SELECTING THE CORRECT "THREE BUCKET" PRE-RETIREMENT PENSION FUND

A comparison of Colonial Wholesale and MLC Fundamentals fund options currently recommended by BL&A

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GEARING OR NO GEARING?

The first decision that the investor must make, relates to the decision to utilize internal gearing or not. Under the BL&A model, our 3rd bucket options incorporate funds which offer:

1. no internal gearing
2. moderate level of internal gearing; and
3. Internal gearing.

Detailed information on internal gearing can be found in our document titled *Inside the 3rd Bucket – a generic look at the impact of gearing*.

In making this decision there is no right or wrong choice. It is more about what makes the investor "sleep at night" and their investment objectives. It is also true to say that "one size does not fit all", in that an investor may choose to mix and match funds within their portfolio, having (say) 70% of their 3rd bucket in a non-geared fund, and 30% in one with gearing. It is also possible to change the mix over time, as share markets and the cost of borrowing changes. It should not be forgotten that the 3rd bucket is about investing for the long term, and there will naturally be good and bad cycles over this period. It is therefore unlikely that an investor's strategy will be set in stone for that entire period.

CATEGORY ONE

Funds which have no internal gearing

For the reasons outlined in the document *Inside the 3rd Bucket – a generic look at the impact of gearing*, where you choose not to utilize internal gearing, it is our preference to use *index funds*. Share index funds will typically comprise the same shares that comprise the index (for example, the ASX 200), with their weighting in the fund mirroring their respective weighting in the index. In other words, if BHP makes up (say) 12% of the value of the ASX 200, an Australian share index fund will have 12% of its portfolio in BHP shares. An active manager may have 15% in BHP (if they are bullish about it), or none.

Administratively, their fee structures are less expensive and the investor is guaranteed a very broad range of diversification within their portfolio (I.e. they are getting every stock within the index).

The funds that we would use within this category are:

MLC

- MLC – Vanguard Australian Share Index
- Vanguard International Shares Index Fund (Unhedged)

Colonial First Choice

- Colonial First State Wholesale Index Australian Share
- Colonial First State Wholesale Index Global Share

Both MLC and Colonial FirstChoice provide index funds for both Australian and international shares. Being index funds, there is virtually nothing to separate them, in terms of performance, as both invest in the broader index. Neither of the global index funds hedge movements in the $A.

Until recently, we have maintained a bias towards Australian shares over global shares. This is because the return in Australian shares is enhanced through the addition of franking credits and it also removes volatility caused through fluctuations in the $A. However, the ASX has become increasingly concentrated in two sectors, Financials and Materials (banks and miners). These two sectors now make up some 50% of the ASX 200 by market capitalisation. As profitable as these sectors have been, they are victims of their own success. As their profitability has risen, so too has the share price of companies in these sectors, and their overall weighting in the ASX 200. In terms of risk minimisation through diversification, the ASX 200 index has just become too skewed towards these two sectors.

Additionally, the Information Technology sector comprises only 4% of the Australian ASX 200. This is now the largest sector in the US share market, with household names such as Apple and Microsoft all listed on the US share market. To obtain a larger exposure to this sector, we simply need to invest a higher percentage in the global share market.

