Our Investment Philosophy

A human-centric approach to investment

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WELCOME FROM THE CHAIRMAN

"A DIFFERENT WAY TO HELP PEOPLE MANAGE THEIR MONEY."

I worked in many areas of finance before pursuing a nagging feeling I should become a financial adviser. During those years I watched and learned from my colleagues and the media how to invest. Looking back now, it is fantastic how many bad decisions I was making with my money.

From day one working as a financial adviser, I was thankfully surrounded by people who were pursuing a different way to help people manage their money. It took me some time to unlearn my previous behaviours, but once I grasped how insights from financial science could be applied into transparent, diversified, and low-cost portfolios, I was converted for life.

Our investment approach not only delivers better investment outcomes, but a better investment experience too. Clients regularly tell me they feel empowered and less anxious about how their money is working to help them enjoy a wonderful life. The details of implementing an investment plan will always remain relatively complex, but the principles employed in a sound investment strategy can and should be simple for all of us to understand.

My hope is this overview of our Investment Philosophy helps you appreciate the time and energy we spend thinking about how investments can be better allocated so we can spend time on more meaningful areas in our lives. Not only will this give you the gift of time, but almost certainly result in even better investment outcomes by reducing the risk of our emotions interfering with a compelling investment approach.

Even the best investment strategy still benefits from a behavioural coach to ensure adherence over the long-term. As an independent advice firm, our team is on your side always and will teach you how to live with an inherently uncertain and complex world rather than try to predict the future.

Rick Walker
Chairman

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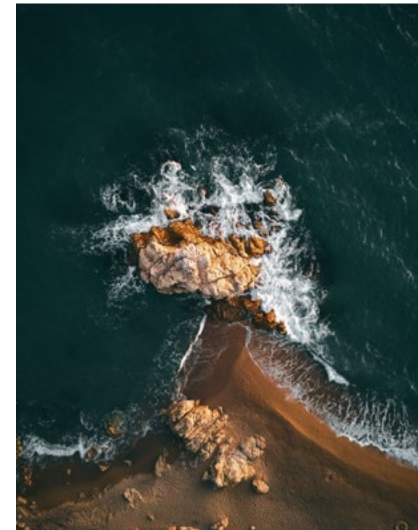

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1

“Far more money has been lost trying to anticipate and protect from corrections than has been lost in corrections themselves.”

Peter Lynch, US fund manager

Investing is about people, not just money.

First and foremost, investing should be about you. Your goals. Your lifestyle. Your future. Investments are made to support individuals, couples and families. Our goal at Lorica Partners is always to help align your investments with your values and objectives.

Investing is one of the rare fields in which the right temperament can often be more important, and more beneficial, than knowledge or skill.

This is because building something large, like the savings a person may need for retirement, takes a long time. And when dealing with long timeframes, often large amounts of human intervention can be more of a hindrance than a help. Patience, long-term thinking, and a focus on the end goal. These are the keys to investment success.

We think of long-term investing like planting an oak tree. From the moment an acorn is planted, through to the shade it gives decades later, very little human intervention is required. In fact, too much interference can keep the tree from reaching its natural potential.

Markets go up and down. Understandably, this can lead many investors to react to market conditions, struggling to separate emotion from investment. Unfortunately, this reactionary approach often leads to poor investment decisions. Our investment approach is different. We focus on two things: the individual, and the end goal.

The Lorica Partners approach is to consider each client on an individual level, from lifestyle, hobbies, desires, values, family makeup, right through to long-term future plans. We then set a course that integrates in a meaningful way their investments with their particular values and objectives, and over time will facilitate the lifestyle they desire.

Being goal-oriented in this way means we consistently maintain a disciplined approach, making scrupulous investment adjustments along the way. This discipline, combined with our personalised, long-term approach, underpin our investment philosophy, and empower the success of our clients.

Financial markets are inherently volatile. We know that, and anyone investing in the stockmarket should know this as well. We *expect* stockmarkets to periodically fall. This volatility is the price investors pay for the higher long-term performance.

When stockmarkets fall, the only surprise to us is the catalyst. Who can predict a pandemic? We tell clients when they retire we expect their portfolio to experience three or four substantial falls during their lifetime. Whilst that may be the bad news, the good news is we have already planned for these events in our strategy for them. So life can go on.

