

Tuesday 22 May 2012

## Changes to BlackRock's Australian fundamental equity management

I am writing to advise you that BlackRock's Australian Scientific Active Equity (SAE) team will assume sole responsibility for all Australian equity products. Consequently, our Australian SAE team will transition all funds currently managed by BlackRock's Fundamental Australian Equity (FAE) investment team to the SAE investment strategy on or after June 14, 2012.

This change follows an intensive review of our Fundamental Australian equity capabilities. It concluded that the BlackRock's SAE team's unique investment philosophy and process is best-placed to meet these Funds' performance expectations going forward.

On or after June 14, your client's funds will be invested in a combination of two long-established BlackRock Australian Scientific Equity investment strategies via the BlackRock Equitised Long Short Fund and the BlackRock Indexed Australian Equity Fund. Full details are contained in the Supplementary Product Disclosure Statement (SPDS) available on our website at [www.blackrockinvestments.com.au](http://www.blackrockinvestments.com.au)

BlackRock's SAE team has a long record of investment success, managing Australian equities, since 1996. We are excited to bring SAE's class leading long/short strategy to you and your clients.

### Performance

SAEs investment process has been proven, tested, refined and consistently improved over more than two decades globally and for more than 15 years locally.

Below is an illustration of the SAE's team performance history for both their active long/short and passive Australian equity strategies. The table below highlights the gross performance returns for the two underlying funds [BlackRock Equitised Long Short Fund (BELSH) and BlackRock Wholesale Indexed Australian Equity Fund (BIFAEI)] that the affected funds are intended to invest in after the change in investment strategy as described in the SPDS.

	1 year % p.a.	2 years % p.a.	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since 31-Dec-01* % p.a.
<b>Equitised Long/Short Fund (BELSH) – gross returns</b>	10.13	8.68	21.60	3.52	15.98	16.30
Outperformance (versus S&P/ASX200 Accumulation Index)	<b>16.19</b>	<b>10.11</b>	<b>10.35</b>	<b>5.56</b>	<b>9.04</b>	<b>9.46</b>
<b>Aust. Equity Index Fund (BIFAEI) – gross returns</b>	-6.26	-1.35	11.40	-1.95	7.01	6.92
Outperformance (versus S&P/ASX300 Accumulation Index)	<b>0.00</b>	<b>0.01</b>	<b>0.04</b>	<b>0.15</b>	<b>0.08</b>	<b>0.08</b>

For illustrative purposes only, the table below shows back-tested (i.e. blended historical performance numbers) for an example portfolio that has invested 45% in the BlackRock Equitised Long Short Fund and 55% in the BlackRock Wholesale Indexed Australian Equity Fund. That is using the actual performance of the existing underlying funds, reflecting the strategic allocation intended to be implemented in respect of the FAE funds. The intent is to show how the changed investment strategy may work in practice. The back-tested performance numbers are an example and are only indicative of performance had the affected funds been subject to the new investment strategy.

### Gross performance of *Blended Portfolio* (45% BELSH & 55% BIFAEI) to March 31, 2012

	1 year	2 years	3 years	5 years	10 years	Since 31-Dec-01*
	% p.a.	% p.a.	% p.a.	% p.a.	% p.a.	% p.a.
<b>Blended Portfolio</b> – gross returns	0.85	3.09	15.94	0.54	11.02	11.10
Benchmark**	-6.27	-1.37	11.35	-2.10	6.93	6.84
Outperformance (versus S&P/ ASX300 Accumulation Index)	<b>7.12</b>	<b>4.46</b>	<b>4.58</b>	<b>2.64</b>	<b>4.08</b>	<b>4.26</b>
Tracking Error	-	-	2.70	3.01	2.66	2.66
Information ratio	-	-	1.70	0.88	1.53	1.60

\* Inception month for the BELSH fund.

\*\* S&P/ASX300 Accumulation Index for BIFAEI and blended portfolio and S&P/ASX200 for BELSH.

Performance returns shown are gross (i.e. assumes all income is reinvested but does not take into account fees, expenses or tax).

Past performance is no indicator of future performance. Long term performance returns show the potential volatility of returns over time.

The value of investments and the income from them can fall as well as rise and is not guaranteed.

The above returns assume the combined portfolio is rebalanced on a monthly basis which is consistent with the approach to be taken in management of the FAE funds.

The actual allocation may vary within a range close to the strategic weightings according to our view of the outlook for investment markets.

This example illustrates the outperformance the SAE team has generated in their long/short fund and the exciting opportunity these changes bring to investors.

