



# Position yourself to weather storms

In this uncertain environment the prudent investor is seeking insulation from volatility, writes **Bina Brown**.

**P**ositioning your portfolio for the worst-case scenario might seem overly pessimistic but in this uncertain environment it could also be prudent. Having survived the ups and downs of 2011, the last thing your portfolio needs is a further setback.

The key concern for most investors is the pace at which global economic events are changing. Just as it looked like the European debt crisis was under control, credit downgrades to several countries came as a kick in the teeth.

Closer to home, concern that China's growth may not be sustainable hangs over Australia's already choppy economy.

If there is a unanimous view on the outlook for financial markets it is that volatility is here for a while yet. What that means for portfolios will largely depend on where you are in life: a retiree desperate to preserve a lifetime of savings will take a very different view to someone with a 20-year time frame.

HSBC Bank's head of savings and investments, Mike Danby, says with prolonged volatility diversification and long-term investing have become all the more relevant.

He says that if you take the view that short termism is driving sentiment and emotion then it is important to look at longer-term pricing and opportunities.

Where historically staying invested has been a passive buy-and-hold approach, today it means

reviewing and rebalancing your portfolio regularly to capture opportunities and mitigate risks.

Here are five ways to insulate what you do have.

#### Reassess your situation:

The saying goes that if you can't stand the heat, get out of the kitchen. Well, if you really can't take any more equity market volatility and you don't have a decade to enjoy the smoothing effect of time, now might be the time to cut some losses and seek wealth elsewhere.

While having everything in cash might seem like the ultimate safe haven, even the short-term returns may not keep up with inflation and your money will quickly erode.

An investor with considerable holdings who would feel better out of the market altogether could think about selling and putting some money in the bank, but do it gradually, says PSK Financial Services adviser, James Gerrard.

"If selling means realising losses then now might not be the time to do it, but if it is going to help emotionally then you might incrementally build a pool of cash," he says.

Without the benefit of a crystal ball to tell whether things are going to improve or worsen, Gerrard suggests people position the equities component of their portfolio in case something bad happens.

Rather than moving entirely into cash, he advocates selling small cap stocks, which are by nature more volatile, or growth stocks which are vulnerable to overseas shocks, and buying defensive stocks.

Stocks likely to continue to pay a dividend regardless of a fall in the share price, such as the banks, are also worth hanging onto.

"Woolworths, CSL and AGL are stocks that held their value during the GFC and should continue to do

so if the economy starts to slow," Gerrard says.

Cameron Howlett, principal of Melbourne-based Personal Wealth Advisers, says clients often have a portfolio of 10 to 12 good quality stocks and those they bought pre or during the GFC that have failed to go anywhere and even retreated.

By good quality, he means companies with lower levels of gearing, consistent and maintainable earnings and dividends. "Clean out the rubbish and get back to basics," he says.

#### Income or growth?

Much of what you have in your portfolio will depend on whether you are looking for income or growth. If income is important then make sure you are invested to receive it regardless of what the underlying asset does, Howlett says.

In the case of stocks it means buying stocks paying a good and hopefully fully franked dividend. The share price might move up and down but the dividend should remain constant.

In fixed interest, the price of bonds also fluctuates but the income paid can remain the same throughout the term of the bond.

It is important to remember all investment returns are the same regardless of whether they are income-generating or growth-oriented, says Prescott Securities financial adviser David Middleton.

That is, total investment return includes the changing value as well as income. People often overlook the income or forget that they've had it.

"Right now, there is good income available and investors should grab it," says Middleton. "You just need to know where to look and how to manage your risk. It is possible to

**Continued next page**



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## From previous page

get a risk-free 5 per cent from a term deposit in a bank or, if you are prepared to put up with some volatility, you can own shares in the same bank and get a 10 per cent return.

“As long as you can switch off and just take the income then, when a recovery comes along, the value of these relatively conservative investments will improve.”

Middleton says the key is to focus on high-quality investments with low debt and solid yields funded entirely from free cash flow.

John Donald, principal and senior adviser with Perth-based RMG Financial Services, says it is important investors are across the time frames they have to invest in and what they can control with respect to their finances.

Portfolios should have three distinct pools: one might be wholly in cash to meet short-term expenses; one might be in a mix of income and growth assets for medium-term expenses; and one might be in growth assets for the longer term.

## Diversify:

The concentration of many people's superannuation in equities and low exposure to fixed income is becoming well known. Adding some fixed income to a portfolio steeped in equities is a good way to smooth out overall returns.

There is no escaping that 2011 was a shocker for equities with a loss of 15.18 per cent. Meanwhile government bonds had an excellent year with a 20.15 per cent return.

While past performance is no great pointer to what is to come, there is growing evidence to suggest having both equities and fixed income is better than betting on one or the other.

FIIG Securities says while the differential in 2011 was abnormally large, the opposing returns are intuitive.

When the economy looks stretched and negative sentiment prevails, equities typically decline. A poor environment for equities coincides with falling interest rates and flight to quality and movement of funds into low risk assets.

This generally means a rise in the value of fixed-rate assets, particularly long-dated government

bonds and a slump in equities.

Bonds rise in value when yields/interest rates fall. By mixing up a portfolio with some fixed-interest investments like bonds, say 50/50, the 2011 year could have resulted in a much more palatable return of 4.97 per cent.

FIIG Securities' director of strategy and market development, Stephen Nash, says one rule of thumb for investing is to allocate your age as the percentage of fixed income in your portfolio.

So if you are 65 years old, invest 65 per cent in fixed income. Applying this to a simple portfolio of fixed income investments ranging from government bonds to listed hybrid securities (a mix of debt and equity) and equities, the 2011 return could have been a more respectable 7 to 8 per cent.