CATEGORY TWO

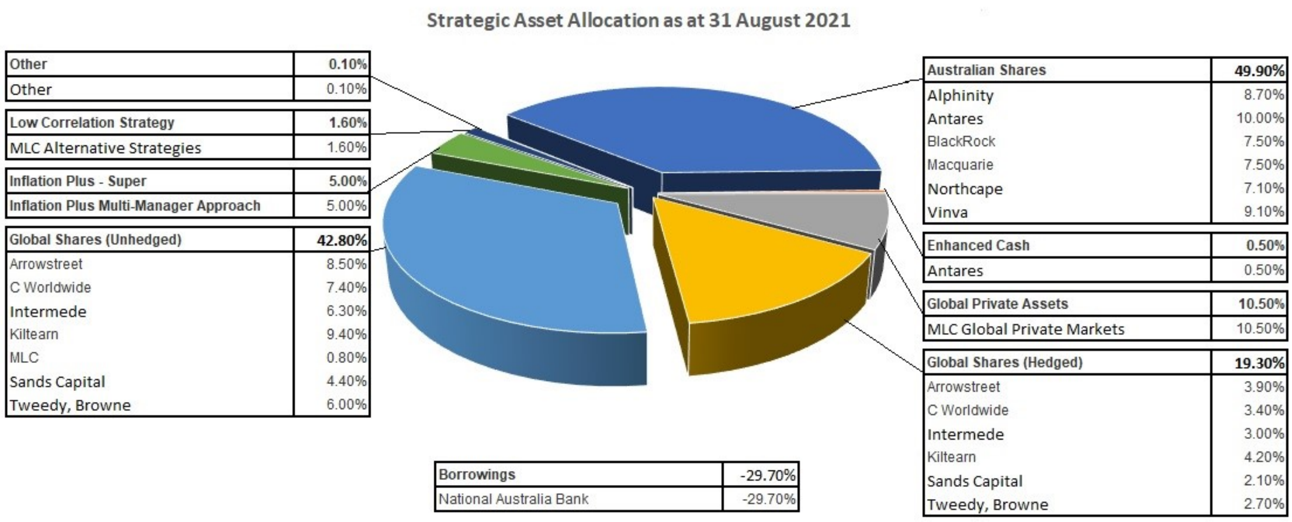
Fund with a modest level of internal gearing

MLC Accelerated Growth Portfolio (Horizon 7)

The MLC Horizon 7 product adopts a conservative level of gearing (30%), with approximately $30 of gearing for every $100 of investment funds. This low level of gearing (compared to alternative geared funds), means that the short term volatility will not be as great, but longer term returns will not be as high.

The Horizon 7 Fund is a multi-manager fund, where MLC select a range of Australian and global fund managers, and then distribute the investments between them. The number of fund managers, their weighting and the managers themselves is under constant review. As part of its ongoing review process MLC monitor the performance and strategies used by their selected managers, and turn these managers over as they see the need. At present the current mix of the fund is seen in the graph below.

The other noticeable thing concerning the Horizon 7 Fund is that MLC determine the weighting of the Australian/global share mix, as well as the degree of hedging of the currency in the global portfolio.



Advantages of the MLC Horizon 7 Fund

We see two main advantages of this fund compared with alternatives. In the first instance it incorporates a level of gearing that is “not as exciting” as alternatives. By having a 23% gearing ratio, the fund will enhance long term returns compared with non-geared options, but will be less volatile in the short term than funds with a higher level of gearing.

The other advantage of this fund is the significant level of diversification within the fund. As can be seen from the pie chart above, no individual investment manager controls more than 10% of the portfolio. Quite simply, with over a dozen different investment managers, the possibility of them all selecting the “wrong shares” is considerably minimised. With so many investment managers selecting shares independently of each other, the end result is a larger share portfolio overall, with no one share dominating the portfolio. At present, the H7 Fund has around 200 different Australian shares in the portfolio, whereas other single-fund managers can have as few as 30-40.

The same “underlying conservativeness” of the MLC approach is seen with hedging of the global share portfolio. When investing in offshore assets, movements in the $A can either enhance or detract from the investment returns. To avoid this additional risk, it is possible to “hedge” the currency, which effectively equates to taking out an insurance policy against a massive appreciation of the $A against the currencies that the overseas shares are held in.

As can be seen by the diagram, the Horizon 7 hedges some of the global portfolio but not all of it.

Disadvantages of the MLC Horizon 7 Fund

Some could argue that the advantages of the Horizon 7 Fund (significant diversification and moderate gearing) are also its disadvantages. By having such significant diversification within the fund, the possibility of selecting the “wrong shares” is greatly diminished, but so too is the possibility of picking only the “best shares”. A diversified fund like MLC is likely to end up almost replicating the share market index rather than being overweight or underweight in any particular sector of the share market.

The conservative level of gearing (30%) can also be a disincentive to those not concerned about short term volatility, but are after greater long term returns. Compared with alternatives (which gear up to 55%), the Horizon 7 portfolio is relatively “unexciting”.

