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### Diversification between asset classes

The answer is simple: if you put all your eggs in one basket, and something goes wrong, you might end up with a messy omelette. Put differently, a portfolio that consists of a **mix of different asset classes** will improve the risk and return profile of your investments.

#### What is an asset class?

Broadly speaking, an asset class is a category of financial assets that share certain characteristics, and that are tradable. Traditionally, the main asset classes are equities (shares), bonds, cash (money market) and property. Asset classes are often also split into local and international or offshore. Finally, there are the so-called alternative asset classes, such as private equity and hedge funds, which may or may not share characteristics with other asset classes.

#### Why is it important to diversify between asset classes?

Different asset classes tend to behave differently under different economic conditions, and their performance will tend to be uncorrelated to one another. Therefore, having a mix in asset classes acts as 'insurance' against changes in economic and market conditions. The size of each asset class in the portfolio can be adjusted to make the most of the prevailing economic environment. This is called 'asset allocation', and is used to great effect by asset managers to improve returns and reduce risks (see box to right).

For instance, in an environment where inflation and interest rates are high, cash will perform well. Bonds perform poorly when expectations are that future inflation will be high. Equities will perform well when the outlook for growth in corporate profits is good, and this is often when interest rates are low. Similarly, property performs in low interest rate environments.

#### Importance of asset allocation:

The consensus among most financial professionals is that asset allocation is one of the most important decisions that investors make. In other words, your selection of individual investments is secondary to the way you allocate your investment in equities (shares), bonds, cash, property and alternatives, which will be the principal determinant of your investment results.

*(Investopedia)*

## Isn't this all just theory? Show me the numbers!

The table below ranks the performance of various asset classes over 1, 3 and 5 years.

Rank	One Year	Three Years	Five Years
1	Inflation	Equities	Equities
2	Cash	International	Property
3	Equities	Property	International
4	International	Cash	Cash
5	Bonds	Inflation	Bonds
6	Property	Bonds	Inflation

Source: Fairbairn Capital Investment Intelligence, Inet. As at June 2008

We can draw three key lessons from this picture:

- Over different periods, different asset classes outperform.
- Over the past year none of the asset classes beat inflation, which, according to StatsSA, is now running at record levels (CPIX for August 2008 was 13.6% year-on-year).
- Equities perform better over the longer term, and are the best option for beating long-term inflation.

Clearly, a combination of all these asset classes will improve the risk/return profile of a portfolio.

## Should an investor look to diversify his investments between asset classes in all market conditions?

The inherent differences in nature of various asset classes means it is a good idea to combine them in a portfolio regardless of economic and market conditions. Giving a greater weight to equities and listed property (in a more aggressive fund) will increase the volatility of the portfolio. Adding bonds and cash will provide stability. On the other end of the spectrum, a conservative portfolio with mostly cash will reduce volatility considerably, but will not offer great capital growth prospects in the longer term. Lastly, adding offshore exposure will reduce the risk posed by a weakening currency.

## **What funds does Fairbairn Capital provide to assist in constructing a portfolio that is diversified between asset classes?**

Fairbairn Capital offers a wide range of funds from asset managers across the industry. These include funds with an investment mandate that ensures a balanced exposure to the main different asset classes in a single fund. These funds form an ideal core for many investors around which they can construct their investment portfolios. Examples of such funds available on Investment Frontiers and Galaxy include, inter alia, the range of Smoothed Bonus funds (e.g. Absolute Smooth Growth Portfolio and Smoothed Performance Fund), the Symmetry Balanced Fund of Funds, the Old Mutual Balanced Fund and the Allan Gray Balanced Fund.

In addition to these balanced mandate funds, Fairbairn Capital also provides a wide range of funds with exposure to each of the respective major asset classes - equities, bonds, property, cash and alternative assets (such as private equity) - including those that specialise in particular sectors within an asset class, such as equity funds focusing on the Mining & Resources sector.

For more information on all the funds, visit the Fairbairn Capital website at [www.fairbairncapital.com](http://www.fairbairncapital.com).

**Over the next two weeks we unpack another two ways that clients can diversify their investment portfolios using the range of solutions available on Fairbairn Capital.**