

FPA National Roadshow

HOW PASSIVE AND ACTIVE MANAGEMENT CAN CO-EXIST IN A CLIENT'S PORTFOLIO



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Agenda



Why the rapid growth of passive strategies?



What this means for Investors & Advisors?



Active or Passive?



Implications for Active Managers & how they are responding



Unintended consequences

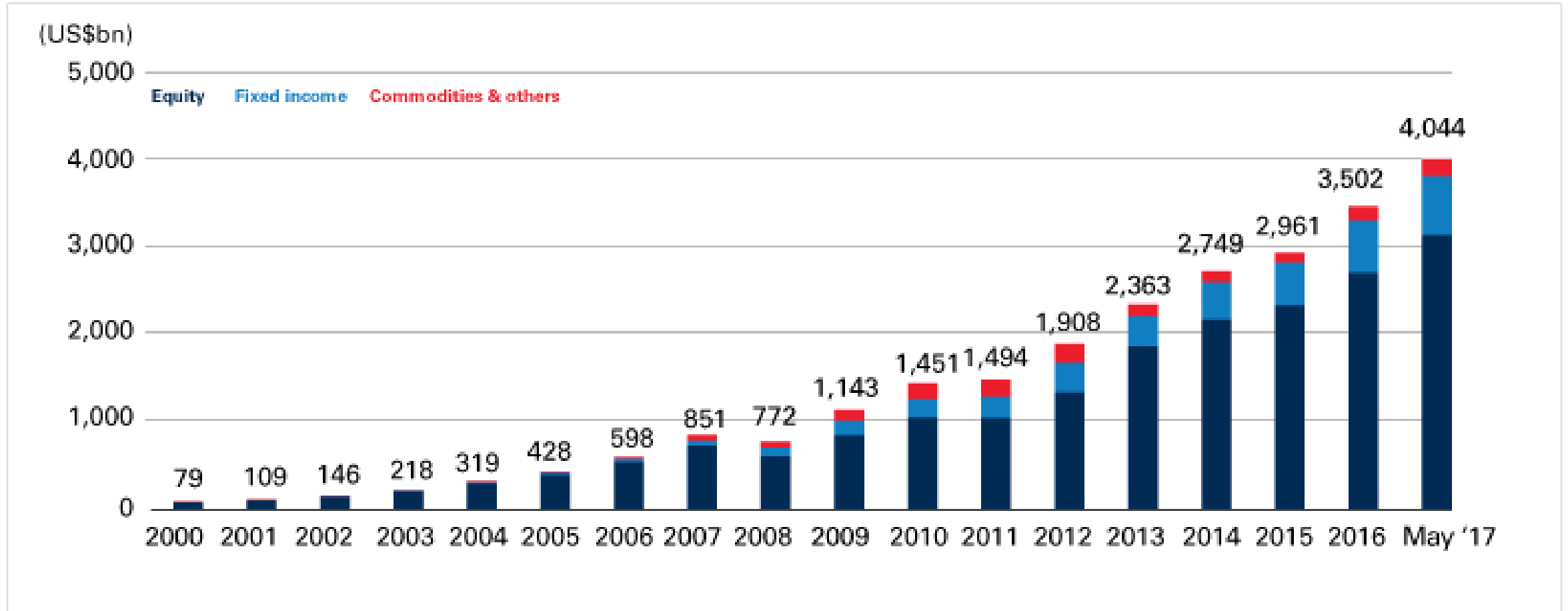
An aerial photograph of a city skyline, likely Vancouver, featuring a wide river in the foreground and several tall, modern high-rise buildings along the waterfront. The image is overlaid with a semi-transparent purple filter. The text "Why the rapid growth in passive strategies?" is written in a white, serif font across the middle of the image.

Why the rapid growth
in passive strategies?

Passive strategies have grown rapidly...

ACCELERATING GROWTH POST-GFC

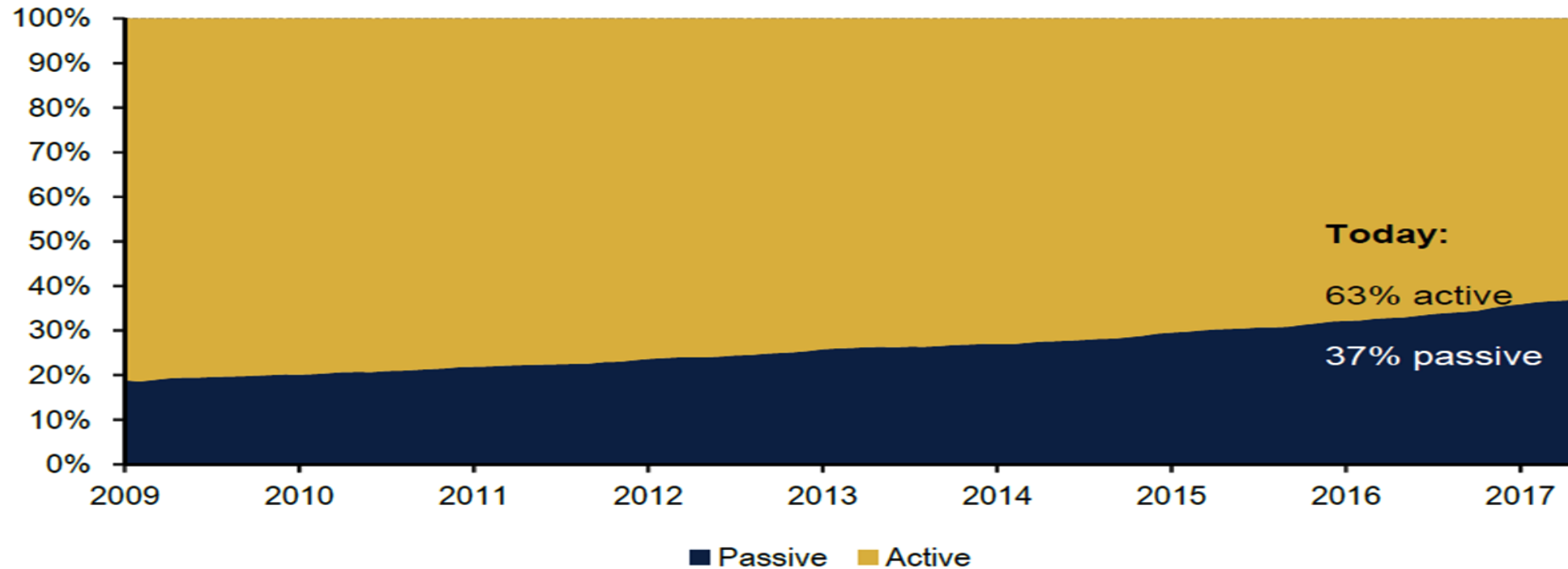
Figure 1: Global ETF AUM (\$USbn)



...especially in the US

US EQUITIES MARKET LARGEST PASSIVE GROWTH

Chart 3: Asset split between active vs. passive US-domiciled equity funds, 2009-5/2017



Passive provides a number of benefits...

