

FactFile

Asset classes:

what you need to know

This fact file explores the differences between asset classes, the pros and cons of each, why certain asset classes are more appropriate for different types of investors and why no asset class consistently outperforms the others.

What are asset classes?

An asset class is a category of investment. Understanding the different asset classes and the advantages and disadvantages they offer will help you determine which types of investments are best suited to your individual needs, goals and investment time frame.

There are four main asset classes – cash, fixed interest, property and shares. Each of these is explained in more detail below.

Cash

Cash includes money in bank accounts, as well as investments in bank bills and similar securities which have a short investment time horizon. Cash investments provide stable, low risk income in the form of regular interest payments.

Fixed interest

Fixed interest investments include term deposits, debentures, mortgages, and government and corporate bonds. The recommended investment time frame for fixed interest investments is one to three years. 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.

Property

You can invest in property directly (eg when you buy a house or commercial premises such as a shop) 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. Property is usually considered a medium term investment, with a time frame of three to five years.

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. Shares are generally considered a long term investment, with a time frame of five to seven years.

Defensive vs growth investments

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

Defensive investments such as cash and fixed interest aim to provide investors with regular income. 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 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.

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 – 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.

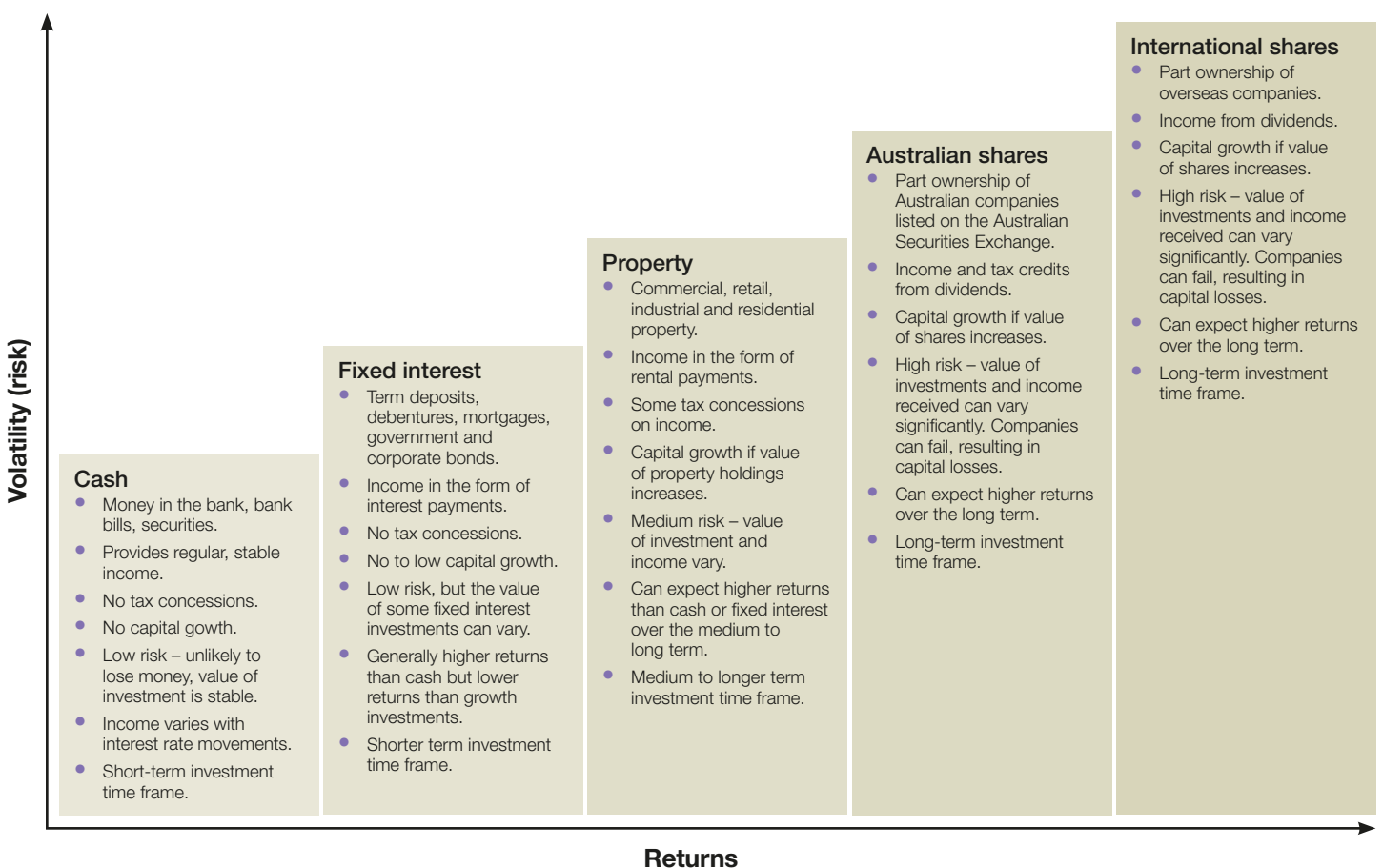
On the other hand, if you are comfortable with short term fluctuations in the value of your investments and want to invest for the long term, growth investments such as Australian and international shares may be the best option for you.

