PORTFOLIO CONSTRUCTION

One frequently asked question is: How is a portfolio actually constructed?

Well, as much as it would be great to say “very easily” the truth is somewhat more complex. A good portfolio is made up of many moving parts. Those parts must be identified.

A well-constructed portfolio will also have a strategy. That strategy will incorporate many concepts but ultimately has a theme. One common theme for retiree investors is the need for income to meet lifestyle objectives.

Every investment in the portfolio should be there by design, not by accident. It should qualify as a ‘stand-alone’ investment in its own right. Each asset included in the portfolio should also complement the other assets as a whole. When an asset is no longer viable in its own right and/or no longer fits in the broad portfolio or theme, then an active decision must be made about retaining or changing the asset.

A good portfolio will also resist too many changes. This is because discipline is required (the discipline to stick to your strategy even when current events are making you nervous); or perhaps your Risk Profile has been incorrectly identified; and, because a frequently changing portfolio is probably indicative of a poorly designed strategy.

Some of the points for consideration when designing the portfolio strategy & theme may include some or all of the following:

Fundamental Analysis

When talking about stocks, fundamental analysis is a technique that attempts to determine a security's value by focusing on underlying factors that affect a company's actual business and its future prospects. On a broader scope, you can perform fundamental analysis on industries or the economy as a whole. The term simply refers to the analysis of the economic well-being of a financial entity as opposed to only its price movements.

Fundamental analysis serves to answer questions, such as:

- Is the company's revenue growing?
- Is it actually making a profit?
- Is it in a strong-enough position to beat out its competitors in the future?

- Is it able to repay its debts?
- Is management trying to "cook the books"?

Of course, these are very involved questions, and there are literally hundreds of others but it all really boils down to one question: Is the company's stock a good investment?

Fundamentals: Quantitative and Qualitative

You could define fundamental analysis as "researching the fundamentals", but that doesn't tell you a whole lot unless you know what fundamentals are. The big problem with defining fundamentals is that it can include anything related to the economic well-being of a company. Obvious items include things like revenue and profit, but fundamentals also include everything from a company's market share, brand recognition to the quality of its management.

The various fundamental factors can be grouped into two categories:.

Quantitative – capable of being measured or expressed in numerical terms (eg financial statements)

Qualitative – related to or based on the quality or character (eg brand recognition, quality of a company's board members and key executives, patents, proprietary technology etc).

Intrinsic Value

One of the primary assumptions of fundamental analysis is that the price on the stock market does not fully reflect a stock's "real" value. After all, why would you be doing price analysis if the stock market were always correct? In financial jargon, this true value is known as the intrinsic value.

This leads us to one of the second major assumptions of fundamental analysis: in the long run, the stock market will reflect the fundamentals. This is what fundamental analysis is all about. By focusing on a particular business, an investor can estimate the intrinsic value of a firm and thus find opportunities where he or she can buy at a discount. If all goes well, the investment will pay off over time as the market catches up to the fundamentals.

The big unknowns are; You don't know if the estimate of intrinsic value is correct; and You don't know how long it will take for the intrinsic value to be reflected in the marketplace.

Some Common Fundamental Terms & What They Mean

Div Yield *– Dividend Yield, the amount of cash the security pays on an annual basis. This is usually expressed as a %. So, a security that is trading at $100.00 with a cash dividend of $5.00 is paying a dividend yield of 5%.*

DPS – Dividend per Share; the amount of dividend, expressed in cents per share that the company is paying.

EPSG *– Earnings per Share Growth, this represents the annualised rate of net-income-per-share growth over the trailing one-year period for the stocks held by a fund. Earnings-per-share growth gives a good picture of the rate at which a company has grown its profitability per unit of equity. All things being equal, stocks with higher earnings-per-share growth rates are generally more desirable than those with lower earnings-per-share growth rates.*

Franking *- The amount of tax that the security has paid before paying the dividend to shareholders. Usually expressed as a % against the full corporate rate of tax (currently 30%). So a dividend that is 100% franked means that it has had 100% of the company tax (30%) paid for it.*

Gross Yield *- The total dividend paid for the security including both the cash component (Dividend) & the Franking Credits.*

ROE *- Return on Equity, simply put is net income, or the bottom-line profits reported divided by the shareholders' equity. Shareholders' equity is assets minus liabilities on a firm's balance sheet and is the accounting value that is left for shareholders should a company settle its liabilities with its reported assets.*

Technical Analysis

Technical analysis is a method of evaluating securities by analysing the statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts, technical indicators and oscillators to identify patterns that can suggest future activity. Unlike fundamental analysts, technical analysts don't care whether a stock is undervalued - the only thing that matters is a security's past trading data and what information this data can provide about where the security might move in the future.

