



Investment planning and asset allocation

aspects of investment have become increasingly relevant to individual and institutional investors. As at October 2019, there was nearly £25 billion invested in UK ethical retail funds according to the Investment Association (IA).

Risk tolerance and capacity

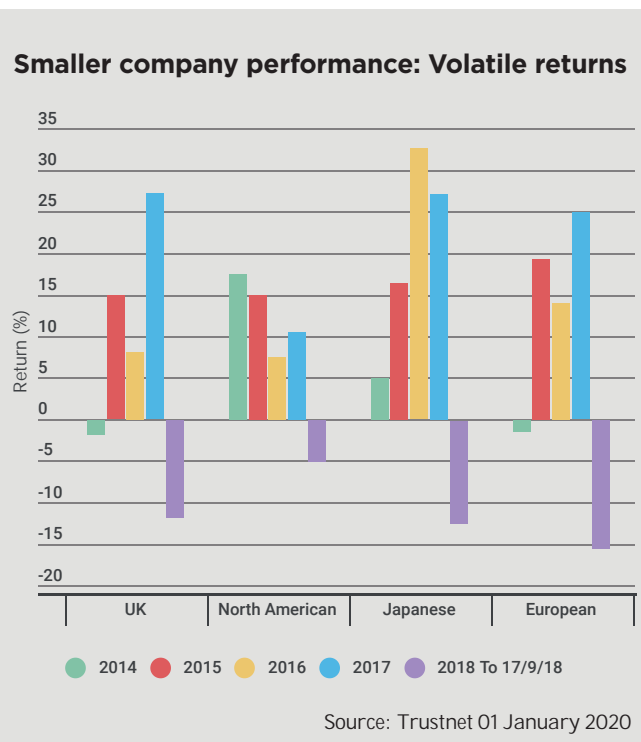
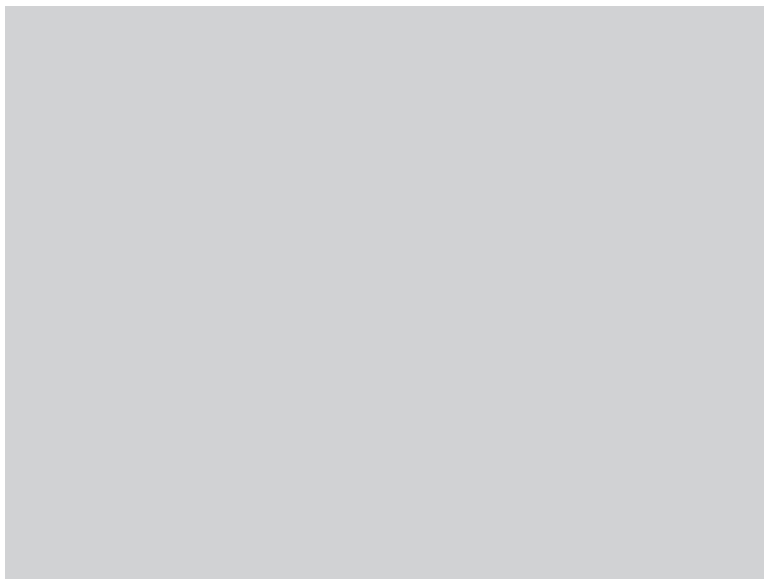
In considering risk at the personal level, there are two thresholds that must be assessed:

- 1. The level of risk you are prepared to accept.** The assessment of your risk tolerance is now usually carried out with the help of a series of profiling questions, which may be in the form of a computerised questionnaire.
- 2. The level of capital loss that your finances can absorb.** You may feel comfortable about taking a high-risk approach to your investments, but that does not automatically mean you should invest in volatile assets. The greater the risk, the greater the possibility of a substantial loss. Unless you have sufficient resources to cope with potential significant loss, you should not expose yourself to the risk. Your adviser will assess your loss capacity, based on a detailed analysis of your assets and liabilities through the investment term. The result of that exercise could mean your recommended portfolio has a lower level of risk than your attitude to risk alone suggests would be appropriate.

Planning point
 Investment markets can be very volatile, especially in the short term. There are no guarantees a high-performing fund will repeat its success in the future.

ASSET ALLOCATION

There is considerable academic research to show that asset allocation is a crucial factor in determining overall investment returns. This is well illustrated by looking at the IA sector fund performance over various terms. The table below shows results across five calendar years.



