



SELECTING THE CORRECT “THREE BUCKET” COLONIAL FIRSTCHOICE WHOLESALE ALLOCATED PENSION FUND

A comparison of Colonial Wholesale 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 utilise internal gearing or not. Under the BL&A model, our 3rd bucket options incorporate funds which offer:

1. no internal gearing; and
2. 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

Colonial 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).

Colonial FirstChoice provides index share funds, for both Australian and international shares. The funds that we would use within this category are:

| | |
|--|------------|
| Colonial First State Wholesale Index Australian Share | 50% |
| Colonial First State Wholesale Index Global Share | 50% |

Being *index funds*, there is virtually nothing to separate them, in terms of performance, from any other broader index fund. The global index fund does not 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

Colonial funds with internal gearing

The Colonial FirstChoice fund offers seven different geared share funds, however only two of these are currently recommended. It is generally our approach to

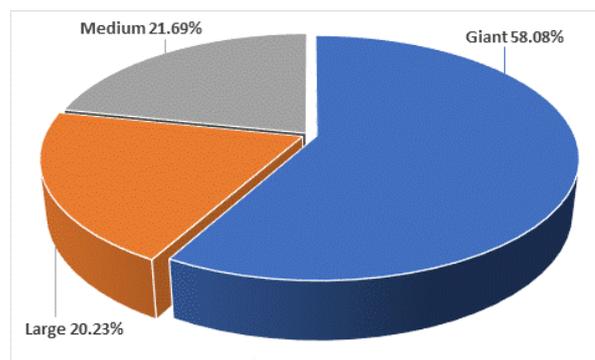
make up a “Colonial Third Bucket Portfolio” by investing two thirds in Australian shares and one third in Global shares.

Category Two (a) - First Sentier Wholesale Geared Share Fund

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 utilize 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 exposure to small companies.

This is seen in the graph below.



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% |

Category Two (b) - The Acadian Wholesale Geared Global Equity Fund

There are three major points to note about this fund.

The Acadian Wholesale Geared Global Equity Fund has a target gearing ratio of 55%. In line with the comments made in the document titled *Inside the 3rd Bucket – a generic look at the impact of gearing*, this will mean that the Acadian Geared Global Equity Fund will have greater short-term volatility but offer the possibility of greater long-term returns.

Secondly, the fund is a bottom up/quantitative research manager. A manager of this style will use technology to monitor the performance of up to 20,000 stocks worldwide and select stocks based on their respective value against other stocks within that sector and country. This means that the portfolio will not necessarily hover around the world index, but will construct a portfolio based purely on “where the best companies are”.

Finally, this fund will not look to hedge the investor's funds against currency risk (the movement of the \$A against the currencies in which the shares are owned) however, the fund may hedge up to 100% of the currency exposure for the borrowed funds.

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

| | |
|----------------------------------|---------------|
| Microsoft Corporation | 4.54% |
| Apple Inc | 3.95% |
| Amazon.com Inc | 3.66% |
| Alphabet Inc—Class A | 3.46% |
| Facebook Inc—Class B | 2.54% |
| JP Morgan Chase & Co | 2.40% |
| Berkshire Hathaway Inc - Class B | 2.27% |
| Home Depot Inc | 2.06% |
| Johnson & Johnson | 1.95% |
| PPG Industries Inc | 1.66% |
| Total | 28.49% |

COMBINING THE COLONIAL OPTIONS TO PRODUCE A GEARED 'COLONIAL 3RD BUCKET' PORTFOLIO'

The two Colonial options, outlined previously, can be taken in isolation or combined to provide additional diversification. It is always debatable as to what is the correct mix between Australian and international shares, however we feel comfortable in recommending the following combination should a client wish to adopt a geared “third bucket portfolio” within the Colonial funds.

First Sentier Wholesale Geared Share Fund **50%**

Acadian Wholesale Geared Global Equity Fund **50%**

This mix would provide an overall level of gearing of approximately 50%. It must be stressed that this mix between Australian and global shares is not set in concrete, and will vary depending on tactical asset shifts.

