Regional Financial Planning Investment Philosophy

Version Number: 2

Dated: 19th March 2018

RFPCQ Pty Ltd ABN 67 122 988 916, RFPNQ Pty Ltd 69 101 628 755, RFPSQ Pty Ltd ABN 78 169 27 020, RFPLW Pty Ltd 61 123 530 245 trading as Regional Financial Planning and Mining Insurance Services Pty Ltd ABN 76 151 091 879 Authorised Representative of Apogee Financial Planning Limited ABN 28 056 426 932, Australian Financial Services Licensee, 105-153 Miller Street North Sydney NSW 2060.

Introduction:

A major part of what we do at Regional Financial Planning is investing clients' money. Yes, we spend a lot of time on tax strategy, asset protection, estate planning and client structuring - things that can be termed "traditional financial planning" - but the investment of accumulated assets remains central to helping clients achieve their financial objectives. In the past we have spent a lot of time educating our clients about investing – how we invest, what we believe and particularly how we as a firm add value through this process. However, until now we haven't formalised or documented this process. This investment philosophy attempts to do just that - formalise our investment beliefs (and provide some evidence to them).

It's important to understand that not every wealth management business shares these beliefs. There are numerous varied methodologies to manage money and we constantly spend our time as investment advisers looking at things that can improve our process in the way we manage money. Having clients who truly understand the way we invest is also vital, after all there is little point in trying to follow a strategy of patient investing if clients panic at just the wrong moment.

At Regional Financial Planning we tailor individual solutions for every client in recognition of the fact that every client is different and has particular investment needs. However, every tailored solution is built on a solid investment framework and set of core beliefs. For us, successful investing is about getting the big decisions right which means making sure clients are invested in the correct asset classes and that they are invested in an efficient manner that ensures they capture the returns that each respective asset class provides.

At Regional Financial Planning we don't speculate with clients' money. We don't use options, futures, derivatives or complicated products. All of the investment managers and asset consultants we use are solid, trusted and respected organisations our clients will be familiar with. For us to move away from this approach would introduce a level of risk we don't think our clients would be compensated for.

We write this document with the hope that our existing clients and potential clients will better understand how we manage money, how we are different from the mainstream institutions and the value of this approach. As we outlined above this document is by no means static and we encourage clients to challenge our business on any of the decisions set out in this document because we find that only by continually challenging and evolving this investment process are we able to produce the best results for clients.

Our Investment Philosophy:

- Trust the **experts**
- **Diversify** – don't put all your eggs in one basket
- Investment is **NOT** speculation
- **Invest for income** NOT for capital gain
- Investing in **productive enterprise** is the best way to grow wealth
- There is **no "one size fits all"**

These beliefs form the core of our approach and are important for you to understand.

Belief 1: Trust the experts

Many investors spend a great deal of time selecting and managing their own portfolios rather than using the skills of investment experts. Often there is a cost of trying to pick your own portfolios. A US study by research group Dalbar found that over a 20 year period ending 2005 the US share index (S&P 500) returned 12.98%p.a. This outperformed the average investor by almost 10%p.a. as they received only 3%p.a. That's the same as turning $100,000 into $180,000 as opposed to $1.3million – or a difference of almost $1million over 20 years!

Experts can avoid the mistakes that lead investors to get this result because they don't get caught up in the emotion of investing which often drive the bad decisions made by investors. Also, with literally thousands of investment choices available in Australia it requires an enormous amount of research and detailed analysis to identify excellent managers, blend them together and undertake ongoing monitoring and change.

Belief 2: Diversification – don't put all your eggs in one basket

Diversification is a genuine way of reducing uncertainty in your portfolio by spreading investments and not taking a concentrated approach. Whilst most people understand and accept the concept of not putting "all your eggs in one basket" many do not implement it in their investment portfolio. At Regional Financial Planning we look to diversify in many ways:

- Across multiple asset classes;
- Across multiple investment managers;
- Across multiple securities.

