Investments

Building a Portfolio

There are a number of steps to follow to build a portfolio that suits your financial goals and preferences. These steps are illustrated in the diagram below:

An explanation of these key steps is provided below.

Understand the Key Asset classes

It is important to understand the main asset classes and how they can affect the returns and risk of your portfolio. The types of asset classes include:

- Shares
- Property
- Bonds (or fixed interest as they are often called)
- Cash

There may be asset types within each asset class. For example, within shares, there is a choice of Australian and international shares and within international shares, there is choice of specific regions or countries like China or emerging market shares.

Generally ‘growth’ assets like shares and property provide the prospect of higher returns over the long term compared to ‘safer’ assets like bonds and cash. However growth assets have a higher level of risk including the risk of capital loss and more ups and downs in returns particularly over the short term. ‘Growth’ assets are only appropriate if you have an investment time horizon of at least five years due to their higher level of inherent risk.

Shares: Shares represent part ownership in a company and usually provide income payments through dividends and can produce growth if the share price increases.

For Australian companies, these dividends can be franked, which means that you receive a tax credit for the tax already paid by the company so that you are not taxed twice (once at the company tax rate and again at your marginal tax rate). If your tax rate is less than the company tax rate (currently 30%) you will receive a refund for the extra tax paid by the company. If your tax rate is higher you may need to pay some extra tax.

Property: An investment in property provides you with ownership in a property or a number of properties through a managed structure. Property investments allow you to benefit from the rent received by the properties as well as the change in the valuation of the property over time. The returns of these properties will depend on the quality of the tenant and the rent paid as well as the location and type of property such as residential, industrial or commercial.

Bonds (fixed interest): A bond is a tradeable debt security, usually issued by a government, semi-government or corporate body to raise money. Investors in the bond have effectively lent money, for which they receive a fixed rate of interest over a set period of time. The bond is repaid with interest on the predetermined maturity date.

For example, if you invest in a 5 year bond paying 3% coupon you will pay $1,000 to invest in the bond. In return, you will receive $30 (3% of $1,000) each year. At year 5, you receive the coupon of $30 plus the original $1,000 outlay.

It is possible to experience capital losses from a bond investment if it is cashed before maturity and interest rates have risen or capital gains if the reverse occurs. They are not as safe as cash.

Cash: Cash is one of the safest investments. Cash compared to other assets tends to provide lower variability in returns, high level of security on the capital invested and acts as a more defensive investment. This reduces investment risk so the money is available when you need it, with a minimal potential for capital loss.

Income and Growth

The returns from the various asset classes are provided in the form of income and/or growth resulting from a change in the price of the investment. Some investments like cash will only provide income returns while the return from other investments may include a mix of income and capital growth.

Income returns can include interest from cash and bonds, rental income from property and dividends from shares. Managed fund may also pay realised capital gains as part of the income return.

This income is included in your tax return and is taxed at your marginal tax rate. If franking credits have been derived these will be passed onto you and can help to reduce tax payable.

If an investment is sold, this may create a capital gain or loss depending on whether the price of the security or unit price of managed funds has changed since investment. If a capital gain has been realised on units held for more than 12 months a 50% capital gains tax discount will apply unless the units were owned by a company.

Diversification

You can invest in a mix of asset classes or securities as a means of ‘diversifying’ your portfolio. Diversification is a key investment principle used to manage the risks of a portfolio and involves investing in a variety of assets and investments that perform differently to each other over time. It is often described by the proverb “Don’t put all your eggs in one basket”.

It also allows you to have an exposure to a spread of assets and securities including both ‘growth’ and ‘defensive’ assets. It means that you avoid taking big bets in one or a few asset class and/or investments that may adversely affect your returns if it underperforms.

Diversification can reduce the risk in your portfolio but it will not eliminate the risks. Your portfolio is likely to experience ups and downs in returns over time but by a lower level of variability.