The field of technical analysis is based on three assumptions:

1. The Market Discounts Everything

A major criticism of technical analysis is that it only considers price movement, ignoring the fundamental factors of the company. However, technical analysis assumes that, at any given time, a stock's price reflects everything that has or could affect the company - including fundamental factors. Technical analysts believe that the company's fundamentals, along with broader economic factors and market psychology, are all priced into the stock, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as a product of the supply and demand for a particular stock in the market.

2. Price Moves in Trends

In technical analysis, price movements are believed to follow trends. This means that after a trend has been established, the future price movement is more likely to be in the same direction as the trend than to be against it. Most technical trading strategies are based on this assumption.

3. History Tends To Repeat Itself

Another important idea in technical analysis is that history tends to repeat itself, mainly in terms of price movement. The repetitive nature of price movements is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time. Technical analysis uses chart patterns to analyse market movements and understand trends. Although many of these charts have been used for more than 100 years, they are still believed to be relevant because they illustrate patterns in price movements that often repeat themselves.

In reality a portfolio will include many aspects of both technical & fundamental analysis. This may not mean that every portfolio should be designed this way, or even that your portfolio is designed as such. But it is a good place to start.

Economic Factors

Top Down investing. This is where consideration is given to the overall economic conditions prevailing right now; and, where they may be headed. An example might be to look at the local growth rate and comparing it to longer term historical averages, and shorter term trends. What is being sought is an understanding of whether the region is in a growth or contraction phase. Ideally, investors want to participate in growth regions if possible.

The old saying “a rising tide lifts all boats” is a simple explanation of taking advantage of an area of the market that is growing, and hopefully most assets within that area of the market will ‘rise’ along with the broader trend that has been identified.

Investment Specific Factors

Bottom Up investing. In this scenario investors are ignoring economic conditions and seeking investments that have something unique about them, that is going to do well despite any broader economic issues. Think of selling ice-cream at the beach on a hot day – even though the broad local economy may be bad, everyone loves an ice-cream when it is 40° in the shade. Another topical example might be around the risks of buying a mining stock, such as BHP, when global commodities are suffering both in price & sales volume - due to a slowdown in Chinese demand – in turn due to slower global demand for ‘value-added’ products.

Prevailing broad stock market forces: Technical analysis on a whole-market rather than individual-stock scale. What is happening to share market prices right now? Is the market undergoing a rally or a correction? If there is a correction underway, how long has it been going on? Is it likely to reverse anytime soon?

Technical analysis can be in itself a whole investment philosophy/ methodology. Day trading is typically an example of extremely short-term technical analysis as investors are trying to avoid holding a stock except for the prospect of a quick share price gain.

Currency Issues

Where an investor is including International assets in a portfolio, is the applicable cross-rate suitable right now? Or, should we wait? Or, perhaps we use hedging to offset currency risk.

To hedge or not to hedge: The best way to understand hedging is to think of it as insurance. When people decide to hedge, they are insuring themselves against a negative event. This doesn't prevent a negative event from happening, but if it does happen and you're properly hedged, the impact of the event is reduced. So, hedging occurs almost everywhere, and we see it every day. For example, if you buy house insurance, you are hedging yourself against fires, break-ins or other unforeseen disasters.

Currency hedging is designed to reduce the impact of exchange rate fluctuations on investments that are traded in another currency, such as US shares or international exchange traded funds.

Hedging can be likened to an insurance policy that limits the impact of foreign exchange risk and can be used by investors and businesses that have international holdings.

Specific Risks

In this example an investor is looking at issues that impact on a specific asset. Think of the recent floods in Queensland. Insurers that had significant exposure (and sometimes even insignificant exposure) suffered on-market as investors fled Insurance Stocks due to the potential multi-billion dollar claims that the insurers may be forced to payout on.

Specific risks might include the ‘known’ current risks, such as commodities prices on mining stocks. It may include ‘known unknown’ risks such as insurance claims for major disasters. Then there is the truly ‘unknown unknown’ – perhaps major events that no-one saw coming nor could reasonably foresee that may also have a major impact on the price of the asset.