This has the effect of reducing overall risk and lessens the impact that any single event can have on your portfolio. A well-diversified portfolio can offer a much smoother pattern of returns and reduces the "roller coaster" ride.

Combining managers reduces volatility

Excess returns versus the S&P/ASX300 (All Ords before April 2000).
Rolling 12 month periods – July 1996 to September 2005 (monthly)

Source: Mercers Investment Consulting

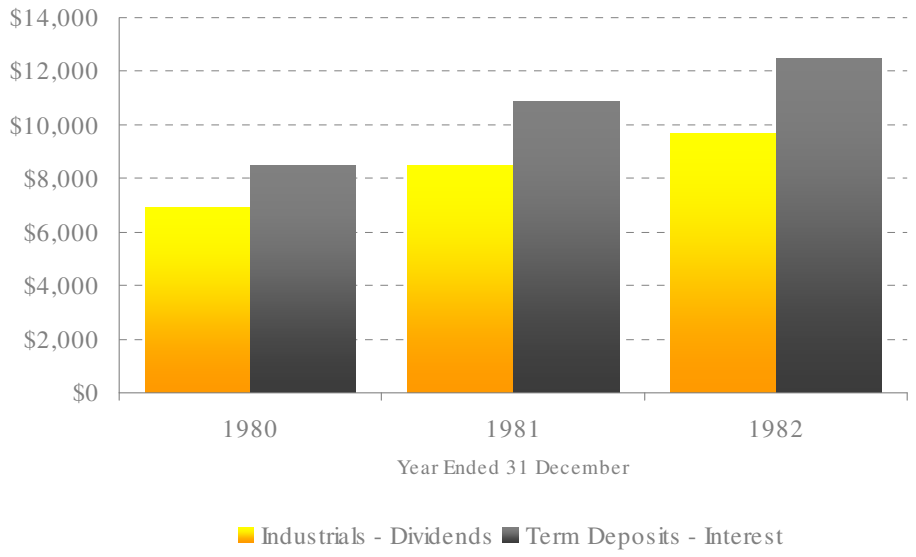
Belief 3: Investment is NOT speculation

Successful investing is a long-term process. Wikipedia defines investment as "the dedication of resources or assets to creating financial benefits in the form of income or profit in the future." In contrast it defines speculation as "the purchase of an asset with the expectation that the asset will increase in value".

At Regional Financial Planning we invest our clients' money – we don't speculate with it.

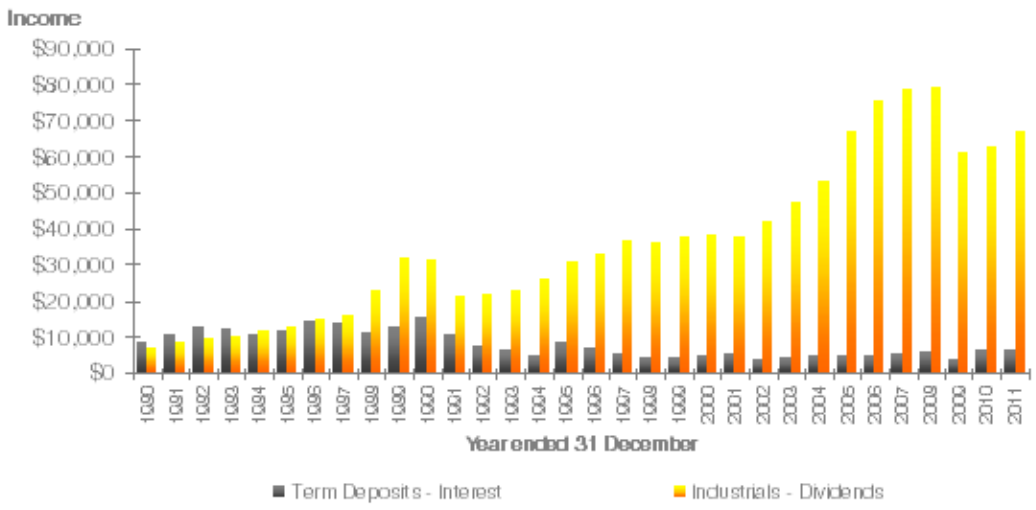
The chart below shows the income of two different asset classes (industrial stocks and cash) for a client investing $100,000 in 1979. **If we were to show this chart to client's which asset class will the majority of clients choose to invest in?**

Chart 1.0 - Income from two asset classes over 3 years



Answer: The Term Deposits or cash asset class because in the short term it has the higher income. However, once we show clients the same chart on a long-term view which do clients choose?

