portfolio construction

CONFERENCE

130/30 Australian Equity Investing

Squeezing more out of up and down markets

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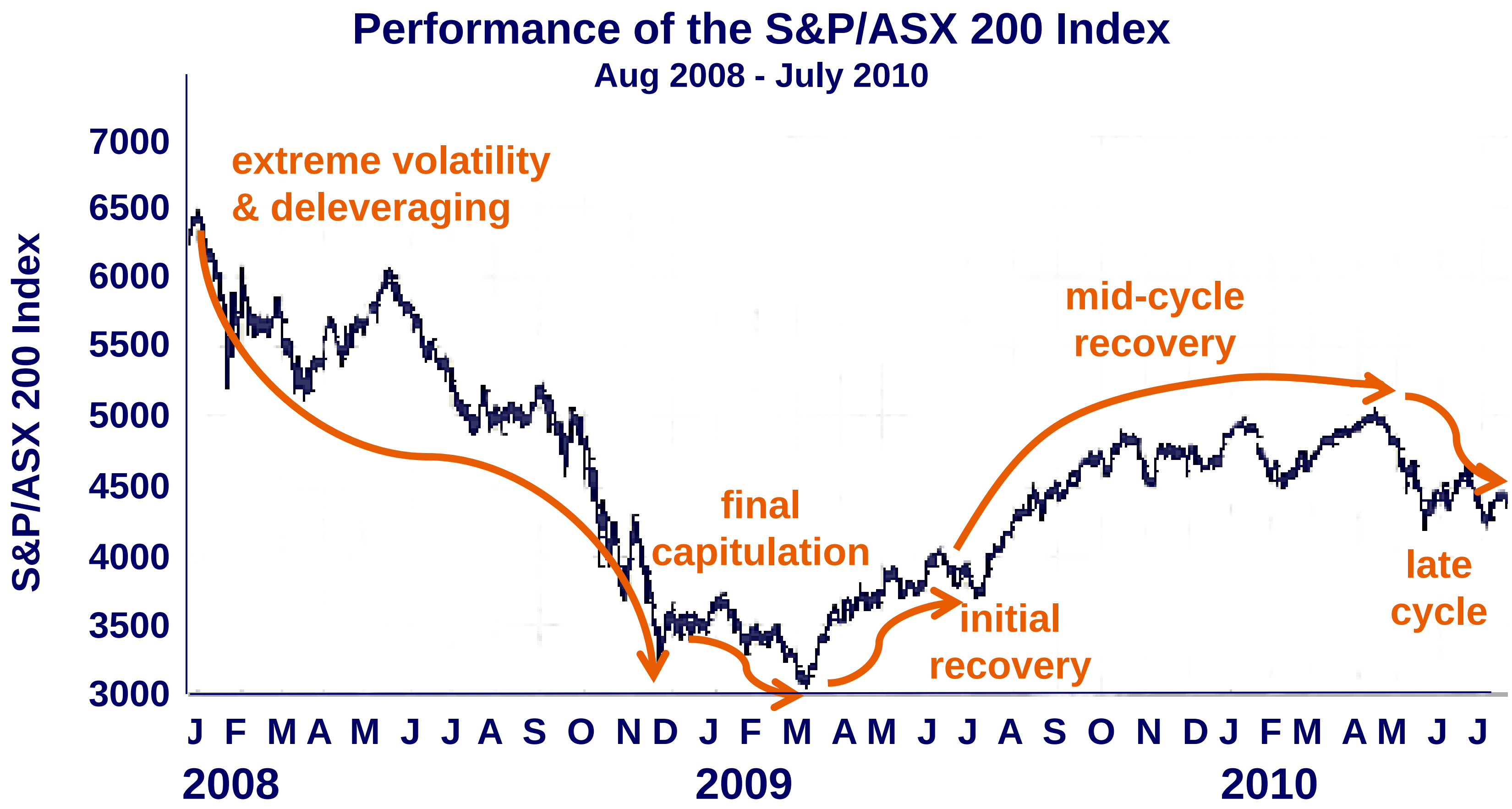
ING Investment Management

Portfolio Construction Forum,
Sydney 24-26 August 2010

www.ingim.com.au

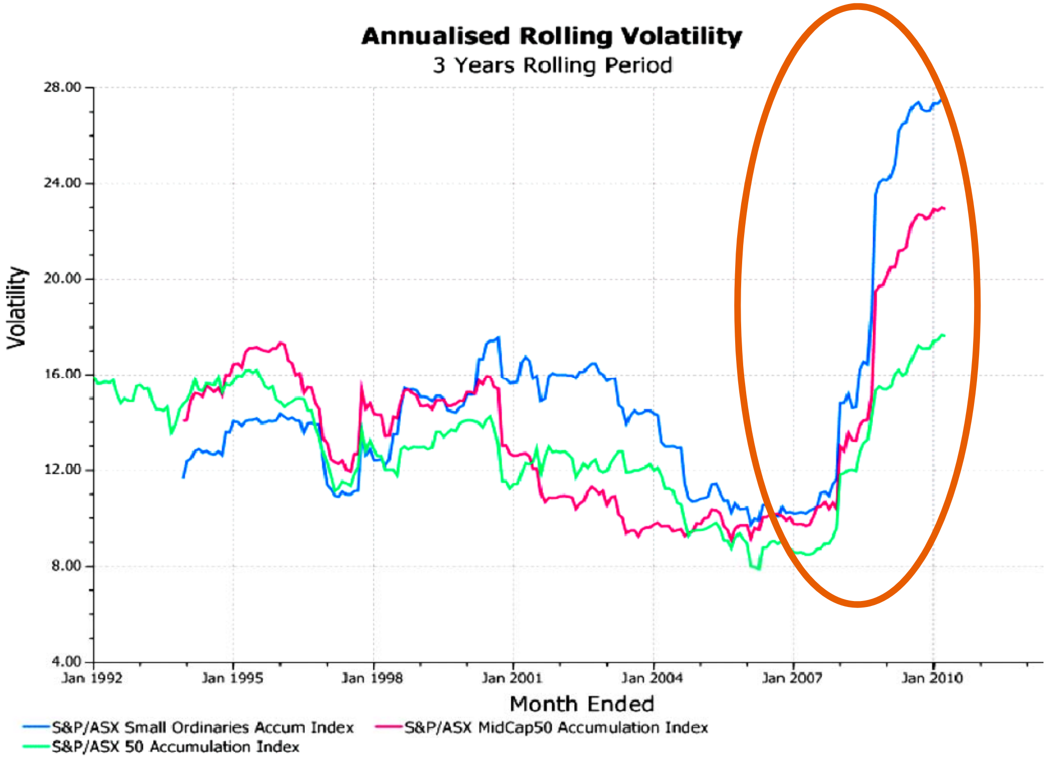
Five distinct phases since the GFC



Source: ING Investment Management and Australian Stock Exchange.

