Investment fundamentals

Your guide to investing in any market

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Investment markets are complex and may appear difficult to understand for the average investor.

There are however a few basic investment fundamentals which can help ensure you are better positioned to utilise opportunities and weather any market volatility.

This booklet will guide you through some of the more important aspects of investing. You will learn some of the important rules of investing as well as gain a better understanding of market cycles and how they impact your investment.

Of course everyone is different and will have different objectives, timeframes and expectations. Having an understanding of the fundamentals will assist you in making informed, educated decisions with your financial adviser.

When your investment objectives are incorporated into a well formulated financial plan, you will be in a good position to meet your financial and investment goals.

So read on and learn more about the fundamentals of investing.

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Investment fundamentals

What is investing?

In short, investing is all about putting your money to work for you. Rather than just putting money aside, an investment offers potential profit via interest or appreciation in value. The aim is to grow your wealth over time, while giving you the financial security and the lifestyle you desire.

Investing at any stage in your life can grow your wealth, but generally, the earlier you start the better the long-term results will be.

The first step in investing is deciding what you want to achieve. For example, are you saving to provide your children with money or a better education? Are you investing for your own retirement or just looking to make the most of your money?

Whatever the case, investing a relatively small sum regularly can make a significant difference to your long-term wealth.

What options do I have when investing?

The answer to this question will depend on your personal investment goals, risk tolerance and your investment timeframe. There are a number of options available, whether they're direct, through superannuation or managed funds.

The strategies described in this booklet touch on just some of the options available. There are many methods of investing available to you, and a financial adviser can assist in suggesting a strategy that fits your personal situation and goals.

Fundamentals of investing

Whatever your personal goals are, there are some fundamental investment techniques that may help you to grow your wealth.

Basic fundamentals of investing

- ✓ Create a financial plan, and stick to it, to help you meet your long-term goals.
- ✓ Don't just save – invest.
- ✓ Start early and you'll appreciate the rewards of compound interest.
- ✓ Invest in growth assets to help build your wealth.
- ✓ Diversify your investment to help avoid risk and grow your investment.
- ✓ Spend time in the market. Investing over the long term can help you to weather market volatility and make the most of compound interest.

Why a financial plan is so important

A financial plan is a bit like a road map: it shows the final destination but also highlights what is required to get there and any possible detours you might have to make on the way.

Everyone has different aims and ambitions, but reaching your personal and financial goals still requires a disciplined, systematic approach to investing. Without prudent planning, it can be more difficult to reach your final destination without making compromises on your financial goals.

Selecting appropriate investments is just part of an effective financial plan that might also include retirement and estate planning, insurance, tax and superannuation strategies, risk tolerance, budgeting, etc.

A financial plan can help you:

- build your wealth
- protect your wealth
- make debt work for you
- have the money you need for retirement
- invest tax effectively.

No matter what your investment goals and plans are, keeping to your risk/return profile and investment plan will help put you in a better position to manage your investments through any market.

How an adviser can help

Regular professional advice can help ensure you have an asset allocation that is right for your risk tolerance, goals and timeframe.

Advisers also have access to important research, information and experience to help you create a unique plan that fits your goals.

As a general guide, you should meet with your adviser around once a year to review and perhaps rebalance your portfolio to ensure that your assets are still allocated properly to meet your long-term goals. This periodic maintenance will help ensure that your portfolio performs well on a long-term basis, and will help you reach your investment goals.

It is also important to update your adviser with details of any significant changes in your life, including family death, marriage, birth of child, inheritance, sale or purchase of a property, significant pay increase, job loss or health issues. These can all affect your investment outcomes.

If you do not already have a financial adviser, simply call 133 665 and OnePath will assist you in finding one.

Determining your goals and risk profile

Every investor is different: age, income, assets, investing experience and personality type all come into play when determining your risk/return profile.

As an investor, you aim to get the highest return at the level of risk you feel comfortable with. However, you need to consider how tolerant you are of market fluctuations and the probability that your investment returns may not meet expectations, and may even fall in value.

