BetaShares
Exchange Traded Funds

REVISITING HVST

BETASHARES AUSTRALIAN DIVIDEND HARVESTER FUND (MANAGED FUND) – ASX CODE: HVST

The BetaShares Australian Dividend Harvester Fund (managed fund) (HVST) is an investment fund that trades on the ASX and is designed to provide high after tax income, along with reduced volatility, and aims to defend against losses in declining markets.

HVST has become one of BetaShares' most popular funds since its inception in October 2014. Since its launch, we have received a number of queries about the Fund, including questions relating to HVST's investment objectives, the performance attributes of HVST and how the Fund might be expected to perform in various market conditions. This document therefore aims to provide existing and interested investors with a broad understanding of the Fund and some of its essential features.

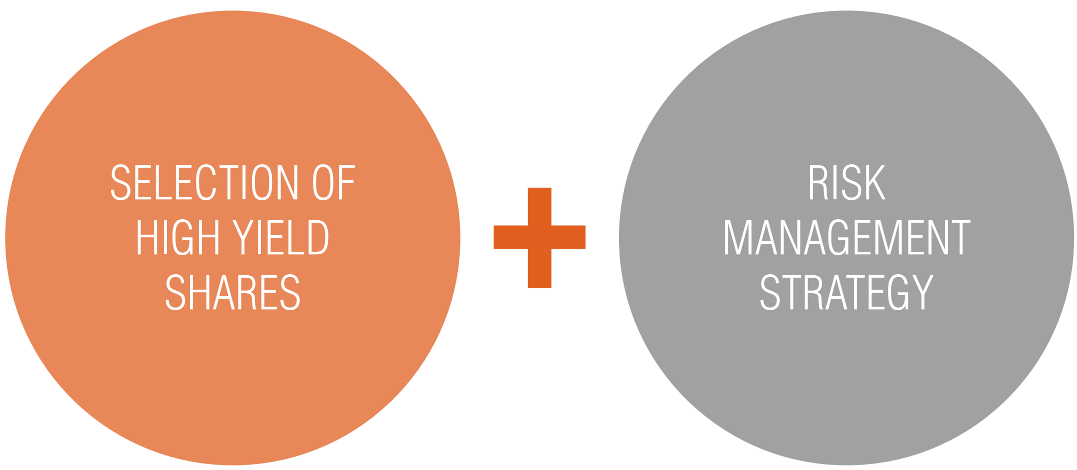
What is HVST?

HVST is an objectives based fund. Importantly, this means that HVST does not aim to track an index or a benchmark. Rather, it follows a set of rules which allow it to meet its objectives. These objectives are to:

- Provide investors with regular franked dividend income derived from large capitalisation Australian shares which is at least double the income yield of the broad Australian share market on an annual basis
- Reduce the volatility of the equity investment returns and defend against losses in declining markets

To seek to achieve this HVST generally holds a portfolio of at least 14 stocks from the universe of the largest 50 stocks on the Australian sharemarket (this universe is known as the S&P/ASX 50 Index). In order to pursue its dividend objective, the Fund holds these stocks over their dividend paying period. The stocks are generally selected based on being the highest gross dividend yielding stocks (based on expected dividends including franking credits). The portfolio is rotated approximately every 60 days to another selection of stocks that will be paying dividends over that period. If fewer than 14 stocks meet the yield threshold at the time of rebalance, then one or more ASX exchange traded funds (ETFs) with broad Australian sharemarket exposure will be added to the portfolio.

The Fund's stock holdings are combined with a risk management strategy which aims to manage the Fund's volatility and provide a downside cushion against general market declines. This risk management process utilises ASX SPI 200 futures with the aim of reducing market exposure during periods of higher than average market volatility. These futures are highly liquid and transparent instruments that are traded on the ASX.



What is HVST not?

HVST is not an index fund, and therefore should not be compared to one

HVST does not adhere to a market index, due to its underlying equity portfolio which rotates regularly, and also because of the performance impact of the risk management strategy. As such, HVST's total returns have differed, and will continue to differ, from the returns of a broad market index over differed time periods.

> HVST performance can diverge significantly – both positively and negatively – relative to the S&P/ASX 50 Index

HVST does not hold options

HVST holds ASX-listed securities as part of the dividend rotation component of the strategy and futures contracts as part of the risk management component of the strategy. HVST does not hold options.