Portfolio construction will always try to incorporate the known risks and the known unknown risks. Of course, while it would be wonderful to also avoid any unknown unknown risk, reality is somewhat more of a lottery.

Specific Needs

An investor may have certain specific requirements within their portfolio. There may be a need to generate a specific level of income; or, perhaps to provide for known capital expenditure.

Another type of specific need that is proving more common may be an investor's desire for ethical investments.

Overall Balance

Once a range of assets and amounts invested has been selected for inclusion in an investment portfolio a portfolio manager will take a step back and look at the overall picture – for balance. It is always possible to get lost in the fine detail and miss the bigger picture – creating a portfolio that is not balanced.

Each investment selected must not only add to the overall portfolio by itself, it should also be complementary to the portfolio as a whole.

Twilight also utilises additional tools to reduce asset risk (the chance of including a 'bad egg' in the basket) eg multiple source **Research** including Morningstar, Bell Potter, CommSec, Desktop Broker, Lonsec & various fund manager updates.

It is impractical for a portfolio manager to suggest that they can know everything. Rather, the manager should incorporate multiple sources of quality information to assist in making investment decisions.

Major research houses offer fundamental & technical research for sale. By purchasing this research a manager can often get an understanding of the major issues and opportunities in a timely manner.

By comparing multiple sources of information a manager can get a picture or consensus of what many different researchers think. Hopefully this leads to fewer investment mistakes.

Twilight Financial Planning Investment Committee (IC). The IC is made up of the collective experiences of Alwyn, Margaret, Andrew & Stuart. We consider what may be relevant right now and develop portfolio themes. Construction is then made around this theme.

Of course, your portfolio may or may not follow any particular theme. It really depends upon what your own needs are and how we can best achieve your investment objectives.

Quality Filters

When looking at the potential inclusion of any specific asset, it is useful to have certain quality filters to help eliminate lesser quality assets. Some of the filters that may be included are:

- Market capitilisation. By including the larger stocks (invariably the largest 200 stocks on the ASX) we are usually 'fishing at the deep end'
- Liquidity. Good stocks will have good on-market liquidity. By choosing stocks that meet this criteria an investor is hopefully avoiding being 'stuck' with an illiquid stock - just at a time that the investor wants to sell that asset
- Stock vs industry average ratios. By comparing the asset in question with its peers in the same industry or business, we can hopefully avoid buying assets that are not doing as well as their competition
- Stock specific ratios. For example, what yield do we want from this stock? How much earning per share growth do we expect? What leverage are we comfortable accepting?

Strategic or Tactical Asset Allocation?

Strategic Asset Allocation (Long Term)

Strategic Asset Allocation is about spreading risk across asset classes over a long term (5-10 years).

Before you determine your Strategic Asset Allocation, you need to appreciate the importance of having defensive assets in your portfolio.

Defensive assets are crucial – Quality defensive assets, like bonds and cash, play an important role for investors during periods of market stress.

Tactical Asset Allocation (Short Term)

Tactical Asset Allocation is the ability to move between asset classes, as opportunities to enhance returns or limit falls arise; it takes into consideration the prevailing market conditions. Over the short term your portfolio may take tactical positions differing from the longer-term strategic asset allocation.

Consistently adding value through Tactical Asset Allocation requires discipline and conviction in your process, as often it will involve taking 'contrarian' positions; this includes being underweight equities following a strong bull market, or going overweight equities after markets have fallen considerably.

Increasing your portfolio exposure to growth assets will increase the short-term volatility of your portfolio as the values may rise or fall in line with the underlying assets.

Tactical Asset Allocation may involve Top Slicing, for example an investor may make tactical decisions to reflect what is happening right now and what they feel is going to happen next. We name this a dynamic investment approach.