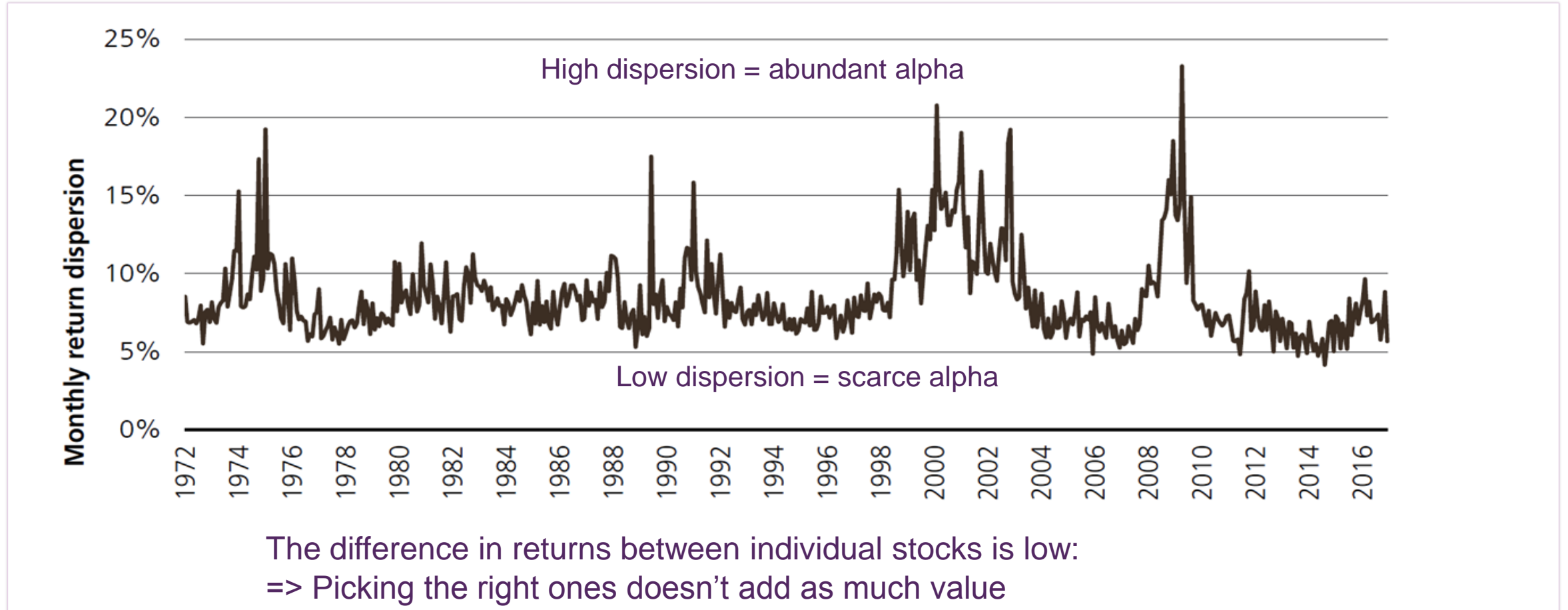
CATALYSTS TO THE GROWTH IN PASSIVE INVESTING

1. **Low costs** – fees matter more in a low-return environment
2. **No benchmark risk** – guaranteed to achieve benchmark return (pre-fees)
3. **Wide range of choice** – easy access to a large range of asset classes
4. **Listed structure** – ETF structures provide convenience and transparency
5. **Less active alpha** – active managers have struggled in post-GFC environment

Active alpha prefers high dispersion...

DISPERSION HAS BEEN LOW POST-GFC

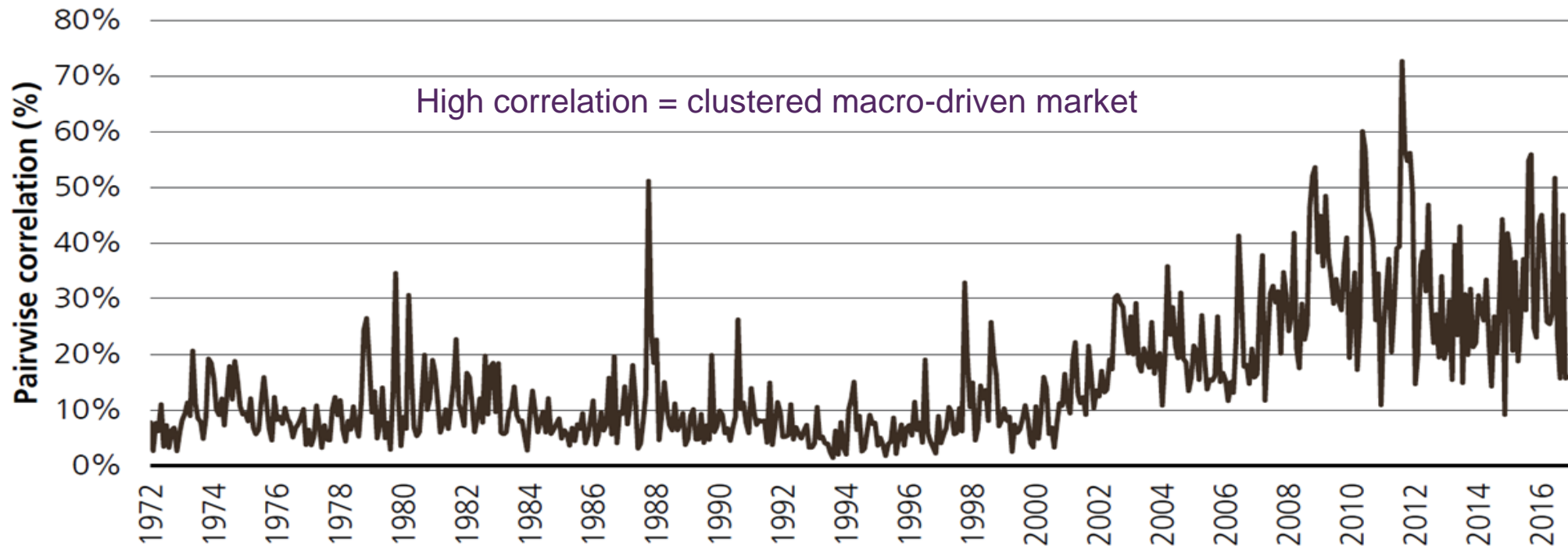
Figure 13: Cross sectional volatility of the United States



