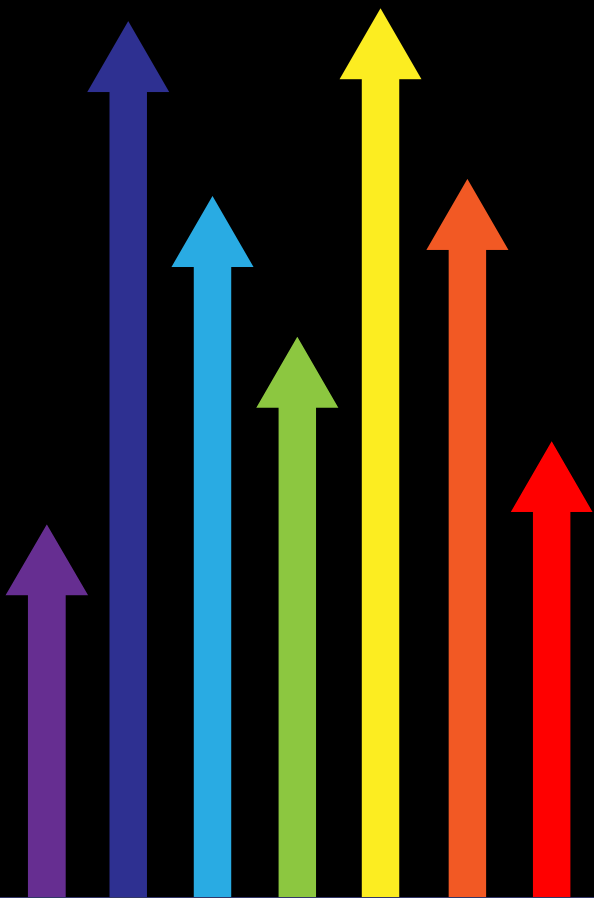
GUIDE TO

CREATING A DIVERSE INVESTMENT PORTFOLIO

HOW TO WORK OUT YOUR OWN INVESTING STYLE WHEN THINGS AREN'T BLACK AND WHITE

FINANCIAL GUIDE



Myers Davison Ginger Ltd
Goldsmiths House, 10-14 Cambridge Street, Aylesbury, Buckinghamshire, HP20 1RS
Tel: 01296 392999 Fax: 01296 392983 Email: advice@mdgifa.com

WELCOME

How to work out your own investing style when things aren't black and white

Welcome to our *Guide to Creating a Diverse Investment Portfolio*. 'Don't put all your eggs in the same basket' is probably the best known proverb advising investors about the importance of portfolio diversification to spread and reduce risk.

The major advantage of portfolio diversification is its ability to protect your entire portfolio from volatility associated to various asset classes. In this guide, we look at ways to protect your portfolio by spreading your risk across several different asset classes and some of the many different assets in which you can invest, each with different risk characteristics.

Whilst the risks attributable to assets cannot be avoided, when managed collectively as part of a diversified portfolio, they can be diluted. Individual assets have a bearing on the overall level of risk you are exposed to, and the correlation between the assets has an even greater bearing. This guide considers how a well constructed investment portfolio should be diversified in a variety of ways, including overall investment style, number of individual asset classes, spread of geographical allocation and the approach of the fund manager.

Is it time to review your investment portfolio?

Creating and maintaining the right investment portfolio plays a vital role in securing your financial future. Whether you are looking to invest for income or growth, we can provide the quality advice, comprehensive investment solutions and ongoing service to help you achieve your financial goals. Please contact us to discuss your requirements – we look forward to hearing from you.

CONTENTS

It's usually recommended that you hold no more than 30 investments (be it shares or bonds). If you're investing in funds, 15 to 20 should be a maximum.

PORTFOLIO DIVERSIFICATION

Managing the risks you are exposed to in order to avoid suffering losses to your capital

Whether you're planning to start investing your money, or even if you're already a seasoned investor, it's crucial to make sure you manage the risks you are exposed to in order to avoid suffering losses to your capital. The key is to build a diverse portfolio with a mix of different investments that makes sense for your attitude to risk.

A balanced investment portfolio will contain a mix of equities (shares in companies), government and corporate bonds (loans to governments or companies), property, and cash.

Assets moving independently
Having a mix of different asset types will help you spread risk. It's the old adage of not putting all your eggs in one basket. The theory behind this approach is that the values of different assets can move independently and often for different reasons.

Shares move in line with the fortunes and prospects of companies. Bonds are most prominently influenced by interest rates, and property values, while also influenced by interest rates, are also more closely connected to the performance of the domestic economy.

Get the right asset allocation and you could make a healthy return, while also protecting yourself against the worst downturns in individual markets.

Different investment sectors
Say you held shares in a UK bank in 2006. Your investment may have been very rewarding, so you decided to buy more shares in other banks. When the credit crunch hit the following year, sparking the banking crisis, the value of your shares in this sector (financials) would have tumbled.

So, once you've decided on the assets you want in your portfolio, you can diversify further by investing in different sectors, preferably those that aren't highly correlated to each other.

For example, if the banking sector suffers a downturn, this will not necessarily have an impact on the precious metals sector. This helps to make sure your portfolio is protected from dips in certain industries.

Some investors will populate their portfolios with individual company shares directly, but others will gain access to different sectors through managed funds like unit trusts and OEICs (open-ended investment companies).

Stock market movements
Investing in different regions and countries can reduce the impact of stock market movements. This means you're not just affected by the economic conditions of one country and one government's economic policies. Different markets are not always highly correlated with each other – if the Japanese stock market performs poorly, it doesn't necessarily mean that the UK's market will be negatively affected.

However, you need to be aware that diversifying in different geographical regions can add extra risk to your investment. Developed markets like the UK and US are not as volatile as those in emerging markets like Brazil, Russia, India and China. Investing abroad can help you diversify, but you need to be comfortable with the levels of risk involved.

Range of different companies

Don't just invest in one company. It might hit bad times or even fail. Spread your investments across a range of different companies. The same can be said for bonds and property. One of the best ways to do this is via a unit trust or OEIC fund. They will invest in a basket of different shares, bonds, properties or currencies to spread risk around. In the case of equities, this might mean 40 to 60 shares in one country, stock market or sector.

