



BARNETT LILLEY
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*Using the
BL&A “Bucket
approach” to
investing.*

**A read that is essential to all
investors.**

Barnett Lilley & Associates Pty Ltd (BL&A) aims to offer financial advice of the highest standard. This is an individual process, with no two clients being the same.

Perhaps the one common link between investors is that they all want to obtain the highest returns on their investment, yet still “sleep at night”. The largest contributing factor to an investor’s ability to sleep well at night is the amount of risk that their investments are exposed to.

What is risk?

Risk is defined as many things to many people. In its simplest form however, *where there is more than one possible outcome, risk represents the chance that you will not achieve the desired outcome.*

Every possible investment involves risk of one description or another. A term deposit with a bank may involve virtually no possibility of default (commonly called credit risk), yet it exposes the investor to a potential loss of earnings if interest rates increase during the term of the deposit (commonly called *interest rate risk*), as well as the risk of not being able to access the entitlement should circumstances change (commonly called a *liquidity risk*).

Risk is part of our everyday life. *The desired outcome* may not eventuate when we cross the street, drive our car or even make a purchase. Risk is so inherent in our daily life that we often do not recognise it.

Risk with investments

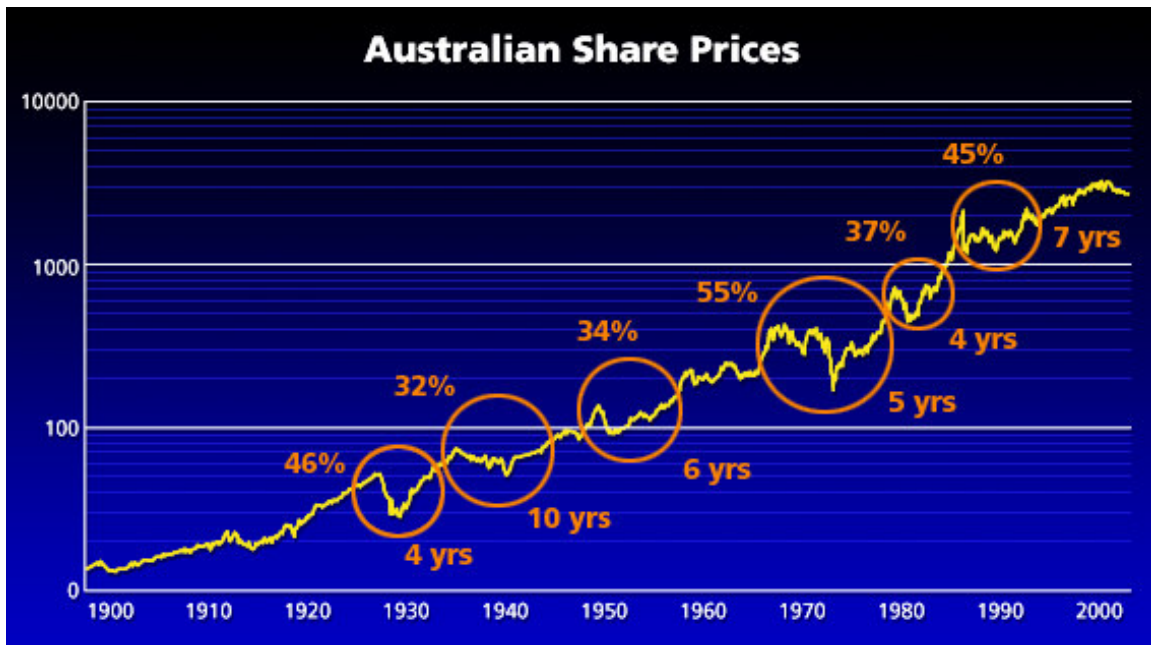
There are many forms of risks associated with even the most simple investment. However, the most obvious form of risk, and perhaps the one of greatest significance to investors, is that of the risk of the loss of capital.

The fundamental objective of investing is, of course, that the asset(s) purchased will increase in value over time, or provide a secure income. For some investments (such as Government bonds), there is very little possibility that this desired outcome will not occur. It is for this reason that investments in Government bonds and bank backed securities are said to contain less risk than other investments such as shares and property.

