

# understanding core+satellite investing

## WHAT IS CORE + SATELLITE INVESTING?

The idea behind core + satellite investing is to allot the major portion of a portfolio's assets to core investments to get exposure to the broad market, be it in equities, property trusts or bonds. The remaining funds are placed in satellite investments where active management skills may measurably improve performance. The resulting core + satellite portfolio keeps pace with broader market averages, while providing the potential to earn better-than-market returns from a few selected specialist asset managers.

## HOW IT WORKS

The core + satellite approach is based on the premise that asset allocation will be the primary driver of the variability in portfolio returns, with fund selection playing a lesser role.

The core + satellite approach seeks to distinguish between the general performance of the underlying investment market, and the returns achieved over and above the broad market due to the fund managers' skill.

The role of the core part of the portfolio is to provide market-like returns while limiting management fees, whereas the role of active satellites is to provide investment diversification and to generate outperformance over the benchmark.

The satellite investments are comprised of investments that will aim to increase the overall returns for the portfolio. Such satellite investments may include concentrated equity portfolios, small cap funds, hedge funds, enhanced yield funds, commodity strategies etc. This satellite component will generally be much smaller in size than the core part.

## WHY USE THIS APPROACH?

Investors have used a core + satellite approach for some time to gain better overall portfolio returns for lower overall fees. Some developments over the past five years that have reinforced the logic of this approach are:

- Many investment managers tend to

hug the index rather than trying to substantially outperform it, by holding the leading stocks at much the same weight as they are in the index. Unfortunately, this means investors are paying active management fees, but only getting index-like performance.

- Traditional asset classes have become more positively correlated (i.e. they move up and down in line with each other). Therefore the

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benefits of diversification across the various asset sectors are being reduced. Satellite investments provide a source of differentiation in risk / return characteristics.

- Many investment managers fail to outperform on a consistent basis, particularly for portfolios that are similar to the broad market. This is making it increasingly hard for investors to pick winning active managers.
- A period of lower market returns will make it harder for fund managers using traditional investment strategies

to deliver the high returns investors have become used to. With lower overall returns, the impact of fees becomes more critical in terms of preserving investors' net return.

- Management fees are usually lower for the core part of the portfolio where the market itself is providing the bulk of the returns. High management fees are paid only for the part of the portfolio that is truly actively managed.

For these and other reasons, it makes sense to hold a core portion of a client's portfolio in a low cost investment strategy which will capture the broad market returns, and to combine that with some satellite investments using active managers that are better positioned to capture higher returns in their particular area of investment expertise.

## HOW IS IT IMPLEMENTED?

The core portfolio is made of managed funds which are closely aligned to the broad market's capitalisation.



This article by Patrick Bennett (above), Head of Research.

Consequently, the core funds are usually index funds, index tracking funds such as i-Shares, or portfolios that hold a large number of stocks. The funds may have a particular style bias, i.e. more small cap stocks over mid/large cap companies, more value stocks over growth stocks, etc but will be relatively consistent with their respective indices. Their function is to moderately outperform the index after fees, not to try and deliver large and probably volatile returns above (or below) the market's return.

Because of this, the core funds are typically characterised by:

- Market driven returns. It is the market that should deliver the vast majority of the return in the fund.
- Index-like volatility. The fund should not be significantly more or less volatile than the underlying broad market.
- Low turnover for tax considerations. This is an important part in reducing the net cost to the investor.

The satellite investments should improve not only the return but also the risk profile of the entire portfolio by adding sources of value (such as non-correlated strategies assets) that differ from those in the core part of the portfolio. The satellite funds in the

portfolio may be used to tilt the portfolio towards certain outcomes, such as greater exposure to emerging markets, small cap stocks, or towards alternative assets such as hedge funds. Essentially all these types of investments have a greater reliance on the fund manager's skill and a lesser reliance on the underlying broad market to deliver their expected returns.

Some characteristics of satellite investments are:

- A reliance on the individual skill of the fund manager, as opposed to the market providing the returns.
- The satellite funds should provide an element of diversification and should display lower correlation to index and to the core funds.
- It is usual for satellite funds to display higher volatility than the core funds
- Because the funds are actively managed and traded, fees and turnover in the funds tends to be higher. These funds are not as tax efficient as some of the core funds.
- Potentially limited capacity. Some satellite funds such as small cap equity funds are constrained as to how big they can get before they begin to underperform.

## IMPORTANT ISSUES

It is important to realise that a portfolio should be viewed in its entirety and that the core and satellite components are integrated. Each has an important role to play in the portfolio. The satellite funds are not stand alone investments, unrelated to each other or to the core component and the investor should understand why he or she is holding those particular satellite funds.



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