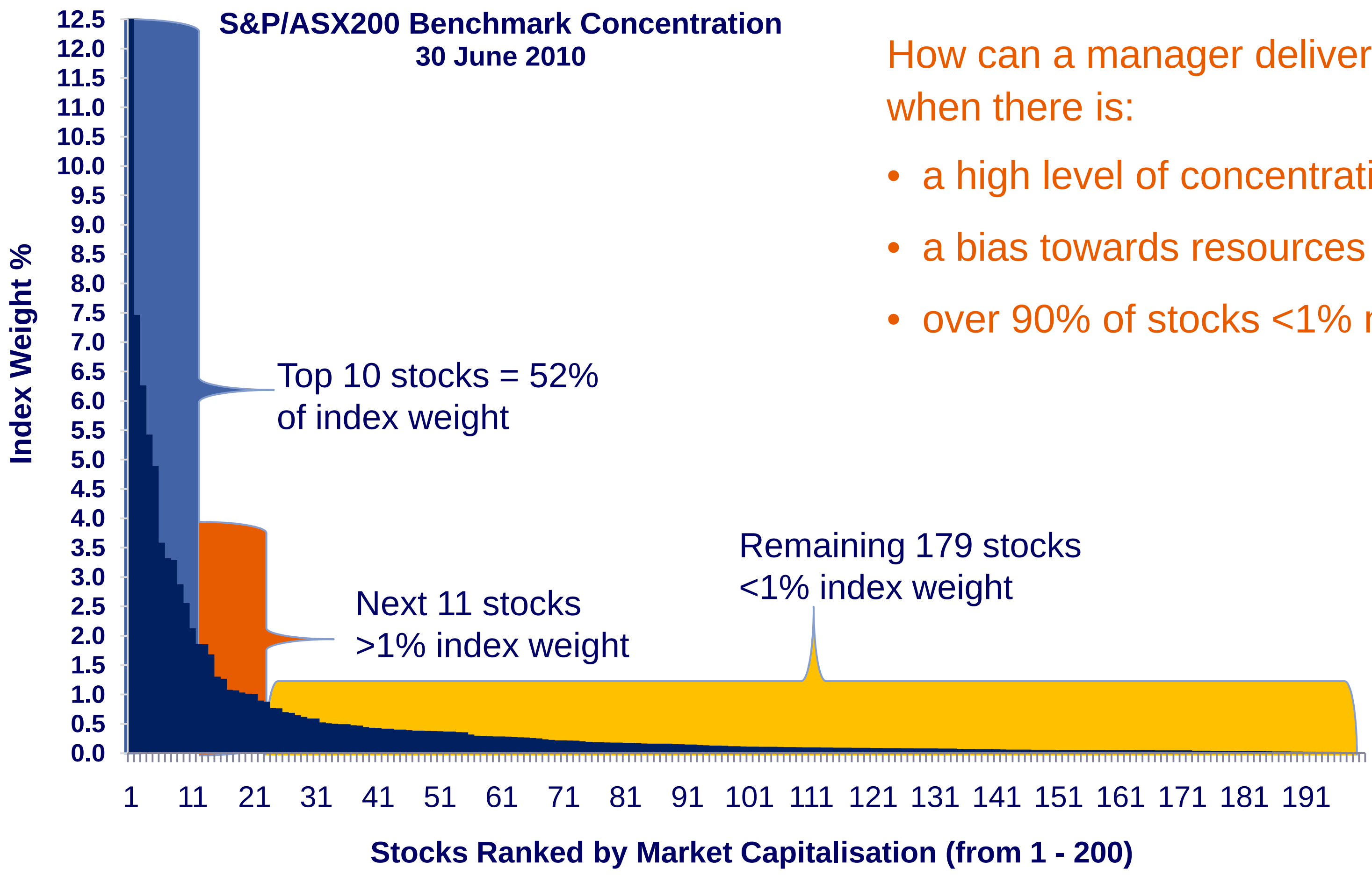
Increased volatility

- Economic cycle will look different from past decades
- Equity markets will undergo multiple rallies and pullbacks
- Supporting alpha generation
- Need to be cognisant of price points
- Opportunistic turnover to capture alpha



Source: van Eyk estimates, Bloomberg taken from van Eyk Research Limited, "Australian Equities Specialist Overview – Sector Review 2010" (June 2010)

