Investment Strategy Review

The Jack Brockhoff Foundation

23 August 2016

THIRD SECTOR ADVANTAGE

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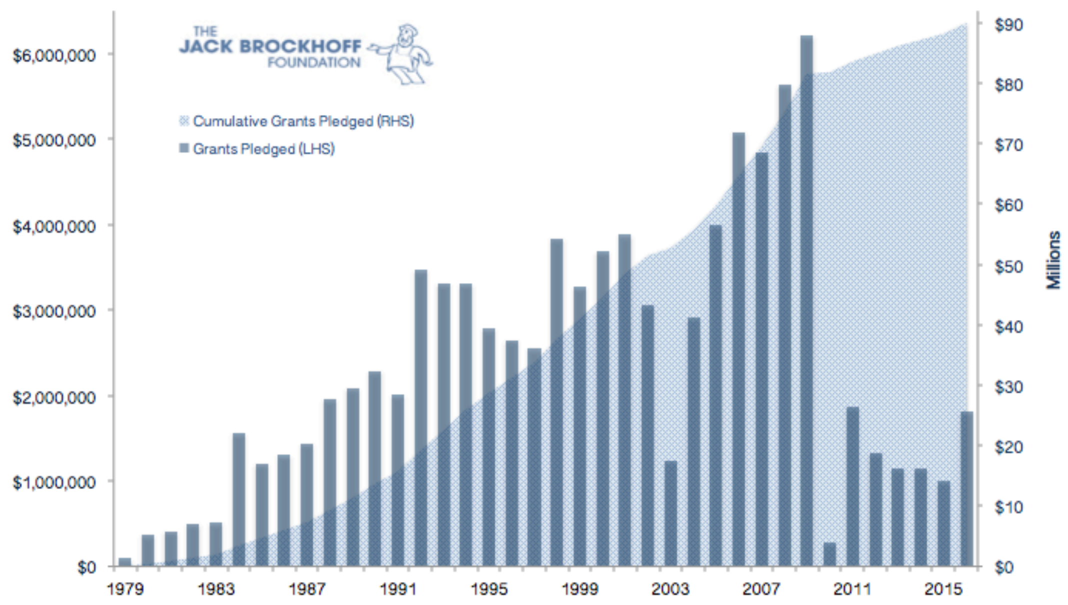
About The Jack Brockhoff Foundation

The Jack Brockhoff Foundation was established in 1979 by the late Sir Jack Brockhoff for the purpose of providing philanthropic support to organisations whose activities are designed to have a positive and enduring impact on the health and well-being of communities, with a particular focus on supporting disadvantaged and disabled people in Victoria.

From an initial endowment of $250,000 and subsequent donations and bequests of about $14 million, the portfolio has grown to be valued at more than $48 million and has distributed in excess of $90 million in grants.

The Directors are tasked with the responsibility of monitoring and maintaining an investment strategy that ensures The Foundation's grant-making activities can be sustained in perpetuity.



Executive Summary

Patchy growth, low inflation and worries of a collapse in the Chinese economy all contributed to what was a frustrating and extremely challenging year for investors, including the Foundation which starts the new year with a corpus approximately $3 million lighter than this time last year.

With the mid-term economic outlook not much better, the Directors have raised concerns as to whether maintaining the Foundation's aggressive, high-growth strategy remains appropriate.

This report has been prepared with the view to assisting the Board of Directors in evaluating The Foundation's existing strategy, placing particular emphasis on ensuring that portfolio risk is managed appropriately.

We also provide some feedback in reply to the Directors' enquiries around the expected impact from introducing an "ethical" filter to The Foundation's portfolio.

For the sake of readability, we have focused this report on our key findings and recommendations. This report, along with a more comprehensive discussion of issues, in particular, the impact of 'ethical investing' practices, is provided online (password required).

I welcome any questions or comments.

Best regards,

Joel Mitchell, CFA
F.Fin, MAppFin, GDFP
Director, Third Sector Advantage

Current Portfolio

The Jack Brockhoff Foundation's portfolio closed the year valued at approximately $47.5 million. With the exception of a small holding in cash deposit and operating accounts assets are managed by Deutsche Bank, Macquarie Private Portfolio Management, and Vanguard Investments, in accordance with the Foundation’s investment guidelines.

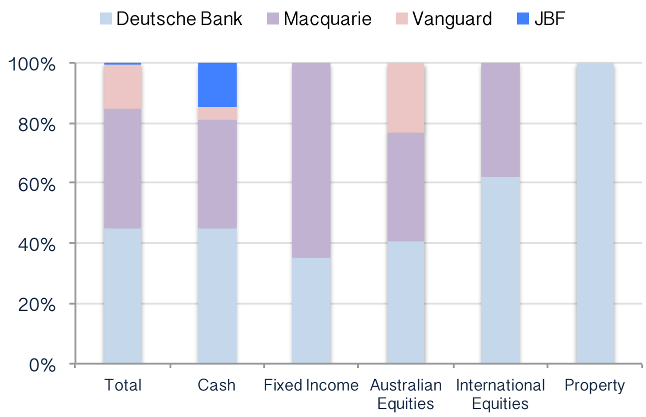
Over a challenging year for investment markets The Foundation’s corpus reduced in value by approximately $3.0 million[1] (5.84%), comprising portfolio disbursements and expenses of $2.46 million and investment losses of roughly $520,000.

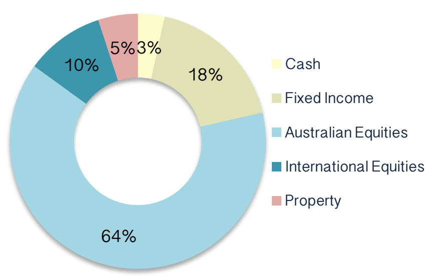
The worst performer was Vanguard Australian High Yield Fund, which was responsible for losses of more than $547,000 despite holding less than 17% of Foundation assets. Both Deutsche Bank and Macquarie also underperformed their benchmarks, although they each managed to deliver a slightly positive return.

Performance Summary

Manager	Asset-Weighted Benchmark	Benchmark*	Actual (TWR)	Relative Performance
Deutsche Bank	4.26%	4.26%	0.85%	-3.41%
Macquarie	2.59%	2.59%	1.10%	-1.49%
Vanguard	0.88%	-6.59%	-6.64%	-0.05%
Portfolio	**3.07%**	**1.97%**	**-0.16%**	**-2.13%**

Asset Allocation





[1] Accruals basis.

NB: Asset Weighted Benchmark: calculated as index/benchmark return weighted to portfolio allocation, without style bias. Note Vanguard's asset-weighted benchmark (ASX300) is 0.88%, while nominated benchmark (ASFA High Dividend Index) is -6.59%.

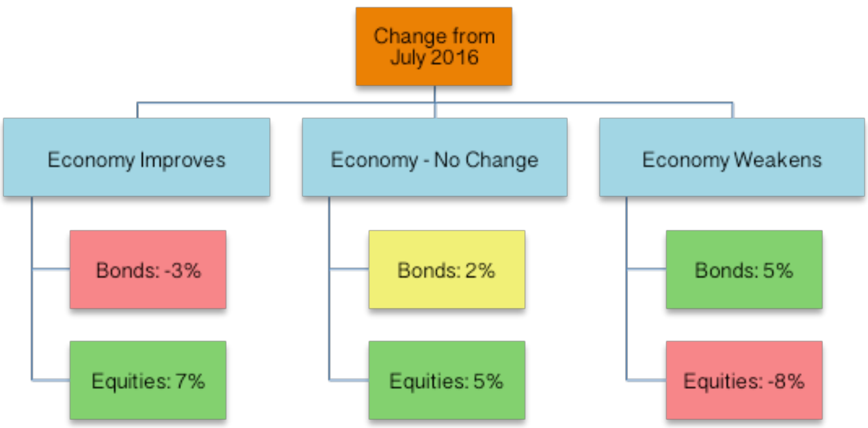
Investment Strategy Review

The Foundation has an investment return target of 5% p.a. income, plus capital growth of CPI plus 1% over rolling 5-year periods. To achieve this objective a 'high growth' strategy has been adopted, with up to 85% allocated toward growth assets and 15% of defensive and fixed-income assets. Included in this defensive exposure is cash equivalent to one year's projected distributions plus six months' operating expenses. The Foundation accepts that a negative return is likely to occur on average one in every five years.

Although these return objectives have been appropriate and achievable for The Foundation in past years, in an investment climate defined by low inflation, extremely low-interest rates and a generally dour economic outlook, the race to meet these targets may inadvertently expose the Foundation to risks it is neither prepared for nor capable of handling.

One such risk is the mismatch between the Foundation's risk tolerance and 5% income target. While a 5% target makes sense (4% distributions plus ~1% operating expenses), it can result in portfolio managers chasing yield when interest rates are low while dedicating less of the portfolio toward income-oriented assets in times of high-interest rates. The consequence is a portfolio can become heavily exposed to interest rate risk when rates are low (the riskiest time to be exposed to interest rate risk) and underweight yield-oriented assets when they present the greatest opportunity. A related concern is the portfolio's heavy exposure toward Australian banks which, though offering exceptional dividend yields, are experiencing substantial headwinds to credit/earnings growth.

We also consider asset valuations to present a significant mid-term risk. While we accept there is little real value in comparing current valuations to historic norms, as investors adapt to the "lower for longer" hypothesis, markets appear to be overlooking (or just ignoring) the full extent of economic uncertainty and risk. This is not only evident in bond markets, where today close to $12 trillion in debt is held on a negative real yield, but also in equity and property prices that reflect expectations of stable (though relatively low), uninterrupted, earnings growth. It's a situation where either bond or equity investors will be proven to be correct. There is a very, very fine crossover point at which they both win. The likelihood of economic growth and inflation hitting this sweet spot seems increasingly unlikely.



This leaves us with a situation whereby if economic conditions deteriorate further, market uncertainty and asset risk premiums should rise; or economic conditions improve, in which case equity prices may see a small improvement but bond prices are likely to crash.

