The fundamental nature of assets

Most people consider cash, fixed interest investments and equities (stocks and shares), as three distinct types of investment.

In fact, the return on cash, the return on fixed interest investments and the returns on equities are all returns on capital invested in the economy. They are therefore all equity returns.

An investor places money in a bank and receives interest on the deposit. The bank lends the money to a company that produces goods or services and receives interest for the loan. The return the company must earn on its investment must be higher than the money it pays the bank. All returns are generated by the company which pays the bank which allows the bank to pay the depositor.

If economic growth were to collapse, so would the return on cash and fixed interest securities. Ultimately, cash and fixed interest investments would all cease to have value.

The only reason cash is a lower risk investment is because a bank is able to spread the risk of all its loans and the financial system would come to its rescue in the event of default. But a widespread collapse of the economy would also see a widespread collapse of the financial system.

After all, the money you place in a bank is not actually in a bank, but owed by an individual or a company.

In reality, over the long term, investors in cash are taking the same economic risks as an investor in an equity investment while accepting a lower level of return.

Because cash and fixed interest investments are exposed to inflation risk, cash and fixed interest investments are actually higher risk investments than equities over the very long term.

If the above is true, why do people simply not invest in equities and avoid cash and fixed interest investments?

Over the short term (the short term can be as long as 5 and 10 years and, in some case significantly longer) equities can be higher risk investments than cash and fixed interest securities for two reasons.

- **Short term economic risk** - the value of a company depends on its current and expected future earnings. During a recession, both current earnings and forecasts of future earnings can fall significantly. The effect of this risk to earnings is reflected in the often significant falls in equity prices. Because of this, capital invested in equities, save for the dividend income, should not be relied upon to support short term financial security.

- **Stock market risk** – the biggest part of a stock's price is determined by the market's expectations of future earnings. At times, expectations can become over optimistic and as a result market valuations bear no relation to the ability of the companies or the economy to produce growth. Buying at these levels exposes investors to excessive risk.

At times an investor is unlikely to ever recover the value of the real capital invested. In reality, the only reason why a balanced portfolio of equities is a risky investment is because of the way in which they are priced by the stock market.

As far as cash and fixed interest investments, providing economies recover, they are secure short term investments, offering certainty of both income and capital.

Three simple rules

From the above we can derive three simple rules for investors

- Equities are not appropriate short term investments.

- Cash and fixed interest investments are not appropriate long term investments.

- Over time, equities which are high risk short term investments become lower risk higher return investments. Over time, cash and fixed interest securities, which are lower risk short term investments, become higher risk lower return investments over the longer term. Therefore at a certain point in time equities cease to be higher risk investments and cash and fixed interest cease to become lower risk investments.

Rationale investors with no financial demands on their assets should hold equities as long term investments because they are superior investments with higher long term return and lower long term risks.

Conservative investors who are averse to the greater short term risk of equities will hold more lower risk investments than they need. The decision as to what type of investor you are is your decision, not your advisors.

The above does not represent all that the investor needs to be exposed to before they or the advisor can assess risk, but it is something that needs to be understood above all.

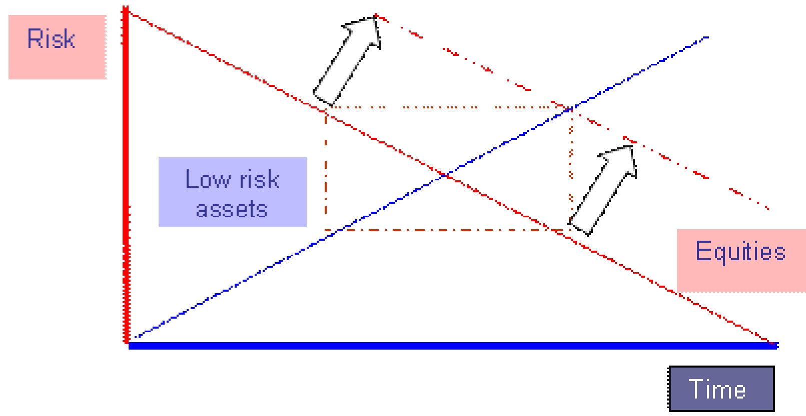
Fundamental nature of assets

- Cash and fixed interest returns are components of the return on equity. Over the long term, they are exposed to the same economic risks. Long term holdings of low risk assets do not diversify natural risk.

- Over the long term, nominal lower risk assets are exposed to greater risks than equities because of inflation.

- Over the short term equities are higher risk investments because they are exposed to stock market (valuation risks) and short term economic risks. Over the short term, lower risk assets provide greater income and capital security.

- Over time the risk of equity investment relative to the risk of low risk investment falls and the risk of low risk investment relative to equities rises. At some point in time low risk assets become higher risk assets than equities. This time frame is referred to by TAMRIS as the period of "significant short term stock market and economic risk" and is key to defining the optimal long term asset and liability allocation.



The red line (above graph) shows the relative risk on equities falling over time, the solid blue, the relative risk on low risk assets over time. The dashed red line shows that the actual time frame is affected by both valuation and economic risks and that the period of risk shifts and the box the management of allocation in response to excess valuation and economic risk.

Fundamental rules

Because of the fundamental nature of assets over time, in the presence of inflationary risk and the absence of risk aversion, for a given liability profile over time there is an optimal allocation to cash, fixed interest and equities. The basic structural rules for the management of assets within a liability management framework are therefore as follows.

- Outside of risk aversion and excess valuation risk, the only rationale for lower risk assets is to provide short term security of capital and income needed to meet liabilities in the event of significant short term stock market and economic risk.

- In the absence of liabilities equities are the most efficient long term asset class.

- The amount of low risk assets held within a portfolio is directly related to the amount of liabilities a client has arising over the designated period of ”significant short term stock market and economic risk”, or the short term continuum .

- Longer term assets (equities) are held within the time frame over which they are most efficient, while low risk short term assets are allocated to where they are most efficient. The allocation at the margin is managed in accordance with fundamental management of excess risk and return.

The structure provides a defensive box in which income and capital security can be maintained while the management of excess risk and return can be used to enhance return and risk management over time at the margin within a time frame which does not expose the portfolio or liabilities to excessive risk.