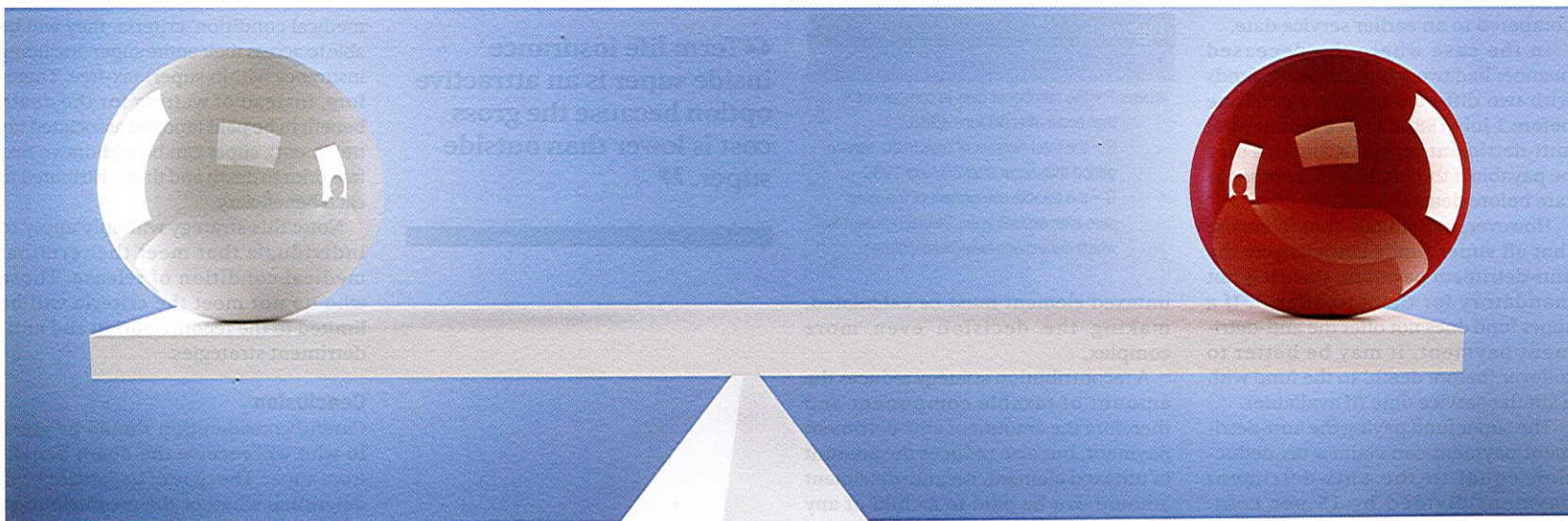


Opinion Equities

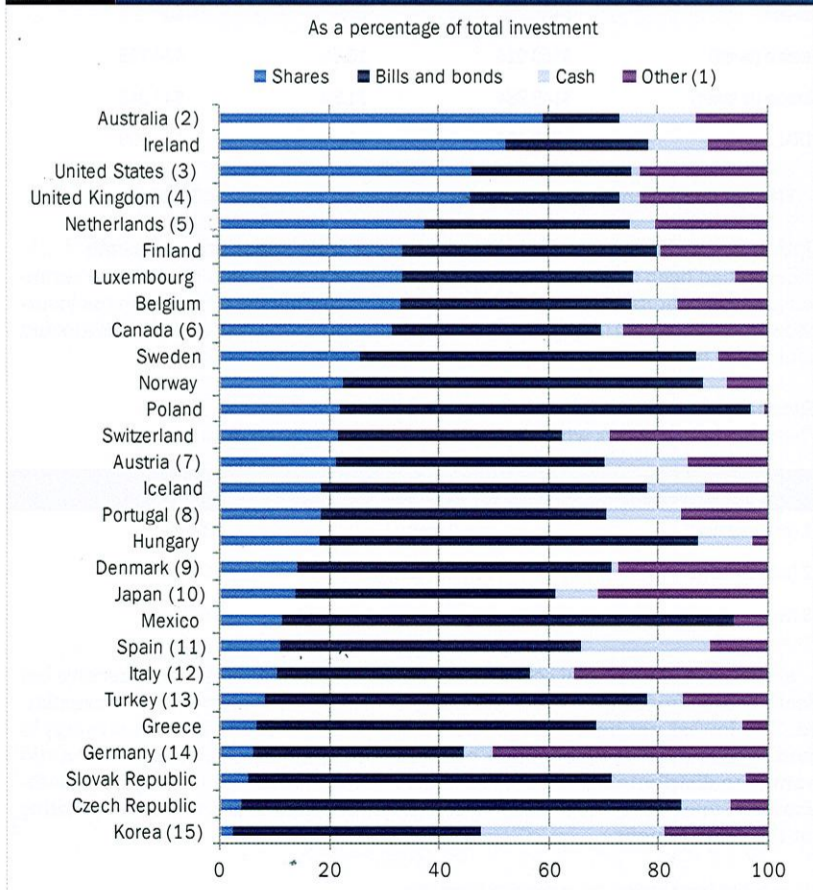


Striking a balance



There is a heavy reliance on equities when it comes to portfolio construction, but getting the balance right is no easy task, writes **Stephen Hart**.

