



Strengthening your portfolio core

How to navigate difficult markets and create long-term wealth

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Asset allocators face three key challenges in portfolio construction. How to:

1. Achieve diversification over the market cycle.
2. Minimise ongoing fees, turnover, transaction costs and tax impacts.
3. Deliver strong, long-term performance.

Many active managers fail to address these points, pursuing investment strategies that are high conviction or skew to a particular style or risk premia, charging fees that are sometimes many multiples above passively managed funds and/or failing to deliver outperformance.

A core portfolio constructed using low-cost index tracking funds, including broad market exposures, together with 'smart-indexing' exposures, has the potential to solve these issues and provide a strong core over the long term.

Building a core portfolio in a world of uncertainty

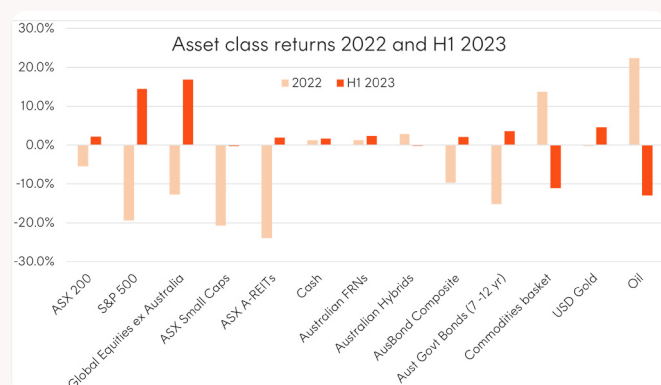
So far the economic backdrop for 2023 has looked like a continuation of 2022:

- Inflation persistently high despite central bank rate hiking.
- Leading indicators of activity and sentiment pointing towards elevated recession risk.
- Yet surprisingly robust "hard" economic data, particularly in the labour market.

Where this year has been very different to the last has been in the turnaround in performance of various asset classes. Among the worst drawdowns in 2022 were in global equities and fixed rate bonds, but so far this year those asset classes have provided some of the highest risk-adjusted returns.

Despite these reversals of fortune, significant challenges exist for asset allocators.

- Equity markets remain 'priced for perfection', despite elevated recession risk.
- The recent rally in global equities has largely been driven by an incredibly narrow group of perceived AI 'winners', underwritten primarily by multiple expansion rather than earnings growth.



Source: Bloomberg. H1 2023 figures are as at 30 June 2023. **Past performance is not an indicator of future performance.** 'Global Equities ex Australia' is Solactive GBS Developed Markets ex Australia Large & Mid Cap Index, 'ASX Small Caps' is S&P/ASX Small Ordinaries Index, 'ASX A-REITs' is S&P/ASX 200 A-REIT Index, 'Cash' is Bloomberg AusBond Bank Bill Index, 'Australian Hybrids' is Solactive Australian Hybrid Securities Index, 'AusBond Composite' is Bloomberg AusBond 0+ Yr Index, 'Australian Government Bonds' is Solactive Australian Government 7-12 Year AUD TR Index, 'Commodities Basket' is Bloomberg Commodity Index, 'USD Gold' is XAU Currency Index, and 'Oil' is Bloomberg WTI Crude Oil Subindex Index. You cannot invest directly in an index.

- As a result, some global exposures, and the US market in particular, appear concentrated, and broad market beta may not offer the diversification it once did.
- Factor or investment style leadership has flipped again, with quality switching from the doghouse to the penthouse.
- Fixed rate bonds have been offering income, but uncertainty on rates has led to significant volatility in the first half of this year.
- Markets appear to be trending towards a world of shorter, sharper cycles.

So, given the economic outlook and these challenges in markets, how should investors approach portfolio construction?

Let's start with some key principles for building a robust core portfolio

The core of a portfolio is, by definition, the 'anchor' of any investor's portfolio. We believe the investments used to construct such a core should have the following characteristics:

- Provide diversified exposure to the specific asset class, to help ensure the strategic asset allocation can be achieved across the portfolio as a whole.
- Be able to be held for the long run, to reduce turnover and transaction costs, and to avoid the temptation to try to time markets.
- Demonstrate compelling 'value', usually reflected in strong, long-term, net-of-fee performance, before and after tax.
- Contribute to the overall risk characteristics of the portfolio from a volatility and drawdown perspective.

Selecting the core of your portfolio to best match the asset allocation objectives is likely to result in a more efficient portfolio with desirable risk and return outcomes.

What type of investment strategies can deliver on the requirements above?

Many investors start with a choice between broad market index funds (essentially low-cost broad market beta exposures) and actively managed funds that attempt to outperform their chosen benchmark (such as a broad market index).

