



'A Wise Man Should Have Money in his Head, But not in his Heart'

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With the exception of his novel, Gulliver's Travels, I must admit that I am not familiar with the work of Jonathan Swift. However when I came across one of his quotes – the title of this month's newsletter – I was unable to find a more fitting subject to explore.

The world of investing is an emotional journey simply because money is important to us. The highs and lows of this emotional rollercoaster are magnified by the amount of risk we are prepared to take and the amount of return we expect to achieve for taking this risk.

Possibly the greatest challenge for any investor is maintaining a consistent approach to risk management. For some people, the appetite for maximising investment returns becomes irresistible and the temptation to underweight defensive assets (cash and fixed interest) and overweight riskier assets (shares and property) results in a higher risk profile than they would normally be comfortable with. This can seem like a completely feasible tactic at the time, but it is not uncommon for investors to overlook the increased volatility that their portfolio is exposed to by taking short-term positions.

Maintaining a diversified portfolio is essential to achieving long-term investment goals. Taking short-term bets against a long-term strategy becomes somewhat of a gamble unless the risks are clearly assessed and understood, rather than just being blindly accepted.

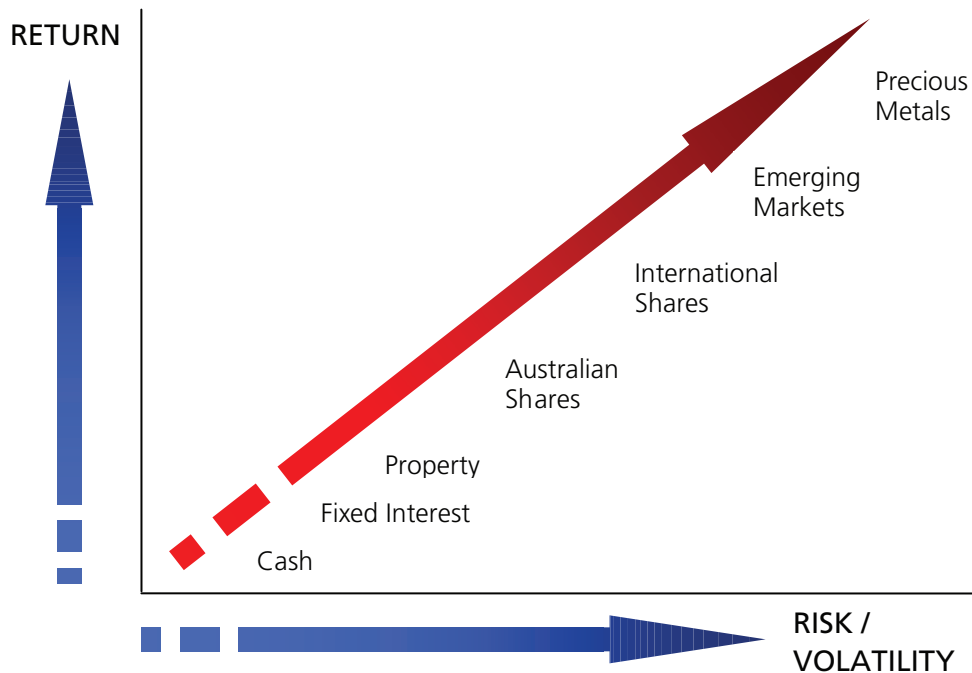
Defensive assets have a number of key roles to play in any portfolio including:

- Meeting known income requirements for the next 1 – 2 years;
- Smoothing out the volatility of the overall portfolio without excessively detracting from performance; and
- Providing returns that are not correlated to the returns of shares and property.

By underweighting defensive assets, we are reducing the effectiveness of our portfolio in achieving its long-term objectives. I can all but guarantee that the heart would say, 'go on, do it. This China boom is our chance to make some real money', whilst the head is thinking, 'Hmnn! Is it worth risking an additional 10% of my capital for an extra 10% return this year?'

An extreme case in point is Storm Financial clients. Although these investment decisions were made under flawed financial advice and misplaced investor trust in their advisers, there must have been moments of clarity in their decision-making process when they thought that the risk of drawing all of the available equity out of their homes, investing in shares, then borrowing on those shares and investing that into more shares, was a strategy wrought with danger.

So, let's have a look at the relationship between risk and return:



As the table above shows, the asset class with the lowest risk is cash; but it also has the lowest expected return. You may be familiar with the term 'risk-free rate'. The risk-free rate refers to the long-term cash rate which generally averages around 5 – 5.5% p.a. To obtain this rate you would generally take on very little risk, perhaps by investing in a Government guaranteed bank deposit. Unless the Government defaulted on this guarantee, you would not be risking your capital.

Investment risk can be described as the likelihood that investment capital will fluctuate in value or that returns may not meet expectations in the short-term (i.e. 1 - 3 years). Therefore, the higher the amount of risk accepted, the higher the possibility that investment capital may fluctuate in the short-term. These fluctuations are known as volatility, and the greater the fluctuations, the greater the volatility or risk. In return for taking on this additional volatility, we can reasonably expect a higher return over the long-term (the key phrase being 'long-term').

That is not to say that it is an incorrect decision to take on short-term positions that diverge from a pre-determined risk profile. What is important is that we use our heads and not our hearts, by assessing the amount of additional risk we are taking on board, understanding the downside, and making an objective judgement on whether the risk is acceptable for the expected return of the investment decision. This is known as pricing the risk.

Financial advice

For any further information or to discuss your financial situation, please don't hesitate to contact me on **0413 244 733** or email simon.whiteley@eqtsuper.com. I look forward to hearing from you.

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