Financial Linx

The Science of Investing

There is a **new model of investing:**
a model not based on speculation but on the science of capital markets. Decades of research guide the way.

The mission of Financial Linx is to deliver the performance of capital markets and increase returns through state-of-the-art portfolio design and trading.

Capital markets build wealth.

Rather than trying to outguess the market, let it work for you.

MARKETS WORK

Markets throughout the world have a history of rewarding investors for the capital they supply. Companies compete with each other for investment capital, and millions of investors compete with each other to find the most attractive returns. This competition quickly drives prices to *fair value*, ensuring that no investor can expect greater returns without bearing greater risk.

Traditional active investment managers strive to beat the market – this rarely succeeds. Studies have shown less than 30% of active investment managers consistently outperform the market, and when their fees are taken into account – less than 1% provide a return better than the market. Meanwhile, as managers chase the next 'hot share', capital economies thrive – and financial markets reflect this.

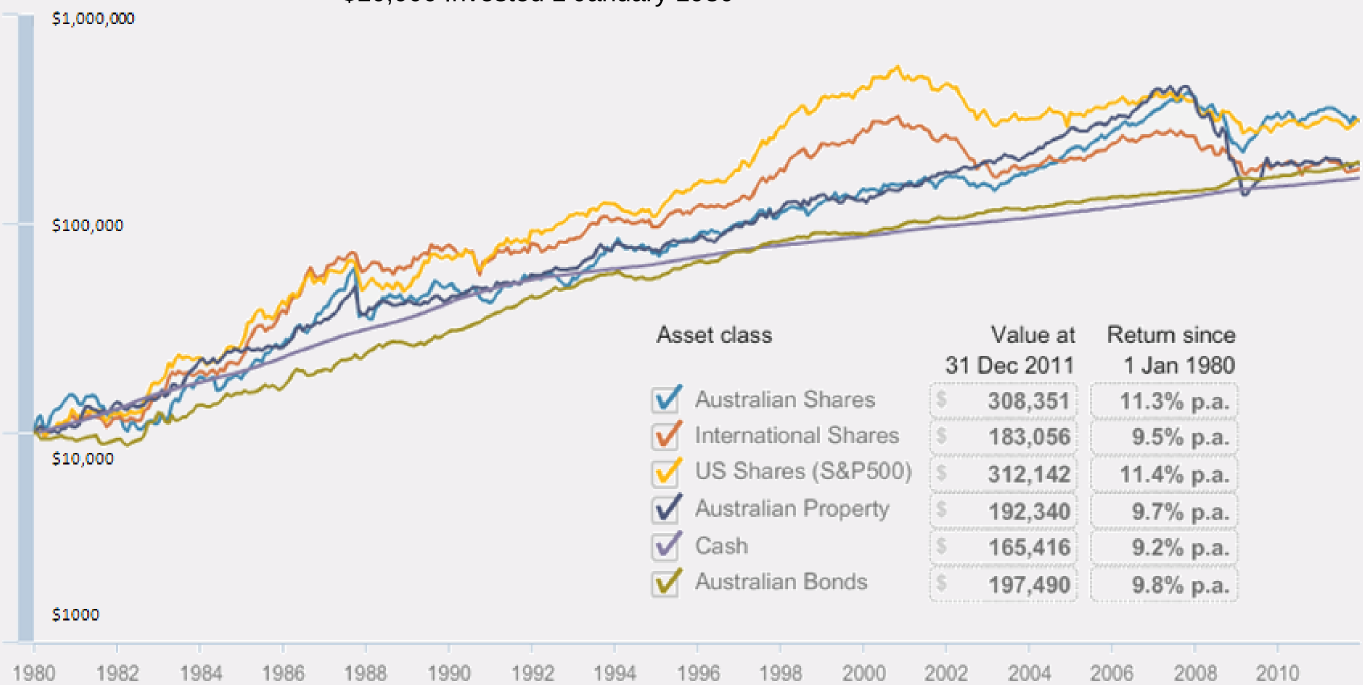
INVESTING VERSUS SPECULATING

The futility of speculation is good news for the *investor*. It means that prices for public securities are fair and that persistent differences in average portfolio returns are explained by differences in average market risk. It is certainly possible to outperform markets, but not without accepting increased risk.