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

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 image below for more information.

The attributes of each asset class



Source: Colonial First State. Past performance is no guarantee of future performance.

Managing investment risk with asset class diversification

One of the best ways of managing investment risk is through diversification. This is the strategy of investing your money across a range of different asset classes to reduce risk.

The more ways you diversify, the more you can reduce your risk. For example, you can invest:

- across different asset classes
- in more than one investment within each asset class (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.

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 1990 to 2009. 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

	Australian shares	Global shares	Australian property securities	Australian fixed interest	Cash	Diversified*
Annualised last 20 years	9.8%	4.7%	7.7%	8.9%	6.6%	8.3%
Dec 1990	-17.5%	-15.1%	8.7%	19.0%	16.1%	-4.0%
Dec 1991	34.2%	20.2%	20.1%	24.7%	11.2%	26.0%
Dec 1992	-2.8%	4.5%	7.0%	10.4%	6.9%	4.0%
Dec 1993	40.5%	24.4%	30.1%	16.3%	5.4%	27.6%
Dec 1994	-8.8%	-8.1%	-5.6%	-4.7%	5.4%	-6.4%
Dec 1995	20.7%	25.9%	12.7%	18.6%	8.0%	20.2%
Dec 1996	14.3%	6.3%	14.5%	11.9%	7.6%	11.5%
Dec 1997	11.4%	41.1%	20.3%	12.2%	5.6%	19.4%
Dec 1998	8.5%	32.1%	18.0%	9.5%	5.1%	15.4%
Dec 1999	19.3%	17.1%	-5.0%	-1.2%	5.0%	10.3%
Dec 2000	6.2%	2.2%	17.8%	12.1%	6.3%	8.1%
Dec 2001	10.5%	-9.7%	14.6%	5.4%	5.2%	4.4%
Dec 2002	-8.6%	-27.2%	11.8%	8.8%	4.8%	-7.0%
Dec 2003	15.0%	-0.5%	8.8%	3.0%	4.9%	7.0%
Dec 2004	27.9%	10.3%	32.0%	7.0%	5.6%	17.3%
Dec 2005	22.5%	17.0%	12.5%	5.8%	5.7%	15.1%
Dec 2006	24.5%	11.7%	34.0%	3.1%	6.0%	15.8%
Dec 2007	16.2%	-2.1%	-8.4%	3.5%	6.7%	5.4%
Dec 2008	-38.9%	-25.3%	-54.0%	14.9%	7.6%	-23.9%
Dec 2009	37.6%	0.8%	7.9%	1.7%	3.5%	14.3%

Actual indices returns: This table is based on the standard indices used by investment professionals to measure performance of asset classes. Percentage return over rolling 1 year. UBS Australia Bank Bill Index, UBS Australian Composite Bond Index, S&P/ASX 200 Property Accumulation Index (ASX Property Accumulation Index pre April 2000), S&P/ASX 300 Accumulation Index (ASX All Ordinaries Accumulation Index pre April 2000), MSCI World Net Index (A\$). All dividends reinvested excluding fees and charges.

