

building  
shock resistant  
portfolios

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# Risky Business

## Building Shock Resistant Portfolios

PRESENTED BY

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**LEGG MASON**  
Australian Equities

# Agenda

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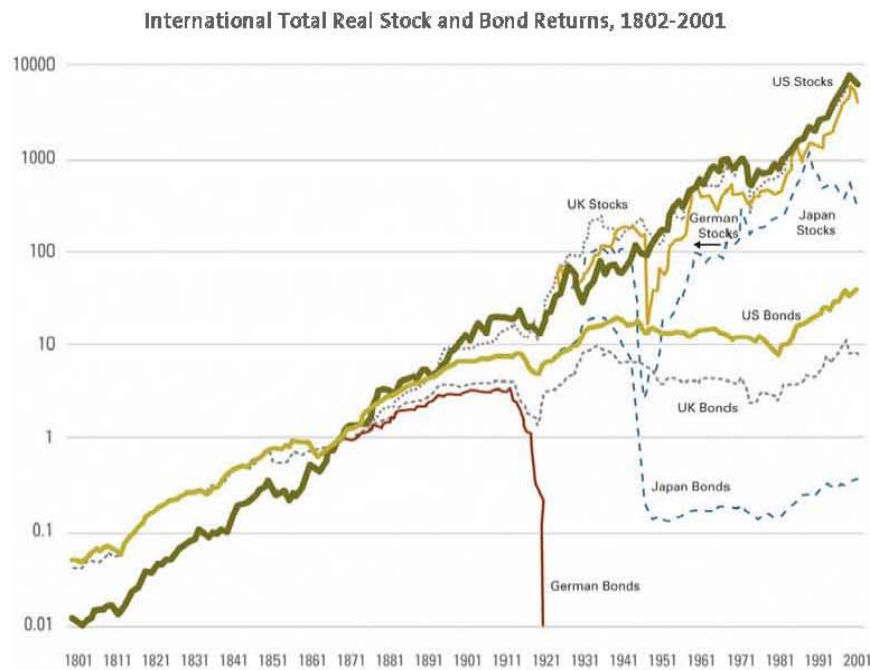
1. Australian equity volatility vs. shocks
2. Volatility and shocks in the approach of fund managers
3. The cost of mis-interpreting risk
4. Avoiding shocks in active management
5. Conclusion and take-outs

# Australian equity volatility vs. shocks

Volatility is normal

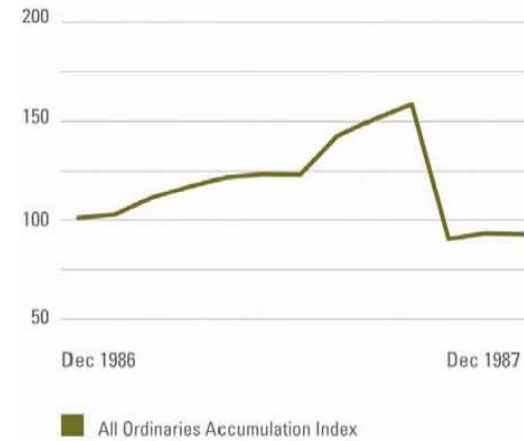
Volatility gets washed away with time and positive returns

