Legg Mason Australian Equities Perspectives

REECE BIRTLES
CIO
Legg Mason
Australian Equities

ASHTON REID
Property Portfolio
Manager
Legg Mason
Australian Equities

Rethinking portfolios for retirement... the times they are a changin'

Back in 1964 Bob Dylan famously penned "The Times They Are a-Changin'" as an anthem of change for the moment. Intended then as a feeling rather than a statement, in many ways his words are as appropriate today as ever; particularly as Australia's baby boomers begin to move into their next life cycle.

More recently Dylan has licensed this classic for commercial use (you may have seen it in a number of TV ads) as he, like all of us, recognises that financial needs just can't be ignored. It's all about refocusing and so as investors begin to move into this retirement phase of their investment life cycle, I see three issues as paramount.

Firstly, retiree's will require the bulk of their investment return to come in the form of yield in order to meet their cash flow needs as they age post-retirement. Secondly, so that they can maintain spending power and retire in comfort, that dividend stream will need to grow with inflation so they can meet future rising costs, such as increased healthcare spend. Finally, lower volatility in their invested capital base will become vital.

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1. Australia's demographics, the state of superannuation and the lack of retiree focussed product

When its comes to superannuation, over last 20 years Australians have been very focussed on accumulating assets and investing for a total return. This has been both the nature of and indeed the natural state of our system. However, the pending retirement of many baby boomers will see a marked shift in that natural order. Attention will turn to producing sustainable income streams in retirement and away from the accumulation of savings assets.

A sizable market that's not well catered for

The numbers speak for themselves when I look ahead at the coming shift in investor needs. The Cooper Super System Review's Final Report highlighted the following:

> "Treasury estimates that the number of people receiving some form of superannuation pension will roughly double to 1.4 million by 2035."
>
> "Analysis by Rice Warner Actuaries suggests that by 2024, post retirement assets will comprise more than a third of total assets, up from a fifth at present and will be worth $1.5T in nominal terms. Similarly, Treasury estimates that post retirement assets will more than triple by 2035 to reach $850B in real terms. "
>
> Source: Cooper Review: Super System Review: Final Report

Post retirement market: assets

	2009		2014		2019		2024	
	$M	%	$M	%	$M	%	$M	%
Corporate Funds	7,030	3.3	6,514	1.4	3,012	0.3	1,239	0.1
Industry Funds	18,810	8.8	76,113	16.8	193,560	22.0	367,429	24.8
Public Sector Funds	32,353	15.1	49,950	11.0	74,382	8.5	113,304	7.7
Retail Funds	97,162	45.4	204,305	45.0	399,486	45.5	675,581	45.7
SMSFs	58,693	27.4	117,068	25.8	207,698	23.7	321,312	21.7
Total Post Retirement Market	**214,048**		**453,950**		**878,139**		**1,478,864**	
% of all Super Assets		**20%**		**25%**		**31%**		**35%**

Source: Rice Warner, Surviving Longevity, March 2010. Cooper Review: Super System Review: Final Report

Furthermore the Cooper Review went on to highlight the lack of products tailored to the meet the specific needs of the retiree market:

> "as people live longer, they will require more options to manage their assets over a longer period and the system will need to become more flexible so it can provide these options."
>
> "the main longevity product currently available in the market was a guaranteed lifetime annuity which is unpopular among retirees because it has been seen as not offering good value for money."
>
> "In the context of the terms of reference of this Review, the Panel notes that post retirement product innovation, while showing promising signs, is still at a relatively embryonic stage in Australia."
>
> Source: Cooper Review: Super System Review: Final Report

Increasing life expectancy - a fact of life

As each year passes Australian's are living longer and this trend is forecast to continue. This means that at traditional retirement age we will still have a long investment time horizon:

"Men aged 60 in 2050 are projected to live an average of 5.8 years longer than those aged 60 in 2010, and women an average of 4.8 years longer"

Source: Australian Treasury Intergenerational Report 3 2010

"When pension at 65 yrs was introduced in 1909 average male life expectancy was 55 yrs – today a 65 year old male will live to 84+ years"

"2010 is the first year that baby boomers retire (1945 + 65 = 2010)"

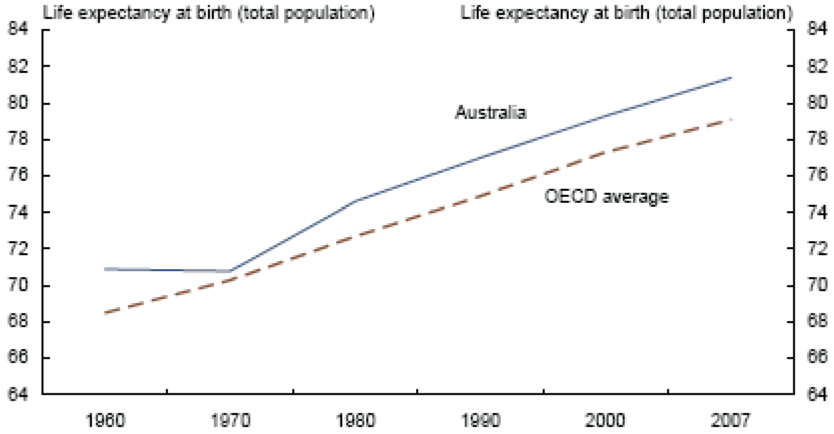
"The retiree segment: in 1969 (8%); 2009 (13%) and by 2049 it will almost double (22%) in a 40 year window"

Australians' projected life expectancy (years)

	2010	2020	2030	2040	2050
Life expectancy at birth					
Men	80.1	82.5	84.5	86.1	87.7
Women	84.4	86.2	87.8	89.2	90.5
Life expectancy at age 60					
Men	23.4	25.2	26.7	28.0	29.2
Women	26.6	27.9	29.2	30.4	31.4
Life expectancy at age 67					
Men	17.6	19.1	20.4	21.6	22.6
Women	20.4	21.6	22.8	23.8	24.8

Source: Treasury

Life expectancy at birth (1960-2007)



Source: OECD Health at a Glance 2007. Table A.2.1a; OECD Health at a Glance 2009.

