Understanding investments

SUNCORP

Client Fact Sheet

July 2012

A simple definition of "invest" is to apply or use money with the intention of obtaining income or profit. Too often investing is confused with speculation. "Speculation" refers to buying and selling stocks and other assets to take advantage of short-term fluctuations in prices to make profits. Speculation is subject to a high degree of uncertainty and risk, that is, taking a gamble to buy low and sell high (but how high is high enough and what if the price drops instead of rising?).

To understand investments and to subsequently make investment decisions that meet your needs, it is important to understand the following key concepts:

- Asset classes – understanding the investment return and risk profile of each asset class will help you match your investments with your investment time horizon.
- Income vs growth investments – understanding the type of return each asset class is likely to deliver will help you match your investments with your investment income goals.

A few other investment concepts worthy of consideration when determining your investment strategy are:

- the potential for volatility in returns – the case for diversification, and
- investing internationally.

Asset classes

The main asset classes that may be invested into directly or via managed funds are generally cash, Australian fixed interest, international fixed interest, Australian shares, international shares, listed property (ie. listed on the stock exchange) and direct property.

The risk and performance of investments can be determined by measuring the returns against a benchmark. Some commonly used benchmarks are shown in the following table.

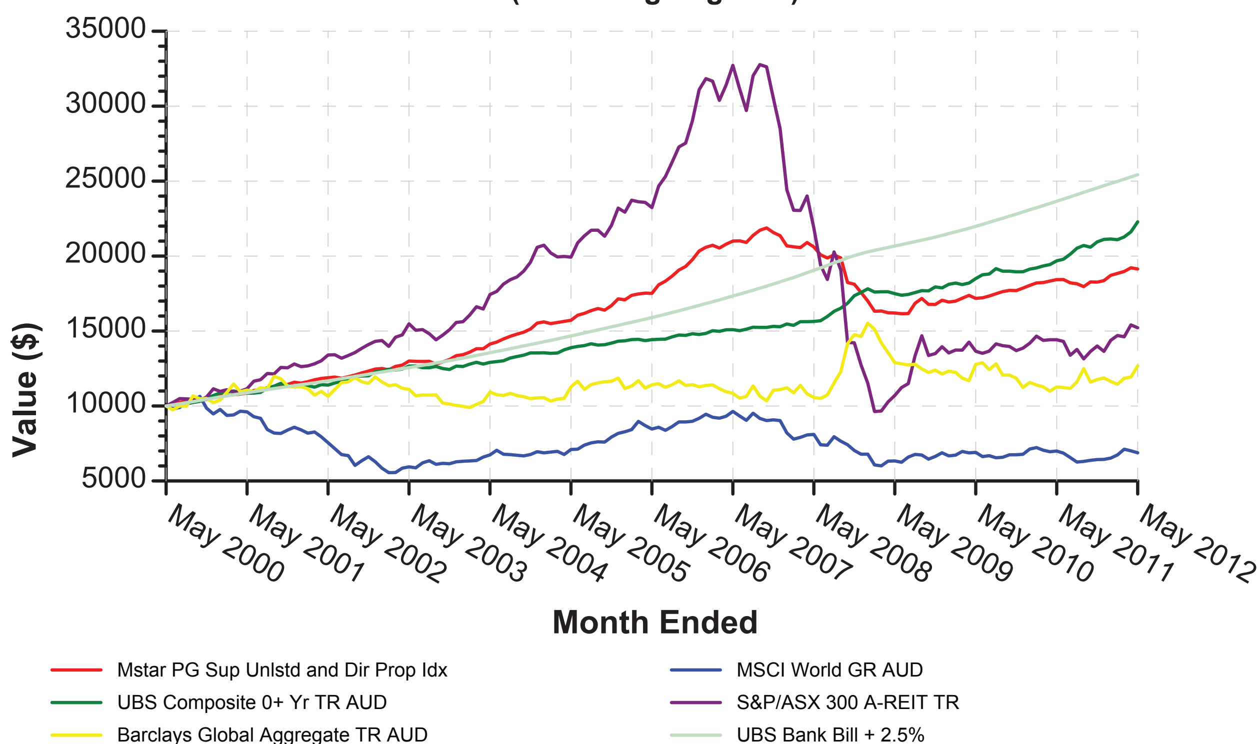
Asset class	Benchmark
Cash	UBS Australian Bank Bill Index
Australian fixed interest	UBS Australian Composite Bond Index (All Mat)
International fixed interest	Salomon Smith Barney World Government Bond Index (ex Australia) Barclays Global Aggregate Bond Index
Listed property	S&P/ASX 300 A-Reit Index
Direct property	Morningstar PG Unlisted and Direct Property Index
Australian shares	S&P/ASX 200 Accumulation Index
International shares	MSCI World Index

