Affluence
FUNDS MANAGEMENT

# Guide to
# Managed Funds

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INVEST
DIFFERENTLY

# 01 INTRODUCTION TO MANAGED FUNDS

There are now over 12,000 managed funds available to choose from in Australia, and this number continues to grow each year. The sheer number of funds, managers, structures and strategies means it can be daunting to find the ones that suit your investment needs.

Through managed funds you can now gain exposure to the four major asset classes (property, shares, cash and fixed interest) as well as many types of alternative investments such as commodities, infrastructure and currencies. You can gain access to investments in Australia and overseas. Some funds invest broadly across many different markets and geographies, while others are very specific, targeting a specific subsector, location, or investment strategy.

Affluence estimates that around 90% of managed funds fail to beat the underlying market in which they invest over the long term, after fees and costs. While this can be disheartening, there are still a great number of funds run by exceptional managers, using differentiated investment strategies, that can help to deliver great returns while also diversifying your investment portfolio.

At Affluence, we are continually assessing the best managed funds. This guide contains insights on how we do it and what we look for.

We have not included a list of the best managed funds in this guide, because our views change over time, based on the performance of the manager and our opinion on the value of the underlying markets they invest in. You can access an up to date list of our key investment holdings for our flagship Affluence Investment Fund at any time, by registering as an Affluence Member on our website (www.affluencefunds.com.au).

We hope the information in this guide is of value to you in your own investing journey. As with all our publications, we value feedback, so please let us know if there is anything we can improve upon.

## 1.1 About Affluence Funds Management

Affluence Funds Management was founded in 2015 to provide investors with a better investment solution. Our focus is on delivering superior long-term investment performance and in providing quality education and investment ideas.

At Affluence, we believe in doing things differently. We are contrarian, value focused, and invest for the long term. We aim to offer our investors only the very best quality investments. We focus not only on finding the best investments, but on being aware of market cycles and on diversifying investments across all types of assets in our search for consistent, positive long term returns.

# 1.2 What is a Managed Investment Fund?

A managed investment fund or managed fund is a specialised type of investing entity. It is a special type of trust that pools together investors' funds and invests them under an approved strategy. The fund has a trustee, who oversees the investing activities and acts in the best interests of the investors. The trustee must obtain and maintain an Australian Financial Services License (AFSL) issued by the Australian Securities and Investments Commission (ASIC). Qualified professional investment managers will then buy and sell investment assets on behalf of the pool of investors.

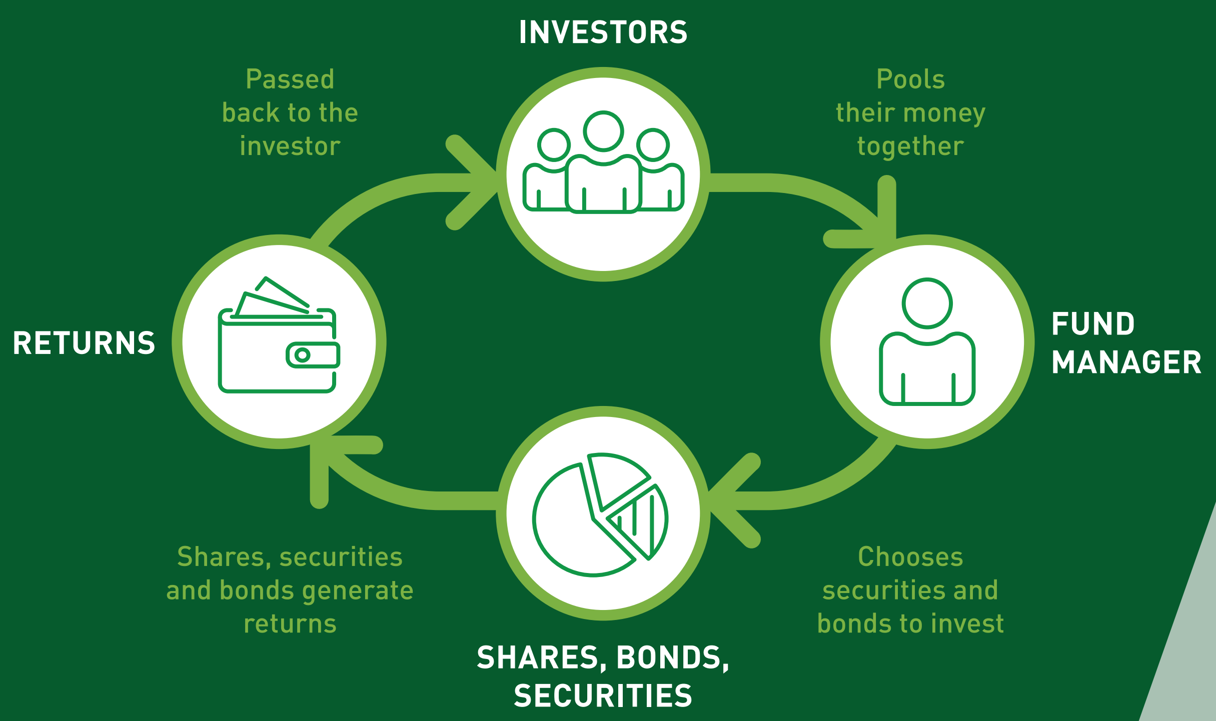
Most managed funds are not listed or traded on the Australian Stock Exchange (ASX) or any other similar securities exchanges around the world. Instead, units are issued to fund investors (called unitholders), based on the value of the underlying investments that the managed fund holds at the time the units are issued.

