

## Portfolio Management in Difficult Conditions

We are currently in historically extreme market conditions with investments being sold down with little regard to their economic value (even assuming a severe global economic slowdown).

During times of extreme stress, good quality growth assets including high quality companies and properties survive and are the first assets to recover value.

We have been asked by several clients what should be done in such difficult conditions.

Should I sell, park my money then buy back in. Or, I knew it was coming why didn't we sell months ago?

Trying to time entry out of and then back into markets over time is expensive and extremely difficult to do with any added value. There is also little point in trying to buy or sell in markets that are moving up or down 5-6% per day as you run the risk of being put a price that can reflect an entire year's return or loss. More normal trading conditions (volatility and volume) are required to enter and exit long term investment portfolio holdings efficiently.

The key to dealing with extreme volatility is to establish the right portfolio in the first place that can weather then recover from difficult conditions.

Our client portfolios have been designed to deal with these conditions, despite how bad they might look now. Appropriate asset class diversification and holding high quality assets will see your portfolio recover and achieve the long term target returns set.

### How do we know this?

At NEWTON ROSS we construct portfolios to deal with market volatility by giving regard to the strategic asset allocation of the portfolio. The asset allocation is built by considering:

- ❖ The length of time of investment. The longer the timeframe the greater the ability to take risk and therefore achieve higher returns.
- ❖ The capacity for clients' to endure risk over this timeframe. Everyone is different and therefore their portfolios are different.
- ❖ The likely net rate of return and variability of that return (risk) for each type of asset in future. We use the longest available data time frames from each asset class to help determine the range of risk and returns for each asset class (back to 1926 for US share prices). This ensures our calculations take into account the chance of extreme events and these probabilities are catered for.
- ❖ We then combine asset classes in different ratios to establish a portfolio allocation that will meet the clients target net rate of return and capacity for risk for the investment time frame. Setting the correct asset allocation is critical to delivering long term returns.

## Securities Selection:

The next step in the process is to select the right securities to own in each asset class and NEWTON ROSS has always taken a conservative approach to this.

- ❖ We do not want to own fixed interest investments (and have not) that fail and cause total capital loss (such as finance companies). We therefore only invest in investment grade bonds that carry very low levels of risk.
- ❖ We also want to ensure that our directly held Australasian growth assets such as shares and property are high quality and are generally considered on a multi-year holding basis.
- ❖ Where we use managers for overseas growth assets, they are carefully selected from a large pool of potential managers because of their ability to add value over time. Active managers in particular can show their value during extreme market periods.

## How are portfolios holding up?

The chart below shows the expected return from our model portfolio (using exactly the same assets as our client portfolios) but with the following weightings:

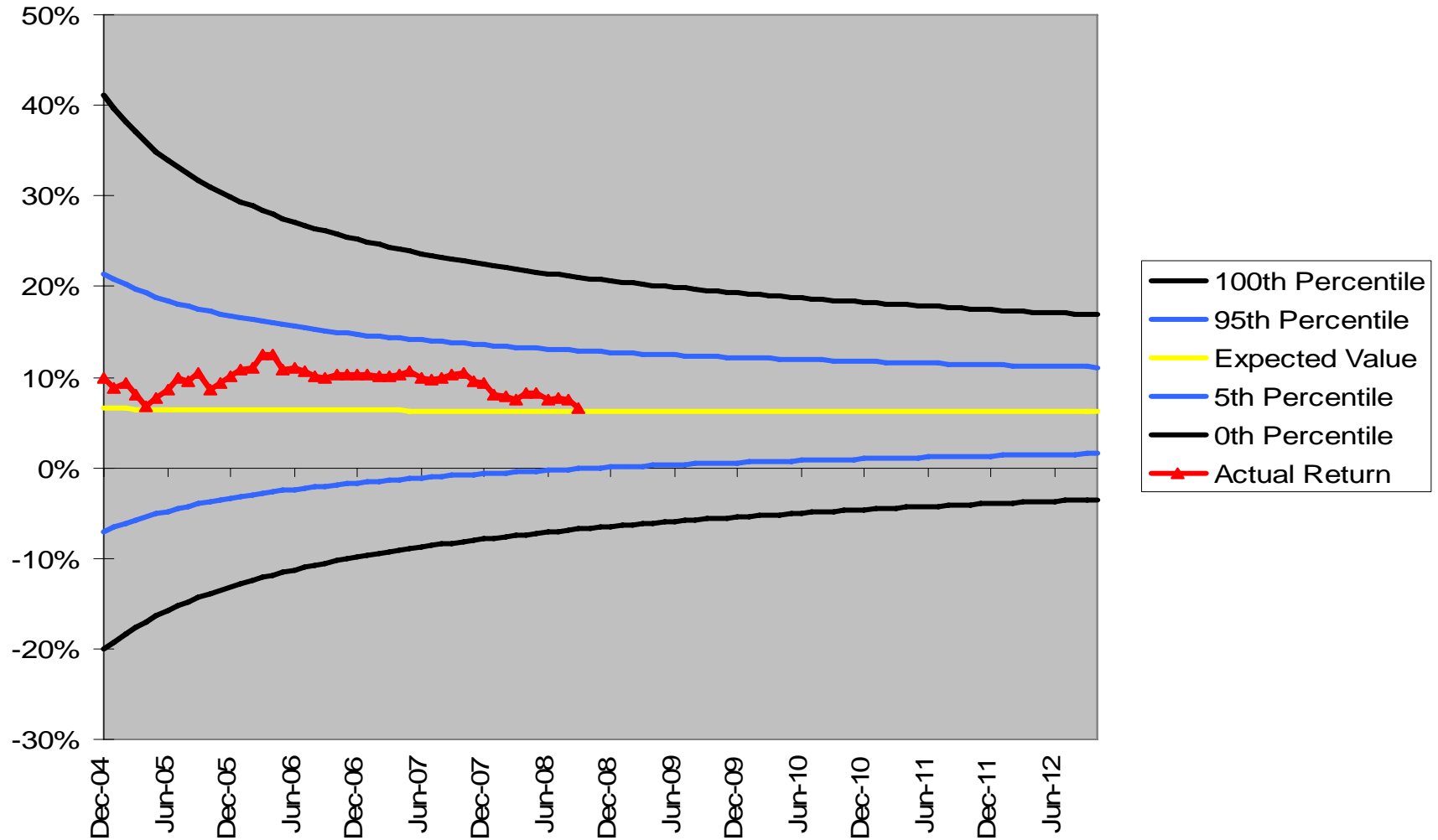
Asset Class	Weighting
Cash	5%
Bonds	35%
Alternative Assets	10%
Global Shares	35%
Australasian Shares	15%
Total	100%