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Direct versus Managed Funds

You can access assets and/or securities by buying the investment directly or via a managed trust. Direct investments involve buying the security such as a specific share or property such that you are a part or full owner of the security. As an example, you can become an owner in a specific company by buying its shares on the Stock Exchange which entitles you to receive dividends and vote at General Meetings (depending on your share structure).

An alternative means of gaining exposure to assets is via a managed fund. A managed fund is a professionally managed investment portfolio that pools the money of multiple investors. A fund manager is appointed to manage the fund including selection of the underlying investments and maintaining client records. By pooling money with other investors you may gain access to investments not normally available if you invested directly or enable you to achieve a greater level of diversification.

If you invest money into a managed fund you will receive a number of 'units' in that fund. The number of units you receive is calculated as the amount of money you invest divided by the unit price on that day. This is why managed funds are also often called "unit trusts". The unit price may increase or decrease in line with the value of the underlying investments.

Each investment approach has its advantages and disadvantages that you should consider. These will include the implications for fees and investment control.

Investing directly in securities may require you to actively review and manage the investments in your portfolio on a regular basis. You may be required to make decisions and changes to account for corporate action events in the case of buying shares directly such as takeovers, rights issues and share purchase plans. This can require you to have the time and inclination to manage your direct investments portfolio. On the flip side, the advantage provided by a managed fund is that you do not need to devote the time to be actively involved in the investment decisions.

Risk Profiling

There are a number of factors that you need to consider to determine the most appropriate investment for your personal preferences and financial goals. A key driver of this decision is your risk profile which measures your attitude towards risk. Your risk profile will depend on how you feel about a range of different issues such as:

- Your comfort and knowledge of investment markets. The higher your knowledge, the more comfortable you may be investing in riskier assets like shares and property.
- Your preference for capital growth (compared to capital preservation and/or income). The higher your preference for growth may be better suited to investing in riskier assets that offer a higher potential for capital growth.
- Your level of concern when markets suffer a loss. If you are likely to sell and feel stressed from this loss, then a lower exposure to risky assets may be suitable.
- How important it is to you for your investments to keep pace with inflation. If this is important to you, then shares and property are more likely to meet this need.
- Your investment time horizon. If you are investing for the long term (at least 5-7 years), then you may consider investing in shares and property. Generally, risky assets are not suitable if you are investing for shorter periods of time and a higher level of investment in cash and bonds may be more suitable.

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Structures for Holding Investments

There are various ways of owning investments and these can include in your own name, in your spouse or kids' names, via a family trust, superannuation or private company. There are a number of issues to consider when determining the most appropriate structure to hold the investments and these include the following:

- Tax
- Fees and costs
- Liabilities and responsibilities
- Flexibility and complexity
- Estate planning

Investment Strategies

Once you have decided on your portfolio, there are various approaches to investing and withdrawing your money.

If you are concerned about the ups and downs in financial markets and are unsure about whether it is a good time to invest in risky assets, you can consider investing using a 'dollar cost averaging' approach. This involves investing a set amount regularly over a period of time rather than investing the full amount at a single point in time. In this way, you can avoid trying to time your entry into financial markets. By making regular investments over time you may be able to minimise the risk of investing all your money during a market peak. This can help to minimise investment risk and average the purchase price of your investments by buying more assets when prices are low and fewer assets when prices are high.

If you are withdrawing funds from your portfolio, you can use a regular drawdown strategy that has similar benefits to dollar cost averaging (but in reverse). That is, you can withdraw funds over time rather than withdrawing the full amount at a point in time. In this way, you can minimise the risk of withdrawing all your funds from financial markets at the bottom of the market.

Your portfolio can benefit from 'compounding interest' particularly if you reinvest your income returns. If the interest you receive is added to your initial investment, you can receive interest on the total amount and effectively receive interest on the interest reinvested. This is called 'compound interest' and has the effect of increasing your overall returns. The more frequently that interest is calculated, the higher will be the compounded returns.