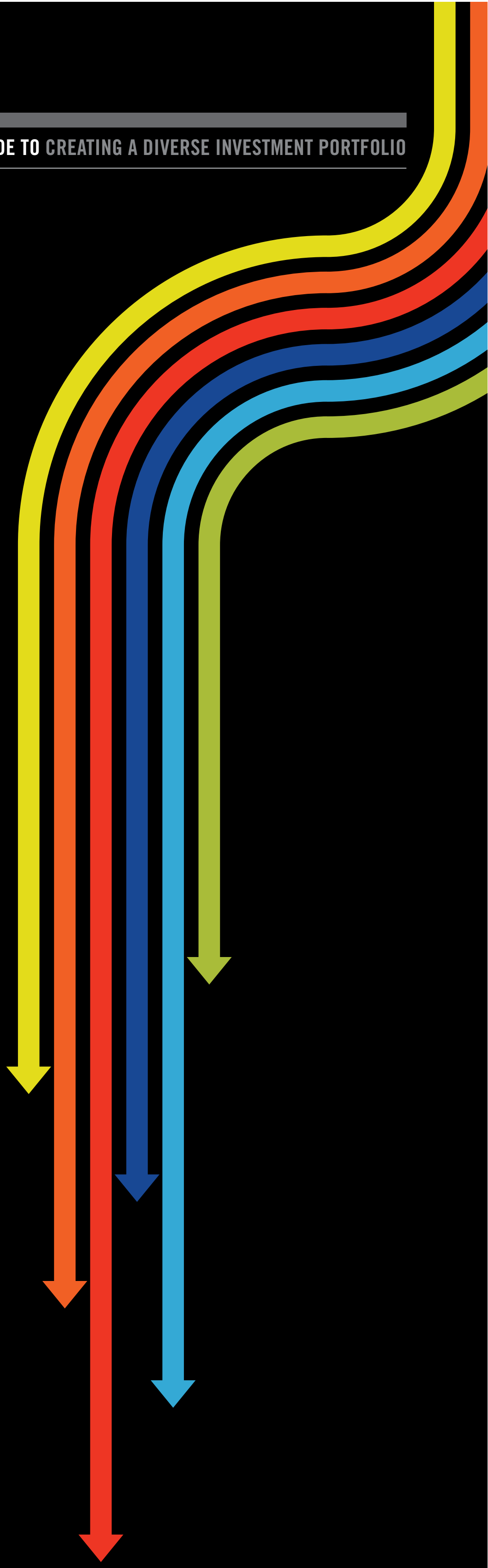
With a bond fund, you might be invested in 200 different bonds. This will be much more cost effective than recreating it on your own and will help diversify your portfolio.

Capacity for growth

Holding too many assets might be more detrimental to your portfolio than good. If you over diversify, you might not end up losing much money, but you may be holding back your capacity for growth, as you'll have such small proportions of your money in different investments to see much in the way of positive results.

It's usually recommended that you hold no more than 30 investments (be it shares or bonds). If you're investing in funds, 15 to 20 should be a maximum.

Finally, for many investors – especially those without the time, confidence or knowledge to make their own investment decisions – professional financial advice is a must.



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PRINCIPLES OF DIVERSIFICATION

Minimising exposure to volatility and market setbacks

Investing would be easy if markets rose in a straight line. Unfortunately, that is rarely the case. Over the long term, assets such as shares and bonds have tended to produce positive returns, but there have been several bumps along the way. In any event, past performance of investments cannot be taken as a guide to their future performance.

There are steps investors can take to minimise their exposure to volatility and market setbacks. One of the most important considerations is to apply the principles of diversification, or spreading your money across a range of assets rather than sticking with one type of investment.

By not putting all your eggs in one basket, you reduce the impact of losses on your overall portfolio. However, investors should bear in mind that a diversified approach will also limit the potential for gains from the rise in a single investment's value.

Returns for investors
Funds make it easy for investors to build a diversified portfolio by reducing the volatility and potential gains and losses associated with individual shares. A typical fund manager investing in UK companies may hold perhaps 30 or 40 different shares in a single fund.

Shares can be volatile and may fall in value. Indeed, during a crisis, all the shares in an index tend to fall together. But it is less likely that shares in 30 or 40 companies will perform in the same way over time.

Some may perform strongly, while others may not. By holding a number of individual assets, funds tend to smooth out long-term returns for investors.

Single asset class
Investing in different assets, including shares, bonds, property or cash, further improves the level of diversification in your overall portfolio. Some funds hold a single asset class, such as shares, while multi-asset funds contain a range of these assets in a single portfolio that is overseen by a fund manager.

Asset classes offer different potential returns based on varying degrees of risk. For example, shares have historically produced higher returns but pose a higher risk of capital losses. Bonds generally produce lower returns but with a lower risk of losses.

In addition, assets can react in different ways to the same market forces. Assets that move in opposite directions in response to the same economic changes or market forces are described as having a low or negative correlation.

Offset by gains
When these assets are held together within a diversified portfolio, losses in one part of the portfolio are likely to be offset by gains elsewhere. For example, the prospect of higher inflation is often detrimental to the bond market. The income available from bonds is usually fixed, and is therefore less valuable when inflation is rising.

By contrast, stock markets have tended to cope better with higher inflation, partly because companies can put up prices to combat it, which in turn is reflected in their share prices. Likewise, the value of gold has tended to rise during periods of

Diversification doesn't only apply to the types of assets in your portfolio, but also to the regions and sectors within these asset classes.

higher inflation, as it is traditionally seen as a hedge against rising prices.

Holding a range of asset classes is also important for income-seeking investors, who try to ensure that their income stream remains relatively steady by drawing it from a variety of sources – coupons from bonds, dividends from companies, rents from commercial property and so on. That way, if one asset class is hit by a change in the economic environment, investors would not expect to see their income stream evaporate.

Types of assets

Diversification doesn't only apply to the types of assets in your portfolio, but also to the regions and sectors within these asset classes. For example, investors could hold shares from different regions of the world, such as the UK and emerging markets, which have tended to produce different returns over time. Emerging markets include Brazil, India and China.

Investors could also look for companies with different market capitalisations, such as large caps and small caps. Broadly speaking, a large-cap company in the UK is considered to be one listed on the FTSE 100 index, which contains the 100 largest companies by market capitalisation. In contrast, small caps in the UK are typically shares listed in the FTSE Small Cap index or on the AIM index of small, fledgling companies.

Shares in fast-growing smaller companies have tended to offer the prospect of stronger returns than larger blue-chip companies, but they are usually much more volatile. As a result, investing in small-cap stocks is riskier than investing in larger companies.

Exchange-traded funds

There are a significant number of funds available that target various asset classes and sectors, from American smaller companies to emerging market bonds. In particular, the growth in low-cost exchange-traded funds has made it simple and cheap for investors to track a significant range of stock markets and asset classes.

A further way that investors could build a diversified portfolio is to apply different selection criteria when picking assets within any given market. For example, this could mean choosing a mix of defensive and cyclical shares that are more likely to perform differently in response to trends in the wider economy.

Defensive shares, such as utilities or tobacco companies, are those that have a good track record of consistent dividends and stable earnings regardless of the economic climate. As a result, these shares have the potential to perform better than the rest of the market during periods of weaker economic growth.

Strong economic growth

In contrast, the performance of cyclical shares, such as house builders or luxury retailers, is more closely linked to the economy. These shares have the potential to perform strongly during times of strong economic growth, but often fall in value when the economy is performing less well.

The balance of assets in your overall portfolio should reflect your appetite for risk and reward. Generally speaking, the

Maintaining a diversified portfolio should help smooth out returns for investors. It can protect you from some of the worst market declines but still allow you to benefit from potential upswings in performance.

larger the proportion of equities held in a portfolio, the riskier it is considered to be.

For example, a higher-risk portfolio may hold 50% developed market equities from the UK, US or Europe; 20% emerging market equities; 10% bonds; and the remainder commodities, property and cash.

Lower-risk portfolio
By contrast, a lower-risk portfolio may only contain 15% developed market equities, 5% emerging market equities, 20% bonds, 40% cash and the remainder in property and commodities. A balanced portfolio would be somewhere between these extremes.

Multi-asset funds can offer a one-stop shop for investors looking to build a diversified portfolio from scratch, combining a range of assets from different regions and sectors to reduce volatility and the risk of potential losses.

Investors should choose a multi-asset fund to match their risk appetite based on the proportion of shares in its portfolio. Multi-asset funds commonly feature labels such as adventurous, balanced, cautious or absolute return, representing different levels of risk, while others feature a numerical risk rating.

Multi-asset funds
The Investment Association, an industry trade body, groups multi-asset funds into four categories, from 'Mixed Investment 0-35% Shares', which are lower risk, to 'Flexible Investment', the riskiest category of multi-asset funds which can hold up to 100% in shares.

