INVESTMENT REPORT

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ASSET CLASS SELECTION DRIVES INVESTMENT SUCCESS

By Arin Ruttenberg, financial advisor at Brenthurst Wealth Sandton

Many investors are searching for the one thing that will deliver investment success. The best place to start and arguably the most important investment rule is this – asset allocation. As coined by investor David Swensen: "Overwhelmingly, the most important is asset allocation" he said. "It actually explains more than a hundred percent of returns in the investment world."

Asset allocation is more than diversification. It means dividing up your capital among different classes, or types, of investments (such as stocks/equity, bonds, commodities, property and even Bitcoin) and in specific proportions that you decide in advance, according to your goals or needs, risk tolerance, and stage of life. Although different goals may have different asset allocations e.g. cash for emergencies or equity for a long-term wealth plan, an entire portfolio from retirement funds, tax free savings accounts (TFSA's), discretionary investments to physical properties should be looked at as a whole to make sense of an overall asset allocation strategy.

Harry Markowitz, the Nobel Prize–winning father of modern portfolio theory famously said: **"Diversification is the only free lunch."** This is because spreading capital across different instruments or asset classes decreases risk, increases upside returns over time, and does not cost anything. The trick is sticking to the overall asset allocation plan and not deviating from it.

DIVERSIFICATION VS ASSET ALLOCATION:

Diversification means spreading capital among different asset classes, whereas asset allocation refers to the percentage allocated to each asset class.

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"Determining your portfolio's ideal asset allocation is not a once off process. It is important to regularly make sure your asset allocation reflects your current financial situation, time horizon and risk tolerance. If this is something you struggle with, it may be worth considering the help of a professional."

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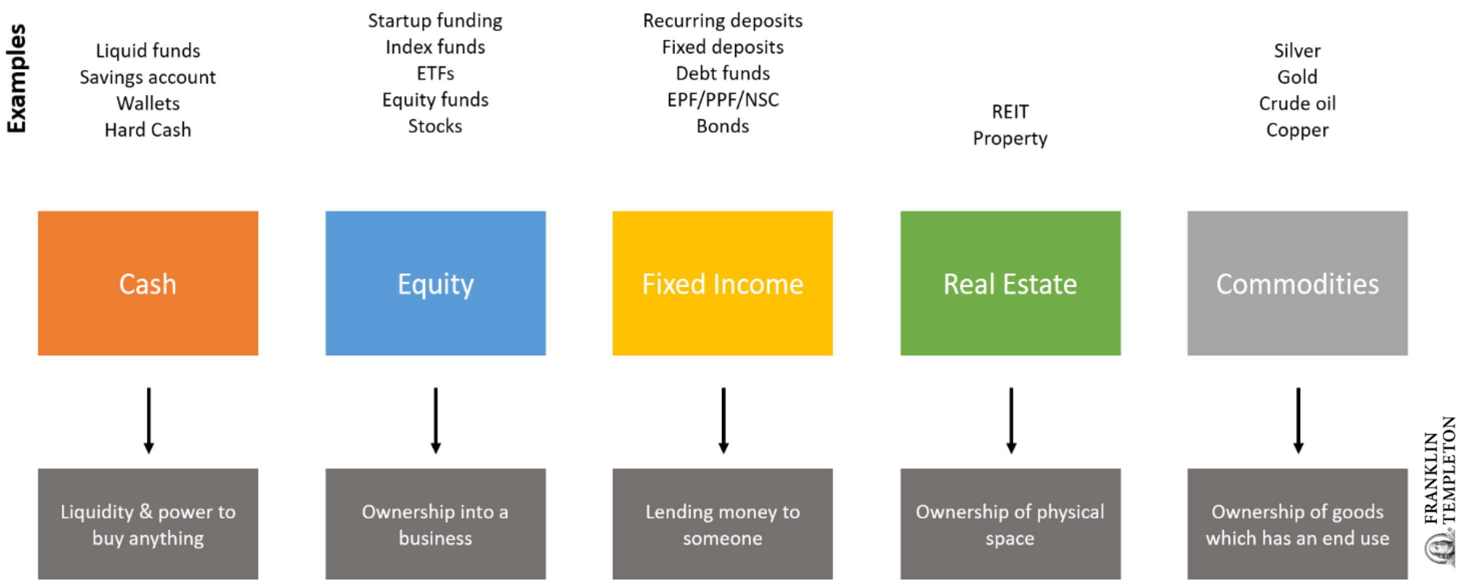
We have all heard the old saying "Don't put all your eggs in one basket." Asset allocation protects you from making that financial mistake.

Sounds easy but I know people who have violated this by investing all their capital into South African listed property, put most of their capital in Steinhoff as well as a couple who have invested most of their capital over many years into but-to-let properties (and have had faced many challenges over the past 10 years).

In all three scenarios the different asset classes behave differently at different times. To make smart choices it is important to understand the purpose of each asset class and its behaviour during different times in the market cycle, in order to make smarter financial decisions depending on the investors' financial goals.

What is important to understand is that what goes up, must come down. This means during the investment lifetime there will be drops in the value of the investment (think about the market drama of 1987, 2000, 2008 and 2020.) Whilst the value of investments is designed to go up over time, this does not mean investing in one specific asset class is ideal.