Figure 1 Pension fund asset allocation for selected investment categories in selected OECD countries, 2008



Source: OECD Pensions Markets in Focus, October 2009, Issue 6, p.4).

Australians rely too heavily on equities when constructing investment portfolios, and our tax system promotes the practice of over allocating to high-risk equities to take advantage of short-term tax benefits. There are a number of other misconceptions that promote the more volatile equities (when compared to bonds) that put investors' capital at risk.

This article identifies some of the more common portfolio misconceptions before considering one 'spillover' situation with regard to the definition of a 'balanced' portfolio. A revision to the definition of a balanced portfolio is then proposed with a lower equity allocation.

Common misconceptions

I have referred to Figure 1 in earlier articles (*Bond Ambition*, *Money Management*, 27 May 2010 and *Weighing up the Reviews*, *Money Management*, 21 January 2010) and it is appropriate to use it again to support my contention that the Australian market has been and remains overweight in equities.

This higher risk weighting has been partly justified by the notion that investors need to expose themselves to growth assets in order to access long-term returns. There are two significant problems with this view.

Firstly, the term 'growth' in asset terms is a term that implies past performance will drive future performance. Other economies, including Japan, have concluded that complacency comes at a price. Japanese investors need little reminding that so-called growth assets, such as domestic equities, can produce negative to zero returns over long periods. Historical performance does not reliably predict future performance and should not be used in isolation as the basis for asset allocation.

Secondly, risk is a permanent feature of equity investing and is not short term in nature.

Spillover

Misconceptions about growth assets have spilled over into the debate on what constitutes the definition of a balanced portfolio. Specifically, the definition of a balanced portfolio has moved away from a literal translation, partly on the back of these misconceptions, to embrace higher allocations to risky assets, including equities.

Recently, the Cooper Review referred to the current definition of a balanced portfolio in these terms: "... some balanced investment options have 80 per cent of so-called growth assets, while others have as little as 60 per cent." (Cooper Review, final report, part 2, Ch.4, 5.2, p.109).

These definitions of a balanced fund, as summarised by the Cooper Review, indicate that an allocation to equities of between 50 per cent and 75 per cent of an investment portfolio is appropriate when defining a balanced portfolio.

In order to determine combinations of equities and bonds in investment portfolios you should properly consider the underlying components of each. Specifically, the All Ordinaries ASX Accumulation Index is used to assess the characteristics of the equity market risk and return, while the UBS, 0+ Year Government Bond Index is used to assess the bond market risk and return. By examining data for assets that have the supposed growth characteristic like equities ('Equity (e)') and data for assets that have the supposed 'defensive' characteristics like Government bonds ('Gov_0+ (g)') it is possible to summarise the risk and return characteristics of the asset classes.

Figure 2 indicates that the annual return for equities (around 9 per cent since 1998) is higher than bonds (around 6 per cent since 1998) yet the risk of investing in equities significantly outweighs the 3 per cent premium. Having concluded that the notion of past returns predicting future returns is problematic, a proper analysis of

the underlying risks should be the prime objective. In other words, assess risk first and allocate according to risk – not the other way around.

The table in Figure 2 above also suggests the following:

- Equity risk dwarfs equity return, especially relative to bonds;
- The trade-off between risk and return tends to balance out if the allocation between equity and bonds is equal; and
- The reduction in return, relative to the reduction in risk, is small as we increase the allocation to bonds.

While in general terms the summary in Figure 2 suggests that the point of 'balance', in terms of risk and return, is delivered with a 50 per cent allocation to equities, a time series of rolling annual returns provides a more precise indication of the variation in portfolio returns over time, as shown in Figure 3.

As the chart indicates, a higher allocation to equities equates to higher volatility. Investors needing to sell at the low point in the equities cycle risk substantial losses. Bond portfolios outperform equity portfolios in stressed or economic downturns, when fears of recession are prevalent and interest rates are falling. Bonds (fixed rate) perform well during these periods because they expose portfolios to interest rate risk.

In Figure 3, the green line shows that a 50 per cent allocation to equities would have resulted in a maximum negative annual return of around 20 per cent during the recent stress period in 2009. Also, the 50 per cent allocation tends to limit the positive return periods to around a 20 per cent annual increase. Going further, the purple line shows the rolling annual return of a portfolio that has a 30 per cent allocation to equities. In this case the maximum and minimum range of annual returns is +10 per cent to -10 per cent.