HVST is not a fund which aims to outperform a benchmark

HVST is run to a set of rules that seek to allow the Fund to meet its objectives. At no time does the portfolio manager have discretion as to what stocks HVST holds, or about the level of risk management that should be employed. These are determined by the governing portfolio management rules for the Fund. Investors have full transparency over the complete portfolio and the level of risk management in HVST, which is disclosed daily on the BetaShares website.

What contributes to the performance of HVST?

The performance of HVST can broadly be separated into two components.

- Performance of the underlying stock basket
- Performance of the risk management process

Although HVST is not an index fund, how is it expected to behave compared to the broad market?

Although we can't predict how any market, fund or stock will behave, we can explain the relative behaviour of HVST compared to the behaviour of the sharemarket more broadly. For the purposes of the section below we refer to the S&P/ASX 50 Index as "the Index".

The performance of HVST relative to the Index will be based on how the stocks held by HVST perform relative to the Index, plus or minus any contribution from the risk management process.

In general, and over time, the stocks held by HVST have performed broadly in line with the Index. However, over various shorter time periods, this performance has diverged.

- In the period 30 September 2015 to 29 April 2016, the stock portfolio in HVST outperformed the Index by 5.15% (10.36% vs 5.21%)
- In the period 31 December 2016 – 30 June 2017, the stock portfolio in HVST underperformed the Index by -6.19% (-3.85% vs 2.35%)[1]

Relative Performance of HVST stock portfolio vs. the Index (29-Oct-2014 to 30-Jun-2017)

Source: BetaShares, Bloomberg. Past performance is not an indicator of future performance

- As an example, HVST underperformed the Index in the year to 30 June 2017, partly because HVST was overweight banking stocks during April and May 2017 (when three of the big four banks paid their dividends). During this time, the Australian banking sector underperformed the Index in the wake of the bank levy announced in the May 2017 Federal Budget. The underperformance was then increased in June when HVST rotated out of banks and the banks rebounded.

[1] Source: BetaShares, Bloomberg. Past performance is not an indicator of future performance.
Note – this refers to the stock portfolio without the risk management process.

HVST will underperform the broader market if it is overweight a sector which underperforms, or if it is underweight a sector which outperforms. In the period March to June 2017, both of these circumstances arose.

The effect of the risk management process varies over time. Because the primary aim of this process is to defend against large market downturns, it often behaves differently over shorter periods. The risk management process uses the volatility of the Fund and its path to determine the level of risk management (or hedging) to apply[2]. In trending markets, this is effective (reduce hedging when the Fund is moving up, increase it when it is going down). Unfortunately, because markets are volatile, and because we can't predict where they will go, the signals to increase or decrease hedging can cause a performance drag on the Fund in certain market conditions (for example, hedges can increase when the Fund moves up or vice versa). This will detract from the Fund's overall performance at certain times and improve the Fund's performance at other times.

- During the period 31 July 2015 – 31 January 2016 the risk management process provided a cushion which generated approximately 4.2% outperformance relative to the Index
- During the period 8 November 2016 – 30 June 2017 (post Trump's election victory), it generated drag of approximately -4.2%, relative to the Index[3]

The Fund's risk management strategy is provided by Milliman, one of the world's largest institutional risk managers. Milliman's risk management strategies are used to hedge ~US$500B globally, and have been run for the last 15 years. Their clients include some of the largest firms and institutional investors. Strategies used by Milliman helped their clients navigate the 'tech bubble' and global financial crisis.

[2] For more information on how the risk management process works see http://www.betashares.com.au/wp-content/uploads/2016/12/BetaShares-Australian-Dividend-Harvester-fund-managed-fund-HVST-Product-Brochure.pdf

[3] Source: BetaShares. Past performance is not an indicator of future performance.

