1 When Should You Rebalance Your Portfolio?

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1.2 Key takeaways:

- Portfolio rebalancing is used to manage risk exposure, ensuring one's portfolio still aligns with an accepted level of risk
- It is important to regularly review your portfolio and the weight of holdings in your portfolio
- Investors must weigh up the trade-off between letting a winning position run and the opportunity cost from rebalancing a portfolio
- One of the common traps that investors fall into is to put all their eggs in one basket, rather than diversifying their portfolio. It may not even be one stock. Instead, it might be a series of holdings all in the one sector, or leveraged to the same theme.
- Combined with periods of market volatility, investors with a concentrated amount of capital in a small number of holdings face greater risk across their portfolio. While this may prove favourable when things work out well, it can also result in magnified losses if the tide turns.
- This sort of complacency is something that investors should learn to manage, or at least have the appropriate tools to manage. Portfolio rebalancing is one strategy that can help you keep your portfolio on track, control long-term risk exposure, while also harnessing potential for returns via countercyclical trades.

1.3 What is Portfolio Rebalancing?

In simple terms, portfolio rebalancing is the act where an investor adjusts the allocation or 'weight' of individual assets or stocks in their portfolio to match the original allocation as set out by an investor with regards to their risk and reward profile.

This strategy ensures that a series of investments do not deviate away from an investors' goals and objectives. The aim is to bring asset allocations back into line with one's investment preferences.

1.4 Why Rebalance Your Portfolio?

The main purpose of portfolio rebalancing is to ultimately manage your overall risk exposure.

If you are one to not follow your portfolio all that regularly, you might find that one day your portfolio is no longer a reflection of what you originally invested in. Furthermore, you might find that the holdings in your portfolio, or the weight of the holdings in your portfolio, no longer align with your goals, attitudes, or life circumstances.

In many respects, if you do not rebalance your portfolio from time to time, you are entirely reliant on the market to shape your risk exposure. And if there is one thing that investors should be cognisant of while investing in shares, it is crucial that investors do everything within their means to consider and manage the risks that exist.

If you find that your portfolio sits outside your goals or risk appetite, you may well face a situation where you are overexposed to individual stocks or certain sectors. Should volatility arrive in these areas and market sentiment deteriorates, you face the prospect of a bigger hit.

1.5 How to Rebalance Your Portfolio

The first step is to make sure that you are actively monitoring your holdings on a regular basis.

Whether it be every fortnight, once a month, or every quarter, review the size and performance of your holdings, taking into account the weight that each stock represents within your portfolio. You may also go one step further by considering the weight of stocks from various sectors within your portfolio.

From here, if you identify that an individual stock, or a cohort of stocks from a particular sector make up an excessive portion of your portfolio – and this will vary depending on your goals and risk appetite – you might be inclined to review whether you should reduce, sell, or buy stocks in order to adjust the allocations of each holding in your portfolio.

Perhaps it is the case that you wish to realign portfolio allocations to their original levels.

If you add new funds to your account, those funds might be deployed elsewhere to dilute the size of an 'oversized' holding. Alternatively, you might reduce your exposure to one holding in order to redeploy that capital elsewhere and 'rightsize' the individual weight of each holding in your portfolio.

Periods of significant market volatility can distort the weight of holdings within a portfolio, so it is important to consider the broader context that serves as the basis for your portfolio review.

If a stock has become too 'large' in your portfolio by virtue of the fact that other stocks have significantly underperformed, you may decide that it would be inappropriate to rebalance your portfolio.

1.6 Practical Outcomes of Portfolio Rebalancing

While investors may be inclined to let their winners run, there is also a school of thought that it never hurts to take profits along the way.

In this sense, if an investor chooses to cut their exposure to a stock that represents a large weight of their portfolio, they may be managing their risk, but they also face the potential outcome where they limit the upside or potential profits from that position if it continues to perform well.

Nonetheless, many investors opt to take some money off the table during circumstances including but not limited to:

- When a certain stock outperforms in a short period of time
- Where an investor decides a stock races ahead of its intrinsic or fundamental value
- Stocks with higher risk profiles
- Companies with low-growth outlooks

In these cases, investors are sometimes inclined to redirect sales proceeds into stocks that they believe are either undervalued, offer a more defensive profile, or where increasing the weight of another holding would provide desired exposure to a certain industry, sector, or theme.

