

Insights

Tools for sound decision making

August 2008

In this issue

Why now isn't the right time for you to switch to cash.

The old Wall Street saying goes,
"the market will always act in such
a way as to frustrate the greatest
number of investors. Just when you
think it's going to zig, it zags."

So, switching your investments to
cash now means you may miss the
benefits of the market upswing.



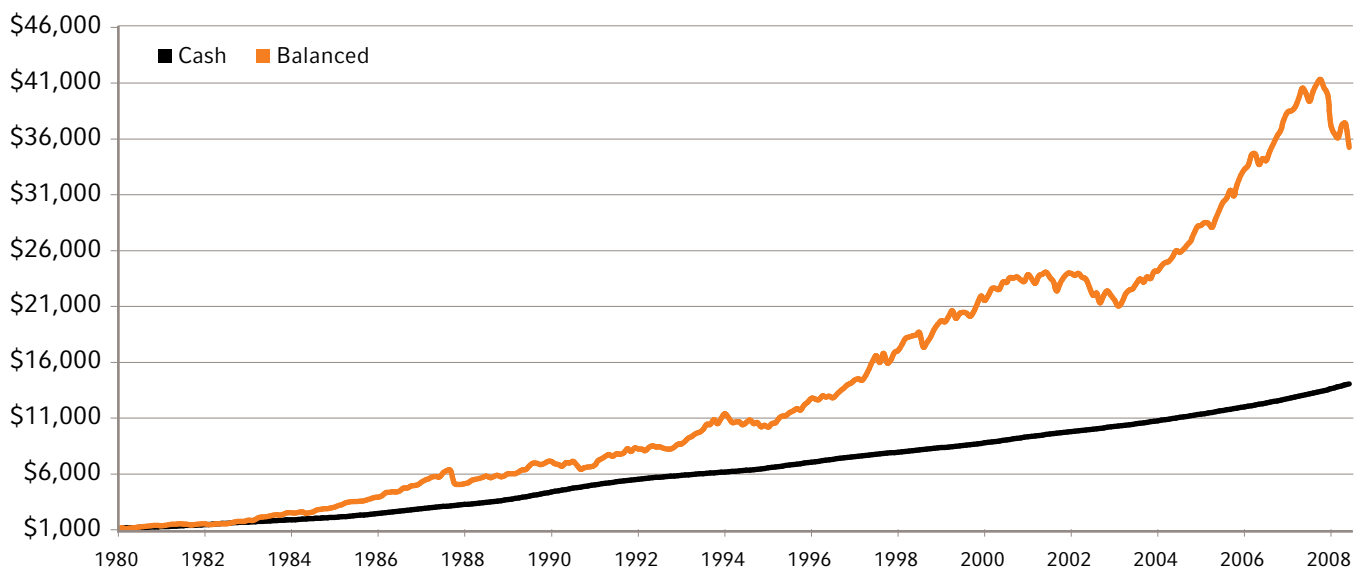
Synopsis

With the current market turbulence, many investors have asked the question, “why don’t I just switch to cash?” In this issue of Insights, Russell Investments gives a perspective on why cash may not be such an attractive option, particularly in times of market volatility.

Recent market turmoil has attracted much media attention of late, with finance company collapses, sub-prime contagion, share market downturns and volatility all seeing time in the spotlight.

Having witnessed these events, or been directly affected by them, some investors have asked, “things appear too risky at the moment, why don’t I just switch to cash?” This is certainly a fair enough question. With the current Cash Rate at 7.25%, the certainty of this return appears very attractive relative to the scenarios being projected for global share markets by many public and media commentators. However, by their very nature, the financial markets are unpredictable and there are a number of sound reasons why switching your investments to cash is not the sustainable option.

