

Listed Security SMA Portfolio Update

7 January 2021

In October 2020, as part of our investment review process, we engaged Clime Investment Management along with Mercer for Australian equities investment consulting, strategic and dynamic asset allocation, and portfolio construction advice.

Part of this process included Mercer undertaking a health check on the Strategic Asset Allocation (SAA) of the portfolios. The health check examined the current investment objectives of each portfolio. It is important to note, Mercer's SAA health check is a forward-looking assessment. Given the current conditions and market outlook the results of the modeling indicated that, based on the existing SAA, the portfolios are not likely to meet the CPI objectives over the coming 10 years. Whilst this was determined by several factors, there are two key drivers to this assessment; the current (and expected long-term) returns in the cash and fixed interest asset classes, and the need to access financial instruments that better meet the risk and return profiles of the portfolios.

In line with the guidance and assessment received, ProActive Portfolios is making the following changes to include several new sub-asset classes where direct investment exposure can be gained including:

- Emerging Market equity
- Global listed property
- Global credit and Absolute Return Fixed Interest exposure

Implementation of changes

- The SAA changes will be implemented in 2 stages as we try to minimise the transaction costs but to also ensure that over time, we are consistent with our Dynamic Asset Allocation (DAA) views – see page 2 i.e. not trading unnecessarily to move back towards a SAA
- The portfolios will continue to be reviewed monthly/ongoing with the DAA to be revisited quarterly

Recommended Strategic Asset Allocation (SAA) Changes:

	Income			Conservative			Balanced			Growth			High Growth		
	Current	Diff.	Rec.	Current	Diff.	Rec.	Current	Diff.	Rec.	Current	Diff.	Rec.	Current	Diff.	Rec.
Australian Equity	-		-	11.90%	7.10%	19.00%	35.30%	-6.30%	29.00%	39.40%	-0.90%	38.50%	46.10%	0.90%	47.00%
International Equity (UH)	-		-	4.10%	-2.60%	1.50%	9.40%	0.10%	9.50%	11.40%	-0.65%	10.75%	16.30%	-3.30%	13.00%
International Equity (H)	-		-	-	4.50%	4.50%	2.10%	10.40%	12.50%	4.00%	9.75%	13.75%	6.70%	9.30%	16.00%
Emerging Markets Equity (UH)	-		-	-		-	-	4.00%	4.00%	-	6.00%	6.00%	-	8.00%	8.00%
GREITs (H)	-		-	2.80%	2.20%	5.00%	4.10%	0.90%	5.00%	4.70%	-1.70%	3.00%	5.20%	-2.20%	3.00%
Global Listed Infrastructure (H)	-		-	2.00%	3.00%	5.00%	3.80%	1.20%	5.00%	3.70%	-0.70%	3.00%	4.60%	-1.60%	3.00%
Gold	-		-	2.10%	-2.10%	-	2.00%	-2.00%	-	4.00%	-4.00%	-	3.00%	-3.00%	-
Australian Fixed Interest	11.80%	-11.80%	-	8.60%	-8.60%	-	6.20%	-6.20%	-	5.50%	-5.50%	-	1.90%	-1.90%	-
Australian Government Bonds	15.30%	-7.80%	7.50%	12.50%	-5.50%	7.00%	9.30%	-4.30%	5.00%	5.70%	-5.70%	3.00%	3.40%	-3.40%	-
Australian Non-Government Bonds	20.30%	-5.30%	15.00%	-	10.00%	10.00%	-	7.00%	7.00%	-	6.00%	6.00%	-		-
Australian ILBs	-	15.00%	15.00%	-	12.50%	12.50%	-	6.00%	6.00%	-	6.00%	6.00%	-		4.00%
International Fixed Interest (H)	8.80%	-8.80%	-	12.00%	-12.00%	-	-		-	-		-	-		-
Developed Markets Non-Gov Bonds (H)	-	32.50%	32.50%	-	25.50%	25.50%	-	12.00%	12.00%	-	8.00%	8.00%	-		6.00%
Cash	43.90%	-13.90%	30.00%	43.90%	-33.90%	10.00%	27.80%	-22.80%	5.00%	21.60%	-19.60%	2.00%	12.90%	-12.90%	-
Total	100.00%		100.00%	100.00%		100.00%	100.00%		100.00%	100.00%		100.00%	100.00%		100.00%
Growth	0.00%		0.00%	23.00%		35.00%	56.70%		65.00%	67.20%		75.00%	81.90%		90.00%
Defensive	100.00%		100.00%	77.00%		65.00%	43.30%		35.00%	32.80%		25.00%	18.10%		10.00%

The ProActive Portfolios SAA process utilises Mercer's forward-looking Capital Market Assumptions to ensure that the portfolios are structurally aligned to the current market environment, whilst maintaining a reasonable probability of meeting return objectives within the risk parameters over a 20-year forward-looking horizon. The recommended SAA represents the long-term neutral position of the portfolio. A Dynamic Asset Allocation (DAA) overlay is then applied to ensure that the portfolios are positioned to capture the "medium" term (1-3 year) outlook and to minimise transaction costs.

