ASX

Russell Investments

SMSF Perspectives

2012 Long-Term Investing Report

In this article, Eric Quak, SMSF Development Manager for Russell Investments discusses how SMSF portfolios can benefit from diversification.

The 2012 Long Term Investing Report puts into perspective the performance of various asset classes over the medium to long term. The Report considers the real-life impact of tax, costs and borrowing on ultimate investment returns, providing insight to financial professionals and SMSF Trustees on how longer term investments are tracking after tax and expenses.

Safety in bricks and mortar?

Residential property has been a stand-out asset class over the last 10 and 20 years[1]. However in order to access the performance this asset class offers, investors need the dual benefit of:

» The luxury of time:
Residential property has performed relatively well over the long-term, but short-term returns can be disappointing due to barriers to entry like transaction costs and larger one-off maintenance bills.

» Sufficient asset base to allow such investments:
According to the Australian Taxation Office's Self-Managed Fund Statistical Report, 50.1% of SMSFs have balances under $500,000[2]. And with the average residential property price across the five major Australian cities being $556,000[3], it's not easy to get into this market.

SMSF members under age 45 have the luxury of time. However they often don't have the asset base to take advantage of the residential property market (though gearing in super is helping open this door). Conversely, SMSF members aged 55-65 years often do have the capital to invest in this asset class, but no longer have the luxury of time to wait for the value of their purchase to increase in value. This demographic also usually demands other characteristics from their investments, such as liquidity and cash flow – which residential property does not always deliver.

Another issue is that the investment fundamentals of residential property are becoming less attractive compared to listed shares. According to data from the Real Estate Institute of Australia, an average three bedroom house in Sydney offered a gross rental yield of 3.4% per annum at the end of 2011. In Melbourne, the yield was 3.2% and 4.3% in Brisbane[4]. These are gross yields that take no account of the costs of maintaining and managing an investment property. By comparison, the dividend yield on the S&P/ASX 300 was 4.5% at the end of December 2011. Adding imputation credits gives a gross yield of 6.1%. The Russell Australian High Dividend Index, which selects companies according to their ability to deliver dividends, offered a yield of 8.2%, including imputation credits at the end of 2011.

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Eric Quak
SMSF Development Manager,
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1 Before taking into consideration the impact of dividend yields for shares and rental returns for property.
2 Self-Managed Super Fund Statistical Report, December 2011, www.ato.gov.au/superfunds/content.aspx?menuid=49150&doc=/content/00309172.htm&page=14&H14
3 RP Data, May 2012, www.propertyobserver.com.au/residential/rp-data-rismark-march-1-daily-index/2012030153640
4 Russell Investments' calculations. Real Estate Institute of Australia (REIA) Real Estate Market Facts - March Quarter 2011, June Quarter 2011, September Quarter 2011 and December Quarter 2011.

Growth investments

The growth asset classes of Australian shares and international shares have traditionally been used by SMSF Trustees to construct the growth components of their portfolios. These asset classes have all exhibited volatility over recent years; however there are diversification strategies that can be employed to help protect these growth sources.

1. Managing share market volatility

In the 2012 SPAA/Russell report[5], 34% of investors thought equity markets were too volatile to invest in. Although Australian shares have performed strongly in the long-term, there have obviously been a lot of ups and downs along the way. One way to deal with volatility is to look at alternative assets that can provide growth-like returns with low correlation to equity markets. Infrastructure and commodities are two alternative assets (which fall under the growth component of portfolios) that may provide some risk diversification and help deal with volatility.

2. International equities

The global financial crisis and recent strength of the Australian dollar have been a hindrance on international equities, but the new currency analysis added to this year's Long Term Investing Report shows that by removing the currency exposure through hedging international equities, the returns from this asset class are better than headlines suggest (which are often quoted in unhedged terms). SMSF Trustees have traditionally stayed away from international equities, however there are good reasons to invest in this asset class, particularly if you hedge your exposure to remove the currency risk.

Defensive investments

Recently, we have seen a shift towards the more defensive and relatively risk-free safe havens of cash and term deposits. SMSF trustees who have made, or are considering making this shift need to ask themselves; is the cushion of cash really a safe haven for the long-term accumulation of retirement savings and will it overcome the costs of inflation?

Constructing a defensive portfolio

The current high allocations to cash and term deposits mean many investors are essentially relying on cash to perform multiple roles in their portfolios. Namely, to reduce risk, generate income and drive performance - a lot to ask for from one simple asset class.

This increasing allocation towards cash and term deposits demonstrates the growing SMSF trend towards defensive type assets. There are, however, a number of strategies which can be used to construct a defensive portfolio outside of cash and term deposit allocation alone, while concurrently taking an investor's risk-return appetite into consideration.