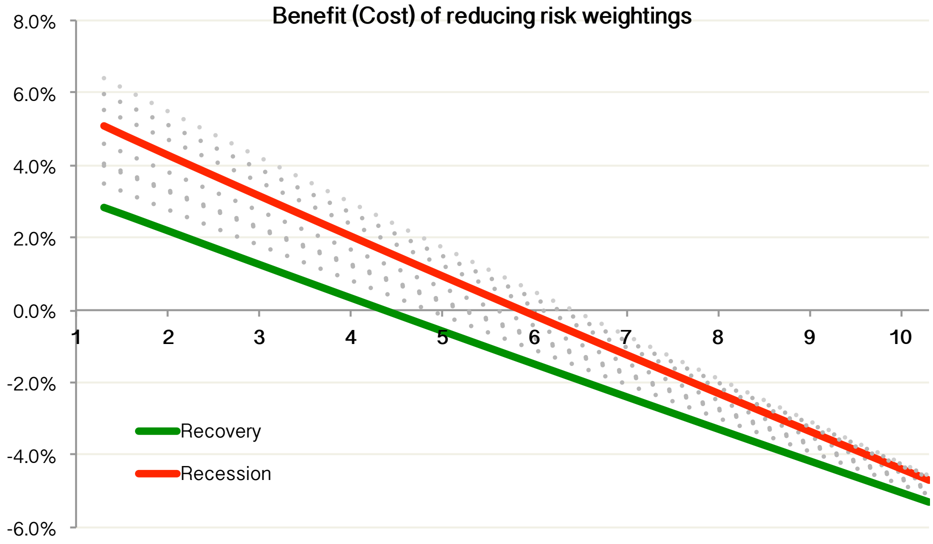
While the Foundation's investment managers are capable of managing these risks, they must be afforded sufficient flexibility (both in the mandate, targets, and timeframe) with which to design, implement and manage their investment strategy.

On consideration of the present economic and market climate, as well as The Foundation’s long-term objectives and risk tolerance, we recommend a revision of investment guidelines and a temporary reduction in exposure to risk assets.

Reducing Risk - *an example*

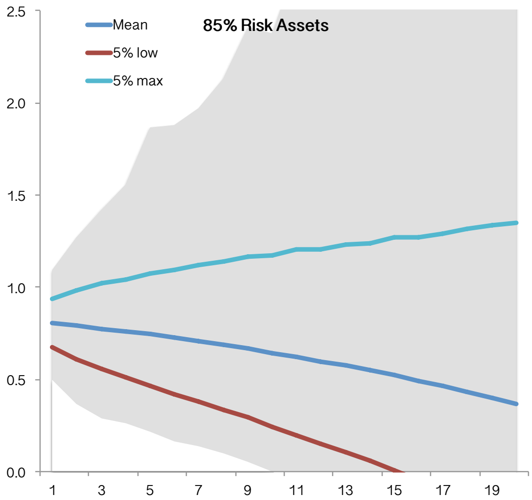
To provide an example as to how a temporary reduction in risk may assist The Foundation in meeting their long-term risk and return objectives, we offer a comparison of the Foundation's existing strategy against an alternative where risk assets are reduced by 20% (to 65% of the portfolio), and proceeds are reallocated to a diversified, low-risk short-duration portfolio of AAA Bonds and Term Deposits. At current rates, we could expect to achieve a yield of approximately 2.38% (after costs).

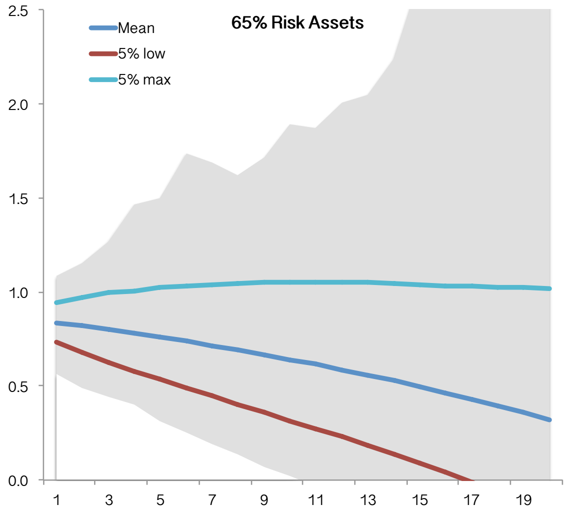
Comparing these two portfolios under a range of different scenarios allows us to see the effect on returns. As the chart below illustrates, if a change in economic conditions or risk premiums occur in the next 4 – 5 years, we would expect a superior result from the lower-risk portfolio. If we see no change over this time the existing strategy (~85% growth assets) will probably outperform.



Of course, it stands to reason that a higher allocation to risk assets will outperform a portfolio heavy in defensive, low-risk assets over the long-term (15 years+). Though these rules also apply to The Foundation's investment strategy, we must also consider that *sequencing risk* is an issue; that is to say that the timing of returns and withdrawals has an impact on the sustainability of the portfolio.

To understand the impact of cash flows we can compare the two portfolios, based on current Foundation overheads and disbursement guidelines. Over a large number of simulations[2], we see that the higher risk strategy does indeed produce a higher average (mean) result but with a wider range of results.





However it's interesting to note how similar the results are. The first point is that both portfolios see a gradual decline in the real (inflation-adjusted) value of the portfolio, indicating that if returns are in fact "lower for longer" The Foundation will struggle to maintain the real value of its corpus, let alone consistently meet a CPI+6% target. We conclude that making a temporary change to risk allocations is unlikely to have a significant impact on the value of the corpus.

In summary:

1. If returns are "lower for longer" a lower risk strategy will have minimal impact on overall returns.
2. If economic conditions strengthen, overall returns under both strategies will be better, just slightly less so with the lower-risk strategy.
3. If economic conditions deteriorate or markets become more nervous, lower risk strategy will be less adversely impacted and will have additional capital available to re-deploy at a higher rate of return.

To measure the "cost" of a lower risk strategy we need only compare the difference in outcomes under each of these scenarios. From this we see that over a five-year period, in an environment of stable pricing and moderate earnings growth, the lower-risk portfolio would be expected to underperform by approximately $2 million. Over 7 years the cost increases to around $3 million.

This cost can be compared to an insurance policy on the portfolio, with $2 million (in deprived returns) providing the Foundation with roughly $10 million (20%) of capital that can be redeployed as opportunities arise at any time within the next 5 years.

Note: Be aware that your other advisers will most likely have their own opinions and assessment of current investment conditions and their ability to achieve certain risk and return targets during this time.

[2] Monte Carlo simulation using 20,000 independent trials (parametric, normal distribution, cash flow adjusted)

Summary

In the past, the Jack Brockhoff Foundation has sought to meet its obligations and grow the corpus by pursuing a total return target of CPI+6% (comprising 5% income and capital growth of CPI+1% over rolling 5-year periods).

Though these targets have been both reasonable and achievable in past years, maintaining this return objective in the current climate of low inflation and extremely low-interest rates may inadvertently expose the Foundation to an unacceptable – and unnecessary – level of investment risk.

These risks are not only limited to systematic risk and interest rate risk but also risks due to portfolio inefficiencies caused by portfolio managers hunting for yield in an effort to meet a 5% income target.

On consideration of the Foundation's risk tolerance and return objectives and investment conditions, we recommend that a temporary adjustment be made to the Foundation's return and asset allocation targets.

Further details are provided in this report's recommendations.

Manager & Asset Allocation - 30 June 2016

Manager	Total	Cash	Fixed Income	Equities (AU)	Equities (Int.)	Property
Deutsche Bank	21,323,484	719,354	3,018,980	12,266,172	2,941,856	2,377,121
Macquarie	18,924,261	586,652	5,531,561	11,008,243	1,797,805	-
Vanguard	6,996,210	69,962	-	6,926,248	-	-
JBF	232,085	232,085	-	-	-	-
Total	47,476,040	1,608,053	8,550,541	30,200,663	4,739,661	2,377,121

Manager	Total	Cash	Fixed Income	Equities (AU)	Equities (Int.)	Property
Deutsche Bank	45%	45%	35%	41%	62%	100%
Macquarie	40%	36%	65%	36%	38%	0%
Vanguard	15%	4%	0%	23%	0%	0%
JBF	0%	14%	0%	0%	0%	0%
Total	100%	100%	100%	100%	100%	100%

Manager	Total	Cash	Fixed Income	Equities (AU)	Equities (Int.)	Property
Deutsche Bank	100%	3%	14%	58%	14%	11%
Macquarie	100%	3%	29%	58%	10%	0%
Vanguard	100%	1%	0%	99%	0%	0%
JBF	100%	100%	0%	0%	0%	0%

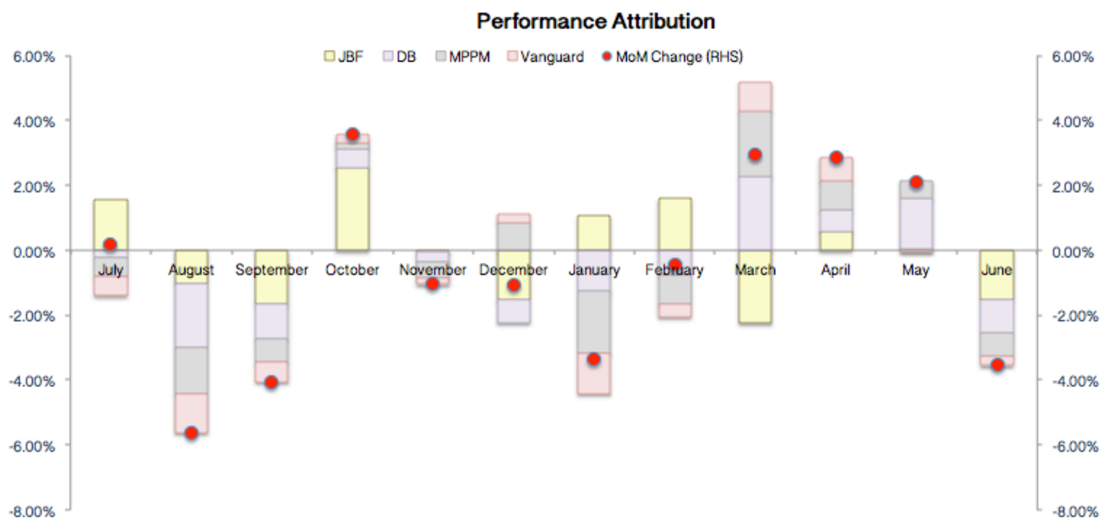
Investment Manager Review

At the close of trade on 30 June 2016, The Jack Brockhoff Foundation's portfolio was valued at $47.48 million. Adjusted for accrued interest, imputation credits, refunds and prepayments of $1.03 million, the total value of The Foundation's investment assets is valued at approximately $48.51 million. This represents a $3.0 million reduction from the Foundation's opening balance (including receivables) of $51.52 million.

In accordance with investment guidelines three investment managers are employed to invest the Foundation's assets. Deutsche Bank and Macquarie manage the bulk of these assets (~85%) using an active management style, while Vanguard (~15%) employs a passive rules-based approach.

