Vanguard®

Building your investment portfolio

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Contents


12.550
11
12
13
14
15
16
17
18
19
45.00

Building your investment portfolio

One thing we know is that you can't control investment markets. Volatility is part of investing. What you can control is your investment strategy—having the framework in place to give you the best chance of meeting your goals and objectives and aligning investments to your risk profile.

Whether you're investing directly or using a financial adviser, you need to be aware of some important considerations. This Plain Talk® guide walks you through the process of building an investment portfolio from the ground up, covering asset allocation, implementation, rebalancing and reviewing your investment strategy.

Planning your investment strategy

Taking some time to plan your strategy before you start investing can be the difference between simply aspiring to your goals or achieving them.

Having a clear idea of your investment objectives, timeframe and attitude to risk provides a solid basis on which to build your investment portfolio. The more specific you are, the better your chances of success.

Just like life, your investment plan is a work in progress. It should be flexible enough to cater for changes and market challenges—both big and small.

Here are a few factors to consider:

Why are you investing?

First, work out what you want to achieve from your investments. Break your goals down into short (1 to 3 years), medium (3 to 5 years) and longer-term goals (5 years plus).

People have different goals at different stages of their lives. Your longer-term focus might be building financial security for you and your family or saving for retirement. While in the shorter-term you may simply want to make the most of your income.

What is your time horizon?

Also known as investment timeframe, this refers to how long you are planning to invest your money. It tells you how long you have to realise your investment goals and provides a framework for the investments you choose. Usually the longer your investment timeframe the more aggressive you can be with your investments—although this depends on your tolerance for risk. For short-term goals like buying a car or taking an overseas holiday, lower risk, income type investments, such as cash and money market securities are more suitable.

Know your risk/return profile

Understanding your attitude to risk and return is arguably the most important decision when planning your investment strategy. You might be attracted to the prospect of great performance, but how much risk are you willing to take to achieve it?

What are your current circumstances and limitations?

While you might have grand plans for your future lifestyle, your current means may not be sufficient to get you there. It's important to keep a realistic view of your goals while keeping in mind any limitations that might stop you from achieving them. A diversified, long-term investment strategy can certainly help build your wealth and put you on the road to achieving your goals, but you should be realistic about possible shortfalls.

Do you expect your needs to change in the future?

You may be expecting to come into a major windfall or a substantial increase in your income. On the other hand you might be planning to start a family or buy a new home which will mean having less disposable income. Whatever your prospects for the future, make sure you take them into account when planning your investment strategy.

How much control do you want over your investments?

This will have implications for the types of investments you choose and whether you decide to invest in the share or property market directly, use managed funds or implement your investment strategy through a financial adviser.

Smart investing tip 1: Watch costs

Costs can take a large chunk out of an investor's return. So, it's important to compare fund fees before you invest. Look at things like brokerage fees, contribution fees, adviser commissions and management costs. These can all add up over time.

Major asset classes

Investments can be divided into income assets and growth assets. Growth assets primarily provide returns in the form of capital growth and include Australian and international shares and property investments.

Investing in growth assets such as shares and property can help protect the purchasing power of your money over time. Some shares and property investments also provide income distributions and dividends.

Income assets primarily provide returns in the form of income and include fixed interest and cash investments. Income assets tend to provide more stable, albeit lower returns over the long term.

Investment markets move in cycles, reflecting the underlying strength of the economy, industry trends and investor sentiment. The graph over page shows the annual returns of each of the major asset classes over the past 30 years.

Generally, the longer your investment timeframe the higher the level of growth assets you can include in your portfolio.