Chart 2.0 Income of two asset classes over 21 years



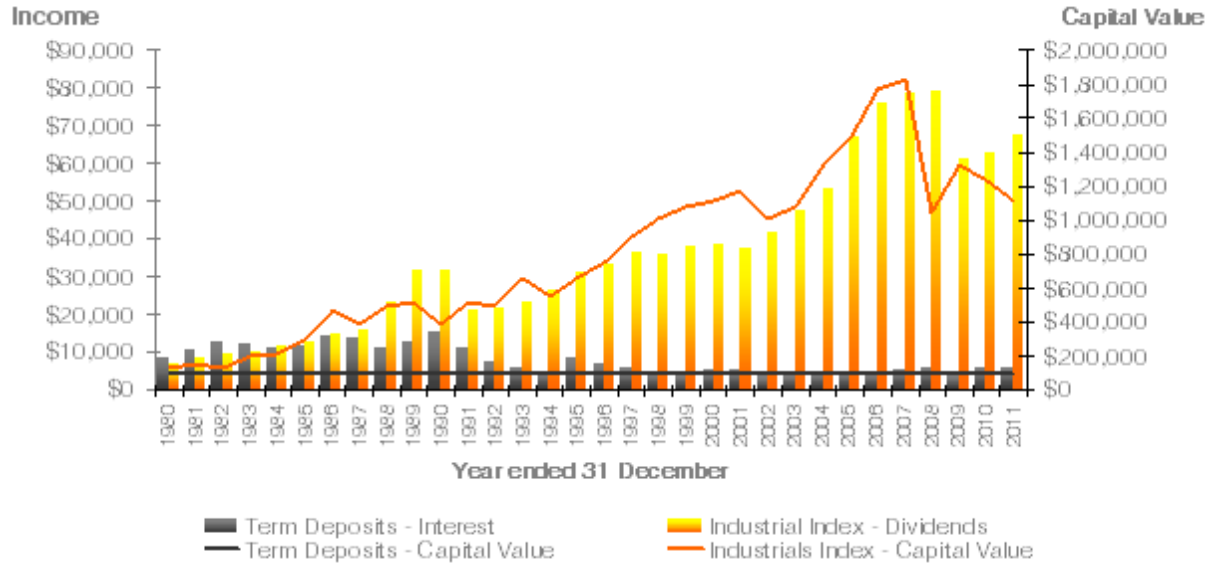
They choose the industrial shares.

Our value proposition when investing clients' money is to help clients understand the timeframes that they should be investing for and to help them select the correct asset class to fund this investment timeframe. The value of this advice over time is clear from the chart. The client that invested their $100,000 into Term Deposits in 1979 generated an income in 2011 of roughly $7,000. The client that invested their money into the industrial shares generated an income of $70,000.

Belief 4: Invest for income NOT for capital growth

One of the reasons I feel many clients and investors generally start to speculate and fail to achieve the obvious benefits in long term investing shown above is that they focus on the short term movements in **capital value** rather than the long term accumulation of passive **income** from investing. The following chart shows is the same comparison as above but with the capital values of the $100,000 added.

Chart 3.0 - Income and Growth of two asset classes over 21 years.



There are 3 key take-outs from this chart:

Point 1: Over the long term a higher return on the shares has grown $100,000 in 1979 to just over $1.1million at December 31 2011 while the "term deposit investor" still has only $100,000 (remember for both asset classes we are assuming the investors "live off" and spend the income each year rather than compound it for growth).