When considering your investment strategy, ask yourself:

- How great a fall in the value of your investment funds could you cope with, and for how long?
- Are you willing to accept more risk for greater returns?
- How soon do you want to reach your financial goals?

Risk and return

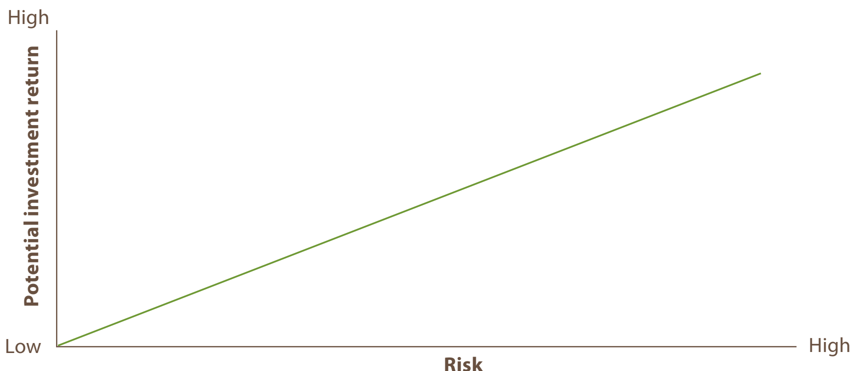
Risk and return tend to be closely related and so by choosing a lower level risk investment or adopting a lower risk investor profile you are also choosing to reduce your longer term return expectations.

It's important to recognise the level of risk you feel comfortable with. Some investors are more risk averse and prefer to invest in safer, low-interest cash and bank deposits where the value of their money is highly unlikely to fall.

Other investors may accept that the value of their money may go down over short periods of time but have the potential to earn a higher return over a longer timeframe if they invest in growth assets such as shares or property. It is important to remember that losses are always possible, depending on the fluctuations in the sharemarket.

Without accepting some degree of risk, you could be limiting your investment's potential growth.

The risk/return trade off



Time horizon

Time can be an investor's best friend because it gives compounding interest time to work (Refer to page 19). Having a clear long-term investment plan in line with your objectives and risk profile is far more important than chasing yesterday's winners and focusing on short-term trends.

A long-term investment perspective can also help you weather periods of market volatility. Time tends to smooth out the short-term market fluctuations and places sudden declines and gains into perspective.

In determining which investments are best for you, you should also consider an investment's time horizon. Each asset class has a distinct time horizon, which helps to determine its suitability. For example, if your time horizon is one to two years, you may consider a lower risk investment, such as cash or fixed interest assets.

Determining your risk/return profile

Your financial adviser will assist in assessing your tolerance and expectations to investment risk and return. Be realistic about your expectations – there may be many different investment strategies available to you and your financial adviser will work with you to find a solution that complements your objectives.

Risk can be managed, but never eliminated.

Asset classes

There are four main asset classes that you can invest in – cash, fixed interest, property and shares. The return you achieve and the level of risk associated is different for each asset class.

To build a balanced portfolio, you could invest in a combination of these asset classes. This method is called diversification.

Cash

Cash funds include interest bearing deposits and investments in securities such as treasury notes, with a term of less than one year.

When it comes to meeting short-term saving needs, such as saving for a holiday, the stability of cash is a great virtue. For cash investments, the risk of capital loss is lower than other asset classes. However, cash investments generally aren't suitable for long-term investment goals because the returns are likely to be low and may not meet your long-term financial goals, such as a comfortable retirement.

Fixed interest

A fixed interest investment or bond is a debt security issued by a corporation or government in return for cash from an investor. The issuer pays interest at set intervals over the life of the bond as well as the principle when the bond matures. Bonds can be issued over any time horizon but generally range from short term (0 - 2 years), moderate (2 - 10 years) and long term (greater than 10 years).

Interest rates can impact on the value of a bond, therefore they can be a higher risk than cash, but bonds can potentially offer better returns.