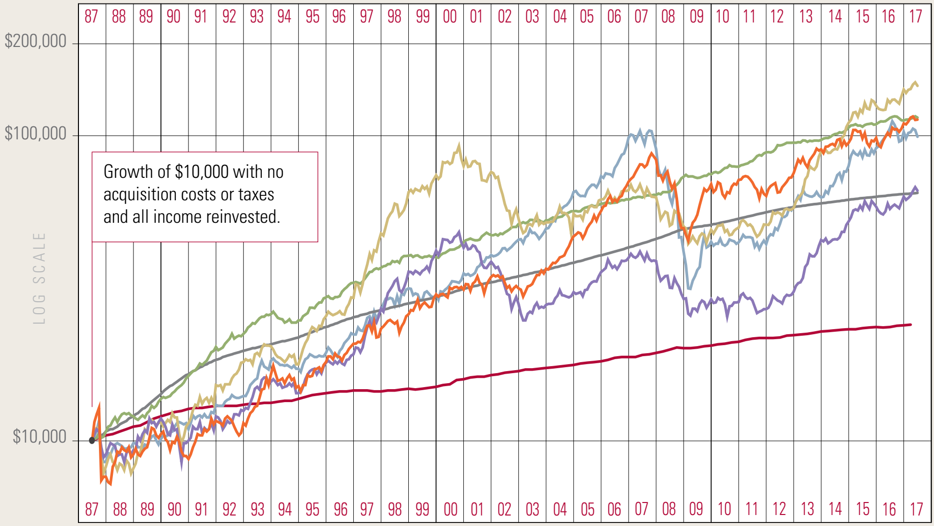
While growth assets, like shares and property securities, tend to have more volatile returns over the shorter term – meaning they are likely to produce negative returns more often than income type investments – they have the potential to produce higher returns over longer-term timeframes.

Of course, if your primary need is for income and you need quick access to your money, you may benefit from a higher exposure to income assets.

The right type of investment for you will depend on your investment objectives, timeframe and tolerance for risk.

The value of long-term investing

Financial year total returns for the major asset classes for financial years ending between 1987 and 2017.



Percentage returns (% p.a.) as at 30 June 2017[1]

	1 Year	5 Years	10 Years	20 Years	30 Years
Australian Shares[2]	13.1	11.6	3.5	8.1	8.4
International Shares[3]	14.7	18.2	5.1	5.3	6.5
US Shares[4]	13.8	21.3	8.2	7.0	9.4
Australian Bonds[5]	0.2	4.3	6.2	6.2	8.5
Listed Property[6]	–6.3	14.1	0.1	7.1	8.0
Cash[7]	1.8	2.5	3.9	4.7	6.4
CPI (to March 2017)[8]	2.1	2.0	2.5	2.5	3.0

Sources: Australian Bureau of Statistics, ASX Limited, Bloomberg Finance L.P., Commonwealth Bank of Australia, Melbourne Institute of Applied Economic & Social Research, MSCI Inc., Reserve Bank of Australia, Standard & Poor's, Thompson Reuters. Notes: 1. One-year returns are total returns from 1 July 2016 to 30 June 2017. 5, 10, 20 and 30 year returns are average annual compound returns to 30 June 2017. 2. S&P/ASX All Ordinaries Accumulation Index. 3. MSCI World ex-Australia Net Total Return Index. 4. S&P500 Total Return Index. 5. Prior to December 1989 the index is the Commonwealth Bank All Series Greater Than 10 years Bond Accumulation Index. From September 1989 the index is the Bloomberg AusBond Composite 0+ Yr Index. 6. S&P/ASX 200 A-REIT Accumulation Index. 7. Data prior to March 1987 supplied by Reserve Bank of Australia. From March 1987 the index is the Bloomberg AusBond Bank Bill Index. 8. ABS Consumer Price Index (to March 2017). Disclaimer: The information contained herein is intended for informational purposes only. It is not intended as investment advice, and must not be relied upon as such. No responsibility is accepted for inaccuracies. Past performance does not guarantee future returns.

Beware of investment risks

When constructing your investment portfolio it is just as important to be aware of the risks as well as the potential rewards. All investments carry some level of risk. The type and degree of risk will vary depending on the investments you choose. Usually, the higher the risk the higher the potential return. Risk is measured in terms of the likelihood of achieving a negative return in any one year.

The graph below illustrates how the ups and downs of investment markets tend to even out and the gap between the highest and lowest returns closes over time. This is why it is important to consider your timeframe when choosing your investments.