Source: Challenger & Australian Treasury Intergenerational Report 3 2010

Source: Australian Treasury Intergenerational Report 3 2010

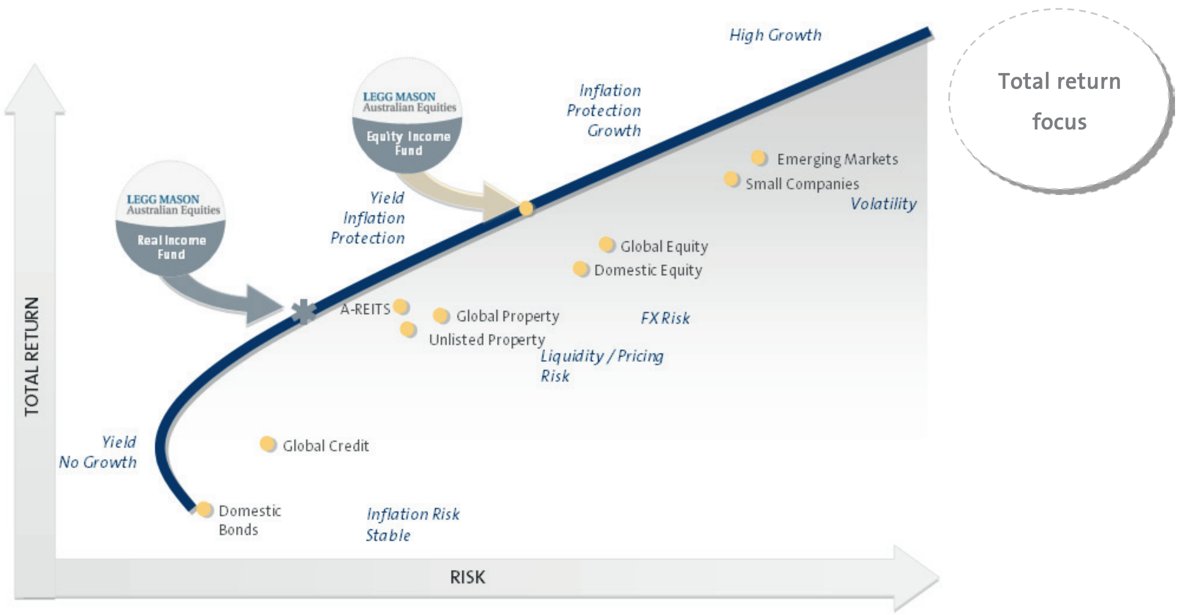
2. The pitfalls of our traditional approach to Portfolio Construction

The traditional approach

Traditionally balanced portfolio allocations have looked at total return versus risk. In the tradition of a Markowitz efficient frontier the chart below should look very familiar. Low risk Bonds sit at the bottom left of the chart while higher return and higher risk Emerging Markets are situated at the top right. The hard asset space of property and infrastructure or what we collectively term Real assets sits in the middle. I've also highlighted the different risks the asset classes face but I'll discuss that in more detail later.

To explain the concept of the Markowitz efficient frontier a little further, combining different assets into a portfolio is "efficient" if it has the best possible expected level of return for its level of risk. So every possible combination of assets can be plotted in this risk return spectrum. Then within this plot of possible portfolio combinations, the leftmost boundary of this region, a hyperbola, is referred to as the "Efficient Frontier".

A Tradional Markowitz Efficent Frontier



Source: Legg Mason Australian Equities

The next step in the financial planning pathway is to determine the appropriate asset allocation given investor appetite for and ability to shoulder risk. As fundamentally returns are not perfectly correlated with one another, combining different asset classes will reduce overall risk when looking at the variability of returns. As the idiom goes "don't put all your eggs in one basket". Therefore, having a mixture of asset classes is more likely to meet investor's wishes in terms of amount of risk and possible returns.

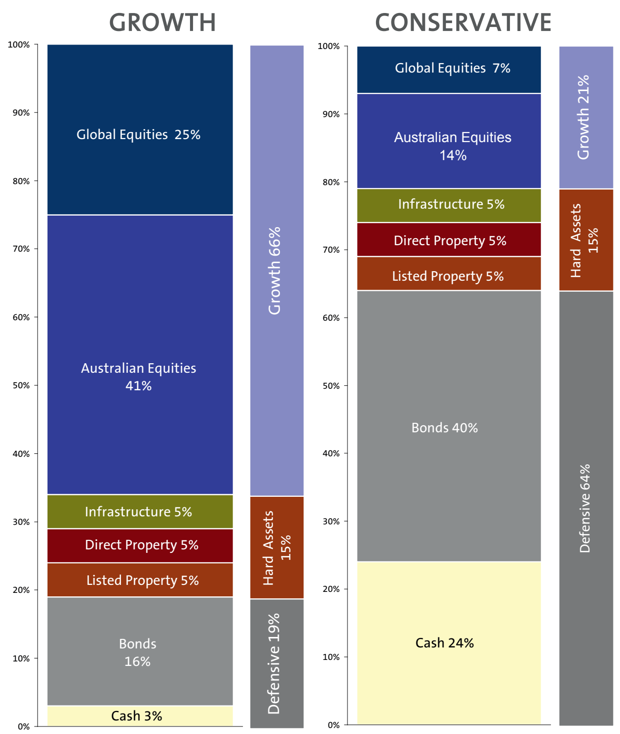
The final step is to then determine risk appetite based upon an investor profile that examines the investor's needs and objectives. Investors then seeking high returns and willing to expose their investments to an elevated amount of risk will allocate more to growth assets. Investors seeking stability and income will allocate a greater portfolio proportion to defensive asset classes.

In the following bar charts, I've mapped out the traditional asset allocations that the industry has adopted for those in either the Growth phase or Conservative phase of their investment life cycle.