Some draw upon several managers as well as asset classes. These multi-manager funds can benefit from the investment styles of a wider range of experts, and they can also give you access to managers who may not normally be marketed to private investors.

Maintaining a diversified portfolio should help smooth out returns for investors. It can protect you from some of the worst market declines but still allow you to benefit from potential upswings in performance. Diversification, in short, should make investing a less nail-biting experience.

Please remember that regardless of whether you diversify, the values of all investments can fall as well as rise, and you may get back less than you invested. Past performance is not a reliable guide to future performance.

WHY ARE YOU BUILDING AN INVESTMENT PORTFOLIO?

Every investor is unique, but everyone faces the same trade-off between risk and reward

The best place to start when you are looking to build a diverse investment portfolio is to ask yourself why you're building a portfolio. For most of us, the central task is to build a pot of money that involves you, the investor, taking some risk over the long term, at the end of which you will have ideally built up a sizeable portfolio of diversified assets that will last you through to your retirement years.

Some investors don't have such a long-term objective and are thus less willing to take on risks. They might, for instance, only be saving for ten years to cover school fees. Alternatively, they may already be in retirement and need to generate an income while preserving their money against inflation, even at the cost of future opportunity. For both of these latter groups, a sensible investment strategy is likely to involve a relatively low level of 'risky' assets such as equities.

Above-average returns
So every investor is unique, but everyone faces the same trade-off between risk and reward. In simple terms, you can't hope for long-term, above-average returns unless you are willing to take on more risk. This might sound like a simple idea, but an astonishingly large number of investors persist in the myth that double-digit year-on-year growth is possible without risking the loss of a substantial chunk of their assets.

Investing in equities is only a viable option for the long term (at least five years, if not ten), and if capital preservation is your primary objective, you should probably steer clear of stocks and shares, and stick to less risky, less exciting assets such as bonds and cash.

Perceptions of risk
As you grow older and your requirements change (as well as your perceptions of risk), your portfolio of assets must also adapt. To give you an idea of how your portfolio might change, lifecycle or lifestyle funds have been developed. These funds mix equities, bonds and property assets in different proportions according to how close the holders are to retirement (or how far beyond it).

Simply put, they start with 100% of assets in risky equities for a worker in his or her thirties, and then end with a portfolio where 75% is allocated to low-risk bonds for an investor into his or her retirement.

Old rule of thumb
This is known in the investment industry as 'lifestyling'. It's a term for a very old rule of thumb: subtract your age from 100, and that's how much you should hold in equities if appropriate to your particular situation. So if you're 30, have 70% of your investment portfolio in equities. If you're 60, have 40% in stocks and shares.

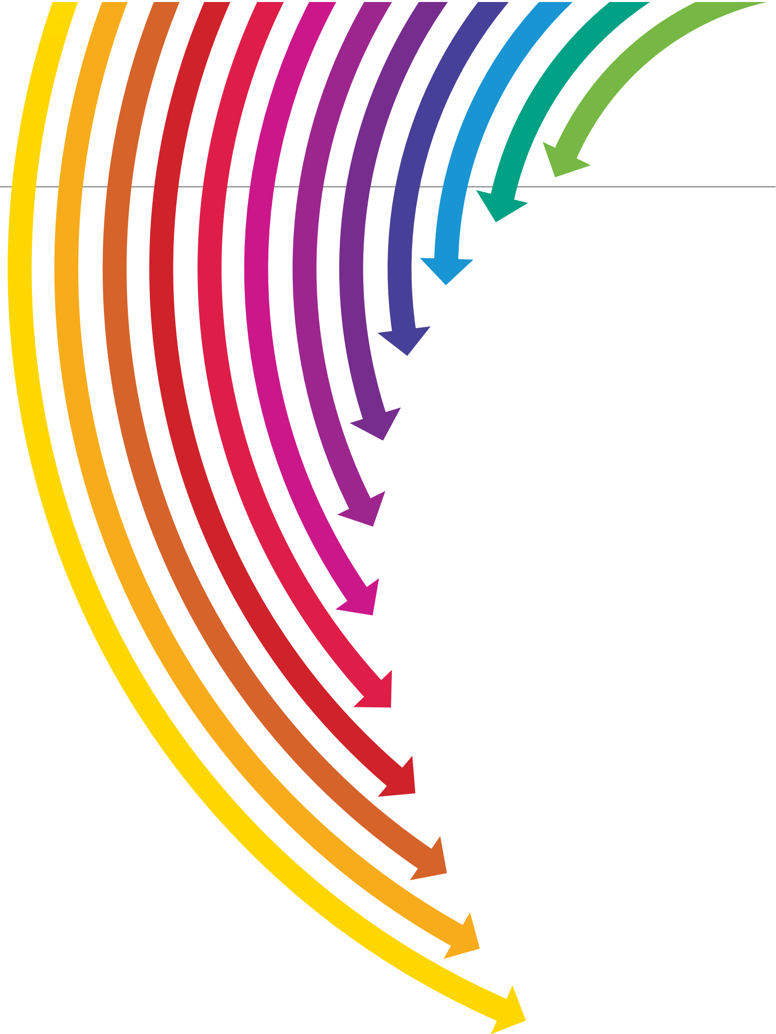
It is vitally important that any rearrangement of your portfolio is controlled and measured. Never forget that every time you buy and sell assets, some of your money is lost in fees. Virtually every analysis of historical returns suggests that investors shouldn't over-trade, shouldn't try to time the markets and absolutely should avoid turning into speculators.

Long-term strategy
Instead, the consensus is that private investors should work out a long-term strategy, build a diversified, robust portfolio, and then sit tight as a buy-and-hold investor.

The basics of building an investment portfolio are surprisingly simple. Work out your own investing style, and then make sure that your diversified mixture of asset classes mirrors your own risk-reward trade off.

Higher risk levels
If you're willing to embrace higher-risk levels and won't need the money for a while, think about tilting your portfolio towards shares. If you only have a narrow time horizon for what you want to achieve from your investment, give more weight to bonds and cash.

And don't get too carried away: keep the underlying funds within your portfolio simple and cheap, and don't over-trade.



REDUCING INVESTMENT RISK

Choosing a broad spread of instruments in which to invest

If you require your money to provide the potential for capital growth or income, or a combination of both, and provided you are willing to accept an element of risk, pooled investments allow you to invest in a large, professionally managed portfolio of assets with many other investors. As a result of this, the risk is reduced due to the wider spread of investments in the portfolio.

Collective investments

Pooled investments are also sometimes called 'collective investments'. The fund manager will choose a broad spread of instruments in which to invest, depending on their investment remit. The main asset classes available to invest in are shares, bonds, gilts, property and other specialist areas such as hedge funds or 'guaranteed funds'.

Most pooled investment funds are actively managed. The fund manager researches the market and buys and sells assets with the aim of providing a good return for investors.

Passively managed

Trackers, on the other hand, are passively managed, aiming to track the market in which they are invested. For example, a FTSE 100 tracker would aim to replicate the movement of the FTSE 100 (the index of the largest 100 UK companies). They might do this by buying the equivalent proportion of all the shares in the index. For technical reasons, the return is rarely identical to the index, in particular because charges need to be deducted.

Trackers tend to have lower charges than actively managed funds. This is because a fund manager running an actively managed fund is paid to invest so as to do better than the index (beat the market) or to generate a steadier return for investors than tracking the index would achieve. However, active management does not guarantee that the fund will outperform the market or a tracker fund.

