

A diversified portfolio of growth and defensive assets helps to balance out returns

Spreading your money across a range of investments is one of the most effective ways to reduce risk. But is this an effective strategy when all the major growth asset classes fall at the same time, as they have done in the recent bear market?

Diversification through bear markets

There have been many bear markets over time. Generally in a bear market, the performance of various growth asset classes suffers – but not always. For example, in the bear market ended March 2003, global shares and emerging markets were hit the hardest. At this time, a diversified portfolio of growth and defensive assets balanced out returns.

However, the global financial crisis of 2008 resulted in a downturn in every growth asset class. The defensive assets – cash and bonds – were the only asset classes to provide positive returns during both times (see Table 1 on the next page).

Time in the market and performance

History shows that when markets fall in the short term, growth assets all tend to fall together. This means that generally, growth assets are suited to investors with a medium to long-term timeframe, who have the time to ride out market volatility.

You should also consider how different classes of growth assets perform when the time horizon is lengthened. Chart 1 (on the next page) shows the three-year returns of different asset classes since 1993, and the difference between the best and worst asset classes. Even when the returns of all asset classes are negative, the difference between best and worst is still substantial.

This is why diversification across a number of growth assets is important. Exposure to a range of growth assets can help reduce the risk of being over-exposed to the asset class that happens to be one of the poor performers over a medium to long-term horizon.

Defensive assets are crucial

Diversification between growth assets makes a difference over the medium to long term. But defensive assets, such as cash and bonds, also play an important role. This is especially the case during periods of market stress.

Cash is widely considered the most reliable asset class when markets decline. And while Australian bonds do not always provide a positive return in down periods for shares, when there is a 'flight to safety', bonds can hold an important place in an investor's portfolio.



Defensive investments over the long term

To illustrate defensive assets' contribution to longer-term performance, let's look at three example investor portfolios:

- 100% Australian shares
- 50% Australian shares and 50% global shares
- a traditional balanced portfolio with 70/30 split between growth and defensive assets.

Table 2 shows that the balanced portfolio achieved an almost identical return to an investor with 100% Australian shares, but with significantly less risk. Also, the worst cumulative three year return over this period was around -30% for both share strategies, compared to a much lower -15.2% for the balanced fund.

These results clearly show the importance of defensive investments within a diversified portfolio and their ability to improve returns and reduce risk over the long term.

