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Introduction to investments

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Risk versus return

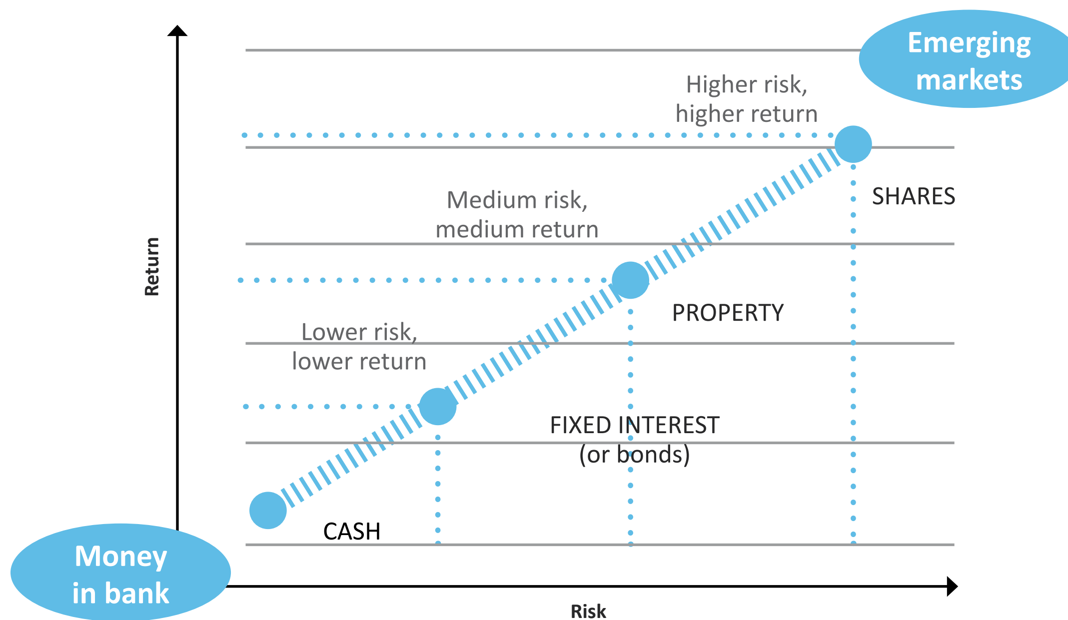
The basic investment trade-off

This introduction explains the fundamental concept of risk and return.

The fundamental investment principle is that you can only earn a higher return if you take more risk. To put this another way, if you want to reduce your risk, you must be prepared to accept a lower return. For example, if you put all your money in the bank, your return will probably be very low but you have the comfort of knowing that it is more likely the amount you deposited will always be there.

On the other hand, if you put all your money into emerging markets, your return could be very high for one or two years, then very low and quite possibly negative the next. In other words, your returns, particularly over the short term, are likely to be very volatile.

Whether you invest your money in cash, fixed interest, property, alternatives or shares—or some combination of investments—depends on things like your age, income, savings and personal preferences.



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The nuts and bolts of investing

The Fund's investment options include a range of asset classes each with its own risk and return characteristics. An asset class is a group of securities that exhibits similar characteristics, behaves similarly in the marketplace and is subject to the same laws and regulations.

The three main asset classes are equities (or shares), fixed income (or bonds), and cash equivalents (or money market equivalents).

More detail about the key asset classes you can invest in with smartMonday, from least to most risky are:

- **Cash** is typically defined as short-term fixed interest securities with a maturity date of less than one year. Cash investments offer low risk of capital loss but generally lower returns than most other asset classes. Term deposits are usually classified as cash.
- **Fixed interest** investments are debt securities issued by governments, banks or corporations. They pay interest at specified dates and repay the principal amount at maturity. Fixed interest investments carry the risk that the issuer will not be able to meet their payment commitments. This is known as credit risk, and some issuers such as companies may have a higher risk of default on payment than, for example, the Australian Government. This asset class can also carry interest rate risk, which is the risk that interest rates may increase after the fixed interest instrument has been purchased. An increase in interest rates would typically decrease the market value of a fixed interest portfolio. Conversely, a decrease in interest rates would increase the market value. Over the longer term, returns from fixed interest investments are generally lower than shares and property, but higher than cash.
- **Property trusts** and managed property funds can invest in commercial, retail, industrial, residential and hotel real estate. Property investments offer returns based on the value of real properties and rental income streams available from tenancy arrangements on those properties. Property trusts can either be listed on a stock exchange or unlisted. Listed trusts tend to have greater liquidity. Returns tend to be cyclical but property trusts offer the potential for higher returns over the longer term than cash and fixed interest.
- **Alternative assets** include market-neutral funds, hedge funds, private equity, commodities and infrastructure. Hedge funds may use specialist investment strategies such as short-selling and arbitrage. Infrastructure investments include utilities and other essential services such as motorways, water distribution and oil pipelines. Alternative assets may be useful to diversify a portfolio because the timing and pattern of returns often differs from traditional assets. Some alternatives may be relatively stable across economic and investment market cycles. Some alternative investments are unlisted and therefore less liquid than listed investments.
- **Shares** represent part ownership of a company. Owning shares can provide both capital growth and income in the form of dividends. Listed shares are traded on stock exchanges and prices can move considerably and frequently over the course of a day. Investments in shares offer the potential for higher returns over the longer term compared to cash, fixed interest or property. Shares are generally considered riskier than most other investment types, and some shares are riskier than others.

Defensive and growth asset classes

Asset classes are broadly divided into defensive and growth assets.

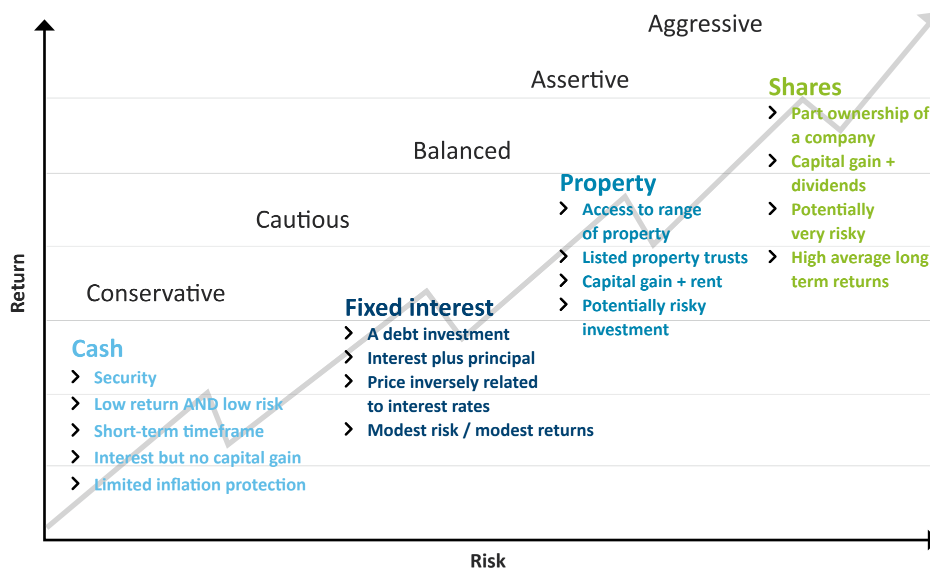
Defensive assets include cash and fixed interest investments. They're called defensive because their returns are generally more stable than growth investments due to a higher proportion of returns coming from interest.

Growth assets include shares and property which are expected to generate higher capital growth over the long term than defensive assets. They may also provide some income in the form of dividends from shares and rent from property, but this is typically a smaller proportion of the total return over the long term.

Over the long term, growth assets tend to offer a higher return than defensive assets. This potential higher return can make a big difference to long-term investments like superannuation. However, the risk of declines in prices over the short and medium term is higher.

Despite the nervousness experienced by many investors during periods of declining prices, history shows that patient investors may reap substantial rewards from investing in shares and property over the long term.

A financial adviser can assist you in determining an appropriate mix of growth and defensive assets for your circumstances, time horizon and financial objectives.



smartMonday products offer:

- superannuation investments in each of these asset classes as well as 'pre-mixed' options with varying allocations across the asset classes
- a direct investment option for those who want to be more hands-on with their super.

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Asset class performance

You just can't pick it

Markets are affected by political and economic events, and ups and downs are a fact of life for investment returns.

Investors are constantly reminded that past returns are not reliable indicators of future returns. The chart below shows how an asset class can go from best to worst performer, or from worst to best, in just 12 months. It can be a real roller-coaster ride—look at Australian shares since 2007.