Stocks & Shares ISAs can contain shares, bonds and investment funds. There are no restrictions about where in the world you can invest: it does not have to be all in the UK.

A HIGHER RETURN ON YOUR INVESTMENT

Invest as much of your annual ISA allowance as you like in either a Stocks & Shares ISA or a Cash ISA, or any mixture of the two

Some people never look beyond Cash Individual Savings Accounts (ISAs), but by using Stocks & Shares ISAs too, you could get a higher return on your investment. Stocks & Shares ISAs can contain shares, bonds and investment funds. There are no restrictions about where in the world you can invest: it does not have to be all in the UK.

ISA allowance

Following 1 July 2014, you can now invest as much of your annual ISA allowance as you like in either a Stocks & Shares ISA or a Cash ISA, or any mixture of the two, as long as you don't exceed the annual limit. The annual limit is currently £15,240 for the 2015/16 tax year.

Building up a reserve of ready money before heading into riskier assets like shares is good practice, and it has been recommended that people try and maintain three to six months' worth of income saved as cash which can be used for emergencies.

Financial plan

At this point, having created a buffer, the next step is to decide on a financial plan, determining what your investment objectives are, your financial capability and, most importantly, how much risk you are willing to take.

Whatever your age, risk profile and wider portfolio, it is inadvisable to put all of your money in the same asset class. So don't invest everything in the UK stock market or US government bonds. Diversification is one of the first principles of investing.

Did you know?

- You can decide how you want to split the £15,240 between the Cash and Stocks & Shares parts of an ISA
- Or you can allocate the whole £15,240 into either a Cash or Stocks & Shares ISA
- Previously, you could only put up to half the annual ISA allowance into a Cash ISA
- You can move your money from a Stocks & Shares ISA into a Cash NISA, or vice versa
- Previously, you couldn't move money from a Stocks & Shares ISA into a Cash ISA
- You pay no tax on the interest you earn in a Cash ISA
- With a Stocks & Shares ISA, you pay no capital gains tax on any profits and no tax on interest earned on bonds. The dividends paid on shares or funds do have the basic rate of 10% tax deducted. This means that higher- and additional-rate taxpayers don't have to pay their higher rate of tax on their dividend payments

Lower-risk options

For those who prefer a lower-risk option, there are various options you can take besides simply leaving all your money in cash.

You could find a fund that invests in fixed-interest securities, known as 'bonds'. These are less risky than shares but may perform better than cash, especially with today's current low interest rates.

If you want to take as much risk off the table as possible while still using your entire ISA allowance, it may make sense to leave the maximum amount in cash and invest the other funds in government or corporate bonds.

Although bond funds are low risk, it is still worth noting that the value of your investment may go down as well as up, and you may get back less than you put in. That said, the best bond funds have an excellent record at preserving investors' capital and have grown it significantly too.

Remain defensively positioned
If you are seeking a higher return on your investment but still want to remain defensively positioned, you could start looking at the stock market.

Accessing stocks and shares (or 'equities') through funds enables you to invest mainly in larger companies in developed markets, such as the UK, US and Western Europe, or a defensive global fund. 'Income' funds that invest in companies that pay dividends can be a good choice, because strong companies can maintain dividends even in bad times when their profits and share prices are falling.

Your main choice will be between actively managed and passively managed funds. Active funds are run by a fund manager who tries to beat the market by making better investing decisions than everyone else. Passive funds, which have lower fees and charges, try to match the performance of a well-established index, such as the FTSE 100.

If you go with an active fund, be sure to check the fund's reputation and performance, but bear in mind this is not necessarily a guide to the future. With a passive fund, the important things are that it tracks its index accurately and has low fees.

Pound cost averaging
We've all heard that stock markets can be volatile and that the value of investments can go down. But there can be a positive side to these market conditions by regularly saving into funds through a Stocks & Shares ISA, a benefiting from a concept known as 'pound cost averaging'.

Pound cost averaging is about regular saving. When investing, it's always best to buy at the cheapest point – when prices hit the bottom. Yet predicting that point is extremely difficult. As a result, many investors miss it and act when the market starts rising.

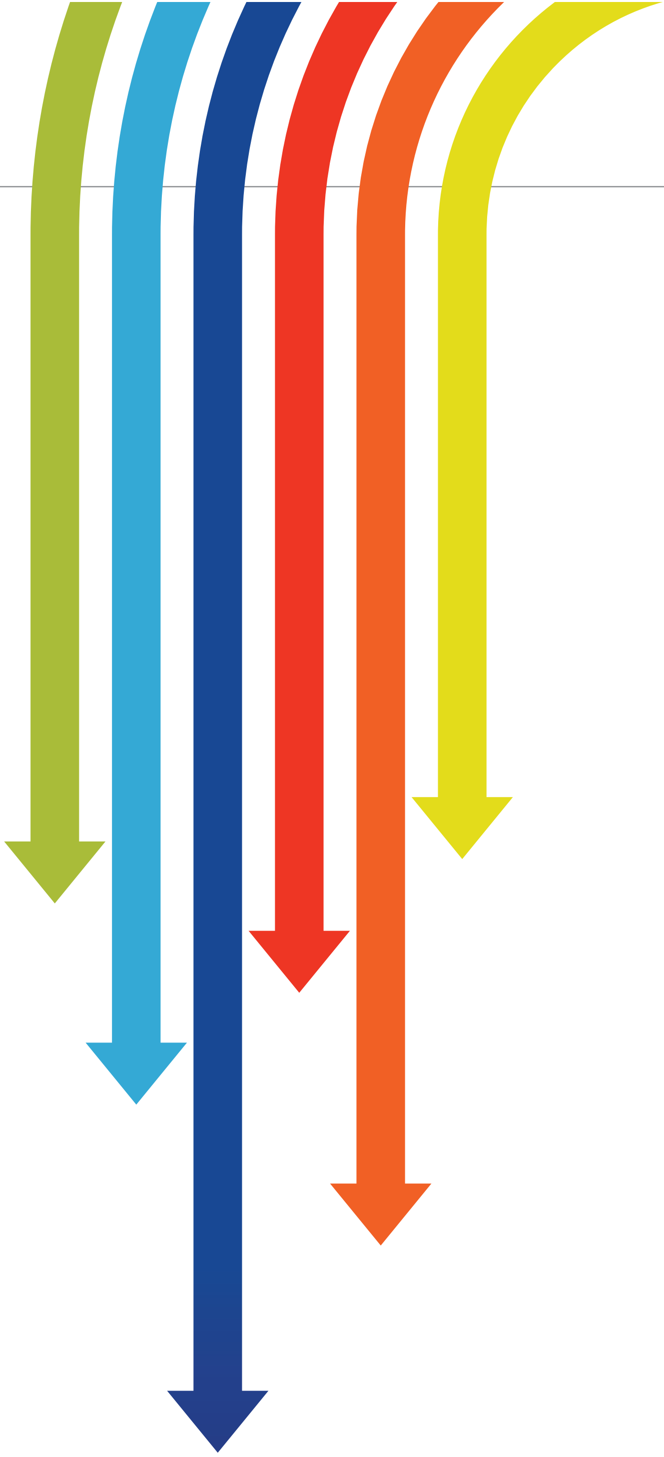
However, you can even out the ups and downs when you make regular payments into a Stocks & Shares ISA investment, instead of paying in a one-off sum. By investing regularly – throughout the year, let's say monthly – you spread the risk.

