BetaShares
Exchange Traded Funds

The 3 most important things for core portfolio allocations

KEY TAKEOUTS		
Core exposures form the foundation of a portfolio	**Longevity, value, and the ability to meet asset allocation objectives are key**	**ETFs are compelling investment vehicles for core exposures**
A critical decision for advisers is the choice of core exposures, which serve as the long-term foundation of client portfolios.	Core exposures should be robust through all market cycles, demonstrate compelling value net of fees, and meet asset allocation objectives while enhancing overall portfolio outcomes.	ETFs make it simple for advisers to construct a liquid, transparent and cost-effective foundation for client portfolios.

A critical decision for advisers is the choice of core exposures, which serve as the long-term foundation of client portfolios.

Three essential characteristics of core exposures are that they should:

- be able to be held long-term, through all market cycles
- meet asset class objectives while enhancing overall portfolio outcomes, and
- demonstrate compelling value, net of fees.

ETFs are worthy candidates for a portfolio's core exposures, their liquidity, transparency and cost-effectiveness making it simple for advisers to construct the foundation of client portfolios.

In this article, we discuss our top 3 criteria, and provide examples of core exposures that we believe meet those criteria.

Ability to hold long-term through all market cycles

As the foundation of a portfolio, the aim should generally be to hold core exposures for the long-term.

Reducing turnover helps to minimise transaction costs, and also reduces the number of capital gains tax events for a portfolio.

To qualify as a long-term holding, an exposure should meet the criterion of being robust through all market cycles.

Example – global equities

There are many options available for the international equities component of a portfolio.

However, if there is one investment style that should suit a long-term perspective, it is that of Quality. Quality businesses are those that demonstrate:

- high return on equity
- low debt
- strong cashflow generation, and
- stable earnings profiles.

We believe the **BetaShares Global Quality Leaders ETF (ASX: QLTY)** offers clear advantages over both actively managed global equities funds, and market cap-based passive funds, delivering the 'quality' factor in a cost-effective and transparent way.

QLTY's Index (adjusted for QLTY's management costs) outperformed every actively managed Australian-domiciled Global Equities Fund among the funds with 10y+ track records over the period to end July 2020, as shown below. It also significantly outperformed the MSCI World (ex-Aust) Index (AUD).

Performance against top decile active management over the long-run: as at 31 July 2020

	3 yr Return % p.a.	5 yr Return % p.a.	10 yr Return % p.a.
Average	9.61	6.99	10.78
Top Decile	**16.67**	**10.65**	**13.26**
MSCI World Ex Australia NR AUD	11.61	8.11	12.35
QLTY's Index	**18.70 (Top 6%)**	**13.11 (Top 4%)**	**16.47 (No. 1)**
Number of funds	*249*	*211*	*160*

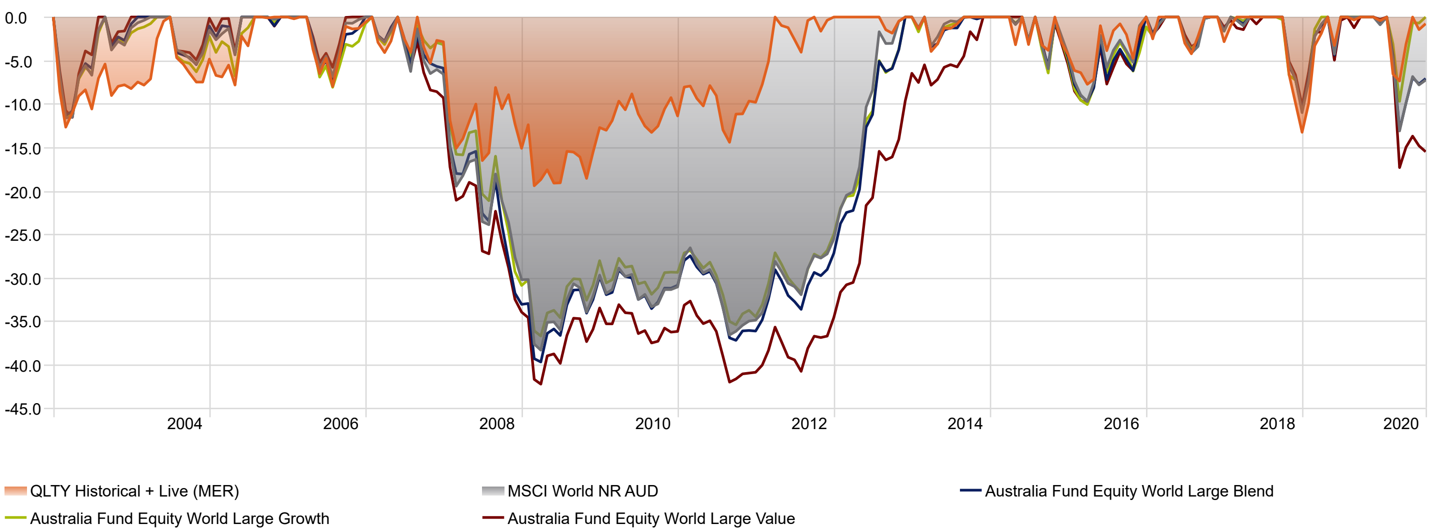
Source: Morningstar Direct. Universe defined as "Australia Fund Equity World Large Blend", "Australia Fund Equity World Large Growth" and "Australia Fund Equity World Large Value" Morningstar Category. Index figures in the table above for QLTY's Index take into account the effect of QLTY's management costs. You cannot invest directly in an index. Past performance is not an indicator of future performance of index or ETF.

