

q&a

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Q 1: Could you please say what you think about bank shares? I am about to collect my superannuation which I will take as pension (50%) and lump sum. I am anxious about what to do with the lump sum, and someone told me that bank shares might be better than fixed term deposits for this.

C.L., Holder

A 1: Your question raises a key discussion point for many people who look to invest their hard earned savings, whether within superannuation or outside of superannuation. While I would expect shares to get a better long term return than term deposits, there are additional risks involved. Here are some thoughts:

- 1) The common saying with investments is “to diversify.” This is important not only for reducing the volatility of your investment (movement up and down), but very importantly, it helps reduce the risk of permanent capital loss by your investment disappearing entirely.
- 2) The risk of permanent loss is real. Consider this – if you invested your lumpsum 100% in National Australia Bank (NAB) shares say, then the success of your investment hinges entirely on the performance of the NAB. IF NAB performs well (eg whether due to the economic environment or good management), share prices should rise. If they perform poorly, then share prices should drop. The real risk though is if NAB collapses then your entire investment could be gone!
- 3) While it is hard to imagine a large “blue chip” company collapsing entirely, this is exactly a “risk” of an investment. You may consider NAB collapsing a lower risk compared to a smaller company say (which is why a large established company can be called “Blue Chip”) but there is still a risk of it collapsing. Noone saw the 140 year old company Lehmann Brothers in the US collapsing either! And, there may well still be issues to come out for banks relating to their derivatives exposure.
- 4) To reduce the risk of your investment being lost due to a company collapse, you should spread the risk of your investment across more than 1 company. Statistically, you need at least 20 companies to achieve effective diversification. A managed fund however would spread your risk across 100 companies say. Investing in a number of managed funds can give you an investment across 500 companies. An index fund can give you diversification across thousands of companies.
- 5) Spreading your investment across many companies gives you a better chance of achieving a return OF your money first, before then a return ON your money.
- 6) Diversification across many companies is the first step, but you then also need to spread your risk across investment sectors, ie banks, retail, resources, etc as these sectors will perform differently in different economic environments.
- 7) You then need to diversify across asset classes, which means investing in property and emerging markets, fixed interest and cash, as again, these sectors will behave differently in different economic environments.
- 8) Going one step further, you should consider diversifying your investment globally aswell, as the Australia sharemarket for example, represents less than 2% of global production.

In short, there is a real risk of an individual company or investment (ie property development) collapsing. Diversification allows you to spread the risk of losing the investment entirely, and it also allows you to reduce the volatility of the investment. A good Certified Financial Planner will be able to assist you make appropriate investments to reduce these risks.

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