Investment timeframe

One of the primary issues to consider is the timeframe of investing, that is, the length of time to hold various classes of assets to obtain the benefit of investing. Investment time frames are generally described as short term (1 – 3 years), medium term (3 – 5 years) and long term (5 – 7+ years).

Generally, it is recommended to hold cash and fixed interest type investments over the short term, property over the medium term and shares over the long term, due to the varying degrees of volatility (variability in returns) associated with these investments.

The benefits of holding long term type investments (such as shares) compared to short-term type investments (such as term deposits) are best shown in the following graph:



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Income versus growth investments

Generally investments are purchased for their income-producing potential or because the capital value is expected to grow over time, or for a combination of both reasons. Income can come in the form of interest from cash and fixed interest assets, dividends from shares or rental income from property. Capital growth can come from shares and property growing in value. When comparing income investments with those producing capital growth it is important to compare the total after-tax return from each.

Income producing investments

Income producing investments generally offer the advantage of high security of original capital. These investments include bank deposits, mortgages and debentures with major finance companies. Property and shares also will provide income as a result of rents received and dividends, however these investments are not typically categorised as income-producing due to the inherent potential for capital volatility in the underlying investment.

The disadvantage of pure interest-bearing investments is that the return is generally fully taxable. For example, if you were to earn 6% per annum and your marginal tax rate was 38.5% (including Medicare levy of 1.5%), your after-tax return would be only 3.69% per annum. The effective (or real) rate of return depends on the rate of inflation and your marginal rate of taxation. Your after-tax return therefore needs to be more than the rate that prices increase each year, otherwise the purchasing power of your money will be reduced.

Income-producing investments provide good security of original capital but no additional growth potential to maintain the ability of investment returns to keep pace with inflation.

Capital growth investments

Capital growth investments include property investments, Australian share investments, and international share investments. These investments rely on an increase in the capital value of the asset purchased, whether the investment is directly held in real property, shares or similar, or indirectly by investment through a managed fund. Many capital growth investments also provide an income. For example Australian and international shares provide dividends, while property investments provide rental income. The balance of growth and income varies so it is important that you seek advice when deciding which options best suit your needs.

There are two major considerations for capital growth investments:

Firstly, by diversifying into asset classes (such as shares and property) it is possible to take advantage of favourable investment conditions which generally provide superior growth over the long term (5-7+ years).

Secondly, for individuals, capital growth on the sale of all or a portion of an asset, if the asset has been held for more than 12 months, is subject to capital gains tax (CGT) as follows:

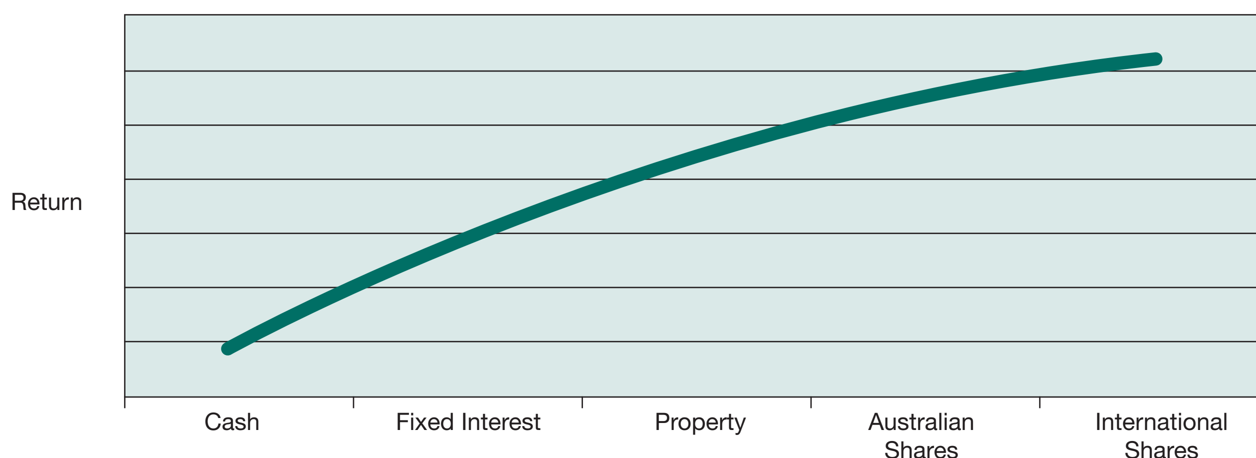
- for assets purchased before 20 September 1985, the gain is exempt from CGT.
- for assets purchased on or after 20 September 1985 and before 21 September 1999, the investor has a choice between using the indexed cost base method or the discount method (50% for individuals) for calculating the gain.
- for assets purchased on or after 21 September 1999, 50% of the gain is subject to CGT.

