Smart Money Market turmoil

How to protect your capital

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It would be safe and sound from Greek debt woes, or downgrades in the US credit rating.

But ipac did the calculations. Assuming an inflation rate of 2.75 per cent, $500,000 cash under the mattress would be worth the equivalent of $381,199 in 10 years' time.

In 20 years, its purchasing power would deteriorate even further to the equivalent of $290,625 today.

If the same $500,000 was invested in cash through super and earned 5.25 per cent a year, the result would have the desired impact of preserving the capital – assuming the interest rate did not fall in that period. But the cash would be worth $589,869 in today's dollars, after taking into account the 15 per cent tax rate applied to earnings on super investments.

After 20 years, you would have today's equivalent of $695,892. All these calculations assume you withdraw no money at all from the account.

So is there a better strategy for preserving capital?

"We encourage people to think that it does not have to be all or nothing," Dani says.

"Reallocating a portion of their balance to cash will give them some comfort but when the market does recover they won't miss out on the growth entirely."

If the same $500,000 super account was invested in a balanced portfolio expected to return an average 7 per cent per annum over 15 years – including a few bad years in that period – it should, in theory, be worth today's equivalent of $679,456 in a decade.

After 15 years, it should be worth $792,058 and after 20 years, $923,321 in today's dollars.

A balanced portfolio invests the majority of assets in shares, but also includes other assets such as cash and fixed interest to stabilise performance. Such a portfolio, on average, is expected to generate a higher return than investment options that are often considered more suitable for retirees.

Still, the theoretical numbers above might be cold comfort to people who witnessed a 20 per cent decline in the value of their assets from the market peak recorded prior to the global financial crisis.

Someone in that position who previously had $500,000, now has only $400,000, so the result in 15 years' time will be comparatively disappointing. Assuming a balanced portfolio does return 7 per cent over the next 15 years, they would end up with capital of $633,646 in today's dollars.

This is quite a bit less than the savings that could be accumulated by those people who sold at the market peak in August 2007 and put their money into cash at 5.25 per cent. They should have $762,423 in 15 years from that date, again assuming the interest rate doesn't fall, which is unlikely as interest rates can be as volatile as the sharemarket itself.

But if you are kicking yourself that you didn't turn a $500,000 balance into cash four years ago and now have, say, only $400,000, the gains from switching to cash are markedly reduced.

After inflation, it would be worth just $512,533 in 15 years' time.

So capital preservation might be all about tinkering with a portfolio so that it contains sufficient shares, and similar assets, that will keep pace with inflation, but also enough cash and bonds to help people sleep safe in the knowledge that a bear market will not wipe out their savings. The proportion that goes into each asset class is a matter entirely for individuals.

We encourage people to think that it does not have to be all or nothing.

Retirement strategies

Cut back on shares

Retirees and those close to retirement are among the worst hit by the global financial crisis as they do not have the means to make extra contributions to super to replenish their accounts, and so are entirely reliant on investment returns to recoup lost capital.

"If you have got enough capital to sustain your retirement needs by putting it into fixed interest then right now that could be an easy choice to make," says Godfrey Pembroke adviser Mike Ingham, from Camberwell in Melbourne.

But Ingham's advice is to keep at least some capital in shares due to the potential for extra capital growth. He recommends retirees opt for a strategy that puts less in shares than a younger person might.

His preference would be the conservative or capital secure option offered by most super funds with 70 per cent of assets in a mix of fixed interest, cash or bonds and the rest in equities.

Such options are expected to return, on average, 5 per cent a year over 15 years – and got close to that with an annual 4.7 per cent return in the 15 years to June 30.

If money is held outside super then Ingham says it would be hard to go past term deposits. A return of 6 per cent for the next 12 months, as offered by the best paying institutions, would be a good option for some people.

It is often suggested retirees should always keep cash to fund three years of expenses, to avoid selling shares in a falling market.

Another financial adviser, Errol Woodbury from Woodbury Financial Services, agrees retirees shouldn't abandon the sharemarket.