When investors reject costly speculation and guesswork, investing becomes a matter of identifying the risks that reliably provide compensation and choosing the risks to take. Financial science identifies the source of investment returns and we apply the science to deliver a successful investment experience.

A PICTURE OF GROWTH

$10,000 Invested 1 January 1980



From 1980 to 2011, the compound annual growth rate of return was 11.3% for Australian Shares, 9.5% for International Shares, 11.4% for US shares, 9.7% for Australian Property, 9.8% for Australian Bonds and 9.2% for Cash. General: Fees, transaction costs and tax have not been taken into account in the calculations. All results are displayed in nominal dollars i.e. inflation has not been taken into account. All returns quoted in Australian dollars. US and International Share returns are affected by exchange rate movements. Performance: The chart shows the growth of $10,000 invested at the start of 1980. It assumes that the $10,000 is fully invested (and remains fully invested) in the relevant index for the asset class and that all income is reinvested. The results are in nominal dollars, inflation has not been taken into account. All returns quoted in Australian dollars. Data: Australian Shares: S&P/ASX All Ordinaries Accumulation Index. International Shares: MSCI World ex-Australia Net Total Return Index. Australian Bonds: Feb 1977 to Dec 1989 Commonwealth Bank All Series Greater than 10 years Bond Accumulation Index. From Sep 1989, index is the UBS Warburg Australia Composite Bond Accumulation Index. Cash: Data prior to March 1987 supplied by Reserve Bank of Australia. From March 1987 index is the UBS Warburg Australia Bank Bill Accumulation Index. US Shares: S&P 500 Total Return Index.

Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

GAINING CLARITY

The guiding research behind our investment process emerged in 1981 with early research into the stronger investment returns of small companies. Later, a comprehensive analysis of share prices worldwide gave us even greater insight. This evolution reflects an abiding belief in financial science and the efficacy of capital markets.

At Financial Linx, we see markets as an ally, not an adversary. Rather than trying to take advantage of the ways markets are mistaken we take advantage of the ways markets are right – the ways they compensate investors. The firm designs portfolios to capture what the market offers in all its dimensions.

Relieve the stress and confusion of investing with a clear and practical approach to wealth management.

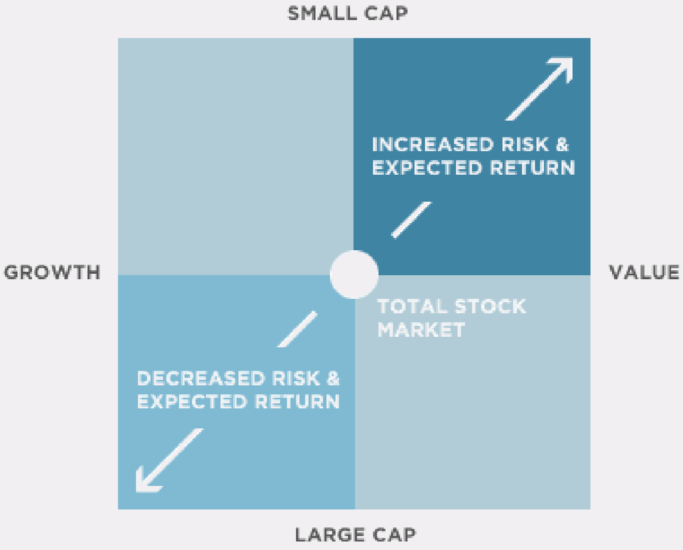
How known risk factors deliver.

TAKE RISKS WORTH TAKING

Evidence from practising investors and academics alike points to an undeniable conclusion: Returns come from risk. Investment profits are rarely accomplished without taking a risk, but not all risks carry a reliable reward. Financial science over the last 50 years has brought us to a powerful understanding of the risks that are worth taking and the risks that are not.