A real shock: breakdown in long term return drivers

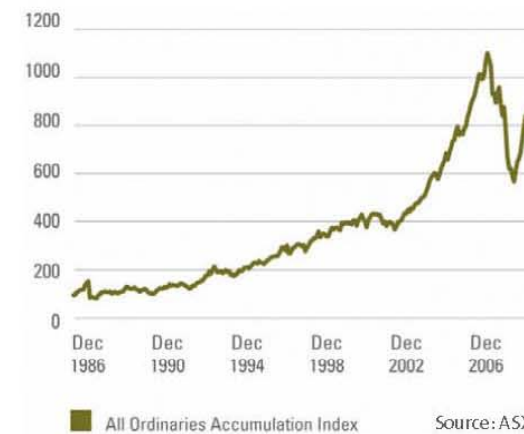


Source: Stocks for the Long Run by Jeremy Siegel

Australian Equity Performance during the 1987 crash



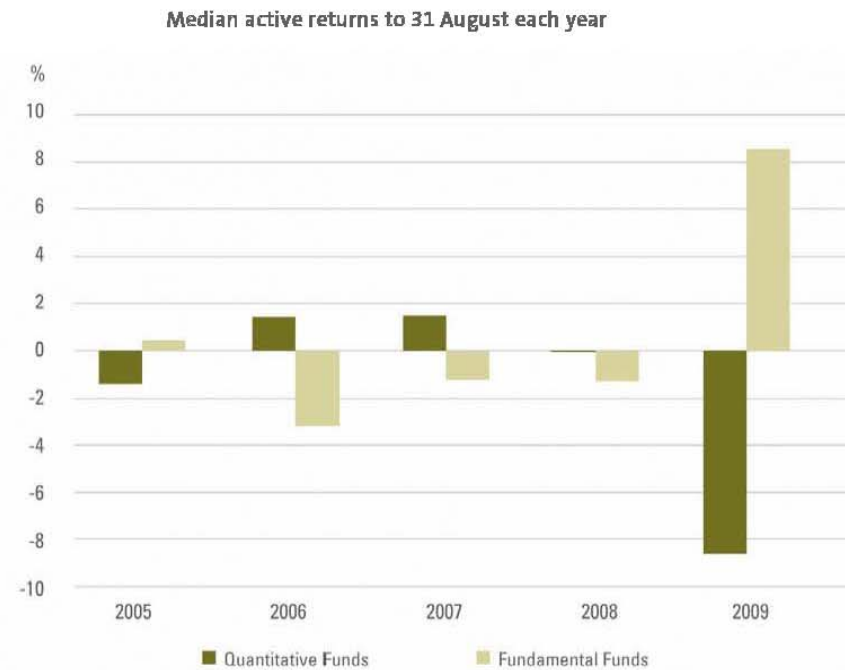
Australian Equity Performance over 26 years



# Volatility and shocks in the approach of fund managers

- Managers target outperformance with their own investment philosophy and process
- A process creates a pattern or signal of investment returns
- Patterns lead to cyclical performance or volatility

Performance of quant versus fundamental funds



# Volatility and shocks in the approach of fund managers

Risk premiums: What are they?

- additional return on offer for taking on volatility risk
- associated with any investment: Default, Property, Liquidity, Inflation, Equity, Small Caps
- can suffer long periods of underperformance, they are not riskless

Short term investors & Risk models care about the volatility that exposure to these premiums create

Long term investors care about the additional return potential and whether the risk premium is under or over priced