Property

Property investments can include investments in direct property, global property, securities, listed property trusts (LPTs), mortgages and other property securities. LPTs invest in a range of residential and commercial property, office buildings, hotels and industrial properties.

LPTs are pooled property investments which are broken into units and listed on the stock exchange like shares in a company. Funds which invest in property securities allow you to take advantage of the benefits of diversification from investing across a range of different property sectors.

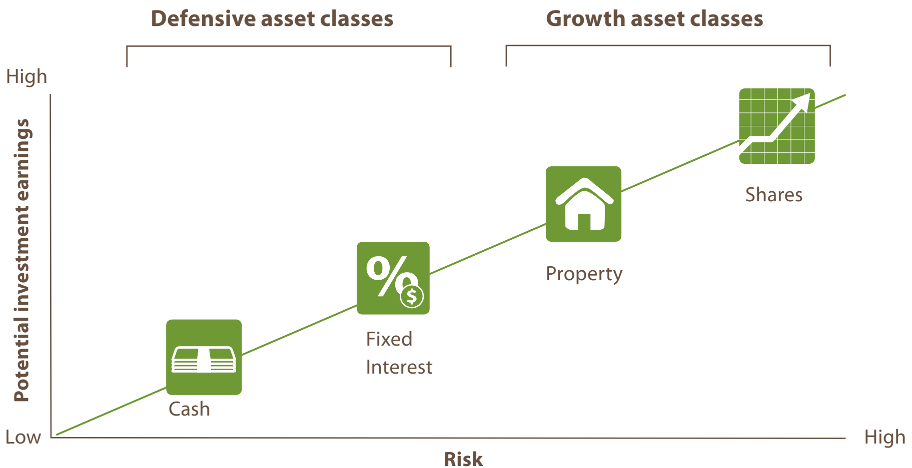
Property investments have a higher risk than fixed interest investments, but usually less than shares.

The expected investment timeframe for property investments is five years.

Shares

Shares or stocks are securities representing ownership of a company. When you buy a share in a company, you become a joint owner of the business. When companies distribute profits via dividends, the investor receives part of it.

Shares are generally known to provide the potential for the highest return of all the asset classes over the long term. But a company's value can rise or fall due to changes in economic and industry conditions and the company's profitability which means they carry the highest risk of loss. For this reason, the minimum time horizon for investing in shares is five to seven years.



Past performance is not indicative of future performance.

Alternative assets

Alternative assets are investments that generally do not fit into traditional asset categories outlined above. Risk can be controlled by limiting exposure to individual investments and seeking diversification of alternative asset opportunities. Examples of alternative assets include private equity, leveraged leases, direct property and property related investments (e.g. infrastructure assets) and commodities hedge funds.

Diversification

Importance of diversification

History shows that spreading your assets and investments across various asset classes can be the best way to guard against short-term volatility in any one asset class. Whether it's short-term cash deposits, property investment or shares – you can diversify your investments based on your comfort level.

Market conditions change regularly, including interest rates, demand in property and shares markets, or even legislation and policy changes. Investment performance can be influenced by these changes, even for the defensive asset classes.

Each asset class may be the best performer at different times of the market cycle. Diversifying across asset classes helps ensure that you don't lose all your investment if a particular investment is exposed to adverse market conditions.

A balanced diversified managed fund, for example, may offer 70 growth assets and 30 defensive assets. This combination would provide growth during a strong market and help offset negative returns during a weak market by reducing full exposure to the higher risk assets.

Every asset class has its day

Different asset classes perform better at various times and it's impossible to predict which one will be the star performer in a given year.

The table below shows asset class performance over a 29 year period.