The money in your fund is used to buy units. If the unit price at that point is lower than the average price over a period of time, this can result in greater potential value. Remember though that, as with all forms of investing, nothing is guaranteed. You could gain less or lose more than if you had invested in one lump sum.

Potentially higher return
For those who are prepared to take more risk in order to get a potentially higher return, a move away from income-producing assets (such as bonds or the shares of big companies) towards capital growth may be worth considering. If you are willing to take an aggressive approach, it may be worth looking at small- to mid-cap companies and emerging market funds.

Bear in mind though that you may need to change your asset allocation over time. As retirement approaches, for instance, you might want to use your ISA as a source of additional income (remember, you do not have to pay tax on any income you take out of your ISA, but income from a pension is liable for tax). In your fifties and sixties, you may want to switch some of your investments from stocks and shares to bonds, for example.

Ultimately, while ISAs offer welcome tax-efficient incentives to savers, the rules of the market still apply. All the tax exemptions under the sun won't return your cash if you make some awful investment decisions. After all, it's just a wrapper – it's what you put in it that counts.



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OPEN-ENDED FUNDS

Professionally managed collective investment funds

Unit trusts and open-ended investment companies (OEICs) are professionally managed collective investment funds. Managers pool money from many investors and buy shares, bonds, property or cash assets and other investments. An open-ended fund could be visualised as a big pool of money – the money belongs to thousands of small investors.

The fund, or pool, is divided into units. Investors can buy or sell units at any time. As people buy units, the pool gets bigger; as they sell them, it gets smaller (this is what is meant by the term 'open-ended'). The unit price is calculated daily by working out the value of all holdings in the fund – cash, shares, bonds or whatever – and dividing it by the number of units.

A fund manager makes decisions about what to invest the money in, within the scope of the agreed investment mandate. The objective is to provide returns to the fund's investors, either in the form of capital growth (an increase in the price per unit) or income (dividends paid to the unit holders in proportion to the number of units they hold).

The point of investing in an open-ended fund is that you believe a fund manager can make better investment decisions than you can on your own.

There are two main kinds of open-ended funds available to investors in the UK:

- **Unit trusts** – their units are dual-priced and there is a (higher) buy price and a (lower) sell price. If you invest in these, it is important to realise that you are in effect being charged an additional fee by the fund manager: the difference between the buy price and the sell price (sometimes called the bid and offer price)
- **Open-ended investment companies (OEICs)** – these have a single unit price. Most unit trusts have now been converted to OEICs

In all other important respects, unit trusts and OEICs work in exactly the same way. In fact, the term 'unit trusts' is sometimes used loosely to refer to both unit trusts and OEICs.

Forward pricing
Another important feature of open-ended funds is forward pricing. This mechanism means that when you place an order to buy or sell units in a fund, you will not be sure exactly what the unit price is until the deal is done.

Say the fund is priced daily at 12 noon. If you place an order at 10am on Wednesday to buy or sell units, that order will be carried out after the fund is priced at noon on Wednesday, at the new price.

If you place an order on Wednesday at 4pm, you would have to wait until Thursday at 12 noon for that order to be executed, at Thursday's price.

The main purpose of forward pricing is to discourage short-term trading in open-ended funds, which could make life difficult for fund managers.

Investment return
Open-ended funds usually invest in shares (equities) or bonds. They may also invest in derivatives or keep money in cash, but this is mainly to help them manage their portfolios and is not usually expected to produce an investment return.

It is less common for open-ended funds to invest in physical property. This is because units can be bought or redeemed at any time. If a lot of people suddenly wanted to sell their units, it would be hard for the fund to sell properties quickly enough to pay them back.

The value of your investments can go down as well as up, and you may get back less than you invested.

Some assets are riskier than others. But higher risk also gives you the potential to earn higher returns. Before investing, make sure you understand what kind of assets the fund invests in and whether that's a good fit for your investment goals, financial situation and attitude to risk.

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BUILDING BLOCK OF MANY INVESTOR PORTFOLIOS

Investing in bonds, pooling your money with thousands of other small investors

Bonds are debt issued by either a government or a company and are an essential building block of many investors' portfolios. When you buy a bond, you are effectively extending a loan to the issuer of the bond.

The issuer agrees to pay you a set interest rate (the 'coupon') at a set number of times per year before returning your initial 'loan' in its entirety at the date set out at the issuance of the bond (the 'maturity date'). If the company (or country) defaults, you're not going to get that loan back.

Spread your risk
Most private investors in the UK do not buy individual bonds direct, but invest through bond funds. By investing in a bond fund, you are effectively pooling your money with thousands of other small investors. That money will be invested in a portfolio of perhaps 50 or 100 different bonds, enabling you to spread your risk. Even if one bond defaults and investors get nothing back whatsoever, the impact on the fund is relatively minor.

Having said that, the opportunities for UK investors to buy individual bonds are increasing following the introduction of the Order Book for Retail Bonds (ORB) by the London Stock Exchange. It's also worth noting that both individual bonds and bond funds can be included in a Stocks & Shares ISA.

Real value of money
People invest in bonds for a steady income and do not usually expect growth on their investment. Their capital tends to be fairly safe, although some bonds are safer than others. The less safe a bond is perceived to be, the higher the coupon: it has to compensate investors for the risk they are taking.

One of the risks of investing in bonds is that inflation will erode the real value of your money. This is the same risk you face if you leave your money in cash. As a result, the lower inflation falls, the more popular bonds tend to be with investors. If inflation turns negative (deflation), it can be a dream scenario for bond investors. They buy a bond for £1, and when they get their £1 back on maturity, it is worth more than it was before.

Denominated in currencies
A further risk of investing in bonds denominated in currencies other than sterling is currency risk. If you buy a Japanese bond and the value of the yen falls against the pound, you'll be sitting on a loss in sterling terms.

Bonds fall into two main types: government bonds and corporate bonds. Government bonds have colourful names depending on which government issued them. UK government bonds are gilts, US government bonds are treasuries and German bonds are bunds.

Regarded as safe
A government bond is seen as quite low risk, as it is unlikely that governments will go bankrupt. Admittedly, recent events in the Eurozone have made investors much more nervous about the bonds issued by certain debt-burdened countries. But bonds issued by the UK and US are still regarded as safe and hence have low coupons. After all, governments can always print more money to meet repayments (although this would probably lead to inflation, reducing the value of the bond in real terms).