Despite the *opportunity* to generate outperformance in a volatile market from careful security selection, historical evidence shows there have been very few active managers that have actually managed to *deliver* on that promise of outperformance¹. It's hard beating the market on a risk-adjusted basis, especially after fees and costs.

It's generally proven to be even harder to do this consistently over long periods of time, amid greater competition among active managers². Active manager alpha or outperformance is overwhelmingly transient. This means that, for an investor using active funds to stay ahead, successfully time their investment switches into the minority of active funds that actually outperform in the subsequent period. Ignoring the challenge of successfully timing manager selection, such an investment process violates a number of key principles of 'core' as outlined above, as it increases turnover and potential performance drag through transaction costs and tax impacts.

For many investors, including at least some allocation to broad market beta within a core portfolio at the lowest possible cost is an effective long-term investment strategy.

Betashares is proud to offer a broad market Australian equity ETF and a broad market global equity (ex-Australia) ETF that are amongst the lowest cost currently available in Australia.



ASX: BGBL

Case for →

Betashares Global Shares ETF

BGBL provides instant exposure to a globally diversified index comprising approximately 1,500 companies from more than 20 developed market countries, making the fund a compelling candidate for a core portfolio allocation to global equities.

BGBL is one of the lowest cost diversified global equity ETFs with a management cost of only 0.08% p.a.*



ASX: HBGL

Case for →

Betashares Global Shares Currency Hedged ETF

HBGL provides exposure to the same global equity portfolio as BGBL, hedged into Australian dollars, with a management cost of only 0.11% p.a.*



ASX: A200

Case for →

Betashares Australia 200 ETF

A200 is the world's lowest cost Australian equity ETF*, which aims to track the performance of an index (before fees and expenses) comprising 200 of the largest companies by market capitalisation listed on the ASX.

A200's management cost is only 0.04% p.a.*



ASX: DHHF

Case for →

Betashares Diversified All Growth ETF

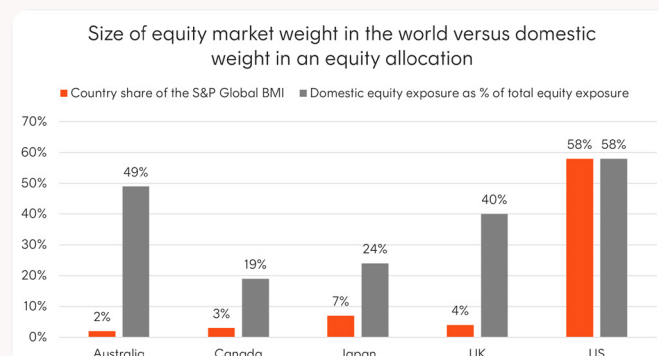
DHHF is an all-in-one, 'all growth' assets ETF providing blended exposure to both Australian and global equities, including around 8,000 equity securities listed on over 60 global exchanges, in one ASX trade.

DHHF's management cost is only 0.19% p.a.*

What if I want to include some allocation to investments that offer something different to broad market beta?

There are lots of reasons why an Australian investor would want to incorporate investments that provide a different risk/return profile to a broad market exposure into their portfolio core. Depending on what else is in your portfolio, your view of markets or financial objectives, you may prefer to include a fund that tilts towards value, growth or quality stocks, or aims to generate enhanced income or a defensive, lower volatility return profile.

An obvious reason to look beyond broad market beta is our home country bias and the skewed sector makeup of the Australian equity market. In aggregate, Australian investors have amongst the largest home country equity portfolio allocations relative to the size of our equity capital markets, and therefore are skewed to value/cyclical stocks and underweight growth/defensive stocks⁴.



Source: S&P Dow Jones Indices, Global Pension Assets Study (GAPS) 2023. As at 31 December 2022.

One alternative for seeking a return premium or exposure beyond just the broad market beta is actively managed funds that employ so-called 'style biases', such as structural overweight exposures to companies with high profitability or low price-to-book ratios. These active managers will often highlight the importance of their unique expertise, research process and security selection in constructing their investment portfolio.

However, over the last twenty years, a whole new field in indexing has developed around factor or smart-beta investing. And it turns out that factor investing targets the same risk premia that many active managers have long relied on. Investors can now get exposure to these risk premia through lower-cost funds that seek to track a rules-based factor index.

