

## Investment Considerations

All investments contain an element of risk and it is important for investors to have an understanding and awareness of the risks associated with any investment they may hold or that is being recommended. Risk can be defined as the potential for an investment to achieve a return lower than that which was expected at the time of investing. This 'unexpected return' can be due to numerous variables such as market changes, adverse economic conditions or specific risks.

The level of risk that investors are comfortable with can vary greatly. Some investors may be more comfortable investing in volatile investments, so it is critical that any recommendations made to investors are consistent with the level of risk that is acceptable to them. Investors need to have a comprehensive understanding of risk to enable them to make informed decisions in relation to their investment portfolios. Risk, to some may mean the possibility of losing a portion of their capital, while for others the primary concern may be that assets produce sufficient income on which to live.

Risk and uncertainty cannot be eliminated; however they can be measured and managed within your portfolio. The key is to determine the appropriate level of risk for you. Taking on greater uncertainty and short-term risk may be necessary for you to gain the long term returns needed to achieve your lifestyle goals and objectives. Any assessment of risk appetite should be in the context of your goals and the timeframe in which you wish to achieve your objectives. An integral part of the ongoing management of risk is to have your financial adviser review your risk profiles and current situation to assist in making investment decisions.

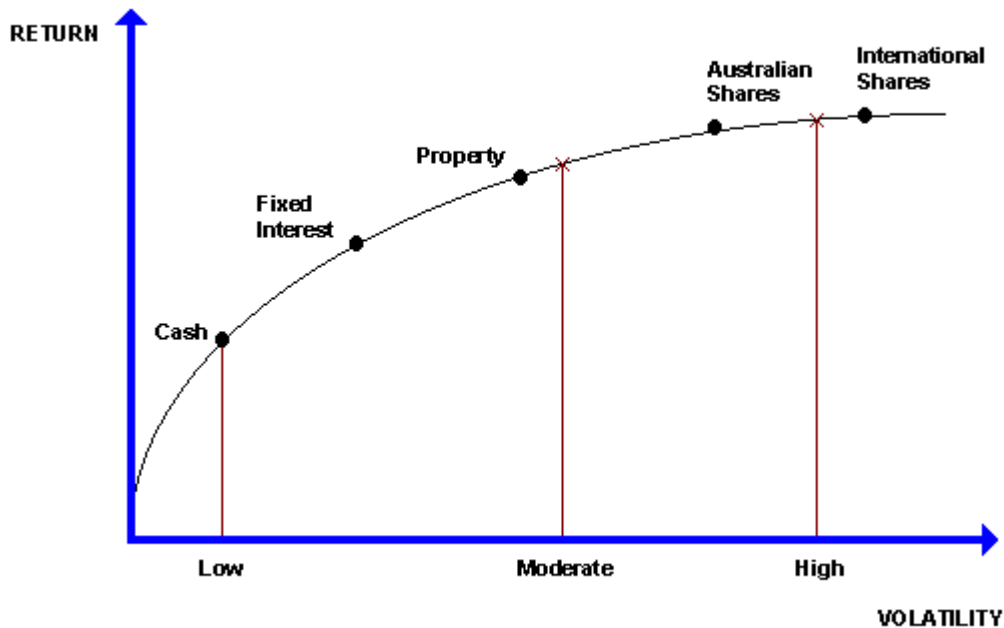
### Risk and Return

You need to look at how to best manage your investments with regard to your personality and your goals. Think of it as a three-stage process:

- The emotional aspect - firstly understanding who you are as an investor and where your risk tolerance level lies.
- The logical aspect - assessing the realities and misconceptions about the risks of various investments.
- Finally, choosing investments that will both meet your goals and also strike the right balance for you, emotionally and logically.

The relationship between long term risk and return in different asset classes is illustrated in the following graph.

# Risk Return Trade - Off



The major asset classes (cash, fixed interest, shares and property) all have unique risk profiles based on their level of price volatility or instability. Investors will generally be comfortable with a higher level of risk if the expected return is proportionately higher than that of an investment with a low level of volatility.

## Asset Classes

The underlying asset classes are cash, fixed interest securities, shares and property. It is important to have the right mix in your portfolio to meet your needs. There are advantages and disadvantages of all asset classes as you can see below.