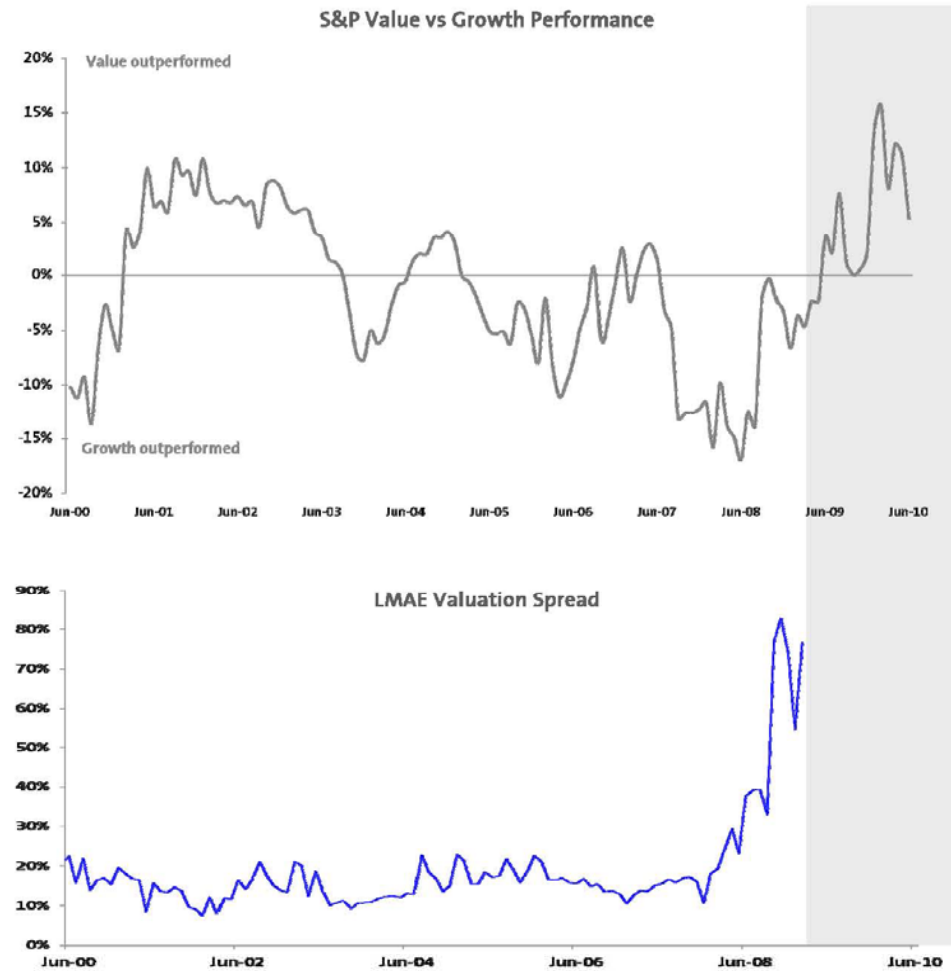
The Small Cap risk premium has a strong long term track record



A 0.5 overweight exposure to small companies equals 1% tracking error on Barra

# Volatility and shocks in the approach of fund managers

In the face of volatility, measuring opportunity is far more important than historic returns