If staying invested in equities is part of your mantra, then diversification across different sectors is equally important.

HSBC Bank's Mike Danby says it is worth remembering that since the GFC, unlike many governments and consumers, companies have been managing prudently. “While the former were building debt to unsustainable levels, companies were paying down borrowing and building cash balances. Equity dividend yields stand at attractive levels compared with government bonds, while company balance sheets are enabling them to grow dividends which is very attractive in a low-interest-rate environment.”

Middleton's suggestion for a diversified share portfolio with a total yield of 7 to 9 per cent is spread across banking, financial services, engineering, retailing, telecommunications, health care, and insurance. More specifically: the three big banks, National Australia Bank, Westpac and ANZ have low price-earnings ratios and average anticipated yield of more than 7 per cent fully franked; ASX for when shares become interesting again but in the meantime there is an expected 6 per cent yield fully franked; engineering construction company UGL; Metcash for staples and retailing; Telstra as a beneficiary of the NBN with a clearer future and good leadership; Sonic Healthcare for health care exposure; Perpetual for its leverage

to market movements; and QBE, a well and conservatively managed insurance company.

## Consider your costs:

Anyone living off investments will be aware of the impact drawing an income will have on capital reserves that are static or going backwards. Where possible control your spending, says RMG Financial Services' principal and senior adviser, John Donald.

For some people it may mean returning to the workforce as a way to help build up reserves, particularly in superannuation. If that's not a possibility, then it becomes even more important to manage costs. Middleton says one place to check for excessive costs is charges for the administration of your investments, such as those in a wrap account.

If the assets are only in a couple of investments then you may not need to pay fees for administration. You could easily do yourself. Even half a per cent on a portfolio of \$500,000 can be better spent if you hold only a few key investments.

“There are numerous ways that your portfolio can leak fees if you don't have a full understanding of how you are being charged,” says Middleton. “Ensure you are actually getting benefits from using the superannuation system rather than simply assuming you are.”

“The superannuation system is more expensive than simply owning investments yourself and it can generate more costs than savings.”

Middleton says investors with larger amounts in superannuation may be better off saving on administration costs by setting up a self-managed super fund.

If you do this, then be realistic about some of the services you might end up paying extra for, such as financial advice, brokerage and accountancy.

One cost few should have to pay is for contributing to their super fund. Kate McCallum, director and financial adviser with Multiforte Financial Services, says people should check to see whether money contributed by their employer as either salary sacrifice or super guarantee is attracting a charge.

“It is not uncommon to find people being charged a 2 per cent



contribution fee. That money is going straight to an adviser they may never see," McCallum says.

**Don't blow it:**

The temptation to try to recoup losses is understandable. The big mistake is to take on excessive levels of risk. No matter how desperate you become about your investments, stick to good quality choices rather than those that look attractive and

may provide a good return but put you out on the risk scale, John Donald says.

And don't confuse risk with volatility. Volatility is price movement, whereas risk is the chance that the investment will lose some or all of its value.

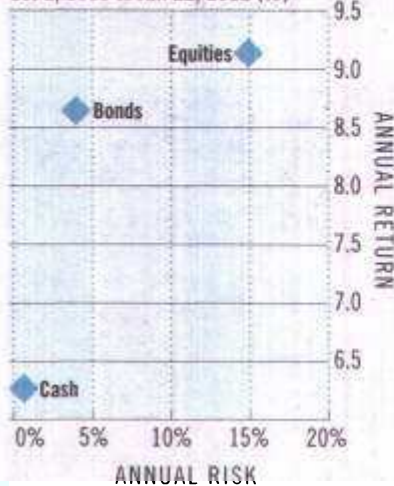
An example might be the difference between investing in bank shares and putting your money in a

term deposit with the same bank. The income you earn from the bank shares may be greater than the interest rate on the term deposit, but the value of the shares will rise and fall, bringing risk into the equation.

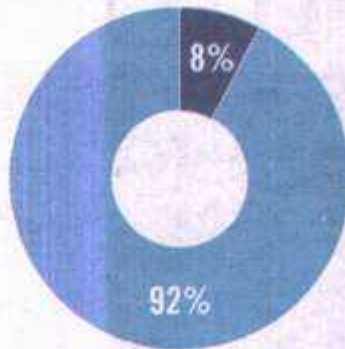
"In times like these, it becomes critical to employ strategies to reduce risk to a level with which you are comfortable," Middleton says.

**Risky business**

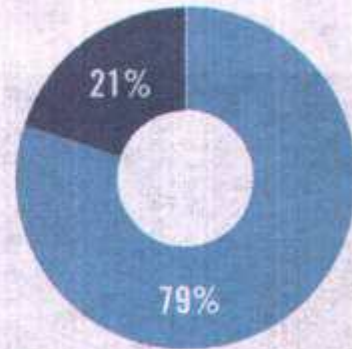
Risk v return of various asset classes  
 Oct 2, 1989 to Jan 22, 2012 (%)



Balanced portfolio risk attribution



50% equity/50% bond portfolio risk attribution



■ Bond risk ■ Equity risk

This chart demonstrates that the greater the risk the greater the return. The introduction of bonds into a portfolio can considerably reduce the risk for not much less return.

Volatility of bonds is large compared to equities but including more bonds in a portfolio helps to reduce the risk. In a balanced portfolio with 75 per cent equities about 8 per cent of the volatility can be attributed to bonds and about 92 per cent from equities. If you increase the proportion of bonds in a portfolio to 50 per cent, then 21 per cent of the volatility (as measured by the UBS composite bond index) can be attributed to bonds and 79 per cent to equities.





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Photo: LAUREEN BRABANT

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