IA sector performance				
Year	Best performing sector	Average fund	Worst performing sector	Top fund
2019	Technology and telecommunications	+31.3%	UK direct property	+3.5%
2018	UK direct property	+3.9%	European smaller companies	-5.1%
2017	China/Greater China	+35.9%	Short term money market	+0.2%
2016	North American smaller companies	+40.0%	Short term money market	+0.4%
2015	European smaller companies	+19.3%	Global emerging markets	+1.1%

Return figures are calculated on a bid price to bid price basis (mid to mid for open-ended investment companies (OEICs)) with net income reinvested. Source: Trustnet.com. Past performance is not a guide to the amount you will receive in the future.

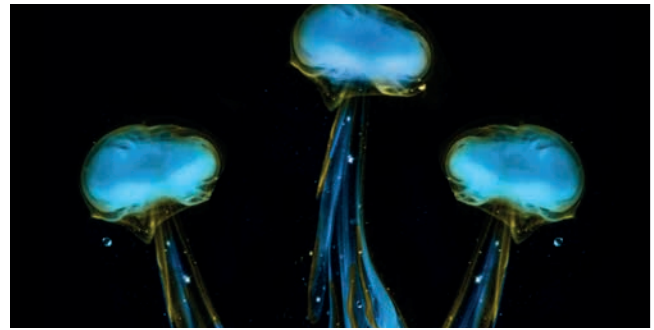
Asset allocation is not just about picking asset sectors. As the table shows, the top sectors are often at the more volatile, higher end of the risk scale such as the smaller companies sectors. The volatility of smaller company performance is demonstrated in the graph.

The asset allocation decision is especially important in the management of risk. Diversifying across different asset classes, such as UK shares, foreign shares, fixed interest securities, property and commodities, can reduce your investment portfolio's volatility. What is bad news for one asset class might be good news for another.

For example, a jump in inflation can be negative for fixed interest securities, but it may be positive for index-linked government bonds. The same can hold true for individual shares. For instance, the strengthening of sterling throughout 2019 held back large multinationals with overseas earnings, such as Unilever, but was better news for the more UK-focussed companies, such as Lloyds Bank.

An example of the differing fortunes of two main UK asset classes – equities and government bonds (gilts) – is shown in the graph below. In most years, both asset classes have moved in much the same direction, if not to the same degree, but there have been notable exceptions. This was particularly the case during the financial crisis of 2008 to 2009 when first gilts outperformed strongly and then, in the following year, equities did so.

The process of matching asset allocation to your risk profile and investment goals is now one that can rely on computing power. This allows a portfolio to be constructed that takes account of the historic performance relationships or correlations between asset classes. As the graph above



shows, gilts and equities often move in the opposite direction – a negative correlation. Therefore, a 50/50 combination of equities and gilts frequently produces more stable returns than either class alone. In the five years to the end of 2019, the 50/50 mix provided a return at just about the mid-point of the two classes with lower volatility in the yearly returns.

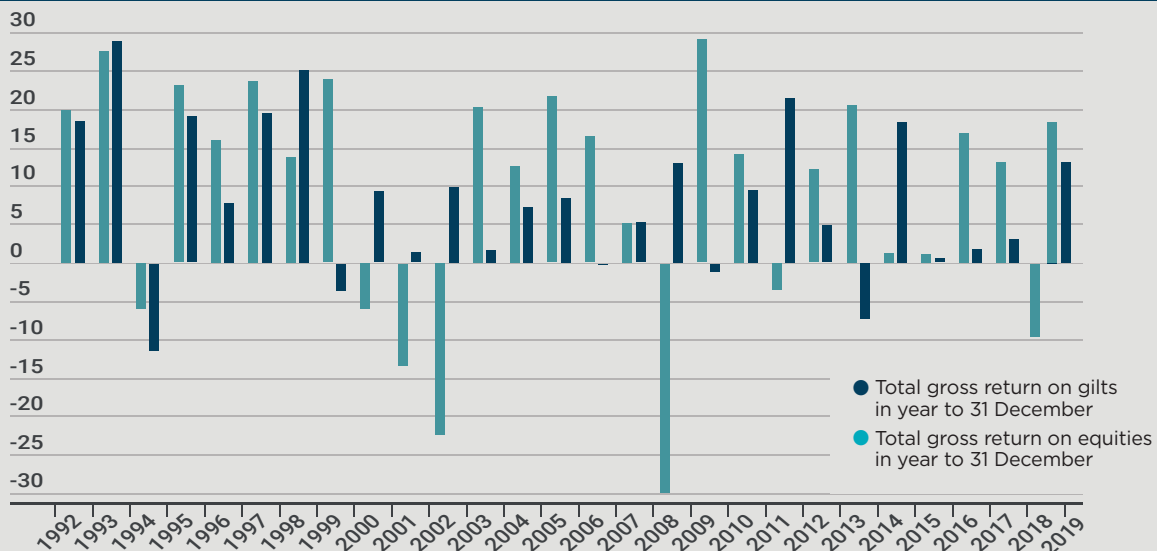
Planning point

A diverse investment portfolio can help mitigate the risks of volatility in individual sectors.