Defensive Assets		Growth Assets	
Cash Fixed Interest		Shares Managed Funds Property	
Income in the form of interest but no growth of the initial investment amount.		Capital growth of the initial investment and generally some income	
Advantages	Disadvantages	Advantages	Disadvantages
Value does not generally fall it is less volatile	Inflation may erode real value	Growth means investment has a better chance to keep pace with inflation	Volatile- investment value goes up and down
Income is generally fixed or known for a certain time frame	Generally lower rate of return than growth investments	Generally higher rate of return than defensive assets	Income is not guaranteed or fixed.
Easy access to funds	Returns are generally fully taxable at the marginal rate	Returns usually more tax efficient	Returns are not guaranteed and can be positive and negative

Security for capital	Little opportunity to find better rates as providers tend to match rates	More chance for diversity across different industries and countries	In some cases the initial value of the investment can be lost eg purchasing shares in a company that goes bankrupt
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Risk (often referred to as volatility) is a term that refers to the unpredictable upward and downward shifts of investment values over a period of time. The greater the volatility the more frequent the shifts is.

Risk and Return are closely related. In general, the higher the degree of risk associated with an investment, the higher the return required by investors for acceptance of the risk. Low risk investments, such as cash deposits, offer relatively low returns as a reflection of their greater security, and are better suited to risk conservative investors. This is called the risk/return trade-off, and is used as a guide to selecting the appropriate asset allocation for your portfolio.

When investing it is important to acknowledge that all investments have associated risks and to understand the risks associated with the chosen investments. Growth and Income rates shown below are estimates made, based on past returns in the relevant sector, averaged over the recommended term of investments in that sector and as such they are not predictions of performance of the individual investments.

The table below shows the historical performance of the asset classes recommended and/or discussed:

## Financial Year Returns for Major Asset Classes

Year (30 June to 30 June)	Australian Shares	International Shares	Property Securities	Australian Fixed Interest	Cash	International Fixed Interest
<b>Annualised</b>						
1992	-2.5%	11.0%	16.3%	15.9%	7.8%	15.8%
1993	34.6%	32.8%	26.8%	16.5%	5.7%	14.7%
1994	6.3%	-6.2%	-1.4%	-4.2%	5.0%	2.1%
1995	10.6%	12.2%	9.9%	16.5%	7.7%	13.1%
1996	10.3%	8.4%	12.3%	12.2%	7.7%	11.2%
1997	25.8%	35.6%	24.2%	14.6%	6.2%	12.1%
1998	-4.7%	22.4%	14.6%	9.3%	5.1%	11.0%
1999	16.3%	17.5%	0.0%	1.4%	4.9%	5.5%
2000	21.2%	30.3%	9.1%	5.9%	5.9%	5.0%
2001	-4.4%	-21.1%	16.2%	10.7%	5.8%	9.0%
2002	1.2%	-26.6%	11.7%	5.7%	4.6%	8.0%
2003	11.8%	0.7%	6.2%	5.5%	4.9%	12.2%
2004	20.7%	9.4%	29.0%	5.2%	5.5%	3.5%
2005	31.7%	12.8%	16.5%	5.7%	5.7%	12.3%
2006	16.0%	16.8%	25.6%	4.8%	5.9%	1.2%
2007	32.7%	2.1%	20.1%	3.5%	6.5%	5.2%
2008	-27.1%	-17.0%	-40.4%	8.4%	7.7%	8.7%
2009	8.5%	-12.7%	-23.7%	7.1%	4.3%	11.5%
2010	0.7%	-2.7%	-4.1%	7.3%	4.3%	9.3%
2011	-8.7%	-4.7%	-6.2%	9.0%	5.0%	5.7%
<b>Best</b>	<b>34.6%</b>	<b>35.6%</b>	<b>29.0%</b>	<b>16.5%</b>	<b>7.8%</b>	<b>15.8%</b>
<b>Worst</b>	<b>-27.1%</b>	<b>-21.1%</b>	<b>-40.4%</b>	<b>-4.2%</b>	<b>4.3%</b>	<b>1.2%</b>

Source: Colonial First State and Vanguard, 2011.

***Past investment results should not be relied upon as a guide to future performance.***

Any investment decision you make means that you must take a risk of some sort. The decision will directly relate to the amount of money you invest, your circumstances at the time and your needs for the future. If you have a better understanding of risk, you can make a more informed investment decision, accepting some risks and rejecting others. The important point is that you understand the relationship between risk and reward, particularly over your investment time frame. Following is a summary of some of the risks that can affect investors.

