

SuperViews

From the Office of Beryl Ashe, Full-Time Board Member –
SAS and FSS Trustee Corporations



WINTER 2000

VOLATILITY and sound investment practice

“Share prices soar on positive economic data!”

“Alarm bells sound for sagging Australian sharemarket!”

These contrasting headlines recently appeared within the space of a few days, highlighting again the age-old issue of volatility of investment markets and returns.

There is no doubt that we have been going through a period of unusually high sharemarket volatility. The ups and downs of financial markets this year have been caused by strong economic growth on one hand and investors' concerns about rising interest rates plus the unrealistic valuations placed on some hi-tech companies on the other.

What exactly does volatility mean for my super savings?

It means that as share prices rise and fall in the short term – sometimes quite dramatically – your personal account will rise and fall. If you exit your fund (SASS & FSS) when the market has fallen, you may receive less than anticipated. If you exit when the market has risen, you may receive more. Your super fund cannot determine when sharemarket

fluctuations or crashes will occur and can only give you estimates of your exit benefit as at the day requested.

How is my money invested?

Your super fund invests your money in different investment assets classified according to their risk and return characteristics. Each investment asset has an expected rate of return and a level of volatility or uncertainty (risk) associated with that return. Australian and international shares, venture capital, direct property and listed property trusts are growth assets. They generate strong long-term returns but with significant shorter-term fluctuations.

By contrast, investments in cash (term deposits and short-term money market securities) typically generate returns closely related to prevailing short-term interest rates. They are low volatility investments, giving investors relative certainty about their expected returns (hence low risk).

While cash investments never yield negative returns, they are the poorest performers of all investment assets in the long term. For superannuation purposes, having all your investments in cash would hardly ever be an appropriate option, as cash investments rarely provide sufficient income over time

to sustain living standards in retirement, given the lower returns and the effects of taxation, inflation and fees.

Bonds represent loans to the bond issuers, whether governments, banks or other public companies. The issuer promises to make regular fixed interest payments to the investor, usually semi-annually, and to repay the principal (face value) of the bond at maturity. Because the rate of interest is fixed at the time of issue, and each payment is for the same amount until maturity, bonds are classified as fixed income investments.

While similar in nature to cash returns, bond returns are more volatile because bonds are longer-term investments and their market value is more susceptible to interest rate rises and falls. If rates rise, for example, the price or market value of an existing bond will fall so that

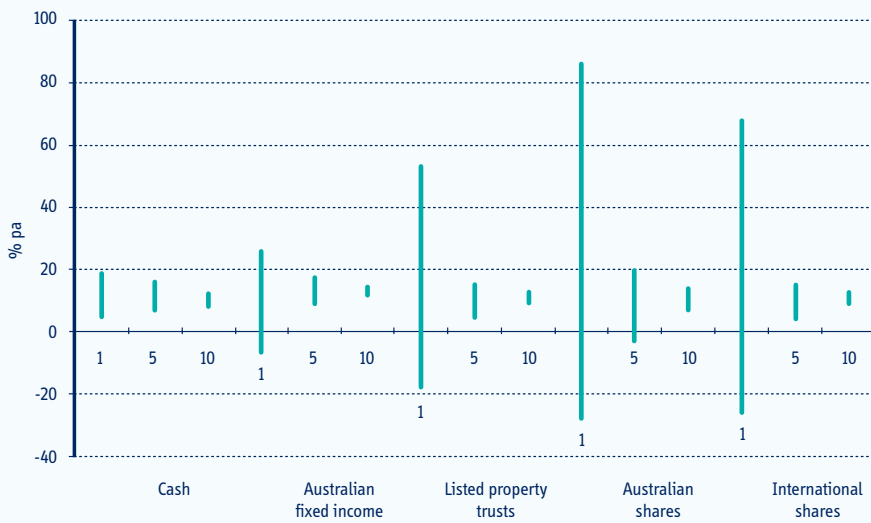
This article was prepared by Deutsche Asset Management, a member of the Deutsche Bank Group

Deutsche Asset Management

Deutsche Bank Group

Chart A: RISK OF VARIOUS ASSET SECTORS

Range of returns over 1, 5 and 10 year periods (April 1985 – March 2000)



Source: Deutsche Asset Management using market data

the yield (interest as a percentage of the market price paid for the bond) matches the higher rates available on comparable newly issued bonds. However, if bonds are acquired prior to a fall in interest rates they will appreciate in value (achieve capital growth) as a result.

The range of annual returns for the same asset sector are shown in the Chart A for 1, 5 and 10 year periods from April 1985 to 31 March 2000. Note how the volatility of each asset sector diminishes over time.

Chart B also clearly demonstrates volatility of returns from the various asset sectors, and shows that, over time, high volatility/high risk investments achieved higher returns over the long term than cash and fixed income.

The 15-year period covered in the charts includes the major sharemarket crash of October 1987 (note how the passage of time smoothed away the effects). In addition, cash rates were exceptionally high in the late 1980s

and their fall through the 1990s greatly favoured bond investments due to the resulting capital growth.

