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Opportunity cost of switching assets can be high

The thought of switching into less volatile assets would have crossed the minds of many equity investors of late. With the outlook for equity returns looking less than glamorous in the short term and high interest rates on offer in cash type investments, you can easily understand why.

On face value switching assets might seem like the rational thing to do, but there are a few things to consider before taking the leap.

There is no doubt the official cash interest rate of 7.25 per cent is a decent risk-free rate of return in the current environment. While in the short-term cash is a tempting alternative, switching out of equities means you may miss out on future growth by being out of the market when it does rebound. It could also end up costing you more when you do decide to get back into the market. This can end up being costly over time.

This is a particularly important point for longer-term investments like super. Andrew Boal, managing director or Investment Consulting firm Watson Wyatt says a typical balanced growth super fund earned an average return of around 10.3 per cent a year over the past 20 years, compared to conservative fund returns of around 8.7 per cent over the same period. During this time, the conservative option outperformed its growth counterpart on seven occasions.

"During that period if a member had switched their account balance to the better performing option from the previous year, then they would have ended up switching ten times and successfully wiped off about 0.7 per cent a year in performance, compared with just sticking with the growth option for the whole period," Boal said.

While 0.7 per cent a year might not seem like much, it can make a huge difference to your final benefit over a lifetime of investing. "A reduction of 0.7 per cent a year over a 40 year period of saving would reduce the final lump sum retirement benefit by about 15 per cent," said Boal. This could wipe three or four years off the longevity of your final retirement benefit.

Selling equities in a falling market crystallises losses. Until you actually sell shares the negative returns on your financial year-end report are just that, paper losses.
If you look at equity market returns over longer time periods you start to see the benefits of holding tight over periods of short-term volatility. The table below compares the average annual returns of Australian shares and cash over different time periods. While the return for the last financial year is not a pretty sight for equities, longer-term returns are much more respectable.

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Period to 30 June 2008	Australian shares annual return	Cash annual return
1 year	-12.1%	7.4%
5 years	16.8%	6.1%
10 years	11.3%	5.7%
20 years	10.8%	7.5%

Source: Andex Charts Pty Ltd
Past performance is not an indicator of future performance.

While the last decade has experienced its fair share of global economic and political jolts, the Australian market has proved its resilience. The US invasion of Iraq, September 11 bombings, dotcom crash, and rising world oil prices have all provided short-term setbacks, the Australian market has continued to enjoy long-term growth. Hopefully, the world credit crisis will prove the same.

Another often forgotten cost of switching asset classes is tax. Unlike shares, all income from fixed interest and cash investments is treated as income and taxed at your relevant tax rate. So if you're on the top marginal tax rate you could lose around half of your return in tax.

According to the latest Russell/ASX Long-Term Investing Report Australian shares delivered the best after-tax and after-cost returns of all the asset classes over the 10 and 20 year periods to 31 December 2007. Dividend imputation is the main reason why Australian shares offer the lowest effective tax rate of all asset classes. Because companies listed on the Australian Stock Exchange have already paid tax on the profits they distribute, investors receive a franking credit for the amount of tax the company has paid.

The right asset mix for you depends on your risk/return profile, investment objectives and personal circumstances. Recent experience has highlighted the importance of two things: diversification and taking a long-term investment perspective.

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