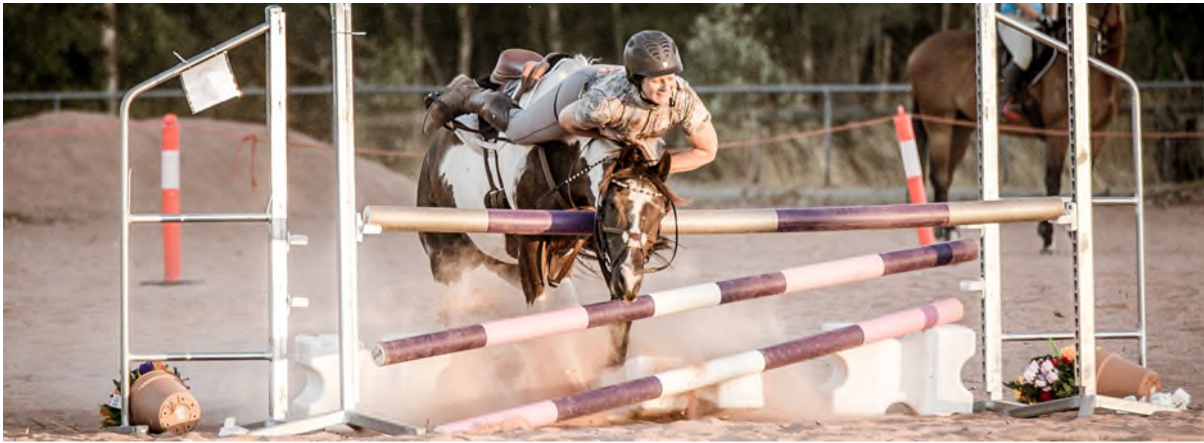
Let’s assume that the stock market price of a major asset - use Commonwealth Bank (CBA) for the exercise – has risen by 20% in the last few weeks. The investor decides to decrease the number of CBA shares held within the portfolio (go underweight) to take advantage of the current very high price. A period of time elapses and the share price of CBA retracts to a more ‘normal’ price, at which time the investor decides to buy back the underweight position and return to a neutral weighting for CBA. The investor was fortunate enough to get the trading decision correct (i.e. the share price of CBA fell over the time that the investor held the underweight position), enabling the investor to buy back the previously sold shares at a lower price. This is an example of a tactical decision (top-slicing) – the deliberate short term movement away from the existing strategy to take advantage of current market conditions.

Risk Profile Explanation

Attitude to risk is a very important factor in developing an appropriate investment strategy. To achieve higher returns an investor will generally have to accept a higher risk of capital loss because of funds and assets that are more volatile than those producing lower returns – something called the “risk/return trade off”.

All investors have differing attitudes towards risk. When it comes to investing, it is important to consider your risk profile or tolerance carefully, including how comfortable you are with the possibility of losing money, or that returns on your investments could vary widely from year to year.

To establish an investment strategy that suits your risk profile you need to consider the possibility that the value of your investment may fall. Are you prepared to accept the possibility of a negative return at any time in exchange for potentially higher long-term returns? What percentage of your money would you be prepared to invest in higher-risk investments?



Understanding your personal risk tolerance will help you choose an appropriate asset allocation - the following points can help you to determine an investment mix that's appropriate for your needs.

Risk Tolerance

To establish an investment strategy that suits your risk profile you need to consider the possibility that the value of your investment may decline (even though this may be temporary).

Are you prepared to accept the possibility of a negative return at any time in exchange for potentially higher long-term returns? What percentage of your money would you be prepared to invest in higher-risk investments?

Which of the following are important to you:

- Avoiding any short-term losses
- Receiving regular income from investments
- Long-term growth in the value of investments
- Protection against inflation.

In October 1987 the stock market fell more than 20% in one day. If you owned an investment that fell by 20% in a short time what would you do or what did you do in 1987?

Sell all of the remaining investment (Conservative)
Sell a portion of the remaining investment (Conservative to Balanced)
Hold the investment and sell nothing (Balanced or Aggressive)
Buy more of the investment (Aggressive).

Asset Allocation
We recommend a number of different investments and structures to help implement strategies.

Cash
Most common form of cash is currency held in cash funds or bank accounts. Cash is generally seen as risk free and will provide a low level of return. Interest paid as income at regular intervals.

Fixed Interest
Funds deposited and held for a period of time into a financial institutions or government accounts. These are commonly called term deposits interest and bonds. The institution / government pay the investor a rate of interest for an agreed period of time at regular intervals. Funds can be returned at the end of the investment period or reinvested for another term.

Property
Funds used to buy a building or land. Most common investments are residential houses or office / factories. The property maybe held directly or through a managed fund. Rent paid by tenants provides the investor with an income stream. Capital growth can also be achieved as the value of the property increases over time.