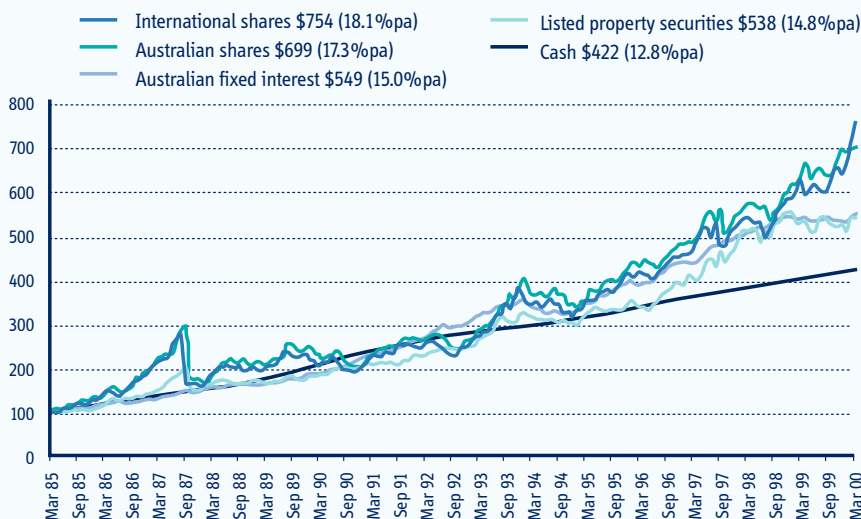
Why are growth assets more volatile?

Market prices of growth assets will normally fluctuate because investors are constantly assessing current and future value of investments in the light of a wide variety of new information and changing expectations. Interest rates and expectations of rate changes are important considerations, as they always are for fixed income investments. But many other short-term factors, be they specific to individual companies such as earnings reports, economy-wide economic data, global trends affecting particular companies and industries, or simply changes in investor perceptions, can play key roles in determining valuations at any particular time.

How much risk is right for me?

In recent years Australian investors have increasingly accepted the benefits of investing in higher risk growth assets to provide for their retirement. Around 45% of adult Australians now own shares directly, a percentage exceeded only in the

Chart B: PERFORMANCE OF VARIOUS ASSET SECTORS Value of \$100 invested on 31 March 1985



Source: Deutsche Asset Management using market data

NOTE: Investment returns only. No tax, administration or investment charges have been deducted. Your fund invests across the full range of asset sectors on a proportionate basis, using different fund managers to further diversify the risk. (NB: FSS does not hold direct property).

USA. In addition, the great majority of Australians own shares indirectly, through their superannuation or other managed investment funds. This proportion is likely to increase further in the years ahead. An ageing population means that more people will be planning carefully for their retirement while compulsory superannuation savings will continue to channel a growing stream of investment funds into the Australian and international sharemarkets.

Today more Australians are exposed to investment market volatility than ever before. Retirees relying on investment income are an important example. Many appreciate that they need to choose and maintain a worthwhile exposure to higher risk growth assets to protect their standard of living over the period of their retirement.

Are you taking too much risk? Obviously factors such as your age and investment horizon influence your risk tolerance. But one of the hazards of investment planning is taking a too short-term view of market behaviour and investment returns. In other words, being overly-influenced by and responding inappropriately to short-term market volatility.

In addition to the beneficial effects of time, diversification through spreading your investment dollars across a range of investment assets has long been practised as a most effective method of risk management. Because different investments have varying degrees of volatility and no single investment asset always performs better than others, diversified portfolios usually provide a more consistent (less risky) pattern of returns.

Some members, however, may still be reluctant to invest in growth assets or maintain little more than a token exposure, preferring the security of fixed income investments. The real costs, in terms

FSS Investment Strategies	INVESTMENT ALLOCATIONS %		Current benefit (\$) (as at 31/3/00)
	Cash/Fixed income	Growth	
Cash	100	–	262,830
Capital Guarded	70	30	375,541
Balanced	50	50	393,898
Diversified*	30	70	405,585
High Growth	10	90	409,098

* Members of the Pooled Fund only have one investment option which is equivalent to the FSS Fund's diversified strategy.

of income forgone, of a too conservative approach to investment risk can be shown in the following example.

The table shows the different outcomes for a member (salary \$45,000, superannuation contributions of 6% p.a.) who had \$50,000 invested in super in March 1985. If the member had invested entirely in the Capital Guarded option since then, the member's benefit would now have grown to \$375,541. The same investment in the Balanced option would now be worth \$393,898. The High Growth option, with its large allocation to growth assets, would have given the member a current balance of \$409,098.

However, if the member had sought safety from short-term volatility in the very low risk cash investments, the current balance of \$262,830 would be lagging far behind all of the alternative strategies with their varying exposures to growth assets.

The lower risk investment options are actually more risky for you if they don't provide the long-term returns to meet your retirement needs.

What if I want more certainty on the level of my super benefit close to retirement?