2 Investing Versus Holding Cash

2.1 Key takeaways:

- Higher inflation leads to a greater loss of purchasing power
- Where interest on cash savings lags inflation, *real* returns are negative
- There is an opportunity cost – both positive and negative – to holding cash

With inflation currently at multi-decade highs, leading to higher prices across the board, it's a good time to think about what your money is doing for you.

Is it worth putting money in the bank as interest rates rise, or does it make more sense to put spare money into the stock market? In considering this question, one needs to understand that while the inherent value of a dollar remains the same, inflation may erode the spending power of that money – in other words, money loses value over time.

With that in mind, let's consider how the two options stack up.

2.2 Inflation and its Impact on Purchasing Power

While holding some 'emergency' cash for unforeseen circumstances is a prudent move, it may be a different story if you are talking about all your savings.

The reason for this stems simply from the loss of purchasing power that occurs with inflation.

Inflation is the phenomenon where rising prices reduce consumers' purchasing power. For the same product or service, consumers pay more than before. Alternatively, consumers pay the same amount as before for less goods. This decrease in purchasing power is measured across a basket of goods and services throughout the economy.

Now more than ever, a loss in purchasing power is particularly important as we move through one of the worst inflationary environments in decades. Much of this was fuelled by a significant increase in money supply after governments around the world printed money at an unprecedented rate in response to the pandemic and lockdowns.

Even though interest rates are now rising sharply in an effort to bring down inflation, there is a lag for this to take effect. In the meantime, for as long as there is a disparity between savings rates and inflation, purchasing power continues to slip, despite the value of said money remaining unchanged.

The Reserve Bank of Australia has warned that 15% of bank accounts pay zero interest, while more broadly, banks are being scrutinised for not passing on the full magnitude of rate hikes to savers.

There is some thought that once inflation starts to approach the RBA's benchmark target, the central bank may be inclined to shift monetary policy from a restrictive setting back to an accommodative stance.

Therefore, even though it may seem like savings rates would be higher once inflation cools, rate cuts would likely flow through to savers as well. Regardless, the central bank sees inflation running above target for another two years.

2.3 Understanding Opportunity Cost

If a loss in purchasing power is just one potential risk factor associated with holding cash during an inflationary environment, the other issue that needs to be considered is opportunity cost.

This economics principle relates to the loss of other alternatives when one alternative is chosen. In other words, by choosing to invest in cash and generating a fixed return, investors forgo the alternative of investing in the stock market, where returns can be much higher – and also, where negative returns are possible.

On this front, every investor will have their own views on whether the risk-return tradeoff is appropriate for them. It may depend on their age, goals, lifestyle needs, assets, and a host of other personal circumstances. Nonetheless, over the long-term, the stock market is considered one of the most successful asset classes to invest in.

Despite the ups and downs, the stock market tends to go up over time. With this, investors need to have a long-term mindset. By investing in the stock market, volatility and negative returns will be encountered from time to time.

That means there will be specific periods where cash outperforms the stock market, even if it is a case of minimising one's losses. However, across a long-term horizon, stock market returns have proven more rewarding for investors. Do remember, past performance is no indicator of future performance, but history does offer interesting insights.

Investors should ask themselves whether it is an efficient means of wealth creation to store all their surplus funds in cash, and to the contrary, whether it is too risky to store all their funds in the stock market.

It is worth remembering, inflation erodes the value of money, and savers incur *real* losses when savings rates are below inflation – that's without taking into account tax payable on interest as well.

Cash has a particular importance for those looking to preserve capital, whether it be due to their circumstances or short periods of extreme market volatility, but the opportunity cost associated with being in the stock market – both positive and negative – should be considered as an alternative.

2.4 Final Thoughts

For investors, everything really needs to be considered in the context of one's investment horizon. The majority of investors will be looking at a long-term timeframe. Historically, the long-term performance of the stock market has shown favourable returns compared with most other assets, particularly cash, where an opportunity cost has emerged.

Cash may have its place when things get turbulent, or where investors need to prioritise stability in lieu of returns, but an environment where savings rates fail to keep up with inflation effectively locks in negative *real* returns for cash.

Listed investment companies (LICs) like Australian Foundation Investment Company (ASX: AFI), MFF Capital Ltd (ASX: MFF) and WAM Capital Ltd (ASX: WAM) are three of Australia's biggest (and some might say, best) LICs. In our regular Queste Live show I took a look at these 3 LICs and the difference between LICs and ETFs.

Below the video, I explain the basic difference between LICs and ETFs. If you want to know more about the 3 LICs, tune into the live show on Queste's YouTube channel.