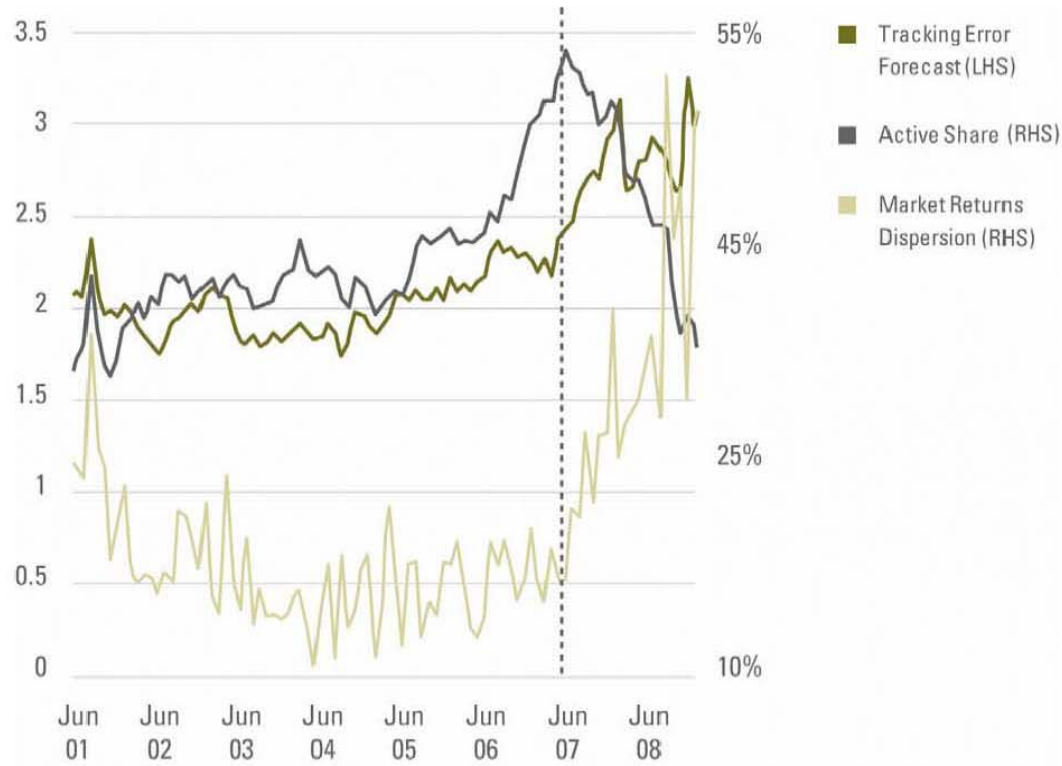




# The cost of mis-interpreting risk

Tracking Error relies on historic information

Active Share can reveal a build up in risk exposure





# Avoiding shocks in active management

Diversity of opinion drives better investment decisions

## Value?



## Or Value trap?

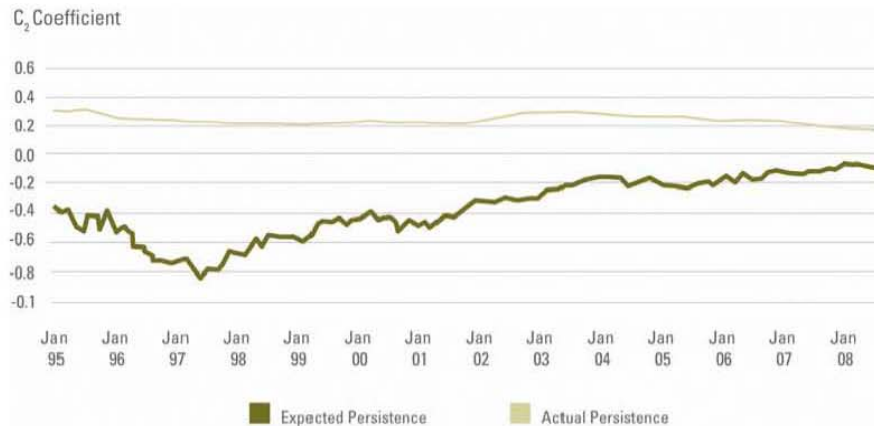


# Avoiding shocks in active management

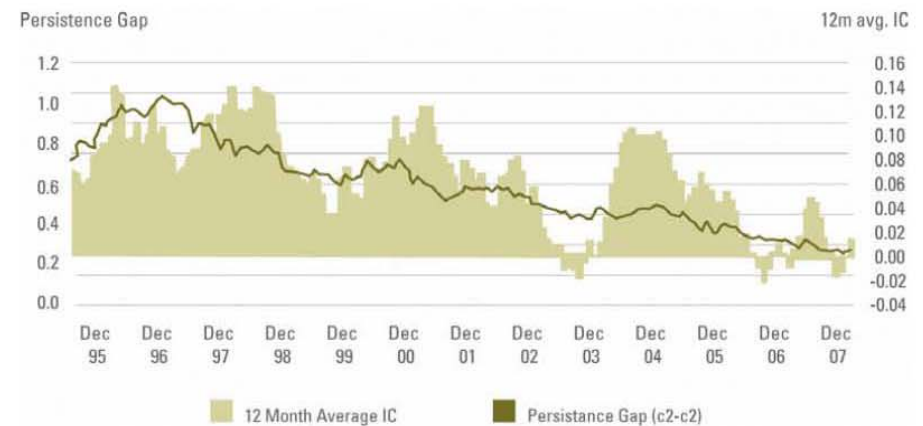
Why past performance is *really* not a reliable indicator

## When it goes wrong

S&P/ASX 300: Actual versus expected earnings revision persistence through time (5 year rolling regression)



