Investment Concepts – Asset Allocation

Asset allocation is the proportion of your portfolio spread across a number of asset classes, markets and regions. The aim is to achieve a return for an acceptable level of risk by combining asset classes in a calculated way. This also helps smooth the ups and downs of each asset class returns. There are several approaches to asset allocation in common use. They all have their advantages and disadvantages so it is important to understand the basic differences.

Strategic asset allocation (SAA) is the process of setting and maintaining the long term structure of the portfolio. It reflects expectations about assets over the long term and is designed to reflect your long term objectives and appetite for risk.

Tactical asset allocation (TAA) refers to short term changes to asset allocation to take advantage of short-term views of the markets.

Dynamic asset allocation (DAA) is in between strategic and tactical asset allocation. It's an active approach to altering a portfolio's asset allocation over the medium term. DAA recognises markets will constantly move around from what is considered 'fair value'. It provides a level of flexibility to alter the asset mix of the portfolio to take opportunities as they arise or to help preserve wealth if markets fall.

Below is a brief description of the main types of defensive and growth asset classes including distinct features such as expected returns and volatility.

Defensive asset classes

Defensive assets have a lower potential rate of return over the long-term but are also generally less volatile and have less potential to lose value than growth assets. Cash and fixed interest investments are defensive assets.

Cash

Cash and short-term securities include deposits, bank bills and other similar assets whose price is linked to short-term interest rates.

Risks and Consequences

- Cash and short-term securities are generally the least volatile asset class and tend to offer the lowest potential return over the long-term.
- The return is typically all income which is considered assessable for tax purposes.

Australian and international fixed interest

Fixed interest investments such as bonds pay a fixed dollar income in the form of a coupon payment for an agreed period of time.
There are many forms of bonds including investment grade corporate bonds, high-yield corporate bonds, emerging market bonds, nominal government bonds and inflation linked bonds.
There is one important difference with international bond funds relative to Australian funds. As the funds hold fixed interest investments in foreign currencies, exchange rate movements impact on both the capital value and the income return from the investment.

Risks and Consequences

- If you sell a fixed interest investment prior to maturity and interest rates fall during the time you hold the investment, you could enjoy a gain on the original investment.

- If interest rates fall, the capital value of a fixed interest investment is likely to rise and the income return should gradually decrease to reflect the lower interest rates available in the market.
- If you sell a fixed interest investment prior to maturity and interest rates rise during the time you hold the investment, you will receive a lower value than you would have received upon maturity, therefore incurring a loss.
- If interest rates rise, the capital value of a fixed interest investment is likely to drop and the income return should gradually increase to reflect the higher interest rates available in the market.
- If you decide to reinvest in a fixed interest investment, your new investment may provide a higher or lower level of income than your original investment, given interest rates may be higher or lower at maturity than at the time you made your investment.
- Generally, the longer the bond has to maturity the more sensitive its price will be to changes in market interest rates. Therefore it is generally more appropriate for long-term investors who can tolerate short term volatility.
- The different maturity and forms of bonds may perform differently in varying economic and market conditions and they can rise and fall in value. Concerns about defaults on loans may result in a loss on your investment.
- As bonds can fluctuate, they are more volatile and offer a higher potential rate of return than cash and short-term securities but they are also generally less volatile and offer a lower potential rate of return over the long-term than growth assets.

Growth asset classes

Growth assets have the potential to earn a higher rate of return over the long-term but are also generally more volatile than defensive assets.

Australian shares

Australian shares represent a part ownership in an Australian company. Australian shares can provide the opportunity for capital growth, income and tax benefits through the dividend imputation system. The dividend imputation system generally allows an investor to receive a tax credit for any tax the company has already paid on the income distributed to them.
Although Australian shares can be expected to outperform many other investment classes over the long-term, due to sharemarket volatility, share investments are likely to fluctuate in value across all time periods, particularly in the short to medium term.

Risks and Consequences

- Investing in a single share or a very small number of individual shares is more likely to expose you to greater fluctuation in the value of your investment than investing across a range of shares. It is possible to further reduce fluctuations by investing across different sectors in the economy.
- Small companies are generally considered higher risk investments.
- Share prices can rise and fall suddenly in response to many factors including company profits, market sentiment, industry issues and economic trends. For this reason Australian shares should be viewed as a long-term (5-year plus) investment as they can experience significant levels of short to medium term volatility.

