WaveStone
CAPITAL

Case Study: Blending variable beta

Blending a variable beta strategy with a long only fund

To examine the benefits of using a variable beta strategy in a traditional long only portfolio, we undertook an exercise blending the return profile of a variable beta strategy with a traditional long only fund. The research blended the historic monthly return series of the WaveStone Dynamic Australian Equity Fund (a long/short fund) with the Morningstar Median Australian Share Fund (a proxy for a traditional long only portfolio). Both return series were after fees.

The Morningstar Median Australian Share Fund (Median Fund) is the monthly median performance of all the funds in the Morningstar's Australian Share universe. All are measured on an after fee basis.

The analysis shows that blending a long only fund with a variable beta fund will:

- Reduce the portfolio's volatility, without sacrificing upside capture
- Reduce the magnitude of portfolio drawdown in falling markets
- Produce a higher risk adjusted return (as measured by the Sharpe Ratio) than a median long only portfolio.

Net effective exposure of the Dynamic Fund

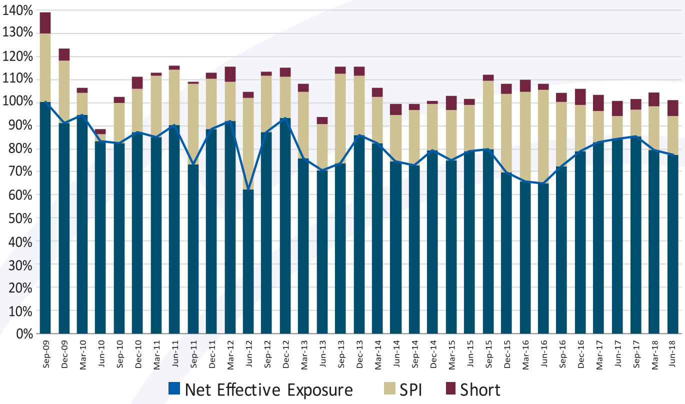
The WaveStone Dynamic Australian Equity Fund, as the name suggests, can vary its exposure to the market. The net effective exposure of the Dynamic Fund will vary depending on market valuation, the number of investment opportunities, interest rates and the outlook for earnings growth. Typically long only strategies will always be fully invested.

Table 1: Strategic Asset Allocation

Strategic Asset Allocation ranges	WaveStone Dynamic Australian Equity Fund	Typical median Long Only Australian Share Fund
Long portfolio	50-150%	90-100%
Cash exposure	0-50%	0-10%
Shorted stocks	0-50%[1]	0%
Derivatives	0-50%	0%
Net effective exposure	50% – 100%, typically 80%	90-100%
No. of long stocks	25-50	30-50
No. of short stocks	0-10	0

Source: WaveStone Capital. [1]PDS allows for a maximum of 100% short securities however the portfolio is managed to a maximum 50%.

Figure 1: Net effective exposure of the WaveStone Dynamic Australian Equity Fund



Source: WaveStone Capital

Since inception the Dynamic Fund has on average held a net effective exposure to 81% of the market. The average long position has been 108%. Shorted stocks and derivatives on average have been -27%.

WaveStone Capital is an Australian active high conviction manager which uses a bottom up approach to investing. The team invests in companies with large, proven business models with an equity market cap of over $350 million. Typically the long portfolio invests in companies which are prudently financed, well managed and have a track record of success. Companies in the short portfolio typically have inferior corporate DNA, and/or face strong industry headwinds and may be over leveraged.

The calculation

To establish the blend, 50% of a hypothetical Australian Equities portfolio was invested in the Dynamic Fund and 50% was invested in the Morningstar Median Fund. The analysis used the monthly total return series for each portfolio since the inception of the Dynamic Fund (July 2009). Both return series are measured on an after fees basis. For the purpose of this theoretical exercise, the portfolio was rebalanced annually, to ensure there was a balanced exposure over the period to the two strategies. Reinvestment of income was assumed given it is a total return time series. Tax and turnover implications were not considered during rebalancing.