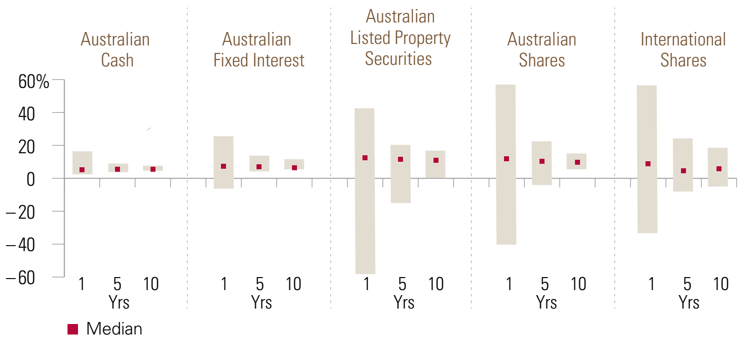
What are the risks?

No risk can be a risk in itself

Rising prices due to inflation can erode the real value, or purchasing power, of your investments. In some cases, the real value of your money may actually fall over time.

Risk of major asset classes

Range of returns over 1, 5 and 10 year periods (1 January 1990 - 30 September 2017)



Note: Past performance is no indication of future performance. Assumes 100% reinvestment of distributions without any consideration of fees.
Source: Vanguard calculations using data from Morningstar Inc.

Market risk

This is the risk that share, property, fixed interest or cash markets will decline in value. The sharemarket is influenced by a number of factors, including the underlying strength of the economy, political factors, industry trends and investor sentiment. On the other hand, fixed interest and cash markets are influenced by expectations of interest rates and inflation.

While specific asset classes can be risky in the short term, time has a moderating effect. Market risk can be reduced by holding a diversified portfolio of investments across different asset classes.

Manager risk

This is the risk that a managed fund will underperform its benchmark or market index due to poor investment selection. Active fund managers will try to pick stocks they believe will outperform the market based on their philosophy and research. Sometimes this works in their favour and sometimes it doesn't. Some active funds are reliant on individual fund managers for their performance and can be subject to key person risk if that manager decides to leave.

Investing in index funds can reduce your susceptibility to individual manager risk. Because index funds invest in all or most of the securities in an index, you are not relying on the fund manager's investment selection ability and skill.

More information about risks can be found in the fund Product Disclosure Statement (PDS). For further information about risks and how they may impact your portfolio, seek advice from a financial adviser.

Smart investing tip 2: Invest long term

People often get caught up with short-term stock selection which can deliver inconsistent results. While one stock might deliver great returns one year, it is difficult to pick winning stocks every year. When it comes to investing, it generally pays to invest for the long term.

The importance of diversification

Spreading your money across a range of investments is one of the best ways to reduce your exposure to market risk. This way you are not relying on the returns of a single investment.

Investment markets move up and down at different times. With a diversified portfolio of investments, returns from better performing investments can help offset those that underperform. Ways to diversify are:

- include exposure to different asset classes, like shares, fixed interest and property
- hold a spread of investments within an asset class, like different countries, industries and companies
- invest in a number of funds managed by different fund managers. For example, blending active with index managers—this is covered in the types of fund managers section.

It's time in the market, not timing the market, that counts

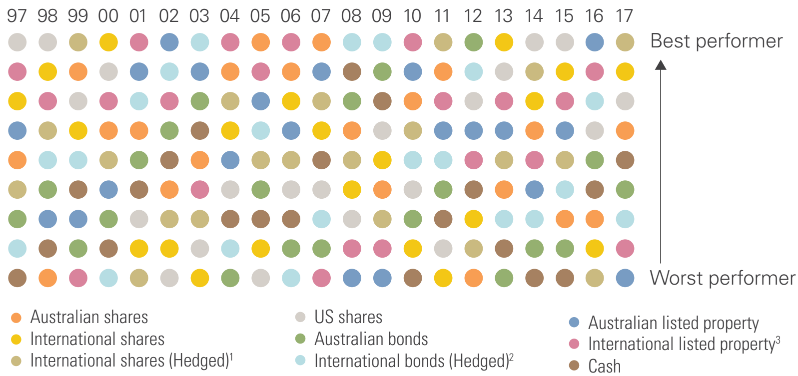
Timing the markets for the best time to invest is easier said than done. Intuition tells us that the best time to buy is when prices are down, and the best time to sell is when prices are up.

