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PARAGEM
Dealer Services

Prudence Report

PRIMARY QUESTION:
Is it prudent to recommend Asset Class Investing to a client?

SECONDARY QUESTION:
If so, is it prudent to use predominately one manager?
Therefore is it prudent to place a majority or all of a client's funds in trusts managed by Dimensional?

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Disclaimer

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Executive Summary

This document has been prepared under the principles of open governance at the request of Dimensional and its content reflects an independent assessment of issues that financial advisers may consider when assessing Asset Class Investing.

Asset Class Investing involves the construction of funds that reliably deliver the returns of specific asset classes – groups of securities that share common risk-and-return characteristics.

These funds are constructed by purchasing all or a large number of the securities within the asset or sub-asset category under consideration. No subjective forecasting or market timing is involved.

The asset class funds are then blended to produce portfolios that match the risk appetites of investors. This process is based on risk profiling and consideration of their goals and personal circumstances.

We understand Dimensional is the only fund manager currently employing Asset Class Investing in Australia.

This document addresses the following questions in relation to Asset Class Investing:

- Is it prudent to recommend Asset Class Investing to a client?
- If so, is it prudent to use predominately one manager?
- If so, is it prudent to place the majority of, or all of, a client's funds in trusts managed by Dimensional?

The questions are considered from both a professional standards and a legal perspective.

Our view is that Asset Class Investing is a legitimate and proven way to construct investment portfolios aimed at building and protecting wealth.

This process has the capacity to eliminate many forms of risk traditionally associated with funds management. It appeals to those who believe that market returns (at asset class and sub-asset class level) are the prime driver of investment outcomes and that diversification is key to managing risk in a portfolio.

Dimensional offers a range of products across all the main asset classes. These products are designed to be consistent with the principles of Asset Class Investing and are created consistently and reliably using the same investment methodology. We note it is the adviser's responsibility to recommend an asset allocation suitable to each client's risk profile. Further, the Dimensional suite of products provides advisers with the necessary building blocks to construct well-diversified portfolios.

From our review, we note that Dimensional's Asset Class Investing strategies have -

- captured the performance of each asset class in a cost-effective and tax-efficient manner
- added value where appropriate through allocation to value and/or small cap stocks that have a higher expected return, trading strategies and efficient implementation
- avoided the risks generated by predicting individual stock price movements and attempts to time the market
- provided fixed interest strategies that reduce overall portfolio volatility

We also agree it is difficult for advisers to identify managers who consistently outperform the market. This difficulty is highlighted by academic research on the scarcity of managers able to outperform benchmarks after allowing for costs and risk[1].

[1] French 2008, Carhart 1997, Brinson Hood Beebower 1986

In this context we believe it is prudent for advisers to consider the Asset Class Investing approach when looking to add value for clients.

As to using predominately one manager, we conclude that traditional arguments advanced for diversifying managers can be significantly diluted when considering an asset class manager.

For example as the nature of Asset Class Investing enables access to a broadly diversified set of securities within each asset class, it can be argued that this negates the need to seek complementary investment styles. In addition Asset Class Investing generally has lower costs than other approaches.

From an investment perspective, there is therefore sufficient evidence to argue that it is prudent for an adviser to recommend Asset Class Investing to a client.

We further note that using predominately one manager does concentrate exposure to the operational risks of a business. We observe that Dimensional addresses this through industry best-practice risk management processes, excellent governance and, importantly, the holding of all assets with external custodial services.

We note that advisers thinking of recommending Dimensional's products to a client should be aware of Dimensional's business model, which requires accreditation and technical training in Asset Class Investing so that the full suite of products can be accessed for portfolio construction.

Finally, we feel the current changing regulatory environment - including the parliamentary inquiry into wealth management and the planning industry - positions Dimensional at the forefront of expected reform. Dimensional's policy of paying no commissions or sponsorships reflects transparency and integrity. Further, the operations and systems of the company appear well equipped to handle any envisaged regulatory change that impacts on product providers.

1. Introduction

1.1. Scope of this Report

The scope of this report is limited to:

- Australian financial advisers considering or already recommending Dimensional products to their clients
- The specific Dimensional products listed in Appendix 1

1.2. Prudent Investment Advice

This paper addresses questions about prudent advice in the context of a licensed financial adviser providing advice to retail clients in Australia. For the purposes of this paper, prudence will be measured against two tests:

- Professional standards
- Legal requirements

1.3. Asset Class Investing

This paper is not intended to provide a detailed explanation of Asset Class Investing or the specifics of how it is implemented by Dimensional. That information is available for interested readers on the Dimensional website, in the PDS for Dimensional's trusts and in other documentation supplied by Dimensional.

It is, however, useful for this paper to briefly define Asset Class Investing.

> Asset Class Investing involves the construction of funds that seek to reliably deliver the returns of specific asset classes – groups of securities that share common risk and return characteristics. These funds are constructed by purchasing all or a large number of the securities within the asset or sub-asset category under consideration. No subjective forecasting of market or economic conditions is involved. Essentially, no attempt is made to distinguish between undervalued and overvalued securities. Securities are considered for purchase when they meet the asset class parameters defined by the investment manager; they are considered for sale when they do not.[2]

The approach allows for significant flexibility. Once an asset class is defined it does not require all stocks in the asset class to be held continuously.

Asset Class Investing uses a variety of techniques to add value. Not having to reproduce an index frees up the manager to buy and sell stocks patiently and flexibly. As Dimensional does not rely on forecasts or strong convictions about individual stocks this enables them to focus more on the costs of trading. Value is also added through the use of momentum filters, security exclusions, opportunistic trading, liquidity and tax management.

In equities, asset class portfolios provide disciplined exposure (either individually or in combination) to large, value and small cap stocks. According to the principles of Asset Class Investing, small cap and value securities have different risk and return characteristics than large cap and growth securities respectively and deliver higher expected returns over time. Asset class strategies are designed to enable advisers to adjust the degree of risk and expected return for clients by varying the allocations to these asset classes. Fixed interest strategies are designed primarily to dampen overall portfolio volatility, although value-adding techniques are used within strict risk control parameters.