International shares

International shares represent a part ownership in an international company.
Investing in international shares enables you to diversify your sharemarket exposure not only across a broader range of countries but also into companies and industries that do not exist in the Australian share market.

Risks and Consequences

- International shares have similar characteristics to Australian shares with two important differences:
    - the income return from international shares generally does not provide a dividend imputation tax benefit, and
    - both the capital value and the income return of the investment may be influenced by currency exchange rates.
- In the short-term, adverse market conditions may result in a significant decline in the value of International shares and it may take some time for the value of the investment to recover. For this reason, International shares should be viewed as a long-term (5-year plus) investment.

Australian property securities

Investing in property securities as an asset class is different to buying a house or an investment property. These are referred to as Australian Real Estate Investment Trusts (AREITs).
AREITs are an investment listed on the Australian stock exchange that provides exposure to a portfolio of direct property investments. AREITs own a range of properties such as residential, commercial, retail and industrial. Some invest across all of these property types and others focus on specific sectors.
Some managed investment funds invest in a portfolio of AREITs. The advantage of this is investors access the benefits of investing in property (for example, capital growth and income) whilst their investment remains liquid. Also, managed property securities funds spread investors' risk as they provide a more diversified property portfolio.
Property securities primarily earn income from rent. Historically, this type of investment provides a reasonably regular income relative to other growth assets. Over the long-term, they should appreciate in value and offer a portfolio some protection against the impact of inflation.

Risks and Consequences

- In the short to medium-term, the value of AREITs is expected to increase or decrease in value in accordance with movements in both the AREIT sector and the sharemarket generally. As a result, property securities are more volatile than defensive assets and should be viewed as a long-term (5-year plus) investment.
- Property securities tend to generate higher returns in income than capital growth.

International property securities

International property securities are investments listed on international stock exchanges and provide exposure to a portfolio of direct property investments. These are referred to as Global Real Estate Investment Trusts (GREITs). GREITs own a range of properties such as residential, commercial, retail and industrial. Some invest across all of these property types and others focus on specific areas.
Investing in GREITs enables you to diversify your portfolio, not only across a broader range of countries but also property assets and sectors that do not exist in the Australian market.
International property securities primarily earn income from rent. Property securities generally produce higher levels of income than other listed equities.

Risks and Consequences

- Both the capital value and the income return of the investment may be influenced by currency exchange rates.
- In the short to medium-term, the value of listed property trusts is expected to increase or decrease in value in accordance with movements in both the listed property trust sector and the sharemarket generally. As a result, property securities are more volatile than defensive assets and should be viewed as a long-term (5-year plus) investment.
- Property securities tend to generate higher returns in income than capital growth.

Direct property

Buying a residential or commercial property to rent out is a way of investing directly in property. Property investors have personal control and management over their investment. Capital appreciation over the longer term is likely to keep pace with or exceed the rate of inflation, depending on the location and physical condition of the property. Tax deductible expenses may include depreciation, maintenance, insurance and financing costs. Furthermore, the equity in a property may be used to leverage other investments.

Risks and Consequences

- Large amounts of capital are required to purchase a direct property.
- There are significant establishment costs and ongoing costs associated with maintenance of the property.
- Direct property assets can be illiquid, resulting in the inability to draw down a portion of your capital in the future.
- You risk being heavily reliant on the income stream from a single investment sector.
- You risk losing income whilst the property is untenanted.
- As a significant amount of capital is required to purchase a direct property, your portfolio may lack diversification.

Alternative assets

Alternative assets cover a wide range of investments that are not considered traditional assets like those already described. Some examples include hedge funds, infrastructure and gold.

These types of investments are generally included in portfolios to increase diversification and provide returns that aren't strongly linked with the performance of traditional assets.

Risks and Consequences

- To access some alternative investments you generally need to do so through a managed fund.
- As most alternative investments aren't listed on an exchange, determining their value for a fund's unit price can be difficult and may involve a considerable time lag.
- Some alternatives such as hedge funds involve greater complexity and therefore may be more difficult to understand.
- Some alternatives are illiquid which may make them difficult to buy or sell when you want to.
- Alternatives may be included in a portfolio for their growth or defensive characteristics.
- Hedge funds may use a range of uncommon investment management techniques to achieve objectives and may use leverage, short-selling and derivatives extensively.
- Alternative fund managers may charge relatively higher fees.

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