Risk	Explanation
<b>Inflation Risk</b>	The real purchasing power of your money may not keep pace with inflation. Inflation is an important consideration for all investors. If the after tax return on your investments is less than the rate of inflation, then the real value of your money will decline.
<b>Interest Rate Risk</b>	For investors relying on fixed rate investments, maturing money may have to be reinvested at a significantly lower rate.
<b>Market Risk</b>	Movements in the market mean the value of your investment can go down as well as up, sometimes suddenly. Different types of investments experience different levels of volatility. Volatility becomes a problem if you do not have the time frame to withstand the rough

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	<p>patches. It is important to remember that markets go through regular ups and downs and that capital losses can occur if investments are redeemed when markets are down.</p> <p>While it is tempting to sell out of an investment after its value has fallen, history has taught us that investors who stick with their strategy generally go on to recover and prosper.</p>
<b>Risk of not Diversifying</b>	<p>All your capital will be affected if your single investment does badly. Diversification means spreading your money across different investments and asset classes to reduce risk. The right asset allocation is an important driver for the long-term returns of your portfolio.</p>
<b>Market Timing Risk</b>	<p>Anticipating market rises and falls can be extremely difficult because no two economic cycles are the same. Market timing is not a good long term approach that tends to result in an overall poor return and high transaction costs.</p> <p>A sensibly balanced diversified portfolio will generally outperform a continually changing portfolio.</p>
<b>Credit Risk</b>	<p>This applies to debt type investments such as term deposits and debentures. The institution you have invested with may not be able to make the required interest payments or repay your capital.</p>
<b>Liquidity Risk</b>	<p>You may not be able to access your money quickly, or without cost, when it is required.</p>
<b>Legislative Risk</b>	<p>Your investment strategy could be affected by changes in the current laws and regulations.</p>
<b>Mismatch Risk</b>	<p>The investment you choose may not be suitable for your needs and circumstances. A perfectly sound investment choice for you now may not be best for you at another time.</p>

Risk and volatility can be managed or minimised in various ways. A particularly risk averse investor may wish to invest only in cash or fixed interest and this may seem appropriate. It must be remembered, however, that a strategy of this type may reduce volatility but is risky in its own right as the investor is foregoing the potential for capital growth in the portfolio.

### **Diversification**

The most widely recognised method for managing portfolio risk is through diversification of investments and investment management. In order to minimise the volatility and risk of your investment portfolio, it is prudent to ensure that it is sufficiently diversified against over exposure to a single asset, asset sector, geographical region or investment manager. This is because no one asset, asset class, geographical region or investment manager provides the best performance over all time periods. A range of investments should reduce the risk of the portfolio experiencing drops in performance across the board simultaneously, as one asset class or manager may perform well to counter the poor performance of another.

### **Diversification Across Asset Sectors**

Historically, no single asset class has consistently outperformed all others every year and hence by investing across the four main asset sectors, shares, property, bonds and cash, investors may be able to reduce the volatility of their portfolio return. If any sector is particularly volatile or performing poorly, other sectors may compensate and vice versa.

A well diversified investment portfolio would include exposure to the four major sectors. However diversification can be further achieved within each asset sector, for instance the Australian share market has many types of sectors including banking, resources, manufacturing, technology and media. Spreading of investment within this sector can reduce the volatility of returns as each industry's performance will differ depending upon prevailing market conditions.

### **Diversification Across Investment Management Styles**

Different investment management styles tend to excel at different times under different economic and market conditions. Diversification of investment managers can lower the risk profile of your portfolio by providing exposure to different management styles. For instance, one manager may have a buy and hold approach while another may adopt an aggressive trading strategy. Managers may have preferences for shares with certain characteristics, for example targeting those that produce franked dividends or that are likely to produce high capital growth.

Each of these management styles can have an impact on your portfolio return and your risk profile. By combining a range of investment managers with complementary investment styles you will be able to reduce the bias to any one style in each asset sector and can reduce the impact of any one investment under-performing for a period of time in comparison to other investments.

### **Diversification Across Markets and Regions**

It is also valuable to spread your exposure within each asset sector across a wide range of countries and currencies. This global approach ensures that your investment is not narrowly concentrated in a particular region or industry, and helps to reduce the impact of a regional or industry downturn.

There is no right or wrong mix of investments or management styles for a given portfolio. The mix depends entirely on your risk profile and your individual desires and objectives for the portfolio. Some investors may be comfortable with investing entirely in the share market while others may seek only limited share market exposure.

Before accepting and implementing any investment recommendation you should be comfortable that the benefits of diversification have been considered and that, where appropriate, a balanced, well-diversified portfolio is structured to meet your needs.

### **Income or Capital Growth**

Some investments are structured to provide regular distributions of income, others to mainly generate capital growth, and some offer a balance of both.

