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Editor : Mr Paul Saliba

Regular contributors :

| | |
|-------------------|----------------------|
| Ms Ana Bennett | Mr Prabath Ekanayake |
| Mr Mark Bennetts | Mr Paul Furlong |
| Mr Ben Bowen | Mr Stuart Graham |
| Mr Scott Dixon | Mr Nathan Haslem |
| Ms Bianca Doering | Mr Paul Mannion |
| Ms Barbara Drury | Mr Paul Saliba |
| Mr James Dunn | Ms Jenny Zielke |

Lachlan Partners' team

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| Mr Greg Layton | Mr Graeme Weidenhofer |
| Mr Thomas Lee | Mr Roger Wilson |
| Mr Eric Maillard | |

Consultant

Mr Donald de Boer

Chief Investment Officer

Mr Paul Saliba

Our Melbourne office

Level 35, 360 Collins Street
 Melbourne Vic 3000
 Phone (03) 9605 9200
 info@lachlanpartners.com.au

Our Brisbane office

Level 5, 49 Sherwood Road
 Toowong Qld 4066
 Phone (07) 3871 0599
 brisbane@lachlanpartners.com.au

Our Sydney office

Level 18, 201 Kent Street
 Sydney NSW 2000
 Phone (02) 9291 2800
 info-syd@lachlanpartners.com.au

www.lachlanpartners.com.au
www.investingtimes.com.au

Newsletter direct line 1300 131 526

Email: newsletter@investingtimes.com.au

WHY THE OLD ZONE SYSTEM HAD TO BE REFINED

by Paul Saliba

The GFC highlighted a fundamental weakness of long term strategic asset allocation - the finance world's name for a fixed weight allocation of investment funds to different investments such as Australian shares, international shares, property, Australian and international fixed interest and cash. Even with tactical tilts, the collapse of 2008/09 left investors with a significantly reduced asset base.

Lachlan Partners, through an acquisition, inherited a thematic quantitative tool previously known as the Zone System. Lachlan Partners recognised that the tool, if implemented well, could achieve outperformance with less severe declines in portfolio values. It was clear from published papers of previous users that the Zone System, although an excellent tool, had not been maximised and Lachlan Partners took the opportunity to take the Zone System to the next level.

The Zone System has outstanding, yet simple, principles of buying low and selling high. The Zone System has five zones set around a trendline of the markets where:

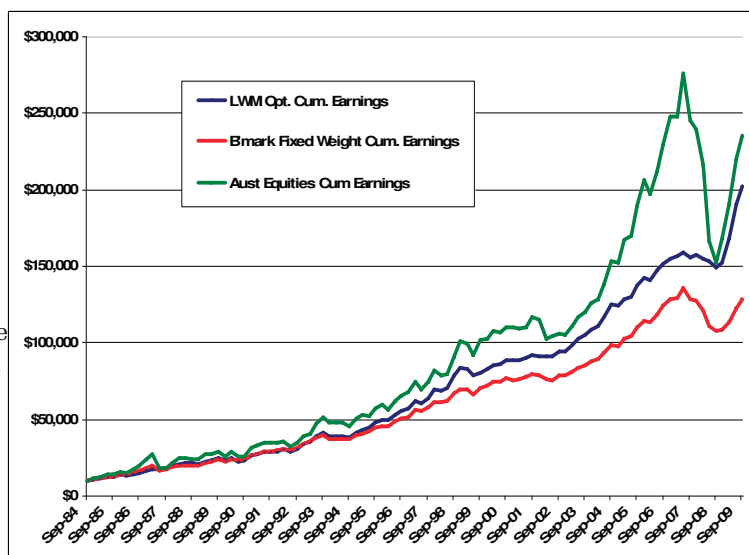
- Zone 1 is very unfavourable buying and by definition holding and high risk.
- Zone 2 is unfavourable buying and by definition holding and above average risk.
- Zone 3 is average buying with average risk.
- Zone 4 is favourable buying and below average risk.
- Zone 5 is very favourable buying and low risk.

According to a 25 year simulation by the Melbourne Centre of Financial Studies (MCFS) (now known as Australian Centre of Financial Studies) using the Zone System asset allocations for a balanced portfolio, first introduced in the Investing Times in November 2008, the System produced an outperformance of just 0.1% excluding management fees and transaction costs. After allowing for advice fees, funds management fees and transaction costs, any outperformance would be effectively eroded.

According to the creator's own research, as reported in Investing Times 18 December 2001, investing in Zone 1 was on average going to produce a five year return of a 12.8% loss per annum over the subsequent five years with a total loss of a staggering 49.8%. An allocation of 20% to Australian shares, 3% to listed property trusts and 10% to international shares in Zone 1 was therefore going to significantly detract from performance. Compounding this was the creator's findings that investing in Zone 3 created a loss of 7.3% per annum over five years, for a total loss of 31.5%.