All Fund managers underperformed their benchmarks. The most severe underperformance relative to benchmark was from Deutsche Bank (+0.85% vs. +4.26%), while the worst absolute return was from Vanguard (-6.64% vs. -6.59%)

Manager	Asset-Weighted Benchmark	Benchmark*	Actual (TWR)	Relative Performance
Deutsche Bank	4.26%	4.26%	0.85%	-3.41%
Macquarie	2.59%	2.59%	1.10%	-1.49%
Vanguard	0.88%	-6.59%	-6.64%	-0.05%
Portfolio	**3.07%**	**1.97%**	**-0.16%**	**-2.13%**



Deutsche Bank AG

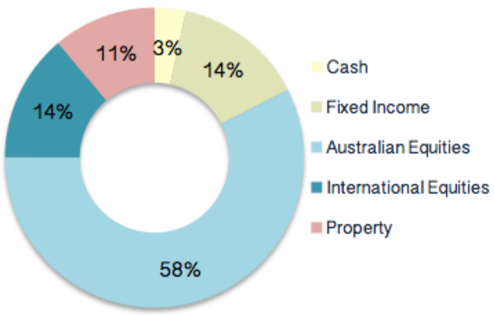
Deutsche Bank manages approximately $21.3 million of The Foundation's assets. This is equivalent to approximately 45% of Foundation assets. The account manager is Director and head of Discretionary Portfolio Management, Tim Gough.

For the financial year to 30 June 2016, Deutsche Bank's portfolio underperformed its benchmarks, achieving a time-weighted return (inclusive of all franking credits) of approximately 0.85%, as compared to an asset-weighted benchmark return of 4.26%.

This rather significant underperformance (-3.41%) appears almost entirely attributable to poor security selection, as opposed to reckless investment behavior. Though this is comforting to know, their net results are especially disappointing when we consider that their asset allocation (exposure to equities, property, fixed income etc.) decisions were actually very well formed.

Put simply, FY2016 seems to have been a year where they got the themes (strategic asset allocation) right, but tactics (security selection) wrong.

On review of their portfolio, risk management guidelines and track record over 3 and 5 years there does not appear to be any immediate cause for concern as to their competence or motivation to act in the best interest of The Foundation.



Macquarie Private Portfolio Management

Macquarie Private Portfolio Management (MPPM) manages approximately $18.9 million of The Foundation's assets. This is equivalent to approximately 40% of Foundation assets. The account manager is Senior Investment Advisor, David Mattner.

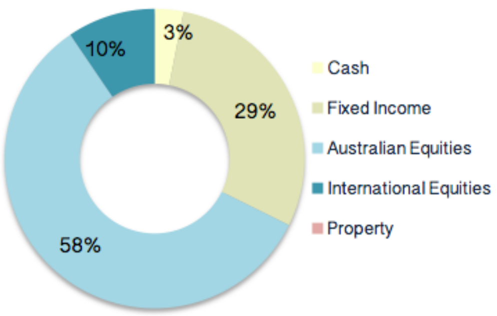
For the financial year to 30 June 2016, Macquarie's portfolio underperformed its benchmarks, achieving a time-weighted return (inclusive of all franking credits) of approximately 1.10%, as compared to an asset-weighted benchmark return of 2.59%.

Relative to benchmark, MPPM underperformed across all asset categories, though by a less dramatic margin than Deutsche Bank. MPPM employ a segmented approach to portfolio management, appointing each asset category toward a portfolio recommended by specialist asset management teams.

After adjusting for franking, MPPM's Australian and international equity portfolios underperformed by approximately 0.11% and 0.27% respectively. A more substantial underperformance was realised by the fixed income portfolio, which fell short of the benchmark by an estimated 2.6%.

On the matter of fixed income performance, we must note that the Foundation's investment strategy (with both MPPM and Deutsche Bank) is somewhat different to that of the benchmark, as both managers have incorporated hybrid issues and a somewhat more conservative tilt to their securities selection. Although this appears to have been a drag on returns over the past year, we must bear in mind that the benchmark's strong performance is more a function of a worse-than-expected economic slowdown and falling interest rate cuts. We believe both MPPM and Deutsche Bank have been prudent in their approach to fixed-income portfolio construction.

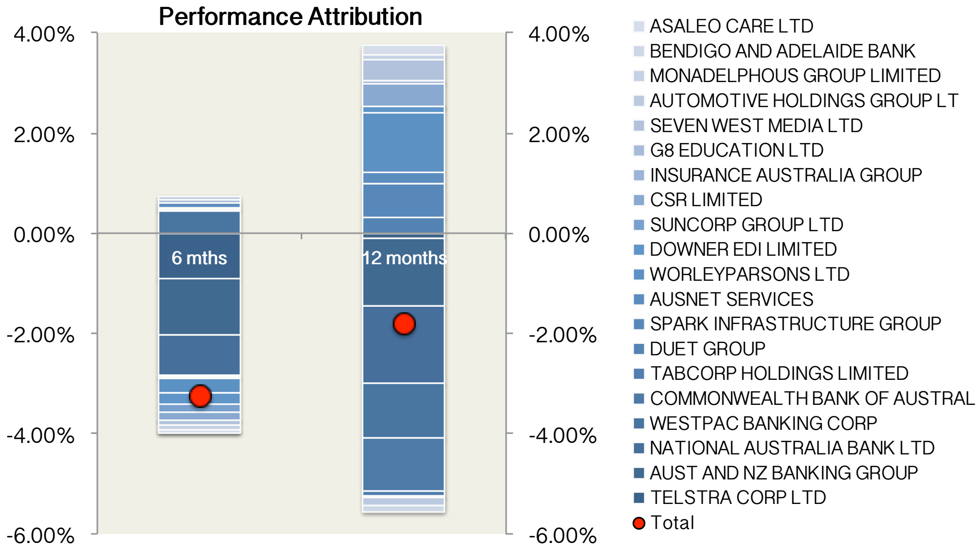
Despite Macquarie's underperformance over the past year, the underlying strategies remain consistent and on-track with their medium to long-term objectives.



Vanguard High Yield Fund

The standout non-performer over the past year has been the Vanguard High Yield Fund, which delivered a loss of 6.64% (~$547,000). In response, the Directors have, quite appropriately, sought to review the Fund's strategy and it's suitability for ongoing inclusion in The Foundation's portfolio.

To provide an answer to this question we must appreciate that the Vanguard High Yield Fund's objective is not to achieve an absolute return on capital or to avoid loss; rather it merely tries to mimic the FTSE ASFA Australian High Dividend Yield Index. As a "rules-based" benchmark that is focused only on the prospective dividend yield of Australian shares the Fund is not interested in the risk or sustainability of its constituents.



At close, 31 July 2016	Recent returns		Average Annual				
	Month	YTD	1 year	3 years	5 years	10 years	*Since Inception*
Total	6.19%	5.36%	-2.71%	4.57%	10.68%	6.05%	7.96%
Gross	6.22%	5.60%	-2.32%	4.99%	11.13%	6.48%	8.37%
Benchmark	6.23%	5.40%	-2.61%	4.75%	10.94%	6.97%	9.05%
Alpha	-0.04%	-0.04%	-0.10%	-0.18%	-0.26%	-0.92%	-1.09%

This approach offers a number of benefits, including ensuring a good level of liquidity and a reasonably well-diversified portfolio under normal conditions. However, this approach does have a number of downsides. Most obvious is that the ranking and weighting process can lead to periods of significant portfolio concentration. A related point is that as the construction methodology does not consider qualitative factors, which can over-expose the portfolio to companies forecasting abnormal, unsustainable or unattainable levels of dividends.

An example of this is the Australian banking sector, which has seen many of our largest banks dramatically increase the proportion of earnings distributed to shareholders. As credit growth continues to slow this may indeed be the best use of shareholder capital (best outcome for bank shareholders); yet whether it justifies investing in the banks – especially when retained earnings are often necessary for growth - is an entirely different matter.

Despite the Fund's relative success in tracking its benchmark, we do have our reservations as to whether it remains appropriate for The Foundation at this moment in time. Of particular concern is that as valuations between sectors diverge this strategy is prone to becoming over-exposed to particular sectors or "yield traps".

As at 30 June 2016, the portfolio had approximately 40% of the portfolio invested in four banks, plus Telstra. This is despite the fact that within the Fund's portfolio these companies offered among the lowest prospective yield.

Summary

For the 2016 Financial Year, the Foundation's investment portfolio recorded a loss of approximately $520,000 (1.02%), with disbursements and expenses producing a reduction in total assets (including receivables) of approximately $3.0 million.

All external investment advisers underperformed their benchmarks over the year. While not ideal, returns were still within range of their asset-weighted benchmarks. This should be viewed as a relatively satisfactory outcome given very challenging investment conditions.

Both Deutsche Bank and Macquarie Private Portfolio Management successfully managed portfolio risk. Vanguard, which as a passive strategy makes no attempt to manage risk, contributed most to the portfolio's overall risk and portfolio losses.

Having reviewed each manager's portfolio, investment style, and risk management controls, we see no reason to doubt Deutsche Bank and Macquarie PPM's ability to add value to the Foundation's investment strategy. We do have some reservations over Vanguard's High Yield Fund given issues of market concentration, in particular, the banking sector.

Top 25 Australian Shareholdings

Each manager's 'Top 10' is highlighted. As at 30 June 2016.

Code	Manager			Total	
	DB	Macquarie	Vanguard	Allocation %	Cumulative
CBA	12.0%	7.8%	7.0%	9.4%	9.4%
WBC	6.5%	8.3%	9.9%	7.9%	17.3%
TLS	4.4%	8.2%	9.9%	7.0%	24.3%
ANZ	6.0%	6.1%	7.1%	6.3%	30.6%
NAB	5.5%	4.2%	6.8%	5.3%	35.9%
WES	0.0%	6.3%	9.5%	4.3%	40.2%
BHP	4.8%	3.9%	0.0%	3.4%	43.6%
CSL	5.9%	2.5%	0.0%	3.4%	47.0%
WOW	2.9%	3.9%	0.0%	2.6%	49.7%
AZJ	0.0%	1.8%	8.5%	2.5%	52.2%
RIO	3.0%	2.9%	0.0%	2.3%	54.5%
AGL	2.2%	3.6%	0.0%	2.2%	56.7%
DUE	1.9%	0.0%	6.0%	2.2%	58.8%
MQG	2.2%	1.9%	2.2%	2.1%	61.0%
TAH	0.0%	3.7%	2.9%	2.0%	62.9%
BXB	2.0%	3.0%	0.0%	1.9%	64.8%
QBE	2.0%	2.8%	0.0%	1.8%	66.7%
OSH	1.9%	2.9%	0.0%	1.8%	68.5%
SUN	0.7%	3.1%	1.6%	1.8%	70.3%
AST	0.0%	3.2%	2.8%	1.8%	72.0%
AMP	0.0%	3.8%	1.5%	1.7%	73.7%
KIN.Em	3.8%	0.0%	0.0%	1.6%	75.3%
SKI	1.6%	0.0%	4.1%	1.6%	76.9%
TTS	0.0%	4.1%	0.0%	1.5%	78.4%
GMG	3.3%	0.0%	0.0%	1.4%	79.8%
Total	**72.8%**	**88.0%**	**79.8%**	**79.8%**	**79.8%**

Ethical screening: Impact on investment returns

The Board has raised the question as to whether an ethical screen can be implemented without substantial impact on the income or maintenance of capital value.