EQUITY MARKET KNOWLEDGE

Everything we have learned about expected returns in the equity markets can be summarised in three dimensions. The first is that shares are riskier than fixed interest securities. Relative performance among shares is largely driven by the two other dimensions: small/large and value/growth. Studies have shown small companies and value shares outperform because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk.



THE DIMENSIONS OF RISK AND RETURN

SMALL COMPANY

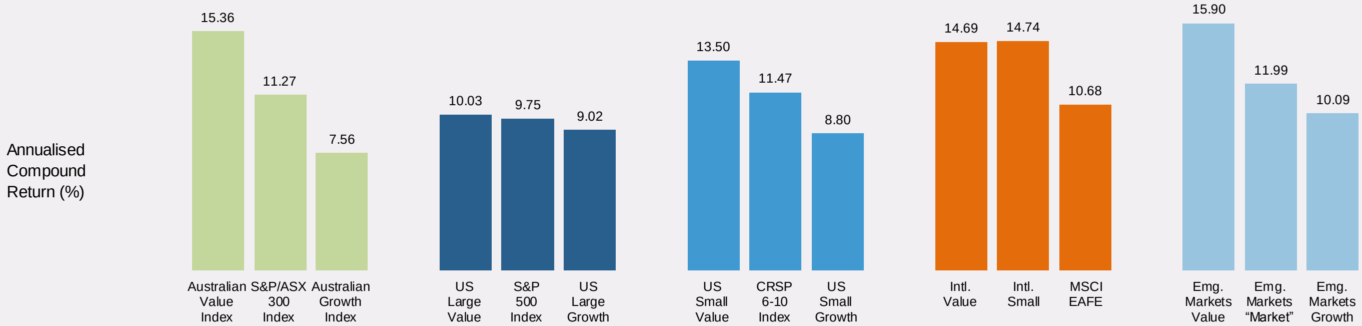
Research shows, over the long term, small companies provide higher expected returns than larger companies. Our objective is to deliver a small company performance premium and provide worldwide diversification. We define small companies as those who fall outside the ASX300.

VALUE

Our value strategies are designed to capture the return premiums associated with undervalued companies – these are companies whose net assets far outweigh their market capitalisation.

Our value portfolios are constructed by ranking the total market by their value premium and then choosing only the top 25%.

SIZE AND VALUE EFFECTS ARE STRONG AROUND THE WORLD



	Australian Stocks 1980-2011			US Large Capitalisation Stocks 1927-2011			US Small Capitalisation Stocks 1927-2011			Non-US Developed Markets Stocks 1975-2011			Emerging Markets Stocks 1989-2011		
Average Return (%)	18.52	13.64	10.12	13.63	11.77	11.29	18.82	15.72	13.74	17.44	18.23	12.98	22.86	17.77	15.63
Standard Deviation (%)	27.53	23.24	23.56	27.10	20.41	21.81	35.07	30.84	33.90	24.81	28.32	22.37	42.31	36.47	34.77

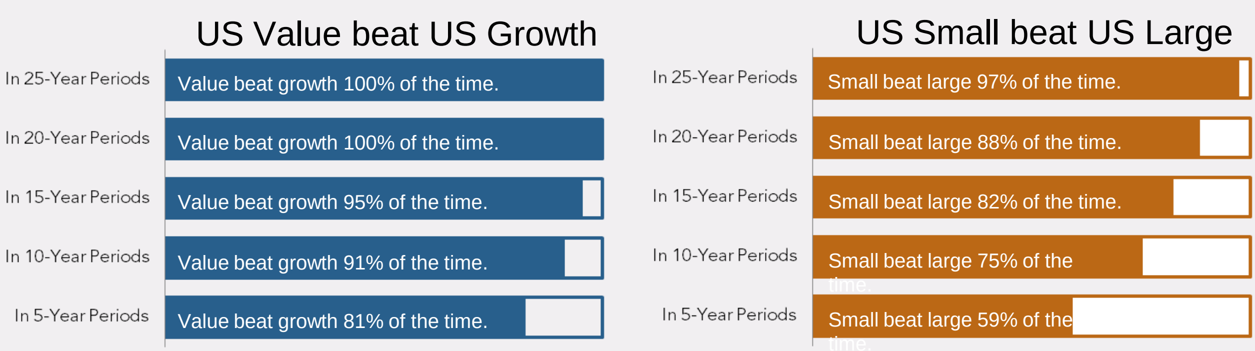
Size and value matter

Small company and value effects are strong around the world. Smaller and lower-priced value shares have higher risk and greater expected returns than larger and higher-priced growth shares.