Australian Shares
Funds used to buy equity in Australian Companies. Commonly share market listed companies. The listed Australian Share Market is called the Australian Stock Exchange (ASX). Each share purchased will have a price. The price will go up and down as it is traded on the ASX. Listed companies can share the profit with shareholders through a dividend.

International Shares
Funds used to buy equity in non-Australian companies. Commonly share market listed companies. International Share Markets include the New York Stock Exchange (NYSE), National Association of Securities Dealers Automated Quotations (NASDAQ), London Stock Exchange (FTSE) and Tokyo Stock Exchange (TYO). Each share purchased will have a price. The price will go up and down as it is traded on the exchange. Listed companies can share the profit with shareholders through a dividend.

Alternatives
Funds used to buy tangible assets such as precious metals, art, wine, antiques, coins, or stamps. These investments may provide a regular income and or provide growth options. As alternatives a specialist is required to ensure specific advice is received.

Managed Fund
Is an investment where a number of investors pool their funds for a common investment purpose. Run by a professional team of investment managers whom make investment decisions based on the aim of the fund. An example of the aim of a fund could include: To produce a return 3% greater than the cash rate by investing in 100% Australian Shares. Each investor owns a number of units. Investors receive distributions, which is the income from the fund.

Master Trust
An administrative service that enables investors to hold a portfolio of investments in one place. The investments normally held in a master trust is limited to cash and managed funds. This allows for easier reporting and tracking of investments. Switching between investment options can be easily done in the same service. Investors pay an administration fee for this service.

Investor Directed Portfolio Service (IDPS)
An investor directed portfolio service, also known as a wrap account, allows investors to hold a portfolio of investments and shares in one place. This allows for easier reporting and tracking of investments.

Switching between investment options can be easily done in the same admin service. Investors pay an admin fee for this service.

Investment Concepts
The following are some of the key fundamental investment concepts we give consideration to when building a portfolio:

Age and Income
Your age and your income - particularly the stability of your income - are important factors to consider when determining your investment profile. If you are young you can afford to take a longer term view and any short-term losses may have minimal effect. If your income or employment is unstable you will need to take this in to account when setting your investment goals

The following table shows the main asset classes and the link between risk and return.

	Aust. Shares	Global Shares	Direct Property	Global REITS	Fixed Interest	Cash	Domestic CPI
Return (% pa)	9.4	5.6	9.5	10.6	7.6	5.5	2.7
Average real return (% pa)	6.7	2.9	6.8	7.9	4.9	2.8	2.7
Worst 1 year return (%)	-40.5	-33.4	-12.9	-57.9	-4.3	2.7	-0.3
Best 1 year return (%)	45.1	56.5	21.6	76.8	20.0	8.0	6.1
Chance of negative return (1 year in … years)	4.9	3.0	13.4	4.8	24.1	0.0	26.8
Probability of negative return (%)	20.3	33.6	7.5	20.7	4.1	0.0	3.7

Source: Mercer, period from 30 April 1994 to 30 April 2014.

The above table demonstrates that investments with a higher level of risk such as shares and property can have vastly different returns over any 12 month period compared to relatively low risk investments like cash and fixed interest. It also shows that although shares and property have greater potential for a higher return, they also have a greater probability for a negative return in any 12 months. For these reasons, it is recommended that more risky investments be held with the intention of staying invested for a long term such as 5 or more years. Please note that past performance is not an indicator of future performance.

Direct or Managed?

What makes Managed Funds so attractive?

You can start small

To invest in a managed fund, you can start with a smaller amount of money (as little as $1,000) to gain exposure to the various sectors of the market and dozens of individual stocks.

It is an easy way to diversify your investments
The beauty of managed funds is that you can access different asset classes, companies, industries, sectors and countries with a relatively small amount of money. Investing directly requires larger sums of money to gain the same range of exposure.

It is a cost effective way to invest
Investing directly into shares or property comes at a cost. Expenses such as brokerage, stamp duty and agents fees can have a significant effect on the value of your investment.

Managed funds allow you to access certain investments at a fraction of the usual cost. This is because you share these costs with other members of the fund, rather than having to pay the minimum investment fee on your own.

Experts manage your money
Your investment will be managed by professionals who have the education and skill to make appropriate investment decisions. These experts have access to investment research and information not easily available to individual investors.

You don't need to sell an entire house to access your money
You can generally access your money within five to ten days after making a request. Accessing capital in direct investments, particularly property, can be very difficult, costly and time consuming. Managed funds have a major advantage over direct property investments, in that you don't have to sell the whole investment to access some capital.