What are LICs?

Listed Investment Companies (pronounced “licks”) are some of the most popular types of investments on the ASX for yield-focused investors.

A LIC is a company that’s specifically created to invest in other companies, shares, debt markets — or, really, just about anything. For example, you could have a LIC that invests in gold. In this example, technically, you wouldn’t own the gold yourself — but you would own shares in the LIC (because it’s a company) which in turn owns the gold bars.

A LIC is formed and operates in much the same way any company does:

A bunch of management personnel decide to start a company

The company is registered with the Government

Management has a strategy to grow (e.g. a business plan, an investment strategy, etc.)

They raise capital through an IPO or Initial Public Offering by getting investors to swap some shares for cash

The company takes shareholder money and invests on their behalf

The key step is #4.

That is, the initial investors during the IPO of the company/LIC are the ones who put their money into the company’s bank account. After that, when an investor sells his or her LIC shares, your money comes from another investor who wants to buy your shares (via the stock market).

For example, if I started a LIC/company called ‘ Magic Money LIC’ and said to you, “do you want me to invest, say, $5,000 for you? We’re about to IPO our new company, so I’m looking for investors who want to buy shares in my newly formed company. If you buy $5,000 worth of shares now, I’ll give you $5,000 worth of shares, and use the money to invest on behalf of you and my shareholders.”

When you decide you want to sell, you would have to find a buyer for your shares. But the company would still keep ahold of the original investment. It’s the same type of thing when you sell your BHP shares — the company doesn’t give you $5,000 — another investor is buying your shares.

The important thing to remember is that the first investors (e.g. during the IPO) put their money ‘inside’ the company/LIC. After that, any buying or selling on the ASX is just transferring shares back and forth between investors.

Are LICs different to ETFs?

There are two vital differences between LICs and ETFs you must understand.

1. LICs are ‘companies’, so you own ‘shares’.
2. An ETF is a ‘trust’, so you get ‘units’.

Meaning, they are different legal structures — and the key difference is how they are taxed. See the middle circle of the following flowchart.

In the chart above, you can see that a company/LIC is taxed (e.g. at 30%) and because it owns the investments (not the investor) a LIC is not obligated to ‘pass through’ all of the profits or dividends it receives from the investments inside its portfolio back to the investor. Because it pays its own tax in Australia, a LIC can generate its own franking credits — as well as collecting the franking credits it receives from its portfolio.

You can also see that an ETF/trust is not taxed because all it does is “hold” onto the investments on behalf of the investor. Therefore, the investor is ‘passed through’ all of the income tax that is due in a given year, as well as any capital gains (which occur when the ETF sells an investment for a profit). Because an ETF is not taxed it does not generate its own franking credits, however an ETF can ‘pass through’ franking credits it receives on the investment portfolio.

Since an ETF/trust is legally required to send tax back to its investors, a LIC can be more tax effective for highly taxed shareholders because the LIC manager can control when tax is paid and passed back. Some LICs, like AFIC, also are part of the DSSP system — which would be extremely interesting for some shareholders.

Active versus passive

Secondly, most LICs use active investment strategies, run by a team of professionals. Whereas ‘many’ (but definitely not all) ETFs use a passive or thematic index style strategy. This is reflected in the higher fees (and performance fees) typically charged by LICs compared to ETFs.

When I use LICs

When I’m building a Core portfolio, I almost always prefer to use an ETF for the Core/large part of our portfolios. ETFs tend to be lower cost and are fully transparent with all of their holdings (anyone can see what’s inside a passive ETF, on the ETF provider’s website).

That said, there are times when the legal/tax structure of a LIC makes more sense (e.g. when investing into markets without daily liquidity or harvesting franking credits). For example, with private market investments (e.g. when private companies are owned by a LIC), in micro caps or small caps, I find LICs to be quite interesting because they don’t suffer from the daily liquidity requirements of an ETF (this is why most ETFs won’t invest in small cap Aussie shares — the shares are too small for the ETF).

For most of the other stuff, such as when I’m investing in blue chip shares, overseas markets, or things like bonds, an ETF is my preferred exposure (or I’ll just buy some shares directly). To be clear, nearly all of my Core portfolio is ETFs. The same can be said of all of the portfolios we build for Rask members.

However, LICs are still a very tasty satellite alternative for shrewd investors.

