

INVESTMENT FUNDAMENTALS

E-BOOK



Investment fundamentals

what you need to know

If you're just starting out as an investor, there's a lot of information to absorb. This fact file defines and explores the pros and cons of each asset class, why certain asset classes are more appropriate for different types of investors and why no asset class consistently outperforms the others.

Snapshot

- Cash, fixed interest, property and shares are the four main asset classes.
- Defensive investments include cash and fixed interest.
- Growth investments include property, shares and alternatives.
- Generally the higher the return, the higher the risk.
- Diversifying your portfolio and investing over the long term can help reduce this risk.

Understanding asset classes

Most investments fit into one of four main categories or asset classes:

Cash

Cash includes money in bank accounts, as well as investments in bank bills and similar securities and some short term (up to 12 months) term deposits. Cash investments provide stable, low-risk income in the form of regular interest payments.

Time horizon: short term

Fixed interest

Fixed interest investments include term deposits, debentures, mortgages, and government and corporate bonds. The income return is usually in the form of regular interest payments for an agreed period of time. For fixed interest investments that are tradable (eg bonds), there is the potential for capital growth or decline depending on interest rate movements.

Time horizon: one to three years

Property

You can invest in property directly (eg when you buy a house or commercial premises such as a shop or office) or indirectly (eg by purchasing units in a property trust that is listed on a stock exchange). This asset class includes residential, commercial, retail, hotel and industrial property.

Time horizon: three to five years (medium term)

Shares

A share represents part ownership of a company. Shares are generally bought and sold on a stock exchange. Returns usually include capital growth as well as income from dividends. You can choose to invest in Australian shares, global shares or a mix of both.

Time horizon: five to seven years (long term)

Defensive vs growth investments

The main asset classes can be separated into two broad groups – defensive and growth investments.

Cash and fixed interest

Defensive investments, such as cash and fixed interest aim to provide investors with regular income at relatively low risk. They generally experience only slight fluctuations in investment returns and values over short periods. The downside of this security is that defensive investments do not usually grow in capital value and returns are generally lower than those of growth investments over the medium to long term.

Property and shares

Property and shares are usually classified as growth investments. As well as income, growth investments aim to increase the value of the capital invested. While investment returns are expected to fluctuate over the short term with market movements and economic changes, growth investments have the potential to produce higher returns than defensive investments over the long term.

Alternatives

Alternatives assets fall outside the four traditional asset classes and include commodities (eg precious metals), currency, private equity and some forms of infrastructure (eg public utility assets). Alternatives are included in the growth allocation as they can have very high levels of capital volatility in the short term and generally do not provide high or consistent levels of income. Alternative investments can produce different returns to both defensive and growth assets at different points in the market cycle.

Risk vs return

All investments provide a certain level of return and are subject to a certain level of risk. This means that as well as making money on your investments, there's also the chance you could lose money or not make as much as you expected. All investments carry some risk – due to factors such as inflation, taxation, economic downturns or a drop in a particular market.

As a general rule, the larger the potential investment return, the higher the investment risk and the longer you need to remain invested to reduce that risk. The amount of risk involved with an investment can be managed by matching it appropriately with the length of time you have available to invest and your tolerance towards volatility or fluctuations in returns.

Diversification

Another way of managing or reducing investment risk is through diversification. This is the strategy of investing your money across a range of different investments. The exact mix of investments you choose will depend on:

- your financial objectives
- the amount of time you have available to invest
- your personal tolerance for risk.

Diversification is important because every type of investment has its ups and downs. Owning a diverse range of investments can help you achieve smoother, more consistent investment returns. The more ways you diversify, the more you can reduce your risk. For example, you can invest:

- across different investment types or asset classes (cash, fixed interest, property, shares)
- in more than one investment within each type (eg invest in several different industries and companies when investing in shares)
- in more than one type of fund, and more than one fund manager, when investing in managed funds
- inside and outside of super.

Dollar cost averaging

By implementing a regular investment plan you will be able to take advantage of 'dollar cost averaging'. When you invest a set amount at regular intervals, sometimes you will purchase units or shares at a higher price, and sometimes at a lower price. Over time, this spreads out your costs and insulates you against changes in the value of the assets you are purchasing.

The power of compounding

Compounding is often described as 'earning interest on your interest'. Each time you earn a dividend, distribution or income payment from your investment, you reinvest it to buy more units or shares. In turn, these reinvested earnings generate additional earnings. Compounding can make a huge difference to the value of your investment over time. To take full advantage of the effect of compounding, think about starting early and leaving your money invested for as long as possible.

Which asset classes are best for you?

When a financial adviser creates a financial plan, they use a number of factors to determine which combination of asset classes will work best for you. These factors include your attitude to risk, your investment time frame and your financial and lifestyle goals. The end result or how your money is invested across the different asset classes, is known as your 'asset allocation'.

For example, if you are a risk-averse investor looking for stable returns or wanting a low-risk, short-term investment option for a sum of money (eg a home deposit) – your adviser would probably weight your asset allocation more heavily towards defensive investments such as cash and fixed interest.