...and low correlation

CORRELATION HAS BEEN HIGH POST-GFC

Figure 14: Pairwise correlation in the United States



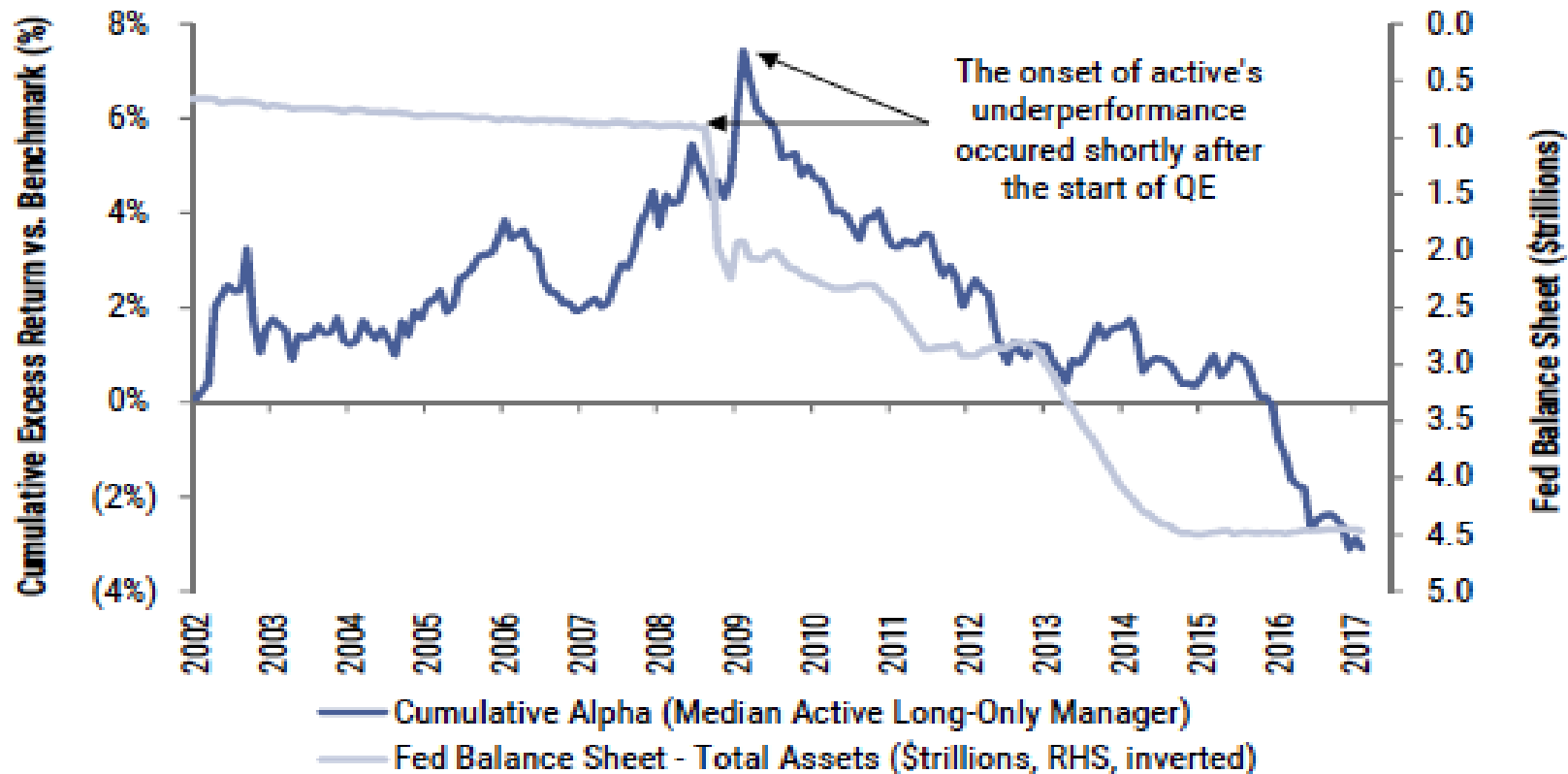
Stocks tend to go up and down together:
=> Hard to add value when everything moves the same way!

Driven by the effects of QE

THE US FED INTERVENTION

Did QE trigger the onset of active's run of underperformance? Managers have consistently lagged their benchmarks since the start of QE

Cumulative Excess Returns for Median Active Manager (LHS) vs. Total Assets on Federal Reserve Balance Sheet (\$trillion, RHS, inverted)