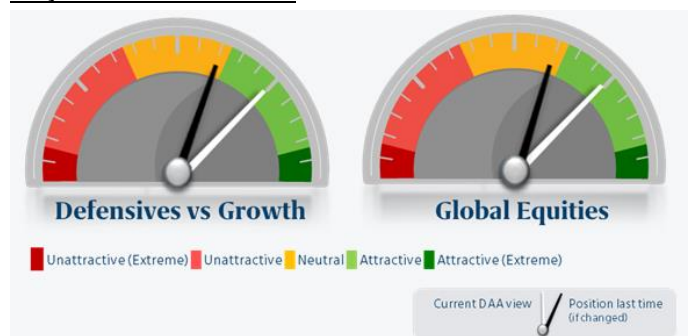
Dynamic Asset Allocation Views

International equities

While economic activity is likely to be weak over the next few months in the US, Europe, and other countries with renewed virus case increases, the outlook for 2021 Q2 and beyond is much improved. Over the DAA time horizon of 1 – 3 years, economies will be in an early/mid-stage recovery, which tends to be positive for risk assets. There are considerable excess savings and pent-up demand to be released by consumers while businesses are in the middle of a restocking cycle as inventories are at an almost ten year low. People will be eager to start spending on services, which could lead to a mini-boom through the middle of 2021 bringing developed economies led by the US back towards their 2019 levels. From there, we expect to transition into the normal early to mid-cycle part of the growth phase. Neither governments nor central banks will be in a hurry to withdraw policy support as the recovery continues. Indeed, they are likely to increase support in case of any temporary setbacks.

For companies, this means strong earnings growth from a low basis in an early cycle environment, potentially rising but not galloping inflation and ongoing policy support. We will reposition the portfolios to benefit from an early cycle growth environment by being overweight growth assets. This is expressed as moving to an overweight in emerging market equities relative to developed market equities and moving global small caps to an overweight position.

Major Asset Class Views



Source: Mercer

Sub Asset Class Views: Global Equities

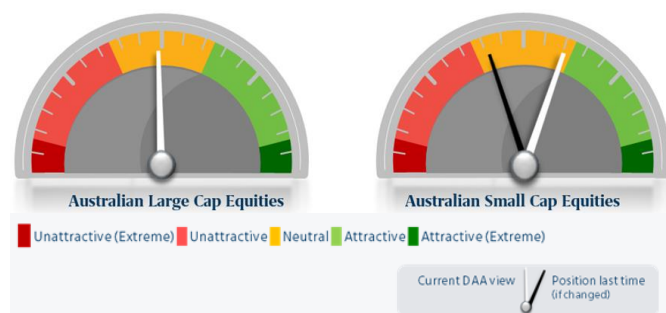


Source: Mercer

Australian Equities

Australia is better positioned than most other countries – not only in controlling COVID-19 but in driving growth during the recovery. The dial for Australian Small Cap Equity has increased towards favourable as a result of Australia's success and the improving economic outlook which is likely to be more supportive of small caps given the reduction in refinancing concerns and prospective returns on offer.

Australian shares have generally underperformed global share markets over the last 10 years (since October 2009, in local currency terms). There is now good reason to believe that this relative underperformance will reverse in the year ahead if the Australian economy recovers faster, cyclical sectors (like resources and financials) come back into favour versus growth stocks (like IT and healthcare), and as commodity prices rise.



Source: Mercer

The Australian equities allocation within the portfolios is currently invested largely in the Vanguard Australian Shares Index ETF (VAS) and ASX 100 stocks. The ETF comprises approximately 47% of the Australian equities' allocation with ASX100 direct shares accounting for 95% of the remainder. This combination is viewed as unlikely to result in long term after fee returns above benchmark therefore the passive allocation will be reduced to 30% in the first instance and 20% in the second stage of changes with the balance to be actively managed in accordance with the Clime Investment Team's process.

The existing portfolio is heavily weighted to health care, at 28% of the active component compared to 12% for the ASX 300 Index. Our view is that the health care sector overall is likely to underperform in the near to medium term given the economic recovery underway. The sector has previously outperformed due to its defensive characteristics and many of the stocks in this sector are trading at historically high earnings multiples. We will shift the holdings within the Australian equities component to hold stocks that we consider high quality i.e., with characteristics including high returns on capital, high margins, and low gearing.