Point 2: Particularly relevant for 2011; Is that the capital value moves up and down at times whereas the term deposit doesn't. This "volatility" can cause great angst for clients in the short term and there is very little an investor can do about it. We certainly don't think we / any clients / any professional fund managers have the ability to "time the markets" to mitigate these fluctuations in capital value that ***do and will continue to occur over time***. One of my famous sayings to my clients is that if you invest in shares I will guarantee you will get a negative annual return in your portfolio when investing with me (on average 20% of the time or once every 5 years).

Point 3: While clients do worry about the "risks" of point 2, I highlight to clients a bigger risk than volatility that is the risk of not investing – longevity risk. The *"**risk**"* I see in "investing" in term deposits is the risk of ***totally eroding the purchasing power of money***. Yes, there has never been a negative yearly return on term deposits but over that time the VALUE of your $100,000 (that could in 1979 buy you a very nice house) is nearly fully eroded through inflation (and now would struggle to buy a block of land 50km from the city).

By investing for income and not capital growth we believe our clients are less likely to panic and sell down when they experience negative capital growth. We believe a big part of investing is simply avoiding the mistakes that the large majority of investors make. There have been many behavioural finance studies showing that without advice investors will consistently make mistakes which cause their portfolios to perform poorly. The Financial Research Corporation released a study prior to the 2001-2 bear market which showed that the average mutual funds three year return was 10.92% while the average investor in those same periods gained only 8.7%. The reasons were simple: investors were chasing the hot sectors and funds and secondly without advice, clients always buy high and sell low.

Belief 5: Investing in productive enterprise (businesses through shares) is the best way to grow wealth over the long term.

One of the things I often get asked from clients is "why do the income bars in the above example grow over time for shares and why are you certain this will happen in the future?". The best way to explain this is to show a client a very simple example of how an industrial business model works using a lemonade stand as an example.

Chart 4.0 Business Model of an industrial company

Year	Business Assets	Profit (R.O.E)	Dividend	Retained Earnings
1	100.00	10.00	5.00	5.00
2	105.00	10.50	5.25	5.25
3	110.25	11.00	5.50	5.50
4	115.75	11.60	5.80	5.80
5	121.55	12.20	6.10	6.10
6	127.65	12.80	6.40	6.40
7	134.05			

To start the business $100.00 of working capital is raised from shareholders (column 1). Shareholders will only provide capital if they believe a company will earn a return on their money – in this instance the business plan projects a 10% "return on equity" (ROE). With the $100 invested the company begins making and selling lemonade at a weekend market.

After year 1 the company meets its forecast and a $10 profit is made ($100 x 10% ROE). The shareholders require their "share" of this profit (through a paid dividend) and in this instance this "share" (called the dividend payout ratio) is set at 50%. Therefore, in year 1 the company pays a $5.00 dividend (column 3) to shareholders. The balance of $5.00 is reinvested back into the company as retained earnings (column 4).

We start year 2 with $105, the original capital of $100 plus the retained earnings of $5.00 from year 1. A 10.00% return on $105 equals $10.50 and if we again pay half, $5.25 and retain the other half to reinvest back into the business we start year 3 with $110.25. The chart now becomes self-explanatory, 10.00% return on asset base, half of this amount paid out, half retained and reinvested in the business.

Notice the similarity of the figures in column 3 with the dividend bars in the previous chart. Note also, the increasing value of the company and the similarity with the value line in the previous chart. The reinvestment of retained earnings back into the business is the reason we feel confident that both income (dividends) and the capital base (reflected in share prices) rise over time.

Belief 6: There is no "one size fits all"

While the above clearly shows our long-term belief that investing in industrial equities and living off the dividends is our preferred investment approach, by no means does this mean we exclude other asset classes or approaches to mitigate the "share price volatility" which clearly exists with this approach.

For many clients "volatility" is something that they have to worry about. There is no point investing all one's assets into an under-priced share-market if clients need the funds within the year. John Maynard Keynes quote "the share-market can stay irrational longer than you can stay solvent" rings true.