More challenges for investors
- the shortcomings of the index



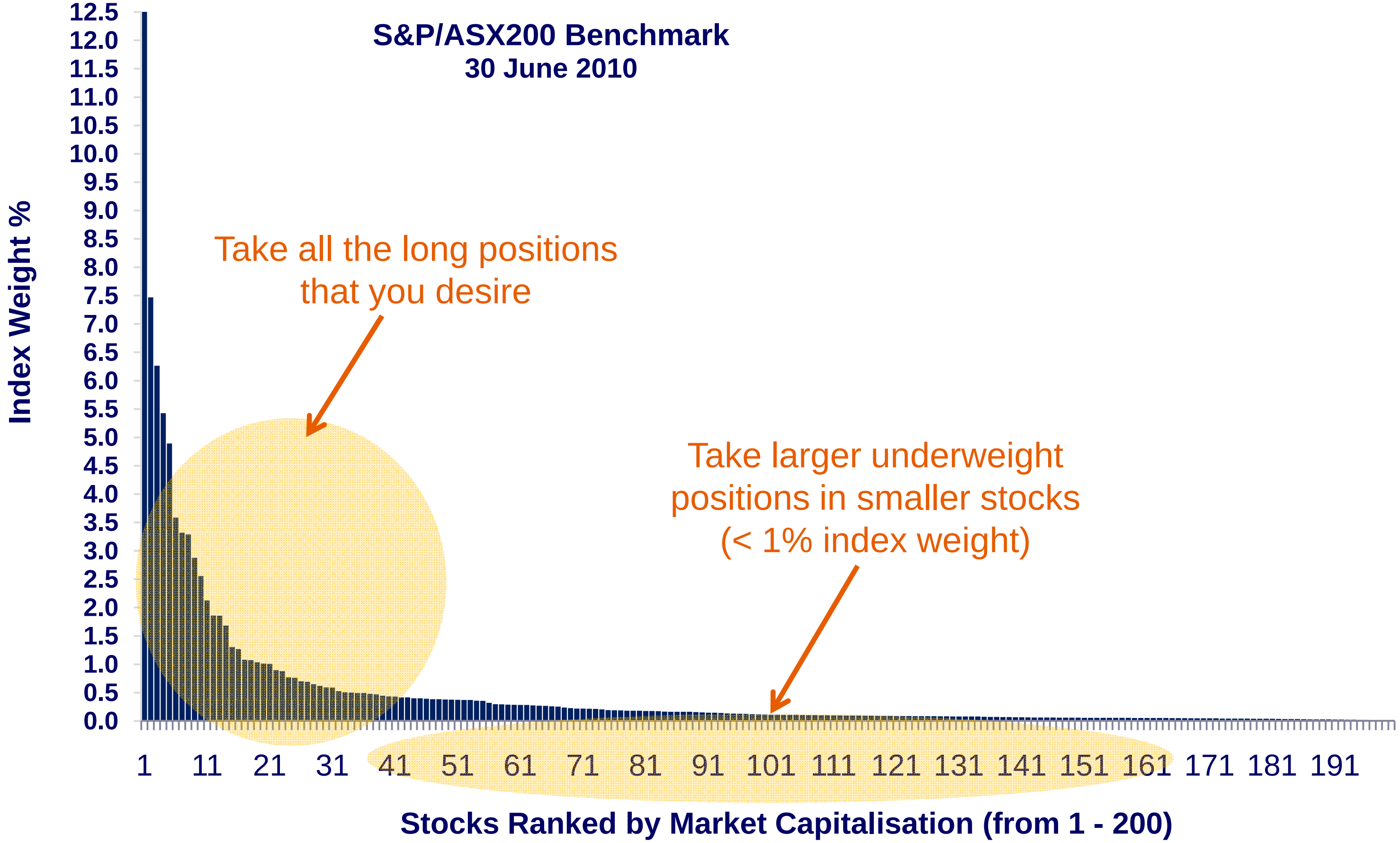
Source: ASX and ING Investment Management

How can a manager deliver more alpha when there is:

- a high level of concentration (top 10 stocks)
- a bias towards resources and banks
- over 90% of stocks <1% market cap

Overcoming the shortcomings of the index

Relax the long-only constraint by adding shorting tools to the mix!



Source: ASX and ING Investment Management

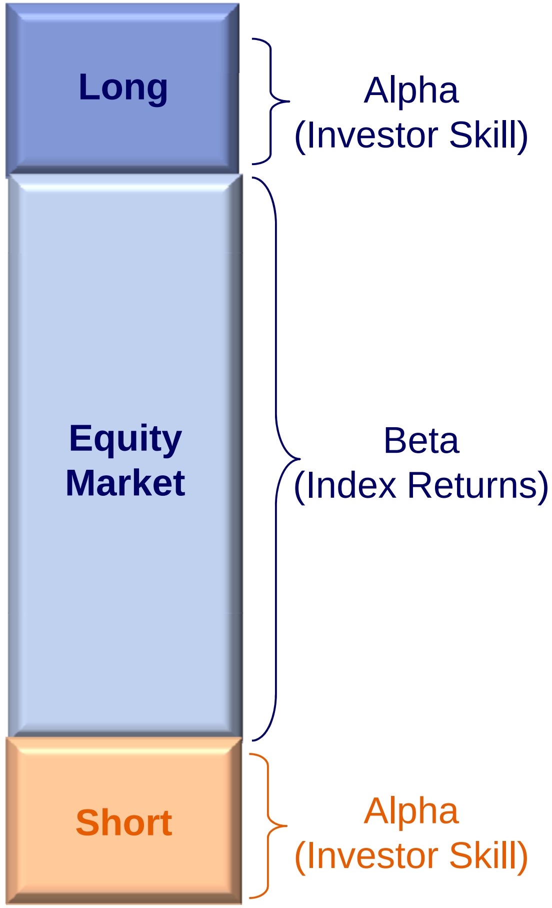
Mechanics of Shorting

You can initiate short positions by:

- borrowing stock and physically selling on market
- using the options market, typically bought put options
  - may be either exchange traded or European OTC
- short futures - index or custom (OTC)

Introducing a 130/30 long/short solution

- 130% long offset by 30% shorts to retain 100% net equity exposure (beta 1)
- **Expanded opportunity set** to generate alpha
  - negative views rewarded through shorting
  - high conviction positive views rewarded through increased exposure
- Can **add value in both rising and falling** markets
- Provides a level of **capital preservation**
- **Capital efficient** - increases active positions with minimum capital outlay



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Unlocking alpha - the benefits of 130/30

- Better portfolio efficiency[1] than long-only strategies over the long term
  - higher excess return
  - higher information ratio
- Long only restrictions have a significant effect on portfolio performance.

US 130/30 Long/Short v Long-Only Equity Funds

(1994-2006)

	Excess Return	Info. Ratio	Tracking Error	Batting Average	Turn-Over
Domestic					
Long-Only	7.61	1.25	5.43	61	52
130/30	11.27	1.51	6.48	65	106
Ratios	1.48 x	1.21 x	1.19 x	1.06 x	2.04 x

Table by Clarke, de Silva and Sapra for the period 1994-2006 for US (i.e. Domestic) and International equity markets.