This includes the following changes:

ASX code		Action
ADH	Adairs	added
BAP	Bapcor Limited	removed
BHP	BHP Group	added
BXB	Brambles Limited	removed
CSL	CSL Limited	removed
EOS	Electro Optic Systems	added
HSN	Hansen Technologies	added
JIN	Jumbo Interactive	added
M7T	Mach 7 Technologies	added
MFG	Magellan Financial Group	removed
NAB	National Australia Bank Limited	increased
NCK	Nick Scali Furniture	added
QUB	Qube Holdings Limited	removed
RUL	RPM Global	added
SCG	Scentre Group	added
SYD	Sydney Airport	removed
TAH	Tabcorp Holdings Limited	removed
TCL	Transurban Group	removed
TLS	Telstra Corporation Limited	removed
VAS	Vanguard Australian Shares Index ETF Exc	reduced
WBC	Westpac Bank	increased

Cash and Fixed Interest

Our primary focus in repositioning the portfolios is to sufficiently diversify defensive assets and support the focus on both liquidity and return/yield targets. The next decade will be challenging for bond investors. Given the 'lower for longer' return environment, which is particularly prevalent within defensive assets, we are looking to introduce allocations to non-government bond sectors and sub-strategies.

In particular, we have looked to make the portfolios more resilient through the introduction of inflation protection as we believe that it is prudent to introduce this before the cost of implementation becomes too costly. This is in light of the recognition of the increased importance of inflation risks, given the shift in policy from monetary to fiscal, stimulus levels, and resulting debt levels. There is little margin for error at these low yield levels, an outbreak of unexpected inflation due to policy or other changes could leave bond investors badly shaken if defensive portfolios do not have some inflation protection built into them.

We will be reducing the cash allocation and re-allocate this to other defensive assets. The very low cash rates represent a large return drag across all portfolios, and whilst prudent as a defensive position, given the uncertainty prevalent in the early part of 2020, it is now impacting the probability of the portfolios meeting their objectives in the long-term.

Fixed-income assets such as high yield, loans, and emerging market debt provide a good opportunity for return, whilst balancing credit risk. While credit spreads have narrowed sharply over the last few months, we believe further contraction could occur given the outlook of continued economic recovery, the lack of yield available elsewhere, and the prospect of continued policy support. Indeed, if economic activity or financial markets weakened sharply, the US Federal Reserve and other central banks would probably directly support credit markets, given the inability to ease policy via Quantitative Easing or interest rate cuts.

We expect government bond yields to stay roughly where they are, although, given current yields, a move higher is more likely than a move lower. We continue to prefer high-quality non-government bonds. Within this space, our preference is securitized credit over investment-grade credit as the scope for a rally from here is smaller than it was for the latter, whilst the former still gives a higher spread margin with exposure to the consumer who we believe will continue to be resilient due to fiscal policy support. We will continue to hold an exposure to nominal Government Bonds to provide deflationary protection despite yields now being well below long-term average levels. Low yields coupled with low inflation also pose a potential for the negative correlation seen between equities and bonds for the last 20 years to reverse.

Investment Grade credit provides additional diversification through the widening of credit spreads has since narrowed resulting in a lower level of forward-looking returns from this sub-strategy. Whilst these assets became notorious during the global financial crisis, we believe that the sector is much sounder now following widespread reforms including tighter regulations on consumer lending practices and requirements for risk retention by originators in securitisation as well as sounder risk management practices.

The main aim has been to refocus and reconsider non-traditional fixed income approaches to ensure that the portfolios are diversifying into alternative income-generating assets within the bond portfolio.

Implementation: stage 1

The stage 1 changes which are detailed in the table below aim to transition the current portfolios through changing allocations to asset classes for which the current portfolios already hold exposure to; and gradually introducing exposure to new asset classes to provide access to financial instruments that better meet the risk and return profiles of the portfolios.

As part of the first phase implementation, the following changes will be made:

- Introducing **International Equity (H)**, **Emerging Market Equity**, **Australian ILBs**, **Global Credit exposures**.
- Introducing new managers for the new asset classes listed above. As a result, property allocation will divest from **AREITs** to **GREITs (H)**.
- We will also implement changes to the active/passive split within **Australian Equities**.
- In line with our DAA view, we will also implement the following changes:
 - Decreased exposure to **Australian Sovereign Bonds**
 - Incorporated DAA through **increased allocation to Growth assets** compared with the current allocation (excluding Income portfolio).