	Australian Shares (%)	International Shares (%)	Property (%)	Australian fixed interest (%)	International fixed interest (%)	Cash (%)
1983	34.70	74.85	23.69			
1984	13.47	3.34	35.30	17.66		10.24
1985	36.51	63.11	11.76	12.99		12.82
1986	42.49	56.39	23.76	17.28	33.21	17.19
1987	54.01	33.35	41.31	12.86	5.43	17.11
1988	-8.61	-9.49	-2.79	17.16	-0.52	12.54
1989	3.53	18.70	-1.09	5.32	9.62	15.74
1990	4.09	2.42	15.24	17.28	2.45	18.48
1991	5.86	-1.41	7.70	22.36	13.03	13.51
1992	13.35	7.75	10.90	22.05	23.57	9.00
1993	9.91	32.58	17.67	13.93	24.63	5.91
1994	18.46	0.43	7.96	-1.13	-4.09	4.93
1995	5.71	14.74	8.87	11.88	22.44	7.10
1996	15.83	7.15	3.55	9.45	-9.60	7.75
1997	26.56	29.11	29.29	16.76	9.13	6.77
1998	1.64	42.68	10.21	10.88	26.19	5.11
1999	15.34	8.54	3.11	3.28	-2.57	5.04
2000	15.06	24.17	16.62	6.17	14.07	5.58
2001	9.11	-5.67	13.90	7.42	14.53	6.08
2002	-4.54	-23.21	14.85	6.21	3.14	4.66
2003	-1.61	-18.15	12.15	9.78	-2.47	4.97
2004	21.73	19.90	17.24	2.33	1.71	5.30
2005	26.03	0.53	18.10	7.79	-1.66	5.64
2006	24.02	20.44	18.05	3.41	2.40	5.76
2007	29.21	8.27	25.87	3.99	-9.97	6.40
2008	-13.68	-20.83	-36.35	4.43	3.45	7.34
2009	-20.34	-15.13	-42.26	10.83	9.95	5.47
2010	13.04	5.77	20.41	7.87	11.51	3.91
2011	11.90	3.22	5.86	5.54	6.93	4.98
Average return	**13.89**	**13.23**	**11.41**	**10.21**	**7.94**	**8.41**

Data: Australian Shares – S&P/ASX 300 Accum. Index, International Shares – MSCI World (ex Aus) in $A – unhedged, Property Securities – S&P/ASX 200 Prop Trust, Australian Fixed Interest: Commonwealth Bank Bond Index (Pre Sept 89) / UBSA Composite Bond All Maturities Index (Post Sept 89), International Fixed Interest: Citigroup WGBI Ex AUD Hedged, Cash: UBSA Bank Bill Index.

Source: Datastream

Note: Returns based on June 1 year rolling returns.

Best performing asset class for the year.

Lowest performing asset class for year

Past performance is not indicative of future performance.

Market movement and your investments

Investment markets tend to move in cycles. They can vary from providing strong returns year after year, known as bull markets, to bear markets where stock markets are declining. Bear markets can, of course, be quite alarming and challenging for investors.

It's important to recognise that investing is generally for the medium to long-term, and understand there will be periods of both outperformance and underperformance.

Those with shorter time horizons and lower acceptance of risk often opt for more conservative asset types that are less prone to market movement, such as cash and fixed interest.

It can be tempting to react to market volatility by jumping in and out of certain investments. But timing the market requires you to make two correct decisions that are very difficult to make: exactly when to buy and exactly when to sell.

Being out of the market at the wrong time - even if it's for a short period can significantly reduce the overall performance of your investments and cause you to realise a loss.

Historically, markets do recover. So if you stay put and don't make rash decisions, your investment should be well positioned to benefit from any upturn.

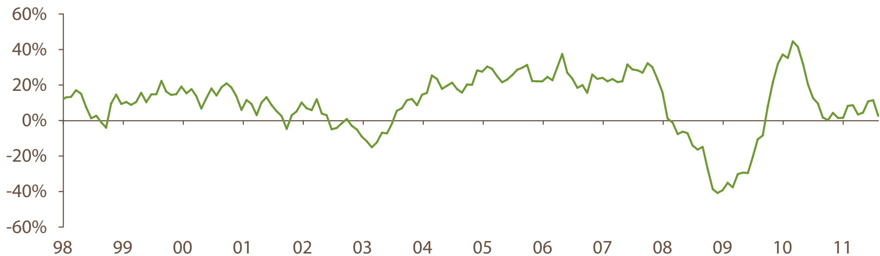
It is all about time in the market

Each investment fund has a suggested minimum time horizon. This is the minimum period of time you should consider holding your investment in a particular fund. Holding an investment for the suggested time does not guarantee a positive return, but it may increase the likelihood.

