

Spreading your investments around, or diversifying, is one of the best ways of reducing investment risk and improving your chances of achieving a more consistent investment return.

Time, not timing

History shows that many investors try to 'time' their investments into the strongest performing asset class of any given period. However, determining the right time to buy and sell requires as much good luck as good judgement.

More often than not, 'market timers' sell when a market is low and are out of the market when the inevitable rally occurs. Short-term investors may also trigger capital gains tax when they sell an asset, and incur costs such as brokerage on their transactions.



Table 1 – Investing in the previous year's best performing asset class

Dec-86	Australian Shares	\$100,000
Dec-87	Australian Bonds	\$92,145
Dec-88	Australian Shares	\$100,800
Dec-89	International Shares	\$118,340
Dec-90	Australian Bonds	\$101,083
Dec-91	Australian Shares	\$126,098
Dec-92	Australian Bonds	\$123,182
Dec-93	Australian Shares	\$143,288
Dec-94	Australian Cash	\$130,864
Dec-95	International Shares	\$141,376
Dec 96	Australian Shares	\$150,862
Dec-97	International Shares	\$169,309
Dec-98	International Shares	\$224,875
Dec-99	International Shares	\$264,384
Dec-00	Australian Listed Property	\$270,956
Dec-01	Australian Listed Property	\$311,155
Dec-02	Australian Listed Property	\$347,895
Dec-03	Australian Shares	\$378,551
Dec-04	Australian Listed Property	\$482,910
Dec-05	Australian Shares	\$544,229
Dec-06	Australian Listed Property	\$680,098

Source: Datastream
Asset class indicates highest return for that year, the next year's investment.

Table 2 – Investing in the previous year's worst performing asset class

Dec-86	Australian Bonds	\$100,000
Dec-87	Australian Shares	\$114,972
Dec-88	International Shares	\$135,525
Dec-89	Australian Listed Property	\$172,066
Dec-90	Australian Shares	\$187,033
Dec-91	Australian Bonds	\$251,069
Dec-92	Australian Shares	\$268,443
Dec-93	Australian Bonds	\$390,214
Dec-94	Australian Shares	\$411,136
Dec-95	Australian Bonds	\$494,136
Dec 96	International Shares	\$531,529
Dec-97	Australian Bonds	\$755,765
Dec-98	Australian Bonds	\$794,619
Dec-99	Australian Listed Property	\$834,417
Dec-00	International Shares	\$984,631
Dec-01	International Shares	\$889,639
Dec-02	International Shares	\$648,233
Dec-03	International Shares	\$646,359
Dec-04	Australian Bonds	\$713,755
Dec-05	Australian Bonds	\$754,734
Dec-06	Australian Cash	\$800,180

Source: Datastream
Asset class indicates lowest return for that year, the next year's investment.

Poor market timing can reduce returns

Table 1 shows how \$100,000 would have increased in value over a 20-year period, had you invested each year in the best performing asset class of the previous 12 months. That is, had you invested \$100,000 in December 1986 in the best performing asset class of the previous 12 months (Australian shares). At the end of 1987, you withdrew your money (it's now worth \$92,145) and reinvested in the best asset class of 1987, which was Australian bonds, and so on.

Using this strategy, after 20 years, your \$100,000 investment would be worth \$680,098.

In contrast, Table 2 shows the result of investing \$100,000 each year in the previous year's worst performing asset class. Using this strategy, your initial \$100,000 investment would be worth \$800,180 after 20 years.

This highlights the greatest risk in attempting to time markets. One year's best performing asset class can easily become the next year's worst. Few investors can accurately predict movements in various markets.

The need to diversify

A far more sensible strategy is to invest in a range of asset classes and not panic if one particular market falls. As we've illustrated, timing your investments is not usually a sound investment strategy. A much better strategy is to diversify your money across a range of asset classes and to ride out the performance troughs in each market. By placing your money in a number of asset classes, the good returns you receive from one investment in a certain time period can help offset the poor performance of another.

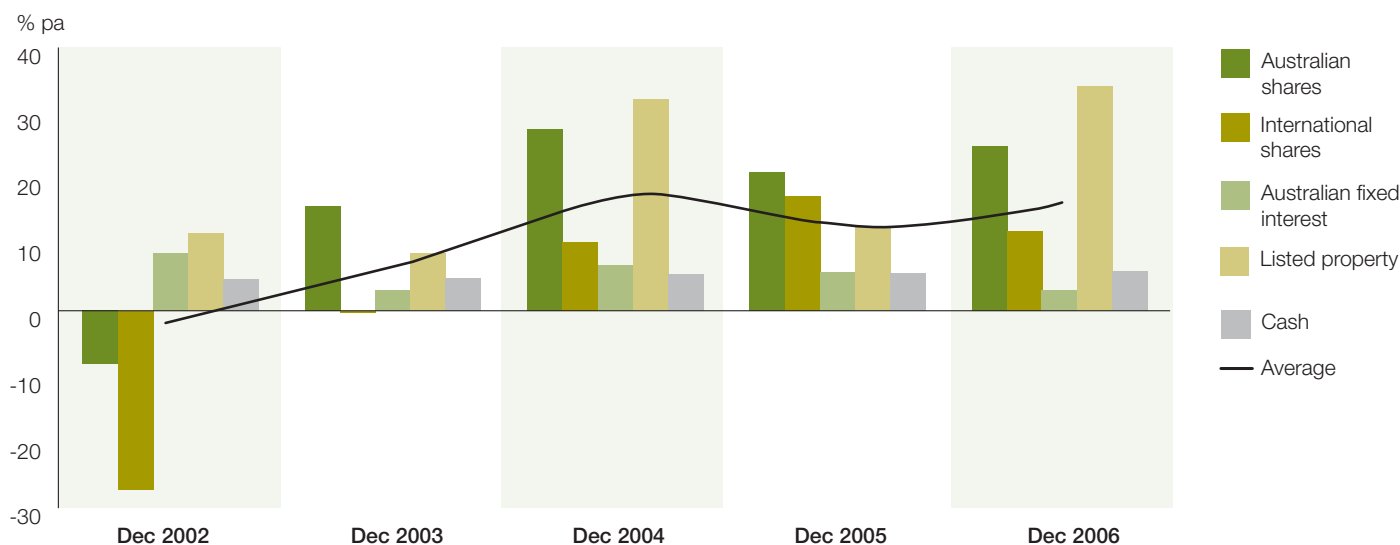
Chart 1 shows the performance of a range of asset classes over the past five years. While the performance of each asset class has varied widely, the average return (represented by the black line) provided a much smoother return.

Consider a savings plan

Making regular investments by way of a savings plan is another way to reduce the risk of market timing. If you are unsure when to invest, whether it's now or later, the 'drip feed' approach ensures you are always in the market. A fortnightly, monthly or quarterly investment allows you to build your investment progressively.

Chart 1 — Annual asset class performance

Diversification can provide a much smoother ride



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