The Disadvantages of a Managed Fund are:

- Management fees are generally a lot higher than brokerage costs which can include a base Management Expense Ratio (MER) fee and a performance fee
- The fund must be invested in a set percentage in the market according to their mandate even if it is not a good time to invest
- There is generally less income paid to the investor as opposed to direct shares as any dividends are normally included in the unit price. This can be a

problem at retirement as the most important aspect is the income that the investment generates
- Tax benefits such as franking credits may not always be full passed on to the investor
- There are no voting rights in regards to corporate actions such as share purchase plans, takeover options and hybrid security options
- There is generally less advice provided by the adviser as no work is required on their behalf in regards to the fund.

What do Direct Investments offer?

- Direct ownership with no layers between the investment and the owner. This also provides greater transparency for the investor as they know exactly what what and how much they have invested in each holding.
- The portfolio can be tailored towards the investor's specific needs to ensure there is allocation towards direct shares, cash, fixed interest, listed property and hybrid securities
- An investor that is retired and solely dependent on income would have a different portfolio to an investor that is still in accumulation phase
- You are able to sell down a specific share instead of selling down the entire portfolio. This provides a great advantage especially when there is a capital gain and you can specifically target one investment to take the profit and keep the remaining portfolio unchanged
- The tax benefits are more transparent and can be more beneficial eg franking credits on dividends
- Direct ownership allows voting rights in respect of corporate actions for direct equities, where you have choice to participate or not
- Ongoing reviews and management is generally provided.

The Disadvantages of Direct Investments are:

Diversification is generally less than what Managed Funds can provide
There are potentially brokerage costs per buy and/or sell or stamp duty payable
You generally require an investment adviser to manage the investments unless you do it yourself
Dollar Cost Averaging into a range of direct investments can be much more difficult or (in the case of property) impractical
Similarly, if you want to reduce exposure (perhaps to draw down) it can be more difficult.

Diversified v Concentrated Portfolio?

With investing it is important not put all your money into one investment or type of investment, or all your eggs in one basket. All investments are subject to some level or risk. By placing your money into a number of investments an investor may improve their chances of evening out the highs and lows of investment returns.

No one type of security, asset class or investment manager provides the best performance over all time periods. So a range of investments should reduce the risk of each of the investments within a portfolio experiencing drops in performance at the same time. This is simply because one asset class or manager may perform well to counter the poor performance of another.

A diversified portfolio will include investments in a range of different GICS sectors, each aimed at adding to the overall performance of the portfolio within the risk parameters the investor is comfortable with. For example, investors with a high reliance upon yield may choose to diversify across better yielding GICS sectors such as Financials, Telecoms, & Utilities. A more growth focused investor may choose greater emphasis to Materials, Energy & Health.

A concentrated portfolio is less diversified and is based on the investor's belief that a particular investment or asset class will outperform the rest of the investment universe. An investor with a high need for yield may choose to 'concentrate' their portfolio into just a few stocks in the highest yield sectors.

Franking credits

For investors in Australian shares you may be entitled to franking credits. Franking credits represent your portion of the tax which has already been paid by the company you are invested in. Companies pay tax on their profits at the company tax rate of 30%. If these profits are then distributed to you, the Australian Tax Office (ATO) gives you a tax credit for the tax already paid by the company and you instead pay tax on the dividend at your marginal tax rate. Franking credits reduce your tax payable and, if they exceed the tax you have to pay, are refunded to you.

Investors can reduce their income tax liability by investing in shares or managed funds which provide franking credits. If your franking credits exceed your income tax liability, you can usually claim the unused franking credits from the ATO via your annual tax assessment.

Global Industry Classification Standard (GICS) Analysis

GICS system – sectors and industries

In studying the share markets anywhere around the world, it can be useful to compare companies that are somewhat similar in what they do. That is, for example, to compare the performance of financial stocks or materials stocks or consumer stocks.

To help do this there is a globally recognised and standardised classification, where companies are allocated a code within the system. This is the GICS coding system. GICS is a joint Standard and Poor's / Morgan Stanley Capital International (MSCI) product aimed at standardising industry definitions worldwide. To bring Australia in line with the rest of the world all ASX listed entities were reclassified according to GICS, and from 1 July 2002 the former ASX industry classification system became redundant.