Volatility is particularly important for our retiree clients that are drawing down on their capital. For these clients it is through our advisers structuring the overall portfolio along the lines of time horizon diversification i.e. splitting your wealth according to short, medium and long-term horizons that we seek to mitigate the problem of drawing down on growth assets (long term capital) to fund short term liabilities (pension payments).

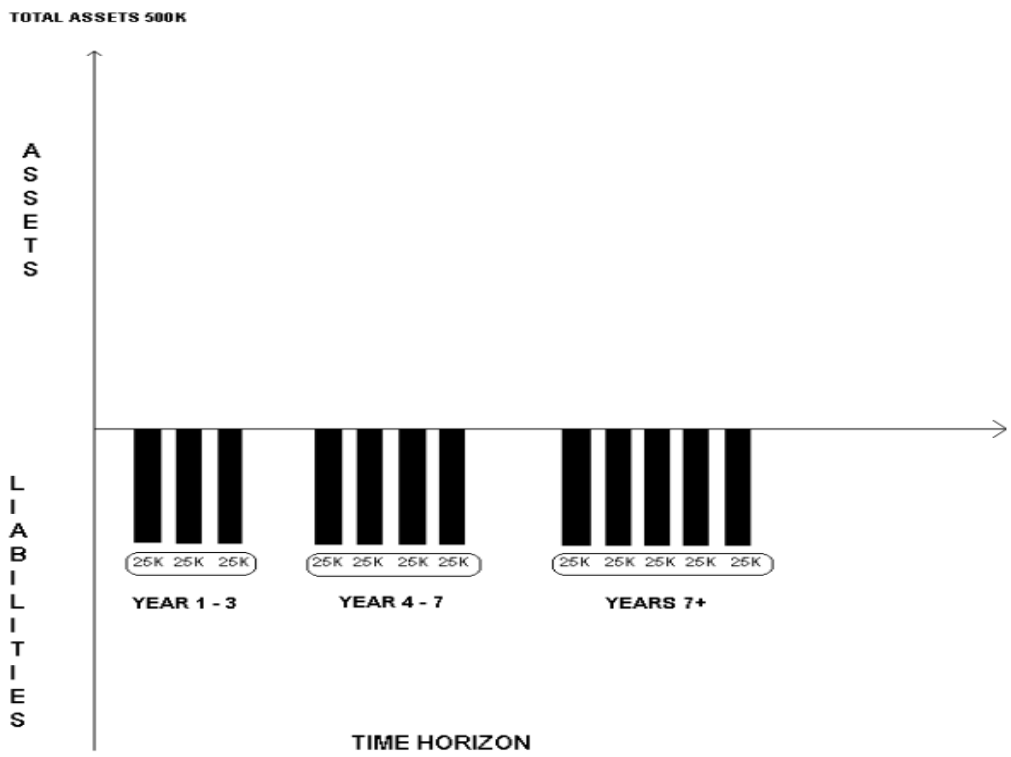
Portfolio Construction Process - Implementation

Having an investment philosophy is one thing – implementing it within our practice and for our clients is another and this is what we at Regional Financial Planning pride ourselves upon. The following step by step process shows you how we go about ensuring this. It also gives you an insight into the depth of work that Regional Financial Planning does behind the scenes that you may not be aware of.

Step 1: Understand Client Current Balance Sheet and Future Goals / Objectives and Needs:

The first step in constructing a client's portfolio is for us to understand your current balance sheet (asset and liability) profile and specific risk tolerances you may have. While this sounds complicated, it's not. We find that once we understand and can model your lifestyle requirements we are able to project the long-term mix and growth of portfolio liabilities. The following graph highlights a 'Retirement Income' portfolio liability scenario as an example.

Graph 5.0 - The asset and liability profile of a typical client



The above example shows a client that requires an annual pension payment of $25,000 with a current balance of $500,000.

Step 2: Formulate asset allocation and ensure risk profile is met.