Lachlan Partners identified that the Zone System's basic principles were valid. In addition, with the resources available to Lachlan Partners in terms of validation, industry knowledge, and qualitative and quantitative analysis, we were able to develop and apply a more robust asset allocation, with greater sophistication regarding implementation.

Lachlan Partners commissioned leading financial academics at MCFS to provide an improved solution. The solution they provided used the Australian market's Zone positions to determine asset class allocation.



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WHY THE OLD ZONE SYSTEM HAD TO BE REFINED

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The results were, not surprisingly, to have greater exposure at the bottom of the market and lower exposure at the top of the market – this has been well documented in recent editions of Investing Times.

Lachlan Partners has subsequently tested the process over the last 10 years on other markets. Lachlan Partners used the MCFS suggested asset allocations to growth and defensive assets for each Zone, where each market was the growth asset and allocated to Australian Bonds as the defensive asset. Assuming transaction costs of \$55 and a yield on equities of 3% per annum over the period, the Zone System outperformed all equity markets that we applied it to: the UK FTSE, the US S&P 500, Hong Kong's Hang Seng, Japan's Nikkei, the MSCI World index, the US Russell 2000 and the All Ordinaries by an average of 3.7% per annum as detailed in this table.

However, this was still taking market exposure in Zones 1 to 3, which on average is known to be loss making. So we then decided to test the last 10 years, buying only markets we consider the process indicates as cheap. This produced an impressive level of outperformance of 6.91% p.a. compared to a balanced portfolio for the ten years to December 2010, excluding dividends for the equity exposures. Quite clearly the system has significant merit!

While past performance is not an indication of future performance, in applying a more dynamic asset allocation strategy, what we have done is increased the potential to generate outperformance with much better downside protection at market peaks.

The implementation of the Zone System requires active management – not set and forget. In hindsight, this is quite evident by the Zone System's clear indication to recommend selling down prior to the GFC.

Today, the Zone System, owned and operated by Lachlan Partners, is a robust asset allocation tool, providing clear allocations for each Zone and clear sell signals when markets rise and buy signals when low. Further, this proprietary information is only available via Lachlan Partners Wealth Management (part of the Lachlan Partners Group).

For further information on the applicability of the Zone System to your investments, please contact your advisor or email Paul Saliba/Gordon Jenkins at paul.saliba@lachlanpartners.com.au or gordon.jenkins@lachlanpartners.com.au.

Estimates of Return Risk and Sharpe Ratio

| | Qrtly Return % | Qrtly Std Dev % | Sharpe Ratio | Annualised Return % |
|----------------------------|----------------|-----------------|--------------|---------------------|
| LWM Model optimised | 3.01 | 4.18 | 0.720 | 12.6 |
| Fixed Weight Index B/mark | 2.55 | 4.54 | 0.562 | 10.6 |
| Asset Class Returns | | | | |
| Australian shares | 3.16 | 9.22 | 0.343 | 13.2 |
| International shares | 1.96 | 8.49 | 0.231 | 8.1 |
| Property | 2.47 | 9.59 | 0.257 | 10.2 |
| Alternative Assets | 2.04 | 6.43 | 0.318 | 8.4 |
| Fixed Interest | 2.62 | 4.08 | 0.642 | 10.9 |
| Cash/Short Duration | 2.04 | 1.07 | 1.903 | 8.4 |

Source: MCFS

| \$100,000 invested | FTSE | Russell 2000 | S&P 500 | All Ords | Nikkei | Hang Seng |
|-------------------------------------|-----------|--------------|-----------|-----------|-----------|-----------|
| Zone System | \$268,813 | \$245,429 | \$161,870 | \$246,799 | \$179,485 | \$278,322 |
| Holding the market | \$214,174 | \$186,422 | \$115,576 | \$195,707 | \$ 91,086 | \$197,410 |
| Impact | \$ 54,639 | \$ 59,007 | \$ 46,294 | \$ 51,092 | \$ 88,399 | \$ 80,912 |
| Annual Growth | 10.4% | 9.4% | 4.9% | 9.5% | 6.0% | 10.8% |
| Mkt annual growth | 7.9% | 6.4% | 1.5% | 6.9% | -0.9% | 7.0% |
| Outperformance | 2.5% | 3.0% | 3.5% | 2.5% | 7.0% | 3.7% |
| Time in Australian Government Bonds | 41% | 31% | 20% | 44% | 50% | 37% |

Comparison of Zone System