Traditional income-producing investments, such as cash deposits and Government and semi-Government bonds offer no capital growth, although government bonds do have the potential for capital profit (and loss) on sale. Assets such as shares and property (owned either directly, or held via managed trusts and insurance bonds) are primarily capital growth generating investments. They may, however, offer varying balances of growth and income returns and can, therefore, be a tax-effective hedge against inflation, or a valuable source of dividend income.

The income/growth situation is simply illustrated by the case of an investment in residential property. A house bought for investment will hopefully increase in value over time – this increase is capital growth. During the time you own the house, your tenants will pay you rent – this rent is income return.

The funds we are recommending will over the longer term produce both income and growth. The estimated income and growth figures are shown later. We recommend that where possible, the income generated by these investments be reinvested back into the funds to maximise the return on invested funds, rather than being used for the payment of interest on the borrowed funds. However, should the funds be needed at any time, the payment of distributions to you can easily be arranged.

### Dividend Imputation

You should also consider the impact that imputation credits on dividends from Australian shares will have on your fund returns. In 1987, the Federal Government introduced the Dividend Imputation system to eliminate the double taxing of Australian resident company dividends. Previously, the company paid tax on its profits and the shareholders then paid tax on their dividends.

The Dividend Imputation system allows tax already paid by a company on its profits to be credited against any tax the shareholder would normally pay on dividends paid from those profits. The taxpayer, therefore, is entitled to a rebate or *tax credit*. These tax credits are often referred to as *imputation* or *franking* credits.

Dividends which carry imputation credits are called *franked* dividends and may be fully- or partially-franked, depending on the amount of tax paid by the company. Franked dividends will be effectively tax-free in the hands of the superannuation fund as the dividend comes with an imputed credit of 30%, whilst tax on the income of the fund is payable at 15%.

The excess rebate (the difference between 30% imputed credit and the 15% tax payable) can be used to offset the tax payable on other investment income also the higher the value of Australian shares in the portfolio the greater the franked dividends and the lower the overall rate of tax payable on the investment income.

### Dollar Cost Averaging

Dollar cost averaging takes some of the risk out of investing in fluctuating markets because it removes the factor of deciding when to invest.

The basis of dollar cost averaging is that you invest a set amount on a regular basis, no matter whether the market is up or down. When the market is up, your set amount purchases fewer units, but your existing holding is worth more. When the market is down, your existing holding is worth less, but new units are cheaper to buy.

Typically over the long term, the average cost of units purchased will be lower than the average price of the units over the same period.

#### How it works

Assume you invested \$200 per month into an investment where the unit price fluctuates from month to month.

Month	Amount Invested	Units Purchased	Unit Price
January	\$200	400	\$0.50
February	\$200	500	\$0.40
March	\$200	417	\$0.48
April	\$200	385	\$0.52
May	\$200	370	\$0.54
June	\$200	400	\$0.50
Total	\$1200	2472	

Final Account Balance = 2472 @ \$0.50 each  
= **\$1236.00**

So you can see that over the six month period in this example, whilst the units firstly fell and then rose again only to their starting point, the investor was able to still make a return over that period of approximately 3%. This happened in a period when the units lost some 20% of their value and only recovered to their starting point. This is possible because, when the units dropped in value, more were able to be purchased. As shown, when the market recovered, the profit on the units that were bought in February and March at a cheaper rate outweighed the losses suffered on those units purchased in April and May, and those of January and June where the prices did not alter.

### Investment Time Frame

The time period over which you are considering investing is very important. When considering financial assets, such as equities, the returns in the form of dividends and capital growth are not guaranteed and it is possible to experience periods of negative growth.

On the other hand, investments such as bonds and fixed interest assets have a much lower risk of not paying a coupon (*or interest*), however, due to this lower risk, they offer a lower return than equities.

It is fair, then, for investors to expect a higher return for the higher risk (i.e. the risk of a negative return) that they accept in their investment recommendations. Since fixed interest products and bonds pay regular amounts of interest at set intervals (i.e. an *annuity*), the time frame for investing can be relatively short term.

When considering other asset classes such as fixed interest and cash, a time frame of 3 years or less may be appropriate. This is because these funds have very low risk and provide a positive return over a shorter period.

When considering growth investments such as Australian Share funds, a time frame of approximately 5 years is necessary. This does not mean that you cannot access your funds at anytime. When investing money you need to be prepared to leave the funds for that period in order to ride out the highs and lows that come with investing in share markets.