

# understanding enhanced asset class investing

## INTRODUCTION

Asset class investing involves the construction of portfolios that reliably deliver the returns of a specific asset class. These portfolios are constructed by purchasing all, or a large number of the securities within an asset class. No subjective forecasting of market or economic conditions is involved and no attempt is made to distinguish between undervalued and overvalued securities. Securities are bought when they meet the asset class criteria defined by the investment manager, and only sold when they no longer meet those criteria.

Enhanced asset class investing adds an extra dimension to this portfolio construction process. Enhanced asset class investing is founded on many years of academic research by leading business schools and financial economists, including several Nobel Prize winners. To enhance returns, various tilts are systematically made to the asset class portfolios using two market factors which have been proven to add value over time. Again, while portfolio returns can be systematically enhanced, there is no requirement to try and pick winners, time the markets, or significantly increase the overall portfolio risk.

## WHAT FACTORS ENHANCE ASSET CLASS RETURNS?

There are two key risk and return factors that are used to enhance equity portfolio returns and deliver an additional premium:

**Value Premium** – Stocks that have low market prices relative to the underlying value of their assets are called value stocks. This is measured in a stock's Book to Market ratio. In essence, those stocks with high Book to Market ratios are either distressed, or more likely out of favour with investors. In return for taking on the additional risk from investing in these companies, investors have historically been rewarded with higher returns. In the Australian context, these value companies become very attractive in that they generally pay steady fully franked dividends.

**Size Premium** – Compared to their large company counterparts, small companies can grow faster and deliver significantly higher rates of return to their shareholders. However, small companies also tend to be more volatile than large companies. Their lower liquidity and the market's lower tolerance for small companies' underperformance are the two major reasons for the higher risk. Despite this additional risk, over time, small companies do deliver a return premium over that achieved from large companies.

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It should be noted that the value and size premia are not constant. There will be periods where these factors underperform or outperform relative to the broader market. However, it has been proven that over the longer term, the size and value effects can provide an added return with some additional portfolio diversification benefits.

## IMPLEMENTING ENHANCED ASSET CLASS INVESTING

It is one thing to academically identify factors that may enhance the returns

from a diverse portfolio of stocks. It also requires a rigorous and disciplined process to capture those benefits in a systematic way.

For our Strategic Australian and International Equities Trusts and our Strategic Global Property Trust, we employ a fund manager that has demonstrated a highly systematic way of capturing these size and value premia within a broad asset class portfolio. This is achieved by having small tilts to increase the small cap and value stocks' exposure relative to the market as a whole. In other words, the portfolios will look similar to the broad market, but have a permanent bias towards small and value stocks and a correspondingly lower exposure to large cap stocks and those with lower Book to Market ratios. At no point are any forecasts made over the future value of the individual stocks within the portfolio – the intent is simply to capture the small cap premium and the Book to Market premium as and when they are available.

The efficiency with which these tilts can be implemented is extremely



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

important, as it directly impacts on the costs of managing the investment process. It is detrimental to returns to trade frequently in and out of stocks, especially in small cap stocks which may be relatively illiquid.

Consequently, the fund manager can incrementally increase or reduce the size of their exposure in a predetermined way, rather than be forced to implement a trade just because a stock's market capitalization has changed. This way, costs can be kept low.

## USING ENHANCED ASSET CLASS INVESTING IN PORTFOLIOS

Some investors believe that they can consistently outperform the market by stock-picking. Most active fund managers attempt this by analysing stocks individually, and then concentrating their holdings in the more favoured stocks. The overwhelming evidence is that while a small number of fund managers are indeed very good and can add value, it is difficult to do so consistently, especially after their fees are taken into account.

This is further exacerbated by the pressure on fund managers to adhere to a certain "style" and risk level, irrespective of what direction the market might be heading. The implication is that generally an investor will not receive much of the extra return that these fund managers might generate.

Furthermore, it is very difficult to know in advance who these good managers are and whether they can repeat their success in the future.

A sound way to apply the enhanced asset class investing concept in a portfolio is to adopt what is called a core + satellite approach. The enhanced asset class portfolio, with its in-built tilts towards value and small caps, is the core and actively managed funds are the satellites.

The purpose of the satellite investments is to try to add some additional return over that of the market. The larger part of an investor's portfolio should comprise the enhanced asset class investing component as the way to maximise the certainty of getting the market return at low cost. This core component can then be complemented by having a smaller proportion of the asset class allocation invested in a satellite investment, where the manager has demonstrated some ability and consistency in adding additional value after fees.

## A WORD OF CAUTION

While enhanced asset class investing is an excellent way to get the market's return at lower cost than is possible from most other actively managed strategies, it does not diminish the risk inherent in the market itself. Diversifying across a large number of stocks and maintaining a value bias will certainly reduce the stock specific risk in the portfolio but the overall market risk remains.

This means that when the market falls, the enhanced asset class portfolio will fall too. This market risk can not be completely diversified away.

In addition, the tilt towards the more volatile small cap sector will tend

to increase the overall volatility of the portfolio.

## FINAL THOUGHTS

The enhanced asset class investing approach provides a sound way of implementing a robust academically validated process, to ensure that investors achieve consistent, above average returns after fees. It supports the idea of investing for the long term, rather than short term speculation.



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