Shares and property

Shares and property are investments that are *volatile* by nature. Unlike Government bonds, there is no rigid price setting mechanism for the price of these assets, with the supply and demand within the market determining what a “fair price” is. History has shown repeatedly that these markets will experience both strong periods of growth and decline. For investors in the share market, October of 1987 represented a period of substantial and rapid decline, with the value of the share market decreasing by some 45%.

The diagram on the following page represents the performance of the Australian share market over the last century.



The first thing to note about the diagram is that the market has trended upwards. To consider the share market over the entire century the clear trend is for continued growth, with the six periods of decline merely being no more than “interruptions”.

However, investors are not able to look at an investment timeframe of a century. Investors live their life year by year, day by day. This point is of significance when the diagram is examined in greater detail.

The six periods of decline (shown by the circles) were more than an interruption in the lives of many investors. Taking the 1987 decline as an example, share market investors saw the value in their shares decline by approximately 45%. It took seven years for the All Ordinaries Index to regain its lost value. For a “five year” investor entering the share market in September 1987, an investment in shares did not provide pleasant

memories or much “sleep at night”. This is an example of an investment *not producing the desired outcome*.

Should investors stay clear of volatile investments?

Given the potential for things not going according to plan with volatile investments, the question is whether they should form part of the investment portfolio.

The answer is clouded by the fact that it is these volatile investments that provide higher returns *over time*. As can be seen from the table on the following page, shares have outperformed less volatile investments over the long term. In any given short period (for example, in any one year “snapshot”), there is no clear pattern as to whether shares and property will outperform less volatile investments.

Percentage returns in a calendar year

| <i>Year</i> | <i>Aust. Shares</i> | <i>Aust. Fixed.Int</i> | <i>Int'l Shares</i> | <i>Property Securities</i> | <i>Cash</i> |
|--------------------------|---------------------|------------------------|---------------------|----------------------------|-------------|
| 1985 | 44.06 | 8.07 | 70.20 | 5.25 | 16.19 |
| 1985 | 52.22 | 18.92 | 45.63 | 35.42 | 16.36 |
| 1987 | -7.86 | 18.60 | 6.91 | 5.75 | 13.68 |
| 1988 | 17.88 | 9.39 | 4.27 | 16.06 | 12.84 |
| 1989 | 17.40 | 14.89 | 26.03 | 2.35 | 18.48 |
| 1990 | -17.52 | 19.01 | -15.10 | 8.70 | 16.13 |
| 1991 | 34.24 | 24.75 | 20.18 | 20.08 | 11.20 |
| 1992 | -2.31 | 10.41 | 4.48 | 6.99 | 6.92 |
| 1993 | 45.36 | 16.32 | 24.40 | 30.12 | 5.39 |
| 1994 | -8.67 | -4.66 | -8.05 | -5.57 | 5.36 |
| 1995 | 20.19 | 18.63 | 25.88 | 12.74 | 8.03 |
| 1996 | 14.60 | 11.87 | 6.28 | 14.49 | 7.57 |
| 1997 | 12.23 | 12.23 | 41.12 | 20.31 | 5.63 |
| 1998 | 11.63 | 9.54 | 32.08 | 17.95 | 5.14 |
| 1999 | 16.10 | -1.22 | 17.11 | -4.97 | 5.01 |
| 2000 | 4.80 | 12.08 | 2.24 | 17.85 | 6.27 |
| 2001 | 10.49 | 5.45 | -9.72 | 14.60 | 5.24 |
| 2002 | -8.64 | 8.81 | -27.17 | 11.76 | 4.77 |
| 2003 | 14.96 | 3.05 | -0.52 | 8.80 | 4.90 |
| 2004 | 27.92 | 6.96 | 10.26 | 32.01 | 5.62 |
| 2005 | 22.45 | 5.80 | 17.00 | 12.50 | 5.74 |
| 2006 | 24.51 | 3.14 | 11.74 | 34.03 | 6.02 |
| Annualised Return | 15.73 | 10.55 | 13.87 | 14.42 | 8.75 |

Source: Colonial First State

This raises two key issues **that every investor must consider before investing in “growth assets”**:

- what is the likely timeframe of the investment; and
- what is the investor’s personal feelings concerning exposure to volatility.