> Based on academic research, the principles underlying Asset Class Investing are:
>
> - Markets work
> - Risk and return are related
> - Diversification is imperative
> - Structure determines investment performance

[2] http://www.assetclassinvesting.com.au/index.php?CID=100008

Classifying Asset Class Investing

Traditionally fund managers are classified into one of two broad groups – active or index (sometimes termed passive). More recently some managers are described as enhanced index.

Classifying Asset Class Investing within this framework has some challenges, and may ultimately be irrelevant for advisers. If a classification must be made, we feel that in broad terms the active label is perhaps most appropriate although the choice is subjective:

Like an index approach, Asset Class Investing employs broad diversification, is low cost, and does not seek to predict individual stock prices.

Like active management, Asset Class Investing seeks to add value over traditional benchmarks using a range of techniques. It does not seek to replicate commercial indexes and accepts tracking error to add value.

Unlike the traditional active or index approaches, Asset Class Investing is focused on capturing asset class or sub-asset class returns and allows greater flexibility in trading and tax management techniques.

1.4. Dimensional Firm Background

Dimensional's parent company DFA LP was established in the United States in April 1981 to implement the academic basis of Asset Class Investing. DFA LP has subsequently expanded its range of offerings and the countries in which it operates, but its strategies are still firmly based on the principles of Asset Class Investing and the firm maintains close links with academia to test and enhance its thinking.

DFA Australia was established in August 1994 to trade the Asia and Pacific Rim portfolios of the group. It started offering the trusts outlined in this report from 1999. As at December 2009, the group worldwide managed $A183 billion in funds. At that time, Australian-sourced funds under management amounted to $A15.5 billion, while the Sydney office managed $A33 billion.

2. Asset Class Investing and Professional Standards

2.1. Formulating Investment Strategies for Clients

The Financial Planning Association defines Financial Planning as:

The process of developing strategies to help you manage your financial affairs so you can build wealth, enjoy life and achieve financial security.

It then goes on to specify a six-step process for financial planning:

When developing a financial plan for you, known as a Statement of Advice (SOA), a Financial Adviser will follow a structured process to help understand your needs and recommend an appropriate strategy.

The six-step financial planning process is as follows:

1. Gather your financial information
2. Identify your goals
3. Identify financial issues
4. Prepare your financial plan (called a Statement of Advice)
5. Implement the recommendations based on your financial plan
6. Review and revise the plan at regular intervals, or when circumstances change[3].

Having properly understood the client's situation by undertaking Steps 1 to 3, formulating an appropriate investment strategy is a critical part of Step 4. Commonly, there are four elements involved in developing an investment strategy:

A. Determine the client's risk profile and appropriate asset allocation
B. Seek to add value
C. Ensure the strategy meets the client's liquidity needs
D. Ensure the overall strategy meets the client's needs and objectives

A: Determine the Client's Risk Profile and Appropriate Asset Allocation

Once a client's situation, needs and goals are understood, an adviser must formulate an appropriate investment strategy as part of preparing a financial plan. In doing so, the adviser must consider a wide range of investment options and decide which are suitable for the client's specific circumstances, and in what combination.

From a portfolio construction perspective, Dimensional's funds are designed to give advisers access to a range of asset classes and sub-asset classes that can be used to construct highly diversified portfolios. By breaking down equity markets into sub-asset classes, the Asset Class Investing approach enables an extremely high degree of diversification and control. According to the principles of Asset Class Investing, by combining sub-asset classes in equities that are not perfectly correlated, advisers are able to reduce overall portfolio volatility for clients without decreasing expected returns. Advisers are also able to increase expected returns by tilting to higher risk assets or reduce risk by favouring lower risk investments. With this approach, fixed interest is used as a volatility dampener, although higher returns are targeted within strict risk controls. These portfolio construction concepts are applied across both Australian and international markets.

Dimensional's products are designed on the strict principles of Asset Class Investing, based on rigorous academic research and process. They all provide a widely diversified exposure to nominated asset classes (or sub-classes). Some of the equity products are designed to provide enhanced returns within Australian or international equities through added exposure to the two risk dimensions that research shows provide appropriate

[3] www.fpa.asn.au/FPA_Content.aspx?Doc_id=1056

compensation for added risk – value stocks and small caps. The fixed interest products take relatively little credit or duration risk and add value using a variable maturity approach. This approach to fixed interest stems from Dimensional's view that the best use of fixed interest in a diversified portfolio is to reduce portfolio volatility.

The suite of products is designed so that a combination of funds can be used to structure portfolios with a range of expected risk/return outcomes.

In considering Dimensional products, a prudent adviser also would note the relatively low-fee structures built into the products. This is a function of the following:

- The process of Asset Class Investing being relatively low-cost - individual securities are not selected on the basis of projected outcomes prepared by analysts but rather on the basis of the quantitative and qualitative principles of Asset Class Investing
- Dimensional does not advertise or pay commissions to advisers, so there are no in-built marketing costs to support commissions

In practice, this means Dimensional funds generally are priced materially lower than funds from most other managers, and are priced comparable to or slightly higher than funds from index managers. The overall effect of this is an increase in fund returns to investors without an increase in their risk profile, achieved at a cost lower than most managers can offer.

The sections below provide an overview of the asset class strategies currently offered by Dimensional in the Australian market and their role within the asset allocation process:

Australian Equities

The Australian equities products offered by Dimensional are based on a quantitative approach with qualitative overlay. The product range includes the following funds:

- Australian Core Equity Trust - investing in a broad range of Australian listed shares and REITs, with tilts (in equities) to value and small cap stocks.
- Australian Value Trust - investing in a broad range of Australian listed shares classified as value companies.
- Australian Large Company Trust - investing in the top 100 Australian listed shares using a quantitative (index replication with trading and tax overlay) approach.
- Australian Small Company Trust - investing in small cap Australian listed shares (ex ASX100 and greater than $50m market cap).