On the other hand, if you are comfortable with short-term fluctuations in the value of your investments and want to invest for more than five years, growth investments such as Australian and international shares may be the best option for you.

If you are concerned that your asset allocation does not match your investment goals or attitude to risk, it's important to review your financial plan with your financial adviser. They can adjust your asset allocation as required to help you achieve the best possible results.

Key takeaways

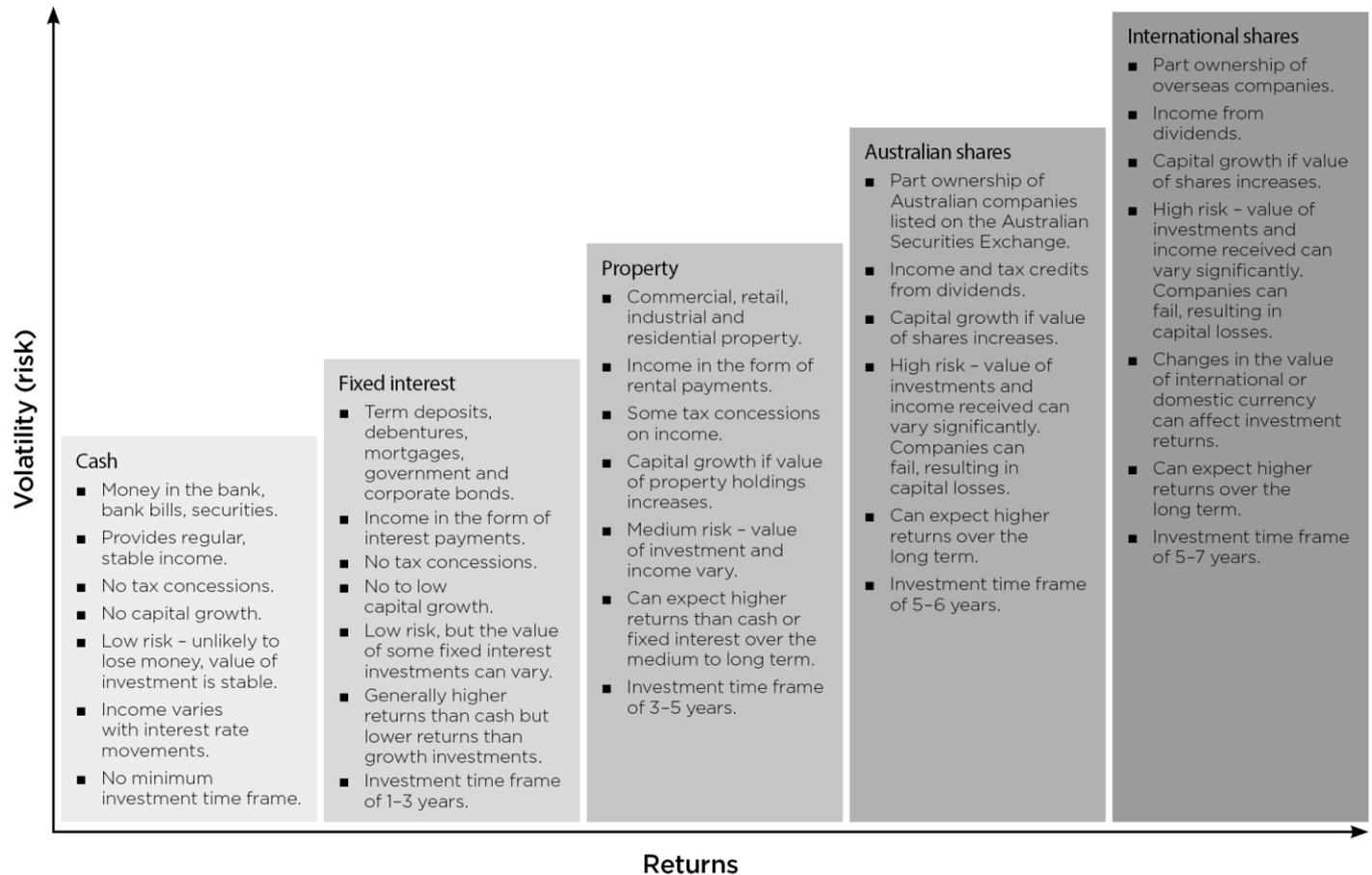
- Understand your risk profile and consult with your financial adviser to select investments that match it.
- Diversify across asset classes, industries and funds to minimise the impact of unexpected market shocks.
- If you take a long term view, you can enjoy the advantages of dollar cost averaging and compounding.

Understanding risk and return

The level of risk an investor takes relative to the investment return they expect to receive is sometimes known as the 'risk to return ratio'.

As a general rule, the larger the potential investment return, the higher the investment risk and the longer you need to remain invested to reduce that risk. See the chart below for more detailed information on each asset class.

The attributes of each asset class



Source: Colonial First State. Return forecasts above inflation are based on the long-term historical characteristics of each asset class. Past performance is no guarantee of future performance.

Managing investment risk

If you invest in just one asset class and its value falls, the value of your investment will drop with it. However, by investing in several asset classes, you spread your risk and can offset underperformance in one asset class with positive performance in another. This could help you achieve smoother, more consistent returns over time. Each asset class has its good and bad times, so while a diversified portfolio will never achieve the top return in any given year, it will never receive the lowest either.