Regarding active managers that pursue a style bias, we have observed the following:

- Often, any 'outperformance' above broad market beta is in fact partially or fully attributable to a factor exposure rather than the manager's stock specific bets (i.e. true alpha).
- The management costs of rules-based factor index ETFs are generally far lower than active funds.
- Over longer investment time horizons, rules-based factor index ETFs have tended to outperform the majority of active funds with the same factor or style bias on a net-of-fee basis⁵.

In addition, the systematic approach of rules-based factor index ETFs do not allow for a subjective active judgement call to allocate to cash, which would otherwise create the risk of unintentionally altering the strategic asset allocation for end investors.

* Other costs, such as transaction costs, may apply. Refer to the applicable Product Disclosure Statement, available at www.betashares.com.au, for more information.

¹ S&P Dow Jones Indices, SPIVA® Australia Year-End 2022

² For more on this, read Larry E. Swedroe and Andrew L. Berkin, *The Incredible Shrinking Alpha: And What You Can Do to Escape Its Clutches* (BAM ALLIANCE Press, 2015) and Charley Ellis, *Winning the Loser's Game: Timeless Strategies for Successful Investing* (McGraw-Hill, 2002).

³ Source: Bloomberg, based on expense ratios of Australian shares ETFs based in Australia or on overseas exchanges.

⁴ For example, as at 30 June 2023, Financials and Material made up 53% of the Solactive Australia 200 Index. Source: Bloomberg.

⁵ Based on a comparative analysis undertaken by Betashares of the performance of selected "quality" and "value" active funds to Betashares funds which track an index of the same factor over a five-year period to 30 June 2023.

Smart indexing equity ETFs to add balance to your portfolio

Betashares has a range of ETFs that offer the best of both worlds - intelligent indexing for outperformance potential beyond broad market beta and the cost effectiveness typically expected of ETFs.

These core portfolio solutions include the following global and Australian equity funds:



ASX: QLTY

Case for →

Betashares Global Quality Leaders ETF

Seeks to track an index (before fees and expenses) designed to provide diversified exposure to 150 high quality global companies. Companies are evaluated based on four key quality characteristics designed to capture persistent, high profitability, and QLTY's index is weighted to seek to avoid stock specific risk.

QLTY's management cost is 0.35% p.a.*



ASX: QUS

Case for →

Betashares S&P 500 Equal Weight ETF

QUS's index is an equally-weighted portfolio of 500 leading listed US companies. The market capitalisation-weighted S&P 500 Index has recently reached levels of concentration not seen in 50 years, with the top five names representing approximately one quarter of the overall index weight⁶. QUS offers a potential solution to this problem with better diversification at a stock and sector level.

QUS's management cost is 0.29% p.a.*



ASX: AQLT

Case for →

Betashares Australian Quality ETF

Aims to track an index (before fees and expenses) designed to provide exposure to 40 high quality Australian companies, while catering for the unique characteristics of the Australian equity market to provide a core quality exposure.

AQLT's management cost is 0.35% p.a.*



ASX: QOZ

Case for →

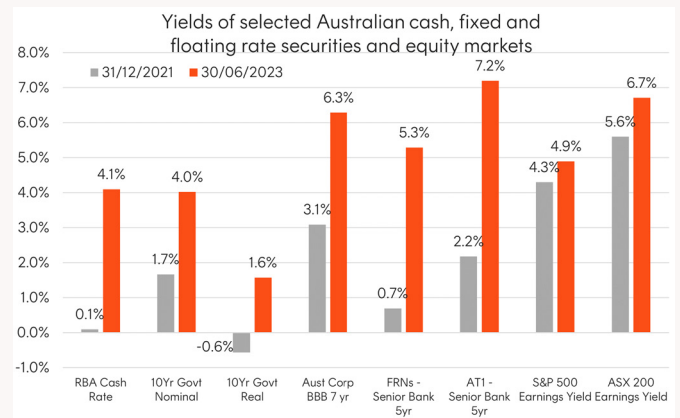
Betashares FTSE RAFI Australia 200 ETF

Access a "fundamentally weighted" portfolio of 200 large Australian companies through a fund that aims to track an index (before fees and expenses) designed to capture companies' economic importance to the Australian economy, rather than the market capitalisation of its constituents. By removing the link between stock price and weight, QOZ's index provides an exposure which dynamically tilts to value and benefits from mean reversion in stock prices over time.

QOZ's management cost is 0.40% p.a.*

Being efficient in defence: Does fixed income still have a place in a portfolio core?

2022 was the worst year on record for fixed rate bond returns. But, as the chart below shows, yields have lifted across all categories of fixed income. Bonds now look attractive versus equities, as the equity risk premium has compressed. And importantly, stock-bond correlations have reverted to being negative in 2023, as last year's concerns about inflation have now shifted to concerns about growth and corporate earnings.