Markets will always fluctuate but the longer you stay invested, the less affected you are by short-term volatility, as illustrated below.

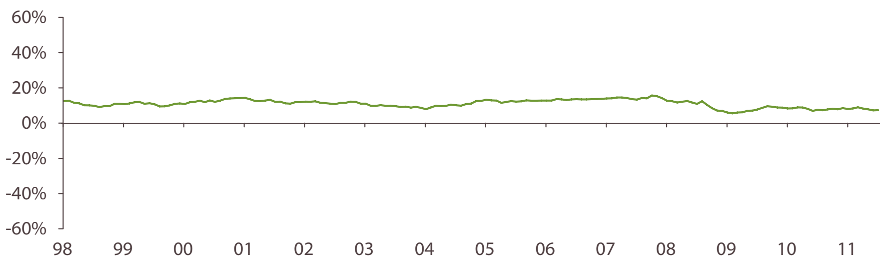
Over the short term, markets are volatile.

Rolling 1 year returns



Over the long term, volatility is reduced or smoothed.

Rolling 10 year returns



Source: S&P/ASX 300 ACC IDX, 1 and 10 year returns as at 31/07/2011.
Past performance is not indicative of future performance.

When to invest

It's never too early to start investing. In fact, one of the best ways to ensure that your financial needs will be met in retirement is by investing early.

Even if you can't afford to invest vast sums, the power of time can turn a small investment into a substantial amount of money. Statistics have shown that people who begin investing for retirement in their 20s or 30s are more likely to achieve, and even exceed, their retirement goals over the long-term.

The power of compound returns

The power of compounding returns is the single most important reason for you to invest early. Ongoing investment earnings can be made on both your original investment and the interest your account has returned. When your assets compound for a long period of time, this can give a substantial boost to your retirement portfolio.

For example, if you decide today to invest an initial amount of $1,000, then contribute $100 per month into a managed fund that earns 8% p.a., in 10 years' time, you would have $20,071. If you started investing the same amount three years later, you would only have $12,708. This is where the power of compound interest takes effect.

Spending more time in the market, or investing earlier, can make a big difference to your long term investment goals. Just imagine starting investing for retirement 10 years sooner – it could mean the difference between a modest or a comfortable lifestyle in retirement.

Benefits of dollar cost averaging

Dollar cost averaging (DCA) is a strategy of investing a fixed amount at regular intervals. DCA lowers the risk of investing a large amount into a single investment at the wrong time. The benefit of DCA is that the timing risk is reduced and as a result the cost is averaged out over time.

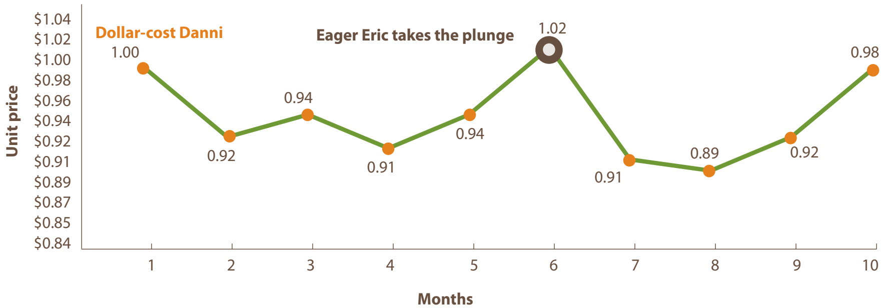
Within managed funds, for example, unit prices can fluctuate in response to market movements. By making regular investments rather than a one-off contribution, the unit price evens out over time.