Indeed the question as to whether the ethics and behavior of companies affect shareholder returns is one that has attracted significant attention over recent decades from investors, academics, analysts and product manufacturers alike.

Of course, the starting point in evaluating the impact of ethically screened portfolios is first to define what we mean by ethical, or perhaps what more importantly what consider unethical (or otherwise earmarked for exclusion).

The Jack Brockhoff Foundation has enquired as to the potential impact of an ethical screen that specifically excludes companies whose primary businesses are in tobacco, alcohol, gaming, and armaments. Our review seeks to identify and quantify the costs associated with this type of filter, and evaluating the impact of this on The Foundation's long-term goals and objectives.

As The Foundation's focus is on the impact of excluding specific business practices we focus our attention on the body of research covering Socially Responsible Investment (SRI) practices[3]. Furthermore, we have concentrated our efforts on measuring and estimating the impact of SRI on prospective returns; we have not discussed the qualitative or ideological reasons for pursuing such a strategy, partly because this is relatively inconsequential for secondary market securities[4].

Evaluating the cost

To ensure a fair and balanced assessment of the costs or benefits of SRI we approached the question of impact on investment returns from three distinct, yet ultimately related angles:

- Review of the existing research.
- Opportunity cost.
- Administration costs.

In the interest of brevity, we limit our discussion here to only our key findings. A more comprehensive discussion on this subject along with references is provided in the appendices of this report, available online.

[3] This acronym is commonly used interchangeably with Sustainable and Responsible Investment (SRI). Be aware that the approach used in SRI differs from ESG (Environmental, Social, and Corporate Governance), which focuses less on the sector in which a company operates, and more on how the company is managed.

[4] Though shareholder advocacy has increased asset managers' influence on the behaviour of business, this concentrates more on the corporate governance and reputational aspects, not business activities. Within the context of large secondary-market securities (such as listed equities), the decision to divest from particular sectors is likely to be inconsequential to the companies in question.

Results (highlights)

- There is a direct relationship between the strictness of SRI-screening parameters and the costs incurred. The stricter the requirements the higher the cost. The ethical screen proposed by The Foundation is toward the lowest-cost end of the scale.
- Implementing a complete ethical screen (SRI) can be expected to reduce listed property and equity investment returns by between 0.10% and 0.22% per annum, over the long term. This is equivalent to a reduction in The Jack Brockhoff Foundation's gross returns of between $37,000 to $82,000 per annum.
- Both Deutsche Bank and Macquarie have indicated there will be no direct increase in fees as a result of changing the investment mandate, however, we should accept there will be an indirect cost through their managed fund holdings. We estimate this cost at $14,000 per annum.
- Between $23,000 and $68,000 per annum (0.05% - 0.14%) can be attributed to opportunity costs (reducing the number and breadth of eligible securities)
- The costs from implementing an ethical screen are highest for equity investments. Thus a reduction in risk assets would be expected to reduce the overall cost.
- While the evidence suggests that SRI reduces returns over the long run, SRI portfolios tend to exhibit lower overall volatility and outperform their market benchmark in times of market crisis.
- In periods of crisis, companies that fare the worst also tend to share the lowest SRI and ESG ratings, though this relationship is only statistically significant on an ex-post basis. SRI rankings appear to be of no use in predicting future performance.
- We note that outperformance in times of crisis is likely a side effect of SRI portfolios carrying less market exposure than normal equity portfolios (i.e., a beta of less than 1.0; research suggests an average of around 0.8). It's important to note that this paints a somewhat distorted view of returns: on a risk-adjusted basis SRI strategies tend to return about the same as unconstrained equity mandates, yet this comparison only takes into account portfolio volatility and not real capital risk or alternative use of cash.
- While the evidence suggests that SRI strategies underperform in the long run, there is insufficient evidence to suggest that "unethical" industries offer higher returns to investors. This leads us to believe that SRI underperformance is a second order effect; a consequence of investment constraints, additional compliance and management fees and reduced portfolio efficiency.
- SRI mandates necessitate ongoing monitoring and management. The Foundation must be careful to define what assets are and are not eligible for investment, and must put measures in place to ensure compliance with these directives.

Conclusion

Our research suggests that implementing an ethical screen to The Jack Brockhoff Foundation's portfolio can be expected to reduce prospective returns by between $37,000 and $82,000 per annum (0.08% - 0.17%).

While the overall cost of implementing the suggested ethical screen is low in proportion to The Foundation's long-term return objectives it is prudent to consider the cost of this decision against the potential benefit that may be achieved from investing with an unconstrained mandate.

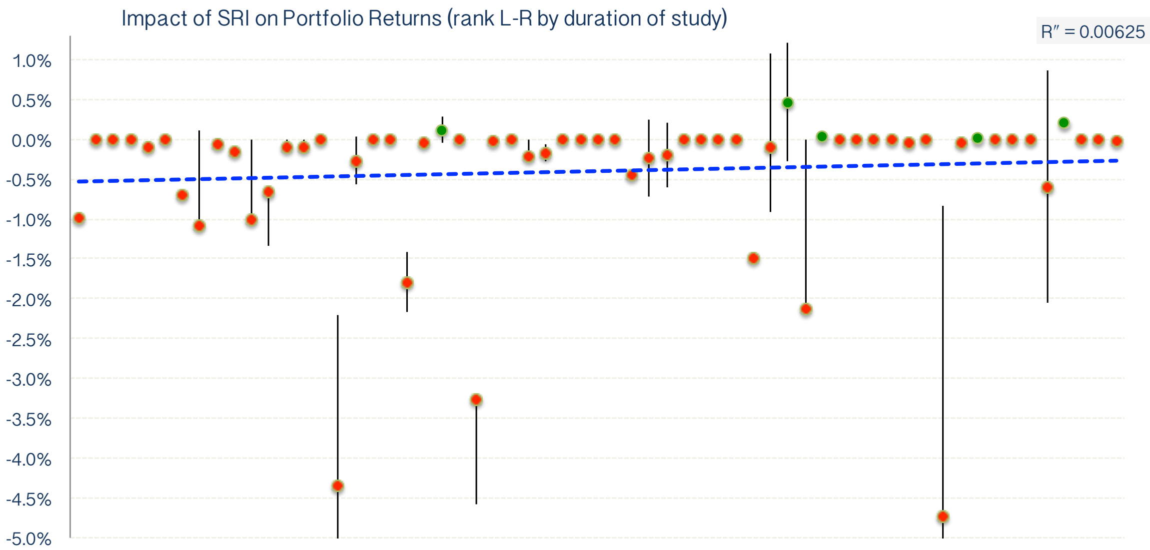
In other words: is more "good" achieved by increasing Foundation disbursements or by avoiding particular sectors.

The Board must also consider the practical and administrative implications. Placing exclusions on assets based upon their behaviour invariably increases the likelihood of a breach occurring, particularly if sections of the portfolio are managed via external unit trusts or internally by The Foundation's staff.

In conclusion, we find that while implementing an ethical screen does come at a cost it is unlikely to have a substantial impact on The Foundation's investment income or ability to preserve the inflation-adjusted value of the corpus. It does, however, present a number of administrative challenges and responsibilities that will require ongoing monitoring and management.

Region	Number of studies	Years covered		Results *(vs. Benchmark)*		
		From	To	High	Low	Average
Australia	5	1986	2008	0.20%	-2.17%	-0.72%
US	22	1963	2006	1.08%	*-1.33%**	-0.46%
UK	8	1984	2010	1.21%	-0.71%	0.02%
Europe (ex UK)	21	1980	2010	0.87%	-4.58%	-0.52%
Canada	2	1990	2003	0.00%	-0.21%	-0.11%
World	3	1991	2009	0.00%	-6.50%	-1.45%

*Adjusted for outliers



Recommendations

An effective investment strategy is vital to ensuring The Jack Brockhoff Foundation can continue its good work in providing support and funding to organisations that benefit the community. Our recommendations are designed to ensure this objective can be sustained in perpetuity, with the highest degree of certainty possible given difficult investment conditions.

Summary of Recommendations

1. Risk and Return Targets:
    a. Reduce exposure to risk assets
    b. Adjust return targets
2. Withdraw from Vanguard Australian High Yield Fund
3. Board to consider costs/benefit of Ethical Screening

Recommendation 1: Risk and Return Targets

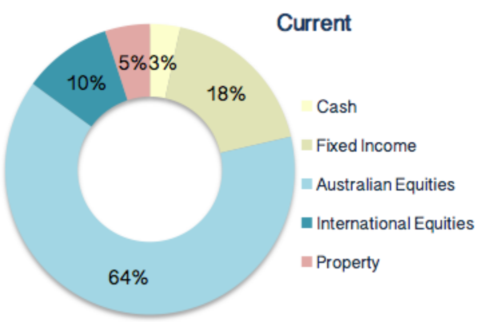
The Foundation's investment strategy specifies a target asset allocation of 85% growth assets (currently 79%) and 15% in fixed income and cash. The investment guidelines also set an income target of 5% per annum and capital growth of CPI+1%.

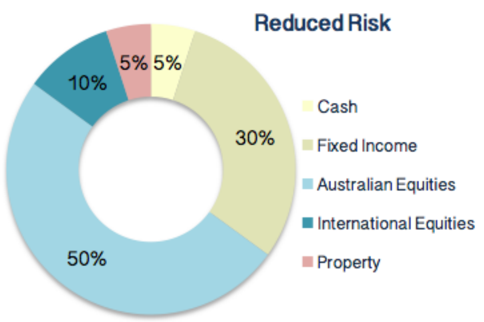
On an assessment of the current investment climate, including the continued decline in cash and fixed income yields, we believe the Foundation's investment targets command a level of risk which could result in permanent, if not irreparable damage to the corpus.

Recommendation 1a:
For this reason, it is recommended that the Foundation consider reducing making a temporary adjustment to investment allocations, reducing exposure to growth assets from 85% to 65%.

This reduction in growth assets will be balanced by a 20% increase in defensive assets. We must accept that this reallocation will (or at least should be expected to) result in a material reduction of portfolio earnings. While we don't want to forfeit returns unnecessarily, the primary focus of this rebalance must be capital preservation[5].

In an effort to best address the issues around portfolio risk we would suggest this 20% reduction come from Australian equities. The cost of this risk reduction is estimated at $2 million in lost earnings over five years. Beyond the benefits in reducing portfolio volatility, this can be expected to provide a net financial benefit in the event that during this time the local share market sustains a fall of 16%. We believe that a market adjustment will be more substantial (and quite likely sooner) than this, hence we believe the cost (i.e., lower earnings) justify lowering the Foundation's exposure to risk assets. This reduced risk allocation should be reviewed every 12 -18 months.