Cash definitely has a part to play. However, perhaps a better way to look at constructing a defensive portfolio is to look at cash as a structural decision that is critical to ensure short-term, lifestyle needs are met. The cash allocation then becomes a simple calculation based on income needs over a set number of years. For example, many pension portfolios hold enough cash to cover pension payments and fund expenses for three years.

This short-term structural allocation should be clearly differentiated from long-term investment allocations in defensive portfolios. Now we can look to combine the defensive asset classes to deliver the most appropriate risk/return outcomes based on investor needs.

This combination will typically include fixed interest, which has a significant role to play in defensive portfolios. Not only has this asset classes performed well over the long term (6.4% p.a. over 10 years, 7.6% p.a. over 20 years) it diversifies risk through its low correlation with equities. This low correlation can be clearly seen when comparing the performance of the Australian share market with the semi-government and government bond market. It shows how performance of the bond market and equity markets

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5 Russell Investments / SMSF Professionals' Association of Australia (SPAA), 2012 Intimate with Self-Managed Superannuation study, www.russell.com/AU/financial-professionals/publications-and-tools/market-insights/smsf-study/

tend to move in opposite directions over quarterly periods – so when Australian equity markets are underperforming, investors can rely on bonds to help offset some of the underperformance.

Conclusion

Growth assets (particularly Australian shares and residential property) have delivered better long-term performance over 10 and 20 years compared to defensive assets such as cash and fixed interest. Despite the significant volatility of recent years, investors who are sitting on cash should take comfort in these long-term performance figures, remain cognisant of their long-term investment objectives, and consider some of the diversification strategies available to help protect the growth components of their portfolios.

Engaging in knee-jerk reactions to market developments and fleeing to defensive asset classes, such as cash, can put a significant dent in a portfolio's overall investment outcome. It is during times of market volatility when the value of an adviser can really come to the fore. An adviser will help keep you on track, ensuring your investment objectives stay true and that you maintain focused on your long-term goals.

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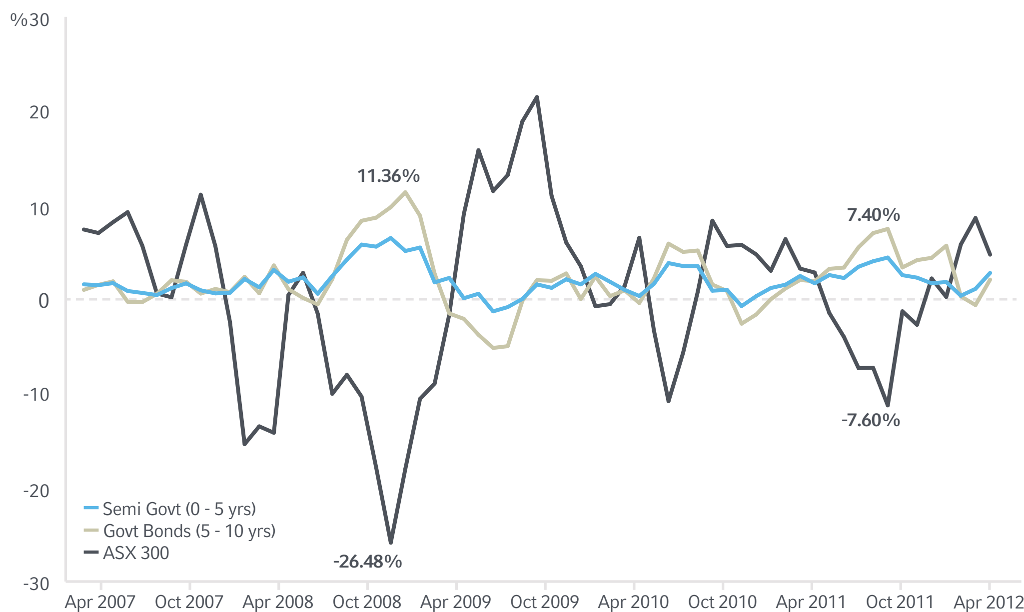
Bond returns compared to equity returns Rolling quarterly index performance



Source: S&P Indices, DB IQ Indices. Returns represent past performance and are not a guarantee of future performance. Indexes are unmanaged and cannot be in invested in directly. Returns shown are based on rolling quarterly returns for the S&P/ASX 300, DBIQ 5-10 year Australian Government Bond Index and the DBIQ 0-5 year Australian Semi-Government Bond Index.

For the quarter ending 31 December, 2008 the Government Bond (5-10yr) Index returned +11.36% compared to -26.48% for the ASX 300

For the quarter ending 30 September 2011, the Government Bond (5-10yr) Index returned +7.40% compared to -7.60% for the ASX 300

This article is intended to be read alongside the **2012 Long-Term Investing Report.**
You can download the full report from www.russell.com.au or www.asx.com.au

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