2

We value your values.

The value of your portfolio and your personal values should not be mutually exclusive. You can do well by doing good (in fact, you might do better).

Environmental, Social, and Corporate Governance

As fiduciaries to our clients, we have an obligation to consider how personal preferences can — or should — play a role in your portfolios. This includes environmental, social and governance (ESG) factors. ESG investing variously attracts a range of support and criticism, but there are several ways for an investor to consider it.

Although people tend to focus predominantly on the environmental component, we believe it more constructive to think about ESG in its totality. The environmental focus is important, but so are the social and governance aspects.

Environmentalism

Lorica Partners holds an evidence-based approach to all advice we present to clients, and the scientific consensus is that society must conserve in order to progress. It appears most people agree with this need, but debate primarily centres around the nature and speed of change required.

By definition, a sustainable environment is requisite for sustainable business. It is instructive that the Greek word for 'home' is the root of both 'ecology' and 'economics.' While for much of human history these two subjects were viewed as separate, Lorica Partners believes they are inextricably linked.

Environmental sustainability is clearly important from an ethical perspective. But from an investment perspective, since sustainable environments also facilitate sustainable business, responsible and ecologically-sound growth invariably complements sound investment.

Social (working conditions, health and safety, diversity)

The sustainability of a company's long-term profits relies on its entire value chain, comprising suppliers, customers, employees, as well as regulatory bodies. If a business is paying too low a tax rate, for instance, underpaying staff, or applying unfair pressure on its suppliers, it jeopardises its long-term viability. In this way, the social aspect of ESG is a critical factor to consider, regardless of an investor's environmental views.

Governance

Put broadly, the governance side of ESG examines how a company is managed. Is the Board effective? Are shareholding voting rights protected? Is remuneration for senior executives appropriate? Ultimately, companies with good corporate governance practices are more desirable from an investment perspective, and attract higher valuations.

Thinking about ESG is fundamental to our value-led approach to investment. Such ethical investing is directed toward positive impact and long-term change: for our investors, our communities, and society at large.

ESG investing is a personal preference, and many of our clients wish to ensure their portfolio incorporates sustainable principles. The solutions we provide today will evolve tomorrow, just as they have over the past decade, so we are continually reviewing ways for our clients to implement impactful portfolios.

3

Focus on what you can control.

The world changes, and that's okay. In a highly complex, rapidly evolving financial ecosystem, change is inevitable; fluctuations are normal. We focus on what we can control, and don't waste time worrying about what we can't.

By nature, financial investment involves a large number of variables. These are constantly changing, not only as a response to market activity on a daily basis, but over time in response to economic, social, political, and environmental changes. As a result, often what has worked in the past may no longer be the best approach.

Paradoxically, this constancy of change is what tends to make stoicism, patience and long-term focus the most appropriate and beneficial qualities for successful investment. Indeed, the entire investment system works in large part due to its ubiquity; operating as it does in all corners of the world.

In developed markets, the rules of this process are codified by formal capital markets, and most investors participate through tightly regulated exchanges of securities in public markets. As new information moves market prices; as individuals and companies buy and sell, and a new price equilibrium is reached: the global economy continues to assess, measure and value risks on a daily basis, which leads to constant revisions to expectations for the future and consequent prices investors are prepared to pay for assets.

Things change. There's going to be positive news, there's going to be bad news. Markets will shift and prices will respond accordingly. The system is doing what it's designed to do.

For every seller, there must always be a buyer at the agreed price. When stock prices fall, clearly some investors think it is a good time to sell; but on the other side of the transaction, other investors think it is a good time to buy. Buying low and selling high to build wealth often means you are transacting against market sentiment. This is why having an adviser in your corner helps to quell emotions.

We focus on those things we can change, allowing you to focus on what's most important in your life.

4

Redefining risk.

There is a clear relationship between risk and return. However, not all risks are created equal. The size and nature of any given risk is contingent on the goals you're trying to achieve, and what constitutes a risk for some, may not for others.

Risk is a very broad term that gets used a lot in investment talk, often in ways that don't reflect the reality risk plays in an investor's life and portfolio management. In short, there are risks worth taking, and risks that are not. This is the essence of an Evidence-Based Investment Philosophy. In the view of the world's leading investment researchers, you bias your chances in favour of obtaining higher returns by only taking risk that has been reliably rewarded in the past, and can be expected to be rewarded in the future.