[5] This is important to keep in mind. With global interest rates trawling record lows, fixed income Funds are struggling to find returns. Many have responded by reducing portfolio credit quality, increasing duration and focusing on headline yields. This gives the appearance of better returns in the short term, but a significant risk if the global economic outlook improves. Accordingly, high-quality short and medium term bonds and deposits will be more appropriate than some of the superficially attractive issues, such as those currently being offered by "third-tier" lenders/financiers.

We should also note that changing the asset allocation targets would cause a mismatch with the Foundation's return objectives. By allocation a higher proportion of a portfolio to assets yielding a relatively low (<2.6%) return the guideline income target of 5% will become further out of reach. Attempting to meet this target through the portfolio's growth assets would corner investment managers into chasing yield at the expense of maximising total return and risk of permanent loss of capital.

Recommendation 1b:
Therefore it is recommended that the Foundation make two changes to investment guidelines:

1. **Income Target:** *It is recommended the income target be set with reference to the official cash rate (example: RBA cash rate + 2%).*
2. **Total Return Target:** *The Foundation should focus on total returns relative to CPI. The Foundation's existing target is equivalent to CPI+6% over rolling 5-year periods. This remains appropriate, albeit at the higher range of market expectations over the mid-term given tolerance for negative returns no more than one-in-five years.*

This will improve the flexibility with which investment managers can pursue The Foundation's long-term return objectives, reduces the risk of channeling investment managers toward potential yield traps.

A short summary of a selection fixed income products and associated risk profiles are provided in the appendices.

Recommendation 2: Vanguard Australian High Yield Fund

Although Vanguard's Australian High Yield Fund has done consistently well in tracking its benchmark, we do have concerns as to whether the strategy is appropriate given the Foundation's discomfort with risk and the present outlook for the Australian economy.

Of particular concern is the Fund's investment methodology, which ranks securities on the basis of prospective yield, without regard to dividend stability or company quality. If weakness in Australia's economy persists we could see earnings growth reduce sharply and dividends reduced across sectors with either high levels of debt or capital adequacy requirements (such as banks' CET1).

Bear in mind too that markets tend to react quickly and favorably to increases in dividends, and equally quickly but negatively when dividends are cut. Vanguard's strategy – which is only rebalanced quarterly and on the basis of *prospective* dividends - is by design more prone to the negative impacts from of dividend announcements.

While an economic downturn is by no means assured, history has shown that mandates with the flexibility and agility to respond to market crises tend to outperform (both protecting and redeploying capital).

Recommendation 2:
For this reason, it is recommended that The Foundation withdraws from Vanguard's Australian High Yield Fund.

Note: We have not provided advice on where to redeploy this capital, though we do point out that the investment guidelines recommend using a minimum of three investment managers.

Recommendation 3: Ethical Screening of Investments

Having reviewed the research, performed an attribution analysis of the Australian share market and analysed the Foundation's investment portfolio we conclude that the direct impact from implementing an ethical screen in the manner proposed by the Foundation is between 0.08% and 0.17% per annum (roughly $37,000 to $82,000 per annum).

Though this cost is fairly minimal in comparison to the size of the portfolio and return objectives, we must acknowledge that formal implementation of an ethical screening process may cause compliance issues, especially if the definition of what does or does not constitute an 'ethical' investment leaves room for interpretation.

What's more, these costs also bring forward the important question as to whether a loss of prospective returns achieves greater benefit[6] (i.e., more "good") than would otherwise be created were these additional returns contributed toward disbursements.

Of course deciding whether the Foundation should or should not pursue an ethical mandate is not for us to say. We can confidently assert that there will be a cost and potential compliance risks, but as the motive behind 'ethical investing' is not to increase returns the Board must decide whether the qualitative and ideological benefits justify the expense.

Note: I will comment that should the Foundation wish to pursue an ethical strategy, the investment guidelines should be worded very carefully (perhaps stating a *preference* to avoid particular industries). This will reduce inadvertent breaches of the guidelines.

[6] Keeping in mind that the secondary market neither adds nor removes capital from the firm. In fact, it can be argued that shareholders have greater influence voting rights.

Closing Remarks

In conducting this review of The Jack Brockhoff Foundation's investment strategy we identified a number of issues, which unchecked could result in the portfolio's managers from taking on excess risk or becoming too concentrated toward particular sectors.

We, of course, appreciate that the past year has been extremely difficult for investors and advisers alike, particularly for risk-averse asset allocators who (quite sensibly) tended to hold shorter duration bond portfolios and lower exposure to equities and property. It's the nature of markets to surprise, and on that basis FY2016 certainly didn't disappoint.

Looking forward we face a similar problem to last year, except we have now further advanced down the path of lower interest rates and tighter equity risk premiums. Almost all assets now look expensive, and the small pockets of opportunity uncovered over the past year have either been exhausted or are no more attractive than roulette. On the balance of probability, it's probably not going to end well.

This brings us to the central question as to whether the Foundation's existing investment strategy remains appropriate.

As we discussed throughout this report we find a number of instances where the current approach to asset allocation and income focus could, in fact, be detrimental to long-term returns and, inevitably, to the ability of the Foundation to meet its objectives in perpetuity.

Our recommendations provide a summation of our views on these key issues and suggestion of how to manage these risks.

Please bear in mind that for ease of reading we have refrained from getting writing too much about the details of our methodology, assumptions, and research, however, I am more than happy to answer questions or elaborate on any matter discussed in this document.

Feel free to contact me on 0406 695 257 or joel@insightws.com.au

Best regards,

Joel Mitchell, CFA
F.Fin, MAppFin, GDFP
Director, Third Sector Advantage

Phone: 0406 695 257

Appendices & Further Reading

Ethical Investing: Costs and Benefits

The Research

To better understand the likely impact of adopting an ethical screening process we undertook a review of the already significant body of research on the subject.

Across more than 60 peer-reviewed studies covering 47 years and 3,000 SRI-screened Funds, we found that applying an ethical filter to portfolio selection processes created an average drag on returns of approximately 0.37%.

This includes close to 40% of reports that found no material difference in returns; excluding these reports the average cost was 0.79% per annum. We also found evidence of a significant negative skew, though portfolio volatility tended to be lower. This gives the impression that SRI strategies perform roughly the same as unconstrained strategies on a simple risk-adjusted basis.

Region	Number of studies	Years covered		Results *(vs. Benchmark)*		
		From	To	High	Low	Average
Australia	5	1986	2008	0.20%	-2.17%	-0.72%
US	22	1963	2006	1.08%	*-1.33%**	-0.46%
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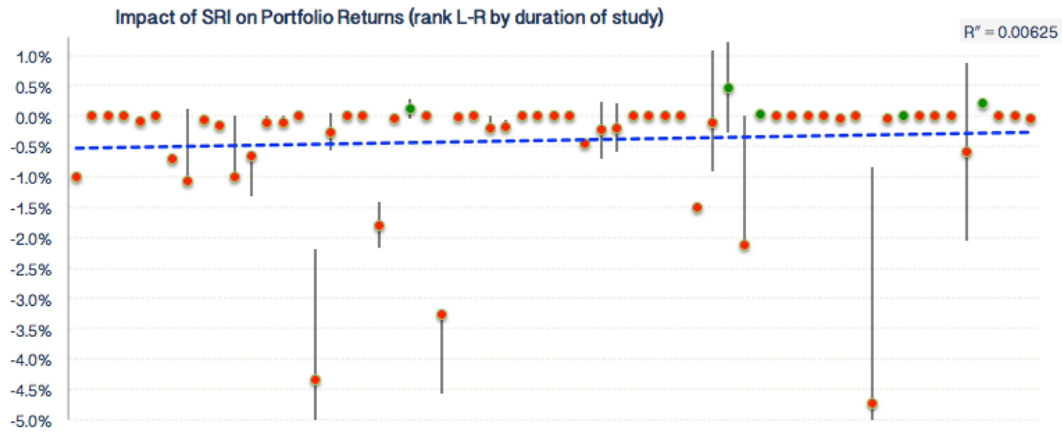


As to be expected from such a broad review, we found many conflicting results and different methodologies, especially from academic research that focused on smaller samples and shorter periods of time. Of research that found SRI *enhanced* returns, the empirical data used for each review took in an average of 26% fewer Funds and 46% shorter time period were analysed. This is not surprising as we found SRI strategies tended to be characterized by long periods of underperformance, followed by short bursts of outperformance in times of market crisis.

On a related note, we also observed that the relatively few research papers that found SRI enhanced return tend to be cited much more often than the papers showing a link between SRI and reduced returns.

This is, of course, to be expected given that many of the authors and firms citing or reproducing this data are themselves in the business of manufacturing or marketing "ethical" investment products. This point only warrants attention to help illustrate that the facts, as they are presented to the casual observer, are likely to be manipulated to some extent by the author. For a truly fair and unbiased review, we need to treat all data with a healthy dose of skepticism.

Despite a conspicuous lack of consensus in defining what is (and isn't) an 'ethical' investment, we did nevertheless extract a number of key findings of the way in which ethical screening processes affect returns:

- The strictness of the SRI-screening process and parameters has a direct bearing on the costs incurred; the stricter the requirements the higher the cost.
- SRI portfolios slightly outperform the market benchmark in times of market crisis, however, we should point out that this is characteristic of actively managed strategies, more generally.
- Despite reducing the number of assets available for investment, over the long run SRI portfolios tend to exhibit lower overall volatility with slight negative skew.
- The risk-adjusted return of SRI portfolios is approximately the same as normal, unconstrained portfolios. This does not consider correlation with other strategies.
- There is evidence to suggest that companies with the poorest governance practices (ESG) perform the worst in all market conditions.

A final point worth mentioning is that back-testing data on the basis of SRI – particular where SRI incorporates ESG considerations - is fraught with inaccuracies. One of the problems here is that significant events such as negative company announcements or environmental breaches can often only be identified *after* they occur. When they do we often see a fall in shareholder's confidence in management (plus the expectation of fines, delayed production etc.) reflected in share prices. For investors and analysts comparing performance, there are practical limitations to categorizing companies based upon their corporate behavior and operations for each moment in time.

In addition, we note that much of the research employs a theoretical attribution analysis, comparing the relative performance of a market portfolio with- and without-SRI-excluded sectors. Given that commercial applications of SRI are still relatively new this certainly appears to be a more robust method for considering the impact of SRI on return characteristics. We do, however, note that fees and taxes are not considered. With SRI more likely to trigger portfolio rebalances, plus the additional costs associated with monitoring and managing this strategy, it is likely that the true difference in return is slightly greater than indicated by the research.

In summary, we find the evidence supports the view that Socially Responsible Investing (SRI) weighs on investment returns, though tends to outperform in times of market.

Applying these findings to The Jack Brockhoff Foundation's portfolio, we estimate that adopting an ethical screen through SRI specialist managers could reduce gross returns by as much as $268,000 per annum.