- Introducing shorting increases the transfer coefficient
  (allows all information to be transferred into performance)

130/30 is about getting financial rewards for negative stock views as well as positive stock views

[1] Based on studies by Gordon Johnson in 2007 from Lee Munder Capital Group. Please note that transaction costs were not factored into the model but these would not be large enough to seriously affect the general conclusion of this empirical test.

The information ratio (IR) measures a portfolio manager's ability to generate excess returns relative to a benchmark, and also attempts to identify the consistency of the portfolio manager. This ratio will identify if a manager has beaten the benchmark by a lot in a few months or a little every month. The higher the IR the more consistent a manager is.

Where do 130/30 long/short strategies fit?

Features	Long Only	Active Extension (eg. 130/30 long/short)	Hedge Funds
1. Investment Style	• Relative Return	• Relative Return	• Absolute Return
2. Benchmark	• Index	• Index	• Risk-free rate (Cash)
3. Beta	• Beta 1	• Beta 1	• Beta 0
4. Short Selling	• No - Long only	• Yes - Long /Short	• Yes - Long / Short
5. Leverage	• No	• Yes - Restricted	• Yes - Not restricted
6. Management Fee	• Base Fee	• Base Fee + Performance Fee	• Base Fee + Performance Fee

A 130/30 Manager views the market in the same way as a long only manager due to a Beta 1 exposure

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Shorting Strategies to suit different objectives

A range of shorting strategies should be used because:

- different methodologies work for different types of market and stock conditions
- a manager should preserve capital as well as increase alpha
- it can improve the risk profile of the portfolio

Alpha shorts

Pairs Trades

Funding Shorts

Alpha Shorts (outright shorts)

What is it? An outright short position on a company (structural short)

When do you use it? You expect the stock price of a company will fall in value.

Catalyst:

- Based on analysts' valuations, price targets and/or conviction scores
- Typically companies with balance sheet issues, structural flaws or excessive valuations

Key Points: Requires tight risk management controls ie. stop loss limits; option overwriting

Implementation Tools:

- Put Options - to implement the short
- Call Option - to implement the stop-loss at a pre-determined price

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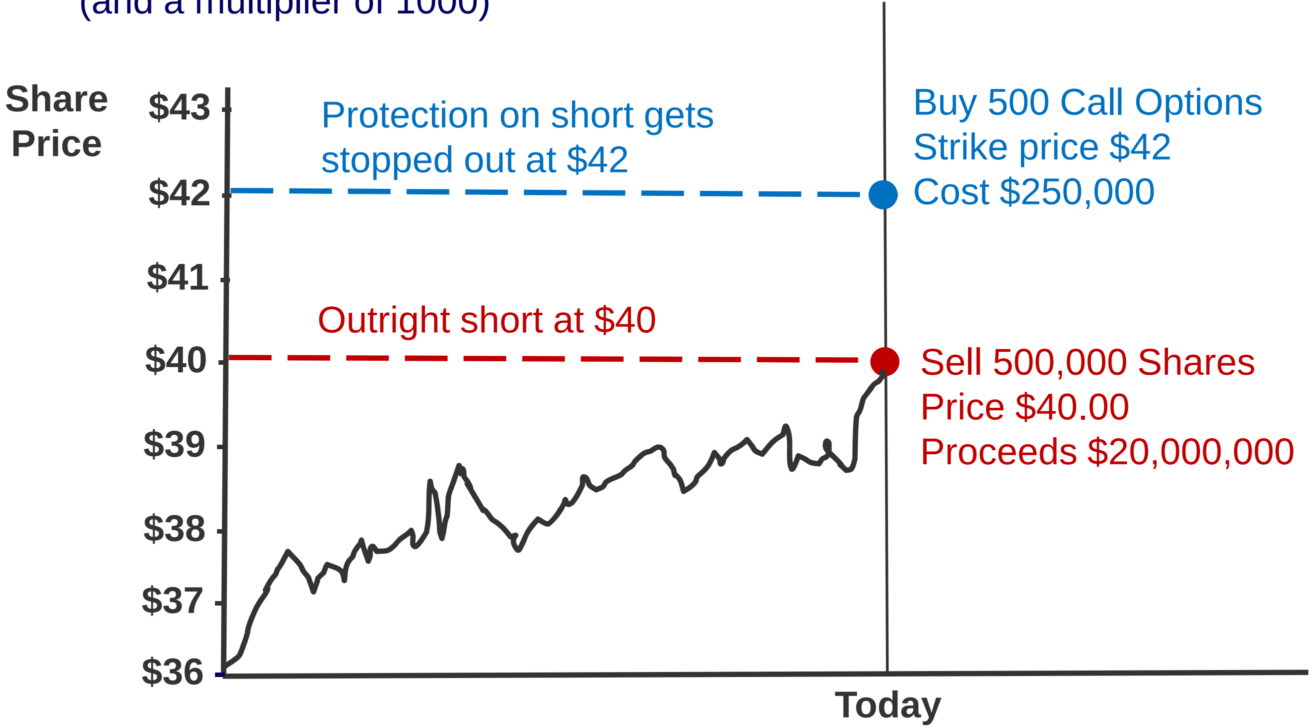
Alpha Shorts: A Case Study

Company A's stock price is expected to fall

- Investor sells shorts 500,000 shares @$40
- Receives proceeds of $20m
- Protects this exposure with 500 out-of-the-money call options with a strike price of $42 (and a multiplier of 1000)