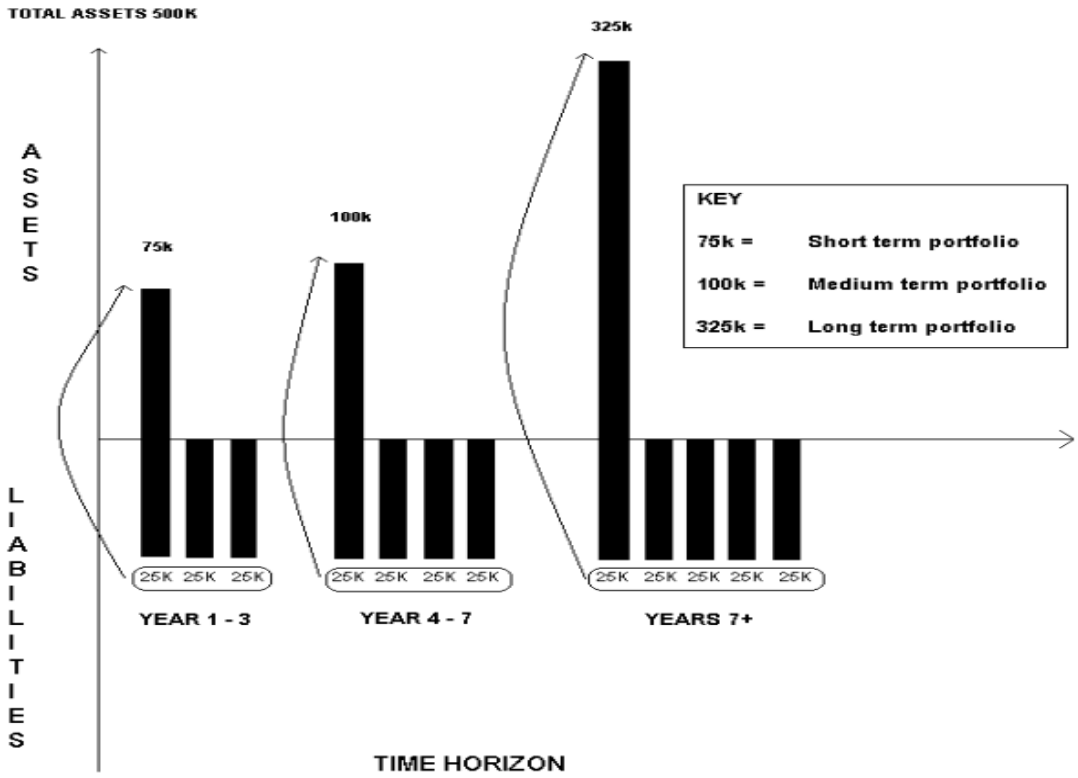
Once we know the pension liability we are trying to fund we then seek to create three distinct portfolios' (short, medium and long term). Each portfolio is specifically designed with the characteristics to fund a different time horizon liability. These portfolios and their characteristics are shown in the table below.

Table 6.0 The time horizon portfolios

Duration Portfolio	Characteristics	Asset Classes
Short Term portfolio (years 1-3)	-Capital Security; -No negative returns over 1-3 years timeframe; - Addresses liquidity risk	- Cash Reserve - Term Deposits - Diversified Fixed Interest
Medium Term portfolio (years 4-7)	-Moderate volatility -Low chance of negative returns over 4-7 year period; -Diversification benefits; -Some protection in falling markets;	- Diversified Balanced Fund
Long Term portfolio (7+)	-Highest returning portfolio;	- Australian Shares - Global Shares - Property

In the example above $75,000 would be allocated to the short term portfolio, $100,000 to the medium term portfolio and $325,000 to the long term portfolio.

Table 7.0 Asset and Liability Profile of typical client with time horizon portfolios



Rather than have clients continually draw down on their growth assets every pension – which they do in any balanced fund (industry fund or corporate fund) we effectively segregate clients wealth according to needs and time horizon.