ADJUSTING THE GEARING LEVEL OF YOUR 'COLONIAL 3RD BUCKET PORTFOLIO'

You may also use a combination of non-gearred and geared options to adjust your level of gearing.

Bucket 3 – recommended Australian share options (non-gearred and geared)

- Colonial First State Wholesale Index Australian Share (non-gearred)
- First Sentier Wholesale Geared Share Fund

COMBINING THE COLONIAL OPTIONS TO PRODUCE A GEARED 'COLONIAL 3RD BUCKET' PORTFOLIO'

The two Colonial options, outlined previously, can be taken in isolation or combined to provide additional diversification. It is always debatable as to what is the correct mix between Australian and international shares, however we feel comfortable in recommending the following combination should a client wish to adopt a geared "third bucket portfolio" within the Colonial funds.

| | |
|--|------------|
| First Sentier Wholesale Geared Share Fund | 50% |
| Acadian Wholesale Geared Global Equity Fund | 50% |

This mix would provide an overall level of gearing of approximately 50%. It must be stressed that this mix between Australian and global shares is not set in concrete, and will vary depending on tactical asset shifts.

ADJUSTING THE GEARING LEVEL OF YOUR 'COLONIAL 3RD BUCKET PORTFOLIO'

You may also use a combination of non-gearred and geared options to adjust your level of gearing.

Bucket 3 – recommended Australian share options (non-gearred and geared)

- Colonial First State Wholesale Index Australian Share (non-gearred)
- First Sentier Wholesale Geared Share Fund

Bucket 3 – recommended international share options (non-gearred and geared)

- Colonial First State Wholesale Index Global Share (non-gearred)
- Acadian Wholesale Geared Global Equity Fund

The choice of gearing in the 3rd bucket is not black or white (that is, to be geared or not geared). Investors can choose to use geared and non-gearred bucket three fund options to obtain a tailored level of gearing.

For example, if the investor selected an even distribution across the above 4 funds, the 3rd bucket would have approximately 34% of gearing which lies some way between electing (all) geared or (all) non-gearred options. 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".

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

For further information on this, refer to the document titled *Inside the 3rd Bucket – a generic look at the impact of gearing*.

1ST AND 2ND BUCKETS

In the past, the investment strategy and performance of the first and second buckets have generally not differed greatly from fund to fund. It is for this reason that we have recommend the fund be selected on the basis of the third bucket, with the funds for the first and second buckets merely “going along for the ride”. With an environment of very low interest rates, some Bucket 2 “diversified” funds have moved to a higher level of growth assets. This gives the opportunity to further tweak your portfolio to enhance returns albeit at the “cost” of a higher risk level.

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

| Buckets | Colonial FirstChoice Funds |
|---------|---|
| 1st | FirstRate Wholesale Saver (100%) |
| 2nd | Colonial First State Wholesale Index Diversified; and/or Colonial First State Wholesale Index Growth |

In accordance with our bucket approach, the 1st bucket must be 100% conservative as this is the part of the fund from which any payments will come. 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 Colonial First State Wholesale Index Diversified fund has a traditional diversified fund mix of 50% growth assets and 50% defensive assets. The Colonial First State Wholesale Index Growth fund has a mix of about 80% growth assets and 20% defensive.

The growth assets of these funds are predominantly shares. 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.

COLONIAL FIRSTCHOICE WHOLESALE ALLOCATED 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 fee will be.