HOW TO PICK AN INVESTMENT FUND

Once the asset allocation has been set, the next decision is how to invest in the selected asset classes. For most private investors, that will mean using collective funds, such as unit trusts and open-ended investment companies (OEICs). The direct purchase of assets may not make sense because of the costs involved and/or the difficulty of achieving an adequate spread within the asset class. Even for the wealthiest private investors, collective funds may be the only option for some asset classes, such as commercial property.

UK equities versus government bonds: 1992–2019



Source: Barclays Capital Equity Gilt Study 2019/FTSE

Smoothing returns			
Year	Equities	Gilts	50/50 mix
2015	1.10%	0.50%	0.80%
2016	16.4%	11.5%	13.95%
2017	12.9%	2.2%	7.55%
2018	-9.10%	1.0%	-4.05%
2019	19.17%	12.03%	15.60%
Average total return	7.75%	3.38%	5.56%

Past performance is not a guide to the amount you will receive in the future.

Fund selection is not a simple matter of looking at a set of performance league tables and picking one of the top three. League tables only tell you what has been achieved, not how it was done, nor the likelihood of continued performance. For instance, a top-performing fund may have:

- adopted an unacceptably high-risk strategy which, as recent high profile cases have shown, may not be immediately apparent to investors;
- performed well while the fund was small, but may now be much larger and less flexible;
- recently lost its lead manager to another investment group;
- just struck lucky. The fact is that luck can play a role in fund performance, particularly for more concentrated funds that have few relatively large holdings.

The uncertainties about future fund performance have prompted the increased use of index-tracking funds. They are often called 'passive' funds to distinguish them from 'active'

funds where decisions are made by an investment team rather than an index setter.

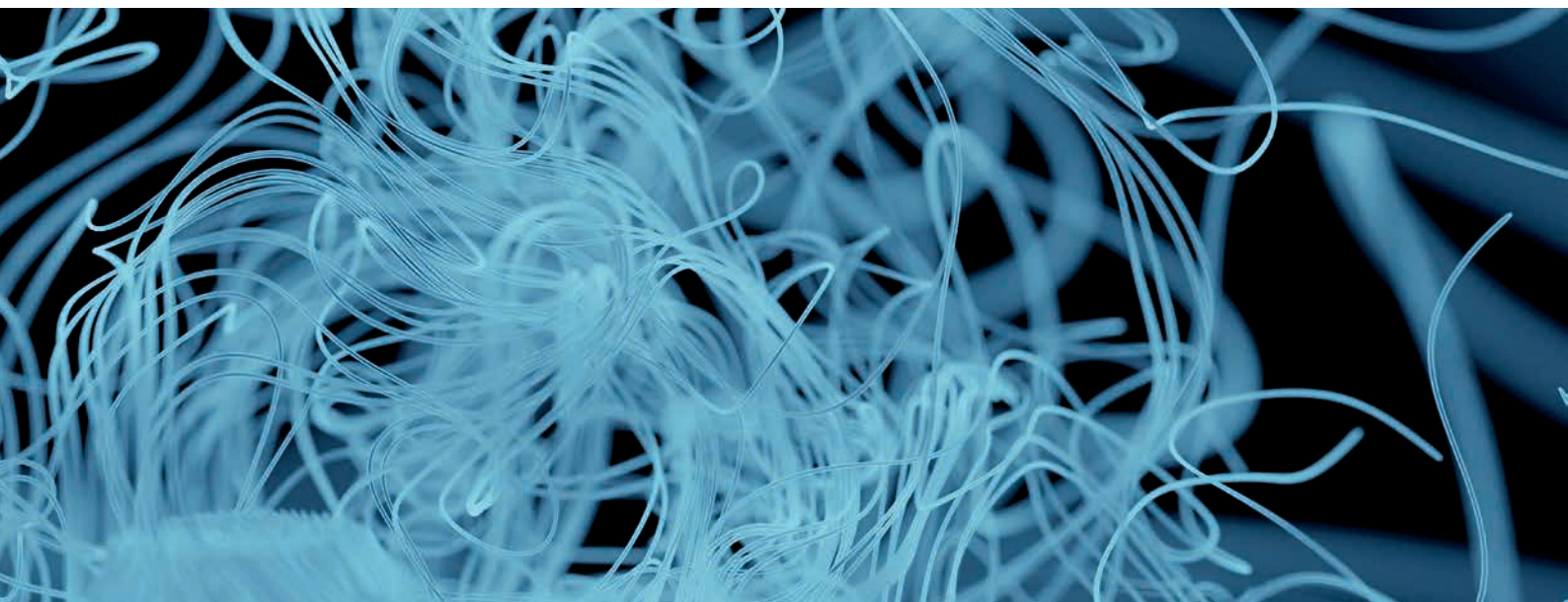
Proponents of active fund management argue that an index fund should deliver returns slightly below the market index it is tracking, because of the effect of charges, whereas an active fund, without index constraints, can outperform. Passive fund managers accept this point, but argue that picking next year's outperforming fund is virtually impossible and that overall, the higher costs associated with active funds more than counter their supposed performance benefits. For both passive and active funds, selection involves an in-depth analysis of a variety of performance statistics. But it also requires a qualitative assessment of the fund manager. Even funds tracking the same index have differing returns. For active fund selection, it is also necessary to investigate the manager's investment process.