The lessons here are:

- this year's winner could be next year's loser
- trying to pick the winners is a risky practice
- spreading or diversifying your money across different investments reduces that risk and helps smooth investment returns.

The chart below is an extract from Russell Investments. *The value of diversification, 2017 edition.* You can view the full poster, commentary and indices used at russellinvestments.com

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
BEST ANNUAL PERFORMANCE	AUS. SHARES 22.5	AREITs 34.1	AUS. SHARES 16.2	AUS. BONDS 15.0	AUS. SHARES 37.6	INT. SHARES HGD 13.5	AUS. BONDS 11.4	AREITs 32.8	INT. SHARES 47.8	AREITs 26.8	AREITs 14.4	AREITs 13.2
	INT. SHARES HGD 18.5	AUS. SHARES 24.5	CASH 6.7	INT. BONDS HGD 9.2	INT. SHARES HGD 28.4	INT. BONDS HGD 9.3	INT. BONDS HGD 10.5	AUS. SHARES 19.7	INT. SHARES HGD 32.3	INT. SHARES 15.0	INT. SHARES 11.5	AUS. SHARES 11.8
	INT. SHARES 17.1	INT. SHARES HGD 17.6	INT. BONDS HGD 6.6	CASH 7.6	MULTI-ASSET 17.3	AUS. BONDS 6.0	CASH 5.0	INT. SHARES HGD 19.1	AUS. SHARES 19.7	INT. SHARES HGD 12.4	MULTI-ASSET 4.3	INT. SHARES HGD 10.5
	MULTI-ASSET 15.3	MULTI-ASSET 15.9	INT. SHARES HGD 6.4	MULTI-ASSET -22.5	AREITs 9.6	CASH 4.7	AREITs -1.6	MULTI-ASSET 16.1	MULTI-ASSET 19.1	INT. BONDS HGD 10.4	INT. SHARES HGD 3.7	MULTI-ASSET 9.0
	AREITs 12.7	INT. SHARES 11.8	MULTI-ASSET 6.3	INT. SHARES -25.9	INT. BONDS HGD 8.0	MULTI-ASSET 3.7	MULTI-ASSET -2.0	INT. SHARES 14.7	AREITs 7.3	AUS. BONDS 9.8	INT. BONDS HGD 3.3	INT. SHARES 8.2
	INT. BONDS HGD 6.6	CASH 6.0	AUS. BONDS 3.5	AUS. SHARES -38.9	CASH 3.5	AUS. SHARES 1.9	INT. SHARES HGD -2.4	INT. BONDS HGD 9.7	CASH 2.9	MULTI-ASSET 9.9	AUS. SHARES 2.8	INT. BONDS HGD 5.2
	AUS. BONDS 5.8	INT. BONDS HGD 4.4	INT. SHARES -1.9	INT. SHARES HGD -39.4	INT. SHARES 2.0	AREITs -0.7	INT. SHARES -5.7	AUS. BONDS 7.7	INT. BONDS HGD 2.3	AUS. SHARES 5.3	AUS. BONDS 2.6	AUS. BONDS 2.9
WEAKEST PERFORMANCE	CASH 5.7	AUS. BONDS 3.1	AREITs -8.4	AREITs -55.3	AUS. BONDS 1.7	INT. SHARES -1.4	AUS. SHARES -11.0	CASH 4.0	AUS. BONDS 2.0	CASH 2.7	CASH 2.3	CASH 2.1

Source: Russell Investments. Extract from *The value of diversification, 2017 edition*.
Note: Past performance is not a reliable indicator of future performance.