Some investors will also dislike the fact that in the Horizon 7 Fund there is no (personal) discretion in the weighting between Australian and global shares. It is not inconceivable that an investor may want more global shares in their portfolio, to counter a large personal holding of Australian shares.

Alternatively, an investor could prefer a greater weighting in Australian shares because of the tax concessions provided through the franking system. The mix of Australian and global shares in the Horizon 7 Fund is decided by the scheme trustees, using a strategic asset allocation. This means that the trustees take a long term view, and do not alter the weightings significantly with regard to short term changes in market fluctuations.

From a cost perspective, the ongoing administration fee in the Horizon 7 Fund is comparable to that of its competitors. Having said this however, MLC provide a fee rebate when the balance of the investment exceeds $200,000 and an total rebate for the funds that exceeds $1,150,000, which reduces the differential. This is further detailed in the Fees section on page 6.

CATEGORY THREE

Fund with a higher level of internal gearing

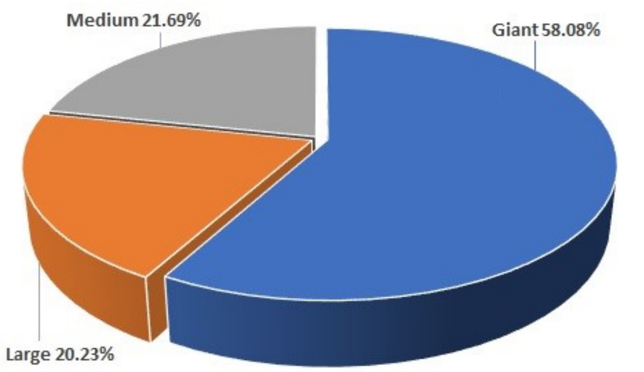
First Sentier Wholesale Geared Share Fund

This is the only geared share fund offered by the Colonial FirstChoice fund for Transition to Retirement Pensions.

This fund has existed since 1997 (under the name Colonial First State) and hence is one of the few geared share funds to have a long term track record. Colonial utilise a concept known as dynamic gearing where the gearing ratio can be increased or decreased depending on market conditions. The gearing ratio cannot exceed 55% and is usually around 50% meaning that it borrows $100 for every $100 invested.

The investment strategy of this fund is known as “GDP Plus”. It focuses on the shares of Australian companies that have strong balance sheets and whose earnings are expected to grow at a greater rate than the Australian economy as a whole. The strategy focuses on larger companies, with very small or no exposure to small companies.

This is seen in the following pie chart.



Within the fund (as at 31 August 2021), 58.08% of funds were held in shares in ‘giant’ Australian companies, 20.23% in ‘large’ Australian companies with none held in what would be considered ‘small’ or ‘micro’ companies.

Having said that this fund has a “blue chip” focus, it is also important to appreciate that the fund will rarely have more than 35 shares in the portfolio. Additionally, the “GDP Plus” investment approach will focus on “growth based” stocks, rather than those that (for example) pay consistent dividends.

The published list of the top ten stocks in the portfolio and their respective weightings as at 31 May 2021 is:

BHP Group Ltd	9.62%
Commonwealth Bank of Australia	8.49%
CSL Ltd	8.06%
National Australia Bank Ltd	5.96%
Westpac Banking Corporation	5.35%
Woolworths Group Limited	5.02%
James Hardie Industries NV	4.07%
Afterpay Ltd	3.23%
Goodman Group	3.19%
Domino’s Pizza	3.10%
Total	**56.09%**

SUMMARY OF OPTIONS

Where a client does not wish to have internal gearing, the third bucket will be comprised of an Australian index fund and a global index fund.

The choice between MLC and Colonial is pretty much a toss of a coin , as both index funds are, by definition, very similar.

There are two ways to achieve a moderate degree of risk if that is what the client wishes.

The first is with MLC, where they would place their third bucket in the Horizon 7 Fund. The alternative would be to choose the Colonial First Choice fund and create a third bucket comprised of BOTH the (non-geared) index funds and the geared fund.