This is a comprehensive suite of Australian equities products which all are based firmly on the principles of Asset Class Investing. The strategies are broadly diversified within the sector, or sub-sector as appropriate, with overweight positions in value and small cap stocks as indicated to achieve added value.

International Equities

The international equities products offered by Dimensional are based on a quantitative approach with qualitative overlay. The product range includes the following funds:

- Global Core Equity Trust - investing in a broad range of global developed market listed shares and REITs, with tilts (in equities) to value and small cap stocks. This trust has unhedged, AUD hedged and NZD hedged classes.
- Global Value Trust - investing in a broad range of global listed shares classified as value companies.
- Global Large Company Trust - investing in global large cap listed shares.
- Global Small Company Trust - investing in global small cap listed shares.
- Emerging Markets Trust - investing in the listed securities of value companies in emerging markets.

These global trusts are similar in structure to their Australian equities equivalents, with the addition of the Emerging Markets Trust. They too are a comprehensive suite of products, although they don't offer advisers the option of country-specific or geographic funds, other than perhaps the Emerging Markets Trust. Currency hedging is available in the Global Core Equity Trust only.

The international equities products also are broadly diversified within the sector, or sub-sector as appropriate, with overweight positions in value and small cap stocks as indicated to achieve added value.

Property

The one dedicated property fund provided by Dimensional (noting also that Australian REITs are included in the Australian Core Equity Trust and global REITs are included in the Global Core Equity Trust) is the Global Real Estate Trust. This fund invests in real estate securities listed on global developed markets with a bias towards Australian REITs driven by investor preference and tax considerations.

As property is a separate asset class to equities, with differing risk and return characteristics, this fund offers investors diversification within a portfolio. Further, the correlation between REITs across countries is very low. These low correlations make listed property an extremely effective component of a diversified portfolio. To capture the specific risk and return characteristics of listed property, Dimensional sets strict criteria for inclusion in its real estate product; i.e. the security must:

- generally generate at least 75% of its income through rents; and
- be tax transparent.

The fund is a blend of Australian REITs and international REITs, with domestic REITs being weighted at three times their natural free-float market cap weight (i.e. approximately 43% of the fund at time of writing) and the remainder in international REITs. This weighting is driven by investor preferences and tax considerations. The tax considerations are strongly influenced by the requirements related to Foreign Investment Funds (FIFs). This means that although the international universe of the fund allows for 12 countries outside Australia, the fund in practice is overweight UK and US REITs and underweight other jurisdictions (Belgium, Canada, Germany, Greece, France, Hong Kong, Japan, Netherlands, New Zealand and Singapore).

The impact of all this is that an adviser should be aware of which exposures are available through the fund. An adviser wishing to recommend specific Australian and/or international property exposures to a client, or combinations thereof, may not find the mix of the fund meets the client's requirements. However, in this case the fund does provide the potential for use as a core property exposure where the adviser could select other funds as satellites to gain the required mix.

Noting the security selection and country weighting points raised above, the fund otherwise is structured on the principles of Asset Class Investing: It aims to achieve the risk/return characteristics of the sector, it is tax efficient and it transacts on a patient basis. A prudent adviser could use the fund for the purpose for which it was primarily designed – to achieve appropriate diversification within a properly constructed portfolio.

Fixed Interest (Australian and International)

The fixed interest products offered by Dimensional are:

- Short Term Fixed Interest Trust - investing in high-credit-quality AUD-denominated fixed interest and money market securities with a maximum maturity of 2 years and an overall maximum portfolio weighted-average maturity of 1 year.
- Two-Year Diversified Fixed Interest Trust - investing in high-credit-quality domestic and global fixed interest securities with a maximum maturity of 2 years, where foreign currency exposure is hedged to the AUD.
- Five-Year Diversified Fixed Interest Trust - investing in high-credit-quality domestic and global fixed interest securities with a maximum maturity of 5 years, where foreign currency exposure is hedged to the AUD for AUD-denominated units or the NZD for NZD-denominated units.

As can be seen, the focus of all fixed interest products is high credit securities, with an emphasis on yield curve management. This follows from Dimensional's view that once an investor moves too far down the credit risk spectrum they start to take on equity type risks. These risks also can be less transparent in fixed interest where market processes differ. While the appropriate degree of credit risk taken is an investor preference, Dimensional believes investors need to be careful not to compromise the diversification and volatility dampening benefits of the asset class.

Dimensional's diversified fixed interest strategies, therefore, conservatively manage maturity and credit risk within strict limits to deliver a long-term premium over cash without compromising the other goals of this asset class in providing liquidity and lowering portfolio volatility.

If an adviser did not agree with this academically supported process and wished to pursue higher returns in this asset class, the adviser would have to seek alternative funds or products for their client outside of what Dimensional offers.

There are no specific longer-dated, AUD-denominated funds. So advisers with a view of the relative merits of Australian and international fixed interest don't have a choice in that respect. However, the funds are able to move between domestic and international, so this allows Dimensional to maximise its position depending on the shape of the yield curve.

A prudent adviser would pay heed to the research upon which Dimensional forms its views of fixed interest. On that basis, the prudent adviser would also be well served in using the Dimensional products for the purpose for which they were designed – reducing volatility as part of a well-constructed portfolio's asset allocation.

Alternative Asset Classes

Dimensional does not offer any funds which invest in alternative asset classes. This is consistent with its views, based on robust academic research, on where suitably compensated risks and returns can be obtained in the market and the most efficient and effective means by which they can be achieved.

If an adviser took a different view (that they wanted to recommend alternative assets to a client) it would still be quite feasible to use Dimensional products as the core of the client's portfolio with satellite alternatives from other managers.

