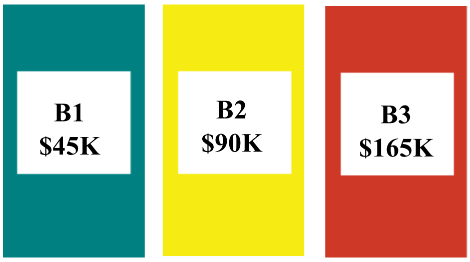
THE HARVEST PROGRAM

Clients of BL&A will be familiar with the use of the 3 buckets. In general, the client's investment is divided into three different 'buckets', with the 1st (B1) being a short term investment strategy and buckets 2 (B2) and 3 (B3) invested in accordance with medium and long term investment strategies respectively. In doing this, each bucket is invested in line with a consumption timeframe, with money to be consumed in the short term (1-3 years) kept in the conservative investment of B1. Funds for medium term consumption (4-7 years) are held in B2 and long term funds (8 years and beyond) are held in B3. This is seen in the example below:

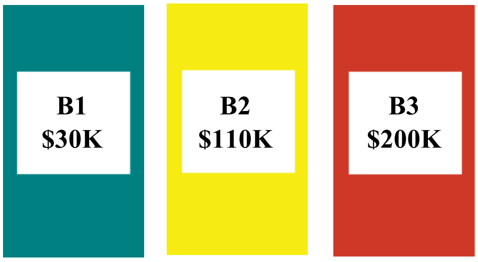


In the example above, the $300K investment has been apportioned on a 15/30/55 ratio between the three buckets. This is based on the idea that the individual will withdraw $45K over the next 3 years (being $15K annual pension payments only) and $90K over the following four years ($15K annual pension payments and a $30K lump sum withdrawal).

By separating the investments, we know that each of the 3 buckets will behave differently from that time forward. We know that B1 will start to run down, as this is the bucket where pension payments and other withdrawals will come from. If this $300K was an allocated pension for someone in the 65-74 age category, then B1 will have to make a minimum pension payment of $15K per financial year (5% of the balance). This will come entirely from B1, leaving B2 and B3 to simply compound with earnings/ growth.

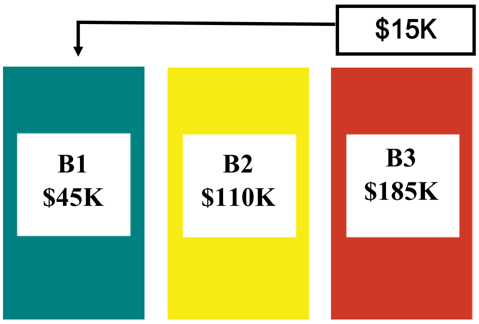
If we fast-forward a year, the reality is that the balances of the respective buckets will have changed, with pension payments and/or withdrawals reducing B1 and B2/B3 moving up or down in line with the investment markets.

In this example we will assume that markets have been positive and the three buckets now look as follows:



From here we have a number of options as to how to deal with these gains.

The logical first step is to harvest the gains from B2 or B3 to top back up B1. As this is a rolling program, we must always try and ensure that there are sufficient funds in B1 to cover the next 3 years of consumption. So, as B1 runs down with withdrawals and pension payments, it is logical to harvest the gains (in this case) from B3 and top up B1. This is seen below, where B3 is reduced by $15K (from $200K to $185K) and B1 increased by the same amount (from $30K to $45K).

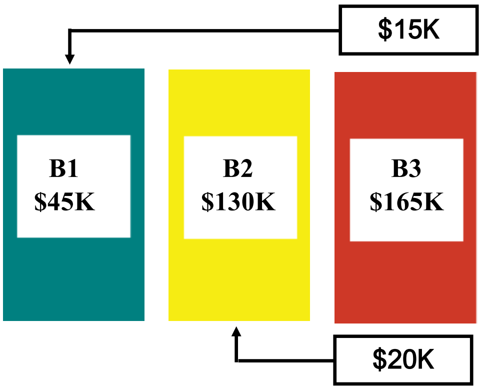


This is the essence of *the harvest program*. It would be inappropriate to let B2 or B3 grow indefinitely, while B1 runs down to nothing. As no one ever knows when the music will stop (and share markets subsequently turn negative), it is always best to harvest the gains as they come along, just in case things turn sour sooner rather than later. Additionally, if we do not manually harvest the gains from B2/B3, the portfolio will become more aggressive as B1 falls and B2/B3 rise.

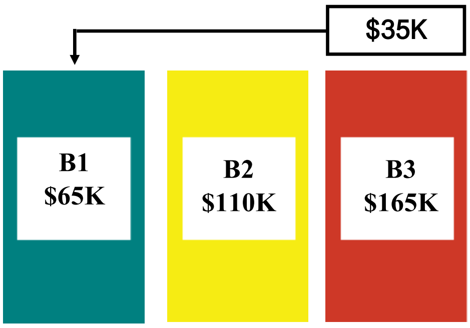
It is also logical to try and harvest these gains in smaller chunks. Rather than wait for B1 to fall by 33% (as in this example) before moving gains across from B3, it makes sense to keep B1 topped up as soon as a shortfall occurs, as long as there are also gains in B2 or B3. It is for this reason BL&A asks clients to consider signing a 'switch form' that can be re-used for multiple switches. This re-usable switch form enables us to harvest gains from B2 and B3, to top up B1, as soon as the opportunity arises.

