flow on impact to other forecast data. They are a guide only and we do not provide any guarantee of future performance.

The forecast returns are prior to fees and taxes, and based on the relevant market benchmark. They do not consider any investment management portfolio skill (or alpha) from stock selection, manager selection, asset allocation, currency, portfolio hedging, etc. The risk metric is based on the average rolling five-year standard deviation over the past 10 years to April 2020.

Actual returns will vary from these figures based on the underlying investments selected and portfolio composition. As mentioned, the assumptions are a guide only, and we do not provide any guarantee of future performance, and past performance is not a reliable indicator of future performance.

**Table 8 Assumptions for Asset Class Returns**

| Asset Type | Yield %pa | Growth %pa | Risk %pa |
|---|---|---|---|
| Australian shares | 4.0 | 4.0 | 11.5 |
| International shares (currency unhedged) | 2.6 | 3.5 | 11.6 |
| Australian Listed Property | 6.2 | 1.6 | 11.9 |
| Domestic Fixed Interest | 2.0 | 0.0 | 2.7 |
| International Fixed Interest | 2.0 | 0.0 | 2.6 |
| Cash | 1.7 | 0.0 | 0.1 |
| Real Assets (Australian core property) | 5.0 | 1.8 | 12.5 |
| Alternatives (varies with manager skill and type) | 2.0 | 3.2 | 6.9 |

## GLOSSARY - INVESTMENT RISKS

There are a variety of risks associated with investing, including the following:

| Risk type | Description |
|---|---|
| Business risk | The specific business you invest in or through may lose money or fail and you lose or reduce your initial capital investment or not receive the return you expected. |
| Counterparty risk | A counter party to a contract fails to meet its obligations to honour the contract. A counter party may be a broker, lender, issuer and clearing exchange. |
| Credit risk | The institution you have invested with may not be able to make the required interest payments, repay your funds or may suffer a fall in their credit rating that could result in a lowering of the quality and value of the security. |
| Currency risk | Investments held in other countries may rise or fall in value due to movements in international exchange rates against the Australian dollar. |
| Dependence risk | A break down in operational controls or administrative procedures may cause a disruption to day to day fund operations. |
| Derivatives risk | The derivative may fluctuate in price by a larger amount than the underlying investment in which it is invested, resulting in unexpected losses or gains. |
| Economic and Political Risk | Changes in inflation, interest rates and risks caused by changes in governments, their policies and legislation. |
| Hedging risk | An investment exposure entered into to hedge another exposure does not achieve the desired neutralizing effect when markets move. |
| Inflation risk | The purchasing power of your investments may not keep pace with inflation. |
| Interdependence risk | An allocation to investment strategies is based on assumptions about historical relationships that do not persist in the future. |
| Legislative risk | Your investment strategies or products could be affected by changes in current laws and regulations. |
| Leverage risk | Gains and losses may be magnified to a greater degree than if the investment exposure wasn't leveraged. Leverage is the ability to control a larger investment exposure using a smaller amount of capital by using borrowed funds. |
| Liquidity risk | You may not be able to access your money as quickly as you need to without suffering a fall in its value. |
| Manager risk | Personnel or ownership of the fund manager may change and they may no longer have access to the skills or attitudes that contributed to earlier performance levels. |
| Margining risk | Positions in futures contracts and/or holdings in underlying funds must be sold to meet margin requirements set by clearing houses and exchanges. This occurs when insufficient funds are held with a clearing firm to maintain an investment exposure. |
| Market risk | Movements in the market mean the value of your investment can go down as well as up, and sometimes suddenly. |