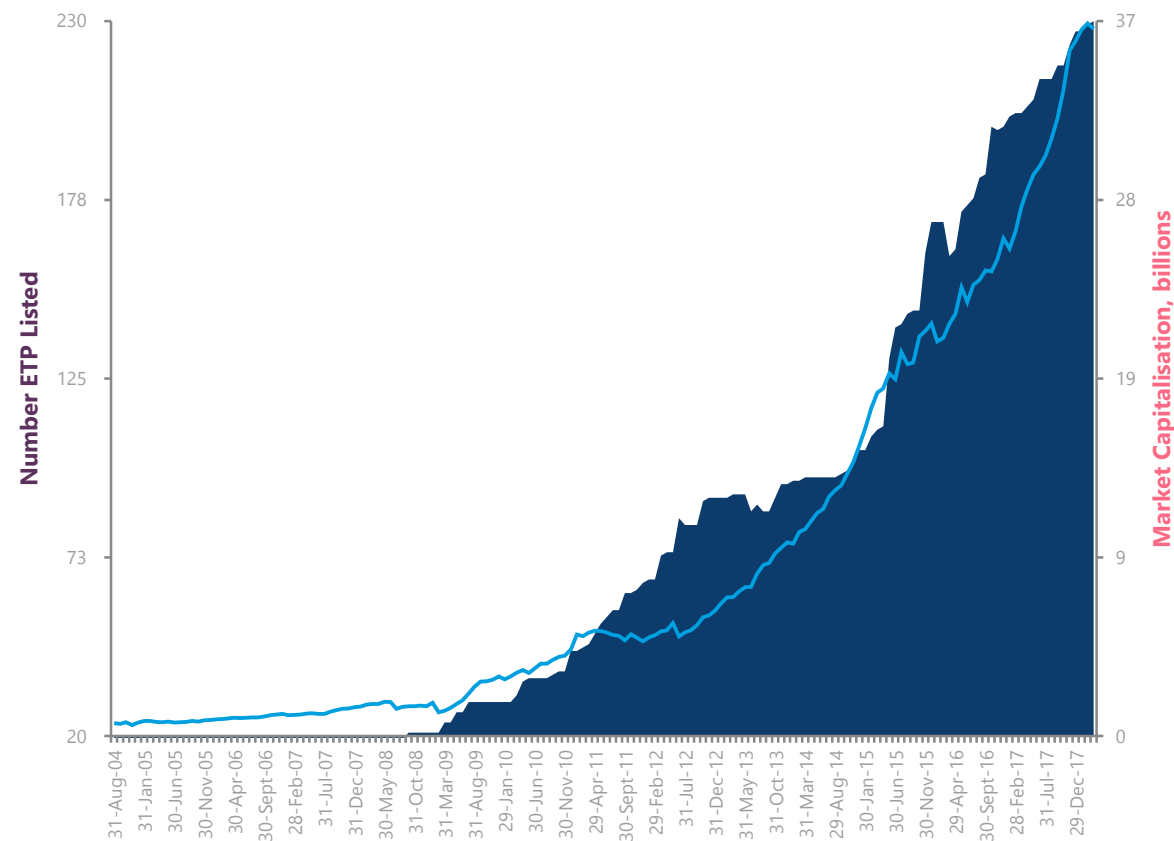


What this means for Investors & Advisers?

Lots of choice and potential benefits...

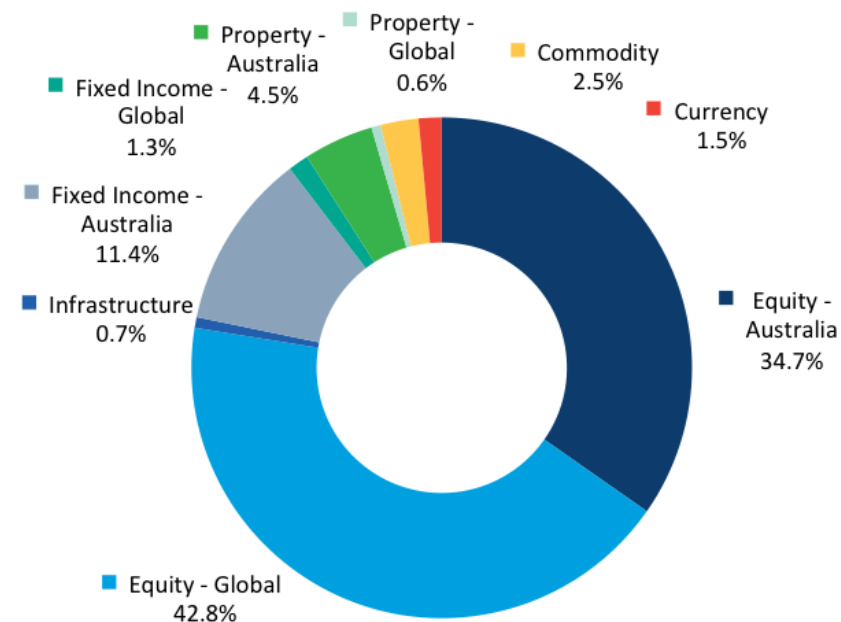
ACCESS TO A WIDE RANGE OF ASSET CLASSES

ETP Market Growth



Source: ASX

Asset Spread of ETPs, Current Period FUM (A\$)



Type to enter a caption.

...but also comes with some risks

“What should we think about the willingness of investors to turn over their capital to a process in which neither individual holdings nor portfolio construction is the subject of thoughtful analysis and decision making, and in which buying takes place regardless of price?”

– **Howard Marks, Oaktree Capital**

Adding Value when you need it most

ACTIVE MANAGERS TEND TO OUTPERFORM IN DOWN MARKETS

Periods of active outperformance include:

- Recession of the early 1990's
- Tech-wreck in the early 2000's
- GFC in 2008-9

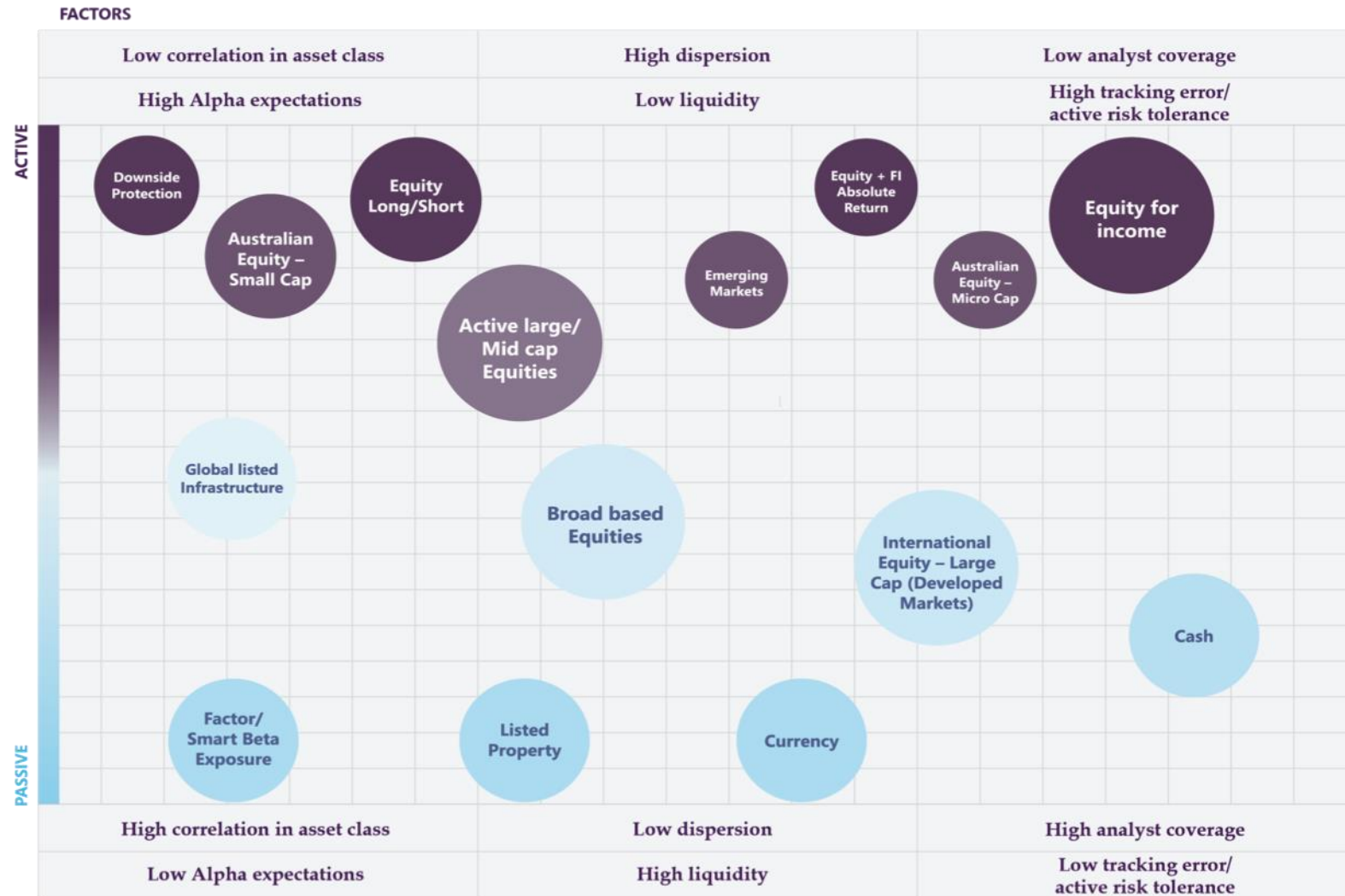
Greater allocation to passive = greater sequencing risk



Active or Passive?

Depends on the strategy

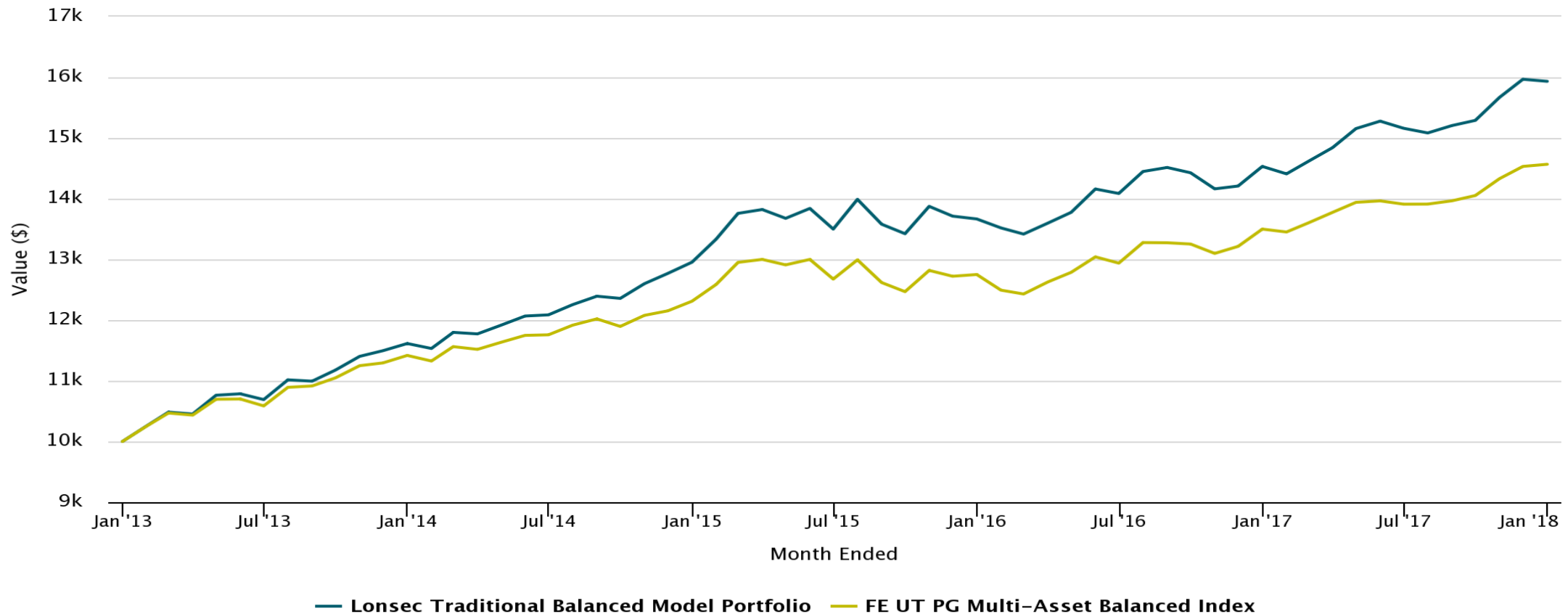
THE ACTIVE VS PASSIVE MANAGEMENT FRAMEWORK



It's all about Portfolio Construction...