Planning point

There is a wealth of information on fund performance available to investors. With some research you can build a greater understanding of how and why a fund may succeed.

TAX STRUCTURE DECISION

Tax is not always directly relevant to the design of an investment portfolio and should never dictate an investment decision. If tax saving is the sole motivation for your investment, then warning bells should sound. History is littered with tax-efficient, loss-making investment schemes. However, once the choice of asset classes and funds has been made, your personal tax position does become relevant in determining the structure – sometimes referred to as a 'wrapper' – in which you should hold the investments. For instance, you could hold the same investment fund directly, or in an individual savings account (ISA), or in a self-invested personal pension (SIPP) or in an investment bond. You can add a LISA (Lifetime ISA) to this list if you are under age 40.



The tax consequences of each option are different. There are two layers of tax treatment to consider, within the chosen investment wrapper, and then your personal position when you take withdrawals from it – unless you choose to hold the investments directly

The use of a variety of wrappers need not add great complexity to the management of your portfolio, as we explain in the next section. Some investments are better suited to being held in tax wrappers rather than directly. For example, income from fixed-interest funds is free of UK tax in an ISA, but currently taxed at rates of up to 45% if held personally.

Platform selection

The construction and management of fund-based investment portfolios is now largely undertaken using investment platforms. At its simplest, an investment platform provides a means of assembling and administering a spread of different funds from a range of investment managers, which can be held in a variety of tax structures.

The number of platform providers has grown as investment administration strategies have changed, although there have also been some disappearances. Your adviser will consider a range of factors when recommending a platform to you, including:

- Choice of funds and investment managers – generally the more the better.
- Range of tax structures available.
- Provider's record for administrative efficiency.
- Level of fees charged and their collection method.
- Financial strength of the platform provider.

Planning point

Your investment plan needs to be dynamic and respond to changes in performance and values, as well as your requirements. So, you should regularly review your portfolio.

Reviewing your portfolio

The selection of the platform providers is the final step before the creation of your investment portfolio, but it is by no means the end of the process. Your investment plan should never be fixed or incapable of change. It needs to be regularly reviewed to check that both the asset allocation and chosen investments are still appropriate to your financial goals and that those goals have not altered.

A review that makes no changes is rare. For example, to maintain the original asset allocation there will often be a need to rebalance holdings because of intervening moves in investment values. At the fund level, manager changes, revised fund objectives or disappointing performance can all prompt adjustments. New investment opportunities also need to be considered.

If your portfolio is not subject to regular and systematic reviews, it may soon become just a random collection of investments rather than a coherent portfolio. The discipline of a regular review is therefore a key component of successful investment planning.

The value of your investments and income from them may go down and you may not get back the original amount invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and your financial circumstances. Tax planning is not regulated by the Financial Conduct Authority.



HOW WE CAN HELP

We can help with your investment planning and asset allocation in several ways:

- Obtain up-to-date valuations, acquisition dates and initial outlay for your existing investments, including pension plans and any investment-linked life assurance. This gives a clear picture of your starting point.
- Guide you through the setting of your investment goals, helping you to consider how much risk you are willing to accept and the level of potential loss that you can tolerate.
- Recommend appropriate asset allocations, fund and platform providers, drawing on our extensive market knowledge.
- Undertake reviews of your plan to keep it on track with your investment goals.
- Keep you advised on how any new government legislation could affect your investments.



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