

Building a fool

How many people have suggested you put your money to work by investing in shares, and how often have you failed to take up the suggestion because you have no idea where to start? Let *Trish Power* guide you through the basics of creating a sound share portfolio.

The African animal kingdom has its 'Big Five' — the elephant, the leopard, the lion, the white rhinoceros and the Cape buffalo. These majestic animals were traditionally the most desired targets of the big game hunters, but today they are the pride of the African continent and the main draw card for tourists on safari. So, too, the investment world has its own Big Five. These draw cards are the major asset classes — cash, fixed interest, Australian shares, property and international shares.

Understanding each of the major asset classes is one of the most important aspects of managing a successful portfolio. A portfolio is your individual collection of investments. Each asset class has a role to play in a diversified portfolio and each asset class needs to be understood completely before you make any decision as to which individual assets to purchase (see Table 1).

Tracking the Big Five

Diversification, or spreading your risk, can be summed up by a phrase that we have all heard before: 'Don't put all of your eggs in one basket'. While that sentiment certainly captures the essence of the issue, it provides little guidance as to the practical implications of how diversification plays a role in an investor's portfolio.

You don't diversify for diversification's sake. The point of diversification is to create a portfolio which includes multiple investments in order to reduce risk. Consider, for example, an investment that consists only of shares issued by a single company. If that company's share price suffers a serious downturn, your portfolio will sustain the full brunt of the decline. By splitting your investment between the shares of two different companies, you immediately reduce the potential risk to your portfolio.

The most effective way to reduce the risk in your portfolio is to include a range of asset classes including fixed interest, property, cash and international shares. The choice of which asset classes to invest in, and how much of your portfolio should be directed to each asset class, is the single most important determinant of investment returns.

This process of 'asset allocation' accounts for a massive 94 per cent of the ups and downs (or volatility) of a portfolio's total return, according to a recent US study conducted by Brinson Partners (published in *Financial Analysts Journal*)



proof portfolio

TABLE 1 THE SHORT STORY OF THE BIG FIVE

	Asset classes				
	Cash	Fixed interest	Australian shares	Property	International shares
Good for	Liquidity	Income Capital stability	Capital growth Income	Income Inflation hedge	Growth
Not good for	Growth Wealth accumulation	Wealth accumulation	Stability	Liquidity	Stability Liquidity
Likely return over 5-year period	Low (CPI plus 2.5%)	Low (CPI plus 2.5%)	Medium to high (CPI plus 4%)	Medium to high (CPI plus 4%)	High (CPI plus 4.5%)
Type of return	All income taxable	Income taxable	Franked income Capital gain	Income Capital gain	Income Capital gain
Likely risk (volatility)	None	Small	Medium to High	Medium to High	High
Tax effective	No	No	Yes*	Yes*	No
Role in portfolio	Liquidity	Income Stability	Exposure to underlying economic growth	Inflation hedge Income producer	Exposure to underlying global economic growth
Importance to long-term returns	Small	Medium	High	High	High

*No tax on growth of investment until sold. Share income (dividends) provides franking credits, and property income has some tax-free components. Reprinted with permission from 'You Don't Have to be Rich to Become Wealthy: The Baby Boomers Investment Bible' (Wrightbooks).

In summary, by combining a number of asset classes, you are able to build a well-diversified portfolio that generates long-term returns, with less volatility than investing in only one asset class and without giving up that much in investment returns.

Every dog has its day

Table 2 on page 44 lists the returns for the different asset classes over the past 20 years. The highest performing asset class for a 12-month period is highlighted in blue and the worst performing asset class is highlighted in red. You can see that every dog does indeed have its day.

The choice of which asset classes to invest in, and how much of your portfolio should be directed to each asset class, is the single most important determinant of investment returns.

For example, international shares have delivered a return as high as +60.96 per cent over the 24-year period, and a return as low as -34.45 per cent. Cash has delivered a return as high as 19.11 per cent, and a return as low as 4.77 per cent. Cash has been the highest-performing asset class in four years out of the 24, and the worst-performing asset class in five years out of 24.

Creating your portfolio

If the secret to creating a well-diversified portfolio is to invest in the right mix of assets, it is important to understand that the appropriate allocation depends on your individual risk tolerance, your return needs and how long you plan to hold your money in investments.

Typically investors fall into one of the following categories:

- conservative
- moderately conservative (cautious)
- moderately assertive (balanced or prudent)
- assertive (growth)
- aggressive (high growth).