Expected Long Term Average Net Return	6.6% p.a.
Expected Risk	+ or - 8.7% p.a.
Chance of loss in a year	23.0%
Chance of loss worse than -10% in a year	2.1%

We can plot the return of this portfolio looking at the annualized return up to any month since inception in 2003. The actual return is the red line. The yellow line represents the average target return. We would expect 90% of the annualized returns to fall within the blue lines with a probability that 5% of the returns would be above or below the blue lines.

## Return Percentiles: Model Portfolio

Net return after costs and tax withheld

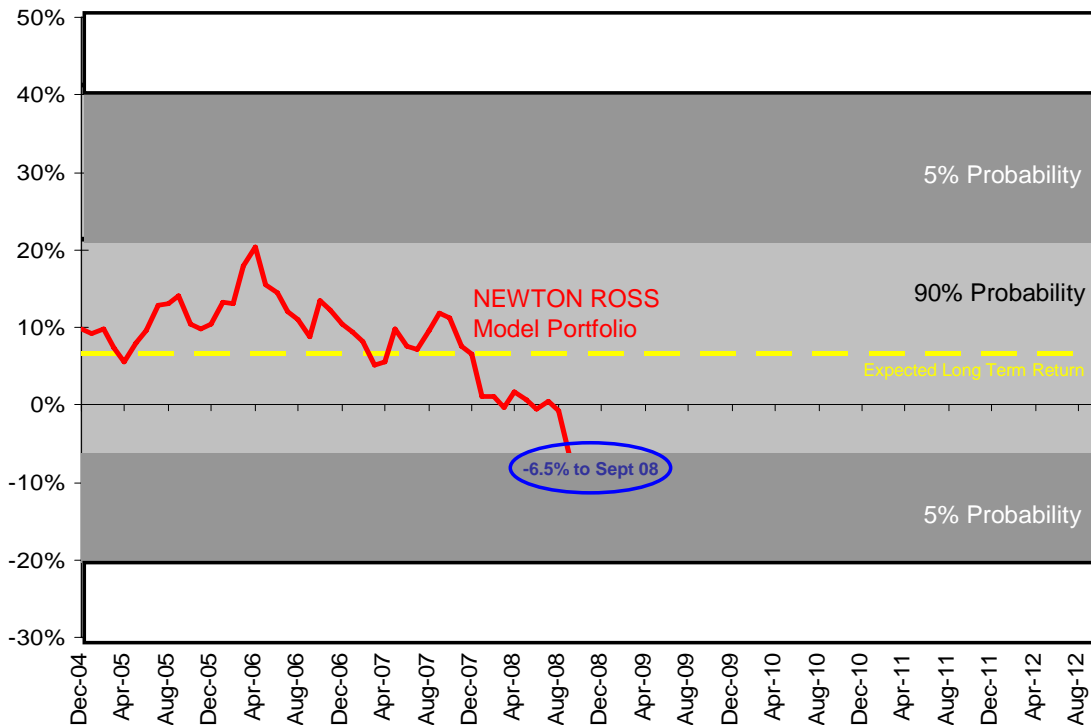


To make the portfolio performance more relevant for clients that have established their portfolios with us since 2003 we can show a portfolio with 12 month returns plotted each month (see the graph below). This means that each monthly point on the red line represents the net return for the prior year to that month.

For instance, the last point shown in red is the portfolio return of -6.5% for the 12 months to September 2008. This means the portfolio was at the extreme edge of the 90% probability range and only just within expected limits. Similarly in 2005/06 the portfolio almost breached the upper limit at just over 20%.

Despite the difficult conditions to the end of September our portfolios are staying within their expected modeled limits. There has always been a remote but none the less 5% chance that an extreme event occurs (and perhaps that is happening now) which may drop the line lower by the end of next month but again our calculations for long term portfolio returns do take this into account.

**Model Portfolio Rolling 12 Month Return**  
Net return after costs and tax withheld



Please let us know if you would like to review the risk and return limits we established for your portfolio and we can show how your returns are plotting against this.

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