

## Australian shares in focus

30 November 2006

ipac is investigating a range of opportunities to further enhance the return potential from the Australian shares sector. These enhancements build from a solid base.

In the year to the end of September 2006, ipac's Pathways Australian Shares Strategy delivered a return of 17.3%. This return is superior over one, two and three years compared to the benchmark, median manager, and key multi-manager competitors.

### the theory in a nutshell

ipac constructs sector strategies that combine many sources of return by blending managers with unique investment skill and implementing these ideas effectively. The end result over a market cycle should be more consistent returns above benchmark.

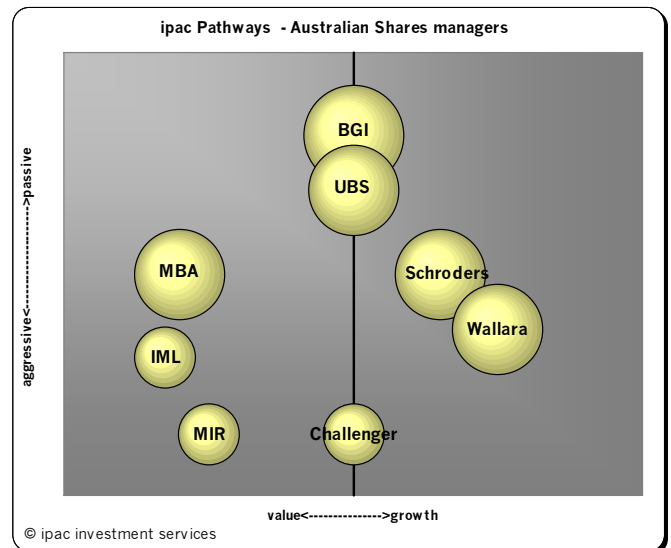
Put simply, there are three drivers of excess return in a portfolio – manager skill, the variety of decisions made to generate return and how efficiently you transfer the ideas into the portfolio.

Australian shares offers many diverse opportunities for skilled managers with different philosophies to add value. Multi-manager provides the strategy for harvesting this breadth of return sources, by employing a range of specialist approaches. The more sources of return you combine the more consistent the outcome. The challenge is to find managers with the skill to consistently add value.

The diversification of a multi-manager portfolio enables the addition of more specialised approaches that would have a higher degree of risk on a stand alone basis. When combined with the total portfolio the exposure to this risk is reduced while the potential return is increased.

Poor implementation can erode the return reducing the benefit of these investment ideas. A focus on efficiency is just as important if you are to generate the best possible return for risk.

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The current sector construction is shown in the chart above. It highlights the different style of managers. The size of each bubble represents the allocation to each manager. In aggregate, the portfolio should be fairly style neutral over time.

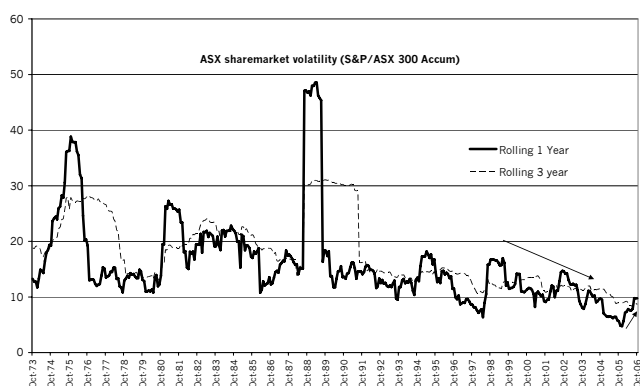
The first type of return you want to capture is where the general market rises or where companies broadly do well. A manager like BGI with its Alpha Tilts process invests across the index taking slightly larger and smaller positions than the benchmark. A manager like UBS is also broadly style neutral but takes larger bets.

With the core of the portfolio covered it is then important to capture the potential return from the growth and value styles of investing. Over a market cycle both styles come to the fore.

Managers such as Maple-Brown Abbott exploit certain value characteristics. Schrodgers generally has a bias toward growth. The appointment of value and growth managers that focus on other value and growth style drivers of return, like Investors Mutual and Wallara respectively, boost returns when these factors run hard.

Multi-manager investing enables the inclusion of less benchmark aware managers with specialist skill like Challenger and MIR. These managers are more aggressive, providing the potential for increased return, and also offer diversification benefits as they focus on specific sources of return. The benefit from these unique investment approaches is best seen by the inclusion of Challenger. In the year to the end of September 2006, Challenger generated a return 9.1% above the index.

## future developments in the Australian shares sector



source: InTech

A feature of the Australian share market over the last decade has been a general fall in volatility as illustrated in the diagram above. While ipac's performance in this sector has been very competitive over recent years, we are continually seeking ways to enhance the excess return potential through the inclusion of more manager skill, greater breadth of active management decisions and improved implementation.

ipac is examining the scope for our current managers to take increased risk to further utilise their skill. An example may be allowing some managers to opportunistically invest in a small number of international stocks.

In addition, the portfolio is likely to benefit from exposure to more diverse sources of return if manager skill can be identified in areas such as:

- ~ a price and earnings momentum focus. Research suggests that price and earnings momentum is well rewarded in the Australian market.
- ~ a top-down based approach. A top-down approach seeks to identify and act on broader economic, political and market themes that may have a positive impact on companies and sectors. The impact of Chinese demand on the resources sector is a good example of a top-down market impact.
- ~ other more efficient approaches such as short selling and alpha transport.

There may also be greater potential to combine passive management with more aggressive benchmark unaware managers.

It is likely that any new managers will be introduced gradually to the portfolio.

ipac will also seek to further increase the efficiency of our implementation. Among the considerations are strategies to reduce the transaction costs incurred by Australian share managers, for example through centralised portfolio management.

ipac will advise on the findings of this ongoing research progressively through 2007.