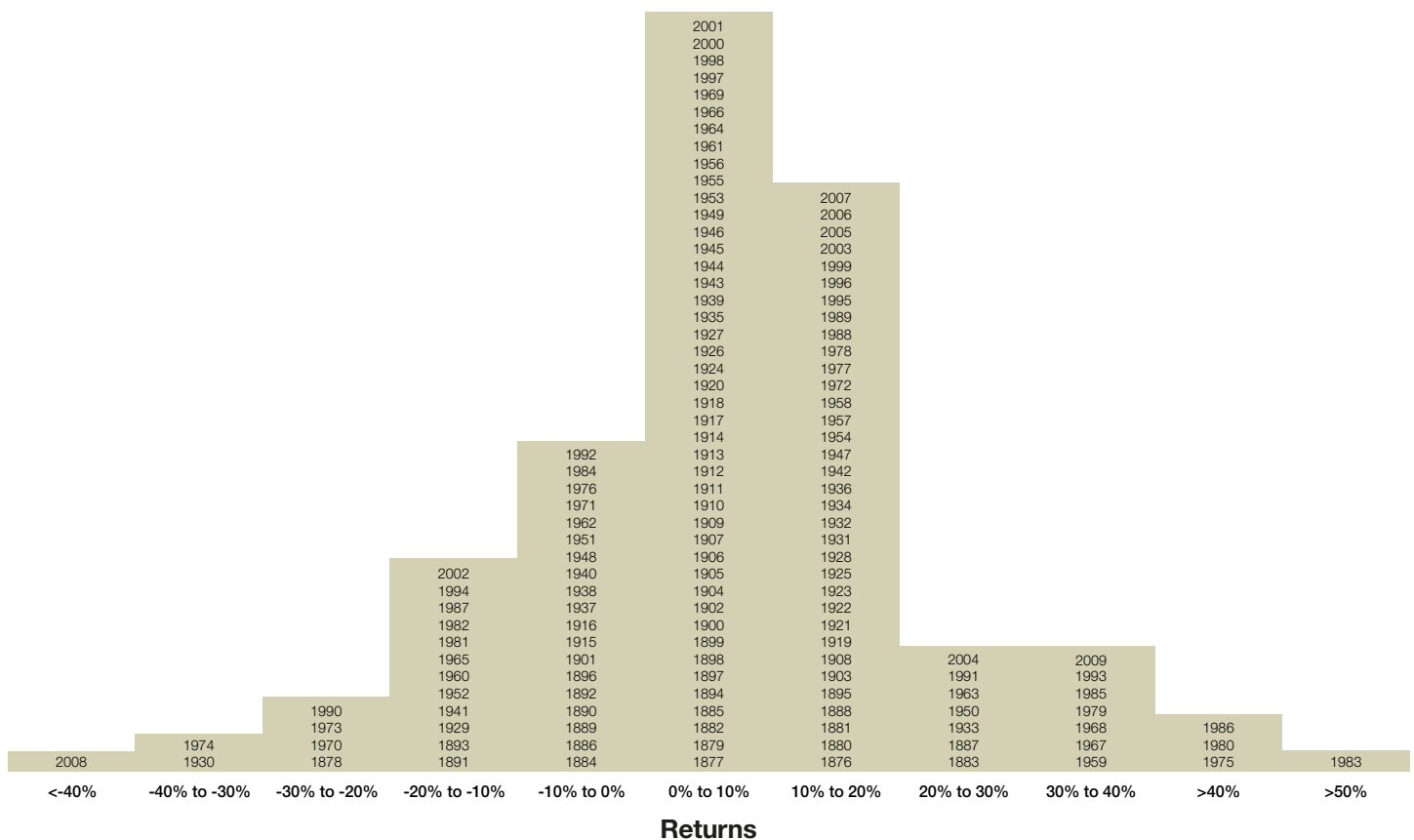
* Non Actual Returns. The Diversified Portfolio is a portfolio constructed from the returns of these market indices with the asset allocation of: 35% in Australian shares, 25% in international shares, 25% in fixed interest, 10% in Australian property securities, 5% in cash. The Diversified does not represent any Colonial First State portfolio nor the actual returns that this portfolio achieved because it does not exist. The constructed Diversified Portfolio illustrates how such a portfolio may have performed based on the new market indices. Each Colonial First State portfolio has a different asset allocation from the illustrated diversified portfolio used above. Past performance is not an indicator of future performance. The above actual index returns and non actual returns for the Diversified portfolio also cannot be directly compared to an individual Colonial First State fund's return for many reasons such as they do not include allowances for fees or taxation and do not reflect the asset allocation or stocks held now or over time.

Understanding returns

Just as each asset class has its ups and downs, so does the sharemarket as a whole. Returns vary from year to year, influenced by a variety of factors such as investor sentiment, the economy, politics and world events. Cycles in the economy and sharemarket are part of life and sharp falls in the value of investments happen from time to time.

The image on this page shows annual returns for the Australian sharemarket as a whole from 1876 to 2009. As you can see, returns vary significantly from year to year, however the majority of returns are clustered around the middle of the graph – from 0% to 20%. Overall, there are far more positive than negative years.

Historical S&P/ASX All Ordinaries index annual performance



Source: Bloomberg, Goldman Sachs JB Were, Colonial First State. Data to 31 December 2009. Past performance is no indication of future performance.

Speak to us for more information

If you would like to know more about asset classes, contact our office and talk to your financial adviser. We can give you more detailed information on the best approach for your situation.

Important information

This general advice has been prepared without taking into account your particular financial needs, circumstances or objectives, and is based on Financial Wisdom Limited's understanding of the economic situation as at 1 April 2010. While every effort has been made to ensure the accuracy of the information, it is not guaranteed. All investments are subject to risk, including loss of income and capital invested. Past performance is no guarantee of future performance. You should obtain professional advice before acting on the information contained in this publication.

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