How HVST works
– An analogy

As a way to better understand how HVST works, we use the analogy of driving a motor car. When undertaking a long journey, the aim is to get from point A to point B as quickly as possible, without breaking any rules, and ensuring that the journey is safe (and comfortable). To achieve this, the driver must:

Obey the rules of the road (speed limits, road signs, traffic lights etc.). In HVST, the "rules of the road", are the rules which govern the stock selection for the Fund. At times, when driving, the road rules may seem unnecessary or redundant (for example, why is there a speed limit during the day on a wide, straight, uninhabited stretch of road? Or why do I need to stop at a red light late at night when I can clearly see there is no traffic coming?). The answer – the rules are to create an overall safe framework for ALL drivers. Whilst certain individuals may be able to drive safely at above the speed limit, or cross an empty intersection against a red light, the rules are in place to cover all drivers in all situations. They need to be clear, uncomplicated and unambiguous. So too for HVST! The stock selection rules are based on the objective of deriving high levels of income from dividends, using some of the largest and most liquid stocks in the market. The universe is restricted to the components of the S&P/ASX 50 Index. In general, in the past, the stocks in the HVST portfolio have performed in line with the market, however over shorter periods, they have variously underperformed or outperformed.

Use the accelerator and the brake to drive safely at all times. Although the temptation exists, when driving, to use the accelerator as much as possible, and the brake as little as possible, they both need to be used judiciously to ensure a smooth safe ride, and to adhere to the rules of the road. This means slowing down on bends, when visibility is low, or when there is traffic; and accelerating when things are clear and conditions are right. Because of this emphasis on safety, we could say that in hindsight, drivers often use the brakes too cautiously. If so, all that is lost is a bit of time, and some brake padding. If caution is warranted, a potential tragedy is averted. So too with the risk management process within HVST. This process essentially "puts on the brakes" when it looks like the market is going down, and releases them when the market looks like it is going up. Because no-one can be certain whether the market is going to go down or up, sometimes we may put on the brakes and the market goes up, or vice versa. This creates a drag on performance during those times.

Over the life of HVST, the risk management process has at times been both a contributor to, and a detractor from, the performance HVST. This will continue to be the case going forward.

Answers to some commonly asked questions on HVST

FAQ #1: Why do you, at times, report total return as being positive, when the price of HVST has declined?

For example, from 31 December 2015 to 31 December 2016, the total return of HVST was 8.37%, yet during this period the unit price (ie the net asset value per unit) decreased from $21.40 to $20.72 (-3.19%)[4].

Since inception, the unit price of HVST has decreased. Through this period, it has had periods of both positive and negative total return. Overall, since inception, the total return of the Fund has been 0.06% p.a. net of franking credits, or 3.12% p.a. gross of franking credits[5].

How can this be? The simple explanation for this is that if the total return of the Fund is less than its yield, the unit price (i.e. the net asset value per unit) will decrease.

% TOTAL RETURN =
% CAPITAL RETURN + % INCOME RETURN

The yield of HVST has been approximately 10% to 11% per year. On the other hand, the long term return of the Australian sharemarket has been in the range 7% to 8% per year[6]. Simplistically, the gap between the yield of HVST and the market return has been 3% to 4%, so investors should reasonably expect the unit price to decrease annually by approximately this amount.

- When the total return of the Fund is less than its yield over a period, the unit price will decrease
- When the total return of the Fund is greater than its yield, the unit price will increase
- Long run return rates for the market have been less than the yield of HVST, so we should expect that over time, the unit price of HVST will decrease.

Investors in HVST (or, for that matter, any fund explicitly targeting a high level of income) should focus firstly on total return, and, secondly, if you are an Australian investor, on total gross returns. The after tax impact of the franking credits generated by HVST is significant when compared to a fund not focused on dividend income.

If investors wish to retain their capital invested, then HVST operates a fully flexible dividend reinvestment plan (DRP). Under the DRP an investor can choose to reinvest some or all of their income in new units in HVST (at the time the income is paid, without incurring brokerage costs). In such a scenario, while the unit price may still decrease, the total number of units an investor holds in HVST will increase if they participate in the DRP. For an investor who started holding 1,000 units of HVST at inception, the number of units they hold would have increased as follows based on historical data:

	No DRP	100% DRP
Inception	1,000	1,000
31-Dec-14	1,000	1,009
31-Dec-15	1,000	1,124
31-Dec-16	1,000	1,252
30-Jun-17	1,000	1,313

Source: BetaShares. Past performance is not an indicator of future performance

Putting some numbers to the above. At the inception of the fund, an investor with 1,000 units in HVST would have received $235 in income (as part of the November 2014 distribution). As at the June 2017 distribution, the same investor would have received $167 in income had they not participated in the DRP. By contrast, an investor who had participated in the DRP at 100% since inception would have received $219 in income (which would subsequently be reinvested), or 31% more compared to a non-DRP investor[7].