By way of contrast, the so-called balanced portfolio (red line), with allocations to equities of between 50 per cent and 75 per cent, displays far greater volatility in annual returns, with a range from maximum to

minimum annual returns exceeding 70 per cent. The reasons for these results are many and varied but, the reader can see that the traditional definition of a balanced fund has been skewed by long periods of positive equity returns and a taxation system that encourages investors to invest in riskier assets. In other words, the portfolio generally accepted as being balanced is a de facto risky, or growth portfolio.

Towards a better definition of a balanced portfolio

A balanced portfolio should deliver mid-range returns from mid-risk assets. While this definition does not necessarily need to take account of the age of the contributor, the significance of volatility increases with age. If an investor, with a balanced portfolio constructed in accordance with the examples quoted in the Cooper Review, had been fully funded to retire in 2008 but had retired a year later in 2009, upon retirement they might have seen a greater than 20 per cent shortfall in their future needs.

Advice from some quarters ahead of an economic downturn may recommend an adjustment to the composition of the equity portfolio away from growth equities to 'defensive' equities. However, defensive equities will fail to preserve capital because they remain the highest risk in the capital structure (see Figure 4) in the event of liquidation. By way of contrast, bonds are generally higher in the capital structure and accordingly of lower risk and provide diversification by exposing the portfolio to movements in market interest rates.

It is recommended that the definition of a balanced portfolio be returned to a more literal meaning with an equity portfolio in the range of 25 per cent to 50 per cent, with at least an equal allocation to bonds. The result will be a lowering of portfolio volatility and increased diversification.

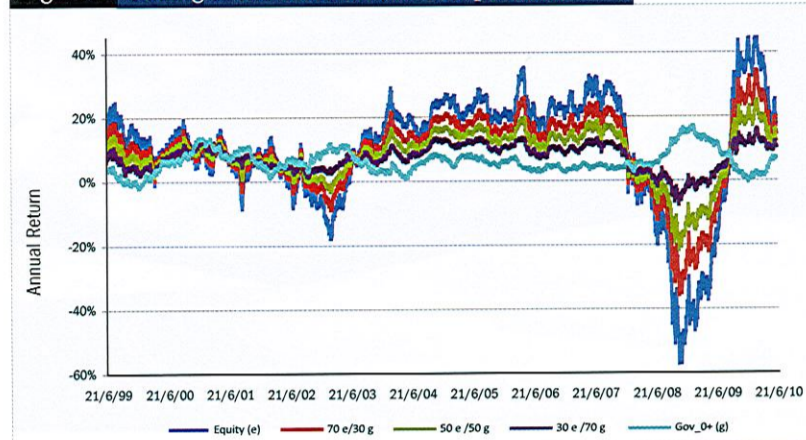
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Figure 2 Equity risk and return

	Equity (e)	70 e/30 g	50 e/50 g	30 e/70 g	Gov_0+ (g)
Ann. Ret %	8.90%	7.98%	7.37%	6.75%	5.83%
Ann. Risk %	15.81%	10.84%	7.67%	4.88%	3.92%
Ret/Risk	0.56	0.74	0.96	1.39	1.49

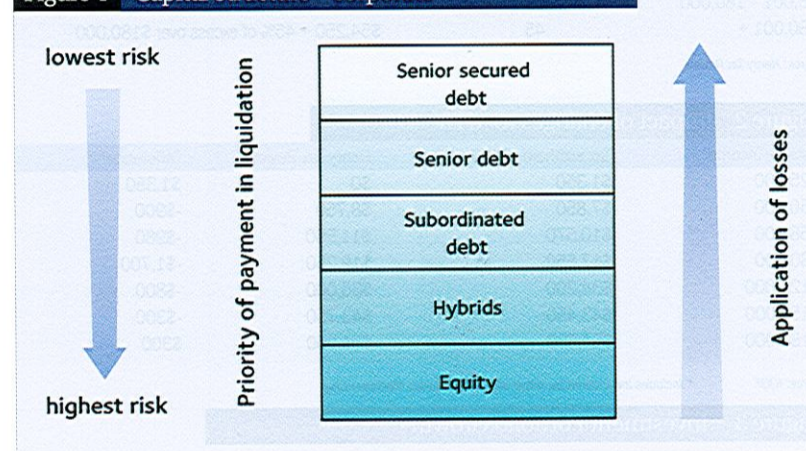
Source: FIIG, UBS, Bloomberg, ASX.

Figure 3 Rolling 12 month return, various portfolios



Source: FIIG, Bloomberg, ASX, UBS (Time Period: 3 July 1998 to 29 June 2010).

Figure 4 Capital Structure – corporate



Source: FIIG Securities.