The level of risk associated to a corporate bond depends entirely on the company issuing the bond. The greater the probability of a company not being

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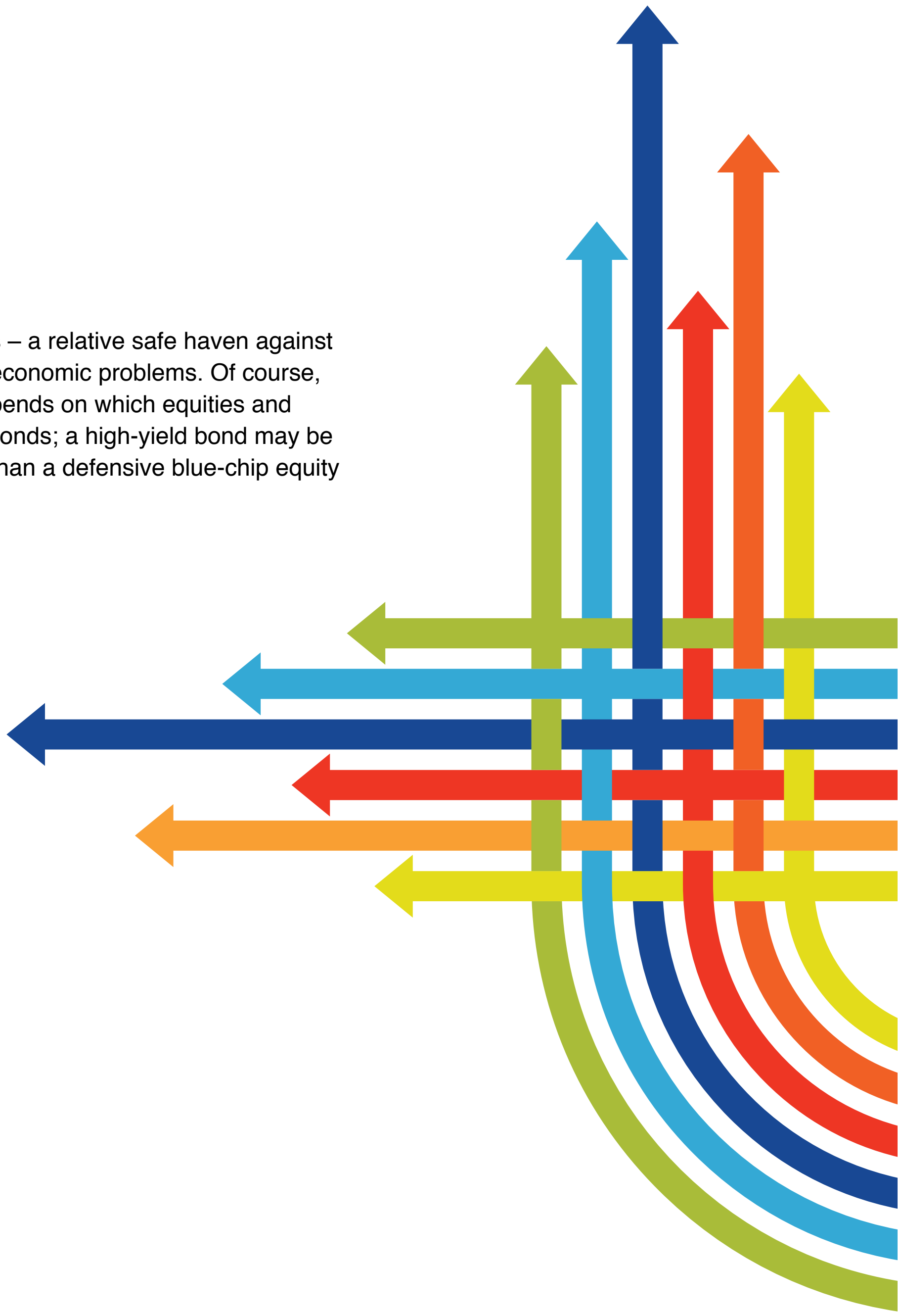


able to meet its repayments, the higher the coupon. Ratings agencies rate both government and corporate bonds for the benefit of investors; however, they can be wrong, as witnessed during the financial crisis of 2008.

Bond funds

- Gilt funds, which invest in UK government bonds
- Traditional corporate bond funds, which invest mainly in bonds that are issued by companies in the UK. They may also put a minority of their assets into gilts
- Global bond funds, which buy bonds from high-quality companies around the world
- High-yield funds, which invest in lower quality companies but will normally pay out more due to the higher risk
- Emerging market bond funds, which invest in the government debt of developing countries such as Brazil. (Emerging market corporate bond funds are very rare because companies in emerging markets are seen as too risky)
- Strategic bond funds, which have a wide remit and can buy anything from risky high-yield bonds to gilts. These may be more or less risky depending on the fund manager's strategy
- Bonds are still seen as lower risk than equities – a relative safe haven against global economic problems. Of course, this depends on which equities and which bonds; a high-yield bond may be riskier than a defensive blue-chip equity

ASSET ALLOCATION

Deciding how to weight your portfolio

Asset allocation is the bedrock of successful investing. The challenge for investors lies in deciding exactly how much to allocate to each asset class.

Assets classes

Once you understand your investment goals and risk tolerance, the challenge lies in deciding how to weight your portfolio. It should have exposure to the main assets classes: cash, bonds, equities (shares in companies) and property.

The idea is that those with a lower risk tolerance will overweight in assets offering more certain returns, like cash and bonds. And those less averse to risk, and with longer investment time horizons, might invest in more volatile assets, like shares, that have a higher potential return.

Picking funds

There are, for example, nearly 2,000 funds that can be held within a Stocks & Shares ISA, according to The Investment Association, and those not confident picking funds needn't fear. Trackers, which aim to match the performance of an index or asset class, offer a passive way of building a diversified portfolio with only a few funds.

However, the principles of diversification mean that this minimalist approach is risky. For example, within the shares asset class, you will want exposure to investments that focus on growth as well as dividends. And it is difficult to achieve this through just one fund. On the other hand, the ease with which we can buy funds now means that investors must be careful – avoid buying too many when structuring your portfolio, as they may overlap with each other.

Potential returns

The potential returns available from different kinds of investment, and the risks involved, can also change over time as a result of economic, political and regulatory developments, as well as a host of other factors.

Asset risk/return characteristics

When putting together a portfolio, the starting point is cash. The aim of employing the other asset classes is to achieve a better return than could be achieved by leaving all of the investment on deposit.

Cash

The most common types of cash investments are bank and building society savings accounts and money market funds (investment vehicles which invest in securities such as short-term bonds to enable institutions and larger personal investors to invest cash for the short term).

Money held in the bank is arguably more secure than any of the other asset classes, but it is also likely to provide the poorest return over the long term. Indeed, with inflation currently above the level of interest provided by many accounts, the real value of cash held on deposit is falling.

Your money could be eroded by the effects of inflation and tax. If your savings are taxed, that return will be reduced even further.

Bonds

Bonds are effectively IOUs issued by governments or companies. In return for your initial investment, the issuer pays a pre-agreed regular return (the 'coupon') for a fixed term, at the end of which it agrees to return your initial investment. Depending on the financial strength of the issuer, bonds can be very low or relatively high risk, and the level of interest paid varies accordingly, with

Asset allocation is the bedrock of successful investing. The challenge for investors lies in deciding exactly how much to allocate to each asset class.

higher-risk issuers needing to offer more attractive coupons to attract investment.

As long as the issuer is still solvent at the time the bond matures, investors get back the initial value of the bond. However, during the life of the bond, its price will fluctuate to take account of a number of factors, including:

- **Interest rates** – as cash is an alternative lower risk investment, the value of government bonds is particularly affected by changes in interest rates. Rising base rates will tend to lead to lower government bond prices, and vice versa
- **Inflation expectations** – the coupons paid by the majority of bonds do not change over time. Therefore, high inflation reduces the real value of future coupon payments, making bonds less attractive and driving their prices lower
- **Credit quality** – the ability of the issuer to pay regular coupons and redeem the bonds at maturity is a key consideration for bond investors. Higher risk bonds such as corporate bonds are susceptible to changes in the perceived credit worthiness of the issuer

Equities

Equities, or shares in companies, are regarded as riskier investments than bonds, but they also tend to produce superior returns over the long term. They are riskier because, in the event of a company getting into financial difficulty, bond holders rank ahead of equity holders when the remaining cash is distributed. However, their superior long-term returns come from the fact that, unlike a bond, which matures at the same price at which it was issued, share prices can rise dramatically as a company grows.

