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Learn how these powerful trends will shape portfolio performance.



By Robin Bowerman, Vanguard

The New Year is often a catalyst for investors to update their portfolio, get tax matters in order and review how the past year has treated them.

Certainly there were many investors glad to ring out the old in terms of 2011 and welcome the optimism that surrounds the beginning of a New Year, because for share investors it was a testing year indeed. In the second week of December, the Australian market was showing losses of minus 13 per cent as measured by the S&P/ASX 300 index.

Probably the only solace for share investors is that dividend yields on some of Australia's blue-chip companies are strong, so if regular income is your main objective and you can ignore the capital value movements, Australia's general economic and corporate health provides a level of comfort.

The asset class that topped the performance tables in 2011 was Australian fixed interest: bonds provided the same sort of safe harbour that they did in 2008 when the GFC was in full cry. It was another reminder that probably the single most important decision investors make is how much to allocate to each asset class.

Synchronised swimming, anyone?

The New Year is also the season for predictions. Regardless of how worthy and well intentioned they may be, it is worth remembering they are just that - predictions. It is always sobering to look back 12 months and remind ourselves what the pundits were saying then.

Remember 2010 had been a relatively good year, so some of our leading economists suggested 2011 was likely to be a year of "above-average growth in the global economy". And do not forget all the bullish forecasts about the emerging-markets sector; the 2011 MSCI index (in Australian dollars) was showing a return of minus 17.8 per cent to the end of November, proving again that in a global crisis, markets can deliver a good impersonation of synchronised swimming.

Interest rates are another fertile area for forecasters. When we look back to the start of 2011 the general expectation was for rates to rise as a consequence of the Reserve Bank wanting to rein in the economic growth. Again, events moved in the opposite direction to that predicted.

So when reading all the projections for the year ahead it pays to treat them with a healthy dose of scepticism, simply because the future is unknown and clearly the challenges facing the global economy are significant and will require long-term adjustments.

With that in mind, some clear trends emerged through 2011 that investors will have to grapple with in 2012.

Taking control

The first surrounds the issue of investors taking control of their own destiny. The continuing steady stream of self-managed super funds is the strong and unambiguous signal of that. SMSFs are now the largest part of our super system and the latest statistical overview of the sector, released early in December by the Australian Taxation Office, showed that on average, for the five years ended June 2009, \$10 billion in assets flowed into SMSFs while new funds were being set up at a steady rate of 2100 a month.

This is a phenomenon that is reshaping the super landscape and puts more people directly in control of their super investments. But with that trend comes the responsibility to manage the fund's portfolio.

The search for balance

Regular portfolio reviews are a great discipline for investors to stick to because change is a good thing if it means staying on track towards your long-term financial goals. Investors should regularly review their strategy, in particular to ensure that it still fits their objectives and risk profile, and the asset allocation limits set within the financial plan.

After a year like 2011 there is a reasonable chance that some parts of the portfolio may well have moved above or below the asset allocation target levels (a percentage weighting in your portfolio that suits your risk tolerance and investment goals).

One of the best things investors can do annually is rebalance their portfolio back to their target asset allocation. That is a lot easier said than done because it typically means selling winners and buying the underperforming asset class. In the real world of January 2012, that possibly means selling fixed interest or term deposits and putting the money into shares. You can see the emotional challenge right there.

Volatility

The volatile market environment in recent years has provided a significant challenge for many investors who traditionally may have favoured Australian equities investments for the majority of their investment portfolio.

Even major institutional investors such as large super funds are openly questioning whether they are hold more shares as part of their default portfolios. A significant shift to cash is a big theme of the past year as term deposits offered a safe haven to investors responding to short-term market shifts.

Now for a trivia question for your next dinner party or perhaps a share club annual dinner: what was the most volatile decade for Australian shares since the 1950s?

The answer is supplied from a new academic research project by the Australian Centre for Financial Studies, which in its first phase is developing a unique database of Australian equities performance data going back to 1948. That is no mean feat because it requires getting hard copies of state stock exchange records into digital format. Ultimately the aim is to build a digital data record back to the early 1900s.

The lack of long-term historical records has long been a

frustration of sharemarket researchers so the project will fill a significant gap in analysis of the Australian market. At this stage the database has monthly data on almost 6000 companies across 63 years of records. The project has much further to go but already is revealing interesting perspectives from early analysis.

For example, the answer to the trivia question is the 1980s, with a volatility measure of 36 per cent, compared with 17.5 per cent between 2000 and 2010.

What that is suggesting is the volatility of the past year is not that unusual in a historical context.

Some work recently completed by Vanguard's US research function called *Asset Allocation in a low yield and volatile environment*¹ involved looking at popular asset allocation strategies and how they might fare in the expected continuing volatile investing environment. The outcome of the study showed the likelihood that the average returns on a 50/50 equity/bond (US-based) portfolio over the next 10 years will exceed those of the past 10 years is approximately 70 per cent.