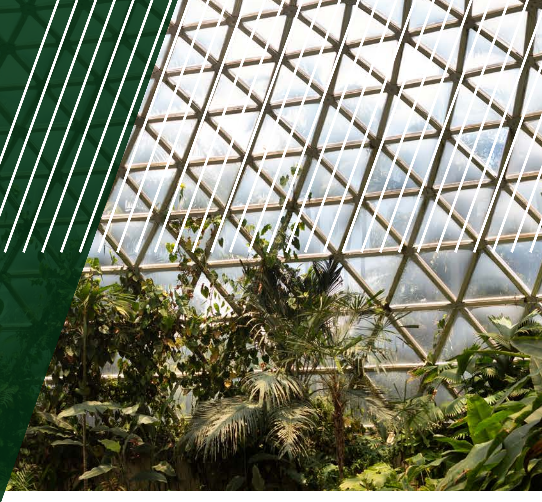
To provide an extra layer of investor protection, many managed funds appoint a custodian to hold the investments and other assets of the fund on behalf of fund investors. The custodian (or the trustee, if no custodian is appointed) must meet certain financial requirements.

# 1.3 Why Invest into Managed Funds?

There are many different reasons why people invest in managed funds, but the most common reasons you might consider it are:

- To achieve better diversification by investing in a fund which holds many underlying investments.
- To access the skills of a professional investment manager.
- To get exposure to a market, sector or asset class.
- To access investments that are too large for you to purchase by yourself (for example commercial property).





# 02 TYPES OF MANAGED FUNDS

## 2.1 Wholesale vs Retail Funds

### Wholesale managed funds

Wholesale managed funds are only open to certain types of investors. To qualify to invest in these types of funds, you must meet one of the following criteria:

- Invest at least $500,000.
- Provide a certificate from a qualified accountant that you meet either an income test ($250,000 or more gross income for each of the past 2 financial years) or an assets test (you and your associated investors control net assets of at least $2.5 million).
- Be deemed a sophisticated investor, which requires you to be assessed as having the requisite skills, experience and/or qualifications to properly assess and understand the investment.
- Be deemed a professional investor, which is generally restricted to people working within the funds management industry.

Wholesale funds may be registered with ASIC but are not required to be. The trustee of the Fund issues a special type of document, normally called an Information Memorandum which is provided to potential investors and contains all relevant information about the fund, investment strategy and how it works.

Retail managed funds are open to all investors, and provide some additional features designed to better protect investors. They are managed by a responsible entity, which is a special type of trustee. The responsible entity is a company and is governed by a board of directors.

### Retail managed funds

Retail managed funds are required to be registered with ASIC. They must prepare audited annual accounts and lodge them with ASIC. They are also required to have a compliance plan, which governs how they intend to meet the various requirements of being a managed fund, and to have this compliance plan audited annually. Investors in retail managed funds invest through a Product Disclosure Statement (PDS) which must be issued by the responsible entity. A PDS has a higher standard of disclosure than an Information Memorandum.

Investors in retail managed funds have access to additional investor protection mechanisms that wholesale investors do not have. Examples include access to an external complaints handling process, colling of periods and enhanced PDS disclosure requirements.

# 2.2 Open Ended vs Closed Ended Funds

The most common type of fund is an open-ended fund. This allows investors to buy and sell units in the fund at regular intervals. The manager may issue new units in the fund to new and existing investors when they make an application. Likewise, they may redeem (buy-back and cancel) units if they receive withdrawal requests from investors. This process of issuing and cancelling units is usually described in the IM/PDS, and can happen daily, weekly or monthly.

A closed-ended fund offers the opportunity for investors to apply to purchase units in the fund when it first opens, but the fund is only open for investment for a specified amount of time. The fund then stops accepting any new applications for a predetermined investment period, normally several years. If you want to sell units in the fund during this period, you either must wait until the investment period has expired or seek to find a buyer (either by yourself of with the help of the fund manager). Closed end structures are most often used when the underlying assets of the fund are not easily tradable or saleable in a short period, or cannot be divided into small amounts, such as property or infrastructure. This "liquidity risk" can be a very important factor to take into account when investing in closed ended funds.

# 2.3 Active vs Passive Managed Funds

For asset classes such as Australian shares, global shares, REITS, cash and bonds, there are both actively managed funds and passively managed funds.

## Passively managed funds

Passively managed funds (including index funds) aim to replicate the overall performance of a benchmark (for example the ASX 200 Index) less fees. They usually achieve this by buying each individual stock that forms part of the index. For example, an ASX 200 Index fund may seek to own all 200 shares in the index with the same proportionate weighting as the index. The managers of these funds typically charge a much lower fee than for an actively managed fund. Proponents of this type of fund believe that there is little chance of an active investment strategy outperforming the market over the long term, and investors would therefore be best to own the fund with the lowest fees.

## Actively managed funds

Actively managed funds (which Affluence offer and invest in) do not track a benchmark or index, but instead are less constrained in what assets they purchase and their weightings in the fund. Therefore, whether the fund outperforms the relevant benchmark is down to the skill of the investment manager.

Active funds have the potential to significantly outperform passive funds, and likewise to significantly underperform as well.