Returns from equities are made up of changes in the share price and, in some cases, dividends paid by the company to its investors. Share prices fluctuate constantly as a result of factors such as:

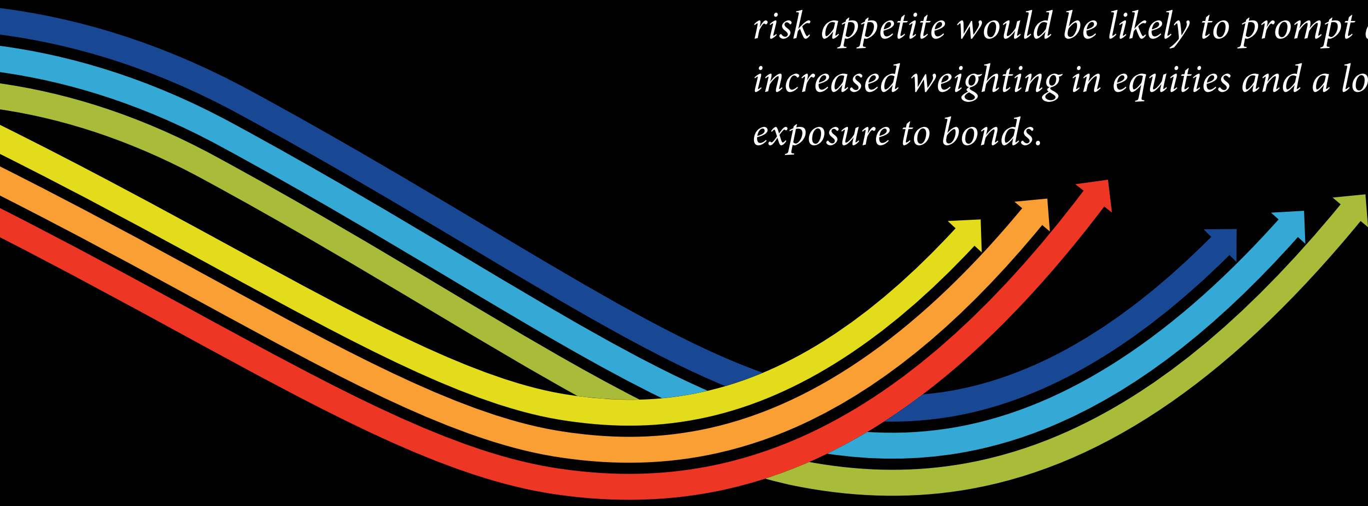
- **Company profits** – by buying shares, you are effectively investing in the future profitability of a company, so the operating outlook for the business is of paramount importance. Higher profits are likely to lead to a higher share price and/or increased dividends, whereas sustained losses could place the dividend or even the long-term viability of the business in jeopardy
- **Economic background** – companies perform best in an environment of healthy economic growth, modest inflation and low interest rates. A poor outlook for growth could suggest waning demand for the company's products or services. High inflation could impact companies in the form of increased input prices, although in some cases, companies may be able to pass this on to consumers. Rising interest rates could put strain on companies that have borrowed heavily to grow the business
- **Investor sentiment** – as higher risk assets, equities are susceptible to changes in investor sentiment. Deterioration in risk appetite normally sees share prices fall, while a turn to positive sentiment can see equity markets rise sharply

Property

In investment terms, property normally means commercial real estate – offices, warehouses, retail units and the like. Unlike the assets we have mentioned so far, properties are unique – only one fund can own a particular office building or shop.

The performance of these assets can sometimes be dominated by changes

As a rule, an environment of positive or recovering economic growth and healthy risk appetite would be likely to prompt an increased weighting in equities and a lower exposure to bonds.



in capital values. These unusually dramatic moves in capital value illustrate another of property's key characteristics, namely its relative illiquidity compared to equities or bonds. Buying equities or bonds is normally a relatively quick and inexpensive process, but property investing involves considerable valuation and legal involvement.

As such, the process is longer and dealing costs are higher. When there is a wholesale trend towards selling property, as was the case in 2007, prices can fall significantly. Conversely, when there are more buyers than sellers, as happened in 2009, price rises can be swift.

The more normal state of affairs is for rental income to be the main driver of commercial property returns. Owners of property can enhance the income potential and capital value of their assets by undertaking refurbishment work or other improvements. Indeed, without such work, property can quickly become uncompetitive and run down.

When managed properly, the relatively stable nature of property's income return is key to its appeal for investors.

Mix of assets

In order to maximise the performance potential of a diversified portfolio, managers actively change the mix of assets they hold to reflect the prevailing market conditions. These changes can be made at a number of levels including the overall asset mix, the target markets within each asset class and the risk profile of underlying funds within markets.

As a rule, an environment of positive or recovering economic growth and healthy risk appetite would be likely to prompt an increased weighting in equities and a lower exposure to bonds. Within these baskets of assets, the manager might also move into more aggressive portfolios when markets are doing well and more cautious ones when conditions are more difficult. Geographical factors such as local economic growth, interest rates and the political background will also affect the weighting between markets within equities and bonds.

Underlying portfolios

In the underlying portfolios, managers will normally adopt a more defensive positioning when risk appetite is low. For example, in equities, they might have higher weightings in large companies operating in parts of the market that are less reliant on robust economic growth. Conversely, when risk appetite is abundant, underlying portfolios will tend to raise their exposure to more economically sensitive parts of the market and to smaller companies.

Some investors choose to build their own portfolios, either by buying shares, bonds and other assets directly or by combining funds investing in each area. However, this is a very time-consuming approach, and it can be difficult to keep abreast of developments in the markets, whilst also researching all the funds on offer. For this reason, most investors prefer to place their portfolio into the hands of professional managers and to entrust the selection of those managers to a professional financial adviser.

INVESTING FOR INCOME

Alternatives for income-seekers during a period of low interest rates

One of the tools available to the Bank of England to stimulate the economy is interest rates. Lower interest rates mean that it is cheaper to borrow money and people have more to spend, hopefully stimulating the economy and reducing the risk of deflation.

This is why the Bank of England has aggressively cut them. With interest rates at their lowest levels in history, those relying on the interest from bank or building society accounts to supplement their income potentially face a problem. Indeed, once tax and inflation are taken into account, for many, their capital on deposit is at risk of losing money in real terms.

If you are an income seeker, much will come down to your attitude to risk. If you want no or very low risk, you may wish to consider a traditional cash bank account and accept that income levels are likely to remain low for the foreseeable future. However, if you're further up the risk scale, you may wish to consider some of these alternatives.

Gilts

If you're willing to take on a slightly higher degree of risk and you need the extra income, you may wish to consider gilts (or gilt-edged stocks), which are bonds issued by the Government and pay a fixed rate of interest twice a year. Gilts involve more risk than cash, because there's a chance the Government won't be able to pay you back. It's highly unusual for a government to default on a debt or on the interest payments, so they have been considered safe. But in this current economic climate, this risk increases.