| Investment option | Admin Fees (pa) | ICR | Invest Fees (pa) | Total Management Fees (pa) | Cost (pa) \$10,000 Invested |
|---|-----------------|-------|------------------|----------------------------|-----------------------------|
| FirstRate Wholesale Saver | 0.35% | Nil | Nil | 0.35% | \$35 |
| Colonial First State Wholesale Index Diversified | 0.20% | 0.18% | 0.14% | 0.52% | \$52 |
| Colonial First State Wholesale Index Growth | 0.20% | 0.22% | 0.14% | 0.56% | \$56 |
| Colonial First State Wholesale Index Aust. Share | 0.20% | 0.00% | 0.14% | 0.34% | \$34 |
| Colonial First State Wholesale Index Global Share | 0.20% | 0.00% | 0.15% | 0.35% | \$35 |
| First Sentier Wholesale Geared Share – net | 0.20% | 0.36% | 2.02% | 2.58% | \$258 |
| – gross | 0.09% | 0.17% | 0.96% | 1.22% | |
| Acadian Wholesale Geared Global Equity – net | 0.20% | 0.56% | 2.53% | 3.29% | \$329 |
| – gross | 0.09% | 0.25% | 1.15% | 1.49% | |

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

IMPACT OF GEARING ON FEES

In order to compare “apples to apples”, the gross total fees percentages shown above relate to the fees charged against the client’s own investment and the borrowed funds.

For example, if there was no gearing in the First Sentier Wholesale Geared Share fund, the cost would be 1.22% or \$122 for \$10,000 invested. With the estimated \$11,148 borrowed, the cost is increased by \$136 (1.22% of \$11,148) for a total cost of \$258 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 53%.

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 Colonial First State Wholesale Strategic Cash and FirstRate Wholesale Saver 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. Without the Management Fee rebate, the Management Fee would be \$3,300.

| 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 |

FIRSTRATE SAVER ACCOUNT

From 3 September 2021, Colonial will introduce 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 0.20% p.a. (an increase of 0.10% p.a. on the current rate). The Management Fee is variable and can range from 0.35% to 0.50% p.a.. The interest rate offered is also variable which means 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 table below shows the Buy/Sell spreads for each of the recommended fund options.

For example, a member makes a \$10,000 contribution to the Colonial First State Wholesale Index Diversified option when the unit price is \$10.00. 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 \$10.00, the 1,000 units would be redeemed using the Exit unit price of \$9.99 and the withdrawal amount would be \$9,990 (another \$10 is paid to cover the exit transaction costs).

| Investment option | Buy/Sell Fees | Cost per \$10,000 traded |
|---|------------------------|--------------------------|
| FirstRate Wholesale Saver | Nil/Nil | Nil/Nil |
| Colonial First State Wholesale Index Diversified | 0.10%/0.10% | \$10/\$10 |
| Colonial First State Wholesale Index Growth | 0.10%/0.10% | \$10/\$10 |
| Colonial First State Wholesale Index Aust. Share | 0.05%/0.05% | \$5/\$5 |
| Colonial First State Wholesale Index Global Share | 0.05%/0.05% | \$5/\$5 |
| First Sentier Wholesale Geared Share – net | 0.20-0.50%/0.20-0.50%* | \$20-\$50/\$20-\$50* |
| Acadian Wholesale Geared Global Equity – net | 0.05-0.15%/0.05-0.15%* | \$5-\$15/\$5-\$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 and 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 and is shown in the table below.

| Investment option | Admin Fees (pa) | Adviser Service Fee (pa) | Total Admin/ Adviser Service Fee (pa) | Cost (pa) \$10,000 Invested |
|---|-----------------|--------------------------|---------------------------------------|-----------------------------|
| FirstRate Wholesale Saver | 0.35% | 0.66% | 1.01% | \$101 |
| Colonial First State Wholesale Index Diversified | 0.52% | 0.66% | 1.18% | \$118 |
| Colonial First State Wholesale Index Growth | 0.56% | 0.66% | 1.22% | \$122 |
| Colonial First State Wholesale Index Aust. Share | 0.34% | 0.66% | 1.00% | \$100 |
| Colonial First State Wholesale Index Global Share | 0.35% | 0.66% | 1.01% | \$101 |
| First Sentier Wholesale Geared Share – net | 2.58% | 0.66% | 3.24% | \$324 |
| Acadian Wholesale Geared Global Equity – net | 3.29% | 0.66% | 3.95% | \$395 |

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

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