So combining diversification benefits, a customer's risk profile and their investment horizon we arrive at either:

- A typical Growth balanced portfolio allocation of 70% growth and 30% defensive asset mix, or
- The traditional Conservative asset approach for retirees or those seeking income where the mix switches to a 30% growth and 70% defensive allocation.

Tradional Asset Allocations



Source: Legg Mason Australian Equities

Let's take a moment to focus in upon the Australian Equities asset class. Here we have traditionally constructed portfolio's that:

- are benchmark aware rather than income focused - our industry has been trained to focus on capital growth and relative return against benchmark,
- have benchmarks driven by indices that are market capitalisation based and designed for no one,
- has ignored an individual's specific tax rate, and
- focused investor attention upon the volatility of their capital, producing poor behavioural outcomes.

I don't really think this is meeting the needs of retirees or income seekers. The Global Financial Crisis (GFC) only served to accentuate this point. This traditional approach pushes all of a retiree's attention onto the asset value of an equity portfolio. Secondly, moving into retirement an individual is pushed towards thinking that risk tolerance and investment horizon have suddenly significantly shortened. Adopting this traditional approach and thinking with such a short time horizon leads to some very poor behavioural outcomes, such as buying high (keeping up with the Jones's) and selling low (sell before I lose everything).

So what do retiree’s need?

What is a retiree’s key financial need and what investment product features are suitable for this growing part of the population?

Put simply a sustainable income stream, protection from inflation and a portfolio that is low risk. To expand a little further, retiree’s will require the bulk of their investment return to come in the form of income in order to meet their cash flow needs as they age. Secondly, so that they can maintain spending power and retire in comfort, that dividend stream will need to grow with inflation so they can meet future rising costs, such as increased healthcare spend. Finally, lower volatility in their invested capital base will become vital.

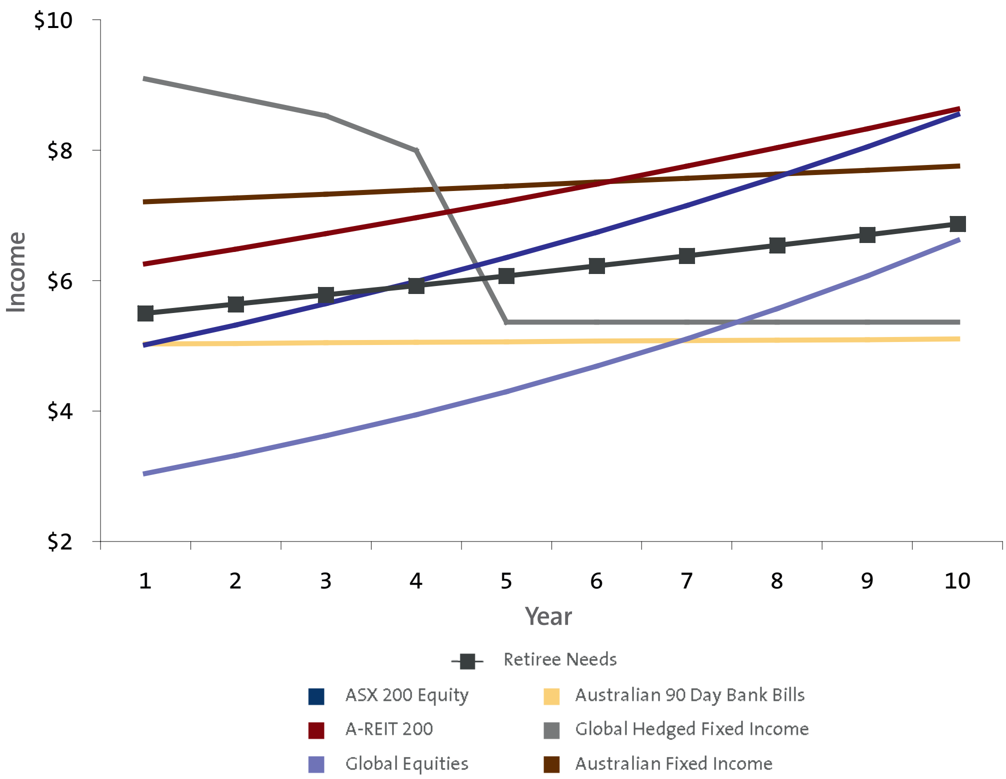
In my view, what is required is a whole new way of thinking about the way we build investment products to suit retiree needs. A new school of thought that departs from the traditional approach to portfolio construction I’ve outlined above.

3. An alternative approach that meets retiree needs

The starting point for developing an alternative strategy focussed on retirees is to rather consider the income or dividend flow of each asset class over time and then ask the question "does this meet the needs of an Australian retiree over time?" And so I propose a different approach. Its beauty is in its simplicity and simply involves a shift in focus to think about income not capital.

3 (a) Examining income generation by asset class over time

Asset class income profile over a 10 year window



Source: Legg Mason Australian Equities
Past performance is not a reliable indicator of future performance.

This is a busy chart but let's focus upon the plot of Retiree Needs over time (the black line checked by boxes). It is assumed that to generate sufficient income from a savings pool, investors typically need to generate at least a $5.50 of Income per $100 of capital invested. Importantly, these needs are not a fixed through time and they will rise in-line with the increase in cost of living. Here I have assumed that this cost of living rises by an inflation rate of 2.5% per annum. This 'Retiree Needs' curve may well be steeper, as for example Health Insurance premiums are currently rising at a rate of 6% pa.

It's insightful to look across the asset classes to see how well they meet retiree needs over time. Global Equities (the blue line) for example, despite its high expected growth rate, will take a long time for its $2.50 starting dividend yield to grow sufficiently to meet the needs of a retiree looking for a year 1 income yield of $5.50 that escalates each year with inflation.