As both Deutsche Bank and Macquarie Private Portfolio Management have indicated there would be no additional cost to the Foundation, the costs would likely be much lower at around $82,000 per annum.

Opportunity Costs

A key tenet of investment is that limiting the breadth of investment opportunities invariably restricts an investor's ability to achieve optimal returns. While this somewhat oversimplified[7], we are able to say with confidence that limiting the number of potential investment opportunities cannot, in and of itself, enhance returns.

Previously we have reviewed the empirical research on ethical filters and noted that several reports point to SRI enhancing returns while reducing risk, and many others that suggest no material difference in return. While these results somewhat contradict Modern Portfolio Theory, to err on the side of caution and to keep an open mind we give equal attention (and skepticism) to all studies.

What we found interesting was that many of the reports that found some benefit, or at least no disadvantage, included at least one market crisis. This may not seem significant at first, but we consider the performance of sectors is inextricably linked to the broader economic environment it stands to reason that highly cyclical, discretionary products and services are first to be cut in times of crisis. For example, in the recent Global Financial Crisis tobacco and gaming shares were hit particularly hard. We also see moments of crisis less directly linked to the consumer, such as the recent oil glut/price crash, which wiped *trillions* off the value of oil company shares.

It's these infrequent bouts of devastation that provide SRI strategies with a chance to shine. Left holding higher allocation to slow and stable mature businesses (like grocery stores, agriculture, toll roads), their assets tend to also have “stickier” revenue streams thus making them more resilient and more attractive for investors spooked by plunging share prices.

For a more rounded view of SRI strategies, we must try to determine what level of return is attributable simply to the period of time being studied, and how much is actually due to the SRI screening methods.

To do this it helps if we start by looking at the companies excluded by SRI screening. We can then measure their performance and market-weight to determine their influence on the overall result. Having performed this exercise against some of the largest tobacco, gaming and oil companies in the S&P500 (United States) we find many examples of abnormally higher returns from companies that would normally be banned from SRI portfolios.

Tobacco, for example, has a volatile yet remarkably strong record over recent decades, delivering shareholders an annualized return roughly twice that of the broader share market (to put this in perspective, $1 million invested 20 years ago in the S&P500 would now be valued at around $3.7 million. The same $1 million invested in British American Tobacco would be valued

[7] In practice this does not always hold true. For example, the costs associated with analyzing every investment may eclipse the additional return available from such an exercise.

at approximately $10.5 million). Similar, less spectacular examples of outperformance can also be observed with defence contractors, gaming venues (casinos etc.) and alcohol manufacturers and distributors.

Though this disparity in returns suggests that companies excluded by SRI criteria outperform, we find, somewhat surprisingly, that the evidence to support the idea that non-SRI companies outperform is very weak. Of the few investment managers that do specifically and purposefully target companies excluded by common SRI guidelines, we find that performance after fees is very similar to that of the broader market, with slightly higher levels of volatility.

This brings us to the conclusion that the true cost of “ethical investing” is not simply a result of “ethical” companies generating a lower return for shareholders than “unethical” companies. Rather the cost arises indirectly as a consequence from missed opportunities, the full impact of which requires consideration of the number of investment opportunities excluded by any particular filter, as well as the investment manager's skill in working with these constraints while allocating capital in the most efficient manner possible.

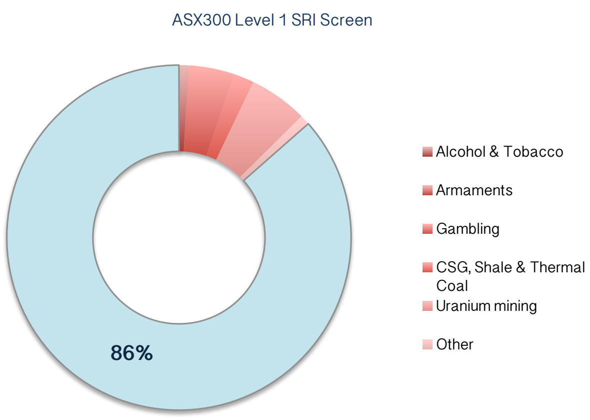
Filters and missed opportunities: ASX 300

To get some feel as to how this affects prospective returns in a real-world environment it helps to see how an ethical filter actually affects the breadth of investment opportunities available to us.

Given The Foundation's bias toward Australian equities and the relatively small and concentrated nature of our market, we decided to take a closer look at the 300 largest companies on the Australian share market and consider how our investment opportunities might be restricted by an ethical screen.

<u>**Level 1 SRI Screen**</u>

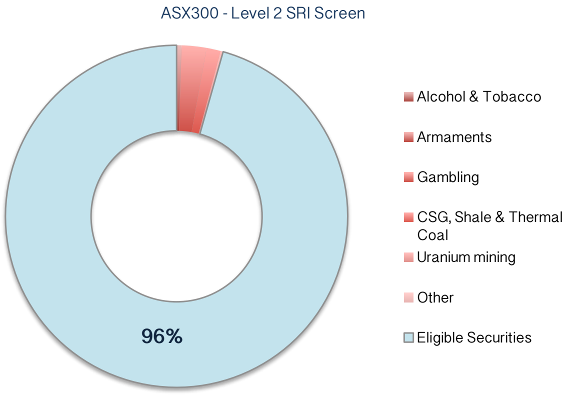
We found that by applying a standard “full” SRI screen[8] only excluded about $219 billion (~14%) of the market. Three of these companies (BHP, RIO, and Woolworths) account for nearly $116 billion of this.



[8] Excluded if more than 5% of revenues directly involved in Alcohol & Tobacco, Armaments, Gambling/Gaming, Uranium Mining, Human Rights, CSG, Shale & Thermal Coal, Exploitative Lending Practices.

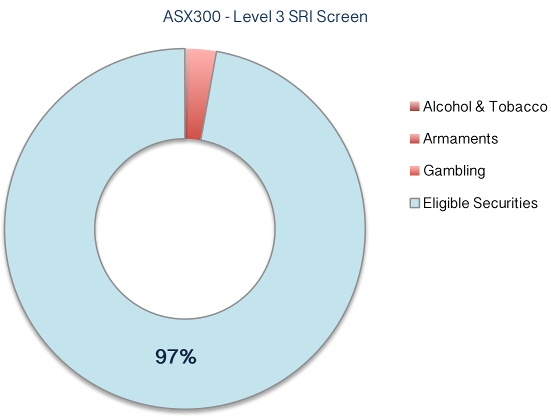
Level 2 SRI Screen

Loosening up the filter a little, we then sorted through companies on the basis of their primary business interests and activities[9]. This reduced the number of excluded companies down to $71 billion (less than 5% of ASX300).



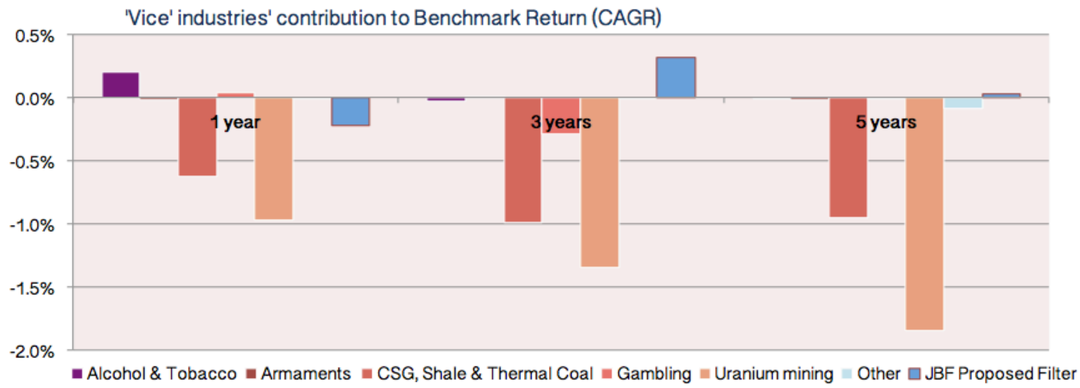
Level 3 SRI Screen

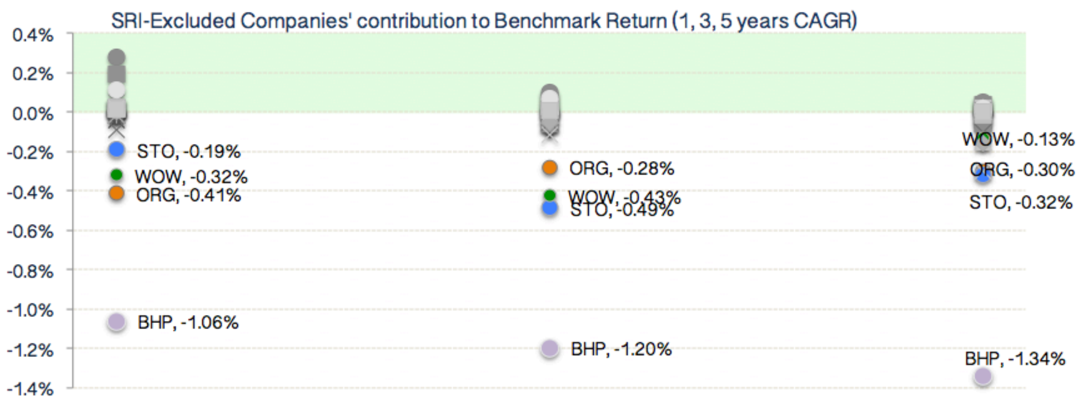
Finally, we then concentrated our filter to only exclude companies that derive the majority of their income from alcohol, tobacco, armaments and gambling. This resulted in $46 billion of excluded securities (less than 3% of the ASX300).



Performance

Upon comparing the relative performance of each of these hypothetical portfolios we find that SRI strategies that avoided the heavy losses of the past 8 years sustained by the energy sector outperformed over one, three and five years (to 28 July 2016). Most of the losses were attributable to four companies: BHP, Santos, Origin Energy and Woolworths.





[9] More than 50% gross revenues.

Administration: implementation, management, compliance

In conducting this review we felt if prudent to bring attention some of the practical aspects involved with mandates that involve restrictions or special considerations.

Ensuring compliance with investment allocation objectives and restrictions is paramount. In the case of ethically screened investment portfolios, this can present challenges, particularly as many large businesses operate multiple lines of business across different jurisdictions.

To manage these potential conflicts many investment managers have dedicated ESG teams or advisers, or rely on external research from organizations such as CAER, Sustainalytics etc.

Naturally, this comes at a cost. For markets in which the Portfolio Manager is selecting individual securities, their reaction time may slow. For markets in which they use external managers (unit trusts etc.), indirect management costs will likely increase as SRI-specialist managers are employed.

There is also the question as to who takes responsibility for The Foundation's overall compliance with their investment strategy, particularly when a portion of assets are managed in-house, by an external (non-SRI) unit trust, or via a passively managed strategy.