THE RESULTS CAN BE VASTLY DIFFERENT

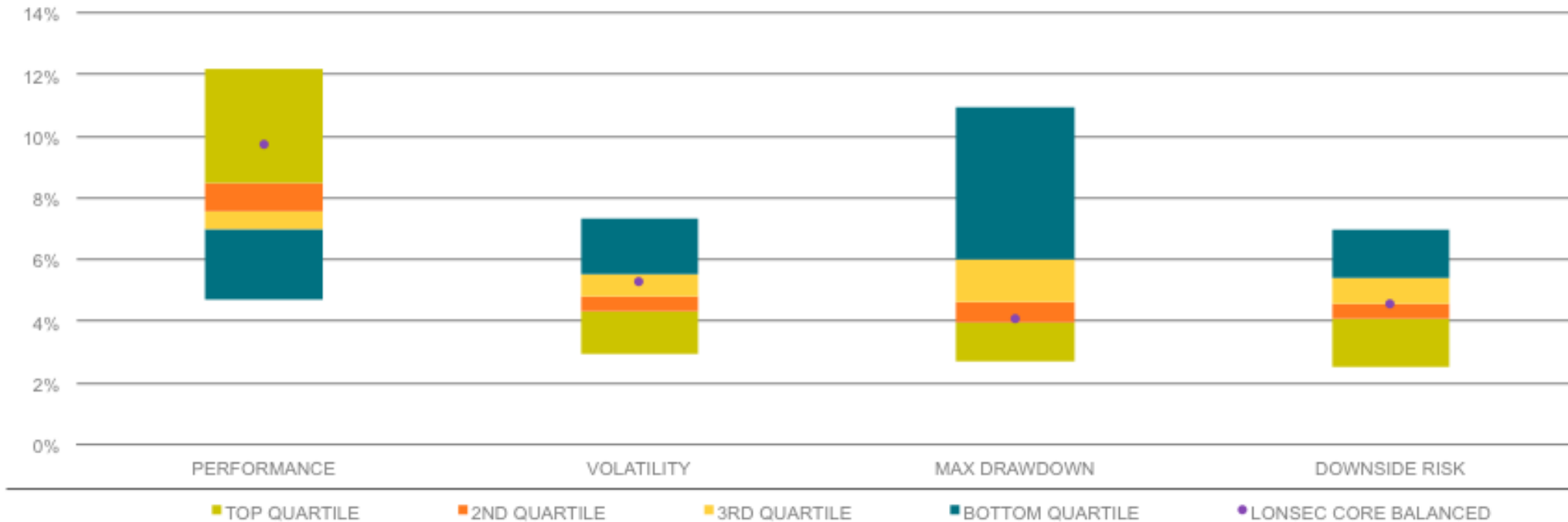
Growth of \$10,000 – Income Reinvested



Ask the experts...

TOP QUARTILE PERFORMANCE, WITH LOWER VOLATILITY

Peer Group Comparison^ - 5yr to December 2017



^Comparison against FE UT PG Multi-asset Balanced Index – Source: Lonsec Research, FE Data

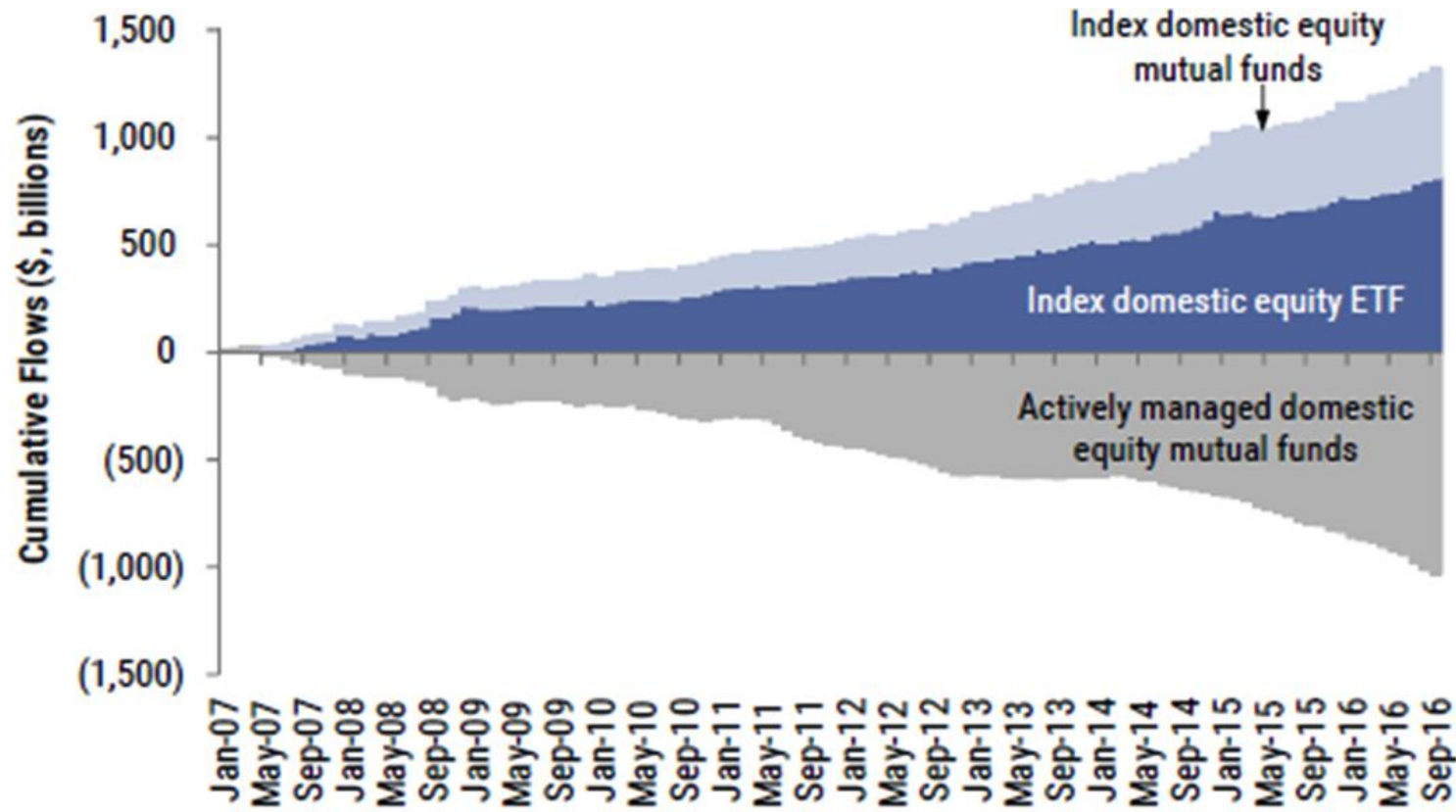


Implications for Active Managers & how are they responding?