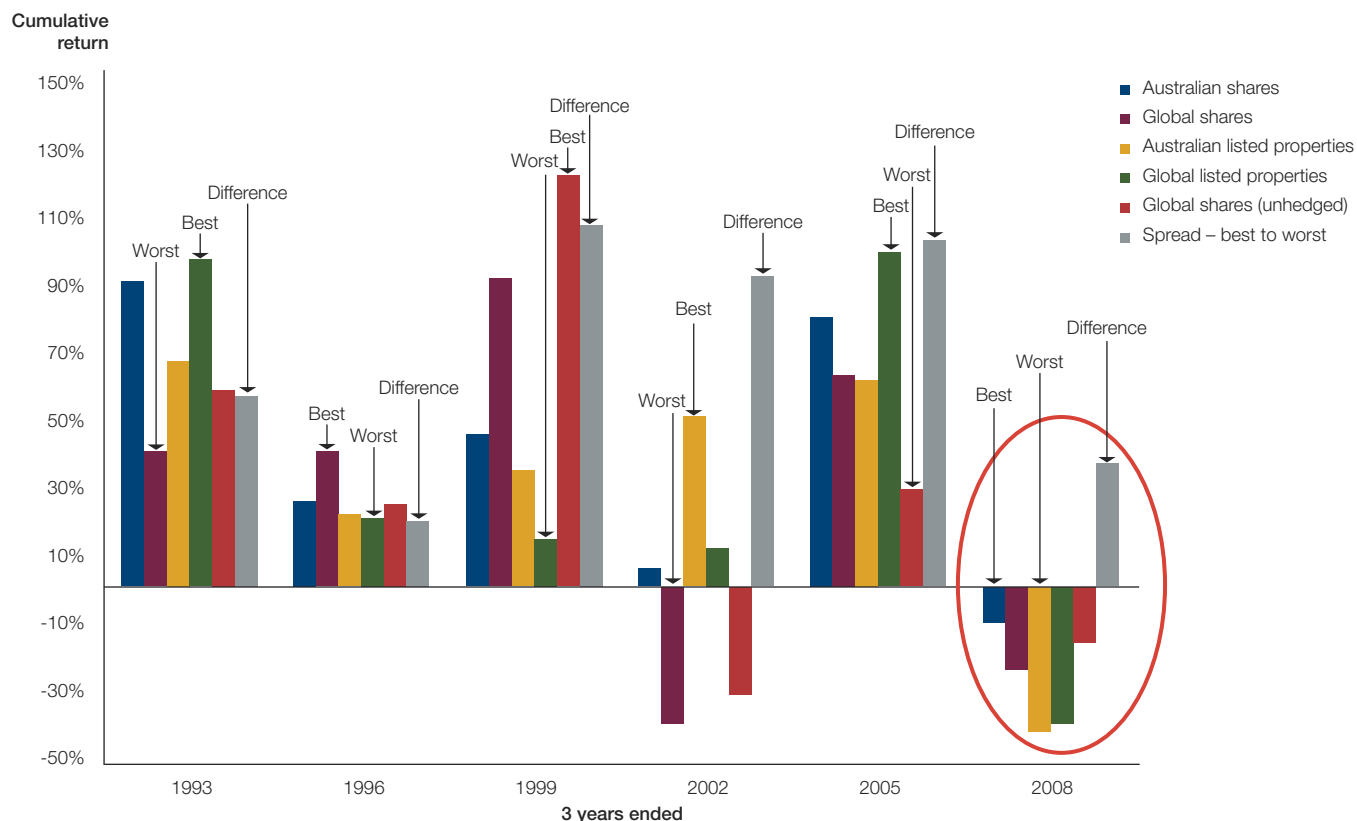
Diversification remains key

We believe that this basic investment principle plays a key role for investors over the long-term, whatever the market conditions, to help reduce risk and improve returns.

The way you diversify your own investment portfolio will depend on your objectives, your timeframe and attitude to risk. We have a range of diversified funds available to suit different investor needs – visit www.perpetual.com.au to find out more.

Chart 1 – The benefits of diversification are clear

Cumulative 3-year return of each growth asset class since 1993



Source: Datastream, Mercer, IRESS.

Table 1 – A broad downturn across all asset classes

	Last bear market (Cumulative return three years to 31 March 2003)	Current bear market (One year return to 31 December 2008)
Growth assets		
Australian shares	2.6%	-38.4%
Global shares	-45.9%	-38.4%
Australian listed property	50.3%	-54.0%
Global listed property	0.0%	-45.0%
Emerging markets	-31.5%	-45.7%
Global shares (unhedged)	-45.3%	-24.5%
Defensive assets		
Australian bonds	26.0%	14.9%
Cash	16.9%	7.6%

*Source: Datastream, Mercer, IRESS.

Table 2 – A similar outcome with significantly less risk

31 December 1979 to 30 June 2009

	100% Australian shares	50%/50% Australian and international	Balanced (70% growth)
Return (%pa)	11.8	11.7	11.5
Volatility (%pa)	17.8	13.7	10.1
Worst cumulative 3 year return (%)	-28.0	-30.4	-15.2

Source: Datastream, Mercer, IRESS. 70% growth fund asset allocation: 40% Australian equities, 25% international equities, 5% property. 20% fixed interest, 10% cash. Passive rebalancing assumed monthly. Buy/sell spreads for rebalancing assumed to be 0.30% each way on Australian equities, international equities and property and 0.10% each way on Australian fixed interest.

Notes for tables

Returns for global shares, global listed property, global small caps and emerging markets shown in local currency. All other returns are in AUD. Australian share returns are S&P/ASX 200 Accumulation Index (prior to 31/3/00 All Ordinaries Accumulation Index used). Global shares returns are MSCI World ex Australia Index. Australian listed property returns are S&P/ASX 200 A-REIT Accumulation Index. Global listed property returns are FTSE EPRA/NAREIT Global Index. Emerging markets returns are MSCI Emerging Markets Index. Global small caps returns are FTSE Global Small Cap Index. Australian bonds returns are UBS Composite Bond Index All Maturities Index. Cash returns are UBS Bank Bills Index. Foreign currency returns calculated as the difference between the MSCI World ex Aus (unhedged) Index and MSCI World ex Aus (hedged) Index.

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