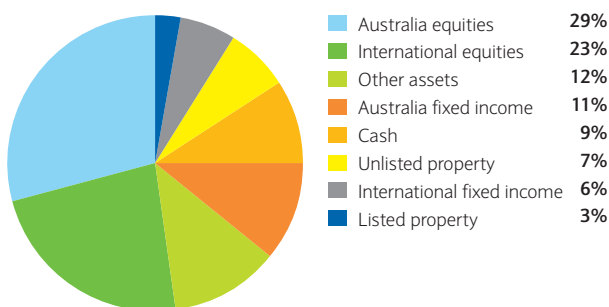


STRATEGIC ASSET ALLOCATION (SAA)

What is Strategic Asset Allocation?

One of the first decisions when investing is to choose the broad categories of investments (or asset classes) to include in the overall portfolio and how much to invest in each. This long-term portfolio mix of broad asset classes (equities, property, bonds, cash, and others) is commonly known as the *Strategic Asset Allocation*, or SAA. It is the asset mix that will be adopted over the medium to long term to achieve the portfolio investment objectives. The chart shows a typical SAA for a diversified portfolio, similar to many default investment options offered by superannuation funds.

Sample Strategic Asset Allocation



Setting the SAA of a portfolio requires the investor to make assumptions about the return, risk and correlation characteristics of each individual asset class. An *optimal* portfolio can then be constructed which best meets the needs of the particular investor. Changing any of the assumptions regarding the underlying asset classes or the investor's requirements will almost certainly result in a different outcome in determining the optimal SAA.

Predicting asset class returns is, however, extremely difficult. One of the best ways to manage overall portfolio risk is to diversify across a broad range of different asset classes, styles, geographies, and sectors, thus limiting exposure to any one particular asset class.

Historical trends in SAA

SAA traditionally considered a small number of broad, widely recognised, developed asset classes, similar to those shown in the pie chart. More recently, in the search for further portfolio diversification and additional sources of uncorrelated returns, many portfolios have moved towards a much broader array of asset classes within their SAA. It is not uncommon to see allocations to infrastructure, private equity, unlisted property, hedge funds, emerging market equities, and small-cap equities. Many of these asset classes are available as Exchange Traded Funds (ETFs) globally, and in time the product offering in Australia will expand to include more of these.

How should SAA be implemented?

Having set the portfolio SAA, the aim is simply to match the broad market exposures as closely as possible, at reasonable cost and with minimal portfolio volatility. Put simply, implementing the SAA should take into account the three most important factors for any investment portfolio – *return, risk* and *cost*:

Return The investments should seek to match the returns of widely recognised benchmarks, representative of each individual asset class. For example, a US equities investment might seek to match the returns of the S&P 500 Index.

Risk Volatility of returns relative to the chosen benchmark (also known as *tracking error*) should be minimised. This is best achieved by investing in passively managed strategies, which aim to closely track their stated benchmark.

Cost Lower management costs means higher returns to the portfolio. Access to simple, diversified, broad market returns is available at low cost via passively managed index strategies.

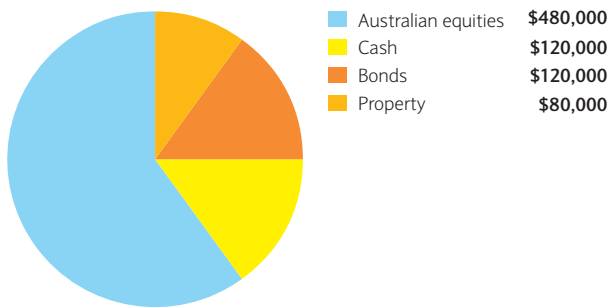
Client case study – Tim and Julia

- **Age:** 40s ■ **Portfolio:** 100% Australian ■ **Interests:** entertaining their young family
- **Goal:** complement their Australian portfolio with broad international exposure

Meet Tim and Julia

Tim and Julia's portfolio consists of Australian equities, property, bonds and cash. Even though they have diversified Australian investments, their assets are all domestic and they would like to diversify their portfolio internationally.

Tim and Julia's portfolio



Factors important to their decision:

- **Risk:** they are becoming more confident of investing in overseas markets that are similar to Australia
- **Time horizon:** they are looking to buy and hold because their focus is on long-term diversification and wealth creation
- **Single stock risk:** They do not want to pick single stocks because they do not know the markets intimately
- **Cost:** they do not want fees to be higher than on their existing Australian investments

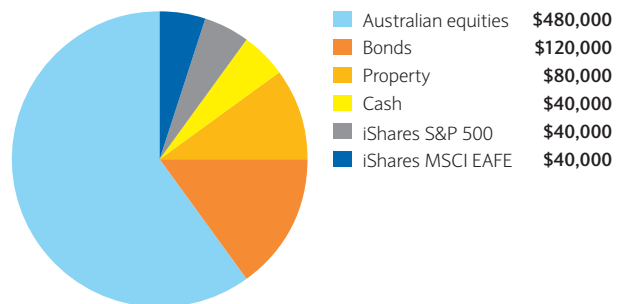
Working with a financial adviser

Tim sets up a meeting with their financial adviser to discuss their options. Developed markets fit best with their risk profile, and after talking through the product options they choose exchange traded funds for their cost-efficiency and diversification.

The financial adviser shows them that an equal investment in the iShares S&P 500 (ASX: IVV) and the iShares MSCI EAFE (ASX: IVE) will provide an international solution that is highly correlated to the MSCI World ex-AustraliaSM benchmark. Tim and Julia are surprised that they can get this exposure with just two ASX trades, through the same process as buying Australian equities and at a cost of just 0.215%* per annum.

They direct their adviser to use existing cash to purchase \$40,000 of each iShares ETF. In the usual T+3 settlement cycle, their adviser confirms their new portfolio.

Tim and Julia's new SAA



The outcome

Good for the client:

- ✓ Broad developed international exposure – developed markets focus with no need to pick stocks.
- ✓ Comfort around the process – same as buying shares.
- ✓ Fees were much less than expected, and significantly cheaper than domestic managed funds.

Good for the adviser:

- ✓ Client is happy with the solution.
- ✓ Offered a differentiated level of service.
- ✓ Greater control over risk and cost through the new SAA.

For more information visit iShares.com.au or call 1300 iShares (1300 474 2737)

* Management costs: Total fund management fees and expenses as a percentage of average net assets, and is equivalent in calculation to the indirect cost ratio ('ICR') and the management expense ratio ('MER').

Important Information

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