

# Understanding investment concepts



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

## **Important information**

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# How to read this document

**Managing your  
finances to meet  
your day to day  
requirements  
as well as your  
long-term goals can  
be a complex task.**

There are many things you need to consider including taxation, legislation, protecting your wealth and assets, associated costs and the risks of investment. When undertaking a financial plan it is important you understand how these issues may impact you and what you should expect over time.

Your financial adviser will provide you with a Statement of Advice (SOA) which sets out the details of the advice and how it will meet your goals and objectives.

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

It is very important you read this document to help you understand the benefits of the strategies recommended to you and the associated costs and risks.

Please contact your adviser if you do not understand anything, or need further information or clarification.

# Understanding investment concepts

## Risk and return

### What is risk?

The meaning of risk can vary. For some it may mean the possibility of losing a portion of their investment due to market movements or a poor decision. For others it may mean not enough income is produced from the investment. Another measure of risk is the variability of returns over time known as volatility. Generally, risk can be viewed as the chance of failure in achieving objectives or goals.

Risk is part of investing. Importantly it can be measured and managed within an investment portfolio. Taking on some risk is necessary for higher returns. The main concern 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. Taking on too much may prove to be a mistake. Taking on too little may cause regret and failure to achieve the returns needed to meet your lifestyle goals.

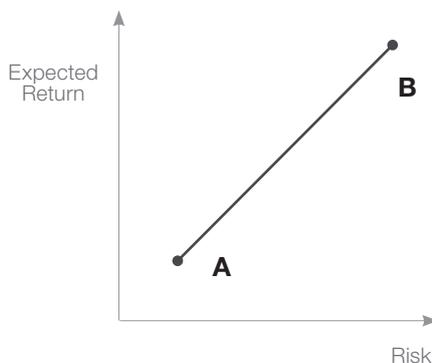
### How do you cope with risk?

It is important to understand the risks 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 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 required by investors to accept this risk. Low risk investments such as cash offer relatively low returns as a reflection of their greater security. This is called the risk/return trade-off.

The diagram below 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 chance that high risk investments will be more volatile in the short term (leading to capital loss if investments are sold in the short term).

### What are the types of risk?

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

- **investment market risk**  
The possibility all investments in a market sector, (such as shares), will be affected by an event.
- **investment specific risk**  
The possibility a particular investment may under perform the market or its competitors.
- **market timing risk**  
The possibility 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**  
The possibility your investment return is below the inflation rate which reduces the spending power of your money.
- **credit risk**  
The potential failure of a debtor to make payments on amounts they have borrowed.
- **interest rate risk**  
The possibility your investment will be adversely impacted by a fall or rise in interest rates.
- **legislative risk**  
The possibility a change in legislation will impact the appropriateness of certain investments for you.
- **liquidity risk**  
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.

# Understanding investment concepts

- **hedging risk**

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.

- **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.

- **derivatives risk**

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, and

- **opportunity cost**

The investment return you may forego from an asset as a result of investing in your preferred asset. That is, there is a risk 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. This means not putting all your eggs in the one basket. 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 by investing:

- **across asset classes**

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.

- **across markets and regions**

Spreading your exposure within each asset class across a wide range of countries, currencies, industries and stocks ensures your investment is not narrowly concentrated in a particular region or industry. This reduces the impact of a region or industry downturn, and

- **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 reduce reliance on any one style in each asset class.

## Asset allocation

Asset allocation is the proportion of your portfolio spread across a number of asset classes, markets and regions.

The aim is to achieve a return for an acceptable level of risk by combining asset classes in a calculated way. This also helps smooth the ups and downs of each asset class returns.

There are several approaches to asset allocation in common use. They all have their advantages and disadvantages so it is important to understand the basic differences.

Strategic asset allocation (SAA) is the process of setting and maintaining the long term structure of the portfolio. It reflects expectations about assets over the long term and is designed to reflect your long term objectives and appetite for risk.

Tactical asset allocation (TAA) refers to short term changes to asset allocation to take advantage of short-term views of the markets.

Dynamic asset allocation (DAA) is in between strategic and tactical asset allocation. It's an active approach to altering a portfolio's asset allocation over the medium term. DAA recognises markets will constantly move around from what is considered 'fair value'. It provides a level of flexibility to alter the asset mix of the portfolio to take opportunities as they arise or to help preserve wealth if markets fall.

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## Asset class characteristics

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.

#### Be aware

- Cash and short-term securities are generally the least volatile asset class and tend to offer the lowest potential return over the long-term.
- The return is typically all income which is considered assessable for tax purposes.

### 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.

#### Be aware

- 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 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. Concerns about defaults on loans may result in a loss on your investment.
- 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.

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## 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 provide the opportunity for 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 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.

#### Be aware

- 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.

### 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.

#### Be aware

- 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, and
  - 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.

### Australian property securities

Investing in property securities as an asset class is different to buying a house or an investment property. These are referred to as Australian Real Estate Investment Trusts (AREITs).