S&P Dow Jones Indices publish a regular report which attempts to measure the performance of active versus passive funds. The following is from the SPIVA Australia Scorecard from 30 June 2023:

*"A slim majority (55%) of Australian Equity General funds underperformed the S&P/ASX 200 in the first half of 2023. A higher percentage of funds underperformed their respective benchmarks in the International Equity General and Australian Equity A-REIT categories. Funds in the Australian Equity Mid- and Small-Cap and Australian Bonds categories had a better record: 48% and 45% underperformed their benchmarks, respectively."*

# 2.3 Active vs Passive Managed Funds (cont')

The following table is from the latest report and shows the percentage of funds outperformed by the index:

### Report 1a: Percentage of Funds Outperformed by the Index (Based on Absolute Return)

| Fund Category | Comparison Index | 1-Year (%) | 3-Year (%) | 5-Year (%) | 10-Year (%) | 15-Year (%) |
|---|---|---|---|---|---|---|
| Australian Equity General | S&P/ASX 200 | 76.53 | 69.30 | 77.55 | 83.33 | 85.37 |
| Australian Equity Mid & Small-Cap | S&P/ASX Mid-Small | 35.85 | 55.48 | 57.97 | 76.79 | - |
| International Equity General | S&P Developed Ex-Australia LargeMidCap | 81.47 | 83.16 | 89.72 | 93.83 | 94.40 |
| Australian Bonds | S&P/ASX Australian Fixed Interest 0+ Index | 26.47 | 55.88 | 46.48 | - | - |
| Australian Equity A-REIT | S&P/ASX 200 A-REIT | 69.23 | 75.81 | 67.16 | 75.34 | 80.00 |
| New Zealand Domestic Equity | S&P/NZX 50 Index | 45.83 | 38.10 | 47.37 | 75.00 | 76.92 |

Sources: S&P Dow Jones Indices LLC, Morningstar. Data for periods ending Dec. 31, 2023. Outperformance is based on equal-weighted fund counts. Index performance based on total return in AUD, except for the S&P/NZX 50 Index whose returns are in NZD and include reinvestment of dividends and imputation credits. Underperformance rates for Australian Bonds and Australian Equity Mid- and Small-Cap categories are reported for time horizons over which the respective benchmark indices were live. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

While there are plenty of active funds that have not outperformed the index, there are still a lot that have. At Affluence, we try to search out fund managers who can significantly outperform the market. Investing this way, if you can do it well, can provide much better results than passive investing. You can view our full performance history by fund, on the Performance page of our website.

The best category for active managers according to the SPIVA report is small and mid- cap Australian equities, with 58% of funds being outperformed by the index over 5 years.

It is no accident that many funds Affluence invests in are in the small and mid-cap Australian equities category.

S&P only include long only funds in selected categories in their comparison, thereby ignoring many other investment strategies (for example there are many outstanding long/short and market neutral funds and managers). The Affluence Investment Fund has substantial investments in these types of funds as we believe they can offer good returns, reduce portfolio volatility and increase diversification.

# 03 HOW DO MANAGED FUNDS WORK?

A Managed Fund is governed by its trustee (or responsible entity), which appoints a board of directors for this purpose.

## 3.1 Investment strategy

All managed funds have a defined investment strategy. Generally, the investment strategy will outline:

- The asset class or classes the fund invests in (e.g. Australian shares).
- The return targets the fund is aiming to achieve and the timeframe for achieving those targets.
- Any investment limits or ranges that will be adhered to.

All investors' funds are pooled together and invested in accordance with the investment strategy.

The investing activities for the fund are normally carried out by specialist investment managers (usually companies). These investment managers are appointed by the trustee. The investment manager may be the same as the trustee, or may be a separate entity. If separate to the trustee, the investment manager must also be licensed by ASIC. The investment manager appoints one or more investment staff (usually known as fund managers or portfolio managers) who undertake the day-to-day investing activities for the fund.

In return for running the investment fund, the investment manager and/or trustee charge a fee to the fund for their services. Fee structures can vary considerably, but typically include a management or base fee (usually a fixed percentage of the Fund net assets). Investment managers may also charge a performance fee (usually a percentage of the returns above a target level). Performance fees are usually subject to a high-water mark, which means any underperformance against the target returns must be regained in the future before any further performance fees can be charged. The fund will typically also pay administration and running costs, although in some cases the manager will agree to pay these out of their management fees.

When an investment is made into a managed fund there is typically a buy spread applied, and when a withdrawal is made there is typically a sell spread applied. The purpose of the buy/sell spreads is to ensure that those investors transacting in the fund's units at a given time bear the cost of the fund buying and selling assets because of their transaction.
For example, when an investment is made into the fund, the investment manager might purchase listed stocks, thereby incurring brokerage costs. The buy/sell spreads help to ensure existing investors in the Fund are not impacted by investors entering or leaving the fund. The buy and sell spreads are not paid to the manager but are retained by the Fund.

# 3.2 How do Managed Funds generate returns?

Investors in managed funds receive returns on that investment in two ways, through distributions and changes in the unit price.

## Distributions

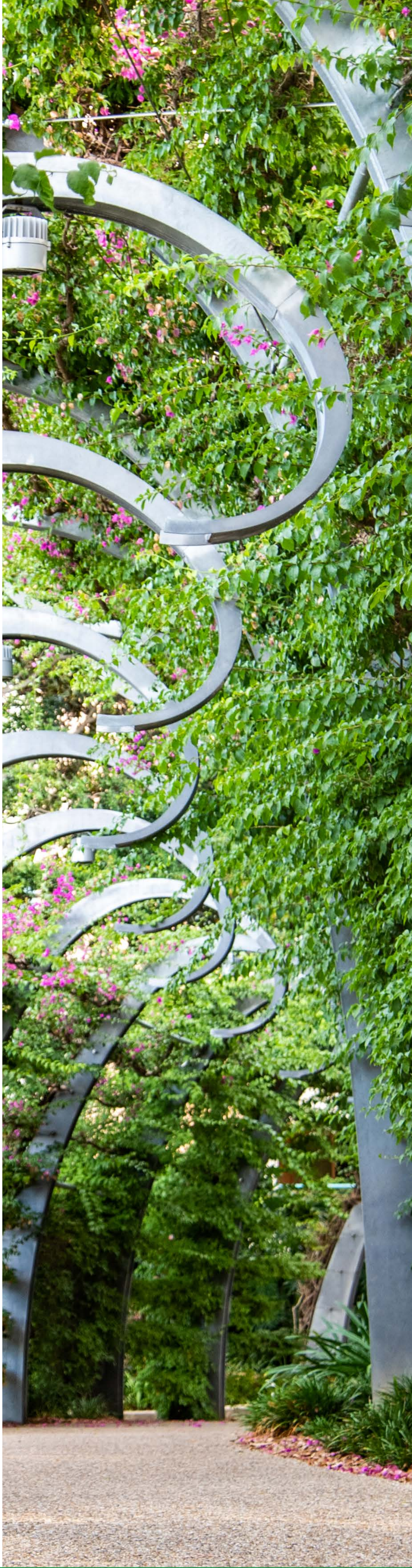
Most funds pay distributions to unitholders. These distributions are usually determined and paid just once or twice a year, but some Funds, for example property and fixed interest funds, can pay more regularly. There are important differences between distributions paid by managed funds and dividends paid by companies:

- Managed funds do not pay any tax directly. Instead, a share of the income and capital gains that would otherwise be taxable are "distributed" to unitholders in proportion to their share of the fund. The investor must then include that income in their own tax return each year and pay tax on it themselves.
- Distributions are taxable when the investor is entitled to receive the payment (the record date), not when it is paid. Distributions can also include some franking or other tax credits if the Fund has received these from the investments it makes.
- The minimum amount distributed each year is normally the taxable income of the Fund, including any realised capital gains.
- Companies pay tax on income and capital gains. They are then able to pay dividends to shareholders from those profits. They can attach to those dividends a franking credit, which is a credit for the tax previously paid by the Company on that amount. Investors include both the cash dividend and the franking credit in their tax return, and can usually offset the franking credit against tax payable on other income.
- Dividends are taxable when the investor is paid, not when they are entitled to receive the payment.
- There is no minimum amount of dividends that must be paid.

## Changes in unit price

The unit prices of managed funds will increase or decrease over time based on changes in value of the underlying investments the fund holds. When the value of the funds' underlying investments rises – so will the unit price of that fund. Similarly, a fall in the value of the underlying investments will lead to a fall in the unit price.

So the returns to an investor in a managed fund will consist of the distributions they receive during the investment term, plus or minus the change in the price of the fund units.



# 3.3 How do Managed Funds compare to other types of investments?

Managed Funds are often compared to Listed Investment Companies (LICs) and Exchange Traded Funds (ETFs). But there are several very important differences between these types of investments that you should be aware of.

| | **Managed Investment Fund** | **Listed Investment Company** | **Exchange Traded Fund** |
|---|---|---|---|
| Listed on ASX | No, unlisted. | Yes. | Yes. |
| Minimum Investment | Varies, but usually $10,000 or more. | Set by broker. Can be $500 or less. | Set by broker. Can be $500 or less. |
| Eligibility | Retail funds with a PDS are available to everybody. Wholesale funds are restricted to certain types of investors. | Anyone with a broker account. | Anyone with a broker account. |
| Pricing | Usually priced based on the value of their underlying assets (NTA or NAV) +/- buy/ sell spread. | Set by market forces. Can vary substantially from value of underlying investments. | NAV +/- a margin, facilitated by market maker. |
| Legal Entity | Trust. | Normally a company, but can also be a Trust (e.g. REIT's). | Trust. |
| What does an investor own | Investors own units in the trust. | Investors own shares in the company. | Investors own units in the trust. |
| Buying and Selling | The trust issues units to investors who wish to go into the trust and redeems (buys back) units from investors who wish to exit. | Investors buy existing shares from another investor on ASX. The LIC can also issue new units or buy-back units from time to time. | Investors buy existing shares from another investor (or the market maker) on ASX. |
| Liquidity | Liquidity varies. May be priced daily, weekly, monthly or less often depending on the size of the fund and the type of assets they hold. | Traded on ASX between 10am and 4pm most business days. Smaller LIC's can be less liquid, with lower trading volumes. | Fully liquid. Employ a "market-maker" who is required to ensure trading price . |
| Minimum size of investment entity | Unrestricted. | ASX sets the minimum size and number of holders for new LIC's. | ASX sets the minimum size and number of holders for new ETF's. |
| Management | Can be internal or external, but normally external. | Can be internal or external, but normally external unless very large. | External. |

# 3.3 How do Managed Funds compare to other types of investments? (cont')

| | Managed Investment Fund | Listed Investment Company | Exchange Traded Fund |
|---|---|---|---|
| Investor Income | Pay distributions. Can be taxable, tax deferred or tax free.<br><br>Can include some franking and other tax credits . | Pay dividends which are usually taxable to the investor and may have franking credits attached. These credits can be claimed by the investor in their tax return. | Pay distributions.<br><br>Can be taxable, tax deferred or tax free. Can include some franking and other tax credits. |
| Income Tax | Do not pay tax but distribute taxable income to investors, who pay tax on it. Therefore, distribution returns are pre-tax. | LIC's pay tax on income. Attaching franking credits to dividends allows investors to receive some "credit" for tax paid by the LIC. | Do not pay tax but distribute taxable income to investors, who pay tax on it. Therefore, distribution returns are pre-tax. |
| Capital Gains Tax | Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold. Any tax deferred distributions received may increase this capital gain. | Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold. | Generally, investors pay capital gains tax on difference between cost and sale value of investment when sold. Any tax deferred distributions received may increase this capital gain. |
| Investment Strategy | Normally active. Tries to beat a market return. | Normally active. Tries to beat a market return. | Normally passive – tries to replicate a market return, less fees. |
| Management Fees | Normally highest. Can include performance fees. | Normally higher than ETF's but lower than managed funds. Can include performance fees. | Normally lowest. Usually does not include performance fees. |
| Annual General Meeting | No. | Yes. | No. |
| Governance | Managed by a trustee (if a wholesale fund) or responsible entity (if a retail fund). May be the same as the investment manager or independent. | Appoints a board of directors, who monitor strategy and the investment manager. | Managed by a trustee or responsible entity. May be the same as the investment manager or independent. |
| Transaction Costs | Set by manager. Buy/sell spread based on costs of buying and selling underlying investments the fund holds. | Buy/sell spread on ASX. Will be variable and dependent on market conditions and liquidity. Brokerage is payable. | Usually a market maker makes sure that costs of transacting are within pre-set limits and approximate to underlying asset value. Brokerage is payable. |
| Investor disclosure | Continuous disclosure rules – normally periodic reports plus ad-hoc disclosure on website or by email. | Announcements on ASX. May be supplemented by other reporting. | Announcements on ASX. May be supplemented by other reporting. |

