logical financial management

Asset Class Diversification

Traditional asset classes respond differently to changes in the economic environment and have different risk/return profiles. Therefore, by investing across different asset classes, the good performance of one class can offset the underperformance of another class, to provide smoother and more consistent returns.

What is the key benefit of investing in different asset classes?

Diversification

Lowering of Risk and Consistency of Performance

By investing across different asset classes, the good performance of one class can offset the underperformance of another class, to provide smoother and more consistent returns. This is known as diversification and is best encapsulated in the common-sense phrase 'don't put all your eggs in one basket'.

The table below demonstrates that just because an asset class has a bumper return one year doesn't mean it will continue at the same pace for ensuing years. In fact, the best performing asset class one year may be the worst performing the next year. For example, in 2015 FY International shares (25.2%) were the best performing assets class but the next year (2016 FY) they were the worst performing (0.4%) asset class.

Having a mix of assets such as demonstrated by the balanced portfolio has historically allowed an investor to perform around the middle of the table over the last 10 years (2009 -2018). That is, it shows that historically a diversified portfolio of assets has allowed an investor to participate in good performing asset classes while reducing the risk of performing at the bottom of the table.

2009 FY	2010 FY	2011 FY	2012 FY	2013 FY	2014 FY	2015 FY	2016 FY	2017 FY	2018 FY
Australian Fixed Interest (10.8%)	Australian REITs (20.3%)	Australian Shares (11.9%)	Australian Fixed Interest (12.4%)	International Shares (unhedged) (33.1%)	International Shares (unhedged) (20.1%)	International Shares (unhedged) (25.2%)	Australian REITs (24.6%)	International Shares (unhedged) (14.7%)	International Shares (unhedged) (15.4%)
International fixed Interest (hedged) (10.0%)	Australian Shares (13.1%)	**Balanced Fund (7.3%)**	International fixed Interest (hedged) (11.9%)	Australian REITs (24.0%)	Australian Shares (17.3%)	Australian REITs (20.2%)	International fixed Interest (hedged) (9.3%)	Australian Shares (13.8%)	Australian Shares (13.2%)
Australian Cash (5.5%)	International fixed Interest (hedged) (11.5%)	International fixed Interest (hedged) (6.9%)	Australian REITs (11.0%)	Australian Shares (21.9%)	**Balanced Fund (14.4%)**	**Balanced Fund (11.6%)**	Australian Fixed Interest (7.0%)	**Balanced Fund (8.9%)**	Australian REITs (13.2%)
Balanced Fund (-11.6%)	**Balanced Fund (10.2%)**	Australian REITs (5.9%)	Australian Cash (4.7%)	**Balanced Fund (19.6%)**	Australian REITs (11.1%)	Australian Fixed Interest (5.6%)	**Balanced Fund (4.1%)**	Australian Cash (1.8%)	**Balanced Fund (10.5%)**
International Shares (unhedged) (-16.2%)	Australian Fixed Interest (7.7%)	Australian Fixed Interest (5.5%)	**Balanced Fund (1.1%)**	International fixed Interest (hedged) (4.6%)	International fixed Interest (hedged) (7.8%)	International fixed Interest (hedged) (5.6%)	Australian Cash (2.2%)	International fixed Interest (hedged) (0.5%)	Australian Fixed Interest (3.1%)
Australian Shares (-20.3%)	International Shares (unhedged) (5.2%)	Australian Cash (5.0%)	International Shares (unhedged) (-0.5%)	Australian Cash (3.3%)	Australian Fixed Interest (6.1%)	Australian Shares (5.6%)	Australian Shares (0.9%)	Australian Fixed Interest (0.3%)	International fixed Interest (hedged) (1.9%)
Australian REITs (-42.1%)	Australian Cash (3.9%)	International Shares (unhedged) (2.7%)	Australian Shares (-7.0%)	Australian Fixed Interest (2.8%)	Australian Cash (2.7%)	Australian Cash (2.6%)	International Shares (unhedged) (0.4%)	Australian REITs (-5.6%)	Australian Cash (1.8%)

Note: Balanced fund assumed asset allocation is as follows: Australian shares (37%), A-REITs (6%), International shares (27%), Australian Fixed Interest (10%), International Fixed Interest (15%), Cash (5%). Indices used are as follows: Australian shares (S&P/ASX 300 Accumulation index), A-REITs (S&P/ASX 300 A-REIT Accumulation index), International shares (MSCI WORLD ex Australia NR AUD – Unhedged Accumulation Index), Australian Fixed Interest (Bloomberg Australian Bond Composite Index AUD), International Fixed Interest (Barclays Global Aggregate Accumulation Index -hedged AUD), Cash (Bloomberg Australian Bond Bank Bill Index AUD).

The benefits of diversification will vary over different time periods. Historically in some periods when there have been extreme adverse market events (e.g. the Global Financial Crisis), the effectiveness of diversification has reduced. Diversification should therefore be measured over medium to long term periods.

Features of a Balanced Fund?

A diversified portfolio can generally be divided into four types – conservative, balanced, growth and high growth. Conservative funds are the more defensive funds with a high exposure to fixed interest and cash. On the other hand, high growth funds are more aggressive with a high exposure to international and Australian shares.

A balanced fund will typically have a higher exposure to growth assets (Australian and International shares, Real Estate Investment Trusts [REITs], Alternative assets, Infrastructure and Direct property) of 60% to 80% and lower exposure to defensive assets (Australian and International Fixed Interest – Bonds/Credit/Hybrids and Cash) of 40% to 20%.

There are 3 key sources of return for a balanced investment portfolio – Strategic asset allocation, tactical asset allocation and security selection.

1. Strategic Asset Allocation

This relates to how much is allocated to each asset class. Your strategic asset allocation (based on risk profile and individual circumstances) is selected and maintained at selected benchmark levels until the end of an investment period or until a major change occurs in the investment environment.

2. Tactical Asset Allocation

This approach involves reallocating funds to those asset classes that have the best prospects based on their analysis and away from those that have the worst prospects. Such changes in asset allocation can be either large (very active asset allocator) or small (active asset allocator) and made frequently or infrequently.

3. Security Selection

This decision is concerned with selecting the appropriate asset. For example, if Australian Shares are considered; How to invest in each Australian share within each sector (e.g. overweight BHP compared to BHP's weighting in the S&P/ASX 300 Index); How to invest in each sector within the S&P/ASX 300 Index (e.g. overweight the resources sector and underweight the financial sector).

Many academic studies both in Australia and abroad have shown that the majority of a balanced funds total return is driven by the strategic asset allocation decision and to a lesser degree security selection. Furthermore, research has shown that it is difficult to consistently add any significant value especially after costs from tactical asset allocation.

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