AREITs are an investment listed on the Australian stock exchange that provides exposure to a portfolio of direct property investments. AREITs 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 AREITs. The advantage of this is 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, this type of investment provides 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.

#### Be aware

- In the short to medium-term, the value of AREITs are expected to increase or decrease in value in accordance with movements in both the AREIT 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.

# Understanding investment concepts

## International property securities

International property securities are investments listed on international stock exchanges and provide exposure to a portfolio of direct property investments. These are referred to as Global Real Estate Investment Trusts (GREITs). GREITs 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 GREITs 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.

### Be aware

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

### Be aware

- 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.

## Alternative assets

Alternative assets cover a wide range of investments that are not considered traditional assets like those already described. Some examples include hedge funds, infrastructure and gold.

These types of investments are generally included in portfolios to increase diversification and provide returns that aren't strongly linked with the performance of traditional assets.

### Be aware

- To access some alternative investments you generally need to do so through a managed fund.
- As most alternative investments aren't listed on an exchange, determining their value for a fund's unit price can be difficult and may involve a considerable time lag.
- Some alternatives such as hedge funds involve greater complexity and therefore may be more difficult to understand.
- Some alternatives are illiquid which may make them difficult to buy or sell when you want to.
- Alternatives may be included in a portfolio for their growth or defensive characteristics.
- Hedge funds may use a range of uncommon investment management techniques to achieve objectives and may use leverage, short-selling and derivatives extensively.
- Alternative fund managers may charge relatively higher fees.

# Understanding investment concepts

## Managed funds

Managed funds allow investors to pool their money with an investment manager who has extensive research facilities and experience. Managed funds may invest in some or all of the asset classes mentioned above. Depending on the assets invested, they may provide a combination of income (including realised capital gains) and the potential for capital growth over the medium to long term. Generally, income distributions can be either reinvested or paid to a nominated bank account.

Managed funds can be purchased in individual names or within your superannuation fund.

### Advantages of managed funds

Some of the advantages of managed fund investments include:

- **diversification**

The large pool of funds available enables fund managers to diversify the spread of investments across all asset classes as well as providing access to investments which may not be readily available to individual investors, such as large retail property complexes and international shares.

- **professional management and expertise**

Fund managers have the expertise to monitor and research investment opportunities and apply their investment experience in managing investment portfolios across all asset classes

- **economies of scale**

Investors in managed funds can access economies of scale in areas such as volume discounts on brokerage and other fees.

- **liquidity**

Investors in managed funds can usually access their funds within 5-30 days (excluding superannuation investments), and are usually able to access a part of their funds without needing to cash in the whole investment

- **regular reporting and information**

Managed funds can take care of the administrative hassles and expenses which would normally accompany direct ownership of investments. Fund managers also provide regular information to investors regarding investment performance and year-end tax summaries, and

- **tax advantages**

Income distributions may be tax advantaged through imputation credits for investments with underlying Australian share assets

### Be aware

- The capital value of managed funds may fluctuate, particularly in the short-term.
- Capital Gains Tax may be payable on any growth in the value of your investments when you eventually redeem or sell them.
- Income distributions are not guaranteed and may fluctuate over time.
- Re-invested income will still form part of assessable income for tax purposes.
- Internal management fees are charged to invest into managed funds.
- Loss of immediate access to your funds.

# Understanding investment concepts

## Separately Managed Account (SMA)

The SMA is a registered managed investment scheme that allows you to access a number of professionally constructed and managed investment portfolios (model portfolios) comprising Australian listed shares and cash in which beneficial ownership is retained by you (or the trustee in the case of a superannuation investment). The SMA can only be accessed via an eligible platform (for both investment and superannuation).

### Key benefits of a SMA

Some of the benefits of investing in an SMA include:

- **individual accounts**

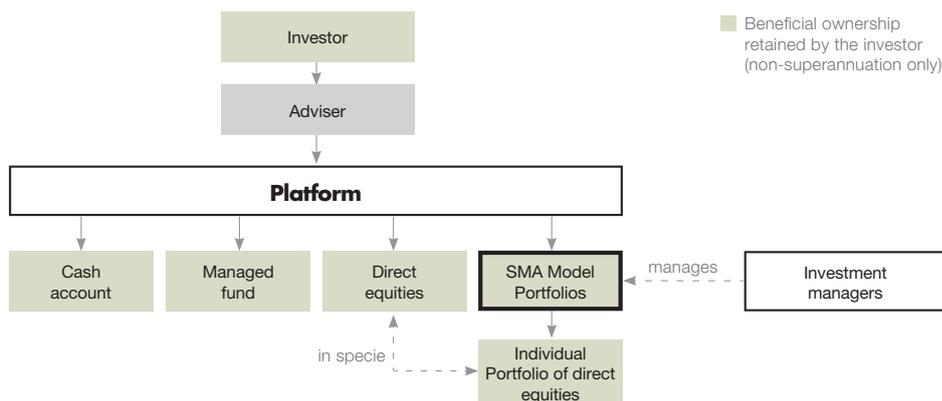
Unlike a unitised managed fund in which investors collectively have an interest in the pool of fund assets, the SMA investor has absolute beneficial ownership in the assets held in their account.