Comparison of persistence gap with 12 month average IC: S&P/ASX 300



# Avoiding shocks in active management

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## Concentration risk

BP's recent experience	BHP's exposure
Macondo Oil Well blew out on April 20, 2010.	BHP produces 60% of its oil in GOM. It produces 65mmbbl of 107mmbbl.
BP (65% and operator), Anadarko (25%) and Mitsui Oil Exploration or MOEX (10%) is ownership.	BHP's GOM interests: Mad Dog (24%), Atlantis (44% and operator), Shenzi (44% and operator) and Neptune (35%).
Pre drill estimate of Macondo was 50mmbbl	BHP Share of 2P reserves: Atlantis (219mmbbl), Mad Dog (113mmbbl), Shenzi (115mmbbl).
BP Contractors: Transocean (driller), Halliburton (cementer), Cameron International (blow out prevention )	Same contractors employed by operators all over the Gulf of Mexico, including BHP.
BP's market cap at April 23 was US\$187bn. It fell to a low of US\$85bn on June 28	A US\$100m exposure is 52% of BHP's market value and 6% of the ASX200

## Conclusion and take-outs

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Understand the difference between volatility and risk – focus on the long term

Australian equities – opportunity to participate in growth of economy

Fund manager styles are cyclical and can experience volatility in performance

Backward looking risk models are limited – a need for fundamental assessment of risk

Focus on future expected returns – valuation can identify style opportunities

Read the effectiveness of signals – they can change over time and create further shock

Be aware of hidden risks like high concentrations

In the same way stocks are diversified, analytical approaches should be blended for thorough analysis

# Overview Legg Mason Australian Core and Value Equity Trusts

	Core Trust	Value Trust
Trust inception	April 1982	November 2006
Performance target	3.0% above S&P/ASX 200 Accumulation Index	3.5% above S&P/ASX 200 Accumulation Index
Benchmark risk aware	Greater focus on risk control	Active position sizes proportional to risk and reward potential
Position limits	Stocks (4%) and Sectors (6%)	Stocks (6%) and Sectors (11%)
Stock numbers	Approximately 60	Approximately 30
Portfolio turnover	<70% expected	<40% expected
<b>S&amp;P Rated</b>	<b>Three Stars</b>	<b>Four Stars</b>

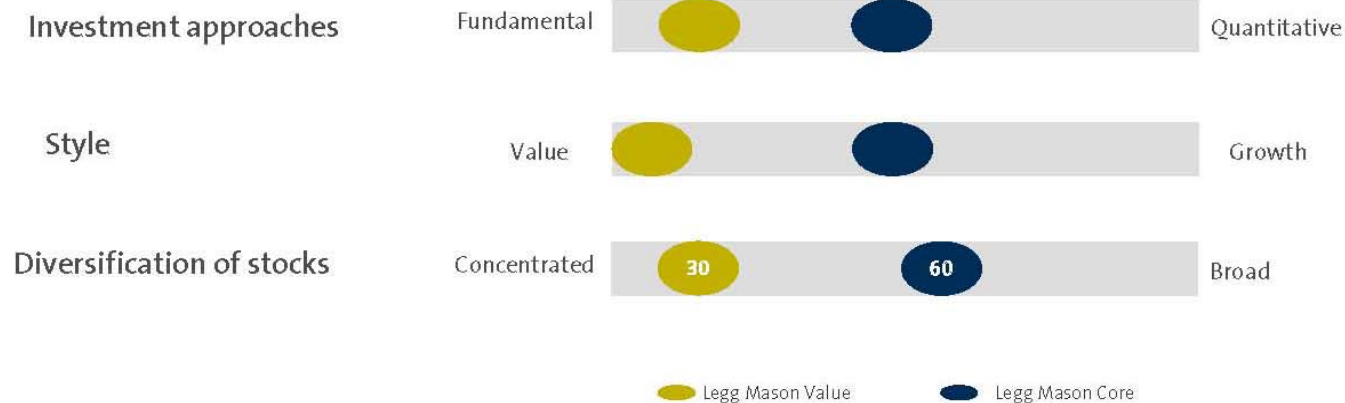
# Investor type and portfolio positioning

## Core Trust

- > Designed as core holding in portfolio, with no major style bias to growth or value
- > Ideal for investors seeking high diversification, relatively low risk and reliable investment performance
- > Blends well with higher-risk strategies like concentrated, deep value or growth Australian equity funds. Can also be used as a stand alone Australian equities fund, instead of index fund