Figure 1: Growth of \$1,000 (1980 – 30 June 2008) Cash vs. Balanced Fund



Source: Russell Investments; Australian Shares: S&P/ASX 300 Accum Index, ASX All Ordinaries Accum Index prior to 31 March 2000; Balanced/70% Growth Portfolio Consists of: 32% Australian Shares, 25% Australian Bonds, 5% Cash, 15% International Shares, 15% International Shares \$A Hedged, 8% Property Securities

Putting all your eggs in one basket - a single bet

A balanced investment portfolio typically consists of an allocation to shares, bonds and cash in an allocation where the risk and return objectives meet those of the investor. The investments within these allocations should be well-diversified across differing investment managers, sectors and countries to reduce risk. An overweight to cash (or indeed a 100% allocation to cash) represents a single bet that cash will outperform the balanced portfolio and there are risks associated with this. With a 100% cash position, the risk comes in the form of an opportunity cost. If other sectors (shares or bonds) perform better, the investor will have missed out.

Figure 1 shows the performance of a balanced investor versus cash only over a 20 year time horizon. At the end of the 20 years, the original investment of \$20,000 returned under \$100,000 if remained invested in cash. But if the investor stuck

with their balanced portfolio the investment would be worth over \$150,000. Of course staying the course in turbulent times is easier said than done.

No potential for upside

An all cash investment does not have the upside of diversification that a more balanced portfolio does. Shares are riskier than cash but over long term investment horizons, shares have historically outperformed cash assets and investors have been rewarded for taking on the extra risk. In addition, the high returns associated with shares come over very short periods.

For example, if you invested \$1,000 in Australian shares in 1980, your investment would have been worth \$40,384 at the end of the 2008 financial year. If you'd kept that investment in cash, it would have only been worth \$10,451. Your shares investment would have seen many more ups and downs, but over the long term, your shares would be worth a great deal more than if you'd kept your money as cash.

There would be a very real risk of missing the good months – those with high returns – if an investor were trying to guess which way the markets were going by swapping out of shares into cash.

Getting back into the market

A further difficulty is that once a decision has been taken to swap out of the market into cash, then at some later stage another decision must logically be taken to swap back into the market. How is this to be decided? What should the trigger be?

History shows us that the greatest market downswings are followed by great market rallies. If your investment strategy was to switch to cash after a downswing, you wouldn't be able to benefit from the upswing.

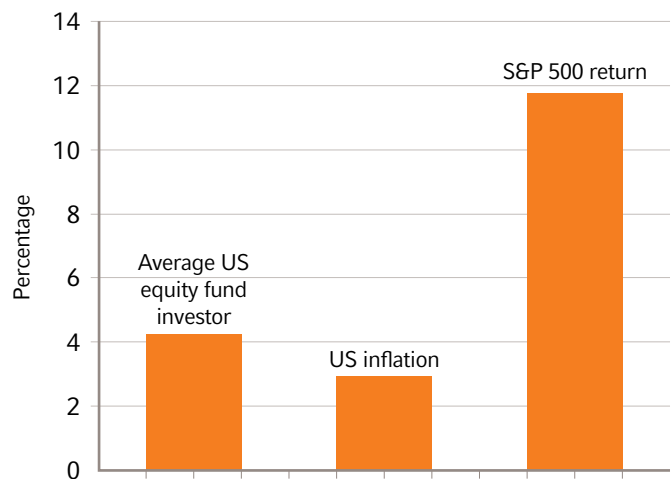
Staying in the market is critical to investment returns. After all, you can't benefit from market returns if you are not in the market. While we would all like to avoid market down turns, very few investors do successfully.

The tendency of investors to make short term decisions about their investments has a direct impact on their returns. This is evidenced in the chart below which shows that the average US equity fund investor underperformed the S&P 500 index by a staggering 7.5%. The figures are based on the findings by the 2007 Dalbar survey.

Why did US equity investors perform so poorly in relation to the index? The Dalbar survey found it was because these investors made poor decisions about cashing up or buying into differing asset classes. The result was a potential reduction in their returns by as much as two-thirds.

What the Dalbar survey suggests is that investors make decisions based on feelings rather than sound formal analysis. Many investors tend to buy at the top of the market and sell at the bottom.

Average annual return over 20 years to 2007



The long term view is best

In summary, cash may seem like a good investment choice right now relative to a balanced or growth portfolio, yet by not taking a long-term view of the market, investors may miss out on valuable returns.

With the guidance of your financial adviser, design a plan that outlines your financial objectives, while taking into consideration your timeframes and your risk tolerance. Once this is in place, resist tendencies to vary from plan and remember to measure success according to meeting your objectives.

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