Investment Timeframe

Both the graph and the table show that a short term venture into volatile or “growth” investments is a strategy that is

fraught with danger. Unless the investor is able to forecast accurately the potential returns over the period, there is exposure to a potential loss of capital through a downturn in the market.

The table also shows that, over the longer term, investments in these volatile markets provide the highest returns.

Quite clearly there is a relationship between the length of the investment and the appropriateness of its exposure to volatile investments.

Personal feelings concerning exposure to volatility

Lack of tolerance for volatility is often referred to as “risk aversion”. All individuals have varying degrees of “risk aversion”, with some quite comfortable investing in volatile investments, while others are willing to give up the possible higher returns for the peace of mind of not being exposed to volatility.

This test ties in very closely with the investor’s ability to “sleep at night”. Perhaps the easiest way to test your own level of *risk aversion* is to ask yourself how you would react to a headline in tomorrow’s paper that read:

“Sharemarket crash - 40% fall”

If the thought of this is too much to envisage, you are likely to be “risk averse”, meaning that it is likely you have had limited exposure to volatile investments. Risk averse investors are prepared to forgo potential higher returns for the security of knowing their investment is unlikely to decline in value *if things do not go according to plan*.

Combining your personal feelings with your timeframe for investment

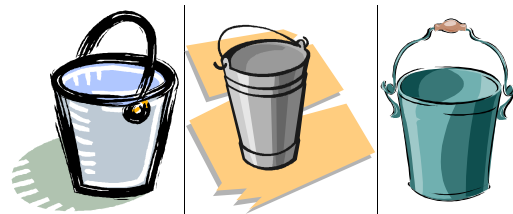
The next step is to overlay your personal feelings concerning exposure to volatility with the investment timeframe. What if tomorrow’s headline stated:

“Sharemarket crash - 40% fall – but you have 10 years to recover!”

Would you still feel the same level of concern, given the information in the graph and table illustrated on the previous pages? Would you be prepared to take a greater level of risk? Would this scenario enable you to sleep at night?

Different investors behave in different ways. However, as can be seen above, investment is fundamentally a function of time.

Before you even start to contemplate what type of investment you will use, what you need to first consider is how much time you have before you need to access your funds. This brings us to the concept of the “three buckets”.



Using a “Bucket approach”

The most important thing about investing money is to put a “label” on it.

You must know what the purpose of this money is, and when it will be consumed, in order to select an appropriate investment strategy for it. Once you know the “label” of the investment, you can place it in a “bucket” that meets that investment objective.

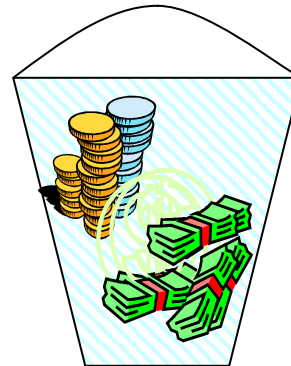
For example, if you knew that you were going to spend \$20 000 on a holiday in six months, then this money should be invested conservatively. This is different to money that will fund a holiday in 20 years time, which should be invested with a view to growing as much as possible until it is required.

In short, we see three “buckets” for investments. The primary distinction between these three buckets is the timeframe in which the investments will be consumed.

It is this consumption timeframe which is critical to the BL&A approach to investing. Quite simply, if the money will be consumed in the near future, it will be placed in a “bucket” that has short term investment characteristics (referred to as “bucket one”). On the other hand, if the money is to be consumed in the distant future, it is more appropriate to invest it in a growth based investment (referred to as bucket three).

Under the BL&A approach, the first thing that we need to know from you is “When will you spend this money?” It is the answer to this question which will determine the type of investment that we recommend.

Bucket one



Timeframe of 1 to 3 Years

The first bucket is the “conservative” pool. The first thing that we will ask of all investors is how much they could possibly need to spend of this investment (worst case scenario) within the first three years.

It does not matter if this spending is done on large “ad hoc” items (holiday, updating cars etc), or used to supplement an income stream. Once we place a timeframe of less than three years on the consumption of this money, we really need to undertake the investment with a very conservative overlay.