TYPES OF ASSET CLASSES



THE THREE MAIN ASSET CLASSES - EQUITIES, FIXED INCOME, AND CASH AND CASH EQUIVALENTS - HAVE DIFFERENT LEVELS OF RISK AND RETURN, AND THUS EACH WILL BEHAVE DIFFERENTLY OVER TIME.

1. CASH/CASH EQUIVALENTS

At some time in our lives, every one of us will need a cushion to cover our needs in case of an emergency or a sudden loss of income. No matter your income level, you need some liquidity —or instant access to cash. It is possible to be rich in assets and feel poor because you do not have cash or liquidity.

A lot of people in the US were caught short in 2008 when the banks froze up and stopped lending (even to one another), and real estate seemed impossible to sell. This cash is also needed for short term needs such as day to day expenses and to cover for emergencies. The best places to save for this are in Bank accounts in liquid savings accounts, 32-day notice accounts or fixed deposits.

2. FIXED INCOME/BONDS

When you buy a bond, you are receiving a promise—to return your money with a specific rate of interest after a period of time (the maturity date). That is why bonds are called "fixed-income investments." The income - or return - you will get from them is fixed at the time you buy them, depending on the length of time you agree to hold them. And sometimes you can use those regular interest payments as income while the bond matures. There are many bonds, many of which are rated by various agencies according to their levels of risk, such as South African government bonds rated as below investment grade or ''junk'' thus offering a higher premium for more risk. Bonds can also be confusing- they increase in value when interest rates go down and decrease in value when rates go up. Who wants to buy my old low-interest-rate bond when a new bond with a higher interest rate comes on the market (hence the value of my bond decreases) and vice versa. One way to avoid worrying so much about price fluctuations in bonds is to diversify and buy into a low-cost bond index fund, Unit Trust.

3. EQUITY

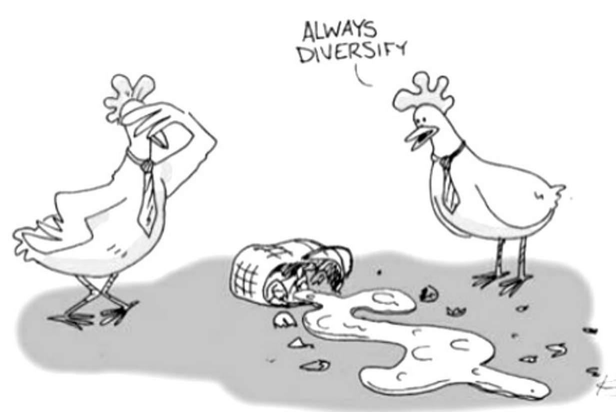
Equity or stocks are shares of ownership issued by companies. Equity has gained popularity over the last decade and can further be sub-categorized into small-cap funds, mid-cap funds, large-cap funds, large and mid-cap funds, dividend yield funds, thematic funds, quality funds, value funds, focused funds, sectoral funds to name a few.

4. PROPERTY/REAL ESTATE

Residential property as an investment to Real Estate Investment Trusts (REITS) that are companies which invest in different types of property locally and abroad such as Residential, office, commercial, malls, industrial all with the objective of trying to invest. This type of investment is more sensitive to changes in interest rates and an important part of any portfolio specifically those looking for income.

5. COMMODITIES

A commodity is a resource which is used in the economy. Examples include oil, gas, timber, gold and wool. Commodities are used by manufacturers as raw materials in their production processes. Like any good, the prices of commodities are set by the market, as a function of supply and demand. The prices will fluctuate due to changes in industrial demand, supply constraints or seasonality. Gold being the most popular in the investment universe is a very popular hedge against inflation and should be used as part of every portfolio. Bitcoin, not a commodity, interestingly enough is supposedly expected to be the longer-term replacement of gold. Whether this will be the case we will have to wait and see.



TYPES OF ASSET ALLOCATION:

There are a few types of asset allocation, but three that I would like to make specific mention of:

- **STRATEGIC ASSET ALLOCATION:** This is deciding on the allocations to each asset class with the goal of striking the optimal balance between risk and return. For a long-term investment this would imply trying to achieve the greatest return with the least amount of risk. A portfolio can be rebalanced annually in this case.

- **TACTICAL ASSET ALLOCATION:** Is a much more active approach of allocation to take advantage of current market movements, those with this type of strategy move in and out of positions more actively depending on market trends.

- My personal favourite, the **CORE-SATELLITE ASSET ALLOCATION STRATEGY** which uses a strategic asset allocation to make up the core of a portfolio with a tactical asset allocation to make up the satellite components such as using tech, biotech, healthcare, gold or Bitcoin.

CONCLUSION:

Regardless of whether you need a portfolio that is more concentrated in stocks or bonds, always consider diversifying within each asset class as well. For instance, if you are investing in stocks, you might want to hold some large-cap stocks, mid-cap stocks and small-cap stocks. You might also base your investment decisions on geography, holding both domestic and international stocks. Similarly, when it comes to fixed-income allocation, you might want to hold bonds of various maturities. All the above can be done either using a portfolio of low-cost index funds, active manager funds or in my preferred case, both.

Determining your portfolio's ideal asset allocation is not a once off process. It is important to regularly make sure your asset allocation reflects your current financial situation, time horizon and risk tolerance. If this is something you struggle with, it may be worth considering the help of a professional.

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