### What are you required to do?

You and your clients are not required to do anything. The fund's parameters are broadly staying the same. The table below provides a snapshot of what's staying the same and what's changing.

Unchanged	Changing (refer to SPDS for details)
Fees – there is no change to any fees	Investment process
Funds will aim to consistently outperform the benchmark over rolling 5 year periods	Investment benchmark going from S&P/ASX 200 Accumulation Index to S&P/ASX 300 Accumulation Index*
Quarterly distributions	The Fund's daily notification cut-off time for applications and redemptions will be 1pm rather than 2pm
The funds will still benefit from receiving franking credits	The fund will now hold long and short positions in Australian equity stocks
Reporting and communication	
Buy/sell spreads	
Accepts daily applications and redemptions via the same process	
Risk targets (tracking error)	

\*The benchmark for the BlackRock Australian Share Fund Plus and BlackRock Equity Fund remain unchanged.

If you have any queries about these enhancements or the BlackRock's Australian Scientific Active Equity capabilities please do not hesitate to contact our Adviser Services Centre on 1300 366 100, contact your Account Manager or visit [www.blackrockinvestments.com.au](http://www.blackrockinvestments.com.au)

Yours sincerely



**Scott Phillips**

Managing Director and Head of Retail, BlackRock Australia

## More detail about these changes

### Why have we made these changes

The investment landscape globally has changed greatly. We have to respond to the changed investment environment by aligning our capabilities in ways that can best meet the needs of our institutional and retail clients.

We think that the SAE investment philosophy and process is a great fit for today's investment environment. Markets aren't behaving the way they used to. In this era of stock market swings and interrelated markets, we think that investments need to be flexible enough to adapt to rapidly changing markets. We believe that SAEs investment process is the right answer for today's more volatile investment environment.

This change makes available to the broad Australian market an outstanding capability that has until now largely been the domain of institutional clients. We believe that our SAE team, the rigour of their philosophy and effectiveness of their investment process is second-to-none. We think this is an exciting development for our clients in particular and the broad Australian market in general.

We believe that our SAE team's capability is second-to-none. Their unique investment philosophy and process is best placed to achieve strong returns from active Australian equity investing, in our view. This action makes a pre-eminent investment capability accessible to the broad Australian retail market and we are excited about its prospects.

SAE has a strong record of success which testifies to the team's capability. The SAE-managed BlackRock Equitised Long Short Fund has achieved the #1 ranking in Mercer's Investment Performance Survey of Australian Shares over the year ended March 31, 2012 (versus more than 140 other funds) and is also the top performing fund in its category (Australian Shares Long/Short Sub-Universe) over the past one, two, three, five and 10 years.<sup>1</sup> BlackRock is excited to bring the world class investment capability that has made this achievement possible to all our actively managed Australian equity products.

### What do these changes mean

SAE will transition all funds currently managed by BlackRock's Fundamental Australian Equity (FAE) investment team to the new investment strategy effective on or after June 14, 2012. Risk relative to benchmark has been reduced in the interim.

The following Fundamental Australian Equity portfolios are affected:

- ▶ BlackRock Wholesale Australian Share Fund
- ▶ BlackRock Australian Equities Pooled Super Trust
- ▶ BlackRock Australian Share Fund
- ▶ BlackRock Australian Share Fund Plus
- ▶ BlackRock Professional Investor Australian Share Fund
- ▶ BlackRock Equity Fund [Please note that a PDS is unavailable for this product as this is a closed fund. See appendix A for further details on the fund's profile].

### BlackRock's commitment to Australia

Australia is one of the world's largest and most sophisticated asset management markets and BlackRock is ambitious to grow its local business. The A\$1.3 trillion Australian superannuation industry and a further A\$1.9 trillion in non-superannuation personal savings – in banks, shares and investment properties – makes this one of the world's most compelling investment domains.

BlackRock's goal is to be the premier investment manager in Australia and we want to have a broadly diversified business. We believe we have major growth opportunities ahead and are greatly enthused about our ability to meet clients' service and investment expectations.

SAE is an outstanding investment franchise and we believe in the team's capacity to meet or exceed clients' investment expectations. The change is to ensure that our capabilities in Australia best meet the needs of our institutional and retail clients.

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1. Mercer Investment Performance Survey of Australian Shares (as of March 31, 2012) "Australian Shares (Long/Short) Sub-Universe."

# The Scientific Active Equity Business

## Leadership

Mike McCorry, CIO of the Australian Scientific Active Equities is a 15-year BlackRock veteran (including his years with BGI) and leads the Australian SAE team. He is a proven research and investment leader and the SAE team's investment performance, cohesion and spirit of innovation have been exemplary under his guidance.