If an investor were to place 50% of their third bucket in the (non-geared) Colonial index fund and the other 50% in the Colonial geared fund, they would effectively create an overall gearing ratio within the third bucket of around 34%. If they chose a 70/30 weighting, the gearing ratio would fall to around 24%. To this extent, the Colonial option provides greater flexibility, over time, to vary gearing levels depending on market factors. This arrangement may also suit the investor who wishes to gradually build up exposure to a geared investment, thereby reducing the possibility of entering the fund on the “wrong day”.

The third bucket could initially be invested 100% in the (non-geared) index funds, and then gradually moved (say at 5% every quarter), towards the geared fund.

Where a client is seeking high gearing levels, in order to maximize returns, then clearly the Colonial geared fund should be used.

1ST AND 2ND BUCKETS

It is our belief that, with the funds available for the TTR products, the investment strategy and performance of the first and second buckets will not differ greatly from fund to fund. It is for this reason that we recommend the fund is selected on the basis of the third bucket, with the funds for the first and second buckets merely “going along for the ride”.

With this in mind, the Colonial options for the first and second bucket are:

Buckets	Colonial FirstChoice Funds
1st	FirstRate Wholesale TTR Saver (100%)
2nd	FirstChoice Wholesale TTR Multi-Index Diversified

The FirstChoice Wholesale TTR Multi-Index Diversified fund has a traditional diversified fund mix of 50% growth assets and 50% defensive assets.

For an MLC portfolio, the recommended funds are:

Buckets	MLC Funds
1st	MLC TTR Cash (100%)
2nd	MLC TTR Index Plus Conservative Growth or MLC TTR Index Plus Balanced and MLC TTR Index Plus Growth

The MLC TTR Index Plus Conservative Growth portfolio also contains a 50/50 mix of growth and defensive assets.

In accordance with our bucket approach, the first bucket must be 100% conservative as this is the part of the fund where any payments will come from. This must be invested in cash, accepting that this will not provide any sort of dynamic return. Its job is to be stable, to allow the rest of the fund to seek the higher returns.

The role of the second bucket is to provide income 4-7 years from now. It must have enough in it to cover any withdrawals during this time, and must be invested appropriately until these funds are required.

The key thing about shares is that they produce relatively low levels of dividends (around 4-5%), so we are reliant on capital gains to increase their value. The FirstChoice Wholesale TTR Multi-Index Diversified fund also contains property securities and infrastructure assets within its portfolio. Unlike residential property (which, like shares, has low income and relies heavily on capital gains), commercial property and infrastructure receives a much higher income yield. This takes the pressure off capital gains.

PRE-RETIREMENT PENSION FEES

For as long as you are a member of the fund, the fund will charge you an ongoing fee. This fee covers the fund's ongoing role in the area of investing and administration. Logically, the more complex a fund is, the higher the administration fee will be.

TTR Investment option		Admin Fees (pa)	ICR	Invest Fees (pa)	Total Fee (pa)	Cost (pa) $10,000 Invested
COLONIAL			%			
FirstRate Wholesale TTR Saver		0.35%	Nil	Nil	0.35%	$35
FirstChoice Wholesale TTR Multi-Index Diversified		0.20%	0.14%	0.49%	0.83%	$83
FirstChoice Wholesale TTR Multi-Index Growth		0.20%	0.23%	0.56%	0.99%	$99
Colonial First State Wholesale TTR Index Aust. Share		0.20%	0.00%	0.14%	0.34%	$34
Colonial First State Wholesale TTR Index Global Share		0.20%	0.00%	0.15%	0.35%	$35
First Sentier Wholesale TTR Geared Share	– net – gross	0.20% 0.09%	0.56% 0.25%	2.07% 0.97%	2.83% 1.31%	$283
MLC						
MLC TTR Cash Fund		0.32%	0.00%	0.24%	0.56%	$56
MLC TTR Index Plus Conservative Growth		0.32%	0.10%	0.29%	0.71%	$71
MLC TTR Index Plus Balanced		0.32%	0.08%	0.29%	0.69%	$69
MLC TTR Index Plus Growth		0.32%	0.05%	0.29%	0.66%	$66
MLC TTR Vanguard Australian Share Index Fund		0.32%	0.00%	0.25%	0.57%	$57
MLC TTR Vanguard International Shares Index Fund		0.32%	0.00%	0.38%	0.70%	$70
MLC TTR Accelerated Growth Horizon 7	– net – gross	0.32% 0.25%	0.60% 0.46%	1.80% 1.39%	2.72% 2.10%	$272

The net rates are calculated as a percent of your own investment. The gross rates are on your investment plus borrowings.