# 04 CHOOSING A MANAGED FUND

Choosing and investing in managed fund is a personal decision and will be heavily influenced by your personal circumstances, your investing philosophy and your portfolio goals.

## 4.1 What should you look for?

At Affluence, we assess managed funds on three broad criteria:

01 The quality of the manager and their potential to deliver above average returns.

02 The investment strategy of the fund and how its performance will compare to other investments in our portfolio.

03 How expensive or cheap the underlying assets the fund invests in are, relative to long-term averages.

Put simply, we seek to invest into high quality funds with outstanding managers when the assets they invest in are cheaper than average. This requires a consistent strategy, patience and discipline.

### Key factors in assessing quality

There are many factors which can determine the attractiveness on a managed fund investment. Below we have set out the key factors we consider. There are also many others which can be taken into account.

# 4.2 Understanding the strategy

For each managed fund, we like to develop a detailed understanding of the investment strategy being employed. This is key to understanding how a fund might fit into your existing portfolio.

This information can be found in several places, but most commonly in the PDS or Information Memorandum, on the fund or managers' website (if it has one) or in regular investors reports.

Some key questions we ask to help us understand the investment strategy of a managed fund are:

- What types of assets does the fund invest in (e.g. shares, property, diversified)?
- Does the Fund focus on a small, niche market (e.g. microcap ASX stocks) or does it invest more broadly?
- What market or geography does the Fund invest in? Is it focused just on Australia, in one or a combination of overseas markets, or both?
- Is the fund long only (e.g. it only purchases assets and holds cash), or does it also short assets or borrow to invest (known as leverage or gearing)? Gearing and shorting have the potential to enhance returns, however also have the potential to magnify losses.
- What are the investment managers' return objectives for the fund? Have they managed to achieve that so far?
- What should the funds' performance be measured against? For example, if the fund invests mostly in large ASX listed stocks, the ASX200 accumulation index may be the best benchmark.
- How much discretion does the fund manager have within the asset allocation strategy (e.g., can they hold a large amount of cash if they cannot find compelling investment opportunities?) Some of the best performing funds historically have tended to be those which have the most discretion, particularly around cash holdings. They also tend to have less volatile performance, particularly in down markets.
- How does the fund manager aim to beat the market? What is the advantage they have that can allow them to do so?
- How will the fund complement your investment portfolio? Is the investment manager doing something or investing in something that is different to what you currently hold? If so, this can allow you to achieve greater diversification.

If you have time, it may make sense to review the last few years' fund reports and other continuous disclosure announcements. This may assist to provide additional background on the fund and to understand if the trustee/investment manager has deviated from, or changed strategy during that period. Past announcements for funds are usually available from the fund or managers' website.

# 4.3 Assessing performance

It is said (and in fact ASIC demands all investment managers make it clear) that historical performance is no guide to the future. While that is true – historical performance can be a great indicator of the potential for future performance, provided it is looked at in the right way.

The right way to assess performance is not by looking at the absolute returns generated, but by comparing those returns to a fair benchmark and measuring how the fund (and the manager) has performed relative to that benchmark.

The manager will almost always publish the performance of the underlying investment portfolio. This represents their performance as a manager of that portfolio. Portfolio performance, if possible, should be assessed after all fees to the manager. This result should then be compared to an appropriate benchmark. Assessing performance in this way will assist to understand how the manager has performed relative to the market or asset class they are investing in. Returns are typically expressed as a percentage, and are annualised for periods longer than one year. Usually they will include returns from both distributions and increases in the unit price.

Ideally performance should be measured over a reasonably long period (e.g. 5 years or more). In fact, in a perfect world it should be measured over a full investment cycle - which can be 7 years, 10 years or longer. So, the longer the period you have data for, the better.

It's very important to look at how the fund has performed in down markets, as this will give you some idea as to how aggressive or conservative the strategy is. For example, a fund which invests in small cap stocks may outperform others over the very long term, but may severely underperform in negative markets. That may be OK for you if you can handle that level of volatility, but if you cannot, you may be susceptible to selling at the worst possible time.

