Investment Strategy

Objective-based investment strategies

Why do people invest money? In simple terms, people invest so that they have more money in the future than they have today. However, when we actually sit down with our clients and work with them to understand what they are seeking to achieve with their investments, we discover that they have a range of different objectives. In general, investor objectives fall into three categories: preserve capital, generate income and grow capital. Often people can and do have multiple objectives at the same time.

Some investors also have very specific objectives. For example, a client may want to purchase a property in six months' time with part of their capital. With another part they may want to generate a certain level of income to support their lifestyle and with money left over they may want to make long term investments on behalf of their grandchildren. In this example, the investor may need to make different investments to satisfy the different objectives.

Let's look at these three investment objectives and examine what types of investments can best be used to meet the objective in the current market environment.

Capital Preservation

Investors with a capital preservation strategy primarily want their capital to remain intact with a high degree of certainty. They are less concerned with income and growing their capital. The time frame over which the capital needs to be preserved will determine the precise blend of investments, however, for shorter time periods cash investments and bank term deposits are usually the most suitable investment choices. This is because in Australia, bank deposits of up to $250,000 are guaranteed by the Australian Commonwealth Government and Australia's banks are relatively healthy compared to banks in other parts of the world. For longer time horizons, fixed income securities such as bonds that are highly rated by a credit ratings agency are the most suitable. For example, ten-year Australian Commonwealth Government bonds are rated AAA by Standard & Poor's and, although the yield on these bonds is only about 3.5% per annum, there is an extremely high probability that investors will get their capital back on the maturity date.

We also find that some of our clients want to preserve the "real" value of their capital. This means that they want their capital to be protected against a loss in purchasing power from inflation. For these investors we can source inflation-linked bonds and inflation-linked bank deposits which grow in line with inflation. These bonds and deposits can have both their interest rate and capital value adjusted to the Consumer Price Index, which is a quarterly measure of inflation in Australia.

Income Investing

Investors seeking income are primarily interested in generating a *higher* income and are prepared to accept short-term fluctuation in the capital value of their investments, as they usually have a longer time horizon, with no requirements to sell. Income-seeking investors may also be interested in trying to maximise their after-tax income and ensure that their income grows with inflation and as their living expenses grow.

However, income-based investing cannot just be focused on income generation. Capital preservation should also be taken into account in selecting the mix of investments. We often see less sophisticated investors gravitate towards investments promoting very high rates of interest income without fully understanding the risks that they are taking and the higher risk of a capital loss at a later date. That's why it is also important to have a diversified range of different income-producing investments.

Some of the best income-generating investments at the moment are corporate and high-yield bonds and corporate loans. These are bonds and loans to companies which may be rated either investment grade or lower (that is, speculative grade) by the major credit ratings agencies. With lower-rated securities it is very important to have a large number of securities so if one company runs into financial troubles, potential investor losses are minimised.

Within this corporate bond and loan category, we encourage investors to consider investing internationally on a currency-hedged basis (so that currency changes don't impact the value of the investment). This is because international investment provides a much larger number of bonds and loans outstanding, compared with the number available in Australia.

Other income-generating investments include high-yielding shares and commercial property. Shares which have been popular for their high dividends include banks, telecommunications companies, food retailers, property securities as well as utilities and infrastructure companies. Many of these companies have stable earnings, which means their dividends tend to be relatively stable and grow with inflation, for example as food prices, phone and utilities bills increase.

However, the global financial crisis reminds us that companies with stable earnings and high levels of debt, such as banks and some listed property and infrastructure companies, can also suffer in a financial crisis and often dividends must be cut to help such companies survive.

Investment Strategy

Objective-based investment strategies (continued)

Another income-generating investment we can include in client portfolios is unlisted commercial property. This gives investors exposure to rental income from office, retail or industrial properties and rents tend to increase over time with inflation and can often have tax deferral benefits. Unlike listed property, the value of the unlisted investment tends to only fluctuate with changes in the valuation of the building rather than stock market moves, although investors are generally locked into the investment until the properties can be sold, which for investors with a longer term time horizon may be acceptable for a portion of the portfolio.

Capital growth investing

For investors with a long term investment horizon, (for example, 10 years or more), interested in growing the value of their capital, we will generally recommend higher growth investments. These include some share and property types and alternative investments. Generally, such investments don't provide much income, as any income generated is usually reinvested or used to reduce debt, which in turn increases the future capital value of the investment.

Within this category, certain types of listed shares can provide strong capital growth over the longer term. For example, smaller companies, technology and biotechnology, emerging markets, companies in cyclical industries such as resources, media and airlines can, at different times in the business cycle, be attractive high growth investments.

Certain types of property investment are also attractive as a source of potential long-term capital growth. For example, many investors borrow to invest in residential property which means they have "negative income" from the investment but enjoy magnified capital gains on their property if it rises in value over time. Other property investment strategies such as property development, land ownership and property repositioning or renovation, are growth strategies which don't necessarily generate income but can provide attractive capital gains over long term time horizons.

Alternative investments that offer attractive growth potential (and which we recommend) for long-term investors include venture capital, private equity, hedge funds, commodities and collectible investments. Venture capital and private equity are shares in unlisted companies that offer high levels of earnings growth because the businesses are either high growth technology businesses or more mature businesses purchased with significant amounts of debt funding.

Hedge funds, similarly, usually do not pay income, but generally reinvest capital, so investors enjoy the benefits of compound returns over many years. Finally, commodities and collectibles, such as gold bullion or works of art, can provide long term capital growth potential at certain times. Although they don't generate income, over longer time frames such assets can rise in value and keep pace with inflation.

Conclusion

So, as we can see in the example of the $10 million portfolio (see table right), different investment types can be used to meet different investment objectives an investor may have. In this example, the investor has created three "sub-portfolios" with different levels of risk, expected return and time horizons. Each sub-portfolio is designed to meet specific objectives and performance against these objectives is monitored over time. However, this portfolio construction process is different in its design and construction to a traditional balanced or conservative portfolio, the latter of which may be designed more around the investor's maximum risk tolerance, not on meeting specific objectives and tracking performance against those objectives over time.

By Nick Ryder, NAB Private Wealth, Investment Strategist

Portfolio $10 million

Objective / Sub-portfolio	Capital Preservation	Income Generation	Capital Growth
Investment	$3 million	$5 million	$2 million
Time horizon	24 months	5 years	10-15 years
Investments	• Cash and term deposits • AAA-rated short term government bonds	• Portfolio of corporate bonds and hybrid securities • Portfolio of ASX-listed high yield shares • Unlisted commercial property funds • International high yield bond and loan fund (hedged into Australian Dollars)	• Portfolio of international shares in the technology and healthcare sectors • Private equity funds • Hedge funds • Property development fund
Expected annual return	3% or $90,000	6% or $300,000	12% or $240,000
Expected risk	Very low	Medium	Very High

Blended return	6.3% or $630,000
Blended risk	Medium