Passive growth at the expense of active

ONGOING NET OUTFLOWS FROM ACTIVE

Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs (\$, billions)



Responses of active managers

OFFERING MORE FOR LESS

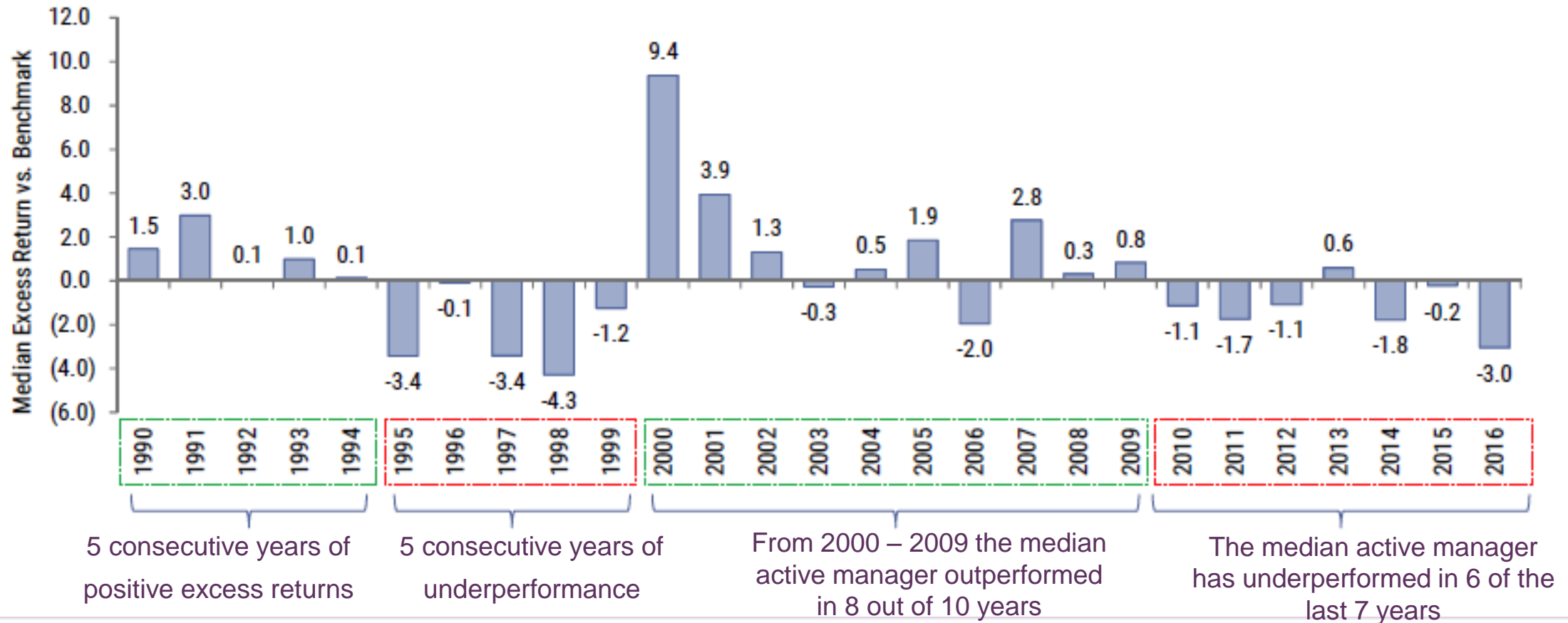
1. **Product innovation** – developing new products not easily replicable by passive strategies
2. **Less benchmark driven** – increased focus on absolute returns
3. **Listed structures** – moving to listed ETMF structures provide convenience and transparency
4. **Lowering costs** – fee structures becoming more competitive
5. **Industry consolidation** – driven by institutional in-housing

But don't write active off yet

ACTIVE ALPHA IS CYCLICAL

There have been 4 distinct alpha cycles since 1990

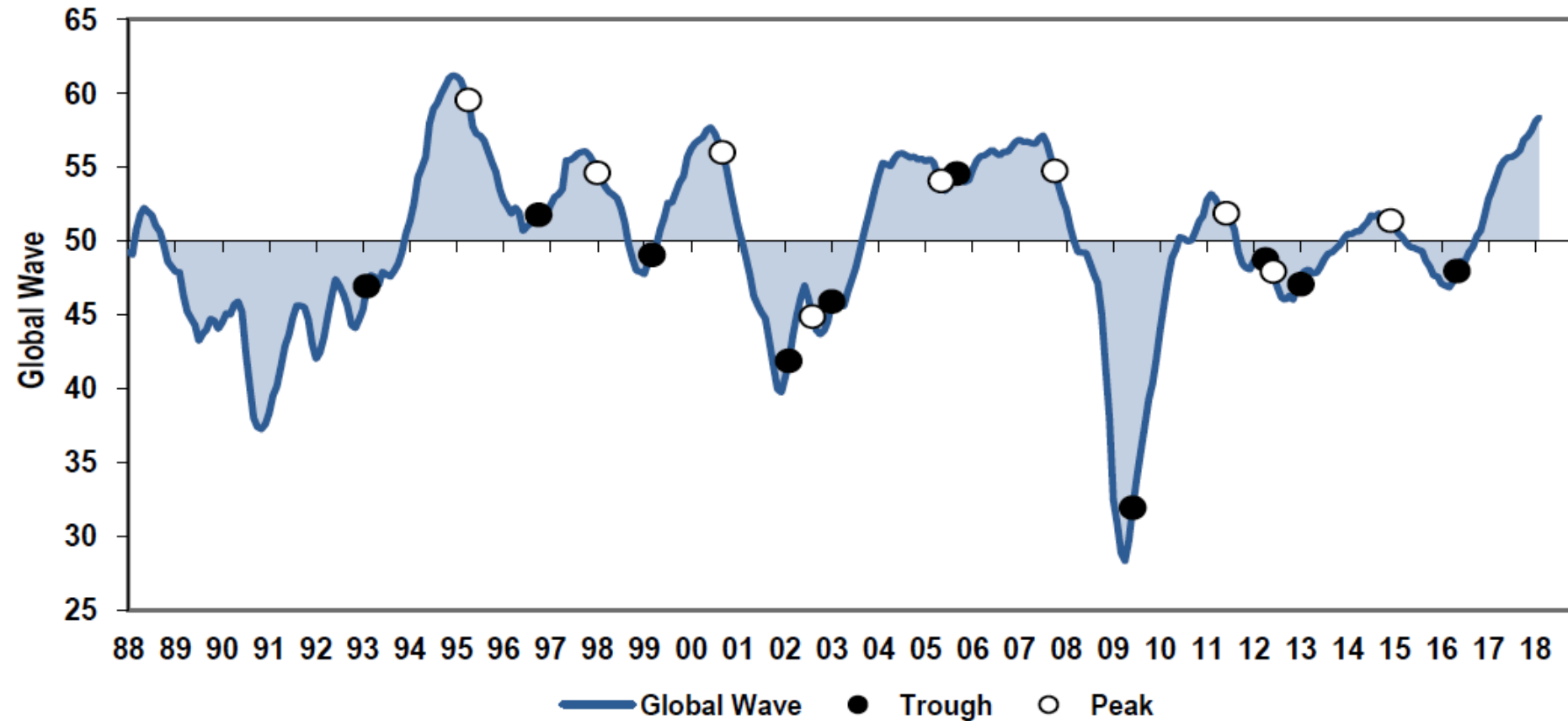
Median Excess Returns vs. Benchmark; Includes Actively Managed, Large Cap, Long-Only, US Funds