Following discussions with Macquarie PPM and Deutsche Bank, the explicit costs of implementing an ethical screen appear to be minimal, though we should expect – and indeed accept - that indirect costs will increase.

Against The Foundation's current portfolio we would expect overall administration and management costs to increase by approximately $14,000 per annum.

Fixed Income Returns

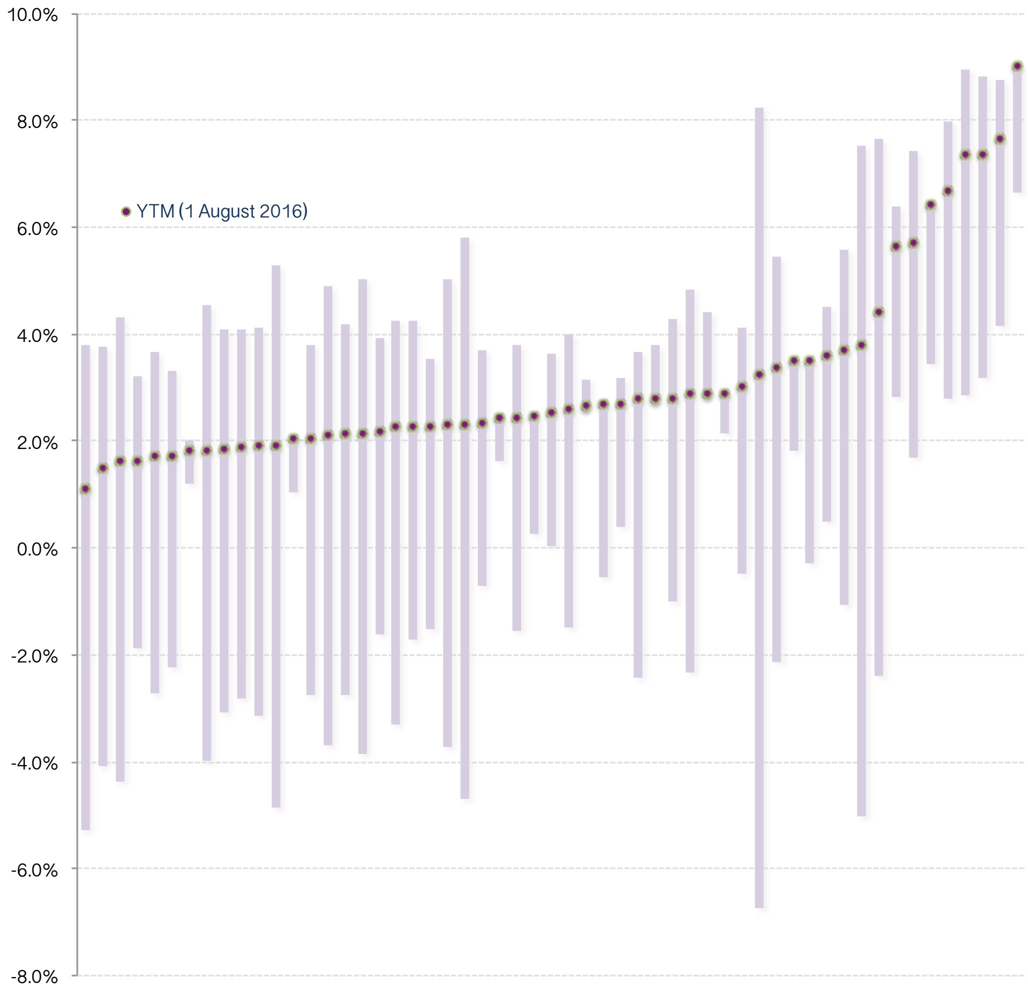
A selection of fixed income funds and corporate bonds:

Ranked by YTM

1. Yield to Maturity
2. Return under weaker economy (credit quality based default and 0.5% interest rate cut)
3. Return under weaker economy (0.5% interest rate rise)

Portfolios are ranked based on current Yield to Maturity. A general observation is that markets appear to be pricing in further deterioration in the local economy. Yields on government issued bonds (state and Federal) are being squeezed to record lows while the same effect is not flowing through to corporate bonds (the exception being the banks and some large foreign issues like AAPL).

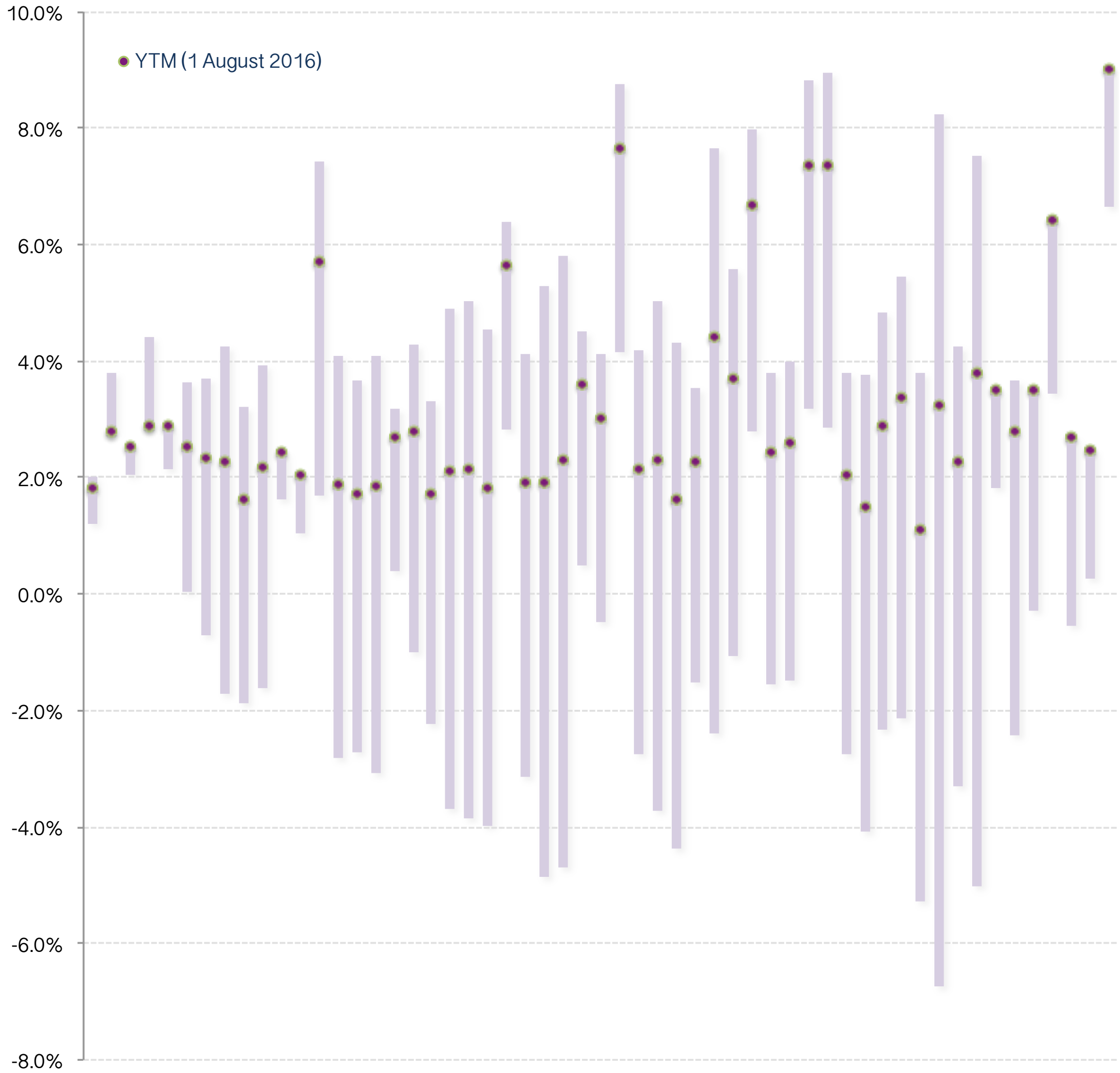
Considering the balance sheets of many of the companies issuing debt it does seem that default risk is somewhat overstated. In saying that, once we get above a YTM of around 4% we see a moderate acceleration in risk. To minimise the capital at risk (default-less-recovery risk) investors would be well served by focusing on issuers' balance sheets, as well as free cash flow to equity and interest coverage margins.



Ranked by Risk

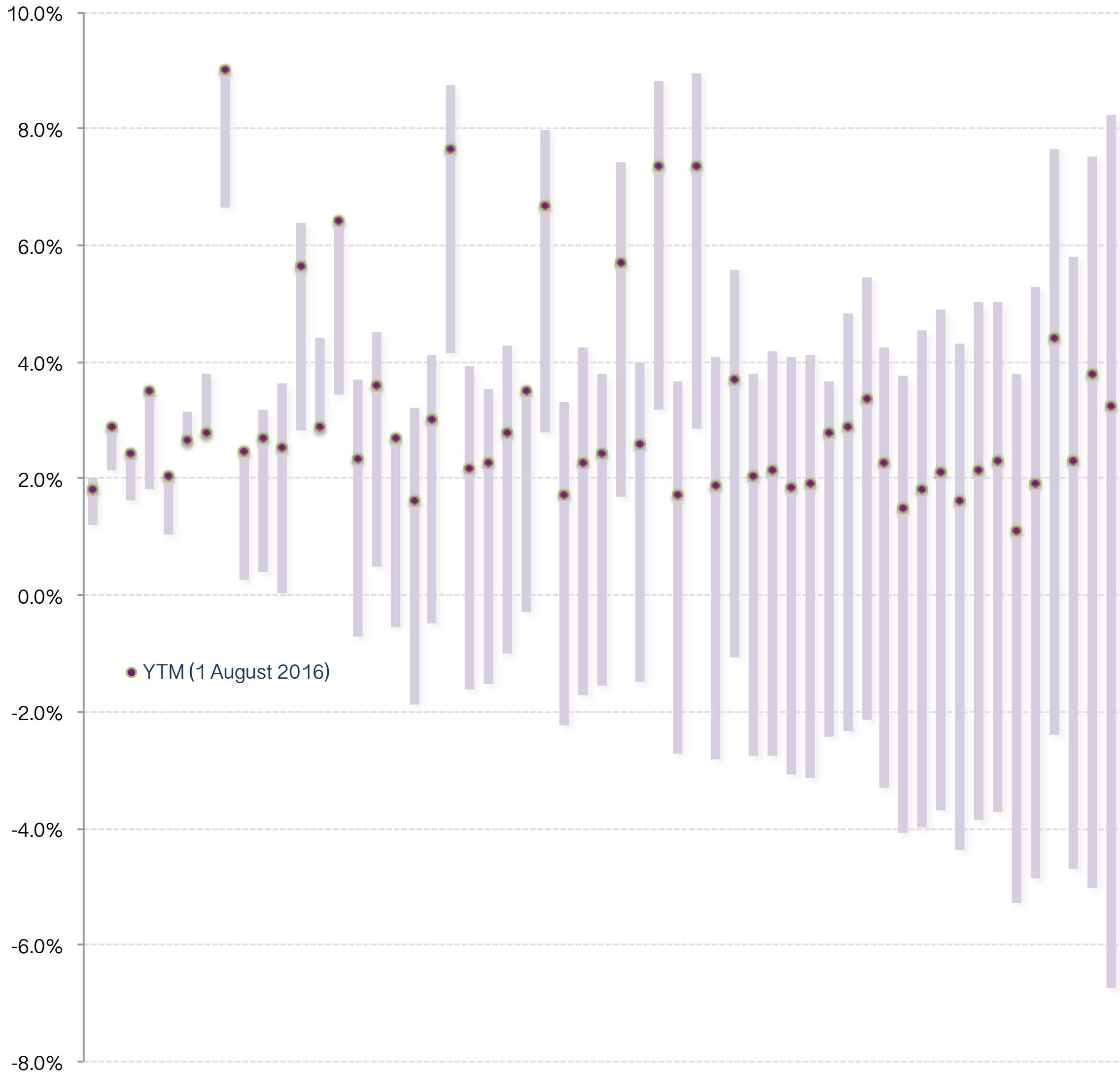
1. Yield to Maturity
2. Return under weaker economy (credit quality based default and 0.5% interest rate cut)
3. Return under weaker economy (0.5% interest rate rise)

Portfolios are ranked based on underlying risk (left = low risk, right = high risk). This includes credit risk, interest rate risk and manager risk (where applicable).