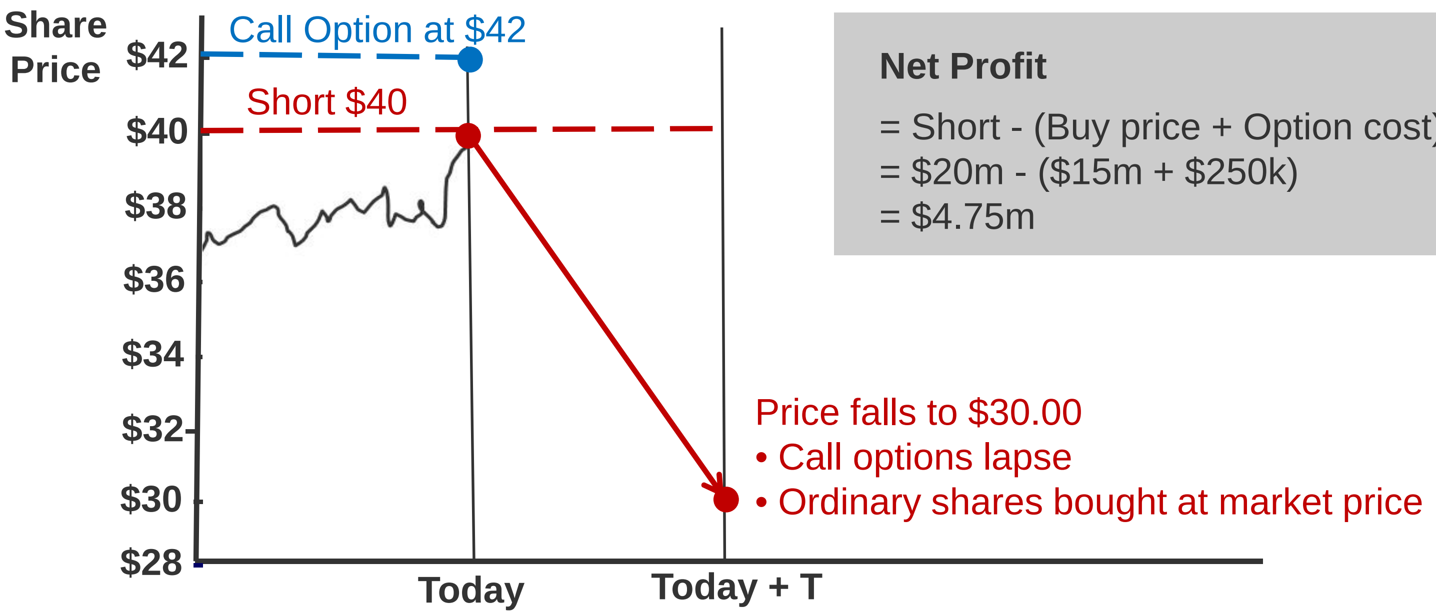


Source: ING Investment Management. Note: This theoretical representation of a trade does not include transaction costs

Alpha Shorts: A Case Study

Scenario 1: Trade goes as planned and stock price falls to $30

- Investor closes out shorts by buying equivalent amount of stock at $30 per share
- Buys back short position for $15m
- Protection (ie. call options) is left to lapse
- Profit of $5m less protection cost is $4.75m



Net Profit

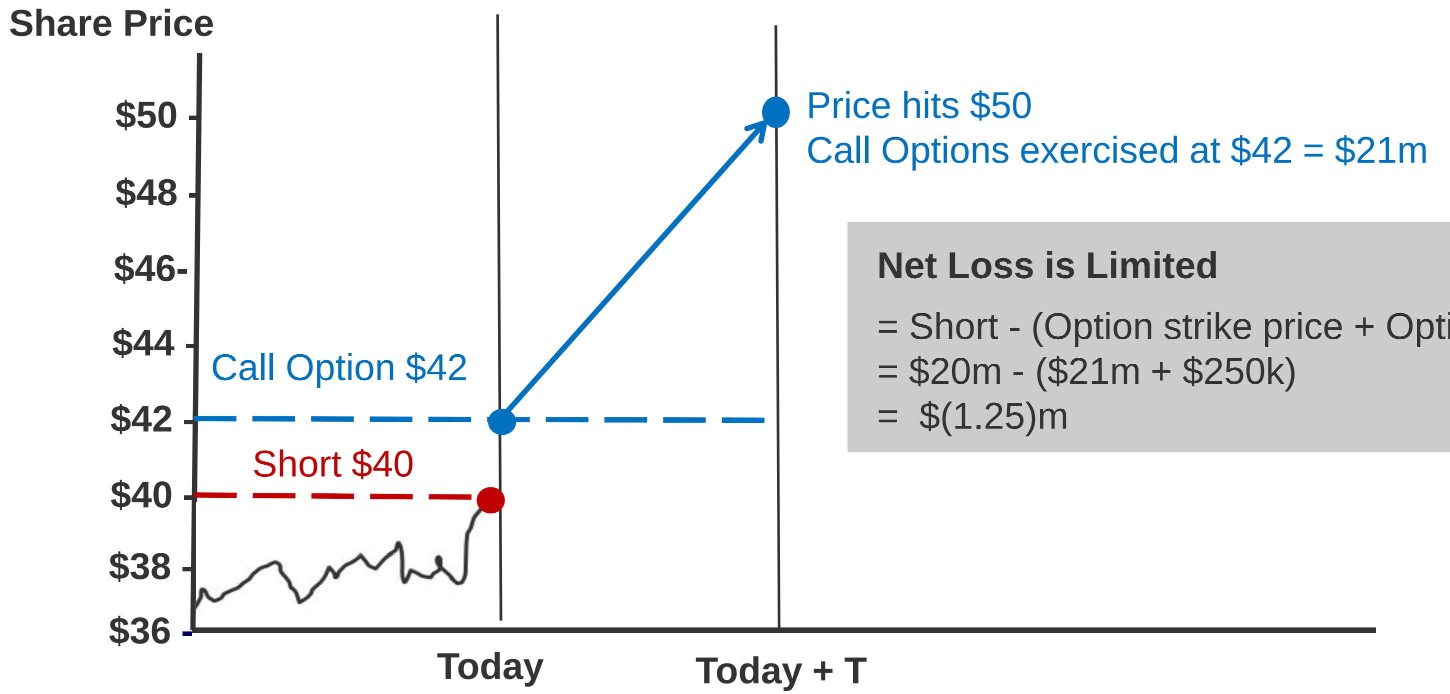
= Short - (Buy price + Option cost)
= $20m - ($15m + $250k)
= $4.75m

Source: ING Investment Management. Note: This theoretical representation of a trade does not include transaction costs