Typically investment timeframes of three years or less are too short to invest aggressively in shares or property, and we must therefore be content to invest within cash and short term fixed interest. By doing this you are assured that when the time comes to spend the money in this “bucket”, the amount that you require will be there, and will not have declined in value. This stability is the most important function of the “first bucket”.

Bucket two



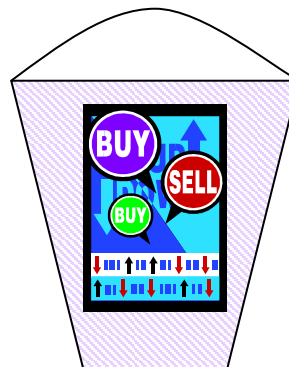
Timeframe of
4 to 7 Years

The second “bucket” is used where the funds are going to be consumed in four to seven years time. Over this timeframe the funds should not be left in a “bucket one” (conservative) style of investment, as the timeframe is too long to merely have funds sitting in cash and short term fixed interest. On the other hand, as seen earlier with the 1987 share crash, the timeframe is too short to embark on an aggressive shares/property portfolio.

Given that this is a “medium term” investment timeframe, the second bucket will have a “medium term” investment strategy. A “balanced” investment strategy is appropriate for this type of timeframe, as it has both growth and defensive assets. It invests across all of the asset classes, ie cash, fixed interest (both Australian and international), property, Australian shares and international shares.

The second bucket is seeking longer term returns than bucket one, but the longer consumption timeframe allows for greater short term volatility.

Bucket three



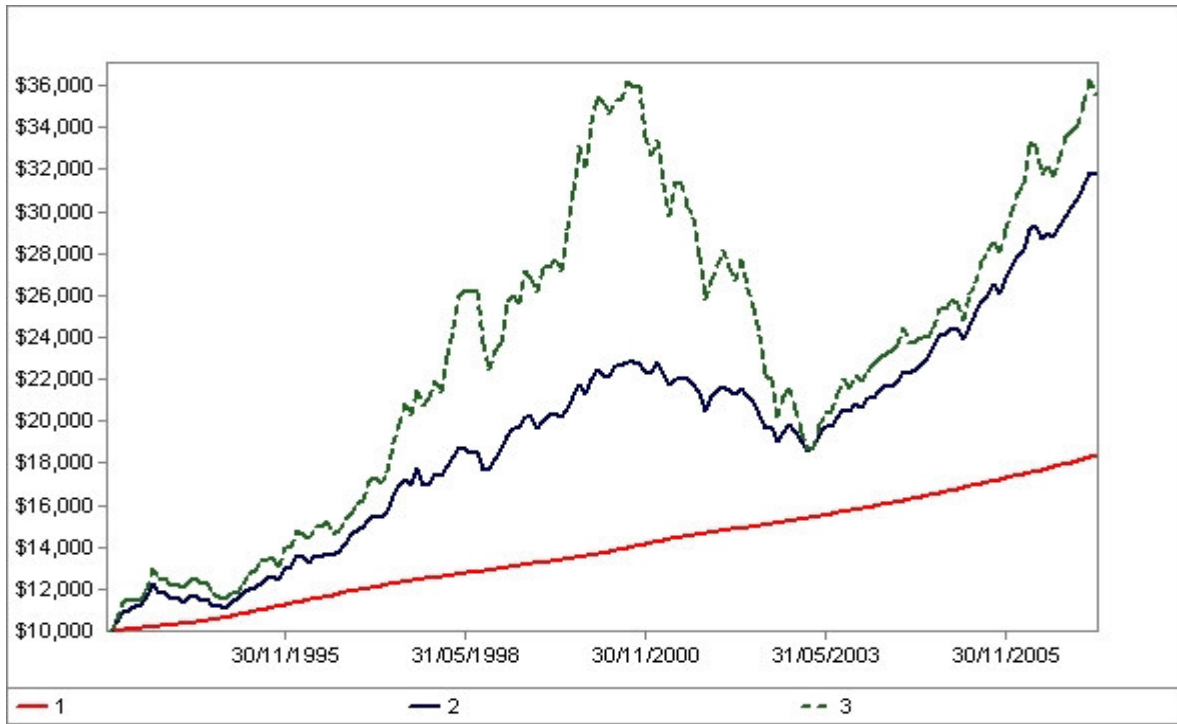
Timeframe of
8+ Years

If we have done things correctly, there is enough money in “buckets” one and two to meet your consumption needs for the next seven years. This means that any funds that are not required to be consumed in the next seven years can be invested with a view of seeking maximum long term returns. This way, when they are to be consumed (in eight years plus), they will have a significantly greater value.

