
UNDERSTANDING THE ASSET CLASSES

There are four major asset classes that people should be aware of. These are: -

- Cash
- Fixed Interest
- Property
- Shares

Each of these asset classes has specific advantages and disadvantages that should be taken into consideration when constructing an investment portfolio. They also have differing risk and return characteristics. We will discuss each in turn.

Cash

Cash represents funds held at call. The main advantage of cash is its liquidity. It can be accessed at very short notice and does not fluctuate in value. Cash offers the lowest expected long term returns because it is the safest investment over a short time period. The main risk with cash is that the returns derived rarely exceed inflation, especially after taking tax into account.

Fixed Interest

Fixed interest investments (eg bonds, debentures and term deposits) involve the lending of funds to another in exchange for interest. The returns from fixed interest investments are generally higher than that of cash. On the downside, funds are generally unavailable for a specified term. Generally, the longer the term of the fixed interest investment, the higher the return. This higher return compensates investors for the risk that they might need the funds when they do not have access to them.

A common misconception is that fixed interest investments do not fluctuate in

value. Many fixed interest investments do in fact fluctuate in value yet people do not realise this is taking place. An existing fixed interest investment might fall in value for example if official interest rates increase. This is because the interest rate on an existing investment is less desirable compared to new investments that are offered at the new, higher interest rate.

Property

Property investing involves the purchase of an asset (typically land and buildings although cars, artwork and collectibles are also examples of property) and then leasing or renting that asset out. The advantages of this approach are that returns are generally higher than for cash or fixed interest, the asset is something tangible that you can see and touch and that the value of the property does not fluctuate wildly in value. The downsides are that there may be prolonged periods where you cannot rent or lease your property out, your property is exposed to the prospect of damage and there are often many factors outside of your control such as nearby developments which increase the supply of property in your area or reduce the desirability of your location.

Shares

Shares represent a share in the ownership of a business. Typically, these shares are listed on a stock exchange although there are any number of unlisted shares such as those in a private company. As you would expect, shares are the "riskiest" asset class because their price fluctuates the most. However, shares offer the highest expected returns and therefore can be the "safest" asset when thought of in terms of whether you will run out of money in the future.

Return Expectations

Although there are no guarantees when it comes to investing, a good understanding of the markets and the analysis of historical data can help us to set reasonable expectations upon which we can base our investment decisions.

Taking these factors into account, we believe the following table gives a reasonable guide about the expected returns from each asset class:-

<u>Asset Class</u>	<u>Expected Return</u>	<u>Net Return Above Inflation</u>
Cash	4%	1%
Fixed Interest	6%	3%
Property	8%	5%
Shares	10%	7%

Inflation is assumed to average around 3% pa.

It is intuitive that cash would offer the lowest expected returns because it fluctuates least in value. It is also intuitive that shares would offer the highest expected return because no-one would set up and run a business unless they expected to make a higher return from it.

Although any given asset class can be volatile, the impact of this volatility diminishes as the time frame that you are invested for increases. This can best be illustrated by looking at returns from the share market. The following table shows the worst share returns that have been experienced in Australia and US over the last 25 years:-

Asset Class	Average Return	Worst 1 Year Return	Worst 5 Year Return	Worst 10 Year Return	Worst 20 Year Return
Australian Shares	13.7% pa	-31.9% pa	-3.7% pa	5.9% pa	11.8% pa
International Shares	14.3% pa	-29.5% pa	-3.8% pa	8.1% pa	11.4% pa

This shows that large falls in a share market are possible (eg: -30% in a single year). However, these events occur infrequently and if the share component of your portfolio is held for longer periods such as 10 or 20 years it has an excellent chance of being successful. This principle holds true for all the asset classes and is one of the reasons why a long term investment timeframe is very valuable.

Another reason why a long term investment timeframe is important is because of the concept of compounding. The following table shows the difference that a longer investment timeframe can make through the power of compounding assuming \$100 to start with and an average return of 8% pa:

Starting Amount	After 1 Year	After 2 Years	After 5 Years	After 10 Years	After 20 Years
\$100	\$108	\$117	\$147	\$216	\$466

As this shows, in the first year you only make \$8 bringing your total investment to \$108. In the second year, you are able to make \$9 bringing the new total investment to \$117. However, in the 20th year, you are able to make \$34 and bring the total investment value up to \$466. This highlights why it is important to start investing early, because the sooner you start, the greater the rewards.