Conversely, consider Australian 90 Day Bank Bills (the yellow line) a traditional favourite for retirees. Upfront the current starting $5.00 of income with little risk appears attractive, but in reality fails to meet the needs of today. As Bank Bills offer no growth, every year that passes retirees will fall further behind and they are unlikely to be able to maintain their standard of living.

However, there's more to this story than just income and growth. Let us focus on the risk to income. Global Hedged Credit (the grey line) makes for an interesting examination. The headline yield of $9.00 looks very attractive, but as we observe the low 4% headline yields available in US bond markets it may make you stop to think about how $4.00 on offer in the US can magically turn into $9.00 here in Australia. Of course there is no magic in finance, only structuring and engineering. This Global Hedged Credit Houdini effort can be explained by the interest rate differential between Australian and the US at the short end of the interest rate curve. This supercharges today's yields but looking out over time, interest rate differentials will close and the sustainable yield is in reality more like $5.00.

Australian Equities (the ASX200 navy blue line) offer unique advantages for retirees given the benefits of franking for those on lower tax rates. But even the ASX200 only offers a starting yield of $5.00, as this includes very high weights to stocks that produce low dividends and therefore don't satisfy income focused investors' needs.

3 (b) Developing an Income Risk Matrix

Let's examine further some of these issues around the risk of income for an Australian investor. In simple terms, the more investment risk you take on, the less likely you are to generate enough income to meet your needs. That's the key message but there are also more subtle differences on income risk that need to be highlighted:

Sustainability of Income

I have highlighted the increasing time horizon (up to 25 years) retirees will face when they turn 65 years of age.

At this point retiree's will not just need return in the form of income; they'll need sustainable growth in that income to maintain their spending power, ensuring they can retire in comfort. That dividend stream will need to at least match inflation so they can meet future rising costs, such as increased utility bills.

To expand a little further, I highlighted earlier that the Australian equities market delivers franking benefits to Australian retirees but not all stocks on the ASX are suitable from a dividend paying perspective. High growth companies such as mining stocks naturally don't pay significant dividends. It makes sense to focus a retiree's Australian equity portfolio on naturally more mature businesses that produce surplus cash flows and hence high sustainable dividends.

The emphasis on the word sustainable needs to be highlighted here. Companies with excessive debt levels and those that may face dilutive re-capitalisation risk should also be excluded from a retiree's portfolio. This also talks to building a fundamentally lower risk portfolio for retirees from the respective asset classes like Australian Equities and the Real asset space to deliver on investor preferences for lower volatility of capital.

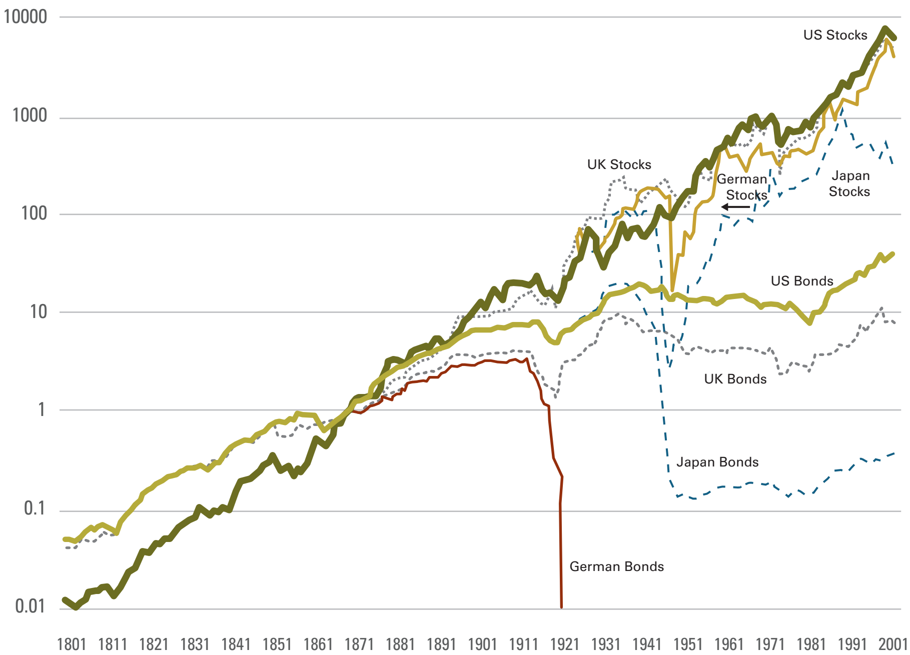
The earlier example of the declining yield of global hedged credit over time serves to highlight how important it is to focus on sustainable income streams.

An Inflation Shock

Importantly, equities represent a real claim on the real economy. In contrast, with no protection from rising prices, an inflation shock can have a deleterious effect on investor returns from bonds.

Jeremy Siegel in "Stocks For The Long Run" highlighted this inflation risk, whereby bonds and bills performed poorly over the 20th century due to persistently high inflation.

International Total Real Stock and Bond Returns, 1802-2001



Source: Stocks for the Long Run by Jeremy Siegel 2002
Past performance is not a reliable indicator of future performance.

As Bradford Cornell, Professor of Financial Economics at California Institute of Technology so succinctly put it

> "The long-run performance of equity investment is fundamentally linked to growth in earnings. Earnings growth in turn, depends on growth in real GDP."

Economic Growth and Equity Investing; Bradford Cornell. Financial Analysts Journal Volume 66 Number 1 2010

As equities have a real claim on the economy they offer a natural hedge to inflation. Similarly, the Real asset space of property and infrastructure has in-built drivers that reference pricing or rents to inflation; this in-turn ensures that revenues are at the very least maintained in real terms.

Clearly investors want stable, low risk returns that beat inflation so they can retire in comfort. Yet it is an inflation hedge to the Australian domestic economy, not global, which is important. For example, falling prices in New York won't help you maintain spending power if you are retiring in Sydney and face a local rising price environment. In the eyes of an Australian retiree looking to match investment returns to local markets conditions, this places offshore investments at a distinct disadvantage.

