Investment Concepts

This document provides some additional information to help you understand the financial planning concepts in relation to investment concepts.

Return and Diversification

Different investments have different risks. A way of reducing risk is to diversify your investments. Prior to investing, it is important that you understand the concept of risk, return and diversification and how this may impact your personal situation.

What Do We Mean by Risk?

Risk, to some may mean the possibility of losing a portion of their capital. For others, the risk of their assets not producing enough income may dominate their concerns.

Risk cannot be eliminated. However, it can be measured and managed within an investment portfolio. The key is to determine the appropriate level of risk for you. Taking on greater short-term risks may be necessary to receive the long-term returns needed to achieve your lifestyle goals and objectives.

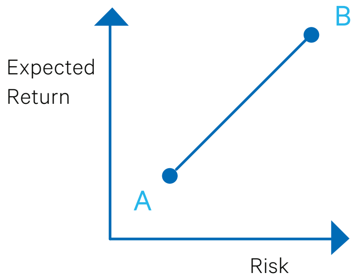
How Do You Cope with Risk?

It is important to understand the risks that you may be exposed to and how they will impact your personal situation. Assessing risk and potential investment returns should be in the context of your goals and the time that you have to achieve your objectives.

The Relationship between Risk and Return

Risk and return are closely related. In general, the higher the degree of risk associated with an investment, the higher the return that will be required by investors to accept this risk. Low risk investments, such as cash, offer relatively low returns as a reflection of their greater security, and are better suited to risk adverse investors.
This is called the risk/return trade-off.

The diagram to the right is a simple illustration of the risk/return trade-off. Investment A offers lower expected return with lower risk compared to investment B which offers higher expected return with higher risk.



All investments and asset classes have different levels of risks and expected returns. For example, low risk investments like cash generally provide a lower return than high risk investments over the long term, but are unlikely to lead to a capital loss. High risk investments generally offer the potential of a higher return over the long term, but there is a higher probability that high risk investments will be more volatile in the short term (leading to capital loss if funds are withdrawn in the short term).

What are the Types of Risk?

There are a number of risks to be considered when constructing your portfolio:

- Investment market risk is the possibility that all investments in a market sector, (such as Shares), will be affected by an event.
- Investment specific risk is the possibility that a particular investment may under perform the market or its competitors.
- Market timing risk is the possibility that your investment may be sold at a time when the sale price is at a low-point, or purchased when the sale price is at a high-point.
- Inflation risk is the possibility that your investment return is below the inflation rate, which reduces the spending power of your money.
- Credit risk is the potential failure of a debtor to make payments on amounts they have borrowed.
- Interest rate risk is the possibility that your investment will be adversely impacted by a fall or rise in interest rates.

- **Legislative risk** is the possibility that a change in legislation will impact the appropriateness of certain investments for you.
- **Liquidity risk** relates to the ease with which you can sell or liquidate your investments. Some investments impose exit fees or have limitations on withdrawals. Other investments may be difficult to sell due to a lack of buyers.
- **Currency risk** relates to global investments. It is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.
- **Hedging risk** relates to a technique designed to reduce the risk from part of an investment portfolio often by using derivatives. While hedging can reduce losses, it also has a cost and therefore can reduce profits.
- **Derivatives risk** is where financial derivatives are used as an alternative to directly owning or selling underlying assets in order to manage risk and/or enhance returns.
  Risks associated with derivatives can include; the value of the derivative declining to zero; the value of the derivative not moving in line with the underlying asset and, the derivative may be difficult or costly to reverse.
- **Opportunity cost** relates to the investment return you may forego from an asset as a result of investing in your preferred asset. That is, there is a risk that the preferred asset you invest in may not return more than the second-choice (next best alternative) asset you did not invest in.

The Importance of Diversification

One of the most effective means of reducing the different types of risk is to diversify your portfolio. No one type of security, asset class or investment manager provides the best performance over all time periods. So a range of investments should reduce the risk of each of the investments within a portfolio experiencing drops in performance at the same time. This is simply because one asset class or manager may perform well to counter the poor performance of another.

Diversification can be implemented in three distinct ways:

1. **Across asset classes** - The major asset classes perform differently under different market conditions. By investing across a variety of asset classes you may be able to reduce the volatility of your portfolio return.
2. **Across markets and regions** - Spreading your exposure within each asset class across a wide range of countries, currencies, industries and stocks ensures that your investment is not narrowly concentrated in a particular region or industry. This reduces the impact of a region or industry downturn.
3. **Across investment management styles** - Different investment management styles tend to excel under different economic and market conditions. By combining a range of investment managers with complementary investment styles you may be able to neutralise the bias to any one style in each asset class.

Asset Classes

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.

Factors to be aware of:

Cash and short-term securities are generally the least volatile asset class, and tend to offer the lowest potential return over the long-term.

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.

Factors to be aware of:

- 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 that 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.
- 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 offer sound long-term value in the form of 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 that 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.

Factors to be aware of:

- 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.
- If your long-term investment strategy includes this asset class, it is important to resist selling your shares in response to short term market movements. If you do not resist, you may sell them for less than you could by adhering to your strategy.

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.

Factors to be aware of:

- 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.
- 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 as they can experience significant levels of short to medium term volatility.

Australian Property Securities

Investing in property securities as an asset class is different to buying a house or an investment property.

An Australian listed property trust is an investment that is listed on the Australian Stock Exchange and provides exposure to a portfolio of direct property investments. Listed property trusts 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 listed property trusts. The advantage of this is that 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, listed property trust investments provide 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.

Factors to be aware of:

- 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.

International Property Securities

A listed international property trust is an investment that is listed on an international stock exchange and provides exposure to a portfolio of direct property investments. Listed property trusts 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 global listed property 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.

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Factors to be aware of:

- Both the capital value and the income return of the investment may be influenced by currency exchange rates.

Factors to be aware of (cont.):

- 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.

Factors to be aware of:

- 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.