You've saved your money, now what? Understanding 'asset allocation'

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John Collett
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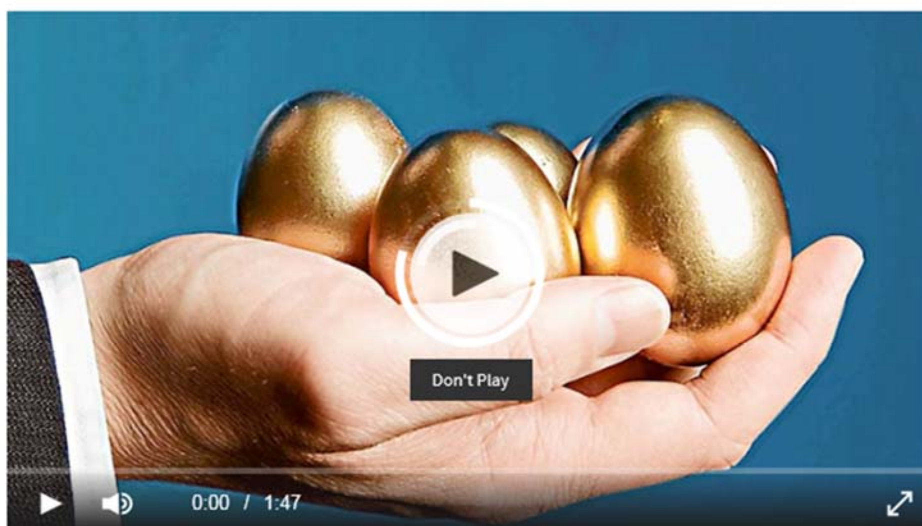
Kate Donnelly has tens of thousands of dollars saved. The problem is the money is held in an online saver and a bank account earning next to nothing.

It's a dilemma faced by many – how to earn higher returns without taking risks with the money.



Why choose a self-managed Super fund?

Thinking of moving to self-managed Super? Money editor Caitlin Fitzsimmons outlines the things to watch out for.

The 27-year-old shares a house in Sydney's inner west and works in public relations.

"I would like to buy a property but cannot afford to buy in my preferred areas of Sydney," Kate says. "I'm thinking of buying an investment property instead, so that at least I can get onto the property ladder."

Kate is conservative with money. "I like to know that my money is going up by small amounts and is not going to go down," she says.

Anytime we think about how money should be saved or invested we are thinking about a concept called "asset allocation".

It's nothing more complex than spreading money between investments to maximise returns while minimising risk, where risk is the degree to which an investment's price moves up and down.

Kate cannot take the risk of moving her savings into shares because her desire to buy an investment property means she is likely to access the money in the near future, says Laura Menschik, a financial planner and director of WLM Financial Services.

If her timeframe to buy a property was longer than five years then she could move some of the savings into shares.

Instead, Kate should consolidate her savings in the highest-yielding online savings account, which should pay about 3 per cent, Menschik says.

Melissa Browne, an accountant, financial adviser and chief executive of The Money Barre, and *Money* columnist, says Kate should look at her asset allocation overall, not just on the money she is saving for the deposit.

Kate could consider switching her super, which is currently in the balanced option, to one with a slightly more aggressive asset allocation that is expected to produce better returns over the long term, Browne says.

Even though the fluctuations in her super account balance will be greater, at 27 Kate has plenty of time to ride them out before retirement.

Asset allocation

When one market is going down, there will usually be some others doing well. By spreading your money around you are always likely to have one or two investment classes firing.

Sticking all of your savings in the bank is not going to earn enough to keep up with rising prices, let alone make some money in excess to inflation.

That's especially the case now, with interest rates at record lows.

The first $250,000 on deposits with a bank and other regulated institutions, such as mutual banks, is covered by the government's deposit guarantee.

That includes not only cash accounts and online savers but also term deposits.

While there is no risk to capital, the interest rates on offer are paltry.

Transactions accounts pay virtually no interest on smaller amounts of money – typically 0.1 or 0.2 per cent. They can have monthly fees as well.

Even the best three-year term deposit interest rates for amounts of more than $10,000 pay 3 per cent, figures from Finder.com.au show. Most are paying about 2.5 per cent.

The best of the online savers pay a little over 3 per cent but they can have tricky conditions.

Often, the base rate can be very low, just above zero per cent, and bonus rates are available only for a limited period.

Higher returns

To get higher returns investors have to take some risk with their money.

Higher returns come with higher "risk" – which really just means how often the investment loses value and by how much, based on the history of the asset class.

But by combining asset classes, higher returns can be achieved without taking on too much risk, says Chris Brycki, the founder of Stockspot, an online investment adviser.

By adding more asset classes, the returns over the longer term will be less than having the money in shares alone, but the ride for the investor will be much smoother.

Figures provided by Mano Mohankumar, the senior investment research manager at superannuation researcher Chant West, show investors in Australian shares can expect to experience six negative years during any 20-year period.