Foreign Currency (FX) and Offshore Market Risk

Domestically focused investments avoid the potential macro and currency pitfalls of going offshore. Noise from such factors as currency and diverse macro economic events can swamp the underlying yield of offshore investments. This can be despite foreign currency hedging. For example, we have recently seen across many of the global REIT investment products, distributions have had to be suspended due to unrealised losses in currency hedge books. Outweighing any benefit from investing in the underlying offshore listed property assets, the fact that global REIT fund distributions have been frozen in such a way raises ongoing questions about how well global REITs can fulfil their role of providing stable yield to local Australian investors.

It also shouldn't be underestimated how much the Australian market suits investor comfort levels. It is nice sleeping at night with the knowledge of how and where one's hard earned dollars are invested; next time you're out buying the groceries you will most likely be standing in an Australian owned supermarket that's housed within an Australian owned shopping centre.

The Real Liquidity Risk of the Unlisted World

The apparent stability in unlisted investments can be misleading, particularly when looking at the volatility of returns. As unlisted investments employ periodic and often subjective valuation points, returns are held to be more stable and less correlated to wider listed markets. This apparent stability is sometimes then used to justify a valuation premium. This is counter intuitive to traditional concepts of an 'illiquidity discount' and should flag to investors the importance of not making an investment decision based upon a simple lack of measured volatility.

> It's only after a crisis that apparently liquid and stable investments reveal their true colours. To quote Robert Olde president of the Australian Direct Property Investment Association on the troubled world of frozen unlisted property funds "One of the key issues is a rethink on providing liquidity to illiquid investments".
>
> "GFC declared over, but who forgot to tell the banks?" IFA Mar 2010

In contrast to unlisted investments, the listed market offers liquidity and clear pricing when investors need it most. The Global Financial Crisis served to highlight the illiquidity risks of unlisted options, while with listed investments retirees always know that they are transacting at a true market price.

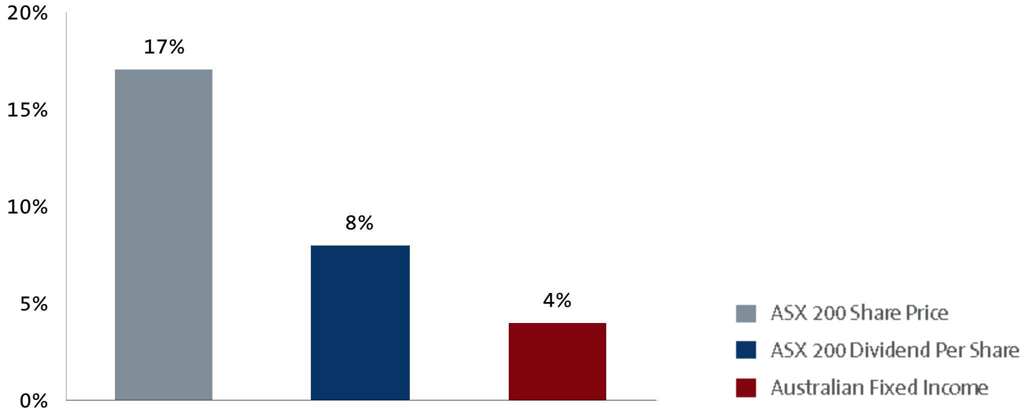
I have brought together these differences on income risk across the asset classes in the following matrix. A green traffic light signals to retirees and income seekers that their needs are being met. An amber light is a signal that these risks are partially but not completely covered, while a red light is a warning to retirees to beware:

Level Of Risk	Foreign Currency Risk	Illiquidity / Pricing Risk	Australian Inflation Protection	Capital Volatility
Domestic Fixed Income	Green	Amber	Red	Green
Global Fixed Income	Red	Amber	Red	Amber
A-REITs	Amber	Green	Green	Amber
Domestic Unlisted Property	Green	Red	Green	Amber
Global Property	Red	Green	Red	Amber
Domestic Equity	Amber	Green	Green	Red
Global Equity	Red	Green	Red	Red

3 (c) The volatility of Australian equity dividends is half the volatility of share prices

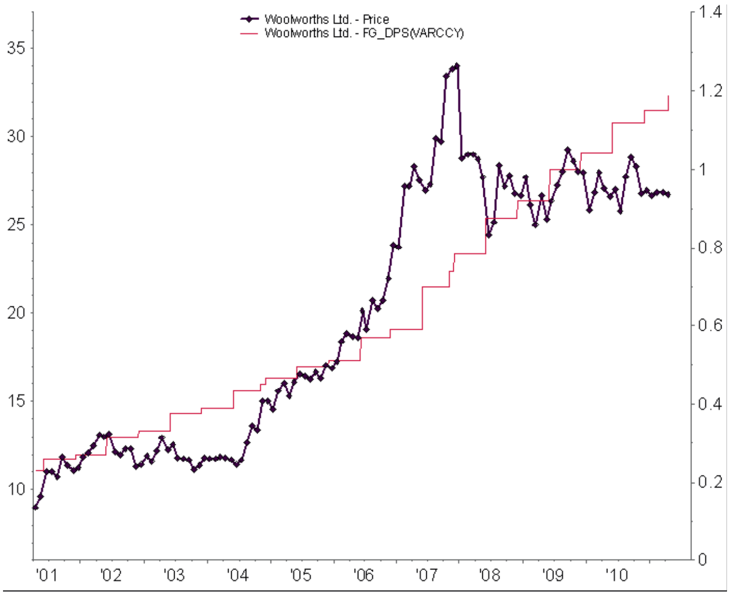
The benefits of a change in focus by investors away from movement in capital prices and towards income are significant. Let's stake some time to examine the volatility of Australian equities versus Australian bonds. The long-term volatility of Australian share prices is around 17%. In contrast, over the same period the volatility in dividends from those same stocks is half that level at 8%. To place this in context, the volatility in income from Australian bonds is 4% over the same time frame. It is important to highlight that this isn't cherry picking data periods as the sample time frame includes the volatile times of the GFC.