He is excited about bringing the SAE team's investment capability to the broad Australian retail market, which until now was largely confined to the institutional market.

Mike reports to Jeff Shen, Managing Director and Head of Asia Pacific and Emerging Market Equity within BlackRock's Scientific Active Equity (SAE) Group.

Under Mike's leadership the SAE has performed outstandingly. For example, the SAE-managed BlackRock Equitised Long Short Fund has achieved the #1 ranking in Mercer's Investment Performance Survey of Australian Shares over the past year (versus more than 140 other funds.)

## The Scientific Investment Process

There are 2 main changes involved in this new investment strategy.

1. Is to make available to you the unique investment philosophy and process of BlackRock's Australian Scientific Active Equity team.

The BlackRock Australian Scientific Active Equity team's investment process systematically applies skill and insight. It represents investment logic with quantitative rigour. The key components of this investment process are:

- ▶ Fundamental Investment Insights identified by the Scientific investment team
- ▶ Rigorous and disciplined research (the scientific method) via quantitative methods is utilised to validate investment ideas. The scientific method exploits mispricing's stemming from human over/under reactions and biases.
- ▶ Portfolio Construction is highly risk-controlled, delivering consistent, incremental investment performance.

2. Relaxing the long-only constraint, which allows short selling. SAE captures returns from a wide range of sources, including risk-balanced, long and short positions in equities.

## The Short Selling Investment Process

The long-only constraint is extremely binding in Australia such that you lose about 40% of the investment ideas gained from research due to only being able to express long (over-weight) views on most stocks.

In broad terms, a 'short sale' is a transaction in which the Fund agrees to sell securities that it does not presently own. Typically the Fund will enter into a securities lending transaction to "borrow" the security to ensure the security sold can be delivered to the buyer.

The aim of short selling is generally to sell a security with the expectation of buying it back, at a later time, at a lower price and therefore profit from the transactions. Securities sold short by the Fund will rise in value as the market price of the security falls and fall in value as the market price of the security rises.

As for any other investment the Fund makes, short selling exposes the Fund to market risk.

In addition, short selling involves the use of counterparties to facilitate and manage the trade from an operational perspective. This in turn may involve collateralisation or similar agreements with those counterparties which exposes the Fund to counterparty risk.

### **Investment Objective**

The Fund has two aims: to achieve capital growth over the long-term through investment in Australian shares and other securities and to provide investors with some tax-effective income through the distribution of franking credits. Overall, we aim to achieve this goal by outperforming the S&P/ASX 300 Accumulation Index over rolling five year periods.

### **What does the Fund invest in?**

To achieve its investment objective the Fund gains exposure either directly or via units of other funds managed by us or other members of the BlackRock group to the following:

- ▶ a portfolio comprising a long short Australian equity investment strategy (“Long/Short Portfolio”) managed closely around a strategic asset allocation of 45% of the Fund’s assets. The long short investment strategy has a maximum exposure to long equity positions of 1x its net asset value and a maximum exposure to short equity positions of 1x its net asset value.
- ▶ An Australian Equities index portfolio benchmarked against the S&P/ASX 300 Accumulation Index managed closely around a strategic asset allocation of 55% of the Fund’s assets.
- ▶ Swaps and/or SPI futures contracts to provide the Fund broad exposure to the S&P/ASX300 Accumulation Index either directly or through underlying investment strategies.
- ▶ Cash held on margin to satisfy the margin requirements for the SPI futures (and/or swaps) contract positions either directly or through underlying investment strategies. This figure will vary depending on the number and value of futures contracts entered into and their margin payment required.

Whilst the constitution of the Fund allows borrowing, it is our intention that no borrowing arrangements will be entered into by the Fund other than temporary overdrafts which may be used as a means of managing certain cash flows. The Fund will, however, gain leveraged market exposure via its exposure to the Long/Short Portfolio which engages in short-selling to establish its short positions.

### **How do we manage your money?**

A single, global investment philosophy unites all BlackRock scientific (quantitative) investment strategies. Knowledgeable investment people leveraging their skills through the extensive use of technology is a hallmark of our scientific investment approach.

We believe that a focus on total performance management is the best way to achieve superior investment results. Through total performance management, we aim to understand; measure; forecast; and manage the three dimensions of investment performance – return, risk and cost.

Our investment approach aims to systematically exploit market inefficiencies validated by research. Investments are made when the risks taken are judged likely to be compensated by the prospect of adequate returns. Finally, the portfolio-construction process integrates the relationship between forecast returns, risks and transaction costs.