[4] Source: BetaShares, Bloomberg. Past performance is not an indicator of future performance

[5] Source: BetaShares, Bloomberg. Returns are from inception to 30 June 2017. Past performance is not an indicator of future performance

[6] Based on the S&P/ASX 50 Index total return in the 15 years from 31 December 2001. Source: Bloomberg

[7] Source: BetaShares. Past performance is not an indicator of future performance. These numbers will vary depending on dividend levels in the market and actual DRP participation level selected by the investor.

FAQ #2: So if the HVST unit price keeps dropping, does this mean the unit price of HVST will eventually go to zero?

Barring a catastrophe where the assets in the Fund actually drop to zero (highly unlikely), the unit price of HVST will never reach zero. However, the price will continue to drop if the Fund's yield is higher than its total return. This drop will be proportional to the unit price at the time (for example if the total return is 7% p.a. and the yield is 11% p.a. over two consecutive periods, then the price will fall approximately by 4%. So, for example, if the unit price is initially $20, it will drop to $19.20 after the first period – a drop of $0.80 - and then to $18.43 over the second period – a drop of $0.77).

FAQ #3: Why has the distribution per unit dropped and what should we expect in terms of ongoing distribution amounts going forward?

Distributions from HVST are derived from the dividends paid by the underlying shares in the portfolio. The factors that affect the yield of HVST include:

- **Yields of the underlying securities** – as the yield of underlying securities increases or decreases, so should the yield of HVST. Because of the rotation strategy in the Fund, HVST will be more sensitive to changes in yield than a broad market index.
- **The price of HVST** – yield is measured relative to price. Any time the yield for HVST is quoted, it is usually with reference to the current price. Because the price of HVST has declined over time (see explanation above), the size of distributions has also decreased. The DRP programme assists with preserving the total dollar amounts received by way of distributions. This is because the investors using the DRP will have ever-growing numbers of units to receive the dollar amount per unit distributed. In addition, the DRP programme is flexible and allows for any percentage participation that an investor may wish (e.g. from 0%-100%). Investors should consider their cash needs as part of this decision.

Going forward – What can we expect from HVST's performance?

Whilst we can't predict what the markets or individual stocks will do in times ahead, we will categorise how we expect HVST to behave relative to the S&P/ASX 50 Index under various conditions and situations:

Situations where HVST may be expected to underperform the Index include:

- Sideways markets – especially where there is high volatility (the risk management process will cause drag)
- Rallying markets with high volatility (if the market is generally moving up, but volatility is high, then there will be a level of hedging which will create drag on the Fund)
- Concentration risks – where HVST is overweight underperforming stocks or sectors, or underweight outperforming stocks or sectors

Situations where HVST may be expected to outperform the Index:

- Large market corrections due to the benefits of the risk management strategy
- Where HVST is overweight outperforming stocks or sectors or underweight underperforming stocks or sectors

And what about Franking Credits?

All the return numbers quoted above are net of franking credits. Another feature of HVST is that along with generating high levels of income, HVST also generates high levels of franking credits compared to the Index. Investors should include the benefit of these franking credits to them in any comparison[8].

Since inception, HVST has generated 5.5% more in franking credits than the Index.[10]

	Franking Credits earned by HVST	Franking Credits earned by the S&P/ ASX 50 Index
Inception to 30-Jun-15	2.1%	1.1%
1-Jul-15 to 30-Jun-16	3.5%	1.7%
1-Jul-16 to 30-June-17	3.2%	1.5%
Total - Inception to 30-Jun-17[9]	9.7%	4.2%

As we will describe below, the additional franking credits generated by the HVST strategy is one of the primary benefits of HVST as an investment, particularly for investors on lower tax rates.

Why invest in HVST? What types of investors does HVST suit?

HVST is designed for investors who are seeking high levels of income derived from dividends from large, liquid Australian shares. It is also particularly useful for investors seeking high levels of franking credits. As outlined previously, this income is achieved using a rotation strategy which focuses on shares from amongst the 50 largest stocks in the market, plus a risk management strategy. Because of this, HVST does not hold stocks representative of the Index, and will not necessarily perform in line with it. This is especially evident over shorter periods.

As the levels of income from HVST are generally higher than long term returns of the Fund, its unit price can, in general, be expected to decline over time. Only where the total return is greater than the yield, will the unit price increase.