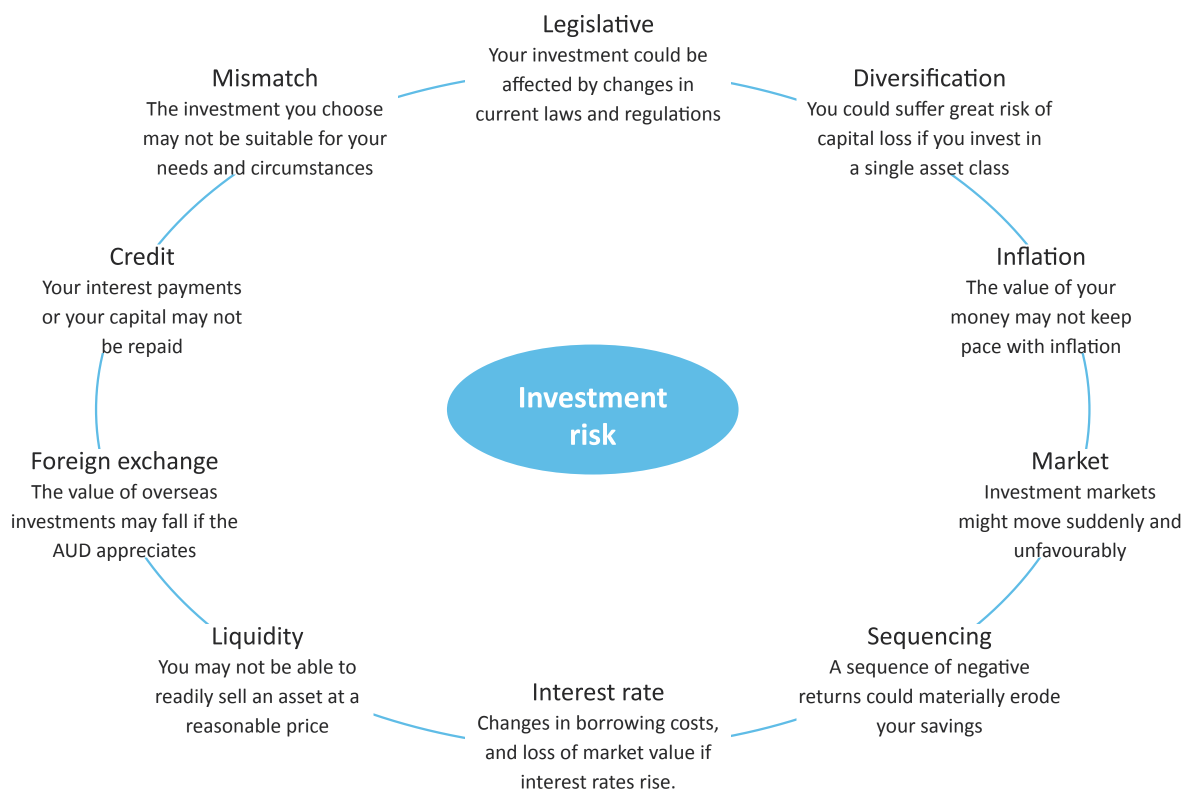
Managing risk

Types of investment risk

There is no single type of investment risk. Rather, there are many different types of risk that you must consider when addressing investments.

For example, you may choose investments that aren't suitable for your particular circumstances, sometimes called **mismatch** risk. In the extreme, there is the risk you may not get your money back, or you may not be able to get it quickly. Also, legislation might change, interest rates could go up or down, you may not have diversified your investments sufficiently, inflation could erode your purchasing power, or investment markets might decline.

As an investor, you'll never be able to avoid these risks entirely but with the right advice, they can be assessed against your financial objectives and appropriate risk mitigation strategies can be devised.