Annual Returns are from January to December.
Australian stocks in AUD; US large, US small, non-US developed, and emerging markets stocks in USD.
Australian Value and Growth data provided by Fama/French from Bloomberg and S&P securities data. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. US value and growth index data (ex utilities) provided by Fama/French. S&P data are provided by Standard & Poor’s Index Services Group. CRSP data provided by the Center for Research in Security Prices, University of Chicago. International data provided by Fama/French from Bloomberg and MSCI securities data. MSCI EAFE Index is gross of foreign withholding taxes on dividends; copyright MSCI 2012, all rights reserved. Emerging Markets index data simulated by Fama/French from countries in the IFC Investable Universe; simulations are free-float weighted both within each country and across all countries.

SMALL COMPANY AND VALUE HISTORIC RESULTS

July 1926 - December 2010



Based on rolling annualised returns. Rolling multi-year periods overlap and are not independent. This statistical dependence must be considered when assessing the reliability of long-horizon return differences. 715 overlapping 25-year periods. 775 overlapping 20-year periods. 835 overlapping 15-year periods. 895 overlapping 10-year periods. 955 overlapping 5-year periods. US Value and US Growth data provided by Fama/French Research Indices. US Small data provided by Fama/French US Small Cap Index. US Large data provided by Fama/French US Large Cap Index. US Stocks data provided by Fama/French Total US Market Index Portfolio.

This chart shows how the risk premiums (in the US) have delivered over various time periods.
The small cap and value premiums are not always present. That is why they are called ‘risk’ factors. But they are more likely to be evident over the long term. And they are available to investors if they stay disciplined.
(NB. US data has been used to allow for analysis extending back to 1926. Australian data is not available for this period)

Better investing

through science.

At Financial Linx, a system of research and practice generates financial progress.

PIONEERS IN PORTFOLIO ENGINEERING

We are always researching tomorrow's solutions today. We do this through strong working relationships with leading institutions and financial economists. By maintaining ongoing liaison with leading financial academics we continuously offer portfolio strategies with the highest probability of delivering a successful investment experience.

The road to investment success lies in identifying the risks that provide compensation, choosing the risks to take, and then striving to minimize the risks and costs. Science-based portfolio engineering makes this possible. Our portfolios implement enduring knowledge of markets, risk and investing. We design strategies that offer consistent, fully diversified exposure to risks that drive long term returns.

DETERMINANTS OF PORTFOLIO PERFORMANCE

The vast majority of a portfolio's returns are determined by asset class selection and only a small portion is determined by market timing and security selection.

Definitions

Asset Class Selection

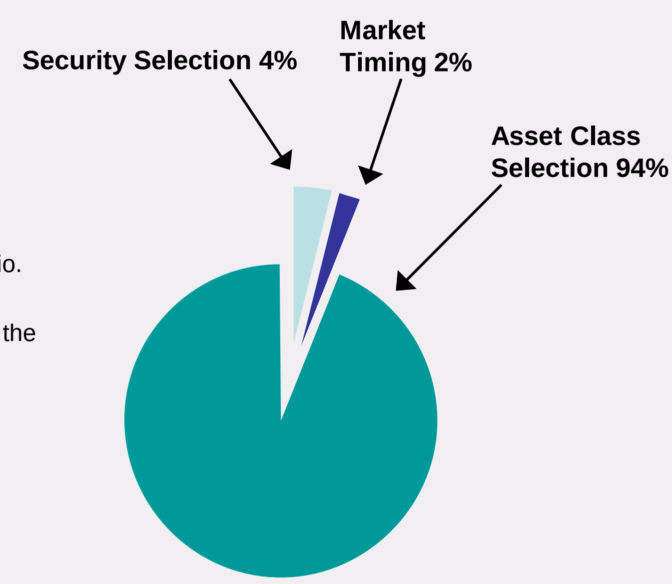
- How assets are allocated in a portfolio.