This long term consumption timeframe affords the opportunity to invest this money in a “growth environment”, and not be concerned about its short term (day to day) volatility. This means that the third bucket money will be invested with 100% exposure to shares.

Although this will show greater short term volatility than the other two buckets, it will provide higher returns over this sort of long term timeframe. With buckets one and two covering consumption over the next seven years, the remaining funds can afford the luxury of being invested for pure growth.

Volatility and Characteristics of each Bucket



| Legend | |
|--------|---------------------------------------|
| 1 | Cash Management Trust (bucket one) |
| 2 | Balanced Fund (bucket two) |
| 3 | Diversified Share Fund (bucket three) |

In the graph above, the red line represents a typical Cash Management Trust. This line reflects the first bucket investment of 100% cash and short term fixed interest. As can be seen, this type of investment is very stable and shows little in the way of volatility. Therefore, it is very appropriate for the short-term timeframe of bucket one investments.

The black line represents a typical Balanced Fund and reflects the bucket two investments. Bucket two investments are a combination of both growth and defensive assets and cover all asset classes of cash, fixed interest,

property and shares. As the graph shows, this type of investment has increased volatility compared to the first bucket, but has provided higher returns over the medium term timeframe.

The graph shows that there are periods where the Balanced Fund's value drops, such as between the years 2001 and 2003. This demonstrates the increased volatility of this type of investment. This short term capacity for falling value is why we believe that this type of investment is not appropriate for the shorter term time frame of bucket one.

The green line represents the third bucket and reflects a typical Diversified Share Fund. Bucket three investments are 100% invested in Australian and international shares. These are obviously the most volatile investments. As can be seen from the graph, there are large swings of highs and lows. However over the long term these investments provided the highest returns. They are therefore appropriate for bucket three investments where we are investing for a period of eight years and more.

So, why not just have one Bucket and one type of investment?

Many people would look at this approach and state: “Why not just throw all the money into a second bucket style of investment (a balanced fund), as it already contains a mix of conservative and growth assets”. The reason why we do not see this as being appropriate is that a balanced fund sells down both growth and conservative assets when withdrawals are made.

If a balanced fund has 70% shares and property and 30% in cash and fixed interest, then when a withdrawal is made, it will be funded by a sale of 70% of shares and property and 30% cash. If it happens to be a bad time in the share/property markets, it does not matter, the fund will sell down the assets in order to make the payment.

Investors know that you do not want to sell down your assets when they have fallen in value. We know that over time shares and property bounce back, but if they are sold before a recovery takes

place, then the loss has been crystallised. This is why we believe that the “three buckets” approach is important, as it provides you with the control over when to sell down your growth assets, ensuring that they do not get sold at a time when they are down in value.

How does it all really work? Won't my bucket two funds, at some stage become my bucket one funds, and so on?

Not necessarily. It is important in making any investments that you review them regularly (every twelve – eighteen months), to ensure they still meet your needs. Let's look at some examples of how this works with regard to your buckets.

Let's say that you have \$300 000 and have calculated how much of these funds you will need to access over the next seven years. You know that you will require \$20 000 per annum to supplement your income, and in about five or six years time you are planning to upgrade your car, expecting to spend around \$25 000.

Given the above scenario, your investment buckets will reflect the following investments:

| Bucket 1 (Yr 1 – 3) | Bucket 2 (Yr 4 – 7) | Bucket 3 (Yr 8+) |
|------------------------|------------------------|---------------------|
| \$60 000 | \$105 000 | \$135 000 |

This is our starting point, but more importantly we have to consider the position twelve months later and move money between the three buckets.