More importantly, however, the paper concluded that the basic principles of portfolio construction remain unchanged, given the expected risk and return trade-off between shares and fixed-income investments - balance, diversification, and a strategic allocation based on long-term goals.

The wall of cash

The build-up of cash in term deposits has sparked considerable debate. On one hand, given the rates offered and the security provided, the trend is understandable and clearly investors voted with their hip pockets in 2011. The deliberate shift to cash is a trend likely to continue in the New Year.

Investment Trends research data from May 2011² showed that SMSF investors held a total of \$39 billion in "excess cash" (cash that would normally be invested in other assets if not for market volatility) and a further \$113 billion in cash invested as a deliberate asset allocation decision.

Using that categorisation, the amount of "excess cash" has not varied significantly in the past few years. Understandably, many investors are troubled by the deep European sovereign debt crisis, the lingering aftermath of

the GFC, and high sharemarket volatility. And annual returns from cash have been higher than for Australian shares over the past 12-month and five-year periods, according to Morningstar.

An investor who moves from shares to an all-cash portfolio following a sharp sharemarket downturn will often crystallise losses and could miss out on a possible rebound in share prices - the worst possible outcome.

(Editor's note: The benefit of an all-cash portfolio is avoiding further capital losses if the sharemarket continues to fall). What the Investment Trends research highlights is a shift with investors (in particular SMSFs) consciously putting funds into cash as a longer-term asset allocation decision, effectively using term deposits as a proxy or substitute for traditional fixed interest.

That may be understandable from an investor behaviour perspective in the short term, but in the longer term it may raise issues around liquidity - something investors have to trade-off with term deposits - and inflation protection.

The challenge for retail investors has been how to access the deep liquidity pool of government and high-grade corporate debt securities. For people managing their own self-managed super fund and perhaps heading into retirement phase, this is a significant issue.

The good news here is that ASIC and ASX have been working towards allowing fixed-interest ETFs in the Australian market. That will help address the issue for investors looking for a broader and better diversified fixed-interest portfolio that can be accessed through the same transaction systems as shares.

Throughout the GFC, fixed interest did its job for investors in terms of risk management and providing diversification to growth assets. It can be a viable alternative asset class for investors who want to manage their risk but do not want to park their assets in cash.

Security is a valid and powerful argument put forward in favour of term deposits, but what about a portfolio of Australian government bonds? To the end of November 2011, a portfolio of Australian government bonds was showing a return of 11.5 per cent for the year to date. That is an extraordinary return in view of the volatile global situation, and demonstrates that high-quality, defensive assets such as government bonds have provided a true safe harbour for investors. This role of

fixed interest in portfolios is perhaps not as well understood, or accessible, as it could be.

Unlisted fixed-interest managed funds have been available for many years but an ETF option would potentially make accessing fixed interest cheaper and possibly easier for investors, particularly those who prefer to operate through ASX.

The core of the matter

Sharemarket investing is sometimes likened to finding a needle in a haystack. And it seems Australian investors are showing an increasing inclination to buy the haystack; that is, buying the whole market.

Rainmaker data at June 2011³ shows that indexed funds under management had climbed to \$223 billion, the highest ever in Australia. Multiple factors are at work here, including disenchantment with active managers who have failed to beat index returns and the development of the ETF market as a way of accessing market returns.

But possibly the bigger influence is the greater awareness among investors and advisers of the importance of the asset allocation decision. This has manifested itself in a shift to using index funds and ETFs as the tools to implement a core-satellite approach, in which investors use low-cost index funds to capture market or market sector returns for the portfolio "core", and add satellite investments where the investor has a higher level of confidence in the outperformance. That might be individual shares, managed funds, property or any other type of investment.

This strategy continues to gain ground with investors and advisers alike as it provides an approach to asset allocation and portfolio construction that allows the flexibility to research and choose investments to augment or tilt the portfolio a particular way without taking excessive risk with the bulk of an investor's assets.

Lowering costs

When times are good, investors may not focus on costs so closely. However, in volatile and falling markets, costs are one of the key things that investors can control.

The good news is that through 2012, reforms to the way financial planners, platforms and fund managers operate are due to take effect, which should make fees more

transparent and comparable.

About the author

Robin Bowerman is Head of Corporate Affairs and Market Development at [Vanguard](#).

Footnotes

1. Davis, J, Aliaga-Diaz, R & Patterson, A J, *Asset Allocation in a low yield and volatile environment*, November 2011.
2. Vanguard/Investments Trends, *Self Managed Super Fund Investor Report*, May 2011.
3. Rainmaker, *Rainmaker Roundup Report*, June 2011.

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