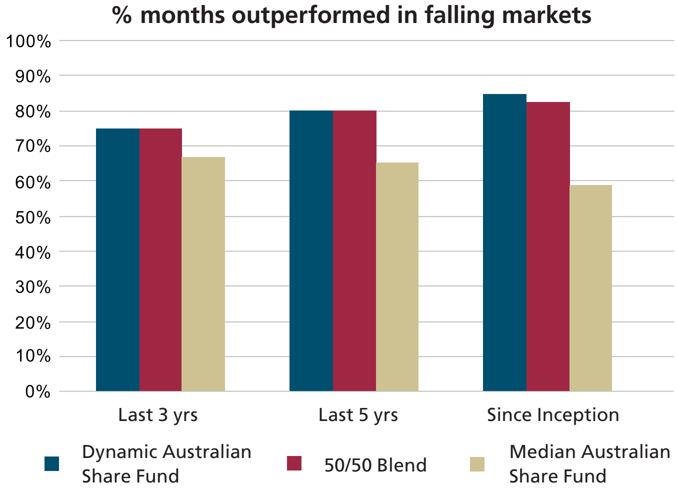
Since 2009, the Median Fund after fees has underperformed the market, approximately by the average fee taken by a long only manager. By blending the Median Fund with the Dynamic Fund (which has outperformed after fees) this will naturally make a blended portfolio appear superior. However, the focus of this analysis is to understand the **benefits of downside protection** a variable strategy can bring to a traditional long only portfolio.

The results

i) Downside capture improves

By blending a long only portfolio with a variable beta approach, the outperformance in falling markets of the Dynamic Fund was strong enough to improve the outperformance of the blended portfolio. As shown in Figure 2 a 50/50 blend outperformed 82% of the time, compared to 59% for the Median Long Only portfolio. This is only marginally below the Dynamic Fund (85%) over that same period. This demonstrates the additional protection a variable beta strategy can bring to a broader portfolio in falling markets.

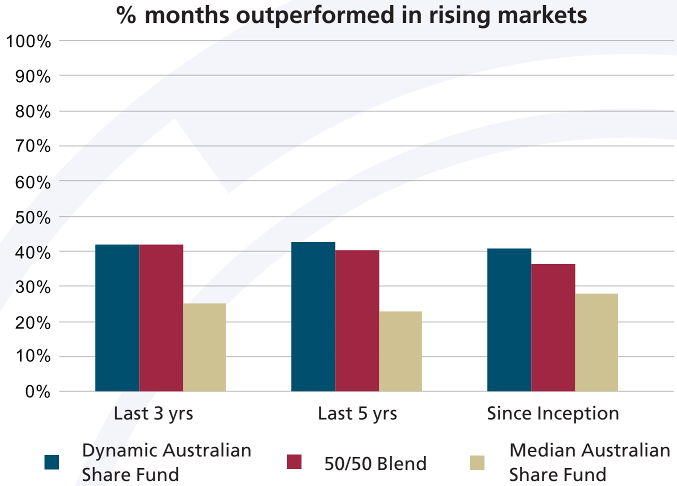
Figure 2: Outperformance ratio in falling markets



Source: WaveStone Capital, Morningstar. Net performance as at 30 June 2018.

In this instance, the outperformance ratio in rising markets also improved for the blended approach as shown in Figure 3. Given the Median Fund since July 2009 has outperformed only 28% of the time in rising markets, the superior stock selection made available via the increased opportunity set on the Dynamic long/short portfolio in this instance improved the outperformance ratio to 36%.

Figure 3: Outperformance ratio in rising markets

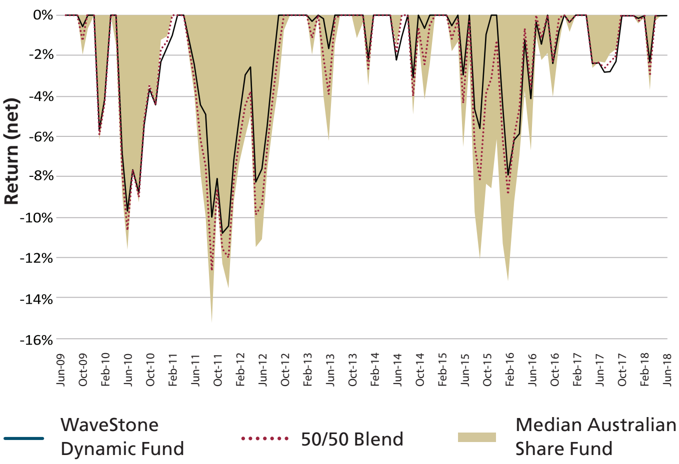


Source: WaveStone Capital, Morningstar. Net performance as at 30 June 2018.