When followed strictly, this strategy can help you reduce risk and avoid costly emotional and spontaneous investment decisions that might see you selling at the bottom of the market and buying in at the top.

Meet Eager Eric and Dollar-cost Danni

Eager Eric decides to wait until the market is running upwards strongly before he invests his $100,000 in managed funds, while Dollar-cost Danni decides to reduce her risk and invests $10,000 every month, regardless of what the market is doing.

At the end of 10 months, Dollar-cost Danni has made a profit, while Eager Eric made a loss. This is the beauty of DCA .



Investor	Price paid for units	Total units allocated	Value of units at month 10	Profits made on investment
Dollar-cost Danni	$0.89 - $1.02	106,238	$104,113	$4,113
Eager Eric	$1.02	98,039	$96,078	-$3,922

Investment stages

When we think of investing we tend to think of share traders or professional investors. But in truth, every Australian with a superannuation account is an investor also.

Whether you're investing in or outside super, your investment stage of life will have an impact on your investment strategy.

There are a number of investment methods available to you both directly and through managed funds. Your strategy will depend on your personal situation and goals.

Accumulation phase – Long-term investment

For most investors, the period of your life in which you are in the workforce is when you will accumulate the most amount of wealth. With regular income from salary, you are more likely to be able to fund both living expenses and contributions to investments.

Whether you are at the beginning or nearing the end of your time in the workforce, the basic fundamentals of investing apply. It is wise to commit to a realistic budget that will allow you to cover any living or short-term expenses while also investing regularly to reach long-term goals.

Diversification of your portfolio across asset classes and investment methods, no matter what your time horizon or attitude to risk/return, will help to smooth out short-term volatility and losses.

Typically, investors with a long time horizon are more inclined to invest a significant portion of their investment in growth assets. With a long time horizon, there is opportunity for your investment to recover after any market fluctuations.

Those with a short timeframe tend to consider defensive assets which are less exposed to market fluctuations.

A significant part of your long-term investment goals should include planning for retirement, even though retirement may seem like a long way off. The decisions you make throughout the accumulation stage will affect your lifestyle in retirement. Considering your current lifestyle, would you feel comfortable living on a $18,961.80[^] p.a. government age pension?

There are many different types of investment available to you. Your financial adviser can help you develop a tax effective strategy which continues to meet your changing needs.

^ The government age pension is indexed quarterly. At 20 March 2011 the government age pension was a maximum of $729.30 a fortnight for a single person (including the Pension Supplement), or about $18,961.80 p.a.

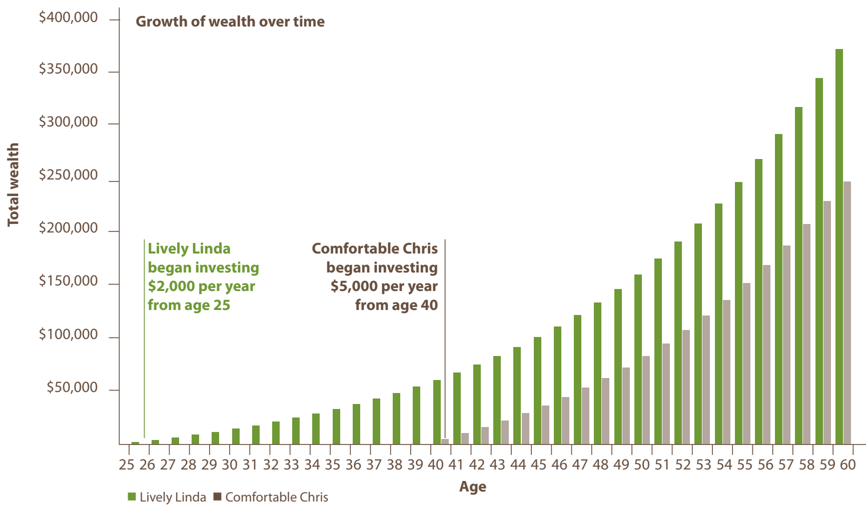
Give it time

Time in the market can have a significant impact on your investment earnings potential.