The table below shows annual returns for the different asset classes from 2000 to 2019. As you can see, the top performing asset class one year may deliver the poorest results the next. This highlights the importance of diversification as a method of managing risk.

Asset class returns (%)

Year	Australian Cash	Global Fixed Interest	Australian Fixed Interest	A-REIT	Australian Shares	Global Shares	Multi-sector balanced	Emerging Markets
Annualised return for 20 years	1.67	4.15	5.14	9.54	10.26	13.78	8.04	13.10
Dec 2000	6.19	11.65	12.04	18.87		2.19	8.00	-18.28
Dec 2001	4.89	8.29	5.48	14.84	10.36	-9.97	5.83	5.97
Dec 2002	4.74	11.57	8.81	11.81	-8.77	-27.44	-3.59	-14.55
Dec 2003	4.89	6.59	3.05	8.81	14.61	-0.76	7.59	16.80
Dec 2004	5.49	8.92	6.96	32.18	27.99	9.94	16.27	21.06
Dec 2005	5.64	3.81	5.79	12.70	22.83	16.84	13.68	43.78
Dec 2006	5.99	5.40	3.12	34.05	24.22	11.49	14.30	23.39
Dec 2007	6.66	6.63	3.50	-8.36	16.07	-2.60	6.49	25.47
Dec 2008	6.98	9.23	14.95	-55.31	-38.44	-24.92	-19.99	-41.04
Dec 2009	3.43	8.03	1.73	9.56	37.03	-0.30	12.70	38.78
Dec 2010	4.68	9.28	6.04	-0.68	1.57	-2.04	3.28	4.58
Dec 2011	4.85	10.51	11.37	-1.56	-10.54	-5.34	-0.35	-18.19
Dec 2012	3.74	9.66	7.70	32.79	20.26	14.14	13.51	17.14
Dec 2013	2.78	2.27	1.99	7.27	20.20	48.03	15.65	13.41
Dec 2014	2.68	10.37	9.81	26.79	5.61	15.01	9.76	7.34
Dec 2015	2.25	3.35	2.59	14.38	2.56	11.80	5.65	-3.94
Dec 2016	1.99	5.24	2.92	13.18	11.80	7.92	6.65	12.14
Dec 2017	1.74	3.68	3.66	6.44	11.80	13.38	7.72	27.53
Dec 2018	1.95	1.65	4.54	3.27	-2.84	1.52	1.34	-4.73
Dec 2019	1.34	7.19	7.26	19.57	23.40	27.97	15.52	19.07

Source: Morningstar. Data to 31 December 2019. Past performance is no indication of future performance. This table is based on the standard indices used by investment professionals to measure performance of asset classes. Cash - RBA Bank accepted Bills 90 Days; Aust. Fixed Interest - Bloomberg AusBond Composite 0+ Yr TR AUD; Intl. Fixed Interest (H) - BarCap Global Aggregate TR Hdg AUD; A-REITs - S&P/ASX 300 A-REIT TR; Aust. Equity - S&P/ASX 200 TR; Intl. Equity - MSCI World Ex Australia NR AUD; Multi-sector Balanced fund - Morningstar Aus Msec Balanced TR AUD; Emerging Markets - MSCI EM GR AUD. Morningstar calculates and publishes proxy market benchmarks for multi-sector funds. Each index is calculated referencing the average asset allocation of Australian funds in the respective category. These asset allocations are recalculated on a bi-annual basis based on the asset allocation of funds on Morningstar's database. The multi-sector Balanced index will likely have an approximate allocation of 60% to Growth assets and 40% to Defensive assets over the long term. Growth assets include equities and property, whilst defensive assets include fixed interest and cash.

Speak to us for more information

If you would like to know more about asset classes and the fundamentals of investing, contact Shannon Smit at Smart Business Solutions Financial Planning for more detailed information on the best approach for your situation.

Phone 03 5911 7000 Email shannon@smartfinancialplanning.com.au www.smartfinancialplanning.com.au

Important information

This document contains general advice. It does not take account of your objectives, financial situation or needs. You should consider talking to a financial adviser before making a financial decision. Smart Business Solutions Financial Planning Pty Ltd ABN 15 631 281 822 is a Member of Count Financial Limited. 'Count' and Count Wealth Accountants® are trading names of Count Financial Limited ABN 19 001 974 625 Australian Financial Services License 227232 Count is 85% owned by CountPlus Limited ACN 126 990 832 (CountPlus) and 15% owned by Count Member Firm Pty Ltd ACN 633 983 490. Count Wealth Accountants® is the business name of Count. Count advisers are authorised representatives of Count.

This document has been prepared by Smart Business Solutions Financial Planning Pty Ltd and Count. Information in this document is based on current regulatory requirements and laws as at 12 April 2020, which may be subject to change. While care has been taken in the preparation of this document, no liability is accepted by Smart Business Solutions Financial Planning, Count, its related entities, agents and employees for any loss arising from reliance on this document.