In the world of investment, there are many kinds of risk. 3 key types of risk include:

- The risk of losing your initial investment;
- The risk of receiving a lower than expected return — for example, the value of an asset increases at a lower rate than expected, or shares sell at a lower rate than expected.
- The risk an investor will not meet their specific investment objectives.

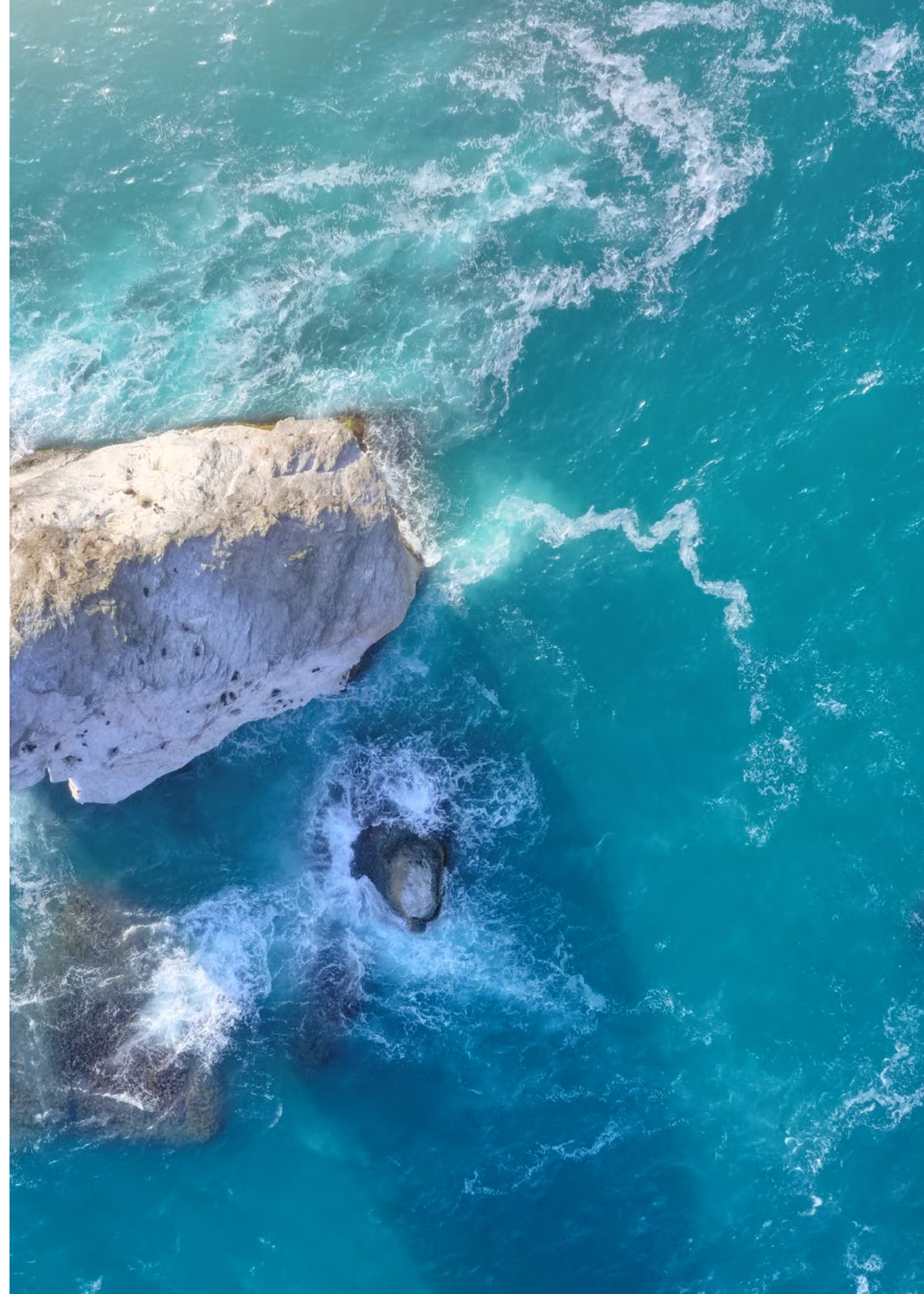
Since risk is dependent on objectives, risk is inherently relative, and you need to think about what it means to you. An investor might think it risky to be involved in the share market. Ostensibly, this is a true claim: over any given period an investment might rise or fall. However, if this investor needs their money to last for the next thirty years or so of retirement, they can be certain money kept in a bank account will not purchase over the next few decades what it can today.