In addition, MLC will charge a fee of $78.00 per annum (on a weekly basis) if your account falls below $50,000. MLC's fees also include the new Trustee Levy of 0.02% per annum.

Impact of gearing on administration and buy/sell fees

In order to compare "apples to apples", the administration fees and buy/sell spreads on Page 8reflect both a gross and a net amount. By using a geared fund the size of the investment increases by virtue of the gearing, accentuating long term returns. The administration fees and buy/sell fees will also increase, based on the level of gearing involved.

For example, if there was no gearing in the First Sentier Wholesale TTR Geared Share fund, the cost would be 1.31% or $131 for $10,000 invested. With the estimated $11,603 borrowed, the cost is increased by $152 (1.31% of $11,603) for a total cost of $283 per annum. By using a geared fund, the size of the investment increases by virtue of the gearing, accentuating long-term returns. The increase in fees will be based on the level of gearing involved, in this case about 54%.

Indirect Cost Ratio (ICR)

The Indirect Cost Ratio (ICR) shows investment-related costs – that is, any amount not already disclosed as a fee that directly or indirectly reduces the return of an option. The ICR is expressed as a percentage of the average net asset value of the fund. The ICR may include costs incurred in underlying investment vehicles. This can include any or all of the following components:

- Expenses paid out of the fund's assets
- Legal, accounting, auditing fees
- Costs linked with derivatives and other investment vehicles
- Transaction costs such as brokerage fees

Fee Rebates

Colonial First State FirstChoice will apply a fee rebate of 0.05% on the portion of the balance that exceeds $100,000 but is under $500,000, a fee rebate of 0.10% on the portion of the balance that exceeds $500,000 but is under $1,000,000 and a fee rebate of 0.20% on the proportion of the balance that exceeds $1,000,000. Note that no fee rebate is payable on FirstRate Wholesale investment options although they are counted first in the portfolio balance bands.

The following table shows the rebate applicable if you had invested $1,500,000 in the fund with $200,000 invested in the FirstRate Wholesale Saver option.

MLC MasterKey will apply a fee rebate of 0.10% on the portion of the account balance in excess of $200,000 (and below $1,150,000) and the full 0.30% on the balance in excess of $1,150,000.

Portfolio balance – Colonial FirstChoice	Rate	Management Fee Rebate
First $100,000 (All FirstRate Saver)	$100,000 x 0.00%	$0
Next $400,000 ($100,000 FirstRate Saver)	$100,000 x 0.00% $300,000 x 0.05%	$0 $150
Next $500,000	$500,000 x 0.10%	$500
Over $1,000,000	$500,000 x 0.20%	$1,000
TOTAL:		**$1,650**

The following table shows the fee rebate that would be applicable if you had invested $1,500,000 in MLC.

Portfolio balance – MLC M/Key Fundamentals	Rate	Management Fee Rebate
First $200,000	$200,000 x 0.00%	$0
Next $950,000	$950,000 x 0.10%	$950
Over $1,150,000	$350,000 x 0.30%	$1,050
Total Fee Rebate		**$2,000**

From 3 September 2021, Colonial introduced a Management Fee of 0.35% p.a. from on their FirstRate Saver account. The interest rate to be offered initially will be 0.55% p.a. for a net return of 0.2% p.a. (an increase of 0.1% p.a. on the current rate) The Management Fee is variable and can range from 0.35% to 0.5% p.a.. The interest rate offered is also variable which means that the net return may, at some time, be negative.

Buy/Sell Spreads

When buying or selling the underlying assets of each investment option, transaction costs are incurred. This is often referred to as the Buy/Sell spread.

