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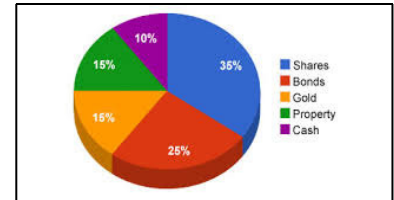
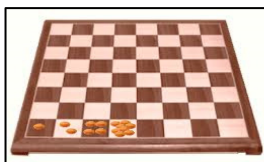
ASSET ALLOCATION – The Why and How:



Asset Allocation can be defined as an investment technique that attempts to balance risk vs reward by adjusting the percentage of each asset class (shares, property, bonds, cash and/or alternatives) in an investment portfolio according to an investor's tolerance, goals and investment time frame. Each asset class has different levels of return and risk, so each behave differently in varying market cycles. Diversification is the most powerful portfolio construction tool we know of – the blending of different asset classes together allows you to benefit from the returns they generate but they will also partly offset each other's risks. Unfortunately, there is no simple formula to find the right asset allocation for each individual investor. However, there are 3 important points that assist us when putting together an investment proposal for our clients:

1. **Risk vs Reward** – This trade-off is at the core of what asset allocation is all about. A well-diversified portfolio can be constructed by blending together Growth, Defensive and Uncorrelated assets. This will result in a superior trade-off between risk and reward over time. If as an investor, you have a higher risk tolerance then more of your funds should be allocated to Growth assets however, if are unable to stay invested through short-term fluctuations / bear markets, then you should have a higher allocation to more Defensive assets.
2. **Objective of the Investment** – We all have our own financial goals, whether long or short-term and depending on what these are, will help determine the asset allocation and ensure it is correctly aligned to attain these goals. An individual who is saving for retirement in 35 years' time will be able to withstand short-term volatility in the equity market but someone saving for a child's education in 5 years, will need to have a higher weighting to 'safer' asset classes such as bonds or cash.
3. **Time** – We often talk about the value of time in investing, but it is difficult to really understand the rewards that can be reaped though compound growth - earning interest today, on interest earned yesterday and so forth. The power of exponential growth is demonstrated by the rice and chessboard story. A King in India offered to reward a wise sage who invented the game of chess with any gift he wished. The sage asked to be paid in grains of rice. The King was to put a single grain of rice on the first chess square and double it every subsequent square. The King agreed and he started placing the rice grains on the board, according to the arrangement: One grain on the first square, two on the second, four on the third, eight on the fourth and so on. The King soon realised that he would be unable to fulfil his promise. By the 20th square he would have to place just over 1 000 000 grains of rice. This meant that the King would have had to place more than 380 billion tons on the last square. That is 500 times this year's global rice production!!! The sooner and the longer you are able to invest, the better!



The ZAR is currently weaker than it has been for some time, local equities are looking expensive and there are crises unfolding in different corners of the globe. It is no surprise that investors are confused about when and where to invest their money. Although it is impossible to accurately predict what will happen next in the markets, what is known is that clients who have started early and let their investments grow, have performed better than those that kept putting investing off hoping that market conditions will improve. For most of us, procrastination is the enemy. Market movements tend to smooth out over time and reward long-term investors. Time in the market is crucial if you truly want to benefit from the wonders of compounding.

SUMMARISING 2015 – Preparing ourselves for what may lie ahead:

As we all know, 2015 has not been an easy year and we have experienced lots of volatility and uncertainty across the globe. This volatility has been centred on the likelihood of the US Federal Reserve increasing interest rates before the end of the year and a structural slowdown in Chinese growth, as they shift to a more consumer-driven economy. The Federal Reserve should be relatively unique in raising interest rates with the US economy at a more advanced stage of the cycle, but weakness elsewhere and an absence of inflation, will allow US policy tightening to be very gradual.

This past decade, particularly in a local context, has been a Golden Era for investors with virtually every asset class providing real returns – meaning that all returns have exceeded inflation and thereby maintaining the real value of money. The expectation of double digit returns has now become the norm for many fund managers and investors alike. Over the last year, momentum investors have been able to ride the wave, while those with a more value bias have had an almost impossible task of keeping up with the high performers. These phenomenal returns have been supported by Central Banks in most developed economies, flooding markets with money to prevent recessions and avoiding deflationary scares. In some major economies, it now *costs* the investor for the privilege of lending to governments. This is clearly not a sustainable situation. The outlook for developing economies is a concern as they contend with slower Chinese growth, less resource intensive demand and tighter financing and fiscal conditions. Although there is expected to be slower growth globally, developed economies will continue to grow at a reasonable pace and provide better opportunities than in the developing markets.

With all the negativity in the media and the expected lower returns going forward, we do think that it is imperative that we all sit tight and understand that the correct asset allocations and time in the markets will continue to provide investors with performance returns over the longer-term.

As we all prepare for the festive season, please note that our offices will close on **Tuesday, 22 December 2015** and will reopen on **Monday, 4 January 2016**. We take this opportunity to thank you for your continued support and to wish all our clients and their nearest and dearest a very blessed and happy holiday. We look forward to working with you in 2016.

As always, please don't hesitate to contact us for assistance.

Kind regards

Stacey Lancaster – end November 2015.
Finlaw Consulting

Sources: Investec (John Stopford); GrayIssue (No: 171); Moneyweb (Paul Jennings)