Alpha Shorts: A Case Study

Scenario 2: Trade goes against plan and the stock rallies to $50

- Rather than pay $25m to buy back shorts, investor closes out short position by exercising call option at $42 per share (cost $21m)
- Potential loss of $5m is capped at $1.25m due to options protection



Net Loss is Limited

= Short - (Option strike price + Option cost)
= $20m - ($21m + $250k)
= $(1.25)m

Source: ING Investment Management. Note: This theoretical representation of a trade does not include transaction costs

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Pairs Trades

What is it? Short positions with an offsetting long position in a similar company

When do you use it? When the valuation gap between two similar companies is compelling (rather than a fall in value or underperforming the market)

Catalyst: One of two situations:

- Relative Earnings – an earnings surprise is expected for one of the companies
- Relative Valuations – valuation differential wider than historical valuation with an inadequate justification

Key Points:

- Positions must be equal and opposite to achieve a net exposure of zero
- Generally high correlation stocks in the same industry.
- May be appropriate in an M&A situation (eg. NCM and Lihir)

Implementation Tools:

- Sell physical stock to implement the short position
- Buy physical stock to implement the long position

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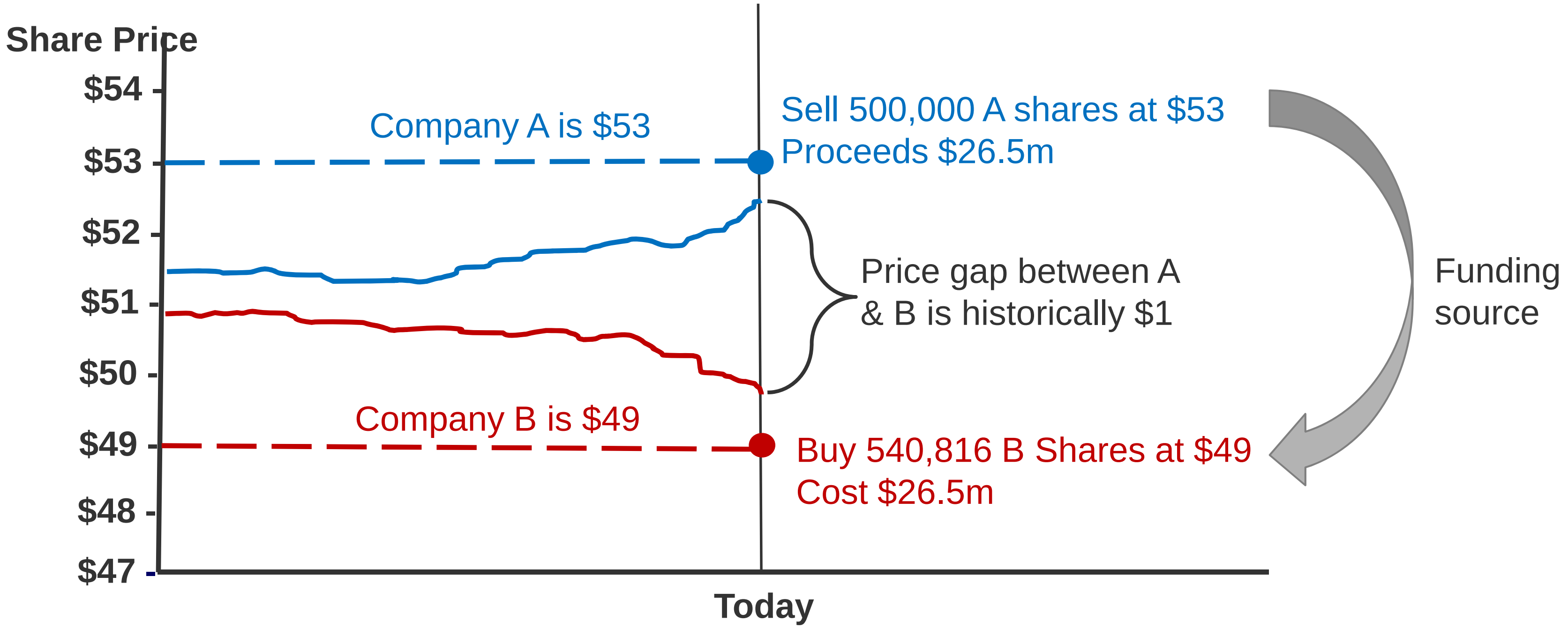
Pairs Trades: A Case Study

Lets consider two companies, A and B

- Current stock price gap between A and B is $4 but the historical gap is closer to $1
- Either Company A is overpriced or Company B is underpriced - but not certain which
- Investor decides to short Company A and buy Company B - take advantage of both possibilities