Watch for, and avoid these negative signs and influences when assessing performance:

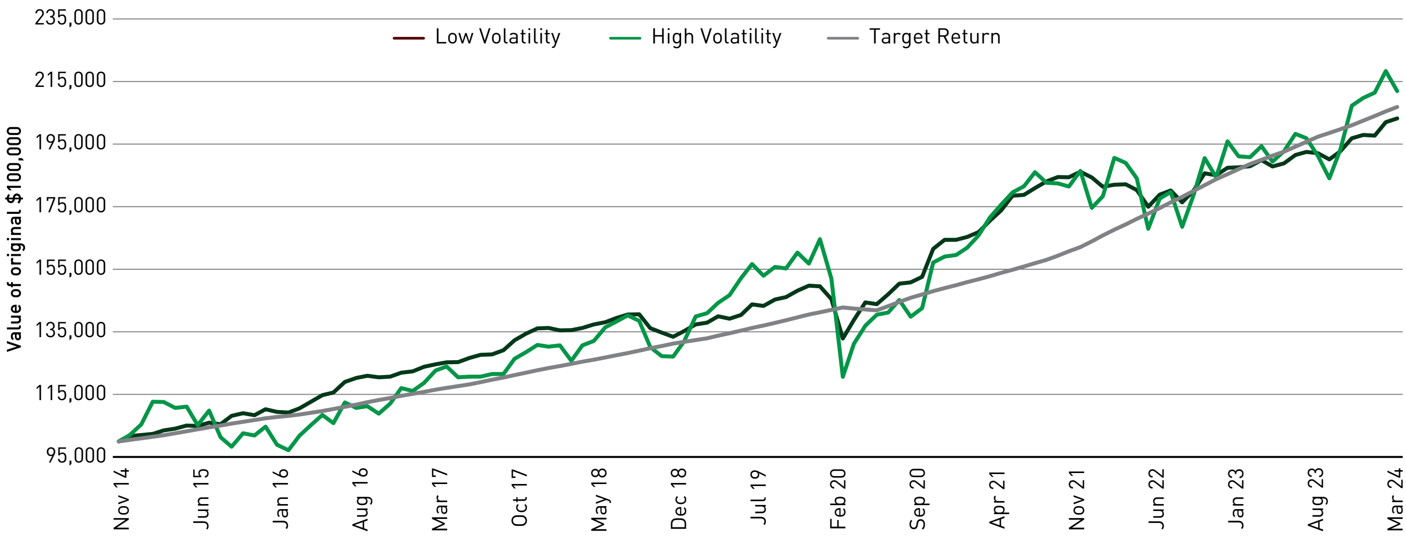
- Is performance stated after all costs and fees to the manager? Performance before fees and costs is irrelevant.
- Stating just total returns accumulated over a long period can be misleading. Performance should be annualised for all periods over 1 year.
- Is there a long enough timeframe to assess performance? While most managers publish performance data for less than one year, it is largely irrelevant for your purposes.
- Is the benchmark fair? A fair benchmark is one which reflects the average return you might expect from the types of assets the fund invests in. For example, is it an accumulation index (does it include income of the underlying assets)? Does it represent the underlying assets of the fund, or a fair long term return? Does it include franking credits,if the performance numbers do? Most managers do a good job of setting a benchmark, but some do not, and you end up measuring performance against an inappropriate yardstick.

Finally, when assessing performance, remember that while it can be useful, it is historical in nature and doesn't necessarily reflect the future. Good managers can have bad periods. More importantly, asset prices can move in cycles, so you should never assume the last 2 or 3 years' performance will be repeated in the next 2-3 years. Your aim in measuring performance is to understand how well the manager has performed relative to the market they are investing in.

# 4.4 Volatility

Performance by itself is great, but to get a full understanding of the fund's credentials, it is also important to understand volatility, or how performance returns vary over time. The holy grail for an investor is the delivery of their targeted returns with very low volatility.

High volatility investments are inherently more dangerous and risky because they can prompt a much wider range of decisions from investors. For example, consider the following 3 investments:




Most investors would prefer to achieve the reasonably consistent, black line over time. If you held the investment represented by the green line, it may cause significant angst as values fall and lead to a decision to sell at an inopportune time.

In this regard, over time:

- Listed investments tend to be more volatile (but obviously more liquid) than unlisted investments.
- Smaller listed stocks tend to be more volatile than larger listed stocks.
- Sectors such as resources, IT and biotech tend to be more volatile than sectors such as healthcare, telecommunications and industrials. The first group of industries may include a higher proportion of early stage businesses which may not be profitable or consistently so. The second group are more likely to contain established businesses.
- Sectors such as bonds and property (when held directly) tend to have much lower volatility than equity based businesses.
- Cash, theoretically, has no, or very low volatility.

Volatility can be measured in a number of ways but is generally not well understood by most investors. It can also be difficult to obtain sufficient data to calculate it properly over time. However, there are some basic things you can do to assess volatility.

Start by looking at a chart of the funds' performance against the index or benchmark. For example, if the fund invests in stocks, you may look at performance against the ASX 200 index. Often managers will make this information readily available. Study the chart, particularly during a time when the market has corrected. Did the Fund move down more, less or about the same as the market?

Some managers also publish limited volatility data. Measures such as standard deviation, up vs. down months and ratios such as the sharp and sortino ratios can be useful tools to assess volatility but generally only if they can be obtained for long periods of time and preferably contain at least one period where a significant market correction occurred.

# 4.5 Assessing the people and investment managers

Performance must be evaluated in light of the stability of the team generating it. We consider the fund managers or portfolio managers for each fund (not the directors, Board, trustee or management company) to be the most important factor in delivering long term returns.

It is important to understand how long an investment management team has been together when assessing the performance of a fund. If the fund has existed for longer than the current key fund managers have been in place, it would be wise to discount or even ignore any performance data from earlier periods, since performance is very much influenced by the team running the portfolio and making to day-to-day investment decisions. Likewise, if a key fund manager leaves a team, it is wise to understand who will replace them and how that might impact returns going forward.

We like to see stability in the investment team and faith in their ability to do the job. Some key factors which may indicate a strong alignment of interest include:

- Where fund managers own part of the management company.
- Where fund managers have a significant personal investment in the Fund.
- Where a fund manager has a long history with the investment management company.