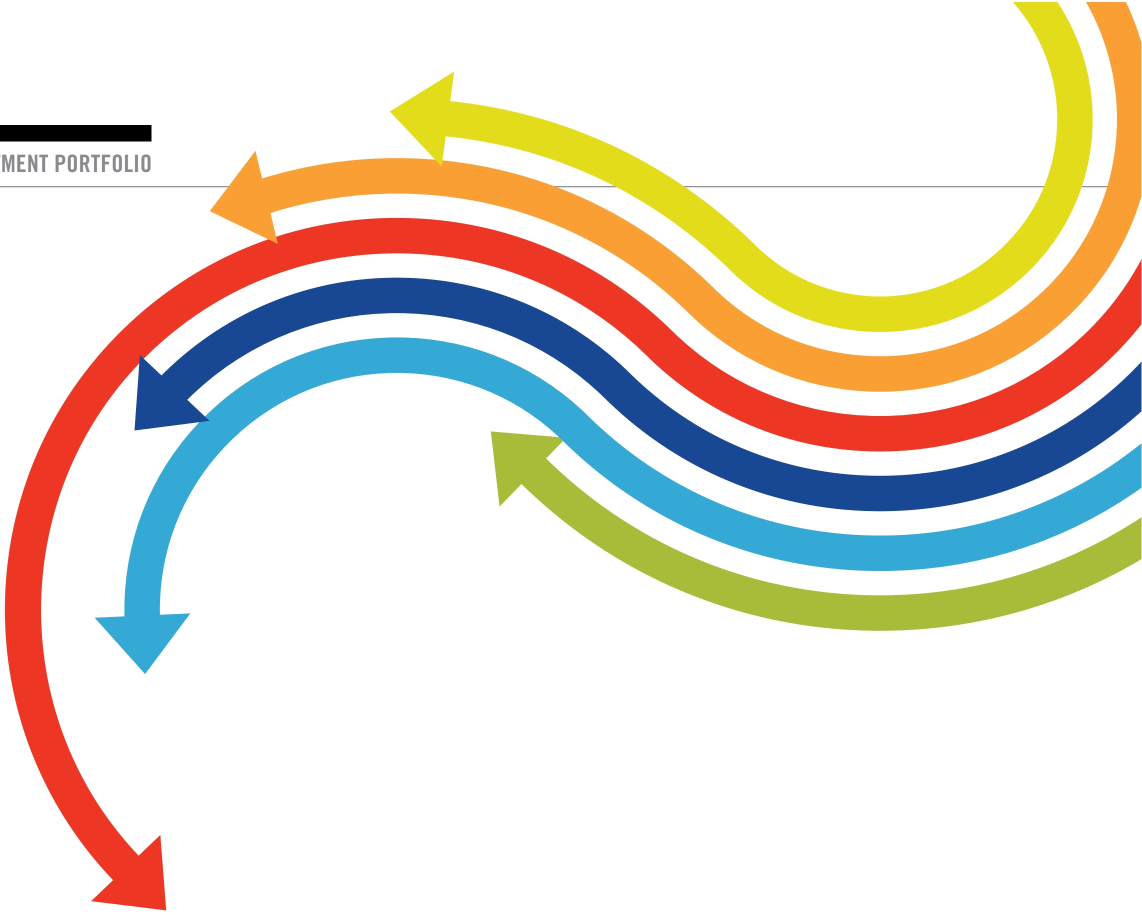
You are not guaranteed to get all your capital back under all circumstances. Not all gilts are bought from the Government and held to maturity: some are bought and sold along the way, so there's a chance for their value, and the value of gilt funds, to rise and fall. There are other types, such as index-linked gilts, which form the largest part of the gilt portfolio after conventional gilts. Here, the coupon is related to movements in the Retail Prices Index (RPI) and is linked to inflation.

Corporate bonds

Next along the risk scale if you are looking for a higher yield are corporate bonds. These are issued by companies and have features that are exactly the same as gilts, except that, instead of lending money to the Government, you're lending to a company. The risk lies in the fact that companies may go bust and the debt may not be repaid. They have a nominal value (usually £100), which is the amount that will be returned to the investor on a stated future date (the 'redemption date'). They also pay a stated interest rate each year, usually fixed. The value of the bonds themselves can rise and fall; however, the fact that bonds are riskier at the moment means companies are paying more in order to induce people to buy their debt. There are an increasing number of global bond funds entering the market that may enable you to get value from a lot of different markets.

Equity income

If your primary objective is the preservation of income, you may not consider the stock market as the obvious place for your money. However, for investors who are prepared to see their investments fluctuate in value while hopefully providing a stable income that grows over time, you may wish to consider equity income funds. These invest in shares, focusing on the big blue-chip firms that have a track



record of good dividend payments. The dividends will be your income.

Global equity income funds
Further up the risk scale are global equity income funds. These are similar to UK funds, except that there are only a handful of the big blue-chip firms that pay reliable dividends in the UK, whereas global diversification offers a significant range of companies to choose from. Investing in other currencies brings an added level of risk, unless the fund hedges the currency.

Equity income investment trusts
Equity income investment trusts are higher risk but similar to other equity income investments. They are structured differently from unit trusts and open-ended investment companies. Investment trusts are closed-ended. They are structured as companies with a limited number of shares. The share price of the fund moves up and down depending on the level of demand, so the price of the trust depends not only on the value of the underlying investments but also on the popularity of the trust itself. In difficult times, when investors are selling up, trusts are likely to see their share price fall more than the value of their underlying investments. This means they also have more potential for greater returns once better times resume. Investment trust share prices are therefore often at a 'discount' or 'premium' to the value of the assets in the fund.

If your primary objective is the preservation of income, you may not consider the stock market as the obvious place for your money.

REGULAR PORTFOLIO REVIEWS

Considering the suitability of your investments

It is important to carry out regular portfolio reviews to consider the suitability of your investments and to make sure that any changes in your attitude to risk are accurately reflected. Over time, your attitude to risk is likely to change. If you are approaching retirement, for example, you may want to preserve capital or generate an income, while if you are investing for growth, you may need to take on more risk to potentially boost returns.

There are two key questions that you should ask yourself: firstly, 'How much capital can you afford to lose?', and then, 'How long is your investment horizon?' The general rule is that the more risk you are prepared to take, the greater your potential returns could be. At the same time, however, it is important to realise that there is a greater potential for loss.

Reviewing the amount of risk

As these two factors can change over time, it is crucial that you are able to adjust your portfolio to reflect them. Please remember that the value of your investments and the income received from them may go down as well as up, and you may not get back the full amount invested.

As well as regularly reviewing the amount of risk taken in your portfolio, it is also important to make sure your portfolio remains as diversified as it can be and that it reflects any changes in your investment objectives. The key to building a diversified portfolio is to take a balanced approach. This means combining a range of investments that can help you meet your investment goals within an appropriate level of risk.

Exposure to different markets

Income-seeking stock market investors may want to diversify away from their home UK market to take advantage of dividend opportunities globally. Meanwhile, in fixed income, the current low yield environment means that investors may need to look across a wider range of global bond sectors and markets to maintain attractive future returns. Either way, you need to make sure you have the right levels of exposure to different markets for the outcomes you're looking for. However, please note that diversification does not guarantee investment returns and does not eliminate the risk of loss.

Investing outside of the UK can involve a higher degree of risk and also involves a degree of exchange rate risk. If you are in any doubt about the suitability of an investment or understanding your risk appetite, please seek professional financial advice.

IS IT TIME TO REVIEW YOUR INVESTMENT PORTFOLIO?

Creating and maintaining the right investment portfolio plays a vital role in securing your financial future. Whether you are looking to invest for income or growth, we can provide the quality advice, comprehensive investment solutions and ongoing service to help you achieve your financial goals. Please contact us to discuss your requirements – we look forward to hearing from you.

Goldmine Media, Basepoint Innovation Centre, 110 Butterfield, Great Marlings, Luton, Bedfordshire LU2 8DL

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