Example 1

Let's firstly look at what may happen in a falling share market. It is now one year later, and you have withdrawn your \$20 000 to supplement your income. Your buckets may now look similar to this:

End of Year 1

| Bucket 1 | Bucket 2 | Bucket 3 |
|----------|-----------|-----------|
| \$42 000 | \$100 000 | \$125 000 |

Bucket one has reduced by the \$20 000 that has been withdrawn for the first year's consumption, but as this bucket is invested in cash and fixed interest it does not have any exposure to the more volatile investments. This means that the leftover funds in bucket one have remained stable this year, earning a small amount of interest.

However, bucket two and, to a greater extent (as expected), bucket three have dropped in value. This is due to their exposure to shares in a **falling** market, not through withdrawals.

In this situation, we would not adjust any of the investments in the buckets at this point in time as we do not wish to crystallise any losses while you still have two years worth of funds in bucket one to draw on. We would review the position in another twelve months.

Example 2

The alternative is to consider what may happen in a rising share market. Again it is now one year after the initial investment with the \$20 000 having been withdrawn to supplement your income.

Your buckets may now look similar to this:

End of Year 1

| Bucket 1 | Bucket 2 | Bucket 3 |
|----------|-----------|-----------|
| \$42 000 | \$115 000 | \$155 000 |

Bucket one looks the same as in Example 1 due to the withdrawal and its lack of exposure to share investments. True to name, bucket one will provide short term stability regardless of rising or falling markets.

However, bucket two and, to a greater extent (as expected), bucket three have increased their value due to their exposure to shares in a **rising** market.

In this example, it would be a good time to take advantage of the gains in buckets two and three and replenish the bucket one funds. Again, we need to take a "next three year" view for this bucket and we find that we only need to increase bucket one by \$18 000 as we are still not expecting to upgrade our car for another four to five years.

So, we would move some of our funds as follows:

| Bucket 1 | Bucket 2 | Bucket 3 |
|----------|------------|-----------|
| \$42 000 | \$115 000 | \$155 000 |
| ← | (\$10 000) | |
| ← | | (\$8000) |

The investments in each bucket at the beginning of your second year would now look as follows:

Beginning of Year 2

| Bucket 1 (Yr 1 – 3) | Bucket 2 (Yr 4 – 7) | Bucket 3 (Yr 8+) |
|------------------------|------------------------|---------------------|
| \$60 000 | \$105 000 | \$147 000 |

As can be seen, buckets one and two both contain the same amount in terms of investment value as you started with. This is because in our example, your needs over the next seven years remain the same as they were twelve months before. Bucket three has increased in size reflecting the gains on your total investments.

Should we treat allocated pensions any differently?

Unlike other investments where you manually draw funds as required, an allocated pension requires you to make periodical withdrawals.

Therefore, regardless of whether the market is up or down, the fund is still required to periodically sell down your assets to make the pension payments. In selling down your assets the fund will not care whether they are crystallising losses or not.

It is therefore true to say that where withdrawals are periodic, like in an allocated or term allocated pension, having the three buckets in place is even more important.

Will I always need to use all three buckets?

No. Sometimes using all three buckets will not be appropriate, it depends on the consumption timeframe. For example, let's say you are 35 years of age and have received an inheritance of \$30 000 which you plan to use in renovating your home within the next two years. These funds would be invested purely in a

bucket one style of investment, meaning they would be placed only in conservative cash and fixed interest investments. The fact that the money will be consumed within the first three years makes buckets two and three irrelevant.

However, the same individual will also have superannuation investments which are fully preserved until they reach their retirement age. For a 35 year old, this means that the funds cannot be accessed for at least another 25 years, until age 60. Obviously, it is appropriate for these to be labeled bucket three funds and invested in more volatile share investments.

In this case, while you have bucket one investments and bucket three investments, you would not have any bucket two investments.

As you can see by this, there are many different scenarios and each investor needs to look at their own needs to determine their individual consumption requirements.

Once the correct amounts have been allocated to the three buckets, BL&A will advise you on the best investment for each of the respective buckets. This will take into account your taxation position and numerous other factors that differentiate between different investment options within each bucket.

Nonetheless, the first and most important issue is understanding and being comfortable with the "bucket approach".



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