Step 3: Portfolio Construction:

Once we know your tailored portfolio mix, we then determine how to implement these portfolio's through portfolio construction. The primary decision driver for the options below is the level of client's assets and the level of service we believe can add value to their position. That is not to say that smaller clients wouldn't benefit from a tailored strategy but the reality is the time required of an adviser to affect the strategy and the cost associated with this would outweigh the benefits. In these instances, cost is the key driver.

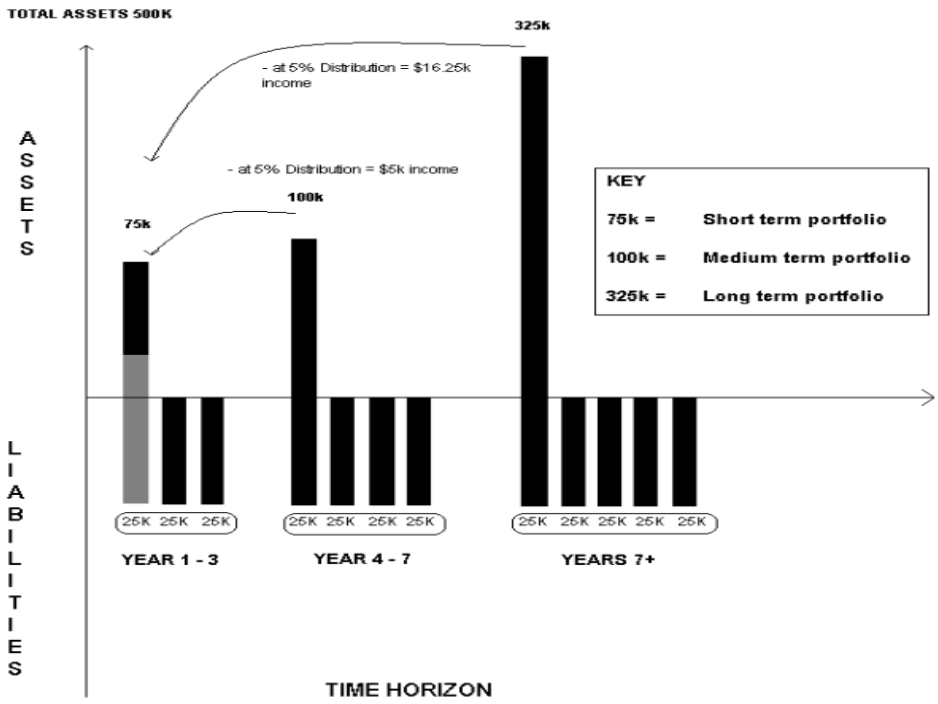
Table 8.0 Implementation options

Asset Class	Option 1	Option 2	Option 3
Strategy	Professionally Managed	Core and Satellite	Self-Managed
Platform	MasterKey	MLC Wrap	SMSF
Suggested FUM level	< $500,000	$500,000+	$500,000+
Short Term Liabilities	Defensive Multi-Manager Fund	Cash Term Deposit	Cash Management Account
Medium Term Liabilities	Balanced Multi-Manager Fund	Bespoke Wholesale funds	nil
Long Term Liabilities	Growth Multi-Manager Fund with Single manager fund Satellites	Constructed Bespoke Model portfolio and SMA	Direct Portfolio or SMA

Step 4: Ongoing Monitoring and Rebalancing:

It is very important for clients to understand that unlike investing in a "set and forget" balanced fund yearly reviews are critical. This is because the strategy and portfolio mixes should be rebalanced each year. Without regular reviews and rebalancing the portfolio can quickly become overly growth orientated as pension payments progressively reduce defensive assets.

Table 11.0 Annual review of clients position and rebalancing



Regional Financial Planning are a professional advice firm that run a fee for advice practice. Part of our value proposition to clients is to ensure these reviews are conducted and this is what our ongoing adviser service fee is for.

In addition to rebalancing the portfolios and re-weighting the tiers all portfolios we use are reviewed on a regular basis by an internal investment committee with input from leading investment ratings houses and asset consultants. As part of our ongoing service offering we undertake monitoring of the portfolio and of the investment managers within it.