In general, we find that the most suitable investor types for HVST are pre-retiree, retirees and investors with self-managed super funds (SMSFs).

Profile of investors for HVST based on usage of the HVST DRP

Investors should consider using the Fund's distribution reinvestment policy (or "DRP"), which, by reinvesting income, can help to maintain the capital amount invested in HVST over time. As illustrations, we consider three cases.

Case 1: Zero DRP

Without the DRP, investors will receive all the income generated by HVST as monthly cash distributions. In addition, they will receive all franking credits generated by their unit holding. This would suit investors who want very high levels of cash income, and who understand that over time, the unit price (and their distributions) – and hence their capital base – has a high probability of decreasing. The number of units they hold will remain static. If they understand the risks, this may suit investors who are looking for regular income payments, including investors who would otherwise consider annuity products (noting that unlike annuity products the income received by HVST will vary).

Such investors should note that, unlike a fixed income investment where the income amount is specified or linked to a market rate, the income generated by HVST is still linked to yields in the equity market. Such investors will, of course, be able to benefit from the high franking credits associated with HVST's distributions.

Case 2: 50% DRP

Half participation in the DRP means that investors will receive as a cash payment half the income generated by HVST, plus ALL the franking credit entitlements from their holding. Over time, the other half of their income will be invested in more units (at the prevailing unit price at the time of the relevant distribution), so the number of units they hold will increase. The amount of capital in their holding will also reflect this. In approximate terms, the total return of HVST only needs to be at or greater than about half the yield of the Fund for their capital invested in HVST to increase.

Using historical distributions, an investor in HVST who took up a 50% DRP would have received income in a similar range to the broad market but with approximately double the franking credits. Capital growth and/or preservation is also more likely in this scenario.

Case 3: 100% (full) DRP

Investors who do not need the cash income immediately, such as those in accumulation phase, can fully reinvest ALL income from HVST. This will increase their unit holding, and provided that the total return of the Fund is positive, their capital invested in HVST will increase. They will still be entitled to all franking credits due on their unit holding, which will be accruing at a compounding rate.

Some investors in HVST who use the full DRP are doing so via their self-managed super fund (SMSF) as a way to help offset tax (which may be income or contributions tax) in their SMSF via the high franking credits available from HVST.

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[8] Franking credits have different benefits to investors depending on their own financial situation and tax rates. Investors seeking more information about the benefit of franking credits should consult their financial adviser or accountant for more information.

[9] Assumes full participation in the HVST DRP. These numbers are based on the difference between gross total return and net total return over the relevant period.

[10] Compared to the S&P/ASX 50 Index, from the period from inception of the Fund to 30 June 2017. Past performance is not an indicator of future performance

Alternatives to HVST: Other BetaShares Funds

Diversification is regarded as one of the key risk mitigation factors for investors. No investor should ever be exposed to a single instrument or factor. Here we outline other BetaShares Funds, which may be better suited to some investors than HVST, or may be used in conjunction with HVST. In this context, we will compare these Funds to HVST. Full information about these Funds can be found on the BetaShares website (www.betashares.com.au).

BetaShares Australian Top 20 Equity Yield Maximiser Fund

(managed fund) (ASX code: YMAX)

Like HVST, YMAX is also a high income fund, however, the significant difference is that the income in YMAX is derived from dividends on a portfolio of shares from the S&P/ASX 20 Index, plus premium income from selling call options over the shares held in the Fund. As a result, the income from YMAX is expected to exceed the dividend yield of the underlying shares. Overall volatility of YMAX is expected to be lower than that of the underlying share portfolio. Total return of YMAX will differ from the S&P/ASX 20 Index depending how the options perform.

As an alternative or complement to HVST, some of the income derived from YMAX is generated from option writing, rather than from dividends. Also, the stock portfolio held by YMAX consists of all the stocks in the S&P/ASX 20 Index in line with their respective index weights, and will therefore be much more closely correlated to the S&P/ASX 20 Index than the HVST portfolio is to the S&P/ASX 50 Index. YMAX's franking credit outcomes will not be as strong as HVST's given the nature of the strategy. As at 30 June 2017, YMAX's net yield was ~9% p.a and gross yield was ~11% p.a. For more information on YMAX, see http://www.betashares.com.au/fund/equity-yield-maximiser-fund/

BetaShares FTSE RAFI Australia 200 ETF
(ASX code: QOZ)

QOZ is a fund which aims to track the performance of an index of the top 200 companies listed in Australia as measured by fundamental size.