We are less interested in the holdings of non-executive or independent directors, as it is the investment management staff (particularly the fund managers) who ultimately add the value and have the greatest influence on long term returns.

We also like the managers to display certain personal traits, such as being humble, realistic, analytical, risk aware, passionate and competitive. It is also important that they are honest about the value of what they are investing in (i.e. they tell you when it's expensive).

# 4.6 This is how we screen for potential investments:

## 01 Quantitative: Assessment of the Manager's Historical Performance

**We prefer managers who:**

- Have outperformed a fair benchmark over a reasonably long timeframe.
- Have outperformed to a greater degree in down markets compared to an appropriate benchmark.
- Have delivered acceptable total returns over a reasonably long timeframe.

## 02 Qualitative: Manager Operates in the Right Environment

**We prefer managers who:**

- Are operating in a boutique area.
- Are investing in a niche asset class.
- Have a wide asset allocation discretion.
- Are capacity constrained.
- Have fair fee structures which reflect intensity of strategy and are aligned to out-performance.
- Have a stable team around them.

## 03 Qualitative: Assessment of Managers Personal Investment Style

**We prefer managers who:**

- Have a strong risk management focus.
- Have a significant personal investment in the strategy.
- Are cycle-aware.
- Are value-focused.
- Have a low turnover/high conviction mindset.
- Display appropriate personal traits (humble, realistic, analytical, risk aware, passionate and competitive).
- Are honest about the current value of what they are investing in (i.e. acknowledge when assets are expensive).

# 4.7 Size and liquidity

Size matters. In general, a bigger fund will find it more difficult to outperform compared to a smaller fund. For example, a talented equities fund manager may find many great opportunities if they only have $100 million to invest. At this level a 5% portfolio allocation is $5 million and allows a very wide investment universe. If the same fund manager had to invest $2 billion, the same 5% portfolio allocation is now $100 million, and they are constrained to only investing in the biggest equities (and thus have a much more limited number of potential investments). We like our managers to impose capacity constraints on themselves in order to preserve their ability to outperform. The capacity (level of funds they can comfortably manage) is dependent on the market they invest in, the strategy they use and the liquidity of those assets.

There is one drawback with smaller funds. Many costs of running a managed fund are relatively fixed. A fund with a smaller amount of investment assets is likely to suffer from a high cost load, because the fixed costs must be spread over a smaller asset pool. This can negatively impact returns. Some investment managers, like Affluence, limit the percentage of costs to net assets that they will seek to recover from the Fund, in order not to negatively impact funds that are relatively small.

Liquidity in managed funds can vary considerably depending on the manager, underlying assets, and stage of the cycle. All other things being equal, we prefer funds with at least monthly liquidity. However for funds that invest in unlisted assets such as direct property and private equity, this is not always possible, because the underlying assets are not able to be sold in parts, or over a short period. Most of these types of Funds have a set termination date when the asset is sold and net proceeds returned to investors.

# 4.8 Other things to take into account

The above factors are the key attributes we consider when assessing the quality of a manager, however they are not the only ones which can be important. Other features which can be important include:

### Capital management

If a fund is listed, how and when they have raised capital. Have they raised below NTA? Generally, you should be wary of any fund which has raised equity at a substantial discount to NTA.

### Taxation

Managed funds are normally trusts which distribute all taxable income. The amount of taxable income produced each year and the level of taxable income passed onto the investor will depend on the strategy and performance of the manager. How important this is to you will depend on your own tax position and tax rate.

### Borrowings

Some funds borrow directly and some invest in underlying assets that are themselves geared. In general, the higher the borrowing level, the higher the potential risk and volatility will be. Given that, an investor should demand a higher level of return from a geared fund, when compared to an ungeared alternative.

### The management company

Most funds are externally managed, which means the manager is being paid a fee by the fund investors. It is unlikely the manager would be terminated or voted out unless they had severely unperformed and a competitor or another party wanted to aggressively pursue management of the vehicle. Such circumstances are rare.

### Distributions

This is one of the least important things we look at. We would suggest never to buy a managed fund based solely on the distribution yield. You should consider the expected total returns and a range of other factors as well.

### Earnings

This is also basically irrelevant as far as a managed fund is concerned. Earnings are reported as being derived from the distributions received from investments, less costs, plus/minus changes in the value of the investment portfolio. However, reviewing long term investment performance is a much better measure than short-term accounting earnings.

### Management fees

In our view, management fees are less important than you might think. We believe fees should reflect the intensity of the investment process and capacity of the strategy. For example, a higher fee may well be justified for a very specialised strategy with a limited investment capacity and a clear competitive advantage. Would you rather have a 3% management fee and 15% per annum returns, or a 0.5% management fee and 2% per annum returns. We know which one we'd prefer. If you look at performance after fees and costs, management fees in isolation become much less important.

# 05 RISKS OF MANAGED FUNDS

Like all investments, managed funds carry certain elements of risk and an investor should be aware of the risks of any managed fund they are looking to invest in. Some of the risks associated with managed funds are:

## 01 Market risks

The major source of risk and volatility with managed funds comes from the underlying assets held by the fund. If for example the ASX 200 index drops by 10% over the course of 12 months, then an Australian equity fund may fall by a similar amount (it could fall by more or less than 10% depending on the skill and strategy of the fund manager).

## 02 Key person risks

The performance of the fund may be affected by the skill or reputation of the fund manager. This may give rise to 'key person risks' should the particular fund manager leave the organisation.

## 03 Liquidity risks

Managed Funds are relatively liquid with most funds providing regular liquidity (often daily, weekly or monthly). In times of severe economic downturns, however, these funds can reduce this liquidity, and potentially even freeze all redemptions for a period of time, so as to protect the holdings of the fund and not disadvantage investors who wish to stay invested. In addition, some funds offer no liquidity during the investment period and investors only receive their investment back when the fund sells its assets.