The harvest program can however be taken much further than this example and can produce a variety of outcomes. This is shown in the scenarios below.

In this scenario, the $35K of gains in B3 have all been harvested, even though it was only really necessary to take $15K of the $30K gains to top up B1. The first $15K used to top up the shortfall in B1 and the remaining $20K was moved to B2, giving it a surplus.



This approach has been popular with our more risk-averse clients, who are keen on not allowing B3 (which is the most volatile part of the portfolio) to simply compound away and become a more dominant part of the portfolio.



If markets turn south, then this investor is limiting the scope of future losses as they are never allowing B3 to get larger than it started out.

An extension of this strategy is shown above, where all the $35K gains from B3 are harvested into B1, rather than being split between B1 and B2. Although working on the same concept as the earlier strategy (moving gains out of B3 before the market has a chance to take them away), this approach allows an additional layer of conservatism to the portfolio. In this case B1 only needed to be topped up to $45K, but it now has $65K in it, or a surplus of $20K. Knowing that B1 is completely immune to share market movement (as it is cash based), where B2 still has some market exposure, this is the ultimate safe bet. The downside of this strategy is that if markets continue to be positive, this surplus in B1 will not benefit from market gains, whereas B2 would have experienced some of these gains.

There is no right or wrong with this. Every investor is going to have a different approach, based on what their investment objective is.

To try and summarise the different harvest options we would suggest:

OPTION 1

Only take gains from B3 to cover a shortfall in B1 or B2. If gains in B3 exceed this, let these gains continue to compound in B3. Generally speaking, a shortfall in B1 or B2 is likely to occur under four different circumstances:

1. pension payments reduce the B1 balance to the point where it no longer contains sufficient funds to cover the next 3 years of consumption;

2. the client makes a lump sum withdrawal from B1, reducing its balance to the point where it no longer contains sufficient funds to cover the next 3 years of consumption;

3. the client sends a new wish list identifying an increased 'wish list' amount within the B1 timeframe; or

4. the overall value of the portfolio has increased significantly, meaning the pension payments for the next 3 years will be higher than they were previously estimated (as pension payments are reset annually based on the fund balance at 1 July each year).

OPTION 2

As gains continue in B3, harvest 100% of them regardless of whether there is a shortfall in B1 and B2. These gains can be placed directly into B1 or B2, or could be spread between them on an agreed basis (for example 50% into B1 and 50% into B2).

OPTION 3

As gains continue in B3, harvest a percentage of them (e.g., 25%, 50% etc.), regardless of whether there is a shortfall in B1 and B2. These harvested gains can then be placed directly into B1 or B2, or could be spread between them on an agreed basis (for example 50% into B1 and 50% into B2).

With both options 2 and 3, our priority will always be to address any shortfall in B1 first. even if a client indicates that they wish to harvest 100% of gains in B3 back to B2, we will only harvest the gains to B2 as long as there is no deficit in B1, ensuring that B1 is always topped up, as these will be the funds consumed first.

In implementing *the harvest program*, it is important for us to understand what your objectives are going forward.

The options above are merely a starting point and there are many permutations of them available. Clearly we will try and ensure that our harvesting arrangements are done in accordance with your desired portfolio objectives. This will also include identifying the points at which future harvests will take place (for example, every time B3 puts on $10K or $20K in gains).

To remain in *the harvest program*, we ask that each client sign a switch form, which can be used to facilitate the switches between the buckets. Depending on the switch point that is used (for example every time that B3 puts on $10K in gains), it may be that we end up doing multiple switches over a very short timeframe. The share market often goes through short, sharp periods of gains, meaning that some clients need 6-7 switches to take place over a very short timeframe.

The switch form is generic to the extent that it does not specify (up front), which investment option the harvesting will occur from. This is something that cannot be decided in advance, as it depends on the investment options used by each client and where the gains have taken place.

For example, it may well be that the portfolio in this example is spread between two different fund managers. Fund Manager A may have experienced all of the gains shown above while Fund Manager B has experienced none. In this situation we would use our discretion to harvest the gains only from Fund Manager A. Even within Fund Manager A, B3 may be divided (for example) between one Australian share fund and one Global share fund.

Again, it is possible that the gains in B3 have not been evenly achieved between the two investment options. If the Global share fund has experienced greater gains than the Australian share fund, then logically we would harvest more from this investment option.

If a client nominates option 2 or 3, it will also be important to set a level at which gains should take place, before such a switch is made. If this level is set too low, then switches could (in times of rising markets) be occurring every day. On the other hand, if the trigger is set at too high a level, we may miss out on the opportunity to get gains before the market has a chance to take them away.

For example, a client may wish that gains be taken every time their combined 3rd bucket grows by $10K. For a client with a combined 3rd bucket of $100,000, it will require the market to move by 10% before we make any switches. We would suggest that this is too high and a target of maybe $3-$5K is more appropriate.

For the client with a combined 3rd bucket of $1 million, then a $10K increase in this would only require a market movement of only 1%. We would suggest this is probably too low and would suggest that switches take place after gains of $30-$50K in B3. Unless you expect a preference otherwise, we will generally look at gains in the 3-5% range.

It is important to appreciate that your position here is flexible. You may change choices at any stage and we will continue to review the portfolio.