Key insights captured in our investment process include:

- ▶ **Earnings expectations:** Reactions to changing earnings forecasts are monitored to discern shifts in investor behaviour. We have found that investors generally under-react to changing earnings forecasts. This tendency allows us to predict the relative performance of stocks.
- ▶ **Relative value:** Company financial data is assessed to arrive at what we believe is the underlying value of individual firms. Valuation models take into account asset values, earnings prospects and the potential for variability in forecasts over short and long time horizons.
- ▶ **Earnings quality:** Company financial data is analysed to determine earnings quality and earnings sustainability. Measures of earnings quality and sustainability embrace financial strength as well as discretionary accounting decisions made by company management and business operating efficiency.
- ▶ **Market signals:** We believe that the share-selling/buying of market participants can signal prospective share price out/underperformance over the medium term.
- ▶ **Style timing:** By analysing market data, we are able to identify the dominance of specific investment styles, such as growth and value, at certain points in the investment cycle.

The factors summarised above are associated with success over the longer term. We complement these factors with shorter-term return enhancing opportunities including:

- ▶ **Dividend reinvestment plans:** By participating in dividend reinvestment plans shares are received at a discount to market prices.
- ▶ **Initial public offerings and Seasoned Equity Offerings:** Participating in newly listed companies which are attractively priced is another potential source of investment return.

### **Long/short investing**

The Fund, through its underlying investments, employs a “long/short” investment strategy. Unlike “long only” investments, which have just one source of return; that is buying stocks that are expected to rise in value, long/short strategies have two sources of prospective return. A fund that employs a long/short investment strategy can generate returns by owning stocks that the manager expects will rise in value (long). At the same time the fund can, sell (short) stocks that are expected to decrease in value. This latter process is known as “short selling”. To implement short selling, a fund will borrow securities from a counterparty that is a securities lender, with the promise to return equivalent securities at a specified time in the future to that counterparty. The borrowed securities will then be sold by the fund on the open market. If the stock falls in value, the fund will purchase the stock and return those securities to the lender, thus generating a profit. However, if the stock increases in value, this will generate a loss for the fund.

The technology, information systems and relationships with institutional market participants such as investment banks required to implement a long/short strategy are considerable and generally not accessible to retail investors. This Fund makes available to retail investors a competitively priced long/short strategy. Please refer below for further information about the risks associated with short-selling.

### **Index investing**

In implementing the underlying index strategy BlackRock takes a full replication approach which means that wherever practical, we seek to hold every stock in the Benchmark index, but will patiently trade into those less liquid stocks over time to minimize transaction costs.

However, simply buying every stock in the index, in index proportions, does not deliver index performance. For this reason to further counteract the impact of transaction costs we employ low-risk enhancement techniques in an attempt to add value and replicate more closely the return of the index. These low risk portfolio enhancement activities include the use of:

- ▶ dividend reinvestment plans
- ▶ futures to efficiently reinvest dividend distributions; and
- ▶ trading strategies to manage changes to the index.

### **Additional risks associated with long/short portfolios**

The Long/Short Portfolio has a maximum gross exposure to long equity positions of 1x its net asset value and a maximum gross exposure of 1x its net asset value to short equity positions. The market exposure of the long portfolio and short portfolio are invested in such a way as to offset each other so that the Long/Short Portfolio has a net market exposure close to zero. Though Long/Short Portfolio borrows stocks to implement its short equity positions the Long/Short Portfolio does not borrow money to increase the portfolio beyond 1x net asset value in either its long or short positions.

**Short-selling risks:** The Long/Short Portfolio engages in short selling. Short selling allows the investor to profit from declines in market prices to the extent such declines exceed the transaction costs and the costs of borrowing the securities. A short sale creates the risk of an unlimited loss, as the price of the underlying security could theoretically increase without limit, thus increasing the cost of buying those securities to cover the short position. There can be no assurance that the securities necessary to cover a short position will be available for purchase. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating any loss.

**Collateral for borrowing securities:** When the Long/Short Portfolio borrows securities from a securities lender (“Lender”) for a short sale, the Long/Short Portfolio is required to transfer collateral, usually in the form of cash or securities (“Collateral”) to the Lender. The Collateral transferred to the Lender is not required to be segregated from the Lender’s other assets and may be dealt with, lent, disposed of, pledged or otherwise used by the Lender for its own purposes. In the event of the insolvency of the Lender, the Long/Short Portfolio will rank as an unsecured creditor of the Lender in relation to any Collateral transferred to the Lender and the Long/Short Portfolio may not be able to recover amounts due to it in respect of such Collateral in full. This means that the Long/Short Portfolio has exposure to counterparty risk with the Lender.