In this way there is a degree of risk to accumulating all savings in the bank. In terms of goals and necessary outcomes, this may even be riskier than being active in the share market.

The same is true for risk aversion; for not acting in certain situations. An investor might feel perfectly safe having everything invested in a very expensive home, for instance. Yet things can go wrong in property markets too.

All investors should understand that significant investment returns cannot be achieved without some degree of risk, and in many ways risk is unavoidable. Having all your eggs in one basket is always risky. And inertia can be just as risky as action. In other words, risk is neutral; neither good nor bad. It is possible to have either too much risk, or too little.

Too much can be a threat to your financial wellbeing, and too little can mean failing to meet your objectives and take advantage of opportunities. In consultation with our clients, we assess how much risk, and what types of risk, are necessary and beneficial for their objectives, and ensure their final plan is something they can sleep with at night.



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"The stock market is a device for transferring money from the impatient to the patient."

Warren Buffet

The generation of profit.

People don't like uncertainty. They like guarantees. But when it comes to markets, genuine uncertainty is actually the gear of potential; the driver of profit. Real opportunities for portfolio growth exist in the face of uncertainty.

In economics and finance, risk and uncertainty are defined differently than in general English usage. Frank H. Night established the economic definition of risk as follows:

'Risk is present when future events occur with measurable probability. Risk can be quantified, either on *a priori* grounds (we know without investigation that a flipped coin will come up heads fifty percent of the time), or on the basis of empirical observation.

Uncertainty, on the other hand, is present when the likelihood of future events is indefinite or incalculable. Uncertainty occurs in circumstances that cannot be analysed either on *a priori* grounds, because they are too irregular, or through empirical observation, because they are too unique. True uncertainty generally occurs in complex systems where lots of elements are interacting over time, such as the economy.

The important point Knight makes is this: real opportunities for profit only exist in the face of genuine uncertainty.

Lorica Partners believes it is vital to understand the distinction between risk and uncertainty. While risk is a personal matter, contingent on the goals of the individual, uncertainty is a feature of the system itself, and the mechanism behind profit-generation.

Investing is, by nature, about the future, and the future is inherently uncertain. We're in an economic system that is trying to price future events, and no one knows with any accuracy what the future holds. But this uncertainty is beneficial. If we knew in advance what was going to happen, prices would converge on what the reality is, and investors could not expect to see a profit.

When an investor sees the market going in a direction they don't desire, or didn't expect, they'll often exit. It's such exiting over extended periods that actually transfers returns from the impatient to the patient.

Investors need to learn to navigate risk, and not to fear uncertainty. In addition to factoring an individual's needs and objectives into risk, in many ways we need to embrace the uncertainties that drive profits in constantly unpredictable markets.

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> "The stock market is a giant distraction from the business of investing."
>
> John C. Bogle

Investment over speculation.

We differentiate between investment as a long-term pursuit, and speculation as a short-term, often emotion-driven enterprise that creates (and is prey to) market fluctuation.

There is a crucial difference between speculation and investment. Investing is the long-term ownership of an asset in the expectation of generating an income or profit from the businesses' accumulation of intrinsic value, derived from the ability of the business to produce goods and services that consumers want, to compete effectively, and to capitalise on change. Over the long term, this kind of investing is what drives the stock market.