To qualify as 'robust through market cycles', an exposure ideally should demonstrate defensive qualities, in the form of lower drawdowns during periods of equity market weakness.

As the chart below illustrates, QLTY has typically incurred smaller drawdowns in market corrections than the broad active and passive universe.

	Max Drawdown
QLTY Historical + Live (MER)	-19.43
MSCI World NR AUD	-38.35
Australia Fund Equity World Large Blend	-39.71
Australia Fund Equity World Large Growth	-36.73
Australia Fund Equity World Large Value	-42.26

Maximum Drawdown



Source: Morningstar Direct. Since common inception to 31 July 2020. Shows performance of QLTY's index adjusted for QLTY's management costs prior to QLTY inception on 5/11/18, blended with live fund performance post inception. Universe defined as "Australia Fund Equity World Large Blend", "Australia Fund Equity World Large Growth" and "Australia Fund Equity World Large Value" Morningstar Category. Shows the average maximum drawdown of funds per peer group over time. Past performance is not indicative of future performance of index or ETF.

Investors seeking to minimise the effects of currency fluctuations on returns can consider the **BetaShares Global Quality Leaders ETF – Currency Hedged (ASX: HQLT)**.

Meet asset class objectives while enhancing overall portfolio outcomes

With the range of funds available that nominally provide exposure to a given asset class, it's essential to drill into the detail of the various options, to determine which investments best meet your client's overall portfolio objectives for risk profile and expected returns.

Example –fixed income

Many fixed income managers use the Bloomberg AusBond Composite Index as a benchmark. However, the character of this index has changed in recent years, due to an increase in government bond issuance (especially short-term bonds), a trend that is likely to continue given COVID-19 stimulus measures.

The increasingly heavy weighting to government bonds has two important implications:

1. Shorter-duration government bond exposures provide little offset of equity risk and pay little (if anything) over cash returns.
2. The 'corporate' component is becoming an ever-diminishing part of the 'Composite' picture.

An investment in a fund that tracks the AusBond Composite in the not too distant future is likely to, for all intents and purposes, resemble a pure government bond exposure.

If the objective of a portfolio's fixed income allocation is to generate meaningful income above cash, and provide defensive benefits in equity sell-offs, we believe there are more attractive options than a fund that tracks the Ausbond Composite.

A simple approach is to use an actively managed fund to try to manage the inefficiencies of the broad composite benchmark.

However, selection of a suitable fund is not made easy by the fact that, according to a SPIVA analysis of fund managers, 81.4% of active fixed income funds have underperformed the AusBond Composite Benchmark (net of fee) over the last 5 years[1].

However, one manager in the analysis was in the top quartile every year for the last 5 years[2] – Western Asset. Their strategy is available in Active ETF format via the **BetaShares Legg Mason Australian Bond Fund (managed fund) (ASX: BNDS)**.

Alternatively, where the ability to tailor fixed income exposure to an investor's specific needs is required, a bespoke fixed income portfolio can be built by blending ETFs targeting specific parts of the fixed income spectrum (credit, duration).