| | |
|---|---|
| Mismatch risk | The investment may not be suitable for your needs, goals and circumstances. |
| Pricing risk | Investments are unable to be priced within an acceptable time-frame. |
| Reinvestment risk | You may have to reinvest maturing money at a lower rate of interest. |
| Strategy implementation risk | Actual returns may be lower than projected returns because an investment manager has not implemented trades and transactions as planned, i.e. markets closing, illiquidity and/or administration error. |
| Structural risk | If investing in managed funds rather than through direct investments such as shares, different income and capital gains outcomes may occur. |
| Substantial redemptions risk | If substantial redemptions occur within a short period of time it may require investments to be liquidated more rapidly than may be desirable. |
| Systemic risk | A disruptive event causes a chain of events to disrupt or compromise the normal functions of the system. |
| Tax risk | Tax implications are determined by Australian tax legislation and tax laws of other places. These may be altered which may negatively impact the returns on investment. |
| Track record | This risk relates to new funds that have no operating history. |
| Timing risk | Timing entry to and exit from markets can expose you to potentially greater short-term volatility. |
| Value risk | You may pay too much for the investment or sell it too cheaply. |

# GLOSSARY OF TERMS

Below are some brief descriptions of various investment terms some of which are referred to in this document.

| Term | Description |
|---|---|
| Alpha | A measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of an investment fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha. |
| Asset class | Refers to a group of similar assets. The most commonly known asset classes are cash, fixed interest, property and shares. There are also various 'alternative assets' now available for investment. |
| Benchmark | A standard used for comparison. |
| Beta | A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means the security will be less volatile than the market, while beta greater than 1 means the security is more volatile than the market. |
| Defensive assets | Assets that generate the majority of their investment performance from income (i.e. cash and fixed interest). Tend to be lower risk and generate lower returns. |
| Diversification | Strategies to lower investment risk by selecting a number of different investments. |
| Enhanced Strategic Asset Allocation | An expansion of the SAA approach where portfolios can include non-traditional assets and more frequent "dynamic" or "tactical" adjustments to the asset mix within the portfolio is made. |
| Estimated return | The return (income and growth) of an investment based on a set of assumptions. Details of assumptions used by Fitzpatricks are outlined in 'Important Information'. |
| Estimated risk | The standard deviation of returns of an investment based on a set of assumptions. Details of the source for Fitzpatricks assumptions are in 'Important Information'. |
| Growth assets | Assets that generate the majority of their investment performance from capital growth (i.e. shares and property). Tend to be higher risk and higher return. |
| Hedging | The act of placing an insurance policy in relation to an investment. This provides a degree of protection if the investment value moves contrary to what is being sought. A premium is paid for the placing of the insurance policy or position. |
| Internal rate of return (IRR) | The return that makes the present value of future cash flows plus the final market value of an investment equal the current market price of the investment. |
| Liquidity | The ability to readily convert investments to cash at short notice. |
| Market Risk Premium | The expected return above cash. |
| Multi-manager fund | A managed fund incorporating investments into other managed fund products from the same or different investment managers. |
| Risk profile | Classification of an investor's risk tolerance. |
| Risk Tolerance | The amount of financial risk you are comfortable accepting. i.e. the "sleep test" to assess whether you have difficulty sleeping at night when your investments are subjected to risk? |

| | |
|---|---|
| Risk Capacity | Your financial capacity to take on risk. i.e. can you afford the risk or will your financial security be impacted if markets drop? |
| Risk | Volatility of expected returns or the difference between the returns you expect to receive and the returns you actually receive. This is a general definition of risk. There are many other investment related risks some of which are outlined in the Glossary – Investment Risks section. |
| Risk Targeted Investing | A portfolio construction method based on the overall portfolio risk without structured benchmarking to asset classes. The portfolio has a "Target" for risk and will contain assets which, when combined, result in a portfolio within this Risk Target. |
| SAA | Strategic Asset Allocation – A portfolio construction method based on a benchmark allocation to the traditional asset classes. |
| SoA | Statement of Advice – A document provided to investors with a recommendation to acquire an investment product or implement a strategy. Sets out the advantages and risks of the product/strategy and why the advice is appropriate considering your personal circumstances, needs, goals and financial objectives. |
| Standard deviation | Standard deviation is a measure of uncertainty or risk. It shows how much variation there is from the 'average' (mean). The larger the standard deviation percentage, the higher the risk. |
| Volatility | The more the value of your investment varies and the greater the fluctuation, the more volatile the investment is seen to be. Note that this could be positive or negative. |
| Yield | Another term for the income portion of the return generated by an investment. |

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