	Income			Conservative			Balanced			Growth			High Growth		
	Current	Impl.	New	Current	Impl.	New	Current	Impl.	New	Current	Impl.	New	Current	Impl.	New
Australian Equity	-	-	-	11.9%	1.6%	13.5%	35.3%	2.2%	37.5%	39.4%	0.6%	40.0%	46.1%	0.4%	46.5%
International Equity (UH)	-	-	-	4.1%	-1.1%	3.0%	9.4%	0.1%	9.5%	11.4%	-0.4%	11.0%	16.3%	-2.3%	14.0%
International Equity (H)	-	-	-	-	3.5%	3.5%	2.1%	4.9%	7.0%	4.0%	6.0%	10.0%	6.7%	5.8%	12.5%
Emerging Markets Equity (UH)	-	-	-	-	-	-	-	4.0%	4.0%	-	6.0%	6.0%	-	6.0%	6.0%
GREITs (H)	-	-	-	2.8%	1.7%	4.5%	4.1%	0.4%	4.5%	4.7%	-0.2%	4.5%	5.2%	-1.2%	4.0%
Global Listed Infrastructure (H)	-	-	-	2.0%	2.5%	4.5%	3.8%	0.7%	4.5%	3.7%	-0.2%	3.5%	4.6%	-1.1%	3.5%
Gold	-	-	-	2.1%	-0.6%	1.5%	2.0%	-2.0%	-	4.0%	-4.0%	0.0%	3.0%	-3.0%	-
Australian Fixed Interest	11.8%	-4.3%	7.5%	8.6%	-3.6%	5.0%	6.2%	-2.2%	4.0%	5.5%	-2.0%	3.5%	1.9%	-1.9%	-
Australian Government Bonds	15.3%	-5.3%	10.0%	12.5%	-3.5%	9.0%	9.3%	-1.8%	7.5%	5.7%	-2.2%	3.5%	3.4%	-3.4%	-
Australian Non-Government Bonds	20.3%	-2.8%	17.5%	-	5.0%	5.0%	-	-	-	-	-	-	-	-	-
Australian ILBs	-	5.0%	5.0%	-	3.0%	3.0%	-	-	-	-	-	-	-	-	-
International Fixed Interest (H)	8.8%	-1.3%	7.5%	12.0%	-4.5%	7.5%	-	-	-	-	-	-	-	-	-
Developed Markets Non-Government Bonds (H)	-	15.0%	15.0%	-	5.0%	5.0%	-	5.0%	5.0%	-	3.0%	3.0%	-	2.0%	2.0%
Cash	43.9%	-6.4%	37.5%	43.9%	-8.9%	35.0%	27.8%	-11.3%	16.5%	21.6%	-6.6%	15.0%	12.9%	-1.4%	11.5%
Total	100.0%	-	100.0%	100.0%	-	100.0%	100.0%	-	100.0%	100.0%	-	100.0%	100.0%	-	100.0%
Growth Assets	0.0%	-	0.0%	23.0%	-	30.5%	56.7%	-	67.0%	67.2%	-	75.0%	81.9%	-	86.5%
Defensive Assets	100.0%	-	100.0%	77.0%	-	69.5%	43.3%	-	33.0%	32.8%	-	25.0%	18.1%	-	13.5%

Manager Changes:

We have reviewed the ETF manager line-up and aligned this to Mercer's high conviction view. These manager changes will be implemented throughout both **stages 1 and 2**. Outlined in the table below are the manager changes.

Current			Future		Status	Action
Australian Equity	Vanguard Australian Shares Index ETF	→	Australian Equity	Vanguard Australian Shares Index ETF	Existing	Reduce
	Direct equity holdings incl Small Caps			Direct equity holdings incl Small Caps	New and Existing	Increase
International Equity (UH)	iShares Global 100 (AU)	→	International Equity (UH)	Vanguard MSCI Index International Shares (UH)	Existing	Reduce
	Vaneck Vectors MSCI World Ex Aus ETF		International Equity (H)	Vanguard MSCI Index International Shares (H)	New	Add
	Vanguard MSCI Index International Shares		Emerging Markets Equity (UH)	iShares Emerging Markets	New	Add
AREITs	Vanguard Australian Property Securities	→	GREITs (H)	VanEck Vectors FTSE (H)	New	Add
AREITs	Vaneck Vectors Australian Property ETF		Global Listed Infrastructure (H)	Magellan Infrastructure ETF	New	Add
Global Listed Infrastructure (H)	Vaneck Vectors FTSE Global Infrastructure				-	-
Alternatives	Betashares Gold Bullion ETF - Currency H	→	Alternatives	-	-	-
Australian Government Bonds	Activex Ardea Real Outcome	→	Australian Non-Government Bonds	Activex Ardea Real Outcome	Existing	
Australian Fixed Interest	Vanguard Australian Fixed Interest Index		Australian Non-Government Bonds	Vanguard Australian Corporate Fixed Interest Index Fund	New	Add
Australian Non-Government Bonds	Vaneck Vectors Aust Floating Rate ETF		Australian ILBs	iShares Government Inflation ETF	New	Add
International Fixed Interest (H)	Vanguard Intl Fixed Interest Index		Developed Markets Non-Government Bonds (H)	Vanguard International Credit Securities Index (H)	New	Add
Cash	Betashares Australian High Interest	→	Cash	iShares Core Cash ETF	New	Add
	Cash			Cash	Existing	Reduce