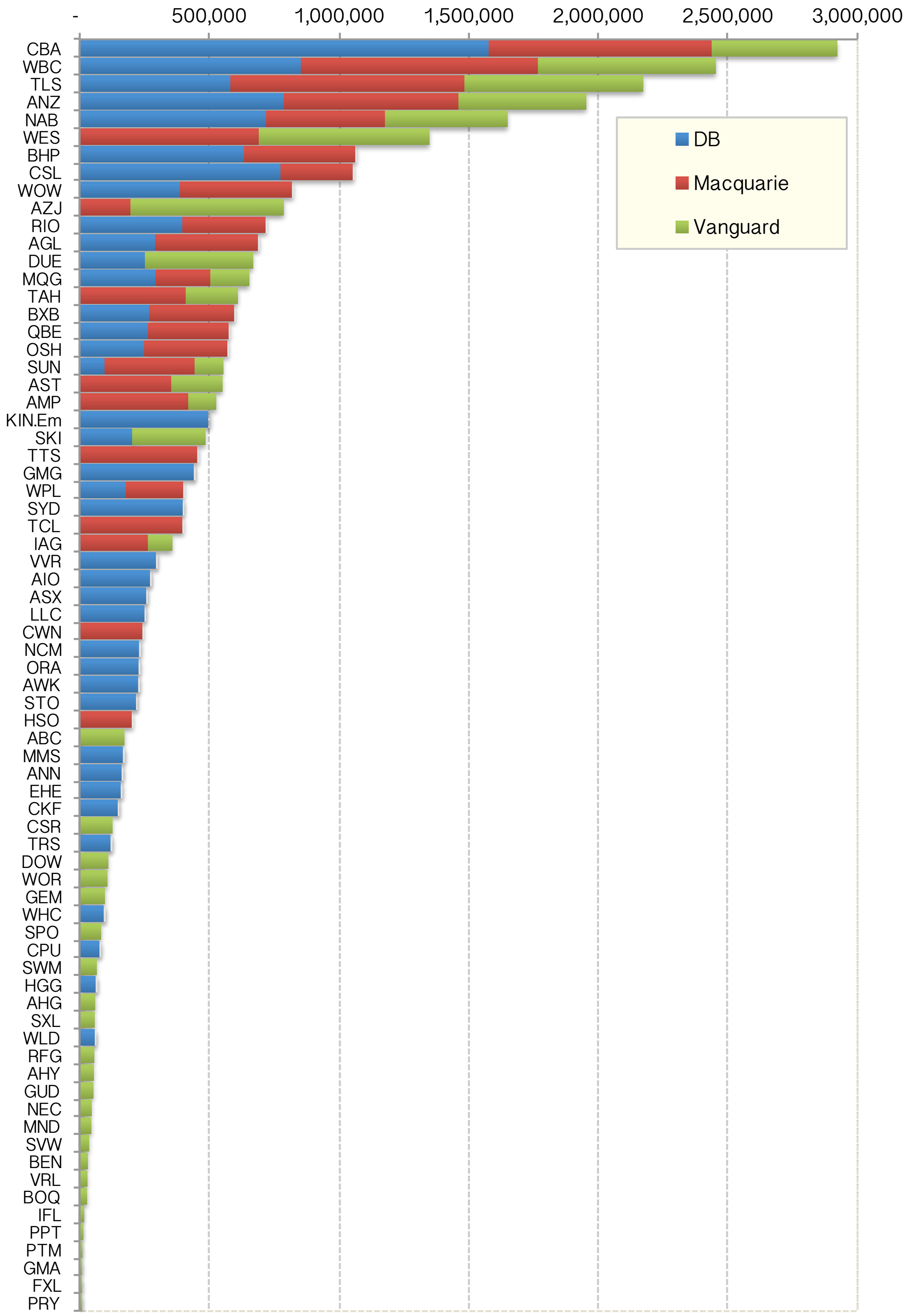


Ranked by Duration

1. Yield to Maturity
2. Return under weaker economy (credit quality based default and 0.5% interest rate cut)
3. Return under weaker economy (0.5% interest rate rise)



Australian Shareholdings



Code	Manager			Total	
	DB	Macquarie	Vanguard	Allocation %	Cumulative
CBA	12.0%	7.8%	7.0%	9.4%	9.4%
WBC	6.5%	8.3%	9.9%	7.9%	17.3%
TLS	4.4%	8.2%	9.9%	7.0%	24.3%
ANZ	6.0%	6.1%	7.1%	6.3%	30.6%
NAB	5.5%	4.2%	6.8%	5.3%	35.9%
WES	0.0%	6.3%	9.5%	4.3%	40.2%
BHP	4.8%	3.9%	0.0%	3.4%	43.6%
CSL	5.9%	2.5%	0.0%	3.4%	47.0%
WOW	2.9%	3.9%	0.0%	2.6%	49.7%
AZJ	0.0%	1.8%	8.5%	2.5%	52.2%
RIO	3.0%	2.9%	0.0%	2.3%	54.5%
AGL	2.2%	3.6%	0.0%	2.2%	56.7%
DUE	1.9%	0.0%	6.0%	2.2%	58.8%
MQG	2.2%	1.9%	2.2%	2.1%	61.0%
TAH	0.0%	3.7%	2.9%	2.0%	62.9%
BXB	2.0%	3.0%	0.0%	1.9%	64.8%
QBE	2.0%	2.8%	0.0%	1.8%	66.7%
OSH	1.9%	2.9%	0.0%	1.8%	68.5%
SUN	0.7%	3.1%	1.6%	1.8%	70.3%
AST	0.0%	3.2%	2.8%	1.8%	72.0%
AMP	0.0%	3.8%	1.5%	1.7%	73.7%
KIN.Em	3.8%	0.0%	0.0%	1.6%	75.3%
SKI	1.6%	0.0%	4.1%	1.6%	76.9%
TTS	0.0%	4.1%	0.0%	1.5%	78.4%
GMG	3.3%	0.0%	0.0%	1.4%	79.8%
WPL	1.4%	2.0%	0.0%	1.3%	81.0%
SYD	3.0%	0.0%	0.0%	1.3%	82.3%
TCL	0.0%	3.6%	0.0%	1.3%	83.6%
IAG	0.0%	2.4%	1.3%	1.1%	84.7%
VVR	2.2%	0.0%	0.0%	0.9%	85.7%
AIO	2.1%	0.0%	0.0%	0.9%	86.6%
ASX	1.9%	0.0%	0.0%	0.8%	87.4%
LLC	1.9%	0.0%	0.0%	0.8%	88.2%
CWN	0.0%	2.2%	0.0%	0.8%	88.9%
NCM	1.7%	0.0%	0.0%	0.7%	89.7%
ORA	1.7%	0.0%	0.0%	0.7%	90.4%
AWK	1.7%	0.0%	0.0%	0.7%	91.1%
STO	1.6%	0.0%	0.0%	0.7%	91.8%
HSO	0.0%	1.8%	0.0%	0.6%	92.5%
ABC	0.0%	0.0%	2.5%	0.6%	93.0%
MMS	1.3%	0.0%	0.0%	0.5%	93.6%
ANN	1.2%	0.0%	0.0%	0.5%	94.1%
EHE	1.2%	0.0%	0.0%	0.5%	94.6%
CKF	1.1%	0.0%	0.0%	0.5%	95.1%
CSR	0.0%	0.0%	1.8%	0.4%	95.5%
TRS	0.9%	0.0%	0.0%	0.4%	95.8%
DOW	0.0%	0.0%	1.6%	0.4%	96.2%
WOR	0.0%	0.0%	1.5%	0.3%	96.5%
GEM	0.0%	0.0%	1.4%	0.3%	96.9%
WHC	0.7%	0.0%	0.0%	0.3%	97.2%
SPO	0.0%	0.0%	1.2%	0.3%	97.4%
CPU	0.6%	0.0%	0.0%	0.2%	97.7%
SWM	0.0%	0.0%	0.9%	0.2%	97.9%
HGG	0.5%	0.0%	0.0%	0.2%	98.1%
AHG	0.0%	0.0%	0.9%	0.2%	98.3%
SXL	0.0%	0.0%	0.8%	0.2%	98.4%
WLD	0.4%	0.0%	0.0%	0.2%	98.6%
RFG	0.0%	0.0%	0.8%	0.2%	98.8%
AHY	0.0%	0.0%	0.8%	0.2%	99.0%
GUD	0.0%	0.0%	0.8%	0.2%	99.1%
NEC	0.0%	0.0%	0.7%	0.1%	99.3%
MND	0.0%	0.0%	0.6%	0.1%	99.4%
SVW	0.0%	0.0%	0.5%	0.1%	99.6%
BEN	0.0%	0.0%	0.4%	0.1%	99.7%
VRL	0.0%	0.0%	0.4%	0.1%	99.7%
BOQ	0.0%	0.0%	0.4%	0.1%	99.8%
IFL	0.0%	0.0%	0.2%	0.1%	99.9%
PPT	0.0%	0.0%	0.2%	0.0%	99.9%
PTM	0.0%	0.0%	0.1%	0.0%	100.0%
GMA	0.0%	0.0%	0.1%	0.0%	100.0%
FXL	0.0%	0.0%	0.0%	0.0%	100.0%
PRY	0.0%	0.0%	0.0%	0.0%	100.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

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