Source: Bloomberg, Westpac. 10Yr Govt Nominal, 10Yr Govt Real, Aust Corp BBB 7 yr are yield to worst. FRNs - Senior Bank 5yr, AT1 - Senior Bank 5yr are All-in-yields. S&P 500 Earnings Yield and ASX 200 Earnings Yield are inverted 12 month forward P/E ratios. Yields are subject to change.

When it comes to fixed income, Betashares currently manages more assets and has received more new investor capital than any other Australian ETF provider⁷.

Core fixed income building blocks

Betashares fixed income ETFs have been designed to provide efficient building blocks to help investors tailor their defensive allocations to meet their needs – whether it be for diversification, capital stability or income.

Betashares currently has 11 cash and fixed income ETFs that can be easily bought and sold on the ASX. We highlight four of those funds below:



ASX: OZBD

Case for →

Betashares Australian Composite Bond ETF

OZBD is designed to be a core portfolio allocation for fixed income. It aims to track the performance of an index (before fees and expenses) that provides exposure to a diversified portfolio of high-quality Australian government and corporate fixed rate bonds selected on the basis of risk-adjusted income potential, while controlling for overall interest rate and credit risk. OZBD offers the potential to deliver superior returns to both active and simple liability-weighted passive investment approaches.

OZBD's management cost is 0.19% p.a.*

* Other costs, such as transaction costs, may apply. Refer to the applicable Product Disclosure Statement, available at www.betashares.com.au, for more information.

⁶ Source: S&P Dow Jones Indices, as at June 2023.

⁷ Based on Morningstar data as at 30 June 2023. Includes current FUM and 1 year net flows for all ETFs available on ASX and CBOE Australia classified by Morningstar as "Fixed Income" or "Money Market".

**ASX: AAA**

Case for →

Betashares Australian High Interest Cash ETF

AAA's assets are simply invested in cash deposit accounts held with selected banks in Australia. As at 13 July 2023, the interest rate earned on AAA's deposits sat at 4.18% p.a. (net of management costs)⁸. AAA's annualised interest rate (net of management costs) has been above the RBA Cash Rate since its inception in 2012⁹.

AAA pays monthly distributions and has the added benefit of being exchange-traded.

**ASX: QPON**

Case for →

Betashares Australian Bank Senior Floating Rate Bond ETF

QPON's assets are invested in a quality portfolio of senior floating rate notes issued by Australian banks, which are among the most liquid and highest credit-rated corporate bonds issued in Australia. QPON has the potential to provide regular attractive income and capital stability, as well as lower interest rate sensitivity compared to fixed rate bonds, and has historically exhibited low correlation to equities.

QPON's management cost is 0.22% p.a.*

**ASX: AGVT**

Case for →

Betashares Australian Government Bond ETF

AGVT invests in a portfolio of relatively long duration Australian government and 'government-related' bonds (e.g. bonds issued by supranationals and sovereign agencies). AGVT targets bonds with a maturity of 7-12 years seeking to enhance defensive characteristics, with a longer duration profile and high credit quality (with an average credit rating of AAA¹⁰).

AGVT's management cost is 0.22% p.a.*

In conclusion

Core portfolio construction must address the issues of diversification, cost and performance, in what is a difficult market to navigate.

Shorter, sharper cycles make market timing even harder to execute, and asset allocators may need to look for balance in their portfolios, particularly given the degree of concentration in global markets and the characteristics of Australia's equity market.

The 'normalisation' of interest rates means fixed income again may be deserving of its role within the asset classes mix. The rate reset may be an ideal time to re-evaluate what defensive allocations are now offering, and whether portfolio adjustments should be made.

As is well known, the majority of active managers have continued to underperform broad market benchmarks. What is perhaps less appreciated is that certain investment styles pursued by many actively managed funds are in fact available through lower cost index funds, avoiding the need to pay high active manager fee loads.

Indeed, low-cost index-tracking funds, including broad market exposures, together with 'smart-indexing' exposures, can provide an excellent toolkit for building a strong core over the long term.




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* Other costs, such as transaction costs, may apply. Refer to the applicable Product Disclosure Statement, available at www.betashares.com.au, for more information.

⁸ AAA's interest rate is variable and may be lower at time of investment. Excludes any brokerage or bid-ask spread incurred when investors transact on the ASX.

⁹ Past performance is not indicative of future performance.

¹⁰ Source: Betashares, as at 13 July 2023. Average credit rating for the bonds in the portfolio. Credit ratings are opinions only and are not to be used as a basis for assessing investment merit. Ratings are subject to change.

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