For example, an adviser could use:

- **BetaShares Australian Government Bond ETF (ASX: AGVT)**
- **BetaShares Australian Investment Grade Corporate Bond ETF (ASX: CRED)**
- **BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX: QPON)**

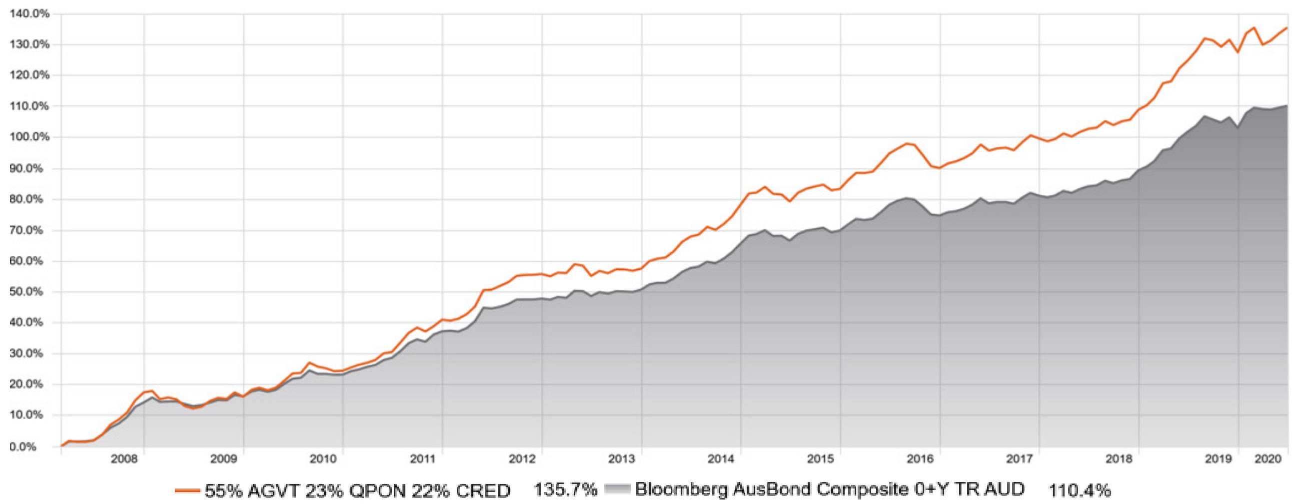
A blend of these three ETFs can create, at similar cost to AusBond Composite tracking funds, either:

- a portfolio with similar yield to Ausbond Composite but greater equity diversification properties, or
- a portfolio with similar equity diversification properties to AusBond Composite but yielding substantially more.

The chart over the page compares the performance of a 55:23:22 blend of AGVT/CRED/QPON (indices adjusted for management costs prior to ETF inception, blended with live performance post inception) with the Ausbond Composite, from March 2008 to 30 June 2020.

1. SPIVA Report as at 31 December 2019. https://www.spindices.com/spiva/#/reports. Past performance is not indicative of future performance.
2. Ibid.

Cumulative growth: Common inception (3 March 2008) - 30 June 2020



Historical growth	1M	3M	6M	1Y	3Y	5Y	10Y	Common inception
55% AGVT 23% QPON 22% CRED	0.81%	2.44%	3.54%	4.75%	6.37%	5.61%	6.67%	7.09%
Bloomberg AusBond Composite 0+Y TR AUD	0.31%	0.53%	3.53%	4.18%	5.57%	4.77%	5.60%	6.12%

	Mod. Duration yrs	Yield to Maturity %	Yield to Maturity + Roll %	Weight
AGVT	7.89	1.00	1.63	55%
CRED	6.54	2.59	3.74	22%
QPON	0.10	0.74	0.99	23%
55:23:22 Portfolio	5.80	1.29	**1.95**	
Bloomberg AusBond Composite	5.80	0.81	**1.36**	
Difference	**0.00**		**0.59**	