The manager changes above reflect the new allocations based on the recommended SAA.

Manager Changes Rationale:

Australian Equity	→	Australian Equity	Introduced Clime Australian All Cap strategy and retained actively managed allocation (80%) and Vanguard Australian Shares Index ETF (20%) . We favour active management with a bias towards mid to small caps in this part of the economic recovery and believe the portfolio will benefit by diversifying its Australian Equities allocation into this sector, as actively managed Clime. Small-cap addition helps to reduce the security and sector concentration inherent in large-cap domestic equity exposures while simultaneously broadening the opportunity set for stock selection alpha.
International Equity (UH)	→	International Equity (UH) International Equity (H) Emerging Markets Equity (UH)	Introduced iShares Emerging Markets to diversify Global equity exposure with Emerging Market Equities. Removed iShares Global 100 (AU) as we believe the Global Equity portfolio is able to provide sufficient exposure through the hedged and unhedged sleeves of the Vanguard MSCI Index International Shares , without the need for the concentrated exposure from the iShares Global 100. Mercer favours Global Smaller Companies and Emerging Markets over Large Cap and Developed Markets at this point in the economic recovery. Having the hedged and unhedged Vanguard MSCI International ETFs allows the portfolio to manage its global currency position while retaining exposure to the global equity market.
AREITs	→	GREITs (H)	Removed the AREITs exposure to Vanguard Australian Property Securities and Vaneck Vectors Australian Property ETF in favour of GREITs (H) allocation to VanEck Vectors FTSE ETF (Hedged) . Mercer views the GREITs (H) universe as providing wider exposure to property opportunities relative to the domestic market. In addition, the Australian equity exposure including the Vanguard Australian Shares Index will hold exposure to the AREIT sector.
Global Listed Infrastructure (H)	→	Global Listed Infrastructure (H)	Retained the Global Infrastructure exposure but have moved to an active ETF through Magellan . Mercer believes that the listed infrastructure index exposure exhibits very high emissions and exposure to companies exposed to climate transition risk and as such believe that this exposure should be held in active strategies.
Alternatives	→	Alternatives	Removed allocation to Gold through Betashares Gold Bullion ETF – Currency H . Gold exhibits reasonable downside risk mitigation characteristics; however, its rapid appreciation during 2020 means that at current valuation levels we believe it is not appropriate within the SAA. We continue to monitor the inclusion of Gold and will reconsider its inclusion at further stages throughout the economic recovery.
Australian Government Bonds	→	Australian Government Bonds	Retained the allocation to Ardea Real Outcome Strategy , to ensure coverage to highly liquid global government bonds typically AA-AAA rated thereby minimising credit risk and associated derivatives across hundreds of trades thereby minimising position risk.
Australian Fixed Interest	→	Australian Non-Government Bonds	Corporate Fixed interest and Inflation Linked Bond Exposures have been introduced as we currently favour high yield and credit exposure in light of the low level of prevailing yields in many fixed income markets.
Australian Non-Government Bonds	→	Australian ILBs	
International Fixed Interest (H)	→	Developed Markets Non-Government Bonds (H)	Developed Market Investment Grade credit remains our preferred exposure within income markets due to the lower bond yields. We continue to monitor the current valuations in this market segment.
Cash	→	Cash	Concentrated the cash allocation into the iShares Core Cash ETF. The BetaShares Aust High Interest Cash ETF was not considered appropriate due to liquidity concerns and that after fee returns have been negative. Where possible, we have decreased cash holdings as the lower interest rate environment becomes further prolonged and the real returns for cash instruments approach zero with little upside potential.

The portfolio changes will be made on **11 January 2021**. The updated holdings reports will be available on the Proactive Portfolios website shortly thereafter.