Three Things to Watch for an Australian Recession in 202

Australia's economy faces a slowdown in the year ahead due to a number of headwinds

Whether the country falls into a recession could be due to factors including but not limited to interest rate policy, the Australian dollar, and the looming mortgage 'cliff'

With a growing number of economists predicting the global economy may stutter into a recession this year, investors will be watching developments closely over the coming months.

On the one hand, inflation has shown signs of potentially peaking in the US. But at the same time, an aggressive commitment by central banks around the world to hike interest rates is expected to weigh on economic growth.

Amid bleak predictions for corporate earnings, what does it all mean on home soil? Can Australia avoid a recession? Here are three factors that may determine if a recession takes place this year.

Interest Rate Policy

Although many analysts have the Reserve Bank of Australia hiking interest rates at least one more time, if not two or three more times in 2023, the central bank was effectively the first in the world to wind back the pace of its rate hike program.

This cautiousness reflects the bank's awareness about the need to balance monetary tightening with local economic growth. However, if it does not do enough to lower inflation, there is a risk that it becomes entrenched in the economy. Inflation currently remains well above the RBA's target range, but it is widely believed inflation peaked in the final quarter of 2022.

Meanwhile, as foreign central banks continue to hike rates, and inflation seemingly responding to those hikes thus far, Australia could be a potential beneficiary. Given the interconnected nature of the global economy, slowing economic growth and moderating consumer prices abroad should indirectly put downward pressure on the local prices for some goods.

Elsewhere, wages growth in Australia has trended well below that in other countries where inflation has been stubbornly higher for a longer period of time. The extreme tightness of the labour market remains a key factor here, risking higher wages growth that can lead to inflation. Immigration has picked up momentum lately, and some observers believe this could resolve labour market tightness.

Whether the RBA decides to pause its rate hikes and assess their impact will go a long way towards the likelihood of a recession. If the RBA continues to hike, not only is it likely the odds of a recession increase, but there is a distinct possibility that monetary policy weighs on the ASX as it did last year.

The Australian Dollar's Response to Global Growth

If a global recession takes hold on the back of economic weakness out of the United States, or even China, commodity prices may face renewed pressure.

Last year ended with some of these factors coming into play, with energy prices dipping to their lowest levels since the war in Ukraine broke out.

However, if another sharp fall in commodity prices eventuates, it could arrest the recent rally in the Australian dollar. This is because Australia's economy is heavily connected to commodities, and China is a major trading partner.

Nonetheless, while export earnings would be lower, a weaker Australian dollar would provide some upside for the Australian economy. In theory, commodity exports should become more affordable and competitive on a global level. This was a predominant factor that allowed Australia to largely avoid the worst of the Global Financial Crisis.

Should China's economic growth pick up dramatically in 2023, and its demand for commodities provide underlying strength for international trade, this is another factor that could provide a benefit for global economic growth, including Australia.

Learn more about the warning signs of a recession.

The Looming Mortgage 'Cliff'

Historically, fixed-rate home loans represented around 15-20% of all mortgages across the nation. This figure is over 80% in the likes of the US, UK, and New Zealand.

During the pandemic, with interest rates at rock-bottom levels, the proportion of fixed-rate loans as a percentage of the entire mortgage market grew to around 35-40%. In monetary terms, this represents about $750 billion in loans.

The RBA estimates that around two-thirds of fixed-rate loans, or 23% of all mortgages, will roll over to variable-rate loans in the second half of 2023.

However, with the official cash rate increasing three percentage points, and potentially even more by the end of the year, borrowers face an extraordinary test by way of higher mortgage repayments. These repayments could be up to 40% higher than the thresholds that lending institutions used to 'stress test' borrowers' ability to meet their financial obligations.

A number of economists have flagged the looming mortgage 'cliff' as posing major headwinds for the property market. However, it also raises substantial risks for spending across the Australian economy, with debt levels sitting at record highs, and the prospect of a surge in the number of borrowers struggling to meet repayments

One favourable trend during the pandemic was that many borrowers managed to get ahead of their mortgage repayments, with anecdotal evidence pointing to strong household savings.

Final Thoughts

Other criteria like business investment, construction activity, and the Balance of Trade will all play a role in determining whether Australia avoids a recession. Arguably, the biggest risk may be the US falling into an official recession, where a slowdown in growth tends to spread across the world.

But as the RBA seeks to return inflation to its target range of 2-3%, interest rate policy, the Australian dollar, and the looming mortgage 'cliff' represent important challenges for the local economy that every investor should take into consideration.