Asset Allocation Summary

The products discussed above provide sufficient exposure to all major asset classes so that an adviser can construct a well-diversified portfolio for most clients. Transparency of fund construction and consistency of approach also are particularly useful for advisers.

Following the Global Financial Crisis (GFC), it became apparent to many investors that their portfolios contained risks different to those they expected. This does not appear to have been a concern to advisers or their clients invested in asset class funds. The transparency of asset class portfolios helps advisers to ensure they are clear on what their client is invested in and that the portfolio remains in keeping with the client's asset allocation and risk profile.

Another interesting trend emerging from the GFC is renewed investor interest in low-cost, properly diversified investment strategies which we note Dimensional offers.

B: Seek to Add Value

In Australia, fund managers who seek to "beat" or add value over market benchmarks have received the majority of managed investments flows. This suggests a widespread belief that this approach can add value.

Recently this has come under increasing scrutiny with strong interest in index and index-like products among many advisers. In the US, academic research (e.g. Brinson Hood Beebower 1986, Fama and French 1992, Carhart 1997) has long cast doubt on the ability of managers to add consistent value after allowing for risk. Recent research by Standard & Poor's suggests this may also be a challenge in Australia[4].

[4] www.spiva.standardandpoors.com.au

The research underlying Asset Class Investing suggests that the traditional attempts by managers to add value may be a zero-sum game and certainly one where it is difficult for an investor to select in advance a manager that will outperform.

The issue, though, is not whether some managers can out-perform indices but whether Asset Class Investing provides a prudent alternative to add value.

Propositions in favour of using Asset Class Investing are:

1. Other value-add approaches may be no better at adding value and usually involve greater costs and risks including higher turnover and reduced after tax returns.
2. Asset Class Investing is more transparent in terms of risk
3. Asset Class Investing is arguably more reliable as it avoids the uncertainties of traditional approaches such as reliance on forecasting skill, increased volatility from concentrated portfolios, asset allocation/risk drift as managers shift investment, key person and market timing risks.

C: Ensure the Strategy Meets the Client's Liquidity Needs

In addition to ensuring clients have access to funds to meet their short-term requirements, the process should take into account that clients' circumstances and personal preferences often change. This means they may need to withdraw all or part of their funds and change their investment strategy. Ideally, the investment strategy should facilitate this convenience and at low cost.

Dimensional's fixed interest funds are designed to be highly liquid. The Short Term Fixed Interest Trust, in particular, is suitable for clients that may need funds in the short term. The two-year and five-year diversified fixed interest trusts and the large company and core trusts also have strong liquidity profiles.

The value and small company trusts may hold illiquid securities. The Emerging Markets Trust may also hold relatively illiquid securities in markets that can be relatively illiquid.

However, there are a few factors that mitigate against the liquidity risk in these funds:

1. Dimensional's business strategy is to avoid clients chasing short term outperformance.
2. Dimensional's equity funds are diversified and have a low portfolio turnover so that individual stock liquidity is less important.
3. Dimensional's experience is that most advisers use the value, small cap and emerging markets funds as only a part of a client's share exposure (the option also exists for an adviser to use less of the illiquid funds if this is a particular concern for a client). This means that the overall portfolio can still provide significant liquidity.

Overall, the illiquidity of some of the Dimensional funds would be a concern only in the most extreme scenario in which there was a major crisis of liquidity combined with demand for rapid fund outflows. It should be noted, however, that even in the extreme environment of the GFC of 2008 there were no liquidity issues for any of Dimensional's funds.

D: Ensure the Overall Strategy Meets the Client's Needs and Objectives

Advisers should always ensure that an investment strategy is appropriate for an individual client's needs and objectives. One issue not yet considered in this respect is the client's need for income.

Generally speaking, compared to products in comparable classes from other managers, the Dimensional products may yield lower levels of income distributions. This is due to:

- the tax-managed nature of the investment process resulting in lower levels of realised gains
- less access to high yield (lower credit quality) fixed interest products

Therefore, an adviser considering recommending Dimensional to a client reliant on income from their portfolio would need to consider alternative forms of cash flow, such as capital reductions.

In this context, though, it is worth mentioning that Dimensional proposes that clients focus on cash flow rather than on income, due to the possible risks associated with chasing income and, in some cases, the worse taxation treatment.

2.2. Recommending Predominately One Manager

We understand Dimensional currently is the only fund manager employing Asset Class Investing in Australia. If an adviser supported the approach and wanted to implement it for all asset classes for a client, this raises the question as to whether it is prudent to recommend only one fund manager or predominately one manager to a retail client.

It should be noted that this is not a requirement for use of Dimensional's products. Anecdotally however, it seems that a significant allocation to the strategies is a common outcome for advisers who choose to adopt Asset Class Investing. This contrasts with regular market practice where it is far less common to principally recommend a single manager.

The prudence of recommending predominately one manager will depend on the individual circumstances. The mere fact of recommending predominately one manager will not of itself breach standards. It comes down to whether just having the one manager could place a client at a disadvantage because it may expose the client to risks inappropriate to their circumstances.

The usual reasons given for diversifying and adopting more than one manager are:

- Blend investment styles within an asset class
- Select the best managers within an asset class
- Spread risk of incorrect predictions by managers
- Make best use of manager expertise across differing asset classes
- Spread risk of corporate or system failure leading to a loss of funds

This market practice is not universal and it should be noted there are instances of use of single managers, or overweight allocations to single managers:

- Historically, "tied" advisers (e.g. those employed by or otherwise closely aligned to an institution) often placed all or a significant proportion of their clients' funds into products manufactured by their parent institution.
- This is perhaps less so these days, but it is still common practice for advisers aligned to an institution to allocate a significant or overweight proportion of clients' funds to the parent product, often through a platform owned or affiliated with the parent institution.
- Some advisers choose to recommend only index funds, and in some cases only use one specific index manager. With the growth in the use of index funds, many advisers are now also using a single index fund provider to provide core asset class exposure. Others are adopting Exchange Traded Funds (ETFs) from a single provider.