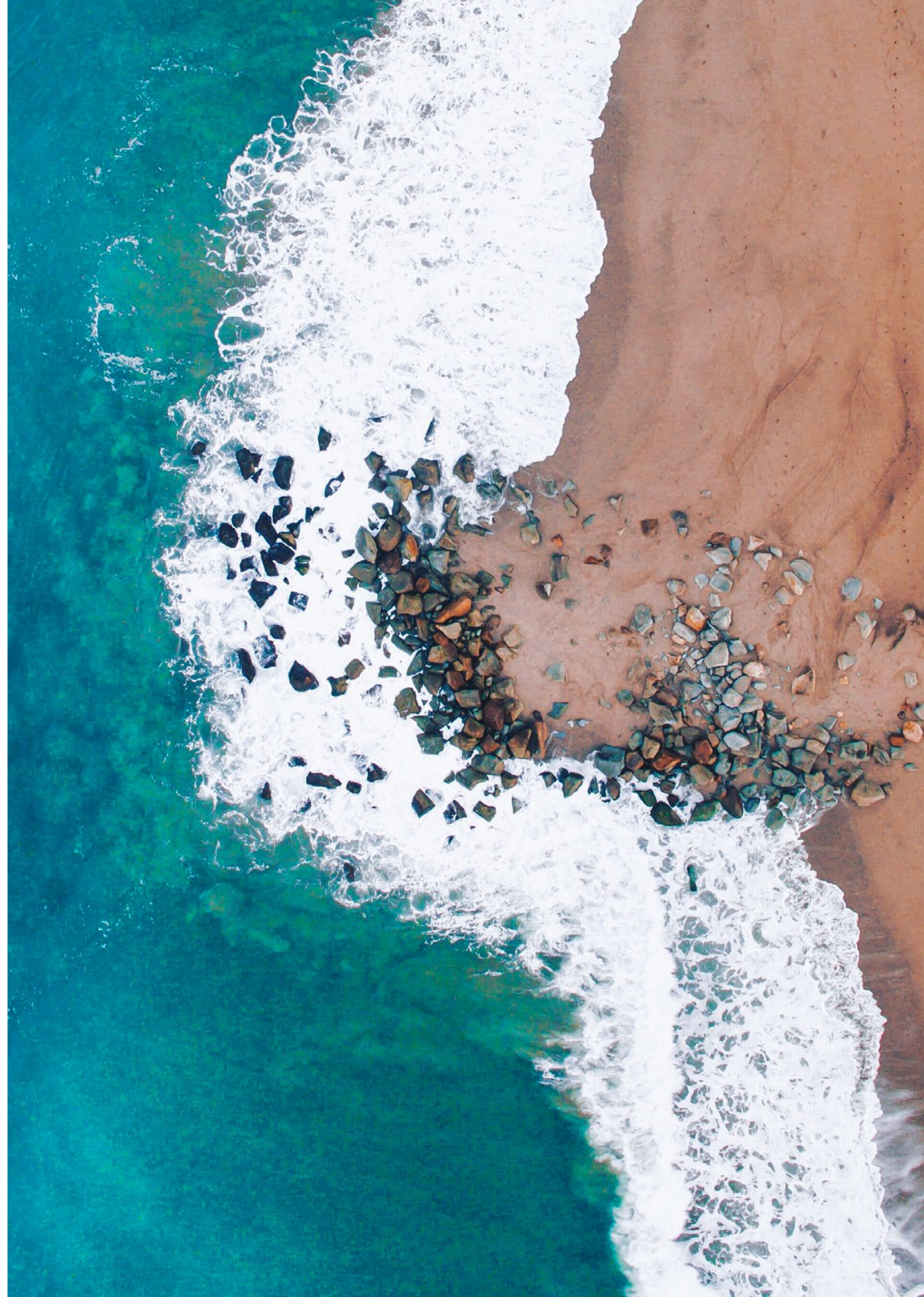
Speculation is precisely the opposite. It is the short-term trading of assets on expectation that their price — rather than their intrinsic value — will rise or fall. Decisions by speculators are often driven by swings in the counterproductive emotions of hope, greed, and fear. Over the short term, and sometimes medium term, such speculation is what generates higher market volatility and turbulence. There is common misconception that being a successful investor entails this kind of speculation.

But evidence demonstrates speculation is usually not a good thing: it doesn't usually help people reach their goals in a predictable or repeatable way. For this reason, being great at business unfortunately doesn't always mean being great at investment. The cornerstone of a great business mind is often seeing something in the future and making it a reality: it entails harnessing future predictions to drive present action. But investment is not business. The discipline of investment is different and requires a different mindset to do it well.

Successful long-term investment requires tenacity, patience, and calm, methodical portfolio management.