Observed Volatility 2000-2010



Source: Legg Mason Australian Equities

The following example of Woolworths Stock Price (black line) and its Dividends Per Share (red line) over the past decade speaks for itself – if we were to think of this as an unlisted investment and focused our attention on Woolworths' steadily growing dividend the GFC would indeed be just an acronym:



Source: Factset

4. What types of products are suitable for retirees?

Next I'll talk through some of the current retiree solutions on offer and their suitability in the context of the identified needs of this growing part of the market.

Guaranteed annuities can have shortcomings

The popular guaranteed annuity has its place in a retiree's portfolio, but it's important that investors are aware of their potential shortcomings given the cost of their capital guarantee. Consider just how much a retiree pays for this guarantee:

- A life company needs to put aside 15% of the annuity as capital, it then needs to earn a minimum 15% Return on Equity (ROE) for its shareholders.
- This equates to the life company taking 2.25% (ie 15% x 15% = 2.25%) in fees from the capital base of the annuity stream.
- While for every $100 invested the guaranteed annuity delivers to investors $5.50, when the $2.25 embedded guarantee cost is included the life company is implicitly saying it can earn $7.75 on your assets.
- This 7.75% return is very similar to the income streams I showed earlier and it's indeed legitimate to ask the question 'why not make this investment yourself?"
- It is also worth highlighting that the capital guarantee does also involve the sponsorship risk of the life company.

Is our super system fully equipped for retirees?

The Superannuation market has to date not done a good job at targeting products to specifically meet the needs of low and 0% tax payers. Australian equities offer retirees unique advantages through franking credits on dividends as these are fully passed through to 0% tax rate investors. Ignoring this franking pass through forgoes significant return.

Bank deposits offer yield and capital stability, but as they are fixed in nature they won't maintain retirees' living standards as costs rise.

While Australian equities protect investors from inflation, standard products aiming for total return don't focus on income or building suitably low risk portfolios. Equally, private investors' personally built Australian equity portfolios (typical of Self Managed Super Funds) that hold 10 or so stocks suffer from concentration risk.

Looking forward, I see strong retiree demand for simple, unstructured and transparent products, with a local focus and where return is skewed to dividend and income.

5. Introducing Legg Mason Equity Income and Legg Mason Real Income

So we've established that as the Australian population ages, there will be a greater reliance on income products that have been specifically created to meet the needs of retirees.

With a focus the baby boomer generation Legg Mason Australian Equities has specifically developed two new investment products that are tailor-made for this retiree income:

- Legg Mason Equity Income Trust and
- Legg Mason Real Income Fund.

Each product has relative strengths but both are focused on generating a sustainable and growing income.

- Equity Income invests in high quality, cash generative businesses and
- Real Income invests in listed A-REITs, Utilities and Infrastructure with the focus being on sunk capital bases that produce reliable income streams with limited business cycle risk

Both strategies screen for debt and the inherent safety of the underlying fund investments. Investment selection is based upon the underlying income traits, the sustainability of those income streams and the inherent risk characteristics that drive cash flows that support dividends. In assessing risk, we employ a strict quality checklist which covers a range of factors that determine the ability of the company to continue paying dividends. The checklist includes business strength, management quality and debt management.

In developing these tailored solutions, we have been proud to work with AXA on its Income Generator product which was awarded Best Innovative Product for 2011 at Money Magazine's prestigious annual Best of the Best awards.

Legg Mason Equity Income

The Legg Mason Australian Equity Income Trust will invest in companies listed on the ASX that have a solid track record of paying dividends. Even in times of market volatility, stocks are selected for their ability to pay attractive, reliable dividends. The strategy is designed to provide an income yield higher than the share market without relying on gearing, derivatives or other complex structures.

A benchmark unaware strategy, it achieves an even spread of investments across the Australian share market. Industry sectors like financials and materials, that have high concentrations in the S&P/ASX 300 share market Index , have a moderated exposure in the strategy. Conversely, industry sectors like Utilities and Health Care, that have low concentrations in the share market have a higher exposure in the strategy given their attractive dividend attributes.

Legg Mason Australian Equity Income offers a better match between investing and spending and is specifically designed for a 0% tax payer by targeting franked income streams. The strategy has a higher allocation (than the benchmark) to those sectors that reflect actual spending habits, such as Consumer Discretionary and Health Care. This offers a degree of 'natural hedge', whereby the spending habits of investors actually supports the investments of the strategy over the long term.

Legg Mason Real Income

The Legg Mason Real Income Fund builds a portfolio of hard assets that owns listed A-REIT's, Utilities and other Essential Infrastructure.

It's an Australian focused product that invests in names where cash flow is sourced from large sunk capital bases with limited business risk such as listed A-REITs, electricity and gas grids, toll roads, ports, airports and hospitals. It ticks the boxes, offering an enhanced yield, inflation protection and low risk attributes.

- With a strong focus on lower than average fundamental risk, we've scanned the investment universe for appropriate stocks, removing those with excessive finance risk.
- This broader universe approach produces a low Beta portfolio and delivers a much lower risk outcome through greater diversification than say a benchmark aware dedicated A-REIT portfolio. As an example, Westfield which is a large part of the market cap weighted S&P/ASX A-REIT 200 Index at 28% may not be owned by Real Income's benchmark unaware strategy if comparative value and dividend is more attractive elsewhere.
- Concentrating solely on the listed market, the strategy doesn't face issues around unlisted liquidity discounts and enjoys transparency of pricing.
- With an Australian focus the Real Income Fund, avoids the currency pitfalls of going offshore and leverages of Legg Mason Australian Equities team's significant experience in looking across the REITS, Utilities and Infrastructure names within a common framework and investment approach developed over a 15+year period.