This paper considers the arguments raised above in favour of diversification in the context of an asset class manager being considered as the sole or predominant recommendation.

Blending Investment Styles within an Asset Class

This argument is based on the premise that different managers can deliver different results depending on the condition of the market. For example, at any point in time the equities market may favour growth over value or vice versa. Hence, advisers traditionally diversify to manage exposure to different styles. Given the relatively concentrated portfolios of many managers and reliance on the research skill of each manager to add value, it arguably makes sense to spread the risk of a manager "getting it wrong" by diversifying by manager.

In contrast, Asset Class Investing involves broad allocations to whole classes of securities with higher expected returns. Because it is designed to deliver the returns of the asset class with some value added, there is a reasonable argument that the broadly diversified portfolios of Asset Class Investing and the process-based investment techniques utilised remove the need for multiple investment managers.

In relation to value and growth styles, the research behind Asset Class Investing suggests that tilting to value stocks can add value over time. On the basis that the supporting research is correct, this logically suggests that offsetting such a tilt with an exposure to growth style simply would bring the overall portfolio to a style-neutral position with no expected value-add, but quite possibly with additional cost.

As an alternative, index or passive investing is designed to deliver returns consistent with the market benchmark. Hence, there is no issue about style bias at any point in time. However, the cost of using an index manager compared to an asset class manager is in forgoing the added value that Asset Class Investing provides through tilting in favour of small cap and value stocks. This opportunity cost needs to be weighed against the slightly higher cost of using an asset class manager, but based on historical results, it appears to be a price worth paying.

> Given the considerations discussed above, there are strong grounds to support the prudence of an adviser (subject to an individual client's requirements) recommending only an asset class manager.

Select the Best Managers within an Asset Class

This argument relies on the idea that it is possible to identify in advance managers who will consistently produce top level returns, or alternatively that it is possible to consistently move from one manager to another and in doing so maintain top level returns (ignoring the tax implications of so doing).

Whether it is possible for one manager to consistently over time produce superior returns is questionable. There certainly are managers who have produced strong performance over extended periods, but an adviser would need to feel satisfied that this was sustainable and that the risks taken by the manager were appropriate.

Rather, the question should be "how can value be added in the most reliable way?" Some managers may well be able to add value for a time (although note the S&P SPIVA research referred to earlier), but they often do so with all the risks inherent in stock picking and market timing.

Asset class managers deliver the performance of the asset class, with added value through relying on additional investment dimensions and trading strategies. Generally, this is done at a cost significantly lower than other approaches. In this context, the issue of trying to continually select top performing managers becomes a non-issue.

As noted, we understand only Dimensional offers an Asset Class Investing approach at present. However, if another manager was to develop a superior asset class approach then an adviser would be well advised to consider it.

Similarly if a non-asset class manager was to develop a superior approach, then there would be an opportunity cost involved in staying with an existing asset class manager. For an adviser, this is a risk to be aware of and one that can be managed only by maintaining knowledge of the market and innovation within it. If a superior methodology emerged, then clearly, after careful research and due diligence, it may be prudent to adopt it.

Make Best Use of Manager Expertise across Differing Asset Classes

The issue to consider is whether it is possible to recommend the "best in class" managers in each asset class. Another way of looking at this is to ask - if only one manager is being used – is there a possibility of sub-optimal performance in some asset classes because the manager does not have the best expertise in each class?

> It is difficult enough to reliably select securities in one asset class, let alone do it consistently across classes. However, an Asset Class Investing process does not rely on individual forecasting skills and is based on a consistent philosophy across asset classes. This argument therefore lacks merit in the context of an Asset Class Investing portfolio.

Spread Risk of Corporate or System Failure Leading to a Loss of Funds

All fund managers and their service providers face the risk of corporate or systems failure. Such risks include the following:

- Failure of the manager's business model
- Fraud or malpractice by staff at the manager
- Failure of the platform through which the client's funds are placed with the manager
- Failure of the custodian who holds the assets being managed

Assuming current regulatory requirements and operational risk practices are adopted consistently for the most part by all managers, these risks arguably are similar in nature from manager to manager. The risk may be different for a boutique manager relative to a large institutional manager, for example, due to comparative backup resources.

It could be argued that, most of the business risks of an asset class manager are no different to any other manager. In fact many managers are exposed to additional key person risk, where their business model relies on individuals to select securities and time markets.

There is, however, the question of whether recommending only one manager exposes a client to inappropriate risks. Clearly, using only one manager does tend to concentrate these business and operational risks, and potentially using more than one manager would spread this risk and minimise a client's exposure.

In terms of the risk of loss of client assets, Dimensional adopts the common industry practice of using a custodian to hold investment funds. This means clients' assets are not held by Dimensional and are not at risk if Dimensional were to fail. While it could be argued that allocating the majority of funds to a single manager results in more concentrated risk, custodial risk is not usually considered a risk worth diversifying.

Most clients using platforms use a single platform with all assets held by the one custodian. Similarly, even within a diversified portfolio of multiple managers, many managers use the same custodian and this is not usually an issue that is considered. In other words, single custodian risk is widely accepted.

Advisers considering using only one manager should, however, ensure they are as informed as possible about the business and operational risks the single manager faces, and should consider these in formulating their recommendations to clients. If the adviser wishes to proceed, it would be prudent to explain these potential risks to the client.

2.3. Other Factors to Consider in Recommending Dimensional

There are a number of aspects an adviser should consider when recommending Dimensional products to clients. These are discussed further in this section of the report.

Product Accessibility

Dimensional does not have direct retail products and can be accessed by advisers only on certain investment platforms. However, a number of widely used platforms do have Dimensional products and as this is a commonly used means of investing clients' funds, gaining access to Dimensional products should not be a significant problem for most advisers.