- **transparency**

The SMA allows you to view the underlying shares you hold within your chosen model portfolio.

- **portability**

If you already own Australian shares that are also included as part of a model portfolio, you can transfer them into the SMA and still retain beneficial ownership. You are able to transfer (in specie) shares out of the SMA into your platform account as well as transfer shares between model portfolios within the SMA.



- **no inherited capital gains**

An individual cost base is established for you on the day the shares are bought in the SMA and this relates solely to the price of the underlying shares purchased for you at the time of your investment. There are no tax consequences for you as a result of other investors' transactions.

- **professional investment management**

The SMA provides you with access to leading experienced professional investment managers who ensure each model portfolio is continually monitored and managed, and

- **lower management costs** than most managed funds.

# Understanding investment concepts

## Insurance bonds

Insurance bonds offer a combination of simplicity, flexibility and security, with tax benefits and professional investment management. They are commonly utilised as a tax effective means of saving for children's education.

### Key benefits of Insurance bonds

Some of the benefits of investing in insurance bonds include:

- tax on investment earnings Paid within the fund at a maximum rate of 30%.
- 10 year tax rule period. Where the fund is held for 10 years or more, withdrawals will be 'tax paid' in the hands of the investor, subject to the 125% contribution opportunity.
- 125% contribution opportunity. You can contribute up to 125% of previous year's contribution without re-starting the 10 year rule period.
- estate planning. You can nominate a plan guardian to look after your plan arrangements so your wishes are carried out
- access to a range of investment options across a range of asset classes.
- can be established by parents, grandparents, godparents, uncles and aunts to provide a child with a helping hand at the start of their adult life
- access to your money
- professional investment management, and
- invest for future education expenses in a tax-effective manner.

### Withdrawals made within 10 years

Withdrawal made	Tax payable
<b>Within 8 years</b>	Any investment gain is included as assessable income and taxed at your marginal tax rate. A tax offset of currently 30% for the assessable amount is also received.
<b>During 9<sup>th</sup> year</b>	One-third of the investment gain is tax paid. Two-thirds of the investment gain is included as assessable income and taxed at your marginal tax rate. A tax offset of currently 30% for the assessable amount is also received.
<b>During 10<sup>th</sup> year</b>	Two thirds of the investment gain is tax paid. One third of the investment gain is included as assessable income and taxed at your marginal tax rate. A tax offset of currently 30% of the assessable amount is also received.
<b>After 10 years</b>	All of the investment gain is tax paid. This means you do not need to pay personal income tax on any investment earnings from this investment.

# Understanding investment concepts

## Dollar cost averaging

Dollar cost averaging involves investing a set amount of money at regular intervals. By investing this way you are not attempting to pick the lows or highs of the market but rather investing a fixed dollar amount regardless of investment market trends.

The following example shows a dollar cost averaged share investment. A fixed amount of \$1,000 was invested in a share each month as the market price fell and then recovered to its original value.

Month	Amount invested	Share price	Units purchased
1	\$1,000	\$20.00	50
2	\$1,000	\$15.00	66
3	\$1,000	\$10.00	100
4	\$1,000	\$15.00	66
5	\$1,000	\$20.00	50
<b>Total</b>	<b>\$5,000</b>		<b>332</b>

In this example, by dollar cost averaging into the market, the shares were purchased at an average cost of \$15.06 ( $\$5,000 / 332$ ). After five months the investment was valued at \$6,640 (332 shares at \$20 per share), a profit of \$1,640. If the shares had been purchased at the commencement of the five months (ie at \$20), there would not have been any gain on the investment when the shares returned to their original value at the end of the five-month period. The \$5,000 invested would still have the same value, ignoring any dividend income.

### Advantages of dollar cost averaging

Some of the advantages of dollar cost averaging include:

- by regularly investing in an investment market, you are not relying on timing strategies aimed at picking when a market has bottomed or peaked. Dollar cost averaging imposes a helpful investment discipline by completely ignoring timing issues

- being beneficial when markets may fall. This is because only a fraction of the total amount to be invested is exposed to declines in the market. Also, when the market price falls, your regular investment amount will purchase more investment shares or units, and
- providing a sound savings regime and ideal investment strategy for people with a regular income but without large sums to invest.

### Be aware

- When market prices are trending upwards, a portfolio purchased up front will do better than the portfolio purchased using dollar cost averaging. This is because the full gain on the price rise is captured by the full amount of money invested up front.
- Over a time period in which prices fall steadily, a dollar cost averaging portfolio will still lose money. Nonetheless, dollar cost averaging will generally lose less than an up front purchased portfolio.