INVEST FOR INCOME

Risk tolerance determines return

STORY BEN GRAHAM

In building a low-risk income portfolio, it's easy to get caught up with the returns while ignoring risk. My advice would be to spend your time understanding the risks and choose your return based on how much risk you are comfortable with.

Over the years we have seen countless failures in products marketed as "low-risk" (property developer Westpoint Corporation, debenture issuer Australian Capital Reserve, etc). The mums and dads who invested in such assets were looking for safe, low-risk investments with regular income; however, what they got were high-risk, complicated products that had a high chance of failure. Had they understood the risks, they would almost certainly not have invested.

Fortunately, the basics of understanding risk are relatively simple and it all starts with something called the "risk-free" rate. This is the rate of a return you can get with zero risk. The most widely accepted rate used is the 10-year bond rate and in Australia that currently sits at a paltry 2.4% a year.

Unfortunately for low-risk income investors, the risk-free rate is about as low as it has ever been. And if you think Australia's 2.4%pa is low, spare a thought for investors in Japan (-0.007%pa in mid-February) and Switzerland (-0.35%pa), where investors are paying these countries to hold their money!

The next thing to understand is risk premium – the return above the risk-free rate that compensates you for the extra risk. Typically the higher the return, the riskier the investment is. I have broken my recommendation into two sections: lower-risk income assets and higher-risk growth assets.

Income assets

Cash, term deposits, government bonds. "Something for nothing" - these are words you will almost never hear in investing but for small investors it is a reality. Currently you can get a six-month term deposit at a rate of just over 3%pa and yet the equivalent government-guaranteed 180-day bank bill is closer to the Reserve Bank cash rate of 2%pa. But because deposits under $250,000 are guaranteed by the federal government, you are effectively taking on the same risk but earning a nice premium.

Corporate bonds. These typically have a higher yield than government bonds. Diversification is key in this space and I don't mean five or 10 bonds – I mean 200. With a share portfolio of, say, 30 stocks, it is likely you will have some big winners that double, triple or more but others that fall or even fail – the winners can offset your losers.

However, a bond is different. The best result is getting your money back with interest but the worst is still losing everything. As an example, take a 10-bond portfolio that yields 5%. If just one fails, your return will be -5.5%. Given your best result was 5% and the risk-free rate is 2.4%, this is not a great result for getting only one wrong.

Hybrids. As the name suggests, these are a mix between debt (bonds) and equity (shares) so they technically don't belong in either category. They typically pay two to three times bank interest but there is a catch.

Like bonds, a successful hybrid will give you what it said it would and no more but, unlike bonds, there can be a lot of complicated provisions such as converting your hybrids to ordinary shares if things get dicey – which means you will own shares just when you don't want to own shares. In short, hybrids often capture the downside risk of shares without the upside potential – this is the reason the returns are two to three times that of bank interest.

Recommendation. I am recommending that 55% of the portfolio be put into term deposits. Corporate bonds and hybrids can be very volatile. During the GFC, falls of greater than 50% were commonplace for even quality-name bonds such as Commonwealth Bank's. I don't think either hybrids or corporate bonds represent compelling value at the moment.

Growth assets

Shares, property and infrastructure. Growth investors seeking income are attracted to Australian shares. Our dividends are high and our franking system further enhances returns. However, our market is highly concentrated. As such I think it's prudent to have some international exposure for diversification purposes, despite the lower income on offer. On a valuation basis, I think property looks slightly better than infrastructure.

Recommendation. Given the very conservative nature of the income portfolio, I am comfortable with the remaining 45% to be in shares and property. I have chosen the Vanguard Property ETF, the listed investment company (LIC) QV Equities Limited and the listed, unhedged Magellan Global fund for my property, Australian share and international share exposure respectively. Historically the Magellan fund has had lower downside volatility than the market and, although QV Equities is new, it's run by well-regarded value managers Investors Mutual, so I would expect the same here as well.

Ben Graham, CFP and FPA member, is principal and financial adviser at Graham Financial, an independently owned boutique financial planning practice based in Toowoomba. grahamfin.com.au.

It's prudent to have **some international exposure** for diversification

GRAHAM FINANCIAL 'LOW RISK' INCOME PORTFOLIO

ASSET	PROPN OF PORTFOLIO	INVESTMENT	MANAGEMENT FEE		PERF FEE	INCOME (INCL FRANKING)	
UBank 6/12 Month Term Deposit	55%	$27,500	none	none	none	3.05%	$839
Vanguard Australia Property Securities Index ETF (VAP)	6%	$3000	0.25%	$8	none	6.00%	$180
QV Equities Limited (QVE)	20%	$10,000	0.86%	$86	none	6.50%	$650
Magellan Global Equities (MGE)	19%	$9500	1.35%	$128	10%	5.00%	$475
		$50,000	0.44%	$222		4.29%	$2144

HOW TO ADAPT IT

Because smaller portfolios suffer more in percentage terms from trading costs, I would exclude the Vanguard property ETF from this portfolio if you had only $20,000 to invest. To keep the same ratio between growth and income assets, I would transfer this exposure to Australian and international shares.

The biggest advantage of larger portfolios is investment choice; most funds have a minimum investment amount of $20,000-plus. So for $100,000, I would replace QV Equities with the Antares Dividend Builder separately managed account (SMA) as its management specifically targets stock selection for tax-effective income.

There are some tax benefits with SMAs over funds; however, the primary reason for this selection is cost. The SMA is 0.14% cheaper than the equivalent fund.

While there are many positive attributes to listed investment companies, the largest negative is the premiums and discounts to net tangible assets (NTA) that can exist.

An example of this is Djerriwarrh, which trades at a 39% premium to its post-tax NTA, and PM Capital Asian Opportunities, which trades at a 13% discount. Buying LICs with large premiums or selling at large discounts is hard to recommend. Funds and SMAs by design will always track their NTA and hence are my preferred option if available.