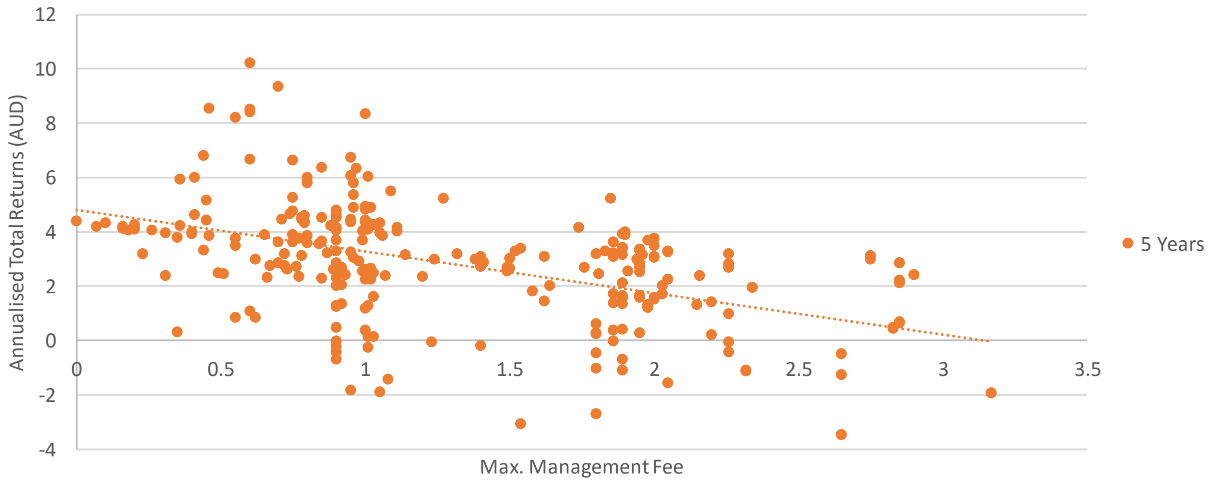
Source: Morningstar Direct, as at 30 June 2020. Past performance is not an indication of future performance.

Demonstrate compelling value (strong net-of-fee performance)

Core exposures should demonstrate compelling value, usually evidenced by strong, long-run, net-of-fee performance.

Historical data has established beyond question that fees matter, with multiple studies documenting the inverse relationship between management fees and investment returns. The chart below illustrates this relationship for Australian Equities, Large Blend funds.

Funds Categorised by Morningstar as: Australian Equities, Large Blend



Source: Morningstar Direct, 5 yrs to 31/5/20. Past performance is not indicative of future performance.

Example –Australian equities

SPIVA reports consistently show both that the majority of active managers have underperformed their benchmark, and that active managers who do perform well typically have not reproduced that outperformance into the future. Recent reports from SPIVA highlighted that[3]:

- 79% of Australian Equities active funds underperformed their benchmark in the 5 years to 31 Dec 2019
- of top quartile actively managed funds for the year ending Dec 2015, none of the 107 Australian Equities funds remained top quartile for each of the next 4 years, and less than 20% even remained in the top quartile the following year.

In addition to the chronic long-term underperformance of the average active manager, even in the March 2020 sell-off more than half the active funds underperformed the benchmark according to the SPIVA Q1 2020 report, debunking the myth that active managers will shine in down markets.

Additionally, blending multiple active managers of different factors/styles may run the risk of ending up with a combined allocation that looks not dissimilar to the broad passive market but at a much higher fee.

These findings all reinforce the importance of selecting cost-effective investments as a portfolio's core exposures. Money saved on fees can compound returns left in the investor's pocket.

One low-cost, diversified Australian equities exposure is the **BetaShares Australia 200 ETF (ASX: A200)** – the lowest fee broad-Australian market ETF in the Australian market with a cost of just 0.07% p.a.

For investors preferring a growth-focused passive approach, the **BetaShares Australian Ex20 Portfolio Diversifier ETF (ASX: EX20)** has a track record of outperformance over the long term and can significantly address the concentration issues of the Australian market.

Holding stocks 21-200 of the Australian market, EX20 can help reduce exposure to many of the cyclical companies in the top 20 and, at the same time, skew exposure positively to many of the companies experiencing structural growth which sit outside of the top 20.

This higher exposure to the EX20 part of the market has seen EX20 (7.8% p.a.) outperform the Australian Broad-market (7.2% p.a.) and similar concentration-reducing strategies such as Equal Weight (7.3% p.a.) from common inception on 5 Oct 2016 to 31 July 2020.

EX20's low fee of 0.25% p.a. means more of the performance benefits of this strategy remain in the hands of the investor and can compound over time.

3. Ibid.

Summary

Core exposures serve as the long-term foundation of client portfolios. To properly fulfil this function, they need to match asset allocation objectives, demonstrate compelling value, and be robust through all market cycles.

ETFs make it simple for advisers to construct a liquid, transparent and cost-effective foundation for client portfolios.

Please refer to the **BetaShares fund range** for key exposures we believe are well-suited to form the core of a portfolio over the long-run.

There are risks associated with an investment in BetaShares Funds, which, depending on the exposure, include market risk, index methodology risk, currency risk, interest rate risk, credit risk and index tracking risk. For more information on risks and other features, please see the Product Disclosure Statement, available at www.betashares.com.au.