Market Timing

- Shifting portfolio assets in and out of the market or between asset classes.

Security Selection

- Finding "underpriced" companies or industries.



Asset class selection accounts for 94% of portfolio performance.

Source: Study of 91 large pension plans over 10 year period.
Gary P. Brinson, L. Randolph Hood and Gilbert L. Beebower, "Determinants of Portfolio Performance", Financial Analysts Journal, July-August 1986, pp. 39-44; and Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, "Revisiting Determinants of Portfolio Performance: An Update", 1990, Working Paper.

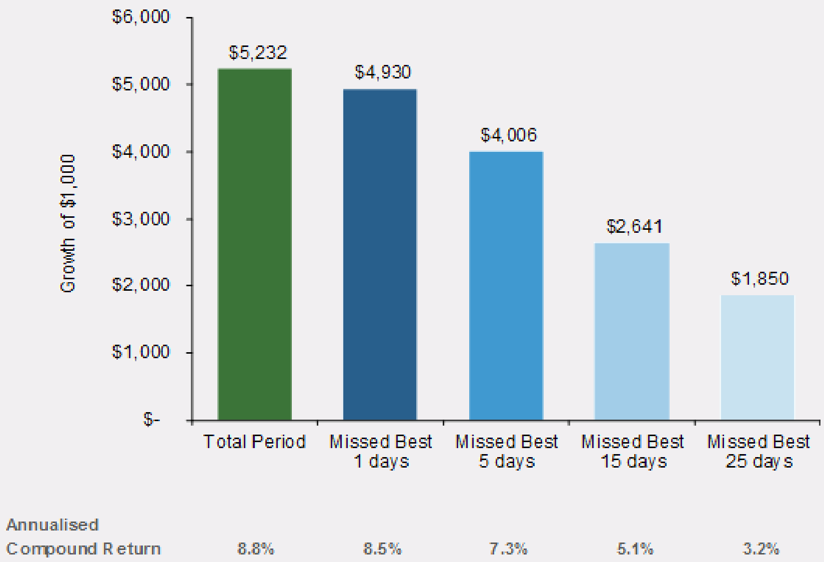
Maintaining discipline

Many people mistake investment for speculation and end up taking avoidable risks. The irony is speculation is unnecessary. Over many years economists have built up a strong understanding of which risks to take and which to avoid. Their findings are based on science & research, not guesswork.

Markets will move up and down, that is assured, but the biggest obstacle to reaching your long term investment goals is often not the market, but your own behaviour.

The proven growth history of the markets, the understanding of risk, and the science of portfolio structure can all be undermined by human tendencies to overrate our predictive abilities or to become distracted by outside influence i.e. media noise. Markets face crises from time to time, but it is in their nature to quickly price in new information and move on. Selling out during difficult times means turning paper losses into real ones. More often than not, those that panic, miss the inevitable rebound when it comes. Unless you are a speculator it's important to take a long term view and just move on.

If you had invested $1,000 in the S&P/ASX 300 Accumulation Index in June 1992 and left it untouched, you would have had a balance of $5,232 by the end of December 2011.
If you had missed the best *fifteen* trading days in that period, the balance would have reduced by nearly 50% to $2,641.



In this example the Australian share market is represented by the S&P/ASX 300. The time period is June 1992-December 2011

A PLAN FOR THE FUTURE

Our work is never complete. The final chapter will never be written. But a process grounded in science can only improve an investor's financial plan. The peace of mind and clarity of such an approach would be reward enough were it not for its long history of documented superior performance.

By applying modern financial principles to wealth management, Financial Linx remains at the forefront of the industry, ready & able to serve our client's investment needs.

An approach that targets the expected returns of capital market dimensions completes an investment program.

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