An important factor relating to CGT is that it is not payable until the investment is sold, thus any tax liability may be deferred into the future at which time lower personal tax rates may apply depending on your situation.

Risk/return trade-off

As investors, in general, are risk averse, they will require a higher rate of return before accepting a higher degree of risk; this is referred to as the 'risk premium'. Accordingly, as potential risk increases, so too does expected return. This relationship is known as the risk/return trade-off. The risk/return relationship, over the long term, as it relates to the major investment markets, is represented in the following graph:

The risk/return trade-off



Potential for volatility in returns – the case for diversification

The table below shows the level of variability in returns (volatility) that was recorded by the main asset classes over the past ten years. The results that would have been achieved by a "balanced" portfolio are also shown for comparative purposes.
The balanced portfolio used in this example adopts the following asset allocation:

Calendar year returns				
Asset class	Highest	Lowest	Average	Number of negative years
Cash	5.65%	0.42%	3.83%	Nil
Aust Fixed Interest	7.97%	1.28%	4.75%	Nil
Listed Property	16.05%	-18.53%	0.25%	6
Australian Shares	15.71%	-2.90%	5.23%	2
International Shares	5.71%	-7.46%	0.45%	6
Balanced	10.24%	-2.51%	3.50%	2

Source: van Eyk Research. Indices used are Australian 90 Bank Bill Index (cash), Australian Commonwealth All Series All Maturities Index (Australian fixed interest), S&P/ASX300 Property Trusts Accumulation Index (property), S&P/ASX200 Accumulation Index (Australian equities) and MSCI World ex Australia (AUD) Accumulation Index (international shares). Balanced portfolio is comprised 5% cash, 25% fixed interest, 10% property, 35% Australian shares, 25% international shares. Past performance is not a reliable guide to future performance.

It can be seen from this table that diversification has the effect of smoothing returns. That is, while a balanced portfolio offers some of the growth benefits of sectors such as property and shares, its cash and fixed interest components ensure that it does not have the same degree of volatility.

Investing internationally

Investing today is truly a global activity. The internationalisation of investments has forged a global marketplace where the economies of the world increasingly interact with and influence each other. The previous table shows the potential benefits that diversification into overseas markets can produce.

The emergence of a global economy has made international investment accessible to small and large investors and given investors the ability to further diversify their portfolio. A properly diversified portfolio now includes different countries as well as different asset classes.

Diversifying over a number of different international markets (like diversifying over different assets such as shares, bonds, cash and property) can reduce investment risk. By investing solely in one market you not only risk poor performance if that market experiences a slow no-growth stage, you also miss out on the potentially high returns from other established and emerging economies.

There are many reasons why investors should consider investing part of their money overseas.

Such reasons include:

1. It enables a spread of risk by being in a mix of markets and currencies.
2. Markets and currencies generally all move at different times and while investing overseas investors will be affected by these movements.
3. In terms of international sharemarkets, the Australian sharemarket is only a small proportion, less than 2% of the total world sharemarket value. Historically the Australian sharemarket has been more volatile than many of the large sharemarkets in other parts of the world.
4. International investment allows investment in expanding sectors of industry that are not represented in Australia through shares on overseas sharemarkets. In the same way it enables access to broader property markets and interest rate markets.
5. It enables participation in economies that may be developing and growing faster than ours.

Need more information?

If there's anything else you need to know, please call your financial adviser, or our dedicated Customer Service team on 13 11 55 and ask for 'Super' between 8am and 6pm (Eastern Standard Time) Monday to Friday. We'll be happy to help.

Important note

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