Meet Comfortable Chris and Lively Linda

Lively Linda is a keen investor. From 25 years of age, she invests $2,000 p.a. in a managed fund earning an average of 8% p.a.

Comfortable Chris doesn't start investing until he turns 40 years of age at which point he invests $5,000 p.a. for the next 20 years, also earning 8% p.a. Both Lively Linda and Comfortable Chris retire at 60 years of age. Below can see how their wealth grows over time.



Total invested	Investment amount	Years invested	Total invested	Value at age 60
Linda	$2,000	35 years	$70,000	$350,000
Chris	$5,000	20 years	$100,000	$250,000

As you can see above, despite putting aside less total savings, Lively Linda has created more wealth than Comfortable Chris. This is simply because Lively Linda chose to invest earlier.

This example is for illustrative purposes only. Calculations do not take taxation into consideration and assume both investments earned 8% p.a. The results may vary if different dollar amounts are invested and if the return earned is higher or lower than 8% at different times.

Approaching retirement

You may now have fewer financial obligations than you did earlier in life - the kids may have left home, you may have almost paid off your mortgage and have fewer financial commitments. If so, there has never been a better time to look at saving more to boost your retirement options.

It might be a good time to reassess your goals and progress with your financial adviser. Often, an investor's tolerance for risk will decrease if you have less time to recover from market fluctuations and you may wish to increase your defensive asset allocation. Keep in mind, however, that growth assets provide an important growth aspect to your investment. A diversified asset allocation will help you to continue growth while investing according to your risk/return profile.

When you retire, your superannuation is likely to be your main source of income. There are a number of effective strategies available to help boost your super during your transition to retirement.

Transition to retirement

Generally, superannuation rules enable workers approaching retirement to 'transition' towards retirement by reducing their work hours and to supplement reduced employment income with pension income.

A transition to retirement (TTR) pension strategy, when combined with salary sacrifice contributions, can also help you to boost your retirement savings or increase your disposable income.

Your financial adviser can help to ensure your transition-to-retirement strategy is tax effective and meets your long-term goals.

In retirement

You've worked all your life and now is the time to retire and enjoy those well-deserved golden years. However, you still need to have a regular income to help you pay for bills and cater for your spending patterns.

To live comfortably in retirement, a single person requires an annual budget of $40,121 and a couple $54,954, though this may vary depending on your own personal needs and objectives.

When you reach retirement age, there are two ways you can access your retirement income. You can either take it as an income stream or as a lump sum, or a combination of both.

An income stream allows you to receive regular pension payments out of your savings. There are a number of flexible options available to suit your needs. Accessing your retirement savings as a lump sum can be an appealing option, however you should ensure that your savings will provide for you throughout your retirement.

Speak to your financial adviser about strategies and social security rules to help you take advantage of your retirement income.

Remember – everyone's personal situation and investment goals will differ. It is important to speak to a financial adviser who can tailor a strategy to meet your financial goals.

Source: * ASFA Retirement Standard – June Quarter 2011.

Managing your investment

The way in which you invest will depend on your personal goals and risk/return profile. You may choose to access the investment markets directly, for example direct shares, or through managed funds or superannuation.

Direct shares can allow access to particular companies you want to invest in. However, if your portfolio is limited to a small selection or shares, you may increase risk or miss out on growth opportunities.

On the other hand, managed funds provide you with access to a team of experts who are able to spend the time required to actively manage your investment. Each fund has a clear objective and strategy so that you can see how your money is being invested. The funds can range from specific sector specialists to fully diversified balanced funds, allowing opportunities you may not otherwise be able to access.

Managed funds

A managed fund is made up of a pool of money which allows people with similar investment strategies to individually invest into the fund. Managed funds are good for those wanting to grow the value of their money as an alternative to traditional term deposits and bank savings accounts and are prepared to take on additional risk. They cater for all types of investors from people with small to larger sums to invest.

When you invest in a managed fund, you generally invest in a range of assets held by the fund. These investments may be spread across single or multiple asset classes, reducing the volatility of the overall investment and the impact of a fall in the value of any one asset.