While many wealth managers claim to be able to time markets, predict events and pick the perfect companies and products to invest in (at the exact right time, no less), the truth is that the market is infinitely complex, and nobody can consistently predict the future.

Luckily, we don't need to. By adhering to the principles of evidence-based investing, we safeguard investor portfolios from deleterious market fluctuations. And by focusing on intrinsic value, we create long-term avenues for portfolio returns.



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Diversification matters.

Since 1926, only 4% of the total number of stocks listed on the US stock market accounted for the entire net gain (Hendrik Bessembiner, 2018).* Poorly diversified portfolios are not only risky, they have a low chance of generating large positive returns.

It's a startling fact that a remarkably low percentage of stocks — around 4% according to one US study* — constituted the entire gain in the stock market. From a statistical perspective, it's counterintuitive that we should see such concentration representing such a significant amount of the whole.

Yet this is the reality: there is such a small number of companies that do so incredibly well that their expansion is lifting up and making up most of what people see as the gain of the aggregate market as a whole. In fact, the majority of stocks listed in the US since 1926 have produced lifetime returns less than US Treasury Bonds, considered the lowest risk asset in the world with consequent low returns.

This gets to the heart of why diversifying a portfolio is crucial for investment, not only from a negative perspective (in order to mitigate potential risk); but from a positive perspective (in order to increase the chance of returns).

From a risk mitigation perspective, diversification is clearly important, since markets inevitably shift, and sometimes very successful companies fail through no fault of their own. Moreover, poorly diversified portfolios most often under-perform in relation to market benchmarks.

From a positive perspective, diversification is beneficial, as it can increase the likelihood of trading those stocks which experience the most significant gains. As investment is a long-term pursuit, a key factor of portfolio management is wealth retention. Successful investors who have made a lot of money tend to safeguard their wealth through diversification; by ensuring they don't have all their wealth invested in limited assets. This mitigates risk and promotes the chances of successful growth, but it also ensures there is wealth that can be drawn on in the case of unexpected shifts in other areas of the market.

Many wealth managers conclude, based on the small number of stocks that achieve such gains, that successful investment entails speculating on what those few stocks will be. The Lorica Partners philosophy is to focus on intrinsic value to manage portfolios in a calm, methodical way, to protect wealth, and to generate positive long-term returns.

*Data Source: Do Stocks Outperform Treasury bills? by Professor Hendrik Bessembinder, Department of Finance, W.P.Carey School of Business, Arizona State University, May 2018. Data Source: Longboard Asset Management called "The Capitalism Distribution". Russell 3000 Index referred to.

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Embracing the market.

Public capital markets very quickly incorporate information from speculation in security prices. Although markets aren't perfect, acting as if they are generally achieves the best results.

There's a long running debate between two economists and Nobel Prize laureates — Eugene F. Fama and Richard H. Thaler — regarding the efficiency of markets, with the former arguing markets are efficient, and the latter that they are not.

We know that global public capital markets are an extremely effective information-processing machine. Millions of participants buy and sell securities in global markets every day to find the most attractive returns, and thousands of companies and governments compete for investment capital. The value of stocks traded each day in 2019 exceeded $635 billion.

This level of complexity means that markets invariably incorporate information very quickly into security prices. Remember – for every seller, there must be a buyer. For this reason, Lorica Partners sides with Fama, and believes that — though imperfect — liquid public capital markets are generally efficient.