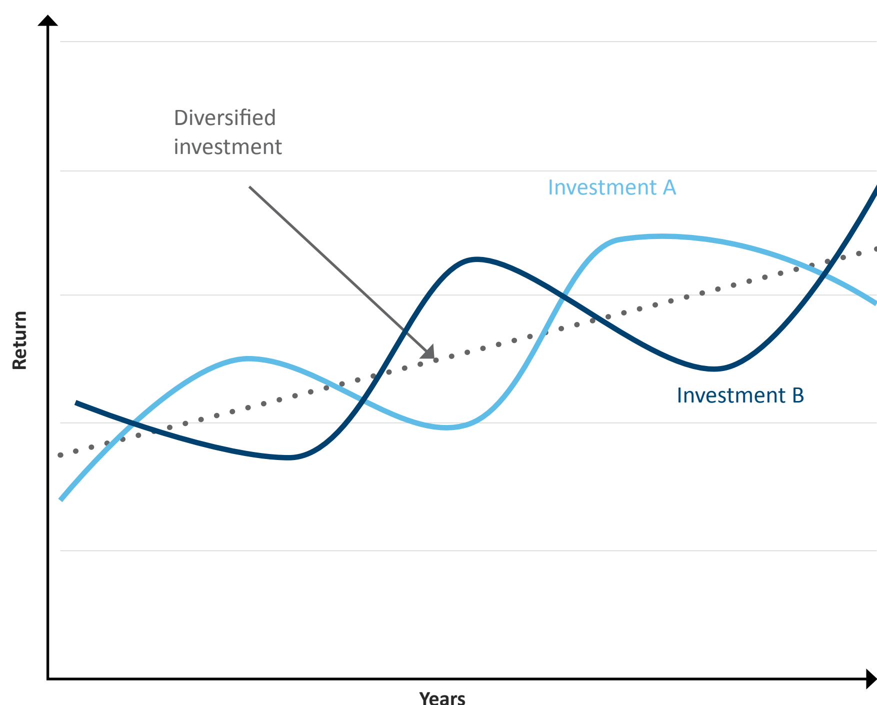


Managing risk through diversification

Even professional investment managers cannot accurately predict the future direction of investment markets. So rather than take a bet on which asset class will perform best, a better strategy is to spread your money across all the different asset classes. In this way, you will reduce the impact that a poor performance in one particular sector will have on your overall return. Generally, by diversifying your investments, you will generate more stable returns by benefiting from investments that are gaining in value when other investments are falling.

There are a number of ways to diversify your investments. You can spread your money **across** asset classes – for example, by putting some money in both shares **and** property, or fixed interest and cash, or any combination of available asset classes. There are different industrial sectors **within** asset classes such as banks, mining, retail, food and household goods and so on. There are also different fund **managers** who have different investment styles so you can spread your investment across managers as well.

The benefit of diversification is that if one asset class, individual investment or individual investment manager doesn't work out, then all is not lost.



Diversification

1. Across asset classes
2. Within asset classes
3. Across managers and manager styles

Diversifying your portfolio

With a diverse range of investment structures and managers to select from, our investment menu offers members choice and flexibility.

Managed investment options

Pre-mixed options

smartMonday products offer 'pre-mixed' options that are diversified across different investments such as cash, fixed interest, property and shares. This mix is referred to as the 'asset allocation' of the option and is set strategically to meet the 'inflation plus' or real return objective for the option over the recommended time frame for investment. This strategic asset allocation is designed taking into account short-term variability in investment returns while looking to realistic longer-term outcomes.

The pie charts show strategic asset allocations for the pre-mixed investment options:

- High Growth, Growth and Balanced Growth hold a greater proportion of growth assets.
- Moderate and Defensive hold a greater proportion of defensive assets.

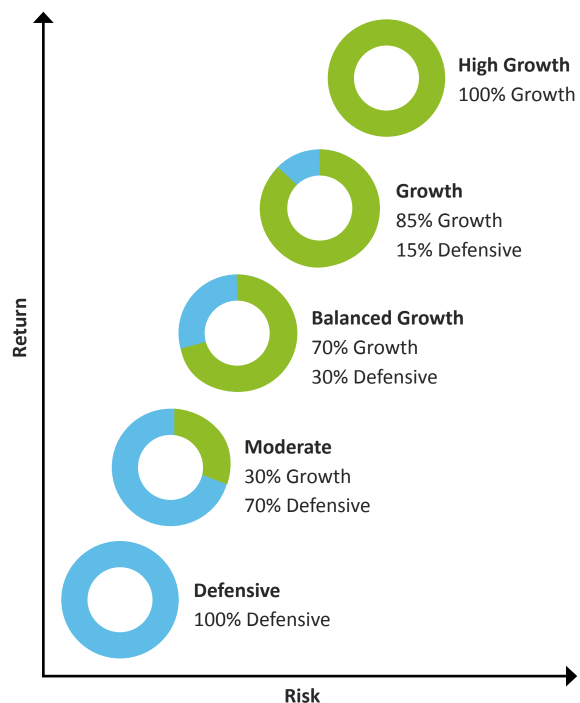
Please note that actual allocations may vary from strategic allocations.

Sector options

You can also diversify by choosing from the sector investment options which offer a 'pick and mix' menu across asset classes.

Direct investment option (DIO)

If you are a member of smartMonday PRIME or smartMonday DIRECT and you want to be more hands-on with your super, you may want to use the direct investment option (DIO). A totally online experience, DIO allows members to invest a portion of their super directly in Australian shares, exchange-traded funds and term deposits.