Trying to pick the top and the bottom of the market is not easy and you risk being out of the market when it rallies. Even professional fund managers find it difficult to continuously time the markets for the right time to invest. Long term investing isn't about chasing the hottest performance. It's about taking a long term view and staying the course. It won't protect you from market downturns, but it ensures you are invested in the market during times of growth.

As you can see from the chart below, the returns from different types of investment can vary dramatically from year to year. This year's top asset class can quickly become next year's worst performer. For example, in 2006 Australian listed property was the star performer, delivering a return to investors of 24.7 per cent over the year. The following year it finished at the bottom of the chart, with a return of 2.3 per cent, comfortably less than cash. With a broad range of assets in your portfolio, returns from better performing assets can help compensate those not performing so well.

The power of diversification

Financial year total returns for the major asset classes for financial years ending between 1997 and 2017.



Source: Andex Charts Pty Ltd June 2017.
Notes: 1. MSCI World ex–Australia Net Total Return Index (Local Currency) – represents a continuously hedged portfolio without any impact from foreign exchange fluctuations. 2. Index prior to 30 June 2008 is the Citigroup World Government Bond Index AUD hedged, from 30 June 2008 the index is the Bloomberg Barclays Global Treasury Index $A hedged. 3. Prior to 1 May 2013, index is the UBS Global Real Estate Investors Index ex Australia with net dividends reinvested.
Past performance is not an indicator of future performance.

SMSF tip 3: Diversify

One of the most important decisions investors make is how they divide their investment between each asset class, referred to as asset allocation. Diversifying across a range of asset classes, industries and securities reduces market risk and can improve your performance potential.

Keep your expectations realistic

Something to keep in mind when you are choosing your investments is that past performance is not an indication of future performance.

While it's easy to get excited by the prospect of 20 per cent plus returns, markets can go down quite quickly and may take time to recover.

No one can predict what future returns will be. The one certainty of investing is that markets will go up and markets will go down. So, you need to be prepared to take the good and the bad. If you are investing for the long term, don't make your investment decisions based on short-term performance.

Smart investing tip 4: Invest often

Timing the markets for the best time to invest is easier said than done. With a dollar cost averaging strategy, you invest a set amount into your investment portfolio on a regular basis, regardless of what the markets are doing. This averages out market fluctuations over time.

Getting your asset allocation right

How you allocate your money to each asset class is one of the most important decisions you can make when constructing your investment portfolio.

Some investors prefer to leave the asset allocation up to a fund manager and invest in a diversified (or multi-sector) fund where a fund manager decides the asset allocation for them. Others prefer to choose the investment mix themselves. There is no right or wrong way providing your asset allocation is designed with your investment objectives, timeframe and risk/return profile in mind.

There are two ways fund managers decide their asset allocation policy—strategic and tactical. Strategic asset allocation is where you set a long-term target for each asset class and stick to it. This type of asset allocation is set according to the investment objective, risk/return profile and investment timeframe.

Tactical asset allocation changes are made in the short-term based on the fund manager's view of the performance relativities of each asset class. Fund managers who use this approach analyse economic and financial factors to predict the performance outlook for each sector. Some fund managers set minimum and maximum ranges for each asset class. Usually, they set a target within this range which is regularly reviewed based on their view of market conditions.

A professional financial adviser will be able to help you determine the optimal asset allocation for your individual needs.

Implementing your portfolio

Once you have decided on your asset allocation, there are a number of different ways to implement it.

Super versus non super

Apart from asset allocation, another important decision you will need to make is the investment vehicle you choose. For people saving for retirement, the tax concessions available in super make it an attractive investment vehicle. Paying less tax on contributions and investment earnings can make a big difference to the value of your retirement nest egg over time.

Remember, most people won't be able to access their super until at least the age of 65[1]. So, if you have other investment objectives in mind you might be better off investing in managed funds or other investments.

Direct investment and managed funds

Whether you decide to invest directly or via managed funds depends on a number of factors including your time, discipline and confidence. One of the major advantages of managed funds is that you can access a much wider range of investments than you can by investing directly yourself.

An Australian equity fund, for example, might have 100 or more shares in its portfolio. This compares to an average of six shares held in a direct investor's portfolio. You also get the benefit of your money being professionally managed for you.