Short-term volatility could affect your end benefit close to retirement and the withdrawal of monies,

either to your advantage with a rising market, or to your disadvantage with a falling market. It would be best for you to seek advice from a financial advisor so that your own situation can be assessed. If you are using your super money to buy a private pension with a similar investment strategy to the one you had, and the market is falling, the price of that pension would also have fallen. Therefore your position should not have changed significantly. However, if you want to change the investment strategy or take a lump sum to pay off your mortgage, you could be disadvantaged in a falling market. You should consult a financial planner.

At present only FSS members can move their money to reduce the risk of short-term volatility. SASS members do not have this facility. However, the Board is investigating such an option for these members.

NOTE: It is always prudent to seek financial advice before determining a course of action. State Super Financial Services Ltd is a company wholly owned by State Super and provides financial planning services exclusively to members and their families.



Members should note that historical returns are no guarantee of future returns.

INVESTMENT NEWS

Many commentators warned that financial markets were likely to be very volatile over the first few months of 2000, but had not anticipated the magnitude of this volatility.

US sharemarket indices, in particular the NASDAQ, which tracks technology stocks, had intra-day swings of up to 15%, but with most daily movements being between 1 – 5%. This volatility was due to a combination of factors. Firstly, it was a response to extreme valuation of the technology sector, where investors were prepared to pay on average more than 180 times the current earnings of the technology shares. Secondly, there was uncertainty over the effectiveness of monetary policy in slowing a surging global economy and avoiding inflation.

Segments of the Australian sharemarket had followed the

NASDAQ on its way up and consequently followed it on its way down, but the broader market did not display the level of volatility seen in other sharemarkets around the world. By contrast the foreign exchange and fixed income markets were more challenging. During the March quarter 2000, the Australian dollar depreciated by 7.5% against the US dollar from US\$ 0.657 to US\$ 0.607 (and has since fallen below US\$ 0.60), and against expectations 10 year bond rates fell from 6.95% to 6.36%.

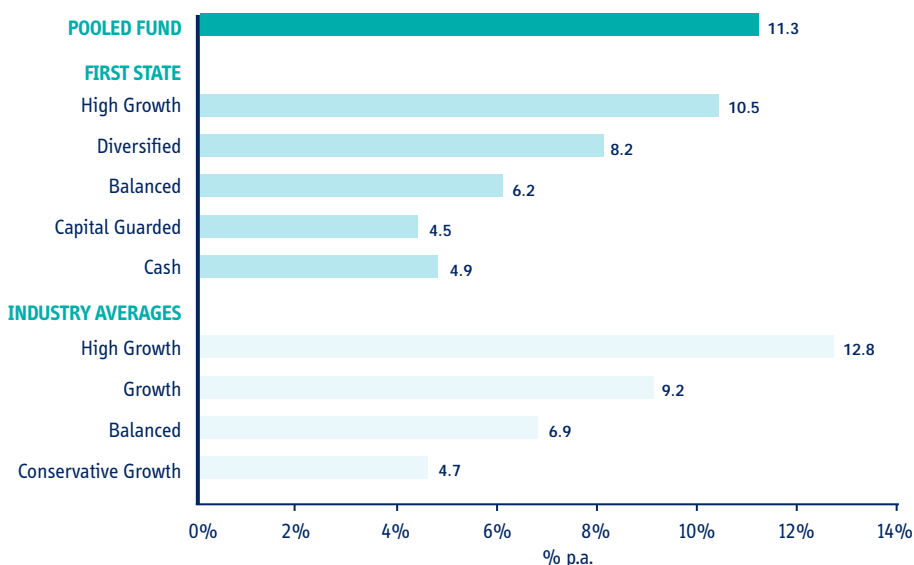
The State Super policy is not to get caught up in short-term volatility. The Boards responsible for the Pooled Fund and the First State Super products outline a medium-term strategy, which is adhered to in a disciplined fashion to generate competitive returns in the medium-term. The strategies are reviewed on a regular basis, but are not changed in reaction to short-term volatility.

For the year ending March 2000,

the Pooled Fund did very well returning 11.3%, which represented top-quartile performance within the universe of growth funds.

With returns ranging from 4.5 – 10.5%, the FSS products, apart from Cash, generated below average performance during the year ending March 2000. This was mainly as a result of some of the fund's active managers in Australian and international shares under-performing their respective benchmarks during the last 6 months. However, over 3 years the product performances remain above the average manager in their respective universes.

STATE SUPER NET INVESTMENT RETURNS – Year ended 31 March 2000



Super Seminars

Members are invited to attend my briefing sessions:

Coffs Harbour	FTC	21/6/00
	STC	20/6/00
Dubbo	FTC	22/8/00
	STC	21/8/00
Newcastle	FTC	24/10/00
	STC	23/10/00
Albury	FTC	21/11/00
	STC	20/11/00
Taree	FTC	28/11/00
	STC	27/11/00

All briefings will be held between 5.00pm and 6.30pm.

To book a seat, email

vivienne.almeida@statesuper.nsw.gov.au
or phone (02) 9238 2514.

Disclaimer: The information in this newsletter gives, by necessity, a general interpretation of the issues. Members should always seek advice from the appropriate authority on their individual circumstances before making decisions which may affect their future.