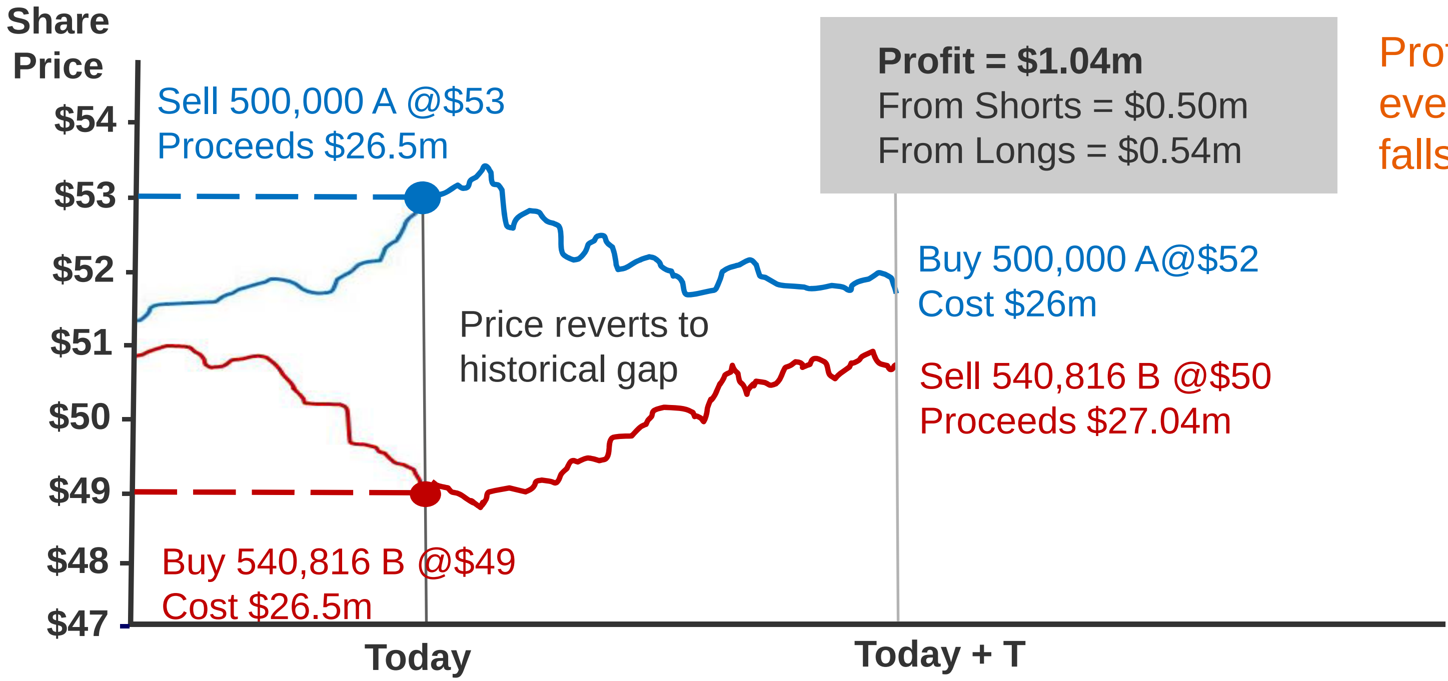


Source: ING Investment Management. Note: This theoretical representation of a trade does not include transaction costs

Pairs Trades: A Case Study

If the trade goes as planned Company A will fall and Company B will rise

- A's stock price falls to $52 - short is closed out at a profit of $1.00 per share
- B's stock price rises to $50 - long position is closed out at a profit of $1.00 per share



Profit can be made even if long position falls in value!

Source: ING Investment Management. Note: This theoretical representation of a trade does not include transaction costs

Funding Shorts

What is it? When a position is required to maintain an overall net long exposure of the portfolio at a desired level ie. fund new ideas without gearing or selling existing positions

When do you use it? When you expect funding shorts to underperform the long portfolio.

Catalyst: Based on the Manager's top down macro/thematic ideas as well as companies that rate poorly on the Manager's stock ranking system.

Key Points:

- Useful when it is expected that a stock cannot keep pace with a market rally (eg. expensive defensives)
- The short position offers a positive return in a relative sense because the stock lags the overweight positions

Implementation Tools:

- Short physical positions
- Funding source may be index futures because it is cheap and no stock-specific risk

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Risk Management of Short Positions

- Unlimited loss potential because share prices can <u>theoretically</u> rise to infinity
- With long only portfolios mistakes self correct ie. active positions get smaller
- With short positions when the market moves away from you, your positions get larger
- Close and effective risk management is critical
    - Aware of price points
    - Option overlays
    - Stop-losses

Introducing

ING Extended Alpha Australian Share Fund

Jim McKay

Head of Wholesale Business

ING Investment Management

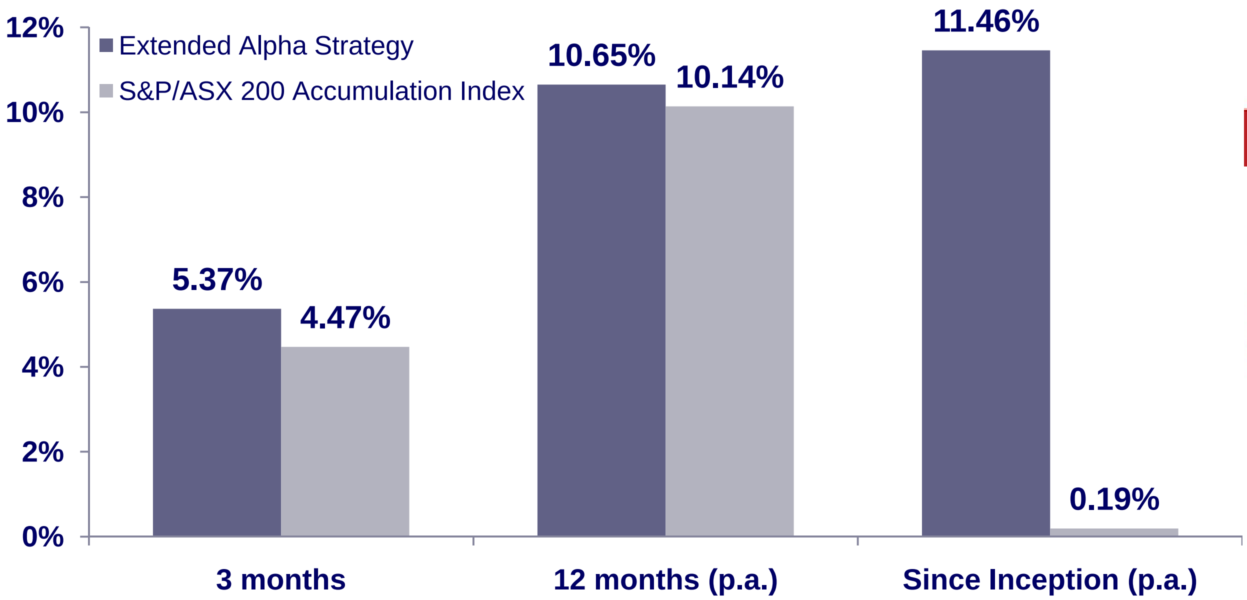
The INGIM Extended Alpha Solution

ING Extended Alpha Australian Share Fund

- **Style independent** - ability to take advantage of opportunities throughout full investment cycle
- Proven **proprietary stock ranking system** of 300 companies
- Backed by a **large analyst team**
- Portfolio Manager with **extensive skills** in shorting, risk management and concentrated portfolio management
- **Fee alignment** = Base 0.75% + Performance fee
- **Platforms** = BT Wrap Investment & Super and Ausmaq

ING Extended Alpha Australian Share Fund
Performance Track Record

Investment Performance to 31 July 2010



LONSEC Highly Recommended

Zenith Recommended

Source: INGIM and Datastream. Inception date of the Extended Alpha Australian Share strategy is 1 August 2008. However, the inception date for the ING Extended Alpha Australian Share Fund is December 2009. Returns shown here are before tax and fees. Past performance is not an indication of future performance.