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Index and active investment

Major considerations when investing include how a fund manager can add value to exceed an underlying market index or benchmark, the risk undertaken by the manager, and the management fees.

Index fund managers seek to track the performance and risk of an index. For example, the Property – Australian Index option is designed to closely match the performance of the S&P/ASX 300 A-REIT Accumulation Index for Australian property. The label 'passive' can be misleading as a lot of day-to-day work goes into managing an index fund. Index managers typically charge less than active managers.

Some active fund managers aim to outperform their benchmark by using research, active portfolio management and trading strategies. Others seek to add absolute value without reference to a market index. There is a risk, especially over short time horizons, that an active manager may underperform the relevant market index. Active fund managers typically charge more because of their higher cost base, but believe potential improved investment performance will justify the cost.

Note: funds that do not track an index may still be passively managed. For example, a buy and hold strategy is passive but not index-hugging.

Index

- Seeks to track performance and risk of a specified index.
- Sometimes known as 'passive'.
- Typically a lower-cost approach.

Active

- Uses research, active portfolio management and trading strategies to outperform benchmark (or may be 'benchmark unaware').
- Typically a higher-cost approach than index.

The impact of inflation

Inflation—a powerful enemy

Inflation is the rise in the price of goods and services. If it is not managed properly, it has the potential to undo much of the good groundwork laid down by compound interest and regular saving.

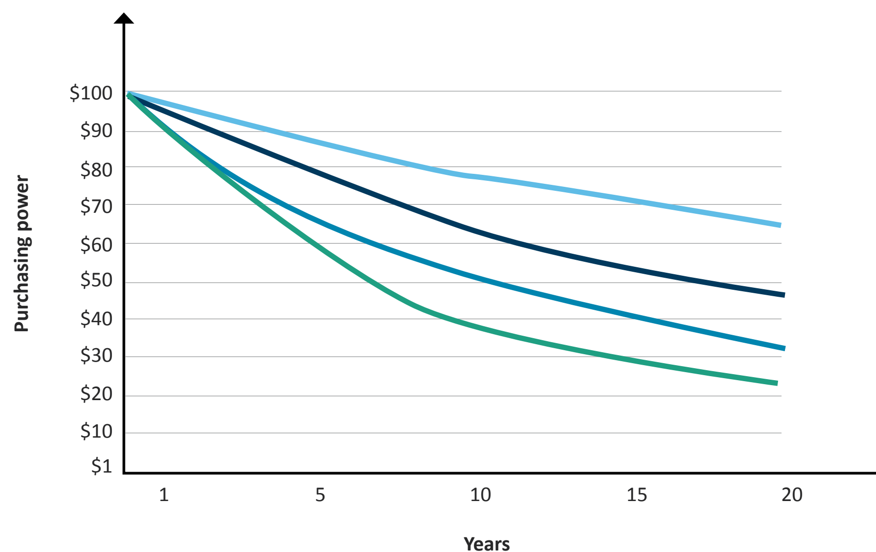
If the price of goods and services rises faster than your income, both your purchasing power and your standard of living will fall.

Inflation in Australia has been relatively low in recent years, compared to the high inflation rates of the 1970s and 1980s.

Over the 10-year period to June 2017 inflation has averaged 2.6% per annum. But no one can predict where inflation will go in the future.

One way to offset the impact of inflation is to have at least some of your money in **growth** assets such as shares. This is because the price of growth assets, like the price of any asset, tends to move in line with the general rise in prices, so the rate of inflation will also boost the performance of growth assets.

From an investment point of view, the 'real', **after-inflation return** is the most important because this figure determines what your money will buy. In Australia we use the Consumer Price Index (CPI) to measure inflation.