If I place both these Equity Income and Real Income products into our earlier income risk matrix they receive green lights on the issues that matter for retirees:

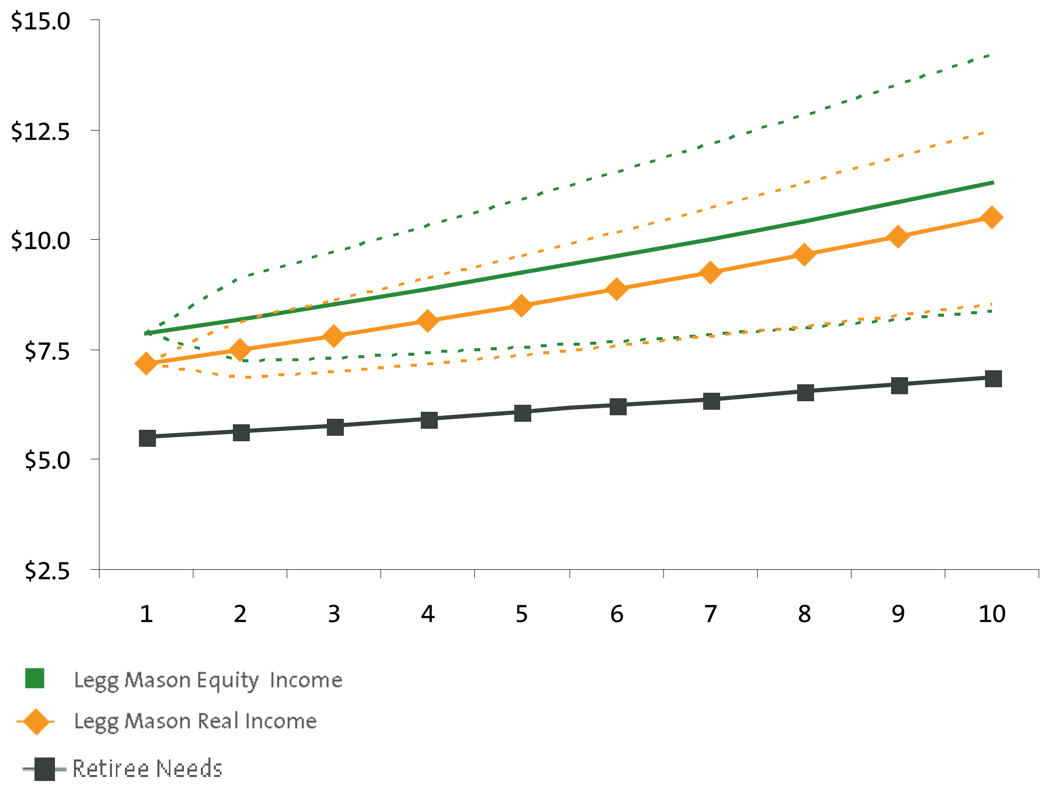
Level Of Risk	Foreign Currency Risk	Illiquidity / Pricing Risk	Australian Inflation Protection	Capital Volatility
Legg Mason Equity Income	🟢	🟢	🟢	🟢
Legg Mason Real Income Fund	🟢	🟢	🟢	🟢
Domestic Fixed Income	🟢	🟠	🔴	🟢
Global Fixed Income	🔴	🟠	🔴	🟠
A-REITs	🟠	🟢	🟢	🟠
Domestic Unlisted Property	🟢	🔴	🟢	🟢
Global Property	🔴	🟢	🔴	🟠
Domestic Equity	🟠	🟢	🟢	🟠
Global Equity	🔴	🟢	🔴	🔴

Meeting retiree needs in good and bad times

The chart below outlines the expected dividend and growth in income over time from both the Legg Mason Equity Income (green line) and the Legg Mason Real Income (orange line) investment strategies. I have again plotted Retiree Needs over time (the black line checked by boxes) on the same chart.

Clearly both strategies meet retiree needs from day one. The other addition to this chart is the possible range of outcomes (the dashed plot lines) of both an upside and downside scenario around the base case for both Equity Income and Real Income. This is in recognition of the underlying volatility in the respective asset classes (Australian Equities and Australian listed Real assets) in which the two strategies invest. Importantly, even after the consistent application of the downside scenario over a 10 year period, both these strategies are still more than meeting investor's growing needs. While the upside scenarios sees our retiree very well placed.

10 year income stream delivered under varying scenarios



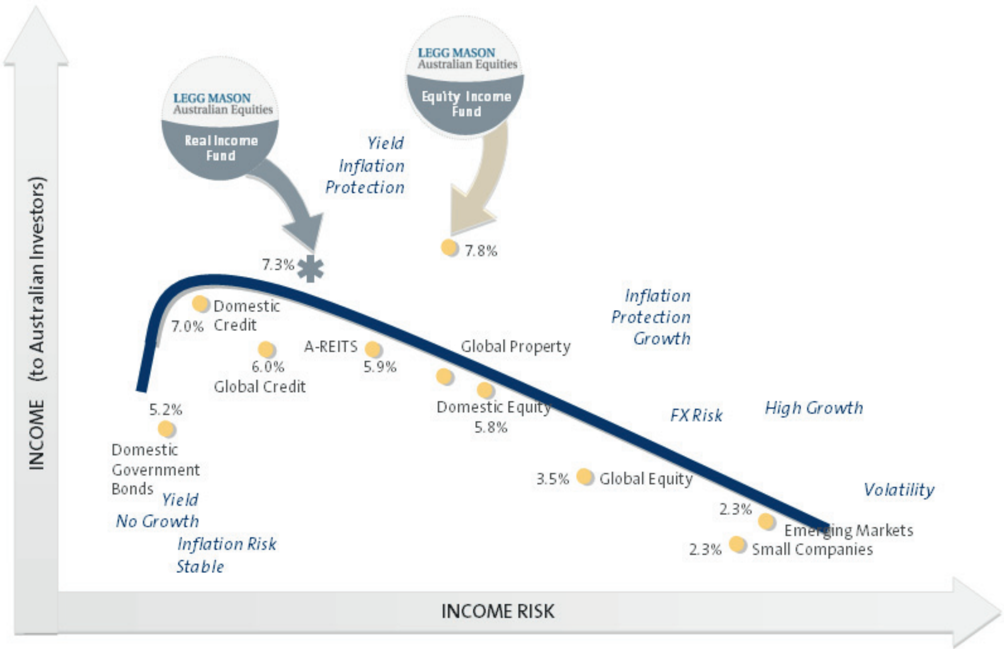
Source: Legg Mason Australian Equities

6. Bringing it all together

Income focused portfolio construction

Let's define income as the current coupon or dividend yield available to an Australian investor and then define risk as the assessment of the sustainability of that income to an Australian investor. Then gathering together my key messages in considering a sustainable income, we can plot the outcomes for each asset class in the chart below.