Access to experts

A managed fund gives you peace of mind that your money is in the hands of experts whose full-time job is to grow your wealth. Investment specialists have access to an array of resources and knowledge and constantly research and monitor investment markets. This helps them to identify both opportunities and investments which should be avoided.

Opportunity

As managed funds pool investors money they typically have the buying power of millions of dollars. This allows them to take advantage of investment opportunities that are not generally available to individual investors.

Cost effective

It's often less costly investing in managed funds than managing your own diversified portfolio. When you go it alone, the research costs, transaction charges and professional fees for accountants and stockbrokers can soon add up.

Convenience

Managed funds offer a convenient and efficient approach to investing. All ongoing paperwork and administration is handled by the fund manager, ensuring investors receive annual taxation statements and regular information on the investment fund's performance. This makes investing in managed funds fairly low maintenance and hassle free.

Types of managed funds

Managed funds may be either managed by a single investment manager or by a combination of managers. They can also be either single sector or diversified across asset classes. Through investing in managed funds, you can access a number of methods of diversification:

Single manager funds

A single manager investment fund is invested by one investment manager. Managers differentiate by their investment approach and can choose to either provide diversified or sector funds or both.

Multi-manager funds

Multi-manager funds use a combination of specialist investment managers in each asset class. This provides additional diversification with potential for less volatility over the longer term, as one manager's good performance can offset the underperformance of another manager.

Multi-manager funds employing investment managers with contrasting but complementary investment styles can adjust the proportion of money invested with each specialist investment manager to favour those whose style best suits the prevailing market conditions.

Gearing

Gearing, or borrowing to invest, can allow you to borrow and invest more to achieve potentially greater investment returns. It makes sense if the investment returns you achieve will exceed the cost of borrowing, but sometimes it can also generate greater losses.

This long-term strategy would suit investors who can cope with higher risks and have income from other sources to service the loan. One of the benefits of gearing is the tax effectiveness, where you may be able to deduct interest expenses and ongoing borrowing fees for tax purposes.

Consider your risk/return profile when looking at gearing as it does not suit investors with a low risk tolerance.

Glossary of terms

Asset classes: Include shares, property, fixed interest and cash. Each has their own unique characteristics such as risk, return and liquidity.

Bear market: When markets fall for a prolonged period.

Bull market: When markets rise for a prolonged period.

Compound returns: A process that involves earning returns on returns – in addition to the initial capital invested. You can earn compound returns by reinvesting income payments from your fund.

Defensive assets: Include fixed interest and cash. These assets tend to produce lower yet more stable returns than growth assets with a consistent income stream.

Diversification: Spreading investments across asset classes, industries, countries or fund managers. The aim is to reduce risk and maximise returns.

Diversified investment fund: A diversified investment fund invests in different asset classes.

Dollar-cost averaging: Investing a set amount of money, at regular intervals, over a period of time.

Fund manager: An individual who determines investments in a fund.

Growth asset: Include shares and property which are expected to provide strong capital growth over the long term.

Investment risk: Potential for fluctuation in the value of an investment. Generally, the higher the potential return over time, the higher the level of risk involved.

Investment strategy: A plan for investing that takes into account individual goals, risk tolerance and time horizon.

Investment timeframe: Time horizon for investing. An investment timeframe can be a key influence on investment strategies.

Market volatility: The extent of fluctuation in share prices, exchange rates, interest rates, etc. The higher the volatility, the less certain an investor is of returns, and therefore volatility is one measure of risk.

Multi-manager: A multi-manager investment fund holds investment with a number of investment managers – thus providing investment manager diversification.

Realise: To sell an investment.

Risk: The variability of returns. Generally, the higher the level of risk an investor is prepared to accept, the higher the potential return over time may be.

Single investment manager: A single manager investment fund is invested by one investment manager.

Single sector investment fund: A single sector investment fund is one that contains only one asset class.

Notes

Customer Services
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