

How the **really** smart money **invests**.



"Why It's Wise to Build an All Weather Portfolio"

Like the weather, financial markets are unpredictable. If you set your portfolio only for warm, sunny days, you can wind up with exposure should the investment climate turn cold, wet and miserable. How do you respond to this? Well, you can rely on the forecasters, whose job is to warn you about the financial equivalent of approaching cold fronts. Trouble is those forecasts, as time has shown, can go badly awry.

A survey of Australian fund managers, published by Russell Investment Group¹ at the end of 2006, found managers pessimistic about prospects for local shares in 2007 and bullish about international equities. As it turned out, last year's best performing asset class was Australian small companies, which returned 22.88 per cent. Worst were Global small caps, down 9.32 per cent. The Australian large caps strategy was another strong performer in 2007, returning 16.16 per cent. Global large caps lost 2.18 per cent, although currency movements had something to do with this. Further highlighting the unpredictability of asset classes, property had a spectacular fall from grace last year.

The S&P/ASX 300 property trust index delivered a negative return of 8.36 per cent, the third worst performing asset class. In 2006, it had topped the rankings, with a gain of 34.05 per cent. Global large stocks had a purple patch in the late 1990s, stopping the table with returns of 44.14 per cent and 31.58 per cent respectively in 1997 and 1998. But by early this decade, global large stocks were the worst performing asset class for three consecutive years. Evidently, it is very difficult to discern a pattern year to year and relying on forecasts in setting your asset allocation can be hazardous to your financial health. This is why it is wise to build an all-weather portfolio, one that is built for all seasons. The financial experts call this process "diversification". But it's really just a way of spreading your risks so you avoid the climatic extremes that can wash away your returns from year to the next.

Let's look at an example. Cast your mind back to 2002, a bad year for the equity markets. The global economy was struggling with the after-effects of the tech wreck, a US recession and the September 11 attacks. Now look at the respective performances of these two portfolios. Both are made up of 60 per cent growth and 40 per cent defensive sets.

Where they differ is that Portfolio 'A' is a simple balanced portfolio, while Portfolio 'B' is an asset class portfolio, with its equity exposure divided into large, small and value components, local and global. Not many people made money in 2002, but if you had owned Portfolio 'B' your losses would have been half as much as if you had owned Portfolio 'A'. This can be explained partly by the fact that Australian value stocks actually delivered a positive return that year. In fact they were the third best performing asset class after listed property and fixed interest. But if you were not in a fully diversified portfolio with exposure to these sub-asset classes, you would not have had that protection on the downside. And that would have left you having to play catch-up.

This is what diversification is all about. Markets are unpredictable and it is impossible to know how each asset class will perform year to year. Or to use our weather analogy, no-one can guarantee there won't be the odd rainy day. But there are things you can do to ensure you don't get drenched. And diversification is one of them.

¹'These Lazy Days of Easy Money Can't Last Forever', Sydney Morning Herald, Jan 27, 2007

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