An aggressive investor will have a higher proportion of growth assets in his or her portfolio than a conservative investor. 'Growth' assets are assets that are linked to the ups and downs of the markets, such as shares and property. Defensive assets are typically cash and fixed interest because such asset classes are generally not linked to the ups and downs of the market.

A conservative investor may prefer a mix of 70 per cent in defensive assets and 30 per cent in growth assets. An assertive investor may lean towards a mix of 86 per cent growth assets and 14 per cent defensive assets. An aggressive investor is likely to have 100 per cent of his or her assets in shares and property.

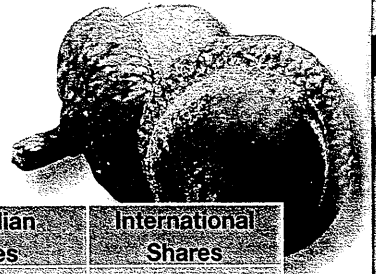


TABLE 2 THE PERFORMANCE STAKES (FOR 24 YEARS AS AT 31 MARCH)

Year to	Cash	Fixed Interest	Property	Australian Shares	International Shares
	%	%	%	%	%
Mar-82	16.35	3.29	-2.92	-31.89	-3.82
Mar-83	16.61	21.50	19.90	17.12	60.96
Mar-84	12.93	18.08	41.33	52.53	10.00
Mar-85	13.26	13.38	13.26	15.52	49.16
Mar-86	18.17	18.01	15.34	42.54	53.98
Mar-87	16.97	10.52	30.24	53.62	45.56
Mar-88	13.83	20.98	9.20	13.61	1.10
Mar-89	14.06	4.33	1.22	8.10	3.04
Mar-90	19.11	16.85	10.06	11.38	6.63
Mar-91	14.54	21.74	12.88	-0.22	3.93
Mar-92	10.12	18.63	10.50	13.82	0.66
Mar-93	6.45	18.06	16.72	9.79	22.41
Mar-94	5.09	6.00	18.46	27.59	15.08
Mar-95	6.24	2.37	2.49	3.39	4.99
Mar-96	7.85	12.80	3.80	21.73	13.08
Mar-97	7.14	12.56	19.89	13.35	9.62
Mar-98	5.41	15.68	26.66	17.83	56.58
Mar-99	5.09	6.65	4.57	12.21	18.72
Mar-00	5.24	1.79	1.02	9.45	27.18
Mar-01	6.36	11.81	13.38	2.31	-6.60
Mar-02	4.77	2.36	17.44	12.29	12.07
Mar-03	4.95	10.14	13.84	-11.78	34.45
Mar-04	5.11	4.17	14.97	24.81	11.89
Mar-05	5.56	4.80	19.76	25.03	8.88
Mar-06	5.80	6.74	18.21	29.37	27.91
Best/Worst scores*	4/5	3/3	4/6	7/4	7/6

*The first number that appears represents how many times the asset class was the best-performing asset in a particular year, and the second number represents how many times the asset class was the worst-performer in any one year. Reprinted with permission from: 'You Don't have to be Rich to Become Wealthy: The Baby Boomers Investment Bible' (Wrightbooks).

Remember that sometimes growth assets, such as shares and property, are described as 'defensive' investments when they deliver regular income in the form of dividends and rent, rather than capital growth.

Identifying your risk/return trade-off

It is important to appreciate the difference between income and capital growth when working out the returns on your investments. You will also need to understand the risks you are facing when investing, and then tailor a strategy to match your personal risk profile.

In general, the more risk you are willing to take, the greater the potential return on your investment. The chosen mix of growth and defensive assets in a particular portfolio is designed to create a specific risk/return trade-off that offers you the opportunity to achieve a certain rate of return on your investment in exchange for your willingness to accept a certain amount of risk. The recommended timeframe for

investing increases as the risk in each investment profile increases. Likewise the reward for investing in higher risk investments is greater.

A conservative investor is typically risk-averse and is not willing to tolerate significant investment losses while an assertive or aggressive investor pursues higher long-term returns and is prepared to take greater risks. According to research house van Eyk, the average annual long-term return for a typical conservative portfolio has been around 10 per cent over a 37-period, while a typical aggressive portfolio delivered an average annual return of just under 15 per cent over the same 37-period.

Rebalancing – the missing link

Asset allocation is the support system for a successful investment portfolio, and the practical application of diversification. However, the most important element of the entire magical allocation process is something that is rarely