Generally speaking, Dimensional prefers that a platform offering its products should offer most or all of them, not just one or two. This is to ensure advisers who wish to adopt Asset Class Investing can do so effectively through their platform of choice and build an appropriate investment strategy for a client across all asset classes. While this requirement could limit access to Dimensional's products, it does provide evidence of the firms commitment to the principles of Asset Class Investing.

We note that in some cases advisers in buying groups are accessing Dimensional products on their badged or white-labelled platforms, presumably on the basis that this reduces overall investor costs.

It should be noted, also, that Dimensional does not provide a superannuation vehicle or a product specifically designed for superannuation. However, this does not preclude a superannuation fund (of any type) from investing in Dimensional products. Indeed, Dimensional funds are available on a number of super wraps.

Adviser Relationships

Dimensional has a clear policy of not paying commissions to advisers, not providing sponsorships and not taking equity participation in any advisory groups. This policy is designed to maintain independence but also so that advisers can recommend Dimensional products with no real or apparent conflict of interest. It has the added advantage of keeping product costs down, which directly benefits investors. Note also the comments in Section 3.2 below regarding possible changes in Australian regulatory requirements in this regard.

> Dimensional supports its products with a rigorous training and accreditation process. In fact, the firm makes this process a requirement for advisers wishing to access its funds. Again, this demonstrates the importance that Dimensional places on ensuring advisers understand the principles of Asset Class Investing and its products.

The need for advisers to have a thorough knowledge of the products they recommend has been clearly reinforced in recent disputes before the Financial Ombudsman.

In practice management terms, advisers are increasingly reflecting on where they add value and holistic advice is becoming more popular. This sits well with Dimensional's offering and approach to educational support. Asset Class Investing effectively enables advisers to concentrate on the value of advice.

Based on anecdotal evidence, it appears that advisers who do support Dimensional develop a strong philosophical commitment to Asset Class Investing and to Dimensional's approach, demonstrating that it is a relationship that works well for advisers and their clients.

Research Houses

Dimensional deals only with those research houses that are willing to research most or all of the firm's product suite, rather than cherry pick individual products. As with the manager's preference for platforms to list all or most of its products, this could reduce access to Dimensional's products (for example if an adviser relies on a research house that does not rate Dimensional), but is supportive of Dimensional's commitment to the principles of Asset Class Investing.

Implementation Risk

Implementation risk is the risk of how well and how consistently Dimensional executes the Asset Class Investing model. Is there a better alternative?

As previously noted DFA Australia is part of a large and established global funds management group with over $A183 billion managed worldwide, $A33 billion managed from the Sydney office.

All of this goes to show that Dimensional is an established and significant participant in the Australian and global funds management industry. Throughout its history in Australia and the world, the Dimensional group has stuck rigorously to the principles of Asset Class Investing, and it is the key point of difference that Dimensional offers. Dimensional has clearly established its credentials and there are no obvious concerns in its implementation of Asset Class Investing.

As to whether there is a better alternative, at the time this report was written there were no other managers in the Australian market offering products based on similar principles to Dimensional, and none proposing to do so to the best of the authors' knowledge. Index products and ETFs are available, but these clearly are distinguishable from the products offered by Dimensional.

Faced with this sort of choice, prudent advisers should maintain their knowledge of managers and their offerings in the market. Should a manager develop a superior product based, for example, on new research, then it would clearly be prudent for an adviser to consider using those products in addition to or as an alternative to Dimensional, a point freely acknowledged by Dimensional. Consideration of any alternative approach should take into account the robust processes Dimensional has displayed compared to the possible exposure to key person risks in other approaches.

Operational Risk

Operational risk is the possibility of Dimensional's business being disrupted in a way that impacts clients or advisers.

Dimensional, like all investment managers, is exposed to operational risks, including those related to investment administration, asset management and information technology. Managing these risks is the responsibility of the directors and management of Dimensional. To do this, the company implements a number of controls designed to mitigate and manage the risks to an acceptable level.

These controls are the subject of an annual report, in which independent auditors test the controls and note any exceptions. At the time of preparation of this paper, the most recent report was for the period 1 July 2008 to 30 June 2009. In that report, 55 control objectives were identified, each with a number of actual controls used to achieve the objective.

In the report, the directors of Dimensional signed off on the effectiveness of the controls. The auditor, Deloitte Touche Tohmatsu, also provided its opinion that the report accurately described the controls, that the controls were suitably designed to achieve their specified control objectives, that the controls were implemented and that they were operating effectively throughout the period. Dimensional is able to provide a full copy of the report to clients on request.

Given these risk management processes it would be reasonable for a prudent adviser to assume the investment administration, asset management and IT risks for Dimensional are being managed in an appropriate manner. As such, the prudence of using Dimensional as the primary provider of product would be consistent with selecting any well capitalised professional fund manager.

Custodian and Outsourced Functions

Like all fund managers in Australia, Dimensional is required to maintain separation of investors' funds and company assets. This is achieved by using a custodian (JP Morgan Chase) to hold all assets for clients investing in the trusts referred to in this report. The primary purpose of using a custodian is to protect investors' funds in the event of any malpractice or failure by the manager by keeping them separate from the manager's assets. A secondary purpose is to obtain scale efficiencies in investment administration and reporting, thus reduce the overall cost to investors.

There is one exception we are aware of to the statement that the custodian holds all client funds. That relates to initial application monies. These are funds taken on application and not yet invested in the Dimensional trusts. The application account for the Dimensional Australian resident trusts is currently held with ANZ. The account is controlled by Dimensional. However, it is a segregated account with assets held only on behalf of the trusts.

There are strict internal controls regarding access to and operation of the account. Funds usually are processed when cleared or on the following business day. In any event, they cannot be held for more than 30 days. In the unlikely event that Dimensional's business failed, the assets would remain for the benefit of the trust investors and could not be accessed for other purposes.