Economic growth is improving

SYNCHRONISED GLOBAL GROWTH

Chart 1: Global Wave



QE is becoming “QT”

GLOBAL RATE CYCLE HAS TURNED





Unintended consequences

Passive is now a major force in markets

PASSIVE INVESTING & CONCENTRATION

Chart 1: % S&P 500 market cap owned by Vanguard

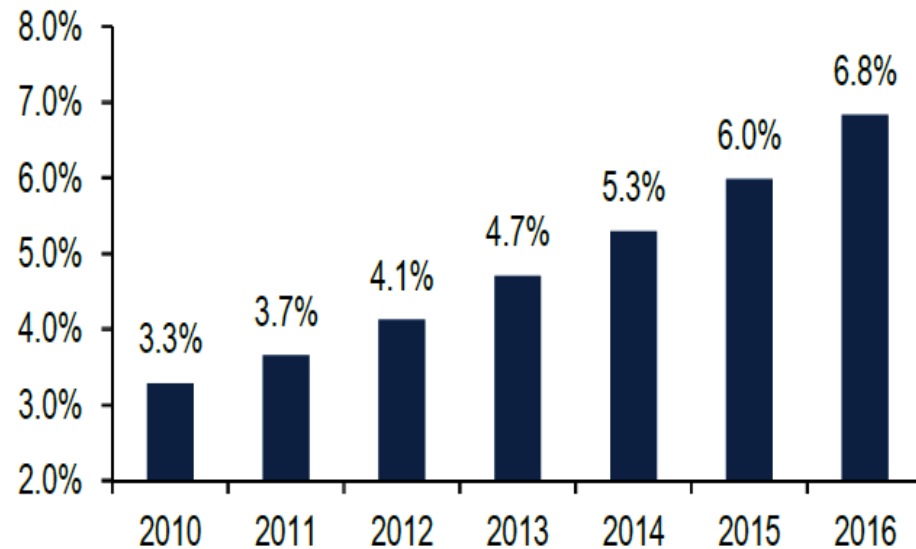
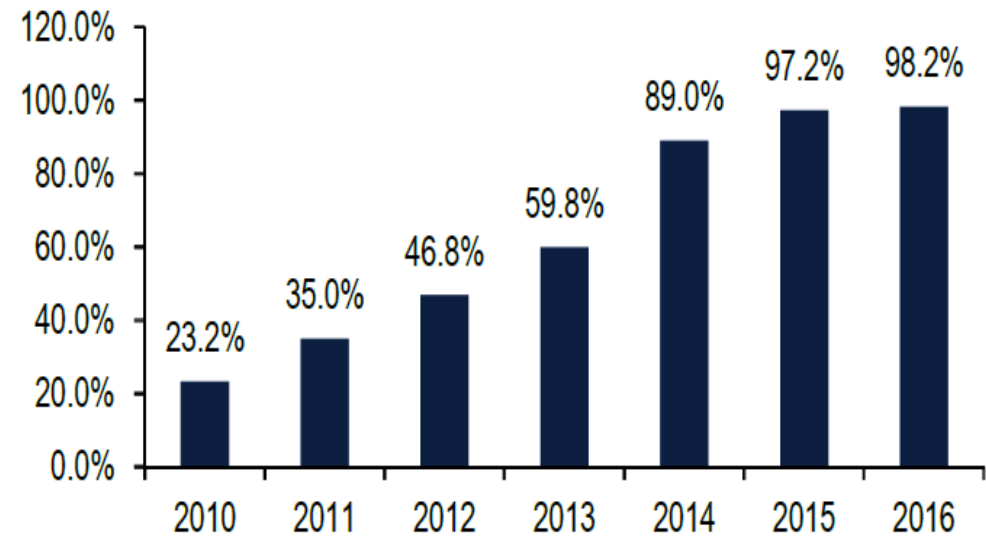


Chart 2: % Stocks where Vanguard owns > 5% of float



Market efficiency impacts

PASSIVE AND ACTIVISM



“If you're an active manager, and you don't like the company, you can sell the company...I can't sell.”



Conclusion

Active and passive both have a role to play

CATALYSTS TO THE GROWTH IN PASSIVE INVESTING

1. Combining Active and Passive makes sense
2. Global macro policy has driven part of the growth in Passive
3. Longer-term cycles have favoured both Active and Passive
4. No one size fits all – it's all about Portfolio Construction
5. The changing macro environment could favour Active going forward
6. There are some unintended consequences to the fast growth in Passive