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A blending option

- Four styles were used:
  - Value (Perennial)
  - Growth (Arnhem)
  - Passive (Vanguard)
  - 130/30 (ING)
- Active Managers were selected based on ratings from Lonsec
- The efficient frontier is based on alpha and tracking error of each fund from Sep08 to June10
  (consistent with life of the ING 130/30 fund)

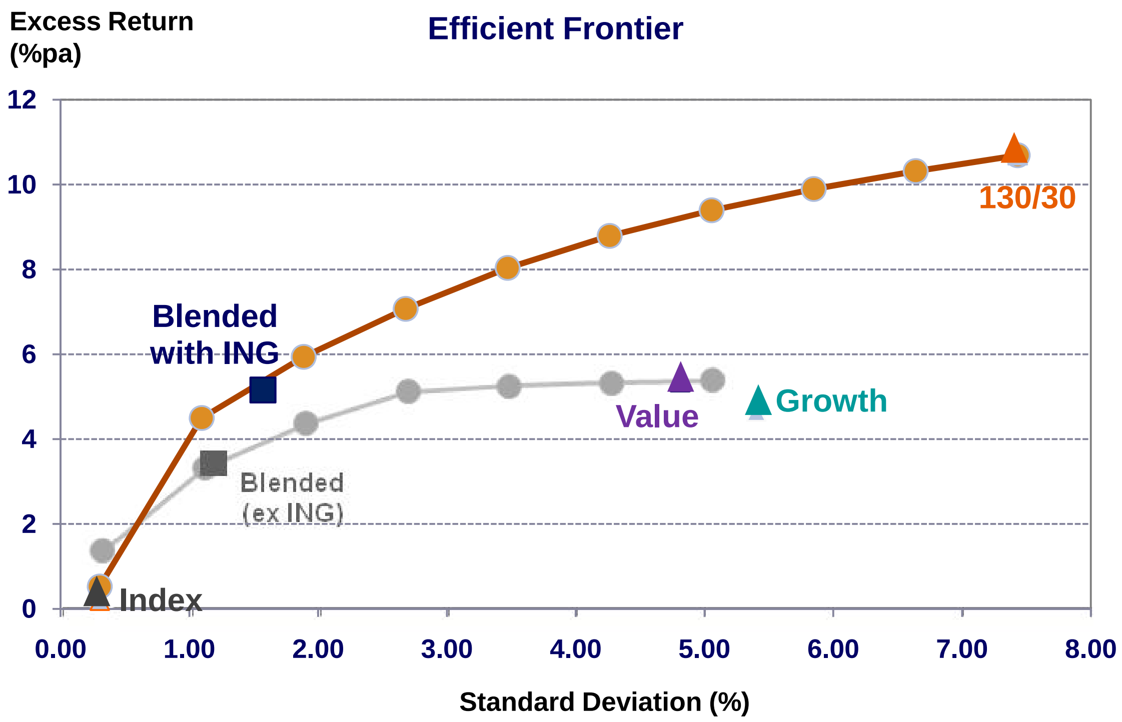
Source: INGIM, Datastream, Mercer Investment Consulting Wholesale MPA, Lonsec Managed Funds Research (Large Cap Australian Equity Sector Review).

Representative managers for blending are chosen as follows:

- *Value Fund: Perennial Value Australian Shares Composite (Lonsec rating: Highly Recommended)*
- *Growth Fund: Arnhem Australian Equity Fund (Lonsec rating: Highly Recommended)*
- *Index Fund: Vanguard Australian Shares Index (Lonsec rating: Recommended)*

Past performance is not a reliable indicator of future performance

Historical Performance (Sep-08 to June 10)	130/30 ING	INDEX Vanguard	GROWTH Arnhem	VALUE Perennial	BLENDED 1/4 each
Alpha (%)	10.69	0.19	4.65	5.34	5.22
Tracking Error (%)	7.43	0.30	5.40	4.81	1.57
Information Ratio	1.44	0.64	0.86	1.11	3.33



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The ING Extended Alpha Australian Share Fund *seeks to provide above index performance returns through applying a long/short 130/30 strategy to stocks which we believe are overpriced (short positions) and underpriced (long positions). The Fund is benchmarked against the S&P/ASX 200 Accumulation Index ("S&P"). S&P is comprised of the 200 largest index-eligible stocks listed on the Australian Stock Exchange (ASX) by float-adjusted market capitalisation. S&P performance is gross, calculated on a total return basis and reflects the reinvestment of dividend income and capital gains. Portfolio returns are net of non reclaimable withholding taxes, dividend income, interest and capital gains. Returns do not reflect the deduction of investment advisory fees. Actual client investment returns will be reduced by the advisory fees plus any other cost a client may incur directly. All performance numbers presented are calculated in Australian Dollars. Additional information regarding INGIM's policies and procedures for calculating and reporting performance returns is available upon request. Attribution is the means to explain the difference between a portfolio return and benchmark return. The formula used by INGIM is Brinson Fachler Arithmetic attribution and uses the Frongello smoothing methodology. Active weights are calculated for each sub-component of the portfolio shown on a daily basis, while returns are calculated as follows:*

- *Portfolio Return: Time weighted return calculated on a daily basis, compounded for the period. End of day cashflow is assumed.*
- *Benchmark Return: The benchmark returns are collated daily and compounded for the period.*
- *Performance within the INGIM Extended Alpha Australian Equities strategy may be affected by, but not limited to, changes in: government policies, tax laws, global/domestic economic conditions, market regulations, investor sentiment and interest rates.* ***Investors should consider the risks involved with this type of strategy which include the possibility of unlimited losses on a short position.***

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