This method of dealing with application monies is common practice in funds management, so the risks associated with it are no different for Dimensional than with any other manager. However, if only Dimensional is used, there is potentially a concentration of this risk, albeit one that is unlikely to transpire in our view.

Otherwise, Dimensional globally outsources some other functions, including middle office transaction processing and recording. In Australia, Dimensional also relies on some IT and business support capability from other parts of the Dimensional group, meaning it can access the scale and expertise of the group world-wide.

The net result of all of this is that a prudent adviser should be aware of the operational issues involved in managing clients' funds, and take some comfort from the existence of robust operational and risk management practices that are not unusual in the investment management industry.

3. Legal Requirements

3.1. Current Requirements in Australia

The current legal test for the prudence of financial planning is contained primarily in section 945A of the Corporations Act which provides, in summary, that an adviser must only provide personal advice on financial products to a retail client if:

1. The adviser determines the client's relevant personal circumstances in relation to giving the advice and makes reasonable enquiries in relation to those personal circumstances;
2. Having regard to the information obtained from the client, the adviser has reasonably considered and investigated the subject matter of the advice; and
3. The advice is appropriate to the client, having regard to the consideration and investigation.

In addition ASIC Regulatory Guide 175 provides ASIC's interpretation of what ASIC considers 'appropriate' advice:

"if it is fit for its purpose - i.e. if it satisfies the client's relevant personal circumstances. Personal advice does not need to be ideal, perfect, or the best to comply with the Corporations Act."

At the time of writing of this paper, various regulatory and policy changes were being publicly discussed. For the purposes of this paper, the current legal test is used, although we discuss below the potential implications of possible changes to the test.

At common law, an adviser must exercise a fair, reasonable and competent degree of care and skill to a standard of an ordinary and skilled adviser exercising and professing to have the skill of providing investment advice, i.e. that which would be expected from a reasonably competent adviser.

There are some other legal requirements that are similar, but not quite directly relevant to an adviser providing personal advice to a retail client:

- SIS Regulation 4.09 lists some of the circumstances to which a superannuation trustee must have regard in formulating and giving effect to an investment strategy
- State legislation governing investments made by authorised trustees refer to the 'prudent person' rule, whereby trustees must, amongst other things, consider the need to diversify trust investments

Prudence of Recommending Asset Class Investing

Nothing in the outline above of legal requirements indicates there is any specific obligation for an adviser to use, or not use, a specific style of investing. Whether it is prudent and reasonable to recommend Asset Class Investing therefore comes down to whether it is appropriate for the client, having regard to their circumstances.

As a general rule, there is no legal impediment to recommending Asset Class Investing. However, there may be some instances where it is less appropriate for a prudent adviser to recommend Asset Class Investing to a client. For example, individual clients who:

- wish to use high risk strategies incorporating individual stock price prediction or market timing
- need a relatively high income component
- seek high realised capital gains
- focus on liquidity, but only in regard to the Dimensional's small cap equity trusts or Emerging Markets Trust

Recommending Predominately One Manager

Again, there is no specific legal requirement that an adviser must diversify fund managers. The prudence of doing so depends on the client's circumstances. As noted above in Section 2.2, there are certain issues to consider in relation to individual clients' circumstances, but it may well be appropriate to recommend predominately one manager to a client.

3.2. Developments in Australian Requirements

Possible Regulatory Reform in Australia

At time of writing, there were a number of regulatory inquiries underway into the financial advice and wealth management industry with potentially profound implications for wealth management businesses.

The key developments being considered which are relevant to this paper include such issues as:

- requiring advisers to adopt a fiduciary duty to their clients so they give priority to clients' interests ahead of their own
- banning or restricting commissions and other forms of distribution incentive and encouraging greater transparency

On both of these issues, Dimensional is well placed should they become adopted. As has been outlined in this paper, there are good arguments in favour of a prudent adviser recommending Dimensional's products, depending on the client specific needs. Dimensional's policy of not paying commissions and other forms of incentive payments means it should comply well with any new requirements and advisers can have confidence in recommending Dimensional if asked about these issues by clients.

In addition, Dimensional's approach to adviser training and accreditation supports advisers making properly informed decisions in their recommendations to clients.

Overseas Trends

In the US, the principles of modern portfolio theory – the tenets of which underly the Asset Class Investing approach – have been put forward by the American Law Institute in Washington DC as forming the basis for a prudent investment strategy. While this is not a legal requirement as such in the US, it does indicate the trend towards having a rational basis for prudent advice, i.e. one that is not only based on robust research but that is also defensible.

In Australia, there currently are no specific requirements to adopt this scientific basis for investment decisions. However, recent debate is shifting in this direction with a focus on the cost of investment options, the importance of diversification and the evidence for fund manager value-add.

4. Sample Portfolio

Asset Class Investing Portfolio

Asset Class Investing funds are designed to be used as part of an overall asset class portfolio. To test the validity of this proposition, the table below compares an Asset Class Investing portfolio with a portfolio constructed using indices. Returns for the individual Asset Class Investing strategies are available from Dimensional.