ii) Protection to the magnitude of falls

Analysis of the different strategies during market drawdowns since 2009 demonstrates the benefit a variable beta strategy can bring to a long only portfolio in falling markets. As shown in Figure 4, blending a long only portfolio with a variable beta strategy offers additional protection in terms of the magnitude of falls.

Figure 4: Drawdown analysis



Source: WaveStone Capital, Morningstar. Net performance as at 30 June 2018.

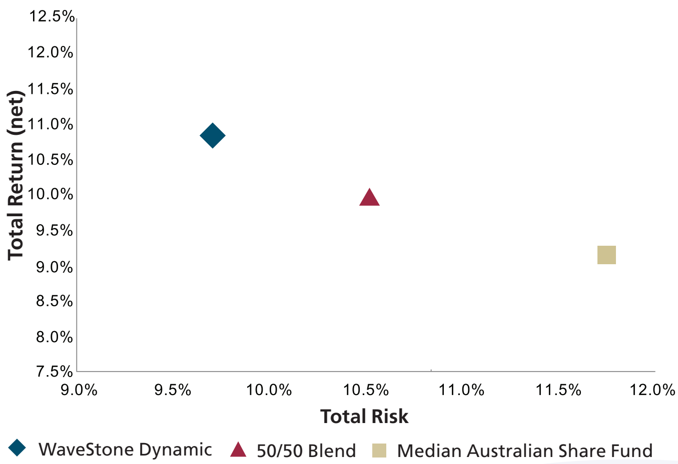
iii) Improved risk-adjusted returns

Figure 5 shows the risk return profile of the blended portfolio. This improves because the volatility of returns reduces when combining a long only fund with a variable beta fund, however not at the expense of performance.

The improved risk adjusted return is also evidenced by the improvement in the Sharpe Ratio in Table 2.

The benefit of a superior risk adjusted return is a smoother ride for all investors. It minimises some level of sequencing risk as the highs and lows will be reduced.

Figure 5: Risk/return profile since inception of the Dynamic Fund (July 2009)



Source: WaveStone Capital, Morningstar. Net performance as at 30 June 2018.

Table 2: Performance statistics after fees

	Dynamic Australian Share Fund	50/50 Blend	Median Australian Share Fund		Dynamic Australian Share Fund	50/50 Blend	Median Australian Share Fund
Historic Total Returns				**Historic Excess Return**			
3 year p.a.	9.0%	8.5%	8.1%	3 year	-0.2%	-0.6%	-1.1%
5 year p.a.	10.4%	9.8%	9.2%	5 year	0.4%	-0.2%	-0.8%
Inception p.a.	10.8%	10.0%	9.1%	Inception p.a.	0.8%	0.0%	-0.9%
Excess Returns (Up markets %)				**Excess Returns (Down markets %)**			
Last 3 yrs	42%	42%	25%	3 year	75%	75%	67%
Last 5 yrs	43%	40%	23%	5 year	80%	80%	65%
Since Inception	41%	36%	28%	Inception p.a.	85%	82%	59%
Excess volatility				**Sharpe Ratio**			
3 year	-1.9%	-1.3%	-0.2%	3 year	0.80	0.70	0.59
5 year	-2.5%	-1.7%	-0.3%	5 year	0.98	0.82	0.66
Inception p.a.	-2.4%	-1.6%	-0.4%	Inception p.a.	0.80	0.65	0.51

Source: WaveStone Capital, Morningstar. Net performance as at 30 June 2018.

Contact us

To find out more about the WaveStone Dynamic Australian Equity Fund, please contact your local **Fidante Partners Business Development Manager** or call the Fidante Partners' Adviser Services Team on **1800 195 853**

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