QOZ is much more akin to a traditional index fund than HVST. It is much more diversified (holding 200 stocks) than HVST, and so will provide exposure to the broad market, without the changes in sector and single stock concentration that occur in HVST. It's yield and associated franking credits will be much lower than the yield of HVST (and closer to the yield and franking credit outcomes associated with the broad market), and it does not have HVST's tailored downside risk management strategy, so is expected to have higher volatility, and over market corrections can be expected to fall broadly in line with the market.

QOZ may be an alternative to HVST for investors who do not require high levels of income (or franking), and prefer a more diversified portfolio. It may also compliment a holding in HVST by adding diversification to an investor's portfolio. As at 30 June 2017, QOZ's net yield was ~5% p.a and gross yield was ~6% p.a. For more information on QOZ see http://www.betashares.com.au/fund/ftse-rafi-australia-etf/

BetaShares Australian Bank Senior Floating Rate Bond ETF
(ASX code: QPON)

QPON is not an equity fund. Rather, it holds a portfolio of some of the largest and most liquid floating rate bonds issued by Australian banks. It pays regular monthly income, which is expected to exceed the income paid on cash and short term bank deposits. This income should rise and fall in line with rises and falls in market interest rates.

Floating rate bonds typically have historically had low correlation to equities, so QPON should be a good diversifier to equity exposures in general. In addition, the historical performance of floating rate bonds has exhibited defensive characteristics including low capital variability during market declines.

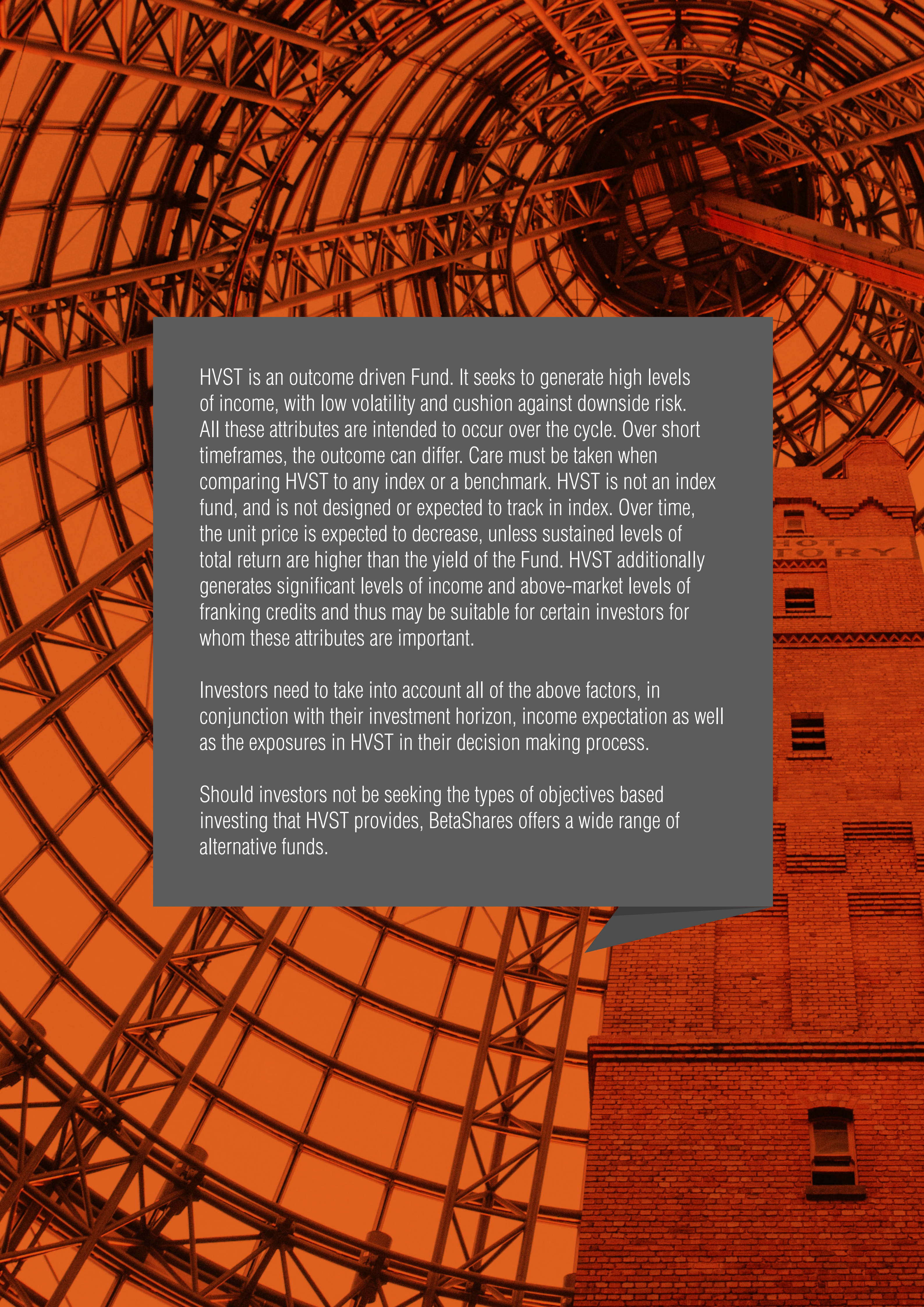
Although the yield in QPON is expected to be considerably lower than that of HVST, it should provide good diversification, and offers much greater capital stability relative to an equities investment. As at 30 June 2017, QPON's running yield was ~2.9% p.a. For more information on QPON see http://www.betashares.com.au/fund/australian-bank-floating-rate-bond-etf/