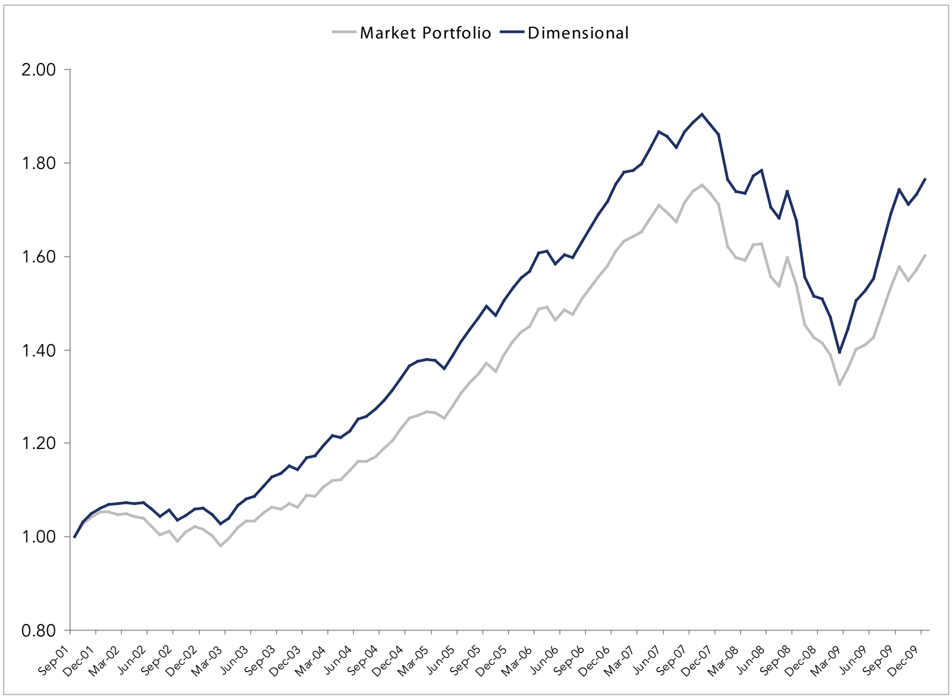
Oct 2001 to Dec 2009	ASSET ALLOCATION (%)	
	Dimensional	Market Portfolio
Australian Shares		
S&P/ASX ACCUM 300 Index		31
Dimensional Australian Large Company Trust	15	
Dimensional Australian Value Trust	10	
Dimensional Australian Small Company Trust	6	
International Shares		
MSCI World Index $A		16
Dimensional Global Large Company Trust	8	
Dimensional Global Value Trust	5	
Dimensional Global Small Company Trust	3	
Listed Property		
ASX ACCUM 300 Listed Property Index	7	7
Fixed Interest		
UBS Composite Bond Index		27
JPMorgan Global / Govt Hedged		6
Dimensional Diversified Fixed Interest Trust	33	
Cash		
UBS 90 Day Bank Bill Index		13
Dimensional Short Term Fixed Interest Trust	13	
Total	**100**	**100**

	ANNUAL RETURN/RISK	
Portfolio Return*	7.13	5.87
Standard Deviation	6.96	6.49

*Analysis covers period where all Dimensional trusts stated above have live returns. Dimensional Trust returns are net of fees and expenses but before tax. No fees, expenses or tax have been deducted from the market portfolio.

Source: Dimensional

Growth of a Dollar - Oct 2001 to Dec 2009



It should be noted that Dimensional does not require only Asset Class Investing funds to be utilised. However, for the purpose of the illustration, we have used a purely Asset Class Investing portfolio for comparison.

The asset allocation is notional, but for the purposes of consistency, it is the same as that used in a prior version of this document produced by Corporate Monitor in 2006. The data was originally sourced from a report in the Sydney Morning Herald Investing supplement on 6-7 March, 2004 which summarised the average asset allocation and returns obtained from diversified managed fund portfolios over the preceding 10 years.

5. Conclusion

This document has addressed the following questions in relation to Asset Class Investing:

> Is it prudent to recommend Asset Class Investing to a client?
>
> If so, is it prudent to use predominately one manager?
>
> If so, is it prudent to place the majority of, or, all of, a client's funds in trusts managed by Dimensional?

The questions have been considered from both a professional standards and a legal perspective.

> Our view is that Asset Class Investing is a legitimate and proven way to construct investment portfolios aimed at building and protecting wealth. This process has the capacity to eliminate many forms of risk traditionally associated with funds management. It appeals to those who believe that market returns (at asset class and sub-asset class level) are the prime driver of investment outcomes and that diversification is key to managing risk in a portfolio.
>
> As to using predominately one manager, we conclude that the traditional arguments advanced for diversifying managers can be significantly diluted when considering an asset class manager.

Because the nature of Asset Class Investing enables access to a broadly diversified set of securities within each asset class, it can be argued that it negates the need to seek complementary investment styles. In addition Asset Class Investing generally has lower costs than other approaches.

From an investment perspective, there is sufficient evidence therefore to argue that it is prudent for an adviser to recommend Asset Class Investing to a client.

We further note that using predominately one manager does concentrate exposure to the operational risks of a business. We observe, however, that Dimensional addresses this through industry best-practice risk management processes, excellent governance and, importantly, the holding of all assets with external custodial services.

About Paragem

Paragem Dealer Services (Paragem Partners Pty Ltd) is an independent business focussed on helping Financial Planning entities comply with the AFSL regulatory environment.

Services offered by Paragem include compliance, governance and risk management, AFSL applications, research and investment education, business and back office support.

The business is 100% fees based, has no association with 3rd party entities with manufacturing and is owned privately by executive that have no commercial competing conflicts. The executive have enjoyed successful corporate careers in the Wealth Management Industry via Licensed entities, the Funds Management industry and the Compliance Industry. The latter has been focussed on the personal advice market and risk management therein.

In terms of size and market experience, Paragem looks after over 190 AFSL's and this extends to around 1,500 Authorised Representatives. Clients range from large institutional dealer groups and Iconic Wealth Management companies through to sole practitioners and accounting firms. Services are generally modular and primarily compliance based / governance focussed with the larger entities.

Appendix 1:

Dimensional Products Covered by this Paper

- Dimensional Short Term Fixed Interest Trust
- Dimensional Two Year Diversified Fixed Interest Trust
- Dimensional Five Year Diversified Fixed Interest Trust
- Dimensional Global Real Estate Trust
- Dimensional Australian Core Equity Trust
- Dimensional Australian Value Trust
- Dimensional Australian Large Company Trust
- Dimensional Australian Small Company Trust
- Dimensional Global Core Equity Trust
- Dimensional Global Value Trust
- Dimensional Global Large Company Trust
- Dimensional Global Small Company Trust
- Dimensional Emerging Markets Trust

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