By contrast, diversified fixed interest can be expected to produce only one or two negative years in any 20-year period.

Australian shares produced an average annual return over the past 15 years of 7.7 per cent but with more volatility than diversified fixed interest, which produced an average annual return of 7 per cent over the same time.

Super funds

Those in charge of investing in superannuation funds appreciate the power of diversification.

Their "default" investment options, where most fund members have their super, are balanced options.

The typical default investment option has about 30 per cent in Australian shares and about 20 per cent in international shares.

A further 20 per cent will be in property with the remainder in fixed interest and cash.

Those looking to invest over the long term, of at least seven years, could do worse than follow the super funds' example.

Super funds' default options are designed as a compromise between the needs of younger fund members, who can take more risk as they have time on their side and older members who cannot afford to have too much of their savings lost.

Shane Oliver, chief economist at AMP Capital Investors, says asset classes can be put into two basic categories.

The first is "growth" assets, such as shares and property, which grow the investor's capital over time.

The other is "defensive" assets, which include cash and fixed interest. They are less risky than growth assets as their return are in the form of income rather than capital growth.

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Shares do outperform other asset classes over the long-term, but there is a warning. Dr Oliver says these returns can be strongly influenced by market fluctuations and can, therefore, vary considerably over shorter time-frames.

Dial-down risk

Stockspot's Chris Brycki says the risk-versus-return profile of your investment portfolio should tilt more to defensive assets as you age.

"The age-old rule of thumb is 100 minus your age in growth assets if the money is for retirement," he says.

For example, someone who is 30 years-of-age should have 70 per cent in growth assets, someone age 50 should have 50 per cent and some aged 60 should have 40 per cent.

Brycki's business provides easy access to exchange traded funds (ETFs), which are listed in the Australian sharemarket. Units in them are bought and sold just like shares where the value of the unit reflects the performance of the market the ETF is tracking.

ETFs cover all sorts of sharemarkets around the word and sectors of sharemarkets as well as tracking the price of gold. The markets and prices they track go well beyond the usual ones.

They are especially useful for those with self-managed super funds who have big tilts to Australian shares and cash and want to get instant diversification.

As well as having a big tilt to shares and cash in their self-managed super funds, trustees will sometimes have an investment property.

"In that case it can make sense to have a higher percentage in defensive assets, even if you're young," Brycki says.

AMP Capital's Oliver says when considering asset allocation it is important to take a total portfolio point-of-view.

"You could make a spreadsheet showing everything, including super and the house you live-in and investment property, and group them by asset class to see the total exposure you have to each asset class," he says.

Don't time market

Chant West's Mano Mohankumar says we are in a period of low growth and high volatility that is likely to last for some time.

He says Brexit, the recent vote by the British to leave the European Union, has only increased global economic and political uncertainty. Sharemarkets around the world are volatile.

Some super fund members may be tempted to switch from their balanced superannuation investment option to a more conservative option, he says.

"We caution super fund members about the dangers of timing the market," Mohankumar says.

"Moving into a more conservative investment option after large sharemarket losses will not only crystallise your losses; you will miss-out on the benefits of subsequent rebounds."

Older members may have a lower tolerance for seeing their balance go down than people in their 20s or 30s, but then super doesn't necessarily stop when you retire, Mohankumar says.

"If you convert your super into a pension to live on, the money will stay in the fund for many more years," he says.

Major asset classes

Shares

* Companies listed on the Australian Securities Exchange and on world sharemarkets

* Risk is high but usually the best-performing asset class over at least 10 years.

* Returns include capital growth or loss and income from dividends.

Property

* Australian and overseas properties, including office buildings and shopping centres

* Riskier than fixed interest but less risky than shares. Includes capital growth or loss and income through rents.

* Less liquid than other asset classes resulting in a higher recommended minimum timeframe of at least seven years. The costs of direct investment in property can be high.

Diversified Fixed Interest

* Includes Australian and international bonds issued by companies and governments.

* Can be riskier than cash, but still relatively stable.

* Income return is usually regular interest payments for a set period. Minimum time frame one to three years.

Cash

* Includes short-term money market securities and some short-term bonds. It also includes bank deposits and term deposits, which are covered by the government's deposit guarantee.

* Suitable for those saving or investing for a short-time or those who don't want to take risks with their money.

* Provides a stable income, usually as regular interest payments.

Commodities

* Investing in commodities means betting that the future price of the commodity, whether oil or gold, will be higher than the current price.

* Often commodities have low correlation with share prices. That is the case particularly with gold, whose price benefits when investors turn fearful.

* Commodity investments do not, like most other mainstream investments, pay an income to investors.

Alternatives

* A hodgepodge of investments whose only common characteristic is that they do not feature among traditional asset classes.

* They include private equity, hedge funds, currencies and collectibles such as art and wine.

* They can be complex investments that can keep faint-hearted investors awake at night.