BetaShares Australian Ex-20 Portfolio Diversifier ETF
(ASX code: EX20)

EX20 aims to track an index based on approximately 180 Australian listed stocks with the largest being ranked number 21 (by market capitalisation). As such, it does not hold the 20 largest stocks in the market, so offers a good form of diversification away from the largest stocks in the market, in particular the large Australian banks and resources giants like BHP and RIO.

As a compliment to both HVST and YMAX, EX20 can add diversification away from the largest stocks to which both the former are exclusively exposed. For more information on EX20 see http://www.betashares.com.au/fund/portfolio-diversifier-etf/

	HSVT	YMAX	QOZ	QPON	EX20
Exposure	Australian shares with a risk management strategy	Australian shares with a 'buy-write' strategy	Broad Australian shares	Australian bank floating rate bonds	Broad Australian shares excluding the largest 20
Strategy	Rules based	Rules based	Index Fund	Index Fund	Index Fund
Income objective	At least double the income yield of the broad Australian market	Exceed the dividend yield of the underlying equity portfolio	Approximately in line with the broad market	Expected to exceed the yield from cash and short term deposits	Approximately in line with the broad market
Volatility expectation, compared to the broad Australian equity market	Lower	Lower	Approximately in line with the broad market	Lower	Approximately in line or higher than the broad market
Distribution frequency	Monthly	Quarterly	Semi-annual	Monthly	Semi-annual
Income levels relative to HVST		Similar – slightly lower	Lower – similar to broad Australian sharemarket	Lower	Lower – similar to broad Australian sharemarket
Behaviour of unit price	Expected to fall over time	Will rise and fall based on the performance of the largest 20 stocks and behaviour of options	Will rise and fall broadly in line with the Australian sharemarket	Relatively stable – rising	Will rise and fall broadly in line with the Australian “small cap” sharemarket



HVST is an outcome driven Fund. It seeks to generate high levels of income, with low volatility and cushion against downside risk. All these attributes are intended to occur over the cycle. Over short timeframes, the outcome can differ. Care must be taken when comparing HVST to any index or a benchmark. HVST is not an index fund, and is not designed or expected to track in index. Over time, the unit price is expected to decrease, unless sustained levels of total return are higher than the yield of the Fund. HVST additionally generates significant levels of income and above-market levels of franking credits and thus may be suitable for certain investors for whom these attributes are important.

Investors need to take into account all of the above factors, in conjunction with their investment horizon, income expectation as well as the exposures in HVST in their decision making process.

Should investors not be seeking the types of objectives based investing that HVST provides, BetaShares offers a wide range of alternative funds.

BetaShares
Exchange Traded Funds

Learn more about BetaShares

BetaShares is a leading manager of ETFs and other Funds that are traded on the Australian Securities Exchange ('ASX'). Our aim is to provide intelligent investment solutions for Australian investors.

Visit our website and explore our full range of Funds that can help you achieve your financial objectives.

www.betashares.com.au