## 04 Investment horizon risks

All managed funds have various recommended time horizons. Some are short time frames (0-3 years) and others are longer time frames (5-10 years). It is important a fund's timeframe is aligned with an investors desired investment horizon, as investment returns rarely occur in a straight line. Markets and investments move up and down, and if an investor is forced to sell early for a loss, they lose the ability to generate a longer term positive return.

The PDS or Information Memorandum for each managed fund should clearly outline the types of risks most likely to impact investors in that Fund. It is important to read this information carefully as it can be helpful to understand whether an investment in the fund matches your risk tolerance.

# 06 SUMMARY

**Invest Differently**

If you want better than average returns, you need to invest differently and more strategically than the crowd.

**Invest for Value**

Value investing works best in the long term, particularly when combined with positive momentum.

**Market Awareness**

Being aware of long-term cycles and seeking to time investments can significantly improve performance.

**Be Patient**

Long term success requires a long term focus, which in turn requires patience and discipline.

## 6.1 Do your homework

Like all investments, it's best to do your homework properly before buying any managed fund.

Buy only quality funds with proven managers you can trust, who have performed well in the past.

Invest in funds which own assets you like, using an investment strategy you understand, with an appropriate structure in place.

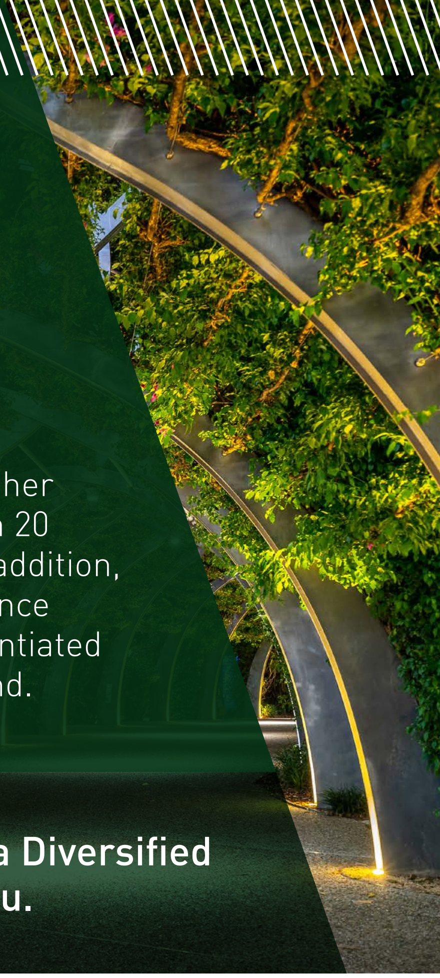
Most importantly, make sure you understand how each managed fund fits into your overall portfolio and how it can add value over your investment timeframe.

## 6.2 Is it the right time to buy?

You may have found a great manager and a fund with the right strategy, that has performed above an appropriate benchmark. But there is a final step before you invest. Are the underlying assets trading at your assessment of fair value? For example, while there will always be individual assets in a particular asset class that trade above and below fair value, if an overall asset class is considered to be overvalued, there is much less chance of achieving a satisfactory return. Remember the old adage "buy low and sell high". There is where patience comes in. It may be necessary to wait months or years until the funds underlying assets are at a value you are happy with. There is little point entering an investment at the top of the market, even if it is with the best manager.

# 07 INTRODUCING THE AFFLUENCE INVESTMENT FUND

The Affluence Investment Fund is our all-weather fund, bringing together our best ideas across all asset classes. The Fund invests in more than 20 funds managed by some of Australia's best investment managers. In addition, the Fund gains access to fixed income investments through the Affluence Income Trust, to LICs through the Affluence LIC Fund, and to a differentiated small cap equities strategy through the Affluence Small Company Fund.



Let us choose a Diversified Portfolio for you.

## Fund Features

- Access to 20+ Underlying Managers
- Monthly Distributions*
- Exceptionally Diversified Portfolio

## Investment Objective

The Fund targets a minimum annualised return of inflation plus 5% over rolling three year periods and a minimum distribution of 5% per annum.

## Investment Strategy

The Fund holds a diversified portfolio and can invest across all asset classes. The portfolio includes over 20 different underlying managers and other investments selected by Affluence. The strategy seeks a balance between maximising returns, delivering regular income and lowering volatility.

## Investment Team

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## Key Statistics

| | | | |
|---|---|---|---|
| Investment Class | Multi-Asset | Applications | Monthly |
| Minimum Investment | $20,000 | Withdrawals | Monthly |
| Suggested Timeframe | At least 3 years | Management Fees | Nil |
| Target Returns | Inflation + 5% | Performance Fee | 12.5% of positive performance |
| Distribution Frequency | Monthly | Buy / Sell Spread | 0.25% / 0.25% |

This information has been prepared by Affluence Funds Management Limited ABN 68 604 406 297 AFS licence no. 475940 (Affluence) as general information only in relation to the Affluence Investment Fund ARSN 617 680 654 (Fund). It does not purport to be complete, and it does not take into account your investment objectives, financial situation or needs. Prospective investors should consider those matters and read the Product Disclosure Statement (PDS) and the Target Market Determination (TMD) for the Fund before making an investment decision. The PDS is available at https://affluencefunds.com.au/aif/ and contains important notices and disclaimers, important information about the offer, as well as investment risks. There is no guarantee of any distribution, forecast, investment return or repayment of capital. This information and the information in the PDS is not a recommendation by Affluence or any of its officers, employees, agents or advisers. Potential investors are encouraged to obtain independent expert advice before any investment decision.

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