"I have empathy for retirees because they are at a different stage," Woodbury says. "But I am still a firm believer in having exposure to equities because of the growth prospects."

Shares can also pay good income, particularly fully franked blue chip shares with a reliable yield.

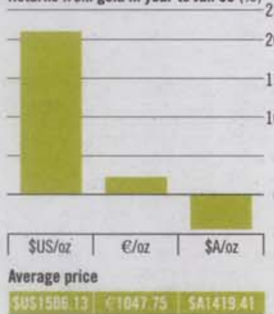
"Provided you can manage your cash flow, going forward you might have less capital due to lower prices but you may still be getting a reasonable income," Woodbury says.

"Plus you have the prospect of the price recovering. It is not uncommon to see people selling shares in a bank which is paying a high yield and putting the money into a term deposit with the same bank only to get a lower yield."

The decision to sell cash comes back to how much someone needs to live off and for how long.

"Your health and wellbeing is at stake too and it is important to look at all the options," Woodbury says.

The hard truth



Cash versus other investments

If you have $500,000 now and put it under the mattress, due to inflation the purchasing power in 20 years will be equivalent to $290,625 today. If you put it in cash within a superannuation fund at 5.25 per cent, you'd have today's equivalent of $695,892. If you invested it in the balanced option of a super fund returning 7 per cent, you'd have $923,321.

Investment option	Investment period 10yrs	15yrs	20yrs
Under the mattress	$381,199	$332,845	$290,625
Cash super fund	$589,869	$640,691	$695,892
Balanced super options	$679,456	$792,058	$923,321

Inflation rate	2.75%
Cash rate	5.25%
Balanced return	7%
Tax rate	15%

SOURCE: BLOOMBERG, LBMA, WORLD GOLD COUNCIL, IPAC SECURITIES

No guarantees

Protection comes at a cost

Capital-protected products, which promise a chance of gain with little potential for loss, should not be considered as a foolproof asset-protection mechanism. Lots of investors were stung in the global financial crisis.

The problem was the mechanism by which the protection was created meant that during the GFC, returns fell to zero but people were stuck in the products until maturity.

Others paid to get out of a product before maturity, which was a bitter-sweet outcome.

Sulieman Ravell, of Funds Focus, says this style of product is no longer sold, but there are still many issues to consider before buying an investment that promises capital protection.

Ravell says there are two types of products on the markets now – the first targeting people who want to borrow the money to invest, and the second people such as DIY investors who want a better return than a term deposit but can't afford to take a capital loss.

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Precautions

Back-to-basics survival checklist

The market nadir in 2007/2008, after the world was rocked by the collapse of major banks, taught investors invaluable lessons:

- Don't get carried away when the market is doing well, and always hold cash and fixed interest. "Over the last two years we've encouraged people to increase their cash and fixed interest by 10 to 15 per cent," says Paul Moran, from Paul Moran Financial Planning in Melbourne. That's a hard sell because the sharemarket has nowhere near fully recovered and many investors are loath to transfer assets before recouping paper losses. But it's a strategy that would have paid off today.

- Retirees would do well to have cash in the bank for up to three years' living expenses. Such a strategy prevents the forced sale of shares in a falling market to generate regular cash flow. Cash can be invested in a series of term deposits with rolling maturities of, say, six months to five years, to hedge against potential interest rate cuts, in a strategy often suggested by advisory firm ipac.

- Margin loans should be monitored daily during a crisis and, if necessary, topped up with cash or other assets to prevent a margin call or the forced sale of shares.

- Re-evaluate your super strategy as you age. David Murray, head of the $75 billion Future Fund, said on Wednesday that the default option within most funds might not suit older people as it's likely to have a high exposure to shares. Consider switching to an option with more defensive assets.

- It is ill-advised to fall in love with investments and devote so much capital to them that a portfolio has insufficient diversification, says Peter O'Toole from Portfolio & Wealth Management in Melbourne.