1 Source: www.superguide.com.au

Index versus active management

Index managers aim to track the performance of a market index by investing in all or a representative sample of the securities in the index. A benchmark index measures the performance of a basket of securities. For example, the S&P/ASX 300 Index measures the performance of about 300 companies listed on the Australian Stock Exchange. Index funds invest in all or most of the securities in the index providing diversification, which means lower risk.

Active fund managers usually try to outperform the market index by choosing a selection of stocks they believe will beat the benchmark. They tend to hold fewer stocks than index managers. They also charge higher fees as they have higher costs due to the need for research analysts as well as transaction costs from trading securities more often.

Seeking advice

A professional financial adviser can help you decide the right investment structure and asset allocation based on your individual needs. You may decide to seek advice on the right asset allocation and investment structure for your needs and then implement your portfolio yourself. Alternatively, you may decide to let the financial adviser do it for you.

A good financial adviser has a firm grasp of the latest super, investment and tax regulations so they can recommend strategies from the simple to more complex, depending on individual needs.

SMSF tip 5: Invest overseas

Investing internationally can increase your diversification further and give access to industries and companies not available in Australia. After all, Australia represents less than 2.5 per cent of the total world sharemarket.

Rebalancing your portfolio

Market fluctuations can affect your asset allocation weightings and change the risk/return profile of your portfolio. For example, if the Australian sharemarket performs strongly your portfolio holdings in this asset class will be valued higher, which will throw your asset allocation off balance.

Rebalancing a portfolio simply means adjusting your investments to match your target mix. It is different to tactical asset allocation, which represents an actual shift in your asset allocation strategy. Rebalancing back to your target asset mix brings your portfolio back in line with its risk/return profile.

On establishment of your investment portfolio you should decide how much you are willing to let your asset allocation shift from its target allocation. Once your allocation hits this trigger point you will need to rebalance your assets.

Professional investment managers monitor asset allocation weightings and reset them regularly. For example, Vanguard maintains its asset allocation within 2 per cent of its strategic targets.

How to rebalance

You should review your portfolio regularly, particularly if markets have moved significantly. You can rebalance in three ways:

Reinvest dividends

Direct dividends and/or capital gains distributions from the asset sector that exceeds its target into one that is underweight.

Make additional contributions
Add funds to the asset sector that falls below its target percentage.

Transfer funds between asset classes
Shift money out of the asset class that exceeds its target into the other investments. When you rebalance you need to consider the costs and tax implications. In most cases you will have brokerage costs and, with some managed funds, an entry/exit fee. There may also be tax consequences when transferring funds between asset classes. Sometimes it is more tax effective to use new cashflow or distributions rather than transferring assets.

If you have a large portfolio, redirecting cash flow or dividends may not be sufficient to bring your asset allocation back into balance. In such instances, you might have to liquidate investments to rebalance, which may have tax implications.

A professional financial adviser will be able to review your portfolio and ensure that it's rebalanced back to your target asset mix in line with its risk/return profile.

SMSF tip 6: Don't chase performance

Don't just choose investments because their recent performance looks good or they promise substantial tax breaks. Make sure the investments you choose are aligned to your investment objectives.

Reviewing your investment portfolio

It is a good habit to review your investment plan on an annual basis to make sure it's still right for your needs. Perhaps your investment objectives or circumstances have changed. Alternatively you may have decided that your original goals are no longer important and your focus has changed. At times like this, it's a good idea to revisit your investment strategy.

Here are some common events that may trigger a review of your investment portfolio.

Career

- starting a new job or being made redundant
- promotion with higher income prospects
- changing your career path or starting a business
- taking a break from the workforce.

Income or expense change

- shifting from a single to double income household, or vice versa
- experiencing a substantial increase or decrease in salary or income
- buying or renovating a new home
- buying or paying off a car.

Family change

- getting married or divorced
- starting or expanding your family or child starting/completing school
- serious illness or death in the family.

Retiring

- planning for or beginning retirement
- downsizing your home
- planning a sea change
- estate planning for future generations.

The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world's highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what's best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

We know we can't control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn't a pricing strategy for us. It's how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.

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