Important

From an investment point of view, the "real", after-inflation return is the most important because this figure determines what your money will buy

Rate of inflation

2%

4%

6%

8%

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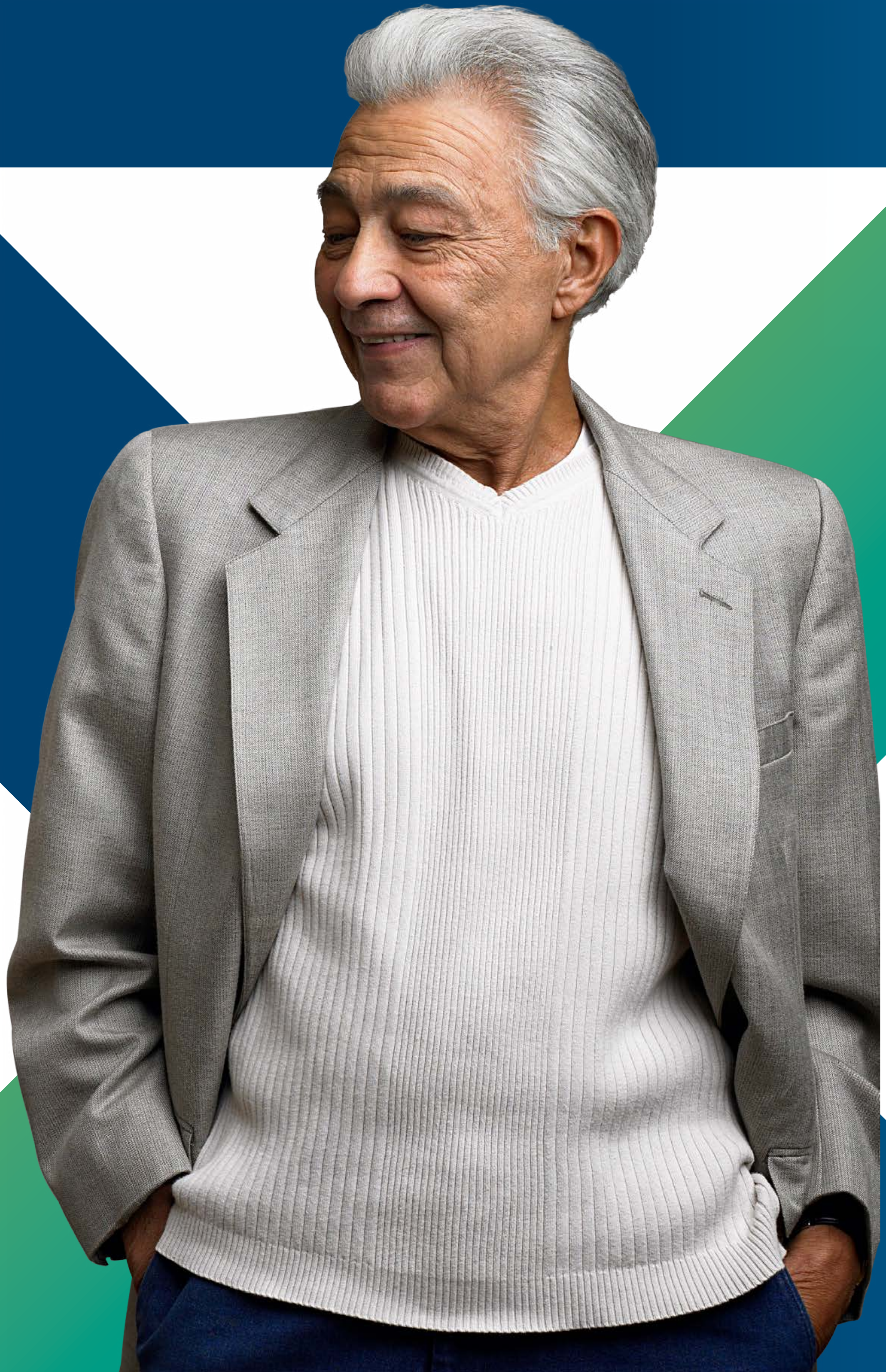
Finding your match

The right portfolio of investments for you should (a) help you achieve your financial goals and (b) suit your financial risk tolerance. To help you find your match, think about:

- your financial goals:
- how much you want to have
- when you want to have it
- how long you want it to last.
- your tolerance to financial risk:
- how comfortable you would be risking a poorer outcome in the hope of getting a better one
- how much a poor outcome would affect your ability to maintain your original goals.

Need some help?

As well as helping you find your investment match, an adviser can help you with all aspects of your financial life—from budgeting and debt management, through to tax strategies and estate planning. If you don’t have a financial adviser, call us on 1300 880 588 or email enquiries@smartMonday.com.au to ask about the advice service you can access through your membership.



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It all adds up