The fund makes an allowance for transaction costs incurred for each investment option by calculating an Entry unit price and an Exit unit price which are respectively higher and lower than the actual unit price. New investments (including switches in) are made using the Entry unit price. Withdrawals (including switches out), fees and taxes are made using the Exit unit price.

The following table shows the Buy/Sell spread for each of the recommended fund options.

For example, a member makes a $10,000 contribution to the Colonial First State Wholesale TTR Multi-Index Diversified option when the unit price is $10. Entry transaction costs are 0.10% of the contributions. An allocation of 999 units is made to the member's account ($10 is paid to cover entry transaction costs). If the member withdraws $10,000 when the unit price is $10, the 1,000 units would be redeemed using the Exit unit price of $9.99 and the withdrawal amount would be $9 99 (another $10 is paid to cover the exit transaction costs).

Investment option	Buy/Sell Fees	Cost per $10,000 traded
FirstRate Wholesale TTR Saver	Nil/Nil	Nil/Nil
FirstChoice Wholesale TTR Multi-Index Diversified	0.10%/0.10%	$10/$10
FirstChoice Wholesale TTR Multi-Index Growth	0.10%/0.10%	$10/$10
Colonial First State Wholesale TTR Index Aust. Share	0.05%/0.05%	$5/$5
Colonial First State Wholesale TTR Index Global Share	0.05%/0.05%	$5/$5
First Sentier Wholesale TTR Geared Share – net	0.20-0.50%/0.20-0.50%*	$20-$50/$20-$50*
MLC TTR Index Plus Conservative Growth	0.15%/0.15%	$15/$15
MLC TTR Index Plus Balanced	0.15%/0.20%	$15/$20
MLC TTR Index Plus Growth	0.15%/0.20%	$15/$20
MLC TTR Vanguard Australian Share Index	0.05%/0.05%	$5/$5
MLC TTR Vanguard International Shares Index	0.08%/0.08%	$8/$8
MLC TTR Accelerated Growth Horizon 7 - Net	0.20%/0.15%	$20/$15

* Transaction costs depend on the specific gearing level of the option.

BL&A Adviser Service Fee

When the client is on a "product and service" arrangement, they are charged an Adviser Service Fee. This ongoing Adviser Service Fee is charged in recognition of the ongoing role that BL&A will continue to have regarding the investment, monitoring and moving the buckets, etc.

Details about this service are contained in the separate documents ***Investing through BL&A and Fees & Ongoing Service***. The Adviser Service Fee (inclusive of GST) charged by BL&A on your own invested funds (i.e. net and not the borrowed funds) is deducted by Colonial First State or MLC and is shown in the following table.

Investment option	Admin Fees (pa)	Adviser Service Fee (pa)	Total Admin/ Adviser Service Fee (pa)	Cost (pa) $10,000 Invested
COLONIAL				
FirstRate Wholesale TTR Saver	0.35%	0.66%	1.01%	$101
FirstChoice Wholesale TTR Multi-Index Diversified	0.83%	0.66%	1.49%	$1492
FirstChoice Wholesale TTR Multi-Index Growth	0.99%	0.66%	1.65%	$165
Colonial First State Wholesale TTR Index Aust. Share	0.34%	0.66%	1.00%	$100
Colonial First State Wholesale TTR Index Global Share	0.35%	0.66%	1.01%	$101
First Sentier Wholesale TTR Geared Share – net	2.83%	0.66%	3.49%	$349
MLC				
MLC TTR Cash Fund	0.56%	0.66%	1.22%	$122
MLC TTR Index Plus Conservative Growth	0.71%	0.66%	1.37%	$137
MLC TTR Index Plus Balanced	0.69%	0.66%	1.35%	$135
MLC TTR Index Plus Growth	0.66%	0.66%	1.32%	$132
MLC TTR Vanguard Australian Share Index	0.57%	0.66%	1.23%	$123
MLC TTR Vanguard International Shares Index	0.70%	0.66%	1.36%	$136
MLC TTR Accelerated Growth Horizon 7 – Net	2.72%	0.66%	3.38%	$338

Companion documents:
Inside the 3rd Bucket – a generic look at the impact of gearing
Investing through BL&A
Fees and Ongoing Service