What are the Benefits of Multiple Share Portfolios?

Key takeaways:

Multiple share portfolios can be used to target different investment goals

It may be easier to monitor underperforming stocks in a portfolio when there is less ‘noise’ acting as a distraction

Allocating separate capital to different portfolios is a useful risk management tool

Between new and experienced investors alike, many individuals look to accumulate a large share portfolio, without really identifying what might be the best way to frame their investment goals, monitor their progress, and manage their risk.

An often neglected strategy that deals with this pitfall is to create multiple share portfolios. Not only does this help investors deal with the psychology of investing, but it instills financial discipline.

Queste members can make the most of their trading account by creating multiple share portfolios, each sitting under the same user login.

So why might you consider multiple share portfolios? Let’s take a look at some of the potential benefits of this approach to investing.

1. Clear, Defined Investment Goals and Strategies

First things first, you can target different investment goals by setting up multiple portfolios.

These goals might include working towards a deposit for a house, accumulating enough for a child’s future education needs, drawing passive income through retirement, earning an income from active trading, funding lifestyle purchases, or building a nest egg.

With each of these possibilities in mind, it’s worth remembering that different investments align with reaching these goals. For example, speculative stocks are hardly appropriate for an individual looking to draw passive income for their retirement living. Therefore, you might choose to invest in different assets that support your varying goals.

For example, a defensive (‘non-risky’) portfolio could help target income. This portfolio might focus on ETFs, exchange-traded bonds, fixed interest and gold, and blue-chip stocks.

However, a risk-oriented portfolio with speculative stocks might be suited to short-term goals for lifestyle purchases, like a new car.

In effect, multiple portfolios help investors define a sense of ‘purpose’ to their investing. This approach helps establish what you are working towards, and it serves a motivational reminder.

Don’t forget, you can also set up different types of accounts with Queste, covering individuals, joint holders, companies, trusts, SMSFs, and even kids investing accounts.

1. Fine-tuned Performance Monitoring

Separate share portfolios allow you to measure and track your progress towards meeting your goals at any moment. It is a useful approach to generate insights that may influence your decision-making, including any portfolio changes that might be necessary to meet your goals.

A multiple-portfolio strategy also helps remove some of the ‘noise’ when monitoring a large portfolio.

Quite often, investors hold blue-chip stocks and a sprinkling of risky, speculative shares in the one portfolio. When all of these stocks are held in the one portfolio, it is easy for the performance of the blue-chip stocks to 'mask' the performance of the speculative holdings. The same applies where a large weight of the portfolio is invested in just one or two stocks, out of a much larger number.

The principal outcome of these scenarios is that investors may neglect to monitor the performance of smaller, more volatile holdings.

As such, from a psychological perspective, it is easier to assess the performance and contribution of these stocks when they are held in a separate, dedicated share portfolio. Greater clarity in the way of performance monitoring can be useful for investors to identify underperforming stocks.

1. Improved Capital and Risk Management

Capital allocation is one of the most important principles of managing a share portfolio. When you have just one portfolio, it is often tough to decide where to deploy capital, especially if you hold a diverse range of stocks.

Things are slightly different if you have multiple portfolios. The first thing you will be guided by is how to split your capital across multiple portfolios.

However, your investment goals, risk appetite, and portfolio exposure will shape this decision. Maybe you decide to allocate capital across two portfolios on a 60-40 basis, or if you have three portfolios, perhaps you spread the money 60-20-20.

The exact breakdown is not the lesson here. Instead, it is the approach based on a predetermined allocation. This 'rule' determines where savings will be invested, and it can help you avoid investing too heavily in one area. If you are in the habit of trying to catch a falling knife, this approach may play an important role in reframing the way you manage your portfolio to maintain diversification.

With capital assigned for a specific portfolio or investment purpose, investors can improve their trading discipline. So long as clear goals are in place, they are also less likely to make impulsive investment decisions.

In many respects, multiple share portfolios assigned separate capital may assist manage overall investment risk, but as always, portfolio rebalancing remains an important factor to consider.

Final Thoughts

Although it may seem as though multiple share portfolios entails more admin, this approach may be more efficient for a number of investors.

Queste members can open multiple portfolios via their trading accounts. Establish different goals for each portfolio, providing you a clear understanding of what you are investing towards.

Furthermore, the ability to monitor these goals in isolation, and the supporting strategies behind them, represent powerful checks and balances to keep you focused while managing capital and overall investment risk.