April 2013

rise financial

Weighing up the cost of not investing

Snapshot

“The risks of being out of the stock market are huge compared to the risks of being in it.”

That was the pearl of wisdom dispensed by the most iconic of successful investors, Warren Buffett, to the shareholders of his US-based Berkshire Hathaway company in March.

It is no surprise the man known as the ‘Oracle of Omaha’ would take this view, given that over time he has made a fortune from investing in companies that pay decent dividends and produce share price growth.

Buffett has stuck to his philosophy that there will be times when the opportunity cost of *not* investing in shares is too high to ignore. Indeed, many Australian investors are currently considering shifting their funds from low-interest, cash-based assets to equities in a bid to reap the higher yields from sharemarket returns.

Around the middle of last year, when it appeared a tentative recovery was underway in some parts of the world, the bear market began to give way to a bull run. This has seen some overseas sharemarkets rise significantly to near-record levels; the Dow Jones is just 3 per cent away from its peak and the London FTSE is about 8.5 per cent from scaling historical highs.

It is important to point out Australian shares are yet to reach anywhere near their pre-Global Financial Crisis (GFC) peaks. The Aussie ASX-200 has more than 40 per cent of wriggle room ahead before returning to pre-GFC levels. However if the last six months is anything to go by, it is making steady progress towards that milestone.

Companies in good shape

So why are listed companies on the Aussie sharemarket in good shape five years on from the GFC? The best companies have tidied up their balance sheets and focussed on running a lean operation. They have taken advantage of lower interest rates and more favourable lending terms.

In fact, recent analysis by the Australian Financial Review shows Australian company earnings, cash flow and profitability over the past six months is starkly superior to the period prior to the GFC in 2008.

Snapshot

Missing out on potential gains

One certainty when investing in shares is that their price will go up and down. And while volatility will always be a risk factor for sharemarket investors, recent experience and near-term indicators show the opportunity cost of completely avoiding equities may mean missing out on potentially attractive gains.

Let's compare the income returns of someone invested in bank bills versus the Australian sharemarket since stocks began the upward trend in early June 2012.

The one-year forward dividend yield for the Australian sharemarket is equivalent to 6.8[1] per cent, well above the current 90-day Bank Bill rate of 3.2 per cent, 12-month term deposit rates of less than 4.5 per cent and the 10-year bond yield of 3.2 per cent.

Now let's take into account total return, not just income yield (dividends plus share price growth or loss). An investor with $100,000 in bank bills would be just $2,600 ahead of where they started if they invested in June 2012, based on the UBS Australian Bank Bill Index.

In comparison, $100,000 invested in Australian shares back in June could have accrued an extra 31 per cent in value, or $31,000 based on the gains in the S&P/ASX All Ordinaries Accumulation Index.

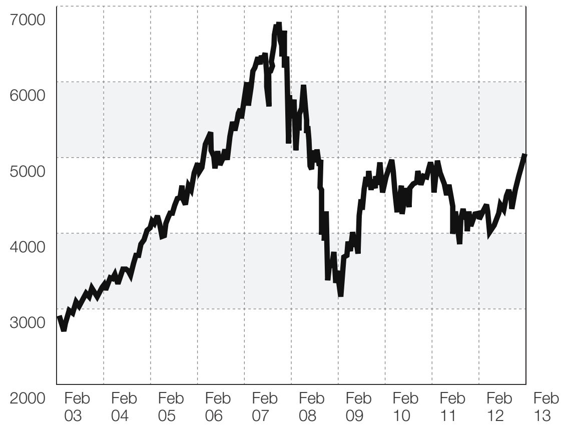
Weighing up risk and reward

There's no doubt investing in equities is a long term game. For anyone thinking about their asset allocation, it's important to consider how comfortable you are with short term risk and the inevitable share price fluctuations.

Just last month saw risks from the faltering euro zone weigh heavily on the sharemarket rally when the €10 billion Cyprus bailout was announced. Investors became concerned about new issues surfacing in debt-laden Europe and the S&P/ASX200 Index declined over the following days.

The following chart illustrates the performance of the S&P/ASX200 over the past decade. As you can see, returns are by no means guaranteed, and losses can be incurred for substantial periods before they are reversed.

Australian Stock Market (S&P/ASX 200)



Source: www.tradingeconomics.com

For some people the opportunity cost may be too high to ignore, yet for others the risks may outweigh the potential for returns.

Of course, past investment performance is not always a guarantee of future performance. But, together with near-term indicators, it can help to inform your decisions about where to invest.

If you would like to discuss your asset allocation, please do not hesitate to call us today.

[1] This figure is pre-tax and includes franking credits
*Figures in this article are as at mid-March 2013

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