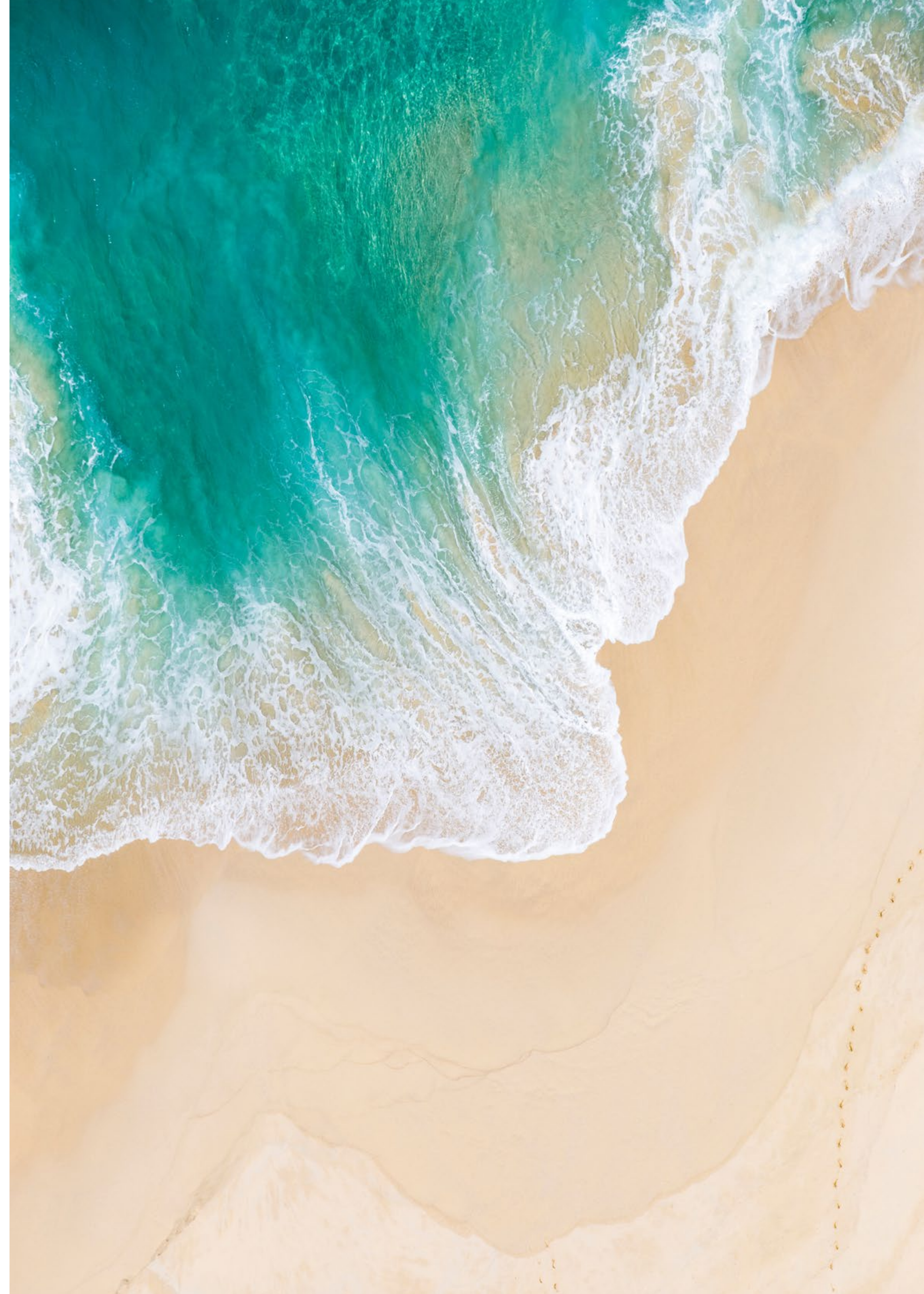
Market efficiency assumes securities adjust quickly to absorb new public information so an investor cannot benefit over and above the market by trading on that new information once it is revealed or used to trade.

Neither technical analysis nor fundamental analysis are reliable strategies to achieve superior returns, because any information gained will already be available and thus already incorporated into current prices. Only private information unavailable to the market at large would be useful to gain an advantage in trading, and only to those who possess the information before the rest of the market does. Even if this weren't completely illegal (insider trading), it would only be useful if the buyer could influence the price by buying enough securities, which generally only happens in very small, illiquid companies.

So, whilst investors are not always rational and the price is not always right, current prices remain the best approximation of intrinsic value, and price changes will occur due to unforeseen events, not existing knowledge. Mispricing can occur, but not in predictable patterns that can lead to consistent outperformance.

Lorica Partners believes that slight anomalies aside, markets are efficient enough that it's wise not to try — or try repeatedly — to out-guess them. They might not be perfect, but in general they absorb information and adjust pricing in an expeditious and reliable way.

With this being the case, our approach is to remain prudent, to encourage clients to act with an appropriate level of caution, combined with the confidence that markets will, by and large, adjust and respond efficiently.



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