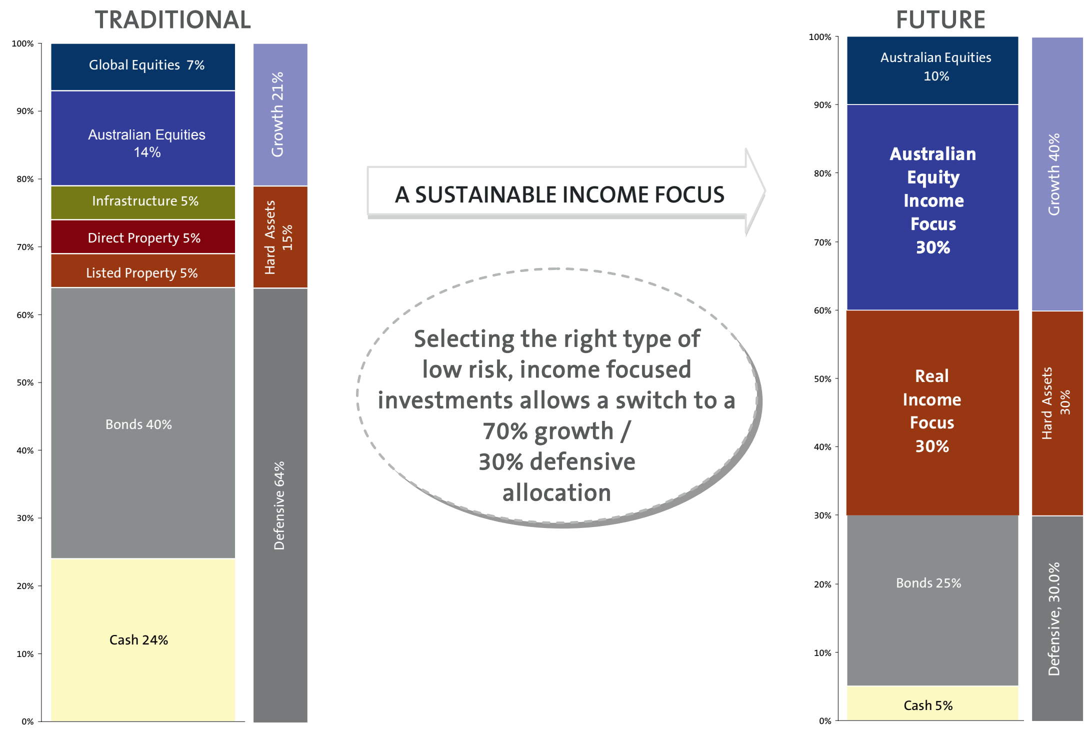
In interpreting this chart, the ideal portfolio outcome will be to achieve a high position on the vertical (income) axis and a low position on the horizontal (risk of income) axis. However, we typically accept that in order to achieve a higher income outcome we will have to move towards the right of this chart by taking on more income risk.



Source: Legg Mason Australian Equities

It's significant that a completely different chart is plotted when compared to the previous Markowitz efficient frontier. The income risk curve is massively different and inversely sloped! Consequently, a quite different picture begins to emerge as to what an income generating portfolio should look like when compared to our traditional Conservative balanced option.

Our new re-cast income generating portfolio for a retiree is depicted below, where we have the transition from the traditional approach on the left to the new income focused portfolio in the column on the right. It has more of the right type of growth assets and hard assets required to beat inflation, but the nature of those investments is quite different to traditional thinking. As we are selecting fundamentally lower risk names in these buckets, with appropriate dividend traits and leverage we can increase the allocation to Australian dividend paying equities with their valuable franking credits and an increase exposure to listed Real assets with a local focus to replace the more traditional unlisted, on and offshore property and infrastructure investments.



Source: Legg Mason Australian Equities

Two product solutions

It's significant that both the Legg Mason Equity Income Trust and the Legg Mason Australian Real Income Fund sit above the inversely sloped curve on the risk of income chart, offering an enhanced yield over their respective asset classes from a fundamentally lower risk portfolio. Both these products focus on the sustainable dividend paying characteristics of each underlying investment, by looking at their fundamental quality and leverage. We screen out those stocks that don't have these essential ingredients.

For example, when looking at the Australian equities bucket it makes little sense for a retiree to invest in a high growth speculative mining stock that has little or no cash flow and no dividend. So by owning the right types of stocks within the asset classes of Australian equities and Real assets we can build a portfolio that is fundamentally less risky, has more attractive dividend traits that can grow sustainably into the future. This allow investors to move above this new downward sloping 'efficient frontier'.

Importantly, within the Australian Equity and Real asset classes this shift to a higher yielding and less risky portfolio will allow investors to increase their growth and hard assets, without necessarily providing additional risk. This has the dual benefit of boosting today's income and its ability to grow into the future.

And the power of the conversation with my Dad was simply to re-focus and ask the question: 'is his portfolio meeting his annual income needs?' By no longer looking at the daily mark to market of his share portfolio he's enjoying both peace of mind and a lengthened investment horizon.

Back then Dylan said it well:

> "As the present now… Will later be past… The order is… Rapidly fadin'… For the times they are a-changin'."

And so they should.