## Value Trust

- > Seeks to maximise returns by holding undervalued securities
- > Ideal for investors seeking higher alpha potential with strong forward looking signals driving stock selection
- > Designed to blend with a lower-risk core holding or other higher-risk strategies like growth Australian equity funds



# Why Legg Mason Australian Equities?

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## Experience in Australian Equities

15 years average experience in team, portfolio managers have 13 years together

## Depth of resources

12-person Australian equities team, leading trading and compliance systems

## Alignment with investors

- > Remuneration structure and co-investment with clients, so best reward comes from best performance

## Global business

- > 10th largest fund manager globally with over 550 investment staff

## Both Value & Core have benefits

- > Different strategies, but each has a place in improving portfolio risk and return attributes

### Why Value?

#### Opportunities are here now

Wide valuation spreads make it an ideal time to invest

#### Higher alpha target

Provides a more highly concentrated, higher alpha target fund for your portfolio, driven primarily by valuations generated by our own insights

### Why Core?

#### Stars are aligned now

Quant signals suggesting positive alpha going forward

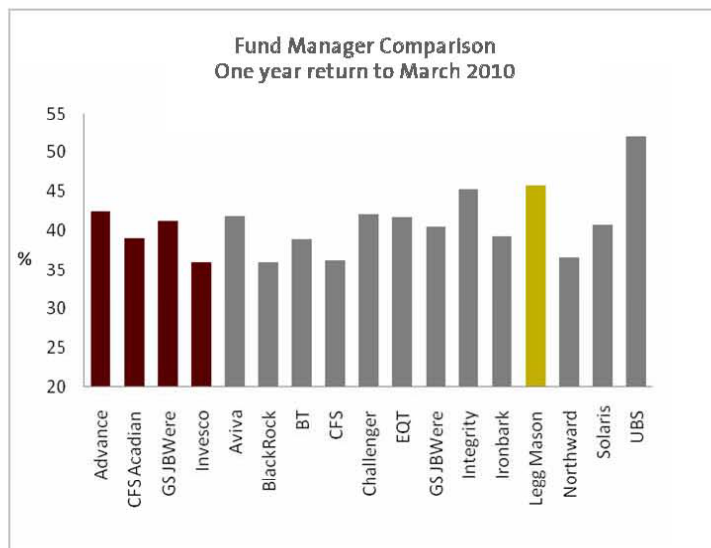
#### Built for risk control

Provides a more risk controlled option for your portfolio, more diversified in terms of stocks and amount of signals used to drive stock selection



# Why Legg Mason Australian Equities?

### Legg Mason Core



■ S&P Quant Managers   ■ S&P Style Neutral/Core managers

### Legg Mason Value

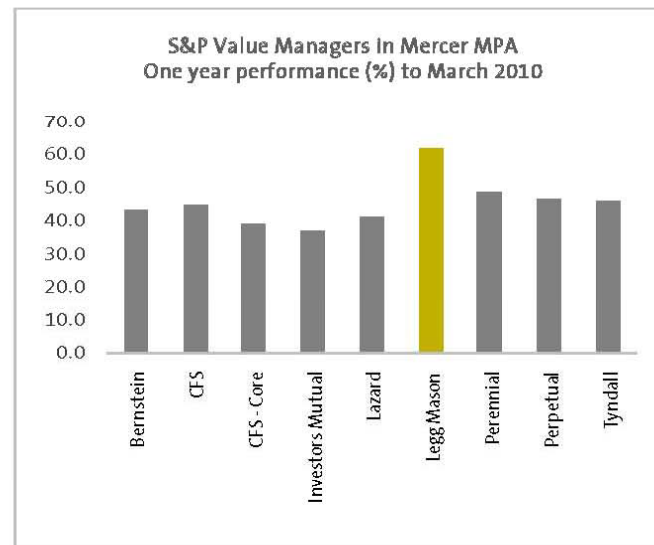


Chart only identifies S&P Value managers that participate in the Mercer MPA survey – it is not an exhaustive list.

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