The GICS system comprises 13 Sectors aggregated from 24 Industry Groups, 68 Industries, and 154 Sub-Industries. Utilising this classification enables investors to compare the performance of like companies not only within the country, but around the world.

A word of caution. Many people tend to loosely refer to share market sectors and industries, and may or may not be referring to the GICS sectors and industries.

GICS sectors

- Australian Real Estate Investment Trusts (A-REITs)
- Consumer Discretionary
- Consumer Staples
- Energy
- Financials
- Financials excluding A-REITs
- Health Care
- Industrials

- Information Technology
- Materials
- Metals and Mining
- Telecommunication Services
- Utilities

A well-diversified portfolio will include a range of GICS sectors (at least 5). In addition to this the portfolio will not have too much emphasis on any one GICS sector.

Investment Experience

How do you describe your investment experience and understanding of financial markets?

Have you just started investing in the last year?

Do you understand the basics of investing?

Have you have been investing on your own for several years and are reasonably confident of your knowledge of financial markets?

Is your knowledge of financial markets is well above average and you make investment decisions confidently?

Investment Goals and Objectives

Why are you investing? Is it for something in the near future (new car, deposit on a home, holiday) or something farther off (a young child's education or your own retirement)?

If your investment goals are short term you want your money to be there - with interest - when you need it. Therefore you will need to focus on relatively short term investments like term deposits or a cash management trust. If on the other hand, you are investing for the long- term, you may be able to afford to take some risk in pursuit of a higher return. Shares and property, which historically have provided higher returns than fixed interest or cash over time, may be more appropriate.

Investment Timeframe
When do you expect to need to access all or part of your investments:

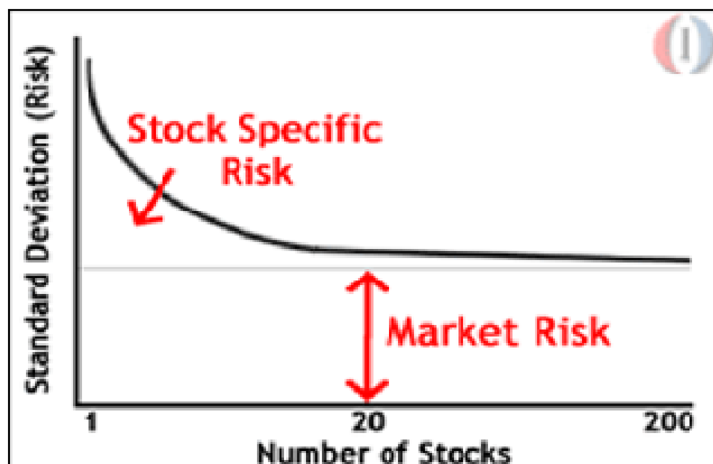
Less than 1 year (immediate access)
Less than 2 years (short term)
2 to 5 years (short to mid-term)
5 to 7 Years (mid to long term)
Over 7 Years (long term).

One way of looking at risk is to look at the possibility of negative returns from the investment. The probability of negative returns from an investment will also depend on how long the investment is held. The longer a "risky" investment is held, the lower is the probability of realising losses.

Liquidity / Cash Requirements
How much money do you need to keep available for emergencies such as house repairs, a dental emergency or serious car repairs? These emergencies can be a serious setback if you are not prepared. The amount of your emergency fund will depend on your current lifestyle and expenses. As a general rule you should have about 3 months of income set aside to meet emergencies without needing to rely on credit cards. A cash management trust that pays high interest can be a good place to keep emergency funds.

Stock Diversification Plateaus
How many stocks should you own to become diversified but not over-diversified? Obviously, owning five stocks is better than owning one, but at what point does adding more stocks to your portfolio cease to make a difference? According to modern portfolio theory, you'd come very close to optimal diversity after adding about the 20th stock. This isn't to say that buying 20 Internet stocks means you are at optimal diversification. Instead, you need to buy stocks of different sizes and from various industries.

Below is a chart showing how diversification reduces stock-specific risk. Notice how the difference between holding 20 stocks and 200 is next to nothing.



Keep in mind that owning a managed fund that invests in 100 companies doesn't necessarily mean that you are at optimal diversification. Many managed funds are sector specific, so owning a telecom or health care managed fund means you are diversified, but only within those industries. Balanced funds offer better risk protection because they own 100 or more stocks across the entire market.

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